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On lags, nightmares and dreams

No early inflation threat from rapid monetary growth

Economists' lags not always bad news for politicians

The current 10% or so annual growth of broad money cannot be reconciled, in the long run, with inflation of under 2 1/2%. But alarmism about inflation in late 1996 and 1997 is misplaced. There is an old saw about how an economists's lag is a politician's nightmare. But it doesn't always work like that. Experience shows that the inflation costs of a period of rapid monetary expansion and above-trend growth often take a long time, perhaps two or three years, to come through. A financially irresponsible government may secure re-election before the voters find out. The economist's lag becomes the politician's dream.

Inflation will stay down in late 1996 and 1997 despite quite high monetary growth,

The immediate outlook for UK inflation is in fact benign. As the manufacturing sector is suffering quite badly from recession in the rest of Europe, its ability to raise prices has been cramped. The annualised increase in underlying producer prices in the three months to March 1996 was a mere 1.0%, sharply less than in the three months to March 1995, when it was 5.0%. (Underlying producer prices are measured by the producer price index, seasonally adjusted and excluding food, beverages, tobacco and petroleum products.) The CBI monthly trend enquiry for April reported a positive balance of only 10% of companies planning to raise prices over the next four months, much lower than the 18% balance in April 1995 and well down on recent months. So the news on inflation at factory gates may improve further. Retail inflation has not made such good progress, but it is falling. The Government's inflation target is expressed in terms of the twelve-month increase in RPIX (i.e., retail price index excluding mortgage interest costs), which went down from 3.1% last September to 2.9% in March. In the two months of April and May last year RPIX increased by 1.2%, partly because of higher food prices. There is a good chance that this year the increase will be more modest at, say, 3/4% - 1%, which ought to bring RPIX within spitting distance of the "2 1/2% or less" target.

but this is *not* a "miracle"

More fundamentally, pay settlements are still at remarkably low levels. According to the wage surveying organisation, Industrial Relations Services, "the next move in settlements is more likely to be down" than up. This is consistent with the level of national output beingg somewhat beneath trend at present, possibly by as much as 2% of trend output. If so, the UK economy could enjoy several quarters of above-trend growth before inflation accelerates. As growth will still be at trend or beneath-trend in the second quarter, inflation will not be a major policy problem this year or even in 1997. But the likely macroeconomic outcome in 1997 - with above-trend growth accompanied by modest inflation - might create precisely the environment in which politicians boast about "miracles" and indulge in foolishly reflationary policies.

Professor Tim Congdon — 8th May, 1996

Summary of paper on

'Miracle vs. mirage'

Purpose of the paper

As the next general election approaches, the debate on the Conservatives' economic record will heat up. The purpose of the paper is to assess the record, and in particular to identify the points of weakness and strength.

Main points

* **The last 17 years have seen a clear acceleration in the rate of growth of manufacturing productivity, which has put the UK close to the top of the growth league tables. This is fairly described as a "miracle" by previous UK standards.**

* **But the upturn in manufacturing productivity growth has not been accompanied by a similar improvement in the trend growth rate of GDP, mainly because of changes in the composition of the labour force.**

* **The two key changes in labour force composition have been an increase in part-time working at the expense of full-time working and a rise in the proportion of female to male employment. There has been a particularly sharp decline in the proportion of men in late middle age at work or in the labour market.**

* **If the number of men at work and the proportion of part-time to total employment were the same today as in 1979, gross domestic product would be 10% higher than it actually is. The Conservatives' record would undoubtedly be judged much more favourably than is actually the case.**

* **The main cause of the decline in labour force participation by men in late middle age is the destruction of incentives to work by the UK's tax and social security systems. The financial system - so strongly criticised in Mr. Will Hutton's *The State We're In* - is not to blame.**

This paper was written by Professor Tim Congdon.

Miracle vs. mirage

An assessment of the Conservatives' economic record

17 years of radical change: has there been any gain?

