

II. The economic story of the UK

The growth process

Economic growth is the increase in a country's capacity to produce goods and services. We care about such gains because they lead to improvements in citizens' material wellbeing through higher consumption, greater leisure and/or improved public services. We prefer these fruits of growth to be as *inclusive* as possible rather than for them to be appropriated by a small, fortunate slice of society. Thus, all advanced economies have mechanisms for distributing the fruits of growth more widely through taxes, benefits and the provision of public goods such as education. And equipping citizens with skills gives them the best chance of participating in the process of growth.

Policies that have a small positive effect on the annual rate of economic growth can have a huge effect on long-term human wellbeing as these increases become compounded over time. An economy that grows at 2 per cent per annum in real terms (which was the UK's average growth rate between 1830 and 2008) doubles its material living standards every 35 years.

The modern theory of economic growth argues that the world's potential to grow is determined in the long run by the accumulation of ideas – scientific, technological and managerial – that make it possible to do more with the raw materials that we have. Sustainable growth is not about increasing the basic labour input of the population but rather about finding ways to do new things as well as doing the same things more efficiently.

Creating a dynamic economy requires investment of three basic kinds: in people (human capital), in equipment and physical structures (infrastructure) and in new ideas and technologies (innovation). Our report focuses on all three. Investments in education and research and development (R&D) help to create new ideas and extend the technological frontier. But they may also help a country to catch up with leading edge countries, making it possible for firms to learn about and absorb innovations from elsewhere.

The modern era of economic growth began around 1800 when a collection of economies initially led by the UK pulled away from the rest. The growth sparked by the industrial revolution was impressive, but what remains remarkable is how few countries emulated the success of the UK and, not long after, France, Germany, Scandinavia and the US. This is because investment requires a supportive climate in which to flourish.

History shows that markets need government support with predictable rules and regulations. Government also plays a key role in supporting a productive economy through encouraging investments in skills, infrastructure and new technologies. But the quality of government depends on institutions that encourage a focus on long-term economic needs. Without these, the powerful forces unleashed by market incentives cannot be harnessed for the common good.

There is no reliable evidence that the growth potential of an economy is limited by the size of the government over the wide range we see in OECD countries. Indeed, the twentieth century witnessed a significant increase in the size and responsibilities of government throughout the developed world alongside large and sustained increases in living standards. Different market economies can be economically successful with high or low levels of state spending – for example, Scandinavia versus the US.

Thus demands for ever greater deregulation and reductions in government spending as a panacea for the UK's growth problems are misguided. Growth is less about the precise size of the state; it is much more about whether the state is smart in the way that it regulates and spends. Having a government that plays a major role in the economy – as we do in the UK – places a premium on well-designed policies that support growth. Achieving this is heavily dependent on having an institutional framework that supports good policy.

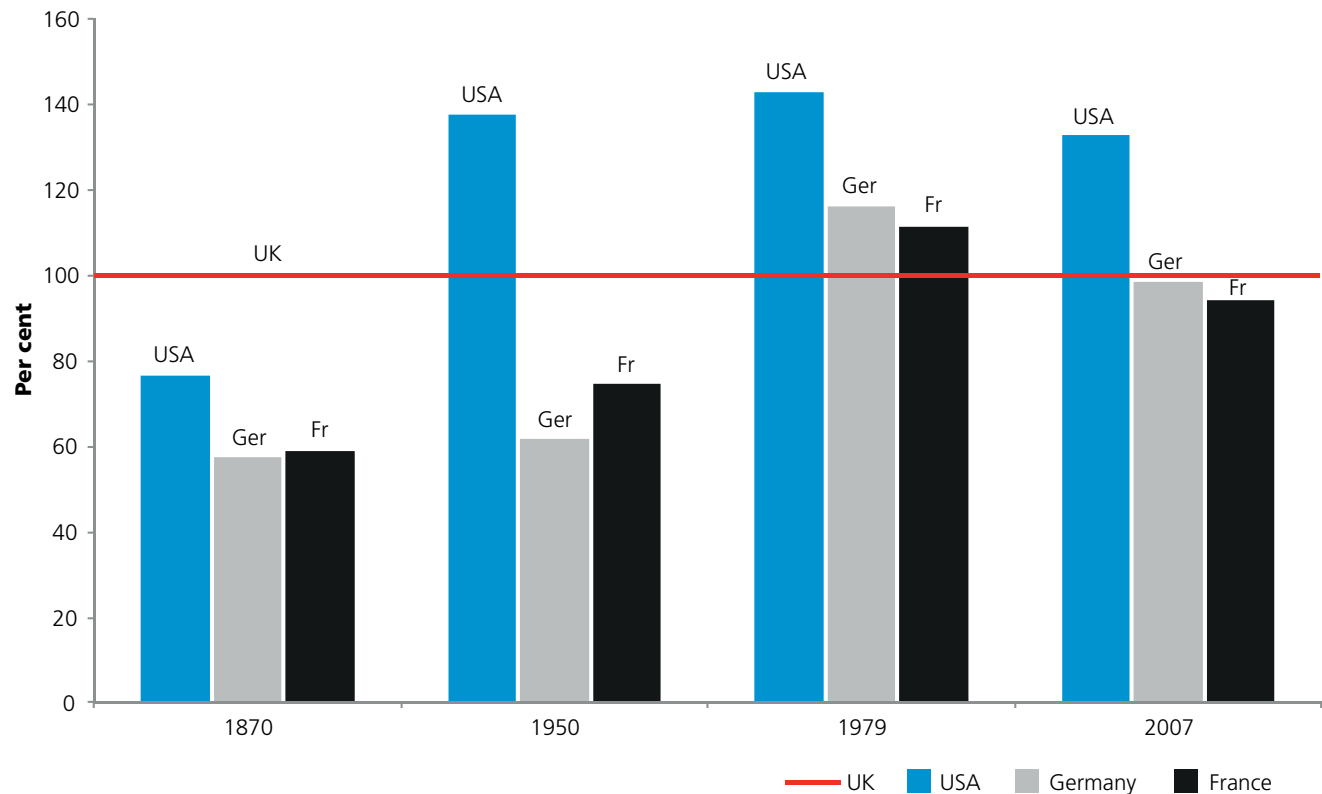
Growth is also shaped by global developments. In recent years, the international division of labour has expanded as countries such as China catch up and in some areas take a lead. The UK faces pressure in a range of industries, particularly the manufacturing sector, although over the medium term, we should expect this to apply to parts of the service sector too. Such changes also create opportunities to move up the value chain and export to China and other emerging economies in areas where we can retain or gain a comparative advantage. Understanding where and how to collaborate and compete will be a crucial part of reinvigorating growth.

