

'The common sense conclusion is that Britain and the other Western countries had full employment for a quarter of a century after the war because their governments were committed to full employment, and knew how to secure it; and they knew how to secure it because Keynes had told them how.' (Michael Stewart). Yet, by 1979, it was said that 'anti-Keynesianism was the world's fastest growing industry'. How did this dramatic change come about, and what was the real contribution of the Keynesian revolution to economic policy and performance in Britain?

The Rise and Fall of the Managed Economy

In the early postwar decades the view that governments knew how to control the economy and secure full employment was shared by both Labour and Conservative administrations. The policies which they adopted in pursuit of this aim were known as 'demand management' (see the box on p. 6). But by the 1970s these policies were being repudiated by leading members of both parties. Recent research into the history of the managed economy in Britain has thrown new light on both the origins of the Keynesian revolution in economic policy-making and its eventual eclipse. A re-evaluation of the policies of the interwar period, and of Keynes's theoretical contribution to postwar economic management, has been stimulated by the deterioration of Britain's economic performance since the early 1970s, and by the massive rise of unemployment since 1979. just as the mass unemployment of the 'twenties and 'thirties gave credence to Keynesian ideas, so the economic troubles of the 'seventies and 'eighties strengthened support for his critics.

Economic management before 1939

Until recently the natural corollary to views such as those held by Stewart was that if only Keynesian ideas had been adopted earlier, the interwar unemployment problem could have been resolved. According to this view it was not until the theoretical wisdom of Keynes's *General Theory* (which was published in 1936) had been assimilated during the Second World War that progress could be made towards the permanent attainment of full employment by proper management of the economy. Those who held this view also believed that the major obstacle to the earlier acceptance of Keynesian policies was the influence of a rival theory on an unthinking, orthodox Treasury. This was the so-called 'classical' economic theory of an earlier age. A crucial premise of this theory was that deficit-financed expenditures (see the box on p.6) could only be made at the expense of a comparable volume of private expenditures. As a result no additional employment would be generated.

Official attitudes in the interwar years, as shown in the Treasury's internal papers, have recently been re-examined by economic historians. (See Glynn and Booth [2] and Middleton [3] for summaries of this research.) Two major points have emerged. First, it has been shown that in fact considerable progress had been made towards acceptance of

some aspects of the policy of demand management by 1939, but that this owed more to rearmament and political forces, than to Keynes and the economists.

Secondly, the Treasury view on deficit-finance has been subject to particularly detailed scrutiny. We now have a much better understanding of the reasons for the Treasury's rejection of the Keynesian message before the war. As indicated above Keynes and his postwar followers laid most stress on the role of economic theory in determining official policy. By contrast, recent writers have emphasised the prevailing political and administrative constraints as limits to the potential efficacy of the Keynesian solution. The Treasury did not, as Keynes suggested, simply *assume full* employment, which would then, of course, have made it impossible to explain unemployment in theory or do something about it in practice. Rather, it pointed to factors such as openness of the British economy, and the financial market's grave mistrust of increased government intervention. Given these features of Britain's economic position the Treasury attached great importance to the adverse effects which deficit-finance would have on the confidence of bankers and businessmen. If this confidence was lost, it would: (a) make it difficult for government to borrow, except at high interest rates; and (b) deter industrialists from making additions to their own capital equipment. The Treasury argued that these two unfavourable consequences might be more than enough to offset any gains from the initial government spending.

The Keynesian revolution

The 1944 White Paper on Employment Policy, which committed government to the 'maintenance of a high and stable level of employment', has traditionally been seen as the formal recognition of the principles of the Keynesian revolution in Britain. However, more recent research has revealed that the pace of official acceptance of Keynesian

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ideas was much slower than previously thought. Even after the 1944 White Paper, the Treasury remained reluctant to support long-term deficit-finance. The reason for this was not theoretical but political: the fear that there would be an explosion of expenditure once the fiscal discipline of a balanced budget was relaxed. If it was conceded that some expenditure might be covered by borrowing, the ability of governments to resist ever-growing popular demands for more money for housing, education, health services and so on would be greatly weakened. The Treasury also continued to emphasise its prewar concerns about industrial efficiency, and argued that a policy of *general* demand management was no cure for unemployment caused by structural problems in *specific* industries or regions.

Tomlinson [5] went so far as to argue that there never was a Keynesian revolution. By this he meant that fiscal policy never became subordinate to the needs of employment creation, but was merely used as an instrument to control inflation and the balance of payments. While this view has found little support, there has been wider acceptance of his more limited conclusion that the role of economic theory in the policy process has been overstated, and that of administrative and political factors understated. This debate about the *application* of Keynesian ideas continues. There is, however, general agreement that during the war years the essential *theoretical* message of the Keynesian revolution - that capitalist economies were not self-stabilising by virtue of some automatic market mechanism - had been firmly accepted. At this date few economists would have denied that if the economy fell into a depression, with low levels of production and high unemployment, some form of government intervention would be needed to stimulate demand and help the economy get back to full employment.

