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The Liberal Democrats are the only party of genuine economic reform - Cable

In a speech to Demos, **Liberal Democrat Shadow Chancellor Vince Cable** will today (Monday) set out the key pillars of the Liberal Democrat economic manifesto.

Vince Cable will say:

Check against delivery

I want today to set out how the Liberal Democrats plan to deal with the aftermath of the credit crunch and recession and the pillars of the manifesto that we will be putting to the British people in the future.

The British economy had a massive heart attack when the arteries of the banking system seized up. The good news is that the patient is still alive, albeit in intensive care, thanks to prompt if unorthodox action by the clinicians: interest rates cut to virtually zero; monetary expansion through QE; extraordinary levels of government deficit funding; partial nationalisation of the banking system; and a big devaluation.

Now we face tricky but important questions around recovery: how quickly to phase out the monetary steroids; how quickly to rectify the budget deficit. Delaying action on the budget risks a secondary infection: a sovereign risk crisis leading to higher borrowing costs. But treatment that is too abrupt – sending off the sickly patient to do 200 press ups in the gym – risks a fresh heart attack: a relapse into recession. Treatment has to reflect the patient's condition. I have set out five objective economic tests to determine when and how quickly the big budget correction should be attempted: the rate of growth; the level of unemployment; credit conditions; the extent of spare capacity (and therefore, inflation risk); and – crucially – the borrowing conditions in international markets.

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But before I develop our views on economic recovery and rehabilitation I want to reflect briefly on the past – what caused the attack – since if we do not

address the underlying problems, they will recur. In part, of course, the issues are global in character. But the fact that Britain has been first in and virtually last out of the recession tells us a lot: we have an economy over dependent on financial services, especially banks, as well as the boom and bust cycle of the housing market. I don't claim to have anticipated all aspects of this crisis but my colleagues and I were right on some essentials: campaigning against the disastrous demutualisation of building societies, a product of the Tory era of bank deregulation; taking up, from 2000, the warnings from the Cruickshank Report that banks should not be allowed simply to maximise profit when dependent on taxpayer guarantees; and warning, well over five years ago, about the dangerous build up in the property bubble and the massive mortgage borrowing which sustained it.

I repeat these things not to say 'I told you so' but to underline the point that the UK has deep structural problems. The Tories are fond of repeating their version of FDR's parable with their claims that Gordon Brown 'didn't fix the roof when the sun was shining'. But this misses the point. The central problem was not the – then – budgetary hole in the roof but deep cracks in the foundations. Plugging the hole in the roof but ignoring the cracked foundations will not work. We cannot return to 'business as usual' – though the dominant mood in the city and in the government and Conservative opposition is to do just that.

Let me summarise what these cracks in the foundations are.

We have an economy too dependent on consumer spending and borrowing rather than saving and investment. Too much financial engineering in banking rather than real engineering; Too London-centric; Too dependent on the City of London rather than the talents of the rest of Britain. Too preoccupied with the artificial, paper, wealth of inflated property prices rather than productive work and invention. Too absorbed by growth for its own sake rather than protecting the environment and maintaining a sense of fairness and community. But we don't have to despair. The challenges are enormous but if we are prepared to face up to them we can use the current crisis as an opportunity to refashion our economy. That means making the sort of radical changes that we propose: a credible plan for dealing with the deficit, sorting out and breaking up the banks, building a sustained recovery and creating a fairer tax system.

The Liberal Democrats are the only major party committed to genuine and far reaching economic reform.

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The immediate issue is that there are two contradictory demands in economic management. One is to maintain a supporting stimulus from monetary and fiscal policy – going back to my original image, keeping the infusion of monetary steroids and fiscal resuscitation techniques until the patient is clearly

past the danger point. The other is to prevent a budgetary crisis which will arise if international bond markets lose confidence in the government's capacity to sustain its borrowing and debt obligations, resulting in a downgrading of sovereign risk rating and/or a sharp increase in borrowing costs, currently at a historic low.

