Fiscal policy and economic management in the 1930s

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SYMBOLS AND CONVENTIONS

1. Dates: / is used for financial years, e.g. 1931/2 for the financial year ended 31 March 1932.
- is used for two or more calendar years, e.g. 1931-2 for the two calendar years 1931 and 1932.

2. Rounding: in many of the Tables estimates are given in such a way that components may not add exactly to totals.

3. Symbols:
.. = not available
– = nil.

CHARTS AND TABLES

CHARTS

TABLES

PREFACE

This dissertation is the result of my own work and includes nothing which is the outcome of work done in collaboration.

That said, in preparing this study, many debts have been incurred, both financial and intellectual. I should like to acknowledge my gratitude to the Social Science Research Council for financing the main part of the research underlying this study, and also the Houblon-Norman Fund and University of Durham's Research Fund for assistance in the later stages of preparation.

Mention should next be made of those who supervised this study. The study commenced under the direction of Professor W.B. Reddaway; later Professors R.R. Neild and L.S. Pressnell assumed the task. Their assistance, inspiration, and wise counsel is gratefully acknowledged: without their vigilant scholarship and persistent questioning of successive drafts the final form of the dissertation would have been even more imperfect than at present. At various stages of the writing, I also benefited from the comments and suggestions of Susan Howson, George Peden, and Stephen Drayson, who read the central body of the dissertation (chapters 4-6), and from the opportunity to give early drafts of chapters 2, 4, and 6 at London and Sheffield University seminars. The responsibility for errors of fact, analysis, and interpretation remain, of course, entirely my own.

Additional assistance, in the form of replies to enquiries for information and to my requests for as yet unpublished papers, was kindly provided by the following: Steve Broadberry, Professor Charles Feinstein, Nigel

Grimshaw, Tim Hatton, Lady Hicks, Bob Holland, Susan Howson, Professors Lord Kahn, J.E. Meade, and Donald Moggridge, R.A.C. Parker, George Peden, Professor R.S. Sayers, Terry Thomas, James Trevithick, G.N. von Tunzelman, and Philip Williamson.

I should also like to take this opportunity to thank the staff of the Public Record Office for their endeavours on my behalf over the last five years or so, the Departmental Record Officers of the Inland Revenue for depositing certain key files in the Public Record Office, Mr. S.R. Prestidge (Head of Library Services, Customs and Excise) for his assistance and hospitality on my visits to work on his departments records, Mrs. Edwards (Archivist, Confederation of British Industries) and Mr. B.S. Benedikz (Head of Special Collections, University of Birmingham Library) for performing similar services for the Federation of British Industries and Neville Chamberlain Papers respectively, and Professors Lord Kahn and Donald Moggridge for allowing me access to the Keynes Papers.

Finally, my thanks go to my colleagues and students at Durham who shared in the burden of my thesis so bravely and uncomplainingly; to Mrs. Towers for her unfailing energy and expertise in typing the manuscript; and to my friends Michael and Posy O'Neill who, after the exacting task of proof-reading the manuscript, still feel able to share in my enthusiasm for Britain in the 1930s.

Durham
April 1981

Roger Middleton

CHAPTER 1

INTRODUCTION: THE INTERWAR BRITISH ECONOMY AND THE PROBLEM OF MASS UNEMPLOYMENT

> Next to war, unemployment has been the most widespread, most insidious, and most corroding malady of our generation: it is the specific social disease of western civilisation in our time. (1)

The validity of The Times's verdict of 1943 is incontrovertible: both contemporaries and postwar writers have judged, and condemned, the interwar period as a bleak episode in our national history. This view principally derives from the particular characteristics of Britain's interwar unemployment problem, its quite unparalleled magnitude, its prolonged nature, and its attendant social misery; it is clearly reflected in the literature of the period, in popular memory of it, and in the attitudes of later politicians and labour representatives who have continued to allude to the interwar period as an example, indeed object-lesson, of the failures of unregulated capitalism.

In part, this view also derived from, and was strengthened by, the subsequent 'Keynesian revolution': "the hard-fought victory of the theory of effective demand",[2] and its translation into practical economic management during the war years. The achievement of full employment since the war (to say 1970), by what were judged to be Keynesian means,[3] served to vindicate the case for fiscal expansion put by Keynes and others between the wars,[4] and the view passed into orthodoxy that interwar unemployment could have been stabilized at a much reduced level by fiscal means.

As yet, the recent reappraisal by economists, and near complete rejection by British governments,[5] of the belief in the stabilizing effectiveness of fiscal policy, has not challenged this orthodoxy to any substantial degree.[6] That it will do so in time seems likely; the present study, however, does not attempt such an exercise, although, where helpful, reference is made to postwar experience. Rather, the object is twofold: to assess the fiscal policy that was followed in Britain in the 1930s; and to investigate the theoretical, political, and bureaucratic determinants of that policy. For this purpose the budget accounts have been reconstructed so as to remove window-dressing and to permit the application of the concept of a constant employment budget (with which to assess changes in fiscal stance); and, as with other recent studies of interwar economic policy, the government policy documents from the Public Record Office have been the main source for information on policy-making.

The dissertation is arranged as follows. In the remainder of this chapter the interwar British economy is surveyed. Chapters 2 and 3 also consider background issues: the Treasury's institutional position and the expenditure side of the budget in the case of the former; and the revenue departments and taxation in the case of the latter. The following three chapters constitute the central body of the dissertation. Chapter 4 considers the interwar budget accounts, budgetary practices, and the question of budgetary orthodoxy. Chapter 5 presents a narrative account of 1930s budgetary history, while in chapter 6 the constant employment budget estimates are employed as a measure of changes in fiscal stance. Finally, in chapter 7, the public works issue is considered and the fiscal policy debate examined from a broader perspective.

*   *   *

An analysis of the magnitude and characteristics of interwar unemployment is a necessary prelude to our investigation of policy. This is undertaken in the first section of this chapter; the second surveys the cyclical and trend course of the British economy 1929-39; and the final section draws the discussion together and suggests a number of features of the economy of this period which need to be taken into account in any assessment of the effectiveness of the policies pursued and the motives underlying their adoption.

1. Unemployment

Without in any sense attempting to diminish the historical significance of this experience of mass unemployment, three points should be made at the outset of this inquiry: firstly, as was recognised as early as 1950, "the persistence of heavy unemployment [may legitimately have] given the interwar years a bad name", but concentration on this one feature of the period has also served to obscure the contemporaneous progress in productivity and real wages;(7) secondly, contemporaries tended to misunderstand and in some ways exaggerate unemployment in statistical terms;(8) and thirdly, modern microeconomic studies of unemployment show the conventional indicators of unemployment to be imperfect and potentially misleading, both as a basis for the investigation of the causes of unemployment, and as a means of identifying the policies required to mitigate unemployment.(9)

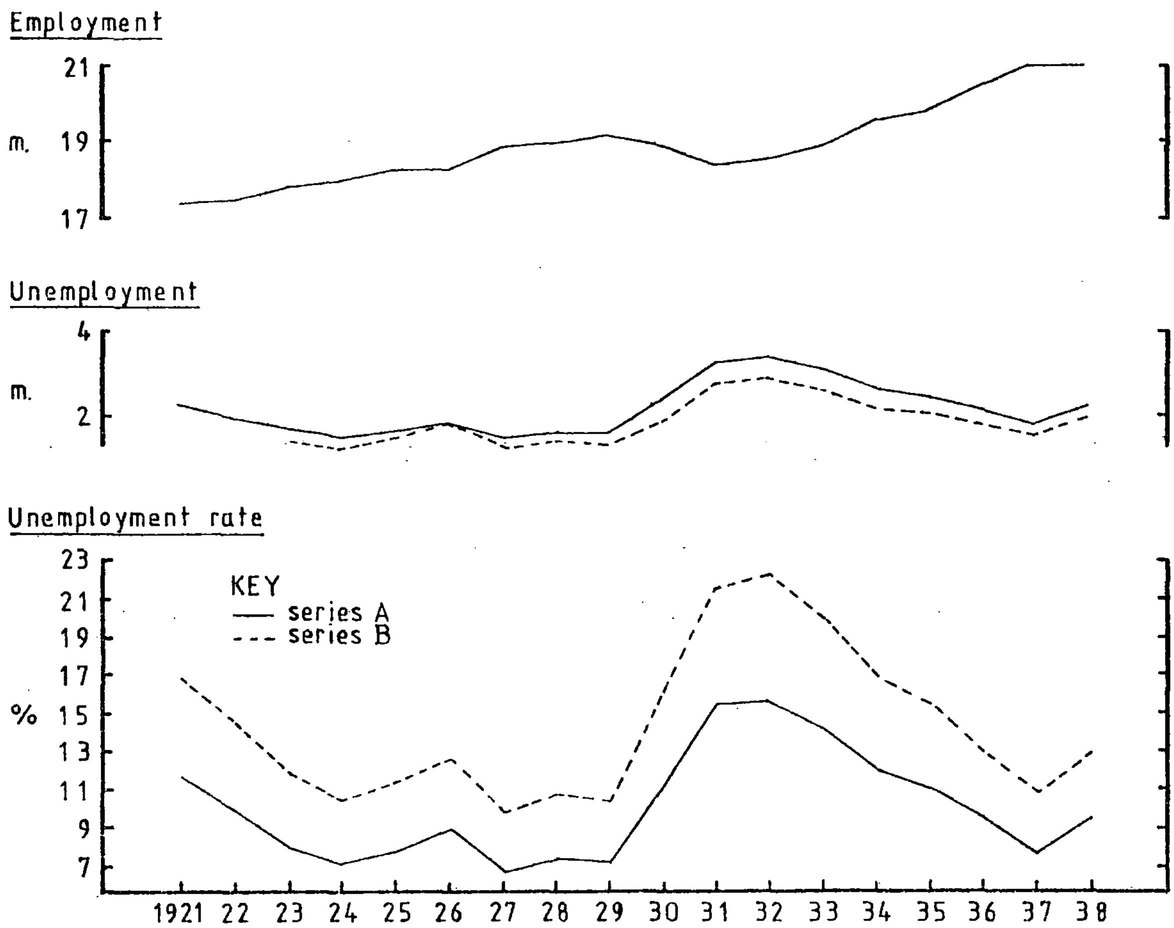
The course of employment and unemployment are given in Chart 1.1 for the period 1921-38. Two different series are presented for unemployment: (A) Feinstein's estimates based on the total working population; and (B) the national insurance returns, the former being a revision of the latter which did not cover the whole of the labour force. The national insurance series is an imperfect indicator of inter-war unemployment:(10) on the one hand, its incomplete coverage results in an understatement of the numbers unemployed, and on the other, as Census data reveal, the rate of unemployment for insured persons was nearly one third higher than that for the labour force as a whole, so that the series overstates the unemployment rate. Thus, throughout the rest of this study, Feinstein's series is used, this being a reasonably accurate representation of unemployment amongst the total labour force;(11) on occasion, however, it is also necessary to use the more limited national insurance series since this was the most important monthly macroeconomic indicator available to interwar governments.

Both series in Chart 1.1 show the marked cyclical fluctuation of the unemployment rate: the range of variations for series (A) is from a lowpoint of 6.8% in 1927 to a peak of 15.6% in 1932, while the figures for series (B) are 9.7 and 22.1% respectively. The average rates of unemployment for the period 1921-38 will therefore also differ significantly as between the two series, being 10.0% for (A) and 14.2% for (B).

Although the exact magnitudes remain uncertain,(12) the trend rate of unemployment between the wars undoubtedly exceeded that of the prewar period; it also, of course,

Chart 1.1

Employment and unemployment 1921-38



SOURCES: A. Feinstein (1972: Table 57).
B. Department of Employment and Productivity (1971: Tables 160, 163).

compares most unfavourably with the postwar record of unemployment to 1970. The concern felt by contemporaries for the high level of unemployment was not without foundation; the unemployment problem cannot be explained away by reference to the inadequacies of the data,[(13)] the economic loss of unemployment was of too great a dimension.*

* As Thomas (1981) calculates, a comparison of the actual course of GNP over 1921-38 with a hypothetical full employment path - assuming a prewar average of 4.7% unemployment - yields the result that the loss due to unemployment over this period was equal to the level of GNP in 1938. Moreover, this is a lower-bound estimate: a higher average level of capacity utilization might legitimately be expected to raise factor productivity, thus resulting in an upward shift in the full employment trend rate of growth and a greater loss of output as compared with the actual employment path of the economy.

Nor, as has recently been argued, can the high level of interwar unemployment be explained in terms of the disincentive effects of unemployment benefits on the search for employment.(14)

With these preliminary comments in mind, the point should now be made that, whilst there was an immense economic loss as a result of mass unemployment and while modern stabilization theory would suggest that this could have been reduced or eradicated by deficit spending, <u>the unemployment problem was not monolithic, nor monocausal</u>.(15) In particular, it is contended that it is erroneous to interpret the period solely in terms of deficient demand, for such interpretations seek a uniformity of experience which was non-existent and fail to take full account of the varied and changing characteristics of interwar unemployment. These will now be explored in some detail, beginning with the relationship between population and labour supply.(16)

A study of Feinstein's series for civilian employment reveals the following features:(17) firstly, it was not until as late as 1935 that the level of employment prevailing in 1920 was again obtained; secondly, employment growth was marginally faster in the 1920s than in the 1930s;* and thirdly, over the whole period 1920-38 total civilian employment grew by 7.4% but the total working population grew by a far greater amount (by 14.0%). Thus, on trend,

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* Employment grew at an annual average rate of 1.21% over 1924-9, but only 1.15% over 1929-37. These are the only legitimate dates for intertemporal comparisons during the interwar period, being trade cycle peaks and years of comparable capacity utilization (Dowie 1968: 63). In later chapters, where endogenous budget items are considered, these dates are also employed so that their trend course can be distinguished from their cyclical behaviour.

unemployment rose: from 1.4m in 1924, to 1.5m in 1929, and 1.8m in 1937 (unemployment rates moving in line, at 7.2, 7.3, and 7.8% respectively).

A comparison with prewar trends provides a partial explanation for this upward shift in the trend of unemployment. Firstly, demographic factors need to be taken into account. Before 1914 the rate of growth of the labour force had approximately equalled that of the growth of population: at annual averages of 0.99 and 0.85% respectively over 1880-1914. During the interwar years population growth declined quite sharply,* to an annual rate of growth of 0.46% over 1920-39; and if prewar trends had continued, a fall in the rate of growth of the labour force would have resulted. Prewar trends, however, did not continue: against the 9.2% increase in population over 1920-39 there was a 14.1% rise in the working population.(18) The divergence between these two rates stemmed from two influences: firstly, the fall in the birth rate led to an increase in the proportion of the population of working age (from 63.8% in 1913 to 69.5% in 1939);(19) and secondly, there was a rise in the proportion of women taking paid employment, female participation rates rising from 32.6% in 1921 to 35.8% in 1938.(20)

It is therefore legitimate to conclude that, "had the pre-war relationships between the two variables remained the same the growth of the labour force would have been lower and unemployment less severe."(21) Furthermore,

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* The fall in the birth rate was so sharp in the 1930s as to give rise to widespread fears that the population would actually soon begin to fall (see Reddaway 1939 for a detailed discussion of population trends and their economic consequences). The 'population question' was of some importance to economic policy during the 1930s, a source of concern as regards the burden of the national debt and the potential of the economy for further growth.

Matthew's (1964) estimates of GDP growth and the contribution of factor inputs suggests that demand factors, in the form of an upward shift in the trend rate of productivity growth, may have also exacerbated unemployment, at least in the short- to medium-term. In the period immediately preceding the war (1899-1913) the 1.1% average annual rate of growth of GDP principally derived from the growth of the labour input, the growth of GDP per unit of labour being minimal (at 0.1% per annum). By contrast, over the period 1924-37, when the growth rate of GDP accelerated to 2.3% per annum, the growth of GDP per unit of labour was primarily responsible (at 1.1% per annum), the growth of the labour input remaining relatively stable at 1.2% per annum as compared with 1.0% in the preceding period.(22) Thus if productivity had maintained the same trend as prewar, the growth of the labour input would have risen and the unemployment problem would have been less serious.(23)

Although serious when viewed in the aggregate, the interwar unemployment problem was made more acute by its uneven incidence as between industries and regions, indeed this is now seen to be its most important feature. These disparities were a vivid manifestation of the serious structural problem confronting the interwar British economy: the secular decline of certain basic industries - the foundations of nineteenth century growth - which, because of the manner in which the industrial structure evolved, were to be concentrated in four regions: South Wales, Scotland, North-east and North-west England.

Regional employment trends are summarised in Tables 1.1 and 1.2.(24) The regional disparities are immediately

Table 1.1

Regional unemployment rates (insured persons), Ministry of Labour Divisions, 1929, 1932, 1937

	June 1929	June 1932	June 1937
London and South east	4.5	13.0	5.4
South west	6.8	15.8	6.8
Midlands	9.1	21.5	6.6
North east	12.6	29.8	12.0
North west	12.6	25.9	12.8
Northern	..	..	16.7
All Northern England	12.6	27.8	13.2
Scotland	11.0	26.8	14.0
Wales	18.2	37.4	20.7
Northern Ireland	13.8	27.4	21.7
Inner Britain	6.3	16.0	5.9
Outer Regions	12.9	28.5	14.5
UNITED KINGDOM	9.7	22.4	10.1

Source: Beck (1951: Table 18)

Table 1.2

Regional employment growth (insured persons), Ministry of Labour Divisions, 1929-37

	% change in employment		
	1929 -32	1932 -37	1929 -37
London	-1.9	22.9	20.6
South east	0.3	25.3	25.7
South west	-2.3	22.1	19.3
Midlands	-8.8	30.8	19.3
North east	-12.4	24.0	8.6
North west	-12.1	17.2	3.0
Northern	-21.6	31.3	3.0
Scotland	-13.2	22.6	6.5
Wales	-18.9	25.1	1.5
GREAT BRITAIN	-8.9	23.9	12.9

Source: Calculated from Fogarty (1945: Table 5, p.15)

apparent from both the figures for unemployment and employment growth: on the one hand must be placed the high levels of unemployment in the declining staple industries;* on the

* The Ministry of Labour estimated in July 1929 that unemployment in the main staple trades (coal, cotton, woollen, and worsted textiles, shipbuilding, iron and steel, and mechanical engineering) accounted for approximately one half of total unemployment amongst

other, account should be taken of the fact that those industries which were expanding, the so-called 'new' industries,[(25)] were located almost exclusively in the areas with already lower than average unemployment.

The regional problem thus assumed two dimensions: the very high rates of unemployment of the industries centred on these depressed regions and their below average rates of employment growth. In addition, cyclical factors were also of importance in contributing to the regions' problems. The depressed regions were heavily committed to producer goods industries which, as with investment in GDP, experienced the most pronounced cyclical fluctuations in output and employment; by contrast, the more prosperous regions of the South and Midlands had more diversified industrial bases - in particular a growth of consumer goods industries - and this lessened their susceptibility to the worst effects of cyclical depression.

The extreme concentration of unemployment on the staple industries, with its consequences for certain regions, forms the centrepiece of recent arguments which have sought to question the traditional view of interwar unemployment as primarily demand deficient and as unduly high as compared with the preceding period.[(26)] Whilst this reinterpretation may have been carried too far, the significance of the regional problem, and its implications for the effectiveness of stabilization policies, is reinforced by study of the dynamics of interwar labour markets.

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insured workers (cited in Aldcroft 1970a: 146). The greatest decline in employment occurred in the coal, textile, and shipbuilding industries; these released a total of 0.69m workers between 1924-38, a fall in employment of 34.1% (calculated from ibid. Table 22).

It is axiomatic that the number of people on the unemployment register rises or falls as the flow of newly unemployed coming onto the register exceeds or falls short of the flow of people leaving the register to take up employment, and that the duration of unemployment is as important an indicator of labour market conditions as the absolute numbers unemployed. As Cripps and Tarling stress:

> An understanding of the dynamics of this process is important both for judging policies designed to mitigate the evils of prolonged unemployment and for interpreting the unemployment statistics as a measure of the pressure of demand in the labour market. (27)

A comprehensive full employment policy requires not only that unemployment be stabilized at some (politically and economically acceptable) target level, but that the average duration of unemployment be monitored and, if possible, regulated so as to prevent the impairment of workers' skills that inevitably results from long-period unemployment. In both spheres, the interwar experience of unemployment failed to meet these criteria; and, as will now be argued, the true significance of the unemployment problem lay not only in the high absolute levels of unemployment in certain depressed regions but in the prolonged nature of this unemployment and its worsening as the period progressed.

Although no data are available prior to 1929, Table 1.3 shows that the average duration of unemployment rose significantly over the 1930s; other evidence suggests that this deterioration was in fact evident from the early 1920s onwards.[28] In September 1929, 89.1% of the total had been unemployed for less than 6 months (short-period unemployment) and only 4.7% for more than 12 months (long-period unemployment); by August 1937, short-period unemployment stood at 65.7% of the total while long-period unemployment

Table 1.3

Unemployment by duration 1929, 1932, and 1937

	as % of total unemployed*				
	less than 3 months	3 months and less than 6	6 months and less than 9	9 months and less than 12	12 months or more
Sept. 1929	78.5	10.6	3.8	2.4	4.7
Aug. 1932	59.0	11.1	7.3	6.2	16.4
Aug. 1937	56.3	9.4	6.0	4.0	24.3

Source: Beveridge (1944: Table 8)

Notes: *The estimates actually covered 85.4, 90.5, and 93.2% respectively of the insured unemployed.

had grown to 24.3%, and had in fact worsened over the recovery period (from 16.4% in 1932). In terms of absolute numbers, the long-period unemployed had grown from 45,100 in 1929 to 287,821 in 1937, by which date they had become "the most serious element in the problem of unemployment."(29) As Beveridge commented "The legacy of the Great Depression was a host of long-period unemployed - nearly 300,000 men and women in enforced idleness - for whom continuous money payments were a manifestly inadequate provision."(30)

The policy implications of this long-period unemployment problem stemmed from its regional nature: for example in 1937, 83.8% of those unemployed at 21 June in London (which had a mean unemployment rate for the year of 6.3%) had been unemployed for less than 6 months and 71% for less than 3 months, while in Wales (mean unemployment rate of 22.3%), only 36% had been unemployed for less than 3 months and 47.3% for less than 6 months, with 39.3% unemployed for over 12 months.(31)

In broad measure, all the depressed areas experienced similar problems to those of Wales: regional unemployment rates significantly in excess of the national average, and characteristics of unemployment in these areas - by age and skill, as well as duration - such as to cast doubt on the effectiveness of a centrally directed stimulus to aggregate demand as a sufficient solution for these areas' problems. This becomes clearer when unemployment is viewed at the sub-regional or local level, the level at which the disastrous effects of an unsatisfactory industrial structure were most pronounced. The astronomical rates of unemployment recorded in certain towns at the depth of the depression (January 1933) are well known - for example, 91% in Saltburn, and 77% in Jarrow;[32] less well known, and infrequently cited, was the accompanying long-period unemployment problem for many depressed area towns. This was vividly brought to the public's attention by a Pilgrim Trust survey of November 1936 which found that, even after four years of strong national recovery, 71% of the unemployed in Crook and 45% in the Rhondda had been unemployed for five years or more, as compared with only 3% in the prosperous southern town of Deptford.[33]

The structural problems confronting the British economy, made manifest in the case of these and other depressed area towns, and the search for possible solutions, forced inter-war governments against a range of problems far wider in scope than those posed simply by the desirability or otherwise of a management of demand. To the economic authorities, the desirability of a revival of demand at local levels was not in doubt; more questionable was whether the existing industrial base of many of these areas was capable of responding, to the degree required, to a general stimulus of demand, and if not, whether government should assume direct responsibility for industrial reconstruction or whether it should retain its previous _laissez-faire_ stance. The still current problem of declining staple industries was first faced by interwar governments; having begun to widen their responsibilities for economic and social affairs in the early years of the century, a _laissez-faire_ stance would have been inappropriate and politically unrealistic. Yet the characteristics of interwar unemployment made comprehensive solutions more difficult; of course, at the same time, its seriousness made them more imperative. Of vital concern also were the cyclical course of the British economy and the various constraints upon policy, subjects to which we now turn.

2. The British economy 1929-39

Whilst, for exegetical purposes, it was important in the previous section to establish the magnitude of interwar unemployment and its main characteristics by isolating them from broader economic considerations, they should now be viewed in relation to the cyclical and trend course of the British economy over this period. As a result of detailed study in recent years, the record of the interwar economy is well known and need not be recounted in any detail. Accordingly, the following discussion is limited in scope, and focuses on those features of the economy which are pertinent to the issues treated in later chapters.

Reference was made earlier to the fact that the persistence of heavy unemployment acted to obscure other more favourable developments of the period. Undoubtedly, the traditional interpretation paid excessive attention to the declining staple industries and poor export performance.[(34)]

The more recent, and now generally accepted, view, is that the period "was by no means as black as has been painted";[35] that substantial progress was made, at both a micro and macro level. In this view, one particularly associated with the work of Aldcroft and Richardson, stress is placed upon, on the one hand, the growth of the 'new' consumer goods industries and the enlargement of the service sector, and, on the other, the acceleration of the underlying growth rate. Put simply, in this view, the improved growth performance derived from a combination of these structural changes at the industry level and an upward shift in total factor productivity associated with more rapid technological change.

There is much of substance in this view, and initially it found substantial favour; as Alford noted in 1972, it had "almost developed into a new orthodoxy."[36] Yet, as is now being more fully appreciated, this reinterpretation has been carried too far. The importance of the 'new' industries, the centrepiece of the arguments about structural change and improved productivity growth, have seriously been called into question; there are considerable difficulties associated with growth calculations between the wars because of the wide amplitude of cyclical fluctuations; and, more generally, whilst growth might have been respectable as compared with earlier or later periods, the point remains that demand still failed to grow at a rate sufficient to match the growth of the labour force.[37]

A thoroughgoing reappraisal of the Aldcroft-Richardson 'new orthodoxy' has yet to be undertaken; nevertheless, serious doubts have been raised about its essentials. Two aspects in particular require further comment since they relate to policy issues.

Firstly, Aldcroft contends that "the sharp contraction of some of the older industries was a positive long-term advantage", since by releasing resources they permitted an acceleration of structural change, and the creation of a development 'bloc' of new, high growth, industries which underlay the rapid recovery from the 1929-32 depression.(38) As Howson comments:

> The flaw in this argument is the assumption of a limited stock of resources, limited in the aggregate by exogenous technical progress and within that aggregate 'over-committed' to the production of the old staples by 'structural' factors. Technical progress and structural factors are not independent of aggregate demand and with one million unemployed there could have been more expansion in the new industries even if the old were not declining, if aggregate demand had been growing sufficiently to create profit expectations favourable to investment in the new industries (primarily domestic-based). (39)

Furthermore, the Aldcroft view ignores the fact that:

(1) In terms of employment, investment, and output, the 'new' industries were still of limited quantitative significance even by the later 1930s,(40) and their contribution to the absorption of labour released by the staple industries was overshadowed by the employment growth of the service sector.(41)

(2) A recovery of the staple industries would have stimulated demand for the products of the 'new' industries, both directly (induced demand) and indirectly through the operation of the multiplier process on aggregate demand.

(3) Since the external balance was precarious throughout the 1930s, a recovery of the export industries was necessary to prevent an external constraint to increased domestic demand.

The authorities' preoccupation with a revival of the staple industries was thus not misplaced.

Secondly, quantitative reference should be made to the interwar growth performance. The problems presented by such an exercise are particularly acute in the case of this period: apart from the perennial problem of attempting to isolate the trend from the cycle, cyclical fluctuations were particularly marked during this period, thus presenting difficulties in the selection of suitable initial and terminal dates for intertemporal comparisons. Indeed, much of the initial overstatement of interwar growth stemmed from Aldcroft's choice of a "variety of base years and sub-periods which distort[ed] the long-term trend."(42)

As was resolved earlier, the only legitimate dates for intertemporal comparisons are 1924 and 1937 (with an intermediate date of 1929). On this basis, real GDP grew at 2.2% per annum, a result which compares favourably with the earlier period 1856-99,(43) especially when account is taken of the economic loss resulting from the persistence of mass unemployment.

Whilst, on trend, the behaviour of GDP approximated to that of earlier periods, cyclical fluctuations were far more pronounced. Matthews calculates that the amplitude of GDP fluctuations was over twice as strong 1920-37 as 1872-1914, and over three times as strong as more recent cycles (1951-64),(44) the primary explanation being the strong cyclical behaviour of exports.(45) The seriousness of interwar cycles is clearly evident from Chart 1.2, the range of fluctuations in GDP (over 12 percentage points) being far greater than any post-1945 experience.*

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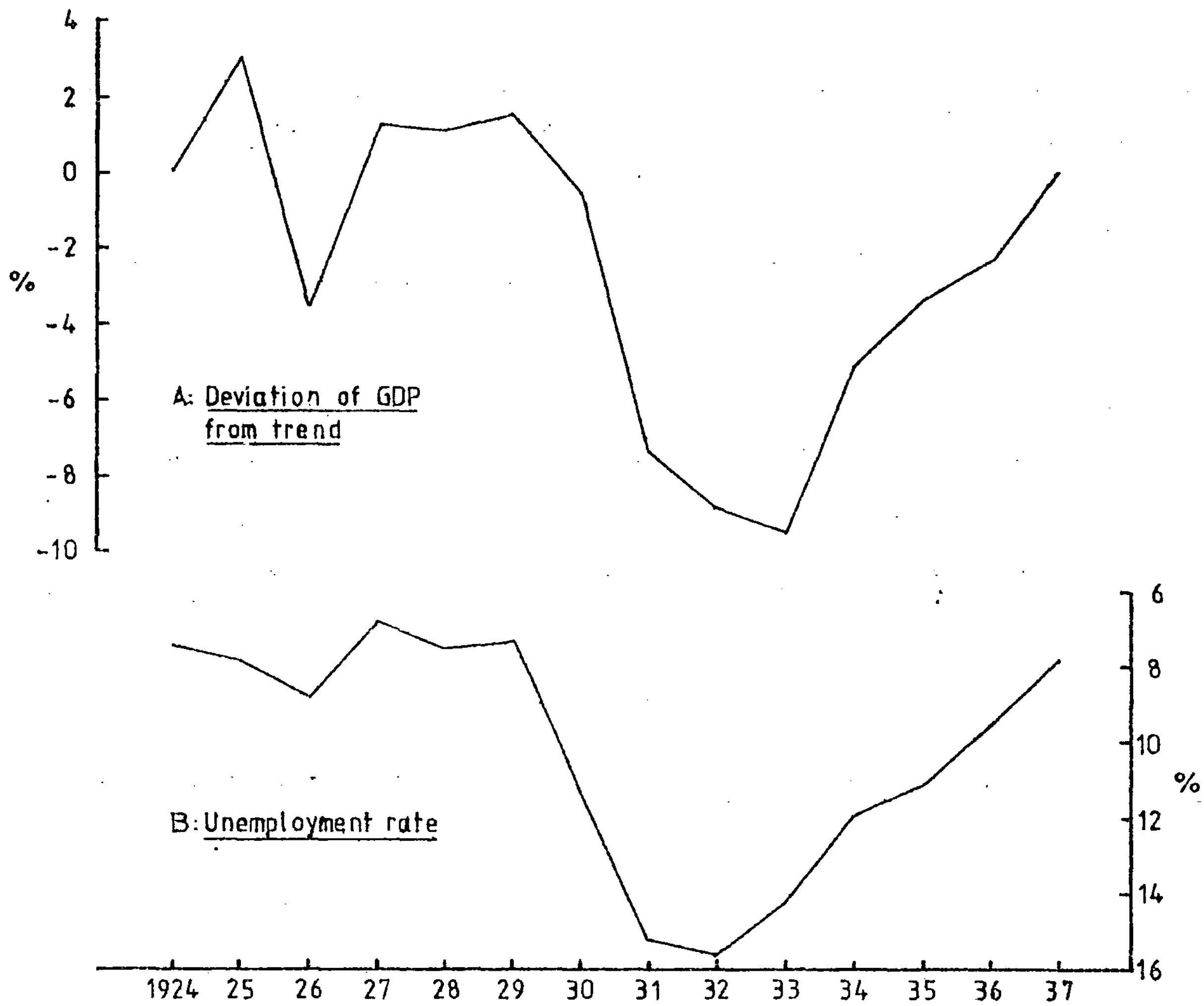
* In addition, Matthews (1969: 122-3) has estimated that even after allowance for lags, proportional fluctuations in employment in the postwar period have been not much more than one third of those in GDP, while in the interwar period employment fluctuated about as much as GDP.

Chart 1.2

Fluctuations in real GDP and unemployment 1924-37



SOURCE: Feinstein (1972: Tables 5, 57).

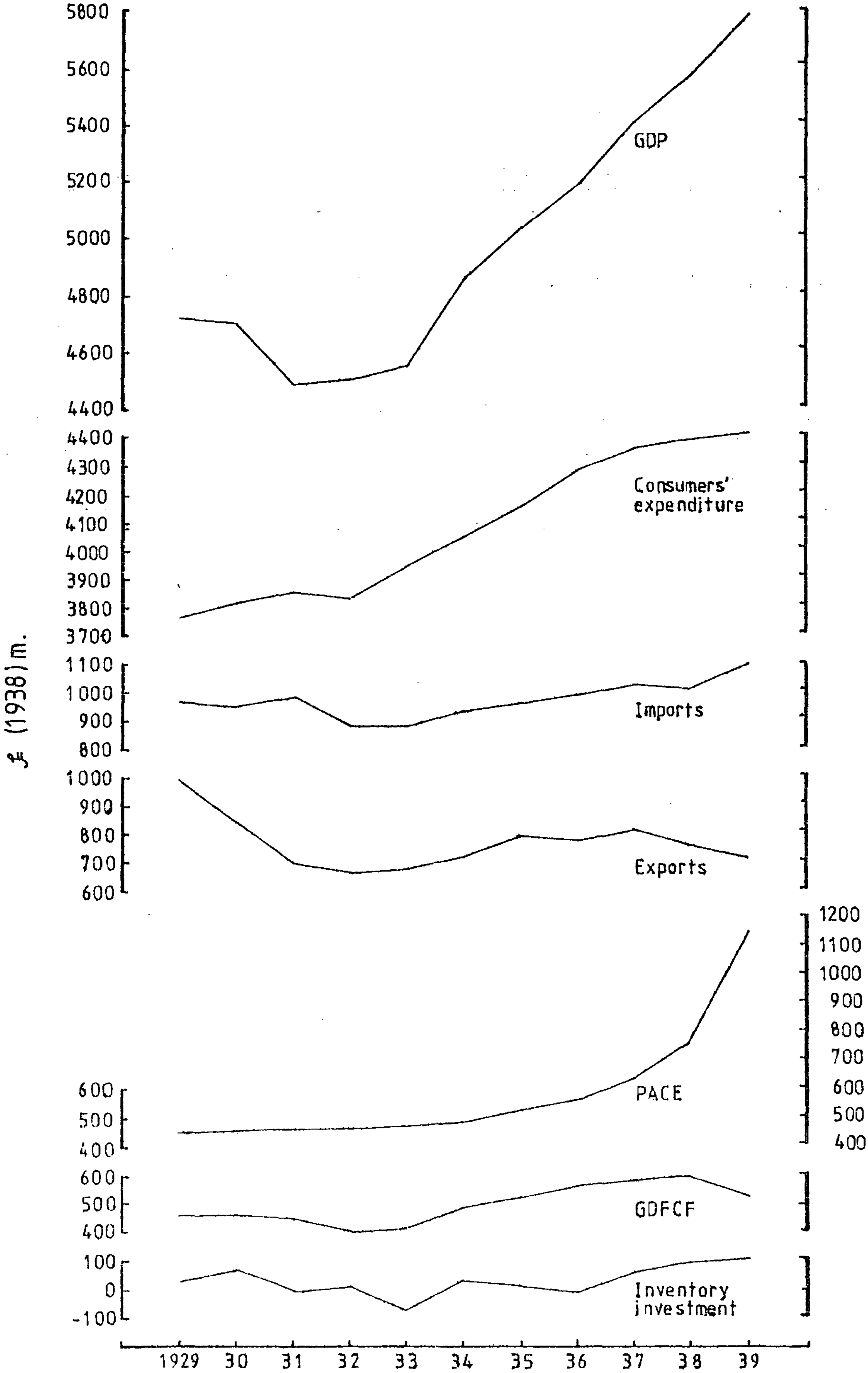
NOTES: A. GDP measured at 1938 market prices. The deviation of GDP from trend is measured as the percentage by which actual GDP varied from what it would have been had GDP grown constantly at the observed average rate of growth between 1924 and 1937.

B. Numbers unemployed as a percentage of the civilian working population.

Turning now to the more limited period under review (1929-39), the general picture of cyclical movements is summarised in Chart 1.3 which records annual figures for real GDP and its components. Three sub-periods, or cyclical

Chart 1.3

Real GDP and components 1929-39



SOURCE: Feinstein (1972: Table 5).

episodes,[46] can be delineated: depression 1929-32, recovery 1932-7, recession and rearmament 1937-9. The main features of each episode are now considered in turn.

(i) Depression 1929-32

The generally accepted interpretation of this episode is that the "economic blizzard of 1929-32 was something that struck Britain from outside",[47] depression being transmitted from the U.S.: (1) indirectly via the curtailment of U.S. foreign lending from mid-1928 which led to a reduction in the purchasing power of those countries which had a large demand for U.K. exports; and (2) more directly by cutting U.S. import demand for U.K. goods once depression had become established in the U.S.[48]

Exports both led at the upper turning-point (1929 III) and experienced the most pronounced losses over the subsequent depression period. As Table 1.4 shows exports fell by 32.2% over 1929-32 as compared with a fall of only 4.9% in GDP (the falls at current prices were much greater, respectively 47.3 and 9.5%).* Depression was not initiated by the bursting of a domestic boom; Britain had in fact failed to share fully in the world boom of 1925-9. Furthermore, as Richardson argues, the relative weakness of the previous upswing was to be a major factor moderating the depression after 1929.[49]

The mildness of the depression can be seen from Table 1.4, depression being only serious in the indicators for unemployment and exports. There were no autonomous internal sources of falling income, and a high floor to activity was

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* Given the downward course of interwar prices, real values are used throughout this study; nevertheless, the point should not be forgotten that the price falls of 1929-32 undoubtedly created the impression amongst contemporaries that the depression was more severe than it actually was.

Table 1.4

Economic indicators 1929-39

	% changes												
	1929-30	1930-1	1931-2	1929-32	1932-3	1933-4	1934-5	1935-6	1936-7	1932-7	1937-8	1938-9	1937-9
A. National income and components (constant 1938 prices)													
1. GDP	-0.1	-5.1	+0.3	-4.9	+1.1	+6.8	+3.8	+3.1	+4.3	+20.4	+3.0	+3.9	+7.0
2. Consumers' expenditure	+1.5	+1.1	-0.6	+2.0	+2.6	+2.9	+2.8	+2.9	+1.7	+13.5	+0.8	+0.5	+1.4
3. Imports	-1.4	+3.8	-10.8	-8.6	+0.1	+4.4	+4.9	+2.5	+3.6	+16.5	-2.2	+8.9	+6.5
4. Exports	-13.9	-19.4	-2.2	-32.2	+1.3	+3.8	+12.8	-2.9	+5.1	+21.1	-6.5	-7.5	-13.6
5. Public authorities' current expenditure	+2.5	+2.4	0	+5.0	+1.1	+2.3	+6.8	+9.1	+11.6	+34.5	+19.5	+51.4	+80.9
6. GDFCF	+0.4	-1.9	-12.8	-14.1	+3.3	+21.8	+4.0	+9.1	+3.4	+47.5	+1.4	-10.5	-9.2
B. Other													
7. Industrial production index (constant 1913 prices)	-4.3	-6.5	-0.4	-10.8	+6.6	+10.0	+7.6	+9.0	+6.0	+45.8	-2.7	..	..
8. Employment	-1.6	-2.7	+0.5	-3.7	+2.2	+3.2	+1.5	+3.0	+3.4	+14.1	0	+3.8	+3.8
9. Unemployment (series A)	+60.0	+37.5	+3.0	+126.7	-8.8	-16.1	-7.7	-12.5	-14.3	-47.1	+22.2	-40.9	-27.8
10. Unemployment (series B)	+58.3	+42.1	+3.7	+133.3	-10.7	-16.0	-4.8	-15.0	-17.6	-50.0	+35.7	-26.3	0
11. Retail prices	-3.7	-6.5	-2.8	-12.4	-2.8	+0.7	+1.4	+2.9	+5.6	+7.8	+0.7	+3.3	+3.9
12. Terms of trade	+9.2	+9.9	+0.7	+20.8	+2.8	-2.7	-1.4	-2.8	-5.8	-9.7	+9.2	-1.4	+7.6
13. Gross profits	-11.9	-10.1	-4.4	-24.3	+9.5	+8.5	+8.9	+12.2	+6.7	+54.9	-4.0	..	..

Sources: (1)-(6) Feinstein (1972: Table 5); (7) Ibid. Table 8; (8)-(10) as Chart 1.1; (11) Feinstein (1972: Table 65); (12) Ibid. Table 64; (13) Ibid. Table 26.

ensured by the continued growth of consumers' expenditure, a result of the downward inflexibility of wages and favourable movements in the terms of trade.

Furthermore, the U.K. depression was mild compared with the experience of other industrial nations: industrial production and incomes fell less than half as much as in Germany and the U.S.(50) The experiences of unemployment, however, were fairly similar. Unemployment (series B) rose from a lowpoint of 9.6% in June 1929 to a maximum of 23.0% in January 1933, an increase of over 1.8m to 2.979m insured unemployed. When adjusted for seasonal factors, the actual maximum of cyclical unemployment was reached in 1932 III, the lower turning-point for other economic indicators.

Given the severity of the depression experienced by the export trades,* and their geographical concentration, the most serious impact of the depression came at the regional level (Tables 1.1 and 1.2). As is argued later, the form of the depression posed problems for any attempt to stabilize demand by conventional (Keynesian) measures.

(ii) Recovery 1932-7

Following the depreciation of sterling in September 1931 there occurred a short-lived recovery (1931 III-IV), evident particularly in the export industries. The contemporaneous tightening of monetary and fiscal policy ensured that this recovery was not supported by a domestic stimulus and thus proved unsustainable, depression forces, being temporarily re-established from early 1932.(51)

It was not until 1932 III that recovery became established.

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* For example, the volume of coal exports fell by 35.5% over 1929-32, while iron and steel fell by 54.8% and cotton piece goods by 52.5% over 1929-31 (calculated from Mitchell and Deane 1962: 121, 148, 183).

The subsequent upswing (to 1937 III) was both strong and of (historically) long duration. Over 1932-7 GDP grew by 20.4%, industrial production by 45.8%, and employment by 14.1%. Unfortunately, the reduction of unemployment was not as impressive: from a (seasonally unadjusted) peak of 2.979m (23.0%) in January 1933 insured unemployment fell to a minimum of 1.404m (9.7%) in September 1937.*

Although impressive when viewed in aggregate terms, the recovery was uneven in its rate of progress and affected different sectors to varying degrees, characteristics which were to have important implications for economic policy. The first stage of recovery, from 1932 III to 1933 IV, saw a vigorous revival of activity, and by the end of 1933 "the economic situation was more favourable than at any time since June 1930. Abroad, on the other hand, the economic outlook remained bleak."[52] The recovery was thus initially domestically based, the export trades remained depressed - a reflection of the slow revival of world trade and the not unconnected increasing economic nationalism of the period. At a national level, the unemployment rate fell from 23.0% to 17.5% over January-December 1933, but this fall was extremely uneven as between the various regions. Against a 23.2% reduction in the aggregate numbers of insured unemployed, the regional figures were 32.4% for London, 34.3% for the South-east, 18.8% for the North-west, and only 9.3% for Wales.[53]

These disparities continued throughout 1934, a year in which the rate of recovery slackened as the initial stimulatory forces became exhausted, exports failing to rise

* The comparable figure for June 1929, the previous upper turning-point, was 1.176m.

as an offset to the reduced growth of domestic demand. Recovery was resumed, however, from the spring of 1935 and tended to assume different characteristics from the preceding phase. Firstly, costs began to rise with increasing intensity from late 1935 and shortages of skilled labour developed. Secondly, world trade began to recover and the export industries to revive, thereby ensuring a more broadly based reduction in regional unemployment rates. Finally, residential construction, which had been crucial in the upturn, started to slacken, but a revival of non-residential construction and producer goods output acted as an offset so that recovery was able to continue unabated until 1937 III. There then occurred a short, sharp recession.

(iii) Recession and rearmament 1937-9

As with the turning-point of 1929-30, exports played a crucial rôle in initiating the downswing of 1937-8,(54) and for depressing demand thereafter. From the behaviour of GDP in Table 1.4 it is not immediately apparent that 1937-8 constitutes a recession period; the course of unemployment, however, portrays a different and more illuminating picture. In fact, the downturn of 1937-8 was sharper than that of 1929-30, but the recession was not general.(55) While export volumes and consumer durables were both seriously affected, output of some industries continued to grow under the stimulus of the rearmament programme.

Insured unemployment rose from a lowpoint of 1.404m (9.7%) to a (seasonally unadjusted) peak of 2.134m (14.2%) in January 1939. The recession had, however, run its course by mid-1938, although a definite upturn was not evident until 1938 IV. Thereafter, recovery proceeded rapidly and, as is shown in later chapters, was largely determined by fiscal operations.(56)

3. Policy issues and policy constraints: a conspectus

It remains in this final section to discuss some broader aspects of the British economy of the 1930s, their relation to policy issues, and the way in which certain economic conditions - conditions largely unrelated to theoretical questions - were to constrain policy.

Firstly, the course of the British economy should be placed in an international context. The mildness of the depression in Britain, as compared with the experience of other industrial economies, has already been noted; mention should also be made of the fact that recovery occurred earlier in Britain than in many other countries, was stronger, and more complete.(57) In particular, the case of the U.S. economy under the Roosevelt administration was instructive: its limited recovery was taken as an object lesson by the British authorities of the dangers associated with unorthodox policies.* It therefore also served to reinforce the authorities commitment to orthodox policies in Britain.(58)

Whilst the case for orthodox policies in Britain was reinforced by the apparent failure of the more ambitious 'New Deal' policies in the U.S., a more direct constraint was to limit policy and the scope for complete economic recovery: that of the precarious external balance (see

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* The Treasury's resolve to avoid deficit-financing was also strengthened by the fact that the debt position was considerably less favourable in Britain than in the U.S. Even with a doubling of the federal debt over 1932-9, largely as a result of the 'New Deal' policies, the debt/GNP ratio only rose from 0.334 to 0.446 (calculated from U.S. Bureau of the Census 1975: I, 224; II, 1117), whereas in Britain, largely as a result of the heavy burden of war debts, the debt/GDP ratio averaged 1.53 over 1933/4-1938/9 (see Middleton 1981b).

Table 1.5

Balance of payments: current account 1929-39

	Current balance as % of GDP
1929	2.0
1930	0.8
1931	-2.4
1932	-1.2
1933	-0.2
1934	-0.5
1935	0.5
1936	-0.6
1937	-0.9
1938	-1.0
1939	-4.2

Source: Calculated from Feinstein (1972: Tables 3,15)

Table 1.5). Contrary to the Aldcroft-Richardson 'new orthodoxy' that the traditional view of the interwar period placed undue emphasis on poor export performance, the behaviour of exports - both on trend and over the cycle - was the most disturbing feature of the economy at that time, and one of the most potent constraints to the achievement of full employment.

Exports consisted primarily of capital and 'high-income' goods, overseas demand for which was highly income elastic.(59) Imports, on the other hand, were still dominated by foodstuffs and raw materials, the income elasticity of which was much lower.(60) An autonomous fall in world incomes, therefore, led to an immediate worsening of the British balance of payments: for example, the depression phase saw a move from a £96m current account surplus in 1929 to a deficit of £103m in 1931 (a deterioration unparalleled with anything of post-1945 experience). In these circumstances, a reflation of British domestic demand (uncoordinated with an international relation),* might have involved serious

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* See Committee on Finance and Industry (Macmillan Committee), Report, Cmd. 3897 (1931), esp. paras. 306-19. Economists in the early 1930s pressed for a coordinated international reflation, by a combination of monetary and fiscal measures,

consequences for the balance of payments, and considerable risks for the continued pre-eminence of London as a world financial centre.

Nor, on trend, was the export position satisfactory. Over the period 1924-37, exports fell by 12.2%, while imports rose by 17.5% and GDP by 27.7% (at constant prices). Accordingly, the importance of the foreign trade sector declined: the export/GDP ratio, which had been 0.324 in 1913, fell from 0.272 in 1924 to 0.232 in 1929, and 0.159 in 1937.(61) The full significance of Britain's deteriorating export position is evident when viewed in the context of world trade: U.K. exports as a proportion of total world trade fell from 13.9% in 1913 to 10.2% in 1937, and in world manufactures from 29.9% to 22.4%.(62) Since the current balance was also deteriorating over this period, from a surplus of 9.3% of GDP in 1913 to a deficit of 0.9% in 1937, and since at least one million were unemployed throughout, a higher level of activity could only have been sustained by measures to rebuild Britain's export industries and/or curtail imports. Even after the insulation of the domestic economy and the more flexible exchange rate policy after 1931, a trade-off between full employment and external balance, such as has plagued the post-1945 economy, was a distinct possibility.

A second possible constraint to the achievement of full employment concerned the elasticity of aggregate supply and the related question of the seriousness of

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but such a policy never received unilateral governmental support, as instanced by the collapse of the 1933 World Economic Conference. It should be said, however, that the reluctance of governments to adopt this approach stemmed, not from doubts about its potential benefits, but from general uncertainty and domestic political pressures which made it difficult to abnegate the freedom to pursue an independent policy.

Britain's structural unemployment problem. Contemporary economists assumed a practically horizontal supply function in the early stages of recovery,(63) an assumption borne out by the stability of prices over 1932-5. From mid-1935 onwards, however, costs and prices began to rise with increasing intensity,* not only as import prices rose but also as structural imbalances developed in labour markets,** there being sufficient excess demand in some sectors to force up wages despite the continuance of heavy unemployment in many other sectors.(64) By the time the upper turning-point had been reached in 1937, "there [were] widespread complaints of shortages of labour and delays in production",(65) and this at a time when there were still 1½m or so unemployed nationally.

Supply constraints thus came into operation long before anything approaching full employment had been attained; indeed Richardson argues that:

> the similarity between the unemployment levels of 1929 and 1937 suggests that cyclical unemployment had been eliminated by the middle of 1937 and that the continuance of heavy unemployment is to be explained by other causes rather than by a failure of recovery. (66)

In this view, cyclical full employment had been reached by 1937 III, and a further stimulus to aggregate demand (irrespective of whether it was private or public sector induced) would not, at least in the short-term, have led to further increases in aggregate output, rather supply constraints would have ensured that the additional demand was exhibited in rising prices.(67)

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* The Board of Trade index of wholesale prices rose 27% between July 1935 and its peak in July 1937.

** A similar development is noticeable in the U.S. economy during 1936-7, a time when there was still considerable general excess capacity (Arndt 1944: 59).

Underlying such an argument is the distinction between structural and cyclical unemployment.[68] Although it is difficult to develop satisfactory criteria for the empirical testing of the structural and cyclical components of total unemployment, a practical distinction can be drawn between them. Structural unemployment can be defined as that form of unemployment specific to certain industrial sectors and resulting from technological and market forces which are exogenously determined. Cyclical unemployment, on the other hand, is more general and more readily responsive to change in aggregate demand.[69]

It should not be inferred, however, that structural unemployment cannot be reduced by an aggregate demand stimuli. Neither economic theory, nor general experience since 1945, would warrant such a conclusion. Nevertheless, it is also clear that certain qualifications need to be made about the efficacy of an aggregate demand stimulus in the circumstances of the interwar period: these circumstances were in some sense unusual (the seriousness and nature of the regional problem), while the subsequent continuance of regional imbalances in unemployment rates in the postwar period (when the average pressure of demand has been significantly higher than prewar) suggests that there is no automatic mechanism whereby a uniform equilibrium results in all sectors of labour markets.[70]

This line of inquiry has largely been neglected to date,[71] and while no detailed analysis is here attempted, reference should at least be made to certain relevant considerations: firstly, income multipliers for disadvantaged regions are generally smaller than their national counterparts;[72] secondly, the depressed areas were handicapped by an unfavourable industrial base, one dominated by declining industries dependent upon export markets; thirdly, although migration from the depressed to the more prosperous areas was not insubstantial,(73) there was a discernible 'mismatch' between the labour released by the contracting industrial sectors and that required by the expanding sectors; and fourthly, the prolonged nature of unemployment in the depressed areas resulted in a marked deterioration in the quality and potential employability of this substantial constituent of total interwar unemployment.(74) Here, as with the previous difficulty, substantial retraining and government assistance would have been required, existing provisions being manifestly inadequate.(75)

These questions are explored further in the final chapter of this study, where they are related to official views on the constraints that might lessen the efficacy of deficit-financing and public works schemes. Before turning to policy issues, we conclude that while, ceteris paribus, a stimulus to aggregate demand was a not inappropriate remedy for Britain's interwar unemployment problem, it seems also that this would have had to be supplemented by both selective demand management measures and action to lessen supply constraints.

CHAPTER 2
THE TREASURY, ECONOMIC POLICY, AND PUBLIC EXPENDITURE

A review of the expenditure side of the budget accounts is a necessary first step in any investigation of both budgetary policy and its impact on the course of economic activity. The chapter starts with a discussion of the Treasury as an institution, its functions, and the forum and conditions under which economic policy was formulated. The course and pattern of public expenditure are then surveyed, and their behaviour related to the trend and cyclical path of GDP. Finally, there follows a discussion of expenditure control and the suitability of existing arrangements for demand management purposes.

1. Economic policy and the Treasury[1]

Amongst the many charges that have been levelled against the Treasury, perhaps the most important has been, and continues to be, the criticism of its inherent scepticism towards new ideas, its reactive character, and almost anti-intellectual bias.[2] It is because of this, and as a reaction to the supposedly unenlightened policies of the interwar years, that there were frequent complaints regarding the dominance of the Treasury in economic affairs.[3]

The achievement of this dominant position by the Treasury has a long lineage,[4] but need not concern us here; it is sufficient to note that during the interwar period the Treasury's influence, in terms of both financial control and the power exercised by virtue of its position as the central department of state, was strengthened by the appointment in 1919 of Sir Warren Fisher as both official

Head of the Civil Service and Permanent Secretary of the Treasury,(5) and by a number of administrative reforms instituted to augment and modernise the existing system of financial control which had been largely unchanged since the Gladstonian reforms of the 1860s.(6)

Two questions suggest themselves: firstly, the consequences of Treasury pre-eminence for the acceptance of the 'new' economics;* and secondly, the validity of the traditional interpretation of the authority and influence exercised by the Treasury. The former question is considered in later chapters; with regard to the latter, much confusion has arisen in interpreting the development of Treasury thinking because many previous studies have viewed the Treasury from too narrow a perspective, in that they have largely ignored the fact that economic policy resulted not from economic forces alone but from the continual interplay of political and economic forces operating at a number of levels of government and ultimately being resolved as much with reference to the political expediency of a policy as to its economic efficacy. To take but one example, the Treasury has repeatedly been accused of unnecessarily restricting the growth of expenditure during the interwar years and for misguidedly enforcing rigorous economy cuts in 1921-2 and 1931-2 - occasions when the stabilization

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* Throughout the following chapters, the term the 'new' economics is used generally as consisting of the writings of Keynes from the late 1920s onwards; the work of the main disciples, Joan and Austin Robinson, Richard Kahn, Roy Harrod, James Meade, and Nicholas Kaldor; and others such as Arthur Salter and Harold Macmillan who, while not themselves directly contributing to the developments in theoretical economics of the period, actively supported the new approach at a political level and were influential in its eventual official acceptance. An excellent account of the theoretical work of many of these economists is contained in Shackle (1967), while Harris (1947), Lekachman (1964; 1967), and Davis (1971), look more broadly at Keynes and the 'new' economics.

objective demanded the opposite course. Yet as one official, active in the 1930s, put it many years later:

> The idea that it was a strong Treasury holding down spending between the wars misunderstands what was happening. It was in fact an economic doctrine permeating everywhere - Parliament, ministers, officials, press - everyone. Even to labour and trade union people the economic laws seemed clear-cut. They really believed these economic laws and were ready to cut expenditures. (7)

Furthermore, nor is the accusation well-founded that expenditure growth was excessively constrained, at least when measured against income growth. The observed elasticity of public expenditure growth relative to GDP growth was 1.60 for the interwar period (1924-37) and only 1.21 for the period 1960-76.[(8)]

The fact that the Treasury was compelled to respond to a variety of pressures - Parliamentary opinion, the City, industrial interests, and the reconciliation of conflicting departmental interests - as well as the strictly economic needs of the time, made the Treasury cautious in its outlook, averting risks wherever possible, and deeply sceptical of the demands of politicians and economists, such as Lloyd George and Keynes, who the Treasury believed failed to take account of the full ramifications of the policies they were advocating.

These characteristics applied to all spheres of policy formulation and execution. One area in which this bias towards risk aversion was particularly evident was in the Treasury's attitude towards new directions in budgetary policy. For example, during the interwar period, the proposal was frequently made that, as a measure to stimulate demand, the authorities should reduce income tax, even though it necessitated initially unbalancing the budget, because it would greatly stimulate economic activity which, in turn, by acting on endogenous budget items (notably the income tax yield and outlay on unemployment benefits), would more than fully compensate for the initial deficit.(9) The Treasury contemptuously termed this the 'act of faith theory',(10) for they felt that the potential benefits (if any) of such a policy were far out-weighed by the accompanying risks.(11) It is at this point that adherence to budgetary orthodoxy assumed a political significance, a theme explored in later chapters.(12)

The locus of Treasury authority within Whitehall was its institutional position at the financial and political centre of government. This position rested on the control of expenditure, for it was this which endowed the Treasury with political power, and made it the most politically conscious of all the departments.(13) This followed not only from the fact that "Most actions of government have financial aspects which automatically bring them into the Treasury's orbit",(14) but also from certain essential features of bureaucratic government, whereby "political institutions are [not] mere filters through which economic forces are automatically translated into policies ... as though these filters have little if any effect upon the outcomes."(15)

In general, Chancellors of the Exchequer during the interwar period had little direct experience of financial policy questions.* In these circumstances it might be supposed that Treasury power was strengthened; for example, Amery's comment about Chamberlain: "the Treasury and City

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* The sole exception was Sir Robert Horne, Chancellor from April 1921 to October 1922.

influences were too strong for a Chancellor ... who, unlike Horne, never really understood monetary problems."(16) The official papers show this view to be fallacious; Chancellors were not mere ciphers, the vehicle whereby Treasury officials transmitted policy advice to the Cabinet. Although there were occasions in which Chancellors did not immediately concur with Treasury advice on important policy issues, there was no question of a Chancellor (or the Cabinet) acquiescing in a policy which they deemed unacceptable. Where a Chancellor was initially unconvinced by the correctness of a policy (e.g. Churchill and the return to the gold standard),(17) it is quite clear that in order to gain the eventual assent of the Chancellor the Treasury officials had to construct extensive justifications for a policy. Treasury officials, then, derived their authority and influence not from the weakness of Chancellors in technical questions,* but from their political strength within Cabinet and Parliament.

As a result of Fisher's administrative reforms, which consolidated and strengthened the Treasury, a wider range of policy questions came into the Treasury's domain. In addition, changes brought about by the First World War, and longer-term trends which had been in operation before 1914, led to a

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* A Chancellor lacking in authority would have seriously weakened the Treasury's position. Such a possibility might have arisen after May 1937 when Simon replaced Chamberlain as Chancellor; it was prevented by the fact that Chamberlain was now Prime Minister and that defence and financial policy questions had become so inextricably interconnected. Simon (1952: 227) recorded in his memoirs his apprehension at, and lack of experience for, becoming Chancellor. His misgivings may not have been unfounded, for by January 1940 his unpopularity was such that Chamberlain, Horace Wilson [Permanent Secretary, Treasury 1939-42] and Norman [Governor, Bank of England] were involved in secret negotiations to replace him by Stamp [Chairman, L.M.S. Railway, and government adviser on economic policy] (Colville 1976: 72-3; Jones 1964: 337-40).

significant widening of the Treasury's responsibilities in economic affairs. The "Treasury's traditional areas of responsibility - budgetary control and debt management - changed both in substance and in magnitude", while at "the same time, the Treasury's responsibilities extended into new areas which either did not exist before the war, or else were not regarded as being the concern of central government."[18] Yet the Treasury has repeatedly been criticised for the "lack of any perception of the impact which [their] administration might have on the economy, [and for] the absence of any idea of the macroeconomic implications of their actions".[19] Such a conclusion may have been permissible in the years before the Treasury papers were made available to researchers, for undoubtedly there was a paucity of material with which to judge the Treasury's interwar performance;[20] yet the foregoing assessment was made in 1972, and as such is totally unacceptable. It erroneously assumes, both that it is permissible to view the interwar Treasury by the standards of modern economic management and that prevailing political conditions can be discounted, conditions which prior to the late 1930s were unpropitious to the development of those very objectives of economic management against which policy is here being appraised. Similarly, to cite Heath's (1927) minimalist definition of the Treasury's rôle, as being "the Department which, subject to the control of the executive and to the authority of Parliament, is responsible for the administration of the public finances of the country," and from this to argue that the failures of interwar policy are hardly surprising,[21] is to create a misleading impression of the actuality of Treasury responsibility for the economy. In formal terms, these responsibilities may have been narrowly defined, but the point at issue is the actual nature of Treasury responsibility and its implications for the economy.

It is this attempt to try and view the Treasury as operating in a vacuum, unrelated and unresponsive to prevailing political conditions, that lies at the heart of much confusion and misunderstanding of the Treasury's economic position between the wars. Reference was made earlier to the fact that the outcome of economic policy decisions was as much a function of political pressures as economic conditions.(22) In reaffirming this point, it should be stressed that it would be mistaken to postulate a situation whereby the Treasury forced their view against Cabinet opposition. While certain politicians complained of the limitations placed upon policy by Treasury cautiousness,* in general terms there was a coincidence of interests and views about the <u>essentials</u> of economic policy.

Treasury authority was also subject to certain additional constraints, the most important of which was that 'Treasury control had no basis save the authority in the Cabinet of the Chancellor of the Exchequer. If this authority is overborne, the Treasury must comply."(23) The two main Chancellors of the period - Snowden (1929-31) and Chamberlain (1931-7) - were both politically strong figures, largely unchallenged within their Cabinets, the latter rising to Prime Minister (1937-40). Although criticised for excessive financial orthodoxy,(24) by both

* For example, MacDonald and certain junior ministers felt strongly in 1932-3 that the Treasury was being unnecessarily restrictive in its opposition to a limited resumption of public works (P.R.O. 30/69/1753, MacDonald Diary, 29 Jan. and 5 Feb. 1933).

their colleagues and wider political opinion, they were able to carry their Cabinets on all major policy issues. There was also the ultimate threat, that of resignation,[25] which, with its serious repercussions both politically and on confidence, could be evoked in order to strengthen the Treasury's case. Such a threat was used by Chamberlain in 1935, both in order to prevent Lloyd George being admitted to the Cabinet and to limit the extent of any resumption of public works expenditures,[26] a subject under review as a consequence of the political threat posed by Lloyd George's 'New Deal'.[27]

Equanimity within Cabinet was not simply a reflection of the general consensus of opinion on financial issues, it was also a result of the way in which Treasury officials sought first to generate such a consensus at a departmental level. Whilst each department had a separate identity and outlook ("a store of knowledge and experience in the subjects handled ... a departmental point of view"),[28] there was also what might be termed a 'Whitehall view', a practical philosophy of government that transcended departmental boundaries. Within the higher civil service there was "a strong tendency to reach agreement and, where conflicts occur, to find as quickly as possible a generally agreed resolution", the objective being to obviate the need for ministerial intervention.[29] This bureaucratic characteristic was reinforced during the interwar period by Fisher's resolve that relations between the departments be improved, "that the administrative class of the Civil Service should be looked on as a single <u>corps</u> <u>d'elite</u>",[30] and that policies should be coordinated through inter-departmental committees.

