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Alternatives to Austerity

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Preface

Established in 2013, the University of Bath Institute for Policy Research (IPR) brings together many of the University's research strengths, so as to foster inter-disciplinary research of international excellence and impact. It bridges the worlds of research, policy and practice and it addresses some of the major policy challenges we face on a local, national and global scale.

The IPR has hosted a range of distinguished contributions – public lectures, policy briefs, research reports – concerned with the policy responses to the recession that followed the 2008 financial crisis. This report draws on some of these, to offer a coherent and distinctive view of the policy challenges we still face, seven lean years after that crisis unfolded. It is intended to add to the debate among policy actors, researchers and those political parties who see the need for an alternative to austerity: and beyond them, their engagement with the public at large.

The analysis presented here is the responsibility of the editor: the individual authors on whose contributions the report draws do not necessarily endorse its overall argument.

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'Harsh austerity in depressed economies isn't necessary, and does major damage when it is imposed. That was true of Britain five years ago – and it's still true today.

Britain's opposition has been amazingly willing to accept claims that budget deficits are the biggest economic issue facing the nation, and has made hardly any effort to challenge … the nonsensical proposition that fiscal irresponsibility caused the crisis of 2008-2009'.

Paul Krugman, 'The Austerity Delusion', *The Guardian*, 29 April 2015

Executive Summary

1. Austerity makes reduction of the public sector deficit the principal economic goal, pursued mainly through cuts in public expenditure. Shrinkage of the public sector is meant not just to reduce the deficit, but also to stimulate the private sector.

2. There is however an alternative and very different analysis of the modern economy. Government must develop a coherent investment strategy, to re-build the UK's economic capacity, as a 'post-industrial' low-carbon economy. It must mobilise the energies and talents of all sections of society: and we are more likely to pull together if the distribution of rewards is less unequal. It must also decide whether budget surpluses should be used to reduce taxes and national debt or to invest in future economic capacity. The last of these must be given priority.

3. The burden of austerity has fallen disproportionately upon the poor and the young. We need a new social contract which provides security to all; invests in everyone's capabilities and provides decent jobs; and supports vibrant local communities, as places of learning and creativity for all. This would leave the market where it properly belongs, as the servant of the community not its master. If the social changes of the 21st Century are to be managed successfully and with public consent, it will need this new social contract to underpin them.

4. High public and private R&D expenditure tend to go together. The fruits of capitalist progress are not therefore the reward for private enterprise alone. Government has a key role to play, investing in infrastructure, human capital and the science base. Today it is imperative to shift to a low-carbon economy. New regulatory regimes will be needed, to secure the public good. The rhetoric of austerity serves however to undermine popular support for active and benign government and to leave capitalist enterprise unquestioned.

5. The globalisation of the world economy reduces what can be done by individual countries. While international banks and corporations bestride national boundaries, governments are left trying to cope from within national jurisdictions. What therefore is needed is a set of reforms to the international order that will enable national governments – working both individually and in concert – to retrieve some control and leverage over their economic and social destinies. This includes the taxation of footloose multi-national corporations.

6. In the Eurozone, the same economic orthodoxy evokes balanced budgets, low inflation, stable currencies and support for business. This ignores Keynes' analysis of the relationship between public investment, economic growth and the public deficit. It also ignores the interconnections of the European crisis, with Germany enjoying a 'virtuous circle' of exports, investment and productivity growth, alongside the weakening of the economies of the European periphery. This is likely to be politically destabilising.

7. In 2008, much of Europe's financial system lay in ruins, its economy and employment under grave threat. Public funds were used to prop up the financial system: spending on public services was cut. Recent decades have also however seen vigorous calls for public and private investment in Europe's knowledge economy, in the social cohesion of its diverse peoples and the solidarity of its regions, whatever their different stages of social and economic development. Without these, Europe is likely to face stagnation for the rest of this decade.

