Why did Monetarism have so much Trouble in the Early 1980s?: 2. The Public Sector Problem

From an article 'Why has monetarism failed so far?: 2. The public sector problem' in The Banker, *April 1982.*

The article had a straightforward argument. One weakness of monetary control as an antidote for inflation is that it has little effect on the public sector. Since the Government can extract resources from the rest of the economy at will (by taxation or printing money), it has no need to hold money balances. There is no particular connection between monetary growth and public sector inflation. The large size of Britain's public sector (relative to, say, the USA) was therefore one reason for both the obstinacy of the British inflation problem in the 1970s and for the severity of the 1980/81 recession.

The Conservative Government may have failed to control the money supply, but it has succeeded in curbing inflation. The 1981/82 pay round seems likely to finish up in the 6 per cent to 8 per cent area. It will be the lowest since the 1977/78 round, which was artificially and unsustainably depressed at the tail-end of an incomes policy. There can be little doubt that underlying inflationary pressures are weaker now than at any time since the late 1960s.

But has this achievement been bought too dearly? Over the last three years the unemployment total has climbed to three million, while hundreds of thousands more have at some stage or other been worried that they also might find themselves without a job. Too small a reduction in inflation seems to have been gained at too great a cost in terms of lost employment. Moreover, this failure does not matter only to the competing monetarist theologians who have bickered incessantly about the rival merits of different money supply definitions and agonized over the vagaries of sterling M3. It has directly affected many ordinary people. Most of them have no interest in the technical mechanics of monetary control and can be plausibly represented as the innocent victims of a government policy they do not understand. Surely, the critics argue, if monetarism works so badly there must be a better alternative.

There are two ways a monetarist might attempt to answer this charge. The first is to say that no one knows what determines the unemployment–inflation trade-off. But, whereas the Government cannot in the long run control the level of unemployment (which depends on labour market institutions), it is responsible – again in the long run – for the level of inflation (which depends on the central bank's regulation of the money supply). This cogent, but highly pessimistic, interpretation of the economic system was implicit in

Friedman's 1967 exposition of the 'natural rate of unemployment', given as a presidential address to the American Economic Association. The natural rate is that at which there is no tendency for wage increases either to accelerate or to decelerate. It is consistent with stable inflation. 'Unfortunately,' Friedman warned, 'we have as yet devised no method to estimate accurately and readily the natural rate of unemployment.'[1] The corollary was that active attempts to manipulate unemployment beneath the natural rate would lead to ever higher inflation. The right approach was therefore to confine monetary policy to its proper role of achieving price stability. The unemployment repercussions, however dire, would have to be ignored.

The second response is more equivocal. It recognizes that the unemployment–inflation trade-off can be affected by government policy. According to this line of monetarist thinking, the key variable to operate on is inflation expectations. The reasoning is straightforward. If people expect low inflation, the adjustment of behaviour to a fall in inflation from a high level is easy and painless. On the other hand, if they expect rapid inflation, the same adjustment not only takes time, but also tends to be accompanied by setting the 'wrong' prices in product and labour prices. These 'wrong' prices include excessive wages, which then lead to unemployment.

Monetarism was never intended as a form of corporal punishment on the British economy. No one wanted unemployment to reach three million and, as is clear from forecasts made in 1979 and 1980, no one expected it to do so. Whatever some Sunday papers may say to the contrary, all monetarists would have preferred the unemployment–inflation trade-off to be more favourable. The question arises of what went wrong and whether anything could have been done to improve the situation. The argument of this article is that a very important cause of the adverse unemployment–inflation relationship was the movement of public sector wages and prices in the first two years of the present Government's period in office. This suggestion may not by itself be new or controversial. But I want in this article to propose a perhaps more provocative extension: it is that monetary policy has almost no relevance (except at several removes) to the containment of public sector inflation. Original monetarist hopes that the inflation problem could be solved solely by reducing the rate of money supply growth were naive. Because the money supply prescription neglected the public sector, it was incomplete. This is the sense in which monetarism was not – and is not – enough. (Sir Keith Joseph wrote an influential pamphlet *Monetarism is not Enough* for the Centre for Policy Studies in 1978, which argued that control over government spending had to accompany monetary restraint, if inflation were to be brought down. But it did not highlight the problem of public sector wages.)

