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Who Should Pay for the UK Blockade in the Face of the COVID-19 Pandemic?

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ABSTRACT
This chapter examines what lessons can be learned from three previous crises that created public debt mountains of similar magnitude to the pandemic: the First World War, Second World War, and Credit Crunch. In all three cases the Treasury pressed for drastic spending cuts, to maintain confidence in sterling and the City. However, in the one case where the Treasury's advice was rejected, there was a substantially stronger recovery. The Treasury has similarly lobbied for austerity measures to deal with the COVID-19 government debt, again raising the spectre of slow growth and mass unemployment.

KEYWORDS
COVID-19; Austerity; Economic recovery; Treasury; Bank of England; Recovery policy.

1. Introduction

Aside from its terrible human toll (which will have enduring impacts), the economic costs of the coronavirus pandemic will be catastrophic, both in the short and longer term. Can Britain learn anything from three previous episodes of international crises that massively increased its national debt, while destabilising the domestic and world economies: the First and Second World Wars and the Credit Crunch?

In some respects, the coronavirus pandemic is different from these crises – it inflicts no significant damage on physical infrastructure; it has not skewed industrial output towards a 'war economy', and – unlike the Credit Crunch – it has not laid bare more fundamental instabilities and insolvencies among key sectors and firms. However, in common with these crises, it will hugely inflate government debt, while generating further costs of economic reconstruction, to save businesses that are fundamentally solvent, but have been driven to the brink of collapse by the lock-down. Britain will also face a major expansion in unemployment and other welfare costs, at least in the short and medium term.

The previous crises are illuminating in showing the solutions that British policy-makers have repeatedly advocated. Influential voices (particularly the Treasury, Bank of England, and leading bankers and City figures) repeatedly advocated placing much of the burden of adjustment on lower income groups, via policies of savage deflation and public expenditure cuts. In only one case did politicians reject this advice, in the special circumstances of an electorate who had learned the lessons of the government response to the First World War aftermath and took the opportunity of the 1945 election to vote in a radical government, committed to social reconstruction and the welfare state.

2. The First Crisis: 1914-31

The First World War was both an unprecedented humanitarian disaster and a huge negative shock to the international economy. Both belligerents and neutral countries greatly expanded their industrial production, especially for staple commodities such as coal, iron and steel, and textiles (which formed the core of Britain's industrial base), creating a problem of massive excess capacity following the Armistice (Scott 2007, 74-85). Until the final months of war, it had been assumed that the outcome would probably be a stalemate, with a strong Germany possibly switching from a fighting war to an eco-nomic conflict with Britain (Cline 2017, 157-81). This challenge was to be addressed by policies of industrial reconstruction and job creation – partly via a massive building programme of 'homes for heroes' (state-subsidised municipal housing). However, the Treasury and Bank of England were strongly opposed to this strategy, which ran counter to their own plans for savage deflation, to bring the pound back to its pre-war gold standard parity and restore the City to its status as the world's main financial centre (Peden 2000, 125).

Germany's sudden military collapse in autumn 1918 enabled the Treasury and Bank of England to implement their deflationary strategy (Garside 1998, 27-9). This contrasted with the policies of most major European nations, including Germany, France, and Italy, which, to varying degrees, relied on inflationary policies to reduce their debt's real value. Adopting such a solution in Britain would have made a resumption of Bank of England co-ordination of the international gold standard impossible, while shattering ambitions for a resumption of the City's status as the world's leading financial center (that, in any case, proved illusory). It would have also adversely impacted the middle classes – the bedrock of Conservative electoral support – by drastically reducing the value of their fixed-interest stocks (Daunton 2002, 64-6). Sparing the middle-classes by focusing on paying off the debt nevertheless enraged the very constituency that the policy was designed to protect, as it entailed high taxation (by pre-1914 standards). The standard rate of income tax rose from 5.8% in 1913-14 to an interwar peak of 30% during the 1918-19/1921-22 tax years (Daunton 2002, 883-9). Top rates were much higher, but a failure to address growing tax avoidance/evasion allowed the super-rich to dodge a growing proportion of their taxes (Scott, forthcoming).

