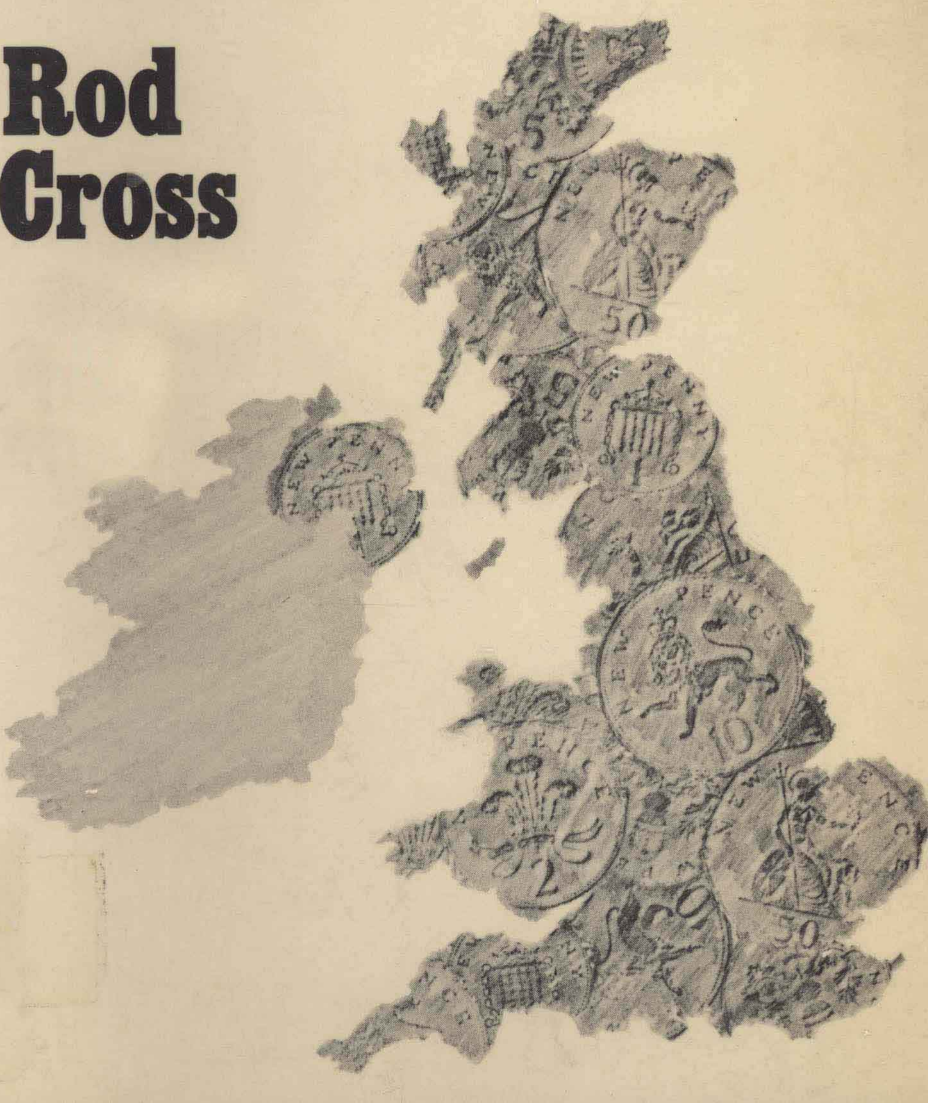
Economic Theory and Policy in the UK

Rod Cross



ECONOMIC THEORY AND POLICY IN THE UK

An Outline and Assessment of the Controversies

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Preface

This book was written in August 1981 and at least in part reflects the preoccupations of this time. Many of the themes discussed, however, are likely to be relevant to the whole of the 1980s, and perhaps longer in view of the tendency of current policy debates to repeat the themes of past policy debates. I would like to thank my ex-colleagues David Laidler and Bernard Corry for unwittingly having helped me to understand some of economic thought. I would also like to thank Keith Shaw for being the inspiration behind the enterprise as a whole; and my colleagues Antoni Chawluk and David Cobham for many helpful discussions of the issues covered in this book. I am indebted to Anne Stewart who prepared the bibliography and assisted the enterprise in many other ways. My thanks are also due to Betty Niven who typed the manuscript. None of the above are responsible for the errors and confusion that remain.

