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MACROECONOMIC POLICIES OF THE 1974–79 LABOUR GOVERNMENT

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MACROECONOMIC POLICIES OF THE 1974–79 LABOUR GOVERNMENT

1. INTRODUCTION●

The immediate economic reality facing the new Labour government in February 1974 was bleak. The expansionary policies of the outgoing government had eventually led to a combination of familiar problems. A short period of rapidly rising economic activity, leading to an exceptionally high rise in real output, with a fall in unemployment from nearly one million in early 1972 to half that number by the end of 1973, had come to an end by the second half of 1973. By that time the current account of the balance of payments was in substantial deficit. Also, the rate of inflation was both high and rising rapidly. These adverse consequences of internal policies were accentuated by external developments. Overseas inflationary pressures became severe in 1973 and were an important factor in explaining rising domestic prices. Import prices rose by 43 per cent between the fourth quarter of 1972 and the fourth quarter of 1973. This was due in part to the effective depreciation of sterling; but even more to the escalation of world commodity prices which over the same period had risen by 48 per cent and caused the terms of trade to deteriorate substantially.

More importantly, for the long-run, the rise in economic activity was not followed by a commensurate expansion of productive capacity: real investment in manufacturing in 1971–73 was substantially lower than the 1970 level. The expansion of imports in relation to exports can be seen, at least partly, as the result of the substantial strain on capacity utilisation of readily available domestic productive resources. As has been correctly suggested the 'Barber boom' was neither an export-led nor an investment-led period of growth; it was mainly a consumption-led period of growth.

These developments were taking place in the context of a relatively poor economic performance of the U.K. economy for the whole of the post-war period. Both the rate of accumulation and the rate of growth of GDP had been consistently lower than those of other OECD countries. But while this relative decline, until the mid-sixties, was taking place under conditions of full employment and low rates of inflation, by the late sixties these conditions had come to an end. Furthermore, following the 1967 devaluation and the subsequent deflationary measures of the 1966–70 Labour government, there was an intensification of the conflict between labour and capital, mainly expressed in the form of resolute action by the organised part of the working class to maintain and improve its living standards. To this both the Labour and the Conservative governments reacted by putting forward plans for legislation with the aim of curtailing the rights of trade unions. Labour's plan was eventually withdrawn under pressure from the trade union movement and by 1973 the Conservatives' Industrial Relations Act was proving ineffectual in the face of the determination of unions to defy it.

This gloomy background became even gloomier following the OPEC decision to cut oil supplies to Western countries by 25 per cent. The overtime ban by the miners and their decision in February 1974 to proceed with a full-time strike in pursuance of their claim of wage increases of between 22 and 47 per cent, figures which could not be reconciled with the average Phase III norm of incomes policy of 8 per cent, further aggravated the situation. In these circumstances Mr. Heath opted to seek the support of the country by announcing a general election in which the basic slogan was the politically loaded question "who runs the country?"

But for a comprehensive account of the 'reality' facing the new government one has to consider, apart from the obvious statistical description of important economic aggregates, the new economic experience gained over the period since Labour lost office in 1970. One such experience was the new phenomenon of stagflation and the demise of the celebrated Phillips curve. A major implication of this, as will be discussed later, was the realisation of the serious limitations on the applicability of traditional Keynesian policies. The response to this by academic economists was to either bring into prominence alternative theories of economic policy which lay neglected in the shadow of Keynesian orthodoxy, e.g. monetarism, or to put forward new theories in the light of the need for urgent solutions to newly experienced problems, e.g. the 'New Cambridge' thesis. Another important development, albeit not entirely new, was the lesson about the need to ensure trade union cooperation in order to implement an incomes policy successfully. It seems a reasonable assessment to say that in the four years of Conservative rule the trade unions were repeatedly successful in fighting policies which were disliked by the trade union movement, despite their importance for the government's economic strategy. This was a lesson governments could no longer afford to ignore.

The 'Barber boom' of 1972–73, engineered in the pursuit of a high growth economy and characterised by an explosion of bank lending and a mounting expansion of liquidity,[1] had eventually attracted a great deal of criticism from all sides for its deleterious effects on the economy; and for the new government it should have been a fresh reminder of the presence of structural constraints which set serious limits to the effectiveness of demand management in a relatively small and open economy such as the UK. Any attempts to produce high rates of growth merely through fiscal and/or monetary policies were bound to produce short-lived results followed by a reversal in policies. This should not of course imply that the problems in the 1970's were exactly the same as those of the 50's and 60's. As indicated above, the situation was definitely

worse both quantitatively and qualitatively.

By the time Labour was taking office it must have also been clear that a flexible exchange rate was not sufficient, at least by itself, to cure the balance of payments problem.

Before we embark on an analysis of the economic policies pursued by the Labour government it is useful to provide an account of the options open to it, as expressed by the conventional (and not so conventional) economic wisdom of the time. In the following section, therefore, the various packages of economic policies put forward by the leading economic schools are considered and assessed.

2. ALTERNATIVE MACROECONOMIC POLICIES

2a. Keynesian School: According to this view, the main exponent of which was the National Institute of Economic and Social Research, the rate of inflation in the 1970's was primarily determined by trade union wage bargaining and changes in import prices, while the level of employment, was, on the whole, regulated by the level of effective aggregate demand. As a result, the main policy prescriptions were the adoption of an incomes policy to deal with inflation; fiscal and, to a lesser extent, monetary reflationary measures to augment aggregate demand; and, if necessary, an adjustment of the exchange rate to cure the trade deficit. It must, of course, be noted that the Keynesian views were not nearly as monolithic as they may appear here, and that certain variants were developing, especially in the light of an intensifying critique by other schools; nevertheless, the above summary provides the main thrust of Keynesianism at the time.

At the same time there existed a number of counter-arguments to this option. First, it was argued that any stimulus from the public sector simply crowded out spending in the private sector – hence the *crowding-out effect*: a government expenditure stimulus financed by either borrowing or taxes has only a negligible effect on the level of nominal income over a period of about a year. It was in fact suggested that expansionary fiscal actions had an initial positive effect which was followed later by an approximately off-setting negative effect. Crowding-out, therefore, occurs within a very short time period. It was argued that the main mechanism through which this takes place is an increase in the rate of interest which, assuming it is a significant determinant of private spending, crowds out private investment and consumption. The rise in the rate of interest comes about through an increase in public borrowing and, given an initial expansion in economic activity, is reinforced by an expanding demand for money for transaction purposes when the supply of money does not expand accordingly.

However, Keynesians pointed out that although it is possible that some crowding-out takes place, what is more important is the extent and timing of such an effect. It was claimed that neither of these is such as to frustrate completely attempts to manage the economy through fiscal measures. Furthermore, it was assumed that, given a private sector which is a net creditor to government, during periods of inflationary pressures private expenditure is automatically 'crowded-out' due to the capital losses of the private sector on their holdings of government bonds. In such cases it is, therefore, necessary for the government, which is the direct beneficiary to increase its deficit spending to offset the reduction in private spending. Governments are the source of this type of crowding out only if inflation is caused by the policies they pursue. If, however, inflation is generated within the private sector and is independent of the level of public borrowing, a government should raise

rather than reduce the budget deficit if a reduction in economic activity is to be avoided.

A different rationalisation of the crowding-out hypothesis was based on the far-fetched assumption that the private sector behaves as if government is an extension of itself, so that government expenditures are considered as a substitute for private expenditures; thus crowding-out may take the form of direct substitution, independently of any adjustments in the interest rate, the price level, inflation or the exchange rate. This extreme view was the basis of the ultra-rationality hypothesis.

A special kind of crowding-out was implied by the late neoclassical Bacon-Eltis (1976) thesis on the British predicament. It was argued that the increased taxation, necessary to finance the expanding public sector spending in Britain, in the last fifteen years, was entirely borne by profits. It was suggested that workers were successful in shifting any rise in taxation onto capital. As a result of the fall in after-tax profits, private investment and exports were crowded out. At the same time, the successful resistance of workers to bear part of the increase in taxation had led to rising inflation. It was argued therefore, that, in the context of the British economy, the expansion of the public sector had been the primary cause of most of the major economic problems.

