19

Economics and Policy in Britain

19.1 INTRODUCTION

Background

Though economic policy and attitudes towards it changed only very gradually, it is possible to point to a number of events in the years around 1870, all significant in producing a change of attitude towards state intervention in the economy.[1] 1873 is often taken as marking transition from the "great Victorian boom" to the "Great Depression" of the 1870s and the 1880s.[2] From 1873 prices fell steadily, and some sectors of the economy, in particular parts of agriculture, suffered. This was the period when Britain's economic position in the world was being challenged by the growth of the German and American economies, and when forebodings concerning Britain's economic decline were first raised, as in Jevons' *The Coal Question*.[3] From 1879, with Germany's move to protection, the system of free trade established in the 1860s began to crumble. Domestically, important developments were the Reform Acts of 1867 and 1884, which greatly widened the franchise, creating an electoral base for policies of social reform. In addition, legislation in 1871 and 1875 enormously increased the scope for trade union activity. The spread of socialist ideas provided further pressure for social reform. Thus by the 1880s the setting for discussions of economic policy was very different from that twenty years earlier.

Of the changes which took place in economic theory, by far the most important concerned the distribution of income. With the final demise of the wage fund doctrine, one of the obstacles to attempting to raise wages had been removed. But even more important was the removal of what Cairnes called "the great Malthusian difficulty": the threat of population growth no longer inhibited proposals to raise the standard of living. Though utilitarian arguments could be used to support proposals for income redistribution, developments in the theory of income distribution were more important than the changes which occurred in the theory of value.

Economists and state intervention

The last three decades of the nineteenth century saw a change, albeit a very gradual one, in economists' attitudes towards the role of the state in the economy. There was a movement towards seeing a much greater role for the state than was the case in the middle of the century[4] Though there may have been some bias towards *laissez faire* and individualism,[5] it is less misleading to stress the enormous increase in the number of cases economists discovered which required state intervention. Representative of this transition from the mid-nineteenth century classical view, to the more modern view is Jevons. In 1869 he described "freedom for *all* commercial transactions" as "the spirit of improved legislation", whereas by 1883 he saw "hardly any limits to the interference of the legislator".[6] In addition to cases where his arguments for intervention were paternalistic, he found cases of public goods. This argument for state intervention was taken up and stated more forcefully by Sidgwick, the culmination of this line of argument coming in Pigou's *Economics of Welfare*, a systematic exposition of the case for state intervention.[7]

In parallel to this discovery of more and more cases requiring state intervention to tackle problems the market could not cope with, was an increased concern for greater equality in the distribution of income. It is true that neoclassical economics abandoned the simplicities of classical macroeconomic distribution theories, and it is true that distribution did not occupy the same place in the new theory of value as in classical theory, but the distribution of income was not neglected. Indeed, the new approach made it possible to examine, in a way not possible for the classical economists, the distribution of income between persons, something of more importance than the factor distribution central to classical theory. Sidgwick was important here, positing a right distribution of income as an object of government policy together with ensuring that production was as high as possible.[8] This emphasis on distribution as an objective of government policy followed from marginal utility analysis, for Sidgwick found that total utility depended not only on the level of income, but also on its distribution.[9] In the following decades marginal utility analysis may not have been taken to what some economists have seen as its logical conclusion, namely the advocacy of complete equality,[10] but the assumption of diminishing marginal utility was used to argue the case for some degree of progression in taxation.

Perhaps the main contribution was that of Edgeworth.[11] Where his predecessors, such as Sidgwick, had interpreted equality of sacrifice to imply proportional taxation, Edgeworth interpreted sacrifice in terms of utility. Rejecting equal absolute and equal proportional sacrifice as giving inadequate guidance as to whether or not taxation ought to be progressive, Edgeworth argued that the total disutility imposed by taxation should be minimized. Edgeworth followed Sidgwick, however, in finding many reasons why this did not imply that there should be complete equality in the distribution of income. These ranged from differences in individuals' utility functions to the need to guard against eroding the incentive to work.

The change of attitude this represented was concisely summed up by Cannan (1893):

> The economist of today is far less hostile to socialism in general than his predecessors of the classical school… . The doctrine of marginal utility stamps as economical many things which could formerly be recommended only on "sentimental" grounds… . Assuming needs to be equal, modern economics certainly

teaches that a given amount of produce or income will "go further" the more equally it is divided. The inequality of the present distribution has no pretension to be in propotion to needs.[12]

19.2 TARIFF REFORM BEFORE 1914

The campaign for tariff reform

Discussions of tariff reform did not begin with Joseph Chamberlain, the issue of "fair trade" having been raised in the 1880s, a period when Britain was suffering severely from the effects of foreign competition on interest and profits; but it was with Chamberlain's arguments for tariff reform, dating from the 1890s, and reaching their climax in 1903, that tariff reform was at its height as a political issue. Chamberlain, as Colonial Secretary, promoted in 1896 the idea of an "Imperial *Zollverein*", an imperial customs union with free trade internally and a common protective tariff.[13] Such a system would not, however, suit colonies that wished to protect their industries from the effects of British competition. Thus Chamberlain moved towards a system whereby Britain would discriminate in favour of colonial foodstuffs and raw materials, the colonies in turn discriminating in favour of British industrial goods. Some moves in this direction were taken, but the critical problem arose in 1903 when Chamberlain failed to get the cabinet to agree to a permanent duty on grain imports,[14] for without such a duty it was impossible to discriminate in favour of colonial produce. Starting in May 1903 Chamberlain embarked on a campaign to convert his party and the electorate to a programme of tariff reform. Though the debate was most intense during 1903, tariff reform remained a major political issue right up to 1914.

