SIR KEITH JOSEPH

Four Speeches that changed the world

WITH A FOREWORD BY LORD VINSON OF RODDAM DENE

Centre for Policy Studies

These lectures, originally given by Sir Keith Joseph shortly after he and Margaret Thatcher founded the Centre for Policy Studies on 12 June 1974, are reprinted on the occasion of the Inaugural Margaret Thatcher Conference on Liberty, held on 18 June 2014 to celebrate the 40^{th} anniversary of our foundation.

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“In the 15 years since the Centre founded by Sir Keith Joseph and myself, it has provided inspiration for many of the policies which our Conservative Government has put into practice. A number of these policy ideas, which were often accused of being impractical when they were first put forward, are now universally accepted and are being implemented by governments across the world… Although the recommendations they make are for policies in Britain, the principles that underlie them are universal.”

Margaret Thatcher
Preface to *Policies of Thatcherism*
Centre for Policy Studies
June 1989

FOREWORD

You would hardly believe what the world was like in 1974 when Sir Keith Joseph and Margaret Thatcher asked me to set up the Centre for Policy Studies. Income tax at 98 pence in the pound; industry riddled with strikes – those in the shipyards sometimes lasting weeks over which union should drill the holes. A prices and incomes policy that destroyed profitability. A planning system where you had to get permission if you wanted to start a business in your own home. A country in which the commanding heights of the British economy were state-owned.

On the other side of the world Solzhenitsyn had written the inside story of totalitarian socialism and the gulags of Russia – risking death by so doing, declaring that "*truth was more important than consequence*."

Keith Joseph and Margaret Thatcher, having witnessed the harmful consequences of Ted Heath's increasing corporatism, felt that they must break away from orthodoxy. Rejecting the middle ground and consensus politics, they set up an organisation to promote alternative policies – the Centre for Policy Studies.

They sought policies that worked with the grain of human nature and reflected the desire for self-betterment that motivates people universally.

It was becoming obvious to them that “when the state owns, nobody owns; and when nobody owns, nobody cares”. Hence their underlying belief in the alternative: a property-owning democracy and a free-market economy under the rule of law. They believed that ownership gives people a stake in society and a sense of control over their own lives. That, as they saw it, is where freedom begins.

They wanted to see an economy where wealth was diffused, in turn enabling multiple sources of individual patronage, which in turn can promote numerous centres of initiative. Keith Joseph regarded entrepreneurs as prime movers of economic progress.

Why go for progress and wealth creation? Above all, they recognised that compassion without resource is ineffective and thus the key to compassion is the creation of wealth. This is the moral case for popular capitalism.

To promote these ends, Keith and Margaret set out to make the speeches that changed the world. The Centre for Policy Studies gave them the intellectual backing to do so. It underpinned their fervour and helped them to proclaim the case for the free-market economy. We now know how this rippled through the globe with such profound effects on Gorbachev and Reagan, to say the least.

But they also knew that capitalism is not perfect and needs a strong moral, legal and democratic framework in which to operate successfully and fairly – where errors are exposed to enable correction.

Perhaps those who today enjoy picking holes in capitalism should remember what socialism did in Eastern Europe and China before they introduced a market economy. And here, how wider home ownership has lifted millions into the middle class.

Now, 40 years on, this message continues under the sagacious and charming leadership of Lord Saatchi and his team. Keith and Margaret would be so proud that their legacy today is as relevant as ever to preserving a free society.

Lord Vinson of Roddam Dene
June 2014

I

THIS IS NOT THE TIME TO BE MEALY-MOUTHED: INTERVENTION IS DESTROYING US

UPMINSTER, JUNE 22 1974

The implications of Mr Benn

Of course it is right that we should react strongly against Mr Benn's proposals to turn us into a nation of lame ducks.

Mr Heath's formidable speech on Thursday exposed the dangers. But it is not enough just to stave off Benn's preposterous proposals. The question we must all ask ourselves is how Mr Benn was able to come within striking distance of the very heart of our economic life in the first place. How could it come about that the suggestions could even be made by a Minister of the Crown after a generation's experience of state ownership of a fifth of our economy? How could anyone expect that the idea of "more of the same" which has nearly brought us to our knees could be seriously entertained?

We must find a satisfactory answer to these questions if we are really concerned with our survival as a free and prosperous nation.

Of course, there is more than one answer. But an important part of the answer must be that our industry, economic life and society have been so debilitated by 30 years of Socialistic fashions that their very weakness tempts further inroads. The path to Benn is paved with 30 years of interventions: 30 years of good intentions: 30 years of disappointments. These have led the collectivists to say that we are failing only because we are taking half measures. The reality is that for 30 years the private sector of our economy has been forced to work with one hand tied behind its back by government and unions. Socialist measures and Socialist legacies have weakened free enterprise – and yet it is Socialists who complain that its performance is not good enough.

If we simply stave off Benn and carry on as before, I fear that we shall have more disappointments – and more assaults. We must work towards the conditions in which the private sector – free enterprise – can realise its full potential for the benefit of all. Only then can it create the well-being which alone will buttress its political standing and preclude further assaults of this kind.[1]

There is no good reason why this country should continue to fail. We have ample talent, the same kind of talent that made Britain great and prosperous a hundred years ago, the envy of the world.

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1 The Regeneration of British Industry, Cmnd. 5710, 1974. This White Paper proposes the setting up of the National Enterprise Board (NEB) which will be on the same lines as the now defunct Industrial Re-organization Corporation. Industry Bill provides £1bn. to NEB. [Bill 73] HMSO, 1975.

We enjoy the objective conditions for success now as we did then.

Too much Socialism

This is no time to be mealy-mouthed. Since the end of the Second World War we have had altogether too much Socialism. There is no point in my trying to evade what everybody knows. For half of that 30 years Conservative Governments, for understandable reasons, did not consider it practicable to reverse the vast bulk of the accumulating detritus of Socialism which on each occasion they found when they returned to office. So we tried to build on its uncertain foundations instead. Socialist measures and Socialist attitudes have been very pervasive.

I must take my share of the blame for following too many of the fashions.

We are now more Socialist in many ways than any other developed country outside the Communist bloc – in the size of the public sector,[2] the range of controls and the telescoping of net income.

Comparison with our neighbours

And what is the result? Compare our position today with that of our neighbours in north west Europe – Germany, Sweden, Holland, France. They are no more talented than we are. Yet,

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2 Some 50 to 60 per cent. of Gross National Product passes through public institutions whose operations are determined independently of profit and loss. In 1973 UK Government expenditure (Central and local government) was £30,342m; 54 per cent of net national income at factor cost (£56.259m), National Income and Expenditure 1963–1973 'Blue Book.' HMSO, 1974].

compared with them, we have the longest working hours, the lowest pay and the lowest production per head.[3]

We have the highest taxes and the lowest investment.

We have the least prosperity, the most poor and the lowest pensions.

We have the largest nationalized sector and the worst labour troubles.

Our education, our social services, our health services – our cultivated barbarisms – all give cause for concern. We find it more difficult than our neighbours to give the right treatment to the disabled and good rewards to such groups as teachers and nurses.

Moreover, unlike our neighbours we are and for some years have been a disinvesting nation. In real terms, we are consuming our capital stock faster than we replace it – our physical capital and our moral capital, the values built up and transmitted over generations. We have been eating the seed corn, neglecting our shrines.

True, some of the countries whose performance I have compared favourably to ours have been governed, at least partly or part of the time, by Social-Democratic parties. But the fact is that some Social-Democratic parties abroad are far more realistic in relation to private enterprise, to the essentials of economic policy, to the limits on government's power to intervene for good, than we here have been sometimes.

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[3] OECD, *Economic Outlook*, July, 1974; OECD, Economic Surveys.

The lessons for us

Mr Benn's new offensive should make us pause to think. But in the event, re-thinking has begun anyway. I have been entrusted by Mr Heath with drawing lessons from the relative success of these countries. To enable me to do this on the scale and depth the subject deserves, I am setting up a small policy study centre.

I hope that in the months to come we shall be producing a flow of papers and presentations, which will deal comparatively and analytically with various features of our economies.

But there is another instructive contrast – between the position as I have described it and our own good intentions. No one intended the present state of affairs to come about. Never in the course of this nation's history have so many good intentions by so many people created so many disappointments.

Then, what has gone wrong? I suggest four main answers.

Short cuts to Utopia

First, for the past 30 years in our party's competitive efforts to improve life, we have overburdened the economy. We have overestimated the power of government to do more and more for more and more people, to re-shape the economy and indeed human society, according to blueprints. We have tried to take short cuts to Utopia. But for lack of a really good map, because we were in too much of a hurry, we have finished up further away than ever. In the social services, alas, we seem to have generated more problems than we have solved. I was very conscious of this when I was the Minister.

We have found it harder than our neighbours to keep the overall level of demand – so important to the economy and to society as a whole – at about the right pitch. Too low – and labour is wasted:

too high, when we try to mop up the last pockets of unemployment amid labour-shortage – and inflation is the result.

Not only have we most of the time over-burdened the economy but for 30 years industry has been distracted and harassed by constant and often unpredictable changes in policy and taxation and in the framework within which business has to operate.

During 30 years we have tried to force the pace of growth. Growth is welcome, but we just do not know how to accelerate its pace. Perhaps faster growth, like happiness, should not be a prime target but only a by-product of other policies.

The lean kine

Second, for 30 years, levels of state expenditure have been greater than the economy could bear. The private sector, the productive sector, has been weighed down by the burden of taxation, by the burden of subsidies to nationalized industries. The public sector has been draining away the wealth created by the private sector – labour, capital and management together.[4]

We have achieved what seemed impossible. We have poured never-ending flows of real resources into coal, rail and shipbuilding, among others, yet after 30 years they are as ailing and problematic as ever. We want healthy, well-paid, self-sufficient industries – giving good service to the public. Despite huge spending we still do not have them.

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[4] George and Priscilla Polanyi, *Failing the Nation: Record of the Nationalized Industries*, Fraser Ansbacher, 1974; George Polanyi, *Comparative Returns from Investment in Nationalized Industries,* IEA, 1968.

These are the lean kine which, as in Pharaoh's dream, are eating the healthy cows – the productive sector of the economy – and yet remain as hungry as ever. For 30 years we have tried to buy social peace at the expense of economic efficiency; predictably, we have got the worst of all worlds, inefficiency, hence poor performance and hence social discontents.

We can all write a list of public expenditure which we would call in question. Has it been wise, for instance, to devote taxpayers' money to tourism – putting hotels before homes? Has it been wise to pour money and skilled people and growth firms – all needed desperately in our big cities – into new towns? Has it been wise to expand our universities quite so fast? There are many other forms of expenditure which need to be re-examined. They all placed burdens on free enterprise – the only creators of the resources we need for general prosperity.

I fought my colleagues hard for extra resources. But when we place too heavy a burden on the private sector, we stall the engine.

Trade Unions

Third, there are the trade unions. Workers here seem to co-operate less in creating prosperity for themselves than do the workers of north west Europe. Our shop stewards and those they lead tend to be more resistant to change, less ready to improve techniques and more prone to strike, more given to damaging wage claims, than workers in north west Europe.

The reasons go back deep into social history. As Tories we have to understand that we are dealing with real people with their own views, habits and prejudices. We certainly do not ask them to neglect their own self-interest. But we do invite them to transmute it into enlightened self-interest as their colleagues abroad have done. We must show that it is in flourishing profitable private firms that they can earn the most in the best conditions.