If the moderation of inflation expectations is necessary to mitigate the unemployment arising from restrictive financial policies, the Government made its first mistake in the June 1979 budget. The increase in value added tax from 8 per cent to 15 per cent had an immediate effect on the retail price index and wage-bargainers regrettably decided to incorporate it in the 1979/80 pay round. This was despite the large accompanying cut in income tax. It should perhaps be said, in the Government's defence, that at the time there was a strong body of informed opinion behind a shift from direct to indirect taxation. For example, the Meade Committee Report for the Institute for Fiscal Studies recommended a big rise in VAT as one part of its proposal to introduce an expenditure tax.

But more serious than the VAT increase was the surge of public sector inflation from mid-1979 until early 1981. It had two aspects. The first was the deliberate raising of public sector prices above the general rate of inflation. In the year to August 1980 the increase of the prices of goods and services produced mainly by the public sector was 26 per cent, while the retail price index as a whole went up by just over 16 per cent. The second was the tendency to grant public sector wage increases much higher than those in the private sector. The evidence on this point is abundant and persuasive. According to official figures published in the Treasury's December 1981 *Economic Progress Report*, the ratio of public to private sector earnings rose from 101.5 (1970 = 100) in 1979 to 108.4 in 1981. An independent assessment in the August 1981 *National Institute Economic Review* had earlier reached similar conclusions.

Retrospective moralizing always sounds smug and patronizing. In this case, it is particularly unhelpful. To say that the Government should have controlled public sector pay and prices better in 1979 and 1980 is all very well, but it shows little appreciation of the local and specific justifications for excessive public sector inflation in those two years. The justifications were usually sound and sometimes compelling. It would have been difficult for any government, even one commanding widespread public support, to resist them. As it happened, the Conservative Government did not command such support and had to acquiesce in numerous pay and price changes it disliked.

The objections to holding down nationalized industry prices were both microeconomic and macroeconomic. In the last two years of the Callaghan administration there had been a politically- motivated failure to raise these prices. A consequent danger was gross resource misallocation with demand being inappropriately encouraged in areas where goods were supplied at beneath cost. The size of the required price adjustment was further aggravated by the second oil shock which pushed up energy bills. Nearly all the nationalized industries in Britain are either energy suppliers or highly sensitive to

the price of energy. In addition to the need to prevent microeconomic distortion, the Government was worried that, if nationalized industries kept prices too low, their deficits would rise and jeopardize its goal of reducing public sector borrowing. Whatever the short-run once-for-all impact on the retail price index from higher nationalized industry charges, a macroeconomic priority was to cut the PSBR as part of the long-run strategy to contain money supply growth and inflation.

If the economic logic behind big increases in public sector prices was convincing, the political expediency of large public sector pay rises was undeniable. The most awkward of these rises stemmed from the Clegg Commission's activities and affected the earnings of groups, such as the teachers, the civil servants and the local authority manual workers, who account for a high proportion of total public sector employment. As the Conservatives had agreed to honour the Commission's awards before the 1979 election, not much could have been done – without patent breaking of pledges – to avoid paying up. In the context of 1979 to 1981, which saw several major public sector strikes anyway, refusal to match the increases recommended by Clegg would have invited at best widespread disruption and at worst open confrontation between the Government and trade unions.

But, however good the reasons for particular public sector wage and price increases, the effect on inflation expectations was very unfortunate. Many nationalized industry price rises were intended to change relative prices, correctly reflecting a sharper increase in the cost of their inputs, like energy, than in other industries. But there is a tendency, particularly in a country as easily swayed by newspaper headlines as Britain, to interpret price movements in certain major industries as symptomatic of a general trend. When 25 per cent or 30 per cent rises in the price of electricity, gas, coal and so on were announced in late 1979 and the early part of 1980, businessmen thought these were indicative of prospective changes in the absolute price level.

