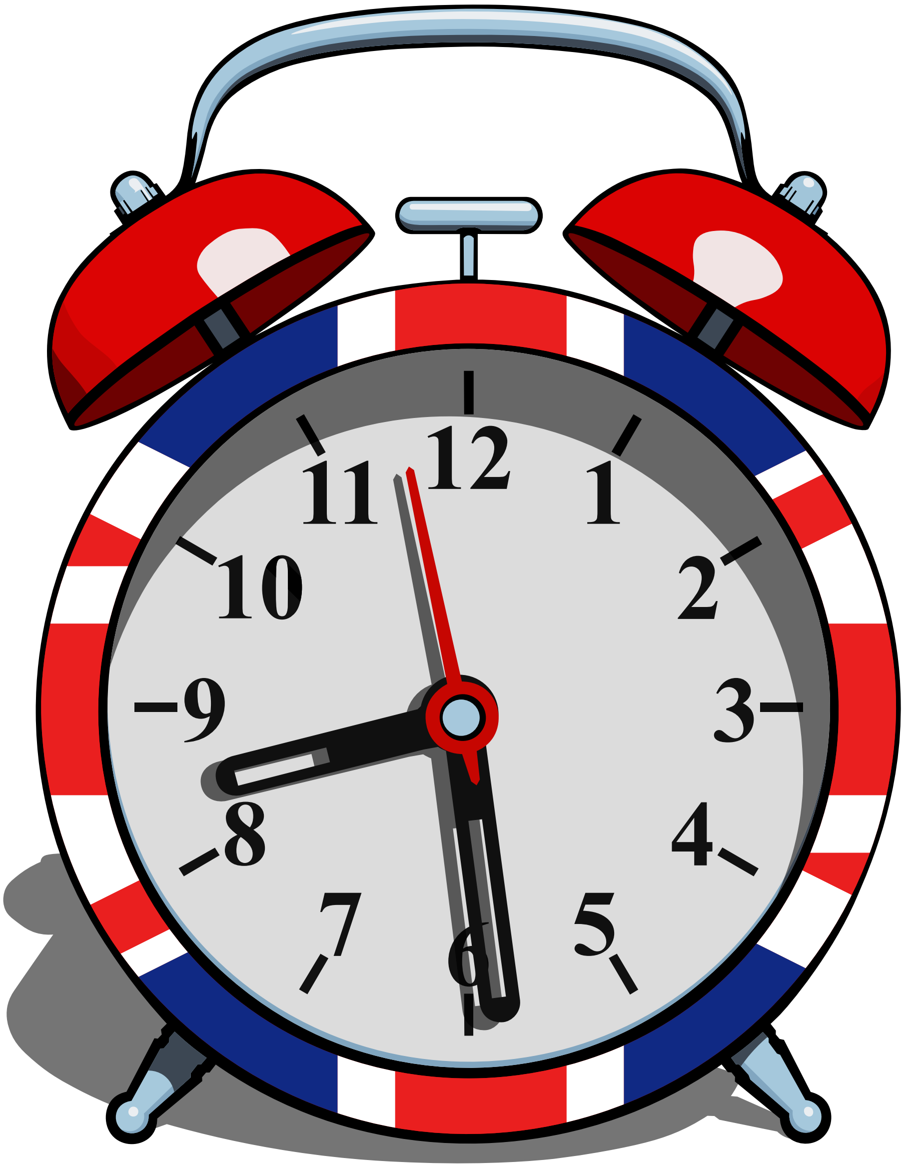
ECONOMY 2030

What can be done to address Britain's relative economic decline over the past decade and a half? The final report of the Economy 2030 Inquiry presents an ambitious strategy for reversing decades of under-investment, by the private and public sectors alike, built on a realistic understanding of the country's core strengths.

Ending stagnation



The promise of shared prosperity is key to our social contract, but that promise is under threat. The cost of living crisis is the immediate issue, but our ambitions must extend beyond getting through it. We are 15 years into relative economic decline and gaps between people and places are too high – the UK has the highest income inequality of any major European economy.

This toxic combination of low growth and high inequality is a disaster for low-to-middle income Britain and younger generations. We might like to think of ourselves as a country on a par with the likes of France and Germany, but we need to recognise that, except for those at the top, this is simply no longer true when it comes to living standards.

Figure 1 shows how middle-income Brits are now 20% poorer than their peers in Germany and 9% poorer than those in France. Worse, low-income households in the UK are now around 27% poorer than their French and German counterparts.

