the £100 billion GAMBLE

on growth without the state

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Acknowledgements

We would like to thank all those who commented on early drafts – Dave Byrne, Sally Ruane and Neal Lawson – although the final words are our own.

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Designed by SoapBox, www.soapboxcommunications.co.uk

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1. Introduction

The old adage of Margaret Thatcher from the 1980s, 'There Is No Alternative' (TINA), is back in fashion again. The custodians of this veiled threat are, as before, a Tory party set on reducing the size of the state. But, this time they are not alone – they have some Liberal Democrats on-board too.

> 'Everyone is agreed that growth is the only way out of this economic situation, but the government's hope is that this will come about by simply creating 'space' for private initiative. It has an agenda for cuts but not for growth.'

Yet TINA will not lead our country out of recession, and the rhetoric that accompanies it ignores key structural factors that jeopardise the UK's long-term sustainability and risks creating a lost generation much like Japan in the 1990. Although a severe double dip remains unlikely, the policy decisions of this Conservative–Liberal Coalition government put growth at risk.

During the 1980s the cuts agenda could be supported by North Sea oil and gas revenues and exports, yet it still left large sections of the country devastated. Today North Sea oil and gas are in decline and a policy based on export-led growth is impossible when Britain's major trading partner, the Eurozone, is also experiencing low growth and fiscal tightening. What's more, there is a very clear alternative to the cuts agenda: tax reform and public investment.

The Labour Party is struggling to put this message across after it allowed Alistair Darling, the then Chancellor of the Exchequer, to talk of cuts deeper than Thatcher. Yet the alternative agenda is there, from Compass, the unions and the TUC, think tanks like the New Economics Foundation, Green New Deal, the Institute for Public Policy Research and a raft of academics.[1]

This report highlights the fundamental flaws in the government's economic plan, flaws so significant that they can only seriously be described as a reckless gamble on the economy. The message of this report is therefore very simple: the cuts won't work; the gamble will not pay off. There cannot be growth without the state, and this time There Is An Alterative.

For the first time in a generation real differences are emerging over economic policy between the major parties. In essence the debate boils down to this: was it the market or the state that caused the problem? and will it predominantly be the market or the state that gets us out of the mess? The Tories, now backed by some of the Orange Book Liberal Democrats, want to pin the blame on the state. They suggest that we are in crisis because public spending got out of control and that this is what happens when the state gets too big. But this is a fantasy unsupported by any sound economic analysis and designed to pursue an ideological project which recklessly puts the economy and long-term recovery at risk.

In doing this, the Coalition government is taking what can only be described as an enormous gamble with the economy. Its flawed gamble is that simply by shrinking the state, the private sector will gain sufficient space to become the engine of economic recovery. Everyone is agreed that growth is the only way out of this economic situation, but the government's hope is that this will come about by simply creating 'space' for private initiative. It has an agenda for cuts but not for growth.

The scale of this irresponsible gamble is only now becoming clear. The government, in effect, is making the equivalent of a nearly £100 billion pound bet, backed by 'no reputable economic theory',[2] that the country can grow while the state is cut. Although forecasts for economic growth are not always accurate, the average accumulated figure reported by the Treasury of all independent growth forecasts before the election predicted growth of gross domestic product (GDP) of 2.4% by 2012 and 2.7% by 2013.[3] As GDP currently stands at about £1,400 billion, if we fail to grow and instead bump along the bottom at an optimistic growth rate averaging 1.3% – which would still be higher than Japan achieved in the 1990s – over the next five years we would lose 6.7% of GDP in growth foregone, which is £93.8 billion over the course of this government.[4] If the Coalition loses this gamble then nearly £100 billion could be lost from the economy over the course of just one

1 Krugman, www.nytimes.com/2010/07/02/opinion/02krugman.html?_r=1&ref=opinion; Stiglitz, www.guardian.co.uk/commentisfree/2010/mar/07/deficit-fetishism-government-spending.

2 'Britain's budget pain', *New York Times*, 8 July. See also the recent Policy Brief published by the Levy Economics Institute, www.levyinstitute.org/publications/?docid=1258; Robert Skidelsky, 'Deficit disorder: the Keynes solution', www.skidelskyr.com/site/view/new-statesman/; George Irvin, www.social-europe.eu/2010/07/method-in-our-budget-madness/; and an excellent piece by Paul Segal at www.guardian.co.uk/commentisfree/2010/jun/17/fiscal-deficit-threat.

3 HM Treasury, *Forecast for the UK Economy: a comparison of independent forecasts*, February 2010.

4 This estimate is based on growth forecasts compiled by the Treasury of independent forecasts. The time frame of this lost economic output is 2010–2016, as assuming that in 2015 we have a change of government the new economic policy will not have an immediate effect and it is likely that growth would continue to be suppressed at least for the first year, but would then grow at a higher rate after that.

parliament. We are forced to ask – is it really worth it?

Although the government suggests that the state is the problem, most economists would support the view that the real cause of the recession is the drying up of liquidity in financial markets. Underlying the liquidity crunch is a more fundamental problem of the unregulated nature of credit and the proliferation of speculative financial instruments and ventures. The issue was therefore not too much state intervention but not enough. When the banks faced bankruptcy because of the fears about exposure to bad debt, it was the state that stepped in to prevent the crisis deepening. Yet the new Coalition government seems to have forgotten this lesson and reverted to Thatcher's model of small state economics. This model is wholly inappropriate and will not provide the growth we so badly need.

It is essential to repeat that the state did not create this crisis; the banking industry did. The image of a bloated state getting fatter on taxpayers' money while crowding out a budding private sector is pure propaganda. The public sector can be made more efficient but it is not bloated, and as Chancellor George Osborne learnt on entering the Treasury, trimming the proverbial fat is virtually impossible when you are faced with public services which are already lean and in many instances under-resourced.

Instead of making the banks pay, Osborne has turned his attention to the easier targets – the poor and the vulnerable. This, it is increasingly clear, is a political project masquerading as economic policy. Those without voice, agency and power will be the biggest losers, particularly as Chancellor George Osborne seems set on reducing welfare budgets. The Big Society is not ready – and probably never will be – to fill the gaping holes in social provision. Most people barely get enough time to spend with their own children, let alone run a school.

The private sector is far from being 'crowded out' by the public sphere; quite the contrary, it is being propped up by it.

What's more, at present Britain has a window of opportunity to build a new, greener sustainable economy. The obsession with cutting back the state means that Britain will miss this opportunity – not simply for the (not insignificant) environmental future of our planet, but also as a strategic economic plan for the future.

Why then is the left so weak in this situation of palpable market failure? After all, it was not the unions, the left or any new social movement that created the turmoil with demands for fairness, democracy and sustainability. Instead it was an internal and systemic crisis of finance capital that brought the world's economy to its knees. Most of the centre left was caught out by the crisis and had no alternative economic model, nor the political force to enact it.

Sadly, the left in Britain is also weak because New Labour paved the way to the crisis. The phrase TINA (There Is No Alternative) may have been coined by Thatcher, but it was a New Labour government that perpetuated the ideology of market fundamentalism throughout much of its period in office. The commercialisation of the public sector and increasingly aggressive legislative programme on welfare, which culminated in the Welfare Reform Bill in 2009, created fertile ground for the Con–Dem Coalition to propose slicing the welfare budget mercilessly. Labour MPs cheered when, as Chancellor, Brown promised both to cut taxes and to increase public spending, but New Labour was deluding itself.

Brown's mistakes do not justify the deep cuts agenda of the Coalition. Instead, Labour has to be honest, principled and positive about its record and about building a genuinely alternative economic strategy that focuses on growth and fairer taxation. In this way we can buy a more civilised society. Through taxation, we collectively receive goods and services we could never afford as individuals.

Instead of supporting the state and the need for collective provision, New Labour paid homage to the virtues of privatisation and free market orthodoxy. New Labour's position is aptly summarised by Robert Skidelsky as amounting to two basic propositions: that markets – including financial markets – are efficiently self-regulating, and that government intervention in the macro economy should be confined to the single point of maintaining the value of money through the Bank of England Monetary Policy Committee's inflation target. The financial crisis has thrown both of these into question.[5]

New Labour's period in government failed to make the case for an active state and failed to create a balanced economy through a long-term industrial strategy or an effective regional

5 Robert Skidelsky, 'Deficit disorder: the Keynes solution', *New Statesman*, 2010, www.skidelskyr.com/site/view/new-statesman/.

strategy. If Labour had a 'strategy' at all, it went little beyond freeing up the financial system. The same holds true for the economic plans of the Con–Dem Coalition

The now near-universal preoccupation with reducing the size of the UK's fiscal deficit and stock of public debt emerged under New Labour and was supported by Alistair Darling, then Chancellor of the Exchequer. When asked by the BBC how his plans compared with Thatcher's attempts to slim the size of the state, Darling replied: 'They will be deeper and tougher – where we make the precise comparison I think is secondary to an acknowledgement that these reductions will be tough.'[6] Darling was not alone – he was supported by the Liberal Democrat leader, Nick Clegg, who stated: 'There will need to be cuts, cuts that are savage and bold.'[7]

> 'This report challenges the four gambles, which go to the heart of the Coalition government's economic policy. It argues, instead, that a preoccupation with reducing the budget through cuts is not an economic necessity'

The broad political consensus on the need for draconian public spending cuts and tax increases is echoed today right across the political spectrum. From ex-New Labour ministers, to the once-loved Vince Cable, to Osborne, the CBI and the City. This coalition of cutters has its eye on the state – particularly on welfare provisions. Yet it doesn't need to be this way.

