On black holes, fiscal discipline and investment-led growth

David Purdy

The new Labour government faces daunting challenges on the economic front, some of its own making.

Within days of taking office in July 2024, the new Labour government commissioned a Treasury audit of the public finances. Three weeks later, the Chancellor, Rachel Reeves, revealed that, relative to what it had budgeted for in March 2024, the previous government had overspent by £22 billion. Describing this deficit as a 'black hole', she announced that in her first autumn budget she intended to plug it. In the meantime, and as an earnest of intent, she proposed to save an estimated £1.4 billion by removing entitlement to the winter fuel allowance from all state retirement pensioners except those with annual incomes below £11,094, who qualify for pension credits.

The announcement provoked a storm of protest from the opposition parties, Labour backbenchers, trade unions and pensioner pressure groups. Critics pointed out that fewer than two thirds of those eligible for pension credits actually claimed them, and that those with incomes just above the cut-off point risked a cliff-edge descent into fuel poverty. The government's subsequent refusal to abolish the two-

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child benefit cap and the disciplinary action taken against rebel Labour MPs further alienated progressives, while the ministerial mantra of 'tough choices' gave rise to widespread foreboding about what lay in store.

These fears were partially allayed when Rachel Reeves finally presented her budget on 30 October. She announced plans to increase public spending by an average of £69.5 billion a year (equivalent to 2.2 per cent of GDP) over the five financial years from 2025/26 to 2029/30, with roughly two thirds going on current or day-to-day spending and one third on public sector investment. The tax changes she introduced were expected to bring in additional revenue of £36.2 billion a year on average, with employers' national insurance payments rising by £25 billion. The resulting deficit was to be covered by higher public borrowing, with the cumulative addition to public debt totalling £142 billion or around 1 per cent of GDP per year. By the standards of recent decades, these numbers represented a significant loosening of fiscal policy.

There were, however, storm clouds on the horizon. To relieve immediate pressures on departmental budgets, the planned increases in public spending were front-loaded, tailing off sharply after the first two years in order to comply with the Chancellor's new fiscal rules. Hence, unless GDP grew faster than the Office for Budget Responsibility (OBR) was forecasting, she was likely to face a really tough choice: borrow even more and break her own rules, raise taxes further and invite a political backlash, or cut future spending in 'unprotected' departments. On top of this, Reeves's efforts to translate the rhetoric of 'national renewal' into a strategy for investment-led growth failed to gain political traction. The government remained deeply unpopular; progressives remained unreconciled; farmers were angry at losing their exemption from inheritance tax; and businesses warned that the steep rise in labour costs resulting from the hike in employers' national insurance payments coupled with a 6.7 per cent increase in the statutory minimum wage would inhibit job creation and might lead to job losses. Retaining the confidence of this last group is, of course, essential for the government's long-term economic strategy to have any chance of success.

In a culture transformed by four decades of neoliberal social engineering, the lasting economic consequences of fiscal austerity would pose a formidable challenge for any incoming government. In what follows, I attempt to distinguish between the baneful legacy Labour inherited and the political constraints it has imposed on itself.

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Metaphors in politics

Politicians, like all communicators, often reach for metaphors, analogies and other figures of speech, hoping to grab attention, enliven public discourse, make issues which are technically or otherwise complex easier for a lay audience to understand, and win support for their position or policy, while damning those of their opponents. There is nothing wrong with this, and we all do it, experts and laity alike. That said, metaphors need to be handled with care, in political as in other kinds of discourse. They are best avoided if they are anachronistic or worn out - think of 'steering the ship of state' or 'leaving no stone unturned'. And they may do more harm than good if, in a specific context, they fail to work as the speaker intends.

The term 'black hole' provides a classic case in point. In astrophysics, it describes regions in space where a star with sufficient mass has collapsed into a single point or singularity, creating a gravitational field so intense that no matter and not even light can escape from it. Since anything caught in a such a strong gravitational field will fall into it with no hope of return, it can be pictured as an infinitely deep 'hole' in space. And since not even light can escape, it is a *black* hole. This *is* a metaphor, but physicists use it all the time and it helps the rest of us to understand a natural phenomenon that is undeniably awesome and strange.

