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Policy Paper

Fiscal austerity: *The 'cure' which makes the patient worse*

Prof Malcolm Sawyer

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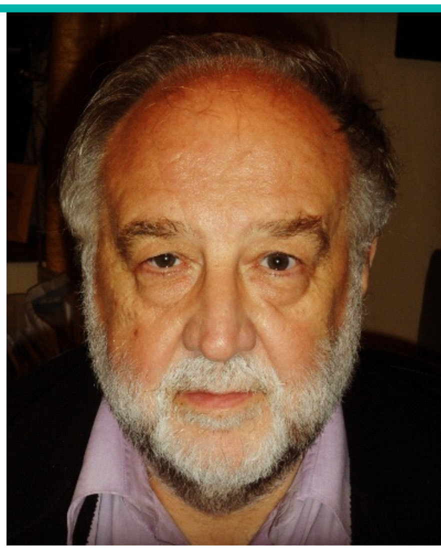

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Executive Summary

Fiscal austerity and cuts in public expenditure do not work – there is a limited, if any, effect on reducing the budget deficit, and any return to prosperity is severely undermined. The reduction of the budget deficit can only come from a revival of private demand which is harmed by an austerity programme. Deficit reduction requires investment programmes and reduction of inequality to stimulate demand.

The arguments of the Coalition government for austerity are entirely spurious. It is cuts to investment in education, health care, and elsewhere and toleration of unemployment which burdens future generations, not the public debt. The budget deficit can be funded as the private sector is saving much more than it is investing, and the deficit is caused by excess of savings over investment and not by government profligacy.

It is the 'jobs deficit', and not the 'budget deficit', which should be at the centre of policy concerns. The 'jobs deficit' has to be addressed through the appropriate stimulation of demand and employment creation programmes. Higher investment, especially green investment, would help rebuild the productive potential of the UK economy which has been badly hit by the financial crisis. Reducing inequality and raising low wages would also stimulate demand. These policy approaches, highly beneficial and advantageous in their own right, would reduce both the 'jobs deficit' and the 'budget deficit'.

Why, when there are unemployed resources, and when there are human needs to be satisfied, cannot the unemployed be employed to produce goods and services which will help satisfy human need? Why is the response to the decimation of the private sector by the financial crisis to decimate the public sector to maintain some kind of 'balance' between the two sectors? Why is not the response to build on the strengths of the public sector, preserve its potential, and seek to re-build the private sector devastated by the financial crisis?

The austerity programme is economically irrational, socially irresponsible, and lacks credibility that it can reduce the budget deficit and secure any return to prosperity.

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Introduction

Fiscal austerity is the sceptre which haunts Europe. It threatens to destroy substantial parts of the public sector and lead to high levels of unemployment for years to come. Fiscal austerity is the problem not the cure, and as a supposed cure it will not work in substantially reducing budget deficits yet will reduce employment. Budget deficits will only fall when there is a revival of demand, and cutting public expenditure reduces demand.

The Coalition government has put out many arguments on why the budget deficit must be cut and why there have to be cuts in public expenditure – all of them are spurious and have to be rejected. The major macroeconomic issue is not the budget deficit but the jobs deficit, and policies should be judged by their contribution to reducing the jobs deficit. The purpose of budget policies should not be some ill-fated attempt to have a balanced budget but should provide high quality public services and underpin high levels of demand to secure full employment. The attention should now be on stimulating private and public investment and of reducing inequalities of income to promote economic growth, which will aid a reduction of the budget deficit.

Austerity – why it does not work

> ***"There has never been any successful austerity program in any large country,"***
>
> ***"Decreasing growth is causing the deficit, not the other way around. I think that austerity approach is going to lead to high levels of unemployment that will be politically unacceptable and make deficits get worse,"***
>
> *Professor Joseph Stiglitz, former World Bank and Nobel Prize winning economist[1].*

> ***"What's wrong with the prescription of spending cuts as the remedy for Europe's ills? One answer is that the confidence fairy doesn't exist — that is, claims that slashing government spending would somehow encourage consumers and businesses to spend more have been overwhelmingly refuted by the experience of the past two years. So spending cuts in a depressed economy just make the depression deeper"***
>
> *Professor Paul Krugman, Nobel Prize winning economist .*

Austerity, and specifically cuts in public expenditure and increases in tax rates at a time of low economic activity and high unemployment, leads to lower economic activity and higher unemployment. Austerity does not work – it does not lead back to prosperity.

