GRESHAM COLLEGE

7 June 2018

The British Economy: Can We Build a Successful Future?

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"The British are absorbent, we put our own inventive stamp on all that we encounter. The British are open to all influences, we are a fusion of the best of many languages, cultures and philosophies with which we have come into contact over the centuries. In the age of globalisation, most countries are open to outside influences. So why are we different? More flexible, more pragmatic? Is it our geographical position, politics, monarchy? It is all of these things and yet none of these. We are actually British in a very subtle way: nationalistic but rarely demonstrating nationalism. We know we are British and so do not have to show it. However, being British there will be a multiplicity of opinion on being British about which we will have the right to disagree."

Anonymous, Pavement (outside Home Office), Marsham Street, London SW1

Nearly two years on from the referendum vote the UK seems less like an international pariah and more a prophet. With the election of Donald Trump in the US and the emergence of many other populist movements in the world, it seems more likely that the UK vote has been at the vanguard of a protest about orthodox economic and social policy. These protests severely question the new classical agenda of globalisation that gathered momentum in the final quarter the twentieth century. If the noise of globalisation was brought to a sudden stop by the financial crisis, the people finally seem to have found their voice.

The key to understanding this protest is the absence of real growth in incomes since the financial crisis. The post-war golden age in the West was conditioned on persistent real income growth year on year, absent the odd minor recession and boom, of some 2%. This kind of growth allowed real incomes to quadruple on average over the course of a lifetime. It also led to widely held expectations of such growth and the gearing of both the financial system and public accounts system to this kind of increase in the income base. If anger results from frustrated expectations, then the past 10 years may well have triggered angry protest. Median real wages are hardly above the level reached in 2008 and although such real wage flexibility had prevented unemployment from rising to double digits the employed do not observe the social consequences of what might otherwise have happened. All they can observe is little growth in the purchasing power of household income.

The post-recession absence of real wage growth suggests that there was both an increase in effective labour supply and a relative fall in the amount of capital employed to produce a given level of output, as firms matched that increase in labour supply by hoarding labour rather than investing in new capital machinery in the face of financial constraints. And this lack of investment tended to reduce labour productivity and hold back real wages. So even if we make the case that unemployment and employment surprised us in the right way in the aftermath of the recession there are still major issues of concern. In particular the fall in median real wages and the unemployment faced by younger members of the workforce is a great worry and as long as expectations do not adjust or performance does not improve we can continue to expect some forms of political revolt.

Indeed it might be worse. The economy may have been frozen by a combination of factors. With the financial sector in retrenchment and subject to increasingly tight controls on new lending, capital has not been recycled to new, young firms. To the extent that banks adopted forbearance capital was also not released from older less productive firms, which may not have invested, and they responded by hoarding labour. We were therefore locked into a state of low investment with high employment and low wages. The monetary response was to facilitate adjustment to lower debt levels by maintaining a low interest rate regime. Though note that the counterfactual of higher interest rates may have precipitated a more rapid adjustment in demand and a more persistent recession, amplified by even larger falls in consumption.

The problem with ultra-low interest rates, which reflect this abnormal state of affairs, has been that this temporary measure has become something of an enduring regime. This year represents the 21st anniversary of the establishment of operational independence of Bank of England and yet for 40% of its time, Bank Rate has been constrained at the effective lower bound and left unchanged. This regime challenges our standard planning structure. Indeed the impact of the financial crisis has been likened to a war (albeit a small one), given the impact it had on the size of public debt. And to an extent that is right. Debt was some 30% of income prior the financial crisis and now seems stuck at some 90% of GDP. Much of the contemporary economic debate has concentrated on the facile question of appropriate debt levels and when fiscal consolidation ought to be about ensuring access to debt issuance in all states of nature. This debate has missed a much deeper point about public debt: that it escalates at times of crisis is well known but that its escalation is itself a challenge for economic reform is usually missed.

The state is a unique position to pick up IOUs on future generations if the current capacity of the economy cannot meet requirements for the provision of public goods. The large increases associated with wartime expenditures during the French Revolutionary and Napoleonic Wars, World Wars I and II were eventually brought into line with transformative economic growth with the proceeds of first, the first industrial revolution and then with the so-called Golden Age of cooperative growth after WW2. But the increases in debt in the 1970s, leading to the arrival of the IMF, paved the way for the neo-liberal approach that has dominated the political agenda under successive governments. The question is what is the correct response and point on the trade-off between being open to globalisation but not accepting such severe competition that domestic lives are stunted.

Take for example the question of whether the apparent increase in inequality is simply related to the increase in capital values, held by those at the top of the distribution, compared to the labour share in income earned by workers. Actually, the inequality picture is complicated. At the bottom end of the global distribution, there has been a remarkable reduction of the numbers in the tail. From 1990 to 2010, the fraction of people living below the poverty line of $1.25 per day in developing countries, fell from 43% to 21%. This fall has taken nearly 1bn people out of extreme poverty and the numbers are forecast to fall below 10% by the end of this decade. The very process that has created such a great concentration of income in the top percentile has also acted to eliminate much, but sadly not yet all, of the extreme poverty at the bottom.

In the UK, the main increase in income inequality occurred in the first half of the 1980s: in the early days of the neo-liberal agenda. And whilst there has been increase in income held by the top percentile from 5% to 15% or so in this period, the share of wealth held by the same percentile has trended down and the fraction of people living with income below 60% of the median has fallen from over 20% to 15%. Whilst there seems to be little overall change in domestic inequality this is because some improvements in the relative position of those below the median have been offset by some acceleration in the extent to which the very top are pulling away. At face value although the picture is complex there may be something of a case for both *ex post* and *ex ante* income redistribution.

