PROMOTING
GROWTH AND
SHARED PROSPERITY
IN THE UK

IPPR

BRIEFING

A PATH BACK TO GROWTH

Tony Dolphin

July 2012
© IPPR 2012

Institute for Public Policy Research

ABOUT THE AUTHOR

Tony Dolphin is senior economist and associate director for economic policy at IPPR.

ACKNOWLEDGMENTS

The genesis of this paper was a discussion with Eric Beinhocker, executive director of the Institute for New Economic Thinking at Oxford. Nick Pearce, Graeme Cooke, Will Straw and members of the panel that advises IPPR on its economic work commented on an earlier draft of the paper and helped improve it, though they bear no responsibility for the final version. This lies with me alone.

ABOUT IPPR

IPPR, the Institute for Public Policy Research, is the UK's leading progressive thinktank. We produce rigorous research and innovative policy ideas for a fair, democratic and sustainable world.

We are open and independent in how we work, and with offices in London and the North of England, IPPR spans a full range of local and national policy debates. Our international partnerships extend IPPR's influence and reputation across the world.

IPPR
4th Floor
14 Buckingham Street
London WC2N 6DF
T: +44 (0)20 7470 6100
E: info@ippr.org
www.ippr.org
Registered charity no. 800065

This paper was first published in July 2012. © 2012
The contents and opinions expressed in this paper are those of the author(s) only.

ABOUT PROMOTING GROWTH AND SHARED PROSPERITY

This major programme of work aims to identify public policies that will promote the economic growth needed to return the UK to full employment and ensure that the benefits of future prosperity are more equally shared.

For more information, see:
http://www.ippr.org/research-projects/44/7144/promoting-growth-and-shared-prosperity-in-the-uk

IDEAS to
CHANGE POLICY

CONTENTS

Executive summary 2

Introduction 3

1. The UK's economic crisis 5

Short-term lack of demand 5

Long-term worries about the potential growth of supply 8

2. A path back to growth 10

Step 1: Quantitative easing 10

Step 2: Fiscal policy 12

Step 3: Infrastructure spending 14

Step 4: Household debt restructuring 16

Step 5: Keeping the long-term unemployed in touch with the labour market 17

Step 6: An active industrial strategy 19

3. Final thoughts 21

References 23

EXECUTIVE SUMMARY

The UK economy is back in recession and needs to find a path that will return it to a higher growth track in the medium term. To not do so will make it harder for the country to tackle the legacies of the financial crisis, including high youth unemployment and government borrowing. In the face of serious headwinds from the eurozone, current policies – even after taking into account new initiatives such as funding for lending and the plan to guarantee up to £40 billion of spending on infrastructure projects – are unlikely to deliver the desired outcome. More effort is required to boost demand in the short term and to ensure that the economy's growth potential is supported in the medium term.

The debate about the role of government policy in the UK's return to recession and about Plan A or Plan A+ or Plan B has become a sterile one, focused too narrowly on the Coalition's fiscal plans. A path back to growth will require a change in fiscal policy, but on its own this will be insufficient. To be effective, policymakers need to make a number of complementary shifts in policy.

These shifts should be designed to reduce uncertainty about the economic outlook. This will encourage households to consume and business to invest and to hire more workers. Private sector companies will only be engines of growth in the UK if they can foresee a positive outlook and healthy returns on their investments. That is patently not the case at present.

Growth on its own is not enough. It needs to be accompanied by reform to address long-standing weaknesses in the UK economy: underinvestment, vulnerability to external shocks, poor export performance and persistent inequalities. The path back to growth should also be a path to a different kind of British capitalism.

The roadmap for growth should have six elements:

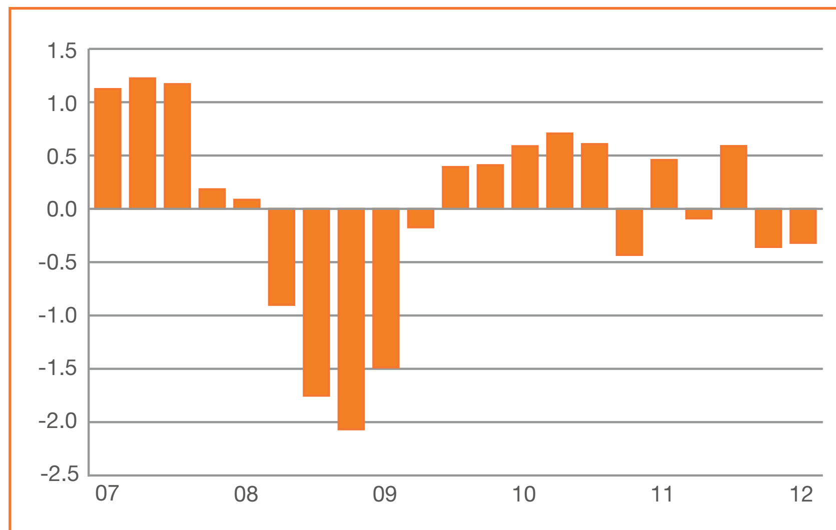
1. an increase in the scale of quantitative easing
2. fiscal measures to boost growth in the short term combined with a reaffirmation of the plan to eliminate the deficit in the medium term
3. additional infrastructure spending
4. measures to make household debt restructuring easier
5. measures to keep the long-term unemployed in touch with the labour market
6. an active industrial policy.

Each of these elements would reinforce the others and increase the chances of a return to sustained growth in the UK over the next year (or, in a worst-case scenario, minimise the impact of a deepening crisis in the eurozone).

INTRODUCTION

The UK is back in recession: real GDP contracted in the final quarter of 2011 and again in the first quarter of 2012. Most forecasters expect growth to resume in the second half of 2012, but with the caveat that a worsening of the eurozone crisis would be likely to lead to an extended downturn.

Figure 1
Real GDP growth (quarter-on-quarter, %)



Source: Office for National Statistics

The Coalition and the Bank of England have announced a number of initiatives to help return the economy to growth. For example, on 14 June, George Osborne announced in his Mansion House speech[1] a 'funding for lending' scheme worth up to £80 billion, under which the Bank of England would take assets from banks in return for cash, on the proviso that the banks use the money to make new loans. More details of this scheme followed on 13 July. On 18 July, the chancellor announced the 'UK Guarantees' scheme, under which the government will undewrite up to £40 billion of investment in infrastructure.

But international bodies are now urging more action. The IMF, for example, in its latest report on the UK economy,[2] called on the monetary policy committee to increase the scale of quantitative easing and to consider a cut in the bank rate, which is already at a historical low of 0.5 per cent.

The IMF also suggested the UK could undertake 'balanced budget fiscal expansion': temporarily increasing tax revenues or cutting spending in ways that will have a relatively small effect on demand, and using the funds to boost public spending in areas where it has a large effect. It suggests smaller increases in public sector pay and better targeting of transfers (which might mean, for example, restricting winter fuel allowances and free travel passes to better-off pensioners) and using the funds to increase infrastructure spending. It also said 'if growth does not build momentum and is significantly below forecasts even after substantial additional monetary stimulus and further credit easing measures, planned fiscal adjustment would need to be reconsidered'. In other words, if the economy remains weak, the government should implement temporary tax cuts and a boost to infrastructure spending not offset by cuts elsewhere. This would mean borrowing more in the short term.