But in a critique of the Bacon-Eltis thesis Hadjimatheou and Skouras (1979) show that the empirical evidence available does not support Bacon and Eltis's conclusions.[2] Also, Thirlwall (1978) argues that the growth of the public sector has not been an autonomous development in the economy but a response to the economy's inability to grow at a rate compatible with full employment because of a serious balance of payments constraint.[3] It can be said that, in general, the evidence produced in relation to the crowding-out debate, if not unfavourable to the hypothesis (Arestis, 1979), is at least inconclusive (Taylor, 1979).

It is worth noting that there is a Marxian counterpart to the neoclassical thesis on crowding-out. If it is assumed that an increase in public spending leads directly, through a rise in taxation, to an equivalent fall in surplus value and, to the extent that the extra employment in the public sector is not productive, then a complete crowding-out of private accumulation occurs (Bullock and Yaffe, 1975). The crowding-out could even be over 100 per cent if public spending also crowds out an amount of personal consumption expenditure. On the other hand those Marxists who accept an underconsumption hypothesis argue that government's intervention is necessary in order to create additional effective demand by absorbing part of the continually mounting volume of surplus which could not be absorbed through private channels. In Baran and Sweezy's (1966) words:

"Given the inability of monopoly capitalism to provide

> private uses for the surplus which it can easily generate, there can be no doubt that it is to the interest of all classes – though not of all elements within them – that government should steadily increase its spending and its taxing." (p.153)

As far as incomes policy is concerned neoclassical economists reject it on the grounds that it leads to a suboptimal determination of relative prices for the time it lasts. But despite its antithetical nature to the notion of a free market economy it has been repeatedly used by Conservative governments. Even the present, so far purely monetarist, Conservative government, despite its repeated abhorence of incomes policies, does not reject the use of a wage freeze as a measure of last resort. However, as experience has shown an incomes policy is successful only if it is acceptable, although, if it is only temporarily acceptable, inflation tends to rebound when the policy breaks down.

The likelihood of exchange rate depreciation improving the external performance of the economy has been questioned by the Cambridge Economic Policy Group (CEPG) on the ground that, following a devaluation, wages tend to adjust to remove the terms of trade effect on workers' standard of living. The same argument is put forward by Ball and Burns (1976). In effect it is argued that devaluation would be effective if it permanently improved the profitability of exports through a decrease in real wages. More specifically, both rival schools, i.e. CEPG and the Monetarist School (MS), argue that, in the presence of free collective bargaining, devaluation will only work in the short-run. This is the implication of the assumption that the benefit, in terms of price competitiveness, conveyed by exchange depreciation is only short-lived. It is therefore agreed, at least implicitly, that, in the absence of an appropriate rise in productivity, a necessary prerequisite for the success of exchange rate policy is a substantial fall in real wages. According to the CEPG:

> "To achieve a large and permanent devaluation without setting in train a wage/exchange rate inflation spiral requires, simultaneously, a large downward adjustment of the exchange rate and strict upper limits on money wage settlements enforced over a period of years to prevent the 'nominal' devaluation being undone by subsequent increases in money wages in terms of sterling." (CEPG, 1976, p.14).

It is, therefore, not surprising that the Keynesian strategy depends so crucially on the success of an incomes policy.

As we will indicate below the economists associated with the CEPG opt for a strategy of import restrictions which it is argued does not involve a terms-of-trade loss and a subsequent redistribution of income from

wages to profits. The monetarists' alternative is a non-discretionary monetary policy which will not accommodate the extra demand for money, following the wage increases generated by the exchange depreciation.

The intractability of the problems of the 1970's has led Keynesians, today, to accept explicitly that 'Keynesian demand management' is, first, not appropriate in dealing with wage-driven inflation or with lack of competitiveness and, second, in the case of Britain not very effective in dealing with unemployment because of the presence of a balance of payments constraint (Blackaby, 1979).

2b. Monetarist School: A radical alternative to Keynesian was provided by the *Monetarist School*. Although best known for its emphasis on the importance of money supply as the cause of inflation, it should be made clear that this school provides a comprehensive package of answers to policy questions. As monetarism encompasses economists with divergent views, what we intend to do here is to discuss the major tenets of the monetarist approach well-established by 1974 rather than specific issues raised by individuals.

The central proposition of monetarism is that active stabilisation policies cause more fluctuations than they cure and therefore they are not likely to be beneficial. The monetarist policy prescription, consequently, is a call for limiting government intervention as much a possible.

More importantly, it is argued, one should not be unduly concerned about fluctuations caused by real shocks, since the economy is basically stable, and in the long-run it converges on a full-employment level of income, the natural unemployment rate, at which the real rate of interest is determined by the traditional forces of 'productivity and thrift'. Indeed, the obvious way of preventing major instabilities in the economy is to adopt a monetary policy that avoids sharp swings between monetary ease and restraint. The best way to do this is to abolish discretionary monetary policy and adopt a simple rule. The stock of money is the relevant magnitude in terms of which to formulate monetary rules, the simplest being one that dictates a constant rate of increase of the money supply; to monetarists, the precise rate is not so crucial, but its constancy is.

In terms of the British experience the failure of the authorities to solve the problem of inflation has been due, according to the monetarist view, to their reluctance to accept, for political reasons, the consequences (mainly unemployment) of a policy according to which money supply should have risen in line with the productive potential of the economy.[4] According to Friedman (1974) ending inflation would have "the side-effect of producing a temporary, though perhaps fairly protracted, period of economic recession or slowdown and of relatively high unemployment." (p.9)

Notwithstanding its importance, the monetarist message is neither new nor convincing. What is new about the contemporary version of monetarism is that it provides a scapegoat for the system's obvious failures: It is asserted that, except for exogenous shocks which are both minor and transient, the crises of the system are caused by unnecessary attempts by government to manage the economy.

The monetarist economic strategy has been criticised by other economists on a number of points. To begin with, it has been argued (Modigliani, 1977) that (a) the cyclical behaviour of the economy is mainly the result of autonomous changes in the private sector, rather than the destabilising effects of discretionary policies, (b) a stable supply of money does not stabilise the economy, (c) on balance, discretionary policies have been stabilising rather than destabilising. Another criticism relates to the assumption that the monetary authorities can, in fact, control the money supply; arguments have been advanced (Tobin, 1963: Kaldor, 1970) which purport to show that money supply is endogenous and not at all easily controllable by the government.

A preliminary assessment of recent developments in the British economy indicates that changes in money supply, production and employment do not conform to monetarist theory. It is observed that for the period 1974–79 an average annual expansion of sterling M_3 of around 11–12 per cent, with stagnant production, is associated with exceptionally high and mostly rising rates of unemployment in terms of postwar experience. Even if the initial increase in unemployment in 1974–75 can be explained in terms of high inflationary expectations, following the expansionary years 1972–73, not duly accommodated by monetary policy, it is not clear why unemployment should persist for so long. Either the speed of self-correction of the economy is very slow indeed or the system is not at all stable in terms of a 'natural' rate equilibrium.

The ideological significance of monetarism for the capitalist system is obvious: it absolves the system from any blame for its crisis; it promotes the idea that substantial deviations of unemployment from its 'natural' rate are either the result of government intervention or the consequence of the workers' refusal to accept a real wage which is compatible with the 'natural' rate – the latter implying the need for a redistribution of income at the expense of workers; it suggests that a high unemployment must be tolerated if the fight against inflation is to be won.

2c. The Cambridge Economic Policy Group: The third major

alternative school of economic policy is associated with the research output and policy prescriptions of CEPG. The relevance of this school for the period in question is that, first, some of its most important policy prescriptions appeared at the time when Labour was resuming government office and, second, some of the economists associated with the views expressed had served as economic advisers to previous Labour governments.

