



PROMOTING  
**GROWTH AND  
SHARED PROSPERITY**  
IN THE UK

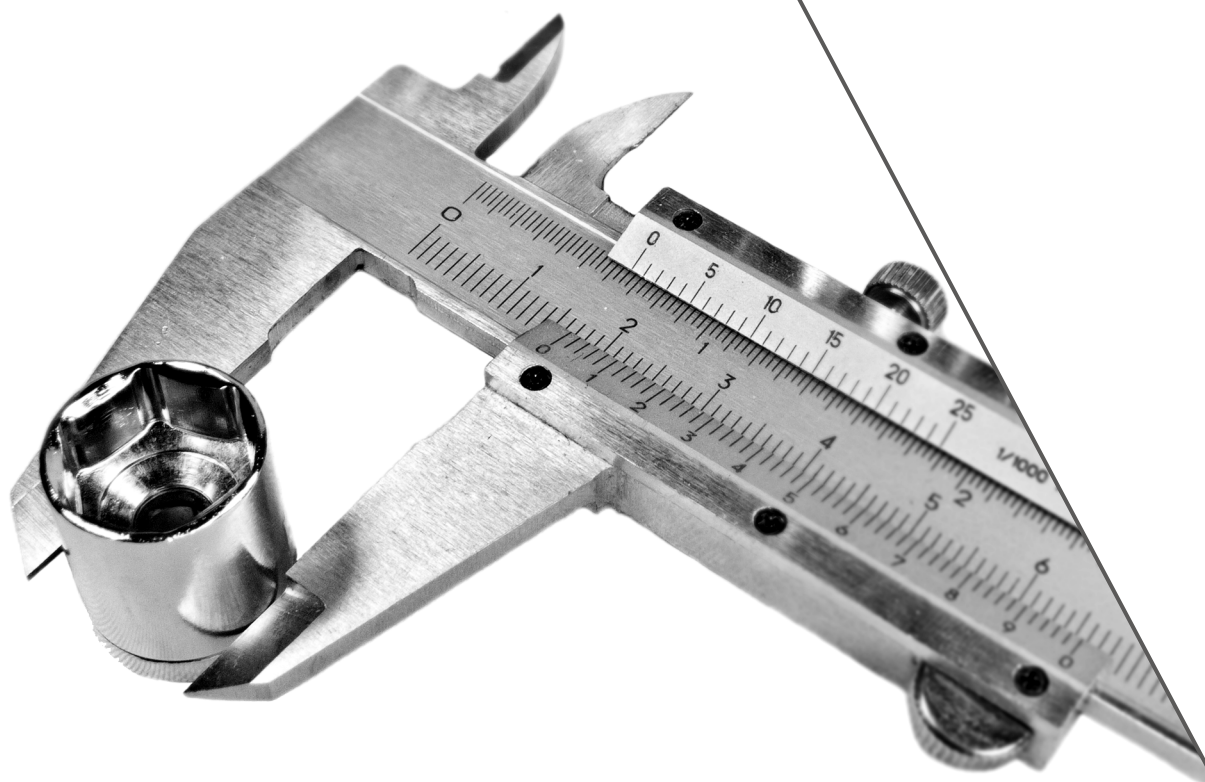
IPPR

Tony Dolphin,  
David Nash and  
Amna Silim

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# THE STATE OF THE ECONOMY

**BRIEFING**





## ABOUT THE AUTHORS

**Tony Dolphin** is senior economist and associate director for economic policy at IPPR.

**David Nash** is a research fellow at IPPR.

**Amna Silim** is a research assistant at IPPR.

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IPPR  
4th Floor  
14 Buckingham Street  
London WC2N 6DF  
T: +44 (0)20 7470 6100  
E: [info@ippr.org](mailto:info@ippr.org)  
[www.ippr.org](http://www.ippr.org)  
Registered charity no. 800065

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## ABOUT PROMOTING GROWTH AND SHARED PROSPERITY

This major programme of work aims to identify public policies that will promote the economic growth needed to return the UK to full employment and ensure that the benefits of future prosperity are more equally shared.

For more information, see:  
<http://www.ippr.org/research-projects/44/7144/promoting-growth-and-shared-prosperity-in-the-uk>

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## EXECUTIVE SUMMARY

The government needs to do more to promote long-term, balanced growth in the UK economy and to ensure that the benefits of increased prosperity are more equally shared. This will require it to develop a modern industrial strategy.

The recovery from the recent recession is shaping up to be the slowest on record. Real GDP growth has disappointed over the last year. On 29 November, the Office for Budget Responsibility will be revising down its forecasts for growth in 2011 and 2012. Even if its forecasts for later years remain unchanged, they will be for only moderate growth, despite being based on optimistic assumptions about exports, investment and households' willingness to take on more debt. Future growth will depend on the efforts of the private sector but the government could be doing more to support growth.

A balance needs to be struck between efforts to rebalance the economy and the need for higher growth of any sort in the short term to get the economy back to full employment. Manufacturing can play a part in the economic recovery, but its share of economic activity has shrunk to the point where it cannot alone drive growth. The UK needs to exploit its other strengths, in areas such as the creative industries, education, and even finance.

The UK economy faces a number of challenges as it seeks to return to full employment: in particular, an ageing population, the rapid development of emerging economies, and technological change. Industrial policies need to be designed with these challenges and their effects, for example on the labour market, in mind.

These same developments also create new opportunities. The UK has been slower than most of its competitors to exploit new markets in emerging economies. Given the UK's poor trade performance over the last three decades, industrial policies designed to rebalance of the economy should favour tradable goods and services.

Economic performance in the UK has been hampered by a number of supply-side weaknesses: on innovation, investment in physical capital, and skills. Productivity levels remain lower than in many of our competitor nations. These weaknesses have been known about for some time but policies to tackle them have not been effective. Government needs to develop better methods, for example looking at a state investment bank to boost levels of infrastructure spending.

The government should also examine what new ways of thinking about the economy, such as complexity economics and evolutionary economics imply for industrial policies. Developing a modern industrial strategy requires mixing what has worked in the UK in the past with what is working in other countries right now and what the best new economic thinkers say will work in the future.

Promoting growth alone is not enough. Powerful forces operating on the economy – globalisation, technological change and financialisation – tend to increase inequalities: between regions, between high and low earners, between generations, and between those in work and those out of work. Policy needs to counter these trends and ensure that increased prosperity is more equally shared than in past. This will not be easy; use of the tax and benefit system for these purposes may be close to its limit. New ideas, like the living wage, are needed.

Promoting growth in the private sector need not mean spending more government money. The existing budget can be spent more wisely to ensure companies continue to attract investment from overseas, have the infrastructure and available skills in the labour market

they need to grow, and are able to exploit their existing comparative advantages to the full and to develop new ones. Public policies can be used to shape markets, increase competition, support ambition and entrepreneurship, and encourage more diverse forms of business ownership in a way that will create the right environment for UK companies to flourish.

# 1. INTRODUCTION

The 2008–09 recession left the UK with the stark legacies of a large fiscal deficit, sharply increased government debt and a high level of unemployment (which is now increasing again). As the economy emerges extremely slowly from the deepest and longest recession of the post-war period, and with the government having put in place a strategy to eliminate the deficit, the key questions now are:

- How can public policy promote long-term growth that is sustainable and resilient, so as to return the economy to full employment as quickly as possible?
- How can we ensure that increased prosperity is shared more equally?

To understand better the challenges faced by policymakers as they seek answers to these questions, this paper assesses the current state of the UK economy. It sets out recent trends (focusing on employment and the structure of the economy); discusses the opportunities and threats facing the UK economy; identifies some of the UK's competitive strengths and weaknesses; and analyses major inequalities and disparities within the economy.

From 1997 to 2007, the Labour government's strategy for promoting economic activity and sharing prosperity combined 'light-touch' regulation and unfettered growth in the private sector with use of the tax and benefit system to achieve a more equal distribution of incomes. Some of the weaknesses in this model were highlighted by the financial crisis and the deep recession of 2008 and 2009. The Coalition government's emphasis on deficit reduction means no convincing alternative approach has yet emerged.

It is now time to identify public policies that will promote the economic growth needed to return the UK to full employment<sup>1</sup> as quickly as possible, while ensuring that the benefits of future prosperity are more equally shared. This is the aim of a programme of work launched earlier this year by IPPR.<sup>2</sup> This flagship project will develop a new framework for the UK economy, set out ways in which UK companies need to change to better exploit their comparative advantages and compete in the global economy, and identify how increased prosperity can be shared across the regions and nations of the UK and through fairer pay and full employment.

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1 Defined as an employment rate of 73 per cent.

2 See <http://www.ippr.org/research-project/44/7144/promoting-growth-and-shared-prosperity-in-the-uk>

## 2. ECONOMIC OVERVIEW

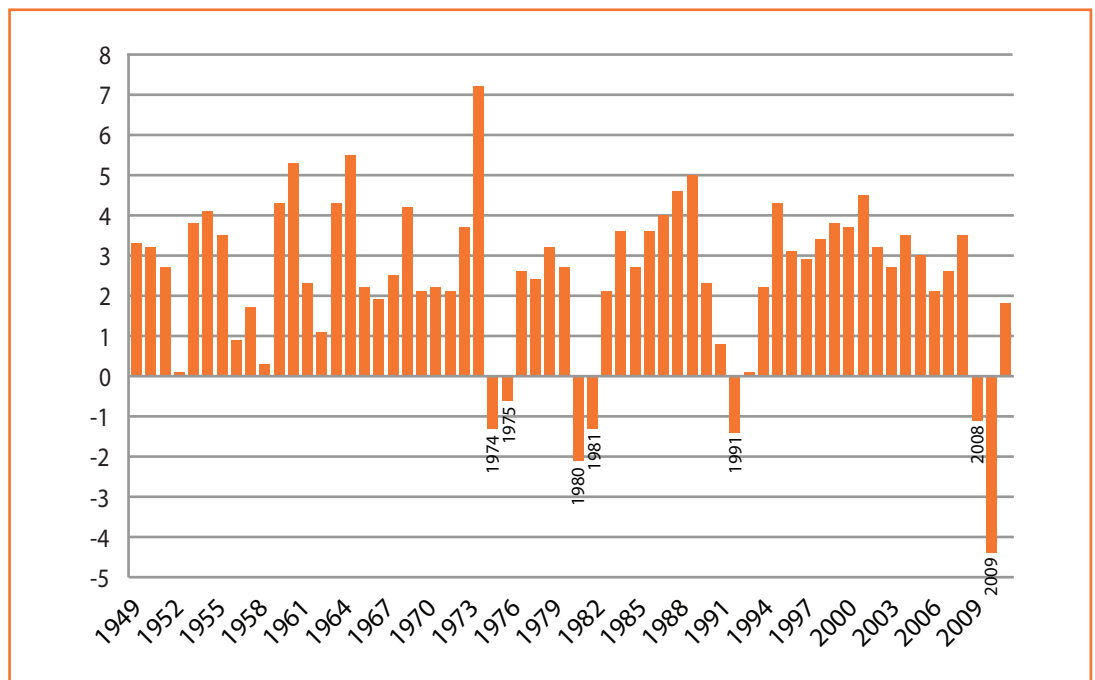
In 2008 and 2009, the UK economy experienced its deepest recession since the great depression of the 1930s. This recession, and the financial crisis that preceded it, laid bare the unsustainable nature of economic developments in the UK during the preceding decade and left legacies in the form of a large fiscal deficit and a high level of joblessness.

The Coalition government has expended enormous political capital dealing with the first of these legacies – the budget deficit – but its efforts to promote the economic growth needed to restore the economy to full employment have been criticised as underwhelming.<sup>3</sup> HM Treasury and the Department for Business, Innovation and Skills [BIS] announced a *Growth Review* in November 2010, and this was followed by *The Plan for Growth* published alongside the March 2011 budget. But the measures highlighted in these documents – cuts in corporate tax rates and regulations, a relaxation of planning rules, and enterprise zones – are widely regarded as inadequate and fall well short of a thorough reappraisal of the underlying model of the UK economy.

### 2008–09 recession

Prior to 1970, the post-war period in the UK was characterised by frequent short economic cycles but no deep recessions. In the last 40 years, cycles have become more extended but have tended to end with deeper recessions. Before the 2008–09 recession, there was a record spell of uninterrupted growth – 16 years from 1993 to 2007. However, the 2008–09 recession was the deepest and longest in the post-war era.

**Figure 2.1**  
UK real GDP growth (%)



Source: Office for National Statistics (ONS)

The 2008–09 recession<sup>4</sup> lasted for five quarters and resulted in the loss of 7 per cent of output and a fall in total employment of over 700,000. However, the drop in employment

<sup>3</sup> See, for example, Sir Richard Lambert's speech in January 2011: <http://www.telegraph.co.uk/finance/economics/8279573/Coalition-putting-politics-before-economy-says-CBIs-Richard-Lambert.html>

<sup>4</sup> Defined as the period when real GDP was contracting.

was not as large as might have been expected given the depth of the recession<sup>5</sup> and, despite the stop-start nature of the economic recovery, almost half of this fall in employment has been reversed. Even so, unemployment remains above 2.5 million and the number of people claiming out-of-work benefits is close to 5 million. This represents a huge loss of potential output for the UK economy (and tax revenues for the government). Designing and putting in place policies to increase employment should be a priority.

Prior to the recession, general government debt in the UK was lower than in most other developed economies. However, largely as a result of the financial crisis and recession, net government debt (excluding the effect of financial interventions) increased from 36.5 per cent of GDP in March 2008 to 60.2 per cent in March 2011 and it is expected to go on rising in the next few years to a peak of around 71 per cent in March 2014 (OBR 2011).