1 http://www.hm-treasury.gov.uk/press_47_12.htm
2 http://www.imf.org/external/np/ms/2012/052212.htm

The Coalition continues to reject this suggestion. It argues that increased government borrowing would put the UK's AAA credit rating at risk and lead to higher interest rates. However, one credit rating agency, Moody's, has already put the UK on negative watch because low growth has led to an upward revision to forecasts of government borrowing. The UK has reached the point where successful measures to support growth, even if they involve more borrowing in the short term, could help to preserve its credit rating.

Furthermore, there is no automatic link between a country's credit rating and its interest rates. Since the agencies cut the US's credit rating in August 2011, yields on US government bonds have fallen.

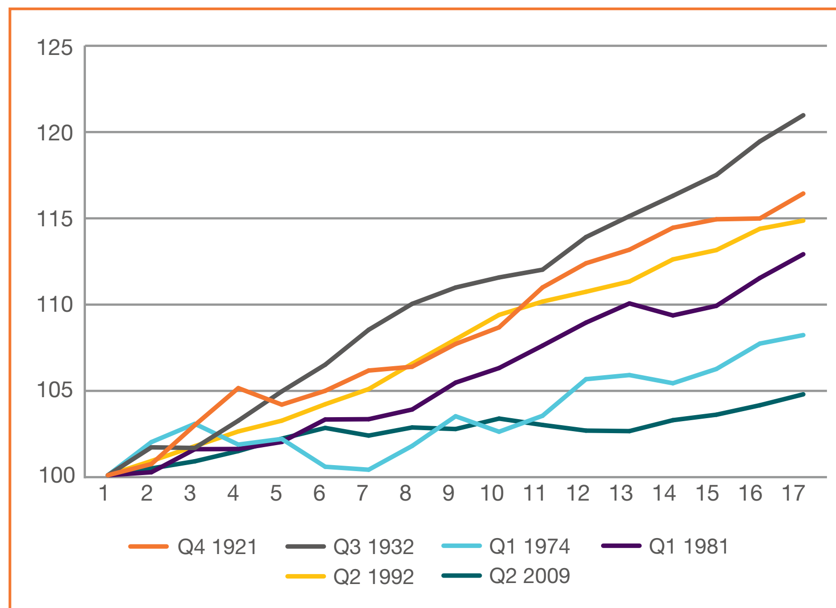
Fears that more quantitative easing would increase the risk of higher inflation in coming years are also misplaced. Inflation pressures in the UK in recent years have been imported and are largely the result of high commodity prices. Domestic inflation pressures, such as wage growth, have been very low and this is likely to remain the case while there is a good deal of spare capacity in the economy. The time to worry about inflation is after the economy is restored to growth, not before.

For the next few years, the priority in the UK is achieving output growth and the declines in unemployment that would accompany it. Measures announced in recent months by the Coalition are steps in the right direction and following fully the IMF's recommendations would further increase the chances of a return to growth. But understanding the UK's economic problems as a combination of weak demand in the short term and the risk of lower potential growth in the medium term makes it clear that a wider set of policies is needed. After an assessment of the nature of the economic crisis in the UK, this paper sets out what these policies should be.

1. THE UK'S ECONOMIC CRISIS

The UK is in the midst of an economic crisis. Official figures show the economy is back in recession; output in the first quarter of 2012 was almost 4 per cent lower than at its peak four years earlier. The recovery from the low point of the recession is turning out to be the slowest for at least 100 years.

Figure 2
UK economic recoveries compared (including OBR forecasts to Q2 2013)



Source: NIESR, ONS and author's calculations

Clearly, this is no ordinary economic downturn. There are two facets to the UK's economic crisis: a short-term one and a long-term one. Any set of policies designed to promote growth in the UK must recognise this fact and tackle both. Failure to do so is likely to result in failure to achieve the desired outcome: a speedy return to economic growth and a steady decline in the number of people who are unemployed in the UK.

Indeed, the human cost of the crisis is most heavily felt through its effect on unemployment. Overall, there are more than 1 million additional people unemployed now than there were before the recession began. Within the general population, some groups have fared particularly badly. In February to April, 886,000 people in the UK had been out of work for more than a year. Many of them are aged over 50 and face the prospect of never securing a permanent, full-time job again. Meanwhile, at the other end of the age spectrum, unemployment among young people stands at 1,010,000 – close to its highest level since comparable records began in 1992. Long periods of unemployment (or moving frequently from one temporary post to another) while people are young has a 'scarring effect' that lasts throughout their working lives. Someone who has been in this situation when he or she is young is more likely in later life to be unemployed or earning less than his or her contemporaries.

Short-term lack of demand

In the short term, the problem facing the UK economy is a shortage of aggregate demand, resulting in unused resources in the form of high unemployment and idle productive capacity. This is the result of a combination of factors.

The government is taking demand out of the economy through its deficit reduction programme. It believes that government borrowing is so high – and the trajectory of public debt over the next few years is so worrying – that this must take priority over all other economic policies. If drastic steps are not taken, it argues, the government risks a downgrading of its AAA credit rating, leading to higher interest rates and, potentially, the sort of problems facing several southern European countries. This is hotly disputed in some quarters and it is argued later in this paper that there would be little risk if fiscal policy were relaxed in the short term, so long as a credible medium-term reduction plan remained in place. However, despite a suggestion from the IMF that the government should slow the pace of deficit reduction in the short term 'if downside risks materialize and the recovery fails to take off',[3] the chances of a change of policy appear to be very slim.

Cuts in public spending will continue for another five years at least, and throughout this period the UK will be relying on the private sector to increase its demand sufficiently to offset their effect and to grow overall demand fast enough to allow unemployment to fall. But, so far, the private sector has not been able to fulfil its appointed role.

The Coalition hoped that exports and private sector investment would fill the gap created by cuts in government spending. But over half of the UK's exports go to the rest of Europe.[4] The crisis in the eurozone has weakened demand growth in the UK's main export market and brought overall export growth to a halt. This has played some part in the UK's return to recession – though not the dominant one suggested by the government. The risk is that a deepening of the crisis in Europe could have a more significant effect on the UK in the future. The latest phase of the crisis has also seen sterling start to creep higher against the euro (and the US dollar) on the foreign exchanges. It was sterling's 25 per cent fall (on a trade-weighted basis) in 2007/08 that generated optimism about exports leading the UK economic recovery. If this fall is reversed, UK exports are less likely to grow strongly, even if demand in the rest of Europe starts to increase again.

Figure 3
Export volumes (index 100 = 2008)

Source: Office for National Statistics

3 http://www.imf.org/external/np/ms/2012/052212.htm
4 In 2011, 53 per cent of the UK's exports of goods went to the EU's 27 members.

Meanwhile, private sector investment has disappointed. In its forecast prepared for the June 2010 budget, the Office for Budget Responsibility (OBR) predicted business fixed investment would grow in real terms by 8.1 per cent in 2011, followed by average annual growth of 9.5 per cent in the next four years (OBR 2010). By the time of the March 2012 budget it was clear that business investment was significantly underperforming expectations in the short term: it increased by only 1.2 per cent in 2011 and is now forecast by the OBR to increase by just 0.7 per cent in 2012 (OBR 2012). The OBR does, though, maintain its optimism about the medium-term outlook, predicting average annual growth in investment of close to 9 per cent from 2013 to 2016. Most other forecasters are less optimistic.