The coherent programme put forward by CEPG has come to be known as 'New Cambridge'. Its central theme is that the policy makers in this country have been implementing their policies the wrong way round. The basis of this approach is the basic identity:

$$(X–Q) = (T–G) + (S–I)$$

which is derived from the standard income identity; where X = exports, Q = imports, T = the sum of direct and indirect taxes, S = savings, I = investment, and G = government expenditure.

This identity, by assuming that (S–I), private sector net acquisition of financial assets, is small and approximately constant, provides the theoretical proposition that changes in (T–G), the budget deficit, will determine changes in (X–Q), the balance of payments. The crucial assumption is, of course, that (S–I), which can be further split into the household sector's surplus, and the company sector's surplus, is small and approximately constant. But since 1974 it has been shown that the private sector's acquisition of financial assets is neither small nor stable. As a result the size of budget deficit has been shown to be a poor predictor of balance of payments deficits. This has been recognized by the main exponents of this thesis who argue that wealth effects, especially during periods of high and uncertain inflation, significantly affect the size of the private acquisition of financial assets (CEPG, 1976). But the important implication of this thesis, when it appeared, was that any attempt to raise the level of economic activity through an increase in budget deficit would fail, since the whole of the extra demand would leak abroad with a deterioration in the external balance. It was therefore recommended that the public sector deficit should normally be set by reference to a medium-term target of the balance of payments.

A somewhat different, but not contradictory, hypothesis put forward by CEPG is that the British economy suffers from a balance of payments constraint on the rate of growth of national output. This arises, on the demand side, as a combination of a high income elasticity of the demand for imports relative to exports. (It should be noted that no adequate explanation is provided as to why in the 1970's the rate of unemployment compatible with an external balance had to be so much higher than its counterpart in the 1950's and 1960's.) This helps to explain why past attempts to expand general economic activity have been blocked by a balance of payments constraint. It was subsequently argued that given the problems associated with devaluation (a direct fall in the standard of living, redistribution of income in favour of profits, the need for an incomes policy and the time required for the effects to fully materialize) a policy of import restrictions is preferable.[5]

Blackaby (1979) accepts the assumption that there is a considerable import leakage but disputes the empirical validity of the hypothesis that attempts to create fiscal stimulus are completely ineffective, while monetarists dispute the need for any kind of import controls.

2d. Labour Election Manifestos and the Alternative Economic Strategy: We begin by focusing, briefly, on the 1964 and 1974 general election manifestos. A comparison of these two manifestos provides useful information on the state and aspirations of the Labour Party on the eve of two important electoral victories. One can assess the differences in these aspirations and the proposed means for achieving them in the light of the Party's ten years' experience (six as government and four in opposition) and in view of the different economic problems facing the country in 1974.

The 1964 manifesto portrays a Labour party which is "restless with positive remedies", "poised to swing its plans into instant operation", "impatient to apply the New Thinking that will end the chaos and sterility". The title of the manifesto and main slogan "Let's go with Labour for the New Britain" is characteristic of the expectancy of a new economic era in which tinkering with stop-go and other traditional policies would have no place; instead, new dynamic policies, indicating a major change in attitude, would be adopted to ensure that the economy moved steadily forward. For this a massive effort was required to modernize the economy, to change its structure and to pursue a vigorous programme of long-term expansion. It was explicitly stated that all these could only be achieved by planning. The concept of planning was the underlying theme of Labour's programme in 1964. The Manifesto is actually presented as the "Case for Planning" and the words plan and planning are frequently used words. For the short-term it was suggested that changes in taxation, better terms of credit for industry, control of take-over bids and mergers, monitoring price increases and applying a comprehensive incomes policy could be used to tackle the problems of inflation and trade deficit.

In contrast, the 1974 manifesto is a much less ambitious document in as much as it makes less grandiose claims for economic growth. It is, nevertheless, a far more radical and ambitious programme for bringing a "fundamental and irreversible shift in economic power in favour of working people and their families" and for achieving " far greater equality – in income, wealth and living standards". The headline slogan

"Let Us Work Together – Labour's Way Out of the Crisis" is indicative of the mood at the time. The party was set to "rescue the nation from the most serious political and economic crisis since 1945". Although no serious analysis of the underlying crisis was offered the party's approach to the "long-standing" challenge of inflation was considered as the central part of the manifesto. And since one important facet of the crisis was trade union opposition to the Conservatives' incomes policy the Labour party was committed to abolish the Pay Board apparatus set up by the Tories in favour of a 'social contract' which would include: a strict price control; food and rent subsidies; extension of protection from eviction; introduction of a wealth tax; help to pensioners, the disabled and parents; and the repeal of the Industrial Relations Act. These measures were intended to "create the right economic climate for money incomes to grow in line with production".

In the sphere of production, in addition to plans for an expansion of nationalisation, a National Enterprise Board and a system of planning agreements were to be established. The exact meanings and modes of operation of these new approaches were not defined. The extent of the power and authority of the bodies responsible for the implementation of these ideas, in taking over sections of private industry and in imposing industrial planning, were the object of disagreement between the two wings of the party.

The importance and relevance of these ideas, especially those concerning the National Enterprise Board and planning agreements, suffered in the process of their implementation as a result of the overwhelming influence of the right wing element within the administration. Despite this, the left wing of the party attempted to explore these ideas further. Although there were important differences in emphasis and variation in content in formulating a viable strategy, it was eventually possible to reach a consensus which culminated in what has come to be known as the 'Alternative Economic Strategy'. But the TUC and the left-wing of the Party have been completely unsuccessful in their effort to impose on the Labour government the main elements of the 'alternative economic strategy'. This is inspite of the fact that this strategy has been adopted in all its essentials, by the Labour Party Conference (1973), and the TUC and numerous trade unions.

The main elements of this strategy may now be summarised:

(i) Britain should reflate through "massive investment" in order to return to full employment which should be the first priority of the government. Reflation should include increases in public spending to be financed not by personal tax increases but by savings on unemployment benefits and higher tax yields from economic expansion; however, there should be a sharp cut in military expenditure.

(ii) Any resulting deficit in the balance of payments could be avoided though the imposition of import controls as well as control of capital movements, coupled with a strategy of planning the growth of imports to be broadly equal to the growth of exports.[6] Strict price controls are considered as possible measures to be used when import controls do not prove sufficient to fight inflationary pressures.

(iii) Expansion of public ownership into key industrial sectors, including the banks and insurance companies, along with a strengthening of the National Enterprise Board.

(iv) Extensive planning: industry would be required to enter into planning agreements with the government of the day, in co-operation with the Trade Unions with the purpose of a substantial rise in accumulation.

These proposals were repeatedly advocated by the TUC in its Economic Review since 1974 and were also put forward and widely discussed by the Tribune Group; with Mr. Benn being the main advocate in the Cabinet. Opposition to some of these proposals was not only confined to the right-wing of the party. The left-wing critiques both inside and outside the party (for example, McDonnell, 1978: Camble, 1977) argued against import controls in particular, for being chauvinistic, exporting unemployment and, therefore, dividing the international working class. The Labour right argued that controls could lead to retaliation, a contraction in world trade, a worsening slump, lower living standards and would eventually contribute to a sheltered, backward-looking and inefficient economy.

It seems to us that, given a balance of payments constraint which could not be effectively overcome through devaluation, a policy aimed at a sustained higher growth economy was not feasible at this time. In view, therefore, of the prospect of a permanently depressed and relatively declining economy, selective imports controls, so as to minimise the adverse effects on the less developed countries, could have been used to provide a breathing space for the necessary restructuring of British industry. Such a policy could have provided a protective shield which would have rendered planning a more plausible and effective proposition.

