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U.S. ECONOMIC DECLINE--
HOW FAR BEHIND THE UK?

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Case Study by JOHN A. BUSHNELL

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John A. Bushnell

SUMMARY

There is no US counterpart to most of the underlying reasons for Britain's slow economic growth during the past 25 years. Social class consciousness, an educational system that does little to promote upward mobility, a we/they antagonistic attitude between management and labor, low prestige and inadequate training for management professionals are not drags on US productivity as they are in the UK. Similarly, extremely egalitarian tax policies reducing incentives for managers and investors and the effects of losing Commonwealth preferences are not US problems. Some warning flags for the US may be apparent in inflation rates and reduced incentives for low-income workers because of social benefit payments. Similarities are great in the rapid growth of government employment and transfers, which place a continually growing burden to support low productivity persons on a continually smaller proportion of the population in high productivity employment.

The main area in which the US might learn from British experience is that the focus of government policies on short-term measures to reduce unemployment or inflation (or manage payments crises) results in a stop-go cycle reducing growth without addressing such basic determinants of long-term growth as saving and investment rates. Only after a quarter century of experience with the failures of stop-go is Britain beginning to realize it is essential to focus on such basic issues as the rate and direction of investment. An imbalance, in which there has not been sufficient investment to provide high productivity jobs for all those wanting to work, is increasingly believed to be the root cause of many of the UK's growth and productivity problems. Treatment of the symptoms of unemployment and inflation is not a sufficient response.

There are signs that, for different reasons, a similar imbalance between investment and the labor force has developed in the US since the mid-1960's and a similar tendency to treat the symptoms with rapidly shifting fiscal and monetary policies. Given the large growth in the US labor force and the lower proportion of US GNP devoted to investment, it appears that the problem of generating sufficient investment to provide high productivity jobs for all who want to work may be at least as hard to resolve in the US as in Britain.

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Introduction

During the past quarter century UK living standards have increased less than in the rest of Western Europe and at a slower rate than in Eastern Europe and many developing countries. In 1950 GNP per person employed in West Germany was only 63 percent that in Britain, in Italy 52 percent, in France 83 percent. In 1973 German GNP per person employed was 129 percent of the British level, France 132 percent and Italy 100 percent. Intercountry comparisons, especially over long time periods, are technically imperfect because of such factors as differences in prices of non-traded goods and different systems of taxation and transfers. However, all the evidence from both observers and data supports the general direction and nature of the change. Productivity has lagged in Britain. For example, productivity in British industry increased by an average of only 3.5 percent a year from 1960 to 1974 while industrial productivity in the continental EEC increased at 5.3 percent. In services British output per employee increased only 1.4 percent a year compared with 3.4 percent in the EEC. Value added per manufacturing employee is now about two-thirds more in France, Germany and the Netherlands than in Britain.

Although the relatively weak performance of the UK economy is widely recognized in both the US and UK, there is little recognition in the US that many measures show the UK improving in relation to the US economy. By asking what have been the basic causes of weak economic performance in the UK, it may be possible to gain some insights into US economic problems.

Major Reasons for Slow UK Growth

There is no consensus in Britain on the reasons for poor economic performance. It is not the purpose of this paper to join this heated debate but merely to summarize roughly the main causes emphasized under two broad areas and four individual causes.

The first of the major areas is the social structure - the class consciousness of the British. Some observers focus on the difficulties caused by labor while others focus on the weaknesses of management. There is general agreement that management has been a neglected profession, until recently low on the scale of social prestige in comparison with other professions, the civil service or the financial community. Advanced university training for management has developed only in the past decade. Even for related professions such as engineering there are many empty spaces in universities while such faculties as history are oversubscribed. Labor leadership often has an uncooperative attitude toward management particularly at the shop level. The development of labor unions by craft instead of one union for a plant or industry has also greatly complicated labor-management relations. The general approach of both labor and management seems to be that of dividing a fixed pie - a zero-sum game. Only recently is the concept becoming widespread that management and labor should cooperate to increase productivity to benefit both.

Social mobility has been low. In Britain a father generally expects his son to do the same sort of work he does or at least to remain at the same social level. Few that start on the shop floor reach management. The education system requires early career choice and contributes to the lack of social mobility. Some observers would rank the educational structure as the greatest problem in social mobility and thus as the major underlying cause of a we/they, zero-sum relationship limiting productivity growth. Labor has turned to national politics for social gains and security instead of to employers, for example for health insurance, subsidized housing and additional holidays. Removal of such items from the collective bargaining table has diminished the number of carrots management has to trade for productivity improvement, if a management should be interested in bargaining for such improvement.

There are of course examples of good management in Britain, especially in technologically advanced private sector industries. The statistics generally show British productivity much closer to EEC levels in these industries. Labor relations are also generally better. Foreign observers report that the profitability of EEC and US companies in Britain compares favorably with profitability at home. Some suggest that adoption of foreign management techniques, usually with British management personnel, is a major reason for foreign firms' productivity being generally higher than that of domestic firms. On the other hand there are few foreign firms in declining industries such as textiles and steel.

In short, one of the main problems in Britain has been a class consciousness and structure that has limited the economy's ability to generate sufficient highest quality managers and to bring labor and management together to maximize productivity.

The second major area of underlying problems is an imbalance between the size of the labor force and the availability of equipment to enable all members to attain high productivity. Some observers focus only on the relatively low rate of investment. Others fault the very rapid growth of the public sector as the underlying reason for the low level of investment because of high taxes and crowding-out from capital markets. Others believe that the level of investment and savings as a percentage of GNP is not so much the problem as the poor allocation of the investment that is made, for example government support for the supersonic transport and nationalized industries. Some blame rapidly changing monetary, fiscal and exchange rate policies for a stop-go economic cycle that they believe has discouraged investment. Others focus on management for inability to adopt newer technological innovations and for too much investment in old and dying industries. Some emphasize the role of labor in resisting new labor-saving machinery. A few cite the attractiveness of investment abroad despite controls as a reason for lack of capital at home.

