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# Introduction

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In the 1980s and 1990s, successive U.K. governments enacted a series of economic reforms designed to establish a more market-oriented economy. The goal was to arrest the long-term economic decline in the United Kingdom relative to other advanced countries and to establish a premier-league economy that would improve living standards for all citizens.<sup>1</sup> At the beginning of the period, the United Kingdom was a highly regulated economy with large nationalized industries, an extensive welfare state, and exceptionally obstreperous labor-management relations. By the end of the period, the United Kingdom was one of the least regulated and nationalized economies in the Organization for Economic Cooperation and Development (OECD), with a welfare system that was increasingly based on in-work benefits, rather than benefits to persons out of work, and a trade union movement that was concerned with the “value added” that unions can bring to the economy more than other union movements in the advanced world. Indexes of economic freedom that measure the market friendliness of economic policies and institutions show that the United Kingdom had moved from the middle of the pack of OECD countries to a lead position, close to that of the United States. Nearly all groups and po-

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1. “Premiere league” refers to the top athletic league in football or soccer in the United Kingdom.

litical parties in the United Kingdom had come to accept many of the initially controversial changes that constituted the “Thatcher Revolution,” albeit with different emphases and concerns over how best to assure that the market reforms benefitted society as a whole.

The extent and breadth of the changes in its economic policies and institutions that the United Kingdom introduced from 1980 to 2000 are breathtaking. Among the many changes that occurred were the following:

- Privatization of most of the nationalized industries and of many governmental functions that had never before been performed by private groups
- Development of new in-work benefits and a reduction in the incentives for persons to be out of work, accompanied by other more active labor market policies
- Revised labor laws that limited union powers and increased the potential for members to affect key decisions, leading to substantial changes in union attitudes and policies in the 1980s and the introduction of new modes for union recognition in the 2000s
- Changes in the structure and financing of the educational system, covering students from age four through the university level, with the development of a national curriculum and a more centralized education system
- Development of new modes of financing pensions that shifted the burden of funding from the state to individuals through company pension plans or private plans
- The enacting of tax laws that encouraged employee share ownership
- Increased housing ownership by the sale of council flats to residents
- Elimination of restrictions on capital flows
- Restructuring of the National Health Insurance medical system
- Elimination of wage council’s modes of setting minimum wages and eventual introduction of a national minimum wage
- Regular publication of league tables in the public sector to measure the effectiveness of individual hospitals and schools

During the reform period, the secular decline of the United Kingdom in productivity and gross domestic product (GDP) per capita relative to other advanced countries—including such major European Union (EU) competitors as Germany, France, and Italy—came to an end. By the 1990s, the country was outperforming most other advanced economies in the level of unemployment and in producing a high employment to population rate. At the same time, there was a large rise in income inequality, which was the result of rapidly growing incomes for persons at the top of the income distribution rather than of falling incomes for persons at the bottom of the distribution. This meant that the United Kingdom avoided the U.S. problem of falling real earnings for lower-paid workers.

The rough concordance of economic changes with reforms provides weak or circumstantial evidence that the reforms succeeded in altering the U.K. economy. The macroeconomic evidence is weak or circumstantial because, at the level of an entire economy, it is difficult to determine what the appropriate counterfactual is for the observed patterns. Perhaps the relative economic performance of the United Kingdom would have improved even absent market-friendly changes in policies. New Zealand introduced diverse market reforms much like those in the United Kingdom, but its economic performance worsened relative to other countries. Some smaller EU countries, such as the Netherlands or Ireland, performed well without undertaking massive pro-market reforms. To determine whether reforms did in fact contribute to the United Kingdom's improved economic performance, to the United Kingdom's rise in inequality, or to both, one must examine the microeconomics of particular reforms and their impact on intended and unintended economic outcomes.

This volume presents a set of studies that assesses some of the economic reforms that the United Kingdom adopted in the 1980s and 1990s. Since it is not feasible to study the full set of reforms in detail, researchers selected some reforms for investigation—in particular, those dealing with labor and product markets that are likely to have had an impact on productivity, employment, and income inequality—while leaving analyses of other reforms to other groups, notably the changes in the national health system and in transportation.