Whatever happened to the Thatcher economic "miracle"? Has it turned into the widely expected mirage? Was Mr. Kenneth Clarke right when he said in the 1995 Budget speech that Britain could become the home of the enterprise culture in Europe? These are basic questions about Britain's political economy. Whatever else might be said about the present Government, there is no doubt that the past 17 years have been a period of radical change. Privatisation, trade union reform and deregulation have had a revolutionary impact in many industries. As the next general election draws closer, political debate will be increasingly influenced by analyses of whether all the upheaval has damaged or benefitted the economy.

Three themes,

i. productivity miracle in manufacturing,

but ii. not in the economy as whole

This paper has three themes. First, it argues that over the last 17 years one part of the economy, manufacturing, has seen a considerable and highly beneficial change in the policy environment. The response has been favourable, with a clear acceleration in the rate of productivity growth. It is not silly to call this improvement "a miracle". Secondly, the acceleration in productivity growth has not been accompanied by a similar gain in the rate of growth of national output. The reason for the discrepancy is not that the number of people in work has declined, but that the composition of the labour force has changed. If different labour force trends had prevailed, the upturn in productivity growth would have led to the UK today having up to 10% more national output than it actually has.

because of iii. adverse changes in the composition of the labour force

Thirdly, the changes in the composition of the labour force - essentially, a move from full-time to part-time working, and a rise in the proportion of female to total employment - are to be explained by the tax and social security system, and perhaps also by the structure of pension provision. Contrary to claims made in Mr. Will Hutton's book *The State We're In*, the UK's failure to capitalise on the manufacturing productivity miracle is not due to weaknesses in its financial system. Since 1979 the UK's financial markets have superintended a higher ratio of the capital stock than before because of privatisation. Despite Mr. Hutton's remarks about the alleged inadequacies of the City of London, the efficiency of the UK's capital stock has increased strongly, more so in fact than in any other OECD country. If the UK is to translate the productivity advances in its manufacturing sector into higher economic growth overall, the priority is to address disincentives to labour force participation caused by tax and social security arrangements. "The City" is the wrong target, and meddling with long-established and successful financial institutions would be a grave mistake.

i. Productivity miracle in manufacturing

The analysis starts with a review of manufacturing productivity. The supply-side reforms implemented over the past 17 years have undoubtedly led to an acceleration in the rate of productivity growth (i.e., in output per person and per person hour). Indeed, it was so pronounced in the 15 years to 1994 that it put Britain virtually at the top of the league of manufacturing productivity growth for the OECD area, which includes all of the world's most advanced industrial economies. The contrast with previous periods since 1945 - when Britain was routinely at the bottom of such tables - is very marked. In this sense the period of Conservative rule has seen a miracle. Moreover, the upturn in productivity growth extends into the early 1990s, spanning both the Thatcher and Major premierships. The key facts are set out in the table on below, from an article by Mr. Nicholas Oulton in the *National Institute Economic Review*.

Improvement most obvious in international comparisons

In the period 1960-73 the growth rate of manufacturing productivity in Britain was the lowest of all the countries cited except the United States. In the period 1973-79 performance was even worse, with a sharp drop in productivity growth compared with the preceding 13 years and Britain at the very bottom of the list. In the period 1979-94, however, Britain was second out of the 12 countries (just behind Japan) and the productivity growth rate was four times that of 1973-79. In his article Mr. Oulton is cautious in his comments on this apparently startling change in relative performance. He notes, for example, that the growth rate in the 1960s and early 1970s was similar to that achieved under the present Government, and - on this basis - the post-1979 record would be better described as a "recovery" than as an "improvement". The change in the UK's position in the league tables is mainly due to a deceleration in productivity growth in other countries, not to the acceleration here. He also warns that the gains in productivity have not been matched by similar gains in output, because manufacturing employment has declined.

