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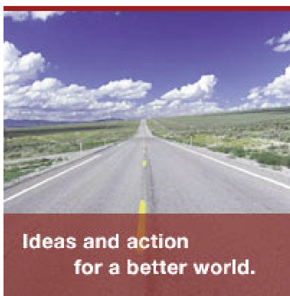
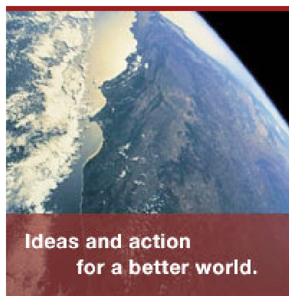




How to beat the recession: public enterprise, not fiscal stimulus

By Oliver Penrose

Since April 2008 the number of unemployed workers in the UK has been rising steadily at the alarming rate of 50,000 per month[1] - that's 600,000 (about 2% of the work force) per year. Considering that a sizeable number of Labour MP's may themselves be out of a job after the next election, it is a little surprising that so few of them appear to take an active interest in the rising unemployment figures and in the hardship and waste of resources these figures represent. During the depression of the 1930s, Labour Party stalwarts like the valiant Ellen Wilkinson stood up for the unemployed, but there is nobody like her in Parliament today.

The importance of new investment

The great economist J M Keynes was the first to explain (during the 1930's) how it could come about that, in a seemingly prosperous society, so many people who were willing and able to work could be unable to find jobs. Compressed into a very small nutshell, his theory[2] says that new investment[3] is the driving force that propels the economy. When there is not enough new investment, high unemployment is the result. The dismal tale told by recent Government statistics[4] is consistent with his theory: between 2007 and 2008 the annual rate of expenditure on new investment fell by about £15 billion, from £257 billion to £242 billion. During that one-year period, unemployment rose by about 600,000 : each time the annual rate of expenditure on new investment fell by £25,000 another person lost his job.

When he became Chancellor in 1997, Gordon Brown introduced a mechanism to control the level of economic activity, as measured by the rate of inflation. Whenever inflation was expected to go above a prescribed level (initially 2.5%, later changed to 2%) the Bank of England would increase interest rates. This made it more difficult for businessmen to borrow money for new investment projects; so the rate of expenditure on new investment went down and the economy slowed down. When prices rose too slowly, on the other hand, the Bank would reduce interest rates, the businessmen could borrow more easily, more new investment projects went ahead and the economy speeded up.

Mr Brown's mechanism worked as intended for over a decade, but it was crushed by the jaws of the credit crunch. Banks cut down sharply on their previously over-optimistic lending, and so consumers could no longer buy new houses and cars so easily; consumers reduced their spending, and so businesses began to fail; businessmen lost confidence in the future, and so they no longer wanted to start new investment projects. Trying to operate the mechanism as before, the Bank of England reduced short-term interest rates (Bank Rate) to near zero and has now turned to the indelicately named Quantitative Easing to try to bring long-term interest rates down as well. But so long as businessmen lack confidence in the future, no amount of manipulation of interest rates will start new investment going again. It is like trying to drive a car whose steering wheel has broken off.

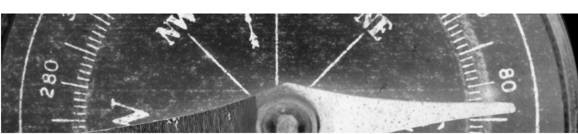
A greater responsibility for the State

If the government is to regain control over the rate of new investment, some policy instrument more effective than the manipulation of interest rates will be needed. Keynes himself recognized this, saying[5] "I expect to see the State ... taking an ever greater responsibility for directly organising investment." Indeed, there seems no reason other than free-market ideology why the State itself should not invest in profitable projects in the same way that a private entrepreneur would. These "public enterprise" projects would be financed by borrowing, the money borrowed being repaid later on (just as in the case of private enterprise) by the profits from the investment.

A modest target for a programme of profitable public investment would be to reverse last year's fall of £15 billion pounds per annum in the rate of new investment. There is no lack of suitable projects to include in such a programme. A strong candidate would be building homes for people currently on local authority waiting lists. It is estimated that there are 1.77 million such households. If building a new house costs £75,000, the Government could invest at the suggested rate of £15 billion per annum by building 200,000 houses per year for rent. As another possibility, the government might offer to finance the insulation of suitable homes, taking as its profit (say) half of the money saved on fuel bills while the householder took the other half. (This would be quite distinct from subsidy schemes such as the the £0.435 billion "extra support to deliver energy efficiency measures" announced in the Budget on 22 April 2009. I am not talking about subsidies here but about profitable investments.) In all, a wide variety of public enterprise projects would be necessary, because of the different skills of the people available and the different places where they live. An essential feature of all such public enterprise projects would be the expectation that they will be profitable, so that the money borrowed to pay for them can be paid back out of the profits. This money would be borrowed from the public or the banks in the usual way. An attractive possibility would be for the recently bailed-out banks in which the Government now owns a majority of shares to finance these investments --- an excellent way for them to show their gratitude for the taxpayers' recent generosity, which amounted to some £55 billion in capital "injections"[7].

