Five ideas for a budget for growth

Laura Chappell

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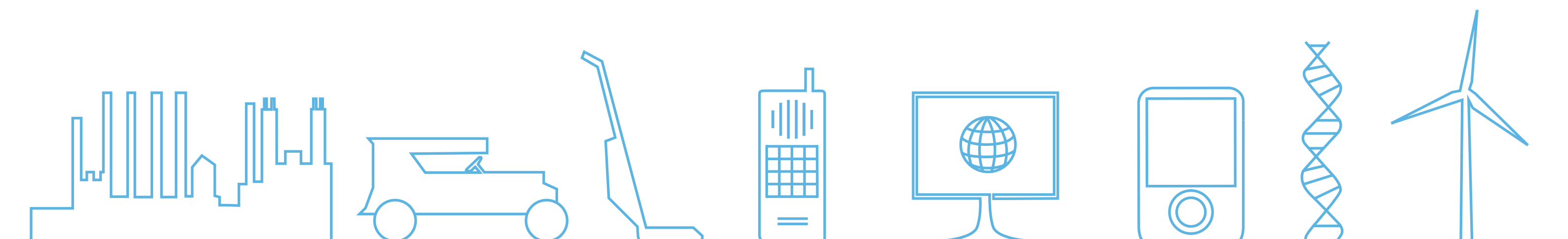

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ippr, 4th Floor
13–14 Buckingham Street
London WC2N 6DF

+44 (0)20 7470 6100

info@ippr.org • www.ippr.org

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About the author

Laura Chappell is a senior research fellow at ippr.

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Introduction

The budget is at hand, and George Osborne has made clear that this will be a budget for growth. This is welcome, given the fourth-quarter 2010 growth figures which saw a shock fall in economic activity of 0.6 per cent.

What is less reassuring, however, is the approach the government looks likely to take in an attempt to deliver this growth. Cutting is the order of the day. Three-pronged reductions across public expenditure, corporation tax, and regulation[1] are together expected to make life easier for business. This, in turn, is expected to make life easier for the rest of us through the creation of wealth and jobs.

Worryingly, this 'three cuts' approach appears to be little more than a return to the thinking of the 1980s, which is a convenient default position, particularly when the Coalition partners disagree over a more substantive strategy. But this is worse than mere laziness – it is a highly flawed approach, and poses serious risks to the UK's recovery from recession.

First, the theory of expansionary fiscal contraction – the idea that a smaller public sector equals a larger private sector, which therefore equals growth – only really finds support on the fringes of economic thinking. Mainstream policy and business opinion takes the opposite view, as put by Sir Richard Lambert in his farewell speech as President of the CBI when he said: 'It's not enough just to slam on the spending brakes. Measures that cut spending but killed demand would actually make matters worse.'

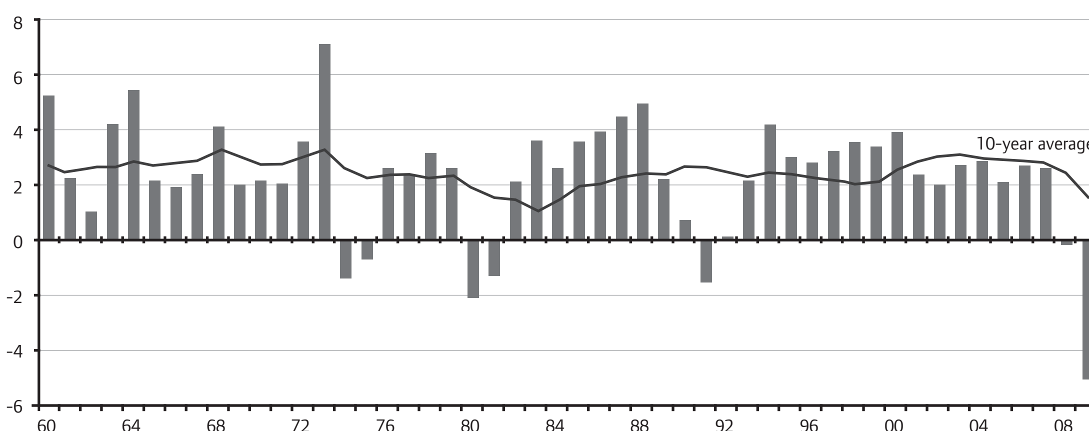
Second, while cutting the corporation tax rate from 28% to 24% may, at the margin, make Britain a more attractive place to do business, it is hardly the best use of £2.7 billion in such a constrained fiscal environment (particularly when accompanied by a decline in capital and investment allowances). Making the UK attractive to business requires a lot more than just making it marginally cheaper to operate here. Indeed, a recent FDI Barometer poll[2] found that almost half of businesses believe that attempts to limit immigration could affect (negatively) the likelihood of their investing in the UK, whereas only 13 per cent said that the decrease in corporation tax might have a (positive) effect.