8. The austerity debate connects to a much wider range of policy debates. The choices we make will shape our societies through much of this century: their cohesion, their prosperity, their democratic institutions, their environmental sustainability and their global influence.

Chapter 1: How a Modern Economy Works

1. Austerity is a policy that makes reduction of the public sector deficit the principal economic and social goal, pursuing this primarily through cuts in public expenditure. For some on the right, this shrinkage of the public sector is not just a means of reducing the deficit. They believe that it will also stimulate the private sector - and it is in any case something that they prefer as a matter of basic political philosophy.

   In current circumstances, parties of the centre-left are generally supportive of such policies of austerity. They prefer them to be implemented somewhat more gently: but they do not seem to have a clear economic strategy that differs substantially from that of the right.

2. From Adam Smith to the present day, the central policy question in economics has been: *'What do markets do?'* In the debate over "austerity" the role of markets is fundamental, yet seldom clearly stated. But common to all the advocates of austerity is the belief that competitive forces will cause prices to tend to their market-clearing levels. So whatever the government does, including impose austerity, the economy will always gravitate back to full employment growth.

   Hence the fundamental issue is: will austerity, the removal of demand from the economy by increasing taxes and cutting government expenditure, be followed by automatic rejuvenation, or will it result in prolonged stagnation, low investment and low productivity growth?

> *'Austerity is not a body of well-worked out ideas and doctrine, an integral part of economic or any other theory. Rather, it is derivative of a wider set of beliefs about the appropriate role of the state in the economy that lie scattered around classical and contemporary economic theory.'* **Mark Blyth** (2013), *Austerity: The History of a Dangerous Idea.*

3. Milton Friedman was quite clear: *'The long-run equilibrium … is not a state that is assumed ever to be attained in practice. It is a logical construct that defines the norm or trend from which the actual world is always deviating but to which it is tending to return or about which it tends to fluctuate.'* (Friedman, 1970)

John Maynard Keynes (1934) had anticipated this argument. He argued that economists tend to

'fall into two main groups. …. On the one side are those who believe that the existing economic system is, in the long run, a self-adjusting system, though with creaks and groans and jerks, and interrupted by time lags, outside interference and mistakes. …. On the other side are those who reject the idea that the existing economic system is, in any significant sense, self-adjusting.

The strength of the self-adjusting school depends on its having behind it almost the whole body of organised economic thinking and doctrine of the last hundred years…. It lies behind the education and the habitual modes of thought, not only of economists, but of bankers and business men and civil servants and politicians of all parties.

If the heretics are to demolish the forces of … orthodoxy … they must attack them in their citadel…. I range myself with the heretics.'

4. In the 1930s, Keynes developed a quite different analysis of how a modern economy works (Keynes, 1936). That was a time of depression and stagnation, when austerity policies were manifestly failing. Keynes offered an analysis which changed the way economists and policy makers thought about the economy.

This account of Keynesian economics is succinctly argued in Eatwell and Milgate, (2011) *The Fall and Rise of Keynesian Economics.*

John Eatwell is President of Queens' College, Cambridge and is Chair of the IPR Advisory Board.

It involved a strong role for government expenditure. This is because in a depression, when business expectations are low and there is much uncertainty, only government can re-build confidence that the economy will soon be more buoyant and that businesses can therefore get good returns on their investments. As economic growth returns, tax receipts rise and the public deficit shrinks, over the medium term if not immediately.

Chris Martin is Professor of Macro-Economics at the University of Bath. His Policy Brief for the IPR concludes that *'QE has produced a limited but probably temporary gain for the financial sector, but that there is little evidence that it has given a significant boost to output or employment'.*

Chris Martin, *A very large gamble: evidence on Quantitative Easing in the US and UK* (IPR, 2013)

Without this government investment, monetary measures – including what we now refer to as 'quantitative easing' – can do little to drag the economy out of stagnation. Such measures lower the interest rate and, it is argued, make it easier for businesses to borrow money and invest. Keynes however showed that if those businesses lack confidence in the future level of economic activity, then no matter how cheaply money can be borrowed, they will not invest in new programmes of activity.