Meanwhile, government borrowing in 2010/11 was over 9 per cent of GDP. The Coalition government has put in place tax increases and substantial cuts in real departmental spending to reduce this to just 1.5 per cent of GDP by 2015/16. This will be a drag on economic activity. The government hopes that the private sector will be sufficiently inspired by its efforts to tackle the deficit to boost spending to more than offset this drag, but there is little evidence over the last year to suggest this will be the case. In these circumstances, the government should do everything within its power to promote growth in the private sector.

## Outlook to 2015

Unlike other post-war recessions in the UK, which were caused by the policy response to a period of high inflation, the latest recession was the result of the bursting of debt and asset bubbles. History suggests that such recessions are generally followed by slower and more difficult recoveries than those associated with tightening monetary policies and overheating (Reinhart and Rogoff 2009). There are two reasons. First, policymakers have very little scope to further ease monetary or fiscal policy to support the recovery. Second, debt levels across the economy remain high, and lenders and borrowers are reluctant to increase them.

This is a fair description of the current situation in the UK. The bank rate is already at the rock-bottom level of 0.5 per cent. The Bank of England is increasing the amount of money it has pumped into the economy through its quantitative easing policy to £275 billion. Meanwhile, fiscal policy is being tightened, not eased. And household debts are extremely high – at 158 per cent of disposable income at the end of 2010, compared to 103 per cent in 1997. As a result, the UK economy is vulnerable to shocks, as is evident in the ‘mini- stagflation’ that the economy is currently experiencing, with inflation at 5 per cent, well above its target rate, and real GDP growth of just 0.5 per cent over the last year, well below its trend rate.

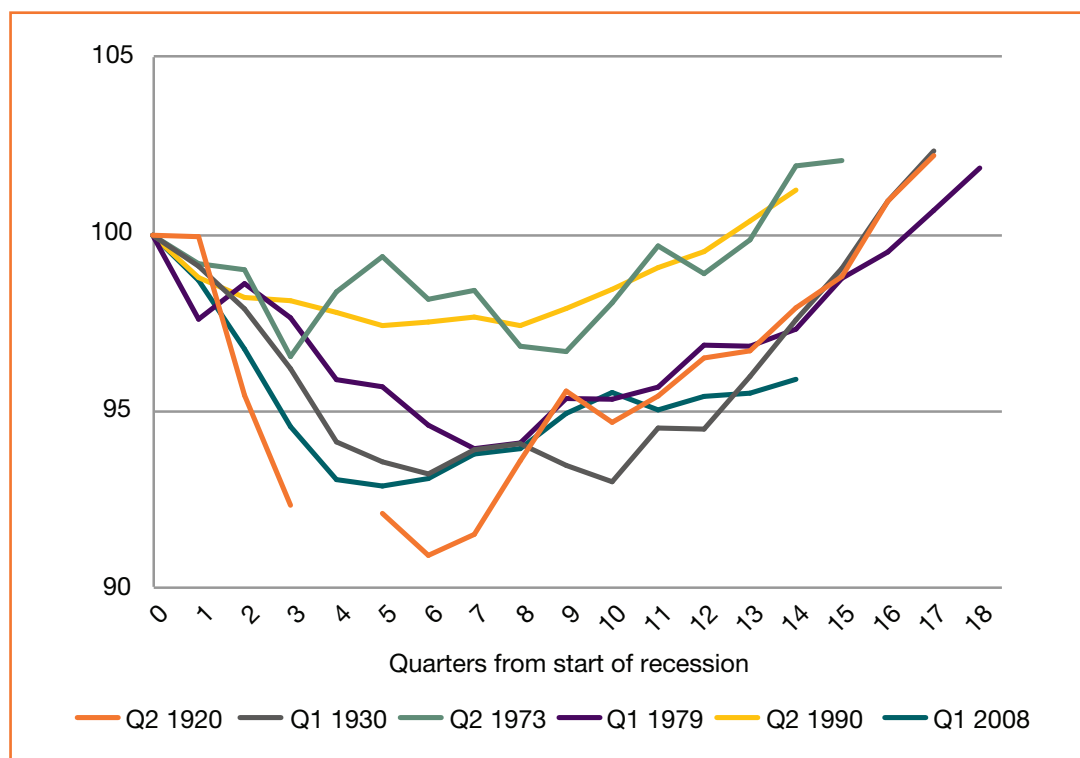
Back in March, the Office for Budget Responsibility (OBR) forecast average real GDP growth of 2.8 per cent from 2012 to 2015 (OBR 2011). When it produces revised projections on 29 November, the forecast for 2012 will have to be lowered and the UK is set for its slowest-ever recovery back to its previous peak in real GDP.

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<sup>5</sup> On the basis of previous recessions, it would have been no surprise if 1.5 million people had lost their jobs.



**Figure 2.2**  
Recoveries from deep  
recessions in the UK  
(real GDP, quarter prior  
to recession = 100)



Source: National Institute of Economic and Social Research, ONS and authors' calculations

Yet the OBR's projections, and the underlying assumptions, have been criticised as potentially too optimistic. The OBR expects the UK to enjoy its best-ever net export performance, a private sector investment boom, strong growth in private sector employment to offset jobs cuts in the public sector, and a further increase in household debt in the next four years. There is scope for disappointment on all four fronts.

The OBR predicts net trade will add 0.7 per cent to output growth in 2011, rising to 1 per cent in 2012, and then falling to 0.7 per cent in 2013, 0.6 per cent in 2014 and 0.5 per cent in 2015. This would represent the biggest five-year boost to growth from trade since records began (and, incidentally, a welcome rebalancing of the economy). Over the last two years, strong export volumes have offered some support for the OBR's forecasts. But momentum has been lost recently and the crisis in the eurozone is an obvious threat in the short-term. Over the medium-term, for the OBR to be right requires a sustained recovery in the UK's key export markets, particularly in Europe, and sterling's exchange rate remaining competitive. UK exporters must also rise to the challenge and invest in extra capacity. So business investment is also expected to add substantially to output growth over the next five years (though it actually declined by 0.6 per cent over the year to the second quarter of 2011). The risk is that, without positive support from public policy, actual performance on exports and investment will fall short of the OBR's expectations.

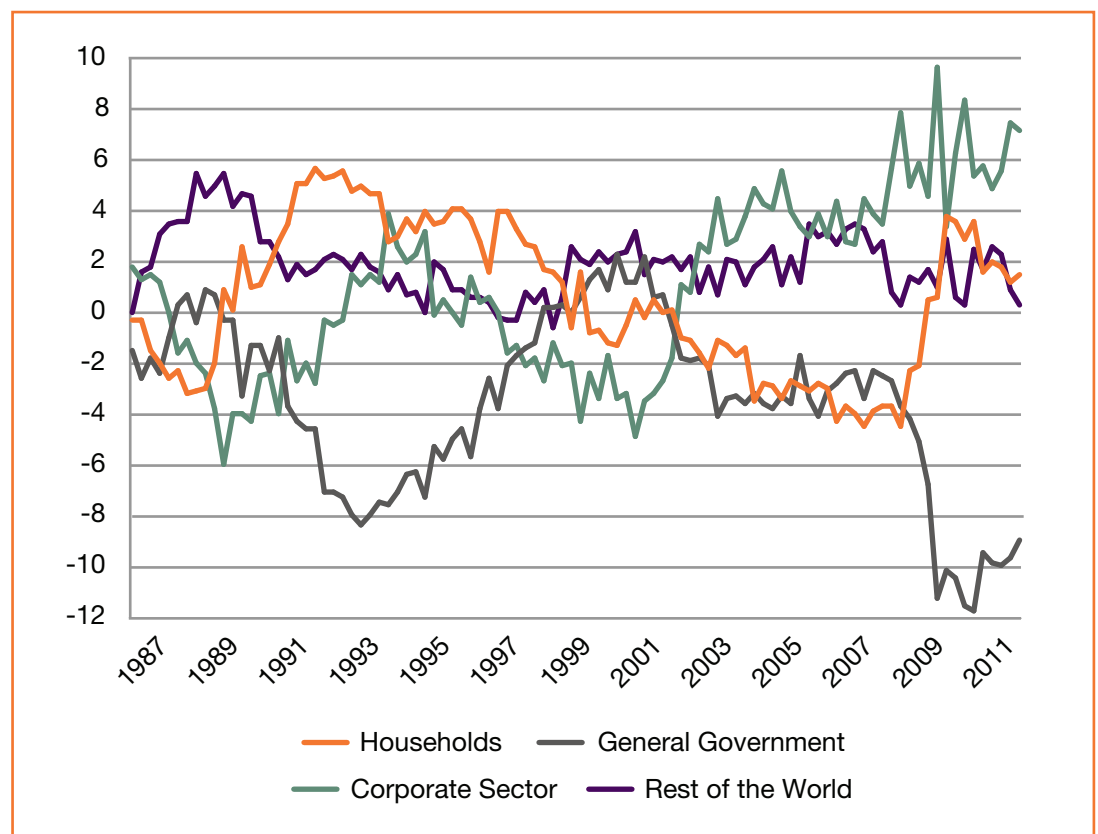
Job losses in the public sector are estimated by the OBR to be 389,000 between the first quarters of 2011 and 2016 as a result of government's spending cuts (though others expect a bigger reduction). Over the next five years, this loss is expected to be more than offset by the private sector creating 1.3 million net new jobs. This looks to be an optimistic assumption; it implies job creation in the private sector will be on a scale not experienced

for many years. Recent data shows that 264,000 jobs were created in the private sector in the last 12 months, but only 41,000 in the last three. Much will depend on whether the public sector has been crowding out job creation in the private sector over the last decade, or filling in to compensate for underlying weakness in the private sector. Buchanan et al (2009) argue that the evidence clearly suggests the public sector has been filling in. If they are right, employment is likely to fall short of the levels forecast by the OBR.

The OBR also expects household debt, which is already higher in the UK in relation to disposable income than in any other country in the developed world (and therefore almost certainly the highest in the world) to start increasing again from 2012. In the face of moderate increases in real incomes, this is necessary to generate the growth in consumption needed to make the OBR's real GDP forecasts add up. However, after the debt binge of the 1990s and 2000s, it might seem more likely that UK households will spend several years reducing their debt. Furthermore, the chancellor is on record, for example in his first budget speech, as saying that growth should no longer be driven by increases in household debt.<sup>6</sup>

Another way to look at where growth in the UK should be coming from is to consider the financial balances of the different parts of the UK economy.

**Figure 2.3**  
UK financial balances by  
sector (% of GDP)



Source: ONS

6 He spoke of 'a sustainable private sector recovery built on a new model of economic growth, instead of pumping the debt bubble back up': see [http://www.hm-treasury.gov.uk/junebudget\\_speech.htm](http://www.hm-treasury.gov.uk/junebudget_speech.htm).

The general government sector has a large financial deficit, which is offset by surpluses in the corporate, household and overseas sectors.<sup>7</sup> The surplus in the household sector is not, however, large by historical standards (other than the period 2000–2008) and growth that relies on households returning to financial deficit would be suboptimal. It would be better for the huge corporate sector surplus to come down as a result of companies spending more on investment. Additionally, a move into deficit in the overseas sector would require the UK's current account position to swing into surplus – this would also be good for growth, if it was achieved through strong exports rather than weak imports.

### Conclusion

The outlook is, therefore, unusually uncertain. Mainstream forecasts are for only modest output growth in the UK over the next few years and the OBR, despite taking what is arguably an optimistic view of the economy, expects unemployment to remain above 2 million until the last quarter of 2015. There is an urgent need to identify policies across a range of areas that could promote private sector growth in the UK by shaping the business environment and helping companies to become world-beaters.

Growth must be less reliant on debt-fuelled consumer spending and based more on exports and business investment; it must be less reliant on a few sectors of the economy, like finance, and more broad-based across sectors; and it must be less focused in the south-east and more regionally spread.

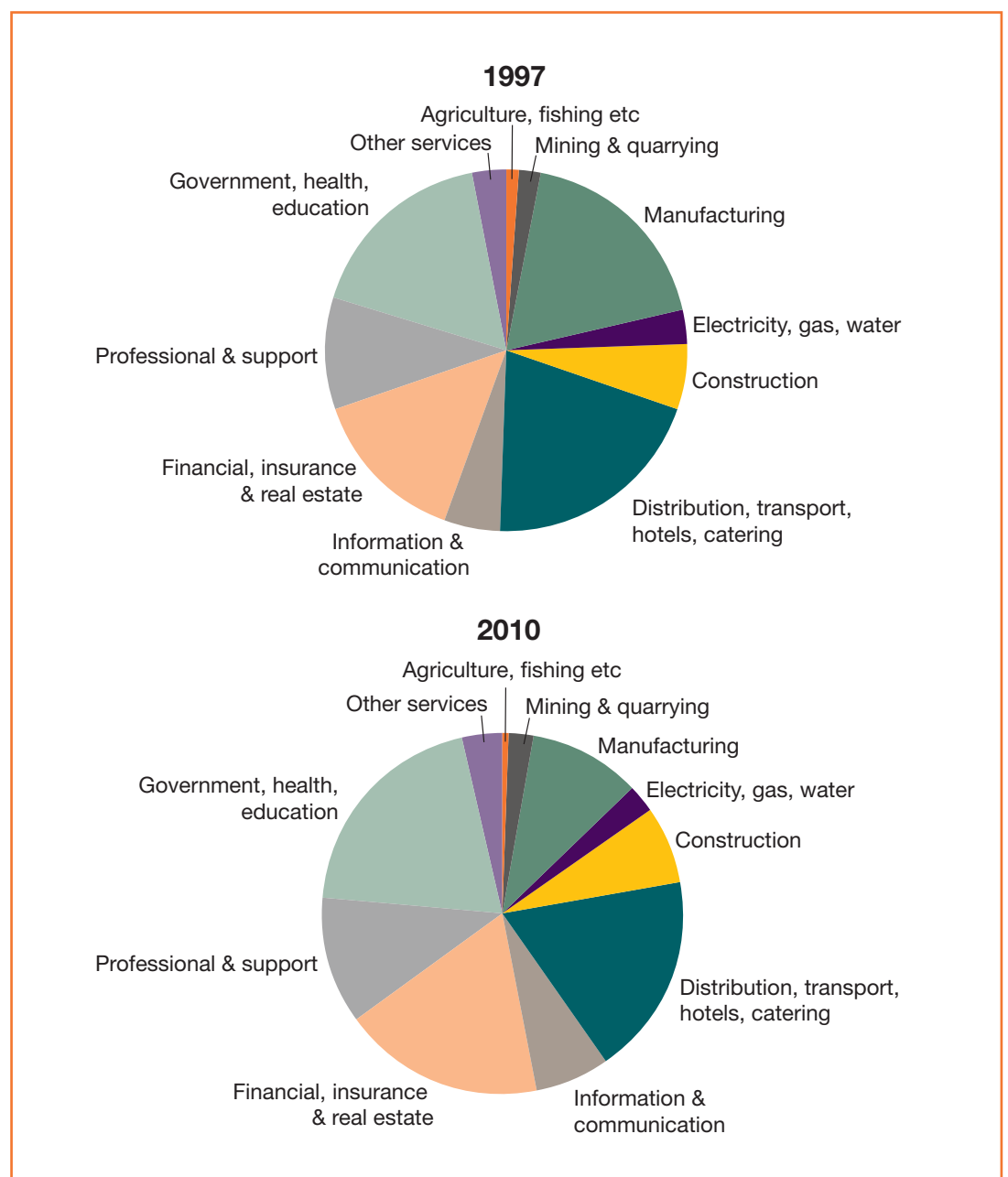
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<sup>7</sup> A surplus in the overseas sector means the UK is attracting net capital inflows from other countries and is the mirror image of the current account position.