Apart from exclusively budgetary matters, questions of economic policy were frequently discussed by inter-departmental committees (at both official and Cabinet levels) representing the main economic departments. This form of decision making carried with it certain implications:

> The great value of the Whitehall process with its numerous inter-departmental committees and its stress on clearing matters at all levels with interested departments is that any course of action finally agreed upon is usually practicable, at least it is practicable in the eyes of Whitehall. Included in the term practicable is the acceptance of the policy by all the departments who will have some part in its administration. <u>The danger inherent in the process, indeed in any process in which a large number of interests and considerations have to be taken into account, is that the ideal course of action may be completely lost sight of in the discussion of departmental difficulties and objections</u>. (31)
> [Emphasis Added]

It is contended that this style of decision making invariably resulted in a bias against policies, which, irrespective of their economic merits, posed considerable administrative difficulties. This, and the civil service's highly developed sense of caution,[(32)] explains the poor response to the considerable administrative challenge posed by Britain's interwar economic difficulties.[(33)]

The existence of policy views, widely shared and extending onto an inter-departmental level, also raises problems of a different order: those for the interpretation of the origins of policy and the channels whereby advice was transmitted to the Cabinet. Firstly, such problems of exegesis derive from the fact that a departmental view was "not something which ha[d] been imposed on a Department by any one individual ... [but] in most cases [was] the result of nothing more startling than the slow accretion and accumulation of experience over the years".[(34)] The manner in which a departmental view evolved is of especial relevance to any assessment of Treasury economic policy, and most particularly the 'Treasury view' on public works. From the way in which Hopkins* gave evidence to the Macmillan Committee in 1930,(35) it might be supposed that the 'Treasury view' originated from Hopkins, or alternatively from very senior Treasury officials. In fact, this was not the case; as will be shown in a later chapter,(36) the opposition to large-scale public works was essentially a 'Whitehall view'. Whilst the theoretical, or strictly economic, constituent of this view was publicly expressed by the Treasury, the views so expressed reflected inter-departmental experience of administering public works schemes since the early 1920s.

In interpreting the basis of the 'Treasury view', indeed a wide range of economic policy issues, the question arises as to whether the Treasury adhered to a formal and explicit theory of economic operations, or whether policy decisions and views were founded on a practical and administrative philosophy of government which owed little to such considerations. In resolving this question, it should be noted from the outset that the Treasury documents are not an entirely satisfactory source for this purpose. Both in its internal papers, and in public statements by Chancellors, the Treasury rarely expressed its general views about economic policy or theoretical issues; almost without exception, statements were limited to an opinion about specific questions. Thus discretion needs to be exercised, and the records used assiduously, whenever conclusions of a general nature are drawn.(37)

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* Sir Richard V. N. Hopkins, Controller of Supply Services, Treasury 1927-8; Second Secretary 1928-42; Permanent Secretary 1942-5.

Finally, reference should be made to a related difficulty: that many subjects are only infrequently mentioned in the papers, even important issues such as the reasons for the continuing allegiance to balanced budgets. This seems to have been a result of certain characteristics of the Treasury as an organisation,(38) and of the personalities of its senior officials.* The nature of policy deliberations, and the way in which a departmental view emerged, were such that senior officials,(39) in large measure, shared a common ground in their approach towards specific issues. This common ground was based on a number of unstated assumptions - for Treasury officials "shared a commonality of background, education and ideals that tended to produce homogeneity and conformity in advice and practice"(40) -, which it was felt unnecessary to record in the papers.(41)

2. The course of expenditure

The First World War resulted in an unprecedented expansion of the public sector,(42) an expansion manifested both in the extension of the range of economic activities subject to state control and in a near doubling of the ratio of public expenditure to GDP.** Whilst in the years

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* Of these, Hopkins was undoubtedly the most important: "with varying titles and in differing forms of organisation, he was the chief adviser to the Chancellor ... on all important aspects of financial policy and on the control of Government expenditure" ('Sir Richard Hopkins' 1956: 117); or as Beloff (1975: 213) put it: "It is hard not to believe that [Hopkins] ... must have been more important in his own right than many cabinet ministers." Apart from Hopkins and Fisher, other Treasury officials of note were: Sir Frederick Phillips (Assistant Secretary 1919-27; Principal Assistant Secretary 1927-31; Deputy Controller 1931; Under Secretary 1932-9); Sir Frederick Leith-Ross (Deputy Controller of Finance 1925-32; Chief Economic Adviser to H. M. Government 1932-46); and Sir Ralph Hawtrey (Director of Financial Enquiries 1919-45).

** Public expenditure as defined in Table 2.1

immediately preceding the war the expenditure ratio had followed an upward course, this increase (largely due to the Liberal welfare reforms) was to be completely overshadowed by developments occasioned by the war.

Table 2.1

Public expenditure by economic category as % of GDP, selected years 1913-37*

	Current goods and services	Gross capital formation	Subsidies and grants to private sector	Current grants paid abroad	Debt interest	Total
1913	8.1	1.2	0.9	-	1.7	11.9
1920	8.2	1.7	4.7	0.2	5.7	20.5
1924	9.0	2.2	4.3	0.2	7.9	23.6
1929	9.2	2.6	4.9	0.1	7.7	24.5
1932	10.1	2.8	7.2	0.1	7.8	27.9
1937	11.7	3.3	5.6	0.1	5.3	25.9

Source: Feinstein (1972: Tables 3, 14, 39).

Notes: * Public expenditure is here defined as current and capital expenditure by central and local government plus capital expenditure by the public corporations.

From 0.119 in 1913 the expenditure ratio rose to a peak of 0.436 in 1918. Following the end of the war expenditure was sharply curtailed: as Table 2.1 shows the expenditure ratio had fallen to 0.205 in 1920, by which time (nominal) expenditure stood at over four times its 1913 level. Thereafter, further reductions in expenditure were hindered, firstly, by the conflicting nature of the government's social and fiscal policy objectives and, secondly, by the unfortunate concatenation of a change in economic conditions (1920-1) which was to make neither of these objectives attainable. On the one hand, the government's social policy, known popularly as a 'Land fit for Heroes', implied an increase in its expenditure commitments;(43) on the other hand, since the Cunliffe Committee Interim Report of November 1918 the prevailing economic view had been that expenditure must be drastically reduced,[44] for only by this method could inflation be controlled* and there eventually follow a reduction of taxation from its wartime levels and a return to the gold standard at prewar parity.[45] In the debate that ensued within government, the latter group of objectives prevailed and budgetary policy was tightened considerably (on both the revenue and expenditure sides) during 1919-20. Of course, the irony was that the recession that followed (1920 II-1921 IV),[46] a recession at least partially induced by deflationary fiscal operations,[47] was itself to frustrate temporarily further efforts to reduce expenditure.

The net effect of these developments was that the expenditure ratio continued to rise, by a further 5.1 percentage points of GDP over 1920-2. Expenditure, in nominal terms had fallen (by 4.6%), but the fall in GDP was very much greater (23.5%). Thus at an early stage there appeared a problem that was to bedevil all interwar governments in their budgetary policies, the problem of the irreconcilability of the balanced budget rule with a budget structure, the characteristics of which was its sensitivity to cyclical fluctuations. In the prewar period, the interrelationship of the budget to the economy, and the implications of this for budgetary policy, was a problem that never raised itself to any important degree. The enlargement of the public sector brought about by the war,

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* Postwar inflations were not limited to the continental European countries, such as Germany. Indeed, the most rapid rate of inflation ever experienced by Britain in modern times occurred in the postwar boom of 1919-20. According to the Board of Trade wholesale price index the inflation rate was 42.5% between April 1919 and April 1920, and at its worst (July 1919-February 1920) it reached 55.2% on an annualised basis (data from Pigou 1947: App.III, Table IV). The experience of this inflation was to be a potent reminder throughout the interwar period of the consequences, ceteris paribus, of large-scale deficit finance.

however, changed conditions fundamentally: public expenditure had reached such a proportion of GDP that this interrelationship could not be ignored. Indeed, in a sense, the history of subsequent developments revolves largely around the authorities attempts to come to terms with this essential (Keynesian) economic truth. In addition, difficulties are also raised for any assessment of the impact of fiscal operations; a subject explored later.(48)

After further economies were made during 1922-3, the expenditure ratio then exhibited a slight upward trend for the remainder of the period under review, rising from 0.236 in 1924 to 0.259 in 1937. Around this upward trend the ratio fluctuated pro-cyclically: as with the fall-off in economic activity of 1920-1, the depression of 1929-32 was also accompanied by a sharp upward movement; this was followed by a fall in the middle 1930s as recovery progressed; and finally the later 1930s were to witness a resumption of the upward movement, this time mainly as a result of rearmament although the 1937-8 recession was also a contributory factor (see Chart 2.1).

From Table 2.1 the enlargement of the public sector, as compared with prewar, can be seen to be the result of the greatly increased expenditures on debt interest and on subsidies and grants to the private sector. Both categories of expenditure constitute transfer payments, and as such do not represent direct claims upon resources (current expenditure on goods and services and public authorities' capital formation). Whilst transfer payments increased more than direct expenditures over 1913-20 (respectively from 2.6 to 10.4% of GDP and from 9.3 to 9.9% of GDP), over the subsequent period the trends were reversed: between

1924 and 1937 transfer payments fell from 12.2 to 10.9% of GDP while direct expenditures rose from 11.2 to 15.0% of GDP. Thus within the total of public expenditure, and in relation to GDP, the public sector's claim on resources was growing throughout the interwar period.*

A number of general features underlay the upward trend of expenditure between the wars, factors which can be grouped under two headings: those that were largely exogenous or independent of policy, and those endogenous factors which in large measure were the consequences of policy and of the problems of the British economy.

Under the first heading, account should be taken of the various war-related expenditures, such as pensions and disability allowances, and of certain demographic changes which were to influence the pattern of expenditure. In particular, as was noted above,[(49)] the falling birth rate resulted both in a rising proportion of the population who were economically active and of those of retirement age, the net effect being additional demands for pension support and, given excess supply in labour markets, for outlay on unemployment benefits.

With regard to the largely endogenous influences, of particular importance was the continuously high level of unemployment, which was to affect total expenditure both

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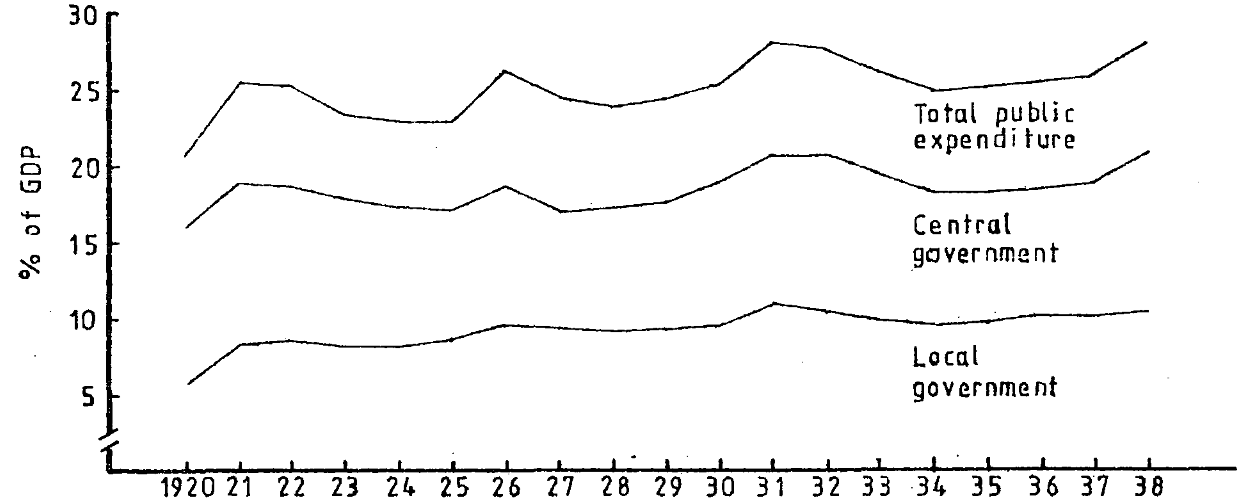
* Mention should be made, however, of one sphere in which the general trend of an extension of the public sector did not operate to such a marked degree, that of employment (see Abramovitz and Eliasberg 1957). Public sector employment had expanded during the war (from 4.2 to 6.9% of total employment 1911-20), but as with expenditure, was curtailed in the immediate postwar period. Thereafter, public sector employment was only to rise marginally faster than total employment, increasing its share from 5.1 to 5.3% over 1924-37 (Feinstein 1972: Tables 57, 59, 60). There were, however, important compositional effects: employment in local government rose continuously and increased both relatively and absolutely, whereas central government employment fell until the later 1920s and the defence forces until the early 1930s.

Chart 2.1

Expenditure ratios 1920-38



SOURCE: Calculated from Feinstein (1972: Tables 3, 12, 13, 14, 39).

directly and indirectly. The direct influence operated through benefit payments and relief work expenditures for the unemployed; the indirect influence was broader in effect and of greater significance.

Whilst it might be supposed that the difficult economic conditions of the period would have served to frustrate demands for further social reforms, and therefore to have acted as a constraint to the continued growth of expenditure, in fact the opposite seems to have been the case. As was noted by contemporaries,(50) and in large measure has been confirmed by more recent experience, economic failures such as heavy unemployment or a deteriorating standard of living can be a potent force intensifying demands for increased social expenditures. Accordingly, the upward trend of expenditure may be seen as another manifestation of the failure to resolve the unemployment problem. It should be noted, however, that the translation of these demands into increased expenditure

Table 2.2

Observed elasticities of public expenditure growth relative to GDP growth (current prices), 1924-37

	Central government	Local government	Total public expenditure
A.(1924-9)			
Current	1.27	2.84	1.39
Capital	..	4.19	3.83
Total	1.24	3.14	1.61
B.(1929-37)			
Current	1.46	1.34	1.29
Capital	5.04	2.86	3.49
Total	1.52	1.71	1.53
C.(1924-37)			
Current	1.41	1.98	1.36
Capital	3.05	3.72	4.03
Total	1.45	2.38	1.60

Source: Feinstein (1972: Tables 3, 12-14, 34, 36, 39).

was by no means automatically assured; it only resulted because there had occurred certain fundamental changes in political circumstances which were conducive to increased expenditure. The widening of the franchise and the emergence of the Labour Party, the two most conspicuous developments of the early twentieth century, were to create conditions of increased party rivalry and a political atmosphere whereby promises of increased expenditure were a powerful means of gaining electoral support.

The background to the interwar growth of the public sector has now been surveyed and the expenditure ratio used as an illustrative measure.* Table 2.2 gives estimates of an alternative measure: the observed elasticity of expenditure growth relative to GDP growth. Estimates are presented for 1924-37 along with two sub-periods; for total public expenditure and for expenditure by central and local

* Account has not, however, been taken of the relative price effect because of the uncertain direction in which it operated during this period.

government; and for current, capital, and total expenditures. The results show that in each case the observed elasticity was greater than unity; that for total public expenditure the elasticity was historically high;(51) that capital expenditure saw the most rapid expansion; and that it was local rather than central expenditures which were growing at the most rapid rate. The latter trend was of some importance and should now be discussed.

(i) Central government

From Tables 2.2 and 2.3 and Chart 2.1 two general features can be established: firstly, that the cyclical timing of the central government expenditure ratio was similar to that for total expenditure, the major difference being that the amplitude of fluctuations were greater in the case of the latter; and secondly, on trend central expenditures grew at a slower rate than total expenditure over the period as a whole, although in the 1930s the rates equalised as the pace of expansion quickened in the case of the former.

As was established above, the increased expenditure, as compared with prewar, was largely a function of greater outlays on debt interest and an extension of grants to the private sector. The significance of the greatly magnified debt burden is considered in a later chapter;(52) as regards the other transfer payments, the most important were the national insurance benefits and other expenditures related to social objectives, and the grants to local authorities which were raised considerably after the 1929 reforms.(53) The relative position of transfer payments was, however, to diminish as the period progressed - over 1924-37 current

Table 2.3

Cyclical behaviour of expenditure ratios

1. Total public expenditure

dates		1920-1	1921-5	1925-9	1929-31	1931-4	1934-8
expansion	% points	5.3		0.9	3.7		3.0
contraction	of GDP		2.2			3.2	

2. Central government

dates		1920-1	1921-5	1925-9	1929-32	1932-5	1935-8
expansion	% points	3.0		0.6	3.0		2.1
contraction	of GDP		2.1			2.3	

3. Local government

dates		1920-2	1922-3	1923-9	1929-31	1931-4	1934-8
expansion	% points	3.0		1.3	1.3		0.5
contraction	of GDP		0.5			1.0	

Source: Calculated from Feinstein (1972: Tables 3, 12-14, 34, 36, 39).

expenditure on goods and services and capital formation increased its share of total central expenditure from 25.5 to 35.1%, the main explanation being the reduced debt burden resulting from the lower interest rates of the 1930s.(54)

The course of the expenditure ratio for central government suggests that this sector exercised a stabilizing influence on demand during the depressions of 1920-1, 1929-32, and 1937-8. This, however, needs to be qualified, for the ratio will show an upward movement not only if the numerator (expenditure) increases but if the denominator (GDP) falls. Such, in fact, was the case with the first two of these cyclical episodes, so that difficulties are raised in assessing the stabilizing nature of expenditure. These can be illustrated with reference to the developments of the early 1920s.

Account should firstly be taken of the fact that, whilst the expenditure ratio rose by 3 percentage points of GDP between 1920-1 expenditure (expressed in nominal terms) only rose by 1.9%, and whereas between 1921-2 the expenditure ratio only fell by 0.3 percentage points the fall in expenditure was much greater (12.0%). The behaviour of GDP is thus crucial, but here there are also difficulties: at current prices GDP fell by 14.2% over 1920-1 and by 10.8% over 1921-2, but at constant prices GDP only fell by 5.8% over the former period and rose by 3.5% over the latter.(55)

The behaviour of prices, therefore, would also appear to be of some importance. Government expenditures, unlike revenue,(56) were largely unresponsive to price changes, but as already noted they varied directly with the level of economic activity. Nevertheless, the behaviour of the expenditure ratio over 1920-3 was not solely a reflection of these automatic changes; at the same time, the authorities were attempting to make discretionary adjustments to expenditure, both in total and in detail.

Mention should be made here of the Geddes Committee,(57) appointed following the alarm expressed during the budget debates of 1921 at the continued high level of expenditure at a time of falling revenues.(58) In its three reports it recommended economies totalling £86m, of which £46.5m was to come off Defence Votes and £18m from the provision of education services. The political reaction to these reports, and the government's defensive response, were to be a portent for the second major attempt at economy nearly a decade later, that of the May report of 1931.(59) Whilst in 1922 a consensus undoubtedly existed that expenditure should be reduced, for this would permit the reduction of taxation required to stimulate economic recovery, there was no such consensus about the form that the economies should assume. Consequently, there was a strong adverse reaction to these reports, even from within government (from the Admiralty),(60) and there was thereafter a marked reluctance to make economy a live political issue. In these circumstances it is understandable that the further efforts made at economy, of 1926 and 1928,(61) were limited in intent, and concentrated more on creating an atmosphere of parsimony which would constrain the further growth of expenditure than on making actual cuts in planned expenditures.

In essence, these difficulties epitomised the political changes of the early twentieth century which had created such powerful forces for the growth of expenditure: the strengthening of vested interests, the changed nature of party rivalry, and the beginnings of the debate about the legitimate rôle of the state in economic affairs. This debate was undoubtedly of great significance, not only for the genesis of demand management, but also because a consensus had to be established on the criteria by which the growth of expenditure was to be evaluated. Without such a consensus, periodic crises, such as those of 1922 and 1931, were inevitable.(62)

(ii) Local government

It remains to look at the local government sector, the expenditure of which, if not of equal weight to that of central government, was nevertheless of comparable importance. Indeed, as has been noted by previous writers,(63) if transfer payments are discounted, then the direct command of resources by this sector actually exceeded that of central government.* The weight of capital expenditures as between the two sectors was primarily responsible for this.

It should be noted, however, that the importance of local expenditure was diminishing in relation to total public expenditure when viewed from a rather longer historical perspective than that purely of the interwar period. The long-term growth of public expenditure (in relation to GDP) was accompanied, and in part caused, by a 'concentration' process, whereby there was an increased transference of responsibilities (and thereby expenditure) to the central authority.(64) This process was, on the one hand, limited by the strength of local autonomy, and, on the other, fostered by:

> economic development[s which] produce[d] changes in the technically efficient level of government, and also produce[d] demands for equality of treatment (e.g. in services such as education) over wider geographical areas. (65)

The strength of these opposing pressures is of some importance to the British case, and are considered later.(66)

The estimates in Table 2.2 showed that over 1924-37 the elasticity of expenditure growth relative to GDP growth was significantly higher for local than for central expenditures, and that the greatest difference between the respective elasticities was in the 1920s. We should therefore expect a rising ratio of local to total expenditures; however, at the same time, local government was also becoming increasingly

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* Current expenditure on goods/services and capital formation as % of GDP:

	central government	local government
1913	4.2	5.1
1920	4.8	5.0
1924	4.4	6.8
1929	4.2	7.6
1937	6.5	8.3

(Calculated from Feinstein 1972: Tables 3, 12-13, 34, 36, 39).

dependent upon central grants, particularly after the reforms of 1929. Such grants only constituted 17.4% of local government current revenue in 1913; this had grown to 24.6% by 1920, to 27.2% by 1929, and to 30.4% by 1937.[67] This situation arose because of the failure of local rates to keep pace with expenditure, a failure which stemmed partly from the technical deficiencies of rates as an income source and the erosion of that base - the 1929 de-rating scheme - by central directive. Thus local authorities were forced into a position of greater dependency upon central government,[68] a dependency that was to have implications for economic management.

(iii) Public authorities' investment

For any comprehensive assessment of the stabilizing effects on demand of government policies the analysis should not be confined to the behaviour of expenditure but should encompass the complete range of policy instruments. Nevertheless, in the first instance, it is legitimate to consider separately the behaviour of public authorities' investment, for a successful stabilization policy requires not only the stabilization of total demand but also its constituent parts. The balance of supply and demand in capital goods markets is thus of some importance.

The first step in such an analysis requires details of the composition of gross domestic fixed capital formation (GDFCF) and the demand leverage exercised by the public sector. Table 2.4 shows, firstly, that the private sector's contribution to GDFCF was significantly greater during the interwar period than during the more recent period 1967-77; thus, even given the absence of a commitment on the part of

Table 2.4

Gross domestic fixed capital formation by sector 1929-38

	Private	Public corpor-ations	Central govern-ment	Local govern-ment	TOTAL (%)	Total GDFCF as % of GDP
1929	72.2	0.5	3.4	24.0	100.0	10.4
1930	69.7	1.4	3.4	25.5	100.0	10.3
1931	65.2	2.5	3.4	28.9	100.0	10.5
1932	65.7	3.5	3.5	27.4	100.0	9.2
1933	73.7	2.8	2.8	20.7	100.0	9.5
1934	77.3	1.9	2.8	18.0	100.0	10.7
1935	74.8	1.5	3.1	20.6	100.0	10.9
1936	72.9	1.5	3.5	22.1	100.0	11.9
1937	69.7	1.6	4.0	24.7	100.0	12.2
1938	66.6	1.7	4.9	26.9	100.0	11.9
averages for periods:						
1924-9	70.0	-	3.8	26.2	100.0	10.1
1929-38	70.8	1.9	3.5	23.9	100.0	10.8
1967-77	57.4	18.1	5.6	18.9	100.0	19.0

Sources: 1924-38: Feinstein (1972: Tables 3, 39)
1967-77: C.S.O., National Income and Expenditure 1967-77 (1978), Tables 1.1, 10.1, 10.3.

government to the counter-cyclical control of its investment, autonomous fluctuations in GDFCF were likely to be of greater amplitude than if the private sector had been of smaller dimension.(69) The second feature of note is that the volume of capital investment undertaken directly by central government was small in relation to that of local government; for example, during the depression period 1929-32 an average of 3.4% of GDFCF was controlled by central government compared with 26.5% by local government. In terms of demand leverage, this gives figures of roughly 0.4 and 2.7% of GDP respectively, considerably less than that for the contemporary British economy. Two further points should also be made: firstly, whilst variations in public investment undoubtedly influenced GDFCF, it by no means follows that such investment could have been expanded sufficiently to fully compensate for autonomous fluctuations in private investment; and secondly, the fact that local authorities, rather than central government, largely controlled public investment had certain unfavourable results for economic management.

While Table 2.4 brings out the weighting of the various sectors in GDFCF, the presentation in Chart 2.2A better illustrates their cyclical and trend path.* Even this, however, is not completely adequate for our purposes: although the upward trend and cyclical fluctuations of GDFCF are clearly represented, the respective contributions of private and public investment are not immediately evident. Accordingly, the method adopted to assess the stabilizing effectiveness of public investment on GDFCF was to estimate the deviations (in volume terms) of public and private investment from their respective linear trends (at constant prices). The results are presented in Chart 2.2B. For stabilization purposes, an optimal result would be for the deviations of the public sector to offset those of the private sector, so that the two summed to zero, and where the elasticity (or coefficient) of public sector deviations with respect to private is -1.(70)

For the data shown in Chart 2.2B it proved impossible to obtain a statistically significant relationship.(71) However, the introduction of a one year lag, of public against private investment, did yield a statistically

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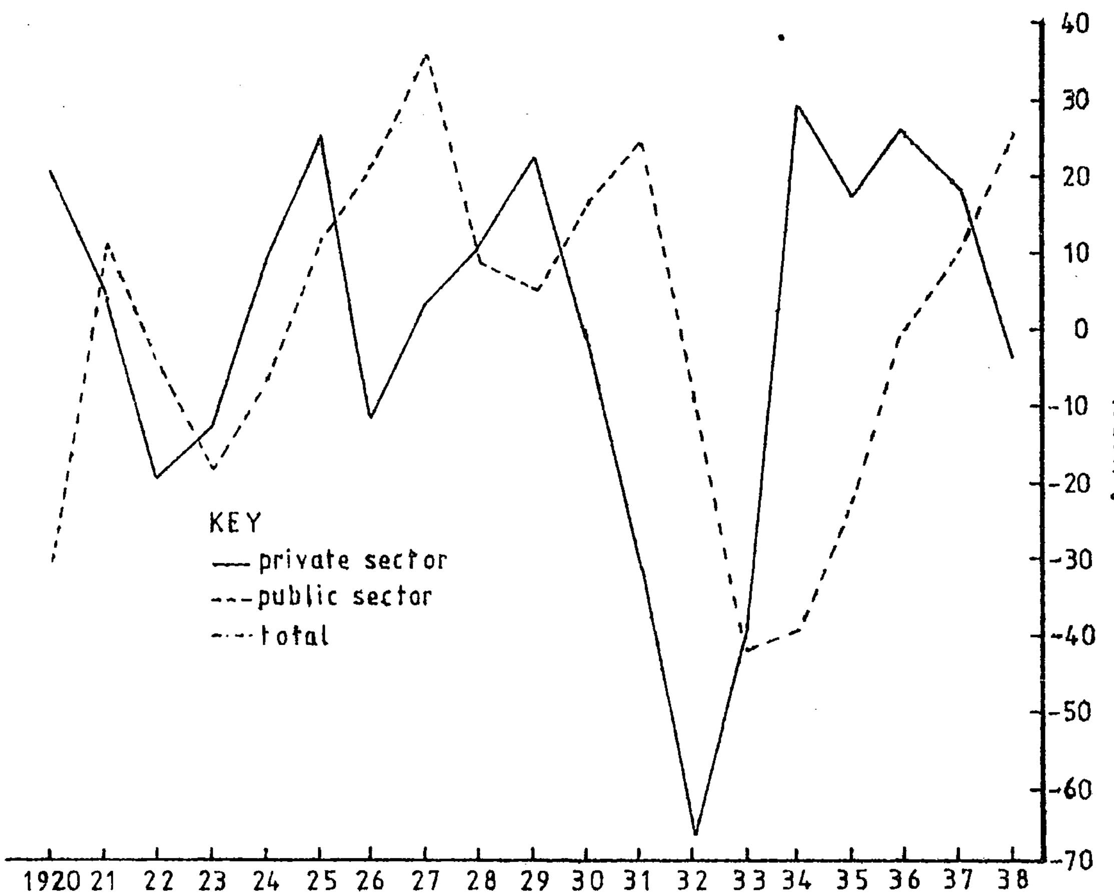
* Chart 2.2 represents a slightly wider definition of public investment than that of Table 2.4, the principal difference being the inclusion of the public utilities (see Feinstein 1965: 46). Although many were private companies, their investment programmes were subject to some degree of governmental influence (Bretherton et al 1941: ch.V).

Chart 2.2

Fluctuations in gross domestic fixed capital formation 1920-38

A. GDFCF by sector

B. Private and public sector capital formation, deviation from trend



SOURCES: A. Feinstein (1965: Table 3.34).
B. Ibid; for method of calculation, see text.

significant equation, with a coefficient of +1.4.* Thus, even when permitted a delay in responding to an autonomous fluctuation in private investment, the public authorities were destabilizing over the period as a whole.(72) Nevertheless, policy did respond correctly on occasions (1920-1, 1929-31, 1936-8) and was only seriously destabilizing on one occasion, 1931-2 (the trough of the depression). Furthermore, when judged against the destabilizing course of public investment in more recent periods,(73) the interwar period does not compare that unfavourably, although the amplitude of fluctuations was greater. The question, which is explored in later chapters, is whether the stabilizing effectiveness of public investment would have been improved if there had been a commitment to a counter-cyclical policy or whether certain institutional factors would have militated against such an outcome.

3. The Treasury and expenditure control

The Treasury's administrative responsibilities for financial control were both complex and of wide compass, permitting the Treasury to extend its authority from purely financial to policy questions. Treasury control,(74) however, was far from complete, nor was it uniform as between the various spending agencies constituting the public sector. In particular, as will now be shown, the degree of control exercised over central and local expenditure varied considerably, and this was to have certain ramifications.

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* $Y = \underset{(0.035)}{0.118} X_{t-1}^{1.4}$ ($R^2 = 0.4099$; DW = 0.9761; t = 3.32)

where Y = public sector deviations and X = private sector deviations. Annual data was used for 1920-38, giving 18 observations when account is taken of the one year lag.

(i) Central government

The "saving of candle-ends" has been taken as the epitome of Treasury attitudes towards expenditure control;(75) as Bridges complained as late as 1950, it was but:

> a picturesque phrase ... embodying the attitude of extreme frugality which has led to the reputation of cheese-paring or meanness that the Treasury has so long enjoyed (if that is the right term). It recalls at once the wish, believed by so many to be still endemic in Treasury Chambers, to refuse all proposals of expenditure however worthy the object. (76)

In the following, it will be argued that this term is manifestly inappropriate to the reality of interwar expenditure control.

It has been traditionally maintained that expenditure control was excessively strict between the wars, both in total and in detail;(77) for example, Roseveare argued that the period:

> saw the painful and laboured reassertion by the Chancellors of both governing parties of the Gladstonian tradition of public finance, and they saw its ultimate eclipse. (78)

Detailed scrutiny of the available evidence seriously weakens such arguments and finds the traditional interpretation largely wanting. Firstly, reference has already been made to the fact that, when judged against a more recent period, the growth of expenditure was rapid between the wars.(79) Secondly, the traditional view rests on a basic confusion between the Gladstonian administrative structure of expenditure control and the attitudes guiding that control. While the Gladstonian era may well have represented the apotheosis of economy in expenditure,(80) it should be recognised that there occurred certain fundamental changes during the period of the Liberal administrations of 1906-14, and that these:

> led to a much wider view of the proper objects and extent of Government expenditure in the modern State: and as a result Treasury Control became less concerned with the prevention of all public expenditure, and more concerned with ensuring the most prudent and economical spending of money on approved projects. (81)

Whilst it is indisputable "that Gladstone contributed more to the development of the modern Treasury than any one man before or since", the legacy of the Gladstonian era was not an excessively severe attitude towards new expenditure, but the "inheritance of ... a unified system of efficient administration, spreading outwards from the Treasury to all parts of the Government machine, and a unified system of control of expenditure to match and support it."[(82)]

This system of financial control, which after its long evolution was well-suited to normal peacetime conditions, was to be subject to severe strains during the First World War, for the war not only required expenditure on an unprecedented scale but also forced the abandonment of many traditional control mechanisms.[(83)] In the immediate postwar period, the Treasury naturally sought to reimpose these peacetime controls; they also attempted a more radical strengthening of expenditure control. Firstly, the position of Accounting Officer in each department was strengthened, the object being that policy and its financial consequences should not be treated separately but in conjunction with each other, a reform that "did much to induce a greater sense of financial responsibility into Departments generally ... [and] fostered an atmosphere of greater confidence between Departments and the Treasury".[(84)] Secondly, Treasury control was strengthened at a Cabinet level with the resumption of the prewar arrangement whereby all schemes involving expenditure had first to be discussed with the Treasury.[85] This was not an attempt to impose economy upon unwilling politicians; rather it was an important means whereby Treasury officials were able to relate possible expenditures to available resources and to inform the Cabinet of the action that would be required were the proposal to receive approval.[86]

While there is little evidence to support the view that Treasury control of aggregate expenditure was unnecessarily constraining, given prevailing economic conditions and the unanimity of political opinion on the desirability of limiting expenditure growth, there is rather more substance in the charge that control was excessive in detail. The rearmament programme, undertaken from the mid-1930s, is a case in point; for both officials, politicians, and outside observers assigned to Treasury 'tightfistedness' much of the blame for the programme's slow progress, its deficiencies, and the inadequate level of preparations at the outset of war.[87] The point at issue is not whether Treasury control frustrated the defence departments in their efforts to expedite a rearmament programme _per se_, for this is admitted even by writers who have favourably judged the Treasury's stance on rearmament,[88] but whether the way in which control was exercised, operated to the actual detriment of Britain's preparedness - both military and economic - for 'total' war. The economic and budgetary problems posed by rearmament are discussed in later chapters;[89] it is sufficient to note here that the judgement of recent research has been that Treasury control, given the financial limits on expenditure, acted in a beneficial manner by enforcing priorities upon the defence departments and, by limiting the extent of disturbances to the civilian economy, preserved Britain's economic strength. Therefore, as Peden concluded:

> It would be rash to conclude that laxer Treasury control before the war would have quickened the pace of essential parts of the rearmament programme, for the Treasury made every effort to see that essentials received due priority, and that less important proposals were not allowed to clog the programme. (90)

The nature of Treasury control operated to put departments on the defensive, their expenditure plans being restrained by anticipation of Treasury criticism.[91] Apart from the special difficulties raised by rearmament for Treasury control, it appears from the official papers that relations with the spending departments were generally harmonious and that Fisher had promoted "team work throughout the Civil Service ... with conspicuous success."[92] Nevertheless, it would be quite wrong to suppose that conflicts never arose; two examples, those concerning the Ministry of Labour Estimates for 1932/3 and 1933/4 and the expenditure of the Road Fund in 1935, are considered in later chapters.[93]

Heclo and Wildavsky have identified five maxims of modern day Treasury control;[94] these are equally applicable to the case of the interwar period:

(1) the full implications of an expenditure proposal must be investigated in order to ensure that no large expenditure commitments are approved unknowingly because the expenditure seemed small in the early years;

(2) there is the strongest possible bias against open-ended expenditure commitments;

(3) there is the avoidance of precedent setting behaviour, the avoidance of settlements with one department which would have the effect of raising expenditures in another;

(4) an antipathy towards disguised expenditure (such as

subsidies and loans) which by being unidentified cannot be controlled; and

(5) a basic attitude of mind which sought to avoid risks in the planning of future expenditure commitments:

> The Treasury as an institution has never believed in the philosophy of economic growth. Its officials may not be against growth as such, but they are vehemently against committing resources on the basis of what one deputy secretary called a 'hoped-for, phony paper growth rate, which only leads to false expectations, disappointments, cuts, and further disillusionment.' They want to see the colour of the money first and relish pointing out the risks of actions based on hypothetical increases in wealth. (95)

To conclude this part of the discussion, mention should be made of the general inflexibility of central expenditure control and planning systems.(96) Space precludes a detailed discussion of the 'supply cycle', the term used to describe the compilation and eventual presentation to Parliament of the departmental Estimates.(97) The essential points for our purposes concern the chronology of events. Firstly, consideration of the Estimates began, as at present, in the early autumn and after discussions between the Treasury and the spending departments (and the Cabinet in respect of the defence Estimates) they were presented to Parliament in the following February or March. Secondly, this chronology had certain important consequences, in particular that Parliament considered expenditure proposals prior to the budget, which was therefore only a tax budget.(98)

The supply procedures of the House of Commons were more rigid and inflexible than at present, and without modification would have been unsuitable for counter-cyclical purposes where the necessity would often arise for making adjustments in expenditure programmes at short notice. Once expenditure programmes had been settled, further supply would only be granted on application of a Supplementary Estimate. Whilst no major Supplementary was refused during the interwar period,[99] they were used infrequently and with definite reluctance.[100]

This general inflexibility in the setting of expenditure programmes was reinforced by the fact that central government had no specific powers to borrow funds without Parliamentary sanction,[101] and, as was noted above, the possibilities were severely limited for its stabilizing private investment by varying its own capital outlays.

(ii) Local government

Although economic policy was formulated at the centre, the British financial system had evolved in such a way as to limit the channels through which central government might operate its fiscal policies: neither the Treasury nor Parliament directly controlled local expenditure, either on current or capital account, and despite the increasing importance of central grants, local authorities had not become simply the spending agencies of central government.[102]

In considering central-local government financial relations it should be noted from the outset that:

> in practice there will never be a great divergence between the general policy of the Government and the opinions expressed by the generality of Local Authorities. There may be time-lags, there may be the differences which creep in owing to the different mechanics of actually registering electoral opinion. But there is little or no chance, for example, of Local Authorities representing the great majority of the population wanting a large housing programme being confronted by a Government strongly opposed to such a programme. There will, of course, be differences of opinion on the administration of and finance of any policy and these differences may affect the harmony of the two sets of democratic institutions but the basic agreement should be there. It is therefore unreal to refer to central-local relations as though a Government Department may have to coerce Local Authorities representing the great majority of the electorate.

> Should there be a head-on clash between a Department and the mass of Local Authorities on any general issue the Minister may be mis-interpreting public opinion or the fault may be on the side of the Local Authorities. But it cannot be assumed that the Minister must necessarily be right. In the long run it is axiomatic that the two sets of views must be in broad agreement. (103)

The second feature of note is that, as at present, "while local authorities are the creatures of Parliament, they are in no sense under the absolute control of the central government's administrative departments."(104) Local autonomy was strong, and seen as of some importance in British constitutional practice. Central control was limited to that granted by specific legislation; there were no general powers permitting central direction of the localities.* In these circumstances, the degree of central influence on the economic activities of local authorities rested upon the effectiveness of persuasion, exhortation, and financial inducement.

Before discussing the operation and effectiveness of the channels whereby central government sought to influence local activities, a third feature of central-local relations should be mentioned, that of the fragmentation of central responsibility for local government and the wide-ranging and disparate nature of the local spending units themselves. At a central level, control of the localities was dispersed across a wide range of departments, including the Treasury, the Ministries of Health and Transport, and the Scottish Office, none of which were charged with overall responsibility or a coordinating function. At a local level, the form of

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* Of particular importance was the fact that central departments had no powers either to determine the level of rates which an authority might decide to levy or to prescribe directly how the funds so raised should be expended (Chester 1951a: 47).

the prevailing administrative structure was even less propitious for direct central control. Firstly, as Sykes concluded, local authorities were "not ordinarily the optimum economic spending units", there being no fewer than 25,340 separate units in 1927 having powers to enter into financial transactions, and even after the major reforms of 1929, this number was only reduced to 11,619.(105) Secondly, not only were there an inordinate number of separate spending units, each of varying size, but there was a complete absence of any uniformity in their financial circumstances. For example, in its evidence (1927) to the Royal Commission on Local Government, the Ministry of Health detailed the cases of a sample of 72 local authorities, the smallest of which had a 1d. rate produce of £11 and the largest £382, while 42 had less than £100.(106) The small size of many local authorities, combined with financial weakness due to depressed local economies, was in many instances to limit their ability to provide statutory social services and, even with central grants, works projects to mitigate unemployment.

Reference has already been made to the increasing importance of central grants to local authorities; the question should now be posed whether this growing formal dependence upon central government was of a form which permitted the centre to further its economic policy objectives. In particular, this question is of especial relevance to the ability of central government to stimulate local authority capital outlays as a means of stabilizing employment.

In approaching this question, it should first be stressed that grants were rarely designed to cover the full cost of a local service or capital project, so that it is necessary to take into account the form of the grant and the financial position of local authorities, both in general and those specifically seeking assistance. To local authorities, the attractiveness of a grant might be said to be dependent upon: (1) the likely increase in rates resulting from a decision to proceed with a service or project eligible for grant assistance; and (2) the existing level of rates.

These conditions were best satisfied by specific grants, variable rather than fixed, and available for a limited period. Perhaps the most successful of such grants was the subsidy payable to local authorities under the Housing and Town Planning Act, 1919.* Under this Act, local authorities received a subsidy equivalent to the difference between the capital cost of a house spread over a period of years and the amount of income the house earned when let at rents that the working class could afford above the proceeds of an additional penny levied on the rates. The local authorities' liabilities were small and fixed and there was no obligation to economise on capital costs. While, on the one hand, "as a sheer creator of living accommodation", the Act was the "most successful measure of its kind that Britain saw until after the Second World War", on the other, it forced up building costs, caused disruption in capital markets as local authorities took part in an "uncoordinated scramble for house building money", and resulted in considerably greater expenditure than was felt to be necessary.[107] Herein lay the root of the problem of central-local

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* More generally known as the Addison Act, named after its promoter Sir Christopher Addison (President, Local Government Board 1919; Minister of Health 1919-21).

financial control, the conflict between the requirements of 'normal' expenditure control (economy and ease of administration) and the objective of securing a large and immediate response from local authorities. These problems remained unresolved throughout the interwar period; yet, as will be argued shortly, the economic debate of the period should also have been accompanied by a far reaching investigation of the suitability of existing methods of financial control.

The use of grants to stimulate local capital expenditures as a means of mitigating unemployment also raised difficulties at a local level. As Chester has written:

> The memories of Local Authorities of the inter-war years are not particularly happy so far as Exchequer grants and central control were concerned. One year they were being encouraged - indeed pressed - to push ahead with great schemes of expansion for several services, with large grants being promised in return. Then, just as they got going, schemes approved, building well under way and commitments of all kinds entered into, the central Government would start an economy campaign, in which grants would be cut, and sanctioning of loans and expenditure for grant purposes would become very stringent. The total effect of this central policy of fits and starts was, on occasion, to cause the progress over the period in question to be less than if there had been a steady policy; the Local Authority might even have suffered some financial injury, and it cannot be wondered that many Local Authorities saw substantial merits in a grant which was fixed for a period and on which they could base their programme. (108)

Having established, at least in general terms, the quite serious limitations facing central government in its control over local expenditures, the discussion can now be widened and brought to a conclusion by considering the expenditure of the public sector in its entirety and the possibilities for its effective counter-cyclical regulation.

(iii) Counter-cyclical expenditure control

Both the officials and economists responsible for the compilation of plans for postwar stabilization assigned considerable importance to the counter-cyclical variation of public expenditure (particularly capital expenditures); by contrast, public expenditure as a counterweight in balancing demand has actually held a subordinate position since 1945, and the volume and pattern of public expenditure have continued to be principally dependent upon a composite of the economic and social objectives associated with individual expenditure programmes.(109) A case in point is that of public investment, where there was a growing appreciation of the resource costs associated with counter-cyclical regulation - the continual compromising of medium-term plans by destabilizing and disruptive short-term interventions - and the apparently insoluble problem of devising forms of expenditure control which gave both the requisite degree of flexibility and ensured the efficient allocation of resources.(110)

The starting point for our discussion is that interwar public expenditure management should be viewed in relation to this postwar experience. A distinction, however, should be drawn between the problems associated with increasing expenditure in a situation of chronic under-investment or prolonged cyclical depression, and the rather different problems posed by the mechanics of fine-tuning. In broad terms, the former might be taken as the case of the interwar period, and the latter as representative of the postwar period.

The higher average pressure of demand in the postwar period, as compared with the interwar period, and the fact that the trade cycle has been of shorter duration and lessened amplitude,(111) has magnified the possibility that discretionary changes in public expenditure programmes might in fact be destabilizing. Such a situation was not a possibility of any importance during the interwar period; consequently, the following comments about this period apply largely to the administrative, technical, and political difficulties which would have arisen if it had been decided to stimulate public expenditure as a counterweight to a permanent, if variable, deficiency of demand.

At this stage of the argument, it is assumed that the balanced budget constraint (at both a central and local level) effectively precluded either counter-cyclical variation of current public expenditure or a significant increase in the overall demand leverage exercised by the public sector on current account, the latter option being discounted because of the requirement for additional revenue to finance the enlarged expenditures. The remaining option concerned an enlargement of public sector capital outlays, and it is on this that the following discussion concentrates.

The decision to adopt a public works programme of sufficient magnitude to exert a significant effect on aggregate demand would have required either:

(1) a system of generous grants to local authorities; or

(2) a fundamental change in the financial relations of the centre to the localities, bringing a greater volume of public investment under direct central control.

The first option involved a variety of dangers for normal expenditure control; the second was the subject of considerable political controversy and was implacably opposed by the Treasury, on grounds of both efficiency and the fact that it would threaten local autonomy.(112)

Further considerations also need to be taken into account. Firstly, while an immediate response from spending agencies has been an essential pre-requisite of an effective stabilization policy in the postwar period, due to the fact that lags in implementing a policy could actually make it destabilizing, it is arguable that, although economic conditions were very different, this would also have been the case in the interwar period. The explanation, however, is rather different: assuming, for example, that the Treasury had become convinced by the case for large-scale loan financed public works, and it is likely, that strong centres of opposition to such a policy remained, the policy would have been seen very much as an experiment, the validity of which would have been crucially dependent upon its visible results. There would undoubtedly have been the natural expectation that if a large programme was instituted, visible benefits would be both fairly immediate and of not inconsiderable magnitude; were such expectations to be unrealised, itis not inconceivable that the reaction against the programme would have been sufficient to have threatened its continuance, and there might even have been a serious second order effect with adverse results for the level of economic activity. Thus, the question of timing is not one that can be dismissed.

Secondly, if the speed of a policy's implementation was of some importance, in particular in the case of an expansion of expenditures, it follows that a physical planning agency would have been necessary to prepare and coordinate local authority investment plans, and that the form of central control over local borrowing might also be of some importance. Unfortunately, in both areas there were major deficiencies.(113) As Hicks concluded:

> It does not appear that the present methods of control over local finances are capable of carrying through a very effective cyclical policy. While over-borrowing is amply guarded against, and long-period expansion probably not hindered by loan regulations, sudden changes such as are necessary for a public works policy to be effective are not easy to bring about. Sudden expansion means that local plans must already be worked out, and this is difficult to secure when the number of authorities is large. Sudden contraction can be somewhat more easily secured, but it is difficult to avoid waste when planning is uncentralized and investment vicarious. The chief necessity for successful cyclical policy is an adequate planning department ... But it must be noticed here that Great Britain appears to be deficient in co-ordinating machinery relative to those countries which have so far most successfully worked a cyclical expenditure policy. (114)

Proposals for a National Investment Board, to assume such functions,(115) were put on a number of occasions but were treated unenthusiastically by all interwar governments. Similarly, while the call for increased central control of public expenditure received widespread support from many quarters, outside of certain sections of the Labour and Liberal parties it was treated with disdain by the mass of politicians. The maintenance of local autonomy was an important political issue, a serious impediment to change; in addition, the fact that a major reform of central-local relations had already been undertaken with the Local Government Act, 1929, was to create the attitude that the new system should be tested for some years before further modifications were contemplated.

These administrative and political questions were rarely debated publicly, or indeed on any substantial level within government. Even when so debated, they were seen in some sense as separate from the issues raised by the economic debate of the period. More particularly, there was a failure on the part of economists to appreciate that major administrative reforms - increased centralization and greater flexibility in expenditure control - were a necessary concomitant to acceptance of the 'new' economics and its successful translation into practical economic management.(116) The unbalanced and one-sided nature of the policy debate that resulted from the divorce of economic from administrative and political issues has received almost no attention in the literature of the period. Yet, as is argued later, this omission is partially responsible for the confusion that still surrounds the interwar Treasury.

CHAPTER 3

TAXATION, THE REVENUE DEPARTMENTS AND POLICY

As a subject for detailed study, accounts of the inter-war budgetary system have tended to focus on the expenditure side of the account; with few exceptions, taxation has been largely ignored.(1) The result of this somewhat narrow approach is that the rôle of taxation in the budgetary process remains largely unknown, while excessive attention has been paid to the determinants and course of expenditure. Accordingly, the purpose of the present chapter is to survey the revenue side of the account; to look at the rôle of the revenue departments in the formulation of budgetary policy; methods of forecasting tax yields; the structure of receipts; and contemporary attitudes towards taxation and economic activity.(2)

1. The revenue departments

By the interwar period the revenue departments had, like the Treasury, fully matured as departments of finance and, in large measure, had assumed the functions and responsibilities that they currently hold.(3) The Boards of Customs and Excise and Inland Revenue, along with their Secretaries' offices, constituted the central coordinating machinery of the two revenue departments. They were responsible not only for macro policy matters and for advising the Treasury, but also for the more detailed organisation and administration of the tax laws. From this followed a certain duality in their position. While the Boards were responsible to the Chancellor,(4) they also had a distinct constitutional existence of their own, the purpose of which was that the administration of the tax system be "kept free from any suggestion that political influence might be exercised in relation to particular cases."[5] In matters of taxation policy, however, the revenue departments were subordinate to the Treasury, both constitutionally and in practice.

There are few instances, at least recorded in the papers,[6] in which the Treasury pursued a course of action in the face of strong objections by the revenue departments. Where disagreements arose, two general factors were primarily responsible: firstly, Treasury officials frequently voiced the concern that the revenue departments were too cautious, in particular with regard to the forecasting of tax receipts; secondly, and of more importance, as was noted in the previous chapter,[7] the Treasury as a department had to respond to much wider considerations than those confronting most other departments. In the field of taxation, the imperative of maintaining budgetary equilibrium (particularly in the early 1930s) often forced the adoption of tax changes and revenue devices which, in less difficult times, would have been considered totally unacceptable.

It should be stressed, however, that as with the Treasury's relations with the spending departments, disputes were rarely serious; in general, there was a coincidence of interests between the financial departments, a coincidence strengthened by the interchange of staff between the various departments.*

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* A number of Treasury officials had formerly served in Inland Revenue - Fisher had begun his career there and risen to Chairman in 1918, moving in 1919 to the Treasury as Permanent Secretary; Hopkins had followed a similar course, rising to Chairman by 1922 and then moving to the Treasury in 1927; more junior staff such as E. Rowe-Dutton had also served in the Inland Revenue. Nor was the movement of staff uni-directional: Grigg who had served in the Treasury (1918-30) moved first as Chairman of Customs and Excise (1930) and then of Inland Revenue (1930-4).

Where disputes occurred they took a number of forms: (1) as a counterweight to the inherent cautiousness of the revenue departments in forecasting tax yields, in almost all the years under review they were instructed to 'stretch' their estimates, thereby balancing the budget ('on paper') or reducing the extent of discretionary action required to ensure (ex ante) budgetary equilibrium.(8) In general, this practice was not pursued excessively although there were instances in which it was thought to be inadvisable.(9)

(2) on occasion, Inland Revenue were instructed to vary the rate of collection of income and surtax, the objective being to transfer revenue between years according to the exigencies of the budgetary situation.(10) There were considerable risks associated with such a practice - namely that it might adversely affect the revenue of subsequent years;(11) consequently, recourse to such an expedient was avoided wherever possible.

(3) although disagreements rarely resulted over the advisability of a tax increase or modification of existing taxation arrangements, when they did occur the revenue departments did not easily succumb to Treasury persuasiveness and would fight the issue until overruled by the Chancellor. Such an incident occurred in early 1931 over the means whereby the April budget was to be balanced: a time when the budgetary position was acute and it was felt could only be balanced if a number of expedients were adopted. The dispute, between Inland Revenue and the Treasury, centred on the appropriate expedients, in particular upon the proposal to secure a non-recurrent gain by varying the dates of

collection of (Schedules B, D and E) income tax.* Although the Treasury ultimately overruled the Inland Revenue's technical objections to such an expedient,(12) the episode is of interest because, had circumstances been more propitious, they would undoubtedly have accepted the legitimacy of these objections. The Treasury view prevailed, therefore, because on a balance of risks such an expedient was the least disadvantageous method of securing additional revenue.(13)

The revenue departments, however, were far from passive in the budgetary process. Constitutionally they had to follow Treasury directives; nevertheless, by virtue of their expertise in taxation matters, they were able to exercise an important influence in budgetary deliberations, an influence much wider than that of specific taxation questions. This is clear from the advice tendered by the revenue departments during the 1931 financial crisis.

As is well established, discussions over the balancing of the budget during the 1931 crisis largely centred on the expenditure side of the account;(14) there also occurred, however, debate about the appropriate taxation measures. The May Committee in forecasting a prospective deficit of £120m for 1932/3 had recommended economies of £96.5m, leaving a residual of £23.5m to be found from additional (but unspecified) taxation. The Labour Cabinet had failed to agree to such economies, whilst in addition the prospective deficit had risen to £170m, so that a greater

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* Income was taxable under five Schedules: A (ownership of land and tenements); B (occupation of land); C (interest and dividends payable out of the public revenue); D (profits and other interest); and E (employment and pensions) - see Magill et al (1934: 17-18). Under the Finance (No. 2) Act, 1915, income tax was payable in two equal instalments, on 1 January and 1 July.

sum was required to be found from taxation. In these circumstances, it might be supposed that the Cabinet would have given equal weight to the question of taxation in their discussions and actively considered the form of additional taxation. In fact, questions of taxation rarely feature in the Cabinet discussions,(15) and it fell largely to the revenue departments and the Treasury (including the Chancellor) to determine the form, though not the magnitude, of the additional revenue. As a result of the Cabinet's effective abnegation of much of its powers in the financial sphere, the financial departments were able, at a time of national political crisis, to assume responsibility for the taxation proposals, thereby ensuring that the form of taxation would proceed along orthodox lines and that radical solutions (such as that adopted in Australia during the crisis of 1930)(16) would be easily dismissed.

Apart from the amount of additional taxation to be imposed, discussions centred upon three interrelated questions: the feasibility of a tax upon 'rentier' incomes, the likely effects of an increase in income and surtax, and the way in which additional taxation should take a form compatible with the Cabinet's policy "that the Budget must be balanced by the application of the principle of a common sacrifice and effort."(17)

The case for a tax upon 'rentier' incomes* differed somewhat from that of the capital levy proposed in the early

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* The term 'rentier' was used in a wide variety of senses, as were a wide range of schemes suggested for their taxation. The common features of all such schemes were the dual preoccupation with the increasing real burden of the national debt and the desire to tax those income groups which could be identified as having benefited from the falling price level.

1920s:[18] previously concern had centred on the debts' enlargement in nominal terms as a result of war expenditures; it now centred on the rising real burden of the debt resulting from the downward price trend.[19] Within government, the proposal to tax the real gains of the rentier class had first been put by a Cabinet Committee in January 1931;[20] the proposal (in various forms) was renewed later that summer with the financial crisis, receiving support over a broad political front, e.g. from opinions as diverse as Samuel* and the T.U.C.[21]

The Inland Revenue favoured the principle of 'equality of sacrifice', but were concerned about the results of additional taxation on higher income cohorts, and more generally opposed a special tax on rentier incomes. Whilst this opposition was expressed in technical, rather than political, terms it seems that there was opposition to the use of taxation for redistributive purposes.**

When asked to report on the question in late August 1931 they pointed out, firstly, that the income tax system already strongly discriminated against investment incomes, and secondly, that few individuals had investment portfolios limited to fixed income securities. In fact, they contended, higher income cohorts had suffered badly from the depression[22] - for example, dividends had fallen by 20% over 1929-31 - so that "it is extremely doubtful whether the average investor has on balance gained in purchasing power over the last few years." A universal tax on all investment incomes would pose serious administrative problems; a more preferable course would be a change in income tax allowances.[23]

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* Sir Herbert Samuel (Liberal M.P., Home Secretary 1931-2).

** As late as 1942 the Inland Revenue were still strongly of the opinion that "the purpose of the income tax is not the redistribution of income" (Sayers: 1956: 97-8).

Apart from these technicalities, it was also felt that there were serious risks associated with further taxation of higher incomes, mention in particular being made of the stimulus this would give to tax avoidance and evasion.[24] This problem, a relatively new one for Britain,* was thus felt to constrain higher direct taxation - a view frequently expounded to the Treasury and one which they were forced to accept by early 1932.[25] On these grounds, Inland Revenue argued against an increase in surtax rates. They expressed the fear that a further increase in income or surtax would have an adverse effect on the rate of collection of these taxes, thus deflating their yield,[26] but conceded that it was possible:

> that taxpayers would be willing to meet the extra demands upon them if the increased tax formed part of a scheme of equal sacrifice and they felt that they were not singled out to bear an undue share of the burden. (27)

On this basis, when the financial departments sent in their proposals for additional taxation of £37m in 1931/2, the Inland Revenue's position clearly dominated their approach:

> we are not yet aware of the nature of the Government['s] proposals in the sphere of economy and we wish to make it very clear that in our view the yields of direct taxation shown in this note will not be obtained unless the whole Government plan is received as a fair and just plan demanding equal sacrifices from all section of the community. (28)

Thus not only were the Cabinet pressured externally to agree to acceptable economies (both in amount and in detail), it seems also that pressure was applied from within, from the bureaucracy. The document previously cited clearly hinted that unemployment benefits must be cut; other evidence suggests that Inland Revenue also stressed the urgency of

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* Almost all the Finance Acts of the 1930s contained clauses to combat tax evasion and limit the scope for avoidance.

immediate action, that the Finance Act must be passed quickly if direct taxes were to yield additional revenue because all income tax liabilities would have to be reassessed.(29)

As had occurred previously, Inland Revenue objections to raising taxes on income were overruled: the September 1931 Budget saw an increase in the standard rate of income tax, a reduction of allowances, and a surcharge on surtax. But the Treasury's victory was far from total, certain concessions were made: the wear and tear allowances on plant and machinery were increased as a partial offset to the increased standard rate, while Hopkins had been forced to accede to the Inland Revenue's view that "Direct taxation can no longer be relied upon as before."(30)

From this brief survey it can be seen that while the revenue departments were very definitely junior partners in the budgetary process, their rôle was not completely passive, and on occasion they could be an important influence on events. In the shaping of budgetary policy, Inland Revenue's contribution greatly surpassed that of Customs and Excise, whilst in addition, Customs and Excise was more frequently subject to Treasury directives about its estimates and was in a generally weaker position than Inland Revenue. The difference in influence exercised by the two departments is not easily explained, but it would seem to follow from the fact that the issues involved with taxes on expenditure were more straightforward, and the relationship between these taxes and the level of economic activity better understood, than was the case with taxes on income where the issues were more open to debate.

Finally, it should be stated that the key to understanding relations between the financial departments lies not in any conflict of interests between them but in the fact that there was a conflict of objectives as between the revenue departments and the Treasury. The Treasury's concerns were largely immediate and short-term: the balancing of the budget over a one, or possibly two, year time period. In the difficult conditions of the 1930s attainment of this objective often compelled the Treasury to overrule the revenue departments even though, had conditions been more favourable, they would quite possibly have accepted the viewpoint of the revenue departments. In this sense conflict was unavoidable. The revenue department's concerns were less immediate; they operated over a much longer time horizon; and their concern was not solely with the yield of a tax, but also with its efficiency, equity, and ease of administration.

2. The course and structure of receipts

The course of expenditure has already been examined in some detail,(31) and, since both the expenditure and receipts ratios followed broadly similar paths, we need not repeat the earlier exercise as fully in the case of revenue.

The 'displacement effect' of the war on the level of taxation is clearly evident in the course of the receipts ratio: the ratio of public sector receipts to GDP almost doubled as a result of the war, from 0.113 in 1913 to 0.204 in 1919.(32) Whilst following the war, public expenditure was rigorously curtailed, no such development occurred on the taxation side of the account.(33) After a short interval, the receipts ratio continued its upward trend, rising from

0.209 in 1920 to 0.256 in 1922. This movement differed in one important respect from that of the previous period of increase; it was a reflection not only of higher tax rates but also of falling money GDP. This was a pattern to be repeated in later depression periods (e.g. 1929-32 when the receipts ratio rose from 0.238 to 0.274). Apart from this later depression, the receipts ratio followed a fairly steady upward trend over the interwar period (from 0.233 in 1924 to 0.244 by 1937).

This upward trend resulted from increased rates on existing taxes and some widening of the tax base. Over the course of the war taxes on expenditure had remained fairly stable at about 5% of consumers' expenditure; thereafter they exhibited a marked upward trend: from 7% in 1920 to 8.8% in 1929 and 10.7% in 1937.(34) The most important development, however, concerned the income tax which "changed out of all recognition."(35) Between 1913 and 1918 the standard rate was increased from 6% to 30%, and the yield from £47.3m in 1913/14 to £291.2m in 1918/19.(36) The standard rate was maintained at 30% until 1922, when it was reduced to 25% and a year later to 22½%. Thereafter, it fluctuated for the greater part of the period in the range 20-25%, before being raised in the later 1930s with rearmament (to 27½% in 1938 and 37½% in September 1939).(37)

Looking now in more detail at the 1930s, and at central government, there were a number of important developments in the field of taxation. The base for taxes on expenditure was widened with the adoption of a protective tariff in 1931-2,(38) and the reintroduction of the tea duty in 1932,(39) while an additional tax on incomes, the National Defence Contribution levied on profits, was inaugurated in

1937.[40] These changes were reflected in the structure of receipts (Table 3.1): taxes on expenditure increased from 7.3% of GDP in 1929/30 to 9.3% in 1933/4 and then remained fairly stable until 1936/7 before falling back to 8.1% of GDP in 1939/40 as increasing prices began to affect the specific duties. Taxes on income followed a similar course in the earlier period, rising to a peak of 9.5% of GDP in 1931/2, but thereafter fell significantly before resuming their upward trend in the later 1930s as rates were increased markedly, especially on income tax. Taxes on capital exhibited a slight downward trend (varying between 1.4 and 2.2% of GDP), while national insurance contributions rose to a peak of 2.4% of GDP in 1936/7 and then fell back, again as a result of rising prices. Finally, mention should be made of the class of miscellaneous revenues, consisting of a variety of tax and non-tax revenues; these do not fit conveniently into a functional analysis of revenue and, for certain reasons, require separate treatment.[41]

Changes in the structure of receipts reflected not only discretionary action on the part of the budgetary authorities,[42] but also the effects of variations in economic activity on endogenous revenue items, which in turn depend upon the characteristics of the main revenue classes.[43]

The increasing importance of income and surtax (from 32.9 to 39.8% of total receipts, 1929/30 to 1931/2)[44] in the early years of the depression reflected not only rising tax rates but also the fact that payment of these taxes was lagged with respect to income.* Thus, even without

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* See App.II. The method of assessment had been modified in 1927, with the effect that income tax became more sensitive to cyclical variations, while increased progression in surtax also heightened its sensitivity. Prior to 1927, income tax had been assessed on the average of the preceding 3 years' income, resulting in both a lower sensitivity and a delayed response to income changes (Hicks 1938: 300; Bretherton 1937: 177-8).