The studies were undertaken by a team of British, Canadian, and American economists under the auspices of the NBER, the Centre for Economic Performance (CEP), and the Institute for Fiscal Studies. The researchers regularly discussed the issues with government, union, business, and academic decision makers as well as with experts in the United Kingdom as the work proceeded. The studies were conducted during 1998–2001, when the U.K. economy was performing exceptionally well and when many analysts around the world viewed the U.S. economic model as being the most effective capitalist economy and viewed the United Kingdom as the closest representative of that model in the EU.

With the exception of chapter 1, the work is almost entirely microeconomic in approach, focusing on the impacts of particular reforms on closely associated outcomes rather than on the macroeconomy. This microeconomic approach offers more readily determinable counterfactuals than do analyses of aggregate outcomes. It allows researchers to compare specific outcomes before and after reforms; to compare the outcomes for persons, firms, or sectors more or less affected by the reforms; and to make composite comparisons of outcomes before and after reforms between people or enterprises more or less affected by the reforms (differences in differences). Given the measurement error of GDP, any particular reform will probably have impacts on GDP that are hard to discern, and so the micro

approach provides the only reliable way to assess the benefits and costs of particular changes. At the same time, the microeconomic approach misses the possibility that reforms cumulate to something greater than their linear sum and that they produce nonlinear synergies or externalities in the aggregate economy.

### **The Major Theme**

The principal finding of this volume is that the bulk of the U.K. economic reforms that were studied contributed positively to the economic performance of the country but with some cost in rising inequality. Since the real wage rose, however, policy did not create poverty, although possibly some other set of policy changes might have reduced (or raised) poverty. However, some heralded reforms in social programs, such as changes in benefit schedules, had more modest positive impacts on economic performance than proponents anticipated and correspondingly less adverse impacts on income distribution than opponents feared. The reason for this is that the United Kingdom's income-linked benefit system is highly interrelated, so that the declines in the amount received or the eligibility to participate in one benefit program are often partially offset by increased participation in other benefit programs. This makes both the incentive effects and the income distribution effects of reforms much less than might first appear to be the case from an analysis of a single program. Reforms of trade union law accomplished their purpose of weakening union power in the labor market but, in conjunction with a more competitive economy, also contributed to important changes in union behavior. Underlying this broad theme is a set of specific findings pertaining to the reforms that our project analyzed.

### **Specific Findings**

First, the U.K. reforms accomplished their main policy goal of making the economy and, in particular, the labor market more market-friendly. Diverse measures of the degree to which market forces rather than administrative rulings determine economic outcomes show that the United Kingdom became one of the most market-friendly economies in the advanced world. These measures range from the broad aggregate "indexes of economic freedom" developed by conservative think tanks to more specific indexes of labor market and product market regulations that the OECD and various independent scholars have developed. The United Kingdom deregulated product markets and privatized nationalized industries earlier and/or to a greater extent than its main EU partners. In the labor market, the absence of employment protection and other regulations meant that the United Kingdom was more market dependent than other EU countries, even while they reduced regulations and the United Kingdom did not do so (Card and Freeman, chap. 1 of this volume).

Second, in the area of product-market reforms, our studies have found that the privatization of traditionally nationalized industries was a major part of the U.K. economic reforms and reduced the publicly owned proportion of GDP from 12 percent in 1979 to 2 percent two decades later. Much of the privatization effort was undertaken so that the private sector would make the massive investments needed in the relevant sectors, rather than having the public sector make the investments, which would be counted as part of public spending. In most cases, however, because of the nature of the business, privatization was accompanied by increased regulatory activity. Privatization was associated with improved productivity, but the improvement occurred largely before the actual act of privatization as the public-sector managers restructured existing plants in order to bring the public firm to market. Whether the public-sector firms could have undertaken similar changes while remaining public is uncertain (Green and Haskel, chap. 2 in this volume).