The net zero transition brings many changes and some opportunities – but it is not a silver bullet

Countries can go through phases of relative stability, but the UK in the 2020s will not be such a country. Longstanding demographic and technological shifts will combine with Brexit, rising geopolitical tensions and the net zero transition. These will bring significant disruption for some, though not the radical reset for our economy or large job losses that many predict. Instead, rather than solving our stagnation, these challenges risk reinforcing it.

The net zero transition is crucial to the planet, and to making the UK a greener and healthier place to live. Our ability to navigate it is underpinned by a high degree of public consensus but maintaining that requires clear-sightedness about the opportunities, and disruption, it brings. The disruption won't be in the form of large-scale job losses, with job change rather than destruction the norm.

Low growth and high inequality is a toxic combination

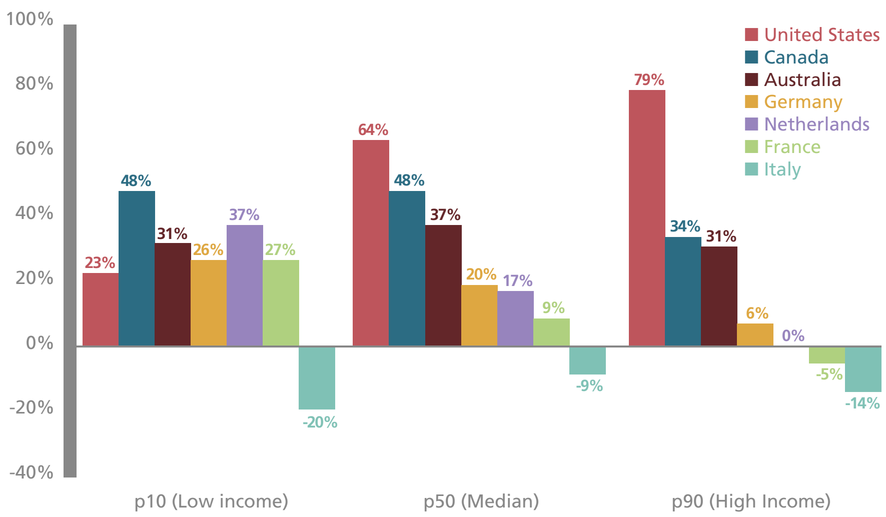
We cannot go on like this. Britain needs a new economic strategy

Why is a strategy needed? First, because the challenges are large and persistent. Almost nine million younger Brits have never worked in an economy that has sustained rising average wages. Second, because those deep-rooted challenges and disruptions to come are interdependent. And third, because the global financial crisis of 2007-09 and Brexit have blown up major components of the country's longstanding growth model, which had itself been found wanting given the large and persistent gaps between people and places.

The test for a broader economic strategy is that it combines goal orientation (being clear about the problem that the strategy is trying to solve), clarity about context, realism about trade-offs and policies of sufficient scale that they can plausibly move the dial. Finally, staying power is required because change takes time and short-termism has been a key UK weakness for decades.

Figure 1:

Median household incomes in the UK are lower than in many advanced economies



Notes: Difference between selected countries compared with UK p10, p50 and p90 household incomes using OECD PPPs for household final expenditure. International inequality comparisons are challenging because there are differences in survey coverage across countries and because of the difficulty in measuring prices across countries – both what components and weights of the price index should be, how to measure their relative levels, and how this interacts with things like housing tenure and how health and education are paid for. Correcting for some of these factors (such as imputed rents given that the income measure does not include imputed rental income) would improve the relative position of the UK. **Source:** OECD Income Distribution Database; Eurostat, EU-SILC Distribution of income by quantiles; DWP, Households Below Average Income. Used in the Economy 2030 report *Ending Stagnation*.

If Britain closed the average income and inequality gaps with its peer economies, the typical household would be £8,300 better off

Turning around our second cities will boost national income and shrink regional gaps, but it needs change on a scale not yet contemplated

A key challenge for a services-dominated economy is that exports and productive activity tend to be geographically concentrated. In the UK, that currently means in the capital, which accounts for 63% of the UK's surplus in services trade and, aside from Edinburgh, the country does not have any highly productive mid-sized metro areas (see Figure 2). This holds back Britain's ability to take advantage of growing global markets.

While our current economic specialisation is consistent with future shared prosperity, our regional divides are not. At the heart of this problem are the UK's twin second cities: Greater Manchester and Birmingham. With populations of around 2.8 million each, their size means that they must be centre stage not just for the sake of their own prosperity, but also for the sake of Britain's. They are too big to fail.

