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Wyn Grant

Economic Policy in Britain

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Economic Policy in Britain

Wyn Grant

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Contents

List of Tables		viii
Preface		ix
Introduction		**1**
	Key issues and disputes in British economic policy	2
	How different is New Labour?	5
	Globalization and the autonomy of the nation state	8
	Structure of the book	9
1	**From the Postwar Settlement to Thatcherism**	**13**
	Introduction	13
	The Second World War and modern macroeconomic policy	16
	Periods of economic policy	18
	Greater prosperity: Keynesianism, Butskellism and Robot	21
	The Brighton Revolution and the shift in economic policy	24
	The failure of modernization and a period of transition	30
	A new political settlement?	34
	The Major government	37
	New Labour	39
2	**Globalization and Europeanization**	**41**
	Introduction	41
	Three perspectives on globalization	45
	Europeanization of economic policy	47
	The Blair government and globalization	49
	Global economic governance	50

3	**Economic Theory and Economic Policy**	**65**
	Introduction	65
	The market and the state	65
	Market failure	67
	Government failure	74
	A challenged paradigm: relative economic decline	76
	Keynesianism	81
	Thatcherism	87
	The depoliticization thesis	90
4	**Monetary Policy**	**93**
	Introduction	93
	Monetary policy in the 1950s and 1960s	93
	The 1970s: a period of transition	96
	The 1980s: the disappointment of monetarism	98
	The 1990s: the ERM episode	100
	The development of EMS and EMU	103
	The case for economic and monetary union considered	107
	The case for and against British membership	111
	The management of entry	115
	The role of the European Central Bank	118
5	**Public Expenditure and Taxation**	**122**
	Introduction	122
	Long-term trends in public expenditure and taxation	124
	The control of public expenditure	127
	Devolution and the Barnett formula	132
	Taxation and the budget	136
	Taxation and expenditure under the Blair government	138
6	**The Supply Side and Competitiveness**	**144**
	Introduction	144
	Competition policy	146
	Transport	152
	Skill formation	155
	Utility regulation	158
	Conclusions	163
7	**The Electorate and the Economy**	**164**
	Introduction	164
	Models of voting behaviour	167

Explaining the elections of 1992 and 1997 174
An assessment of economic voting models 180

8 Economic Policy-Making 183
Introduction 183
The Prime Minister 183
The Prime Minister–Chancellor relationship 188
The Treasury 195
The Bank of England 201

9 Parliament, the Media and Organized Interests 207
Introduction 207
Parliament 207
The media 213
Pressure groups 218
The limits of insider decision-making 223

10 Conclusions 225
The regulatory state 226
The disappearance of economic orthodoxies 227
The limits of the Third Way 229
Engagement or disengagement with Europe? 230

Further Reading and Web Site Guide 234

Bibliography 237

Index 249

List of Tables

1	Inflation, unemployment and the misery index	3
1.1	The UK's ranking in terms of real GDP/person, benchmark years 1870–1999	16
1.2	Rates of growth of real GDP/person, selected periods, UK 1870–1999	25
2.1	Size of secretariats of global governance agencies	51
5.1	Real average annual increase in taxation and spending	138
8.1	Involvement of postwar prime ministers in the economy	184
8.2	Prime minister–chancellor relationships	190

Preface

This book arises from many years' experience of teaching the third year Making of Economic Policy module at the University of Warwick as well as a postgraduate module on Problems of Economic Management. The Making of Economic Policy module has been taught with a succession of economists all of whom have increased my respect for their discipline. In the late 1970s and 1980s I taught the module with the late Shiv Nath with whom I wrote a book on economic policy. The module was then taught for several years by Jim Bulpitt, an original thinker on a wide range of issues. After Jim's premature death, I started to teach on the module again, at first with Professor Lord Skidelsky. It was a real privilege to teach with someone with such a powerful intellect, a profound range of knowledge stretching across several disciplines and direct experience of the world of politics and policy. His successor, Geoff Renshaw, brought to the module a sophisticated understanding of economics and a relentless questioning of my assumptions and beliefs that I found refreshing and challenging. He also helped me with the collection of statistical tables for the book.

