

A NEW GOLDEN RULE

Putting the corporate sector
surplus at the heart of
economic decision making

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**FABIAN
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First published August 2012

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Acknowledgements

We would like to thank Ian Mulheirn and Jonathan Portes for comments on an earlier draft.

The Fabian Society would like to thank Richard Speight, Ed Wallis and Sofie Jenkinson for proofing, typesetting and comments during the writing of this report. The views and especially the errors in this report are entirely those of the author alone.

Summary

This Fabian report identifies persistent and excessive business saving as a key factor underpinning Britain's current economic woes and recommends the next Labour government adopt a new fiscal rule seeking to reduce both the public sector deficit and the corporate sector surplus. The report argues:

- Labour's economic record up to 2007 was little short of exemplary. The subsequent crisis and its aftermath were handled well. The idea that Labour is congenitally incapable of managing the economy is a slander whose job is to imply that if there is no alternative to austerity and no alternative to the Conservatives.
- But despite the economic record, the economy was becoming unbalanced and this was becoming visible by 2004. Although always hard to recognise at the time, Labour's adherence to the consensus view made timely recognition much harder still.
- The critical sign of imbalance was that UK corporate sector had become a 'permanent' net saver, obliging the other sectors between them to be net borrowers. This imbalance grew much larger in the wake of the crash and has abated only slightly since. No return to economic normality is possible until it is removed.
- As the principal (domestic) macroeconomic problem, the corporate sector surplus needs to be at the heart of decision-making about the economy. Putting the corporate sector balance into the golden rule underlines its importance and makes it clear that restoring the corporate sector to normality is the government's business.
- The 'restoration of normality' will entail urgent reform. The reforms that are needed will include ones directed at financial regulation and corporate governance.
- Labour has found reform very difficult; the record after 1997 is salutary. In general, its failings were ones that felt like they were in the not-possible box and so were never really considered. Labour now needs to create that space, space which, by contrast, the Conservatives have been much better at doing for more than 40 years.

1

INTRODUCTION

What went wrong with the UK economy started going wrong several years before the financial crash of 2008. During the crash it got very much worse. It is still seriously wrong even now. Just as it dragged Labour down, so it will drag down the coalition. As a result, the government that follows the coalition needs to learn the right lessons from Labour's past. The economic situation in 2015 is going to be different in many ways from what it was in the years leading up to 2007, but in a crucial respect, it is very likely to be fundamentally the same. What we are talking here is the corporate sector and the way that it has ceased to be the driver of the UK economy.

While many of the immediate - and deeper - causes of the financial melt-down rested elsewhere, the economy was becoming unbalanced. The public sector deficit is one aspect of this imbalance. But it is not the only one. Much less discussed is another side of it, the corporate sector - Britain's companies, large and small - behaving as long term savers, spending less than they earn.

There are many reasons why a long-lasting corporate surplus - hoarding - is a problem but the simplest is that if the economy is to grow and develop, it is companies that need to lead it. Far from always having more money than they know what to do with, there ought to be times when dynamic and innovative companies know of more things to do than they have the money for. In short, companies as a whole should, for some of the time, be net borrowers. Yet for 10 years now they have been net savers and on a big scale.

Labour, along with just about everyone else, missed this shift in the behaviour of the corporate sector balance sheet. Previously it had been cyclical; since 2002 it has been permanently in surplus. That does not mean it is permanent for ever, but for the time being, and the foreseeable future, it is. In looking to the future, Labour must cope with the consequences of this shift and find ways of addressing it.

Labour has promised that it will set out new fiscal rules for 2015 before the next election. Unlike both Labour's original golden rule, and Osborne's increasingly discredited 2010 alternative, policy must focus on more than the public sector alone. The key requirement is that government must take the corporate sector surplus fully into account in policy making. More precisely, 'taking it into account' means, firstly, that the collective behaviour of the corporate sector and its surplus should be an object of government policy and

secondly, that reductions in the public sector deficit and reductions in corporate sector surplus are linked.

In order to give the corporate sector surplus the status it requires, we advocate that it should explicitly appear within a new golden rule, to capture the way that reductions in the public sector deficit depend upon reductions in the corporate sector surplus. Others may feel that this is too strong and merely want it to sit alongside a new rule. Either way, putting the corporate sector surplus at the heart of economic decision making is the key. For so long as the surplus seems permanent, that remains the case.

Such a rule has several characteristics. First, by bringing both the public and corporate sectors into the picture, the rule refutes a key tenet of conventional wisdom for 25 years that the only imbalances that matter are those in the public sector - that only the public sector can muck up the market, but not the other way round. Events have proven that wrong and the rule responds.

Second, critics of austerity, proven amply right by events, argue that the pace of deficit reduction should be slower. The trouble with this argument is that it is incomplete. What it is missing is any indication of how much slower, or slower for how long. A rule that includes the corporate sector surplus creates a yardstick against which to calibrate the speed of public sector adjustment. It is not perfect and it is not straightforward. But in principle it is correct in a way that no one sector rule possibly can be.

Third, the rule carries the message that restoring the corporate sector to normality is the government's business. The key to this 'restoration of normality' is reform. The urgent reforms that are needed will include - but are not restricted to - ones directed at financial regulation (though not just stability) and corporate governance (including possibly strengthening shareholders).

Finally although this analysis is aimed at the Labour party and its supporters, the lessons may have a wider significance. The Labour government of 1997 to 2010 was not particularly left wing. Its economic policy was based on established, mainstream economic thinking - even though from that base it tried to alter the way the market economy it inherited worked in a more social democratic direction. It is therefore entirely plausible that some of its successes and failures reflect strengths and weaknesses in mainstream views of how economies work.

Certain elements of those views continue to hold sway and have become intensified - especially a fairly hands-off approach to corporate behaviour. As its policies are different, so the economic effects of the coalition are different from those of Labour. But if those policies end up delivering nothing more than austerity without end, those policies too will also be judged as a failure. The relevance of the Labour record to those parts of the coalition who are willing to listen is that they may give clues to where the coalition, too, has gone wrong.

As the failure of austerity at home and abroad becomes daily more apparent, so the need for Labour's political opponents to paint the party as eco-

nomically incompetent will intensify. If the coalition does eventually admit that there is an alternative to austerity after all, it cannot allow the public to conclude that the policy u-turn requires a political u-turn too: trashing Labour's credentials as steward of the economy will be an indispensable part of a coalition plan B.

To counter this, Labour first needs an objective reckoning of the economic successes and failures of its own economic record between 1997 and 2010. How did Labour do? Promising growth and stability, Labour's record across the first two terms, and in many cases all the way up to 2007 was one that any government, Labour or Conservative, over the past 50 years, would have been proud of. After 2007, the subsequent crisis and its aftermath were handled well.

And yet: something was going wrong - and with hindsight was going wrong well before 2007.

2

LABOUR'S ECONOMIC RECORD 1997-2010

Our examination of Labour's record seeks to investigate both the successes and the failures: to point out where the coalition's attempts to pass the buck for its economic failure, endlessly blaming its inheritance, are wide of the mark; but also to learn the genuine lessons of what Labour got wrong based on sound evidence. Before descending into the statistical evidence, it is worth stepping back to see what it is that Labour's leaders said they were trying to achieve with the economy after 1997 - and then to see too how both they and the Conservatives responded after things had gone wrong 10 years later. The source for this is what the politicians said in their general election manifestos, from 1997 to 2010.

2.1 The politicians' holy grail? Economic growth and stability

At the time of their publication, manifestos are more likely to help their opponents than their authors. Labour's 1992 manifesto, on which the Tories based their 'Labour's tax bombshell' campaign, was widely believed to have been crucial in denying Labour the victory that it expected. Subsequent Labour manifestos went out of their way to avoid the fate suffered in 1992.

Yet manifestos are also rare examples of considered, wide-ranging expressions of what political parties and their leaders believe to be important. In a party that after the bitter lesson of 1992 was so careful about what it said, Labour's subsequent general election manifestos are key statements of what Blair and Brown thought mattered most.

1997 - 2005

After Blair's memorable 1996 declaration that "education, education and education" would be his "three main priorities for government", education had to be at the top of list in 1997. At number two was a commitment to refrain from putting up either the basic or top rates of income tax. Then came this:

"We will provide stable economic growth with low inflation, and promote dynamic and competitive business and industry at home and abroad."

Elaborating on this a few pages later, the manifesto stressed “economic stability to promote investment” and identified “too much economic instability, with wild swings from boom to bust” as first among the underlying causes of inflation, low growth and unemployment.

Four years later, economic stability was put at the top of the list of first term achievements. In his introduction, Blair described it as the “foundation” on which had been built:

“...mortgages as low as possible, low inflation and sound public finances; reform further education, and help 750,000 adults achieve basic skills; expand the Children’s Tax Credit to offer up to £1,000 per year for parents of newborn children; create a new Child Trust Fund for every child at birth increase the minimum wage to £4.20; not raise the basic or top rate of income tax and extend the 10p band; strengthen regional economies with venture capital funds and new powers for reformed Regional Development Agencies; develop the Small Business Service and cut red tape; give British people the final say in any referendum on the single currency.”

