5. Is anything left of the 'Keynesian revolution'?

The conduct of British fiscal policy has changed during the post-war period, reflecting both the pressure of events and the evolution of thinking about macroeconomic policy. This essay reviews the changes in policy approach and relates them to the ultimate objectives of macroeconomic policy. Two objectives are usually emphasized, high (or full) employment and price stability, although equilibrium in external payments and economic growth are sometimes also mentioned.

The argument will be that between the 1940s and the 1980s attempts were made to replace atheoretical Treasury orthodoxies with policy approaches clearly grounded in macroeconomic analysis. Unhappily, the two main approaches – Keynesianism with its focus on fiscal policy and monetarism, to be understood as a reliance on monetary policy which sought its rationale in the quantity theory of money – were to conflict. The differences between them were radical in principle, and led to bitter disputes in practice. Despite these tensions, all economists involved in the debates on fiscal policy between the 1940s and the 1980s appealed to macroeconomic theory and analysis to support their positions. However, in the 1980s – and more particularly in the 1990s – the debates fizzled out, while the fiscal ground rules became disconnected from the understood objectives of macroeconomic policy. Despite their authors' insistence on their modernity, the new ground rules had many echoes of those espoused in the Treasury before the 1940s.

I

The key precept in fiscal policy until the post-war period was that the government should balance its budget. The concept of budget balance depended on a distinction between 'above-the-line' and 'below-the-line' items, with the aim being to maintain the balance (or even achieve a small surplus) above-the-line. The distinction was related, but not identical, to that between current and capital expenditure. In essence, recurrent items of capital expenditure were deemed to be 'above-the-line' and their cost had to be covered from current revenue, which would be predominantly taxation. Borrowing was legitimate to cover the cost of exceptional, non-recurrent items of capital expenditure, but that was all. Continuous borrowing to meet the cost of recurrent capital expenditure was rejected, as it 'would only increase the costs over the years by unnecessary payments of interest'.[1] Implicitly, high levels of debt interest were regarded as misguided, even dangerous. Although they were an internal transfer between different citizens of the same nation (from taxpayers to bondholders), they raised the tax burden with adverse consequences for incentives and economic efficiency. These definitions and conventions originated in the era of Gladstonian sound finance in the late nineteenth century. They were affiliated to distinctions between the Consolidated Fund and the National Loans Fund set out in the Exchequer and Audit Departments Act of 1866. To macroeconomists who had absorbed Keynes's ideas in his *General Theory* of 1936 they were old-fashioned hocus-pocus. The Keynesians believed that the budget balance should instead be varied to influence the level of demand in the economy and, at a further remove, the number of people in work. While Keynes's own prescriptions for fiscal policy were never stated with much precision, most Keynesians thought that the right concept of the budget balance was that which measured the net 'injection' or 'withdrawal' of demand to or from the economy. In their writings, this can be most readily interpreted as the change in the public sector's financial deficit (or surplus), where the financial deficit is the net incurral of financial liabilities to other agents. The PSFD has no clear or necessary connection with the budget balance above-the-line.

So the debate about fiscal policy in the 1940s and 1950s can be viewed as being between the guardians of old Treasury traditions and the apostles of Keynesian theories of demand management. The debate ran partly in terms of definitions, but it was also, more substantively, about the purposes of policy. The Keynesian theorists portrayed themselves as more rigorous, scientific and modern, partly because they were focused on a standard aim of macroeconomic policy, namely to sustain high employment. A familiar textbook account of the period is that enlightened Keynesianism vanquished benighted Treasury orthodoxies, with contra-cyclical adjustment of the budget deficit being vital to the attainment of full employment. According to Winch in his 1969 study of *Economics and Policy*, 'Post-war stabilisation policy in Britain has mainly been conducted in terms of tax changes designed, for example, to stimulate private investment and, more important from a quantitative point of view, to influence consumer spending by altering the level of disposable income'. Further, economic management on these lines enjoyed 'comparative success' in the immediate post-war decades.[2]

The debate between the Treasury mandarins and the Keynesian evangelists was in reality far more even-handed than the textbook story suggests. An important study by Matthews, published in 1968, emphasized that 'throughout the post-war period the Government, so far from injecting demand into the system, has persistently had a large current account surplus . . . [G]overnment saving has averaged about 3 per cent of the national income'.[3] The persistence of a 'large current account surplus' may have been due to the application of the old Treasury rules, because it would be the logical by-product of financing a significant proportion of capital spending (the recurrent element) from taxation. Indeed, public sector accounts continued to refer to the distinction between above-the-line and below-the-line items until the early 1960s. These notions survived, despite repeated criticism – and even outright mockery – from academic Keynesians.

