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Economic Growth: Executive Summary

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Although the UK economy performed relatively well over the last two decades, recent experience has shown that this was increasingly based on an unsustainable model of unbalanced growth. Comparing the 1990s to the latest decade we find a pattern of:

- **Debt fuelled household consumption** – As a share of GDP household debt increased from 66% to 88%.
- **Expanding public sector** – Government spending grew by 29%, outstripping the rest of the economy (which grew by 24%).
- **Weak business investment** – The share of business investment in GDP fell from 11.7% to 10.5%, the worst in the G7.[1]

At the **sectoral level**, while most advanced economies saw an increase in their financial and business services sectors, the UK stands out in terms of their disproportionately large contribution to growth.[2] This was also reflected in unbalanced growth at the **regional level,** with London and its surrounding regions growing faster than the rest of England since 1989.

The context for future growth

The UK's long term prospects need to be seen in the context of the continuing changes in the global economy. The last few decades have seen an **acceleration in the pace of globalisation**, with world trade increasing more than tenfold since the 1980s. This was facilitated by **rapid technological progress**, particularly in ICT and logistics. These have led to the development of global value chains in which individual components of a product are now designed and manufactured in disparate parts of the world.

On the demand side, a number of factors are driving significant changes in the composition, location and scale of global demand, including:

- **Rising per capita incomes** – Moving the composition of consumer demand more towards areas such as recreation, health care and travel.
- **Environmental standards** – Driving demand for 'environmental products' and changes in how other goods and services are produced.
- **New technologies** – Creating entirely new products, business models and ways of engaging with consumers.
- **Ageing population** – Shifting demand towards housing, energy and healthcare, as well as posing challenges for the UK labour market.
- **Growth in emerging markets** – Leading to global spending power shifting towards middle income countries and their rapidly growing urban middle classes.

Analysis of trade data shows that the UK has a strong Revealed **Comparative Advantage** in sectors such as Financial and Business Services, Pharmaceuticals, and Aerospace. By contrast emerging economies are more specialised in lower skill, more labour intensive sectors such as Textiles, Metal products and Machinery.[3]

This latter point emphasises the need for the UK to compete on the basis of its capabilities in areas such as skills, innovation and design, where low-wage competition is weakest. This means building on existing strengths, as well as looking to exploit opportunities in high growth, emerging sectors. In addition, we need to maximise productivity growth in non-tradable sectors.

When analysing UK sectoral strengths, it is also importance to consider underlying sectoral capabilities in skills and innovation, impacting on future performance, as well as present trade data.

- The UK's **productivity performance** is relatively strong in sectors such as Financial Services, Publishing and R&D, but weaker in Precision Instruments and Mechanical / Electrical Engineering.[4]
- In terms of sectoral **R&D intensity** UK firms in Pharmaceuticals, Aerospace and Financial services invest relatively more intensively in R&D than their G7 counterparts. By contrast Precision Instruments, Computing and Transport Equipment are less R&D intensive.[5]
- **UK patent applications** are relatively concentrated in areas such as Chemistry, Pharmaceuticals and medical technology, but less concentrated in ICT and machinery.[6]
- Taking numbers of new graduates as a proxy for **Skills Intensity,** OECD comparisons suggest that UK graduates are relatively focussed in mathematics and sciences, but less focussed in engineering skills.[7]

Four pillars for growth

The UK needs to take advantage of these global opportunities and respond effectively to growing international competition. Growth needs to be more balanced; with a greater role for the private rather than public sector, investment rather than debt, and with all sectors and regions contributing.

Above all, this means a renewed focus on opening markets up to drive growth through both the entry and expansion of more efficient firms, and incentives to improve productivity growth in existing firms. Our approach draws on economic theory and international evidence to identify four pillars, each representing a policy area which is crucial to driving growth. These are:

- **Pillar 1: Providing the stability business needs**.
- **Pillar 2: Making markets more dynamic**.
- **Pillar 3: Effective government that supports investment and growth**.
- **Pillar 4: Supporting individuals to fulfil their potential**.

The role of each pillar in driving growth is analysed in more detail in the following sections. These also briefly assess UK performance in each area, and outline some of the key policy challenges.