In the tariff reform controversy there were not merely two, but an enormous variety of standpoints. There were extremists on both sides: some tariff reformers claimed this to be a remedy for virtually every economic problem; whilst on the other side there were those for whom to question free trade came close to blasphemy.[15] But even within less extreme opinion there was a wide range of attitudes. In part this was because political arguments were, right from the start, inseparable from economic ones. For Chamberlain, for example, tariff reform was merely part of a political programme in which imperial unity and social reform were the over-riding issues. Relations with the empire apart, tariff reform raised the question of British relations with Germany and the US. Some supporters of tariff reform failed to share Chamberlain's views on imperial unity; others feared extensive social reform.

Protection could, furthermore, be advocated on quite different grounds, as was done by Balfour, Prime Minister in 1903, in his attempt to find a way in between Chamberlain's tariff reform and free trade as advocated by other members of his party. Balfour's "Insular Free Trade" was based on the premise that, though universal free trade was desirable, free trade might not be desirable in a world in which other countries were protectionist. It would be wrong to give up the bargaining position offered by a tariff: "we should openly and avowedly announce that this country no longer considers itself debarred by economic theories from making the best commercial bargain it can with other countries".[16]

Against both these positions were ranged free traders, who included not only politicians but a substantial number of academic economists. The most significant expression of academic opinion came in what was described as the manifesto of the 14 professors, contained in a letter to *The Times* on August 12th 1903, the signatories to which included Edgeworth, Pigou, and, most important of all, Marshall.[17]

This was an attempt to use the authority of scientific, academic economics in opposition to the protectionist cause.[18] Its outcome, however, was to emphasize the lack of unanimity amongst economists. Though there were exceptions, Clapham, for example, supporting free trade, and Price opposing it, free trade was generally supported by economists sympathetic towards economic theory, and protection by those favouring a more historical approach to the subject, Hewins and Ashley being perhaps the most prominent.

The economic issues

Perhaps the most important economic aspect of the controversy concerned the effect of a tariff on food prices: would the so-called "stomach taxes" raise the price of food? This was a problem ideally suited to the Marshallian apparatus of supply and demand. Even within this framework, however, the effects of a tariff were complicated, for they depended on the relative magnitudes of various elasticities: domestic, colonial and foreign elasticities of supply and demand.[19] Whilst such reasoning should have been able to counter some of the more simplistic arguments as to why the tax should have been paid by foreigners, it carried no weight against arguments that would not fit in to the Marshallian framework. These included not only political arguments, but also important dynamic arguments about the effects of a tariff in stimulating industry and employment in Britain, and in encouraging the development of new sources of food supply in the colonies. The importance of factors that could not be fitted into the framework, together with the absence of reliable statistical evidence on the relevant elasticities, made the Marshallian "organon" of little direct relevance.

There were also considerable differences of opinion on what use could be made of empirical data on trade flows, and on the performance of countries that had adopted protection. Against the protectionists' claim that tariffs had been an important cause of German and American industrial success, it was possible to point, for example, to the size of their domestic markets, or to the extent of their natural resources. It was hard to use trade statistics even to establish the weakness of British industry without protection:[20] not only were the statistics subject to enormous margins of error, but even growing exports could be interpreted as indicative of either weakness or strength.[21]

These issues were complicated enough, but there were still further economic issues. Tariff reform became linked with unemployment. An example here illustrates the danger academic economists faced of their carefully worded comments being misused. In early 1903 Ashley made the following remark, citing Bagehot's work[22]: "the older writers minimised unduly the difficulty with which labour transfers itself from one industry to another, even a closely allied one".[23] In Chamberlain's hands this argument was re-phrased as an attack on

> This doctrine, this favourite doctrine, of the "transfer of labour" is a doctrine of pedants who know nothing of business, nothing of labour. It is not true... . You cannot teach men who have attained to skill and efficiency in one trade, you cannot teach them on a moment's notice, skill and efficiency in another.[24]

Another economic issue was the revenues to be obtained from protection, this being one reason for the increase in support for tariff reform gained within the Unionist Party in the years leading up to 1914. Revenue from a tariff was a means whereby military expenditures and social welfare measures could be financed without the increases in direct taxes that Churchill and Lloyd George, in the Liberal Party, were demanding.[25] Yet another issue was the link between the gold standard and trade policy, some free traders arguing that the system of international economic relations, of which the gold standard was a part, was founded on free trade.[26]

The outcome

Free trade, together with the desire to avoid the "dear loaf" was one of the main issues on which the Liberal victory in the 1906 election was based.[27] Within the Unionist Party, protectionism became strongly established; this did not, however, mean that Chamberlain's original campaign had succeeded. Support for protection was, especially in times of depression and high unemployment, such as 1908–1909, stronger than support for imperial preference. Furthermore, the revenue arguments for protection as an alternative to what were seen as the Liberals' attacks on property through income taxation, appealed to very different interests from those at which Chamberlain had wished to appeal with his strategy of vigorous social reform and imperial regeneration. Though tariff reform became accepted by the Unionist Party, its purpose, the ideas on which it was based, and the interests to which it appealed, had changed to such an extent as to raise the question of whether it should really be described as the same policy.

The implications of the tariff reform campaign for the economics profession are also interesting. The manifesto of the professors backfired in the sense that, far from asserting the authority of academic opinion, it demonstrated the lack of agreement amongst economists, providing occasion for ridicule of abstract theorizing. In addition, the controversy helped re-open the division within the profession that had been patched over since the methodological controversies of the 1880s and the early 1890s.[28] Though this has been questioned, it has been argued that Pigou's support for free trade was a significant factor in his election as Marshall's successor in 1908, in preference to Foxwell and Ashley, two supporters of tariff reform.[29] Whilst it seems hard to believe that the election of Foxwell or Ashley rather than Pigou would have made any significant difference to the way economic doctrines developed over the following decades, the institutional structure of the profession in England might well have been different.