Table 3.1 Central government revenue as % of GDP, 1929/30-1939/40

	1929/30	1930/1	1931/2	1932/3	1933/4	1934/5	1935/6	1936/7	1937/8	1938/9	1939/40
1. Taxes on income	7.0	7.9	9.5	8.3	7.4	7.0	6.9	7.0	7.5	8.3	8.6
2. Taxes on expenditure	7.3	7.4	8.1	9.2	9.3	8.9	8.8	8.9	8.5	8.1	8.1
3. Taxes on capital	1.9	2.0	1.7	2.0	2.2	2.0	2.1	2.0	1.9	1.5	1.4
4. National insurance contributions	1.9	1.9	2.2	2.3	2.4	2.3	2.3	2.4	2.3	2.2	1.9
5. Miscellaneous revenues	2.9	2.9	2.2	2.0	2.0	2.0	2.0	2.0	1.9	1.9	1.9
6. TOTAL (T)*	21.1	22.1	23.6	23.9	23.2	22.2	22.1	22.3	22.0	22.0	21.9

Source: Financial Accounts; Table 6.1 below.

Notes: * For the definition of receipts, see pp.101-02 below.

discretionary action, the yield of these taxes would have risen in the early depression phase, indicative of the destabilizing characteristics of the main taxes on income.*

Data on the payment of taxes on income by sector show that total payments rose from £295m to £352m (an increase of 19.3%) over 1929-32 but that the amount paid by the corporate sector fell marginally (from £67m to £64m). The personal sector thus bore the increased burden. Nevertheless, an increased rate of tax was being paid on a depressed level of profits: gross trading profits fell by 24.3% over 1929-32, from £1,145m to £867m.(45)

Income tax continued as the major tax on income. The importance of surtax diminished, despite higher tax rates.(46) This was a source of some concern and, after 1931, the authorities were reluctant to impose additional burdens upon surtax payers. The final tax on incomes, the National Defence Contribution, remained relatively small.(47)

From 1932/3 to 1935/6 the relative weight of taxes on income fell as against taxes on expenditure, a result of the slow response of income and surtax to recovery, and the reduction in direct tax rates which was not matched by significant reductions in indirect taxes. After 1936/7 the process was reversed: both direct and indirect tax rates rose but taxes on income increased by 1.6 percentage points of GDP whereas taxes on expenditure were reduced by 0.8 percentage points of GDP. The reasons for this divergence become clearer as we examine taxes on expenditure.

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* Profits earned in the peak of 1929 were paid in 1930/1 and 1931/2, years of worsening depression; similarly, in the peak year of recovery, 1937/8, the taxes paid were levied on the profits of 1935 and 1936, the former a year of comparative depression. Postwar arrangements for taxing profits have displayed similar, but more serious, destabilizing characteristics - see Hansen (1969: 406-07, 435, 446-7) and Ward and Neild (1978: 23).

Throughout the period there was a clear preference for taxes levied on a specific rather than an *ad valorem* basis, a reflection of the fact that the latter were more difficult to administer.[48] Moreover, from the standpoint of the authorities' objective of maintaining a stable revenue in the face of fluctuations in economic activity, specific duties were preferable as they were less sensitive than those levied *ad valorem*. This followed from the fact that specific duties did not directly reflect changes in the price of the taxable commodity;[49] rather, changes in the price level operated through the effective rate of duty which rose as prices fell, and *vice versa*.

In large measure, the behaviour of taxes on expenditure during this period was determined by the course of prices. For the specific duties, effective rates rose until the mid-1930s as prices fell; thereafter, prices rose and this was reflected in the diminishing importance of taxes on expenditure (from 8.9% of GDP in 1936/7 to 8.1% by 1939/40), the *ad valorem* duties being of insufficient weight to fully compensate for the erosion of revenue by rising prices.

Changes in the terms of trade were also of some importance. These improved by 24.2% over 1929-33, but then deteriorated down to 1937 (by 12.1%) before improving again by 7.6% over 1937-9.[50] Thus, during the periods when the budgetary authorities were most hard pressed, revenue from imports was being reduced (most import duties were *ad valorem*), although at the same time the improved terms of trade had favourable effects on consumers' expenditure and hence on economic activity.[51]

The problem was that the base for taxes on expenditure was too narrow; the main commodity taxes were too selective to respond to a general movement in consumers' expenditure, and, with the sole exception of the motor vehicle licence duties, there were no taxes which could pick up revenue from the increasing expenditure on consumer durable goods. Unfortunately, there are no estimates of the proportion of total consumers' expenditure allocated to taxable goods;(52) it may be conjectured, however, that this proportion was falling.*

The narrowness of the base for taxes on expenditure had a number of implications for budgetary policy: firstly, the limited range of commodities subject to tax was such that the yield of taxes on expenditure only just matched the growth of GDP;(53) secondly, "The wider the base of the tax - the larger the consumption taxed - the lower the rates needed to bring in a given revenue";(54) and thirdly, there were considerable difficulties associated with any attempt to increase rates of duty on the main taxes. The system was inflexible; what was required was a form of sales tax.** This came with the purchase tax, introduced in 1940.

When extra taxation was required, Customs and Excise feared the political repercussions of increasing the commodity taxes. For example, in early 1938 they advised: "In view of the alarums in the political world about the rising cost of living it is to be presumed that both tea and sugar are not really practical politics."(55) Hydrocarbon oils, a product with a low price but high income

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* An indication of this is given by the fact that over 1929-37 expenditure on durable household goods and transport and communications rose from 12.7 to 14.0% of total consumers' expenditure (Stone and Rowe 1966: Table 71). Neither broad category of expenditure was subject to taxation of any importance.

** During the later 1920s a wide range of new taxes were considered by Customs and Excise but rejected on grounds of administrative impracticability or paucity of yield (see documents in W.V./216).

elasticity of demand, were seen as the "only item worth serious consideration", while tobacco, spirits, and beer all carried the risk that an increased rate of duty might yield no additional revenue.(56)

Nor did the import duties, greatly expanded 1931-2, live up to expectations. The duties had two functions: firstly, the protection of the domestic market and encouragement of import substitution and reorganisation of the 'basic' industries; secondly, the raising of revenue. In terms of the authorities' expectations, the tariff was somewhat of a disappointment, proving to be more effective at protection than at revenue raising.(57)

Finally, despite these various difficulties, over the period 1929/30 to 1937/8 tax revenues expanded at a faster rate than GDP (at 2.1 and 1.5% per annum respectively). Nevertheless, this was not solely a result of the automatic growth of revenue (with an aggregate tax elasticity of greater than unity);(58) it was also a reflection of discretionary changes which increased the average tax burden.(59) As is shown in chapter 5, throughout the 1930s it was a source of some disquiet to the Treasury that the growth of expenditure constantly threatened to outpace that of revenue.

3. Revenue forecasting

At a time when budgets were finely drawn, the importance of accurate revenue forecasting - a function performed by the revenue departments' Intelligence Branches - cannot be overstressed.(60) Given prevailing circumstances, the record of revenue forecasting was fairly impressive;* nevertheless, the effective formulation of budgetary policy was to be hampered by the limited, and perforce rather crude, forecasting techniques available to the revenue departments. The revenue departments' documents abound with statements to this effect. For example, an Inland Revenue paper of October 1930 was forced to conclude:

> Any attempt to revise this [tax] forecast at the present date involves guess work as to the effect of the trade depression on the profits of the current year ... and as to the length of time which must elapse before the depression passes away. (61)

A detailed account of forecasting techniques is not possible here;(62) instead, the following discussion focuses on a number of general problems, the nature of which help to explain the cautiousness exhibited by these departments.

Although the determinants of individual tax yields were well understood, and rules of thumb applied with some precision as to likely yields, the number of variables involved and the possibility of unforeseen developments ('budgetary disturbances' such as forestalments), made forecasting problematical prior to the final quarter of the financial year. Indeed, it was not until the final month (March) that the revenue picture, for the year about to close, assumed any degree of certainty, and informed judgements could be made concerning the forthcoming year. As a result, the final stages of budgetary planning were

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* From a study of total receipts the predictable pattern emerges whereby over the depression phase (1929/30-1932/3) revenue failed to meet the estimates (by an average of 1.8%) while over the recovery phase (1933/4-1937/8) receipts consistently exceeded the estimates (again by an average of 1.8%). Variations in detail, however, were much greater.

invariably hurried: uncertainty left little time to consider new policy directions and tended to reinforce budgetary orthodoxy. Only once was a serious attempt made to forecast revenue over the medium-term, thus permitting a rather longer time horizon for budgetary planning and consequently the possibility that a wider range of policy options might be considered.(63)

Inadequate and incomplete statistical information lay at the root of the problem. National income data were not used in forecasting before 1941.(64) The Inland Revenue (and other economic departments) had the expertise to compile national income accounts, indeed they did so in 1929,(65) but the exercise was not repeated. Whether the potential applicability to taxation forecasting of national income accounts was perceived, remains unknown.

More generally, the necessity for a strictly balanced budget placed impossible burdens upon the forecasters to produce accurate estimates. This made them extremely cautious and disposed towards risk aversion, the result being an in-built tendency to understate (<u>ex ante</u>) revenue;* a tendency which in turn led to countervailing Treasury pressures for the estimates to be stretched.

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* It also resulted in secrecy on the part of the revenue departments, particularly Customs and Excise. For example, in early March 1931, Webb privately advised his Chairman: "I should be glad if, in giving any figures to the Treasury, we can avoid being finally tied down at this stage, not only because of the forestalments position, but also because some of the estimates are otherwise quite conjectural ... & the late[r] I can wait before being definitely committed, the better it will be" (W.V./230, Webb to Floud, 6 March 1931); while in 1934 figures were actually withheld from the Treasury: "This is another revised edition [of the tax forecast]. I think you had better keep this for yourself & the Deputy Chairman, & <u>not</u> send anything more to the Treasury unless they ask for it (& in <u>no</u> case send them the Table!)" (W.V./270, Webb to H. J. B. Lintott [Private Secretary to Chairman], 27 March 1934).

4. Taxation and economic activity

It remains to look briefly at the relation between taxation and economic activity, a subject that will be explored further in later chapters. The subject is of particular importance, for there were frequent complaints by the business community that excessive taxation was a primary cause of Britain's interwar economic difficulties.

Whether taxation levels were 'excessive', in any absolute sense, is impossible to determine. While the war resulted in a permanent upward shift in taxation levels, there are considerable difficulties involved in assessing the implications of this for economic activity. In particular, there is a dearth of objective yardsticks with which to make such an assessment and reliance usually has to be placed upon impressionistic evidence.

Sufficient data, however, are available with which to make international comparisons:(66) from this it seems, firstly, that the receipts ratio was high in Britain; and, secondly, that there was a long lineage to the relative unimportance of indirect taxes in Britain.(67) The high level of taxation, vis-a-vis Britain's industrial competitors, was officially recognised, but the implications of this remained a subject of dispute. For example, the Colwyn Report,* which might be expected to have considered this question in some detail, limited itself to the statement that the heavy tax burden had "to some extent affected our industry ... although we regard it as of minor importance

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* Chaired by Lord Colwyn, previously chairman of the 1919-20 Royal Commission on the Income Tax, this committee had been established in March 1924 "to consider and report on the National Debt and on the incidence of existing taxation, with special reference to their effect on trade, industry, employment and national credit" (Committee on National Debt and Taxation, Report, Cmd.2800 (1927), p.viii).

compared with more general difficulties affecting our foreign trade."[68]

The disincentive effects resulting from the high levels of taxation required to finance an enlarged public sector have, since the early 1970s, been increasingly commented upon.[69] This was also true of the interwar period: the issues were fully investigated by the Colwyn Committee, which reported in 1927, and in lesser detail by the Balfour Committee on Industry and Trade which issued reports between 1927 and 1929.[70]

According to the Colwyn Committee, the central issue was that of the burden of the income tax: whether, as business representatives maintained,[71] the incidence of the tax was being shifted from producers to consumers, for if this was the case the tax was "responsible for raising prices, and [was] therefore a potent factor in depressing trade."[72] Following the evidence of economists such as Pigou,[73] the committee rejected this view, and concluded that "prices [are] determined by considerations into which the Income Tax does not directly enter", a conclusion that was "true over practically the whole field and for practically the whole of the time, any exception being local or temporary and insufficient to invalidate it."[74]

Later commentators have not taken this view;[75] indeed, the report has been criticised for its unthinking acceptance of the classical economists' analysis that, in the short-run, an income tax could not be shifted either by an individual or corporate body.[76] Furthermore, the analysis was unsatisfactory because it was based upon conditions of perfect competition,[77] conditions which quite patently did not hold by the interwar period.[78]

The committee had summarised its views as follows:

> We conclude, with regard to enterprise, that the effects of high income taxation have been almost negligible in the field of employments and professions; over a great part of the industrial field, while appreciable, they have not been of serious moment, but it is clear that they must often have put a check on the more speculative class of business ... Wider causes than taxation, however, and particularly the dislocation of our old export markets, must be held mainly responsible for the lack of buoyancy in recent years. Relatively, income taxation has not been a factor of high importance. (79)

The business community neither concurred with this view, or the assumptions underlying it, and throughout the interwar period organised business pressed the contrary view: that high rates of taxation depressed business confidence and, whilst other market forces contributed to the difficulties of British industries (particularly in export markets), a reduction of the income tax was the primary means whereby government could assist economic recovery.

The opinions of organised business on taxation questions can be illustrated further by reference to the papers of the Federation of British Industries (F.B.I.), the largest and most influential of the employers' organisations.(80) Throughout this period the F.B.I. pressed, both publicly and in representations to the Treasury, for a reduction of income tax; this to be financed by further economies in expenditure.(81) The F.B.I.'s attitude on this question was well expressed by Lithgow* in a meeting of its Taxation Committee in March 1931. Lithgow "emphasised the fact that, in the past, increases in public expenditure had gone hand in hand with increased industrial prosperity, which alone rendered the country able to bear the burdens", but that, since the war, public

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* Sir James Lithgow, President of the F.B.I. (1930-2).

expenditure and national income had not grown in line, "directly depriv[ing] industrialists both of the capital and of the psychological incentive which was essential to real development."(82)

In part, the F.B.I.'s views on taxation followed from their conception of the rôle of government in economic affairs, so that the question of high taxation was not a purely economic one. For example, shortly after the 1931 crisis, the following policy statement was approved for publication:

> Heavy expenditure on social services and on general administration and the crushing load of direct taxation has undoubtedly seriously accentuated the difficulties inevitably imposed upon the country by the world crisis. In the opinion of the Federation the country has been attempting to work an economic system based on private enterprise under circumstances which made the successful conduct of such a system impossible. Private enterprise can only function efficiently and afford good employment and a good standard of living for the people if it is allowed to operate with reasonable freedom from Governmental restraints and is given the essential conditions for success. The most essential of these conditions is a plentiful and cheap supply of capital. Great Britain must therefore again become a country in which it is easy to accumulate capital and attractive to invest it. Heavy direct taxation, especially of the present type, e.g. Income Tax, Super Tax [sic], and Death Duties, all at high rates, is peculiarly inimical to the accumulation of capital and a serious deterrent to its investment. It is also psychologically a serious discouragement to the enterprise and initiative which is essential to the wellbeing of an industrial and trading nation. (83)

Rarely did the F.B.I. voice its opinions so strongly; nevertheless, the passage clearly illustrates the strength of feeling against prevailing tax rates.

Within the business community, and in its discussions with government, debate focused not only on the rate of income tax but also on the question of allowances for business undertakings. A limited measure of financial relief had been granted in 1929 with the derating scheme, whereby rates were reduced on property used for productive industry or freight transport, the central government reimbursing to local authorities a sum equal to the estimated loss of revenue from these sources.*

Following the report of the Royal Commission on Income Tax (1920),[(84)] depreciation allowances had been granted in respect of wear and tear on plant and machinery,** a further (obsolescence) allowance also being paid if a capital asset was replaced before exhausted. The Royal Commission had further recommended that the obsolescence allowance be granted irrespective of whether the capital asset was replaced or not. This proposal had not been accepted,*** but was seen by the business community as an important means whereby the income tax could be used to aid industrial rationalization.

The question was considered in some detail by Inland Revenue and the Treasury in 1930; firstly, as a response to representations from the F.B.I. and the British Chambers of Commerce;[(85)] and later, after an amendment - proposing full relief against tax for the whole capital cost of new plant and machinery - had been put down on the Finance Bill.[(86)] The objections raised by the two departments to these schemes have a wider applicability, to the general question of using taxation to stimulate economic activity.

Firstly, Inland Revenue maintained that since the real difficulty was in obtaining capital to finance rationalization schemes, rather than in entrepreneurs being

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* The cost was approximately £22m per annum for local authorities in England and Wales (Burns 1941: 120).

** The allowances were increased in 1931 and 1938, on both occasions as a partial offset to the increased standard rate of tax.

*** It had also been rejected by the Colwyn Committee.

"deterred from [so doing] because they [did] not get obsolescence allowances", such allowances would do little to generate additional investment. Therefore, "as a subsidy given from the Revenue to industry for the purpose of fostering rationalisation ... the price would prove to be altogether out of proportion to the results."(87) While such an argument was far from decisive, it was overshadowed by other, more weighty, objections: the schemes' cost was difficult to estimate - both departments were always reluctant to enter into open-ended commitments; and it threatened certain basic canons of the income tax code - therefore carrying with it the risk that it would be used as a precedent by other groups and would eventually result in a marked diminution of the tax base.(88)

Capital allowances were firmly opposed throughout the rest of the 1930s. Indeed, all but very limited financial concessions to industry remained an anathema within Whitehall. Nowhere is this more clearly evident than in the very strong reaction of the authorities to the third report of the Special Areas Commissioner for England and Wales.(89) The Commissioner, Sir P. M. Stewart, had not only made the radical suggestion that the further growth of industry in London should be controlled, but had also suggested a package of financial measures to induce new firms to locate in the Special Areas. Of these, the most controversial was the proposal to relieve from income tax profits not distributed but put to reserve, and exempt from income tax profits not exceeding £500.(90)

Inland Revenue, believing "that the trouble of the depressed areas [was] high cost[s] of production and [that] the taxation of the profit margin cannot lower the cost[s] of production",[91] dismissed the proposal as of little financial significance to firms in these areas.[92] Moreover, there were grave dangers associated with such a proposal: it was quite indefensible to give preferential treatment to new industry over existing industry in the Special Areas and, in the case of large companies, impossible to differentiate which of their factories made what profit; in the case of factory extensions it would be impossible to tell the extra profits due to the extension; concentration on profits gave no help to firms making losses; the Special Areas were not the only areas having depressed industries; and finally, tax reliefs could never be temporary. Accordingly, the memorandum concluded:

> that if the State is to embark upon the policy of holding out financial inducement for the development of enterprise in the Special Areas the true course is to determine the subsidy in a form that is available irrespective of the profits that may result from the enterprise and is directed to reducing any handicap that these areas suffer from. To attempt it through the Income Tax queers the Income Tax pitch and produces a capricious form of relief that does nothing effective to assist the Special Areas. (93)

The Treasury shared these objections to the proposal; more generally, they placed special emphasis upon the fact that subsidies (either as negative or positive expenditures), by virtue of the fact that they were not selective, were financially expensive in terms of the results achieved, and raised administrative and political questions much wider than the specific issue of financial assistance to the Special Areas.[94]

Financial assistance on any substantial scale to the business sector was seen as the first step in an irreversible process which would steadily erode the revenue base, and therefore threaten budgetary stability;

it would also open up a Pandora's box of administrative difficulties with profound political implications for the rôle of the state in the economic-political life of the country. Experience since 1945 lends support to the existence of these difficulties, the legitimacy of which is largely a matter of political choice rather than economic debate. There was a definite reluctance to use the taxation system as a vehicle to aid industrial recovery; in addition, as is well established, interwar governments generally avoided intervention wherever possible. Where intervention proved unavoidable, as increasingly became the case in the 1930s (e.g. shipping), intervention was ad hoc, was directed to the industry as a whole, and most importantly did not operate through the taxation system.

Finally, a few preliminary conclusions may be drawn. Whilst there was a reluctance to use the tax system in a discriminatory manner, it was firmly accepted within the financial departments that taxation was a potentially important instrument of economic management, and that in particular a cut in income tax (which would affect both corporate and personal incomes) could have beneficial effects in promoting recovery. It was also recognised that in a depression increased taxation could exacerbate deflationary forces. Thus the foundations for modern economic management were already in existence; but it was the continued adherence to the balanced budget rule which prevented the effective translation of these attitudes into practical demand management. The reasons for the maintenance of budgetary orthodoxy must now be examined.

CHAPTER 4
THE BUDGET AND BUDGETARY POLICY: INTRODUCTION

Fiscal policy in the years following the abandonment of the gold standard, indeed throughout the whole interwar period, has been judged by a number of writers to have been limited in its scope and objectives, and seriously destabilizing in its operation.(1) These questions are explored in this and the two following chapters:(2) first, a satisfactory definition of the budget is obtained, and then the main issues involved in evaluating interwar budgetary policy are introduced; in chapter 5 the budgetary history of the period 1929-39 is chronicled; and, finally, in chapter 6 constant employment budget balance estimates are employed as a measure of changes in fiscal stance.

1. The budget: conventional and adjusted definitions

A necessary starting point in any discussion of budgetary policy during the interwar years is the budget definition employed by the authorities. The figures used in this study relate to central government plus the social insurance funds, not to the public sector as a whole, the concept now currently in use.* For the interwar years, when there were no nationalized industries and only a few public corporations, the principal omission is local government. Since it was, to a large extent, independent of central government,(3) its omission is not inappropriate: our objective is to embrace within our definition of the budget that sector of the

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* This does not, however, preclude consideration of the expenditures of local authorities and public corporations where appropriate; for example, when assessing the total effects of fiscal operations in chapter 6.

economy over which the Treasury had effective control and through which it therefore exercised its fiscal policies.

The interwar financial statistics for central government present a number of difficulties:

(1) The budget, as conventionally defined at the time (see identity (1) below), was not based on a coherent concept, nor did its definition remain constant. The exact components of the two sides of the account in any year were "to some extent at least a matter of chance and partly even of choice."[4]

(2) The accounts were not only an amalgam of current and capital receipts and outlays, the composition of which varied from year to year, but in addition the budget did not cover the whole of central government activities; in particular, it excluded the social insurance funds (although the central government contribution to these funds was included in 'Ordinary Expenditure').

(3) Expenditure as conventionally defined (G_c in identity (1) below) also omitted expenditure financed by borrowing under specific Acts of Parliament, while debt redemption was incorporated in general expenditure. Revenue (T_c in identity (1) below), on the other hand, covered not only current tax and non-tax revenue but also included non-recurrent transfers as devices to aid the balancing of the budget.

Account of these factors was taken when redefining the budget on an unchanging and unambiguous basis. The starting point was the conventionally defined budget:

$$B_c \equiv T_c - G_c \qquad (1)$$

where B_c was the budget balance; T_c 'Ordinary and Self-Balancing Revenue' which included the major tax receipts, the proceeds of sales of state property, repayment of loans granted to foreign governments, interest payments, shares in profits, receipts from special funds and the revenue from the Post Office; and G_c 'Ordinary and Self-Balancing Expenditure' which covered debt interest and sinking fund payments, expenditure on the Armed Forces and Civil Departments, capital expenditure (except certain capital items voted outside the budget by specific Acts relating mainly to outlay by the Post Office and, in the later 1930s, to defence expenditure), and the (current account) expenditure of the Post Office.

Thus defined, B_c was the balance used by the authorities and economic commentators in presenting and assessing policy. A balanced budget therefore meant that G_c should not exceed T_c.

The definition of the budget used in this study is:

$$B \equiv T - G \tag{2}$$

where B is the budget balance and

$$T \equiv T_c - NRT + SIFPC \tag{3}$$

$$G \equiv G_c + (CE + OB + DB - SF) + (SIFB - SIFGC) \tag{4}$$

where T_c and G_c are as before, and

NRT = Non-recurrent revenue included in T_c

SIFPC = Private sector contributions to the social insurance funds

CE = Capital expenditure financed by borrowing

OB = Other expenditure financed by borrowing

DB = Defence expenditure financed by borrowing

SF = Sinking fund payments included in G_c

SIFB = Total benefits paid by the social insurance funds

SIFGC = Central government contributions to the social insurance funds included in G_c

These adjustments serve two purposes: firstly, they revise the coverage of the central government accounts so that they conform more closely to those now currently in use;[5] secondly, they remove the effects of fiscal window-dressing; that is, the exclusion of non-recurrent receipts and the inclusion of various items of expenditure financed by borrowing nullifies the accounting devices employed by the Treasury to aid the achievement of a target balance B_c.[6]

2. Fiscal window-dressing

Table 4.1 records the conventionally defined budget balance (B_c) and the adjustments made to expenditure and revenue as part of the procedure for obtaining an unchanging, and economically more significant, definition of the budget (B). As above, these adjustments can be considered in two stages.

The exclusion of sinking fund payments and extension of the budget definition to incorporate fully the social insurance funds requires little comment. Its effects are clear: the budget balance is improved in the case of the former; whereas, in the case of the latter, the balance on the social insurance funds could, at certain times (e.g. 1929-31) have important consequences for budgetary stability. A discussion of this is deferred until a later chapter.[7]

Table 4.1

Budget balance, revenue and expenditure adjustments, 1929/30-1939/40 (£m)

	Budget balance (B_c)	fiscal window-dressing expenditure	fiscal window-dressing revenue	Sinking fund	Budget balance (B_A)*	Social ins. funds	Budget balance (B)
1929/30	-14.5	-15.3	-3.5	+47.7	+14.4	+3.0	+17.4
1930/1	-23.2	-11.0	-23.2	+66.8	+9.4	-33.6	-24.2
1931/2	+0.4	-18.1	-20.9	+32.5	-6.1	-39.6	-45.7
1932/3	-32.3	-33.4	-11.9	+26.3	-51.3	+1.1	-50.2
1933/4	+31.2	-6.5	-10.0	+7.7	+22.4	+10.9	+33.3
1934/5	+7.5	-7.5	-	+12.3	+12.3	+13.5	+25.8
1935/6	+3.0	-10.5	-8.0	+12.5	-3.0	+19.0	+16.0
1936/7	-5.6	-13.5	-11.8	+13.1	-17.8	+32.5	+14.7
1937/8	+28.8	-81.9	-5.1	+10.5	-47.7	+32.0	-15.7
1938/9	-12.7	-150.7	-1.5	+13.2	-151.7	+14.5	-137.2
1939/40	-276.0	-513.8	-1.4	+7.2	-784.0	+34.8	-749.2

Sources: See App.I for both sources and methods of adjustment.

Notes: * $B_A \equiv T_A - G_A$, where $T_A \equiv T_c$ - NRT, and

$G_A \equiv G_c$ + CE + OB + DB - SF.

Prior to 1937 fiscal window-dressing on both sides of the budget accounts was small in magnitude at less than 1% of GDP. Thereafter the difference between the conventionally defined and adjusted budget balances, respectively B_c and B_A, widened appreciably as fiscal window-dressing altered in form - the expenditure element increased markedly as defence expenditure (only part of which was included in G_c) came to dominate the course of budgetary policy, while on the revenue side fiscal window-dressing became insignificant, the scope for such transactions being greatly reduced as potential sources of revenue were exhausted. Whilst for the greater part of the period the total magnitude of fiscal window-dressing was not large, such practices were central to budgetary planning; consequently, an appreciation of them is crucial in understanding budgetary policy during this period, for fiscal window-dressing acted to conceal deficits and thus provided, within certain limits, a means of avoiding discretionary action and its consequent adverse effect on demand, if a target balance (B_c) was to be attained.

Fiscal window-dressing on the expenditure side took the form of excluding various categories of expenditure financed by borrowing - for capital purposes, defence, and miscellaneous items - which more correctly should have been assigned to the budget. Although in one sense these items were visible, even if only to a few financial experts, and the veil over the authorities' activities was transparent, in general the authorities were successful in obscuring the true expenditure position and conveying the impression of adherence to orthodox financial principles. Similarly, on the revenue side, non-recurrent items were brought in which should have been excluded according to the accounting practices ostensibly in use. These receipts were varied from year to year, according to the exigencies of the budgetary situation, as the Treasury sought to maintain the illusion of a balanced budget throughout the greater part of the 1930s. While the sums involved in this sphere of fiscal window-dressing were generally smaller than on the expenditure side, the operations were more intricate, largely invisible and involved a more complicated subterfuge.

The ability to indulge in this type of fiscal window-dressing or cosmetic action primarily stemmed from the absence of a rigorous statutory definition of the budget. By the interwar years, as Chancellors were forced to try and accommodate demands for greater social expenditure within the dictates of budgetary orthodoxy, the budget identity had become an amorphous hybrid, an amalgam of current and capital accounts, devoid of any internal consistency or tangible economic significance. There is no evidence in the Treasury papers that budgetary reform was seriously considered.(8) Primarily because few were really aware of the extent to which such devices were employed in budgetary policy,* there was no real pressure for reform. As Phillips argued:

> there is no great technical difficulty in producing for a series of years budgets which are balanced at the end of the year to the nearest penny ... Perhaps half a dozen financial writers in the country would understand from published accounts what was happening, but I doubt if any one of the half dozen is capable of making the position clear to the public. (9)

There were, however, limits to the Treasury's activities in this field. Under Churchill's stewardship of the national finances (1924-9) "devices of unprecedented ingenuity for balancing the budget" had been employed which deeply offended conservative financial interests.** In the 1930s the Treasury was careful not to run the risk of having its activities exposed. Hence the use of such expedients in any one year was limited; for example, in April 1933 (when the Treasury had already decided to appropriate £10m from the War Loan Depreciation Fund), Phillips suggested that in addition £3.8m could be obtained by taking two years' surplus from the Savings

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* For example, Hicks (1938: 279-89), Clark (1933: 434; 1937: 136-7), the Liberal Industrial Inquiry (1928: 418-25), and <u>The Economist</u> (e.g. Budget Supplement, 10 April 1937, p.1), were all aware of such practices, though not the full extent of them since they had to rely on published accounts, and pressed for budgetary reform. The majority of contemporary writers, however, seemed unaware of this dimension of policy.

** Hicks (1938: 7, 11). During the period 1926/7 to 1928/9 an estimated £52m was taken into revenue as a result of Churchill's activities in this field (T172/1684, Note by Phillips, 23 Oct. 1929).

Banks in one year. Hopkins, however, firmly opposed such a course: "in my view one big sin like the Depreciation Fund is all right, but one big one and one little one side by side sounds too unorthodox and I shouldn't do it."(10)

While non-recurrent receipts paid into revenue (T_c) were postponed or accelerated according to 'necessity',* in addition, during discussions preceding the presentation of the budget, the Treasury would manipulate the revenue and expenditure estimates so that a potential deficit "would then be covered on paper."(11) As was shown in the previous chapter, the Inland Revenue would occasionally relax pressure for the collection of income and surtax in the final quarter of the financial year if it was anticipated that the estimate would be exceeded and the financial position was likely to be more serious the following year. The sums not collected would then be taken as arrears the following year.(12) In normal circumstances the Treasury avoided recourse to the device of under-estimating expenditure and inflating the revenue estimates, for in the first case they ran the risk of having to introduce a Supplementary later in the year, while the second course entailed the danger that their activities would be exposed.(13) Moreover, a budget that was so tightly planned would not contain a 'hidden reserve' which was seen as necessary to meet unforeseen contingencies.(14) Nevertheless, the serious

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* Using the Treasury's internal receipts book (T239/25-7) the exact date of a receipt can be pin-pointed. These registers show that, in general, the Treasury paid items into Miscellaneous Revenue in the first three quarters of the financial year, thus reducing the central government deficit during the period when expenditure, irrespective of whether the final budget outturn was in balance, greatly exceeded revenue. If the budget forecast, however, was a deficit, although of an uncertain magnitude, receipts from items such as the profits of the Bank of England note issue, the National Debt Commissioners, and the Enemy Debt Clearing Office were taken in the last week of the financial year, their magnitude being varied (roughly) according to the sum necessary to balance the budget.

budgetary difficulties of the early 1930s meant that such devices were employed; in particular, the estimates for expenditure on unemployment were reduced in 1932 and 1933 below the figures recommended by the Ministry of Labour as part of the Treasury's attempts to avoid raising taxation further and thus retarding the nascent recovery.[15]

In the circumstances of the 1930s where the existence of mass unemployment made it politically difficult to achieve the tightening required to balance the budget in the face of autonomous fluctuations in activity, fiscal window-dressing and related practices served the essential function of allowing the Treasury apparently to adhere to orthodox financial principles whilst simultaneously limiting the extent of fiscal tightening required in a depression to maintain a balanced budget (B_c).

The existence of such budgetary practices would support the rather cynical view, expressed in a more recent budget debate, that "all Budgets are to some extent mythical creatures comprising a considerable admixture of illusions."[16] It also suggests some scope for revision of the traditional interpretation of the authorities' belief in balanced budgets, in that adherence to budgetary orthodoxy would appear to owe something to political expediency as well as 'sound' economic principles.

3. Budgetary orthodoxy

We consider first the principles underlying nineteenth century public finance.[17] In general terms, these can be summarised in a set of propositions which hinged on the balanced budget convention (or rule) that the minimum objective of government in the financial sphere was to cover its expenditure with its receipts. Two exceptions, or relaxations of this rule, were permitted: (1) in war-time the exigencies of the situation allowed limited recourse to borrowing; and (2) capital projects shown to be remunerative in an accepted accounting sense could be financed by borrowing. A number of related propositions followed from the balanced budget convention and the view of the limited functions of the state from which it, in turn, derived:

(1) Since taxes were a burden on productive enterprise, and expenditure should be limited to those functions of government considered absolutely necessary, the size of the budget (in relation to GDP) should be kept small, and the aim of budgetary policy should be an *ex post* surplus to permit debt redemption and/or remission of taxation.

(2) The balanced budget convention was further reinforced by the antipathy towards deficit finance, a process which was viewed as withdrawing funds from productive employment.

An appreciation, however, is essential of the historical setting in which these principles of public finance evolved: firstly, in understanding their strength and diuturnity; and secondly, why they ceased to be appropriate in the changed economic and political conditions of the twentieth century.

When Adam Smith propounded the maxim in *The Wealth of Nations* (1776), which underlay the balanced budget convention, that "What is prudence in the conduct of every private family, can scarce be folly in that of a great Kingdom", the target for attack was the then prevailing mercantilist doctrines. It was not intended as an absolute rule, immutable, and applicable to all historical situations. Rather, it derived from Smith's conviction (which was shared by the later 'classical' economists) that the state was an inefficient form of organization for wealth creation, because it rested on a pattern of special trading privileges, grants of monopoly and tariffs; and that governments, unless constrained by a balanced budget rule, would retard capital formation if they were permitted to borrow funds since these would otherwise be productively invested. Thus the classical case for balanced budgets rested on a series of interrelated propositions, of both an economic and political nature, which reflected attitudes towards the rôle of the state, the responsibilities of government, and the belief that the unconstrained operation of market forces would ensure full employment equilibrium.(18)

Similarly, the preoccupation of contemporary economists and financiers with redeeming the national debt reflected prevailing conditions, notably that control over the rate of interest or the domestic price level was not within the power of the authorities, and thus the debt could become an important restrictive element in the economy whilst, in addition, frustrating operations calculated to reduce the burden of the debt.(19)

A number of other factors were also important. In the conditions of primitive accounting control which held prior to Gladstone's reforms of the 1860s, a balanced budget was used as a means of assessing the efficiency of financial management. More generally, the budget was a political event, a means of discussing and criticising the economic policy of a government.(20) As has recently been shown, the balanced budget convention, the cornerstone of the nineteenth century 'fiscal constitution', was not "some unthinking Victorian moral code which had nothing whatsoever to do with the rational conduct of government affairs"; on the contrary, it "played a crucial role in ... constraining the otherwise inherent biases of that system to over-expenditure and deficit finance."(21) These biases or weaknesses in the fiscal constitution centred on fears of profligacy of politicians in a democratic political setting, the weak position of Parliament in the financial control it exercised over the executive, and the leverage exerted by the service departments, with their incessant demands for increased expenditure, within the executive.(22)

As Hicks has argued, adherence to balanced budgets in the nineteenth century was "a sound economic instinct" given the backcloth of rapidly expanding population and growing prosperity. Moreover, the evidence suggests that towards the close of the century there occurred "a not insignificant change of heart, at least in the sense of reluctance to increase tax rates substantially in bad times", while the balanced budget convention:

> became increasingly embarrassing, and indeed economically inappropriate, as the strong expansionary phase of the British economy died away. It seems that a sort of horse-sense prevented the later Victorians from following too faithfully an inappropriate fiscal policy. The attempt to return to the pure milk of Gladstonian finance in the next Great Depression (particularly in the second budget of 1931 ...) finally demonstrated that the old medicine was no longer safe, unadulterated, for internal use. (23)

Returning now to the interwar years, we may summarise as follows the traditional interpretation of the allegiance to budgetary orthodoxy:

(1) Many have argued that the Treasury, consciously or unconsciously, adhered to some sort of belief, stemming from classical economics, "that all factors of production are normally and inevitably utilized by private business, [and that] it follows that the State can obtain the use of such factors only by preventing private business from using them ... From this it follows that the first principle of 'sound' Public Finance is that the budget should be balanced."(24) Furthermore, unbalanced budgets were counter-productive because they would have an adverse effect on business confidence, especially if they resulted from unremunerative public works. As one contemporary put it, "What was gained on the swings of public investment was, therefore, liable to be lost in part on the roundabouts of private investment."(25)

(2) Within this schema it was further contended that unbalanced budgets were inflationary.

(3) An increase in the size of the deadweight national debt was seen as highly undesirable for the increased debt charge (interest payments and sinking fund) would place additional burdens on productive enterprise.

Against these supposed tenets of orthodox thought Keynes and other perfervid advocates of a more active and interventionist policy argued that in the circumstances of the 1930s it was absurd to hold that a budget deficit would 'crowd-out' private sector demand or that an increase in the money stock would be inflationary. The fact that the financing of the deficit would have monetary consequences, in the sense that the government's debt operations acted on the credit base, was not a matter of contention; the area of dispute was whether inflation was automatic and not instead dependent on the pressure of demand in the labour market. Since this was a central theme of the interwar policy debate, the various aspects of this question are considered in greater detail in the following section.

The automatic association of budget deficits with inflation stemmed principally from a misinterpretation of the causes of inflation and resulted from the fact that classical economic theory drew an artificial distinction between real and monetary forces.(26) In addition, there had developed a strong and apparently irrational fear of inflation, which was to influence many of the policy decisions of the period - in particular, the return to the gold standard in 1925 and the heroic attempts made to remain on gold in 1931.

It is usually argued that the preoccupation with the national debt stemmed from a fundamental confusion between the position of a private business or individual and that of the state, for it ignored the fact that whereas the former must default unless able to meet expenditure out of income, the latter's debt was not a burden in the same sense since the state represents the community as a whole and holds its debt with the same body it represents. In fact, the authorities' fears were not as irrational as one would suppose. As has been shown, the interwar years were characterized by a falling price level, fears about future population trends, and a greatly enlarged debt charge caused by the First World War.(27) The latter was to reinforce the already existing deflationary bias in budgetary policy, while the greatly increased transfer payments within the economy acted, given the generally regressive nature of the tax system, to depress the overall propensity to consume and thus aggregate demand.

The question whether the direct demand effects of an unbalanced budget would be counteracted by an adverse effect on business confidence and therefore private sector demand, either through the effect on the rate of interest or more generally on business expectations, was central to the economic policy debate of the 1930s and in a sense is still pertinent today, for to a large extent the success of fiscal operations in a capitalist society depends on their being favourably received by financial markets.

On strictly economic issues the Treasury's position has been misunderstood. On the question whether unbalanced budgets automatically resulted in inflation, the Treasury, in the early 1930s, held the following position:

> There is a strong public instinct which associates unbalanced Budgets with inflation, and no men have done more than the present Government to impress that view on the country. The public instinct is right, but it would be an entire mistake to suppose that an unbalanced Budget means immediate or rapid inflation. In the case of a financially strong country the process from Budget deficits to inflation is a long drawn out agony which may drag on for years. So long as the Government can borrow from the public to cover the deficit there is no inflation. The cost of borrowing will rise which makes the Budget position worse but the crash will only come, if it does come, at long last when the public is completely discouraged and will lend the Government no more money. Till that moment arrives there will be no inflation. (28)

This document suggests that the balanced budget convention in addition to having an economic rationale also derived from political and psychological origins.

Maintenance of balanced budgets was publicly expressed in terms of adherence to certain economic principles, whereas political considerations were of paramount importance. On this point it is worth citing at length a Treasury document - a comment on Keynes's Means to Prosperity (1933) - which articulates these political considerations and puts the policy prescriptions of the 'new' economics within a political, as well as economic, context:

> If the Budget were unbalanced by £50 millions to take a shilling off the Income Tax, the process would not stop there. If once expenditure can be incurred without the unpleasant necessity of imposing taxation to cover it it would become impossible for the Chancellor of the Exchequer or the Government or the House of Commons to control public expenditure, especially if borrowing for current expenditure was advocated as the road to prosperity.
>
> ......
>
> We can see what has been the painful experience of other countries, and it will be remembered that immediately after the war when we were still meeting current expenditure out of borrowings there was an orgy of expenditure of all kinds and that after a year or two far heavier taxation even than that of the war years had to be imposed to pay for it. We do not want to repeat that process. Keynes and Co., whilst agreeing that normal Budgets must be balanced to prevent disaster, say that this is the one psychological year when a concatenation of circumstances has arisen to justify deliberately unbalancing the Budget. But can anyone suppose that, once a precedent of this kind was set, people would remember the special arguments adduced to justify it? Whatever may be thought by people outside, members of the House of Commons will realise how impossible it would be once we had abandoned the principle of paying our way to stop a rising tide of expenditure. Within a year or two (i.e. very near the next General Election) there would be the sort of situation we had in 1931, i.e. the need for new cuts and new taxes. (29)

From this a very important conclusion followed: remission of taxation only had a favourable psychological effect when occasioned by a previous budget surplus:

> Would there be the same psychological effect when the remission was only given by unbalancing the Budget and when it would be followed immediately by clamant demands for new expenditure, every demand justified on the same grounds as had led to the original unbalancing of the Budget and the beginning of borrowing. Would not the ordinary taxpayer and the business man very soon begin to have a feeling of uneasiness and apprehension? After all people will

> realise that the bill must be paid if not this year next year or the year after. Uncertainty and apprehension as to the future would very quickly cancel out any immediate psychological benefit which the reduction of taxation by unbalancing the Budget would promote. (30)

Thus the precept of the balanced budget acted as the ultimate constraint on the growth of expenditure, since it moderated and tempered the natural demands of politicians and sectional interests for new expenditure, and provided a 'neutral' framework within which competing demands were reconciled.

This conclusion relates to recent literature in 'public choice' economics,[(31)] in particular the new critique of Keynesian economics developed by Buchanan and Wagner.[(32)] This is concerned less with the fundamental accuracy of the Keynesian diagnosis of inherent instability and potential for under-employment equilibrium in market economies, and more with the realism of the political philosophy underlying the 'new' economics. This critique rests on two premises:

(1) The instrument Keynes introduced to ensure full employment - budget deficits - removed completely the institutional constraint to the growth of expenditure.

(2) Keynes's assumptions about political behaviour - termed by his biographer the "presuppositions of Harvey Road"[(33)] whereby Keynes implicitly assumed that the small élite responsible for formulating economic policy would, even in the face of historical evidence to the contrary, always act in accordance with the public interest and not succumb to political or other pressures -, although both highly idealistic and altruistic, were also naive and had dangerous implications for political-economic stability.

It is contended that such a view, combined with the additional instrument of economic policy provided by the 'new' economics, was both unrealistic and totally unsuitable for the conditions of a representative democracy, for the abandonment of the balanced budget constraint permitted politicians to engage in operations against the long-term public interest by serving their short-term political and electoral advantage.

The foregoing analysis suggests that the Treasury held a similar position, although it was never articulated in such a systematic and precise form, and instead derived from an intuitive conviction that, whilst Keynes and other advocates of an active fiscal policy essentially desired long-term balanced budgets,(34) such a policy of 'functional finance' was politically unrealistic and even naive, for political pressures would vitiate the imperative of raising taxation (to create the surplus) as boom developed.

Even in the 1944 Employment Policy White Paper,(35) the so-called "formal recognition of the principles of the Keynesian Revolution in Britain",(36) there was a definite unwillingness to countenance unbalanced budgets as a long-term policy. Beveridge accused the Treasury of being "still far too inhibited in regard to central finance, too fearful of increasing the national debt",(37) whereas, in fact, the Treasury's attitude reflected the fear, which was quite widely held in Whitehall, that the complete removal of the balanced budget rule (either over one year or the course of a trade cycle) would lead to an explosion of expenditure and the assumption of greatly increased state powers in the postwar period.

It is also interesting to note that in the formative period of the monetarist counter-revolution of the 1960s, an integral part of the attack on the efficacy of fiscal policy centred on an appreciation of the political factors involved in formulating budgetary policy and the way in which discretionary action could in practice be destabilizing. Admittedly, the main thrust of attack centred on theoretical issues, in particular whether changes in the money stock had an indirect effect on aggregate demand as a result of wealth effects, but as Friedman says:

> In the United States the revival of belief in the potency of monetary policy was strengthened also by increasing disillusionment with fiscal policy, not so much with its potential to affect aggregate demand as with the practical and political feasibility of so using it. (38)

In the following chapters it will be shown that while on economic grounds alone the Treasury remained sceptical throughout the 1930s of the efficacy of the policy prescriptions of the 'new' economics, on strictly political grounds monetary policy remained a more acceptable instrument of stabilization policy for in a sense it was politically neutral. Thus Phillips in comparing the respective merits of fiscal and monetary policy as recovery devices concluded:*

> The truth is that neither Budget deficits nor excessive public works can bring about inflation unless and until certain special conditions are fulfilled. Those conditions are that the Government borrows not from the public but from the Central Bank; and that the Central Bank uses the new assets which it receives in the form of Governmental promises to pay as the basis of a fresh creation of credit. It is the increase in Central Bank assets which produces inflation under certain conditions, and Budget deficits operate only through that factor. Everything

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* Inflation in this context meant reflation, rather than an increase in the price level for its own sake. Phillips's theoretical position was very similar to that of Hawtrey (1925)

> that a Budget deficit can do, could be done very much more simply by the Central Bank increasing its assets on its own account by buying gold or securities. The Budget deficit is a useless complication and a very dangerous one because it is difficult to reverse and [can get] completely out of control. (39)

This fear of the continued growth of expenditure was a major preoccupation throughout the interwar period. Thus the May Committee had lamented the deplorable state of affairs where the dice had become so heavily loaded in favour of expenditure,(40) explaining this development in the following terms:*

> After the heavy sacrifices of the war large sections of the nation looked to the post-war period with the natural expectation of a general improvement in the old conditions of life. The disappointment of many hopes in the economic sphere seemed to intensify demands for improvements from political action and all parties have felt the insistent pressure for promises of 'reforms' as the price of support, such 'reforms' being in fact mostly of the nature of privileges or benefits for particular classes at the cost of the general taxpayer. The results of this pressure are to be seen not only in the lavish promises contained in the election addresses of the period since the war but in the undertakings freely given by individual Parliamentary candidates to sections of the electorate. At election times those desiring increased expenditure on particular objects are usually far better organized, far more active and vocal than those who favour the vague and uninspiring course of strict economy; and as a result candidates not infrequently find themselves returned to Parliament committed, on a one-sided presentation of a case, to a course which on fuller knowledge they see to be opposed to the national interests. (41)

What exactly should be understood by political neutrality, in the context of the choice of monetary or fiscal policy? Political neutrality may be thought of not only as a belief in the <u>laissez-faire</u> ideal that market forces, unencumbered

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* This problem was particularly acute with regard to the unemployment insurance system: "Each successive Government has made changes in the scheme, which have been determined less by the need for the careful balancing of income and expenditure than by a desire to attract, or do as little as possible to repel, electoral support" (Royal Commission on Unemployment Insurance (Gregory Commission), <u>Final Report</u>, Cmd.4185 (1932), p.164).

by government interference, would ensure the attainment of full employment equilibrium and the optimal allocation of productive resources, but also the fear, in some Hayekian sense,[42] that since political parties and pressure groups always violate general economic rules, acceptance of the policy prescripts of the 'new' economics would create the opportunity for politicians to interfere with the operation of market forces for the benefit of particular groups, this development culminating in the situation in which politicians, for electoral purposes, would be forced to pursue policies against the long-term public interest.

The Keynesian revolution as applied to public finance overthrew the balanced budget convention but failed to substitute an alternative set of guidelines calculated to constrain the natural profligacy of politicians in a democratic political setting. Thus was created the possibility of political-business cycles.[43] While such cycles were not possible in the interwar period, the influence of political factors cannot be completely discounted. Accusations were made against Churchill's 1929 budget (delivered only some six weeks before a General Election), which had remitted taxes across the board, that it was a blatant act of electioneering;[44] similar comments were evoked by the change in the government's unemployment policy in 1935, the liberalization in attitudes towards public works reflecting the political threat posed by Lloyd George's 'New Deal';[45] and there is no doubt that Chamberlain's budgetary strategy of 1932-5 was strongly influenced by political considerations.[46]

The importance of political neutrality as a guideline for policy* may be illustrated by reference to two important episodes during the interwar period: the adoption of tariffs in 1931-2, and the motives for the return to the gold standard in 1925.

At first sight the adoption of tariffs would seem to conflict with the view that, in general, the economic policies adopted during these years attempted to solve economic problems without creating a series of vested interests which would endanger long-run economic and political stability. But, in the eyes of the authorities, such a situation was guarded against by the creation of the Import Duties Advisory Committee which,(47) rather than the Board of Trade, was charged with overseeing the operation of the tariff and considering applications from specific groups for further tariff protection, thus appearing to take tariff questions 'out of politics'. This objective is visible from the very earliest stages of planning the tariff. Thus the Conservative Research Department's _Tariff Committee Report_ of June 1931 (on which the official tariff was largely based) stated:

> The tariff can never be 'taken out of politics', and the original emergency tariff must be purely the work of politicians and the Government ... But the right way to carry out the adjustment and transformation of the original tariff ... is in our opinion through the machinery of a non-political impartial Tariff Commission, whose recommendations the Government may either accept or reject, but shall not go beyond. To nothing connected with the tariff do we attach higher importance than to the correct functioning of this body ... (48)

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* See Booth (1978) for the way in which the National Government, usually with Chamberlain as the motivating force, tried repeatedly to divorce policy questions from their political context. This was primarily achieved by creating administrative bodies, such as the Unemployment Assistance Board, which were quasi-independent of executive control.

In a rather different sense the idea of political neutrality has an applicability to the motives underlying the return to gold, for in its most extreme theoretical form the gold standard can be viewed as the very embodiment of the laissez-faire ideal in that the adjustment mechanism would be entirely automatic, thus precluding state intervention or management.(49) For example, at the famous dinner party in March 1925 when Churchill assembled together Keynes, McKenna, Niemeyer, and Bradbury to discuss the merits of return, Grigg (the only source for this episode) relates that Bradbury "made a great point of the fact that the Gold Standard was knave-proof. It could not be rigged for political or even more unworthy reasons."(50)

This raises the interesting question why the economic authorities, indeed informed opinion generally, were unwilling to trust politicians with economic management. Thus Snowden believed that:

> [In] the control of credit and currency, the administration of the control must be kept free from political interferences. I will tell you why. In the first place Parliament is not a competent body to deal with the administration of such highly delicate and intricate matters. The second argument is this, that I have seen and I know something of the danger of the control of credit and the means of starting an inflation policy, and it might be highly dangerous in the hands of a Government that wanted to use this means in order to serve some purpose, or to gain popular support. (51)

One possible explanation is that this type of view:

> derived partly from the experience of inflation during and after the war, which was put down to political chicanery rather than to the war. Out of it arose the moral denunciation of the 'managed currency' of 1914-25, and the dangerous myth that a gold standard like the one of 1925-31 was automatic, and not (as it in fact was) also 'managed'. (52)

In the creation of this 'myth' the example of the Continental inflations of the early 1920s was undoubtedly instrumental.

Whilst we can see ex post facto that this fear of inflation stemmed from a misunderstanding of cause and effect in inflationary processes, we can also appreciate the profound impact on those responsible for formulating economic policy in Britain of the impoverishment and destitution of much of the German middle class and the subsequent growth of extremist politics. Nor should the British inflation of 1919-20 be forgotten:[53] this was to have a lasting impression upon policy makers and, very likely, was to prejudice the case against deficit finance in the very different circumstances of the 1930s.

The balanced budget convention and belief in the automatic operation of the gold standard were thus in a sense analogous, in that they were perceived as a means of controlling political action which could be disadvantageous to the long-term public interest, and had developed as responses to the dangers inherent in a democratic, pluralistic society. It is within this framework of analysis, rather than one which views adherence to balanced budgets exclusively in terms of an economic rationale, that we can now proceed to survey the budgetary history of the 1930s. Before doing so, however, the crowding-out issue is further considered.

4. Crowding-out

In this final section we discuss more fully the crowding-out debate, its relevance to the issue whether budget deficits and public works programmes can be employed as policy instruments to mitigate unemployment and stabilize demand, and the reasons why the business community might react adversely to particular economic policies.

In discussing the crowding-out issue it is necessary first to distinguish between real productive resources and financial resources, a distinction not always made evident in the literature.[54] Our concern here is with the latter.[55] Crowding-out may be described in the following manner: with a given money stock, an increase in bond sales (to finance a budget deficit and/or public works programme) would have little or no impact on aggregate demand because the rise in interest rates required to sell the additional bonds would crowd-out an equivalent volume of other expenditures (private investment and consumption, in so far as they are sensitive to interest rates). In its most extreme form, therefore, it would be held that fiscal operations could not affect the level of aggregate demand, their influence being limited to determining the allocation of expenditure between different purposes.[56]

Unfortunately, the use of such arguments during the interwar period were characterized by a failure to specify clearly what factors were operating to raise interest rates and the channels through which they operated. Two main alternatives suggest themselves:

(1) that with a fixed money stock and at a position of full employment, the financing of a deficit purely by bond sales crowds-out private expenditure because extra transaction balances are required for a higher level of incomes and these will be released from asset balances only as interest rates rise; or

(2) also with a fixed money stock but at a position of less than full employment (or, indeed, irrespective of the state of demand in labour markets), a deficit financed by

bond sales would crowd-out private expenditure if there was sufficient opposition to, and apprehension about, the government's policy that there was an increased demand for cash balances (a change in liquidity preference) which prevented idle balances from taking up the additional bonds without raising interest rates.

The first case represents what is commonly termed crowding-out; the second may be viewed as a form of psychological crowding-out. It is of especial relevance to the interwar policy debate where the attitude of financial markets could effectively neutralize fiscal operations. In both cases, ceteris paribus, an accommodating monetary policy - financing the deficit or increased public works expenditures by new money rather than by bond sales - could have prevented crowding-out. But here also, there was scope for adverse confidence effects; that is, such a monetary policy might be viewed as irresponsible, thus reducing private sector investment via an adverse change in business confidence.(57)

The first form of crowding-out also represents the supposed position of the Treasury during the interwar period.(58) Thus Stein (in common with other economists) has described the 'Treasury view',(59) as expressed in the Memoranda on Certain Proposals Relating to Unemployment (1929),(60) as:

> the position that the amount of savings available at any time was given and in use, so that an increase in government borrowing to pay for public works would only displace private investment and would not add to total employment ... [This view was] a particular application of 'Say's Law', an old economic principle which says that supply creates its own demand and that there cannot be a general deficiency of demand. This is the same as saying that all income that is saved is automatically invested and constitutes a demand for goods. (61)

But as will be shown in a later chapter, and as suggested above,(62) references by the Treasury to a crowding-out mechanism were not of this first type, but rather of the second. Accordingly, the determinents of confidence amongst the business and financial communities require consideration.

Why were these groups in general opposed to a counter-cyclical fiscal policy? - opposition, it was believed, sufficiently emphatic to ensure that the effectiveness of such a policy would be constrained by a rise in interest rates resulting from an adverse change in liquidity preference when the bonds to finance such a policy were marketed. A number of explanations may be suggested:

(1) the business community had a very low level of trade cycle consciousness (i.e. a limited perception of the trade cycle) and tended, in times of depression, to attribute their difficulties "to particular factors which affect the particular business or at best the particular industry, such as the activities of competitors at home and abroad, a shift in the direction of demand, and so on", rather than to a general deficiency of demand.(63)

(2) on political grounds the business community might view as undesirable an increase in government expenditure because it would - especially in the case of public works - be accompanied by increased state interference in industry.

(3) more generally, if it were believed on economic grounds that fiscal operations were incapable of permanently raising the level of employment - because they did little to improve the economy's productive base -, such a policy would flounder on the fears that the increased debt charge would eventually have to be covered from higher taxation. The prospect of

such an increase in taxation might anyway itself ensure the failure of such a policy as a result of disincentive effects on investment.

Similar considerations applied to the state of confidence in financial markets, although special factors, stemming from London's pre-eminent position as an international financial centre, should also be taken into account. In particular, apprehensiveness (no doubt made legitimate by the 1931 crisis) that the government's financial policy would be viewed abroad as 'unsound', with the risk of an outflow of sterling (with consequences for the domestic credit base) and upward pressure on short-term interest rates, imposed an 'external constraint' on policy-making. The strict standards required to act as a leading financial centre imbued economic policy with a moral dimension which, by the interwar years, acted to Britain's disadvantage because it made imperative more exacting standards of financial conduct than those adhered to by other countries. When, as occurred in 1931, Britain was deemed to have failed to meet these standards, the consequences were severe.(64) Moreover, the reluctance to balance the budget strictly, characteristic of other countries during periods of depression, was an important means of avoiding the deflationary demand effects of adherence to budgetary orthodoxy in the face of severe autonomous fluctuations in activity. British policy makers considered this course of action to be unavailable, although fiscal window-dressing was to serve the same objective, albeit with a large element of deception.

It is contended that, in the past, arguments which rely on business psychology as an explanation of opposition to the policy prescriptions of the 'new' economics have been too easily dismissed by holding that such opposition was irrational and/or unascertainable. For example, Winch takes the view that:

> The trouble with this type of psychological argument is that it can never be proved or disproved. It tends to be circular: if things go well, it must be because confidence has been restored; if things go badly, it must be because there is insufficient confidence. However, there is something suspect about arguments that can only be used to support the status quo. It is often simply another way of saying 'Be orthodox', or 'I dislike what is being done', while at the same time evading the uncomfortable business of having to say why ... It seems simpler to say that Chamberlain and his Treasury advisers concentrated on narrow budgetary considerations, and were unaware of the deflationary consequences of what they were doing. (65)

By virtue of its intangibility, confidence cannot be accurately specified or measured; that fact, however, hardly questions its existence or potency. Moreover, this dismissive viewpoint has resulted from an approach which is too narrow in its perspective, in that it has focused on what would appear to be the purely economic interests of the business and financial communities and has ignored the political and indirect economic dimensions of the question. Unfortunately, the business community rarely expressed the grounds for their opposition to unbalanced budgets and large scale public works programmes as remedies for unemployment.* Even amongst the papers of the F.B.I., the largest and most vocal of the employers' organizations, there are but few references to the subject.

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* More generally, when opinion on a subject is unanimous the literature of the time tended not to go deeply into the reasons for a particular belief. This problem of exegesis is especially true of the reasons underlying the return to the gold standard in 1925 (see Morgan 1961: 1268); it is also equally true of the issues considered here.

The following, however, is one of the few F.B.I. documents that does illustrate business opinion on this question. Written in late 1930, at a time when serious budgetary disequilibrium was first becoming apparent, it shows first that the F.B.I. did not question the desirability of restoring budgetary equilibrium, and further that this should be achieved by expenditure cuts (no account being taken of the consequent adverse effect on demand). Finally, there was a medium-term objective of remitting taxation to stimulate industrial recovery.

> [We] cannot continue further along the present road without disaster. Not only must further additions to our unproductive national expenditure be regarded as suicidal, but a drastic overhauling of our existing expenditure is imperative if the situation is not to become progressively worse.
>
> The Budget position is extremely grave. British industry has been struggling for nearly a decade to recover its position in the markets of the world, handicapped by a load of taxation which not only far exceeds that of any other important commercial country, but so far from showing signs of decreasing has actually grown cumulatively more burdensome. This at a time when many of our competitors are making forced cuts in taxation, so that the burden of taxation on British industry is being relatively intensified. Added to this we are in the midst of what is likely to prove the greatest world trade slump of the present generation.
>
> ......
>
> [The] circumstances which have led to the present disquieting state of affairs are, in [our] opinion, a direct consequence of the policy of successive Chancellors of the Exchequer in framing their Budgets, and in particular their estimates for current expenditure, with little regard either for the conditions of our national production, or the needs of those responsible for its efficient operation. In particular, no account appears to have been taken during recent years of the cumulative effect of the burden of taxation on a decade of industrial depression, accompanied by a falling price level and credit stringency.
>
> ......
>
> [The] limits of industry's taxable capacity have been exceeded, and ... the present volume of our national production is insufficient to provide the sums at present being expended - and under contemplation - by the State on unproductive objects ... The paramount need ... is for an immediate retrenchment in our national expenditure. (66)

Admittedly, this document was prepared at a time of rapidly deepening depression, but it also reflects industry's general attitudes towards budgetary policy and the rôle of the state in promoting recovery: the preferred remedy for high unemployment, low demand, and low profitability was remission of taxation, a remedy based on an implicit belief in the potency of market forces and, as already noted, the view that income tax entered into costs.(67) Given the balanced budget constraint, continued 'unproductive' expenditure on public works inhibited such a remission of taxation, while, insofar as businesses viewed the demand for their products in narrow terms (part of the aforementioned low level of trade cycle consciousness), it was difficult for them to perceive that expenditure on public works was more effective in inducing recovery than a reduction in costs and the stimulus to investment afforded by a reduction in taxation. In these circumstances, opposition to unbalanced budgets and public works programmes become rather more cogent. While on strictly economic grounds this viewpoint was misfounded, because in general the multiplier effects of an increase in expenditure exceed those of a cut in taxation, in formulating this policy preference attention was not exclusively confined to the direct economic issues, other considerations intervened. The state of business confidence must once again be accorded a significant rôle in any explanation of the continuance of financial orthodoxy by governments during the interwar period.

CHAPTER 5
BUDGETARY HISTORY 1929-39

In this chapter we survey the budgetary history of the 1930s, attention being focused on the annual budgets, and the way in which budgetary policy changed in its nature and functions so that by the later 1930s it had assumed a central rôle in macroeconomic management. An evaluation of changes in fiscal stance, and the manner in which such changes were influenced by the characteristics of the fiscal system, is deferred until the following chapter. The overall budgetary position is summarised in Table 5.1.

