History Repeating?

The lessons of the postwar recovery

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About the Author

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About the Centre for Policy Studies

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Founded in 1974 by Sir Keith Joseph and Margaret Thatcher, the CPS has a world-class track record in turning ideas into practical policy. As well as developing the bulk of the Thatcher reform agenda, it has been responsible for proposing the raising of the personal allowance, the Enterprise Allowance, the ISA, transferable pensions, synthetic phonics, free ports, and many other successful policy innovations.

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1. Introduction

Ever since the start of the coronavirus crisis, comparisons with the Second World War have been inescapable.

Boris Johnson, and other leaders, have referred to themselves as leading 'wartime governments'[1] – a sentiment that is more than justifiable in terms of the disruption of everyday life, the impact upon the economy and the public finances, and increasingly the death toll.[2]

From an economic point of view, the parallels are particularly apt. Just as in WW2, government intervention in the economy has grown enormously, while vast economic damage is occurring. Much of the economy, especially the private sector, had to shut down for several months, and will operate below capacity for a significant period.

This crisis, like that one, has transformed the economy. People are living differently, working differently and buying differently. As happened during global war, international trade collapsed, although there has since been a welcome rebound.[3] It is likely that the economy will by necessity need to adjust significantly compared to the pre-pandemic world, just as the postwar economy was transformed by the trends and technology that emerged during WW2.

Of course, the parallels only go so far. The death toll from the pandemic is horrific, but still far below that of WW2. The virus, unlike the rockets and mortar shells, is killing people but leaving infrastructure and buildings unscathed (and deaths are concentrated among the elderly). Currencies and central banks still broadly have credibility, and it is unlikely that we will see a repeat of the post-war hyperinflations that occurred in some countries. With the exception of certain medical goods, such as PPE and vaccines, governments have not tried imposing central planning on the economy via rationing, and market mechanisms are mostly still operating.

> **“The death toll from the pandemic is horrific, but still far below that of WW2.”**

However, there are more than enough similarities to ensure that the postwar period is worth studying to glean insights into the policy choices governments should make once the pandemic ends. In particular, as the approval and rollout of vaccines against Covid-19 gathers steam over the coming months, governments will look to try and spark economic growth to

1 BBC, ' Coronavirus: 'We must act like any wartime government'', (17 March 2020). https://www.bbc.co.uk/news/av/uk-51936760

2 BBC, 'Covid: 2020 saw most excess deaths since World War Two', (12 January 2021). https://www.bbc.co.uk/news/uk-55631693

3 Financial Times, 'Global trade recovers to pre-pandemic levels', (25 January 2021). https://www.ft.com/content/add4d744-30da-4df4-b703-80488c1b3104

quickly recover from the deep recessions that the pandemic has caused.[4]

> **“In postwar Britain, government continued to intervene extensively, via an economy that was heavily taxed and highly regulated.”**

Just as during WW2, there are already calls to maintain a permanently larger government, which intervenes more extensively and spends and taxes more. But as this paper will show, the key lesson from the postwar period – in contrast to much of the received wisdom – is that this would be a serious mistake.

In postwar Britain, government continued to intervene extensively, via an economy that was heavily taxed and highly regulated. That strategy strangled the private sector and impeded growth. In postwar America, West Germany, or Japan, efforts to reduce government spending, rates of taxation, and interference in the economy led to a faster recovery which maximised private sector job creation – even once you take account of the boost that came from rebuilding the industrial capacity of the defeated powers.

Provided government does not get in its way, the private sector is flexible enough to adjust to even the largest upheavals. If it was strong enough to restore prosperity after the WW2, it will certainly be able to handle the job of reigniting growth after the pandemic.

4 Such has been the economic carnage of the pandemic and the lockdowns that have been imposed to try and prevent transmission that many countries are experiencing among their worst recessions on record. For example, recent ONS estimates suggest that the UK's GDP fell by 9.9% in 2020, the largest decline since the Great Frost of 1709 when bad weather caused a fall in GDP of 13%. Partington, Richard, 'UK economy hit by record slump in 2020 but double-dip recession avoided', (The Guardian, 12 February 2021). https://www.theguardian.com/business/2021/feb/12/uk-avoided-double-dip-recession-despite-covid-slump-in-2020-ons-gdp

2. Postwar America – a rapid return to prosperity

WW2 is often seen as a time of plenty for the US.

The standard revisionist theory goes that it was the war, rather than FDR's faltering New Deal, that dragged America out of the Great Depression, and laid the foundations for postwar prosperity. Output figures and GDP data certainly show a wartime boom – followed by a sharp contraction, with output falling by over 20% in 1946 and inflation running high.[5]

In reality, as Robert Higgs has shown, these figures are simply wrong – distorted by price controls and central planning which inflated GDP growth, and postponed inflation during the war.[6] When the figures are properly adjusted, one finds that growth was poor during the war and then surged once peace was declared in 1945.[7]

For most people, even in America, WW2 was anything but prosperous. It was a time where the economy was centrally planned and rationing was widespread.[8] Yes, unemployment was minimal – but only due to massive military expansion.

"For most people, even in America, WW2 was anything but prosperous. It was a time where the economy was centrally planned and rationing was widespread."

The cost of the war was enormous,[9] and despite the common idea that mobilisation helped to boost productivity and growth, the evidence suggests it had the exact

5 See for example Figure 1 in: Higgs, Robert, 'From Central Planning to the Market: The American Transition, 1945-1947', (The Journal of Economic History, 1999), p602. https://www.cambridge.org/core/journals/journal-of-economic-history/article/from-central-planning-to-the-market-the-american-transition-19451947/5FF9B0755DE510489FE5C4D4E09FF3FE

6 Higgs, Robert, 'Wartime Prosperity? A Reassessment of the US Economy in the 1940's', (The Journal of Economic History, 1992), p44-49. https://www.cambridge.org/core/services/aop-cambridge-core/content/view/5D69B5C53EAE15CF69CA3DFD7EBF7D7A/S0022050700010251a.pdf/wartime_prosperity_a_reassessment_of_the_us_economy_in_the_1940s.pdf

7 *Ibid.* See column 'GNP' in Table 2.

8 The role of rationing in the US is an underappreciated point. During the war many everyday consumer durables were unavailable, but rationing extended to very basic goods as well like food, meaning many people had to make do with inferior foodstuffs such as poor-quality meat. All of this meant the wartime was far from a period of prosperity if you were a consumer, and it wasn't just the inability to purchase goods or the lack of choice, there was a direct cost in having to queue up at several different shops in an attempt to find one that had the good in stock that you were after. For more on the cost to consumers of the war see: Horwitz, Steven & McPhillips, Michael, 'The Reality of the Wartime Economy: More Historical Evidence on Whether World War II Ended the Great Depression' (The Independent Review, 2013). https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2095699

9 When you add up the immediate cost of the war plus the cost of veteran's benefits, then in real terms the second world war cost very nearly as much as all the other wars that the US fought in the 20th century and in terms of share of average GDP during the war it was significantly more costly. For more see Table 1 in: Jaworski, Taylor & Fishback, Peter V, 'World War II' (prepared for the Oxford Handbook of American History, 2014). https://warwick.ac.uk/fac/soc/economics/seminars/seminars/conferences/conf/world_war_handbook_2014.03.20.pdf

opposite effect – acting as a drag on growth over the long-term.[10]

It was not until after WW2 that prosperity truly returned to America – as the US ditched central planning and returned to a more free-market system.[11] Spending was cut massively, falling by 75% between 1944 and 1947, from 55% of GNP down to just 16%.[12] By 1947 price and production controls had ended, as had rationing, and factories had gone back to producing consumer goods rather than the tools of war. For the first time since entry into the war, American consumers were able to go out and buy new products.

The data bear this out. Taking proper account of inflation, real personal consumption hardly grew during the war – rising by under 7%. As soon as peace was declared, it began to rise sharply, increasing by almost 20% in 1946 alone.[13] By the end of 1946, after little more than a year of peace, production of a large number of consumer durable goods such as cars, radios, and refrigerators had recovered, or in some cases exceeded pre-war levels.[14]

This recovery took many economists – especially the new Keynesian variety – by surprise. They had feared that when WW2 ended, a depression would follow unless government intervention continued, since millions of men would need to be demobbed and industry reoriented to peacetime production. After the Great Depression, the assumption was that the private sector simply could not cope with the task. These fears were voiced by respected economists such as future economic Nobel Prize winners Paul Samuelson and Gunnar Myrdal, not cranks or serial pessimists.

“Taking proper account of inflation, real personal consumption hardly grew during the war – rising by under 7%.”