The challenge of restoring growth must also address the problem that faces all countries of managing climate change. An industrial revolution driven by the search for low-carbon technologies is likely to emerge as one of the most important areas for innovation in the coming years.

UK decline and rebound

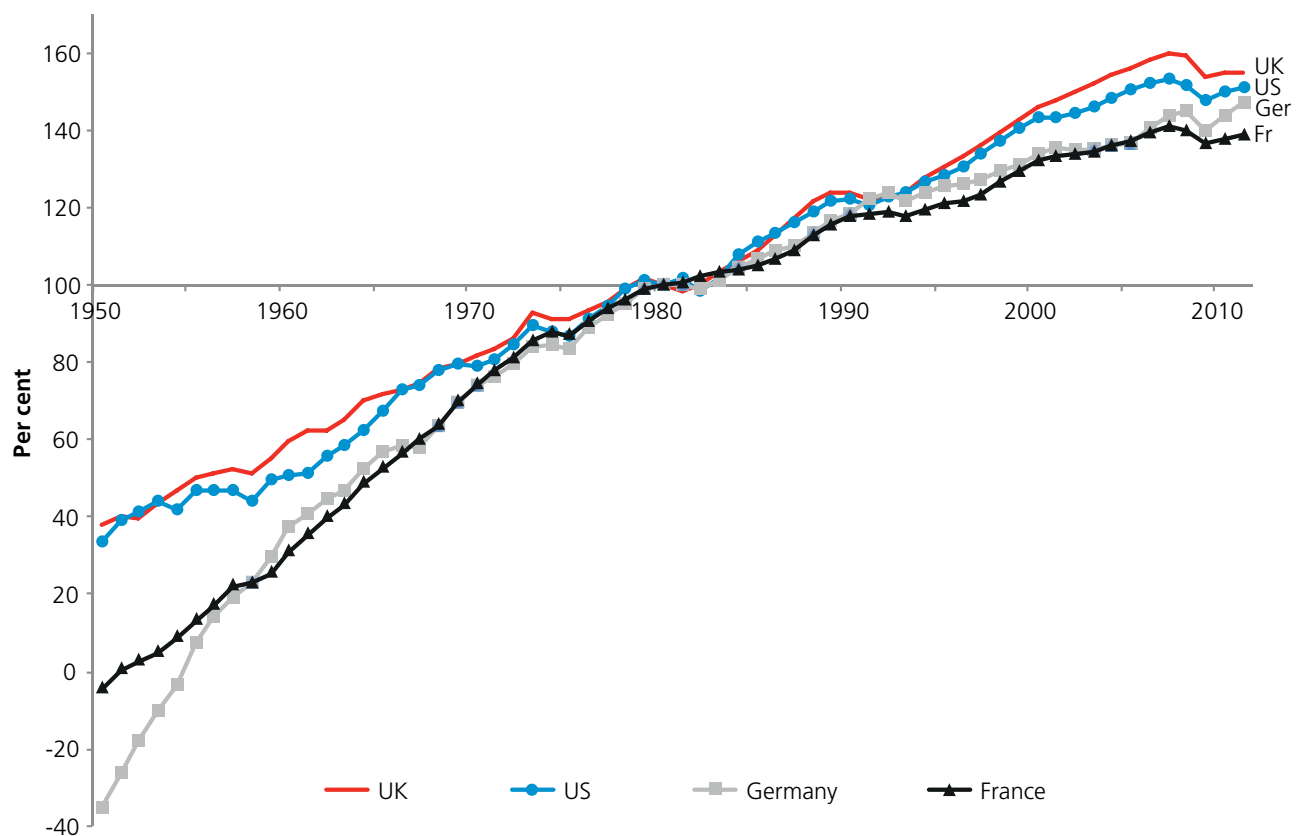
It is sometimes remarked that the British are the only people who indulge in *Schadenfreude* about themselves, revelling in stories of national decline. This is perhaps the inevitable legacy of being the first industrial nation and the global superpower of the nineteenth century. Although the UK has enjoyed significant improvements in material wellbeing for well over two centuries, UK GDP per capita was in *relative* decline compared with other leading countries, such as France, Germany and the US, from around 1870.

At first, the UK's relative decline reflected an almost inevitable catch-up of other countries whose institutions created the right kind of investment climate. But by the late 1970s, as Figure 1 shows, the UK had been comprehensively overtaken: US GDP per capita was 40 per

Figure 1: GDP per capita 1870-2007 (UK=100)

Notes: In each year the base is UK=100 and each country's GDP per capita is relative to this. So a value of US=120, for example, implies the US has a 20% higher GDP per capita than the UK.

Source: Crafts (2012)

Figure 2: GDP per capita 1950-2011 (1980=100)

Notes: GDP is US\$, constant prices, constant PPPs, base year 2011. For each country the series is set to one hundred in 1980, so the level of the line in any year indicates the cumulative growth rate (for example, a value of 110 in 2001 indicates that the series has grown by 10% between 1980 and 2001). The steeper the slope of the line, the faster growth has been over that period.

Source: Conference Board data, extracted on 8th of June 2012.

