

Policy Brief

The role of public spending and incomes policies for investment and equality-led development in the UK

Özlem Onaran, Maria Nikolaidi and Thomas Obst, University of Greenwich
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Abstract: This policy brief presents how a mix of fiscal and labour market policies could affect growth, investment and public budget in the UK. Based on an econometric model, we simulate the joint impact of an increase in public spending by 1% of GDP (about £20bn per year) along with more progressive taxation (increasing effective tax burden on capital by 1% and decreasing tax burden on labour by 1%) and an increase in the wage share by 1% of GDP. As a result, GDP increases by 3.37%. Private investment increases as well by 0.72% as a ratio to GDP. The budget balance in the UK improves by 0.04% as a ratio to GDP. Inflation increases only slightly: the price level goes up by 1.8 percentage points. The effects are even more favourable if policies are implemented simultaneously together with our trade partners in the EU.

Keywords: public investment, wage share, wage-led growth, incomes policies, progressive tax, equality-led development, Europe

JEL codes: C23, D22, G31

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Corresponding author:

Özlem Onaran: Greenwich Political Economy Research Centre, University of Greenwich, Park Row, Greenwich, London, SE10 9LS, UK, e-mail: o.onaran@gre.ac.uk, phone: +44 20 8331 8519.

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The public discontent expressed by the Brexit referendum shows that tackling both inequality and insufficient public infrastructure should be at the forefront of the UK economic policy in the next years. Our recent research (Obst, Onaran and Nikolaidi, 2017) shows that, apart from its beneficial social effects, a policy mix that would include an increase in public spending and a redistribution of income from capital to labour would have a favourable impact on key UK macroeconomic variables, such as growth, private investment and public budget.

In particular, based on a multi-country econometric model, we simulate the joint impact of an increase in public spending by 1% of GDP (about £20bn per year) along with more progressive taxation (increasing effective tax burden on capital by 1% and decreasing tax burden on labour by 1%) and an increase in the wage share by 1% of GDP. As a result of such a policy mix, GDP in the UK turns out to increase by 3.37%. Private investment increases as well by 0.72% as a ratio to GDP. This means that crowding out is not a problem since public investment complements and crowds in private investment. Importantly, the budget deficit does not deteriorate. On the contrary, budget balance improves by 0.04% as a ratio to GDP because the beneficial fiscal effects of higher economic growth and higher tax rates on capital offset the impact of higher spending. Inflation increases only slightly: the price level goes up by 1.8 percentage points.

A coordination of policies at the European level would further improve the effectiveness of the suggested policy mix due to strong positive spill-over effects. For example, if the same policy mix is implemented across the EU, growth in the UK would increase by 4.47% and budget balance would improve by 0.13%.

The key message of our results is that expansionary fiscal policy can have a significant contribution to economic growth and can be sustainable when it is combined with wage policies and progressive taxation. In practice, the suggested wage policies can be implemented by re-regulating the labour market, improving the union legislation, increasing the coverage of collective bargaining, and enforcing equal pay legislation more effectively. A rise in minimum wages could also have significant beneficial effects. Particularly in the UK with a decentralised collective bargaining system, Guschanski and Onaran (2016) find that such a policy could offset the negative impact of technological change or globalisation on the wage share.

The positive effects of public spending go beyond those examined with our econometric model. Public investment as part of an industrial strategy is key to achieving higher productivity, which in turn is crucial in reducing the UK's trade deficit. While higher demand might lead to a small deterioration in the trade balance in the short run, in the long run, productivity gains are likely to improve exports and reduce import dependency.

Public spending in physical and social infrastructure can also be conducive to environmental sustainability and gender equality. For example, public investment in green projects could reduce the carbon intensity of the UK production and consumption. Also, spending in health, social care, education, and child care is crucial for improving gender equality and could lead to the creation of jobs with high labour intensity – having an additional beneficial effect on carbon intensity.

References

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