# Chapter 1: The post-war settlement: Not a blueprint for post-COVID UK

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## 1.1 Introduction

**The transition from war to peace in the years after 1945 is often regarded as a great British success story. The economy moved rapidly to a 'golden age' of inclusive economic growth, with a welfare state that provided economic security 'from the cradle to the grave'. The unemployment of the 1930s was eliminated, while inflation remained under control.**

There is still a great deal of nostalgia for the policy reforms of early post-war Britain. In a flagship speech called 'A New Chapter for Britain' (2021), the Labour Party leader, Sir Keir Starmer, hailed the determination of those years to pursue fundamental reform and argued that there is now a similar mood to that prevailing in 1945 to build a better, more secure future. It is routine for commentators to call for 'a new Beveridge Plan' or, slightly more circumspectly, to argue that 'a good start for a post-pandemic society would be to learn the lessons of the 1940s' (Lansley 2021).

However, it is important to take away the right messages from past reforms, rather than look at them through rose-tinted glasses, as is so often the case. In this chapter I shall argue that although the results of the post-war settlement may look good at first sight, regardless of political perspective, it was in many ways disappointing. Some of the important lessons of the 1940s are about not repeating the mistakes that were made then.

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## Key findings

- The post-war settlement delivered very low unemployment but was a serious constraint on much-needed policy reform.
- Post-war growth was strong, but the UK was still outperformed by its European peer group.
- Financial repression squared the circle of expanding the welfare state while reducing the public debt to gross domestic product (GDP) ratio.
- The post-war welfare state failed to prevent a big increase in health inequalities.
- The Beveridge Report should be viewed critically rather than reverentially.

This chapter considers the post-war settlement and its outcomes through three main focal points:

- *Prima facie:* An era of great progress.
- Reality check: Serious shortfalls in performance.
- Lessons from history: The 1940s does not offer a template for post-COVID reconstruction.

## 1.2 The post-war settlement

Following the end of World War II, the Labour government made major economic and social policy reforms that shaped Britain for a generation. The post-war settlement was based on the ideas of Beveridge and Keynes regarding the welfare state and the maintenance of full employment. Added to this were increased state intervention in the economy, higher taxes and the acceptance of an implicit trade union veto on economic policymaking. The state aimed to provide security 'from the cradle to the grave' in a more equal society. The introduction of the National Health Service (NHS) in 1948 was widely celebrated. At the time it was believed that poverty had been eliminated, and that there would be no return to the hard times of the 1930s.

Central to this new dawn was the end of mass unemployment, which had scarred the interwar period. The 1944 White Paper on Employment Policy pledged that the maintenance of a high and stable level of employment was a primary aim and responsibility of government. It soon became conventional wisdom that this was a *sine qua non* for a government to be re-elected. The influential analysis of opinion poll data by Goodhart and Bhansali (1970) found that unemployment greater than 400,000 (about 1.8% of the labour force) implied that the governing party had no chance of leading in the polls. Presiding over a return to interwar levels of unemployment (which were never below 1.8 million) would therefore be electoral suicide.

Achieving such a low level of unemployment without igniting inflation was problematic, but was addressed by an implicit social contract between governments and organised labour that sought to deliver wage restraint in return for supply-side policies designed to please trade unions (Flanagan et al. 1983). This led to the persistence of weak competition policies, high marginal tax rates, state-owned enterprises, protectionism and dysfunctional industrial relations.

## 1.3 Prima facie: An era of great progress

Macroeconomic performance in the long post-war boom seemed to be outstanding and certainly much better than could have been hoped for at the end of the war. The economic environment was much less hostile than the 1930s' experience of depression and trade wars. Western Europe had the opportunity for rapid growth through reducing the productivity gap with the United States and recovering from the shocks of depression and war. As can be seen in Table 1, this was a time of rapid productivity growth, low unemployment and tolerable inflation.

**Table 1. Macroeconomic performance, 1950-73**

| | |
|---|---|
| Unemployment (%) | 2.63 |
| Consumer price index inflation (% per year) | 4.70 |
| Labour productivity growth (% per year) | 3.74 |

Source: Thomas and Dimsdale (2017): unemployment from Table A50, Column J; inflation from Table 47, Column E; productivity growth based on hours worked and calculated from Table A8, column B and Table A54, column AW.