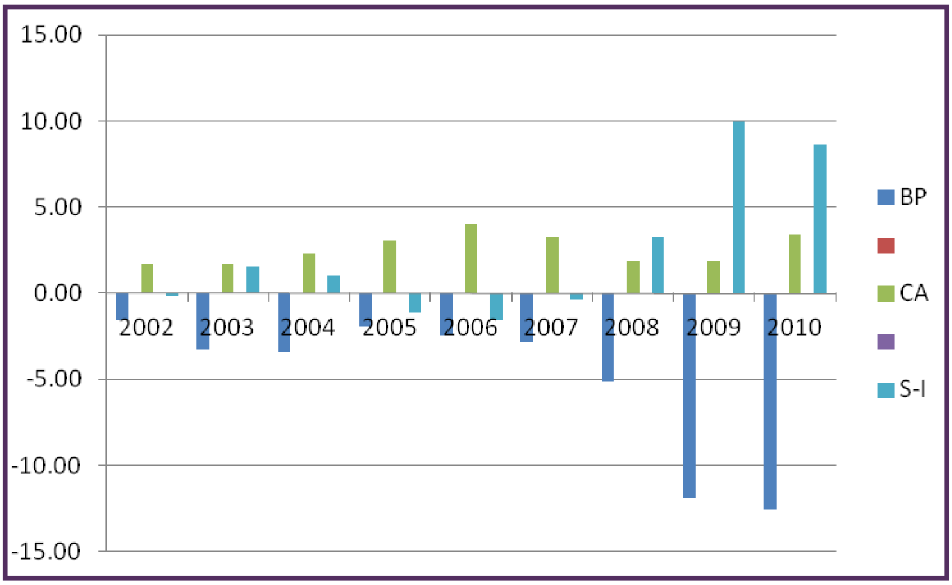
When we say austerity does not work, we mean that austerity does not lead to the reduction in budget deficit on the scale envisaged (as we indicate below, the reduction in budget deficit is likely to be of the order of at most one third of the reduction in public expenditure). Austerity does not cause a revival in the economy. Austerity will not bring growth, though growth will bring a lower budget deficit. If growth of private sector demand revives, then the budget deficit will decline. But austerity itself does nothing to bring about that revival of private demand, and indeed is more likely to hold it back. When Nick Clegg says that "Austerity alone does not create growth…It is a necessary but not sufficient step"[2], he is wrong – austerity kills growth, and is certainly not necessary.

It is self evident that one person's borrowing is another person's lending. The key relationship is that public sector borrowing is equal to private sector net lending plus lending by overseas. The borrowing by the public sector is the difference between its (tax) revenue and public sector expenditure (current, capital, transfer payments and interest on debt). The private sector net lending is the difference between private savings (by households and corporations). The lending by overseas (and hence borrowing by the UK) is the capital account inflow and is equal to the current account deficit. Figure 1 overleaf shows some relevant statistics for the UK for 2002 through to 2010, and it is not coincidental that the three bars in the first part of Figure 1 for each year would sum to zero – that is assured by the national income accounting system.

The story told in Figure 1 is well-known – the collapse of investment and the rise in savings (reflecting fall in consumer expenditure) following the financial crisis lead to a large rise in the budget deficit. The rise in the budget deficit helped to cushion the depth of the recession as the 'automatic stabilisers' and some rather limited discretionary increases in public investment and temporary reductions in tax rates came into effect. A less familiar story is also evident from Figure 1 that the bulk of private savings is made by corporations and relatively little by households. It is also evident that corporations persistently have been saving more than they have been investing, whereas the household sector (which includes unincorporated businesses) have been investing more than they have been saving.

