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## Productivity Growth and Unemployment Under Mrs. Thatcher Reconsidered

*Nigel F.B. Allington\* and John S.L. McCombie\*\**

### *Introduction<sup>1</sup>*

Mrs. Thatcher's controversial premiership in the UK ran from 1979 to 1990. It witnessed the end of the post-war Keynesian macroeconomic consensus and the introduction of monetarist policies targeting inflation by attempting to control the growth of the money supply. The commitment to the maintenance of high and stable employment was abandoned and labour markets were deregulated in an attempt to improve Britain's poor economic performance since the Second World War.

This article focuses on Mrs. Thatcher's supply-side policies by considering the labour market and unemployment. Specifically, it considers whether or not her policies facilitated a productivity 'miracle' and the eventual attainment of a low unemployment rate. And whereas the OECD (1996 and 1999) argued that the Thatcher labour market reforms in the UK increased labour market flexibility, more recently (2007) it claimed that wage flexibility is no longer the *sine qua non* of efficient labour markets. A re-examination of these issues will also have a bearing on the present debate over continental Europe's current lackluster economic performance (Blanchard 2005). So, what are the implications of the Thatcher 'experiment' for present day continental Europe?

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*Productivity Growth in UK Manufacturing*

Given the importance of manufacturing to economic performance during this period and the fact that it accounted for 80 per cent of the UK's exports, we confine our attention to this sector<sup>2</sup>. Although manufacturing output per worker increased at three per cent per annum from 1950 to 1973, this was low compared with the other advanced countries: France, Germany and Italy all had rates of about five per cent. Whereas government policies designed to raise the UK rate in the 1960s and 1970s largely failed, Thatcher attempted to increase the efficiency of British industry and raise productivity by reducing the power of the trade unions and over-manning.

Table 1 reports manufacturing productivity growth from 1956 to 1992, with 1971 – 1992 using the Percentage Utilisation of Labour index, which, as its name suggests, is the labour input adjusted for changes in work intensity. Although productivity growth over the Thatcher Government was rapid (four per cent annually), it was no better than that under the Wilson or Heath Governments.

*Table 1: UK Manufacturing Productivity Growth (% per Annum) and Political Party in Power, 1956–1992*

Administration		Productivity Growth
Conservative:	<i>(Macmillan and Home)</i> August 1956 – September 1964	3.7 <sup>1</sup>
Labour:	<i>(Wilson)</i> October 1964 – January 1970	4.6 <sup>1</sup>
Conservative:	<i>(Heath)</i> March 1971 – February 1974	5.7
Labour:	<i>(Wilson and Callaghan)</i> February 1974 – May 1979	1.7
Conservative:	<i>(Thatcher and Major)</i> May 1979 – September 1992	4.3
	May 1979 – April 1986	2.9
	April 1986 – September 1992	5.7
	May 1988 – March 1991	7.5

<sup>1</sup> Indicates output per operative hour (PUL index used from March 1971).

Note: Periods do not always exactly coincide with administration dates.

Source: *Smith-Gavine/Bennett (1977: table 2)*.

This is confirmed by econometric studies. Harvey et al. (1986) and Darby/Wren-Lewis (1991) estimate the underlying manufacturing productivity trend growth rate from an employment equation relating the logarithm of employment to the logarithm of output and the lagged logarithm of output and employment. In Harvey et al., the trend term is treated both de-

<sup>2</sup> There are also problems in measuring the output growth in services, which are often the growth of the inputs with an arbitrary allowance for productivity growth.

terministically and stochastically and they find no increase in the underlying trend of productivity growth in the 1980s. Darby and Wren-Lewis used quarterly data from 1964Q1 to 1987Q1 and estimated a deterministic trend for annual manufacturing productivity growth of 2.75 per cent that is consistent with earlier economic performance. However, productivity growth fell between 1975 and 1977 because firms were overoptimistic about the rate of output growth, which led to excessive labour hoarding and underutilization. Consequently, part of the rapid growth in productivity after the late 1980s can be attributed to labour shedding, as firms adjusted their expectations about growth. Thus Darby and Wren-Lewis find there was no supply-side miracle.