In 2005, economic stability remained top of the list, with an emphasis now on the ‘prosperity for all’ that it had brought in its wake:

“Labour’s economic record is unprecedented - the highest employment ever, longest period of uninterrupted growth in modern history, lowest sustained interest and inflation rates for a generation. Our economic policies will build on the platform of stability and growth in three ways: entrenching a low debt/high-employment economy which generates investment in public services; supporting enterprise and wealth creation by making Britain the best place to do business; and helping every part of Britain and every person in Britain to contribute to and gain from the strength of our economy.”

These few quotes by no means exhaust the references to economic stability in the 2001 and 2005 manifestos or overplay its importance. Stability was not just a technical matter but translated into concrete outcomes for individuals and households. As Blair put in 2005, it had “banished” Labour demons about not being able to run the economy well.

2010

Having put the achievement of economic stability above all else, the economic crash that began in 2007 could not be anything less than a political catastrophe for Labour. A government - a party - that had such great store by its competence (another Blair claim in 2005) found that the very bedrock of its record - ‘no more boom and bust’ - had been swept away.

The resultant hole in the 2010 manifesto is gaping. Not surprisingly given

the state of the economy, there are now no references at all to economic stability, nor to Labour's long-term record. Where stability is mentioned at all, half are international and mainly non-financial, two are to do with the health service while the other five refer to institutional reforms needed to ensure financial stability in future. These were not unimportant. But what this highlights by way of contrast with the predecessors is the loss of the single, simple message that summed up what Labour had been about since 1997.

The Conservative manifesto of 2005 is full of detailed points about what was wrong with what Labour was doing (though crucially not on big picture issues such as regulation of financial services). Whether valid or not, they could make little headway against Labour's far grander claims of competence and stability. In 2010, the positions were reversed. Labour was left making the detailed points while it was the Conservatives who now had the simple message:

"Our belief in responsibility with public finances is the starting point of our plan for economic recovery and growth. We want your consent for a programme of public spending control that will deal with Labour's debt crisis and stop the Labour jobs tax that would kill our economic recovery."

Britain, the manifesto went on, needed a new economic model whose "bedrock" would be:

"...the stability and low interest rates that come from a credible plan to reduce our record budget deficit, protect Britain's credit rating and give taxpayers value for their money."

As with Labour in 1997, so the Conservatives' attempt in 2010 to portray themselves as the party of economic stability was at that point mere assertion. What had happened in Labour's third term gave them that opportunity.

2.2 1997 to 2010: the evidence

The record can be divided into two, either side of the 2005 election (although in economic terms the first period really goes up until 2007). Political rhetoric aside, the record for 1997 to 2005 is obviously going to look good: the real question here then is 'how good'? Set against what went before, the record for 2005 to 2010 can only look bad: the question here then is 'how bad'?

The first two terms: 1997 to 2005

Income, inflation, employment and productivity

Table 1A presents seven headline indicators by which to reach a first judgment about the Labour economic record up to 2005. They are:

- the growth rates of GDP (the economy as a whole) and household disposable income;
- the inflation rate;
- the number in employment, and the unemployment rate;
- the rate of growth of productivity in the market and non-market (public) sectors.

In five of the seven cases, the table shows how the UK compares with either the average for the G7 group of countries or for the US. There are five statistics per indicator, for the three election years and two, four year averages for the two government terms.¹ The final 'comment' column offers a simple assessment, usually based on 40 to 50 year run of the statistics back to the mid 1960s or early 1970s.

- Compared with a long term average of about 2.5 per cent a year, economic growth between 1997 and 2005 averaged about 3.5 per cent. Both the first and second term averages exceeded those for the G7 as whole, especially in the second period when some other countries - but not the UK - suffered a mild recession. Only during the (overlapping) eight year period up to 2000 did the UK economy grow faster than between 1997 and 2005.
- The growth in household disposable income - a proxy for the growth in living standards - slightly exceeded the record over the eight years to 2000. In line with the growth of the economy as a whole, living standards rose by some 30 per cent between 1997 and 2005.²
- The record on inflation was even better, this eight year period not only being the equal of the earlier overlapping period - and the best such period since at least the 1960s - but inflation was also consistently lower than the G7 average.³
- The more than two million increase in employment between 1997 and 2005 is also good - while it falls short of the 2.8 million increase in the eight years from the early 1980s, that was from the very low level to which employment had then fallen as a consequence Conservative monetarist policies.
- The rate of unemployment came down steadily during the period. The comparison with the G7 is especially marked, being above the G7 rate in 1997 but well below it by 2005. But as a sign of how things have changed in the labour market over the longer term, though a record low for the post-1979 period, the 2005 figure would still have been a record high for the 1945-1975 period.

Table 1A: economic indicators, 1997 to 2005⁴

	One year			4 year averages		Comment: comparison back to mid 60s or early 70s
	1997	2001	2005	1st term	2nd term	
Overall economic (GDP) growth (%)	3.9%	2.9%	2.8%	3.7%	3.0%	Good - although 8 years to 2000 was better
- compared with G7	+0.6%	+1.6%	+0.5%	+0.5%	+1.2%	
Household disposable income growth (%)	4.1%	5.4%	1.8%	3.7%	3.0%	Slightly better than 8 years to 2000 but less good than 8 years to 1991
Inflation (RPI) %	3.1%	1.8%	2.8%	2.8%	2.3%	Best 8 years (and comparable with 8 years to 2000)
- (CPI) compared with G7	-0.2	-0.9	-0.3	-0.4	-0.5	
Employment (millions)	26.5	27.7	28.8	27.1	28.3	8 year rise well short of the 8 years to early 1990
Unemployment rate (%)	6.9%	5.1%	4.9%	6.1%	5.0%	2005 best rate since mid 1970s
- compared with G7	+0.4%	-0.9%	-1.4%	0.0%	-1.4%	
Labour productivity growth: market sectors	2.5%	2.0%	2.3%	3.0%	2.6%	Comparable with post 1979
- compared with US	-0.9%	+0.2%	-0.1%	-0.6%	-0.5%	Poorer (because US better since 1997)
Labour productivity growth: admin, health, education	1.0%	0.3%	0.3%	0.7%	-0.8%	Poorer
- compared with US	+0.2%	-1.3%	-1.5%	-0.2%	-2.1%	Poorer

- Strikingly, the growth of labour productivity in the private sector - the key determinant of prosperity for an economy and indicator of efficiency - was among the best in the G7 over this period. It was also comparable with what had been recorded under the 18 years of Conservative government after 1979 (which of course benefited from improved statistics due to the recession reducing the workforce). The performance was not far short of the US which was going through the period known as the 'productivity miracle'.⁵
- Labour productivity in the public sector was pretty flat over the eight years as a whole and lower than both the previous Conservative governments and the US post-1997. The growth of labour productivity after 1997 was lower than in the preceding 18 years for the EU as a whole. On average the fall was slightly less than in the UK, although individual countries, notably France, saw a larger fall. Research suggests that falling rates of productivity growth here is commonly a consequence of increased expenditure on services.⁶

With the exception of public sector productivity, the outcome on each of these indicators made 1997 to 2005 either the best eight years over the last 40 or at least the second best. The international comparisons are usually favourable to the UK too. Taken together, this adds up to an economic record over the first two Labour terms which was very good in general and outstanding in several particulars, especially growth and inflation.

The public finances

But was this performance only bought at the expense of damage to the public sector finances?

Table 1B shows the three most important indicators of this, that is: total public spending; the public sector deficit (the amount by which public spending exceeds taxation and other public sector revenues); and the public sector debt (the cumulative amount of public sector borrowings over the years). In each case, the indicators are given as percentage of GDP.

- The share of GDP taken by public spending was lower between 1997 and 2005 than in any eight year period since the mid 1960s. Even in the second term, when the public spending share was a couple of percentage points higher than in the first term, the share was still lower than in any four year period prior to 1997.
- The pattern is the same for the public sector deficit with 1997 to 2005 being the eight years with the lowest deficit since mid 1960s but with the first term being better than the second. Here the contrast between the two terms is a lot sharper, the first term surplus being followed by a second term deficit. In itself a small deficit is quite acceptable: the Maas-

tricht criteria, for example, specify no more than 3 per cent. The second term deficit was well below this and well below too the average for the 30 years up to the mid 1990s.

- Public sector debt is better measured at the end of the term. On this basis, both 2001 and 2005 are lower than most years since the mid 1970s. Measured over four year periods, only the four years 1988 to 1992 was better than Labour’s first term.

Table 1B: economic indicators, 1997 to 2005⁴

	One year			4 year averages		Comment: comparison back to mid 60s or early 70s
	1997	2001	2005	1st term	2nd term	
Total public expenditure (TME: %GDP)	38.2%	37.7%	41.2%	37.1%	39.1%	Lowest 8 years - even 2nd term is lower than any four year period before 1997
Public sector surplus/deficit +/- (%GDP)	-0.7%	0.0%	-2.9%	+0.8%	-2.1%	Lowest 8 years - 2nd term one percentage point lower than the average from the mid 60s to 1997
Gross public sector debt (%GDP)	41%	30%	35%	36%	32%	Only the four years from 1988 better than 2nd term

There is nothing in any of this to support the idea that success up to 2005 was at the expense of the public sector finances. Although it is true that these indicators are slightly less good - in the sense of being less prudent, cautious or small-c conservative - for the second term than the first, that is just a reflection of quite how exceptional the first term was. A telling symbol of Labour’s attitude was its decision not to spend the £22bn proceeds of the sale of 3G mobile phone spectrum licences in 2000, but instead to use it to reduce national debt.