There are a number of reasons for business investment falling so far short of expectations. For some firms, for example, the problem is difficulties accessing finance. But uncertainty about the outlook for demand seems to be the most important factor. When the government is cutting its spending, the UK's main export market is facing turmoil and there are fears that household debt repayment will prevent domestic consumption from increasing at a healthy pace, there is an understandable reluctance on the part of companies in the UK to spend money on increasing their productive capacity. Government ministers have called the business environment 'favourable' and accused companies of whingeing about government policy when they should be investing their cash piles.[5] But, from a business perspective, the outlook is decidedly uncertain, and this is a major deterrent to making long-term plans and spending money. Policy needs to be oriented towards reducing uncertainty.

Weakness in consumer spending is another part of the aggregate demand problem. In 2008/09, the recession was the result, in part, of a sharp increase in the household saving rate. Although real incomes increased, households borrowed less and saved more and, as a consequence, were forced to cut their spending. In 2010 and 2011, the situation reversed: real disposable incomes fell (in 2011 by more than in any year since the end of the second world war with the sole exception of 1977) and the saving rate declined modestly. The net result is that household debt has fallen very little in relation to disposable income and remains higher in the UK than in any other major economy. It is likely, therefore, that, even should real incomes start to increase again, households would use some of the extra income to reduce their debts and so any growth in consumer spending would be modest.

Table 1
Household liabilities, 2010 (% of nominal disposable income)

Country	%
United Kingdom	165.2
Canada	150.5
Japan	125.7
United States	124.4
France	99.0
Germany	97.5
Italy	89.5

Source: OECD Economic Outlook 91 annex table 58[6]

5 *Financial Times*, 14 May 2012: http://www.ft.com/cms/s/0/c2143264-9cf4-11e1-aa39-00144feabdc0.html#axzz1ur9YzhyD

6 http://www.oecd.org/document/61/0,3746,en_2649_34109_2483901_1_1_1_1,00.html

Any roadmap for growth must recognise that an excessive focus on austerity in the short term adds to the problem of inadequate aggregate demand in the UK. In addition to the direct effect on growth of the higher taxes and public spending cuts that have already been implemented, the knowledge that around nine-tenths of the spending cuts are still to come, and that public sector austerity will predominate for several years yet, has an indirect effect by lowering consumer confidence and increasing uncertainty for businesses. The Coalition's measures to tackle its budget deficit were predicated on the assumption that they would lead to greater confidence and certainty about the future; in fact, they have had the opposite effect. As a result, the private sector is not inclined to increase its spending. Unless measures are taken to support demand in the short term, growth in the economy is likely to remain disappointing. Ultimately, this could have a detrimental effect on the economy's long-term prospects.

The weakness of demand means that remedies for the UK's economic ills which centre on cutting corporate tax rates more aggressively or easing labour market regulations so that it is easier to fire workers are unlikely to be successful. In the current context, such measures will be ineffectual at best and could potentially make the situation worse. If companies are not hiring and investing because the economic outlook is so uncertain, a cut in corporate tax rates is unlikely to make enough of a difference to their expected returns to cause a change of view. And making it easier to sack workers could backfire if it causes workers, in their role as consumers, to become more cautious and to save more and spend less.

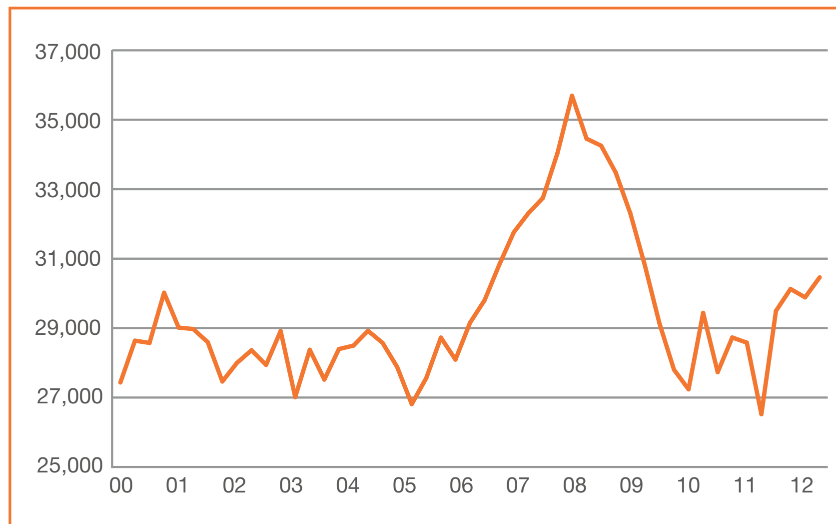
Long-term worries about the potential growth of supply

At a time when aggregate demand is patently falling well short of the supply potential of the economy, it might seem odd to worry about the UK's longer-term growth in supply potential. But there is a risk that an extended period of weak demand – and an understandable short-term retrenchment by businesses – will ultimately lead to a lower medium-term trend rate of growth for the UK economy (as happened in Japan in the 1990s). The two most likely reasons why this might happen are (a) underinvestment in productive capacity and (b) workers leaving the labour market or finding they no longer possess skills that are in demand.

Investment is crucial for the growth of the economy. Investment in physical capital – buildings, machines, equipment, computers and software – increases productivity by increasing the level of capital per worker (capital deepening), which should increase output per worker, and by ensuring that the latest, most efficient, technology is brought into the production process. If the UK economy experiences a long period of weak business investment, there is a risk this will be followed by slower productivity growth – and thus slower growth in output. In this respect, it is extremely worrying that business investment in the UK in 2011 was 13 per cent lower, in real terms, than it was in 2007 (and only 6 per cent higher than in 2000), and that most forecasters expect it to increase little, if at all, in 2012 (see figure 4 over).

In addition to productivity growth, increases in the labour force add to potential output growth. These too could be affected by an extended period of weak actual growth in the economy. While the economy is weak, unemployment is likely to remain well over 2.5 million (the latest OBR forecasts suggest it will peak at 2.8 million in the second half of 2012 and the first half of 2013 and not fall below 2.5 million until 2015). The longer unemployment is at such elevated levels, the greater the risk that some people – particularly those who are approaching retirement age – will give up searching for a job and effectively quit the labour market, while others will only find employment in roles that do not fully utilised their skills. Both represent lost potential output for the economy.

Figure 4
Business investment
(2009 prices, £ million)



Source: Office for National Statistics

Any set of policies for growth must include elements designed to restart the private sector investment cycle and to ensure that the unemployed remain in contact with the labour market. Failure to include such elements would put at risk the UK's long-term growth potential (and make tackling the country's public and private debt problems much harder).

Boosting the level of investment spending would also begin to address one of the UK's long-standing economic weaknesses: a persistent tendency to invest less, relative to GDP, than other comparable countries. Other weaknesses that need to be tackled include an overreliance on debt; poor export performance, which has seen the UK run a current account deficit in every year since 1983; increased levels of income inequality; and greater differences in regional outcomes. Growth needs to be accompanied by wider reform if these problems are to be successfully addressed.