### 3. THE STRUCTURE OF THE UK ECONOMY

Since the depth of the recent recession became clear in 2008, there have been numerous calls for a restructuring of the UK economy to reduce the risk of another downturn on a similar scale. Such calls generally include a reduced role for the financial sector – because its size is seen as an explanation as to why the recession hit the UK relatively badly. Typically, they also envisage an expansion of manufacturing, although the more thoughtful contributions also note other potential areas of growth.

**Figure 3.1**  
UK gross value-added  
by industry (% of total)



Source: ONS

Such sectoral rebalancing, it is presumed, would also help the UK economy in other ways. In particular, stronger growth in manufacturing is associated with more exports and investment spending and relatively less consumer spending. This could lead to a reduction in the UK's long-standing trade deficit.

However, while the increased financialisation of the economy has created problems in recent years, finance is one area where the UK has a definite comparative advantage. Shrinking the financial sector may not be the best solution for the economy, given the need to generate strong private sector growth in coming years, as there is no guarantee that it will lead to faster growth in other sectors of the economy.

Similarly, the notion that manufacturing is 'good' and services are 'bad' is far too simplistic. Given the UK's persistent trade deficit, a better focus for support and expansion might be the tradable goods and services sectors of the economy more generally.

## Finance

Financialisation is more advanced in the UK than in most other developed economies. Between 1997 and 2010, the finance, insurance and real estate sector increased from 14 per cent of the UK economy to 18 per cent. This has had spill-over effects into the rest of the economy. For example, directors and senior managers in other sectors compare their pay and bonuses to those of their counterparts in the financial sector and aspire to match them. And capital flows into the financial sector have meant that sterling's real exchange rate has been higher than it would have otherwise have been. This has left firms in other sectors – particularly manufacturing – less competitive, resulting in an accelerated relative decline.

As the last few years have shown, this concentration on financial services carries large risks, but it is equally clear that this is an area where the UK has a comparative advantage, and not just in the development of fancy and dangerous derivatives. The UK is one of the top countries in the world for asset management, including hedge funds, corporate finance and other financial and professional services.

Despite the recession, financial and professional services continue to make a significant contribution to the economy. From a trade perspective, the UK experienced a trade surplus in financial services of £42 billion in 2009 (City of London 2010). This sector also contributes significantly to government revenues. A PwC report estimates that in 2009/10 it provided £53.4 billion in tax revenue, 11.2 per cent of total tax receipts (PwC 2010).

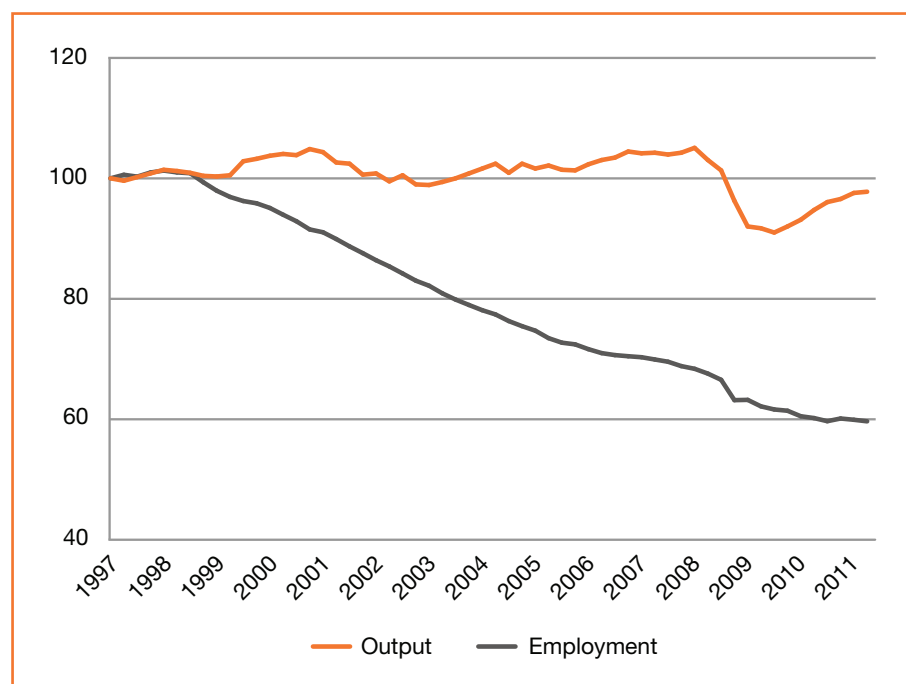
This presents policymakers with a conundrum. They clearly want to reduce the reliance of the UK economy on the financial sector and to have an economy that is better balanced and thus more resilient. At the same time, they also want the private sector of the economy to grow as rapidly as possible in the next few years so that it returns to full employment as soon as possible. But this ambition will not be helped by discouraging a part of the economy where the UK appears to have a demonstrable comparative advantage. A critical analysis of the complex role of the financial services industry in the UK is needed to weigh up the advantages and disadvantages they bring to the economy.

## The role of manufacturing

Developed countries across the world have been shifting from manufacturing to service sector production for many years, but the pace of change has picked up in the last 15 to 20 years as a result of the rapidly changing and increasingly interconnected global economy.

The UK, which was once a global leader in manufacturing, is one country that has undergone a major restructuring of economic activity. Manufacturing's share in total value-added almost halved from 23 per cent in 1990 to 12 per cent in 2009, with the steepest decline beginning after 1997. In 1980, manufacturing industries provided one in four jobs in the UK; by 2010 it was less than one in 10. Over the last decade, over 1 million jobs have disappeared from manufacturing, at a rate of 4 per cent a year.

**Figure 3.2**  
Manufacturing output  
and employment,  
(Q1 1997 = 100)



Source: ONS

These statistics almost certainly exaggerate the scale of the decline in manufacturing activity. The growth of outsourcing means a job that was once classified as being in manufacturing (such as a canteen worker directly employed by a manufacturing company) might now be classified as being in the service sector (the same canteen worker now employed by a support services company). The production line is now a heavily capital intensive process, with fewer labour requirements. Labour is, however, increasingly found in the service, repair and maintenance parts of manufacturing, which might also be outsourced.

There have also been widespread changes in manufacturing as a result of advances in technology and innovation, and many companies are operating under a new business model. As a result, the distinction between services and manufacturing is becoming increasingly blurred, with companies operating in both areas. Rolls Royce is a successful example of this, having evolved from a pure manufacturing company into an integrated solutions provider with half of its revenue accounted from services.

Even so, it is clear there has been a substantial decline in the importance of manufacturing output and employment in the UK.

The growing gap between output and employment trends in manufacturing suggests there has also been a rapid increase in productivity in the sector over the last 15 years or so and it is true that many companies have been able to boost productivity through the greater use of technology. But some of the increase in aggregate productivity is simply the result of low-productivity companies closing down because they have been unable to compete with low-cost producers overseas.

The UK still has a comparative advantage within some parts of manufacturing. Globalisation has led to an increasing trend towards high-value manufacturing, which contributes positively to exports – 70 per cent of manufacturing goods that were exported in 2007 came from high-tech and medium-tech manufacturing sectors (Brinkley 2009). Meanwhile, traditional industries such as textiles, clothing and footwear have shrunk dramatically.

The UK is still a global leader in some manufacturing industries, including aerospace, where in 2006 it accounted for 13 per cent of the global market (BERR 2008). It also hopes to develop strength in newer areas, such as low-carbon technologies by leading in the development of alternative energy products and lower-carbon production techniques. Traditional strengths in research and development, design, and innovation will also support manufacturing industry in the future.

However, despite talk of a rebalancing of the economy, there is a limit to the extent that manufacturing can lead a revival of the British economy. There are 10 times more people working in the service sector than in manufacturing in the UK. Exclude the public sector and that ratio drops to seven times. This means employment in manufacturing would have to grow seven times faster than employment in the private service sector if more jobs are to be created in manufacturing than in services. This seems an unlikely outcome.

Even so, there are reasons for policy to be directed at slowing, or even arresting, the decline of manufacturing, not least because the UK needs to drastically improve its trade performance. As part of an effort to boost growth rates in tradable sectors, manufacturing should be supported. However, the UK's future is as a predominantly service-based economy and policies designed to promote growth should take that as a starting point.

### Areas of comparative advantage

Apart from finance, there are a number of industries where the UK is a strong global competitor. These include pharmaceuticals, creative industries, education, aerospace and defence. There should be excellent opportunities for future growth in all of them.

The chemical and pharmaceutical business in the UK is a £60 billion industry, which contributes positively to the balance of trade. It employs 600,000 people, mainly in high-skilled, high value-added jobs that pay relatively high wages. Chemicals and pharmaceuticals account for 12 per cent of total manufacturing output (CIA 2010).

Creative industries also contribute positively to the economy. Exports of services from the creative industries in 2008 amounted to £17.3 billion, or 4.1 per cent of all goods and services exported. The sector accounts for 5.6 per cent of gross value-added (GVA) in the economy and grew by 5 per cent a year between 1997 and 2007, compared to average growth of 3 per cent for the whole economy. On a global scale, the UK is ranked third for the exported value of creative services and is the sixth-largest exporter of creative goods. The industry is also a significant employer, providing around 2.25 million jobs in mid-2010 (CMS 2010).

UK defence exports account for 20 per cent of the global market and the UK is ranked the second-largest defence exporter after the US. The UK is also ranked second in aerospace exports. Aerospace industry revenues in 2009 were £22.2 billion, 5.4 per cent higher than in the previous year. The industry relies heavily on exports – 70 per cent of total turnover is exported. Moreover, defence contributes significantly to the aerospace market, being worth 52 per cent of revenues in 2009 (ADS 2010).

The UK is a top destination for international students, second only to the US. In 2008, the UK attracted 335,870 international students for higher education (OECD 2010). As a result, estimates by Universities UK indicate that higher education contributes over £5 billion in export earnings to the UK economy every year. It is also estimated that total higher education in 2008 contributed £34.1 billion to the economy, 2.3 per cent of GDP (Universities UK 2009).

All of these areas need to be nurtured by policymakers if the UK is to achieve its full growth potential in coming years.

### The labour market

There have been significant changes in the structure of the UK's labour force since the 1980s.

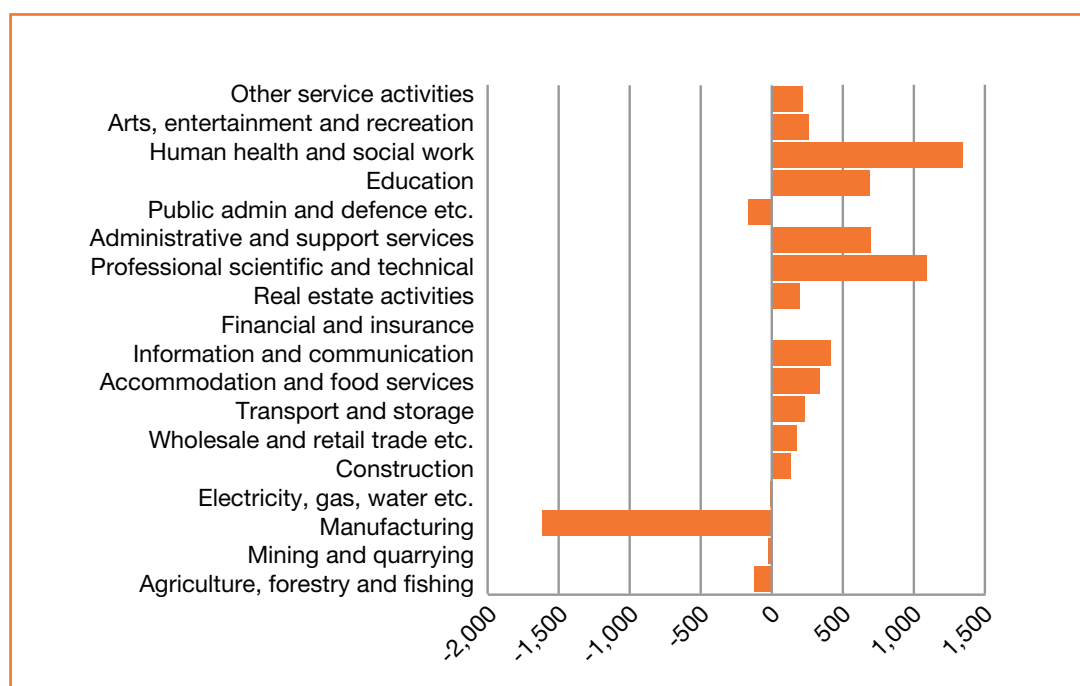
First, while the aggregate inactivity rate (the proportion of people not in work or actively looking for a job) has been remarkably constant, there has been a decrease in the male rate (including big decreases during recessions) and a steady increase in the female rate. As a result, there are more women in the workforce and more two-income households. However, as public services are the only part of the economy where female workers are in the majority, these trends could change over the next four years.

