AUSTERITY: NOT AGAIN!

A briefing paper on managing the public finances

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Compass

#BuildBackBetter

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About the author:

Martin Yarnit is a Compass Associate and the co-founder of Talk Shop, an initiative to promote active participation in public policy discussion. He has written widely on education and is developing a national project on food hubs with the support of the Winston Churchill Memorial Trust.

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With advice also from Professor Trevor Evans who, until he retired in 2015, was professor for monetary theory, monetary policy and international monetary relations at the Berlin School of Economics and Law. He is a member of the coordinating committee of the European Economists for an Alternative Economic Policy in Europe.

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About Compass
Compass is the pressure group for a good society, a world that is much more equal, sustainable and democratic. We build alliances of ideas, parties and movements to help make systemic change happen. Our strategic focus is to understand, build, support and accelerate new forms of democratic practice and collaborative action that are taking place in civil society and the economy, and to link that up with top-down/state reforms and policy. The question we are trying to help solve, which we explore in the recent document 45 Degree Change, is not just what sort of society we want, but, increasingly, how to make it happen?

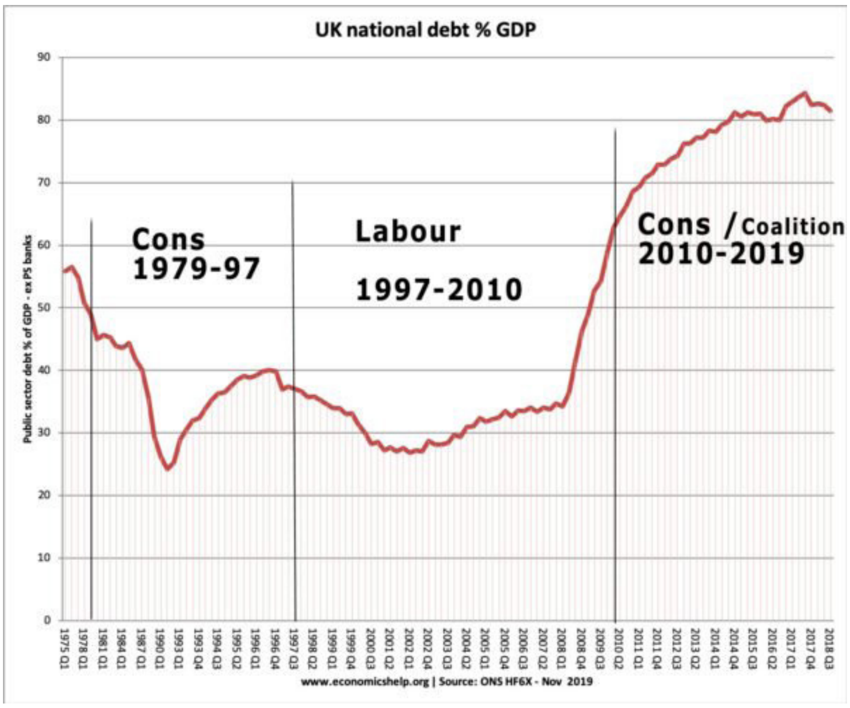
Given the scale of the government's borrowing to deal with the Covid-19 crisis it's not surprising that people on all sides of the political spectrum are talking about what to do with the debt. The last time we had that debate in 2010 'the left got the blame', as Gordon Brown recently observed. Here, from Compass' perspective, is the case we need to make this time for a more sustainable and socially just way of managing the public finances in order to create the well-being economy that many are now discussing.

How big is the debt? How does it compare with previous government borrowings? How does it compare internationally?

A definition before we begin: the *debt* is the accrued total of *deficits* created by an excess of government spending over income.[1]

The government has announced an extension of the job retention scheme until October. In effect, it will be paying the wages and benefits of half the workforce, increasing the current debt of around £200bn by maybe 50% according to the Resolution Foundation. That will amount to 90% or even 100% of GDP but that compares to the level of 270% that Britain faced as it emerged from the Second World War.

