The IPPR Commission on Economic Justice

Time for Change

A New Vision for the British Economy

The Interim Report of the IPPR Commission on Economic Justice

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The IPPR Commission on Economic Justice

The IPPR Commission on Economic Justice is a landmark initiative to rethink economic policy for post-Brexit Britain.

Launched in November 2016, the Commission brings together leading figures from across society – from business and trade unions, civil society organisations and academia – to examine the challenges facing the UK economy and make practical recommendations for reform.

The Commission is undertaking a wide-ranging programme of research and policy consultation on issues including industrial strategy, macroeconomic policy, taxation, work and labour markets, wealth and ownership, sub-national economic policy and technological change. Through a major programme of communications, events and stakeholder engagement it aims to contribute to both public debate and public policy on the economy. Non-partisan, it has been welcomed by both Government and opposition parties.

The Commission's Final Report will be published in autumn 2018.

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NOTE

The IPPR Commission on Economic Justice presents this Interim Report in order to stimulate vital public debate. Individual members of the Commission agree with the broad thrust of the arguments made in this report, but they should not be taken to agree with every word. Commissioners serve in an individual capacity, and this report should not be taken as representing the views of the organisations with which they are affiliated.

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PHOTOGRAPHY

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Time for Change

A New Vision for the British Economy

The Interim Report of the IPPR Commission on Economic Justice

CONTENTS

WE, THE MEMBERS OF THE IPPR COMMISSION ON ECONOMIC JUSTICE, ARE PLEASED TO PRESENT OUR INTERIM REPORT.

We believe the issues it raises are important and urgent, and we hope it will stimulate wide public debate. We welcome responses and contributions as we consult widely towards our final report in 2018.

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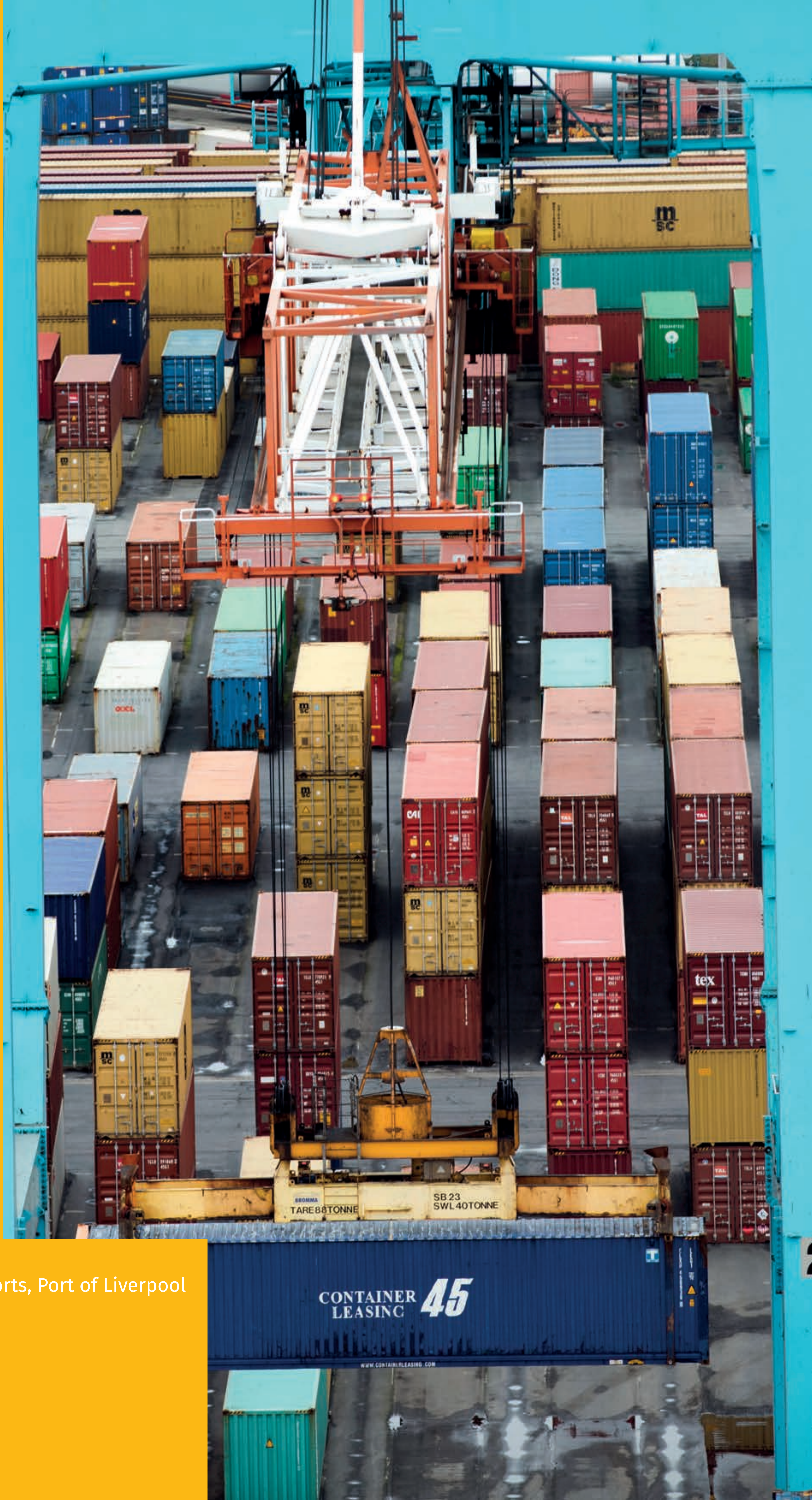

Peel Ports, Port of Liverpool

SUMMARY

The British economic model needs fundamental reform. It is no longer generating rising earnings for a majority of the population, and young people today are set to be poorer than their parents. Beneath its headline figures, the economy is suffering from deep and longstanding weaknesses, which make it unfit to face the challenges of the 2020s. Fundamental reform has happened before, in the 1940s and 1980s. The persistent economic problems we have experienced since the 2008 global financial crash demand change of the same magnitude now. This should be guided by a new vision for the economy, where long-term prosperity is joined with justice for all.

This Interim Report of the IPPR Commission on Economic Justice sets out the case for a new approach to economic policy. It argues that the economy we have today is creating neither prosperity nor justice. This is not inevitable, but the consequence of decisions made in recent decades. The economy exists to serve society, not the other way round. So we can choose to change it, if we have the ambition and determination to do so. If we want to change the economy we have, we need to describe the economy we want.

In this report, the Commission proposes some broad directions and areas for reform. Our final report in 2018 will make specific policy recommendations.

In this report we offer a new vision for the economy in 2030 – an economy in which prosperity is joined with justice, which enables everyone to flourish and builds the common good. We want to build a more dynamic economy in which seizing the opportunities of technological innovation achieves higher productivity, creating better jobs with higher wages and shorter working hours. This must be a balanced economy, in which all the nations and regions of the UK thrive, and we succeed in manufacturing as well as service sectors. We seek an inclusive economy which distributes economic rewards fairly and so allows everyone in society to achieve their potential and to have good and fulfilling work, decent housing and an improving quality of life. We need a sustainable economy that constrains its environmental impacts within the earth's limits, taking care of the long term as well as the short. And we desire a partnership economy, in which successful and responsible businesses, a smart and accountable state, strong trade unions and a vibrant civil society work together for the common good.

This is not the economy we have today.

The British economy today is not generating rising prosperity for a majority of the population. Economic growth no longer leads to higher pay: the period from 2008 to 2021 will be the longest period of earnings stagnation for around 150 years. Young people today are poorer than previous generations at the same age. For too many people and parts of the country, the 'economic promise' of rising living standards has been broken.

- **The UK is the most geographically unbalanced economy in Europe.** Almost 40 per cent of UK output is produced in London and the South East, and only those regions have recovered to pre-2008 levels. Median incomes in the North West, South West and West Midlands are now more than 30 per cent lower than in London and the South East; in Wales, 35 per cent; in Scotland 22 per cent. For people in deindustrialised areas and declining communities, there has been little sign of economic recovery.
- **The UK's high employment rate has been accompanied by an increasingly insecure and 'casualised' labour market.** Fifteen per cent of the workforce

are now self-employed, with an increasing proportion in 'enforced self-employment' driven by businesses seeking to avoid employer responsibilities. Six per cent are on short-term contracts, and almost 3 per cent are on zero-hours contracts. More workers are on low pay than 10 years ago. Insecure and low-paid employment is increasing physical and mental ill-health.

- **The UK economy distributes rewards very unequally.** Between 1979 and 2012, only 10 per cent of overall income growth went to the bottom half of the income distribution, with almost 40 per cent going to the richest tenth of households. Although these households' incomes have fallen slightly since the financial crisis, the UK remains among the most unequal of western European countries. Nearly a third of children – four million – live in poverty, and this figure is now rising again.

The British economy suffers from deep structural problems. We have less a 'British economic model' than an 'economic muddle'– a mixture of powerful strengths and profound weaknesses. Many of these problems go back a quarter of a century or more. Many are the product of deliberate policy choices. Together they have generated an economy in which too much power is concentrated in too few hands.

- **We have both world-leading businesses and world-lagging productivity.** UK productivity is 13 per cent below the average for the richest G7 countries, and has stalled since 2008. Our leading firms are as productive as elsewhere, but we have a longer 'tail' of low-productivity businesses, in which weak management and poor use of skills leads to 'bad jobs' and low wages. A third of adult employees are overqualified for their jobs, the highest proportion in the European Union. This has been enabled by a labour market that is one of the most flexible, or deregulated, in the developed world. Too many sectors have effectively fallen into a low-pay, low-productivity equilibrium.
- **We have one of the world's largest financial sectors, yet a lower rate of investment than most of our major competitors.** Public and private investment is around 5 percentage points of Gross Domestic Product (GDP) below the average for developed economies, and has been falling for 30 years. Corporate investment has fallen below the rate of depreciation – meaning that our capital stock is falling – and investment in research and development (R&D) is lower than in our major competitors. Among the causes are a banking system that is not sufficiently focussed on lending for business growth, and the increasing short-termism of our financial and corporate sector. Under pressure from equity markets increasingly focussed on short-term returns, businesses are distributing an increasing proportion of their earnings to their shareholders rather than investing them for the future.
- **We are both succeeding and failing in international trade.** The UK has a trade surplus in services, but an overall current account deficit that – as a percentage of GDP – is the largest of all the G7 countries. This indicates a serious problem of competitiveness, made worse over recent decades by an overvalued currency. The UK's manufacturing sector now makes up just 10 per cent of GDP, lower than in most of our major competitors. The UK's exports are concentrated in a small number of sectors and many of our industrial supply chains are highly dependent on imports.
- **We have experimented with bold monetary policy, but are constrained by pre-Keynesian fiscal orthodoxy.** Since the financial crisis, the UK economy has been supported by extremely low interest rates and a major programme of 'quantitative easing' (unconventional money creation) by the Bank of England. Fiscal austerity – public spending reductions and tax rises – has left the UK's recovery in this period slower than almost all of our major competitors. Growth is now being fuelled again by consumer spending, based on rising debt and falling savings. With monetary policy having little further scope to deal with a slowdown, there is a strong case for increased public investment now to drive demand.

- **The economy depends on public spending, but we have not been sufficiently willing to pay for it.** Public spending cuts are putting increasing pressure on the public services on which our economy and society depend. These pressures are set to increase as the UK's population ages, particularly in health and social care and pensions: as the working-age proportion of the population declines, we will face a growing 'fiscal gap'. Public spending as a percentage of GDP is around 40 per cent, around the developed world average. Yet this exceeds total government receipts at around 37 per cent of GDP, and at around 33 per cent of GDP UK taxation is considerably lower than the average for comparable economies. The complicated nature of the British tax system, and the significant 'tax gap' between taxes owed and those collected, suggest that this is a field open to reform.

These structural problems argue for a new approach to economic policy. The case is made stronger by the challenges and opportunities confronting us as we enter the 2020s. Britain faces a 'decade of disruption', for which we are as yet largely unprepared.

- **Brexit** will be a momentous change to Britain's economic governance and trading relationships. While there remains considerable uncertainty about its impact in both the short and long term, it will clearly require – and may create opportunities for – the British economy to become more resilient and competitive, focussed on higher productivity and export performance.
- **Deeper globalisation** will continue to challenge the UK's role in international trade. As the international economy moves east and south, trade in data and services, in particular, will grow. With emerging economies increasingly able to compete in higher-value products, the UK will need to secure access to global markets in services, and to take advantage of new technological opportunities for advanced and more localised manufacturing.
- **Demographic change** raises serious questions for policymakers, with the population aged over 65 forecast to grow by 33 per cent (from 11.6 million to 15.4 million) by 2030, while the working-age population grows by just 2 per cent. An ageing population will lead to rising demand for spending on health and social care and pensions, and for immigration to bolster the labour force.
- **Technological change** has huge potential to improve living standards, but will need to be managed to ensure that the gains are fairly shared. Automation will change many jobs through advances in artificial intelligence, machine learning and robotics, but higher unemployment can be avoided if the productivity gains are translated into higher earnings and are re-spent in the economy. Society will also need to address the growth of digital companies with near-monopoly power in some markets and in the control of data.
- **Environmental degradation** is reaching critical global and local thresholds across a number of fields, including climate change, air pollution and global habitat loss. 'Green growth' offers significant opportunities for the UK, which is already a leader in some low-carbon and environmental industries. But it will require a much stronger policy framework, including for the almost wholesale decarbonisation of the economy by mid-century.

To respond to these challenges and opportunities of the future, and address the economy's structural weaknesses inherited from the past, the economy will need fundamental reform.

Reform of this kind has happened twice before in the last century, following similar periods of economic crisis. The established economic order broke down first after the Great Depression of the 1930s and then again after the oil shocks and 'stagflation' (simultaneous high unemployment and inflation) of the 1970s. In both cases, economic crisis led to a major shift in economic understanding, policies and institutions. The 2008 global financial crisis has precipitated a comparable breakdown in the economic settlement of the last three decades. And in the same way that the postwar Keynesian settlement was established in response to the first breakdown, and the 'free market' or 'neoliberal' settlement by the second, we believe that a new settlement must now be forged today. This must be underpinned by a new understanding of what makes economies successful in the 21st century, drawing on the many powerful insights of modern economics.

This is, therefore, the moment for new, radical policy options to be debated. That means rethinking the institutions, frameworks and rules that govern the economy, and confronting the concentrations of economic power that hold back economic success. In exploring possible policy recommendations for our final report in 2018, the Commission seeks to define a new settlement for the 21st century underpinned by three principles of reform:

First, putting the economy on stronger institutional foundations, enabling long-term prosperity by providing the greater certainty that supports investment. We are considering:

- a new vision, indicators and institutions of economic policymaking, including a stronger partnership between governments, business, trade unions and civil society
- a new approach to macroeconomic policymaking, including fiscal, monetary and exchange rate policy
- a new settlement for the UK's nations and regions, including new powers and institutions.

Second, making the British economy more competitive, more innovative and better set for long-term success. We are considering:

- a new approach to industrial strategy, aimed at strengthening innovation, raising productivity in the 'everyday economy' and using 'missions' to address major challenges, including reducing the economy's impact on climate change and the environment, and responding to an ageing society
- improving entrepreneurialism and market competition, particularly through open data and a new framework for digital monopolies
- reforming the finance sector to support long-term investment, through both banking and equity markets
- reforming corporate governance to promote long-term business success.

Third, wiring the economy for justice. We are considering:

- how to promote better-paying and more secure jobs, including strengthening the role of trade unions, regulating unjust practices in the labour market, promoting better work/life balance and eliminating the gender and ethnic pay gaps
- reform of the tax system, to make it fairer, smarter and simpler
- measures to spread wealth more fairly, including better taxation, new approaches to housing and widening the ownership of firms.

This is an ambitious agenda to rewrite the rules of the British economy. For at this moment of uncertainty and anxiety, there is a profound risk that – in a very British way – we simply attempt to 'muddle through'. That way will not address the issues we face. We believe the country now needs to chart a new direction. We must face up to the problems honestly, find the courage to confront them boldly, and act with vision and determination to seize the opportunities that lie ahead. By shaping the future through the active choices we make as a society, we can achieve prosperity and justice together.

Over the next year, the Commission will consult widely on our final report, which will be published in autumn 2018. We welcome reactions to the arguments and proposals we have made here and further contributions to our work.

INTRODUCTION

This Interim Report of the IPPR Commission on Economic Justice argues that the UK economy needs fundamental reform.

We start by setting out our vision of a good economy. Chapter 1 reflects on the UK's current economic and political circumstances and describes the kind of economy we believe Britain should be aiming for by 2030.

The Commission's case for change rests on four pillars, set out in the subsequent chapters.

First, the UK economy is no longer raising living standards for a majority of people. Chapter 2 describes the performance of the economy from the perspective of ordinary households. It reveals the major divides found in our society and poses the question: whose economy is it?

Second, the economy's poor performance arises from deep and longstanding structural weaknesses. Chapter 3 describes our current economic settlement, the result of both global economic trends and the policies of British governments over the last three decades. It analyses five key areas where the economy has the characteristics more of a 'muddle' than a coherent model, and where it needs reform.

Third, we face profound challenges and opportunities in the next decade for which we are not well prepared. Chapter 4 analyses five areas presenting such challenges and opportunities, arguing that the country faces a 'decade of disruption' in the 2020s.

Fourth, fundamental economic reform has happened twice before in the last century, each time following economic crisis. Chapter 5 compares the present moment following the financial crash of 2008 to previous periods of major economic change. It argues that now is the time for a fresh direction to economic policy, and describes some of the new economic thinking that underpins our approach.

We conclude by describing the reforms that are on our agenda for the year ahead. The Commission's recommendations for reform will be set out in its final report in the autumn of 2018. Chapter 6 describes our core principles, and sets out proposals we are exploring in 10 policy areas. Our aim is to 'rewrite the rules' by which the UK economy creates wealth and shares the proceeds. We close by describing the Commission's work over the next year and seeking the feedback and contributions of people from across the country and from all parts of the economy and society.

Lee Edmunds, electrician, Tata Steel,
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1.
WANTED: A NEW ECONOMIC VISION FOR BRITAIN

We stand at a moment of great economic uncertainty. Today, the unclear prospects of Brexit loom large over our economy and our politics. Yet the economic outlook was troubling even before the 2016 EU referendum. Since the financial crisis of 2008, the UK economy has been performing neither normally, nor well.

It is a startling fact that – so deep was the post-crisis recession, and so slow the recovery – average household disposable incomes have only just surpassed the levels they reached before the crisis.[1] Indeed, it is only in London and the South East that output per capita has returned to its 2007 peak at all: no other nation or region of the country has yet seen a full recovery.[2] Real incomes are now falling again:[3] the decline in UK real wages since the financial crisis has been the largest of all developed countries apart from Greece, Mexico and Portugal,[4] and we are in the middle of the longest stagnation of earnings since the 1860s.[5] All this has occurred in spite of eight years of the lowest interest rates in the Bank of England's history, held at 0.5 per cent or less since 2009,[6] and £445 billion being pumped into the economy through 'quantitative easing'.[7] GDP growth in 2018 is now forecast to be well below 2 per cent, with few projecting strong growth in the foreseeable future.[8]

The failings of the British economy are central to the political upheavals of the past three years. In the EU referendum, the slogan of the winning Leave campaign, 'take back control', clearly resonated with many people who feel a sense of powerlessness in the globalised economy of today. Whatever the merits or otherwise of the arguments about the EU, the result expressed a strong sense of economic dislocation and disenfranchisement in many parts of the country and among many groups of people.

And in the general election of 2017, it was striking that a ballot ostensibly called on the question of Brexit rapidly focussed on the state of the country at home – for example schools funding, deficits in the NHS, public sector pay and reductions in police numbers. The astonishing increase in voting by people in their twenties and thirties suggested particularly widespread frustration among younger generations, so many of whom are unable to access decent housing, weighed down by student debt and likely to be poorer than their parents. The election result seemed to confirm an appetite for economic change.

The appalling disaster of Grenfell Tower – a deeply political tragedy – has further crystallised a sense that the fabric of British society has been torn. It is hard not to see Grenfell as a hideous monument to inequalities of wealth and power; to the sense that the British state – whether national or local – simply did not care for its citizens because they were poor, and had prioritised the drive for deregulation above human safety.

For the Commission, the lesson of these turbulent political times is that the economy does not belong exclusively to those at the top of it, whether in business, government or society. It belongs to us all. The economy should serve society, not the other way round. If we do not like the way it is working, we need to assert our collective power to change it.

Successful change demands a destination to guide its direction. As we prepare for the new post-Brexit world, we believe the country needs a new vision for the economy we want to achieve. Writing in 1944, William Beveridge described a vision of 'full employment in a free society'.[9] It gave much-needed direction for the postwar government which created a new economic and social settlement for Britain. We need a comparable vision today.

We are convinced that most people in Britain want the same things from the economy. They want an economy that creates broadly shared prosperity, that is balanced across households and regions of the country, and that is environmentally sustainable. They want an economy that works for everyone, not just a minority of people who are already better-off. An economy that not only improves individual living standards and wellbeing, but also strengthens the public goods we share in common; and that safeguards the future, as well as enriching the present. So we have written down – below – our vision of the kind of economy we believe Britain should be aiming for over the next decade or so, to 2030. Critics will no doubt say that such a vision is utopian. But there is no reason why we cannot build an economy like this if we have the will. And the first step is to have the ambition to do so.

OUR ENDOWMENT

Britain has a great endowment on which to build the economy of the future – but one that presents its own particularities and challenges too. We have a diverse population; deep roots in industry and enterprise; an extraordinary cultural heritage; vibrant creative industries; and a world-leading financial centre. We are a scientific superpower, and we have enduring and powerful institutions, for good and ill.

The four nations of the UK have a diverse and growing population of many backgrounds and cultures. With the fastest-growing population in Europe, we are set to be its largest country by the middle of the 21st century.[10] The diversity of modern British society is accelerating: by 2030, nearly a third of Britons will be from black and minority ethnic backgrounds.[11] The millennial generation – diverse, growing, digital and energetic – have asserted their political power for the first time in decades.

We have vast ingenuity and creativity among our people, where enterprise and industry have deep roots going back to the Industrial Revolution. Even as the UK's manufacturing sector has shrunk to just 10 per cent of GDP, we have retained some of the world's leading industries, such as aerospace, pharmaceuticals and automobiles, and a good base from which to expand manufacturing in the future.[12] Britain has the greatest number of artificial intelligence firms of any country other than China and the US.[13] Yet some aspects of our economic past cannot be changed. Needlessly aggressive deindustrialisation made the British economy more concentrated, and many heavy industries are unlikely ever to return since the skill base they depended on no longer exists.

One of the legacies of the first industrial age was a society divided by class. Class divisions have changed, but they have not been eliminated. They appear on new economic fault lines: between those able, through education and culture, to seize the opportunities of a globalised economy, and others who find themselves unable to escape poor jobs on low wages; and between cities that have found new economic strengths, and post-industrial areas that have not. Some of these class divides came to the fore immediately following the EU referendum, in the views of some supporters of Remain and Leave towards one another. These essentially class-based divisions will need to be understood and overcome in the building of a new economy. Economic justice must begin with a greater sense of fellow-feeling – a hard task in a divided country.

Our extraordinary cultural heritage – our long history and wealth of artistic achievement – is perhaps our greatest asset. The emergence of English as the world's common language and the legacy of our links across the globe have positioned Britain to have outsized cultural influence. Our creative industries have thrived in recent decades. Not only are these industries a successful sector of our economy; they also promote capabilities that will be crucial in the 21st century. As the pace of change accelerates, the capacity to think and act creatively only increases in importance.

Our country is home to the world's leading financial centre in the City of London, with Edinburgh another, and financial services are well distributed across the nations and regions of the UK. The financial sector not only generates significant trade surpluses; it also possesses the power, currently underutilised, to channel investment into the wider British economy if we can get the framework, incentives and institutions right.

The crucial contributor to this country's wealth has been our scientific pre-eminence. When, in 1620, Francis Bacon authored *Novum Organum Scientiarum* – 'the new instrument of science' – he established what we now understand as the 'scientific method'. The Royal Society – the world's first scientific society – created the system of peer review and publication. Many of the most important scientific discoveries in human history have taken place in Britain, advancing not only this country but also the entirety of humanity. Our approach to science reflects who we are as a people: open-minded, ambitious, curious and seeking to make a bigger contribution to human understanding.

Today, we remain a scientific superpower. Not only do we possess some of the best universities in the world, they are distributed across the whole of the country. It is why we are well positioned to become a global leader in developing the technologies of the future – technologies of incomparable power to shape our economy, our society and our lives. In the past we have made too little of these advantages and failed to sufficiently translate our scientific pre-eminence into enterprise. We must not be so complacent in the future.

Britain has long-established and globally respected institutions, from the Civil Service to the BBC. Yet in the economic sphere there has been a sterility of thinking and a failure of policy, which suggests the need for institutional reform, across both public and private sectors. One of the more difficult endowments to confront is complacency: the belief that we can 'muddle through' the future, in the same way we have done in the past.

That view is illustrative of a wider malaise we wish to challenge: in recent times we appear to have lost the spirit of possibility. In too many aspects, we have allowed a 'can't do' attitude to prevail. Perhaps as a result of the great endowment that we have – and the vested interests that go with it – British economic policy has felt diminished in ambition. The IPPR Commission on Economic Justice aims to tackle that sentiment head on: to open up intellectual space, and to propose novel solutions that build on our endowment and prepare us to succeed in the future as well as to celebrate that which is good about our past.

THE COMMISSION'S VISION FOR THE BRITISH ECONOMY IN 2030

The good economy

Our vision is of a good economy, where prosperity is joined with justice. The good economy works for all by achieving sustainable growth and broadly shared prosperity. In the good economy, everyone – in all parts of the country – has an equally good chance of leading a good life. It allows each of us to flourish: to fulfil our economic and human potential, no matter our starting point, and meet our needs at each stage of life. This means opportunities for good and fulfilling work; a decent income providing good living standards; and time for love, leisure, creativity and care and service to others. The good economy values people for who they are as much as what they do. It is judged not only by its results but also by the conduct of those within it, and is concerned with reciprocity, generosity and kindness. It offers hope for the future by fulfilling the promise that successive generations will have the opportunity to lead better lives.

The good economy is concerned with building the common good as well as with improving individual living standards. It meets our human and economic needs for education throughout life; for high-quality health and social care; for affordable housing and transport; for a diverse culture and vibrant democracy; and for beauty and safety in our shared spaces as well as in our private ones. The good economy ensures that our commons are well tended: valuing our natural inheritance and being good stewards for future generations by diminishing the impact of economic activity on the earth's climate and resources.

The dynamic economy

By 2030, we want Britain to have seized the opportunities of the 'fourth industrial revolution' to create one of the most dynamic market economies in the world. The powerful deployment of new technologies will have made it easy to create new businesses, resulting in competition that spurs innovation and promotes efficiency. Strong relationships between business, universities and the public sector will mean that innovations spread quickly throughout the whole of the economy. Per capita, we should be producing as many engineers as Germany and as many data scientists as California. We should be attracting the top international students from around the world as the destination of choice for research.

The dynamic economy will be focussed on solving real problems, not simply producing more things for us to consume. It will be directed at enriching lives and ensuring that we live sustainably within the earth's limits.

In 2030, the dynamic economy will be enabled by a smart and supportive state, recognising that wealth is co-created by the private and public sectors together. The smart state will help to energise innovation by defining problem-solving missions for the economy, promoting investment, ensuring that business can succeed by keeping aggregate demand buoyant and making sure that British exports are competitively priced. The supportive state will encourage entrepreneurs to establish new businesses by diminishing personal risk. It will ensure that markets are truly open to entrepreneurs by breaking up concentrations of power and promoting vigorous competition.

The balanced economy

By 2030, we want a new industrial strategy – to be nationally diversified and regionally distinctive – to have succeeded. There will be centres of technological and industrial excellence in every nation and region of the country, with our strengths in services complemented by a renaissance in manufacturing. Britain will be on its way to becoming a net exporter of goods as well as services, having significantly reduced our trade deficit. By 2030, we want substantial economic decision-making powers to be located in the nations and regions of the UK through strong and well-financed institutions with devolved fiscal powers that support national and regional industrial strategies. The productivity and income gaps between London and the South East and the rest of the country should be substantially closed.

The just economy

By 2030, we want Britain to have a fairer distribution of economic rewards. A larger proportion of national income will go into wages and salaries, with an increased share for those in the bottom half of the income distribution. Both income and wealth inequalities will have been reduced.

The just economy will prioritise the quality and security of work as well as the level of employment, with stronger rights and greater opportunities for lifelong learning and job progression. Citizenship will no longer stop at the workplace front door: workers will have greater voice in decision-making, offering new ways to boost productivity. By 2030, the British economy will have closed the gender pay gap and the ethnic pay gap. Average working hours will be falling while productivity will be rising, and mental and physical ill-health from work will be reduced.

The just economy will create opportunities for people of all ages. It will give all young people access to decent housing, whether owned or rented. By 2030, many people in the last third of life will still be partly working, not forced to by poverty but because the economy creates meaningful opportunities. As a result, we will have tackled inadequate pension provision, and social isolation and loneliness will have diminished.

The sustainable economy
By 2030, we want the British economy – as part of the global economy – to have radically reduced its global environmental footprint, allowing priority to be given to the needs of the developing world. As a result, the UK should be heading towards full decarbonisation by mid-century, our economy and homes largely powered and heated by renewable energy, much of it decentralised and all of it smart. The electrification of vehicles, the greater use of public transport and increased take-up of cycling and walking should have largely solved the problem of urban air pollution. We will measure and sustain our natural capital. By 2030, the greening of the global economy should be making the environmental goods and services sector one of our most successful. Across both industry and households, we will have pioneered the shift to a more 'circular' economy, where resources are stewarded throughout their life, wastes tend to zero and resource productivity is maximised. We will measure the success of our economy by its sustainability as well as its prosperity.

The partnership economy
By 2030, we want the economy to be guided by a new social partnership: between responsible businesses, a smart and accountable state, strong trade unions and a vibrant civil society. In 2030, most successful businesses will recognise that they have obligations to their employees, stakeholders and communities, and not just to their shareholders. The focus on short-term 'shareholder value' will have been replaced by a commitment to investment and long-term success. Employers and employees will acknowledge their mutual responsibilities, where the recognition of workers' rights, voice and creativity is rewarded by greater productivity and pride in work. The public are no longer considered solely as passive 'consumers' but rather as 'economic citizens' endowed with rights to share in ownership and public decision-making, meaningful opportunities to create their own businesses, and responsibilities to contribute to the economy's success. As a result, the UK has one of the widest range of business forms in the world, including socially owned, mutual and cooperative enterprises of various kinds.

A NEW PATH

Our vision is unapologetically bold and ambitious. People and governments commonly overestimate what they can do in two years and underestimate what they can achieve in 10. It is a vision of a productive economy that is also a just one. Some will say that this cannot be done; that one must be traded off against the other. We profoundly reject this claim. It is not what the economic evidence says, as we show in this report. Some of the most successful and dynamic countries in the world are also some of the most equal – and for good reasons. We do not believe that Britain should aim for any less.

At this moment of uncertainty and anxiety, there is a profound risk that – in a very British way – we simply attempt to 'muddle through'. That way should not be good enough for any of us. We believe that the country urgently needs to chart a new direction. We must face up to our problems honestly, find the courage to confront them boldly, and act with vision and determination to seize the opportunities that lie ahead. The future is not predetermined. We must shape it through the active choices we make as a society, for the economy belongs to us all.