Second, there has been a big decline in employment in manufacturing (over 1.5 million jobs lost since 1993). This has been more than offset by large increases across all parts of the service sector. In particular, there has been strong growth in employment in professional, scientific and technical activities and in health and education. These last two areas are, of course, dominated by the public sector and will see much smaller increases – and probably cuts – in employment over the next few years.

Third, there has been an increase in the number of high-skilled jobs and a (smaller) contraction in mid-skilled jobs. Meanwhile, the number of low-skilled jobs is little-changed, though there have been significant changes within the aggregate. Thus, there are many fewer people working as process, plant and machine operatives and in clerical roles, and many more working in personal services.



**Figure 3.3**  
Change in UK  
employment by sector,  
1993–2011 ('000s)



Source: ONS

The most important driver behind these changes is technological advance. Technology complements the work of high-skilled workers, improving their ability to use their skills and talents (for example in design and research and development) and it cannot replace low-skilled jobs that are hard to mechanise (such as many jobs in the hospitality sector). But it also causes the skills component of some jobs, for example in retailing and personal services, to be reduced. The result is that labour markets in developed economies, including the UK, are becoming increasingly polarised. Over the nine years to the end of 2010, the number of high-skilled jobs in the UK increased by 1.5 million; the number of mid-skilled jobs fell by 250,000, and there was an increase of 100,000 in the number of low-skilled jobs.<sup>8</sup>

These trends are likely to remain important in the future and will overlap with the new factor which is government cuts in the number of public sector jobs to ensure that there will be further significant changes to the structure of the labour force over the next five years.

It would be helpful to have a better understanding of the flows within the labour market that are brought about by these factors. While we have snapshots showing the structure of the labour market at different points in time, and we can see that there are fewer production line workers and more classroom assistants in the UK now than there were 10 years ago, we have little information on the dynamics of the labour market. Where did those production workers who lost their jobs go? And where did the classroom assistants come from? Without this data, it is harder to understand the impact that structural change is having on people's lives.

<sup>8</sup> High-skilled = managers and senior officials and professional occupations; mid-skilled = associate professional and technical, administrative and secretarial and skilled trades; low-skilled = personal services, sales and customer services, process, plant and machine operatives, and elementary occupations

## Conclusion

The UK has seen large changes to the structure of output and employment over the last three decades. In particular, there has been a diminution in the importance of manufacturing and a growth in financial and other business services and in personal services. Further change is likely in future, driven by technological change, globalisation and – over the next few years – by cuts in the public sector workforce.

Attempts to rebalance the UK economy have to be seen in this context. In particular, a balance needs to be struck between, on the one hand, supporting those parts of the economy, including the financial services sector, where the UK appears to have a comparative advantage, so as to maximise growth and a speedy return to full employment and, on the other hand, ensuring that future growth is sufficiently diversified – with more strong sectors – to be resilient to shocks. With hindsight, in the 2000s, the balance was skewed too much in favour of the former. A modern industrial strategy now needs to be developed that will redress the balance.

## 4. OPPORTUNITIES AND THREATS

This new industrial strategy will also need to be framed with regard to some of the key opportunities and threats facing the UK economy. Often these come from the same sources. Three of the most important are the rapid growth of emerging economies and demographic and structural change.

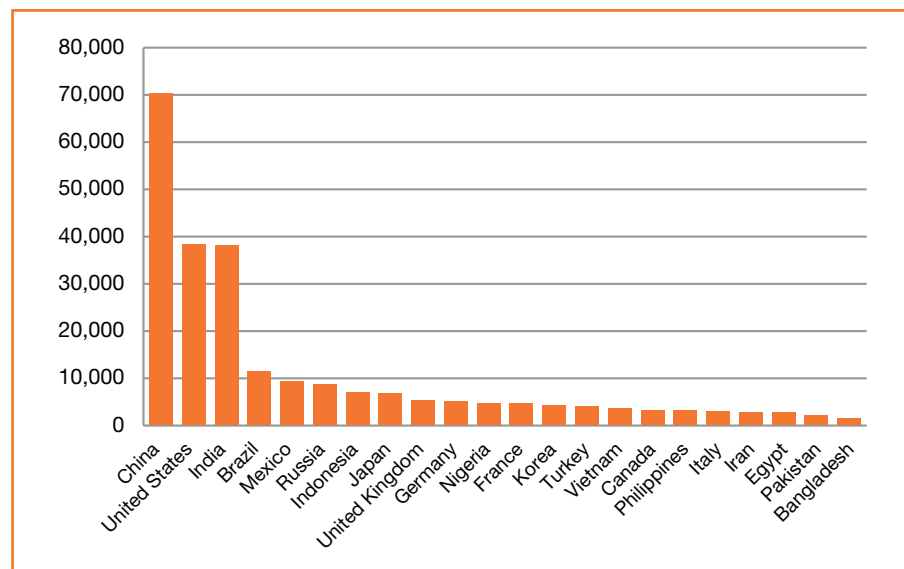
### Emerging economies

The rise of the emerging economies represents a challenge to the UK, but also a significant opportunity, not least because there is a general consensus among economists and policymakers that trade and investment are critical for recovery and long-term growth.

The four BRIC economies,<sup>9</sup> particularly China and India, have become important forces in the global economy. However, the UK has so far failed to take advantage. Only 6 per cent of UK exports currently go to the BRIC economies – less than most of our major competitors'. This represents a lost economic opportunity.

Projections by Goldman Sachs suggest China's economy will soon be the largest in the world, overtaking the US by 2027, at which point it will account for around one-third of the global economy (O'Neill and Stupnytska 2009). By 2031, the four BRIC economies will, in aggregate, be larger than the six biggest developed economies.

**Figure 4.1**  
The world in 2050  
(GDP, US\$ billion)



Source: GS Global ECS Research in O'Neill and Stupnytska 2009

As the BRIC and other emerging economies become richer, they will not just be competitors in export markets and low-cost competition for low value-added manufacturing in the UK. They will be a growing consumer market and potential market for exports. McKinsey (2010) estimates that between now and 2020 approximately 900 million people in Asia will enter the middle class, with a disposable income that will enable them to look overseas for luxury goods, and for services. The Chinese government's latest five-year plan includes the aim of rebalancing the economy towards domestic consumption and developing domestic services. As a result, the type and level of demand will change.

<sup>9</sup> Brazil, Russia, China and India.

This is an opportunity for the UK economy. If the UK is to achieve export-led growth over the next few years sufficient to help restore the economy to full employment and to close the trade deficit, it is likely that it will have to do better in these large export markets. The government appears to recognise this fact, and the prime minister has led trade delegations to both China and India – David Cameron announced £1.4 billion of trade agreements after a meeting with Chinese premier Wen Jiabao in June 2011. However, other countries are eyeing up the same opportunities – the next day, Wen Jiabao signed trade agreements worth over £10 billion with Germany. The UK has much ground to make up.

Seizing the opportunities presented by the development of China and other emerging economies will bring additional benefits, on top of extra export revenues and growth. Firms competing in the global market improve their skills, knowledge and management practices as a result of the ‘export learning effect’ (BIS 2011). There is, therefore, much to gain, but the UK’s recent historical track record does not provide grounds for optimism.

Britain has traditionally been a very open economy – to trade, capital and labour flows – and if growth is to become better balanced it must remain so. But without an active industrial strategy that tries to support the tradable goods and services sectors of the economy, there is a risk that the opportunities presented by the growth of emerging economies will be missed.

### Ageing population

The UK is in the midst of a major demographic transition. It is estimated that by 2030 people aged 65 and older will make up over 20 per cent of the population (McKinsey 2010). This represents a significant challenge to the economy.

There are widespread concerns about how the UK will be able to cope with ageing on this scale, and in particular its fiscal effect through increased demands on public expenditure in areas such as long-term care, health and transport. In 2010, around 65 per cent of Department for Work and Pensions benefit expenditure went to those over the normal working age and spending on services for older people made up nearly half of personal and social services spending (Cracknell 2010). If the state is to continue to provide benefits and pensions at the current level, the cost will increase by £10 billion per year for every additional 1 million people over working age (ibid). The McKinsey report (2010) estimates that, assuming no change in retirement patterns, this demographic shift represents up to 6 per cent of GDP between 2010 and 2030.

The ageing population also opens up intriguing possibilities for companies. Older people now live longer and consume more when they retire than they have ever done before. Their spending patterns differ from those of younger people. There is potential for growth in meeting their needs – as illustrated, for example, by the University of the Third Age. Product innovation might focus on pharmaceuticals, financial products and other goods and services tailored to older people’s needs (Purdy et al 2011).

### Technological change

One of the most important challenges facing the UK economy in the next few years will be anticipating and responding to the opportunities and threats posed by continued technological change. Britain has a relatively poor history in this regard and has been left behind in the past when other countries have led the way – for example, during the transition to the steam engine, the introduction of mass production techniques in the early part of the last century and the adoption of flexible production in the 1960s and 1970s (Lent and Lockwood 2010).

If the UK is to secure sustained economic prosperity, it is critical that businesses move towards the head of the curve as future technological changes occur. One change that will be particularly important in the near future is the development of web 2.0 technologies. These will change business processes and operations across all sectors of the economy, from business services to cultural industries and the retail sector (see Lent and Nash 2011).

The speed at which the latest web technologies – such as online prediction markets, social networking, micro-blogging and peer-to-peer services – are being utilised by companies across the board is striking. A McKinsey survey of global companies found that 65 per cent of firms now use such technologies for business purposes – compared to 50 per cent just three years ago – and that 65 per cent of firms are increasing investment in the interactive web in anticipation of future business needs (Bughin and Chui 2010).

The business opportunities presented by web-based technological change are significant and potentially ground-breaking. They range from productivity gains in production to more effective marketing techniques and improved interactions with customers and suppliers, all of which can have a positive effect on the company's profitability. Furthermore, McKinsey found those firms that make the widest use of the web – including for internal, customer relation and business partner and supply chain purposes – are 50 per cent more likely to report market share gains and faster earnings growth (ibid).

Similarly, companies that embrace 'prosumption' – by which customers are directly involved in the innovation process – may find they can more effectively identify and target core markets and better design and produce their goods and services to match customer demand (Lent and Lockwood 2010). Given that many of the sectors in which the UK enjoys a comparative advantage (legal and finance-based services, creative industries etc) are heavily web-oriented, British businesses are in a good position to benefit from the productivity and market gains promised by the application of these technologies and other emerging web-based innovations – should they choose to embrace them.

However, the same developments pose a number of threats to the economy. In particular, the widespread use of web 2.0 technologies could open up UK industries such as retailing to greater competition, as traditional store-based distribution and sales methods are challenged. In the case of local services and other customer-facing sectors, the transfer of work online will severely impact on jobs and communities. Furthermore, the 'factorisation' of many customer-facing and clerical jobs, which has been driven by advances in technology, has had a levelling-down effect on skills development and utilisation. Going forward, these threats will need to be addressed and mitigated.

British businesses can most effectively respond to and benefit from technological change – web-based or otherwise – if they themselves are the drivers of new technological innovations. Currently, the UK is home to a number of highly innovative niche industries that have significant prospects. In areas such as satellite communications, digital gaming, biochemicals, regenerative healthcare, plastic electronics, marine and wave energy and electric vehicles, UK firms have the potential to fundamentally alter their sectors (HSBC 2011).

Both government and the private sector are critical to stimulating and supporting new and future technological and process-based innovations. But the UK has some way to go in terms of creating the enabling conditions for innovation. NESTA (2011) has suggested that the UK's position on access to finance, public procurement to stimulate innovation, and skills for innovation are average at best. At the same time, infrastructure to support new technologies and processes is severely lacking.

## Conclusion

There will be many challenges facing the UK economy over the next decade; some cannot be identified at this juncture, but others can. Rapid growth in the emerging economies, demographic change and technological advance are likely to be three of the most important. But all three also offer opportunities. When developing economic policies to promote growth, these challenges and opportunities need to be taken into consideration; otherwise the UK is likely to be left behind.

