# BRITAIN'S BROKEN ECONOMY

## – and how to mend it

The new political economy network

# Britain's Broken Economy – and how to mend it

There is no cast-iron law that states that crises of capitalism end in victories for the left – and certainly not in Britain. And yet this is not a Conservative moment – it is clear that the Coalition has no viable plan for rebuilding the economy. The problem is that Labour does not have one either. The task for Labour now is to come up with a vision of the economy that is different from what it was offering just before the crash.

Labour made the mistake of buying the snake oil of neo-classical economics. It must now discard it, and develop ideas for the economy that are both practical and humane – based on the principles of environmentally sustainable wealth creation, durability, cultural inventiveness, equality and human flourishing.

This e-book is the story of how Labour might begin to do this. We identify the main material sources of security in people's lives – our jobs, homes, pensions and access to finance and credit. We explain why these have now become sources of insecurity, and outline a new macroeconomic policy, and a series of reforms that will help to create a more secure, stable and sustainable economy.

**Britain's broken economy – and how to fix it**

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The New Political Economy Network is a non-aligned, centre-left initiative that brings together experts in economics and other disciplines, existing research projects, campaigning organisations, think tanks, journalists, activists and politicians.

The context for setting up the network was the belief that the recession has brought to an end an economic era. The economic crisis should herald a new progressive moment for the centre left, but instead there is a lack of a sense of purpose, and a difficulty in defining a new radical politics. Nowhere is this problem more acute than in the realm of political economy, where the discrediting of neo-classical economics has left an intellectual void in policy making.

The revival of a progressive politics requires a new political economy that will enable Britain's transition from casino capitalism to a balanced, low carbon, equitable form of economic development. We need an economics whose principles are ecologically sustainable wealth creation, cultural inventiveness, equality and human flourishing.

The aim of the New Political Economy Network is to help build the intellectual foundations and shape the policy framework of this new economy.

For details about the New Political Economy Network and to give feedback on this e-book, contact newpolecon@googlemail.com

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# Foreword

The world changed on the day that Lehman Brothers went bust. Thirty years of neo-liberalism came to an end in the month of mayhem that followed in the world's financial markets. Things will never be the same again, after the collective and decisive action taken by finance ministries and central banks from the G20 countries to prevent the Great Recession in the winter of 2008 becoming a second Great Depression.

How many times have you heard those pat phrases in the past eighteen months? Many times, in all likelihood. It has become an easy, even lazy, cliché in progressive circles that the game is up for the conservative view of the world that predominated in the final twenty-five years of the twentieth century and the first decade of the twenty-first.

But as the past few months have shown, those who think this way are guilty of dangerous complacency. After its show of unity in 2008 and 2009, the G20 is now split between the minority that favours a continuation of stimulatory economic policies and a majority that supports immediate deficit reduction.

In Britain, the coalition between the Conservatives and the Liberal Democrats has turned the economic clock back, not just three years to the pre-crisis days of 2007, but to the 1930s, when the 'Treasury View' insisted that only balanced budgets could deliver stability and growth. Orthodoxy has returned – perhaps even more quickly than might have been expected given the profound shock to the status quo from the freezing up of financial markets in August 2007.

Even so, this remains a moment of great opportunity for those of us who believe that the market fundamentalism of the past thirty-five years has been not just conceptually wrong but inherently dangerous when put into practice. Interventionist policies have been deeply frowned upon since the mid-1970s, but it was the willingness to jettison that ideological baggage that enabled a floor to be put under the global economy's descent in 2008 and 2009. Ironically, the actions taken in Washington, London, Berlin and Beijing were perhaps too successful: a deeper crisis would have still further tarnished the old regime and so made reform that bit easier.

But we are where we are. Strategically, those who had fought a long guerrilla war against neo-classical economics and conservative politics went into the crisis in a weak position. The belief in the primacy of markets, the virtues of deregulated finance and the malign effects of government was deeply entrenched in finance ministries, central banks, business, the media and academia. The crisis provided for progressives the kind of opportunity that opened up for the free-market right when the first oil shock of 1973 brought the Keynesian post-war boom to an abrupt halt. But it was an opportunity and no more than that. Unlike the neo-classical movement, which in the 1970s had a coherent alternative to Keynesianism to offer – after writing, thinking and arguing their case during the three decades since 1945 – the left's intellectual wellspring was in danger of drying up.

It had not, of course, run completely dry. There had always been a diaspora of discontents – old Keynesians, socialists, Marxists, greens, liberals, members of non-governmental organisations – that kept going during the long, wilderness. And it was in an attempt to bring together these voices, in the hope that the sum would be more than the parts, that the New Political Economy Network was born. The left's answer to the Mont Pelerin conference in 1947 that launched the fightback against collectivism was a meeting in *The Guardian*'s new offices in King's Cross in the autumn of 2009. A series of seminars and public meetings followed, and the network continues to grow. This e-book is the first attempt at piecing together an alternative to the orthodoxy. It is still very much work in progress.

For me, the process has three distinct elements. The first is that any set of proposals has to be intellectually solid. The great strength of Keynes in the 1930s was that he was able to dismantle the classical economic model and prove there was a better way. Unless the left is able to show a similar clarity and sharpness of thinking, it will get nowhere. That may mean melding ideas from different quarters, as the Green New Deal group has done with Keynes and Schumacher. It may mean looking outside economics for insights into how economics works.

The second requirement is to piece together a practical set of ideas to stimulate jobs, protect the environment, tackle the housing shortage, address the looming problem with pensions, control the banks and rebalance the economy away from its reliance on finance. A persistent argument running through this e-book is that the old system of allowing banks to choose to whom they lent and on what terms was responsible for stifling growth in the parts of the economy that were not to do with London, housing or finance. To my mind, little progress will be made without a willingness to put big finance back in the cage to which it was confined in the three decades after 1945. That won't be easy, but it is vital. To take one obvious example: how can the progressive left ensure that, say, the innovative ideas on pensions in this e-book are taken up?

Finally, the programme needs to have a political edge. It is all very well to think great thoughts and to construct policies that get a rapturous reception when aired at small gatherings of the deeply committed, but unless we believe that the imminent collapse of capitalism is going to drop power into our hands, serious thought has to be given to political agency.

My assessment of the current situation is this. The deep defects in the global economic system have not been remedied. The current upswing will therefore be brief. Another, perhaps even more serious, crisis is likely. When it happens the left must not be caught, as it was last time, with its pants down. So read this e-book, tell us where we have got it right and, more importantly, where we need to sharpen up our act. Will Labour run with these ideas? This is the opportunity of a lifetime; it would be criminal to waste it.

Larry Elliott, September 2010

# Introduction

## Labour's Future

Contrary to what you may have heard, no cast-iron law states that gigantic crises of capitalism end in victories for the left: certainly not in Britain.

The Great Depression led to Stanley Baldwin and his smallholder capitalism, with greater protection for shop-keepers and small businesses. The oil crises of the 1970s found their political punchline in Margaret Thatcher. And this time round, a crisis of private-sector debt (all those consumers and companies up to their eyes in loans) is about to provoke the most savage cuts in the public sector since the second world war.

And yet, and yet. This does not feel like a Conservative moment. Not just because David Cameron failed to win a majority for his party, though he had been dealt the best hand a politician could hope for. But because it is precisely the right's monotonous answer to all matters of economic policy – keep the state out of the way and let markets rip – that has been found wanting: it is the free-market fundamentalism dreamed up by the right that has led us to this pass.

The problem is that the labour movement is floundering in the ideological vacuum left by New Labour. It has neither the alliances across civil society nor the political agency to secure a new radical electoral agenda. It lacks a story that defines what it stands for. Market fundamentalism – with its belief in self-regulating markets and a minimal state, and its narrow view of human beings as rational economic actors – may be fantasy. But it remains the only story of economic life on offer.

The task for Labour now is to offer voters a different story; to outline a vision for the economy different from what was on offer just before the crash. The answer it comes up with will determine its future.

The answer is not self-evident. Labour has not only lost an election; it has also lost people's trust. Between 1997 and 2010 it lost 1.6 million lower-income voters and 2.8 million middle-income voters – mostly people who had gained very little from Labour's economic boom.

In government Labour bowed to the interests of the City. It failed to protect the security of its citizens because it did not regulate the dangerous activity of the financial markets. It allowed the housing bubble to grow and personal debt to balloon – as a means of covering up for the huge gulf that was growing between the small wealthy elite and the rest.

The British had wealth and record growth – but it was unsustainable and mostly benefited the rich. Too many people had to borrow to keep up their standard of living. Society looked prosperous but below the surface a lot of people were frantically paddling to stay afloat. Now many are at risk of sinking.

## A view of the past

New Labour was in general embarrassed by the history of the labour movement, especially its traditions of political struggle and of workers organising themselves. These did not appeal to the floating voters Labour needed to attract in order to win the 1997 general election – so the leadership decided to ignore this aspect of its past. Instead of mutual improvement it promoted a narrow idea of individual aspiration.

If it is to thrive in the next decade Labour has to develop new ideas. And that will also involve digging deep into its own political traditions – and into the history of British capitalism.

There have been two major revisions of Labour politics in the last sixty years, both dreamed up during long periods of opposition. While Anthony Eden was in Number 10, Anthony Crosland published *The Future of Socialism*. While John Major was enduring his long drawn-out death agonies, Tony Blair and Gordon Brown came up with 'third way' politics.

Both revisions were only partial successes, because both accepted too much of the status quo. For Crosland, that meant being far too optimistic about the achievements of welfare Keynesianism. For Blair and Brown, there was no alternative to Margaret Thatcher's free market revolution.

Both these major revisions of Labour politics were predicated on the assumption – perhaps more plausible then than now – that British capitalism was working. No-one can make that argument this time. As Labour develops a new political economy it must be based on the understanding that the UK's current business model is bust. Something different will replace it. It is up to Labour whether it helps define what that successor model is – or leaves the task to the Conservatives.