The Socialist vendetta

And fourth is the running vendetta conducted by the Socialists against our free enterprise system and those who manage it. Throughout the years a large section of the Socialist leadership has been downright antagonistic towards our wealth producers and towards the industry – national and multinational, large and small – which provides so high a proportion of our jobs, our exports and our tax revenue.[5]

They have condemned the profit motive and attacked profits indiscriminately though for years profits have been too low for industrial health.

Indeed profits are the source of economic progress and, through their linkage with investment, of increased earnings and social services. Low profits today mean low earnings and low pensions tomorrow.

Profits earned within the law and in competition are thoroughly to be welcomed. But this has not been Labour's attitude over the years. A football team could not perform at its best if it were treated in the way that Socialists have treated British management.

It is pointless to argue about the level of investment when existing investment cannot be used properly because of poor labour relations, inflation, unpredictability created by continually

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5 Hugh Gaitskell, *Socialism and Nationalization*, Fabian Tract 300, 1956. Capital Transfer Tax, Cmnd. 5705, 1974.

changing government expedients. It is the quality and direction of investment that counts. We have destroyed or are destroying the market criteria for investment and production and have yet to produce another set.

These are the four main reasons why, in my view, things have gone wrong.

There are other reasons too. Rent controls and local authority housing have almost destroyed the ability of people to move.[6]

Our well-intentioned social workers and misguided left-wing teachers have between them helped to erode the will to work.

Public opinion and prosperity

I do not believe that our neighbours in north west Europe suffer the same difficulties. Trades unions, governments and public opinion understand to a greater degree than here the value of thriving private enterprise and provide therefore a more sympathetic and workable climate in which it can operate.

This much we can already learn from one or more of them: that poverty is not ended by levelling down: that great prosperity has no link with public ownership: that high earnings are bred by co-operation not by conflict.

It was Schumpeter who said that free enterprise would die only because it would by its very success lack defenders.

How absurd it would be if now, with the success of private enterprise and the failures of any alternative exposed before our

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6 *Verdict on Rent Control*, IEA, 1974.

eyes, we were to allow fashionable Socialism to continue to impose its prejudices.

We have inherited a mixed economy which has become increasingly muddled, as we tried our best to make semi-Socialism work. Its inherent contradictions are intractable. Judging from the past 30 years and paraphrasing Lincoln we have to ask "can a country prosper, half collectivist, half free?" Certainly we couldn't prosper if we were even more collectivised.

The only practicable basis for prosperity is healthy, competitive free enterprise – a market economy within a framework of humane laws and institutions.

We must decide whether to go down with Benn or on to a more rational economy.

It is the Conservatives' job to try to bring about conditions in which free enterprise can carry the country and its standard of life and of social services forward to the levels that others nearby are enjoying.

We have the big task of opening the public's eyes to what is practicable. Governments are only free to act within the constraints set by public opinion. It is my job and the job of the Centre for Policy Studies now being set up to show what can be done, indeed what has been done, in nearby humane societies.

II

INFLATION IS DE-CAPITALIZING BRITISH INDUSTRY

LEITH, 8 AUGUST 1974

Argument over Mr Healey's second quarterly budget is likely to continue in one form or another until the run-up, if this government survives, to his third in the late autumn. This new Labour invention, the quarterly budget, epitomizes the frantic escalation of intervention to which Labour has committed itself. No sooner has one budget been introduced than Mr Healey is discussing its successor apparently designed to counteract the unanticipated effects of its predecessor. In other words, the economy, the business community, the public, are being turned into a kind of punch-ball – inflation, deflation, reflation, higher taxes, something off, expand, contract – until we are completely punch-drunk.

While this non-stop performance is going on, British industry – and the jobs and the social services that depend on it – is in danger of bleeding to death from loss of profits.[7]

And I mean this without exaggeration. In my Upminster speech I used the word "debilitated" and meant it. Here I am spelling out why I used that word to describe the condition of much of British industry.

Socialist politicians tend to welcome any business failure as evidence of the weakness of the free enterprise system. It is not such evidence. The fact is that ever since the war industry has been debilitated by well-meant but damaging political policies.[8]

It has no reserves with which to cope with inflation and with the mischief of Mr Healey and Mr Benn.

Three decades of almost continuous inflation and erratic government intervention have so debilitated British industry that large sections of it could soon come near to collapse unless something is done to remedy the harm. I say this with full awareness of the seriousness of what I am saying. Things are worse than most of us in Parliament realize, worse even than many people inside industry itself fully grasp, or if they understand it are prepared to state publicly, or if they have said it, have not been given a hearing.

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7 HMSO, *National Income and Expenditure 1963–73*, 1974; A J Merrett and Allen Sykes, "The Real crisis now facing Britain's industry", *The Financial Times*, 30 September 1974; M. Panic and R.E. Close, "Profitability of British Manufacturing Industry", *Lloyds Bank Review*, July 1973.

8 T W Hutchison, *Economics and Economic Policy in Britain, 1946–66*, Allen & Unwin, 1968.

The profit haemorrhage

Profitability has declined to such an extent that some firms can no longer replenish their working capital, to accumulate the additional working capital needed to finance operations in face of rising prices let alone to finance new investment. Many firms are finding it increasingly difficult to meet their obligations. Few can raise new capital in the money markets as they did in the past, because they do not produce the profits needed to service it.

A substantial part of manufacturing industry will soon as a result of debilitation by government policies and union attitudes over a long period, intensified by inflation and by the unprecedentedly damaging policies of the present government, be in serious difficulties through lack of profitability. Unless something is done soon significant numbers of basically sound companies will, for these reasons find it difficult to continue trading.

The next government – whether or not it is Conservative – will need to enable industry to improve its profit position if grave danger to employment, the social services and the fabric of our society is to be avoided.

Why have we only now woken up to this state of affairs? There are several answers. Companies do not like to publicize their own difficulties; politicians and business experts do not like to cry wolf.

But the main answer is that inflation has not only helped to undermine profitability but has also masked the process for some time. We were inebriated by inflation.

But first let me outline the facts. Over the past 12 years or so as I have said, profits have suffered a catastrophic decline. The profitability of all private sector companies fell by over half in less than 10 years. From the late 1960s, even nominal profits have begun to fall in spite of substantial new investment over the past dozen years.[9]

Taxing non-existent profits

These published figures are bad enough. But they understate the decline in profits. You will all realize that £100 today is worth only half of what it was in the mid-1960s. So an apparently stable rate of profit means decline. But that is not all. For our tax laws do not recognise the existence of inflation. On the contrary, they regard an increase in the money value of stocks held as profit to be taxed, though in fact companies do not benefit from this increase. On the other hand, the tax authorities allow firms to offset depreciation of their assets against tax only on the basis of historic cost, although we know very well that a new machine will now cost two or three times what the old one did. In other words, profits in company accounts are inflated three times over – as revenue; by revaluing stocks, and by understating true depreciation.[10]

This means that firms are paying tax on profits which do not really exist. It also means that they may be paying dividends on profits that do not exist either.

As I have said, on average the rate of profit has fallen by over half in 10 years. This is the average figure. By and large some fields of business have done better than average and some worse.

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9 Company net-of-tax profits have dropped by 42.5 per cent in money terms during 1973 and are now running at around 37 per cent of their 1963 level despite an increase in real fixed investment during this period of over 50 per cent. These comparisons are before correcting for changing money values.

10 Merrett and Sykes, op. cit.

Manufacturing industry has on the whole done worse, particularly the metal industries which have to re-equip often: it is not only that machines wear out, but technology advances.

A NEDO study last September summed up the situation in the engineering industries, the heart of British economy.[11]

It reviewed inflation in relation to accounting, and re-examined company accounts for the period 1966 to 1971. After adjusting for the changed value of money, it discovered that firms which on the face of it had made good earnings and ploughed much of them back into the firm, had in fact scarcely made any profit at all. When stock appreciation and the real replacement cost of their fixed assets were taken into account, they had gained little, some were even running down their net worth.

Most of the companies concerned have continued paying dividends of sorts on their paper profits. But if they were not making real profits, or certainly not enough to cover dividends, where were the dividends coming from? The NEDO study comes to the conclusion that a substantial number of engineering companies have been simply running down their business in order to meet current outgoings, interest on loans and dividend and other obligations. They are not keeping enough in the kitty to re-equip themselves. In many cases they are now short of working capital. As current prices rise further or their cash receipts fall, for any reason, they face serious liquidity problems, which could prove fatal for some, unless the situation is mended soon.

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[11] NEDO, Inflation and Company Accounts in Mechanical Engineering, September, 1973.

You may say that it is illegal to pay dividends out of capital; directors have been tried and imprisoned for this in the past. True, but that was in the bad old days when money retained its value for decades. Today the law obliges firms to pay tax out of capital on paper profits; it cannot easily forbid paying dividends out of the same paper profits. A change in our tax laws to recognise inflation, the declining real value of money, is now well overdue.

Capital not for borrowing

If firms cannot meet their investment needs out of their own resources, and in many cases not even their working capital needs, where will they find their capital? Until recently, a sound firm could raise all the capital it needed in London through the merchant banks and the Stock Exchange. London is the world's capital market. But now our manufacturing firms, however technically sound and well managed, cannot raise capital any longer, if government and unions do not permit them to earn the profits needed to service it.

When money loses its value at the rate of 10, 12, 15 or 20 per cent per year, when banks pay 12 per cent interest and charge 15, who will lend money – his own, or his depositors' – to firms which at best make a few per cent profit and may well soon be making losses?

The Causes

Here then are the facts. Before I come to the implications for all of us, let me deal with the causes. Why should British industry, which still leads the world technically in many fields and has been profitable for most of modern history, now suffer reduced profitability? Let me list some of the causes that have brought industry nearly to its knees.

a. Inflation, the arch-destroyer, has inexorably sapped the vitality of industry, forcing up the scale of working capital required, squeezing profit between price control and soaring costs, undermining the one area of certainty and stability on which business and most other plans depend.[12]

b. Taxes required to finance increased government expenditure have placed additional costs on industry for many years past,[13] rates, corporation tax – and that which it replaced – national insurance contributions, and a host of subsidiary levies, direct and indirect. Profits of industry have not only to help finance the social services, and defence and much else, but also help support loss-making nationalized industries and industries receiving subsidies. Now I am not arguing here about the principle of the mixed economy, but about the mix. The lean kine have eaten the fat kine and grown even hungrier as a result. There are few fat kine left.

c. Another cause of debilitation is dear money. The rate of interest has risen spectacularly, partly to offset the decline in the value of money, partly because central and local government have been taking such a large share of savings available. Local authorities now take up a substantial proportion of short, medium and long-term credit available through the Stock Exchange, money market and banks. They can always find the money needed to pay going interest rates – however high, they adjust income to meet expenditure. This both forces up interest rates to industry and leaves them less

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[12] C Clark, "Inflation and Declining Profits", *Lloyds Bank Review*, October, 1974.

[13] L R Myddelton, *The Power To Destroy: A Study of the British Tax System*, Johnson Publications, 1969.

credits. So, in effect, town halls, community centres and swimming baths are built at the expense of industrial development.

d. Wage increases have soared far beyond productivity increases. Increases in wages are in themselves good, provided they do not cause price increases. But there has been a widespread lack of co-operation in increasing productivity by the use of new machinery and techniques. So wage increases have far outstripped productivity increases, prices have soared and profits have been squeezed.[14]

e. Incessant policy changes by governments, though undertaken with the best intentions, have undermined industry's ability to plan ahead, improve its efficiency as much as it would have desired, and even to meet commitments. "Stop-go" has made good management difficult. Over the past 25 years government policy on investment incentives, etc. has changed 16 times! Instead of concentrating on the market and on serving it, management is forced to devote much of its time to coping with government gyrations. All these burdens and uncertainties have prevented proper forward planning, and forced industry to live increasingly from hand to mouth, rather as government now does. You can insure against acts of God, but not against acts of government, though the latter are becoming more cataclysmic.

f. For much of the period industry has been subject to price controls, formal and informal.[15]

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14 HMSO, Financial Statistics, Interest Tables.