It would be nice to think, in classic Gramscian terminology, that this is a moment of interregnum: the hiatus between two epochs.[8] The old order is not yet dead; the new has not yet been born. But to make this prospect a reality requires a sea change in politics. At the very least there is now a better balanced opportunity to contest the three-decade-long hegemony of the new right on the cuts agenda and the role of the state versus the market.

This is not merely a technical argument but one of major economic and political significance, as it determines not just whether and how quickly we return to growth but whether the market or the state is seen broadly as part of the problem or the solution.

That doesn't means we should be blasé about the state, far from it. The state is not a benign force and needs to be reformed and made more efficient. We shouldn't be market fundamentalists, nor should we be 'state fundamentalists'. However, it is critical to Britain's economic future that the state is not blamed for the crisis but rather is viewed as part of the solution. If we do not accept this point then building a long-term basis for renewal that is more equal, sustainable and democratic will be all the more difficult, and there will be no interregnum – just one more crisis in the continuing domination of financialised capitalism.

The practical debate is first and foremost about growth and jobs: are these objectives best secured through public investment or public sector cuts? The Con–Dem economic policy is based on four big gambles:

1. The state is the problem.
2. We must deal with the deficit immediately.
3. If the state is cut back the private sector will flourish.
4. Cuts can be progressive.

This report challenges the four gambles, which go to the heart of the Coalition government's economic policy. It argues, instead, that a preoccupation with reducing the budget through cuts is not an economic necessity; it is an ideological political project, which ignores the fundamental role of the state in modern society. It argues that cutting the deficit now is not only unnecessary, but could seriously jeopardise our longer-term economic future. Finally, it argues that in the medium to long term, the deficit can and should be reduced, but not by means of a fiscal policy that most hurts those on middle and low incomes.

Although it is widely recognised that it is not sound economic policy to maintain a large structural deficit in the long run, cutting the public realm is not the only option. This time there is an alternative.

A government with a credible plan to cut the stock of public debt must understand the importance of growth. Equally, it must look at fairer tax reform in the medium to long term. Pay at the top

6 Larry Elliot, 'Alistair Darling: we will cut deeper than Margaret Thatcher', *Guardian*, 2010, www.guardian.co.uk/politics/2010/mar/25/alistair-darling-cut-deeper-margaret-thatcher.

7 'Clegg: 'savage' spending cuts needed', Channel 4, www.channel4.com/news/articles/politics/domestic_politics/clegg+apossavageapos+spending+cuts+needed/3349797.

8 Antonio Gramsci, *Selections from the Prison Notebooks* (London: Lawrence & Wishart, 1971).

rocketed over the last 30 years and is rising again. A fair tax regime would mean that those with the broadest shoulders would bear the greatest weight. Under the current government, it is not only those on low incomes who will suffer but also those on modest and medium incomes, as tax credits are removed, child benefit frozen and unemployment rises.

Yes, the structural deficit needs to be reduced once growth resumes, but a credible plan to reduce the deficit should be established over the medium to long term. Such a plan must balance sensible spending reductions in non-desirable public expenditure with growth-inducing investment in long-term infrastructure, sustainable industrial modernisation and a fair rebalancing of the tax system. In the short term, the government should accept that a high public debt–GDP ratio is necessary to promote growth and encourage investment – knowing that ultimately only public investment will see a return to growth and consequent shrinking of the stock of debt. Unlike the Coalition's economic strategy, such an approach is not a gamble – it is the sensible prudent route to growth.

2. The First Big Gamble: the state is the problem

In his 2009 Conservative Party conference speech the now Prime Minister David Cameron said:

> *Why is our economy broken? Not just because Labour wrongly thought they'd abolished boom and bust. But because government got too big, spent too much and doubled the national debt.*

David Cameron was suggesting that the cause of the economic crisis was not big banks, but big government. This false history now pollutes much of government policy; it fails to recognise that it was only through the support of the state that the economy survived. First, the government had no choice but to bail out the banks after Lehman Brothers collapsed in 2008 – a policy initially opposed by the Conservatives – (although it did have a choice about what degree of authority to exercise over them). Second, it was only through Labour's fiscal stimulus in 2008/9 that the economy started to pull out of recession in the first quarter of 2010, seeing growth of 0.3% in the first quarter and 1.1% in the second.[9] But for state action here and abroad, Britain and the rest of the world would be deep in depression. The Conservatives made the wrong call at every stage of the financial crisis

The causes of the financial crisis in the US and the UK, which preceded the economic recession, were in large part created by an inflated housing market – caused by the under-investment in housing stock, a severe shortage of houses and easy credit, which helped push house prices ever upwards – and by large scale financial speculation using complex financial instruments such as collateralised debt obligations, which few traders fully understood.[10] The market misunderstood the real risk of the products they were dealing in; when the situation became clear, liquidity dried up and banks across the globe faced bankruptcy. When this happened, nation states stepped in and propped up the banks by guaranteeing interbank lending and pursuing a policy of quantitative easing. Nevertheless, loans to consumers and businesses dried up, more banks faced bankruptcy, the majority of OECD countries slipped into recession, unemployment increased, and as a result so did government spending as the tax take rapidly declined. The financial crisis led to a crisis in the real economy. This meant that the size of government borrowing grew and the deficit grew with it, forcing governments to borrow and pushing up the stock of public debt everywhere.

A return to strong and sustained growth would reverse this trend by reducing the deficit, but this cannot be achieved by simply stopping the clock and rewinding. We cannot re-inflate the bubbles that have burst and we cannot go back to an economy dependent on financial services. A return to growth in the UK alone also cannot be relied on to ensure we reduce the deficit, since our main trading partners in Europe have also embraced fiscal tightening. As a result, growth throughout the EU is likely to be sluggish. Moreover, as the UK's potential growth path adjusts downward, the size of the structural deficit grows.[11]

In the long term, a sustainable industrial strategy – one that focuses on investment and green growth – is the only solution. This should and can be accompanied by a reduction in the deficit but not by cutting the state, which provides valuable services and is currently propping up the economy as private investment has dried up. Reducing the deficit and public indebtedness over the longer term will be achieved by a combination of higher growth and raising taxes in a way that is fair; asking those with the broadest shoulders to bear the greatest weight is the right economic strategy.

9 Office for National Statistics, www.statistics.gov.uk/cci/nugget.asp?id=192.

10 For further discussion of the causes of the financial crisis see Toby Lloyd, *Don't Bet the House On It* (London: Compass, 2009).

11 Essentially the 'structural deficit' is the difference between government income and spending which would exist were the economy on its long-term potential growth path. Because the 'potential' growth path has been lowered bythe recession, the structural deficit has grown *pari passu*.

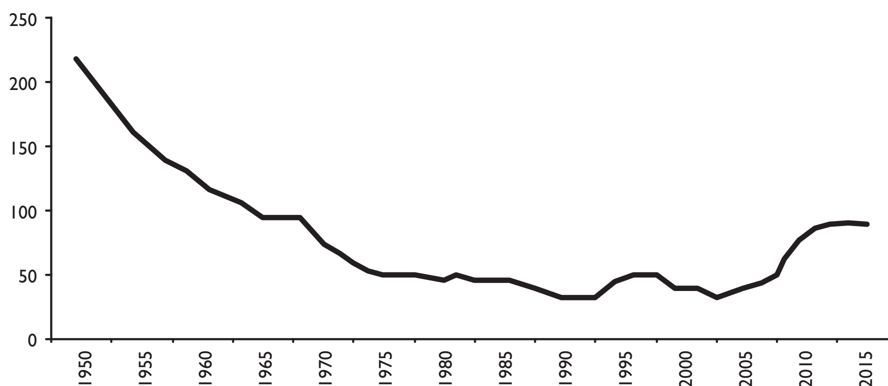
3. The Second Big Gamble: we must deal with the deficit immediately

The truth about the deficit

While the Coalition government talks endlessly about the danger of too large a deficit and the need for immediate cuts, the truth is that in the short to medium term the focus should be on growth and economic restructuring. Chancellor George Osborne states that it is not an 'either or' situation, arguing that the cuts can take place in the short term and growth can also be encouraged. To contest this we will first demonstrate why cutting now is not necessary, and why cutting now could in fact also be dangerous for growth. Then we will argue that growth is very unlikely in the economic environment created by Osborne.

