

FOREWORD

This is an invaluable and timely report. It looks at the underlying problems in the UK economy and describes current policy options. Our woeful productivity performance over the last decade points to an urgent need to rethink government policies in many areas. The financial crisis has left its mark, as have the longer term trends arising from globalisation, advances in technology and ageing. One clear lesson from this analysis is the need for the winners to compensate the losers, and a clear challenge is for public policy to create inclusive growth. In particular, when planning a sustainable fiscal path we need to take account of the costs of compensating the losers and turning them into winners. This process needs careful thought: simply giving subsidies to individuals or firms without working out what will be most helpful will not work. We saw this in the industrial policies of the 1970s, which had the state picking winners and prevented fundamentally uncompetitive firms from shutting down – a process that, in my experience, rarely worked.

The best advice is to protect the workers not the jobs. This means training people in the skills that are needed and rewarded. Of course, this involves more government spending, as does ensuring that we have sufficient welfare support to manage the transition between jobs. If the government is going to spend more, it must improve the productivity of spending. One obvious suggestion is to improve the design and generosity of maternity pay, which will allow more skilled women to remain attached to the workforce. Similarly, we could look more closely at switching expenditure from curing problems to preventing them happening in the first place. For example, we could review whether spending differently is more effective than spending more on education and health. International evidence suggests that our performance in these areas could be significantly improved. Similarly, on the tax side there is clearly more scope to tax externalities, which has the added advantage of addressing broader problems such as climate change.

One of the most damaging consequences of the Brexit saga has been the lack of attention to these issues over the last two years. And since the trade negotiations will drag on for years, this will continue to take up a lot of capacity within government. Several papers in the first theme of this report analyse the data to understand why people voted Leave. One clear conclusion is that most of the reasons relate to deficiencies in government policies that are not primarily caused by our membership of the EU. So whatever the outcome of Brexit, we need ministers and the civil service to work on the fundamental issue of raising the productivity of our private and public sectors. The forthcoming spending review offers the perfect opportunity. Unfortunately this has been partially pre-empted by the NHS settlement, but the 10 year NHS plan shows some positive signs for tackling this sector's productivity problems. This approach needs to be expanded to cover all departments and in particular those areas which cross departmental boundaries. The overall objective should be to improve the wellbeing of the nation and to reduce inequalities. Brexit has made matters more urgent as investments have been delayed, and some probably lost forever. This report offers a wealth of important ideas that should be debated and the best ones implemented, lest we risk extending our relative decline.

LORD O'DONNELL

Former Cabinet Secretary and Head of the Civil Service

PREFACE

Even though Michael Gove's observations about experts during the EU referendum campaign in June 2016 were (somewhat unfairly) over-interpreted¹, the sentiments commonly attributed to him still capture the spirit of the age: at the end of a decade of turmoil, Britain has often appeared to be a country that is tired of experts. Political debate and thus policymaking of late has often prioritised sentiment and perception over evidence and scholarship. At the time of writing, Parliament continues to debate Britain's exit from the European Union, a debate that has all too often demonstrated various degrees of disregard for evidence and expertise, not to mention basic facts of law and policy.

That disregard has many consequences. Most immediately, it is likely to result in suboptimal policy choices with consequences that are not just unforeseen but more importantly *unexplained* to voters, whose resultant disappointment and surprise are likely to have further consequences. More widely, failing to consider evidence and expertise closely enough makes it harder for policymakers to understand the causes of the events and trends they are attempting to address and manage. If policymakers do not properly understand the way political and economic events since the financial crisis interacted to contribute to the vote to leave the European Union, how can they begin to devise, implement and explain the policies that will best respond to those events?

This Report is an attempt to fill that gap in the policymaking process. It exists because of the partnership between CAGE and the Social Market Foundation, a partnership that works to ensure that the world-class scholarship that CAGE supports has substantive impact on policymaking. Such impact is an essential objective of the SMF, a cross-party, evidence-led think-tank. For 30 years, we have worked at the heart of Westminster to help inform policymakers about what works, what doesn't, and why. Our

¹ Gove's full, albeit interrupted, quote on Sky News in June 2016 referred narrowly to economic forecasters from bodies such as the International Monetary Fund and the Organisation for Economic Cooperation and Development: "I think the people in this country have had enough of experts... from organisations with acronyms saying that they know what is best and getting it consistently wrong."

work is available to politicians of all parties, to anyone involved in forming and implementing public policy, and to the public as a whole. For all those audiences, our goal is the same: a better understanding of the effects of policies, both those in place today and those that are not. This Report, like all our work with CAGE, is a central part of that mission. Here, policymakers can find evidence-based analysis and insight into the events that led Britain to its current situation, and ideas about how they should proceed from here.

Expertise and evidence have fallen out of fashion in recent years, but fashions change. This Report is for anyone who wants to help to turn the tide and ensure that the next decade addresses the problems of the last one rather than repeating them.

