Centre for Policy Studies

Pointmaker

PAIN AVERSION

ADDICTIVE, BUT NO BASIS FOR MEDIUM-TERM ECONOMIC POLICY

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SUMMARY

- This paper sets out the case for more strenuous and rapid government spending cuts.
- UK government debt is already at unacceptably high levels – and is planned to increase by another £400 billion before the government books are in balance.
- Too large a State sector and too much debt will reduce the future growth prospects of the UK economy.
- Despite the depth of the recession, the immediate consequences have been remarkably mild.
- The rate of corporate failure has been very low by historic standards. The recession of the early 1990s was only one third as deep as the current one yet corporate insolvencies then ran at six times the level of today.
- The low corporate failure rate is largely the consequence of low interest rates and massive government support of businesses (unpaid corporate taxes now total about £30 billon).
- Low interest rates and growing inflation now penalise the (blameless) prudent.
- This is unsustainable. Attempting to solve the problem of too much debt by using more debt is similar to treating heroin addiction with more heroin. The addict feels better in the short term but the underlying problem gets worse.
- Government plans to cut the deficit are welcome but do not go far enough. Despite the tough rhetoric, spending in 2015-16 will still be at the same level as it is today in real terms.
- We need to face up to the need to cut government spending more quickly, and to accept a far higher corporate failure rate.
- This would mean more unemployment and more business failure in the short term. But, by transferring more resources from the public to the private sector, it should also provide a much better base for future growth.
- It should be recognised that this is the right thing to do, both economically and morally. The debt we run up will be our children's problem.

1. INTRODUCTION

Net UK government debt is 59% of GDP. If you include the cost of supporting the banks (as the ONS now does), it is 155% of GDP. If you add in public pensions and PFI commitments, the figure gets close to 250% of GDP.

We reached a position where the government has been spending £4 for every £3 it raised in taxes. The £1 does not vanish. This deficit is still largely there: the Government borrowed £700 million a day last November – the highest borrowing month ever.

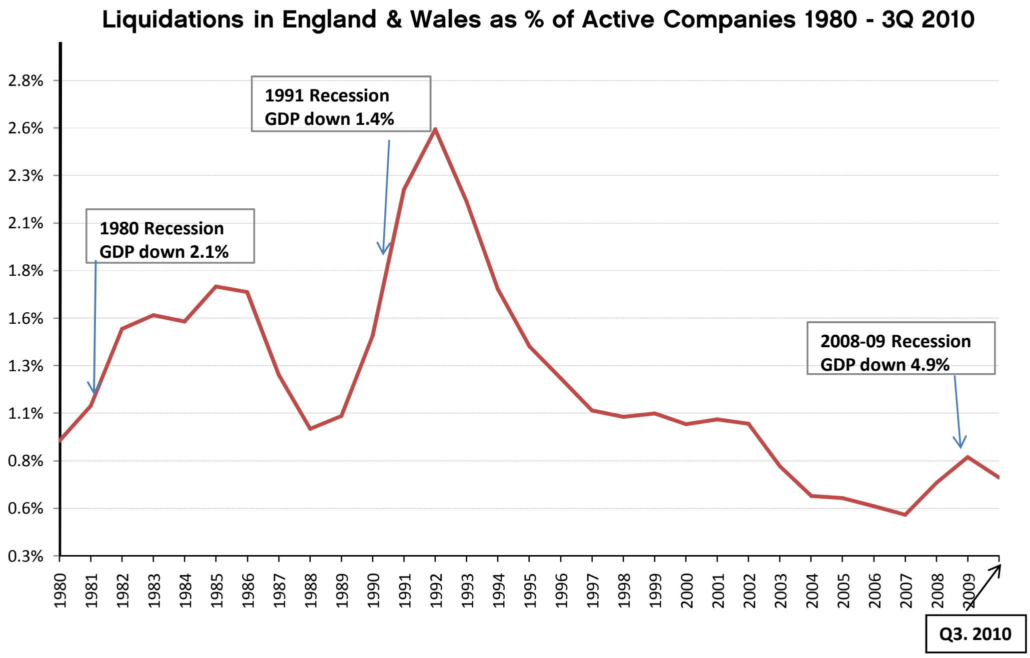
This has been going on for a long time. 20 years ago the total debt in the UK private sector ran at 150% of GDP. That doubled to 300% eight years ago and increased to 450% by 2010.