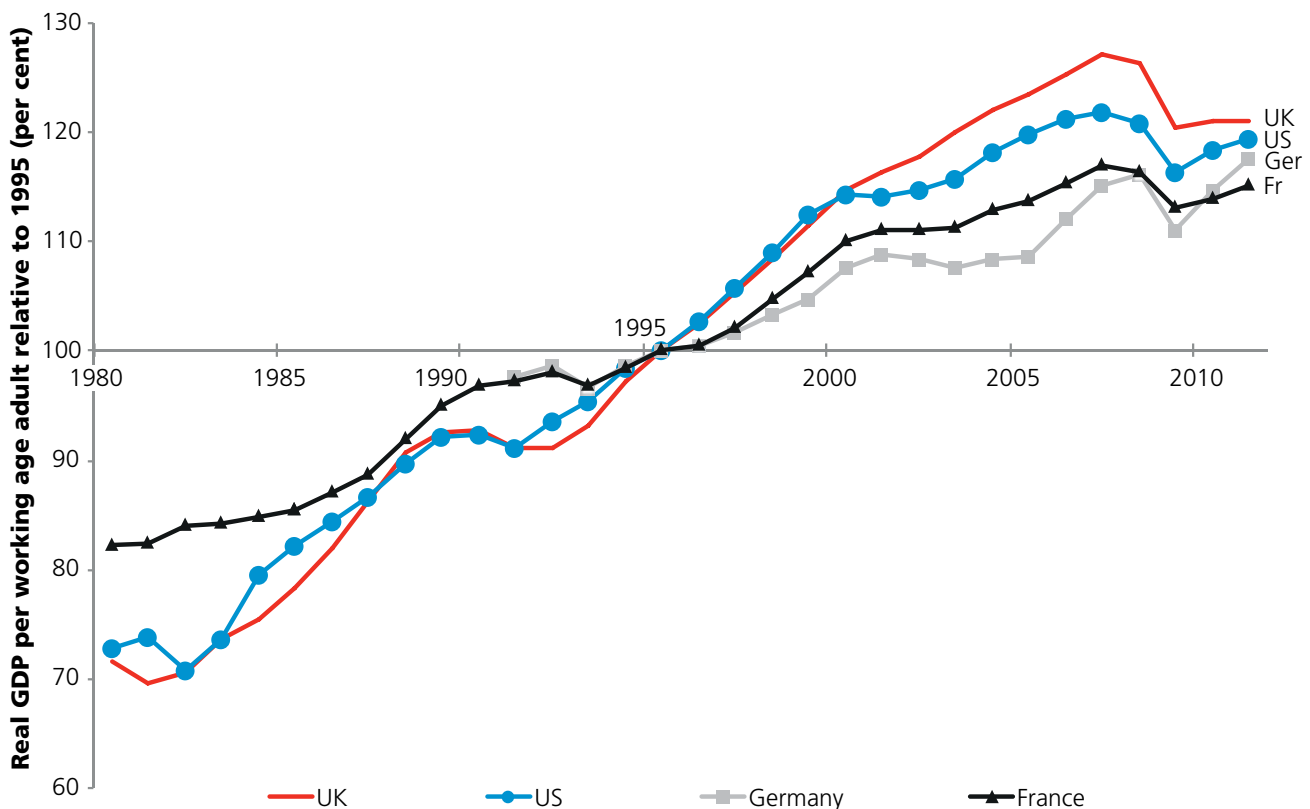
cent higher than the UK's and the major continental European countries were 10-15 per cent ahead. The subsequent three decades, in contrast, saw the UK's relative performance improve substantially so that by the eve of the crisis in 2007, UK GDP per capita had overtaken both France and Germany and reduced significantly the gap with the US.

Figure 2 shows trends in UK GDP per capita since 1950. After falling behind for most of the post-war period, the UK had a better performance compared with other leading countries after the 1970s. Figure 3 focuses on the later years (partially correcting for demographics by looking at GDP per adult rather than GDP per capita) and shows a similar story of a strong relative performance especially before 2008.

The improvement in GDP per capita can be broken down into increases in the employment rate (the proportion of the adult population that is working) and increases in labour productivity (GDP per worker or GDP per hour worked). Jobs growth in the UK was facilitated by an improvement in the functioning of the labour market through more activist employment policies and greater wage and job flexibility. But productivity growth was also impressive: among the G6 countries, the growth of UK GDP per hour was second only to the US in the decade to 2007 and the growth of the employment rate was better than that of the US.