19.3 UNEMPLOYMENT POLICY BEFORE 1914

The emergence of employment as an object of economic policy

Although protection came to be proposed as a remedy for unemployment, it was not originally seen in these terms, an important reason for this being that it was not until the very end of the nineteenth century that unemployment came to be seen as an economic problem. The term "unemployment" itself came into common use only in the mid 1890s.[30] For most of the nineteenth century unemployment, or "irregularity of employment" as it was more commonly called, was seen primarily as a social problem caused by the normal working of the economic system. The New Poor Law of 1834 was based on the assumption that unemployment was, at least for the able bodied, an inevitable occurrence which men should predict and provide for out of their earnings whilst employed.

Though it was recognized by the middle of the century that unemployment could be wasteful, unemployment being seen by Senior, for example, as eroding workers' skills and habits of regularity, it was in the 1880s that perspectives began to change. Unemployment came to be seen as one of the most harmful consequences of trade depressions, and as a chronic social problem amongst certain groups of the population. One of the earliest contributions by an economist was Foxwell's *Irregularity of Employment and Fluctuations of Prices* (1886), in which it was argued that it was the irregularity and insecurity of employment, rather than the average level of earnings, which lay at the root of many social problems. Rather than encourage the dependence of wages on market forces, Foxwell argued, the government should aim, as a major object of policy, to increase the regularity of employment, "giving to the artisan and the labourer as much social security as is enjoyed by the salaried and professional classes".[31] Another economist who clearly saw unemployment as an economic problem was Hobson.[32] It was Hobson who provided a formal definition of unemployment, defining it to cover "all forms of involuntary leisure suffered by the working classes". Though he defended this as corresponding to the general usage of the word, he went on to argue that "The more scientific definition would, however, identify unemployment with the total quantity of human labour power not unemployed in the production of social wealth, which would rank … as superfluity or waste."[33] This was wider than official definitions, which excluded, for example, seasonal unemployment, on the grounds that taking the year as a whole workers unemployed in one season were nonetheless essential to production. In addition, he provided an economic theory treating unemployment as an aspect of trade depression, with under-consumption being its "direct economic cause".[34] As a remedy he proposed income redistribution aimed at increasing the level of consumption.

The most important work, however, on unemployment was done not by economists, but by what one historian has described as "a group of intellectual hybrids, who were concerned partly with general economic hypotheses, partly with sociological investigation, and partly with administrative reform",[35] the most important being Hubert Llewellyn Smith, Charles Booth, William Beveridge, and Sidney and Beatrice Webb. Llewellyn Smith, author of the Board of Trade's index of unemployment, helped to clarify and define the nature of the problem by providing, in 1893, what became for many years the standard classification of types of unemployment.[36] Booth and the Webbs, in the late 1880s and the early 1890s, conducted detailed investigations into the nature of unemployment, its connection with poverty and the nature of the labour market. The focus of attention was above all on casual labour, the case receiving most attention being London dock labour. In these studies, unemployment was seen as a problem associated with the organization of the labour market, their aim being to find administrative methods of improving this, and hence alleviating the problem of unemployment. Booth, for example, proposed the decasualization of dock labour. Unemployment was not seen primarily in macroeconomic terms.

Beveridge

In 1909 two works were published which between them contained most of the remedies for unemployment discussed in the next two decades. One of these was Beveridge's *Unemployment, a Problem of Industry* (1909). Beveridge's starting point was the same as that of Booth and earlier investigators, but he went beyond their work in looking at employment in a wider range of industries, those unionized as well as ones dominated by casual labour, and in considering the organization of the labour market in general. Beveridge saw unemployment as an inevitable aspect of growth in a competitive economy.

> Unemployment arises because, while the supply of labour grows steadily, the demand for labour, in growing, varies incessantly in volume, distribution and character. ... [S]o long as the industrial world is split up into separate groups of producers ... there must be insecurity of employment. ... Unemployment, in other words, is to some extent at least part of the price of industrial competition – part of the waste without which there could be no competition at all.[37]

He argued, however, that the problem of unemployment could be reduced to "relative insignificance" with two types of policy. The first was a system of labour exchanges, designed to increase the "fluidity" of labour between different employments. Beveridge saw this as

> a policy of making reality correspond with the assumptions of economic theory. Assuming the demand for labour to be single and the supply to be perfectly fluid, it

is not hard to show that unemployment must always be in the process of disappearance – that demand and supply are constantly tending to an equilibrium. The ideal for practical reform, therefore, must be to concentrate the demand and to give the right fluidity to the supply.[38]

Labour exchanges would, of course, alleviate the problem of casual labour through helping workers to find alternative employment, and they would assist the movement of workers out of declining industries. But their significance went beyond this. For example, young people could be better guided as to choice of careers and into industrial training.[39]

Labour exchanges were also important for Beveridge's other main proposal: the extension of unemployment insurance. Whilst he saw this as coming about in a variety of ways, he argued that it should be supported by the state, either through assisting trade unions in their provision of unemployment insurance, or through the provision of unemployment insurance directly. It was only if an efficient system of unemployment registration were instituted that an insurance scheme could be protected from abuse, which meant that a system of labour exchanges was a pre-requisite for adequate unemployment insurance.[40]

Beveridge did not reject other means of alleviating unemployment, such as altering the timing of public works schemes, and wage flexibility, but he described such schemes as "minor measures". It was the reorganization of the labour market to which he attached most significance.