Pillar 1: Providing the stability business needs

There are clear economic costs associated with macroeconomic volatility and financial instability. In the UK, the cost of macroeconomic volatility was particularly evident in the 1970s and 1980s, while the cost of financial instability is currently being felt both globally and in the

UK. The evidence shows that macro-economic and financial stability is important for long term growth, for example:

- Following periods of rapid debt accumulation, which are usually associated with **asset price booms,** economies are often hit by financial crises which lead to significant falls in asset prices. In general these **financial crises are extremely costly**, involving large falls in output and increased debt.[8]
- A number of studies have found that **macroeconomic volatility is associated with lower average growth rates**, even after accounting for the impact of volatility on average levels of investment.[9]
- **Reduced macroeconomic volatility can lead to improved living standards**. Households generally prefer stable and predictable conditions so they can smooth their consumption over time, this is more difficult in a volatile environment which can bring income and mortgage insecurity.[10]
- **Greater stability may improve the quality of investment which helps support improvements in productivity**. Investment is highly cyclical and the productivity of investment tends to be lower in booms than downturns. Lower volatility would curb these extremes raising the average productivity of investments made over the cycle.[11]
- **Macroeconomic stability can foster greater flexibility at the firm level.** Reduced volatility allows the price mechanism to function more effectively, as firms and individuals are able to distinguish underlying trends in demand, supply and relative prices more clearly. This provides a stronger information set on which to base pricing, production and resource allocation decisions.

Pillar 2: Promoting efficient and dynamic markets

Markets drive investment and growth by encouraging improvements in productivity – through both efficiency improvements within firms and the entry of new, more competitive firms. But markets can also fail to deliver desirable outcomes for a range of reasons, relating to externalities (including environmental externalities), and their tendency to move towards non-competitive structures. Government therefore has a key role in setting market frameworks to ensure that competition is fair, markets are open to trade, and regulatory burdens on businesses are reduced to the minimum necessary.

Open and dynamic markets

Trade and competition create incentives and opportunities for firms to benefit from knowledge transfer, improved management and innovation; all of which contribute to raising productivity. Evidence from recent studies underlines the importance of open and competitive markets to long run growth, including:[12]

- **The majority of UK productivity growth is estimated to come from the process of dynamic competition** (42% from the reallocation of activity between firms, 37% from the exit of poor performing firms and the entry of new ones, compared to 22% from within firm productivity growth).
- **Exporting firms contributed around 60% of UK productivity growth**, demonstrating the benefits of exposure to international competition.

The UK domestic competition regime is ranked among the best in the world. However we want to continue to improve it. Merging the functions of the Office of Fair Trading and the Competition Commission will create a more aligned and streamlined competition regime. The European Single Market has already delivered considerable benefits to the UK and full implementation could roughly double the existing benefits.

Foreign Direct Investment (FDI) and growth

FDI is another means of transferring technology and know-how, which can lead to more efficient production processes and enhanced organisational structures, ultimately contributing to aggregate productivity. In particular, foreign multinationals undertake significant R&D in the UK. However, there is mixed evidence about the overall impact of FDI on growth. In particular, assessing the impact of FDI on employment, plant survival and the demand for skilled labour is complex.[13]

Better regulation

By addressing market failures and tackling inefficiencies **regulation can boost the productive potential of the economy** thus facilitating economic growth. Well designed regulation that provides long term signals to individuals and businesses has an important role in incentivising investment and innovation, **but badly designed or contradictory regulations can place unnecessary burdens on businesses** and constrain economic growth.

The UK performs well on some international measures of regulation, for example the OECD ranks the UK joint first on product market regulation. However, according to the World Economic Forum ‘Global Competitiveness Report’ the UK’s relative position in terms of regulatory burden has declined in the last few years. Whilst our regulatory burdens have not been increasing, other countries appear to have reduced burdens by more.

Table 1: International Comparisons of Regulation[14]

Rank	WEF Global Competitiveness (2010/11)	World Bank Doing Business Report (2011)	OECD Product Market regulation Index (2008)
1	Switzerland	Singapore	**United Kingdom** (joint first)
2	United States	Hong Kong	United States (joint first)
3	Singapore	New Zealand	Ireland
4	Sweden	**United Kingdom**	Canada
5	Denmark	United States	Netherlands
12	**United Kingdom**		

Going forward, there needs to be a change in culture to drive greater use of alternatives to regulation to produce a desired outcome, with regulation used only as a last resort. While the “one in one out” programme will help ensure that the overall burden of regulations does not increase.

Corporate Governance

Corporate Governance plays an important role in supporting growth by creating the incentives for investors and managers to raise firm productivity, and by improving the information available to investors, which reduces the cost of finance raised by the firm. **The corporate governance framework in the UK scores well in international comparisons**, although some rankings have fallen following the credit crunch.

Recent developments have prompted a number of debates around the effectiveness of corporate governance arrangements. In particular there are concerns that investors are increasingly focused on short term returns and that the length of the investment chain introduces multiple information asymmetries. This may reduce the quality and quantity of engagement between shareholders and boards. These concerns are particularly relevant during takeovers, and in the setting of executive pay.