Rod Cross
St Andrews
September 1981

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1 Introduction

> The worst readers are those who proceed like plundering soldiers: they pick up a few things they can use, soil and confuse the rest, and blaspheme the whole. (Friedrich Nietzsche, *Mixed Opinions and Maxims*, 1879)

This book attempts to explain and assess the main controversies regarding the conduct of macroeconomic policy in the UK. The aim is to make it easier for the beginner or layman to understand the issues involved in such controversies. We hope that in presenting a summary of the issues on which economists are divided we have not proceeded like the plundering soldiers in the quotation above.

The point of departure for many of the controversies regarding economic policy in the 1980s has been the policy innovations introduced by the Conservative government which came to power in May 1979. This new economic strategy was

> based on four principles: first, the strengthening of incentives, particularly through tax cuts, allowing people to keep more of their earnings in their own hands, so that hard work, ability and success are rewarded; second, greater freedom of choice by reducing the state's role and enlarging that of the individual; third, the reduction of the borrowing requirement of the public sector to a level which leaves room for the rest of the economy to prosper; and fourth, through firm monetary and fiscal discipline, bringing inflation under control and ensuring that those taking part in collective bargaining are obliged to live with the consequences of their actions.[1]

This strategy marked the culmination of the retreat from demand management policies evident since the mid-1970s; marked the beginning of a supply side strategy for managing the economy; and marked a return to restrictive fiscal and monetary policies rationalized by arguments similar to those used by the authorities in the 1920s and 1930s.

In the 2 years after this strategy was initiated unemployment rose from 1.3 million to nearly 3 million; the rate of inflation rose from 13.4 per cent in 1979 to 18 per cent in 1980 before falling back to around 12 per cent in 1981; industrial output fell by 15 per cent over the 2 years; the effective exchange rate for sterling rose from 88.1 in June 1979 to 102.5 in February 1981 before falling back to 95.4 in June 1981; and the UK experienced the most severe cyclical downswing in economic activity experienced since the interwar period. It is absurd to blame the government for everything that has happened in the UK economy over the last 2 years, but it is equally absurd not to attribute a good part of what has happened to the government's economic strategy. As far as the rest of the 1980s is concerned the government's view is that the economy will recover from the present severe recession under its own steam on the basis of current policies. The argument here is that the rate of inflation will fall sufficiently to allow the limits for money spending implied by the Medium Term Financial Strategy to permit a recovery in real spending in the UK economy. Once such a turnround occurs, the argument goes, the policies to stimulate the supply side of the economy will come into their own. Such a prognosis reflects what can be called a *New Classical Macroeconomics* view of the economy.

The government's economic strategy has encountered severe criticism from those who see the current strategy as a recipe for a severe depression in the UK economy during the 1980s. Many of the government's own supporters have called for a U-turn in economic policy, recommending activist measures to expand aggregate demand. More radical policies have been suggested under the banner of the Alternative Economic Strategy (AES) espoused by sections of the Labour party and other socialist groups.[2] Significant differences exist amongst the left regarding the constituents of the AES,[3] and the following is merely a list of the elements included in at least one version of the AES: increased public spending; relaxation of monetary policy; import controls; nationalization of the banking system and certain large companies; industrial democracy in work-places; controls on capital movements; direction of the investment funds of the large institutional investors; prices and/or incomes policies; planning agreements between the government and private sector; a shorter working week; national minimum wages and maximum salaries; and a wealth tax.

