Getting a grip

The economy is in a mess – and Liz Truss' approach will not fix it. Labour needs to offer the prospect of radical reforms, argues *Stephen Beer*

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We are in a severe economic crisis. We are reaping the results of historic complacency and poor government decisions. We may not be fighting a war but similar urgency and focus are required. The Conservatives have changed leader again, but without inspiring any confidence they can get to grips with the situation. It is no surprise Labour is ahead on economic credibility in the opinion polls. To stay there, it should aim to radically reform the economy and government.

Inflation

The most immediate problem we face is inflation. Energy prices are by far the main driver. Gas prices, caught up with Russia's invasion of Ukraine, are driving up energy bills for households and businesses. Food prices are higher following disruption of supplies and droughts. Supply chain bottle necks have contributed, as have Covid lockdowns in China. We have been hit by a series of one-off price rises, pushing up the inflation rate and raising costs everywhere. This has made us all poorer as wage increases lag inflation, with the poorest households hit hardest.

Spikes in commodity prices after the global financial crisis were absorbed, painfully, by businesses and households because monetary conditions were tight as banks rebuilt their balance sheets. This time prices rises are much higher and spreading to other sectors, helped by pandemic quantitative easing (QE), an increase in money supply, and central bank complacency. It is easier for businesses to push through price rises to consumers.

High inflation is a problem for many reasons. It is a tax on incomes and savings, unless you are lucky enough to have an inflation-busting pay rise. It benefits those with debts but harms those who save or who have fixed incomes. High inflation usually means more volatile prices. It encourages us to be short-termist – if you need a durable good tomorrow but believe the price will rise, you will buy it today. It is unfair. It sows division and erodes hope. Pray that when it gets worse the weather will be too cold for riots.

Policymakers could make things worse

Bank of England independence from 1997 worked well and supported Labour's economic credibility. However, the Bank later fell into an institutionalised mindset and it has struggled to see the wood for the trees. Now it is trying to catch up with events by rapidly hiking interest rates, forecasting five quarters of recession as a result with businesses suffering and unemployment rising.

The Bank is also, independently of government, reversing QE, which could push up government borrowing costs because both will compete to sell gilts to the same market, when markets are already running scared of the UK. It does not know what impact this 'quantitative tightening' will have on the money supply and inflation, because its models do not consider it.

Threats to Bank independence should be resisted unless we admire Turkey's 80 per cent inflation rate. However, the Bank seems to be constraining fiscal policy with damaging determinism, even before Liz Truss' tax cuts lead to higher interest rates. It is likely something will snap: the economy or Bank independence, or the Bank will reverse course and start up QE again down the line. All three could happen.

A century ago, the Bank, wedded to conventional wisdom and a fear of losing credibility, led calls for sterling to rejoin the gold standard, resulting in depression and high unemployment. That finished off a Labour government, after which conventional wisdom was ignored and the link with gold was cut. "No one told us we could do that," ex-minister and Fabian Sidney Webb is reported to have exclaimed and it took a new generation of Fabians to rebuild Labour's economic approach. The Bank may be making a comparable mistake today. The inflation mandate is clear but that does not mean the Bank alone should decide how quickly to get inflation to target or, where hitting it is unaffected, constraints on fiscal policy.

Such has been the scale of the crisis that it became obvious over the summer that something would be done. With energy bills soaring there had to be further government support. That is why Labour's plan to freeze the household energy price cap was so warmly received. Neither Liz Truss nor Rishi Sunak seemed to have given the matter much thought when they began their leadership campaigns and they frequently shifted rhetoric and policy to catch up with public concern. The election remained what Michael Gove called 'a holiday from reality'. That reality now faces Liz Truss: the early signs are we can expect the government to lurch between knee-jerk responses to the crisis and ideological commitments to cut taxes and spending while borrowing more.