Such reform should also include steps to rebalance the economy so that growth is less dependent on the financial sector and generated more widely in the rest of the economy. This is not because there is a 'right' level for finance as a share of GDP. Rather, it is because there is no evidence that the increased share of finance has led to an improvement in capital allocation or returns on savings and investments; it reflects greater rent-extraction from the rest of the economy. It would be benefit the economy overall if this was reduced.[7]

7 IPPR will be publishing a report on the financialisation of the UK economy in the autumn of 2012.

2. A PATH BACK TO GROWTH

A set of policies designed to lift the UK economy out of its current crisis needs to address the short-term problem of inadequate aggregate demand and the longer-term risk of weak potential growth. Improving the supply potential of the economy will be futile if it means demand falls even further short of supply. Boosting demand in the short-term without supporting the supply potential of the economy in the long-term would risk recreating the problems that led to the financial crisis and recession. What is required is a judicious mix of 'Keynesian' and 'structural' policies designed to reduce uncertainty in the private sector, particularly among businesses.

The main elements of the roadmap for growth should be:

1. an increase in the scale of quantitative easing
2. fiscal measures to boost growth in the short-term while ensuring that a credible plan remains in place to eliminate the deficit in the medium-term
3. additional infrastructure spending, including on transport, energy supply and social housing
4. measures to make household debt restructuring easier
5. measures to keep the long-term unemployed in contact with the labour market
6. an active industrial strategy to support key sectors of the economy where the UK has a comparative advantage.

Step 1: Quantitative easing

In normal circumstances, macroeconomic policy should be conducted through monetary measures, in particular through adjustments to the level of interest rates. But circumstances in the UK are far from normal. Interest rates are at what economists call the 'zero bound'. The Bank of England's base rate has been held at 0.5 per cent for over three years. Meanwhile, the yield on a 10-year government bond is below 2 per cent – around its lowest-ever level – and yields on corporate loans have been dragged lower as a result. From this point on, any further falls in yields may not support growth because they are interpreted instead as reflecting a deteriorating economic outlook.

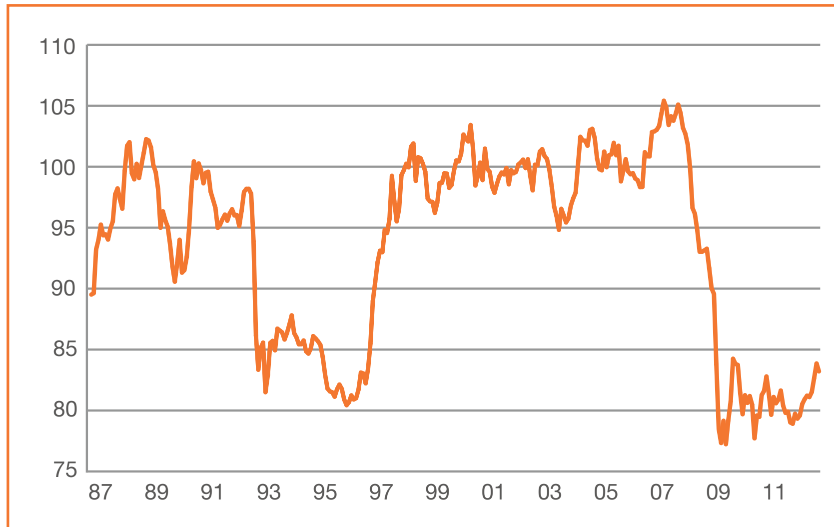
Once interest rates reached the zero bound, the monetary policy committee (MPC) resorted to quantitative easing (QE) – increasing the supply of money in the economy by buying, mainly, UK government bonds – to support growth. The scale of QE has now reached £375 billion but the MPC should be prepared to provide additional easing if necessary. It should also explore alternatives to simply purchasing government bonds with this additional money. Given how low government bond yields are in the UK, there is now a strong case for purchases of corporate bonds and commercial paper.

However, this would not directly help small and medium-sized businesses – and the risk remains that they cannot get the credit they need to expand (or even to survive). This can also be a problem for larger businesses if the smaller companies in their supply chain cannot provide them with the inputs they need. MPC member Adam Posen has argued in the past that QE should be used to aggregate and securitise loans to small and medium-sized businesses so that banks could make more new loans available to them.[8] The government and Bank of England's £80 billion 'funding for lending' scheme is designed to have much the same effect, without the formal link to QE. This scheme should be implemented as soon as possible and expanded if it is successful.

8 http://www.bankofengland.co.uk/publications/Documents/speeches/2011/speech517.pdf

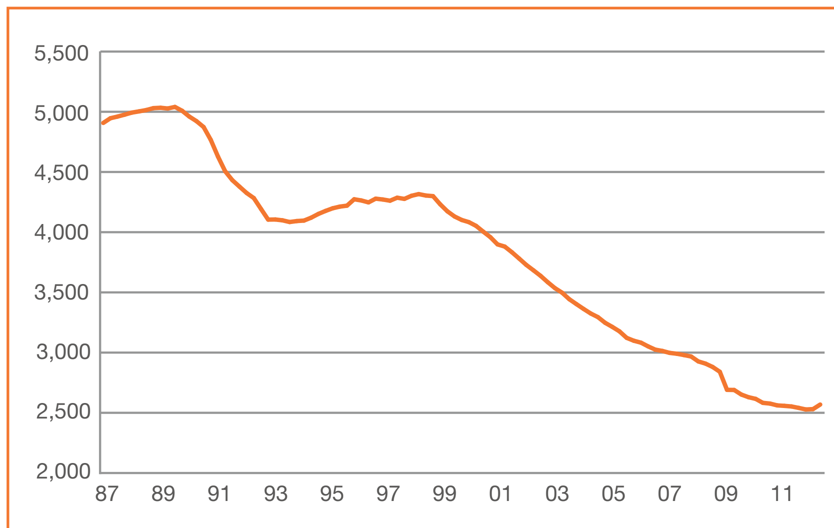
Quantitative easing is designed mainly to boost demand in the economy in the short term, much in the way that a cut in interest rates does in normal times. But it may also support the economy's growth potential in the medium term, if it helps to prevent a rise in sterling. If sterling appreciates and UK companies believe its gains will not be reversed, they will be less confident about their prospects of selling into overseas markets and so will invest less. In the 1990s, after sterling left the EU exchange rate mechanism (erm), its value fell by around 20 per cent and the UK enjoyed strong export growth and a revival in manufacturing activity and employment. Less than five years later, sterling reversed its post-erm decline and the mini-renaissance in manufacturing was snuffed out.