In reality, they were proved completely incorrect. Despite there being over 20 million people, whose jobs disappeared – either via being demobbed or working in industries supplying the military – there was

10 As Alexander Field points out, when you examine the data you find that productivity growth in manufacturing was actually lower during the war than before or after it. This is unsurprising, since the mobilisation for war led to vast numbers of experienced workers being transferred from their jobs into the military and replaced by women or teenagers who lacked experience – this represents a large loss in human capital. Furthermore, what gains in productivity that did occur were mostly in industries with existing low levels and were achieved by adopting management practices already widely used in other parts of the private sector. Field also points out that much of the 'learning by doing' gains that were made during the war were not readily transferable into the peacetime period as the output mix was so different. This is an issue which Higgs also covers in regards to capital investment in war structures and equipment, since there was substantial cost in redeploying such sector-specific capital – so massive investment during the war was unlikely to create a long-lasting boost to growth. For more see: Field, Alexander J, 'The Productivity Impact of World War II Mobilization in the United States' (2018). https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3110832 ; Higgs, Robert, 'Wartime Socialization of Investment: A Reassessment of U.S. Capital Formation in the 1940s' (The Journal of Economic History, 2004) p518. https://www.jstor.org/stable/3874782?seq=1; Jaworski, Taylor & Fishback, Peter V, 'World War II' (prepared for the Oxford Handbook of American History, 2014). https://warwick.ac.uk/fac/soc/economics/seminars/seminars/conferences/conf/world_war_handbook_2014.03.20.pdf

11 Higgs, Robert, 'Wartime Prosperity? A Reassessment of the US Economy in the 1940's' (The Journal of Economic History, 1992). https://www.cambridge.org/core/services/aop-cambridge-core/content/view/5D69B5C53EAE15CF69CA3DFD7EBF7D7A/S0022050700010251a.pdf/wartime_prosperity_a_reassessment_of_the_us_economy_in_the_1940s.pdf

12 Henderson, David R., 'The U.S. Postwar Miracle' (Mercatus Center at George Mason University, 2010), p14. https://www.mercatus.org/system/files/U.S.%20Postwar%20Miracle.Henderson.11.4.10.pdf

13 See table 4 in: Higgs, Robert, 'Wartime Prosperity? A Reassessment of the US Economy in the 1940's' (The Journal of Economic History, 1992), p52. https://www.cambridge.org/core/services/aop-cambridge-core/content/view/5D69B5C53EAE15CF69CA3DFD7EBF7D7A/S0022050700010251a.pdf/wartime_prosperity_a_reassessment_of_the_us_economy_in_the_1940s.pdf

14 See figure 3 in: Henderson, David R., 'The U.S. Postwar Miracle' (Mercatus Center at George Mason University, 2010), p15. https://www.mercatus.org/system/files/U.S.%20Postwar%20Miracle.Henderson.11.4.10.pdf

no new depression. Mass unemployment failed to materialise, with the jobless rate peaking at 3.9% in 1946.[15] In total, about one-third of the entire US labour force was successfully reallocated to serving private consumers, a remarkable achievement.[16]

Popular explanations are wrong

Many alternative explanations have been suggested for America's postwar prosperity, beyond the robust power of the free market. Yet most turn out either to be less important than assumed, or just plain wrong.

For example, the idea that unemployment remained low because women who had entered the labour force during the war suddenly left it is only partly true. Just over half left – about 2.5 million. That figure is far too small to balance against the many millions of jobless men at the end of WW2.

Another explanation is that the GI Bill temporarily kept veterans out of the labour force while they were retrained. Yet at its peak (in 1946) the GI Bill put just 800,000 veterans into college. Had they all been unemployed instead, the unemployment rate would have increased by just 1.4 percentage points.[17]

Finally, a common explanation is that there was a consumer boom as people spent 'forced savings' which they had built up during the war, when many consumer goods had been unavailable. This would certainly offer an encouraging precedent for the pandemic, given the sudden spike in savings as people's spending options have been forcibly reduced.

> **"In the last full year of WW2, gross private domestic investment stood at just $15.4bn."**

However, the evidence does not support this. Individual holdings of liquid assets did not fall postwar. Instead of spending their savings, they significantly lowered the proportion of their income that they saved going forward: falling from 25.5% in 1944 to 4.3% in 1947.

In reality, then, the recovery had far more to do with a consumer and investment boom which the government helped to perpetuate by slimming down and getting out of the way.

The consumption boom, as people embraced the feeling of euphoria that peace brought, meant there was no shortfall in demand.[18] The same is true of private investment, which as Figure 1 shows, finally exceeded the real terms levels that had last been reached in 1929.[19]

15 Henderson, David R., 'The U.S. Postwar Miracle' (Mercatus Center at George Mason University, 2010), p14. https://www.mercatus.org/system/files/U.S.%20Postwar%20Miracle.Henderson.11.4.10.pdf

16 Higgs, Robert, 'From Central Planning to the Market: The American Transition, 1945-1947' (The Journal of Economic History, 1999), p613. https://www.cambridge.org/core/journals/journal-of-economic-history/article/from-central-planning-to-the-market-the-american-transition-19451947/5FF9B0755DE510489FE5C4D4E09FF3FE

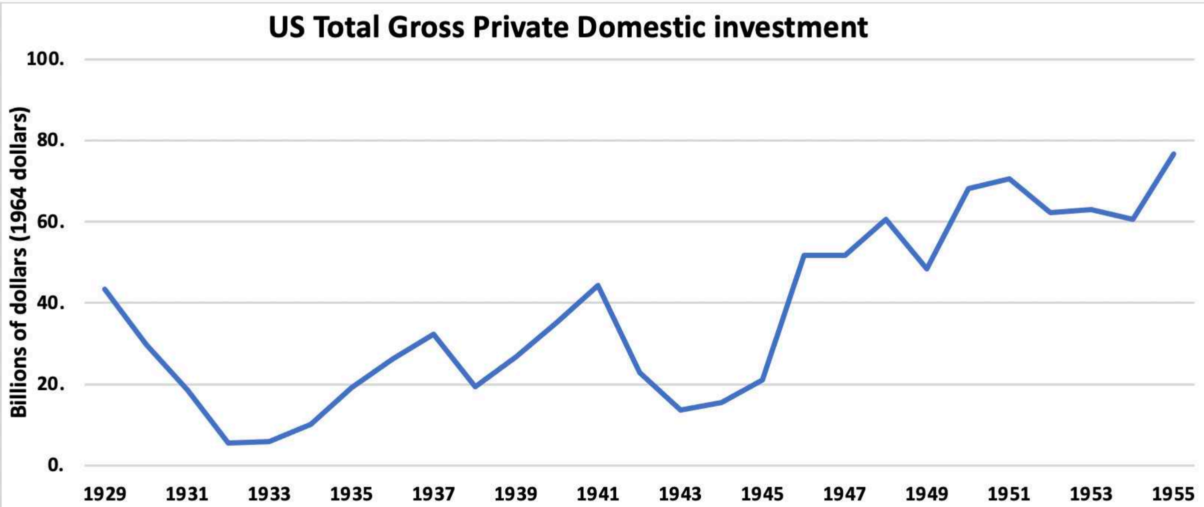
17 In fact, because of the special unemployment benefits given to veterans acted as a subsidy for veterans to be unemployed – thus unemployment was likely higher under the GI bill than otherwise. See: Higgs, Robert, 'From Central Planning to the Market: The American Transition, 1945-1947' (The Journal of Economic History, 1999), p.618. https://www.cambridge.org/core/journals/journal-of-economic-history/article/from-central-planning-to-the-market-the-american-transition-19451947/5FF9B0755DE510489FE5C4D4E09FF3FE

18 The usual explanation for this – that the large stock of 'forced savings' that many people had built up during the war was used to finance higher consumption is not correct. As Robert Higgs shows, individuals did not reduce their holdings of liquid assets after the war, instead they reduced their rate of personal savings. See: Higgs, Robert, 'From Central Planning to the Market: The American Transition, 1945-1947' (The Journal of Economic History, 1999), p607-609. https://www.cambridge.org/core/journals/journal-of-economic-history/article/from-central-planning-to-the-market-the-american-transition-19451947/5FF9B0755DE510489FE5C4D4E09FF3FE

19 Technically private investment in 1944 did just exceed the level of 1929, but until the postwar years that was the only year which came close to the previous high level.

In the last full year of WW2, gross private domestic investment stood at just $15.4bn. But in 1946, the first full year of peace, it shot up to $51.7bn. High levels of investment continued as the boom gathered pace, reaching $70.6bn by 1951.[20] These high levels of investment provided the means for the US to innovate and increase productivity.

FIGURE 1[21]



The power of business confidence

While many economists were indeed pessimistic about America's postwar prospects, it is clear that business people and investors were far more optimistic. Polling by Fortune magazine in 1944 poll of business executives shows that over 50% thought that prospects for their company would be better after the war, with just 8.5% saying worse. With the death of President Roosevelt and the ascension of Harry S. Truman, this optimism increased, with polls showing that business people felt that Truman would be more favourable to industry and less favourable to labour unions.[22]

Robert Higgs has argued persuasively that the reason why the Great Depression lasted so long, and why prosperity returned after WW2, is 'regime uncertainty'.[23] During the years of the Great Depression, Roosevelt would often make searing rhetorical attacks on the business community. During the so-called Second New Deal of the mid- and late 1930s, a cadre of fervently anti-business individuals joined the Roosevelt administration and pushed for more government intervention and central planning.

It may seem nonsensical now, but at the time many business people and investors feared – given what was happening in the rest of the world, and the rhetoric and reality of many of the policies Roosevelt was pushing – that a planned economy,

20 See Table 2 in: Henderson, David R., 'The U.S. Postwar Miracle' (Mercatus Center at George Mason University, 2010), p14. https://www.mercatus.org/system/files/U.S.%20Postwar%20Miracle.Henderson.11.4.10.pdf

21 Data taken from table B-2 in: 'Economic Report of the President, January 1965' (Federal Reserve Bank of st louis), p190. https://fraser.stlouisfed.org/files/docs/publications/ERP/1965/ERP__1965.pdf

22 Higgs, Robert, 'Regime Uncertainty: Why the Great Depression Lasted So Long and Why Prosperity Resumed after the War' (The Independent Review, 1997), p581-582. https://www.jstor.org/stable/24560785?seq=1

23 *Ibid.*

or even some form of dictatorship, was a real possibility. The belief that their property (i.e. future returns from investments) was no longer safe duly imperiled the incentive to invest.