Soup kitchen, Birmingham

2. WHOSE ECONOMY IS IT?

At first sight, the British economy appears to have been doing reasonably well. Since national income recovered to its pre-financial-crisis level in 2013, the economy has been growing at around 2 per cent a year.[14] The downturn that many forecast following the referendum vote to leave the EU did not materialise, even if the outlook is highly uncertain. Employment is at its highest rate since records began, with 75.1 per cent of the working-age population now in work.[15] At 4.4 per cent, unemployment is at its lowest level for 40 years.[16] So, on the surface, things look good.

But there are darker clouds on the horizon. With both inflation and Brexit-related uncertainty rising, most forecasters have adjusted their expectations for growth downwards. The Office for Budget Responsibility (OBR) projects growth to remain at 2 per cent in 2017 and fall to 1.6 per cent in 2018; the Organisation for Economic Co-operation and Development (OECD), 1.1 per cent in 2017 and 0.9 per cent in 2018.[17]

Underneath these figures, however, there is a deeper story. The economy that ordinary households experience is not that of national output and aggregate employment. What most people observe is more direct: they see their own individual and family incomes, the ways in which jobs and job opportunities are changing, and the sense of prosperity or decline in their local economy. To understand properly how the economy is performing – and who it is performing for – we need to look at it from this perspective. What is happening in the economy as it is actually lived? In this chapter we gather the evidence.

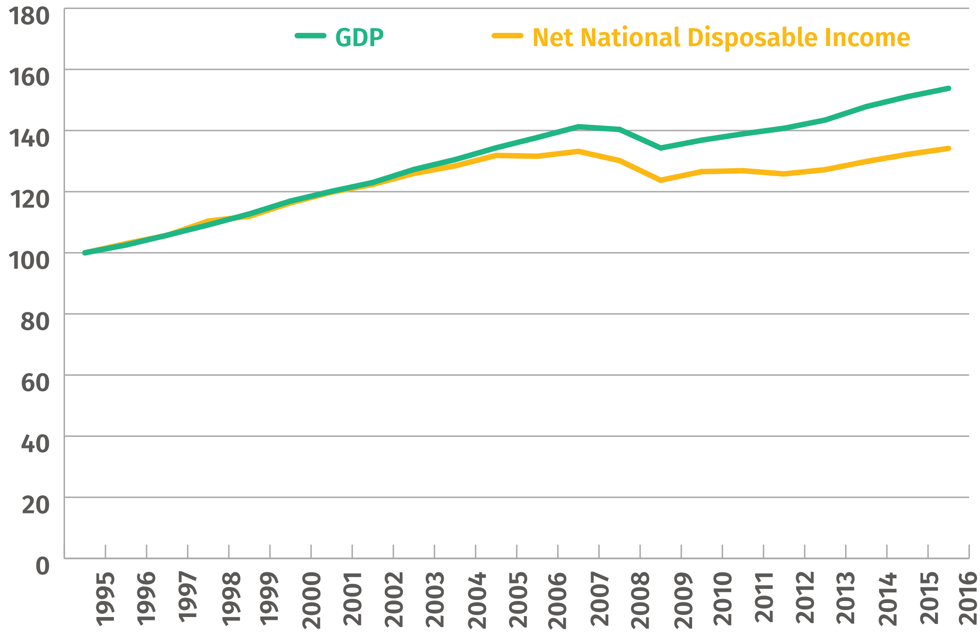
HOUSEHOLD INCOME AND EARNINGS

We start with the trends in household incomes. Here the headline GDP numbers are at odds with many people's experience. Overall GDP is 10 per cent higher than in 2008. But when adjusted for the UK's growing population and income flowing to overseas residents (as well as overseas income earned by British residents), national disposable income per head has barely recovered at all, only just surpassing its pre-crisis peak at the end of 2016 (see figure 2.1).[18]

FIGURE 2.1

Despite growth in GDP, disposable income per person has barely recovered its pre-crisis peak

Trend in real national disposable income per head, 1995-2016, 1995 = 100



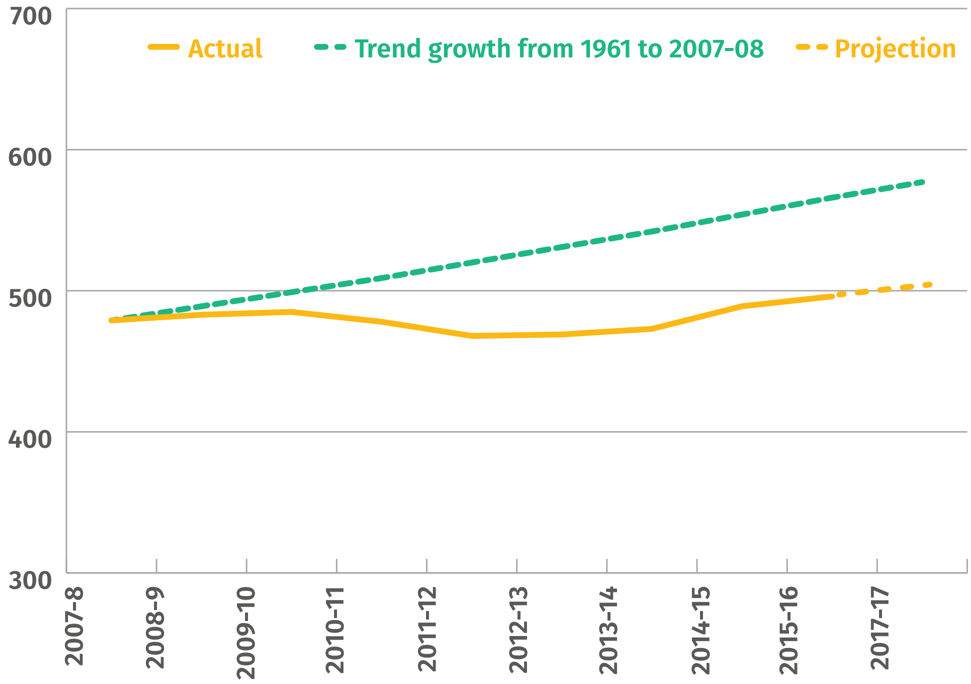
Source: IPPR analysis using Office for National Statistics (2017) 'UK economic accounts time series dataset (UKEA)' (database) https://www.ons.gov.uk/economy/grossdomesticproductgdp/timeseries/mwb7/ukea

Real median (average) household incomes are in fact today only 5 per cent higher than they were in 2007. This is 10–15 per cent lower than would have been expected had incomes continued on their pre-crisis growth rates – the equivalent of almost £4,000 per year 'lost income' for the average household.[19] And this trend looks set to continue. The OBR forecasts no real growth in median income over the next two years, and only modest growth thereafter. This would leave the incomes of half of the population in 2021–2022 more than 15 per cent below where they might have been expected before the financial crisis hit – equivalent to over £5,000 per household per year on average.[20] Based on OBR data, the Institute for Fiscal Studies (IFS) forecasts that the incomes of the poorest fifth of the population will actually fall over the next five years.[21]

FIGURE 2.2

Incomes are well below their pre-crisis trend

Weekly equivalised net household income (£), 2007-08 - 2016-17, 2017-18 constant prices



Source: Hood A and Waters T (2016) *Incomes and Inequality: The Last Decade and the Next Parliament*, Institute for Fiscal Studies https://www.ifs.org.uk/publications/9192

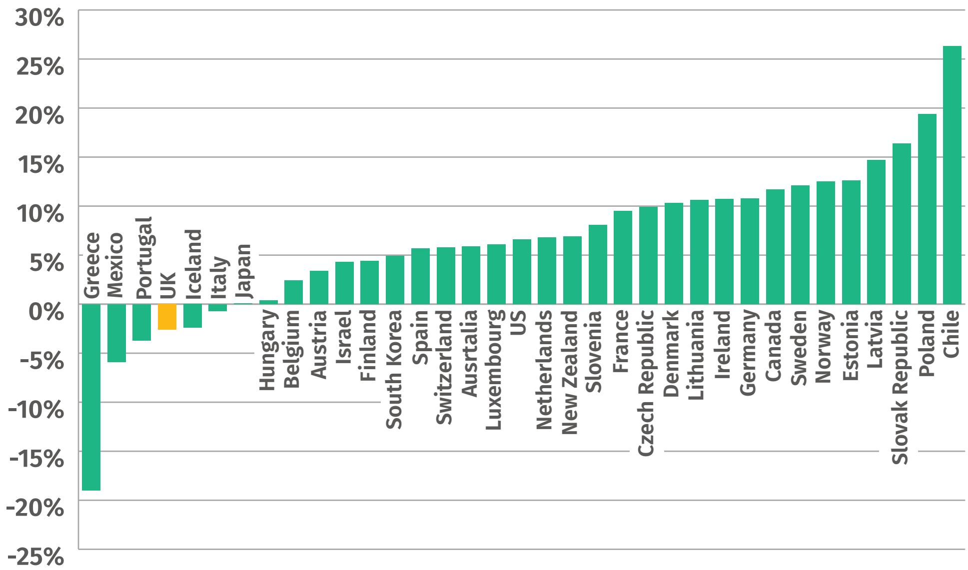
At the heart of these income trends lies a startling squeeze on earnings. Following the financial crisis, real pay in Britain fell almost continuously for six years, as small increases in nominal pay were outweighed by inflation. Since 2014, there has been some earnings growth, as inflation fell and the minimum wage rose. Yet at the beginning of 2017, real average pay was still over 3 per cent lower than it was in 2008; indeed, it was barely higher than in 2005.[22] And again this looks likely to continue. With inflation rising and nominal wage growth slowing, the OBR forecasts that, by 2021, real wages will still not have recovered to their 2008 level.[23] This would represent the longest period of earnings stagnation since the 1860s.[24]

While all countries have suffered since the financial crisis, the UK's record on earnings has been significantly worse than almost every other developed economy. Between 2007 and 2016, annual real wages grew 10.8 per cent in Germany, 9.5 per cent in France and 6.4 per cent on average across the countries of the OECD. In the UK, however, they *fell* by 2.6 per cent.[25] Of 35 OECD countries, only in Greece, Mexico and Portugal were 2016 earnings even further behind 2007 than in the UK (see figure 2.3).[26]

FIGURE 2.3

The UK is one of only six OECD countries where earnings are still below their 2007 level

Percentage change in average annual wages between 2007 and 2016, 2016 constant prices at purchasing power parity (PPP)



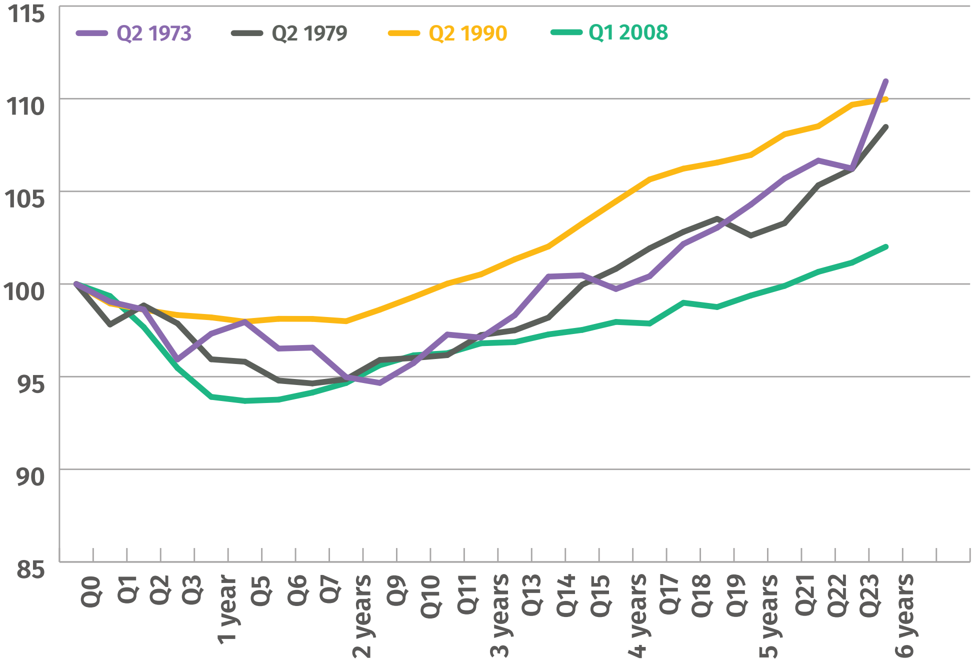
Source: IPPR analysis of Organisation for Economic Co-operation and Development (2017) 'Average annual wages' https://stats.oecd.org/Index.aspx?DataSetCode=AV_AN_WAGE

Two different trends have intersected here. The first is slow growth. It is not just that the UK, like other countries, suffered a huge hit to output and incomes in the aftermath of the financial crisis. It is also that the economy's recovery since then has been the slowest after any major recession since the 1970s (see figure 2.4). Following major downturns in 1973, 1979 and 1990, GDP recovered its pre-recession peak after 4 years or less, but following the 2008 recession, GDP did not recover its 2007 levels for more than five years, due to a far slower rate of growth.[27]

FIGURE 2.4

The recovery from the 2008 recession has been the weakest since the second world war

Trends in real GDP following major recessions since 1945, 100 = final quarter of consecutive contraction



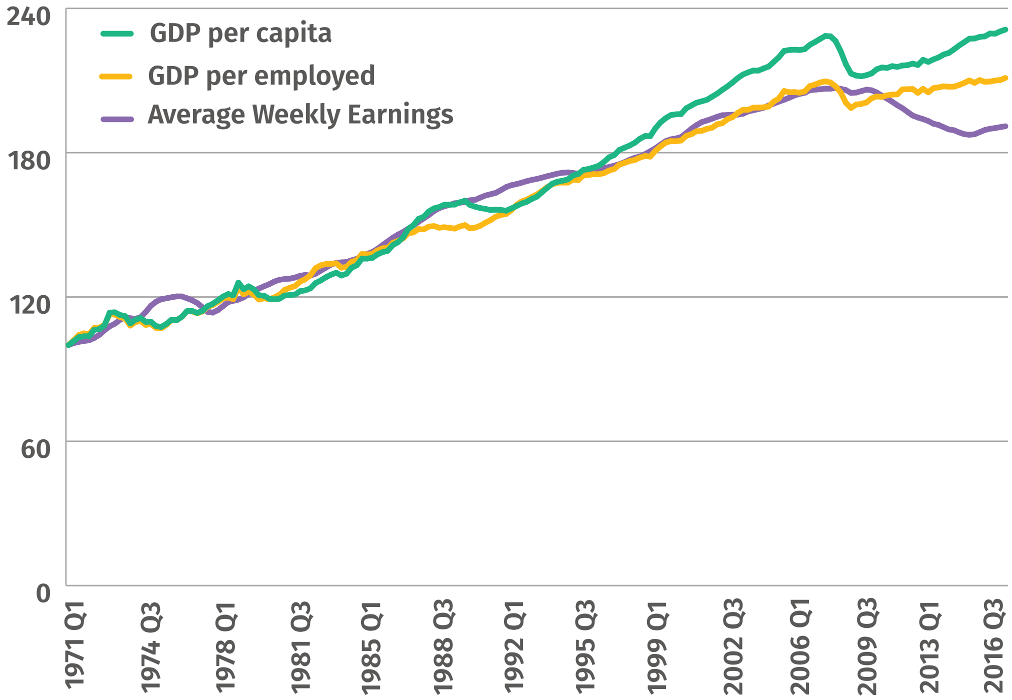
Source: IPPR analysis of Office for National Statistics (2017) 'Gross Domestic Product: chained volume measures: seasonally adjusted £m' https://www.ons.gov.uk/economy/grossdomesticproductgdp/timeseries/abmi/pgdp

Second, and even after accounting for the number of people in employment, economic growth has become 'uncoupled' from average earnings growth (see figure 2.5). We have an economy today that is growing in size but not translating this into higher earnings for a majority of the working population.

FIGURE 2.5

Average weekly earnings have decoupled from GDP growth for the first time since comparable data has been available

Real GDP per capita, real GDP per employee and real average weekly earnings Q1 1971 to Q3 2016, 100 = 1971 Q1



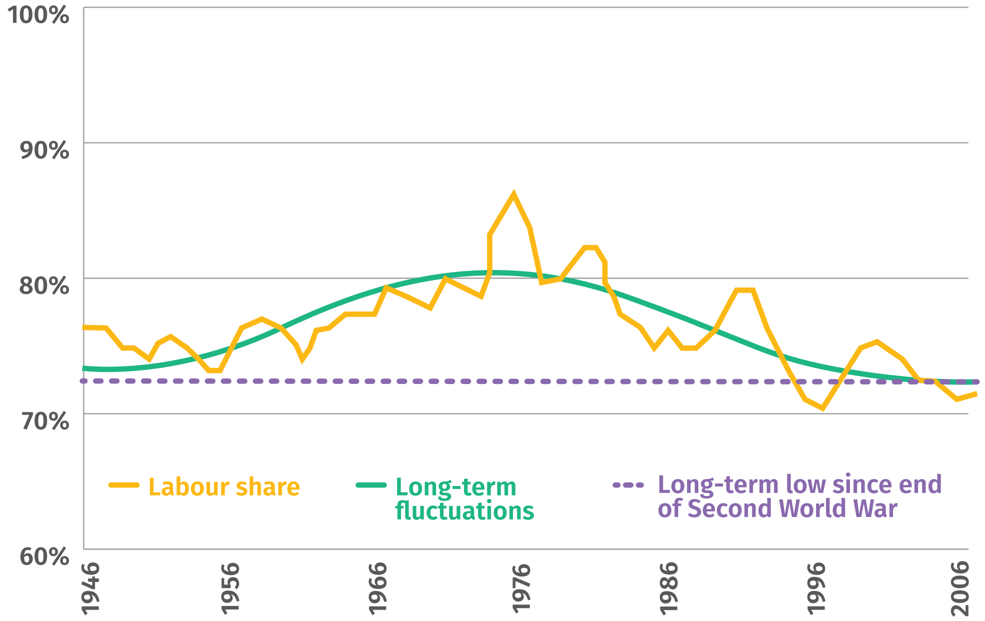
Source: IPPR calculations using various Office for National Statistics (ONS) data series
Note: The official average weekly earnings (AWE) series does not go back before 2000. AWE prior to 2000 has been derived from imputed ONS data on a like-for-like comparison to the modern series. All AWE data has been converted to real terms using an index for Retail Price Index (RPI) inflation.

This most recent period follows a much longer one in which the share of national income going to labour (that is, to wages and salaries rather than as returns to capital) has been in decline. Figure 2.6 shows a very striking pattern: a rising share of national income going to labour from the second world war to the mid-1970s, and then a falling one until the financial crisis.[28] This is a trend observed in most developed countries: it suggests a major shift in how modern economies both generate growth and distribute its rewards.[29]

FIGURE 2.6

GDP growth was driven by rising wages for a quarter of century, but since the mid-1970s the share of wages in national income has been falling

Total wages in the economy as a proportion of GDP, actual and long-term fluctuations, 1946–2008



Source: Reproduced from Organisation for Economic Co-operation and Development (2015) *The Labour Share in G20 Economies*, International Labour Organization and OECD https://www.oecd.org/g20/topics/employment-and-social-policy/The-Labour-Share-in-G20-Economies.pdf

For ordinary British households, these patterns together tell a troubling story about our economy. The economic promise that has underpinned public life at least since the second world war – that economic growth would generate consistently rising living standards for the country as a whole – appears to have been broken. It is perhaps not surprising that so many people today feel that the economy is not working as it should.

THE GENERATIONAL DIVIDE

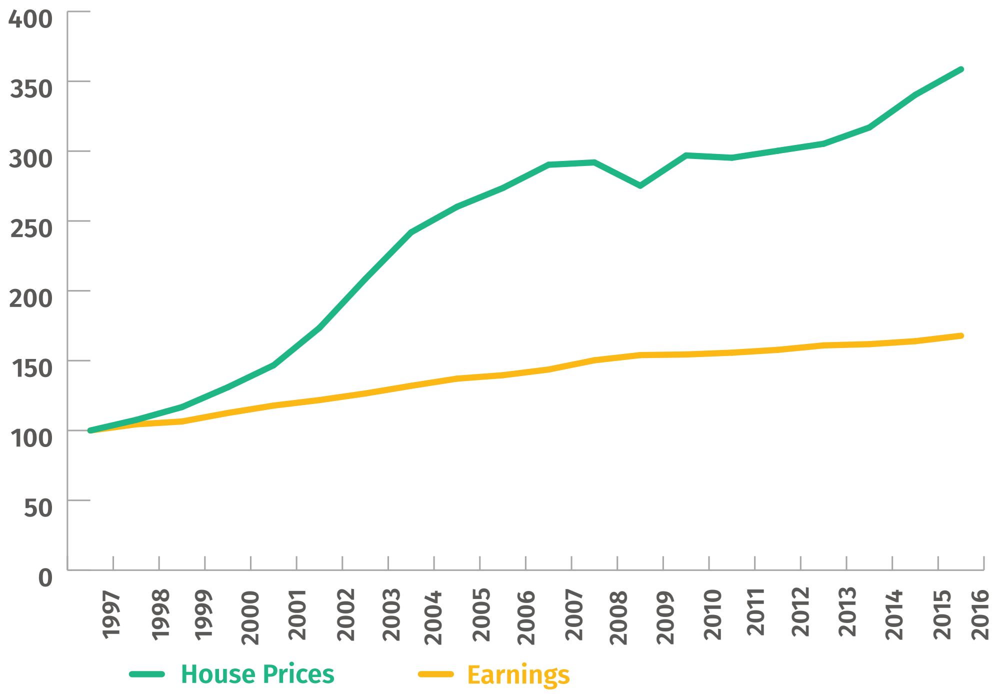
The impact of these trends is not evenly distributed, with some groups hit much harder than others. For younger people, this has been a particularly tough decade. Those aged 22–39 have experienced a fall in real earnings of over 10 per cent from their pre-crisis peak to early 2017, while the increase in tuition fees and the interest paid on them have seen a dramatic rise in student debt.[30] Students now graduate with average debts of £50,000, with 75 per cent unlikely to ever repay their debts in full.[31]

The problem of housing has become particularly acute for young people. Twenty years ago, the average home cost around 3.6 times annual earnings; today it is 7.6 times (see figure 2.7).[32] Unsurprisingly, this has meant that home ownership has begun to fall: from a peak of 71 per cent of households in 2003 to 63 per cent today.[33] For younger and poorer people, this has made it harder to get on the housing ladder. In the last decade, the proportion of 25- to 34-year-olds taking out a mortgage has declined from 53 per cent to 35 per cent; in 2015–16, two-thirds of first-time buyers were in the top two income bands.[34] This has left younger people increasingly concentrated in the private rented sector, with the proportion of 25- to 34-year-olds renting privately rising from 24 per cent to 46 per cent over the same period.[35] Those renting privately not only face greater insecurity of tenure; on average they also pay almost twice the housing costs of those buying a home.[36] The Resolution Foundation estimates that in London a quarter of households in the private rented sector are spending more than half of their income on their rent.[37]

FIGURE 2.7

House price inflation has significantly outstripped wage growth for almost two decades

Median full-time earnings and median house prices, current prices, 1997–2016



Source: IPPR analysis of Office for National Statistics (2017) 'Ratio of house price to residence-based earnings (lower quartile and median)' https://www.ons.gov.uk/peoplepopulationandcommunity/housing/datasets/ratioofhousepricetoresidencebasedearningslowerquartileandmedian

People over the age of 65 have, in general, been hit less hard over the past decade, in part because of housing wealth. In 2014, total housing costs for adults under the age of 30 were a fifth higher than for those aged 65-74, and more than twice as high as for those aged 75 or over. Retired households, protected by the 'triple lock' on the state pension, have also seen their incomes grow by 13 per cent in real terms since 2008.[38] By contrast, the three million working-age households with children in receipt of tax credits and benefits will see real incomes shrink by an average of £2,500 per year as planned benefit cuts are introduced.[39] The Joseph Rowntree Foundation estimates that, in 2017, a working couple with two children earning the national living wage will be £59 per week short of achieving an acceptable standard of living, compared with £50 in 2016.[40]

DIVIDED BY GEOGRAPHY

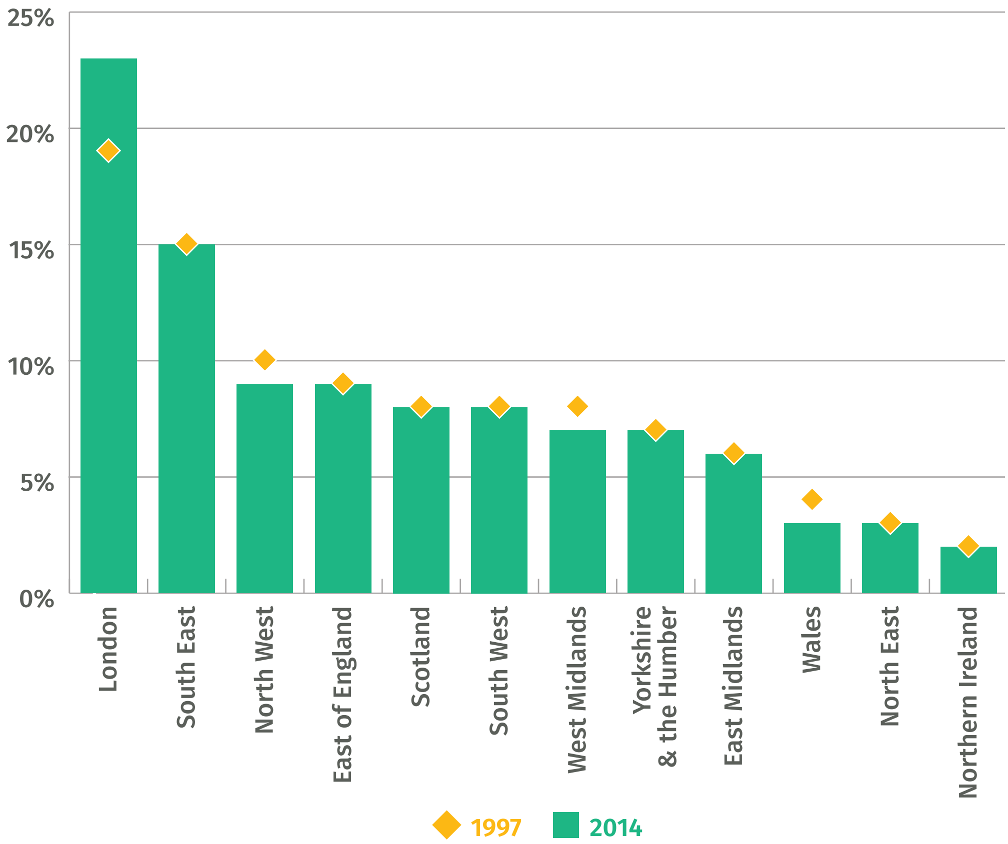
The UK's geographical disparities in income are particularly wide. The remarkable fact is that only in London and the South East has GDP per head recovered to its pre-crisis peak: no other region or nation of the country has yet seen a full economic recovery.[41] Median incomes in the North West, West Midlands, and South West are now more than 30 per cent lower than in London and the South East; in Wales, 35 per cent; in Scotland 22 per cent.[42]

These geographical differences in income reflect the major gaps in output and productivity that now exist between different parts of the country. Over the past 30 years, the gravity of the British economy has tilted strongly towards London and the South East. This is as a result of the decline of older manufacturing industries in the north of England, Scotland and Wales, combined with the growth of London as a global financial centre, and the development of new industries along the M4 and around Cambridge.[43] Almost two-fifths of the UK economy's output is now produced in London and the South East, and output per head in London is more than twice that of most of the other regions of the country (see figure 2.8). Productivity – output per person – in London is 32 per cent above the national average; indeed, London is the only region or nation of the country with above-average productivity. In Northern Ireland and Wales it is almost 20 per cent below the national average, and in the Midlands and the North, 10–15 per cent below.

FIGURE 2.8

London and the South East are responsible for almost 40 per cent of total UK output

Percentage of UK gross value added (GVA) by region/nation, 1997 and 2014



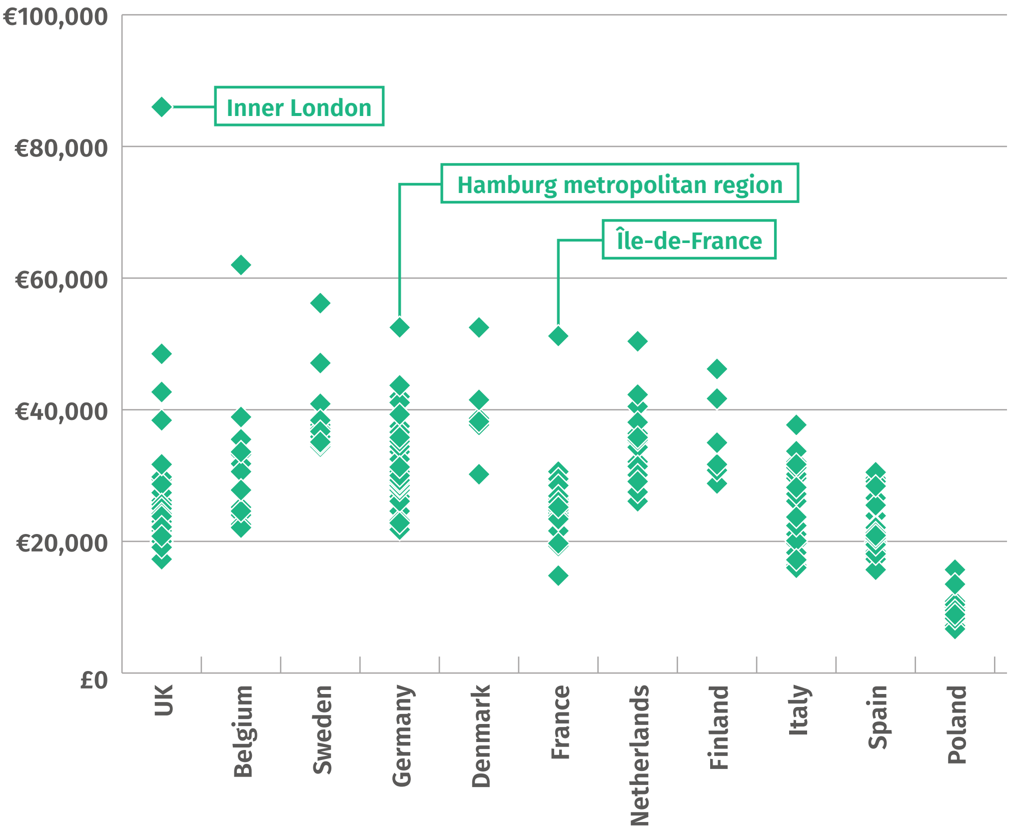
Source: Office for National Statistics (2016) 'Regional Gross Value Added (Income Approach)' (dataset) http://www.ons.gov.uk/economy/grossvalueaddedgva/datasets/regionalgrossvalueaddedincomeapproach
Note: Total UK GVA used in the calculation of regional proportions excludes the extra-region and statistical discrepancies as defined by the Office for National Statistics.

These disparities make the UK the most geographically unbalanced economy in Europe (see figure 2.9). While London (notwithstanding its own internal inequalities) is by far the richest region in all of Europe, more than a quarter of UK regions lag behind, with lower output per head than almost every other region in northern Europe.

FIGURE 2.9

The UK is more economically imbalanced than other countries, even after accounting for variations in population

Output (GVA) per capita (€) by region for selected European countries, 2011



Source: Eurostat (2016) 'Gross domestic product (GDP) at current market prices by NUTS 2 regions' (dataset) http://appsso.eurostat.ec.europa.eu/nui/

Geographical disparities in income contribute to the sense of economic injustice. This is because people live in communities, and are conscious not only of their own living standards but also of how their local areas and regions are faring more generally. Run-down high streets full of pound shops and betting shops in post-industrial and coastal towns, and in poor neighbourhoods in major cities, make it hard for many people to accept the idea that the economy is doing well – because where they live, it is not.

