Austerity fails to eliminate UK deficit

History warns against going for growth, but it may be worth the risk

by Brian Reading in London

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Seven years of austerity have failed to eliminate Britain's budget deficit. Growth has suffered. Real incomes have shrunk. Social costs have been grievous, such as the failing health service and housing crisis. But history warns against going for growth. Booms named after former chancellors ended in tears. A balance of payments crisis aborted the 1963-64 Maudling boom. The Barber 1972-73 and Lawson 1986-88 booms burnt out in inflation. In each case international developments were malign, notably the early 1970s commodity and oil price explosions.

Supply constraints are an argument against a dash for growth. Increased demand could raise prices more than production. The Office for Budget Responsibility, the UK fiscal watchdog, has cut its potential growth estimate substantially. Productivity growth has failed to recover to its pre-financial crisis rate and the OBR no longer expects it to do so within its forecast horizon. It cites various reasons, including cheap credit providing life support for zombie companies. But monetary profligacy has been an ineffective antidote to fiscal stringency, distorting income and wealth distribution.

Austerity undoubtedly depresses demand. The International Monetary Fund and others now accept that the multiplier effect of government spending on national income is much greater than previously supposed. Economists maintain that investment drives growth and largely explains cycles in demand. Demand for a product or service elicits investment.

This starts a feedback loop, where demand leads to investment, in turn supporting GDP and productivity growth. If a lack of supply constrains labour and capital inputs, productivity sets the limit to growth. Correlation does not indicate causation. Inadequate demand may explain sluggish productivity growth rather than the reverse.

Data from the Bank of England reveal trends from cyclical series are extremely sensitive to the chosen period. Post-crisis below-trend gaps in GDP range to 19% on the shortest trend period (1985-2006) from 9% on the longest (1885-2006). Whole economy labour productivity (GDP/employment) shortfalls, which matter for living standards, range to 21% from 10%. Post-crisis employment has risen slightly more than pre-crisis trends. The data show a positive correlation between the annual rates of growth of productivity and GDP, and between total factor productivity and GDP growth for both long and short pre-crisis periods. This correlation is strongest for the post-crisis years 2007-16.

Similar below-trend growth and productivity losses suggest that inadequate demand goes a long way to explaining poor productivity. Indeed, productivity is no puzzle when seen from the demand side. The puzzle results from intense analysis of supply constraints without considering whether these are consequences rather than causes of slow growth. Disappointing private non-residential investment despite cheap and plentiful money is understandable, given weak and uncertain demand coupled with cheap labour. Skill shortages long pre-dated the crisis.

Uncertainty around the UK's exit from the European Union is an added factor depressing demand, growth and consequently investment and productivity. The ingredients of a dash for growth are largely accepted outside the Treasury, and it could be worth the risk this time. Cheap finance, while it lasts, is a golden opportunity for enhanced public sector infrastructure investment. Returns exceed costs and benefits accrue to younger generations. Cutting government investment leaves a future burden of maintenance and improvement to be financed when aging squeezes workers' incomes. Debt finance should be taxed to match taxation on dividends. There is no shortage of worthwhile proposals.

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