Whatever the correct mix of underlying causes there has not been sufficient investment of the right kind to provide a high productivity job for each member of the work force.

Other Reasons for Slow UK Growth

The above general categories subsume most of the commonly mentioned explanations for slow British growth, but four individual factors warrant mention. First, incentives for high productivity increases from labor, investors and managers have been weakened by government policies, especially egalitarian tax policies. The marginal rate is 83 percent on taxable earned income over 21,000 pounds ($36,750 at March 1977 exchange rates). A surcharge of 15 percent is added on investment income over 2000 pounds. The marginal rate on taxable earned income reaches 50 percent, the maximum US rate on earned income, at taxable income of about $14,000. Some believe that such steep rates strongly discourage managers from making additional effort toward higher productivity and promotion. Some of the best managerial talent is said to migrate to the US and Europe in considerable part because of the tax structure. Since the tax collector will be the principal beneficiary of entrepreneurial success while the entrepreneur stands to be the loser, the incentive to take risks is greatly reduced. On the other hand some argue that British managers and professionals work as hard as such personnel in other economies, that fringe benefits (some of which continue to escape tax although the system is continually tightened) partially offset high tax rates, and that entrepreneurs in particular have found ways to escape high tax rates.

Similarly a strong case in logic can be made that the tax and social benefit structure strongly discourages additional work at the lower end of the income scale. At some levels in the vicinity of $3000 the marginal value of additional income is actually negative. The reduction of rent subsidies, property tax rebates and family income supplements coupled with payment of taxes on additional income leaves a worker with less as he earns more. Most British observers believe this situation - gradually being corrected in recent budgets - has little effect on work attitudes.

The second specific explanation of slow British growth is a rapid structural shift with an increasing proportion of the

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economy being in areas of relatively low productivity. Between 1964 and 1974 manufacturing dropped from 33.0 percent of GDP to 27.4 percent while public administration, defense, public health and educational services rose from 9.9 to 13.5 percent. Commentators such as Bacon and Eltis in Britain's Economic Problem: Too Few Producers argue that the problem is a shift from the productive sector to the non-productive sector, which is defined to include such services as transportation and distribution as well as government. They point out that government spending, including pensions and other transfers, increased from 38 percent of GNP in 1964 to 49 percent in 1974. Moreover, they argue that much of this increase is because of public salary increases at rates above the national average. They doubt that public sector productivity has increased commensurate with the increase in salary levels.

The third economic factor frequently mentioned is the inflation rate, one of the highest among developed countries. Inflation can distort productive activities, for example by creating misleading paper profits on inventory while a firm is being reduced in real size because depreciation allowances are not sufficient to replace equipment which is no longer useful. Steps have recently been taken to reduce these effects through accounting and taxation changes. Rapid inflation may be more an effect of slow growth than a cause; the efforts of various groups to increase their standard of living, while overall growth is low, tend to cause inflation.

The final of these specific explanations for slow British growth is the effects of the loss of "empire." Some economists argue British industry tended to be structured to serve the Commonwealth markets, where it had tariff and other privileges. Because of the great variety of demands from this market, ranging from India and Ghana to Australia and Canada, production runs tended to be short and specialized, often without the newest technology or highest quality. In contrast export industries in Germany and Japan developed the longest possible runs and stressed quality to get into the worldwide market. As Commonwealth members produced more manufactures and special import privileges disappeared, British industries had neither the capacity nor the management attitude necessary to compete in the tougher worldwide market.

To complete the inventory there are some factors which most students of the UK do not believe contributed to weak economic performance. No one cites insufficient labor, though the labor force grew much less than expected a generation ago. Most believe labor has been mobile to the extent necessary in terms of both geographic movement and entering needed trades or professions; shortages of good managers and certain types of engineers may be exceptions. Although a few mention the loss of the political empire as a major contributor to the problems of sterling, most agree that sterling problems have been more the result than the cause of internal problems. Occasionally failure to develop advanced technology in a particular field is mentioned, but there is little evidence that the UK has been left behind on production technology. OECD figures show British manufacturing plant is on average newer than that of the US.

Do the British Have a Problem?

Some British challenge the hypothesis that the UK has done less well than other countries. They argue the GNP figures do not measure the peace of mind and security inherent in advances such as assured health care, an improved pension system and greater equality of living conditions between those with high and low incomes. Some argue that the standard comparisons do not count on the plus side the human advantages inherent in what is called overmanning and that, quite the opposite of productivity in government being low, it is high in features involving attention to human problems. Environmentalists point out that Britain has made greater strides toward clean air and water than some countries with which it is compared. Cleaner air and water do not count in GNP. Another way in which a few approach this issue is that the British are in the vanguard of developing a new social order in which work and output, as traditionally measured, are lower priority. Although such views are generally believed to be held by only a small minority, the comment is frequently made that a key problem in improving national productivity is the lack of a consensus on either the desirability of expanding output or on its distribution.

Most UK opinion leaders seem to believe there is a growth problem as indicated in a 1976 survey in which the British Consumer's Association asked members of Parliament, trade union leaders, industrialists, financial leaders, and economists what they thought caused Britain's slow growth. Four items received the strongest support: insufficient investment, bad government, trouble with unions, and overmanning. Bad management and antiquated social values received fairly strong support. Opinions were divided on: profits-too-low, taxes-too-high; too much government spending; and others work harder.

The Situation of the United States

There are so many differences between the British and American economies that any comparisons must be made with caution. The US has the world's largest economy, and there is little possibility that its overall predominate position will soon be challenged by countries with much smaller populations. However, when measured on a per capita basis, most other developed economies appear to be catching up with the US and in many cases generating development momentum that promises to carry them well beyond US production and living standards.

