palgrave macmillan

The Unbalanced Economy

A Policy Appraisal

Ciaran Driver and Paul Temple

The Unbalanced Economy

Also by Ciaran Driver

INVESTMENT, GROWTH AND EMPLOYMENT (*co-edited with P. Temple*)

INVESTMENT, EXPECTATIONS AND UNCERTAINTY (*with D. Moreton*)

STRUCTURAL CHANGE IN THE UK ECONOMY (*co-edited with P. Dunne*)

TOWARDS FULL EMPLOYMENT

Also by Paul Temple

MERGERS AND ACQUISITIONS: Critical Perspectives on Business and Management, 4 volumes (*co-edited with S. Peck*)

THE BENEFITS OF STANDARDS (*with G. Williams*)

INVESTMENT, GROWTH AND EMPLOYMENT (*co-edited with C. Driver*)

BRITAIN'S ECONOMIC PERFORMANCE (*co-edited with T. Buxton, P. Chapman*)

The Unbalanced Economy

A Policy Appraisal

Ciaran Driver

and

Paul Temple

palgrave
macmillan

Softcover reprint of the hardcover 1st edition 2012 978-0-230-28031-1

First published 2012 by
PALGRAVE MACMILLAN

Palgrave Macmillan in the UK is an imprint of Macmillan Publishers Limited, registered in England, company number 785998, of Houndmills, Basingstoke, Hampshire RG21 6XS.

Palgrave Macmillan in the US is a division of St Martin's Press LLC, 175 Fifth Avenue, New York, NY 10010.

Palgrave Macmillan is the global academic imprint of the above companies and has companies and representatives throughout the world.

Palgrave® and Macmillan® are registered trademarks in the United States, the United Kingdom, Europe and other countries.

ISBN 978-1-349-32751-5 ISBN 978-1-137-27179-2 (eBook)
DOI 10.1057/9781137271792

This book is printed on paper suitable for recycling and made from fully managed and sustained forest sources. Logging, pulping and manufacturing processes are expected to conform to the environmental regulations of the country of origin.

A catalogue record for this book is available from the British Library.

A catalog record for this book is available from the Library of Congress.

10 9 8 7 6 5 4 3 2 1
21 20 19 18 17 16 15 14 13 12

Contents

List of Tables and Figures

Tables

Figures

Preface

This book provides a context for debating the course of the British economy and for discussing which fresh policy measures are needed to propel growth. It will appeal to those with an interest in understanding the trajectory of the economy from the inception of market-led policies in 1979 to the current state of financial distress and seeming policy impasse. It is a book written by economists but not, we hope, just for economists: the big economic policy choices that face us are essentially political. Given the extent of disagreement about how the economy actually works in practice, there can only be risky choices that are made with an eye to which class or group will bear the brunt if things go wrong. As Gamble (2009) recently noted, we are entering the third generalized crisis of capitalism of the last hundred years, 'they arise politically, they are constructed politically and they are resolved politically' (p.10).[1]

In our view, the biggest policy wager in recent decades has been that a more market-friendly regime – aimed in particular at restoring profitability by bearing down on organized labour – would by itself raise productivity growth and general prosperity. Although much was wrong with pre-1980s Britain, we show in this book that such optimism in markets was misplaced. More worryingly, the policy direction, once chosen, became difficult to reverse, as the market based agenda became the default for policy initiatives. Beginning with the first Labour administration of 1997 there was some acceptance that more proactive policies were needed to coordinate economic activity, but for the most part these lacked substance. Instead, for a variety of reasons, policymakers chose the 'double-up' option and pursued a course of continuous liberalization under the twin beliefs that global capital markets were necessarily benign and that states possessed very little leverage over them in any case.

The book argues that the market based approach was unbalanced leading to the unbalanced economy to which our title refers. We want to restore coherence to economic policy so that the great problems of jobs, incomes and wealth distribution between citizens are addressed.

[1] Gamble, A. (2009) *The Spectre at the Feast: Capitalist crisis and the politics of recession*, Palgrave Macmillan.

It has become commonplace to call for a 'rebalancing' that means something else – including a switch from public to private provision and from consumption to savings. Neither of these ideas of rebalancing feature strongly in our account because they conflate means (budget cuts and more savings) with ends (sound finance and strong investment). We do however address other imbalances that have a direct bearing on jobs, such as the sectoral composition of output – which, as we argue in Chapter 8, requires new institutions for industrial strategy and coordination – and the neglect of capital investment and R&D which has impeded growth. Our emphasis on these twin concerns of manufacturing and investment does not stem from any mercantilist notion, but is based on the argument in Chapter 4 that a sector's policy importance should be inferred from the extent of the frictions and failures of actual markets. We have all too little to say about the important issue of regional disparities which is too large a subject to be easily addressed in a general text such as this. However some of these inequalities would be ameliorated were the allocation of resources to shift back toward investment and manufacturing.