15 Hutchinson, op. cit.

g. While prices and profit margins have been severely constrained, costs have remorselessly risen, not least by government action.

h. Lastly, the seventh lean cow to eat up our wealth producers for most of the post-war period – the £ sterling has been over-valued, as a result of efforts to keep the economy running at a high level by over-expanding demand. This has made it harder for British industry to export and even to compete with imports into this country.

All these difficulties for industry were created as a result of economic policies which were well-intentioned but harmful in their effects. It is not enough to take one's share of the responsibility: the lessons must be learned and urgently applied.

The vendetta against profits

But still worse, and less excusable, there has been a whole range of difficulties created by the anti-profit, anti-private industry climate which has prevailed in parts of government, media, universities and trade unions. So the private sector has been on the defensive. "Profit should not be a dirty word", Mr Healey told a business audience recently.[16]

When I hear him tell a Labour or union audience this, I shall believe in his change of heart. For if profit is a dirty word in many circles, who made it so?[17]

In those countries which are our successful competitors, the prestige of industry – ownership and management – is high.

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16 CBI annual dinner, Hilton Hotel, 14 May 1974.

17 Socialism and Nationalization, op. cit.

Industrialists and managers are recognized as the real creators of wealth, as the men on whose shoulders the whole economy is carried, whose efforts provide employment, find the taxes to pay for schools, defence, welfare, whose dividends underpin pensions, insurance policies, and savings. In Britain a large proportion of political and intellectual opinion-formers is convinced that we can dispense with profits. Socialist governments are torn between trying to weaken the private sector, so that they can take it over, and trying to make it work in the meantime to support the economy.

No wonder that their utterances and actions alike are so self-contradictory, and that industry suffers.

Conflicting purposes of trade unions

Trade unions suffer from the same politico-economic split personality. As economic men, they want private firms to be healthy and profitable, to be able to afford good wages and conditions for their workers. But as political animals they want to fight capitalism, bash the bourgeoisie, usher in state capitalism, even though they know that the state is a bad employer, which over-mans, underpays, uses the public sector as an economic regulator, and generally depends on Treasury hand-outs for improvement in wages.

Industry's hostile environment

And then, to add insult to injury, after all the difficulties placed in industry's way, politicians and press have the cheek to chide industry for its poor performance. People who could not tell a lathe from a lawnmower, and have never carried the responsibilities of management, never tire of telling British management off for its alleged inefficiency.

I would not dream of claiming that all is well in British industry, or that it ever will be perfect. But by and large, the quality of British industrial management, initiative and design are highly thought of in the industrialized world.

Indeed, considering all the obstacles placed in its way by government and unions, British industry has done remarkably well and deserves combined congratulation and commiseration – not blame.

The fact of the matter is that we politicians have over-estimated the ability of government to do good by intervention. We politicians have been guilty of hubris: it is British industry on which nemesis has been visited. We have no right to tell the industrialists: “Find you own way out”, while we are standing on their lifeline. We must get off it.

Even Socialists need profits

I know that Socialists and Trade Unionists may be in two minds over this prescription. If difficulties they have helped to create make it easier to take firms or whole industries over, why not welcome the difficulties as doing this good work? But they had better look before they leap.[18]

It is one thing to take over profitable firms, man them with loyal self-confident Socialist protegés, and hope for the best. But what do you do if nationalization in whatever form or by any other name has the effect of making losses? Where will you find the money to subsidize these new flocks of lame ducks?

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18 A Glyn and R B Sutcliffe, *British Capitalism, Workers and the Profit Squeeze*, Penguin Books, 1972.

And if some of the firms collapse in the meantime, if some of the profitable private sector vanishes, there will be a shortage not only of jobs and much else but also tax revenue. The government – unless it raises other taxes – will have difficulty in honouring properly its huge existing commitments, to the NHS, to education, to the pensioners, to defence, let alone have the funds for wholesale rescue. Moreover, a substantial part of industrial and other equities are held by institutions – pension funds, insurance companies, small investors through unit trusts. One study suggests that 85 per cent of all families are to a greater or lesser extent dependant on the yield of securities.[19]

What would happen if there were wholesale failures of companies in which such institutions have invested? This is no distant prospect.

Already some firms are having to make good the shortfall of pension fund investments out of profits or capital, just at a time when profits are at their weakest and working capital under pressure. True, local authorities and nationalized corporations can make up their employees and staff pension-fund shortfall out of higher rates and taxes. But as profits fall, where will additional taxes and rates come from?

Liquidity crisis looming

When you go round and see factories working, boards meeting, you find it hard to believe that there is a crisis just round the corner. But do not be deceived. The liquidity crisis is on us. One

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[19] Based on a Stock Exchange Study of 1966.

firm after another will go to the banks for loans to top up working capital, but loans will add to costs and cannot be unlimited.[20]

Once some companies begin to falter, the effects could be incalculable.

One is reminded of a house being eaten away by termites: one moment it looks as it has always done, the next it has collapsed.

It is against this background that Mr Healey's second quarterly budget – his July budget – must be assessed. I appreciate his dilemma. If he inflates a little – let us use plain English rather than talking about reflation, giving back, etc., – it will temporarily halt the deterioration. But at what cost? The shot in the arm – and what an apt simile – will get the blood flowing faster, but then the haemorrhage, the loss of profits, will go on faster too. Pep pills are no cure for haemorrhage.

Needs for increased prosperity

Successive governments – Tory and Labour – with the aid of the unions, and the encouragement of the media, have helped undermine British industry – with the best of intentions, of course. Now Healey and Benn wish to give it the *coup de grâce*. Even a strong economy might not be able to afford a Healey or a Benn, but we certainly cannot afford them now after three decades of debilitation.

There is no easy way out, we need urgent measures to increase profitability and to help bring home the facts to the public, all the

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20 '… we are sick and tired of the queue of Rolls-Royces one can see every day outside the Dept. of Industry: begging bowls of their passengers at the ready', Mr Kilroy-Silk, Col. 1753. Hansard, 12 July 1974.

public. At present, pronouncements by Mr Benn – but on behalf of the whole Labour leadership and Labour policy – have encouraged workers to believe that they have nothing to lose from their firm's difficulties, only to gain – if the firm stumbles, government will take them over. Let Mr Healey and Mr Wilson say publicly what they know privately: that at a time like this, if industries fall the government will be in no position to catch them, it already has its hands full. Let them tell the unions to stop throwing stones, because they live in the same glass-houses as their employers.

Unless the next government – whether it be Conservative or not - enable industry substantially to improve its profit position, it will do serious damage to employment, social services and the fabric of British society.

III

INFLATION IS CAUSED BY GOVERNMENTS

PRESTON, 5 SEPTEMBER 1974

Inflation is threatening to destroy our society. It is threatening to destroy not just the relative prosperity to which most of us have become accustomed, but the savings and plans of each person and family and the working capital of each business and other organization. The distress and unemployment that will follow unless the trend is stopped will be catastrophic. There is a risk moreover that political parties which preside with well-intentioned ineffectiveness over such a universal frustration of expectations will pave the way for those who will offer solutions at the cost of freedoms.[21]

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[21] H G Johnson and A R Nobay (eds) *The Current Inflation*, Macmillan, 1971; Inflation: *Economy and Society: Twelve Papers by economists, businessmen and politicians on causes, consequences, and cures*, IEA, 1972.

It has happened elsewhere.[22]

It could happen here. Our proud achievements, our great history, our still superb national talents do not render us immune to the processes of despair and disintegration which ultimately invite dictatorship.

Our fate lies in our own hands. If we recognize the nightmares which galloping inflation brings, we can abate it. It is a question of priorities. Mr Heath and Mr Carr and all of us say that inflation is the most important issue before the country. We say this, not only because inflation destroys jobs by destroying employers, not only because it savages the vast majority of our population in their savings and plans, but also because all other social and economic objectives will be lost unless inflation is abated. Growth, social peace, full employment, regional balance, social services – no one of these aims can be sustained if inflation is allowed to continue at its present or anything like its present pace.

But, you may ask, if inflation is so pernicious, why was it allowed to get a grip in the first place? Why did successive governments for the last score years, led by well-intentioned and intelligent people advised by conscientious officials and economists, take a course which led inexorably and predictably to the present nightmare? I say predictably, because there were warnings as far back as 1950, charting with painful accuracy the course on which the country embarked.

Political and economic historians will pronounce in due course. As a participant in the process, I may lack their perspective. But at

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22 German 1923, Hungary 1946, China 1937 and 1949, Brazil 1960, Indonesia 1948–67. See P B Lilley, *Notes on Three Typical Hyperinflations*, W Greenwell & Co., 1974.

least I know how things seemed to us, why we acted as we did, and with the vision of hindsight where we went astray. So, as a participant, retracing my steps seems the best introduction to the problem.

I begin by accepting my full share of the collective responsibility. It is not right for government to claim credit for what goes well unless they accept their share of the blame for what goes badly. For over the past 30 years governments in this country have had unprecedented power over economic life. It is only fair that we should accept correspondingly heightened responsibility for what has gone wrong.

A self-inflicted wound

In retrospect it seems to me that inflation is largely a self-inflicted wound. I once believed that much of our inflation, particularly recently, was a product of rocketing world prices – and they certainly made things much more difficult – but they are not the dominant cause. In general terms you could say that inflation is the result of trying to do too much, too quickly. In more specifically economic terms, our inflation has been the result of the creation of new money[23] – and the consequent deficit financing – out of proportion to the additional goods and services available.

When the money supply grows too quickly, inflation results. This has been known for centuries. Until a few years ago I should not have had to labour the point. Now an influential group in Whitehall, Cambridge and the National Institute of Economic and Social Research seem to deny the proposition. I had understood that the laws of supply and demand are basic economic truths.

23 In 1972 and 1973 the annual increase in M3 was 15 and 25 per cent.

Certainly, Maynard Keynes recognized that excessive creation of money is inflationary.[24]

I should here emphasise that changes in the relationship between demand and supply do not instantly effect prices and employment. There is a time lag of many months, or even as much as a year or two.

It has always been known that to create too much money – "excess aggregate demand" is what the economists call it – is to court the danger of inflation. But government after government chose to take the risk, for several – in themselves not ignoble – reasons. The assumptions were probably always the same; that the inflation would only be mild; that it could be stopped; and above all, that mild inflation seemed a painless way of maintaining full employment, encouraging growth and expanding the social services – all highly desired objectives. We see now that inflation has turned out to be a mortal threat to all three. In this speech I am concentrating on employment. I shall discuss growth on another occasion.

Incomes policy no cure

It was feared that the apparently high levels of unemployment and the low rate of growth which resulted whenever sound money policies were essayed would create intolerable social and political tensions. Experience has shown that far more menacing tensions are generated by inflation itself and that, in circumstances of excess demand, they cannot be cured by incomes policy.[25]

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24 *General Theory of Employment, Interests and Money,* Macmillan 1936. Chapter 21.

25 Robert L Schuettinger, *A Brief Survey of Price and Wage Controls from 2800 BC to AD 1952*, The Heritage Foundation, 1974; F W Paish, *Rise and Fall of*

With the wisdom of hindsight – and if we do not all have the wisdom of foresight, let us at least have the wisdom of hindsight – I now see that any effective incomes policy must be based on sustaining the overall balance between demand and supply. By this I mean demand for and supply of goods and services at a level of full employment which can be sustained. If supply and demand are not in balance, if money is being pumped into the economy at a faster rate than the growth of goods and services, no incomes policy can conceivably mitigate inflation, let alone prevent it.