Closing Greater Manchester and Birmingham's productivity gaps with London to those that Lyon and Toulouse have with

Understanding your country is a prerequisite for making a success of it: we are a services superpower

Britain is a broad-based services economy, the second largest exporter of services in the world, built on successful musicians and architects as well as bankers. We're about information and communication technologies, education, culture and marketing, as well as finance.

And our services specialism does not lie behind our recent underperformance: on average, services-led economies tend to be richer than manufacturing-driven ones.

We have narrower, but important, manufacturing strengths too: aerospace and beverages stand out, while there are green technologies – from offshore wind to carbon capture – on which specialisms can be built. But the services-led nature of our economy is not going away, and our path to future prosperity lies in being a better version of Britain, not a British version of Germany.

Membership of the European Union provided Britain's trade strategy for the last half century. Post-Brexit, a new one has yet to emerge, but it must if the shift of domestic manufacturing towards lower productivity activities is to be avoided, and the opportunities of growing global services trade seized.

Figure 2:

The UK's large cities are further behind the capital than in France

Notes: PPP adjusted. Spatial units are a combination of OECD metro regions and NUTS3 for non-metro regions. Metro areas are shown in darker bubbles in the figure. Bubbles are proportional to the number of workers in each region. Gross value added (GVA) is the value of a unit's outputs less the value of inputs used in the production process to produce the outputs. **Source:** Analysis of OECD, Regional Economy Database. Used in the Economy 2030 report *Ending Stagnation*.

Paris respectively would increase total gross value added (GVA) by almost £20bn a year. This 1% boost to national productivity would narrow the UK's GVA per worker gap with Germany by 20%.

But honesty about the scale of change required is essential. It would require increasing each city's business capital stock by 15 to 20%; over 160,000 additional high-skilled workers in each city; city centres expanding up or out; and billions of central government investment to expand transport networks.

Ensuring that more places can be at the cutting edge of the UK economy holds out the possibility of raising national growth and shrinking regional productivity gaps, reducing both national inequality and local poverty. Yet within-region inequality could widen – a richer Greater Manchester would have less poverty, but more higher earners too. Housebuilding must be expanded, because the goal is more successful cities, not clones of London with low earners facing exorbitant housing costs.

Residents are understandably ambivalent about higher local inequality, and the significant disruption involved in going for growth. This is why meaningful progress will not happen without bold and empowered local leadership who are able to manage the disruption involved, which in turn reinforces the case for genuine fiscal devolution.

The UK is a country living off its past, not investing in its future

Investing too little for one year is manageable, but doing so year after year is a recipe for relative decline. This is precisely what the UK has been doing and where it finds itself. In the 40 years to 2022, total fixed investment in the UK averaged 19% of gross domestic product (GDP), the lowest in the G7. Virtually all of the productivity gap with France is explained by French workers having more capital to work with.

> We must be just as serious about reducing inequality as boosting growth

Although the majority of investment is in the private sector, public investment matters too. Here, the average Organisation for Economic Co-operation and Development (OECD) country invests nearly 50% more than the UK and the results are everywhere to be seen: UK hospitals have fewer beds than all but one OECD advanced economy and UK workers spend more time commuting than those in all but two.

Our public investment is not just too low, it is too volatile. This prevents forward planning, raising the costs and challenges of getting investment done: even where public investment increases have been planned, £1 in every £6 allocated hasn't been spent.

The UK's fiscal rules should be reformed to banish feast and, more commonly, famine, in favour of sustained public investment of 3% of GDP. The Treasury should switch its focus to improving the quality, not fiddling with the quantity, of public investment.

Stability alone won't raise business investment – reforms must stoke firms' desire to invest and ability to get things built

British business has caught the same low investment disease as the British state, consistently lying in the relegation zone (bottom 10%) of the OECD business investment league table. If UK business investment had matched the average of France, Germany and the United States since 2008, our GDP would be nearly 4% higher today, boosting wages by around £1,250 a year.

The UK stands out for low investment, though not for low returns on investment when it does take place. But there is an unusual lack of pressure on British managers from above – via engaged owners – or below – from empowered workers – to focus on long-term growth, and difficulty in getting anything built.

Ownership of British firms has become more remote, with foreign ownership rising from 10% in 1990 to over 55% in 2020. Ownership has also become extremely dispersed, as our pension funds – the overwhelmingly most important source of domestic capital and ownership – moved away from holding equities directly.

It is time for a major programme of pension fund consolidation: a far smaller number of far larger, and more active, pension funds is what UK plc needs.

