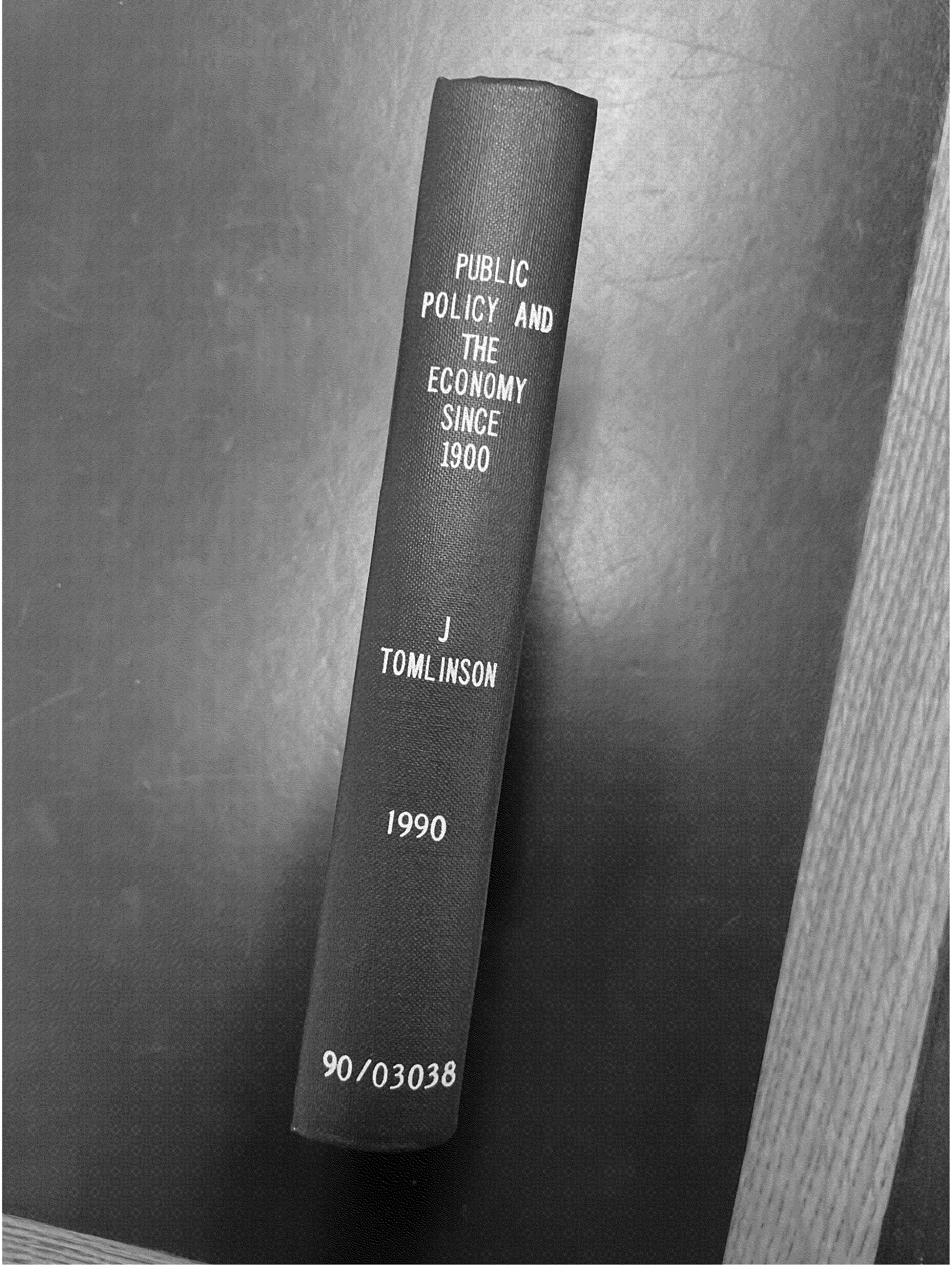
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services has followed, but little has moved internationally, even within the EC where further liberalization waits upon 'harmonization' of legal, accounting, and other institutional conditions.

