

LSE GROWTH COMMISSION

LSE Growth Commission Launch Event **With Professor Larry Summers and Professor Stephen Nickell**

*Please note that the views expressed by the evidence givers do not necessarily
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In order to mark the launch of the Commission, and assist in setting its agenda, Professors Larry Summers and Steve Nickell gave evidence on Monday 23 January on how to improve the growth performance of the UK economy in the medium to long term. This note provides a summary of the main arguments made.

Opening the discussion, Nickell took an orthodox view with a focus on the supply side of the economy. He began by noting that while output growth is made up of two components: labour input growth and productivity growth, the key focus of any growth strategy must be on productivity growth. In levels, the UK lags behind the US, Germany and France, and there are a number of areas that should be addressed to close this gap. He began by citing the McKinsey report from 1998¹ which identified the primary barriers to productivity growth for the UK as: low competitive intensity, regulatory barriers, poor management practices and skills. Also identified were low capital intensity and a lack of labour force skills.

Over the years since 1998, he argued, the competition policy regime has greatly improved, but not much else has changed. Given the fact that the main contributor to overall productivity growth is the service sector (due to its sheer size), we must focus on how to remove the remaining barriers that affect this sector. With respect to regulation, planning regulations are most relevant for retail, distribution and construction; immigration controls for education and there are significant regulatory barriers to introducing competition for health. Rather than merely producing a list of what is needed, the Commission should consider the political challenges of removing or changing some of these regulations, which are substantial in all these areas.

For Nickell, a shortage of skills is an important issue, in particular with respect to mid-level skills. There is a lack of numeracy and literacy in the bottom 60% of the ability range, and while an apprenticeship system has been introduced, Nickell noted that it took Germany and Switzerland 100 years to develop theirs.

On the need to improve management capabilities, Nickell referred to the extensive work of John Van Reenen², and gave the example that multinational owned firms tend to be better managed.

¹ "Driving productivity and growth in the UK economy", McKinsey, October 1998

² For an introduction to this work, see "Why Do Management Practices Differ across Firms and Countries?", Journal of Economic Perspectives, Winter 2010

Despite the evidence that MNE activity can be good for productivity (he cited the example of the UK car industry), there tends to be significant political objection to foreign takeovers.

On the widely discussed need for rebalancing the UK economy, away from services and towards manufacturing, Nickell noted that the size of the UK manufacturing sector is similar to that of France or the US, with Germany being an outlier. On the dominance of financial services and associated risks, he felt that it would be better to focus on setting appropriate capital requirements to prevent future crises and bail-outs, rather than introducing policies that cause the banks to move elsewhere.

Nickell closed by summarising some other specific areas which are important for productivity. These included: the need to fund infrastructure investment from alternative sources, improving the UK's capabilities in commercialising scientific innovations, and examining the tax system with respect to R&D incentives and innovation. Finally, access to credit, the regulation of banks and the resulting higher cost of capital will all be important, even for long-term growth.

Larry Summers took a different angle, emphasising the need to consider the demand side in addition to the supply side. He began by making three high level observations about the world in 2012.

First, humility is required in formulating an approach to growth policy. Surprisingly, the correlation of a country's economic growth from one decade and the next is close to zero (and this holds across many countries and different decades). This tells us that the commonly cited determinants of growth: such as savings, work ethic, or culture are not that important. If they were, you would expect some persistence in growth performance. Therefore, it appears that there is no set "formula" for achieving growth.

Second, the world is changing. Over the past 27 years in the US, there has been a 50-fold increase in the price of healthcare relative to TV sets. A combination of inelastic demand and rapid technological progress limits the employment opportunities in sectors such as TV-set manufacturing. What is needed for growth is a combination of demand and productivity increases.

Third, the world is becoming smaller and more integrated. The most telling signs of this are the increase in reciprocal investment between countries and the increase in trade in tasks rather than goods. Rather than merely focusing on increasing exports of domestic companies, these changes imply the need for viewing the nation as a platform for economic success – upon which it is attractive for companies to locate. It also implies that countries need to build on strengths rather than compensate for weakness, with less need for diversified economies and more focus on comparative advantage.

A series of more specific observations followed. Summers argued that macroeconomic policy cannot be separated from long-run growth. If output remains below potential, this will impact the capital stock inherited by the next generation, the career prospects of school-leavers and managerial habits. A 3% reduction in potential GDP due to the recession is large relative to any gains that can be achieved through supply side policies.

For Summers, one of the issues that the Commission should turn to first is establishing clarity on its attitude towards financial services. While one must be sensitive to the sector's role in instability and inequality, the UK's comparative advantage in the sector is clear and it is unlikely that other sectors can be found to replace the City as a wealth generator. Where subsidy is not a driving factor, one should not seek to judge exports of financial services. In terms of addressing inequality, Summers argued that a better starting point might be examining tax laws that make the UK a favourable destination for foreign billionaires.

On the issue of pure versus applied science, Summers emphasised the role of culture in encouraging entrepreneurship and innovation amongst scientists. However, he pointed out that this also implies trade-offs and difficult decisions: what proportion of their time should professors and students spend on commercial activity rather than pursuing scholarly interest (the higher the proportion, the higher the likelihood of finding marketable ideas, but also of making mistakes), and how should rents be shared when commercially successful innovations have been funded by research councils or universities? These are decisions that need to be made by university leadership and will in turn create the culture that determines the levels of commercial activity.

Summers agreed with Nickell on the importance of skills for medium to long-term growth, but also raised the need for the UK to ensure that it not only educates, but retains the most talented graduates.

Finally, Summers noted that this type of project rarely gives sufficient weight to economic geography. According to economic theory, regional disparities in productivity should equalise. However, this is not seen in the data. Lagging areas are more of a drain on the UK economy than in other countries, and to address this it is necessary to either move capital and entrepreneurship to areas where they are lacking, or move people to areas where they are plentiful.

In the exchange with the Commissioners, some other issues were raised, in particular with respect to measurement of output, and whether other measures should be considered by the Commission in addition to GDP, such as education, health and the environment.

On public sector output measurement, both Nickell and Summers agreed that while it can be very difficult to measure meaningfully, this is more the case in some areas than others and some measure should be included in total GDP. In addition, both agreed that other measures are also important, but argued that trying to create a composite index would be less useful than just considering those other measures in addition to GDP.

Another interesting measurement issue was discussed in light of the size of the manufacturing sector, and its apparent decline in recent years. Nickell explained that in the UK, outsourcing is a much more widespread phenomenon than in other countries and leads to a much lower portion of GVA being recorded in the manufacturing sector than the business services sector (which carries out a lot of the administrative, financial and housekeeping activities which were traditionally all carried out in-house by manufacturers). This, he argued may imply that total activity from manufacturing has not declined as much as is commonly thought.

All the issues discussed at this launch event are to be considered by the Commission in its meeting on Friday 27 January where it will be setting its agenda.