The managed economy since 1945

The assessment of postwar economic management and of Britain's economic performance must be made in the context of the four major objectives of the policymakers. Until the advent of Thatcherism these were: full employment, price stability, a surplus on the current account of the balance of payments, and economic growth. The central problem for economic management since the war has been the incompatibility of these objectives. Initially, the most difficult problem was to reconcile the desire for rapid economic growth with the need for a balance of payments surplus. Later, the main problem faced by the policymakers was how to achieve full employment without at the same time encouraging more rapid increases in wages and prices. Some progress was made, but the position gradually deteriorated to the point where Britain seemed condemned to suffer both high unemployment and rapid inflation, while growth remained slow and the balance of payments weak.

This process can be seen in Fig. 1. In the top chart the solid line shows unemployment as a percentage of the labour force, and the broken line shows the annual rate of increase of prices. The rise in both lines from the end of the 1960s is very striking. The bottom chart indicates Britain's inability to escape a recurrent deficit on the balance of payments. (The surplus (+) or deficit (-) on the balance of payments is kept in scale with the growth of the economy by expressing it as a percentage of gross domestic product - GDP.) These problems of unsuccessful economic management became the basis for increasingly severe crises, political as well as economic. By the 1970s this process culminated in the final rejection of the earlier consensus on the advantages of a Keynesian policy of economic management. We shall look briefly at each of these dilemmas to see how this came about.

In the early postwar decades the rate of economic growth in Britain was slow compared to that being achieved in countries like France, Germany, Italy and Japan, and there was considerable public pressure for more rapid expansion.

The problem for economic management was that whenever growth speeded-up, and unemployment dropped to very low levels, the balance of payments would get worse. This happened for several reasons: first, imports increased with the need for additional raw materials for industry; and exports fell as manufacturers preferred the easier option of selling in a booming home market. Secondly, as the economy moved closer to full capacity, there were shortages of both labour and materials. This stimulated higher wages and prices and this in turn harmed exports and helped imports. The result was a serious balance of payments crisis.

Demand Management: The central feature of the managed economy was the belief that the government could and should influence the economy-wide level of output and employment by changing the level of demand. This might be demand from households for consumer goods such as cars and TVs; or demand from firms for machinery and other capital goods; or the government's own demand, for school buildings, military equipment, and so forth. The principal instrument which the government could use to influence demand in the private sector was the level of taxation (fiscal policy). Thus taxes would be lowered in a recession, when it was desirable to stimulate demand; and raised in a boom, when it was thought necessary to restrict demand. Other instruments included interest rates, control over bank lending and hire-purchase regulations.

Deficit Finance: This refers to government expenditure which is financed by loans because it can not be covered from revenue raised through taxation. An important part of the Keynesian revolution was the suggestion that the government should resort to Deficit Finance to raise demand and so reduce unemployment in a depression.

The government was forced to respond to this, and did so by raising taxes, cutting government expenditure and generally acting to reduce demand in order to slow down the growth of the economy. This was the 'stop' phase of what came to be known as the 'stop-go' policy of demand management. Once economic activity had fallen to a lower level, and the balance of payments had improved, the political pressure for faster growth and lower unemployment would again be felt, and the weapons of economic management would be used to reverse the process, cutting taxes to stimulate demand: the 'go' phase. These cycles occurred repeatedly through the 1950s and 1960s, and are very evident in Fig. 1.

The second dilemma which gradually emerged to cause acute problems for supporters of demand management was the trade-off between full employment and price stability. Initially the record was very good: from the end of the war until 1966, the proportion of the labour force unemployed was never greater than 2.5%, and the rate of increase of wages and prices was reasonably satisfactory (see Fig. 1). There was perhaps a tendency for prices to rise more rapidly than policymakers would have wished, but it was not seen as a major problem. From the mid-1960s this situation changed dramatically. The precise reasons for this are still a matter of debate. Those who think the trouble started on the

side of costs can point, in particular, to growing awareness on the part of organised workers of their ability to take advantage of full employment to press for higher wages. This ability had initially been restrained by fears of a return to the era of mass unemployment, but these fears were eroded as memories of the interwar years faded, and a new and more militant generation entered the labour force. After 1969 this pressure on labour costs was strongly reinforced by the actions of the OPEC oil cartel.