Only a couple of Western nations – Ireland and Iceland – managed to increase their debt relative to GDP faster than the UK in the last three years.

While this is bad, we are not alone. The western world is generally overspending and overindebted – and with poor demographics too. The US government will spend $1.40 for every dollar it raises this year. Ireland, Greece, Portugal, Spain and Italy are all in deep trouble. Events outside our borders are a risk for our economy. Global financial stability seems daily less likely.

The UK's debt binge is set to continue. Despite the Coalition's tough rhetoric, its current plans see £400 billion added to government debt before it is planned to stop that debt increasing.

The extraordinarily low rate of corporate failure



1. Source for total number of company liquidations: http://www.insolvency.gov.uk/otherinformation/statistics/historicdata/HDmenu.htm
2. Source for total number of active companies: Companies House Management Information Unit (MIU)
3. Source for GDP % fall for recessions of 1980, 1991, and 2009: Bloomberg

2. NO PAIN, NO GAIN?

The recession exacerbated what was already a poor fiscal situation. UK GDP fell by around 6% in a year. The deficit shot up to £180 billion. Yet despite the gravity of the situation, there has been – *in relative terms* – remarkably little pain. Unemployment went up, but by surprisingly little – from 5% to 8% (this was much less than the 4.5% to 10% rise in the similarly recession-afflicted US). And Figure 1 shows how company failures are at near 30 year lows.

Similarly, housing repossessions are startlingly low given the financial shambles. House prices have suffered little – indeed people with large mortgages on variable rates have seen a huge rise in their disposable incomes.

The reasons lying behind the remarkably mild short-term consequences of the last decades of the debt binge are mostly the result of policies designed to lower interest rates to levels not seen in 30 years in the UK. You can manage a lot of debt if you pay next to no interest. The Bank of England printed money (lightly disguised and much obscured by the new name "quantitative easing"). The Government increased borrowing to avoid cutting spending and to maintain low interest rates. This definitely has reduced unemployment and avoided much financial distress.

But this cannot go on. We have tried to solve the difficulties of too much debt by using more debt and making that debt tolerable – at least for a short time. This is the same as treating heroin addiction with more heroin. The addict may feel better but the problem grows. The debt is still there, and bigger, the day after. By avoiding pain now, we are making the future economy weaker and riskier.

3. CORPORATE FAILURE IS NECESSARY

In the business world, the low failure rate is the consequence of:

- low interest rates;
- massive government support of businesses with unpaid taxes of £30 billion plus propping up scores of thousands of enterprises;
- a banking sector generally unwilling or unable to recognise losses.

Industrial debt now runs at about twice the level of the early 1990s recession. That recession was only one third as deep as our recent one. So if interest rates rise we should expect more failures than then. But corporate insolvencies then ran at six times today.

This lack of corporate casualties does reduce job losses and the very real pain that involves in the short term. But it is not entirely good news. Many uncompetitive enterprises that would normally have perished continue to trade. Assets and people that are tied up in those hopeless businesses would do more good for the economy deployed elsewhere.

This failure to accept reality is also true in banking. The unwillingness to take the – huge – pain of more Bank failures during the crisis means that the banking sector remains so far largely unreformed – and remains a major threat to financial stability.

4. A FAILURE OF POLITICAL WILL

It was not easy to believe from their words that any of the parties in the last election were aware of how bad the national finances were. Pain aversion was at the core of politics. The politicians danced throughout the election campaign between the awful reality that they faced and their desire for election.

To stop debt rising further, the Coalition Government has announced plans to reduce real-term outlays from £697 billion this year to £686 billion in 2015-16. However, if the Government were to get income equal to expenditure in just one year, it would need to cut spending (or raise taxes) by about £150 billion. If this were to be achieved by spending cuts alone, this would be necessitate a 28% reduction in all departments. This of course is almost inconceivable politically.