The Making of Economic Policy course at Warwick was established by Professor Malcom Anderson. He is now an emeritus professor of the University of Edinburgh, a citizen of France and actively involved in both academic writing and policy work in Brussels. When I first came to Warwick he was effectively my mentor, although we did not use that term in the 1970s. He offered me invaluable advice on the development of my research and teaching. I owe him a lasting debt and this book is dedicated to him.

Steven Kennedy, my publisher at Palgrave, guided the development of this book with his usual care and thoroughness, making a number of invaluable suggestions for its improvement. I would also like to thank an anonymous reader for the comments provided. In the department at Warwick, Peter Burnham has many shared interests, not least in the historical development of economic policy in Britain in the second half of the twentieth century. Despite our different theoretical perspectives, we have had many fruitful discussions, not least on trips to the Public Record Office. Nicholas Crafts of LSE provided me with his latest unpublished work on relative economic decline which was of great assistance in the final stages of writing. In the different world of football, Alan Curbishley offered a role model of the virtues of calm deliberation under much greater pressure than I ever have to face. As always, I owe a great debt to my wife, Maggie. Hopefully, the twenty-first century will offer a more successful and fairer economic setting in which my granddaughters, Clarissa, Lauren and Victoria, can grow to adulthood.

WYN GRANT

Introduction

Economic policy since the Second World War has been concerned with influencing the behaviour of the economy as a whole with the objective of securing key objectives such as low inflation, low levels of unemployment and high rates of economic growth. These objectives were pursued by government manipulation of policy instruments including interest rates, taxes and control of the money supply. The emphasis after 1945 was thus on macroeconomic policy, the attempt to control economic aggregates through the manipulation of economic demand. A number of other policies were seen as having an effect on the failure or success of economic policy – for example education policy and skill formation – but these were seen as distinct arenas of policy. Policies that focused on the meso or micro levels of the economy were categorized separately, for example industrial policy and regional policy.

This traditional approach changed with the election of the Thatcher government in 1979. Not only was the traditional ordering of priority objectives reversed, with greater emphasis given to the control of inflation rather than unemployment, but also the methods used to achieve them changed. There was a new emphasis on the supply side of the economy in contrast to the previous emphasis on the demand side. The new orthodoxy was summarized by Nigel Lawson in his 1984 Mais lecture:

> the proper role of [macroeconomic and microeconomic policy] is precisely the opposite of that assigned to [them] by the conventional post-war wisdom. It is the conquest of inflation, and not the pursuit of growth and employment, which is or should be the objective of macroeconomic policy. And it is the creation of conditions conducive to growth and employment, and not the suppression of price rises, which is or should be the objective of microeconomic policy. (Lawson, 1992, pp. 414–15)

The Blair government has built on the economic foundations established by Thatcher and Major, retaining an attachment to sound money, but giving a greater emphasis to sustained growth and to an element of redistribution. The major change in the conduct of economic policy under Blair was the immediate surrender to the Bank of England of one of the key instruments utilized by governments, the control of interest rates. This forms part of a larger trend towards the depoliticization of economic policy (Burnham, 1999, 2001).

Even if it is becoming more depoliticized, economic policy has not lost its central role in the political process. One of the indicators of this continuing centrality is the enhanced role of the Treasury in the Blair government. The perceived competence of governments in managing the economy is an important factor in the voting decisions made by electors and has been one of the explanations of the electoral success enjoyed by New Labour. The success or otherwise with which the government manages the economy influences all other areas of public policy. If the economy enters a recession, tax receipts fall and spending on social security rises. Increasing taxes could lengthen the recession, so government either has to cut public spending or borrow more money (or probably some combination of both). This funding shortfall then affects the extent to which public services can be maintained or improved, a key concern of the electorate.

