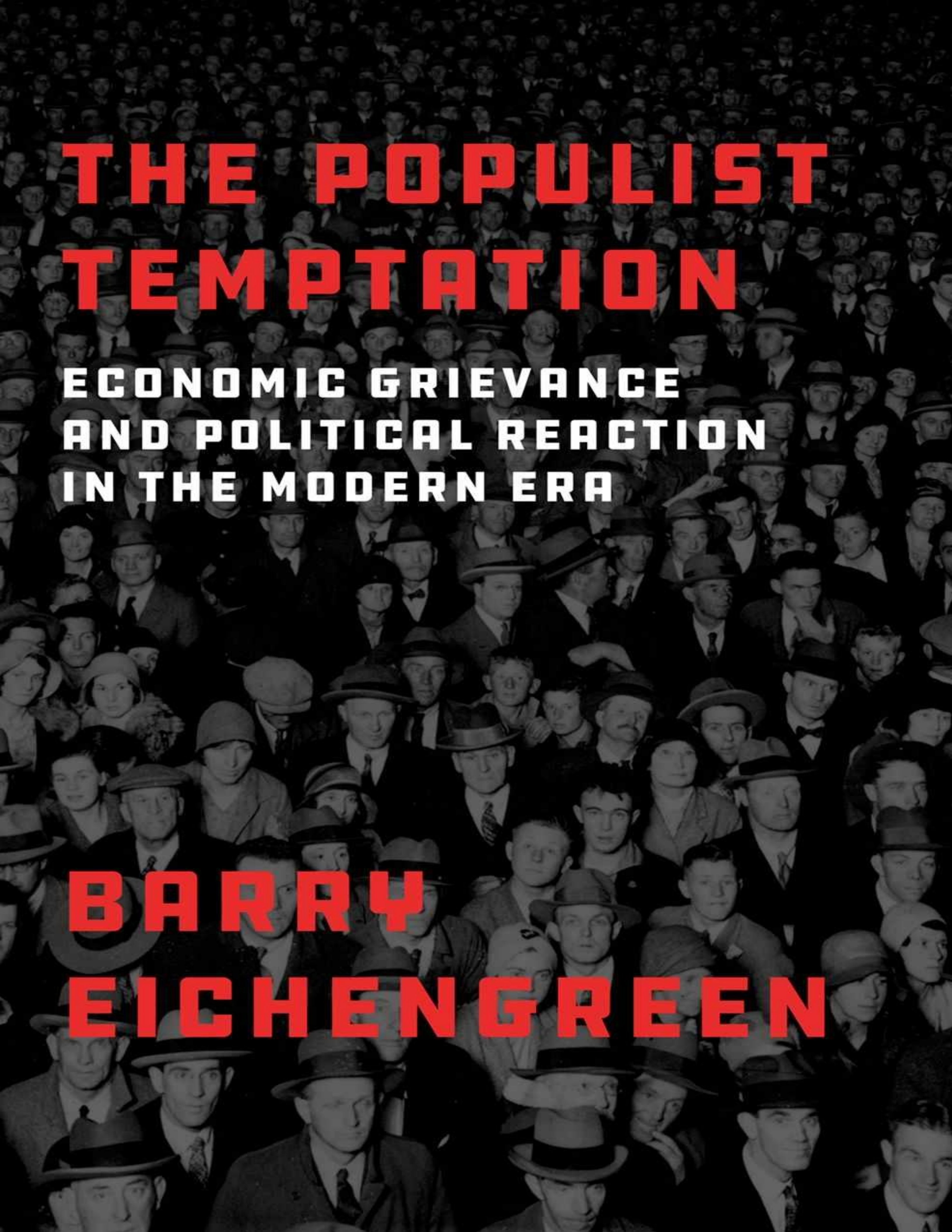

THE POPULIST TEMPTATION

ECONOMIC GRIEVANCE AND POLITICAL REACTION IN THE MODERN ERA

BARRY EICHENGREEN

6

Unemployment and Reaction

the 1920s and 1930s were years of crisis not just in the United States but globally. High unemployment, collapsing incomes, and all the associated socioeconomic ills—rising poverty, declining family formation, and deteriorating health status—were widespread, especially in the 1930s, when economic turbulence was greatest. In some places the political reaction developed even earlier, in Italy, for example, in response to the postwar recession and banking crisis, and in Germany in the chaos of post–World War I demobilization and then hyperinflation in 1923. Inflation in the 1920s and unemployment in the 1930s undermined confidence in the ability of mainstream politicians and governments to manage the economy. The failure of the political establishment to do more to help those feeling the most damaging effects and instead curtailing even those limited programs of social support of greatest value to the masses—the decision to opt for what today we would call austerity at the cost of the working class—bred support for political extremists on the Left and Right.