According to the data, investment remained far below 1929 levels until after WW2 – and, equally importantly, there was a sharp shift away from longer-term to more short-term investments in the 1930s.[24] Further evidence can be found by examining the yields on corporate bonds. During the mid-1930s, a spread opened up with longer-term bonds seeing much higher yields[25] – suggesting that investors were pricing in an increasingly higher risk premium the longer the investment, because they worried that their future returns were potentially threatened.

This spread began to fall in 1941/42 – just at the moment when the administration was appointing a host of business executives to improve war production and mobilisation. As WW2 progressed, there was a gradual turnover of staff in the administration, with more pro-market appointees joining and most of the fervent interventionist New Dealers departing.

With Truman's succession to the presidency, the transformation of relations with business was complete. While still a New Dealer, Truman was seen as far less interventionist and more pro-market than Roosevelt. Higgs argues that this led investors and businesspeople to feel secure that the government wouldn't suddenly try to confiscate any future returns from investments that they made. The fact that investment boomed after WW2, and the spread in yields on corporate bonds had mostly closed by the early 1950s, gives credence to this theory.[26]

Freeing the market

The Truman administration certainly carried out a number of pro-market, pro-growth reforms (admittedly partly as a result of the Republican landslide in the 1946 mid-term elections, which put pressure on him to be less interventionist). While postwar America was not entirely laissez faire,[27] and although aspects of the system of wartime economic control remained after the war, the US did mostly go back to being a market system.[28]

"With the price system allocating resources, entrepreneurs had accurate signals for the first time in many years of the most economically efficient decisions to make."

With the price system allocating resources, entrepreneurs had accurate signals for the first time in many years of the most economically efficient decisions to make. Without rationing or price controls the shops soon became full again and

24 Ibid. p583

25 The usual explanation is that this is due to a flight to liquidity. However, the fact that there was a spread between for example 5 year and 20-year corporate bonds suggests this explains at best only part of the story – since a 5-year bond is hardly more liquid than a 20-year bond so a flight to liquidity would hardly explain a spread between them.

26 Higgs, Robert, 'From Central Planning to the Market: The American Transition, 1945-1947' (The Journal of Economic History, 1999), p582-585. https://www.cambridge.org/core/services/aop-cambridge-core/content/view/5FF9B0755DE510489FE5C4D4E09FF3FE/S0022050700023500a.pdf/from__central__planning__to__the__market__the__american__transition__19451947.pdf

27 Price controls were briefly reintroduced in 1946 after prices adjusted to the monetisation of government debts during the war and the inflation that resulted. They were very rapidly repealed again that year when they inevitably caused shortages.

28 Jaworski, Taylor & Fishback, Peter V., 'World War II' (prepared for the Oxford Handbook of American History, 2014). https://warwick.ac.uk/fac/soc/economics/seminars/seminars/conferences/conf/world__war__handbook__2014.03.20.pdf

consumers no longer had to waste valuable time queuing at multiple shops to try to obtain a particular good, as had often been the case during the war.[29]

Reducing taxes and spending

Key to the boom in investment were the tax reforms that were passed in the Revenue Act of 1945. These lowered the top corporate tax rate from 40% to 38%,[30] and repealed the excess profits tax which had taxed profits above a set limit at an effective rate of 85.25%.[31] Coinciding with the postwar consumer boom, these changes led corporate after-tax profits to increase significantly, which increased retained earnings, which in turn provided an important source of financing for the high levels of investment that occurred after WW2.[32]

Especially beneficial for growth were the massive cutbacks in government spending, falling from 55% of GNP in 1944, to 16% in 1947. It is worth emphasising how large a fall this was. David Henderson pointed out in a 2010 paper that the same 35% GNP reduction today would amount to over $5 trillion in real terms.[33] And these cutbacks were not drawn out: by 1946 most of them had already been completed.

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This might have withdrawn demand from the economy. But it also, crucially, meant that taxes could be cut. Government revenue as a share of GDP fell from about 22.5% in 1945 to 19.6% in 1946, eventually reaching a low of 14% in 1950. This substantially improved the incentive to work and invest. But more importantly, the fall in spending and the demobilisation of the economy freed vast amounts of real resources – labour and capital – for the private sector. Guided by the signals from the market price mechanism and their unique disaggregated knowledge of their specific industry and region, entrepreneurs and business people were able to more efficiently allocate these scarce resources than the government would ever have been able to in peacetime, leading to greater growth, innovation, and prosperity.[34]

29 Henderson, David R., ‘The U.S. Postwar Miracle’ (Mercatus Center at George Mason University, 2010), p10. https://www.mercatus.org/system/files/U.S.%20Postwar%20Miracle.Henderson.11.4.10.pdf

30 Tax Policy Centre, ‘Major Enacted Tax Legislation, 1940-1949’, (Urban Institute and Brookings Institution, 2020). https://www.taxpolicycenter.org/laws-proposals/major-enacted-tax-legislation-1940-1949

31 The Committee on Postwar Tax Policy, ‘Financing Defense: Is An Excess Profits Tax the Solution?’, (the Tax Foundation, 1950), P9. https://files.taxfoundation.org/20200430103359/financing-defense.pdf

32 Higgs, Robert, ‘From Central Planning to the Market: The American Transition, 1945-1947’ (The Journal of Economic History, 1999), p609-610. https://www.cambridge.org/core/journals/journal-of-economic-history/article/from-central-planning-to-the-market-the-american-transition-19451947/5FF9B0755DE510489FE5C4D4E09FF3FE

33 Henderson, David R., ‘The U.S. Postwar Miracle’ (Mercatus Center at George Mason University, 2010), p7. https://www.mercatus.org/system/files/U.S.%20Postwar%20Miracle.Henderson.11.4.10.pdf

34 A good summary of why the market price system is better at allocating resources than central planning can be found in FA Hayek’s seminal paper ‘The Use of Knowledge in Society’:
Hayek, F. A. “The Use of Knowledge in Society.” The American Economic Review 35, no. 4 (1945): 519-30. Accessed January 18, 2021. http://www.jstor.org/stable/1809376.

3. Western Europe and Japan – recovery and rebuilding

Unlike America, much of Western Europe and Japan lay in ruins at the end of WW2, with significant damage to infrastructure and industrial capacity.

For example, in France it is estimated that over 1.2 million dwellings, about half of the docks and warehouses in ports, and just under 40% of railway stations were lost due to war damage.[35] Despite this, or perhaps even because of it, postwar growth was historically high in many countries.[36] Japan, which at the end of the war had basically collapsed economically – with rampant inflation and a huge budget deficit – managed from 1951 to 1971 to achieve average GDP growth of 9.4% per year.[37]

In Europe the standout performer was West Germany, whose per capita GNP grew at an average of 6.3% between 1949-59. Italy also managed an impressive 5.5%, while France and especially the UK lagged behind with 3.6% and 2.1% respectively.[38]

As can be seen in Figures 2 and 3 – which show an index of real GDP per capita from 1950-1970 and the annual change in real GDP per capita from 1951-1961 respectively – the rapid growth of Japan and West Germany is clear, as is the lagging behind of the UK.

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Although UK growth does not look too bad when compared to the US, it should be remembered that the US was already significantly wealthier than the UK in 1950 – GDP per capita in 1950 was over $14,400 in the US compared to about $10,350 in the UK. As Figure 4 shows, Japan, West Germany, Italy, and France all managed to significantly catch up and narrow the gap with the US – whereas in the UK, the ratio of GDP per capita compared to the US

35 Saint-Paul, Giles, ‘Chapter 4: Economic Reconstruction in France: 1945 – 1958’, in: Postwar Economic Reconstruction and Lessons for the East Today (eds. Rudiger Dornbusch, Wilhelm Nolling, & Richard Layard, 1993), p84.