Returning to gold at pre-war parity (£1 = $4.86) required substantial price falls to counter war-time inflation. However, the government's deflationary policy mainly acted to increase unemployment rather than reduce prices. Nevertheless, in April 1925 the Chancellor, Winston Churchill, took Britain back to gold at its old parity (which proved to be substantially over-valued). As John Maynard Keynes famously noted, what he estimated to be a 10% sterling overvaluation meant that:

whenever we sell anything abroad, either the foreign buyer has to pay 10 per cent more in his money or we have to accept 10 per cent less in our money. That is to say, we have to reduce our sterling prices, for coal or iron or shipping freights… by 10 per cent in order to be on a competitive level, unless prices rise elsewhere. (Keynes 1970, 23; emphasis in original)

Britain was a negative outlier in terms of its poor economic growth during the 1920s, largely as a result of deflationary policy which continued after 1925 in order to defend its over-valued exchange rate (Eichengreen 2004, 322-3). Ultimately the policy was not sustainable; a loss of international confidence in sterling triggered a political crisis in the summer of 1931 and one of the first acts of the new Conservative-led 'National' government was to take Britain off the gold standard. Contrary to the Treasury and Bank of England's dire predictions, the value of the pound did not collapse, but settled at a more internationally competitive rate, which assisted Britain in achieving one of the strongest recoveries from the 1929-32 depression. However, despite a surge in economic growth and employment, the staple industries (principally coal, iron and steel, and textiles) were slow to recover from a decade of being priced out of international markets, creating what proved to be a permanent north-south divide in British prosperity.

3. The Second Crisis: 1939-51

The Second World War saw a much wider mobilisation of domestic resources than the First, in a conflict where, for a time, Britain stood alone. At its peak, almost all working-age adults, including civilians, were subject to some sort of conscription and, thanks to the Luftwaffe, many urban residents faced a real threat of death or injury. Government accepted the imperative to keep food and other necessities both affordable and available, via a system of rationing, price controls, and subsidies. These policies sharply reduced living standards for the upper and middle classes, while improving the nutrition of many manual workers' families. Rationing did not remove disparities in living standards – the affluent retained their better housing, could still dine at smart restaurants where food was unrationed, and enjoyed better food at home by using the ration coupons of their domestic servants. However, the system was based on equality of sacrifice and "fair shares" for all, according to needs, rather than wants (Roodhouse 2013, 2-6).

Contrary to some popular accounts, there was no consensus within the war-time government that post-war economic policy should prioritise domestic reconstruction and Keynesian full-employment policy. An influential coalition of Bank of England and Treasury officials advocated an economic policy based on prioritising the restoration of sterling's credit-worthiness – in the face of Britain's huge war debts – through another round of severe deflation. Keynes criticised this group for prioritising international "obligations" over the war-time commitment to build a fairer society – which would amount to a repetition of the 1920s gold standard debacle – though his direct influence was ended with his untimely death in April 1946 (Newton 2004, 262-3).

However, the deflationary lobby failed to appreciate the drastic change in popular opinion, reflecting the levelling tendency in socie ty brought about by the collective nature of the war effort. Most senior politicians recognised the impracticalities of the Bank of England's 'sterling first' policy, while the remainder had their dreams shattered by Labour's landslide 1945 election victory. Clement Atlee's 1945-51 Labour governments used a continuation of rationing and other wartime direct controls to create a comprehensive welfare state and nationalise what Labour saw as key areas of the economy, while avoiding any deflationary plunge into recession. Moreover, they achieved substantial economic growth, with GDP rising at a respectable 2.5% per annum from 1946-51. The October 1951 election saw the return of a Conservative government, which increasingly followed Treasury and Bank of England advice to prioritise a strong and stable pound and an early re-opening of the City, over wider domestic economic and social reconstruction. Nevertheless, many of the gains of the Attlee era, including the NHS, the welfare state, and a commitment to full employment, persisted.