The first thing to remember is that it is the stock of debt that matters – we worry about the deficit only because, when financed by public borrowing, the stock of debt will grow. If it grows faster than GDP, we say that the debt–GDP ratio is growing. There is no 'ideal' debt–GDP ratio. As Figure 1 shows, from the end of the war until the early 1960s, a period of prolonged prosperity, the ratio remained above 100%. Indeed, it was this prosperity which enabled the ratio gradually to be reduced.

Figure 1 – UK debt–GDP ration, historical and projected, 1950–2015



Source: See IMF, 'Navigating the fiscal challenges ahead' IMF Fiscal Monitor, Washington DC, May 14th

Box 1 The structural deficit and the debt–GDP ratio

The 'structural' deficit is in essence a measure of how large the deficit in public spending would be if the economy were to return to a theoretical full potential output and then grow at its 'trend' growth rate and stay at that growth rate into the future.[12] Current estimates from HM Treasury put the structural deficit in the region of 8.8% in 2009/10;[13] it is fair to say that this is historically large. There is also a large 'cyclical' component to the deficit – the component attributable to the decrease in tax revenue and increase in social transfers brought about by recession.

The 'structural' component of the deficit is thought to be important because it tells us what we will need to borrow from the public when 'normal' growth resumes, tax receipts rise and social transfers for the unemployed fall. If our annual borrowing requirement is very large, this implies that the stock of public debt, and thus the debt–GDP ratio, will rise. If this ratio is very high, paying interest on the debt becomes onerous.

An important rule is assessing the 'sustainability' of a particular debt–GDP ratio is whether the real rate of growth (g) of the economy is higher than the real rate of interest (i) payable on the debt. If $g > i$, then even

12 Howard Reed et al, *Rethinking Deficit Reduction*, 2010, www.progecon.org.uk/panel-members/.

13 Office for Budget Responsibility, *Pre-Budget Forecast*, June 2010, http://budgetresponsibility.independent.gov.uk/d/pre_budget_forecast_140610.pdf

after interest payment, the ratio of debt–GDP will be falling. (Where, less favourably, g < i, although the ratio will be rising, the extra borrowing required will be the difference between g and i.) In short, under conditions of high growth and low interest rates, the debt will pay itself down. Equally, 'sustainability' is related to the maturity structure of the debt; Britain is fortunate in having an average maturity structure higher than most other EU countries.[14]

Finally, the reader should note the difference between the current 'headline deficit' and the 'primary deficit'. The latter leaves out interest payments on the debt and is widely used by the IMF and World Bank as an indicator, mainly because interest payments on the debt fluctuate according to short-term monetary policy and investors' inflationary expectations. By EU standards, the UK has a high primary deficit – mainly because tax receipts have fallen so dramatically – but a reasonable debt–GDP ratio.

So why do we have a structural deficit?

On entering government in 1997, Labour tied itself initially to Conservative spending plans for the first two years and also declared it would be running its fiscal policy on a two-rule framework:

- *The first rule: the 'golden rule'*: The government would run a balanced current account budget over the business cycle on average (although additional borrowing to pay for capital investment was permitted on top of this).
- *The second rule: the sustainable investment rule*: The government committed to keeping the overall ratio of public sector debt to national income (debt–GDP) below a 'stable and prudent' level, which it defined as 40% of GDP (two-thirds of the conservative 'Maastricht' level of 60% agreed under Thatcher).

When announced, this framework attracted considerable support from independent commentators and led Gordon Brown to proclaim that the boom and bust of the business cycle had been 'abolished'. He was certainly not alone in this view. Ben Bernanke wrote in 2004 of 'the great moderation' saying 'one of the most striking features of the economic landscape over the past twenty years or so has been a substantial decline in macroeconomic volatility'.[15]

However, following the two-rule framework, by 2007 a small structural deficit in the public finances of 2.5% of GDP had appeared. Simultaneously, debt as a proportion of GDP rose from 28.8% of national income to around 33% in 2007/8, but remained within the parameters of the sustainable investment rule.

In 2007 the UK's net liabilities were significantly lower than those of the US, Japan, Germany, France, Italy and Greece (Figure 2).[17] By 2010 a gap between spending and income had emerged and this gap had to be made up by borrowing, so borrowing rose but has remained well within comparable levels in other countries.

Table 1 – Net liabilities as a percentage of national income[16]

	2007	2008	2009	2010
United States	43.0	48.2	59.0	69.3
Japan	80.4	84.3	97.1	106.6
German	43.0	45.1	51.1	56.9
France	34.0	41.9	49.5	57.0
Italy	87.1	89.7	97.8	102.1
United Kingdom	28.8	33.6	47.5	61.0
Canada	23.5	21.7	27.3	32.6
Greece	69.8	72.7	78.7	83.5

Source: data is based on findings in Irvin et al (2009) In Place of Cuts

Between 2007/8 and 2009/10 government revenues declined from 39% to 36% of GDP, spending rose to 43% and total spending (including capital investment) increased to 46%. The size of the gap or 'cyclical component' – an extra 6% of GDP – is largely explained by the effect of the recession on the level of GDP.[18] As revenues declined and spending went up, the deficit grew. But because of the fall in estimated future output, part of this extra deficit was considered 'structural', since it would remain even if the economy returned to growth and stayed there.

The Office for Budget Responsibility (OBR) projects that the structural deficit will be 8.8% of GDP for the current year, 2009/10, or 0.5 percentage points higher than assumed in the

14 A further explanation is given by George Irvin, 2010,. www.social-europe.eu/2010/07/method-in-our-budget-madness/

15 Ben Bernanke, 'Remarks by Governor Ben S. Bernanke at the meetings of the Eastern Economic Association, Washington, DC, 20 February 2004', www.federalreserve.gov/boarddocs/speeches/2004/20040220/default.htm.

16 Figures based on IFS Country Comparison Data, www.ifs.org.uk/fiscalFacts/fiscalAggregates; also see Treasury Databank, C4, www.hm-treasury.gov.uk/psf_statistics.htm.

17 Net liabilities exclude government paper held by the government itself, for example bonds held by the Treasury or the Bank of England.

18 Howard Reed et al., 'Rethinking Deficit Reduction', 2010, www.progecon.org.uk/2010/06/rethinking-deficit-reduction/: 'Spending commitments are set in cash terms, not as a percentage of GDP, so any reduction in national output pushes them up as a share of GDP – and the UK suffered a 6% drop in output during this period.'

March Budget.[19] Note from Figure 2, however, that in 2010 the debt–GDP ratio in the UK is 61%, not very large by international standards.

It is critically important to point out that a large proportion of the total deficit (as well as the growth of the structural deficit) is the consequence of the financial and economic crisis. Much of the drop in output caused by the crisis is permanent; the economy will not return to trend output level over the next business cycle, which is why the structural deficit emerged and government borrowing grew.[20]

It is estimated that at least two-thirds of the increase in the structural deficit was a result of the financial crisis of 2008.[21] The deficit is not the 'fault' of a bloated state but of an under-regulated financial market that became too big to fail.

The Coalition now wants to blame the fire-fighters of the state for the burnt out economy while the free market arsonists are left free. The Coalition is not just looking to blame the wrong people, as cutting will make things worse rather than better.

Why shouldn't the Coalition cut? There are three answers to this question:

- First, cuts put at risk a fragile recovery; if they further retard growth, cuts could cause the structural deficit to widen rather than shrink.
- Second, balancing the budget immediately is not necessary.
- Finally, the budget balancing exercise is not accompanied by a growth strategy.

Recovery is not yet secure…

Key indicators suggest that the recovery is not yet secure. Nationwide consumer confidence declined in July 2010 for the third month in a row in the UK (see Figure 3). This suggests that there is a declining level of public confidence in the economy, which could impact negatively on consumer spending and indicates that the economy is certainly not out of the woods yet. Although UK unemployment figures for the second quarter of 2010 showed a slight improvement, with 7.8% unemployed, down 0.2% on the previous quarter, the jobs market is certainly not without problems. The quarterly increase in total employment was mainly driven by part-time workers, whose numbers increased by 115,000 over the previous quarter to reach 7.84 million, the highest figure since comparable records began in 1992. The number of short-term unemployed declined, but the number of people unemployed for over 12 months increased by 33,000 over the quarter to reach 796,000. Furthermore, although the number of people claiming Jobseeker's Allowance (the claimant count) fell by 3,800 between June and July 2010 to reach 1.46 million, this reduced figure is far lower than was hoped. There has also been an increase in pay restriction deals, which could depress the economy further, and explains why the earnings annual growth rate for regular pay (excluding bonuses) was 1.6% for the three months to June 2010, down from 1.8% for the three months to May.[22]

'In this economic climate, cutting public spending could trigger a double dip recession, or what Keynes referred to as the death spiral. This would be a downward economic spiral where the economy fails to grow at all or even experiences negative growth.'