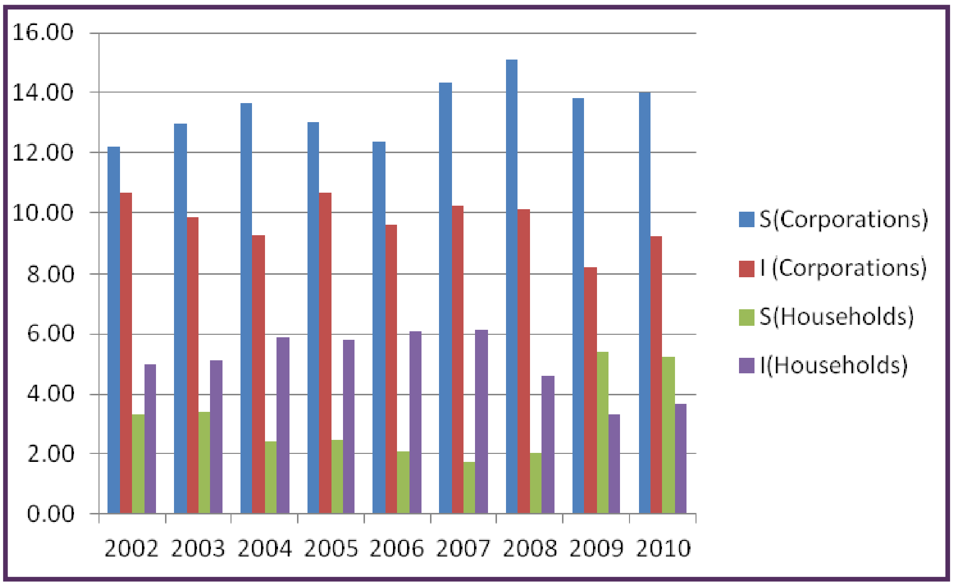
Figure 1

Budget position, capital account and net savings as per cent of GDP



BP = budget position (negative = deficit); CA = capital account inflow (=current account deficit); S – I private savings minus private investment: all expressed as per cent of GDP.

Savings and investment by corporations and by households (per cent of GDP)



Source: Calculated from National Income Blue Book, 2011

The important story to be told from the relationship portrayed in Figure 1 is that:

Budget Deficit = Private Savings – Private Investment plus Capital inflow

A budget deficit can only decline if it is accompanied by some combination of lower savings, higher investment and lower capital inflow (which in turn corresponds to smaller current account deficit with an increase in exports relative to imports). There are then two ways to try to reduce a budget deficit, austerity or stimulating public demand.

The first is the route of austerity which depresses employment and income, and then savings and imports fall as income falls. This route is fraught with difficulties as tax revenues fall and hence budget deficit falls less than anticipated, and investment is discouraged. The result is economic misery and a small reduction, if any, in the budget deficit.

Yet, in contrast to the Stiglitz quote above, there are those (for example, Alesina and Ardagna, 2010) who argue for ‘expansionary fiscal consolidation’. This asserts that in seeking to reduce a budget deficit by reducing government expenditure and raising tax rates, this will lead to not only deficit reduction by output, but also employment expansion. Indeed the Coalition government’s approach is based on this. It is somehow assumed that austerity brings the return of the ‘confidence fairy’ (to use Krugman’s phrase).

There are examples which at first sight appear to support this case, in that a government sought to reduce the budget deficit and was successful in doing so and this was accompanied by returning prosperity. But, at closer inspection, these cases owed much to a combination of good luck and devaluation of the currency of an economy heavily engaged in international trade. A good example of this is the case of Ireland in the late 1980s.

Tightening of the government budget went alongside the 'Lawson boom' in its major trading partner so exports boomed (see, for example, Kinsella, 2012), and the deficit could be reduced as output rose. However, the cause of the rise in output was a boom in exports.

The second route is to stimulate private demand whether it's through consumer expenditure (tax cuts), investment or exports. In the short-term these measures may well appear to increase the budget deficit—tax cuts for example, but as a matter of simple arithmetic, higher investment, higher consumer expenditure and higher exports will lead to lower budget deficits.

Analysing the Coalition's arguments for austerity

The Coalition Agreement between the Conservative and Liberal Democrats "recognise[d] that deficit reduction, and continuing to ensure economic recovery, is the most urgent issue facing Britain". It committed to "significantly accelerate the reduction of the structural deficit over the course of a Parliament, with the main burden of deficit reduction borne by reduced spending rather than increased taxes" with a plan for deficit reduction to be set out in an emergency budget which followed in June 2010 (Cabinet Office 2010, p.15). Deficit reduction and fiscal austerity have been central to their economic policies. Various justifications and rationales for fiscal austerity have been advanced by the Coalition government, though all of them have been used many times in the past and been proved wrong[3]. The justifications and rationales do not hold water.