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Perhaps the most important ingredient in economic growth is investment, and the US ranks at the bottom of the OECD league in proportion of income devoted to investment. In 1970-74 US gross investment was only 18 percent of GDP compared with 26 percent for West Germany and 38 percent for Japan. Even the lagging UK invested 20 percent of its GDP. The population of the US has been growing faster than that of many other developed countries because of both higher natural increase and greater net inward migration. From 1960 to 1974 the US population grew 17 percent while that of West Germany increased 11 percent and of the UK 6 percent. Thus a greater part of investment in the US must be used to provide for the more rapidly growing population. The result is apparent in the growth rates of per capita GDP. In 1975 US GDP per capita in current prices was 2.5 times what it had been in 1960. Using current exchange rates, which should roughly offset differing inflation rates among countries, the increase over the same period in West Germany was 5.0 times and in Japan 9.6 times. UK per capita GDP grew by a factor of 2.8, modestly more than in the US; France by 4.4 and Italy by 4.2. In 1964 US labor costs were 268 percent of those in the UK, in 1974 194 percent. Labor costs in other countries have been growing much more rapidly and are now as high as the US in Germany and Scandinavia. In 1964 Japanese labor costs were only one-sixth those in the US; in 1974 they were half US costs.

British economists question whether it is the US which might follow Britain into relative economic decline or the other way around. Certainly many of the signs of the relative economic decline which has now become a major concern in the UK are also present in the US, although the level of public awareness in the US is still low as it was in the UK a decade ago.

US/UK Comparison

Most of the underlying reasons for relatively slow growth in the UK do not apply in the US. The US social structure is usually used by the British as the ideal against which to measure their weaknesses. Social mobility in the US is high, class consciousness low. The current stress on upward mobility for women, blacks and other minorities emphasizes the continuing vigor of such mobility. Management is a high prestige profession, and the US is generally considered a leader in management techniques and training. Although more hours per worker are lost to strikes in the US than in the UK, most experts believe US unions and management generally are much more cooperative in improving productivity.

The incentive structure is much stronger in the US with a relatively low cap to the progressive tax structure for earned income. Various government policies encourage large financial rewards for innovation and production that pleases the market. Initial signs of concern are being voiced, however, at the lower end of the income scale. Some families can increase their take-home income by quitting their jobs and collecting tax-free unemployment benefits supplemented by welfare payments and food stamps. Even in times of high unemployment most Americans seem to accept the need for low-skill immigration and believe it does not displace citizen labor because American workers will not take certain low-paid jobs.

The structural shift toward services has caused little concern because productivity in other private sectors in the US such as transportation and distribution seems to be closer to manufacturing levels. There is concern with the growth of government employment. The parallel with the UK is disconcerting. From 1961 to 1974 UK local government employment grew by 54 percent and increased from 7 to 11 percent of the work force. US state and local government employment doubled between 1960 and 1975, increasing from 8 to 13 percent of the work force.

Inflation rates have been substantially lower in the US, although inflation in the 1960's has become a major concern. There is no counterpart for the US to the loss of Commonwealth preferences.

The one major area of underlying problems in Britain for which there seems to be a close US parallel is the imbalance between investment and labor. The hypothesis of this paper is that during the past decade there has been insufficient US investment of the right kind to provide a high productivity job for each member of the work force. This situation was partially disguised during the mid-1960's by the effects of the Indo-China War. The reasons for the development of this imbalance are quite different in the US from those in the UK. For example, most economists would put less emphasis on poor use of investment resources in the US and more on the low percentage of GNP saved and invested.

Most would also give heavy emphasis to the rapid growth of the US labor force from 77 million in 1966 to 97 million in 1976. Part of this increase was caused by the maturing of the postwar baby boom and substantial inward migration. Another important factor was the increased participation of women. In 1965 39 percent of women were in the labor force; in 1975, 47 percent. Had female participation stayed at the 1965 level, in 1975 there would have been 6,000,000 fewer in the labor force. Other things being equal, there would have been a labor shortage in 1976 instead of an unemployment problem. Logic would indicate a rapid increase in the labor force requires an increase in saving and investment for high productivity, yet savings rates dropped from 8.0 percent of GDP in 1960-64 to 7.5 percent in 1970-74.

In the UK the work force has not increased over the past decade. Thus all net UK investment was directed toward increasing per capita productivity while a substantial proportion of net US investment was required to provide the tools for additional workers. In short, the proportion of GDP available to increase

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productivity is substantially lower in the US than in the UK. The fact that US productivity increases have been only slightly below those in the UK suggests that investment capital is better used in the US because of some combination of management, labor efficiency and the natural resource, market, governmental environment.

The most valuable lessons the US might learn from the British experience of the past quarter century involve understanding the ways imbalance between investment and labor supply feeds on itself and causes or complicates other problems.

Vicious and Virtuous Circles

Articulation of a vicious circle of imbalance between investment and the labor force as a framework for considering slow British growth is a feature of this paper. There is general recognition in the UK that more investment in high technology areas is essential to provide high productivity jobs for the presently unemployed, that growth in low productivity public sector employment is not a viable alternative, and that the tendency to overmanning and overconcern with redundancy is a major problem. Although most UK groups including the Trade Union Congress, management groups, economists and even politicians share these views, there has not been a general framework to relate these and other closely related economic factors, especially monetary and fiscal policy and inflation.

A great deal of attention is given to the ups and downs of the business cycle and the supposed tradeoff between unemployment and inflation. But little national policy attention is given to the development of underlying productive capacity. Because of the more immediate political concern with employment and inflation, the fundamental role of investment and saving tends to be overlooked. Perhaps the benefits of investment decisions, which are usually years in the future, are too far over the political horizon.