In the worst cases, such as Hitler's Germany, the demagogues assuming power targeted religious and ethnic minorities as responsible for society's ills. They repudiated free trade and prohibited a broad swath of cross-border financial transactions. They renounced the market and brought large segments of the economy under government control. They undermined checks and balances and more generally the institutional foundations of the political system. They showed scant respect for individual rights.

Benito Mussolini's assumption of power in Italy similarly owed much to the chaos that engulfed the country after World War I. Like Hitler, Mussolini used an aggressive nationalism to cultivate support in a turbulent economic environment, when many Italians already had doubts about their government's competence in light of its pathetic performance in the war. He cultivated the image of a strongman to appeal to those who believed that only an authoritative, even authoritarian leader could restore order. He organized visible demonstrations of his economic prowess, commissioning roads, bridges, and most famously the Monumento Nazionale a Vittorio Emanuele II, crowned by two bronze statues of Winged Glory, in 1925. He undermined political and economic institutions, substituted personal decision-making for judicial and constitutional rule, and superseded the market system, all with the goal of limiting individual liberty and strengthening the state. “The Fascist conception accepts the individual,” as he explained in a 1932 article for the *Enciclopedia Italiana*, “only in so far as his interests coincide with those of the State.”[1] Mussolini maintained his power base by showering favors on cronies, attacking the hostile media, and cultivating sympathetic journalists. If his impact was ultimately less catastrophic than Hitler’s, this only reflected his more limited competence.

In other cases, like that of Britain, the fascist reaction failed to command widespread support. Influenced in part by Mussolini’s example, the aristocratic and temperamentally impatient Oswald Mosley formed the New Party in 1931 and then the British Union of Fascists in 1932.[2] As a member of the Labour Party, Mosley had been charged with developing policies toward unemployment for the MacDonald government, formed in 1929. His proposals, which included tariffs, nationalization of major industries, and an ambitious program of public works—all characteristic populist initiatives—were spurned by a cautious prime minister and a cabinet anxious to establish Labour’s financial bona fides. Rejection of his populist agenda precipitated Mosley’s resignation, his political turn to the Right, and his conversion into an anti-system politician.

It was not immediately clear, however, that Mosley’s was a losing bet. Labour’s failure to contain the spreading economic crisis created political disarray. It led to the collapse of the MacDonald government in August 1931 and then to popular repudiation of the party and its program in the subsequent general election. These conditions were just the type on which an authoritarian, quasi-fascist leader could conceivably capitalize.

But though Mosley shared Mussolini’s military bearing, his image as a strongman, and his oratorical skills, his movement never caught fire. Mosley’s rallies and marches remained small. All but two of twenty-four candidates fielded by his New Party for the October 1931 general election failed to win the 5 percent vote share needed to obtain a refund of the deposit tendered to stand. (Mosley himself was one of the two.) The Mosleyites were then unable even to contest seats in the next general election, in 1935. At its height, the British Union of Fascists numbered no more than twenty thousand members.[3] At the other end of the political spectrum, twenty-six Communist candidates stood for election in 1931, but none was victorious, and only two received more than ten thousand votes. Instead, the National government, made up of a coalition of mainstream politicians with various party affiliations, but in practice dominated by the Conservatives, won a landslide victory and controlled British politics for the balance of the decade.

There is no single explanation for these contrasting outcomes. Still, there are some general lessons for those seeking to understand the roots of anti-system reactions and how they are successfully contained.

First, the economic legacies of World War I were fundamentally less amenable to conventional policy solutions in some countries than in others. Germany experienced high unemployment not just in the Great Depression but earlier, in the wake of World War I. Already in the early 1920s, inflation, by expropriating the middle class, undermined the legitimacy of the mainstream politicians who presided over it and weakened faith in the country's political institutions. Nor were these challenges that even a competent German government could meet. The country's economic and financial problems, and its internal struggle over distribution and inequality, were linked to the reparations burden imposed by France and the other victorious Allies, which raised the intractable question of who, within Germany, would pay.[4] There was no way for a reasonable government to extricate Germany from the reparations tangle and transcend its domestic political consequences. A solution would be found, ultimately, only by that least reasonable of governments.