4. The Third Crisis: 2008-15

The Credit Crunch was a very different type of economic shock than the two world wars, in part a financial crisis (on a scale never seen before), but also a crisis of the global economic system. From the 1980s, governments had increasingly ceded their regulatory functions to markets, private sector institutions, and central banks, on the basis of a philosophy that markets could fix any problems they could create, if set free from the heavy hand of the state. However, the events of autumn 2008 shattered this myth, as the spike in equities, house prices, and securities based on home mortgages suddenly burst, threatening to bring down the international financial system.

The subsequent fall in house and equity prices over 2008-09 wiped out $1.5 trillion of British household wealth, equivalent to 50% of GDP (according to an IMF estimate), with 10% of home-owners facing negative equity (Tooze 2019, 156). Internationally, trillions of pounds of taxpayers' money was mobilised by the world's leading industrial nations, to save banks from their own mistakes and mismanagement. The new reality produced a rapid, if short-lived, ideological volteface, with many of the people who had hitherto been the strongest advocates of market-based solutions making ever-more desperate pleas for massive government bailouts. As former Federal Reserve chairman Alan Greenspan admitted, "I made a mistake in presuming that the self-interest of organisations, specifically banks and others, was such that they were best capable of protecting their own shareholders" (Beattie, Politi 2008).

Across the developed world, eye-wateringly expensive bank bailouts were mobilised, via loans, recapitalisations, asset purchases, and state-backed guarantees. These were reinforced by similarly huge government economic stimulus packages to prevent a global economic meltdown. Gordon Brown's plan to recapitalise Britain's ailing clearing banks, while taking equity stakes in them, is generally regarded as one of the most successful bank bailouts (though the Labour governments of which he had been Chancellor, then PM, must shoulder substantial responsibility for earlier failures to introduce stronger regulation) (Tooze 2019, 190-2). Meanwhile Britain's clearing banks were remarkably unrepentant. For example, RBS – the world's largest bank on the eve of the crisis, based on its 2008 balance sheet – insisted on honouring £1 billion of bonus contracts, despite just having been saved from bankruptcy by an enormous injection of taxpayers' money (Tooze 2019, 292). Then, once the crisis was averted, the banks aggressively lobbied for a quick return to business as usual.

As in 1919 and 1945, the Treasury lobbied for prioritising deficit reduction over maintaining living standards (Tooze 2019, 349). The 6th May 2010 general election failed to produce a Parliamentary majority, with the Tories gaining the most seats and the Liberals holding the balance of power. However, negotiations soon revealed the Liberals' top team to be dominated by economic liberals, having much more in common with the Tories than with Labour. They thus signed up to a Conservative programme of 'austerity', in stark contrast to their manifesto pledges. This was a very different brand of austerity than that employed by the 1945-51 Labour governments, based around 'fair shares' and equality of sacrifice. Instead, austerity was disproportionately targeted on lower income groups, cutting welfare benefits and raising regressive taxes, particularly VAT. The rich were much less impacted, largely due to their ability to avoid or evade taxation and make capital gains through borrowing at historically low interest rates to purchase houses or other scarce real assets, which rose in value owing to the volume of cash chasing them (Moore 2016).

One major element of the Tory-Liberal austerity was a further rolling back of the welfare state. From September 2009 to July 2016 over one million public sector jobs were cut or transferred to the private sector (outstripping the earlier cuts by the Thatcher or Major governments) (Tooze 2019, 350). This included substantial cuts in police numbers (followed, several years later, by an epidemic of gun and knife fatalities), while the NHS was progressively starved of resources (relative to its sector-specific inflation rate), leaving it ill-equipped to cope with a major flu epidemic, let alone the worst pandemic for a century. There were also deep cuts in welfare benefits. The 2012 Welfare Reform Act replaced unemployment-related and income benefits by Universal Credit. Despite some positive features (such as rationalising the benefits system), it required claimants to wait over a month before receiving their first payment. As many had little or no savings, waiting five or six weeks without money often led to be ing evicted from their homes and/or amassing huge debts to 'payday lenders', charging extortionate interest rates. This plunged substantial numbers of families into the type of deep absolute poverty not seen in Britain since the 1930s, including several cases of death by starvation for vulnerable people refused benefits (Butler 2020).