The debt-GDP ratio indicates how the a country's public borrowings relate to its productive capacity. As the graph below shows, the Tories managed to increase the debt level from just over 60% in the last year of New Labour rule to over 80% in the last year. While pursuing their campaign against excessive public spending.



In 2010, when George Osborne introduced his first Coalition austerity budget, the GDP debt ratio was 60%. Two US economists, Reinhart and Rogoff, argued, at that time, that as the debt-GDP ratio approached 90%

economic growth slowed down sharply. And even if the ratio was well below that in 2010 it was vital to take pre-emptive action, an argument supported by the then governor of the Bank of England, Mervyn King, who pointed to the perilous state of the Greek economy and the reluctance of the markets to lend to the government there. As it turned out, Reinhart and Rogoff's calculations were faulty, but the 90% rule took hold amongst policy makers and Labour took the blame for the 2008 banking crisis and its aftermath.[2]

How would a debt-GDP ratio of 90-100% compare internationally? Japan's ratio is 237%, Singapore 109%, and the US 106%. None of these has any difficulty financing its debt (especially the US whose dollar is the world's reserve currency – the currency in which other nations must trade) although their ratios are far higher than cash-strapped South Africa (58%) or Zimbabwe (21%). This is because investors are keen to lend to the UK, the US, Japan and Singapore where the returns are good and the risks low. And to look at borrowing from the government's point of view, with interest rates at an historic low, borrowing has never been cheaper.

What are the economic implications of the debt? Could it bankrupt the UK?

Bankruptcy would mean that our currency collapses in value compared to the dollar so that we couldn't afford to pay for imports. This is because international trade is transacted mainly in dollars. Currently, we are a long way away from that. The reason for this is that in the UK and across the world central banks have recognized that the state has a new role as an insurer against economic disaster and have stepped forward to buy up the debt created by government.

The other risk is high and rising inflation. A large part of the debt is being absorbed by loans from the Bank of England but that is new money on a spreadsheet and economic theory suggests that printing money in vast quantities leads sooner or later to inflation. However, currently inflation is just under 2% and with high unemployment likely to act against rising wages there are no signs that it is about to explode. A low level of inflation – around 2-3% - is helpful in gradually eroding the value of debt but a higher level would act as a brake on the economy and a tax on the less well off.

The UK is well placed to borrow because as one of the world's major economies it has the capacity to pay off the loans, sooner or later. Interest rates are at an historic low and investment cash is desperate for somewhere to go.

> "In a sign of the clamour for UK bonds, the UK Debt Management Office saw record breaking order volumes for some of those IOUs in its latest fundraise. Around £53 billion of orders were chasing £7 billion worth of 2061 bonds, which are due to be repaid in

41 years" Evening Standard, 19 May 2020

So, there's never been a better time to borrow to boost demand when faced with a slump. Servicing the debt – paying the interest payments – is manageable when interest rates are so low. Investors are keen to buy UK government debt so currently there seems no difficulty in selling the debt.

What are the options for dealing with the debt?

Broadly, there are three ways of dealing with the government's debt – or some mixture of these: cut public spending, treat the debt as an emergency or raise taxes.

Cut public spending

Remarkably, although it would intensify the coming recession, there are some calls for a repeat of George Osborne's austerity medicine, not least from Osborne himself. Some Conservatives and their media supporters insist on treating the public debt like a household debt – ignoring the fact that if the government slashes spending it cuts demand creating bankruptcy and unemployment. But as Anne Pettifor has argued, cutting public spending coupled with the deflationary impact of too much private, especially corporate, debt would lead to 'rises in unemployment while coronavirus continues to demobilize consumers and immobilize travellers'.[3]

Treat the debt as an emergency

Economists such as Paul Mason and Ann Pettifor advocate deferring any decisions about how to deal with the debt until the danger of recession is over. Conservative economists are divided with some wanting action now to reduce it. Others, however, argue that now is not the time to remove the disaster insurance provided by the government with the backing of the Bank of England. Rupert Harrison, once George Osborne's chief of staff and now portfolio manager at investment firm, Blackrock, does not believe that a dose of austerity is what is needed. 'We need to manage the transition [to post-Covid-19 stability]…very gradually reduce the debt… over a very long time'.[4]