INSECURE WORK AND POVERTY

The UK has a high level of employment, with the unemployment rate having dropped to 4.4 per cent – a 40-year low. Nonetheless, this disguises a much higher rate of part-time employment than in most other developed economies. Surveys indicate that as much as 8 per cent of the workforce is now under-employed – that is, wanting to work more hours than they do.[44]

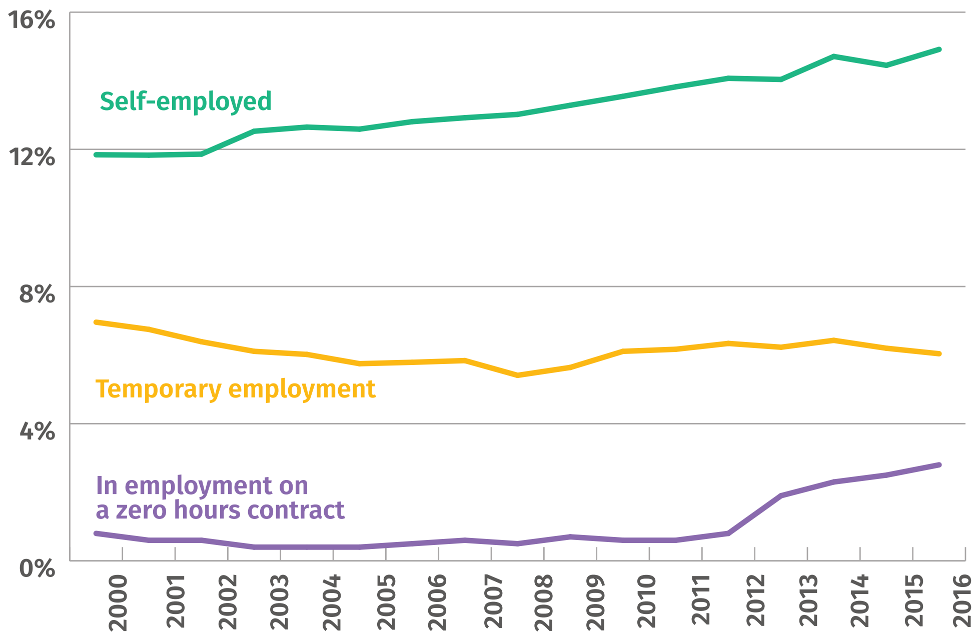
We have also seen a rise in self-employment, from around 13 per cent of the workforce in 2008 to 15 per cent in 2017, or around 4.8 million people.[45] For some, this represents an active choice for improved flexibility or entrepreneurial activity. But as recent employment tribunal cases have revealed, some instances reflect a new kind of 'enforced self-employment', driven by businesses seeking to take advantage of a more flexible workforce and minimise social security liabilities.[46] It is also notable that self-employed people earn less on average than they did 20 years ago, and some work effectively below the national minimum wage.[47]

In 2016, around 2.8 per cent of all people in employment were on a zero-hours contract. This compares with just 0.6 per cent in 2007 and represents a rise from around 170,000 people to more than 900,000 (see figure 2.10).[48] A zero-hours contract provides a worker with no security of employment or pay on a day-to-day basis, making it impossible for them to know what their income is going to be, and therefore making the management of household budgets and planning ahead very difficult. Such contracts also generally come with very few employment rights, such as sickness benefit, maternity or paternity pay or paid holidays. In many respects, this kind of casualised labour market represents a return to 19th-century employment practices.

FIGURE 2.10

The rise in insecure work has accelerated since 2007

Proportions of self-employed, temporary employees and zero-hour contracts among all workers, 2000–2016



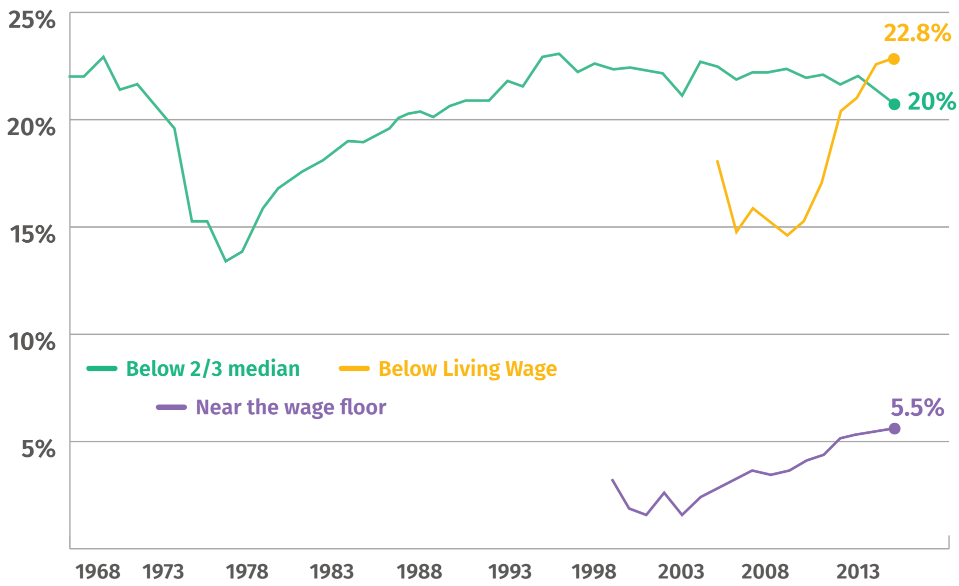
Source: IPPR analysis of Office for National Statistics (2017) 'Contracts that do not guarantee a minimum number of hours', May 2016 https://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/earningsandworkinghours/articles/contractsthatdonotguaranteeaminimumnumberofhours/may2017; Office for National Statistics (2017) 'UK labour market', August 2017 (dataset) https://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/employmentandemployeetypes/datasets/summaryoflabourmarketstatistics

Partly as a result of these changed patterns of employment, the prevalence of low-paid work in the British economy has risen (see figure 2.11). Although the national minimum wage has been rising in real terms (now £7.50 per hour for workers over the age of 25, and between £3.50 and £7.05 for those under 25), the proportion of the workforce on or around this wage level is higher than 10 years ago, and there are more workers now earning below the national living wage. This means that people in low-paid work find it very difficult to progress out of it: Resolution Foundation analysis suggests that only one in four workers will escape low pay over a 10-year period.[49]

FIGURE 2.11

The proportion of employees on low pay has remained persistently high since the 1980s

Proportion of all employees below selected low pay thresholds, 1968–2015



Source: Reproduced from Clarke S and D'Arcy C (2016) *Low Pay Britain 2016*, Resolution Foundation http://www.resolutionfoundation.org/app/uploads/2016/10/Low-Pay-Britain-2016.pdf

It used to be the case that having a job kept people out of poverty. But the rise in low paid work means that this is no longer the case. Indeed, it is a striking fact that, after taking housing costs into account, more people in poverty now live in working households (54 per cent) than non-working households (46 per cent).[50] Overall, 14 million people (22 per cent of the population) now live on incomes below the official poverty line after housing costs; this includes 4 million children, or nearly one in three.[51] Over the last decade child poverty has fallen by just 3 per cent, compared with 21 per cent in the previous decade,[52] and it is now projected to start rising again.[53]

It is also clear that insecure and low-paid employment is a source of mental and physical ill-health and financial anxiety.[54] The trade unions GMB and UNISON and the organisation Citizens UK work with many people in insecure and low-paid jobs, and the testimonies they have provided to the Commission give some sense of the stress it causes (see Box 2.1).

In extreme circumstances, poor mental health and employment outcomes can be both the cause and effect of homelessness. By its very nature, the prevalence of homelessness is difficult to measure, with almost two-thirds of single homeless people thought to be 'hidden'. However, the number of families who are statutory homeless stood at 14,420 households at the end of 2016, and the Government's own estimates for rough sleeping now stand at more than 4,000, after an average rise of 16 per cent every year since 2010.[55] Since 2010, at least one homeless individual living on the streets has died every two weeks.[56]

Box 2.1: The experience of work: testimonies from the front line

'[I] know of a home care provider who will regularly roster a care worker to make over 50 home care visits in one day over a 20-hour period … Rosters sometimes allow as little as three hours' sleep between shifts before they are out for another 20-hour day – often in a dirty uniform because the provider has refused to provide enough for the week. And when they get paid they find their pay is as low as £4.30 per hour. You might ask why anyone would put up with those working conditions – and the answer is simple – zero-hour contracts. If you refuse a shift – or question standards – you'll be out of work.'
Pat, social care worker, Manchester

'I start work at 6am, get up for 5am and am in work to gone 5pm most days. I am in a state of anxiety and take medication … having little money and only more hours with no overtime rates means that my family struggle … Have not been on holiday for eight years.'
Ann, retail worker, Cornwall

'My job is standing in one place, eight hours a day, sometimes 10 hours, inducting clothes into an automation system. At the end of each day my feet and legs hurt. No one is allowed to sit unless they are pregnant.'
Chris, clothing warehouse worker, Barnsley

'I work weekends and shifts so I don't often see my wife or family for full days. My wife and family have nine to five Monday to Friday jobs so we don't often have quality time together. I work 12-hour shifts, which are always extremely busy and I often go over eight or nine hours without a break and regularly finish later than my scheduled finish time. This means that my first day off is spent catching up on sleep and feeling worn out.'
Darren, paramedic, Nottinghamshire

'I have had to defend agency workers who have been called in to disciplinary hearing for going to the toilet and on one occasion for sustaining an injury.'
Vaughan, GMB workplace rep, West Sussex

'Staff are too afraid to speak out against unjust practices for fear of having hours cut. Bullying is rife and easier to execute.'
Sam, library assistant at a university, London

'There is a fear expressed by staff that if they don't accept work when offered under zero-hours contracts, they will not get used again. There is an expectation that the workers are always available despite no guarantees of work'.
Lucy, domestic assistant, East Anglia

'Always treading on eggshells. If you fall out with management, you could lose hours – some colleagues have just had this happen to them where their hours have fallen.'
Alex, homecare worker, West Midlands

'Sitting by the phone waiting for a chance to feed your family is not acceptable.'
Gavin, sales assistant, Merthyr Tydfil

Source: GMB, UNISON, Citizens UK. Some names have been changed.

INEQUALITY AND SOCIAL MOBILITY

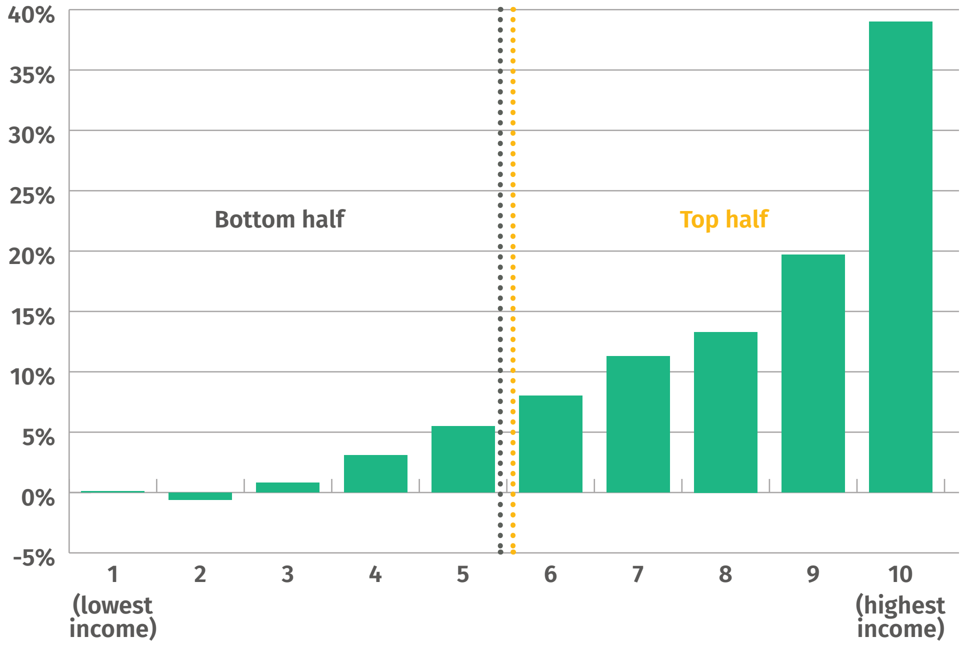
Not everybody is struggling, however, and this raises deeper questions about the British economy and the society it has helped to create. Thirty years ago, company chief executives were paid on average around 20 times the salary of the average worker. It is now around 150 times.[57] Between 2010 and 2015 alone, while many workers were seeing their pay fall in real terms, the average pay for directors in FTSE 100 companies rose 47 per cent. In most cases this was unrelated to the performance of their companies.[58]

If the seemingly runaway nature of high pay among executives and in the City of London bears little relation to the experience of the majority of people, this in fact reflects a deeper observation about the British economy. Figure 2.12 shows how different income groups have shared in economic growth over the past three decades. Before taxes and government transfers are taken into account, only 10 per cent of overall income growth between 1979 and 2012 went to the bottom half of the household income distribution; those in the bottom third barely shared in the growth at all. Meanwhile, the richest 10 per cent took almost 40 per cent of the total.[59] This is, by any account, a remarkably unequal distribution of rewards.

FIGURE 2.12

The pre-tax, pre-benefit incomes of the poorest half of the population have barely benefitted from overall economic growth

Share (%) of the growth in real original household incomes among economically active households between 1979 and 2012, by income decile*



*Note: 'original incomes' are defined as incomes prior to any taxes or benefits

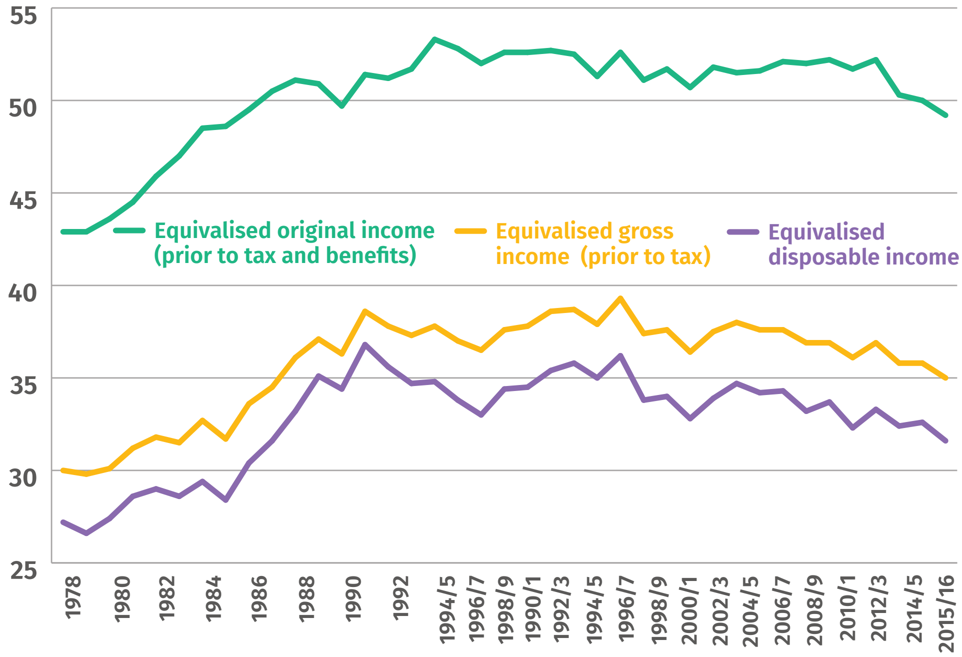
Source: Bailey D, Cowling K and Tomlinson P (2015) *New Perspectives on Industrial Policy for a Modern Britain*, Oxford University Press

Taxes and benefits do help to ameliorate these outcomes. As figure 2.15 shows, inequality of disposable income has been in gradual decline since the early 1990s, as a range of policy measures – such as tax credits, higher pensions and the minimum wage – have supported households on the lowest incomes. This has continued to be true in the period since the financial crisis, as higher earnings have fallen further than those at the bottom of the earnings distribution. This is not true, however, of inequality between the richest 1 per cent and the rest of society, which has continued to rise.[60] And overall, there has been no reversal of the steep increase in inequality that occurred during the 1980s. Put into simple numbers: in the 20 years from 1997 to 2017, the bottom fifth of the population saw their real incomes increase by just over £10 per week, while the top fifth saw theirs increase by just over £300.[61]

FIGURE 2.13

Social policy since 2002 has achieved a small reduction in inequality, but the steep rise that occurred in the 1980s has not been reversed

Gini coefficients for original, gross and disposable equivalised household income in the UK, 1977–2015/2016*



Note: 'original incomes' are defined as incomes prior to any taxes or benefits; 'gross incomes' are defined as income prior to tax but after the inclusion of benefits; 'disposable incomes' are defined as incomes after taxes and benefits. 'Equivalised' incomes are adjusted for the number of members in a household.
*Where 0 = perfect equality, and 100 = perfect inequality.

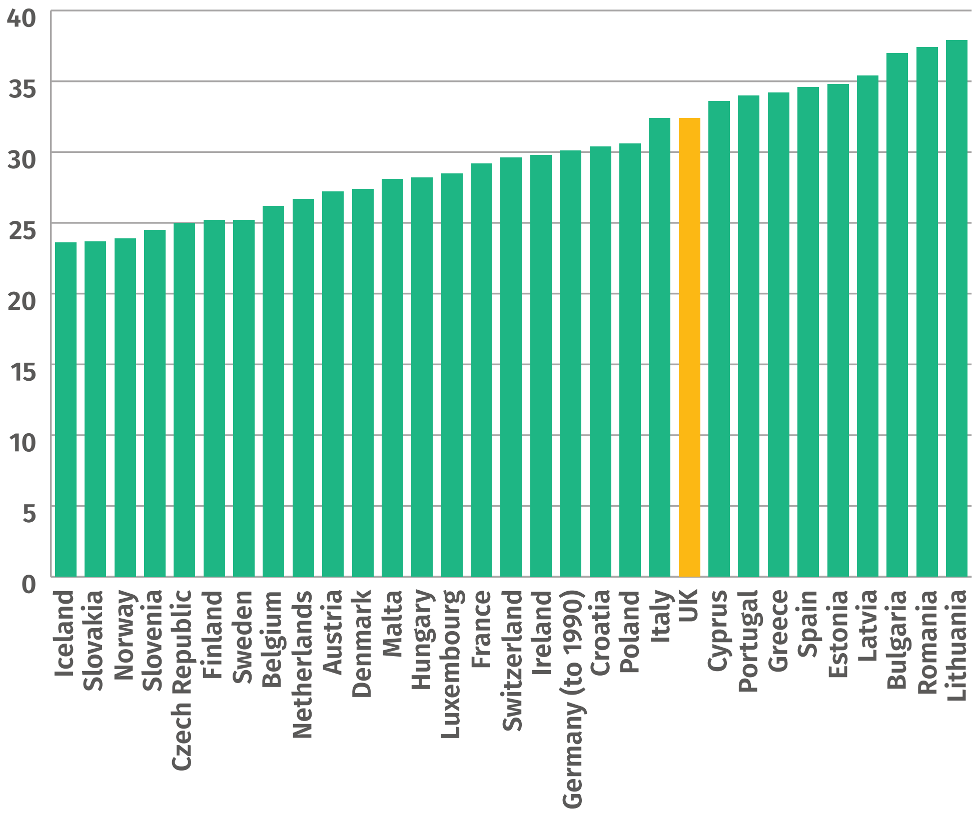
Source: Office for National Statistics (2017) 'Household disposable income and inequality: financial year ending 2015' http://www.ons.gov.uk/peoplepopulationandcommunity/personalandhouseholdfinances/incomeandwealth/bulletins/householddisposableincomeandinequality/financialyearending2016

The result is that the UK remains among the most unequal of western European countries. The difference in income between the top 10 per cent and the bottom 10 per cent of households is five-fold in Denmark, seven-fold in France and Germany and 11-fold in Britain (see figure 2.14). Worryingly, on the Government's current austerity plans for real-terms cuts to benefits and tax credits over the next five years, the Institute for Fiscal Studies forecasts that inequality will start increasing again.[62]

FIGURE 2.14

The UK remains one of the least equal countries in Western Europe

Gini coefficients of equivalised disposable income, selected European countries, 2015



Source: Eurostat (2017) 'Gini coefficient of equivalised disposable income – EU-SILC survey' (dataset) http://appsso.eurostat.ec.europa.eu/nui/show.do?dataset=ilc_di12

Inequalities extend beyond income groups. Although falling, the gender pay gap has remained stubbornly higher in the UK than the European average: median pay among full-time workers is 10 per cent higher for men than it is for women.[63] A similar pay gap exists between white and black and minority ethnic (BME) workers, particularly for black graduates, who are paid on average 23 per cent less than white graduates, and black A-level school leavers, who are paid 14 per cent less than their white peers.[64] Unemployment rates for people from black and minority ethnic groups are almost double those for the white population.[65] Economic justice must extend to all parts of society.

Meanwhile, inequalities of wealth are double those of income. Half of the UK's wealth is owned by just 10 per cent of its population, with the richest 1 per cent owning 14 per cent. By contrast, 15 per cent of adults have no or negative wealth (that is, they owe more than they own).[66] Wealth inequality is now rising again as rates of home ownership decline – particularly between generations. The huge growth in property values since the early 1990s, coupled with the decline in final salary pensions, have made older generations successively wealthier than younger ones. Remarkably, a typical adult born between 1981 and 1985 had only half as much total net wealth at age 30 as a typical adult at the same age born just five years before them.[67] With housing costs continuing to rise sharply, young people today can now expect to be poorer than their parents. This is not the promise once made of our economy.

The consequences of these inequalities are profound. Those with wealth are better able to invest in their education, to have a secure place to live, to wait for the right job rather than taking the first one to come along, and to be able to take risks with potentially high rewards. By contrast poverty causes a severe stunting of life opportunities. There is increasing evidence, summarised in a number of recent health reviews, that deprivation and stress in childhood leave permanent scars on neural development, leading to disadvantage in later life.[68] As the Government's Social Mobility Commission has documented, those from poor backgrounds have consistently worse educational attainment, employment rates, earnings and health than those from better-off families.[69] Poverty cuts life expectancy: in the poorest areas of Britain, people on average have eight years' less life than those living in the richest areas.[70]

Inequalities have wider impacts on society. In cross-country studies, high levels of inequality are correlated with a variety of social ills – not just for people living in poverty, but also across the population as a whole. These include higher rates of mental ill-health, obesity and crime, and lower recorded social trust, education attainment and individual wellbeing.[71] More equal societies are happier societies. Inequality has an impact on all of us.

WHOSE ECONOMY?

The trends described in this chapter prompt the question: whose economy is it? Our economy is plainly no longer working for everyone. And for some groups of people and some parts of the country, it does not seem to be working at all.

For people struggling in a low-paid and insecure job, sometimes having to do more than one of them to make ends meet; for those 'just about managing' while their real earnings fall; for those whose living standards have more or less stagnated for a decade; for those young people desperate to find decent housing and to save enough for the future; for post-industrial communities for whom the benefits of globalisation and technological change seem to have gone elsewhere; and for everyone aware that these things are happening around them – it is hard to say that the British economy is performing well. The outcomes we have described in this chapter demonstrate a profound state of economic injustice. And for that reason we do not believe that the economy that has generated them should be described as successful. The economy belongs to everyone, and its fruits should be shared fairly among all.

We need a different approach.

Dese, fruit picker,
Wisbech, Cambridgeshire

3. THE BRITISH ECONOMIC MUDDLE

As chapter 2 has set out, the British economy is not doing well in its core purpose of generating decent and rising living standards for the majority of people. Real average earnings have yet to recover their 2008 peak, the gap between the richest and poorest parts of the country has grown wider, and many people are struggling to make ends meet in insecure and low-paid work. Poverty and inequality are at levels that are damaging the social cohesion of our communities. This is a poor record for an advanced, rich economy. The question is: why?

This is not a question being asked only in this country. Most developed countries have been experiencing some of the same kinds of economic conditions as us. Over the past 30 years or so, globalisation – the deepening economic interconnection between countries arising from the increasing movement of capital, goods, services, people, technology and information – has changed the structure and character of all economies. Old industries, and the communities around them, have declined in almost all developed countries, while new ones have grown; and new information-based technologies have changed the location and patterns of work, business models and consumption. The financial crash of 2008 was a global economic disaster.

Yet the UK's economic performance has been considerably weaker than that of most of our major competitors in the north of Europe and in the rest of the developed world. Our economic recovery since the crash has been slower; our productivity and investment rates lower; and our average earnings and balance of trade worse.

We do not contend that this is the case in every dimension or in comparison with every other developed country. Yet it does appear that the UK suffers from a very particular set of underlying economic weaknesses.[72] Indeed, the striking fact is that many of these comparisons with other advanced countries have not looked good for the UK for a long time, in some cases a quarter of a century or more.

Commentators sometimes speak of the 'British economic model'. But in many ways we have less of a model than an 'economic muddle'– a mixture of powerful strengths and profound weaknesses in which different parts and policies often act against one another and do not combine into a coherent whole. In this chapter we set out five areas in which the British economy exhibits an almost paradoxical character: where strong economic performance has been juxtaposed with very weak investment, and high ambition with low attainment. If the economy is to be made to work better, we believe that these need to be understood more clearly than has generally been the case in our national economic debate.

Several conclusions emerge from this analysis. Many of our most serious economic problems are not new. They are of long standing, the product of structural weaknesses in our economy that have been present in some cases for decades. They are mutually reinforcing, one exacerbating another. And they are not accidents. Many of our most serious problems have roots in deliberate choices made by policymakers over the past three decades. Yet at the same time, many are also not products of intended policy design. They are the result of a failure to 'connect the dots' across different issues, where policy choices have accumulated over time. Too often policymakers have channelled received economic wisdom without challenging it, and applied a narrow analytical lens without looking at the wider economic picture. It is, therefore, little surprise that the result has been a muddle rather than a coherent economic model.

Above all, today's economy reflects the dangers of concentrating too much economic power into a small number of hands. We have too many markets that are not properly competitive, where large firms dominate and can extract rents from the system – such as in financial services, energy and new technology platforms. In many firms, management has too much power over people's working lives, both in the way flexible labour markets work and in the way businesses are run. And British economic policymaking is overly concentrated in impenetrable institutions in Whitehall, with insufficient powers and resources devolved to the UK's nations and regions. Solving the UK's economic weaknesses will therefore require both a new understanding of how the economy is working and a programme of coherent and deliberate reform commensurate with the scale of the problems we face.

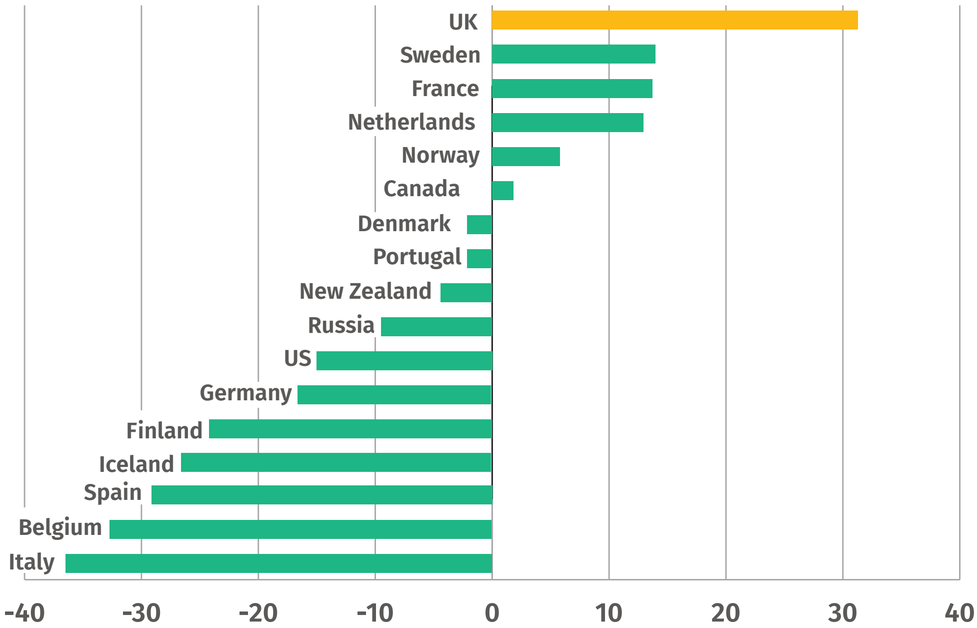
WE HAVE BOTH WORLD-LEADING BUSINESSES AND WORLD-LAGGING PRODUCTIVITY

Britain's leading businesses are among the best in the world. More of the top 100 global companies by market capitalisation are headquartered in the UK than in any country other than China and the US.[73] We have world leaders in technological innovation in a range of high-growth industries, from pharmaceuticals to car manufacturing, from artificial intelligence to aerospace engineering. Our financial sector and creative industries are among the most successful in the world, and dynamic growth in the past decade has established the UK as the 'tech capital of Europe'.[74] We are a nation of entrepreneurs: since the financial crisis our rate of new business creation has increased more quickly than any other OECD country (see figure 3.1).[75]

FIGURE 3.1

The UK has seen a big increase in new enterprises compared with other advanced economies

Percentage increase in the number of new firms created between 2007 and 2016



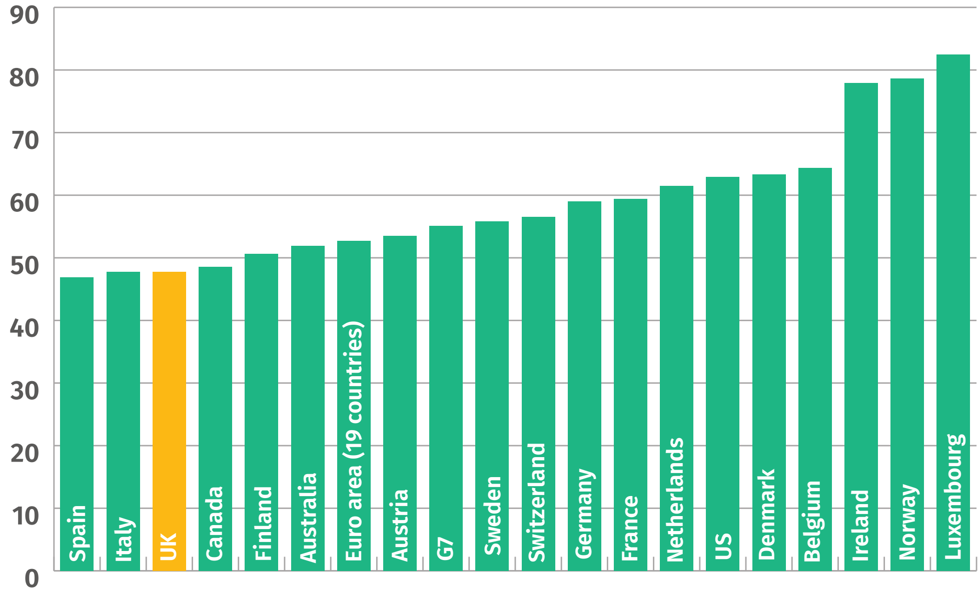
Source: Reproduced from Organisation for Economic Co-operation and Development (2016) *Entrepreneurship at a Glance 2016* http://www.oecd.org/industry/entrepreneurship-at-a-glance-22266941.htm

Yet, at the same time, the productivity of the UK economy is much lower than that of our major competitors. Measured by output per hour, productivity in the UK is fully 13 per cent below the G7 average (see figure 3.2). This gap is sometimes stated in the form that ‘it takes the average British worker five days to produce what a worker in Germany, France or the US produces in four’. But this is misleading: it is not to do with how hard people work, but rather is a result of a much lower level of investment – in physical and human capital, in management and production systems, and in the creation and diffusion of technology across sectors – compared with other leading economies. The consequence is that wages and salaries in the UK are also on average lower.

