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The political economy of fiscal deficits in the UK

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Abstract. The focus of this study is on aspects of public debt and austerity policy in the UK. It attempts to provide an evaluation of fiscal policy under neoliberalism and to consider the relationship between this policy and the macroeconomic performance of the UK economy. There also seems to be ambiguities among the policy makers about austerity. Therefore, it seems important to examine the issue of government imposed austerity policies and fiscal deficits. There is need to borrow to cover the deficits as there is no inflationary pressure in the UK. Most democratic solutions against any inflationary pressures are to reduce money in circulation through higher taxes. Further I argue that a number of counter measures could possibly be taken such as placing a requirement on financial institutions such as pension funds to place some minimum proportion of their asset portfolio into government stock.

Keywords. Public Debts, Fiscal policy, Austerity, Neoliberalism.

JEL. E63, H62.

1. Introduction

The disaffection with the EU in the UK reflects a concern about both the quality of and increased demand for public services as well as fears about declining wages and incomes, rises in population and the impact on cultural change, especially in small towns and rural areas. There also seems to be ambiguities among the policy makers about austerity. Therefore, it seems important to examine the issue of government imposed austerity policies and fiscal deficits. I find there is a gap in the literature about the impact of austerity policy in UK, especially since growth is not picking up as expected. The recent IMF report has lowered its estimate for UK GDP growth in 2017, downgrading it from 1.7% to 1.6% and expects the economy to grow by 1.5% in 2018 (Elliott & Inman, 2017).

Further, on public debt, the IMF report says: "But the UK's public debt remains high at 87% of GDP, so continued reduction in the deficit is critical to create further room to respond to future shocks." (IMF Report cited in Elliott & Inman, 2017). Therefore, there is a more urgent need to revisit the austerity policy and I hope my study will contribute towards more discussions on this very crucial issue.

The 'Leave' vote was in part a protest against the economic model that has been in place for the past three decades and against the austerity policies that emerged from it. Austerity was given renewed vigour by the Conservative and Liberal coalition government when it came to power in 2010. It has since affected the living standards of a large proportion of the working people. Blanchflower (2016) argues that:

[T]he lack of post-Brexit plan and the rise in uncertainty... have caused the UK economy to nosedive. This uncertainty will not be resolved for several years. The good news is you should be able to make money by buying shares and gold. The bad news is that this will widen inequality further, as it does

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nothing to help the poor, the young and ordinary strugglers who don't have assets (Blanchflower, 2016).

The Brexit side in the UK's referendum orchestrated a campaign with features typical of the ethno-populism resurgent throughout Europe. Some critiques blame the uneven effects of globalisation, which has failed to help those most disadvantaged by its impact (Boyer, 2012). It is still important to discuss austerity policies and their overall impact on the economy, because the British government has an unclear policy, particularly since the Brexit vote. Philip Hammond, the current Chancellor of Exchequer has said that he will not to aim to meet George Osborne's debt targets and fiscal rules aimed at balancing the budget by 2020 because these are no longer viable.

Soon after the financial crisis in 2008, the UK government allowed the budget deficit to rise to expand domestic demand. In the budget for 2008/09 they announced a budget deficit (public sector net borrowing) of 2.9% of GDP (2.7% cyclically adjusted) with expected growth of around 2% annually (HM Treasury, 2008). However, a year later, in the budget report for March 2009, the forecast budget deficit was a further 4.4% of GDP (7.3%) of which 0.5% was ascribed to discretionary measures (Fontana & Sawyer 2012). In 2010, the EU began to show concern about rising deficits and announced suggestions to achieve a balanced budget. Following the British Parliamentary election in May 2010 and with the formation of a coalition government of Conservative and Liberal Democratic Parties, deficit reduction as a central policy was announced to address the concerns of the credit rating agencies and global financial markets. The planned reduction in public expenditure under the Coalition government was 60% greater than that advocated by the Labour government in 2015. There was a further reduction of £32 billion in addition to the £52 billion reduction already announced, making a total of £84 billion. The Coalition government estimate was to reduce budget deficits from 7% of GDP in 2010/11 to 1.9% of GDP by 2015/16, and then to 0.7% of GDP in 2016/17 (Fontana & Sawyer 2012).

It was assumed that there would be relevant changes in saving, investment, and exports, given that mainstream economists assume a substantial rise in business investment following fiscal 'consolidation' (Boyer, 2012). The forecast was based on high levels of optimism, whilst it ignored the costs of such drastic measures. As Fontana & Sawyer (2012) warned:

"The balanced budget may be achieved with sufficiently draconian austerity programs, though such programs would run a severe risk that economic activity, and thereby tax revenues, would fall. Of course, provided that a £1 million reduction in public expenditure reduced the budget deficit to some degree, a balanced budget could be achieved. However, this result will be achieved at the cost of greater damage to the economy. What we cast doubt on is the simultaneous achievement of a balanced budget and a zero output gap" (Fontana & Sawyer 2012:37). They further argued:

The development of credible plans to reduce budget deficits would boost confidence, lower interest rates, and so on, which would stimulate investment. But, no evidence has been presented to support the view that the reduction of public expenditure is necessary for the restoration of confidence, "animal spirits", and the like, which would then boost investment (Fontana & Sawyer 2012:37).

Balancing the budget is seen by the government to be very important, and not adhering to that means fiscal irresponsibility. The importance of balancing the books is repeatedly emphasised by the British government, which ignores that economy is different from a family. Contrary to the UK government's claim, Stiglitz (2017) argues:

In an economy, when government spends more and invests in the economy, that money circulates, and recirculates again and again. So not only does it create jobs once: the investment creates jobs multiple times. The result of that is the economy grows by a multiple of the initial spending, and public finances turn out to be stronger: as economy grows fiscal revenues increases,

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and demands for... social programmes to help the poor and needy, go down (Stiglitz, 2017).