JAMES KIRKUP

Director, Social Market Foundation

INTRODUCTION

QUO VADIT? DIRECTIONS FOR UK ECONOMIC POLICYMAKING IN THE AFTERMATH OF THE GLOBAL ECONOMIC CRISIS AND BREXIT

Most, if not all advanced economies have suffered gravely from the 2008 global financial crisis. Growth, productivity, real income and consumption have plunged and inequality, and in some cases poverty, spiked. Some countries, like Germany and Australia, were better able to cope with the consequences but austerity has taken its toll even on the strongest economies. The UK is no exception and the more recent period of economic recovery might be halted or even reversed by the political, economic, and policy uncertainty created by the Brexit referendum. This uncertainty-related risk to growth could be even greater if the UK leaves the economic and legal framework provided by the EU.

This CAGE policy report offers proposals from different perspectives to answer the overarching question: What is the role of a government in a modern economy after the global financial crisis and the Brexit vote? We report on economic and social challenges in the UK and discuss potential policy responses for the government to consider.

The German newspaper, *Die Welt*, said of Brexit on 5 December 2018, “What no war or revolution ever could, Brexit achieves: it plunges the British Parliament into despair.”² UK politics before the 2008 crisis was marked by a post-Thatcher consensus between the Conservatives and New Labour on economic policies for growth – openness and integration that grew the economy but also increased inequality. The consensus can be illustrated by Lord Mandelson’s famous quote: “I am intensely relaxed about people getting filthy rich as long as they pay their taxes.” By 2012 he admitted he was no longer “intensely relaxed...” given rising inequality and stagnating middle-class incomes brought about by the damaging downsides of globalisation.

² <https://www.zeit.de/2018/51/brexit-grossbritannien-parlament-krise>

The financial crisis of the Noughties and Brexit have made the societal cleavages and potential policy failures more apparent. This has raised political awareness of the drawbacks of a laissez-faire approach to economic policy. In the post-economic crisis, post-Brexit era, the old consensus is shattered. The majority of UK citizens have made it very clear that they want things to change.

Brexit poses the question of how to embrace change – in political preferences, in the domestic economy and in the international economic environment – to generate a political and policy approach that supports economic growth in the UK. Tension has grown around the distribution of growth between urban hubs and less connected regions, challenging policymakers to find ways to allow the markets to work freely, at the same time as reducing inequality so that no part of the population feels left behind.

Rethinking our approach to growth-producing economic policies in the UK starts here. Our four themes consider this topic in the context of: the rise of populist and anti-immigration sentiments; the labour market; industrial, regional and fiscal policy; climate and tax policy; social policies for education and maternity leave, and social services such as housing and healthcare. We discuss ways to foster growth in the aftermath of economic and political crises and offer new perspectives on the parts of society that have been left behind by the internationalisation of production and financial markets.

The first set of contributions examine the demographic, social and economic conditions that prevail in the regions that voted to leave the EU. These areas where citizens feel left behind tell us something about the link between globalisation, the economic crisis and inequality. They also contain lessons about attitudes towards immigration and preferences for extreme and populist parties.

Looking at the redistribution of wealth within a country, it is often the better off and not the left behind who dislike the societal and cultural heterogeneity to which immigration contributes. Then the focus moves to the question of who benefits from redistribution, which can result in so-called welfare chauvinism. The contributions show that there is clearly an economic aspect to populist and anti-immigration sentiments: these are not purely

cultural phenomena. With that in mind, David Cameron's emphasis on the partial privatisation of the NHS to balance the government's budget might have fostered anti-immigrant sentiments rooted in concerns about the fiscal sustainability of the NHS. The implication is that the design of social benefits becomes crucial. Social benefits can be provided in-cash or in-kind. Because their consumption is geographically bounded and their supply is constrained in the short-run, in-kind transfers are especially prone to activating distributional conflict between immigrants and natives. Political leaders need to be aware of a given program's propensity to foster an anti-immigrant backlash.

This argument is supported by the finding that individuals' grievances about their personal financial situations can partly explain the propensity to vote Leave. In addition, regions that were more affected by austerity measures display greater support for extremist and anti-immigration parties. Thus, welfare reforms that imply taking something away from people who have little to begin with can push them to favour an anti-immigration political stance.

In summary, austerity, welfare competition, and redistribution preferences of the better off that are affected negatively by more societal heterogeneity generate a dilemma for any national government, and specifically for the UK government.

From the first theme we learn that personal financial situations and austerity play a major role in shaping preferences over redistribution, welfare spending and immigration. Together they can explain to a large extent the Leave vote in the referendum.

The Brexit campaigns and the outcome have shown definitively that large parts of the electorate no longer agree with the pre-crisis consensus. Political rhetoric about the 'squeezed middle', the 'left behind' and the 'just about managing' shows that politicians are acutely aware that their approach to government spending and redistribution must change, and must address real and perceived inequality. There is a trade-off between equity and efficiency, challenging us to find the balance between optimal economic growth and not increasing inequality between regions, communities and individuals.

