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Reykjavik-on-Thames?

George Irvin

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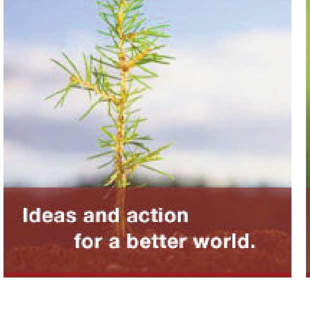

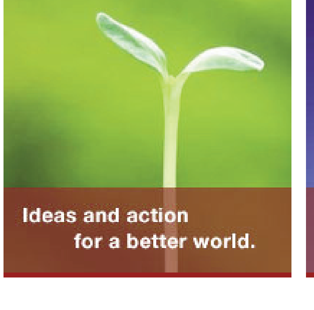

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Britain needs a radical recovery plan

The recession seems to deepen by the day. The Government's £500bn bailout has not unfrozen private bank lending; instead, bank shares are falling again and further bankruptcies loom. Nightly television news reports the grim count of job losses, and monthly figures show economic indicators plunging.

A very costly recession

What started as a financial crisis is now a full-blown economic recession---not any old recession but the possibly the worst slump since the 1930s. GDP in the last quarter of 2008 feel at an annualised rate of 6%, greater than the peak-to-trough fall in output in 1929-33. This mega-recession will sweep away swathes of jobs, further deskill the industrial workforce, narrow the scope for improving public services and generally make life even more insecure for that half of the population living at or below median household income of approximately £23,000, and indeed all Britons who pay tax at standard rate or below---which is to say, the vast majority.

Moreover, although many Britons considered themselves 'prosperous' before the recession, the shallowness of that prosperity is best judged against the reality of Britain's performance in the past three decades. Amongst EU countries, Britain scores poorly in educational achievement; it accounts for over half of total private indebtedness; its industrial sector is sclerotic and income distribution is one of the most unequal. Nearly a quarter (22%) of the population lives in households at or below the poverty line, a proportion exceeded only by 5 of 27 EU member states. The richest tenth (top decile group) of income earners receives about 30% of total income while the poorest tenth receives only 2%[1]

True, most readers have seen these figures before, but the point is that unless radical measures are adopted by the government, a prolonged recession will make income inequality far worse.

Brown's strategy

To date, the Brown government has followed a three-pronged recovery strategy. First, it has bought massively into the banking system---in effect nationalising it without running it--- in the hope that solvency would quickly be restored and lending would return to normal. Secondly, it has 'persuaded' the Bank of England to cut interest rates, and thirdly, it has adopted the Keynesian fiscal stance of propping up consumer demand by means of a large increase in public borrowing, although the money has been used mainly to finance a cut in VAT. However, propping up the banks has had little effect, and while there have been announcements about loan guarantees for small and medium enterprise (SME), a national scheme for mortgage lending or even (slightly) higher taxes on the rich, there has been more promise than substance in their adoption. In a word, we are still a long way from adopting a programme of radical economic restructuring required to get Britain moving.

Four Principles

Let me suggest four principles upon which a truly social-democratic recovery plan should be based. First, a far bigger fiscal boost is needed for the economy of which the main component should be public investment. Secondly, financial restructuring will require not merely better regulation, but the creation of publicly owned banks and specialised credit institutions. Thirdly, rather than aiming to return to 'business as usual', the core aim of the recovery package must be a greener 'new deal'. Finally, the recovery programme (including its finance) should benefit labour, not capital. Similar principles have already been urged on the incoming Obama administration by a group of eminent economists in the USA;[2] to urge their adoption in Britain is hardly revolutionary.

A bigger fiscal boost

How large a fiscal boost is needed? In a previous Compass piece I argued that the total fall in household net assets (mainly house prices) since the inception of the crisis could reduce private consumption by as much as 8% of GDP by 2010.[3] And there are other reasons for wanting a large fiscal boost, too. For one thing, multiplier effects are likely to be lower in a recession because of consumers' reluctance to spend; for another, as recession bites overseas, the demand for Britain's exports falls, and indeed the current trade gap is widening, not narrowing. UK GDP is currently about £2tr; 10% of GDP over two years (ie, about £200bn in total) seems a sensible target.

Several further quick points suffice to answer the 'bishops' argument'---which has wide resonance---that Britain is already too indebted. First, it is the private sector which is indebted; to pay off its debt it must start to grow again and the only way to stimulate growth is through public 'pump priming'. Secondly, the interest rate on medium to long-term bonds is low and falling---so government borrowing costs less. Thirdly, as everybody should now know, Britain's public debt is a relatively low percentage of GDP. Most important, in the absence of such a stimulus, Britain will forego income for many years and incur the social costs of prolonged recession. The cost of inaction outweighs the cost of action.

New public institutions

What new public institutions are needed? In the housing sector, a number of measures can and must be taken to get things moving. First and foremost, Britain needs a massive investment programme in affordable green housing aiming to build a quarter of a million units a year. If we take the average cost of affordable accommodation to be £100k per unit, the total annual cost of such a programme would be £25bn (well within the £100bn per annum total).

Additionally, we need a People's Mortgage Bank---indeed it is supremely ironic that the British taxpayer now owns Northern Rock, but that the government seems too frightened to turn it into a popular mortgage bank. Along with a mortgage bank, a mortgage guarantee facility should be created; ie, a British 'Home Owners' Loan Corporation' modelled on the US version created by Roosevelt in 1933.