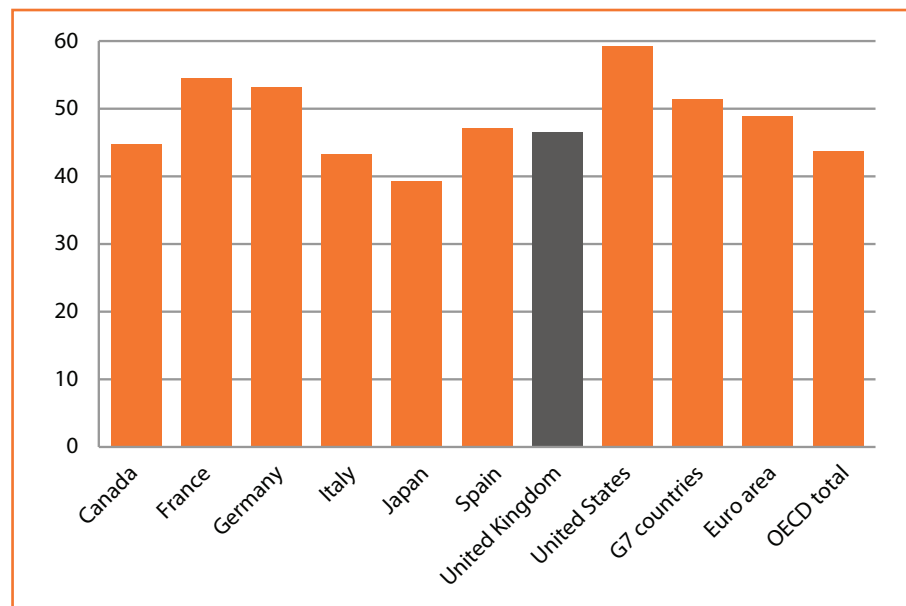
## 5. SUPPLY-SIDE DEFICIENCIES

At this juncture, with the economy struggling to emerge from recession and over 2.5 million people unemployed, a balance needs to be struck between rebalancing the UK economy to make it more resilient to shocks and achieving the maximum possible growth in order quickly to return output to something like full capacity. Progress towards both aims is likely to be assisted by measures to reduce the supply-side deficiencies that are holding back economic activity. These deficiencies are reflected in the UK's still relatively poor productivity and trade performance, and are apparent in areas including investment, skills and innovation.<sup>10</sup>

### Productivity

Productivity is a key driver of economic performance. While significant productivity gains have been made in the British economy in recent years (GDP per head in the UK increased faster than in any other G7 economy between 1994 and 2009), productivity in the UK remains lower than in our major competitors. GDP per hour worked in the UK is lower than the G7 average and around 20 per cent lower than in the US, 14 per cent lower than in France and 10 per cent less than Germany.

**Figure 5.1**  
GDP per hour worked  
in the major economies,  
2010 (US\$)



Source: OECD

Large firms in the UK – particularly, but not exclusively, those that compete in international markets – compare favourably with their overseas counterparts. They have to, because if they did not they would lose market share, become less profitable, and eventually go out of business. The UK's productivity problem is due to a 'long tail' of smaller firms in domestic sectors, where they are not open to overseas competition. These firms have relatively low levels of productivity. McKinsey (2010) attribute this weakness to poor management structures and processes and a lack of effective competition.

Some argue the UK's relative position is not as bad as it seems. A recent report by BIS and NESTA (2011) adopts a different approach to measuring UK productivity. They account for spending on knowledge or intangible assets as investment rather than

<sup>10</sup> This section draws heavily on research conducted by Adam Lent and David Nash (2011).

as intermediate consumption. Intangible investments include design and intellectual property, research and development, software development and investment in training, organisational development and branding. According to this study, labour productivity growth has been higher in the UK than traditional measures suggest.<sup>11</sup> To the extent that the UK spends more on these items, this implies that the productivity gap between the UK and its competitors is not as great as it may at first seem (Marrano et al 2007).

However, the balance of evidence still suggests the UK lags behind many of its competitors in productivity levels – and that it has done so for many years. This is likely to reflect deficiencies in a number of areas, including innovation and investment in skills, machinery and infrastructure.

## Trade

The UK's trade performance in recent decades has been noticeably poor. Like other developed economies, the UK has seen its share of world trade shrink as emerging economies increase their shares, but the decline in the UK has been rather greater than elsewhere. More particularly, the UK recorded a trade deficit in 23 of the last 25 years, and in each of the last 14.

The problem appears to have begun in the early 1980s when – in part because North Sea production led to a trade surplus in oil and in part due to extremely tight monetary policies – sterling's exchange rate rose significantly.<sup>12</sup> This led to a marked deterioration in the trade balance in non-oil goods as exporters struggled to compete in world markets and imports surged during the 'Lawson boom' in the late 1980s. There followed a brief respite in the mid-1990s, when UK companies enjoyed a boost to their competitiveness after sterling was ejected from the European exchange rate mechanism (ERM) – this was the last time that the UK recorded an overall trade surplus. Subsequently, there has been a steady deterioration in the overall trade balance and in the balance in goods, while services have recorded surpluses. Capital inflows to the City, driving the exchange rate higher and so making other industries less competitive, are part of the explanation for these trends. The recession in 2008–09 led to only a temporary and very small improvement in the trade balance.

There are hopes that, as part of the rebalancing of the UK economy, the UK's trade performance will improve, and this is built into the OBR's forecasts for the next five years (OBR 2011). At the beginning of 2011, there were grounds for optimism, as export volumes were increasing strongly, but more recently growth has slowed in line with a slowdown in world trade. Exports have increased by just 4 per cent, in volume terms, over the last year. It seems that, just as in the mid-1990s, UK exporters can benefit from past weakness in sterling's exchange rate – but only when the global economy is also strong. Sterling's 25 per cent fall (in trade-weighted terms) in 2008–09 was larger than its decline when it left the ERM.

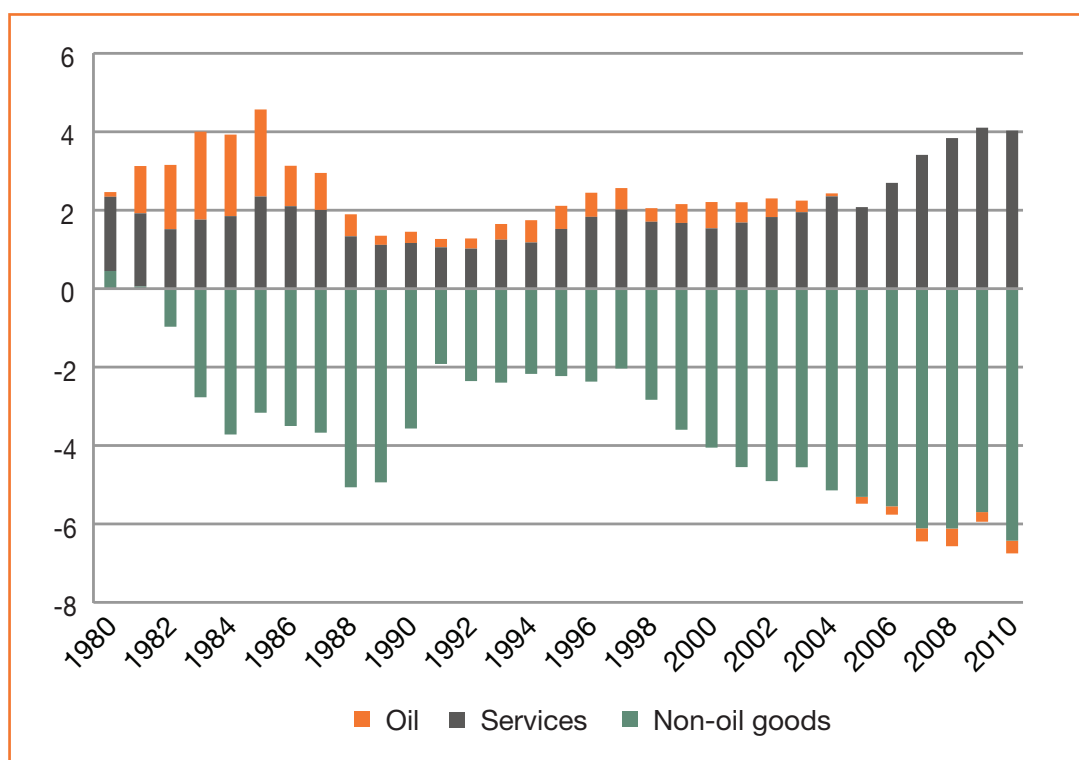
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11 Because value added by companies is higher if intermediate inputs are lower.

12 Economists refer to the rise in the real exchange rate following the discovery and exploitation of a large natural resource as 'Dutch disease'.



**Figure 5.2**  
UK trade balance  
(% of GDP)



Source: ONS

However, sustaining this performance will require the European economic recovery to be maintained (which is extremely unlikely in the short term), since Europe is the destination for over two-thirds of the UK's exports, and sterling to remain around current levels. Even then, there is a long way to go before the UK becomes a trade-surplus nation again.

The evidence of the last 30 years is that the UK economy, if left largely to its own devices, will not produce a healthy balance of growth between exports and meeting domestic demand. It could be argued that running a persistent trade deficit has been sustainable and is not, therefore, a problem, or that the UK's deficit is due mainly to factors outside its control (such as a surplus of savings in emerging economies). But there is a limit to how long the UK can go on selling its assets or taking on external liabilities to cover its trade gap.

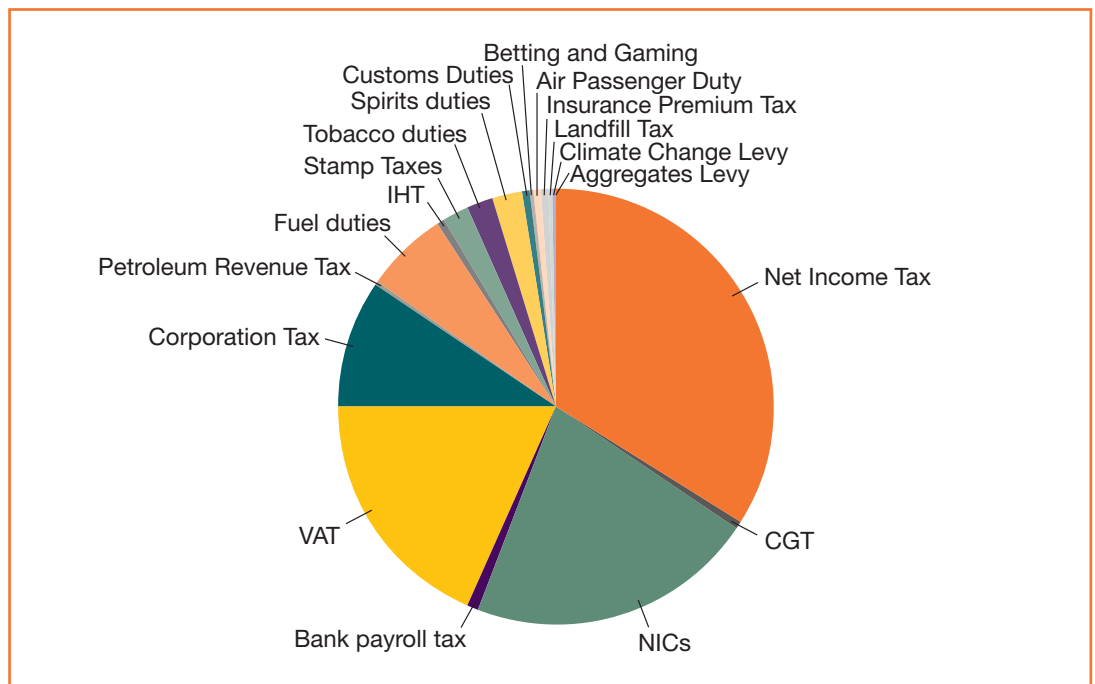
### Tax base

The Mirrlees report – the result of a multi-year study – argues that the UK tax system should be efficient and equitable (IFS 2011). It defines efficiency as raising the maximum amount of revenue for the minimum loss of welfare to the population as a whole but it cannot offer a definition of an equitable system because there is no universally accepted measure of equity. It goes on to recommend a number of changes to the UK tax system to make it more efficient and equitable.

The last few years have highlighted another desirable feature of the tax system: resilience. The UK fiscal deficit widened more than deficits in other European countries as a result of the 2008–09 recession because of a relatively large fall in tax revenues. This limited the government's ability to respond to the recession with discretionary tax cuts or spending increases, and contributed to the scale of the fiscal problem now being tackled by the

Coalition government. A more resilient system – one that brought in revenues from a more diverse mix of sources – would have given the government greater flexibility in the recession and left it with a smaller problem in its wake.

**Figure 5.3**  
Tax revenues, 2010–11  
(% of total)



Source: HM Revenue and Customs

The problem was that the government was over-reliant on two sources of revenue – the City and the housing market – which, as it turned out, were connected. Just before the recession, the City was paying around one-quarter of all corporation tax paid in the UK. In addition, rocketing salaries and sky-high bonuses boosted income tax receipts and national insurance contributions from the same source. Meanwhile, the booming housing market meant higher revenues from stamp duty, capital gains tax and, to a lesser extent, inheritance tax. The government's spending plans were based, in part, on the assumption that these sources of revenue were sustainable.

With hindsight, this was not the case. Rebalancing the economy could help to make the tax base more resilient, for example if future housing bubbles were avoided or the role of the financial sector was reduced. But a reassessment of the mix of tax revenues is also required so that future governments have more room to manoeuvre in future downturns, while ensuring that incentives for growth are maintained and disincentives are minimised.

## Innovation

Innovation is a key driver of productivity growth, and thus of economic growth. The most recent annual innovation report produced by NESTA and BIS says that innovation accounted for 63 per cent of labour productivity growth between 2000 and 2008, while investments in intangibles accounted for another 23 per cent (BIS and NESTA 2011). It also argues that in 2008 innovation helped to limit the negative impact of the recession on productivity.

On several measures, UK companies appear to be less innovative than foreign firms. According to Eurostat (2011), the UK ranks 17th out of 27 EU member states in terms of the number of businesses classified as ‘innovation active’. Only 46 per cent of UK businesses have undertaken some form of innovation activity – whether product or process-based – compared to a reported 80 per cent of German firms and 50 per cent of French firms. UK firms also tend to be less successful in generating turnover from product innovation than many of their European competitors. In 2006, the UK ranked 11th in the EU for the share of business turnover derived from product innovations – only 8.5 per cent of total sales of UK firms was attributed to product innovation, compared to 19.2 per cent for their German counterparts.