Key issues and disputes in British economic policy

These have centred on the key objectives of economic policy and how they might be achieved. The precise mix of objectives has differed over the postwar period, but the level of employment and the rate of inflation have always been at the heart of debates about economic policy. Added together, as they have been by many commentators, they form the 'misery index' (Brittan, 1995, p. 130) (Table 1). The term 'was invented by the late Arthur Okun' (Dornbusch and Fischer, 1990, p. 547). Until 1970 this was in single figures (apart from one year which was influenced by high inflation because of the Korean War). It peaked at 30.5 in 1975, but was also high in the early 1980s, finally falling to single figures again in 1997. Up until 1979 higher priority was given in practice to the employment objective, but since 1979 the emphasis has been on inflation. Since around 1960 a high and sustainable rate of economic growth has been an objective. Until the early 1970s a principal objective of

Table 1 Inflation, unemployment and the misery index

Decade	*Inflation mean (%)*	*Unemployment mean (%)*	*Misery index*
1950–59	4.1	1.5	5.6
1960–69	4.6	1.9	6.5
1970–79	12.9	3.7	16.6
1980–89	7.6	9.6	17.2
1990–99	3.9	7.2	11.1

Notes: lowest unemployment figure, 1.1% (1955); highest unemployment figure, 11.5% (1986); lowest inflation figure, 1.5% (1954); highest inflation figure, 26.7% (1975); lowest misery index, 2.8 (1954); highest misery index, 30.5 (1975). The measure of inflation used is YBGB = GDP (expenditure) at market prices deflator (seasonally adjusted). This is the broadest of three available measures of inflation. It includes prices of all goods and services that are included in GDP. The longest unemployment series is BJCA (a technical term for the claimant count). This goes back to 1950 and is labelled 'claimant count' in modern terminology, but used to be called 'registered unemployment'. The misery index used here is the sum of the mean annual unemployment rate and the mean annual inflation rate for each decade. Thanks to Geoff Renshaw for collecting data and calculations and to Mark Stewart for advice.

policy was sustaining a fixed exchange rate, and associated with this was a need to manage balance of payments difficulties. A fixed exchange rate is one where the pound is maintained at a predetermined level (or fluctuates within a very narrow range) against some other currency, the dollar in the earlier postwar period. If the exchange rate can vary against that of other currencies, it can be devalued to boost exports (which become cheaper in foreign currencies) and restrain imports (which become more expensive in pounds). If the exchange rate is fixed and overvalued, as it often was in Britain, the economy will suffer a series of balance of payments crises in which imports of goods and services outweigh exports.

The major political parties tried to differentiate themselves in terms of the degree of state intervention in the economy. This debate centred particularly on an adversarial argument about the merits or otherwise of public ownership of key sectors of the economy. In practice, apart from the denationalization and renationalization of the steel industry, this debate produced few practical effects as the distance between the parties was far less than they pretended was the case. Up until 1979, both Conservatives and Labour accepted the idea of a 'mixed economy' in which there was substantial government intervention, both through direct ownership and other means. Both parties provided substantial subsidies to firms in difficulty and to encourage economic development in the less successful regions.

After 1960 both parties agreed on the need to improve Britain's economic performance, compared with its competitors, usually measured in terms of a higher rate of economic growth. The parties had different explanations of the causes of poor performance with the Conservatives emphasizing trade union power and Labour paying more attention to underinvestment. There was, however, general agreement that government intervention in some form had to be part of any solution. It often seemed, however, that the objective of both main parties was the more effective management of decline. The Thatcher government made the reversal of decline one of its key objectives, seeing the accommodation with labour as one of the main obstacles that had to be overcome (Gamble, 1988). In taking such a stance the Thatcher government was obliged to breach an important part of the postwar economic settlement which had coopted organized labour into economic policy-making, leading eventually to a weak form of corporatism known as tripartism. In its continental European form, corporatism involved the cooption of key interests, particularly organized labour, into the economic policy decision-making process on the assumption that they would help to implement the agreed policies. The decentralized and fragmented trade union movement made it difficult to use such an approach to policy-making in Britain.