There is no simple, coin in the slot, formula which tells us how to balance these concerns. That is why I have suggested a series of tests and why the Conservatives are wrong to be so dogmatic. But what is absolutely clear is that the incoming Chancellor, probably on May 7th, must have a clear plan to eliminate the structural deficit. The government keeps changing its definition of what and how big the structural deficit is but the common sense point is that public spending was built up on impermanent sources of tax – windfalls from the boom in the City and in the housing market – and now needs to be scaled back to levels which the UK taxpayer can pay for. The current government estimate of 5.5% of GDP is a guess; it could be worse. The government plan to reduce this deficit by half over four years may also prove to be too laid back for the markets. It is however a starting point. It is also a major challenge and tough by the standards of previous fiscal tightening.

In recent weeks, the markets have been jittery about the outcome of the General Election and the uncertain aspect of its outcome on Government spending. They are right to worry: the consequences of failure to bring the deficit under control are serious. This cannot be allowed to happen – what we need is a credible plan to deal with the deficit.

Let me be clear that bringing stability back to the public finances is an unambiguous commitment. For the Liberal Democrats it is the first pillar of our economic policy.

Deficit reduction has to come from spending cuts primarily though there is a role for taxation. We have suggested a supplementary profits tax on the banks which also serves the important task of requiring the banks to pay a premium for the insurance – the guarantee – which the state provides against counter party risk.

We do not approach difficult spending decisions with relish. We realise that we are dealing with staff who, for the most part, have a real sense of public service and with services which are valued. We are willing to be tough on inefficiency but we recognise that “inefficiency” and “waste” are often a politicians' cop out from making serious choices. Business people often say it is easy to take 10% out of costs. The problem is identifying the right 10%. The right 10% is usually the duplication of middle and upper management. But these are the functions which report to ministers and a ‘yes minister’ culture will protect them. The operating model has to change.

Our councillors have real world experience of trying to do that, slashing costs while maintaining the quality of service provision in the big cities. We run 7 out of 10 of the biggest cities in England and Wales outside London (and excluding Birmingham and Leeds which we run in partnership with Conservatives). They provide good examples of how to run the public sector. It is possible to run the public sector more efficiently though no one should pretend that this is easy.

Nor is it honest to say that some government budgets, like the NHS, should be 'ring fenced' from cuts. By doing so, the government and the Tories are condemning other valued services to deeply damaging cuts. By cutting in a haphazard and panicky way, in some departments but not others, this government has already made a start on arbitrary cuts which are hitting important scientific research as well as capital spending on affordable housing and further education. Nothing good comes out of a panic.

What is needed is a calm and rational plan, a proactive rather than reactive approach, identifying the priority steps which need to be taken to reduce government spending. The Liberal Democrats have for a start put on hold many of our previous spending commitments – to free personal care, to a generous citizens pension, to universal child care – which are undoubtedly popular ideas but are not, now, affordable. And as against the government's own benchmark:

- A tougher public sector incomes policy, limiting any pay increase to a maximum £8 a week, and requiring discipline over two years, initially. And scrapping bonuses.
- The first steps in fundamental reform of public sector pensions, which could have an early impact through contributions rates; though this is a complex area requiring an independent review along the lines of the Turner Commission.
- Some cuts in welfare spending: tax credits for higher earners and scrapping future Child Trust Fund contributions.
- Axing much of the superstructure of the centralised British state from the command and control system overseeing local government and NHS administration.
- Cutting much of the RDA budget.
- Serious and substantial reductions in defence procurement: in the long term for Trident and for shorter term choices, axing

Eurofighter and instigating a rapid defence review – within strict financial constraints – to determine priorities.

- Scrapping expensive Home Office projects like ID cards and the intercept modernisation programme.
- Rejecting arbitrary targets for universities and over expansion with an emphasis on alternatives in vocational training in FE colleges that are more helpful in achieving employability, as well as cheaper.

Some of these savings we would want to switch to areas of spending of higher priority notably early years schooling through our “pupil premium” and to job creating capital projects. But, even taking that into account, we have so far identified an additional £10bn in net savings beyond what the government has put forward which is, altogether, about half of what would be needed to meet the government’s deficit reduction objective. I do not hide the fact that much more would need to be done.