3. MACROECONOMIC POLICIES PURSUED

Given the unusual combination of problems inherited by the Labour government in 1974, the task of choosing the right policies for managing the economy became a formidable exercise. On the one hand, the high rate of wage and price inflation and the substantial balance of payments deficit was a deterrent to a reflationary budget; an additional factor discouraging the adoption of this option was the large public sector borrowing requirement, which, as we shall see below, was associated by Healey with the monetary expansion of 1972–73 and the ensuing inflation. On the other hand, the rapidly rising unemployment and widely predicted recession did not seem to constitute the right background for a Labour government to pursue a deflationary budget. In the event Healey opted for a neutral or mildly restraining course of action. The rise in public spending, mainly in the form of food and housing subsidies, pensions and social benefits, was more than covered by increases in direct and indirect taxation.

Most of the increases in public spending were in line with the manifesto pledge to create the right climate for a restraint in incomes. This was considered to be the government's contribution to the fight against inflation in the context of the social contract. But there was another important measure directed towards deflation: the public sector borrowing requirement (PSBR) was to be reduced from £4.25 billion in 1973–74 to £2.7 in 1974–75. It seems that the government considered the huge expansion in PSBR, in 1972–73, as one of the major causes of the observed monetary expansion, which was repeatedly condemned by Labour as a reckless policy.

> "The vast deficit of the public sector was then an important factor in the excessive monetary expansion. So I am aiming at a massive reduction in the public sector's borrowing requirement, a reduction of about £1,500 million compared with 1973–74." (D. Healey, *Budget Statement,* March 1974).

The association of the monetary expansion with the simultaneous rise in prices and in the balance of payments deficit must have been in Healey's mind in taking this decision.[7] It was also expected that a reduction in PSBR would have a depressing effect on interest rates, both directly, through a reduction of public borrowing, and indirectly, through its favourable effect on inflationary expectations. As a result of this decision it was intended to raise some of the prices of nationalised industries' output (especially in the case of output for industrial use) so that the amount spent on deficit subsidisation could be reduced.

Apart from a certain tightening of exchange control measures, no significant policies were announced in relation to the external deficit. As far as inflation was concerned, it was hoped that the unions, in the light of government's policies, would reciprocate by restraining themselves sufficiently in bargaining for wage increases. It seems reasonable to say that although the initial measures of the government did a good deal towards legitimising the new administration in the eyes of the working class they contributed nothing towards an improvement of the level of accumulation.

The economic measures announced in July of the same year did not come as a surprise. First, Healey had stated in his March Budget that he expected that a yearly intervention in the form of the traditional major budget would not be sufficient for managing the economy, and second, it was widely expected that a general election was forthcoming within the year. By the end of June the annual rate of inflation was running at 15.8 per cent (12.8 per cent end of March), while, unemployment and the current account deficit were also rising. The higher than anticipated rise in the rate of inflation had, by July, resulted in six threshold agreements; payments based on these agreements were clearly contributing to a sharp increase in labour costs per unit of output in the second quarter of 1974. The July measures were designed mainly to secure an easing in the rate of increase of prices, while at the same time applying a modest stimulus to demand. In the meantime the TUC was offering guidelines on pay settlements to member unions, as part of its contribution to the social contract in an effort to moderate inflation. According to these guidelines the aim of pay bargaining was to maintain, rather than increase, real incomes.

With the election behind them, and an overall majority of only three, the government presented a new budget in November. The economic situation was deteriorating rapidly and the Chancellor warned the country of the need for stern policies:

> "For the next few years the great majority of us cannot expect any appreciable increase in our living standards, and increases in public expenditure will have to be held below the average increases in national output." (D. Healey, *Budget Statement*, November 1974).

A medium-term strategy for reversing the relative decline of the economy was needed and the budget was considered as the first stage in implementing this strategy. The relative decline, according to the Chancellor, was the result of a low growth of productive capacity and productivity due to low investment. It was, therefore, made clear that the first priority in economic management was to shift resources from consumption, both private and public, to investment and exports. For this, increases in real incomes would have to come to a halt, and the growth of public expenditure would have to be smaller than the growth in national output. This line of argument seems to be very closely related to the Bacon-Eltis thesis.[8] But although Bacon and Eltis specify that it is

the fall in after-tax profits, caused by the expansion of the public sector and the refusal by workers to bear part of the extra taxation, that prevents rates of private accumulation being higher, Healey did not provide any explanation of the mechanism through which low accumulation comes about. It is clear, however, that the remedy suggested aimed to raise profitability at the expense of labour incomes. The first dose of the remedy included measures to ease price controls, introduced in the first Labour budget, and, thus, to halt the erosion of profit margins, and a scheme to defer a considerable amount of corporation tax on 'profits' arising from abnormal increases in the value of stocks. These measures were expected to alleviate the shortage of liquidity in the company sector which was threatening to deepen at the recession. The resulting increase in the borrowing requirement by the public sector was expected to be partially offset by the decrease in the growth of bank lending to companies – which was thought to have been one of the main causes of monetary expansion (*Bank of England Quarterly Bulletin*, December, 1974).

The PSBR was for the second time revised upwards. The pre-November prediction of £5.5 billion, already significantly higher than the £2.3 billion predicted in March, was now revised to reflect the cost of tax relief, both to industry and households – the new estimate being £6.3 billion. A large part of the increase over the year was the result of food and housing subsidies and large wage settlements in the public sector.But it is true that repeated forecasts were wrong because they failed to account for the effects of changes in unemployment, inflation, and the absence of cash limits on both the revenue and expenditure sides of the public sector accounts.

It is clear that since 1974 the size of the PSBR has been a prominent preoccupation of government. Its use as a policy instrument, however, has been criticised on a number of grounds. There is, for example, sufficient evidence now that inflation has a depressing effect on private spending (Howard, 1978); this can be attributed to the fact that, given that the government is a net debtor in relation to the rest of the economy, rising prices cause a redistribution of wealth at the expense of the personal sector. So unless the government expands the budget deficit, inflation is deflationary! When adjusted for the effects of inflation on real public debt, the PSBR is substantially lower than its national accounting measure (Taylor and Treadgold, 1979). Furthermore, it seems that in using the PSBR as a target the Labour government had failed to take sufficiently into account both the endogeneity of this variable and the composition of public expenditure and revenue. As a partial remedy it has been suggested that a more appropriate measure is the full employment public sector borrowing requirement which has gained widespread acceptance in the U.S. The latter measure implies a much smaller public sector deficit in 1974–6 and a budget surplus in 1977–9 (Ormerod, 1980; Blackaby, 1979).

The Chancellor reaffirmed his concern about the effect of the size of the PSBR on the expansion of the money supply and through this on the rate of inflation; he was also concerned about the effect of the pressure on resources, the balance of payments and the level of interest rates (the latter consideration was more explicit in the budgets of March and July of that year). It must be noted, however, that despite the rapidly rising PSBR both the rate of increase of the money supply and the rates of interest had declined since 1973.

Given the above statements, it is clear that the various schools of thought, discussed earlier, could have claimed some influence on the Chancellor's thinking. At the same time all schools were probably disenchanted with the government's actions. Despite Healey's pronouncements, public expenditures, the PSBR and tax revenues as percentages of GNP were rising; discretion was preferred to rules; import controls were rejected outright; and the attempt to implement a wage restraint was proving a 'failure'.

The budget of November 1974 on the whole was considered to be reflationary on account of its estimated effects on revenue and expenditure. Whether an actual expansion of aggregate demand was to materialise depended crucially on the effect of the tax relief for industrial capital on the level of investment. Given the failure of the government to (a) curtail increases in real wages, (b) reduce the rate of inflation and (c) halt the decline in real profitability, and the accelerating decline in capacity utilisation, it was not surprising that the volume of investment went on falling.