Figure 5
Sterling effective exchange rate (index 100 = January 2005)



Source: Bank of England

Figure 6
Workforce jobs in manufacturing ('000s)



Source: Office for National Statistics

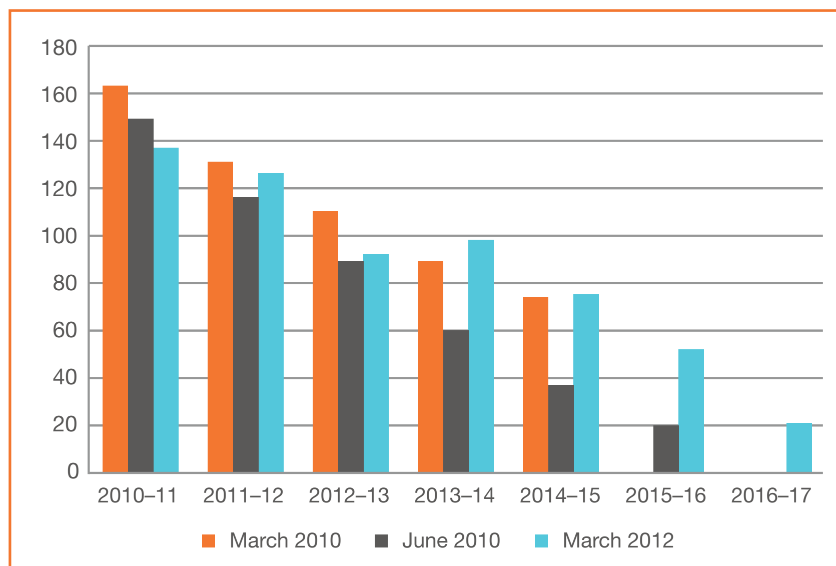
Worries about the inflationary effect of quantitative easing can be put to one side. Monetary laxity will only create serious inflation pressures when there is little or no spare capacity in the economy. In the UK, this is not the case. Indeed, the Bank of England should make it clear that it will tolerate inflation above the target rate of 2 per cent until the economy has been expanding at a normal pace for some time. Higher inflation helps to reduce the real value of debts and keeps real interest rates lower.

That said, the MPC must be careful to withdraw QE in a timely manner when the economy improves, and there are dangers if it gets the timing wrong. The Bank of England's forecasting model has proved a poor guide to events over the last five years and it should be investing time and resources to developing new models. These should be based on new ways of thinking about the economy, such as network theory, rather than on the discredited neoclassical approach.[9]

Step 2: Fiscal policy

When interest rates are at the zero bound, Keynesian economic theory says fiscal policy should be used to boost aggregate demand. But it has little to say about the extent to which this might be possible in a world of rapidly increasing public debt-to-GDP ratios, powerful credit rating agencies and countries at risk of default. What the last two years have shown, however, is that even in these circumstances attempting to cut the deficit too rapidly can be self-defeating if, as a result, output growth and government revenues are weakened and government spending is increased. Despite the Coalition's accelerated programme of tax increases and spending cuts over the last two years, the profile for borrowing in the OBR's latest forecasts is very similar to the one set out in March 2010 by the Labour government. Total borrowing from 2011/12 to 2015/16 is now expected to be £120 billion higher than planned at the time of the June 2010 post-election budget.

Figure 7
Public sector net borrowing (£ bn)



Source: UK budgets March 2010, June 2010, March 2012

9 This idea is developed further in a book of essays on new economic thinking to be published in summer 2012 by IPPR.

A better-designed deficit reduction plan would allow the pace of reduction to be slowed when the economy is weak and speeded up when it is stronger (see Dolphin and Lent 2011). In the present circumstances, this would allow a short-term stimulus – in the form of additional spending or a temporary tax cut – to be financed by increased revenues at a later date. This combination of temporary measures that increase borrowing in the short term and new measures that ensure the deficit will still be eliminated in the medium term should not worry credit rating agencies. On the contrary, by reversing the experience of the last two years, measures that boost growth in the short term can actually make it more likely that medium-term targets are hit.

This is what has happened in the US with the introduction of a temporary 'payroll tax' cut: the US economy has continued to grow at a reasonable pace, whereas the UK has slipped back into recession.[10] In the UK, a payroll tax cut would take the form of a cut in the employee national insurance (NI) contribution rate. Primarily, such a cut would benefit the squeezed middle classes, allowing them to spend a bit more or to pay down some debt. A two-year, 2p reduction would cost around £7 billion a year in lost NI revenues, though there would be some offset thanks to the extra tax revenues that the additional growth would generate. The net cost could be paid for by introducing a mansion tax: a 1 per cent levy on the value of all houses in the UK in excess of £2 million. This would not be implemented immediately (for practical reasons) and might bring in only £1.7 billion a year,[11] so it would take a number of years for the government to recoup the cost of the NI cut. But that is the point. The temporary NI cut combined with a permanent mansion tax would provide an immediate boost to the economy in the short term, helping to support aggregate demand, while keeping in place a credible plan for eliminating the deficit in the medium term.

The ability of fiscal policy to support the economy need not be limited to measures that increase the deficit. In its latest *World Economic Outlook*, the IMF argues that 'economies that are not under market pressure and where tax rates are not high could usefully undertake balanced-budget fiscal expansion' (IMF 2012). By this, the IMF means temporarily increasing tax revenues, particularly in ways that will have a relatively small effect on demand, and using the funds to boost public spending in areas, such as infrastructure, where it has a large effect on demand. The net effect would be stronger demand and output in the economy but no initial change in the budget deficit (and an eventual reduction as stronger growth provides higher revenues and lower spending).

The UK fits very well the IMF's description of an economy that could benefit from such a policy combination and the Social Market Foundation (SMF) has suggested (to their credit, before the IMF document was published) how balanced-budget fiscal expansion might look in the UK context (Mulheirn 2012). The SMF proposes measures to increase revenues and cut spending by a total of £15 billion, including halving higher-rate tax relief on pensions, capping maximum ISA holdings and cutting winter fuel allowances and free TV licences for better-off pensioners. This £15 billion could be recycled into infrastructure capital spending and the net effect would be to raise output by £10 billion (or 0.7 per cent) a year.[12] There would also be long-term benefits to the UK from having a better infrastructure than it would otherwise have had.

10 Real GDP growth over the last year was 2.0 per cent in the US but -0.1 per cent in the UK.

11 http://network.libdems.org.uk/manifesto2010/libdem_manifesto_2010.pdf

12 This calculation is based on the fiscal impact multipliers set out in table 2.

It is wrong to argue there is no scope for fiscal policy to support aggregate demand in the economy. Excessive austerity in the short term is self-defeating if it leads to weaker growth and thus to lower tax revenues and higher government spending. Policies designed to boost growth that do not relax the current fiscal austerity will not work.

Step 3: Infrastructure spending

Additional infrastructure spending tackles both facets of the UK's growth problem. It provides a short-term boost to aggregate demand and it raises the growth potential of the economy in the medium to long term. It also encourages companies to invest and expand where the provision of new or upgraded infrastructure complements their activities.

Almost all the initial boost from an increase in infrastructure spending goes directly into the UK economy in the form of wages and purchases of British raw materials. Only a small amount is lost to overseas economies in the form of imports. When comparing different forms of fiscal stimulus, capital spending compares favourably with tax cuts. This is because some of the extra disposable income that results from a tax cut will be saved, rather than being spent in the economy, and of the new income that is spent a significant portion will go on imported goods and services, or ones with a large import content. According to the Office for Budget Responsibility (2010), money spent on capital spending generates roughly three times more output in the UK than tax cuts and two-thirds more than spending on current goods and services.