Level of productivity in manufacturing now similar to that in Germany and France

Yet Britain appears in recent years to have done well, compared both with its own past and with its industrial competitors. The level of output per head in manufacturing may now be only slightly behind that in Germany and France, and is probably somewhat above the average in the European Union. There is no longer any reason for the British to suffer a national inferiority complex on this score. (In some sectors such, such as food manufacturing and the steel industry, British output per head is well ahead of that in Germany.) The productivity recovery has transformed Britain's underlying competitiveness.

Growth of output per hour in manufacturing

% per annum	1960-73	1973-79	1979-89	1979-94
United States	3.28	1.41	2.34	2.47
Canada	4.44	2.03	1.45	1.81
Japan	9.59	5.15	4.58	4.18
Belgium	6.69	5.83	4.16	3.73
Denmark	6.22	4.09	1.28	1.68
France	6.55	4.39	3.28	3.04
Germany	5.17	4.21	1.83	2.22
Italy	6.14	5.60	3.86	3.91
Netherlands	7.15	5.32	3.40	3.04
Norway	4.69	2.21	2.03	2.06
Sweden	6.25	2.35	2.53	2.87
United Kingdom	4.14	1.01	4.13	3.95

Source: Oulton 'Supply side reform' *National Institute Economic Review*, November 1995

Direct wage costs in Britain are much the same as in France and considerably lower than in Germany. If everything else were equal, the approximate equivalence in output per head would imply unit labour costs in Britain similar to those in France and less than those in Germany.

and labour costs are lower

But everything else is not equal. Largely as a result of the Conservative Government's struggle to curb the public sector, the ratio of government expenditure to national output in Britain is now almost 8% lower than in Germany, and almost 15% lower than in France. The burden of some taxes - such as value added tax - is roughly equal in the three countries owing to EU harmonisation. With expenditure lower but some taxes the same, other taxes have to be much lower in Britain. The big difference is concentrated in social security contributions, particularly those paid by employers. Whereas employers' contributions in France amount to more than 12% of gross national product, and in Germany to almost 8%, the figure in Britain in less than 4%. As a result, total labour costs per unit of output are significantly lower in Britain than in its continental neighbours. Logically, Britain has become host to many large direct investments from overseas, whereas Germany's direct investment in other countries in 1995 will be five times as large as other countries' direct investment in Germany.

Gains in manufacturing despite cut in state support

In one respect the advance of British manufacturing is surprising, even paradoxical. In the early 1980s the rhetoric of the Thatcher Government was widely regarded as anti-manufacturing and pro-services. There was alleged to be a particular bias towards financial services in the City and against basic manufacturing industries. In line with these preferences, state aid to industry has been slashed. Government expenditure on trade and industry in the current financial year will be lower, even in money terms, than in 1979/80. Yet manufacturing performance has been impressive, with productivity growth significantly higher than in service industries. Despite the removal of billions of pounds of state support, manufacturing is in good shape.

or because of it?

Of course, the advocates of the kind of policies pursued over the last 17 years - reduced state aid, a deliberately more competitive environment, privatisation, and the infusion of more robust and better-motivated management in (what remains of) the state sector - would see nothing strange in the conjunction of less interventionism and more growth. Whereas in the 1970s industry was being killed by the kindness of excessive state handouts, in the 1980s it has been revitalised by the harshness of a more free-market approach. Anti-interventionists would say that the elimination of state support ought to be followed by a shift of resources from inefficient to efficient industries, with positive effects on productivity. This, it seems, is precisely what has happened. The notion that Britain's economic miracle (if such it be) is substantially a manufacturing miracle may be difficult to accept, but the facts are compelling.

A puzzle remains. The undoubted progress in manufacturing - where output per head has virtually doubled since 1979 - does not seem to have been accompanied by a comparably spectacular improvement in living standards.