A White Paper, Cmnd. 2014, on *Reform of the Exchequer Accounts*, was published in 1962 and seems to mark the watershed between Gladstonian and Keynesian fiscal accountancy, although it is rarely mentioned in books about the period. Also significant were developments, in far from glorious circumstances, during the Labour government of 1964–70 led by Mr Harold (later Lord) Wilson. Wilson had himself been an economist before entering politics and in its early years his administration saw the recruitment of large numbers of academic economists to Whitehall. Most of these economists had strongly Keynesian sympathies. Unfortunately, from the outset the Wilson government was plagued by a weak balance-of-payments position and it was obliged to devalue the pound in November 1967. As the balance of payments did not improve quickly, the British government borrowed from the International Monetary Fund (IMF) in 1968. In addition to imposing certain conditions for its loan, the IMF introduced new measures of both monetary and fiscal policy. Its target for the British authorities was stated in terms of 'domestic credit expansion (DCE)', which can be regarded as the sum of new bank credit extended to all UK domestic agents (that is, to the public and private sectors combined).

The thinking was that the balance-of-payments deficit would be roughly equivalent to DCE minus the growth of the money supply. (Bank credit would create new money balances, unless the expenditure it financed went to foreign suppliers.) So – for any given rate of money supply growth – control over DCE would strengthen the balance-of-payments position. As bank credit to the public sector was part of DCE, the IMF guidelines implied some limit on the total of public sector borrowing which might, potentially, be financed from the banks. This total was known as 'the public sector borrowing requirement' or PSBR for short. (The PSBR was essentially a cash measure of the deficit, since it was a cash concept that was most readily integrated with monetary policy.)

The acceptance of IMF restrictions on Britain's public finances implied that satisfactory balance-of-payments outcomes had a higher policy priority than the achievement of full employment. This was undoubtedly a setback for the Keynesians. However, the IMF's involvement in policy-making in the late 1960s had another and rather different long-term significance. The vocabulary and form of macroeconomic policy shifted, giving more scope for monetary variables such as money supply growth, domestic credit expansion, bank credit to the private sector, non-bank financing of the budget deficit and, crucially for the future, the PSBR. It was this shift – not the Keynesians' ridicule in the 1940s and 1950s – that finally expunged the Victorian notions of sinking funds, above-the-line deficits and such like from the copybook maxims of British public finance. (The concepts of the Consolidated Fund and the National Loans Fund survive to this day.)

The move to floating exchange rates in the early 1970s gave policy-makers a new freedom from the external balance-of-payments constraint on fiscal and monetary expansion. They abused their freedom totally. DCE and money supply growth ran at fantastic rates in 1972 and 1973, far higher than anything previously recorded in the post-war period. The PSBR, which had been in small surplus in the 1968/69 fiscal year, recorded a deficit equal to 9 per cent of GDP at market prices in the 1974/75 fiscal year. The annual rate of retail price inflation exceeded 25 per cent in early and mid-1975, in conjunction with a vast current account deficit on the UK's balance of payments. In the autumn of 1976, the government again sought assistance from the IMF, which – as in 1968 – spelt out its targets in terms of DCE and the PSBR.

In this environment of macroeconomic anarchy, a number of British economists rejected the Keynesian principles held by the majority of their profession, and advocated monetary control as the right answer to inflation. A new body of thought, conventionally known as 'monetarism', began to influence policy thinking. The government had already introduced a target for money supply growth in July 1976, a few months before seeking IMF help, and refined it in conjunction with IMF officials in the closing months of the year.