Similarly, although there was disagreement among the parties about the extent to which redistribution should be an objective of policy, both of them accepted the idea of the redistribution of income and some limited redistribution of wealth. This was achieved through a progressive tax system, centred on direct taxation, the funds raised being in part used to provide a variety of welfare services that were of particular benefit to the less well-off members of the community. The Thatcher government substantially changed taxation policy, significantly reducing the higher rates of income tax, and shifting the tax burden from direct to indirect forms of taxation. The unpopular community charge or 'poll tax' was one of the causes of her ultimate downfall. She would have also liked to make inroads into the welfare state, but, apart from a significant reduction in spending on public housing, it remained largely intact.

Until 1979 there was broad agreement between the two main political parties on the importance of maintaining full employment. The Thatcher government gave greater importance to the control of inflation, although arguing that sustainable employment would not be possible without sound finances and low inflation. This provoked disagreement between the parties about the ranking of objectives and also about the efficacy of different policy instruments in achieving them. Between the early 1960s and 1979, both Conservative and Labour governments relied considerably on incomes (and to a lesser extent prices) policies as a means of controlling inflation under conditions of employment. After 1979 the Conservatives placed a new emphasis on the control of the money supply and public-sector borrowing.

These policy instruments were controversial and brought very mixed results. The debates about the control of inflation in the 1980s led to a new emphasis on rules in the conduct of economic policy that would establish credibility for government actions in the judgement of other economic actors, not least the financial markets. New Labour

> deepened [a] commitment to the ‘rules-based’ economic strategies begun by the Major administration. ‘Rules-based’ approaches attempt to build counterinflationary mechanisms into the economy by reordering part of the government’s responsibility for economic policy onto non-governmental bodies. (Burnham, 2001, p.136)

How different is New Labour?

The Labour view of recent economic history, as set out by Tony Blair, is that Thatcherism brought about important and necessary changes in the British economy, but it is now necessary to move beyond Thatcherism. Nevertheless, Labour’s economic policies have been built on an unmistakably Thatcherite platform, tightened by the introduction of new rules governing the conduct of fiscal policy. The control of public expenditure under the first Blair government was almost certainly tighter than it would have been under a re-elected Conservative government. Heffernan observes (2000, pp. 65–6) that the Blair government has taken up four economic policy objectives of the Thatcher and Major governments:

> (1) Ensuring financial stability by promoting sound money and placing the reduction of inflation at the heart of both fiscal and monetary policy; (2) placing the market at the centre of economic life through deregulation and the rejection of direct state intervention; (3) Privatisation of state-owned industries and utilities so withdrawing the state from direct control over economic activity; (4) Controlling trade union activity by legislation and (together with other measures) so disciplining the labour market.

In political terms, New Labour was anxious to differentiate itself from both Old Labour and from the Conservatives. The 'philosophy' of the Third Way offered a means of doing this, even if it was largely constructed after the Labour victory in 1997 in two books written by Giddens (1998a, 2000). Much of the thinking behind the third way was imported from the United States (Deacon, 2000; Giddens, 2000, p. 3). The Clinton Democrats did not accept the Reagan and Thatcher view that government was the problem, not the solution; they did not want to revert to big government, but they thought that government was a tool that could be reinvented and used more selectively in the twenty-first century. Government needed to be more limited in its use of resources and to target them on real needs.

The third way accepted the reality of government failure: 'Government and the state are the origins of social problems as well as markets' (Giddens, 2000, p. 28). However, it was accepted that 'Markets can't even function without a social and ethical framework – which they themselves cannot provide' (Giddens, 2000, p. 33). The vision of economic policy was predicated on a normative and empirical acceptance of the realities of globalization. Third-way politics was characterized as a 'globalizing political philosophy' (Giddens, 2000, p. 122), and it was accepted that 'Economic globalization, by and large, has been a success' (Giddens, 2000, p. 124). The question, for whom, is not one that fits very well into the third way.