Cosmologists cannot affect the distant objects and events they study and seek to describe, and explain them solely in physical terms. Politicians, by contrast, are actively engaged in an ongoing struggle for power and must make their moves and choose their words carefully, paying close attention to the historical and cultural context in which they find themselves. Rachel Reeves doubtless had her reasons for describing the spending overrun she inherited from her predecessor as a 'black hole'. Like all chancellors presiding over a spending review, she wanted to strengthen her hand in negotiations with departmental ministers. She was also keen to remind voters who is responsible for the plight of broken Britain, just as David Cameron and George Osborne managed to pin the blame for the burgeoning budget deficit that emerged during the recession of 2008-9 on Gordon Brown's 'fiscal irresponsibility'. (In fact, of course, the surge in the deficit had been a consequence of the crisis, not its cause. 'Light-touch' regulation had allowed bank lending and financial speculation to get out of hand, leading to the near collapse of the banking system and precipitating a steep fall in spending, output, employment and tax revenues across the world.)

Nevertheless, the 'black hole' metaphor was a bad choice. For one thing, given its association with astrophysics, the chancellor could be taken to be saying that budget deficits are inherently dangerous and should never even be contemplated, let alone condoned or deliberately chosen in preference to the alternatives. Her words also carried echoes of the Thatcher years and of the Tories' more recent essays in fiscal austerity. And, amidst the consternation caused by her unheralded decision to cut the winter fuel allowance, her sombre account of the state of the nation and her sketch of a new fiscal dispensation got lost. Other ministers and Labour MPs followed her example, and 'black hole' soon became not just a shorthand descriptor of Britain's many-layered crisis, but a blanket excuse for taking 'tough decisions'. And both usages focused on the current state of the public finances rather than on the long-term, structural weaknesses of the British economy.

Ironically, there was, or might have been, an escape route from the Tories' toxic fiscal legacy. £22 billion could have been recouped simply by reversing the cuts in national insurance contributions introduced by Jeremy Hunt in a desperate bid to convince voters that low-tax, small-state, free-market capitalism is still a desirable and feasible option in an age of mounting global disorder, looming environmental catastrophe and rampant inequalities of income, wealth and power. But in the name of 'working people', Labour had forsworn this option by pledging not to raise the rates of income tax, employees' national insurance, VAT and corporation tax during the current parliament. Between them, these taxes bring in some two thirds of total tax revenue.

Fiscal and monetary policy: ends and means, then and now

Many people share Margaret Thatcher's homespun belief that managing the public purse is no different in principle from managing a household budget. This analogy is flawed. It is simply not true that what holds for individual actors at the micro-level of the economy applies equally to a national government grappling with the problems of the economy as a whole. Households do need to be careful about getting into debt; but a government with extensive powers of taxation in a country with its own currency and a sophisticated banking and financial system has wide - albeit not unlimited - latitude to spend beyond its income. And not only *can* it do so, there are times when it *should*: notably, when aggregate spending on newly produced goods and services falls short of aggregate output, threatening to plunge the economy into recession.

In general, fiscal and monetary policy need to be combined. Monetary policy, conducted by the central bank, works mainly through changes in interest rates, but these can, if necessary, be supplemented by transactions with the commercial banks known nowadays as quantitative easing or tightening. Historical experience suggests that monetary measures work best when used to restrain an inflationary boom; they can also be useful adjuncts to fiscal policy in counteracting a slump, but they are more or less useless in a prolonged depression. Thus, if recession looms or sets in, it is generally better for the government to administer a deficit-financed stimulus aimed at minimising the loss of output and employment than to cut public spending and raise taxes in a self-defeating attempt to balance the budget. I say 'generally' here, because when it comes to policy-making, as distinct from theorising, generalisations, not hard-and-fast rules, are the best we can hope for. Keynes, a policy-pragmatist if ever there was one, had a ready rejoinder to critics who accused him of inconsistency: 'When the facts change, I change my mind. What do you do?'.

Fiscal policy serves more than one purpose. Taxation provides the funding for public services such as defence, policing, health care and education, as well as for social transfer programmes such as state pensions and universal credit. But tax policy is not a simple matter of 'balancing the books': budgets are also tools for managing the economy as a whole. And taxes and subsidies have long been used to influence the pattern of output and the allocation of resources in cases where market prices fail to reflect the social costs or benefits of production and consumption: hence the so-called 'sin' taxes imposed on alcohol, fuel and tobacco; and the subsidies dispensed to universities, rail operating companies and what is left of the steel industry. In designing a budget, the Chancellor must take all these considerations into account, as well as attending to the state of public opinion and the exigencies of party politics.