Table 2
Estimates of fiscal multipliers

	Impact multipliers
Capital expenditure by government departments	1.0
Welfare measures	0.6
Current expenditure by government departments	0.6
Change in VAT rate	0.35
Change in the personal tax allowance and national insurance contributions	0.3

Source: OBR 2010: 95

Importantly, there is no question in the present circumstances of additional infrastructure spending crowding out activity in the private sector because there is ample spare capacity in the construction industry. Construction output was down over 10 per cent between Q1 2008 and Q1 2012, and the number of jobs in construction at the end of Q1 2012 was 2,038,000 – down 300,000 from than the average number in 2007 and 2008 (see figure 8 over).

The Coalition is well aware of the potential for extra infrastructure spending to boost growth in the economy but, due to its refusal to alter its deficit reduction plan, will not countenance spending more government money in this area. Instead, it is exploring alternative sources of funds for investment in infrastructure, including private sector pension funds and overseas sovereign wealth funds. If it succeeds, these could be useful sources of additional finance in the medium term, but they are unlikely to provide much of a boost in the short term. The idea that pension funds should invest a bigger proportion of their assets in infrastructure has been around for many years, but – despite the best efforts of investment bankers to devise suitable vehicles – little has happened because pension fund trustees tend to adopt conservative asset allocation strategies. The low returns available on government bonds might have created an environment that

causes some funds to be a little more adventurous in seeking returns, and the National Association of Pension Funds and the Pension Protection Fund are developing a 'pension infrastructure platform' to make it easier for them to invest in infrastructure. But this will take time and, initially at least, is unlikely to be on a sufficient scale to make a difference to the macro economy.

Figure 8
Workforce jobs in construction ('000s)

Source: Office for National Statistics

In the short term, the only solution is for the government to increase its own spending on infrastructure. This will not affect its principal fiscal target, which is based on the cyclically-adjusted current balance (excluding capital spending), but it will mean borrowing more. However, the cost of additional government infrastructure spending – in terms of additional debt interest payments – would be extremely low in current circumstances. Jonathan Portes pointed out in May that, at then-current yields in the government bond market, a £30 billion investment programme would cost just £150 million a year in addition interest payments, or as he puts it, 'we could fund a massive job-creating infrastructure programme with the pasty tax'.[13] Since then yields have fallen further, so the cost would be even lower now (though the pasty tax has been abandoned, so an alternative source of funding is required). Additional spending of £30 billion would only partially reverse the cuts in gross investment spending currently being implemented by the Coalition (a series of cuts it inherited from the last Labour government). Ideally, it would also signal a permanent shift in the balance of public spending in the future in favour of more capital spending relative to current spending.

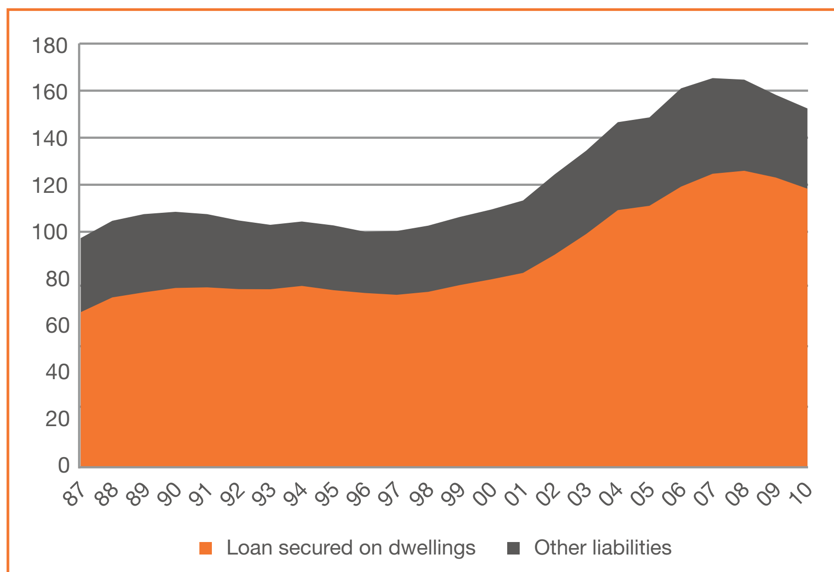
New infrastructure spending could be spread across a number of areas. The UK needs to build more low-carbon electricity generating capacity to ensure there is adequate supply to meet future increases in demand and so that it can meet its targets for cutting carbon emissions. There is a chronic shortage of housing, so more social and affordable housing could be part of an infrastructure spending package. Investment in planned transport projects could be accelerated, as could investment in super-fast broadband.

13 http://notthetreasuryview.blogspot.co.uk/2012/05/four-charts-and-why-history-will-judge.html

Step 4: Household debt restructuring

The UK has a higher ratio of household debt to disposable income than any other advanced economy (and thus probably than any other country in the world). Some argue this does not matter as much of the debt is secured against houses and their value has increased, so the overall net asset position of households has not deteriorated.[14] But some households are in a difficult position due to their mortgage debt: the Bank of England (2011: 30) reports FSA estimates that 5 to 8 per cent of mortgages may be in forbearance already (depending on the definition used). This is despite very low interest rates. There will be many households in a poor position to cope with higher mortgage payments when interest rates start to return to more normal levels.

Figure 9
UK households' liabilities (% of disposable income)



Source: Office for National Statistics

This makes it likely that the debt ratio will fall over the next decade. Households, in aggregate, will save more and borrow less. As a result, consumer spending will grow less rapidly than during the last few recoveries and this will be a drag on the economy.

The idea that policy might usefully play a role in household deleveraging has entered mainstream thinking. In its latest *World Economic Outlook*, published in April 2012, the IMF states: 'Government policies targeted at reducing the level of household debt relative to household assets and debt service relative to household repayment capacity can—at a limited fiscal cost—substantially mitigate the negative effects of household deleveraging on economic activity' (IMF 2012: 91). Broadly speaking, these policies should have three aims: to help prevent foreclosures by restructuring mortgages, to provide transfers to credit-constrained households with a high marginal propensity to consume,[15] and to reduce instances of negative equity (mortgages that are larger than the value of the property against which they are secured).

14 See, for example, MPC member Ben Broadbent's speech from March 2012: http://www.bankofengland.co.uk/publications/Documents/speeches/2012/speech553.pdf

15 That is, those households that will tend to spend a high proportion of any increase in their disposable incomes.

Iceland has implemented a series of policies in recent years designed to achieve these aims. These policies include a temporary moratorium on foreclosures, giving households the option of restructuring their loans and ensuring that 'new banks' are in a position to write down the value of loans. The 'Making Home Affordable' programme in the United States has similar aims. Its main elements encourage mortgage providers to reduce the amount those who are in negative equity owe on their homes and to lower the interest payments of those who are struggling to meet their existing commitments for reasons such as job loss or reduced earnings.

The situation in the UK is not as bad as in Iceland or the US. In particular, foreclosures are much less of a problem. But consumer spending will be held back by the costs of servicing high levels of debt for much of the rest of the decade. Several large mortgage lenders increased their standard variable mortgage rates at the beginning of May (a typical example was the move from 3.5 to 3.99 per cent by the Halifax, which will add £200 a year to the payments on an average mortgage). At some point, when the MPC decides it is time to increase its base rate from its record low of 0.5 per cent, mortgage rates will go up further. This will hit living standards.