Finally, reducing the regulatory burden is also a problematic strategy for promoting growth: getting government 'out of the way of business' is no silver bullet. This is illustrated by the remarkable lack of change in the UK's growth trend last time this sort of approach was attempted, in the 1980s: trend growth was marginally higher before deregulation in the 1960s and 1970s than it was afterwards, as is shown in Figure 1 below.

The overarching problem, however, is that the idea that less government – whether via reductions in spending, regulation or tax – is the route to growth fundamentally fails to understand the process by which growth is generated. The cuts-based perspective sees growth as something that entrepreneurs do, as something apart from governments. This is what leads David Cameron to suggest that if we 'eliminate the enemies of enterprise' then all will be well. But neither the economic literature nor British – or global – history of wealth creation supports this idea.

As Eric Beinhocker's *The Origin of Wealth* reveals, our hunter-gatherer ancestors around 15,000 years ago had a per capita income of around $90 per year.[3] That isn't surprising – our lifestyles today are infinitely different to theirs in almost every way. But what is fascinating is how incomes have evolved in the intervening years. Over the next 12,000 years, incomes across the world barely

Figure 1: Annual real GDP growth, UK 1960–2009 (% change)



Source: Lent A and Lockwood M (2010) *Creative Destruction: Placing Innovation at the Heart of Progressive Economics* London: ippr

changed at all, so that around the time of the ancient Greeks in 1000BC, incomes were only about $150 per year on average. Even more remarkably, they grew very little even up until the year 1750, when they averaged $180.

However, from that point on, an enormous, historically unprecedented leap in wealth creation took place, with incomes having increased 37 fold in around 250 years. As a result, incomes globally now average around $6,500 – and are much higher in countries like the UK. The last 250 years have seen a wealth creation miracle – and with these changes our lives have been transformed. Here in Britain, we now expect to die in our 70s or 80s, twice the life expectancy we would have had even just 100 years ago. And we can afford to educate all our children to adulthood, investing in our children's futures rather than simply sending them out to work.

So what has driven this flowering of wealth creation? The cutting edge of economic thought – driven by thinkers like John Kay, Carlota Perez and Ha Joon Chang in the UK and Dani Rodrik in the United States – makes clear that wealth creation has been driven by the development of a specific kind of capitalist market economy, combining relatively free markets with supportive state institutions. A whole range of institutions – market and non-market – need to be in place and arranged in the right configuration in order for growth to be unleashed. Removing restraints and 'liberating' people and businesses from the state is entirely misguided, because it incorrectly identifies the key players in the growth game. It isn't individuals that drive growth: it's ecology.

More specifically, the right 'ecology' involves a configuration of state and markets that facilitates the process of economic evolution. Structured correctly, evolving economies provide people and businesses with the freedom, resources and incentives to try new ways of doing things. This experimentation covers the spectrum of economic life and millions of different products, business models, technologies and methods.

But as well as promoting innovation, the right kind of system also provides lots of feedback to the innovators about 'what works'. Products or ideas that gain the approval of others in the economy – for a range of reasons, including price, novelty, ethical standards and so on – tend to be allocated additional resources. As a result, innovations which are seen as useful succeed and grow, while those that don't meet with approval die off.

This is a form of evolution – a process of variation, selection and replication. In biology, evolution takes place through sexual reproduction; in economics, something very similar happens as firms, governments and consumers produce innovations, feed back on their usefulness, repeat what works, and discard what doesn't. The crucial lesson of history – currently being unpicked by the vanguard of new economic thinking – is that certain configurations of firms, governments and consumers facilitate this process more effectively than others. Moreover, one in particular – a relatively free market economy with an active, supportive state – does it most effectively of all.