FIGURE 3.2

Productivity levels in the UK are among the lowest for an advanced economy

GDP per hour worked, 2015, purchasing power parity (PPP, $), 2010 constant prices



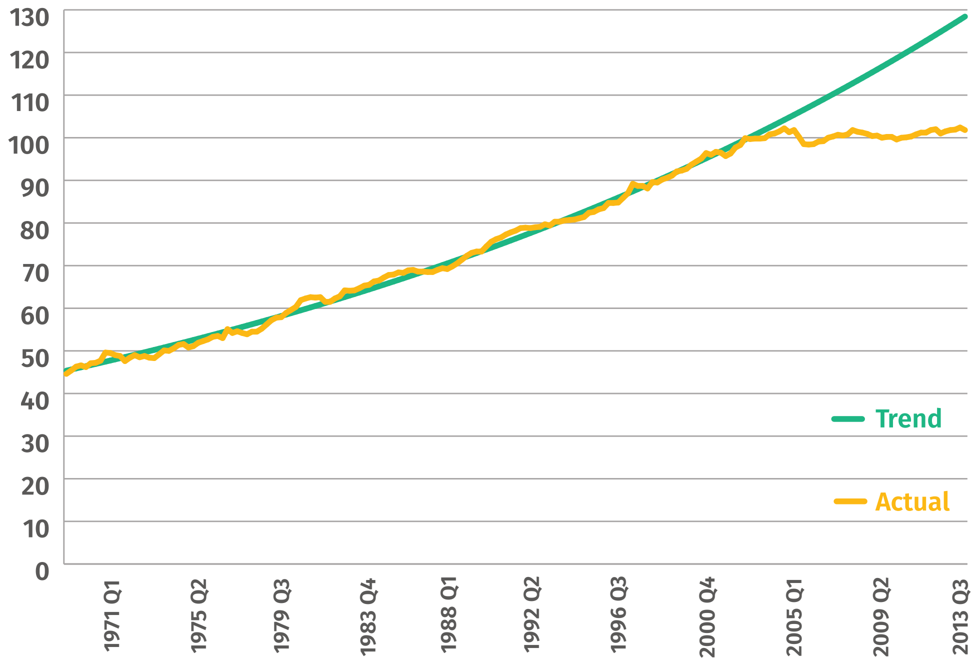
Source: Organisation for Economic Co-operation and Development (2017) 'GDP per capita and productivity levels' (database) http://dx.doi.org/10.1787/data-00686-en

In fact, the productivity position is worse than this. Since the financial crisis, productivity growth in the UK has more or less stalled altogether. This is a stark divergence from the long-running trend (see figure 3.3), and it has occurred across almost all sectors.[76] It goes a long way to explaining the stagnation of earnings over the past decade.

FIGURE 3.3

UK productivity growth has stalled since the 2007–2008 financial crisis

UK output per hour (actual versus long-term trend), Q1 1971–Q1 2017, 2013 = 100



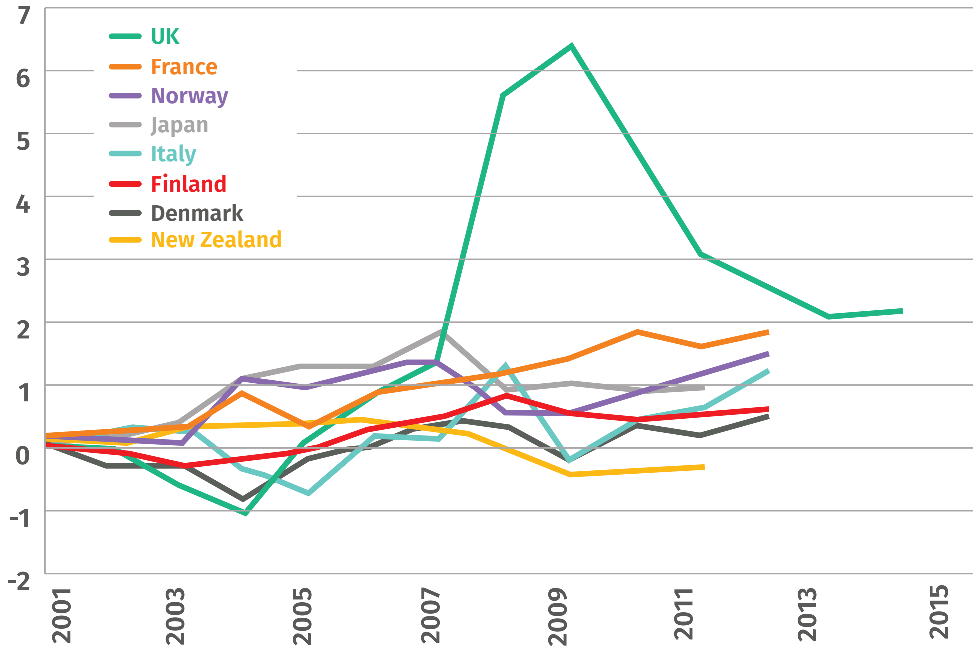
Source: IPPR analysis of Office for National Statistics (2016) 'Labour Productivity time series dataset' (dataset) https://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/labourproductivity/datasets/labourproductivity

What explains this poor record on productivity? It is not that leading British firms are less productive than their competitors overseas. It is that we have a 'long tail' of low-productivity firms.[77] As figure 3.4 shows, the UK has a small proportion of businesses with high productivity, of over £100,000 per worker; and a very much larger number earning under £50,000 per worker. This dispersion is considerably greater in the UK than in other OECD countries.[78] The 'long tail' of low-productivity businesses is particularly marked geographically. There are high- and low-productivity firms in every area of the country; but on average productivity is much higher in London and the South East than elsewhere (see figure 3.5). This is partly because of the different sectors that predominate in different regional economies, but it is not explained by it: there is wide geographical divergence in productivity even between firms in the same sectors.

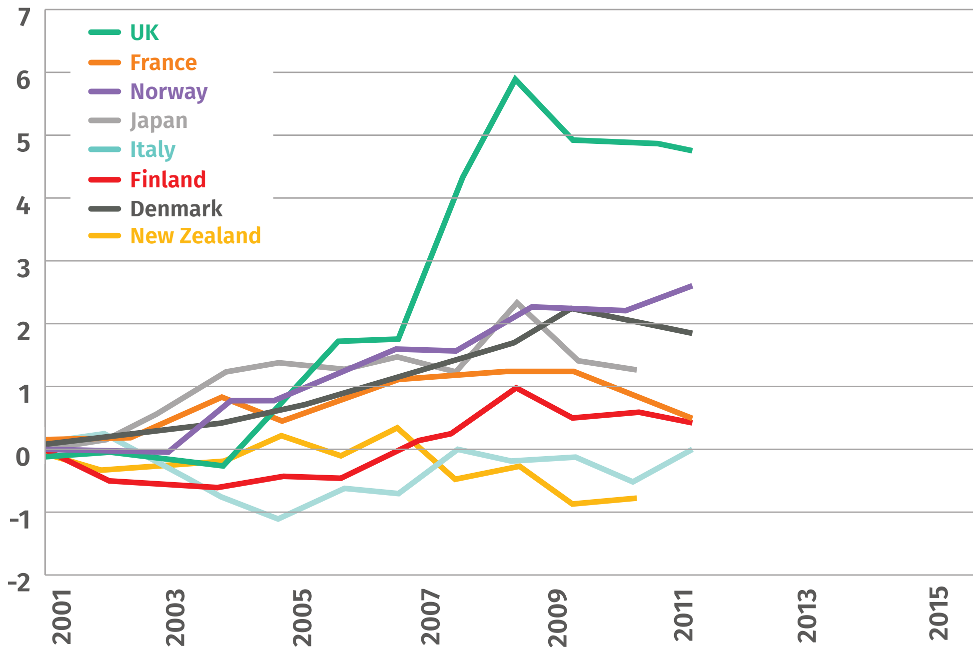
FIGURE 3.4

Dispersion in productivity levels among firms has risen far higher in the UK than in other advanced economies

Percentage difference in productivity between the 90th and 10th percentile firms within services sectors, selected countries, 2001–2015



Percentage difference in productivity between the 90th and 10th percentile firms within manufacturing sectors, selected countries, 2001–2015



Source: Reproduced from Haldane A (2017) 'Productivity puzzles', speech, London School of Economics, 20 March 2017 http://www.bankofengland.co.uk/publications/Documents/speeches/2017/speech968.pdf

The UK's productivity problem has a number of causes, some of them relating to general economic conditions such as competition and planning policy, the education and skills systems, and infrastructure. There is no question, for example, that the extraordinary skewing of infrastructure spending towards London – which over the next five years is due to get more transport spending than the rest of England put together – contributes to the UK's unbalanced regional productivity performance.[79]

A key causal factor also appears to lie at the level of individual firms. Many British businesses appear to be less well managed than those in other advanced economies. In international and sectoral analysis of management practices, UK firms emerge notably poorly, and there is a clear correlation between poor management and low productivity.[80]

The UK lags especially behind Germany, Japan and the US in the quality of its management.[81] One explanation may be a culture of amateurism and a bias towards more 'traditional' academic subjects; engineering is still often valued less than accountancy. While the UK has a small number of top-tier business schools, we do not offer business education or management training at anything like the scale of many comparable countries. The problem is particularly acute in middle management tiers where there are few qualifications that command the respect of employers.

As a result of relatively weak management, UK firms have, in general, lower take-up of new technologies and processes than in other advanced countries; and their use of skills is poorer.[82] It is often remarked that the UK has a skills problem, but this is generally thought to be one of insufficient supply of appropriately skilled workers. In fact, the deficiency lies as much in the *demand* for skills. Many British businesses are not organising their workforces in a way that maximises the productivity of the workers they currently have, and they do not seek to employ enough workers with higher skills.[83] A recent cross-European study estimates that one-third of adult employees in the UK, over five million people, are overqualified for their job, the highest proportion in the EU.[84]

This approach is only possible because the UK has one of the most flexible, or deregulated, labour markets in the developed world. The World Economic Forum ranks the UK eighth of 140 countries in terms of labour market flexibility.[85] It is now possible for an employer to take on a worker with almost no attached responsibilities on the employer's part, or rights for the worker, at all. From the perspective of productivity, it has become too easy and too cheap to raise output by adding a low-wage worker rather than by investing in new technology or innovating in workplace organisation. It is notable that the development of the 'gig economy' and other forms of casualised work has occurred much faster and further in the UK than in many other developed countries.[86]

One result of this is that we have a much higher employment rate than most other countries. But this has been achieved at the expense of productivity. The UK has effectively gained high employment through low wages and poor working conditions. In too many sectors the UK economy has fallen into a low-pay, low-productivity equilibrium.[87] Without reform of our labour markets, and a much stronger effort to get businesses to invest in new technology and in workplace innovation, it is difficult to see how we can climb out of it.

WE HAVE ONE OF THE WORLD'S LARGEST FINANCIAL SECTORS, YET A LOWER RATE OF INVESTMENT THAN MOST OF OUR MAJOR COMPETITORS

The UK's finance sector is one of the world's largest, producing over 7 per cent of national economic output. World-leading in terms of technological innovation, expertise and global reach, it employs around 1.1 million people across the

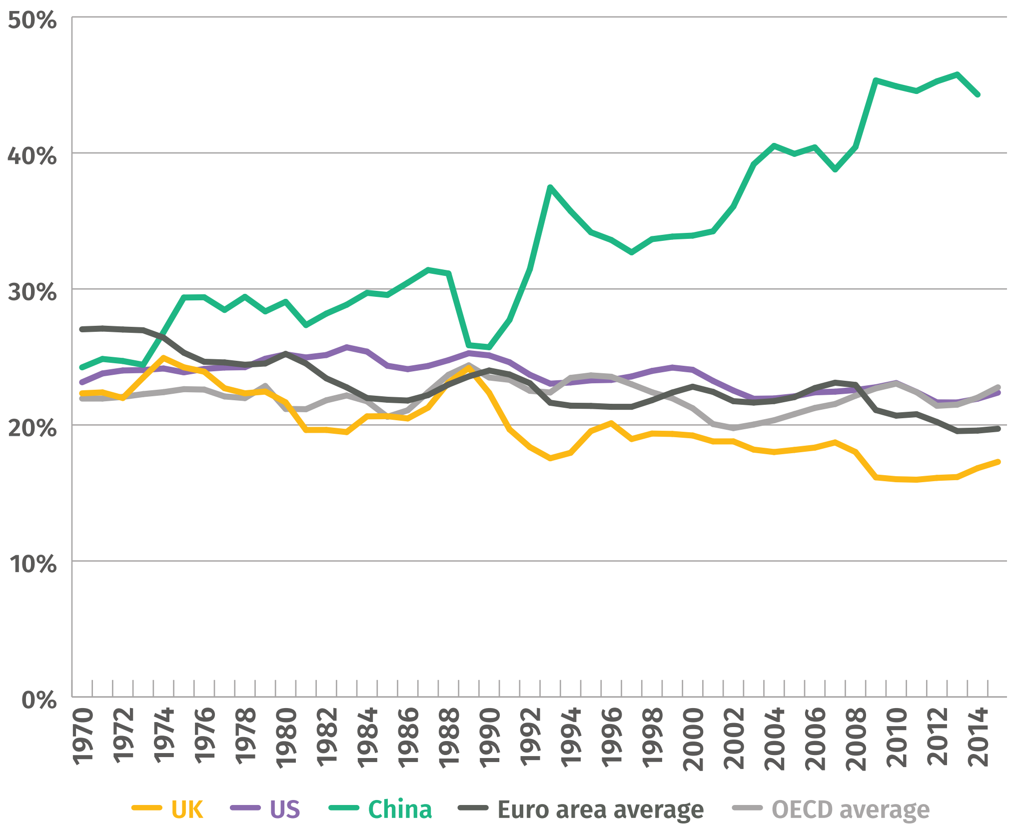
UK; is responsible for a roughly £60 billion trade surplus in financial services, equivalent to around 3 per cent of GDP; and contributes more than £24.4 billion to the Exchequer in taxation.[88] Half of the world's financial firms have their European headquarters in London; around 78 per cent of European capital markets and investment banking revenues come from the UK; and 46 per cent of equity in the whole of the EU is raised in the City of London.[89] This is, on any account, a hugely successful part of the UK economy.

Yet the UK performs very poorly by international standards on investment. Investment is the engine of any economy; it drives both productivity and income growth. But at around 17 per cent of GDP, the rate of public and private investment in the UK economy is around 5 per cent below the OECD average. This gap has widened over the past 50 years; indeed, the UK investment rate has been falling for most of the past 30 years (see figure 3.5). A similar gap exists for private sector investment alone: corporate investment in fixed assets (not including construction) fell from 11 per cent of GDP in 1997 to just 8 per cent in 2014 – well below the rate of capital depreciation, meaning that the stock of business capital is actually falling. The comparable rate of corporate investment in the US in 2014, for example, was 12 per cent.

FIGURE 3.5

Investment is lower in the UK than in most other comparable economies, and has been declining for the last 30 years

Gross fixed capital formation as a percentage of GDP, UK, China, US, and euro area and OECD averages, 1970–2014



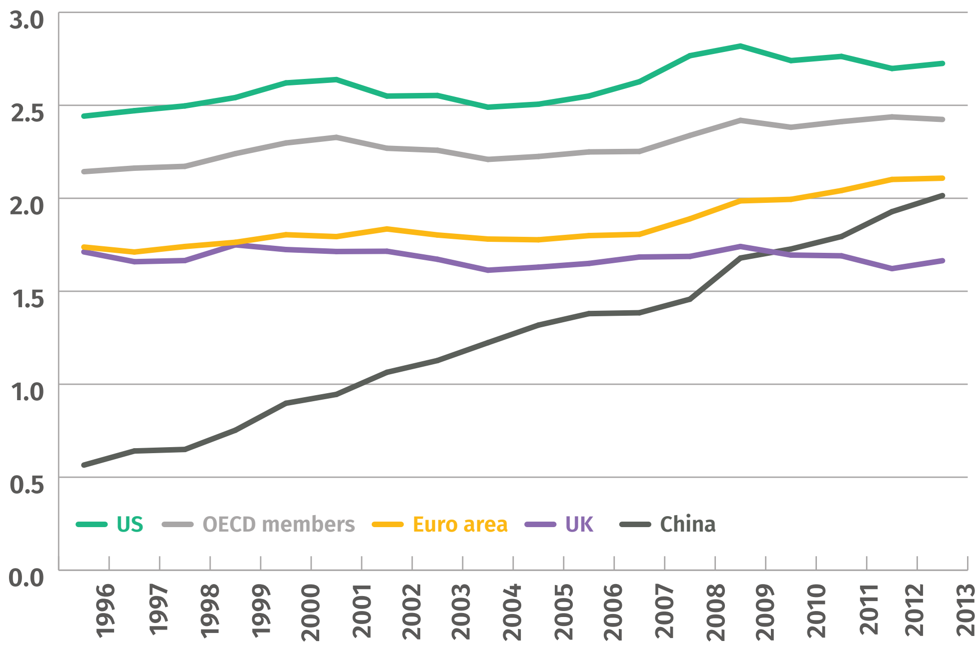
Source: World Bank (2016) 'Gross fixed capital formation (% GDP)' (dataset) http://databank.worldbank.org/data/reports.aspx?source=2&series=NE.GDI.FTOT.ZS&country

Some of this can be explained by the structure of the British economy, which, with a proportionately smaller manufacturing sector, is less capital-intensive than other leading nations. It is also partly a question of measurement; when 'intangible' investment in areas such as R&D, software, product design and training is taken into account, the UK's performance improves.[90]

FIGURE 3.6

In contrast to many countries, spending on research & development (R&D) in the UK has not risen for almost 20 years

Total spending on R&D as a proportion of GDP, UK, US, China and averages for advanced economies, 1996–2013



Source: World Bank (2016) 'Research and development expenditure (% of GDP)' (dataset) http://databank.worldbank.org/data/reports.aspx?source=2&series=GB.XPD.RSDV.GD.ZS&country

However, the UK's record of investment in R&D is an area of particular concern. R&D is the engine of innovation: it drives long-run productivity improvement and keeps the economy at the frontier of globally competitive sectors. Over the past 20 years, as a proportion of GDP, UK spending on public and private R&D has remained more or less flat, while that of our major competitors has risen (see figure 3.6). In 2015, the UK invested 1.7 per cent of GDP in R&D, compared with 2.8 per cent in the US, 2.9 per cent in Germany and 3.5 per cent in Japan.[91] Again, some of the gap can be accounted for by the UK's disproportionately large service sector, but OECD data shows that R&D spending is lower in the UK than in many other advanced nations even after adjusting for the industrial composition of the economy.[92] And given the importance of R&D and innovation to overall economic performance, that is anyway little consolation.[93]

The juxtaposition of a highly successful financial sector and weak investment might appear paradoxical, but it is not difficult to explain. Many of the UK's financial services serve the global market, not the domestic one: their purpose is not financing investment in the UK economy.

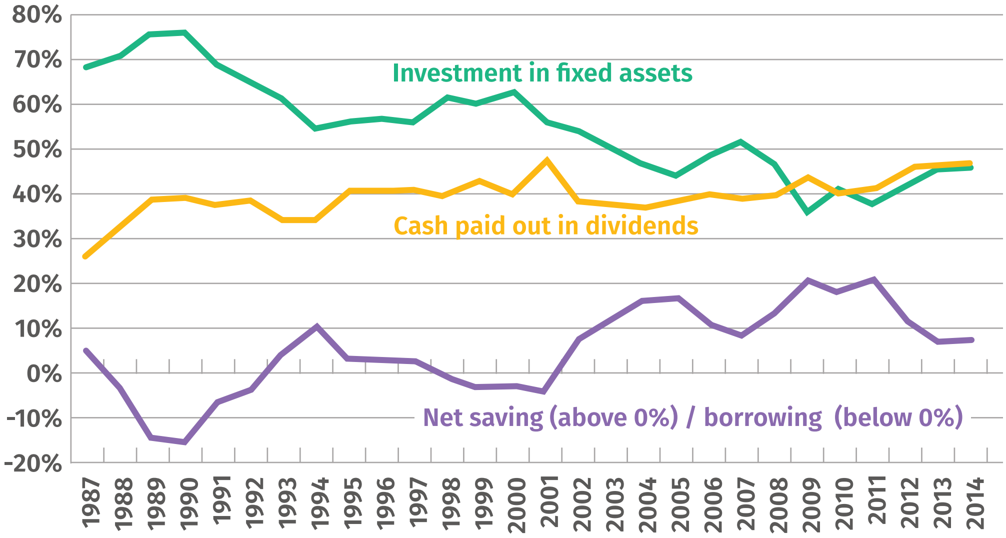
The UK's banking sector, nevertheless, needs reform. Having contributed to the growth of systemic risk, which precipitated the 2008 financial crash, it has been beset by revelations about poor ethical standards, including the mis-selling of financial products, the manipulation of interest rates and, most recently, allegations of criminal conduct during the financial crisis. At the same time, it has performed poorly in one of its core functions, that of providing finance for investment in British businesses.[94] Loans to UK businesses account for only 5 per cent of total UK bank assets – around a third of the proportion across the Eurozone, with UK banks lending a much higher proportion for land and property.[95] (The bulk of real estate loans and mortgages do not increase the productive capacity of the economy or contribute to growth; instead their primary effect is to drive up asset prices.) Moreover, British banks are unusually focussed on real estate as collateral for their lending, which limits the ability of many businesses to borrow and ignores the potential to value other, more intangible assets.[96] There appear to be particular gaps in the long-term or 'patient' finance being made available by both banks and private equity to smaller, fast-growing and innovating firms, particularly outside London and the South East.[97]

It is in the relationship between financial markets and the way British companies are governed, however, that the major problem of investment lies. Over the last quarter of a century there has been a notable change in the behaviour of UK listed companies. The proportion of profit distributed to their shareholders has risen: from 39 per cent to 46 per cent between 1990 and 2014. In turn, the proportion reinvested into their businesses has been declining. In the past, the UK corporate sector was a net borrower in the economy. This reflected the traditional role of companies as channels for investment – taking savings from others and investing them in productive, growth-generating activity. Over the last 15 years, however, the corporate sector has become a growing net saver – effectively, a lender of money to governments and households (see figure 3.6). In 2014, non-financial companies ran a net surplus of £107 billion, or 7 per cent of GDP.[98]

FIGURE 3.7

The UK corporate sector is now a net saver, not a borrower, and corporate investment is declining

Proportion (%) of UK non-financial corporation cash flow allocated to investment, dividends and saving, 1987–2014



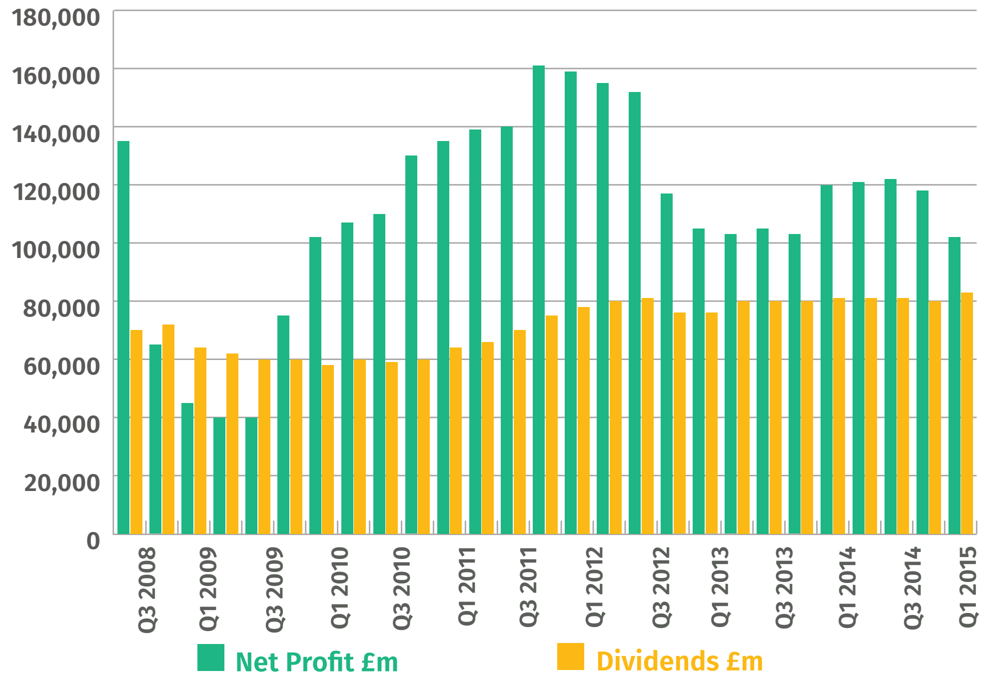
Source: Reproduced from Tomorrow's Company (2016) *UK Business: What's Wrong? What's Next? Creating value for shareholders and society through a focus on purpose, values, relationships and the long term*
http://tomorrowscompany.com/wp-content/uploads/2016/05/UK-Business-Whats-wrong-Whats-next.pdf

Over the last decade, it is striking that the distribution of dividends to shareholders by UK companies has remained largely constant even as profits have fluctuated, suggesting that providing a certain level of 'expected' dividend payouts has assumed overwhelming priority (see figure 3.8).[99] At the same time, 'share buybacks'– another way of returning money to shareholders – have seen a significant increase.[100] Indeed, since the financial crisis the value of share buybacks has actually exceeded the value of shares issued, with the result that the UK equity market has now become less a source of net new financing for businesses than a means of extracting value from them.[101]

FIGURE 3.8

Distribution of dividends by UK companies has remained more or less constant despite large fluctuations in profits

Dividends and profits for FTSE 350 firms, £ million, rolling 12-month basis, Q3 2012 to Q12015



Source: Big Innovation Centre (2016) *The Purposeful Company: Interim Report* http://www.biginnovationcentre.com/media/uploads/pdf/ThePurposefulCompany_InterimReport.pdf

Why has profit distribution taken increasing precedence over investment in this way? Part of the explanation may lie in a lack of profitable investment opportunities as a result of insufficient domestic and global demand for the goods and services that investment would generate. Yet there is also a deeper, underlying reason: the increasing 'short-termism' of corporate management teams and financial markets.

As Bank of England research has shown, and as the 2012 Kay Review of Equity Markets comprehensively documented, over the past 20 or so years the UK's capital markets have given an increasingly higher priority to short-term over long-term returns.[102] Share prices have incorporated significantly higher discount rates (the way in which future returns are valued relative to current ones) than warranted by underlying profitability. This has had a calculable cost in terms of otherwise profitable investments not being undertaken.[103]

A major reason for this is that the structure of shareholding has changed. Between 2000 and 2014, the proportion of individuals, insurance funds and pension funds, among all direct beneficial share owners resident in the UK, fell from 85 per cent to 45 per cent.[104] They have largely been replaced by various kinds of intermediaries, such as investment and hedge funds, whose managers tend to be rewarded on the basis of short-term stock market performance relative to one another, rather than on long-term corporate value creation. For relative performance, the frequency and speed of trading are key determinants of success.[105] Today the average length of time a share is held is less than six months, compared with around six years in 1950; large numbers are now held for no more than milliseconds, in high-frequency trading conducted by algorithm.[106] Hedge funds, high-frequency traders and propriety traders now make up over 70 per cent of equity market turnover in the UK.[107]

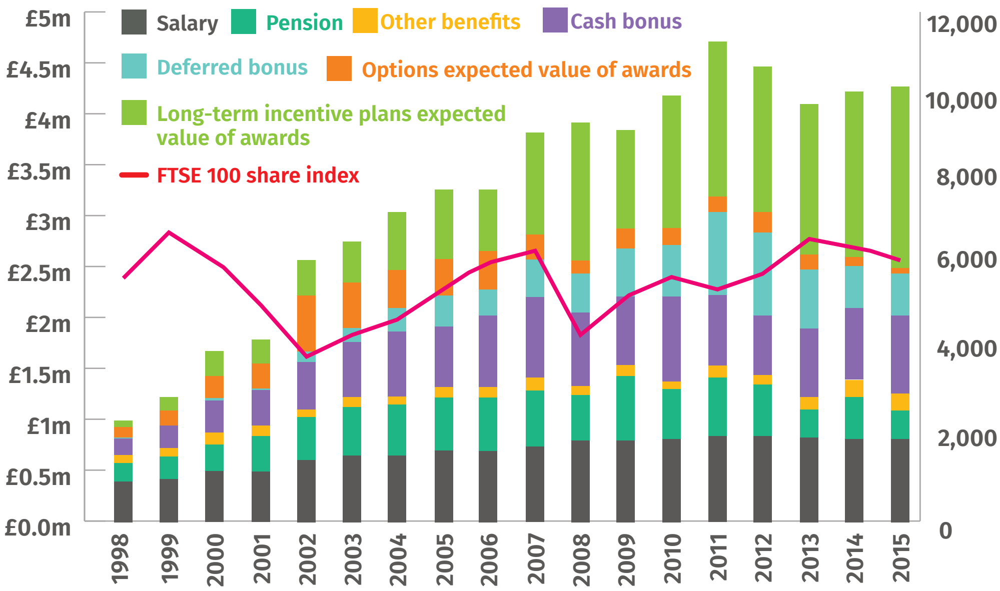
This matters because of the UK's system of corporate governance. Unlike most European countries (but like the US, whose companies and stock markets exhibit a comparable short-termism), the way in which British companies are governed gives exclusive rights to shareholders, with company directors legally bound to promote their interests.[108] Few companies have the kind of long-term investors with a significant or controlling block of shares that are common in European companies.[109] So the interests of financial intermediaries in UK stock markets tend to get transmitted to companies as pressure to generate short-term returns and guaranteed dividend payments. Surveys of company directors show an increasing need to demonstrate strong financial performance over a one- to two-year period, compared with the five- to 10-year returns that might be expected of major capital investments.[110] While some of our best company boards already take a longer time horizon and pay attention to a broader range of stakeholders – workers, customers, suppliers and so on – rather than having a sole focus on shareholders, more must be encouraged to do the same. Companies that look to their stakeholders rather than only upwards to shareholders will be more successful, and by doing so will in fact serve the long-term interests of their investors too.

These problems have been compounded by the structure of executive pay. Over the last 20 years, remuneration packages for company directors have increasingly been made up of stock options, annual bonuses and so-called 'long-term incentive plans', which are in fact based almost entirely around short-term metrics of financial performance (see figure 3.9). These are widely regarded as having distorted incentives for company directors, encouraging them to focus on short-term share price movements rather than long-term growth.[111]

FIGURE 3.9

Remuneration packages for company directors are increasingly focused on 'long-term incentive plans', but pay levels are largely unrelated to stock market performance

Level and structure of average FTSE 100 CEO pay (£, left-hand side) and FTSE 100 share index (right-hand side), 1998–2015



Source: Reproduced from Department for Business, Energy and Industrial Strategy (BEIS) (2016) *Corporate Governance Reform Green Paper* https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/584013/corporate-governance-reform-green-paper.pdf

The result of these trends is what has been described as an increasingly 'financialised' corporate sector, in which company boards are frequently more focussed on financial engineering than on the long-term creation of value.[112] It is a trend notably more evident in the UK (and the US) than in other European countries, Japan or South Korea, where different corporate cultures prevail.

