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978-1-107-04293-3 - Expansionary Fiscal Contraction: The Thatcher Government's 1981 Budget in Perspective
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1 The 1981 statement by 364 economists

Robert Neild

In 1981 my colleague Frank Hahn and I wrote a letter criticising Sir Geoffrey Howe's Budget. We intended to send it, signed by the two of us, to *The Times*, but it grew into a 'statement' signed by 364 economists that created rather a stir when it was published. I here recount how that came about and how I now see the episode in retrospect. At eighty-seven, my memories, filtered by age, are clear but of course subjective. I refer to documents and statistics of the period to the best of my ability.

The monetarist debate

The statement was a climax in the Keynesian/monetarist debate, the nature of which it is worth briefly recalling.

Keynes' great contribution to economics was a causal explanation of why aggregate demand in an economy may not match its productive potential with the consequence that there is unemployment – or inflation. In *The general theory*, published in 1936, he thus led us to understand why unemployment had plagued the world in the interwar years.[1] Then in *How to pay for the war*, published in 1940, he estimated how much civilian demand would need to be restrained by budgetary means if war expenditure was to be met without inflation.[2] In doing so, he pioneered the use of national income accounts in macroeconomic management.

With few exceptions, economists accepted his theory. It is logically coherent; it relates to measurable variables (in the national income and expenditure accounts); and it recognises the importance of psychology, in particular the 'animal spirits' of entrepreneurs: it is rational and realistic.

For twenty-five years after World War II budgetary policy was based on demand management using Keynesian analysis: the probable course of

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[1] J. M. Keynes, *The general theory of employment, interest and money* (London, 1936).

[2] J. M. Keynes, *How to pay for the war: a radical plan for the Chancellor of the Exchequer* (London, 1940).

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aggregate demand was forecast, and the balance in the budget was set so as to bring aggregate demand towards the full employment level. The technique was far from perfect but the result was low unemployment, moderate inflation and real growth of 2 per cent a year.

This period of relative economic harmony was shattered in the 1970s when inflation exploded, triggered by sharply higher prices for oil, and by the reaction of the trades unions to the consequent squeeze on real wages. The annual rate of inflation hit a peak of 24 per cent in 1975 and averaged 14 per cent a year in that decade.[3] British governments, reluctant to reduce aggregate demand so as to cause unemployment to the point at which money wages were checked, tried negotiating incomes policies with the trades unions and employers. They had little success: there were strikes and social unrest.

It was against this background that monetarist doctrine was adopted by Sir Keith Joseph and other Conservatives in the 1970s and became part of the policies that were evolved in that period and applied to the economy when Margaret Thatcher came to power in 1979. The dominant evangelist of the doctrine was Milton Friedman. His message, like that of other evangelists, was wonderfully simple. Unions were not to blame for inflation, nor were oil sheiks. It was all the result of excessive expansion of the money supply: '[I]nflation can be mastered. The technical instruments of controlling the money supply are available. The obstacle is lack of political will.'[4] The policy would involve high unemployment only temporarily since the economy, being self-regulating, would soon return to the 'natural rate of unemployment'. The message was supported by a graph or graphs showing that, over time, prices and the money supply move approximately together.

The doctrine had two flaws. First, demonstrating that the money supply and prices move together is no better than showing that the length of life and the number of meals a person has eaten move together: a simple association between two variables tells one nothing about causation. Second, the causal explanations that Friedman offered did not bear scrutiny.

At the beginning of 1980 Frank Hahn and I criticised monetarist doctrine on these grounds in an article in *The Times*, entitled 'Monetarism: why Mrs Thatcher should beware'.[5] We quoted Friedman's view that unemployment would revert to a natural rate, which 'is the level that would be ground out by the Walrasian system of general equilibrium equations, provided there is embedded in them the actual structural characteristics of the labour and commodity markets, including market imperfections', and explained that:

[3] Office for National Statistics, long-term price series CDKO.
[4] M. Friedman, cited by R. R. Neild, 'The meaning of monetarism' ('Economic notebook'), *Guardian*, 30 September 1974.
[5] F. H. Hahn and R. R. Neild, 'Monetarism: why Mrs Thatcher should beware', *The Times*, 25 February 1980.

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(1) in the previous decade mathematical economists had shown that, even if there were no market imperfections, the Walrasian equations could not be expected to produce a general equilibrium with full employment;
(2) the idea that they would do so in the presence of market imperfections, which abound in reality, was even more far-fetched.

We concluded:

> There are neither theoretical foundations nor empirical support for the monetarists' proposition that the real economy is self-regulating and that activity and employment can be relied upon to recover automatically from the present fiscal and monetary squeeze.
>
> It is not our purpose to propound or debate alternative policies here. Indeed we have held different opinions about policy in the past and might well do so again were we to debate it now. Our common concern is that the Government's policy, as well as analysis and debate of alternatives, should not be based on a misleading notion of how the economy works.