Viewed from this standpoint, the decision over recent years to make reduction of the deficit the top short-term priority has been unnecessary and unhelpful. Unhelpful because if government expenditure is continually cut back, the economy is likely to stagnate: business investment will remain low, the growth in the underlying capacity of the country will be slow, and tax receipts will be flat or falling. It is like the medieval practice of blood-letting, overlooking that this only weakens the patient and reduces the likelihood – or at least the speed – of recovery.

5. For an economy mired in recession, Keynes welcomed any expansion of public expenditure, as boosting the general level of economic activity. This included for example expenditures to support the unemployed and their families. When modern social security systems – the welfare state – were established in the 1940s, they were intended not only to help those thrown out of work in times of economic downturn, but also as counter-cyclical measures, that would expand public expenditure at just the time when private expenditures were falling. In other words, they were meant to have a stabilising effect, rising when the economy entered a downturn, and falling when it began to grow.

More generally however, Keynes and his successors placed particular emphasis on the role of public investment in building the long-term capacity of the economy. This might be through investment in infrastructure or human capital or the science base. It would involve long-term projects which were of a scale or duration which no private investor could contemplate. It might involve projects whose benefits were collectively enjoyed but which did not offer realistic returns to any individual private investor. What all these public investments recognised was, first, that capitalist economies develop by expanding and transforming their human and technological capacities; and, second, that this is unlikely to take place at the optimal rate if this investment is left to the private sector. Capitalist economies need to be steered and coordinated. From this point of view, austerity as a way of addressing our economic woes is fundamentally misplaced.

6. From the 1940s until the 1970s, Keynesian ideas – if not always under that label - provided the broad framework for thinking about the economy across much of the western world, albeit varying in its application. This was the central theme of Andrew Shonfield's classic study of *Modern Capitalism* (1965). By the 1980s however much of the economic orthodoxy of the 1930s was re-established, albeit in the new language of free market economics and monetarism. By the time that a new recession hit, in the years after 2008, the Kewynesian debates had in large measure been forgotten, along with their fundamental re-thinking of how a modern economy really works (Eatwell and Milgate, 2011: Ch 1).

Chapter 2: Policies for a Modern Economy

7. During the economic difficulties of recent years, there have been numerous discussions of how to re-work Keynesian and other critiques of the current orthodoxy. What is still lacking however is a simple and clear set of strategies around which an alternative to austerity might cohere.

   Such an alternative might be an economic strategy with two main elements.

8. First, the government needs a well-framed investment strategy, to re-build the UK's economic capacity and ensure we are well-placed to perform well as a 'post-industrial' and low carbon economy, not overly reliant on the City of London and on low-wage, low-skilled jobs. This investment strategy should include education and training – human capital – and investment in new ideas and industries – notably through our science and technology universities.

   It is only such a strategy of investment that can deliver the improved economic performance that is required, if we are to reduce the public sector deficit on a sustainable basis.

Phil Tomlinson is Senior Lecturer in Business Economics at the University of Bath. His IPR Policy Brief and seminar in October 2013 were concerned with industrial policy in the UK: see also his co-authored book *New Perspectives on Industrial Policy for a Modern Britain* (2015)

Chapter 4 deals with this in more detail.

9. Secondly, government needs to mobilise the energies and talents of all sections of society, if we are to meet the economic challenges that face us. We are however more likely to pull together if the distribution of rewards is less unequal.

   This is different from the argument sometimes advanced that raising public sector wages is itself a form of Keynesian investment that will get growth going again. We may decide that such wage rises are necessary; that cuts to public services erode the quality of life; and that the fall in living standards for the mass of the population is unacceptable. We may also decide that super-rewards for the 1% are likewise intolerable.

   This needs however to be recognised as in large measure a matter of redistribution, whose justification is primarily moral, along with the belief that 'we are all in this together'.