Over the period when the 'post-war consensus' held sway, living standards improved steadily, as shown in Table 2. Real GDP per person (and real wages) nearly doubled in this golden age, while hours of work in 1973 were about 25% lower than in the 1930s. The proportion of households in relative income poverty declined slightly from 13.2% to 13.0% (Gazeley 2014; Gazeley et al. 2017), and life expectancy rose from 69.0 to 72.1 years (Office for National Statistics 2015), which was beyond what had been thought possible in the 1930s. By the late 1950s, the Prime Minister, Harold Macmillan, had coined the slogan, 'You've never had it so good!' The high point for happiness in the period after World War II was in 1957, the year of Macmillan's famous speech.[1]

**Table 2. Changes in real GDP/person and hours worked, 1950-73**

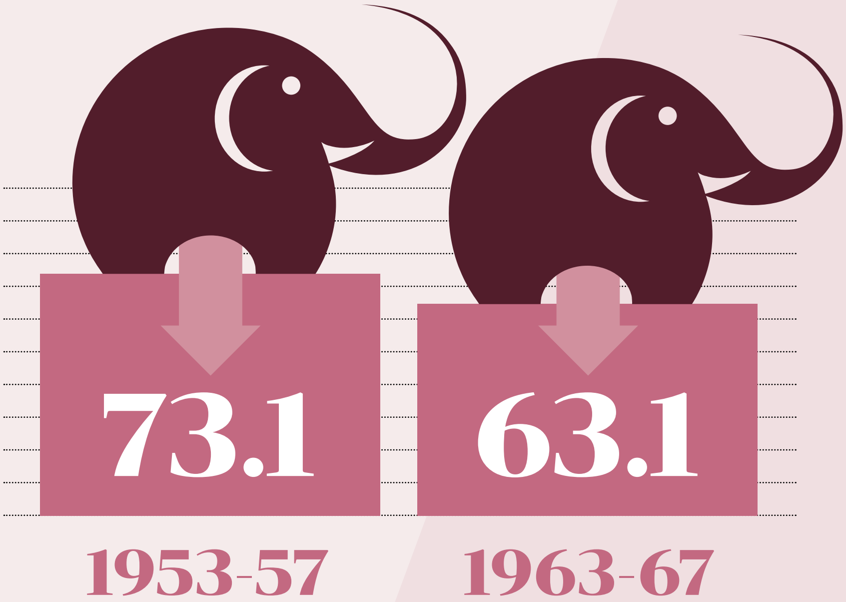
| | Real GDP per person (2013 prices) | Annual hours worked |
|---|---|---|
| 1950 | 7,114 | 2,184 |
| 1973 | 13,902 | 1,860 |

Source: Thomas and Dimsdale (2017): GDP/person from Table A21, Column X; hours worked from Table A54, Column AW.

The expansion of the welfare state was accompanied by a rapid reduction in the ratio of public debt to GDP, as shown in Table 3. Fiscal sustainability was not an issue despite the expansion of the welfare state at a time when government debt had ballooned through wartime borrowing. This was, of course, helped by the low unemployment and strong economic growth of the period. A decline in the public debt ratio was also propelled by very low real interest rates, which were generally well below the rate of growth. Low real interest rates reflected policies of 'financial repression', and were underpinned by capital controls that stopped an outflow of savings to other countries and onerous bank regulations that compelled banks to hold large amounts of government debt (Crafts 2016). This allowed the government to borrow from 'captive lenders' on very favourable terms.

[1] As measured by the valence of words in books; see Sgroi et al. (2017).

# Financial repression




FINANCIAL REPRESSION INDEX SCORE (BATTILOSSI) 2004

A POLICY OF 'FINANCIAL REPRESSION' can be defined as one in which government intervention reduces the nominal interest rate on public debt to below the free market rate. Combined with inflation, this will be conducive to a more favourable configuration of the interest rate relative to the growth rate and may well entail a negative real interest rate on government borrowing. The methods by which this may be achieved include the imposition of interest rate ceilings, balance-sheet regulation of the banking sector, control of central bank interest rate policies, and restrictions on international capital mobility. The general idea is to create captive domestic savings from which the government can benefit.