36 The prime example of how not to do postwar recovery is Argentina, which managed to go from a rich first world nation to a third world nation with a ruined economy in the space of just a few decades – again this is because even more so than in the UK, the Argentinian government took on much too large a role in the running of the economy and meddled with the market mechanism in how resources were allocated. A good summary of the main macroeconomic mistakes made in postwar Argentina can be found in: De Long, Bradford & Eichengreen, Barry, ‘The Marshall Plan: History’s most successful structural adjustment program’ (National Bureau of Economic Research, 1991), see here: https://ideas.repec.org/p/nbr/nberwo/3899.html

37 Ohno, Kenichi, ‘The Economic Development of Japan’, Chapter 11 ‘The High Growth Era’ (GRIPS Development Forum, 2006), p170 and figure 11.1 on p162. https://www.grips.ac.jp/forum/pdf06/EDJ.pdf

38 All data on GNP taken from table 14 in: Dornbusch, Rudiger & Wolf, Holger C., ‘Monetary Overhang and Reforms in the 1940’s’ (NBER, 1990), p32. https://papers.ssrn.com/sol3/papers.cfm?abstract__id=987262

actually fell (from 72% in 1950 to 68% in 1970).[39]

It should be noted that UK growth would likely never have been as impressive as that seen in West Germany or France, because there was less scope for catch-up growth after the destruction of war, and less room to transfer labour from agriculture to higher productivity sectors.[40] However, even accounting for these factors, postwar growth in the UK was still about 0.75-1% lower annually than it could and should have been.[41]

FIGURE 2[42]

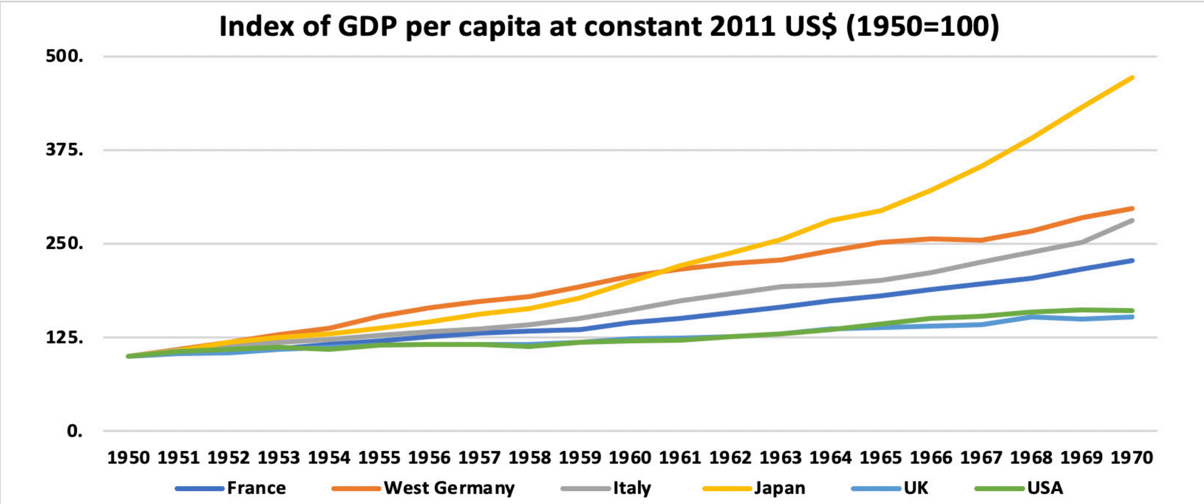
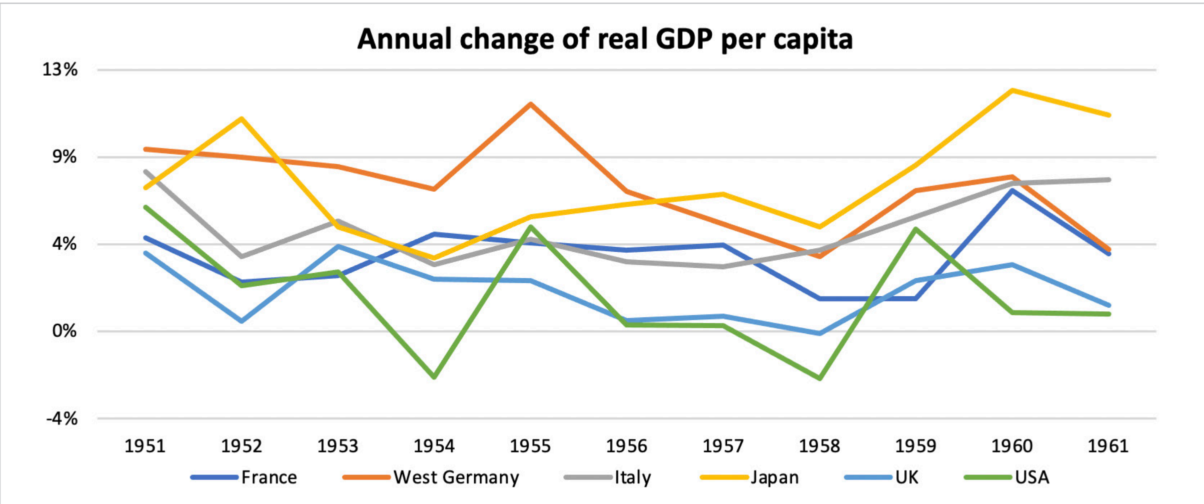


FIGURE 3[43]



39 GDP per capita figures calculated by author using data on real GDP and population size from: Feenstra, Robert C., Robert Inklaar and Marcel P. Timmer (2015), “The Next Generation of the Penn World Table” American Economic Review, 105(10), 3150-3182, available for download at www.ggdc.net/pwt

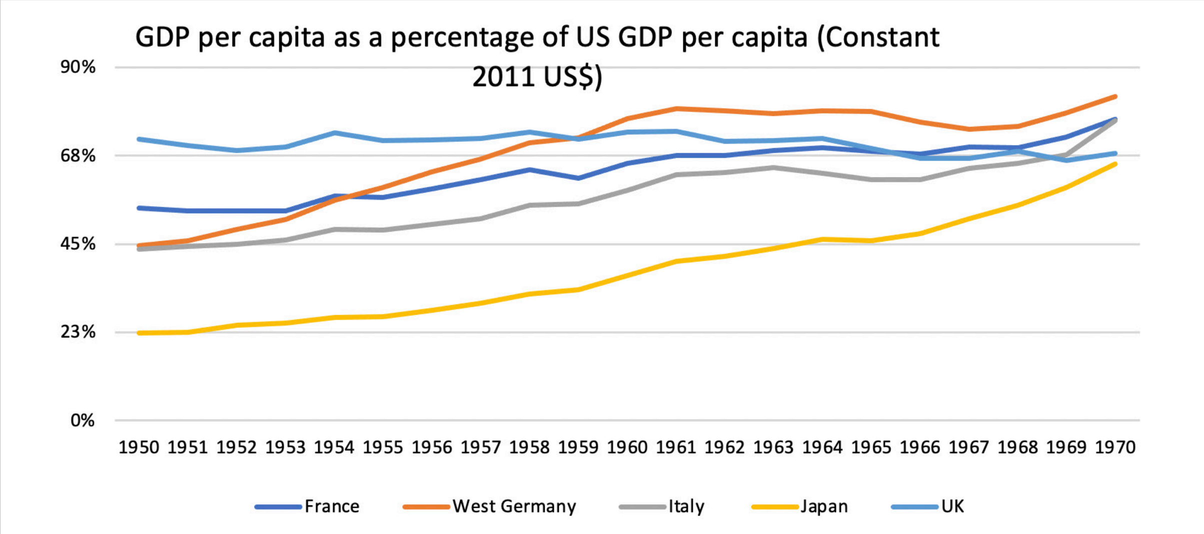
40 The UK economy has been damaged less than either of the other countries by the war and British agriculture was already pretty labour efficient.

41 Broadberry, Stephen & Crafts, Nicholas, ‘UK Productivity Performance from 1950 to 1979: A Restatement of the Broadberry-Crafts View’ (Wiley on behalf of the Economic History Society, 2003). https://www.jstor.org/stable/3698724?seq=1

42 GDP per capita figures calculated by author using data on real GDP and population size from: Feenstra, Robert C., Robert Inklaar and Marcel P. Timmer (2015), “The Next Generation of the Penn World Table” American Economic Review, 105(10), 3150-3182, available for download at www.ggdc.net/pwt

43 *Ibid.*

FIGURE 4[44]



Killing inflation and freeing the market

For many countries, the key to recovery was dealing with inflation – especially since the Axis powers in particular had resorted to rampant money-printing to pay for the war. In Japan, inflation was in the triple digits. In Germany, the currency had become so debauched that people had resorted to bartering.

Most countries solved this issue by currency reform.[45] The most famous example was the 1948 reform in West Germany (or the occupied Bizone as it then was).[46] Against the advice of the occupying powers, and many economists, Ludwig Erhard – the head of the Bizonal economic administration and later Chancellor of West Germany – forced through the conversion of the old Reichsmark currency for the new Deutsche Mark. The reform was an immediate success. With a balanced budget (which eliminated the need to inflate away its debts), West Germany became a fervently low-inflation country.[47]

44 Ibid.

45 In fact, in Western Europe, the only major countries not to go down this route were the UK and Italy.

46 The Bizone, which came into existence on 1 January 1947, consisted of the occupied American and British areas of Germany. When French occupied areas were added on 1 August 1948, this became the Trizone, which would become West Germany on 23 May 1949.

47 Two points are worth bearing in mind here: 1. Although most of the countries referenced in this essay such as West Germany, Japan, and the USA both practised fiscal conservatism and simultaneously shrunk the state in the postwar period, the two policies do not have to go hand in hand. The UK for example also balanced its budget in the immediate postwar years (partly because this was a condition of receiving Marshall Plan aid), but at the same time maintained a heavily interventionist state. A high-tax and high-spend country can still be fiscally conservative provided it is roughly balancing its budget.