As for the growing number of house repossessions, an immediate policy response (quite possibly to be adopted by Obama in the US) could be to change the law governing foreclosure in a manner which allows home ownership to be assumed by the local authority and gives defaulting mortgage holders the option of renting for 10-20 years; ie, in the extreme case low-income owners would become council tenants. Taking Alan Blinder's model for the US as a point of reference, back-of-the-envelope calculations suggest the cost of the above to be a further £10bn a year over 2 years, bringing the total to £35bn a year.

The government has recently (January 2009) announced plans to guarantee £20bn in credit for Small and Medium Enterprises (SMEs) and this too is vital if the high street service sector is to get through the crisis. True, funds are available both from British and EU sources (eg, the European Investment Bank) for such loans, and Peter Mandelson's new guarantee scheme is not a panacea. In my view the preferred solution would be the creation of a publicly owned bank to lend to this sector. Amongst others, Wolfe and Mercieca at the University of Southampton argued the need for SME banks at EU regional level before the credit crunch.[4] As a simplifying assumption, I shall assume that a successful public sector scheme would cost £30bn over two years, or £15bn per annum.

A green new deal

Turning to public investment and job creation, it is clear that the central thrust of a recovery package must aim at a 'Green New Deal' along the lines set out by the New Economics Foundation here in Britain. Based on research carried out by Robert Pollin's Political Economy Research Institute in the USA, a total investment of £50bn over 2 years would create about 2mn jobs in the short term and a further 500,000 per annum in the medium term. The green component would focus on programmes to improve the energy efficiency of the housing stock through local subsidies for improved insulation and double glazing in the short run, and to reduce transport emissions through investment in public transport in the longer term.

Research funding in green technology would also have an immediate impact on incomes and spending. Other public transport initiatives such as building a main-line high speed rail link (in place of a third runway at Heathrow) would increase real incomes and reduce greenhouse gases in the medium term. For example, lowering the cost of using the bus and tube by means of large subsidies to both fares and infrastructure provision---as practised in most other EU countries---would raise working class living standards and shift more people from cars and aeroplanes to cheaper public transport, thus helping to lower carbon emissions.

In total, a combination of building affordable housing, creating public institutions to finance mortgages, opening an SME bank and undertaking a major UK infrastructural investment programme aimed at achieving a 'green new deal' would inject about £200bn per annum into the economy over two years. Instead of merely bailing out the banks and hoping to return to the status quo ante, the government could move Britain onto a different and environmentally sustainable growth path.

Can we afford it?

To those who claim this is unaffordable pie in the sky, one should make two final points. First, the measures taken to date have neither revived the economy nor much improved the lives of ordinary people. Economics and politics are closely intertwined, and any programme which is not seen to be effective by ordinary people is unlikely to succeed. The legitimacy of the financial bailout programme is already thin; its collapse would rob government of a vital tool for economic reflation. Securing political legitimacy means adopting measures which go well beyond the financial sphere.

Secondly, 'funding' such a programme by cutting unemployment benefit and other social services---as the Shadow Chancellor George Osborne wants---is a contradiction in terms, particularly when there are a number of socially useless or harmful projects crying out to be axed. Below are some approximate figures. The UK could save £12bn per annum alone from axing the following (all expressed in annual costs): ID cards (£3bn); Trident (£3bn); Titan prisons (£2bn); Iraq and Afghanistan (£4bn). Additionally, according to Professor Prem Sikka of the University of Essex, introducing a 50% marginal tax band for incomes above £100,000 could bring in £7bn, and abolishing the NI cap would raise a further £9bn---altogether £26bn per annum. And according to Richard Murphy's conservative estimate, abolishing tax havens and tightening tax loopholes would bring in another £25bn, so there's half the extra annual spending for economic recovery covered already.[5]

The Fifth Principle

Here's the rub, though. A major push to reflate the real economy would come to nothing were there to be another major financial crisis followed by a run on sterling. As Will Hutton rightly says, there is another round of crisis brewing in Britain's financial sector (eg, RBS, Barclay's) which, unless the government acts quickly, could turn Britain into another Iceland.[6] Willem Buiter at the LSE has been putting this argument for years. So here's a fifth point to add to the four set out above. Britain can insure itself against a run on sterling by announcing that it will be joining the euro as soon as possible. In a recent piece for Compass, I set out the advantages and disadvantages of joining and took a cautious position in favour.7

I now think that it's too late for caution. Labour has been dithering for years: we need to adopt a 'Nike strategy'---
Just Do It!.

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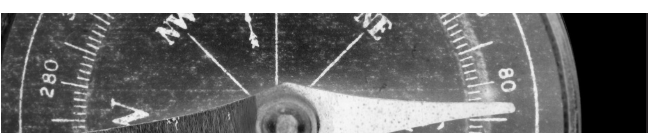
End Notes

[1] See http://www.poverty.org.uk/01/index.shtml
[2] See 'A progressive program for economic recovery and financial reconstruction' Schwartz Center for Economic Analysis, The New School, New York, 31 December 2008.
[3] See http://www.compassonline.org.uk/news/item.asp?n=3503.
[4] See http://economia.unica.it/joomla/images/paper/Mercieca_Wolfe_May07.ppt
[5] See Richard Murphy, 'The missing billions: the UK tax gap' , Touchstone pamphlets, TUC, London, 2008.
[6] See http://www.guardian.co.uk/commentisfree/2009/jan/18/recession-banking
[7] See http://www.compassonline.org.uk/news/item.asp?n=3547



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