Monetarism was – and remains – a heterogenous set of ideas, and its diversity is analysed in other essays in this book. But, according to one very influential strand of British monetarist analysis in the late 1970s, control over money supply growth was essential to the control over inflation, while quantified targets for the PSBR facilitated control over money supply growth.[4] This strand of analysis received an obvious impetus from the two episodes of IMF borrowing, but the UK met its money supply and DCE targets easily in 1977, and its dependence on IMF support was short-lived. Much valuable analysis on the relationships between the budget deficit and money supply growth was home-grown, with the London Business School and City stockbroking firms (notably by Gordon Pepper at W. Greenwell & Co.) making important contributions.

When the Thatcher government came to power in 1979, the central themes of macroeconomic policy were avowedly monetarist. In the Budget of 1980 the medium-term financial strategy (MTFS) was announced, with multi-year targets for both the PSBR and money supply growth. However, if this was British monetarism's sunny high noon, the sky soon became overcast. The validity of the approach to macroeconomic policy implied by the MTFS was challenged by totally unexpected developments. In the summer and autumn of 1980 the money supply target was exceeded by a wide margin, and yet economic activity deteriorated and inflation started to fall sharply. Monetarist theory, with its emphasis on the link between money growth and inflation, looked silly. Meanwhile opponents of monetarist thinking assembled an array of expert opinions about macroeconomic theory and policy for the Treasury and Civil Service Committee of the House of Commons. The committee's report was damning in its repudiation of the relationship between the PSBR and money supply growth, which was the analytical kernel of the MTFS. According to officials active at the time, the role of money supply targets in policy decisions was downgraded as early as the autumn of 1980. Nevertheless, broad money targets continued until 1985 and – to that extent – the proposition that a large budget deficit undermined monetary control still had official blessing. The retention of the PSBR – which, to repeat, is a cash concept that can be related to the government's bank borrowing and, hence, to money growth – had a logical basis in economic theory.

II

The development of post-war British fiscal policy until the mid-1980s can now be summarized. There had been two main battles of ideas. The first had been between Treasury orthodoxies and Keynesianism. Whereas Treasury orthodoxies could be fairly characterized as having no clear meaning for any of the ultimate policy objectives, Keynesianism's ultimate objective was – very explicitly – the achievement of full employment. According to the textbooks, this battle was resolved in favour of the Keynesians at some point between 1940 and 1970, with most authorities taking the view that the 1941 Budget was the critical turning point. Further, the textbooks judge that – whatever the ambiguities about the exact date of its adoption by officialdom – Keynesianism was a success. Crucially, the application of its ideas is reputed to have been the dominant reason for the impressively low unemployment recorded in the 1950s and 1960s.[5]

The second battle was between the Keynesians and monetarists in the 1970s, as policy-makers and economists close to them grappled with double-digit inflation. The monetarists urged that macroeconomic policy as a whole concentrate on lowering inflation and that, by means of PSBR targets, fiscal policy be made subsidiary to money supply targets. Plainly, Keynesians and monetarists had divergent views about the best way of formulating fiscal policy, about the manner of fiscal policy's interaction with the rest of policy-making and about the effects of fiscal policy on the economy at large. These divergences were deeply felt and publicly disputed. But, equally plainly, both the Keynesians and monetarists validated their views on fiscal policy by reference to understood objectives and received theory. They were a long way apart, as the Keynesians stressed the goal of full employment, whereas the monetarists were concerned almost exclusively with inflation. Nevertheless, their discourse made a recognizable appeal to 'macroeconomics', in the sense of an intellectual discipline that was much more than glib formulae that could easily be converted into newspaper headlines.

Strong arguments can be presented that neither 'the Keynesian revolution' nor 'the monetarist counter-revolution' amounted to all that much. The Keynesian revolution was far less substantial in actual fiscal practice than it was as a set of nostrums and aspirations shared by a large number of university dons; the monetarist counter-revolution was retrospectively dismissed by the media as a temporary political fad, since it had never had a serious hold on the long-term policy-making establishment in the Treasury and the Bank of England. Subsequent narrative accounts of the period by the key players suggest that the media's characterization of the official attitude towards monetarism was accurate.[6] However, this leaves much unexplained. If neither Keynesian nor monetarist approaches to fiscal policy held sway by the late 1980s, then what set of ideas did influence policy?