2. The discussion around inflation and balancing the books is different today to that in the postwar period. Whereas today inflation is less of a concern, as explained in this essay in the postwar period it was a big issue and was a big barrier to growth. Governments at that time were much more constrained in being able to borrow in order to fund current spending, and rapidly bringing the budget into balance was more important in ensuring markets retained confidence and didn't start to sell off the currency, thus imperilling the fixed exchange rates system that operated. Today with floating exchange rates and little immediate threat of inflation or the need to rapidly increase interest rates, governments can more easily borrow in the short term in order to fund deficit spending. However, this doesn't mean that the government can or should borrow as much as it wants for as long as it wants. Unless government deficit spending can boost growth so that GDP increases more quickly than government debt, deficit spending will necessitate higher taxation further down the line. The expectation of this – just as with the regime uncertainty outlined earlier in this essay – could itself supress growth. For example, if businesses expect to face higher rates of taxation in the future, this could bias them against making profitable investments today or expanding production and hiring more employees, and international investment would be disincentivised from investing in the country.

Erhard combined this reform, like his counterparts in the US, with abolition of most price controls and substantial tax reforms to restore the price mechanism and incentivise work and investment. Income tax rates fell substantially for all but the very highest income bracket. Many of the extremely high marginal rates saw double digit percentage point reductions.[48] The government also made changes to encourage investment, such as generous investment tax credits. These reforms helped to boost and sustain high growth rates throughout the postwar period. Higher growth meant that despite the substantial reduction in tax rates, revenue still increased the following year.

France did less well than West Germany. While as with the rest of Western Europe (including even the laggard Britain) it had a historically strong recovery, it is clear that compared to the more market-friendly policies of West Germany, the dirigisme of France was less successful in generating growth and creating prosperity.[49] The 1940s and 1950s were unsettled, both politically and economically. Once some stability was established, as it was in the 1960s, France managed to record strong growth figures. However, it should be remembered that a big part of the growth that France achieved was created by modernisation in agriculture and the transfer of labour to higher productivity uses.

In Italy, the postwar period initially brought high inflation and large deficits. But by the late 1940s, reforms pushed by economic liberals such as Luigi Einaudi (who became president in 1948) squeezed credit, brought the budget back into balance, and liberalised trade.

“The 1940s and 1950s were unsettled, both politically and economically. Once some stability was established, as it was in the 1960s, France managed to record strong growth figures.”

This of course did not make the country a laissez faire paradise. Despite the efforts of liberals such as Einaudi and pressure from the Americans, large state-owned companies were not able to be sold off. Nevertheless, relative to the UK or France, Italy saw a move in the immediate postwar period away from central planning and big government, and towards the market and sound fiscal and monetary policy – and reaped the benefits in terms higher growth and lower inflation.[50]

The sound policy choices of West Germany and Italy, and the resulting rapid growth, are reflected in the figures for industrial production in Figure 5.[51]

48 Dornbusch, Rudiger & Wolf, Holger C., ‘Monetary Overhang and Reforms in the 1940's’ (NBER, 1990), p30-31. https://papers.ssrn.com/sol3/papers.cfm?abstract_id=987262

49 Saint-Paul, Giles, ‘Chapter 4: Economic Reconstruction in France: 1945 – 1958’, in: Postwar Economic Reconstruction and Lessons for the East Today (eds. Rudiger Dornbusch, Wilhelm Nolling, & Richard Layard, 1993).

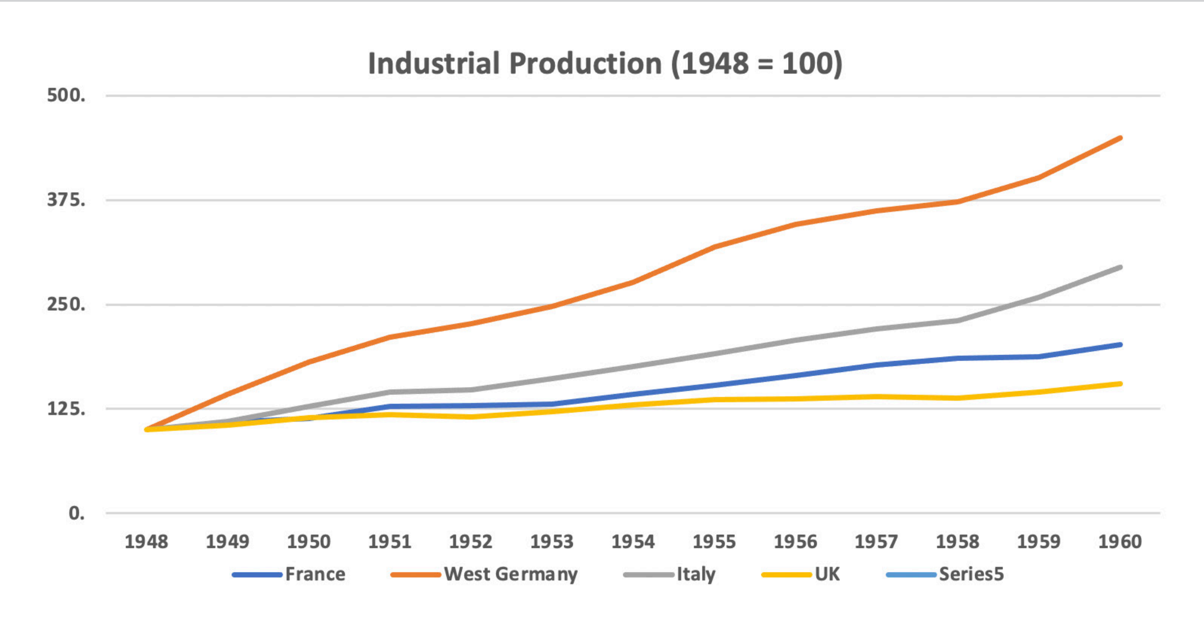
50 De Cecco, Marcello & Giavazzi, Francesco, ‘Chapter 3: Inflation and Stabilization in Italy: 1946 – 1951’, in: Postwar Economic Reconstruction and Lessons for the East Today (eds. Rudiger Dornbusch, Wilhelm Nolling, and Richard Layard, 1993).

51 It is interesting to look at the original data, where the base year is 1937. This allows us to compare prewar with postwar (although there are difficulties with doing this since prewar figures are for the whole of Germany, whereas the postwar data is for West Germany only). It shows that by 1946 the UK was already producing at very nearly the same level as in 1937. France and Italy were both substantially below prewar output (at 76% and 71% respectively) and West Germany even more so (although its data only begins in 1948 when its index stands at 63%). By 1950 all countries had exceeded prewar levels and were converging at a similar level of output. The 1950s saw West Germany and Italy push on and production was soon exceeding French levels, who in turn did better than the UK. By 1960 Industrial production stood at 208% of 1937 levels in France, 283% in West Germany, 292% in Italy, and just 177% in the UK. The strong growth of West Germany is doubly impressive when it is remembered that the German economy had shown strong growth in industrial production in the 1930s as rearmament went into full swing and by the late 1930s was probably overheating (whereas French industry by 1937 was still producing substantially below the levels reached in the mid to late 1920s). The point of this is that German industrial production levels in 1937 were probably artificially high, whereas the level in France was still depressed – so the fact that West Germany had exceeded 1937 levels by more than France demonstrates just how strong its postwar recovery was.

Although there may have been some economic benefit to these countries from being able to modernise their industrial base after the devastation of war, its impact should not be overemphasised. Despite the widespread bombing during the war, industrial equipment and plants survived to a remarkable extent. Even in countries like Germany and Japan, who were mercilessly bombed for much of the war by the allies, industrial fixed capital was significantly higher in 1945 than it had been in 1936 – rising by 20% and 30% respectively. Power generating capacity was expanded, but needed little repair.[52]

It is true that repairing damage to crucial infrastructure such as transport networks was crucial to recovery, but most of this was rapidly complete – for example, by the end of 1946, freight transport on Western Europe's railways had virtually recovered to pre-war levels.[53] As Tamas Vonyo emphasises, it was not a lack of productive capacity that held back growth but institutional and geopolitical factors.[54] In particular, as explained below, it was not the Marshall Plan aid itself that boosted growth, or even the investments that aid made possible, but the fact that the terms attached helped to encourage countries – especially West Germany and Japan, which were subject powers rather than independent allies – to introduce the necessary reforms, and lay the foundations for strong economic growth.

FIGURE 5[55]



52 Vonyo, Tamas, 'Recovery & reconstruction: Europe after WWII' (VOX.EU, November 2019). https://voxeu.org/article/recovery-and-reconstruction-europe-after-wwii

53 Figure 8, p32 in: De Long, Bradford & Eichengreen, Barry, 'The Marshall Plan: History's most successful structural adjustment program' (National Bureau of Economic Research, 1991). https://ideas.repec.org/p/nbr/nberwo/3899.html

54 Vonyo, Tamas, 'Recovery & reconstruction: Europe after WWII' (VOX.EU, November 2019). https://voxeu.org/article/recovery-and-reconstruction-europe-after-wwii

55 Data recalculated with 1948 as the base year. Original data had 1937 as base year and is taken from table D1 in: Mitchell, B.R., 'European Historical Statistics 1750-1970' (The Macmillan Press Ltd, 1978), p180-182.

West Germany and Japan: contrasting paths to competitiveness

Although both Japan and West Germany were rebuilding their economies from the ground up, the exact policies pursued were not always the same. While the pro-market philosophy of Ordoliberalism strongly influenced the architect of the West German Wirtschaftswunder Ludwig Erhard,[56] in Japan they were more comfortable with limited government intervention, via the Ministry of International Trade and Industry (MITI).[57]

But in broad terms, in those countries which had the strongest postwar growth the policy mix was similar: less government, more market; fiscal and monetary conservatism; and a key focus on increasing competition and productivity.