Even if the administrative and political power of government can hold down wages in some sectors inflation will emerge with redoubled force in other sectors less susceptible to control. We have seen the process at work – some wages controlled (with difficulties and distortions) while house prices, interest rates, and pay which cannot be controlled of people like building workers, secretaries, engineers on piece rates, all rocket. Let us not forget the understandable outrage and the widespread resentment at the soaring rise of property values – a by-product of inflation – felt by those whose income was held down. The property values have since been eroded, but the resentment remains.

Incomes policy alone as a way to abate inflation caused by excessive money supply is like trying to stop water coming out of a leaky hose without turning off the tap; if you stop one hole it will find two others. We tried incomes policy – more than once; Labour tried incomes policy. The great and the good favoured it – and many still do. But bitter experience reinforces elementary economic logic – with excess demand it will not work. All this I spelt out when

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Incomes Policy, Hobart Paper 47, IEA, 1971. Sir Richard Clarke, *Incomes Policy Phase Four*, Manchester Business School, 1974.

winding up the debate on the Pay Board for the Opposition on July 18 this year. The all-party Parliamentary sub-committee came recently to the firm conclusion that incomes policy is neither desirable nor workable. I wish their admirable report and the evidence on which it was based were widely read and digested.[26]

But long before this year, we knew all the arguments. We had used them in Opposition in 1966–70. Why then did we try incomes policy again? I suppose that we desperately wanted to believe in it because we were so apprehensive about the alternative: sound money policies.

The shadow of unemployment

To us, as to all post-war governments, sound money may have seemed out-of-date; we were dominated by the fear of unemployment. It was this which made us turn back against our own better judgment and try to spend our way out of unemployment, while relying on incomes policy to damp down the inflationary effects. It is perhaps easy to understand; our post-war boom began under the shadow of the 1930s. We were haunted by the fear of long-term mass unemployment, the grim, hopeless dole queues and towns which died. So we talked ourselves into believing that these gaunt, tight-lipped men in caps and mufflers were round the corner, and tailored our policy to match these imaginary conditions.

For imaginary is what they were.[27]

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26 HMSO, *Public Expenditure, Inflation and the Balance of Payments*, 1974.

27 John B. Wood, *How Much Unemployment?,* Research Monograph 28, IEA, 1972.

There never was serious unemployment since the war on anything remotely like the scale or conditions of the 1930s – and could not have been had we not seriously debilitated the economy by prolonged inflationary policies.

Since the war until this present critical period there has been virtually no unemployment on Keynesian terms on a national as opposed to a regional scale. For practically the whole period we have had full employment on any meaningful yardstick. Indeed, for much of the time we have had negative real unemployment, that is a shortage of labour – what you might call fuller-than-full employment.

But you will ask, how do I square this with the monthly unemployment statistics which receive banner headlines and strike gloom into politicians' hearts – 500,000 – 600,000 – 800,000 – fears of one million unemployed? Is this not ample justification for reflation – for spending our way out of unemployment – as Keynes is said to have prescribed in those days when he overthrew classical economics?

No, it is not. And if we wish to fight the battles of the seventies with the weapons of the thirties we would do well to find out what was actually said and done in the thirties, not least by Keynes himself. We owe that much to the memory of a great man.

Unlike many of his followers Keynes was discriminating in his definitions of unemployment.

He never dreamed of aggregating all categories of registered unemployed as a basis for prescribing policies. On the contrary, he stressed, and all reasonable men in his day accepted, that there were widely differing phenomena included under the umbrella term "unemployed", and that each needed its own specific treatment. What helped one kind, would not necessarily help another, and could even harm.

Categories of the unemployed

First, Keynes recognized that there was temporary unemployment. He called it "frictional". Men left one job – or it left them – on Friday afternoon; they would rarely be in another by the following Monday morning. Nor would they necessarily take the first job offered. They would shop around, they might even take a few days' additional holiday. The more jobs going, the longer they can afford to look around. They have savings, there is unemployment benefit, there are tax repayments, in a number of cases there are redundancy payments. At most times in recent years, frictional unemployment as variously defined will have accounted for a quarter to a third of all registered unemployed.

Then there is a whole spectrum of people who are not easy to place or keep at work. They range from the inadequate who need help, through the "difficult to place" – due to age or ill-health or other factors – to the actual scrounger. A recent study reported in the *Monthly Gazette* of the Department of Employment – March issue 1974[28] – describes a part of this group as "somewhat unenthusiastic in their attitude to work" and estimates that the voluntary unemployed – as this whole collection of groups is known – in total accounted for a third of all registered unemployed over a period.

Here again I am not suggesting that we should be complacent about this situation. It is bad for society, bad for the economy and demoralizing for the people concerned, especially for children

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[28] "Characteristics of the Unemployed: Sample Survey", June 1973.

who grow up in such an atmosphere. What we can do about it is another matter. We have probably not made the problem easier by raising the relevant benefits. They have risen over a period of years from about a half to over three-quarters of the net average income of a breadwinner with a wife and three children.[29]

As the scale has risen, we have increased the proportion of relatively low earners with large families who would be better off unemployed, and of the many more who would scarcely be any better off if they were at work. In the light of this, we should express admiration for the hundreds of thousands of lower-paid workers with sizeable families who resist the demoralizing influence of our well-intentioned welfare system and go on doing a fair weeks work regardless.

We should be gratified that the actual scroungers – however infuriating – constitute such a relatively small proportion of the labour force.[30]

I was nearly four years at the DHSS and found no tolerable way of doing much about this small but costly minority. But the answer certainly does not lie in increasing the money supply.

Just as the frictional unemployed merges into the voluntary, so the voluntary merges into what Keynes called "hard-core" and we sometimes call "unemployables." They are people who cannot obtain or hold down a job even if they try. Some are not up to it physically, some mentally or temperamentally, quite a few are elderly. Some are in and out of prison. Here again, we should not

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29 HMSO, *Social Trends No.4*, 1973, Table 47.

30 Ibid.

give up our efforts to rescue these people wherever possible and help them become productive members of the community. But creating excess demand for labour by printing money is certainly no way of doing it.

Then, there is fraudulent unemployment, that is to say, people who draw benefit while earning money. There is evidence of this in casual occupations like the building industry. It helps explain why at one period the statistics showed 100,000 unemployed in the building industry while builders all over the country complained of a labour shortage. There are the drifters and hippies who draw "welfare" but engage in activities to earn money, legal or illegal. From time to time the Ministry carries out local checks, and suddenly the number of registered unemployed melts away. How many fraudulent unemployed there are at any given time can only be estimated, but they probably account for at least a tenth of the registered unemployed at normal times. We ought to do more about such people, but expanding demand will not turn them into honest men.

Another group, which accounts for half the non-manual unemployed, consists of white collar workers compulsorily retired at 60 with occupational pensions but required to stay on the register till 65 if they are to be excused the national insurance contribution and still be entitled at 65 to the retirement pension. And at some times in the year students seeking temporary jobs in the vacation appear on the register.

Only when we have deducted all these categories, the frictional – say up to eight weeks between jobs – the unenthusiastic, the unemployable, the fraudulent and the elderly who are obliged to register – do we have the real involuntary unemployed in the Keynsian sense, that is to say people who are both willing and able to work and who have been unemployed for over eight weeks. During the post-war period, their numbers will have fluctuated between 100,000 and 300,000 or so. They tend to be unskilled, semi-skilled or less skilled, older than average, and a substantial proportion of them are in the less prosperous areas.[31]

Labour shortages

Now as against these, there have been something like a million unfilled vacancies for most of the period; it has only rarely dropped below 600,000. As the Department's own statisticians recognize, vacancies registered with Employment Offices account for about a quarter to a third of all vacancies. These are, for the most part, vacancies in the sort of job at the kind of pay and conditions which keep these jobs substantially though not fully manned. Everyone can give examples: there is the building industry, public services all over the country – transport, hospitals, driving – including London; steel works and shipbuilding in Scotland and the north east of England; many engineering works. All these labour shortages co-exist with large numbers of registered unemployed and much smaller numbers of involuntary unemployed in a Keynsian sense.

It is therefore quite fair to say that for almost the whole of the post-war period there were on a national basis several times as many real vacancies as involuntary unemployed, to use Keynes' term. We have had most of the time fuller than full employment, we have had nationally an overall shortage of labour.

How otherwise should we have been able to absorb over one million workers from overseas? Most of them have been unskilled

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31 J B Wood, op.cit.

or semi-skilled, as were the majority of our registered unemployed. If so many could find work at any given time, there must have been work.

Paradoxically the self-same Socialists who constantly criticize the allegedly high level of unemployment over the years have continued simultaneously to justify Commonwealth immigration on the grounds of a labour shortage.

Throughout the period, a disproportionate number of the involuntary unemployed have been in the development areas. These deep pockets of unemployed cannot be floated to work by any conceivably practicable level of national demand. That is why we use regional policies; that is why we use training and re-training schemes – the Conservative programme for training was the largest and most ambitious ever;[32] that is why we use local development schemes and encourage mobility of labour and youth employment projects – all to reduce unemployment in the black spots. In recent years, we have had more serious pockets of unemployment in the midlands and south east too.

We should indeed be concerned about each one of the different groups. Each group and each sub-group raises different problems which we should try to solve for social as well as economic reasons. We should not become reconciled to the current or higher rates of unemployment – frictional, structural or regional, voluntary or fraudulent. On the contrary, in the quest for individual self-respect and economic health, we should try to ensure that as near as possible the whole labour force is employed.

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32 Conservative Central Office, *The Campaign Guide 1974*, pp 156–176, 1974.

Alas, since the war successive governments have allowed all sorts of rigidities and obstacles to grow up which make this harder than it need be[33] – but on that I will talk another day. What I am saying now is that every form of unemployment needs its own specific treatment – and that we have brought upon ourselves over the last 20 years' desperate inflation by too often expanding demand above supply as the single cure for a whole variety of forms of unemployment. This panacea has helped to bring about just the very evils that we feared.

Over-reaction to temporary recessions

Now from what Keynes wrote it seems likely that he would have disowned most of the allegedly Keynsian remedies urged on us in his name and which have caused so much harm. His thesis was that even when there was large-scale medium- and long-term involuntary unemployment, the proper way of dealing with it would not necessarily be to increase the money supply or demand.

He placed greater emphasis on achieving better distribution of demand rather than increasing it, different techniques for depressed areas or branches of industry.

So much for what Keynes advised. What was said and done in his name has been quite different. For much of the past 20 years, successive governments, faced with a rise in registered unemployed, have deliberately increased public sector spending. This has been financed not by real savings but by Bank of England operations.

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33 T W Hutchison, *Economics and Economic Policy in Britain 1946–1966*, Allen and Unwin, 1968; F Broadway, *State Intervention in British Industry, 1964–68,* Kaye and Ward, 1969.

