Economic Perspective 4

THE THATCHER GOVERNMENT'S ECONOMIC IDEOLOGY - MUST INTERVENTION BE PRECLUDED ?

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The present Government's approach to economic policy is radically different from that of any other post-war UK government. The difference is not simply that the government wishes to reduce the Public Sector Borrowing Requirement (PSBR); or control the money supply; or privatise nationalised industries; or reduce regulation. These policies have been espoused by previous governments. What is different is the single-minded way in which the present government pursues this policy package: a single mindedness which borders on religious fervour.

The present government's economic policies are founded on an ideology which accords the market a pivotal role in ensuring economic and political freedom. This perspective spells out this underlying ideology and assesses its validity. To this end a crucial distinction must be drawn between market prices as a source of private incentives and as a measure of social valuation. The implicit presumption of the government is that these are one and the same. "Pricing themselves out of the market" and "uneconomic" thus become moral imprecations. This is the fundamental source of conflict between the government and a number of prominent religious leaders. The latter do not share this moral position.

The recent statement by Mr John Gummer that bishops can no more pontificate on economics than the Pope could correct Galileo on physics totally misses the point. Economics is not physics: it has no universal laws or empirical constants. Economic policy must ultimately be based on ethical or moral statements about what **ought** to be done.

What then is the government's ideology ? It is basically that of nineteenty century liberalism which emphasises the position of the individual in society. Freedom is defined as the absence of coercion. The allocation of resources via the market, it is argued, minimises coercion. Governments are by their nature coercive since they are only needed if someone is to made to do something which he would not do voluntarily. Consequently, government is a necessary evil whose role must be minimised.

This classical liberal ideology has been resurrected in the last forty years by a number of writers in economics and the other social sciences. The most influential of these has been F. A. Hayek whose writing and ideas have been popularised through the pro-market Institute of Economic Affairs. His thinking has clearly influenced a number of senior Conservative politicians, including the present Prime Minister.

The label "monetarist" is often attached to this government. However, its monetarism is at best a secondary part of its policy package: a tactical means of dealing with the short-term problem of inflation, but one which has the added ideological advantage of being consistent with reducing the role of government. It is significant in this regard that "control of the money supply" has been superceded in the official litany by "reducion of the PSBR" as the main focus of economic management. Reduction of the PSBR implies constraining the public sector, one of the articles of faith of the liberal economic ideology.

The government's attitude to trade unions also derives from its economic liberalism rather than from monetarism. Milton Friedman, one of the most prominent advocates of monetarism, has consistently argued that unions cannot cause inflation. Unless a government facilitates inflation through slack monetary control, unions, according to monetarists, can only bid up the wages of their members at the expense of other workers. In such a framework, control of the money supply is therefore sufficient to control inflation. Clearly, successive pieces of trade union legislation bear witness to the fact that this view is not espoused by the government. Unions are seen as a source of monopolistic power in the labour market and an illiberal force in society restricting the freedom of the individual. Therefore, unions must be constrained.

The economic liberal sees the market as an institution which can co-ordinate economic activity without coercion because it provides incentives to individuals to act in their own and society's interests. Hayek has written eloquently of the markets ability to co-ordinate behaviour without coercion. It is an efficient mechanism for transmitting information about changing economic circumstances, a mechanism which operates with no master plan but with each individual reacting to signals (in the form of prices) about which resources are scarce and where profits are to be made.

Entrepreneurs exist by searching out such profitable opportunities. In so doing they perform the function of directing resources to their highest-priced use. Resources in low-priced uses are attracted to these higher-priced uses by the entrepreneur's ability to pay a higher price for them and still retain a profit. Thus Smith's **Invisible Hand** is the outcome of the independent decision of a large numbers of entrepreneurs. Prices in this scheme of things provide economic agents with a great deal of information, but in a highly compact form. It would be impossible for the controllers of a centrally planned economy to generate the amount of information contained in an economy's relative prices.

