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PERSPECTIVE

A Progressive Growth Strategy for the United Kingdom

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The Macroeconomic Position

The economic history of the United Kingdom over the past 30 years can be summarised as a period of fairly successful microeconomic reform, leading to relatively high productivity growth, interspersed with episodes of disastrous macroeconomic and financial mismanagement. Unfortunately, we are living through such an episode at present. Although growth has now returned this remains the slowest recovery in the United Kingdom's recorded economic history. The National Institute of Economic and Social Research (NIESR) forecasts that real per capita gross domestic product, the simplest measure of how prosperous we are as a country, will not return to its 2008 for several more years.

How did we get into this mess? The financial crisis of 2007–2009, and the ensuing Great Recession, was global. However, UK policymakers, especially those in power in the 1990s and 2000s, contributed as much as anyone to a prevailing philosophy that the only appropriate intervention in markets was to deal with specific, identified cases of market failure.

When it came to financial markets, that approach proved to be wholly inadequate. The direct result was a combination of perverse incentives, failures of corporate governance and unanticipated systemic risk in the financial sector that helped spark the crisis. Indirectly, it increased inequality at the top end of the income distribution (at the same time as, thanks to the introduction of the national minimum wage and tax credits, it was falling at the bottom end for the first time in decades). And it meant that the United Kingdom was far too reliant on one volatile sector for both growth and tax revenues, which in turn left the public finances extremely vulnerable to a severe downturn in that sector. All this meant that the crisis hit the United Kingdom particularly hard.

By contrast, the initial policy response in 2008–2009 – bank recapitalisation and fiscal stimulus – was relatively successful. Unfortunately, however, emergency bank recapitalisation was not followed up by proper restructuring. And, in mid-2010, leading the way in the G20, the Coalition Government reversed course on fiscal policy in mid-2010, with the Prime Minister David Cameron describing the new approach as »fiscal conservatism and monetary activism«. This was justified by sustained attacks on those calling for a more balanced approach. The Prime Minister suggested that the »the only way out of a debt crisis is to deal with your debts. That means households – all of us – paying off the credit card bills.« The Deputy Prime Minister claimed that the government will »wipe the slate clean of debt« for the sake of our children.

While, fortunately, the reality has not been nearly as extreme as the rhetoric, as the government has by and large allowed the automatic stabilisers to operate, it is still the case that »fiscal conservatism« – described by the International Monetary Fund as a »large and front-loaded« fiscal consolidation plan – had a substantial and negative impact on growth. The halving of public sector net investment (a cut of more than 1.5 per cent of GDP), planned by the previous administration and implemented by this one is now almost universally recognised as a major policy error.

But the impact of »monetary activism« is far less clear. Although the Bank of England did indeed expand its quantitative easing programme, this has become subject to diminishing marginal returns. Meanwhile, the financial sector remains dysfunctional. It is manifestly failing to fulfil its primary function of channelling credit to the real economy, particularly small businesses, while larger businesses, many of whom have ample cash reserves, are reluctant to invest given the continued uncertainty about future demand, both in the United Kingdom and elsewhere.

The result, combined with even worse policy failure in the Eurozone – where the pursuit of misguided fiscal policy has been far more dogmatic, and hence damaging – has been two years of stagnation. Perhaps even more serious is the long-term impact of underinvestment, both public and private, on future growth.

Of course this applies with even more force to the European Union as a whole; we have seen the creation of a death spiral of deficit cutting, leading to reduced growth – which in turn leads to reduced revenues and pressure to cut deficits faster. Paradoxically, the EU was set up in part to avoid such problems by allowing members to cooperate to secure better outcomes. But, instead of economic policy coordination, what we've actually had is a fiscal suicide pact.

Fortunately, with fiscal consolidation having slowed, financial conditions easing, and, at least for the moment, apparent stability in the eurozone, the UK economy has returned to growth – although the fact that even in current conditions this has been accompanied by house price rises, concentrated in London and the South East, gives cause for concern. With unemployed workers and plenty of spare capacity, there is plenty of scope for improvement in the short term. The United Kingdom suffers from both creaking infrastructure and a chronic lack of housing supply, and long-term interest rates remain very low by historic standards.

It would be sensible and realistic to target an increase in public investment spending of perhaps 2 per cent of GDP, focused particularly on housing, until macroeconomic conditions have normalised, with growth above trend and unemployment heading back down towards the pre-crisis rate. Ideally, such an approach should be coordinated at a European level – all EU countries, especially those in severe and prolonged recessions, would currently benefit from a coordinated boost in demand.

Sustainable Growth in the Medium Term

But getting short-term macroeconomic policy right can only limit the damage – it cannot in itself generate sustainable growth. A progressive growth strategy needs to reorient the UK economy towards equitable long-term growth that is less reliant on the financial sector and more oriented towards investment and exports. This means both building on some of the successes of the past thirty years – and they were real – as well as addressing areas in which we have underperformed. I would identify three main challenges; first, our people; second, our welfare state and public services; and third, economic dynamism.