How does this relate to growth? In some ways, this is the wrong question to ask – economic evolution isn't just related to economic growth, it is fundamental to it. Economic evolution describes how the world's various resources are translated ever-more effectively into things which have value to people. It is, in more familiar economic language, the process by which innovation and investment enhance productivity, leading to higher real wages and profit levels. The evolutionary perspective simply provides a deeper explanation of how growth actually takes place.

But what does this mean in practical terms? How does altering our basic understanding change what the government should put it its 'budget for growth'? We suggest this understanding of growth and the conditions best suited to it has at least five implications, five ideas for growth, five things we would like to see come out of George Osborne's red box.

1. Set out a new vision for innovation

The evolutionary process described above has three stages – variation, selection and replication. In economies, the first pillar of the process – variation – happens through innovation. This places innovation at the very heart of growth, so promoting innovation must be at the centre of any successful growth strategy.

The government may find this encouraging. They haven't, after all, been silent on innovation. We have the notion, for example, of turning the Old Street roundabout into the heart of Britain's own Silicon Valley, tapping the creative potential of East London and the wellspring of new technology companies already in the area. We have the protection of the science budget, a nod to science's central role in cutting-edge research and development. And we have plans to invest in a network of Technology and Innovation Centres to drive growth in the UK's most high-tech industries by bridging the gap between universities and business.

Nevertheless, the evident problem is that these initiatives – positive though they are – are just that: initiatives. The thinking behind them sits entirely apart, it appears, from the 'three cuts' approach being taken to growth elsewhere. In the technocratic language of government, innovation and growth aren't 'joined up'. The danger of this approach is that it limits the ambition of the measures which are devised to promote

innovation. Innovation has been characterised as something done by a few clever people working in a few sectors in a few locations in the UK.

In reality, however, this is the complete antithesis of the innovation process, which is something that takes place in every corner of economic life – from the manager of a local Starbucks branch experimenting with a new shift system, to the creation of 'reggae reggae' hot sauce, to the development of cloud computing, to the restructuring of the NHS around GP commissioning. Each of these innovative moments involves someone trying a new way of producing something, or a new version of a product. An innovation-based growth strategy must be interested in this creative process as a whole, not just the isolated pockets of science, technology, and research and development.

With its neglect for innovation as a core component of growth, the 'three cuts' approach may, at best, simply be irrelevant. But there is a danger that the government's approach actually takes us away from the 'right' kind of economy by taking away some of the institutions we need to sustain innovation, selection and replication.

The budget must avoid these outcomes. To do so, it must be positioned within a new vision for promoting innovation across the whole scope of the UK economy. This vision might point, for example, at ideas to promote greater creativity in schools, strategies to encourage a wider diversity of business structures (including those which actively seek ideas and direction from the 'shop floor') and changes to intellectual property regimes to promote 'open innovation' and allow smaller firms in particular greater access to new technological developments, thereby spurring further adaptation and innovation.

2. Prioritise macroeconomic stability

Unfortunately for George Osborne, promoting innovation isn't straightforward – the answers aren't available 'off the shelf'. This is not just because the evolutionary nature of economic growth has only fairly recently been identified but also because the historical, institutional perspective which produced these insights also emphasises the importance of historical circumstances. The specific structures, and therefore policy tools, which 'work' in facilitating the evolutionary processes at one point in time will not necessarily be relevant or efficacious at another. This isn't surprising – economic evolution will produce very different results in the internet age than it did in the age of pen and paper, for example.

Nevertheless, research has begun to identify the type of role that a state should play regardless of the historical period, and the first of these is very familiar. Even from this new perspective on the economy, maintaining macroeconomic stability remains a vital task for government. Without this stability, businesses and individuals struggle to plan and consequently to innovate and invest. If innovation and investment are stymied, evolution falters.

> "An innovation-based growth strategy must be interested in the creative process as a whole"

What this means for the detail of macroeconomic policy in modern Britain isn't entirely clear. However, we have argued elsewhere[4] that interest rate targets should be set with more of an eye on unemployment, alongside the traditional focus on inflation, in these times of lay-offs and underemployment. It would also be good to see a form of macroprudential policy aimed at preventing asset bubbles and, in particular, keeping a lid on house prices. And alongside this support for positive steps must come the avoidance of potentially damaging ones, with excessively quick and deep public spending cuts of particular concern.[5]

3. Establish the means to monitor global technological developments

Another of the key roles that successful supportive states can play is to keep a watching brief on what is taking place within the 'global innovation system'. Evolutionary studies of the economy suggest that innovation tends to take place in waves: while smaller-scale innovation takes place every day, in every part of the economy, large, transformational innovations also occur, of a qualitatively different kind. These 'general purpose technologies', which seem to develop every 30 or 40 years or so, create major productivity gains and are integral to the development of new models of production and consumption.