The last time we were at such a conjuncture – after the oil shocks – the victory of Thatcher marked the coming to power of a New Right. The welfare model of capitalism that had come out of Keynesianism was rejected, along with its culture of collectivism; it was replaced by a free-market ideal based on neo-classical political economy and a consumer society of individuals. The New Right promised a renaissance of capitalism that would enhance individual freedom and reverse the long-term decline of the British economy. By reducing the role of the state, markets would have the freedom to expand and create new sites of wealth production and capital accumulation.

No longer would the state crowd out private enterprise. Instead, private enterprise would lead the UK back to a new era of prosperity. That argument became simplified further, to the mantra: markets good, government bad.

For all its self-proclaimed hard-headedness, free-market economics have over the years been dealt several major blows by leading economists. George Akerlof, Joseph Stiglitz and others have shown how markets can fail when one side has more information than the other. Daniel Kahneman, Amos Tversky and the behavioural economists have shown that people are not as rational or as keen on choosing as the neo-liberals claimed. These advances in economics were not obscure movements in poky old labs – all the individuals named above have won Nobel Prizes in economics, and their work has become part of the discipline's canon.

Yet this 'neo-liberal' creed did its political job. It created the conditions for the political defeat of the labour movement and the destruction of the ethic of collectivism.

The most significant development of market fundamentalism has been the growing power of finance. Following the Big Bang of 1986 and the deregulation of the City of London, the financial sector began to play an increasingly central role in the British economy. The privatisation of the utilities was justified by the idea of a share-owning democracy. The 1980 Housing Act and the 'right to buy' your council house was promoted as an example of a 'property-owning democracy'. Both these reforms encouraged the idea of a popular capitalism in which universal property ownership could give ordinary individuals a share of capital.

Millions of people were integrated into the global financial markets like never before, as their savings, pensions and personal and mortgage-backed debt became feedstock for the financial markets. The banks created new sources of profit by selling new financial products to individuals and households. Very few people understood the true nature of these increasingly complex products. Levels of personal debt began to rise.

Over the last thirty years, the influence of the financial sector has led to its business model being adopted by corporations and by the state. Companies increasingly re-engineered in a process of continuous change, as a way of increasing their shareholder value. Government reform employed Rational Choice Theory in new forms of public management that recast every relationship on the lines of a commercial contract. Public services were turned into quasi-markets governed by cost efficiency and targets. Commercial values all but supplanted the ethos of public service. The result was a state of permanent revolution without a cause.

A new kind of consumer compact between the individual and the market began to replace the old social welfare contract. This new compact was based on the myth of rational choice and the idea that markets would allocate risk to those most willing to shoulder it. There was no acknowledgement of human need or dependency, or of the kinds of asymmetries of information described by Joseph Stiglitz, and yet this compact provided a foundational structure for the development of a market society of consumers. It also legitimised the redistribution of wealth and resources away from the public sector and towards the private sector, through the various means of privatisation, outsourcing and the marketisation of utilities, pensions and public services.

## Economic failure

Alongside the 'financialisation' of the economy there has been deindustrialisation in the Midlands, the North East, Wales and Scotland. Following the collapse of manufacturing industry in the 1980s, the private sector failed to reinvest in these areas. Millions of jobs have been lost both here and elsewhere, and new employment has depended on state expenditure. The virtues and cultures of industrial ways of life built up over generations have been devastated. Intergenerational poverty has created high levels of chronic illness and an accumulation of social and psychological problems. More generally, levels of anxiety and insecurity have been aggravated by government policy on flexible labour markets and welfare reform. Taken together they have transferred risk from business and the state onto individuals, and have helped to create systemic insecurity.

Market fundamentalism not only failed to grow the economy in areas of deindustrialisation: it also failed to restore the health of British capitalism. Instead Britain now has a system of state-supported capitalism in which financial capital has huge power without responsibility. The bubbles and speculative activity it has caused in the housing market have contributed little to substantive economic development. Its business model of shareholder value has enriched company directors but has failed to spread wealth or to improve business productivity. Mergers and acquisitions have become a profitable game serving the interests of investment banks and asset strippers, further hollowing out the economy.

We have now exhausted two alternative post-war economic models. The coalition government may have some short-lived success in reviving the neo-liberal model by privatising the NHS and the education system, and transferring public assets and services to companies like Serco and Capita; and this might help meet the government's 'private sector job creation' target. But it would be without economic value and would cause immense social harm.

Labour may oppose the timing and extremity of the Coalition's public sector spending cuts, but it as yet has no alternative political economy for creating prosperity. Its pre-election plan to halve the deficit in four years runs the risk of raising deflationary pressure. And the discrediting of neo-classical political economy leaves a gaping hole in its own policy-making, and methodologies for measuring economic value. Its old strategy of allowing City excess, and redistributing the tax revenue it generated to the Midlands and the North via health and education expenditure, was a way to avoid confronting the chronic condition of British capitalism, and the deeper problems of wealth creation and structural joblessness. The financial crash brought this strategy to an abrupt end.

In the decade ahead, state distribution alone will not rebuild our economy, or achieve a fairer, more reciprocal, society. We agree with David Cameron and Nick Clegg in their insistence that the economy has to be rebuilt and rebalanced away from financial services and towards more diverse sources of incomes. But they are being far too optimistic in arguing that markets alone will achieve this.

Historically Britain has resolved its major economic difficulties by exporting them abroad. One way of doing this was through the empire, and the forcible introduction of commodity trade; and through enforcing the claims of British capital in its role as a major international money-lender. A second way was through the emigration of superfluous workers to colonies; and a third was through war and the productive expansion of the economy. None of these options are open to us now, for three main reasons (leaving aside the issue of their desirability).

Firstly, within ten years the rise of the BRIC nations, particularly China, will transform the global geo-political balance of power. Its sheer size and economic power will threaten to relegate the place of the EU and Britain in the world. This transformation will alter the internal balance of social forces within western nation states. China is already trying to expand its internal demand, urging employers to improve workers wages.

Second, our economy faces ecological limits. A recovery strategy of unlimited consumption and economic growth is no longer an option. Global warming, peak oil, insecure energy supplies, diminished UK agricultural capacity – all pose systemic threats to our way of life. At the same time an emerging 'producers market' in raw materials will raise commodity prices and impact on profitability, altering the balance of power between Britain, the EU and poorer economies.

Third, the financial crisis is not yet over. There are very large numbers of people indebted and with insufficient means of paying off their debt. People did not borrow to increase their consumption. They borrowed to compensate for wages that were increasingly falling behind productivity increases. As household debt rocketed between 2001 and 2007, levels of consumption as a proportion of GDP actually fell.

The logic of capitalism in its pursuit of profit eventually leads to the kind of crisis we are currently experiencing. Joseph Schumpeter explained capitalism as a constant process of creative destruction. Karl Marx described a system in which 'all that is solid melts into air'. It took our foremothers and forefathers in the labour movement more than 150 years to build a counter movement to defend society against these dangers. Much has been undone in the last thirty years, but the groundwork on which to build anew remains intact.

## A new political economy for Labour

In the immediate future, Labour needs to develop an alternative approach to the deficit that is more than simply opposing cuts. It has to be based on stoking environmentally sustainable growth and job creation: reducing the deficit as the economy grows. The pre-election commitment to a four-year deficit-reduction plan is unnecessary and too rigid. The deficit has not sparked a crisis in the bond markets. Bond yields remain low because Britain is not Greece, but a country with a long record of honouring its public debts and a large pool of domestic savers who reliably mop them up. The principal concern of government should be to restore capital investment and to ensure sufficient demand to restore business confidence.

A crisis in the private sector caused by massive market failure and corporate abuse of power has been reinvented as a crisis of the public sector. A public debt that is modest by historical comparison and largely attributable to a fall in tax revenues has been turned into an opportunity for the Coalition government to pursue a destructive level of fiscal austerity.

This folly, and the reinvention of economic reality by the right and its media allies, is a consequence of the left's political weakness and Labour's lack of a social and democratic political economy. The Coalition's economic policies threaten to plunge Britain back into recession or a protracted period of stagnation. Millions of people who gained little if nothing from the economic boom will be asked to bail out the few who took the lion's share.

Labour is faced with a challenge unmatched since the 1930s. The kinds of changes it must strive to enact match those of the post-war Attlee government. This is the scale of the task before it. Central is the need to develop a new political economy. Recovery, and rebuilding the economy, will require a strategic and more interventionist style of government. To achieve this the state will need radical reform from top to bottom to make it much more democratic. Power needs to be decentralised to the nations and to local government. The state will have to be capable of regulating markets and asserting the public interest in the wider economy, while also being responsive to individual citizens and small businesses. On current trends the social economy will become the biggest sector by value and employment. Labour will need to develop novel ways of linking the formal and informal economy, creating a state capable of interacting with social and community organisations, and devolving real power and decision-making to workers and users.

The consumer compact between the individual and market has created social fragmentation and eroded family life. Labour needs to develop an alternative – a reciprocal and democratic relationship between government, society and the individual. It needs a new language and politics able to engage with people's everyday lives, and reconnect not only with the traditional working-class heartlands, but also with the estranged middle classes in the South and in the suburbs of our cities.

The old class identities and cultures that were once the bedrock of Labour support have now largely gone. Labour has to build a new political coalition out of a diverse range of identities, classes and interests. To do this it needs to develop a political relationship with people that is more than a set of promises to targeted segments of the electorate. This needs to have the cultural weight, and social and historical depth, of a democratic covenant. This kind of relationship can be the basis of a vision of the good society, and of a moral economy of wealth creation and distribution; it will mean a more democratically involved citizenship, and more power to civil society institutions and organisations, including trade union representation at work.