In contrast with many other European countries, the lack of "owner voice" is matched by a lack of worker voice. This should change, with worker representatives on the board of all larger UK firms.

Even if firms have the desire to invest, they also need the ability to do so. In future, businesses submitting applications consistent with local plans should be automatically approved.

Claims that there are too many degrees distract us from the fact we need to invest more in skills, not less

While the UK has a world-class university system and performs reasonably when it comes to school attainment at 16, provision after that for those not following an academic route is patchy at best, and a disgrace at worst. Almost one-third of young people are not undertaking any education by age 18 – compared with just one in five in France and Germany. And only one in 10 workers are qualified at sub-degree level (levels 4 and 5), half the share it should be given the make-up of the UK economy (see Figure 3).

Clearer non-academic routes, buttressed by increased student support, are needed. At the heart of these reforms should be a new "apprentice guarantee" for all qualified young people, with two-thirds of the Apprenticeship Levy ringfenced for the under-25s to reverse the trend of employers increasingly focusing on existing, older employees – apprenticeship starts for 19-24-year-olds have fallen by one-third in the past decade.

Higher investment has to be paid for

In time, higher investment will create higher living standards, not to mention a greener economy. But only in time. A new economic strategy backing higher investment needs to confront the more immediate consequences with an unflinching eye: it requires higher savings (lower consumption) at home, or more borrowing from abroad.

There are strong resilience arguments for higher investment to be accompanied by higher saving. The success of pension auto-enrolment should be built on, with a 50% increase in minimum contribution rates. But savings at the level of the economy as a whole do not just reflect the behaviour of households. The state also has an important role to play.

Investment and growth require a sustainable macroeconomic framework – we don't have one today

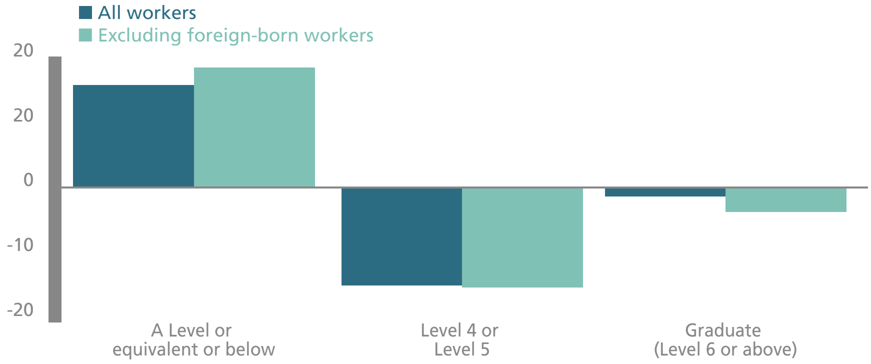
Economic, not just policy, stability underpins investment. Important guarantors of that are the ability to support the economy during downturns and keep the public finances on a sustainable path. The repeated "once-in-a lifetime" shocks of the past 15 years have seen public sector net debt rise from 36% to around 100% of GDP – an unprecedented peace-time rise.

The lesson of those shocks is that both main political parties' focus on debt falling slightly outside recessions will not be enough in practice to avoid debt being on an upward trajectory. A tighter fiscal policy will have to be run in good times. The best way to keep the requisite tightening manageable is to contain the pressure for the Treasury to spend big in bad times.

The scope for the Bank of England to cut rates in a downturn should be increased by preparing for slightly negative interest rates (as seen in the likes of Denmark and Switzerland). And, if we return to a world of low interest rates, the inflation target should also be raised from 2% to 3% in coordination with other advanced economies.

Figure 3:

Shortages of intermediate and advanced skills are widespread in the UK economy



Notes: This chart plots the difference between the share of workers outside of the strategic sectors with a given level of education and the share expected to possess a given level of qualification given the underlying occupational composition (according to the US-based O*NET data). Positive values indicate an excess of workers with that level of education. The teal bars indicate what the difference would look like if we excluded foreign-born workers from the computation of workers' actual qualifications. **Source:** Analysis of ONS, Labour Force Survey linked to O*NET (US Department of Labor). Used in the Economy 2030 report *Ending Stagnation*.

We must be as hard-headed about lower inequality as higher growth

Success for Britain does not look like becoming America. We must be just as serious about reducing inequality as boosting growth. To make a serious dent in inequality, we need a two-pronged approach: good work must be a central objective of a new economic strategy, not a hoped-for byproduct of it, while choices on tax and benefits ensure rewards and sacrifices are equitably shared.