The Conservative legacy

Against the assertion that Labour governments are invariably and inevitably poor stewards of the economy, the record between 1997 and 2005

is a decisive rebuttal. Labour set out its stall in 1997 to deliver growth and stability. The evidence presented here - composed of obvious, headline indicators rather than a tendentious selection to illustrate a favourable story - shows that across the first terms it most certainly did that. The lack of growth of public sector productivity is a serious shortcoming. But this is really a political problem rather than an economic one, there being no evidence here that the extra spending was taking the public finances into dangerous terrain, at least without the benefit of hindsight.

It is sometimes said that Labour success after 1997 is down to the economic legacy of its Conservative predecessor. We don't accept that: sustained success over such a long period cannot just be a matter of legacy: if Labour behaved as disastrously its detractors like to pretend, eight years was more than enough time to go off the rails. In any case many of the things that Labour did on economic policy are firmly grounded in academic evidence of what works to boost productivity and economic performance.

It is true that the evidence assembled here tends to show that the Major government did leave the economy in better shape than Labour admitted in the 1997 - 'things can only get better' - general election. Yet what must also be said is that this Conservative legacy is a shining exception to the usual pattern. A glance at the statistics shows that it was Conservative governments, from 1959 onwards, who engineered unsustainable booms in the run up to elections. It was left to Labour governments, in 1964, 1974 - and if they had been elected - in 1992, to 'clear up the mess'. However at odds with the current 'austerity' rhetoric, this history reminds us that if, in an attempt to improve their electoral chances in 2015, the coalition were to try to engineer a mini-boom (say via tax cuts), it would only be returning to Tory-type.

The third term: 2005 to 2010

So how much damage does the third term do to Labour's economic record when that is judged on the same basis as 1997 to 2005? Table 2 sets out the same indicators as before for 2005, 2007, and 2010. This last year, a measure of Labour's economic 'legacy', is the main focus.⁸

Table 2: economic and public finance indicators, 2005 to 2010⁹

	One year			5 year average	Comment: 2010 compared with the period back to mid 60s/early 70s
	2005	2007	2010	3rd term	
GDP growth (%)	2.8%	3.6%	1.8%	0.8%	Below the pre-97 average
- compared with G7	+0.5%	+1.4%	-1.2%	+0.3%	
Household disposable income	1.8%	1.2%	-0.2%	1.3%	Only four years pre-97 were lower
Inflation (RPI) %	2.8%	4.3%	4.6%	2.8%	Slightly better than the pre-97 average
- (CPI) compared with G7	-0.3%	+0.1%	+1.9%	+0.5%	
Employment (millions)	28.8	29.2	29.0	29.1	3rd best year - and still above 2005
Unemployment rate (%)	4.9%	5.3%	7.8%	5.8%	About equal to the pre-97 average
- compared with G7	-1.4%	-0.2%	-0.4%	-0.6%	
Labour productivity growth: market sectors	2.3%	2.9%	-	-	
- compared with US	-0.1%	+1.8%	-	-	
Labour productivity growth: admin, health, education	0.3%	0.7%	-	-	
- compared with US	-1.5%	-0.7%	-	-	
Total public expenditure (TME: %GDP)	41.2%	40.9%	46.7%	42.9%	Three percentage points higher than the pre-97 average (but not highest ever e.g. see eight years from mid 60s when higher)
Public sector surplus/deficit +/- (%GDP)	-2.9%	-2.4%	-9.2%	-5.1%	2nd highest after 2009
Gross public sector debt (%GDP)	35%	37%	61%	41%	Highest since end of 60s

To the brink of the recession

Before turning to this, we look at the situation in 2007 to see whether the rosy picture up to 2005 had already started to deteriorate before the crisis hit.

It is, in fact, mostly positive. The economy continued to grow strongly, compared both with the historical and G7 averages. Employment was higher than 2005. Private sector productivity growth continued to be strong too. Over the ten years to 2007, the comparison with the US on this measure (2.8 per cent a year versus 2.9 per cent) looks even better than the comparison up to just 2005. The two negatives are that despite higher employment, the unemployment rate had risen slightly; and inflation was back above 4 per cent, for the first time since the early 1990s (mostly due to commodity prices surging). Living standards had continued to grow, albeit at a much slower rate.

The combination of strong growth and rising inflation does perhaps suggest that something was going wrong by 2007. The presence of rising unemployment in the mix shows how difficult the challenge had become. Whether the public finances should have been better (given the strong growth) is arguable. But the key point here is that there is nothing really about the public finances, even in 2007, to support a charge of Labour profligacy. Over the short-term, both total public spending and the public sector deficit as a share of GDP were smaller than they had been two years earlier. Public sector debt as a share of GDP, at 37 per cent, was still below its 1997 value.

Recession and recovery

Turning to 2010, once again there is a mixture of positives and negatives. While the negatives certainly weigh much more heavily than before, it is the positives that are the more surprising.

First and foremost among those positives, economic growth had returned after the 6.5% fall in GDP during the recession in 2008 and 2009. While the rate was below both the G7 and long term UK averages, nearly 2 per cent in 2010 is nevertheless respectable - and will be regarded as a sign of improvement if such a rate is recorded any time in the near future. Hardly less striking, despite the severity of the recession, employment remained above its 2005 level. Although the unemployment rate was up sharply on 2005, it remained below the G7 average. On the long view back to the start of the 70s, the 2010 rate looked no worse than average. Even inflation, at still under 5 per cent, was no worse than an average year on the same long view. But household disposable income fell, the first time that had happened since the early 1980s.

Obviously, the rises in unemployment and inflation and the falls in employment and household disposable incomes represent negatives. Against Labour's claims of having secured stability, these negatives were serious enough. But it was what happened to the public finances that was seized upon by the Conservatives, and then the coalition, as evidence of Labour's incompetence. Among the indicators shown in Table 2 the public spending share of GDP is the least problematic of the three. The six percentage point rise since

2005 took it to a level that, although above the pre-1997 average, was still within the range recorded over the last 40 years (that is, below the levels of the mid and late 1970s and early 1980s).

By contrast, the public sector deficit, although down on 2009, was outside of the range of historical experience. This was due partly to the 'automatic stabilisers' that push up spending on social security as people lose their jobs in a recession, and partly to deliberate counter cyclical policies like the temporary cut in VAT. The most important factor of all, however, was the collapse in government revenues - which is why a merely higher than average spending share went hand in hand with such a large deficit.¹⁰ The next worst figure, some two percentage points lower, occurred in 1993. Deficits on this scale rapidly add public sector debt, which at 60 per cent in 2010 was back at a level last seen in the 1960s.

The record in context

A full account of the record after 2005 requires consideration of what would have happened if different policies had been followed. What, for example would have happened if Labour had not rescued the banks? And what would have happened if the April 2009 London Summit G20, where Gordon Brown played a leading role, had not reached the deal to restart global growth? While the answer is probably that the outcome would have been much worse all round, this is not something that our evidence can address.

What our evidence does allow us to do is to put the Labour legacy in the wider context. On growth, inflation, unemployment and even public spending, what the recession and its aftermath had done was to take things back to where they used to be before 1997 (or perhaps more accurately, before 1993). In other words, the performance was disappointing, and on spending suddenly quite poor, but it was by no means unprecedented.

Having spent 10 years claiming to have discovered the holy grail of economic growth and stability, there was no comfort in this for Labour.

A sense of perspective helps too even with the worst parts of the Labour legacy. For example, public debt at 60 per cent of GDP (and rising) in 2010 took the UK back to the late 1960s - but this was still nowhere near where debt stood in 1945, when it was approaching 250 per cent of GDP.

Public sector deficits always deteriorate sharply in recessions. The size of that deterioration under Labour, from a pre-recession low of 2.3 per cent in 2006 to 11.1 per cent in 2009, is almost exactly the same as the rise under the Conservatives from a low of -1.3 per cent in 1988 to 7.7 per cent in 1993. As Reinhart and Rogoff show, deteriorations this large have happened before following financial crises (Japan, Argentina). At the start of the 1990s, the deterioration in the public finances in Finland and Sweden were even worse.¹¹

But the headlines on the annual deficit and total debt were seized on by the Conservatives and turned into an attack on both public sector largesse and Labour competence. Nowhere, as far as we know, did they acknowledge

that it was only thanks to the public sector (i.e. the state) propping up a reckless - and in large part bankrupt - banking sector, that the recession of 2008 and 2009 did not become depression.

Whatever future history books say about the deficit reduction plan - for example whether its pace was too quick and the inevitable pain within the third and public sectors it caused - they will also no doubt make clear that allowing the deficit to rise sharply was the right course to avert global economic catastrophe and to limit the effects of the financial crash and world recession on UK citizens.

2.3 Conclusion: A record as good as any - yet something did go wrong

While it is certainly possible to have plenty of reservations about other aspects of what was, or was not, achieved during the first two terms of the Labour government, when viewed from the standpoint of mainstream economics, Labour's overall economic record over those years - and indeed up to 2007 before the crash - is as good as any. Against this background, neither the general charge of Labour incompetence nor the specific one of public sector profligacy remotely stand up.