Manufacturing productivity has doubled, but not GDP

The UK's GDP in 1995 was about 35% higher than in 1979, not double the 1979 level. What has gone wrong? Why hasn't the manufacturing miracle bolstered the aggregate performance of the economy? What, if anything, has gone so badly wrong elsewhere in the economy that the gains in manufacturing appear to have been dissipated?

ii. Adverse effects of changes in labour force composition

Here we come to the second theme of this paper. Part of the explanation for the divergence between manufacturing and the whole economy is simple. Over the past 20 years manufacturing has always been less than a quarter of the economy. So a rise in manufacturing productivity growth, no matter how spectacular, cannot generate a miracle for the whole economy. There must also be a higher growth rate of productivity in services, construction, farming and so on. As it happens, productivity growth in these other activities has been much the same under the present Government as before.

Some arithmetical benefit from faster manufacturing productivity growth ought to have come into GDP growth

But the transformation of British manufacturing ought still to have had some impact, even if only a marginal one, on the growth rate of total national product. With manufacturing productivity growing at 4% a year since 1979 compared with 1% before, and with manufacturing representing more than a fifth of the economy, the growth rate of gross domestic product ought to have been boosted by about 1/2% to 3/4% a year. Unfortunately, recent growth trends suggest that this has not happened. While there is room for debate about the amount of spare capacity (if any) currently in the British economy, the behaviour of the key data is more consistent with the idea that the trend growth rate since 1979 has been 2 1/4%, or at most 2 1/2%, than with the claim that it has been nearly 3% a year. (The actual growth rate between 1979 and 1995 was slightly under 2% a year. But 1979 was at the peak of an economic cycle, whereas in 1995 GDP was probably more than 2% beneath its trend level. Arguably, 1983 and 1995 were years at roughly the same point in the cycle. Between them GDP grew at 2.3% a year, bang in line with prevailing consensus on the UK's long-run average growth rate.)

but it has not

So what has gone wrong? Why has the revolution in manufacturing not been followed by an increase in Britain's overall growth rate? The question becomes even more pointed when it is noted that the number of people at work today is much the same as it was 17 years ago, at about 25 million. If output per head in manufacturing has almost doubled, why has there not been some positive effect, however small, on the growth of total output? Has productivity growth outside manufacturing actually deteriorated under the Conservatives? In an accounting sense, it is true that the growth of output per head in the dominant non-manufacturing part of the economy has been slower since 1979 than was typically the case in the preceding 30 or 40 years. But the productivity of the same type of worker doing the same kind of non-manufacturing job for the same length of time each week has, on the whole, been increasing at much the same rate over the last 17 years as before.

The trouble is that the type of worker, the nature of work and the length of the average working week have all been changing. The composition of the British

The trouble has been the changing composition of the labour force, with

working population today is quite different from what it was in 1979. This change in labour-force composition goes far to explain the disappointing growth of national output. To understand the importance of changing labour- force composition, a perhaps audacious generalisation has to be made. This is that the most productive type of worker is a male working full-time between the ages of 35 and 65. In the era of officially sponsored equality between the sexes and of government blessing for flexible part-time working, this generalisation may seem controversial. However, it is amply confirmed by all surveys of individual workers' pay, including the annual *New Earnings Survey* prepared by the Department of Employment. The latest NES, carried out in April 1995, showed that on average women work slightly fewer hours than men and earn 72% as much. Meanwhile, part-time employees typically work about 15 hours a week, compared with almost 40 hours a week for full-time employees. Part-time workers' earnings are only slightly more than a third of those of full-time workers.

