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GERRARD

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Sudden return of "feelgood" factor

Economic background to next general election becomes more interesting

Several news items point to return of "feelgood" factor,

Several items of news suggest that the "feelgood" factor is returning. This is not a surprise, as most forecasters have been saying for a long time that various windfalls (notably because of building society de-mutualisation) and tax cuts would help consumer sentiment in mid- and late 1996. However, the change in mood seems to have happened rather suddenly, which is puzzling. (People have known about the windfalls and tax cuts for many months.)

such as MORI's "Mood of the Nation" index,

a better housing market

and reports of rising sales of durable household goods, furniture and carpets

An index of the "Mood of the Nation" prepared by MORI Financial Services is particularly striking. It jumped from 91 in March to 106 in April, which - according to MORI's British Public Opinion - was "easily its biggest monthly change and the first time it has ever exceeded its baseline of 100 set in April 1993". The revival of optimism has helped the housing market. The April survey from the House Builders Federation recorded the largest positive balance of companies with higher net reservations, compared with the year-earlier figure, since mid-1994. Last month the Halifax house price index rose again to stand 4.3% up on the recent trough in July 1995 and to reach the highest level since August 1992. (The number of "negative equity" households must therefore have declined significantly since last summer.) Meanwhile the CBI Distributive Trades Survey highlights some fascinating developments, which contrast markedly with the gloom of the trends enquiry for manufacturing. Every month a % balance is prepared of retailers with sales higher rather than lower a year ago. In April the positive balance for durable household goods retailers was a massive 73% and for retailers of furniture and carpets 64%. The corresponding figures in April and May 1995 for durable goods were 17% and 20%, and for furniture and carpets 30% and minus 65%. (It is possible that much of the current upturn in buying is not coming into the official retail sales figures, because an increasing proportion of spending is direct with wholesalers instead of via retailers. This is particularly true of boom areas, like computers and related equipment.)

No case for lower interest rates

The apparent surge in buying interest for durable goods, furniture and carpets is important, because these big-ticket categories of spending are classic leading indicators for the economy as a whole. This fits in with the view that at some point in late 1995 or early 1996 demand and output in the economy as a whole will start growing at an above-trend rate. Admittedly, conditions are still difficult in many manufacturing businesses at present, partly as a by-product of the recent recession in our European neighbours. But the case for another cut in interest rates seems unconvincing.

Professor Tim Congdon 4th June, 1996

Summary of paper on

'How much will the general election matter?'

Purpose of the paper

A widely-held view is that the expected Labour victory at the next general election will not lead to much change in the economic outlook. The paper reviews the economic record of the present Government over the last 17 years, to judge whether the long period of Conservative rule has made any difference to the UK's economic situation.

Main points

* **Subsidies are smaller now as a share of GDP than at any time in the post-war period. As subsidies cause resource misallocation, this is a sign of better microeconomic policies compared with the Labour Government of the mid-1970s. (See p. 3.)**

* **Partly because of the success in curbing subsidies, public spending is lower as a share of GDP in the UK than in the three other large European countries. (See p. 6.)**

* **Taxes also are now lower as a share of GDP in the UK than in the three other large European economies. (See p. 7.) Indeed, the excess of the tax/GDP ratio in these three countries over that in the UK is greater than the excess of the tax/GDP ratio in the UK over that in Switzerland. (See p. 8.)**

* **The difference in the tax burden is particularly marked in social security contributions, which are less than half as high (as a % of GNP) in the UK as in Germany, France and Italy. This is one reason for lower unemployment in the UK. (See p. 9.)**

* **Lower employment costs have stimulated an influx of foreign direct investment, so that the ratio of the stock of FDI to GDP is far higher in the UK than in comparable European societies. (See p. 10.)**

* **The UK economy is undoubtedly very different today from what it would have been if Labour had been in power since 1979. *General elections do matter.***

This paper was written by Professor Tim Congdon.

How much will the general election matter?

A selective survey of the economic results of 17 years of Conservative rule

Would the Labour Party change policy all that much?

The Labour Party will probably form the next British Government. Much newspaper comment implies that Labour under Mr. Blair will be rather like the Conservatives under Mr. Major. The accuracy of this assessment depends partly on the answer to the prior questions "How different has the current Government Conservative been from its Labour predecessor?" and "Is it really true that the Conservatives have had little impact on Britain's economy and society?". The purpose of the current *Monthly Economic Review* is to provide some information relevant to answering these questions.