One of the defining features of our society is its insecurity. Large numbers of people in the working and middle classes experience it in their jobs, their homes, their pensions and in the difficulty in getting credit at a reasonable rate. If electoral success is to be linked to transformative democratic change, a new political economy is needed that can deliver four essential sources of security: decent jobs; good homes; stable and proper pensions; and fair finance.

Labour bought the snake oil of neo-classical political economy. It must now discard it, and become an organisation at the leading edge of new economic thinking. It needs to develop a moral economy, based on a democratic covenant with the people and macroeconomic policies for investment and sustainable economic development and market growth across the regions of Britain.

* * *

This e-book is the story of how Labour might begin to do this. We have divided it up into two parts. The first part, 'No way to run an economy', begins with the problem of inequality and its impact on society and the economy. At the heart of our argument is the belief that individuals are of equal worth and that the primary aim of a new political economy must be to sustain a more equal, good society, in which everybody shares the prospect of flourishing and living decent lives of their choosing. The rest of Part 1 sets out the reasons why our current economic model fails to do this. We identify the main material sources of security in our lives as being our jobs, our homes, our pensions and our access to finance and credit. Each chapter explains why these have now become sources of insecurity. We conclude with a short chapter that puts this insecurity into the wider context of globalisation.

In the second part, 'Manage markets before they manage you', we set out a viable alternative: the first chapter sets out a new macroeconomic policy, and the second identifies the kinds of reform we need to build a more secure, stable and sustainable economy, from the bottom up.

The e-book has been a collective effort by a group of individuals involved in the new political economy network. This is part of a wider debate about the future of Labour and its new political economy. We hope you will give your opinion, and help carry on this vital debate.

# PART 1

## NO WAY TO RUN AN ECONOMY

# 1. Unfair shares

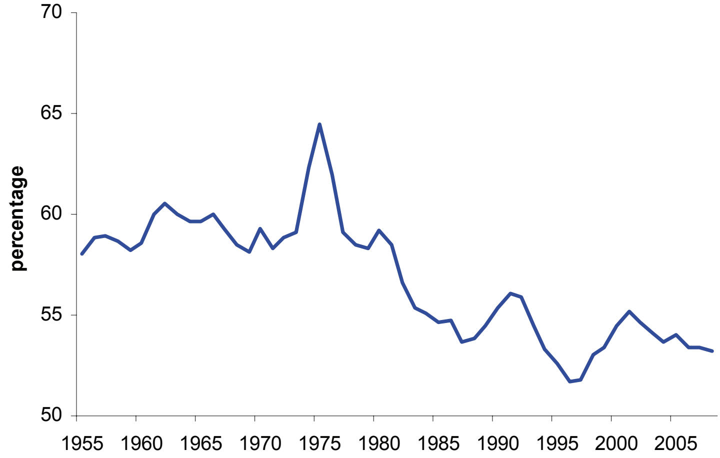
The defining story of our economy over the last three decades is the gap between the rich and the rest.

When inequality becomes too extreme it not only wrecks the lives of people living in poverty; it also creates problems of anti-social behaviour, crime, poor health and bad schools, and rising costs for everyone. It is in all our interests to create a more equal society. That means rejecting market fundamentalism, because it has had a profoundly negative impact on so many people's lives.

In 1979 Britain was one of the most equal of the richer nations, today we are one of the most unequal. The rising wealth and income gap has been a relentless trend that three Labour administrations

**Figure 1: How the profits squeeze gave way to the wage squeeze, UK**

**Wages as a proportion of GDP, 1955 to 2008, percentages**

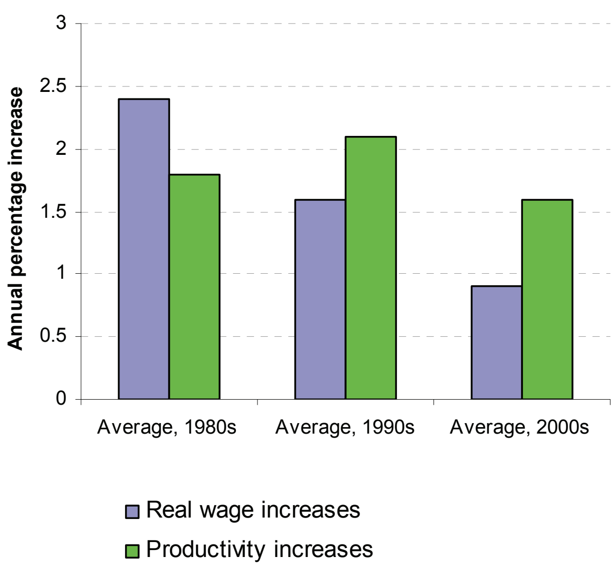



*Source*: Office for National Statistics have failed to reverse. As Peter Mandelson famously said, 'We are intensely relaxed about people getting filthy rich'. He has complained that the press excluded what he went on to say: 'as long as they pay their taxes'. But of course many of them didn't – because Labour failed to close up the tax havens and loopholes.

At the heart of the inequality trend is a thirty-year-long squeeze on people's wages. The share of the nation's output going to wage-earners peaked at 65 per cent in 1975, but has been in freefall ever since. In 2007 it reached as little as 53 per cent (see Figure 1). In contrast, the share of output taken in profits in that year had reached a near post-war peak.

Wages for most of the population have been falling behind the growth in productivity, and at an accelerating rate (see Figure 2). Between 1980 and 2007, real wages rose by an annual average of 1.6 per cent, while economic capacity grew by 1.9 per cent. But

**Figure 2: How real wages have lagged productivity, 1980 to 2008, UK**

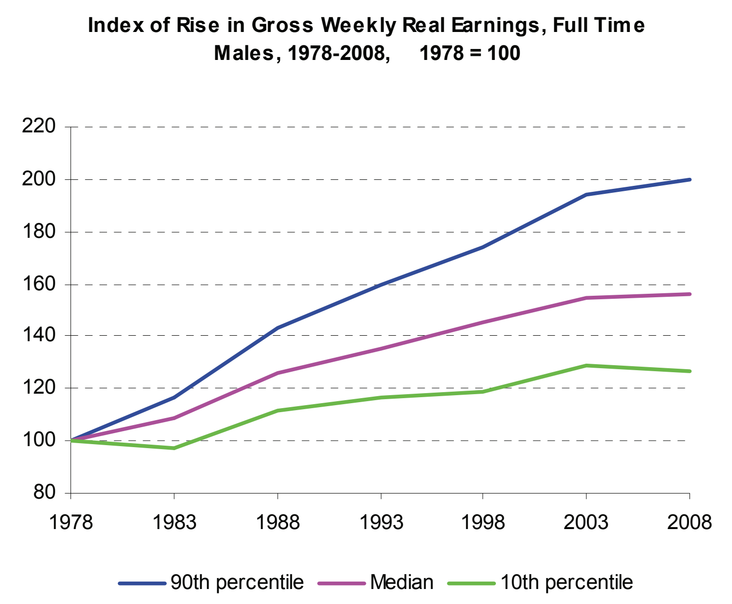



*Source*: Oxford Economics

from 2000, productivity has been rising at almost twice the rate of earnings.

These headline figures actually understate the full extent of the decline in the wage share for most of the workforce. This is because of the increasing concentration of earnings at the top. As Figure 3 shows, real earnings have risen much faster for high-earners than for median- and low-earners. As a result, the brunt of the falling wage share has been borne almost entirely by middle- and lower-paid employees, with the bottom two-thirds of earners facing a shrinking share of a diminishing pool.

**Figure 3: How earnings have become more unequal over the last 30 years**




*Source*: Author's calculations from *Annual Survey of Hours and Earnings* (for 1997-2008), and *New Earnings Survey* (for 1978 to 1996). The earnings figures have been adjusted for changes in the retail price index.

*Note*: *ASHE* covers the UK and *NES* covers GB.

Three key elements of market fundamentalism have caused this problem. The first element was the abandonment of the post-war commitment to full employment. The rate of unemployment since 1979 has averaged nearly 8 per cent. This is more than three times the average of the period from 1950 to 1979. Secondly, there has been a succession of measures aimed at weakening unions, axing employee rights and eroding the role of collective bargaining. Thirdly, the adoption of a new business model of shareholder value was aimed at maximising short-term share prices and profits, through a wave of financial engineering and cost-cutting. Take these three elements together and they represent a profound shift in power and wealth to an unaccountable business elite.

Supporters of this Thatcherite model claimed it would boost business investment and productivity. All sections of society would benefit. But this has not been the case, since little of the profit has been invested in the productive economy. In 2007, banks invested some £50 billion in manufacturing. In the same year they invested close to £800 billion in a variety of complex financial products. Instead of stability we have had economic turbulence. It should be noted that while the UK experienced only one mild and short-lived recession between 1950 and 1970, the period since 1979 has brought three deep recessions, culminating in the meltdown of 2008-9.

The resurgence of market capitalism has enriched a small plutocratic elite. Inequality – both domestic and global – not only creates serious social problems and instability. It is an economic time-bomb. This is because greater inequality has a negative effect on the spending power of a majority of the population. One consequence of this is that families, faced with a declining wage share, have become increasingly indebted: personal debt as a proportion of disposable income rose from 45 per cent in 1980 to 160 per cent in 2007.

