THE BIG PICTURE

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The UK economy is still suffering a hangover from the financial crisis. Austerity is not yet over, productivity is way below pre-crisis projections, interest rates remain at historically-low levels while the growth of median living standards has stalled. Brexit is a damaging part of this hangover. Economic history tells us that major crises can be expected to have long-lasting consequences for the design of economic policy, as is borne out by both the 1930s and the 1970s, but the implications of the recent crisis are not yet clear. It is important to recognise that crises can provoke political reactions, which promote seriously damaging shifts in economic policy that are hard to reverse – the protectionism of the 1930s is an obvious case in point, as is Brexit today.

In this context, the chapters in this Report draw lessons from recent experience which can help to guide evidence-based policy reform. These include explicit suggestions for changes in policy, basic principles for the making of economic policy, mistakes not to repeat in future and gaps in the evidence base that should be addressed. A key priority is to improve productivity performance while at the same time ameliorating the position of left-behind voters. Ideally, economic growth should return to being inclusive. That said, workers should be protected, not jobs; strong productivity performance requires a return to efficient resource reallocation after the impairment resulting from the crisis.

The financial crisis caused not only an immediate severe recession but also a permanent reduction in the level of potential GDP, which according to conventional analysis may have been around 4 to 5 percent (Oulton and Sebastia-Barriel, 2017). On the fiscal side, there was a large rise in the public debt to GDP ratio and a big government deficit. Fiscal consolidation ensued. The evidence presented here notes that the burden fell quite unequally across districts and ignited the anger of voters in disadvantaged areas. The upshot was the rise of UKIP and voting for Brexit (Becker et al., 2017). Cushioning these voters was perfectly feasible but not considered important. The result was a further damaging blow through the adverse productivity implications of leaving the EU, which may well double the medium-term hit to potential GDP. In the short term, uncertainty has been created by the referendum result and the lack of clarity on what kind of Brexit will eventually be put in place. The report stresses that modern research shows that policy uncertainty has high costs, for example, through the postponement or cancellation of investment.

Two policy points arise from this. First, the design of fiscal consolidations needs to consider the political reactions it might provoke. More generally, as Rodrik (1998) emphasised, maintaining support for globalisation requires an adequate social safety net. The evidence presented in this report points to the need for this provision to be seen to be fair and not to give rise to conflict between immigrants and natives. Second, prevention of financial crises has a very large benefit. As we are reminded in this report, the key is to ensure that banks have sufficient loss-absorbing equity capital and that capital adequacy requirements are made stricter. This would imply an increase in the cost of capital but the output loss from this would be relatively small (Miles et al., 2013). The social benefit-cost ratio of tighter regulation of banks is very substantial.

Generally, financing social spending and redistribution entails some efficiency loss and some reduction in economic growth through the disincentive effects of taxation. It follows that value for money is a key aspect of the welfare state especially at the present juncture. The report highlights through international comparisons that welfare state spending levels are only weakly correlated with desirable outcomes in terms of poverty gaps, health, and education. It is already well known that student achievement as measured by OECD PISA scores depends far more on the organisational design of the schooling system than levels of public expenditure on education (Woessmann, 2016).

Two further policy points developed in the report follow from this. First, it is important to make sure that those in poverty access income support. Support must be provided in a way that recognises that poverty impairs cognitive skills and that people on low incomes should not have to wait unduly for payments, and that provision should be simple to access. Second, the level of qualifications in technical and vocational skills not only needs to be markedly improved but routes to achieve valuable training need to clearly signposted. Investment in raising the quality of the labour force is a good way to raise productivity while making growth more inclusive, and there is ample scope given the existing shortfall.

This raises a more general issue that surfaces in several ways in the report, namely, that the UK is failing to make the most of its stock of potential human capital. Only partly is this related to failings in education and training. One important aspect which is underlined in the report is the implication of childbearing for the lifetime productivity and earnings of women. Evidence suggests that improving the design and generosity of maternity pay can address the risk of dilution and waste of human capital. A further problem that the report highlights is that of mismatch in the labour market. Partly this relates to geographic mismatch between vacancies and unemployment but it also reflects disparities between a worker’s qualifications and their employment which imply that the social returns to education are not always realised. Here there is a clear need for more evidence especially with regard to wage setting, to develop appropriate policy responses.

Human capital and skills are important but by no means the only area of supply-side policy which should be improved with a view to improving UK productivity performance. Other areas of concern include policies relating to infrastructure, innovation, regulation and taxation where there is plenty of evidence pointing to sensible reforms but implementation has not happened. Nevertheless, what is required is modification rather than abandonment of the pre-crisis approach. In particular, the report warns against a return to the 1970s in terms of industrial and competition policies.

The search for better policies is certainly not a good reason to lose sight of basic economic principles. Two important examples of this point can be found in this volume. First, a vital role for government is in the correction of market failures which arise in many ways including externalities, market power, public goods etc. Climate change is a hugely important example. An appropriate policy response is to tax the use of energy which raises carbon emissions; this will, of course, raise energy prices and hurt poor households. Since the tax raises revenue for the government it also provides the means to compensate poor households. The energy tax should not be discarded because of its distributional consequences but attention should be given to how a new compensation scheme is designed. Second, fiscal sustainability over the long run is an important policy objective and is a central priority of the Office for Budget Responsibility. However, basic macroeconomics tells us that this should not be interpreted as requiring that government never runs budget deficits or that the budget should immediately be re-balanced when an adverse shock like the financial crisis comes along. For example, in general, tax smoothing is a more appropriate policy in response to shocks (Barro, 1979) and when real interest rates are very low, as at present, budget deficits may well be consistent with a falling public debt to GDP ratio over time.

It is deeply worrying that labour productivity measured by real GDP per hour worked in 2018 is about 21 percent below what would be expected if the pre-crisis trend rate of growth of 2 percent per year had been sustained (ONS, 2018). The reasons for this shortfall are only partly understood and it is right to see this outcome as a productivity puzzle. There are, however, quite plausible reasons to suppose that productivity growth will accelerate in future as the impact of new technologies associated with artificial intelligence and robotics comes through. Indeed, recent estimates suggest that the median job in the OECD countries has a 48 percent probability of being automated in the next 20 years or so (Nedelkoska and Quintini, 2018). The downside is that at least the direct effect of this technological progress will be to eliminate tasks done by low-skilled and low-paid workers. Here is a prime example of a major issue in making economic growth inclusive. Standard economics tells us that keeping a flexible labour market, including keeping low levels of employment protection regulation, will be an advantage in containing unemployment (Mortensen and Pissarides, 1999) but this may well not appeal to the left behind.

Designing balanced welfare state policies is a difficult challenge but will be crucial in mitigating the impact of the new technology and softening opposition to its rapid diffusion. More generally, aligning the reality of the UK economy and society with the vision of a brighter future will depend on constructing policy frameworks that can facilitate growth without unacceptable increases in inequality. This may well become more rather than less difficult and is not a challenge that can be met by populism rather than expertise.

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