For example, in the first half of the 20th century, North America and western Europe witnessed the development of mass production technologies – ā la Henry Ford – as a result of which physical processes and managerial practices changed dramatically, allowing very large numbers of products to be produced quickly and cheaply. This helped to usher in an era of 'consumer satisfaction', as ownership of consumer durables rose rapidly, with washing machines, televisions and central heating all becoming the norm. This was followed by the move to 'flexible specialisation' and consumer choice, and we may now be seeing the first transformation of the 21st century, with the rise of online production, consumption and choice.

This is particularly important for the government because of the UK's specific place in the world: while general purpose technologies affect all capitalist economies to some extent, they seem to affect

individual economies in different ways. In particular, where an economy is already well established and successful, it tends to be harder for it to adjust to a new technology, because its physical and human capital is bound up in the old way of doing things. Of course there are examples of countries successfully adapting to new business models even when they are heavily invested in the status quo – for one, the United States was fairly successful in moving from a mass production to a flexible specialisation production model through the latter part of the 20th century – but if a state can recognise early the changes that are taking place then it is more likely to react in a way which eases the process of adjustment. Understanding the global dynamics of innovation will help the UK to respond as best it can to a process which is now operating in Asia's favour.

What precisely might this mean for British policymaking? It implies a need to establish a greater range and number of in-depth research and analytical functions within government, to monitor technological change and the associated changes in business models more closely. This sort of government oversight of the economy has long been unfashionable, on the grounds that government can never know as much about the broad direction of the economy as markets (as famously emphasised by Friedrich Hayek). And indeed, the inability of governments to know what was happening, what might happen in future, and what should happen was *the* major flaw behind the planned economies of eastern and central Europe.

Nevertheless, while the idea that governments have a meaningful ability to understand economic developments – or even to make predictions – fell out of fashion, it didn't fall out of practice. The Bank of England, for example, has a major monitoring role, appraising the details of the economy in the UK and internationally in order to understand inflationary pressures and anticipate future developments, and thereby to set interest rates. No-one has claimed that it is incapable of this understanding simply because it is a public institution. A similar role is filled by sector skills councils, which assess sector skills requirements and plan training and other initiatives. And in terms of explicitly looking forward, the government has its respected 'Foresight' team, which identifies issues (such as migration and climate change) that are expected to fundamentally affect policymaking in years to come and tries to assess what might come to pass and how government might respond.

Perhaps most important in turning the intellectual tide in favour of some state capacity in this area, however, is the rise of China and India. Both countries (and others with successful economies, such as South Korea) make extensive use of data gathering and analysis in economic planning, far more so than in the West. While each country is different – and the rise of neither India nor China can be explained simply by their belief that government can usefully try to understand and anticipate economic trends – it is increasingly accepted that this has been a crucial element in their success. We need the British government to take this on board.

4. Develop a new sectoral policy framework

As well as steadying the ship, and monitoring long-term trends in the global economy, the government needs to make some fine-grained interventions to facilitate the evolutionary process in particular sectors. We stress the need for a response with a clear sectoral element because there are clear differences between sectors, and different levels and kinds of state support are required in order for them to grow.

We acknowledge that this is controversial. Indeed, for several decades now, since the totemic disaster that was British Leyland, it has been an absolute no-no in economic policy circles to focus on specific sectors and firms. We aren't meant to care which sectors flourished, or to treat them differently from one another – or at least this was the public discourse. Again, privately, government actions haven't entirely reflected the rhetoric, and different sectors have been treated differently. In the 1980s, for example, much state support was ostensibly withdrawn. However there remained some sectors, including the pharmaceutical industry, the defence industry, and indeed parts of manufacturing (through, for instance, the incentives given to attract Japanese car manufacturers to the UK) which retained substantial government assistance, and continued to flourish. And now, with 'rebalancing' in vogue across the political spectrum, taking a sectoral focus isn't merely acceptable, it is an active goal of both government and opposition.