   Chapter 3 deals with this in more detail.

10. Such redistribution and the protection of public services involve expenditure on current account, to be paid from current tax revenues. This should be kept in balance over the course of the economic cycle: or even run a surplus, to enable reduction of the overall level of national debt, and the interest payments that this incurs.

    Quite separate is the investment expenditure discussed previously. This will be paid for by the long-term improvement in economic performance which it is intended to make possible and the improved tax receipts that this will generate. Such an explicit rationale – focussed on building the UK's economic capacity - should commend itself to the international financial markets and the sovereign wealth funds of other countries, whose readiness to purchase UK government bonds is critical to our continuing financial stability.

    Government will need to strike a balance in deciding how far to use budget surpluses to reduce taxes, to reduce national debt or to invest in future economic capacity. The tendency is recent years has been to prioritise the first and second of these: this has been misguided.

11. Any economic policy requires attention to the money-raising side of the public finances, as well as the expenditure side. The economic strategy outlined above may well mean that we need to increase tax receipts: whether by raising tax rates, reducing tax allowances, tackling tax avoidance and evasion, or expanding the tax base.

    One aspect of the tax base is the taxation of multi-national corporations (MNCs). **Chapter 5** deals with this in more detail.

Chapter 3: Austerity and the Common Good

12. The burden of austerity has fallen disproportionately upon the poorer sections of society and upon the young.

Following 2008, Britain experienced an unprecedented and protracted fall in real wages. This has been driven by stagnation in levels of productivity, and top earners taking a larger portion of the wage cake. Real wages of ordinary workers continued to fall throughout 2013 and the first half of 2014.

Paul Gregg is Professor of Social Policy at the University of Bath. These paragraphs draw on several of his Policy Briefs for the IPR:

What are the prospects of a Wage Recovery in the UK? (2014)

Youth employment – still waiting for the upturn (2013)

The 2013 Comprehensive Spending Review and the implications for making work pay and family poverty (2013)

Recessions always hit young people hard. They rely disproportionately on new hiring, as they move from education into the world of work. However, until 2013 the jobs recovery benefitted them little. The UK, along with Italy and Sweden, has been one of the worst in this respect, with the unemployment rate for young people remaining nearly four times greater than for the adult population.

Emma Carmel and **Thanos Maroukis** are members of the IPR. This paragraph draws on their IPR Policy Brief *Temporary agency work in the UK today* (2015).

In the last quarter of 2014, the UK unemployment rate reached its lowest level for more than six years (5.8%). However, this was accompanied by a rise in temporary, insecure and precarious work for both British and migrant workers: trends in the labour market that pre-date the recession. In 2014 the number of temporary agency workers (TAW) was around 1.1 million. Agency work is promoted as offering flexibility and freedom for workers. In reality, such workers face uncertain working hours, inadequate income and poor working conditions. Many work in health care, where employers try to cope with cuts in budgets by cutting the permanent workforce and using zero-hour contract workers.

Meanwhile, in order to cut the public deficit, the UK government has increasingly turned to cuts in working age welfare. It has operated a 'salami slicing' approach: cutting or capping out-of-work benefit entitlements, in-work tax credits and Child Benefit. This has been combined with reducing the entitlement of some groups to benefits, through tougher testing or by changing the rules of entitlement. For example, access to some disability benefits has bene limited to a year, where the person has some other income sources; and Child Benefit has been removed for better off families. At the same time, those claiming out-of-work benefits face the threat of more severe sanctions, if they fail to comply with stringent job search requirements.

13. This unequal distribution of the burden of austerity can be viewed from a variety of standpoints. Some argue that inequality is the inevitable if unfortunate price that we pay for economic recovery and progress: but this recovery will eventually 'trickle down' and benefit even the poor. This has however been subject to a rising wave of criticism, in face of the evidence brought together by a wide range of social scientists (Piketty, 2014).