In a rather aggressive reply a week later, Friedman accused us of writing about the 'Phillips curve', to which we had made no reference. After this diversion, he went on to say: 'We can know that a bird flies and have some insight into how it is able to do so without having a complete understanding of the aerodynamic theory involved.' He then listed a series of points, to the effect that there was an historical association between money and prices, with variable time lags. Without offering any better causal explanation than that, he reasserted in remarkably strong terms his view that the economy would recover automatically from the monetary squeeze: '[R]educed monetary growth, such as Mrs Thatcher's government is trying to achieve, may increase unemployment temporarily, to be rewarded by a much sharper reduction in unemployment later.'[6]

That was the doctrinal background to our letter. The economic background was that unemployment was rising to levels not seen since the interwar years. Since the war the central objective of economic policy had been full employment, which had come to mean a rate of unemployment of 3 per cent or less, and that had been pretty well maintained until the 1970s. When unemployment rose to 7 per cent in 1980 and to 10 per cent in 1981, I certainly felt morally indignant that the great achievement of modern economics – the creation of full employment in place of the mass unemployment and the misery of the pre-war years, which I could remember – was being betrayed. I believe most economists felt the same. The feelings of the 364 economists were surely roused by the introduction of further fiscal tightening in the 1981 Budget when unemployment was already so high.

There was a further contributory cause, but I hesitate to mention it since it is personal. I do so because it is germane to understanding what

[6] M. Friedman, 'Monetarism: a reply to the critics', *The Times*, 3 March 1980.

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happened. It is that Milton Friedman, who was very clever and made original contributions to economics, was an exceptionally artful debater, whose rhetorical skills in the advocacy of monetarism were such that some politicians embraced him as a saviour offering a painless escape from inflation, while some economists saw him as a charlatan.[7]

At this time I was invited by the BBC to debate monetarism with him live on television. I was forewarned by my next-door neighbour, Elaine Sofer (a sociologist, daughter of Benjamin Graham, the father of modern equity investment theory), that Friedman was a dangerous opponent in debate. She, when helping as a student to organise debates at the University of Chicago, had found that he was a most brilliant and enthusiastic debater. He did not mind being asked at short notice to take part in a debate, and typically would consent before asking what the subject was. If told that it was, say, capital punishment, he would say 'Great! Which side?' and perform brilliantly whichever side he was on. Although forewarned, I found the way he avoided saying what caused the historical association between money and prices, by means of prevarication and mockery, so maddening that I lost my temper with him on the live programme. The shame I felt at making a public exhibition of myself imprinted the episode in my memory.

The relative importance of these three strands of opinion – that monetarism was theoretically incoherent, that unemployment was already shamefully high and that Friedman was behaving as a charlatan – will have differed from person to person; and other considerations may also have been in their minds. But, as I remember those days, these were the dominant reasons why so many economists signed the statement. How it came into being was this.

The statement

After the Budget, Frank Hahn and I, over coffee at the Faculty of Economics (at the University of Cambridge), set about drafting a joint letter to *The Times* criticising its monetary foundations. Others wanted to join in and add their names, until they were so numerous that I telephoned *The Times* to see how many signatures they would publish. Since the number wanting to sign exceeded the limit, the alternative somehow evolved of turning the letter into a statement and inviting economists in all the universities in the country to sign it. I was amazed at the huge response.

The statement, which in essence repeated what Frank and I had said a year beforehand in *The Times*, read as follows.

[7] Paul Samuelson's obituary in *The New York Times* recounted that 'Mr Samuelson said he always had fear in his heart when he prepared for combat with Mr Friedman, a formidably engaging debater. "If you looked at a transcript afterward, it might seem clear that you had won the debate on points," he said. "But somehow, with members of the audience, you always seemed to come off as elite, and Milton seemed to have won the day." M. M. Weinstein, 'Paul A. Samuelson, economist, dies at 94', *New York Times*, 13 December 2009.

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Statement on Economic Policy

The following statement on economic policy has been signed by 364 university economists in Britain, whose names are given on the attached list:

"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 thereby 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."

Analysis

Those who signed include:

a) 76 present or past professors

b) a majority of the Chief Economic Advisers to the Government since the war: Professor James Meade, Lord Roberthall, Sir Alec Cairncross, Sir Bryan Hopkin and Sir Fred Atkinson

c) the President, 9 of the Vice-Presidents, and the Secretary-General of the Royal Economic Society.

The statement was circulated as university terms were ending. The rates of response have therefore been influenced by when term ended, by how dispersed is the community of university teachers in the vacation, as well as by the climate of economic opinion in each university.