It is reflected, for example, in the much higher rate of takeovers in the UK than elsewhere. Taking the period from 1998 to 2005, just before the financial crash, the value of all mergers and acquisitions in the UK was equivalent to around 22 per cent of GDP, compared with under 11 per cent in the US, 10 per cent in France, 7.5 per cent in Germany and a mere 2.5 per cent in Japan. At 67 per cent of bids, the UK also had the highest success rate for hostile takeovers among advanced economies in this period, a result of the UK's particularly liberal takeover rules.[113]

Many takeovers have saved British businesses and heralded renewed investment, job creation and global expansion. Indeed, many foreign business owners operating in the UK have proved to be strong examples of responsible governance, high investment and good employee relations. Nonetheless, it is now recognised that takeovers (particularly large ones) can also destroy value rather than creating it.[114] The reason is that they provide perverse incentives for corporate management: the best strategy to avoid a takeover is expansion of revenues rather than improvement of operating performance and profitability. This is damaging for productivity growth.

There has been a long line of British businesses sold to foreign companies over the last 25 years from a position of weakness rather than success, including famous names such as Asda, Bentley, British Steel, Cadbury, ICI, GEC, Jaguar

Land Rover, P&O, Pilkington, Rolls Royce, Rowntree Mackintosh and Scottish & Newcastle. Around 30 per cent of value added in the UK comes from foreign-owned enterprises, compared with 16 per cent in France and 18 per cent in Germany.[115] It is more or less inevitable that investment decisions made in companies headquartered overseas are more at risk than those made in companies headquartered at home.

If the UK is to raise its investment rate, we are therefore likely to need both a new way of governing British companies and a new focus for our financial sector.

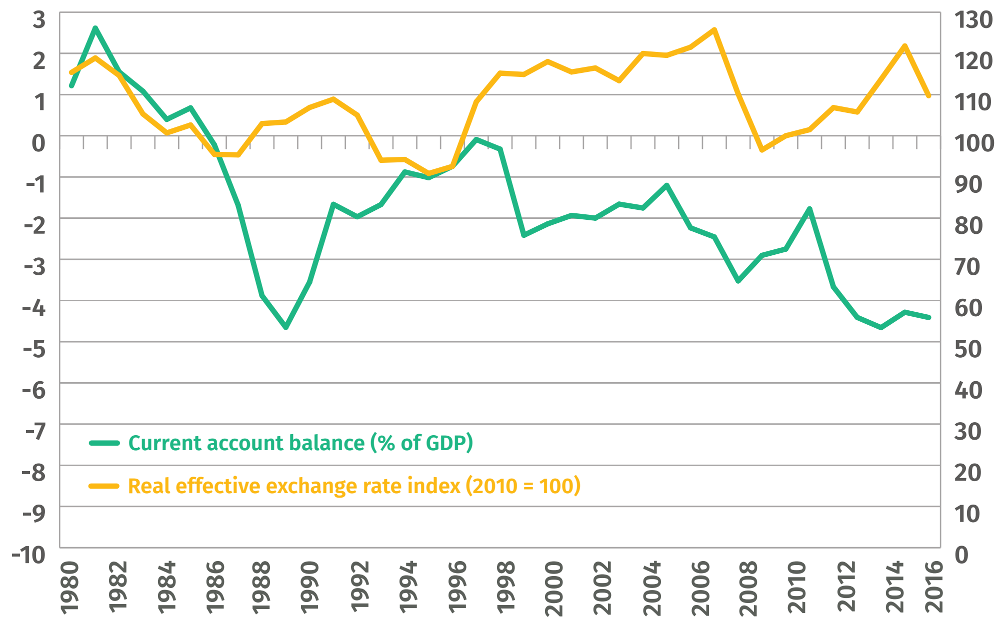
WE ARE BOTH SUCCEEDING AND FAILING IN INTERNATIONAL TRADE

After the US, the UK is the most successful exporter of services in the world. Our trade surplus in services is around £100 billion per year, or a little over 5 per cent of GDP.[116] Financial services account for the bulk of this, with an overall surplus of around 2 per cent of GDP.[117] But we also have trade surpluses in a range of other fields, including professional services, transport, architectural and engineering services, telecommunications and information services, intellectual property, and waste treatment, agricultural and mining services.[118]

FIGURE 3.10

The UK's current account has been in long-term decline, and has broadly mirrored the value of sterling

UK current account (proportion of GDP) and the UK's effective exchange rate, 1980–2016



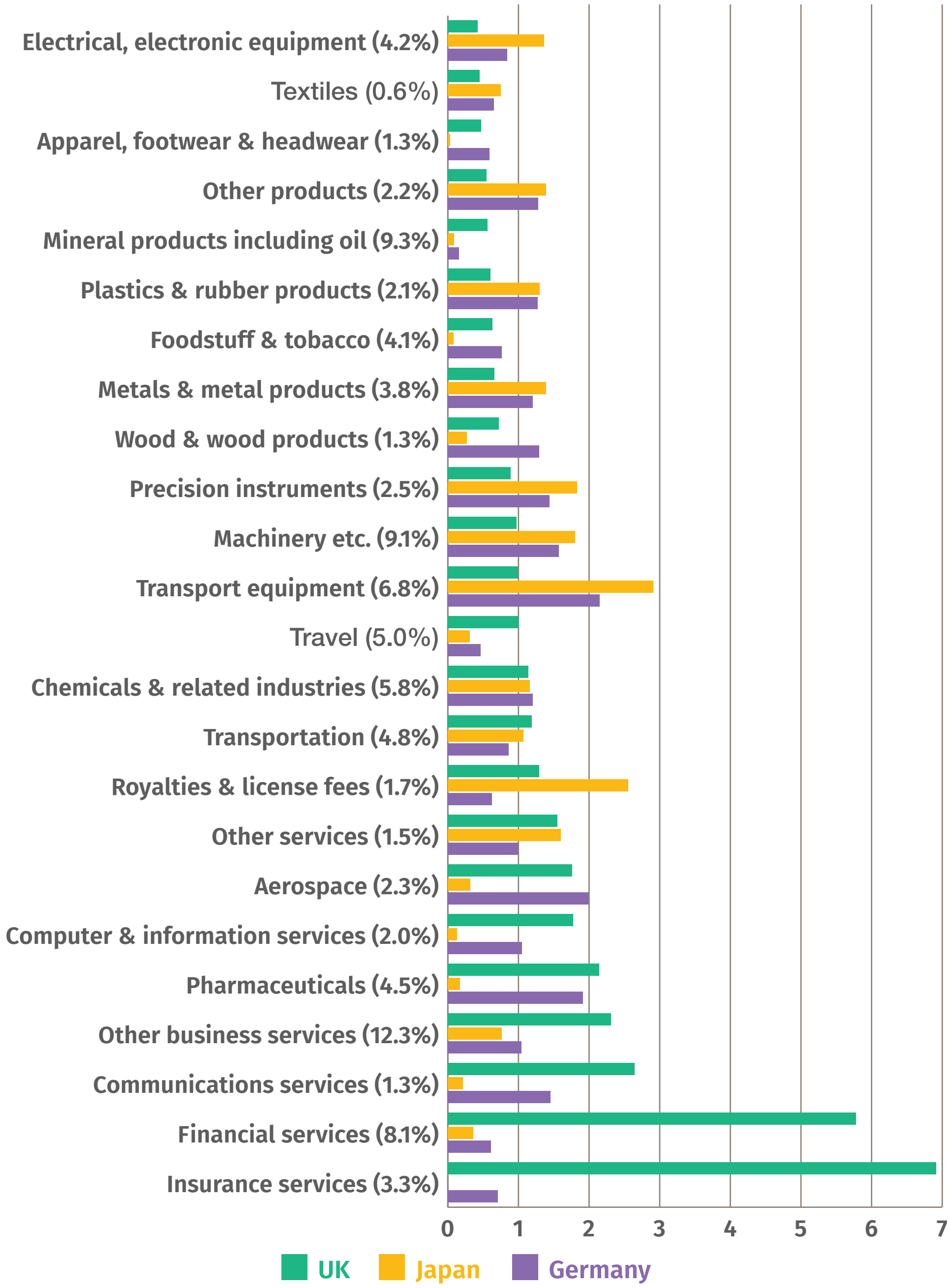
Source: World Bank (2017) 'World Bank Development Indicators' (dataset) http://databank.worldbank.org/data/home.aspx

Overall, however, the UK buys far more from the rest of the world than we sell to it. Our trade deficit in goods is around 7 per cent of GDP, outweighing the surplus in services. Indeed, our overall trade deficit has exceeded 2 per cent of GDP for 15 of the past 16 years, and in many of those it has exceeded 3 per cent (see figure 3.10). In 2015, the UK recorded the largest current account deficit as a percentage of GDP of all G7 countries.[119] This persistent imbalance indicates a serious problem of competitiveness relative to other developed economies.

FIGURE 3.11

The UK is disproportionately reliant on a small number of exporting industries

Revealed comparative advantage by industry for the UK, German and Japanese economies (with UK sector share of total UK exports in brackets), 2012



Source: IPPR analysis of International Trade Centre (2014) 'Trade statistics' (dataset) http://www.intracen.org/itc/market-info-tools/trade-statistics/

The UK's trade weaknesses run deep. Compared with most other advanced economies, the UK is disproportionately dependent on a small number of industries to supply its exports. This can be measured through the concept of 'revealed comparative advantage': the ratio between a given industry's share of total UK exports and the same industry's share of global exports. Figure 3.11 shows the spread of 'revealed comparative advantage' in the UK economy compared with Germany and Japan – two advanced economies with significant trade surpluses.

It shows that the UK's revealed advantage is hugely dependent on just two industries, both of them in the financial sector, while Germany and Japan display a much more balanced and diverse spread. This reflects the UK's overall trade weakness, particularly in manufacturing. It also reveals the significant economic risk posed by the possibility that the UK's financial services sector may lose its 'passporting' rights in the forthcoming negotiations with the EU.

The UK finances the deficit on its current account (which comprises trade in goods and services and other forms of international income) with a surplus on its capital account. This is made up of the flows of assets (including both long-term foreign direct investment and short-term purchases of shares and bonds) to and from the UK. So long as there is demand for UK assets, the current account can continue to be financed in this way. However, if the value of UK businesses and their perceived future growth prospects were to decline – with foreign lenders demanding higher returns to hold UK assets – the value of sterling would fall and the current account would have to adjust, at least in the short term, with a reduction in imports and a decline in consumption and living standards. This would pose real recessionary risks. The large current account deficit therefore makes the UK especially vulnerable to a weakening in domestic economic conditions, a fact of particular concern given the uncertainties of Brexit.

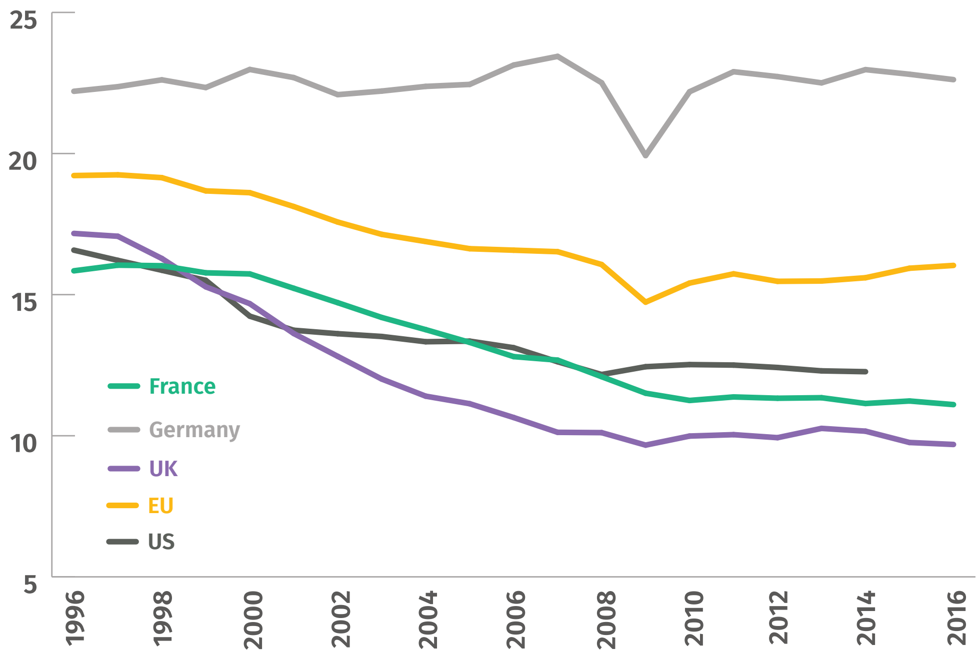
The depreciation of the pound since the EU referendum is a reflection of such concerns. Sterling fell 15 per cent against the dollar and 8 per cent against the euro between the first quarter of 2016 and the first quarter of 2017.[120] Although this has raised import prices and created inflationary pressures, it can in many ways be seen as a welcome correction of a currency that had become overpriced. Throughout the past three decades, the pound has been sustained at levels that have both reflected and supported the success of the UK's financial sector. The effect on the rest of the economy has arguably constituted a kind of 'Dutch disease', with British exports made too expensive compared with those of our competitors, and imports too cheap.[121]

In turn, this has both driven, and exacerbated, the decline of UK manufacturing. As a proportion of total output, manufacturing has declined in all advanced countries, both as a result of productivity improvements and as a consequence of deindustrialisation and globalisation. But over the past 40 years this process has gone much further in Britain than elsewhere. Manufacturing in the UK now makes up just 10 per cent of the economy's total gross value added (GVA), compared with 23 per cent in Germany, 21 per cent in Japan, 12 per cent in the US and 11 per cent in France (see figure 3.12).[122] In turn, this has contributed to the UK's lower level of investment, productivity and wages.[123]

FIGURE 3.12

Manufacturing output has shrunk faster in the UK than in other advanced economies

Manufacturing gross value added (GVA) as a proportion of total economy GVA, selected economies, 1996–2016



Source: Organisation for Economic Co-operation and Development (2017) 'Value added by activity' (indicator) https://data.oecd.org/natincome/value-added-by-activity.htm

Sterling's recent depreciation may already have begun to lift the level of exports, including in manufactured goods, although in some cases exporters appear to have used it to raise profits (by holding their prices constant) rather than sales.[124] Around two-thirds of input costs are domestic in origin, meaning that they are priced in pounds, while around one-third are imported components, meaning that they are purchased at world prices. As a result, a 15 per cent reduction in the value of sterling translates into a 5 per cent reduction in price on world markets. Given the intensity of price competition for manufactured goods, this has the potential to improve the UK's competitiveness.

Nonetheless, after decades of policy neglect, the UK manufacturing sector has been left in a weak position. A more competitive pound will not, on its own, be sufficient to support a sufficiently broad revival of manufacturing (or a reduction in the trade deficit). The UK's weakness can be seen in the proportion of manufactured exports that are reliant on imported components when compared with other industrialised countries.[125] UK manufacturing is too narrowly focussed and too dependent on foreign industrial supply chains. This contrasts, for example, with Germany, Japan and the US, where manufacturing supply chains are typically maintained domestically in strong industrial 'clusters'. These create mutually beneficial spillover effects in innovation, adaptability and competitiveness (while also maximising the benefits of a competitive currency).[126] As a result, the UK needs a broad strategy to support the expansion of manufacturing – through an active industrial policy, with a proper geographical focus outside London and the South East – if it is to correct its long-run weaknesses.

WE HAVE EXPERIMENTED WITH BOLD MONETARY POLICY, BUT ARE CONSTRAINED BY PRE-KEYNESIAN FISCAL ORTHODOXY

Since the global financial crisis of 2008, UK macroeconomic policy has seen a combination of creative monetary policy and a return to pre-Keynesian fiscal policy. The boldness of the former stands in sharp contrast to the orthodoxy of the latter. If we are to forge a more effective path for the 21st century, neither classical orthodoxy nor a simple Keynesian stimulus will be sufficient on its own.

The Bank of England has been testing the limits of its capacity to stimulate demand in the economy. Interest rates have now been held at 0.5 per cent or less for eight years, a period without precedent in the Bank's history. They remain at 0.25 per cent today. Over the same period it has injected £445 billion into the economy through the unconventional – and largely experimental – policy of 'quantitative easing' (QE), or purchase of government (and some corporate) bonds.[127] The Bank's latest stimulus package was introduced in immediate response to the EU referendum in 2016, along with a new scheme to encourage commercial bank lending.[128]

Unconventional monetary policy has been accompanied by an approach to fiscal policy that pre-dates Keynes. Since 2010, governments have been focussed on reducing the budget deficit (the difference between annual public expenditure and receipts), with the ultimate goal of 'balancing the books' of the state. This policy of 'austerity' has seen public spending cut from around 45.3 per cent of GDP in 2009/2010 – the high it reached in the wake of the financial crisis – to around 39.4 per cent in 2016/2017.[129] Along with a net increase in taxation, this has brought the deficit down to around 2.4 per cent of GDP, a reduction of three-quarters from the postwar peak of 9.9 per cent in 2009/2010. The deficit today is the same as it was in 2007/2008, prior to the financial crash – although still much higher than successive governments have aimed for and predicted.[130]

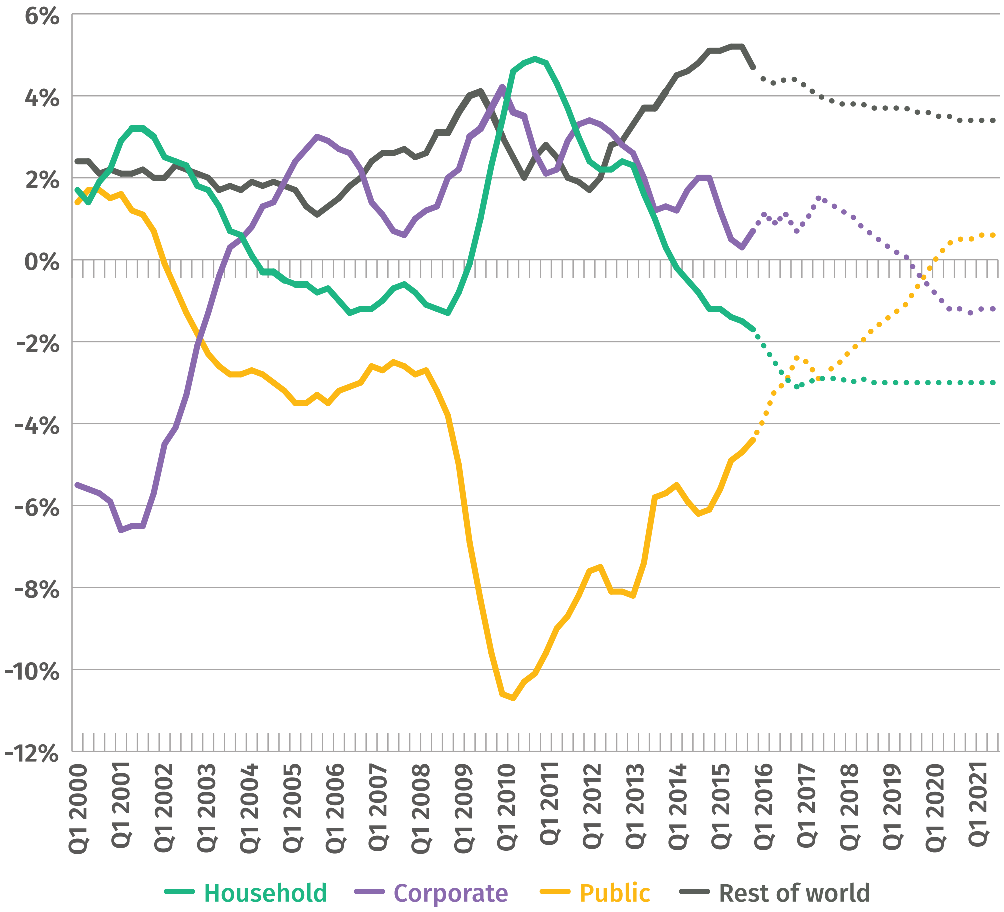
Monetary and fiscal policy have therefore been effectively acting against each other, one injecting demand into the economy while the other withdraws it. This might have worked if the UK economy had seen strong demand from business investment or exports. But (as discussed above) business investment has been weak, with the UK corporate sector now a net saver in the economy: in 2016, private sector investment began to contract again.[131] And we have had a record trade deficit. The result is that growth has been largely dependent on household spending, fuelled by rising levels of consumer debt. The OBR estimates that, in 2017, household consumption will drive nine-tenths of the estimated 2 per cent GDP growth.[132] Average household debt has risen by over 15 per cent since 2010, and now stands at 142 per cent of disposable income. A continuation of this trend would take household debt beyond its 2008 peak (160 per cent) in under three years.[133] The Bank of England has already warned of the dangers.[134]

None of this, however, should have been unexpected. One of two often-overlooked reasons why austerity has not worked well is that, across the economy as a whole, all saving and borrowing must mathematically balance. So if the government deficit declines, other sectors of the economy (households, firms and the 'rest of the world') have to make up the difference (see figure 3.13).

FIGURE 3.13

As the government deficit declines, other sectors of the economy need to increase their net borrowing to maintain overall balance

UK sectoral net lending (% of GDP), outturn, and government projections, 2000–2021*



Note: dotted lines indicate government projections as opposed to actual net lending, from Q4 2015 onwards.
Source: Office for Budget Responsibility (2016) 'Economic and fiscal outlook charts and tables – March 2016' (dataset) http://budgetresponsibility.org.uk/data

So long as the UK continues to run a high current account deficit (which equates to net lending by the rest of the world), and the corporate sector remains a net lender, government and households must be net borrowers. It should therefore not come as a surprise that the budget deficit has not fallen as fast as governments sought, or that household debt has been rising.

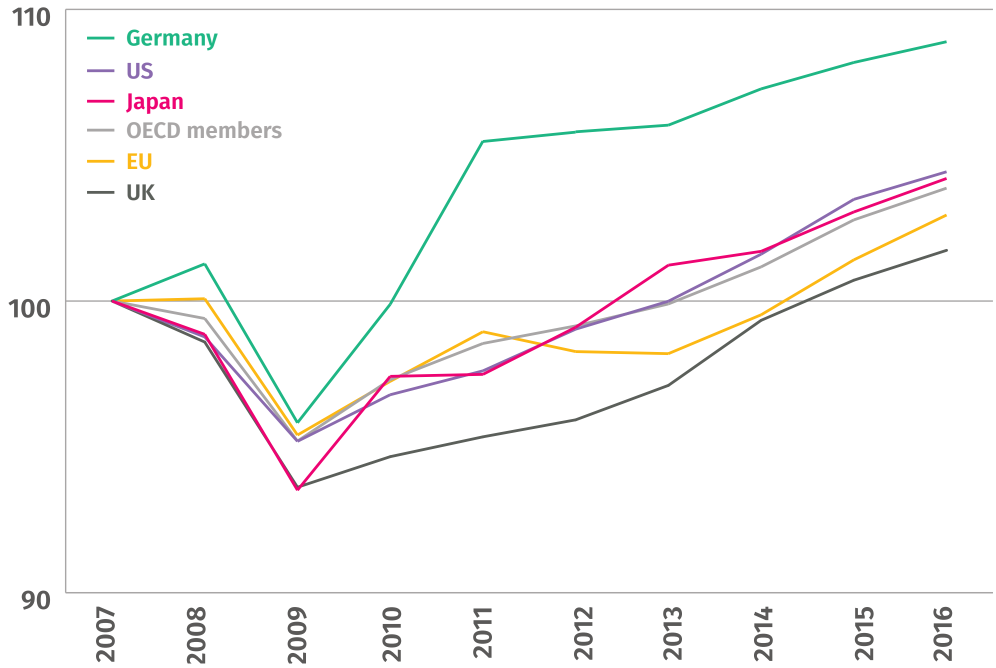
The second overlooked reason involves a deeper Keynesian insight. The state can provide stabilisation and stimulus in the economy, not only through the demand it generates directly and indirectly through government expenditure (its 'size') but also through the coordination provided by its institutions (its 'scope'). In both cases, the state can help to give assurance against risk for the private sector, either through the predictability of (public) demand in the economy or through the predictability of the private investment environment. Both of these roles were especially critical when the private economy was still reeling from the damage of 'unknowable risk', following the 2008 financial crisis.[135] But from 2010, when markets needed further stabilisation policy and signalling from government to more accurately understand and price economic risks, government deliberately diminished its own role through reduced taxation, spending and coordination in labour and capital markets.

The consequence is that the combination of macroeconomic policies has not yielded strong growth. The UK's recovery from the crisis has been one of the slowest of all developed countries: lower than both the EU and OECD averages, and well behind Germany and the US (see figure 3.14).[136]

FIGURE 3.14

The UK had a deeper recession, and has recovered more slowly, than many advanced economies

Trends in GDP per capita for selected economies, 2007–2016, 2007 = 100



Source: Organisation for Economic Co-operation and Development (2017) 'Gross domestic product (GDP)' (indicator) https://data.oecd.org/gdp/gross-domestic-product-gdp.htm

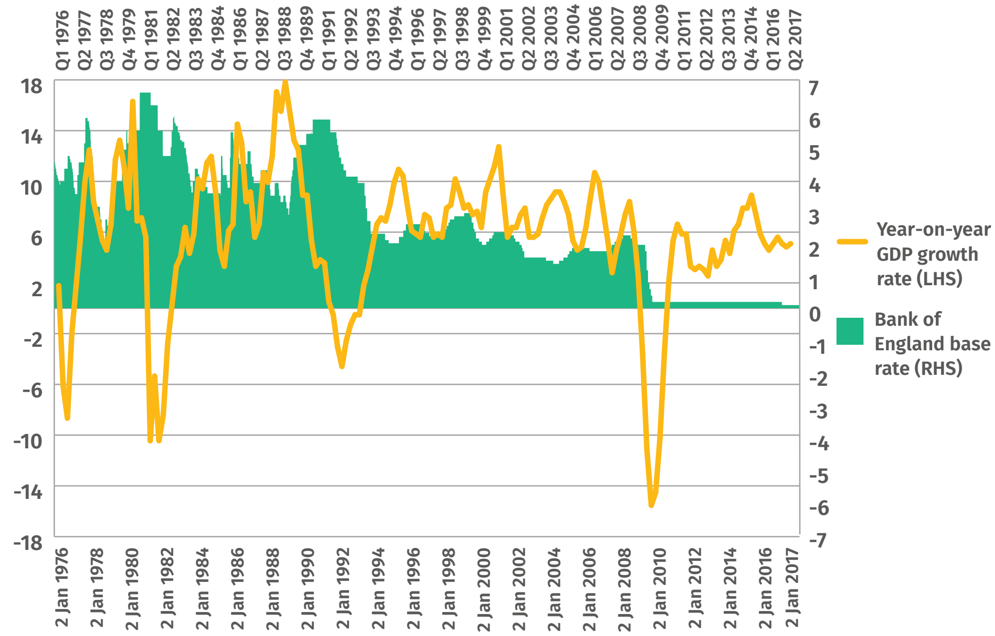
It is in the prospects for the immediate future, however, that most concern perhaps lies. With interest rates at near-zero (their 'effective lower bound'), there is little further scope for monetary policy to stimulate demand if consumption now falls. With inflation rising and an economic slowdown already apparent, the next recession is already likely to be closer than the last.

The limits of monetary policy have been apparent for some time. One of the striking trends of the last 40 years has been the secular decline in interest rates. A pattern has emerged in which, when economic growth slows, interest rates are lowered in order to stimulate consumer demand and business investment; but each time, rates have tended not to recover to their pre-recession levels before being cut again in response to the next downturn (see figure 3.15). As a result, the economy has adjusted to cheaper credit, with each subsequent downturn requiring increasingly loose monetary policy while starting from an ever-lower base.

FIGURE 3.15

The scope for conventional monetary policy to counter slow growth has run out

Quarterly GDP growth (year-on-year, left-hand axis) and Bank of England base rate (right-hand axis), January 1976 to August 2017



Source: Office for National Statistics (2016) 'Gross Domestic Product: q-on-q4 growth rate' (dataset) https://www.ons.gov.uk/economy/grossdomesticproductgdp/timeseries/ihyr/pn2; Bank of England (2016) 'Statistical Interactive Dataset – official Bank Rate history' (dataset) http://www.bankofengland.co.uk/boeapps/iadb/Repo.asp

This pattern of progressively declining demand requiring ever-higher doses of monetary stimulus is not unique to the UK. It is one symptom of the phenomenon described by former US Treasury secretary Larry Summers as 'secular stagnation', in which persistently deficient demand and excessive saving mean that normal rates of economic growth can only be sustained at very low or even negative interest rates.[137] Across the developed world, the causes of low demand are contested – demographic shifts, overhanging debt, a slowing of the rate of technological innovation and increased financialisation of the private sector have all been put forward as candidates.[138] What is hard to dispute is the unusual persistence of these conditions. The extraordinary glut of corporate saving across the developed world can be seen as both part cause and part consequence.[139]

For the UK, the position looks particularly serious. Stagnant productivity since the financial crisis has left the economy effectively unable to drive growth from within. The OBR now estimates that the UK's 'output gap' – the amount by which an economy can grow in a year without causing inflation – has turned positive for the first time since 2008, meaning that there is little slack in the economy to take up any increase in demand.[140] If fear of inflation now prevents further stimulus, there is a real risk that the UK's 'lost decade' of growth will become permanent, and GDP will never catch up with its pre-financial crisis trend.[141]

It is hard to avoid the conclusion that we need a new approach. With interest rates still at record lows, the case for public investment to drive demand is particularly strong. Borrowing for public investment is not the same as borrowing for current consumption: investment (assuming it is well made) generates long-term growth. There is considerable scope for higher public investment today, in infrastructure, in innovation and in education and skills. It used to be believed that public sector investment would 'crowd out' private sector investment, but in today's conditions, the reverse is much more likely. By stimulating demand, public sector investment can ‘crowd in’ finance from the private sector.[142] The need to improve the UK’s rates of investment and productivity suggests there is considerable scope for the development of an investment-led strategy for growth.

THE ECONOMY DEPENDS ON PUBLIC SPENDING, BUT WE HAVE NOT BEEN SUFFICIENTLY WILLING TO PAY FOR IT

Modern economies rely on public spending. The private sector could not generate production or profit without the core services provided by the public sector – education, childcare, health, transport, policing, environmental protection, scientific research and so on, along with the myriad social, welfare and cultural services that sustain livelihoods and social cohesion. Through these services the state assumes and collectivises vital risks and costs, on which the private sector relies but which it could not itself replicate. And public services are also a crucial part of the economy in their own right, employing over five million people, generating their own tax receipts, and creating markets for public procurement worth around £200 billion a year.[143] Their outputs constitute an important part of the country’s prosperity.

The reduction in the budget deficit over the last seven years has been achieved largely through reductions in public expenditure. Of the total deficit reduction, around four-fifths (78 per cent) has come from government spending falling as a proportion of GDP, and only one-fifth (22 per cent) from rising tax revenue.[144] But this has come at a cost. It has become painfully clear that at current spending levels, many public services are under severe strain. It is hard to miss the almost daily news stories of pressures in the NHS, in schools, social care, the police service, prisons and throughout local government, along with the hardships generated by cuts to benefits and tax credits and the continuing freeze on public sector pay.[145]

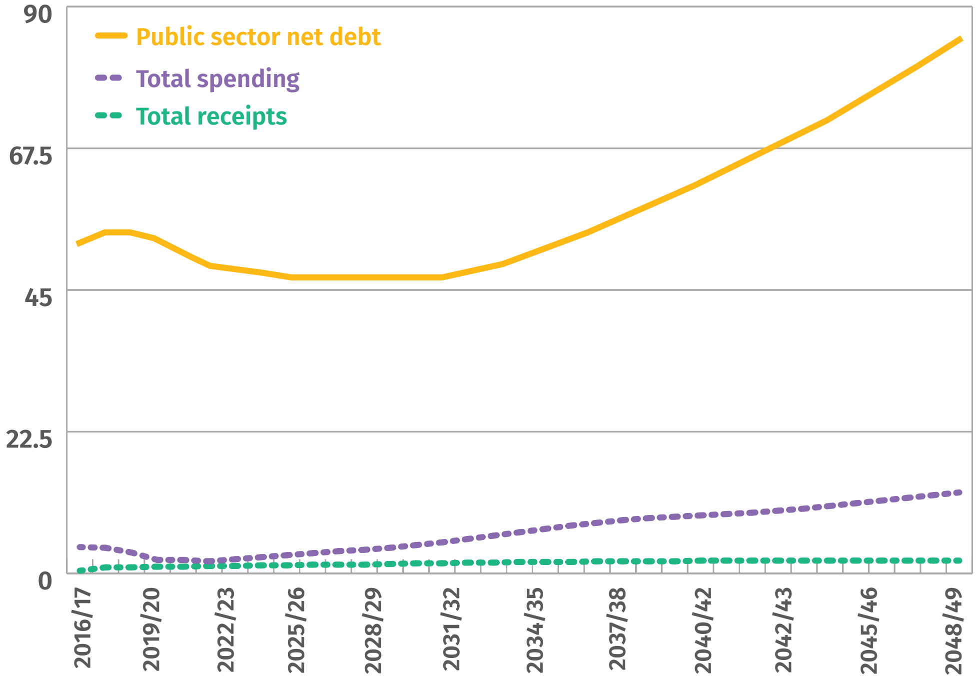
The question facing the country, therefore, is whether public spending can or should be cut further, as is currently planned; or indeed should be increased. This is not just an issue for today. The deeper challenge we must confront is the pressure on public spending that is building in the future.

