LSE Business Breakfast: Thoughts on Rebalancing

John Van Reenen, Professor of Economics and Director of Centre of Economic Performance

December 11th 2010

1. Summary

What is rebalancing & How to facilitate it?
What has been Recent UK performance?
Where are we in strengths & weaknesses?
What should we do?
What are the key questions?

2. Introduction

2.1 What is Rebalancing?

Within Private Sector: The UK is “overweight” in finance and construction & underweight in manufacturing, high VA services? [2007: 15% of GDP in financial & professional services cf to 11% EU-15 average; 12% in manufacturing compared to 18% in EU-15, MGI 2010]

Example of Talent misallocation from Sir John Harvey-Jones, former chairman of ICI (at that time the largest manufacturing company in Britain; Jan 1995), “When I was chairman of ICI all the advisers that we used, advisers mark you, were all paid more than I was, be they the auditors, be they the merchant banks, be they the City solicitors. Now I ask you, in realistic national terms, who is likely to have the biggest impact on the fate of the bloody country?”

Between Public and private sector: too large. Extreme austerity discussion – problem isn’t direction but speed of change. Can lead to premature capital of human and fixed capital.

Geographical: half of all growth in last decade in Greater London & neighboring regions

2.2 How to get more rebalancing?

• State is a bad judge compared to market, but can facilitate (or damage) creative destruction

• Essentially role of the state is to help can the environment right to foster productivity & growth. A lot of this is to do with providing key inputs – infrastructure, skills, safety, etc.

• Much will happen “naturally”. Example of Financial services regulation
  i. Too big to fail (contagion within and between). Bail out creates moral hazard problem and excess risk at all levels
ii. **Solutions**
   a. **Better regulation** (Basel capital requirements, closer supervision; living wills, etc.)
   b. **Structural changes** (Reducing incentives/ability to be large & create systematic risk so less need to bail out; Vickers, Myners)
   c. **Payment systems.** Factoid: top 10% increased their share of wage bill from 27 to 30% 1998-2008. Most of this was top 1% and ¼ of this was bankers’ bonuses. Bad incentives & public outrage. Transparency a market friendly solution (Walker). Unlikely to cause max exodus. Win-win policy.

3. **Recent UK Performance**
   - Too much doom and gloom about last 15 years
   - Productivity is key indicator (GDP per hour or per worker). Why? High wages.
   - In 1995 UK GDP per hour was 10% less than EU-15 average we have now bridged that gap (e.g. GDP/worker higher than Germany).
     - This is related to (i) increase of college % from 15% to 27% 1997-2010; (ii) increase in R&D/GDP post 2003 after a 20 year decline; (iii) competition policy
   - Contribution of sectors to productivity growth of 23% between 1995-2005: (i) 6% manufacturing (1/4); (ii) 5% prof and financial services
   - Jobs market (high rate of employment in 2007; better performance of unemployment than previous downturns)
   - But still ~15% gap with the US. This means we could take Friday afternoons down the pub.

4. **Where are we?**

4.1 **Strengths** (building strengths in areas of growth)
   - Universities (2nd in G8 after US, best in per $ spend). Research and International students,
   - Bio-sciences (2 top pharma firms HQ’d in UK)
   - Creative sectors
   - English language

4.2 **Weaknesses**
   - Management – McKinsey/LSE work (competition, skills, family firms)
   - Skills (e.g. low/intermediate)
   - Retail (e.g. planning)
   - Public sector productivity – health, education

5. **How to support?**
   - Don’t intervene too much: our liberalized labour and product markets is a strength
   - Innovation : R&D tax credit, patent box
• Skills – university issues (overseas student permits; subsidy for non-STEM); apprentices, EMA.
• Tax – Mirrlees, Structure more than level (e.g. treatment of debt; move to tax land and consumption rather than labour)
• Regional policy – enable mobility; regional pay
• “industrial policy” – green growth

6. **Questions**
   - What is state’s role in enabling growth
   - What to do if extreme austerity goes wrong?
   - University finance
   - Management
   - Technology
   - Finance

7. **Conclusions**

No easy answer

Rebalancing mainly from private sector but state can facilitate by

i. Getting environment right
ii. Sector specific interventions
iii. Regulating smartly (e.g. finance and pay)