Assume that the differences in pay reflect underlying differences in productivity. (This too may seem a little presumptuous and offend the feminist lobby, but the alternatives are arbitrary and less plausible.) It is then easy to show that the change in the composition of the British labour force since 1979 has significantly reduced national output. First, in June 1979 60% of the workforce were men, but in June 1995 this has fallen to 55%. Whereas the number of men at work has fallen by about 1.25 million over the past 16 years, the number of women has increased by about 1.25 million. With the total number of both men and women in work taken as given, the shift towards greater female employment since 1979 has reduced national output by almost 1.5%. Alternatively, if the number of men employed today were the same as in 1979, total employment would be 1.25 million higher than it actually is, and national output would be increased by roughly 6%.

a. fewer men at work and more women, and

b. more part-time workers and fewer full-time workers

Secondly, the role of part-time employment has doubled to more than 12% of total employment in the 17 years of Conservative rule. As part-time workers are about a third as productive as full-time workers, the expansion in the part-time share has cut national output by perhaps 3 1/2% to 4%. The changed composition of the workforce can therefore be "blamed" for a loss of national output of somewhere between 5% and 10%. (To reach the 10% figure, the losses because of both less male employment - i.e., 6% of national output - and more part-time employment - i.e., 3 1/2% to 4% of national output - are added together.) The precision of the 10% figure is a little misleading and should not be over- emphasized, because it depends on the preferred assumption about "what might have happened, but didn't". But, even allowing for all the inevitable uncertainties of any discussion about counter-factuals, there can be little dispute that the shift towards more female employment, the decline in male employment and the growth in part-time employment have reduced Britain's growth rate relative to what it might otherwise have been.

Indeed, the 5% to 10% loss of output due to the changed composition of the workforce equates over 16 years to a loss in the annual national growth rate of

The loss from the change in labour force composition cancels the gain from the manufacturing productivity miracle

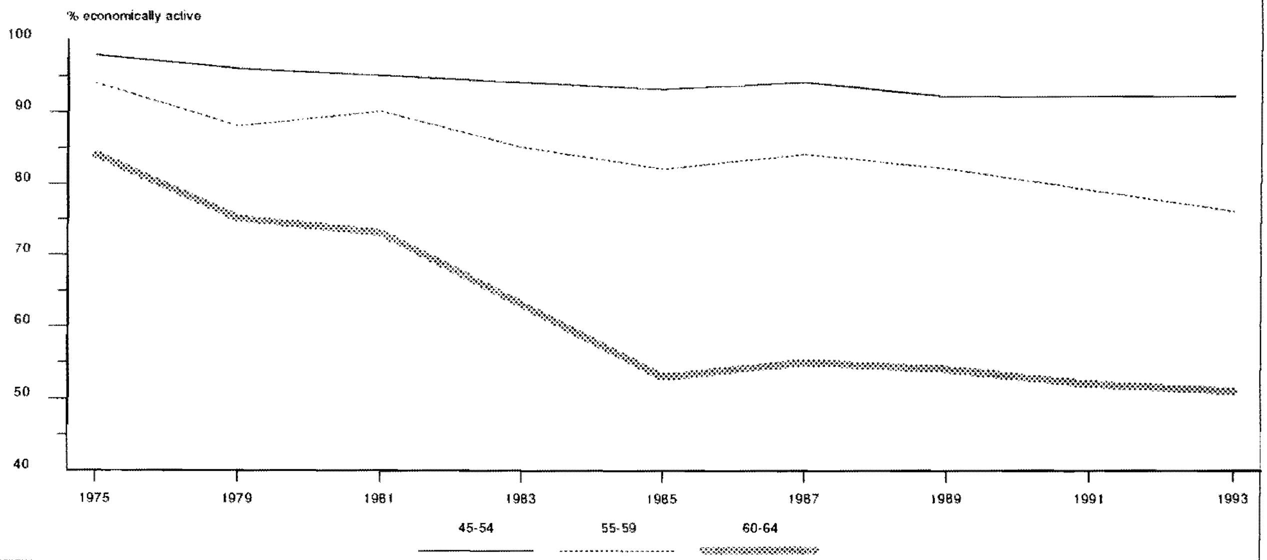
0.3% to 0.6%, roughly matching the gain that ought to have resulted from faster growth in manufacturing productivity. When a further allowance is made for higher unemployment, it becomes clear why the manufacturing miracle has failed to boost Britain's overall growth rate. This is a crucial result. The standard left-of-centre interpretation of the economic policies of the Conservative period - the sort of interpretation given by Mr. Will Hutton in *The State We're In* - would hold no credibility if labour force composition today were as it was in 1979. If labour force composition had remained stable, there is no doubt that the Conservatives' economic record would today be judged a success. Indeed, in international comparisons the UK would seem to be in an outstandingly good position, with its trend growth having increased to about 3% a year whereas across the OECD area trend growth rates have otherwise declined to under 2 1/2% a year and, in some cases, under 2% a year. The divergence between the UK, where so-called "Thatcherite" policies have been implemented, and its continental neighbours, where they have been eschewed, would be particularly evident.