The financial and economic challenges Britain faces today are daunting. The ratio of government debt to GDP has risen inexorably since the days when Gordon Brown pledged to keep it below 40 per cent: in August 2024, it crossed the psychological threshold of 100 per cent. There has also been a marked slowdown in economic growth: over the relatively benign period from 1992 to 2007, real (inflation-adjusted) GDP grew at an average rate of 2.8 per cent a year; across the turbulent period since 2007 - the year when the banking system began to seize up - the growth rate has fallen to only 1.1 per cent a year. Britain's experience is far from unique. With one exception, every other G7 country shows a similar pattern of rising public debt and falling economic growth. The exception is Germany, which has combined slow growth with a stable debt ratio. Of course, the fact that rising debt has coincided with falling growth tells us nothing about the causes of either. Nevertheless, there is good reason to believe that, in general, slow growth causes high debt, not the other way round.

Looking back from the vantage point of the Second World War, Keynes summed up the policy lessons of the inter-war years as follows: 'Take care of employment and the budget will take care of itself'. Keynes, however, was thinking about the scourge of mass unemployment, which for three decades after the war had been kept at bay by instituting a managed form of capitalism dedicated to maintaining full employment. The problems facing Rachel Reeves today cannot be solved simply by using fiscal and monetary tools to influence aggregate demand: they call for complementary policies aimed at removing or easing shortages and constraints on the supply side of the economy, from the housing market and transport networks to the law courts and the health service. The government, she argues, should formulate clear and defensible fiscal rules and then stick to them for long enough to provide private firms with a stable framework for their production and investment decisions. The case for fiscal discipline in this sense is reinforced by the priority Labour attaches to investment, both public and private. The government has set no specific targets, but has made it clear that a substantial uplift in the proportion of GDP devoted to investment is a pre-requisite of economic regeneration.

If the UK were emerging from a deep depression, with ample reserves of readily employable labour and plenty of spare capacity, investment and consumption could advance together. As it is, after fifteen years of anaemic growth and decades of under-investment - not just in infrastructure, buildings, machinery and equipment, but in mental health, preventive medicine, education and training, social cohesion and the green economy - skilled labour is in short supply and there is little spare capacity: in the jargon of economists, the output gap - the difference between potential and actual output - is uncomfortably close to zero.

How this situation came about I shall consider later. Here it suffices to note the implication. The scale and pace at which new building and other capital projects are set in train has to be consistent with keeping inflation under control. Until these projects are completed and existing capacity is enlarged, day-to-day spending on public services and social transfer programmes will need to be kept on a tight leash. The scope for raising taxes to finance higher spending is limited by Labour's election pledges, and any unfunded spending spree would soon run up against the capacity constraint, reigniting inflation and forcing the Bank of England to raise interest rates. Higher interest rates, in turn, would not only curtail household spending and private investment, but would also add to the cost of servicing public debt, putting further stress on the government budget.

The age of austerity

In response to the global financial crisis of 2007-8, besides establishing the G20 to co-ordinate policy at the international level, Gordon Brown and his Chancellor, Alistair Darling, took prompt action to shore up spending in the UK, reinforcing the so-called automatic stabilisers - falling tax revenues and rising benefit outlays - with a modest fiscal stimulus. Since the mid-1970s, the idea of deliberately unbalancing the budget to combat a slump had been considered anathema by mainstream economists, and its re-emergence in 2008-9 was widely - though prematurely - seen as marking 'the return of Keynes'. In Britain, as in the US, this brief departure from conventional fiscal wisdom was accompanied by the adoption of what became known as unconventional monetary policy. The Bank of England had been slow to react to the gathering signs of a banking crisis, but, following the collapse of Lehman Brothers, it joined the other main central banks in slashing its policy rate towards zero.

This was the traditional response to a crisis. But with the economy still in free-fall and Bank Rate at 0.5%, the lowest level in the Bank's history, interest rate policy could do no more. An extra tool was needed to guard against the danger of price deflation (falling prices or negative inflation), a problem that had bedevilled attempts to escape from the Great Depression in the early 1930s. The Bank, therefore, created a new facility that would enable it to buy a range of financial assets from the commercial banks - primarily long-term government bonds - paying for them by expanding the amount of reserves (narrow money) they held with the Bank. That would increase the availability of bank credit (broad money), and, it was hoped, stimulate more borrowing by firms and households so that, as the loans were spent, the economy would recover. Quantitative easing (QE) had arrived.