New investment changes the demand for labor in two opposite ways. Some investments are labor-saving; they permit the same or even increased production with less labor. Such investment is the motor force increasing productivity and living standards, but it increases unemployment. There are other investments, essentially duplications of existing plants to produce more, which require additional workers. Such investments increase total output but not per worker productivity. These two sorts of investment are, of course, often combined. The amount of total investment and the mix between these two types change over time.

The size of the national work force is also changing over time. It would be ideal if the change in the labor force required by the net effect of investment were identical with the actual change (assuming an initial balance). Traditionally economic theory argued that over time investment and labor would be kept in balance by market forces. If there were too much labor, wage rates would decline and entrepreneurs would turn to more labor intensive production. There would be less demand for capital; interest rates would drop; there would be less saving and investment. If there were too little labor, wage rates would be bid up and more investment would be directed to substitution for labor. Things did seem to happen along these lines from 1800 to about 1930.

Now such major restraints have been placed on these market forces that they can no longer be expected to balance investment and labor supply. Wages are inflexible downward because of union action and contracts and because of government actions such as the minimum wage. As a firm's labor force is usually one of its most valuable assets, in which immense investments in training and experience have been made, both the firm and the labor union prefer to preserve the living standards of the current workers regardless of how many non-employees may be unemployed. Lester Thurow has recently advanced understanding of this point. He argues that initially much employment requires on-the-job training which can only be provided with the help of those already employed. Those already employed are willing to accept new workers only so long as this involves no cost to themselves, i.e., no wage cutting.

Moreover, government policies have largely replaced market forces in setting interest rates, and interest has only a limited effect on savings rates in part because much consumer saving has been institutionalized. In short developments in the past 50 years have crippled or eliminated the always imperfect market mechanisms which might keep labor and capital in balance, but modern societies have not substituted any alternative mechanisms to provide such a balance.

Unfortunately some of the government actions which have in part replaced market forces make the imbalance worse. The usual reaction to an increase in unemployment is increased government spending on both unemployment transfers and employment creation. Not only does such spending erode the market effects of potential wage changes but it also requires that the government raise additional funds. Often these funds are raised, through taxes or borrowing, in direct competition with investment financing. Thus, while the desirable situation would be for investment to increase to provide high productivity jobs for the "surplus" workers, investment may actually decline. Provided it is mainly productivity-increasing investment that declines, thus avoiding displacement of additional workers, this result may be employment stabilizing. But, as wage rates have not declined nor the pace of technology development changed, there is no reason for this sort of investment to decline. Since unemployment is associated with an expectation of slower growth in demand, the reduction in investment is likely to be precisely in the sort of plant-duplicating investment that might provide additional jobs.

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There has been a tendency in both the US and UK to measure underutilization of economic capacity by the unemployment rate. Such measurement illustrates the widespread fallacy that there "must be" a balance between physical productive capacity and labor supply. Acting on this fallacy governments take a series of measures to increase total demand, focusing on the lack of demand for the output of the unemployed but missing the key ingredient of efficient plant to produce the additional goods, in particular the right mix of capacity to produce the goods for which demand has increased. There is always excess capacity in some industries, especially declining industries, and a shortage of capacity in industries to which demand is shifting. As demand is increased, some additional workers are employed to use some of the excess capacity. However, as the process continues physical capacity bottlenecks are reached for more and more products, resulting in price increases and increased imports of these products. The result may be a balance of payments crisis and/or inflationary pressures even while largescale unemployment continues.

As the physical capacity bottlenecks become more numerous, business accelerates investment. The effect may be to increase inflation or payments pressures because of this addition to total demand depending on the level and nature of excess capacity in the capital goods industry. For a sustained substantial increase in investment to go forward an increase in savings is necessary. Higher business profits and a reduced government deficit resulting from the higher demand promote an increase in saving. But the general improvement in confidence often associated with a business pickup promotes an offsetting reduction in consumer saving.

The pattern in Britain has been for inflationary and/or payments pressures to cause governments to restrain total demand well before the beneficial effects of the increased investment could be felt. Action to restrain demand tended to reduce investment; sometimes such action was concentrated on investment demand.

There is another discouraging aspect of this vicious circle. As substantial unemployment persists over a considerable period, the society tries to reduce unemployment through make-work and overmanning. Workers resist labor saving machinery. Governments employ additional personnel even though providing them with little capital (or tasks). Governments support more training programs, keeping teachers and students off the unemployment roles even though there are no jobs when training is completed. The result is lower productivity and slower growth. When inflation and payments problems develop, there are increasing pressures to increase taxes to pay for the government employment creation. The increase in taxes often draws funds in part that would otherwise have gone to investment.

In Britain such demand expansion, demand contraction policies are called a stop-go policy. A stop-go history itself becomes a drag on investment. Businessmen learn that, if they invest on the go-phase, they will have the new capacity available just in time to be unprofitable during the stop-phase. Similarly price and wage controls have reduced investment by holding down profits just when relatively high profits should have provided both the signal and the funds for increased investment.

The history of the US economy during the 1970's is similar in many respects to the stop-go, incomes policy, investor uncertainty history of Britain.

Several factors in addition to the rapid increase in the labor force have contributed to this vicious circle in the US. The energy crisis and the wide fluctuations in basic food prices have tended to exaggerate both capacity bottlenecks and underutilized capacity as the composition of demand has changed faster than investment can be shifted. Business confidence that it can predict future demand has been weakened by several developments: an increasing rate of technological change, increasing discretionary income giving consumers greater flexibility in shifting demand quickly, the spread of government regulation, and the tremendous expansion of international trade. Business must predict both the level of demand in future years and whether or not it will be able to meet potential competition not only from other domestic firms facing similar labor, financial and government conditions but also from foreign firms which may have quite different conditions.

In summary, just at the time when substantial increases in saving and investment rates were needed to provide the productive equipment for a rapidly growing US labor force, various factors have interacted to restrain investment.