The third way sought to develop a new mixed economy involving 'a wide-ranging supply-side policy which seeks to reconcile economic growth mechanisms with structural reform of the welfare state' (Giddens, 2000, p. 52). There is quite an emphasis on regulation as a tool of an active government; it is argued that 'greater regulation of economic life, in some respects, and some contexts, is necessary' (Giddens, 2000, p. 84). If one looks at the justifiable grounds for regulation given in Giddens (1998b) they are quite extensive. The third way therefore provides an intellectual underpinning for the development of a regulatory state. More generally, its critics saw it, at best, as an attempt to find some compromise between neo-liberalism and old-style social democracy, but tilted towards the former.

Even if the third way offers a less distinctive and clear philosophy than is sometimes claimed, the economic policies followed by New Labour are not the same as those of the Conservatives. The Conservatives would not have introduced a minimum wage, signed the social chapter of the Maastricht Treaty so as to open up new rights for workers, or used the tax and benefits system to introduce an element of redistribution in favour of working families. However, the similarities and continuities outweigh the differences. As Heffernan observes (2000, p. 173), 'in terms of objectives as well as methods, "New" Labour offer a distinctive political strategy dramatically at odds with the Thatcherite project.' New Labour is working within the terms of a new political settlement initiated in 1979. Policy will continue to develop in new directions, but such initiatives as using private provision in the public services are entirely consistent with a market-based approach to economic policy.

Do all these developments mean that the ideology and the politics have been taken out of economic policy and it has become increasingly a matter of the application of predetermined rules within a broad market-based consensus? In many respects, yes. The state has lost many of its old roles in economic policy: owner; manager of the macro economy; and provider of subsidies. It has gained one new important role, as a regulator, so that many writers have come to use the term 'regulatory state'. Economic management has become increasingly a managerial task, as illustrated by the fact that Gordon Brown's big project in the second Labour government appeared to be improving productivity: worthy, but hardly exciting. There is, of course, one major exception to this trend towards depoliticization – the debate about whether Britain should join the euro. Many of the fierce ideological disputes of the past have, however, transferred to the international level and the fight against globalization. For young political activists, the appropriate targets are not national governments but the European Union (EU), international summits and the World Trade Organization (WTO).

Globalization and the autonomy of the nation state

In the middle of the twentieth century the place of the state in the making of economic policy in Britain and other western countries seemed secure. Keynesian economics provided a politically acceptable toolkit for achieving full employment. It involved the use of counter-cyclical demand management to avoid recession. Even if it was necessary to enter into negotiations with the Americans about the management of the international system of economic management, the nation state was seen as the principal decision-maker in matters of economic policy. It might be constrained, but it was sovereign.

By the beginning of the twenty-first century, the empirically and normatively contested concept of globalization cast a shadow over debates about the continued viability of domestic economic policy. Those writers who doubted whether there was a new phenomenon called 'globalization' emphasized 'that, in proportional terms, levels of cross-border trade, migration and investment were as high (if not higher) in the late nineteenth century as they were in the run up to 2000' (Scholte, 2000, p. 19; see Hirst and Thompson, 1996). Those analysts who thought that something rather more significant than accelerated internationalization was occurring emphasized the magnitude and speed with which sums were traded across international financial markets and the consequent rapidity with which a minor national crisis could become a major global one. Analysts in the former camp argued that the events of 11 September 2001 signalled the end of globalization, while those in the latter group argued that it might be slowed down, but would not be reversed.

Certainly one view that was often heard was that, at least in economic policy, the system of nation states established by the Treaty of Westphalia in 1649 was coming to an end. According to this account, responsibility for the shaping of economic policy was likely to flow both upwards and downwards. At the international level, the International Monetary Fund (IMF), the World Bank and the WTO came to be perceived as major sources of economic power, even though the WTO is in many respects a very weak organization. For many observers, they were simply the institutional face of market power. At a seminar of major international economic decision-makers attended by the author, someone posed the question 'Who calls the shots? Not us, say the international financial institutions, it's the G7 finance ministers [the grouping of leading economic powers]. Not us, say the finance ministers, it's really the markets.'