By the time the fourth budget was presented, on the 15th April 1975, it was clear that the economy was in a severe recession. Real private gross domestic fixed capital formation (GDFCF) between the first quarter 1974 and first quarter 1975 declined by 6.6 per cent – the fall for manufacturing industry being 7.3 per cent. Inflation exceeded 20 per cent on an annual basis; unemployment was fast approaching the million mark; and GDP was down by 2.7 per cent, in comparison with the high level reached in the third quarter of 1974. The only improvement was with respect to the balance of payments whch, despite the substantial deficit in the current account, was improving appreciably, probably partly as a result of the depreciation of sterling. That the social contract was not working as envisaged by the government was clear from the marked rise in incomes. Average earnings for all industries and services by the end of March 1975 were rising by 32.8 per cent p.a. For the same period the real per capita personal disposable income rose by 5 per cent. As a result the share of personal disposable income in GDP increased from 77.5% in 1973 to 80.1% in 1975. At the same time the fall in profitability, measured in various ways, had been larger than expected from its secular downward trend. (*Bank of England Quarterly Bulletin*, 1978).

The April 1975 Budget was deflationary. The rises in direct and indirect taxation (the basic income tax rate was raised to 35 per cent) were directed almost entirely at personal spending. This, and the decision to cut public expenditure by £900 million (2¼%) at 1974 prices, for 1976/77, was in line with the medium-term strategy of fighting productive capacity constraints. To this effect, the PSBR was to be cut by £1 billion in 1975–76 and by £3 billion in 1976–77, by reducing public expenditure through a phasing out of food subsidies and nationalised industries' deficits and by raising taxes. The Chancellor's concern with the size of the PSBR was this time explicitly linked with the New Cambridge thesis:

> "... I think most commentators would agree that it is impossible to bring about a sustained and progressive improvement in the balance of payments over a period of years if at the same time the public sector financial deficit is increasing rapidly as a percentage of GNP." (D. Healey, *Budget Statement*, April 15th 1975).

In the light of this deflationary budget, it can be argued that the fact that a Labour government was prepared, in spite of the bleak prospects for employment, to take measures to deliberately increase unemployment, is strong evidence of the extent to which fundamental principles – in this case the commitment to full employment – would be sacrificed, when necessary, for the viability of the system. This, of course, is not surprising, given the balance of power within the Labour party; the changes for radical policies were negligible.

Further evidence of the sacrifice of fundamental principles to the viability of the system was the determination of the government to convince the trade unions of the need for effective wage restraint. The trade union leaders were, at last, prepared to oblige. It seems that the main reasons for this, apart from a continuous pressure by the Government on the Unions to implement their side of the Social Contract, were the extent of inflation and the fear of a catastrophic run on the sterling (Taylor, 1978, p.6). After extensive discussions with the TUC and the CBI the government proposed a voluntary incomes policy, according to which pay increases from 1st August should not exceed £6 per week for all employees who were earning £8,500 per annum or less; no increases were to be allowed for other employees. Only increases in wage costs which conformed to this limit were to be allowed to be reflected in higher prices. Although this was a voluntary policy, the government warned that statutory sanctions would be applied in cases where the policy was not observed. In the attempt to secure a success a government pamphlet entitled *'The Attack on Inflation'* was distributed to each household. Finally, the TUC Annual Congress on September 3rd approved the £6-pay policy by a 2–1 majority.

By the time the Chancellor presented his fifth budget, on April 6th, 1976, he was in a position to express cautious satisfaction with certain developments in the economy. The rate of inflation was declining, partly because of the improvement in the terms of trade, but mainly because of the success of the incomes policy; GDP was on a recovery course since the last quarter of 1975, and the downward trend of the current account external deficit had brought the seasonally adjusted deficit, for the first quarter of 1976, below £100 million. But, at the same time, investment was still on a declining course and registered unemployment, excluding school leavers, was as high as 1.22 million. It is worth noting that contrary to expectation based on theories of consumers' behaviour the period 1974–79 is characterised by a substantial decline in the average propensity to consume. The resulting decline in aggregate demand was, thus, reinforcing any reluctance by capitalists to undertake new investment. Finally, the effective sterling exchange rate fell by 12 per cent between first quarter 1975 and first quarter 1976. In January 1976 the IMF approved loans to Britain, totalling 2 billion dollars, after the Chancellor's application in November.

The budget itself was a rather subdued affair, probably because of the need to strike the right balance in view of the plethora of constraints and targets: to avoid impairing the success of the incomes policy, to control the PSBR and monetary expansion, to help towards an industrial recovery through a rise in profitability, to maintain the downward trend in inflation and to moderate the rise in unemployment. It is interesting to note in this context that despite the Chancellor's desire to keep the PSBR as low as possible he stated that it was worth accepting an increase in it in order to achieve a lower rate of inflation. This apparently contradictory statement, in view of his expressed concern for the rise of the PSBR and the ensuing monetary expansion, is indicative of the importance attached to the success of the incomes policy. What it meant was that there were limits to the extent to which public expenditure/taxes could be cut/raised without putting in jeopardy the co-operation of the trade union movement. This is indicative of the contradictory nature of the legitimisation and accumulation functions of the capitalist state.

Another aspect of this Budget was the Chancellor's firm reiteration of his intention to control the money supply.[9] In analysing the importance attached to changes in the money supply during the Labour administration, it is useful to trace the apparent increasing official concern with the behaviour of monetary aggregates in the 1970's. Evidence of such concern can be found in the 1969 'Letter of Intent' sent to the International Monetary Fund by the Chancellor stating that the level of domestic credit expansion[10] was to be a variable which the Bank of England would set out specifically to control. If one, then, thinks of the domestic credit expansion as an indicator of the money supply, it follows that the monetary authorities in the UK were proposing to put more emphasis on this money supply rather than on interest rates – which had

previously been their main concern. More evidence of this change of emphasis can be deduced from parts of the Competition and Credit Control reforms introduced in September 1971. In line with the laissez-faire element in Conservative philosophy, the clearing banks were to be encouraged to compete with each other in the terms and services they offered to the public; all the lending requests and advances ceilings which had been employed before 1971 were thus abolished. In addition, all banks, not just the clearing banks, were to adhere to a 12½ per cent minimum reserve asset ratio;[11] all these, so it was assumed, would give the government more room for manoeuvre in their attempt to control the volume of credit and thus the money supply. The control of the latter two elements was to be achieved through the market mechanism of interest rates; and as the then Governor of the Bank put it:

> "Basically what we have in mind is a system under which the allocation of credit is primarily determined by its cost (and in which) we expect to achieve our objectives through market means." *(Bank of England Quarterly Bulletin,* 1971).

The implementation of Competition and Credit Control was followed by a period of rapid monetary expansion as banks aggressively, and successfully, attempted to increase their business in the 'parallel' money markets from which they had previously been excluded. More importantly perhaps, rising interest rates failed to check the very rapid growth of the broadly-defined money stock, thus raising:

> "doubts as to whether the interest-elasticity of the demand for credit was sufficiently high to enable the new system of attempting to regulate bank lending by the cost of credit rather than by lending requests and advances ceilings to operate smoothly". (Savage, 1979, p.48).

Not surprisingly in December 1973 the Bank of England introduced, against the spirit of Competition and Credit Control, the Supplementary Special Deposits Scheme,[12] which has come to be known as the 'corset'. This scheme aimed at penalising banks when the growth of their liabilities exceeded a specified ceiling; it was thus seen as an effective way of moderating monetary expansion without leading to rises of interest rates to 'unacceptable' levels.

It was within the context of this approach to monetary policy that Mr. Healey in his budget speech of April 1976 declared that one of his main aims was:

> ". . . . that the growth of the money supply should not be allowed to fuel inflation as it did under my predecessor. To this end, I aim to see that the growth of the money supply is consistent with my plans for the growth of demand

expressed in current prices." (Hansard, 6th April, 1976, col.237)

The Chancellor did in fact keep his word: the period leading to the May 1979 general election saw the adoption of explicit money supply targets on the sterling M_3[13]; and the public sector borrowing requirement was to be manipulated to achieve these targets.