Spending on research and development (R&D) is another indicator used to gauge the pace of innovation, though this is using a measure of input to assess the level of output. R&D intensity<sup>13</sup> in the UK is in-line with the European (EU-27) average at around 1.8 per cent. However, it is below the level recorded in the US, Germany and France. In part, the gap between the UK and Germany may reflect differences in the sectoral mix of these economies: on the whole, there is less R&D expenditure in financial services and more in manufacturing, and the UK does relatively more of the former while Germany does more of the latter. But this does not explain why the UK lags behind the US and France. The UK is described as a ‘mid performer’ in terms of the conditions required for innovation spending. It scores poorly on access to finance and the use of government procurement to stimulate innovation.

Research by NESTA reveals how innovation stems from a variety of sources, not just R&D. Intangible investments are increasingly recognised as significant sources of innovation and when these are taken into account the UK performs better in comparison with other countries (BIS and NESTA 2011).

Nevertheless, the UK does appear to have a weakness in this area. Government has a direct role in supporting basic research, and the fact that the science budget was spared the worst of the public spending cuts is to be welcomed. But it also needs to encourage spending on research and development by companies and on better commercialisation of new ideas. One possible solution might be an expansion of innovation zones, but other approaches also need to be explored.

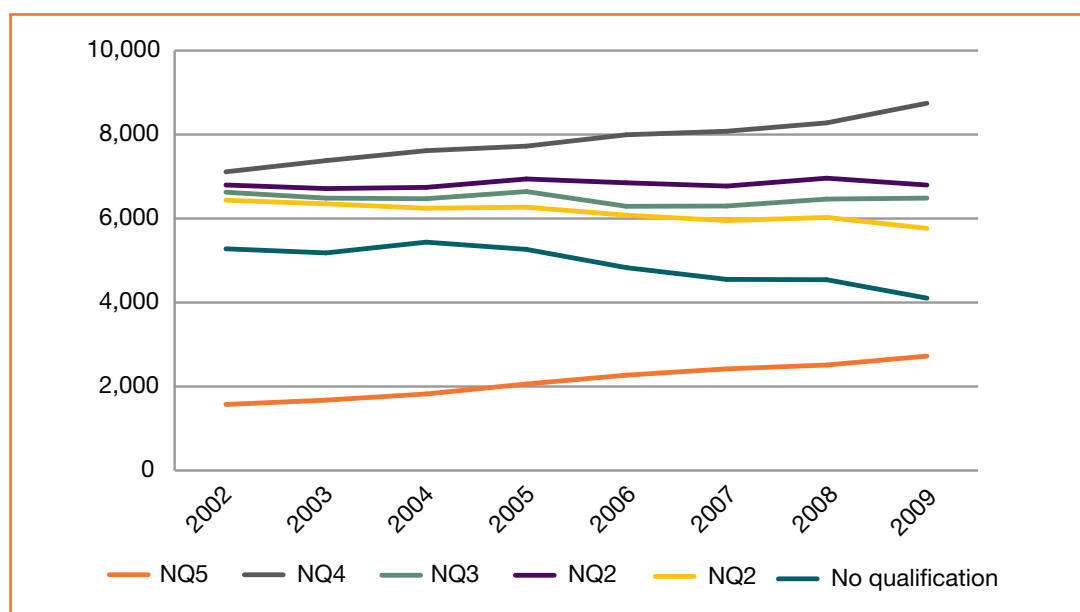
## Skills

The UK has registered significant improvements in education attainment at all levels over the past two decades. Between 1994 and 2005, the proportion of adults in England with a higher level qualification increased from 21 to 29 per cent, while the proportion without a qualification fell from 22 to 13 per cent (Leitch 2006). However, the same is true in many of our competitor countries.

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13 The total level of expenditure as a share of GDP.

**Figure 5.4**  
UK workforce by highest  
level of qualification  
attained ('000s)



Source: UKCES 2011

The UK's skills base remains relatively poor compared to many of our key competitors. According to the latest comparative data, compiled by the OECD for 2008 (published 2010), the UK ranks:

- 17th out of 31 OECD countries in terms of the proportion of adults aged 25–64 with low or no qualifications (described as 'below upper secondary', which equates to less than level 2 in the UK), with 30 per cent in this category. Although identical to France, this is more than double the proportion in the best-performing nations. Only 15 per cent of adults have low or no qualifications in Germany and only 11 per cent in the US.
- 21st for the proportion with intermediate education (upper secondary and post-secondary non-tertiary), with only 37 per cent of adults qualified to this level. This compares to 43 per cent of adults in France, 48 per cent in the US, 57 per cent in Japan and, thanks to its highly-developed apprenticeship system, 60 per cent of adults in Germany. The UK has made minimal progress since 1997 in raising the proportion of adults qualified to this level.
- 11th in terms of the number of adults acquiring tertiary (university) education, with 33 per cent holding a university degree in 2008. This is notably higher than in France and Germany (27 and 25 per cent respectively), but lower than in the US, Japan or Canada, where the proportion of adults qualified to this level is over 40 per cent.

A particular problem appears to be a shortage of young people qualified in the STEM subjects (science, technology, engineering and maths). A CBI/EDI study in 2010 found that nearly half of employers were struggling to hire STEM-qualified employees and predicted that the situation would worsen over the following three years.<sup>14</sup>

Another problem is that increases in the supply of skills have not always been matched by increases in demand from businesses for skilled professionals. This leaves people frustrated at not utilising the skills they have acquired, sends the wrong message to

<sup>14</sup> See <http://www.guardian.co.uk/education/2010/may/18/skills-shortage-worsens>.

others about the benefits of getting more skills, and represents underutilisation of the UK's human capital, and thus a loss of potential output.

Businesses have also been reluctant to take responsibility for funding in-work training and skills development. This problem tends to be associated with small and medium-sized – and particularly family-run – firms, and is often blamed on a lack of capital to tap into skills and poor management structures and HR practices (Bloom and Van Reenen 2010). As a result, the UK's record on business investment in skills and training is relatively poor and it is a below-average performer on various measures of training and apprenticeships. Currently, one in three UK firms provides no training at all, rising to half in some sectors and especially among smaller businesses (UKCES 2009).

The recession had an impact on employer investment in training, but the effect was less pronounced than might have been expected, with total investment falling by only 5 per cent after inflation in 2009. Moreover, although the percentage of the UK workforce receiving training in 2009 fell by 7 per cent (to 56 per cent, or 12.8 million people), more is being spent per head on each member of staff being trained (ibid). However, there is a significant risk that the government's newly-proposed employment law reforms, which will remove incentives for employers to invest in workforce skills and retain staff, may lead to reduced spending by business on skills investment.

The root cause of the UK's relatively poor performance on skills is not simply a shortage of resources, although historically less has been spent on public funding for education in the UK than in many other countries and it is only in recent years, following substantial increases, that public funding has risen to just above the OECD average.

The UK's skills deficit and underutilisation of skills has a negative impact on economic productivity and also on employment levels. Approximately one-fifth of the UK's productivity gap with countries such as France and Germany is due to our skills deficit (Leitch 2006) and it has been suggested that the UK's employment rate could increase by 10 percentage points over the next 30 years if adult skill levels were significantly improved (Leitch 2006). Certainly, employment rates increase with skill levels, from around 50 per cent for those with no qualifications to over 85 per cent for those with degrees (UKCES 2009).

Previous governments have attached enormous importance to skills policy as the driver of everything from economic growth to social justice, so the UK's relatively poor outcome is not the result of lack of effort to make improvements. This suggests a new approach, in terms of the conception of skills policy and the way it is implemented, needs to be developed. This should recognise that improving the nation's skills will only help businesses to grow if employers can be persuaded to use people's talents to the full, if qualifications provide the skills that match the future needs of the labour market, and if skills policy is coordinated with other relevant policy areas.

Given the constraints on public spending, there will have to be more incentives for employers in sectors where there are skills gaps to invest in workforce skills. But, while skills gaps per se are a problem in some key growth sectors, in many low-paid sectors the issue is instead the poor utilisation of skills by employers, and consequently low productivity. As a result, one-fifth of the UK workforce is low-paid, and millions of people work in low-skilled jobs that offer poor opportunities for progression.

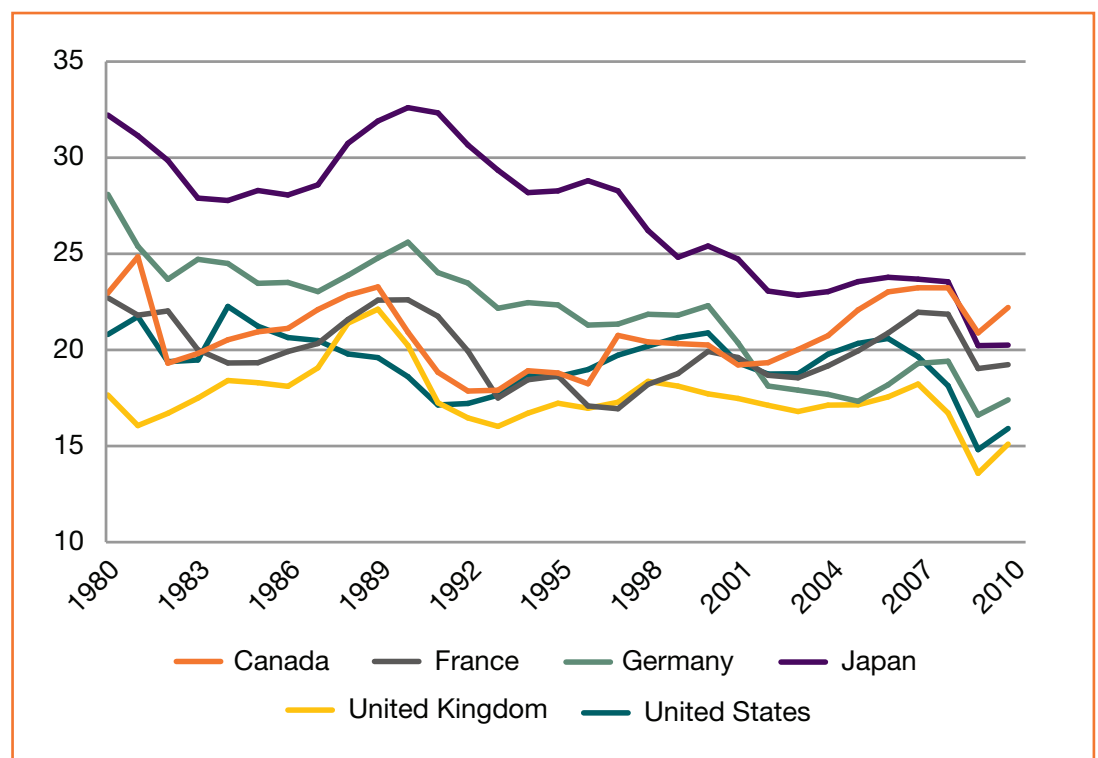
Work needs to be done to understand how the design, delivery and funding of skills policy in the UK can be improved to meet the need for a sustainable economic recovery and

to support the government's vision for a better-balanced economy. This should include scrutinising the impact of labour market flexibility on workers, skills and productivity and exploring how to create career ladders for people in low-skilled, low-productivity jobs. It will also have to look afresh at the institutional framework for skills to see how employers can be encouraged to do more and how collective cost-sharing by employers, the state and individuals might work. Recognising that globalisation and technological change will keep job turnover high, it should also look to overseas examples, such as the Danish system which combines relatively low levels of employment protection with high levels of support for life-long learning.

### Investment

Investment as a share of GDP in the UK has for many decades lagged investment in major competitor countries, such as Germany, the US and Japan. While this gap appeared to be narrowing after the early 1990s, it has begun to widen again recently. Business investment in the UK fell to a low of 9.7 per cent of GDP in 2006 and only recovered to reach 10.2 per cent in 2008 while the US, Germany and France saw business investment rates rise to 11.7 per cent, 12.3 per cent and 12.7 per cent respectively in 2008 (BIS 2010).

**Figure 5.5**  
Total investment levels  
(% of GDP)



Source: IMF, World Economic Outlook Database, September 2011

Although one might expect business investment rates to be lower in the UK than in an economy like Germany's – because of the dominance of the service sector, which is less capital-intensive and requires lower levels of investment in fixed assets than manufacturing – the UK's sectoral mix is not very dissimilar to the mix in most of its competitor economies. In 2007, services contributed 76.3 per cent of GVA in the UK, less than in the US and France. Yet the UK investment rate has been persistently lower than in both

these countries, suggesting the UK does have a problem of low business investment. Furthermore, a disproportionate share of investment in the UK has tended to be skewed towards property and financial services rather than innovation and productivity in a wider range of sectors.

There is also a perception that the UK's infrastructure is inferior to that of many of our European neighbours'. Having the right level of infrastructure – including traditional infrastructure like roads and railways and more modern infrastructure such as high-speed broadband – will be crucial if the economy is to grow strongly in the medium term. It is hugely disappointing therefore that the Coalition government has followed through with its predecessor's plans to make huge cuts in government capital spending over the next few years.

Other funds are unlikely to fill the gap because there are large externalities in infrastructure spending that act as a deterrent to private sector provision. This suggests that one possible solution to the UK's low investment problem could be a state investment bank.

Depending on its mandate, this could also be used to help tackle regional inequalities, increase the supply of social housing, improve the state of the nation's infrastructure and support the transition to a low-carbon economy. The government has already announced the establishment of a Green Investment Bank, but it is on a very small scale<sup>15</sup> compared to state banks in other countries, such as the German KfW Bank and the Nordic Investment Bank, and has a much narrower mandate.

