Original Article

What did Margaret Thatcher do for the UK economy?

Patrick Minford
Cardiff Business School, Colum Drive, Cardiff CF10 3EU

Abstract The Thatcher reforms brought inflation under control and raised growth and living standards, by injecting competition into most areas of the economy. The recent banking crisis is not attributable to Big Bang but rather to the 1997 Labour government's removal of supervisory powers from the Bank of England. The fact that most large continental economies have failed to achieve supply-side reform puts the Thatcher achievement in stark perspective
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Introduction

In this article I provide an outline of Margaret Thatcher's economic legacy. I first met her in opposition to discuss future Conservative economic policy together with Sir Keith Joseph and her main economic allies Sir Geoffrey Howe and Nigel Lawson. As she wanted to test her ideas against a wide range of opinion and not simply rely on her civil servants, she liked to have outside advisers, mostly academics like me; and so I was fortunate to be able to help her with advice on and off during the rest of her political life, both at No. 10 and after. Margaret Thatcher had an impact on many areas of British life; she was a social revolutionary, a cultural icon, Falklands and cold war warrior and much else. But for reasons of space and my own competence I focus here solely on her impact on the UK economy.

The British Economy in the 1970s and the New Economic Thinking

In the 1970s Britain's economy was in serious trouble. Growth slowed because of industrial inefficiency, due to outdated technology and over-manning. Unemployment was rising as these same industries lost market share at home and abroad. To

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generate more growth and employment first the Heath and then the Labour governments resorted to fiscal and monetary stimulus, which only produced high inflation; this even reached 25 per cent in 1975 and was pushing up again towards 20 per cent at the end of the decade.

As a member of the Heath government Mrs Thatcher watched in helpless frustration as the policies failed. She and Sir Keith Joseph decided in opposition to fight for new ones. But as Prime Minister she faced overwhelming odds against the success of what in the end turned out to be the greatest economic reform programme of British history.

It is hard now to recreate the thinking of that time among those who shaped British economic policy. To them policy consisted of using stimulative demand policies to obtain growth while deploying wage and price controls to contain inflation. It never occurred to them that what the economy produces is because of what resources it has and how well it uses them, namely the ‘supply side’ forces we now all accept are the key factors; nor that wage and price controls would cut to the heart of our economic freedoms, while inevitably failing to stop inflation.

Before we consider how the Thatcher policies evolved, it is important to recreate this thinking in more detail. The prevalent macroeconomic model of the time was one in which inflation expectations were backward-looking and ‘adaptive’ at a slow rate to actual inflation developments; some argued that they were even immune to economic forces altogether, being set by the ‘sociological’ forces of union wage demands. With inflation therefore at best reacting modestly to monetary and fiscal policies to contain or reduce it, policymakers argued that such policies, if turned against inflation, would only increase unemployment. Unemployment was rising in the late 1970s and by 1979 had reached 7 per cent; this was argued to show that there were indeed unemployed resources, so that expansionary fiscal and monetary policy would generate growth. Since it was also desirable to bring down inflation, policies to mollify union demands and to curb wage and price setting by law were seen as the only means to do so.

These ideas are by no means all dead today; with inflation low and wage demands weak, some economists have argued for expansionary fiscal policy as well as unconventional monetary policy in the form of massive printing of money, given that interest rates have fallen close to zero, to stimulate the main Western economies. However, the ideas have mutated after the experience of the last three decades since 1979. No longer is there any support for wage and price controls, nor is inflation considered to be immune to monetary and fiscal policy. The debate today centres, rather, on exactly what the supply limits might be on the economy and whether demand stimulation can be effective, given solvency limits on governments.

That shift in the debate began with the ideas about policy that Mrs Thatcher put into action, ideas largely shared across the Atlantic by Paul Volcker at the Fed and later President Reagan in the White House. These ideas sprang from what we can call the ‘classical model’ revival. In this model (that is, set of assumed relationships) the

economy was driven by its capacity to produce, with fluctuations in this and in demand creating temporary movements around 'full employment output'. Apart from natural resources the main driver of capacity was productivity, derived from entrepreneurship, innovation and competition. Capacity in turn dictated the level of unemployment; if workers were willing to offer their labour at rates that produced competitive output, employment and capacity would grow, and unemployment would settle at a low rate. But institutions such as weak union laws and an over-generous welfare system, which encouraged strikes and unrealistic wage demands, would undermine employment and create an enduringly high rate of unemployment. The role of prices was to equate monetary demand, driven by fiscal and monetary policies, with capacity; this it would do flexibly and rapidly, with expectations of inflation quickly catching up with market realities – in one version, expectations were 'rational', that is, fashioned directly by these realities.