The government claimed that in the UK welfare spending is too large and needs to be drastically reduced. In contrast Ha-Joon Chang argues that:

The reality is the UK welfare state [spending] is not large at all. As of 2016, the British welfare measured by public social spending) was, at 21.5% of GDP, barely three-quarters of welfare spending in comparably rich countries in Europe - France's is 31.5% and Denmark's is 28.7% for example. The UK welfare state is barely larger than the OECD average (21%), which includes a dozen or so countries such as Mexico, Chile, Turkey and Estonia, which are much poorer and/or have less need for public welfare provision. They have younger populations and stronger extended family networks (Chang, 2016).

George Osborne claimed during the last Parliament that the budget deficit would be eliminated. He asserted that the negative balance between public revenue and overall public expenditure required urgent policy measures. The proponents of balanced budgets argue that deficits keep upward pressure on market interest rates. As a consequence, those government bonds sold on the market will compete with private borrowing, leading to a rise in interest rates and in the cost of borrowing which will ultimately cause a fall in investment, an effect sometimes described as 'crowding out' (Wade, 2009). The George Osborne said on 10th June 2015:

[I]n normal times, the governments of the left as well as the right should run a budget surplus to bear down on debt and prepare for an uncertain future... [i]n the budget we will bring forward this strong new fiscal framework to entrench this permanent commitment to that surplus, and the budget responsibility it represents (Osborne, 2015).

The plan of the article is as follows: section 1 presents background information on the topic. Section 2 discusses the debate on public debt. Section 3 analyses the reasons behind turning to austerity. Section 4 focuses on neoliberalism and financialization. Section 5 looks at macroeconomic performance. Finally section 6 concludes.

The question arises as to why governments would pursue an economic austerity policy in the current context of economic recession. It seems that class interests lie behind the ideology of austerity as an analysis of the distribution of benefits and burdens shows. In fact, the ideology of "budget surplus" ignores the fact that during the recession, aggregate demand, economic activity and tax revenues decline, while at the same time unemployment benefit payments increase. In fact, history offers scant examples of the pro-cycle fiscal contraction programmes that have succeeded in avoiding macroeconomic stagnation (Blyth, 2013).

From 2010, the coalition government found an opportunity in the crisis and imposed austerity, reducing public spending and benefits thus ensuring that the burden of their policies fell disproportionately on the poorer sections of British society. UK's social policies aimed at disciplining vulnerable sections of the society. As Davies notes:

Under Britain's 'benefit sanctions' regime, welfare payments can be suddenly suspended for up to a month on account of trivial breaches, without any sense of procedural reason as to how the rules are applied. One man had a heart attack on the way to an appointment, but was nevertheless sanctioned; another lost his benefits for going to his brother's funeral, having been unable to get through when he tried to phone the job Centre. Over a million people in the UK have received sanctions for one reason or another. Thousands have died after being declared 'fit to work' by workfare contractors and having their disability benefits cut (Davies, 2016:122).

Despite the UK's dependence on the financial sector there is a sharp difference between the ability of Eurozone countries and of the UK to cope with the consequences of the recessions in that the UK has its own central bank and currency and can potentially pay its own debts, most of which are denominated in sterling (Dunn, 2014). For Eurozone member countries the ECB does not have an explicit 'lender of last resort' obligation as in the case of the US Federal Reserve and the Bank of England (Wade, 2009).

2. The debate on public debt

The issue of public debts in the past had been widely discussed and debated. Since 2010, rising public debts were also seen as alarming and austerity was proposed in some quarters to reduce levels of public debt. Therefore, it would be useful here to examine historically how the policy makers and academics presented their views on this subject. It is also more important because mainstream economists ignore the historical, social and political ideas of classical economists and divorce economics from its historical context. They present the primacy of markets in determining relative prices and income distribution and further argue that government spending undermines the functioning of the market (Siddiqui, 2015a; Venugopal, 2015).

David Hume the 18th century British classical political economist focused on the re-distribution effects of public debt. He denounced it and emphasised that the burden of taxation in the 18th century fell on landowners and poor labourer who financed the interest payment received by the financiers. David Hume expressed his views on public credit in his essay “Of Public Credit” in 1752, and his views appear not to relate to the historical facts. Public debt as we know it only goes back to about three centuries. In 1700, British public debt was £14.2 million. Hume in another essay, “Of Civil Liberty”, emphasised on debt-service:

[T]axes may, in time, become altogether intolerable, and all the property of the state be brought into the hands of” the government. If it is not curbed, we may come to “curse our liberty (cited in Laursen & Coolidge, 1994:146).

Another prominent classical economist, namely Adam Smith, witnessed that the British government’s borrowing was consistently rising in order to fund foreign military adventure. He expressed concerns about the rising sovereign debt and criticised the mercantilist attempt to finance overseas expansion through the debt which, according to Adam Smith, imposed fiscal burdens on future generations. Later on, in the early decades of the 19th century and during the end of the Napoleonic wars, Britain had accumulated a huge amount of public debt. Compared to Adam Smith’s era, and later when David Ricardo was writing, Britain was more advanced in technology, commerce and trade, and had also colonised more overseas territories. Ricardo analysed the issue with relative ‘equivalence’ of financing a war by means of taxation or by issuing of government bonds (Ricardo, 2002, first published in 1817). He ignored the redistributive effects of public debts as he himself was the largest loan contractor to the government. Ricardo argued that people would most likely oppose increased taxation to fund the war but were in favour of borrowing. He concluded: “During peace, our increasing efforts should be directed towards paying off that part of debt which has been contracted during war” (Ricardo, 2002: 288). As Joan Robinson commented that:

For fifty years before 1914 the established economists... had all been preaching one doctrine of laissez faire... free trade and balanced budgets were all that was required... The doctrines were still dominant in 1914 (Robinson, 1972:2).

Now let us look at the issue of public debt in the first half of the 20th century. After World War I, British hegemonic power declined and the country was unable to take strong policy measures. The US, which was the emerging global power, was reluctant to step in and provide liquidity during this crisis. In Britain during the 1920s, there were already growing socio-economic crises with high levels of unemployment and balance of payments deficits, but nevertheless the government continued to pursue restrictive economic policies. Despite this, little success was achieved in reducing public debt. Neo-classical economists blame the cause of Great Depression largely on the role of restrictive monetary policy implemented as a result of the gold standard (Tcherneva, 2012). Public debt as a percentage of GDP rose from 25% in 1914 to 182% in 1923, and in 1929 it declined to 160%, but

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during the Great Depression public debt rose to 178% in 1933. However, as the economy picked up, public debt fell to 111% by 1940 (Konzelmann, 2014).