The second set of issues targeted in this report is poverty, inequality and redistribution. Poverty acts as a cognitive tax and this has implications for education, political participation and welfare policies such as universal credit. This also implies that more welfare spending might not be the best response. Instead, policies to improve outcomes in social mobility, health, life expectancy and inequality that do not exacerbate the cognitive burden of poverty will be more effective. These considerations also affect how the tax and benefit system is designed to protect the poor, but also to provide efficient incentives for economic and growth producing activities.

The question of how to design policy and spend scarce resources on growth promoting but efficient fiscal, labour market, and welfare policies continues in the third theme addressed in this report. Globalisation and market integration have changed the labour market. Technological change and a move towards services impacts the relationship between capital and labour. Anti-immigration sentiments and the effects of Brexit on labour mobility will affect the distribution of skills and thus the demand and supply of labour. Regional and industrial policies will have to respond to these challenges.

To increase overall productivity and close the productivity gap between the UK and other highly developed economies, UK policymakers will need to act on the level of skills, solving the problems of skills mismatch and the urban-regional divide. Again, simply increasing overall spending on education or infrastructure doesn't provide the solution. One of the issues that seems relevant for the UK is the existence of a geographical skills mismatch, where better infrastructure and incentivising potential job-seekers to take more distant jobs could reduce the skills mismatch, increase productivity and reduce unemployment. However, concentrating on agglomeration benefits for productivity can be misleading. It is not necessarily the case that cities in the UK in general perform better than non-cities in terms of productivity. Skills mismatch in general can have large effects on productivity and unemployment but policies that solely focus on improving skills, such as education or vocational training might not be best suited to solving the problem. If wages do not reflect skill shortages, skilled workers will try to fetch the best price for their labour regardless of the quality of the match.

Thus the demand side, especially compensation of skills in high demand, has to be better adjusted to solve this problem.

Of course, education and teaching relevant skills remains one important aspect of enhancing productivity, but simply increasing spending on education might not foster upward social mobility. A redesign of the educational system that allows for better access to higher education for disadvantaged children and a system of lifelong learning remains desirable.

Another way to improve productivity is to remove impediments to the career opportunities, labour market participation and earning capacity of women, especially mothers. A combination of limited but generous maternity benefits coupled with better provision of early childcare might help to maintain the productivity of female talent, especially in highly skilled sectors. This would help to close the productivity gap.

Finally, we discuss how economic growth can be made more inclusive. Growth was more inclusive in the 1950s and 1960s but income growth started to drift apart from economic growth in the 1970s. The post-Thatcher consensus on economic policymaking and new technologies fostered growth at the top end and thus increased inequality. With the global economic crisis and Brexit, policymakers have to rethink what kind of trade-off they are willing and able to allow, given that the substitution between labour and capital seems to have changed, in part because of technological change. Can fiscal, monetary, regional and industrial policy counterbalance the negative consequences of Brexit in a post-crisis economy?

To foster more inclusive growth it seems unwise in the medium to long-term for governments to introduce interventionist policies. It would be preferable to maintain the current competition policy, support a horizontal industrial strategy with a focus on skills and improving matching, and invest in infrastructure, research and development. This might bring some stability to counterbalance the policy and economic uncertainty generated by Brexit. One aspect of providing greater certainty is the opportunity to introduce higher equity requirements than have been required by the EU. This would increase the stability of the banking system and be an improvement on the current EU regulation, which is based on the Basel III agreement.

In addition, careful design of fiscal policies in the UK has to take into account the challenges generated by Brexit. Simply increasing or decreasing spending is not enough. The choice is not just about larger or smaller government but about the type of spending that can support sustainable growth: generating deficits to finance capital formation or investment is different from deficit-financed current account spending.

The issues addressed in the four themes of this report are related in their perspective on the UK economy in a post-crisis, post-Brexit society. The pre-crisis political agreement on economic policy has to be rethought, as it is clearly failing many communities and regional economies. Brexit has shown that the majority of citizens want changes to immigration and trade relations, and thus to labour markets and growth policies. All our themes describe different aspects of the same development: the integration of product and labour markets (or the future partial disintegration of markets, particularly labour markets) is also linked to regional politics, e.g. with respect to particular industries such as the car industry, and the industrial strategy. Mismatch in the labour market is also a regional issue, which is why a new industrial policy has to consider the implications for regions, sectors and occupation categories.

The people and areas that have been described as 'left behind' need to be offered new policies for immigration, education and productivity but also new regional and industrial strategies. These policies will hopefully address the populist tendencies and anti-immigration sentiments that emerged during the Brexit campaign. Such policies will improve access to education, jobs and vocational training, provide support for healthcare and housing, and reduce inequality, without constraining trade relations and the potential for economic growth.

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