Britain, in contrast, while not without economic problems, was not burdened by reparations.[5] And unlike in other countries, there was no banking crisis to radicalize public opinion. While there was much debate about the causes and consequences of the economic downturn, the fact is that the depth of the Great Depression, as measured by the fall in real GDP, was less than in virtually any other country, and that decline in GDP was successfully arrested by 1932.[6] The authorities took a number of visible steps to jump-start growth: abandoning the gold standard, allowing sterling to depreciate, and cutting interest rates to historically low levels. There was also the imposition of a tariff, more on which below. This proactive response solidified support for the political status quo.[7]

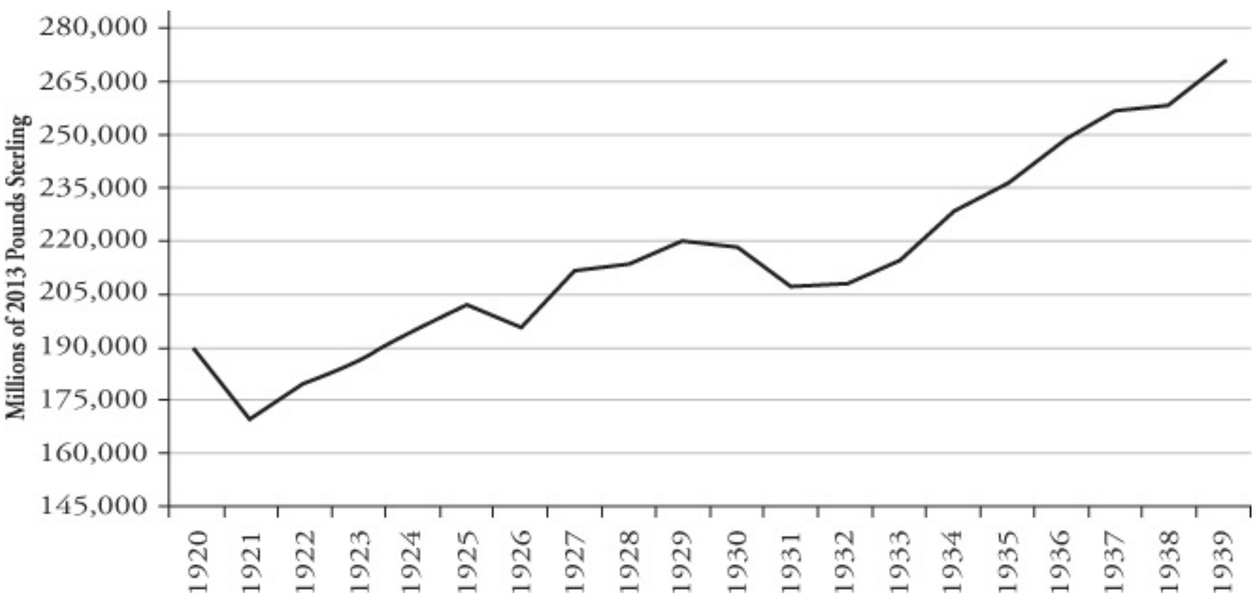

Figure 6.1 GDP in the United Kingdom, 1920–1939

Source: Sally Hills, Ryland Thomas and Nicholas Dimsdale, “The UK Recession in Context – What Do Three Centuries of Data Tell Us?” *Bank of England Quarterly Bulletin* (2010), Data Annex – Version 2.1.

In Germany, in contrast, there was no resumption of growth at the end of 1931, nor even the distant prospect of such under the Grand Coalition of mainstream parties led by Hermann Müller from 1928 or the Center Party–led government of Chancellor Heinrich Brüning, in power from 1930 to 1932.

This leads to the second point, that different governments went to different lengths to address economic insecurity. The signal economic problem of the interwar period was unemployment. There was more consciousness of unemployment as an aggregate phenomenon now that academicians had given it a clear definition and governments gathered statistics on it. There was more awareness of unemployment as an economic and political problem to be solved, or else, now that the franchise had been broadened, unions had acquired additional strength, and labor and socialist parties had come on the scene.