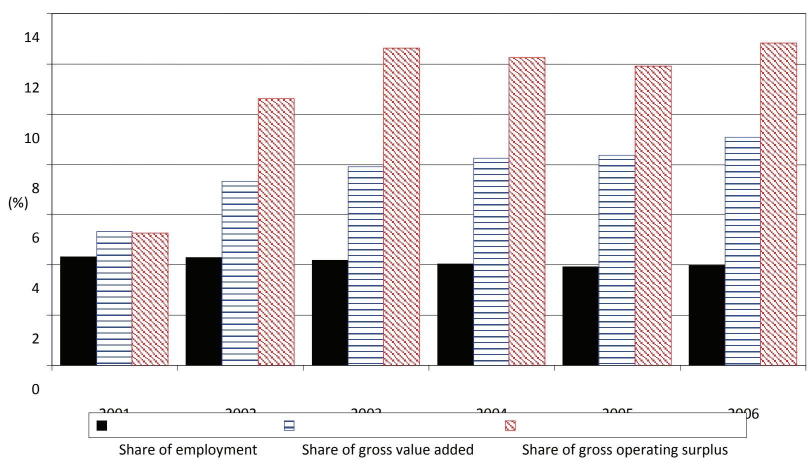
There is a limit to the degree of wealth inequality consistent with economic stability. Beyond that limit economies implode. The wealthy have largely bounced back from the slump. The banks are making big profits, while people's wages are being squeezed and many live in fear of losing their jobs. Labour failed to act to reform the economic system, and the market fundamentalism of the Coalition government is threatening to pitch the economy back into recession. Inequality is set to rise and rise. The seeds of the next economic crisis are already being sown.

# 2. Profits before jobs

The squeeze on wages has been matched by the squeeze on jobs. The decline of British manufacturing has stripped out nearly 5 million jobs from the economy, while the rise of finance has added only a few hundred thousand. Since the 1980s the two leading sectors of job creation have been the state sector and what we call the 'para-state' sector. The 'para-state' sector is where workers have a private employer who is dependent on public funding.

In 1997 New Labour inherited an economy with an enfeebled manufacturing sector, a bias towards finance, and a reliance on the state for employment creation. Ironically, the most durable benefit of the Thatcher years had been a million-plus increase in public sector employment. New Labour continued this reliance on the state to fill in for the failure of private sector job creation. By 2007 the state and para-state had become the leading sectors of the economy, employing 7.5 million people, or 28 per cent of the workforce.

Fig 1: Finance sector's share of UK employment, gross value added



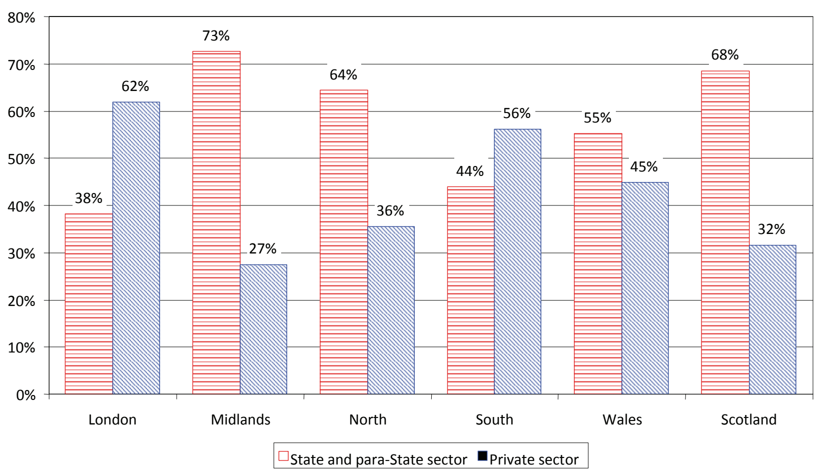

*Source*: J. Buchanan, J. Froud, S. Johal, A. Leaver and K. Williams, 'Undisclosed and unsustainable: problems of the UK national business model', CRESC Working Paper 75, University of Manchester 2009:
http://www.cresc.ac.uk/publications/documents/wp75.pdf

*Note*: The employment data excludes Northern Ireland and the self-employed.

New Labour's job creation was largely an unintended effect of its spending on health and education. In the years after 2000, real public expenditure increased by nearly 50 per cent. The public sector deficit pushed towards 3 per cent, which was the formal limit under EU rules. This meant that further expansion of the state and para-state was unsustainable. What to do next? No-one asked, and then the credit crunch hit in summer 2007.

Labour's public spending increases were dispersed right across the national economy. But their impact was greatest outside London and the South East, in areas where private sector job creation was weak or failing. In London and the South, the state and para-state accounts for no more than 38 to 44 per cent of employment growth between 1998 and 2007. In the North East and West Midlands, it is as high as 79 per cent and 153 per cent. In the ex-industrial areas declining manufacturing was not replaced by any other autonomous private sector activity. Labour's spending saved them from disaster.

Fig 2: Share of new job creation in the UK between 1998 and 2007 split by private and state and para-state sectors




*Source*: as for Figure 1 above

*Note*: The data excludes Northern Ireland and the self-employed. The Midlands group contains the government office regions (GOR) of East of England, East Midlands and West Midlands. The North group contains the GOR of the North East, North West and Yorkshire and Humber. The South contains the GOR of the South East and South West.

The state and para-state sectors have been equally important for boosting female employment. Nearly 70 per cent of this workforce is female, and half these jobs are part-time. Across Britain, the state supports the female wage-earner in the average household. The Coalition's public spending cuts will therefore disproportionately hit women, and pitch many families into poverty.

The failure of market-fundamentalist economic policy to create new jobs was compounded by the way it made existing jobs more insecure. Its 'conventional wisdom' is that 'flexible' labour markets offer the best economic outcomes. Over the last thirty years, successive Conservative and Labour governments in Britain have gone a lot further than most of our competitors in deregulation of the labour market. Indeed, Labour's 2001 *White Paper on Enterprise, Skills and Innovation* called for a system of training and education that would create autonomous entrepreneurs rather than dependent employees.

Britain now has one of the least regulated labour markets in the western world. Trade union membership and bargaining coverage in the private sector has collapsed, and security of job tenure has decreased. And yet despite this, the private sector has still failed to create sufficient new jobs across large parts of Britain. There is no proof that increased labour market flexibility has a consistent positive impact on economic performance. Nor is there evidence that countries with more deregulated labour markets have lower levels of unemployment, higher economic growth, or perform better on any other index of aggregate economic well-being.

Britain has a weak record of job creation, and, where there are jobs, a flexible labour market has allowed employers to squeeze the wages of their workforces and to cut costs. In place of improved performance there has been an increase in profits. Instead of work satisfaction there have been high levels of employee stress and anxiety, and a squeeze on time available for family life.

# 3. Home sweet loan

With massive spending cuts looming over us, and the threat of recession hovering over the economy, people's fear of unemployment is increasingly matched by the fear of not being able to pay the mortgage. Britain not only lacks jobs; it also suffers from a chronic shortage of homes. There are simply not enough houses for people to live in. This obviously creates homelessness, but it also pushes up the price of homes, and adds to the general feeling of economic insecurity.

Housing is central to our economic problems. A housing market bubble was artificially inflated by reckless mortgage lending. At the same time, housing policies and subsidies encouraged ordinary households to take on dangerous levels of debt in order to get onto the housing ladder. The bubble created an artificial sense of wealth that was used to compensate for the wage squeeze and for the declining value of pensions. The banks encouraged people to borrow more against the rising value of their home.

The housing crisis is another consequence of market fundamentalism, and the associated belief that home-ownership and rising asset values are socially and economically beneficial because they generate wealth and distribute it among home-owners. Thus Alan Milburn called on Labour to embrace a culture of earning and owning, drawing on the examples of the housing markets in Spain and Ireland as models to emulate (see his article 'Assets for all', *Guardian*, 10.11.03).

This is wrong. Our homes are not a private matter. Individuals may want to own their own homes, and seem to get rich from rising house prices, but this does not in any way mean that private home-ownership and rising prices are good for society as a whole. The disastrous fate of the housing markets and in Ireland and Spain is evidence enough of this. And though our homes may be in the private sphere, this does not mean that their rising value (which is largely based on the bubble that has driven up all asset prices) should become a private good.

The truth is that rising house prices are socially and economically destructive. Increases in the value of the existing housing stock do not represent wealth generation. Instead they redistribute wealth from non home-owners to home-owners – from younger to older generations, from the less well off to the richer – all the while increasing the demand for the debt and mortgages that feed the banks. The supply of new money into the housing and housing finance market comes from the wages and future wages of the young and others who do not own property – heavily mortgaged first-time buyers and those hauling themselves up the property ladder.

The housing market has created a new urban feudalism. In some areas, only those who inherit property wealth can ever hope to own a home. Rising prices and inadequate supply has excluded millions of people from the market; while housing supply is now down to a record low. In fact it has been inadequate ever since the state withdrew from meaningful housing provision in the 1980s.

The house-building industry is a classic example of market failure. It is geared to short-term speculation, poorly built housing units, and the rationing of supply in order to keep prices high. As prices soared production failed to keep up. When prices began to fall, output plummeted. There is now no hope of reaching the target of building 240,000 new homes per year for the foreseeable future.

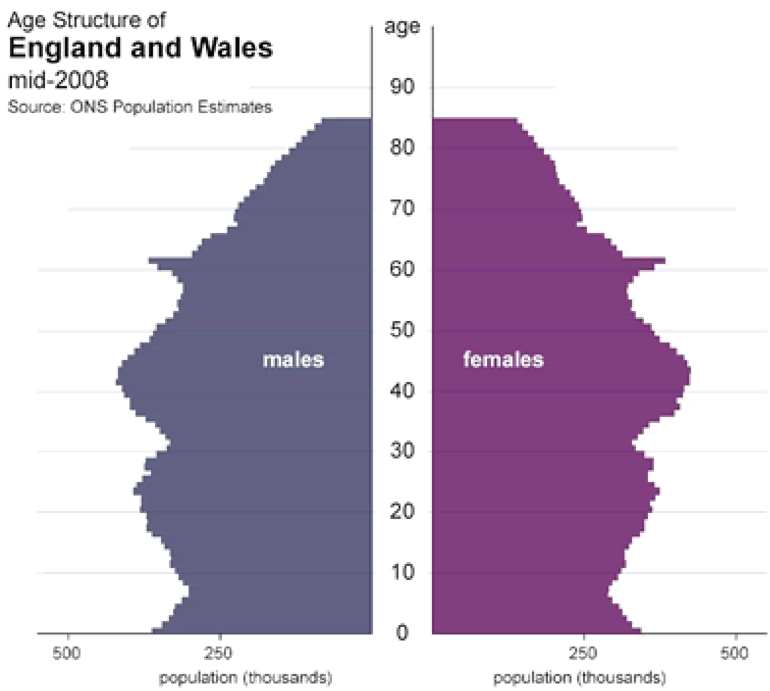
Market fundamentalism has created a housing disaster. It failed to recognise the critical role that housing plays in wealth distribution. It did not acknowledge the wider social consequences of poor housing. And it did not believe in the need for public action to remedy market failure.