1. Depression 1929-33

Even before the onset of the world depression the Treasury had anticipated that the falling price level would lead to the development of an unfavourable budgetary situation, and had advised Churchill that contingency action be taken.(1) The depression in Britain was to have an immediate and marked effect on the budget balance which moved into deficit as a result of the automatic response of receipts and expenditures to a cyclical downturn, not because of discretionary action for stabilization purposes. As Table 5.1 shows, between 1929/30 and 1932/3 the budget balance (B/Y) deteriorated by 1.7 percentage points of GDP (or £67.6m); the deterioration of the conventionally defined balance (B_c/Y), however, was smaller (0.6 percentage points of GDP, or £17.8m) and followed a somewhat different course, reflecting the authorities' attempts to minimise by fiscal window-dressing the published deficit.

Detailed accounts of budgetary policy during the early depression period, that of the administration of the second Labour Government, can be found in the work of Skidelsky and others.(2) Here we are concerned with the main features of the individual budgets of 1929, 1930, and 1931. These are summarised in Table 5.2, the analysis for the final year being complicated by the existence of two budgets, in April and September 1931.

Tables 5.1 and 5.2 record the authorities' attempts to restore budgetary equilibrium in the face of deepening depression; they indicate that prior to September 1931 these efforts centred on raising additional taxation. The emphasis in the 1930 budget was almost exclusively on direct taxation, while in the 1931 budgets direct taxation was raised by approximately twice as much as indirect. This strategy followed from two factors: (1) on grounds of equity, and under the influence of electoral pressures, the Labour Government attempted to minimise the increase in indirect taxes because of their regressive incidence; and (2) in the early stages of a depression indirect taxes were more sensitive to income changes whereas (because of the lag between earnings and assessment) income and surtax maintained their yield.(3) Nevertheless, in the April 1931 budget the Treasury decided against a further rise in income tax because of the presumed adverse effect on confidence and therefore the level of economic activity;(4) they also hoped that expenditure cuts would later become politically possible. In fact, by early 1931, it was the expenditure side of the account that, at least for the Treasury, dominated discussions about restoring budgetary equilibrium. These discussions, the establishment of the May Committee, and the subsequent response to its report,

Table 5.1

Central government receipts, expenditure, and budget balance: conventional and adjusted definitions, 1929/30-1939/40*

A. (% of GDP):

	(T_c/Y)	(G_c/Y)	(B_c/Y)	(T/Y)	(G/Y)	(B/Y)
1929/30	19.2	19.5	-0.3	21.1	20.7	+0.4
1930/1	20.7	21.2	-0.6	22.1	22.7	-0.6
1931/2	22.0	22.0	0.0	23.6	24.8	-1.2
1932/3	21.9	22.7	-0.9	23.9	25.2	-1.3
1933/4	21.1	20.3	+0.8	23.2	22.3	+0.9
1934/5	19.8	19.7	+0.2	22.2	21.6	+0.6
1935/6	19.9	19.9	+0.1	22.1	21.7	+0.4
1936/7	20.2	20.3	-0.1	22.3	22.0	+0.3
1937/8	19.9	19.3	+0.6	22.0	22.3	-0.3
1938/9	19.9	20.1	-0.3	22.0	24.7	-2.7
1939/40	20.0	24.8	-4.9	21.9	35.1	-13.2

B. (£m.):

	(T_c)	(G_c)	(B_c)	(T)	(G)	(B)
1929/30	815.0	829.5	-14.5	893.9	876.5	+17.4
1930/1	857.8	881.0	-23.2	915.1	939.3	-24.2
1931/2	851.5	851.1	+0.4	914.5	960.2	-45.7
1932/3	827.0	859.3	-32.3	903.9	954.1	-50.2
1933/4	809.4	778.2	+31.2	890.0	856.7	+33.3
1934/5	804.6	797.1	+7.5	899.3	873.5	+25.8
1935/6	844.8	841.8	+3.0	935.7	919.7	+16.0
1936/7	896.6	902.2	-5.6	990.0	975.3	+14.7
1937/8	948.7	919.9	+28.8	1051.5	1067.2	-15.7
1938/9	1006.2	1018.9	-12.7	1114.1	1251.3	-137.2
1939/40	1132.2	1408.2	-276.0	1241.0	1990.2	-749.2

Sources: The actual figures are drawn from Financial Accounts and the working notes to Feinstein (1972); the GDP figures from Table 6.1.

Notes: * See above pp.100-02 for the budget definitions.

reveal much of interest about contemporary attitudes towards budgetary policy. The following section consequently considers this committee in some depth.

(i) The May Committee

Towards the close of 1929 Snowden, perturbed that the financial situation was "becoming progressively gloomier as we add still more to our existing commitments", warned the

Table 5.2

Budget summary 1929/30-1932/3: published forecasts and results (£m)

	1929/30	1930/1	1931/2 (April)	1931/2 (Sept.)	1932/3
1. Budget balance (B_c) of previous year	+18.4	-14.5	-23.2	..	+0.4
2. Budget on existing basis					
Revenue (T_c)	834.7	823.6	847.6	825.8 (6)	846.4
Expenditure (G_c)	822.7	865.9	889.9	900.5 (7)	848.1
Balance (B_c)	+12.0	-47.3 (1)	-37.4 (3)	-74.7	-1.7
3. Discretionary changes					
(i) taxation					
first year					
- direct	-	+31.5	+10.0 (4)	+29.0	-
- indirect	-7.9	+2.3	+7.5	+11.5	+2.5
full year					
- direct	-	+43.5	-	+57.5	-
- indirect	-8.0	+2.4	+8.0	+24.0	+3.0
(ii) economies	-	-	-	+35.7 (8)	-
(iii) misc.	-	+16.0 (2)	+20.0 (5)	-	-
4. Budget Estimates					
Revenue (T_c)	826.3	873.3	885.1	866.3	848.9
Expenditure (G_c)	822.7	871.0	884.9	864.8	848.1
Balance (B_c)	+4.1	+2.2	+0.1	+1.5	+0.8
5. Budget outturn					
Revenue (T_c)	815.0	857.8	-	851.5	827.0
Expenditure (G_c)	829.5	881.0	-	851.1	859.3
Balance (B_c)	-14.5	-23.2	-	+0.4	-32.3

Sources: Financial Accounts; Financial Statements

Notes:

1 Deficit (estimated) of £42.3m for 1930/1 plus £5m as the first instalment towards repayment of the 1929/30 deficit (§.48 Finance Act, 1930).

2 Transfer from Rating Relief Suspense Account.

3 Deficit reduced from £42.3m to £37.4m by a transfer from the Rating Relief Suspense Account.

4 This gain consisted of a rescheduling of income tax payments, the benefit to the Exchequer only applying for one year.

5 Planned transfer from old Exchange Account.

6 Change in revenue estimates since April Budget:

Budget Estimate	885.1
reduced tax yield	
Inland Revenue	-25.0
Customs & Excise	-4.0
Hoover moratorium	-30.3
	825.8

7 Change in expenditure estimates since April Budget:

Budget Estimate	884.9
Hoover moratorium	-13.6
reduced debt interest	-5.6
" sinking fund	+0.8
Supplementary Estimate	
Cessation of borrowing for	
Unemployment Fund	+25.0
Road Fund	+9.0
	900.5

8 Comprising economies of £22m and a reduction in planned sinking fund payments of £13.7m

Cabinet that the magnitude of inherited expenditure obligations, combined with the uncertain revenue prospects and the commitment to repeal the McKenna duties,(5) had seriously upset budgetary equilibrium. Deficits (B_c) of £45.3m, £57.7m, and £64.8m were forecast for 1930/1, 1931/2, and 1932/3 respectively.(6)

Concern over the expenditure side of the account largely centred on the growing cost of unemployment insurance and transitional benefits, and in particular the disquieting regularity with which Bondfield* had to approach Parliament with requests for further borrowing powers. As early as January 1931, Hopkins (operating on Snowden's instructions that Parliament and the Cabinet must be made aware of the need for economy) told the Royal Commission on Unemployment Insurance that:

> continued State borrowing on the present vast scale without adequate provision for repayment by the Fund would quickly call in question the stability of the British financial system. (7)

The deteriorating financial position of the Unemployment Fund is shown in Table 5.3. Since the fund was not fully consolidated into the conventionally defined budget accounts,(8) not all of the increased outlay on benefits revealed itself in the conventionally defined budget balance (B_c). This source of relief, however, was to be short-lived as the fund's borrowings became the focus for comment and criticism of budgetary policy generally.

The question of economy in the wider sense had been mooted occasionally in Parliament; but from early October 1930, with the publication of the Liberals' How to Tackle Unemployment,(9) demands for another 'Geddes axe' to expenditure became more insistent.(10) The Cabinet responded,

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* Margaret Bondfield, Minister of Labour 1929-31

Table 5.3

Outlay on unemployment benefits 1929/30-1931/2 (£m)

	Exchequer contributions to unemployment insurance and transitional benefits	Balance of income and expenditure of Unemployment Fund for the period	Status of the Unemployment Fund at the end of the period	Total outlay on unemployment benefits
1929/30	20.4	-3.0	-39.0	59.7
1930/1	36.8	-36.4	-75.4	103.5
1931/2	57.9	-39.6	-115.0	125.1

Sources: Working notes to Feinstein (1972); Royal Commission on Unemployment Insurance (1932), Minutes of Evidence, pp.157-61.

firstly, by immediately appointing a Royal Commission to review the unemployment insurance issue;(11) and, secondly, some months later, it concurred in the establishment of the May Committee to consider the general question of economy.(12)

The origins of this latter body lay in a two day House of Commons debate of 11 and 12 February 1931 which had censured the government for the rapidly deteriorating budgetary situation. The outturn was that Snowden agreed to establish a small independent economy committee,(13) not as a concession to an over-zealous House of Commons, but rather because it served two important purposes: (1) it provided a breathing space for the Treasury and the Cabinet; and (2) as Snowden later wrote:

> I welcomed this agitation for a reduction of expenditure because I realised that no Government could embark upon a drastic reduction unless it were supported by a strong public opinion. (14)

The committee, appointed by a Treasury Minute of 17 March and chaired by May,* was given the following terms of reference:

* Sir George May, Chairman Prudential Assurance Co.

> To make recommendations to the Chancellor of the Exchequer for effecting forthwith all possible reductions in the National Expenditure on Supply Services, having regard especially to the present and prospective position of the Revenue. In so far as questions of policy are involved in the expenditure under discussion, these will remain for the exclusive consideration of the Cabinet; but it will be open to the Committee to review the expenditure and to indicate the economies which might be effected if particular policies were either adopted, abandoned or modified. (15)

Both the terms of reference (identical to the earlier Geddes Committee), and the membership (May plus two members from each of the three Parties) were, it may be surmised, carefully calculated to ensure the attainment of the Treasury's objectives.

Operating from the premise "that the country must face the disagreeable fact that its public expenditure - and in this we include local as well as national expenditure - is too high and that it must be brought down to a lower level"(16) three general principles guided their recommendations:

> (i) that the rise in the value of money in recent years provides a strong prima facie case for the revision of money obligations fixed under other considerations ...
> (ii) that existing financial difficulties make it necessary for the nation like the private individual to consider seriously what it can afford and not merely what is desirable. Reviewed from this standpoint much expenditure is unwarrantable at the present time, which, under more favourable conditions, we should deem justifiable and even a wise investment of the national resources.
> (iii) that only by the strictest regard to economy and efficiency over a long period can the trade of the country be restored to its pre-war prosperity and any substantial number of the unemployed be re-absorbed into industry. (17)

Whilst in general this position has been discredited by modern stabilization theory, at the time it was widely held, not just within Whitehall but also by other influential interest groups. In particular, as was shown in the previous chapter, the principles governing the May Committee's investigations were also shared by the F.B.I.(18) Such views were put on a number of occasions in representations to the

Treasury, particularly in pre-Budget deputations,(19) whilst simultaneously other bodies also pressed for economy.* Of these, the most noteworthy was 'The Friends of Economy', "a body of prominent men", formed at the beginning of 1931, which organized the 'great City Meeting' held at the Cannon Street Hotel on 27 January 1931 at which a number of leading politicians - E. C. Grenfell, Viscount Grey, Sir Robert Horne (an ex-Chancellor), and Sir Ernest J. P. Benn - had made economy the central political and economic issue of the day.(20)

There is no question that, in general, there was a complete absence of serious and informed opposition to the principle of economy in the months preceding the financial crisis which, for Britain at least, commenced in mid-July 1931. Indeed, acceptance of the eventual need for economy, combined with the inevitable delay before the May Committee and the Royal Commission completed their reports, permitted Snowden to introduce a far less deflationary budget than would have been the case if full account had been taken of the effects of depression on endogenous budget items.

The problem of budgetary disequilibrium facing Snowden in April 1931 was serious: 1930/1 had closed with a deficit (B_c) of £23.2m and the forecast deficit for the coming year was £37.4m, reflecting almost equally the effects of depression on the revenue and expenditure sides of the account (see Table 5.2). In his budget speech Snowden was,

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* The Association of British Chambers of Commerce in 1931 also took as their central theme "that only by the most stringent retrenchment can this country be saved from catastrophe" for without "immediate and determined remedial action, the effect upon this country's credit must be disastrous; in fact it cannot be long before there is a very definite flight from the pound." (T172/1516, 'Deputation to the Chancellor of the Exchequer', 17 Feb. 1931).

however, careful to stress that:

> The apparent deficit of £23,000,000 is apt to be misleading especially to foreign opinion. On the basis of some foreign Budgets and commercial practice instead of a deficit of £23,000,000, the year would have closed with a surplus of £43,500,000 [because £66.8m of sinking fund payments were included in the budget] ... It says much for the soundness of our national financial position that, in a year of unparalleled industrial depression, we have not only been able to pay our way but to make such a substantial reduction of the Debt. (21)

The whole budget was dominated by two interrelated objectives: on the one hand (as above) to maintain domestic and international confidence by making the current budgetary position appear in the most favourable light; while, on the other hand, maintaining the momentum of opinion that severe retrenchment would be required later in the year. Consequently, as an interim solution, Snowden felt justified in temporarily abandoning his life-long adherence to 'sound' financial principles; and resort was made to a number of expedients.*

Firstly, under §.48 Finance Act, 1930, the Treasury was obliged to repay (in three instalments) the deficit of 1929/30, and further to cover any subsequent deficit by a pro rata increase in the Fixed Debt Charge. Snowden, however,

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* For Snowden the framing of this and the following budget must have been an extremely instructive exercise, one calculated to test to the full the degree to which political necessity could override ingrained economic beliefs/ prejudices. In general, Snowden's belief in balanced budgets and a 'sound' financial policy was unquestioning - attitudes probably stemming from his early belief that success, in electoral terms, for the I.L.P. would be precluded if the Party took an unorthodox stance on monetary questions (Cross 1966: 66, 246). Thus his reaction to Churchill's period as Chancellor had been one of total disdain, and on being informed of the widespread use of devices to balance the budget (see T172/1684, Note by Phillips, 23 Oct. 1929), Snowden wrote to Churchill: "The difference between us does not lie in a nice calculation of figures. It lies in differing conceptions of sound finance ... A well balanced Budget is not a luxury which is to be avoided: it is a necessity which must be provided for." (T172/1690, Snowden to Churchill, 23 Jan. 1930).

proposed that the windfall of £9m from the German Mobilization Loan should be taken as completing the obligations for the 1929/30 deficit.(22) Secondly, there was the question of the 1930/1 deficit of £23m:

> I do not think the Committee should expect me or will expect me to make provision by an addition to the fixed Debt charge - that is by an increase of taxation - to meet this shortage of £23,000,000 immediately out of present resources. Moreover, I am confidently expecting that, as the outcome of the recommendations of the Economy Committee ..., considerable reductions of expenditure will be made during the year, which will automatically go to Debt reduction. It is also possible that during the year conditions may be favourable for considerable Debt conversion operations ...*

Finally, the prospective deficit for 1931/2 of £37.4m was to be covered by: (1) a £20m raid on the old Exchange Account;** (2) an alteration to the payment dates for income tax under Schedules B, D, and E which would give a non-recurrent gain of £10m; and (3) an increase in the oil duty calculated to fill the residual gap of £7.5m.(23)

The clear alternative would have been a sharp increase in taxation (a tariff having been explicitly rejected in the most scathing terms)(24) which Snowden was loath to undertake:

> [It] is only too clear that in many directions increased rates of taxation would at this time produce a disappointingly low increase in yield ... I regard this Budget ... as one dealing with

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* 251, H.C. Deb. 5s., 27 April 1931, col.1397. Snowden was here anticipating that conditions might become favourable for the conversion of the 5% War Loan. The operation was, in fact, not announced until late June 1932, having been delayed by the 1931 financial crisis (see p. 150 below).

** The account had been established during the First World War to make purchases of foreign exchange to cover overseas, principally dollar, obligations. By the late 1920s the account had largely fallen into disuse, although its funds were used twice yearly in financing the U.S. war debt payments (see T171/287, Hopkins to Snowden, undated (but about 19 March 1931); T188/48, Hopkins to Fisher and Chamberlain, 26 Feb. 1932).

> a temporary emergency and justifying temporary measures.
>
> ......
>
> I cannot ignore the psychological effect on trade and commerce of any increase in direct taxation at a time when they are, I hope, on the point of emerging from an unprecedented slump. I have, therefore, decided not to propose any increase in the Income Tax. (25)

Thus the budget was a stop-gap; although viewed as most unsatisfactory by certain Conservatives,[(26)] it did at least delay the full imposition of deflationary fiscal measures.

Meanwhile, the May Committee reviewed the financial situation, receiving assistance in its task from the Public Accounts Committee which suggested possible areas for consideration (as it could not itself deal with them since they were matters involving policy).[(27)] The May report was first made available on 24 July, and considered by Cabinet at its meeting of 30 July,[(28)] where, with "the kind of systematic ineptitude that it seemed determined to display at this period, it took note of the report simply with the casual remark that all departments 'affected by the report should send in their observations not later than 18 August'",[(29)] and then dispersed for the summer recess believing that detailed consideration of the report could safely be left for a few weeks. The report was published on 1 August, and, as is well known, marked the real turning-point in the financial crisis: it changed its nature from a largely technical difficulty (a shortage of liquidity in Europe) to a crisis of confidence in sterling.[(30)] Such an adverse impact might have been avoided with more imaginative statesmanship: publishing it alongside a declaration of policy.[(31)] In fact, Hopkins had urged in the strongest terms permissible for an official:

> I submit for your earnest consideration that the publication of the May Report should be accompanied by an announcement that a Cabinet Committee including the Prime Minister and yourself [Snowden] will sit in the holidays to present to Parliament immediately on its re-assembly proposals designed to repair the budgetary position and render it sound. They need not, of necessity, be exclusively proposals for economy: they may include proposals for increased taxation. On this I would only say that in my view the limits of direct taxation in times of slump are nearly reached.
>
> Unless action on these lines is taken I cannot help expressing my fear that the consequences may be very grave.

Furthermore, Hopkins expressed his opinion that:

> The majority report shows no mercy. It assumes that we ought, even in the midst of a slump to pay the contractual sinking fund and borrow nothing for unproductive purposes (e.g. Unemployment and Roads). On this basis it shows a gap next year of £m.120. This in my view may exaggerate the position but the figure of £m.120 will be flashed round the world.(32)

The advice was ignored, and as Hopkins warned, the consequences were "very grave", although a more sensible policy towards the publication of the report would have been unlikely to have prevented the eventual collapse of sterling.

The main features of the majority May report were as follows: on the basis of a forecast deficit for 1932/3 of £120m (assuming a cessation of borrowing for unemployment and roads), economies of £96.5m (some £66.5m to come from unemployment insurance alone) and new taxation of £23.5m were proposed.

The rôle of this report in exacerbating the financial crisis, the failure of the Labour Government to agree on the required economies, and the subsequent formation of the National Government, are well known.(33) Here we merely survey the main features, attention being concentrated on the framing of the September 1931 budget.

The first point of importance is that the principle of a balanced budget, even in time of depression, was not questioned, not even by the minority report signed by the two Labour members.[34] Dissent was limited to the way in which the economies were to be achieved. In the case of the minority report, it was decided that the principle of 'equality of sacrifice' should be adopted, and that this could best be attained by imposing a surcharge on rentier incomes. Nevertheless, even with these reservations, the task of balancing the budget was pursued with doctrinaire purposefulness, as evidenced by the demand that cuts in expenditure, rather than increased taxation, must make the major contribution towards the restoration of budgetary equilibrium.

> The nation can[not] continue as at present borrowing to meet current requirements and deluding itself that by still showing a sinking fund in the national accounts it is not only meeting its liabilities but actually paying off debt. This course will lead inevitably to an intensification of the financial difficulties until the day comes when far greater sacrifices than those we suggest are forced upon the country. The other method is to endeavour to right the position solely by means of additional taxation, but to achieve a truly balanced budget next year in this way the extra taxation would need to be very heavy and we fear the consequences. The margin of safety is already narrow. (35)

Secondly, the major emphasis within the proposed economies was on the necessity for cutting outlay on unemployment benefits. Whilst this was the most rapidly growing item of expenditure - because of its high cyclical sensitivity -,[36] there were, in addition, three

> analytically separate bases for the pressure to retrench radically on the unemployment system: the view that it itself contributed to unemployment; opposition to the 'anomalies' and 'abuses' with which it was alleged to be riddled; and fears of the effects of continuous borrowing to maintain it. (37)

Cuts in unemployment benefits thus assumed a symbolic importance. As one contemporary later put it:

> The recent 10 per cent. cut is not important because of the relief it gives to our national expenditure. The cut is important because the dole is a support and a symbol of our lack of flexibility and our blind resistance to change. (38)

Thirdly, the majority and minority reports' diagnosis of the causes of budgetary disequilibrium differed fundamentally. The majority report (and later Cabinet discussions) justified the cuts in pay and benefits on the grounds that "the rise in the value of money in recent years provides a strong prima facie case for the revision of monetary obligations fixed under other conditions,"[39] while the minority report used the same reasoning to press for higher taxation on rentier incomes. While the majority report saw the budgetary difficulties as stemming from the unceasing growth of social expenditure, itself determined by the weakness of politicians who succumbed to electoral pressures, the minority report maintained that such services were "essential to modern large-scale industry", and that the real villain of the piece was the increasing real burden of the debt charge. They contended that it was here that remedial action was required.[40]

In fact, such a course would have been untenable, indeed counter-productive if the real objective was not to balance the budget *per se* but to restore confidence. This was particularly true of proposals to reduce sinking fund payments; as Snowden informed the Labour Cabinet shortly before its collapse:

> the Leaders of the Conservative Party, and also the Representatives of the Bankers, had stated that any attempt of this kind to camouflage the true position would be at once detected, and that it was of paramount importance that the Budget should be balanced in an honest fashion. (41)

Two further questions require consideration: that of the British budgetary position vis-a-vis other countries; and that of the likely employment effects of balancing the budget in the manner recommended by the May Committee.

Henderson, in his capacity as Secretary to the Economic Advisory Council, was asked by MacDonald for his comments on the May report. By mid-1931 Henderson had moved some way from the policy position he had held with Keynes in 1929, and had been concerned by the worsening of the financial position for a number of months.(42) Nevertheless, Henderson still felt compelled to write that the report had "laid on the dark colours very thick indeed" and that:

> the Committee's criterion of a properly balanced Budget seems to me to be unreasonably austere. The prospective deficiency of £120 millions is reached by adding in the whole of the expected borrowing for the Unemployment Fund and the Road Fund, while maintaining the Sinking Fund at £52 millions ... This is to go far beyond what would have been regarded as the requirements of prudence in the hey day of orthodox finance ...
> ......
> On the whole, indeed, the British budgetary system has so far stood the test of depression decidedly better than those of most other countries; and the suggestion conveyed by the May Committee that our position is exceptionally unsound and will remain so, unless a gap of £120 millions is bridged next year, is thus, from the standpoint of international comparison, misleading in the extreme. (43)

Henderson's latter comment is substantiated by the evidence presented in Table 5.4 which gives the budget accounts, on roughly comparable bases, for the four major industrial nations at that time. Special circumstances, however, necessitated that Britain adhere more strictly to orthodox financial principles and thus deflate further than other countries - the necessity to restore confidence, prevent a flight from sterling, permit reductions in manufacturing costs, and facilitate a general reduction of interest

Table 5.4

Central government budget accounts:
Great Britain, France, Germany, and United States,
1929/30-1932/3

		Receipts	Expenditure	Balance	Debt payments included in expenditure
Great Britain (£m)	1929/30	815.0	829.5	-14.5	47.7
	1930/1	857.8	881.0	-23.2	66.8
	1931/2	851.5	851.1	+0.4	32.5
	1932/3	827.0	859.3	-32.3	26.3
France (Francs m)	1929/30 (15 months)	64268	58849	+5419	-
	1930/1	53094	53265	-171	-
	1931/2	50977	53362	-2385	-
	1932 (9 months)	38069	42991	-4922	-
Germany (Reichmarks m)	1929/30	7509.8	8186.6	-676.8	-
	1930/1	7784.2	8391.8	-607.6	-
	1931/2	6812.4	6994.9	-182.5	-
	1932/3	5821.6	5964.7	-143.1	-
United States ($m)	1929/30	4044.6	3854.2	+190.4	553.9
	1930/1	3191.6	4127.5	-935.9	440.1
	1931/2	2003.9	4865.3	-2861.4	412.7
	1932/3	2083.7	3873.4	-1789.7	471.6

Sources: Great Britain: League of Nations (1936: V, Table IIa); France: League of Nations (1937: XI, Table IIa); Germany: League of Nations (1937: XII, Table II); and United States: League of Nations (1937: XXXIV, Table II).

rates.(44) ~~Thus~~ during the discussions preceding the September 1931 budget, at Treasury and Cabinet level, there was firm opposition to any reduction in sinking fund payments as a method of easing the pressure. As Hopkins wrote:

> We are endeavouring to overcome a radical lack of confidence abroad in our financial position. Half measures will not gain this end, and even in the best atmosphere an inroad into Sinking Fund is never well received. From this point of view any reduction at all could only be justified if it were part of a scheme which commanded the respect of the world.
>
> Reduction of sinking fund will pro tanto render it more difficult to get back to the possibility of a large Conversion operation. (45)

Why was heed not paid to Henderson's comments?* Howorth's

* The sinking fund provision was in fact reduced to £32.5m.

(Deputy Secretary to Cabinet) reaction to Henderson's memorandum shows that there was apprehension lest it "produce on the P.M.'s mind an impression that things are not really as bad as they appear to be". In any case, the prospective deficit had now become £170m and not "the lower and less devastating figure" of £120m,* while:

> increased taxation of the order required seems out of the question if the taxation experts are right in their view that we have reached saturation point, at all events as regards direct taxation, and that fresh burdens of this tremendous volume would not in practice produce more cash than the present taxes.
> The problem may be insolvable, but to impose new taxation would be bad enough in any case, while to fail to collect it would be the beginning of the end. (46)

The effects on employment, incomes, and output of the adoption of the proposed measures also received scant attention. At the official level, the question was in one sense irrelevant (since the restoration of budgetary equilibrium was paramount), but it was of importance with regard to forecasting <u>ex ante</u> what the <u>ex post</u> effect of the measures would be on endogenous budget items. Keynes, however, did give the matter some thought in both his private and public pronouncements against the authorities' deflationary stance.

Despite reservations about the May report's recommendations, Henderson had been forced to conclude that the report's unfortunate timing, the threat of a collapse of confidence in sterling, and the policy objective of maintaining the gold standard, made it imperative to accept its recommendations. Keynes, however, took a completely different line: first,

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* The prospective deficit for 1932/3 was widened by further reductions in estimated tax yields as the depression depeened and the net effect of the Hoover moratorium (see Notes 6 and 7 to Table 5.2).

in a private letter to MacDonald, and later in a New Statesman article. In the former Keynes clearly stated his general objections:

> The Com[mittee]'s recommendations obviously represent, in substance and broad effect, an effort 1/ to make the existing deflation effective by bringing incomes down to the level of prices. They are part and parcel of the policy of seeking equilibrium by 2/ general reductions of wages and salaries, and they would indeed, if they were taken in isolation, be a most gross perversion of social justice ...
>
> My advice is that we do not attempt to make the deflation effective, because, apart from the question whether it is intrinsically desirable, I am convinced for the following reasons that an attempt made now would be both futile and disastrous:-
>
> (i) The first effect of adopting the proposals of the Economy Com[mittee] and analogous measures would certainly be a further decline in business profits and a substantial increase of unemployment, because ... economies which are not balanced by reduced taxation must necessarily reduce demand relative to supply, - the buying power of those immediately affected would be diminished, whilst no one else's buying power would be increased. Thus there would be no initial success from adopting the policy ...
>
> (ii) The cut in money incomes which would be required to reach equilibrium by this route would be more than those concerned would submit to ...
>
> (iii) It would be impossible to obtain the public consent to such measures unless bond-holders, etc., were treated in the same way. I know no practical means to secure even a modicum of social justice.
>
> (iv) But above all - and this is the new fact within the last two months - it is now nearly certain that we shall go off the existing gold parity at no distant date. (47)

Keynes's opposition is interesting in its duality and farsightedness: not only did he oppose the economies as such, but believed they were unnecessary since the imminent departure from the gold standard would remove one of the basic constraints on domestic policy, thus permitting the eventual pursuit of a reflationary monetary and fiscal policy. Keynes's published note advanced the argument one step further by presenting estimates of the macroeconomic effects of balancing the budget, the first time such an approach had been used in the interwar policy debate.

Concerned that the May Committee "show[ed] no evidence of having given a moment's thought to the possible repercussions of their programme, either on the volume of unemployment or on the receipts of taxation", Keynes pointed to the symmetry of fiscal action: "the immediate consequences of the government reducing its deficit are the exact inverse of the consequences of its financing additional capital works out of loans." A £100m reduction in expenditure, Keynes calculated, would only reduce the budget deficit by £50m because of the adverse effect on employment and incomes of reduced government demand. Accordingly, he concluded:

> At the present time, all governments have large deficits. For government borrowing of one kind or another is nature's remedy, so to speak, for preventing business losses from being, in so severe a slump as the present one, so great as to bring production altogether to a standstill. It is much better in every way that the borrowing should be for the purpose of financing capital works, if these works are any use at all, than for the purpose of paying doles ... But so long as the slump lasts on the present scale this is the only effective choice which we possess, and government borrowing for the one purpose or the other (or a diminished Sinking Fund, which has the same effect) is practically inevitable. (48)

The main details of the subsequent events may be summarised as follows:(49) between 12 and 23 August the Labour Cabinet and its Economy Committee endlessly discussed a variety of budget packages calculated to attain the interrelated objectives of budgetary equilibrium, the restoration of confidence, and the raising of further credits to support sterling. Following the inability of the Labour Cabinet to secure an agreed programme of both the required type and amount, MacDonald formed a National Government on 24 August. A further Economy Committee was appointed on 26 August which was to agree to economies totalling £70m (including a 10% cut in unemployment benefit rates) and £80m in increased taxation, the full programme of "drastic and disagreeable measures" being presented to Parliament on 11 and 12 September.(50)

Details of these budget measures are given in outline in Table 5.2. The form of the cuts in expenditure are particularly interesting since they differ in an important respect from those instituted during similar episodes in the postwar period. The major economies comprised expenditure on goods and services and transfer payments to the unemployed; the only capital item curtailed was road expenditure at £7.9m.(51) In contrast, postwar governments, when faced with the necessity of cutting expenditure, principally during sterling crises, have been able to take the politically more palatable and less disadvantageous course of concentrating their cuts on capital items,* for the composition of expenditure has changed markedly over the intervening period, the proportion of capital expenditure to total expenditure having increased significantly.

(ii) The crisis continued 1932-3

Chamberlain replaced Snowden as Chancellor in November 1931,(52) MacDonald having long wanted to send Snowden to the House of Lords in order to permit a freer hand with regard to economic policy, and tariffs in particular.(53)

Chamberlain's immediate aim on taking office was to secure the introduction of a general protective tariff, an objective attained in early February 1932.(54) Chamberlain then felt able to turn his attention to more general budgetary

* Thus the Labour administrations of the 1960s when facing crises in July 1965, 1966, and January 1968, concentrated their cuts on public authorities' investment - Price (1978a: 113-16).

matters, and as he later told the Cabinet:

> [W] hen he took office he had made it his definite aim, in dealing with national finance, to build up the resources of the nation until they were in an unassailable condition. He had also wanted to demonstrate the strengthening of the national resources by progressive remissions in successive Budgets. So far he had been successful in carrying out that policy. It had been almost an essential of that policy that his first Budget should be an unpopular one. His second Budget had been a little better, and he hoped that his third would be better still. To complete the policy it was important to avoid an anti-climax in the case of his fourth Budget by making all the concessions and remissions in the third Budget. (55)

Mention should now be made of the War Loan conversion operation,[(56)] since the course of budgetary policy in the early recovery period was primarily determined by the easing of monetary conditions that resulted from the successful conversion of the 5% War Loan to a $3\frac{1}{2}$% basis. Undertaken between June and December 1932, some 92% of the £2,085m (outstanding at 31 March 1932) 5% stock was converted, resulting both in lower interest rates and a significant easing of the burden of debt payments on the budget.[(57)] Cheap money had long been a Treasury objective,[(58)] a means of promoting industrial recovery and of relieving budgetary pressures; and once instituted, it was to become (with tariffs) the centrepiece of domestic recovery policy.[(59)] Recent research has reaffirmed the traditional view that cheap money underlay the strong recovery of 1932-7;[(60)] the positive contribution of cheap money to the budgetary position also remains unquestioned; nevertheless, the point should also be made that cheap money was to inhibit the adoption of other, less orthodox, policy instruments. In particular, the authorities' fear that cheap money would be threatened - via adverse confidence effects - by a policy of deficit finance and/or resumption of large-scale public works programmes acted to reinforce the commitment to an orthodox budgetary policy. Thus a trade-off existed, that between an active monetary policy and an expansionist fiscal policy.(61)

Shortly after assuming office Chamberlain instructed Hopkins to prepare, in conjunction with the revenue departments, estimates of "the amount of scope ... over a period of three or four years for remitting tax burdens or permitting increased expenditure."(62) In undertaking this exercise, known as 'Old Moore's Almanack', Hopkins advised Forber and Grigg that they were "on present indications to take a middle course between optimistic and pessimistic prophecies",(63) viz. that by 1935: prices and earnings would have recovered to near 1929 levels; the "home trade [would have] regained activity and vigour", while the U.K.'s share of international trade would have risen from 11 to 13%; there would have occurred a substantial improvement in unemployment (to approximately 1.2m), but depression would continue in the staple industries; gilt-edged rates would be approximately 4%, equity values and stock exchange activity would be at normal levels; on balance there would be an ending of the burden of war debts, while the savings from the War Loan conversion would be counterbalanced by future larger sinking fund payments; a planned 10% increase in defence expenditure; and that "progress towards the assumed 1935 level will be at a uniform rate year by year from the outset of 1932."(64)

As Howson says the "assumptions afford an insight into what the Treasury thought a policy of cheap money could achieve",(65) whilst at the same time 'Old Moore's Almanack' also marked a completely new departure in forward budgetary planning.(66)

On the basis of the working assumptions outlined above, Hopkins was able to inform Chamberlain that there might be a surplus of £80m available by 1935, a "mournfully small" sum in the light of the increased taxation of the previous two years. Such a disappointing result stemmed from two factors which were to dominate budgetary planning during the recovery phase: (1) "it illustrate[d] painfully the time lag before the Exchequer participates in increasing prosperity when the country is on the upgrade"; and (2) it reflected the "onward march (even under a strict economy policy)" of social expenditure, the likely high future cost of transitional benefits, the necessity of increasing defence expenditure, and the inevitable reduction in Miscellaneous Revenue "through the exhaustion of war remanets." Hopkins did however add the caveat that the estimates had been "hurriedly prepared" and were "based on assumptions which, though defined, are merely an exercise of the imagination. When 1935 comes the picture will be different (for better or worse) ..."(67)

The "fiscal revolution" in tariffs(68) executed between November 1931 and February 1932 was not to be repeated in the wider sphere of budgetary policy. As Tables 5.1 and 5.2 show 1931/2 closed with a small surplus (B_c, not B where the deficit in fact widened), but the final result was in fact somewhat more complicated. For almost the whole of the final six months of 1931/2 the Treasury anticipated a deficit which might approach £8m, largely as a consequence of the anticipated failure of the Inland Revenue duties to meet the estimates.(69) That a surplus prevailed resulted from two factors: (1) in the previous

September, when framing the estimates of expenditure for the remainder of 1931/2, the Treasury had exercised extreme caution in order to minimise the risk of having to introduce a further Supplementary which would have not only prejudiced the policy objective of a balanced budget but might also have had an adverse effect on confidence at a critical time; fortunately, unemployment failed to rise to its expected level and there was consequently a moderate saving on the expenditure side of the budget;(70) (2) the "magnificent response" of income and surtax payers during March 1932 ensured that together these were £19.4m above the estimate.(71)

Towards the end of February 1932, Hopkins was able to inform Chamberlain that he was "fairly confident" of a surplus and thus there arose the question whether the whole of the £20m transfer, authorized under the Finance (No. 1) Act, 1931, from the old Exchange Account should be taken into revenue.(72) To Hopkins:

> The essence of the matter is that things are going to be terribly tight next year and we cannot reasonably afford to allow a surplus this year to be applied to a reduction of debt in addition to the £32 million of Sinking Fund. (73)

Hence it was decided that only an amount necessary to balance the budget should be taken, the balance being assigned to the following year's revenue.(74)

Whilst 1931/2 did in fact close with a surplus, the framing of the budget for the following year presented innumerable difficulties and was a source of considerable disquiet for the Treasury. As 1931/2 drew to a close a deficit in the region of £6-8m was expected for the coming year, although, as was noted in a previous chapter,(75) such estimates were crucially dependent on the level of income and surtax receipts in the final quarter of 1931/2. To ensure budgetary equilibrium, the Treasury officials, acknowledging the considered opinion of the revenue departments that it was impossible to raise tax rates further, while the yield of taxes already in force was more uncertain than usual,[76] decided on a number of courses. Before the decision to proceed with the establishment of the Exchange Equalization Account there existed the possibility of taking part of the remaining balance of the old Exchange Account into Miscellaneous Revenue. This avenue was closed in the final week of March when Chamberlain approved Phillip's plan for the account.[77] It then fell to the Ministry of Labour to bear the costs of the necessary readjustment. They had originally submitted an estimate for unemployment benefits of £72.5m which was calculated on the basis of an average Live Register of 2.6m unemployed.[78] Whilst this was £6.5m lower than the forecast made in the previous September, Hopkins still believed it to be unduly pessimistic, and agreed with Phillips that:

> It would certainly be disappointing if the tariff and the depreciation of the pound had no effect whatever in reducing unemployment below its present high level. The general world distress and the restrictions imposed by foreign countries on our exports cannot be ignored, but on the whole it is perhaps not too optimistic to expect that the general level of unemployment might be 10 per cent. lower between 1st April 1932 and 31st March 1933 than it is at the present time. (79)

The Treasury (with Chamberlain's approval)[80] pressed for a figure of £65m. The Ministry of Labour was forced to acquiesce:

> We had no option but to defer to the views of the Treasury on the subject, but we made it clear that we could accept no responsibility for the lower figure,

> and Hopkins said that he recognised that they were running the risk of possibly having to provide a Supplementary Vote during the course of the year which might amount to as much as £8,000,000 or more.
> ......
> [Such] information as we have obtained [since the discussions with the Treasury of mid-February] from our Local Offices confirms the view we held that there is no such sign of better conditions in trade and industry as would justify the more optimistic view which is reflected in the Estimates. (81)

Whilst on the basis of the reduction in unemployment since the abandonment of gold there was a natural expectation of some further improvement in trade and employment, the primary motive was budgetary. Hopkins later justified the decision as follows:

> A year ago the Ministry of Labour suggested that the Live Register for the year 1932/3 ought to be taken at 2,600,000. The Treasury, <u>with one eye on what they believed to be the probabilities and the other eye on the financial stringency and the need to take risks in order to keep the Budget balanced</u>, advised the Chancellor to adopt the figure of 2,400,000 and this figure was adopted. (82)
> [Emphasis Added]

Such an expedient was to occur the following year, despite the fact that a Supplementary did have to be presented for unemployment towards the close of 1932/3. Treasury instructions to the revenue departments for the framing of their estimates also illustrate the extent to which the Treasury sailed close to the wind during this period, deliberately over-estimating revenue to avoid the necessity for further tightening. Both departments were asked to review their figures "in the light of [the Treasury's] representations that the estimates should allow for a substantial improvement in general conditions in 1932."(83)

In early April 1932 Chamberlain was informed that the prospective deficit for 1932/3 had now fallen to £4.3m and:

> should it be decided that a balance must be obtained on the existing basis without new taxation it could be done without extravagant stretching of the figures ... But it would be hard to say that the Budget in this form [would] contain anything of a hidden reserve. (84)

Accordingly, in order to lessen the already serious risks they were facing, the Treasury "consider[ed] how to clothe" certain non-recurrent revenue items "in a sufficiently respectable garb",[(85)] and, in the budget, filled the remaining gap by the reintroduction of the tea duty and a number of miscellaneous duty increases.[(86)]

With such a small margin for manoeuvre, given the policy constraint of a balanced budget, remission of taxation or restoration of the expenditure cuts were unachievable. Thus the crisis measures were maintained during fiscal 1932-3, the clear expectation being that there would be a limited recovery in the following year which would permit a loosening of fiscal stance. The budget was thus clearly based on an 'act of faith', although as we shall now see certain contingency measures were receiving active consideration.

(iii) 'Economy' 1931-3

The presentation of the economy programme to Parliament in September 1931 was accompanied by the issue of a number of circulars to local authorities and central departments stressing the urgency of a "stringent pruning of expenditure."[(87)] The way in which the economies were instituted, by the National Economy Act, 1931, is particularly interesting. The Act gave powers to the government to enforce the economies by Order in Council, but, as Fergusson later explained to Chamberlain, it:

designedly refrained from giving power to restore those cuts by Order in Council or any other means except of course fresh legislation. This was done so that, if the Labour Party won the impending General Election, they would not be able to restore [the] cuts except by a Bill passed by both Houses of Parliament. (88)

The first moves in reconsidering the economy policy came in early December 1931, but such moves remained tentative throughout 1932 as the budgetary position remained unfavourable.[(89] Indeed, despite the severity of the economy cuts already instituted, shortly after the completion of the 1932 budget the Treasury was to face a worsening of the budget estimates. The central problem was that:

Chamberlain, like his predecessor a year ago, has produced a budget which depends for its fulfilment upon business recovery. His estimates of revenue are frankly based in a number of important respects upon a revival of trading and financial activity which the burden of taxation itself goes far to nullify. (90)

Whilst there existed an influential group that believed that the budget strategy was doomed to failure because of the absence of active measures to induce recovery,[(91)] politically there was also strong pressure for further moves in the direction of economy.[(92)] Waterfield* summarised the budget position in early May 1932 as follows:

(1) This year's Budget has been balanced with great difficulty, and only by the retention of taxation at a level which the Chancellor of the Exchequer himself has admitted is excessive, and both Parliament and the taxpayer regard as well-nigh impossible.

(2) In a number of respects the Budget takes an optimistic view of the future, e.g. (a) in the estimates of the level of unemployment during the year, (b) and of the yield of the Import Duties ..., and (c) in its deliberate exclusion of any provision for the interest on the U.S.A. debt in December ...

(3) The chance of a deficit by the end of March cannot therefore be overlooked. But that will make it all the more incumbent on us to balance the 1933 Budget. Yet what are the prospects? Even assuming a revival of trade in the course of 1932, the Inland Revenue estimates of revenue from existing taxation in 1933, as forecast for the purposes of 'Old Moore's', is only about equal to this year's figures. And with every week of 1932

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* A. P. Waterfield, Assistant Secretary, Treasury 1927-31, Principal Assistant Secretary 1932-8.

that passes with further dreary evidence of reduced profits and dividends passed, the prospect of a revival of trade coming in time to benefit the 1933 figures grows more remote. (If the revival does not come at all this year, the prospect for 1933 is pretty desperate; the figures might well be as much as £20/25 millions below 1932). Nor are the figures for Customs and Excise likely to be much more satisfactory, judging by the forecast made for 1935 ('Old Moore'), which showed an increase of only £24 millions between 1931 and 1935.

(4) On the other hand, the latest forecast of Expenditure in 1933 suggested a net 'automatic' increase of some £7½ millions including £6 millions on defence (which, though alarming, will be very difficult to resist ...)

(5) Further, it is impossible to exclude altogether the possibility that in 1933 we may have to provide something at least towards interest in the U.S.A. debt ... [which, though] impossible to guess ... might quite possibly be a net payment of between £5 and £10 millions.

(6) Miscellaneous Revenue is likely to be some £3½ millions down in 1933.

(7) It may well happen therefore that next March we shall be faced with the prospect of revenue, based on existing taxation, of about the same as this year (perhaps further additional [import] duties may produce a little more, but it would not be safe to rely too much on these for revenue purposes), and with a 'potential' expenditure some £10 to £20 millions greater.

(8) Yet it is certain that both Parliament and the taxpayer expect a substantial remission of taxation in one form or another next year, and will make their dissatisfaction felt plainly enough if they don't get it.

(9) There are only 2 ways in which such remission can be made possible, either by an early revival of trade or by a reduction of expenditure. However much we may hope for the first, we have no right to assume it as a certainty. We must be prepared for the second contingency ... (93)

A detailed inquiry into the potential for further economy cuts was therefore proposed; it was accepted and carried out during May-June 1932.(94) Economy was considered at both a national and local level; the latter, apart from being "urgently needed in the interests of industry", would also:

in some cases directly and in all cases indirectly, benefit the national expenditure. So far as grant aided services are concerned any reduction of expenditure would affect the Exchequer twice; first by a reduction in the direct grant in aid of the service, and secondly by a reduction ultimately of the general block grant, which is dependent on the total expenditure of Local Authorities generally. (95)

But as Strohmenger informed Fisher:*

> I am not too hopeful of very much being done and am clear that little indeed would be done without a very grave effort. But if for political or budgetary reasons it is essential that further steps towards economy should be taken, an intensive attack on local expenditure might be considered. (96)

An additional problem was that on technical grounds economy in local expenditure was a medium-term policy option, since an essential prerequisite was for a body to investigate the scope for such economies. Thus the appointment of the Ray Committee in early July 1932 essentially served a short-term political purpose,** and it is likely that a major factor in the genesis of the committee was the pressure being exerted by the House of Commons Private Members Committee.(97) Before turning to consider the recommendations of the Ray Committee, reference should be made to the issue of national economy.

In this sphere there were also certain difficulties. The only real scope for further economies lay with social expenditures, but since the cuts of the previous September were "linked together in the public mind in a way which makes them appear part of a comprehensive all round economy scheme" it would "be extremely difficult to revise the [previous cuts] with a view to increased economy except as part of a further all round scheme of equal sacrifice." Acceptance of these political judgements inevitably meant that "the field of economy is very substantially restricted",(98) a conclusion communicated to Parliament in early June 1932.

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* Sir E. J. Strohmenger (Under Secretary, Treasury; Controller, Supply Divisions).

** Chaired by Sir William Ray, the Committee on Local Expenditure was instructed "to consider the whole field of expenditure and make recommendations ... for ensuring reductions in such expenditure, whether defrayed from Exchequer Grants, Rates or other sources ..." (Report, Cmd.4200 (1932), p.8).

Chamberlain, stressing that he "decline[d] altogether to accept the view ... that we have come to the end of the possibilities of reduction in national expenditure", told the House of Commons:

> [If] you are to obtain substantial reductions in national expenditure you have to contemplate something more than a mere paring down ... It has been suggested that all I had to do was to take my pen and write quickly how much I wanted the bill reduced, and that there was no reason why that should not be done at once. I have seen attempts at national economy made before now. I have seen economy undertaken in haste and repented of at leisure. One has to be careful, in the first place, that substantial changes ... can be permanent, [that is] not be reversed within a short time because they had been insufficiently thought out.
>
> [Secondly], if you look at the main items in our national expenditure which are of such a size that they would warrant the belief that substantial reductions can be made, they arise in matters of very vital importance either to the safety of the country or to the standard of living of its people ... I do not say that in no circumstances should any of these things be touched, but I do say that we want to be very sure that changes are necessary before we undertake them.
>
> [Finally], while I believe it is necessary to watch carefully the situation, and that we must certainly lose no opportunity of reducing national expenditure where it can properly and wisely be done, yet I say that we have already taken measures which should prepare the way for a rapid advance as soon as general conditions become favourable. (99)

Further difficulties arose from the continued increase in unemployment. On 6 June Betterton* circulated a memorandum informing the Cabinet that unemployment had risen by a further 0.17m between March and May, that "Reports ... received in the last few days [from] Departmental Controllers are gloomy in the extreme and indicate an increasing loss of public confidence in an early revival of trade", so that "there can be no prospect now of our realising" an average Live Register of 2.4m during 1932/3 and a Supplementary - as the Ministry

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* Sir H. Betterton, Minister of Labour 1931-4.

of Labour had warned when the Estimate was fixed - would be required.(100)

Phillips accepted that "the legitimate expectations entertained last March of a substantial improvement in employment due to our better competitive position look like being defeated or at least postponed for a time", but argued that an attempt should be made to try and dispel this pessimism which he considered was retarding recovery.(101) The magnitude of the Supplementary required was dependent on the course of world trade, which was considered to be highly unpredictable.(102)

Simultaneously, revenue (especially income and surtax) was failing to meet the estimates. By late October, the time when "forecasts [were] usually at their gloomiest", a deficit of approximately £32m was anticipated, or £38m if unemployment averaged 3m rather than 2.75m.(103) For economic and political reasons a further tightening of fiscal stance was considered to be impracticable; thus the natural course was to make the budget accounts appear in as favourable a light as possible:

> Supposing the deficit to be as bad as it looks at present, viz. of the order of £32,000,000, the Chancellor will be able to claim that there have been definite savings on the interest charge of £13,000,000 [due to the War Loan conversion]. These are genuine cash savings which apart from book keeping would be set off against the deficit. It can also be pointed out that we shall have provided out of revenue some £13,000,000 for the Unemployment Fund which under the system in force before the National Government took office would have been borrowed.
> ......
> This is not too bad a showing and if presented in the proper way ought not to produce an unduly depressing effect on financial circles. (104)

Of importance at this juncture was the change in the public mood concerning the emergency measures of September 1931: by late 1932 further economies would have been problematical while there also arose more insistent demands for an active recovery policy. This changed atmosphere is important in understanding the Cabinet's reaction to the Ray report which had recommended wide-ranging and controversial economies totalling £35-40m.(105) As was to be expected, the committee had treated the effects of these measures as outside their terms of reference.(106)

The question of the Ray report was first raised in Cabinet on 8 March 1933 when a draft circular to local authorities was discussed.(107) MacDonald was concerned that the circular would "appear in a hostile and critical atmosphere" and therefore desired the preparation of an accompanying note for the press which would:

> bring out the expansive points in the circular, making clear that the Ray Report is not supported and that the economies are in administration and not on services themselves. <u>If the Government were thought to be imposing further cuts many of their supporters would be antagonised and the political consequences would be serious</u>. (108) [Emphasis Added]

In accordance with these political objectives the Cabinet approved a revised circular drawn up by a Cabinet Committee.(109)

Following Cabinet discussions about the change in public opinion,(110) MacDonald informed Parliament that the "present financial situation offer[ed] no hope that it [would] be possible to restore the [expenditure] cuts", but that no <u>further</u> cuts were being considered.(111) Nor were false hopes encouraged that a reduction of taxation would be possible until <u>after</u> the recovery of receipts to a satisfactory level,(112) although Chamberlain did try to reassure the business community by stating that while a deficit was likely in 1932/3 taxation would not be increased further to cover it.(113) Thus prior to the debates on recovery policy generated by the April 1933 budget, Chamberlain was unsympathetic towards the expansionist case:

> There is nobody more anxious to reduce taxation than I am, both on personal grounds and out of sympathy with the taxpayer. But I should conceive I was failing in my duty if I were to undermine the feelings of confidence that have been inspired throughout the world in the stability of this country's finances ...
>
> If I were to deliberately unbalance the Budget in order to reduce the income-tax ..., well, the consequences would very soon be felt in a way far more disagreeable to the taxpayer than even the continuance for a little longer of the burdens which press upon us so hardly. (114)

2. Recovery 1933-7

The main details of the budgets over the recovery phase are summarised in Table 5.5 which should also be examined in conjunction with Table 5.1 above.

(i) 1933 budget (115)

As predicted 1932/3 closed with a deficit. Its magnitude - £32.3m as measured by B_c - was determined by a number of factors: the payment of £28.9m for U.S. war debt obligations (unplanned in April 1932); a total shortfall in revenue of £22m resulting from the disappointing yield of the tariff as imports were checked more than anticipated, and failures to reach the estimates on beer, income and surtax. There were, however, savings amounting to £10.5m on the expenditure side of the account. The deficit would have been larger still (over 1931/2 to 1932/3 the deficit as measured by B widened from £45.7m to £50.2m) had it not been for borrowing to cover the cost of the War Loan conversion operation and savings' certificates encashments (£25.9m) and a transfer of £8.9m to revenue from the profits of the Bank of England Note Issue. (116)

Table 5.5

Budget summary 1933/4-1936/7: published forecasts and results (£m)

	1933/4	1934/5	1935/6	1936/7
1. Budget balance (B_c) of previous year	-32.3	+31.2	+7.5	+3.0
2. Budget on existing basis				
Revenue (T_c)	795.2	814.0	826.1	872.4
Expenditure (G_c)	781.0	784.9	820.5	893.7
Balance(1)	+14.3	+29.1	+5.6	-21.3
3. Discretionary changes				
(i) taxation				
first year - direct	-11.5(2)	-20.5	-4.5	+12.0
- indirect	-11.5	-0.2	-1.1	+4.5
full year - direct	+0.9	-24.0(4)	-10.0	+16.5
- indirect	-13.4	-	-1.3	+4.7
(ii) economies	-	-7.6	-4.0	-
(iii) miscellaneous	+10.0(3)	-	+4.5(5)	+5.3(5)
4. Budget Estimates				
Revenue (T_c)	782.3	791.2	824.8	894.2
Expenditure (G_c)	781.0	790.4	824.3	893.7
Balance(1)	+1.3	+0.8	+0.5	+0.5
5. Budget outturn				
Revenue (T_c)	809.4	804.6	844.8	896.6
Expenditure (G_c)	778.2	797.1	841.8	902.2
Balance (B_c)	+31.2	+7.5	+3.0	-5.6

Sources: *Financial Accounts*; *Financial Statements*.

Notes:

1 In contrast to previous years no sum was specifically allocated for debt redemption, nor was provision made for US war debt payments.

2 Includes a one year only transaction of £12m remitted when restoring payment dates for income tax to their original basis.

3 Transfer from War Loan Depreciation Fund.

4 Assumed effect of discretionary changes. Reduction of motor vehicle duties (first year effect - £2.2m, full year - £4.0m) but cost almost wholly borne by the Road Fund.

5 Transfer from Road Fund.

That 1932/3 closed with a deficit effectively limited action for the following year; in particular, if financial confidence were to be maintained, the following year's budget would have to be framed on a conservative basis. The dominant

Table 5.6

Expenditure on debt service, 1929/30-1939/40 (£m)

	Interest	Management and expenses	U.S. War debt	Sinking fund	Total*	
					£m.	as % of GDP
1929/30	277.5	2.3	27.5	47.7	355.0	8.4
1930/1	264.6	1.3	27.3	66.8	360.0	8.7
1931/2	274.0	1.9	13.6	32.5	322.0	8.3
1932/3	260.2	2.1	19.9	26.3	308.5	8.2
1933/4	211.9	1.1	3.3	7.7	224.0	5.8
1934/5	210.7	1.0	-	12.3	224.0	5.5
1935/6	210.5	1.0	-	12.5	224.0	5.3
1936/7	209.8	1.1	-	13.1	224.0	5.0
1937/8	215.3	1.0	-	10.5	226.8	4.7
1938/9	215.7	1.1	-	13.2	230.0	4.5
1939/40	221.8	1.0	-	7.2	230.0	4.1

Sources: Financial Accounts; GDP data from Table 6.1 below

Notes: * Total payments equals 'Fixed Debt Charge'.

feature of the 1933 budget was the reduction in the debt charge resulting from the War Loan conversion and low Treasury Bill rates (Table 5.6). This created a number of technical difficulties, first considered by the Treasury in October 1932.

The Finance Act, 1928, had established the Fixed Debt Charge (F.D.C.) with an initial figure of £355m. Special powers, however, had to be taken to reduce this to £322m in 1931/2 and £308.5m in 1932/3, but it was due to revert to the original figure in 1933/4. With interest and management charges estimated at £226m for 1933/4, this would give sinking fund payments of £129m. As Phillips commented:

> This would be absurd in present circumstances and legislation will be required both for this reason and because the total charge will in any case need permanent revision if we can exclude the United States Debt and also allot the saving on the War Loan conversion to the taxpayer, as clearly we must.

Phillips therefore suggested an F.D.C. of £258.5m which would cover interest and management charges and also provide £32.5m for debt redemption, while in subsequent years a £50m sinking fund should be adopted. This would be:

> not altogether inconsistent with a balanced Budget and ... at the same time not so low as to rule out the hope of a return to a more vigorous policy of debt redemption in more favourable circumstances later. (117)

By the time of the presentation of the budget, however, a radical shift in policy had occurred; for Chamberlain announced that the F.D.C. was to be set at £224m which omitted allowance for sinking fund payments altogether, powers instead being taken to borrow for the statutory sinking funds (amounting to £7.5m):

> I do not think that even the strictest financial purist will quarrel with me for borrowing that small sum to meet my purposes in the present year. In times like these, of unemployment and stress on all sides, and of trade depression, we can, in my opinion, use our money more wisely and more profitably than in the redemption of Debt, provided, of course, that we make generous provision for it when good times come. (118)

This practice was continued throughout the remainder of the 1930s, powers being taken annually in the Finance Act, whilst in addition, where interest paid on savings certificates exceeded the margin available in the F.D.C. the Treasury borrowed the requisite funds.* By such practices, the burden of budgetary difficulties was eased, and the deflationary impact of fiscal operations lessened.

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* For much of the 1930s interest continued to accrue without being claimed, whilst the F.D.C. had been so reduced that there was no margin available to cover it. Thus by 31 March 1937 interest amounting to £124m had accrued and the Treasury were deeply disturbed by the consequences if a substantial volume of certificates were cashed because this would have necessitated large-scale borrowing to meet their liabilities (T171/340, Phillips, 'Note on the Annual Debt Charge', 3 Feb. 1938). The possibility of such an occurrence, although unlikely, undoubtedly strengthened opinion in the Treasury against 'rash economic experiments' such as a deliberately unbalanced budget which might have an adverse effect on government credit.

In the final quarter of 1932/3 the revenue forecasts continued to show the effects of depression, while unemployment was to peak in January 1933. Nevertheless, the Treasury would only agree to a Ministry of Labour Estimate at the previous year's figure (the Ministry had applied for an additional £4m).(119) Thus, as in 1932, the Treasury enforced their will against departmental opposition. While the Live Register for 1932/3 was expected to average 2.785m, and "if we ... follow the inferences from 1932 the proper figure for 1933/4 would be about 2,950,000", Hopkins nevertheless believed:

> that would be to assume that we shall continue to run down hill. The right assumption at this stage not merely for unemployment but for everything seems to be that conditions will at least remain stable, if they do not get a little better ... (120)

Similar assumptions guided the framing of the revenue estimates for 1933/4, which showed a reduction (T_c) of £53.7m on 1932/3, primarily because the current yield of income and surtax was based on the depressed years of 1931 and 1932,(121) while beer and spirits were also performing badly.(122)

To permit a limited remission of taxation - which was viewed as politically necessary, if insignificant economically - potential raids were investigated and it was decided to appropriate £10m from the War Loan Depreciation Fund.(123) This gave a prospective surplus of £24.3m and permitted a reduction in beer duty (because the previous rate was apparently seriously affecting consumption and thus the duty's yield) and the restoration of payments of income tax under Schedules B, D, and E to their original dates.(124)

Such remissions, however, failed to satisfy those who had campaigned for a relaxation of budgetary policy sufficient to stimulate recovery - a campaign opened by The Times in late January 1933,[125] and later developed by M.P.'s of all parties,[126] and a number of leading economists;[127] a campaign greatly strengthened by Keynes's articles in The Times of mid-March 1933, 'The Means to Prosperity', which sought to advance the theoretical basis of the expansionist case.[128]

Despite these pressures, Chamberlain was not prepared to unbalance the budget to permit further remissions of taxation. His adherence to balanced budgets may be said to derive from two interconnected influences, firstly that economic policy was a quasi-moral issue, secondly that unbalanced budgets were ineffective in inducing recovery.

With regard to the former, Chamberlain expressed his views in one of the weekly letters to his sisters:

> [T]he Times has an article almost every day demanding reduction of taxation and the Mail & Express are adding their shriller notes now - I receive deputations from M.P.'s who urge 'imaginative finance' plus a wide variety of specific interest groups, e.g. brewers, film companies, etc.
> ......
> And every one of them represents that his particular interest is in a moribund condition entirely owing to taxation. I foresee that I shall soon be the most unpopular man in the country, while at the same time I receive rather grudging & very belated praise for a 'sound' Budget last year and for the Conversion which it made possible. I should think few Chancellor's have had a more difficult task than I and I add (between ourselves) my conviction that few men in my position would resist the temptation to bid for popularity. (129)

Towards the end of the 1933 budget speech Chamberlain took the opportunity to reply to the "agitation - I might almost call it a drive - in favour of deliberately unbalancing the Budget in order to take a substantial slice off the Income

Tax". Chamberlain summarised the protagonists' case as follows:

> That the time has now come when trade recovery is on the point of materialising, and that a reduction of direct taxation would give such a psychological fillip to the country that the wheels of industry would start running again at such a rate that in a comparatively short time, say in three years, we might expect to find ourselves in possession of a substantial surplus of revenue. That programme is to be combined with a programme of [capital] expenditure, and the combined programme is to be announced beforehand so that the public may be directed to pay attention only to what is to happen at the end of the period, and to disregard the question of whether at any intermediate stage there is a surplus or deficit.