Even the record between 2007 and 2010 can be defended. In particular, its single worst feature - the steep deterioration in the public sector deficit - was not unprecedented. Much worse outcomes that were certainly possible were nevertheless avoided. Above all, the recession was brought to an end with moderate growth restored by 2010.

Yet a bust, which Labour said it had abolished (along with booms), did happen; the worst bust, as the chancellor Alistair Darling said, in 60 years. How did it come about that a government which had placed such emphasis on economic stability failed to see that it was presiding over an economy that turned out to be vulnerable to such a calamity?

There is no doubt that problems elsewhere, in particular in the US, and massive global imbalances played the key role in the bust. In her analysis of the Labour record, Kitty Ussher identifies specific US policies in four key areas (during both the Clinton and Bush years) as the main contributory factors.¹² There is also no doubt that problems in the UK's own financial sector, starting with Northern Rock, were among the earlier signs that something serious was going wrong.¹³ The question is, though, whether these blows from outside were striking an otherwise sound economy, or whether instead there was something not quite right with the UK economy, something beneath the surface of the impressive record that we have laid out above?

Our answer to this question is that, yes, there was something wrong with the UK economy 'beneath the surface' - and not just in the trivial sense that this must be so since Northern Rock is part of that economy. Our explanation is set out in chapter 2. But before plunging into it, there is another question

that needs answering first. This is, after all, a report whose ultimate aim is to argue what Labour should be doing if it returns to office in 2015. Defending its historical record against its coalition detractors, as we have done in the first chapter, serves that end. But digging into the detail of what went wrong only does so if it can serve as a lesson for the future. So is there such a lesson?

Again the answer is yes - and it is a lesson about the corporate sector and the way that it has ceased to be the driver of the UK economy.

3

LABOUR'S ECONOMIC AGENDA 2015-?

3.1 An imbalanced economy

There is an argument to suggest that Labour bought too much into the neo-liberal model, that it let markets function too freely, particularly the financial sector and the banks, not least as they provided the tax revenue to fund investment in Britain's public services. At its strongest, this argument implies that there was a conscious pact with the private sector: 'you make the money, we spend the tax revenues and otherwise leave you alone'.

We think that is too simplistic and misleading. Labour did attempt to reform company behaviour, especially the culture of 'short termism' which was recognised as a particularly British economic disease.¹⁴ Perhaps it did not go far enough or act effectively but that is a different type of argument.

But in this paper, looking forward to what Labour should do in 2015, there is another reason to look more carefully at what was happening without ascribing it all to a pact with the City. If Labour does return to office in 2015, it will be only the third time in its history that it has done so after just one term in opposition. The two precedents - 1929 and 1974 - are not auspicious. If Labour 2015 is to avoid this fate, one of the conditions is that it learn the lessons from its still recent experience in government. We return in the last part of this chapter.

On the other hand, it is true that the seriousness of the 'bubble' and what it might be the product of was insufficiently recognised both here and abroad. It also obscured many of the real underlying issues from policy makers. For a long period in the mid 2000s, finance was readily available to many business ventures and business start-ups, and profitability was good. However it was not as apparent as it should have been that too many of these did not provide the deep beginnings of companies in new, growth sectors, but were ephemeral firms that were as much about manipulating financial capital as about producing goods and services.

Political economy factors were also high on the agenda. A Labour generation schooled in an era where harsh lessons had been learnt with regard to the importance of the private sector ensured a high priority was always given to trying to keep business on board. Moreover an acute awareness of the reality and power of globalisation - the mobility of capital and some types of labour

- had major implications in terms of limiting the set of options, such as regulation and tax, that were looked at.

As a result, fundamental questions about how the British market economy was working and what was going on beneath the surface of the economy were not properly addressed. This matters most in terms of corporate behaviour and macro economic policy. In short, while the economy was continuing to grow, it had become seriously unbalanced.

The economy's four sectors and their surpluses and deficits

One sign of this imbalance was what was happening to household savings. During Labour's second term, the rate of growth of household disposable incomes slowed down (Table 1A). To help keep their spending up, households compensated by saving less and borrowing more. The resulting consumption boom and house price inflation were later identified by some as contributory causes of the financial crisis.

Labour should surely have done more about this,¹⁵ for example via better policies on the taxation of housing, including land taxes and capital gains on homes. But at the time, not only were these not seen as politically viable, most economists, including those at the Bank of England, who were aware that the level of consumer spending based on easy credit and the expectation of ever higher property prices was not sustainable, kept on predicting a 'soft landing'.

A close relative of household savings is the household sector surplus or deficit. As well as households in the ordinary sense, the household 'sector' includes the business activity of sole traders (like window cleaners or decorators) and non-profit organisations (such as universities and trade unions). This sector's surplus or deficit, which measures the extent to which its income exceeds or falls short of its spending, is directly analogous to the public sector surplus or deficit. In line with the fall in household savings, the household sector went from surplus during most of the 1990s to deficit after 2002, reaching 1.5 per cent of GDP that year and 3 per cent in 2004.

Having brought the household sector in alongside the public sector, we now need to complete the picture. The National Accounts (which is where these economic statistics come from) divides the economy into four sectors. In addition to the household and public sectors, the other two are:

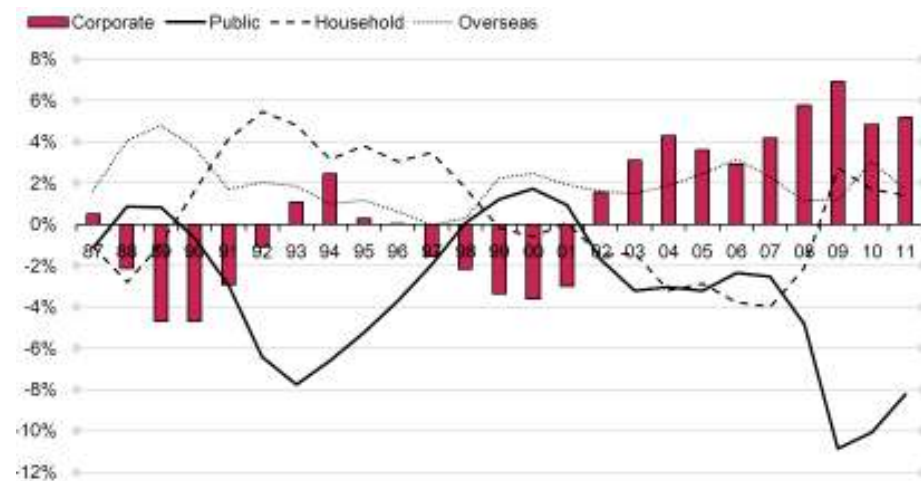
- the (private) corporate sector, containing the big private companies, both financial and non-financial, smaller incorporated businesses and partnerships; and
- the rest of the world and its economic transactions with UK households, companies and the government through exports, imports and capital flows like business investment, overseas earnings, tourism and so on.

The key point about the deficits or surpluses of the four sectors is this. Over a given period of time, although any sector can have a surplus or a deficit, the way National Accounts work means that the four sectors' balances always add to zero. If this idea seems rather baffling (not least to economists who reason differently from accountants), the trick to getting the hang of it is to see that net spending by one sector represents net income for another. As a result, if, say, the household sector buys £100 worth of goods from the corporate sector, the household balance goes down by £100 (i.e. its surplus shrinks or its deficit grows) while the corporate balance does the opposite.

This accounting constraint says nothing about what causes what: in practice, every sector impacts upon every other sector. But if there is a shift in the outcome for one sector, there is always an equal and opposite shift in the joint outcomes for the other sectors. The resulting 25 year dance of the sector balances, from 1987 to 2011, where a move by any one is compensated by moves among the others such that surpluses and deficits always add to zero, is presented in Figure 3. The big picture here is that the pattern of moves after 2001 looks very different from the pattern of moves before it.

Up to 2001, the most obvious feature is the way in which the public and household sectors mirror one another: when one is in surplus, the other is in deficit; and vice-versa. They are also the two sectors whose balances are subject to the biggest swings. The corporate sector and the rest of the world also fluctuate, but to a lesser extent.

Figure 3: Annual sector surpluses (+) and deficits (-) as a percentage of GDP: 1987 to 2011¹⁶



In 2002, two things change. First, instead of being mirror images of one another, the public and household sectors drop into deficit together and remain there until 2007. Second, the corporate sector moves into surplus and stays there. From 2008 things change again. Now, the household sector swings back into surplus (although nowhere near the levels of the early 1990s) while

the corporate sector surplus jumps again, spiking in 2009 but still at pre-crisis record levels in the two most recent years.

The early 1990s suggest that during recessions and their immediate aftermath, the corporate sector can be expected to swing from deficit to surplus. That happened in 2002, for although there had not been a recession in the UK, there had been one in other many countries at end of the dotcom boom. So in both 2002 and 2003, a corporate sector surplus could reasonably have been seen as being in line with the 'normal' pattern after recession, when any fall in net profit is more than offset by falls in fixed investment and both dividend and interest payments. Up to this point then, nothing was obviously amiss.