There is also a virtuous circle in which a high rate of investment and/or decline in the labor force results in insufficient labor being available for all the productive capacity. The shortage of labor results in more efficient labor use, bidding labor away from the least productive uses. Because the virtuous circle imbalance of labor and capital increases productivity substantially, the rapid growth of incomes and living standards facilitates the high rates of saving and investment which keep the virtuous circle going. West Germany and Japan seem to have found their way on to this virtuous circle.

<u>The Future</u>

In some developing countries authoritarian regimes are able to hold "surplus" labor in subsistence agriculture or marginal slums, permitting investment to be concentrated on rapid growth for the rest of the economy. Alternative ways of balancing investment and the labor force will have to be found in the US and UK. But there has not yet developed either a full discussion or a consensus on future economic goals.

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Some question the objective of providing sufficient capital for all workers to be highly productive with the accompanying concentration on material goods. As the distribution of unemployment today does not seem to be anyone's choice of a "leisure" option, such an option would probably require major action to encourage people to leave the labor force. A required two years of community service for young (or old) people would also fit such an option, as would reductions of the workweek and workyear. More relaxed work standards may present major problems in the efficient use of capital. If a rapid growth strategy is to be the means of sustaining full employemnt, effective ways must be found to increase saving and investment rates and hold them steadily high regardless of inflation and unemployment rates.

Over the next couple of decades the imbalance should be reduced in the US as reduced birth rates mean smaller cohorts of teenagers will be entering the work force. There is also some limit to the increase in female participation. Immigration trends are uncertain. A key question is to what extent overmanning and other disguised unemployment are being bulit into the economy in ways that will not be easily reversed when labor becomes scarcer.

ANNEX - WHAT'S NOT IN THE PAPER

To maximize possibilities for publication of the basic paper effort was made to keep it short. This annex includes additional related material and comments on some of the problems brushed over in the basic paper.

Summarizing the British View

The greatest problem in preparing this comparison between the British and US economies was establishing a framework to describe the reasons for poor UK economic performance. There are about twice as many views on the basic causes of slow UK growth as there are Englishmen. The emphasis depends in part on the weather and the day's headlines. Moreover, few observers make a black and white argument, i.e. that the cause is a and not b. Instead the usual argument is that a is very important and b, while having some influence, is not in the same league.

Moreover, it was often difficult to distinguish cause and effect. For example, the paper emphasizes social class consciousness; it also gives considerable attention to the effects on incentives of the highly egalitarian tax structure. Many would argue that the tax structure is an outgrowth of the class consciousness - the working classes attempting to level down their "superiors" - and thus is subsumed within that underlying cause. Others would argue that the class consciousness itself is merely an outgrowth of the education system and should not be classed as a basic cause.

There was a trade-off between presenting a fairly long list, in which one could do a good job of clarifying individual causes, and a much shorter grouping of related causes. Because of the many ways in which one factor affects another and the difficulties of separating cause and effect, it was decided to focus on two broad general categories. Some individual causes were also identified either because they were not included in the broad categories - loss of Commonwealth - or because they tended to get so lost in a broad category that they received insufficient attention - growth of government.

Admittedly, in constructing the framework for the British part, one eye was on the US comparisons. It might appear that factors on which the US is different were placed in one broad category - social class consciousness - and factors where there is similarity were placed in the other - the imbalance between labor and investment. This was not the plan. The economic factors such as saving, fiscal policy, productivity and changes in the labor force fell together because they are interrelated. As the study progressed, it was clear that the interrelationships

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among these economic factors were the most relevant elements of the British situation for the US, even though the relationships are still poorly understood in Britain. Thus these interrelationships became the focus of the study.

This focus assisted greatly in handling the various time-phases of the analysis. The debate on short-term monetary and fiscal policy tends to ignore completely the underlying factors of saving and investment. Similarly, discussion of underlying productivity factors proceeds independent of short-term fiscal and monetary policy. This paper attempts to bring them together.

One aspect of the British situation which is related to many of the factors mentioned but seemed to get omitted in the summarizing is the seeming lack of dynamism in British society. Perhaps the change in Britain's place in the world during the lifetime of many of its current opinion leaders sapped some of the spark. Perhaps stability in labor force and population erodes enthusiasm. In some respects this British attitude seems similar to the US pessimistic "turn-off" on the nation following Watergate, Indo-China and the energy crisis. However, what may seem a lack of dynamism may in fact be an adjustment to a different national life-style.

A brilliant new book, <u>Social Limits to Growth</u>, by a British economist and journalist who has lived in the US for years may contain the beginnings of a framework to understand these changes. Fred Hirsch asks why economic growth has been so unsatisfying and why problems of distributional equity tend to loom larger as incomes increase. He identifies part of the answers as a natural shortage of "positional goods." Positional goods are hierarchical in nature such as being the boss, having a superior education, or owning a secluded home in the countryside or on an ocean beach. As people get richer in GNP terms, they become frustrated trying to obtain more positional goods. (Ambassadorships are a good example of position goods, high in prestige because they are limited in number.)

One of Hirsch's many interesting points is that a society should try to separate two sorts of rewards, positional goods and income which can be used only to buy more non-positonal goods. For example, chief executive officers of large companies would be paid less than their senior technicians because part of their pay would be the positional satisfaction of being the boss. The British have moved some distance toward such a system.

<u>Theories Omitted</u>

According to the press (Reuter, January 24, 1977), former Prime Minister Wilson told a television audience that the wartime lendlease pact was a major cause of Britain's problems. "Two World wars took all our investments. And the lendlease agreement with the Americans not only took all our markets, which was justified as we didn't want shipping going to Latin America, but we had to give them all our inventions." He mentioned nuclear inventions, the hovercraft, penicillin and radar. This line of reasoning was omitted from the paper because all these inventions do not seem to have boosted US growth in comparison with Germany and Japan.