The Royal Commission on the Poor Laws

The other important contribution made in 1909 to the discussion of unemployment was the report of the Royal Commission on the Poor Laws. The background to this was that, especially since the 1880s, local authorities had been empowered to provide unskilled relief work to alleviate the worst instances of unemployment, a policy which eventually found expression in the Unemployed Workmen's Act of 1905. These schemes had many faults, and from 1905 to 1909 were investigated by a Royal Commission. Whilst the majority report of this Royal Commission favoured continuing the existing policy of relief works, a more ambitious proposal was put forward in the minority report, the main authors of which were the Webbs, together with A. L. Bowley, who worked out the statistical details. The minority's main proposal was that a substantial part of the normal public works expenditure of the national government and local authorities should be earmarked as to be undertaken in years when unemployment was particularly high. In other words, the pattern of government spending was to be altered so as to smooth out the demand for labour, thus removing cyclical unemployment. Other types of unemployment could be alleviated by improving the operation of the labour market.

It was in the same year, 1909, that an act was passed establishing labour exchanges all over the country. Two years later, the National Insurance Act provided a system of insurance against unemployment.

The Ricardian view of public works

The Ricardian view of public works expenditure was that, in providing work for the unemployed the government merely "takes work from people employed by private individuals, and gives it to people selected by the state".[41] Though this view came into prominence in the late 1920s as the "Treasury View", it was being put forward in discussions of public works before 1914.

Its leading academic exponent, Hawtrey, wrote in 1913,

> The writers of the Minority Report appear to have overlooked the fact that the Government by the very fact of borrowing for this expenditure is withdrawing from the investment market savings which would otherwise be applied to the creation of capital.[42]

Hawtrey, however, was virtually alone amongst academic economists in supporting this view. Another writer on the cycle, Robertson, criticized this argument two years later. The earliest modern critique of this argument, however, was that of Pigou in his inaugural lecture (1908). Citing the use in Parliament of an argument similar to that later used by Hawtrey, Pigou argued that though raising loans or taxes to finance relief works might reduce private employment to some extent, only a part of the money would be taken from funds destined for the employment of labour. There would thus be a net increase in employment.[43]

19.4 THE GOLD STANDARD AND EMPLOYMENT POLICY, 1918–1939

Background

In the inter-war period unemployment dominated discussion of economic policy as never before. Thus although, for example, protection was still an important issue, especially within the Conservative Party,[44] the context of the discussion was very different. Furthermore, the nature of the employment problem had changed significantly since before 1914. After the collapse of the immediate post-war boom, unemployment remained substantially higher than before 1914, averaging approximately 10% throughout the 1920s. Furthermore, due to the publication of monthly unemployment statistics, people were much more aware of the extent of unemployment than was the case before 1914. It was not only the level of unemployment, however, that distinguished the post- and pre-war situations, for its character was very different too. Unemployment could no longer be seen as a problem associated primarily with casual labour, for it was clearly associated with the decline of certain traditional staple industries, in particular coal mining, textiles and shipbuilding. The situation was also very different from the pre-war in that unemployment insurance, its coverage having been substantially increased by the Unemployment Insurance Act of 1920, now covered most of the working population. Furthermore, the contributory nature of the scheme was immediately undermined, for the scheme was based on the assumption that the normal level of unemployment was 4–5%, whereas unemployment rose to 17% in 1921, before any reserves had been built up in the National Insurance Fund. Though attempts were made to "disguise" this as loans to the National Insurance Fund, a large part of unemployment compensation was met out of taxation. Thus not only did the cost of unemployment benefits provide a further reason for concern about the level of unemployment, but the issues of unemployment and budgetary policy became linked much more closely than before the war.

The situation changed yet again in the 1930s, after the slump of 1929. In the 1920s unemployment was primarily a British problem, for though some other countries, such as Germany, had high unemployment, this could be explained in terms of specific factors. For the United States in particular, the 1920s were a period of expansion and prosperity. But not only was the unemployment problem of the early 1930s more severe than that of the 1920s, it was also very clearly a world problem, not explicable in terms unique to Britain. Indeed, Britain suffered less from the slump after 1929 than did the United States and many other countries.

The monetary situation was also very different after 1918. Prior to 1914 the gold standard was, with the exception of the controversies over bimetallism, virtually unquestioned. During the war Britain left the gold standard. This meant that after 1919 monetary policy was a topic for discussion, if only because a decision about the standard had to be taken: even if it was taken for granted that the pre-war gold standard had to be restored, there were the issues of how and when to do so.

The questions of money and unemployment came to be linked in a way not true of pre-1914 policy discussions. An important reason for this was the changed nature of the employment problem, for unemployment was now substantially a problem of the export industries, whose performance depended on their competitiveness. The exchange rate, costs and wage rates were thus brought into the discussion of unemployment in a new way.

The gold standard

Following the recommendations of the Cunliffe Committee in 1918 and 1919, the decision was taken to return to the gold standard at the pre-war parity of £1 = $4.86.[45] The return could not take place immediately, however, for British prices were too high relative to American prices for this exchange rate to be feasible.[46] From 1920 to 1925 there was a 40% fall in the price level, with British prices falling relative to American, which made it possible to contemplate returning to the pre-war parity in 1925. The problem was that, despite the price fall, sterling was still overvalued at $4.86, the exact amount being the subject of dispute, and the following years saw attempts to reduce wages in order to reduce exporters' costs. It was this downwards pressure on wages that was responsible for the General Strike in 1926. The gold standard was maintained for six years, until 1931, when as a result of a financial crisis it had to be abandoned and sterling was devalued. There were thus three distinct phases of exchange rate policy: the period from 1920 to 1925 when preparations were being made to return to gold; the period of the restored gold standard, from 1925 to 1931; and the period off gold after 1931. In each of these the constraints on, and the background to, the use of monetary and fiscal policy were very different.