Every time successive governments have tried this policy it has been brought to a forced halt. This has usually been through a sterling crisis, which itself has been a result of excess demand at home. Of course, in a boom all kinds of unemployment are for a brief period reduced. But the boom is a cruel deception on those whom it is designed to help. During its course people do find jobs more easily than they otherwise would. But these are short-lived. The other side of the coin is that there are grave shortages of labour (and therefore goods) long delivery dates, waiting lists, increased imports and all the rest of the familiar troubles. Sterling sinks and import prices rise. The jobs gained in the boom or "go" year have inevitably been lost in the next recession or "stop". Wages and prices alike are much more sticky in the face of downward pressures than when market forces are pushing them upwards. The result is that the rate of inflation increases rapidly every time we allow demand to overtake supply, but slips back only slightly during the subsequent brief recession. As for unemployment, the effect of these spurts of monetary expansion followed by drastic "stops" is simply to create cycles around an underlying level which has not improved but, if anything, deteriorated. And as each cycle progresses, the less efficient or skilled workers, the less efficient firms, the less economic areas find themselves in the same disadvantaged positions.

If the argument seems abstruse, just check it by the facts. In each upswing the rate of inflation has gone to higher levels – we used to think 5 per cent very worrying. We would now regard 10 per cent as an enormous change for the better. Unemployment on the other hand has, taking the good years with the bad, actually shown an upward trend. *The effect of over-reacting to temporary recessions has been to push up inflation to ever higher levels, not to help the unemployed, but to increase their numbers.*

Excessive injections of money

Thus excessive injections of money, undertaken by intelligent and enlightened men with good intentions, have wrought great havoc in our economy and society. The benefits have been largely temporary – and in any case cruelly reversed in the inevitable "stop" that follows, but the evil has lived on. In many Latin American countries, where inflation rates are very high and very volatile, the end results of budget deficits and credit creation are so well known that they cease to give even a temporary boost to output and employment. Their entire and immediate effect is on the price level. If a patient is given the same doses too frequently, his system will become immune.

Let me pose the choice with which successive governments have been faced on several occasions since the war. On the one hand, unemployment figures have risen by, say, a quarter of a million or even 300,000 to 400,000. As we have seen, unemployment statistics overstate the real number of involuntary unemployed – in the Keynsian sense – at this stage in the cycle at least twofold. Home demand is still in excess of supply; this is reflected in the level of balance of payments deficit and by the contrast between the numbers of involuntary unemployed and the real current vacancies – a multiple of those reported to Employment Offices.

On each occasion, the government – by which I mean almost every post-war government – has chosen to boost home demand by deficit financing, in spite of the virtual certainty that the additional balance of payments deficits generated would oblige them to call a halt fairly soon and thereby lose at least as many jobs as they were creating, while keeping the additional inflation.

My point is that (by logic of hindsight) on such occasions governments should weigh the short-lived – I repeat short-lived –

benefits they may bring to a quarter of a million or even 300,000 to 400,000 men and their families, against the permanent – and I repeat permanent – repercussions of such deficit financing on the whole population of 55 million people. All these 55 million people have on each such occasion since the war seen inflation increasingly stimulated and savings increasingly eroded.

If policies are to be judged by the criterion of the greatest good of the greatest number, then excessive expansion of the money supply has been tried and found wholly wanting, in practice and theory alike.

I may be told that making even temporary work for a few hundred thousand people is the top priority; that getting people off benefit and into temporary jobs will be, in 1975, more important than anything else. The condition of 55 million people is even more important. We cannot talk about fighting inflation as the overriding priority and then in the same or another speech say that we can take no monetary action which might threaten some jobs. We cannot have it both ways.

Let me emphasise that I am not saying, have never said and do not believe that we need a certain level of unemployment to avoid inflation. I believe that full employment is compatible with stable prices, collective bargaining and a sound balance of payments. A healthy economy in a world with normal trade conditions should sustain full employment and all these other objectives. What I am saying is that it is the methods that successive governments have used to reduce registered unemployment – namely expanding aggregate demand by deficit financing – which have created inflation, and without really helping the unemployed either.

What we have to do is to set a level of domestic demand sufficient for that level of full employment which can be sustained without inflationary pressures, and then to work within it to deal with specific employment problems, while helping to soften the potentially harsh process of change by generous short-term unemployment, resettlement and retraining grants, and particularly by help to individual areas. In a basically healthy economy, it is much easier to deal with pockets of unemployment or depressed areas. Once you overheat the economy and create a "stop-go" cycle, all other aims are made more difficult to achieve.

Tightening the garotte on industry

This is the background. I now turn to the present position and prospect. Both to reduce the balance of payments deficit and to slow down inflation, the previous government cut public expenditure in late 1973, and so Mr Healey was able to reduce the public sector borrowing requirement by £1,500 million.[34]

But the methods Mr Healey chose to achieve his reduced borrowing requirement were, either from malice or from misunderstanding, such as to intensify sharply the squeeze already imposed on employers generally by inflation and price control. The tax on profits was increased[35] and companies were forced to pay tax a year ahead of time, when profits were already under heavy pressure from inflation. I explained in detail in my speech at Leith how companies are being taxed on profits which do not really exist. The Chancellor chose to tighten this garotte at a time when the cash needs of companies have never been so

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[34] Estimates of public expenditure on goods and services in 1974–5 have been revised upwards by £550m.

[35] Corporation tax for 1973/4 raised by 2 per cent to 52 per cent.

high, and the ability to meet them from the banks and the capital market never so constrained. This kind of budget may have bought Mr Healey some temporary popularity, but its legacy will be felt in our jobs and living standards for a long time to come.

Over and above the budget damage, industry has been having to put up with the anti-business, anti-profit attitudes of Ministers and the threat of state grab and state interference to every large firm. Mr Wilson may play down the centralizing, nationalizing intention while an election looms, but he will not have eased the anxieties of those who run our industries and are responsible for our exports, investment and employment. The total effect of all these influences can be seen in the plunge in Stock Market prices.[36]

Some rich and very many not so rich people may have lost a lot of money; so certainly millions of ordinary citizens find their pensions and insurance policies at risk. But above all, a fall of this size reflects a catastrophic loss of confidence in business prospects. The losses of a few rich people will be no consolation to those who are going to lose their jobs because investment and expansion plans are cancelled for lack of finance which the Stock Exchange could otherwise have provided.

It is a fallacy to suppose that these hammer blows to confidence, to profits, to survival can be muffled by any number of budgets, mini or maxi, designed to increase "home demand" – even if we could afford such budgets when we are spending overseas every day £12½ million more than we are earning. The first necessity to

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[36] The downward trend has continued. On 6 January 1975, the Financial Times Industrial Ordinary Index plunged to 146.0, the lowest since 30 April 1954.

restore confidence is for Labour to drop their vendetta against business and to treat it sensibly.

I have argued that there are strong forces working both for high and rising unemployment and for worsening inflation. The present slow upward trend in unemployment, disregarding seasonal influences, up by 36,000 adults in the last three months is likely to accelerate.[37]

The question that businessmen, trades unionists and economists are asking is not whether unemployment will go above a million, but how far above it and how soon. The self-same inflationary policies which have accustomed us to a two-figure rate of inflation are now facing us with the prospect of seven-figure unemployment into the bargain.

The Labour Chancellor, Mr Healey, certainly shares these fears about our future. He was sufficiently alarmed to introduce a reflationary mini-budget in July; and he has promised another for the autumn if he is still at the helm.[38]

But he or his successor have small room for manoeuvre. This country – with its inflation, its debts, and its dependence upon foreign credit – no longer has the option of spending its way out of unemployment. That way lies accelerated inflation, the decapitalization of industry, the disappearance of jobs, the loss of foreign confidence. If we try to solve our problem by printing

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[37] November 1974 total of unemployed in GB was 622,000. Because of a civil servants' dispute the December figures have not been calculated but an estimate of 700,000 would be regarded as true.

[38] Third budget during 1974, announced on 12 November 1974.

money we will end up with Latin American rates of inflation and mass unemployment.

If Labour were re-elected, they could not escape these realities. They might try to insulate us from the rest of the world, to establish a siege economy. At best they would buy a few months at the price of much worse long-term damage.

Here again, we come to the time factor. By extending ever since the war government intervention we have increasingly politicized our economy. A result is that longer-term considerations have since the war often been subordinated to short-term political convenience. The old saying “not in front of the children” has become “not in front of the electors – at least until after the election”. But an election, even more than any other time, should be the occasion for thorough analysis of the main problem – its cause and cure. Now surely is the time for all who have views to explain them fully and clearly to the country – now before the electors are asked to make their decision. We shall be living here after the election and wish the country to be fit for our children and grandchildren to live in. Our present plight is in good measure the result of putting short-term political convenience so high. On several occasions over the past 20 years, Socialist exaggeration of unemployment levels, together with marches on Parliament, invoking the memory of the 1930s, has stampeded us into rash over-expansion with resultant price increases and economic dislocation. We must not be stampeded again.

What must be done

On all this I will end by making a few comments. First that inflation at its present pace cannot be abated entirely painlessly. Secondly, the cure by gradual abatement would be infinitely less painful than what would happen if we reflate as Labour now seems committed to do. Thirdly, there is one thing worse – far worse – than stopping inflation, and that is not stopping it.

It follows from these considerations that the next government should adopt a broad but gradualist strategy to phase out excess demand – and stick to it, refusing to be stampeded. That is essential. Because the money supply has been too sharply checked,[39] there should within this general policy be scope for some necessary relief to the company sector and the jobs that depend upon it; this must be given soon, while we are working towards a non-inflationary monetary growth rate.

It is quite true that the growth in money supply was apparently sharply checked – and certainly the Labour budget has savagely withdrawn money from commerce and industry. But at the same time, the government has been increasing public spending, in relation to tax revenue. So the budget deficit,[40] with all its inflationary implications, may not turn out to have been so much reduced as Mr Healey announced on budget day. But this in turn is likely to start off again the zig-zag movement of the money supply and of the growth of spending, from which we have suffered so much. The existing vast overhang of money in the economy will continue to fuel inflation and the balance of payments deficit for many months to come. Thus, once again, fiscal and monetary policies are pointing in opposite directions – a sure recipe for disturbance and inflation.

But if we can in fact gradually start moderating the trend rate of growth of money supply – which entails also moderating the

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39 Reduction of M3 from 25 to 15 per cent.

40 Currently running at £4,500m.

budget deficit – then the balance of payments deficit, and after a lag, the rate of inflation will start to ease. In due course, and without any artificial stimulus or reflation, spontaneous in-built correctives will begin to make themselves felt. The treatment that will gradually eliminate the balance of payments deficit and the treatment that will gradually abate inflation and the treatment that will gradually give us a firm basis for progress are all more or less the same. Then as domestic spending power is stabilized, exports and the replacement of imports will absorb some of the displaced labour – “redeployment”, as Mr Wilson called it in 1966. There will be jobs for others of those who are displaced in the public utilities which are crying out for more staff. Those who argue that even a minor curb on the trend of the money supply would generate deflation, lower real incomes and reduce investment, should be helped to realize that the effects they envisage would be largely temporary, while the economy adjusted to running at a lower but stable and soon generally expanding level of domestic demand. The first period of self-restraint by the Chancellor will be the worst, but it will be the beginning of the cure.

No one can be sure how long it will take to secure anything approaching stable prices and to reverse the downturn in employment. A great deal will depend on the attitude of the trades unions. They have it in their power, as Mr Heath emphasised, to price their members or fellow workers out of jobs; and no monetary or fiscal policy can prevent this. There is a case for an educational pay board, as I suggested in my speech on 18 July to spell out the implications. If the consequences for incomes and jobs of gradually reducing excess demand are to be understood and accepted, then we would be wrong not to use any instrument that could help in this process.

It may be that by measures of improved threshold agreement and by indexation of the tax system, we can allay some of the underlying worries. The whole issue of indexation, or insurance against inflation, needs to be debated much more thoroughly than democracy.[41]

But it is no panacea, and if it were introduced as such it would do more harm than good. Escalator clauses will help only if total demand – money supply – is under firm control. We cannot expect any increase in living standards while we are in such deficit, so any cost-of-living compensation could not be complete while we are in this difficult phase.