The further increase in the surplus in 2004 is a different matter. Not only does this take it outside of its previous range but it is the opposite of what might have been expected. As a result, even though there is a small fall in 2005, it now looks like the corporate sector surplus has become a 'chronic' feature rather than a cyclical one which emerges as growth slows and disappears as it speeds up. While we choose to date it to 2004 (the point at which it first becomes clear that something different is going on), it is perfectly possible that the factors behind it were first taking effect in 2002.¹⁷

A long-lasting corporate sector surplus

Our argument in a nutshell is that Labour, along with just about everyone else, missed this shift in the behaviour of the corporate sector balance. Previously it had been cyclical; since 2002 it has become permanent - and at a level between two and three times what had been the previous maximum (of about two per cent). That does not mean it is permanent for ever, but for the time being, and the foreseeable future, it is. In looking to the future, Labour must both cope with the consequences of this shift and find ways of addressing it.

Why pick on the corporate sector like this?

Since all four sector balances always add up to zero, why prioritise the corporate sector? After all, if the corporate sector surplus is deemed to have become problematic sometime after 2002, it is equally possible to say (per Figure 3) that at that point something else odd - and problematic - emerges, namely, that both the public and household sectors started running deficits simultaneously. Why pick on the corporate sector surplus rather than these twin deficits?

There are several responses to this. To begin with, we agree: if we are looking for signs of something going wrong, then it is perfectly reasonable to point to the twin deficits. There are two main reasons why the corporate sector surplus should be treated as a problem (rather than just taken as a sign).

The first is because of the corporate sector's special position within the economy. While any sector of the economy can kick-start economic activity by

spending, it is much the best if companies do so, through business investment. The reason why business investment - spending on new equipment, raw materials and labour - is so highly favoured by economists is that it does not just mean growth but higher productivity too. As he waxed lyrical in 2010 about how his Budget would lead to "a gradual rebalancing of the economy, with business investment and exports playing a greater role and government spending and debt-fuelled consumption a smaller role", George Osborne was reflecting this view. If there is one thing that he and Ed Balls could agree upon, it is that the best way for the corporate surplus to come down would be as a result of a surge in business investment.

Second, even if lenders go on providing money for years, those in deficit - borrowers - always face the possibility of external pressure (from those lenders) to adjust, either by borrowing less, paying more for it, or both. By contrast, those in surplus - savers - are not in the same situation. Even if they are disappointed by the returns on their money, there is not the same, sharp, external pressure to force a correction. There is something badly wrong if companies, whose very reason for being is to seek out and exploit profitable opportunities for growth and expansion, choose instead to stockpile their money year after year, rather than use it productively.

Why is the corporate sector saving?

There are parallels for the emergence of a chronic corporate sector surplus elsewhere in the world, most notably in Japan after the collapse of the property bubble in 1989. Here the story is that while Japanese companies remained hugely profitable - the world still wanted their products - their balance sheets were bust, their property assets having collapsed in value even while their debts remained unmoved.¹⁸ The companies ran surpluses for many years in order to pay down those debts.

It is possible that similar motivations were operating in the UK, either after 2001 as companies sought to cope with the damage to their balance sheets from the dotcom bust, or again after 2008 following the crash. Evidence that would be consistent with this explanation would be a decline in company indebtedness. Among non-financial companies, there is indeed such evidence after 2008, with both short-term and total loans owed by those companies peaking in that year and then falling, by about £110 billion and £75 billion respectively, over the next two years. Over this period, the corporate sector surplus has been averaging around £80 billion a year. Japanese-style 'deleveraging' might well account for the higher levels of corporate surplus since the crash.

By contrast, there is no sign of anything like this happening after 2000. Instead, loans to non-financial companies rose every year from a value equivalent to 56 per cent of GDP in 2000 to 92 per cent in 2008. By 2010, it had fallen back to 85 per cent.¹⁹

One way or another, 'chronic' corporate saving is a sign that financial con-

siderations are taking precedence over productive ones. If it is to pay down debt, as it has been recently, it can be seen as defensive. It is also possible that saving - to build up a financial war-chest - may also be a sign that the corporate sector in general, and not just financial corporations, judged that there was more money to be made through financial speculation than productive activity.

3.2 A new 'golden' rule?

Confirmation that the UK economy dipped back into recession over the winter of 2011-12 has dented the coalition's own reputation for economic competence. That Ed Balls has been proved right about the consequences of austerity means that it is also a political gain for Labour. Yet the economic situation is little changed and in response to the failure so far, Osborne simply promises more of the same: 'austerity without end'. What both the 1930s and 1980s show is that these are conditions in which the Conservative party, with its antipathy to the public sector, flourishes electorally. This is Cameron's trap for Labour.²⁰ How can Labour escape it?

More than the public sector

In his speech to the Fabians' New Year Conference, Ed Balls repeated the commitment that before the next election, Labour would set out fiscal rules for a future Labour government. Based on our analysis, what might such a rule or rules look like?

Our starting point is that the UK economy is not only badly out of balance now but has been for several years. While the precise date at which an imbalance first became apparent is a matter of judgement, it was certainly before the financial crash: we suggest that with hindsight, it was 2004.

The size of the public sector deficit is a key aspect of this imbalance. The resulting level of public sector debt, especially the fact it is rising, is directly related to it. It is perfectly fair and sensible for the public sector's deficit and debt to be seen as the most important and visible aspect of the UK's imbalanced economy and also the one perhaps most easily amenable to policy. However, since the imbalance is neither confined to the public sector nor wholly caused by it, the answer as to what Labour should do cannot be restricted to statements about the public sector alone. At its most general, therefore, our answer is that:

"Labour should look to steer the economy with an eye not just to the public sector balance but also to one or more of the household, corporate and overseas sectors' balances as well."

If people had had this in mind in 2004, when both the public and house-

holds sectors moved strongly into deficit together, the sense that there really was problem taking shape would have been easier to locate and appreciate.

Clearly enough, an answer like this is too general. Before going on to make it more specific, it is worth pausing to draw two comparisons, which help place it in context.

Labour's golden rule and Osborne's replacement

The first of these comparisons is with Labour's original 'golden rule', dating from its first budget in 1997, and the coalition's replacement for it, in its first Budget in 2010. Labour's rule was that over the course of the economic cycle, government would borrow only to invest, with current spending being paid for out of taxation. To this 'golden rule' was added a second rule, that public sector debt should remain at a 'prudent and stable' level over the cycle.

In consigning the golden rule to history in 2010 (with the observation that over the cycle, it was going to have been missed by £485bn), Osborne identified its fundamental flaw as being the fact that it was backward-looking, meaning that "past prudence" could be "an excuse for future irresponsibility". Logically enough, he replaced it with a forward-looking rule. But like the old rule, this new rule - 'that the structural current deficit should be in balance in the final year of the five-year forecast period' - was concerned exclusively with the public sector (as well as being an ever moving target).

This does not mean that Osborne had no views about what ought to happen to the other sectors of the economy. On the contrary, as we have in fact already seen, his description of how the Office for Budget Responsibility (OBR) saw his policies leading to "a gradual rebalancing of the economy, with business investment and exports playing a greater role" has strong implications for all the other sectors. The crucial point is, however, that like Labour before 2010, the only sector balance that the coalition thought it had to manage to bring about this happy result was the public sector's - and that this would 'crowd-in' private sector activity. By contrast, our answer says that, for the foreseeable future, this is not enough.²¹

Old Labour's problem

The second comparison is with the decades before the election of the Thatcher government in 1979. Over that period, from at least 1945 up until the point when controls on international capital flows to and from the UK were abolished in 1979, the conduct of UK economic policy was just as pre-occupied with the balance of payments (the mirror image of the overseas sector balance) as with the public sector balance. The two were seen by many economists to be directly connected, with the perennial threat of a balance of payments crisis being the major constraint on the rate of economic growth.

None of the details of this matter here aside from the basic point that for at least 35 years, UK governments - above all, the Labour government of the 1960s - had to concern themselves not just with one sector balance but with

two. In proposing that a future Labour government should concern itself, too, with balances other than just that of the public sector, our proposed 'new' approach is really a return to a pre-Thatcherite perspective. But where we differ from the old approach, is in the specific question of which 'other' sector is now the problem.

A rule for the public and corporate sectors together

Our earlier analysis also showed that the 'other' problem sector is, and has been since about 2004, the corporate sector.²² In this situation, the key requirement is that government must take the corporate sector surplus fully into account in policy making. In order to give the corporate sector surplus the necessary status, we advocate that it should explicitly appear within a new golden rule. A more specific version of our answer that does this is:

"In the present situation, and for the foreseeable future, Labour should seek to reduce both the public sector deficit and the corporate sector surplus. Planned changes in the public sector deficit have to be made with explicit reference to expected movements in the corporate sector surplus."

Some who agree with our basic point of view but feel that this is too strong (given the limited understanding of the causes of the corporate sector surplus and a fear that it takes too much attention away from the public sector deficit), may advocate instead a reference to the corporate sector to sit alongside a new public sector only rule. If that can be done whilst still giving the corporate surplus the right sense of priority then so be it. In our view, however, putting the corporate sector surplus into a golden rule is the best way to ensure that it is at the heart of economic decision-making.