Projections by the OBR show that over the next 30 years there will be a widening gap between expected public spending and forecast tax receipts (see figure 3.16). On central assumptions about economic growth, and without a change in fiscal policy, the public sector deficit will grow throughout the 2020s and beyond, rising to over 5 per cent of GDP in 2056–2057. As a result, overall debt is projected to rise from around 90 per cent of GDP today to 172 per cent by 2056/2057.[146] This ‘fiscal gap’ will continue to widen until 2066/2067, the final year of the OBR’s projections. The OBR warns starkly that this is ‘an unsustainable fiscal position over the long term’.[147]

FIGURE 3.16

Public spending is forecast to outstrip total receipts from the 2020s

OBR forecasts for total government receipts, total government spending and public sector net debt as a proportion of GDP, 2016/2017–2050/2051



Source: Office for Budget Responsibility (2017) *Fiscal Sustainability Report – January 2017* http://budgetresponsibility.org.uk/fsr/fiscal-sustainability-report-january-2017/

This widening deficit is driven largely by demographic change and the rising costs of health and social care. Between 2015 and 2050, the proportion of the UK's population aged over 65 is expected to rise from around one in six to one in four.[148] A larger older population means higher spending on both pensions and health and social care. At the same time, improved technologies and treatments will continue to drive health spending upwards. Across advanced countries, OECD data shows that the long-run trajectory of the health sector is set to expand at GDP growth plus 2 percentage points.[149] Together these changes are expected to contribute to an increase in public expenditure of as much as 8.5 per cent of GDP between 2019–2020 and 2034–2035.[150]

On the other side of the fiscal gap, demographic change also underpins the shortfall in projected tax revenues. As life expectancy continues to increase, and fertility rates remain historically low, the proportion of people of working age relative to the population as a whole will continue to decline. Over recent years this trend has been partially offset by the inward migration of working-age adults, but in current circumstances it is not clear whether or how far this will continue. Even if it does, it seems inevitable that, over the coming decades, a proportionately smaller working-age population will be required to pay for a larger, and more expensive, non-working one.

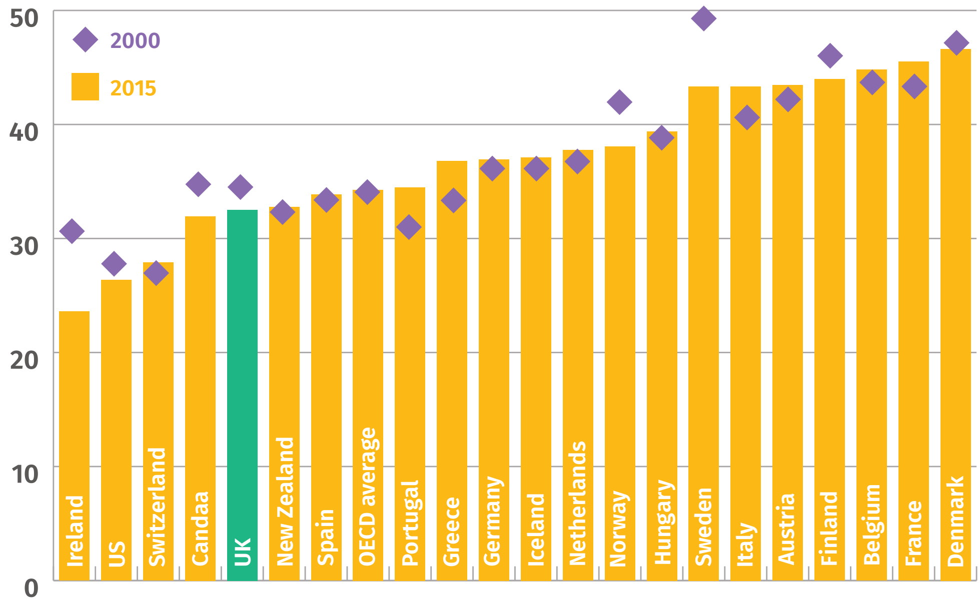
These concerns, in both the present and the future, inevitably raise questions about the rate of taxation levied by the UK economy. The arithmetic is plain. Unless we can engineer a significantly stronger rate of economic growth, as a society we will have to choose whether to cut spending further, to allow the deficit to rise, or to raise taxes. In the short term, as the Institute for Fiscal Studies has pointed out, it would be possible to cancel all currently planned spending cuts and tax rises and leave the deficit unchanged over the next five years.[151] But that would still leave public services in their current distressed state, and it would not respond to the future pressures that the OBR has set out.

Taxation is in many ways the hidden issue in British public debate. By European standards the UK is not a high-tax country. As a percentage of GDP, tax revenues in the UK are significantly lower than the OECD average. At around 33 per cent of GDP, they are on a par with Estonia, the Czech Republic and Poland, and well below our principal competitors such as Germany (37 per cent), the Netherlands (38 per cent), France (46 per cent) and Denmark (47 per cent) (see figure 3.17). Different levels of taxation partly reflect national economic conditions, but they are largely determined by the political decisions that countries have made over the quality of their public services and welfare spending. As the experience of different European economies shows, there is no simple relationship between economic performance and the level of taxation and public spending, taken together.[152] Rather, there are different choices that societies can make.

FIGURE 3.17

Levels of taxation in the UK are lower than in most other advanced economies

Total government taxation as a proportion of GDP, selected OECD countries, 2000 and 2015



Source: Organisation for Economic Co-operation and Development (2017) 'Revenue Statistics – OECD countries: Comparative tables' (dataset) https://stats.oecd.org/Index.aspx?DataSetCode=REV

There is a strong case for these choices to be aired more widely in debates over the UK economy than they have been in recent decades. It is often remarked that the British public aspires to Scandinavian levels of public services but American levels of taxation. This is no longer sustainable: we will have to adjust either our expectations or our taxes. The pressures on public services being experienced now, and those which will arise in the future, make that clear. British public attitudes on taxation and spending indeed appear to be shifting.[153]

A more open debate on taxation could valuably encompass not just the appropriate level of tax, but also how and on whom and what it is levied. The British tax system is ripe for reform.[154] It is highly complicated, with the tax code now taking up more than 10 million words and 21,000 pages.[155] It embodies perverse incentives, for example by taxing labour highly and unearned wealth scarcely at all. The UK's rate of corporation tax is very low by international standards, and can largely be avoided by internet platform companies and other multinational businesses, while business rates penalise physical investment. We have the lowest rate of taxation raised locally (just 1.7 per cent of GDP) of any major western European country.[156] At the same time, the UK has a sizeable 'tax gap' between the liabilities owed to the Government and those actually collected by HM Revenue & Customs. This is partly the result of high levels of tax avoidance and evasion, to which Britain's international service-based economy is particularly vulnerable.[157] Government estimates put the tax gap at £34 billion a year, or 6.4 per cent of total tax liabilities, but other estimates are far higher – potentially up to £120 billion.[158]

So we have a very British muddle: exceptional high-tech firms but lagging productivity and poor exports; powerful finance but weak investment; 21st-century monetary policy but 19th-century fiscal policy; and a large public debt but a diminished public sector. In some cases, these challenges have been present for a quarter of a century or more, and together they undermine the ability of the UK economy to deliver rising living standards for much of society. However, seeking to tackle these challenges will also present opportunities, particularly in view of the fast-moving trends that will come to bear on the UK economy over the coming decade. In the next chapter we examine what these trends are, and how the economy will need to be re-forged to meet them.

Solar farm, Abbots Rippon, Cambridgeshire

4.
CHALLENGES AND OPPORTUNITIES IN THE 2020S

In chapter 3 we saw how many of Britain's economic problems are of long standing. This is the inheritance with which policymakers today must deal. But they must also look forward, for over the next 10 to 15 years the economy will face a number of major challenges that are reconfiguring the economy as we know and experience it today. These are challenges, but they are also opportunities, if the UK economy can be shaped to seize them. In this chapter we set out five of the most significant.

BREXIT: AN UNCERTAIN FUTURE AHEAD

The principal economic challenge facing the country today is plainly Britain's exit from the EU. It is a momentous change to the UK's economic governance and trading relationships and it will affect almost every part of the UK economy. Indeed, it is already doing so: a combination of general uncertainty, and the higher rate of inflation that has followed the depreciation of the pound, have already had a dampening effect on consumption and investment, and therefore on economic growth.[159] The Commission does not take a position on whether the decision to leave the EU was either right or wrong. Rather, we take it as a powerful message of the inadequacy of the status quo and the urgent need for change to Britain's economy.

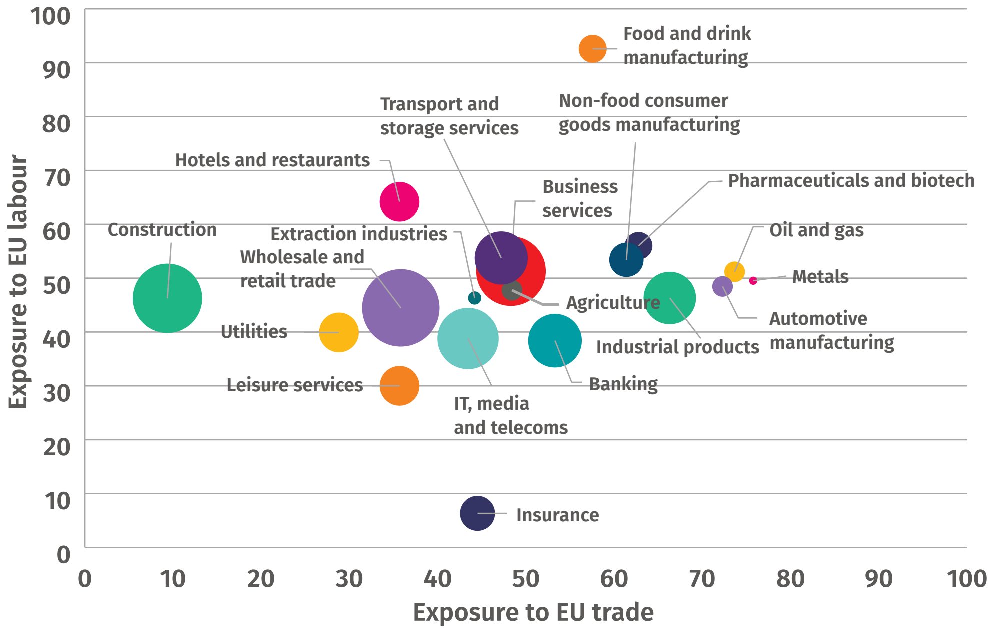
The scale of the medium-term economic impact of Brexit remains unclear. It will depend on the deal that is negotiated over the coming months, particularly on whether the UK continues to participate in the single market and the customs union, or diverges from them; and on whether or not there is a transitional arrangement after March 2019 that smooths the path to a future relationship between Britain and its European neighbours.[160] We know that some sectors will be highly affected, whatever kind of deal is negotiated – notably agriculture and fisheries, which will require new domestic regulatory and subsidy arrangements to replace those currently governed by the EU.[161] Others are also likely to experience a significant impact, depending on the nature of the final deal (and this in turn is likely to impact on different parts of the country differently). The UK's financial services sector is a particular example, with the future location of many businesses and jobs dependent on the 'passporting' rights into the EU market, or alternative 'regulatory equivalence' arrangements, which are negotiated.[162]

For most sectors, the impact of different possible Brexit outcomes will depend on two factors: their exposure to trade with the EU, and their reliance on EU labour.[163] Figure 4.1 places some of the UK's major sectors in relation to these two axes. The degree to which the final Brexit deal sustains freedom of trade and/or freedom of movement will do much to determine the eventual impact on different sectors. It will be highly complex too, with major interdependencies between sectors creating secondary impacts – such as between hospitality and food and drink, and automotive manufacturing and metals. This is also true of trade, where many industries have complex supply chains involving both imports and exports of components and final goods. Were EU–UK trade to fall back on World Trade Organization (WTO) rules, different sectors would face very different levels of tariffs: from zero in the case of pharmaceuticals to upwards of 10 per cent for food and clothing.[164] Many service sectors – which make up much of Britain's exports – are not covered by WTO rules and face various restrictions on access overseas.

FIGURE 4.1

Key UK export sectors such as food and drink and car manufacturing are highly exposed to EU trade and labour markets

Industrial sectors by size of output (percentage of all gross value added) and exposure to EU trade and labour markets (respectively), KPMG indices of exposure



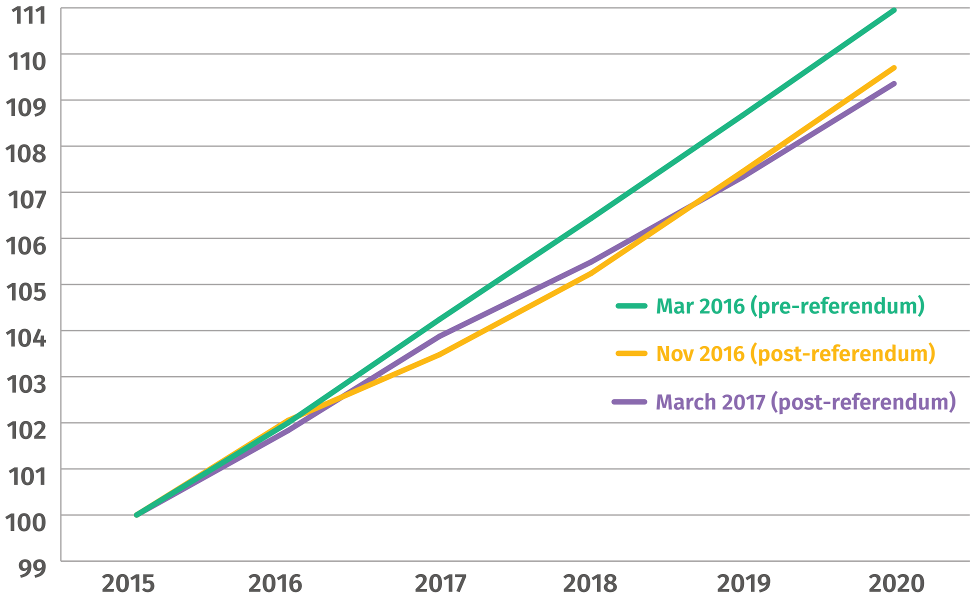
Source: Reproduced from KPMG (2017) 'Brexit: the impact on sectors' https://assets.kpmg.com/content/dam/kpmg/uk/pdf/2017/03/brexit-the-sector-impact.pdf

It is, therefore, impossible to forecast the eventual economic impact that Brexit will have. For the period up to 2030, the vast majority of economic projections show slower economic growth compared with a scenario in which the UK remained in the EU.[165] But there are significant variations between these models, and the ranges within them indicate both the different possible scenarios for future trading and labour market arrangements, and the uncertainties inherent in such forecasting. Figure 4.2 shows how the Office for Budget Responsibility has adjusted its forecasts since the referendum vote. What can be said is that under all circumstances the British economy will need to be as strong and resilient as possible to withstand the changes it will face. Supporting key sectors of the economy to raise their productivity and competitiveness through industrial policy, and ensuring that Britain trains the workers it will need in tomorrow's labour markets, will be crucial.

FIGURE 4.2

Forecasts for economic growth have been weaker since the EU referendum result

Respective OBR forecasts for real GDP before and after the EU referendum, 2 016–2020 (2015 = 100)



Source: Office for Budget Responsibility (2017) 'Historical official forecasts database' (dataset) http://budgetresponsibility.org.uk/data/

GLOBALISATION: A NEW WAVE OF GLOBAL GROWTH

Whatever the UK's future relationship with the EU, we will continue to be affected by the wider forces of the global economy. These are changing, and will require the UK economy to respond if it is to maintain its place in the international economic order.

Over the last 40 or so years, globalisation has had a dramatic impact on global economic growth. Average global real income rose by around 120 per cent between 1980 and 2015, and global poverty – particularly in China and the rest of Asia – was significantly reduced.[166]

Yet the benefits of such growth have not been equally distributed (see figure 4.3). While globalisation has reduced inequalities between developed and developing nations, it has generally amplified them within the advanced countries. Almost all have seen a widening of income disparities between low- and middle-income households and those at the top.[167] The geographic dislocations have been even more marked. The shift of manufacturing production to China and other parts of the developing world has had a particularly sharp impact on jobs and communities in traditional industrial areas, while the benefits of greater trade – both in lower prices and in new jobs created – have been more dispersed and less obviously visible.

FIGURE 4.3

Outside of the world's very poorest people, globalisation has hit income growth hardest for the lower- to middle-income households in advanced economies

Global growth in average per capita household income of each percentile group, 1998–2008

Source: Reproduced from Corlett A (2016) *Examining an Elephant: Globalisation and the Lower Middle Class of the Rich World* http://www.resolutionfoundation.org/app/uploads/2016/09/Examining-an-elephant.pdf

Within changes across time it can be difficult to disentangle the impacts of globalisation from the simultaneous effects of technological change and other forces. In its 2017 *World Economic Outlook*, the International Monetary Fund (IMF) looks at the falling share of national income paid to workers in developed countries over the past 40 years, a major source of rising inequality. It estimates that around half of this trend can be attributed to technological change (particularly the impact of information and communication technologies and manufacturing automation) and only a quarter to global integration (trends in final goods trade, participation in global value chains, and foreign direct investment).[168]

Crucially, the impact on incomes of both of these trends is mediated through policy choices; it is not uniform, nor inevitable. Trade agreements can protect workers through high labour market standards, or expose them to lower wage competition from overseas. Domestic policies to redistribute income, raise wage levels, retrain workers, support industrial transition and stimulate local economies can all help to ameliorate adverse impacts.[169] It is widely acknowledged today that the issues surrounding globalisation are less about the gains from trade than about how they are shared across the economy.[170]

The processes of globalisation, however, will not be the same in the future as they have been in the recent past. The huge growth of trade and financial integration that occurred up until the 2008 financial crisis has not continued since. From 2002 to 2008, global trade grew at an annual rate of 12.5 per cent, more than twice as fast as global GDP; since then it has grown at under 3 per cent, or about the same rate as global GDP. Foreign direct investment flows, which grew from 6.5 per cent of world GDP in 1980 to nearly 32 per cent in 2006, have fallen by around a third since the financial crisis. The global stock of foreign assets and liabilities nearly trebled between 2000 and 2007, but has remained little changed in the decade since. These trends indeed make the period since 2008 the longest period of trade stagnation since the Second World War.[171]

It is not yet clear whether this plateauing of trade and financial integration is the long after-effect of the financial crisis that will eventually rebound in a new wave of growth; or a 'new normal' to which the world will now have to grow accustomed. But there are good grounds for thinking that the pre-crisis period was the anomaly: the result of particularly dramatic changes – financial deregulation, the development of new information technologies and China's integration into the world economy – that are not likely to be repeated.[172] Over the coming decade, China will be much less focussed on export-led growth; new international financial rules are intended to stifle any risk of another credit boom; and politically the drive towards ever-increasing trade liberalisation appears to have been stopped, or at least slowed down.

If global trade is more likely to grow at around the same pace as GDP in the future, it will also change in character. First, more of it will take place in the south and east of the world. Urbanisation and the expansion of the world's 'middle class' will be the central dynamic. By 2030, China alone is expected to have 17 of the world's top 50 cities by GDP, more than either North America or Europe. Over 40 per cent of the world's consumption demand will come from Asia.[173] As the populations of Asian and African countries continue to grow, the WTO predicts that, by 2030, 30 per cent of all global trade will be between emerging markets, more than double their share today.[174]

Second, data is the growing cross-border commodity. Digital flows of information, searches, communications, transactions and intracompany traffic have become the new lifeblood of international trade, with an estimated 12 per cent of global goods trade now carried out via e-commerce platforms, which until recently did not exist at all.[175] In their analysis of this field, the McKinsey Global Institute suggests that cross-border data flows enabled resource reallocation and increased productivity that may have added 3–4 per cent to world GDP over the past 10 years, with larger potential in the future.[176]

Third, the other major field of growth will be in trade in services: a projected three-fold increase from $4.8 trillion in 2015 to $12.4 trillion in 2030, compared with an expected doubling of trade in goods.[177] As emerging economies develop, so their demand for services will grow. But equally so will their capacity to supply them. It is clear that one of the strongest trends of the next decade will be the movement of China and other developing countries up the value chain, capturing a larger share of global trade in high-end goods and services at the expense of the traditionally advanced countries.[178] Where once sophisticated R&D would be carried out in the developed world and simpler manufacturing assembly in developing countries, this will no longer hold true in the future.

These trends pose real competitive challenges for the UK. As we saw in chapter 3, our exports are dominated by financial and other services. The growth in global trade in services offers the UK new and larger global markets; but only if we are able to access them. The position of the UK in relation to cross-border data flows after Brexit is unclear, and might challenge our existing strengths in this area. Non-tariff barriers to trade tend to be much higher in services than in goods; as emerging economies are more able to compete in these sectors, this will place a premium on reciprocal trade agreements aimed at reducing them.[179]

At the same time, there are likely to be new opportunities. Recent developments in manufacturing suggest an increasing potential for 're-shoring'– the replacement of imported manufactures by domestic supply. This arises in part from new technologies such as 3D printing, and in part from the shift to 'bespoke' and precision manufacturing in which the physical proximity of manufacturer and customer becomes more important.[180] It is not yet clear how significant these opportunities will be, but they point to a much stronger need for industrial policies aimed at strengthening the UK's manufacturing sectors, particularly in advanced manufacturing. Ensuring that the UK expands its spending and capacities in innovation and R&D will be particularly important – it will be British firms' ability to stay ahead of the global technological frontier that will ensure our competitiveness in the new global economy now emerging.

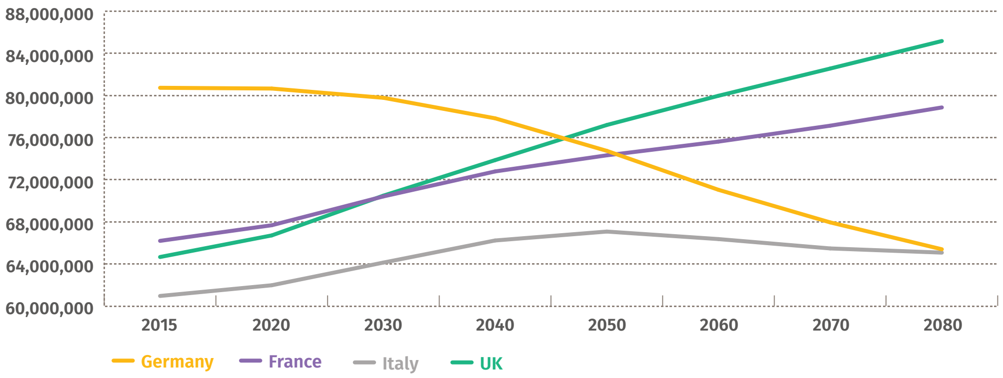
DEMOGRAPHIC CHANGE: A GROWING, DIVERSIFYING AND AGEING POPULATION

Over the next three decades, the population of the UK is projected to grow more quickly, and become more diverse, than that of most developed countries. This will have significant implications for the economy.

The UK is set to overtake France's population by the early 2030s, and will become the biggest country in Europe by population by the mid-2040s (see figure 4.4). Growth will be centred in cities, with London, for example, projected to grow to 10 million people by 2030, up from 8.5 million today.[181] The non-white population of the UK is expected to rise from 14 per cent in 2011 to an estimated 21 per cent by 2030 and a third of the population by 2050.[182]

FIGURE 4.4

The UK population is projected to grow faster than in other developed countries
Projections for total population, selected countries, 2015–2080



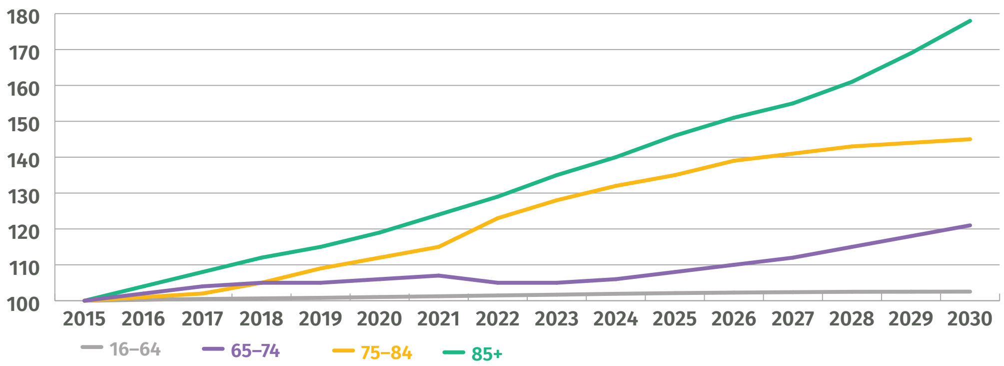
Source: Office for National Statistics (2015) 'National Population Projections: 2014-based Statistical Bulletin' (dataset) http://www.ons.gov.uk/peoplepopulationandcommunity/populationandmigration/populationprojections/bulletins/nationalpopulationprojections/2015-10-29#2014-based-principalpopulation-projections

As we grow, we will also age. The proportion of the population aged over 65 is forecast to grow by 33 per cent between 2016 and 2030 – from 11.6 million to 15.4 million – while the over 85s will nearly double by 2030.[183] By contrast, the working-age population (aged 16–64) will increase by only 2 per cent (see figure 4.5). The 'support ratio' (the ratio of the working to the non-working population) will therefore decline.

FIGURE 4.5

Population growth will be disproportionately fast for the over 65s

Trend in UK population growth by age group, 2015–2030



Source: Office for National Statistics (2015) 'National Population Projections: 2014-based Statistical Bulletin' (dataset) http://www.ons.gov.uk/peoplepopulationandcommunity/populationandmigration/populationprojections/bulletins/nationalpopulationprojections/2015-10-29#2014-based-principalpopulation-projections

As described in chapter 3, an ageing society will contribute to a growing 'fiscal gap' in the 2020s and beyond. Pressures on healthcare, long-term social care, the state pension and other old-age benefits are forecast to increase annual public spending by around 2.5 per cent of GDP between 2019/2020 and 2030.[184] Tax revenues drawn from a working population which is becoming proportionately smaller, relative to the non-working population, will not keep pace. Whatever the results of the Brexit negotiations, this will ensure continuing high levels of demand from employers for immigration to the UK. It may also exert upward pressure on wages, as labour becomes scarcer and its bargaining power consequently greater. At the same time, it is likely to maintain pressures to raise the pension age, and to encourage more people to continue working, perhaps part time, beyond it. Today more than one in 10 people aged over 65 is still in employment.[185]

The rise in numbers of older people will also lead to changes in the composition of demand between sectors and for skills. For example, the number of people who will need daily physical assistance to wash, feed or clothe themselves is projected to double between 2010 and 2030, to two million, part of a much broader demand for health and social care in the decade ahead.[186]

An ageing population will have particular implications for the level of saving in the economy. We are currently saving far too little. Household pension savings rates have fallen well below the levels required to provide the incomes that most people expect in retirement – particularly as those retirements will be longer than ever before. It is estimated that people retiring between 2017 and 2057 may need to save an additional £365 billion each year in order to achieve an adequate income in retirement – a figure equivalent to 13 per cent of GDP.[187]

If we are not saving enough now, an ageing population is likely to result in even lower savings in the future. The lifetime pattern of saving is that workers gradually raise the level of their savings as they grow older, and these are then drawn down in retirement. So as the proportion of pensioners in the population increases, the overall savings rate declines. This is precisely what has happened in Japan, which is already experiencing the economic impact of an ageing society. Today more than a quarter of the Japanese population is aged over 65, and this figure is rapidly growing.[188] Japan has seen a dramatic reduction in its savings rate over the past 30 years, from 15 per cent in 1986 to only 2 per cent now, with negative savings forecast over the next 20 years.[189] This is already having two consequences: net household wealth in Japan is falling, leading to downward pressure on overall consumption; and fewer resources are being made available for domestic investment. Both effects are holding down growth and living standards, extending Japan's long period of economic stagnation.[190]

So an ageing population will have serious impacts on the British economy. We have already noted in chapter 3 that this will inevitably raise the question of the appropriate level of taxation in the economy. It also forces even deeper attention to our productivity. Only if a smaller working population can generate much greater output per person than today will we be able to generate the wealth to support a larger non-working population. Raising the rate of investment in productive capital and technology will be essential to our ability to sustain higher living standards in the future.

TECHNOLOGICAL CHANGE: TOWARDS 'DIGITAL CAPITALISM'

Since the beginning of the Industrial Revolution, technological innovation has driven economic growth. Today, rapid advances in a wide variety of fields, from human genomics and 'systems metabolic engineering' to nanosensors and 2D materials, are creating both fresh solutions to old problems and whole new fields of human activity.[191] But it is on the linked developments of digitalisation, artificial intelligence, machine learning and advanced robotics that much economic debate is now focussed. Two issues have come to the fore: what will be the impact of automation on jobs and incomes in the future; and how should economic policy respond to the growth of digital 'platform' monopolies (such as Amazon, Facebook and Google) that increasingly dominate the digital world, and the newly emerging 'digital capitalism'?

Automation

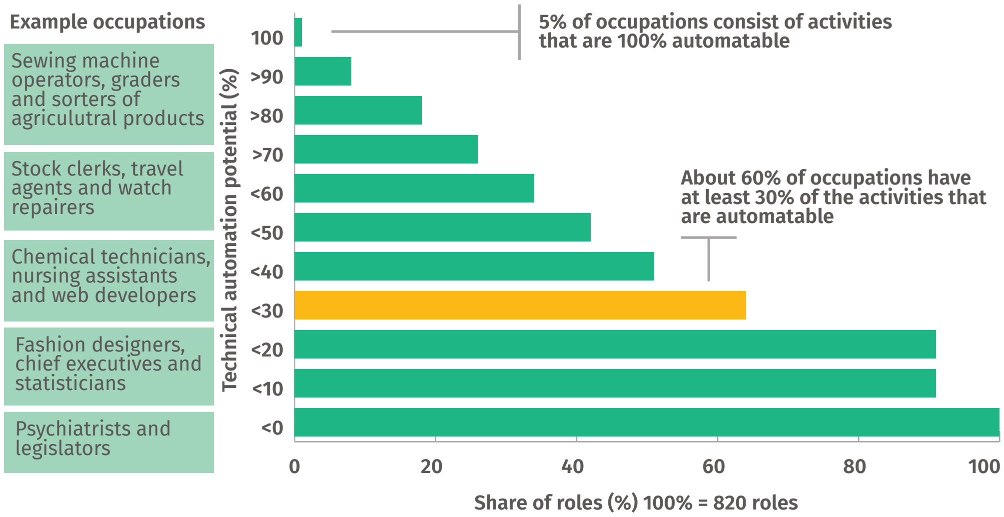
Much of the recent discussion of automation has been apocalyptic, with predictions of large numbers of jobs disappearing as algorithms and robots take over not just routine manual jobs but also cognitive ones in fields such as law, medical diagnosis and accountancy.[192] Indeed, some commentators have argued that in a future of widespread unemployment we may require a whole new way of distributing work and reward, such as through a 'universal basic income' of some kind.[193] Yet automation is not a new phenomenon: the whole history of technological advance is one of machines replacing people, from the first industrial looms through robots on car assembly lines to self-service tills in supermarkets. Over the course of more than 200 years, many jobs have been lost, but many more have been created. The impact of the new wave of automating technologies now being developed and introduced will be more complex than is sometimes suggested.