The question may not have seemed particularly pressing during the boom in the final years of Nigel (later Lord) Lawson's period as Chancellor of the Exchequer. The public finances recorded large surpluses, as tax revenue was boosted by excessive domestic expenditure. At any rate, in the 1988 Budget Lawson took the opportunity to spell out a new rule for fiscal policy, that 'henceforth a zero PSBR would be the norm'. The rationale for this apparent restoration of the principle of a balanced budget was that it provided 'a clear and simple rule, with a good historical pedigree'. Further, the balanced budget rule would – according to Lawson in his book of memoirs, *The View from No. 11* – give the Treasury 'a useful weapon in the unending battle to control public spending'. Among other arguments for a balanced budget, he referred to 'the burden of debt service and therefore the tax level in years to come'.[7] (A large deficit would add to the debt and debt-servicing costs, and hence increase future taxes.)

Lawson's discussion of the zero PSBR rule – in both the Budget speech of 1988 and his memoirs – referred only tangentially to the debate between the Keynesians and monetarists which had raged in the 1970s and early 1980s. Indeed, the comment on debt interest and the virtues of expenditure restraint echoed many statements from senior Treasury officials in the 1930s and 1940s, almost as if the Keynesian/monetarist debate had never been. But one of Lawson's claims – that the zero PSBR rule had 'a good historical pedigree' – was misinformed. Even in 1988 the PSBR was hardly an historical concept. It had been introduced to the UK as recently as the early 1960s, while at no point in the following 25 years had a zero PSBR been the main guideline for fiscal policy. The PSBR is an altogether different measure of the fiscal position from the balance above-the-line, which had in fact been the focus of Treasury attention in the early and middle decades of the twentieth century.

The tendency of the Lawson years was therefore to downplay the macroeconomic objectives over which the Keynesians and monetarists had fought so furiously. The government did not have a target for unemployment, as in the heyday of full employment policies, but it did not have a specific target for inflation either. Instead fiscal policy seemed to be motivated by rather old notions, such as the need to deliver long-run fiscal solvency and tight expenditure control. One item of expenditure in particular, the debt interest burden, was mentioned often in official speeches, in line with the comments in Lawson's memoirs. The Conservatives remained in office for almost eight years after Lawson's resignation in October 1989, and kept his zero PSBR rule. The aim of maintaining a balance was not particularly controversial. Economists with a monetarist background were happy with a zero PSBR, since that did not pose a threat to monetary control, while many Keynesian economists had come to accept that the goal of full employment could no longer be pursued merely by means of demand management.

However, the concept of the PSBR came under increasingly sceptical scrutiny. Embattled Treasury politicians and civil servants routinely relied on the PSBR target as their principle obstacle to more public spending. The concept of the PSBR was therefore reviewed and questioned. The critics seemed to think that the definition of the term, rather than the sequence of political choices being made by ministers, was to blame for the lack of particular kinds of public spending. For example, the PSBR was attacked by supporters of more public housing. They thought it was anomalous that extra capital spending by public corporations increased the PSBR, as the public sector had another asset (that is, public housing) to match increased debt. A report in 1995 from the Chartered Institute of Housing and Coopers & Lybrand considered 'whether there are alternatives to the current emphasis on the PSBR which would avoid undue constraints being imposed on investment by public corporations.'[8]

The election of a Labour government in 1997 aroused high expectations of a change in the fiscal rules, including the demotion of the PSBR from its pivotal role. In a sequence of statements in late 1997 and 1998 Gordon Brown, the new Chancellor of the Exchequer, did indeed greatly alter the *form* of the fiscal policy framework. (Whether he also altered the *substance* is more debatable.) Building on proposals in the Labour Party's election manifesto, in June 1998 the government published a paper on *Stability and Investment for the Long Term*. The PSBR had already been renamed 'the public sector net cash requirement (PSNCR)'. As widely hoped by lobbyists for more public expenditure, it was now downgraded in the list of fiscal concepts and ceased to be the subject of any policy rule. Instead, the government set two new rules for fiscal policy. The first – the so-called 'golden rule' – said that, over the business cycle, the government would borrow only to invest and not to fund current spending; the second – termed 'the sustainable investment rule' – intended that 'net public debt as a proportion of GDP will be held over the economic cycle at a stable and prudent level'.[9]