This rule makes several points. First, by bringing both the public and corporate sectors into the picture, the rule refutes a key tenet of conventional wisdom for 25 years, that the only imbalances that matter are those in the public sector - that the public sector can muck up the market but not the other way round. Events have proven that wrong and the rule responds.

Second, the rule confirms that the public sector deficit should be brought down as fast as possible - but not faster. Both the coalition as well as Labour critics such as the authors of *In the Black Labour*, assume that reducing the public sector deficit is just, in the end, a matter of political will. It is not, as we hope our discussion of the interplay between the four sectors has shown. Unless the rest of the world moves into deficit with the UK (very unlikely as this would require much faster economic growth in the rest of the world and especially in the euro area to deliver a big boost to UK exports) or the household sector sinks into deficit (possible but very undesirable), the only way that the public sector deficit can come down is if the corporate surplus comes down too. Introducing this conditionality into the rule is not a softening of

the resolve to address the public sector deficit but just an explicit recognition of economic realities.

Third, this is not a rule forever. But how can one tell when it should cease to apply? At bottom, this is a judgement that must be made on the basis of what the four sectors together are doing. In our view, the original golden rule should have had such a condition attached to it. When it was introduced in 1997 it was perfectly adequate since none of the other sector balances was either obviously in an odd position or following a strange path. By 2004, when it was clear - for example, from the new conjunction of public and household sector deficits - that this was no longer true, the rule should have been modified or replaced.

Even if Labour does not adopt this particular rule, it does need something of its form. At the moment, the debate is limited to a question of timing: whether the public deficit should be brought down faster or slower. The trouble with this is that it offers no guidance as to how much faster or slower. Making the pace of reduction of the public sector deficit pay attention to reductions in the corporate surplus remedies that. Insisting that the rule always be kept under review in the light of the developments across the four sectors helps protect against tunnel vision.

Fourth, bringing the corporate sector surplus into the equation makes what goes on in the sector the government's business. This may actually be the most important difference between this rule and either Labour's original golden rule or Osborne's replacement. The three other points about this rule have been macroeconomic or fiscal ones, about spending and tax and the like. By contrast, this one about altering the behaviour of the corporate sector and the conditions in which it makes its decision is a microeconomic one which links growth and reform, the "twin pillars" as Ed Balls put it, of a credible alternative economic policy.

3.3 Growth and reform

Growth and reform mean going beyond interest rate policy as the only tool outside of fiscal policy, with more powerful macro-prudential regulation and a re-assessment of the targets that the Bank of England is trying to hit. One thing that will be needed is a more independent fiscal body. Some centre-left economists have been arguing for this since before 1997. The Office of Budget Responsibility only represents a partial response. The extension of a reformed OBR's remit follows from the wider approach that we are proposing, focusing on two or more sectors, and not just the public sector deficit and debt. While the OBR - which is much more transparent on its forecasts than the Treasury ever was - already publishes the necessary forecasts, our understanding is that its corporate sector forecast is fairly rudimentary. This would need to change.

But the main thrust of the reform agenda needs to be towards companies and the corporate sector. This is not new terrain for Labour. From 1997, Labour considered and attempted a range of reforms.²³ The experience of those reforms, and the lessons to be drawn from them, are the natural starting point for 2015.

Some criticise the measures that Labour tried to introduce as doomed to failure, since they lacked radical ambition and avoided a full-blown attack at the way that capitalism and the neo-liberal construct works, in terms of issues like company governance, workers power, privatisation, shareholder value capitalism and the power of financial capital.²⁴

This is an important perspective, especially if it suggests that some things a more 'moderate' Labour government wanted to do were impossible unless some of these radical transformations first took place. The issue of firms under-investing may be one of these for instance.

However, Labour's general approach was more about incremental change on the view that the way to build a reformed model of capitalism is not really about one or two big changes, but a whole plethora of smaller ones, which address specific needs and in aggregate alter the incentives on markets. For example, labour market regulation had industrial as well as equity objectives. The minimum wage stopped firms from making profits simply by paying very low wages. Making union recognition easier and improving individual rights around holidays, time off and flexible working were motivated by equity considerations - but they also put pressure on management to improve productivity.

In the absence of any mooted 'big bangs', there is no alternative but to take the same incremental approach in 2015. This being so, the crucial question for 2015 about this experience is why with many of these measures Labour too often pulled back from the more difficult and radical versions of them, or did not see them fully through. We look at a few of these below.²⁵

Specific areas of policy

Industrial policy and the corporate sector

Labour economic policy has always contained a strong sense that the corporate sector needed to be 'nudged'. Crucial had been the view that macro-economic stability would encourage business investment and activity. Labour was also keen to be stronger on industrial policy itself. However in reality Labour found itself going round in circles on this issue.

This was partly a consequence of history - the phrase 'industrial policy' was felt to be too much of a return to the old failed 1970s policy of 'picking winners' and Labour was nervous of interventionism of any kind, which was seen as offering soft subsidies to firms who were better at lobbying than being innovative and efficient

The net result was at best industrial policy 'lite', with Labour secretaries of

state for industry using phrases like 'active' policy and adopting policies seeking to promote manufacturing and innovation through things like the Manufacturing Advisory Service, tax credits for research and development (R&D) and investment allowances.

The knowledge economy angle was used to try to help think about high-end manufacturing, and those areas connected with hi-tech and the science base, which was funded very well indeed and blossomed in the New Labour years. The early Knowledge Economy White Paper²⁶ took major steps forward to build up venture capital, start-up support and encourage university spin-offs.

However, in-depth analysis to think about how the business sector was behaving and really see if it could be pushed in another direction was not top of the agenda - certainly before the crash. This contributed to the fact that the private sector economy that emerged had faults and weaknesses which would help unbalance the economy.

Regional policy

Labour tried very hard to do something about Britain's tradition of a strong London and south-east and much weaker economic performance in many other areas, especially the northern ones.

The regional development agencies (RDAs) represented a major attempt to locate centres of industrial policy closer to the firms and localities that needed help. Most evaluations of them were, in fact, very positive but, given the stated (ambitious) aim to reduce regional inequalities, they clearly did not succeed (although as ever things might well have been worse without them).

However, the Public Service Agreement target - which committed the government to maximum growth in all regions and narrowing the gap between worst and best performing regions - reflected the ambiguity at the heart of the government as well as within the Treasury on the issue. Was the view that for UK plc to prosper, the north must prosper - as the original Northern Way Task Force advanced - ever wholly adopted within Whitehall? The short answer is no.

This was partly a political issue. For example, it is hard to argue that the whole government machine was really behind getting a 'yes' vote in the referendum for an elected tier to oversee regional governance in the north-east in 2004; nor was it seen within the Treasury and Number 10 that such a new governance would necessarily have positive economic impact.

If, however, the vote had been won, a greater consensus may have developed and further devolution of powers, levers and resources would no doubt have happened slowly but inexorably since the London, Scottish and Welsh new institutional arrangements were put in place.

But while some tier of sub-national regional planning and strategy is, as the Conservatives have already found, still needed - with for example regional outposts of the Department for Business, Innovation and Skills (BIS) and the new NHS Commissioning Board - it is far more clear now that the key eco-

conomic geography is the great cities and city regions that drive growth and that this is where power must be collated around.

In the wake of the referendum defeat, there was an attempt to start boosting and supporting city regions. However, Labour was slow on empowering the great cities. As time went on more powers were given to them - especially in the wake of the 2007 Sub National Review.²⁷ Greater Manchester was the most successful of these in emulating the governance and power of what is in effect a city-region in London, but Liverpool, Leeds, Newcastle and Sunderland, amongst others, began to make good progress and contributed to a northern urban renaissance after many years of decline under the Conservatives.

There is - and probably will, given the Conservatives' antipathy to anything regional, also remain - a need for a pan-Northern Economic Prosperity body to co-ordinate policy and act as a champion voice for those areas currently most adversely affected and which, in due course and certainly by 2015, will distinctly feel 'left behind' as London, Scotland and Wales governance is further strengthened over the coming two years.

Corporate governance

More profound - when one thinks about altering the way that capitalism works - were attempts to alter how firms operated, and how they interacted with their shareholders and other stakeholders. The aim - not often clearly stated - was to stop firms begin short-termist, putting an emphasis instead on long-term growth and value creation, and to ensure that profits were not made at the expense of social and environmental objectives.

There were attempts in this area especially in the first term. Various steps were taken to give shareholders a bigger role in determining the remuneration of executives - arguably one of the key levers to influence firm behaviour. Over time, pension trustees were given new duties to make them more open and accountable. A major review of company law was set up by the first Department for Trade and Industry (DTI) Secretary of State, Margaret Beckett with a radical remit to look widely including at the duties of directors.

These initiatives, however, did not change nearly as much as its advocates had hoped. This was partly due to the fact that ministers' attention wavered, the Treasury was very cautious, and the company law exercise was largely taken over by lawyers and officials more keen to re-write company law than to really change the way in which firms worked.

But the whole debate suffered from the fact that there was no real agreement or clarity within Labour as to what the objective was. Tony Blair had been frightened off by the stakeholder debate in the mid 90s and was reluctant to interfere with shareholder and business rights. Since the economy was doing well in this period, pressure on business and others was reduced too and the imperative for change was lost. Labour, in this respect, was a victim of its own success.