On the other side of the debate are those who think costs can only have an impact on prices if the supply of money is increased to allow prices to rise. According to this view, it was the failure of the governments, both in Europe and the United States, to control the growth of the money supply which was responsible for the acceleration of inflation in the mid-sixties. Whatever the causes, the results of the process were very clear, and through the 1970s Britain was made increasingly aware of the new evil of stagnation, a previously unknown combination of slow growth and high unemployment with rapid inflation.

Britain's postwar economic performance

It is important to see Britain's postwar growth record in its historical perspective. The postwar record was good by the standards achieved by Britain in earlier periods. For example, the total quantity of goods and services produced each year (real GDP) grew at an average annual rate of 2.8% over the years 1951-73, as compared with 2.2% in the interwar period 1924-37, and only 1.8% over the pre-World War I period, 1873-1913. However, this improvement over historical standards was the common experience of our industrial competitors, and their postwar rate of growth was much better than ours: over the period 1950-73, the average for the six original members of the European Economic Community was over 5% p.a., almost double the British rate. We thus need to understand both how we improved our own performance, and also why we did not do as well as others.

It is natural to ask about the relationship between Britain's relative success - by its own standards - in the postwar period, and the policies of economic management. Was the Keynesian revolution in economic policy responsible for the postwar improvement in growth rates, and, in particular, for the achievement of full employment? In a seminal paper of 1968, written before the long boom of the western economies had faltered, Matthews (reproduced in [1]) argued that Keynes's contribution was in fact only indirect, and that full employment could not have been the consequence of deficit financing because the budget was in surplus, not deficit, throughout this period. He attributed it instead to two other major features of the postwar period. The first was the high level of capital expenditure in industry, power supplies, transport, etc. This was undertaken to take advantage of the favourable investment opportunities created by the rapid technological advance in these years, and also to make good the backlog of investment needs which had been created during wartime and the prolonged depression of the interwar years. The second stimulus for activity and employment was the boom in the world economy associated both with the rapid growth already noted in the EEC, Japan and other countries, and with the free trade policies which were generally introduced after World War II. This enabled Britain's exports to expand much more rapidly than had been possible in the depressed and tariff-protected markets of the interwar years.

Although Matthews was criticised for the way in which he measured the government's surplus, the essence of his argument survived. It was sufficient for Tomlinson [5] to

make the important observation that the highly fortunate set of circumstances of the 1950s and 1960s led to an exaggeration of the government's capacity to deliver a high level of activity and full employment in adverse conditions. This misunderstanding of the power of Keynesian policies was in turn a contributory factor in the subsequent disillusionment with demand management. Too much was expected of these policies, and their inability to live up to these expectations made them more vulnerable when faced by the combined challenge posed by monetarist economics and changes in political attitudes.

The crisis of demand management

In 1979 the consensus in support of the postwar Keynesian revolution was broken. Thatcher's newly-elected Conservative government formally abandoned the macroeconomic objectives that had been adhered to (though not necessarily achieved) by all former governments. The new administration explicitly denied that stabilization by means of demand management was either possible or desirable; and it asserted its belief in an

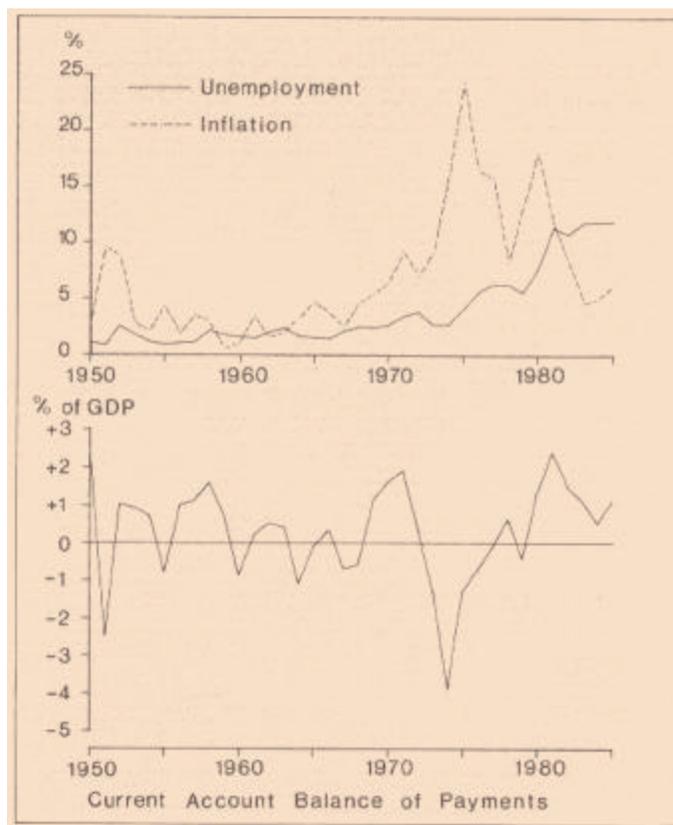


Fig.1 Inflation, Unemployment and the Balance of Payments.

older tradition of a liberal market order with a minimum of state intervention. It was the impossibility of reconciling full employment with price stability which was most immediately responsible for undermining the Keynesian era, since wage stability had always depended in part upon the possibility of unemployment. For a time, it was thought that all that was required to sustain a programme of demand management was a refinement of its techniques, and the addition of more effective incomes policies to regulate the growth of wages. Gradually, however, it was recognised that some more fundamental adjustment was called for.