Simultaneously, on the international front, the Baltic Dry Index has been showing significant fluctuations. The Baltic Dry Index is a number issued daily by the Baltic Exchange, which tracks worldwide shipping prices. Traders often treat is as a barometer of global trade. In May 2008 the Baltic Dry Index hit its record high ever, 11,700 points. From there it began its steep fall starting in mid-July 2008. By 5 December 2008 it had slumped to 663 points, a record low. As global recovery started to set in towards the end of November 2009, the Baltic Dry Index had recovered to 4,661 points. As of 14 July 2010, the Baltic Dry Index had fallen to 1,761 points. Although it is now rising slowly again, it is a key indicator suggesting that global trade remains uncertain and that the economic recovery is not yet secure.

In this economic climate, cutting public spending could trigger a double dip recession, or what Keynes referred to as the death spiral. This would be a downward economic spiral where the economy fails to grow at all or even experiences

19 The OBR's assessment of the structural deficit is less favourable than the forecasts published in March because the OBR takes a more cautious view on the degree of existing spare capacity that exists and the prospects for trend growth.

20 The OBR now assumes that the growth potential of the economy will be adversely affected in the short run by the severity of the recession, so we will not return to trend growth of 2.5% for some time to come.

21 Progressive Economics network 'Testing Times', March 2010, www.progecon.org.uk/papers/.

22 Unemployment figures provided by the Office for National Statistics, 2010; see www.statistics.gov.uk/cci/nugget.asp?id=12.

negative growth. In consequence, tax revenues decline rapidly, unemployment rises and so too does public spending, creating a larger and larger debt–GDP ratio. Moreover, if inflation turns negative, the real value of debt (both public and private) grows. These are entirely feasible scenarios. The line that must be walked to avoid them is a fine one. By cutting spending when actually what is needed is growth and investment, the government is in danger of tipping the economy over the edge – particularly as the global recession has now become a global obsession with fiscal austerity. If everyone cuts then no one grows.

Timothy Geithner, current US Secretary of the Treasury, serving under President Barack Obama, previously the president of the Federal Reserve Bank of New York and a long-standing monetarist economist, is deeply worried by UK and other EU cuts.

Geithner's concern is echoed by those on the right of American economic policy. Desmond Lachman, a scholar at the American Enterprise Institute, stated: 'I have sympathy for Geithner. It just seems to make no sense at all in having all countries engage in severe budget tightening at the same time when the recovery we are having is anaemic.'[23]

More and more UK economists agree. The managing director of the COS Group, James Emery, said, 'I think [the Bank of England] are right to review their forecast and to expect a slower recovery based on the new government's decisions regarding public sector spend, and the surely obvious resulting fall-out of these.' [24]

Even if a severe double dip is avoided, it is likely that these measures will ensure that growth remains sluggish and the economy continues to bump along the bottom much as Japan did throughout the 1990s and 2000s.

As Martin Wolf wrote in the *Financial Times*: 'Structural reductions in public net borrowing will average 1.4% a year – unquestionably, an impressive headwind against growth.'[25]

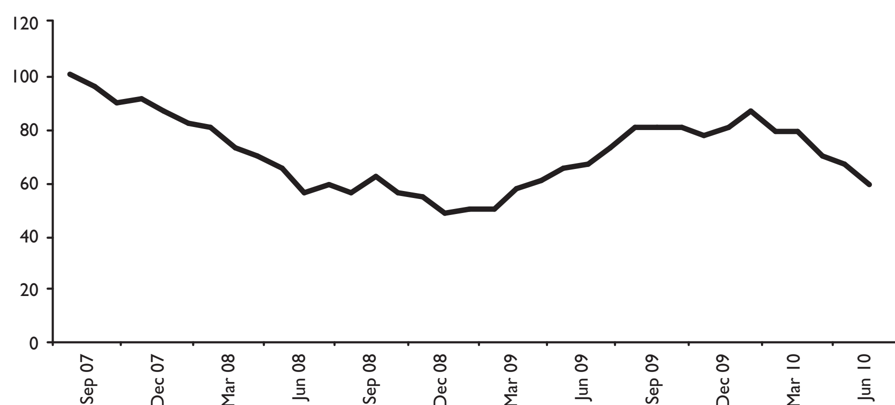
Wolf's fears are echoed by Charles Dumas of Lombard Street Research, who warned that spending cuts were driving the major economies into a prolonged period of low growth:

> *The effect of all the austerity packages in the euro area and the UK will be disappointing growth coupled with rising unemployment. This in turn will hit consumer confidence and further weaken business investment.*[26]

The Coalition government plans to reduce the deficit from £155 billion in 2010 to £115 billion next year. That's £40 billion or about 3% of GDP taken out of the economy in one year alone (see our proposals for alternative methods of achieving this in Table 1). If households and firms are forced to reduce their spending, and the government at the same time cuts its own spending, unemployment will rise, because one person's spending is another's income. If the UK reduces spending and the rest of the EU does so at the same time there cannot be export led growth.

Treasury figures leaked to the *Guardian* show that the austerity budget will result in the loss of up to 1.3 million jobs across the economy over

Figure 2 – Nationwide consumer confidence 2007-2010



Source: See Nationwide Consumer Confidence Survey

23 Quoted in Toby Helm et al., 'Europe embraces the culture of austerity – but at what cost?', *Observer*, 13 June 2010, www.guardian.co.uk/business/2010/jun/13/europe-embraces-cult-of-austerity.

24 Graham Henry, 'Bank warns of choppy recovery', Wales Online, 2010, www.walesonline.co.uk/business-in-wales/business-news/2010/08/12/bank-warns-of-a-choppy-recovery-ahead-91466-27045795/.

25 Martin Wolf, 'A bloodbath none was prepared for', *Financial Times*, 22 June 2010.

26 George Osborne, 'Let Ireland's downgrading be a lesson to you', *Guardian*, www.guardian.co.uk/business/2010/jul/19/ireland-credit-downgrading-lesson-uk.

the next five years. The job losses in the public sector will result from the 25% inflation-adjusted reduction in Whitehall spending over the next five years, while the private sector will be affected through the loss of government contracts and from the knock-on impact of lower public spending.[27]

Furthermore, as the Compass report *In Place of Cuts* showed,[28] any cuts in jobs when there is significant unemployment saves the government relatively little. For example, cutting a public sector worker on £25,000 results in a public expenditure saving of less that £2,000 under conditions of less than full employment, because that worker no longer pays in taxes and instead receives welfare benefits. What is more, they can no longer spend as much as they could when they had a job, which can lead to other job losses, and they no longer perform a useful social function as a teacher, nurse or cleaner.

The Coalition government suggests that these losses will be mitigated by a 2.5 million growth in jobs in the private sector that will come about through favourable interest rates and projected growth figures.

However, on 21 April 2010 the International Monetary Fund cut its 2011 UK growth forecast from 2.7% to 2.5% and held its prediction for expansion in 2010 at 1.3% because domestic demand 'remains subdued'. The National Institute of Economic and Social Research (NIESR) is forecasting that GDP will grow by 1% this year, picking up to 2% and 2.2% in 2011 and 2012. In this environment such a large increase in employment seems unimaginably optimistic.

Indeed as John Philpott, chief economist at the Chartered Institute for Personnel and Development, stated:

> *There is not a hope in hell's chance of this happening. There would have to be extraordinarily strong private sector employment growth in a… much less conducive economic environment than it was during the boom.*[29]

Indeed, total job creation in the seven year period from 2000 to 2007 was less than 2 million. Furthermore, following the fiscal tightening in the 1980s, it took eight years to create 2.5 million jobs in far more favourable economic circumstances.[30]

Professor John Weeks's projections are even gloomier. He writes:

> *A year ago I was extremely optimistic that the US fiscal stimulus combined with Gordon Brown's modest one, plus the policies then in place on the continent, would make the recession short and 'shallow'. Mr Brown is gone, Angela Merkel has become [an] expenditure reducer (despite a small public deficit and a trade surplus), and the Cal-Co team makes Jack the Ripper seem benign. Plan on depression.*[31]

In this light, fiscal tightening – driven by an ideological project to shrink the state – looks like folly. It is likely it will ensure that the necessary growth to reverse increasing unemployment will not take place.

We simply don't need to cut… Britain is not Greece, Spain or Canada but it might be Japan

Coalition members, particularly the junior partners, repeatedly cite the Greek sovereign debt crisis as evidence that the situation is worse than they thought and therefore justifies deviation from their manifesto. On the 14 June 2010 Nick Clegg said, 'Our problems are more serious than we realised and there are no more excuses. We have to get on with putting things right.'[32] He was referring of course to the promised cuts. David Cameron in his speech to business leaders at the World Economic Forum in Davos stated:

> *The people of Greece are already suffering the cost of a loss of confidence in their economy, with an extra three per cent on the interest rates they pay to borrow. If Britain follows them, the interest bill on a £150,000 mortgage could go up by more than £200 a month. This is not some wild dystopian vision.*[33]

Yet the Greek crisis, far from demonstrating the need for cuts, demonstrates that the world monetary system is very fragile. Indeed the markets have taken fright and downgraded the credit status of countries like Spain after austerity measures were announced because of the feared negative consequences for growth. On 19 July

27 Larry Elliot, 'Budget will cost 1.3m jobs – Treasury', *Guardian*, 29 June 2010, www.guardian.co.uk/uk/2010/jun/29/budget-job-losses-unemployment-austerity

28 George Irvin et al., *In Place of Cuts: tax reform to build a fairer society* (London: Compass, 2009).

29 Ibid.

30 T Baum, 'Causes of the growth crisis in Europe', www.springerlink.com/index/10q6398137rk1661.pdf.

31 See 'One big dip…', http://jweeks.org/Current_Commentary.html.

32 See www.cabinetoffice.gov.uk/newsroom/news_releases/2010/100615-choices.aspx. For a critique of Clegg's economics, see www.compassonline.org.uk/news/item.asp?n=9950.