The absence of a comprehensive free trade offensive by the Conservatives is understandable, even if somewhat in contradiction to their rhetoric. The underlying position is that in manufactures (which account for most of Britain's trade) the scope of existing protection is small—most of Britain's imports came from the EC without any restriction. Whilst free-traders may rail against the MFA and VERs their economic impact on the UK is small, and the short-term political cost of abandoning them could be high, given the likely displeasure of both domestic producers currently protected and international partners to these agreements.

### *The Budgetary Framework*

As discussed in Chapter 10, the budgetary system had undergone a severe crisis in the mid-1970s. This had been precipitated by the sharp increases in both public expenditure and borrowing which occurred in the years from 1972 to 1975. Public expenditure had been propelled to its highest-ever level both in absolute (real) terms and as a share of output (see Table 10.1). The succeeding years 1976/7 and 1977/8 saw a sharp reversal in this trend with very sharp falls in public expenditure, in turn reversed in 1978/9.

The Conservatives thus inherited an upward trend in public expenditure, but where the level was substantially below the peak of 1975/6. In addition they inherited a composition of public expenditure which had previously proved difficult to alter in its fundamental shape. Seventy-five per cent of expenditure went on five broad programmes—health and social services, social security, defence, education, and the Scottish, Welsh, and Northern Irish Offices. The largest of these, social security, was exempt from the cash-limits system introduced by Labour. The Conservative commitment to reduce public expenditure in absolute terms thus implied some combination of significant cuts in these major areas of expenditure, or deep cuts in some of the remaining much smaller programmes.

The difficulty in broad terms was that demand for public expenditure on education and the NHS is substantially demographically determined (Levitt and Joyce 1987). In addition, defence was a political priority for the Conservatives who were committed to a real increase of expenditure in that area, along with law and order. So although cash limits had proved their efficacy as an instrument of cuts in the mid-1970s, they had not of course reduced the political problems associated with such exercises. The inherited structure of public expenditure and their political commitments substantially 'boxed in' Conservative decision-making in this area.

As regards public borrowing, the pattern of a sharp fall from a mid-seventies peak followed by a more gentle upward trend by the time of the Conservative accession is repeated. On the tax side the Conservatives inherited a structure which had been moving for a long time towards a higher incidence of income tax, coupled with lower receipts from indirect and company taxes. In addition they had the growing revenues from North Sea oil, which were destined to reach their peak in 1985/6.

It was within this framework that the Conservatives had to pursue their policies of simultaneous cuts in public borrowing, taxes, and spending. Clearly this was an ambitious programme given the framework outlined here. The Conservatives' actual achievements in this area are returned to below (Politics and Policies).

## Agencies

### *The Treasury*

The strategy of the 1979 Conservative government focused on public finance. It simultaneously downgraded the importance of the government's (direct) role in determining what happened in the real economy, and emphasized the centrality of a sound financial framework. Such a posture clearly fits well with the Treasury's traditional role, a role akin to a Ministry of Finance rather than an economics ministry, with a focus on public finance and public expenditure. Hence the post-1979 period saw a 'natural' enhancement of the Treasury's role *vis-à-vis* other Whitehall Ministries.

The Treasury also gained in influence from the centralization of decision-making into small committees of Cabinet Ministers, usually dominated by the Prime Minister and including the

Chancellor or other Treasury Ministers. This increase in power should not, however, be exaggerated. The Treasury conspicuously failed to deliver the cuts in public expenditure that the Conservatives had aimed for, actual spending increasing throughout the early 1980s (Table 11.2; Pliatzky 1984, pp. 190–207; Thain 1985, pp. 279–81).

In the initial discussions of the MTFS from late 1979, the Treasury seems to have evinced some scepticism over the policy. This seems to have focused on the dangers of committing the government to such long-term targets, as well as doubts about the supposed effects of the policy on wage-bargainers' expectations (Thain 1985, pp. 265–6). On the other hand the MTFS was seen as useful from a Treasury viewpoint as a bargaining weapon with the spending Departments to keep public expenditure down, though in retrospect this seems to have been an exaggerated hope.