The Bank insisted that QE did not involve a *permanent* rise in the money supply: the assets purchased would be sold again once the economy was back to 'normal'. In the meantime, QE was commended on both pragmatic and ideological grounds: it was a timely addition to the Bank's tool-kit in a situation where interest rate policy had run out of road; and monetary expansion was better than public investment as a cure for recession because it avoided a government role in the allocation of capital. The second of these arguments had an obvious appeal for economic liberals. On taking over as Conservative leader in 2005, David Cameron had cast himself as the 'heir to Blair'. But, after Labour's response to the 'Great Recession' had evoked the spectre of Keynes, he and his chief lieutenant, George Osborne, rediscovered the virtues of the small state and began to craft an alternative macro-economic strategy which combined QE with fiscal austerity. By 2010, when the Conservatives returned to government in coalition with the Liberal Democrats, the idea of an 'expansionary fiscal contraction', once considered an oxymoron, was sweeping across Europe's finance ministries, and both parties made it their lodestar.

Fiscal retrenchment, it was claimed, would cause output to grow by increasing business and consumer confidence. A credible programme of deficit reduction would stimulate private spending on a scale that would more than offset any adverse effects of fiscal contraction. It was also claimed that spending cuts were more effective in restoring confidence than tax increases. Osborne was strongly committed to this argument, and tax rises played a minor role in his budget packages: indeed, money was regularly found for tax cuts. The role of QE was to underpin private-sector confidence in a context of cuts to the budgets of 'unprotected' government departments and programmes. The aim was to eliminate the 'structural' or cyclically adjusted budget deficit, while simultaneously making room for tax cuts. The Bank of England's job was to counteract the depressing effect of fiscal contraction on prices, output and employment by maintaining ultra-low interest rates and an abundant supply of credit.

The results of this policy experiment were distinctly underwhelming. Recovery from the 2008-9 recession was painfully slow. GDP did not regain its pre-recession peak until 2014, making it the slowest recovery since the early 1800s. In 2015, after five years of public sector restraint and cutbacks, the headline deficit had fallen from 10 per cent of GDP to 4.1 per cent in 2015/16, but most of that reflected a cyclical recovery. The structural deficit - the supposed target of fiscal austerity - was still over 2 per cent of GDP, just about where, back in 2010, the OBR had predicted it would be.

Recovering from austerity

Fiscal austerity did enormous damage to the public sector, much of which only became visible to outsiders in later years as services buckled under pressure or disappeared altogether. The same applies to the wider economic consequences of George Osborne, which were not confined to the years it took for GDP to regain its previous peak, but continued to be felt long afterwards. In a typical recession or slowdown, output falls relative to its potential level: i.e. the output gap grows larger. But the slow and faltering recovery presided over by Osborne caused potential output itself to fall. Productive capacity shrank because workers who were unemployed or re-employed in what they regarded as inferior jobs became demoralised and deskilled, and because firms failed to invest in future productivity. These impairments to the supply side of the economy meant that recovery now depended not just on increasing the demand for goods and services, but on rebuilding supply.

In the UK, the impact of this double debility was felt not so much in the prolongation of high unemployment as in the growth of insecure, low-paid and low-productivity jobs. Duncan Weldon notes that the 2008-9 recession and the subsequent slow recovery were the first real stress test of the liberalised labour market created during the Thatcher and Major years.[2] In the counter-inflationary recessions of the early 1980s and early 1990s, the percentage of the workforce unemployed had climbed into double figures before inflation was subdued. After 2008-9, however, unemployment peaked at 8 per cent, only three points up on its pre-recession level. And from 2012 the rate fell rapidly, reaching 5.5 per cent by the time of the 2015 election. The employment rate, moreover, actually rose, as previously 'inactive' people entered the workforce. By 2015, 74 per cent of the working-age population were in employment, the highest rate in British economic history. But the obverse of what the Conservatives hailed as a 'jobs miracle' was a productivity collapse. Rapid growth in the number of hours worked coupled with slow growth in overall output added up to a steep fall in productivity growth. Whereas output per hour worked grew at a steady rate of 2.2 per cent a year over the three decades before 2008, in the next fifteen years it grew at only 0.5 per cent a year.

The damage done by austerity might conceivably have been repaired had Labour won the 2015 election. As it was, the Conservatives managed to secure a small overall majority, enabling them to dispense with the Liberal Democrats, but by the same token obliging them to keep their manifesto pledge to hold an in-out referendum on Britain's membership of the EU. Had they still depended on Lib Dem support to stay in government, Cameron planned to ditch it. This unexpected turn of events ushered in nine years of turmoil. Labour swung left, the Tories swung right, and the country was hit by a succession of shocks: Brexit, Covid-19 and the fall-out from the Russo-Ukrainian war. The first of these was a home-grown imbroglio, the others originated abroad, but all took up the full bandwidth of government, precluding serious engagement with Britain's underlying economic weaknesses.