Since 1997 the number of households on English local authority waiting lists has increased from 1 million to 1.7 million. And as ever more join waiting lists for social housing that is not being built, many others now face losing their homes. Coalition plans to cut housing benefit will have a devastating impact on all this, and threaten increasing levels of homelessness. Working- and middle-class households will be affected by negative equity, unsustainable debt and inadequate housing. Many of those who did well out of the housing market in the past will now have to withdraw equity on their homes to help their children buy somewhere to live.

The double whammy of housing insecurity and job insecurity are the legacy of our economic boom. But if things are difficult in present time, the future, unfortunately, offers little comfort – for our pensions no longer promise much security in older age.

# 4. Pensions are bust

Living longer offers us an historic opportunity to begin a new third age of life. But for the majority of us the future of aging will be one of financial insecurity. For the next twenty years people will be retiring in greater numbers than ever before. But Britain has a pension problem. This population pyramid for the UK shows what is happening:




The number of people of state pensionable age is projected to increase from 11.3 million in 2006 to 12.2 million in 2010. The number will reach almost 15 million by 2031. And the baby-boomer generation now approaching retirement has under-saved. They have consumed more than any previous generation, and rising house prices have meant that too much of their cash has gone into buying homes instead of saving for retirement.

The pension costs of this generation will escalate. In 2007/08 the 'pay as you go' state pension cost the Exchequer £61.5bn. In 2010/11 it is expected to cost £69.5 billion, plus £3.6 billion in other old-age benefits. This amounts to 47.7 per cent of all UK benefit expenditure, or 10.4 per cent of all government spending.

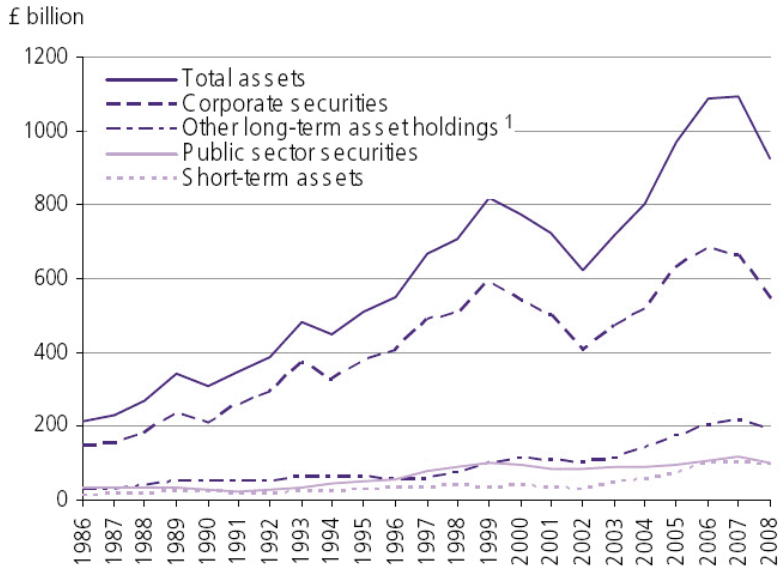
This is only part of the story. In 2007/08, total pensions paid out amounted to approximately £122bn. And during this period, apart from the £61.5bn cost of the state pension itself, a further £25 billion was paid by the state to its former employees, and about £38 billion was given in subsidy to private and occupational pension funds.

This means that pension provision cost the state £125 billion in that year – and yet the total amount of pensions paid from all sources, including private sector funds, was just £122 billion. In other words, every single pension payment made in 2007/08 was made at direct cost to the state. The private sector did not bear any of the burden in that year of paying pensions to members of private sector pension funds.

If the state is actually funding all pensions paid at present, directly or indirectly, then what is the purpose of companies so called 'funded' pension schemes? The assets in which pension funds are invested expose future pensioners to considerable risk; and at the same time they make many companies extremely vulnerable to shifts in the value of their pension funds – which they have an obligation to fund. This is a largely a consequence of the risky assets in which pension funds choose to invest:

Around 60 per cent of pension investments are in corporate securities. 99 per cent of this kind of investment is made in second hand-assets already in issue. The issuing companies receive no direct benefit from their purchase. In other words, no new investment or employment opportunities are created. In economic terms these are savings activities and not investment activities.

Figure 2: Fluctuations in assets held by pension funds




1 Other long-term asset holdings comprise overseas government securities; loans and mortgages; fixed assets; holdings in insurance-managed funds; property unit trust holdings and other UK or overseas asset holdings.

Thus demand for pensions is increasing, while all pensions are being paid at cost to the state. As the demographic profile changes, and fewer people are in work and paying tax, the state's capacity to fund its pension obligations is likely to fall. But the company 'funded' pension schemes are expensive to operate, and absorb a considerable state subsidy for no guaranteed return. Nor are they using the assets under their control to create new investment or employment opportunities. What is more, they appear unable to meet their obligations without continuing and potentially unaffordable subsidy from the tax-payer.

A massive industry in managing pensions funds has been created, which reallocates an enormous amount of wealth to the City, but which appears unable to pay adequate pension returns, either now or in the future. The current pension industry drains enormous sums of money out of the economy and into saving. The reverse flow is necessary. Money needs to go into the economy to create investment, jobs and future well-being – which can thereby underpin future pensions.

The future is aging, but our economy is not prepared for this revolution. Indeed market fundamentalism is incapable of planning for the future needs of society. Markets pursue short-term profits, and companies chase competitive advantage; and the consequences of this are a failure of longer-term investment and the loss of wealth generation for a common prosperity (though ensuring the enrichment of the few). The knock-on effects have damaged jobs, homes and pensions. And the cause of many of these problems can be found in the business practices of the banks.

# 5. Rotten banks

Following the dot.com boom and crash in 2000, banks shifted their market and started to make massive profits by selling financial products to individuals and households. Their financial products became more complex, more risky and more of a threat to the whole economy. In the end they were making profits by loaning money to people who could never pay the debt back. The toxic debts from these sub-prime loans were then bundled up with a few secure loans and sold on for a profit. Like a game of musical chairs they were passed from bank to bank – until the music stopped and someone was left holding billions of dollars of worthless assets.

Gordon Brown believed in this highly profitable financial economy. In his now infamous 2007 Mansion House speech, he declared that we are living in an era 'that history will record as the beginning of a new golden age for the City of London'. The following year house prices in Britain lost 13.3 per cent of their value, HBOS and the Royal Bank of Scotland faced bankruptcy, and money markets froze. As the banking system imploded and the British economy came close to collapse, a second Great Depression was only avoided by the government's £289 billion bailout of the banks.

But now, as public services are being closed and privatised, the power of the banks remains undiminished. And, though there can be no democracy or common prosperity in Britain until they are brought under control, the political elites are still too timid to face up to the power of the bankers.

Government had no choice about bailing out the banks, despite the problem of 'moral hazard' – of which much has been made in the recent financial crisis. 'Moral hazard' refers to the existence of an implicit state guarantee that it will not allow banks to fail: this encouraged them to take greater risks in pursuit of ever higher profits and bonuses, knowing that any market failure would be underwritten by the tax payer.

But government's hands are tied, because withdrawing its guarantee could mean that a collapse of one major player would have a domino effect on other financial institutions. There would then be major repercussions for firms and households outside finance. Effectively, the banks can hold the population of Britain to ransom.

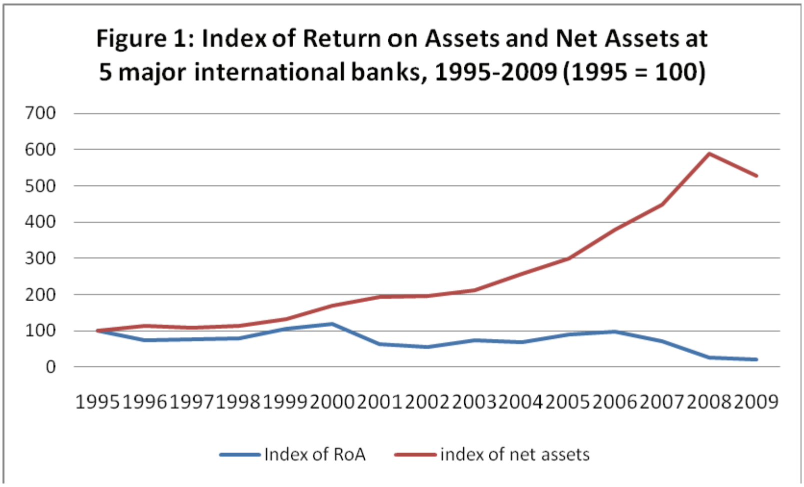
In return for all this the banks give nothing back. Banking in Britain delivers very little social benefit for the economy. Between 1996 and 2008, while all those profits were being made, productive business investment remained at a steady 10 per cent of GDP, and lending to manufacturing was flat. In other words, banks – as they currently operate – do not allocate capital usefully in our economy.