In reply, Chamberlain advanced the following counter-argument:

> [1] Suppose that I were to take a shilling off the Income Tax this year. That would cost £50,000,000. Then, according to the plan, I am to expect in 1934 that I shall draw somewhere about level, and that in 1935 I shall have a surplus of not less than £50,000,000, so that over the whole three years the Budget is to balance. That means that an extra £50,000,000 has to materialise in 1934, and an extra £100,000,000 in 1935. If those results are to be produced out of Income Tax alone, as some people suppose, it would mean that the profits of 1933, this present year, would have to be increased by £250,000,000 and the profits of next year would have to be increased by £500,000,000. Of course, these vast figures are purely academic. We all know that any general increase of prosperity would affect the Budget in many ways. I dare say that most of them would be favourable. But I put it to the Committee that, at least, these figures show the necessity of caution in accepting too readily the anticipations which are so hopefully attached to the idea of a three years' Budget.
>
> As a matter of fact, however, everyone knows that you cannot possibly, in these times, forecast what is to happen over three years. Even one year may produce quite unexpected results, as the Committee has seen in the review I have given of the year that is past. If I were to pretend that I could lay out a programme under which what I borrowed this year would be met by a surplus at the end of three years, everyone would very soon perceive that I was only resorting to the rather transparent device of making an unbalanced Budget look respectable.
>
> [2] No Finance Minister, as far as I know, has ever deliberately unbalanced his Budget when he possessed the means of balancing it ... No Finance Minister would willingly abandon the primary bulwark against

> extravagance or forget that an unbalanced Budget may presently have to be balanced again. But although no Finance Minister voluntarily unbalances his Budget, sometimes external circumstances perform that task for him.
>
> [3] Look round the world to-day and you see that badly unbalanced budgets are the rule rather than the exception. Everywhere there appear budget deficits piling up, yet they do not produce those favourable results which it is claimed would happen to us. On the contrary, I find that budget deficits repeated year after year may be accompanied by deepening depression and by a constantly falling price level. Before we embark upon so dangerous a course as that, let us reflect upon this indisputable fact. Of all countries passing through these difficult times the one that has stood the test with the greatest measure of success is the United Kingdom. Without underrating the hardships of our situation - the long tragedy of the unemployed, the grievous burden of taxation, the arduous and painful struggle of those engaged in trade and industry - at any rate we are free from that fear, which besets so many less fortunately placed, the fear that things are going to get worse. We owe our freedom from that fear largely to the fact that we have balanced our Budget. By following a sound financial policy we have been enabled to secure low interest rates for industry and it would be the height of folly to throw away that advantage. If we were to reverse our policy, just at the very moment when other Governments are striving to follow our example and to balance their Budgets, after experience of the policy which we are now asked to adopt, we would stultify ourselves in the eyes of the world and forfeit in a moment the respect with which we are regarded to-day. (130)

The existing domestic recovery policy, and the continued commitment to budgetary orthodoxy, were thus reaffirmed in the budget speech. Nevertheless, the expansionist case had not gone unheard. The sinking fund had largely been suspended, and a limited remission of taxation made possible by fiscal window-dressing. Furthermore, whilst, within the Treasury, the view prevailed that it was "essential that the Government should not be deflected from the main lines of [its] present policy", it was also recognized that, on political grounds, "there would ... have to be some alteration in the attitude towards public works adopted in the King's speech".(131)

(ii) 1934 budget

In one sense, Chamberlain's optimism or carefully calculated risk of April 1933 was justified: 1933/4 closed with a surplus (B_c) of £31.2m. Careful inspection of the revenue and expenditure data shows, however, that the surplus did not result from a revival of economic activity as such - revenue (T_c) in fact fell by 2.1%, but expenditure (G_c) fell by as much as 9.4%, the whole of this change being explained by a reduction in the F.D.C.

With the publication of the budget accounts for the first six months of 1933/4 the view began to gain ground that the year would finish with a substantial surplus.(132) Such a possibility was first mentioned in Cabinet on 18 October,(133) but was not actively discussed until 6 December 1933,(134) when it was "unanimously decided that the benefit should be spread over those who have been cut as well as those who have been burdened".(135)

However, the first complete budget forecast drawn up was "very disappointing",(136) because of unfavourable developments on both the revenue and expenditure sides of the account. With regard to the former, Inland Revenue duties were estimated to yield £390m in 1933/4 but only £380m in the following year, largely because of the continued fall in profits in 1933 and the fact that the former year had contained £13m of duties on the Ellerman Estate. But this estimate was made before the Budget samples of profits were prepared (during February),(137) and Phillips commented that "having regard to the improvement in unemployment and other signs of trade recovery I find it myself difficult to believe that Inland Revenue in 1934/5 will be so poor."(138)

Similarly, the Customs and Excise forecast was considered questionable, leading Phillips to comment that it was "low, but quite clearly it is not excessively low." (139) Finally, there was the £10m from the War Loan Depreciation Fund included in Miscellaneous Revenue in 1933/4 which would not be available in the following year while receipts from the Enemy Debt Clearing Office were also falling off.

> The picture is too gloomy to be faced. I think in view of the size of this year's surplus we must try to carry over some of the Miscellaneous Receipts to next year. It is not altogether a desirable proceeding (and it could not of course be repeated in 1935 when the bump down in miscellaneous receipts must be faced). (140)

To remedy this situation Phillips proposed to transfer £6.5m of miscellaneous receipts from 1933/4 to 1934/5, and to raise the Inland Revenue estimate by a maximum of £10m and Customs and Excise by £4m.

On the expenditure side, the continuance of the low figure for the F.D.C. was no longer certain and was likely to increase as recovery led to a hardening of Treasury Bill rates (a question that remained a preoccupation for much of the rest of the 1930s); the Ministry of Labour estimate for unemployment of £66m (based on an average Live Register of 2.2m) was "probably unduly pessimistic"; while Supply Services in general were "disappointing".

Without some contingency action the surpluses for 1933/4 and 1934/5 were likely to be £31.8m and £2.1m respectively; with such action they would be £25.3m and (approximately) £22.6m. (141)

By the end of February 1934 conditions had changed somewhat: receipts, especially for income tax, were more buoyant than expected, and the likely surplus for 1933/4 was in the range £26.5-30m.[142] Hopkins advised:

> I am sure [that] we ought not to press I[nland] R[evenue] unduly to limit their intake. It is easy enough to worsen a standard of collection and very difficult to get it back to its former level. Indeed all that can readily be done on this subject has been done already. (143)

Accordingly, Inland Revenue were asked to make only moderate efforts to limit their rate of collection of income tax in 1933/4,[144] but Customs and Excise were asked to inflate their estimates.

The budget forecast drawn up in mid-March 1934 shows clearly the Treasury's difficulties; on the basis of existing taxation and assuming the transfer of £6.5m of miscellaneous receipts to 1934/5, budget surpluses in 1933/4 and 1934/5 of £32m and £20.8m respectively were forecast. With the cost of a 6d. cut in the standard rate of income tax at £20.5m, restoration of the unemployment cuts at £3.6m, and half the remaining cuts at £3.9m, revision of the revenue estimates would be required.

> The position of the two Revenue Departments is not quite identical. For many reasons the yield of direct taxation lags behind changes in the state of trade and business. It does not decline so rapidly as might be anticipated at the beginning of a slump and its recovery tends to be delayed when conditions improve. On the other hand Customs and Excise ought to respond almost at once to better conditions.

Inland Revenue and Customs and Excise were asked to stretch their estimates by £3m and £5m respectively.[145]

Preliminary consideration was also given to the prospects for 1935/6. It was feared that this would see a deterioration over 1934/5 of approximately £38m, as a result of:

(1) full year effects of 1934 budget changes;

(2) long-term decline in Miscellaneous Receipts;

(3) rising cost of defence;

(4) the likely increase in the F.D.C. due to rising interest rates and the fact that it would be "difficult not to provide at least for the <u>contractual</u> sinking funds."(146)

Outside of the Treasury few were probably aware of these difficulties, and as Chamberlain noted shortly before the 1934 budget:

> There is no doubt that events are justifying my prophecy that my difficulties would begin when there was any sign of anything to distribute. The uproar from the would be recipients is terrific and the papers keep whipping them on by new and more fantastic estimates of what the surplus will be. I fear there will be a good deal of disappointment on April 17 and I shall once more come in for a good deal of abuse. But I can very honestly say that I care little for that. My time will come 20 years hence and though I shall probably not be there I am satisfied to leave my reputation to posterity. (147)

The central problems in framing the 1934 budget may be summarised as follows:

(1) the revenue departments had been extremely cautious in their forecasting and the Treasury anticipated that there would be complaints about the low revenue estimates. Such complaints did in fact arise during the budget debates,(148) and despite Chamberlain's careful explanation in the budget speech of the reasons why the yield of income tax lagged behind recovery,(149) the Treasury were probably correct in their judgement that, in general, Parliament was uninformed about the basic characteristics of the fiscal system.

(2) concern was beginning to be shown about the future cost of the F.D.C. and the fact that it did not cover the full cost of savings' certificates interest. This was a medium-term problem: "the end of at least relatively cheap money is not yet in sight",(150) while the problem concerning the savings certificates might never be realised.

As stated earlier 1933/4 closed with a surplus (B_c) of £31.2m, but by law this had to be allocated to debt redemption and was not available to aid budgetary relaxation. By the time of the presentation of the budget the Treasury had been able to modify the revenue and expenditure estimates so that, on the existing basis, there was a forecast surplus for 1934/5 of £29.1m (see Table 5.5). This was "sufficient to enable [Chamberlain] to begin the long awaited process of relief from the burdens and sacrifices of the last few years."(151)

In announcing the budget changes explicit reference was made to Snowden's advice that a "surplus now must in justice be devoted, as far as it will allow, to relieving those classes who suffered when the crisis was acute."(152) Thus not only was the standard rate of income tax cut by 6d. but the cuts in unemployment benefits were fully restored and the salary cuts partially restored. On the expenditure side, these measures served a social and political purpose; with regard to the tax side:

> [O]ut of £81,500,000 of extra taxation which was imposed [in 1931], the Income Tax payers found no less than £57,500,000, or 70 per cent. of the extra taxation. Although their burdens were already heavy, they shouldered an extra 6d. on the standard rate; there were general reductions in the Income Tax allowances; and there was an addition of 10 per cent. to the Surtax charge upon the larger incomes. Moreover, all these increases of taxation took effect from April, whereas the cut only became operative in the autumn. I think, too, one must not forget that since 1931 many of these Income Tax payers have also suffered a further serious reduction in their incomes owing to the operation of the Conversion Loan. Therefore, the case for some remission is overwhelming, and the only question is what form it should take. In deciding upon the form, I thought I ought to consider the effect of any remission not merely upon the individual taxpayer, but upon the country as a whole. Looking at it from that point of view, I had no hesitation in coming to the conclusion that the relief which would confer most

> direct benefit upon the country, which would have the greatest psychological effect, and which would impart the most immediate and vigorous stimulus to the expansion of trade and employment, would be a reduction in the standard rate of Income Tax. (153)

Thus, whilst in general a remission in taxation was desirable on political grounds, the form was determined by economic considerations.[154]

(iii) 1935 budget

When making the 1934 budget changes there had been the clear intention that the following year should see a further relaxation so as to restore the pre-1931 position. However, as early as July 1934 definite fears existed within the Treasury that this objective would be frustrated, and that even "The prospects of a surplus in the current year's Budget have become somewhat clouded by recent decisions",[155] namely Supplementaries of £7-10m already being contemplated and the possibility of a rise in defence expenditure. Moreover:

> The revenue appears to be doing well and it would be rather early yet to anticipate an actual Budget deficit this year. A merely balanced Budget is altogether insufficient however since there is universal expectation of further concessions to be made in 1935/36. The actual outlook for 1935/36 and the succeeding year 1936/37 is becoming most threatening.

The 1934 budget changes had full year costs of an extra £6.7m; the full costs of completing the restoration of the pre-1931 position were far greater. Restoration of the second half of the pay cuts and the income tax allowances was estimated at £19m in 1935/6 and £35.5m in a full year; the reduction in surtax at £4m; while if the public demanded a further 6d. off the standard rate of income tax a further £20m would be lost in revenue in 1935/6. In addition, as had been anticipated, substantial declines in Miscellaneous Revenue had to be faced, by £9.5m and £11.5m in the following two years. Finally, "there is no hope that the debt charge can be maintained indefinitely at its present extremely low figure", although there was no prospect of affording a "return to normality in respect of our debt policy [which] would involve the provision of say a total of £50 millions a year for debt redemption."

In total, there was the grim prospect of a worsening of the financial situation by £65m and £90m in 1935/6 and 1936/7, or £85m and £115m respectively if it were also desired to cut further the standard rate of income tax.

> The plain reading of these figures is this. The financial prospects for 1935/6 and 1936/7 have become bad. Some help may be forthcoming from growth of the main heads of ordinary revenue and from a reduction in unemployment - though this latter process has come to a stop for the moment. But no reasonable man could anticipate such a degree of help from these sources as to cancel out all the above liabilities.
>
> The possibility of a further reduction in income tax next year has disappeared.
>
> The possibility of restoring the income tax allowances next year has been gravely imperilled, and in the event of further expenditure being incurred will disappear likewise. (156)

Meanwhile, the revenue reports for the current year continued to be reasonably favourable;[157] concern centred over the likely growth of revenue in 1935/6, the prospects of which, Hopkins warned in November 1934, had become "more black than I had guessed."[158] Hopkins was instructed to prepare a note on the budget prospects for a Cabinet meeting which was to be called because it was felt "that the Cabinet does not appreciate the gravity of the situation".[159] From the new budget forecast, Hopkins concluded that "the position [was] a little worse", the deficits for 1935/6 and 1936/7 (on the same basis as the July forecast) having risen to £70.7m and £93.2m respectively.[160] A month later, having received the draft Estimates, the situation had deteriorated still further, the increase in expenditure commitments being "prima facie utterly beyond anything that can be covered by increased produce of taxes." Hopkins suggested: (1) that the revenue estimates for 1935/6 might be too cautious and thus capable of being stretched;(161) (2) investigating possible raids, transfers between years, and other devices, "though it would be dangerous to suppose that we can do more that way than find the £7½ million to replace the automatic fall in Miscellaneous Revenue"; (3) reduce the Estimates, care being taken not to force Supplementaries upon the departments.

> I conclude therefore that all we can do at present is to create an atmosphere of parsimony and financial difficulty and to ask all Departments alike to give us all they can and that any actual decision as to the use of the axe should be postponed till the end of next month: the axe, if then used, (as I fear it must be), will need to be accompanied by assurances that supplementaries will be allowed if they prove unavoidable. (162)

The proposal to modify the Estimates raised important questions of policy. In sending Hopkins' note up to Chamberlain, Fergusson commented:

> How far it is worthwhile to pursue this course depends to a large extent, like the question of budgeting for a deficit, on when a General Election is likely to occur and, so far as the estimates of expenditure are concerned, we shall have to decide what to do by about the middle of February at the latest.
>
> It is much safer and easier to exercise discretion on revenue estimates than on expenditure estimates, and I have hitherto hoped that it might be possible to bridge the gap by the former method alone; but it is beginning to appear that this will not be possible. However, we ought to have some further indication of the revenue outlook before final decisions have to be reached on the main expenditure estimates. (163)

As the time for the presentation of the Estimates to Parliament approached Hopkins further reviewed the situation:

> I cannot point to any Estimate which I believe will actually bear a cut of £½ million, or anything like it, without new legislation or changed policy. I do not myself feel that the £2 million or so which could be wiped off the book figures (though not off the intrinsic situation) is a sufficiently large advantage to set against the disadvantage of the probable very unusual Supplementaries later in the year. I would prefer to write up the revenue slightly above £700 millions, remembering that the Inland Revenue and Customs figures are not added together in the actual budget statement, so that the passing of the £700,000,000 mark will not be strikingly brought out.
> ......
> An over estimate of revenue [is more satisfactory, and] taking all the circumstances into account I think I can reconcile it to my conscience. (164)

It was thus decided that the gap (now estimated at £26.6m) should be met by firstly writing up the revenue estimates, and secondly, manipulating the figures for Miscellaneous Revenue so that "With some trifling changes in minor heads of revenue, the ... deficit would then be covered on paper."(165)

A month later, however, Phillips was writing that while it was possible to raise the revenue estimates "I should not rank very highly our chance of actually collecting such additional sums".(166) But a new factor had intervened at this point: the possibility of a raid on the Road Fund.

A day after the preparation of the February budget forecast Hore-Belisha (an ex-Financial Secretary, and now Minister of Transport) had informed Chamberlain that revenue was running ahead of expenditure on roads so that he anticipated that there would be a balance of £5m by the end of the financial year.

> This is a much more favourable position than either of us expected, and I hope that you will see you way both to increasing the amount of the road programme and to agreeing to rates of grant which will enable the local authorities to resume work on some of the important suspended schemes which they were only induced to undertake originally by a promise of grants of 75 per cent. or more. (167)

Hopkins, however, was:

> much more interested in the very tempting amount of money which it is now found that the Road Fund will contain at the 31st March, and the large growing balances of the immediately succeeding years.

The buoyancy of the motor vehicle duties meant that even if authorisation were given to the 5 year road programme being contemplated at that time, the balance of £5m could be taken into Exchequer receipts while further sums would probably be available in the future.(168) Hore-Belisha, however, was furious, and according to Chamberlain, "sent in a written protest accompanied by requests for assurances to which I shall pay no attention."(169)

The question arises why the 1935 budget was so difficult to frame. The first point of note is the political context, for from December 1934 onwards Lloyd George had been campaigning for a change in the government's economic policy. The necessity for a popular budget was in any case strengthened by the legitimate expectation that from 1934 onwards the government was committed to further remissions of taxation. Furthermore, attention was already being given to the timing of the next General Election(170) and a popular pre-election budget was imperative in order to counter a successful attack by the Opposition parties on the government's recovery policy. On economic grounds, it had also been noticed that there had occurred a slackening in the pace of recovery in the second half of 1934,(171) and a further fiscal stimulus was obviously desirable.

The problem was that expenditure, which was beginning to become influenced by rearmament, was outstripping the growth of revenue, itself slow to respond to recovery. Further remission of taxation and the completion of the last stage of restoring the 1931 economy cuts cost a total of £9.6m. This was only secured in 1935 by transferring miscellaneous receipts from 1934/5 to 1935/6, raiding the Road Fund, and, to a limited extent, stretching the revenue estimates.

The actual Financial Statement[172] contained little of interest, except for the final paragraph:

> We are framing our requirements to-day at a time of fresh anxiety in Europe. We must recognise that our further progress may be powerfully affected by events over which we have little control. Moreover, we have ever before our eyes those districts, once the seat of our most prosperous industries, which to-day still lie under the shadow of world depression. We must not, we shall not, relax our efforts by any or every measure which offers a reasonable prospect of success to restore them to a position in which they can play their part in the normal life of the nation. But, taking the country as a whole, looking back over these 3½ years, we can see the improvement has been solid, continuous and steady. To that result many things have made their contribution - tariffs, conversion operations, cheap money, balanced Budgets, remissions of taxation. They have done it largely by creating a spirit of confidence. Confidence is the mother of enterprise, and, when it operates upon many individuals and through many channels, it is far and away the most effective form of promoting a general and rapid expansion of economic activities. Broadly speaking, we may say that we have recovered in this country 80 per cent. of our prosperity. Our task is now to win back the remaining 20 per cent. without jeopardising the confidence that we have already established. Given peace abroad and a fair measure of unity at home, I see no reason why we should not during this current year make a further substantial advance towards prosperity, and it is in that conviction that I have framed my Budget estimates. (173)

Thus stated, this in essence represented Chamberlain's philosophy of economic management, and of budgetary policy in particular. Whilst the Treasury cannot be accused of financial orthodoxy in any strict nineteenth-century sense, for the period 1932-6 saw a number of major departures from orthodoxy - the virtual abandonment of sinking fund payments and the use of fiscal window-dressing to conceal deficits. In a wider sense, however, the influence of the nineteenth-century fiscal constitution on policy formulation is clearly discernible, in the refusal to countenance deliberately unbalanced budgets and in the reliance on 'normal' channels to promote trade recovery. Nor were the characteristics of the fiscal system particularly suited to the maintenance of balanced budgets in the face of autonomous fluctuations in activity, a theme we explore in the next chapter. In 1935 Chamberlain was convinced of the correctness of the financial policy being pursued:

> Though the financial policy of this Government has frequently been criticised on the ground that it is wanting in boldness or imagination, I think we may say that the proof of the pudding is in the eating, and that the results which have been accomplished have justified us in sticking to sound principles of finance. I have sometimes been criticised on the opposite ground, in that I have not in recent Budgets provided for a regular sinking fund. As a matter of fact the outcome of the four Budgets for which I have been responsible have resulted, either in a fixed debt charge or in Budget savings, in the provision of £87,500,000 towards the redemption of debt. In view of that fact I do not think I need fear any prickings of conscience on the score of my unorthodoxy. (174)

(iv) Rearmament - a preview

The cryptic reference to "fresh anxiety in Europe" made at the close of Chamberlain's 1935 budget statement reflected the increasing burden of defence expenditure on the budget. Following the Cabinet's decision of 1919 - known as the 'Ten Year Rule' - "that the British Empire will not be engaged in any great war during the next ten years, and that no Expeditionary Force is required for this purpose",[175] the defence Estimates were progressively reduced during the 1920s, reaching a minimum of £103m in 1932/3.[176] By that date, it is generally agreed that "retrenchment had reduced Britain's defence services and armaments industry to a dangerously low level."[177] Consequently, the Japanese invasion of Manchuria in September 1931, which dramatically brought home British military vulnerability in the Far East, provided the opportunity for a revision of the rule. Its cancellation was recommended by the Committee of Imperial Defence in March 1932,[178] and approved by the Cabinet after much discussion.[179] Nevertheless, since the Treasury's view - "that to-day financial and economic risks are by far the most serious and urgent that the country has to face and that other risks must be run until the country has had time and opportunity to recuperate and our financial situation to improve"[180] - remained unchallenged, the cancellation of the rule meant in effect that: "The services had won the right to plan, but not to spend. The story of rearmament in the thirties revolves around this second battle."[181]

The importance of this constraint on the growth of defence expenditure is clearly visible in the figures for the defence Estimates up to 1934/5 and in the modest programmes drawn up to rectify the worst deficiencies of the defence services. Defence expenditure only began to increase substantially from 1934/5 and by 1936/7 had reached £136.9m, some 32.9% above the low point of 1932/3. Similarly, it was not until February 1934 that the Cabinet was presented with a detailed rearmament programme, and this only proposed additional expenditure of £77m over 1934/5 - 1938/9 with a further £16m in subsequent years.[182] The worsening of the international situation in 1935 compelled the Cabinet to review the situation, and following recommendations by the Cabinet Committee on defence issues - the Defence Requirements Committee (D.R.C.) - in November 1935 for a substantial enlargement of the rearmament programme, a revised scheme totalling approximately £1015m (compared with a total of £634m under the original programme) was approved in February 1936.[183] With the decision to permit part of the rearmament programme to be financed by borrowing, the size of the programme was to be further enlarged in subsequent years. This was not possible until 1937, but the question of borrowing was discussed much earlier.

(v) Discussions over borrowing 1935-6

A defence loan was viewed from two different, although interrelated, perspectives: (1) that it would permit the execution of a larger rearmament programme than that possible under the constraint of a balanced budget; and (2) by reducing the additional taxation required to finance a programme of a given size, it would minimise the electoral disadvantages of such a programme, an important consideration in its initial stages when the Cabinet were by no means convinced that a full scale rearmament programme would be politically acceptable.(184)

A defence loan had been suggested in June 1934, but had found little favour and was easily dismissed by Chamberlain.(185) As a policy option, it was first seriously raised by the D.R.C. interim report of the autumn of 1935 which, as Shay says, had been framed "without reference to financial limitations".(186) Subsequently, the committee were to press home the point "that we could not compete on a taxation basis against nations who were acting on a loan basis";(187) and this was to lead to widespread discussion of the question. Naturally the focal point for such discussions was the Treasury, debate centring on Fisher's support for the D.R.C. proposal of a defence loan.

Both Phillips and Hopkins believed that defence borrowing could not be justified on the grounds that it was capital or non-recurrent expenditure:

> It was held thirty years ago that there was a special case for borrowing to meet the expense of military and naval works of some permanence, such as barracks and fortifications. There is however no real economic ground for distinguishing such expenditure from expenditure on the upkeep of the forces. Neither type of expenditure is productive and both types involve simply an economic loss. The only valid reason which would ever be given for borrowing for armaments is a budgetary reason. It must be supposed to be clear beyond doubt that the level of expenditure contemplated is abnormal and non-recurrent and beyond the ability of the country to discharge immediately out of revenue. But, if so, it is the total expenditure that matters and the attempt to distinguish between different kinds of armament expenditure according as they are supposed to be of a 'capital' or revenue character is a useless complication. Moreover, the procedure adopted [thirty years ago] under the Military and Naval Works Acts resulted in a large part of the armaments programme being withdrawn from detailed Parliamentary control, a fact which contributed largely to the discredit into which the system fell.
>
> The great danger of admitting too readily an argument based on the supposed non-recurrent character of the expenditure is that men always over-estimate their present suffering and are incurable optimists as to the future when it pays them to hold that view.
>
> [Emphasis Added]*

The desire to avoid justifying rearmament in terms of its (supposed) capital value stemmed from concern over the effectiveness of the traditional constraints to the growth of civil expenditure if such a course were adopted:

> It would be unfortunate if the country began to think of a Defence Loan as a comfortable Lloyd-Georgian device for securing not only larger forces but also lower estimates, Budget surpluses and diminishing taxation. (188)

> I think ... it would be best to avoid the term 'extra-ordinary Budget' like poison, even in Cabinet discussions. Continental practice has made this phrase synonymous in the minds of informed financial circles with all that is unsound and dangerous in national finance; and the uninstructed public in this country might easily see a way out of all their troubles in 'extra-ordinary' budgets for Depressed Areas, etc., etc. (189)

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* T160/688/F.14996/1 and T171/324, Phillips, 'General Note on methods of financing the Defence Programme', 29 Nov. 1935, pp.3-4. This accorded with Hopkins's advice that "the only ground for borrowing - though it may be a sufficient one - is that the expenditure places the Exchequer seriously in deficit when the country is taxed to full capacity, and the measure of the reasonable borrowing is provided by the amount of the deficit ..." (T160/688/F.14996/1 and T172/1832, Hopkins to Fisher and Chancellor, 7 Oct. 1935, p.1).

Out of these early discussions arose agreement that the <u>sine qua non</u> of rearmament finance was that before borrowing could commence, two conditions had to be fulfilled:

> a) the amount of defence expenditure to be borne out of revenue should be largely increased over its current amount, as an earnest of the country's endeavour;
>
> b) it should be convincingly shown that taxation (already extremely onerous) has been carried to the highest point that the country can bear without grave detriment to its economy. (190)

Borrowing was agreed in principle in December 1935, but not undertaken until 1937/8 because, in accordance with the principles established above, it was first necessary to reach a position where at least £170m of defence expenditure was financed from revenue, this figure being the estimated annual defence charge once the rearmament programme was completed.

The decision to limit borrowing, both in amount and in its timing, stemmed from a number of factors. Firstly, this put Britain at a disadvantage <u>vis-a-vis</u> Germany which was rearming via borrowing:

> it may be argued that it is pedantic to pursue principles of this kind at a time when the world as a whole is disregarding them. It is quite true that principles of sound finance are little honoured today outside the British Empire. It is quite true that numbers of countries great and small - countries recently bankrupt, countries now bankrupt and countries still hovering on the edge of bankruptcy - are adding to their national debt with no regard to the consequences. This argument, however, would not give soundness to any unsound measures we adopted; it would merely aver that we drop back into unsound finance in a large, if rather distraught and disreputable, company. Nor have we the wide margin of safety which some of our formidable rivals enjoy; after several years of ruinous finance the debt burdens of the United States and of Germany are still far less in proportion to the size and wealth of those countries than the burden of our own debt. Sound finance has been the foundation upon which the spirit of confidence has been revived at home and trust in this country has been re-established abroad, and presumably the Government would be slow to depart from it. (191)

Accordingly, borrowing was delayed until 1937/8, and the 1936/7 budget was framed on the assumption that revenue should be sufficient to cover expenditure.

(vi) 1936 budget

From 1935 onwards expenditure commitments (both for civil and military purposes) were clearly beginning to outstrip the automatic growth of revenue, and, having decided to defer borrowing to 1937/8, were to cause serious difficulties in the framing of the 1936 budget, the last budget of the 1930s to be balanced according to the conventional budget definition.

The process of preparing public opinion for the difficulties ahead began in the autumn of 1935 when Chamberlain publicly warned that the growth of defence expenditure had substantially reduced the possibilities for further remission of taxation.(192) The publication of the Estimates in February-March 1936 reinforced the desired impression, leading one commentator to note that they were "a large enough sum to test any Chancellor's revenue-finding ability."(193)

As 1935/6 drew to a close it became clear that there would be a substantial surplus (which, as in 1933/4, had to be alloted to debt redemption), a consequence of revenue exceeding the estimates.(194) It was suggested that, as in previous years, the position for the forthcoming year - estimated in February 1936 as a minimum deficit of £20m - could be improved by postponing the collection of various revenue items, notably the resources of the National Debt Commissioners Death Duty Account, to 1936/7.(195) But by late February the Treasury were anticipating a deficit (B_c)

of £27.5m for 1936/7, a deficit calculated on the existing basis of taxation and on the assumption of a transfer of approximately £10m of non-recurrent receipts. One device adopted to minimise the readjustment necessary to ensure budgetary equilibrium was the inflating of the revenue estimates - Customs and Excise were instructed to increase their estimate by £4m,(196) and Inland Revenue by £5m,(197) the former department being extremely apprehensive about this device.* That such devices had been employed did not go unnoticed by the financial press: The Economist commented that the revenue estimates were far less cautious than usual, although "not excessive, given the major presumption of a continuance of recovery."(198)

Further taxation, however, was still required to fill the gap. Income tax first came under scrutiny, despite Fisher's firm belief, expressed in the previous December, that nothing should be permitted to constrain as rapid rearmament as possible:

> The pressing problem is rapid and effective insurance in the form of rearmament; this may, with luck, prove a reliable deterrent; but if we ourselves jeopardise it by antagonising our own people at the outset, insistence in 1936 on 'sound finance' may cost us our independence and inure solely to the benefit of Germany in the form of savage impositions by her.
>
> Naturally the existence of government indebtedness to the tune of £7,000 million is a grave handicap and should inculcate prudence; but the supreme interest of the stockholders is the integrity of the State - not merely meaning thereby 'sound finance' - but also, and much more, in the sense of preservation from destruction by external force.
>
> In all the circumstances, therefore, and particularly because of the dangerous ignorance and illusions still prevalent in this country, I think it would be most unwise to increase taxation next year. (199) Fisher

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* As Webb noted privately, "This [the revised estimate] includes so much 'water' that I think some of the items have become silly. But I suppose it is no use protesting." (W.V./287, Webb to G. E. P. Murray [Chairman, Board of Customs and Excise 1934-40], 3 April 1936.

Phillips discussed the question in purely economic terms:

> Against an increase of 6d. in income tax ... (i) that the income tax payer who has clearly been deprived already of a 6d. reduction in tax by the growth of defence expenditure ought not in pursuit of a fetish to have his burden actually increased, (ii) that the effect on trade and industry will be severe and economic recovery now so promising will be finally checked.
>
> The effect of a high income tax on industrial development is in the long run deleterious for the reason mainly that new industrial processes and new inventions tend to seek out countries where taxation of profits is relatively low. In the short run as income tax is charged on profits, there is no economic reason why a change of rate should change prices or influence markedly the course of trade. The adverse result of increasing the tax is a matter of psychology. My guess is that in this case the psychological reaction might be pretty sharp, but not long lived. There might be a pause in industrial recovery for say three months, but progress should be resumed thereafter. (200)

Phillips was thus fairly optimistic about trade prospects, a view widely held in Whitehall at that time, as seen in the Committee on Economic Information's (C.E.I.) 'Economic Surveys' and the monthly Board of Trade reports on 'The State of Trade'.(201)

Fisher, however, disagreed and believed that "the psychological effect of an increase of taxation, [and] in particular of the Income Tax, might be little short of disastrous".(202) Even in late March, as the shape of the approaching budget began to take form, he felt "as strongly as ever that an increase of taxation in 1936-7 w[oul]d be madness".(203) As Permanent Secretary to the Treasury Fisher's views obviously carried weight, but on this occasion (to be repeated in 1938 and 1939) it was overruled, indicating "how limited Fisher's influence was on the purely fiscal ~~aspects~~ of policy."(204)

Nor did the Inland Revenue particularly approve of an increase in income tax. Thus Forber wrote:

> Any increase in the standard rate would of course not be welcome by industry [and] everything which the Chancellor said in 1934, in defending the reduction of 6d. then given, as something carrying beneficient psychological effects not to be found in other taxation reliefs, will be used in evidence against any increase.
> ......
> It seems to me that if there is a small gap to be bridged it would be desirable to do it without recourse to a small [and] irritable addition to the Income Tax if that is at all possible. (205)

Unfortunately, the gap was not small, and in late March was estimated at approximately £35m.(206) With the writing-up of the revenue estimates and the transfer of £4.5m of Miscellaneous Revenue to 1936/7 the forecast deficit was reduced to £16m,(207) but by the time the budget was presented, certain rearrangements of the figures had resulted in the prospective gap widening to £21.3m. Equilibrium was brought about by an increase of 3d. on the standard rate of income tax (£12m), an increase in tea duty (£3.5m), a raid on the Road Fund (£5.3m), and minor adjustments totalling £1m (see Table 5.5 above).(208) No doubt Hopkins provided the final justification for the tax increases when he wrote the following, a comment on the fact that current defence expenditure was running at £180m per annum compared with less than £125m in the previous year:

> Plainly it would be inadmissible to provide from Revenue merely the sums provided in the past: a much bigger effort must be made. Nor is it sufficient that taxpayers should forgo the reliefs which would otherwise be available to them: they must consent to such further sacrifices as can be borne without detriment to our general economy. (209)

The budget thus set the scene for borrowing in the following year.

The budget was not well received by the financial press,(210) the frustration of those who had anticipated further remission of taxation being outweighed by those who feared the adverse effects of the budget on the continuance of recovery. In fact, the (apparent) tightening of fiscal stance does not seem to have had such adverse effects, for the pace of recovery accelerated during 1936-7 as the economy moved towards a position of 'cyclical' full employment.(211)

Expenditure grew faster than planned. Over 1934/5-1936/7 expenditure (G_A) grew by 13.9% while revenue (T_A), excluding fiscal window-dressing, also rose but at the lower rate of 10.0%. By July 1936 the widening gap between expenditure and revenue had grown more visible and Chamberlain announced that a deficit in 1936/7 must be anticipated(212) since it was expected that defence expenditure would exceed planned levels of £178.3m.* The budget outturn (B_c) for 1936/7 was a deficit of £5.6m and, although the Treasury papers are not clear on this point, it seems that the expenditure and revenue figures were rearranged so that the deficit would be less than sinking fund payments.(213)

3. Rearmament and recession 1937-9

The final phase of budgetary policy was dominated by the needs of rearmament: total military outlays rose from £265.2m in 1937/8 to £1142m in 1939/40, an increase of 330.6%, while total central government expenditure (G) only increased by 86.5% over the same period (the increase in G_c, which excluded defence borrowing, was much smaller at 53.1%). Table 5.7 records this increase in expenditure and the way in which it was financed, while Table 5.8 summarises the main details of the budgets over this period.

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* _Ex post_ defence expenditure in 1936/7 was £186.2m (see Table 5.7).

Table 5.7

The financing of defence expenditure 1935/6-1939/40 (£m)

	Defence expenditure				Change in all other items of expend-iture since previous year	Total change in expend-iture since prev. year	Total central govern-ment expend-iture (G_c)	Revenue				Budget balance (B_c)
	Financed from		Total	Change in defence expend-iture financed from revn. since prev. year				Change in total revenue since prev. year	Resulting from		Total cent. govt. revn. (T_c)	
	Revenue	Defence Loans Acts, 1937 and 1939							Auto. grth.[3]	Disct. changes in taxt.		
1935/6	136.9	-	136.9	+23.0	+21.7	+44.7	841.8	+40.2	+45.8	-5.6	844.8	+3.0
1936/7	186.2	-	186.2	+49.3	+11.1	+60.4	902.2	+51.8	+35.3	+16.5	896.6	-5.6
1937/8	200.3	64.9	265.2	+14.1	+3.6	+17.7	919.9	+52.1	+36.9	+15.2	948.7	+28.8
1938/9	272.1	128.1	400.2	+71.8	+27.2	+99.0	1018.9	+57.5	+27.1	+30.4	1006.2	-12.7
1939/40												
(April)[1]	247.8	380.0[2]	628.8	-24.3	+18.0	+6.9	1025.8	+19.8	-4.5	+24.3	1026.0	+0.2
(Sept.)[1]	..	502.4[2]	1249[2]	..	..	+488.5	1514.3	+52.7	-54.3	+107.0	1078.7	-435.6
(outturn)	242	491.7[4]	1142[2]	-30.1	..	-106.1	1408.2	+126.0	..	..	1132.2	-276.0

Sources: Financial Accounts; Financial Statements; T171/ 349, 'Review of 1939-40', undated.

Notes:
1. Budget Estimates.
2. Approximate figure.
3. Automatic growth in revenue plus fiscal window-dressing (which more correctly is a discretionary item).
4. In addition, £408.5m of the September 1939 Vote of Credit was taken.

Table 5.8

Budget summary 1937/8-1939/40: published forecasts and results (£m)

	1937/8	1938/9	1939/40 (April)	1939/40 (Sept
1. Budget balance (B_c) of previous year	-5.6	+28.8	-12.7	..
2. Budget on existing basis				
Revenue (T_c)	923.1	994.8	1001.7	971.
Expenditure (G_c)	938.0	1024.8	1025.8	1514.
Balance(1)	-14.9	-30.0	-24.1	-542.
3. Discretionary changes				
(i) taxation				
first year - direct	+15.2	+22.3	+13.3	+76.
indirect	-	+8.1	+11.0	+30.
full year - direct	+36.0-41.0(2)	+26.5	+21.5	+160.
indirect	-	+9.0	+12.4	+66.
(ii) economies	-	-	-	-
(iii) miscellaneous	-	-	-	-
4. Budget Estimates				
Revenue (T_c)	938.3	1025.2	1026.0	1078.
Expenditure (G_c)	938.0	1024.8	1025.8	1514.
Balance(1)	+0.3	+0.4	+0.2	-435.
5. Budget outturn				
Revenue (T_c)	948.7	1006.2	-	1132.
Expenditure (G_c)	919.9	1018.9	-	1408.
Balance (B_c)	+28.8	-12.7	-	-276.
6. Planned defence borrowing	80.0	90.0	380.0(3)	500.

Sources: *Financial Accounts*; *Financial Statements*.

Notes:
1. As for the period 1933/4-1936/7 no specific sum was allocated for debt redemption.
2. Full year yield of National Defence Contribution uncertain, but estimated at £20-25m.
3. The Estimates in February 1939 had provided for borrowing of £342.5m, but in the Budget it was announced that owing to defence acceleration and expansion the figure might be expected to rise to £380m.

(i) 1937 budget

Chamberlain had announced in the 1936 budget speech that borrowing for defence would be undertaken from 1937/8.(214) This departure from strict budgetary orthodoxy had implications for the timing and framing of the budget. When a balanced budget had been the policy objective, the expenditure Estimates had been settled in February and early March, while the revenue estimates had not been finally agreed until early April, the time remaining before the presentation of the budget (usually about 2-3 weeks) being sufficient for the Chancellor to decide on any necessary changes in taxation. But with unbalanced budgets the situation altered somewhat: since the defence Estimates published in early March had to show the amount to be borrowed,* the revenue estimates also had to be completed by this time, and decisions made about new taxation before the close of the old financial year.(215) This change undoubtedly made budgetary forecasting more hazardous.

In the light of the 1936/7 deficit, and the decision to borrow £80m in 1937/8, the Treasury felt that taxation must not only be raised but be raised sufficiently to ensure an *ex post* budget surplus (B_c). As Hopkins put it:

> we want above all to have a Budget surplus to make the Defence borrowing look a little more respectable in retrospect, and heavy autumn supplementaries to be met out of Revenue ... if they are not provided for in the original Budget. (216)

The revenue estimates were framed on the general assumption that during 1937/8 "the trade and employment curve will continue to rise; that the Coronation will bring grist to the Customs and Excise mill; and that the summer

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* As required by the Defence Loans Act, 1937. Changes in planned borrowing required Parliamentary approval.

and winter will be more 'seasonable' than has been the case with 1936/7."[217] In the circumstances, the assumption that recovery would continue was a legitimate expectation, although it was not, in fact, to be completely realised since recession set in from late 1937.[218]

By mid-February 1937 it had been decided to raise the hydrocarbon oil duty and the standard rate of income tax, the latter by a further 3d. to 5s.* This would reduce the expected deficit of £16.6m to a surplus of £0.3m (on the assumption that £80m of defence expenditure was covered by borrowing).[219] At the same time, Chamberlain and Hopkins were working on a proposal, originating from the former,[220] for reviving the Excess Profits Duty in a revised form. This took shape in the form of the National Defence Contribution announced in the budget speech.[221]

Whilst the automatic growth of revenue was insufficient to cover the growth of expenditure (even with planned borrowing of £80m) and taxes were raised to bring in an additional £15.2m, Chamberlain obviously did not announce in the budget speech that he expected a substantial surplus at the end of the year. The surplus subsequently realised - £28.8m with only £64.9m borrowed for defence - was to exceed their expectations. How then was the hidden reserve created? The surplus resulted from developments on both sides of the budget accounts: receipts were £9.5m above

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* The Treasury papers throw no light on the reasons for the increase in income tax, although there is evidence that the Inland Revenue informed the Treasury that the increase in standard rate might adversely affect the rate of collection of income tax in 1937/8 and thus its <u>ex post</u> yield. No account, however, seems to have been taken of this factor when drawing up the estimates (I.R.63/143, Gregg to Hopkins, 19 March 1937).

estimates,* largely as a result of the performance of income tax; expenditure also gave savings totalling £19m, most notably £8.5m on the Vote of the Unemployment Assistance Board. But as Simon stated:**

> The other savings make up a substantial total, but they are not individually very large; in some cases indeed they represent underspending which will have to be made good this year. (222)

In particular the problem of underspending on rearmament was beginning to emerge, reflecting shortages of industrial capacity, skilled labour etc. and the government's decision (not modified until March 1938) that rearmament orders should not impede ordinary trade.[223] Concurrently, the Treasury were also deeply perturbed at the rate of growth of rearmament (and, to a lesser extent, civil) expenditure, and their inability to control it.

(ii) Rearmament as a budgetary problem

> Economists may assume 'perfect knowledge', and historians have hindsight, but Treasury officials advising on the balance of risk between military and economic weakness had to do so in face of an uncertain and unpredictable future. The Treasury's attempts to limit defence expenditure are only explicable if seen in their historical context. Apart from uncertainty as to where the balance of risk lay, estimates of the money available for defence varied with the fortunes of the economy, public opinion (and therefore the willingness of the taxpayer to contribute to his own defence) and with the ability of the Government to raise loans. The balance between military and economic priorities

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* In 1936/7 all three main direct taxes had fallen short of the estimates, which seemed to support the view that they had been framed on a far less conservative basis than was usual (The Economist, Budget Supplement, 10 April 1937, p.1). The Treasury must have been anxious to avoid a repetition of this, and the conservative framing of the estimates in 1937/8 was thus able to serve a dual purpose.

** Baldwin retired on 28 May 1937; Chamberlain became Prime Minister; and Sir John Simon, Chancellor.

> moved from a position in 1932, when defence expenditure was entirely subordinated to the economic situation, to the summer of 1939, when priority for defence was such that the Treasury had to advise the Government that quasi-wartime controls over the economy would be required to maintain current defence expenditure after the autumn of that year. (224)

In this section we briefly discuss some of the factors which determined this 'balance of risks'.

The financial and economic limits to rearmament received detailed consideration in Inskip's* December 1937 interim report to the Cabinet on the status of the defence programmes.[225] It was first stressed that:

> the fact that the problem is considered in terms of money, must not be allowed to obscure the fact that our real resources consist not of money ... but of our manpower, and productive capacity, our power to maintain our credit, and the general balance of our trade.

The latter, in particular, was seen as of central importance, as being "closely connected with our credit":

> The amount of money which we can borrow without inflation is mainly dependent upon two factors: the savings of the country as a whole which are available for investment, and the maintenance of confidence in our financial stability. But these savings would be reduced and confidence would at once be weakened by any substantial disturbance of the general balance of trade.

Finally, the report closed with a classic statement of finance as the 'fourth arm in defence':

> This country cannot hope to win a war against a major Power by a sudden knock-out blow: on the contrary, for success we must contemplate a long war, in the course of which we should have to mobilise all our resources and those of the Dominions and other countries overseas ... We must therefore confront our potential enemies with the risks of a long war, which they cannot face. If we are to emerge victorious from such a war, it is essential that we should enter it with sufficient economic strength to enable us to make the fullest use of resources overseas, and to withstand the strain.

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* Sir Thomas Inskip, Minister for Co-ordination of Defence (March 1936 - January 1939).

> While, therefore, it is true that the extent of our resources imposes limitations upon the size of the defence programmes which we are able to undertake, this is only one aspect of the matter. Seen in its true perspective, the maintenance of our economic stability would more accurately be described as an essential element in our defensive strength: one which can properly be regarded as a fourth arm in defence, alongside the three Defence services, without which purely military effort would be of no avail.

This document clearly expresses the essential reasons underlying the financial constraints imposed upon the growth of rearmament expenditure; it puts into perspective the Treasury's refusal to accommodate the insistent demands by the defence departments for greater expenditure; and shows as misfounded the accusation, made at the beginning of the war and repeatedly thereafter, that Treasury control of expenditure had dangerously prejudiced military preparations for war.

For analytical purposes we may separate the motives for controlling rearmament expenditure into three classes: 1/ economic, 2/ political, 3/ and strategic:

(1) economic: rearmament was constrained by the availability of financial and real resources; throughout the period 1937-9 the authorities attempted to strike a balance between increased taxation and borrowing, the former being increased to that level which was considered just compatible with a continuance of trade recovery, the latter being determined by the twin objectives of preventing inflation or a hardening of interest rates. The constraints imposed by the availability of real resources were considered to be of equal importance: aggregate government expenditure, and its components, was planned with the specific intention of preventing an exacerbation of the already existing supply constraints, in particular the shortages of skilled labour and productive

capacity in the capital goods industries. A connected problem was the deteriorating current account of the balance of payments,* a problem first brought to the Cabinet's attention in late 1936;[226] and one which was a partial reflection of the adverse effects of rearmament: either directly, by the redirection of exports to the home market and the high import content of rearmament expenditures,[227] or indirectly, by the increase in export prices.

(2) political: in essence the question here was to make decisions about the relative magnitudes of the military and civil components of total government expenditure, a decision to increase military outlays meaning that either total expenditure had to be raised or civil outlays constrained. Such a choice had a political dimension.

(3) strategic: the control of expenditure assumed a strategic dimension by virtue of the fact that with limited total resources available, the object of control was to ensure that essential programmes "received due priority, and ... less important proposals were not allowed to clog the programme."[228]

The problem facing the Treasury was its:

> increasing inability to challenge the programs of the services on technical grounds, because of the escalating technological expertise required to evaluate those programs, and the services' monopoly of that expertise. (229)

Bridges** put the problem in the following terms:

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* Between 1935-7 the current balance deteriorated from a surplus of £23m to a deficit of £47m, a change of 1.4 percentage points of GDP; a deterioration which primarily reflected the slow growth of exports (2%) as compared with imports (6.2%) (calculated from Feinstein 1972: Tables 3, 5, 15).

** E. E. Bridges, Principal Assistant Secretary, Treasury 1936-8; Secretary to Cabinet 1938-46; Permanent Secretary, Treasury 1946-56.

> Our only effective weapon [against the rapidly increasing defence Estimates] is to take the line that there is not more than a certain amount of money available.
>
> ......
>
> [U]nless we act firmly on these lines ... we shall find that Defence expenditure will overwhelm us. Every day I find further evidence of the continuing growth of defence expenditure on objects we cannot possibly prove to be unnecessary. There is only one answer: to say that there is a given sum of money available and no more. (230)

Accordingly, various schemes of rationing were employed to ensure that rearmament expenditure did not grow more than was compatible with the achievement of the government's other objectives.

(iii) 1938 budget

A major factor determining the planning of the 1938 budget was the amount that could be borrowed in 1938/9. Whilst borrowing had been agreed in principle in late 1935, it was not until 11 February 1937, when the Defence Loans Bill was introduced, that firm proposals were communicated to the public.(231) The Bill was passed on 19 March, and an issue of £100m 2½% National Defence Bonds 1944/48 was made shortly after the budget. The issue was badly planned, "a flop of the first magnitude."(232) It has been estimated that the Public Departments were forced to take up at least £90m of the loan; and its failure was "the result of attempting to borrow such a large sum from general investors at the time when the boom was nearing its peak, security markets were jittery, and the banks were heavy sellers of bonds".(233) The failure of this loan must have done much to reinforce the view held within the Treasury that it was extremely difficult ~~to raise 'new'~~ funds, as opposed to the issue of securities ~~for~~ conversion operations. Moreover, it was to lead to some revision of the attitude towards borrowing for rearmament. As Inskip's interim report of December 1937 stated:

> the present position in regard to borrowing is now more difficult than in the Spring. If it were decided that it was necessary to spend substantially more than £1,500 millions on defence over this period of years, it would probably be found necessary that the excess should be found by an increase in the level of taxation, rather than by increasing the total sum made available for defence from borrowed money above £400 millions. (234)

Despite the review of the whole defence programme undertaken in the autumn of 1937 the rate of growth of defence expenditure was to accelerate significantly. Even when the Estimates for 1938 had been pared,* the anticipated rise between 1937/8 and 1938/9 was 23.4% (the actual rise was to be much greater, some 50.9%, as rearmament was accelerated following the Anschluss and Munich crisis).**

One response to this situation was to call for a halt to the onward march of civil expenditure. Thus the Treasury applied pressure to the Civil Departments while,*** on the wider political front, Chamberlain made speeches stressing the need for economy.(235) This marked an important change in policy, for in 1934 Chatfield's suggestion that civil expenditure should be curtailed,**** to enable a greater defence effort, had been dismissed out of hand as politically

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* Draft Estimates of £357.6m were reduced to an agreed £343.3m (T171/340, Bridges, 'Draft Note for the Chancellor of the Exchequer to send to the Prime Minister', 14 Jan. 1938.

** Calculated from the following figures of defence expenditure (£m):

	Budget Estimate	Budget outturn
1937/8	278.3	265.2
1938/9	343.3	400.2

(Source: Financial Statements; Financial Accounts).

*** The proposal to curtail public authorities' capital expenditure was also receiving active consideration.

**** Sir Ernle (later Lord) Chatfield, First Sea Lord (January 1933 - August 1938); Minister for Co-ordination of Defence (January 1939 - April 1940).

unrealistic.(236) Nevertheless, there was (even in late 1937) still no real attempt to come to terms with the essential problem:

> we are attempting to combine an unprecedented effort in defence with the maintenance and increase of the standard of life and of contentment of the people, and while that is so we have just to be carried along with the current, and heroic measures of economy involving reversals of policy appear to be impossible.*

The budgetary problem, however, as viewed by the Treasury, had also begun to change in late 1937. As Hopkins expressed it when commenting on the draft 1938 Estimates:

> I do not think that these figures afford ground for special apprehension in connection with the forthcoming Budget. It is true that apart from this increase in civil expenditure there will be an enormous increase in the cost of defence. But next year we shall have the yield of the N.D.C. and the very materially higher level of revenue arising inter alia from the income tax on the high profits of this year, and we have a considerable elasticity of choice as to the portion of the total borrowable sum of £400 millions which we borrow next year. Moreover, the current year will probably show a substantial surplus.
>
> My concern is really different. So long as revenue is rising and unemployment is sinking and we can borrow what in reason we please, the real Budget problem is pushed to the background. But in four years borrowing powers will have lapsed, and one day (whether before or after that time) revenue will be falling, not rising, and unemployment will be rising, not falling. Then will come the day of reckoning. (237)

Increasingly during 1937-8 the Treasury referred to the danger of a severe slump after 1941/2 (the ending of the rearmament programme) which would make it difficult to bear the maintenance costs, assuming an end to borrowing, of the greatly enlarged defence forces.(238) These forecasts may

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* T171/340, Hopkins, 'Civil Estimates, 1938/9', 15 Dec. 1937. Phillips commented on the rise in civil expenditure as follows: "The 1930-37 rise took place despite (a) May C[ommittee] and such like, (b) a falling cost of living - it was 171 in 1930 and went down heavily for a long time though rising a bit towards the end, (c) a reduction of unemployment at the end to $1\frac{1}{4}$ millions, which is probably a normal figure (some 800,000 being the absolute minimum in the wildest boom). The next five years will show a rising cost of living and no drastic economies: a very small advance all round for cost of living on salaries and social services means a great deal of money." (T161/783/S.48431/3, Note by Phillips, 29 Oct. 1937).

not have been unduly pessimistic, given the severity of the 1937-8 recession and the fact that the subsequent recovery was largely a result of expansionary fiscal operations;(239) in addition, however, these forecasts were also a political tactic employed to limit the growth of current expenditure by stressing that future funds would be extremely limited.

The second major factor influencing the 1938 budget was the expected level of economic activity. The upper turning-point had been reached in 1937 III; there then occurred a short period of marking time followed by a downturn more severe than that of 1929-30. The revenue returns throughout the final two quarters of 1937/8 remained favourable - even Customs and Excise duties which would respond first to recession; indeed, the main duties were to exceed their estimates.(240) Nevertheless, as Webb informed the Treasury early in the final quarter of the year:

> It is, of course, extremely difficult to estimate for next year in the midst of conflicting opinions about the general trade position. We are told in public speeches that there is no ground for any 'recession' - while the American situation and our own unemployment figures seem to belie them! (241)

Webb met Phillips shortly afterwards and recorded that:

> The Treasury view about the outlook in trade and industry ... is that 1938 might be 'about level with' 1937; the same may be said for 1939; and by 1941 or 1942 there may be a slump ...
>
> This represents a rather drastic check on the curve of prosperity, but in face of the unemployment figures, the hesitation in many industries about the future, the fall in prices, and the setback in America which, if prolonged, must react on us, this view would seem to be no more than caution would dictate. (242)

The buoyancy of revenue and the low level of unemployment (at least for the greater part of the year) led to a surplus in 1937/8 much greater than anticipated. In early

January 1938 a surplus of approximately £20m was being forecast, a source of some disquiet for the Treasury since it would "be a good deal criticised as bad estimating" whilst it would also create corresponding problems for 1938/9 when budgetary stability was problematical.(243)

In mid-February it was estimated that £231.3m would be available out of revenue for defence in 1938/9 compared with £198.3m in 1937/8, an increase of some £33m. Phillips believed this to be a very disappointing result:

> (i) we have not kept pace with the growth in the Defence charge, the gross expenditure on Defence is estimated at £343 millions, an increase of not £33 millions but nearly £65 millions over last year's estimate, and (ii) while the revenue estimates are up by £54 millions the amount available for defence is only £33 millions up.
>
> The latter result is even worse than it looks for in fact the 1937/8 estimate with which comparison is made proved to be too high:-
>
> Non Defence Expenditure

Budget estimates 1937/8	664,580,000
Budget actual result 1937/8	646,000,000
Budget estimate 1938/9	685,857,000

> The present estimates are inspired by mild optimism. Things may easily turn out worse in fact, for it has not been assumed in the figures that there will be any serious spread or aggravation of the present set-back to industry. The Inland Revenue estimates seem to be optimistic ... There is nothing to be done by juggling with the figures. (244)

Once again, therefore, the growth of civil expenditure was becoming incompatible with the successful execution of the rearmament programme. The problem for the Government was to reconcile the demands for economy, to enable rearmament to proceed at a faster rate,(245) with the natural demands for increased expenditure on unemployment as recession deepened.(246)

March 1938 TAX

A month later increased taxation was again in prospect. With the defence Estimates at £343m and (on the existing basis) only £231m available out of revenue, a gap of £112m had to be filled from borrowing and additional taxation. In expounding the case for increased taxation Simon drew upon three arguments. Firstly, since "The year before a General Election [was] the worst year to choose for beginning increased taxation", an increase in the current year meant that it was "more likely that [they] could escape yet further taxation in 1939-40", with consequent political advantages. Secondly,

> Further taxation imposed now might possibly drive into the heads of the spending Departments the idea that bigger and better ships and guns, lavishly estimated and impetuously demanded, are not an unmixed blessing, and that we really are at our wits' end to pay for them. On the other hand, after all our Treasury protests, a comparatively 'popular' Budget may only encourage the spending Departments to believe that there is plenty of money left.

Finally, a decision to finance the deficits of 1938/9 and 1939/40 ~~wholly by borrowing~~ would, apart from technical difficulties, leave only £69m of the original £400m of borrowings available for 1940/1 and 1941/2, a wholly inadequate provision.

> Against an increase in taxation:
>
> 1. [one case would run] You have a surplus of £25 millions; only £70 millions of the loan money has been expended; you recognise that you must use borrowed money to the tune of £80 millions; is your objection to using £112 millions of borrowed money sufficient to justify this most unpleasant and unexpected shock?
> 2. ... further taxation is not generally expected.
> 3. It no doubt is possible, and indeed comparatively easy, to get through this year without further taxation and taken by itself the course would be justified; it is because we have such anxieties over the necessarily uncertain future that we hesitate to take the easier course. But it is possible that the future will not be quite so difficult as we fear.
> 4. [Increased taxation might] administer such a shock to business confidence, which is always based on short views, that the recession which may be on its way will be magnified.
> 5. ... how is one to evaluate and put into the scale the prospect of political improvement and an easing of the tension? I think, however, that if this blessing did arrive, it would not make increased taxation at present look foolish and might indeed be the occasion for a very welcome reduction. (247)

The decision to raise the income tax was taken around 16-17 March. Hopkins believed that:

> It would ... be entirely premature to increase the borrowing powers, and this prematurity would in my judgement greatly increase the impairment of Government credit which any great increase in the borrowing powers must entail. (248)

Concern was also voiced about the effects of accelerating the rearmament programme because it would inevitably require the withdrawal of skilled labour from private industry, thus constraining 'ordinary trade', although Hopkins believed that it would not have an adverse effect on the 1938/9 revenue receipts.(249) Furthermore:

> There is now an opportunity of uniting the nation in support of any effort the Government may decide to be necessary. Opportunities should occur, if they are waited for and rightly used, to raise money both by taxation and maybe by borrowing in quantities greater than until recently seemed possible without grave impairment of our economic resources ... As I see it the Budget as now settled is on the whole adequate for present needs and sufficiently forthright for the temper of the people. I doubt if Government credit would at the present time stand up against severer proposals. We should, I suggest, stand upon the programme as settled and give financial circles time to recover their breath after the political and general alarms to which they are now giving way rather than think of a more rigorous programme. Any less rigorous one is clearly unthinkable. (250)

Having settled the budget in outline, two factors then intervened to complicate the situation: (1) the inadequacy of current Fixed Debt Charge (F.D.C.) payments; and (2) a Customs agreement with Eire which adversely affected the revenue.

The F.D.C. had been set at £224m in 1933/4, it being considered that this was adequate not only to provide for all interest and management charges but also for the statutory sinking funds and a small margin for debt redemption. As 1937/8 drew to a close, however, it became clear that there would be insufficient funds to cover the statutory sinking funds. Since the surplus for 1937/8 on the budget was likely to be "uncomfortably large" there would be no necessity to cover that deficiency; the real problem was 1938/9 and thereafter.(251) It was agreed that provision for the F.D.C. should be increased to £230m, for otherwise they would not be "providing honestly from the Budget for debt interest and management, leaving debt redemption out of account altogether." It was also justified on other, more important, grounds:

> Parliament, the Cabinet and the spending Departments have been warned time and time again of the ominous threat to future Budgets which has been concealed for so long by the fixing of the debt charge at a total of £224 millions, a figure only possible under quite temporary and abnormal circumstances. No one will pay any attention to these warnings until the figure is visibly moved up. (252)

The completion of negotiations with Eire over tariff levels,* and the signing of an agreement on 25 April 1938, entailed a loss of current revenue amounting to £4m in 1938/9 but also a non-recurrent capital gain of £10m. Unfortunately the latter could not be used to offset the former: "the indecency of treating any part of this sum as revenue would be so great as to rule that course right out."(253)

Furthermore, while it had been agreed to raise the standard rate of income tax (first year yield £28m, full year £32m), Simon was anxious that some concessions should "be devised in order to mitigate, for some class[es] of taxpayer, the full rigors of the increase", although they should "be more of a gesture than anything else."(254) Accordingly, it was agreed to raise wear and tear allowances,

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* Trade agreements were also being negotiated with the U.S., Switzerland, and India, which would cost a further £2.5m (W.V./307, 'Budget Brief, 1938. Second and Final Edition', 26 April 1938, p.4).

and maintain the existing level of earned income reliefs for smaller taxpayers.(255) With increases in tea and petrol duty, the budget was forecast to balance with a small surplus, that is excluding the planned defence borrowing of £90m.*

What policy underlay the budget? Since Chamberlain had introduced the Defence Loans Bill there had been criticism that no statement had been made outlining the criteria used for deciding on the balance between additional taxation and borrowing.(256) When framing the 1938 budget there had been no discussion of whether savings were adequate to meet planned borrowing. Rather, the Treasury had viewed the question from the perspective that only if taxation were increased would investors be forthcoming for government bond issues. As one contemporary put it, the budget "contrived to combine extensive borrowing with an impression of draconian orthodoxy."(257)

(iv) 1939 budget

Writing in early July 1938 Hopkins admitted that the 1938/9 budget had been "drawn pretty tight", and that while, within certain limits, defence Supplementaries could be met from borrowing, the "general course of trade and profits since the time when the Budget was prepared is not very inspiring and at present the Budget looks more like ending in a deficit than in a surplus."(258) Deepening recession, as rearmament orders failed fully to compensate for the decline in private sector demand, was to give a £12.7m deficit (B_c) in 1938/9 or £137.2m (B) when account is taken of defence borrowing.

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* Provision was also made to cover further defence Supplementaries that year out of borrowed funds (335, H.C. Deb. 5s., 26 April 1938, col.61).

In order to maximise the amount of defence expenditure that could be financed from taxation further efforts were made to curtail the growth of civil expenditure. In June 1938 Hopkins,* perturbed at the growth of total expenditure, recommended that Simon stress the urgency of economy upon the Cabinet.(259) Thus a month later Simon told the Cabinet:

> It was clear that we could not continue indefinitely to borrow for defence. It followed that we could maintain our financial stability only in one or other of the following ways:
> First, that we should obtain an increase in the yield from taxation on the existing basis, and no one could reckon on this happening.
> Secondly, that we should obtain additional revenue by an increase in the rate of taxation, or by putting on new taxes.
> Thirdly, that we should reduce Civil Expenditure.
> He was deeply concerned lest our finances should become unmanageable as a result of the growth of expenditure.
> He suggested that, when proposals for new expenditure were submitted, they should be considered from the point of view that another £25 millions represented 6d. on the income tax.