It is important to be clear about what is not meant by a new sectoral policy. Recognising that some sectors have flourished with higher levels of government assistance doesn't mean that all sectors need greater intervention. Some, such as retail and communications, appear to grow very effectively with little attention from government. The structure which facilitates economic evolution is, after all, just as dependent on relatively free markets as it is on the supportive state.

Also, crucially, we aren't talking about supporting sectors that are fundamentally uncompetitive. Intervention is not about propping up failing sectors or firms (indeed, we don't think a firm-level analysis is the correct way to proceed at all).

Rather, it is about government providing support in appropriate ways to sectors that have the potential to grow and flourish, and where it can make a real difference. In Germany and Italy, for example, where firms faced much the same structural pressures as they did in Britain in the 1980s (competition with lower-wage

economies and so on), supportive government policy meant that traditionally strong manufacturing sub-sectors (including textiles, ceramics and engineering) remained internationally competitive.

So what kinds of intervention can be designed to support different sectors? Adam Lent recently argued in Going for Growth, co-published by ippr,[6] for replacing volume-based training (training focused more on the quantity of people trained rather than its quality or content) with sharper, demand-led approaches. In other words, skills policy needs to provide the UK workforce with skills that better reflect the needs of employers. It also needs to work harder to ensure that employers invest in and use skills – this could involve, for example, creating employer-led skills institutions to design and deliver training, funded by levies on employers.

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Another approach could include more strategic procurement by the government (as Stian Westlake argues in the same publication). At present, the UK has the Small Business Research Initiative, which takes strategic procurement a certain distance. But there is the potential to go further, following the United States' Small Business Innovation Research model.

Beyond procurement, let's take one sector – renewables – as an example for the kinds of interventions that are possible. In this case, feed-in tariffs and the Renewables Obligation, which mandates the big energy firms to source a certain percentage of the power they supply from renewable sources, could be stepped up. At present, in the latter case at least, we are moving in the opposite direction, towards phase-out by 2017.

A new sectoral policy framework could involve establishing sectoral monitoring bodies to mirror the global monitoring body discussed in section 3 above. The UK has been hugely reliant on a few key economy-wide statistics, especially inflation and GDP growth figures, for policymaking over the past few decades. Of course, when the objective is to promote growth, GDP figures are absolutely vital to monitor progress. But, as we learnt to our great detriment during the financial crisis, focusing on this dataset alone, without complementary sectoral statistics, meant that we didn't understand the process by which growth was being generated. At the extreme, this contributed, at least in part, to the 'growth' we saw across the financial sector throughout much of the '00s, where the paper value of assets rose but bore no relation at all to their underlying rates of return.

Similarly, post-crisis, we now recognise that much of the growth which took place in the later New Labour years was funded by debt-financed consumption and underpinned by rising house prices, rather than exports or investment – and that this matters for whether growth will be economically sustainable over the medium term. This analysis shines a spotlight on the sorts of real sectoral dynamics we believe the government needs to get to grips with.

To do this, we believe the government should establish more extensive and rigorous sectoral bodies, bringing together business people, other sectoral stakeholders and civil servants. These bodies would help government to understand how a sector is developing and to work with businesses and other stakeholders to develop a strategy to enhance growth. Dani Rodrik at Harvard has studied how this can work most effectively, and has said that the ambition should be to facilitate a 'discovery process', through which government works with business and other interest groups to discover collectively how policy can most effectively support the sector.[7] This builds on the insight from evolutionary economics that growth isn't the simple result of 'more business' (business channeling its demands to government) nor of 'more government' (policymakers trying to monitor and 'direct' business) – for everybody invested in our economy, partnerships are necessary to the successful creation of the right kind of ecology for growth.

5. Tackle inequality

The UK's long-run growth potential will only be maximized if the benefits of growth are shared. If the alternative, polarised scenario – the few zooming ahead and most left behind – comes to pass, those at the bottom are unlikely to have the resources and knowledge needed to participate in the economy. As a result, the size of the population involved in innovating, selecting and replicating will be limited, and wealth creation constrained.