Allen (2014) provides a detailed account of how financial repression was achieved in the 1950s, with approaches including the obligation for banks to have high levels of liquid assets to deposits which could be met by holding Treasury Bills, controls on interest rates, credit restrictions for private sector lending, and comprehensive foreign exchange controls. The financial repression index score calculated by Battilossi (2004) was as high as 73.1 in 1953–7 and 63.1 in 1963–7. This index has three equally weighted components: reserve requirements for banks, real deposit rates of banks and government liabilities held by the banking system. Each of these is measured on a scale of 0 (minimum) to 100 (maximum), standardised to a normal distribution. Politically, financial repression fitted with an era of very steep top marginal income tax rates in a rather egalitarian climate, and a strong preference for the tight regulation of the financial system following the banking crises of the interwar period.

The modern version of financial repression mentioned in the text (section 1.5) would take advantage of the commercial bank reserves held at the Bank of England that have accumulated through the purchases of government bonds under quantitative easing. A point to note is that interest rates on these reserves are currently very low but could rise rapidly if monetary policy were to 'return to normal'. Freezing reserves and ceasing to pay interest on such reserves amounts to a tax on banks but protects public finances against rising interest rates on around £900 billion of bank reserves. The attractions and practicalities of such a policy are discussed by Charles Goodhart and Adair Turner in the House of Lords (2021).

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| Table 3. Fiscal sustainability data: Average for 1950-73 | |
|---|---|
| r: real interest rate on government debt | 0.15 |
| g: real rate of growth of GDP | 3.20 |
| b: primary budget surplus/GDP (%) | 2.34 |
| b*: required primary budget surplus/GDP (%) | -3.53 |
| Aide memoire: public debt/GDP | |
| d in 1950 | 1.995 |
| d in 1973 | 0.505 |

Note: b* = d(r – g) is the primary budget surplus required for $\Delta d = 0$.
Source: Middleton (2010) database; Feinstein (1972).

## 1.4 Reality check

In his well-known book, Hennessy (1993) declared that in the early post-war decades there was 'progress on a scale and a duration never surpassed in the nation's history'. Clearly, there was considerable progress; however, a closer look at the outcomes of the post-war settlement reveals a less rosy picture, even for health. Although the evidence suggests that the NHS healthcare system seems to have achieved a high degree of horizontal equity (Propper and Upward 1992), i.e. equal access for equal need, which is unlikely to have been achieved in the interwar period, health inequalities rose steadily in the post-war years. A frequently used measure relates to social class differences in age-standardised mortality rates, which show that mortality in social class V was 1.37 times higher than in social class I in 1951, but had increased to 2.50 times higher in 1981.[2] The most important reason for this is probably deprivation, which suggests a failure of the welfare state rather than the NHS.

Optimism that poverty had been virtually eliminated stemmed from Seebohm Rowntree's third survey of York, which found that 4.8% of working-class households (implying about 2.8% of all households) were in poverty in 1950, compared with 31.1% in 1936 (Rowntree and Lavers 1951). In this context, 'poverty' was measured in terms of Rowntree's 'human needs' concept. However, later analysis of the surviving records from Rowntree's survey found that the results published in 1951 were unreliable. After correcting for errors in Rowntree's original analysis of his data, Hatton and Bailey (2000) calculated that the true figure, based on Rowntree's own criterion, was that 11.8% of working-class households or 7.1% of all households were in poverty in 1950. They also found that Rowntree had overstated the impact of welfare state reform on poverty. They estimated that if the 1936 social security system had still been in place in 1950, the fraction of working-class households in poverty would have risen by 3.7 percentage points.

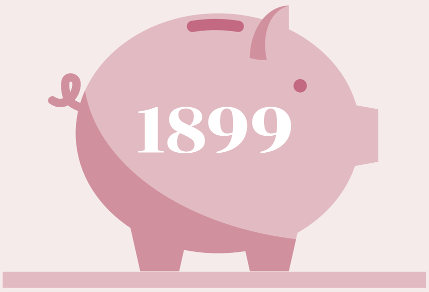
Contrary to Rowntree's original findings, a significant amount of poverty was still present in the early 1950s. An analysis of the 1953/4 Family Expenditure Survey found that 13.2% of all households were below 60% of median equivalised income, a conventional criterion for 'relative income poverty' (Gazeley et al. 2017). No comparable estimate has been made for the late 1930s, but extrapolating from the postwar period it can be estimated that about 16% of the population may have been below 60% of median income in 1937.[3] By using this measure poverty was lower after World War II, but had not been dramatically reduced.