An attempt was also made to encourage more 'partnership' working. While little to do with German-style corporatism, this did try to 'nudge' towards different forms of behaviour on both sides of industry using mechanisms like the new union modernisation fund and bringing in rights to information and consultation arrangements for firms over a certain sizes. Unions were also brought into dialogue with government far more. But in truth the poor condition of the social partners in the United Kingdom made certain approaches unfeasible. The trade union movement was not only declining, it was becoming less able to engage in serious strategy discussions - especially on the private sector side.

Labour came back to the governance agenda in the period after the crash, partly as a failure of corporate governance was seen as one of the causes of the banks' behaviour and partly because an active industrial policy (of which attempts to strengthen corporate governance are one part) became fashionable again in response to the perceived failure of the pure market views to have helped achieve lasting prosperity.

Competition policy

Another attempt to alter the set of incentives facing firms was the radical strengthening of competition policy so firms would find it harder to raise profits through anti-competitive practices and mergers that stifled competition to the detriment of consumers. Of course this is contested terrain on the left - some believe that going too far in this area stops firms taking long-term decisions, and stops collaboration for innovation - but the general drift was and remains generally correct.

However, it was the case that takeovers remained too easy - even in a world where all the academic work consistently fails to find benefits from mergers, and the threat of (easy) takeover causes firms to have to act in short-term ways to avoid predators (or to welcome them!). Labour did not put enough 'grit in the wheels' of the system to prevent short-termist acquisitions that weakened the industrial base, partly due to the vigorous opposition from the business and financial community and partly for fear of denting too much the benefits of competition for corporate control.

Again, Labour later became less nervous in this area. The 2010 manifesto was radical on takeovers - not least in the wake of the takeover of Cadbury at the start of that year by the US food giant Kraft - proposing a steep rise to two-thirds of shareholders in the threshold needed for success, for bidders to set out how they would finance their bid, more transparency on fees, and more requirements on shareholders to declare how they voted.

One way of reading this is that once it became clear that the economy was suffering, radical change - rather than stability - became the Labour mantra. The trouble was, however, that after extolling the virtues of stability up to 2005, it was impossible for Labour to manage such a complete reversal. This is very important for 2015.

Financial service regulation

The biggest failure, certainly in retrospect, concerned financial services and the tipping of the economy into that area of activity - either via the growing size and power of investment banks and equity funds, mergers carried out to manipulate short-term financial advantage, or the excessive degree of credit and leverage individuals and firms took on. The failure was less about having a successful financial sector but in letting it become too dominant a sector within our economy and society.

So why did Labour fail to regulate this sector as strongly as it ought to have done? A lot comes down to a lack of real awareness of the pace and scale of change in the financial sector, and crucially of its potential risks. Labour was not alone in this, either domestically where the Conservative party, during these years, argued for less regulation rather than criticising the rather light-touch approach that was the fashion at the time - nor internationally where lots of other countries were making the same mistakes.

But there was and always had been a lack of serious analysis of financial capital in Labour thinking - except for a general cry against 'casino capitalism'. Thompson and MacDougall argue that "capital markets do matter and they are not benign in their effects", but New Labour was reluctant to challenge this.²⁸ Certainly much of the light touch and deregulatory talk of the times - especially around financial markets - looks very naïve from today's perspective. As Robert Shiller has argued, it was very easy to get the "social contagion of boom thinking" as things seemed to be working.²⁹

With the City and United Kingdom financial services looking like a success story and the fact that even with a more sceptical eye, the identification of systemic risk would have been very difficult, the Labour government was as taken aback by the sudden crash as everyone else.³⁰

Education, training and skills

Many progressive objectives revolve around education, training and skills. They help boost productivity and get people into jobs and so create more wealth, helping living standards and the financing of public services. They help people in less good jobs progress and achieve their aspirations. They are also rooted in a 'self-improvement' philosophy that Labour has always had as a part of its ideology. And they potentially help the UK leap out of what some have termed a low skills equilibrium. It is unsurprising therefore that there was a strong focus on skills. But it was much less clear what exactly to do about it.

Labour's traditional policy had been to have compulsory levies to fund training, so that firms were forced to contribute to training rather than having a collective under-supply of training due to 'poaching'. But for a variety of reasons this had been ditched before 1997. The new policy was to empower workers and citizens through having their own funds to pay for the training they wanted. The early days of the Individual Learning Account showed a

great deal of 'additionality' and popularity; at its height, 2.5 million members registered as eligible to undertake subsidised learning and some 9,000 organisations registered as learning providers. Unfortunately, the scheme was bedevilled by poor design which allowed a small percentage of providers who were playing the system to severely discredit it. It was closed to new entrants in 2001 and the government sadly never had the nerve to try something like that again.

A second attempt to tackle the issue was the 'Train to Gain' scheme born out of the Leitch review of 2006. This offered employees full funding for a first level 2 qualification (broadly equivalent to five good GCSEs) with the hope that this would allow people to have a transferable certificated level of skill to help them progress within or across firms and sectors. Although this made a significant difference to many people's lives and helped many firms raise skill levels, overall it turned out not to be as great a success as predicted. This was partly because it tended to merely give a certificate to people for skills they already had rather than give them new skills and partly due to the difficulty in getting take up in smaller firms where there are the most acute skill problems.

Training for those already in work therefore remained and remains a lacuna. The balance still needs to be found between more compulsion on employers with respect to training and a world with more SMEs and people rapidly changing jobs.

Lessons from policy for 2015

Several themes recur across these different areas of Labour policy. The first is that any major reform requires both a unity of purpose within government and a clear commitment from the very top if it is to stand a chance being successfully implemented. The absence of this commitment is identified here as lying behind the lack of reform to corporate governance and the failure to make much progress of regional policy. In developing his 'responsible capitalism' agenda in recent months, Ed Miliband has signalled his commitment to the reform of British capitalism directed at encouraging and supporting both the world class giants like Rolls Royce and GlaxoSmithKline and the many small, dynamic enterprises.

In the early years after 1997, economic success was always a good reason to do less rather than more, both for those cautious about change within government and for those outside opposed to it. This - the downside of 'growth and stability' - was certainly influential in staying Labour's hand on more financial regulation. The inverse proposition, that 'stagnation and instability' represent an opportunity for radical reform is one that the coalition, along with Conservative governments from 1970 onwards, understood well.

The credit Labour took from 'growth and stability' meant that when, after 2007, it concluded that change was needed, it was very difficult to get that

over, particularly when it meant going against some of what it had been saying in the a earlier period. The consensus view, that everything was either all right or, at worst, that there would be no more than a soft-landing, held Labour back from addressing financial reform in that crucial period after the dotcom bust but before the financial crash.

Discomfort with Labour history is another factor. This seems to have weighed heavily on industrial policy, where any suggestion of a comparison with policies of the 1960s and 1970s would be damning. The persistence of this attitude strikes us as potentially very problematic. It is inevitable that responses to the crisis of the economic order that came into being in the 1980s will sometimes resemble things that were attempted in the years before. So while it is right to be wary of some of what went on in earlier Labour periods, like picking winners amongst particular firms or precise technologies, Labour needs to get itself into a position where such a comparison is neither a virtue nor a vice.

A paucity of serious analysis has been identified here as lying behind the failure to do more both on financial regulation and industrial policy. This paucity (which could surely be cited as a reason in almost every case) obliges Labour to define itself negatively, in relation either to its past (whether 'new' or 'old') or the Conservatives, rather than positively. This criticism, and the reason behind it, applies much more to the 'reform' side of the new equation than the 'growth' side.

A lack of clear goals is cited here as having hampered Labour's policies on corporate governance, industrial policy and regional policy. We think this is the place for Labour, in looking forward, to start. The conclusion of our earlier analysis, expressed via a possible new golden rule, is couched in the terms of the macroeconomic analysis from which it emerged. But another way of putting the point that the corporate sector surplus should come down is that companies, collectively, should revert to their earlier (pre-2001) 'normal' pattern of behaviour.

Beneath this goal of a 'restoration of normality' lies two, specific questions. The first concerns financial regulation. Clearly, one of the goals of Labour reform of financial regulation would be to reduce both the likelihood and severity of future financial crises. The question is whether this is enough; whether, in other words, the goal should be to stabilise the present situation or whether instead it should be to make, as Churchill said, "finance less proud and industry more content". The priority that Miliband has attached to the need to reform the system of finance for small and medium enterprises is a sign that the goal goes well beyond mere stability. At the same time, he has also floated the idea of a British Investment Bank.

The second concerns governance. We have argued that governance reform last time round was held back by a reluctance to interfere with shareholder rights. It is now an interesting question where the threats to those rights are perceived as coming from and whether it is any longer a matter of 'interfer-

ing' with those rights or one of strengthening them. The 2010 manifesto proposal on takeovers points towards the latter. If so, this could be made more general, building upon the recent evidence of increased (and successful) shareholder activism directed against executive remuneration.³¹ More radical ideas still on board structure (and regional banks) that draw on Germany have been championed by the Labour peer Maurice Glasman.³² Whether these or any other particular ideas are correct is always arguable; but that it is now a matter that must be remain high on the Labour 2015 agenda is not.