If we were to think of these top earners and wealth holders as a fixed group of infinitely lived people then we might be particularly concerned. But the data simply says that if you become a high earner or owner of wealth, you may own a large fraction of national income. Estimates of intergenerational mobility suggest that when we move from one generation to the next, high levels of income in the previous generation explain less than 30% of the income of the next generation. And if we move this forward a number of generations and take 0.3 to some power, how rich your ancestors may have been may explain very little of our own income or wealth outcomes. Luck or personal endeavour explain much of our life's outcomes: perhaps as it should be but not in line with a deterministic setting. In other words, every dot on the timeline of inequality measurement represents a different set of people. Churning of income and wealth is good and people move quite a lot over the distribution without there necessarily being a change in the overall measures of inequality. If we live in a high rise block and are randomly allocated to live on different floors, the average height of all dwellers does not change.

And business dynamism seems to have reduced. Business births have been lower since the start of the financial crisis, down from 20% to 17%, whilst business deaths have also fallen. Typically some 28% of jobs are created or destroyed in any 12 month period. There are some 2.7mn jobs created every year with some 2.5mn lost. But in the first years of the financial crisis the number of jobs created by firm entry fell from some 900K to some 500K. An industrial re-birth will require some attention to job destruction and creation, particularly under some measures the former plays a role in the latter.

Perhaps the biggest charge we can put against the EU is whether its supranational identity somehow favoured the large and well established rather than the small and dynamic. So all roads seem to lead to the referendum result itself. It is somewhat of a truism but the UK has had a difficult relationship with the European Union, and its predecessors the European Economic Community and the European Community, along many dimensions, as long-run polling data and both the announcement and result of 2016's advisory Referendum confirm. But despite imminent exit from Union, the UK remains a European nation. So whether the country is a full member of the supranational organisation or ultimately becomes simply an observer, our relationship with Europe will continue to be a hugely significant point of departure for our external trading and political relationships. The trigger for exit from the EU was rejection of the four freedoms, particular over migration of labour, but economic growth will still require skilled labour inputs. Producing a home grown variety rather than importation will take time to evolve, given the cultural norms and the state of technical education in the country.

The sense of disaffection manifest in the referendum result, whilst coming from a variety of sources, will not simply disappear because of the referendum result. We may wish to challenge the emergent narrative after the referendum that suggested the ‘Leave’ vote was that of the socio-economically ‘left behind’ and suggest there is an alternative that the referendum vote is better understood in broad socio-cultural terms and may therefore act to be more binding on future political choices. The level of schooling, the extent of professional occupation, age, jobs vulnerable to imports, the recent change in the level of immigration and those identifying themselves as English were all significant factors in factors in vote choice. Indeed income distribution played a role in this ‘rebellion’. It seems clear that higher levels of deprivation in each area were associated with greater share of Leave votes and, vice versa, where less deprivation was associated with a lower share of Leave votes. Analysis that accounts for many explanatory factors tends to find a significant role for deprivation in explaining the Leave vote share.

It is perhaps not too strong an interpretation then to think of the vote as a form of rebellion by the rest of the UK (except Scotland) against London that the same sense of rebellion that led to the triumph for the vote to Leave will act to constrain political choice in the run up to the triggering of Article 50 and the negotiations that follow. It is possible to argue that the referendum result was not an emotional outburst to be regretted on the morning after but rather maps out a clear directive for the UK outside the European Union to adopt a ‘hard’ exit from the European Union.

The socio-cultural factors that explain recent political results will help shape future democratic values and these are likely to play a dominant role in the strategic choices of democratic institutions. These institutions may then also play a role in affecting choices. The tension between elites and the populace seems palpable and decisions will have to be taken about whether elites give up some power to defend the economic structures or whether power will revolve away from those cosy elites with a process that might be more difficult to manage. We need to offer a fresh perspective on the political economy of democratic institutions, for example how we set objectives for central banks, as well as the interplay between policies and cultural change. Does this reasoning simply imply more regional-level decision making, more protection for domestic industries or expenditure on infrastructure?

Perhaps. I think it will imply some recognition by elites that they have to develop the ability of incoming, younger generations to live productive lives. The question facing us all is whether the post-referendum climate will prove to be sufficiently fertile to grow dynamic institutions that allow such regeneration or whether we will fall into base nationalism. But whatever set of institutions we adopt we will have to realise that our own influence on global events seems likely to continue to fall. In 2014 the UK represented just over 2% of world income, a quarter of a century earlier it was just under 4% and at the start of the 20th century it was around 10%. We will have to find a way to pay our way as a relatively small nation in terms of world output rather than a central one. This is a sobering thought and one that will require all of our famous inventiveness.

Principles for reform

- Addressing the Productivity Trap requires the recognition that we have entered a "bad" equilibrium in the transition to new forms of production;
- Monetary and Fiscal tools have concentrated on stabilising the economy and creating smoother aggregate responses but they have not helped this transition: lending is too property-oriented and fiscal policy needs to support public investment;
- Regional, industrial and financial policies must balance support for fading industries and those vulnerable to a compression in EU trade against increasing opportunities for new firms;
- The physical infrastructure of roads, rail as well as national broadband capabilities are in need of attention and do not fear the building of more housing;
- Bring forward plans to develop technical further education and work-related apprenticeships;
- Institutional reform of government departments to meet the democratic deficit posed by globalisation;
- Re-consider the question of corporate governance and the ongoing development of employees when in work.