33 See www.dailymail.co.uk/news/worldnews/article-1246838/Dangerous-weakness-EU-states-threaten-euro-zone-Germanys-economy-minister-warns.html

2010 Moody's, the credit ratings agency, downgraded Ireland's rating to AA2. This downgrading occurred after severe fiscal austerity was announced and was partly driven by fears over Ireland's ability to grow in the coming years.

In cutting now, the government risks remaking the mistakes of the international financial crisis of 1931 when, two years after the start of the Great Depression, a budding recovery was aborted through fiscal tightening, forcing Britain off the gold standard. Students of the Great Depression will recall that Roosevelt's attempt to balance the budget in 1937 resulted in a 40% fall in US industrial production.[34]

'In cutting now, the government risks remaking the mistakes of the international financial crisis of 1931 when, two years after the start of the Great Depression, a budding recovery was aborted through fiscal tightening, forcing Britain off the gold standard'

In the calendar year 2009, the UK recorded a general government deficit of £159.2 billion, which was equivalent to 11.4% of GDP. At the end of December 2009 general government debt was £950.4 billion, equivalent to 68.1% of GDP. It is worth repeating the figures. The budget red book put UK debt at 61.9% of GDP in 2010/11 against 177% in 1932, with debt interest payments at 6.3% of public expenditure now, compared with 40% in 1932. Yet we are being told to take the same medicine.[35]

Furthermore, growth in the eurozone, Britain's major trading partner accounting for nearly 60% of all UK exports, will be much lower than anticipated, judging by the events of the past months. As David Blanchflower, the only member of the Bank of England's Monetary Policy Committee to predict the recession, warns: 'the deteriorating conditions in the eurozone have made it even more dangerous to cut spending now'.[36] It is clear that aggressively cutting now is dangerous for economic growth.

Indeed as much was said in Vince Cable's assessment of Osborne's Mais lecture on 24 February this year:

> *Slashing spending now could push the economy back into recession and inflict further structural damage on the UK that will make it harder to sustain our credit rating. He [George Osborne] fails to appreciate that what the markets are looking for is a credible plan to reduce the deficit, not a willingness to slash regardless of economic conditions. In the current climate it is essential that decisions about the speed and timing of tackling the deficit are based on the state of the economy, not political dogma.*[37]

Furthermore, the Greek comparison is an erroneous argument for a number of reasons:[38]

- The debt–GDP ratio in the UK is far healthier than in Greece. In Greece, at the end of 2009 it stood at 79%, while in the UK it was 47%. The UK has the lowest debt–GDP ratio for 2009 of all large EU economies.[39] The UK debt burden in relation to the size of its economy is much smaller than that in Greece, so it is easier to borrow and easier to finance that borrowing.
- The *Financial Times* puts the average UK debt maturity at 13.5 years, which compares with 7.9 years for Greece, 6.4 years for Spain, and 5.4 years for Ireland. A May 2010 article in the Financial Times noted that 'the UK is a stark outlier: the average maturity of the gilt market is currently 14 years, longer than almost anywhere else in the world'.[40] This reduces the annual financial borrowing requirement and means the UK finds it easier to borrow and is less affected by changing market conditions.
- UK debt is easier to finance because a large proportion (nearly 80%) is bought and held domestically. By contrast, almost all Greek net debt is held by foreign buyers. This means that Greece is far more subject to the whims of the international financial markets than Britain.
- The UK government and central bank can control our currency and set interest rates in for the good of the domestic economy. The pound has depreciated by nearly 25% since the crash, making UK exports more competitive and offsetting some of the effects of the recession; Greece has not had this luxury.
- Greece hid much of its debt from its creditors, in order to speed up the process of becoming a member of the EU. When this came to light the markets feared that Greece would default

34 See www.novelguide.com/a/discover/egd_02/egd_02_00440.html.

35 See *The Budget* (June 2010), www.hm-treasury.gov.uk/junebudget_documents.htm.

36 See 'Osborne's cuts will nip growth in the bud, *New Statesman*, www.newstatesman.com/economy/2010/05/banks-government-growth-cuts.

37 See 'Osborne is out of his depth says Cable', February 2010, www.libdems.org.uk/press_releases_detail.aspx?title=Osborne_is_out_of_his_depth_says_Cable&pPK=7755ff1f-5e2c-41d5-a82b-7573ca25dab1.

38 These arguments have been put forward by several economists, including Rachel Reeves MP, who was previously at the Bank of England.

39 See Figure 2. Further comparisons can be found through the OECD, www.oecd.org/home/0,2987,en_2649_201185_1_1_1_1_1,00.html.

40 David Oakley, 'UK gilts show their attraction in times of crisis', *Financial Times*, May 2010, www.ft.com/cms/s/0/c9fa36fe-5e26-11df-8153-00144feab49a.html

and lowered its credit rating accordingly, driving up the price of borrowing.

- The problem of debt in Greece is long-standing. Unlike in other countries, including the UK, the credit crisis may have been the final straw, but it was certainly not the cause of the debt crisis in Greece.

From the points noted above, it should be clear that the UK economy is in no way comparable to that of Greece. That is why it is even more worrying when Professor Mike Devereux (director of Oxford University's Centre for Business Taxation) points out that over four years the cuts proposed by Osborne go further and deeper than those of the Greek government, which is facing a much greater fiscal crisis.[41]

Politicians also fear that the markets will punish the UK if it does not have a credible plan for deficit reduction as a reason to cut now. They suggest that unless we reduce the deficit immediately, or aren't sufficiently 'tough', the markets will punish us, believing that the UK risks defaulting, and as a result the interest rates which the UK government has to pay to service that debt will increase.[42] In practice this would probably occur through a downgrade of the UK's status with the credit rating agencies Moody's, Standard & Poor's and Fitch – in the same way that Greece and Spain were recently downgraded by these agencies.

Although a ratings downgrade remains unlikely, even if this were to happen it is argued by Professor David Blanchflower that a downgrade is far preferable to running the risk of cutting the deficit too early. At present, the UK pays a nominal rate of 3.31% on its debts; even if downgraded four rungs to a level equivalent to Italy, the rate Italy is paying is only 4.01%. Such a rise would be equivalent to an extra 0.5% of nominal GDP, far less than what the UK will lose as a result of the budget cuts.

The cuts are not accompanied by a growth strategy…

Cuts to services are highly problematic for those who depend on those services, and as a result to society as a whole. When they are carried out dogmatically and unaccompanied by a growth strategy they can wreak havoc with the economy and people's lives. As the American economist James Galbraith has warned, 'To focus obsessively on cutting future deficits… is also a path that will obstruct, not assist, what we need to do to re-establish strong growth and high employment.'

The economists Marcus Miller and Robert Skidelsky point out in an article in the *Financial Times*: 'The government is spending so much because the private sector is investing so little.' Or again, as Professor David Blanchflower puts it:

> *There are two ways to get the increase in total spending that we call 'economic growth'. One way is for government to spend. The other is for banks to lend. Leaving aside short-term adjustments like increased net exports or financial innovation, that's basically all there is. Governments and banks are the two entities with the power to create something from nothing. If total spending power is to grow, one or the other of these two great financial motors – public deficits or private loans – has to be in action.*[45]

Although Osborne suggests that cuts or growth is not an 'either or' situation – the above clearly suggests that it is. This is not to say that unnecessary projects shouldn't be cut, projects like Trident renewal are unnecessary and wasteful, nor is it saying that the public sector cannot be made more efficient and services improved. But taking a large slice of money out of the economy at this point will not stimulate growth.

It is apparent that there is a consensus about the need for fiscal austerity on the political front benches, but major criticisms have come from the chief economist at the *Financial Times*, Martin Wolf, who on 15 April, argued:

> *The single most effective way to bring the public finances back under control is [through] greater demand and higher GDP. This needs higher investment and net exports and more dynamic supply. Measures that seek to close the fiscal deficit, but destroy demand in doing so, will not help: fiscal austerity is just not enough.*[46]

A mere three months ago on 22 April 2010, also writing in the Financial Times, Samuel Brittan concurred: 'Too early a start on cutting the UK Budget would threaten a still precarious economic recovery.'[47]

41 See Ruth Sutherland, 'Budget 2010: Osborne's "rebalancing" risks hitting a regional generation hard', *Guardian*, 2010, www.guardian.co.uk/uk/2010/jun/23/osborne-rebalancing-regional-risks.