There are lessons to be learnt from past, successful, attempts at major fiscal correction. I would single out the experience of the Canadian Liberals under Jean Chrétien and Paul Martin. Canada had become a basket case in the OECD with unsustainable public debt and interest payments. Once elected in 1993 they required ministers to identify deep cuts in their departmental spending – based on zero budgeting – but the leadership then spent around nine months before their first budget taking their proposals to the country. They consulted everywhere at every level to ensure that the public understood what was planned and to seek out better ideas. Liberal Democrats believe we could learn from that approach and adapt it here. We worry, by contrast, that the Tories – if elected with the support of 1 in 4 of the electorate – want to say as little as possible before the election, then agree rapid painful cuts behind closed doors, and ram them down the public’s throats. It won’t work. One reason it won’t work is that public sector employees, and the public, will say: ‘why should we pay for a crisis we didn’t create? Why are we the scapegoats?’ The public has to feel that the process is fair; that pain and rewards are fairly distributed; and that those who caused the crisis are being properly dealt with. That takes me to the banks.

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I have written at length about the reasons for the banking crisis. I don’t need to rehearse all the history. I have acknowledged that, after the bad mistake of ignoring a dangerous credit and housing bubble, the UK – and the US – intervention last October, including part-nationalisation, was necessary and broadly correct. A major disaster was averted. But the government has rested

on its laurels. There are several changes required and these constitute the second pillar in the Liberal Democrat economic programme.

The semi-nationalised banks have been allowed too loose a rein resulting in bonus indiscipline (this of course being taxpayers' money) and a lurch from irresponsible lending to ultra-conservative lending policies, (though the regulator is as much to blame as the banks). Risk aversion has led to numerous healthy, solvent, British companies – mainly small and medium sized – being deprived of working capital except on very onerous terms. The resulting 'credit crunch' could actually become more, not less, serious if the economy recovers.

I want to see UKFI, the government's shareholding body, giving a much firmer steer to those banks to act in the wider national interest. Lord Mandelson, no less, condemned the Kraft takeover of Cadbury and threatened "huge government opposition." But the capital to fund the leveraged buy-out came from publicly owned RBS! This is taking arms length ownership to ridiculous extremes. Eventually these banks will have to be reprivated and run fully independent of government. But Swedish and other experience suggests that it could take a decade to realise maximum value for the taxpayer.

There is a big, structural, issue which until recently was being studiously avoided by both the Government and the Tories. Since the banking crisis broke in November 2008, I have argued that this question cannot be ducked since the British global, banks which are too big to fail are too big to bail out and are a danger to the stability of the economy. Now that President Obama has taken on the issue of breaking up the banks on his side of the Pond, it is time that we do the same in the UK. A modern version of Glass Steagall is required separating retail and investment banking and there is need too for more meaningful competition in business and mortgage lending. Until the banks are broken up, and are able to compete and succeed or fail without UK government guarantees, they should pay an insurance premium – a supplementary tax on bank profits.

Parallel action needs to be taken to strengthen bank supervision and to reform and improve regulation. I set out my proposals in a speech to the Stock Exchange on July 20th. There is now a general acceptance of the need for more macro prudential regulation to negate boom and bust, especially in housing; but nothing much has happened yet. There is consensus too that the bonus culture must be curbed by severely restricting high risk cash bonuses though, again, rhetoric has run ahead of action. And all high level remuneration should be fully transparent as it is at present only for directors of public companies.

There seems to be a nervousness about what are called "City competitiveness" concerns; that banks will run away if regulation – and tax – is subject to unilateral action. That fear is greatly exaggerated since the US, leading EU

countries and even Switzerland are tightening their regulatory grip. President Obama's announcement last week is a step in the right direction. And Britain is in a more exposed position than these other major countries, with a higher level of dependence on banking and associated, systemic, risk. I say again, business as usual is not an option.

Beyond that, there is need for a much more varied ecology in the banking industry: local banks; more mutuals including credit unions; a banking arm for the Post Office network to reach the financially excluded; specialist banks to support, with long term finance, new ventures and for infrastructure: a point I shall discuss below. I see, at present, no evidence that the government (or the Conservatives) have any vision of banking beyond the immediate crisis. Yet we have a once in a generation opportunity, with the public ownership of two major banks and a medium sized bank (Northern Rock), to remould them in a way that meets the wider needs of the economy, before they return to private ownership.