Muellbauer (1991) estimated an orthodox production function for UK manufacturing and compared total factor productivity (TFP) growth for the period 1959–1972 with 1980–1990. The trend annual growth rates were 2.9 and 3.3 per cent respectively. The latter is somewhat higher, he argues, because the collapse in manufacturing production in 1979 and 1980 resulted in capital scrapping being under-recorded. Consequently, TFP growth was overestimated during the 1981 upswing. Like Darby and Wren-Lewis, Muellbauer argues that labour shedding gave productivity growth a temporary boost (see also Layard/Nickell 1989). This provides a plausible explanation for the small gain in productivity growth in the decade after 1980.

Consequently, there was no noticeable long-run gain in productivity growth under Thatcher, although there is the problem of specifying the counterfactual. Given that after 1973 there was a marked productivity slowdown in the continental European countries, it could be argued that without the Thatcher supply-side reforms, productivity growth in the UK would also have worsened significantly. But given the importance of technological catch-up in the post-war period (Crafts/Toniolo 1996), the reforms should have enhanced this source of productivity growth, but they clearly did not.

### *Labour Market Deregulation and Unemployment*

In 1973, at the end of the long boom known as the Golden Age, unemployment was low in nearly all OECD countries and Germany had one of the lowest rates (one per cent) (OECD 2008). During the ensuing recession, all countries experienced increasing unemployment, although individual performance differed. By 1986 Spain had the worst rate (17.5 per cent), followed by the UK (11.2 per cent), Belgium (ten per cent) and France (9.7 per cent), whereas the lowest rates were found in Austria (3.1 per cent), Norway (two per cent), Sweden (2.7 per cent) and Japan (2.8 per cent). When Thatcher came to power in 1979, the UK's unemployment rate (4.7 per cent) was reasonable by international standards, although Germany had a lower rate (2.6 per cent). But more importantly from a political perspective, the UK's rate was significantly higher than the rate of 2.6 per cent in 1973.

Early deflationary macroeconomic policies under Thatcher increased the rate of unemployment to 11.2 per cent in 1986. Unemployment then fell and rose again, peaking at 10.2 per cent in 1993. It then fell continuously until 2004 when it was 4.6 per cent (although there was a slight rise to 5.3 per cent in 2006). This compares favourably with European

unemployment rates in the largest economies in 2006: France (9.4 per cent), Spain (8.5 per cent), Germany (8.4 per cent) and Italy (6.8 per cent).

Thatcher's government attempted to reduce unemployment in the UK by reforming industrial relations, especially the national multi-plant bargaining practices of trade unions. In essence, the reforms encompassed light state regulation, low unemployment benefits, weak trade unions and reduced coverage of collective bargaining. Trade unions, the government argued, raised wages in the unionised sector and consequently reduced employment there. In the competitive non-unionised sector, the real wage fell and, given the level of unemployment and welfare benefits, unemployment increased. Thus the more flexible labour market model adopted by Thatcher acknowledged that real wage flexibility was the *sine qua non* for achieving and retaining full employment, and this was initially endorsed by the OECD (1994).

The neoclassical model underpinning these reforms accepts that there is a structural or equilibrium natural rate of unemployment, to which any economy gravitates after a shock. The natural rate is influenced by supply factors, including the degree of real wage rigidity. In the long run, if the ratio of the money wage rate to productivity (Keynes's efficiency wage) is too high, the natural unemployment rate rises above the minimum that is associated with a perfectly competitive labour market. More deregulated labour markets and greater wage flexibility will therefore reduce the natural rate.

The standard method for determining the value of the natural rate is to equate it to the rate of unemployment where inflation is constant (the non-accelerating inflation rate of unemployment or NAIRU). Changes in the actual unemployment rate can affect the natural rate through changing supply-side factors (hysteresis). But the natural rate is assumed to be independent of, and unaffected by, demand factors. However, the fact that estimates of the natural rate track the observed rate of growth undermines the usefulness of the concept. In the UK, the natural rate was estimated to be eight per cent in 1970–1982; nearly six per cent in 2002 and less than five per cent in 2003. As Coats (2006: 40) points out, the fact that it was around 4.5 per cent in 1980–1982, when labour markets were putatively at their most rigid levels, takes some explaining. A similar result is found for Germany and France.