State investment banks are in theory able to provide the funds for projects that are less attractive for the commercial banking sector. In part, this reflects their ability to raise funds more cheaply than commercial banks. But, more importantly, in assessing the attractiveness of a project, they are able to build into the benefits side of the equation any externalities that will result from its completion.

This is not a new idea, but it now needs to be taken forward through a detailed and technical analysis of what a UK state investment bank would look like and what lessons can be learned from state banks in other countries. This would need to cover the governance structure of the bank, its potential lending practices (what it would fund) and the constraints that would be placed on such practices to avoid 'mission creep', how the bank would be capitalised, and how it would raise funds. Consideration would also have to be given to EU rules on state aid, which might pose difficulties for a fully-fledged state investment bank.

An alternative idea would be for the UK to set up an investment fund – possibly along the lines of the sovereign wealth funds established by a number of other countries, including Norway, China and several Middle East oil exporters. Generally, these funds are being used to store the wealth of finite windfall gains by the present generation (in the form of North Sea oil in the case of Norway) so that it will benefit future generations. As such, they invest in a broad range of assets domestically and in overseas countries. A UK sovereign wealth fund would be rather different in nature. It might be funded by the proceeds of the sale of the state's banking assets and of 4G licences, and be more constrained as to where it could invest.

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15 Its initial capitalisation will be £3 billion and it will not be able to borrow on capital markets until the government has begun to reduce the aggregate level of public debt.

Surveys of business consistently show that a lack of available credit is a barrier to investment, particularly for small and medium-sized enterprises that are very reliant on banks for finance. Ways need to be found to make the financial system more supportive of growth in the rest of the economy or to find alternative sources of finance (and the government is exploring the notion of 'credit easing'). This should not just be about increasing the supply of credit from banks to small and medium-sized companies, although that will be important, but also about developing a deeper market for corporate credit.

### Small businesses

It appears that much of the weakness in the UK's economic performance, relative to our competitors, is due to small and medium-sized businesses. This could be particularly problematic over the next few years. Much employment growth in the last decade was concentrated in large employers – government, the NHS, the City, retailers. Over the next decade, they are likely to be shedding workers, in aggregate. If the economy is to rebalance and return to full employment, small businesses (and self-employment) will have to take up much of the running in terms of job creation.

For this to happen, they will have to improve their productivity performance and become more competitive. This will require a better record on training and employee engagement. They will also require the finance to enable them to expand, and the desire to develop export markets and to move from being small to medium-sized businesses.

### Conclusion

Productivity levels in the UK are only likely to be lifted closer to those in other developed economies by a concerted effort involving companies and government. A new approach is needed and this should be based on what has worked in the UK in the past, what works in other countries and on new ways of thinking about the economy – seeing it as a dynamic system without a natural tendency to equilibrium. Such a policy would emphasise collaboration between government and private industry to discover the best way forward in areas such as infrastructure, skills and competition law. It would identify the ways in which stakeholders in the economy could embark on a discovery process to find the best ways to support growth and look at how institutions might need to change to facilitate this process. And it would analyse the types of intervention that might be necessary, whether to correct specific market failures, such as through a state investment bank, or through more holistic interventions, such as smarter forms of regulation and improved competition laws.



## 6. DISPARITIES

If the first priority is to ensure that the UK has strong and sustainable growth over the next few years, the second is to ensure that the proceeds of that growth are more equally shared than in the past. Four disparities should be of particular concern:

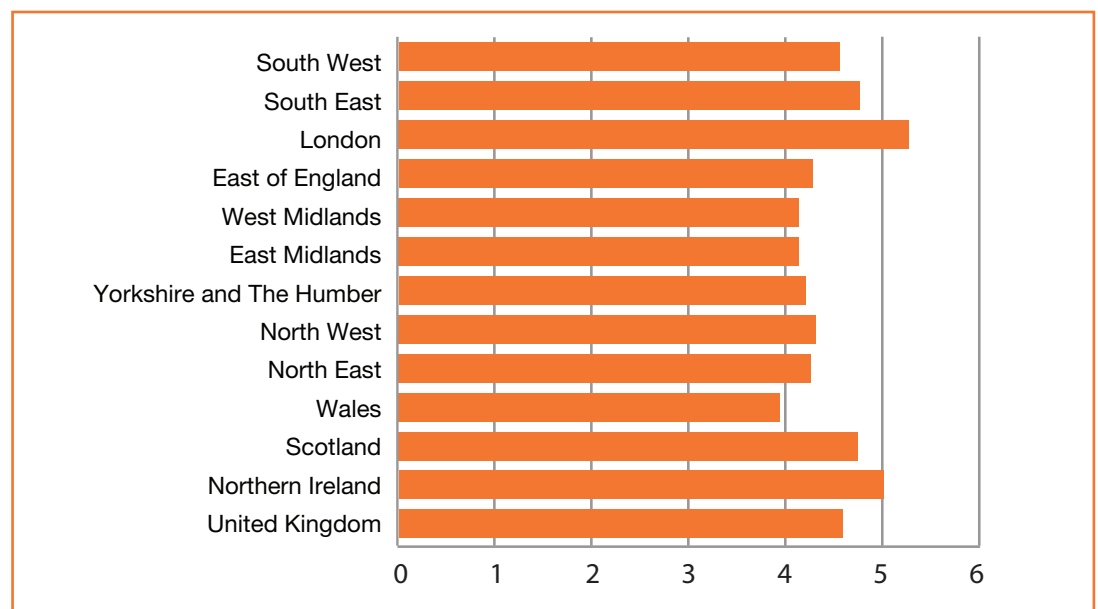
1. Regional disparities
2. Income (and wealth) inequalities
3. Disparities between those in work and those unable to find work
4. Intergenerational inequalities

### Regional disparities

There have been large regional differences in economic performance across the UK in recent economic cycles. Broadly speaking, the south of England (London, the South East and the South West regions) has fared rather better than the rest of the country.

This is evident in growth rates of GVA per head.<sup>16</sup> Since 1989, national GVA per head has increased at an annual rate of 4.6 per cent, but all three regions in the south of England did better (as did Scotland and Northern Ireland), while all regions in the north of England and the Midlands fared worse. The differences may not appear large in figure 6.1, but when accumulated over 20 years they become very significant. London's GVA per head was up a total of 180 per cent between 1989 and 2009, compared to an increase of 125 per cent in both the West and East Midlands.

**Figure 6.1**  
Annual GVA per head  
growth rates by region,  
1989–2009 (%)



Source: ONS

As a result, London's share of national GVA increased from 15.9 per cent in 1989 to 19.2 per cent in 2009, and the share of the south of England was up from 37.4 per cent to 41.9 per cent.

<sup>16</sup> The figures quoted here are in current prices. Constant price figures, which would show real growth in GVA by region, are not available. The analysis is based on region of residence. Data is also available based on region of workplace and that shows very similar results.

There were also distinct regional trends in employment during the last economic recovery. Over the 15 years from April 1993 (the trough for employment after the 1990s recession) to April 2008 (the peak for employment ahead of the most recent recession), employment in Great Britain increased by 16.6 per cent. Across the south of England and in Wales, employment growth was stronger; in the Midlands, the north of England and in Scotland it was weaker.

**Table 6.1**  
Changes in employment  
by region, 1993–2008  
(%)

	April 1993 to April 1998	April 1998 to April 2008	April 1993 to April 2008
North East	1.1	8.9	<b>10.1</b>
North West	0.5	9.0	<b>9.6</b>
Yorkshire and the Humber	1.6	10.8	<b>12.6</b>
East Midlands	5.9	9.0	<b>15.4</b>
West Midlands	7.1	3.1	<b>10.5</b>
East	7.0	10.3	<b>18.0</b>
London	7.0	18.4	<b>26.7</b>
South East	8.6	8.9	<b>18.2</b>
South West	9.1	11.9	<b>22.0</b>
Wales	4.3	13.3	<b>18.1</b>
Scotland	3.7	11.8	<b>15.9</b>
<b>Great Britain</b>	<b>5.4</b>	<b>10.6</b>	<b>16.6</b>

Source: ONS, Labour Force Survey

There were two distinct sub-periods during this time. The overall annual rate of growth was similar in both, but the regional distribution was very different.

In the first five years of recovery, employment increased at an annual rate of 1.1 per cent in Britain. Three regions – the North East, the North West and Yorkshire and the Humber – lagged well behind. Over the next 10 years, aggregate annual employment growth was 1.0 per cent. In this period, employment growth in London was well above the average, reflecting the increasing importance of areas such as finance and business services, while the decline in manufacturing meant that employment growth in the West Midlands lagged well behind the national average. Across other regions, with the exception of Wales, employment growth was very similar and close to the average.

However, employment in some of the regions that lagged behind during the last recovery – particularly the North East, Yorkshire and the Humber, the West Midlands and Scotland – was boosted disproportionately over the period from 1998 by increases in public sector employment. Research suggests more than half of job creation in the UK over the period 1998–2007 took place in the state and para-state<sup>17</sup> and that in some regions – the North East, Yorkshire and the Humber and Scotland – the proportion was considerably higher (Buchanan et al 2009). Indeed, in the West Midlands it appears private sector employment contracted and the increase in state and para-state employment was larger than the

<sup>17</sup> That part of the private sector that is dependent on public spending.

overall rise in employment. Only in London, the South East and the South West did the private sector account for more than half of all job creation in this period.

So, unless there is a remarkable turnaround in private sector jobs growth, large areas of the country face a particularly difficult few years while the government is cutting public sector employment. The result could be an increased polarisation of the labour market – relatively depressed in much of the north of England and in Scotland, with any increase in jobs concentrated in the south.

If the government desires balanced growth across the country, it will need to take action to ensure such an outcome. Regional development agencies have been abolished, replaced by local enterprise partnerships (LEPs) – locally-owned partnerships between local authorities and businesses charged with identifying economic priorities and driving economic growth and local job creation. How successful they can be in meeting these aims will depend, to a large extent, on the powers that they – and local councils – are given. For example, LEPs will need to take responsibility for business support, innovation and attracting inward investment into their areas. And they need financial incentives to drive growth. Tax incremental financing is a start, but the government should also lift restrictions on other forms of local revenue-raising and ultimately reach a new financial settlement with those LEPs that can demonstrate success.

However, the likelihood is that, if future prosperity is to be enjoyed across all regions of the UK, a new industrial strategy with a substantial regional element to it will have to be designed and implemented.

### Income and wealth inequalities

There was a big shift in income inequality in the UK in the 1980s. A range of measures, including the Gini coefficient<sup>18</sup> and the ratio of income at the 90th percentile to income at the 10th percentile, show a large increase in inequality whether incomes are measured before or after taxes and benefits and whether pensioner households are included in the analysis or not. By comparison, since the end of the early 1990s recession, shifts in income inequality have been less dramatic.

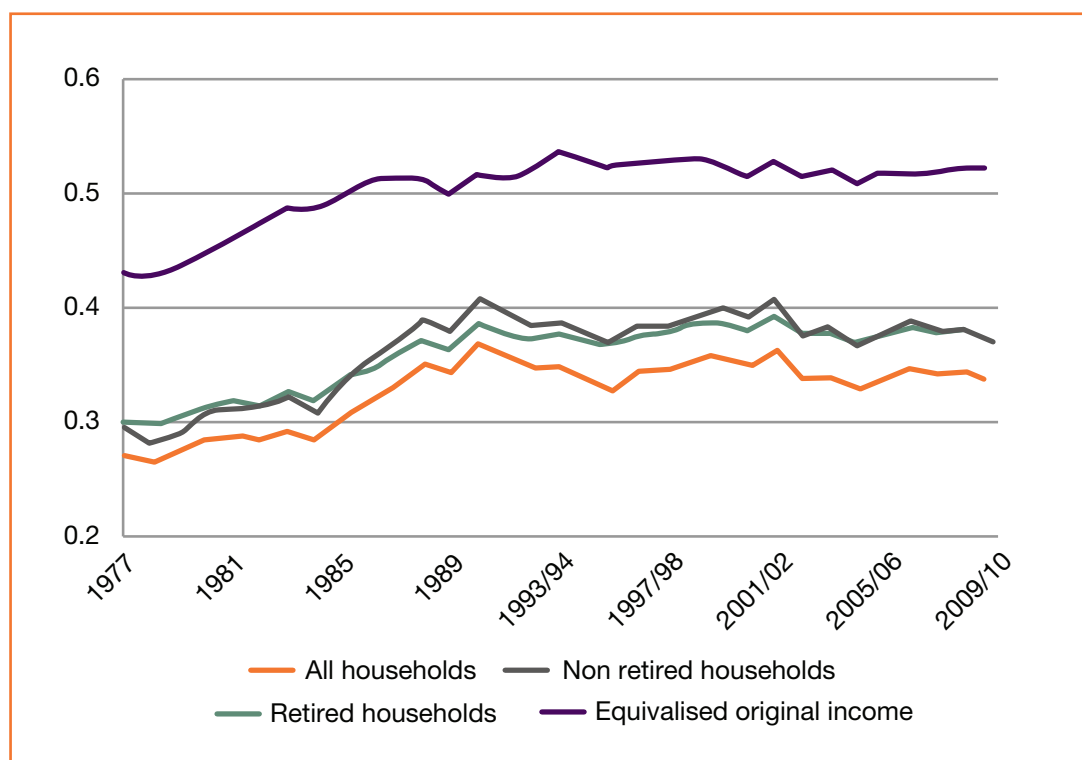
Detailed analysis by the Institute for Fiscal Studies (IFS) shows that income inequality did edge a little higher under Labour from 1997 to 2010 (Jin et al 2011). This was largely due to rapid income growth for the top one or two per cent of the income distribution. The IFS's analysis shows that in 1979 a person marginally in the top percentile of earners had an income 3.0 times larger than someone on the median income. By 1996/97, that ratio had increased to 4.4 times, and to 5.6 times by 2009/10.