'Debt burden on future generations'

> ***"I actually think we have a moral duty to the next generation to wipe the slate clean for them. We have set out a plan - it lasts about six or seven years - to wipe the slate clean to rid people of that deadweight of debt that has built up over time."***
>
> *Nick Clegg, May 2012[4]*

A deficit does, of course, lead to borrowing and a rising debt (though not necessarily relative to national income). A key feature of government borrowing is that while government bonds are a debt of the government they are an asset of those who acquire the bonds. The interest on government debt is in effect a transfer from one group (tax payers) to another group (bond holders). Currently a quarter of government bonds is held by the Bank of England, a quarter by pension funds, a quarter by private individuals, and a quarter by foreigners. The historic experience has been that the government has borrowed more each year than the interest payments on past debt – the government borrows from one set of rentiers to pay interest to another set of rentiers.

It is austerity itself that imposes major and real burdens on future generations (as well as on present generations). The burdens come from cuts in public expenditure, which means lower expenditure on education and on health, less investment in infrastructure—insert your own view on what is lost by an unnecessary reduction of public expenditure. High levels of unemployment, particularly amongst the young, can scar the unemployed well into the future as their future job prospects are harmed. It should be the moral duty to ensure the next generation are not scarred now by the experience of unemployment, and that resources which otherwise stand idle are used to invest in the future.

'It's like the credit card being maxed out'

Let us first be clear that if the UK government had not borrowed £126 billion in the financial year 2011/12, then people (including through pension funds) would not have been able to save the amount they did. Government borrowing enabled people to realise their savings intentions – without the government stepping up to borrow, there could not be that volume of savings.

There is a limit on how much government can and should borrow – it is the amount the private sector would want to lend when the economy is operating at full employment, the difference between the amount the private sector wants to save and the amount it wants to invest. Borrowing more would 'crowd out' private investment; borrowing less would lead to less savings and unemployment. The government's credit card is only 'maxed out' when full employment is reached.

Comparing the government with the household has an intuitive appeal but can lead to mistaken impressions. It forgets that the government's responsibility is not to balance the budget but to balance the economy by moving it to full employment. There is the similarity that if a household cuts back its expenditure it will reduce demand in the economy, as will a government – and if households cut back together then the economy will fall into recession. Similarly if firms cut back on their investment programmes, the economy will enter recession – as happened in the aftermath of the financial crisis in 2008.

'We'll end up like Greece'

It is not the intention here to go into the story of Greece and its economic, political and social difficulties. But it is clear that the measures of austerity which have been imposed by the EMU on Greece have brought great suffering and unemployment without having a great deal of effect on the scale of the budget deficit. The difficulties for Greece sprung from the fact that as a member of the EMU, its central bank was more a branch of the European System of Central Banks, and its central bank could not issue its currency nor was its central bank able to purchase the government debt. The issue of the euro currency was in the hands of the ECB, who would not (or could not) provide the currency directly or indirectly to the Greek government. This was clearly not the case for the UK whose debt is denominated in sterling and whose central bank can provide money to the UK government to ensure that its deficit can be financed. The Bank of England has become a substantial holder (of the order of 25 per cent) of UK government debt, whereas the ECB has shown a remarkable reluctance to do likewise with regard to Greece and other EMU members.

'There isn't the money'

At a technical level that's clearly not right – government borrows through the sale of bonds and money is issued (via Bank of England in exchange for bonds) to finance deficits. If you want to buy something, you may say that you do not have the money. But if you were only able to work 20 hours a week when you would like to work 40 hours, then the reason you cannot buy is because you are not able to work as much as you would like and earn more. You want to work and produce so that you can buy. For the economy as a whole, the ability to produce is limited in the end by the resources available – the people, the machines etc. If there was full employment, then it would be right to say that there are not the resources to have more undertaken by the public sector unless less is undertaken by the private sector. But when there is unemployment, the resources are there to produce more in both the private sector and the public sector. There are 2 ½ million resources waiting to be employed in meaningful and socially beneficial employment.