If I had to give a personal guess about the total time horizon of a successful anti-inflation policy, I would say three or four years. A healthy economy – and more still an economy that needs to recover health – requires a reasonable time scale. Fine-tuning, quarterly budgets, short-term adjustments have not worked and will not work. We have the most frequent budgets in western Europe – and the least successful economy. The time has surely come to turn for advice to economists, critical but constructive, who proved painfully right in their forebodings.

It seems to me that all this is common sense, though I know that some will label my line of argument monetarist. If this means that the growth rate of money spending must be gradually brought closer into line with the growth of our production, I will gladly accept the label. If it means that we need a long-term strategy to do this, without self-defeating changes of direction every few

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[41] Four articles appeared in the *National Institute Economic Review*, November, 1974, pp. 38–75; OECD, *Indexation of Fixed-Interest Securities*, 1973; Milton Friedman, *Monetary Correction*, IEA, 1974.

months, again I am ready to stand up and be counted. And surely more and more people are coming to realize that there is no hope of controlling the growth of spending if the government does not control its own deficit, especially if it allows that deficit to be financed by money creation by the banking system.

The monetarist thesis has been caricatured as implying that if we get the flow of money spending right, everything will be right. This is not – repeat, not – my belief. What I believe is that if we get the money supply wrong – too high or too low – nothing will come right. Monetary control is a pre-essential for everything else we need and want to do; an opportunity to tackle the real problems – labour shortage in one place, unemployed in another; exaggerated expectations; inefficiencies, frictions and distortions; hard-core unemployment; the hundreds of thousands who need training or retraining or persuading to move if they are to have steady, satisfactory jobs; unstable world prices. There is no magic cure for these problems; we have to cope with them as best we can.

This prescription will not be easy nor enjoyable. But after a couple of years we should be on to a sounder basis and be able to move forward again.

Conversely, if we do not get the trend of the increase of the money supply over the next few years on to a steady and low rate, more and even more rapid inflation will follow. We will destroy our monetary system; we will make all our existing problems worse – and will add as yet undreamed nightmares beside. Continued rapid inflation will destroy every plan and every prospect; jobs and savings will evaporate; society will be fractured. It was not for nothing that Lenin recommended inflation as the arch destroyer of what he called bourgeois democracy and we call democracy.[42]

We need a government with strong nerves to set broad policy lines and stick to them. Then we can recover our footing, and then the road to realism, stability and steady spontaneous progress will be open to us again; the harm of our excessive post-war pursuit of growth will be gradually remedied and the soundness of our economy – on which jobs, standard of living and social services all depend – will be restored.

Can we expect the Socialists to do this even if they think it to be necessary? No! In the first place, for them, economic policy is a perpetual popularity contest. Promise today, disappoint tomorrow, and then blame industry, finance, the banks, anyone but their own exaggerated promises and spendthrift policies. Electioneering breeds inflationeering. We, the Conservatives, are not without blemish, I freely admit, but how much of this derives from bi-partisanship, from middle of the road policies, from confusing a distinctive Conservative approach with dogmatism.

The Socialists by and large hold to the Platonic myth, that rulers should tell the masses only what is good for them. Tories have traditionally favoured trusting the people, telling them the truth as we see it. Can we afford to? Experience leads me to ask, can we afford not to?

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[42] John Maynard Keynes, *The Economic Consequences of the Peace*, Macmillan, 1971.

IV

MONETARISM IS NOT ENOUGH

STOCKTON, 5 APRIL 1976

My theme is that monetarism is not enough; perhaps I should say 'so-called' monetarism, because the word is a verbal snare implying a non-existent antithesis between monetarists and some other non-monetarist kind of economist. But every economist is by definition a monetarist in that he accepts that the supply of money impinges on price levels in almost all circumstances. Monetarism as now used normally refers to the policy of trying to move towards and then maintain a stable growth in money supply closely related to the probable growth in output capacity, as most likely to create the conditions for prosperity and high employment in freedom.

The false antithesis between monetarists and some so-called Keynesians really hides the antithesis between those economists who believe that monetary policies should be used to tackle monetary problems on the one hand and those on the other hand who believe that monetary policies can master non-monetary problems – such as union obstruction, lack of skills, overmanning, housing rigidity, lack of confidence – and non-monetary policies – like control of wages, prices and dividends – can master the monetary problem of inflation. This is precisely the opposite of what is needed. Whether you try to use excess monetary demand as a means of overcoming real obstacles to full employment and growth, or use deflationary pressures to achieve specific non-monetary objectives, you are mis-using monetary policy. The greatest advocates of this mistaken approach in the post-war world have been some pseudo-Keynesians.

Exegetical arguments about what Keynes really meant cover a great deal of paper. I am not qualified to follow them, except to say that it seems to me that Keynes was certainly not a Keynesian, and that he was a monetarist by any reasonable definition of the term. The essential difference between some of those who arrogate to themselves the term Keynesian and those against whom the epithet 'monetarist' is brandished in order to frighten us off, is that the so-called monetarist rejects wonder-cures. True, we have been accused of advocating deflation as the cure-all, but the facts do not bear this out.

I put my position, as a so-called monetarist, on this matter in the following terms in my speech at Preston in September 1974.[43] I will try to restate this view in even broader terms: monetary stability provides a framework within which the individual can best serve his own – and therefore, if the laws and taxes are appropriately designed, the nation's – interests.

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[43] See above.

Needless to say, applying monetary policies even for appropriate purposes and particularly after a period of inordinacy requires very active government, great skill and strong nerves, readiness to make judgements and face dilemmas. We have much to learn from the latest stage of Germany's success story. Having insulated themselves from imported monetary inflation by floating the mark, the German Government and the Central Bank kept down the growth of the money supply to the level they had prescribed and thereby, as we can see, kept inflation within bounds. I refer you to Dr Emminger's notable speech[44] at the World Banking Conference here in London five weeks ago on 10 December.

If we desire a monetary framework within which steady growth and high levels of employment can be achieved, we have no alternative but to maintain a stable money supply eschewing the use of demand creation as a short cut to growth and full employment. And to achieve this we must educate public opinion in the need for it.

And yet I still insist that monetarism is not enough; there are other parallel imperatives which will perhaps become clearer if we consider some aspects of the background to our present difficulties.

In explaining our fall from grace, we don't need to go back today beyond 1919. At that time, the monetary and economic policy-makers did not grasp the extent of the harm inflicted on the British and world economy by the blood-letting of the First World War and its repercussions.

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44 'The Role of the Central Banker', Second World Banking Conference, *Financial Times*, 1976.

The emotionally attractive idea of 'back to normal' was formulated in that year by the Cunliffe Committee[45] and accepted by the Government. After five years of deliberate deflation we returned to gold at the unrealistically high value of our pre-war parity.[46]

The result was heavy strain on the economy, intensified by the short-sighted intervention of the monetary authorities and the Treasury. Much of the economic history of the inter-war period has been rewritten by Socialists and Keynesians.[47]

The truth is not that the inter-war Governments followed *laissez-faire* policies and applied orthodox economics, as a whole generation has been misled into believing. The parity decision and all that flowed from it was interventionism – 'looking the dollar in the face' – in conflict with orthodox economic theory and a far cry from *laissez-faire*.

We were as a country in a transitional stage from world industrial primacy, and our need was in fact to adjust to new realities. The technological decline of our old staple industries, now having to face fierce competition from other countries, was not sufficiently offset by the growth of our new industries, particularly as depression and protection dramatically cut world trade. The response of government, industry, trades unions, advisers was to

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45 *Currency and Foreign Exchanges,* HMSO, 1918 and 1919.

46 $4.86 to the £.

47 The following books and their bibliographical references: Donald Winch, *Economics and Policy: A Historical Study*, Hodder & Stoughton, 1973; W Arthur Lewis, *Economic Survey 1919–1939*, Allen & Unwin, 1949; Sidney Pollard, *The Gold Standard and Employment Policies Between Wars*, Methuen, 1970; Goronwi Rees, *The Great Slump: Capitalism in Crisis, 1929–33*, Weidenfeld & Nicolson, 1970.

move rather to work-sharing cartels, rationalisation and restrictive trade oligopolies than to modernisation and competition.

In short, they tried to thwart change rather than smooth a path for it.

Their task was not made easier by the unions and their members which were deeply conservative – with a small 'c' – but had come increasingly to rationalise this conservatism by the use of heroic Socialist phraseology. Their restrictive practices and wage-demands were incompatible with changed world-market conditions, even without an exchange rate 10 per cent too high. Britain was thereby made more vulnerable than it need have been to the German and Wall Street crashes.

Much of the damage was later undone by the financial policies of the National Government, which corrected the over-valuing of the pound when it was forced off gold in 1931 and simply relinquished many of the interventionist measures, maintained a 2 per cent interest rate and let the economy look after itself, with occasional bouts of *dirigisme*, none of any great magnitude.[48]

It is often forgotten that the thirties was a period of growth, expanding employment, rising living standards for a majority of manual workers.[49]

Our growth rate was higher in the 1930s than that of other countries such as the USA, Germany and France. We could not reach full employment because the world was in depression –

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[48] A C L Day, *The Future of Sterling*, Oxford University Press, 1954.

[49] Between 1930–8 money incomes rose by 6 per cent and real incomes 8 per cent. B. R. Mitchell, *Abstract of British Historical Statistics*, Cambridge University Press, 1962.

indeed, the same constraint applies to us with even more force now that we are comparatively weaker economically than we were then – but relatively, Britain was successful. The rate of expansion of building for home ownership was phenomenal.[50]

There was very serious deprivation in the older industrial areas, which suffered most from the combination of structural obsolescence and decapitalisation. But by and large, Britain was on its way forward again in the early thirties well before Keynes published his General Theory.[51]

It was later, during the war and early post-war years, that the history of the inter-war years came to be rewritten and the syncretism of Marxism and Keynesism, whose basic incompatibility was happily ignored by many, the easy answers, the panaceas found an eager audience. We tend to underestimate the impact of war on our institutions and economies. The First World War – in whose genesis the great pre-capitalist dynasties of the Romanovs, Hohenzollerns and Hapsburgs played so large a part – struck a far stronger blow against the economic and socio-psychological basis of the British capitalist democracy than was appreciated at the time, or for that matter now. The Second World War continued this process, in several ways.

It not only further increased the actual role of the state, but also increased belief in the efficacy, indeed the virtual omnicompetence of state intervention. The closing victorious

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50 More houses were built in the second half of the 1930s than the first half of the 1970s. Ibid., and HMSO, *Housing and Construction Statistics*, 1975.

51 Macmillan, 4 February 1936.

years of the Second World War were euphoric. The war had helped re-establish much of the social solidarity which had been undermined by the blood-letting of the first and the subsequent impoverishment and depression. Wars are times of full employment, of national purpose, of an expanded role for government. It was only natural that the Socialist-Keynesian theses on the capacity of government to solve social and economic problems should find the climate congenial.

I may seem to excuse everything by explaining everything, but this is not my intention. A few brave and percipient souls spoke out.[52]

But most of us were part of the new climate. We wanted to believe that full employment, high growth rates, stability, etc., were all within our grasp if only we wished. My own party was strongly influenced by those who held such beliefs; in the political auction then taking place, outright scepticism seemed unprofitable.