Decline in subsidies as share of GDP,

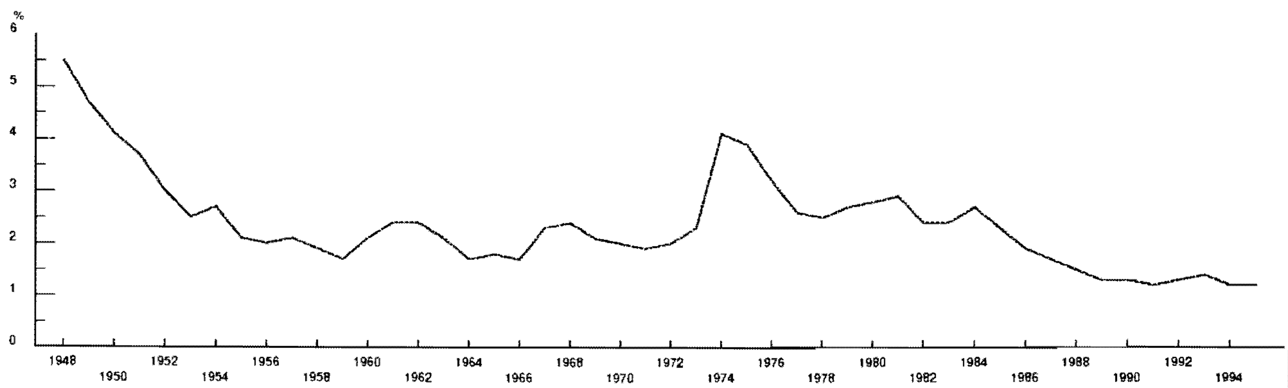
A starting-point is the chart at the bottom of the page which compresses a great deal of social and political change. It goes back almost 50 years and shows the ratio of government subsidies to GDP. The ratio was highest just after the Second World War War and then declined all through the post-war period until the 1970s. A second and smaller peak was recorded in the mid-1970s, but the decline resumed through the Conservative years from 1979. Today subsidies represent only slightly more than 1% of GDP. Since the mid-1970s the Government has in fact cut subsidies to the car industry, the steel industry, to Concorde and the aerospace industry, and to a host of smaller supposed "good causes". It has also, by privatising the large utility industries, reduced or eliminated the state support they used to require for their investment programmes.

which is a sign of better government

Most economists agree that subsidies are a cause of resource misallocation. They are financed by taxing some companies and industries (which are therefore smaller than they would otherwise be) and allow the recipient companies and industries to sell at beneath cost (so they are larger than they would otherwise be). Curbs in subsidies are therefore usually taken as an indication of good government. The decline in the ratio of subsidies to GDP is a sign that microeconomic policy has improved over both the last 20 years and, indeed, over the last 40 or 50 years.

The decline of subsidies

Chart shows ratio of subsidies to GDP at factor costs, using 1990 prices for GDP



Conservatives have a satisfactory record controlling public spending,

The decline in subsidies is one reason that the present Government has a satisfactory record in controlling public spending as a whole. Admittedly, the record is not particularly impressive if today's figure for government spending as a share of GDP is compared with the UK's own past. The ratio of government spending to GDP is similar now to that in the late 1970s and rather higher than in the 1960s. (See the chart on p. 6.) But the record is good compared with the UK's European neighbours, which have been subject to similar social and demographic pressures. Europe nevertheless has a large state sector compared with the USA and Japan.

The difference in the size of the state sector has led to a similar difference in the burden of taxation. (See the chart on p. 7.) This has not always been so. Back in the early 1980s the tax burden in Britain was quite high relative to other G7 countries, at slightly more than a third of GNP. But more recently the UK's relative position has become markedly more favourable.

In the UK taxes are still a little bit more than a third of GNP, but there has been such a large rise in the tax burden in other countries that the UK is now the third lowest-taxed country in the G7. Italy and Canada have slipped behind badly, while there is also a substantial gap in tax as a share of GDP compared with France. In this key area of public policy, the present Conservative Government has differentiated the UK from its neighbours.

which has led to taxes in the UK being lower than in most of its European neighbours

The table on p. 8 shows the ratio of taxes and social security contributions as a percentage of GDP, and has a preponderance of European countries. 20 years ago Switzerland was universally regarded as a tax haven, with a large and obvious difference in the tax burden between the UK and Switzerland. But the table shows that in 1993 this was not so. The ratio of taxes to GDP was only 2% higher in the UK than in Switzerland, a trifling difference. The gap between the UK and the three other large European countries was much greater. Meanwhile the gap between the UK on the one hand and Netherlands and Sweden on the other has become enormous. To Swedes, and even to the Dutch, the UK has become something of a tax haven. Again, the Conservatives have clearly differentiated the UK from its neighbours.

encouraging more employment

Logically, the difference in tax burdens is starting to have a significant effect on the labour market and the direction of inward investment. The unemployment rate is lower in the UK than in any of the other large European countries (i.e., Germany, France and Italy) and well beneath the European average. Moreover, labour force participation among people in the 25 to 45 age group is higher than in most of our neighbours. (See the table on p. 9.)

and more inward foreign direct investment

On the direct investment front, the UK now captures a disproportionately high share of the inward investment from outside Europe into Europe. In fact, the stock of foreign direct investment in the UK is not much smaller than in Germany, France and Italy combined. (According to the OECD, at end-1994 it was $219b. in the UK, compared with $273b. in the three other large European countries.) Survey evidence shows that productivity in foreign-owned enterprises tend to be higher than in their indigenous competitors, implying that FDI brings better methods and technology to the UK. One consequence of the FDI influx ought to be that UK productivity at least remains within striking distance of the best-practice levels currently available. The spread of knowledge and experience about best-practice methods is also strengthened by the UK's heavy foreign direct investment abroad. As the table on p. 10 shows, the UK has unusually high ratios of both inward and outward FDI to GNP.