'Fiscal austerity is needed to appease the credit rating agencies'

The 'fear of the credit rating agencies' argument is a convenient scare tactic and needs to be critically examined. It may first be noted that the credit rating of a government should be based on the ability of that government to service its debt. It is well-known that a government can always service debt provided that it is denominated in its own currency. At the limit the UK government can 'print the money' in order to service the debt: this would not take form of literally 'printing money' but rather the Central Bank being a willing purchaser of government debt in exchange for money.

Second, the credibility of a programme designed to reduce a structural budget deficit cannot only be judged by the perceived commitment of the government to make public expenditure cuts and raise taxes. An achieved reduction of the budget deficit requires, as a matter of an accounting identity, some combination of a rise in the balance between private investment and savings and a rise in net exports (exports minus imports). Fiscal austerity threatens to bring that about through a decline in output and income which depresses savings and imports. The government's hope (the return of the 'confidence fairy') is for a boom in investment and exports, which finds support in the forecasts of the Office for Budget Responsibility. But (as argued in Fontana and Sawyer, 2011, 2012) those forecasts are close to incredible. "The Office for Budget Responsibility's forecast of a return to growth next year, driven by a surge in investment and exports, has looked absurd for months. The idea that business investment will jump 40% by 2015/16, the biggest since 1945, is risible" (Hutton, 2012).

Third the reputation and judgement of the credit rating agencies had been severely undermined by their roles in the build-up to the financial crisis. An oft-quoted example has been the degree to which triple A ratings were given to mortgage backed securities and credit default swaps. This would not deny that in the event of the credit ratings agencies downgrading government debt the government concerned could well be faced with higher interest charges and difficulties in borrowing, as funds are moved from that government's debt to others. But what is questioned is the basis on which the ratings are made, and what actions by a government would lead to a downgrade.

Will cuts in public expenditure reduce the budget deficit?

The declared intention is to reduce the budget deficit and to achieve a near balanced budget by 2016/17 (a target which has already been put back by a year). The route to this is fiscal austerity coming from a mix of near 80 per cent from cuts in public expenditure and 20 per cent increases in tax. “The greatest contribution to the Government’s fiscal consolidation will come from public spending reductions, rather than tax increases. This approach is consistent with OECD and IMF research, which suggests that fiscal consolidation efforts that largely rely on spending restraint promote growth. Tax measures can be an effective tool for reducing the deficit quickly, allowing for phased reductions in public spending. The Government’s consolidation plans therefore involve a rising contribution from public spending over the forecast period” (HM Treasury 2011, p. 15).

How much effect does a cut in public expenditure have on the budget deficit? Think of say a cut of £1billion from public expenditure. The first effect is that there is a loss of income tax and national insurance contributions on the employment income of those working in the public sector (or in the private sector if the public expenditure cuts involved reduced contracts for private firms, e.g. from a cut in infrastructure investment). There would be further losses through lower VAT receipts and other indirect taxes, as those no longer employed cut back their expenditure. There are then further ‘multiplier’ effects when those who would have been employed providing goods and services to the former public sector workers lose their jobs, income and the taxes they would have paid. The first round effects could well reduce tax revenues by the order of £300 to 400 million (that is the average tax rate from income tax, national insurance contributions, VAT and indirect taxes). The second round (and third round…) effects could be of the order that national income is reduced by a further £1 billion on which tax receipts would have been a further £300 to £400 million. Thus a ‘conservative’ estimate would be that the deficit might be reduced by the order of £300 million for a reduction of public expenditure of £1 billion.

There are two 'facts' on which everyone should be able to agree. First, government budget deficits rise during economic slowdowns through the operation of 'automatic stabilisers' and falling tax revenues, and fall during economic booms through rising tax revenues. Second, any attempt to reduce the government budget deficit can only be successful if there are corresponding changes in the component of domestic and foreign aggregate demand. Attempting to reduce budget deficits (say through expenditure reductions) will only lead to the maintenance of the level of output and employment if accompanied by some combination of increases in investment, in net exports, and reductions in savings and rises in output requires private components of demand to rise substantially to offset the effects of decline in public demand.

