MEMO

Square up to conservatives on fiscal discipline

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The last few years have demonstrated the need for a new social democratic narrative based on fiscal discipline. The post-crisis race to regain control of public finances through a series of fiscal adjustment packages has benefited the centre-right. Such austerity policies have traditionally been part of conservative economic recipes, putting centre-left governments on the back foot in communicating the need for fiscal adjustment.

However, this should not be met with despondency and despair. The electoral fortunes of centre-left parties will be linked to the economic agenda in the years to come – and they can win the economic and fiscal debate. There are two crucial arguments that should be made. First, social democrats are better managers of the economy than conservatives (since the 1960s, centre-left parties have overseen more years of economic growth than conservative parties). Second, social democrats offer the best policy options for reducing large public debts created by irresponsible bankers, while maintaining the capacity of the state to play its strategic role in forging more sustainable economies and more equitable societies.

1. Centre-left parties are as fiscally responsible as their centre-right counterparts. Contrary to popular perception, 51% of the fiscal adjustments that occurred in the OECD in the last four decades were implemented by centre-left governments. Although conservative parties have traditionally associated fiscal adjustments with their preference for a small public sector, the truth is that fiscal discipline is perfectly compatible with a larger state presence in the economy. In fact, the reluctance of many conservative governments to raise taxes generated public debts in advanced economies in the postwar period. These fiscal imbalances had to be rebalanced by progressive governments when they regained office, as demonstrated by Bill Clinton in the United States and Tony Blair in the United Kingdom.

2. Fiscal adjustments can be progressive if they are composed correctly. A fiscal adjustment is basically a reduction in the public deficit, which in turn accounts for the difference between public revenues and expenditures. A deficit reduction can therefore be attained through very different combinations of revenue increases and expenditure cuts; it does not need to be exclusively associated with painful cuts in social spending.

With respect to the composition of adjustments, the existing evidence shows that the main difference between progressive and conservative fiscal adjustments over the last 40 years in Europe is that those carried out by centre-left governments have tended to rely more on revenue increases than expenditure cuts. If forced to cut spending, governments of the centre-left have normally reduced public salaries and froze social programmes in order to maintain or even increase public investment in physical, human and technological capital. This is clearly related to the strategic role that progressive economists give to supply-side policies financed by the state.

Typically, therefore, centre-left governments have preferred to raise public revenues in order to maintain the pre-existing level of public spending and social transfers. There are different ways to increase revenues, and all of them can be used by social democrats as part of their fiscal adjustment strategies. Increasing the tax rate for upper-income levels is the traditional response. Nevertheless, in countries where wage-earners already bear a significant tax burden, it would be more efficient and equitable to tax property and wealth. In addition, social democrats should promote the transition from tax systems that tax "good behaviour" (such as work and savings), to tax systems that tax "bad behaviour" (such as excessive consumption, excessive waste and pollution and excessive speculation). Moreover, the fight against tax evasion should become a central pillar in the new progressive fiscal agenda (pushing for a co-ordinated response at the international level and for wider use of digital money at the domestic level).

3. Differences in the composition of fiscal adjustments become very clear when comparing the ongoing consolidation processes in the UK and Spain. The UK coalition government is carrying out a major fiscal adjustment focused on the largest expenditure cuts registered since the Second World War, amounting to around 5.6% of GDP in 2010-2014. The revenue side of the adjustment barely amounts to 20% of the overall deficit reduction (while in Spain it represents 55%). However, it is not the size but the composition of the cuts, and their long term consequences, that are most significant and in many ways worrisome.

In the UK, the welfare state will be profoundly affected by the cuts, with social spending decreasing by 1.3% of GDP. While David Cameron has reduced the levels of support to families in the lowest income sectors, the Spanish government has preserved and increased such support. This has been achieved through special benefits for the long-term unemployed, whose regular benefits were exhausted; maintaining lower-income pensions at the highest levels in Spanish history; and through special assistance and benefits for the most dependent in society. In fact, the share of social expenditure to Spanish GDP has significantly increased, even during the crisis, reaching 58% in 2011, up from 43.4% when the conservative People's Party left office. The Institute for Fiscal Studies has concluded in a recent study that the measures undertaken by the UK government in this regard could lead to an increase in long-term inequality since low-income and vulnerable families will see their incomes fall disproportionately.

In addition, access to the British higher education system has been altered, with an average increase in university fees of around 143% according to some estimate. Meanwhile, the Spanish government has even in the current period, increased both the number of scholarships, with an overall increase since 2004 of 107% in value and 30% in the number of beneficiaries, and the total expenditure on education, which has doubled in absolute terms in the seven years that Jose Luis Zapatero has been in office. Simultaneously, most public departments have seen their budgets significantly cut in the UK, by an average of 13%. As part of this plan, the massive dismissal of 600,000 public servants is being predicted. In contrast, the Spanish government has made adjustments to current expenditures, including a decrease in public servant salaries that is proportional to their incomes (15% for high-ranking civil servants and 5% for the rest), without affecting socially productive public investments that are the determinants of social capital and thus the future of society.

4. Progressive fiscal adjustments are the determinants of the transition towards a more "dynamic state". Conservatives are trying to use fiscal adjustments during times of crisis to reduce the role and size of the state, in line with confusing concepts and theoretical frameworks such as "the Big Society". In contrast, the centre-left should defend an activating, forward-looking and socially-efficient role for the state. Well-designed fiscal adjustments can help the transition towards a more "dynamic state", one that combines economic activation with effective protection for those who need it most, where all measures adopted serve several medium- or long-term objectives in building not a “bigger” but a “better society”, and where social effectiveness remains a central decision criterion for decision making.

5. Progressive fiscal adjustments can increase economic potential and help the transition to a more sustainable economy. If fiscal adjustments raise additional revenues to finance additional investments in physical, human and technological capital, they can be economically productive. In fact, some of these additional resources should be used to finance new entrepreneurs in the sectors of the future (renewable energy, biotechnology, ICT, cultural industries, social services, etc). Some might argue that taxing the private sector to channel public credit to new sectors is not economically efficient. This may be so in normal times, but not in the aftermath of a credit crunch and a huge financial collapse. The public sector is the only source of financing available for risky projects in these circumstances, and it has to play this strategic role. If new revenues come from additional taxation on unproductive wealth and negative externalities (such as short-term financial transactions), the productive part of the private sector will benefit overall. And the whole strategy will accelerate the transition to a more sustainable economy, based less on real estate and financial speculation and more on new sectors that increase the quality of life.

6. Progressive fiscal adjustments can also increase equality. Fiscal adjustments that rely on deep tax reforms can redistribute income. But even in the absence of these reforms, revenue-based adjustments that help finance additional investments in education can have a positive impact on social mobility. And most importantly, all fiscal adjustments that manage to bring down the public debt-to-GDP ratio have a positive overall impact on intergenerational equality, since they reduce the debt burden on future generations and this increases their freedom to spend and invest future income.

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