In Britain, many of these changes were already under way before World War I, resulting in adoption of that country's pioneering unemployment insurance system in 1911.[8] That system now provided a basis for the further development of public policy. As a result of the precedent and of a consensus for building on that foundation, Britain elaborated one of the most comprehensive unemployment insurance schemes of any country, with near-universal adult male coverage. The British system was not without its critics, but it succeeded in providing assistance to many of those most directly affected by unemployment, defusing more radical political reactions.[9]

In Germany, in contrast, state-organized insurance had never covered joblessness. A limited unemployment insurance scheme was finally agreed in 1927, but benefits quickly came under the gun with deepening financial difficulties in 1929.

The French and Italian economies, by comparison, were more heavily agrarian. In 1921, 59 percent of employment in Italy was in agriculture; fifteen years later, the figure was 52 percent. Italy and France had little need for extensive unemployment insurance programs, either before or after World War I, because urban industrial workers had the option of returning to family village and farm.[10] In France, unemployment insurance organized by trade unions on behalf of their members and by municipalities on behalf of their residents covered just 171,000 people as late as 1931.[11] Small landowners and shopkeepers saw no need for unemployment insurance. A compulsory system of contributory insurance was considered by legislators in 1928 but rejected as unnecessary.[12]

Yet despite mounting only a limp institutional response, France did not experience a German-style political reaction. In 1936 the French electorate threw out the latest in a series of conservative governments for a short-lived socialist administration under Léon Blum, but that reaction was mild compared to what took place east of the Rhine. The structure of the French economy, still heavily village and household based, helps to explain this response.

Finally, the weakness of political institutions empowered political extremists hostile to the system to a greater extent in some places than others.[13] The British parliamentary system was well established, and successive reform acts tinkered with it only at the margins. There might be important changes in the political landscape, such as the rise of the Labour Party and the decline of the Liberals, but these could be accommodated by the country's well-established parliamentary institutions. In turn, this capacity to accommodate new parties and movements gave those dissatisfied with the political status quo reason to work within the system rather than seeking to overturn it.[14]

German institutions, by comparison, were weak. The Weimar Republic had been born of weakness; it was declared in Weimar, in the state of Thüringia, in February 1919 because Berlin was still occupied by the Communist-inspired Spartacists and other dissident groups.[15] That the new German constitution bore little resemblance to earlier political arrangements did not inspire confidence or promote allegiance. Pure proportional representation opened the door to representation in the Reichstag of scores of small political parties whose members had little incentive to move to the political middle, unlike the United Kingdom's first-past-the-post electoral system. Political fragmentation made for a succession of unstable, ineffective coalition governments, weakening support for the constitution. Key groups that might have been expected to defend it instead displayed their apathy, starting with the army's failure to intervene on behalf of the government during the Kapp Putsch, the unsuccessful coup attempt organized by the right-wing autocrat Wolfgang Kapp in 1920.[16] Article 48 of the constitution, which gave the president decree powers, including the power to suspend civil liberties, acknowledged these weaknesses but was readily exploited by political opportunists like Hitler, who invoked it, using the Reichstag fire as a pretext, less than a month after taking office. Poor design thus contributed to the vulnerability of Weimar's institutions, although so too did lack of familiarity with and fidelity to the new arrangements.

In Italy, Mussolini gained office by conventional means, being asked by the king to form a government, but the weakness of the political system allowed him to entrench and extend his power. These problems of institutional weakness had a long history. With only slight exaggeration it can be said that the unification of Italy had essentially been based on the transplantation of Piedmontese institutions to the rest of the country, where they failed to firmly take root. Political unrest centering on strikes by peasant farmers and workers in Sicily had led Prime Minister Francesco Crispi to declare a state of emergency, suspend civil liberties, and place the island under military law in 1894. In 1898 Crispi's successor Antonio di Rudini had called in the military to break up strikes and food riots in Milan. These events in Sicily and Milan were both indications of the sense, on the part of working-class Italians, that the political system was inadequately responsive to their needs. Then in 1900 King Humbert I was assassinated by the anarchist Gaetano Bresci. The 1907 financial crisis and Italy's disastrous foray into World War I, highlighted by the catastrophic Battle of Caporetto, fanned dissatisfaction with the political mainstream and fed support for the Socialists, who made significant gains in the 1919 general election.