There was also the prospect of a downwards shift of authority from the level of the nation state. An understandable reaction to the development of a global economy is to demand that political power be devolved to a local level so that people can have some influence on their own immediate circumstances. As globalization proceeds, the value of more immediate identities increased. In Britain this was reflected in the creation of a Scottish Parliament and a Welsh Assembly, the Scottish Parliament having the power to levy additional taxes. Within Scotland in particular, the terms of political debate were increasingly constructed in Scottish terms.

One response to these dilemmas was to argue that political control of globalization was only possible at a Europe-wide level. The EU could be seen as an attempt to build a dynamic European economy that was distinctive from that of the United States in so far as it tried to offer a higher level of social protection. Its neoliberal critics argued that the result would be a more regulated, less flexible and more rigid economy unable to compete in a globalizing world economy. In any case, there was a paradox at the heart of the enterprise. The EU represented both an attempt to facilitate globalization through the construction of an internal market and an attempt to constrain it through policies designed to achieve a 'social Europe'.

Structure of the book

Whatever the importance of globalization, the EU and subnational governments, significant economic policy decisions are still taken at the level of the nation state. In order to understand where we are, we need some knowledge of how we got there, particularly for students for whom the first government they can remember is that of John Major. Chapter 1 therefore reviews the historical development of economic policy in Britain since the Second World War, identifying the distinctive features of the British economy and economic policy together with the major periods in the development of economic policy and the key issues that were faced in them.

Chapter 2 considers in greater depth the arguments about the impact of globalization on the making of economic policy advanced in this chapter. It reviews the roles of the leading global governance agencies that attempt to provide some form of policy coordination in the global economy. It also considers the extent to which economic policy-making has shifted to the EU level. Chapter 3 reviews the general theoretical perspectives available on the making of economic policy. It covers issues about market failure and government failure, the increasing influence of Polanyi's work, and a range of theoretical perspectives from Keynesianism to Thatcherism.

Chapter 4 is the first of three chapters concerned with specific aspects of policy. It examines the development of monetary policy in Britain and the implications of economic and monetary union for economic policy. Chapter 5 is concerned with one of the areas of policy in which the main decisions are still taken at the nation-state level – taxation and public expenditure. Chapter 6 extends to the discussion to policies concerned with the supply side and competitiveness, including skill formation, competition policy and transport policy.

The final three chapters before the conclusion are concerned with aspects of the decision-making process. Chapter 7 reviews the evidence on the extent to which election outcomes are influenced the way in which governments manage the economy. Chapter 8 is concerned with the core executive institutions involved in the making of economic policy in Britain, particularly the Treasury. Chapter 9 looks at the influences outside the core executive in terms of the influence of Parliament, the role of the media and of organized interests. Chapter 10 attempts to bring together the various issues examined in the book in a review of the future of economic policy.

This book is meant to be an analytical, rather than a prescriptive, work. Nevertheless, some indication of the author's own value position is appropriate. Crouch (2000, pp. 3–4) has drawn on the work of van Apeldoorn to distinguish between pure and embedded forms of neo-liberalism (not dissimilar from the distinction made between pure and social market approaches in Grant, 1982, pp. 13–17). What Crouch also calls 'European neo-liberalism' identifies 'a need for markets to be embedded in certain wider institutions if they are to receive infrastructural support and social consent, though the aim remains as little actual interference with markets as possible' (*ibid.*, p. 4). Although the author is sceptical of the benevolence and efficiency of government, he would see a case for intervention, for example, to improve the general living conditions of the least well-off sections of society or to protect the environment. He is, however, relatively agnostic about the mechanisms by which objectives are achieved (market, state, non-governmental or, most likely, some combination of all three). The overall position taken is a social market one, but with a considerable emphasis on social provision if only to ameliorate the harsh inequalities which a pure market system can generate and from which all citizens are losers in the long run.