Against this, it can be argued that whether these 'trickle down' effects are real or imagined, it is an affront to our sense of social justice that the poorest are not better protected in hard times. This should be of the highest political concern, whether their suffering is manifested in disorder directed against society at large, or in higher rates of ill-health, malnutrition and family breakdown (OECD, 2015). If the poorest are left to live in

such conditions, this will militate against the development and utilisation of their capacities, so that they cannot contribute fully to societal functioning. We can ill afford to waste their potential talents.

14. The recent direction of UK social policies has been to push as many as possible into the market place and to reduce public generosity towards those of working age who remain. In contrast, the post-war social contract, between State and citizen in advanced western democracies, involved the pooling of risks and uncertainties through systems of social security (Titmuss, 1968: Ch 15). The same period saw governments confronting the economic instability of capitalist society, as a necessary part of that same social contract. It was accepted that Government should invest not only in the security of citizens, but also in their creativity, and in their social, economic and political communities.

15. Consider therefore a new social contract with several interrelated elements, going well beyond traditional welfare systems:
    - Individual security against risks of income interruption. This was the heartland of traditional welfare states, although in recent decades it has been in retreat, in face of neo-liberal hostility to State welfare;
    - Investment in everyone's capabilities, not just those with parental wealth. This is what many have referred to as the 'social investment state' (Esping-Andersen, 1996: Ch 9). There is good evidence that for a given financial outlay, it is investment in the lowest-skilled that can produce the greatest benefit for national productivity (Coulombe et al., 2004);
    - The rebalancing of our economies to provide 'decent jobs' which make use of everyone's capabilities (http://www.ilo.org/global/about-the-ilo/decent-work-agenda/lang--en/index.htm);
    - Investment in vibrant local communities, as places of education, learning and creativity for all: in particular for disadvantaged communities, which are often poorly connected to society at large.

16. This would involve a broad range of policies of relevance to us all, rather than focussing just on the least fortunate. It would limit the risks of poverty but also promote economic growth; promote individual security but also collective resilience and adaptability. It would rebuild local and national communities, as points where these different policies can be connected. It would leave the market where it properly belongs, as the servant of the community not its master.

    Through the 21st Century, our societies are likely to face major upheavals as a result of technological change, environmental pressures and global shifts in power. If these changes are to be managed successfully, they need this new social contract to underpin them. This is important in securing public consent to change – by providing everyone with a sense of security for the future, and a sense that 'we are all in this together'.

Graham Room is Professor of European Social Policy at the University of Bath. He was Founding Director of the IPR. These paragraphs draw on a public lecture he gave at Victoria University in Wellington, New Zealand, in February 2014.

Chapter 4: Rejuvenating the Economy

17. Capitalist economies develop by expanding and transforming their human and technological capacities. The 'entrepreneurial state' has a key role to play in this. This includes investment in infrastructure, human capital and the science base, especially through long-term projects of a scale and duration which the private sector cannot contemplate. Government also plays a key role in creating and shaping new markets: including in recent times the development of e-commerce, and now the development of new markets for green technologies and energy sources. This goes far beyond the argument that government should intervene only in cases of 'market failure'.

Mariana Mazzucato is Professor in the Economics of Innovation at SPRU, University of Sussex. These paragraphs draw in part on a public lecture she gave at the IPR in April 2015. They are further elaborated in her book *The Entrepreneurial State* (2014) and her report for Innovate UK, *A Mission-Oriented Approach to Building the Entrepreneurial State* (2014).

High private R&D (research and development) expenditure therefore tends to go hand in hand with high public R&D. Even in the United States, the ideological home of free market capitalism, Government has played this central role in developing the new technologies and markets of the modern era: for example in IT, biotechnology, nanotechnology and fracking.

18. This gives the lie to the argument that in order to jump-start economic growth out of recession, the public sector must first shrink. This, as we have seen, is part of the ideological underpinning for current austerity policies. It also gives the lie to the argument that the public sector is a burden on economic growth, while the private sector is the engine of creativity.