One consequence was that the critical variable for control purposes became the balance on the current budget or 'public sector current budget'. The golden rule implied that this should be nil or even in surplus. Of course, if the PSCB were balanced, and yet capital spending financed by borrowing were to increase sharply, the PSNCR (or PSBR, to use its old title) could explode. The purpose of the second rule was therefore to limit public sector debt. However, the words first chosen to defend the rule – 'stable' and 'prudent' – were mealy-mouthed. Neither of the government's two rules had an obvious link with macroeconomic theory, as conventionally understood. Indeed, *Stability and Investment for the Long Term* contained almost nothing about the relationship between fiscal policy and employment, on Keynesian lines, and no mention whatsoever of any measure of the money supply. The silence on the money supply contrasted sharply with Treasury statements in the same subject area 15 year earlier under the Conservatives or 20 years earlier under the then Callaghan–Healey Labour government. Plainly, the Treasury no longer had much interest in the relationship between fiscal policy and money supply growth. An observer might ask whether its political masters – and presumably its officials – remembered anything about the theoretical rationale for the initial programmes of PSBR/PSNCR reduction in the late 1970s.

So what were the arguments for the Labour government's new rules? According to *Stability and Investment for the Long Term*, the new spending control regime was to be 'based on the distinction between current and capital spending' (p. 20). Spending on capital items 'creates assets which support services and benefits taxpayers in future years as well as now' (p. 20). The golden rule was therefore 'fair', because 'those generations that benefit from public spending should also meet the cost' and it would ensure inter-generational equity by matching 'the costs and benefits of public spending across generations' (p. 21). What about the second rule, that total debt should be kept under control, even if borrowing were to finance investment? In the crucial paragraph, a reference to sustainability was tacked on to the emphasis on stability and prudence. Fiscal policy settings were described as 'sustainable' if 'on the basis of reasonable assumptions, the government can continue to meet its current spending and taxation policies indefinitely while continuing to meet its debt interest obligations' (p. 22).

In short, the golden rule was concerned with intergenerational equity, while the 'sustainable investment rule' would clearly be breached if debt interest were rising much more rapidly than national income. New Labour politicians apparently believed that they were entering unexplored territory. The White Paper on the Comprehensive Spending Review – published in July 1998 – was replete with references to modernity. In his foreword, the Prime Minister, Tony Blair, relentlessly emphasized how up to date he and his government were. The idea of 'money for modernisation' was – he said – a 'new principle'. The first chapter said that the overall spending plans would result in 'a modern and flexible role for the Government', while the Treasury would 'oversee a capital modernisation fund to provide for additional innovative projects'. Even the National Health Service would have its own 'modernisation fund'.

But how modern were the new fiscal rules? It is interesting to compare the New Labour views in *Stability and Investment for the Long Term* with the thoughts of Sir Herbert Brittain, an old-style Treasury knight, in his book on *The British Budgetary System* published in 1959. New Labour claimed that, under the golden rule, borrowing – and the associated increase in the national debt – could be justified if it were for investment purposes; Brittain observed that '[a] good deal of borrowing below-the-line may be offset by productive assets and to that extent . . . the increase in the national debt on this account need not cause undue alarm'.[10] New Labour and Brittain were clearly thinking in much the same way. The government's 'sustainable investment rule' was partly addressed to the danger of an ever-rising debt interest bill; Brittain noted that borrowing to finance current spending might stimulate the economy, but 'in future years . . . the general taxpayer will have to find the interest which has to be paid to the holders of the newly-created debt'.[11] Again, the reasoning of self-consciously avant-garde Labour politicians was similar to that of a fuddy-duddy Treasury knight of the 1950s.