In this model, inflation therefore was caused directly by government policies, while government's supply side policies, impacting on the institutions of the labour and product markets, would set the prospects for long-term capacity growth and for unemployment. Any government demand stimulus would have little impact on output and at best only temporarily, but a quick and permanent impact on inflation.

These ideas were being rehearsed in the United Kingdom against a background of inflation rising towards 20 per cent in 1980, and unemployment rising towards double-digit percentages. The situation in other Western countries was a bit better but not in essence much different. What emboldened the new generation of politicians in the 1980s, of whom Mrs Thatcher was the first and the boldest, was the obvious failure of the old policies. Thus there was a willingness to think in terms of the classical model and to try the policies it suggested.

The Battle against Inflation

The first Thatcher government's task was to bring inflation under control. Its 'monetarism' simply asserted the classical precept that government monetary stimulus, abetted by large government deficits, must push people's demands ahead of the economy's supplies, so creating inflation. Therefore, inflation must be cured by restraining such government excess. Initially this restraint was bound to cause recession; this in turn brought out fierce opposition to the policy even in Mrs Thatcher's own Cabinet. 'U-turn' and compromise were suggested to her; she refused because she knew that the electoral cycle is short and to ease up would have left inflation endemic, with the policy seen as a failure and a return to the 1970s regime.

She battled on; money remained tight and the budget was tightened sharply. By the end of 1982 inflation had also dropped sharply and interest rates were no longer in the stratosphere. The biggest political fight was over the 1981 Budget. This cut the budget deficit at what seemed to be the deepest point of the recession. The knives

were out and 364 economists famously joined in the attack on her. I had already been quite heavily involved in the policy debate, and had quite close contacts with the Treasury team of Geoffrey Howe as well as with No. 10. My view was that budgetary toughness was vital to creating confidence in sustained monetary tightness: a large deficit is most cheaply financed by printing money. This was also the view of my mentor and PhD supervisor, Alan Walters, who was her personal economic adviser and had pushed for the toughest possible budget. I defended the Thatcher policies against my fellow economists vigorously in a *Times* article; typically she wrote me a nice personal letter of thanks. Later a joke went the rounds after Michael Foot asked her in Commons questions to 'name two professors of economics' who agreed with her policies. She named Alan Walters and me; but in the car back to No. 10 remarked 'thank goodness he did not ask for three!' It was astonishing to me how slowly macroeconomic thinking changed in UK academia even subsequently.

The Supply-Side Programme

Fortunately, attempts to get rid of her and reverse the policies failed; the economy recovered well from around that time and by 1983 it was growing robustly. However, all was not as well as most monetarists had hoped. With all the cuts to subsidies and the removal of the other props to our sagging industries, unemployment soared in spite of the recovery.

The defeat of inflation revealed to view the underlying ailment of deep inefficiency. Mrs Thatcher now turned to reform of the 'supply side'. As we all know, she tackled problem after problem, the solution of each uncovering yet more deep-seated ones behind.

Many think that at the start there was some great plan to do all these things; there never was, because the full extent was not known until the changes started to be made. The policies came out in an order largely dictated by events and political timing: the abolition of exchange controls, privatisation, union laws, competition (especially the City 'Big Bang'), reform of the benefit system, council house sales, rented market liberalisation, local government tax overhaul, the list goes on and few areas of British life went untouched. As we know, one has never finished with the supply side, because modern government has spawned a mass of distortions in its attempts to meet the demands of 'social justice'. Today the coalition government is trying to reform education and to embed the internal market in health care that Mrs Thatcher began. But as growth falters it realises how much else it needs to sort out – bank regulation, tax, the list goes on.