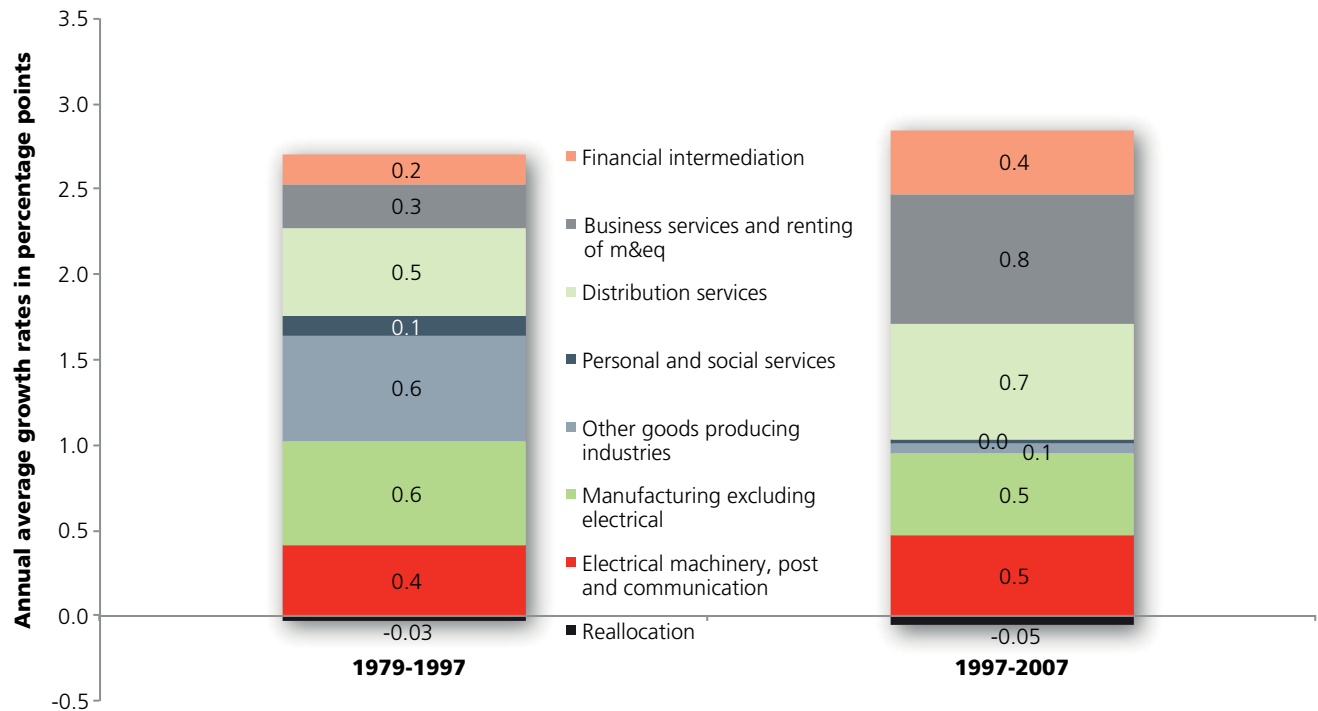
Some commentators have suggested that these productivity improvements were all based on one narrow sector, finance. But this claim is wrong. As Figure 4 shows, productivity growth between 1980 and 2007 was *not* mainly due to the financial services sector. If we focus on the 'market sector' (by removing health, education, public administration and property, all sectors in which output is very hard

Figure 3: Trends in real GDP per working age adult, 1980-2011 (1995=100)



Notes: GDP is US\$, constant prices, constant PPPs, base year 2011. The number of working age adults, which is obtained from the US Bureau of Labour Force Statistics, includes the civilian population aged over 16. Data for unified Germany is from 1991. For each country the series is set to one hundred in 1995, so the level of the line in any year indicates the cumulative growth rate (for example, a value of 110 in 2001 indicates that the series has grown by 10% between 1995 and 2001). The steeper the slope of the line, the faster growth has been over that period.

Source: Conference Board data, extracted on 8th of June 2012.

Figure 4: Finance directly contributed only a small part of market sector productivity growth

Notes: These numbers are for the 'market economy'. This excludes the sectors where value added is hard to measure: education, health, public administration and property.

Source: Corry et al (2011) using EU-KLEMS data.

to measure), productivity (real output per hour) grew at around 2.8 per cent per annum between 1980 and 2007. Finance only accounted for 0.4 per cent of the 2.8 per cent annual productivity growth in the market economy between 1997 and 2007. Distribution and business services were much more important contributors to productivity growth.

The other way to see that the UK's positive pre-crisis performance was not driven mainly by finance is through the two versions of GDP growth published by the Office for National Statistics (ONS). One uses an output measure based on summing value added growth across industries, which could in principle be subject to a bias from overestimating output in financial services (although Figure 4 shows that this is not a major issue). The second measure, based on the 'expenditure' side, adds up the growth of real consumption, investment, government spending and net exports. The output of financial services would only affect these calculations through an overstatement of net exports (at most 0.1 per cent of GDP growth).

If there is a discrepancy between these two measures of GDP, the ONS uses the expenditure-based measure. Since this is not biased by mismeasurement of financial services output, finance cannot have caused direct overstatement of GDP in the years before the crisis.

So if it wasn't all a finance-driven statistical mirage, what led the UK to achieve those improvements? The answer is that policies mattered.¹ It is worth focusing on important policy *changes* to understand where the economic gains in Figures 1-3 came from:

- Increases in product market competition through the withdrawal of industrial subsidies, movement to effective competition in many privatised sectors with independent regulators, a strengthening of competition policy (for example, through the 1998 Competition Act) and our membership of the European Union's (EU) common market.

¹ There is good evidence that policy reforms helped to foster UK growth. Card et al (2004) summarise the evidence from the Thatcher-Major era and Corry et al (2011) summarise the evidence from the Brown-Blair era. OECD (2012a) shows the international evidence of how such reforms foster growth.

- Increases in labour market flexibility through reform of the public employment service in improving job search for those on benefits, reducing replacement rates, increasing in-work benefits and restricting union power.
- Openness to foreign business and global talent: restrictions on foreign direct investment were eased in the 1980s and restrictions on immigration relaxed in the late 1990s.
- Sustained expansion of the higher education system: the share of working age adults with a university degree rose from 5 per cent in 1980 to 14 per cent in 1996 and 31 per cent in 2011, a faster increase than in France, Germany or the US.

