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Why Governments Won't Invest

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Abstract

The UK Government is currently exerting a sharp and tightening squeeze on public investment at a time when borrowing for public investment has never, historically, been cheaper with interest rates close to zero in real terms on long term public borrowing. Moreover, financially prudent and disinterested bodies like the IMF are calling for the UK to be more expansive in public investment. In this paper I discuss the Treasury's aversion to public investment, an issue which has persisted for some time, but become all the more pressing since the financial crisis. I argue that policymakers should focus on identifying and investing in high quality, professionally assessed, public projects – something that can be aided by a National Investment (or Infrastructure) Bank which would neatly complement the newly created Infrastructure Commission. But, like the Green Investment Bank, and other institutions before it, it would be allowed only a very modest role unless the institutional obsession with curbing public investment can be overcome.

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To many of us it borders on the incomprehensible that the UK government is not taking advantage of historically low, long-term, market interest rates to borrow to invest. 10-year index linked gilts have a 2.5% coupon of which 2% is expected inflation. Government borrowing is virtually interest-free. Yet not only was public (net) investment slashed in the wake of the financial crisis, this government plans to cut it further from 1.9% of national income in 2014/15 to 1.4% at the end of the parliament[1] (from over 3% of GDP in 2008/9).

This is not only a British issue. The slowdown in the world economy predicted for this year and deeper pessimism captured in the idea of 'secular stagnation' as advanced by Lawrence Summers among others, have led to advocacy of a fresh fiscal stimulus based on public investment.[2] The IMF advocates such action in countries with fiscal discretion, especially where there are concerns about the effectiveness and potential negative side effects of further monetary easing. The USA and the UK are both candidates. The current trajectory of fiscal policy is however in the opposite direction.

There is no shortage of ideas for potential investment, not least from British businesses who complain continually about inadequate or dilapidated infrastructure: broadband, roads, railways, airports and ports. There is clear empirical evidence that capital investment produces multiplier effects on employment and output considerably greater than equivalent amounts of other forms of public spending or tax cuts. Moreover, there is no shortage of creative ideas for institution building to shield public investment from political interference or to develop a concentration of technical, financial and management expertise. One example is the newly created National Infrastructure Commission[3]; another is the concept of a National Investment or Infrastructure Bank, promoted by Keynesian critics of the government.

Yet it doesn't happen. Nor is this a new problem. Under different governments and different economic conditions there has been enormous resistance to public investment led by the Treasury. The pre-crisis Labour government eschewed government market borrowing for more expensive PFI finance and, post crisis, cut capital spending ahead of current spending. Throughout, public enterprises like the Royal Mail were starved of investment capital required for modernisation. Under the Coalition, despite the efforts of some of us within it, capital spending was severely curbed. New institutions which I launched with the support of Liberal Democrat colleagues like the Green Investment Bank and the British Business Bank were heavily constrained in their borrowing ability; and it was necessary to privatise the Royal Mail to liberate it from investment rationing.

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[1] Calculated based on the latest data in OBR Economic and Fiscal Outlook, March 2016
[2] Lawrence Summers, Strategies for Sustainable Growth AEA 2013.
[3] One of the key recommendations of the LSE Growth Commission

By the time of the 2015 election, both Labour and Liberal Democrats had revised their position and advocated market borrowing by the state to finance higher levels of public investment. But they lost and are unlikely to be able to implement their new policy for the foreseeable future. The question remains as to whether this is the right approach and why there has been so much resistance.

The Historic Legacy

Many of the habits of mind that influence policy today were formed in the different, and generally more relaxed, policy environment before the crisis.

The dominant strand of thinking was 'crowding out theory'. The economy was (more or less) fully employed. The government was one of the competitors in capital markets and heavy public borrowing would push up the cost of capital, discouraging private investment.

And in pre-crisis days there was also a belief in 'efficient' financial markets; markets would efficiently incorporate in the price of capital all the various elements of risk to ensure that private capital is efficiently allocated, in contrast to the supposedly haphazard and politicised bargaining over priority projects in Whitehall.

The same ideological mind-set encouraged the belief that, for a variety of reasons, the public sector will always manage projects worse than the private sector: the 'agency problem' of civil servants with an interest in job protection or buck passing rather than delivery; political interference and a reluctance to axe failing projects; lack of project management expertise. A long list of horror stories from CCGB power stations to NHS hospitals and IT contracts endlessly delayed and over budget gave plausibility to this narrative; as did a lot of international experience from Japanese 'roads to nowhere' to old fashioned aid extravaganza of various kinds.