4

CONCLUSION

4.1 Reform is the key to economic growth

The argument of this paper can be summarised in half a dozen propositions. First, Labour's economic record all the way up to 2007 was, by conventional yardsticks, little short of exemplary. The subsequent crisis and its aftermath were handled well. The idea that Labour is congenitally incapable of managing the economy is a slander whose job is to imply that if there is no alternative to austerity and no alternative to the Conservatives.

Second, despite the economic record, the economy was becoming unbalanced and this was becoming visible by 2004. Although always hard to recognise at the time, Labour's adherence to the consensus view (which said that everything was either all right or, at worst, that there would be no more than 'soft-landing') made timely recognition much harder still.

Third, although there were several signs of that imbalance, the critical one was that UK corporate sector had become a 'permanent' net saver, obliging the other sectors between them to be net borrowers. This imbalance grew much larger in the wake of the crash and has abated only slightly since. No return to economic normality is possible until it is removed.

Fourth, as the principal (domestic) macroeconomic problem, the corporate sector surplus needs to be at the heart of decision-making about the economy. Putting the corporate sector balance into the golden rule underlines its importance and makes it clear that restoring the corporate sector to normality is the government's business.

Fifth, the 'restoration of normality' will entail urgent reform. The reforms that are needed will include - but are not restricted to - ones directed at financial regulation (though not just stability) and corporate governance (including possibly strengthening shareholders).

Sixth, Labour has found reform very difficult; the record after 1997 is salutary. In general, its failings - or 'mistakes' - were ones that felt like they were in the not-possible box and so were never really considered. As Martin McIvor has noted: "New Labour's compromises and calibrations were the result of hard headed calculations by people convinced that the realities...left them no other line of advance".³³ Labour now needs to create that space, space which, by contrast, the Conservatives have been much better at creating for more

than 40 years. We don't pretend it will be easy, especially when Labour is not totally 'trusted' on the economy and when business - who the public to some extent listen to with regard to assessing economic competence of parties - is often hostile. But it is essential.

Finally, let there be no doubt about what is at stake. Some Tories will portray our analysis of the new golden rule as an 'excuse' to show no resolve on public sector spending. More perceptive Tories, however, will read it quite differently. For so long as the corporate sector surplus remains at its current levels, the rest of the world fails to return to strong growth and the household sector refuses to go on a new spending spree, cuts in public spending will leave the public sector deficit untouched. Pointing to the deficit as the reason for cuts, the Tories can cut public spending today - and then come back tomorrow to cut it again. 'Austerity' suits them perfectly.

Endnotes

- 1 This use of 'election years' means that the figures for 1997 (and even more so when data are for financial years where e.g. 1997/98 is labelled 1997) are in effect the legacy of the previous Conservative government rather than a reflection of what Labour did.
- 2 Although that rate of growth did slow towards the end of the eight year period, it remained positive throughout. As the table shows, in 2005 itself, average living standards rose by 1.8%.
- 3 It is true that if house price inflation had somehow been incorporated into the index then the picture would look less good - but it is really only reasonable to judge a government by the official yardsticks in use at the time.
- 4 Source: HM Treasury, Pocket databank, 12 July 2012, <http://www.hm-treasury.gov.uk/d/pdb.xls> (except for statistics on productivity). EU Klems: http://www.euklems.net/data/091/uk_output_091_alt.xls and http://www.euklems.net/data/091/usa-naics_output_091_alt_rev.xls (for statistics on productivity)
- 5 Corry, D., A. Valero and J. Van Reenen, *UK Economic Performance since 1997: growth, productivity and jobs*, Centre for Economic Performance special paper 24
- 6 Corry, D., A. Valero and J. Van Reenen op cit p16.
- 7 Source: H.M. Treasury, Public finances databank February 2012, http://www.hm-treasury.gov.uk/d/public_finances_databank.xls
- 8 Although the election was held in May 2010, it seems reasonable, given the lags between the announcement and even implementation of policies on the one hand, and their effects on the other, to credit 2010 (and for financial years, 2010/11) to Labour. In exactly the same way, table 1A attributed 1997 (1997/98) to the Conservatives.
- 9 Sources: as for tables 1A and 1B
- 10 See, for example current Lib Dem special adviser Giles Wilkes in the excellent Wilkes, G., (2009), *A balancing act: fair solutions to a modern debt crisis*, Centre Forum: <http://www.centreforum.org/assets/pubs/a-balancing-act.pdf>
- 11 Reinhart, C. and K. Rogoff, 2009, *This time is different: eight centuries of financial folly*, Princeton, Table 14.1.
- 12 Ussher, K., 'Labour's record on the economy' in Diamond, P. and M. Kenny (Eds), 2011, *Reassessing New Labour*, Wiley-Blackwell.
- 13 So whereas the collapse of Lehman Brothers, in September 2008, took place after the start of the UK recession (in the second quarter of that year), the run on Northern Rock, in September 2007, took place before.
- 14 Corry, D., 'Labour and the economy 1997-2010: more than a Faustian Pact' in Diamond, P. and M. Kenny (Eds), 2011, *Reassessing New Labour*, Wiley-Blackwell.
- 15 C. Crouch, 'What will follow the demise of privatised Keynesianism?', *The Political Quarterly*, vol. 79, no. 4, 2008, pp. 476-87
- 16 Source: ONS, UK Economic Accounts, series identifiers: RPYN+RQBV (corporate); RPYH+RQAJ+RQBN (public); RPZT (household); RCQH (overseas); YBHA (GDP). It should be noted that the data in this graph are for calendar years.
- 17 This interpretation is given further support by other evidence going back to 1970 (not

included here because of definitional differences in the data). This earlier data (source: CSO Blue Book 1992, table 3.5) confirms two key points made here about the corporate sector balance, namely: that the balance cycles between surpluses (nine years between 1970 and 1986, including all of the recession years and their immediate aftermath in the 1980s) and deficits (seven years); and that the 'normal' range, as per 1987 to 2002, is between a deficit of 4% and a surplus of 2%.

- 18 See Richard C. Koo, 2008, *The Holy Grail of Macroeconomics: Lessons from Japan's Great Recession*, Wiley.
- 19 Source: ONS, Blue Book 2011, table 3.1.9.
- 20 Jackson, B. and G. McClymont, 2012, *Cameron's trap: Lessons for Labour from the 1930s and 1980s*, Policy Network:
http://www.policy-network.net/publications_download.aspx?ID=7730
- 21 And in any case the crowding in theory has very little empirical evidence to back it up.
- 22 In saying this, we do not rule out the possibility that, just because it has not provoked a crisis, the now very long-lasting imbalance with the rest of the world - that is, its surplus or 'our' balance of payments deficit - could also be a problem. The multi-sector view of these balances which we propose here allows this question to be posed.
- 23 See Corry, D., 'Labour and the economy 1997-2010: more than a Faustian Pact' in Diamond, P. and M. Kenny (Eds), 2011, *Reassessing New Labour*, Wiley-Blackwell.
- 24 D. Coates and C. Hay, 'The internal and external face of new Labour's political economy', *Government and Opposition*, vol. 36, n. 4, 2001, pp. 447-71.
- 25 For a fuller exposition of this material see Diamond, P. and M. Kenny (eds), 2011, *Reassessing New Labour: Market, State and Society under Blair and Brown*, Wiley
- 26 http://webarchive.nationalarchives.gov.uk/+http://www.dti.gov.uk/comp/competitive/wh_int1.htm
- 27 http://www.hm-treasury.gov.uk/d/subnational_econ_review170707.pdf
- 28 Thompson, P. and A. MacDougall, 'The politics of New Labour's economy', *Renewal*, vol. 11, no. 4, 2003, introduction
- 29 Shiller, R., *The Subprime Solution*, Princeton, NJ, Princeton University Press, 2008.
- 30 A. Milne, 'Macro prudential policy: what can it achieve?', *Oxford Review of Economic Policy*, vol. 25, no. 4, 2009, pp. 608-29
- 31 A revolt which in May 2012 claimed the scalp of the chief executive of the insurer Aviva, following revolt against its pay plans. Given the way that insurance companies are themselves large scale shareholders, this revolt may have much wider significance.
- 32 Glasman, M., *Debt and Democracy: National Economic Institutions in a Global Order*, NPEN, May 2012
- 33 M. McIvor, 'The lessons of powers', *Renewal*, vol. 18, nos ¾, 2010, p. 7.

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A NEW GOLDEN RULE |

PUTTING THE CORPORATE SECTOR SURPLUS AT THE HEART OF ECONOMIC DECISION MAKING

Peter Kenway
Dan Corry
Steve Barwick

While many of the immediate – and deeper – causes of the financial crash of 2008 rested elsewhere, in the years leading up to it the UK's economy was becoming unbalanced. The public sector deficit is one aspect of this imbalance. But it is not the only one. Much less discussed is another side of it, the corporate sector – Britain's companies, large and small – behaving as long-term savers, spending less than they earn.

Labour, along with just about everyone else, missed this shift in the behaviour of the corporate sector balance. Previously it had been cyclical; since 2002 it has become permanent. In the future, Labour must cope with the consequences of this shift and find ways of addressing it.

In order to give the corporate sector surplus the status it requires, in this Fabian Report, Peter Kenway, Dan Corry and Steve Barwick advocate that it should explicitly appear within a new golden rule, to capture the way that reductions in the public sector deficit depend upon reductions in the corporate sector surplus.