The UK is, therefore, one of the countries the IMF is talking about when it urges measures to help highly leveraged homeowners. The government should explore with mortgage providers ways of helping families that are in negative equity and easing the burden on mortgage-holders who face genuine difficulties in making their interest payments.

One possibility would be to use the welfare system to do more – perhaps by establishing a form of 'mortgage insurance'. This might provide short-term support for someone who loses their job and needs help with their mortgage payments while they sort out their housing costs. Any money received would then be paid back through the national insurance system once a person is back in work. Of course, this would not help those who potentially will get into difficulties when interest rates increase. The government should work with lenders to devise ways to smooth the transition to higher rates for this group so as to minimise the risk of mortgage arrears and write-offs. At the same time, the government should seek to increase competition in the mortgage market with the aim of reducing spreads between mortgage rates and the bank rate.

These measures would help to support demand in the economy in the short term. They would have a positive effect on the supply potential of the economy in the medium term. Families in negative equity find it very hard to move home, a circumstance which could prevent them from exploiting a job opportunity in another locale. Instead, helping families to deleverage can increase flexibility in the labour market.

Meanwhile, it is not too early to start thinking about how to prevent asset bubbles building in the future. In the UK, the last four recessions have all been associated with the reversal of rapid increases in house prices. Ensuring the future stability of the economy is more likely to be achieved if house price inflation can be kept under control (even more so than consumer price inflation). Interest rates are too blunt an instrument for this task. Measures such as caps on loan-to-value and loan-to-income ratios are likely to be required.

Step 5: Keeping the long-term unemployed in touch with the labour market

Following the early 1980s recession, unemployment in the UK peaked at 3¼ million (over 11 per cent of the labour force). Even when the economy began to grow relatively rapidly in the mid-1980s, unemployment remained stubbornly high. When it did fall, it was only for a short period during the so-called Lawson boom at the end of the decade.

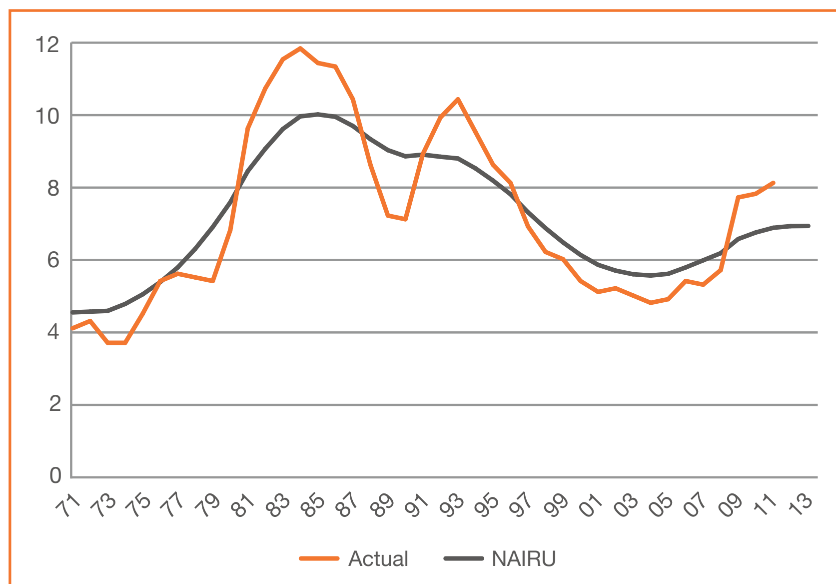
As a result, people gave up on the prospect of finding a job. Some took early retirement; others went from seeking work to being described as unable to work. So, although the number of unemployed people fell, the number on out-of work benefits fell much less. A short-term cyclical increase in unemployment became a long-term structural problem – a phenomenon that economists call hysteresis.

This had long-lasting negative effects on the economy. Even after 15 consecutive years of economic growth, at the end of 2007 there were still 4.25 million people claiming out-of-work benefits (a figure that rose above 5 million in the 2008/09 recession and stood at 4.8 million in November 2011).

There is a risk that this pattern will be repeated in the present cycle. Unemployment has increased by over a million since the recession began in 2008 and even the most optimistic forecasts expect only a modest decline in the next few years. Long-term unemployment – where the risk of hysteresis is greatest – is at its highest level since 1996 and could increase further during the rest of the year (reflecting last year's increase in short-term unemployment).

Hysteresis would be reflected in an increase in the UK's non-accelerating inflation rate of unemployment (NAIRU).[16] In the 1970s and 1980s, NAIRU in the UK doubled from 5 to 10 per cent; it was only after the mid-1990s that it fell significantly. Even then, it did not return to its early-1970s level. According to the OECD, UK NAIRU has already increased from 5.6 to 6.9 per cent between 2005 and 2011. Although this is not the OECD's forecast, the risk is that the NAIRU continues to rise in the next few years, 'locking in' an increasing number of unemployed.

Figure 10
UK actual unemployment and NAIRU (% of labour force)



Source: OECD Economic Outlook 91, annex table 22 and OECD database

The Coalition's Work Programme is designed to tackle long-term unemployment and prevent hysteresis. Anyone who has claimed jobseeker's allowance (JSA) for 12 months (or nine months if they are aged 18 to 24) or who has claimed employment and support

16 As its name suggests, this is the 'safe' level of unemployment below which the risk of higher inflation increase significantly.

allowance and is now judged to be close to being fit for work is provided with additional help to find employment by a Work Programme service provider. These providers are paid almost entirely for results: getting a person into sustained work (lasting at least 26 weeks).

As yet, the programme is too new to be properly evaluated. But an initial assessment by the Employment Related Services Association (ERSA), the back-to-work providers' trade body, discovered that about one in five people referred to the Work Programme have had jobs found for them. However, the ERSA expressed concern that many of these jobs were part-time or fixed-term contracts. Welfare-to-work providers are finding it hard to place people into full-time jobs while the labour market is weak; employers are reluctant to recruit and the number of vacancies has fallen in relation to the level of unemployment.

So, although the Work Programme might help to reduce the risk of hysteresis, additional measures are needed.

The government should introduce a job guarantee scheme. This would guarantee a job, paid at the minimum wage or above, to anyone who has been out of work and claiming JSA for more than 12 consecutive months. The guarantee would be accompanied by an obligation to take up the offer or to find an alternative that does not involve claiming JSA. The job should be for no more than 30 hours a week, to allow a reasonable amount of time for continued job search, and should last for a maximum of six months. Jobs could be provided by the third sector or government.

A job guarantee would add to government spending. The net cost of a job created by the Future Jobs Funds was £4,000, once lower benefit costs and higher national insurance contributions were taken into account. At this rate, the cost to the Exchequer of guaranteeing a job to young people aged under 25 would be £400 million a year, rising to £2.5 billion a year if the guarantee was made available to everyone who has been out of work for more than 12 months. This would help to alleviate the short-term demand problem facing the UK economy. Importantly, it would also support the economy's future growth potential by reducing the risk of hysteresis.

Step 6: An active industrial strategy

Any roadmap for growth should include an active industrial strategy. This does not mean identifying companies that might be 'winners' (though the chancellor's announcement at the 2011 Conservative party conference of £50 million in funding to support the commercialisation of graphene shows that this is a temptation all politicians find impossible resist). Even less does it mean shoring up failing companies. It does mean identifying key strategic sectors where the UK has a comparative advantage or there is potential for rapid growth in the future and working out how government policies can facilitate development in those sectors.