Winston Churchill also endorsed Treasury view in his 1929 budget speech: the burning question of whether national prosperity can be restored or enhanced by the government borrowing money and spending it on making more work. The orthodox Treasury view... is that when the government borrow[s] in the money market it becomes a new competitor with industry and engrosses to itself resources which would otherwise have been employed by private enterprise, and in process it raises the rent of money to all who have need of it (Churchill, 1929: 53, cited in Konzelmann, 2014:712).

After the First World War, the economies of European countries such as Britain, France and Germany were very weak, whilst the US emerged much stronger economically. These European countries tried to return to gold standard, but they faced difficulty in re-establishing parity at pre-war level. This meant adapting austerity policies to reduce domestic prices. In the UK, the Treasury's views on balancing the budget were maintained up to the late 1920s when the post war slump turned into deep depression. As the Chancellor of the Exchequer, Stanley Baldwin commented in 1922: "Money taken for government purposes is money taken away from trade, and borrowing will thus tend to depress trade and increase unemployment" (cited in Blyth, 2013:123).

Britain returned to the gold standard in 1925 with the aim to deflate prices to their pre-war levels, but the country was much poorer economically and financially very weak. Then the attempt to restore pre-war parity was extremely painful but was, however, fully endorsed by the Treasury and the City of London. At the same time the UK used interest rates to compete with the US to attract foreign investors with much weaker economy. The economic crisis and high levels of unemployment created a lot of resentment among the working people and culminated in the 1926 general strike. However, despite the austerity, the UK's debt increased rather than decreased and public debt rose from 170% of GDP in 1930 to 190% of GDP in 1933. Germany and France returned to gold standard in 1924 and 1926 respectively (Manson, 2016; Glyn, 2006).

During the post-war period, the major European economies encountered enormous difficulties, the UK and France had accumulated huge amounts of debts to the US, while Germany was asked to pay the allied powers huge reparations (Dunn, 2014; Glyn, 2006). At the same time the US had excess capital available, which soon began to flow to Europe, where the possibility of higher returns existed. But in 1928 the US Federal Reserve increased the rate of interest in order to dampen domestic demand and to control the rise in prices. This development reversed the flow of capital as investors found the US market more attractive. Capital flight also increased and under this situation European countries imposed greater doses of austerity. The access to loans declined and tariffs were raised. The economic crisis deepened and ultimately sterling was devalued against US dollar. The recession turned into the Great Depression. Soon after, Germany and the US came off the gold standard; thus both countries could adjust domestic costs by allowing their exchange rates to slide rather than forcing internal deflation of wages (Tcherneva, 2012).

In such a gloomy economic environment, macro-economic management was seen by J.M. Keynes (1936) as a vital policy tool. He came out in support of the state playing a leading role in the economy with the aim to maintain full employment along with monetary and fiscal stability. During the Great Depression, Keynes publicly argued that government spending is crucial to reduce unemployment. He supported Lloyd George's policy initiative of reducing unemployment with the help of public works which could be financed by borrowing. Furthermore, among businesses and political elites who earlier did not favour public works, state intervention and economic planning, there was reflection and critical thinking about what went wrong, which resulted in reluctant support for Keynesian policies in the UK and the US (Siddiqui, 2015a). According to Keynes, the purpose behind increases in public spending during a slump is to

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mobilise unused resources, especially labour, so that aggregate demand could be increased. Multiplier effects ensure that ultimately economic activity exceeds initial government spending (Glyn, 2006).

However, Friedrich Hayek (1960) expressed scepticism about Keynes' proposition. According to Hayek most of the trouble is due to 'imprudent borrowing and spending on the part of public authorities'. Hayek was seen as the father of neoliberalism and it is true that he was not a big supporter of state activism. Hayek in his book *The Constitution of Liberty* (1960) viewed the transition in the late 1940s from a very elitist perspective. He emphasised competition as the defining characteristic of human relations. For him, the market would discover a natural hierarchy of winners and losers and the market would be able to create a more efficient system than could ever be devised by planning and state intervention. He suggested several policies that impeded this process, such as government regulation, higher taxation on businesses, trade union activities or state provision, would be counter-productive. According to Hayek (1960), unrestricted entrepreneurship would be able to create the wealth and employment that would later on 'trickle down' and benefit the whole society. Commenting on adoption of neoliberal policies in recent decades, George Monbiot, (2016) argues:

Their [Thatcher and Reagan's] massive tax cuts for the rich, crushing of trade unions, reduction in public housing, deregulation, privatisation, outsourcing and competition in public services were all proposed by Hayek and his disciples. But the real triumph of this network was not its capture of the right, but its colonisation of parties that once stood for everything Hayek detested... Hayek's triumph could be witnessed everywhere from Blair's expansion of the private finance initiative to Clinton's repeal of Glass Steagall Act, which had regulated the financial sector (Monbiot, 2016).

Michal Kalecki (1944) suggested that budget deficits could be used as a mechanism to secure full employment and high levels of economic activity. When there is no presumption that saving and investment will be in balance at full employment then a deficit budget could be used as an important policy tool to raise economic activity in the country. Kalecki proposed three alternatives to secure a level of demand to be consistent with full employment namely, (i) the use of budget deficits, (ii) income redistribution and (iii) stimulation of investment. The use of income redistribution could be consistent with arguments of the progressive approach to reduce deficit and it could be a massive redistribution of income from higher incomes to lower income group i.e. from profits to wages. This could lower the propensity to save and hence stimulate aggregate demand. Keynes argued in support of balancing the current budget across the business cycle: deficits during the slump, surpluses during the boom and using the capital budget to ensure full employment. Kalecki emphasised the need for permanent budget deficits to keep full employment across the business cycle. Kalecki suggested: "it is true that profits would be higher under a regime of full employment than they are on average under laissez faire...[D]iscipline in factories and political stability are more appreciated by the business leaders than profits. Their class instincts tell them that lasting full employment is unsound... and that unemployment is an integral part of the normal capitalist system". (Kalecki, 1971:141, cited in Konzelmann, 2014:716) Kalecki further acknowledges that "the pressures of all these forces, in particular of big businesses, would most probably induce the Government to return to the orthodox policy of cutting down the budget deficit (Kalecki, 1971:144, cited in Konzelmann, 2014:716).