What is a still bigger problem is that the financial sector is a mass of transactions that entangle the fate of companies in a latticework of mutual exposure and obligation. This latticework is complicated even more by the nature of wholesale banking business models.

These models are driven by the pursuit of volume growth rather than of improvement in profit margins. Margins are very low and difficult to improve in virtually all banking business lines. It is therefore only possible to boost profit by increasing the volume and value of transactions, as opposed to reducing costs to increase margins. Figure 1 presents a composite index of five major international banks with wholesale activities.

Return on assets remained fairly constant (at a low level) until the late 1990s, when increases in the volume of transactions began to boost profits.

Banking has become an industry that makes money only for itself. Ever expanding, and entangling banks in a state of mutually assured destruction, it concentrates wealth in a few hands. It is a kind of transaction-generating machine that operates in its own interests. It lacks transparency, and benefits from high levels of information asymmetries. The senior work force have a vested interest in sustaining this system, because increasing the volume




*Source*: Thompson One Banker

and value of transactions, and inventing ever more arcane financial products, swells their pay and bonuses. This business model was never challenged, because the drive for volume growth and the doctrine of shareholder value effectively united the interests of the senior workforce and shareholders. And the collusion has resulted in practices which are economically dysfunctional and socially destructive.

Market fundamentalism has created a crisis of economic coordination, and this is an important aspect of the financial crisis. Too much capital is allocated to leveraged and unsustainable asset-price growth. Too little is channelled into productive, socially useful investment that might generate sustainable economic growth.

And we can see a similar pattern in the global economy. Banking is a crucial part of the City of London, and the City has been a powerhouse of a model of globalisation that has undermined poorer economies and distributed wealth to the already wealthy.

# 6. The globalisation express

Globalisation has exacerbated Britain's problems of deindustrialisation and a dysfunctional economy. But while it is true that globalisation has reduced the agency of national government, its effect in limiting the room for manoeuvre has tended to be exaggerated. And rather than seeking to protect individuals from its onslaught, British governments over the last three decades have instead championed a culture of entrepreneurialism and self-reliance: individuals have been told to invest in their own human capital and compete in the open market. Success was about grabbing opportunities when they came along. Those who failed were cast as failures or social problems.

Unfortunately, the economic and social problems created by the untrammelled forces of globalisation prompted only limited official rethinking. In his 2005 Labour Party Conference speech Tony Blair signally failed to grasp the implications of globalisation. He identified a world that is 'unforgiving of frailty. No respecter of past reputations … has no custom and practice'; but rather than considering any of that a problem, his response was to celebrate those who are 'swift to adapt' and 'open, willing and able to change'.

For the elite, the Globalisation Express is basically on the right track – all that's needed is a few more signalmen at key points. They cannot face up to the fundamental failures of the last three decades. Instead they call for more, better and diverse institutions: a G20 that includes India and China; a banking regulator for the eurozone; and an IMF that better monitors international flows of money.

The problem with this analysis is that it ignores the unaccountable power of ultra-mobile capital, and the penalties that have been inflicted on labour. The kind of globalisation embraced by New Labour after 1997, and enthusiastically endorsed by the Liberal Democrats and Conservatives, aspired to cut government down to size. Markets always knew better than voters or politicians. The state could do little in the face of global markets except train up its citizens to compete for jobs, and hand out limited and conditional welfare to those who fail.

What was missing from their enthusiasm was any kind of definition of the driving forces behind globalisation, or its effects on national economies and people's livelihoods. Indeed, much of New Labour's ideology now looks naive and uncritical. It was too timid in regulating markets, and it was almost cavalier about what would happen to workers who lost their jobs. It also underestimated the bumpiness of integrating giant economies in to the global marketplace.

As anyone who has studied history – or simply looked around – would know, opening your country up to the forces of global trade is not a good recipe for economic development. The countries whose economies have most successfully developed, either in this round of globalisation or throughout history, have never played by the free market rulebook. The US economy came of age during the first phase of globalisation, from the 1870s up till the first world war; and in 1913 it was still putting 44 per cent taxes on imports – far more than any poor country would dare nowadays.

Similarly, China and India, which still rely on central planning, and are among the most protected economies in the world, have done well in this phase of globalisation. Conversely, other, smaller countries, forced to follow the strictures of the IMF, the World Bank, the World Trade Organisation and the capital markets, have failed to develop as impressively over the last couple of decades. So much for the benefits of full openness to global trade.

And the former cheerleaders of globalisation in the West are now also qualifying their enthusiasm. Thus there is a growing body of research showing that 'skilling-up' (which, politicians agreed, was the best way to compete with low-wage countries) is nowhere near as effective as advocates claimed. There are signs, too, that British voters are growing less tolerant of home-grown and longestablished companies being bought up and shaken down by foreign buyers.

And then there is the political shift. In the dying months of the Labour government, as the credit crisis ripped through the world economy, ministers rediscovered 'industrial activism' – the need for government to intervene to support industry and give some kind of direction to economic development. But it was a limited effort, which largely preserved the old illusions; it was not able to explain how any kind of orthodox industrial policy could work under current British conditions.

British politics has worked around globalisation, rather than managed it. Successive British governments have heightened many of the long-running problems in the economy, even while encouraging dangerously volatile growth. A major consequence of Labour's complicity has been to undermine the sources of its own political support and to negate the power of progressive politics.

Labour has to reckon with its failures, and then it has to recognise that a new political economy will mean managing globalisation, rather than merely letting it rip, in order to redress Britain's economic weaknesses. To do this it must develop a convincing macroeconomic policy strategy.

# PART 2

## MANAGE MARKETS BEFORE THEY MANAGE YOU

# 7. A new political economy for Labour

The failure to appreciate the full risks of free market globalisation is a symptom of a much deeper failing of Labour's political economy. Until the crash of 2008, discussion of macroeconomic policy and the overall working of the economy was notable mainly in its absence from British politics. All three major parties broadly accepted the theoretical doctrines of neo-classical macroeconomics that underpinned market fundamentalism.

For New Labour that has meant reducing economic policy to a question of competence rather than values. The aim of policy was simply economic growth, with little regard for its distribution or sustainability. The necessary prerequisite for growth was low and stable inflation, and this could best be achieved by an independent central bank, immune from political pressure. Thus it would set interests with this one goal in mind. Fiscal policy had almost no role in this macroeconomic settlement.

Markets, especially financial markets, were seen as efficient mechanisms that required little interference; indeed any government interference ran the risk of causing distortions and producing suboptimal outcomes. On assuming power in 1997, Labour outsourced monetary policy to the Bank of England, and fiscal policy was constrained by the 'golden rules' on government borrowing. The Treasury handed over the reins of macroeconomic policy to technocrats, and instead busied itself with microeconomic reforms.

Whilst important progress was made at a micro level – tax credits, the New Deal and the minimum wage – Britain essentially ceased to have a democratically controlled macroeconomic policy. Instead, the Bank aimed to use interest rates to control inflation, the

Treasury began a policy of modest redistribution, and the City was allowed ever-greater freedoms.

By its own yardsticks this policy was highly successful in the period before the crash. But underneath the headline indicators all was not right. Growth was driven by consumer spending, which was often financed by borrowing, and personal debt rose to unprecedented levels. Whilst headline inflation was low, housing costs soared. The economy, and government revenues, became dangerously unbalanced towards finance and property, whilst manufacturing declined.

These underlying problems were viciously exposed in the crash, as credit ceased to flow. Private sector investment collapsed, driving large falls in GDP, whilst a record deficit developed in the government's accounts, driven not by an expansionary programme but by falling tax receipts.

The government belatedly rediscovered Keynesianism in late 2008. However this was more rhetorical than actual. Its modest fiscal stimulus – a cut in VAT and the bringing forward of some capital spending – was enough to prevent total economic Armageddon, but not enough to forcibly kick-start growth. By 2010 much of this stimulus has been withdrawn, and the principle macroeconomic dividing line of the 2010 election campaign became the question of the timing of £6 billion of 'efficiency savings'.

## A new macroeconomic policy

Labour must now construct a new political economy capable of rebuilding a wealth creating and distributing economy across all regions of Britain. Blind faith in markets, a reliance on finance and an acceptance that providing low inflation is the only macroeconomic role of government has now been challenged to breaking point. If macroeconomic policy is to succeed it must address both the demand side and the supply side of the economy;

it must ensure that there is enough demand to drive forward growth, whilst also making sure that the resources exist to meet this demand. A return to traditional pre-oil crisis Keynesian welfare capitalism, with too much emphasis on demand alone, is not the answer.

In the 1920s much of Labour's economic thinking was rooted in theories of under-consumption. The argument was that as one becomes wealthier, one tends to save a greater proportion of one's income; so that vast disparities in wealth lead to too much saving in the economy as a whole, and not enough demand. Social liberal and liberal socialist thinkers such as J.A Hobson, E.F Wise and J. Strachey, associated with the Independent Labour Party, made the case for a more equal distribution of income not only on moral grounds, but also on economic grounds. A redistribution of the economy's wealth towards the working class would lead to higher consumption and hence higher employment.

This insight still holds true. As we argued at the beginning of this e-book, the impact of rising inequality has been masked for the past three decades by increased borrowing by those further down the income scale. But increased personal indebtedness has proved unsustainable, and, given this difficulty, if living standards are to be maintained a solution will have to be found in greater wealth equality. Government intervention will be required – whether through increasing the minimum wage or using the power of public sector procurement to enforce a living wage – as will changes in the tax system to reduce taxes on low earners.

However, a focus solely on boosting consumption would be misguided. The share of consumption in GDP is already too high. As cannot be stated too often, the most alarming – and underreported – macroeconomic development of the past two years has been the collapse in private sector investment. This has not only driven the short-term fall in GDP and been the largest contributor to the recession; it is also likely to damage the UK's future growth potential.