The arguments used by the proponents of the return to gold were centred on the uncertainty to which investors were subject under a managed currency. Without the constraint on currency expansion of its having to be convertible into gold there was the persistent danger of credit expansion and inflation. Given the examples of wartime inflation and, a few years later, of inflation in the Weimar republic, such a view made much more sense then than it would today. There was also the moral argument that sterling debts had been incurred under the understanding that sterling could be exchanged for gold at a certain price, and that to devalue was to renege on a contract.[47] Such behaviour was inconsistent with the maintenance of a stable international financial order on which trade and prosperity were dependent.

The decision as to just when to return to gold was taken in the light of the report by the Bradbury Committee in February 1925. The Bradbury Committee did not consider the question of a lower parity for sterling – indeed it hardly had to, for the Anglo-American price gap was, wrongly as it turned out, estimated to be as little as 4.5%. Allowing for the margin between gold points (the maximum and minimum values between which sterling could fluctuate on the gold standard) this would necessitate a deflation of only about 1.5%. In addition the committee viewed the prospects of deflation with equanimity, the 40% fall in prices since 1920 being taken as evidence for this. It was felt important to return to gold while the prospects were favourable, for delay might reduce confidence in sterling, lowering the exchange rate and making a return to the pre-war parity more difficult.

The most prominent opponent of the decision to return to gold was Keynes. In his *Tract on Monetary Reform* (1923) he acknowledged the injustices resulting from inflation, but he saw the consequences of deflation as worse.[48] He argued that it was time to abandon prejudices about entrusting the management of the price level to the government. When the return to gold did come, Keynes responded with his *The Economic Consequences of Mr Churchill* (1925), directed against the then Chancellor of the Exchequer. He argued that the price gap was much greater than the Bradbury Committee thought, nearer 10%, and that because of the difficulty in reducing wages the resulting overvaluation of sterling would have severe consequences, especially on the export industries.

To a great extent, therefore, the difference of opinion between Keynes and the advocates of the return to gold concerned the interpretation of empirical evidence rather than differences in economic theory. They had different beliefs as to the extent of the deflation required by the return to gold, Keynes' estimate of the price gap being much higher than that of the Bradbury committee. In addition, Keynes argued that the deflation seen since 1920 had been possible only because wages had never properly adjusted to the rise in prices up to 1920; he argued that *because of* the deflation which had occurred, any further deflation would be very difficult. In contrast, his opponents saw past deflation as evidence that future deflation would also be possible.

Public works policy in the 1920s

After 1918 the view of most British economists was that public works expenditure could be used to reduce the level of unemployment, this view being held not only by socialists such as the Webbs, but also by more orthodox economists. Several years before, both Pigou (1908 and 1912) and Robertson (1915) had rejected the Ricardian view that public expenditure would merely divert expenditure from private investment, a view which they continued to advocate after the war. The only prominent British economist to argue against public works in the 1920s was Hawtrey.[49] Though Hawtrey was joined in the 1930s by economists such as Hayek and Robbins, influenced by Austrian theories of the cycle,[50] it remained true that the majority of economists supported the use of public works policies to tackle unemployment. It would involve only a slight exaggeration to endorse Keynes' remark, made in 1929, that "I know of no British economist of reputation who supports the proposition that schemes of National Development are incapable of curing unemployment."[51]

It was in the Treasury and the City, not amongst economists, that opposition to public works was to be found. Even here, however, there were important changes of emphasis through the period.[52] In the early 1920s there was some official support for relief works and contra-cyclical public works, of the type proposed in the Minority Report of the Royal Commission on the Poor Laws in 1909.[53] Experience of previous slumps meant that unemployment was expected to be temporary, and public works organized by local authorities were a fairly cheap form of unemployment relief, not involving the Exchequer. It was only after 1925, when high unemployment was no longer seen as temporary, that attitudes hardened and moves were taken to restrict relief work. There was a shift from seeing unemployment as a cyclical problem towards seeing it as a structural one, for which the appropriate remedies were industrial reorganization, labour mobility and cost reductions. In the words of one historian, "Within the space of a few years, therefore, both relief and contracyclical public works had been discredited, and the Treasury was enunciating the view for which it became infamous."[54] Moreover, not only did the Treasury start disputing the value of public works schemes, but it also started using new theoretical arguments to defend its view. Thus a Treasury statement made in 1927 could argue that

> The decision taken by the Government at the end of 1925 to restrict grants for relief schemes was based mainly on the view that, the supply of capital in this country being limited, it was undesirable to divert any appreciable proportion of this supply from normal trade channels.[55]

By 1929 Churchill, addressing the House of Commons, claimed that

> It is *orthodox treasury dogma, steadfastly held*, that whatever might be the political or social advantages, very little additional employment can, in fact, and as a general rule, be created by State borrowing and expenditure.[56]

According to this orthodoxy, Britain's economic problems were not due to insufficient demand, but were explicable in terms of four factors: the burden of unproductive debt and overlavish spending by central government and local authorities, these resulting in budgetary problems; excessive costs in certain industries; and the attempt by all classes to maintain an unduly high standard of living.[57]

Real wages and unemployment

In view of the tendency in post-war writings on "Keynes and the Classics" to see wage cuts as the "classical" remedy for unemployment, it is worth pointing out that support for wage cuts was, amongst economists, very limited. Though there were of course prominent economists, most notably perhaps Cannan, who supported a policy of wage reductions, the economist most commonly associated with "classical" economics, Pigou, did *not* advocate such a policy.[58] On the issue of wage cuts versus policies to expand demand there was little difference between his view and that of Keynes. Although Pigou's position was stated in his *Industrial Fluctuations* (1927) an even clearer statement is to be found in the evidence he later gave to the MacMillan committee.[59] In this he conceded that *given the level of demand*, reductions in real wages would increase employment, but he argued that an expansion of demand would be preferable. It was because he took the existence of unemployment as indicating that supply of labour exceeded demand that he believed that an increase in demand could raise employment without any fall in real wages.[60]