We had other inhibitions, too. There was guilt. We came increasingly to be thought of as the party of the well-off, though millions who were not well-off preferred to vote for us rather than for Labour. We found it hard to avoid the feeling that somehow the lean and tight-lipped mufflered men in the 1930s dole queue were at least partly our fault. And so paradoxically we were inhibited from questioning the misleading unemployment statistics of our own times since the last war which exaggerate the numbers of those who were unemployed – in the sense that an expansion of economic activity would permanently absorb

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52 For example, W H Hutt, Friedrich Hayek, Lord Robbins, Sir Arnold Plant and Theodore Gregory.

them into productive employment – and understate the numbers of vacancies. It was as though we were trying to make amends to the unemployed of a generation back by exaggerating unemployment in our own time.

As a result, we based our judgements and our policies on an unsound statistical basis.[53]

Even while we were encouraging or at least justifying mass immigration of workers first from Commonwealth, later from non-Commonwealth third world countries on grounds of labour shortage, we found nothing incompatible in risking inflation by expanding demand on grounds of the need to achieve fuller employment.

Because we failed to examine the implications of full employment policies, and the Welfare State, as well as the high taxation that accompanied them, we were inhibited from recognising the symptoms of failure when they appeared.

Although our post-war growth rate has been historically fast until recently,[54] in retrospect it can be seen that the post-war policies of stimulating demand and high taxation began to eat away the sinews of the economy. This was not immediately evident – though we should have reacted to the skew in favour of consumption and against investment which has long been known. The resulting decapitalisation affected not only the range and

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53 John B Wood, *How Much Unemployment?; How Little Unemployment*, Institute of Economic Affairs, 1972 and 1975; Centre for Policy Studies, *What the Unemployment Figures Really Show,* published each month.

54 HMSO, *National Income and Expenditure (Blue Book),* 1967 and 1974 (Tables 6, 8, 14), 1968 and 1975.

effectiveness of our productive capacity, but also our infrastructure and the stock of savings.[55]

Undated War Loan, for example, now stands at not more than a tenth of its original purchase value, which means that someone else has consumed the other nine-tenths. The same holds good for most other outstanding monetary debt. Whole sections of the population, including many of the most valuable, came to accept erosion of their living standards, property and savings. Many important branches of industry and construction suffered slower growth rate, stagnation and then actual de-capitalisation, though this was partly masked by the effects of inflation, and inflation-blind accounting.

Among the first symptoms of the failure was relative economic sluggishness. Those Keynesians,[56] or pseudo-Keynesians as it would be more correct to call them, who turned Keynesian economics into a new kind of magic, prescribed their wonder-drug: demand. It seemed to work at first, but, as we had been warned by the wise, the effects soon wore off and left the economy with the original symptoms, only in a more severe form than before. More demand was then tried. It created a balance of payments imbalance, an imbalance of payments. This in turn called for a 'stop'. We refused to believe that it was the drug which had caused the need for a stop, hence we still say 'stop-go', but it is the go which causes the stop, not vice-versa. True, the stop causes withdrawal symptoms which lead to pleas for more of the drug. But there are better ways of curing them.

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55 Ibid.

56 For example, Joan Robinson, Lord Kahn, Lord Kaldor, Lord Balogh, Sir Roy Harrod, G D N Worswick, Piero Sraffa, Roger Opie, Robert Nield.

Finally, a new stage in dependence arrived with what came to be called 'stagflation'. We were mystified by it, but there was no real cause for mystification. What had happened was that the economy had become more vulnerable through inflation-generated debilitation. We did not realise it. We were convinced that there must be some way of expanding demand while preventing the inflationary consequences. For all that happened was that to provide the same stimulus, the dose needed grew steadily.

In this new stage of dependency the economy reacts to demand expansion differently. As people anticipate inflation, the quantum of additional demand needed to stimulate the demand for labour to the desired level moves through an economy shackled with price controls and inflation-blind accounting procedures fast enough to create its depressant effects on activity and employment almost simultaneously with its stimulus, instead of subsequently, as hitherto.

This is a qualitatively new stage, not just an intensification of the previous stage, when progressively increasing levels of demand were needed to maintain a given employment rate. This finds the government trapped. If it does not increase demand, the withdrawal symptoms increase: bankruptcies, lay-offs, etc. If it expands demand, it also causes economic haemorrhage even while it stimulates the blood supply. It is no longer just stagnation and inflation which co-exist, but recession and inflation, or slump and inflation, 'slumflation' perhaps – one notch worse than the 'slumpflation' invented by the *Economist*.[57]

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57 'Banking in Slumpflation', 3 May 1975.

The second symptom of failure has been the declining birth rate of new enterprises as reported by the Bolton Committee.[58]

Risk-taking has little appeal these days: the upward potential is small: the downward risk is almost unlimited.

And all this while those pseudo-Keynesian economists who have advised the politicians have been claiming for pseudo-Keynesian policies the credit for the full employment and the growth in post-war Britain. But Japan, Germany, France and, up until recently, the United States all had full employment and in the first three cases phenomenal growth rates – and yet they had hardly heard of Keynes, and generally applied orthodox fiscal and monetary policies. So did the wonder economies of Hong Kong, Singapore and Malaysia. Note what has happened to the United States since the application of Keynesian remedies from 1964 onwards.[59]

Kennedy had tried to apply them but had failed to persuade Congress. Johnson, carrying on with the same advisers and strategies, did manage to get these proposals through Congress. The inflationary results were exported for as long as faith in the dollar persisted, and then erupted into the American economic crisis and the world inflation of the late 1960s and 1970s.[60]

There is another important factor to consider. Despite our pioneering of the industrial revolution business has never been as esteemed or as attractive to the very talented as in rival countries.

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58 HMSO, *Small Firms Committee of Inquiry,* Cmnd. 4811, 1971.

59 Professor Alan A. Walters, 'Keynesian Policies', Letters to the Editor, *The Times,* 24 January 1976.

60 OECD, *United States; Economic Survey*, July 1975.

Perhaps this in part explains the lack of enterprise in British management so widely observed at the turn of the century and earlier. The First World War with all its demands had infused a fresh surge of vitality into British management, but decades of cartelisation, rationalisation and Second World War controls had, not surprisingly, diminished what zest for enterprise and risk-taking we had as compared with businessmen in other advanced countries.

On top of this lesser business vigour and on top of all the well-meant but debilitating demand-management, we have added our Socialist anti-enterprise climate: indifference, ignorance and distaste on the part of politicians, civil servants and communicators for the processes of wealth creation and entrepreneurship; high taxation; very high marginal rates of taxation; perhaps most important of all – increasing capital taxation on the makers of wealth – whether self-employed, small, medium or large.[61]

It was Keynes himself who stressed the importance of the animal spirits of businessmen.[62]

Business involves risks as well as opportunities for power and wealth. By taxation, by inflation, by the remorseless flood of regulations and legislation, by controls and by the constant and arbitrary interventions of authority, successive governments since the war have cumulatively taken away both the pleasure and the rewards that once made risk-taking worthwhile.

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61 HMSO, *Select Committee on a Wealth Tax,* Vols I–IV, 1975; John B Wood and George Polanyi, *How Much Inequality?,* IEA, 1974.

62 'The State of Long-Term Expectation', Ch. 12, *General Theory*, Macmillan, 1936.

By this attitude we have driven out some wealth-creators; discouraged others; shrivelled the impulse to expand and throttled enterprise. Unions have their share in responsibility by their short-sighted resistance to change, by the strike-threat and by over-manning. No one can measure the loss of wealth that would have benefitted all – repeat all – that this combination of influences has caused.

It is here in Britain that pseudo-Keynesian policies of demand management and deficit financing coupled with Socialist attitudes to wealth creation have since the war been put most sustainedly into action. The results can be summarised all too briefly: among industrial countries we have nearly always been at the top of the inflation and at the bottom of the growth league.

The result has been that our standard of living, our resources for defence and social services and all else have been less than they could have been. We have been surpassed by the performance of all other industrial countries.

This would seem therefore to be a time for governments and advisers to take thought. To a limited extent, this has been happening. But much more needs to be learnt and attitudes changed if there is to be hope of prosperity and sustained growth and high employment again. New ideas, the way out, will have to come from outside the treadmill. At the moment, we are still inside.

I have dealt with inflation, so far, as a monetary phenomenon; it is other things besides. Inflation, as you will be aware, alters the balance of the economy in a number of dimensions; between the state and the private sectors; between consumption and investment; between profitable and tax-borne activities; this changed balance, in turn, creates new monetary pressures.[63]

Perhaps I can here touch on the particular discouragement of the manufacturing sector. Normally in a balanced economy we need not worry about the direction of enterprise – primary, secondary or tertiary sectors, farming, manufacture or services – because the advantages and disadvantages are market questions and enterprise will go where there is demand for it. But the choice is no longer balanced: legislation, taxation, inflation, union attitudes all make the employment of labour and the risks of manufacture more and more disproportionate to the potential rewards. So the balance has been shifted sharply in favour of service activity – and the consequent loss of manufacturing enterprise narrows the base on which all depends.

The changed balance between the state and private sector is crucial, both in itself – in the sense that it impinges on the kind of society we have as well as on economic efficiency – and because it reacts on the level of inflation. However, the division between state and private must be supplemented by a parallel division between subsidised and self-sustaining sectors. The point about state activity is not that the shares are owned by government, but that its existence does not depend on its ability to earn in the market an income to match its out-goings. The state sector – the public services from defence to education and health and the rest – is dependent, sustained either wholly or partly from taxation

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[63] Harry G Johnson and A R Nobay (eds), *The Current Inflation*, Macmillan, 1971; IEA, *Inflation: Economy and Society, twelve papers by economists, businessmen and politicians on causes*, *consequences and cures,* 1972; F A Hayek, *Full Employment at Any Price*, IEA, 1975.

or other imposts. This is true of nearly all nationalised industries and the subsidised private firms.[64]

I grant at once that price control by governments has imposed a heavy toll of losses. But in electricity, gas and the others, insofar as they enjoy monopolies granted by law, then it might still be true even if their charges covered their cost, since their statutory monopoly permits them to charge higher prices than competition might allow. This public sector is relatively insensitive to economic conditions; it does not spontaneously adapt; it exerts a huge force of not merely inertia but also of impetus. This matters little when the insensitive public sector is relatively small, but now that nearly two-thirds of our national activity flows in some way from the government, its insensitivity can be disastrous.[65]

However, just as in a predominantly free market economy, the market tends to set its stamp on all other institutions, so, in a state-dominated society, the state tends to set its stamp on nominally private institutions. In our case we see this proceeding along several axes. One is that in order to deal with the state bureaucracy, the man-made environment of licences and permits, planning permissions and regulations, grants and write-offs, premiums and taxes, forms and forms and forms, business has

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64 George and Priscilla Polanyi, *Failing the Nation: Record of the Nationalised Industries*, Fraser Ansbacher, 1974; IEA, *How Much Subsidy?,* 1974.

65 In 1974 Public Sector Expenditure, which includes the Current and Capital accounts of the Central Government and the local authorities together with the Capital account of the Nationalised Industries, together with Debt Interest of all these categories was 56 per cent of GDP at factor cost in 1974. HMSO, *Economic Trends Annual Supplement No 1,* 1975, pages 5 and 113. According to OECD estimates of GDP and recent trends in public spending the figure could reach 62 per cent in 1975.

become increasingly bureaucratised. Whether retired civil servants are taken on strength, or whether recruits are trained to imitate them, the state re-makes private industry in its own image.

As we know, the right to work has come to mean the right not to work, the right to go on receiving wages, usually high wages, unrelated to economic contribution. In the name of the right to work, some large private firms have come to receive heavy and open-ended subsidies to keep them going. I do not wish to discuss the economic or social rationale of overmanning, except to say that none of the arguments in favour stand up to rational examination, and that the practice fits neither capitalist nor Socialist economics and ethics, but is simply opportunist.