Investment has been the most volatile component of GDP, an insight recognised by Keynes in the 1930s. In the financial crisis of 1929-1931, the Labour government of Ramsay MacDonald faced a similar collapse in investment, and, driven by the economic orthodoxy of the time, it responded by curtailing government spending to balance the budget. A policy based on the expansion of working-class purchasing power was rejected, because Chancellor Snowden was fearful of the inflationary consequences of such an expansion of demand, given the depressed state of business.

Keynes forcibly argued that when demand fell away the only solution was for the government to borrow to invest. This would not only keep people in work and prevent a deflationary spiral; it would also boost the confidence of private sector actors and encourage them to spend.

The popular association of Keynes with budget deficits and an active fiscal policy is, however, misguided. Keynes argued that this policy was required in times of exceptionally low demand in the economy, as in the 1930s or currently; but it was not his preferred solution to what he termed 'the economic problem'. In the ordinary run of things he would have preferred to run an economy by monetary rather than fiscal policy. It is also notable that Keynes argued for the running of budget deficits to increase spending on investment, rather than to boost consumption. In this regard the decision in 2008 to cut VAT was not exactly Keynesian.

The evidence is that relying on education and the most micro of micro-measures did not help the UK economy become less lopsided in its dependence on the City and the housing market, and it did not create private-sector jobs north of the Watford Gap; there are therefore clear grounds for the government to intervene further – even while playing by the globalisation rulebook.

Over the next few years – in sharp contrast to the austerity policies of the coalition – the economy will need higher government spending on infrastructure: social housing, transport projects and the green industries of the future. Over the medium term, however, the monetary lever will be more important than the fiscal, as Keynes, by background a monetary economist, also recognised. A policy of fiscal Keynesianism based on boosting consumption – essentially the macroeconomic policy pursued by governments up to the mid-1970s – will eventually force demand to levels well in excess of supply and result in inflation.

(Of course, the policy that followed was even worse. Monetarism, with its emphasis on high interest rates to hold down money supply and hence inflation, was a doctrine which favoured finance over industry, destroying jobs and increasing inequality; and modern macroeconomic policy, with its focus on low consumer price inflation, has ignored asset bubbles, once again favouring financial over real capital.)

The macroeconomic policy of the future, over the medium to longer term, will have to be focused on supporting industry. The first step would be to move towards creating a genuinely more social and community orientated capitalism. We need to recognise that the problems of the 1970s included wage-price spirals that had their roots in Britain's industrial relations. The old Labour religion of free collective bargaining could not in the end be squared with the macroeconomic need to co-ordinate and control wages.

One solution to this is to encourage a diversity of business models – for example employee ownership schemes along the lines of the John Lewis model could be tax-incentivised; and there is also a need for the reform of corporate governance in order to incorporate worker representation in the decision-making of firms. This would offer a way of bringing the economy and profit seeking under greater democratic control by a wider range of stakeholders. Changes to company law to embed wider social responsibility into boardroom decisions are also crucial. A publicly held sovereign wealth fund or similar vehicle could also be created, funded by equity capital derived from an annual levy on UK publicly quoted companies (which could replace stamp duty on UK share transactions). The government should also encourage the development of a social analogue of the private equity sector, which could buy up existing companies and transform them into large-scale social enterprises.

Second, we need measures to unlock and encourage enterprise and creativity, not just among a few managers or entrepreneurs but in the private (and public) sector workforces as a whole. The encouragement of mutual ownership and industrial democracy would help here. So would a wider role in British workplaces for trade unions – whose presence has been shown in recent empirical work to be associated with greater take-up of high-performance working practices, but who face widespread opposition from managers schooled in the anti-union rhetoric of Thatcherism. Incentivising union membership through tax breaks (for example a lower rate of corporation tax for unionised firms) might help break this logjam.

Third, Britain should not be cutting public spending on items which are essential to our future economic prospects – such as higher education, science and transport infrastructure. The 2009 Compass publication *In Place of Cuts* shows how spending on key areas such as this can be maintained by using a combination of tax increases to bring in around £40 billion per year of extra revenue (see www.compassonline.org.uk/news/item.asp?n=6164).

Finally, policy to decarbonise Britain's economy needs to be much more ambitious – and to draw on the work of the New Economics Foundation's Green New Deal group (see www.neweconomics.org/projects/green-new-deal). For example, a large-scale programme of investment in insulation to convert all UK residential dwellings and business premises into low-carbon buildings would provide a massive stimulus to the nascent low-carbon industrial sector, as well as creating employment on a large scale.

A new macroeconomics requires a monetary policy based on 'cheap' but not 'easy' money. Low interest rates will fund the much-needed increase in investment. However, regulation of the financial sector will be required to ensure that lending is not used simply to finance consumption and speculation. Perhaps the most perverse result of the current financial crisis has been the refusal of the very same banks that financed the bubble to lend to the real economy.

Greater democratic control of the credit system would allow industries designated as being of strategic importance to borrow at rock-bottom interest rates (for example, renewable energy firms and green technology start-ups). Growth would be driven by investment rather than consumption. As Britain's industrial base is rebuilt, the balance of payments would improve – although there is no need to cling to the fantasy of 'export-led growth' in a world where nearly every country is aiming for the same outcome. Much of this approach is not new: it was conceived of in the 1930s by Labour's young generation of Keynesian economists – Evan Durbin, Hugh Gaitskell, Douglas Jay and Nicholas Davenport. They advocated a programme of monetary reform, guided by Keynes, with the aim of making finance the 'servant' of industry.

The surest route to a sustainable recovery is a short-term increase in government investment, until such a time as the private sector is prepared to invest itself, coupled with an expansion of the purchasing power of lower- and middle-income families, and a long-term focus on the financial sector supporting the real economy. A macroeconomic policy focused on green and sustainable growth in the real economy, in recognition that the government has an important role to play here, will create greater equality and a more stable economy. It will have direct effects on the lives of low- and middle-income households, who will have less need to borrow. It will provide the foundation for reforms to the jobs market, and to housing, pensions and the banks.

# 8. Common wealth

Seventy-five years ago, in the aftermath of the Great Depression, Neville Chamberlain announced: ‘By cuts, by economy and by severe taxation the Budget was balanced’. He failed to mention that, as a consequence of his policies, income was falling, consumption was being reduced and unemployment had doubled. As Keynes said, referring to politicians like Chamberlain, ‘practical men, who believe themselves to be quite exempt from any intellectual influences, are usually the slaves of some defunct economist’. Keynes would no doubt say the same thing today about George Osborne, who has learned nothing from history. Despite the role Keynes’s theories played in ending the Depression and creating economic stability and growth, his ideas must still be fought for, never mind being revised and developed. The macroeconomic policy set out in the previous chapter will require from Labour a robust defence of deficit spending in hard times, and a sustained intellectual assault on the ideology of neo-classical economics.

There is only one force capable of matching and countering the profit seeking of capitalism and the social damage and insecurities it causes, and that is democracy. Democracy is the prerequisite for a moral economy that is based on a common prosperity and the give and take of reciprocity. Developing a new political economy means also a commitment to deepen and extend democracy across politics, society and the economy.

The principles of a moral economy are environmentally sustainable wealth creation, durability, recycling, cultural inventiveness, equality, and human flourishing. Our obligations as good workers must be matched by government and business working for the common good to secure decent jobs, secure homes, proper pensions and fair finance. In this final chapter we briefly outline the kinds of reforms in these areas that we will need if Labour is to build such an economy in the decade ahead.

## Decent jobs

The most important activity in a new moral economy is work. Not underpaid exploitative work, but good quality jobs, fairly rewarded and equitably spread across the regions. Market fundamentalism has failed to deliver this basic requirement of the good society. It has failed to recognise that government has a central role in working with business, finance and civil society partners to identify and develop new areas of market potential. The two issues of climate change and job creation must be brought together in employment-intensive activities such as recycling, repair and maintenance to deliver a low-carbon future. The private sector alone will not rebuild a sustainable British economy. There is no further case for it receiving general tax cuts as incentives.

The state and para-state sectors will be crucial to economic recovery. We need to use the lever of public procurement to introduce a living wage. In the client private sector there should be tough regulation on profits, decent labour conditions and gender pay equality. Up to now public private partnerships have divided risk and reward unequally and usually to the disadvantage of the government and tax-payer. In their place we will need to reinvent forms of social partnership and reinvigorate not-for-profit businesses. A social and community oriented model of capitalism will only work if there are genuinely different business models, mutual ownership and economic democracy.

Alongside a new job-creating economic paradigm Labour must improve conditions of work. Fair employment protection legislation can reduce job insecurity and inequality and so enable all workers to benefit from flexible working patterns; while an increase in Jobseekers Allowance will not only give greater financial protection but also help to boost demand in the economy. Conditionality in the benefits system has to be accompanied by improved support for unemployed people, as a part of a wider development and integration of welfare, health and employment services.

Britain needs a workforce that has the craft skills and education to rebuild the economy. This will mean investing in the future by expanding funding for adult skills, further and higher education, and training subsidies, particularly for low-skilled workers. Employees should have a stakeholding in the companies they are working for, and, alongside trade unions, they need a greater role in improving their skills.

These reforms would help create an economy geared to good work decently paid. They would redefine labour market flexibility as a process which operates in working people's favour rather than threatening their job security and living standards. The best option for reducing inequality in Britain is a new wealth-creating economic paradigm that can deliver a more secure labour market, an extension of collective bargaining rights to a greater proportion of the workforce, and a living wage.

## Good, affordable homes

Housing market stability and affordable homes are essential for people's security and for a prosperous economy. Taken together they will help reduce wealth inequality, regional polarisation, and generational inequity. Housing reform can also address the problems of debt, pensions and the under-investment in productive enterprise.