42 There is an implicit assumption in this analysis that the markets will see spending cuts as 'tougher' action to close the deficit than tax increases – although no actual economic rationale for this distinction is given by its adherents.

43 James Galbraith, 'In defense of deficits', *Nation*, 22 March 2010.

44 Marcus Miller and Robert Skidelsky, 'Do not rush to switch off the life support', *Financial Times*, 3 March 2010.

45 David Blanchflower, 'Osborne's cuts will nip growth in the bud', *New Statesman*, 2010, www.newstatesman.com/economy/2010/05/banks-government-growth-cuts.

46 Martin Wolf, 'Spare Britain the policy hair shirt', *Financial Times*, 15 April 2010.

47 Samuel Brittan, 'The sad return of state worship', *Financial Times*, 22 April 2010.

Indeed, as David Blanchflower further argues:

> *There is no economic basis whatsoever for arguing that delaying the start of deficit reduction would put long-term recovery at risk. It would not. There is also zero empirical evidence to justify their claims that further stimulus would 'darken consumer and business confidence'.*[48]

Without a plan for growth the cuts are deadly and now even the city is recognising it. A recent report by respected economic analysts Lombard Street Research echoed fears from the city that the fiscal tightening could be dangerous for the economy after the G20 was unable to agree a plan that would promote growth.[49]

In early July 2010 the OECD reported a concern that the Coalition's deficit reduction plan should not come at the expense of money to tackle the labour market legacy of Britain's post-war recession. The OECD said it expected the UK recovery to be 'too muted to result in strong job creation'.[50] Indeed, ONS figures released on 12 July 2010 show that Britain would still be in recession if it were not for government spending.

A leading firm of UK property advisers, Savills, is already blaming a drop in public sector building programmes on low levels of commercial property development. 'Austerity measures are now firmly impacting on the development market, with activity for public sector clients now in double dip territory,' said Savills head Michael Pillow.[51] The public and private sectors cannot now be decoupled; the later relies firmly on the former. Cut one and you cut the other.

Growth and the jobs the UK so badly needs will not result from draconian cuts in public sector spending.

48 David Blanchflower, 'Trust me, inflation is not a problem', *New Statesman*, 2010, www.newstatesman.com/economy/2010/03/inflation-rpi-stimulus-cpi.

49 Lombard Street Research, *Monthly Review*, June 2010, www.lombardstreetresearch.com/.

50 OECD, 'Policies for a sustainable recovery', July 2010.

51 Public sector cutbacks stoke builders' recession fears, *Evening Standard*, 12 July 2010, www.thisislondon.co.uk/standard-business/article-23855053-commercial-development-falls-to-lowest-level-in-11-months.do.

4. The Third Big Gamble: if the state is cut back the private sector will flourish

Osborne's implicit assumption is not merely that cuts are essential to securing the recovery, but that the state is somehow suppressing the entrepreneurial spirit and that private activity will automatically burst forth once the public sector is cut down to size. In fact, this is the backbone of his view of private sector growth.

There are few signs that the private sector can stand on its own feet in the absence of government support. Over the last few years the pound has depreciated by nearly 25% yet net exports have not increased nearly as much as they should have. Britain's share of world manufacturing has shrivelled, the recovery in the US is petering out and the eurozone – the destination of about 60% of UK visible exports – is crisis-ridden and economically stagnant.[52]

The monthly report by the 12 regional agents of the Bank of England, published on 21 April 2010, confirmed that UK growth is anaemic. The report noted weakness in retail sales, the housing market, the construction sector, investment and employment intentions, and in pay settlements. Bank credit had improved only 'marginally'.[53]

If the pound thus appreciates against the euro (which is happening in the current European climate), any progress that the economic stimulus achieved under Labour would be reversed and growth predictions would be even lower.

The Con–Dem Coalition likes to draw comparisons with the last time the Tories ran a very tight monetary policy – the budget in 1980/1 under Geoffrey Howe. They argue that after this brutal attack on the state the economy soon recovered and grew. That may be true as far as it goes, but it is not the whole story, for the reasons listed below.

- In the early 1980s, at the time of the last cuts, inflation and interest rates were high. In 1981 the UK annual inflation ran at 12% and the interest rate (minimum loan rate) was 14%; there was plenty of room for offsetting tight fiscal policy by looser monetary policy and, indeed, Geoffrey Howe's budget cut the interest rate by 2%. Compare this to today, when the inflation rate is 3.1%[54] and interest rates are set at 0.5% by the Bank of England. There is little room to boost private sector growth.
- In the 1980s devaluation of the pound gave rise to a strong recovery in Britain's trade balance. By contrast, the 25% devaluation of the pound in 2008/9 has had little impact in relation to the enormity of the economic crisis this time, even allowing for the usual time lag.
- Britain was the only country trying to emerge from recession in the 1980s, although there was recession in several major economies including the US. But it wasn't precipitated by the kind of huge financial crisis that erupted in 2008, or 1929. Today all the major OECD countries are trying to balance their budgets. Fiscal austerity across the globe and sluggish growth in the EU will have an effect on Britain's ability to 'recover through cuts'.
- The cost of borrowing for small businesses is now very high, compared with the 1980s, even though the base rate is low. Therefore small businesses are struggling to find investment and, if they can find it, it comes at an unmanageably high cost.
- The recovery was entrenched with the Big Bang in the City as deregulation swept through the banks. Profits soared but so did the conditions for the crisis of 2008.
- Perhaps most significantly, the UK could depend on large revenues as an exporter of North Sea oil and gas. However, at the beginning of 2010 the UK became a net importer of gas and the North Sea oil is drying up.[55]

In any case, there is good evidence that Howe's 1981 budget actually resulted in growth being lower and unemployment higher for several years more than they would have been if he had produced a more neutral budget.[56]

Although it is possible, if somewhat implausible, that a new source of revenue and jobs will emerge, it seems unlikely that such a source could fully offset the job losses in both the public and private sphere resulting from the cuts. It is certainly questionable whether Osborne's imagined private sector growth will occur for a long, long time.

52 It should be noted that Germany's strong showing in the second quarter of 2010 is largely the result of rapid export growth with China.

53 See 'Agents' summary of business conditions', Bank of England, April 2010.

54 See 'United Kingdom inflation rate', *Trading Economics*, www.tradingeconomics.com/Economics/Inflation-CPI.aspx?Symbol=GBP.

55 See Edmund Conway, 'North Sea oil is dragging us into the red', *Telegraph*, 2010, www.telegraph.co.uk/finance/comment/edmundconway/6505670/North-Sea-oil-is-dragging-us-into-the-red.html.

56 See Larry Elliot, 'The lunatics are back in charge of the economy and they want cuts, cuts, cuts', *Guardian*, 2010, www.guardian.co.uk/business/2010/jun/14/lunatics-economy-cuts-frankin-roosevelt.

5 The Fourth Big Gamble: cuts can be progressive

The Coalition does not deny the scale of the cuts but does claim they will be progressive – that those who can afford least are hit least and that all should share the pain. The evidence suggests otherwise. However, the director of the Institute for Fiscal Studies (IFS), Robert Chote,[57] wrote when looking at the distributional impact of the budget:

> *Mr Osborne and Mr Clegg have been keen to describe yesterday's measures as 'progressive' in the sense that the rich will feel more pain than the poor. That is a debateable claim.*[58]

And the authors of the latest IFS report argue:

> *Once all of the benefit cuts are considered, the tax and benefit changes announced in the emergency Budget are clearly regressive as, on average, they hit the poorest households more than those in the upper-middle of the income distribution in cash, let alone percentage, terms.*[59]

The IFS goes on to identify a number of reasons for this. First, the VAT increase from 17.5% to 20% from January 2011 will raise £12.1 billion in 2011/12. VAT hits those with higher expenditures in relation to income hardest. Therefore, those with lower incomes tend to be hit harder than others by a rise in VAT. The distributional impact of a rise in VAT is shown in Figure 3.