1

From the Postwar Settlement to Thatcherism

Introduction

The British economy in the postwar period can only be fully understood in terms of Britain's unique industrial history. The three key terms that need to be understood here are: early industrialization; empire, and individualism. The term 'industrial revolution' has become a contentious one for economic historians, not least because more recent work has shown that the acceleration of economic growth was slower than had earlier been supposed (Crafts, 1985). There had been manufacturing industries in Britain before the late eighteenth century and 'already in the 1700–60 period Britain had a relatively high proportion of the labour force in industry' (Crafts, 1985, p. 64). However, traditional industrial production was transformed by the application of steam power, the development of the factory and a series of technical innovations, initially in the textile industry. By 1840 'Britain had a far higher proportion of exports in manufacturing than any country achieved, by far the highest urbanization level, by far the lowest proportion of the labour force in agriculture' (Crafts, 1985, p. 60).

Why should Britain be the first country to industrialize? A whole book could be written on this subject, but some key factors can be selected (Owen, 2000, pp. 10–11):

- A relatively commercially oriented (since mediaeval times) and increasingly efficient agricultural sector which generated capital and released labour for industry.
- Based on the political settlement of 1688 (the so-called 'Glorious Revolution'), a stable and orderly polity – essentially an aristocratic oligarchy under an often incompetent but generally harm-

less monarchy with an ability to accommodate commercial interests, for example through Parliament.
- An endowment of mechanical and craft skills built up through long-established trades (often luxury goods industries stimulated by high consumer demand). The inventors and innovators of the industrial revolution came from this background.
- An efficient transport system (canals, later railways), facilitating regional specialization and 'industrial districts' which assisted skills formation and technical development.
- An abundant energy source (coal).

The imperial experience

Because it is a distant memory for current generations, it is easy to forget the extent to which the British economy was configured by the experience of Britain as an imperial power. Indeed, it produced a mindset that persisted into the middle of the twentieth century and influenced Britain's attitude towards the emerging European common market in the 1950s. From the time of the Commonwealth under Cromwell, Britain sought, if not always systematically or consistently, to build a global empire based on its naval strength. Once industrialization occurred, the empire offered an assured source of agricultural goods and raw materials and a protected market for British manufacturing exports. However, it meant that Britain was overreliant on the export of goods to less advanced or semi-industrial countries (Crafts, 1985, p. 161).

The emergence of this pattern of exchange involved the defeat of agricultural protection through the repeal of the Corn Laws and the endorsement of a system of free trade that suited an economically dominant Britain. As Britain's economic strength weakened from the late nineteenth century onwards, the political strength of protectionism increased, leading to the introduction of imperial preference (favourable treatment for imports from the empire and the 'dominions', countries such as Australia and Canada). First introduced in 1919, it formed part of a general system of tariff protection introduced in 1932. The general consequence was to shield the British economy from competition and thus remove an important stimulus for its reorganization.

The ethos of individiualism

Because the British economy was the first to industrialize, largely through the efforts of individual entrepreneurs, there were important consequences for the role of government. It produced a very individualistic ethos that confined the state to a spectator role in contrast to the 'developmental state' that emerged in Germany (Marquand, 1988). Systematic approaches to training and research and development received relatively little support. An important consequence was that Britain performed badly in the second or 'scientific' industrial revolution at the end of the nineteenth century. This was particularly noticeable in the key new chemical industry where Germany outperformed Britain in terms of technical innovation. Britain was also relatively slow to apply electricity to industrial production and to adopt new 'Fordist' systems of automation and plant organization, although they may have been more applicable to a country like the United States with a workforce of unskilled immigrants (Crafts, 2001, p. 22; Lewchuk, 1989). Britain 'was unable to take advantage of a higher growth path based on the opening-up of higher returns to investment in education and science' (Crafts, 1985, p. 160).