While both West Germany and Japan sought to encourage competition, they went about it in slightly different ways. In West Germany, the focus was on anti-cartel law and trade liberalisation as a means of introducing international competition into the domestic economy. In Japan, the occupying Americans initially attempted to stamp out cartels by abolishing the system of zaibatsu, but these efforts were later relaxed.

Furthermore, while international trade was permitted after the 'Dodge Line' in 1949,[58] the policy was hardly free trade, and high tariff barriers did not really start to fall in Japan until the 1960s.[59]

"Although both Japan and West Germany were rebuilding their economies from the ground up, the exact policies pursued were not always the same."

The Japanese government was not necessarily being overtly protectionist during the postwar period. Rather, it was constantly concerned about the balance of payments situation. Given that demand for imports of fuel, raw materials, industrial machinery, consumer goods and technology grew much more quickly than export capability in postwar Japan, officials felt they had little choice but to restrain imports or risk a ballooning current account deficit and potentially being forced into devaluing the yen, something they were adamant to avoid. This situation only started to change in the 1960s, once Japanese exports began to take off and the persistent current account deficit turned into a significant surplus.

56 Handelsblatt, 'Ordoliberalism and the alleged aberration of German economics' (Handelsbaltt, 2018). https://www.handelsblatt.com/english/politics/handelsblatt-explains-ordoliberalism-and-the-alleged-aberration-of-german-economics/23580920.html

57 It is an open question of whether the policies of MITI were beneficial, negative, or neutral in terms of increasing Japanese growth in the mid 50's and 60's. Some industries succeeded without its help, and others failed despite its explicit support. Furthermore, the econometric evidence is inconclusive, not least because of the difficulty of constructing a realistic counterfactual of Japanese growth without the interventions of MITI. It seems clear however given the postwar success of the US and West Germany that Japan succeeded firstly because of private dynamism. Any boost that government intervention may have made to growth are of a secondary importance in comparison. A good overview of the role of MITI in the postwar Japanese economy and the evidence about its impact can be found in: Ohno, Kenichi, 'The Economic Development of Japan', Chapter 11 'The High Growth Era' (GRIPS Development Forum, 2006), p170-174. https://www.grips.ac.jp/forum/pdf06/EDJ.pdf ; Furthermore, a good summary of the explicit case against MITI explaining the postwar recovery in Japan can be found in: Sakoh, Katsuro, 'Japanese Economic Success: Industrial Policy or Free Market?', (Cato Journal, Vol. 4, No. 2, Autumn 1984). https://www.cato.org/sites/cato.org/files/serials/files/cato-journal/1984/11/cj4n2-8.pdf

58 The Dodge line refers to the programme of fiscal austerity and financial reconstruction as proposed by Joseph Dodge head of an official US mission to rehabilitate the Japanese economy and who was also the chief financial advisor to the Supreme Commander for the Allied Powers, General MacArthur. Key to the programme was balancing the budget, reducing government subsidy and intervention in the economy, fixing the exchange rate at a stable level of 360 yen = $1.

59 Ohno, Kenichi, 'The Economic Development of Japan', Chapter 10 & 11 (GRIPS Development Forum, 2006). https://www.grips.ac.jp/forum/pdf06/EDJ.pdf

Indeed, although post-war growth in Japan was remarkably high, many economists think that if the Japanese government had been less concerned about a current account deficit and had relaxed controls on imports earlier, growth in the 1950s and 1960s could have been even higher.[60]

“In 1951, government expenditure represented almost 30% of GNP. By 1961, it had settled at about 20%, where it remained for the next decade.”

Of greater importance was the strict fiscal and monetary conservatism that was pursued after the ‘Dodge Line’ reforms, alongside the phasing out of price controls. Prior to these reforms, huge budget deficits had been paid for by simply monetising the debt. While inflation had been brought down, it was still running at over 100% prior to the reforms.[61] This was achieved partly by abolishing government subsidies to industry (such as fukkin loans), running a balanced budget, and successfully maintaining a fixed exchange rate of 360 yen to the dollar until 1971. Arguably, Japan was even more committed to fiscal conservatism than West Germany; despite its lending to industry, it is a remarkable fact that it was not until 1965 that the postwar Japanese government started issuing bonds.[62]

This commitment to fiscal conservatism while the economy was growing strongly meant that the size of Japan’s government could shrink significantly. In 1951, government expenditure represented almost 30% of GNP. By 1961, it had settled at about 20%, where it remained for the next decade. Lower spending meant taxes gradually declined in a similar manner. Both lower taxes and lower government demands on the economy’s productive resources boosted growth.

The Japanese government also pursued policies designed to improve the competitiveness of Japanese firms. For example, in order to combat inflation caused by the demand boom of the Korean War, interest rates were raised and credit was tightened. This forced firms to cut costs and innovate or perish. Essentially, rather than trying to support failing firms as they had after the First World War, the Japanese government pursued a fairly Darwinian economic policy of survival of the most competitive.[63]

The UK – the sick man of Europe

As already outlined, UK postwar growth lagged behind most other countries. There were admittedly long-standing structural issues in the postwar British economy which acted as a drag on growth, the most prominent of which was poor industrial relations.[64] However, the policies that were pursued failed to confront these fundamental flaws, and in many ways contributed to making them worse.[65]

60 Sakoh, Katsuro, ‘Japanese Economic Success: Industrial Policy or Free Market?’, (Cato Journal, Vol. 4, No. 2, Autumn 1984). https://www.cato.org/sites/cato.org/files/serials/files/cato-journal/1984/11/cj4n2-8.pdf

61 Ibid. See figure 10.2 on page 151.

62 The Dodge line had ingrained fiscal conservatism as a norm by committing the Japanese government to running a ‘super balanced budget’ – with the primary budget balanced, meaning that the overall budget would be in surplus. Ohno, Kenichi, ‘The Economic Development of Japan’, Chapter 10 & 11 (GRIPS Development Forum, 2006). https://www.grips.ac.jp/forum/pdf06/EDJ.pdf

63 Ibid. Chapter 11

64 Kirby, MW, ‘Institutional Rigidities and Economic Decline: Reflections on the British Experience’ (Wiley on behalf of the Economic History Society, 1992). https://www.jstor.org/stable/2597412?seq=1

65 Kirby, MW, ‘Institutional Rigidities and Economic Decline: Reflections on the British Experience’, (The Economic History Review, 1992). https://www.jstor.org/stable/2597412?seq=1

It should be noted, as mentioned above, that UK growth would likely never have been as impressive as that seen in West Germany or France.

In particular, although the postwar UK balanced the budget and reduced the vast national debt that had been run up during WW2, the size of the state acted as a drag on growth. Whereas other countries such as the US or West Germany abolished most wartime controls and restrained the state from intervening, the UK largely maintained and in certain areas extended state intervention (e.g. via the nationalisation programme and continuance of rationing until 1954). This created systemic issues which over the long term significantly contributed to lax productivity, and therefore GDP growth.[66] The tax system, with a narrow base, high marginal rates and the focus on direct rather than indirect taxation, was another significant impediment.[67]

Unlike West Germany and Japan, which both pushed to increase competition and drive domestic firms to be more productive, UK policy too often ended up subsidising failure.[68]

This lack of competition in the British economy has been identified as being perhaps the key explanation for why British economic performance was so poor up until the Thatcherite reforms of the 1980s, after which the UK outperformed countries such as West Germany, France, and Italy.[69] For example, Britain's postwar trade policy was designed to protect domestic firms rather than exposing them to international competition in order to force them to improve management practices and innovate.

“By the late 1950s, tariff rates in the chemicals industry were 15% in the UK but only 8% in West Germany.”

While West Germany liberalised trade, UK tariffs remained stubbornly high. By the late 1950s, tariff rates in the chemicals industry were 15% in the UK but only 8% in West Germany. The rates for textiles were 23% in the UK but 11% in West Germany, while for non-electrical machinery they were 17% and 5% respectively, and in electrical machinery they were 23% and 6% respectively.[70] These rates did not begin falling until the 1960s and 1970s as the General Agreement on Tariffs and Trade (GATT) and entry into the European Economic Community (EEC) forced the UK to liberalise.

Minimising the Marshall Plan

As with America, many myths have taken hold about Europe's postwar recovery. One common claim is that Western Europe in general and West Germany in particular recovered so strongly after WW2 because of the $13bn of aid – or

66 Minford, Patrick, ‘Chapter 5: Reconstruction and the UK Postwar Welfare State: False Start and New Beginning’, in: Postwar Economic Reconstruction and Lessons for the East Today (eds. Rudiger Dornbusch, Wilhelm Nolling, and Richard Layard, 1993).

67 Crafts, Nicholas, ‘The Postwar British Productivity Failure’ (Warwick Economics Research Papers, 2017). https://ideas.repec.org/p/wrk/warwec/1142.html ; Minford, Patrick, ‘Chapter 5: Reconstruction and the UK Postwar Welfare State: False Start and New Beginning’, in: Postwar Economic Reconstruction and Lessons for the East Today (eds. Rudiger Dornbusch, Wilhelm Nolling, and Richard Layard, 1993), p124-128.

