Would a Corbyn-led Labour government subordinate Finance to the role of servant, not master?

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> "All widespread trade depressions in modern times have financial causes; successive inflation and deflation, obstinate adherence to the gold standard, reckless speculation, and over-investment in particular industries...
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> Finance must be the servant, and the intelligent servant of the community and productive industry; not their stupid master. "
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> National Executive Committee of the Labour Party (June 1944*). Full Employment and Financial Policy.*

UK GDP in 2014 was £1.8 trillion. About £1.0 trillion of that was paid to households in wages or earned by self-employed individuals. Spending on goods and services in 2014 was around £2.5 trillion. But, as the Bank of England explains in a recent report, the total value of payments made through the United Kingdom's domestic payment and settlement systems was far larger — around £245 trillion. The Bank explains that:

> "..this is principally due to all of the buying and selling of assets and other financial market transactions that take place each year. Houses are one example, with around £0.3 trillion bought in 2014. But financial assets, such as shares and bonds, represent a much larger share because they are often bought and sold multiple times in the space of one year."
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> Some assets are physical assets, such as dwellings, which in the United Kingdom are valued at close to £5 trillion (or £180,000 per household, on average). But many are financial assets, such as loans, deposits, shares and bonds. The 'financial system, in this context, is the sum of all the financial assets owned by banks and non-bank financial companies in the United Kingdom. At £20 trillion, it is around twelve times the size of UK annual GDP as measured in the National Accounts."

It is disappointing that in the early days of the new, more radical Labour Party opposition, such little attention is paid to the finance sector as represented by the City of London. This is especially so given the very recent Great Financial Crisis of 2007-9, the Party's own history, and the deluge of financial transactions that with increasing frequency, overwhelm, upend

and disrupt the British economy. Instead Jeremy Corbyn's new Treasury team are narrowly focused on the tiny share of the economy taken up by British households and firms. This is surprising because even orthodox economists, Carmen Reinhart and Kenneth Rogoff concede in their book *This Time is Different* that:

> "Periods of high international capital mobility have repeatedly produced international banking crises. Banking crises almost invariably lead to sharp declines in tax revenues as well as significant increases in government spending…On average, government debt rises by 85% during the three years following a banking crisis. These indirect fiscal consequences are thus an order of magnitutde larger than the usual costs of bank bailouts" [i]

To be fair, John McDonnell the Labour Shadow Chancellor has identified Britain's "extraordinarily concentrated banking sector" as not serving customers properly, particularly small businesses, and has proposed

> "a network of regional and local banks, in tune to the needs of their local businesses and communities."

However there remains an apparent blind spot for the larger issue - London's globalized finance sector, whose links to "local businesses and communities" are increasingly remote. This has meant that the Shadow Treasury team avoids discussion of the role the finance sector has played in the periodic crises that have damaged "local businesses and communities" since the liberalization of finance in 1971, and worsened the public finances. That financial revolution occurred as Duncan Needham and others have documented, when monetary policy was transformed by the 1971 Competition and Credit Control (CCC), and by subsequent financial de-regulation. ii

Under pressure from sections of the Parliamentary Labour Party and also by some on the Left, John McDonnell seems to have bowed to a flawed Conservative Party narrative based on the assertion that Labour government ministers (and not the finance sector's collapse) were responsible for the rise in public debt and the increase in annual deficits after 2009. As a result, so the argument goes, Labour cannot be trusted to manage the public finances. In response, McDonnell has promised to "rewrite the rules":

> "Rewriting the rules today means three things. First, an absolute commitment to responsible financing by a future Labour government. The old rules meant relying too much on tax revenues from financial services, and too much on expensive funding schemes like PFI. We didn't do enough to clamp down on tax avoiders. We should show how we can account for every penny in tax revenue raised, and every penny spent. There is nothing left-wing about ever-increasing government debts, or borrowing to cover day-to-day expenses. Borrowing today is money to be repaid tomorrow." [iii]

It is my view that such a limited approach to the public finances will not restore public trust in Labour. For that to happen requires an honest appraisal of New Labour's misguided attachment to "unavoidable globalisation" (to quote David Blunkett MP [iv]) and with it to a commitment to the unfettered movements of capital, trade and labour. This approach was augmented by a New Labour's commitment to 'light touch regulation' of the City of London. [v] Finally, it requires the development of an economic strategy that will restore stability to Britain's financial system, and that will subordinate the finance sector to the interests of the wider economy, both private and public.