The plans from the June emergency budget imply 'the longest and deepest sustained cuts to spending on public services since at least WW2', according to IFS analyst Rowena Crawford.[60]

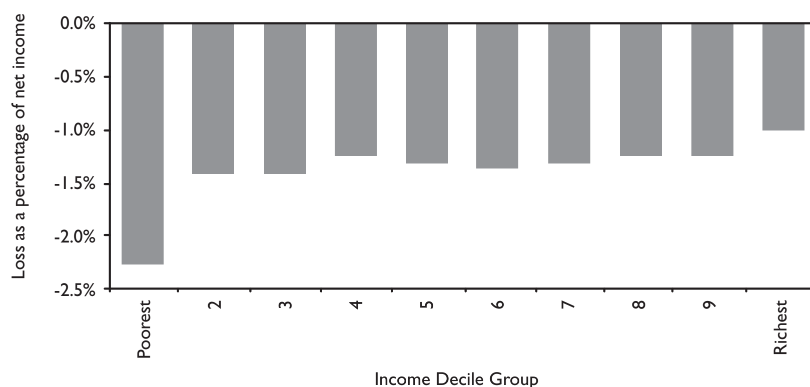
Second, the budget forecast is that the biggest welfare savings will come from reductions in tax credits (£3.2bn) and housing benefits (£1.8bn). A saving of £110 million is to be made by cutting housing benefits to the long-term unemployed. Campbell Robb (chief executive of the homelessness charity, Shelter) estimates that some people will be losing up to 40% of their total rent:[61] 'People will be forced out of one form of accommodation, but there is nowhere for them to go. We expect to see debt and evictions rise as a result of this.'[62]

Third, the IFS suggests that the only reason the reforms to tax and benefits can be called progressive is because of the reforms already announced by the previous Labour government (see Figure 4).

Fourth, the IFS shows that because the Treasury only looks at reforms up to 2012/13, the benefits cuts announced in the emergency budget for subsequent years hit the poorest the hardest and will continue to hit them the hardest year on year.

Fifth, the IFS argues that the Treasury does not account for cuts to housing benefit, Disability Living Allowance and reforms to in-year changes to tax credit awards. These are all likely to hit the poorest harder than the richest. So the IFS conclude that: 'the overall impact of [the]… budget was regressive'.

Figure 3 – Distributional impact of increasing VAT rate to 20% by income decile



Source: See Institute of Fiscal Studies (2010) The distributional impact of public spending in the UK

57 Robert Chote will now be heading up the Office of Budget Responsibility

58 Institute for Fiscal Studies, 'Emergency budget June 2010',www.ifs.org.uk/projects/330.

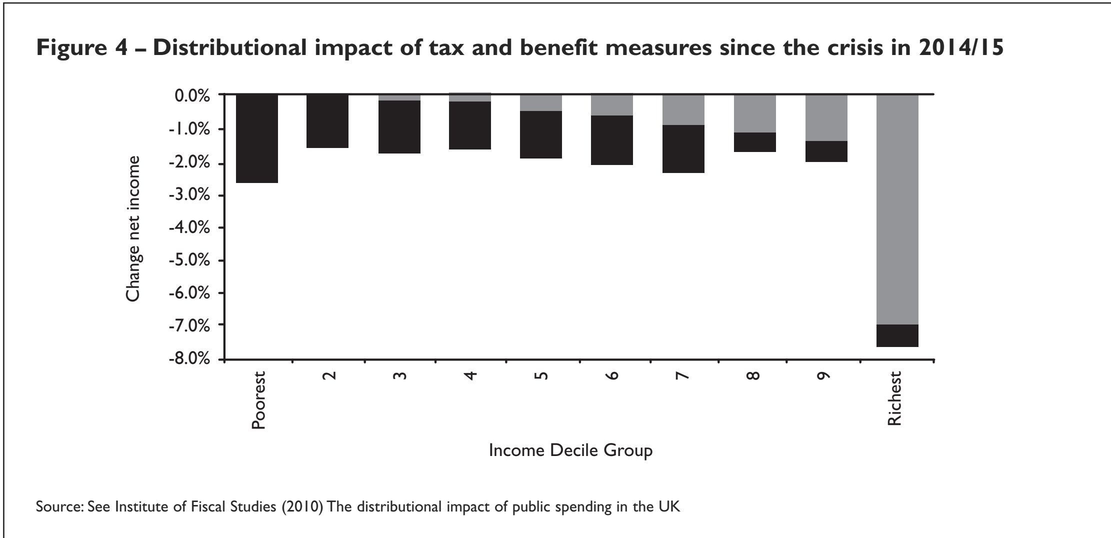
59 See www.ifs.org.uk/publications /5245.

60 Rowena Crawford, 'Public services: serious cuts to come', 2010, www.ifs.org.uk/projects/330.

61 See www.guardian.co.uk/ politics/2010/jun/24/benefit-caps-homeless-welfare.

62 'Benefit caps will tip poor into homelessness, warn charities', *Guardian*, www.guardian.co.uk/ politics/2010/jun/24/benefit-caps-homeless-welfare.

Figure 4 – Distributional impact of tax and benefit measures since the crisis in 2014/15



Source: See Institute of Fiscal Studies (2010) The distributional impact of public spending in the UK

Tim Horton, of the Fabian Society, and Howard Reed, previously chief economist at the IPPR, have looked at the cuts to public services and their distributional effects. They show that when the impact of these spending cuts is combined with the government's own analysis of the impact of the budget's tax and benefit changes – in order to generate a picture of the budget's overall impact – the result is, once again, deeply regressive. In particular, the magnitude of the impact of spending cuts on households dwarfs the impact of the tax and benefit changes.[63]

Overall, the combined average annual loss in income and services for the poorest tenth of households is £1,514, equivalent to 21.7% of their household income. For the richest tenth of households, the annual loss in income and services is £2,685, equivalent to just 3.6% of their household income.

Cutting now will damage the economy. Cutting without a plan for economic growth could lead to a lost generation of unemployed and ensure we struggle to grow in the future. A plan for fiscal austerity that focuses on closing the structural deficit in the course of one parliament with 77% spending cuts will hit those on middle and low incomes hardest. The so called progressive cuts are a delusion and must be challenged.

So if the Coalition's big gambles won't work… what will?

63 Tim Horton and Howard Reed, 'Don't forget the spending cuts! The real impact of Budget 2010', TUC, 2010.

6. An alternative

No one can take lightly the job of using and spending the public's money effectively and efficiently. However, although a government should always be looking for greater efficiencies, simply cutting essential programmes will not make our public services more efficient.

There is no evidence that a less austere fiscal policy would have been rejected by the markets; indeed the markets are now increasingly jittery about the inability of governments to plan for growth. Furthermore, as this report suggests, the UK is in a strong position relative to other countries affected by a debt rating downgrade – the UK is well placed to borrow in the short term, both to protect the longer-term economic growth and those who would be harmed by cuts.

Although growth, loose monetary policy (and even mild inflation) can ultimately close the structural deficit gap, it is not wise to rely solely on growth given the current situation, so it is important to consider fiscal measures, namely some combination of spending cuts and tax increases.

Labour's plan in its 2010 election manifesto was for two-thirds spending cuts versus one-third tax rises. The Coalition budget represents a total consolidation of £113 billion per year by 2014/15 and £128 billion per year by 2015/16, of which £99 billion per year comes from spending reductions and £29 billion per year from net tax increases. By 2015/16, 77% of the total consolidation will be delivered through spending reductions and 23% through tax increases.[64] The Coalition predicts that this will ensure that the structural current deficit will be eliminated by 2014/15, and public sector net debt will peak at 70.3% of GDP in 2013/14, before declining to 67.4% of GDP in 2015/16.

But why cap the public net debt ratio at 70%? Why would peak debt of 80% of GDP (or indeed 100%) not be an acceptable price to pay for reasonable growth and employment figures in 2014/15? The US debt ratio is projected by the IMF to approach 100% in 2015, while in Japan the current debt–GDP ratio is nearly 200%.[65] But the Bank of Japan is not paying exorbitant interest rates on its debt; indeed, the yen has recently soared and the Bank of Japan's long-term bond yields have fallen.[66] Moreover, quantitative easing (printing money) in Japan has not led to inflation – Japan is still suffering from falling prices! The focus on a reduced timescale for deficit reduction in the UK, coupled with a preference for public sector cuts over tax rises, ensures that this will be an incredibly painful process.

The Coalition government like to suggest that there is no alternative. This claim is deeply misleading: there is a clear alternative, as this report demonstrates.

However, while political parties seem keen to insist on specific deficit reduction plans, the degree of uncertainty about future economic performance suggests that any timetable for the elimination of the structural deficit should be suggestive at best. Growth in the UK and abroad, the efficency of tax collection and automatic stabilisers could all affect the rate at which the deficit would be reduced. There are no specific economic reasons why the whole or even half the deficit has to be eliminated over the lifetime of the next parliament, and committing to a timetable which is too tight could be counterproductive.[67]

Fiscal reform

As an initial guide there are tax reforms and certain spending cuts that could be introduced to reduce the deficit in a way that is progressive. Britain does not lack the capacity to reduce its deficit and a combination of cuts to unnecessary projects and tax rises could significantly reduce the deficit in the medium to long term, supplementary to growth.[68] We outline below a set of alternative measures, which could help put Britain's finances back on the path not merely to growth, but to growth with greater fairness.

First, introduce a 50% Income Tax band for gross incomes above £100,000. This reform introduces a new 50% band of Income Tax for taxable incomes above £94,000 per year (approximately £100,000 a year gross income).This would raise £4.7 billion compared with the current (2009/10) tax system, or an extra £2.3 billion compared with introducing this band at £150,000 as proposed by the previous chancellor, a proposal that the Tories may well scrap.