Third, with its freedom to move capital and extensive stock market, the United Kingdom has a particularly open capital market, which makes it easy for foreign firms to enter. Establishments that are foreign owned tend to have higher and more rapidly increasing labor productivity than domestic firms. This is due primarily to higher levels of investment and a larger proportion of skilled and higher-paid workers. But establishments that change ownership nationality do not experience large changes in productivity. Thus, it appears that it is largely through greater investment in human and physical capital that foreign-owned firms make a special contribution to the U.K. economy (Griffith and Simpson, chap. 4 in this volume).

Fourth, the United Kingdom sought to increase share ownership by workers in their own firms with the hope of improving the commitment of workers to the firm and raising productivity through employee ownership. The specific policies to encourage employee ownership and involvement varied modestly over time, but the basic idea in all cases was to give tax breaks to firms that provided profit sharing, stock options, or stock ownership to workers. Unlike the United States, where employee stock ownership plans encourage collective ownership in retirement plans, the U.K. schemes encourage individual ownership. The results of this policy appear to be positive. Firms that reward workers in part on the basis of company performance have a higher incidence of information sharing and consultation with workers than do other firms. Also, while the productivity effects of programs vary with the particulars, firms that have profit sharing and employee share in ownership tend to outperform other firms in productivity and financial performance (Canyon and Freeman, chap. 3 in this volume).

In the area of social policy reforms, the United Kingdom sought to improve the incentive for working in its social welfare system, with some modest success.

The fifth finding is that the main thrust of U.K. reforms of welfare programs has been to increase the benefits that accrue to those who work compared to those who do not. In 1988, the relevant legislation was the Family Tax Credit of 1988. In 1999, this was replaced by the Working Families Tax Credit. The U.K. reforms had a much more modest effect on labor supply than comparable reforms in the United States, where the Earned Income Tax Credit and the Temporary Assistance for Needy Families (TANF) welfare policy produced a sizable drop in welfare roles and increased employment among the affected families. The prime reason for this is that in the United Kingdom income from in-work benefits counts as income in the computation of housing and other benefits, and thus policy reforms have a much-dampened impact on the incentive to work. In addition, the United Kingdom increased out-of-work benefits while the United States reduced those benefits, providing less incentive to increase labor supply (Blundell and Hoynes, chap. 10 in this volume).

Sixth, U.K. policies toward unemployed young persons were also designed to move people from dependence on the state to work. The New Deal for young people introduced in 1998 had both push and pull elements to get young unemployed persons into work. Some of the push involved toughening the work search criterion along lines originally developed in the mid-1980s. The pull involved a job subsidy for employers as well as government or volunteer work for young persons unable to find regular jobs. Despite publicity that implied that the program involved massive increases in spending and huge numbers of young people, the program had a marginal positive impact in raising youth employment at a modest additional cost. On net, the social benefits of the additional employment appear to have outweighed the costs (Van Reenan, chap. 11 in this volume).

Seventh, the basic design of the United Kingdom's pension reforms was to encourage workers and firms to contract out a portion of pensions through fully funded occupational schemes, which would reduce the pay-as-you-go costs of publicly provided pensions. The law required individuals to belong to some pension plan: an employers' scheme, a state-funded scheme, or an individually purchased scheme. Favorable tax advantages induced a large proportion of the population to purchase personal pensions in the 1980s and 1990s. At the end of the 1990s, the Labour Party government introduced further reforms with its stakeholder pensions for low-wage workers. The shift to greater reliance on private pension provision allowed the United Kingdom to have the lowest rate of future state spending on pensions among advanced countries. The development of private pensions appears to have improved job mobility, with workers who chose private pensions evincing more mobility than those with company pension plans (Disney, Emmerson, and Smith, chap. 6 in this volume).