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What has to emerge from this crisis is a sustained recovery not an ephemeral or unstable one; not another bubble; not a boom which depends on the fickle fortunes of the banking sector. There are forces at work which are already helping to provide the first elements of that recovery. Devaluation in particular has given a powerful stimulus to exporting and important competing industries and services. But, at the same time, there are opposing forces widening the imbalances in the economy: the future round of general spending cuts, unless carefully managed, will disproportionately hit weaker regions of the UK which are already badly hit by recession; there is another property bubble forming centred on London; government cuts already planned are concentrated on capital spending and, therefore, the already depressed construction industry.

A sustained recovery will rely on the private sector, especially small and medium sized business, to generate jobs. For this to be possible, government will have to help create a business environment conducive to start ups and small business – centring on moderate taxes, getting rid of red tape, secure intellectual property rights and ensuring that there is a flow of credit on competitive terms. Beyond that most entrepreneurs want to be left alone. But there are several respects in which government has to give a lead to underpin stable, sustainable growth in future and this is the next pillar of our economic policy.

One element is to provide economic stability. Gordon Brown's 'abolition' of 'boom and bust' has become his signature: and a joke. But there are ways of mitigating financial instability. We must maintain the operational independence of the Bank of England. My Liberal Democrat predecessors were the first to argue for the importance of independence and I made my maiden speech in

support of it. Its terms of reference must now include management of asset – that is housing - inflation, as in the case in Sweden. We also need greater independence in the monitoring and assessment of fiscal policy. It does not require a big new quango to be set up as the Tories suggest; a beefed up

National Audit Office would do perfectly well.

A second key role is education (as opposed to training where the private sector is better placed to specify its needs). A key priority for the Lib Dems is to reallocate some of the financial savings made to reinvest in early years education of the most deprived children so that there is a reduction in the apparently endless cycle of educational failure for those at the bottom. Another priority must be science and maths education at all levels. The current dearth of young people with good mathematical literacy – the fact, for example, that few sixth formers outside the private sector do further maths – is alarming for a country that has to be competitive in knowledge based activities, if it is to compete at all.

The third is the financing of capital investment in infrastructure, in the widest sense. Britain has, on most measures, poor infrastructure. There is a need for substantial investment in energy networks and storage, digital networks, public transport systems and new renewable energy. Much of this investment cannot come from government because of mounting public debt; bank lending and PFI have been hit; stock markets are interested more in short term returns. Yet there are vast sums of money in institutional investors – annuity funds in pension and insurance companies – looking for good but safe returns. And unable to find suitable investments in the UK (as opposed to – say – US corporate bonds). We want to create an Infrastructure Bank, with some pump priming, through public money (or assets), but essentially privately financed. The European Investment Bank, or even the World Bank, are plausible models.

Sometimes there is reference to a Green New Deal which links the recovery of the economy an employment to environmental priorities. That could well be a priority of investment by the Infrastructure Bank. Until the Bank can be established we would seek to maintain investment through a programme of public investment in social housing and home improvements centred on rehabilitated, improved empty property.

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It could be that there is a painful period ahead of slow growth or weak recovery with continuing high levels of unemployment and severe restraint or cuts on public spending. The public will accept such privations if they understand the necessity for these measures and if there is a sense of fairness in the sharing of burdens. That is why we suggest as the fourth and final pillar of our strategy, a

revenue neutral package of tax changes centring tax cuts for the low (and average) paid, by lifting the income tax threshold to £10,000. Such tax cuts are a means of sustaining disposable income amongst low paid workers and pensioners but also provide an incentive to work for those facing very high marginal tax rates because of a combination of tax, National Insurance and benefit withdrawal. The tax cuts would be paid for by raising taxes on the wealthy by removing relief such as higher rate tax relief on pensions, closing the differential between earned income and CGT, an extra levy on high value property (over £2million) and some 'green taxation', on aviation. A package of this kind would achieve tax cuts for the majority while contributing to a greater equality of wealth and income and a greater sense of social cohesion.

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The Liberal Democrats believe that it is simply not possible to address the problem of an unsustainable budget deficit without parallel action to rebalance the tax system and eliminate the unfairness at its core. There are painful times ahead but we believe that the measures I have set out to support economic recovery will do much to reduce the pain. We understand the enormity of the challenge ahead and are ready for it.