How is it then that the OBR are supporting government's view that the budget deficit will be virtually eliminated by 2016/17[5] even though the timing of near balanced budget has already been put back a year? Simple – by forecasting that investment and exports will boom, providing employment (taking up those 'released' from the public sector), income and tax revenue, and by asserted that the high levels of investment and exports can be maintained. These forecasts are to my mind incredible (as reflected in the quote from Will Hutton above), and any credit rating agency worth its salt should realise the flimsy basis on which this so-called credible deficit reduction plan is based on.

But the OBR are being asked the wrong question: the question to be asked is what difference does, say, cutting public sector employment by 100,000 make—does it lead to more or less employment, more or less output? It is important to have clear indications of the impact which the austerity programme is forecast to have.

Let us suppose for a moment that the OBR forecasts can be a foundation on which policy can be based. Even with the forecast boom in investment and exports from 2013 onwards, the economy would still be operating in 2016/17 (according to forecasts reported in HM Treasury 2012, Table 1.4) at below potential, albeit only to the extent of 0.4 per cent (the so-called output gap between actual and potential output). But this means that in the intervening years there would be slack in the economy (and looking at figures for unemployment, slacker than indicated by the so-called output gap). Thus there would be no reason to cut public expenditure in the next few years – there will be slack in the economy, and during those years maintaining the levels of public expenditure would provide more employment and economic activity.

We have questioned this notion of potential output and how far it should be taken as a constraint on the level of economic activity (Sawyer, 2012b). Suffice to say here that we argued that potential output is not what it sounds – it is not the full potential of the economy and would involve significant levels of unemployment. The economy could (and should operate) at a level of output higher than 'potential output'. The main point to make here is that the estimates of 'potential output' have been revised down on a number of occasions in the past five years. It starts with the Pre-Budget Report of November 2008 (HM Treasury 2008b) where 'potential output' was revised downwards (as compared with the estimate which had appeared in March 2008 in HM Treasury 2008a) by 4.5 per cent. There have been subsequent downward revisions, and the 'potential output' now estimated by the OBR (having taken that responsibility over from HM Treasury) is some 6 per cent lower than it would have been had previous trends continued, which translates into potential output of the private sector being 7.5 per cent lower. Although there is a reluctance to do so by government, this reduction in 'potential output' should be seen as the substantial cost of the financial crisis (Haldane, 2010). The question particularly relevant here is whether this estimate of potential output should be accepted and taken as binding on the level of economic activity.

Another question is how to approach any lowering of potential output. One would be to adopt policy measures (notably on investment) which would rebuild productive capacity and permit higher levels of potential output. The approach should be one of repairing the damage caused by the financial crisis through investment, and not to cause further damage to the public sector.

Jobs deficit not budget deficit

It is bizarre to think that the budget deficit is regarded by the Coalition as the major problem (Cabinet Office 2010, p.15), without any reference to unemployment, poverty and environmental issues. The sustainability of public debt is seen as a more important issue than the sustainability of the planet and furthermore the sustainability of the public debt is not in serious doubt which cannot be said about the sustainability of the planet.

For macroeconomic policy, including fiscal policy and budget positions, the major deficit is the jobs deficit. It is the jobs deficit which consigns so many to unemployment and it is the jobs deficit which prevents the UK realising its productive potential. Instead of judging every policy by its impact on the budget deficit, the judgement should be on its impact on the jobs deficit. Yet, reducing the jobs deficit would help to reduce poverty, and reducing poverty would pump demand into the economy and reduce the jobs deficit. The promotion of ‘green investment’ can simultaneously reduce the jobs deficit and make a contribution to environmental sustainability.

Financial responsibility or social responsibility?

It is often claimed that the government has to be financially responsible and credible, and there would be few willing to argue for financial irresponsibility and incredibility. Those promoting fiscal austerity have managed to present themselves as responsible and credible when the opposite is the case. I have indicated above that the present government's plans to reduce the budget deficit lack creditability.