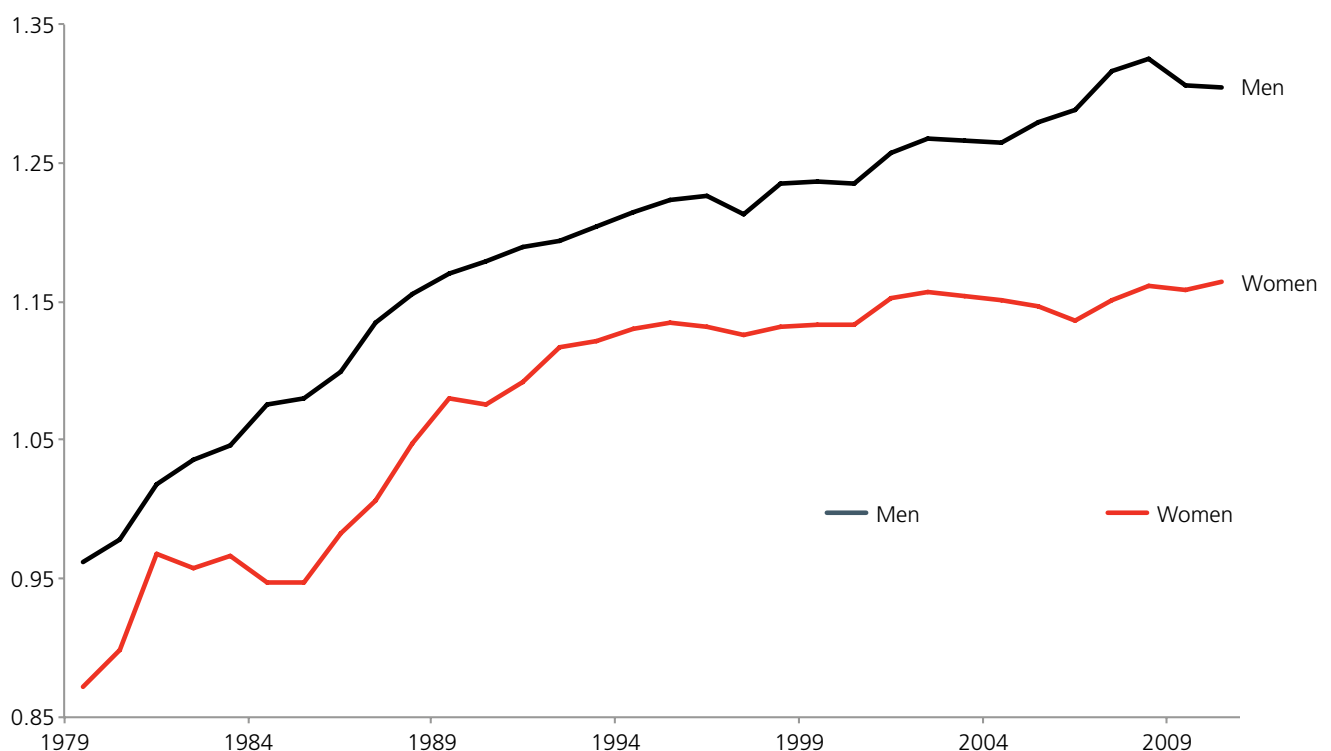
In spite of these policy successes, a number of long-term investment failures have not been tackled. The most important of these are:

- a failure to invest in mid-level skills.
- a failure to build adequate infrastructure – particularly in transport and energy.

- a failure to provide a supportive environment for private investment and innovation.
- a failure to distribute the fruits of growth more widely: alongside the improvements in the UK's growth performance in the three decades before the crisis, the country has experienced substantial increases in inequality.

UK levels of inequality are much higher than those in continental Europe and Japan. As in the US, UK inequality rose dramatically from the late 1970s onwards. Figure 5 gives one illustration of this phenomenon, showing the difference between the richest 10 per cent and poorest 10 per cent of workers (separately for men and women) between 1979 and 2010. There was a large increase in wage inequality, especially in the 1980s. Although some of this was related to worldwide pressures of technological change and international trade which have increased the demand for skilled workers, policies such as the weakening of unions and the lowering of welfare benefits also played a role. The distribution of income has widened and the median household's income (that is, those in

Figure 5: Wage inequality 1979-2010



Notes: Difference in the natural logarithm of weekly wages of full-time ("FT") workers at the 90th percentile (richest tenth) and 10th percentile (poorest tenth).

Source: Lindley and Machin (2012) using data from NES and ASHE (1% sample of all UK workers).

the exact middle of the distribution) has risen more slowly than the average household. Hence, focusing on the median paints a less rosy picture of economic progress over the last three decades than looking at the average.

Increasing inequality is not an inevitable by-product of growth, especially if policies are pursued that make growth more inclusive. A strong education system and an efficient labour market help people to participate in productive processes. Redistribution helps society to deal with the dislocation caused by innovation and globalisation. Although the UK's tax and benefit system is progressive and softens earnings differences, lower marginal rates on the better-off and reductions in real benefit levels during the 1980s exacerbated the degree of post-tax income inequality. This trend was reversed in the mid-1990s as in-work benefits became much more generous (for example, working family tax credits). In addition, the national minimum wage, introduced in 1999, helped to narrow inequality at