Simon asked that the Cabinet stress the gravity of the situation to their departments, while Chamberlain suggested that serious thought should be given to actual reductions in civil expenditure.(260)

The attack on civil expenditure was renewed in January 1939. After some delay in collecting the necessary information, Hopkins in late March 1939 completed a memorandum on curtailing civil expenditure which he wanted Simon to circulate to the Cabinet at its meeting before the discussion of the budget proposals: "It seems to me to make a pretty good preliminary atmosphere for that function."(261) Simon agreed,(262) but although the paper

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* Hopkins noted that the growth of civil expenditure was itself sufficient to require a 3d. or 4d. increase in the standard rate of income tax in 1939/40. Amongst the economies being actively considered at that time were the lapsing of the Special Areas legislation, and curtailing road expenditure.

was circulated to the Cabinet for its budget meeting there is no record of its having been discussed. (263)

A month later, however, Simon was impressing upon the Cabinet the view that:

> We must face hard facts. We cannot finance ourselves by inflationary methods which, if they gave relief for a certain period to an embarrassed Exchequer, would be followed with certainty by a collapse in the purchasing power of our currency, so that the loans we could raise would represent little in buying power. We cannot continue to lose gold in great quantities indefinitely or we shall find ourselves in a position when we should be unable to wage any war other than a brief one. There is a limit to the rate at which we can raise money, and that limit, to the best of my judgement, is already reached. We can go on for another six or nine months if there are no further additions or accelerations, but thereafter, unless something unexpectedly favourable happens, it may well be that the present rate could not be maintained. (264)

At its meeting of 23 May, Cabinet approved Simon's paper and the suggestion that thenceforth financial control should be tightened.[(265)]

By December 1938, as it became clear that revenue and expenditure would both fail to meet the estimates and that a deficit (B_c) was in prospect for 1938/9, Phillips was urging: "It is most important that we should not have a formal deficit for two years running and we ought to have a good margin therefore" in 1939/40. On present estimates, the 1939/40 budget would provide £232.5m out of revenue for defence, yet the annual maintenance costs of the services would be approximately £300m once the rearmament programme was completed, a gap of £70m which had to be met "or go bankrupt as a nation":

> I can see no prospect of obtaining any such sum except by further very heavy taxation of profits and by the imposition of a substantial turnover tax. The effect of such additional taxation on the scale required would be to depress general trade and in particular to reduce

the yield of the income tax and surtax. Nor is it quite the type of taxation which is suitable in present circumstances.

At this point it would be well to consider what are the dangers we are running from our policy, now to be extended, of borrowing large sums for defence. It is commonly said that this means all round inflation and imperils the exchange value of the pound. The second of these statements is true but not the first. There is not in fact grave danger of inflation until we shall be much nearer than at present to a state of full employment. 'Inflation' is a thing which is inconsistent with the existence of 1,800,000 unemployed.

But the danger to the pound is real. We are borrowing great sums and shall borrow more, to be spent largely on wage payments and increased profits to people who make munitions and aeroplanes. If the sums so disbursed are spent by the recipients on grouse moors and holidays at Blackpool or even on Scotch whisky or English beer no great harm is done to the £. But we know that a substantial part will on the contrary be spent on increased imports, largely of a luxury type, from abroad, and that is where the danger lies.

[Emphasis Added]

Since it would be impracticable to raise an extra £70m immediately, Phillips believed that only £20m should be raised initially, the extra taxation being:

> applied where it is likely to help the other objective of strengthening the £. The obvious places to explore are such matters as increased h.p. duty on motors and increased duties on all foreign goods of a luxury type, wherever our commercial [agreements] leave us free. We shall of course be met by the type of argument that has been used in the past, for instance that a higher duty on tobacco would not produce any more money because manufacturers would put less tobacco in each cigarette. But these arguments are no longer valid, it seems to me, even if they ever were. Either an increased duty will produce more revenue, or it will check consumption and so reduce imports, or it will do a bit of one and a bit of the other. Any of these results would be to the good.*

From these tentative suggestions were to follow the first attempts actively to manage demand - in a Keynesian sense - using the budget as an instrument of economic policy. By the time of the April 1939 budget the Treasury was awaiting the achievement of full employment - induced by

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* T171/341, Phillips to Hopkins, 15 Dec. 1938; see also Hopkins to Fisher and Simon, 25 Jan. 1939. The proposal to increase the horse power duty on motor vehicles had first been suggested by the Committee on Economic Information (see p.216 below).

the greatly expanded military outlays - for only then could taxation be significantly increased. Full employment, with its accompanying higher level of savings, would also permit greater borrowings from the non-banking sector.(266) These were important changes in fiscal policy; they were, however, partially (and deliberately) obscured from public view as the Treasury sought to maintain the appearance of orthodoxy. As with earlier periods, the objective at this time was to maintain confidence. The Treasury felt that the size of borrowing in 1939/40 was such that it could only be financed, without inflation, by raising aggregate demand; and while defence expenditure would, ceteris paribus, ensure this end, a collapse of confidence with its consequent adverse effect on private sector demand would jeopardise this increase and therefore the increase in current savings felt to be necessary.(267) The question of confidence thus assumed a new meaning.

In the months preceding the budget debate took place within the Treasury over the form of the required addition to taxation. From early 1939 Fisher took the view:

> To introduce a new and more realistic psychology, as well as an adaption of our 'economy' to the grim realities of today, I would:
> (1) deal effectively in the tax sphere with profiteering and if necessary make it a crime;
> (2) steepen considerably the super-tax;
> (3) make the standard Income Tax 6/- in the £, offset by improved allowances, especially the personal allowance;
> (4) increase the duties on tea, sugar, beer (and other alcohol), and tobacco;
> (5) use our protective system to hit luxuries ... with great severity. (268)

By mid-February it had been decided that additional taxation was to be "in the nature of a gesture rather than a substantial contribution to fill the gap", and it had been agreed (not only within the Treasury, but also by Chamberlain) that the tobacco and motor vehicle duties, and surtax should be increased, giving in total an additional £15m in 1939/40.(269)

A month later, however, Hopkins felt that this was insufficient:

> In the face of recent German actions, can the Chancellor go to the House with so small a programme? Equally, can he announce still greater expenditure within the year on defence (as must undoubtedly be necessary) without making any provision at all out of Revenue for the increase?
> I feel disposed to recommend that the new taxation should be ... £m30 in the first year rather than £m15, [and] that the extra £m15 sh[oul]d be used as a supplementary margin for additional defence estimates.

Hopkins suggested that this additional revenue should be obtained from the sugar and estate duties: he firmly opposed increases in either income tax or N.D.C. "in the present state of trade".(270) Simon discussed the question with Hopkins and Phillips, both of whom concurred with Simon's view (as expressed in a letter to Horace Wilson) that:

> any effective step which would bring the spending Departments to face the appalling consequences of continued increases in outlay would be very valuable ...
> But would another 6d. on the Income Tax produce this revolution of feeling in the spending Departments. I put 6d. on last year, and it did not produce the effect we anticipated. Much as I need an ally in trying to curb expenditure, I doubt very much whether this expenditure at this moment would operate as powerfully as you were inclined to think.
> ......
> [The psychological effect of an increase] might be very damaging. The announcement I made in February that I proposed to raise from revenue towards the £580 millions bill for defence not more than £230 millions from taxes has undoubtedly been a most material contribution to the measure of recovery that has taken place since. I must as you know get more from taxes since the Defence bill is bigger still but my advisers here and I are greatly concerned at what would be the effect of a further rise in the Income Tax rate.
> ... I have come to the conclusion that the economic reasons against an increase in the standard rate this year are too strong to be ignored. (271)

Simon later justified the budgetary strategy as follows:

> to choose a middle course between so severe an increase of taxation as would have crippled industry and destroyed confidence and, on the other hand, so exaggerated a recourse to borrowing as would have over-strained our resources and dried up our reserves. The situation with which we had to deal could not have been solely met either by taxation or by loan, and to steer a course between the two was not only right but necessary.
>
> ......
>
> ... even if it had been possible to cover the whole cost of rearmament by current taxation, this would have caused a tremendous dislocation of business in all directions, to say nothing of the over-whelming strain of so vast a burden suddenly imposed on the taxpayer. Borrowing, therefore, of a substantial amount was justified to enable the country to adjust itself more easily to the sudden increase in armament production. Rearmament must have priority, but, subject to this condition being satisfied, he stood for the view that the less normal economic arrangements were dislocated the better for the present and the future. (272)

By the time the (April) budget was presented the defence Estimates had risen from £580m to £630m. With available revenue at £223.5m it was decided to borrow £380m (compared with £128.1m in 1938/9) and to raise an additional £24.3m from taxation, comprising motor vehicle duties (£6.3m), surtax (£4m), estate duty (£3m), tobacco (£7m), and sugar (£4m).[(273)] The increase in taxation was less than in the previous year, while total revenue was only providing £247.8m for defence in 1939/40 as compared with £272.1m in 1938/9 (see Table 5.7).

The Treasury's difficulties of 1938-9, those posed by the twilight between peace and war finance, were political as well as economic in character. The management of the proto-war economy, in particular the suppression of the inflationary pressures generated by the rearmament programme, ultimately could only be exercised with the full range of controls available, and politically acceptable, in war time.*

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* This point is particularly applicable to the government's wish, as early as 1938, to exercise controls over labour and the munitions industries (see Parker 1957: ch. III).

Thus certain constraints were placed upon fiscal policy prior to the outbreak of war. Nevertheless, policy was not unsuccessful in this final phase. On the one hand, the Treasury recognised that since the effects of the rearmament programme on domestic demand were slow to appear, heavy increases in direct taxation were to be avoided in the initial stages of the programme; on the other hand, that confidence had to be maintained and the policy of extensive borrowing should, to some extent, be masked by the appearance of financial orthodoxy. Moreover, strictly financial issues were beginning to become subordinated to the problem of the availability of productive resources. Thus Phillips noted that the success of the rearmament programme:

> clearly depends on our ability to secure the fairly rapid passing into employment of unused labour resources and to increase the national income, and thus the yield of taxation. Nothing could be more absurd than deflationary tactics at this juncture merely from the fear that later on we may have to struggle against inflation.
> ......
> our position is that we have not yet got out of the depression, and to be frightened of inflation with unemployment as heavy as it is is absurd.
> ......
> [The] essential point is that if and when we reach a stage of full employment and prices continue to rise without more labour being absorbed into work we must be ready to revert to all the usual controls, including heavier taxation, heavier customs duties, higher bank rate, a strong loan policy, reduction in floating debt and so on. There are two fallacies to be avoided here. First it may be argued that if inflation threatens we ought to take precautions <u>now</u>. But if so we shall never get the unemployed to work, which is a condition for success in rearmament. The second fallacy is that it is inconsistent to aim consciously at a state of fuller employment having the intention if the plan comes off of imposing financial checks which would bring back unemployment. But once full employment has been reached, the country can very well stand increased financial pressure <u>without</u> going back to a state of unemployment, and there will be no reversion to deflation unless the monetary authorities are ignorant of their job. (274)

4. Conclusions

A few preliminary conclusions can now be drawn. A more complete analysis must await discussions of the effects of fiscal operations and the public works issue; these are considered in the two following chapters.

We have seen that from 1937 onwards rearmament necessitated large scale borrowing and a relaxation of the strict tenets of financial control; that the Treasury recognised that rearmament orders were stimulating employment; and that the budget was being used as an instrument to manage demand by the eve of the Second World War.*

That there were changes in budgetary policy over this period is not a matter of dispute.(275) The question at issue is the form of these changes and the underlying principles which guided them. In a later chapter it is shown that the Treasury's moves towards conscious economic management were less the result of deep-seated changes in its theoretical thinking, and rather more a pragmatic response to the political and economic problems generated by rearmament.(276)

Furthermore, the rearmament phase saw but a temporary lapse from orthodoxy. The partial financing of rearmament by borrowing after 1937 was accompanied by an intensification of demands for greater expenditure (of both a military and

* The budget was being used to manage both total demand and its composition. Thus in the 1938 and April 1939 budgets borrowing expanded more rapidly than taxation as the Treasury sought a recovery of demand. In addition, the increase in tobacco and horsepower duties (which had been recommended by the C.E.I. in December 1938 - Howson and Winch (1977: 149) in April 1939 marked an attempt to redirect demand, improve the balance of payments, and set free industrial capacity for rearmament orders (see The Economist, 29 April 1939, pp.237-8). Moreover, the Treasury records, especially those for the later 1930s, corroborates Bridges (1950a: 9) statement "that from the 1920s onwards, the Treasury staff began to think of expenditure rather less in terms of the prospect of the spending of so much public money and rather more in terms of the employment of resources"

civil nature). As had been predicted in the 1933 policy debates over unbalanced budgets,(277) the removal of the balanced budget constraint made Treasury expenditure control more problematical. The rearmament phase also suggested two further lessons for the authorities: (1) the experience of under-spending in the programme's initial stages reinforced the already existing belief that the rapid execution of a large public expenditure programme presented major technical difficulties; (2) the significant lag experienced before rearmament orders had beneficial effects on employment, and the narrowness of these effects in terms of the range of industries affected by rearmament, must also have strengthened the authorities' reluctance to embark, in the future, upon a large public works programme as an employment measure. And finally, the Treasury remained committed to a return to balanced budgets from 1942/3, when the rearmament programme was completed and borrowing powers terminated.

Despite the absurdity by 1939 of the system of budget accounts ostensibly in force there were still no moves towards reform; nor had the Treasury begun to contemplate the necessary changes in the characteristics of the fiscal system which would have made the maintenance of balanced budgets less problematical in the face of severe autonomous fluctuations in economic activity.(278) Whilst it was recognised that rearmament expenditures were directly stimulating employment,* this as such did not give validity to the policy prescriptions of the 'new' economics; rather,

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* Immediately prior to the outbreak of war the rearmament programme had grown to £2,100m over 1939/40-1941/2, of which it was planned to borrow approximately £1,190m (Cab 24/287, C.P. 149(39), 'Note on the Financial Situation', 3 July 1939, pp.3-4

it highlighted and reinforced what the Treasury had always maintained: that public expenditure could only be used, and would only be effective, as an employment measure, in special circumstances, circumstances dependent on a favourable concatenation of political, economic, and psychological factors.

CHAPTER 6
AN ASSESSMENT OF CHANGES IN FISCAL STANCE 1929-39

Having completed our survey of 1930s budgetary history we can now proceed to more detailed issues: firstly, the measure employed in this study for assessing changes in fiscal stance (the constant employment budget balance); secondly, the characteristics of the fiscal system and their influence on the course of policy; and thirdly, the application of the constant employment budget balance estimates to an evaluation of changes in the authorities' fiscal stance.*

1. The constant employment budget balance

It is now well established in fiscal policy studies that the actual *ex post* budget balance is an inadequate and misleading indicator of fiscal stance since it is subject to:

> the well-known difficulty that it does not distinguish changes in the budget balance caused by variations in tax rates or expenditure programmes from changes caused by movements in income and expenditure associated, for example, with autonomous variations in investment or exports. (1)

The resulting inadequacy of movements in actual budget balances as a measure of changes in fiscal stance was particularly acute in the 1930s, when there were marked cyclical variations in unemployment rates. As soon as the dependence of tax receipts and endogenous expenditures on the level of aggregate income is acknowledged, it follows that variations in economic activity,

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* The present study was completed before my attention was drawn to Thomas (1981) in which a similar exercise, albeit of a more limited nature to the one reported here, is undertaken as part of an investigation into demand deficiency between the wars. Apart from minor differences, Thomas's estimates of the budget balance at a standardized rate of unemployment confirm our results; in addition, the fact that his estimation procedures differed from those adopted for the present exercise corroborates the usefulness of this method for assessing budgetary policy.

unless the authorities take countervailing action, will automatically act on the budget balance. A fall in income, therefore, will cause the budget balance to deteriorate even when fiscal policy is contractionary, and *vice versa*.[2]

Thus the inadequacy of the *ex post* budget balance as a measure of fiscal stance stems from its failure to separate the effects of discretionary action from those of autonomous changes in economic activity; to distinguish the budget's influence on the economy from the economy's influence on the budget. To remedy this central defect, the concept of the full (or constant) employment budget balance was developed.[3] This is defined as the budget balance that would result (with the same nominal tax rates and public spending plans) if private sector demand was just sufficient continuously to maintain activity at a constant rate of unemployment. It is thus a measure of the budget balance which would have occurred had there been no deviation of economic activity from its trend path. Since such a measure will not be "affected by fluctuations in economic activity that shrink or swell the revenue base relative to that associated with the path of potential growth", it consequently provides a means "to focus on the policy actions that determine expenditure programs and tax rates, and to separate them from a consideration of the autonomous strength of private demand and of the posture of monetary policy."*

The following identity is used for the constant employment budget balance, or fiscal stance:

$$\frac{B^*}{Y^*} \equiv \frac{t.Y^* - G^*}{Y^*} \tag{1}$$

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* Okun and Teeters (1970: 78). The alternative approach has been to reject the use of a summary measure, and instead employ a model to describe both total variations in GDP and those which would have taken place in the absence of a government sector, the residual being the deduced impact of fiscal operations - see Neild (forthcoming) and Lotz (1971: 4-7); and for an example of recent empirical work, Pryor (1979).

where B* is the budget balance at constant employment, t the overall tax rate, Y* the constant employment level of GDP (i.e. the estimated value of what GDP at actual prices would have been if the percentage rate of unemployment had remained constant at the figure chosen for the exercise), and G* the value of central government expenditure at the constant employment level of incomes.*

A change in B*/Y* between two periods indicates a discretionary change in fiscal policy (the fiscal stance)**; a higher constant employment balance denoting a more restrictive policy, and _vice versa_.*** The automatic stabilizing properties of the fiscal system are measured

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* In all cases the superscript * denotes the constant employment value of an item. See above p. 101 for the budget identity at actual employment.

** Discretionary changes have usually been defined as those resulting from a change in tax rates or expenditure programmes, while automatic changes are those resulting from variations in economic activity. Such a definition, however, gives rise to the problem that with a progressive tax structure there is an automatic tendency for tax revenue to rise with the growth of income, and if that is not off-set by reducing nominal tax rates and/or increasing public expenditure, the fiscal stance will tighten. Hence, changes in nominal tax rates or expenditure programmes cannot be taken as evidence of a change in fiscal stance unless income is unchanged. Consequently, the more appropriate definition would seem to be that discretionary action is "any act which causes a change in fiscal stance, regardless of whether this is associated with changes in nominal rates of taxation or benefit" (Ward and Neild 1978: 3).

*** A number of writers have suggested - e.g. Lotz (1971: 14,18); Chand (1977: 411) - that discretion is required in using the constant employment balance measure because a change in the budget balance resulting from a given fiscal policy change measured at constant employment may differ from that measured at actual employment levels, i.e. the measure implicitly assumes that the ranking of budgets at constant employment is invariant to the degree of capacity utilization. But, as Chand says, if "the tax structure underlying one budget is more progressive than that underlying another budget, the ranking at actual output levels could involve reversals from the full-employment ranking, the by the change in B (the actual budget balance) in relation to the change in Y (the actual level of GDP) when Y deviates from Y*.

2. Constant employment GDP

The rate of unemployment selected for the computation of Y*, the constant employment level of GDP for any year, will affect the value of B*/Y*, the constant employment budget balance, but will have a minimal influence on the changes exhibited year to year in the value of B*/Y*. Thus the value assigned to Y* is of secondary concern,* since the major focus for study is the yearly changes in B*/Y*.

The series for Y* were calculated as follows: two base years, 1929/30 and 1937/8, were selected when unemployment rates were approximately similar, at 10.8 and 11.1% respectively of the insured workforce,(4) while they also represented peaks in economic activity.(5) Following the

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likelihood of which increases, the further the economy is from its full-employment level. Thus, what might appear to be a more expansionary budget at full employment could, in reality, be a more contractionary budget at actual employment levels." This was not a problem in this study since the progressiveness of the tax structure did not change significantly over the period.

* This is illustrated by a comparison of changes in the constant employment balance as a percentage of GNP for three recent years using different estimates based on different benchmark rates of unemployment.

Changes in constant employment budget balance as% of GNP

	1974-5	1975-6	1976-7
Treasury			
(5% unemployment)	-1.0	+2.7	+3.5
(3% unemployment)	-1.3	+2.7	+3.3
National Institute			
(2.6% unemployment)	+1.0	+2.4	+4.5
Ward and Neild			
(2-2.5% unemployment)	-0.9	+2.8	+2.7

Source: Calculated from Hartley and Bean (1978: Table 1)

Table 6.1

Actual and constant employment GDP, 1929/30-1939/40

	GDP at constant factor cost			GDP at current prices (£m	
	Actual (Y)	Constant employment (Y*)	Ratio (Y*/Y)	Actual (Y)	Constant employment (Y*)
	(1)	(2)	(3)	(4)	(5)
1929/30	100	100	1.000	4245	4245
1930/1	98.0	102.3	1.044	4146	4328
1931/2	95.5	104.6	1.095	3872	4240
1932/3	96.6	106.9	1.107	3783	4188
1933/4	101.0	109.4	1.083	3831	4149
1934/5	106.2	111.8	1.053	4054	4269
1935/6	111.2	114.4	1.029	4236	4359
1936/7	116.7	116.9	1.003	4438	4459
1937/8	119.6	119.6	1.000	4777	4777
1938/9	118.8	122.3	1.030	5068	5220
1939/40	122.7	125.1	1.020	5668	5781

Sources: col. (1) Feinstein (1972: Table 8) recalculated on to a financial year basis using the standard method. Figures for 1939 and 1940 are estimates derived from Ibid. Table 6 using the compromise estimates for GDP. col. (4) Ibid. Table 3 recalculated on to a financial year basis.

method established by Cary Brown in his study of fiscal policy in the U.S. in the 1930s,(6) the actual series for GDP at constant factor cost were interpolated between the two base years assuming that the growth of Y* was the same as that of Y between the two base years. GDP at constant factor cost grew by 19.6% between our two base years, equivalent to an annual rate of growth of 2.25%. An index was calculated of Y* at constant factor cost using this annual growth rate (Table 6.1 col.2) from which the deviations of Y from Y*, termed the ratio (col.3), were obtained for each year. The series of money Y was then adjusted by the ratio to obtain a series for Y* at current prices (col.5).

It is well established that in the short-run unemployment varies less than output and with a time lag.(7) Moreover, there are grounds for supposing that in a prolonged depression labour exhibits a tendency to transfer into the low wage, low productivity service sector. A substantial movement of this type appears to have occurred during 1929-32,* and given the lower productivity growth of this sector relative to the industrial sector,(8) there are some grounds for stating that GDP in 1937/8 would have been somewhat higher if constant employment had been continuously achieved during the 1930s, and therefore that the trend rate of growth interpolated between the two base years understates the constant employment trend rate of growth. Whether this higher productivity trend should have been taken into account or not depends on the hypothesis that is made regarding the duration of the constant employment level of activity. If it were assumed that we were measuring the level of activity and the budget balance if constant employment had been continuously maintained throughout the period, then the higher productivity trend is a relevant consideration. A full counter-factual history, however, is not being postulated; instead, we are measuring the level of income and the budget balance if, immediately within a year, or from one year to the next, the economy had shifted from the actual to the constant employment position. In these circumstances, it is appropriate to use the actual productivity trend since it is valid to assume that, in the short-run, labour is slow to transfer between sectors and the effect on productivity is delayed.

In calculating the constant employment level of GDP no adjustment was made to the composition of GDP between the broad categories of income that comprise the main tax bases

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* During the downturn of 1929-32 employment and output (at current prices) in the industrial sector fell by 10.5 and 16.8% respectively, while in the service sector employment increased by 3.9% but output fell by 7.1% - Feinstein (1972: Tables 9 and 59).

(consumers' expenditure, income from employment and profits) since the elasticity of the major component of taxes on expenditure, Customs and Excise receipts (other than import duties), with respect to GDP (0.96-1.30) was of the same order of magnitude as the overall elasticity of receipts with respect to GDP (1.02-1.22). Hence, the effect of changes in the share of consumers' expenditure in GDP, within the range of variations observed in the 1930s, was found to be relatively unimportant, and other compositional effects were ignored.

3. The characteristics of the fiscal system

Summary measures of the response of the budget to income variations can be used to indicate the changing characteristics of a fiscal system over time. For this purpose macro-marginal budget rates have been used, defined as the ratio of a change in receipts and endogenous expenditures to a change in income.(9) The advantage of macro-marginal budget rates over tax elasticities is that they incorporate the tax elasticity and also take account of the response of endogenous expenditures to income variations and the size of the budget in relation to GDP.

The response of the budget balance to income variations depends on the form the variation takes:

(1) growth of real GDP over time, at constant employment, resulting from productivity growth and the increase in the labour force;

(2) cyclical changes in real GDP; and

(3) changes in the price level.

Changes in the price level are not explicitly considered since the composition of the budget was such that these effects were relatively unimportant.(10) Prices fell for the greater part of the period but had insignificant effects on public expenditure, since only some public sector employees' wages and salaries were index-linked. As was noted earlier,(11) the major influence came on taxes on expenditure, the yield of ad valorem duties falling relative to those duties levied on a specific basis. Two macro-marginal budget rates, corresponding to (1) and (2) above, were calculated:

$$b_t = \frac{\Delta B^*}{\Delta Y^*} = \frac{\Delta T^*}{\Delta Y^*} \quad (2)$$

where b_t is the macro-marginal budget rate with respect to trend growth.* Since, on trend, all expenditures are by definition autonomous, this is identical to the macro-marginal tax rate, and measures the growth of central government receipts at the trend rate of growth of real GDP on the basis of nominal tax rates prevailing in each year.

$$b_y = \frac{(B^* - B)}{(Y^* - Y)} \quad (3)$$

where b_y is the macro-marginal budget rate with respect to cyclical variations in GDP and is a measure of the automatic stabilizing properties of the fiscal system.

Macro-marginal budget rates and aggregate tax elasticities with respect to the trend rate of growth of real GDP at constant employment are given in Table 6.2. The trend macro-marginal rate rose markedly between 1929/30 and 1932/3, reflecting a rise in the aggregate tax elasticity and a significant increase in the average tax burden as the authorities attempted to achieve a target ex post budget balance in the face of a cyclical downturn. Thereafter the macro-marginal rates fell to 1935/6 as taxes were cut, and

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* In accordance with our definition of discretionary action (above p.221) b_t may be taken as a measure of the extent of fiscal drag in the system.

Table 6.2 Response of central government receipts to trend growth in real GDP, 1929/30-1939/40*

		1929/30	1930/1	1931/2	1932/3	1933/4	1934/5	1935/6	1936/7	1937/8	1938/9	1939/40
Trend macro-marginal budget rate	$\left[\frac{\Delta T^*}{\Delta Y^*}\right]$	0.215	0.231	0.278	0.299	0.295	0.282	0.272	0.272	0.270	0.269	0.272
Tax elasticity	$\left[\frac{\Delta T^*}{T^*} \Big/ \frac{\Delta Y^*}{Y^*}\right]$	1.02	1.06	1.17	1.22	1.23	1.22	1.20	1.20	1.21	1.22	1.21
Ratio of receipts to GDP	$\left[\frac{T^*}{Y^*}\right]$	0.211	0.218	0.238	0.245	0.240	0.231	0.227	0.227	0.223	0.221	0.225

Sources: Data taken from Financial Accounts and adjusted to a constant employment basis using the estimating procedure outlined in App.II.

Notes: * Estimates are shown on a receipts basis, although they incorporate income and surtax estimated on an accruals basis to take account of the lag between earnings and assessment. Stamp and estate duties are excluded, their trend growth being negligible.

Table 6.3 Response of budget balance to cyclical variations in real GDP (selected years) and autonomous expenditure, 1929/30-1939/40*

		1929/30	1930/1	1931/2	1932/3	1933/4	1934/5	1935/6	1936/7	1937/8	1938/9	1939/40
Cyclical macro-marginal budget rate	$\left[\frac{B^*-B}{Y^*-Y}\right]$	..	0.440	0.436	0.447	0.420	0.432	0.470	..	..	0.356	..
Ratio of autonomous expenditure to GDP**		0.194	0.194	0.198	0.200	0.182	0.189	0.189	0.200	0.205	0.220	0.330

Sources: As for Table 6.2; data on unemployment benefits from working notes to Feinstein (1972).

Notes: * Estimated on the same basis as the trend macro-marginal budget rate, account also being taken of the response of unemployment benefits to income variations.
**Autonomous expenditure comprises all items considered to be invariant to changes in economic activity and equals total central government expenditure (G*) less outlay on unemployment benefits (SIFB*).

then remained fairly stable until the end of the period. Tax rates were raised yearly from 1936/7 (although the fiscal stance continued to loosen as expenditure outstripped the growth of revenue), but the macro-marginal rate failed to rise while the ratio of receipts to GDP remained below its peak level of the early 1930s. During the later 1930s a number of influences seem to have been operating:

(1) The failure of the aggregate tax elasticity to rise, as had occurred with the tightening of 1929/30 to 1933/4, is probably explicable in terms of (a) a reduction in the elasticity of taxes on income consequent upon a rise in the average effective rate of tax on personal and corporate incomes from 1936/7; and (b) discretionary increases in taxes on expenditure, especially in 1939/40, centred on those duties with a low elasticity with respect to GDP compared with the aggregate tax elasticity.

(2) Simultaneously, the rise in the general price level (by 10% over 1936-9) resulted in the yield of taxes levied on a specific basis (which comprised the bulk of taxes on expenditure) falling relative to those levied on an *ad valorem* basis.

At the beginning of the period an increase in GDP of £100m would, at constant employment, have led to a rise in central government receipts of nearly £22m; by 1932/3 this would have risen to £30m, and by 1937/8 it had fallen back to £27m. If real GDP had grown at 2.25% per annum - the assumed constant employment growth rate - receipts would have grown by approximately the same amount in 1929/30, but by 2.8% in 1932/3 and slightly less in 1937/8, thus providing scope for increased expenditure and/or remission of taxation whilst maintaining an unchanged fiscal stance. In the absence of such countervailing action, the fiscal stance would have tightened.

Table 6.3 gives estimates of the cyclical macro-marginal budget rate and the ratio of autonomous expenditure to constant employment GDP. Difficulty in obtaining a satisfactory statistical relationship for outlay on unemployment benefits against GDP has meant that estimates cannot be provided for all years,(12) while stamp and estate duties have been excluded because of the difficulties of estimating a stable relationship between asset prices (the tax base for these duties) and GDP. Since they were highly cyclical their inclusion would raise the cyclical macro-marginal budget rate.

The evidence suggests the cyclical macro-marginal rate rose between 1929/30 and 1930/1 as the increase in eligibility for unemployment benefits, introduced in March 1930, made endogenous expenditure more responsive to income variations. The fall in 1931/2 reflected the return to the previous eligibility conditions and the reduction in benefit rates, while the increased rate in 1932/3 resulted from changes in the response of receipts - an increase in the cyclical macro-marginal tax rate more than compensating for a decline in the response of endogenous expenditure. Thereafter, the macro-marginal budget rate fell, rising temporarily in the mid-1930s with the extension of the unemployment benefits system, down to 1938/9.

On the basis of these estimates, it can be seen that the extent of automatic stabilization fell over the period; a deviation of GDP of £100m from its benchmark level would have resulted in a change in the budget balance of £45m in 1932/3 and £36m in 1938/9, i.e. a 5% deviation in GDP would cause a change in the budget balance of 2.3% of GDP in the former year and 1.8% in the latter. From comparison with estimates of the cyclical macro-marginal budget rates for the contemporary British economy,(13) it would seem that the extent of automatic stabilization has changed only marginally over the past forty years, although the ratio of autonomous expenditure to GDP has more than doubled over the intervening period and thus exerts a greater stabilizing function than in the 1930s.

The explanation of this surprising conclusion lies in conflicting developments on the receipts and expenditure sides of the budget. On the receipts side the aggregate tax elasticity (see Table 6.2) was roughly comparable to that of the postwar period,(14) but since the ratio of receipts to GDP is approximately twice as high in the later period, the cyclical macro-marginal tax rate has been significantly higher. On the other hand, on the expenditure side, the cyclical macro-marginal rate appears to have fallen because of changes in the response of unemployment to income variations. Since the level of unemployment benefits in relation to the average wage was lower before the war than after, and outlay on unemployment benefits only constituted between 1.0 and 1.9% of constant employment GDP, the response of unemployment to a change in GDP must have been greater in the 1930s.

Ward and Neild calculate (for the late 1970s) that a 1% deviation in Y from Y* would result in a change in unemployment (within the first year) of only 0.22% of the labour force, and further that a cyclical deviation of as much as 10% from its trend value only gives rise to a change in outlay on unemployment benefits of 0.5% of GDP.(15) The situation in the 1930s differed significantly: for example, in 1930/1 the 4.4% deviation in Y from Y*, after a year of no deviation, resulted in a rise in the numbers unemployed of 7.5% of the insured labour force and an increase in outlay on unemployment benefits of 1.2% of GDP. Unemployment was thus more responsive to changes in GDP than in the postwar period: not only did unemployment adjust more speedily to a change in GDP but a relatively greater proportion registered as unemployed than in the postwar period, trends that reflect the different characteristics of the labour market between the two periods. In particular, a significantly higher pressure of demand in the postwar period, relative to that of the interwar period, has resulted in a marked fall in the output-employment elasticity.(16)

The conclusion suggested by these estimates is that during the 1930s adherence to the balanced budget rule was made more problematical by a budget sensitive to cyclical variations; the higher the cyclical macro-marginal budget rate the stronger the automatic stabilizing properties of the system and the greater the tightening that is necessary in the face of a cyclical downturn if a target budget balance is to be achieved.

4. <u>The fiscal stance 1929-39</u>

During the 1930s Britain alone among the major western industrial economies eschewed "resort to a policy of budget deficits to promote internal recovery";(17) instead reliance was placed on an active monetary policy, tariff protection, devaluation, and specific intervention at a microeconomic level.(18) As was shown in earlier chapters, the rôle accorded to budgetary policy as a stabilization instrument was limited: the principal objective was the maintenance of domestic and international confidence in the authorities' economic policies, and this dictated adherence to balanced budgets and orthodox financial principles. Consequently budgetary operations were potentially destabilizing, for the contemporary practice was to attempt to balance revenue and expenditure with little regard for autonomous fluctuations in economic activity.

As a subject for detailed study, the influence of fiscal operations on the course of economic activity during the 1930s has been somewhat neglected by scholars. With few exceptions, previous studies have tended to be rather cursory and superficial so that it is difficult to speak of a 'traditional interpretation' of budgetary policy during these years in any meaningful sense. Nevertheless, a consensus exists that policy was limited in its scope and objectives, and destabilizing in its operation. Richardson, one of the few writers to have attempted a serious assessment of the question, summarised his conclusion as follows:

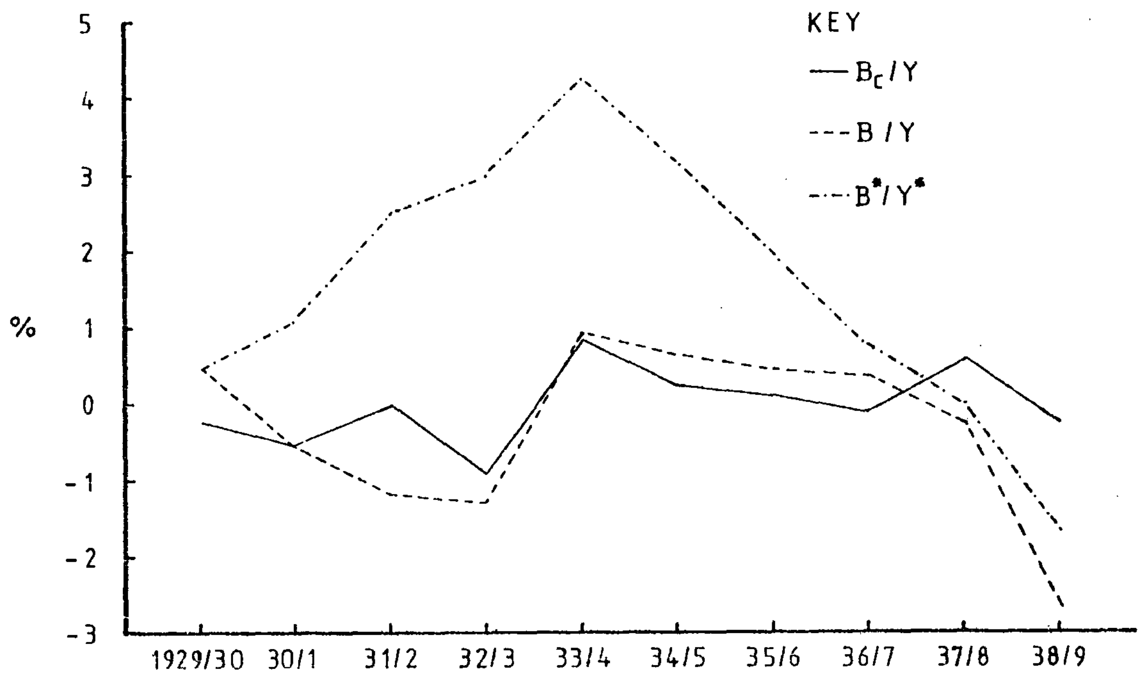
> [The] government did not have a fiscal policy as such in the 1930s. The nearest it came to an attempt to control the public finances with a view to recovery was its stress on a balanced budget, not with the direct aim of stabilization but rather to restore business confidence at home and confidence in sterling and the government's ability to meet the crisis abroad ... [Broadly] speaking, fiscal operations were destabilizing in their effects over the 1930s as a whole. The budget was balanced at the trough of depression, and this failed to impart a direct stimulus because expenditure was not increased. Later in the decade, when the economy was entering boom conditions there was a tendency for a budget deficit to develop because of the requirements of rearmament expenditure. This was the opposite of what was desirable on stabilization grounds. On the other hand, high levels of expenditure on rearmament and other items acted counter-cyclically in the recession of 1937-8, though this was not a conscious policy ... British experience in the 1930s hardly provides a model of a counter-cyclical fiscal policy. (19) [Emphasis Added]

A number of general features of budgetary policy during the 1930s have been identified by previous writers who have used the conventionally defined budget balance (B_c in Chart

6.1 and Table 6.4) as an indicator of the setting of the budget:

Chart 6.1

Budget deficit as % of GDP, 1929/30-1938/9



SOURCES: As Table 6.4.

(1) Budgetary policy was slightly reflationary in 1929 and 1930, the early stages of the depression, for despite increased taxation, expenditure growth was more rapid and the budget deficit widened.

(2) The severe tightening of revenue and expenditure necessary to balance the budget in 1931/2 (the trough of the depression) was highly deflationary, but these adverse effects were partially mitigated by the restoration of confidence, which followed from the restrictive measures, and the concomitant effects on business expectations.

(3) The delay in remitting taxation and restoring the cuts in expenditure most probably retarded the onset and pace of recovery.

(4) As a consequence of rearmament, rather than of a deliberate stabilization policy, budgetary policy became markedly

Table 6.4 Central government receipts, expenditure, and budget balance, actual and constant employment, 1929/30-1939/40

A. (% of GDP):

	(T_c/Y)	(G_c/Y)	(B_c/Y)	(T/Y)	(G/Y)	(B/Y)	(T^*/Y^*)	(G^*/Y^*)	(B^*/Y^*)
1929/30	19.2	19.5	-0.3	21.1	20.7	+0.4	21.1	20.7	+0.4
1930/1	20.7	21.2	-0.6	22.1	22.7	-0.6	21.8	20.7	+1.1
1931/2	22.0	22.0	0.0	23.6	24.8	-1.2	23.8	21.3	+2.5
1932/3	21.9	22.7	-0.9	23.9	25.2	-1.3	24.5	21.5	+3.0
1933/4	21.1	20.3	+0.8	23.2	22.3	+0.9	24.0	19.8	+4.2
1934/5	19.8	19.7	+0.2	22.2	21.6	+0.6	23.1	19.9	+3.2
1935/6	19.9	19.9	+0.1	22.1	21.7	+0.4	22.7	20.7	+2.0
1936/7	20.2	20.3	-0.1	22.3	22.0	+0.3	22.7	21.9	+0.8
1937/8	19.9	19.3	+0.6	22.0	22.3	-0.3	22.3	22.3	0.0
1938/9	19.9	20.1	-0.3	22.0	24.7	-2.7	22.1	23.7	-1.6
1939/40	20.0	24.8	-4.9	21.9	35.1	-13.2	22.5	34.7	-12.2

B. (£m.):

	(T_c)	(G_c)	(B_c)	(T)	(G)	(B)	(T^*)	(G^*)	(B^*)
1929/30	815.0	829.5	-14.5	893.9	876.5	+17.4	893.9	876.5	+17.4
1930/1	857.8	881.0	-23.2	915.1	939.3	-24.2	941.7	894.6	+47.1
1931/2	851.5	851.1	+0.4	914.5	960.2	-45.7	1008.8	902.1	+106.7
1932/3	827.0	859.3	-32.3	903.9	954.1	-50.2	1024.6	900.1	+124.5
1933/4	809.4	778.2	+31.2	890.0	856.7	+33.3	997.5	823.3	+174.2
1934/5	804.6	797.1	+7.5	899.3	873.5	+25.8	986.8	848.8	+138.0
1935/6	844.8	841.8	+3.0	935.7	919.7	+16.0	988.5	902.7	+85.8
1936/7	896.6	902.2	-5.6	990.0	975.3	+14.7	1011.7	974.3	+37.4
1937/8	948.7	919.9	+28.8	1051.5	1067.2	-15.7	1063.5	1067.2	-3.7
1938/9	1006.2	1018.9	-12.7	1114.1	1251.3	-137.2	1155.1	1235.8	-80.7
1939/40	1132.2	1408.2	-276.0	1241.0	1990.2	-749.2	1303.8	2007.9	-704.1

Sources: The actual figures are drawn from Financial Accounts and the working notes to Feinstein (1972); for the computation of the constant employment estimates see App.II.

expansionary from the later 1930s and ensured that the recession of 1937-8 was of short duration, and further, that the problem of abnormal unemployment of the interwar years was beginning to be resolved.

Using the constant employment budget balance as a measure of changes in fiscal stance permits a more precise and systematic exegesis of budgetary policy to be presented than the interpretation outlined above; moreover, the results obtained (summarised in Table 6.4) would seem, at least for part of the period, to be at variance with the accepted view and thus suggest that some reinterpretation is appropriate.

For the period as a whole two general features are shown in Chart 6.1 and Table 6.4:

(1) the differences between the budget balance at actual and constant employment, respectively B/Y and B*/Y*, are large, reflecting a variation of over 13 percentage points in unemployment rates amongst the insured labour force between the peak and trough years.

(2) changes in fiscal stance were extensive (a maximum change of approximately 6 percentage points between 1933/4 and 1938/9 in B*/Y*), a result not of attempts to stabilize activity by fiscal means, but of firstly, striving to attain a balanced budget in the face of severe cyclical fluctuations in activity, and secondly, the imperative of rearmament which necessitated large scale borrowing from 1937 onwards.

(i) Depression 1929-33

Between 1929/30 and 1932/3 the budget balance (B/Y) deteriorated by 1.7 percentage points of GDP. In contrast, the constant employment balance moved into substantial surplus as the authorities attempted to balance the budget in the face of declining economic activity. This tightening (3.8 percentage points of GDP over 1929/30-1933/4) continued almost unabated until 1933/4, the remission of taxation in 1933 being insufficient to compensate for the severe tightening in 1931 of both receipts and expenditure.

The change in fiscal stance was achieved almost entirely by raising the ratio of receipts to GDP. In this respect it was comparable to the tightening of the period 1967-70 which, until recently, was the most severe of the postwar period - a change in the constant employment balance of nearly 7 percentage points of GNP, the expenditure ratio only falling marginally.[20] But since the size of the budget in relation to GDP was only half that of the postwar period, a given change in fiscal stance of (say) 2 percentage points of GDP required nearly a 10% change in receipts in 1931/2 but less than 5% in 1967.

The extent of the perverse fiscal action during the depression years can be said to depend on:

(1) the percentage fall in GDP;

(2) the response of the budget, as measured by the cyclical macro-marginal budget rate (b_y), to a change in GDP; and

(3) the extent to which discretionary action could be avoided by fiscal window-dressing.

GDP at constant factor cost fell by only 5% over 1929-32, but the marked cyclical sensitivity of the budget to income variations ensured that even this small change resulted in a significant deterioration in the budget balance, although this was partially mitigated by increased taxation yearly from 1929 and cuts in expenditure in 1931. The increasingly deflationary stance adopted by the authorities in their attempts to maintain a balanced budget (B_c) was, however, significantly tempered by fiscal window-dressing - over 1929/30 to 1933/4 revenue (T_c) included £59.5m of non-recurrent receipts while £39.1m was borrowed. The authorities were thus able to avoid discretionary action totalling nearly £90m, a figure approximately equivalent to an additional 6d. on the standard rate of income tax over the period. Following upon the already severe tightening that had occurred, the consequences of such a further increase in taxation would have been extremely serious.

The increased taxation and expenditure cuts (estimated full year effects of £80m and £70m respectively) imposed in September 1931 have generally been viewed as the most deflationary budget of the whole interwar period; their continuation is also seen as having retarded recovery:[(21)] an impression substantiated by the change in the constant employment balance of 1.4 percentage points between 1930/1 and 1931/2 and a further 1.7 percentage points by 1933/4.

Many contemporaries, however, believed that by restoring confidence amongst business circles and the international financial community in the government's financial policy, the budget achieved a psychological stimulus which outweighed the direct restrictive effects.[(22)] As was noted earlier,[(23)] confidence cannot be accurately specified or measured, and therefore the importance of this factor is difficult to establish; on somewhat stronger grounds, the authorities,[(24)] and many writers since, believed that the balancing of the budget (B_c not B which continued to move into deficit until 1932/3) in 1931 and the consequent restoration of confidence permitted the cheap money policy,* which many see as the mainstay of recovery in the 1930s.(25) Thus the 1931 budget was neutral or:

> reflationary only because it led to the War Loan conversion and was accompanied by circumstances which caused or greatly assisted recovery. These circumstances were unusual and are unlikely to recur. In general, a policy of cutting expenditure and raising taxes will not alleviate but deepen a depression. (26)

Furthermore, the war loan conversion permitted the large fall in debt charge on the budget - a reduction of 30.4% from £322m in 1931/2 to £224m in 1933/4 (see Table 5.6) - which formed the basis of the loosening of fiscal stance that occurred from 1934 onwards.

Whilst the dictates of a balanced budget restricted the scope for fiscal operations to be stabilizing in a depression, the central government's deflationary policies could have been partially offset by an expansion of public investment and local authority expenditure, both of which were outside the coverage of the conventionally defined budget. Gross fixed capital formation by public and semi-public authorities exerted a stabilizing influence during 1929-31, expanding (at 1930 prices) from £167m to £198m and thus nearly compensating for the decline in capital formation by the private sector from £266m to £229m. Thereafter, public investment was cut back sharply in 1932-3 as a consequence of the economy campaign, and thus in the two most critical years when fiscal stance was tightening public investment

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* For example, Nevin (1955: 69, 76-82) partially attributes the recovery of bond prices in early 1932 - a recovery which aided the transition to cheap money - to the recovery of confidence engendered by the balancing of the budget and the formation of the National Government. Against these beneficial effects, however, must be placed the possibility that the 0.6% fall in consumers' expenditure over 1931-2 - as compared with a rise of 2.6% over 1929-31 - resulted from the tightening of fiscal stance. (Calculated from Feinstein 1972: Table 5)

was destabilizing.[27] Total expenditure by local authorities followed a similar course, expanding during the first two years of the depression and then being seriously curtailed during 1931-4.[28] Nor should the expansionary effects of these expenditures of 1929-31 be overstated, for much of the increased capital expenditure was financed out of additional current expenditure and new borrowing was partially offset by simultaneous repayment of debt,[29] while, in addition, expenditure was lowest in those areas with the highest unemployment.[30]

(ii) Recovery 1933-7

Although there is disagreement over the precise impact of the government's deflationary policy in 1931-2, a consensus exists that the crisis measures were maintained too long, for once "confidence had been restored, conditions were such that a reflationary fiscal policy could have materially assisted an early recovery."[31] Within the constraint imposed by the prevailing orthodoxy, the timing of budgetary relaxation was delayed by two factors: firstly, the yield of taxes on income (which constituted 30 to 40% of total receipts) was slow to respond to recovery, and secondly, whilst in the early stages of the recovery the total numbers unemployed fell rapidly, there was a proportionately smaller effect on outlay on unemployment benefits charged to the budget as conventionally defined. The first factor is explicable in terms of the lag between earnings and assessment for income and surtax;[32] the second derives from the rather complex administrative arrangements governing outlay on unemployment benefits.

Unemployment amongst insured persons reached a peak of 2.979m in January 1933, falling rapidly to 2.288m by the end of the year,[33] a reduction of 23.2%. This fall was accompanied by a marked reduction in total outlay on unemployment benefits, but because of the nature of the central government's contribution to the unemployment benefits system, its contribution fell proportionately less than the reduction in outlay of the system as a whole.

From October 1931 onwards central government contributions took three forms:

(1) payments to the Unemployment Insurance Fund on the basis of equal thirds contributions from the state, employers, and employees;

(2) responsibility for the whole cost of transitional payments (unemployment assistance from 1935);

(3) the debt of the Unemployment Fund having reached its statutory maximum of £115m, the Exchequer was obliged to meet by a deficiency grant any shortfall in revenue relative to expenditure.[34]

Between March and December 1933 that part of the unemployed for which central government was fully responsible fell far less (by 11.9%) than those receiving benefits from the Unemployment Insurance Fund (a reduction of 28.2%) for which only part of the charge was borne by the budget.[35] The burden of unemployment charges on the budget was thus slow to respond to recovery:[36] while the average numbers unemployed fell by 24.3% between 1932/3 and 1934/5, the unemployment charge on the budget only fell by 15.5%.

As a surplus began to accrue to the Unemployment Fund this had to be allocated to redemption of the Fund's debt.*

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* The Treasury estimated that for every 0.1m by which the Live Register fell below 3m there would be a saving of approximately £3.8m to the Budget, but that when the register had fallen to 2.4m the saving from any further reduction in unemployment would go primarily to reducing the debt of the Unemployment Fund and relief to the budget would be small (T171/296, Hopkins to Fisher and Chamberlain, 16 Nov. 1931).

Given the budget identity in use, such transactions did not appear in the budget accounts, just as in 1929-31 borrowing had also been excluded. A surplus began to accrue from June 1933 onwards so that the burden of the deficiency grant no longer fell on the budget, the net effect on the budget being a result of two factors: (1) the numbers of insured unemployed (corresponding to the short-term unemployed) fell faster than those receiving transitional benefits (essentially the long-term unemployed), a usual occurrence in a cyclical upturn;[37] and (2) the effect of the change in eligibility for insurance benefits introduced in October 1931 were beginning to lead to the transference of the unemployed from insurance benefits to transitional payments.

Revenue adjusted for non-recurrent receipts (T) continued to be depressed until 1934/5, falling by 2.7% over 1931/2 to 1933/4, but expenditure (G_c) fell far more rapidly (by 8.6%) over these years, so that a substantial surplus (B_c) was achieved in 1933/4 which permitted a loosening in fiscal stance from 1934 onwards. This change was occasioned solely by the reduced debt charge on the budget, resulting from lower interest rates and the near abandonment of sinking fund payments. Remission of taxation and restoration of the expenditure cuts followed gradually in the budgets of 1934 and 1935, but the scope for relaxation remained very tight, for although receipts were beginning to reflect the recovery of economic activity, they were outpaced by the growth of expenditure as rearmament began to dissipate the gains that should have followed from recovery.

The extent of this relaxation is measured by a 2 percentage points change in the constant employment balance between 1933/4 and 1935/6, far less than the tightening of the previous period. This change in fiscal stance resulted almost equally from variations in the ratio of receipts and expenditure to GDP, the former reflecting remission of taxation, the latter the restoration of the expenditure cuts and the growth of rearmament expenditure. Overall the direct contribution of fiscal policy to recovery was extremely limited; by 1935 fiscal stance had changed comparatively little since the depression years, the relaxation had been delayed until long after the onset of recovery, and public investment had been destabilizing in the early stages of recovery.* Against these factors, however, must be placed the undoubted contribution to recovery of the restoration of confidence and the cheap money policy, both deriving from the apparent adherence to budgetary orthodoxy.

(iii) Recession and rearmament 1937-9

The final phase of budgetary policy was inextricably connected with the needs of rearmament. Total defence expenditure increased from £136.9m in 1935/6 to £265.2m in 1937/8 and had reached £1,142m by 1939/40, when it constituted 19.8% of constant employment GDP (see Table 6.5). The growing importance of rearmament expenditure was reflected in the change in fiscal stance over these years; the period of economic recovery 1932-7 had seen a limited relaxation in fiscal stance, a change in the constant

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* The later stages of recovery, however, were supported by a revival of public sector investment. Between 1935-7 gross fixed capital formation (at 1930 prices) by public and semi-public authorities rose from £175m to £220m, an increase of 25.7%, while capital formation by the private sector rose from £311m to £328m, an increase of only 5.5%. (Feinstein 1965: Table 3.34). There was also an expansion of local authority expenditures over this period (Peacock and Wiseman 1967: Table A.20).

employment balance of just over 4 percentage points of GDP, while the years 1937/8 to 1939/40 saw a change of over 12 percentage points. The ratio of receipts to GDP remained constant over this period, although tax rates were increased yearly from 1936, and the change in fiscal stance reflected the rise in the expenditure ratio as military outlays were greatly expanded.

Table 6.5

Summary figures of defence expenditure, 1929/30-1939/40

	Total Defence Expenditure*		
	(£m)	as % of central government expenditure (G*)	as % of constant employment GDP
1929/30	113.0	12.9	2.7
1930/1	110.5	12.4	2.6
1931/2	107.3	11.9	2.5
1932/3	103.0	11.4	2.5
1933/4	107.9	13.1	2.6
1934/5	113.9	13.4	2.7
1935/6	136.9	15.2	3.1
1936/7	186.2	19.1	4.2
1937/8	265.2	24.9	5.6
1938/9	400.2	32.4	7.7
1939/40			
(April)	628.8	..	..
(Sept.)	1,249	..	..
(outturn)	1,142	56.9	19.8

Sources: Figures for defence expenditure from: Statistical Abstract for the United Kingdom, 1924-1938, Cmd. 6232 (1940), Table 151; Central Statistical Office, Annual Abstract of Statistics, 1935-46, 84 (1948), Tables 253-4; T171/349, 'Review of 1939-40', undated; GDP data from Table 6.1.

Notes: *Expenditure covered by revenue, borrowing under the Defence Loans Acts, 1937 and 1939, and the Vote of Credit granted on 3 September 1939. In addition to the expenditure of the three defence forces, expenditure on civil defence and food storage also included.

The timing of this change in fiscal stance was most fortunate; despite the absence of a formal commitment to an active counter-cyclical fiscal policy by the authorities, fiscal operations acted to mitigate the recession of 1937-8.* Nevertheless, the growth of rearmament expenditure and the decline in private sector demand were not exactly synchronized and the recession was able to develop for some months before fiscal operations became sufficient first to stabilize activity and then to stimulate recovery.[38] By the spring of 1939 both the authorities and economic commentators were agreed that recovery was proceeding rapidly and that the abnormal unemployment, the 'intractable million',[39] which had plagued the interwar economy, was being reduced as a result of rearmament,[40] for not only did it stimulate aggregate demand but it also had marked effects on the depressed areas where defence contracts had been specifically placed.[41] The change in fiscal stance between 1938/9 and 1939/40 ensured the achievement of full employment towards the end of 1940. There is evidence, however, that full employment would have been attained some months earlier had it not been for the outbreak of war which temporarily halted the progress of recovery. Unemployment had fallen rapidly from 2.134m to 1.295m between January and August 1939, but had risen thereafter as a consequence of the disruption produced by the onset of war, and it was not until March 1940 that unemployment had recovered to its August 1939 level.[42]

5. <u>Conclusions</u>

The overall efficacy of budgetary policy during this period is difficult to evaluate since current objectives

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* It has been estimated that unemployment might have risen as high as 3m compared with its actual figure of 1.6m if the authorities had decided to balance the budget in 1938/9 rather than borrow over £120m for rearmament - Bretherton et al (1941: 92).

and targets of budgetary policy are at variance with those of the 1930s. Within the limited rôle accorded at the time to budgetary policy as a stabilization instrument, budgetary policy can be judged to have been not unsuccessful, for, with the exception of the débâcle of 1931, fiscal operations provided a stable environment for business and permitted an expansionary monetary policy, conditions conducive to recovery.* It is when budgetary policy is appraised with reference to modern objectives of budgetary policy, objectives formulated and developed during the 1930s in response to the limitations and unsatisfactory macroeconomic impact of the existing policy, that its deficiencies and destabilizing characteristics become evident.

The foregoing study suggests that the traditional interpretation of budgetary policy during this period requires modification on two counts:

(1) The budget balance at actual employment (B_c or B) was shown to be an extremely misleading indicator of changes in the setting of the budget since in the early years of the depression it appears to signify a loosening of fiscal stance whereas, in fact, as indicated by changes in the constant employment balance, budgetary policy was becoming progressively more restrictive.

(2) The traditional interpretation, that the direct deflationary effects of the 1931 budget were outweighed by the restoration of confidence, whilst intuitively appealing, should be subject to serious scrutiny; the extent of the

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* As Sabine (1970: 285) concluded, budgetary policy was "pitched in a minor key but played a vital, if unspectacular part in the limited recovery of 1933 to 1936 by a delicate combination of inflatory and deflatory measures".

tightening in the depression and early recovery periods was severe, and consequently any recovery of private sector demand induced by the restoration of confidence would have had to be considerable to compensate for the contraction of public sector demand.

In conclusion it should be stated that while in recent years doubts have arisen regarding the effectiveness of fiscal policy as a stabilization instrument, in the conditions of the 1930s, with its heavy unemployment and falling price level, few would disagree "that recovery proceeded less strongly and rapidly that it would have done with more enlightened budgetary policies."[43] In earlier chapters, we saw that such policies were not pursued because of adherence to budgetary orthodoxy and an implicit faith in the potency and efficacy of market forces. Other factors were also of importance, for had more 'enlightened' policies been adopted the nature of the unemployment problem of these years was such that fiscal policy would have had to be supplemented by selective demand management measures. In particular, an active regional policy would have been required while, in the circumstances of the abnormally depressed level of world trade, a higher level of activity would have resulted in balance of payments problems.

CHAPTER 7

CONCLUSIONS: THE 'TREASURY VIEW' AND PUBLIC WORKS

In studying the interaction between economic thought and policy during the interwar years research has primarily focused on the gradual evolution of Keynes's policy prescriptions and theoretical writings, culminating in the General Theory (1936), and their acceptance and adoption by the Treasury, as instanced by Kingsley Wood's 1941 budget and the 1944 Employment Policy White Paper,(1) the explanation being couched in terms of the Treasury, guided solely by economic objectives, succumbing by the force of reason to the theoretical correctness of the 'new' economics. From the foregoing investigation of 1930s fiscal policies, we can conclude that such an approach is not incorrect, merely incomplete, for it excludes the political dimension of these developments: that is during the 1930s the Treasury and governments objected to the 'new' economics, and more generally to those advocating a more enlightened and active fiscal policy, on grounds not only economic in character but more fundamentally political and administrative, while the acceptance of the 'new' economics during the war years is explicable in terms of a change in political attitudes and prevailing administrative conditions, as well as the conversion to the Keynesian theoretical position.(2)

The purpose of this final chapter is to examine the fiscal policy debate from a rather broader perspective than that of previous chapters, to comment on the public works issue and the 'Treasury view',(3) and to suggest possible reasons for the ultimate failure of the case for a more expansionist fiscal policy.

1. Public works and the 'Treasury view' 1929-31

The proposal that, in a depression, public works might provide a useful employment stimulus has a long lineage.[4] In Britain, their first active use on any substantial scale came in the 1920s;[5] conceived of as a purely temporary relief measure, there later developed dissatisfaction with their effectiveness, and increasingly they were opposed on theoretical grounds. By the later 1920s, this opposition had supposedly hardened into a dogma,[6] the so-called 'Treasury view', whereby loan financed expenditures were regarded as diversionary or inflationary and thus provided no net addition to employment.[7]

Our analysis begins in 1929, with the rejection of the Liberal Party's proposed £250m two year public works programme,[8] a rejection that has traditionally been ascribed rather more to the dominance and stultifying influence of the 'Treasury view',[9] and rather less to the programme's technical deficiencies, and the widespread distrust of it as a mere electioneering stunt.[10] The 'Treasury view', as expressed in the White Paper Memoranda on Certain Proposals Relating to Unemployment,[11] has further been interpreted as deriving from classical economics, with its implicit assumption of full employment and a fixed fund of savings.[12] Yet, this interpretation has been too readily accepted: as will now be suggested, the theoretical basis of the 'Treasury view' has been misconstrued, and the whole 1929 policy debate interpreted too narrowly.

It is generally held that the "heart of the White Paper lay in the Memorandum prepared by the Treasury", and that this "comprise[d] a rag-bag of objections to public works which [gave] the impression of proving too much."(13) In fact, the White Paper, although a coherent unity, divides distinctly into three parts: a consideration of the labour supply available for public works; a comment on the practicality of the proposed schemes; and the Treasury memorandum on the finance of the proposed programme. This document represented a general Whitehall view, rather than a purely Treasury view; it reflected the "past experience of public works ... [and was] a description of what in fact ha[d] been found often to happen."(14) Nor would the available evidence support the view that these practical objections were without substance, a mere screen for more fundamental, and largely indefensible, theoretical objections.(15)

In chapter 1 it was suggested that, apart from the well-defined period of general demand deficiency (1930 to mid-1933), the characteristics of interwar unemployment were such as to cast doubt on the suitability of a centrally directed public works programme as a means of effecting a <u>permanent</u> stimulus to employment.(16) Such was also the opinion of the Ministry of Labour in its contribution to the White Paper: reference was made to the Liberal's overstatement of the current level of cyclical unemployment, their misunderstanding of the dynamics of the labour market, the difficulty of matching (both occupationally and geographically) the available labour supply to the labour required for the schemes, and the failure to specify the microeconomic linkages whereby public works aided the export industries and permanently stimulated other 'normal' channels of industry (i.e. promoted structural change).(17)

The other departments' memoranda, on the various works projects, concerned themselves with more administrative (and ultimately political) issues: the technical problems associated with the implementation of such a large works programme over such a short time-period, they concluded, would prejudice normal expenditure controls, force the quite unacceptable overriding of private interests, and threaten the autonomy of local authorities.(18)

The 'Treasury view' embraced these wide-ranging technical, administrative and political objections: they constituted the disruptive intermediary which prevented the theoretical potentialities of public works from being translated into practical and effective results, the neutralising mechanism being as outlined in earlier chapters,(19) whereby a large public works programme caused a loss of confidence, leading to an adverse change in liquidity preference, and resulting in psychological crowding-out. In this interpretation of the 'Treasury view', a large loan financed public works programme would still have no substantial net effect on employment, but the sequence of events and causes of crowding-out were rather different from those accepted hitherto.

In an earlier chapter the theoretical basis underlying adherence to balanced budgets was shown to have been misinterpreted by certain earlier writers;(20) this would also seem to have been the case for the 'Treasury view' on public works. At no time did the Treasury doubt, ceteris paribus, that in the short-term state expenditure could raise aggregate demand and employment. Rather, their objections were twofold: firstly, as argued above, they contended that a number of constraints would operate to neutralise the favourable effects of state expenditure if it was on the scale envisaged by the Liberals (objections not applicable to smaller scale projects); and secondly, such a course was undesirable because it failed to offer a permanent solution to heavy unemployment. It was here, with the second set of factors, that in 1929 and thereafter, there were deep-seated theoretical differences between the Treasury and the 'new' economics.

It has generally been argued that the Treasury's theoretical analysis ignored both the multiplier effects of,(21) and social rate of return on, public investment.(22) Whilst the multiplier was not formally specified until 1931,(23) it was undoubtedly implicit in much of earlier economic literature;(24) a similar judgement can also be made about the social rate of return.(25) Hopkins, in his evidence before the Macmillan Committee,(26) showed an awareness of both concepts, but nevertheless discounted them as inapplicable, given the current facts of unemployment, and inoperative, when considering a programme of the magnitude and type proposed by the Liberals.