    The fruits of innovation should not therefore be viewed as a reward for private enterprise alone. This then opens the question, what dividend should be captured for the public good: including reforming the tax system, and putting more pressure for companies to reinvest profits back into the real economy. Governments hesitate however even to raise these issues, lest they are punished by the international financial ratings agencies for being business-unfriendly, and they frighten off the footloose MNCs whom they compete to attract.

19. Private enterprise benefits from public sector investment. What also matters is the investment by individuals in their own creative capacities: and our investment in vibrant local communities, as places of education, learning and creativity for all. It is in part to build such communities that a public dividend must be captured from business innovation and enterprise.

20. Public investment helps to drive the economy in new directions: building new markets and expanding human and technological capacities in specific ways. Today the pressing need is to shift to low-carbon production and consumption and to a more environmentally sustainable future. Markets alone do not provide socially optimal directions.

    This will require major shifts away from long-standing government support for fossil fuel industries and for a wide range of other economic interests entrenched in the present carbon-based social order. An 'entrepreneurial green state' approach means investing in renewable energy and ensuring that the rewards are socialised, not just the risks. For the moment however, the rhetoric of austerity serves to undermine popular support for active and benign government and to leave capitalist enterprise unquestioned.

Chapter 5: From the National to the International Economy

21. The Keynesian perspective – as presented earlier - was focussed on the national economy. Nevertheless, Keynes did not ignore the international. After WW1 much of his attention was focussed on the economic consequences of the Versailles treaty - and the effects of the reparations that it imposed on Germany for the European economy as a whole. During and after WW2, he concerned himself with the architecture for a new international financial system.

Paragraphs 21-23 draw in part on **John Eatwell's** IPR Public Lecture in February 2015: *Why is policy making so difficult today?*

See also Eatwell and Milgate (2011), *The Fall and Rise of Keynesian Economics,* Chapter 7.

22. The international financial system of Bretton Woods, of which Keynes was a major architect, involved fixed exchange rates and controls on the international flows of capital. This provided a stable order within which western governments were able to manage and steer their respective national economies. The world of today is very different, with floating exchange rates, the globalisation of financial markets and domination of the world economy by huge MNCs.

23. In these changed circumstances, it is reasonable to wonder what individual countries can do to address these challenges. National governments have in any case been weakened or 'hollowed out', as major areas of public activity handed over to the private sector. In addition, the transnational integration of markets (within Europe and globally) means that while international banks and corporations bestride national boundaries, governments are left trying to cope from within irrelevant national jurisdictions.

24. What therefore is needed is a set of reforms to the international order that will enable national governments – working both individually and in concert – to retrieve some control and leverage over their economic and social destinies. Reference has already been made to the erosion of the tax base: in relation in particular to the taxation of MNCs. At the moment, the problem is three-fold:

    a) Nations compete with each other to offer 'low cost regimes' to attract MNCs and the employment they offer: but MNCs then threaten to re-locate elsewhere, unless their current host provides additional incentives, including on taxation.

    b) MNCs and their accountants re-work their internal transnational transactions so as to minimise their overall tax bill.

    c) MNCs, their executives, their major individual shareholders and their accountants use secret tax havens, to minimise their tax liabilities.

    The Organisation for Economic Cooperation and Development (OECD) is concentrating upon (b) and (c) – all related to its lead role in addressing transparency, corruption and evasion. However (a) is potentially at least as important. It would require some degree of standardisation of company tax regimes internationally: this will be slow and difficult to achieve: but it is already on the agenda of the EU. Its justification is that the competition between nations to attract MNCs is a zero-sum game: more precisely, it is the MNCs who win, and the public finances of all the countries concerned who suffer.