68 Crafts, Nicholas, ‘British relative economic decline revisited: The role of competition’ (Explorations in Economic History, 2011), p23. https://www.sciencedirect.com/science/article/abs/pii/S0014498311000295

69 Broadberry, Stephen & Crafts, Nicholas, ‘UK Productivity Performance from 1950 to 1979: A Restatement of the Broadberry-Crafts View’ (Wiley on behalf of the Economic History Society, 2003). https://www.jstor.org/stable/3698724?seq=1

70 Crafts, Nicholas, ‘British relative economic decline revisited: The role of competition’ (Explorations in Economic History, 2011), p24 table 7b. https://www.sciencedirect.com/science/article/abs/pii/S0014498311000295

roughly 2% of US GDP[71] – that America sent via the Marshall Plan.

The Marshall Plan was certainly useful, in particular in terms of placating interest groups and smoothing the path for painful but necessary reforms. But in reality, it was the reforms themselves that created the extra growth, rather than the aid.[72]

The stringent conditions that America attached to receipt of aid in Western Europe and direct rule of Japan helped to push countries to embrace market economics.[73] This, not aid, was the major way that the US helped increase growth in Europe and Japan in the postwar period[74] – reinforcing again the key point that the route to prosperity fundamentally depends on sound pro-growth policy, rather than external injections of resources.[75]

While American aid may have helped countries with the cost of reconstruction, much of the work of repairing and rebuilding critical infrastructure – such as transport systems, electricity grids and water systems – was accomplished very rapidly. For example, by the end of 1946, freight transport on Western Europe's railways had virtually recovered to pre-war levels.[76] By the time that Marshall Plan aid had started flowing, the critical reconstruction work was mostly complete.[77]

"One common claim is that Western Europe in general and West Germany in particular recovered so strongly after WW2 because of the $13bn of aid – or roughly 2% of US GDP"

American leadership in the postwar world also helped to boost growth by fostering a series of international institutions and organisations, whose explicit aim was to achieve greater economic integration and to break down the economic barriers – such as high tariffs – which had so blighted the interwar years.

It must be stressed that all nations benefited substantially in the postwar world from the creation of the Bretton Woods system, and the financial and commercial stability that it engendered. The creation of the International Monetary Foundation, and its ability to bridge temporary imbalances of payments, removed a lot of economic

71 The aid represented about the same share of the collective GDP of recipient countries. Eichengreen, Barry, 'Lessons from the Marshall Plan', (World Bank Group, 2010). https://documents.worldbank.org/en/publication/documents-reports/documentdetail/907961468155715855/lessons-from-the-marshall-plan

72 See the two principal lessons Dr WF Duisenberg, then President of the Netherlands Bank and the Bank for International Settlements, draws from the Marshall Plan in a speech he gave in 1997, p3. https://www.bis.org/review/r970602c.pdf

73 Furthermore it should be noted that some countries such as the UK, used a large portion of their aid to retire public debt in order to improve public finances and establish financial stability – again aid being used to encourage and facilitate pro-growth reforms rather than as a fiscal stimulus as is sometimes supposed.

74 A good summary of how the common folk myth about the Marshall plan boosted growth via the material resources that it transferred is wrong, and how it was the conditionality attached to the aid which was actually the key ingredient in raising western European postwar growth rates can be found in:

De Long, Bradford & Eichengreen, Barry, 'The Marshall Plan: History's most successful structural adjustment program' (National Bureau of Economic Research, 1991). https://ideas.repec.org/p/nbr/nberwo/3899.html

75 Whether that should be from foreign aid or resource discoveries such as North Sea oil.

76 Figure 8, p32 in: De Long, Bradford & Eichengreen, Barry, 'The Marshall Plan: History's most successful structural adjustment program' (National Bureau of Economic Research, 1991). https://ideas.repec.org/p/nbr/nberwo/3899.html

77 It is important not to overlook the substantial aid that America gave prior to the Marshall Plan, which may well have played an important role in the immediate postwar task of reconstruction in Western Europe. In fact, America gave far more aid in the years 1945-1947, $21.7bn, than the $13bn it transferred as part of the Marshall Plan. See table A3-7 on page 43 in: Dornbusch, Rudiger & Wolf, Holger C., 'Monetary Overhang and Reforms in the 1940's' (NBER, 1990). https://papers.ssrn.com/sol3/papers.cfm?abstract_id=987262

uncertainty, and helped to provide a stable environment in which international trade could flourish as it did.[78]

“It must be stressed that all nations benefited substantially in the postwar world from the creation of the Bretton Woods system, and the financial and commercial stability that it engendered.”

The signing of the GATT in 1947 likewise helped to foster greater trade liberalisation around the world – opening up new markets and boosting international competition. In Western Europe the Organisation for European Economic Co-operation (OECD) – emerging in 1948 out of the Marshall Plan – was the first of a series of organisations which sought to break down trade and commerce barriers in the region. It was to be followed over the next decade by the European Payments Union, the European Coal and Steel Community, and eventually the EEC. Though hardly an age of high Victorian free trade, it was a vast improvement on the protectionism that had blighted growth in the prewar years.

78 Michael Bordo, ‘The operation and demise of the Bretton Woods system: 1958 to 1971’, (VoxEU CEPR, 2017). https://voxeu.org/article/operation-and-demise-bretton-woods-system

4. Policy lessons for today

The granting of emergency use authorisation for the Pfizer/BioNTech vaccine in the UK on December 2nd may well go down in history as the beginning of the end of the pandemic.

Since then, the Oxford/AstraZeneca and the Moderna vaccines have also been approved for use in the UK and other countries, with more vaccines still in the pipeline.[79] Once these vaccines have been rolled out and we reach population immunity, then we can finally escape the virus – even if we have to keep updating our stock of vaccines as new variants emerge.

The historically rapid rollout of the vaccines may ensure that this pandemic is historically short: generally, they have tended to last about 18 months to two years in their most acute phase.[80]

At that point, many governments will shift their focus to how they can best support growth. And the clear lesson from the postwar recovery is for them to do less, not more.

Free the economy

Crucial to successful recovery will be ensuring that the supply side readjusts as rapidly as possible to focus on giving consumers what they want. Luckily, compared to WW2, this time the price system is relatively undamaged – despite some dangerous noises about export controls on vaccines, and Italy's imposition of price controls on masks.[81,82]

One area where the government has intervened more substantially is via wage subsidies and direct business support to try to keep businesses afloat and stop mass redundancies. This means that there will be firms which have survived only because of the government support they have received, and, unfortunately, are essentially unviable.

"Crucial to successful recovery will be ensuring that the supply side readjusts as rapidly as possible to focus on giving consumers what they want."

Furthermore, once the pandemic is over, many consumer demands will have changed, and the pre-pandemic economy of February 2020 will no longer adequately cater to them. There will need to be an adjustment as capital and labour is reallocated away from now unviable firms, towards new entrants, those that remain viable, or can innovate enough to survive.

At this moment, we can have no idea what this adjustment will look like – or which changes during the pandemic will be short-term, and which are here to stay.

81 Sky News, 'Coronavirus: Price controls considered in UK to stop hikes in virus essentials', (Sky News, 2020). https://news.sky.com/story/coronavirus-regulator-considers-price-controls-to-prevent-virus-rip-offs-11950202

82 Wall Street Journal, 'Italy's Covid Price-Control Fisaco', (Wall Street Journal, 2020). https://www.wsj.com/articles/italys-covid-price-control-fiasco-11589842827

Even in terms of home working vs going into the office, it is difficult to know exactly how radical a change the pandemic may bring about.

> **“The key is to let the economy go through the adjustment process and for the government not to reduce the flexibility of the market by trying to prop up unviable firms.”**

The key is to let the economy go through the adjustment process and for the government not to reduce the flexibility of the market by trying to prop up unviable firms. The sooner that such firms either cut costs and innovate to regain competitiveness, or exit the market, the quicker the labour and capital tied up in such companies can be reallocated to more productive firms. The quicker the economy adjusts, the sooner it will be able to serve the new set of consumer demands which have arisen, and return to being healthy and competitive.

In this situation the best thing that the government can do is to stop policies which impede changes and innovations inevitably resulting from the pandemic. It must pursue the postwar policies of the US, West Germany, and Japan: end subsidies, and encourage competition. What we must not do is go down the path that the UK took of subsidising failure and protecting uncompetitive firms.

Governments will inevitably come under significant pressure to resist the gales of creative destruction that will sweep the world once the pandemic ends. And there will doubtless be a continuing need to support those who have lost out through no fault of their own, via the unemployment system and retraining programmes. But accepting the adjustment, and rewarding those able to innovate and cut costs, is what will increase productivity, growth, and job creation throughout the economy.

As part of this, governments cannot afford to turn away from globalisation by erecting new trade barriers. It was precisely the rejection of interwar protectionism which was so crucial to increasing competition and raising the productivity of firms after WW2. The contrasting examples of postwar growth in West Germany and the UK show how bad the decision not to embrace globalisation and international competition can be for the health of an economy over the long term.

Demand can look after itself

Another point of key importance when thinking about recovery is that the current recession is not fundamentally caused by too little demand – though fear of the virus will certainly depress it. The recession was driven by a massive supply shock caused by the pandemic, and the legal restrictions that were imposed in response.[83] Such restrictions have reduced the capacity that many businesses can operate at, and some have been outright banned from reopening.

While controls remain in place, a V-shaped recovery looks unlikely. More likely is a U-shaped recovery, with the economy depressed while the pandemic is ongoing. However, once controls are relaxed, we could see a rapid recovery and a mini-boom in spending – just as occurred after WW2 – as consumers celebrate the end of the traumatic experience of the pandemic.