So, was it in fact the case that a Labour Chancellor became a 'converted monetarist'? It is true that the adoption of a 9–13 per cent growth target for sterling M_3 for the financial year 1976/77 did represent a major change in official attitude in the U.K. (Gowland, 1978, p.123), and a number of reasons have been put forward for this change:–

(1) As a move to inspire confidence to the financial community. This argument often puts the emphasis on a belief by the authorities, especially the Treasury, that basically the financial community is monetarist, while the economy functions in a Keynesian manner. Thus, money supply targets boost confidence, but have no other economic meaning.

(2) Perhaps the Chancellor was convinced that control of the money supply was a necessary but not a sufficient condition for conrol of the rate of inflation. This would be consistent with a neo-Keynesian view that both monetary and fiscal policies can be utilised in the attempt to fight inflation. (Modigliani, 1977, is a very good example).

(3) Money supply targets were forced upon the authorities through international pressure exerted by the IMF, a body whose instincts lie much closer to monetarism than to Keynesian demand management. In fact explicit monetary targets were adopted in December 1976 when the IMF made the introduction of these targets a precondition for the granting of a 3.9 billion dollars loan.

(4) Finally, one could argue that monetary targets became inevitable following the much-criticised monetary 'explosion' of 1972–73; and that the Chancellor in December 1976 was merely endorsing official monetary thinking in as much as "Control of the money supply was initially a confidential internal objective of the Bank". (Savage, 1979, p.44). Perhaps more significant in terms of the announcement of monetary targets was the 15 per cent increase in sterling M_3 in the first half of the 1976/77 financial year: very much reminiscent of the 1972–73 experience.

We take the view that, given the Labour government's emphasis on incomes policy and the use of targets in a discretionary manner,[14] rather than the adoption of a constant, rigid, rule, the argument that the Labour government at that point in time showed clear signs of a conversion to monetarist policies with the full implications as exemplified in section 2, is not well founded. We believe that, although elements of 1–4 above may have contributed to a change of policy, the use of monetary targets was an indication of the intention of the authorities not to accommodate increases in the demand for money arising from 'excessive' wage demands. The threat of higher unemployment emanating from this policy was constantly used by the government in its effort to persuade the unions to adhere to 'incomes policy' and to accept its consequences for the distribution of income. It is also true to say that, although the year-on-year actual increase in the money supply in the period 1974 until the election of 1979 does not fully conform to the targets set, these increases had been kept at a much lower level than the increases allowed by the 1970–74 Conservative administration.

The Government having succeeded in enforcing its policy on incomes (the TUC at their annual congress in September 1976 voted to continue their backing for the social contract[15]) was not turning its attention towards cutting public expenditure and the PSBR. In July and December 1976 economic measures were introduced according to which public expenditure was to be cut by £1 billion in 1977/78 and by £1.5 billion in 1978/79. The aim was to reduce the PSBR by £2 billion to £8.7 billion in 1977/78. It was clear that, as in the case of incomes policy in the preceeding year, the Treasury was now determined to ensure that the new measures were effective. According to the new programmes, public expenditure, instead of being levelled off as previously envisaged, was to be reduced, compared with 1975–76 and 1976–77. The need for the cuts arose from the Government's view that

"The slow rate of growth of real resources (in the last fifteen years) has sharpened the conflict between the claims of private and public spending. It has contributed to each of the three acute problems now facing us: the large deficit in the balance of payments, the high rate of inflation, and the high level of unemployment. Associated with these problems is a large public sector borrowing requirement (PSBR) which poses considerable problems for monetary management and industrial financing." (*The Government's Expenditure Plans,* Cmnd 6721–I, HMSO, 1977, p.11).

The aim was

"to restore confidence, to bring the economy back into balance and to reduce the strains that the financing of the public sector was imposing in financial markets" (ibid., p.12). These statements, as they attempt to provide a rationale for the cuts in pubic expenditure, are extremely significant, in that they imply that there is a continuous conflict between the public and the private sectors. Although the nature of this conflict is not elucidated, this view marks an important departure from the traditional Keynesian approach to public spending and economic policy. It is a pity that the (academic) source of the 'intellectual' wisdom underlying this view of economic and/or political reasoning is not provided. It is obvious, however, that with one significant difference this reasoning is akin to the Bacon and Eltis thesis. The difference is that the Labour government, at least in this context, did not seem to share Bacon and Eltis's view that the low rate of growth is itself the result of the excessive expansion of the public sector. The implication was that the low rate of growth was the main cause of the intensification of the antagonism between the two sectors.

Despite this, we feel that the government's thesis was biased in that it failed to locate correctly the primary source of conflict. The conflict is between capital and labour.[16] Government policies, as determined by the requirements of capital accumulation, the relations of production and the balance of class forces, very often reflect this conflict and may very often lead to its exacerbation. (This is, for example, clearly illustrated by the measures taken by the Labour government in 1974–75 in its effort to impose an incomes policy). But, in the last instance, capitalist governments try to resolve the conflict, or 'cure' the crisis, in favour of capital, e.g. by policies directed towards restoring profitability at the expense of labour income.

This is confirmed by Labour's policies in 1975–9. As we have seen in section 2, the evidence in support of the hypothesis that the expansion of the public sector has been the main cause of Britain's economic problems is far from convincing. Given the redistribution of wealth, caused by inflation, in favour of the public sector it has been argued (Taylor and Threadgold, 1979) that an expansion of the PSBR is necessary to counter-balance the fall in private spending. The decision to cut public expenditure was the result of (a) the desire of the authorities to control the expansion of money for the reasons given above (pp. 29–30); (b) the need to restore the confidence of capital, which was asking for this kind of action, and to comply with the demands of the IMF; (c) the welcoming of the subsequent deflationary effects on the economy resulting from such cuts, including an increase in the 'reserve army of unemployed', as necessary in the fight against inflation.

Table 1 shows the growth and changing composition of general government expenditure over the period 1970–78. It can be seen that the growth that occurred in 1974–75 was only partly reversed in 1976–77. Another noteworthy observation is that the relative importance of transfers, mainly in the form of current grants and subsidies, increased

markedly at the expense of public investment. This reflects, first, the effect of increasing unemployment and, second, the impact of the social contract. This contrasts with developments in 1964–67, another period of rapid expansion in government expenditure, when the relative importance of public investment was increasing at the expense of public consumption.

In a study on public expenditure one of the authors (Hadjimatheou, 1979) has shown that periods of Labour administration have always been associated with an above average expansion of government expenditure and that most of the rise in public spending during the life of a Labour government occurs during the first couple of years of Labour holding office. The tentative conclusion reached is that the degree of radicalism of the parliamentary Labour party, usually very high when in opposition, declines substantially as it gradually comes face to face with the economic realities of the capitalist system and the continuous pressures for support of the government, which mainly consists of centre-right elements of the party, as it strives along a predictable compromising course.

Probably the most significant development in 1976 was the continuous decline in sterling. Between January and October there was an effective depreciation of 22 per cent. The pressure on sterling partly reflected a growing loss of confidence in the pound, but a deterioration in the current balance also contributed. The balance of payments has remained in large deficit on current account. There was still widespread concern about the size of the PSBR and the sudden acceleration in monetary expansion in the second half of the year. However, towards the end of the year there was a noticeable improvement in confidence. The completion of negotiations with the IMF, whereby a standby arrangement of SDR 3,360 million was agreed, the arrangement of a facility in relation to the official sterling balances, and the raising of 1½ billion dollars on behalf of the government by a group of domestic and foreign banks, all contributed towards an improvement in confidence. Terms were, of course, attached to the standby facility offered by the IMF, mainly in the form of targets for monetary expansion and the size of the PSBR. In the meantime the depreciation in sterling set a halt to, and soon reversed, the downward trend of inflation.

The overseas confidence in the fortunes of the UK economy were, of course, related to the results of an effective wage restraint and cuts in public spending.