This book is not in any sense against markets, an institution that has often brought both progress and liberty. But any serious economist is as aware of the deficiencies of markets as much as their benefits. Our objection is rather to what might be called the *market as metaphor* where market affirmation is used to convey a political intention that the interests of capital will be privileged over those of labour. It was in this spirit that much of both labour market reform and the liberalization of capital markets were conceived, sometimes in the belief that greater profitability would necessarily lead to more innovation and investment. The process of liberalization was inherently dangerous because the market as metaphor naturally led to a generally held belief in efficient markets, including the ideas that asset bubbles could not and should not be constrained, that credit expansion was warranted by the demand for it and that ownership of companies did not greatly matter to how they were run. Much of the market rhetoric failed to notice that there were deep implications for economic institutions; and in particular for that of the modern industrial enterprise.

In the months after the financial crisis some of the big hitters of the old era were for a while contrite. The Chairman of the US Federal Reserve, for whom New Labour arranged a knighthood, expressed doubts about his earlier free market beliefs while the previous enthusiast for shareholder value, General Electric's Jack Welch now called it the 'dumbest idea'. Others recanted from excess liberalization saying that too much faith was put in financial markets and that income inequality had got out of hand. It seems that some things happened that we didn't much like in the days before the financial crash. But the damage inflicted by that event was as much associated with the real economy as with banks and finance. The same ideas of markets as both omniscient and efficient have allowed a hollowing out of the real economy and a lack of coherence in the domestic industrial structure. 'Industrial policy in Britain since 1979 has been minimal at best', wrote Kitson and Michie in 1997.[2] It is no less true today. The market as metaphor came to paralyze decision-making to the point where, in the UK at least, policy advisers could only set out the issues, while lacking the policy levers to resolve them. Paradoxically perhaps, it is now often top industrialists and employers' organizations that are backing a strategic interventionist policy and supply chain planning to reinvigorate corporate Britain.

The great financial crash of 2007 was international in scope but its effects are in large measure due to the domestic policy stance taken in the decades leading up to the crash. Among the policies that contributed were of course an over-reliance on a lightly regulated banking and shadow banking sector that drove the asset bubbles; the corresponding excessive private debt and a neglect of capital investment and of sectors where sunk costs meant that market solutions were inadequate. There was also a lack of attention to the interplay between income disparities and sustainable growth; a failure to build a sense of fairness with an equitable tax system; and a reluctance to implement far-reaching reform of company law that would align the interest of companies with those of its stakeholders and permit better decision-making. The book traces the policy debates by relating them to the economic theories that shaped or supported the market-oriented agenda in the UK. We have tried to present these economic ideas as simply and transparently as possible. Where we have added technical detail we hope to have done so in a way that complements the textual discussion in a manner that allows it to be skimmed by the general reader who is more interested in the flow of the argument. In particular parts of Chapter 2 outline the 'NAIRU model' that we see as underpinning the heavy emphasis on labour market reform so evident in the UK. It discusses the historical emergence of these ideas and inevitably has to engage with the relevant economic theory. Chapter 3, while also addressing economic concepts such as the

[2] Kitson, M. and J. Michie 'Does Manufacturing Matter?', *International Journal of the Economics of Business*, (1997) 4(1), 71–95.

balance of payments, is on the whole less technical. A central argument of the book is that capital investment is not well supported by market signals and we make that point at length in Chapter 4, with a discussion of the economics of investment and decision-making.

While the book contains some formal content, the writing style is intended to be direct and may at times seem to verge on the polemical. However much of what we say in these pages has been contained in previous, more technical accounts, which are referenced throughout for the interested reader. Our practice has been to omit many of the caveats and doubts that any academic feels in the hope that readers themselves will weigh the merits of the arguments. While the approach is a critical one, it reflects our belief that orthodoxy has not served the country well in recent decades.

We are grateful to those who provided forums for us to test out these ideas in debate during their long inception period, including presentations at The French Economic Association 2009, The Wharton School Conference on Corporate Governance 2010, The Centre for Corporate Governance, University of Birmingham 2010, The European Network on the Economics of the Firm 2011 and presentations at the Royal Economic Society, the Australian National University and the University of London. Paul would like to acknowledge members of the innovation policy community for providing inspiration including in particular Peter Swann and Ray Lambert. Thanks also to our colleagues at SOAS and the School of Economics at Surrey, who inadvertently or otherwise stimulated our thoughts. The forbearance of our families certainly needs acknowledgement. Especial thanks are due to Monika Temple who read and commented on the entire manuscript. The mistakes are of course all our own.