83 Davies, Steven, ‘Going Viral: The history and economics of pandemics’, (Institute of Economics, 2020), p24. https://iea.org.uk/wp-content/uploads/2020/04/Going-Viral.pdf

Many people have built up substantial amounts of savings,[84] and they will therefore have the financial resources to go on a spending spree if they wish – either by spending this stock of savings, or by reducing their high savings rate back down to pre-pandemic levels (as happened in the US from 1946), or both.

While unemployment will be higher than pre-pandemic – and this will weigh on demand – the postwar experience suggests this will not derail a recovery. In the US, consumer spending and recovery were not curtailed by the 20 million plus people who found themselves out of a job at the end of WW2[85] – therefore, it does not seem unrealistic to expect a mini-boom in consumption once the pandemic and restrictions end, which in turn will be the swiftest way to drive down unemployment.

Cut taxes and cut spending

The postwar period also demonstrates the importance of having a tax system which incentivises work and investment. Of course, any tax will act as a disincentive to some degree, but the system can be structured to minimise the impact on growth. Take the US and West Germany, both of which substantially reformed their tax systems after WW2 so that marginal rates came down and investment was encouraged. In contrast, the UK maintained a system with very high marginal rates, a narrow base, and an over-reliance on direct rather than indirect taxation.

After the pandemic, most governments will no doubt look to raise more revenue. There are already alarming reports that the Treasury in the UK is focusing on precisely this.

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But the lesson from the post-war period is that the emphasis should be on reforming the tax system to boost growth, not simply raising more revenue in the short term. For example, West Germany's generous system of investment tax credits was key to its recovery and subsequent growth. Today, Western governments could do similarly by adopting some version of full expensing on capital spending – a policy repeatedly called for by the Centre for Policy Studies.[86]

What governments absolutely must not do is introduce lots of uncertainty about taxes, especially those impacting corporations and investments – since this could create regime uncertainty about whether investors and businesspeople are going to be able to realise their expected returns. As mentioned earlier, this was one of the main reasons why investment and growth in the US was so poor in the lead-up to WW2.

84 US Bureau of Economic Analysis, 'Personal Saving Rate (PSAVERT)', (retrieved from FRED, Federal Reserve Bank of St. Louis, 2020). https://fred.stlouisfed.org/series/PSAVERT. It should be noted however that not all people are managing to save, low-income households who are more likely to have lost their job during the crisis and seen their income fall are more likely (relative to richer households) to have been depleting any savings they had or building up more debt during the pandemic, see here: BBC news, 'Coronavirus: People saving more but get little return', (BBC, 2020). https://www.bbc.co.uk/news/business-53234128

85 Higgs, Robert, 'From Central Planning to the Market: The American Transition, 1945-1947' (The Journal of Economic History, 1999). https://www.cambridge.org/core/journals/journal-of-economic-history/article/from-central-planning-to-the-market-the-american-transition-19451947/5FF9B0755DE510489FE5C4D4E09FF3FE

86 Tax Foundation, 'Reviewing the Benefits of Full Expensing for the Post-Pandemic Economic Recovery', (Tax Foundation, 2020). https://taxfoundation.org/benefits-of-full-immediate-expensing/

Finally, the postwar period demonstrates that after the state balloons in size, one of the most pro-growth policies available is to shrink it. The slashing of most countries' governments after WW2 – especially in the US, West Germany and Japan – and their commitment to fiscal and monetary conservatism freed up vast amounts of real resources which the private sector was then able to more productively use.

> **"After the pandemic, most governments will no doubt look to raise more revenue. There are already alarming reports that the Treasury in the UK is focusing on precisely this."**

Today the state has not reached the same vast size that it was at the end of WW2, but it is nonetheless much larger than pre-pandemic. The evidence suggests that deficit reduction plans focusing on spending restraint lead to much better economic outcomes than those based on raising taxes. An interesting study published in 2018 found that trying to balance the books by cutting spending leads to a shorter and shallower reduction in output compared to attempting the same via increasing taxes. In fact, if spending reductions occur when the economy is growing – which is the situation the economy should be in as we emerge from the pandemic – then the cost in terms of economic output is zero.[87] The authors suggest that the primary reason that cutting spending is better than raising taxes is that it improves the confidence and expectations of investors.

By cutting spending, the need to increase taxes in the future to fund spending is reduced. By contrast, increasing taxes will do nothing about rising spending levels – in other words it will do nothing to reduce the amount of tax the government will need to raise going forward. This is reflected in private investment and business confidence, which respond positively to deficit reduction based around cutting spending but negatively when governments try to achieve the same aim by raising taxes.

Of course, this point also suggests that even if the government doesn't raise taxes straight away, running a deficit with a clear unwillingness to cut spending will feed into expectations, leading businesses and consumers to expect higher taxes further down the line. This alone could act to depress investment and growth. This is part of what's known as 'crowding out', whereby government spending crowds out private spending and investment and thus lowers growth. It can also work by increased government spending pushing up interest rates and pushing down private investment. Admittedly, while there have been a number of studies which have found that increased government spending does reduce growth and the relationship is statistically significant, the evidence is not yet conclusive and other studies have found the opposite.[88]

The opposite side of this particular coin is the 'multiplier effect', the idea that an extra £1 of government spending will create more than £1 of economic activity. Here again the evidence is inconclusive, though many studies have found that the effect is smaller than the government often claims it is and may well be smaller than 1, meaning extra government spending

87 Alesina, Alberto et al, 'Climbing out of debt', (IMF, 2018). https://www.imf.org/external/pubs/ft/fandd/2018/03/alesina.htm
88 Stratman, Thomas & Okolski, Gabriel,'Does Government Spending Affect Economic Growth', (Mercatus Center, 2010). Does Government Spending Affect Economic Growth? I Mercatus Center

reduces economic growth.[89] Furthermore, recent studies suggest that as societies age, the fiscal multiplier becomes significantly smaller, suggesting that in rapidly ageing Western societies the power of government spending to boost economic growth is becoming weaker and will continue to do so going forward.[90]

It is worth considering here the point that once the pandemic draws to a close and restrictions begin to loosen, the economy should move from being in recession into a period of strong growth. While the question of whether higher government spending increases or decreases economic growth has yet to be settled empirically, there is good evidence that when the economy is not in recession the benefits of government spending are considerably smaller than when the economy is in recession.

Furthermore, at the moment a large proportion of government spending is going on supporting specific jobs and companies. The danger is that once the pandemic ends and restrictions relax, the government won't remove this spending. Doing so risks keeping alive businesses and jobs which will no longer be viable even after all restrictions are removed. By continuing to support them, the government risks exacerbating the issue of 'zombie' firms, an issue which some have cited as one of the primary contributors to the productivity slowdown that has occurred since the global financial crisis.[91] (The plentiful availability of cheap credit is also a contributing factor.)

"It is worth considering here the point that once the pandemic draws to a close and restrictions begin to loosen, the economy should move from being in recession into a period of strong growth."

No doubt when the pandemic ends, most governments will be itching to intervene with fiscal stimulus in order to try and boost growth. But the competitive market economy will always be better at allocating resources and innovating productivity improvements than the state. Governments should instead cut back the subsidies and support schemes they introduced to support businesses during the crisis, and look at other areas where cuts can be made in order to free up the resources to power a private sector-led recovery, and ensure that growth-sapping tax increases are not necessary.

89 Ibid.

90 Basso, Henrique & Rachedi, Omar, 'Population ageing reduces the government spending multiplier', (VoxEU, August 2020). https://voxeu.org/article/population-ageing-reduces-government-spending-multiplier

91 The Economist, 'The corporate undead: what to do about zombie firms', (The Economist, September 2020). https://www.economist.com/leaders/2020/09/24/what-to-do-about-zombie-firms ; For a good paper on the case that zombie firms are a major cause of the recent productivity slowdown see: Müge Adalet McGowan, Dan Andrews, Valentine Millot, 'The walking dead? Zombie firms and productivity performance in OECD countries', (Economic Policy, Volume 33, Issue 96, October 2018, Pages 685–736). https://doi.org/10.1093/epolic/eiy012

Conclusion

Once the pandemic ends, many countries will find themselves in a position similar to the end of WW2: an economy with significant government interference compared to pre-crisis levels; much of the private sector geared to fighting the war; and an immediate need to rapidly generate many millions of new jobs.

The lesson of the postwar recoveries is that with robust consumer and investor confidence there is negligible need for government stimulus. Rather, governments can boost growth most effectively by getting out of the way and giving markets the flexibility they need to discover the best ways of allocating resources and meeting consumer demands.

After WW2, the US massively shrunk the size of its state, ended wartime interventions such as price controls, and reformed taxation. Despite the fears of some economists, the economy flourished and tens of millions of new jobs were rapidly created as a consumption and investment boom powered growth.

“Despite the fears of some economists, the economy flourished and tens of millions of new jobs were rapidly created as a consumption and investment boom powered growth.”

Similar policies in West Germany, Japan, and Italy also resulted in extremely high post-war growth rates. In contrast, countries such as France and especially the UK which adopted more interventionist policies, with more government and less market, ended up with much lower growth in the postwar period.

Rather than looking at maintaining large governments after the pandemic, what we need is a smaller government which intervene less, giving the private sector the resources, support and certainty it needs to power the country back to growth.

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