Moreover, it is not true that the war cost Britain its overseas investments. Even though Britain has borrowed large amounts, especially in the past decade, its external balancesheet showed equal assets and liabilities at the end of 1975. Among the major items were: private direct investment overseas excluding oil of nearly 14 billion pounds compared with such foreign investment in the UK of 6 billion; foreign borrowing by the public sector of nearly 11 billion pounds; liabilities of about 5 billion pounds in sterling advances and deposits. Britain's period as a net capital importer has been characterized not by sale of its overseas assets (largely private sector) but by large public sector borrowing. The same pattern has occurred for the US in recent years as the Treasury has borrowed directly through sales of government bonds to OPEC and other surplus countries and indirectly through the holding of the reserves of surplus countries in dollars.

Another omitted theory is that the UK did not suffer enough destruction during the Second World War. Much of its industry was repaired while Germany and Japan had to start all over and thus introduced more modern equipment. OECD data show that UK industrial equipment on average is newer than that in the US, perhaps because the US had even less wartime damage. However, little of the plant now being used in Germany and Japan was built as long ago as 1950.

The paper barely mentions nationalization of industry - a hot political issue in Britain. In part this omission is because the division of British opinion is such that the paper would have to note that some believe productivity has been substantially reduced because there has been too much nationalization and some believe insufficient nationalization has reduced and distorted investment. Most would agree that the back-and-forth on nationalization has reduced productivity. The threat of nationalization must also have reduced investment to some extent, perhaps on inefficient plants where it should have been even lower.

The underlying problem is the general tendency in Britain to stick with declining industries. To the extent nationalization was an alternative for a low-productivity business going out of existence and freeing resources for higher productivity use, it was a disaster. But in few cases was demise the alternative. In short the practice of shoring up industries in trouble, whether through nationalization or the many other means employed, is the real problem and in most cases nationalization itself is merely a noisy distraction.

The paper tried to avoid discussing such issues as nationalization and the growth of government in such emotional terms as socialism or free enterprise. However, for many class consciousness is in large part a difference between belief in a decentralized market and belief in government action. Problems of socialism are frequently cited as the root of UK problems. For example, in an interview published in The Director Prince Philip blamed the decline of Britain on high taxation and socialist measures that have diminished incentives.

The figures indicate that UK after-tax-income is distributed more equally than in any other country with the possible exception of Australia.(The US is among the least equal among developed countries.) But the concern with improving equality continues to be a driving force in British political life, more so than in most other countries. One aspect is the reduction of wage differentials between skilled and unskilled workers. The strike at Leyland Motors in early 1977 was caused largely because of the concern of tool-makers - skilled workers who maintain the machines - that they are paid little more than the unskilled workers who run the machines. Some believe the pressures on the middle middleclass - the skilled workers, the small entrepreneurs, the whitecollar technicians - to fall into the living patterns of the unskilled is one of the most serious aspects of the British situation. They argue that this large group, on whom much of productivity depends, increasingly see little possibility of maintaining a significant margin in living standards over the unskilled. Therefore the skilled increasingly perform with indifference.

The final hypothesis, omitted from the paper more because it was unclear than because it may not have central importance, is that an inadequate financial structure is a major cause of low British saving and investment rates. This argument is sometimes little more than a justification for government ownership or, alternatively, higher after-tax profits. However, there is a real problem. In 1973 household savings as a percent of disposable income were 15 percent in France and Germany and 24 percent in Italy but only 7 percent in the UK and 8 percent in the US. One reason frequently given for low US and UK personal savings rates is that social benefits have been expanded so that there is no longer an incentive to save for such things as medical emergencies and old age. But similar improvements have taken place in countries with much higher savings rates.

Another explanation is that neither the private nor the public sector has developed sufficient mechanisms for average people to see their savings translated into useful assets. Those who argue along these lines suggest such programs as: discount sale of stock to a company's workers, customers and suppliers; schemes which allow consumers to obtain lower utility rates in exchange for investment in the utility companies; sale of public housing to the residents. The increasing provision of housing by government and the virtual elimination of small private landlords by rent control

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and other regulations appear to be important in reducing savings in postwar Britain. Both owner-occupants and small landlords have considerable savings built into mortgage payments. Support of housing for the poor has recently become one of the most rapidly increasing areas of government expenditure in the US.

A related hypothesis on UK saving rates is that saving is discouraged when more activity is concentrated in big firms. The share of the largest 100 UK firms in manufacturing rose from about 25 percent in the mid-1950's to nearly 50 percent in recent years. Some believe the answer to many of Britain's problems is widespread contracting out to make many more people their own boss and encourage productivity and saving. The Economist deputy editor, Norman Macrae, argued in a recent groundbreaking article that the world has reached the end of the era of the big corporations and that the revolution in communications has opened the way for a whole new style of working, living and saving.

Some economists have argued that saving rates are generally high when incomes are growing rapidly. People tend to consume along patterns of previous years and thus save a fair portion of rapid increases in income. Thus, in part, low and high saving ratios may be features of the vicious and virtuous circles.

Much more work is needed on the underlying factors accounting for differences in national savings rates. Meanwhile, virtually all that can be said is that there are large inter-country differences. A 1975 survey of consumer attitudes in 40,000 EEC households showed the British as the least thrifty. Only one percent in Britain would invest a sharp increase in income in bonds or shares (4 percent in Germany and 12 in Denmark), only 8 percent in their homes compared with 20-50 percent in other EEC countries.

The Historical Perspective

Some economic historians argue Britain has been in relative decline for as much as a century and there is nothing special about the past 25 years. They note that there have been periods, such as the 1930's, when Britain did better than most other economies and periods, such as the 1920's or 1960's, when its performance was weaker. Social class consciousness started in the feudal period in the UK, and US mobility has its roots in the nature of settlement and the long availability of the open frontier. Many of the declining industries, such as ship-building and textiles, which have bedeviled Britain in the post-war period are the very industries that made it the greatest and most rapidly growing industrial power 100 years ago. A historic perspective is a serious omission from the paper. Unfortunately the vast literature was too much to review.