Car output will soon be treble its 1982 level

The inflows of capital and technology from abroad are of course giving a highly positive boost to the areas of the economy most affected, such as the car industry. Car production in Britain will probably be about three times as high in the early years of the next decade as it was at the trough in 1982. In 1982 Britain produced about 800,000 cars, despite the heavy subsidies to British Leyland and the steel industry. The subsidies have been largely eliminated, trade union power has been limited and - despite the UK's traditionally poor reputation in the car sector - there have been major foreign investments in the industry. By, say, 2002 Britain could well be producing about 2,250,000 cars, a trebling of production compared with 20 years earlier. Output per head will be more than twice as high. (See chart on p. 11.)

The growth of manufacturing productivity has accelerated, but not the growth of GDP

But the car industry is only part of the economy. A more comprehensive measure of success and failure is provided by statistics on manufacturing productivity. The acceleration in the growth of manufacturing productivity since 1980 is now well-attested and uncontroversial, and it was discussed in last month's *Monthly Economic Review*. The chart on p. 12 shows the growth rates of manufacturing productivity in the seven leading industrial countries over the last 15 years. The UK is actually at the top, slightly above Japan and Italy and quite bit above Germany, France and the North American countries. As already explained in the May *Monthly Economic Review*, the upturn in manufacturing productivity growth has not led to a corresponding improvement in GDP productivity growth. The reasons for this failure are a matter of debate, but a case can be argued that the UK's central problem has been the decline in labour force participation by men in middle and late-middle age. Contrary to claims made by Mr. Will Hutton in his book *The State We're In*, the UK's financial system is not to blame.

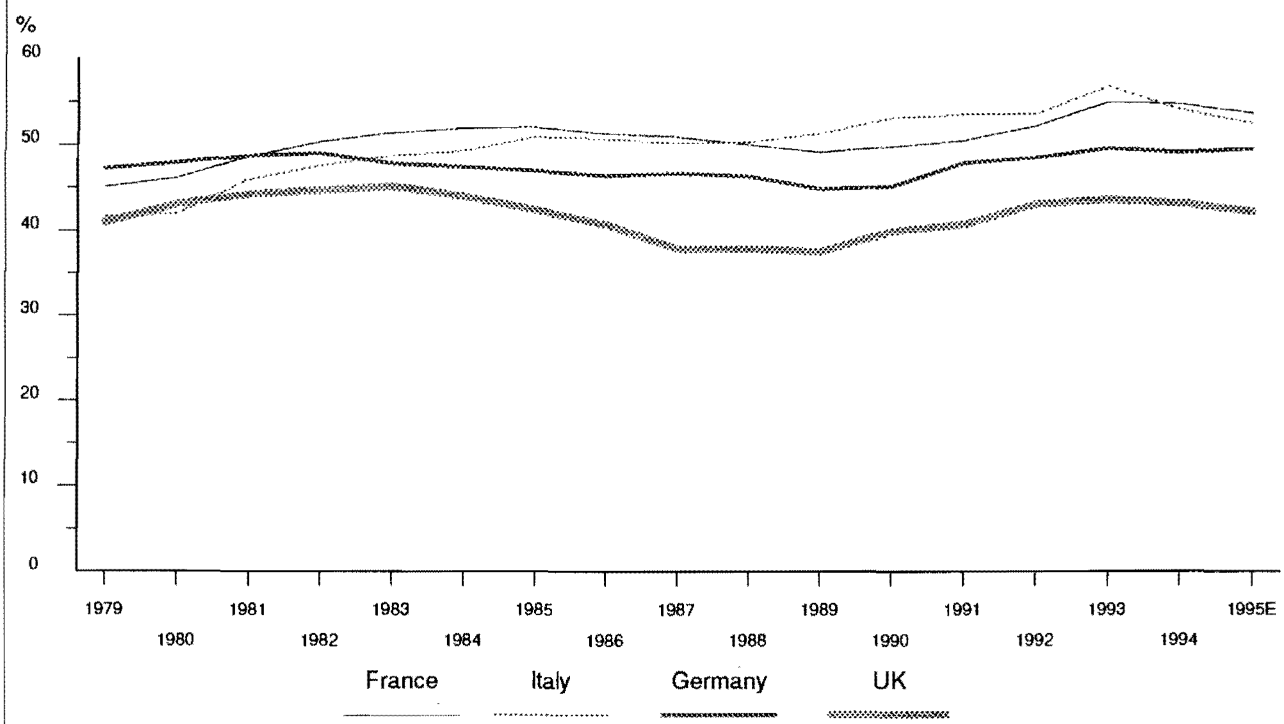
Over the long run Conservatives and Labour governments are very different

Of course, there is much more to say. The evidence assembled in these few pages is partial and incomplete, and - some might say - rather biassed. But it is very difficult to argue that the present Conservative Government - now almost into its 17th year of office - has done little to change the British economy. In some areas the changes have been revolutionary, while in others they have been of only marginal importance. There are of course parts of the economy where mistakes have been made. But the notion that the UK would be much the same today if there had been a Labour Government since 1979 (and indeed continuously since 1974) is absurd. By extension, the outcome of the next general election matters hugely to the UK's economy and society, and it is most unlikely that Mr. Blair and Mr. Major would pursue fundamentally similar policies.