3. Reason behind turning to Austerity

Austerity policy failed in the 1930s to promote recovery. In the 1930s, unemployment exceeded 20% in the US and the UK. Keynes criticised the weakness of the neo-classical theory that it assumed full employment could persist for a long period and automatic mechanism could propel the economy towards full employment. Keynes further attacked the theory for assuming unemployment was

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either frictional or voluntary. The former is a short-lived phenomenon and is the outcome of disequilibrium between demand and supply in isolated markets. In the latter case, it arises due to higher wage demands i.e. above marginal productivity by the workers. In the long run aggregate supply and aggregate demand would reach an equilibrium point at full employment. Keynes challenged this and argued that unemployment of the 1930s was involuntary unemployment and was due to lack of demand (Konzelmann, 2014).

It is very logical to hope that an increase in public investment could lead to higher private investment and higher growth, which would presumably generate more business opportunities and employment. Then why would businesses oppose any such move? The crucial point of the austerity is how to maintain investors' confidence. This determines not only the ability to borrow but also the terms and conditions upon which the banks will be willing to lend. In fact, if government debt rise to such levels that cause creditor concerns about their investments along with perceived higher risks, this could demand higher rates of interest. Therefore, the costs of borrowing may increase.

The question also arises as to the level of public debt which might be described as 'too high'? The public debt-to-GDP ratios for average advanced economies have fluctuated widely. The average public debt in 1922 was 116.2% of GDP, which during World War II rose to 144.6% in 1945. In 1932 during the Great Depression the average levels of public debt for Western Europe and North America was 94.7%, which declined to 72.8% in 1937 (Tcherneva, 2012).

Moreover, it is also important to stress that the financial sector has become very important for the advanced economies as it contributes huge amount of tax revenue and helps globally to control strategic resources and generate profits as indicated by the outflows of capital to advanced economies (Siddiqui & Armstrong, 2017). For example, in 2014 the US had the largest stock of foreign direct investment (FDI) (US\$ 4,935bn), the UK had the second largest stock of the FDI (US\$ 1,606bn), France (US\$ 1,081bn), Germany (US\$ 852bn), Netherlands (US\$ 670bn). The outwards FDI in terms of percentage of their GDP were the following: the Netherlands (174.4%), UK (54.9%), Germany (41%), the US (33.4%) and total for OECD is (42%) in 2014. In the list of top 500 global corporations, the UK was in second position behind the US (OECD, 2016).

The proponents of orthodoxy also argue that government should avoid public sector deficits because it could create inflationary pressures in the economy (Reinhart & Rogoff, 2010). This assertion might be considered erroneous as at present in UK the rate of inflation is less than 1% despite historically high deficits. The deficit has fallen slowly and for the fiscal year 2014-15 was less than £60 billion, which is below 5% of GDP, compared to more than 10% in 2012. In the UK currently government borrowing has fallen, inflation is almost zero, and there is hardly any expectation of dramatic rise in the deficit. Under such circumstances hardly any justification is needed in favour of an austerity programme (Skidelsky, 2016).

The IMF (2012) cross-country study has found that fiscal consolidation promotes growth and creates employment. The study relied on the data from developed and developing countries between 1970 and 2007. A negative relationship was found between government debts and subsequent per capita GDP growth. The study claims that a 10% increase in the initial debt-GDP ratio was associated with a fall in GDP per capita growth of 0.2% per annum. Another study by Reinhart & Rogoff (2010) also observed a significant positive correlation between high levels of public debts and economic stagnation. Their study found that following a financial crisis, employment and output recovered very slowly and the average duration of debt overhang episodes is twenty-three years. They argued that a public debt 'threshold' of 90% of GDP at which economic growth begins to contract. Their study was used by the governments to launch austerity policies. For instance, Olli Rehn, the EU Commissioner for Economic Affairs, argued citing the above study as the benchmark for EU countries. According to Rehn, public debts in

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Europe are expected to stabilise only by 2014 at above 90% of the GDP and such high levels of debts act as a permanent drag on growth (Rehn, 2013).

Reinhart & Rogoff (2010) suggest that government debt above a critical threshold of 90% can be a drag on the economy and could become an obstacle to achieve economic growth. There has been a wide range of critiques of their report. For instance, Paul Krugman argues that large debt can be accommodated at lower costs by running a balanced budget in times when growth rises and economy is in the upswing, therefore, real GDP increases faster than debt during the high growth rate, the debt stock will shrink in real terms over time (Krugman, 2012). It is obvious that low growth could lead to more debt so a sensible policy option should be to increase growth. Theoretical justification was provided by Reinhart & Rogoff (2010), for a long-term relationship between public debt and economic growth. According to them, higher public debts could lead to a stagnation of growth. In such a situation, the government has limited options for reducing public debt to restore growth. They note further that such measures can be expected to increase business confidence. This is expected to have ultimately a positive effect on private sector investment and output. Reinhart and Rogoff state that once the debt-to-GDP exceeds the threshold ratio of 90%, average growth fell from 3% to -0.1% in the Post-World War. However, critics say that significant data omissions, questionable weighting methods and elementary coding errors have been found (Herndon *et al.*, 2014).

The Reinhart & Rogoff (2010) study has been rejected by other economists on the grounds that their analysis did not cite any theoretical work and could not demonstrate logically that such a link between high levels of public debts and economic growth exists. Their study has been challenged on ground of methodological weaknesses as Herndon *et al.*, (2014:277) comment:

[The] use of data to construct a set of stylised facts characterising the relationship between public debt levels and GDP growth for a range of national economies and a range of time periods... [Reinhart and Rogoff] RR made significant mistakes in reaching the conclusion that countries facing public debt levels in excess of 90% of GDP will experience a major decline in their GDP growth rate. The key problems we have identified with RR's work, exclusion of available data, spreadsheet errors and an inappropriate weighting period, significantly reduced the measured average GDP growth rate for countries in >90% public debt/GDP category... into a false image that high public debt ratios inevitably entail sharp declines in GDP growth.

