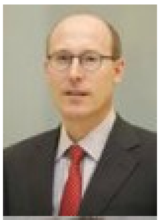
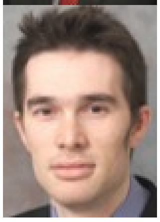
Investing in UK prosperity: skills, infrastructure and innovation can get us out of the current stasis





The latest GDP figures confirm that the UK economy has essentially been flat-lining for the five years since the financial crisis began. The UK's inability to achieve sustainable growth is rooted in longer-term problems arising from a failure to invest, notably in skills, infrastructure and innovation. ***Timothy Besley*** *and* ***John Van Reenen****, co-chairs of the London School of Economics Growth Commission, which publishes its final report today, propose an integrated set of solutions.*

The outlook for the UK economy looks bleak even for a British winter with output depressed for a longer period than even during the Great Depression. The institutions of UK economic policy-making seem unable to steer the economy out of nearly five years of stagnation and into a sustainable recovery. While the specific issues vary country-by-country, this theme resonates across the advanced world with output below potential and unemployment generally high. The spectre of Japan's two 'lost decades' following an asset crash casts a shadow over much policy debate.

The LSE Growth Commission, which we have co-chaired, is a collaborative effort drawing on academic, business and policy-making expertise. Its aim has been to develop an evidence-based approach to policy over the long term. And the perspective also takes politics seriously, focusing on the structures that are needed to support growth policy beyond the next budget cycle, the next spending review and the next parliament.

The UK's economic story

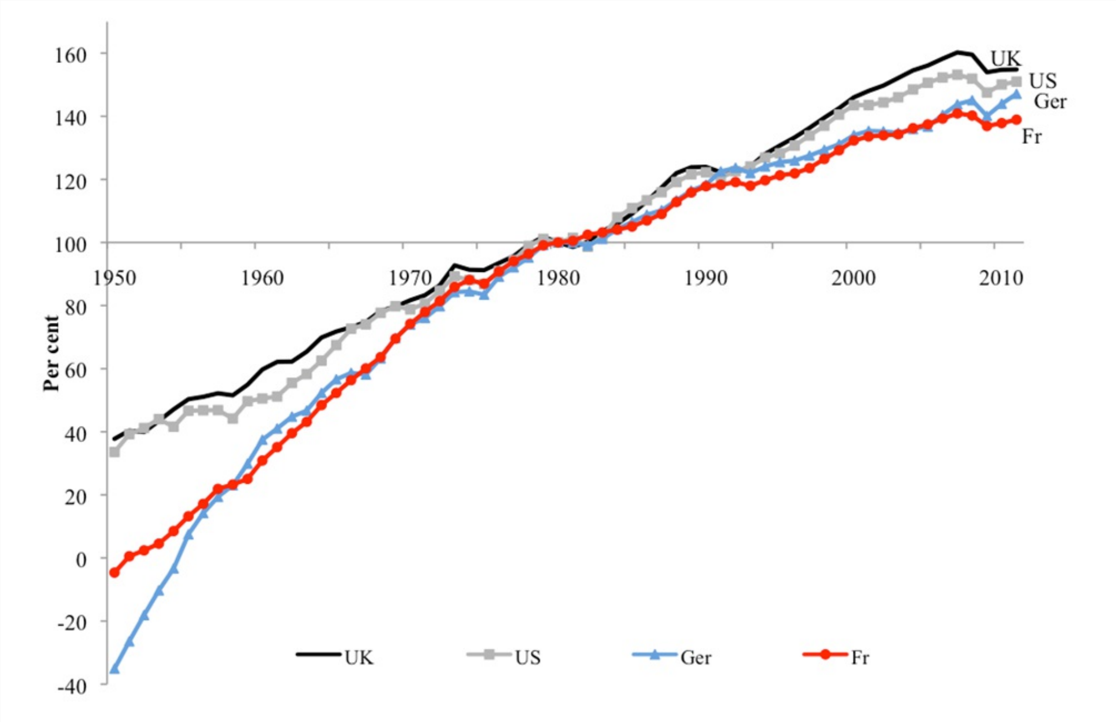
It is sometimes remarked that the British are the only people who indulge in *Schadenfreude* about themselves, revelling in stories of national decline. This is perhaps the inevitable legacy of being the first industrial nation. Although the UK has enjoyed significant improvements in material wellbeing for well over two centuries, UK GDP per capita was in *relative* decline compared with other leading countries, such as France, Germany and the US, from around 1870.

At first, the UK's relative decline reflected an almost inevitable catch-up of other countries whose institutions created the right kind of investment climate. But by the late 1970s, as the UK had been comprehensively overtaken: US GDP per capita was about 40% higher than the UK's and the major continental European countries were 10-15% ahead. The subsequent three decades, in contrast, saw the UK's relative performance improve substantially so that by the eve of the crisis in 2007, UK GDP per capita had overtaken both France and Germany and reduced significantly the gap with the US. Figure 1 shows trends in UK GDP per capita since 1950. After falling behind for most of the post-war period, the UK had a better performance compared with other leading countries after the 1970s.