To start with, it is rarely whole jobs that can be automated. Rather, it is specific *activities* that different jobs involve. Activities that have high potential for automation are those which involve processing or collecting data, performing routine manual work or operating machinery in a predictable environment. By contrast, those involving interfacing with people, applying expertise to decision-making, planning, creative tasks and managing and developing people, have low automation potential.[194] In an analysis of more than 2,000 work activities across more than 800 occupations, the McKinsey Global Institute estimates that fewer than 5 per cent of all occupations can be automated entirely. But about 60 per cent of occupations have at least 30 per cent of constituent activities that could be automated with technologies available today (see figure 4.6). These jobs occur across a range of sectors, with accommodation and food services, manufacturing, transportation and warehousing, agriculture and retail having a relatively larger number of more susceptible occupations; but there is considerable variation even within these sectors. In general, lower-waged and lower-skilled occupations have higher automation potential, but all occupations (including senior managerial and professional ones) have some activities that could be automated. As new automation technologies are developed, these percentages are likely to increase.[195]

FIGURE 4.6

For 60 per cent of all occupations at least 30 per cent of activities can be technically automated

Proportion of activities within an existing occupation that can be technically automated with existing technology, US



Source: Reproduced from Manyika J, Chui M, Miremadi M, Bughin J, George K, Willmott P and Dewhurst M (2017) *A Future that Works: Automation, Employment and Productivity*, McKinsey Global Institute

This does not mean, however, that most of these jobs are about to be 'lost'. First, the technical potential for automation is not the same thing as this potential being realised. Most significant advances in technology have taken decades after their initial introduction to work through the economy. A whole series of factors will determine the pace at which businesses actually install automation technologies.[196] These include:

- the need for generic advances to be turned into occupation-specific applications, which will take time and proceed unevenly
- the cost of developing and deploying automation solutions – which currently makes most of them not viable for the majority of businesses – although costs will inevitably fall over time as deployment increases
- the competing cost, supply and quality of labour, to which automation must be a cheaper alternative to be economically viable.

As long as many low-skilled jobs continue to be paid very low wages, automation will remain unattractive for many firms. Though automating technologies will offer significant performance benefits for many businesses, many will remain underutilised by those which are not sufficiently capitalised or innovative to adopt them. In some cases, regulatory barriers and social acceptance may also affect the deployment of new technologies – self-driving vehicles and the use of robots in caring roles being examples.

Second, the application of automating technologies is likely to change the character of most jobs rather than destroying them, in the same way it has in the past.[197] Routine and data-processing activities will increasingly be carried out by machines and software, while the non-machine-replicable 'human' aspects of work – caring, cognitive, decision-making, creative and managerial roles – will become more important. As human labour and machines increasingly complement one another, this is likely to raise the skill level (and likely job satisfaction) of jobs that are partially automated.[198]

The number of people employed in occupations that undergo some degree of automation may still decline, in some cases steeply. But the impact of automation on jobs in the economy as a whole is not certain. The historical experience is that a whole series of effects occur simultaneously.[199] In some sectors, the number of jobs will undergo drastic reduction, as the demand for the things they produce does not keep pace with productivity improvement – the decline in agricultural employment in the 20th century provides a good example. In others, technological advances will combine with rising demand to increase employment – healthcare being a likely case in point. In general, rising productivity from automation raises incomes and makes goods cheaper, leading to higher demand for goods and services throughout the economy – and therefore raising employment in the sectors producing them.

At the same time, technological advances generate new products altogether, while employment is also raised in the sectors producing the automation technologies themselves – as the huge growth of jobs in software and information technologies over recent decades demonstrates. Historically, the net effect of these various dynamics has tended to be positive rather than negative, with the overall level of demand in the economy a crucial determinant. The way in which automation plays out over the next few decades cannot be known, but it will not be a simple case of job losses. It will be far more complex than that.

For the UK, the challenge of automation is acute. The problem is not that we are being taken over by robots; it is that we do not have enough of them. The UK's uptake of industrial digital technologies has been slower than in many of our competitors; to improve the economy's productivity we need to see a faster rate of automation.[200] If this is to contribute to a more just economy as well as a more productive one, it must be managed carefully, to ensure that the ensuing productivity gains go substantially into wage rises for employees and not simply into the profits of automating companies.

For the real risk of automation is not that it will cause massive job loss, but that it will contribute to rising inequality. There are two reasons for this. First, automation is effectively a substitution of capital for labour, and it therefore risks accentuating the existing trend for the labour share of national income to decline over time and the share returned to capital to rise.[201] As automation will tend to cut the number of jobs in any given automating workplace, it may be hard for the remaining workers to secure the pay rises which can be made available through rising productivity unless there are strong arrangements for collective bargaining. The gains may simply go to the employer.

Second, many of the jobs likely to be displaced in the next decade are in low- to middle-skilled occupations undertaking relatively routine tasks. This will lead to a further polarisation of employment of the kind that has already occurred over the past 20 years, with a larger proportion of both high-skilled and unskilled jobs and a hollowing out of those available in the middle.[202] This will risk many middle-skilled workers having to find lower-skilled jobs and seeing their incomes fall as a result, a phenomenon already familiar for many of those displaced by new technologies and deindustrialisation in recent years.[203]

For these reasons, growth of automation will require a strong policy response, ranging from industrial strategy support to accelerate the introduction of new technologies, to the provision of skills retraining for workers at risk of displacement.[204] It will be important too to ensure that the profits made from automation are properly taxed so that the economic gains are recirculated within the economy.

The platform economy

The new platform economy, by contrast, poses a rather different set of challenges to policymakers. The platform economy consists of online marketplaces that involve at least three parties: the platform, the supplier of labour or assets and the consumer.[205] The platform provider acts as an intermediary, coordinating the supply and demand of the other two parties, where the actual production and consumption occur. Crucially, the intermediary role allows the platform to shift most of the costs, risks and liabilities to the other two parties, while retaining full access to and control over the data, processes and rules of the platform. This creates powerful 'network effects', which in turn tend to create near-monopolies. The fact that they are digitally based means that platforms can grow with very low marginal costs, which furthers the trend towards economic concentration. Airbnb, Amazon, eBay, Facebook, Google, Instagram, LinkedIn, Netflix, Snapchat, Spotify, TripAdvisor, Twitter, Uber and YouTube are prominent examples.

Platform companies of these kinds have had dramatic economic impacts over the past decade or so, driving innovation and disrupting old business models. They have also accumulated significant market power of a kind that in older industries would attract anti-monopoly regulation. To take an example, Facebook and Google between them now attract 57 per cent of the global digital advertising market, with huge consequences not just for other forms of advertising but also for journalism, since newspapers have lost significant income as a result of their growth.[206] Critics of Uber – to take another example – have suggested that this market power has not always been used fairly in competition with established providers.[207]

A second concern relates to taxation. Since digital transactions are not territorially located, it is relatively easy for platform companies to disguise their national revenues and find the lowest tax jurisdictions to declare their profits. Amazon, eBay and Google have all been accused of underpaying UK corporation tax in this way.[208] It is apparent that 20th-century tax systems are not fit for 21st-century firms.

A third issue concerns the control of data. The 'fourth industrial revolution' is being powered by data. The value of many platform companies lies in the data they collect from their consumers. This raises many different questions, from personal privacy to the responsibilities of online publishers.[209] It also raises more fundamental economic questions about the future path of innovation. The data that is created by all of us is increasingly captured by a small number of firms.

Data in the 21st century is playing a similar role to electrification, which began in Britain in the mid-1880s: it is driving radical changes in business models and step-change improvements in productivity, just as the arrival of electric power did nearly 150 years ago. Just as in the 20th century we came to understand that electrical power was not a privilege for the few but an essential feature of modern life, so in the 21st century, access to data will be regarded similarly.

One of the most important sources of innovation today is 'big data'– the mining of large datasets for patterns and relationships, which can provide insight into complex problems and issues. Big data offers huge opportunities to find new ways of solving social problems and for commercial application. It is a problem, therefore, that so much data – most of it provided by consumers in exchange for services – is owned by so few companies. This is almost certainly stifling innovation in the wider economy.

In these ways, the growth of platform companies has not only provided a huge stimulus to economic growth over recent years; it has also raised important challenges for policymakers.

THE ENVIRONMENTAL IMPERATIVE: GREENING THE ECONOMY

All human societies and economies are ultimately dependent on the natural environment, to provide material and energy resources and to assimilate wastes, and to maintain fundamental 'ecosystem services' such as the regulation of the water cycle and a stable climate.[210] Today, many of the natural systems that sustain human life and economic activity are under severe threat.

The risks of unchecked climate change have become better understood by most of the public and policymakers in recent years. Unless current emissions of greenhouse gases are drastically reduced, the earth is on course for an increase in the average global temperature of 3–4 degrees Celsius or more. The Intergovernmental Panel on Climate Change warns that severe impacts are likely to occur even at two degrees of warming. These include:

- a higher incidence of extreme weather events (such as flooding, storm surges and droughts), which may lead to a breakdown of infrastructure networks and critical services, particularly in cities and coastal regions
- lower agricultural productivity, increasing the risk of food insecurity and the breakdown of food systems
- increased ill-health and mortality from extreme heat events and disease
- a greater risk of the displacement of peoples and conflict
- a faster loss of ecosystems and species.[211]

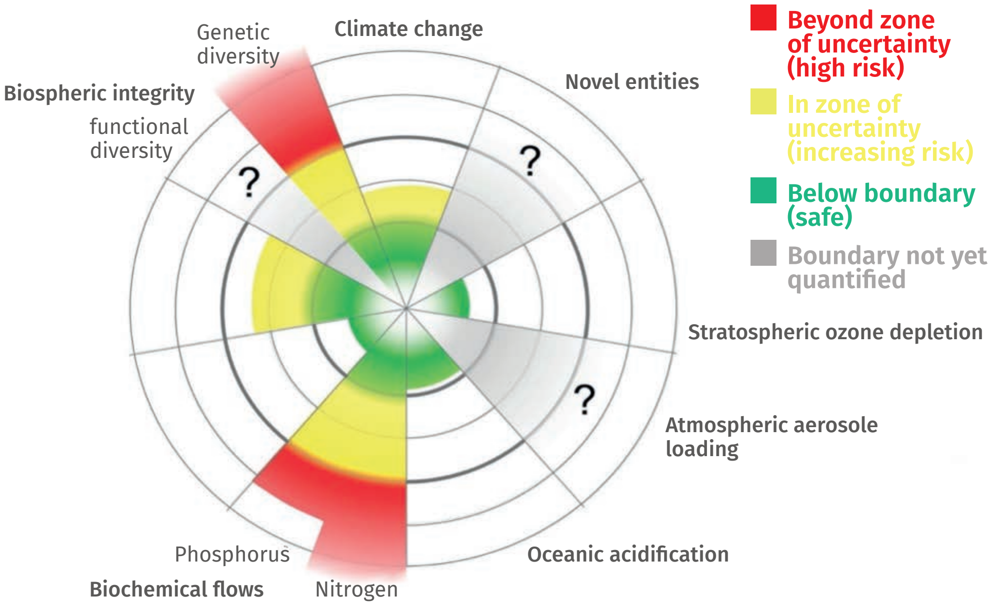
Climate change is only one of many kinds of environmental degradation that have resulted from the increasing impact of a growing global population and economic growth. The loss of biodiversity is accelerating, with species extinction now estimated at around a thousand times the background rate, sufficient for this now to be described as the 'sixth major mass extinction' period in the earth's history.[212] A third of all arable land is now degraded.[213] By 2025, it is estimated that 1.8 billion people will be living in countries or regions with absolute water scarcity, and two-thirds of the world's population could be living under water-stressed conditions.[214] The increase in carbon dioxide emissions has increased the acidity of the oceans by 30 per cent since the Industrial Revolution.[215]

Recent scientific work has attempted to establish the risks posed by these trends, developing the concept of a 'safe operating space' for humanity across a range of environmental functions. The safe space is marked by 'planetary boundaries' beyond which environmental degradation will cross critical thresholds or 'tipping points', risking catastrophic and/or irreversible damage.[216] Analysis suggests that for biodiversity loss and the nitrogen and phosphorous cycles, human activities are already outside the safe operating space, with climate change and land use change (such as deforestation and the loss of wetlands) at increasing risk of approaching this condition (see figure 4.7). In almost all fields, the risks are rising. The dominant influence that humanity is now having on natural systems has led many scientists to argue that we have entered a new geological era, the 'Anthropocene'.[217]

FIGURE 4.7

Planetary systems are already being altered by excess nitrogen and phosphorus and a lack of genetic diversity

Status of global control variables relative to the threshold beyond which they significantly alter planetary systems



Note: The green zone denotes safe operating space, yellow denotes uncertain impact, red denotes high risk of impact and grey denotes a control variable where the planetary boundary is not yet quantified. The control variables have been normalised for the zone of uncertainty; the centre of the figure therefore does not represent values of 0 for the control variables. The control variable shown for climate change is atmospheric CO2 concentration.

Source: Reproduced from Steffen W, Richardson K, Rockström J, Cornell SE, Fetzer I, Bennett EM, Biggs R, Carpenter SR, de Vries W, de Wit CA, Folke C, Gerten D, Heinke J, Mace GM, Persson LM, Ramanathan V, Reyers B and Sörlin S (2015) 'Planetary boundaries: guiding human development on a changing planet', *Science* 347(6223) http://science.sciencemag.org/content/347/6223/1259855

Reducing these environmental impacts to sustainable levels will require a concerted and urgent global effort, in which the UK will have a critical role as a leading developed nation. The adoption in 2015 of the United Nations Sustainable Development Goals (SDGs) and the Paris Climate Agreement have created the right international framework of objectives and commitments, but much more needs to be done to embed environmental imperatives into national economic policy.[218]

The conceptual underpinning now widely used for this is that of 'green growth'.[219] This recognises that continued (and inclusive) economic growth is possible even while environmental impacts are reduced, but only if there is a deliberate policy focus on increasing the economy's 'resource productivity'. This is the rate at which the economy generates added value from the use of environmental resources; raising it needs to become as important a source of economic growth as labour productivity. A recent study for the United Nations Environmental Programme, for example, suggests that resource efficiency policies could boost GDP in advanced countries by around 3 per cent by 2050, with even larger global gains.[220]

Raising resource productivity can take many different forms. The structural shift in the composition of output from manufacturing to services and digital products, which has occurred in developed economies, has already generated a marked reduction in domestic environmental impact – although some of this has merely been exported to developing countries where the bulk of manufacturing is now conducted.[221] But technological innovation is driving further dramatic improvements: from renewable energy sources such as wind and solar, to 'smart' electricity systems that manage supply and demand; from new lighter materials and water-efficient industrial processes, to new forms of agricultural management that reduce greenhouse gas emissions.[222] The development of the 'circular economy', focussed on reusing and recycling materials and cutting waste, offers particular potential to 'decouple' growth, resource use and environmental impact.[223]

It is important, however, to recognise the scale of the productivity improvements that are required. The decoupling has to be absolute, not relative; and at a sufficient pace to bring environmental impact within sustainable limits. For example, to keep average global warming to below 2 degrees by 2050, global greenhouse gas emissions will need to fall by about 5 per cent per year. But with continuing economic growth of over 2 per cent per year, the carbon intensity (or resource productivity) of the global economy would have to fall by around 7 per cent per year. This is about 10 times faster than it has been falling since 1990.[224] While global economic growth appears to be increasingly decoupled from carbon emissions, it is too early to tell whether this trend will continue, and whether the effect will be large enough to keep temperatures from rising more than 2 degrees by 2050.[225] This appears to be technologically feasible but it will involve a transformation in the way today's economies are structured, including a more or less complete decarbonisation of energy, transport and industrial systems by mid-century.[226]

Indeed, as the Paris Climate Agreement acknowledged, achieving the goal of limiting warming to under 2 degrees (or under 1.5 degrees, to which the Agreement aspires) will require the reduction of net emissions to zero in the period beyond 2050.[227]

The policy challenge to achieve resource productivity improvements on this kind of scale – across multiple environmental issues – is therefore very large. But the economic benefits are also likely to be significant. Environmental improvement requires investment and creates demand for new goods and services, which stimulates economic growth and job creation. Over the past 10 years, environmental policies both at home and overseas have led to a significant growth in the UK's low-carbon and environmental goods industries. The low-carbon and renewable energy sectors in the UK alone generated £43 billion in turnover in 2015, or 1.3 per cent of the total non-financial turnover of the UK economy, and employed around 234,000 full-time employees, or around 1 per cent of total non-financial employment.[228] The UK is already a world leader in a number of environmental industries, with growing global markets and huge potential for technological innovation.[229]

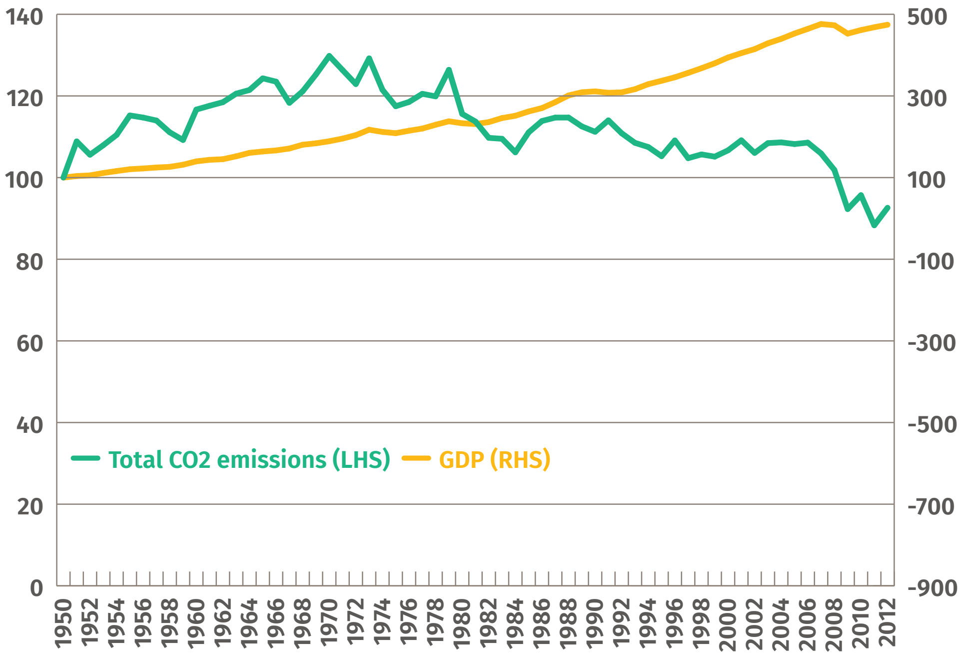
The wider health and social benefits from environmental improvements are also very significant. Around 40,000 deaths per year in the UK are now attributable to exposure to outdoor air pollution, with an estimated overall economic cost in excess of 3.7 per cent of GDP.[230] Road transport emissions are the dominant source of transport-related air pollution.[231] So the growth in vehicles on the UK's roads, particularly those with diesel engines, and the failure of emissions standards to accurately measure their contribution to air pollution, are major causes of low air quality in urban areas.[232] Although air pollution levels are falling in many urban areas, the continued failure to comply with legal standards has led the European Commission to issue a final warning, after which it may impose large fines.[233]

The policy framework to achieve the scale of green growth necessary is not yet in place. Although the UK has been successful in decoupling its economic growth and greenhouse gas emissions (see figure 4.8), the Government's independent Committee on Climate Change has noted that we are not on track to meet the statutory 'carbon budgets' after 2020, which governments have set under the Climate Change Act 2008 (see figure 4.9). A range of policy instruments is available to incentivise stronger environmental performance. These include pricing carbon and other environmental externalities more highly, new forms of smart regulation and support for innovation and skills training in environmental sectors. The existing success of the UK's environmental industries suggests that this field has the potential to be a major focus of industrial strategy.

FIGURE 4.8

The trend in CO2 emissions has been decoupled from economic growth

Indexes for UK CO2 emissions and GDP, 1950–2012 (1950 = 100)

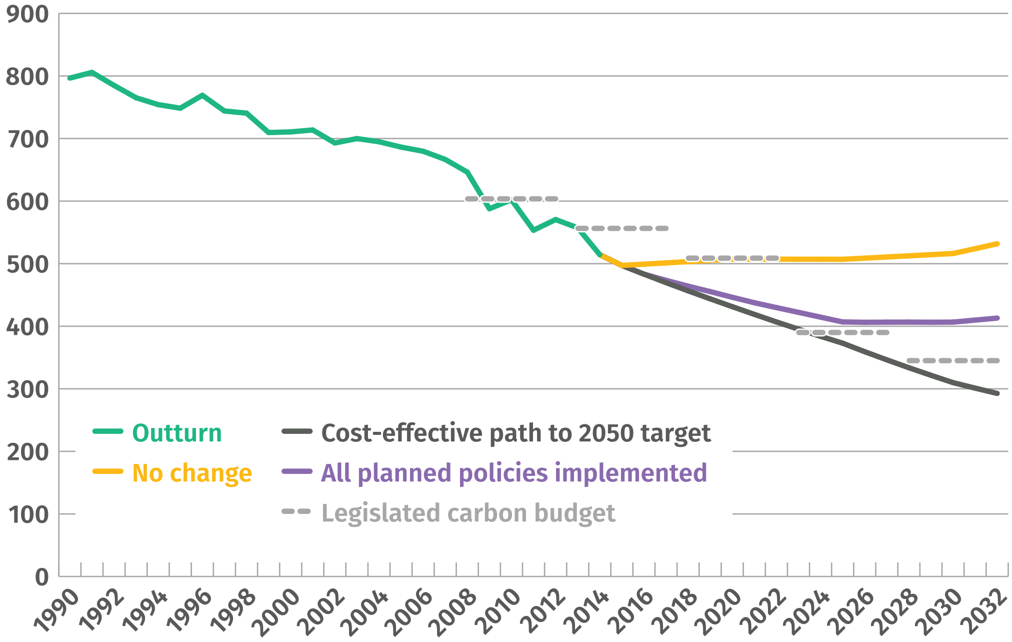


Source: Committee on Climate Change [CCC] (2016) *Meeting Carbon Budgets – 2016 Progress Report to Parliament*, supporting data: 'Chapter 1: Economy-wide progress' and 'Chapter 2: Power' https://www.theccc.org.uk/publication/meeting-carbon-budgets-2016-progress-report-to-parliament/; Department for Business, Energy and Industrial Strategy [BEIS] (2016) 'Final UK greenhouse gas emissions national statistics: 1990-2014' (dataset) https://www.gov.uk/government/collections/final-uk-greenhouse-gas-emissionsnational-statistics

FIGURE 4.9

Even accounting for all policies that are currently planned, the UK is not on course to meet its 2050 targets

UK greenhouse gas emissions (MtCO2e) by sector, 2005–2015 UK greenhouse gas emissions (MtC02e), actual (to 2014) and projected (from 2015), 1990–2030*



Source: IPPR calculations using Office for National Statistics (2016) 'Gross Domestic Product: chained volume measures: seasonally adjusted £m' (dataset) http://www.ons.gov.uk/economy/grossdomesticproductgdp/timeseries/abmi/pgdp; World Bank (2016) 'CO2 emissions (kt)' (dataset) http://databank.worldbank.org/data/reports.aspx?source=2&series=EN.ATM.CO2E.KT&country=#
* 'MtC02e' = 'million tonnes of carbon dioxide equivalent'

In sum, we face a decade of disruption. Even as the UK negotiates its new relationship with the EU and wider world, an accelerating wave of economic, social and technological change will reshape the country, in often quite radical ways. Compounding this, the imperative of responding to climate change will drive powerful shifts in how we organise the economy. Taken together, these powerful trends are likely to create immense challenges. However, they also offer an opportunity to build a more equitable, sustainable and productive future.

Telegraph pole engineers,
South Wales

5.
RETHINKING THE ECONOMY

We have argued so far that the UK economy is not performing well in fundamental ways. This is the outcome of longstanding weaknesses in the way in which the economy is structured, along with some serious failures of policy over many years. At the same time, we are facing a number of new challenges and opportunities in the future for which we are as yet not properly prepared.

Our conclusion is that the UK economy needs fundamental reform. Without a radical change in the way the economy is structured and in the approach governments take to economic policy, Britain will not be able to achieve the combination of prosperity and justice we seek, and which we believe most people want.

This kind of fundamental reform has happened before. Twice in the 20th century a major economic crisis led not just to a change in economic policies, but also to a shift in understanding of how the economy works. In this chapter we seek to draw parallels between those crises and the one we have experienced over the past decade since the financial crash. And we describe some of the insights of modern economics that can underpin a new approach.

LESSONS FROM HISTORY

The 20th century saw two major economic breakdowns, which led to radical shifts of economic policy and analysis. The first breakdown was marked by the Wall Street Crash in 1929 and the Great Depression that followed; the second by the oil crisis and 'stagflation' (simultaneous high unemployment and inflation) of the 1970s. Both events brought a long period of economic orthodoxy to an end and marked the beginning of a new era.[234]

The first breakdown

The Wall Street Crash of 1929 followed a long period of orthodox economic policymaking on both sides of the Atlantic. Classical ideas of 'laissez faire' held sway: that markets operated efficiently without government intervention, and unemployment and inflation were the consequences of poor choices by individuals or investors. Financial markets should be only lightly regulated. When the crash caused confidence and output to plummet and unemployment to soar, both the US and the British Governments reacted in the prescribed fashion. They cut public sector wages and expenditure in an attempt to price labour back into jobs. But these measures reduced spending power across the economy, which only worsened the situation – in the UK, between 1929 and 1933, exports fell by a half, investment by a third, and more than 15 per cent of the workforce was left unemployed.[235] It took the outbreak of the Second World War for government spending to expand sufficiently to restore full employment.

This breakdown in the real economy accelerated an intellectual revolution in economics. John Maynard Keynes' *General Theory of Employment, Interest and Money* was published in 1936.[236] His work became the foundation of a new approach to both economic theory and policy. Understanding that the level of employment was a function of aggregate demand rather than simply the price of labour, Keynes recognised that an economy could be in equilibrium even with mass unemployment. His understanding of how government spending could stimulate demand and investment eventually came to underpin the 1944 White Paper on employment, which committed the Government to maintaining full employment.[237] Accepted thereafter across more or less the whole of the political spectrum, it subsequently became the basis for a new economic settlement.[238]

The modern welfare state was one of the outcomes, informed by the Beveridge report of 1942.[239] At the same time, western governments established the international Bretton Woods institutions, creating a system of fixed exchange rates to end the currency wars of the 1930s. Laissez-faire economics was largely jettisoned in theory and practice, and a new 'postwar consensus' was reached in Britain and across the west.

The postwar settlement was to survive until the 1970s. Fuelled by new technologies and expanding global trade, the economy produced close to full employment during this period. Economic growth was quite volatile, but deep and lasting recessions were avoided. At the same time, however, problems were building.

The second breakdown

The second breakdown was precipitated by a series of economic shocks in the 1970s. At the start of the decade, president Nixon announced an end to the Bretton Woods system of exchange rates pegged to gold, resulting in a global surge in inflation. When the Organization of Arab Petroleum Exporting Countries (OAPEC) sharply raised oil prices in 1973, the British economy, like others, was tipped into recession.

The 1970s saw the British economy struggle with a series of structural weaknesses, not least the sclerotic state of much of British industry, some of it nationalised. Government efforts to quell inflation by constraining public sector wage rises led to a series of strikes. As the phenomenon of 'stagflation' gripped the economy in the 1970s, Keynesian economics appeared to offer no answers.

Others claimed they could. A new intellectual movement had been growing for nearly half a century around the political and economic ideas of Milton Friedman and Friedrich Hayek. Inflation, they argued, could be controlled by contracting the money supply. Regulation held back growth; government spending crowded out private investment; inequality stirred enterprise. These propositions came to be variously known as 'free market economics' by their proponents and 'neoliberalism' by their detractors.[240]

In a little over a decade, the transition to a new settlement had taken place. Under president Reagan in the US and Margaret Thatcher in the UK, labour markets were deregulated and trade union rights rolled back. Publicly owned companies were privatised. Tight monetary and fiscal policy squeezed the less productive elements of the British economy, leading to deindustrialisation and high rates of unemployment. The finance sector was deregulated in the City of London's 'big bang' of 1986. Taxes were cut and the welfare state cut back. Growth and inequality both surged.[241]

Much of the new settlement was accepted by the Labour governments that took office after 1997. Some elements were strengthened (for example, by making the Bank of England independent), while others were substantially ameliorated, not least through a significant expansion of public services and a redistributive programme of tax credits, pensions and benefits. Government saw its role as to create the macroeconomic framework of stable inflation and strong public services and to facilitate redistribution, but largely to stay out of the productive economy. Its contributions were to be focussed on the 'supply side', providing infrastructure, equipping workers with skills and ensuring 'light-touch' regulation. The powerful new forces of globalisation and information and communication technologies would drive growth.[242]

The composition of the economy shifted dramatically in this extended period. Deregulation and international openness contributed to London's growth as a global financial centre, but also saw it increasingly 'uncoupled' from the rest of the economy.[243] Technological advancement helped to increase the wage premium attached to higher-skilled jobs in the service sector. Meanwhile trade liberalisation exposed lower-skill industry to competition from workers in developing economies. Coupled with an overvalued exchange rate (partly the consequence of the North Sea oil boom), the combined effect was an acceleration in the long-term decline of manufacturing and a rise in investment, employment and growth within the service sector. That largely produced the shape of the economy we have today.

The present breakdown

There are good grounds for seeing the financial crash of 2008 and its aftermath as a breakdown similar in kind to those experienced in the 20th century.

It is hard to exaggerate the scale of the financial crisis. Following the multiple failures of leading banks and insurance companies in 2007/2008, the entire global economy contracted in 2009 for the first time since the second world war. UK output fell 4.3 per cent in 2009 alone.[244] To prevent an even bigger crisis, governments had to put unprecedented sums of taxpayers' money into bailing out the banks: in the UK the Government's exposure for support provided to the banks in the form of cash and guarantees peaked at £1.16 trillion.[245]

The financial crash exposed the inadequacy of some of the economic approaches of the previous period: financial markets were not as efficient as hypothesised, and debt-fuelled growth was not ultimately sustainable. But the argument that we are living in a moment of breakdown and transition rests not just on the financial crash, but also the failure of the consequent policy response. Initially, in 2009/2010, the British Government (along with others) attempted a Keynesian approach, including tax cuts and public spending increases.[246] But this was short-lived, replaced in 2010 by a programme of austerity, including very significant cuts to public spending. This has yielded poor results. Since the 1970s, annual growth during the three years immediately following a recession had averaged around 3 per cent; during the first three years following the 2009/2010 recession, growth averaged just 1.6 per cent.[247] Overall, the recovery has been the slowest on record.[248] Today, despite eight years of ultra-low interest rates and unconventional increases in the money supply (quantitative easing) – the economic equivalent of life support for the economy – growth rates remain weak, with productivity largely stalled altogether. At the same time, average household incomes have been stagnating for a decade, and there is little sign that real earnings will rise in the immediate future.[249] As we have argued in this report, these are not the symptoms of a successful economy, or of a successful approach to economic policy.