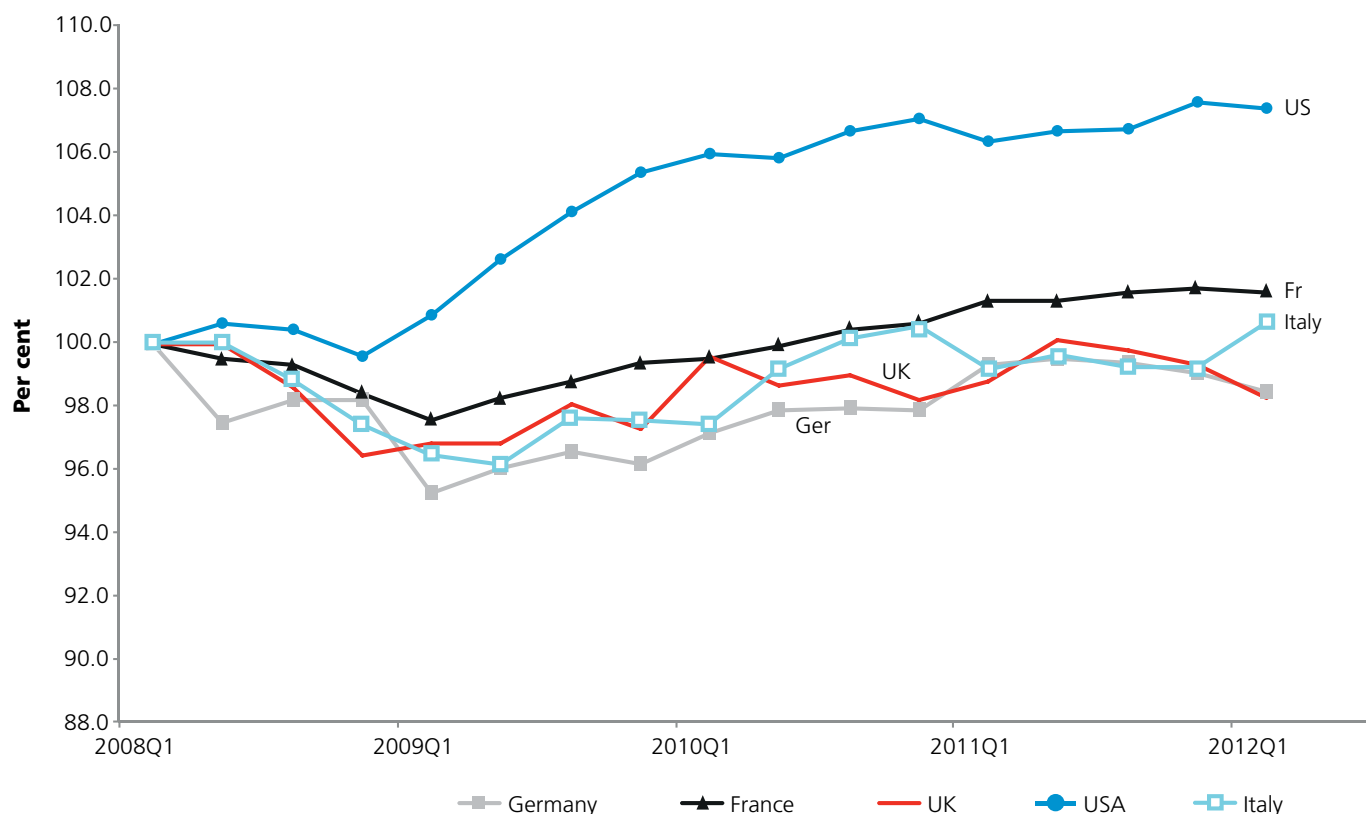
the lower end of the wage distribution. But less has been accomplished in addressing some of the sources of wage inequality, for example, by improving mid-level skills.

Decline again after the crisis?

In the wake of the crisis, the public mood has shifted from euphoria to depression with the general belief that the UK's previous economic success was illusory. We do not think that this is the case, but GDP does still remain around 3-4 per cent below its peak in early 2008 and the pace of recovery is slower than in every previous UK recession. The crisis has taken a severe toll on all OECD countries with the UK faring somewhat worse than average in terms of GDP but better than average in terms of jobs.

UK labour productivity has fallen since the crisis began and is about 10 per cent below where it would have been had the pre-2008 trends

Figure 6: Output per hour (2008 Q1=100), seasonally adjusted



Notes: US output per hour only covers the business sector.

Source: ONS (2012) 'The Productivity Conundrum, Explanations and Preliminary Analysis' (http://www.ons.gov.uk/ons/dcp171766_283259.pdf)

continued. But as Figure 6 shows, the UK is hardly unique: just about every OECD country has seen such a decline in productivity with the exception of the US, which had a much larger shakeout of jobs. This suggests that the causes of depressed productivity are common across the advanced economies rather than due to a UK-specific issue. Further, as discussed above, the evidence in Figure 4 shows that the pre-2007 UK productivity gains were not primarily due to the financial services bubble.

Many possible explanations have been put forward for the low output and productivity of the UK and other advanced economies since the onset of the crisis.

Demand-side explanations of the continued slow recovery emphasise the way that fiscal austerity has been a drag on growth, especially when simultaneously pursued by most advanced economies with interest rates stuck at close to zero. The UK government has so far kept to a tough austerity programme and that seems destined to last for a number of years. Low domestic demand has been sharpened by a recession in the eurozone, the UK's main export market, which is also struggling with fiscal retrenchment, banking crises and sovereign debt problems. This uncertainty has been compounded by the unresolved fiscal issues in the US.

The principal supply-side explanation of the slow recovery stresses the damage done by the shock to the financial sector:

- The first problem is that banks are repairing their balance sheets, which is making them reluctant to lend.
- The second problem is that small and medium-sized enterprises (SMEs) are finding it hard to access finance and this is inhibiting growth and new entry.
- The third problem is one of exit: while low interest rates and some forbearance by banks have led to fewer defaults by households and businesses, this has slowed the adjustment process. Many businesses and households would go bankrupt under normal market conditions.

Together, these three factors have created a problem of capital misallocation and debt overhang that may take many years to unwind. This weighs down on incentives to invest in housing and private capital.

These demand- and supply-side factors are interrelated. There is a risk that if high levels of unemployment persist for many years, the long-term unemployed will lose their skills, motivation and networks, thus reducing potential supply. If there are fewer innovative new entrants, this will drag down potential growth for many years.

Even though these factors create serious headwinds, standard growth theory and economic history suggest that permanent falls in the rate of

growth are unlikely. For example, growth rates did not fall permanently after the Great Depression. Although there may be some permanent loss in the level of output, this loss has tended not to be large in most past recessions. Hence, although policy remains important in determining the speed of the recovery from recession, we do not believe that the crisis has revealed that the pre-2008 improvements in the UK's economic position relative to the EU and the US are likely to unravel. Nevertheless the effectiveness of these improvements will be undermined if we do not address the problem of investment failure.