There seems to be two alternative views. One view is that fiscal consolidation and a reduction in budget deficits will boost confidence and lower interest rates, which will ultimately increase investment and economic growth. Another view is that to increase investments and exports, increasing public expenditure are crucial to restore domestic demand. It means there will be no justification for cuts in public expenditure (Skidelsky, 2016).

By the end of June 2016, the total amount of the UK's public debt was £1.7 trillion and the tax collected was £750 billion in the last fiscal year. It has been said "How are they going to pay it back?" and is characterised as "the burden on our children and grandchildren". The UK's public debt is now (2016) at 84% of GDP. According to Reinhart & Rogoff (2010) high levels of debts could be a reason for a rapid rise in interest rates and "potentially massive" fiscal costs and this could require a significant tax rise and spending cuts, and ultimately an increase in unemployment.

The levels of public debt in the UK and the US are much lower compared to Japan's 230% of its GDP. In fact, both UK and US public debt since 2008 have been accompanied by a decline in the cost of public borrowing to near zero. Some argue that it will add to 'the burden on the future generation' as a justification for fiscal tightening. The economist A.P. Lerner (1972) has stated that the burden of reduced consumption to pay for increased public spending is borne by the generation that lends the government the money in the first place (since the real resources used by the government are not available to the current generation), and

if financed by taxes, debt does not rise. Alesina & Ardagna (2010) argue that, whether financed by borrowing or taxation, such a policy would ultimately reduce private consumption.

The critics of austerity argue that fiscal contraction could prolong recession. They further emphasise that reductions in public spending could reduce domestic consumption and could have dampening effects on levels of confidence on businesses and hence undermine potential growth prospects (Skidelsky, 2016). Another study (Chick & Pettifor, 2011) on fiscal consolidation in Pre-War Britain found the public debt ratio increased and macroeconomic conditions worsened, but later in the post-war period with the fiscal expansion the debt ratio fell and the economy witnessed higher growth rates. Their findings were also supported by Crotty's study (2012) that austerity slows down economic growth, increases inequality and unemployment and as a consequence further increases deficits which in turn could further increase demand for austerity. Another more recent study by Stockhammer (2015) argues that rising inequality and falling real wages are the major factors responsible for reducing aggregate demand in the current economic crisis, as the poorer sections of society have a relatively high marginal propensity to consume.

In the UK, during the Second World War, public debt rose. However, with steady GDP growth public debt was paid down and until the end of 1960s, the government seemed to be committed to full employment. There were also controls on credit and macroeconomic stability was kept under control. During this period there was also largely a harmony between labour and capital and also there was a steady rise in living conditions and a decline in inequality.

On the differences in the levels of development, Konzelmann (2014:718-719) observed:

The British economy, as the least war-damaged in Western Europe, had a relatively prosperous 1950s. But it had failed to modernise and remained fundamentally uncompetitive. On the top of this, competition intensified with re-emergence of Japan and continental European countries as leading industrial competitors and with the rapid increase in low cost manufacturing in developing countries. Manufactured imports into other industrialised economies surged, causing a sharp deterioration in trade balances... This resulted in widespread destruction of jobs and rising unemployment.

When the global financial crisis hit the West, the excessive debt-led over-consumption boom reached a critical point. The global financial crisis in 2008 discredited the neo-classical free-market self-regulating model and its policy prescriptions have to be replaced by a Keynesian stimulation package in the advanced economies, but it was continued for only one year.

McCausland, & Theodossiou (2016:1105) argue:

[regarding the] effects of fiscal austerity on debt-to-GDP ratio using from data on a panel of [11 OECD countries] for which data on the relevant factors are available [from 1981 to 2011]. Contrary to traditional predictions, it turns out that over long historical span, fiscal contractions deteriorated rather than improved public debt as a percentage of GDP. This implies that fiscal austerity exacerbates the lack of demand and deteriorates rather than enhances the prospects of economic recovery.

They further reiterated that fiscal austerity increases the national debt and deepens the economic crisis and past experiences provide ample evidence of such claims.

In the 2008 financial crisis, Keynesian ideas became more popular, especially the role of fiscal deficits to rescue the economy. Major industrialised countries such as the US and the UK- in 2009- favoured adopting a fiscal package to stimulate the economy and were able to avert depression, but still levels of unemployment remained quite high and public debt reached high levels (Wolf, 2011). Under such circumstances, both economists and policy makers began to talk about debt and austerity. These arguments were presented as a remedy from the risk of sovereign debt defaults and after one year of the crisis, Keynesian policy

was abandoned. The immediate mechanism for the transformation of private debt into state debt was accomplished quietly. The IMF (2016) estimated a nearly 40% average increase in public sector debt across the OECD countries. Half of this amount is due to replacing lost revenues of the collapsed financial sector i.e. the state had to rescue the financial sector from collapse. For example, the UK's financial sector is responsible for the dramatic fall in tax receipts of about 25% (Mason, 2016; Konzelmann, 2014). The financial sector was deregulated in the name of market self-control, efficiency and growth but ultimately, this resulted in huge losses, which were transferred to the state.

4. Neoliberalism and financialization

In the late 1970s in the UK, criticism of government policy came to the fore in the context of economic crisis. It was argued that the crisis had been brought about by too much state and trade union intervention, which had stifled the economy and led to the economic crisis. Accordingly, the prescription for resolving the socio-economic crisis meant rolling back the state and reduction of workers' rights a theoretical foundation later built on by Margaret Thatcher after the 1979 victory of the Conservative Party (Lawson, 2015; Harvey, 2005).

Defining neoliberalism David Harvey (2005:15) argues that: "the evidence strongly suggests that the neoliberal turn is in some way and to some degree associated with the restoration or reconstruction of the power of economic elites". Further Saad-Filho & Johnston (2004:3) defines financialization as: "[the] most basic feature of neoliberalism is the systematic use of state power to impose (financial) market imperatives in a domestic process that is replicated internationally by globalization".