Good jobs must be centre stage, building on past successes as well as tackling stubborn weaknesses

As the minimum wage has ramped up this century, job satisfaction for lower earners has fallen. Too often, work does not offer them the security, flexibility or control that higher earners take for granted. Low earners are four times as likely as high earners to experience volatility in their hours or pay. Indefensibly, half of shift workers in Britain receive less than a week's notice of their working schedules.

Workers should have new rights to a contract enshrining minimum hours reflecting their usual work pattern, and two weeks' advance notice of shifts. Illness is bad for the financial, as well as physical, health for too many lower earners. Statutory Sick Pay leaves many to live on just £44 if they are sick for a week, and should be reformed to pay 65% of normal earnings.

After raising the floor for workplace standards, we also need to enforce it. Here, institutional innovation is required, addressing industry-specific problems that general employment law is too blunt a tool to crack. Good Work Agreements should bring together workers and employers to solve knotty problems about the quality of work in their industry, setting minimum standards or ways of working to be adopted sector-wide.

Investing too little for one year is manageable, but doing so year after year is a recipe for relative decline

A decent society does not allow poorer people to fall ever further behind

Markets, however fair, and jobs, however good, cannot ensure that growth automatically boosts the living standards of the whole population. This is the job of the social security system, but it is not fulfilling that role today.

The UK has chosen a low level of basic income protection. Working-age benefits have for many decades risen only in line with prices, rather than keeping pace with earnings. In practice, we haven't even managed that recently – benefit levels have failed to keep pace with prices in 10 of the past 15 years. Along with wider cuts since 2010, this has reduced the incomes of the poorest fifth by just under £3,000 a year.

Any economic strategy that claims to be serious about reducing inequality will need to change tack. Ultimately, social security benefits must grow in line with wages rather than prices. The costs are real, but over half of them can be covered by uprating pensions on the same basis as working age benefits, rather than via the triple lock.

We need better, not just higher, taxes

Taxes are up, but their quality is not. Having averaged 33% of GDP in the first two decades of this century, the tax take is now on course to rise by over 4% of GDP (£4,200 per household) by 2027-28. The growth and fairness penalties from our incoherent tax system are rising with the higher tax take.

A new approach must recognise that the burden cannot continue to fall disproportionately on employees, which means taxing income consistently whatever its source so that landlords pay the same taxes as their tenants and taxes on self-employed corporate lawyers are levelled up to those facing bankers.

Economic change has slowed down – it must be embraced, and steered

The goal for a new economic strategy is not a somewhat richer, somewhat fairer, version of the UK's stagnant status quo, but a more enduring shift in direction. The pace of economic change, contrary to popular claims that it is speeding up, is slowing down; the reallocation of labour between sectors is at its lowest level in over 90 years. That matters: higher productivity sectors growing and lower productivity ones shrinking used to add 0.4 percentage points per year to growth in the pre-financial crisis decade.

For good firms or higher productivity sectors to grow, workers need to move to them. But for too long we have assumed that the UK's flexible labour regime, with the relative ease of hiring and firing, automatically engenders a truly dynamic labour market. It does not: the proportion of workers switching job each quarter declined by 25% between 2000 and 2019. The missing ingredient is empowered workers, willing and able to take risks.

A key barrier for higher earners is a welfare state that offers them next to no income protection, so new unemployment insurance should cover 65% of previous wages for the first three months. In contrast, lower earners receive greater income protection from the benefits system, but often risk losing informal security and flexibility over the hours they work when moving on. Stronger rights to security will mean taking a leap for a new job is more of a promise and less of a threat.

Slow growth and high inequality are not inevitable. Britain has huge catch-up potential

Renewing the UK's economic strategy will be far from easy. But we have a lot of catch-up potential.

Consider a set of comparator economies: Australia, Canada, France, Germany and the Netherlands. We would long have considered them our peers and, though impressive, they are not the richest, or most equal, countries in the world. But all are now richer and more equal than Britain.

If Britain closed its average income and inequality gaps with these peer economies, the typical household would be 25% (£8,300) better off, with income gains of 37% for the poorest households.

A better future for the UK does not need global growth to accelerate suddenly, or Britain to match American levels of productivity and Scandinavian levels of inequality. It just requires us to have the resolve to do what is necessary to converge with similar countries who, in the scheme of things, are not so very different to us. There is a lot to play for.

The 'Ending Stagnation' report is published by CEP and the Resolution Foundation (https://economy2030.resolutionfoundation.org/wp-content/uploads/2023/12/Ending-stagnation-final-report.pdf).

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