To criticise opportunistic make-work subsidies to overmanned or economically obsolete enterprises in no way implies that policies should not be designed to maximise employment. On the contrary, short, medium and long term stability of employment, particularly the medium and long term, are legitimate and rational policy objectives. My criticism of the lame-duck breeding measures – the Chrysler, British Rail, steel-style intervention, is that they are not at all calculated to maximise employment, but on the contrary, precisely that they in fact erode employment while nurturing highly-paid concealed unemployment.[66]

Had the present Government said, in effect, that given the fall in aggregate demand inherent in counter-inflationary monetary policies, it would need to watch very carefully the effects of its policies on employment opportunities at a given level of aggregate demand, it would in consequence have followed a far

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[66] See Upminster speech above.

different path. For by subsidising the least efficient and most capital-intensive firms (fixed and working capital), eg, British Leyland, Chrysler, Govan shipbuilders, at the expense of industry as a whole, the Government could not help decreasing employment many times over in the more efficient and basically healthy small and medium private firms, which provide far more employment per unit of capital. For every job preserved in British Leyland, Chrysler and other foci of highly-paid outdoor relief, several jobs are destroyed up and down the country. If Ministers and union leaders were genuinely concerned to prevent unemployment and to safeguard productive employment, they would not have acted as they have done. On the contrary, they would have helped slim down these costly giants so greedy of resources, and done everything possible to improve the economic climate in which the small and medium firms live.

Given a policy of contracting the real money supply, Mr Healey could have saved more jobs by not supporting overmanning than by supporting it.

So much for the difference between job protection and expanded employment opportunities. What concerns me here is the interaction between inflation and the inter-sectoral balance.

We note that inflation and a changed inter-sectoral balance show marked correlation, whether we define the sectors as state and private, subsidised and unsubsidised, or wealth-creating and wealth-consuming.

For the evidence is that increased Government spending, *pace* Mr Healey, reduces the capacity of the corporate sector to renew itself by natural regeneration.

I have argued that the expansion of the state sector and other segments of the subsidised sector throws an increased burden on the private sector, to a point where segments which would otherwise survive collapse. They then either fall by the wayside or in turn draw subsidies to keep alive, thereby increasing the total burden imposed on the shrinking private unsubsidised sector. Since the mid-1950s, the silver-age of Churchill's post-war administration, the relation between the state and subsidised and private unsubsidised sectors has changed decisively. Then, a wealth-creating sector which accounted for three-fifths of the GNP carried on its back a state and subsidised sector equal to the remaining two-fifths. This was heavy enough, too heavy perhaps to be borne easily in the long-term through a turbulent world economy. But at least then the private wealth-producing horse was still larger, stronger, heavier than its state rider.

By now, the proportions are reversed. When you take the division of the national product, let alone the hidden obligations – eg local government and public sector undisclosed pension-supplement liabilities, undisclosed deficits all of which must be made good from the public purse – it transpires that the state and subsidised sector now accounts for some two-thirds, and the private wealth-producing sector the other third.[67]

The rider is now twice as heavy as the horse instead of only two-thirds as heavy.

This is a qualitative change. It is also a self-perpetuating change, unless we step in to reverse it. For the burden is so heavy that the process would continue by its own momentum even were it not

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67 *National Income and Expenditure* op. cit.

accelerated by further nationalisation measures which turn profitable firms into losers.

It also fuels inflation, since the shrinkage of the private self-supporting sector automatically reduces the tax base, and the Government in order to finance concealed unemployment and to support inefficiency is tempted even more strongly to create new money to meet its growing obligation.

Look at what has been happening. During the ‘go’ phase of the cycle we have expanded demand and government expenditure, either hoping for the best or trying to suppress inflationary symptoms by controls on prices and wages. But during the ‘stop’ phase, successive governments have acted by monetary and fiscal measures which impinge principally on the private sector. Though, it is true, there is always talk of cutting public expenditure, it has remained almost entirely talk. Cutting public expenditure has come to mean juggling with figures, ‘cutting increased expenditure’, ie, increasing public expenditure by less than it would otherwise have been increased. When you study the expenditure figures *ex post*, you will see that for yourselves.[68]

But whereas cuts in public expenditure rarely eventuate, squeezes on the private sector are ‘for real’. The interest rate is increased, bank lending is contracted, taxes are raised, other old-fashioned deflationary measures are used. The private sector is punished for the state sector’s profligacy.

So, each ‘go’ expands the state sector. Each ‘stop’ squeezes the private sector. And, as we have seen, when the squeeze comes,

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68 HMSO, *The Financing of Public Expenditure, Vol I – Report, Vol II, Minutes of Evidence*, 1975.

some enterprises go to the wall – or to the Government. The large ones go to the Government for aid. This is nothing to do with their intrinsic merits, though one can cook up an argument in favour of any decision once it is taken. It is their size hence their concentration of workers, hence their power in union and electoral and media terms, hence the Government's temptation to buy peace.

By and large, these concentrations of unionised workers in large enterprises correspond to high concentrations of capital, fixed and working capital, higher than average. In other words, as I argued earlier, it takes much more money to employ each worker than it does in the smaller enterprises, which are rarely able to bring the kind of pressures to bear to maintain over-manned uneconomic plants. So, when the squeeze is on, those enterprises which are not only least profitable and least economic generally, but those which will need the greatest amount of help per job saved – however temporarily – come to the top of the queue automatically, by virtue of these very characteristics.

So the inflationary spiral is given another turn. This can be seen to be a linked spiral, with the squeeze of private sector, growth of state-supported sector, greater burden on residual wealth-producing sector.

If this squeeze continues the productive base on which all else rests will buckle. So, our monetary policies must be designed to save the private sector while cutting the state-cum-subsidised sector. For if we do not, inflation will be intensified anyway, by the workings of the mechanisms I have traced. Moreover, unless the squeeze is directed against the wealth-consuming sector, the private sector will be left with no alternative but to call for reflationary policies, whatever their middle-term effects, in order to survive in the short term. In other words, monetary policies on their own place the private employers and their workforce willy-nilly on the side of the wealth-consuming sector, in creating political pressures in favour of more wasteful policies, and leaves the anti-inflationeers isolated.

Cuts in state spending are essential both to make way for the revival of the wealth-creating sector and to achieve a deceleration of the growth of the money supply. Cuts in state spending of sufficient magnitude to reduce inflation substantially will require strong nerves. But the alternative would be accelerating decline in standard of living and in employment within the next few years.

To hold down the growth of the money supply to a level commensurate with the expected growth in productive capacity, and to keep it there, is part of the cure for inflation.[69]

If the whole economy were private, then all firms would be subject to the resulting constriction – and only the unsound would need to go. But the whole economy is not private. Nearly two-thirds is statist, and insensitive in itself to contraction of the money supply. It is fed with money which is expanded automatically to maintain given levels of expenditure in real terms – 'funny money', as Samuel Brittan calls it. Indeed, while money supply is contracting, budgetary spending is expanding.

So the state sector bids up interest rates, bids off funds, bids away manpower and leaves the force of the monetary contraction focussed on the private sector. While the activity rate is low, and

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[69] Sir John Hicks and others, *Crisis '75… ?* IEA, 1975. In particular E Victor Morgan's essay 'Turning Point or Moment of Danger?'.

stocks have run down, as now, the private sector feels the pinch of lower demand and increased costs but, though there are record levels of bankruptcies, the sector as a whole can temporarily increase its liquidity.

When the upturn comes and world prices lift, stocks are rebuilt, and investment begins to surge, the spare liquidity will be needed for industry. Then what will become of money supply contraction? The contraction will either become a garotte, strangulating expansion of our trading base, or to counteract this, there will be an explosion in the money supply. Then the next cycle of boom-and-bust will be at even higher Latin-American rates first of inflation and then of inflationary unemployment.

In other words, the monetary process is both a cause of inflation and a link in a wider chain of cause and effect. Monetary contraction in a mixed economy strangles the private sector unless the state sector contracts with it and reduces its take from the national income.

Hence my title: 'Monetarism is Not Enough'. Detaxing and the restoration of bold incentives and encouragements to business and industry are necessary too. Until the state contracts, and indeed until enterprise is encouraged both by this contraction together with some assurance that it will stay contracted, and by less destructive taxation and intervention, there will not be the confidence nor the climate for entrepreneurship and risk-taking that will alone secure prosperity, high employment and economic health.

Cuts mean cuts. At present, we have learned, actual government expenditure has outrun projected by several percent of the GNP. We shall need to cut it back by several percent. Pseudo-cuts of future programmes will not be enough. We shall need to cut state employment and subsidies to rail, steel, housing and the supported sector. We shall need to explain that subsidised employment is not really saving jobs because the subsidies have to be paid for and the paying for them loses more jobs than are saved. We must demonstrate that state spending – including subsidies – is a cause of many smaller firms cutting their labour force or going out of business.

Let me emphasise: to say that 'monetarism is not enough' is not in any sense to retreat from monetarism. On the contrary, it is to advance from monetarism. It is to recognise that our argument has gone a long way towards winning, but it will not be enough to have reduced inflation if we do not enable the private sector to revive when we have won the battle.

For in economics, there are no ultimate causes, only proximate causes. Every cause is itself an effect, a symptom, every effect becomes a cause. Our present irrational economy, which cannot last because it is undermining its own foundations, throws up problems of its own which are variants of more general problems. Our monetary problems reflect the underlying weakness of this man-made chaos, the divorce of work from production, of cost from benefit, of reward from performance, the greatest government spending spree of all time which is designed primarily to keep people busy instead of useful. In a sense, we are moving into the make-believe economy where, instead of digging holes and filling them in again, we make motor cars that no one wants, put three men on a train – which we cannot fill anyway – when only one man is needed.

This is going through the motions, keeping up appearances, window dressing a fraudulent facade. Behind the facade, the private sector that produces the goods which people want is restricted by controls, over-taxed by local and central government and harassed by officials. Our monetary arrangements are bound to reflect this dichotomy. Hence the public sector's 'funny money', which, we now learn belatedly, has led to massive state over-spending,[70] while the ever more constricted wealth-producing sector has to conduct its accounts, taxes and dividends in terms of an increasingly threadbare pound.

For the continually constricted private sector the unit of account was increasingly threadbare pound sterling, good to borrow, less good to hold, meaning less and less as firms which have shown good profits on paper year after year – to howls from Socialists – suddenly find that they are somehow on the verge of bankruptcy, and have been for years, without knowing it. The private sector has the unfunny money.

Monetarism is not enough. This is not intended as a counsel of despair, but a warning note. Government's intention to contract the money supply is welcome and potentially beneficial to all. But it is not enough unless there is also the essential reduction of the state sector and the essential encouragement of enterprise. We are over-governed, over-spent, over-taxed, over-borrowed and over-manned. If we shirk the cure, the after-effects of continued over-taxation will be worse than anything we have endured hitherto. Our ability to distinguish between economic reality and economic make-believe will decline further. We shall experience accelerated worsening of job prospects, the growing flight of

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[70] During 1974–5 the public-sector borrowing requirement exceeded its budget estimate by some £3,000 million (or 4 per cent of gross domestic product). Op. cit., *Financing of Public Expenditure*.

those with professional skills, talent and ability to other countries, and an increase in the shabbiness and squalor of everyday lives.

That is why, by itself, the strict and unflinching control of money supply though essential is not enough. We must also have substantial cuts in tax and public spending and bold incentives and encouragements to the wealth creators, without whose renewed efforts we shall all grow poorer.

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