Hopkins's analysis took as its starting point the difficulties of the staple export industries, difficulties which had been exacerbated by the characteristics of the depression after 1929.(27) From this standpoint, two objections were advanced against large scale public works: firstly, even assuming that the schemes were feasible, they "would concentrate employment in a marked degree upon individual trades which [were] neither unsheltered nor unprosperous ... and while increasing employment and profit making there would be little or nothing for the depressed basic trades";(28) and secondly, this concentration of employment would result in supply bottlenecks, generating cost pressures, which would then be transmitted throughout the economy. The final effect would be a worsening of the already diminished competitiveness of the export sector, and perhaps also increased import penetration, serious consequences given the then prevailing gold standard regime,[(29)] and precarious external balance.

In turn, these objections followed from two central tenets of interwar Treasury economic thinking. Firstly, the Treasury were antipathetic towards the notion, implicit in Keynes and others' writings, of the homogeneity of demand impulses, a reflection of their essentially micro-economic or structural diagnosis of the unemployment problem and of the way in which they viewed income generation. The concept of 'industry', in the aggregate, was rejected as a mere abstraction, one that led to potentially destabilizing policy actions.[(30)] Secondly, and not unconnected, was the belief in what might be termed the 'normal channels of trade', the policy implications of this being that public investment was a complement to that of the private sector, not a substitute for it. Here the textual evidence is far from conclusive, but it would appear that the Treasury held a position whereby public works on any substantial scale distorted the course of economic activity from its normal channels (determined by relative prices), made the ultimate transition to normal employment patterns more difficult, and forced periodic reflationary stimuli in order to permanently sustain the higher level of employment.[(31)] Such a position bore a strong resemblance to Hayek's writings at that time,[(32)] and thus had a certain intellectual pedigree.

Finally, we return to the Treasury's dismissal of the economists' contention that a public works programme gained additional justification from its positive social rate of return. The Treasury's reasoning should by now be clear: while they accepted the logic of this argument at the level of the individual project, they questioned its validity at the macro level, where a general reaction against the programmes might be expected, this leading to the establishment of forces which acted to neutralise at the national level any local benefits accruing from the schemes.

It remains to discuss briefly the public works programmes of the 1929-31 (minority) Labour government. These differed substantially from the Liberal's proposed programme; they were financed from current revenue, undertaken by local authorities (with little central planning), and had to be remunerative projects.(33) Thus their magnitude was limited from the outset,(34) but even given these constraints, the policy was deemed to have been unsuccessful:(35) their employment effects were judged to have been small in relation to expenditure, they had taken a long time to come into operation, and the stock of available remunerative projects was quickly exhausted. By June 1930, a full year after taking office, schemes approved only totalled £110.1m,(36) while even a year later, at their peak, schemes actually in operation totalled but £107.7m (on an annual basis).(37) These gave primary direct employment to 61,165 persons; assuming an equal amount of primary direct to indirect employment and an employment multiplier of 1.5, employment equivalent to only 10.9% of the total numbers unemployed had been generated after two years sustained effort.

These results were criticised by Lloyd George, Mosley and others as totally inadequate, a reflection of the Government's conservatism, obstructionism, and lack of real commitment to the policy.[38] Within Whitehall, however, where it was believed with some justification that the policy had been pursued to the fullest extent possible, the conclusion drawn was that the programme's poor results vindicated Whitehall's earlier objections to large scale public works. Thus the 'Treasury view' was reaffirmed, and for the rest of the 1930s the case for public works was to be prejudiced by the actual experience of 1929-31.[39]

2. The 'Treasury view' 1931-9

As with the refusal to promote recovery by deficit finance, Britain alone amongst the major western countries decided against an active public works programme as part of its domestic recovery policy after 1931.[40] The previous public works experiment terminated with the emergency budget measures of September 1931,[41] and thereafter was not repeated, this despite both widespread opposition to the apparent embargo on public works and the regained freedom afforded by the quietus of previous policy constraints (such as the gold standard).

The tenacity with which ministers and officials continued to oppose public works throughout the 1930s has long been attributed to the pervasiveness and diuturnity of the 'Treasury view', and as evidence of the fact that "the ideas of Keynes had almost no effect on Government policy in this country before 1939."[42] Recently, however, this view of Whitehall's continued theoretical orthodoxy has been challenged, and substantially modified, first by Howson (1975), and later by Howson and Winch (1977). Such a revision can be taken too far; while the evidence does not support Hutchison's sweeping statement "that both the Treasury and the Bank were largely converted to 'Keynesian policies' ... at least a year before the publication of The General Theory",(43) there is sufficient evidence for the more limited conclusion, that, in the realm of monetary policy, Treasury economic thinking was increasingly influenced by Keynes and other economists' policy advice.

As regards fiscal policy, and public works in particular, Howson and Winch have established that by the later 1930s the Treasury were prepared to countenance public works as a stabilization instrument in any possible future recession.(44) By contrast, Peden's researches led him to conclude that prior to the Second World War "the Treasury remained sceptical about the use of public works as a cure for unemployment."(45) As will now be shown, there is no necessary contradiction between these two views: the case rests on the motives for, and permanence of, the change in Treasury policy.

The National Government's unemployment policy came under serious and concerted attack in 1933 and 1935, as represented by the reflationary programmes proposed by Keynes in his 'Means to Prosperity' articles(46) and Lloyd George in his 'New Deal'.(47) On both occasions, the government's response was to allow a limited expansion of public works expenditures,(48) whilst rejecting the general case for large scale loan financed expenditures.(49) This relaxation of Treasury opposition was thus more apparent than real: it was largely a response to certain political pressures - the need to mollify the more progressive government backbenchers, pacify the Opposition, and be seen to be taking account of the change in public opinion since the 1931 crisis measures - and an acknowledgement of the opportunities afforded by gradually improving economic conditions. There was no discernible lessening of the theoretical objections to public works; on the contrary, the Treasury's internal discussions of Keynes's 'Means to Prosperity' programme reveal the genesis of a new theoretical objection, one concerning the monetary prerequisites for effecting a stimulus to demand by fiscal means.

There is strong evidence[50] to suggest that the Treasury had anticipated the debate that was to occur between Keynes and Robertson on the question of the validity of the comparative equilibrium approach of the General Theory.[51] Throughout the General Theory, the explanation of an increase in aggregate demand generated by loan financed expenditure was couched solely in terms of current savings; the other two potential sources of finance - idle balances and an increased money stock - were excluded from consideration. As Trevithick says, this "jeopardised ... the internal consistency of the General Theory" for it introduced "an unfortunate circularity of reasoning in the analysis": if current savings are the sole source of finance then:

> an increase in investment requires an increase in savings before it can become effective, but the increase in savings will only be forthcoming as a result of an increase in income.

Thus "an additional, though temporary, source of finance" was required "to permit the process of expansion to get under way." The Treasury had long maintained such an argument - that an increase in the money stock was required; a point finally admitted by Keynes, after a long and interesting debate with Robertson, in which Keynes changed the emphasis of his argument away from the "simple 'investment determines savings' formula towards a more complex position which acknowledges the interaction between money, saving and investment in a process of disequilibrium adjustment." Thus Keynes eventually held that crowding-out, or as he put it "congestion in the capital market", would result unless the policy calculated to permanently raise activity actually came in two stages:

> Increased investment will always be accompanied by increased saving, but it can never be preceded by it. Dishoarding and credit expansion provides not an <u>alternative</u> to increased saving, but a necessary preparation for it. It is the parent, not the twin, of increased saving. (52)

This theoretical position continued to guide Treasury thinking until at least the end of the 1930s.[(53)] In addition, underlying the Treasury's extreme reluctance, first, to allow the resumption of work on the projects temporarily abandoned in late 1931, and then to support a radical change in policy involving the use of public works as a recovery device, was the fear that such a course of action would conflict with the government's monetary policy (both in its domestic and international aspects) and consequently jeopardise recovery. Thus the question of confidence continued as a major obstacle for those seeking to advance the theoretical case for public works, an obstacle which was largely insurmountable, given its imperfectly specified determinants, and the visible benefits accruing from cheap money.

Later however, in 1937, a change in Treasury opinion has been identified, a change which has been attributed to the growing influence of Keynesian policy prescriptions.[(54)]

This concerned the Treasury's approval (in theory) of a counter-cyclical public works programme to combat the recession that was anticipated as following, first, the run down of house-building, and later, the end of the rearmament programme. On the basis of a priori logic a change in official attitudes towards public works at this time would appear perfectly plausible, given that economists had become more united in their support for, and more convincing in their theoretical justifications of, public works, while the favourable effects of rearmament expenditures on employment could be taken as a demonstration of the legitimacy of the general case for deficit financing. The empirical basis of these influences has been well documented,(55) but their actual influence on the course of events has by no means been proven, for the question at issue is not so much that the Treasury came to support what appears to be a Keynesian policy measure (a policy in fact never pursued because of the war), but whether in actuality this was a change of any particular long-term significance, and whether the operative forces at this time were rather less theoretical developments and rather more the interaction of changing political and economic circumstances occasioned by rearmament.

In pursuing these arguments, our starting point is with the form of the public works programme approved by the Treasury and Cabinet. After investigation by an inter-departmental committee,(56) it was concluded "that the contribution which the Government [might] make towards stabilising employment by a skillful timing of the capital expenditure for which it is responsible is not unimportant; though on the other hand it is not on so considerable a scale as to solve the problem", and that with 'normal' public investment at £250m per annum discretionary adjustments of -£20m and +£30m might be made in years of "abundant employment" and "depression" respectively.(57) The programme finally approved in January 1938,(58) some 4 months after the onset of recession,(59) was thus small in relation to any likely cyclical disturbance: there were to be no substantial additions to the volume of planned public investment, merely an alteration in its medium-term time profile; it was to be financed by local authorities as previously, not by a large central government loan; and the commitment remained to balanced budgets once the rearmament programme was completed. The only policy innovation of any substance was the May 1938 circular to local authorities which requested that they compile 5 year forward investment plans. This has been seen as a "great advance", a first step in the lessening of administrative constraints.(60) Yet, at the time, commentators were rather less sanguine, believing that it was indicative not so much of a commitment to counter-cyclical public works as to an attempt to expedite more speedily the rearmament programme by controlling local authority investment on the basis of the information acquired as a result of the circular.(61)

By mid-1937 sustained pressure for contra-recession measures was being generated by both the economists and a more broadly based, and ultimately more significant, body of political opinion.(62) A future recession was widely forecast, and the view that it could at least be partially mitigated by government action had gained wide currency. This wider opinion, of course, was in part formed by the contemporaneous (theoretical) debates amongst economists;

it was also, however, deeply influenced by empirical considerations, namely the recognition that the measures of 1929-31 had been fatally flawed by overhasty planning (forced by the necessity for immediate action) and easily overwhelmed by the strength of autonomous deflationary forces, whereas if such measures were planned in advance their future effectiveness would be improved accordingly.

These various pressures were most clearly and effectively expressed in House of Commons debates from the autumn of 1937 onwards,(63) debates which became more acrimonious as recession became apparent rather earlier than originally feared, as government failed to respond with a satisfactory policy statement on public works, and instead gave the appearance of "relying upon the acceleration of the defence programme to fill the growing gaps in private enterprise"(64) while giving no real consideration to the period after the ending of the programme. Nevertheless, as we have seen, government was not inactive. It was, however, cautious: the Treasury were anxious that any statement about public works should lay stress upon:

> the need to avoid adding to the already excessive demands upon labour in the building & allied trades & not upon the need to have something in store for the 'slump'. Experience shows how easily business sentiment is influenced & if anything is said that leads to the feeling that the Gov[ernment] agree with those economists who see an imminent slump, many people may shift their plans accordingly and bring about the very thing we all want to avoid. (65)

Once the onset of recession had been recognised, the government's tactics were modified: pronouncements were now made that this was but a temporary setback,(66) and, implicitly, reliance was placed upon rearmament expenditures to stabilize activity 1938-9. Had war not then intervened, contra-recession measures would almost certainly have been applied when necessary after 1941. The decision to finance rearmament partly by borrowing had created a precedent with serious political repercussions: "If you can do that for armaments you are going to have great difficulty in persuading the working men of the country that it is a wrong policy to borrow for real assets in public works."(67) The prospect of a general election in late 1939 or 1940 gave added leverage to those pressing for the forward planning of contra-recession measures.(68)

Treasury documents for 1938-9 show, however, that any such public works effort would have been of limited magnitude,(69) that the individual projects would have had to be 'productive',(70) and that the Treasury were far from accepting the argument that the example of rearmament expenditures served to vindicate the general case for large scale public works.(71) Whilst the favourable employment effects of rearmament were not in dispute _per se_,(72) it was contended that the higher level of employment could not be permanently maintained without further reflationary stimuli;(73) in addition, fears were also being expressed in various quarters that the rearmament programme was retarding structural change and exacerbating the long-term difficulties of the depressed areas.(74)

By the eve of the Second World War, at least on the issue of public works, there were still substantial differences between the Treasury and Keynesian views: the meeting of minds did not come until after the onset of war. But even then, there remained residual doubts about public works, doubts which stemmed from the interwar experience of this policy instrument.(75)

3. Conclusions

In concluding the dissertation reference should first be made to some of the personalities involved in the economic policy debates and attack on Treasury orthodoxy. Two are particularly noteworthy: Lloyd George and Keynes. The former who had been the architect of grandiose employment schemes in 1929 and 1935, and an unwavering critic of government generally throughout the period, was disliked and mistrusted, especially by the two key politicians of the age - Baldwin and Neville Chamberlain.(76) Keynes was similarly tainted by his involvement with Lloyd George,(77) whilst in addition his arrogance and impatience with bureaucrats and politicians,(78) was responsible for the unsympathetic reception given to many of his policy prescriptions and theoretical writings, the General Theory in particular, acceptance of which may have been unnecessarily delayed. In this respect, Phillips's comments on Keynes's 1939 'Crisis Finance' articles(79) is particularly interesting; for although he was in sympathy with much of Keynes's reasoning he felt compelled to make the observation that the articles were marked by "Keynes' customary optimism, over-emphasis and neglect of ulterior consequences. It is almost as though he sets himself out to instil distrust in his readers."(80)

Secondly, the form of the fiscal policy debate requires comment.(81) In view of the practical and administrative problems involved in implementing a public works programme it is somewhat surprising that exponents of the 'new' economics placed so much emphasis on expenditure and so little on discretionary changes in taxation or on automatic stabilizers. On strictly economic grounds there were valid reasons for the economists' preference for adjustments in expenditure rather than taxation: firstly, government expenditure is exhaustive on the first round and thus the multiplier effects are greater than for a given change in taxation; and secondly, since Keynes's diagnosis of under-employment equilibrium centred on a deficiency in investment, the preferred remedy (increased expenditure) was one that acted directly on investment, rather than taxation which operated on consumers' expenditure and only indirectly on investment. Discretionary action on taxes, however, would have probably been more acceptable to the business community - an important consideration given that maintaining confidence had been elevated to a policy objective -, and could have been subject to shorter implementation lags than was the case for expenditure.(82)

As regards automatic stabilizers, these can reduce the problem of time lags,(83) and when compared with discretionary action, are in some sense politically neutral, in that technically it would have been possible to construct a fiscal constitution (with a long-term balanced budget rule) where compensatory adjustments for autonomous fluctuations in activity were effected by automatic stabilizers, the characteristics of which were that they responded speedily to a change in income and were of sufficient importance to prevent cyclical fluctuations becoming unacceptably large.

In an earlier chapter estimates were presented for cyclical macro-marginal budget rates;(84) these showed that the endogenous properties of the 1930s fiscal system were such that the extent of automatic stabilization was marked. With slight modifications, this system would have been eminently suitable for the use of automatic stabilizers to reduce the amplitude of cyclical fluctuations. Moreover, although such a course would have involved a breaching of the balanced budget rule, it did have the advantage that at least the old rule could be replaced by some sort of safeguard calculated to prevent government overspending. This might have done much to mollify Treasury opposition.

One reason why this approach towards stabilization policies was never adopted by the advocates of the 'new' economics may have been the unfamiliarity on the part of most British economists with the continental tradition of public finance studies;(85) public finance in Britain at this time was a branch of economics studied independently of the political process through which decisions on the two sides of the budget were taken.(86) Almost alone amongst advocates of the 'new' economics, James Meade gave the question of automatic stabilizers serious consideration.(87) In general, however, Keynes, on exclusively economic grounds, remained sceptical of their effectiveness,(88) and undoubtedly failed to appreciate the political significance of such an approach to Treasury orthodoxy.

The questions raised by the possible political and operational advantages of automatic stabilizers leads us to a discussion of our third concluding theme: that of the continued belief in balanced budgets. Keynes's attack on this orthodoxy was not confined to the economists; indeed as a proselytiser, he was probably at his most effective in his newspaper articles where he reached and influenced a much wider audience.(89) But it is doubtful that even Keynes, with all his persuasive skills and dazzling literary gifts, could overthrow this doctrine; for too long financial integrity had been perceived as the bedrock of British democracy.[90] Something more fundamental was required: it is the irony of history that this profound change of opinion could only come through the practical experience of successful deficit financing, and that this was to be provided by the Second World War, when the rationale was not full employment as such but the maximum war effort. Indeed this is the key to the whole question, for doubts about unbalanced budgets were only dispelled when deficit financing could be seen to be successful, when it generated full employment without unacceptable political and economic costs. We have seen in the postwar period, and particularly since the early 1970s, that were that success to be in question, were the policy to be seen as imposing unacceptable costs (such as accelerating inflation), the balanced budget doctrine can quickly reappear for it has a simple and eminently logical appeal as an explanation of the root cause of Britain's difficulties.

Fourthly, mention should be made of the complexion of interwar civil service administration, the administrative climate in which economic policies were debated and implemented. The point should be admitted that arguments couched in terms of administrative impracticability are the usual plea of a defensive bureaucracy, and no doubt this was partly the case for the Treasury in the 1930s. Nevertheless, when the Treasury were far from convinced of the fundamental correctness of the 'new' economics, both in theoretical terms and in its applicability to the current unemployment problem, there was an understandable reluctance to institute the major administrative reforms necessary for the adoption of large scale public works, for this would have involved bringing a greater volume of public investment under direct central control and establishing a planning agency to formulate long-term plans and supervise their execution,[91] changes which would have had a profound influence on the structure and operation of British politics.

More generally, however valid be Keynes's specific accusations against the civil service, that it was ruled by those "trained by tradition and experience and native skill to every form of intelligent obstruction",[92] it is clear that the amateurism of the British civil service was becoming increasingly inappropriate to the range and complexity of problems confronting interwar bureaucracy and governments. It is to be regretted that the higher civil service, as it evolved under Fisher's direction, stood "aloof from some of the most significant contemporary developments in the study of public administration", that it was "far more concerned with developing the *esprit de corps* of the civil service than with administration *per se*."[93]

Finally, the questions under consideration also need to be seen in a wider context. An all pervasive feature of the interwar fiscal policy debate was that the form of debate, by all parties concerned, was such as to obscure many of the real issues requiring analysis. This followed inevitably from the fact that the debate was conducted within a limited ambit: economic policy questions were approached from the 'Establishment' point of view, with a number of built-in assumptions which begged a large part of the arguments - assumptions, in particular, relating to the inviolability of the prevailing political system and the rôle of government. The Second World War caused an immediate and profound reappraisal of these assumptions. The emergency which overtook the whole nation was deemed to justify a radical modification of existing administrative and political systems. It could have been argued that the emergency which overtook the unemployed in the 1930s was just as pressing for them as anything that threatened the nation as a whole in the war,[94] but of course no such arguments were articulated. Unemployment was deemed not to constitute such an emergency and thus did not justify any radical changes, changes which were a necessary pre-condition for a successful solution to Britain's unemployment problem.

APPENDIX I

Government borrowing and non-recurrent revenue

Reference was made in an earlier chapter (above pp.100-02) to a number of adjustments made to receipts (T_c), expenditure (G_c), and the budget balance (B_c), in order to obtain an unchanging, and economically more significant, definition of the budget balance (B). A brief discussion follows of the items constituting these adjustments.

1. Government borrowing

On the expenditure side of the national accounts the consolidation of the social insurance funds and the removal of sinking fund payments needs no further explanation. The explanation of the other adjustments (set out in Table IA) is as follows:

(a) Capital expenditure 'below the line'. This, the only item in the budget accounts specifically shown as capital expenditure, covered expenditure on Post Office development, it being considered permissible to finance such expenditure by borrowing because the assets acquired were remunerative in an accepted accounting sense. Other capital items were incorporated in capital expenditure 'above the line', e.g. expenditure on road programmes.

(b) Other expenditure financed by borrowing. This includes two items: (1) borrowing to meet interest on the encashment of savings certificates; and (2) borrowing in 1932/3 to cover the cost of the War Loan conversion operation. Both items properly belong to expenditure, being charges that in normal circumstances would have been met within the budget.

(c) Defence borrowing. This item constitutes borrowing under the Defence Loans Acts, 1937 and 1939, and needs to be incorporated as part of our adjustments since G_c only included defence expenditure financed out of revenue.

2. Non-recurrent revenue

These items (set out in Table IB), which came under the head 'Miscellaneous Revenue' in the financial accounts, can be considered under two headings:

(a) Capital accounts

Old Exchange Account
War Loan Depreciation Fund
National Debt Commissioners - Death Duty Account

(b) Miscellaneous Funds

Road Fund
Rating Relief Suspense Account
Profits of the Bank of England note issue
Enemy Debt Clearing Office - Surplus

Items falling under the former heading were taken into receipts (T_c) for a variety of reasons, but in general the accounts had become obsolete and could be presented as containing capital sums which might be thus appropriated. In general, these sums had usually been put to debt redemption, and thus the transactions were a convenient facade for masking fresh borrowing.*

Under miscellaneous funds, account is taken of 'raids' on the capital balances of the Road Fund, the fictitious resources of the Rating Relief Suspense Account, which was merely an earmarking of past surpluses, and two miscellaneous items: profits of the Bank of England note issue and the surplus of the Enemy Debt Clearing Office, there being evidence that they were included according to necessity.**

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* See, for example, T171/287, Hopkins to Snowden, undated (but about 19 March 1931); T171/309, Treasury Memorandum, 'War Loan Depreciation Fund', undated (but late March 1933).

** See T171/296, Hopkins, 'Budget Estimate: 1932', 15 March 1932; T171/315, Waterfield to Hopkins, 4 April 1936. In the case of the profits of the note issue, the sums included in Table IB are estimates of the discretionary element of total payments, i.e. payments above the average.

Table IA

Expenditure adjustments - sinking fund payments and government expenditure charged to capital, 1929/30 - 1939/40 (£m)

	1929/30	1930/1	1931/2	1932/3	1933/4	1934/5	1935/6	1936/7	1937/8	1938/9	1939/40
Sinking fund (SF)	-47.7	-66.8	-32.5	-26.3	-7.7	-12.3	-12.5	-13.1	-10.5	-13.2	-7.2
Capital expenditure (CE)	+10.5	+11.0	+9.7	+7.5	+6.5	+7.5	+10.5	+13.5	+17.0	+22.6	+22.1
Other borrowing (OB)	+4.8	-	+8.4	+25.9	-	-	-	-	-	-	-
Defence borrowing (DB)	-	-	-	-	-	-	-	-	+64.9	+128.1	+491.7
Total adjustments	-32.4	-55.8	-14.4	+7.1	-1.2	-4.8	-2.0	+0.4	+71.4	+137.5	+506.6

Sources: Financial Accounts.

Table IB

Revenue adjustments - non-recurrent receipts included in 'Ordinary and Self-Balancing Revenue', 1929/30 - 1939/40 (£m)

	1929/30	1930/1	1931/2	1932/3	1933/4	1934/5	1935/6	1936/7	1937/8	1938/9	1939/40
Old Exchange Account	-	-	-12.8	-	-	-	-	-	-	-	-
War Loan Depreciation Fund	-	-	-	-	-10.0	-	-	-	-	-	-
National Debt Commissioners - Death Duty Account	-	-	-	-	-	-	-	-5.8	-1.5	-1.5	-1.4
Road Fund	-	-	-	-	-	-	-4.5	-5.3	-3.6	-	-
Rating Relief Suspense Account	-	-16.0	-4.0	-	-	-	-	-	-	-	-
Profits of Bank of England note issue	-	-3.7	-0.6	-8.9	-	-	-	-	-	-	-
Enemy Debt Clearing Office - Surplus	-3.5	-3.5	-3.5	-3.0	-	-	-3.5	-0.7	-	-	-
Total adjustments	-3.5	-23.2	-20.9	-11.9	-10.0	-	-8.0	-11.8	-5.1	-1.5	-1.4

Sources: As Table IA; Road Fund Accounts; T239/25-7, Treasury Register of Daily Receipts.

APPENDIX II

Estimating procedure for receipts and expenditure

1. Central government receipts at constant employment

Central government receipts at constant employment (T*) are shown in Table IIA according broadly to the five main categories of revenue.

(i) Taxes on expenditure

(a) Customs and Excise other than import duties. Separate elasticities were calculated for taxes on spirits, beer, tobacco, sugar, hydrocarbon oils, and a residual category, using a method adopted from that employed in previous studies of tax elasticities (Bretherton 1937; Edelberg 1940). The first step was to take account of changes made in the rates of duty, by applying the estimates given in the budgets of the time of the effects of these changes on revenue, to obtain revenue series on a constant rate basis. An elasticity of revenue with respect to GDP at current prices was then calculated, taking the change in revenue against the change in GDP between the two constant employment base years. This method yielded the following results:

Tax	Elasticity
Spirits	0.80
Beer	0.32
Tobacco	1.22
Sugar	0.27
Hydrocarbon oils	2.96
Other Customs and Excise	1.49

It is possible to compare these results with those of Bretherton and Edelberg. The former took account of discretionary changes in calculating tax elasticities, constructing hypothetical tax yields which were then related to national income, for three periods: the upswing of the 1920s, the downturn of the early 1930s, and the subsequent recovery period (to 1935/6). Bretherton's indices of hypothetical yields for spirits, beer, tobacco, and sugar conform well with our estimates on a constant rate basis, despite the fact that his starting point was 1922, not 1929, while his estimates of tax elasticities for the upswing and recovery phases correspond fairly closely with our results. Edelberg used the percentage employed (i.e. 100% less the unemployment rate) as his cyclical index of activity, and related tax yields to employment to derive indirectly a measure of the income elasticity of demand, but did not correct for discretionary changes in tax rates. Consequently, there is little correspondence between our results and no further account is taken of them.

Using the above elasticities the actual yields were adjusted to a constant employment basis by applying the ratio (Y*/Y).

(b) Import duties. A similar method was used, but the adjustments were complicated by the fact that a general protective tariff was introduced in 1931-2 (increasing the revenue under this head from £4.8m in 1931/2 to £28.8m in 1932/3) which precluded direct comparison between our end years on a constant rate basis. Hence the actual values for 1930/1 and 1931/2 were roughly adjusted (by the ratio) to derive their constant employment values, while the yields for 1932/3 and subsequent years were adjusted to a constant rate basis, again using the official estimates of the effect of the authorities' discretionary action. An elasticity of revenue with respect toGDP was then calculated for the period 1932/3 to 1937/8, allowance being made for the extent to which GDP was below the constant employment level in 1932/3. The elasticity of import duty revenue with respect to GDP was found to be approximately 2.1.

(c) Motor vehicle licence duties. These duties were first recalculated on to a constant rate basis, and an elasticity of revenue with respect to GDP of approximately 2.1 was obtained, which corresponded closely with Bretherton's estimate.

(d) Stamp duties. Revenue from these miscellaneous taxes upon the transfer of assets was cyclically highly sensitive, with turning-points one year in advance of GDP, but largely insensitive to trend growth: revenue on a constant rate basis peaked in 1928/9 and 1936/7 at £30.1m and £31m respectively. It was assumed that at constant employment these duties would have yielded £30m per annum, thus implying that stock exchange prices would have remained constant at constant employment - an approximate but not absurd assumption for a period during much of which the general price level is assumed to have fallen (in line with the actual course of prices), while output is assumed to have been rising.*

(e) Post Office surplus. This was included as a revenue item since it was subject to government control, but was treated as autonomous (see below).

(f) Other. A residual item of miscellaneous taxes which were small in magnitude (about £2m per annum) and largely invarient to changes in income, and therefore not adjusted.

(ii) Taxes on income

(a) Income and surtax. Their constant employment values were obtained by calculating an aggregate tax elasticity relating changes in their yield at actual

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* There was no clear relationship between changes in asset prices and variations in GDP and hence it was decided to exclude this duty when calculating macro-marginal budget rates. A similar problem was encountered with Estate duties.

employment to changes in GDP,* which were then applied, using the ratio, to their actual values.

A number of general problems were encountered. Firstly, income tax was levied one year and surtax two years in arrears,** so that separate elasticities had to be calculated taking into account the differential lags. Secondly, the official ex ante estimates of the change in revenue resulting from discretionary changes had to be used, but on occasions changes in revenue from year to year were associated with changes in GDP of the opposite direction. Fortunately, such occasions were rare.

The actual yields of income and surtax were adjusted to a constant rate basis for comparison with any two consecutive years.*** Allowing for the lags, changes in yields were then related to changes in GDP and elasticities year by year were obtained. Ignoring the perverse results referred to above, means of observations were taken and found to be 1.60 for income tax and 3.71 for surtax.

The estimate for income tax almost exactly corresponds to Edelberg's estimate of 1.61 for the years 1927-37, despite the fact that his correlation analysis only took account of changes in the standard rate, and not changes in allowances, etc. Comparison with Bretherton's estimate is precluded because, unlike Edelberg, he did not lag receipts against GDP. Other contemporary evidence, however, suggests that an elasticity of 1.60 is of the right order of magnitude for a fully progressive income tax and given the technical details of its levy (Hicks 1938: 292, 300).

Verification of our surtax elasticity proved more difficult. Surtax introduced progression into income tax for the higher income groups, the incomes of which were undoubtedly reduced by depressions and expanded by booms in greater proportion than those with moderate incomes.**** Thus one would expect a large, positive elasticity, but the result obtained (i.e. double that of income tax) is very

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* This method has been used most successfully by Prest (1962).

** Hicks (1938: 303); see also Edwards and Black (1938) and Hicks (1941) for details of the full implications of these lags.

*** This method was favoured because estimates of the effect of discretionary action for these taxes were probably more susceptible to inaccuracy the further away from the base year than estimates for other taxes.

**** See Stamp (1936). Inland Revenue data shows that not only did the distribution of surtax incomes change with the cycle but that there was a marked trend over the period towards a greater equalization of incomes.

Surtax - distribution of incomes (%)

Incomes (£)	1925/6	1929/30	1932/3	1937/8
2,000 - 6,000	44.0	46.7	53.1	50.9
6,000 - 25,000	36.6	35.7	33.4	34.9
25,000+	19.4	17.6	13.5	14.2
	100.0	100.0	100.0	100.0

Source: Reports of the Commissioners of His Majesty's Inland Revenue, 1928, 1933, 1935, 1946 high, primarily because of our observations for 1931/2 to 1932/3.* If this is omitted, the elasticity is reduced to 2.72; this revised elasticity was used in our adjustments, but since surtax was small in relation to total receipts the difference is not important.

(b) National Defence Contribution. This, a profits tax introduced in 1937, was first levied for the accounting period ending 1937/8. The technical details of the tax (see Charge of National Defence Contribution, Cmd. 5485 (1937) enable us to assume that its yield at constant employment would not have differed significantly from its actual yield. Hence no adjustment was made.

(c) Other. This class of revenue consisted of two profits taxes levied during and immediately after World War I, which continued to yield small amounts during the period. Since they were levied on profits earned before 1929, adjustment is unnecessary.

(iii) Taxes on capital

This head comprises estate duty which showed a high cyclical sensitivity because asset prices fluctuated more than national income, and the duty was progressive. As with stamp duties, estate duties were insensitive to trend growth: on a constant rate basis, the yield in our two base years was almost identical - £79.8m in 1929/30 and £80.1m in 1937/8. Consequently, the constant employment values were interpolated between the actual values for the two base years, taking into account rate increases in 1930/1 and 1939/40.

(iv) National insurance contributions

(a) Unemployment. A statistically significant relationship was found between private sector contributions to the Unemployment Fund and the level of GDP. The actual contributions were therefore adjusted by the ratio.**

(b) National Health and (c) Contributory Pensions. The same method was used and found to be satisfactory. Thus, for private sector contributions to all three schemes,

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* Owing to the "heroic efforts" of direct taxpayers in 1931/2 who had paid their surtax promptly, the yield was significantly above the estimate. With few arrears to collect the following year, the yield was considerably below the estimate (see 264, H.C. Deb. 5s. 19 April 1932, cols.1415-17; 277, H.C. Deb. 5s. 25 April 1933, cols. 34-5). Thus, for a given change in GDP, there was an unrepresentative change in yield, and consequently the very high elasticity for 1931/2 to 1932/3 is spurious and should be left out of account.

** This method was tested by standardizing contributions on to a 1931 constant rate basis, adjusting them by the ratio to derive constant employment values, and then, by regression analysis, relating them to constant employment GDP. The only year of any marked divergence from the relationship, 1939/40, is explained by the growth of the armed forces (which, under §.41(1) of the Unemployment Insurance Act, 1920, did not contribute directly to the Unemployment Fund) and the decline of civil employment due to the demands of the war economy.

a unitary elasticity with respect to GDP was implicitly assumed.

(v) Miscellaneous Revenue

This was the residual item in the revenue side of the budget accounts, covering a number of miscellaneous tax and non-tax receipts and the income of the Post Office (less the surplus, included in taxes on expenditure). The revenues varied markedly over the period, but this is explained by the fact that they included: (a) reparation receipts and the sale of war property during the years 1929/30 to 1931/2; and (b) non-recurrent receipts which, as shown above, varied markedly. Removal of such items leads to a fairly stable revenue series, and hence these revenues were assumed to be autonomous.*

2. Test of accuracy of revenue estimates

It is possible to cross-check our results for one year with some estimates published by Kaldor (1944) of the full employment yield of taxes in 1938, derived by a different approach. Kaldor estimated that the achievement of full employment (3% unemployment) would have raised the net national income by 10.7% and been associated with an increase in central government receipts of 11.6%. This gives an aggregate tax elasticity with respect to national income of 1.08, while our method (7.6-8.0% unemployment) yielded a 3.1% increase in revenue corresponding to an increase in GDP of 3.0%, thus giving a marginally lower elasticity of 1.03.

The similarity between the two results provides corroborative evidence of the probable accuracy of the revenue side of our estimating procedure. The difference between the two aggregate tax elasticities is explained by:

(a) Kaldor's estimate for direct taxes was (implicitly) on an accruals basis, whereas ours was on a payments basis, assuming a lag for income and surtax against GDP.

(b) The major part of the growth of employment was assigned by Kaldor to a growth in incomes of the primary and secondary sectors so that, because of the productivity difference between these sectors and the service sector, output and employment were increased significantly for a given increase in employment.

(c) The significant difference between average and marginal shares of undistributed profits in income (7 and 23% respectively) used by Kaldor resulted in a substantial proportion of the increase in income resulting from the attainment of full employment being put to a tax base whose elasticity with respect to income was markedly above the average for the fiscal system as a whole. Consequently, a given increase in incomes resulted in large increases in total receipts.

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* The only constituent of this item which could be expected to vary with income was the trading receipts of the Post Office. No correction has been made to its revenue (or expenditure) since it was a trading enterprise, and, from inspection of its figures, it appears to have had a target surplus which it would achieve (roughly) despite variations in the actual level of employment.

3. Central government expenditure at constant employment

Transfer payments to the unemployed through the Unemployment Insurance Fund and transitional payments (later undertaken by the Unemployment Assistance Board) were the only items of endogenous expenditure adjusted,* although there were a number of other expenditures which were unemployment-related. These were not adjusted since their magnitude was small (reaching a peak of £11.5m in 1931/2), and at our assumed rate of unemployment there would have remained a residual unemployment problem of some seriousness, necessitating expenditure on, for example, the depressed areas where unemployment rates were significantly in excess of the national average.

Outlay on unemployment benefits at constant employment were calculated as follows:** the total numbers unemployed and numbers claiming benefits were assumed at constant employment to have grown steadily year by year with the growth of the labour force.*** These figures were interpolated between the two base years to give their constant employment values. Three assumptions were then made:

(i) Average benefits per claimant would have remained unchanged at constant employment.

(ii) The distribution of claimants between the two unemployment payments schemes would have remained unchanged.

(iii) The numbers claiming benefits as a ratio of the total numbers unemployed would have remained constant (at 0.83).

The results obtained by this method appear to pick up both discretionary changes and the effect of the growth in the numbers unemployed. Their reliability was tested by varying assumptions (ii) and (iii).

With regard to (ii), the short-term unemployed essentially fell within the ambit of the unemployment insurance scheme while the long-term unemployed received their payments from the transitional payments/unemployment assistance scheme. The average cost per claimant was higher in the latter scheme, and hence a change in the average duration of unemployment could be expected to lead to a change in total outlay on benefits.

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* Benefits paid by the other social insurance schemes were assumed to be autonomous. Eligibility for health and pension benefits were largely unaffected by unemployment (Davison 1938: 60-61), while early retirement was not used as a means of mitigating unemployment.

** The calculation of a satisfactory series for outlay on unemployment benefits presented innumerable difficulties. It proved impossible to derive a satisfactory statistical function relating the level of unemployment to outlay on unemployment benefits, nor was there a direct relationship to changes in GDP. It seems that a conflation of unemployment duration effects and numerous discretionary changes in benefit rates and eligibility for unemployment benefits were responsible for these difficulties.

*** Whilst the <u>numbers</u> unemployed increased, the unemployment <u>rate</u> remained within the range 10.8 to 11.1% of the insured labour force.

Between 1929 and 1937, the two constant employment base years when unemployment rates were approximately similar, there was a marked increase in the average duration of unemployment - the proportion of all applicants for unemployment benefits who had been unemployed for over 6 months (i.e. long-period unemployed) rose from 10.9 to 34.3% (Beveridge 1944: Table 8) - largely as a consequence of the intervening depression. If constant employment had been continuously achieved during these years it is likely that the observed duration of unemployment would have been rather different, and this might have affected outlay on unemployment benefits. To test this hypothesis, the ratio of unemployed receiving benefits under the insurance scheme to the other schemes was varied and it was found that the effect on total outlay was negligible: a 5 percentage points change in the ratio of claimants between the two schemes leading to an average change of only £0.52m in total outlay on benefits at constant employment.

Assumption (iii) was also found to have a minimal influence on our results: only in 1930/1 and 1938/9 would the constant employment outlay have been higher than our estimate if the actual ratio of claimants to total numbers unemployed had been left unadjusted, whilst for the rest of the period they would have been lower. The effect in each case was unimportant.

Total central government expenditure, at both actual and constant employment, is given in Table IIB.

Table IIA: Central government receipts at constant employment, 1929/30 - 1939/40 (£m)

	1929/30	1930/1	1931/2	1932/3	1933/4	1934/5	1935/6	1936/7	1937/8	1938/9	1939/40
1. Taxes on expenditure											
Customs and Excise	247.3	256.3	280.7	325.9	318.1	310.6	315.3	321.3	335.6	354.8	411.0
Motor vehicle licences	26.8	30.4	33.0	34.2	36.1	35.0	32.7	32.9	34.6	37.8	35.5
Stamp duties	25.7	30.0	30.0	30.0	30.0	30.0	30.0	30.0	30.0	30.0	30.0
Post Office surplus	9.2	10.1	11.5	10.9	13.1	12.3	11.7	11.0	10.5	9.5	3.8
Other	2.2	2.1	2.2	2.0	2.0	2.1	2.2	2.1	2.0	2.0	2.0
Total	311.2	328.9	357.4	403.0	399.3	390.0	391.9	397.3	412.7	434.1	482.3
2. Taxes on income											
Income and surtax	293.8	323.9	384.3	357.7	334.3	325.4	320.8	330.4	361.0	398.9	478.6
N.D.C.	-	-	-	-	-	-	-	-	1.4	21.9	26.9
Other	2.3	3.0	2.5	2.2	1.8	2.3	1.3	1.0	1.0	0.9	0.6
Total	296.1	326.9	386.8	359.9	336.1	327.7	322.1	331.4	363.4	421.7	506.1
3. Taxes on capital											
Estate duties	79.8	82.7	87.9	87.9	87.9	88.0	88.0	88.0	89.0	89.0	94.2
4. National insurance contributions											
Unemployment	31.4	31.5	37.4	43.3	43.5	45.2	45.9	44.2	44.6	47.0	46.7
National health	26.4	27.6	28.9	29.6	28.9	29.0	28.9	29.4	30.2	31.7	31.9
Contributory pensions	24.5	25.0	25.5	25.5	25.6	25.6	27.0	31.9	33.1	34.1	33.9
Total	82.4	84.1	91.8	98.4	98.0	99.8	101.8	105.5	107.9	112.8	112.5
5. 'Miscellaneous Revenue'	127.9	142.3	105.8	87.3	86.2	81.3	92.7	101.3	95.6	99.0	110.1
6. <u>less</u> non-recurrent receipts	3.5	23.2	20.9	11.9	10.0	-	8.0	11.8	5.1	1.5	1.4
Total receipts (T*)	893.9	941.7	1008.8	1024.6	997.5	986.8	988.5	1011.7	1063.5	1155.1	1303.8

Source: Calculated from the actual figures on the basis of the estimating procedure outlined above.

Table IIB: Central government expenditure, actual and constant employment, 1929/30 - 1939/40 (£m)

	1929/30	1930/1	1931/2	1932/3	1933/4	1934/5	1935/6	1936/7	1937/8	1938/9	1939/40
1. Total Ordinary and Self-Balancing Expenditure (G_c)	829.5	881.0	851.1	859.3	778.2	797.1	841.8	902.2	919.9	1018.9	1408.2
2. Expenditure adjustments	-32.4	-55.8	-14.4	+7.1	-1.2	-4.8	-2.0	+0.4	+71.4	+137.5	+506.6
3. Total benefits paid by social insurance funds	+155.9	+214.4	+239.8	+235.6	+221.0	+220.0	+222.9	+214.0	+220.7	+242.3	+220.1
4. Government contributions to social insurance funds	-76.5	-100.3	-116.3	-147.9	-141.3	-138.8	-143.0	-141.3	-144.8	-147.4	-144.7
5. Total expenditure at actual employment (G)	876.5	939.3	960.2	954.1	856.7	873.5	919.7	975.3	1067.2	1251.3	1990.2
6. Adjustment to constant employment*	-	-44.7	-58.1	-54.0	-33.4	-24.7	-17.0	-1.0	-	-15.5	+17.7
7. Total expenditure at constant employment (G*)	876.5	894.6	902.1	900.1	823.3	848.8	902.7	974.3	1067.2	1235.8	2007.9

Sources: (1) *Financial Accounts*; (2) App. I Table IA; (3)-(4) Working notes to Feinstein (1972).
Notes: * Total unemployment benefits at actual employment less total benefits at constant employment.

NOTES

Chapter 1

1 The Times, 23 Jan. 1943; see also the articles 'Planning Full Employment' of 22-23 Jan.

2 Robinson (1976: 71).

3 But see Matthews (1968) for a powerfully argued critique of the orthodox view of full employment and the postwar British economy.

4 Nowhere is this more clearly argued than in Stewart (1972).

5 In "what must surely be the most breathtakingly frank public pronouncement since St. Paul's First Epistle to the Corinthians" (Jay 1976) Prime Minister Callaghan, speaking at the 1976 Labour Party Conference (see Dean 1979: 50), moved far towards rejecting the whole intellectual basis of deficit finance. Increasing disillusionment with demand management was later made public by the Treasury (Wass 1978), and, of course, has intensified with the present Conservative government (see 1980 budget speech).

6 As yet no academic studies along these lines have been published, but the theme has attracted attention in The Times; see, for example, Congdon (1975).

7 Allen (1950: 464).

8 Booth and Glynn (1975); see also Beveridge (1936: 357-61).

9 See, for example, Wood (1972; 1975).

10 See Department of Employment and Productivity, British Labour Statistics, Historical Abstract, 1886-1968 (1971), pp.12-18 (hereafter Department of Employment and Productivity 1971) for a discussion of their coverage and imperfections.

11 Booth and Glynn (1975: 613-14) have argued that Feinstein's series overstates the numbers unemployed. Hatton (1977), however, has found no grounds for this objection, and in fact shows that the opposite was the case, that the series understates unemployment, a conclusion verified by Broadberry (1980).

12 See Beveridge (1944: 72-3), Galenson and Zellner (1957: 459), and Booth and Glynn (1975: 612) for attempts to recalculate the pre-1914 and interwar unemployment series onto comparable bases.

13 See, for example, Booth and Glynn (1975) who, to a limited degree, adopt such an approach.

14 For such arguments, see Benjamin and Kochin (1979); for a thorough critique of this view, see Hatton (1979).

15 Beveridge (1936); Booth and Glynn (1975).

16 The analysis follows that of Adlcroft (1970a: 135-6).

17 Feinstein (1972: Table 57).

Chapter 1: Notes 18-43

18 Calculated from ibid. Tables 55, 57.

19 Ibid. Table 56.

20 London and Cambridge Economic Service (1972: Table F) (hereafter LCES 1972).

21 Aldcroft (1970a: 136).

22 Data from Matthews (1964: 81).

23 Aldcroft (1970a: 135). Matthews's (1964) estimates have since been updated and will appear in Matthews, Feinstein, and Odling-Smee's forthcoming study British Economic Growth in Historical Perspective.

24 Table 1.1 is drawn from Beck (1951), a comparatively unknown work, but one which along with Beveridge's studies (1936; 1937a; 1937b; 1944) are invaluable statistical sources for any detailed study of interwar unemployment.

25 The 'new-old' industries debate is surveyed in Alford (1972); it is also further discussed at a later point in this chapter, see pp.15-16 below.

26 This reinterpretation is particularly associated with Booth and Glynn (1975); but see also Tomlinson (1978) for a critique of this paper, and Booth and Glynn's (1980) restatement of their position.

27 Cripps and Tarling (1974: 289).

28 See Industrial Transference Board, Report, Cmd.3156 (1928).

29 Beveridge (1937a: 11).

30 Beveridge (1944: 66).

31 Ibid. pp.66-7, Table 9.

32 McCrone (1969: 91).

33 Pilgrim Trust (1938: 75).

34 For critical surveys of the traditional interpretation, see Aldcroft (1966; 1967).

35 Lomax (1964: 15).

36 Alford (1972: 14).

37 The first doubts about the rôle of the 'new' industries in the interwar growth process were expressed by Dowie (1968); they have been confirmed and elaborated by the later work of Buxton (1975) and Tunzelman (1978). See also Pollard's (1970: 5) comments about interwar growth and unemployment.

38 Aldcroft (1966: 234); see also Richardson (1969).

39 Howson (1975: 63).

40 See Buxton (1975: 210-21), and Kahn (1946: ch. VII).

41 Matthews (1964: 91-6); Dowie (1968: 65).

42 Alford (1972: 20).

43 Data from Matthews, Feinstein, and Odling-Smee's forthcoming study. I should like to thank Prof. Feinstein for allowing me to see a summary of their results prior to publication.

Chapter 1: Notes 44-68

44 Matthews (1969: Table 4-1).

45 Ibid. Table 4-2; see also Meyer and Lewis (1949).

46 For a contemporary account of the trade cycle 1929-37, see MacDougall (1938); for more modern analyses, see Richardson (1967: chs. 1-2) and Aldcroft (1970a: ch. 2).

47 Sayers (1967: 53).

48 See Phelps Brown and Shackle (1939); Corner (1956); and Richardson (1967).

49 Richardson (1967: 6).

50 Ibid. pp.15-16.

51 See pp.235-9 below.

52 Richardson (1967: 28).

53 Calculated from Department of Employment and Productivity (1971: Table 162).

54 Phelps Brown and Shackle (1939: 125).

55 Richardson (1967: 33-4); see also Brown (1940) for a contemporary survey of this cyclical episode.

56 See pp.242-4 below.

57 For international comparisons, see Hodson (1938); Richardson (1967: ch.12); and Kindleberger (1973).

58 See p.170 below for Chamberlain's disparaging comments about the recovery policies adopted by other countries.

59 As yet, there is no detailed study of interwar British exports, but see Aldcroft (1970a: ch.8) for a survey of the main issues.

60 The behaviour of imports is discussed in Chang (1951: ch. VI) and Scott (1963: esp. ch. II).

61 Calculated from Feinstein (1972: Tables 3, 5).

62 See Aldcroft (1970a: 247) and references cited therein.

63 See, for example, Kahn (1931; 1933) and Keynes (1933). However, in the General Theory, Keynes recognised that supply constraints might begin to operate before full employment was reached (Keynes 1936: 300-03). On the cyclical relationship between prices and output, see also Shapiro (1976).

64 Aldcroft (1970a: 44-5, 356); Richardson (1967: 31-2, 39, 232).

65 Beveridge (1937b: 181); see also The Economist, 25 April 1936 (Trade Supplement); 26 Sept. 1936 (Trade Supplement); 3 April 1937, pp.1-2; 26 June 1937, p.718.

66 Richardson (1967: 22).

67 A view which, in large measure, found support from Keynes (1937); see also Hutchison (1968: 295-8; 1977: 10-16).

68 See Howson (1981) for a discussion of this problem in the context of the interwar period.

Chapter 1: Notes 69-75

69 Thirlwall (1969: 20-21); Dixon and Thirlwall (1975: chs.4-5).

70 See in particular Brechling (1967) and Archibald (1967) for further analyses of this point; see also Broadberry (1980) who tentatively suggests that regional unemployment differentials have in fact widened since the interwar period.

71 But see Glynn and Howells (1980).

72 See Archibald (1967); and Brown (1972: esp. ch.8).

73 See Makower et al (1939).

74 See, for example, Pilgrim Trust (1938: 71-3) for the seemingly paradoxical situation that arose in the Welsh coalfields in 1936-7 where there was both excess demand for underground workers and apparently also excess supply, a situation that arose because of the practice of long unemployed miners continuing to register their attachment to the industry although unemployment had seriously impaired their ability to be able to undertake such employment.

75 Burns (1941: 263-77).

Chapter 2

1 This chapter draws upon part of a forthcoming paper (Middleton 1981b).

2 Brittan (1964: 33, 39-40); Heclo and Wildavsky(1974: 41-2).

3 See, for example, Amery (1955: 50).

4 See Heath (1927); Bridges (1950a; 1966); Roseveare (1969); Chapman and Greenaway (1980).

5 On Fisher's personal influence, see Hamilton (1951); Watt (1965: 100-16); Peden (1979a); and Chapman and Greenaway (1980: ch.2).

6 Bridges (1950a: 10-12); Treasury expenditure control is discussed below, pp.57-63.

7 Cited in Heclo and Wildavsky (1974: 203). The civil servant's identity is not revealed.

8 See pp.47-8 below for a discussion of the interwar figures; postwar data from O.E.C.D. (1978: 12).

9 This was one of Keynes's favoured remedies for unemployment; see, for example, Keynes (1933). It was also put to the House of Commons on a number of occasions by Macmillan (e.g. 276, H.C. Deb. 5s., 22 March 1933, cols. 346-55).

10 T171/296, P.J. Grigg [Chairman, Board of Inland Revenue 1930-4] to J.D.B. Fergusson [Private Secretary to successive Chancellors of the Exchequer 1920-36], 11 April 1932.

Chapter 2: Notes 11-35

11 See Chamberlain's 1933 budget speech (discussed at pp.168-70 below) for a more detailed account of Treasury opposition to this proposal.

12 See pp.107-22 below.

13 Brittan (1964: 41); Heclo and Wildavsky (1974: 50-6).

14 Chester and Willson (1968: 284).

15 Robinson (1978: 9) and references cited therein.

16 Amery (1955: 81).

17 Moggridge (1972: 64-79).

18 Newman (1972: 340).

19 Ibid. p.18. Newman's comments, strictly speaking, relate to the period 1918-25; nevertheless, the more detailed researches of Moggridge (1972) and Howson (1975) on this period would not lend support to her view.

20 See Booth and Glynn (1979) for the opposing view, the view that the available documents in the Public Record Office are incomplete and potentially misleading, whilst the focusing of research on these papers induces a bias towards the study of administrative processes rather than the causes and effects of policies.

21 Heath (1927: 1) cited in Fry (1969: 26).

22 See above p.32.

23 Jennings (1959: 163); see also Beer (1956: 122-4) and Chester and Willson (1968: 284).

24 For example, the failure of the 1929-31 Labour administration to tackle unemployment has traditionally been partially ascribed to Snowden's orthodoxy (e.g. Attlee (1954: 68-9, 72-3); for an opposing view, see McKibbin (1975).

25 Heath (1927: 63).

26 Neville Chamberlain Papers (hereafter N.C.), N.C. 2/23A, Neville Chamberlain Diary, 28 Jan. 1935. Chamberlain was advised by Fisher that, if he took such a stand, Cabinet would rule out the possibility of Lloyd George's candidature.

27 See Booth (1978); and pp.255-6 below.

28 Bridges (1950b: 15).

29 Beer (1956: 112-13); see also Dale (1941: chs. IV-V).

30 Woods (1954: 376).

31 Chester (1951b: 14).

32 Bridges (1950b: 30).

33 See pp.71-2, 265-7 below.

34 Bridges (1950b: 15-16).

35 Committee on Finance and Industry (Macmillan Committee), Minutes of Evidence (1931), Q.5494-5710.

Chapter 2: Notes 36-50

36 See p.249 below.

37 There are also certain difficulties associated with the Cabinet papers as an historical source, in particular that the minutes of Cabinet meetings (Cab 23) do not fully record disagreements within Cabinet (Roskill 1972: 476-7) while no record was made of the pre-budget meetings of the Cabinet.

38 Space precludes a discussion of Treasury organisation; it is, however, well covered in the published literature (see Heath 1927; Bridges 1966; and Peden 1979b), and in the official papers (see T160/631/F.14575, G. Ismay [Principal, Treasury], 'Work of the First Division', 12 Aug. 1927; S.D. Waley [Assistant Secretary, Treasury 1924-31; Principal Assistant Secretary 1931-9], 'The Work of the Second Division', 12 Aug. 1927).

39 There is a relative abundance of biographical material on Hopkins, and much is known about his personality (see Eady 1971; Harrod 1972; and 'Sir Richard Hopkins' 1956); unfortunately, others are less well served. Fisher's career has been surveyed by Hamilton (1951), although this paper makes no mention of the economic difficulties which faced the interwar Treasury; Phillips is perhaps best described in Keynes's tribute to him (Keynes 1943); Leith-Ross (1968) published memoirs, as did Grigg (1948); while Hawtrey's life is now fairly well documented (see Howson 1978b; Collison Black 1977).

40 Newman (1972: 18).

41 See Heclo and Wildavsky (1974: 67-8).

42 See Peacock and Wiseman (1967: xxxiv-xxxv) on the 'displacement effect' of war on tax levels and therefore on public expenditure.

43 See Johnson (1968) for the failure of social policies and reconstruction in the immediate postwar period.

44 Committee on Currency and Foreign Exchanges after the War (Cunliffe Committee), First Interim Report, Cd.9182 (1918); Final Report, Cmd. 464 (1919).

45 See Pigou (1947); Morgan (1952); Howson (1974).

46 Morgan (1952; 84-6, 105-06).

47 Howson (1974: 89-90, 106; 1975: 23-5). Studies of the 1919 boom, and subsequent slump, have tended to focus on the rôle of monetary policy; fiscal policy has been treated as a subordinate issue and has not received the attention it deserves.

48 Chapter 6.

49 See above p.7.

50 See p.118 below for the May Committee's views on this point; see also Roskill (1972: 544-5) for a similar view put by Sir Maurice Hankey (Secretary to Cabinet 1919-38).

Chapter 2: Notes 51-70

51 See above p.33.

52 See pp.112-13 below.

53 See pp.94-5 below.

54 Data on central government accounts are calculated from Feinstein (1972: Tables 3, 12, 39).

55 Data from ibid.

56 See pp.86, 225-6 below.

57 Committee on National Expenditure (Geddes Committee), First Interim Report, Cmd.1581 (1922), p.2; see also Second Interim Report, Cmd.1582 (1922); Third Report, Cmd.1589 (1922). The committee, established on 16 August 1921, was chaired by Sir Eric Geddes (formerly Minister of Transport), its terms of reference being "to make recommendations to the Chancellor... for effecting forthwith all possible reductions in the National Expenditure on Supply Services, having regard especially to the present and prospective position of the Revenue."

58 Mallet and George (1933: 31, 457-83); Hancock (1962: 104); Mowat (1955: 129-31).

59 See pp.132-49 below.

60 Mowat (1955: 130).

61 The Economy (Miscellaneous Provisions) Act, 1926, reduced Treasury contributions to the health and unemployment insurance schemes, while in 1927-8 the Treasury pressurised the spending departments to make economies in their 1928/9 Estimates "by means of administrative economies, under-spendings, postponement or even abandonment of expenditure." (T175/18, pt.II, 'Economy in 1928', 1 Nov. 1928; see also Cab 24/190, C.P. 323(27), Note by Chancellor of Exchequer, 19 December, 1927).

62 This lack of consensus, particularly as regards social expenditures, is nowhere better illustrated than in the differing positions assumed by the majority and minority reports of the May Committee; see pp.142-3 below.

63 Hicks (1938: 150).

64 Peacock and Wiseman (1967: esp. xxxiv-xxxv, 29-30); see also Chester (1951a; 200-01); Hicks (1963: 14-17); and Gibbon (1936).

65 Peacock and Wiseman (1967: xxxv).

66 See pp.63-4, 71 below.

67 Data calculated from Feinstein (1972: Table 13).

68 Sykes (1939: 58-60).

69 This, of course, also applies to total public expenditure as a proportion of GDP; see Colm (1956: 104-06).

70 The method adopted, at least initially, followed that of Price (1978a: 124-8).

Chapter 2: Notes 71-91

71 I should here like to thank a colleague, John Ashworth, for the assistance I received in undertaking this exercise. The result obtained, although statistically significant, should be viewed as a first approximation; further work is planned in this area.

72 A view held by contemporaries; see, for example, Hicks (1938: 126-8).

73 See, for example, Price (1978a: 124-6) for an assessment of policy over the period 1960-74.

74 Amongst the many works on Treasury control the following were of most use: Hawtrey (1921); Heath (1927); Bridges (1950a; 1966); Woods (1954); and Heclo and Wildavsky (1974).

75 See Bridges (1966: 29n) for the origins of the term 'candle-ends'.

76 Bridges (1950a: 6).

77 Heclo and Wildavsky (1974: 111-12).

78 Roseveare (1969: 258).

79 See above p.33.

80 See Hirst (1931: 139, 241-3) for an account of the fervour with which Gladstone enforced rigorous economy in expenditure during his periods as Chancellor.

81 Bridges (1950a: 7).

82 Bridges (1966: 29).

83 See Chubb (1952: 93-108) and T160/672/F.13865/2, 'Supply and other financial procedure of the House of Commons. Memo. F.5', July 1934.

84 Bridges (1950a: 11-12); see also Woods (1954: 373).

85 Cab 24/95, C.P. 332(19), Memorandum by the Chancellor of the Exchequer, 22 Dec. 1919; Cab 23/20, Cabinet 1(20), 2, 6 Jan. 1920; T160/639/F.6064, 'Circular 12 January 1920 signed by T. Jones on behalf of P.M.'. Jones was Deputy Secretary, Cabinet 1919-30; and Secretary, Economic Advisory Council 1930. His diaries (Jones 1954; 1969) are an important historical source for this period.

86 See Fisher's comments in T160/639/F.6064, 'Treasury Control', 6 March 1923, pp.1-2.

87 See Peden (1979b: 1-2) and references cited therein, the most famous of which was Guilty Men written by three journalists (Michael Foot, Frank Owen, and Peter Howard, using the pseudonym Cato) and published for Victor Gollancz shortly after the flight of the Allied Forces from Dunkirk in June 1940.

88 See, for example, Peden (1979b: 33-4).

89 See pp.196-200 below.

90 Peden (1979b: 34).

91 Heclo and Wildavsky (1974: 46-7).

Chapter 2: Notes 92-114

92 This judgement of 1933 was made by Sir Charles Walker who had just retired as Deputy Secretary to the Admiralty (cited in Peden 1979b: 32).

93 See pp.107, 154-5, 179-80 below.

94 Heclo and Wildavsky (1974: 47-9).

95 Ibid. p.48.

96 A difficulty that has still not been satisfactorily resolved; see Clarke (1978) for a review of expenditure management and control since the later 1950s.

97 The various proceedings are discussed fully in Bridges (1966); Heath (1927); and in T160/672/F.13865/2, 'Supply and other financial procedure of the House of Commons. Memo. F.5', July 1934.

98 This state of affairs still prevails and has been the subject of recent criticism; see Armstrong Report (1980).

99 Einzig (1959: 264, 275); Robinson (1978: 21).

100 See T160/672/F.13865/2, 'Supply and other financial procedure ...'

101 Hicks (1938: 223).

102 Central-local financial relations are detailed in Hicks (1938: ch. X); Finer (1945: 283-339); and Chester (1951a).

103 Chester (1951a: 8-9).

104 Peacock and Wiseman (1967: 98).

105 Sykes (1939: 139).

106 Cited in Chester (1951a: 94). The Royal Commission sat between 1923 and 1929, issuing three reports which, along with its minutes of evidence, form an indispensible source for any detailed study of the financial and planning problems that would have confronted both central and local government if any attempt had been made to institute a large-scale public works programme.

107 Gilbert (1970: 144).

108 Chester (1951a: 200).

109 See Dow (1964: chs. VII-VIII); and Price (1978a).

110 See, for example, Control of Public Expenditure (Plowden Committee), Report, Cmnd.1432 (1961); and Expenditure Committee, Public Expenditure and Economic Management, Report of General Sub-Committee, H.C.450 (1971-2).

111 See above p.17.

112 See p.250 below.

113 Central control over the public corporations' investment programmes was also far from complete; see Dakyns (1938).

114 Hicks (1938: 175).

Chapter 2: Notes 115, 116

115 Liberal Industrial Inquiry (1928: 111-15).

116 Considerably more attention was given to these administrative constraints in the U.S. than in the U.K.; for example, see the detailed studies of Woolman (1930); Clark (1935); and Gayer (1935).

Chapter 3

1 Only Hicks (1938) has studied this general area in any depth, while Bretherton (1937) and Edelberg (1940) have studied taxation and the trade cycle.

2 This chapter summarises much detailed work, the intention being that these questions will be further considered in a later publication.

3 Chester and Willson (1968: 50); Johnston (1965: 20); Griffith (1949: 42-3); Crombie (1962: 31).

4 Bridges (1966: 181).

5 Johnston (1965: 21); see also Crombie (1962: 32-3).

6 The papers bear out Heclo and Wildavsky's (1974: ch. 2) thesis that meetings of officials, especially informal ones - and "nowhere has the chat been elevated into a more pervasive institution than in the Treasury" - were just as important as the flow of memoranda in the formulation of policy. A few of such meetings are referenced in the papers, but not all; thus, if serious disagreements did arise it is likely that many of them were not recorded.

7 See above pp.32-3.

8 See p.106 below.

9 See, for example, p.188 below; see also Customs and Excise Papers, White Volumes 225 (hereafter W.V.), F.L.C. Floud [Chairman, Board of Customs and Excise] to Grigg, 13 July 1929 for comments about Churchill's activities in this field.

10 See p.106 below. This practice appears to have had a long lineage; see Einzig (1959: 300-01) for an account of Lloyd George's manipulation of the income tax accounts for 1910/11.

11 I.R. 63/130, E.A. Gowers [Chairman, Board of Inland Revenue 1927-30] to Grigg, 6 Oct. 1930; Inland Revenue, 'Forecasts for 1930 and 1931', 6 Oct. 1930.