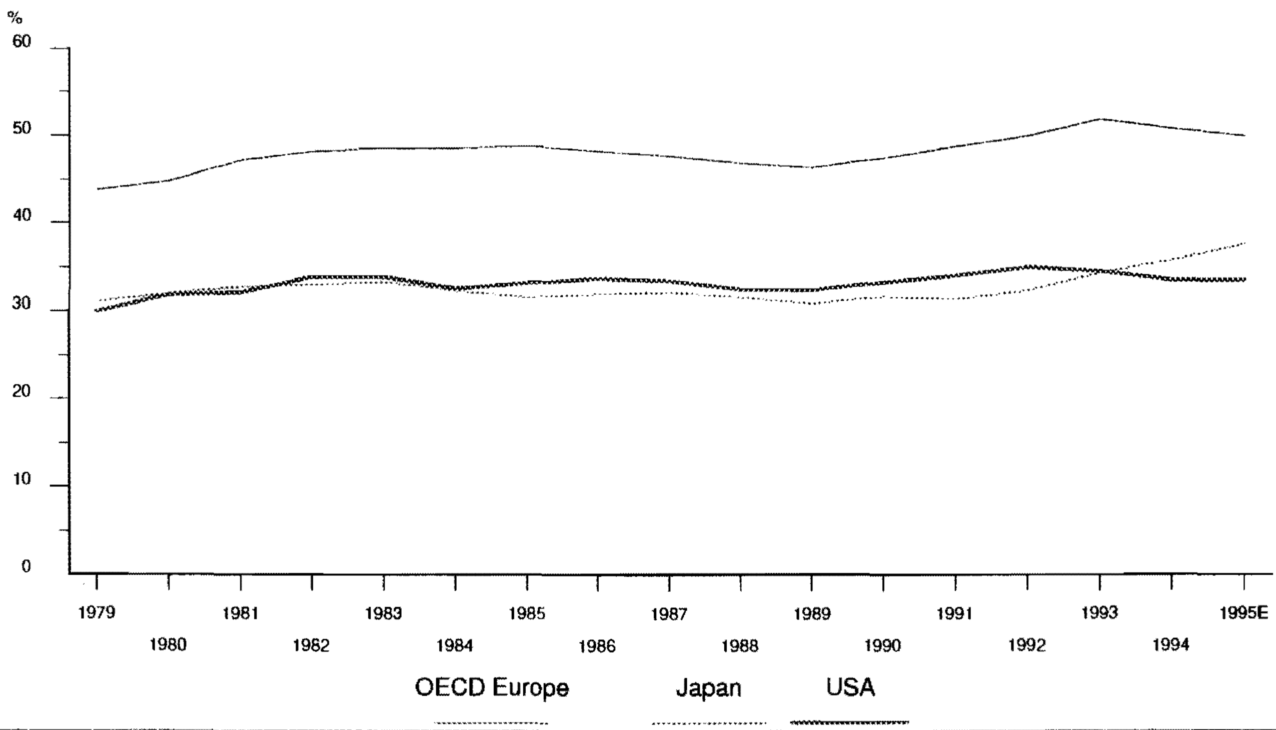
Government spending as a share of GDP

Charts show ratios of general government total outlays to nominal GDP, as %

1. The four largest European economies



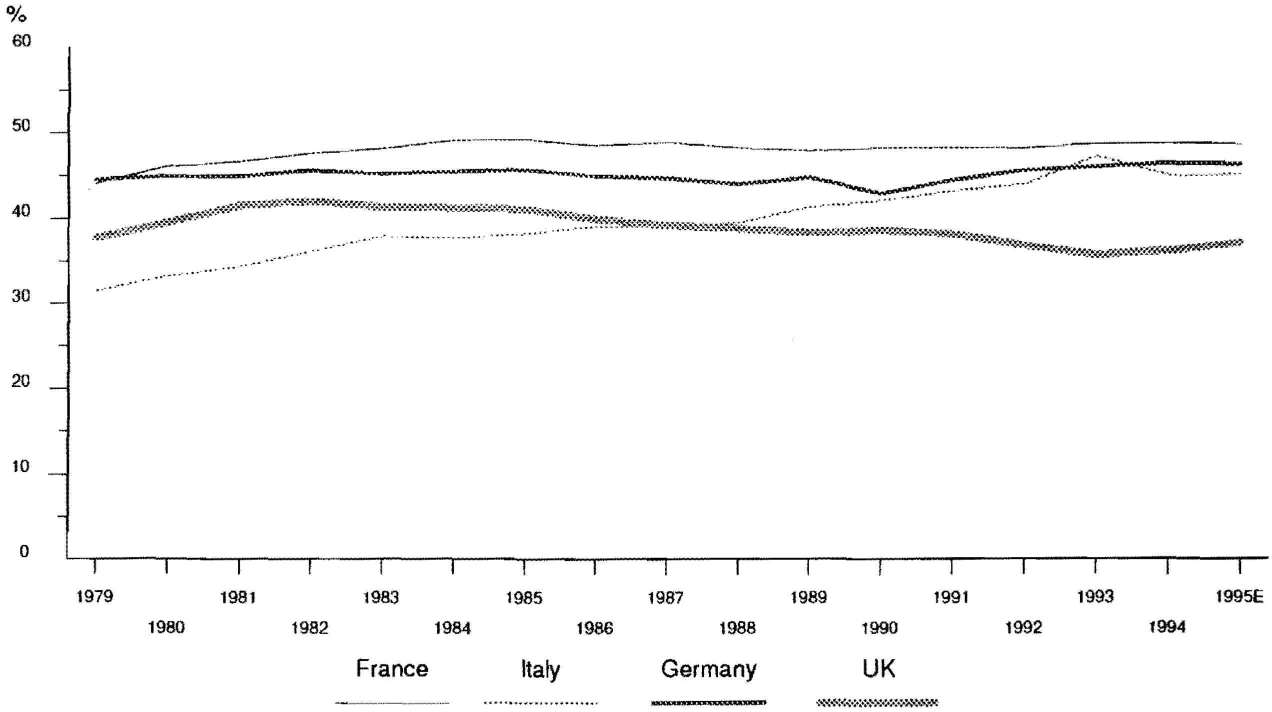
2. Europe, the USA and Japan



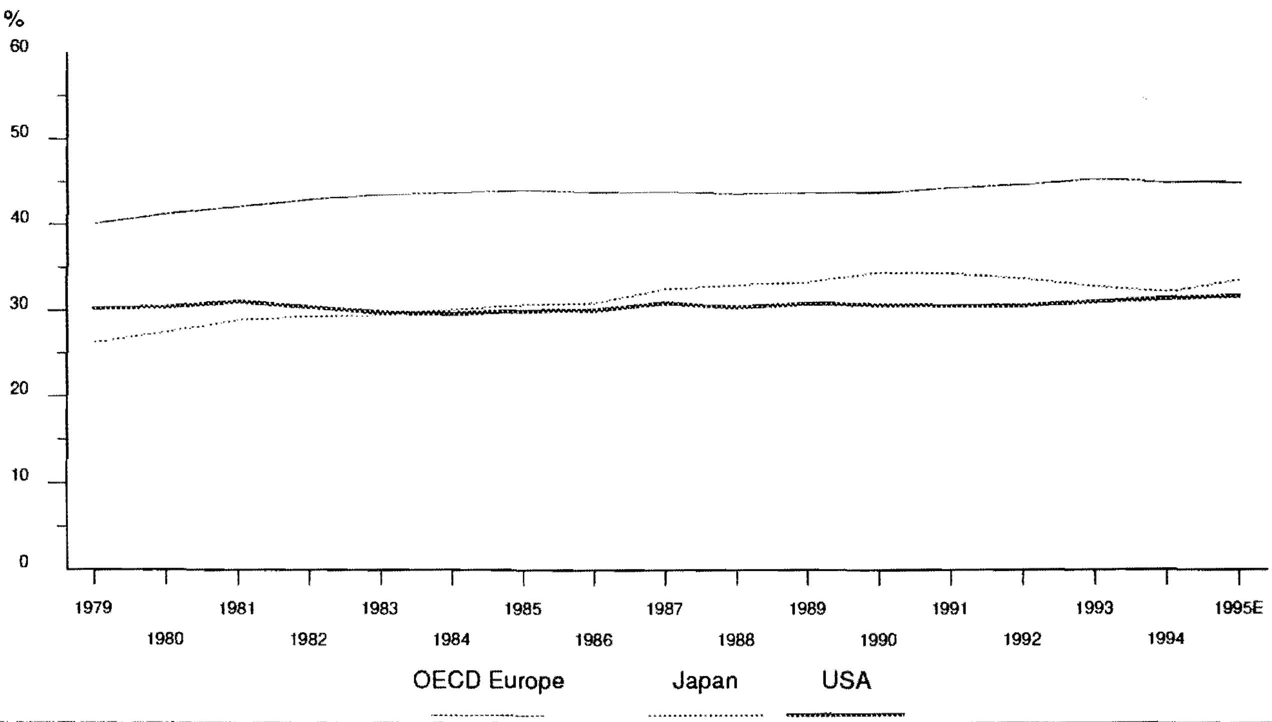
Tax as a share of GDP

Charts show ratios of general government current receipts to nominal GDP, as %

1. The four largest European economies



2. Europe, the USA and Japan



Taxes on employment in 1993

One reason for the UK's relatively low labour costs

Table shows taxes and social security contributions as % of gross national product at market prices.

	Total	Direct taxes on households (mostly income tax)	Social security contributions	
			Total	Paid by employers
UK	33.1	12.2	6.1	3.6
Austria	43.8	14.5	13.3	10.1
Belgium	45.4	16.5	16.2	9.8
Canada	38.6	18.6	4.8	5.0
France	44.2	9.3	19.8	12.0
Germany	42.0	11.8	16.7	7.7
Italy	43.1	16.3	13.7	n.a.
Japan	29.8	11.6	9.6	5.0
Netherlands	48.9	16.9	18.7	3.6
Sweden	52.7	22.0	14.3	13.5
Switzerland	31.1	13.7	11.2	3.5
USA	31.7	14.1	8.3	4.1