Next there was a slow-motion banking crisis starting in the summer of 1920 involving Ansaldo, an engineering conglomerate that both was the principal shareholder in the troubled Banca Italiana di Sconto and had borrowed extensively from it. This was conflict of interest at its most blatant. In the straitened circumstances following the war, Ansaldo predictably found it difficult to repay its loans. A central-bank-organized rescue put off the day of reckoning, but with the troubled bank continuing to take losses on its loans, it was forced to declare bankruptcy in November 1921. The episode provoked not unjustified complaints of cronyism, and popular anger at all involved.[17]

Meanwhile, successive left-liberal coalitions under Francesco Nitti and Giovanni Giolitti, seeking to stem inflation and balance the budget, proposed a capital levy on wealth-holders, which incited the Right, along with cuts in bread subsidies and welfare-related government spending, angering Catholics and the reformist Left, and leaving everyone unhappy with the prevailing state of affairs. The status quo, it seemed, was fractious coalitions, governmental instability, and economic and financial chaos all around.

This political vacuum created the desire for a strong leader. It enabled Mussolini to secure the king's instructions to form a government despite his party having won only 19 percent of the vote in the 1921 election. It allowed him to argue that only a strong, Fascist-led government was capable of balancing the budget, ending inflation, and restoring stability.[18] It gave him cover to close opposition newspapers, ban public protests, and outlaw labor unions, strikes, and competing political parties. It allowed him to embark on a series of quasi-authoritarian initiatives despite Italy's constitutional monarchy.

Seen from this perspective, Britain's success in developing a mechanism for addressing unemployment and beating back radical political elements was exceptional. In fact, the two achievements went hand in hand. Unemployment insurance, put in place for a limited set of relatively volatile sectors, was extended in wartime to cover workers in munitions-producing industries. The precedent having been set, coverage was extended further in 1920. The authorities' motives were clear: there was fear of unrest like that in Germany and

Italy if poverty and lack of work accompanied demobilization. As one historian has put it, “The government genuinely feared civil disorder ‘if something were not done to provide economic security for the British working man.’”[19]

By 1920 the insurance system covered more than 11 million workers, up from 2 million before the war. This was virtually the entire civilian labor force.[20] The Fabian Socialists had evidently made a compelling intellectual and political case for unemployment insurance. And confidence in Britain’s political institutions fostered the belief that government could be entrusted to administer a centralized scheme without capture by special interests.

The British system was supposed to be self-financing on the basis of matching contributions from the worker and his employer. But its expansion in 1920 coincided with a sharp postwar recession, creating an immediate deficit in the insurance fund, which the Treasury was forced to fill using general revenues. This was an unhappy situation, to say the least, for a government committed to running a balanced budget in order to return to the gold standard and then to stay there.

The problem returned, with a vengeance, with the onset of the Depression. Unemployment soared to still higher levels, increasing benefit payments and reducing contributions at the same time. The Labour government that assumed power in 1929 appointed a Royal Commission on Unemployment Insurance to assess the situation and, it was hoped, provide some reassuring words. In the event, its words were anything but reassuring. Sir Richard Hopkins, a high Treasury official, in his evidence to the commission put it in apocalyptic terms. Unfunded unemployment insurance liabilities, he ominously warned, were “bringing the country to the brink of a chasm in which her credit might be lost.”

In February 1931 the government therefore assembled a committee of conservative financial experts to recommend corrective action. The committee was chaired by Sir George May, recently retired secretary of the Prudential Assurance Company—an odd choice, perhaps, for a Labour government, but who better than an insurance company executive to recommend measures to restore the financial viability of an insurance scheme? Predictably, given its composition, the committee in its July 1931 report proposed swingeing economies, headlined by a 20 percent cut in benefits. This was not something the left-leaning members of MacDonald’s cabinet were prepared to accept, however. Its inability to agree was the precipitating event that led to the collapse of the Labour government in August.[21]

The National government, the Conservative Party–dominated coalition formed following the Labour government’s fall, went ahead with cuts in benefits of 10 rather than 20 percent. While those cuts were not popular, they were accepted as legitimate because the government adopting them received a popular mandate, 67 percent of the vote, in the general election that followed the next month. Keynesian hindsight suggests that these perversely pro-cyclical policies were the height of folly in the midst of an unprecedented slump. That said, the fact that cuts were imposed against a baseline where the unemployed received relatively generous support and coverage was widespread meant that the destabilizing consequences, both economic and political, were less than they might have been otherwise.