But is this how markets actually operate in the real world? For one thing, it presumes that businessmen are always correct in their judgement of where the opportunity for profit lies. This is patently false, mistakes are often made with consequences not only for businessmen. For another, it supposes that all economic activity is motivated by entrepreneurship. But entrepreneurship is really only relevant at the margin of economic activity. Most economic activity is routine in nature and does not involve businessmen but bureaucrats - not civil service bureaucrats but managers of large economic organisations, both publicly **and** privately owned.

It has been observed by one Harvard economic historian that the root of Britain's economic problems and lack of competitiveness lies in our inability to come to terms with the change in the nature of the economic system which began **towards the end of the last century** - the replacement of competitive capitalism by managerial capitalism. British industry has lagged behind its American and West German counterparts in the organisational innovations associated with the evolution of the modern corporation. On this argument the return to Victorian virtues advocated by the Prime Minister not only will not guarantee economic success today; it did not provide them the first time round! In the present context what is most relevant is that a not insubstantial proportion of decisions relating to the allocation of resources are not mediated by the market (eg across a grocer's counter) but by administrative decision (eg from one part of a multinational corporation to another). Consequently, the role of prices in allocating resources is reduced.

Furthermore, the government's vision is of a **competitive** market but ignores, or plays down, the existence of monopolistic elements which distort the signals passing through the system. This applies whether the monopolistic element is owned by the State (eg nationalised industries) or by shareholders. If an industry is monopolised other businessmen will not be able to compete away its excessive profits because of some barrier to their entry to that market. But the story does not end here. A logical corollary of the government's conception of the market system is that a distortion in one part of the system must distort the signals being transmitted to other parts of the system. Under such circumstances the market system becomes a highly efficient mechanism for transmitting **distorted** information.

But even if all of the previously noted

sources of market imperfection are ignored and it is assumed that markets perform their function more or less efficiently, prices still are not unqualified indicators of **social** value. Consider a market economy in which all wealth and property rights (including rights to employment) were approximately equally divided among the members of that society. This distribution of the command over resources (ie the money votes which determine prices) would produce one set of prices. If the same economy with the same population (and the same tastes and preferences) had a radically different distribution of wealth and property, say giving 10% of the population 50% of the wealth, the distribution of the command over resources would differ and a different set of prices would arise. Relative prices are a function of the distribution of income and wealth. Only if the existing distribution has some moral significance can prices indicate social value. It is on this fundamental truth that the case for a government's role in the economy rests.

However, the argument should not be taken to its **reducto ad absurdum** and the conclusion reached that prices do not matter and that all decisions about the allocation of resources should be made by politicians or some other group in society. That is the route to chaos or totalitarianism. The market must remain the principal source of private incentive and the transmission mechanism for economic information, with governments mitigating the excesses which the market may produce - such as large scale unemployment and the deaths of communities - which arise from the absence of smooth adjustments or historical accident.

This is not to say that the government should intervene to stop changes in demand from being reflected in employment patterns. What it requires is government intervention to ensure that such adjustments take place smoothly and with minimum hardship and disruption to society. Such intervention **might** take the form of cushioning those involved in an industry which is in decline through limited subsidy. Such a subsidy should not be seen as permanent but directed to the gradual switch of employment away from that industry over a clear and realistic timescale.

An alternative to subsidising the declining industry is to subsidise replacement industries in areas where a declining industry is particularly heavily concentrated. This encourages the movement out of the declining industry by making it more acceptable. It also has the advantage of making it clear that adjustment is going to take place. Hopes that the declining employment might be subsidised permanently are not encouraged. Adjustment will, of course, be smoothest in conditions of buoyant demand and full employment during which the declining industries will be those unable to compete for labour. High unemployment makes adjustment more difficult because for many people it means the only direction of adjustment can be downwards. Under such circumstances the government's responsibility to smooth the adjustment process cannot be denied.