Throughout the 1980s there was a stream of *ad hoc* legislative measures to curtail the power of the trade unions. The Government, in the case of collective labour law, increased the degree of legal intervention. The legislation, *inter alia*, banned the closed shop, secondary picketing and removed the immunity of trade unions engaged in an official dispute from being sued. Ballots of members on whether or not to undertake industrial action required a majority in favour before any official strike could be called. The net effect was to weaken the rights and bargaining power of employees.

Did the Government achieve its twin aims of reducing the incidence of strikes and the level of wage settlements? Certainly there is evidence that the number of working days lost per 1000 employees fell sharply: in 1970–1974, 509 working days were lost through strikes, and in 1980–1984 this fell to 484, but the figure fell dramatically in 1985–1989 to 177 and to 35 in 1990–1994. However, it is necessary to put these results in an international context. Of twenty advanced countries, in two five-year sub-periods 1978–1982 and 1982–1987,

Britain was the fifth most strike prone country in terms of numbers of working days lost per employee. Consequently, the decline in the incidence of strikes in the UK was mirrored by the other advanced countries.

Blanchflower and Freeman (1993) assessed whether the Thatcher reforms improved British labour market performance and came to the conclusion that there was little dramatic effect. The growth of real wages remained high in the UK and this suggests that trade union reforms did not produce a more responsive Phillips curve adjustment. This view is supported by Nickell and Wadhvani (1990) and Stewart (1991). The former found that there was no difference in the response of wage increases between unionised and non-unionised firms and the latter that the union/non-union mark up did not differ over the period 1980–1984.

This provides support for the view of Brown and Wadhvani (1990) who suggest that the move away from multiemployer bargaining and the fragmentation of pay bargaining may have prevented the growth of money wages from falling quickly.

»The increased isolation of ›insiders‹ through single-employer bargaining and associated developments may have facilitated improvements in labour productivity. But these have been achieved at the expense of continued high employment, and a national bargaining structure whose fragmentation gives rise to continued vulnerability to internationally uncompetitive levels of wage inflation.« (Brown/Wadhvani 1990: 67)

They further suggest that it has been competitive pressures rather than government legislation that have led to these modest productivity improvements.

At a microeconomic level, Blanchflower and Freeman (1993) examined whether or not a flexible labour market exhibited a higher probability of workers moving from employment to unemployment with shorter spells of unemployment and values that were comparable to those in the U.S. They found that for men there was little movement towards the value of transition probabilities found in the U.S., although this was not true for women. Also, although the ratio of unemployment benefits to the average wage worsened under Thatcher, Blanchflower and Freeman concluded that while the reforms succeeded in making work more attractive, they did not move the unemployed rapidly into employment (this may have been the case for women). The authors found out that there was some improvement in the way firms responded to shocks, laying off workers more readily in the 1980s, which may have kept the rate of productivity growth temporarily relatively high. There was greater inequality in wages for the same skill level, which is not what would have been expected from a better functioning labour market. In a slack labour market, low-wage firms are not pressured into paying the going rate and to this extent the reforms might have perversely increased labour market segmentation and the dispersion of earnings.

»[T]here is no strong evidence that the British labour market experienced a deep microeconomic change. Indeed, the observed outcomes raise the possibility that the reforms brought the UK the worst of two possible worlds: the massive wage

inequality of the decentralised U.S. labour market together with high and lengthy unemployment, European-style.« (Blanchflower/Freeman 1993: 18)

The reforms might have worked in periods of tight labour markets, but not when there was high unemployment.

Denny and Nickell (1992) take a different view. They examined whether unions reduce the level of investment using three-digit industry data for the period 1980–1984 and a smaller set of industries for 1973–1985. They estimated the level of investment demand as a function of consumer demand variables, relative prices, the rate of technical progress and a number of industrial relations variables. Overall, with competitive firms (which recognise unions and have a high average manual union density relative to those in which unions are not recognised) investment demand fell 16 per cent and about three per cent in non-competitive firms (although the results are »subject to wide margins of error given the number of extraneous assumptions required to generate them« (Denny/Nickell 1992: 884–885)). Moreover, other UK studies found rather inconclusive effects. Gregg et al. (1993: 905–906) used two years data for 328 companies from 1984 and 1989 and found that »there were no differences in productivity growth between union and non-union companies 1984–1987«, but in 1988–1989 productivity growth was highest »in those firms that had experienced at least a partial de-recognition of a union for collective bargaining«. But the time period under consideration is rather short.