Origins

The statement was sent by us to one member of each university on 13 March with a covering letter which said:

"We believe that a large number of economists in British universities, whatever their politics, think the Government's present economic policies to be wrong and that, for the sake of the country – and the profession – it is time we all spoke up. We have therefore prepared the attached statement, cast in terms which we hope will command wide agreement."

A copy of the letter is attached.

F H Hahn
R R Neild

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The aftermath

In March 1984, the third anniversary of the statement, I was one of six of the signatories who were asked to say what they now thought about the statement. The rate of unemployment was then at 12 per cent, which proved to be the peak; it remained above the figure of 10 per cent until the end of 1987. Inflation had fallen from a peak of 18 per cent in 1980 to 5 per cent in 1984. Similarly, the rate of increase in wage rates had fallen from 18 per cent in 1980 to 6 per cent in 1984. A key link in this turnaround was a fall in commodity prices consequent on the decline in demand from the United States, Britain and other industrialised countries as they applied their monetarist deflationary policies.[8] My comment was this:

> I see no reason to modify my view about how the economy works. The levelling-out in activity has been in large part induced by the government relaxation of controls on consumer credit. That's exactly what happened in earlier post-war stop-go cycles. The American recovery, induced by a budget deficit, has helped us too. I suspect that if you disentangle the figures the Chancellor's budget is expansionary.[9]

Today we can judge the budgets of that period by looking at the historical estimates of the cyclically adjusted budget balance, also called the 'structural budget balance', produced by the ONS (see Table 1.1). We can now see that the Budget was expanded by an amount equivalent to 1.5 per cent of GDP between 1981/82 and 1983/84, a significant but not extreme change.

The extent of the tightening that went before is extreme, however. Between 1978/79 and 1981/82 (which reflects the first-year impact of the 1981 Budget) the Budget was tightened by no less than 6.3 per cent of GDP. By far the greater part of that tightening (an amount equal to 4.9 per cent of GDP) was introduced in the 1981 Budget.

Table 1.1 *Cyclically adjusted budget deficit as a percentage of GDP*

1978/79	1979/80	1980/81	1981/82	1982/83	1983/84
4.8	4.0	3.4	−1.5	−1.4	0.0

[8] I am indebted to Wilfred Beckerman for reminding me of the importance of the fall in primary prices.
[9] F. Williams, 'The economic mirage – by "rebel" professors', *The Times*, 30 March 1984.

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The statement in retrospect

Paragraphs (a) and (c) were statements about economic theory. They said that there was no basis in economic theory or supporting evidence for the government's monetarist belief in an automatic recovery, and that there were alternative policies. These, I believe, remain irrefutable propositions.

Paragraph (b) made the prediction that present policies would deepen the depression, with adverse economic and political consequences. In fact, unemployment remained above 10 per cent of the workforce for six years and, as noted above, reached a peak of 12 per cent in early 1984. The depression did not deepen as much as we had predicted; nor did the economy recover within a period consistent with any reasonable interpretation of Friedman's 'variable time lags'. In a vulgar political debate over the consequences of monetarism, the participants might call 'Quits'. Paragraph (d) followed from the others and requires no comment.

To get a better understanding of what happened in this period, economic historians will need to trace causation from the exogenous variables in macroeconomics, the most important of which are actions taken by the government (including the central bank) that influence the level of demand, and changes in demand and commodity prices in the world economy, through to the responses of the economy as recorded in the national income accounts, the monetary statistics and the statistics of unemployment and prices. They will never achieve a perfect explanation but they should be able to do better than I can now.

A few points are worth noting now.

(1) It is clear that, after 1979, many changes in policy were made in pursuit of two aims that were sometimes in conflict: the desire to check inflation and the desire to liberate market forces in the credit markets and other parts of the economy. The expansion of consumer credit that helped to sustain demand in this period is an example.
(2) The Employment Acts of 1980 and 1982 and the Trade Union Act of 1984, which cut the power of the trades unions, must have contributed to the rapid decline in inflation.
(3) The monetarist doctrine of Friedman has now been abandoned in favour of trying to use interest rates to control inflation, not the money supply. It seems to be recognised, implicitly at least, that the money supply is endogenous, not exogenous; a passive indicator of how the demand for loans is going, not a policy instrument. This is a view for which there is ample backing.[10]

[10] This view was implicit in the report of the *Committee on the working of the monetary system* (Radcliffe), Cmnd 827 (London, 1959), paras. 381–98. But the classic explicit statement is by N. Kaldor, 'Evidence to the Treasury and Civil Service Committee', July 1980,

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Conclusion: the veil of monetarism

I now see that monetarism, despite its fallaciousness, served a useful purpose: it provided a veil for the severe deflation that was needed to stop the inflationary spiral of the 1970s.