> ***It is not responsible to be creating unemployment – it is economically and socially irresponsible.***

What does it mean to be financially responsible? Any government, or indeed any individual, has to observe that 'expenditure minus income = borrowing'. But how much can, and should, be borrowed? Does borrowing always have to equal zero, or even average out at zero? The answer is no – the duty of the government is to provide the macroeconomic conditions to achieve full employment and to borrow whatever is required. The most the government can and should borrow corresponds to how much savings would be generated at full employment. To put it in formal terms, the budget deficit should equal Savings (at full employment) minus Investment (at full employment) plus Current Account Deficit (at full employment). A government which operated a budget deficit with sufficient public expenditure to ensure full employment would be economically and financially responsible. There would be sufficient savings to fund the deficit, and indeed the deficit would enable those savings to be realised. It is financially responsible as it is operating within the availability of borrowing. It is economically responsible as it is helping to underpin full employment and make best use of the resources of the economy.

It is often argued that the public think that government should not borrow as it involves rising debt. It is then paradoxical that UK governments have been borrowing in around 90 per cent of the post war period. The government would not have had a pre-crisis national debt to GDP ratio approaching 40 per cent unless it had persistently borrowed – a 40 per cent debt ratio is consistent with a continuing deficit of around 2 per cent of GDP (when the growth of nominal GDP is around 5 per cent)[6]. Germany would not have had a debt ratio of over 60 per cent without persistent deficits of around 3 per cent of GDP—which will mean that Germany's attempt to have a balanced budget will be rather deflationary.

‘Three ways to full employment’

In an article entitled ‘Three Ways to Full Employment’ (Kalecki, 1944), the great Polish economist Michal Kalecki considered three alternatives to securing a level of aggregate demand which would be consistent with full employment, and these three ways are highly pertinent now.

The three ways are:

1. Sustained budget deficits
2. Stimulation of the level of investment
3. The redistribution of income in an egalitarian direction.

Kalecki saw the insufficiency of aggregate demand as a major impediment to the achievement of full employment, though he also recognised that there had to be sufficient productive capacity and that the achievement of full employment would be resisted by political and financial forces (Kalecki, 1943; see also Sawyer, 2008).

The arguments above have indicated that public expenditure provides a stimulus to the economy as well as providing valuable goods and services. When there is a budget deficit with public expenditure exceeding tax revenue, then in effect the government is pumping demand into the economy. Budget deficits in the present junction are a way of holding up demand—consider what the situation would be now if public expenditure were cut sufficiently to eliminate the budget deficit.

There are the two other ways to stimulate demand which Kalecki considered. In Sawyer (2012), I pointed to other ways – reduction of the propensity to save (especially by corporations out of profits), promotion of net exports (but a policy which cannot by definition be available to all countries) and application of the ‘balanced budget multiplier’ whereby an increase in both public expenditure and taxation which left the budget deficit unchanged could nevertheless be expected to increase output and employment. I focus here on the two ways discussed by Kalecki as, in my view, they are much more important than the others in their significance and impact.

An important point here is that if these two ways of stimulating investment and reducing inequality were to be pursued, then not only would there be a stimulus to demand but also the budget deficit would fall as economic activity increased and tax revenues rose. Further, these policies of investment stimulation and income redistribution have much to recommend them in their own right in addition to the favourable effects on demand and employment.

Investment

Investment could simultaneously restore the productive potential which has been laid low by the financial crisis as well as stimulating demand and growth. Investment expenditure (in real terms) was one-sixth lower in 2010 than in 2007. Put the other way round restoring investment to its 2007 level would add £40 billion to demand (approximately 2 ⅔ per cent of GDP) and with multiplier effects could add over 5 per cent to GDP.

There are limits to how far investment stimulation could go, though restoring levels observed before the financial crisis would be a large step. The limits on investment come from the observation that the growth of the capital stock should be broadly in line with the growth of output, which for an economy such as the UK is not likely to be more than 2 ½ per cent per annum, which translates into gross investment (after allowing for depreciation) of the order of 15 per cent of GDP. There are environmental and sustainability considerations which will limit the rate of economic growth.

The present challenge is how to stimulate investment (and of the 'right sort') – the return of the 'confidence fairy' cannot be relied upon, nor can the false optimism of the OBR/Treasury macroeconometric forecasting. Low interest rates and quantitative easing have had little, if any, effect on investment. The direct way to stimulate investment is by the expansion of public investment – taken with the evidence that public investment can itself stimulate additional private investment[7].

