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There is an alternative – unlock the surplus

DUNCAN WELDON continues *Red Pepper*'s widely-circulated series of counter-briefings by looking at a real alternative to spending cuts

The coalition government is constantly arguing that 'there is no alternative' to the devastating package of cuts outlined in its October comprehensive spending review – a line last used with such vigour in the Thatcher years. This is often coupled with the claim that 'there is no money left'. Neither claim is true.

Not only is there an alternative, but there is a great deal of money sitting in corporate bank accounts. Unlocking this pool of cash and transforming it into productive investment is an alternative to the savage cuts and the surest route to growth and decent jobs.

The coalition's argument

George Osborne's argument is premised on the notion that Labour massively overspent while in office, and that the recession was somehow the fault of 'big government'. His political case against Labour means that he cannot consider any alternative explanations; in effect his economic choices are guided by his political rhetoric. The clearest demonstration of this is his desire to close the structural deficit in five years – the length of a parliament rather than a timetable guided by economic realities.

Osborne's policy is guided by a theory known as 'expansionary fiscal contraction'. He believes that at present government spending is 'crowding out' private sector investment – so as government borrowing is cut back, private sector investment will step up to take its place, generating growth and jobs.

Crowding out

This 'crowding out' argument takes one of two forms. In the original use of the term, neo-classical economists assume that there is a fixed amount of savings in the economy, and that if he government is taking these savings (through borrowing) then they are not available for the private sector to use to finance investment.

However, this argument only works if the economy is operating at full potential. If the economy is performing very well and employment is high then resources (savings or workers) used by the state might 'crowd out' the private sector. In the current situation, with many resources standing idle (high unemployment, low investment), this argument in fact makes very little sense.

If the private sector wanted to invest, the resources are already sitting there ready for it to use. The government cutting back would just mean even more resources standing idle – in other words, higher unemployment.

In the second sense of the argument there is the more subtle theory of 'psychological crowding out'. This theory claims that investors and entrepreneurs are worried about future taxation. They can see the large government deficit and know that rationally it will have to be reduced, probably by higher taxation, in the future. This creates a great deal of uncertainty and makes them reluctant to invest.

In other words, businesspeople see deficits as essentially 'deferred taxation', and adjust their spending accordingly. This also means that, contrary to a more Keynesian view, deficit spending does not have much effect on demand in the real economy. This argument is known as Ricardian equivalence after the classical economist David Ricardo.

This can lead into the oddly illogical view that 'investors will not invest as they fear that taxes will rise in the future, therefore we must raise taxes now'. And while Ricardian equivalence is a

Campaigning for an alternative: Kenny Bell and Clare Williams of the Northern Public Services Alliance (see page 14)

Unison

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neat theory, there is no empirical evidence that it holds true in reality – despite many studies over the past 30 years.

Canada and Sweden

The coalition and its allies often point to Sweden and Canada in the early 1990s as examples of how 'expansionary fiscal contraction' can work. In both cases the governments slashed public spending while their economies enjoyed reasonably strong growth.

However, not only were the cuts smaller than those planned by Osborne, but in three crucial ways the conditions were different. First, while Canada and Sweden were cutting spending, their respective central banks were also lowering interest rates to cushion the blow. In the UK interest rates have already been cut to 0.5 per cent, so there will not be the same degree of support from the central bank.

Second, while Canada and Sweden were cutting, their currencies were allowed to depreciate, boosting the competitiveness of their exports. In the UK today sterling has already fallen a great deal. It is unclear how much lower it could fall without seriously risking inflation through higher commodity prices for UK consumers.

Finally, both Sweden and Canada were cutting in the context of an otherwise strongly growing global economy. Their trading partners were enjoying boom times and could soak up increased exports from both. The global situation now is very different, with the UK's major trading partner (the EU, with over 50 per cent of UK exports) also embarking on its own cuts. So the Canadian and Swedish examples are not especially strong guides for the UK.

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Is there no money left?

Whenever pushed on the likely success of their budgetary policies, given the background outlined above, coalition supporters often fall back on the line 'but there is no money left'. Essentially they argue that even if their policies are unlikely to succeed they have no choice but to implement them, as there is simply no money to try anything else with. Nothing could be further from the truth.

The corporate surplus

One little-remarked-on feature of the UK economy over the past ten years is the 'corporate surplus'. In a well-functioning economy the difference between corporate profits and corporate investment would be negative – corporates would be borrowing from household savings in order to fund investment.

In the UK, since 2003, the corporate surplus has been growing. In 2009 it reached £64.7 billion – so at the height of the recession, UK-based non-financial companies were making profits £64.7 billion higher than the amount they were investing. By the end of 2009 (the latest available data), UK non-financial corporations were holding cash and bank deposits worth £652.4 billion pounds with UK banks.

Far from there being 'no money left', there is a pot of corporate savings worth more than £600 billion pounds. That's £600 billion held not by banks or financial companies but by the everyday corporations that make up the majority of British business; £600 billion that could be funding vital investment – high-speed rail, social housing, clean technology and much needed infrastructure improvements. The accumulation of such a surplus suggests something has gone horribly wrong with British business.

What is needed

We need a programme of public investment that aims to 'crowd in' this private sector investment. Corporations are sitting on a large pile of cash because they are nervous about an uncertain future – what Keynes called depressed 'animal spirits'. Public investment in infrastructure can 'unlock' some of this surplus.

If, for example, transport links are improved, then companies may be more willing to invest in better-connected areas. Social housing can help attract workers to previously unaffordable locales.

Policies designed to unlock this surplus – whether direct public investment or subsidies to private sector investment in the form of tax breaks conditional on new investment, matched public investment or the like – would increase investment and hence employment, increasing tax revenue and decreasing the welfare bill. This is the surest way to improve growth and reduce the deficit.

There is an alternative – and the money is there to fund it. ■

Duncan Weldon is an economist who has worked for the Bank of England and the Labour Party and now works for a trade union.
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