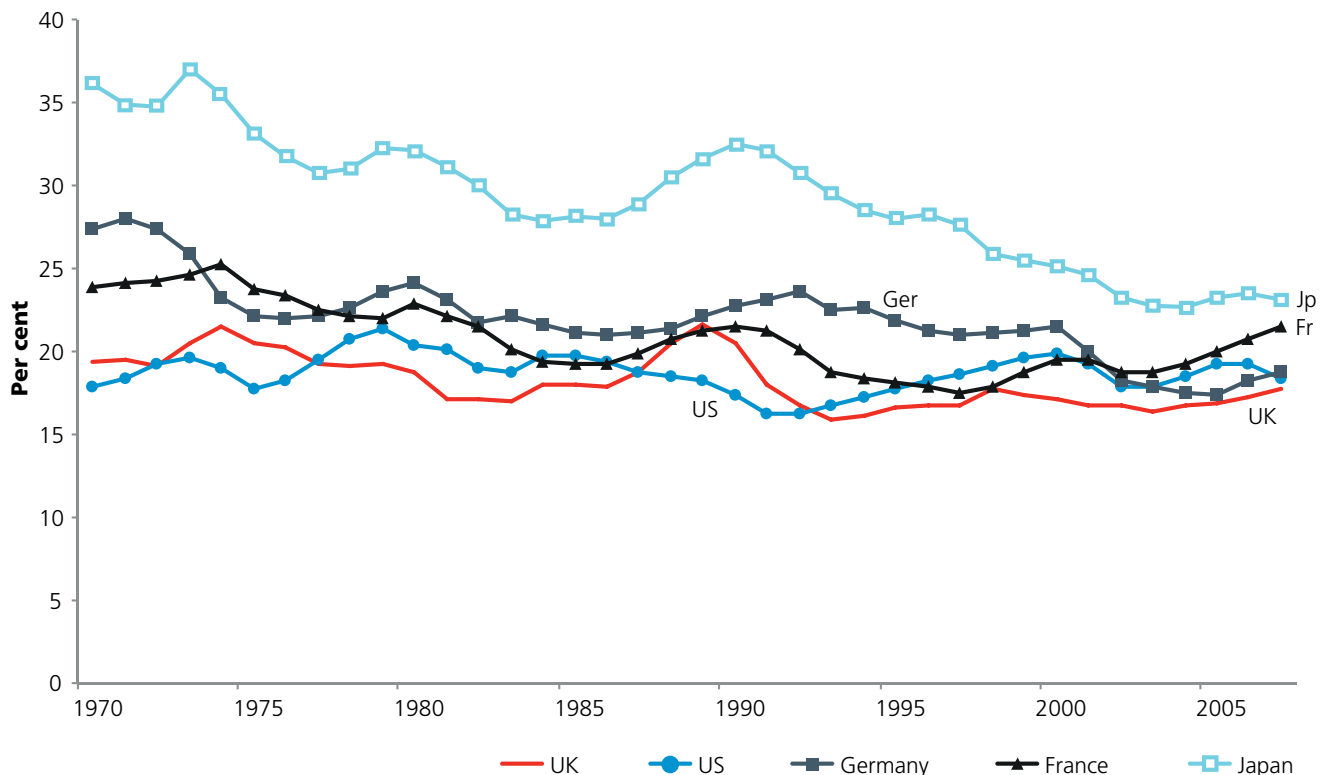
Investment failure: the UK's fundamental problem

The UK was once a paragon of investment. Around the time of the industrial revolution, major investments in roads, canals and railways supported growth and industrial transformation. For example, the turnpike trusts, which were created to extend the road network as well as canal-building programmes, harnessed private initiative to alleviate transport bottlenecks at a time when the absence of infrastructure would have been very damaging. In the late nineteenth and early twentieth century, the UK was also at the forefront of investments in electrification and sanitation, enabling dramatic gains in living standards. The UK had the structures needed to be adaptable to the economic challenges of the time.

The dynamism that saw the provision of infrastructure that enabled the growth of the UK as an industrial power has all but evaporated. Successive policy initiatives have failed to put in place adequate structures to support the identification, planning, implementation and financing of infrastructure projects, particularly in transport and energy. Thus, the provision of infrastructure now constitutes a persistent and major policy failure, one that generations of governments from all parties have failed to address.

The failure to provide infrastructure is matched by the failure of policy since the 1970s to address longstanding problems of low investment. In some cases, policy reforms may actually have made the problems worse. While it is well-known that public and private investment rates have been slashed in the wake of the crisis (with public investment falling from £51.1 billion in 2009/10 to £26.7 billion in [2011/12](#)), investment levels have in fact been low in the UK for many decades (see Figure 7).

These problems of underinvestment are not confined to capital in the classic sense: indeed, they cut across aspects of *skills, infrastructure and innovation*. Despite much evidence on these problems and their impacts on growth (which we document in more detail below), successive governments have failed to address them effectively. Three problems loom large:

Figure 7: Investment as a percentage of GDP, 1970-2007

Notes: This indicator is calculated as the ratio of gross fixed capital formation to GDP. Data refer to fiscal year.

Source: OECD (2012c) Factbook 2009 - Economic, Environmental and Social Statistics.

First, relatively large numbers of children are still exposed to poor quality teaching and leave school inadequately prepared for the rest of their lives. In 2011, 58 per cent of pupils in England got five good GCSEs (A* to C), including English and maths. But only a third (34 per cent) of pupils from disadvantaged backgrounds (classified as those on free school meals or in local authority care) achieved this benchmark. Improvements in human capital are arguably the best way to achieve more inclusive growth and to reverse increases in inequality without putting further pressures on the benefit system.

Second, infrastructure has been neglected, particularly in the areas of transport and energy. For example, more than a fifth of the UK's electricity-generating capacity will go out of commission over the next decade and Ofgem, the energy sector regulator, has warned of power shortages by 2015.

Third, the UK is home to one of the most dynamic world centres for financial services, yet the country seems unable to deliver adequate long-term finance for innovation and private investment.

UK investment levels are significantly below those of other EU countries (see Figure 7). In 2008, the UK's share of total GDP devoted to R&D stood at 1.8 per cent, a lower proportion than in the US (2.8 per cent), Germany (2.7 per cent) or France (2.1 per cent).