So the Coalition has shown that it too is keen on pain aversion. Indeed, its decision to cut net investment by two thirds over the next five years is another sign that the easy way out is being preferred to the harder – but right – alternative.

5. AN ALTERNATIVE

It is generally the case that highly indebted economies grow more slowly than less indebted ones. Less wealth is likely to be available in the future if there is more debt.

Economies grow slower where the State is too large – our State is nearer 50% of GDP than the more traditionally sustainable 40%.

Some things are certain:

- It is certain that every pound of debt put onto the national balance sheet either has to be serviced, defaulted or inflated away.
- It is certain that the levels of debt and deficits in the developed western economies are in historically high and largely uncharted territory. Whilst there have been times of very high debt – for example in the aftermath of World War II – things were very different.
- It is certain that when creditors get to fear default or inflation, interest rates will rise. And that will really damage the highly leveraged UK economy.

Only the timing of this last event is uncertain (although the early signs are clearly visible).

We are stoking up problems for the future. The debt that we are accumulating today means that we live better now. But those who come after us have to deal with that same debt. The low interest rates hurt savers and pensioners and reward those who have borrowed rashly. Pain aversion, and not morality is the abiding characteristic of current economic policy. And pain aversion is in reality pain transfer to those who have no power to avoid that pain.

The Coalition Government is currently talking tough but its spending plans still mean continuing to increase debt for the next few years. In order to balance its books in five years, it relies on low interest rates persisting, on quite good economic growth (which looks rather less likely from recent data) and on stable international financial conditions. Even if all the winds blow in the right direction, achieving this equality between revenue and spending will not lead to Micawber-ish happiness: there would still be a huge debt mountain to be lived with.

It is certainly arguable that it would be better for the country to take more pain now and get the deficit down more quickly.

Yes, it would mean more unemployment and business failure in the short term. But it would provide a much better base for future growth. Resources would move from the public sector to the private sector quicker; and, with a more sensibly balanced and less leveraged economy, sustainable and stronger growth would return.

Cutting the size of the State quickly may indeed be less risky and definitely a great deal more morally honest. But it would also mean that we have to accept pain today. Are we able to face that? It seems that our political leaders don't think we can.

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POLICY INTO ACTION

The following list is a short selection of the proposals, first made by the Centre for Policy Studies, which the Coalition is now implementing (or plans to implement):

- **Capital Gains Tax proposals amended**: following polling and public advocacy by CPS Chairman Maurice Saatchi and CPS Board Member Michael Forsyth, coalition proposals to increase Capital Gains tax were markedly less punitive to savers and investors.

- **Increase tax allowances to £10,000**: proposals to increase tax allowances to £10,000 – and to lift millions of people out of paying tax – were first made by Maurice Saatchi and Peter Warburton in *Poor People! Stop Paying Tax!* in 2001.

- **Tax simplification**: the Coalition has announced plans for simplifying the tax system, adopting many of the proposals made by Michael Forsyth in his Tax Simplification Committee report, *Tax Matters*, and by David Martin in *Tax Simplification* (2007).

- **Abolition of the tripartite regulatory regime**: recommendations in the Financial Services Regulation Bill were first put forward by Sir Martin Jacomb in his 2009 CPS report, *Re-empower the Bank of England*.

- **Benefit simplification:** proposals for simplification of the benefit system followed the recommendations of *Benefit Simplification: why and how it must be done* by David Martin (2009).

- **Freedom for Schools**: the intellectual roots of the Academies Bill and the Education & Children's Bill can be traced to CPS reports such as *Freedom for Schools* (2000) and *An End to Factory Schools* (2010).

- **Abolition of school quangos**: Coalition plans to abolish the several education quangos follow proposals first made in *School quangos: a blueprint for abolition and reform* (2009).

- **Localism**: the Decentralisation and Localism Bill echoes recurring themes of recent CPS publications, including the Direct Democracy series (2008) and *A Magna Carta for Localism* (2010).

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