Recent experience has undermined those earlier certainties. The 'crowding out' model does not seem relevant in current conditions. Even with very cheap capital, many corporates are sitting on large piles of cash rather than reinvesting profits. There has been a surge in merger and acquisition activity and in share buy backs because excess capacity and expectations of weak demand growth have weakened investment demand. In these conditions, it makes no sense to argue that public investment is 'crowding out' private investment. Interventions like the Regional Growth fund and the Green Investment Bank have 'crowded in' investment that would not otherwise have occurred. Indeed, their terms of reference made it clear that they should only invest in these circumstances.

The financial crisis has also seriously undermined confidence in efficient private capital markets. Risks in derivatives markets were not properly priced with disastrous consequences. One consequence of the crisis has been a flight from investment risk in general – what Andrew Haldane (Bank of England) calls 'dread risk'[4] – rather than a readjustment of risk pricing.

The pessimism about public sector project management has had to be reappraised in the light of practical experience of outsourcing projects through public procurement. The same officials who struggled with project management struggled just as much to negotiate complex contracts with private providers. The mixed history of PFI and PPP is replete with bad cases, and where there are lawyer-intensive, impenetrable, performance contracts there have been big incentives for exploitative behaviour by private providers and intermediaries.

In any event, the biggest criticism of public sector investment, that it is easily politicised, can be neutralised by operationally independent, stand-alone institutions. The Green Investment Bank is a good model in the UK and those advocating a National Investment Bank envisage a similar governance structure.

Public Investment and Austerity

Even though the lazier criticisms of public investment have lost some of their force, the post crisis years have not opened the floodgates: if anything the opposite.

When Alistair Darling announced austerity measures at the end of the Labour government, in the depths of post crisis recession, the deepest cuts (by around 50%) were in capital spending even though the negative multiplier effects on output and employment were so much larger than, say, for raising taxes (1.0 versus 0.4 according to the OBR; 1.7 versus 0.9 according to the IMF[5]).

The Coalition adopted and implemented these cuts although the agreed central objective of fiscal policy was to eliminate the cyclically adjusted current, structural, deficit. The rationale was the 'supplementary debt target' (debt as a share of DGP) introduced for the 2010 Spending Review, requiring that the ratio should be falling. In fact, the previous Labour government also had a supplementary debt targets (40% of GDP, net public debt) roughly equivalent to the 60%, gross debt target of Maastricht and, pre-crisis, made much of these being achieved. Within the Coalition, some of us questioned the priority given to debt targets at a time when the twin objectives of policy were to reduce the current structural deficit and to stimulate growth. But towards the end of the Coalition government, and unambiguously under the Conservatives, there has been no pretence that the policy objective is to reduce the 'current deficit'. 'The deficit' was redefined as all government borrowing regardless of whether it was for current or capital purposes.

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[4] See, for example "Stuck" (Speech given on 30 June 2015).

[5] These figures are used in the IMF country report on the UK 2012/13. They are still well below the numbers assumed in Keynes' General Theory of 3 and 2 (see "Keynes and After", by Michael Stewart, 1967).

The reason why the supplementary debt target was regarded as so important had to do with a hypothetical 'trigger point' or 'cliff edge': beyond a certain point, confidence in the government would evaporate leading to a sharp rise in bond yields, and in the cost of government borrowing, thence to the potential of unsustainable debt and market concerns over default. The experience of southern Europe when bond yields reached high levels – double digits – in 2011/12 reinforced fears that such 'trigger points' exist. The academic underpinning for this view came particularly from the work of Reinhart and Rogoff (2010)[6] who argued that a 90% net debt to GDP ratio represented a dangerous 'cliff-edge'. Increases beyond this magic number would fling economies into downward growth spirals. The Reinhart Rogoff work has since been pretty comprehensively debunked but I can confirm it was used on several occasions to warn the Coalition Cabinet of the risks of borrowing.

However, quite apart from the diminished credibility of the Reinhart Rogoff work, recent experience casts doubt on the usefulness of thinking about 'cliff edges'. Japan, whose public debt ratio is roughly three times the level of the UK, has the lowest borrowing costs of any major economy (0.3% for 10 year bonds in nominal terms). Italy, which has a gross public debt ratio well over 100% (134.6% in 2015 Q3[7]) and a poor reputation for managing public finance, has borrowing costs identical to the UK. Such factors as expected inflation, expected growth, debt maturity structure and domestic ownership of public debt (high in Japan and Italy) are as important as the ratio itself. And it is striking that Kenneth Rogoff himself, whose name was invariably used by the Chancellor and the Treasury to justify curbs in borrowing of all kind, has recently advocated government borrowing for productive investment. [8]

Rogoff may have outlived his political usefulness. But Rupert Harrison, who as the Chancellor's Special Adviser was a key influence on economic policy in the Coalition years, has recently set out clearly and honestly (in the Financial Times[9]) why the scares about public debt are of continued value: to maintain a state of 'paranoia' without which fiscal discipline and a continued commitment to deficit reduction are difficult to sustain.