It should be noted that the post-war fiscal design raised taxes by much more than it increased social expenditures (Table 4). To modern eyes it is striking how little was spent on health, even though tax rates had jumped significantly. The amount of redistribution, measured as the total of net payments to households who gained from the tax and benefit system, rose from 8.8% of GDP in 1937 to 13.1% in 1948/9. This is considerably less than many people might imagine, but reflects Beveridge's intention that the welfare state should provide social insurance rather than seek to deliver a significant redistribution of income.

[2] This comparison can sometimes be misleading but after a careful review of the evidence, Pamuk (1985) concluded that the increase in relative social class mortality differentials was genuine rather than a statistical artefact.

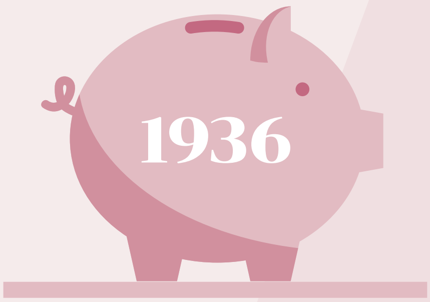
[3] For the period 1961 to 2015, McKnight et al. (2017) estimated this measure of poverty = -0.0496 + 0.7261 Gini. Gini in 1937 = 0.29 so this equation would predict poverty = 16.1%.

# 'Human needs' poverty



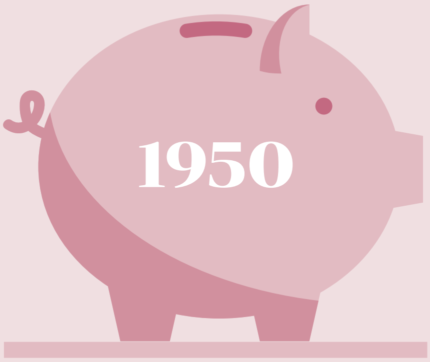

# 114%

**£53.10 PER WEEK**
AMOUNT OF INCOME NEEDED TO MAINTAIN AN ADEQUATE STANDARD OF LIVING IN 1899 AT 2000 PRICES




# 118%

**£71.77 PER WEEK**
AMOUNT OF INCOME NEEDED TO MAINTAIN AN ADEQUATE STANDARD OF LIVING IN 1936 AT 2000 PRICES




# 145%

**£91.06 PER WEEK**
AMOUNT OF INCOME NEEDED TO MAINTAIN AN ADEQUATE STANDARD OF LIVING IN 1950 AT 2000 PRICES

MODERN STUDIES OF POVERTY typically use a measure based explicitly on relative income. A common criterion is that a household is in poverty if it has less than 60% of equivalised median income, i.e. income adjusted for family size and composition. In practice, the percentage classified as poor is quite closely related to the inequality of incomes across the population. In 1953/54, based on this measure and using the Family Expenditure Survey, Gazeley et al. (2017) estimated that 13.2% of households were in poverty.

During the first half of the twentieth century, investigators, including Rowntree using a 'human needs' standard, typically based their poverty estimates on the number of households falling below a poverty line, i.e. the amount of income that a household of their size and composition needed to maintain an adequate standard of living, taking into account nutritional needs, rent, clothing and household necessities.

'Adequacy' connoted considerably more than bare bones subsistence and, as real wages rose, the standard of living deemed adequate by these investigators increased over time. Rowntree's primary poverty budget for 1899 for a couple with three young children was £53.10 per week at 2000 prices (114% of average personal disposable income), his human needs budget in 1936 was £71.77 (118%), and his modified human needs budget in 1950 was £91.06 (145%) (Glennerster et al. 2004). In practice, these poverty lines were also based on a relative income concept, but only implicitly.