Sorry state of the UK economy

The UK has been a low growth and unequal economy for a long time. The financial crisis made things worse, cutting around 1 per cent from annual GDP growth. Business investment growth has been lacklustre and was hit by the own goal that was the Brexit vote and the version of Brexit the Conservatives have pursued. Growth in productivity, in terms of output per hour worked, is low at less than 1 per cent annually in the years pre-Covid. The two are linked. Low wages for many have been the result. Previously, GDP could be expanded by importing labour from the EU. That is now limited and the labour market seems to have changed, with many opting out, or suffering from long Covid or the NHS's failures to treat serious illnesses. There is wide regional disparity in productivity, as the OECD has highlighted, and outside London our cities are not the growth hubs they should be. Unless productivity can be improved, the UK is pretty much condemned to low growth, which means we will fall further behind trying to pay for health, social care, education, and other public services.

Income and wealth inequality remain stubbornly high. Those with financial and housing assets have done very well post financial crisis, as central banks supported markets with ultra-low interest rates and QE, though policy is being reversed now. Money begets money. We are now a "property-owning democracy" in which young people cannot afford to buy their own home.

Powerful long-term trends

Perhaps policy-makers are indeed the "slaves of some defunct economist… distilling their frenzy from some academic scribbler of a few years back" as John Maynard Keynes wrote, but they also operate amidst long term forces which can be at least as influential.

For decades, the global economy benefited from increases in the working population, as China and former communist countries in Eastern Europe opened their economies. As economists Charles Goodhart and Manoj Pradhan describe, this was a downward force on real wages, inflation, and interest rates. It also increased inequality. That was the context for politics in that period. Now the situation is reversed, as the workforce reduces as a proportion of an ageing population. The pressure on real wages, inflation, and interest rates is upwards and the fight against inequality may have a tailwind. There are many unknowns, but we are in a new world with old politics.

Technological development has been rapid and, alongside other intangible assets as outlined by Jonathan Haskel and Stian Westlake, may well be our economic salvation, eventually boosting productivity and so driving growth and incomes. There are risks, such as the artificial intelligence existential risk and the effect on employment, and challenges such as the distribution of gains.

Climate catastrophe is near but we are also on the cusp of profound change and the so-called 'electrification of everything' could be imminent. Today our concerns are energy scarcity and efficiency. In a few years, our concern may be how to use all the energy we have. Some countries and communities will benefit while others will struggle. Suddenly the new world will be the thing and people will scrabble to avoid being left behind. The challenges we face, such as rolling out battery storage and securing supplies of vital metals and rare earth minerals, appear considerable but must be surmounted. Relevant questions are, by whom and who will benefit?

Axioms for policymakers

Policymaking should acknowledge the following:

First, market economies are dynamic. Prices respond to supply and demand, acting as signals and incentives. Uncertainty, and people's perceptions of risk play an important role. Labour has had difficulty appreciating this. Consumers and businesses respond to price changes. Gas prices are intensely painful now but over time will change behaviour. We cannot simply redirect money from A to B and expect people to continue behaving in the same way. We can adjust the factors that incentivise people, clear institutional blockages, and make strategic investments, interventions and redistributions. Government does not need to have all the answers, but it should create the best conditions for innovation, prosperity, and fairness, and fundamentally change some of the rules. Ultimately, we are limited only by our productive potential: the rest of the debate is about how to allocate resources.

Second, the impact of Brexit is so severe that we have to be radical. If economic policy could ever be about doing things just a bit better those days are gone. There will be progressive, fairer, alternatives than transforming London into a 'Singapore on Thames' but they will come with costs, if we do not adopt closer ties. If we are not radical, we will not get the growth required to help those in need and to stop our public services declining.

Third, we need trade. Trade leads to growth. It is about focusing on our comparative advantages while importing goods, component parts, and services that would be more expensive to produce ourselves.

Fourth, current government and public institutions cannot deliver effectively. The vaccine taskforce was an exception because it bypassed the health bureaucracy. There are many examples to the contrary. We waste billions on defence spending for a military which does not know what it needs nor how to get it. The result is insufficient munitions, armoured vehicles over 40 years old still in use, and destroyers that cannot fight in warm water. Yet procurement failures are repeated. Defence is just one government department. Pretty much every area of government is failing and not only due to lack of resources.