These definitions are a bit too broad and do not include the ideas and interests of the ruling elites who formulate the policies. In fact, neoliberalism can be understood as a policy which legitimised markets as self-regulated and presumed that imposing such policies meant their interests could be safeguarded (Girdner & Siddiqui, 2008).

To explain the concept of financialization, Lapavitsas (2008:34) defines it as follows:

Financialization... does not amount to dominance of banks over industrial and commercial capital. It stands rather for increasing autonomy of the financial sector. Industrial and commercial capitals are able to borrow in open financial markets, while being more heavily implicated in financial transactions. Meanwhile, financial institutions have sought new sources of profitability in personal income and financial market mediation.

In another study Lapavitsas has observed that financialization had not only altered power structure, but also impacted on the salariat:

Financialization, finally, has allowed the ethics, morality and mind-set of finance to penetrate into the deepest recesses of social and individual life. Social values have been affected by the outlook of the financier... Waves of greed have been released by the transformation of housing and pension into 'investments', dragging individuals into financial bubbles (cited in Mason, 2010:228).

Therefore, it appears that contemporary financialization is very different from what was envisaged by Hilferding in Germany more than a century ago. He saw then that banks build long-term relationships with industries, which in turn allowed the banks to have significant control over them. In contrast to that "financialization today involves banks and industrial companies acting increasingly independently of one another" (Callinicos, 2012:67).

During the 1990s, the policy of neoliberalism had led to the expansion of the financial sector and their speculative activities rose sharply on the name of innovation (Siddiqui, 2012). It also offered much higher returns on investments than could be obtained through productive investment. Moreover, the expansion of consumer credit and asset bubbles on the housing sector evolved into a mechanism through which effective demand could be created (Dumenil & Levy, 2011). Some

economists have blamed increased financialization on slow growth in the last decade and for them it was due to increased political and economic dominance by the global finance, which have been further institutionalised by neoliberalism (Lawson, 2015; Siddiqui, 2015a).

However, the policy of financial innovation, which aimed to separate credit decisions from their risks by splitting them into various components, contributed to the financial crisis of 2008. Easy access to mortgage credit was made available to the poorer sections of society. In the UK, availability of easy credit acted to maintain effective demand. In the housing market, the rising asset prices raised optimism, which filtered through to demand via equity withdrawals and higher borrowing. Concurrently, the securitisation of subprime loans and other financial innovations have converted the less well-off into Ponzi speculators further fuelling housing prices in the US, UK, and many other countries. This provided a false notion of recovery and easy profits until the bubble burst (Hein & Mundt, 2012). The fallacy is based on the presumption that the financial crisis of 2008 was due to high government spending policy, while in fact it was the result of a private credit-led speculation boom. Greece, Ireland and Spain also relied on credit-driven expansion (Lawson, 2015). For example, in the case of two trading nations such as Greece and Germany, the imposition of austerity could be counterproductive for both countries (Wolf, 2011). It is hardly mentioned that Germany too would be worse off in terms of export demands, employment, and investment because of the imposition of austerity in Greece.

The financial sector has gained greater importance in sectoral terms in countries such as the US and the UK, while in Germany the industrial sector is stronger compared to other industrialised countries. Germany's manufactured goods are still important in terms of employment and export; its manufacturing sector is second in importance after China. Their manufacturing sector is the main contributor to her exports. If we look at the past decade's trend, we find that Germany showed the classic case of what Hilferding (1981) defined as finance capital where banks played a coordinating role with the industrial companies- as Sablowski (2008:154-55) emphasises:

The transformation of a bank-based system to a market-based system [is] under way in Germany, involving the dismantling of the tight link between the banks and their industrial and commercial partners and the beginnings of a 'free market' for corporate control.

The UK economy has proportionately more dependency on financial services and is thus more vulnerable. It seems that its structural and dependency problems will most likely increase due to greater reliance on the finance sector's tax revenue. Furthermore, such development will have an adverse impact on investment funding, unless the government reverses its policies on public debts. The UK budget deficit for 2015-16 was £75 billion and this was higher than forecasted. Public debts in 2016 amounted to £90 billion (Skidelsky, 2016). Moreover, the absence of active fiscal policy is perpetuating the dominance of monetary policy through the role of the Bank of England (Seccareccia, 2012). Monetary policy based on near zero interest rates appears to continue to discourage savings. In the UK, the larger size of the financial sector meant the 2008 crisis brought big losses and tax revenues fell sharply. However, there is a difference between Eurozone countries and the UK. The UK has its own central bank and currency and could potentially pay its own debts, in which most is denominated in pounds (Skidelsky, 2016). For Eurozone member countries the ECB does not have an explicit 'lender of last resort' obligation as Federal Reserve in the case of US and Bank of England in the UK (Morgan, 2009).

The UK should reduce the size of the financial sector by supporting the expansion of the manufacturing sector, especially in high skilled sectors and environmental technology by subsidising and increasing public investment. In fact, de-financialization i.e. a decline of the role of financial sector took place between the 1940 and 1960s. Rapid expansion of the financial sector over the last 30 years

or so along with the de-regulation and financial liberalisation boosted the expansion of financial sector in the economy in most OECD countries. At present the financial sector has become too large and dysfunctional. There are a number of studies which tell us that financial sectors now cost society very highly by absorbing resources unproductively, leading to unemployment and economic instability (Sawyer, 2011). The financial sector should have stakeholder control so that its activities are more likely to benefit society. Outside regulation would build more transparency and be an incentive to more ethical behaviour in the financial sector. Society was told that there was no alternative to neoliberalism, ‘free-markets’ and financialisation but this was an ideological campaign that ultimately led first to the global financial crisis and second, supported the unjustifiable socialisation of losses after the banking crisis (Wade, 2009). In fact, the neoliberalism has remained influential and continued to inspire studies in political economy of the policies since the 1980s and more recently it has become the dominant ideology of the discourse of globalisation (Girdner & Siddiqui, 2008).