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**Table 4. Pre- and post-war redistribution**

| | 1938 | 1951 |
|---|---|---|
| Social expenditures (% GDP) | 8.6 | 11.5 |
| Education | 2.1 | 3.2 |
| Health | 1.6 | 3.4 |
| Social security | 4.9 | 4.9 |
| Taxes (% GDP) | 21.5 | 33.6 |
| % Original income £2K-£3K | 37.9 | 55.7 |
| % Original income £3K-£5K | 43.1 | 62.9 |
| % Original income £5K-£10K | 51.6 | 79.9 |
| Net redistribution (% GDP) | 8.8 | 13.1 |

Sources: Social expenditures and taxes: Middleton (1996). Tax as % original income: Barna (1945); Cartter (1955). Estimates are for 1937 and 1948/9. Net redistribution: Cartter (1955). Estimates are for 1937 and 1948/9.

Considering the above, the popular image of Beveridge's welfare state as a landmark achievement in addressing inequality is perhaps wide of the mark. Indeed, for many years specialist academics have been very critical of the Beveridge design. The declared aims were to achieve an adequate minimum income for all while abolishing means-testing in favour of a system of social insurance that paid out flat-rate benefits for contingencies such as old age, sickness and unemployment, all funded by flat-rate contributions topped up from general taxation.

The aims were not and could not have been fully achieved by Beveridge's proposals. Reliance on flat-rate contributions restricted benefits to inadequate levels, while the huge geographic variability of house rents and the reliance on below-poverty line benefits had to be addressed through means-tested National Assistance. Many old-age pensioners with no income other than benefits qualified for National Assistance but did not want to subject themselves to the application process and remained in poverty. Some 7.1% of households had incomes below the National Assistance level in 1953/4 (Gazeley et al. 2017).

A much more effective approach to social insurance would have relied on funding from taxes and made transfer payments on the basis of need. Such a scheme would have been designed to provide a safety net for privately uninsurable risks including social care, which was omitted, and the erosion of pensions by inflation, which was ruled out by Beveridge's approach. Payment of flat rate benefits related to contribution history was a recipe for rapidly increasing relative income poverty in a period of strong economic growth, and not surprisingly was abandoned in favour of the de facto wage indexation of benefit levels.

Finally, it is important to recognise that the post-war settlement undermined growth performance.
Put into a comparative international context, UK productivity growth in the golden age was not particularly impressive and was notably inferior to that of France and West Germany, as shown in Table 5. Although these countries had more scope for rapid catch-up growth as they started from lower productivity levels, the key point to note is that they had overtaken the UK by 1973 when their labour productivity levels were about 12% higher. UK underperformance relative to what it was reasonable to think possible is about 0.8% per year (Crafts 2017).

**Table 5. Comparative productivity performance in the golden age, 1950–73**

**a) Productivity growth, 1950–73 (% per year)**

| | Y/L | TFP |
|---|---|---|
| France | 4.83 | 4.02 |
| United Kingdom | 3.74 | 2.44 |
| West Germany | 5.83 | 4.06 |

Note: Y/L is labour productivity measured as real GDP per hour worked; TFP is 'crude TFP', i.e. the contribution of labour quality is included. Sources: Bergeaud et al. (2016): Table 1 and the long-term productivity database.

**b) Real GDP/hour worked (UK=100 in each year)**

| | France | West Germany |
|---|---|---|
| 1950 | 80.3 | 70.0 |
| 1973 | 112.6 | 111.9 |

Note: GDP is measured in constant purchasing power parity dollars. Sources: Derived from Thomas and Dimsdale (2017) and The Conference Board (2016).

The productivity growth failure was an outcome of supply-side policy failings, many of which were promoted by the 'post-war consensus' and the attempt to persuade trade unions to exercise wage restraint to maintain full employment without triggering an inflationary spiral. The cardinal policy error lay in the balance between industrial policy and policies to promote competition that favoured the former at the expense of the latter. This slowed down the processes of creative destruction, underpinned a damaging industrial relations system, allowed incompetent management to survive, protected wasteful investment and low effort bargains in state-owned enterprises, and facilitated mergers that raised market power but not productivity.

## 1.5 Lessons from history

After World War II, the post-war settlement dictated that there should be no return to the 1930s. Above all this meant that there should be no going back to the high unemployment of that decade. The equivalent in post-COVID Britain is that even though the public debt to GDP ratio has topped 100% of GDP, there should be no more 'austerity', i.e. fiscal consolidation based on expenditure cuts. This is understandable given the severity and duration of reductions in public spending after the 2008 financial crisis (Crafts 2020).