Second, uncap National Insurance Contibutions (NICs) so they are paid at 11% all the way up the

64 See Treasury, 'Budget', June 2010, www.hm-treasury.gov.uk/2010_june_budget.htm.

65 See IMF, 'Navigating the fiscal challenges ahead', IMF Fiscal Monitor, Washington DC, 14 May 2010.

66 See www.theglobeandmail.com/report-on-business/bank-of-japan-set-for-emergency-meeting-as-yen-soars/article1689384/.

67 The experience of Ireland, which introduced draconian fiscal measures to deal with the structural deficit, but which ended up in many ways in a worse position than when it started, is cautionary here. See for example Michael Burke, 'A genuine economic recovery – the case for fiscal stimulus', June 2010, www.tascnet.ie/showPage.php.

income scale (continuing to exempt pensioners). Currently (2009/10), employee NICs are payable at 11% from £100 a week up to £884 per week – and at 1% above this level. Self-employed NICs have an equivalent structure based on annual profits, paid at 8% up to profits of £43,875 and then at 1% above this. Also, unearned income (for example, income from investments and savings) is not subject to NICs. This reform removes the upper threshold so that employee NICs are payable at 11% on all earnings above £884 per week for employees and at 8% on all profits above £5,715 per year for the self-employed. Additionally, all investment income above £110 per week (or the annualised equivalent) is made liable to NICs at 11%. This results in further revenue of £9.1 billion; thus uncapping NICs would rake in a great deal of money. It would turn NICs into a flat tax, making it 'merely regressive' rather than 'über regresssive'.

Third, introduce minimum tax rates. This reform introduces a lower limit to effective rates of Income Tax above certain levels of gross income, a principle suggested by the TUC in its 2008 report *The Missing Billions*.[69] As gross income approaches each threshold, the personal allowance and other reliefs (for example, tax relief on pension contributions) are 'clawed back' at a high marginal rate until the average tax rate – as well as the marginal tax rate – on income above each threshold is equal to tax rates of 40% and 50% on incomes of above £100,000 and £150,000 respectively. Such a reform raises an additional £14.9 billion.

Fourth, while reducing the decifit is important in the medium to long term, it is important that tax rises don't hit the poorest hardest – which is why we would introduce a special lower tax band of 10% below the poverty line (below £13,500 per annum), while restoring the 'basic rate' to 22%. This costs £11.5 billion, far less than the extra tax take outlined above.

Fifth, increase the tax payable (higher multipliers) for houses in Council Tax bands E to H. This would raise a further £4.2 billion.

Sixth, minimise personal and corporate tax avoidance by requiring tax havens to disclose information fully and changing the definition of 'tax residence'; these two reforms are estimated minimally to yield £10 billion.

> 'Britain does not lack the capacity to reduce its deficit and a combination of cuts to unnecessary projects and tax rises could significantly reduce the deficit in the medium to long term, supplementary to growth'

Seventh, introduce a financial transactions tax (FTT) at a rate of 0.1%, applicable to all sterling transactions. Minimally, this would raise a further £4.2 billion – maximally, it would raise £34 billion, or about 2.5% of UK GDP.[70] In Table 1 we assume that such a tax would raise at least £10 billion per annum. Most of the major EU countries are favourable to such a tax, and on 18 July 2010 the head of the IMF, Dominique Strauss Kahn, announced he would back it.[71]

Eighth, continue levying the Bankers' Bonus Tax introduced by Alistair Darling in 2009, which raised £2 billion.

Such extra revenues from tax reform would ensure that in the medium to long term there would be no need, if ever there was one, to cut public expenditure on essential services.

Table 1 Extra annual fiscal revenue raised by recommended measures (£bn)

1	50% Income Tax band at £100,000	2.3
2	Uncap NICs and make them payable on investment income	9.1
3	Introduce minimum income tax bands	14.9
4	Reintroduce 10% tax band and 22p basic rate	−11.5
5	Abolish tax havens and tax 'non-doms'	10.0
6	Introduce a sterling Financial Transactions Tax (average when levied at 0.05%)	10.2
7	Cost cutting measures described below	5.3
	Total	40.3

68 The following tax rises and cuts were proposed in the Compass report *In Place of Cuts*.

69 Richard Murphy, *The Missing Billions* (London: TUC, 2009).

70 The lower estimate is Richard Murphy's; the higher is George Irvin's. See Irvin 2009, 'Now's the time for a Tobin tax', *Guardian*, 11 December 2009, www.guardian.co.uk/commentisfree/2009/dec/11/tobin-tax-currency-transactions.

71 See www.guardian.co.uk/business/2010/jul/18/tobin-tax-financial-transactions.

In addition to tax reforms there are of course areas of public spending that could and should be cut. The suggestions itemised below are not comprehensive but offer an alternative to the Coalition's cuts and would result in savings of £5.3 billion per annum.

Public sector cuts

Cut Trident and other heavy military goods: two aircraft carriers to be delivered in 2018 at a current cost of £5 billion and the expensive new batch of Typhoon Eurofighter aircraft last estimated to cost £20 billion in 2003. The cost over the next 30 years is put at £120 billion.[72] The corresponding annualised cost figure would be £4 billion.

The Mini-Titan prison programme should be scrapped. The capital and maintenance cost of expanding prisons or building 1,500 'mini-Titans' to accommodate an extra 100,000 prisoners will be about £1.3 billion, so scrapping that project would be a significant saving.[73] Britain already has the highest per capita rate of incarceration in Europe; to raise it further would be a clear failure of social and economic policy.

72This is a conservative estimate. See R. Norton-Taylor, 'Revealed: the £130 billion cost of Trident replacement', *Guardian*, 18 September 2009.

73 See Lord Beith's Justice Committee, www.alanbeith.org.uk/news/000232/beiths_committee_asking_you_how_5_billion_cost_of_prisons_and_probation_could_be better_spent.html.

7. Conclusion

The governing coalition presents its economic plans as dogma-free economic common sense. But as this report demonstrates, the proposed budget is the opposite of common sense. To cut the state in the fashion proposed by this government will compromise future growth. It is a large and reckless gamble. However, there is a sensible and pragmatic alternative.

In the medium to long term the deficit can be reduced by pursuing a public-sector-led growth agenda, financed in part by sensible tax reform, which ensures that those with the broadest shoulders bear the greatest weight while those on middle and lower incomes are protected. The extra revenue and savings proposed amount to £40.3 billion per annum, a non-negligible 3% of GDP.

Compass challenges the government to think again, to postpone deficit reduction until growth is secure, to ensure monetary and fiscal policy remain growth orientated, and only then to initiate a programme for dealing with the 'excessive debt–GDP ratio' based on finding better and fairer ways of reducing the structural deficit. In essence, to deal with public debt, Britain needs the right balance of sustainable growth and greater fairness.

This government describes itself as progressive. This report shows that far from being progressive, the Coalition government has set this country on a course that will leave it poorer and more unequal. If Cameron and Clegg wish to bear the mantle of progressivism they must start living up to it.

It is critical that the state doesn't take the blame for a crisis it didn't start but that it did effectively stop. We can build an alternative economic political model to ensure growth is balanced between socio-economic groups, and regions and sectors, and to accommodate environmental needs.

'Achieving economic balance requires the legitimacy of a strong and democratic state. These are the principles on which Labour and an alliance of progressive forces in Britain must build the future.'

A political economy is in essence an economic programme that supports a certain political philosophy. An unrestrained free-market economy is based on the primacy of the rational individual and the absence of negative externalities and market failure. By contrast, a balanced economy rests on the belief that individuals fully flourish in concert with others and that society needs to regulate the market in its interests. Achieving economic balance requires the legitimacy of a strong and democratic state. These are the principles on which Labour and an alliance of progressive forces in Britain must build the future.

Join today and you can help change the world of tomorrow

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About Compass

Compass is the democratic left pressure group whose goal is both to debate and develop the ideas for a more equal and democratic society, then campaign and organise to help ensure they become reality. We organise regular events and conferences that provide real space to discuss policy, we produce thought-provoking pamphlets, and we encourage debate through online discussions on our website. We campaign, take positions and lead the debate on key issues facing the democratic left. We're developing a coherent and strong voice for those that believe in greater equality and democracy as the means to achieve radical social change.

We are:

- An umbrella grouping of the progressive left whose sum is greater than its parts.
- A strategic political voice – unlike thinktanks and single-issue pressure groups Compass can develop a politically coherent position based on the values of equality and democracy.
- An organising force – Compass recognises that ideas need to be organised for, and will seek to recruit, mobilise and encourage to be active a membership across the UK to work in pursuit of greater equality and democracy.
- A pressure group focused on changing Labour – but Compass recognises that energy and ideas can come from outside the party, not least from the 200,000 who have left since 1997.
- The central belief of Compass is that things will only change when people believe they can and must make a difference themselves. In the words of Gandhi, 'Be the change you wish to see in the world'.

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