It helped, as noted above, that the government took other steps to stabilize the economy. Cutting interest rates to 2 percent and allowing sterling to depreciate on the foreign exchange market halted deflation, removing one immediate obstacle to the resumption of growth. Abandoning the gold standard made the maintenance of strict budget balance less imperative and helped to stimulate recovery, which allowed the 10 percent cut in benefits to be reversed in 1934. Parliament created the Unemployment Assistance Board to run training schemes and provide assistance for workers seeking to move to regions where employment prospects were better.

The most controversial aspect of the response, given the role of free trade in British history, was a temporary across-the-board tariff in November 1931 and then a permanent 10 percent tariff with preferential rates for the Commonwealth and Empire in 1932.[22] As tends to be the case whenever unemployment rises, critics of various stripes pointed to unfair foreign practices as the source of the country's ills. The argument for shutting out imports to provide jobs was compelling so long as the gold standard prevented the government from adopting other fiscal and monetary measures to stimulate employment—so long as there was a fixed lump of spending to be distributed between imports and domestic production. Even sophisticated observers such as John Maynard Keynes supported the adoption of trade restrictions on these grounds, despite awareness of the risk of foreign retaliation.[23]

There remained a reluctance to move in this direction, however, given Britain's history and ideology of free trade and Labour's opposition to import taxation on "dear bread" (cost-of-living) grounds. In the end, Parliament went ahead only after the Conservative-dominated National government succeeded Labour, a shift in political power that should, if anything, have reduced the pressure to address the unemployment problem (unemployed workers not exactly being the Conservatives' core constituency). Even more curiously, it went ahead only after the gold standard was abandoned. Keynes had argued that a tariff was needed to boost the demand for British goods because the constraint of the gold standard ruled out other employment-friendly measures. But now this constraint had been lifted, allowing the Bank of England to cut interest rates and give the British economy the boost it needed.[24] The Bank, for its part, was quick to move in that direction, but no matter. The Conservatives were committed to delivering something to their long-suffering industrial constituency. And the new Chancellor of the Exchequer, Neville Chamberlain, younger son of Joseph, wished to secure his father's protectionist legacy.[25]

But by limiting imports, the tariff insulated British industry from the chill winds of foreign competition, reducing the incentive to innovate. It slowed productivity growth, most visibly in the sectors that were most generously protected.[26] If in the short run the tariff was redundant, in the long run it was counterproductive. And those counterproductive effects—lack of competition, high markups, failure to innovate—persisted not just through the end of the 1930s but even after World War II. This is a reminder that quasi-populist arguments, even when advanced by mainstream politicians, can have unintended, and enduring, consequences. If you are reminded of the Brexit vote in 2016, another proto-populist rejection of economic integration with far-reaching and potentially damaging implications, then you're not alone.

On balance, then, the British policy response in the 1930s had costs as well as benefits and in this sense was far from ideal. Unemployment, in particular, remained a chronic problem—how could it not given the severity of the Great Depression? The October 1936 march from the Tyneside town of Jarrow to London's Hyde Park, organized in protest against chronic unemployment and poverty, symbolized how even after several more years the battle was still far from won. But the fact that Britain developed an encompassing unemployment insurance scheme administered by institutions in which there was a relatively high level of confidence, together with the fact that other measures were taken to stabilize the economy, meant that populist forces gained only limited traction.

Why, then, was unemployment more conducive to political disaffection and extremism in Germany? Insurance against unemployment there was still a recent innovation when the Depression struck, as noted above. There was strong resistance to supporting the jobless on moralistic grounds and for fear that doing so would encourage indolence. Bismarckian social insurance had focused, therefore, on helping the elderly, the ill, and the destitute, who, it could be argued, had little scope for gaming the system. Before World War I, employment in agriculture had actually not been that much less important in Germany than in Italy and France, given the tariff protection enjoyed by growers of rye and other farm products, and the same argument that self-sufficient farmers, and even farm labor, didn't need unemployment insurance also had currency there. Large landowners prominent in the Conservative Party worried, moreover, that unemployment insurance would prevent idle industrial workers from returning to agriculture. Employers generally warned that income support for the unemployed would drive up wages. They resisted national unemployment insurance, arguing that the costs of already existing social insurance programs were straining their resources.[27]

While some trade unions operated unemployment funds for their members, these were self-financed, not unduly burdening employers or taxpayers.[28] But the beneficiaries of union unemployment benefits were few, since only some 5 percent of employees were unionized prior to World War I.