12 The episode is fairly well documented; see I.R. 63/130, Grigg to Hopkins, 16 Feb. 1931; C.J. Gregg [Director, Statistics and Intelligence Branch, Inland Revenue], 'Income Tax', 16 Feb. 1931; Fergusson to Fisher, 19 March 1931; Grigg to Snowden, 31 March 1931.

Chapter 3: Notes 13-22

13 The only possible alternative was an addition to the standard rate of income tax; see pp.139-40 below for the objections finally mounted against such a course.

14 See pp.132-49 below for a more detailed discussion of the financial crisis and September 1931 budget.

15 The question of a revenue tariff was discussed by the Labour Cabinet, but rejected, largely because of Snowden's opposition (Cab 23/67, Cabinets 41(31) and 43(31), 19 and 21 Aug. 1931); later the reformed Cabinet established a committee to make recommendations on additional taxation (Cab 23/68, Cabinet 48(31)1, 26 Aug. 1931) but the surviving records of this committee (Cab 27/459) make no reference to the proposals discussed. The Cabinet minutes (Cab 23/68, Cabinets 52(31)3 and 54(31)5, 2 and 7 Sept. 1931) do, however, record discussion of the proposal (subsequently adopted) to give increased wear and tear allowances on plant and machinery as a partial offset to the increased standard rate of income tax.

16 See Shann and Copland (1931) for an account of Australia's budgetary difficulties and the remedial measures adopted.

17 Cab 23/67, Cabinet 41(31)1, 19 Aug. 1931.

18 See, in particular, Dalton (1923a) and Pigou (1920); and the wider ranging account by Hargreaves (1930: 230-90).

19 See above p.25 for estimates of the burden of the debt.

20 Howson (1975: 73).

21 Samuel (1945) made no reference to his advocacy of this proposal in his memoirs, but see N.C. 2/22, Neville Chamberlain Diary, 27 Aug. and 3 Sept. 1931, and Wrench (1974: 33); and on the part played by the General Council of the T.U.C., see Marquand (1977: 620). Chamberlain recorded in his diary a meeting at which Samuel and the Marquess of Lothian (later Parliamentary Under-Secretary, India Office in the National Government) told Chamberlain and Baldwin that they were "concerned about the possibility that the Budget [would] appear one sided & desired to put before us a suggestion by Lothian which they had not adopted but wished explored", viz. a capital levy of 5% on all property to redeem £2,000m of the national debt which would reduce the annual debt charge on the budget by £100m. After receiving Snowden's permission, this proposal was put to Harvey and other Directors of the Bank of England who "were much attracted by the political advantages but doubted whether it would" reduce the flight from sterling and might "also be taken by the Soc-[ialists] as a precedent to be repeated ad lib". On 3 September, Chamberlain recorded that the scheme had been "turned down by the Bank and dropped." By contrast, the T.U.C. had favoured a special tax on fixed income securities, a suggestion that was to be considered by Inland Revenue.

22 See App.II for the trend of surtax incomes and their behaviour with the cycle.

Chapter 3: Notes 23-45

23 I.R. 63/132, Letter to Chancellor, 27 Aug. 1931.

24 I.R. 63/132, P. Thompson [Deputy Chairman, Board of Inland Revenue] to Hopkins, 10 Aug. 1931.

25 See p.154 below.

26 I.R. 63/132, 'Proposal for all round percentage increase of taxation', 13 Aug. 1931, p.5.

27 I.R. 63/132, A.L. Beck [Assistant Director, Statistics and Intelligence Branch, Inland Revenue], 'Memo. on increase and rate of I.T. and alteration of allowances', 16 Aug. 1931.

28 I.R. 63/132, Fisher, Hopkins, Grigg and A.J. Dyke [Deputy Chairman, Board of Customs and Excise] to Snowden, 18 Aug. 1931.

29 I.R. 63/132, Beck, 'Memo. on increase and rate of I.T. and alteration of allowances', 16 Aug. 1931; Grigg to Fergusson, 'Machinery of Collection', 17 Sept. 1931.

30 I.R. 63/132, Hopkins, 'Economy or taxation', undated (but about 17 Aug. 1931); see also Thompson to Hopkins, 10 Aug. 1931.

31 See above pp.41-51.

32 The definition of public sector receipts used is the same as that for expenditure; see above p.42. Data is taken from Feinstein (1972; Tables 3, 14, 34).

33 The immediate post-Second World War period saw similar developments (Wright 1979: 143).

34 The measure used is that of central government taxes on expenditure as a proportion of consumers' expenditure (less housing); the data is drawn from Feinstein (1972: Tables 12, 24).

35 Sabine (1966: 154).

36 Ibid. pp.154-5; Mallet and George (1929); Kirkaldy (1921: 214).

37 Mallet and George (1933: 561-3) and Sabine (1970: 304) give appendices detailing the rates and various reliefs.

38 See Pollard (1973: 194-6); McGuire (1939).

39 Mallet and George (1933: 407).

40 Sabine (1970: 101-02, 110-12, 289-90).

41 See App.I.

42 See p.221 below for the definition of discretionary action used in this study.

43 The characteristics of the fiscal system, and their relevance to budgetary policy, are treated more fully below, pp.225-31.

44 Details of individual tax receipts are taken from the component parts underlying Table 3.1.

45 Data from Feinstein (1972: Tables 10, 12, 26, 32).

Chapter 3: Notes 46-66

46 See App.II.

47 The N.D.C.'s yield continued to be small throughout the war and had to be supplemented by an Excess Profits Duty which yielded £2,040.9m over 1940/1 to 1945/6 (C.S.O., Annual Abstract of Statistics 1935-46 (1948), Table 251).

48 This followed from the technical difficulty of valuing goods for *ad valorem* tax purposes.

49 Bretherton (1937: 173).

50 Calculated from Feinstein (1972: Table 64).

51 The improved terms of trade was particularly important in maintaining a high floor to consumers' expenditure during the 1929-32 depression (see Richardson 1972).

52 Much of the data required to obtain such an estimate is available in Stone and Rowe (1966).

53 See App.II for details of the response of these taxes to GDP growth.

54 Hicks (1963: 80).

55 W.V./307, A.D. Webb [Director, Intelligence Branch, Customs and Excise], 'Possible Increases in Duty', 6 Feb. 1938.

56 Ibid.

57 See T171/315, 'Customs and Excise Revenue in 1933-34 and Preliminary Estimate for 1934-35', 9 March 1934, p.4.

58 See pp.226-9 below.

59 See Shirras and Rostas (1942: 15, 24-6) and Barna (1945) for details of the interwar tax burden.

60 The Statistics and Intelligence Branch of the Inland Revenue; see Crombie (1962: 48-9) and Johnston (1965: ch. IX) for the duties of these Branches.

61 I.R. 63/130, 'Forecasts for 1930 and 1931', 6 Oct. 1930, p.3; see also W.V./257, 'The Customs and Excise Revenue in April and May, 1932', 8 June 1932.

62 The information for such an exercise, however, is available in the revenue departments' papers, and has in fact been carried out by the present author, although space does not permit the results to be reported here.

63 See pp.151-2 below.

64 See the first national income White Paper (which accompanied the 1941 budget): An Analysis of the Sources of War Finance and an Estimate of the National Income and Expenditure in 1938 and 1940, Cmd.6261 (1941).

65 Stone (1951; 1977); see also Patinkin (1976). Where national income data was used, reliance was placed upon private estimates, particularly those of Clark (1932; 1937).

66 Ilersic (1955: Table 13).

Chapter 3: Notes 67-88

67 Kay and King (1978: 240); see also Ward and Neild (1978: 57-70, App. B); and Economic Trends, 290 (Dec. 1977), pp. 107-19.

68 Colwyn Report, para.674.

69 See the locus classicus Bacon and Eltis (1976); see also Meade Report (1978: 7-11, 24-5); and Kay and King (1978: 33-41).

70 Committee on Industry and Trade, Factors in Industrial and Commercial Efficiency (1927); Further Factors in Industrial and Commercial Efficiency (1928); Final Report, Cmd.3282 (1929).

71 See, for example, the evidence submitted by the London Chambers of Commerce (Colwyn Committee, Minutes of Evidence, pp.516-33).

72 Colwyn Report, para. 293.

73 Minutes of Evidence, pp.41, 47-9.

74 Colwyn Report, paras. 308, 324.

75 For an immediate review of the report, see Robertson (1927).

76 Black (1939).

77 Ilersic (1955: 69-70).

78 See, for example, Hannah (1976).

79 Colwyn Report, para. 451.

80 See Finer (1956) for a general account of the growth of this organisation, and Holland (1981) for a discussion of the F.B.I.'s economic views in the 1930s.

81 Internal deliberations, and meetings with the Treasury, are recorded in the Minutes of the F.B.I.'s Taxation Committee (Federation of British Industries Papers (hereafter F.B.I.), F.B.I./C/61, vols.131-2, and F.B.I./C/62, vol.133) and in T172/1412 and T172/1516.

82 F.B.I./C/61, vol.131, 'Meeting preliminary to Deputation to Financial Secretary to the Treasury', 17 March 1931.

83 F.B.I./EA/GLENDAY/9, 'Draft Report for the Economic Emergency Committee', 16 Nov. 1931. This passage was subsequently published in a revised edition of the F.B.I.'s pamphlet, Industry and the Nation (1932).

84 Royal Commission on the Income Tax, Report, Cmd.615 (1920)

85 F.B.I./C/61, vol.131, 'Minutes of a meeting preliminary to Deputation to the Chancellor of the Exchequer', 6 March 1930.

86 The amendment had been put down by Dr. Edward L. Burgin (Liberal M.P., later Parliamentary Secretary, Board of Trade).

87 I.R. 63/126, Gowers to Snowden, 'Obsolescence Allowance', 24 Feb. 1930, pp.3-4.

88 I.R. 63/126, Gowers to Snowden, 4 July 1930.

Chapter 3: Notes 89-94

89 Commissioner for Special Areas (England and Wales), Third Report, Cmd.5303 (1936). Pigou had also suggested a scheme in 1931 for stimulating industry and employment, but this had also been rejected (I.R. 63/130, A.C. Pigou to Snowden, 21 Feb. 1931; Gregg, 'Note on Proposal made by Professor Pigou in his letter to the Chancellor of 21st February', 6 March 1931).

90 Third Report, para.30.

91 T172/1828, E.R. Forber [Chairman, Board of Customs and Excise (1931-4), Inland Revenue (1934-8)] to J.A.N. Barlow [Under Secretary, Treasury], 16 Nov. 1936.

92 T172/1828, 'Note by Inland Revenue on Taxation Proposals in paragraph 30 of Third Report of the Commissioner for the Special Areas', 16 Nov. 1936.

93 Ibid. Some concessions, however, were made in 1937 (Dennison 1939: 89).

94 T172/1828, Hopkins to Chancellor, 14 Nov. 1936.

Chapter 4

1 See, for example, Pollard (1973: 209-10) and Richardson (1967: 211-12).

2 This and the two following chapters draw upon the authors forthcoming papers (Middleton 1981a; 1981b).

3 See above pp.63-7.

4 Hicks (1938: 279); for further details of the structure of interwar budgets, see Sykes (1933) and Young (1936); and for the general problems associated with government financial data, see Morgenstern (1963: 17-26).

5 See Hicks (1948); Committee on the Form of Government Accounts (Crick Committee), Final Report, Cmd.7969 (1950); and Reform of the Exchequer Accounts, Cmnd.2014 (1963) for a survey of the system of budget accounting, and its deficiencies, prior to the 1965 reforms which led to the presentation of these accounts in a form compatible with the national income accounts.

6 See Buchanan (1960: 59-64) for a discussion of fiscal 'illusions', fiscal window-dressing being a related concept.

7 See pp.134-5 below.

8 See p.217 below.

9 T177/25, Phillips to W.R. Fraser [Principal Assistant Secretary, Treasury], 'Financing the Defence Programme', 27 Nov. 1936.

10 T171/309, Hopkins to Fergusson, 6 April 1933.

11 T171/317, Note by Phillips, 11 Feb. 1935; see also, T171/296, Note by Hopkins, 4 April 1932.

12 See above p.75.

Chapter 4: Notes 13-42

13 T171/317, Fergusson to Chamberlain, 14 Dec. 1934; Hopkins to Fisher and Chamberlain, 12 Feb. 1935.

14 T171/296, Note by Hopkins, 4 April 1932.

15 See pp.154-5 below.

16 968, H.C. Deb. 5s., 18 June 1979, col.948 (Comment by E. Powell on budget speech).

17 For a fuller discussion of this subject, see Burkhead (1954); Corry (1958); Hicks (1953; 1963); and O'Brien (1975).

18 Burkhead (1954: 193, 215).

19 Hicks (1953: 26).

20 Hicks (1963: 144-5).

21 Buchanan, Burton, and Wagner (1978: 46-7).

22 Ibid; Hicks (1953: 26).

23 Hicks (1953: 28).

24 Schumacher (1944: 86).

25 Arndt (1944: 55).

26 Leijonhufvud (1968) and Winch (1972: 97-8).

27 See above pp.7, 25.

28 T175/17, pt.I, Phillips to Hopkins, 28 Feb. 1933, pp.1-2.

29 T171/309, Hopkins, 'Arguments against unbalancing the Budget', undated (but 7 April 1933), pp.1-2. This document was an early draft of the 1933 budget speech.

30 Ibid. p.2.

31 See Buchanan (1975; 1978) and Mueller (1979) for surveys of this rapidly growing branch of economics, an interdisciplinary subject which seeks to apply and extend economic theory to the realm of political and governmental choices.

32 See Buchanan and Wagner (1977); and Buchanan, Burton, and Wagner (1978).

33 Harrod (1972: 214, 226).

34 See, for example, Keynes (1937) and Meade (1937).

35 Cnd.6527 (1944), paras. 74-9.

36 Winch (1972: 279).

37 Beveridge (1944: 264).

38 Friedman (1968: 3).

39 T175/17, pt.I, Phillips to Hopkins, 28 Feb. 1933, pp.2-3.

40 This is discussed in further detail in a later chapter, see pp.136, 142-3 below.

41 May Report, pp.12-13; see also Beer (1969: 354) for a discussion of government expenditure and vested interests.

42 Hayek (1944; 1979).

Chapter 4: Notes 43-67

43 For surveys of the conflicting evidence for political-business cycles in postwar Britain, see Nordhaus (1975) and Frey (1978).

44 See Snowden's comments following the budget speech - 227, H.C. Deb. 5s., 15 April 1929, cols.69-71.

45 See pp.255-6 below.

46 See p.150 below.

47 See Hutchinson (1965) for an account of the subsequent operation of this committee.

48 Para. 33. There is a copy of this document in the Customs and Excise papers.

49 Scammell (1965: 34-5).

50 Grigg (1948: 183).

51 Report of the 29th Annual Conference of the Labour Party (1929), 227-8; cited in Winch (1972: 101).

52 Pollard (1970: 18).

53 See above p.43.

54 Kahn (1978: 545). The term crowding-out has come to have a diversity of meanings; for a comprehensive survey, see Currie (1978).

55 See also pp.248-62 below.

56 For an early statement of this view, see Slichter (1934: 179-80); for modern analyses, see Artis (1979); Buiter (1977); Currie (1978); Taylor (1979); and Tobin and Buiter (1976).

57 See Nevin (1955: 63).

58 See Congdon (1975) for a (monetarist) attempt to relate the crowding-out debate of the 1970s to that of the interwar period.

59 See pp.248-62 below.

60 Cmd.3331 (1929).

61 Stein (1969: 138-9 and n.17); for a thorough analysis of Say's Law, and of the ways in which it has been misinterpreted, see Sowell (1972: esp. 201-18).

62 See above p.113.

63 Bretherton et al (1941: 32).

64 See pp.132-49 below for a discussion of budgetary policy during the 1931 crisis.

65 Winch (1972: 218-19).

66 F.B.I. Committees 1930 (June-December): 'Memorandum Re. Economy', 27 Nov. 1930.

67 See above pp.92-4.

Chapter 5

1 T208/136, Hawtrey, 'The Trade Cycle and the Budget', undated (but internal evidence gives a dating sometime in 1928).

2 See, in particular, Mallet and George (1933: 278-396); Skidelsky (1967); Janeway (1971: ch. 3); and Roberts (1978).

3 See above pp.83, 85; and App.I.

4 See Snowden's comments in the budget speech (251, H.C. Deb. 5s., 27 April 1931, cols. 1405-7).

5 See McGuire (1939: 234, 239) for a description of the McKenna duties, the duties originally introduced in September 1915 as a means of economising on foreign exchange and shipping space but later expanded as a protective measure.

6 Cab 24/207, C.P.344(29), Memorandum by the Chancellor of the Exchequer, 'The Growth of Expenditure', 29 Nov. 1929.

7 Royal Commission on Unemployment Insurance (1932), Minutes of Evidence, Paper no.18, 'Memorandum submitted by the Treasury', para.4. On the reasons why Hopkins's statement was so outspoken, see Janeway (1971: 86-7, 184-5); see also Lees (1955: 72) for an account of the technical difficulties faced by the authorities in covering the borrowings of the Unemployment Fund.

8 See above pp.100,102.

9 Liberal Party (1930). This was a revised version of Lloyd George's How to Conquer Unemployment which had been discussed with, and subsequently rejected by, the Cabinet (see Janeway 1971: chs. 2, 7).

10 See above p.50 for the activities of the Geddes Committee 1921-2.

11 Cab 23/65, Cabinet 62(30)6, 22 Oct. 1930; see also Cab 23/66, Cabinet 12(31)2, 5 Feb. 1931 and Cab 23/90B, C.P.31(31), Memorandum by Minister of Labour, 'Unemployment Insurance. Emergency Financial Measures', 5 Feb. 1931 for the Cabinet's alarm at the rising cost of unemployment insurance, and for clear evidence that the Cabinet discussed the possibility of cutting unemployment benefit rates at this early date (some six months before the financial and political crisis).

12 Cab 23/66, Cabinet 13(31)4, 11 Feb. 1931.

13 Mallet and George (1933: 314); see also Skidelsky (1967: 299-300) for the political bargaining behind this debate and the form the censure motion eventually took.

14 Snowden (1934: 892); see also Cross (1966: 264).

15 May Report, p.4. The working papers of the committee are not to be found in the P.R.O., but correspondence in T160/398/F.12414 shows that Sir Andrew Duncan (a leading industrialist and a member of a number of government committees) was first approached to be chairman.

Chapter 5: Notes 16-39

16 May Report, p.16.

17 Ibid. p.220.

18 See above pp.128-9.

19 F.B.I./C/61, vol.131, Taxation Committee, 'Representations to the Chancellor of the Exchequer', 6 March 1930; 'Deputation to the Financial Secretary to the Treasury', 17 March 1931.

20 There is a scarcity of information on the activities of this organization which remained in existence until 1932. Some details are contained in T172/1516, 'Friends of Economy to Chancellor of the Exchequer', 4 April 1932; and in a file marked 'Public Economy Campaign, 1930-33' contained in F.B.I./S/WALKER/90.

21 251, H.C. Deb. 5s., 27 April 1931, col.1396.

22 Ibid.

23 Ibid. cols.1404-08; see above p.76 for a discussion of the income tax payment dates.

24 Ibid. cols.1402-03.

25 Ibid. cols.1403-05.

26 See, for example, Amery's (1955: 52) comments.

27 Chubb (1952: 114).

28 Cab 23/67, Cabinet 40(31)10, 30 July 1931.

29 Gilbert (1970: 164, n.4).

30 Skidelsky (1967: 339-43); Williams (1963a: 107-09; 1963b).

31 Middlemas and Barnes (1969: 617-18).

32 T175/51, 'Chancellor of the Exchequer', undated and unsigned memorandum. From the handwriting the author was almost certainly Hopkins, and internal evidence suggests a dating of 27 July 1931.

33 Amongst the extensive literature on the 1931 financial and political crisis, the following accounts were of most use: Bassett (1958); Clay (1957: 375-98); Feiling (1946: 189-95); Howson (1975: 75-8); Howson and Winch (1977: 82-95); Janeway (1971); Marquand (1977: ch. 25); Moggridge (1970); and Skidelsky (1967: ch. 13).

34 See Pimlott (1977: 14-15, 38-40) and Winch (1972: 350-60) for discussions of the financial orthodoxy of Labour ministers, and the rank and file of the labour movement, and the implications of this for new directions in economic policy.

35 May Report, p.221.

36 See pp.229-31 below.

37 Janeway (1971: 180-81).

38 Cited in Morton (1943: 57). The work referred to was F.C. Benham's Go Back to Gold (1932), p.23.

39 May Report, p.220; see also Cab 23/67, Cabinet 42(31)2A, 21 Aug. 1931.

Chapter 5: Notes 40-56

40 May Report, pp.13, 229.

41 Cab 23/67, Cabinet 44(31)1, 22 Aug. 1931.

42 See, for example, Keynes Papers EA/1, Henderson to Keynes, 14 Feb. 1931.

43 P.R.O.30/69/260, Henderson to MacDonald, 'The Economy Report', 7 Aug. 1931 (rep. in Henderson 1955: 71-7); see also The Economist, 8 Aug. 1931.

44 See above p.126.

45 T171/288, Hopkins to Snowden, 20 Aug. 1931; see also Cab 24/219, C.P.3(31), Memorandum by the Chancellor of the Exchequer, 'The Financial Situation', 7 Jan. 1931 where the Treasury pointed out to the Cabinet the full consequences if the budget were left unbalanced.

46 P.R.O.30/69/260, R.B. Howorth to Henderson, 8 Aug. 1931; see above pp.76-80 for the way in which the revenue departments were able to influence events at this crucial time.

47 Keynes Papers L/31 and P.R.O.30/69/260, Keynes to MacDonald, 5 Aug. 1931.

48 Keynes (1931). Keynes sent a proof copy of this article to MacDonald - P.R.O.30/69/260, Keynes to MacDonald, 12 Aug. 1931.

49 For accounts of the collapse of the second Labour Government and the subsequent formation of the first National Government, see Bassett (1958); Marquand (1977: chs. 25-6); and Wrench (1972: ch. 1).

50 Cab 23/68, Cabinets 48(31), 26 Aug. 1931 and subsequent meetings to Cabinet 55(31), 9 Sept. 1931; Cab 27/456, C.P. 208(31), Cabinet Economy Committee, Report, 28 Aug. 1931; see also the papers in Cab 27/459-61, and the budget debate (256, H.C. Deb. 5s., 10 Sept. 1931, cols.297-412).

51 Memorandum on the Measures proposed by His Majesty's Government to secure Reductions in National Expenditure, Cmd.3952 (1931).

52 Chamberlain had briefly been Chancellor in 1923; for an account of this episode, see Grigg (1948: 118-19); Feiling (1946: 107); and Macleod (1961: 94-8).

53 Skidelsky (1967: 231).

54 See Chamberlain's speech to the House of Commons when introducing the tariff (261, H.C. Deb. 5s., 4 Feb. 1932, cols. 279-96.

55 Cab 23/77, Cabinet 68(33)5, 6 Dec. 1933. Chamberlain's method and objectives received the general approval of the Cabinet; see also The Times, 16 April 1934 for a perceptive comment about this budgetary stxategy and the influence upon it of electoral considerations.

56 For accounts of this operation, see Howson (1975: 76, 86-9); Nevin (1955: 92-108); and Sayers (1976: II, 430-47).

Chapter 5: Notes 57-76

57 See pp.164-6, 238 below.

58 Howson (1975: 89).

59 Clay (1957: 442).

60 See, in particular, Howson (1975: ch. 5); for an opposing view, see Aldcroft (1970b: 53-64); and Capie (1978) for an assessment of the effects of tariff protection, the other main policy instrument.

61 See p.257 below.

62 T171/296, Hopkins to Fisher and Chamberlain, 11 March 1932; and marginal note by Chamberlain dated 13 March 1932.

63 T175/59 pt.I and W.V./242, Hopkins to Forber, 15 March 1932; T171/296, Note by Hopkins, 11 March 1932. The closure of the I.R.63 papers for 1932 and 1933 prevents a check on the Inland Revenue side of this exercise.

64 T171/296 and W.V./242, Note by Hopkins, 11 March 1932.

65 Howson (1975: 94).

66 On assuming office in 1929 Snowden had also prepared estimates of the future budgetary situation but this was a far less sophisticated exercise than that undertaken in 1932 (see T172/1684, 'Growth of Expenditure', 18 Oct. 1929; this was revised and presented to the Cabinet as Cab 24/207, C.P.344(29), Memorandum by the Chancellor of the Exchequer, 'The Growth of Expenditure', 29 Nov, 1929).

67 T171/296 and T188/48, Hopkins to Chamberlain, 'Speculative Forecast of 1935 on the basis of 'Old Moore's Almanack'', 21 March 1932.

68 Feiling (1946: 201).

69 T171/296, Phillips, 'Estimated outturn of financial year 1931/2', 7 Nov. 1931; see also the revenue forecasts: T171/296, 'Review of Inland Revenue for Nine Months to 31st December 1931', undated (but early Jan. 1932); T171/296 and W.V./242, 'The Customs and Excise Revenue in the first nine months of 1931/2', 8 Jan. 1932; and subsequent reports dated 12 Feb. and 10 March 1932.

70 T160/396/F.12116/31/01, F.G. Bowers [Accountant-General, Ministry of Labour] to Phillips, 3 and 4 Sept. 1931; Bowers to G.C. Upcott [Deputy Controller of Finance and Supply Services' Department, Treasury], 22 Sept. 1931; and Upcott to Fraser, 22 Sept. 1931.

71 264, H.C. Deb. 5s., 19 April 1932, cols. 1415-16.

72 T188/48, Hopkins to Fisher and Chamberlain, 26 Feb. 1932.

73 Ibid.

74 T171/296, Hopkins, 'Budget Estimate: 1932', 15 March 1932.

75 See above pp.89-90.

76 T171/296, Hopkins, 'Budget Estimate: 1932', 15 March 1932; Grigg to Hopkins, 11 March 1932; W.V./242, Forber to Hopkins, 14 March 1932.

Chapter 5: Notes 77-97

77 On the origins, and subsequent management, of the E.E.A., see Bank of England (1968); Nevin (1955: 103-07); and Howson (1980).

78 T171/296, F.L.C. Floud [Permanent Secretary, Ministry of Labour] to Hopkins, 12 Feb. 1932.

79 T171/296, Hopkins to Fisher and Chamberlain, 12 Feb. 1932.

80 Ibid. marginal comment by Chamberlain dated 14 Feb. 1932.

81 T171/296, Floud to Fergusson, 17 March 1932.

82 T160/473/F.12116/33/1, Hopkins to Fisher and Chamberlain, 7 Feb. 1933.

83 T171/296, Grigg to Hopkins, 11 March 1932; see also W.V./242, Forber to Hopkins, 14 March 1932.

84 T171/296, Note by Hopkins, 4 April 1932.

85 T171/296, Hopkins, 'Budget Estimate: 1932', 15 March 1932, p.8

86 264, H.C. Deb. 5s., 19 April 1932, cols.1431-38.

87 Treasury Circular No. 17/31, 4 September 1931; see also p.254 below.

88 T171/315, Fergusson to Chamberlain, 22 Jan. 1934.

89 See above, pp.153-4.

90 Midland Bank Monthly Review (April-May 1932), p.1.

91 See, for example, a letter to The Times of 5 July 1932, signed by the leading economists of Cambridge, Oxford, and eight other universities; and the further letter of 17 Oct. 1932, signed by MacGregor, Pigou, Keynes, Layton, Salter and Stamp (see also the reply of 19 Oct. signed by the L.S.E. economists - Gregory, Hayek, Plant, and Robbins; a letter which the latter now considers mistaken (Robbins 1976: 88).

92 This was shown in a two day House of Lords debate at the end of June 1932 (85, H.L. Deb. 5s., 22 June 1932, cols. 67-126; 29 June 1932, cols.294-352); in the Third Reading of the Finance Bill in the Commons earlier in the same month (266, H.C. Deb. 5s., 10 June 1932, cols.2267-348); and later in the year by a private members Economy Report (see Mallet and George 1933: 474).

93 T175/67, Waterfield to Hopkins, 3 May 1932: see also B.W. Gilbert [Assistant Secretary, Treasury], 'Memorandum on National Expenditure', undated (but internal evidence suggests 2-3 May 1932).

94 T175/67, Note by Hopkins, undated (but internal evidence suggests 3 May 1932).

95 T175/67, Gilbert, 'Memorandum on National Expenditure'.

96 T175/67, Strohmenger to Fisher, 2 May 1932.

97 T172/1790, 'Notes on Economy', undated (but internal evidence suggests early July 1932 since the memorandum was prepared for the Second Reading of the Appropriation Bill on 11 July 1932); P.R.O.30/69/262, 'Note: Genesis of the Ray Committee on Local Expenditure', undated.

Chapter 5: Notes 98-121

98 T175/67, Gilbert, 'Memorandum on National Expenditure'.

99 266, H.C. Deb. 5s., 10 June 1932, cols. 2345-7.

100 Cab 24/230, C.P. 187(32), Memorandum by the Minister of Labour, 'The Employment Situation', 6 June 1932.

101 T175/57, pt.I, Note by Phillips, 6 June 1932; see also marginal comments by Hopkins and Fisher.

102 Ibid; Gilbert to Phillips, 6 June 1932.

103 T171/309, Phillips, 'Budget Forecast', 29 Oct. 1932, pp.1-2.

104 Ibid. pp.4-5.

105 Committee on Local Expenditure (England and Wales) (Ray Committee), Report, Cmd.4200 (1932); see also the separate report on Scotland (Cmd.4201 (1932).

106 Ray Report, p.12.

107 Cab 23/75, Cabinet 15(33)4, 8 March 1933; see also Cab 24/239, C.P. 51(33), Note by the Minister of Health, 'Report of Committee on Local Expenditure', 2 March 1933.

108 P.R.O. 30/69/262, J.A.N. Barlow [Principal Private Secretary to Prime Minister] to A.N. Rucker [Principal, Ministry of Health], 6 March 1933.

109 Cab 23/75, Cabinet 18(33)6, 15 March 1933; Cab 24/239, C.P. 62(33), Note by the Minister of Health, 'Report of Committee on Local Expenditure', 14 March 1933.

110 Cab 23/75, Cabinet 2(33)2, 23 Jan. 1933; Cabinet 6(33)5, 1 Feb. 1933.

111 274, H.C. Deb. 5s., 7 Feb. 1933, col.13.

112 275, H.C. Deb. 5s., 1 March 1933, cols.443-4.

113 274, H.C. Deb. 5s., 7 Feb. 1933, cols. 14-15.

114 The Times, 30 Jan. 1933; a report of a speech made by Chamberlain in Birmingham on 28 Jan. to the Jewellers' and Silversmiths' Association Annual Dinner.

115 The individual budgets and budget debates from 1933 onwards are discussed in Sabine (1970), but readers should note that care must be exercised in using this work since it contains a great number of errors in its budget figures.

116 These transactions are discussed in App.I.

117 T171/309, Phillips, 'Budget Forecasts', 29 Oct. 1932, pp.8, 10-11.

118 277, H.C. Deb. 5s., 25 April 1933, cols.54-5.

119 T160/473/F.12116/33/1, Bowers to L. Hore-Belisha [Financial Secretary to the Treasury], 31 Oct. 1932.

120 T160/473/F.12116/33/1, Hopkins to Fisher and Chamberlain, 7 Feb. 1933.

121 T171/309, Phillips and Hopkins, 'Budget 1933/4. Forecast on basis of existing taxation', 18 March 1933.

Chapter 5: Notes 122-147

122 W.V./257, 'Customs and Excise Revenue, 1932/33 and 1933/34', 13 April 1933.

123 See above p.105.

124 277, H.C. Deb. 5s., 25 April 1933, cols.55-7, 62; see also above p.76.

125 Winch (1972: 217).

126 Of particular note were Sir Robert Horne's call for the suspension of the sinking fund ('Can We Have a Cheerful Budget?', Daily Express, 28 Feb. 1933) and the activities of the 'Northern Group' of M.P.'s in March 1933 (see T171/309, 'Northern Group Deputation. Memorandum').

127 See, for example, the letter signed by 37 leading economists (published in The Times of 10 March 1933), a letter organised by R.F. Harrod with Keynes's support (Keynes Papers A33$_2$, Keynes to Harrod, 2 March 1933).

128 See p.255 below.

129 N.C.18/1/822, Letter: Neville to Hilda Chamberlain, 1 April 1933.

130 277, H.C. Deb. 5s., 25 April 1933, cols.58-61.

131 T175/17, pt.I, Phillips, 'Mr. Keynes' First and Second Articles', 15 March 1933, para.6.

132 The Economist, 17 Oct. 1933, p.659.

133 Cab 23/77, Cabinet 53(33)1, 18 Oct. 1933; Cab 24/243, C.P.231(33), MacDonald, 'Government Policy', 12 Oct. 1933.

134 Cab 23/77, Cabinet 68(33)5, 6 Dec. 1933.

135 P.R.O. 30/69/1753, MacDonald Diary, 6 Dec. 1933.

136 T171/315, Fergusson to Chamberlain, 13 Jan. 1934.

137 I.R. 63/138, Grigg to Hopkins, 9 Jan. 1934; 'Note on Yield of Inland Revenue for 1933-34'.

138 T171/315, Phillips, 'Budget 1934/5', 12 Jan. 1934.

139 Ibid; W.V./270, 'Customs and Excise Revenue in 1933-34, and Preliminary Estimates for 1934-35', 6 Jan. 1934.

140 T171/315, Phillips, 'Budget 1934/5', 12 Jan. 1934.

141 Ibid.

142 T171/315, Waterfield, '1933/4 Outturn', 27 Feb. 1934.

143 Ibid; marginal note by Hopkins of same date.

144 I.R. 63/138, E.M.T. Firth [Assistant Principal, Secretaries' Office, Inland Revenue] to Fergusson, 10 March 1934; 'Note on Inland Revenue Out-turn for 1933 and Estimate for 1934'.

145 T171/315, Phillips, 'Budget 1934/35', 15 March 1934.

146 Ibid.

147 N.C.18/1/864, Letter: Neville to Ida Chamberlain, 17 March 1934.

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148 See, for example, Herbert Samuel's comments on the budget statement (288, H.C. Deb. 5s., 18 April 1934, cols.991-1005).

149 288, H.C. Deb. 5s., 17 April 1934, cols.914-16.

150 T171/315, Phillips to Fergusson, 12 April 1934, p.1

151 288, H.C. Deb. 5s., 17 April 1934, col.917.

152 Sunday Chronicle, 3 Dec. 1933; cited Ibid. col.921.

153 288, H.C. Deb. 5s., 17 April 1934, cols.925-6

154 In addition a change was made in the motor vehicle duties to stimulate exports (Ibid. cols.920-01).

155 T171/317, Hopkins, 'Budget Prospects', 23 July 1934.

156 Ibid.

157 See, for example, I.R.63/140, Gregg to Waterfield, 1 Oct. 1934; W.V./276, 'The Customs and Excise Revenue in the first six months of 1934/35', 8 Oct. 1934.

158 T171/317, Hopkins to Fergusson, 14 Nov. 1934.

159 T171/317, Chamberlain to Hopkins, 14 Nov. 1934. No such Cabinet meeting is actually recorded; there might however have been a meeting of Ministers, reports of which would not necessarily be in the Cabinet Minutes.

160 T171/317, Note by Hopkins, 15 Nov. 1934; Note by Fergusson, undated (internal evidence gives a dating of 15-16 Nov. 1934).

161 For example, Webb estimated total Customs and Excise receipts for 1934/5 at £290.5m but only £293m for 1935/6 (W.V./276, 'The Customs and Excise receipts in the first eight months of 1934/35', Addendum, 7 Dec. 1934).

162 T171/317, Hopkins to Fisher and Chamberlain, 14 Dec. 1934. Fisher minuted his agreement to these suggestions.

163 T171/317, Fergusson to Chancellor, 14 Dec. 1934.

164 T171/317, Hopkins to Fisher and Fergusson, 12 Feb. 1935.

165 T171/317, Note by Phillips, 11 Feb. 1935.

166 T171/317, Phillips to Hopkins, 8 March 1935.

167 T171/317, Hore-Belisha to Chamberlain, 11 Feb. 1935.

168 T171/317, Hopkins to Fergusson and Fisher, 20 Feb. 1935.

169 N.C.2/23A, Neville Chamberlain Diary, 14 April 1935; T171/317, Hore-Belisha to Chamberlain, 12 April 1935. The Budget was revealed to the Cabinet on 12 April (Cab 23/81, Cabinet 23(35)1), but the minutes, as was usual, do not record the details of the discussion, nor does Hore-Belisha's biographer (Minney 1960) refer to the episode.

170 See N.C.2/23A, Neville Chamberlain Diary, 6 Feb. and 16 March 1934, 2 Aug. and 19 Oct. 1935.

Chapter 5: Notes 171-194

171 I.R. 63/140, 'Inland Revenue Estimate for 1935', 7 March 1935.

172 300, H.C. Deb. 5s., 15 April 1935, cols.1617-37.

173 Ibid. col.1637.

174 The Times, 17 May 1935; a report of a speech to the annual dinner of the British Bankers' Association.

175 War Cabinet Minutes, 15 Aug. 1919; cited in Gibbs (1976: 3).

176 Following an initiative by the Treasury, concerned to limit the growth of total expenditure, the 'Ten Years Rule' was strengthened in 1928 (Gibbs 1976: 58).

177 Peden (1979b: 8).

178 Cab 24/229, C.P. 104(32), Note by Sir M.P.A. Hankey, 'Imperial Defence Policy', 17 March 1932.

179 Cab 23/70, Cabinet 19(32)2, 23 March 1932.

180 Cab 24/229, C.P. 105(32), Note by the Treasury, 'Imperial Defence Policy', 17 March 1932.

181 Shay (1977: 24); see also Howson (1978a: 625) for a review of this work and its deficiencies, especially as regards Treasury economic thinking of the later 1930s. Throughout the rest of the present study, the results of Peden's more thorough researches are used.

182 Peden (1979b: 8).

183 Ibid. p.9. The progress of the rearmament programme, and the various changes in policy, are chronicled in the annual defence White Papers (Statement Relating to Defence, Cmd.4827 (1935); Cmd.5107 (1936); Cmd.5374 (1937); Cmd.5682 (1938); Cmd.5944 (1939)); see also Defence Loans Memoranda (Cmd.5368 (1937); Cmd.5945 (1939)) which accompanied the decision to borrow in 1937 and the extension of borrowing powers in 1939.

184 See Middlemas and Barnes (1969: 797, 912-13).

185 Peden (1979b: 69, 72).

186 Shay (1977: 74).

187 Cited in ibid.

188 T160/688/F.14996/1 and T172/1832, Hopkins to Fisher and Chamberlain, 7 Oct. 1935, pp.1-2.

189 T172/1832, unsigned, undated letter to Chamberlain.

190 T171/324, Note by Hopkins, 2 Dec. 1935, p.4.

191 Ibid. pp.6-7.

192 See speech to dinner given by Lord Mayor of London; reported in The Times, 2 Oct. 1935.

193 The Economist, 7 March 1936, p.521.

194 T171/324, Phillips, 'Out-turn of Year 1935/36', 10 Feb. 1936; see also the revenue reports: W.V./287, 'Second Preliminary Estimate. Customs and Excise Revenue 1936/37', 10 Feb. 1936; I.R. 63/141, 'Review of Inland Revenue Receipts in 9 Months to December, 1935', 22 Jan. 1936.

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195 T171/324, Phillips, 'Out-turn of Year 1935/36', 10 Feb. 1936.

196 W.V./287, 'Budget Brief, 1936. Fourth (and Final) Edition', 21 April 1936. On 31 March the Treasury had asked for a £5m increase, reduced to £4m on 6 April.

197 I.R. 63/141, Forber to Hopkins, 1 April 1936.

198 The Economist, 25 April 1936, pp.171-3.

199 T160/688/F.14996/1, Fisher to Chancellor, 2 Dec. 1935.

200 T171/324, Phillips, '1936/37 Budget', 22 Feb. 1936.

201 Cab 58/30, E.A.C.(S.C.)23, Committee on Economic Information, Nineteenth Report, 10 Feb. 1936; Cab 24/261, C.P. 97(36), Note by President of Board of Trade, 'State of Trade - February 1936', 31 March 1936; see also report for March (Cab 24/262, C.P. 120(36)).

202 Marginal note by Fisher on T171/324, Hopkins to Fisher and Chamberlain, 24 Feb. 1936.

203 Marginal note by Fisher on T171/324, Phillips, '1936/37 Budget', 25 March 1936.

204 Peden (1979a: 41).

205 T171/324, Forber to Fergusson, 23 March 1936; Fergusson to Chamberlain, 24 March 1936.

206 T171/324, Phillips, '1936/37 Budget', 25 March 1936.

207 T171/324, Hopkins, 'Table comparing provisional estimates for 1936/7 with estimates and expected out-turn for 1935/6', 26 March 1936.

208 For Chamberlain's budget statement, see 311, H.C. Deb. 5s., 21 April 1936, cols.37-58.

209 T171/324, Note by Hopkins, 8 April 1936.

210 The Economist, 25 April 1936, pp.169-70 viewed the budget as a "bitter disappointment" while The Times (22 April 1936) and Manchester Guardian also viewed it with some despondency.

211 See above pp.24, 28 and pp.241-2 below.

212 314, H.C. Deb. 5s., 3 July 1936, cols.812-23.

213 T171/332, Notes by Phillips, dated 18 Jan. and 10 March 1937. Chamberlain in his 1937 budget speech was at pains to stress that the £5.6m deficit was less than sinking fund payments which had totalled £13.1m (322, H.C. Deb. 5s., 20 April 1937, cols.1601-02).

214 311, H.C. Deb. 5s., 21 April 1936, cols.54-5.

215 T161/855/S.48431/01/2, Hopkins to Fisher and J.H.E. Woods [Private Secretary to successive Chancellors of the Exchequer 1936-40], 20 Dec. 1937.

216 T175/96, Hopkins to Fisher and Chamberlain, 4 Feb. 1937; see also T171/332, Phillips, '1937 Budget on existing basis', 17 Feb. 1937.

Chapter 5: Notes 217-239

217 W.V./300, 'Budget Brief, 1937. Second (and Final) Edition', 20 April 1937.

218 See above pp.24-5 and pp.243-4 below.

219 T171/332, Hopkins, 'New Taxation', 18 Feb. 1937.

220 N.C.2/24A, Neville Chamberlain Diary, 24 Jan. 1937.

221 322, H.C. Deb. 5s., 20 April 1937, cols.1616-20. The National Defence Contribution, as originally proposed, was to generate political and economic objections sufficiently strong to force the Treasury to adopt a much revised form of profits tax; see Shay (1977: 147-55); Feiling (1946: 292-3); and Simon (1952: 228).

222 335, H.C. Deb. 5s., 26 April 1938, col.47.

223 The problems posed by supply constraints on the rearmament programme are extensively discussed in Hornby (1958); see also Parker (1978) and Allen and Thomas (1939) on the shortages of skilled labour.

224 Peden (1979b: 67).

225 Cab 24/273, C.P. 316(37), Interim Report by the Minister for Co-ordination of Defence, 'Defence Expenditure in Future Years', 15 Dec. 1937, paras. 7-10; see also Hancock and Gowing (1975: 68-9).

226 See Cab 24/265, C.P. 339(36), Leith-Ross, 'The Balance of Payments of the United Kingdon', 18 Dec. 1936; and T175/94, pt.II, Phillips to Hopkins, 31 Dec, 1936.

227 See Cab 58/30, E.A.C.(S.C.)33, Committee on Economic Information, Twenty-Sixth Report, 'Problems of Rearmament, December 1938', 16 Dec. 1938 for a detailed discussion of the effects of rearmament on exports and imports.

228 Peden (1979b: 34).

229 Shay (1977:186).

230 T171/340, Bridges, 'Defence Sketch Estimates, 1938', 10 Jan. 1938, pp.9-10.

231 Howson (1975: 124).

232 The Banker, May 1939, p.176; cited in Lees (1955: 69); see also The Economist, 1 May 1937, pp.283-4.

233 Lees (1955: 70).

234 Cab 24/273, C.P. 316(37), para. 24.

235 See Chamberlain's Scarborough speech; reported in The Times, 9 Oct. 1937.

236 Peden (1979b: 69).

237 T171/340, Hopkins, 'Civil Estimates, 1938/9', 15 Dec. 1937.

238 Peden (1979b: 88ff, 164).

239 See pp.243-4 below.

Chapter 5: Notes 240-264

240 W.V./307 and T171/340, 'The Customs and Excise Revenue in the First Three-Quarters of 1937-38', 10 Jan. 1938; T171/340, 'Revenue Returns. Nine Months to 31st December 1937', undated (but about the same date as ibid).

241 W.V./307, Webb to Fraser, 'Estimates for 1938/39', 21 Jan. 1938. It is likely that Inland Revenue were having similar problems, but this cannot be verified since the relevant file (I.R.63/146) remains 'closed' due to its supposed 'sensitivity'.

242 W.V./307, Webb, 'The Revenue in 1937 and 1938', 6 Feb. 1938.

243 T171/340, Letter to Fraser, 4 Jan. 1938; marginal comment by Hopkins.

244 T171/340, Fraser to Hopkins, 15 Feb. 1938; marginal comment by Phillips dated 16 Feb. 1938.

245 See, for example, the Commons debate on public expenditure of 9 Feb. 1938 (331, H.C. Deb. 5s., 9 Feb. 1938, cols.1153-212).

246 See pp.259-61 below.

247 T171/340, Note by Chancellor of the Exchequer, 16 March 1938.

248 T171/340, Hopkins to Simon, 17 March 1938.

249 Ibid.

250 Ibid.

251 T171/340, Fraser to Phillips, 2 Feb. 1938.

252 T171/340, Phillips to Hopkins, 3 Feb. 1938; Phillips, 'Note on the Annual Debt Charge'.

253 T171/340, Hopkins to Simon, 13 April 1938; Note by Simon, 13 April 1938.

254 T171/340, Woods to Chancellor, 4 April 1938.

255 335, H.C. Deb. 5s., 26 April 1938, cols.63-4.

256 See, for example, The Economist, 13 Feb. 1937, pp.341-2.

257 The Economist, 18 June 1938, p.665.

258 T175/104, pt.II, Hopkins to Fisher and Woods, 7 July 1938.

259 T171/341 and T177/42, Hopkins to Fisher and Chancellor, 24 June 1938.

260 Cab 23/94, Cabinet 33(38)6, 20 July 1938.

261 T175/114, Hopkins to Horace Wilson, 30 March 1939.

262 T175/114, Hopkins to Gilbert, 3 April 1939.

263 Cab 24/285, C.P. 82(39), Note by Chancellor of the Exchequer, 'Growth of Civil Expenditure', 19 April 1939; Cab 23/99, Cabinet 22(39)2, 24 April 1932.

264 Cab 24/287, C.P. 118(39), Memorandum by Chancellor of the Exchequer, 'Control of Expenditure', 18 May 1939.

Chapter 5: Notes 265-278

265 Cab 23/99, Cabinet 29(39)3, 23 May 1939.

266 T177/47, Phillips to Hopkins, 24 April 1939; see also T160/1289/F.19426/3, Report of Committee on Control of Savings and Investment, 11 Aug. 1939, p.6 for evidence of the Treasury's acceptance of the (Keynesian) savings-income relationship.

267 See, for example, T175/104, pt.II, Note by Hopkins and Phillips, undated (but Feb. 1939).

268 T171/341, Fisher to Simon, 'Budget 1939-40', 3 Jan. 1939.

269 T171/341, Simon to Hopkins, 13 Feb. 1939.

270 T171/341, Hopkins to Fisher and Woods, 24 March 1939.

271 T171/341, Simon to Horace Wilson, 6 April 1939.

272 Simon speaking to the annual dinner of the British Bankers' Association; reported in The Times, 9 May 1939.

273 346, H.C. Deb. 5s., 25 April 1939, cols.993-6.

274 T177/47, Phillips to Hopkins, 24 April 1939.

275 See Howson (1975: 126).

276 See pp.257-61 below.

277 See above pp.114-15, 169-70.

278 See pp.229-31 below.

Chapter 6

1 Ward and Neild (1978: 2).

2 Blinder and Solow (1974: 13-14); Chand (1977).

3 See Stein (1969: 185-6) and Okun and Teeters (1970: 78-9) for a discussion of the development of this concept in the U.S. during the Second World War; see also Shaw (1979: 44-53) for the possible difficulties associated with this summary measure of fiscal influence.

4 Calculated from Department of Employment and Productivity (1971: Table 160). Approximately equivalent to 7.6 and 8.0% respectively of the civilian labour force.

5 Richardson (1967: 11, 21, 31-3).

6 Brown (1956: 869); see also Peppers (1973) for revisions to Brown's original estimates.

7 Neild (1963); Godley and Shepherd (1964).

8 Aldcroft (1970a:117-20); see also Matthews (1964: 91-2) for a possible explanation of why productivity levels were lower both absolutely and relatively in the service sector as compared with the manufacturing sector.

9 The measures used, and the method of computation, follow the work of Ward and Neild (1978: ch. 3).

10 The effect of price changes on the budget were investigated in the Macmillan Report (1931), paras.200-04.

Chapter 6: Notes 11-38

11 See above p.86.

12 See App.II.

13 Ward and Neild (1978: Table 3.6 and p.25).

14 Ibid. Table 3.1

15 Ibid. pp.23, 25; see also Benjamin and Kochin (1979) and Hatton (1979) for details of the benefits-wage ratio in the 1930s.

16 See above p.17 for mention of Matthews's (1969) estimated output-employment elasticities; see also Morley (1979: 592-3) for the changed relationship since the 1930s between unemployment and the share of profits in national income.

17 Arndt (1944: 125).

18 See Howson (1975: chs. 4-5); Winch (1972: ch. 10).

19 Richardson (1967: 211-12).

20 Ward and Neild (1978: Table 4.2).

21 Aldcroft (1970a: 304-06); Richardson (1967: 211, 219-20).

22 Arndt (1944: 129); Hicks (1938: 15); Pigou (1950: 41).

23 See above p.127.

24 See above p.168.

25 Howson (1975: 108-19).

26 The Economist, 11 June 1938, p.593.

27 Data from Feinstein (1965: Table 3.34).

28 Peacock and Wiseman (1967: Table A-20).

29 Hicks (1938: 126-7).

30 Bretherton et al (1941: 168).

31 Richardson (1967: 220).

32 See App.II.

33 Department of Employment and Productivity (1971: Table 162).

34 Burns (1941: ch. V).

35 Data from ibid. App.II, p.347

36 For further details see The Economist, 28 Oct. 1933,p.808; T160/517/F.12116/33/01, Note by J.C. Carr [Estimates Clerk, Treasury], 13 June 1933; Carr to Hore-Belisha, 15 June 1933.

37 Cripps and Tarling (1974: 289-90).

38 Richardson (1967: 31-5); see also The Economist, Trade Supplement, 24 Sept. 1938, p.17. It had long been appreciated that the scope for manipulating rearmament as a stabilization device was limited - Balogh (1936: 86); but see Henderson (1955: 155) and Hicks (1938: 225) for a dissenting view.

Chapter 6: Notes 39-43

39 Pigou (1947: 42).

40 Howson and Winch (1977: 149); *The Economist*, 27 May 1939, p.483; 3 June 1939, pp.533-4.

41 Richardson (1967: 284-5); Lonie and Begg (1979: 497-8).

42 Department of Employment and Productivity (1971: Table 162).

43 Winch (1972: 218).

Chapter 7

1 See 370, H.C. Deb. 5s., 7 April 1941, cols.1297-1332; *An Analysis of the Sources of War Finance and an Estimate of the National Income and Expenditure in 1938 and 1940*, Cmd.6261 (1941); and White Paper on *Employment Policy*, Cmd.6527 (1944).

2 A detailed study of the acceptance of the Keynesian revolution by government and the civil service during the Second World War has yet to be published. The theme is being explored by Mr. Nigel Grimshaw of Queens' College, Cambridge, and has also been the subject of a recent Oxford D.Phil. dissertation by Dr. R.J. Macleod, entitled 'The Development of Full Employment Policy 1938-45' (1979). Of the published works, Addison (1975: esp. 242-6) surveys the political and social policy background to the establishment of the welfare state and the commitment to full employment; Winch (1972: ch. 12) deals generally with the Keynesian revolution over these years; while Moggridge (1975; 1976: ch. 6) and Harris (1977: chs. 16-17) deal respectively with Keynes and Beveridge's contributions to policy during the war years.

3 The discussion of the public works debate constitutes a very brief summary of much detailed research, the intention being that this issue will be further considered in a later publication.

4 See Harris (1972) for a discussion of public works and unemployment in the years before 1914; see also Anderson (1944; 1945) for the development of theories of compensatory public works; and MacKay et al (1966) for a survey of the contribution of the British labour movement to these developments.

5 For a review of the public works programmes of the 1920s, see Hancock (1960; 1962); Burns (1941: 11-13); and Hill and Lubin (1934: chs. V-VI).

6 See, for example, Churchill's formulation of the 'Treasury view' in House of Commons debates of 1928-9 (222, H.C. Deb. 5s., 8 Nov. 1928, col.268; 227, H.C. Deb. 5s., 15 April 1929, col.54).

7 Hawtrey (1925); Skidelsky (1967: 24-5); Winch (1972: 118-22).

Chapter 7: Notes 8-32

8 Liberal Party (1929); and Keynes and Henderson (1929). For the origins of the programme and its central rôle in the 1929 General Election, see Campbell (1977: chs. 7-8).

9 See, for example, Winch (1972) and Skidelsky (1967); the latter, however, has subsequently rather modified his view (see Skidelsky 1975b).

10 See Williamson (1981).

11 Cmd.3331 (1929) (hereafter Memoranda).

12 For a contemporary view, see Keynes (1929; 1933: 350); for later assessments, see Skidelsky (1967: 25), Robinson (1976: 71), and Hutchison (1978: 155).

13 Winch (1972: 119).

14 Hicks (1938: 222).

15 For example, see Campbell (1977: 234).

16 See above pp.6, 13, 29-30.

17 Memoranda, pp.4-15.

18 See, for example, ibid. p.17.

19 See above pp.122-9.

20 See above pp.111-22.

21 Youngson (1968: 296).

22 Winch (1972: 120-21).

23 Kahn (1931).

24 See, for example, Lavington (1921: 171-3).

25 See, for example, Pigou (1924: pt.II, ch. IX).

26 For Hopkins's evidence, and confrontation with Keynes, see Macmillan Committee, Evidence, Qs.5494-5707.

27 See above pp.20-22.

28 T175/26, Hopkins, 'The Liberal Plan. Draft Notes for Evidence', undated, pp.6-7. Hopkins gave evidence to the Macmillan Committee on 16 and 22 May 1930, and internal evidence gives a dating for this memorandum of early May 1930.

29 Ibid.

30 T175/26, Leith-Ross, 'The Assumptions of Mr. Keynes', 27 Feb. 1930, pp.1, 4; see also Leith-Ross, 'Note on Mr. Keynes' Exposition to the Committee on Finance and Industry. Discussion of 20/2/30', undated.

31 See T175/89, Note by Phillips, 31 Jan. 1935, para.4 for the clearest expression by a Treasury official of such a view; see also Macmillan Committee, Evidence, Q.5565.

32 See Hayek (1933: esp. 20-1, 212ff; 1935: esp. 98-9, 125, 128). Howson (1975: 91) records that in 1932 Phillips expressed his general approval of Hayek's theoretical position.

Chapter 7: Notes 33-48

33 See Burns (1941: 11-13); McKibbin (1975); Janeway (1971: ch. II); and Roberts (1978: esp. ch. 5).

34 See Cab 27/389, D.U.(29) 3rd Conclusion, 27 June 1929; Cab 24/206, C.P. 287(29), Memorandum by Lord Privy Seal, 'Unemployment Policy', 23 Oct. 1929.

35 See T188/72, Phillips to Leith-Ross, 'Recovery from the Trade Depression'; 21 Sept. 1933; T175/17, pt.I, Hopkins to Fergusson, 15 Feb. 1933; Cab 27/468, C.P. 36(32), Cabinet Employment Policy Committee, Report, 25 Jan. 1932, pp.7-9.

36 Cab 27/440, U.P. (30)51, Cabinet Panel of Ministers on Unemployment, 'Progress of Approval of Unemployment Relief Schemes', 21 Jan. 1931.

37 Cab 27/440, U.P. (30)82, Cabinet Panel of Ministers on Unemployment, 'Progress of Approval of Unemployment Relief Schemes', 31 July 1931.

38 Both Lloyd George and Mosley had expansionary public works programmes rejected during the course of 1930; see Janeway (1971: ch. VII) and Skidelsky (1975a: chs. 9-10).

39 See, for example, Prem 1/365, Note by the Treasury, 18 July 1939.

40 See Miller (1972: esp. 203ff; 1976) for a discussion of public works and the National government's unemployment policies 1931-6; see also Royal Institute of International Affairs (1935) for details of the public works programmes in other countries.

41 Burns (1941: 133); Hill and Lubin (1934: 72-3).

42 Youngson (1968: 293); on the Treasury's continued orthodoxy, see Salter (1961: 230, 253-4; 1967: 87-8). Salter was a member of the Committee on Economic Information.

43 Hutchison (1978: 155), a judgement made after a reading of both Howson and Winch (1977) and Sayers (1976); for a more balanced review of the former work, see Cairncross (1977) and Peden (1980).

44 Howson and Winch (1977: 134-48).

45 Peden (1980: 6).

46 Keynes (1933). This programme had been preceded by a campaign by a number of influential economists and The Times for a relaxation of fiscal policy (see Winch 1972: 217).

47 Lloyd George (1935). This had received widespread general support; for example, from Snowden (1935), from The Economist (26 Jan. 1935, pp.165-6; 30 March 1935, p.711), and within the House of Commons (297, H.C. Deb. 5s., 14 Feb. 1935, cols.2095-2216).

48 Public sector investment had begun to revive from 1934 onwards; see Feinstein (1965: Table 3.34).

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49 The rejection of the 1933 proposals came in a House of Commons debate (276, H.C. Deb. 5s., 22 March 1933, cols. 379-91); that of the 1935 'New Deal' was based upon (Cab 24/256) C.P. 150(35), 'Statement by His Majesty's Government on Certain Proposals Submitted to them by Mr. Lloyd George', 18 July 1935 and was published on 22 July as A Better Way to Better Times, the authorship of which was credited to Chamberlain (see Rowland 1975: 721).

50 See, for example, T175/17, pt.I and T171/309, Phillips, 'Mr. Keynes' First and Second Articles', 17 March 1933; Phillips, 'Questions for Keynes', undated (but almost certainly of the same date).

51 The following paragraph owes much to Trevithick (1978).

52 Keynes (1973b: 284-5) cited in Trevithick (1978).

53 See, for example, T161/672/S.40504/09/2, Phillips to Gilbert and Barlow, 27 Feb. 1935; T177/47, Phillips to Hopkins, 24 April 1939.

54 Howson and Winch (1977: 141-52, 156-7). Keynesian influences are seen as operating indirectly through the Committee on Economic Information and more directly through Keynes's published writings (see Keynes 1937).

55 On the 'Keynesian Revolution' and the academic community, see Winch (1972: ch. 9). The Oxford economists' letter of 9 June 1937 (published in The Times) probably best expressed the new unity amongst economists on the question of public works; see also The Economist (23 Oct. 1937, p.151) which noted:'There is a striking unanimity among economists on the desirability of preparing plans for public works; even those who are least disposed to accept the theory of public works in its unqualified entirety agree that in present circumstances ... the case for them is very strong."

56 Cab 27/640, P.C.E. (37)10, Interdepartmental Committee on Public Capital Expenditure, Report, 13 Aug. 1937; P.C.E. (37)15, Addendum to Report, 20 Dec. 1937. The commiteee, established on 1 June 1937, was chaired by Phillips and included representatives from all the principal departments concerned with public works expenditures and their administration. The various working papers of the committee can be found in T177/37 and Cab 27/640.

57 Cab 27/640, C.P. 6(38), Memorandum by the Chancellor of the Exchequer, covering Reports by an Inter-Departmental Committee, 20 Jan. 1938. The figures given for total public investment are rather higher than those estimated by Feinstein (1972: Table 39).

58 Cab 23/92, Cabinet 2(38)5, 26 Jan. 1938.

59 See above pp.24-5.

60 Bretherton et al (1941: 198-9); this is cited approvingly by Howson and Winch (1977: 142).

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61 See, for example, The Economist, 14 May 1938, p.347.

62 See Marwick (1964) for a discussion of this 'middle opinion' in British politics, as represented in works such as the Next Five Years (1935) and Macmillan (1938).

63 See 328, H.C. Deb. 5s., 27 Oct. 1937, cols.90-1, 127, 201-2; 1 Nov. 1937, cols.568-9, 604-5; 331, H.C. Deb. 5s., 10 Feb. 1938, cols.1229-32; 333, H.C. Deb. 5s., 23 March 1938, cols.1219-29, 1232-5.

64 The Economist, 26 March 1938, p.677.

65 T175/94, pt.II, marginal note by Hopkins to Note by Phillips, undated (but Oct.-Dec. 1937).

66 See, for example, 331, H.C. Deb. 5s., 10 Feb. 1938, cols.1229-32.

67 328, H.C. Deb. 5s., 27 Oct. 1937, col.202. This comment was made by A.V. Alexander (Labour M.P., former First Lord of the Admiralty).

68 See Cook and Stevenson (1977: 260-4) for the prospects of an election in 1939-40.

69 See, for example, Prem 1/365, Note by the Treasury, 18 July 1939.

70 Peden (1980: 5-6).

71 See, for example, Keynes (1939c) for such an argument.

72 See above pp.211-16.

73 T208/201, Note by Phillips, 29 April 1939.

74 Dennison (1939: 159).

75 T230/94, Hopkins to H. Clay [Economic Adviser to Bank of England 1930-44], 13 May 1942; see also J.E. Meade [Economic Assistant, Economic Section, Cabinet Offices 1940-5] to Clay, 4 May 1942.

76 Jones (1954: xxxii); Middlemas and Barnes (1969: 288, 518-9); Taylor (1965: 269); Rees (1970: 83).

77 Blake (1976: 216).

78 See Cecco (1977: 18-19). Keynes, however, was on very good terms with the two most important Treasury 'Knights' of the period, Hopkins and Phillips (Robbins 1971: 187).

79 Keynes (1939b).

80 T177/47, Phillips to Hopkins, 24 April 1939, p.1.

81 These issues are treated at greater length in Middleton (1981b).

82 See Peacock and Shaw (1971: 62-3).

83 See Friedman (1948) for a discussion of the circumstances under which discretionary action can be destabilizing. However, automatic stabilizers can themselves be destabilizing in the long-term; see Smyth (1963).

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84 See above pp.227, 229-31.

85 The standard British texts were Bastable (1892), Dalton (1923b), and Pigou (1928). All dates refer to first editions.

86 Buchanan (1978: 8).

87 Meade (1937; 1938).

88 See Keynes's (1938) review of Meade (1938).

89 See Johnson and Johnson (1978: chs. 2-3).

90 This was most vividly revealed in the discussion provoked by the rearmament programme and its financing (see, for example, 338, H.C. Deb. 5s., 15 July 1938, cols.1693-1772).

91 See above pp.69-71.

92 Keynes (1939a: 122).

93 Chapman and Greenaway (1980: 72, 112).

94 This was, in fact, the metaphor used by Lloyd George in the 1929 general election campaign (see Liberal Party 1929).

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