Our target audience is wide. We hope that the book will be used in advanced undergraduate and postgraduate courses in economics, politics and the social sciences generally. We hope also that it will appeal to decision-makers and the informed public who desire an overview of events and theories of the past few decades. Those who have lived through them should find much to recognize while those who have not will, we trust, be able to see a pattern in the drift of events that we chart. The analysis, of course, is just the beginning; the point, as ever, is to bring about change.

About the Book

In this book, Driver and Temple examine how the simple faith of economists and policymakers in free-markets and financialization masqueraded as an economic theory justifying the neglect of investment in capital, skills and technology. The authors survey the damage caused to the macroeconomic climate from the market-era reliance on labour market flexibility and low inflation, and conclude that radical reforms are needed both at the level of the company, through changes in corporate governance, and at the level of industry, by giving institutional form to a system of social partnership for a fair and high performance economy.

About the Authors

Ciaran Driver is Professor of Economics and Head of the Doctoral Programme at DeFiMs, SOAS, University of London, UK. His research interests are capital investment and corporate governance. Recent publications include *Research Policy,* the *Cambridge Journal of Economics, Oxford Economic Papers, JEBO, JBES, IJIO* and the *Journal of Macroeconomics*. He has held visiting posts at the Australian National University, been attached to several global business schools and has advised UK and Irish public bodies on capital investment policies.

Paul Temple is a Reader in Economics at the University of Surrey, UK, with research interests in the economics of innovation, investment, and international trade. He has edited various books including *Britain's Economic Performance* and has published widely in economics journals including the *Cambridge Journal of Economics,* the *International Journal of Industrial Organization* and the *Journal of Business and Economic Statistics*. Previous appointments have been at the Centre for Business Strategy, and the National Economic Development Office (NEDO).

1
Economic Performance in the Market Era

1.1 Introduction

The fallout from the worst economic crisis within living memory has commanded unprecedented attention from economists and others attempting to understand and contain it through a mixture of global and domestic action. In this book we approach the crisis not as a single event but as part of a process whose roots reside in longer-term tendencies that have developed in previous historical periods. To make the study manageable we investigate the issues largely from the perspective of the British economy, which we believe to be representative, indeed an exemplar, of similar liberal market economies. Britain is now one of the most market friendly economies in the world following several decades of a reform programme that began in 1979 with the election of a Conservative government, and which has continued to underpin that of subsequent governments, including that of New Labour (1997–2010). As noted in Card and Freeman (2004): 'Beginning with Margaret Thatcher and continuing under John Major and Tony Blair, these reforms sought to increase the efficacy of labor and product markets and limit government and institutional involvement in economic decision making' (p.9).

This book attempts to understand the crisis through the lens of this longer perspective. In our view, whatever the nuances of policy difference between Thatcher, Major, Blair, Brown and the coalition, the general direction of travel towards a more market-centric society has been unwavering. It is our contention that this has involved an unbalanced approach which has been destructive of economic capacity as well as social cohesion (as perhaps the two are not unrelated). On the economic front it has resulted in a neglect of capacity building (because the market cannot do this very well but was given the job anyway) and the creation of a mode of workplace relations that cannot deliver commitment. Economic performance has not in any real sense improved in the changed policy regime, but a high price has been paid in terms of intensity or work and patterns of inequality. We can do better.

The shock to the economy that occurred in 2007–8 is likely to have long-lasting effects. Economic growth as projected by Her Majesty's Treasury in the budget of March 2011 shows a full 10 per cent shortfall from the budget forecast of March 2007 and that shortfall is projected to persist *indefinitely* meaning a *permanent* loss of that output, through the recession induced loss of capacity. Since the onset of the crisis, the projections for recovery have worsened, with the likelihood of only anaemic growth for some years, even if the problems concerning the Euro are resolved. The result today is that the UK faces a serious lack of demand combined with a composition of supply that is unaligned with future demand conditions. The UK is over-committed to sectors that are not going to recover completely because they are bubble sectors, a situation that poses severe challenges for policy. Even if growth resumes, helped perhaps by the low value of the pound and a resumption of growth in Britain's major markets, we cannot be certain that previous trend growth will resume. This will not be helped by the loss of capacity in sectors of high productivity growth.