Brittain was also eloquent about inter-generational equity, particularly in the context of debt-financed war expenditure. He doubted that borrowing did in fact shift the burden between generations. As he noted,

> [w]ar borrowing – like any other borrowing – means that various members of the public lend to the State . . . the unspent portions of their incomes in return for some form of claim on the State in the future; and that claim is satisfied out of the taxation or borrowing of future years. But all this amounts to is that, in those future years, value is being transferred within the country from one set of people to another from one generation.[12]

Stability and Investment for the Long Term referred to the then current academic fashion for calculating 'generational accounts', which estimated 'each generation's net tax and benefit position over their respective remaining lifetimes', and said that the Treasury was working with outside economists to produce such accounts for the UK.[13] This sounded new and forward-looking. In fact – as is evident from the Brittain quote – Treasury officials had been thinking about the subject, in much the same terms, over 40 years earlier.

III

In conclusion, the new fiscal rules introduced by the Labour government in 1997 and 1998 resemble a number of old fiscal rules which prevailed before the so-called 'Keynesian era'. They cannot be easily related to the recognized objectives of macroeconomic policy or justified by an appeal to macroeconomic theory. More specifically, they have no direct relevance to either the maintenance of high employment or the control of inflation. Their rationale instead runs in terms ('stability', 'prudence', limiting the debt interest burden, matching new debt with productive assets) which Treasury officials of the 1930s and 1940s would recognize, understand and approve, if they could somehow be reincarnated. The new rules are quite unlike the Keynesian principle that policy-makers should relate the budget deficit to aggregate demand and employment; they are also indifferent to the monetarist claim that an excessive budget deficit may need to be financed by monetary means and so lead to inflation. While monetarism (in the British sense, explained in Essay 7) and New Labour's brand of sound finance both endorse small budget deficits or balanced budgets, the authors of the two key rules – such as Ed Balls, the Chief Economic Adviser to the Treasury between 1999 and 2004 – have usually been rude towards monetarism when they have paid it any attention at all. Macroeconomic theory and analysis had some influence on fiscal policy between the 1950s and late 1980s, although the precise nature of that influence can be disputed. But macroeconomics has little or no relevance to the fiscal rules now in force.

This conclusion may sound critical and negative. It is not intended to be. The squabbles of macroeconomists in the 20 years to the mid-1980s were not particularly edifying and did not reach satisfactory, widely accepted answers. Further, a case can be made that – in terms of results – fiscal policy was better before the 1960s and after the mid-1980s than it was in intervening period when macroeconomics-based advice was in the ascendancy. But New Labour's technocrats must not pretend that their fiscal framework is innovative and modern. Such claims ignore the long-standing emphasis on sound finance in Britain's historical record. The golden rule and the sustainable investment rule are best interpreted not as new departures, but as the latest footnotes to that record.

NOTES

1. H. Brittain, *The British Budgetary System* (London: George Allen and Unwin, 1959), pp. 53–4.
2. D. Winch, *Economics and Policy* (London: Hodder and Stoughton, 1969), p. 313 and p. 315.
3. R.C.O. Matthews, 'Why has Britain had full employment since the war', *Economic Journal*, 78 (1968), pp. 555–69. The quotation is from p. 556.
4. T.G. Congdon, *Monetary Control in Britain* (London and Basingstoke: Macmillan Press, 1982), pp. 35–45.
5. For a sceptical assessment of the historical reality of the Keynesian revolution, see T.G. Congdon, 'Did Britain have a Keynesian revolution? Fiscal policy since 1941', in J. Maloney (ed.), *Debt and Deficits: An Historical Perspective* (Cheltenham: Edward Elgar, UK and Lyme, USA 1998), pp. 84–115, of which a revised version is reprinted here as Essay 4 on pp. 81–111.
6. N. Lawson, *The View from No. 11* (London and New York: Bantam Press, 1992), pp. 447–60.
7. Lawson, *The View from No. 11*, pp. 811–12.
8. J. Hawksworth and S. Wilcox, *Challenging the Conventions: Public Borrowing Rules and Housing Investment* (Coventry: The Chartered Institute of Housing, 1995), p. 3.
9. HM Treasury, *Stability and Investment for the Long Term* (London: HMSO, 1998), p. 20.
10. Brittain, *Budgetary System*, p. 53.
11. Brittain, *Budgetary System*, p. 53.
12. Brittain, *Budgetary System*, p. 175.
13. HM Treasury, *Stability and Investment*, p. 22.