The situation faced by the United Kingdom has similarities to the years after World War II, with urgent demands for more government spending (including more generous transfer payments) to address issues of fairness, improve public services and rectify a large backlog in infrastructure investment, while also ensuring fiscal sustainability by stabilising and then reducing the public debt to GDP ratio. Clearly, increases in taxation will play an important role, but the lesson from the UK's experience in the 1950s and 1960s is that the interest rate growth rate differential is a key variable. Negative values for (r – g) in those years made the combination of welfare state expansion and debt ratio reduction eminently feasible. Financial repression and golden age growth made for pleasant fiscal arithmetic. The Office for Budget Responsibility (2019) envisages a medium-term scenario where (r – g) = 0.2%, but noted that this was by no means guaranteed.

Keeping the real interest rate on government debt down and improving productivity growth after its unprecedented pre-COVID slowdown (Crafts and Mills 2020) are high priorities for a new fiscal settlement. It is not possible to replicate the 1950s – capital controls and golden age catch-up growth are the past not the future. It may, however, be possible to use an alternative method of financial repression and improved supply-side policies that address slow productivity growth gain added importance given the fiscal imperative.

The route to a modern version of financial repression lies in exploiting the opportunity provided by quantitative easing, which means that £900 billion (and rising) of government debt has been bought by the Bank of England and is financed at the Bank Rate (currently 0.1%) paid on commercial bank reserves. A substantial part of these reserves could be frozen with no interest paid, although some fraction would have to continue to pay interest to make monetary policy effective. Alternatively, they could be compulsorily swapped for short and medium-term gilt-edged securities (Allen 2021). Either of these methods is in effect a tax on banks, and in economic policy terms the issue is whether any adverse side effects of such a tax outweigh its public finance benefits. Politically, it is hard to think of a more popular way to approach a new fiscal settlement, especially with the 'red-wall voters' who matter so much to the government's chances of winning the next election.

The path to faster productivity growth includes not repeating the mistakes of the early post-war years. The 'old-Labour' state interventionist approach to supply-side policy was rightly jettisoned by both political parties in the late twentieth century and should not be brought back now, even though it may appeal to the former Labour voters who switched to support the Conservatives at the last election (Mattinson 2020).[4] The focal point should be on innovation policy, in particular through facilitating the diffusion of new technology, including through technology transfer. Indeed, a substantial part of the social returns to research and development comes through its 'second face' in supporting the adoption of innovations (Griffith et al. 2004). More generally, 'absorptive capacity' is central to the effective assimilation and diffusion of new technology. Absorptive capacity is underpinned by education, skills and economic competences that include organisational effectiveness, management quality, appropriate business models and training, which are all areas where the UK has considerable scope to improve.

[4] As the Prime Minister obviously recognises. During the general election campaign he promised to 'back British business by introducing a new state aid regime which makes it faster and easier for the government to intervene to protect jobs when an industry is in trouble'.

There is a potential role for selective industrial policy in promoting sectors that are technologically progressive and in which learning spillovers across firms are likely to be important. Aghion et al. (2011) provide some evidence of the successful use of state aid in this context within the European Union, especially for countries with capital market weaknesses. They also stress the importance of using such policies in a competition-enhancing way rather than to sponsor national champions. This chimes with the lesson from the early post-war period that nurturing competition is important for productivity growth. A recent review by the Competition and Markets Authority (2020) highlights that a weakening of competition in the last 20 years or so should be addressed.

## 1.6 Conclusion

It is tempting to think that the 1940s offers a template for post-COVID reconstruction, but unfortunately it does not. The post-war settlement created a policy framework that impaired productivity growth for the next 30 years and does not provide a solution to the current post-financial crisis productivity slowdown. Nor should we turn to the 1940s for insights on how to reduce inequality. The Beveridge Report has iconic status in British political discourse, and it is understandable that people who want an improved welfare state invoke this report; however, Beveridge does not offer a blueprint for social security in post-pandemic Britain. Similarly, although health inequalities have been starkly underlined in the past year, the historical evidence suggests that a better-funded NHS would not be enough to eliminate these inequalities.

**“It is tempting to think that the 1940s offers a template for post-COVID reconstruction, but unfortunately it does not.”**

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