### *The Thatcher Effect and Unemployment in the Long Term*

Although there seems to be little direct evidence that the Thatcher reforms had an immediate and substantial impact on unemployment in the 1980s and early 1990s, the experience of the UK and U.S. in 2006 compares favourably with France, Germany, Italy and Spain. It should be noted, however, that the official figures may understate the true position. Employing a methodology that takes account of those on invalidity benefit who could actually work, Beatty et al. (2007) calculate that the proportion of the working age population unemployed by the claimant count was 2.6 per cent, additional unemployment under ILO definitions 1.8 per cent and hidden unemployment on invalidity benefit 2.9 per cent. Thus the real figure for UK unemployment would be 7.2 per cent in 2006, compared with the OECD figure of 5.3 per cent.

When unemployment in Europe failed to return to the earlier post-war levels in the late 1980s and early 1990s, a consensus emerged that this could be explained in neoclassical terms by rigid labour markets (Saint-Paul 2004). Consequently, the Thatcher reforms, by deregulating the labour market, could have laid the foundations for the observed long-run improvement in the UK's unemployment rate. Sophisticated panel data models estimated in the 1990s using OECD data allow the evidence to be assessed. The results of these studies show that differences in institutional variables in the labour market (the degree of employment protection, benefit replacement ratio, benefit duration, union density and employment taxes) can explain a lot of the cross-country differences in unemployment (Nickell

2003). They confirm the neoclassical rigidity view of unemployment. But these studies have not gone unchallenged.

Baker et al. (2002) take a sceptical view of the wage rigidity explanation after reassessing six influential studies: Nickell (1997), Elmeskov et al. (1998), Belot and Van Ours (2002), Nickell et al. (2002) and Blanchard and Wolfers (2000). They perform an admittedly simple test to determine whether there is a statistically significant correlation between the unemployment rate and six widely used measures of labour market indicators for 19 OECD countries and find »no hint that labour market institutions and policies could explain even a small part of the post-1980 pattern of unemployment« (Baker et al. 2002: 18)<sup>3</sup>. They also have reservations over more sophisticated econometric models. The authors estimate a similar model using revised values for a number of the indicators and different time-periods. They conclude that »there is little evidence here of the consistency of results which could convincingly underpin sweeping recommendations for labour market reform« (Baker et al. 2002: 52).

Howell et al. (2007) also come to the same conclusion in their extensive and critical review of the evidence. For example, they question Nickell's (2003) more informal assessment of the effectiveness of labour market reforms proposed by the OECD (see also Glyn et al. 2006). They argue that the regression results are fragile and that Nickell's analysis fails to identify three of the four high unemployment countries. The only »protective labour market institution« robustly associated with unemployment in the studies that they examine is the level of unemployment benefits. But

»common sense political economy considerations and Granger tests both suggest that much of any statistical association runs from changes in unemployment to changes in benefit generosity« (Howell et al. 2007: 58).

Moreover, even large changes in benefits are only associated with small changes in unemployment.

Schmitt and Wadsworth (2005: 157) concentrate on one of the central predictions of the OECD model

»that greater labour market flexibility should be associated with lower unemployment and higher employment of traditional marginalized workers, including the less skilled, particularly young workers and those with lower levels of formal education«.

Using a number of indicators, they find that the performance of the UK and the U.S. is only average compared with the OECD, so

»flexibility« is neither a necessary nor sufficient condition for improving the labour-market opportunities for marginal workers and that different economic systems as practiced in other countries seem perfectly capable of producing the same, if not better, labour market outcomes« (Schmitt/Wadsworth 2005: 158).

3 These were the replacement rate, an index of the duration of benefits, union density, an index of employment protection legislation, a bargaining coordination index and tax incidence.

That the neoclassical view of the causes of unemployment is too simplistic has been recognised at least since Calmfors and Driffill (1988). They report that the extremes of the highly centralized labour market found in the Nordic countries and Austria and the decentralised system in the U.S., Japan and Switzerland both worked well, whereas the middle position of the UK, Belgium and Netherlands fared badly. As Freeman (2000) points out, there are a wide variety of optimal labour market institutions and the perception of what may be optimal varies over time. Consequently, there is no single 'ideal' set of labour market institutions, rather there are several, and which one a country adopts is path dependent and switching between them is costly. Clearly, one size does not fit all.