Furthermore, the IFS's calculations are all on the basis of income after taxes and benefits. Increases in spending on benefits and tax credits under Labour mitigated the increase in inequality, whereas changes under the Conservative government from 1979 to 1997 tended to increase it (Adam and Browne 2010). The underlying picture, therefore, is for a continued trend to greater inequality in original (that is, pre-tax and benefit) income.

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<sup>18</sup> A measure of the degree of inequality in the income distribution. It takes the value zero when incomes are perfectly equal and one when they totally unequal (ie when one person is getting all the income).

**Figure 6.2**  
Gini coefficients for  
different income  
measures in the UK



Source: ONS

According to OECD estimates,<sup>19</sup> on the basis of the Gini coefficient of income inequality, the UK was the seventh most unequal country out of its 30 members in the mid-2000s – a position that has probably not changed much in the intervening years.

And inequalities in wealth are even greater than inequalities in income. The National Equality Panel, chaired by John Hills, reported the first analysis of the distribution of wealth in the UK based on the new Wealth and Assets Survey in January 2010 (NEP 2010). It used three different definitions of wealth: net financial and physical wealth, net non-pension wealth and total net wealth, and showed that whichever definition was chosen the ratio of the wealth of the richest households to the median is far greater than the same ratio for income.

There has been much debate about the effect on inequality of the tax and benefit changes being implemented by the government as part of its effort to cut the fiscal deficit, with the government arguing they are progressive (that they will reduce inequality), others that they are broadly neutral, and still others, including ourselves, that they are regressive (though those on the highest incomes will be hardest hit – largely due to the 50p income tax rate and changes to tax relief on pensions).

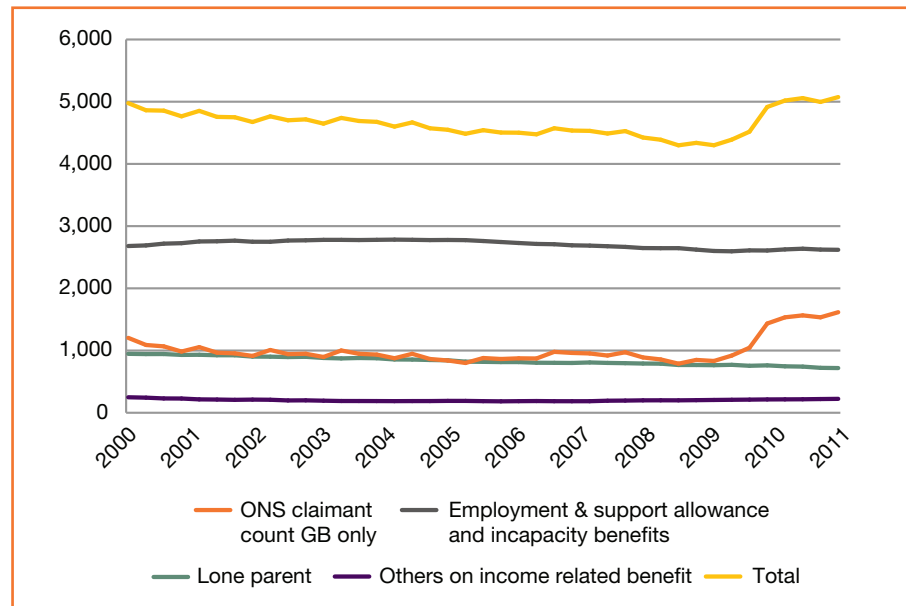
However, unless the underlying trend towards greater inequality in original incomes is reversed, little progress will be made in reducing income disparities in the next few years. Attention now needs to turn to how inequalities in pre-tax pay can be reduced. Ideas like the ‘living wage’ and a high pay commission, among others, need to be developed.

19 Data available at <http://stats.oecd.org/Index.aspx?DataSetCode=CSP6>

## Disparities between the in-work and the out-of-work

Arguably, one of the greatest failures during the last economic recovery was the fact that the number of people receiving out-of-work benefits never fell below 4.25 million, despite 16 consecutive years of output growth. Admittedly, the number of unemployed and the number of lone-parent claimants did decline between 1999 and 2007, but no inroads were made into the numbers claiming employment support allowance (or its predecessors, incapacity and invalidity benefit).

**Figure 6.3**  
Claimants of out-of-work  
benefits ('000s)



Source: ONS

This was a problem that arose initially in the 1980s. As a result of the deep recession in the early 1980s, unemployment in the UK soared to over 3 million and stayed around this level for several years. Eventually, people – particularly those who had previously been employed in declining industries, had non-transferable skills or lived in areas of very high employment – became detached from the labour market.<sup>20</sup> Some took early retirement; others shifted from unemployment benefit to invalidity benefit (as it was then called). So, although unemployment did eventually fall, the total number claiming out-of-work benefits fell less.

The problem developed into a classic insider-outsider one. Workers who held on to their jobs retained their skills and were able to develop them. This made them more attractive to employers, who are naturally more inclined to stick with their existing workforce in any case, so as to avoid hiring and firing costs, and are reluctant to sack existing workers and employ unemployed people even at a lower wage, because of its effect on the morale and productivity of the workforce.<sup>21</sup> Meanwhile, workers outside employment found their skills becoming increasingly irrelevant and their chances of finding sustainable employment diminishing over time.

<sup>20</sup> A phenomenon that economists refer to as hysteresis.

<sup>21</sup> As a result, firms are said to pay an efficiency wage rather than a wage that clears the labour market.

The risk in the next few years is that hysteresis sets in again. If the economic recovery is slow, or is not 'jobs-rich', long-term unemployment will increase and remain high. As a result, some men and – for the first time in the UK – significant numbers of women could permanently leave the labour market, as their skills become redundant or they are discouraged from seeking work. Hysteresis effects could be magnified by regional disparities in employment growth – the North East, Yorkshire and the Humber, the West Midlands and Scotland will lag behind unless there is a marked turnaround in the willingness and ability of the private sector to create jobs in these regions. This requires a direct policy response in the form of a job guarantee for anyone who has been out of work for 12 months or more, combined with the threat of loss of benefits for anyone who refuses to accept the job offered.

Policies to promote economic activity in the private sector will have to be designed to ensure that growth is jobs-rich in order to make significant inroads into the number of people claiming out-of-work benefits. But it will not be enough just to replace out-of-work poverty with in-work poverty: a successful economic recovery would see the creation of more middle-paid jobs, giving those on low pay something to aspire to and combatting the polarisation of the UK's labour market.

### Intergenerational inequalities

The issue of intergenerational inequality in the UK was brought to the fore by the publication of David Willetts' 2010 book *The Pinch: How the Baby Boomers Took Their Children's Future – And Why They Should Give It Back*. In it, Willetts argues that people aged 45 to 65 – the baby boomers – have appropriated a disproportionate share of the nation's wealth, in part by benefiting from massive increases in house prices; will take more out of the welfare state than they put into it, and have not been active enough in countering climate change, thereby leaving the bill to their children and their children's children.

Some of Willetts' conclusions have been questioned. For example, he says that the baby boomers hold more than half the nation's wealth. This may be true, but economists have long argued that people are at their wealthiest in the later part of their working lives. Before that, they are still accumulating wealth; when they retire, they run their assets down. The question – to which there is no satisfactory answer – is what is the 'right' proportion of wealth for any age-group to have? Similarly, Willetts may be right to say that the baby boomers will take out of the welfare system more than they put into it, but preceding generations did so as well – it is something that is inevitable, given the way the system has continued to develop.

However, the generation now in their 20s and those who reach this milestone in the next few years do seem likely to have some things worse than their parents. In particular, they will have to save more for their own retirement, while paying for the retirements of their parents and grandparents. And they will find it harder – and more expensive relative to their incomes – to get a foot on the home ownership ladder. There is, therefore, a case for the baby boomers sharing more of their wealth with the young and policies should be designed to bring this about.

### Conclusion

Countering these disparities in the future will not be easy because they are the result of a number of forces, some internal to the UK and some global in their nature.

Financialisation is partially to blame for larger regional and income disparities and inequality between those in and out of work. The expansion of the financial sector and the concentration of financial activity in London help to explain increasing regional income disparities. The nature of the financial sector – and the extraordinarily high remuneration it is able to generate for senior staff – has had spill-over effects into other parts of the economy and so goes some way to explaining increased income inequality. Meanwhile, capital flows into the financial sector have boosted the exchange rate, making it harder for other sectors, particularly manufacturing, to compete internationally.

Globalisation and technological change have also been important drivers of increasing disparities – and are likely to remain so in the future. Competition from low-cost producers in emerging economies has placed increasing pressure on low value-added manufacturers in the UK, particularly over the last 15 or so years. For some, the result has been low real wage growth; for others it has been the loss of their job, with little hope of obtaining similar employment. This has added to income inequalities and to disparities between those in work and those out of work. Given the historical concentration of manufacturing industry in the Midlands and the north of England, it has also added to regional disparities. Meanwhile, technological change probably has its biggest effect on mid-skilled, mid-income jobs, which has led to a polarisation of the labour market, adding to income inequalities.

An alternative theory is that the UK – along with other developed economies – has run out of easy options for growth and that this is contributing to increasing inequalities. Tyler Cowen (2011) has argued that the US has used up its ‘low-hanging fruit’, in the form of technological breakthroughs (totally new ideas) and ‘smart, uneducated kids’ who can be educated to boost their productivity. The result, he suggests, is an economy that does not create new jobs in the private sector and where real median incomes have been unchanged for three decades. If this is the case, and there is a read-over to the UK, this could help explain income inequalities and disparities between those in work and those out of work.

These forces will remain strong over the next decade, tending to push developed economies, including the UK, towards greater inequality. Although they can be countered to some extent by changes in the tax and benefit system, there are limits to how far that system can be used in this respect. New policy ideas are needed to tackle these inequalities.

## 7. CONCLUSION: WHAT NEEDS TO BE DONE?

The UK economy is at a critical juncture. The 2008–09 recession is estimated to have led to a permanent loss of output of around 7 per cent and left nasty legacies in the form of over 2.5 million unemployed and a fiscal deficit close to 10 per cent of GDP. So far, the recovery from recession has been slow and hesitant and, although mainstream forecasters expect growth to average 2.5 to 3 per cent a year over the next few years, the risks are clearly tilted to the downside, particularly in the short term.

Lifting the economy's trend rate of growth would help to alleviate these problems but this will not be easy, particularly when faced with the challenges posed by globalisation and technological change. The UK has for well over a century tended to revert to a trend growth rate around 2.25 per cent, despite the best efforts of governments with a range of different policies aimed at improving economic performance.

There are three possible reasons why previous efforts by governments have not led to a coherent strategy that promotes growth and shared prosperity. First, it may be that there is no role for government and instead the private sector should be left to its own devices. We reject this conclusion, not least because there are numerous examples where government intervention is clearly necessary (for example in the provision of infrastructure) or can be demonstrated to have brought positive benefit to the economy.

That leaves two possibilities. Either the mix of government policies – on infrastructure, innovation, finance, education and so on – needed to promote growth has been correctly identified, but political problems have prevented effective delivery. Or past efforts have been based on the wrong economic model and new ideas need to be drawn from the latest economic thinking in areas such as complexity, evolutionary and behavioural economics. Most probably, there is an element of truth in both explanations.

It is not difficult to identify supply-side deficiencies in the UK economy – in the areas of innovation, investment (particularly in infrastructure) and skills. Nor is it difficult to look at other countries where they do things better to find ideas that could be brought to the UK, whether it is a state investment bank, encouraging life-long learning or supporting the commercialisation of research ideas. But this has been true for many years. More thought needs to be given to the effective delivery of policy in these areas and in changes in the nature of government that might be needed to bring them about.

There are parts of the UK economy that are performing well. The UK is a world leader in industries as diverse as aerospace, pharmaceuticals, finance, higher education and the creative industries. For now, these comparative advantages are serving the UK economy well. But it does not have enough of them: the balance of trade has been in deficit in 23 of the last 25 years. And it is important to recognise that the global economy is very dynamic: new products and new competitors are appearing all the time. Comparative advantages will inevitably disappear and new ones need to be developed.

Traditional economic thinking is centred on the notion of economies returning to a static equilibrium, and it lacks any great understanding of the dynamics of economic change. A modern industrial strategy – designed to support growth in the private sector so that the UK can reduce, or even eliminate, its trade deficit and return to full employment as swiftly as possible – will have to draw on new ways of thinking about the economy. It will also have to be based on a vision of what the economy might look like in 2020. Such a vision is unlikely to be right in every detail, but it is necessary to recognise some of the major trends that will occur over the next decade – such as the ageing of the population and the continued development of emerging economies – and the trends that we might wish to



see in the UK economy – better balanced growth – and to identify what needs to happen, by way of investment in infrastructure and skills for example, to bring about the desired outcome.

In a modern economy, an active industrial strategy is not an optional extra, it is a necessity. Policies need to ensure that UK companies continue to attract investment from overseas, have the infrastructure they need to support growth, exploit their existing comparative advantages to the full, and develop new ones. This is not about the government spending more money – the reality has to be accepted that there is no more to spend. It is about spending the existing budget more wisely. It is also about how public policy can create the right environment for companies to flourish through shaping markets, boosting competition, supporting ambition and entrepreneurship, and encouraging more diverse forms of business ownership and greater long-term thinking.

Promoting growth will not be enough. In recent decades, the proceeds of greater prosperity have been too unequally distributed. Policy also needs to address how future increases in prosperity can be better shared around the countries and regions of the UK, across generations, between those on high pay and those on low pay and between those in work and those who are not. There are social justice arguments for this approach but doing so will also increase economic resilience and make it less likely that any future recession is as bad as the most recent one.

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