"Putting money into the economy"

The Government's response to the economic downturn, announced by Alastair Darling in his pre-budget report



on 24 November 2008, was quite different from what I have suggested. Its guiding principle was not to increase investment but, in Mr Darling's words "to put money into the economy"[8]. Its two biggest components were (i) a cut in VAT amounting to some £12.5 billion over a 13-month period and (ii) a £3 billion increase in the public sector investment for 2009/10. By Budget day on 22 April 2009, the planned increase in public sector investment for 2009/10 relative to 2008/09 had risen to 0.5% of Gross Domestic Product, i.e. £7 billion[9].

What effect will these "fiscal stimulus" measures have on unemployment? The planned £7 billion increase in Government investment is about half the amount needed to achieve the modest £15 billion investment target mentioned earlier, but the effect of the tax cut is unpredictable. It could be far too little to make up the difference or far too much, since its effect will depend critically on what the consumers choose to do with this windfall.

At one extreme, the consumers might all decide (the future being so uncertain) to save the windfall (an average of about £200 for each person in the country). In that case the tax cut would have no effect at all on investment or employment; it would simply go into people's bank accounts. At the other extreme, they might decide to spend all of it. In that case consumption would go up by £12.5 bn during the year and (disregarding imports for simplicity) employment would be increased by the number of people necessary to produce the extra goods and services consumed. At £25,000 per employee this comes to 500,000 jobs --- enough to provide one year of temporary employment for most of the 600,000 who lost their jobs in the preceding year. Moreover, the newly employed people will presumably spend a good part of the wages they are paid, so that (in this second extreme case) a good part of the £12.5 will be recycled as further consumption, providing temporary employment for some more people, and so on, so that the total number of temporary jobs created could be a million or even more, depending on how often the money is recycled. The actual outcome of the tax cut will be somewhere between these two very different extremes, but nobody can know in advance what it will be because nobody knows how much of the windfall will be spent and how much saved (nor how much "recycling" there will be).

Where will the money come from?

Since fiscal stimulus measures do not bring in any future profit to the Exchequer, it is proposed to pay for them by borrowing (i.e. issuing Government bonds): as the Chancellor said in his pre-budget statement, the intention is "to support businesses and to support families by increasing borrowing"[10] This description is somewhat misleading, however: an increase of Government borrowing does not of itself support businesses; on the contrary it makes life more difficult for them, since it tends to drive up interest rates. To put this point in another way, the Chancellor's description of his fiscal stimulus measures as "action to put money into the economy"[11] is only half the story, since the borrowing whereby he plans to pay for them will take the same amount of money out of the economy as the stimuli themselves put into it.

In the event, this difficulty seems to have been partially circumvented when some of the new bonds issued recently by the Government to finance its borrowing were bought by the Bank of England as part of the Asset Purchase Scheme (another name for Quantitative Easing)[12].

In effect, the fiscal stimulus is being paid for not, as the Chancellor apparently intended, by borrowing existing money from the general public, but by borrowing newly created money from the Bank of England. Unfortunately the creation of new money by the central bank carries a risk : if too much is created it could lead to a damaging inflation. There is no easy way to tell in advance what the right amount to create is; so the central bank is likely to err on the side of caution and resist the creation of enough new money to get us out of the recession.[13]

Conclusions

Fiscal stimulus measures, particularly tax cuts, are a hit-and-miss way of controlling the economy because their outcome depends strongly upon the unpredictable behaviour of human beings. Moreover, such policies are likely to be inadequate because they require the creation of new money, about which central bankers are understandably cautious. A policy based on public enterprise (public investment for profit, financed if possible by bank loans) would be a surer way of bringing unemployment down --- perhaps even in time for the next General Election ...?

Endnotes

[1] Labour Market Statistics, Office of national statistics, March 2009; http://www.statistics.gov.uk/StatBase/Product.asp?vlnk=1944

[2] J M Keynes, The general theory of employment, interest and money (Macmillan, 1936)

[3] "New investment" means here "the formation of new capital", such as the construction of new houses or factories. It also includes changes in inventories, but it does not include some things that are often referred to as "investment", such as the purchase of existing capital (houses, stocks and shares, etc) by one person from another.

[4] UK output, income and expenditure 4th quarter 2008, Office of National Statistics, Feb. 2009; http://www.statistics.gov.uk/statbase/Product.asp?vlnk=818

[5] J M Keynes, Ibid., page 164, chapter 12

[6] Jon Cruddas and Jonathan Rutherford, p. 13 of The crash: a view from the left, Lawrence & Wishart 2009; http://www.lwbooks.co.uk/ebooks/The%20Crash.pdf

[7] Gordon's Debt Mountain, The Economist, April 11-17 2009, page 34

[8] Hansard, 24 Nov 2008, column 495

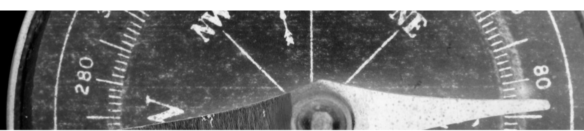
[9] Budget report 2009, table 1.1, which shows public sector net investment increasing by 0.5% of GDP, from 2.6% of GDP in 2008/9 to 3.1% in 2009/10; http://www.hm-treasury.gov.uk/bud_bud09_repindex.htm

[10] Hansard, 24 Nov 2008, column 492

[11] Ibid., column 495

[12] Gordon's Debt Mountain, The Economist, April 11-17 2009, page 34

[13] "I think the fiscal position in the UK is not one where we could say, 'well, why don't we just engage in another significant round of fiscal expansion'." Mervyn King answering questions from MPs at a Treasury committee: BBC News 24 March 2009



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