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Beware Labour's karaoke Keynesianism

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Someone at the Labour party's headquarters has a rudimentary understanding of the Keynesian multiplier and is not afraid to use it.

The party's academic supporters have of late tried to suggest the Corbyn-McDonnell economic worldview is nuanced, with a sophisticated fiscal rule that recognises balance in day-to-day government spending is a reasonable aim, and the unique circumstances where spending more than revenues may be necessary. Well, the viral video launched by the party today eschews all that.

Instead, it's the typical karaoke-Keynesian view you'd expect from someone who hasn't sat an economics class. Freezing teacher's wages will apparently mean less spending on eating out, which means restaurants cancelling renovations, which results in slower economic growth, means the need for more teacher wage cuts, less teacher spending, more cancelled projects, means higher tax credit demand, means more spending cuts and so on. Austerity, it implies, has both reduced economic growth *and* worsened the national debt. It's a false economy.

Now, let's leave pure theory aside for a second. The video, quite simply, doesn't fit the facts of what has happened to the UK economy since 2010. Precisely nobody thought that running deficits at the 10 per cent of GDP the Coalition inherited was sustainable, because it wasn't. The Office for Budget Responsibility estimated the vast majority of that deficit was "structural" and would not dissipate as the economy recovered. If you wanted to stabilise the debt-to-GDP ratio in the long-term, as all sane economists believe is desirable, some form of deficit reduction – restraining spending growth or raising tax revenues – was necessary. If not restraining teacher's pay, then what? And if not in 2010, then when?

The logic of the video is that any spending cuts are always bad for the economy, and any spending increases are good for it. Yet good economic ideas should be scalable. Would the economy really be growing gangbusters if we trebled teacher pay? Of course not. And that shows the video is missing something. Freezing teacher pay means a lower long-term tax burden, and that in itself has an offsetting positive economic impact. It is simply bad economics to chalk up the effects of spending cuts, without recognising that those cuts will mean the restaurants, construction firms and workers will be paying less in tax over their lifetimes.

The reality is that the Coalition government set out spending and tax plans to eliminate the structural deficit within five years, given growth forecasts, and to get debt-to-GDP falling again

by 2015. They front-loaded tax rises and cuts to investment spending (the latter inherited from Labour) to achieve that. By 2011, growth was much slower than expected – and there’s a big debate as to whether that was because the consolidation measures were more damaging in the short-term than expected or whether structural factors limited the economy’s growth potential.

But the government did not cut deeper to compensate, as the video implies. In fact, they continually pushed off their ambitions for structural balance further and further into the future, making consolidation longer but shallower.

The downward spiral of perpetually slower growth and ever-faster growing debt the video implies just didn’t happen. Yes, the national debt as a share of GDP increased – but that was inevitable starting from such a high deficit. Annual borrowing has now fallen from 9.9 percent of GDP in 2009/10 to 1.8 percent of GDP today. As a result, the net debt-to-GDP ratio is expected to finally start falling from next year.

Nor did the British economy begin to shrink. In the years after the tax rises and cuts to investment spending had been made, when cuts to day-to-day spending (such as teachers’ salaries) were doing the donkey work in deficit reduction, the economy was actually growing at a very reasonable clip. It’s pretty clear that the recent slowdown is an uncertainty effect from Brexit and nothing to do with spending cuts. The alternative to this policy framework is not “doing nothing” but more taxation or more borrowing, which themselves would have had detrimental effects on growth in the shorter and longer term.

For all the appeal of the simple story-telling of the video, this explanation that the economy has been weak because of day-to-day government spending cuts just makes no sense. If it were true, we’d have expected both employment and output to have struggled. In fact, employment growth in the UK has been very strong throughout the period of supposed austerity. This scenario cannot be explained through the traditional Keynesian mechanisms of sticky wages or some kind of liquidity trap. The slower productivity growth, high employment outcome we have seen (which, by the way, is also occurring in the US where they ran a stimulus for longer and are still running vast deficits) requires a different explanation.

One could make the theoretical case that higher levels of infrastructure investment or even lower marginal tax rates could have improved the UK’s productivity performance somewhat over the past eight years. You’d have to trade that off against the long-term effects of higher taxes or spending cuts in future, but a decent theoretical argument could be constructed. Yet I’d wager no respected economist would be willing to suggest that higher wages for government employees was the reason that growth in output per worker has been slower since the crash here, or indeed around the advanced world.

Much as the Corbynites wish to will it away, the simple truth is that in the long-term government spending and borrowing has to be financed in some way. Looking at the impact of freezing teacher salaries in isolation, without recognising that that enables lower longer-term tax rates and looser monetary policy in the near-term, is to engage in partial and simplistic reasoning. Today, with interest rates rising, and the problem sustained slow potential growth, we should be moving away from this Punch-and-Judy debate that suggests all economic ills arise from nasty government cuts. But, as with so much else of the party’s platform, Labour seems determined to re-fight the wars of yesteryear.

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