The other major forces which contributed to the political success of the counter-revolution included:

- * new developments in economic theory associated with monetarist ideas;

* increased political hostility to the power of government, involving not only demand management but also matters like the level of taxation and the extent of public ownership; * a new analysis of what was responsible for the long-run decline in Britain's relative economic position, with an emphasis on political and cultural factors; and
 * the deterioration in the international economic environment, and the breakdown of some of the key postwar agreements on exchange rates and trade.

Monetarism

We begin with monetarism. For policy purposes this doctrine had two important elements: the quantity theory of money and the natural rate of unemployment. According to the former, the supply of money can only change as a result of actions by the monetary authorities; and as the money supply changes (with other relevant factors remaining broadly constant), the price level will change proportionately. The cause of inflation is thus the government's action in increasing the money supply.

The natural rate of unemployment hypothesis holds that the economy has a tendency to return to a certain rate of unemployment (determined by institutional factors such as the bargaining strength of trade unions). Any policy which tries to move unemployment away from this natural rate may succeed in the short term, but only at the expense of accelerating inflation in the long term. From this it follows that instead of pursuing full employment goals macroeconomic policy ought to be limited solely to the pursuit of a constant rate of growth of money supply. This, in turn, would stabilize the growth of money incomes.

Thus monetarists rule out the possibility that demand management can affect either real output (as opposed to its money value, which can increase as prices rise), or employment, *in the long run*. In sharp contrast to the Keynesian view that market economies were not self-stabilising, the monetarists revived the argument that they were. For them, it was precisely this self-stabilising property of the economy which invalidated the whole of postwar (Keynesian) demand management. They argued that such policies did not, and could not, create employment, but only inflation. In this way demand management seriously damaged the free market economy, for which *price stability* is an essential foundation.

Supply-side policies

A second feature of the monetarist approach to economic policy was the emphasis on what came to be known as 'supply-side policies'. For the reasons just given they rejected any role for demand management policies. However, they accepted that governments could take action to improve economic performance by microeconomic policies aimed at influencing *individual* households or firms or industries from the supply side.

One aspect of this approach which was given immediate attention was the policy of lowering marginal tax rates for those with high incomes. This was intended to increase

incentives, and generate increased managerial and entrepreneurial contributions to economic progress. For those on low incomes, the corresponding incentives were to be achieved by a reduction of unemployment benefits (particularly the earnings-related payments) relative to wages. Other areas of policy approached from this supply-side perspective included various attempts to increase competition and to reduce monopoly powers exercised by certain groups. This was directed particularly at the trade unions. It was believed that by reducing trade union power it would be possible to achieve both lower inflation and more favourable conditions for the modernisation of British industry.

This view was bolstered by a major study by a distinguished American scholar, Mancur Olson [4]. He argued that slow growth could be attributed to the development of 'distributional coalitions': interest groups such as medieval guilds, trade unions or employers' associations. By seeking to gain or maintain advantages for their members, these groups slowed down a society's capacity to adopt new technologies and to reallocate resources in response to changing conditions. The longer such groups were allowed to operate undisturbed, the greater would be their power and thus their ability to retard growth. His argument was illustrated by a wide range of cases from different historical periods and countries; but the long period of political and social stability which Britain has enjoyed, without the shock of revolution or military defeat, gives his analysis a particular relevance to the British case.

Conclusions

One valuable consequence of the recent work on the Keynesian revolution by economic historians is that we now have a much clearer appreciation of policy constraints facing governments in their conduct of macroeconomic policies. The traditional preoccupation of economic historians with the long-term can also be used to good effect, given that the roots of the 'British disease' clearly predate Keynes, let alone his legacy of demand management. The task now is to use this information and understanding, and to work with other disciplines to produce a broader and better analysis of Britain's economic problems.

Reference

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The editors would welcome comments on this issue and suggestions for topics which might be included in future issues. ReFRESH 6 will be published in the Spring of 1988 and contain articles by Pat Thane on the Welfare State and by Roderick Floud on Living Standards and Industrialisation.

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