Table 11.2 *Public Expenditure under The Conservatives 1979/80–1987/88*

| | Absolute spending (in 1987/8) prices | As share of GDP (%) | |
|---|---|---|---|
| | Excluding privatization proceeds £b. | Including privatization proceeds | Excluding privatization proceeds |
| 1979/80 | 158.6 | 43.25 | 43.5 |
| 1980/81 | 161.5 | 45.75 | 46.0 |
| 1981/82 | 163.3 | 46.25 | 46.5 |
| 1982/83 | 167.6 | 47.75 | 46.75 |
| 1983/84 | 170.5 | 45.5 | 45.75 |
| 1984/85 | 175.2 | 45.5 | 46.25 |
| 1985/86 | 175.0 | 43.75 | 44.5 |
| 1986/87 | 177.8 | 42.75 | 43.75 |
| 1987/88 | 176.7 | 40.5 | 41.5 |

*Source: Autumn Statement*, Nov. 1988 (HC695).

As Thain (1985, p. 269) argues, the Treasury was never able to persuade other departments, local authorities, or nationalized industries that the MTFS was an immutable framework. Public expenditure discussions therefore continued on the old horse-trading basis, and ultimately this meant the targets of the MTFS could not be met. Something had to give if cuts in public expenditure could not finance both tax cuts and cuts in borrowing.

A similar dilemma was resolved in the USA by going ahead with tax cuts and allowing borrowing to multiply; in Britain the opposite occurred, borrowing was reduced and taxes increased. 'In practice the British priority has been fiscal rectitude rather than gambling on the impact of tax cuts in the manner of the Reagan administration' (Riddell 1985, p. 241). This choice probably partly reflected the Treasury's traditional concern with reducing public borrowing, coupled with some scepticism about the at best long-term benefits of tax-cutting on economic growth.

The MTFS embodied the principle of fixed rules both for public borrowing and monetary expansion. Such fixed rules are aimed to narrow the scope of political discretion in policy-making, in the belief that such discretion is likely to respond to pressures in the 'political market-place' rather than any objective notion of the health of the economy. But such a lack of room for manœuvre must be anathema to a government Ministry charged with day-to-day management of the economy and operating within a highly political framework. It is unsurprising, then, that the Treasury, whilst willing to make tactical use of the MTFS, worried about the implied loss of discretion for the Treasury Ministers.

In the event the MTFS did not provide that kind of rigid framework; its targets were largely exceeded. This was most striking in the monetary field (see below), but was also true for the level of public borrowing. However it is right to say that the PSBR is relatively more controllable by the authorities than any money supply target. As Table 11.3 shows, the PSBR targets were exceeded, but not as grossly as the M3 targets. The reasons for this pattern included tax increases noted above, plus such ploys as

Table 11.3 *The First MTFS: Targets and Outcomes*

| | 1980/81 | 1981/82 | 1982/83 | 1983/84 |
|---|---|---|---|---|
| Sterling M3 (% p.a.) | | | | |
| Target | 7–11 | 6–10 | 5–9 | 4–8 |
| Actual | 17.9 | 13.6 | 11.7 | 8.2 |
| PSBR (% GDP) | | | | |
| Target | 3.75 | 3.0 | 2.25 | 1.5 |
| Actual | 5.4 | 3.3 | 3.1 | 3.2 |

*Sources*: *Financial Statement and Budget Report 1980* (HC500, 1979/80).

public asset sales (privatization) which, counting as 'negative public expenditure' thereby reduced public borrowing for any given level of expenditure and taxation. Whilst the politicians could rejoice at this extension of people's capitalism, the Treasury could take credit for an imaginative way of bridging the public finance gap.

From 1982 the aim of reducing public spending was given up. This strategy change resulted above all from the realization that such cuts would have to mean a substantial cut-back in welfare state provision, which a majority of the Cabinet found unpalatable (Riddell 1985). The target then became to reduce the share of public expenditure in national income, thus making possible tax cuts with continuing increases in absolute levels of expenditure. By the mid-1980s this was firmly established as the new strategy, and a successful one in its own terms. The share of public expenditure in national income peaked in 1982/83 and then fell, making possible both a lower level of public borrowing and lower taxes. This was almost Utopia for the Treasury, though tax levels for the mass of the population were no lower than in the last year of the Labour government.