In between the radical strategy of the present government and the radical strategy involved in the AES come a wide variety of economic strategies which could be pursued. It is completely wrong to assert that an economic strategy must be based on demand management or supply management alone. Indeed it can be argued that only strategies which involve the management in tandem of the supply and demand sides of the economy will permit the achievement of policy objectives.

The rest of this book is concerned with explaining and assessing the controversies surrounding macroeconomic policy strategies for the UK economy. Section I details the different views of the way the economy works which are involved in the main research programmes in macroeconomics, and outlines the programmes of political action which are suggested. Section II considers the nature of unemployment, inflation, economic growth and business cycles as objectives of economic policy. Section III outlines the main policy instruments available to the authorities to pursue such objectives: fiscal policy, monetary policy, wage and price controls, import controls and exchange rate policies. During the course of the book we will offer our own appraisal of the controversies and suggest certain courses of policy action. The view taken here is that a hysteresis-augmented version of *Orthodox Monetarism* best explains the workings of the UK economy - see the discussion in Chapters 8 and 12–19. Our appraisals and suggestions are open to the maxim coined by Mandy Rice-Davies: 'Well, he would say that, wouldn't he?'

Section 1

Research programmes in macroeconomics

2 Arguments in macroeconomics

'Do you want an Argument or Abuse?' (Monty Python)

Economists often wash their differences regarding the appropriate conduct of macroeconomic policy in public. On 30 March 1981, for example, several national newspapers in the UK published the following statement, signed by 364 academic economists:

> We, who are all present or retired members of the economics staffs of British universities, are convinced that: (a) there is no basis in economic theory or supporting evidence for the Government's belief that by deflating demand they will bring inflation permanently under control and hereby induce an automatic recovery in output and employment; (b) present policies will deepen the depression, erode the industrial base of our economy and threaten its social and political stability; (c) there are alternative policies; and (d) the time has come to reject monetarist policies and consider urgently which alternative offers the best hope of sustained economic recovery.

On the same day HM Treasury issued a statement 'totally disagreeing' with the statement of the 364. On the following day the Prime Minister and First Lord of HM Treasury, Mrs Thatcher, told the House of Commons that 'I rather thought those 364 did themselves more damage than anyone else'. Of the reasons why certain academic economists did not sign the statement, the following is fairly representative:

> The first clause is wrong – there are theories which would support the government's policies. Moreover the statement is weak because it is wholly negative. Finally, although the present policies should not

have been adopted, and have incurred very heavy costs, it would make no sense to reverse them now. What could be gained? A couple of hundred thousand off the unemployment rate?[1]

Sources of disagreement

Although such disputes are given almost daily coverage in the media, it is not usually clear why such differences exist. Is it simply because academic economists like to argue? Or is it because economists have a vested interest in particular macroeconomic policies? Or because the values of academic economists differ as to relative costs of unemployment, inflation and low economic growth? Or do the differences derive from different conceptions as to the way the economy works? Or from different diagnoses of the current state of the economy? At this juncture it is worth pointing out that, despite pejorative aphorisms such as 'with five economists you will get at least six different opinions', 'lay all the economists in the world end to end and you will not reach a conclusion', other academic disciplines are characterized by somewhat similar disagreements. What differentiates economics, and especially macroeconomics, from other disciplines is that debates at the 'frontiers of knowledge' tend to take place very much in the public eye as well as in learned journals. One of the more obvious reasons for this is that the controversies touch on issues of direct relevance to everyday life. Everyone is an amateur economist in a sense in which everyone is not an amateur physicist.