If the period since 2008 can be seen as one of extended economic crisis, it is hard to avoid the conclusion that fundamental economic change is needed. In the same way that the crises of the 20th century led to new kinds of economic thinking and new forms of economic policy, so today we need a comparable change in approach.

NEW ECONOMIC THINKING

There is no simple new framework of economic theory or policy that should define the new era. Indeed, it is arguably an overreliance on overly simple theories that has contributed to the present situation. Capitalist economies are complex, and analysis of them will inevitably involve a wide range of theoretical insights that need to be tested constantly against empirical observation. In trying to understand why the British economy – in common with most developed countries, although not in identical ways – has been struggling over recent years, and in attempting to formulate solutions, the Commission seeks to draw on a variety of different insights and approaches in contemporary economics.

We are by no means the only ones attempting to do so. Indeed, we have been struck by the extent to which mainstream economic institutions are reassessing previous orthodoxies and arguing for a new approach. In different forms, and to different degrees, the OECD, the World Bank, the World Economic Forum and even the IMF have acknowledged that the economic policies of the past have led to unjust outcomes and poor economic performance and are seeking new solutions.[250] There is by no means universal agreement on what these are, but the idea that we need a new model of 'inclusive, sustainable growth'– growth that has both significantly more egalitarian and drastically less environmentally damaging outcomes – has become widely asserted.[251]

Many within the discipline of economics have recognised that new approaches are needed. The failure of most economists working in the field to predict or understand the financial crash has been followed by a series of other perceived failures to explain the behaviour of developed economies in the period since.[252] Mainstream policy solutions have evidently not worked well to restore stable growth, improve productivity, raise wages or put the economy onto an environmentally sustainable path. Yet at the same time as many old orthodoxies are under question, there has been rich new thinking in the economics field about how modern economies work, and the kinds of policy approaches that might help them to work better.[253] We have sought to draw on some of this thinking in our work – although the following survey is by no means comprehensive.

Markets and institutions

First, there is today a much more sophisticated understanding of how markets and businesses function than once characterised orthodox economic theory. Markets are often thought of in a rather idealised way, as abstract structures in which firms that are assumed to be largely alike compete with one another to supply goods and services to freely choosing consumers. But this is altogether too simple. Markets are better thought of as the *outcomes* of interactions between firms, governments, workers, consumers and other institutions in society, the outcomes of which are determined by both the character and form of those economic actors (which can vary widely) and the wider context of public policy, law, custom and culture within which they operate. In a modern economy there are no such things as 'free markets'; all markets involve government and policy in one form or another.[254]

In this sense it is a mistake to think of economic wealth being produced by the private sector, and the public sector as a consumer of it. It is more realistic to acknowledge that wealth is *co-produced* by firms, states and civil society, and successful economies need all three working well together.[255] The role of government in particular is much wider than allowed simply by the often-used concept of 'market failure'. Markets fail in systematic ways, for example when there are environmental 'externalities', or the undersupply of public goods such as scientific research. But governments need to do much more than 'correct' these failures to ensure a successful economy. The state has a key role in strategic economic management; in coordinating and regulating competition; and in *creating* markets through its own demand as well as in supplying more traditional public goods and public services.[256]

One of the most critical economic roles of government is the assurance of risk. Governments are able to spread risk both across the economic cycle (acting effectively as shock absorbers) and across generations (enabling future generations to help pay for the infrastructure they use, for example); and they can pool risk where markets would otherwise be inefficient or inequitable (such as insurance against poor health and old age). But in activities such as guaranteeing property rights and the rule of law, providing education and skills, and in the strategic oversight of networks in energy, transport and communication, public institutions also help private sector actors find appropriate risk-adjusted prices for goods and services. By giving predictability to the environment for private investment environment, they help to raise and maintain demand in the economy as a whole, and enable firms and households to respond to uncertainty.[257]

So an economic discourse in which 'markets and states' are seen as opposites is unhelpful. Markets work best where there is a strong framework of law, regulation and policy. States work best in concert with dynamic and innovative businesses. It is widely recognised now that industrial strategy of various kinds can play a key role in bringing governments and businesses together to increase investment in innovation and new markets as well as to raise productivity in existing ones.[258]

At the same time, there has been a revival of interest in the wider impact of large corporate players. Businesses are not disinterested actors in public policymaking; they are powerful lobbyists for their own interests, which may or may not equate to the wider public interest. In a range of areas, from taxation and regulation to the outsourcing of public services, it is important to ensure that corporate power is constrained by public purpose and accountability.[259]

There is also increasing acknowledgement that it matters what *kinds* of businesses there are. Firms are not all the same. Different models of ownership and corporate governance, and different business cultures, produce different kinds of behaviours. It is now well documented, for example, that 'short-termism' and 'financialisation' are more of a problem in Anglo-American corporations than in Asian ones.[260] Businesses can also be better or worse managed – a function of both firm-specific factors and, it seems, national management cultures, for example in attitudes towards the workforce.[261]

Indeed, the wider insight that has done much to inform modern economics is that institutions in general are critical to economic outcomes.[262] This is as true of states as it is of companies: there are successful public bodies and unsuccessful ones. The structures of ownership, property rights and incentives in institutions matter. At the same time, the behaviour of economic actors needs to be understood in much more sophisticated ways than in the orthodox model of 'economic rationality'. Modern behavioural economics has given us powerful new insights into how economic actors actually behave, and the kinds of ways in which policymaking can respond.[263]

An important conclusion from these various arguments is that there isn't a single system of capitalism; there are many.[264] Institutions, law and culture differ in different countries; so do outcomes. So we should not be looking to universal, idealised policies that rest on abstract understandings of the economy. We need detailed, particular insight informed by sociological and political understanding as much as pure economic theory. And we should be willing to experiment in economic policy.[265]

The sources of growth

Second, we need to understand the sources of economic growth more clearly. Whereas in the past, growth was thought primarily to come from external or 'exogenous' factors, particularly the rate of technological change (which was seen as a product of non-economic factors), today most economists understand growth as 'endogenous', or arising from within the structure of the economy.[266] In particular, it is investments in technological and organisational innovation that are the driving force behind long-run economic growth. The diffusion of such innovations across the economy affects not just patterns of production, but also patterns of distribution and consumption: it has been the primary source of improvements in productivity and living standards for the past 200 years.[267] It is thus vital to understand how and why innovation occurs.

Since Schumpeter's original description of the processes of 'creative destruction' in capitalist economies,[268] the field of evolutionary economics has done much to explain how innovation occurs.[269] It has explored how firms behave under conditions of uncertainty, where there is no equilibrium to which the economy naturally returns, only turbulence and risk. It has emphasised the impact of 'path dependence'– the fact that economic change is constrained by what has gone before. And it has observed that innovation occurs, not in isolated silos of individual firms or scientists, but in complex 'ecosystems' in which a whole variety of private and public institutions are involved. In particular, public funding for innovation has been far more important in the development of the new technologies of the past 40 years (such as information technology, biotechnology and nanotechnology) than has often been recognised.[270]

These insights can help to inform the approach taken to public policy today. They suggest, for example, that greater attention should be paid to the provision of 'patient capital' willing to finance investments with long-term returns, and to the role of public policy in directing innovation towards societal goals.[271]

In turn, this needs to draw on new understandings of the role of demand in modern economies. Different economies have different structures of demand, some emphasising household consumption, with others focussed more on private sector investment or exports.[272] These patterns affect economic growth in different ways, and require different responses in macroeconomic policy. They may point in particular to a stronger role for fiscal policy, as originally argued by Keynes and more recently by others building on his work. The hypothesis that we may be in a period of 'secular stagnation', in which very low interest rates cannot generate sufficient demand in the economy to stimulate growth, has given further weight to Keynesian arguments.[273] And it has arguably been reinforced by new insights into how the banking system creates money in modern economies, and therefore the role and limits of government or central bank monetary policy.[274]

Modern economics has also placed the geography of economic growth at centre stage. The historical experience is that different regions grow at different rates. An understanding of why and how this happens is vital if we are to achieve a more balanced economy. There has been much discussion in this field of the role of 'agglomeration'– the benefits of proximity leading to the growth of cities and industrial clusters.[275] But there is also increasing evidence on the role of the wider interlinkages that make regions as a whole successful.[276] The central role of self-governing public institutions at the regional scale – including the importance of fiscal powers – emerges strongly from this field of study.[277]

The role of the environment

Third, we need to find a more central place for an understanding of the relationship between the economy and the natural environment. The rapidly growing crisis of climate change has in recent years forced policymakers to confront the long-term impacts of fossil-fuel dependence; but the deeper relationships between economic growth and rising environmental damage have not yet become absorbed into mainstream economic thinking.

Yet modern environmental economics has done much to understand this field.[278] Its core insight is that 'natural capital'– the stock of environmental resources that provide materials and energy, absorb wastes and provide critical services for human society – is as much a foundation of economic production as human and physical capital, but is prone to depletion and degradation if not husbanded in a sustainable way.[279] The value of environmental services to both production and human welfare needs to be incorporated into economic decision-making, with particular recognition of the biophysical limits beyond which natural systems can collapse, with potentially catastrophic impacts on human life and economic prosperity.

As discussed in chapter 4, the sustainable management of the natural environment does not rule out economic growth, if economies become more efficient in the use of resources and are able to shift the composition of both inputs and outputs towards those with lower impacts. A combination of technological innovation and changes in consumer preferences make 'green growth' possible.[280] But because environmental services are largely free, such growth will rarely occur without a significant steer from public policy.

Recent thinking in this field has focussed on the kinds of policies that are needed. Traditionally, economists favoured taxes and other policies that put a price on environmental damage; and these remain central to the environmental policy toolkit. Carbon pricing, for example, through taxes and pollution permit systems, is being increasingly used throughout the world to limit greenhouse gas emissions.[281]

But it is clear now that pricing alone will not be sufficient, because of the sheer scale of change required to shift modern economies onto a sustainable path. Carbon dioxide is not an incidental by-product of modern production: it arises from the energy system on which industrialised societies have been built. Almost our entire way of life – our energy, transport, industrial, land-use and urban systems – has been founded on the use of fossil fuels; weaning us off them will require a structural transformation in these systems, which cannot be achieved through pricing alone, particularly given the kinds of carbon tax rates that have proved politically possible to introduce.[282] Rather, we will have to use a much wider range of policy instruments, including planning policies, regulation, industrial strategy and much stronger support for technological innovation, to drive production and consumption into more sustainable forms.[283] It is clear that there are major benefits to be had from such a transformation, not least cities with clean air and more efficient public transport systems; but this is a societal mission, not a technical exercise in carbon pricing.

Indeed, a central insight of modern environmental economics is that a little bit of green growth is not enough. Across a whole range of environmental issues, developed countries must achieve radical reductions in environmental impact if the world's natural resources are to be sustained within the earth's 'planetary boundaries' and in ways that allow the world's poorer countries to grow in the years ahead. This will require environmental objectives to play a more central role in economic thinking and policymaking than they have hitherto done.

Inequality and public purpose

Fourth, we need a clearer understanding about the goals of economic policy. Over the past 50 years, many economists and others have noted that GDP is not a good measure of human welfare.[284] It was not intended to be so; it was invented, and still serves, as a measure of economic output and national income.[285] Yet GDP growth has come to play an overly dominant role in our understanding of how well an economy is performing.

Over recent years, a number of economists (and others) have sought to understand better how human wellbeing can be understood and measured, and how the goals of economic policymaking should be defined.[286] They have made important distinctions between the development of human capabilities and freedoms, the concepts of 'human needs' and 'happiness', and various measures of quality of life or life satisfaction.[287] Within each of these concepts we know that income and consumption – the traditional economic measures of welfare – are vitally important, but not decisive. In particular, we have learned much about how – beyond subsistence levels – personal wellbeing is a relative more than an absolute measure, largely judged in comparison to others in one's community. We have also understood better the role that collective and public goods of various kinds – such as security, the natural environment and a vibrant culture – play in people's perception of their quality of life.[288] Other aspects of wellbeing – such as the quality of work, the security attached to it and the value of non-working time – have been less well explored but are arguably as important.[289]

One of the products of this field of economics has been a debate about the indicators that should measure economic performance and progress. Some of the critiques of GDP are longstanding, such as that it does not take account of unpaid work, particularly caring, household and voluntary work, which constitute a large part of total economic activity, and have a very gendered structure.[290] Incorporating a proper understanding of the value of unpaid work into mainstream economic analysis remains an urgent task. But other measurement issues have come to the fore in more recent years, such as the difficulty of measuring productivity and investment in a digital economy.[291]

It is the issue of inequality, however, that perhaps most needs to come into focus in today's economic analysis. Over the past 35 years, as we have seen, most developed economies have seen a falling share of labour in national income and an increase in inequality, and more recently many have seen living standards for the majority of households stagnate. But the reasons for these phenomena have not been sufficiently discussed in mainstream economic debate.

What we do know is that different countries are differently unequal, and have not experienced identical trends.[292] So the particular level of inequality experienced in any individual country (such as the UK) is not the result of immutable economic laws. It is the outcome of a whole series of factors related to the structure of labour markets, to investment ratios, to taxation, welfare and housing policies, and even to public values and culture.[293] In particular, recent economic research has clearly established that, contrary to orthodox economic theory, the level of wages in the economy is not determined by the marginal productivity of labour. There has been a marked divergence between productivity and earnings over recent decades. Rather, it appears that inequality is largely a result of the ability of economically powerful groups in society to extract 'rents' or incomes beyond those earned by their economic contribution.[294]

At the same time, we have also learned more about the role that wealth plays in perpetuating inequality. Since wealth (particularly when invested in a constrained market for land and property) attracts increasing returns, which over a long period tend to exceed the rate of economic growth, wealth inequality has been rising.[295] This has further entrenched inequalities of income and social privilege.

Inequality is not good for economic growth. It used to be argued that inequality was the price that countries paid for growth, with wealth 'trickling down' from higher-income groups to those at the bottom. But recent economic research – including by the IMF and OECD – has established that economies with more equal distributions of income and wealth tend to have stronger and more stable paths of economic growth than those with greater inequality.[296] This is partly because of the higher propensity to consume of lower-income groups relative to the rich, a fact that could play a stronger role in macroeconomic thinking about how to stimulate demand. But it is also because higher rates of inequality tend to generate poorer outcomes on a whole range of social factors, including ill-health, which tend to drive up social and public spending costs.[297]

One of the key insights of recent research in this field is that inequality cannot be effectively addressed through redistribution alone.[298] Taxation and welfare policies have important roles to play, but the core dynamics of inequality arise within the labour and housing markets, so it is here that policy needs to focus. In raising wages, productivity is a key factor, but so is the bargaining power of labour. The role of trade unions in helping modern economies reduce inequality is therefore particularly important.[299] So too is countering discrimination in the labour market, which remains an important explanation for the continuing inequality of outcomes for women and people from minority ethnic groups.

These distributional concerns are central to the issues of economic performance, for aggregate or average performance can disguise major inequalities in the experience of particular groups in society. As we consider how to judge economic progress, the question of economic justice must take centre stage.

Railway repairs, Tata Steel, Port Talbot

6.
TOWARDS A NEW ECONOMIC SETTLEMENT

In previous chapters we have set out the case for change. The British economy is not serving our society well, and needs fundamental reform. That means rethinking the institutions, frameworks and rules that govern the economy. In this chapter we set out some of the areas of reform we are exploring as we work towards the Commission's final report.

At the heart of our approach is the idea of economic justice. We need an economy that is more dynamic, competitive and sustainable – where high innovation and high productivity lead to better jobs with higher wages, and environmental impacts are constrained within the earth's limits. It must distribute its rewards fairly, benefiting those who currently have fewer life chances and lower incomes, and in all parts of the country.

This fair distribution must be wired into the structure of the economy, in the way work is organised and rewarded, companies and public institutions are governed and managed, and wealth is owned. Redistribution will always be essential; but it is also, in one sense, a measure of failure. The more it is needed, the more unfair the economy is in the first place. We seek deeper reforms that make it less necessary by putting the economy on a fairer footing.

For the weaknesses and failings of the UK economy do not derive solely from misconceived macroeconomic policies, nor from industrial policy failures, although both of these have played their part. They arise from the fact that the current institutional structures of the economy - its markets, firms and public arrangements – are not now capable of delivering competitive, fair and sustainable outcomes. A new economic policy for Britain will therefore be less about 'tax and spend' than about fundamental institutional reform. It is in this context that the policy agenda set out below must be understood.

Institutional reform may take many forms: corporate law, public and private sector relationships, employment structures, rules for international finance and trade. But the overarching logic in the design of concrete policies should be their potential contribution to the attainment of new national economic and social goals. These goals do not just emerge. They must be set. This is the very purpose of political economy. This is why our long-term vision for the economy is the starting point of the Commission's proposals for a new economic policy.

In building a just economy, we believe that society needs to confront the concentrations of economic and political power – both in the private sector and in the state – that have helped to lead us to our present condition. A major part of the sense of injustice that is so widely experienced across the UK today is the lack of control people feel they have, over both their own economic circumstances and those of the country as a whole. This means opening up the institutions and processes of governance in the economy and in public policymaking. We believe that a new social partnership is required: one that binds together more responsible businesses, stronger trade unions, smarter and more accountable government and a vibrant civil society to achieve, so far as possible, a common purpose.

We are, therefore, exploring 10 areas of economic reform, under three themes:

- putting the economy on stronger institutional foundations
- new policies for making the economy more competitive, dynamic and focussed on long-term success
- new approaches to ensure that economic rewards and burdens are more fairly shared.

STRONGER FOUNDATIONS FOR THE BRITISH ECONOMY

(1) Leading a purpose-driven economy

Remaking the British economy will require a new approach to policymaking. The institutions and processes of economic governance need reform, and the macroeconomic framework should be reconsidered. We are exploring the following areas:

- **A National Economic Vision.** The Commission is looking at how future governments can work with stakeholders from across business, trade unions and civil society to develop a 'National Economic Vision', including the identification of problem-solving 'missions' such as decarbonisation, and measurable objectives such as raising the rate of investment, reducing income disparities between the nations and regions of the UK and improving job quality. This will require the adoption of a wider and more balanced set of economic indicators to measure economic performance
- **Transparency, consultation and citizen involvement.** Current economic policymaking is too opaque, too closed and too elitist. We are therefore exploring how policymaking could become more transparent, more consultative and more inclusive of ordinary citizens. Public discussion on economic policy and the possibilities of economic reform has suffered from too much 'groupthink', so we are considering ways of opening up policy debate to a wider range of views and perspectives
- **HM Treasury.** The Treasury is the most powerful department of government, the common thread that connects decades of economic policymaking across different administrations. We are examining whether the role and functions of the Treasury need to be reformed and how economic policy could be better coordinated across the whole of government.

(2) Reforming macroeconomic policymaking

Macroeconomic policymaking has been unbalanced, focussed too much on monetary policy and not sufficiently on the role of fiscal levers. We are therefore exploring how it can be reconfigured in the following areas:

- **Fiscal rules.** We are exploring the adoption of an appropriate set of fiscal rules to enable governments to promote investment and stimulate growth where required, based on a more balanced relationship between monetary and fiscal policy
- **The Bank of England.** We are examining the mandate and macroeconomic objectives of the Bank of England. We are looking, for example, at the case for targeting nominal GDP and employment as well as price stability, whether the payment system should be changed to allow for negative nominal interest rates, and the possible role of the Bank in advising on the integration of monetary and fiscal policy
- **Exchange rate policy.** We are also exploring the role of macroeconomic policy in improving the cost base for UK exporters, such as through managed

adjustment to the exchange rate or a system of credits to control imports in industrial supply chains.

(3) A new settlement for the UK's nations and regions

One of the fundamental problems holding back the UK economy is the lack of power in the nations and regions of the UK to mobilise local businesses, institutions, knowledge and capital to respond to national and global economic conditions. For Northern Ireland, Scotland, Wales and London, significant devolution has occurred over the past 20 years, but this has not extended to regions in England. Despite recent initiatives to devolve powers to city regions, regional policy in England has been characterised by the creation of weak and poorly funded institutions, with few powers, and lacking democratic accountability. Whitehall has been unwilling to give up control. We are therefore considering significant reform in the following areas:

- **Devolved powers.** We are exploring how greater economic power and resources can be located in the UK's nations and regions through further devolution to strong and democratically accountable institutions. In England we are looking at how the current process of devolution 'deal-making' can be enhanced to give more city and county regions local economic powers. We are examining whether and how far responsibilities for major policy areas such as infrastructure, skills, immigration, industrial strategy and aspects of energy policy could be devolved, and how infrastructure spending can be rebalanced to support growth throughout the UK
- **Fiscal devolution and regional banks.** In England we are considering the potential for larger-scale regional institutions similar to those seen in most economically successful nations. In both the nations and regions of the UK we are considering the scope for greater fiscal devolution, giving stronger institutions greater financial muscle and freedom. We are also examining the case for regional banks, with geographically bounded mandates to support the local economy.

MORE COMPETITIVE, MORE DYNAMIC AND SET FOR LONG-TERM SUCCESS

(4) Industrial strategy for the 21st century

The renewed interest in industrial strategy in government is welcome. Industrial strategy should aim to achieve structural reform of the UK economy to raise the rates of investment and productivity, create better jobs and higher wages, ensure a more balanced geographical distribution of output and income, and reduce the economy's environmental and climate impacts. We are exploring:

- **The 'frontier economy'.** The UK's globally leading industries are too narrowly concentrated, by both sector and geography. Our emerging thinking is towards a strategy that can be summed up as 'nationally diversified, regionally distinctive'. We are exploring how the UK's wealth of universities around the country can support stronger regional clusters in a wider range of technological specialisms and supply chains. We are examining how public support for R&D might be made more effective, including reform of existing tax reliefs and spending
- **The 'everyday economy'.** We are exploring how industrial strategy can be applied to the high-employment but low-productivity and low-wage sectors where many people work, such as retail and social care. We are looking at ways to raise productivity by supporting better management practices, accelerating the diffusion of new technologies, and promoting workplace innovation, employee voice and the creation of 'good jobs'. We are examining how employers can be encouraged to utilise higher skills – perhaps allowing firms to capitalise investment in training – and how the education and training systems can better supply them

- **Missions.** The Commission is exploring how the idea of 'missions' – aimed at addressing key societal challenges – can help to drive innovation and investment in UK supply chains, guiding the direction as well as the rate of growth. We are looking at missions such as the decarbonisation of the economy and reduction in wider environmental impact, addressing the implications of demographic change in health, social care and housing, and harnessing digital technologies and data for social benefit.

(5) New entrepreneurialism in a competitive economy
As the pace of technological change accelerates, the importance of new business creation will increase too. We need to encourage and make possible new forms of entrepreneurialism and more competitive markets. We are considering:

- **Inclusive entrepreneurialism.** We are looking at how to increase the number and diversify the social make-up of entrepreneurs by reducing personal risk and by increasing rates of unsecured lending, rather than simply by increasing potential reward (such as the lowering of capital gains tax) and relying on property as collateral
- **Open data.** The data created by all of us is one of the most powerful sources of innovation and social problem-solving in the new digital economy. But it is increasingly captured by a small number of firms or locked up in the public sector. We are exploring how data could be made more widely available to citizens, companies, researchers and public institutions, while protecting the privacy of individuals
- **A new framework for monopolies.** The digital economy has produced dominant companies with significant market (and social) power in key fields. We are examining how this can be addressed, including potential roles for regulation, taxation and consumer rights, at both national and international levels. We are also looking more widely at how competition in key markets can be enhanced.

(6) Finance for long-term investment
The UK's finance sector makes a significant contribution to the economy in terms of employment, the trade surplus in services and taxation. But it has also increased the UK's exposure to global financial crises; has resulted in large capital inflows that boost the value of sterling and thereby harm export competitiveness; and is failing to provide sufficient investment to the rest of the economy. We are therefore looking at how these deficiencies can be remedied while securing the strengths of the sector:

- **The banking system.** We are exploring ways to better protect the domestic economy from global crises, by introducing a firewall between domestic and international banking. We are examining the case for specialist domestic financial institutions, such as regional or sector-specific banks, with an explicitly limited geographic or sectoral mandate and long-term horizons, which can help to 'crowd in' private sector finance. We are considering how the provision of 'patient capital' for high-growth and innovative businesses can be enhanced
- **Equity markets.** To reduce the pressure on companies for short-term returns and enhance the appropriate stewardship of companies by their shareholders, we are looking at how better to align the incentives and interests of companies, shareholders and pensioners. This includes, for example, the possibility of extending the legal fiduciary principle that applies to pension trustees to the intermediaries, such as asset managers, hedge funds and brokers, who in practice dominate equity markets. We are also examining ways of incentivising longer-term shareholding, including through the reform of stamp duty reserve tax and capital gains tax.

(7) Better corporate governance

Britain's poor performance on investment, productivity and inequality stem in part from how – and in whose interests – British companies are governed. If Britain is to thrive and prosper, we need to improve how our companies are governed: a successful economy needs firms focussed on long-term success. We are exploring the following areas:

- **Directors' duties.** The increasing pressure for short-term returns to shareholders has raised questions about the priorities and purpose of major companies. The Commission is looking at the possibility of reforming directors' duties in law to focus on long-term success rather than simply the interests of current shareholders. We are examining the case for an independent Companies Commission to oversee and regulate major private and listed companies
- **Employee voice and engagement.** We are exploring how to strengthen employee representation in corporate governance and management. We are examining the case for elected worker directors on large company boards and representatives on remuneration committees, achieved either through legislation or through the voluntary corporate governance code. We are also looking at how employee engagement can be enhanced to achieve both greater voice and higher productivity
- **Executive pay.** To address the unjustified growth of executive pay, we are looking at the reform of executive remuneration packages, reform of remuneration committees and stronger accountability to shareholders and employees.

WIRING THE ECONOMY FOR JUSTICE

(8) A just deal at work

The British economy needs to create better, higher-paying and more secure jobs. This is the key requirement for ensuring a fair distribution of economic rewards. Better jobs help to raise productivity, which in turn allows for higher wages. This will require new forms of partnership between employees and employers. We are exploring the following areas:

- **Good jobs.** We are considering policies to incentivise and support businesses and public sector organisations to provide 'good jobs' through, for example, the creation of a 'good jobs' or 'fair work' standard (as already exists in Scotland). This would include strengthening employees' voice and engagement in the workplace, with the aim of raising productivity. We are also exploring how firms can work to improve the representation of women, black and minority ethnic groups and disabled people at all organisational levels, including the elimination of pay gaps and tackling discrimination
- **Modern trade unions.** There is a strong correlation between earnings and the bargaining power of labour. We are exploring whether auto-enrolment for trade unions (similar to pensions), combined with measures to create stronger rights to collective bargaining, could help to raise labour's share of national income and tackle insecure and exploitative employment relationships. We are also examining how to extend the role of trade unions in the 'gig economy'
- **Productivity partnerships for higher pay.** We are exploring ways to give everyone a greater stake in the success of companies, for example through greater profit sharing and employee ownership. We are looking at ways to raise wages in the public sector, particularly in low-paid sectors such as health and social care – there may be scope, for example, for linking public sector pay to economy-wide productivity improvements. We are also looking at the structure and level of the national minimum wage

- **Regulation of the 'gig economy'.** We are examining how workers' rights and pay can be enhanced in the new economy of flexible work, and the appropriate requirements on employers. We are exploring how the minimum wage might be applied in the gig economy, as well as creative ways for workers in the gig economy to share in the benefits of the new business models that have been created
- **Better work/life balance.** We are looking at ways to enable women and men to achieve a better balance between work, childcare and other caring responsibilities, both within the working week and over a lifetime. More generally, we are examining how average working hours might be reduced over time, to allow people to enjoy productivity gains in the economy not just as higher incomes but also as more time spent in other parts of life. This might be done through reductions in the working day, or in the working year – for example by gradually increasing the number of public holidays.

(9) Better tax

The UK's public finances are in poor shape. Compared with other European countries, the problem is not that we spend too much but that we raise too little – and we do so in the wrong way to promote the economy we need. We are exploring how the tax system can be reformed to raise the revenue society needs in a fairer, more economically efficient and publicly accountable way:

- **The level of taxation.** We are considering the appropriate level of taxation for a modern and just economy, and mechanisms to make tax more accountable and publicly acceptable. For example, we are examining the case for hypothecating or earmarking certain revenue streams to those areas of spending most affected by an ageing population
- **Fairer tax.** We are exploring how the tax system can be made more progressive, particularly by reducing the average and marginal rates of tax (both direct and indirect) paid by the lowest-income households. We are looking at how wealth, including land and property wealth, can be more fairly taxed. We are considering how to rationalise the taxation of business assets so that different types of asset – whether fixed, financial or digital – are treated fairly. We are exploring new models for taxing international digital companies, for example on the basis of revenues rather than reported profit. We are also considering how tax avoidance and evasion can be reduced
- **Smarter tax.** We are looking at how the tax system can be designed to incentivise more strongly economic 'goods', such as investment and employment, and disincentivise 'bads', such as rising land and property prices, pollution and natural resource use. We are considering how far taxes could be further devolved, particularly within England
- **Simpler tax.** The tax system is overly complex. We are exploring how it can be simplified.

(10) Broadly shared wealth and ownership

The UK is a wealthy nation, and growing wealthier. But wealth is very unequally shared, both between households and by geography, age and gender. The distribution of wealth has a crucial bearing on life chances. We are interested both in the better taxation of wealth (as discussed above) and in establishing new ways to spread wealth more widely and fairly. We are considering the following areas:

- **Access to housing wealth.** We are exploring innovative ways to expand the housing stock at affordable prices, and mechanisms to spread housing wealth such as shared ownership and community land trusts. We are also examining the case for removing the capital gain exemption on primary residences above a certain valuation and the introduction of a land value tax

- **A sovereign wealth fund.** We are exploring whether a national sovereign wealth fund should be established, to enable the collective sharing of national wealth. We are examining different possible objectives and structures for such a fund, innovative ways to capitalise it, and the different ways its dividends might be used
- **Sharing in the returns to capital.** We are examining the case for giving employees stronger shares in the ownership of companies. Possible mechanisms might include mandatory employee profit sharing for companies above a certain size; the creation of employee ownership funds paying out an annual dividend on top of wages; and the promotion of cooperative and mutually owned enterprises. We are looking, for instance, at the possibility of establishing a 'right to buy' for employees when companies are sold, and providing stronger investment support for cooperative and mutual firms, for example through a specialised arm of the British Investment Bank.

Meeting of the Commission
at 10 Downing St, January 2017

THE WORK OF THE IPPR COMMISSION ON ECONOMIC JUSTICE

It is our hope that this report will stimulate debate. We realise that some of its conclusions will be controversial. It is precisely because the questions that we are exploring are so fundamental that the answers will necessarily be contested. We welcome challenge, from wherever it may come.

Over the coming year, the Commission will be conducting further research on the condition of the British economy, and investigating the policy reforms outlined in chapter 6. We will continue to publish discussion papers and will continue our programme of engagement in different parts of the country and with varied stakeholder groups.

We warmly welcome feedback – for the ideas and approach to be challenged, and for new solutions and proposals to be offered. We will be publishing our final report in autumn 2018.

If you have ideas, queries, questions or comments, please do not hesitate to get in touch – we can be reached at cej@ippr.org and our website www.ippr.org/cej and monthly newsletter will continue to offer regular updates.

Keaton McCleary, Apprentice Academy at Tata Steel, Port Talbot

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