

George Irvin asks: Can we spend our way out of recession?

Thursday, November 13 2008

Tags: [banking](#) | [capitalism](#) | [credit crunch](#) | [economy](#) | [government](#)



The question isn't rhetorical. 'Yes, we can' is the simple answer, and likely to remain so. But it's not as easy as some seem to suggest, particularly on the left. As Mervin King seems at last to have realised, the danger facing Britain (and indeed the EU) is not inflation but deflation; ie, a falling general price level. As he said in a statement on 12 November, "It's highly likely that the retail prices index will go negative next year ...". He added that the Bank of England's (BoE) base rate would probably have to be cut by a further 1.5 percentage points to stop this happening.¹ That's the lowest level ever, and it's because he (and the MPC) believe that we face what is possibly not just the worst banking crisis since 1929, but the worst of all time.

Deflation---a falling general price level----is what turns a recession into a full blown slump. Consumers postpone consumption, and with aggregate demand falling, entrepreneurs postpone investment. Moreover, a given nominal interest rate rises in real terms as does the real value of debt. The paradox of thrift means that the more the private savings grow, the more difficult it becomes to kick start growth. During the 1930s, despite the best efforts of Roosevelt's New Deal, prices fell and the US economy remained stagnant. It took the war and rearmament to get the economy moving again.

The same has been broadly true of Japan in the past two decades. Because the Bank of Japan (BoJ) dithered for well over a year after the property bubble bust at the end of 1989, deflation took hold. It took a full decade for the BoJ to adopt a policy of quantitative easing; ie, selling enough long-term bonds to push nominal interest rates close to zero. In the absence of quantitative easing, eleven supplementary budgets between 1992 and 2002 had only temporary impact; today, gross public debt stands at

¹ See Julia Kollewe and Mike Wearden 'UK recession to be deeper and longer than feared, Bank of England warns' *The Guardian*, 12 November 2008.

180% of GDP, economic growth is erratic, deflation has not yet been overcome and consumer confidence remains shaky.²

Once consumers postpone their spending, it's very hard to boost aggregate demand permanently by means of fiscal spending. Japan's economy has survived in recent years by Asia's growing appetite for its exports. But in today's climate, demand is contracting on a world-wide basis. That's why Gordon Brown is so keen to co-ordinate reflationary policies between the main players.

In Britain, what we are experiencing at the moment is a race between cutting interest rates and falling into the deep liquidity trap of deflation. It is of course quite true that monetary policy must be supplemented by expansionary fiscal policy, but only once monetary policy has worked. In the US where the federal funds target has been lowered to 1%, there is a massive accumulation of reserves in the Fed and the banking system because banks are still not lending to each other. Equally, there is a danger that Fed reserves will grow rather than being lent.³ In short, there are worrying signs that monetary policy at present is being poorly managed.

Brown and Darling have talked a good game over mortgages, forcing most of the banks to lower their rates by a full percentage point---but it does not follow automatically that credit will expand. Unless the banks actively expand lending rather than merely using extra funds to boost their balance sheets, they will have to be fully nationalised. Brown may well live to regret his assertion that government is not in the business of running the banks.

Now, assuming that the monetary part of the reflationary strategy works---a strong assumption---what needs to be done fiscally? Can we 'afford' to cut taxes, and if so what should be cut and how should it be paid for? George Osborne has spoken for the Tories;

² An excellent book on the crisis explaining the relevance of the Japanese case is Graham Turner (2008), *The Credit Crunch*, London: Pluto.

³ See ft.com, Alphaville, 'Fed capitulates; the central bank is broken' 12 November 2008.
<http://ftalphaville.ft.com/blog/2008/11/06/17903/fed-capitulates-the-central-bank-is-broken/>

they want to pay employers to create jobs while ‘funding’ the cost by lowering unemployment benefit. US and Canadian experience suggests that this is a very inefficiency way of creating jobs (2 out of 3 jobs would have been created anyway), and happens at the expense of those who can least afford it.