Walt Rostow identified a preindustrialization stage of economic development followed by a take-off and then sustained growth. Could it be that there is another stage in which economic growth slows or stops? As the first country to industrialize, Britain might be the first to reach the "landing" stage. There is no economic reason why rapid development cannot continue indefinitely, but some have suggested growth of GNP may taper off as a society turns to more leisure and the pursuit of non-economic endeavors. As countries with per capita incomes higher than the UK do not seem to have reached the "landing" stage, it must have more complicated roots than just income levels.

A theme which is suggested by the long span of economic history is that the fortunes of economies come and go. Haiti had the highest per capita income in the Western Hemisphere a short 200 years ago, and the lowest now. Originally the main focus of the study was the fact that high growth and increased living standards are not guaranteed after the take-off stage. Perhaps such a theme is a reaction to the apparently widespread belief in the US that economic prosperity comparable with anywhere else is somehow guaranteed to the US. The title of the study was chosen with this theme in mind. As work progressed, it became clear that there were sufficient similarities between the US and UK to go considerably beyond this limited theme.

Another reason for looking to the UK for signs of things to come is its history of producing economic thinkers. Three economists with the greatest impact on the world wrote largely from and about the UK - Adam Smith, Karl Marx and Lord Keynes. Perhaps what the UK needs now is another great economic theory for these changed times. Government has now become so big and intervened so much that Smith's invisible hand of market forces is in handcuffs. This all happened with Adam's permission, incidently, as he recognized the need for government intervention where there is a social good beyond the benefits to the private parties involved. The identification of social class consciousness as a major part of the British problem is a tribute to Marx. But it is Keynes who has done the most recent harm to the UK and US by focusing too much attention on the relationship between demand and unemployment. He was right during the recession of the 1930's, but fascination with his theory for too long has resulted in neglect of such key growth elements as saving and investment.

What Is Excess Capacity?

One of the most difficult technical aspects of the study was the treatment of business cycle unemployment and the separation of such unemployment from that of the investment/labor imbalance. Demand factors can cause unemployment - even in Germany and Japan - and the usual Keynesian perscriptions are appropriate. The difficult question is when does short-term demand deficiency end and long-term investment/labor imbalance begin. Capacity data for most economies is so weak that it provides little basis for analysis.

A key difficulty is to compare the mix of productive capacity with the mix of effective demand. A large physical capacity to produce CB radios and TVs should not be used to justify tax reductions and other demand creation steps if what people will buy with additional income is largely cars and food. There is suspicion that much so-called excess capacity in the US and UK is toward the finished product end of the production process and that most inflation-causing bottlenecks tend to be in raw materials and certain components. This situation is consistent with a surplus-labor, short-investment situation as basic production processes tend to be more capital intensive. Also as the mix of demand changes most for finished products - from cars to pianos from bicycles to skateboards - it is logical that excess capacity caused by demand shifts is greatest for finished consumer goods.

An energy example might have made the argument in the paper clearer. It is generally agreed that the US basic energy producing industry has been operating close to capacity since the 1973 energy crisis despite high unemployment in the economy. Any government action which increases overall demand also increases demand for energy. The energy part of the demand increase associated with anti-recession policies will not result in any more employment but only in higher energy prices and/or increased imports. The argument of the paper is that there are a considerable number of situations with similar capacity bottlenecks, especially as the economy begins to operate at output levels above previous peaks.

Regional developments can also have a major effect on capacity. The construction industry may have large underutilized capacity and labor to produce houses in the Boston area. But, if population is moving away from that area and many housing units are vacant, increases in total national demand will do much more to bid up housing prices in the sun belt than to put carpenters to work in Boston. In many respects the movement away from cities is a demand shift generating excess capacity. Deteriorating housing in the South Bronx - and the schools, subways, roads and services associated with it - is no substitute for housing in suburban California or Florida.

Because heavy weight is placed on social and racial factors in explaining loss of population in US cities, it may be surprising that UK cities are losing population. London is losing 100,000 or nearly 1 1/2 percent a year. Inner London has lost a fifth of its population since 1961 as has inner Manchester. Inner Liverpool has lost two-fifths. Jobs have vanished from the cities even faster than people, and unemployment rates in inner UK cities are 50-70 percent above the national average.

<u>How Figures Lie</u>

All figures on intercountry comparisons are subject to large margins of error. Some economists argue comparisons of per capita GDP over a decade have no validity. There are three main areas of problems. First, even after much harmonizing work in the OECD each country collects GDP data differently. Also each economy has a different structure of taxation, transfers and government services. These can make substantial differences. For example, what US companies pay as income tax is included in final sales prices and thus in GDP; what French companies pay in value-added-tax is not; thus countries depending more heavily on indirect taxes appear to have lower GDPs.

Second, there are major problems comparing GDP data for several years even in the same country. For example, if government employees are given a pay increase in 1975 but not in 1976, GDP in this sector increases in 1975 but not in 1976. Interyear comparisons are more meaningful in constant prices, but adjustment to constant prices introduces many problems. Should a 1977 4000 pound car be counted as more or less than a 1967 car of the same weight?

Third, the most controversial statistical operation is to convert the GDP of several countries to a common currency. Exchange rates are affected by many factors in addition to the relative value of goods, including capital movements and political events. If the dollar rate for the pound goes down 10 percent in a few weeks as it did in 1976, everyone in the UK is not immediately 10 percent worse off in comparison with Americans. Use of long time periods for comparison helps to minimize the effect of jumpy exchange rate changes. However, while exchange rates may be satisfactory for intercountry comparisons of traded goods, the meaning of such comparisons for non-traded goods is unclear. At current exchange rates a British haircut is worth only half as much in GDP terms as a US haircut, and a seat for a London musical only one-third a seat for a New York production.