The results of the Thatcher reforms for the economy can be seen in the figures. The economic growth rate more than doubled; as the service sector boomed, unemployment came down to around 3 per cent and under a million benefit claimants (5 per cent or so on another newer measure, both measures consistent with 'full

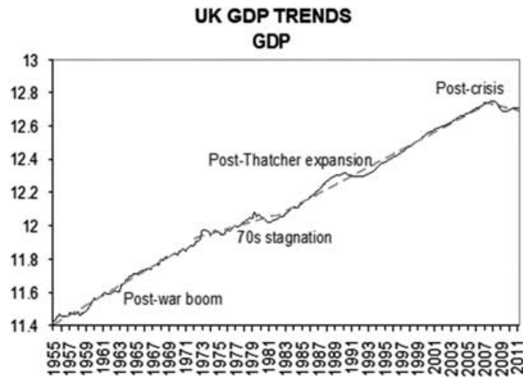

Figure 1: UK GDP; the left hand scale is the natural logarithm of real GDP, so that the slope shows the growth rate.

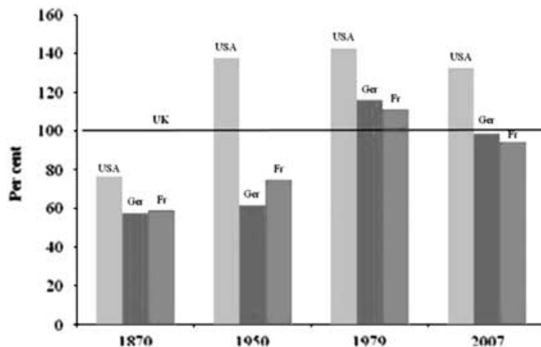

Figure 2: USA, Germany and France GDP per capita (measured in purchasing power terms) expressed as per cent of United Kingdom.
Source: LSE Growth Commission (2013).

employment'). A scholarly review of the microeconomic evidence of the effects on productivity can be found in Crafts (2011); as far as macroeconomic estimates are concerned, these are clearly dependent on an agreed model of the economy but both my work (Minford, 1998, Chapter 5) and that of Layard *et al* (1991) with rather different models, agree that equilibrium unemployment was brought down strikingly by the policies. On a crude reading of GDP trends one can see quite clearly in the data how after 1979 the UK growth rate climbed (Figure 1). UK per capita GDP has overtaken that of France and Germany substantially, having greatly fallen behind by 1979 (Figure 2); factoring in the recent crisis, which hit the United Kingdom harder than others, has not altered this.

Inflation has now been low for two decades; after a turbulent 1980s when different views of how to conduct monetary policy divided the Conservative government, the policy settled down to a regime of inflation targeting, which has at least been highly successful in keeping inflation down, even if there are aspects that the crisis has revealed need attention (see below). It is a transformation from the 1970s and their hallmark 'winter of discontent'.

Reform on this scale means massive change, and such change is bound to be unpopular. But most of the reforms were accompanied by measures that were aimed at compensating those harshly affected.

Problems of the Regions and the UK's Changing Industrial Structure

In Wales as well as many other regions hit by the decline of old industries, such as coal, steel and traditional manufacturing, Mrs Thatcher sanctioned large inward transfers, in addition to the generous Barnett formula for government spending. These transfers were designed to help develop new industries; initially inward investment in large manufacturing plants was chased up but increasingly these have been replaced with competitive manufacturing and service activities, especially business services and finance.

Margaret Thatcher is seen by some, especially in harder-hit regions, as the promoter of the 'get-rich-quick', 'me-first' society. But she herself was a non-conformist and saw the creation of business riches as a means to endow the Good Samaritan. Britain in the 1970s could not produce riches; Britain today does (even though we have had the banking crisis), and inevitably not every rich person who results behaves admirably.

But would Wales and other regions rather be stuck with industries that had little or no future? I think the honest answer, even from those who affect to hate Mrs Thatcher, is a resounding No. The truth is she saved the country from economic disaster and turned Britain once more into an engine of economic progress. Even if the first generation affected by industrial decline suffered, I believe they mostly have had the sense to see that new industries will give their children and grandchildren a future.

Did Thatcher Cause Rising Inequality and a Crumbling Infrastructure?

A related set of complaints concerns rising inequality and a supposed lack of infrastructure investment. The implication in both cases is that the Thatcher government neglected to provide adequately for public goods, whether in the classic physical shape of infrastructure or in the more subtle shape of 'social infrastructure' via income redistribution in cash or kind.