Tragic loss of employment of men in late middle age

What follows from this? The key point is that, because Britain has failed to retain enough middle-aged men in full-time employment, it has been unable to translate very substantial manufacturing productivity gains into a general strengthening of its economic performance. Too many men have stopped full-time work just as they ought, in the second half of their careers, to have been most productive. To some extent they have been replaced by lower paid and less productive women. There is a sanguine view that people are taking out the benefits of increased productivity in earlier retirement and shorter working weeks. But a more realistic and pessimistic interpretation is that the productivity gains in manufacturing have been achieved only by heavy redundancies of skilled and able men.

Declining participation for men over 45

Chart shows economically-active men as % of all men in the three age groups.



One conclusion is definite. The Conservatives' policies of privatisation, deregulation, trade union reform, and the ending of subsidies and undue government intervention in industry, have boosted the efficiency and international competitiveness of British manufacturing. The weakness in Government's policies has not been here, but in the failure to keep a sufficiently high proportion of men in full-time employment. The problem has been most severe for men in late middle age, where the decline in employment (in relation the population in the age group) since the 1950s has been dramatic.

Falling employment among men in late middle age, but rising employment for younger age groups

Some of the evidence is provided in the chart on p.8. In the 1950s over 95% of men in the 50-59 age group were in work; even in the 1960s over 95% of men in this age group were economically active (i.e., in work or unemployed, but seeking work). But the proportion of economically-active men to all men in the 50-59 age group tumbled from 94% in 1975 to 82% in 1985 and 76% in 1993; in the 60-64 age group it collapsed from 84% in 1975 to 53% in 1985 and then held broadly steady over the following decade. By contrast, the proportions of all men in employment between 25 and 34, and between 35 and 49, fell in the same eleven-year period only from 85.2% to 84.7%, and from 88.3% to 86.5%, respectively. It is implausible to attribute this difference in the age incidence of declining labour force participation to a general lack of aggregate demand. The divergence between male and female employment patterns is also striking. Whereas in 1984 58.5% of all women between 16 and 59 were in employment, by 1995 the ratio had climbed to 65.9%. The increase in the employment ratio was highest in the 25 - 34 age group, where the proportion of women in employment was 53.0% in 1984, but no less than 66.4% in 1995. Because of this surge in female participation, the employment ratio for men and women combined in this age group went up from 69.2% in 1984 to 75.7% in 1995. Again, given this fact, it seems thoroughly unconvincing to ascribe unemployment solely on a lack of aggregate demand.

iii. Tax and social security systems are inefficient

Structural features of tax and social security, not lack of demand, cause loss of employment

Instead structural characteristics of the labour market seem mainly responsible for the persistence of a rather high overall unemployment rate. (The unemployment rate, on the definition used by the International Labour Organization, was 11.7% in the spring of 1984 and still 8.6% in the summer of 1995.) In particular, the failure to retain late-middle-aged men in employment may be due, for the most part, to perverse work incentives created by some of Britain's arrangements for protecting people from unemployment and other misfortunes, and providing for their old age. Many analyses of these arrangements have been published, with a wide variety of conclusions. There is no single, simple idea which gives some sort of thematic unity to the subject. However, three aspects of the social security system are widely recognised as discouraging full-time labour force participation by men in middle and late middle age.