5. Macroeconomic performance

I consider that it is important to discuss macroeconomic data if we are to understand whether the austerity policy of nearly a decade has been able to achieve its stated goals or not. The UK’s GDP growth in the last twenty-five years (1991-2015) was on average less than 2% and inflation has remained low as indicated in Table 1. However, unemployment rates have been between 9-10%, while during the higher growth rate period it declined to an average of around 6%, as shown in Table 1. The unemployment rate is the number of unemployed people as a percentage of the labour force. GDP during the period of 1991-2015 has steadily grown, except in 2008-2010. However, the UK’s negative growth performance was poorer than in the US and Germany, while the performance of France and Japan (Siddiqui, 2015b) was lower than the UK during the same period as shown in the Figure 1.

Growth picked up in the UK in 2014, but again slowed in 2015 and is projected to be 1.1% in 2016. The officially registered unemployment rate has fallen to around 5%. The current account deficit has reached 7% of GDP, the highest level on record, increasing vulnerabilities. It seems that GDP growth in the UK is based on weak foundations mainly because of the rise in inequality and stagnation in wages (Stockhammer, 2015). These are among the main causes of recession and in recent years the government did not make any effort to correct this. For instance, real wages are still down by 9% compared to mid-2008. Moreover, the increased ‘financialization’ and sectoral shifts in favour of finance have slowed down investment and growth in manufacturing.

Table 1. UK’s Macroeconomic Data (%) from 1991 to 2016

year	Growth rate	Inflation rate	Unemployment Rate
1991	-1.3	3.6	9.2
1992	0.2	3.7	9.1
1993	2.4	1.5	9.8
1994	4.0	2.4	8.8
1995	2.5	3.4	7.6
1996	2.7	2.4	6.9
1997	3.1	3.1	5.3
1998	3.2	3.4	4.5
1999	3.1	1.5	4.1
2000	3.8	2.9	5.5
2001	2.8	1.7	5.0
2002	2.5	1.6	5.1
2003	3.3	1.3	4.9
2004	2.5	1.3	4.6
2005	3.0	2.0	4.7
2006	2.7	2.3	5.5
2007	2.6	2.3	5.2
2008	-0.5	3.6	5.6

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2009	-4.2	2.1	7.5
2010	1.5	3.3	7.7
2011	2.0	4.4	8.0
2012	1.2	2.8	7.8
2013	2.2	2.5	7.5
2014	2.9	1.4	6.1
2015	2.3	1.6	5.3
2016	1.7	1.0	5.3

Source: Calculated from National Income, various issues, Economic Annual Trends. [Retrieved from].

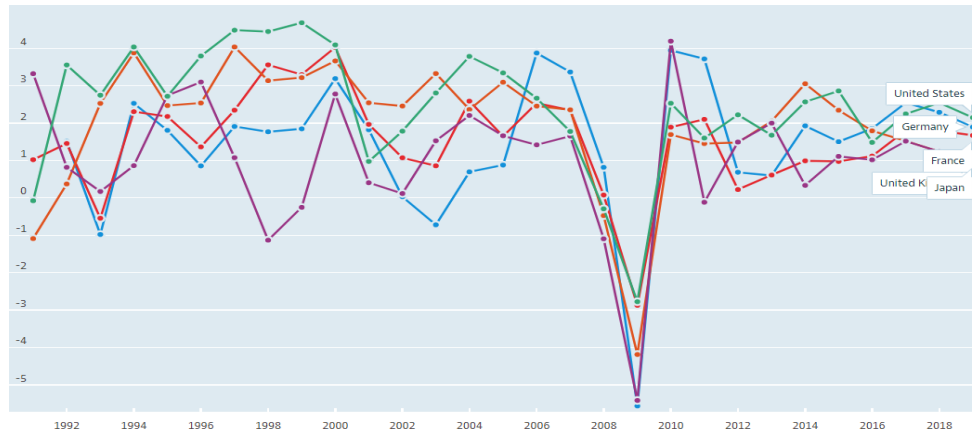


Figure 1. Real GDP Forecast for Selected OECD Countries total, annual growth rate (%), 1991– 2019.

Source: Accessed on January 4, 2018. [Retrieved from].

Note: US shown in green colour, Germany in blue, France in red, UK in orange and Japan in purple colour.

The latest figures reveal that the weaknesses of the UK’s economy are much deeper than widely acknowledged by commentators. As Chang (2016) points out: “Britain has never properly recovered from the 2008 financial crisis. At the end of 2015, inflation adjusted income per capita in the UK was only 0.2% higher than its 2007 peak. This translates into an annual growth rate of 0.25% per year... Japan’s per capita income during its so-called “lost two decades” between 1990 and 2010 grew at 1% a year... At the root this inability to stage a real recovery in the serious imbalances that have developed is the past few decades – namely, the over development of the UK financial sector...”

In the UK, manufacturing’s share of GDP has stagnated at about 10%. This is astonishing because in recent months the value of sterling has fallen by about 30% without bringing about a dramatic increase in manufacturing exports (Mason, 2016).

The advocates of a larger financial sector argue that in a post-industrial knowledge economy, manufacturing matters little (Reinhart & Rogoff, 2010). The example of Switzerland is cited in support of this conclusion, claiming that it has a larger per capita income than the UK while largely basing itself on finance and tourism. Such arguments ignore the fact that despite the growing importance of services in recent years, manufacturing makes a major contribution to productivity growth. This is more visible in chemical processes and the machine sector which are areas of intensive research and development and thus of technology development. Even productivity rises in the services sectors depend on advanced inputs produced by the manufacturing sectors such as computers, fibre-optic cables, GPS machines and so on. The UK’s economic problems are associated with the decline of the manufacturing sector. To reverse these trends, the government must provide more capital, more money for research and development (R&D) and more investment in training and skills to build a balanced and sustainable economy. Short-term recovery has been largely based on debt-fuelled asset bubbles in real estate and finance, with stagnant wages, and welfare cuts, which cannot

provide the real solution. The economy must be able to utilise human potential by providing decent employment - by growth based on rising productivity and wages rather than asset bubbles and periodic crises (Hein & Mundt, 2012).