Figure 1: GDP per capita 1950-2011 (1980=100)

Source:

Source: Conference Board data, LSE Growth Commission



Notes: GDP is US$, constant prices, constant PPPs, base year 2011. For each country the series is set to one hundred in 1980, so the level of the line in any year indicates the cumulative growth rate (for example, a value of 110 in 2001 indicates that the series has grown by 10% between 1980 and 2001). The steeper the slope of the line, the faster growth has been over that period.

A range of important policy *changes* underpinned these economic gains (see, for example, Corry, Valero and Van Reenen, 2011; Card, Blundell and Freeman, 2004; OECD, 2012). These include increases in product market competition through the withdrawal of industrial subsidies, a movement to effective competition in many privatised sectors with independent regulators, a strengthening of competition policy and our membership of the European Union's internal market.

There were also increases in labour market flexibility through improving job search for those on benefits, reducing replacement rates, increasing in-work benefits and restricting union power. The UK was open to foreign business and global talent: restrictions on foreign direct investment were eased in the 1980s and restrictions on immigration relaxed in the late 1990s. And there was a sustained expansion of the higher education system: the share of working age adults with a university degree rose from 5% in 1980 to 14% in 1996 and 31% in 2011, a faster increase than in France, Germany or the US.

In some policy areas, the UK has also led the way in seeking innovative institutional solutions, such as independent regulators, for designing and implementing policy more effectively. This created a better balance between political discretion, technocratic input and predictable rules. Strategic choices, rules and high-level objectives are set by government while independent bodies make decisions based on the criteria laid down by politicians and are held to account by parliament. This has mitigated the problems of political indecision and unpredictability that are important impediments to investment and growth.

In spite of these policy successes, a number of long-term investment failures have not been tackled. The most important of these are a failure to invest in mid-level skills, a failure to build adequate infrastructure – particularly in transport and energy – and a failure to provide a supportive environment for private investment and innovation. These problems have persisted due to the absence of a stable policy framework backed by a cross-party consensus in these areas.

Policy reforms for growth

The reforms that we propose are aimed at tackling these problems. *First, for human capital, where the UK suffers from a stronger link between parental income and pupil performance than other countries, we propose:*

- Improving teacher quality through expanding the intake of teachers and engaging in more rigorous selection. This is because ex ante evaluation of teacher quality is hard, but ex post evaluation easier.

- Creating a ‘flexible ecology’ by which we mean more autonomous primary and secondary schools, greater parental choice and easier growth for successful schools and their sponsors (for example, universities or educational networks).
- Linking targets, inspections and rewards more effectively to hold schools to account for the outcomes of disadvantaged pupils.

We propose developing a new institutional architecture to address the poor quality of our national infrastructure. This would dramatically reduce the policy instability that arises from frequent changes in political personnel and priorities, particularly in transport and energy:

- An Infrastructure Strategy Board to provide independent expert advice to parliament to guide strategic priorities.
- An Infrastructure Planning Commission to support the implementation of those priorities with more powers to share the gains from infrastructure investment by more generously compensating those who stand to lose from new developments.
- An Infrastructure Bank to facilitate the provision of finance, to bring in expertise and to work with the private sector to share, reduce and manage risk.

We propose improving the provision of finance for private investment and innovation through:

- Increasing competition in retail banking.
- Having the proposed Business Bank make young and innovative firms its top priority.
- Encouraging a long-term investment perspective through regulatory changes (for example, over equity voting rights) and tax reforms (for example, reducing the bias towards debt finance through an ‘allowance for corporate equity’).

Prosperity is strengthened when everyone has the capacity to participate effectively in the economy and the benefits of growth are widely shared. *We propose reforming the way we measure and monitor changes in material wellbeing and its distribution, including regularly publishing median household income alongside the latest data on GDP.*

Our core proposals can provide the stable policy framework that has long been lacking in the UK, one that will encourage long-term investment. By ensuring that difficult and contentious long-term decisions are based on the best available independent expertise, they would help to break the damaging cycle of institutional churn, political procrastination and policy instability.

The principle that policy should be evidence-based is now widely accepted, but often more in word than deed. Many of the areas where there are potential benefits to growth are largely untested. The benefits to long-term growth from properly conducted policy experiments in some areas could be significant while the costs of experimentation are modest. *We therefore recommend creating an independent National Growth Council to review relevant evidence and to recommend growth-enhancing policy reforms that could be subject to rigorous evaluation.*

Whether the LSE Growth Commission is successful in influencing the direction of policy remains to be seen. But we believe it offers a template for the engagement of academics in these important policy debates. The engagement with policy will not end with the report – the aim now is to try to build the consensus around a manifesto for growth. The challenge has never been greater given the pressures that mature economies are facing from international competition and a myriad of changes in the world.

About the authors

Timothy Besley *is Professor of Economics and Political Science at the London School of Economics.*

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