The experience of decline

In 1910, Britain still had the highest per capita income and the highest percentage of exports by value in manufactures of any European country (Crafts, 1985, p. 54, 60). However, the United States was increasingly challenging Britain's position: 'One of the consequences of the First World War was to consolidate the position of the US as the world's leading industrial power' (Owen, 2000, p. 23). Britain's share in the value of world exports of manufactures declined from 33.2 per cent in 1899 to 21.3 per cent in 1937 (Gamble, 1994, p. 17), and by 1973 it was to shrink to 9.1 per cent (Crafts, 2001, table 9). The strains of fighting the Second World War meant that by 1945 the economy was effectively bankrupt and dependent on American aid to survive. Awareness of problems of relative economic performance grew and much of the debate about postwar economic policy, particularly after 1960, became dominated by discussion of the phenomenon of relative economic decline. This debate, and the extent to

Table 1.1 The UK's ranking in terms of real GDP/person, benchmark years 1870–1999

1870	2nd (after Australia)
1913	4th (after Australia, New Zealand, USA)
1950	7th
1973	12th
1999	17th

Source: based on Crafts (2001), table 1; measurement basis is \$1990.

which it was a particular ideological construction or reflected an objective economic reality is considered more fully in Chapter 3.

This debate did reflect an economic reality in the sense that the UK continued to slip down tables measuring levels of real GDP/person, an approximate measure of prosperity (see Table 1.1). The single most important explanation of relative economic decline appears to be poor productivity performance that in turn reflects a number of other factors such as powerful but decentralized trade unionism that affected investment and innovation and deficiencies in vocational training. Before the Second World War, British performance was principally deficient when compared with the United States, but in the postwar period it was the continental European economies that started to overtake Britain. A consensus view on the causes of, and remedies for, relative economic decline is not possible because, ultimately, judgements become highly political and value laden.

The Second World War and modern macroeconomic policy

The Second World War was a watershed in the development of British economic policy, representing the beginning of modern macroeconomic policy. It marked the beginning of modern macroeconomic policy manifested in what is often called the postwar settlement by which its proponents mean a broad and implicit accommodation between political parties and/or employers and labour involving greater state involvement in the economy, industry and welfare provision. The extent to which there was a new postwar settlement has been challenged, and one should not forget that there were quite substantial interventions in industry in the interwar period. Nevertheless, the experience of fighting the war through a command economy had a lasting effect on the conduct of economic policy.

The postwar settlement

The broad outlines of the postwar settlement may be sketched out as follows. First, there was a commitment made in the 1944 White Paper on Employment issued by the wartime coalition government to 'high and stable' levels of employment. What this meant was not defined quantitatively, and Beveridge planned a postwar social insurance system that assumed unemployment at 8.5 per cent. However, the commitment to 'full' employment became the leading objective of postwar economic policy and influenced the conduct of politicians up until the 1970s. Second, in order to maintain full employment, the government resorted to Keynesian techniques of aggregate demand management, particularly using fiscal policy instruments, so that taxes were cut when the economy turned downwards and raised when it appeared to be overheating. Third, running the economy at or near full employment inevitably created inflationary pressures. The answer the Treasury favoured to this dilemma was incomes policy (sometimes accompanied by price restraint and dividend control policies). The first of these policies was introduced in 1948. In the 1960s and 1970s, these policies became a semi-permanent feature of the conduct of British economic policy.

Fourth, the resort to incomes policies further increased the political displacement of the trade union movement which had already been granted a new status by the postwar settlement. As a corollary, the organized employers also became more important. The unions and the not particularly well-organized employers proved unable to act as 'governing institutions' engaged in a positive partnership relationship with government:

> It may be more realistic to regard the employers and unions . . . as veto groups, with the power to prevent governments from acting when their vested interests were threatened, rather than as architects of policy. If so, the effect of the war must still be reckoned as far-reaching. The veto groups were now entrenched at the centre of power. (Addison, 1987, p. 18)

Fifth, the immediate postwar period saw a massive increase in social expenditure, particularly arising from the establishment of the National Health Service. It has been estimated that 'between 1936 and 1950 there was, in real terms, an increase of 80 to 90 per cent in social expenditures without counting food and housing subsidies. The largest single element in this increase was the NHS' (Dell, 2000,