1977 was characterised by the following main developments: (a) the drastic reduction of the PSBR both in absolute terms and as a percentage of GNP (from 10.1 per cent in 1975 to 4.2 in 1977); (b) the overfulfilment of monetary targets (both in terms of M_3 and DCE); (c) the deceleration of inflation and its eventual decline from the second quarter onwards; (d) the slow but steady appreciation in sterling; (e) the substantial growth in real private gross domestic fixed capital formation but, at the same time, a slow GDP growth, and another rise in unemployment; (f) the significant fall in real personal disposable income which now stood at £1,305 p.c. at 1977 prices, in comparison with £1,335 p.c. in 1974; (g) the achievement of a current account surplus, and (h) the continuation of the government's tactic of conditional cuts in taxation, the implementation of which depended on the acceptance of the government's pay guidelines. There was of course, no doubt as to the victim of the 'social conract'. The government was, naturallly, moving towards an institutionalisation of the contract. According to stage III of the counter-inflation policy a national earnings increase of less than 10 per cent was necessary. The TUC General Council voted to support the twelve-month rule for pay settlements, but more flexibility was envisaged. As things turned out in the period between second quarter 1977 and second quarter 1978, average earnings increased by 14–16 per cent despite some defeats for individual unions.

The first three quarters of the last full year of the Labour government were, from the point of view of economic indicators, probably the best months for the government. There were obvious improvements in inflation, unemployment, output and standards of living. The 1978 budget presented on April 4th was reflationary. The principal proposals were tax cuts, estimated to cost £2 billion in 1978/79.

After the budget the government proceeded with a proposal for a stage IV of the counter-inflation policy: it was proposed that pay settlements for the year beginning August 1st should not exceed 5 per cent. But the TUC annual conference rejected this proposal. It seems, however, that the government despite the TUC's rejection of the new incomes policy was very hopeful of a satisfactory degree of compliance. As it turned out they should not have been so optimistic. It was the failure of this policy that led to the May 1979 election and the victory of the Conservative party.

In the late summer of 1978, given widespread forecasts of a deterioration in the economic situation, an Autumn general election was generally expected. But, to the surprise of nearly everybody, the Prime Minister in a broadcast on September 7 ended speculation about an Autumn election by announcing that the government intended to carry on for a fifth and final session of Parliament. However, in the light of the end of the Lib/Lab pact in May, the government was bound to be less effective in pursuing its policies. An example of this was the government's defeat in a vote on pay sanctions in December 1978. In the meantime the economic situation was clearly worsening. By the end of March 1979 average earnings were rising at a 15 per cent rate, reflecting the unions' opposition to the 5 per cent rule; unemployment in the first quarter of 1979 was higher than in late 1978; the current account of the balance of payments was in

substantial deficit, after an overall surplus in 1978; the rate of inflation, after a six-year low of 7.4 per cent in June, was 10 per cent and rising; the indices for GDP, industrial production and GDFCF in the private sector, recorded varying falls in the first quarter of 1979. Despite all this, per capita real personal disposable income was rising and by the end of March it was up by 7.8 per cent on March 1978. But most of all it was the tremendous wave of industrial disputes in the Winter of 1978–79 which caused Labour's electoral defeat. The government's failure to sustain its success in controlling pay settlements and the subsequent outbreak of major strikes was probably the most relevant development at that time. The centrepiece of its economic programme, the special understanding between unions and the Labour party, was in ruins. It seemed therefore that Labour was running out of options while the Tories were offering an uncompromising, new, and right-wing radical programme.

Although the pace of monetary expansion in 1978 was somewhat higher than the target set by the Chancellor and the size of the PSBR and public spending recovered, both in absolute terms and as percentages of GNP, in comparison to the corresponding figures in 1977, there was no change in emphasis as to the need to monitor carefully changes in these key variables. The anxiety of the authorities about the consequences of any attempt to change course in fiscal and monetary policies, in the light of the failure of the government's incomes policy was neatly expressed in the following statements by the Governor of the Bank of England:

> "Fiscal and monetary targets have therefore to be maintained. This policy cannot, of course, undo the damage caused by strikes or inflationary settlements; the bills for that damage have to be met in terms of loss of output and increased unemployment. But an attempt to avoid or mitigate that cost by expanding money supply further or by lax fiscal policy would merely serve to undermine the financial stability and confidence that have been achieved since 1976 and in so doing would lead to even higher unemployment." (*Bank of England Quarterly Bulletin*, March, 1979, p.55).

In an outspoken mood, the Governor argued that there was little future for the country unless it was recognised that:

> "Profit margins have fallen to disturbing low levels in recent years, and seem even more vulnerable in the present context. Both in judging the balance between fiscal and monetary policies, and in framing the detail of the former, this needs to be kept constantly in mind." (ibid, p.56).

Finally, in an analysis which is so characteristic of the fetishism with which the establishment approaches social relations an attempt was made to allocate blame:

"If the coming year is a hard one, as I expect it to be, there will be some who would seek to represent it as a result of a collision between excessive pay settlements and the maintenance of firm, as opposed to more accommodating, monetary and fiscal limits. But the real collision is between the level of these settlements and the level of growth of productivity in our economy". (ibid, p.56)

In the light of this analysis the policies of the new Conservative government are not surprising. Despite the abandonment of an incomes policy the basic aims of their programme are not substantially different from those of the Labour government over the period 1975–9. Perhaps the main difference is their attitude towards the union. There are of course differences in policies. The Labour government believed that the co-operation of the trade unions through an incomes policy was necessary if unemployment, on a massive scale, was to be avoided. The present Conservative government is in principle against the use of an incomes policy; the unions will simply have to bear the consequences of their actions in terms of high levels of unemployment.

TABLE 1

Growth and Composition of General Government Expenditure

	1	2	3	4	5	6	7
1955–64	35.0	47.6	10.2	23.8	1.1	11.1	6.2
1965–69	39.8	43.4	11.8	25.4	2.7	9.9	6.8
70	41.2	42.9	11.9	25.8	3.8	9.7	5.6
71	41.7	43.5	11.2	25.3	3.9	8.9	7.2
72	41.6	44.2	10.6	27.4	3.1	8.7	6.1
73	41.0	43.7	12.2	27.0	3.2	9.0	5.0
74	45.1	42.4	11.4	28.6	2.8	9.2	5.6
75	49.0	44.5	9.8	28.0	2.3	8.2	7.2
76	47.1	45.6	9.4	29.2	2.4	9.3	4.1
77	44.2	47.0	8.0	31.6	2.5	10.5	0.4
78	45.0	43.4	6.5	32.2	4.7	10.3	4.1

1. Total General Government Expenditure as a percentage of Total Domestic Expenditure; 2–7 Components of Total General Government Expenditure as percentages of Total: 2) Final Consumption, 3) Investment, 4) Current Grants and Subsidies, 5) Capital transfers, 6) Debt Interest, 7) Net Lending.

Source: Central Statistical Office and *Economic Trends* (September, 1979).

