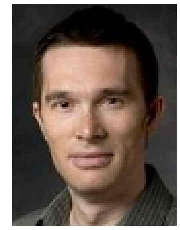
The UK is in dire need of a meaningful plan for growth and the burden is on the Chancellor to provide it

3/18/2013

In advance of Budget Day on Wednesday **John Van Reenen** *highlights a range of chronic weaknesses which are holding back the UK economy, with infrastructure and associated policy uncertainty a particular problem. He calls for a new architecture for UK infrastructure, though cautions that any announcements must be carefully thought-out and avoid the political temptation attached to headline grabbing initiatives.*



UK Chancellor George Osborne will present his fourth budget this week facing enormous challenges. The overwhelming priority is to tackle low growth as national income has shrunk by over 3% since 2008, the most prolonged recession we have suffered for over a century.

I co-chaired the LSE Growth Commission, which recently released its final report recommending policies to secure long-run prosperity and challenged politicians to deliver a "manifesto for growth". Although the Commission focused more on the next four decades than the next four years, what does our analysis imply for the budget?

First and foremost, the UK's fiscal problems are intimately related to slow growth. Flat-lining GDP means weaker tax revenues due to unemployment, low wages and higher welfare payments. The Moody's downgrade of UK public debt, although economically inconsequential in itself, was due not to fiscal profligacy but to poor growth prospects.

The UK has chronic weaknesses in long-run investment in human capital and innovation but investment in infrastructure stands out as a particular problem, especially in transport, energy and housing. Poor performance is linked to endemic policy risk with flip-flops, procrastination and reversals following changes of governments and changes of ministers.The debacles over Heathrow and nuclear power are but two prominent examples. This engenders policy uncertainty, which is very harmful for long-run investment.

A new architecture for national infrastructure is vital. This should combine politically independent expertise, an Infrastructure Bank to give government more financial "skin in the game" and much more generous compensation for the losers from development to tackle NIMBYism. These institutional innovations will increase the costs of political shilly-shallying over important decisions, just as the Monetary Policy Committee makes it hard for the Chancellor to manipulate interest rates and NICE (the National Institute for Clinical Excellence) reduces the risk that the health secretary will buckle under the latest lobbying campaign for an expensive new treatment. Sir John Armitt and Lord Deighton, who helped deliver the London Olympics, have supported the Growth Commission's ideas.

Announcing in this week's budget that there will be changes in the way that infrastructure decisions are made may reduce uncertainty and bring forward private sector investment. But this announcement must be credible, serious and carefully thought-out rather than just a way to grab easy headlines with no actual commitment.

A wise Chancellor would make such reforms, but we also need more immediate action. Unwisely, public investment has once again borne the brunt of the spending cuts in the fiscal consolidation programme as it is less politically visible. It is now clear that this was a mistake and it makes sense to increase public investment now for four reasons. First, the positive impact of investment spending is large during severe downturns when interest rates are near zero, limiting the ability of the Bank of England to stimulate the economy. Recent research by the IMF's Olivier Blanchard, Berkeley's Alan Auerbach and others has shown that fiscal multipliers are larger than previously thought.

Second, financial markets are not likely to be concerned about the short-term increase in debt required for public investment because this creates an asset. It is borrowing to finance a mortgage rather than a cruise in Bermuda. It is crazy that we focus only on debt when making public finance decisions and ignore assets. No one would look only at one side of a firm's balance sheet when evaluating whether or not it is financially sound. Third, the idea that there are no "shovel-ready" public investment projects is claptrap. There is a pressing need for low-cost housing, a multitude of road repairs and better schools (one of the first acts of the government was to cancel a major schools building programme). Large prestige programmes can and should not be suddenly turned on, but there are a multitude of more minor investments with very high ration of benefits to costs. Finally, higher spending on public investment would not violate the Chancellor's fiscal mandate to balance the budget deficit over the next five years because this target is for the cyclically adjusted budget *current* deficit, which explicitly *excludes* capital expenditure.

I would like to see a minimum of £10bn extra in public investment in both 2013/14 and 2014/15. The IFS Green Budget argues that, even under conservative assumptions, this would increase GDP by 1% by the end of 2014. An important question is whether these vital increases in public investment need to be financed by further cuts in current spending or tax rises. There are certainly many areas for rationalisation, such as the winter fuel allowance, extension of VAT and revaluation of council taxes. But the plans for spending cuts are already severe with growth risks much on the downside, so other changes should be made revenue-neutral.

Simply slashing spending, getting rid of all health and safety legislation and raising the speed limit do not constitute a credible growth plan, but fantasy economics. The problem is not the size of the state but what is done with the state's resources. The cycle of UK infrastructure is at a critical juncture. We have procrastinated over decades so that in the next few years we really do risk the lights going off. Fortunately, there is now a confluence of long-term desires and shorter-term necessities to provide institutional foundations and greater finance for infrastructure. The Chancellor should heed our call to action now and use the budget to begin a real manifesto for growth.

Note: This article gives the views of the author, and not the position of the British Politics and Policy blog, nor of the London School of Economics. Please read our comments policy before posting.

About the author

John Van Reenen *is Director of the Centre for Economic Performance and a Professor at the London School of Economics*