Let us though be clear – the stimulation of investment, whether public or private, is likely to require effectively an increase in the budget deficit. The funding of the Green Investment Bank is a clear example of this. The increase can be masked by institutional and accounting practices which place the borrowing 'off balance sheet' – through, for example, creation of a State Investment Bank which borrows from the financial markets (along the lines of the European Investment Bank). But borrowing from a State backed institution is still needed.

Insofar as the stimulation of investment is viewed as a boost to demand while the economy is recovering from recession and not a permanent increase in borrowing and in the budget deficit, it should not be included in the calculation of the structural budget deficit.

Reducing inequality

The last three decades or so have seen rising inequality of income, earnings and wealth in most industrialised countries and often shifts of income from wages to profits. These shifts may well have contributed to the financial crisis as those losing out resorted to debt to try to maintain their living standards. The savings made by corporations and the rich did not flow into investment but rather helped to extend debt to the poor. At a minimum, as incomes of the low and middle income groups were restrained, demand could only be maintained through debt.

There are many reasons for attacking the gross inequalities which mar our societies. Here, I only focus on the impact which the reduction of inequality can make to restoring demand and to reducing the budget deficit (as economic activity is stimulated, tax revenues rise, reducing the budget deficit). The progressive way to reduce the budget deficit is to reduce inequality.

The policy measures designed to shift the distribution of income can be easily listed:

- A significant increase in the minimum wage and the adoption of 'living wage' ordinances.
- The structuring of wage awards in the public sector to increase lower wages faster than higher wages.
- The enhancement of the power of trade unions leading to faster real wage growth and a shift from profits to wages (the high rate of savings in the corporate sector is a major drag on demand in the economy).
- The introduction of a financial transactions tax and/or financial activity tax would help redress the undertaxation of the financial sector, serve to reduce its scale, with relative low impact on demand, and could replace some other taxes.
- Making the tax system progressive through, for example, capital gains treated as income for tax purpose, and removing caps on earnings limits for social security contributions (with no commensurate changes to social security benefits): a more progressive tax system would also enhance the role of fiscal policy as an automatic stabiliser.

These types of changes have much to commend them in their own right. It is important to point out that these types of changes would help stimulate demand and would have the effect of reducing the budget deficit – the smart and progressive way to reduce the budget deficit.

Conclusions

By way of some concluding comments, I want to pose two questions. Firstly why, when there are unemployed resources, and when there are human needs to be satisfied, cannot the unemployed be employed to produce goods and services which will help satisfy human need? It is economic madness to refuse to employ the 2 ½ million unemployed (and others who wish to work more hours) when society would benefit from what the unemployed could produce and when the currently unemployed would gain from being employed.

Secondly, why is the response to the decimation of the private sector (in the literal sense of a loss of 10 per cent in the potential output of the private sector) to decimate the public sector to maintain some kind of 'balance' between the two sectors? Why is not the response to build on the strengths of the public sector, preserve its potential and seek to re-build the private sector devastated by the financial crisis.

The austerity programme is economically irrational, socially irresponsible, and lacks credibility that it can reduce the budget deficit and secure any return to prosperity. The time has come to rebuild through investment and through a major assault on inequality.

Notes

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[1] Remarks at a panel discussion in Vienna on Thursday 25th April 2012: Source: http://news.yahoo.com/europes-austerity-drive-suicidal-stiglitz-104730205--finance.html.

[2] As reported on BBC at http://www.bbc.co.uk/news/uk-politics-17994745 (accessed 10th May 2012).

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[3] I have discussed many of these points at greater length in Sawyer (2011a, 2012a).

[4] At the tractor factory relaunch of the coalition 8th May 2012: reported on BBC at http://www.bbc.co.uk/news/uk-politics-17986209 (accessed 10th May 2012).

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[5] The forecasts reported in the budget, HM Treasury 2012 are for a cyclically adjusted net borrowing of 0.7 per cent of GDP in 2016/17 with a current budget surplus of 0.5 per cent.

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[6] The relationship is that a continuing budget deficit (relative to GDP) of d leads to a debt ratio of $b = d/g$ where g is the growth of nominal GDP (that growth of real GDP plus rate of inflation).

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[7] For recent example see Martinez Lopez, 2006.

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