Ham (1981) has pictured the Conservatives' economic policies as a triumph for the Treasury's attachment to obscurantist economic theory and its unconcern with the real economy. The particular question of doctrine is returned to below, but the general theme of Ham's argument raises the question, how important was the Treasury in bringing the MTFS into being? The broad answer must be 'not very'. The MTFS was largely dreamt up outside official circles; it was pushed through by (a small number of) Ministers rather than imposed upon them. The Treasury welcomed certain aspects of it and worried about others, as noted above. Some Treasury civil servants were enthusiasts for the policy, but Ham surely exaggerates their significance. The MTFS was above all a political strategy, to be understood best as the outcome of certain political calculations, not as the imposition of a Treasury undergoing a renewed attachment to 'pre-Keynesian' theory.

## *The Bank of England*

The role of the Bank of England has been enhanced by recent changes in the environment of policy-making. Above all, the growing focus on financial confidence as the economy has become more open to international pressures has unavoidably enhanced the status of a body, one of whose central concerns is to tell governments about the state of such confidence. The Bank has always functioned as a conduit for presenting the prevailing state of City opinion to the government, and City opinion has come to matter more and more to governments, that opinion seeming to function as an 'objective' assessment of government policy in some accounts (Walters 1986).

In addition the Bank has the expertise in the areas highlighted by recent policy discussions, such as the exchange rate, monetary control and government borrowing. Finally, the Bank has close links with international bodies like the IMF, OECD, and the World Bank, whose own roles have mattered more with the internationalization of the economy (Thain 1984, p. 593).

These had been trends pre-dating the Conservatives' accession to power in 1979, but strongly reinforced after that date. The Bank seems to have played a limited role in the actual formulation of the MTFS (Thain 1985, p. 267) but its monetary targeting in particular accorded with well-established Bank of England desires (see Chapter 10 above). In the event monetary targeting in the early years of the MTFS was a fiasco, and this appears to have been blamed to some extent on the Bank. Certainly it seems to have been the case that the Bank began earlier than the Treasury or the government as a whole to worry about the exchange-rate consequences of policy (Walters 1986, pp. 135, 144; Keegan 1984, pp. 145–7). This accompanied some scepticism about the technical merits of focusing on the £M3 target. However, insider accounts (notably Fforde 1983) suggest that these technical difficulties were initially seen by the Bank as outweighed by the benefits of a simple monetary target in conveying to the public the government's anti-inflationary intentions.

Even before the MTFS period the Bank was conducting examinations of possible alternative targets for monetary policy. However once the initial shock to expectations had been delivered, the Bank argued strongly against replacing the M3 target with any other single measure. In particular it resisted monetary-base control, i.e. a very narrow measure of the money supply, as an alternative, mainly because it believed such a policy would lead to sharp fluctuations in interest rates in the attempt to control this magnitude (*BEQB* 1979; Cmnd. 7858; Keegan 1984, pp. 153–6).

Like the Treasury, the Bank of England favoured the firm anti-inflationary stance of the Thatcher government, and accepted that this meant involve a clear 'no U-turn' posture emphasized in the Medium Term aspect of policy. But its knowledge of monetary behaviour, and above all its attachment to discretion in monetary management, made it wary of the kind of 'fixed-rule' policy that the MTFS could be seen to suggest. Thus the bank played a considerable role in the retreat from the initial 'hard' monetary targeting of 1980 to the much more pragmatic policies of 1981 onwards. These involved an attention to a wide variety of monetary indices, but especially the exchange rate. Unacceptable movements in these indices were to be responded to on an *ad hoc* basis mainly via variations in interest rates. Such a role was extremely congenial to the Bank, combining as it did a focus on its major concern (inflation) with a wide degree of day-to-day discretion on how this concern was to be translated into policy measures.

## Doctrine

The ferment in economic theory evident in the mid-1970s reached a crescendo in the years around the election of the Conservative government. In many accounts of this period the policies pursued by the government are seen as a direct application of new monetarist theories—in Galbraith's often-quoted words, 'Britain has, in effect, volunteered to be the Friedmanite guinea-pig' (cited Keegan 1984, Frontispiece).

There is no doubt that economic theory, especially macro-economics, underwent a profound crisis in the 1970s, paralleled only by the original Keynesian revolution in doctrine in the 1930s. There also can be no doubt that Conservative policy after 1979 could and did draw on economic theory as a defence for its objectives and instruments. However this conjunction of theoretical and policy revolution should not be treated as proof of causation. To try and assess the extent and nature of this link some brief account must be given of the various strands of theoretical argument used to discuss macroeconomics in the late 1970s and early 1980s.