Much work is now being done by the World Bank and the UN to produce statistics based on purchasing power. The initial results are startling. Among LDCs there are cases where country A appears to have only about half as much GDP per capita as country B according to the usual comparison but nearly double the purchasing power per capita based on the cost of certain typical marketbaskets.

The method of intercountry GDP comparison in this paper was to take the value of GDP in the national currency and convert it to dollars at the exchange rate for that year. This procedure tells the change over time for an imaginary German who receives the average German GDP in marks and spends it all in dollars, provided that in each year his expenditures are distributed among products and services in the same way as total US GDP is distributed. Another way of making this comparison, that used by the UN for example, is to measure the rate of change of GDP in constant prices for each country and compare these rates across countries. The difficulties with this system are illustrated by the cases of Venezuela and Kuwait, which have reduced oil production since prices rose. When measured in 1970 prices, their GDPs declined in 1974-5.

In short the figures on GDP used in this paper are highly unreliable indicators of relative living standards. Given other supporting evidence, the direction of change is probably right.

The most emotional figure in the paper is the 6,000,000 women who would not be in the labor force if participation rates had not increased. There is substantial cheating in this gross figure. Part of the increase in female participation is because of a shift in the age distribution of the female population. Half the post-war baby boom was female, and a 23 year-old is more likely to be in the labor force than a 13 year-old. Part of this increased female participation reflects the historical lower participation of women thus assuring that fewer have been retiring from the work force. It would have been desirable to have adjusted the data for these and other factors to isolate the change in female participation caused by different attitudes and desires. However, a brief review of the literature did not identify an appropriate normalization. While the figure would have been smaller, the point would be the same.

There was not space to discuss migration data. Britain has had net outward migration of about 50,000 per year over the past 15 years. The net figure disguises the substantial movement each way, during 1974 184,000 in and 269,000 out. Management and technical level people make up much of the outward movement, while much of the inward migration is low-skilled people from the Indian subcontinent and Caribbean. Nevertheless, a recent UN study estimated that Britain benefited by $3.5 billion in 1961-72 in the value of education and other investment in its immigrants by home developing countries. The estimate for the US was $10 billion. The UN study did not estimate the loss to Britain because of emigration. Certainly it would have been much higher because of the higher number, the higher skill level and the greater cost of British education. On balance migration probably represents a drag on British productivity, but it helps keep unemployment down.

Analysis for the US is complicated by the large number of undocumented aliens not appearing in the data. Despite the considerable inward migration of skilled and professional people, it would appear that on balance migration has reduced the average skill level and thus average productivity per US resident. Moreover, while net outward migration from Britain has allowed all investment resources to be concentrated on increasing productivity, the substantial net inward migration is a significant factor contributing to the investment/labor imbalance in the US.

Management emigration from Britain is considered a major problem by some economists. A survey by Business Development Consultants among executives of the top 1000 British companies found that nearly one out of four senior executives considered moving overseas in 1975. One-fifth of employers reported the desire of executives to work overseas creates manning problems in UK operations. Some executives

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reportedly find the UK overegalitarian. "There's a feeling that you are some sort of criminal if you are doing a senior job earning more than 10,000 pounds a year," one executive said.

The relative decline in after-tax purchasing power for professional levels has become sharp in recent years. In 1971 it took an average managing director 3.5 minutes of work to buy a bag of fish and chips; by 1976 it took 5.0 minutes. An average industrial worker required 19 minutes of work for the fish and chips in 1971 but only 16 minutes in 1976. Similarly, it took 4 weeks of work for a top civil servant to buy a Mini car in 1971 but 8 weeks in 1976. The work time required from the average industrial worker for a Mini rose only from 25 to 29 weeks.

North Sea Oil

Up to this point there has been no mention of the most exciting economic development in the UK this decade - the development of North Sea oil. This windfall will add as much as one percent a year to British GNP and perhaps resolve its payment problems for much of the next decade. New oil production may provide just the time and means for Britain to join its island economy to the more rapidly marching economy of the continent. Without North Sea oil Britain might be a pessimistic place indeed.

This study suggests, however, that the windfall from the North Sea is not likely to be concentrated in the sort of savings and investments that would result in basic changes in the performance of the British economy. Like the often-spent savings from ending the Indo-China War, the effects of North Sea oil may be hard to find in 1985.

Memorable Quotes

Quotes were not used in the paper to support various points but some say it far better than the paper.

> "Britain's chance has been dissipated by the smugness and insularity of its managing classes, by the conservatism and blocking power of its trade unions after their first so-necessary success, and by the easy-life illusions of its now gone empire."
>
> The Economist

"Like democratic parties everywhere, only more so, Britain's parties have treated electoral politics as an auction, bidding up benefits. The costs - although currently more than the nation can afford to divert from investment - are not generally regarded as outweighing the benefits of economic and psychological security that the welfare state has meant for most citizens."

George F. Will

"Americans love machines, the British love dogs."

D. W. Brogan

"The British have workers, high and low, who are in totally unproductive occupations, ensnaring more and more activities into a web of intricate bureaucracies and restrictive practices. Britain now has far more civil servants than it did when it ran an empire that encompassed a quarter of the world's population. And it takes twice as many man-hours to build a car in Britain as it does in France or Germany."

Jonathan Power

"Clothing's troubles are those of British industry, writ large: poor design, inadequate management, outdated production techniques, late and unreliable deliveries."

The Economist

"The national flavor is epitomized by Derbyshire, 54, the Birmingham car worker. He wrote the Birmingham Evening Mail that his department used to turn out 16 bumpers a day with 15 year-old equipment. Now, thanks to new machinery and a revised manning scale, the department produces four bumpers daily."

Bernard Nossiter

"Is it a bad thing that other countries should be getting rich faster than we? Not at all."

Washington Post Editorial

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