Keynes and public works, 1924–1929

Although, as has already been argued, it would be completely misleading to represent Keynes as standing alone, he was one of the most vigorous advocates of public expenditure as a remedy for unemployment. When Keynes first began supporting public investment programmes in the mid 1920s this was not seen as a remedy for cyclical fluctuations, such as the pre-war public works proposals, but as a remedy for the persistent slump in certain industries, a slump destined to continue because of the return to gold.[61] In 1929 he wrote,

> I began to advocate schemes of National Development as a cure for unemployment four years or more ago – indeed as soon as I realised that, the effect of the return to gold having been to put our money rates of wages too high relatively to our foreign competitors we could not, *for a considerable time*, hope to employ as much labour as formerly in the export industries.[62]

Thus Keynes, in an article posing the rhetorical question, "Does unemployment need a drastic remedy?" (1924) supported Lloyd George's proposals for a large programme of public investment. Keynes argued that lack of confidence was inhibiting the recovery of private investment, and that to undertake a programme of public investment would both provide employment directly and restore the confidence of the private sector. Keynes' association with Lloyd George and the Liberal Party continued throughout the 1920s, Liberal Party work culminating in its 1929 election manifesto, *We Can Conquer Unemployment*. This contained the argument that public investment, in schemes ranging from road building to investment in electricity generation and the telephone system, would not only generate employment directly, but also generate further employment in the private sector. The manifesto contained an explicit criticism of the argument that the supply of savings was limited, the claim being made that a large quantity of saving was not finding its way into productive investment, but was being hoarded as bank deposits.[63] This manifesto was publicly endorsed by Keynes.[64]

Depression and recovery, 1929–1939

To understand the nature of the discussions which took place in these years it is necessary to provide a brief outline of the events which took place.[65] The Wall Street crash occurred in September 1929[66] and there followed a worldwide slump. Unemployment in Britain, though it rose less than in the US, rose from 10% in 1929, to 16% in 1930 and to 22% in 1931. This created the prospect of an enormous budget deficit. Taxes were raised in the 1930 budget, and in February 1931 a committee, the May Committee, was set up to find ways of reducing public expenditure. Up to this point the consequences for sterling of the slump had been favourable, for with the collapse of the US stock market boom money became less tight, British interest rates falling substantially from the Autumn of 1929 to the Spring of 1930. In May, however, the failure of an Austrian bank resulted in a financial crisis which spread, first to Germany and then, by July, to Britain.[67] The government's response was to attribute the crisis in large measure to a lack of confidence, this being caused by the large budget deficit.[68] The remedy was seen as involving public expenditure cuts such as those the May Committee recommended in its report, published early in July. The Labour Government split over the issue of a 10% reduction in unemployment benefits, and was replaced on August 24th by a National Government under MacDonald, until then Prime Minister in the Labour Government. Cuts were agreed and an emergency budget passed on September 10th. This failed, however, to alleviate the situation, and on September 21st the Bank of England was relieved of its responsibility to pay gold on demand. The gold standard was thus maintained until the government was forced to abandon it.

Despite the almost universal desire, whilst it was in operation, to stay on the gold standard, there was little support for the idea of returning to it once it had been abandoned.[69] Discussion was rather over the rate at which sterling should be allowed to settle. Though the departure from gold was accompanied by a temporary rise in interest rates, it was soon followed by a period of cheap money, and a relatively low exchange rate, these being intended to aid recovery. The Exchange Equalization Account was set up in 1932 to make it possible to continue this policy in the face of the inflow of capital which occurred as confidence in sterling was restored.[70] Budgetary policy, however, changed little in the early 1930s. The expenditure cuts introduced in 1931 were restored by 1935, but the budget was still balanced. The government objected to, for example, Keynes' proposals for expenditures to be met by future increases in taxation, on the grounds that this was merely a way of attempting to disguise an unbalanced budget. It was only from 1936, and above all from 1937, when it became caught up in rearmament, that budgetary policy changed.[71]

The MacMillan report

Whilst the May Committee took a very short term view, ignoring the wider effects of their proposed expenditure cuts on the economy, a broader perspective was taken by the Committee on Finance and Industry, the MacMillan Committee, which reported later in July. The report of this committee, of which Keynes was a prominent member, is important, for it illustrates the case for expansion as it appeared whilst Britain was still on the gold standard.

In its opening section the report put forward a view of the need for economic management similar to that expressed by Keynes in *The End of Laissez Faire*:

> we may well have reached the stage where an era of concerted and deliberate management must succeed the era of undirected natural evolution. ... We stand in need as never before of a definite national policy in our financial disposition.[72]

Though the committee argued a case for expansion, however, it did not dispute the advantages of remaining on gold.

> This brings us to the question whether adherence to an international standard may involve the payment of too heavy a price in the shape of domestic instability... . If we leave aside the position today, experience does not show that a creditor country with diversified trade is liable to suffer undue strain merely as the result of adherence to an international standard. We are of the opinion, therefore, that we should not be influenced merely by the exigencies of the moment, if there is reason to believe that there may be important countervailing advantages on a longer view. If we need emergency measures to relieve the immediate strain, we should seek them in some other direction.[73]

As for these long term advantages the committee mentioned the earnings from banking and financial services, but more important was the need for a world monetary standard: "there is, perhaps, no more important object within the field of human technique than the world as a whole should achieve a sound and scientific monetary system".[74] By abandoning gold, Britain would be reducing the possibility of progress towards a rational world monetary system, for the committee saw no possibility of early progress towards such a system "except as the result of a process of evolution starting from the historic gold standard".[75] Though Ernest Bevin, who had consistently advocated devaluation, together with one other member of the committee, dissented,[76] devaluation was emphatically rejected.[77]