Water companies waste over a fifth of the water for which we pay and pump sewage onto our beaches, and our energy market multiplies the effects of high gas prices. Yet nationalisation of industries is not a panacea: what matters more than ownership is being clear what we need monopoly providers to do and holding them to account. Failures are often down to regulators, regulations, civil service advice, and political decisions over decades.

The Conservatives have ignored opportunities for vital institutional reform and investment. Government has been treated like a plaything by people with little capability for leadership while structural problems have worsened. An incoming Labour government should avoid managerialism and reform from the beginning or it will waste billions and pay the electoral price for failing to deliver.

Starting with values

A new approach should start with our values, from which should flow economic policy priorities. The ethical socialist vision, as promoted by RH Tawney, should be rediscovered and reaffirmed. It values people as individuals of equal worth, looking for themselves and their families to lead fulfilling lives and thriving in community, with a bias to supporting the less well off.

There is an increasing appetite for expressing values in business and finance, as seen in the rise in responsible/ESG (environmental, social and governance) investing. Business leaders have gone further, trying to fill the democratic policy vacuum by expounding on ethical issues, but they know they need government. We are right to be sceptical but when even City voices are talking about the need to remake capitalism, we should recognise the opportunity. We can learn from the ESG movement how to link principles with action that counts. We can lead by promoting an economy in which all have a stake and which works for everyone.

A policy agenda

The next election, unless it happens soon, will take place after at least one hard winter even if energy prices do not fulfil this summer's doom-laden prophecies. We will need to borrow from tomorrow to get through. This is reasonable as long as any new tax cuts and spending are targeted, borrowing clearly controlled, and measures linked to changes in the use and sources of energy.

Meanwhile, Labour's economic plan should be formed with work on the following elements, each led by a shadow cabinet member:

- A fiscal framework that assures markets government will control spending and focus on sustainable growth.
- Review the Bank of England's inflation target time horizon and the impact of quantitative tightening on fiscal policy.
- Tax reforms that uphold tax as a badge of citizenship while shifting away from penalising labour, including a land tax, clearer taxing of externalities offset by credits for good corporate behaviour and those on poorer incomes, incentives for use of renewable and secure energy, incentives for trade, and a commitment to a stable corporate tax and regulatory environment to promote investment, including by overseas companies.
- Time limits for extra spending unless shown to be effective, as I and other Fabians have advocated.
- Crisis public spending boosts and key manifesto commitments delivered by special taskforces focused on outcomes rather than via existing mechanisms. For example, the social care and NHS waiting list challenges are too urgent to rely on the bureaucracy and divided responsibilities.
- Review and reform of government departments to prevent wastage of billions, with separate procurement departments.
- Continued large-scale investment in infrastructure spending including technology, renewable energy, and support for cities and housing, plus management training for small businesses linked to tax credits.
- Crisis interventions in private sector to be linked to government equity stakes and other reforms, to ensure society benefits from upside.
- Reform regulators to ensure they act robustly in the public interest and have sufficient expertise.
- Reform the City with emphasis on getting companies beyond the initial investment stage, reducing incentives for debt rather than equity, plus promotion of ethical standards and impact investing and reform of executive pay.
- Massive focus on education from early years throughout life, centrally coordinated and sufficiently agile to exploit technology.

Finally, Labour should link economic reforms, such as fighting inflation or boosting growth, with a clear 'citizen's stake' in their success. Keynes proposed fighting inflation, while preventing only a few benefiting from it, by mandating saving until war was over. We need solutions like that today, to ensure everyone benefits after going through hard times.

Rewrite the conventional wisdom

There is much to relearn from Labour's 1997 success, but despite current fashion trends we are not living in a repeat of the late 1990s. We can learn from the experience of the Attlee government as it introduced radical reform amidst economic crisis, severe winters, and fuel shortages – but this is not the 1940s either. A risk today is that to boost credibility Labour binds itself too tightly, with restrictive fiscal rules, blind support for the Bank of England, and conventional thinking. Go down that route and any time in government will be painful and short-lived. However, in both 1945 and 1997 Labour rewrote conventional wisdom. Today should be no different. F