They therefore decided that there would not be much of a penalty, in terms of lost sales, if their own prices were hoisted by similar percentages. They soon discovered that they had made a miscalculation. In the second quarter of 1980 demand for nearly all kinds of industrial product collapsed. It was a classic example of government policy causing private sector decision-takers to set the 'wrong' prices. Similar forces were at work in the labour market. Employment in the public and private sectors can be readily differentiated as a matter of definition, but comparisons between the two are frequent and inevitable. Moreover, the functional dividing-line is rather blurred. Many unions are strongly represented in both and expect them to have similar wage levels, while job interchanges are quite common. When large public sector increases took place in 1979 and 1980, private sector employers felt obliged to give similar rises, irrespective of their own ability to pay. Once

again the Government's approach to controlling public sector inflation was responsible for employers and employees deciding 'wrong' prices which, in this case, meant wage levels inconsistent with the preservation of jobs.

The term 'administered prices' has been suggested for those prices set less by market forces than by bureaucratic decision. Although it may be a misunderstanding to think that the prices of any product can be analysed without reference to supply and demand, there is little doubt that many public sector prices and charges are administered, at least in the sense that the people responsible are not much bothered by the subsequent effect on the quantity sold. The Government's programme to raise administered prices in 1979 and 1980 worsened inflation expectations. At the same time, monetary policy was being tightened to slow down the rise in market prices. The conflict between policy towards public sector administered prices and private sector market prices was total. There was a head-on collision between price-making behaviour in the two different parts of the economy. The smash contributed to the biggest increase in unemployment since the early 1930s.

At this stage of the argument an academic monetarist might start to complain. Surely, he would say, the remedy for excessive public sector inflation is the same as for excessive private sector inflation. It is to reduce the rate of money supply growth. There is nothing special or unusual in the problem.

Here is the mistake. What the academic monetarist fails to understand is that much of the public sector is completely immune to tight monetary policy – or to lax monetary policy, for that matter. It is quite easy to identify mechanisms whereby a reduction in money supply growth checks inflation in the private sector. Slower money growth means that companies' bank deposits are not increasing as much as before; they may perhaps be rising at less than the going rate of inflation. If companies continue to raise wages and carry out investment plans on the same scale as previously their balance sheets come under strain. Their most liquid asset – their balance at the bank – may fail to grow in line with their liabilities, notably bank borrowings and trade creditors.

If this mismatch intensifies, they may be bankrupted. Measures to improve the bank balance are therefore necessary. Such measures may include cutbacks in stocks, lay-offs of workers and deferment of investment, all of which are likely to restrain price and wage increases. The nature of the link between a deceleration in money supply growth and slower inflation is fairly obvious in the private sector, whatever the controversy about its strength and timing. But compare this with the public sector. The civil servants in government departments who manage expenditure do not have to worry about a bank balance. They receive their money from the Treasury and the Treasury can borrow at will from the Bank of England. This power to borrow is, of

course, equivalent to a licence to print Bank of England notes. The notes are legal tender and must be accepted as payment for goods.

It follows that most of the government sector does not have to keep bank deposits as a liquidity reserve to meet unexpected bills. It also follows that slower growth of the total amount of bank deposits has no effect whatever on those individuals whose daily task is to control government expenditure. Although monetary policy acts as a powerful constraint on (or stimulant to) businessmen in the private sector, it is useless and irrelevant as an instrument for influencing civil servants in the public sector. A reduction in the rate of money supply growth cannot solve the problem of public sector inflation.[2] Indeed, the situation is rather worse than that. Suppose that the overall inflation rate is 16 per cent – with public sector inflation at 26 per cent and private sector inflation at 10 per cent. (This broadly describes Britain's position in mid-1980.) Unsympathetic journalists and Opposition politicians are bound to deride 'the failure of monetarism', the apparent inadequacy of monetary restraint as a method of lowering inflation; 16 per cent is, after all, a rather disappointing performance.

The only answer an academic monetarist could propose would be to reduce the money supply growth even more. But it is clear from the numbers what would happen. The private sector, already burdened by its inability to offer wages competitive with government employment and by higher electricity, gas, water, transport and other nationalized industry bills, would have to reduce its inflation rate to 8 per cent or 6 per cent. The imbalance between it and the public sector would be exaggerated. More companies would go into liquidation, more workers would join dole queues and, as long as the public sector pressed on with big wage and price increases, more gloomy inflation news would be announced. (This broadly describes Britain's position in early 1981.)