Figure 2 shows public debt as a percentage of GDP. The UK's public debt was not higher than the US in 2015 and has risen sharply since 2010 as shown in Table 2. Public debt is measured as the sum of total state debts that have accumulated over the years and as a percentage of GDP. In May 2010 when the coalition government took office in the UK, net public debt was £974 billion. This has increased to £1483 billion in December 2014. As a percentage of GDP in May 2010, the net public debt was 62.7% and rose to 80.9% by December 2014. At the time of the global financial crisis, the level of public debt in the UK was lower in historical terms. For instance, in 1998 public debt was 39.9% of GDP, which declined to 29.3% in 2002. However, it rose to 36.7% by 2007; the main reason was due to long-term borrowing to invest in schools, hospitals, and infrastructure (Sawyer, 2011).

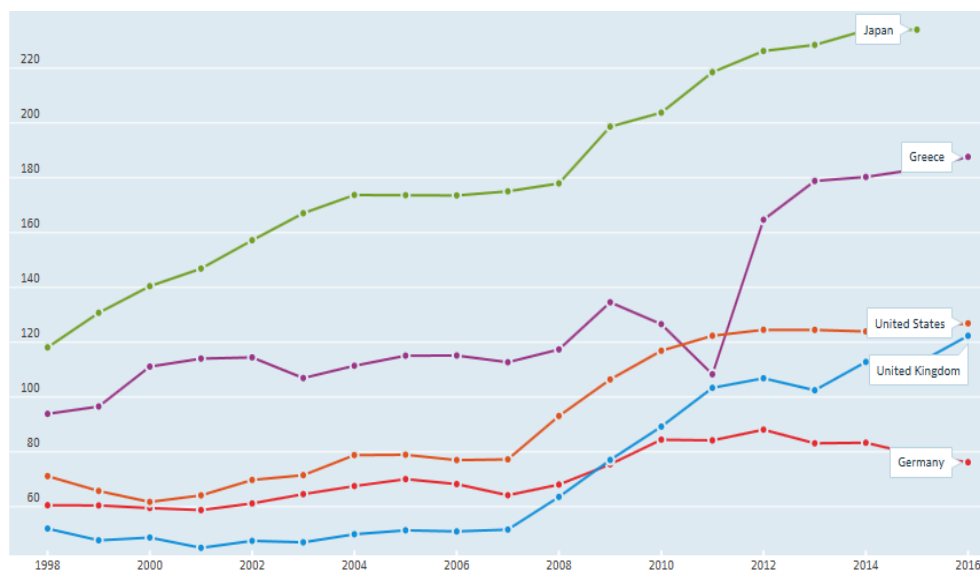


Figure 2. Government Debt as Total % of GDP of Selected OECD Countries, 1998-2016.

Source: Accessed on January 6, 2018. [Retrieved from].

In real terms the central government interest payments in 2010-11 were £47 billion, which remained the same in 2013-14. However, the debt and interest payments rose sharply only after the global financial crisis of 2008 (Wolf, 2011). As a percentage of GDP, the UK's interest payment on public debt has not risen significantly. For instance, in 1995 the UK's interest payment on public debts was 3.5% of GDP and declined to 2% in 2007, but rose again since the global financial crisis and was 3% of the GDP in 2012-13 (OECD, 2016).

6. Concluding remarks

Global finance now blames the government for excessive debt, but ignores the fact that much of this debt was caused by the bailout of the banks in 2008 and by the subsequent impact of the recession on employment and growth. International finance does not favour high levels of public debt because they are concerned about repayment. Under such circumstances they prefer austerity, which undermines working class militancy and resilience through stagnation in wages and welfare cuts. That was the reason Keynes came out in support of the socialisation of investment and wage bargaining between labour and capital, which is anathema to neoclassical economists. For him, attempting to reduce the public deficit by contracting economic activity via austerity was counter-productive. As Keynes

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said, “look after employment and the budget will look after itself” (cited in [Chick & Dow, 2013:15](#)). In the UK, the problem is that, since 2010, the total numbers in employment have risen, while at the same time real wages have fallen. This decline in real wages has had an adverse impact on government revenue via tax reduction ([Callinicos, 2012](#)).

After the global financial crisis of 2008 most of the advanced economies including the UK followed expansionary fiscal policies ([Seccareccia, 2012](#)), but this was discarded as soon as the economy began to pick up and the crisis was thought to have been managed. Then soon after, the policy was reversed in favour of neoliberal dogma and was accompanied by an overreliance on monetary policy ([Siddiqui, 2012](#)). The ensuing reduction in interest rates was expected to restore confidence in the economy and to encourage investment and growth. This present study has argued that austerity and deficit reduction during the recession has led to declining output and to an increase in unemployment. In fact, the current recession is due to a deficiency in demand which remains at a level below the productive capacity of the economy. The capitalist undertakes investment only when demand is expected to increase. The austerity cuts in government spending combined with stagnant wages can hardly stimulate sufficient investment ([Kalecki, 1971](#)).

This study has critically examined the mainstreams view that deficit financing could increase liquidity, nurture an inflationary tendency in the economy and thus, increase the role of state in the economy. IMF recent forecasts predict slower growth next year, therefore there seems to be more pressing need for the government to reverse austerity policy and rely on deficit financing to boost economy, especially in the social sector. In response to deficit leads to inflation Kalecki remarked that, “inflation is sometimes identified with the existence of a large budget deficit, but this definition is not satisfactory... budget deficits do not necessarily involve inflation and that balanced budget is not a safeguard against inflation” (cited in [Sawyer, 2001:250](#)). He further argues: “[I]n spite of the great increase in the amount of the national debt in the course of the war up to the present, the future “burden” of the present debt is not likely to be higher than in 1938-39; and... it is possible to devise special taxes for financing the interest on the national debt which will render its increase harmless in the sense that it will have no repercussions on output and employment...” (cited in [Sawyer, 2001:254](#)).

This study supports increased state intervention as means to enhance long term growth. However, such measures are anathema to most mainstream economists. This study also suggests that austerity as an anti-recessionary policy seems to be counterproductive. Hence, a reduction in government spending and stagnation in wages could have an adverse influence on future business investment decisions, which could lead to a reduction in the country’s output. A number of counter measures could be taken such as placing a requirement on financial institutions (such as pension funds) to place some minimum proportion of their asset portfolio into government stock and the Bank of England could be asked to provide money direct to government to finance its expenditure.

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