Unsustainable booms are not something new to Britain and even the long boom that ended in the 1970s was characterized by a process known as 'stop-go' with blame frequently being put on 'obstreperous labour management relations'.[1] The decisive policy break towards 'flexible labour markets', initiated during the course of the 1980s, was intended to transform economic performance. Some simple statistics may help in making a judgement here. Figure 1.1 shows the progress of overall economic output (expressed as year on year percentage changes) in Britain over the whole period from 1948 through to 2009, a period that divides roughly equally into the period before 1979, and the period of the great market experiment that followed. The period of stop-go is now clearly visible for the early period, but only twice did the stop actually mean zero or negative growth – in 1958, a period which saw an early but short-lived experiment in monetarism, and 1974–5, when the advanced economies were collectively affected by a severe oil price shock, magnified in the UK's case by a previous deregulation of credit markets.

[1] The transferred epithet is in Card et al (2004), p.1.

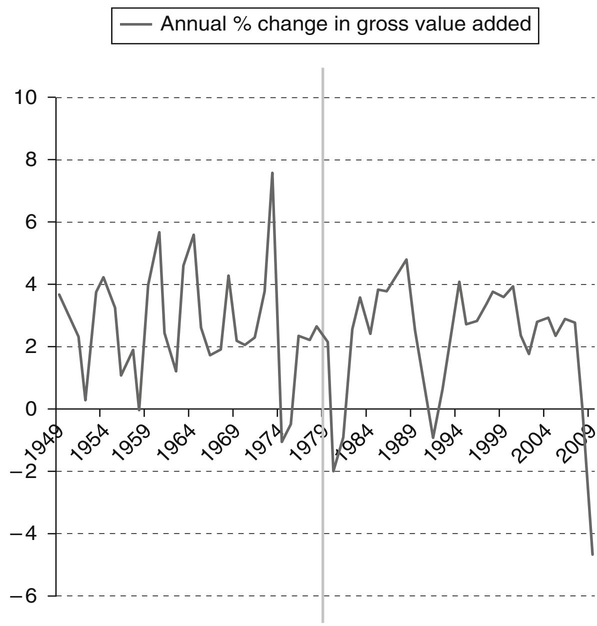

Figure 1.1 Year on year percentage changes in aggregate economic output (gross value added at basic prices) for UK 1949–2009
Source: ONS 2010 Blue Book.

The 'stop' to economic expansion was however given a new meaning from 1979 onwards, when a change in the approach to economic policy heightened the risks of unsustainable growth. As can be seen from Figure 1.1, the era produced three major recessions (in the early 1980s; early 1990s and now), with the current crisis clearly quite unparalleled in post-war British experience. There is also evidence of an old-fashioned 'stop' phase corresponding to the bursting of the 'dotcom' bubble when the historically rapid rates of economic expansion toward the end of the millennium fell back sharply after 2000. Each of the recessions was of course different in various respects, not least in the mix of external and domestic factors in influencing events, but each occurred under a policy regime in which governments placed undue trust in market forces. Economic policy under Margaret Thatcher was based on the idea that controlling the money supply would be sufficient to tame inflation. The credit boom of the 1980s was the result of a widespread belief that there had been sea-change in Britain's economic fortunes which justified the surge in spending and property investment before it ended in a largely domestically induced recession.[2]

Remarkably similar things can be said of the seeds of the current recession, despite the increased relevance of global factors. Most remarkable was how an economy, once again experiencing such an obvious 'bubble' in housing prices, could also be simultaneously experiencing low inflation, deceiving many about the sustainability of growth. This was as true of 2007 as of 1989; on both occasions policymakers apparently believed that control over consumer prices (using measures largely detached from the spiralling cost of house prices) was sufficient – bubbles just do not exist in low inflation market oriented economies. As one economic historian noted of the earlier boom 'Ministers trusted in the self-directing power of unrestricted free enterprise' (Dow 1999, p.359).