Reviewing the literature, Freeman (2000) concludes that empirical research has yielded some interesting conclusions. Firstly, there is strong evidence that wage-setting institutions reduce inequality in wages and salaries and that the difference between unionised and non-unionised firms is not simply due to less variation in the skills of the former. Secondly, most wage-setting and rule-making institutions have little effect on efficient outcomes. About two thirds of studies find that unionised plants, *ceteris paribus*, have higher productivity than non-unionised plants. There is some evidence that trade unions in the UK reduced productivity growth prior to 1979, but not after they had modernized their policies.

The OECD (2007) now accepts that there is little evidence that market oriented policies are sufficient to generate simultaneously good employment and productivity performance:

»*Other successful employment performers* (which combine strong work incentives with generous welfare protection and well-designed regulation) *had, on average, over the past decade, similar GDP per capita growth to that recorded in more market-reliant countries.*« (OECD 2007: 57, italics in original)

Thus, many of the conclusions undermine the neoclassical view of performance in the labour market.

### Conclusions

The UK had one of the slowest productivity growth rates during the Golden Age, but after Thatcher productivity growth improved relative to other advanced countries, although not greatly in absolute terms. Indisputably, Thatcher radically altered the nature of industrial relations in the UK, and although its quantitative effect on productivity growth and unemployment is not clear, it was probably small.

Without a counterfactual, it is difficult to assess the 'Thatcher experiment', and Nordhaus (1989) neatly illustrates the problem. If potential output grew 0.5 per cent faster as a result of the Thatcher experiment, against this improvement must be set the fact that actual output declined from 1979 to 1984. Given this cumulative loss in output due to Thatcher's policies, he wants to know when a faster potential growth rate would offset these losses? If the gains are not discounted, then the benefits from Thatcherism, in terms of GDP,

will be positive sometime after 2010. If the gains are discounted at six per cent, then the loss will never be recovered.

An implication of the evidence cited in this article suggests that the importance of *demand* cannot be ignored in looking at disparities in unemployment rates. While there is not space to discuss this important consideration here, there is little doubt that demand failures have been a major factor in accounting for the high unemployment rates in much of Europe. The evidence does not suggest that the high unemployment is due solely to labour market rigidities and any attempt to reduce Europe's unemployment merely by deregulation of labour markets is almost certainly going to fail.

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## **Dimensions of the Argentine Crisis 2001/02. A Critical Survey of Politico-Economical Explanations**

*Thomas Bernhardt\**

### *Introduction*

When the Argentine economy collapsed in the final days of December 2001, in fact, this did not come too much as a surprise. The country had entered its fourth consecutive year of recession and scepticism about the sustainability of its economic model was widespread. However, the magnitude of the collapse was both surprising and terrifying. In 2002, Argentina's real GDP slumped by approximately eleven percent, gross fixed investment fell by 36.4 percent and private consumption by 14.4 percent. After almost an entire decade of price stability, in 2002, the inflation rate shot up to an annual 41 percent and capital flight added up to more than twelve billion U.S. dollar. This economic misery was accompanied by social unrest and political turmoil. Living standards of the majority of Argentineans had deteriorated considerably in the second half of the 1990s. In mid-2002, open unemployment stood at 21.5 percent and poverty had risen dramatically, affecting 52 percent of urban population.

Even compared to the sad experiences of the various financial crises in the last decade of the 20th century, Argentina's collapse was a particularly dramatic case. In fact, Argentina had been hit by a highly complex multidimensional crisis. The sheer magnitude and complexity of the crisis prompted a wide range of economists to try to deliver explanations of what had happened and why it had happened. In principle, at least three different (though partly interrelated) interpretations of the crisis can be distinguished. Firstly, numerous authors identify the so-called ›convertibility system‹ as the main cause of the crisis. A second group of economists puts the blame on the authorities' fiscal irresponsibility. A third view emphasizes the crucial role played by the external shocks that hit the country in the course of the 1990s. These three principal strands of interpretation will be treated in the following three sections of the paper and rounded off with some final remarks.

### *The ›Convertibility System‹ as the Main Cause of the Crisis?*

When Carlos Menem assumed office as President of Argentina in 1989, the primary task he felt he had to tackle was the hyperinflation that was plaguing the country's economy. In

\* Austrian Federal Chamber of Labour, Brussels Office.