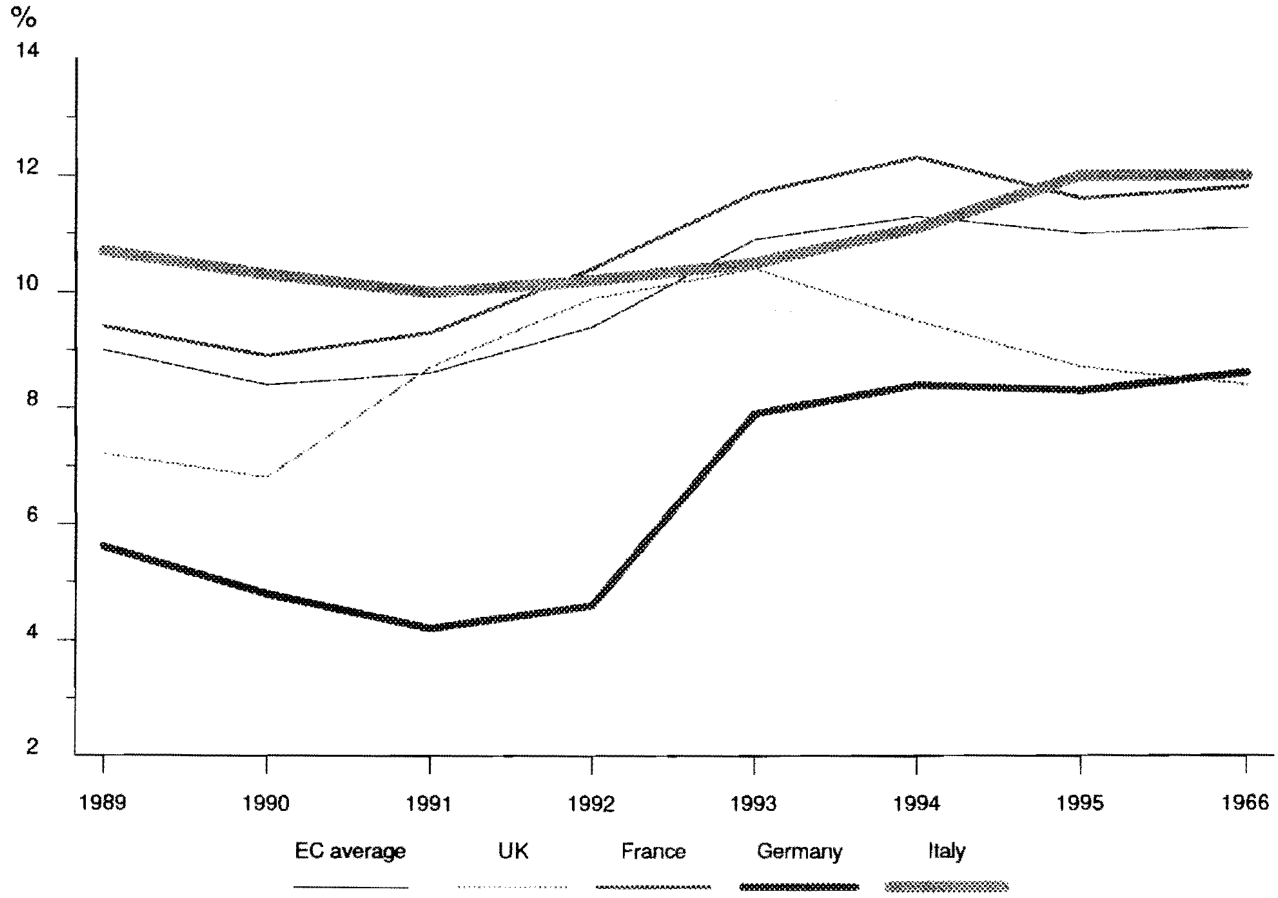
Source: 'Taxes and social security contributions: an international comparison 1983-93', *Economic Trends*, November 1995.

The table demonstrates that employers' social security contributions are a much smaller discouragement to employment in the UK than in any other European country, apart from the Netherlands and Switzerland. Moreover, in these two countries employees' social security contributions are well above those in the UK. The discouragement to employment is felt by the worker rather than the employer, but is just as real. Other labour on-costs should also be borne in mind. A key reason for the low level of social security contributions in the UK is extensive private pension provision, but pension contributions are of course part of labour costs. They are typically far higher in the UK than in other industrial countries, particularly in Europe.

Unemployment: an international comparison

UK unemployment now relatively low by European standards

Chart shows average unemployment rate, %, during year, as standardised by the OECD, for years up to and including 1995. 1996 refers to latest available month.



"Germany" refers to West Germany. Figures for Italy are not available for 1991 and earlier on the OECD standardised basis, and are estimated by Lombard Street Research.

Source: *Employment Gazette* and *Labour Market Trends*, various issues.

In the late 1970s and early 1980s unemployment in the UK was high by European standards. But reforms to labour market institutions - notably the reduction of trade union power, the removal of restrictions on hiring-and-firing and a flexible official attitude towards part-time working - have helped employment in the UK. Indeed, the UK is now widely regarded as being a half-way house between the rigid labour markets of continental Europe and the flexible labour markets of North America. The OECD has estimated that the "natural rate of unemployment" (i.e., the rate at which pay settlements and inflation are stable) has fallen from 10% in the early and mid 1980s to 7% today. A large fall in unemployment since early 1993 has not yet led to higher wage increases.

UK unusually open to foreign investment

Both inward and outward foreign direct investment very large for UK

Table shows the international assets and liabilities of the G7 economies, particularly their direct investments, at the end of 1994, as estimated by th OECD. Stocks of direct investment are expressed as a % of GDP at current prices and exchange rates.