Of course, in the meantime, the debt has to be serviced. However, at current rates, as Jonathan Portes has argued, we could finance the debt for £2bn a year. 'By contrast, the fiscal cost of even a modest 2% permanent hit to GDP would be close to £20bn a year.'[5]

The precedent for letting sleeping dogs lie is 1945. Britain's WW2 debt legacy was vast and its productive capacity hard hit by five years of warfare. On the other hand, it emerged from the war as a major manufacturing force in Europe and thanks to rising exports was able to grow the economy steadily until the early 1970s. That growth – 'the fastest ever'[6] - plus a constant level of inflation enabled the UK to reduce the weight of its public debt. There was one other factor: high taxes on high earnings. The top rate was 83% until 1979 when the Tories reduced it to 60%. Today it is just 45%.

Raise taxes

The Covid-19 crisis has opened up a long-overdue discussion about the need for a progressive and green tax system. Raising income and wealth taxes on the rich could ‘shift the distribution of income…to create more sustainable demand and so stronger investment’, argues Martin Wolf. Or better still, ‘we have a huge opportunity now to replace government lending to companies in the Covid-19 crisis with equity purchases. Indeed, at current ultra-low interest rates, governments could create instantaneous sovereign wealth funds very cheaply’.[7] In a similar vein, Mariana Mazzucato argues for public spending to be used to create value and to support long-term solutions to problems such as the climate crisis.[8] What there is widespread agreement about is that this is not the moment to raise taxes. As the Financial Times says; 'Low interest rates appear to be here to stay. That means governments can live with higher levels of debt than was previously thought — even if it does not mean they can neglect the need for prudence altogether. Timing is everything. Raising taxes during the worst recession for three centuries would be a historic mistake.' (Financial Times, 14 May 2020)

Our View

“There should be no discussion about the deficit until interest rates and inflation start rising substantially because of excess domestic demand. Only then will we know that the recovery is complete.” Simon Wren-Lewis (Guardian, 14 May 2020)

We agree. Britain – as the impact of Covid-19 on the NHS has demonstrated – is still suffering from the austerity regime introduced by the Coalition in which George Osborne served as Chancellor, even if Osborne himself has prospered. As well as his roles as editor of the Evening Standard and advisor to the investment house, Blackrock, at £650,000, he has been made chairman of a panel of advisers to Exor, the listed holding company of the Agnellis, one of the richest families in Italy.

Compass advocates treating the debt as a one off emergency until the danger of recession is over and only then deciding how to deal with it. Then and only then, decisions need to be made taking account of the economic climate in which government borrowing takes place and the political priorities for:

1. moving beyond the Covid-19 crisis,
2. tackling climate change and
3. setting the British economy on a sustainable and socially just course.

Compass supports the call for the government to create a sovereign wealth fund and to take equity in enterprises supported through the job retention scheme, and to raise taxes on wealth and high incomes to support the transition to a green economy.

Endnotes

1. A useful note on definitions and trends from the ONS: https://www.ons.gov.uk/economy/governmentpublicsectorandtaxes/publicspending/bulletins/ukgovernmentdebtanddeficitforeurostatmaast/march2019
2. See Chapter 15 in Tooze, A (2018) How a decade of financial crises changed the world, Allen Lane
3. New Statesman (2020) 'Top economists warn the UK not to repeat austerity after the Covid-19 crisis' in New Stateman, 4 May 2020
4. Speaking on Economics of the Great Pause, convened by Tony Blair Institute, 2 May at https://www.youtube.com/watch?v=NDRXgMW0Wc0 from 22.30 onwards.
5. New Statesman, Ibid.
6. Edgerton, D (2018) The Rise and Fall of the British Nation: a twentieth century history, Allen Lane, p.310
7. Source: https://www.ft.com/content/2c5ddbd0-8e09-11ea-9e12-0d4655dbd44f
8. New Statesman, Ibid.

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