That the pursuit of full employment might lead to inflation was widely foreseen. For example, William Beveridge, in his 1944 book *Full employment in a free society*, wrote: 'There is a real danger that sectional wage bargaining, pursued without regard to its effect upon prices, may lead to a vicious spiral of inflation.'[11] And, in the same year, the White Paper entitled *Employment policy* warned that '[a]ction taken by the Government to maintain expenditure will be fruitless unless wages and prices are kept reasonably stable... [I]t will be essential that employers and workers should exercise moderation in wage matters.'[12]

When inflation struck in Britain the necessary response was (1) a short, hard dose of deflation and (2) a radical reform of the trades unions. A hard-headed Keynesian analysis, or common sense, would have led to that conclusion. But before 1979 Labour and Conservative governments jibbed at such harsh policies, and so did the great majority of economists – of whom I was one.

Much as I abhor the social philosophy of Margaret Thatcher (and her follower, Tony Blair), I now give her credit for having introduced these two controversial policies that were necessary to check inflation – though I deplore the fact that monetarism so blinded the government that it pressed home deflation too hard and too long.

Monetarism served as a veil for politicians and central bankers in that it permitted them to avoid saying that they were imposing deflation, and therefore causing unemployment, so as to check inflation. Instead, they could say that their aim was to check the money supply so as to stop inflation, with or without the rider that they believed – with Friedman – that temporary unemployment would correct itself. I believe that the Conservative politicians who directed economic policy in Britain at this time spoke to this effect with complete sincerity, since they appear to have been converts to Friedman's faith. But that was not true universally. In the important case of the United States, there is strong evidence that Paul Volcker, who, as Chairman of the Federal Reserve, dominated monetary policy, adopted monetary targets cynically as the only means of getting

reproduced in N. Kaldor, *The scourge of monetarism* (Oxford, 1982), 45–8. See also J. C. R. Dow and I. D. Saville, *A critique of monetary policy: theory and British experience* (Oxford, 1988), 219–22.

[11] W. H. Beveridge, *Full employment in a free society* (London, 1944), 199.

[12] *Employment policy*, Cmnd 6527 (London, 1944), para. 49.

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away politically with the big increases in interest rates needed to check inflation. A fascinating, detailed account by William Greider of how he did this was published in *The New Yorker* in 1987. Greider reports that, when Henry Wallich, a member of the board of the Federal Reserve, was told by Volcker that he proposed to adopt money supply targets, he accused him of making a pact with the devil, to which Volcker replied: 'Sometimes you have to deal with the devil.'[13] A little later in the article, Greider writes: 'The monetarist alternative offered a clever solution to Volcker's internal political dilemma: it would serve as a veil to cloak the tough decisions.'[14] A biography of Volcker published in 2004 gives the same interpretation of his tactics.[15]

[13] W. Greider, 'Annals of finance', *New Yorker*, 9 November 1987, 103. [14] Ibid., 104.
[15] J. B. Treaster, *Paul Volcker: the making of a financial legend* (Hoboken, NJ, 2004), 149, passim. See also W. Greider, *Secrets of the temple: how the Federal Reserve runs the country* (New York, 1987).

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2 The 1981 Budget: how did it come about?

Tim Lankester

The 1981 Budget has a mythological status in the history of Margaret Thatcher's premiership. It was highly controversial at the time because its contractionary stance went in the face of the conventional view that, in a deep recession, fiscal policy should be relaxed, not tightened. No fewer than 364 academic economists wrote to *The Times* arguing just that. Yet, on the surface at least, the critics were proved wrong. The economy started to recover in the quarter following the Budget announcements. Consequently, the improvement in Mrs Thatcher's political fortunes from 1981 onwards is often seen as stemming from this Budget. Whether in reality the Budget was responsible for the economic turnaround and recovery, or whether they happened in spite of the Budget, as has been argued, is addressed elsewhere in this volume.

The aim of this chapter is not to argue the merits and demerits of the Budget but to examine how it came about. What were the views of the key players in the run-up to the Budget – the Prime Minister and her advisers, and the Chancellor, his ministerial team, Special Advisers and top officials – and how were these played out?

The answers to these questions are of interest because they throw light on decision making at the highest level at a critical moment in the Thatcher premiership, and on the clash of economic ideas prevalent at the time. They can also illuminate an old debate about the Budget's 'paternity': who among the principal players can claim primary responsibility for the main Budget decisions?

The case for revisiting the 1981 Budget process

The 1981 Budget has already been the subject of many accounts. Several of the key participants have published their recollections of what happened: Margaret Thatcher herself, Sir Geoffrey Howe and Nigel Lawson in their respective memoirs; and Thatcher's two key advisers in the No. 10

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