	Gross value, in $b.	Direct investment as % of gross position	Value of direct investments at end-yr.	Stocks of direct investments, % of GDP
UK -				
Assets	2191	13.1	287.0	26.1
Liabilities	2168	10.1	219.0	19.9
USA -				
Assets	2378	32.0	767.0	10.9
Liabilities	3159	18.4	581.3	8.3
Japan -				
Assets	2423	11.4	276.2	5.6
Liabilities	1735	1.1	19.1	0.4
Germany -				
Assets	1433	11.3	161.9	6.7
Liabilities	1230	5.8	71.3	2.9
France -				
Assets	979	18.4	180.1	11.6
Liabilities	1067	13.4	143.0	9.2
Italy -				
Assets	478	17.7	84.6	7.8
Liabilities	587	10.0	58.7	5.4
Canada -				
Assets	241	42.2	101.7	18.0
Liabilities	455	23.2	105.6	18.7

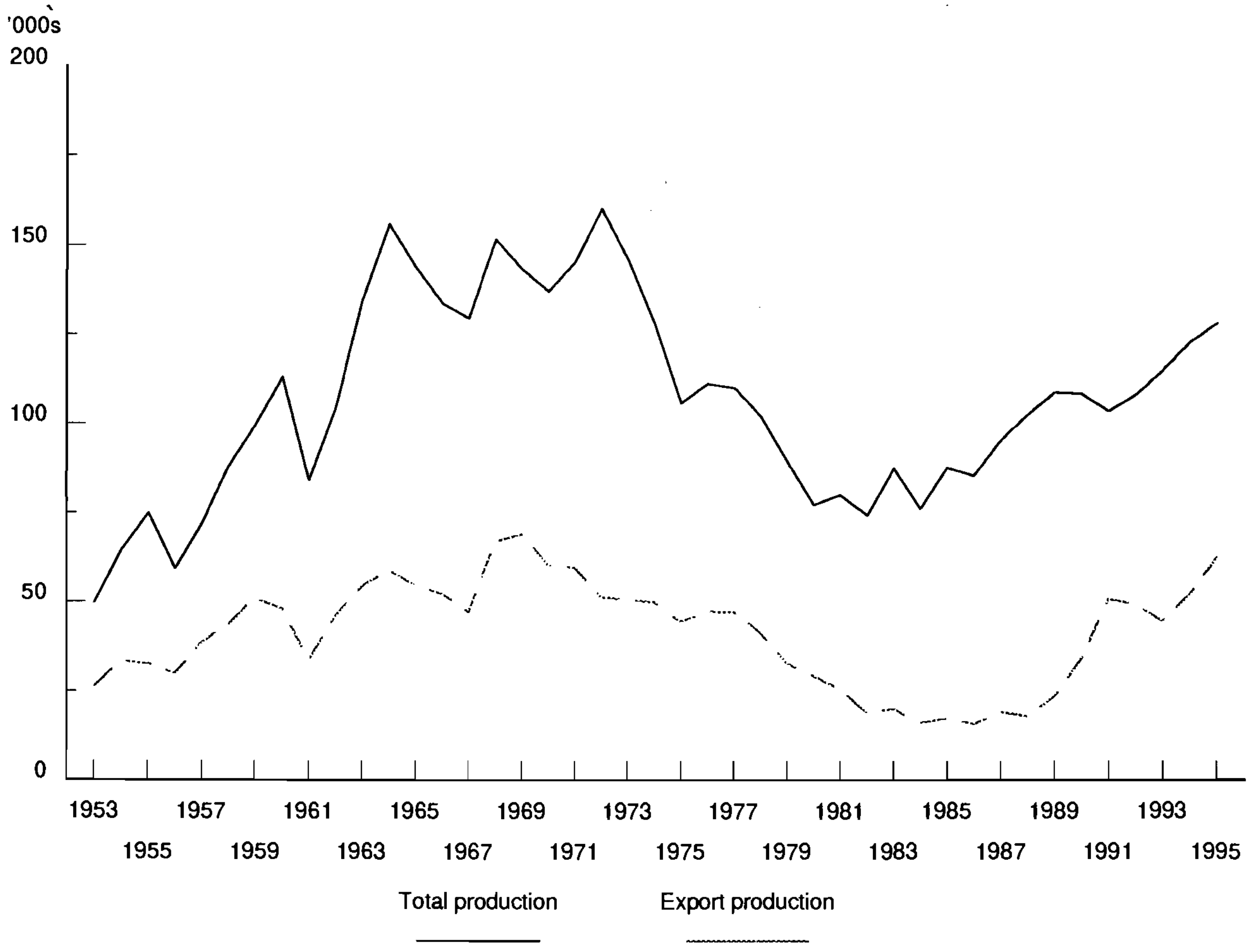
Source: OECD *Economic Outlook*, December 1995, p.27.

The UK is a strikingly "international" economy. By the standards of the G7 and indeed the OECD as a whole, it has a relatively high ratio of trade to GDP and extremely high ratios of inward and outward foreign investment to GDP. Cross-border investment is one means whereby best-practice technology is transferred from country to country. An implication of the UK's high degree of "internationalisation" is therefore that productivity ought to remain within striking distance of the best levels attained anywhere in the world. In other words, the UK should remain a fairly rich country by the standards of the world as a whole. But this of course assumes that the tax and regulatory environment remains hospitable for international investment.