Interpreting the Debt Ratio

Even if we were to concede that the debt ratio really matters, it is still not clear why capital investment should be so constrained since productive investment generates additional output and a

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[6] Carmen M. Reinhart & Kenneth S. Rogoff (2010). "Growth in a Time of Debt," *American Economic Review, Papers and Proceedings*, 100(2), 573-78
[7] Euroindicators News Release, Eurostat, 22 January 2016
[8] "World's economic slowdown is a hangover not a coma", Kenneth Rogoff, Financial Times, 9 October 2015
[9] "In praise of post-financial crisis paranoia", Rupert Harrison, Financial Times, 11 December 2015

stream of income, inflating the denominator (GDP) of the ratio as well as the numerator (debt). To this, the Treasury will make several objections.

First, there will be a time lag between the borrowing and the outcomes. The debt ratio rises temporarily. But this would only be a serious objection if the country where near to a market trigger point.

Second, some projects will not produce a return to offset the increased public indebtedness but are, just, nice to have (a rebuilt school or hospital; a new or refurbished university laboratory). But all of these will have multiplier effects if there are unemployed resources. Even if there were few unemployed resources and low multipliers there are plenty of government investment projects which do produce a commercial or near commercial return (Green Investment Bank projects; investment by London Underground or Railtrack; local authority investment in housing for rent or subsequent sale), and others which produce economic returns (roads) or stop negative returns (flood defences). When the government is making much of an initiative to commission directly housing development of public land, it seems blindingly obvious (but not to the government) that public financing would expedite development. More generally, a small army of economists are employed in Whitehall and beyond on project appraisal to identify projects with good economic returns.

It is sometimes the case that current spending is just as productive, or more, than capital spending. Grants to support innovation, vocational training or further education with transferable skills, or childcare, can produce high rates of economic return, perhaps better than new buildings. Often maintenance (current spending) to sustain infrastructure produces large and quicker returns than new capital works. There is certainly a need for some reclassification of public spending in a way that captures those distinctions.

A third Treasury objection based on its interaction with bond market practitioners is that under the key accounting metrics which markets understand and accept – that is, aggregate government borrowing and total net debt ratios – it will usually make more sense to dispose of public assets than to invest further in them. The sale of shares in a government entity raises cash (and temporarily reduces borrowing) and reduces gross debt but also, depending on valuations, can be presented as a reduction in net debt. By contrast, borrowing to finance investment by a government body may create an asset (machinery, a building) but – bizarre as it may seem – this is not properly accounted for and so the activity is treated as adding to gross and net debt as well as government borrowing. The current enthusiasm for 'selling the family silver' has its roots in bizarre Treasury accounting conventions.

The trend is to squeeze public investment even harder. A substantial number of bodies under private or charitable ownership have recently been reclassified as 'public sector' because of the degree of government control or regulation: housing associations, further education colleges, Railtrack. Universities are similarly at risk. They, like the rest of the wider public sector, including councils and devolved governments, are now blighted by the presumption against public investment. The advocates of a National Investment Bank appear not yet to appreciate the significance of the fact that the Office of National Statistics will classify it, similarly, as public sector. Since the ONS is – these days – independent of political control, government ministers do not have the power to remove this roadblock.

Even if the economic and accounting problems can be surmounted, the Treasury's killer argument will often be that 'there is nothing to invest in'. Technically, this may be true as annual accounting makes it difficult to assemble, evaluate, approve and launch often complex projects within a short period of time. But the absurdity of such self-fulfilling objections merely underlines the urgent need for reforming the way the Treasury manages public finance and the metrics it uses.

The Treasury alternative to public borrowing for investment has been to use private long term institutional investors like pension funds and insurers securing the investment via guarantees (which has a lower charge on public debt) and through incentives provided by the Regulated Asset Base of utilities. In practice, our efforts in the Coalition to mobilise investment in this way were a dismal failure. Regulatory constraints prevented investors from committing funds and the guarantees/RAB formula failed to overcome perceived risk. One odd, indeed ludicrous, consequence of this circuitous route to avoid state investment has been that the main investors attracted are state companies from overseas.

Establishing a National Investment (or Infrastructure) Bank is almost certainly a good idea to create a pipeline of high quality, professionally assessed, public investment projects. It would neatly complement the Infrastructure Commission established under Lord Adonis. But, like the Green Investment Bank, and other institutions before it, it would be allowed only a very modest role unless the Treasury's obsession with curbing public investment can be overcome.