5. Lessons for the Pandemic

The pandemic is creating a debt burden of similar magnitude to these earlier crises. Britain's budget deficit is likely to approach £350 million by the end of 2020, while the national debt is expected to rise to over 100% of GDP (Warner 2020). However, this time there is particularly widespread support for an expansionary solution, from a broad range of the political spectrum. Influential commentators have pointed out that debt is not as big a problem as the 'Treasury view' suggests. Major trading nations typically borrow in their own currency, from their own people – though the debtors and creditors are not one and the same. Government debt is disproportionately owned by the rich, but less so than was the case in 1920 or 1945, owing to the rise of institutional investors that view government debt as a safe, if low yielding, asset.

Adam Tooze and others have suggested that a wealth tax and/or a move against corporate and personal tax evasion would more fairly realign debt holders and payers, thereby avoiding the recent pattern of lower income groups being the main losers from crises and recessions. Moreover, these policies would avoid deflation and thus stimulate growth, in turn reducing the aggregate burden of the debt. Another round of Quantitative Easing would assist growth and the debt burden, while also further lowering interest rates and internalising the debtor-creditor relationship (the state owes debts to itself). 'Printing money' is potentially inflationary, but given the strong deflationary momentum of a 'depression' (even a threatened one) inflationary pressures are severely muted (Tooze 2020). While Britain's debts from the crisis appear staggering, they are unremarkable compared to the other G7 nations (which have typically introduced larger stimulus/support packages) and Britain has the advantage of 'safe haven' appeal to investors facing turbulent international conditions.

In addition to the obvious moral case for equitably spreading the costs of a catastrophe that has impacted all sections of society, there is also a strong economic case. As table 1 shows, while the deflationary solutions pushed by the Treasury and Bank of England after the First World War and the Credit Crunch may have been beneficial for the City of London and the banking and financial sectors, this came at the cost of very slow aggregate growth. In contrast, the more expansionary and broadly-based policies pursued by the Attlee Labour governments achieved significantly higher growth, without preventing them from pursuing other priorities, such as physical reconstruction and founding the Many eminent contemporary economists, notably J.M. Keynes in the first two crises and – during the Credit Crunch – Paul Krugman, were deeply critical of policy prescriptions that would both generate mass unemployment and reduce growth (Keynes 1931; Tooze 2019, 372). In 2020 there are particularly strong reasons for choosing an expansionary strategy, aimed at boosting growth by creating the necessary conditions for the recovery of businesses hit by the crisis. First, this crisis is different from the three discussed above in that there is no 'fundamental disequilibrium' in the economy from inflationary pressures, speculative euphoria, world overproduction, or physical capital destruction. The problem is mainly one of hugely enlarged government debt, which could be addressed by long-term funding, taking advantage of extraordinarily low interest rates. As long as economic growth out-paces the interest rate on government bonds, the real burden of the debt will fall over time, even if it is never paid-off (Hounsel 2020). The government could also follow Gordon Brown's precedent in insisting that loans to ailing businesses should include an equity stake for the government. In addition to reducing firms' debt problems, this would also effectively compel shareholders to make a contribution to their companies' financial support.