The notion that a fiscal stimulus must be funded is of course questionable. When deflation threatens, there’s a good case for monetising the deficit; ie, printing money. However, let’s assume we borrow instead. There are two orthodox arguments against ‘unfunded’ borrowing. First, so-called ‘Barro-Ricardo equivalence’ says that consumers will treat unfunded borrowing as a future tax liability and increase savings accordingly, thus negating any expansionary effect of public spending financed by borrowing. In essence, this argument depends on rational expectations theory, popular in the 1980s but now largely abandoned. The more serious argument is that unfunded borrowing ‘crowds out’ private investment by pushing up long term interest rates. There is some truth here, which is why it is argued above that expansionary fiscal policy must be conditional on rapid monetary easing.

My own prediction is that the MPC will target a 2% base rate before Christmas and that one way or another, banks will be forced by government to expand cheap lending.

There is, however, a quite separate argument for funding expansionary fiscal policy; namely, that recession and unemployment increase distributional inequality and that the matter should be addressed now. As a study by the IFS has shown,⁴ Britain is unique amongst OECD countries in having experienced a 10 point increase in its Gini coefficient in as many years under Thatcher, a situation which has not improved since 1997. Overall tax incidence in the UK is regressive. Indeed, tax incidence is worse in the UK than in the USA under Bush.⁵

⁴ See Brewer, M., Sibieta, L. and Wren-Lewis, L. (2008) *Racing Away: Income Inequality and the Evolution of High Incomes*, London: Institute for Fiscal Studies; <http://www.ifs.org.uk/bns/bn76.pdf>

⁵ See Schmitt, J and V Navarro (2008) ‘Flat tax fever’, Paper presented at the conference on "Crítica y crisis del diseño del sistema tributario y del modelo de gasto público en España en la era del trabajo cognitivo, 1997-2008", El Escorial, Spain, July 14-18, 2008

That is why fiscal policy should concentrate on two things: first, injecting purchasing power into the economy where it's most effective and most needed; it's most needed in the lower half of the income distribution which, because the poor spend a higher proportion of their income, it's most effective. Secondly, in the longer term, taxation must be reformed so that rich individuals and corporations pay their fair share.

Boosting effective demand can be done in a variety of ways. As Prem Sikka has argued, government could increase personal allowances significantly at relatively little cost, or again it could focus on pensioner poverty by boosting Britain's state pension, currently the meanest in the EU.⁶ Such spending could be financed by a levy on the super-profits of the oil and gas companies, and in the longer term by forcing derivative transactions into an exchange (ending OTC transactions); a small turnover tax on such transactions would bring in vast sums. Or again, the TUC estimates that the Treasury could gain up to £40bn annually in extra revenue simply by closing loopholes in corporate taxation and closing tax havens---'secrecy jurisdictions' in Richard Murphy's phrase. Other fairly obvious measures include reforming Council Tax, making National Insurance Contributions progressive over the full income range, closing the gap between income tax and capital gains tax and undertaking a wide variety of social, infrastructural and environmentally sustainable investment. In short, there is no 'funding constraint' on injecting extra purchasing power into the economy.⁷

To repeat, yes we can spend our way out of recession, but two broad caveats apply. First, as recent Japanese experience clearly demonstrates, monetary policy must be used to ensure that we do not fall into the deep trap of deflation. Secondly, if purchasing power is to be injected into the economy, let it go to those who most need it and where it will be

⁶ See Prem Sikka, 'Making tax cuts work' Comment is free, The Guardian, 12 November 2008; <http://www.guardian.co.uk/commentisfree/2008/nov/12/recession-taxandspending>

⁷ For a comprehensive discussion, see Byrne, D and S Ruane (2008), 'Changing tax rates in the current crisis: A possible scheme for transforming the household tax take in the UK so as to be both equitable and progressive and at the same time increase effective demand' Compass Thinkpiece (forthcoming). Also see Larry Elliot, 'We just can't afford tax cuts' The Guardian, 12 November 2008, who argues that the quid pro quo for tax cuts must be taxing the rich and scrapping wasteful government programmes such as Trident and ID cards.

most effective---and let it be paid for by those who are part of the problem and now need to contribute to its solution.

George Irvin, University of London, SOAS