a. effect on incentive to work of higher housing benefit

First, since 1979 the Government has increased council house rents towards "market-clearing levels", whatever they might be. The aim, which has been partly achieved, has been to stimulate the growth - or at any rate to arrest the decline - of the private rented sector. The impact on the incomes of the less welloff households who live in council houses has been offset by increases in housing benefit. But housing benefit has the characteristic that it is reduced more or less pound for pound when an unemployed person resumes work, and increases his or her income from employment. There is no point resuming work. Paradoxically, the effect of trying to encourage market forces to work better in the housing market has been to make them work worse in the labour market.

b. and of invalidity/incapacity benefit

Secondly, invalidity benefit was introduced in its present form in 1971. It is higher than unemployment benefit and, unlike unemployment benefit, it is tax-free. Like housing benefit, it is reduced if people somehow regain their health and return to work, on either a full-time or part-time basis. In 1978/9 there were 600,000 invalidity pensioners, whereas in 1992/3 there were 1.5 million of them. Invalidity benefit has recently been replaced by incapacity benefit, which is supposed to apply more objective criteria to determine eligibility, but newspaper reports suggest that cost savings have been modest. As national health standards have improved since 1979, and as expectations of life have actually increased for people in their 50s and 60s, the question has to be asked, "are all these people really unable to work?". At any rate, the availability of invalidity/incapacity benefit has reduced the incentive for people "with a health problem", but not desperately ill, to find a job.

c. and of means-tested benefits, generally

Thirdly, a well-known weakness of means-tested benefits is that their potential recipients realise that they will not qualify unless they are sufficiently poor, in terms of either income or wealth. For example, the state does not meet nursing home costs for people with assets above a certain level, while housing benefit and council tax benefit are not payable if savings are over £16,000. Unemployed people in late middle age, aware of these features of the welfare state, are unlikely to be as keen to seek new jobs as they might otherwise be. (These three weaknesses of the British tax and social security system are discussed in Hermione Parker's *Taxes, Benefits and Family Life: the Seven Deadly Traps*, published by the Institute of Economic Affairs last year.)

Also present pension arrangements may be partly to blame

Also worth mentioning as an influence on redundancies of employees in late middle age is the UK's standard corporate pension scheme, giving a pension related to final salary. The cost to the employers of making appropriate provision for such people is often much higher than for younger employees of equal productivity, partly because people in late middle age may be at the top of salary scales. When redundancies are required, companies therefore decide to concentrate them on employees over the age of 50. Further, job applicants over the age of 45 or 50 are unattractive to prospective employers because the build-up of pension liabilities is more onerous than for younger applicants. The current moves away from defined-benefit to defined-contribution pension schemes, and from occupational pensions in company schemes to personal pensions, should overcome these drawbacks of the current system, but it will take many years before personalised and defined-contribution pension arrangements supplant the well-established corporate schemes.

The central policy message of the analysis here is readily summarised. If the

UK is to translate good progress in manufacturing productivity into a faster growth rate of GDP, the priority is to alter those features of its tax and social security arrangements which have caused, and are still causing, a decline in labour market participation among men in middle and late middle age. Contrary to a great deal of newspaper commentary, much has already been achieved since 1979 in dealing with the British economy's supply-side failures. But over the long run the rise in life expectancy will impose extra costs on the economy, in the form of both higher payments to the retired and greater expenditure on health care. There is only one way to prevent these costs becoming too burdensome. Because people are living longer, they must also spend longer in productive employment. But at present the average working life is becoming shorter. The Government - whatever its political hue - must consider whether tax and social security structures need to be changed to halt this truncation of the average working life.