In spite of the evidence that low investment in skills, infrastructure and innovation imposes major constraints on growth, poor policies persist along with institutions that fail to provide long-term frameworks for investment and action. The result is that although there were improvements before the crisis, UK productivity levels still lag behind other major countries. In 2011, UK GDP per hour was 27 per cent below the level in the US, 25 per cent behind France and 22 per cent behind Germany.

Why does the UK fail to invest for prosperity? To understand this, we need to understand the nature of the policy successes and failures and the institutions that support them.

The right policy-making environment

Long-term investments require a stable policy environment within which investors can manage risk since returns often accrue over decades, well beyond the typical parliamentary cycle. Stability is fostered by having a predictable policy framework, where possible backed by a cross-party consensus. Failure to create such conditions undermines investments, posing a serious impediment to growth. The evidence suggests that the UK has failed to create an enabling environment in a number of important areas for growth.

The problem of policy instability is compounded by a number of features of the political process:

- First, the time horizons of politicians are typically truncated as they are moved swiftly between ministerial posts and face the electorate every four or five years.
- Second, the adversarial nature of UK politics creates a tendency towards policy switches (and subsequent reinvention) as governments change. Sometimes this means rebranding and reorganisations. In some cases, there is genuine uncertainty about whether the policy framework that is in place will last. The pressure of bad publicity weighs heavily on political decisions and makes it harder for politicians to take unpopular decisions.
- Third, political debates often lack guidance from independent, evidence-based advice. For example, the civil service must maintain the confidence of ministers and is constitutionally barred from advising anyone but the government of the day. Civil servants' incentives appear to be more focused on helping to deliver policies than on helping governments (or others) structure their thinking in the longer-term interests of society as a whole.

Too often, the result is a costly cocktail of political procrastination, institutional churn and poor decision-making. 'Celebrity reviews' are often set up to come to the rescue, sometimes as a genuine attempt

to fill an institutional gap but more often to make it appear that action has been taken, whereas many of the key problems are left unaddressed or action is indefinitely postponed.

In some policy areas, the UK has led the way in seeking innovative institutional solutions for designing and implementing policy more effectively. In many cases, this has been achieved by creating a better balance between political discretion, technocratic input and predictable rules. Perhaps the longest standing is our system of common law, which has allowed independent courts to oversee the evolution of the law while operating at a distance from political interference. More recent examples include:

- The conduct of competition policy under the 1998 Competition Act and the 2002 Enterprise Act, which strengthened the Competition Commission and the Office of Fair Trading (OFT): these two institutions were made more independent and political lobbying was removed from decisions over large-scale mergers.
- The decision to give the Bank of England independence to set interest rates after 1997: a series of structures was put in place to allow for the idiosyncrasies of monetary policy, particularly the need for credible, long-term policy commitments based on sound and transparent expert advice. The UK went from having one of the most unstable macroeconomic environments in the 1970s and 1980s to having one of the most stable. While lessons are now being learned from the crisis, this approach is also being followed in 'macro-prudential regulation' of financial markets.
- The regulators of privatised services, such as telecoms (Ofcom), energy (Ofgem) and water (Ofwat): these agencies aim to provide a framework of rules that safeguard the public interest along with a stable investment climate. They draw heavily on independent expert advice overseen by judicial process.
- The National Institute for Health and Clinical Excellence, which has helped to create a better informed and less polarised debate around the choices of health treatments in the NHS: the government remains rightly in charge of overall spending rules but no longer directly manages difficult detailed decisions where clinical expertise is of primary importance.
- The Migration Advisory Committee, which set up the points-based system for immigration; the Low Pay Commission, advising on the minimum wage; the National Pay Review Bodies for public sector workers; and the Climate Change Committee. In all of these cases, expert opinion is used within a clearly defined framework.

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- The Office for Budget Responsibility (OBR), which has taken over the UK's fiscal forecasting functions from HM Treasury: the new institution monitors the degree to which the government is on track to meet its own fiscal goals; produces long-term assessments of fiscal sustainability; and scrutinises the Treasury's costing of budget measures. In these various roles, the OBR helps to strengthen the external credibility of fiscal policy and raises the quality of the political debate.

Two main lessons follow from these experiences:

First, they have put politics in the right place. The strategic choices, rules and high-level objectives are set by government. Independent bodies make decisions based on the technical criteria laid down by politicians and are held to account by parliament. In so doing, these bodies have mitigated the problems of indecision and unpredictability that are important impediments to investment and growth. By focusing the politics where it should be, they improve accountability, transparency and democracy.

Second, in these successful cases, the political debate is supported by a framework for independent and transparent expert advice, with clear lines of accountability.

Throughout this report, we discuss how these principles of policy-making success can be extended further to foster a better climate to encourage investments in human capital, infrastructure and innovation.

In thinking about institutional ways to reduce policy instability, we also need to consider our relationship with Europe. We cannot predict what will happen with any degree of accuracy. But we shall surely still have Europe as our main trading partner for the foreseeable future and, as discussed above, the common market has been an important driver of productivity-enhancing competition. Hence, calls to leave the EU through a referendum are not only misguided: they create the very uncertainty that will damage investment and productivity right now. It is analogous to the needless self-inflicted wounds that the US is causing in its debates over the debt ceiling and fiscal cliff.

The structure of our report

The remainder of this report is about how the UK can create better conditions for investment. First, we show how the causes of lower UK productivity levels are linked to investment failures – in human capital (Section III), in infrastructure (Section IV) and in private investment and innovation (Section V).

In each section, we ask why the type of investment particularly matters for growth and document the UK's specific problems in these areas. We then give our recommendations, dividing these into the most important core policies first followed by some more auxiliary measures. We also take up the challenge of answering the political economy question: why have these problems not been dealt with adequately before?

The last parts of the report suggest a better way of accounting for our progress in promoting inclusive growth (Section VI) and a call to all sides of the UK political spectrum to sign up to a 'Manifesto for Growth' (Section VII).