At a deeper level a central contention of this book is that over-zealous adherence to market solutions in Britain decisively changed what was deemed possible from public policy, encouraging a repetitive pattern of unsustainable upturns. It is not just that policymakers are content to let booms run on because of the belief that it is the job of the market to stop them. More particularly growth stops because the market does not work well enough to commit sufficient and early resources to meeting the anticipated demand, and so the economy runs short of capacity, generating domestic inflation or international imbalances. Many commentators and forecasting teams have even worried that, in this current uncertain and weak recovery, capacity shortages may already be fuelling inflation.[3] Of course some of the problem may in part be because the unbalanced nature of growth alerted business to its unsustainability so that investment was held back on that account. But it is also due to a learnt pattern of business caution in committing to supply. This has been a perennial problem in the UK. Business (at least outside of some sectors of finance) realizes that the downside risks represent their own potential loss, while the upside is in part a public potential gain. Our

[2] It is easy to imagine that the rapid rise in productivity growth in this period was seen, not as a one-off levels effect but rather as a permanent improvement in trend, thus leading to the surge in consumption, financed largely by second mortgages on appreciating homes. Indeed equity withdrawal from housing during the 1980s was enough to finance the entire growth in GDP, just as it did later under the Blair-Brown period of 1997–2009 (Froud et al 2011).

[3] Generally however commentators focus on labour supply and ignore the importance of capital constraints.

contention in this book is that while the proximate cause of current economic difficulties is the banking crisis and related international events, the vulnerability of the UK to such dangers has its roots in decades of misconceived economic strategy and policies. Indeed at the outset of the Thatcher administration the point was noted by the economist Lord Balogh:

> The fear of excess capacity, the dread of investing in new plant when the old would do, is notable. This means that the limits of expansion are reached in this country before they press on our foreign competitors. Thus, our improvement is interrupted at an increasingly early stage of the upswing.
>
> (Balogh 1979, p.199)

In the remainder of this chapter we look at three crucial questions of economic policy in recent decades. First, how and why do unsustainable booms emerge and to what extent is the current cycle similar or different to the previous one? Second, have the reforms over the whole period resulted in an enhanced ability of the economy to deliver productivity growth? Third, what can be said about the distribution of any productivity gains?

1.2 Repetitive patterns? The tale of two cycles

As we have seen, the modern market era has seen three major recessions and so far just two recoveries (see Figure 1.1). While we find several important similarities between the two completed cycles – which we call the Thatcher cycle (1979–90) and the long cycle (1990–2007) – there are also some important differences both in respect of the way that demand was allowed to develop and the extent to which capacity to meet that demand was adequate.

The sources of demand

How far has unsustainable domestic demand fuelled booms and led to subsequent problems of readjustment in the recession? First, it is important to consider the distinction between the growth of domestic demand and what the economy actually delivers in terms of real output. Domestic demand comprises demand from the private sector – household consumption and gross capital formation, to which the government and other public sector bodies contribute a small and declining share, and government consumption. The latter is comprised of expenditures which eventually result in acts of *individual* consumption – for example expenditures on education and health – and a smaller total which reflects government expenditures on items of *collective* consumption – for example defence. The aggregate balance between domestic demand and domestic production is indicated in Figure 1.2. It can be seen that in the earlier 1979–90 cycle, domestic demand ran ahead of domestic output (measured here in market prices) only in the final few years of what became known as the 'Thatcher-Lawson' boom, comparatively late in the cycle. In the later cycle domestic demand *persistently* grew at a more rapid rate than domestic output especially after the late 1990s when a rise in the real exchange rate made life extremely difficult for exporters. When demand rises faster than output it implies that imports of goods and services are rising more rapidly than exports, resulting in the pattern shown

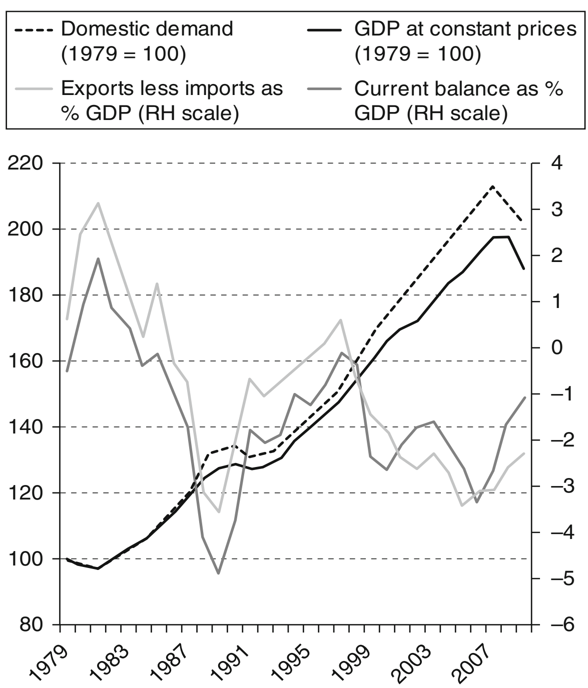

Figure 1.2 Domestic demand and output in the UK 1979–2009
Sources: ONS 2010 Blue Book and 2010 Pink Book.