(a) People: the forgotten 50 per cent

The United Kingdom has seen a remarkable, and remarkably successful, expansion of higher education over the past three decades. But that has been accompanied by a growing socio-economic gradient of educational and hence labour market attainment. The result is that a large proportion of those who don't go on to higher education end up without the skills that are useful in today's labour market – let alone that of the future.

Three policies are needed to deal with this:

- *Schools*. Here we have a clear model: the remarkable, unexpected and unprecedented success of London's schools over the past decade, both in improving average attainment and in narrowing the attainment gap. At its best, this success reflects a number of factors: strong political commitment at both central and local levels, extra resources and embedding high expectations for all pupils in the system.

- *School to work transition*. For those going to university, the path from school to career is clear, if not always easy; for the rest, it is a minefield. We need to set out a clear vision of how young people move from school into apprenticeships, skilled jobs and then careers.

- *A guaranteed (and compulsory) employment scheme* for the young unemployed people who fail to make that transition successfully – not after one or two years on the dole, but after three months. Long-term youth unemployment does long-term damage, both economic and social.

The UK labour market has performed remarkably well during the recession; both workers and employers have been much more flexible than in previous downturns. Jobs haven't been cut – but wages and hours have. It has been painful for many, particularly as it has reinforced a growing trend towards the casualisation of some previously permanent full-time jobs, but is far better than the alternative. In the United Kingdom, the answer is not more labour market regulation, but we should seek to influence the ways that employers behave, and how they value and invest in their workforce.

(b) Public services, welfare, pensions, and housing

The UK public remains committed to high quality public services – education, health and social care – provided largely free at point of use. But it also remains reluctant to pay the taxes necessary to fund them. This contradiction will intensify: over time, an increasingly affluent society (as, on the whole, we will become) is likely to want to spend more on improving the lives of its citizens, and an older society is likely to want to spend more on the priorities of older people. This has to mean, one way or another, better off older people – especially those who benefited from the long house-price boom – paying more. There are lots of ways this could be done – higher property or inheritance taxes, or charges for services, all payable only after death – but we need to end the expectation among relatively well-off people that they are entitled both to depend on publicly financed services in their old age and to leave their houses to their children.

The long-term future and financing of public services and the welfare state cannot be divorced from the operation of the UK housing market, which has done a tremendous amount of economic and social damage over the past half century. The combination of restrictive planning rules, high population growth, social trends towards smaller households, the fetishisation of home ownership and a dysfunctional mortgage market has led to a very large increase in house prices. This has substantially increased the inequality of wealth, probably reduced labour mobility and certainly contributed to the severity of the past two recessions. And it has pushed up the cost of the least effective part of the benefit system, housing benefit.

A progressive government would say that house prices in the United Kingdom should be more affordable, not less; and implement policies – on planning, social housing, the private rented sector and the mortgage market – designed to achieve that.

(c) Economic dynamism

The tragedy of the past 20 years is that so much of the inherent dynamism of the UK economy has been misdirected into rent-seeking in the financial sector rather than value-creating activities. That does not mean that we don't need a healthy financial sector – on the contrary, it is a sector in which long-term global growth prospects are good and we have a clear comparative advantage. But there are huge distortions in the way the sector currently operates. We need to reshape it so that, domestically, it performs its central task of channelling money from savings to investment in the real economy; and internationally so that it delivers real value to customers; or it will not ultimately be sustainable or successful.

That will require changes not just in regulation, but in corporate governance, market structure and ethical standards. Transparency on pay would be a start – perhaps with, as in Switzerland, obligations to secure affirmative consent from shareholders (and indeed, especially in financial institutions, other stakeholders).

The dominance of the financial sector, and its focus on short-term rent-seeking behaviour, has also contributed to the weakness of the UK economy in turning its generally good performance in primary research into innovative businesses. Getting innovation policy right is notoriously tricky and is certainly not about throwing public money at private business; but there is a strong case for redirecting money from the wasteful and ineffective »patent box« (essentially a government subsidy to large pharmaceutical companies) to co-financing riskier, long-term investments.

A real challenge to restoring UK economic dynamism is the current pressure for restrictive immigration policies. Government needs to make clear that immigration, like trade, is indeed central to making the United Kingdom open for business, and hence to our growth strategy. The next step would be to examine each aspect of immigration policy – but in particular those relating to students, skilled workers and settlement – with a view towards reorienting them towards growth. Greater coordination of policy at EU level – in particular, aimed at facilitating mobility of skilled workers – would also help.

Beyond »Growth«

Growth matters. But it matters as a means to an end, not an end in itself. Whether we phrase it in the traditional economic language of »utility functions«, or the more fashionable concept of »subjective well-being«, it is human welfare that we should ultimately be concerned about. That's not just about equity, redistribution or the provision of decent minimum standards for all, although all these are important; it is about giving everyone a chance to succeed; and, if they fail, another chance.

There is no magic formula, either for the United Kingdom or for other developed countries struggling with similar issues. We should be optimistic – taking a medium term view, our countries have never been so prosperous, our people never so educated, technological and scientific progress never so rapid and potentially liberating, and the scope for continuing to improve human welfare never so great. If »progressive« means anything, it should represent a belief in the potential for government and society to fulfil that potential for human progress.

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