Chapter 6: The European Crisis

25. It is not only in the UK that policies of austerity have dominated public policy. The same economic orthodoxy has driven the policy response to the global recession: nowhere more than in Europe. This orthodoxy tells governments to return to the mantras of the 1920s: balanced budgets, low inflation, stable currencies and support for business. If the mass of the population has to suffer, they can rest assured that prosperity will eventually return and trickle down to them.

26. This orthodoxy has two particular elements:
    - The European Central Bank (ECB) insists that a robust and strong Euro requires fiscal conservatism by all member state governments in the conduct of their public finances. This conservatism is embodied in the Maastricht criteria, setting limits on the size of public sector deficits (albeit in the early years of the recession both Germany and France went outside those criteria).
    - The central banks insist that come what may, loans and debts must be repaid (even if public assets have to be sold off cheap for this purpose), lest the stability of the banks be put in question. The national governments support them in this, because they do not want to see another banking crisis.

    According to this orthodoxy, if both of these elements are respected, each member state will grow and prosper. This is supposed to explain Germany's economic success. As Chancellor Merkel put it in 2013: "What we have done, everyone else can do."

27. This overlooks several interconnected elements of the European crisis:
    - Keynes' analysis of the relationship between public investment, economic growth and the public deficit, as summarised above, is widely ignored.
    - Over the post-war period, German industry has enjoyed a 'virtuous circle' of exports, investment and productivity growth: a process of 'cumulative causation' which has however weakened the economies of the European periphery. There is insufficient recognition that the Euro has been lower on the international exchanges than it would have been, based on the German economy alone; and that German exporters have benefitted from this.

Phillip Toner (University of Sydney) is the author of *Main Currents in Cumulative Causation* (1999), an examination of economic theories of these dynamic processes, by such writers as Hirschman, Myrdal and Kaldor. In his seminar for the IPR in June 2015, he underlined the central role of such processes in the present difficulties of the European economy.

- Austerity and unemployment in southern Europe have prompted migration of skilled workers to the job markets of the north, with a transfer of human capital paid for by the home countries. This loss has undermined their own capacity for future economic recovery.
- Market integration in Europe has outrun the capacity of governments, individually or together, to steer their economies and ensure balanced economic development and social cohesion.
- Across Europe, the costs and burden of austerity are off-loaded disproportionately onto the poor. The mass of the population (the '99%') is dispirited and disillusioned with the political class, and inclined to support populist movements such as UKIP, as well as more extreme groups. This could be politically destabilising.
- These elements have come together for Greece – and for Southern Europe more generally – in a 'perfect storm'.

'In 2010–2012, Germany saw a rapid increase in the number of migrants from Southern Europe (especially Italy and Greece), many of whom were young, highly skilled and trained workers, such as doctors, engineers or IT specialists. Thus the cuts in public spending on education and health services – especially in Spain, Greece and Portugal – have been very beneficial to core EU member states [which] were not only able to meet their various skills shortages but also benefited from a highly educated workforce trained at the expense of Southern European taxpayers'.

Theo Papadopoulos (2015) is a member of the IPR and one of the leading writers on the Greek crisis

Theo Papadopoulos (2013; 2015) analyses the consequences of austerity for the European Social Model (ESM) – in terms which echo Keynes' denunciation of the economic and social madness of Versailles and the breakdown it threatened in the European system:

'These reforms aimed to weaken national welfare and labour institutions and redefine the boundaries and normative aspirations of the ESM. The relentless pressure to adopt austerity measures severely undermines member states' capacity to protect their populations.

The strategy of the troika places Greece in a downward spiral of a prolonged recession from which no end is in sight'.

28. Twice in the last century a harsh corset has been placed on the European economy, in the belief that this is the path to economic recovery. In 1919 the Treaty of Versailles imposed heavy reparations on Germany and restrictions on how it might re-build its industrial base. Keynes famously condemned the Treaty in *The Economic Consequences of the Peace* (1919). This was in part on grounds of justice - and the need to build a peace in which the new and democratic Germany would feel included. It was also because a Germany without a thriving economy would hardly be in a position to pay the reparations that were being exacted. It was however primarily in relation to the rebuilding of the European economy as a whole that Keynes advanced his case. Europe involved highly interdependent national economies: within this, the German economy was central: restoring prosperity to Europe would be impossible if Germany remained devastated.