It has become a cliché of modern economic commentary that infrastructure is 'crumbling', as if this is a terrible denunciation of economic policy; indeed the cliché is as widespread in the United States and continental Europe as it is in the United Kingdom. Yet a moment's reflection tells us that such things as roads and railways need to be analysed carefully for costs and benefits. Take the current example of HS2; this appears to have been pushed as a political commitment to infrastructure, even though now it has emerged that the cost-benefit ratio is around unity – in other words it brings no gains – whereas the usual convention is that measured benefits needs to exceed costs by a good margin to offset the general uncertainty surrounding such schemes. Modern growth evidence such as it is by no means supports the view that infrastructure projects create growth of and by themselves. The LSE Growth Commission (LSE, 2013) pushes the case for more infrastructure investment, and has a point, as the coalition government has seemed paralysed by indecision over such things as Heathrow airport. But there is really no evidence that the Thatcher governments held back growth by failing to invest in it. Instead, it appears to have succeeded in achieving growth while containing demands on the public purse from unnecessarily expensive schemes (such as the endless demand for East Coast rail electrification) – 'grands projets' as the French term them.

As for inequality, this has grown worldwide for a long time. The reasons are widely accepted to be a combination of, in the first place 'globalisation' whereby fast-growing emerging-market countries, such as China, Brazil and India expand their exports and increase competition, driving down Western wages in the competing industries; and in the second place technological advance (largely related to computers) that has substituted for existing workers' skills, whether in manufacturing or in service industries. I found that the rise in wage inequality during the 1970s and 1980s was roughly half down to each of these factors (Minford, 1998, Chapter 7). More recently, the trends have apparently continued with as much force.

Governments all over the Western world are finding that it is almost impossible to offset these trends entirely through generous social policy and income redistribution. The problem lies in the cost to taxpayers combined with the disincentive effects of generous benefits in or out of work. The Thatcher government, contrary to much popular assumption, was generous in its dispensation of benefits. Rather than cut unemployment benefits it chose in the 1986 Restart programme to enforce re-entry into the labour market, and it expanded the in-work benefits available for low-paid workers. It also, unwisely, turned a blind eye to spiralling disability benefits. Thus if it had a fault it was in laxity. The coalition government has similarly found that there has to be a limit on benefit generosity and is enacting wide-ranging reform to enhance incentives and increase work participation.

One is left at this point with a trade-off: Will Western countries opt out of growing world trade and technological innovation to protect current generations of workers from rising inequality? Surely not, even if there will be disquiet among

these voters. The point is that again, as with industrial restructuring, voters will accept it for the sake of progress for their descendants, even if they are squeezed in the process.

What about the Banking Sector, Regulation and Big Bang?

The deregulation of the financial sector has latterly spawned the argument advanced by Ken Livingstone, Will Hutton and other left-wing sophisticates, that the seeds of the UK's banking crisis were sown by the Thatcher Big Bang of 1986, under which the City agreed to abandon its rate-setting practices rather than face the Monopolies Commission. Big Bang meant that there was a huge influx of foreign capital into the City and that it became the world's biggest financial centre; the combination of open competition, common law courts and Bank of England supervision within a largely self-regulating system were the prime attractions. Over the succeeding two decades international finance became more and more 'complete', in economists' approving language – meaning that you could pretty much insure any contingency through the intricate operations of these markets. And without them, with instead the old regulated financial world before it, we would not have had a banking crisis. Ergo Mrs. Thatcher is guilty of the crisis!

Let us leave on one side the international parts of the crisis that plainly she could not have caused – such as the US sub-prime loans and products, US monetary ease in the early 2000s and the 25-year world boom from 1982 that caused world commodity prices to spike from 2006. The question then is whether the City's deregulated rise necessarily contributed to the UK's own crisis. Clearly it brought many benefits to the UK economy, directly through its net revenues (now 10 per cent of GDP) and indirectly through the enabling provision of credit to businesses and households. But if the crisis is on the other side of the balance sheet, that would be a big negative.

The argument crucially ignores the 1997 decision by Gordon Brown to make the Bank of England independent on monetary policy and simultaneously to strip it of its supervisory role, giving it to the Financial Services Authority (FSA) and leaving the Treasury in 'overall' charge under the 'Tripartite' set-up. This was a disastrous decision for the effectiveness of supervision. The FSA (let alone the Treasury) did not have the information the Bank had, and which was needed to do the job. The Bank publicly wrung its hands with its Stability Reports and was ignored in the run-up to the crisis. When the crisis hit, it felt unable to pull traditional levers.