The academic monetarist might protest that money supply control does eventually feed through to the public sector. Government employees will, in their expectations about what constitutes a reasonable wage award, take note of settlements in the private sector, while the sales revenue of nationalized industries is determined largely by business conditions in the economy as a whole. These are fair observations. But there is an implied recognition that monetary policy has its direct and immediate effect on the private sector alone; it is afterwards that the public sector has to adjust. Even when the adjustment comes, it is not because of anxiety about balance sheets, liquidity, interest rates and so on; it is because of earlier anxiety about these variables by private sector decision-takers.

Indeed, a case can be presented that to control inflation in a mixed economy by monetary means is almost certainly unfair to the private sector. The inequity can be mitigated by such devices as 'cash limits' on public ex-

penditure, set in accordance with money supply targets or expected private sector inflation. Another possibility is that a formal incomes policy may be more effective in the public sector than the private, helping to redress the discriminatory impact of monetary policy.[3] Both cash limits and incomes policies can be regarded as virtuous confidence tricks, which would mould expectations favourably and help to stop the private sector setting the 'wrong' prices. Whatever the merits of these particular arguments, there is no doubt that textbook versions of monetarism – both as they were available in May 1979 and as they are available today – are silent about the problem of public sector inflation. This silence is symptomatic of a larger weakness in the monetarist position, a haziness about the precise transmission mechanisms by which changes in the money supply influence changes in the price level. Earlier in the article a brief account was given of how companies might be forced to take inflation-reducing action in response to balance sheet difficulties caused by slow money growth. But this was merely a sketch. In the real world there is a rich diversity of other mechanisms at work.

If the monetarist story is to be persuasive, it should explain how these interact with each other, which is the quickest to take effect, which is the most powerful and so on. Instead, monetarists seem to be preoccupied with what are termed 'reduced form' econometric exercises, which try to discover the relationship between one big number (money national expenditure) and another big number (the money supply), ignoring the thousands of little numbers in between. This habit is partly responsible for the tendency to look at the money national expenditure as a whole and to overlook the contrasting behaviour of its two constituents, public expenditure and private expenditure.[4]

A further dimension of the topic needs to be emphasized. Some influential monetarist research was carried out by the Manchester Inflation Workshop, under Professors Parkin and Laidler, in the mid-1970s. Two of its most insistent themes were that inflation was a monetary phenomenon and that what it termed the sociological school, which analysed wage increases in terms of relative bargaining power, was mistaken.[5] The main drawback to the Manchester view is that it regards all wage increases as taking place in the same institutional environment, which is clearly incorrect. In the private sector, market forces are at work and monetary policy is the main determinant of inflation. But in the public sector, market forces are remote from the bargaining process. The money supply does not matter in settling the pay of civil servants, health workers, teachers and so on, but relative bargaining power does. There are economic techniques for analysing bargaining situations, but no definitive theory has been derived. So it is necessary, unfortunately, to pay attention to sociological variables like the political attitudes of

trade union leaders. This is messy, untidy and not to the taste of rigorous monetary economists, but it is also the real world.

The waywardness of public sector inflation is a nuisance not merely for analytical reasons. It also gives rise to the serious practical question of how it should be controlled. If money supply restraint is not the solution, what is?

The major nationalizations and the establishment of a large permanent public sector were completed during the Attlee administration of 1945 – 51. At that time Labour Party intellectuals had few doubts about the problem of public sector pay. Their judgement was that, with so much of the economy in state hands, it would be possible to replace arbitrary market forces by the sweetness and light of responsible centralized wage bargaining. They hoped that at long last incomes could be determined by the ideal of social justice. Ever since governments and trade unions have squabbled about what 'social justice' involves. For the particular producer group affected it normally means 'more for us' and 'less for them'. The determinant of public sector pay is not sweetness and light, but who is the bigger and better bully.