In 2024, against a global backdrop more unsettled and menacing than at any time since May 1940, Labour was elected on a mandate to rebuild Britain - both literally in terms of its physical infrastructure and capital equipment, and metaphorically as a cohesive society that works for all its members. To do this, it must raise the proportion of GDP the UK devotes to investment, both public and private, so as to expand aggregate supply and demand together and steer the economy on to a new, sustainable growth path. By how much does investment need to rise? A comparison of the UK's investment record with that of its G7 peers gives a rough indication. Over the past decade, the UK had the lowest investment ratio in the G7: to match the average of the other six, it needs to raise investment by about 4 per cent of GDP or, in absolute terms, by £110 billion a year.

Given the existing capacity constraint, a shift of this magnitude cannot be achieved in one go without driving inflation above its target range. The transition will, therefore, have to be gradual, extending over at least two parliamentary terms, with projects prioritised according to agreed criteria. But whose priorities and what criteria? And what balance should be struck between public and private investment? Labour's answers to these questions are still a work in progress, but its general approach is becoming clear, and more detail will emerge from a forthcoming White Paper on infrastructural investment, and from a five-year public spending review due to conclude in July.

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The basic premise is that the role of the state in contemporary capitalism is not to give market forces free rein, nor to stifle economic growth by excessive regulation; instead it needs to harness the power of private capital so as to meet social and environmental needs that would otherwise go unmet. Accordingly, to boost growth and generate the tax revenue required to repair the public services, the government intends to form public-private partnerships, or to remove regulatory and other barriers to expansion in those sectors of the economy with the greatest potential to serve these goals: construction; the cluster of industries involved in the transition to net zero; and those hi-tech sectors in which the UK has a comparative advantage, such as finance, AI and the life sciences.

So far, there has been little public debate about the merits of this approach and its attendant risks: AI, for instance, may compromise public safety and undermine civic trust; similarly, an oversized financial sector may destabilise the economy. But then, the only interest groups the government has so far consulted are financial and business corporations. If the push for national renewal is to gain traction, it cannot remain the preserve of the political and corporate elite, but must engage the intelligence and support of other stakeholders such as trade unions and representatives of the UK's nations and regions. The more inclusive the conversation, the greater the scope for broadening the agenda to encompass the development of our *society*, as distinct from the growth of our *economy*.

The events of the past year provide a striking illustration of the relationship between elections and the politics of the long haul. The Tories' central charge against Labour was that if it won the election, the 'tax burden', already at a post-war high, would grow heavier still. Instead of contesting this conventional, but loaded way of describing the ratio of total tax revenue to national income, Labour promised not to raise the rates on the chief sources of revenue. Whether it would have won had it not done so is a matter for debate. Two points, however, are beyond dispute: that the pledge left the Chancellor struggling to fund day-to-day public spending without breaking her own fiscal rules; and that it is impossible to change the way people think and feel about taxation in the space of a six-week campaign. In the short run, the ceiling of public tax tolerance is more or less given; in the long run, it can be raised, but only if sustained efforts are made - at all times, not just during elections - to make the moral and intellectual case for higher taxes. The same applies more generally. With its near exclusive focus on fighting or preparing to fight elections, Labour effectively defers to those prevailing habits, norms, attitudes and beliefs that obstruct or inhibit progress towards a fairer, greener, happier, less divided and more democratic society. Unless and until the party recognises this truth, its room for manoeuvre, in or out of government, will remain tightly constricted.

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David Purdy used to teach at Manchester University, first in the Department of Economics and later in the Department of Social Policy. Now retired, but still aspiring to be an organic intellectual, he lives in Stirling. He was joint editor of *Feelbad Britain: How to make it better*, Lawrence and Wishart 2009.

Notes

1. Reeves has made two changes to the existing rules. First, instead of lumping all government spending together, current or day-to-day spending - on items such as wages, electricity and office supplies - will henceforth be distinguished from investment or capital spending. By the third year of the OBR's rolling five-year forecasting period, the current budget must be in balance, with borrowing used only for investment. Second, whereas previously public debt was equated with *gross national liabilities*, i.e. the total redemption value of all outstanding government bonds, henceforth the value of certain national financial assets, such as student loans and investments the government makes in industry or infrastructure, will be deducted from the gross figure to arrive at a total known as *public sector net financial liabilities*. In computing the ratio of public debt to GDP, this is the measure of debt that will be used. In addition, the requirement that the debt ratio should be falling will now have to be met by the third year of the forecasting period, not the fifth.

2. Duncan Weldon, *Two Hundred Years of Muddling Through*, Little, Brown, London 2021, pp293-4.