I am confident Margaret Thatcher would never have gone down this road. Nor in fact did John Major or Norman Lamont who instituted the inflation target in 1992, with open cooperation between Bank and Treasury in setting interest rates but stopping short of 'independence' – which we know is anyway a pretence since

the taxpayer stands behind the Bank as guarantor. Today that pretence has been totally stripped away. Thatcher understood that the commitment to low inflation had to come from the political process: government had to be fiscally and monetarily disciplined because this was what the people would vote for when properly presented. This was very much the approach of British monetarists as well.

Practically too she trusted the Bank to supervise other banks and the City because that was its job and inbuilt advantage; naturally cautious, she would never have tampered with this role, with its long history of success. But she did not trust the Bank much over policy because she felt it was too much in the pockets of banks and their customers: in 1980 the Bank, full of Keynesians, strongly opposed her tight money policies, as it worried about the banks' bad loans to manufacturing. Making the Bank independent she would have seen as a usurpation of key political clout by jejune technocrats.

Today that judgement seems right. Had Gordon Brown left the system as it was in 1997 the Bank would have blown the whistle on the banks' excessive risk-taking in a time-honoured raising of Governor Eddie George's eyebrows and we would have had a better crisis. I would add that, since the crisis the reaction of the British establishment has also been misguided in several ways that Mrs Thatcher would not have agreed with. First, heavy-handed regulation of the banks has and will continue to block the credit channel, especially to small businesses and households (for whom credit had dried up until recent direct government interventions like Help to Buy to some extent unfroze the mortgage market). It would be better to move back to the more informal checks previously applied by the Bank within a self-regulating system; and at the same time make monetary policy responsive not just to inflation but also to money and credit growth, as was originally suggested in the Thatcher Medium Term Financial Strategy of the early 1980s. Such responsiveness would head off the sort of credit boom that seriously worsened the later banking crisis. As it was, inflation was so firmly anchored by the new inflation target system that it did not move enough to produce the necessary tightening in the face of the credit boom.

Second, the programme of Quantitative Easing (QE) that has massively raised bank reserves has only failed to cause an explosion of money and credit today because the same regulative excess has nullified its effect. Mrs Thatcher would have been horrified by the risks of such a policy. With a return to self-regulation by internal bank prudence, QE could be rapidly dismantled and the risk eliminated.

Unfortunately the crisis has ushered back into positions of prominence the very enemies of the free market that Mrs Thatcher managed to sideline through her reforms. These people are fond of controls, regulations and large-scale state interventions that keep them permanently in the public eye. Somehow we have to get rid of their baleful influence again but without her help.

In sum the Thatcher record of reform stands up well. For today's policymakers faced with the never-ending need to attend to the supply side the lessons are that good economic ideas are hard to translate into reality without good politics – the latter being essentially the art of making sure that any policies embarked on have sufficient support to ensure their survival. The City Big Bang was an important component of the UK economy's resurgence and she got it right.

Mrs Thatcher the Person and Political Leader

'Mrs T', as inevitably I shall always think of her, swung her handbag thoroughly in a policy world largely dominated by well-bred men who wanted to patronise her. I first met her in 1978 when she was preparing her economic policies and at once admired her intuitive grasp of the economy; she was certainly no technical economist but what struck me then and later was how determined she was to make sure she had understood totally and in her own mental terms the risks she was running with any reform she undertook. She staggered me much later in a Chequers seminar on unemployment, when she attacked my suggestion that unemployment benefits should be curbed by quoting the research of a fellow-economist; bloodied but defiant I found myself explaining to her as our voices rose that the economist in question had changed his mind. Later in the evening as I set off back on the 4 hour drive to Liverpool she insisted first on personally cooking me an omelette!

It was this hands-on quality, as well as the devotion she inspired in people through her own obvious commitment, that holds the secret to her unique success as a politician in implementing the rebuilding of the UK economy from the ruins of the 1970s. When we look around Europe today and see how many economies have failed to reform themselves in a similar way, and with what dismal results for growth and living standards, we can hardly fail to wonder at the UK miracle of Mrs Thatcher.

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