To begin to restore trust, the Corbyn-led Shadow Treasury team should embark on a straight-talking engagement with the British public about the role of the finance sector in the financial crisis and the impact of that crisis on employment, wages and earnings – above all on the public finances. Labour's economic credibility can only be rebuilt if the party produces a sound analysis of both causes of periodic financial crises, and their impact on employment, wages, earnings – and government debt.

It is important to note that from the end of the 2nd World War till the 1970s, the current budget was indeed always in balance, while in most years the investment budget was loan financed in part (around 2% of GDP). But that was because the economy – and finance sector in particular - *was servant, not master of the economy*, and was managed to ensure full employment, prevent inflation, economic volatility and financial crises. Unemployment was maintained at low levels, and economic activity (measured in GDP) increased more rapidly than in the current era of liberalised finance (as Messrs Rogoff and Reinhart have shown in their famous book: *This Time is Different.* [1])

The failure to address increasingly recurrent financial crises and their role in unbalancing the public finances, means that the Corbyn-led Shadow Treasury team have conceded the neoliberal interpretation of events – that a Labour government was directly responsible for the rise in public debt. That prognosis led to the introduction of a 'fiscal rule' by Shadow Chancellor John McDonnell based on work by Professor Simon-Wren Lewis and Jonathan Portes. [vi]

Before going further, let me stress that I understand the political context in which the new proposed Fiscal Rules are made: the pressures from the right of the Labour Party (where the new rules have been welcomed); from the government; from the media (the FT approves because as Chris Giles, their chief economics correspondent tweeted, 'they are orthodox'); and from a neoliberal economics profession. Above all there is the challenge of widespread public misunderstanding (deliberately and repeatedly

indoctrinated by this government, but also by economists) that government finances resemble household budgets, and can be fixed the way household budgets are 'balanced' to allow the household to 'live within its means'.

These are major obstacles to the communication of sound economic analyses, policies and a strategy for future management of the economy – but they must be overcome if Labour is to regain economic credibility with the British public. Above all, they must be overcome if Jeremy Corbyn is to retain the support of the widespread anti-austerity movement that catapulted him into the leadership.

Where should Labour's emphasis lie?

Jeremy Corbyn's statement, when as part of his bid for the leadership, he launched a paper "The Economy in 2020" - was sound:

> We all want the deficit closed on the current budget, but there was no need to try to do it within an artificial five years or even the extra five years George Osborne mapped out two weeks ago.
>
> If the deficit has been closed by 2020 and the economy is growing, then Labour should not run a current budget deficit – but we should borrow to invest in our future prosperity.

This places the emphasis where it should be – not on the deficit as an end in itself, but on the state of the wider economy. After all, the deficit is largely a function of the state of the economy. Is the economy working at, or near full capacity? Do we have genuinely full, skilled, well-remunerated employment? Is the private sector investing and flourishing? Fiscal management should take these questions as the start point and end point. This might mean reducing overall public spending, if the economy is overheating. But it will mean that government should spend more if the economy as a whole, and the private sector in particular, are operating below full capacity. And a Labour government should always take action to restore full employment and economic stability.

Today, the economy is still operating far below full capacity. Real wages are 5% below the level they were in 2008. Unemployment is still 1.7 million – which once upon a time would have seemed enormous. Insecure, under-employment and casual labour are rife. We have a vast overhang of private debt, a banking system that is effectively broken, and Britain has for a year tottered on the edge of deflation. We face the likelihood – confronted by previous Labour governments - that when Labour returns to power the economy will be in poor shape. Indeed a Labour government is most likely to come to power after the next grave financial crisis. We must therefeore anticipate a downturn during the first years of a Labour government, and have principles or rules that give appropriate responses for the benefit of the economy.