The British car industry: decline and recovery

In the late 1990s car exports may exceed the previous peaks of the early 1970s

Figures are monthly averages for car production and exports



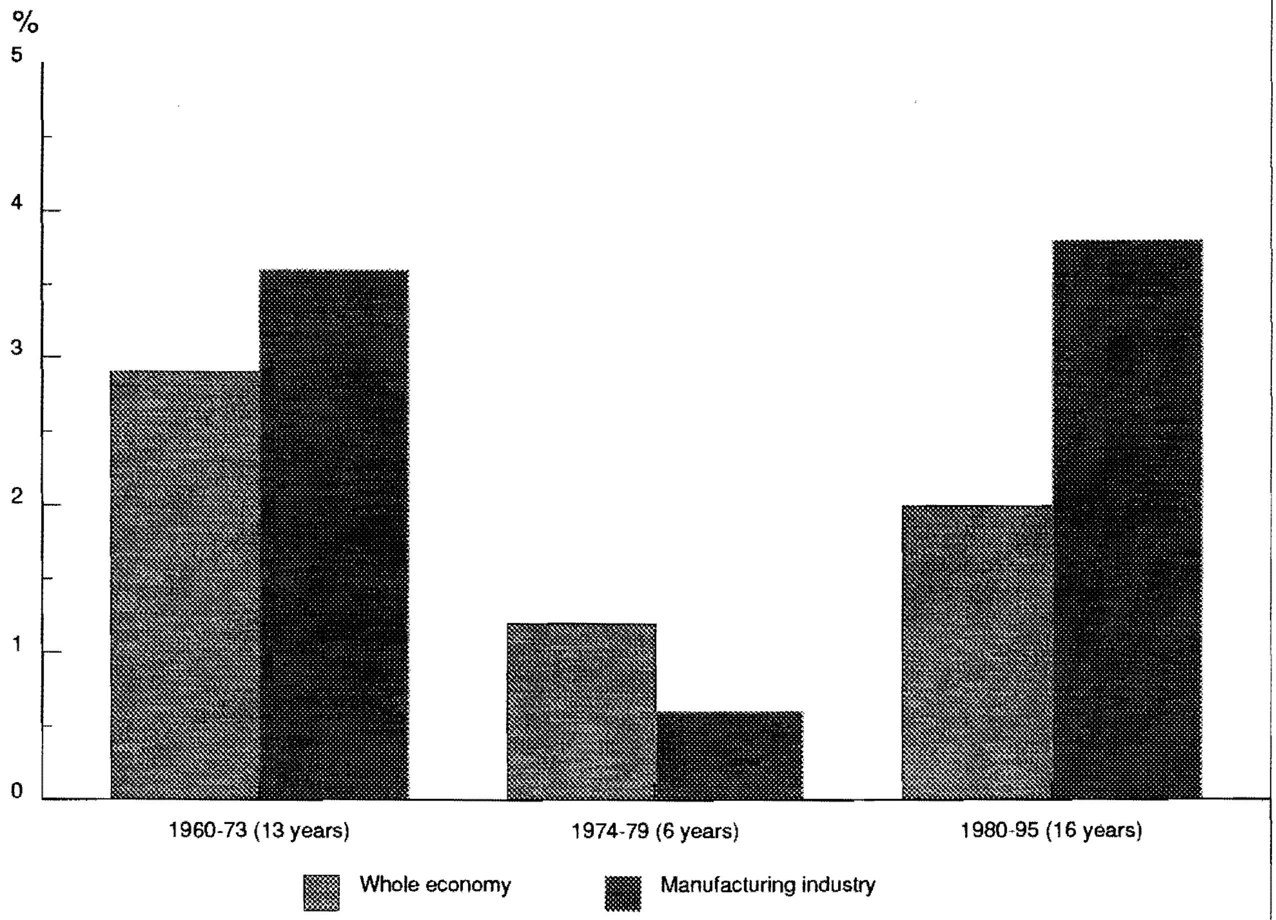
Source: *Economic Trends*

Car output in 1996 will probably run at about 130,000 - 135,000 a month, compared with 74,000 a month at the trough in 1982. However, there is considerable spare capacity in the industry, with the April 1996 CBI industrial trends survey reporting 89% of motor vehicle producers were working below capacity. (This compared with a "below capacity" balance of typically under 50% in 1995.) The industry could therefore produce 150,000 - 160,000 a month with little difficulty, double the 1982 figure. Existing investment plans imply further large increases in capacity over the next few years, almost entirely by foreign companies since there are no significant car companies now in UK ownership. Production for export is approaching 70,000 a month, over four times higher than in the mid-1980s.

The UK's productivity performance

Clear improvement compared with the nadir of mid 1970s

Bar shows compound % a year increase in output per person employed in three periods from 1960-95.



Source: *Economic Trends*

Chart shows the growth in productivity in three periods since 1960, differentiating between the whole economy and manufacturing. Clearly, the six years to end-1979 had the worst performance. In particular, productivity growth in manufacturing came to a virtual halt. The policies being pursued at the time - with wage and price controls, and large subsidies to particular industries - were unsuccessful, although the unstable macroeconomic environment (high inflation, and high and volatile interest rates) must also take some of the blame. The following 16 years have been much better, but productivity gains have been less in the service sector than in manufacturing and the so-called "production industries" (i.e., manufacturing; mining and quarrying, inc. North Sea oil and gas; and energy, gas and water). The increase in whole-economy productivity has therefore been less than in manufacturing and slower than in the 1960 - 73 period.