The housing sector is complex and will require a range of reforms. These reforms should begin with a change in the rules governing local authority spending and borrowing, so that councils can invest in housing construction. After decades of centralisation, local government has a key role to play.

Housing development can be greatly improved by retaining land in public ownership, or by transferring it for free into permanent community or non-profit ownership. Both measures would give the public sector a leadership role in the sector. Publicly owned regional development banks could provide long-term finance for infrastructure and housing growth backed by selling local authority bonds.

We urgently need to rediscover and expand sustainable, mutual models of housing finance, and community-based finance institutions. Pluralism needs to be extended within the field, so that the house-building sector includes housing associations, the public sector, community land trusts, local community groups, self-builders, and emerging models such as co-operative land banks and community right-to-buy schemes.

The housing market has failed, and we should consider a non-profit public clearing house, to which sellers could sell their homes without waiting for a chain of transactions to be in place. There also need to be decent alternatives to home-ownership. Despite the fiscal austerity, the country needs a massive social homes building programme. Tenants need greater security of tenure and longer contracts.

Lastly, the most effective fiscal-policy means of tackling housing booms and busts would be an annual land value tax that would replace council tax and the system of business rates. This would have a significant impact on the economy and on levels of wealth inequality.

These reforms would give people genuine housing choices. Public investment would be targeted at those who need it most. And the reforms would also help to reduce the size of the wealth gap between the higher and lower ends of the housing spectrum, and to develop more and better intermediate options in the middle. On a macroeconomic level they would create a less volatile, more secure economy, and one that distributes wealth and resources more fairly across regions and classes.

## Stable, adequate pensions

The reform of pensions must recognise the fundamental pension contract between generations on which society depends for its future. The older generation, through its own efforts, creates capital assets and infrastructure in both the state and private sectors for the following generation to use in the course of its work. In exchange for use of these assets, the succeeding generation will, in effect, meet the income needs of the older generation living in retirement.

This contract between the generations has been broken and it needs to be repaired. The state must guarantee a Citizens Pension that keeps all out of poverty. Company pension funds need reforming. Their existing deficits need to be eliminated by the host company issuing shares in its own pension fund to the value needed. In addition, consideration could be given to promoting contributions made by employers in kind, by issue of new shares in their companies to their pension funds.

Pension funds need to be transparent, and to provide comprehensible accounts and details of their investment programmes. Short-term, speculative risk in savings has to be replaced by investment for future generations – for example in local authority bonds, shares in a new Green Investment Bank, and hypothecated bonds, which could replace PFI for infrastructure projects. Compulsory saving for old age should be invested in stable, secure and predictable investments, including government gilts, and also in community development, social enterprise and the new green industries. Tax relief on pensions could only be secured if a fund invests proactively to create new capital assets, infrastructure, skills and jobs.

These changes would have a number of profound effects on the economy and the fabric of society. The £80 billion of funds entrusted to pensions each year would ensure the biggest boost to investment in the economy for generations. Accountability would transform pension fund behaviour, as well ending the feeling that pension fund savings are abused by the City for profit. Government funding would be better targeted to ensure favourable, broadly-based outcomes for society. Hopefully, the return to pensioners should improve, as succeeding generations receive from them the capital and infrastructure inheritance they need to ensure they can keep their predecessors in their old age. Much of this depends on reforming the financial sector.

## Fair finance

Banks, as they currently operate, do not allocate capital usefully in our economy. The underlying problem is the volume-driven bank business model. Economic recovery and rebuilding requires wholesale structural reform, not regulatory tinkering. Labour, representing the public interest, must establish a public interest inquiry to address the question of how far finance needs to shrink.

A productive and social model of capitalism needs finance to build the low-carbon, sustainable economy of the future rather than enriching a plutocracy at everyone else's expense. The banks that are 'too big to fail' must be broken up, and investment banking separated from retail banking.

The banks threaten to leave, but Britain literally cannot afford to underwrite the scale of their unreformed transactions and risk another financial crisis. Potential measures of reform include: claiming for the public 25 per cent of the revenue now allocated to the pay and bonuses of the senior workforce; corporate governance reform to ensure employee representation on enumeration committees, so that pay awards to senior staff are made accountable; the setting up of a High Pay Commission to investigate how Britain should deal with high pay and its impact on society and the economy; the capping of interest rates on unsecured loans; and a transaction tax to reduce the volatility of the market.

We need a mix of financial service providers. The mix should include more bond-based and mutual banks, and a regional and community banking system for bringing credit to the people and capital to localities. The allocation of capital, particularly pension funds, should be a democratic process, and geared to job creation for a low-carbon economy. We need greater transparency and accountability, and that means an end to tax havens and corporate tax evasion. Participation in decision-making about financial regulation should be widened, with official agencies such as United Kingdom Financial Investments including on their advisory boards trade unionists, politicians, NGOs and academics.

Britain's business model is currently unsustainable. While the deficit in public spending has been identified as the principal cause of Britain's broken economy, the truth is that the economy suffers from a dearth of capital investment, as vast financial flows chase unproductive short-term profit. Our economy is anaemic because it lacks capital. Consequently it is over-reliant on state spending and redistribution. This outline reform programme should not only shrink banking but also redirect resources into productive, socially useful activity and thereby gradually rebalance our economy towards job creation. Structural financial reform is not only about making banking safe by changing the business model. It is also about redirecting resources to create an economically and environmentally sustainable future. Without it recovery will be long and protracted.

We think this outline offers the basis for a revision of Labour politics and for a new kind of moral economy. But we cannot evade the fact that Labour's revisionism in the past has not paid sufficient attention to the destabilising and sometimes destructive impact of capitalism. The most striking political feature of UK policy in the last thirty years is that big firms and markets have slipped out of public control. Instead of markets being the servants of society, they have become our masters. Democracy has been undermined and society put at risk. Wealth has been transferred from the majority to a small rich elite in the South of England. The overweening dominance of finance, pampered by politicians and excused from the norms of social responsibility, has sucked in wealth and talent from the country and left in its wake an unbalanced and dysfunctional economy.

Recognition of these realities is the necessary starting point for the recreation of democratic control over economic life. Labour has to evolve a democratic model of the state, and a political economy that is capable of regulating financial capitalism and ensuring that markets are embedded in society. A productive, wealth-creating economy serves the needs of society and democracy, not the other way round.

Developing a moral economy based on reciprocity, in which citizens have the opportunities to flourish, is the foundation of the good society. This will mean creating a new kind of democratic agreement between the individual, society and the state, which will replace the old paternalist welfare model. The good society will not be achieved by a centralised, undemocratic and micro-managing state. It will involve the active mobilisation of people, not their passive representation. It will mean a larger role for civil society organisations and institutions and a more democratic Labour Party, committed to developing political leadership and workplace and community organising. In order to mend Britain's broken economy and build the good society, Labour will need to provide the political leadership to engage with people's everyday lives and speak for the common life we share. This is the challenge in the decade ahead.

# Afterword

This e-book offers us a story of Britain's economic model that many will recognise. It has not been a fair model; it has not been very productive; and it does not have a future. The contributors to the e-book offer solutions grounded in Keynesian and post-Keynesian alternatives to neo-classical economics. We should take them seriously because they are credible, make sense, and offer the British people a much better deal than the failing casino economy we currently live with.

But these solutions represent a huge political challenge for Labour. For against a backdrop of almost catastrophic defeat we have to hold fast to the centre ground and win the battle of ideas for a new economic model that will mean radical change: more democracy; reform of an over-centralised and undemocratic state; reform of the banks; the development of new green markets and industries; and a guarantee that obligation, reciprocity and fairness go all the way up and all the way down our society. This will mean upsetting the elites who have run this country into the ground in pursuit of their own vested interests. Their friends in the media will rally to their support. We know our enemies – we have twisted and turned to avoid their attacks. It did not do us much good in the end.

So let us be willing to meet them here on the centre ground of British politics, in the name of economic common sense, human decency and the long history of British liberty. We must be politically smart and build our broad coalition of support, because our aim is to defeat the old elite, and to win power and govern. The economic crisis is not over, and it is realigning British politics. The political divides do not just run between parties; they run through them. They exist between those who favour free markets and those who believe markets should serve society and democracy; between those who believe in a politics of pluralism and alliances and those

who believe in political tribes and themselves alone; and between those who want to spread power through democracy and those who want to concentrate it for political control. In this new political landscape Labour must go on a voyage of self-discovery.
Not since the 1930s has Labour been faced with such challenges.

Barclays Bank has recently announced the appointment of investment banker Bob Diamond as its new chief executive. The message is clear: despite the massive bail out and people's sacrifice, the banks will continue business as usual. They threaten a future financial crash. The Coalition holds fast to its plans to drastically cut back the public sector, even as the economy teeters on the edge, and the IMF, OECD and President Obama urge caution.

The truth is that the Conservatives are economically bankrupt. Their right wing has trapped them in the fantasyland of their neo-classical past. Only Labour can find the courage to move on and stand up for democracy. And only Labour can build a new covenant based on jobs, homes, pensions and the reform of finance. The Conservative Party has always been the defender of the property rights and prerogatives of the rich. The Liberal Democrats have allowed power to pass to their free market fundamentalists. The coalition is proving to be soft on the banks, hard on the poor, and threatening to growth.

As the leadership race comes to an end, Labour will begin creating its alternative. The early years of New Labour – the pluralism, the ethical socialism, the stakeholding economy, the idea of a covenant of trust and reciprocity with the people, the powerful emotional language that reignited popular hope – provide us with a guide to the future. The Conservative mandate is weak. We can win back power and we can realise our ambition to deliver real transformative gains for the people of our country. The ideas in this e-book will help us on our way.

Jon Cruddas, September 2010