The downfall of the Heath Government in 1974, after a disastrous contest with the coalminers and narrow defeat in a general election, encouraged the belief that public sector unions are very good at bullying. The memory of this experience was largely responsible for the sharp improvement in the public sector's relative pay, both in 1974 and 1975, and in the period from 1979 to 1981. It is no surprise that the present Government should have been worsted so badly. The advice it received from its friends was 'control of the money supply is sufficient for control of inflation'. They did not warn that control of the money supply is insufficient for the control of inflation arising in the public sector.

The solution, as more people have come to realize, is for the Government to strengthen its bullying position. There are, of course, many illustrations of the likely success of this course of action. In Communist countries, as there is only a tiny private sector, the problem of inflation reduces to the problem of public sector inflation. Governments maintain tight restrictions over the trade unions, which are merely accomplices of political repression, so that the risk of excessive wage demands is eliminated without further ado. In several Latin American countries, again with large public sectors, the power of independent trade unions has been smothered by military dictatorships.

If these examples are reliable, there is no difficulty about curbing inflation even given the dominance of public sector employment. The Government has only to make itself nasty enough. According to opinion polls, trade union leaders are very unpopular in Britain today. Any government, facing insubordination by a powerful public sector group, would probably command

extensive support from the general public if it showed itself prepared to take the necessary counter-measures.

What are these counter-measures? So far British governments have displayed a certain lack of imagination about the methods available. Recently, however, Professor Meade has outlined some possibilities in his book on *Wage-Fixing*. A union which failed to accept the arbitration of an independent pay tribunal and went on strike should, Meade suggests, be subject to certain sanctions. These might include the withdrawal of the right to redundancy money, the impounding of union funds and the payment of supplementary benefits only in the form of loans. Once a government began to go down this path, it is difficult to see where it might stop. In the last resort, it could evict recalcitrant strikers from council houses or end their right to state pensions. If any union thinks that it is necessarily a bigger and better bully than the government, it is making a serious mistake. The record of many autocratic regimes in the Communist world and elsewhere is testimony to this melancholy but inescapable truth.

There is no easy solution to the problem of public sector inflation. A reduction in the size of the public sector would obviously make the area of potential dispute smaller. The implied recommendations are further denationalization and subjecting public sector employees to market disciplines similar to those already operating in the private sector. There might be disagreement about how these disciplines are to be specified, interpreted and applied, but the objective of parity of treatment in the public and private sectors seems reasonable. This approach might be criticized as too 'ideological'. But, if it is ideological to want to remove an active source of social tension which in many countries has contributed to the establishment of political tyranny, then 'ideological' is surely a term of approval.

Public sector inflation is a political issue and it can be tackled only by political means. The failure of monetarism in the last three years owes much to misunderstanding on this point. Monetary policy did curb private sector inflation. But, because public sector wages and prices rose quickly as a result of Government decisions, inflation expectations were stimulated and 'wrong' prices were set in many parts of the economy. This was responsible for the poor unemployment–inflation trade-off – and so for the increase in the jobless total to three million. The hope must be that in the next few years the trade-off becomes more benign. There are cases, such as West Germany in the early 1950s, where unemployment and inflation declined together. The exercise of restraint by public sector unions may be a precondition for a similar outcome in Britain in the mid-1980s. Much depends on the political situation, particularly the result of the next general election.

Notes

1. The concept of the natural rate of unemployment was advanced in Friedman's 1967 presidential address to the American Economic Association. The paper, 'On the role of monetary policy', was reprinted in M. Friedman, *The Optimum Quantity of Money* (London: Macmillan), 1969.
2. The point was strongly emphasized on p. 58 of T. G. Congdon, *Monetarism: an Essay in Definition* (London: Centre for Policy Studies), 1978.
3. The sequence of 'on–off' periods of incomes policy can be interpreted in terms of the differential impact of monetary policy on the public and private sectors. See T. G. Congdon, 'The incomes policy cycle in Britain: an attempt at explanation', *The Banker*, December 1980.
4. The link between money and private expenditure is, however, noted on p. 30 of D. Smith, 'The counter-inflation strategy in historical perspective' in the London Business School's February 1981 *Economic Outlook*.
5. See, particularly, D. Laidler and D. L. Purdy (eds), *Inflation and Labour Markets* (Manchester: Manchester University Press), 1974.