This cosmopolitan outlook was reflected in the main policy prescription, that

> our object should be, so far as it lies within the power of this country to influence the international price level, first of all to raise prices a long way above the present level, and then to maintain them at the level thus reached with as much stability as can be managed.[78]

As for divergences between national interests and the interests of the world as a whole, it was thought that "such apparent divergences of interest would generally prove to be illusory or avoidable if fully understood".[79] Price stability was to be achieved by central bank credit policy, aimed at stabilizing the rate of investment, both long and short term.[80] By undertaking not to allow "unwanted and unnecessary" accumulations of gold, central banks would avoid transmitting deflation from one country to another. It was only after considering how to make the international monetary system operate better that the committee turned to other issues.[81]

A substantial minority of the committee, including Keynes and Bevin, went further, arguing that wider issues had to be considered. "For if the situation remains unchanged in other respects, we doubt whether it lies within the power of the banking system to restore unemployment to a satisfactory level".[82] The reason given for this was that the main problem was not lack of bank credit, but "the reluctance of acceptable borrowers to come forward".[83] To change this, either the long term rate of interest had to be considerably reduced, or some form of state action had to be taken. Either would put strain on the balance of payments. It was in this context that a system of tariffs and bounties was suggested as an alternative "immeasurably preferable to devaluation".[84]

The policies proposed by the MacMillan Committee are consistent with the framework of the *Treatise on Money* which Keynes had published the previous year. The emphasis was on the need for inflation, for a rise in the price level on a worldwide scale, to raise profits and the incentive to invest.[85] Public spending and expansionary credit policies were a part of this process. The crucial aspect of the committee's recommendations, however, is that neither were these proposals seen as an alternative to the gold standard, nor did the committee reject the long term arguments put forward in favour of the gold standard. Indeed, as the quotation above shows, they could hardly have attached more importance to the maintenance of a stable international monetary system.[86] Thus proposals for protection were not seen as a means of cutting Britain off from the rest of the world, but as a means of enabling Britain to stay on the gold standard, the only feasible starting point for progress towards an improved international monetary system.

The development of Keynes' views

In assessing the development of Keynes' views it is crucial to bear in mind the changing circumstances in which he was writing, for he was continually attempting to apply his ideas to the current situation, bearing in mind the constraints on what was feasible. There was a consistent theme in his writings, however; namely the undesirability of deflation.[87] In the early 1920s he criticized the return to gold on the grounds that the authorities underestimated both the extent and the significance of the deflationary effects of their policy. From 1925 to 1931 he sought ways of inflating the economy, both national and international, whilst retaining the benefits of the gold standard. His motives for supporting the gold standard were a natural extension of his earlier views, for he saw it as a step towards introducing some sort of rational decision making as to the course of the world economy.[88] He continued to argue for expansionary policies after 1931, though with the collapse of the gold standard he switched his hopes for the international monetary system to some sort of sterling area.

This emphasis on inflation contrasted with the orthodox position, which was one dominated by fear of inflation. A major reason why the gold standard was thought to inspire confidence was that managed currencies were associated with inflation. In the early 1930s fiscal policy was motivated by fear of the inflationary consequences associated with an unbalanced budget.

Keynes' advocacy of inflation was, however, contingent on circumstances, as is illustrated by the views he expressed in a series of articles and letters he wrote in 1937.[89] By that time the economy was, Keynes believed, passing beyond the point where there was general excess capacity, as a result of which it was important to pay as much attention to the composition of demand as to its volume. Because of the possibility that a slump might soon develop, and given that suitable investment projects take time to create, he argued that certain items of spending should deliberately be held back so that they could be used, when the time came, to counteract the slump. Thus Keynes was urging restraint, even though unemployment was still over 10%.

Keynes' policy prescriptions, whether on domestic monetary policy, public works or the international monetary system, were all based on the same attitude towards the role of government in the economy. This attitude was spelt out in detail in *The End of Laissez Faire* (1926). The bulk of this comprised a long disquisition on social philosophy, in which he criticized *laissez-faire* orthodoxy, describing it as a "lethargic monster", which had "ruled over us by hereditary right rather than by personal merit".[90] Seeing state socialism as equally anachronistic,[91] he argued, borrowing Bentham's phrase, that it was necessary "to distinguish afresh the *Agenda* of government from the *Non-Agenda*".[92] As regards the former, he argued

> The most important *Agenda* of the State relate not to those activities which private individuals are already fulfilling, but to those functions which fall outside the sphere of the individual, to those decisions which are made by *no one* if the State does not

make them. The important thing for government is not to do things which individuals are doing already, and to do them a little better or a little worse; but to do those things which at present are not done at all.[93]

Seeing the main evils of his time as "the fruits of risk, uncertainty and ignorance" he cited three areas where state action was needed: deliberate control of currency and credit; "some coordinated act of intelligent judgement" as to the desirable level of savings and the directions into which they are channelled; and attention to the size and quality of the population.[94] Keynes thus argued for the deliberate management of the currency, first at a national level and later, when the circumstances required it, at an international level, and measures to ensure a rational level of investment. Underlying all his writings on policy was a philosophy according to which the world was amenable to rational decision-making, and that such decisions should be taken by someone.[95]

19.5 CONCLUSIONS

The complexity of economic policy

In this chapter no attempt has been made to tackle two of the questions most often asked about economics and economic policy, namely what were the main reasons why particular economic policies were pursued, and which policies were the appropriate ones to pursue? There are two reasons for this. The first is that to tackle either of these questions properly would take us further into British economic history than it is appropriate to go here.[96] But the second, and more fundamental reason is that, although these are important questions, they are not necessarily the most important ones from the point of view of understanding the way in which economic ideas have evolved. For this, it is often more important to see how the ideas are related to the circumstances in which they were put forward than to know how the ideas stand up in the light of a modern interpretation of the economic history of the period. To examine ideas about economic policy in this way is not to justify them:[97] they may of course be completely explicable yet erroneous.