The 'Household' or 'Housekeeping' analogy

If Labour is to build on the support that powered Jeremy Corbyn to the leadership, it is important first, to reframe the debate away from the 'household', 'basic housekeeping stuff' and 'credit card' analogies because they have misled the public, hugely damaged public services, worsened public finances and had disastrous electoral consequences for Labour.

When the economy is fragile (as it has been since the 2007-9 financial crisis) the analogy is even more dangerous.

Labour should therefore be contesting as forcefully as possible the household analogy as a) wrong and b) disastrous in practice. We (Professor Victoria Chick, Geoff Tily and myself) have been making this case (in *The Economic Consequences of Mr Osborne*) since 2010.[vii] We have not found it difficult to communicate the argument in the media, or at public meetings. And we have been thoroughly vindicated.

Fiscal rules

We should note in passing that the history of 'fiscal rules' dates back to Henry Simons's (of the Chicago School) 1936 article, 'Rules versus Authority in Monetary Policy'. Simons was a neoclassical economist, and advocated 100 per cent reserve banking, removing the ability of banks to create 'money' through the process of credit creation. As David Smith explains in his excellent history of Thatcherism, *The Rise and Fall of Monetarism,*

> "Milton Friedman took on the Simons idea of 100 per cent reserve banking and allied to it a proposal for stabilization through fiscal policy. In contrast to the Keynesian approach, Friedman said that governments should stick to pre-arranged plans for stable public spending, allowing all the adjustment to come through government revenues. In an economic downturn, at fixed tax rates, a fall in

> revenues would produce a budget deficit. Because of the 100 per cent reserve banking system, this would produce an increase in the money supply, which would push the economy back towards a stable growth path. An economic boom would produce the opposite situation of the budget surplus, monetary contraction, and move back down to stable growth." [viii]

So Milton Friedman is to be credited with the idea of the management of fiscal policy based on strict rules rather than discretion. "The later Chicago emphasis was on the impotence of fiscal policy, and the primacy of monetary policy" writes Smith.

The evidence that fiscal rules improve macroeconomic outcomes is thin, especially in developed economies and states with well-established institutions, like the UK. While fiscal rules may lead to lower expenditure, they are also just as likely to lead to a worse economic performance – as we have seen with the Eurozone. Moreover, in line with orthodox economic thinking, they shift responsibility for the economy from democratically elected politicians to technocrats, while at the same time restricting economic policy choices. The Eurozone's current social upheavals reflect the political consequences of a transfer of vital policy-making from the democratic to the technocratic domain.

Second any fiscal rule invites the 'what would you cut?' question, as has indeed happened to John McDonnell in post-Budget interviews. The (correct) answer to this question should be that cutting has not worked, followed up by an assault on economic outcomes and then into the above argument in positive form. Nor should Labour be tempted into the question of how to fix the 'fiscal black hole in public accounts'. The 'fiscal black hole' exists as *a consequence* of George Osborne's failed economic strategy. It cannot be 'fixed' without fixing the economic strategy.

Labour's fiscal rule

First, may I emphasise that I regard the aim of a surplus on the current budget as a commendable ambition. The points below are not opposed to the achievement of a surplus, but are based on the recognition that *any surplus will only be achieved through a change in economic strategy.* In other words, the achievement of a current budget surplus puts the cart before the (economic strategy) horse.

Second, I do not defend the 'deficits forever' argument associated with some academic economists. Public spending in the argument outlined in this paper will reduce the current budget deficit and lead to a surplus, which will then reduce the government's overall debt.

Third: current and capital spending both work to improve an under-performing economy – thanks to the multiplier - and have obvious political advantages (NHS investment, local authority funding etc.)

Fourth: a Labour government's decision about spending must surely be based on an assessment of spare capacity (under- or unemployment, the output gap, falls in income) in the economy. The notion of spare capacity seems to have been dropped from the argument for, and debate about, a fiscal rule. Given zero inflation there is bound to be spare capacity within the British economy.

Fifth: the multiplier does not seem to feature in debates – even though the IMF and the OECD have tried hard to revive discussions about the multiplier.