The exigencies of war modified this situation. The German government introduced a temporary program of unemployment assistance in 1914 to pacify the labor force, since disruptions on the home front could now threaten national security. This program was extended in November 1918, just weeks after the Sailors' Revolt in Wilhelmshaven, when enlistees in the German High Seas Fleet refused an order from the Admiralty to put out to sea, mere days after the outbreak of the November Revolution against the Empire. The need to placate the unemployed understandably came to be seen as pressing. Then the volatility of the economy following demobilization made eliminating this program, as originally envisaged, inconceivable.[29]

Formally this was still only temporary assistance for the unemployed, not a permanent insurance system. Benefits were not linked to prior work or to contributions to a fund. They were not related to an individual's earlier wages. The requirement that recipients genuinely seek work and related qualification provisions were not imposed.

But temporary assistance changed the terms of the debate. It challenged the presumption that government should not aid the unemployed, as distinct from the elderly, infirm, and destitute. If the choice now was between ad hoc assistance and a properly organized unemployment insurance system, and no longer between unemployment insurance and nothing at all, then employers had good reason to change their tune.[30] By replacing ad hoc assistance with a proper insurance scheme, qualification could be linked to prior employment, eliminating help for those with no record or intention of working. Replacing the earlier flat rate with a payment linked to wages and contributions would avoid subsidizing low-wage workers so much that they had no incentive to work. Employers, as participants in the debate over program design, would be better positioned to limit abuse of the system.

This shift in thinking took time, as shifts in thinking generally do. A majority of employers came around to supporting unemployment insurance only in 1926, and the law on unemployment insurance and employment services was finally passed only in July 1927, scarcely a year before Germany began its descent into the Great Depression. The country succumbed to the Depression even earlier than Britain and the United States because Germany, burdened by reparations and other debts, depended so heavily on foreign finance. That foreign finance dried up abruptly in the summer of 1928, as Wall Street, in the throes of its boom, sucked up capital previously directed elsewhere, including to Germany. With this, spending in Germany began to fall. There was then the further blow of an unusually cold winter in 1928–1929 and slowing growth abroad.

Consequently there was little time to get the German unemployment insurance system fully up and running before it was clobbered by recession and the financial difficulties that followed in its train. Although the insurance fund was permitted to borrow from the Treasury, it could do so only temporarily and in limited amounts. And what Hopkins had said about the cost of unemployment benefits in Britain, that it threatened to bring the country to the brink of a chasm in which her credit was lost, applied to Germany in spades. The German economy depended on foreign credit. Its ability to attract it was tenuous, given uncertainty over reparations.[31] With memories of hyperinflation still fresh, maintaining the mark’s peg to gold was paramount. And budget balance was critical to the maintenance of gold convertibility, as politicians like Chancellor Brüning asserted with almost religious fervor.

As a result, the German government was quick to cut benefits when a deficit developed in the insurance fund and, more generally, whenever fiscal problems deepened. It did so even though the unemployment rate, as measured by the number of people registered as unemployed as a share of the workforce, peaked at even higher levels than in Britain and came down more slowly. Coverage was restricted in November 1929. The earnings limit was raised, and benefits for seasonal workers were cut. In June 1930, the Reichstag adopted a bill cutting benefits yet again. This bill allowed the Treasury to lend the insurance fund no more than half of any projected operating deficit, requiring the balance to be eliminated through benefit cuts and increased contributions. Another expert commission was appointed in January 1931 to examine the scheme's finances, and in June the government, adopting its recommendations, cut benefits once more.

As the crisis deepened, so did the cuts. It didn't help that Germany suffered one of the worst depressions of any country, as measured by the peak-to-trough fall in real GDP.[32] In response, the hyperconservative Franz von Papen, who succeeded Brüning in June 1932, issued an emergency decree under powers granted the chancellor by the Weimar constitution, reorganizing the insurance scheme and reducing benefits by an additional 23 percent. As this and related responses were described by a group of American academics: "Most of the changes [imposed by Brüning and von Papen were] … designed to maintain solvency rather than to overcome defects or improve procedure."[33] Even less were they intended to help the unemployed. That the most dramatic cuts were imposed by decree, circumventing normal legislative deliberation, did not foster popular admiration of the politicians then in office or enhance the legitimacy of the constitutional system. Contrast the British situation, where cuts were applied by a National government with an overwhelming electoral mandate.