In the area of the labor market and income distribution, the eighth finding is that the United Kingdom moved from reliance on collective bar-

gaining in the determination of wages and working conditions to reliance on the competitive market. The decline was due in part to labor-law reforms designed to curb union power but also to the greater competition in the product market that required firms to reform their industrial-relations practices. Prior to reforms, the United Kingdom's unionized sector was marked by lower productivity and considerable strike activity. Faced with a tight macroeconomic environment, greater competition from nonunion firms, and loss of government statutory and nonstatutory support, unionized establishments adopted new work practices that brought labor productivity up to nonunion levels. Since U.K. employers do not have the same antiunion animus of U.S. firms, the Labour government's industrial-relations reforms that make it easier for unions to gain recognition from firms are likely to have only small consequences for the coverage of collective bargaining (Pencavel, chap. 5 in this volume).

Ninth, institutional changes in the labor market—such as the decline of unionization in the 1980s and 1990s and the introduction of the national minimum wage in 1999—had substantial impacts on the level of income inequality. The more rapid decline of unionization in the United Kingdom than in the United States was a major factor in the more rapid increase in inequality in the United Kingdom. By contrast, the introduction of the national minimum wage in the United Kingdom contributed to the convergence in the pattern of inequality among women. Inequality among women was higher in the United Kingdom than in the United States before the United Kingdom enacted its minimum wage and remained higher afterwards, but the minimum wage reduced the U.K. inequality toward the American level in 1999. Overall, the extent and pattern of wage inequality in the United Kingdom became increasingly similar to that in the United States as the United Kingdom adopted a more market-driven U.S.-style economy (Gosling and Lemieux, chap. 7 in this volume).

Tenth, the United Kingdom subsidizes council housing to tenants and sells the housing to tenants at attractive rates. Although home ownership can be viewed as a positive good in itself, it has been criticized as potentially immobilizing tenants and thus producing pockets of poverty and unemployment. However, the implicit rent subsidy in council housing appears to be less important in reducing mobility than the lack of skills among tenants: U.K. residential mobility is in the middle of rates in the EU, and the sale of council housing in the 1990s did not produce ghettoized neighborhoods. In contrast to the localized job market for nongraduate workers, the United Kingdom developed an integrated market for graduate workers. A principal reason for the difference is that unemployed less-educated workers rarely move to different regions without having first found a job, whereas university graduates are highly mobile upon graduation (Gregg, Machin, and Manning, chap. 9 in this volume).

In sharp contrast to the convergence of inequality between the United

Kingdom and the United States, the eleventh finding is that the rates of poverty measured in absolute terms diverged between the two countries. In the United Kingdom, expanding government benefits reduced poverty considerably, whereas in the United States the impact of benefits was almost negligible. The greatest divergence in benefits is for workless households, whose proportion has grown sharply in the United Kingdom while falling in the United States. Over the same period, relative poverty, which depends critically on the distribution of wages, rose more sharply in the United Kingdom than in the United States, bringing the overall income distribution of the two countries closer together (Dickens and Ellwood, chap. 8 in this volume).

### **Conclusion**

Overall, the efforts of successive U.K. governments to make the economy more market oriented appear to have succeeded, particularly in the 1990s. The reforms studied in this volume improved productivity and contributed to the greater work activity of persons obtaining social benefits, while at the same time contributing to earnings and income inequality although not to absolute poverty. Since the reforms—like most other economic changes—almost surely had adverse effects on some groups in society, for which compensation is rarely paid, some may decide that those costs are not worth the improvement in economic performance, while others believe that the benefits exceed the cost. In any case, the general message of the studies in this volume is clear: The market-oriented reforms of the United Kingdom seem to have accomplished their broad goal of improving U.K. economic performance after a long period of relative decline. Still, we note that the market-oriented reforms did not bring U.K. productivity to the level of the United States or to the level of its major EU partners, leaving it a bit short of the premier-league status that the country hoped to attain. This suggests that further reforms may be necessary for the United Kingdom to catch up with the best-performing economies. What those reforms might be, as well as the potential benefits and risks of further movements toward market determination of economic outcomes or of increased public spending and administrative allocation of resources, lies beyond the scope of our study.