During the period covered by this chapter, economic theories were important in discussions of economic policy, academic economists having ample opportunity to make their views known, both before and after the war. The relationship of this advice to the policies pursued was, however, complicated, not simply because policy makers chose to take account of other issues, had vested interests, and failed to understand the ideas of academic economists, but for more fundamental reasons connected with the nature of economic theories. The first reason is that whilst the development of economic theory is to a substantial extent autonomous, in the sense that its evolution is influenced primarily by theoretical considerations, the way economic theories develop is also influenced by the problems economists choose to tackle, and the way they choose to tackle them. These depend on how economists conceive the economy, and on the nature of the economic problems with which policy makers are confronted. The best example of this is perhaps the evolution of attitudes towards unemployment. As long as economists' conceptions of unemployment were dominated by the problems of casual labour in the London docks, they were most unlikely to analyse the problem of unemployment even in the way it was analysed in the inter-war period, let alone in the way economists usually tackle the problem today.

A second reason why the relationship between theory and policy is so complicated is that not only are theories developing, but also there is rarely a one-to-one correspondence between theories and policy prescriptions. A good example of this is provided by the attitudes of Keynes and Pigou towards unemployment policy in the late 1920s. Their positions on unemployment policy were very close indeed, both arguing against wage reductions, and in favour of public investment policies. These policy prescriptions were, however, based on different theories. The theoretical approach of Pigou's *Industrial Fluctuations* is different from that of Keynes' *Treatise on Money*.[98] As an example of the opposite instance, of differing policy prescriptions being derived from the same theory, it is possible to cite the different views on policy derived by economists using the purchasing power parity theory in the early 1920s.

An aspect of this problem, sufficiently important to be worth singling out, is the fact that an economic theory focuses only on certain aspects of a problem. Whilst such "blinkers" may for some purposes, and the logical analysis of economic relationships is one of these, be invaluable, the aspects which are ignored can rarely be left out of discussions of economic policy. A good example here is the use of the Marshallian theory in the Tariff Reform campaign. Problems of economic development are virtually impossible to analyse in a Marshallian supply and demand model,[99] but they were issues which could not be neglected because of the importance many tariff reformers attached to them.

In assessing debates on economic policy it is important to note that certain aspects of economic problems are amenable to quantitative treatment, in the sense that they concern functional relationships between economic variables. Since 1939, especially with the increase in the use of mathematics in economics, the emphasis on these aspects of economic problems has increased. The result of this is the tendency to attach too little importance to factors which cannot be quantified. Consider the orthodox case on the gold standard and public works policy. The Keynesian counter-argument can easily be expressed formally and the weaknesses of the Treasury View stand out clearly. The arguments put forward on the other side, in contrast, *whatever their intrinsic merits*, cannot, at least at present, be analysed in this way. Factors such as confidence, and the reaction of other countries to an "immoral" action, cannot usefully be expressed in terms of simple functional relationships. This would seem one of the reasons, and it is worth emphasizing that it is only one reason, why the orthodox position has been taken less seriously than the Keynesian. It is for this reason that the MacMillan Committee report is so interesting, for it shows Keynes and other advocates of expansionary policies arguing an aspect of the "orthodox" case, namely the importance of the gold standard.

British and American policy discussions

This chapter has been very parochial in its outlook, for unlike economic theory, discussions of economic policy in the period were, to perhaps a greater extent than today, very much affected by the particular circumstances and background against which the economists were writing. This can best be illustrated by considering some of the ways in which the context for American discussions of policy was very different from that of British discussions.

As in Britain, the context in which American discussions of economic policy took place changed substantially in the last third of the nineteenth century, but the reasons for this were very different.[100] The event dividing the century, both politically and economically, was the Civil War of 1862–1865, the decades following 1865 seeing not only a different political balance but an enormous expansion of the economy in terms of both production and geographical area. It was between 1865 and 1914 that the frontier was extended from the Mississippi to the Pacific. During the Civil War a policy had been established favouring the rapid expansion of industry, with minimal controls on business activity. Especially with the enormous concentration of economic power which emerged in the 1890s, due in part to the importance of railroads in the US economy, an enormous concentration of economic power took place, especially in the 1890s. As a result of this the need for controls on business was an issue of immensely greater importance than in Britain.

Monetary problems, too, were the subject of more intense discussion in American than in Britain, the Civil War again having set the scene with enormous increases in the national debt, and with the issue of inconvertible currency (the greenbacks). Further factors underlying the importance of monetary issues in the US were the need of a rapidly expanding economy for circulating medium, and the political importance of farmers. In the depressions of the 1870s and the 1890s, and above all in the Presidential election of 1896, the silver question achieved a prominence unrivalled elsewhere, the free coinage of silver being advocated as a means of expanding the supply of currency.[101] Thus although the theories American economists produced were of the same genus as contemporary theories in other countries, discussions of economic policy were radically different.

As in Britain, labour unions and their behaviour were an important issue, but again the context was different. American labour unions faced much greater problems than their British counterparts, their membership remained low, right up to 1914, and they were relatively weak. Although explicitly socialist ideas did not gain much support, radical ideas were strong in the US. In addition, the tolerance of American economists towards rival viewpoints meant that the association of unemployment with the business cycle, and of the business cycle with under-consumption, was stronger in the US than in Britain. Thus Hobson, for example, received more attention in the US than in Britain. Discussions of unemployment policy had a very different background.