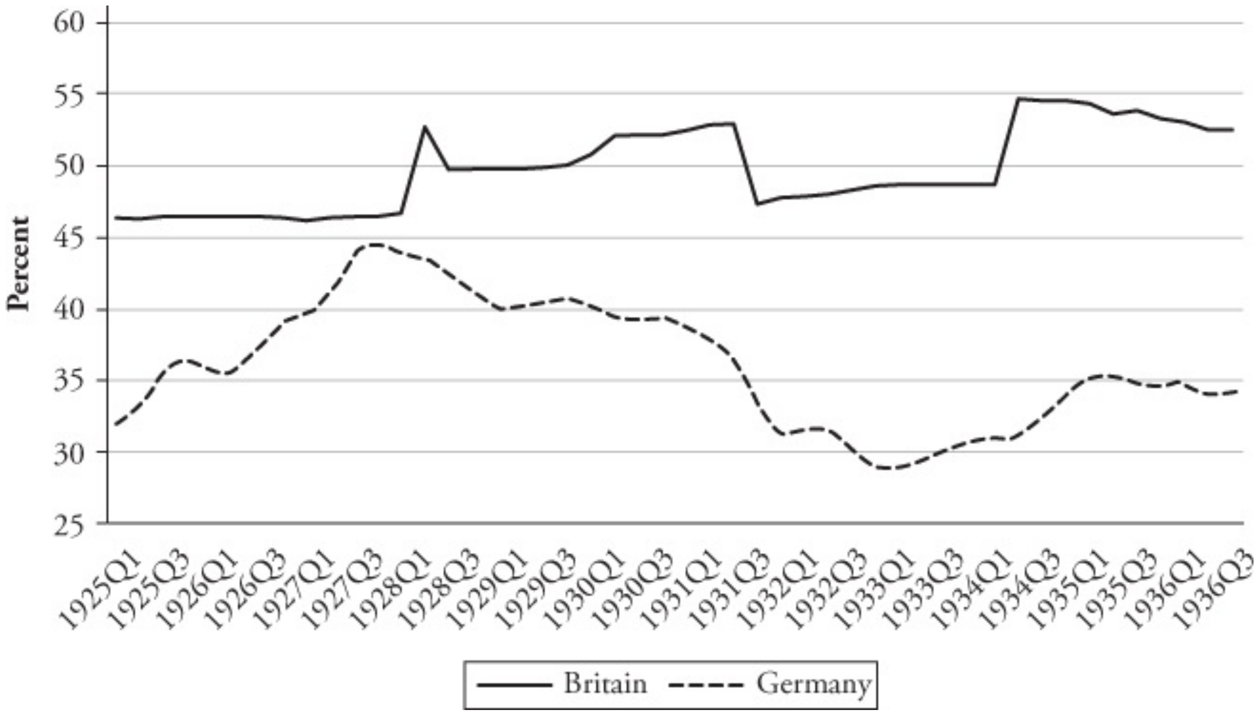

Figure 6.2 Unemployment Benefit Replacement Rates for Britain and Germany, 1927–1936

Source: Nicholas Dimsdale, Nicholas Horsewood, and Arthur van Riel, "Unemployment and Real Wages in Weimar Germany," Discussion Papers in Economic and Social History no.56, University of Oxford (October 2004), and author's calculations.

A standard measure of these policies is the "replacement rate," the share of average after-tax wages replaced by unemployment benefits for the typical newly unemployed worker. In Germany the replacement rate declined from 38 percent in 1928 to less than 34 percent at the beginning of 1933, when Hitler took power—that is to say, by more than a tenth. Although wages were also falling in this period of deflation and depression, benefits were falling even faster.[34] Again, the contrast with the United Kingdom is revealing. Although benefits there were cut as well, the replacement rate rose rather than falling, from less than 50 percent in 1929 to rather more in 1933.[35] In Britain, benefit cuts lagged behind wage declines instead of leading them, as in Germany.

A single statistic is not an adequate explanation for why political extremists assumed power in one country but not the other. Unemployment was not the only form of personal and economic insecurity about which people cared, and income replacement by the state was not the only plaster applied to the sore. That said, it is hard to reject the view that the failure of German society and government to do more for the unemployed was consequential in the worst possible way.