I question the assumptions in the Simon Wren-Lewis and Jonathan Portes Oxford University Discussion paper that is apparently the basis of the new fiscal rule.[ix] In that paper the authors argue that "it is the things that influence debt that matter, *like taxes and government spending*." "Government" the authors argue "should as far as possible smooth taxes and its recurrent consumption spending". I would ask the following explicitly. Where does the output gap and multiplier fit into Portes and Wren-Lewis thinking? I disagree with the authors that spending and taxes are the only "things that influence debt". Instead to repeat, I (and many others) believe that the most important influences on government debt are:

a) monetary and debt management policy (the rate of interest at which government can borrow and the issuance of gilts by the Debt Management Office)

b) the multiplier and net revenues generated by increased spending and associated increases in incomes

c) the amount of spare capacity (the output gap) which at times of private sector weakness, only government spending can address

John McDonnell's fiscal rule

The draft fiscal rule that John McDonnell announced on 11th March is in three parts:

- *A commitment to always eliminating the deficit on current spending in five years, as part of a strategy to target balance on current spending over a target five-year period.* This explicitly excludes investment, which, John said "raises the growth rate of our economy by increasing productivity as well as stimulating demand in the short term."

- *To ensure that the Government's debt is set on a sustainable path, we will commit to ensuring that, at the end of every Parliament, Government debt as a proportion of trend GDP is lower than it was at the start.*

Thirdly, and to deal with serious crises, "if conventional monetary policy again becomes constrained by hitting a lower bound as it did after the global financial crisis, we understand when fiscal policy has to take some responsibility." Therefore:

- *For as long as monetary policy is unable to undertake its usual role due to the lower bound, to suspend our targets so that monetary and fiscal policy can work together.*

Rather than an arbitrary cut off for GDP forecasts, we will suspend our rule in the circumstances when it is clear that fiscal policy needs to work together with monetary policy to get the economy moving again.

On the first point: I appreciate that – unlike the government's present fiscal rule, McDonnell's provides room for the loan financing of investment. (I would like to see a long-term (gross) investment programme of at least 5% per year of GDP, to help prepare the country for the great challenges of the future – e.g. the huge task of transforming the economy away from fossil fuels, managing climate change and adapting to the digital economy…)

As noted above, the biggest driver of current budget deficits has, since the 1970s, not been extravagant government spending, but financial liberalisation and deregulation, which led to recurrent economic and financial crises – in Britain and in all OECD economies. And when the financial crisis erupts, it is the current budget that gets unbalanced, however prudent the government.

On distinctions between current and investment budgets

There is no sharp economic or practical division to draw between the current and investment budgets, even if government accountants find the division useful for some purposes. As has often been pointed out, most investment in "human capital" – in the form of teachers and lecturers, for example – counts as current spending even though it is very much geared to the long-term economic viability of both individual and society. And even though the multiplier ensures that such spending pays for itself – within a very short time.

I am therefore concerned to see Labour proposing a rule that draws such a sharp line, when the needs of the economy at different times may call for different forms of and priorities for investment.

In order to commit to eliminating any current budget deficit over a 5-year period, there are in fact different routes to choose from. It may be (probably will be) necessary for an incoming Labour government to adopt an economic strategy that aims to expand overall economic activity, which may mean that far from cutting government expenditure, it needs to expand at least initially. However, the general impression from the rule as stated will be

that Labour will again try to cut its way to "balance the books" – an impression reinforced by the reference to not adding "rent on the credit card" metaphor John McDonnell employed when launching the rule.

The second commitment comprised within the rule is that, by the end of each Parliament, "Government debt as a proportion of trend GDP is lower than it was at the start". Similar points arise – if trend GDP is positive, then nominal debt should indeed decline as a proportion of GDP. But if there is any significant adverse economic disturbance during the life of a Parliament, then this commitment will either not be capable of being met, or could involve severe counter-cyclical contractionary measures in order to try to achieve it. A Labour government will have set this trap for itself.

The proposed escape clause, in case of a major crisis, is that "for as long as monetary policy is unable to undertake its usual role due to the lower bound, to suspend our targets so that monetary and fiscal policy can work together." The rule explicitly excludes its suspension based on the "arbitrary cut-off" of GDP forecasts.