Secondly, there is plenty of scope for raising tax rates for the rich. In 1970 the top 0.1% and top 1% of personal incomes had income shares of 0.73 and 4.83% of all post-tax personal income. How ever, tax cuts during the 1980s and 1990s, together with growing tax avoidance (facilitated by the abolition of capital export controls), boosted their respective incomes shares to 3.5 and 10.3% by 2000, while the twenty first century has seen further pre- and post-tax income share gains for these groups (Atkinson 2007, 104-5). Even a partial reversal of their tax cuts and tax evasion loopholes could greatly increase the income tax take, especially if accompanied by effective measures against tax avoidance/evasion. There is also good reason to think that initiatives to tackle endemic personal tax avoidance/evasion would command stronger international support than in the preCOVID-19 era. Most other major nations face similar imperatives to increase the tax take. British governments have played no small role in covertly supporting the tax avoidance industry, as part of a broader strategy to support the City of London. If the UK showed that it was finally serious about addressing tax avoidance/evasion, it might find strong support among other European nations.

Higher taxes for top incomes are also likely to be more politically acceptable in the wake of the pandemic. Government has taken on responsibilities to maintain the incomes of a substantial proportion of the population, together with interventions in the lives of British citizens on a scale unprecedented in peacetime. This has produced a 'levelling tendency' reminiscent of the Second World War. For example, the iron curtain that had separated the NHS and the private hospital sector was suddenly torn down in March 2020, effectively requisitioning (by agreement) all private hospital capacity (Neville, Plimmer 2020). A more tacit, but possibly more important, trend has been the re-evaluation of the societal 'worth' of occupations which, despite being skilled, have become relatively less well-paid since the 1980s, especially the nursing and other 'caring' professions. While during Teresa May's administration her Chancellor, Philip Hammond, could brusquely sweep aside calls to remove the austerity-induced cap on public sector pay by stating that public-sector workers were already 'overpaid' (Walker 2017), television coverage of NHS and other carers working long shifts at real risk to their lives (largely owing to shortages of vital equipment) gave the public a more realistic view of their calling. NHS and other care workers have emerged as the heroes of this conflict, as evidenced by an outpouring of popular support, ranging from the Thursday night clapping ritual to street art.

While both May and, especially, Hammond, were arch fiscal conservatives, Boris Johnson's interventionism during the COVID-19 emergency and his longer-term record as London mayor paints a more complex picture of a politician who is at least prepared to consider other options if the political climate is conducive. With the possible exception of Winston Churchill's war-time government, Conservativeled administrations have typically preferred the "Night Watchman state" model, of intervention only to reset the market mechanism, rather than the Bismarckian "developmental state" (Bresser-Pereira 2016). However, it is at least plausible that this might be up for reevaluation, especially if the public and academics show their support for an expansionary route out of this crisis rather than another sacrifice of British economic growth and living standards to meet the narrow interests of the City and the banks.

However, while the Bank of England appears to be broadly supportive of an expansionary policy, the Treasury has reverted to type. Coronavirus debts threaten to become "the battering ram for a new campaign of austerity" (Tooze 2020). A leaked 5th March 2020 Treasury assessment proposed a package of tax increases and spending cuts (including a two-year public sector pay freeze) – equivalent to a 5% increase in the basic rate of income tax – to "enhance credibility and boost investor confidence", despite there being no signs of investors losing confidence in Britain. Even the normally conservative Daily Telegraph was appalled, publishing an article beginning, "There is a special place in Purgatory for Her Majesty's Treasury… Its COVID-19 blueprint for fiscal retrenchment borders on macroeconomic insanity [...] The thinking is a throwback to the inflexible 'Treasury View'", that so exasperated John Maynard Keynes (Evans-Pritchard 2020).

One of the most important lessons from all four crises is that the Treasury is past its sell-by date; indeed it was already past it in 1920. A particularly valuable administrative innovation would be to replace the Treasury with an economics ministry, with a remit giving equal weigh to economic growth and the Treasury's traditional finance functions. However, any real change would require a wholesale cull of senior staff, replacing the Treasury mandarins with professional economists. Only then will the British economy finally be able to break free from the Treasury's dead hand.

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