Areas where the UK has a comparative advantage already include information, communications and technology (ICT), pharmaceuticals and medical devices, financial services, tertiary education, creative industries, and a range of engineering-based high-value-added industries. These sectors should be supported by a national strategy to ensure that the infrastructure they need to expand is in place, that the education system is producing people with the skills they need and that finance is available to enable them to innovate and to exploit new products and ideas commercially. Innovative clusters of industries, like the maritime industries centred on Southampton and Tech City in London, should be encouraged to develop and grow so that new comparative advantages are developed.

It is also possible to identify major trends in the global and UK economies that will persist well into the future. Putting resources into supporting industries that can exploit these trends makes enormous sense. Obvious global trends that the UK should seek to take advantage of include the rapid growth in demand in emerging global markets, such as China and India, and the transition to a low-carbon future. But there are also local trends that UK companies should be in a position to exploit, including the ageing of the population, the need for a massive upgrade of the UK's infrastructure (in particular the need for new, low-carbon electricity generation capacity and improved rail links) and the need for more housing.

Specific policies that would help to develop the UK's growth potential in the medium term as part of an active industrial strategy include the creation of a national investment bank. This new institution would have immediate powers to raise funds on the capital markets and provide finance for areas where investment in the UK has historically lagged behind international norms, such as infrastructure and lending to small and medium-sized businesses, as well as for the transition to a low-carbon economy.

The government should also look afresh at competition policy. Competition in product markets is essential to ensure consumers are not exploited by monopoly or quasi-monopoly suppliers, but also to allow them to pass judgment on new products and designs. Markets should, wherever possible, be freed up to new entrants; in those cases where a high level of competition is impracticable, innovation should be encouraged through other means.

More support also needs to be given to innovation policy. The historical emphasis on tax credits for research and development has had positive results, but a broader set of policies is needed. These should include backing for industrial clusters, such as Southampton and the semi-conductor cluster around Bristol and Bath. These clusters encourage high performance, innovation and entrepreneurialism.

The government should ensure that companies are able to recruit people with the skills they need to thrive and expand. This means reversing immigration policies that prevent firms from recruiting workers from overseas when they cannot find suitable domestic candidates. Such policies have a detrimental effect on growth in the short term, and may also have a longer lasting effect if they discourage foreign direct investment in the UK. This requirement also means encouraging young people to develop the skills likely to be required by companies in the future.

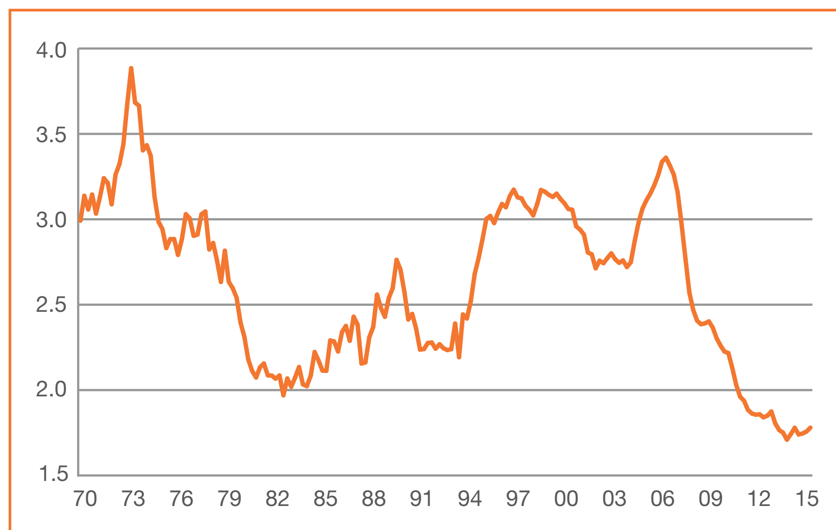
The experience of the 1970s has created a British delusion that industrial strategies do not work. It is impossible to discuss industrial strategy without someone mentioning British Leyland, though it is usually forgotten that Rolls-Royce was also nationalised, in 1971, to prevent its bankruptcy. Other countries successfully implement industrial strategies in a variety of ways. If the UK does not do so too, it risks being left behind.

3. FINAL THOUGHTS

Over the very long run, the UK's average real GDP growth rate has tended to revert to 2.25–2.5 per cent. But over the next few years, if the OBR's forecast is accurate, the 15-year average growth rate will fall to 1.7 per cent – its lowest level in the post-war period. Over a 15-year period, the difference between a 1.7 per cent and a 2.4 per cent growth rate cumulates to a total loss of output of 11 per cent (over £160 billion in current terms). This makes it harder to tackle problems such as high youth unemployment and the budget deficit. It also means living standards and the quality of public services will be significantly lower than they would otherwise have been.

What is more, these forecasts assume a relatively benign outcome to the eurozone crisis and that no new problems beset the UK economy. There is probably little policymakers can do to insulate the UK economy from a severe recession in the eurozone, but they can anticipate more local problems, such as a sharp appreciation of sterling or a big rise in repossessions.

Figure 11
UK 15-year average real GDP growth (%)



Source: Office for National Statistics and author's calculations

The roadmap for growth presented here represents the best chance of beginning to reform the economy in a way that maximises the chances of strong and sustainable growth and big falls in unemployment during the next decade. There are two fundamental problems facing the UK economy: the need for more aggregate demand in the short term and the need to ensure the economy's growth potential is sustained in the medium to long term. Dealing with these problems requires a mix of Keynesian policies to tackle demand weakness and structural policies to support supply potential. Each component of the package of policies presented here complements and reinforces the others. It would be a mistake therefore to implement some and ignore others. Doing so would risk an poorer outcome for the economy.

These policies will require an increase in government borrowing in the short term, but this can be done without jeopardising fiscal credibility. The £10 billion annual cost of a temporary NICs cut and a job guarantee programme could be recouped, eventually, through a mansion tax and by restricting tax relief on pension contributions to the basic rate of income tax. But these recuperative measures should not be introduced immediately because the whole point is to add demand to the economy this year and

next. A £30 billion boost to infrastructure spending would fall outside the Coalition's main fiscal target, which is for the current budget balance, but it too would add to borrowing. However, with the government able to borrow at negative real interest rates, this is an eminently sensible thing to do.

References

Bank of England (2011) *Financial stability report, December 2011*, London

Dolphin T and Lent A (2011) *Deficit reduction averaging: A plan B for fiscal tightening*, London: IPPR. http://www.ippr.org/publication/55/1831/deficit-reduction-averaging-a-plan-b-for-fiscal-tightening

International Monetary Fund [IMF] (2012) *World economic outlook: April 2012*, Washington DC

Mulheirn I (2012) *Osborne's choice: combining fiscal credibility and growth*, London: Social Market Foundation

Office for Budget Responsibility [OBR] (2010) *Budget forecast: June 2010*, Norwich: The Stationery Office

Office for Budget Responsibility [OBR] (2012) *Economic and fiscal outlook: March 2012*, Norwich: The Stationery Office