For me, this escape clause is likely to be inadequate in practice, and is wrong in principle. Monetary and fiscal policy should always work together. It was David Cameron that declared he was a "monetary radical but fiscal conservative". As a result of this skewed approach, the post-2008 financial crisis world is indeed that of the zero lower bound, with central banks taking on much of the responsibility for trying to right the economy – and failing – despite desperate and increasingly extreme measures. Many have pointed out that 'monetary radicalism and fiscal conservatism' has led to a conflict between (expansionary) monetary policy and (contractionary) fiscal policy.

But Labour cannot count on future crises and recessions to lead monetary policy to the historically exceptional "lower bound." One other occasion on which a government incurred major deficits for several years, was under John Major's government, when inflation was high, unemployment soared and central bank rates remained elevated throughout. Yet under the proposed fiscal rule, in similar circumstances a Labour Government would have no room for fiscal policy to take on the burden as the private sector weakens, if to do so would lead to a higher debt to GDP ratio or current budget deficit.

In all other respects, the present government and Chancellor's fiscal rule is much worse, from a macroeconomic perspective, than John's. But the fact that Osborne's rule can be abrogated if GDP has declined or *is likely to decline significantly* (in his case, to 1% or lower annual 'growth') is an advantage, not a disadvantage.

My final comment on Labour's rule as drafted is this. Yes, fiscal and monetary policies should work together for the common benefit – but that means that fiscal policymakers must play their role. The tendency to

outsource what should be democratic choices by elected governments to the technocratic sphere – of central banks – is harmful to our democracy and to society, as the rise of populist politics in the Eurozone attests. Technocratic controls over public policy lead to a sense that citizens cannot influence policy or outcomes – which in turn leads to disillusionment with politicians and the political process. And it is disillusionment with 'business as usual' politicians that fired public enthusiasm for the election of Jeremy Corbyn. It would tragic if that support was dissipated by Labour's renewed attachment to neoliberal fiscal rules.

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[i] Reinhart and Rogoff, p.205 *This Time is Different* Princeton University Press, 2009.

[ii] Duncan Needham p. 3 *Introduction to UK Monetary Policy from Devaluation to Thatcher,1967-82*: Palgrave MacMillan, Studies in the History of Finance 2014. CCC "swept away the restrictions on the largest counterpart of the broad money supply, bank lending to the private sector, that had been in place for much of the 1960s. Henceforth, bank lending would be controlled on the basis of cost, that is, through interest rates. Loans would be granted to those companies and individuals that could pay the highest rate rather than to those that fulfilled the authorities' qualitative criteria within the overall quantitative restrictions imposed on the banks. By allocating bank credit competitively 'on the basis of cost', CCC replaced years of credit rationing 'by control'....Out went the restrictions on lending to less-favoured sectors and ceilings on bank advances. In came the 'interest rate weapon' – more active use of Bank Rate to control the broad money supply."

[iii] John McDonnell speech on Labour List, 11 March, 2916: McDonnell promises to Balance the Books with Fiscal Credibility Rule. http://labourlist.org/2016/03/mcdonnell-promises-to-balance-the-books-with-fiscal-credibility-rule/

[iv] David Blunkett in an interview with the BBC Radio 4 Today programme, 26 May, 2016.

[v] See Gordon Brown's Mansion House speech 21 June, 2006. https://www.theguardian.com/business/2006/jun/22/politics.economicpolicy

[vi] Simon Wren-Lewis and Jonathan Portes *Issues in the design of Fiscal Policy Rules*, May, 2014. http://www.economics.ox.ac.uk/materials/papers/13342/paper704.pdf

[vii] Victoria Chick, Ann Pettifor with Geoff Tily *The Economic Consequences of Mr Osborne.* Published by Policy Research in Macroeconomics (PRIME). July 2010 (revised February 2011) including new March 2016 preface

[viii] David Smith, p. 13 *The Rise and Fall of Monetarism*, Penguin Books, 1987.

[ix] Professor Simon Wren-Lewis and Jonathan Portes: *as above.*