Methodological considerations

To try and disentangle the reasons why academic economists often disagree with each other regarding the appropriate conduct of macroeconomic policy it is useful to look at some methodological considerations. A first and familiar consideration is the Humean guillotine between 'is' and 'ought' statements, or between 'positive' and 'normative' economics. Statements about what 'ought' to be done as far as macroeconomic policy is concerned cannot be derived from statements or hypotheses about the way the economy 'is' structured alone: values regarding political or moral matters need to be introduced in order to derive 'ought' statements. Similarly statements about the way the economy 'is' structured cannot be derived from statements about the way the economy 'ought' to be structured. Providing that we are careful in our use of language - words such as 'bastard', 'drunk' and 'unemployed' often carry both descriptive and evaluative meaning - it is possible to preserve the Humean guillotine between 'is' and 'ought' statements.[2]

Given this distinction, differences between academic economists regarding the conduct of macroeconomic policy can be traced either to differences in their values as to how economies 'should' be structured, or differences as to how economies 'are' structured. Whilst on the surface it would appear that economists differ markedly in the relative importance they attach to such items as having single- rather than double-digit rates of inflation;[3] the distress associated with high unemployment;[4] or the benefits to be derived from a higher rate of economic growth;[5] such differences often prove on closer examination to derive from disagreements about the way economies *are* structured. Thus, different views as to the priority to be attached to policies to reduce the rate of inflation often derive from different estimates of the costs of living with say a 15 per cent as opposed to a 5 per cent rate of inflation; different views as to the importance of taking macroeconomic policy measures to reduce unemployment often reflect different theoretical positions regarding the extent to which unemployment is caused by microeconomic factors, such as real wages or unemployment benefits being 'too high', as opposed to macroeconomic factors, such as aggregate demand being 'too low'; even differences concerning such as the importance of achieving a higher rate of economic growth turn in part on differences regarding the efficiency of resource allocation systems in discouraging any 'bads' which arise from economic growth.

The view taken in this chapter is that the main source of disagreement amongst academic economists arises from 'is' questions rather than 'ought' questions. No doubt there are differences in moral and political judgements amongst academic macroeconomists, but we would argue that such differences do not loom large in relation to the disagreements which concern the way economies *do* work as opposed to how they *should* work.

So far we have only considered the reasons for disagreement amongst *academic* economists. Surely once we come to consider politicians and other amateur economists, disagreements over values or 'ought' questions come to play a dominant role? Even here, however, it is plausible to argue that disagreements over 'is' questions play at least as important a role. The following concluding remarks from Maynard Keynes' *General Theory* make precisely this point:

Is the fulfilment of these ideas a visionary hope? Have they insufficient roots in the motives which govern the evolution of political society? The ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed the world is ruled by little else. Practical men, who believe themselves to be quite exempt from intellectual influences, are usually the slaves of some defunct economist. Madmen in authority, who hear voices in the air, are distilling their frenzy from some academic scribbler of a few years back. I am sure that the power of vested interests is vastly exaggerated compared with the gradual encroachment of ideas. Not, indeed, immediately, but after a certain interval; for in the field of economic and political philosophy there are not many who are influenced by new theories after they are twenty-five or thirty years of age, so that the ideas which civil servants and politicians and even agitators apply to current events are not likely to be the newest. But, sooner or later, it is ideas, not vested interests, which are dangerous for good or evil.[6]

Appraising economic theories

Given our argument that the main disagreements amongst macroeconomists arise from differences in view as to the way economies work, are there rational grounds we can state for preferring one theoretical conception, as to the way economies work, to another? The orthodox answer to this question among economists is that 'positive' economic theory is concerned with the derivation of testable hypotheses about the economic world and with attempts to falsify such hypotheses.[7] This is the *falsificationist* methodological position outlined by the philosopher Karl Popper. As far as the *appraisal* of competing theories in macroeconomics is concerned, this methodological position would have us proceed as follows.

In advance of testing - this is *prior appraisal* - we should prefer one theory T to another theory T' if T makes more falsifiable claims about the economic world than T', that is if T makes more precise claims about a wider range of economic phenomena than T'. After testing our theories - this is *posterior appraisal* - we are instructed to prefer T to T' if (1) T has more *true* consequences or predictions regarding the economic world than T' *and* if (2) T has fewer *false* consequences or predictions regarding the economic world than T'.[8]

Several problems arise with the application of such a method of appraisal in macroeconomics. First, there is the problem that much of