As is the case with innovation, inequality is an issue governments past and present have had on their agenda. The Coalition seems to have shaken off the attitude of previous Conservative governments, making great efforts to try to demonstrate it has a progressive economic policy. Previously, New Labour was very concerned with the ability of growth to touch everyone's lives, and designed policies – such as tax credits – to ensure that those at the bottom of the income spectrum saw some of its benefits. Nevertheless, a structural view of the economic growth process makes clear that both Labour and the Coalition need to re-think their approaches to inequality, albeit for different reasons.

The New Labour government's predominant focus was the ultimate distribution of growth – as a result, it put much of its emphasis on transfers, which enabled the initial rewards of growth to be redistributed more evenly through the tax system. In our view – which sees growth as a process of evolution, with innovation at its heart – it is clear that wielding transfers in order to involve everyone in growth will forever mean running to stand still. In fact, this is exactly where New Labour found itself at the end: inequality hadn't risen, but it hadn't fallen either.

We believe a much more effective approach lies in cutting out the middle man (so to speak) and aiming instead to involve everyone in growth by involving everyone in growth directly. It means, as discussed earlier, devising innovation strategies which aim to raise innovation across all occupations, sectors and regions, rather than focusing on a scientific or technological elite, or a few favoured localities. This would harness more of the talent available in the UK to the task of generating growth and, at the same time, is likely to spread the income rewards of growth more effectively throughout the population, thereby reducing the heavy lifting left for redistributive policies to do.

For its part, the Coalition has shown an early awareness of the importance of participating in growth – for example, the approach they are currently considering for addressing child poverty places a lot of emphasis on improving children's capabilities in the early years. If effectively implemented, this approach could help to ensure that children have the abilities and skills they will need to participate in the growth process more effectively as adults.

But the problems which we discussed in the introduction and section 1 emerge here too – while the government recognises that innovation is important, and that addressing inequality means improving people's ability to participate – not just enhancing their income to some minimum level – none of this is actually linked to their growth strategy. And what is being done in the name of that growth strategy – the cuts to spending, tax and regulation – seem likely to undercut the positive contributions being made by policy in other areas. Somewhat bizarrely, what looks likely to be done in the name of growth is most likely to prevent it – and it will do so at the cost not just of lower growth but also of higher inequality.

Conclusion

This 'recipe for growth' isn't complete, of course. Much more thinking needs to be done, both at the cutting edge of research and within government in order to apply it to the UK economic environment. But our five ideas show government the best direction of travel. A successful growth strategy must have innovation front and centre. It must explore what that means for the UK, recognising that we are now entering an 'Asian century'. We stress the importance of ensuring macroeconomic stability, creating a global monitoring capacity, and promoting a new sectoral policy framework. And it must address inequality, including (to complete the circle) by creating an innovation strategy which involves everyone, not just the elites.

Most importantly, however, the government must recognise the real process by which growth is created. They must understand that successful entrepreneurs don't flourish in a vacuum but within a supportive ecology, with the right social and economic institutions at hand. Current indications are that the Coalition government, with its 'three cuts' agenda, is moving rapidly in the wrong direction. Its thinking is reductive, and the UK sorely needs an about-turn. A huge opportunity looms – we will be watching the budget closely.

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Notes

1 Including in specific locations, through the return of enterprise zones, where reduced planning regulation is the major focus.

2 See Sherwood B (2011) 'Tax cut fails to woo foreign execs' *Financial Times*, 19 January 2011. http://www.ft.com/cms/s/0/9db3fb5e-2336-11e0-b6a3-00144feab49a.html#axzz1HJlp9P29

3 Figures in this and the following paragraph are given in US dollars at 1990 prices.

4 Dolphin T (2011) 'Rethinking macroeconomic policy in the UK' in W Straw (ed) *Going for Growth* London/Bonn: ippr/Left Foot Forward/Friedrich Ebert Stiftung. http://www.ippr.org/publicationsandreports/publication.asp?id=804

5 For greater detail on how the pace and scale of cuts might be adjusted see Dolphin T and Lent A (2011) *Deficit Reducation Averaging: A Plan B for fiscal tightening* London: ippr. http://www.ippr.org/publicationsandreports/publication.asp?id=809

6 Lent A (2011) 'Time for an economic challenge strategy' in W Straw (ed) *Going for growth*. See 4 above.

7 Rodrik D (2009) 'Diagnostics before prescription', symposium paper. http://www.hks.harvard.edu/fs/drodrik/Research%20papers/Diagnostics%20before%20prescription.pdf