4. SUMMARY AND CONCLUSIONS

The term of Office of the last Labour government coincided with the most serious post-war economic crisis. In the case of the UK one can distinguish three dimensions of the complex of economic problems facing the Labour Government. First, there was the impending world recession, from the effects of which a small and open economy could not be easily insulated. Second, there was the long-run decline of the British economy the capitalist remedy of which seemed to require a long-lasting programme of drastic reforms, such as a curtailment of the trade union power, a redistribution of income in favour of capital, with the hope of an acceleration of capital accumulation; a rise in the physical capital-to-labour ratio and a subsequent increase in productivity. It is true, of course, that a squeeze of real wages could inadvertently, produce a realisation problem; it can be argued, however, that the realisation problem did not prevent other countries from achieving consistently higher rates of growth. Finally, but not independently, there was the domestic economic crisis which was expressing itself in terms of a serious economic contraction with an overall fall in production, accompanied by a rise in unemployment; superimposed on this there were the problems of price and wage inflation and the balance of payments deficit. The early 1970's also coincided with an unpredented crisis of Keynesian economic policies. The two crises were not, of course, unrelated. It was mainly the new manner in which the crisis manifested itself that led to the realisation that traditional Keynesian management was no longer appropriate. It was not the case that macroeconomic policies were hopelessly ineffective, but rather that the attempt to use them to achieve full employment would result in deficits in the balance of payments which would fuel inflationary pressures internally, following exchange rate depreciations; as a consequence some of the initial expansionary effects would be neutralised. Furthermore, governmental actions aiming to tackle the problems of deficits in the balance of payments and inflation, would generate, at the end of the day, substantial unemployment. Mr. Callaghan's robust revocation of his belief in the Keynesian orthodoxy is indicative of the spirit of the times:

> "We used to think that you could spend your way out of a recession, and increase employment by cutting taxes and boosting Government spending. I tell you in all candour that that option no longer exists, and that insofar as it ever did exist, it only worked by injecting a bigger dose of inflation into the economy, followed by a higher level of unemployment as the next step...... That is the story of the last twenty years". (Callaghan, 1976)

A crucial implication of the attempt to finance deficits in the balance of payments would be – and has been – to resort to financial help from the international bankers, chiefly from the IMF. The inevitable consequence would be that Britain would be forced into a situation whereby policies would have to be approved, at least partially, by the international moneylenders.

The new Labour government, being confronted with a rapidly deteriorating economic situation and an apparent bankruptcy of the conventional policy wisdom, could have pursued one of two basically different courses of action. It could have proceeded to act directly by replacing market forces by goverment regulation: with strict control over prices; import controls; a substantial extension of the public sector by taking over important sections of both productive and financial capital; the development of a national economic plan to induce and co-ordinate further accumulation; the pursuit and maintenance of full employment and the development of a scheme to democratise industrial relations and decisions over production. A strategy based on this kind of programme would have had the support of the trade union movement, which was its main advocate alongside the left – radicals inside and outside the Party. But given the balance of power within the government and the obvious implications of these proposals for the established interests of capital, it was not surprising that a conventional alternative was chosen. But the programme pursued was also different from the traditional Keynesian management prescriptions. It was a mixture of policies based on a number of schools of thought (analysed in section 2) which came to prominence mostly as a result of the decline of the Keynesian orthodoxy. First, the main function of the budget balance was not to influence the size of aggregate demand but rather to restructure demand so as to augment the level of investment and exports at the expense of public spending and private consumption – the implicit reasoning being based on a belief in some form of crowding out. Furthermore, there were clear signs that the government's policies were influenced by the New Cambridge thesis that the budget deficit was the main determinant of the balance of trade deficit. The monetarist influence, in this instance, was reflected by the authorities concern about the impact of the PSBR on the stock of money in the economy. This concern derived from some tacit acceptance of the importance of the money supply in sustaining inflation. Second, the counter-inflation policy was mainly based on the social contract, the major component of which was voluntary restraint in pay settlements. Spending on social services and tax changes were used to ensure the co-operation of the unions. Compliance to the pay proposals was also sought by applying sanctions on non-conforming firms and by covert threatening of workers with higher unemployment resulting from a non-accommodating monetary policy. Finally, tax reliefs were extensively used to help the liquidity position of industry and unemployment subsidies and retraining schemes were used in an attempt to ameliorate rising unemployment. It is true that it was often recognised by the government that these measures could not by themselves solve the structural problems of the economy.
The measures implemented by the Labour government were mainly

designed, it was claimed, to create the right climate for investment to expand, which would also create more exports and thus help to alleviate the chronically weak balance of payments.

It is our view that the measures pursued by the Labour government failed on both fronts: namely, to create the right business climate, referred to above, and to have any permanent effect on the British economy. They may have been temporarily successful in reducing the rate of inflation, but only at the expense of higher unemployment. Even so, this temporary success came about only when there was a 'voluntary' incomes policy. It would, therefore, seem to be the case that one of the main problems of the policy-makers in the 1970's was their inability to "control" the Trade Union movement by invoking the need for unity for the sake of national interest.

But the Labour government's policies also failed according to another, a more important, criterion: they did not bring any closer the radical changes so explicitly expressed in the Labour Party's 1974 manifesto. The complexity and severity of the problems should not serve as an excuse for the government chose to ignore and oppose suggestions for an alternative economic strategy which could have played the role of the catalyst for a move towards socialism.

FOOTNOTES

- We are grateful to C. Driver, J. Harrison, G. Koolman and Y. Vanson for their helpful comments and suggestions. As always any remaining errors are ours.

1. The supply of broadly defined money, sterling M_3, in the two year period 1972–73 increased by 65 per cent; also the ratio of total liabilities to total financial assets of the personal sector rose from 1.64 in 1971 to 2.31 in 1974.
2. For a critique of the validity of the conceptual framework used by Bacon and Eltis see Ietto Gillies (1978).
3. The main shortcoming of this hypothesis is that it does not explain what causes the level of unemployment, which is compatible with zero deficit in the balance of payments, to vary over time.
4. However, Blackaby (1979) argues that in the context of the UK's experience in the 1970's inflation is politically more damaging for a government than unemployment.
5. Another 'Cambridge' view which looks at the balance of payments as one of the contributory factors to the 'British disease' emphasises the failure of British industry to maintain its share of world trade in manufactures; the main policy implication of this view is the "abandonment of the regime of free trade and free convertibility of currency". (Singh, 1977, p.134).
6. The policy prescriptions put forward by the Cambridge Political Economy Group (1974) are very much related to these proposals. They include repatriation of all U.K. capital and nationalisation of foreign firms operating in the U.K. – with appropriate compensation provided to foreign capitalists for their nationalised U.K. assets – thus reducing dramatically the damaging role of international capitalism over the British economy. The possibility of increasing trade with the Third World and Socialist countries, through bilateral agreements, is considered as part of a move towards the planning of trade.
7. Stewart's (1977) interpretation, according to which the main influence on Healey's decision in cutting the PSBR was the New Cambridge's thesis on the causes of balance of payments deficits does not seem plausible. Judging from Healey's rationalisation it seems more likely that the foremost underlying concern was inflation.
8. Although their complete thesis was not published before November 1975, a short article setting out their arguments under the title "Budget Message for Mr. Healey: Get More People into Factories", appeared in the *Sunday Times,* on 10 November 1974.
9. See Gowland (1978, Appendix B) for a full definition of the money supply and its different forms.
10. Domestic credit expansion is the increase in the money supply plus the deficit (or minus the surplus) on the balance of payments on the current account. (See Artis and Nobay, 1969, for more details.)
11. Assets qualified to be included in the reserve asset ratio were: balances with the Bank of England (other than Special Deposits), British government and Northern Ireland government Treasury Bills, company tax reserve certificates, money at call with the London money market, British government stocks with one year or less to final maturity, local authority bills eligible for rediscount at the Bank of England, and (up to a maximum of 2 per cent of eligible liabilities) commercial bills eligible for rediscount at the Bank of England.
12. This scheme was suspended in February 1975 but was re-introduced in November 1976. It was also suspended in August 1977 to be re-introduced again in June 1978. (For more details see, for example, Gowland, 1978, ch.8).
13. There is, of course, the argument that M_1 should seriously be considered as the money supply target. It seems, though, that sterling M_3 has some relative advantages notably in that, unlike M_1, it is not demand-determined; for more details on this point see Congdon (1979).
14. In the April 1978 Budget an important change was announced as far as the implementation of targets was concerned; that is, targets which had previously been set to prevail without review for a year, were now to be reassessed every six months.
15. Stage Two of the counter inflation policy started in August 1, 1976 and consisted of, mainly, a £2.50/5 per cent/£4.00 pay limit.
16. This view underlies, for example, the recent economic analyses by Rowthorn (1977), and Gough (1979).

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