    The Treaty established a Reparations Commission to enforce its financial requirements. For this purpose, it was given 'wide powers over the internal economic life of the enemy countries, who are to be treated henceforward as bankrupt estates to be administered by and for the benefit of the creditors'. As such it was likely, Keynes argued, to become 'an instrument of oppression and rapine'. Amidst the gloom, he applauded however the American Relief Commission of 1919, which 'not only saved an immense amount of human suffering, but averted a widespread breakdown of the European system'. It was on such generosity that he pinned his hopes for re-building European prosperity.

29. In 1919, much of Europe's infrastructure and industry lay in ruins. Ninety years later, its financial system lay in ruins, and its economy and employment under grave threat. Enormous injections of public funds were used to prop up the financial system and, in an effort to balance government finances, public spending was cut, notably on public services and welfare expenditures. As in 1919, new mechanisms of financial administration at a European level were set in place: new rules of fiscal prudence, to be enforced across the Eurozone.

    This is hardly conducive to proactive public investment programmes of the sort that Keynes envisaged. Without these however, the EU is likely to face general deflation and zero or low growth for the rest of this decade. Fiscal reform and tightening will still be required in many countries. This will however be much easier if economic growth can be re-started: Keynes tells us that if we take care of growth, the public deficit will take care of itself. Fiscal reform can in any case mean many things. It may mean cutting back on public services and support for the poor. But it can also mean cutting back on tax subsidies for the rich and closing tax havens. Politics will be back.

30. How then to rejuvenate the European economy? Europe may have been dominated by talk of fiscal rectitude and economic prudence. Recent decades have also however seen vigorous calls for public and private investment in Europe's knowledge economy, in the social cohesion of its diverse peoples and the solidarity of its regions, whatever their different stages of social and economic development (Room, 2005).

These ambitions are consistent with the discussion of the 'entrepreneurial state' in Chapter 4 above. Nevertheless, any industrial strategy – whether at national or European level – depends on capturing dynamic synergies between human and technological capacities on the one hand, new markets on the other. Only in this way can countries strengthen their position within the international division of labour and avoid long-term dependence.

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Official EC documents and calls for an integrated industrial strategy recognize the need for productive capacity and capability building to address de-industrialisation, a balanced sustainable economy and appropriate public-private partnerships - yet such calls remain largely dormant, dominated by the macro-focus on deficit cutting. The path to European economic rejuvenation will remain fragile and precarious, as long as the wider structural and policy challenges discussed in the preceding paragraphs are not properly addressed.

Chapter 8: Conclusion

31. The starting point for this report was austerity: and the policies that make reduction of the public sector deficit the principal economic and social goal, to be pursued primarily through cuts in public expenditure. We have however seen that the austerity debate connects to a much wider range of policy choices. It connects, first, to the way we see economic growth and the respective roles of public and private sectors.
It connects, second, to the pathways we see to a green economy and to addressing seriously the environmental disaster that is already underway.
It links thirdly to how we view the dynamic interconnectedness of nations and communities and the social and economic options available to their citizens.

    For the United Kingdom, in the aftermath of the 2015 General Election, the renewed debate on austerity and economic policy will take place alongside the preparations for the December 2015 Paris conference on a global climate change agreement - and during the run-up to a referendum on EU membership in 2016-17. These debates are interconnected: and they will express how we think about the fundamental relationships between governments, markets and citizens.

    For Germany, the dominant economic power in Europe, it is no less important that these interconnections are fully recognised; and that Germany takes a major responsibility for building a sustainable Europe for all of its communities. How Germany does this will in large measure shape Europe through much of this century: its cohesion, its prosperity, its democratic institutions, its environmental sustainability and its global influence.

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