Tax and social security system has hindered labour markets participation and been Achilles heel of UK economy

UK's financial system not the problem

The UK's financial system is entirely the wrong target. The last 17 years have seen a large shift from state ownership to private ownership in the commercial part of the economy. (A similar move may also be under way in the non-commercial area, with the formation of NHS trusts which could at a later date be privatised. But this possibility will no doubt be stopped if the next Government is Labour.) In 1981 1,867,000 people worked in public corporations, whereas in 1995 it was only 442,000 (excluding the NHS trusts). Privatisation revealed huge areas of inefficiency and waste in every corporation which had formerly been in public ownership. As the conventional disciplines and incentives of shareholder-owned companies began to apply, the inefficiency and waste were reduced. A significant proportion of the increase in manufacturing productivity growth since 1979 reflects such efficiency gains since privatisation. Given this pattern, which is well-known and uncontroversial, it is bizarre to attack "the City" for the Conservatives' failure to boost the rate of GDP growth.

UK has been efficient in its use of capital

The clincher here is provided by data from the OECD which look at the percentage annual change in factor productivity since 1960. The numbers are set out on p.12. One striking feature of the table is that capital productivity (i.e., output per unit of capital invested) is estimated to have declined sharply in Japan over the 34 years to 1994 and to have declined also, but less spectacularly, in Germany. The declines in capital productivity have been much less in the UK and the USA than in Japan and Germany. So - contrary to the misleading claims made by Mr. Will Hutton in *The State We're In* - the Anglo-American shareholder style of capitalism has made better use of capital than the Germano-Japanese style with its long-term bank lending, absence of hostile take-overs and reputed stakeholder characteristics. (This is not to deny that the stock of capital grew more rapidly over the 34 years in Japan and Germany than in the USA and the UK, and that the faster growth in the number of units offset the adverse effect of the greater decline in efficiency per unit. But in the 1990s it has become clear that the Japanese financial system over-invests and consequently mishandles capital resources.)

particularly since 1979

Perhaps the most decisive point made by the table, however, is in the ranking of the UK since 1979. As with the growth of manufacturing productivity, it is top of the list in the latest period. Capital productivity has increased in the UK since 1979 by 0.5% a year, the best performance in the G7 and, in fact, in 20 countries surveyed by the OECD. (See p. A68 of the OECD's December 1995 *Economic Outlook.*) As the UK's financial system has assumed greater responsibility for managing the nation's capital stock, so the efficiency of that management has increased. The gains have - over the 15 years considered by the OECD - been greater than in any comparable industrial society.

If certain labour force characteristics had been held constant since 1979, UK's GDP today would be 10% higher

The conclusion of this paper is therefore that the central weakness of the Conservatives' supply-side policies has been the failure to maintain high levels of full-time labour force participation. If the split between full-time and part-time work today were as it was in 1979, and if the number of men at work also matched the 1979 level, the well-established acceleration in the growth of manufacturing productivity would have been accompanied by a smaller but still vital acceleration in the trend growth rate of GDP towards 3% a year. GDP in 1995 would therefore be 10% higher than it actually is. The supply-side failure of the last 17 years has not been inefficient use of capital because of the alleged "short-termism" of the UK's financial system. On the contrary, the capital stock has been better managed in the last 17 years than before, and extremely well-managed by international standards, as private ownership has been extended and the usual financial market disciplines have been enforced on managements. The UK's key weakness on the supply side has been the decline in labour force participation, particularly among skilled and experienced men in middle and late middle age. Certain features of the tax and social security system are probably the cause of this decline in participation. The system needs a thorough review by the next Government, whatever its political complexion

Tax and social security must be reviewed

Change in capital productivity

Chart shows % change, at annual rate, in capital productivity (i.e., output per unit of capital), as calculated by the OECD. (See Annex Table S9 of the December 1995 issue of the OECD's *Economic Outlook*.

	1960-73	1973-79	*1979-94*
UK	-0.3	-1.5	*0.5*
USA	0.2	-1.3	*-0.5*
Germany	-1.4	-1.0	*-0.6*
France	0.6	-1.0	*-0.6*
Italy	-0.4	0.3	*-0.9*
Japan	-2.6	-3.4	*-1.9*
Canada	0.2	-1.0	*-2.5*