Pillar 3: Effective Government which Supports Investment and Growth

In facilitating growth government has a dual role, investing directly in areas of the economy where there are particularly strong public good / externality arguments (e.g. basic research, infrastructure), as well as leveraging and encouraging investment by the private sector. The latter requires correcting market failures such as those around access to finance, and encouraging long term investment by business through a favourable business environment; including stable and competitive taxes and a culture of enterprise.

Competitive tax environment

The tax system can play an important role in influencing growth and business competitiveness. High business taxes can reduce productivity by reducing incentives for businesses to invest.[15] **Despite UK Corporation Tax being at historically low rates, the headline rate has become less attractive in recent years, as other countries have consistently cut rates**.

Access to finance

The ability of business to access finance is critical in facilitating new business start ups, funding investment and ensuring businesses become more productive and reach their growth potential. **A lack of finance can constrain growth and hamper businesses' survival prospects**.[16]

It is common for viable SMEs to face difficulties obtaining external finance as a result of market failures – in particular a lack of competition and information asymmetries between the borrower and the lender/investor. **As the economy recovers from a deep recession, certain parts of the economy, especially SMEs, face particular challenges in accessing credit**.

The Government is focused on addressing two key challenges – ensuring that business owners have the right level of finance expertise to access finance and that high-growth businesses have a greater range of external finance options available to them.

Infrastructure

Reliable, resilient and low carbon infrastructure is vital for sustainable economic growth. It provides a business environment which facilitates competition, trade and the diffusion of knowledge and innovation by enhancing businesses' access to workers, customers and suppliers.[17]

The UK has a well developed infrastructure network, however much of it is ageing and becoming outdated.[18] Furthermore the population is growing and so demand for infrastructure services is increasing. In order to meet our greenhouse emissions targets we need to address congestion and move to lower carbon infrastructure.

Science and Innovation

Science and Innovation are key drivers of economic growth, primarily through the improvements they generate in productivity via technological progress. Indeed, in the long run, technological progress has been the most important determinant of growth in advanced economies such as the UK.[19]

The UK performs well in international rankings of the quality and quantity research, but is considered to perform less strongly in terms of successfully commercialising it.[20]

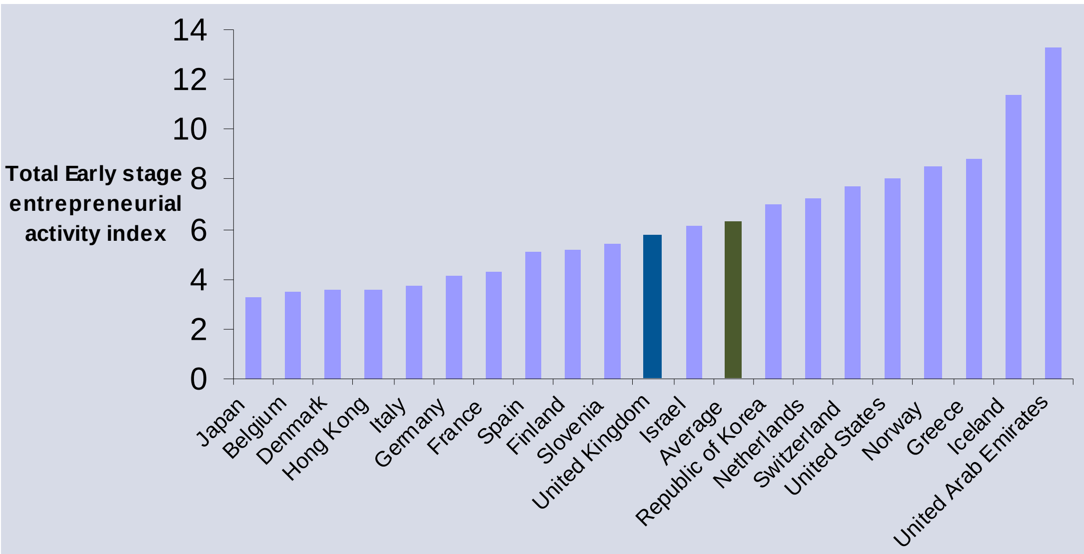
We must also be careful not to focus solely on R&D. Recent research has highlighted the importance of other forms of investment in knowledge assets, which are now more important to the UK than conventional investments.[21] The key challenges going forward are thus to:

- Maintain and improve the attractiveness of the UK as a destination for R&D-based foreign investment.
- Make the UK the most attractive destination for the best researchers.
- Increase the economic impact of the research base.
- Equip the workforce with the STEM skills required for those industries which make the greatest contribution to economic growth.

Enterprise

Enterprise underpins economic growth through its two main components – employment and productivity. New and small businesses drive economic growth by stimulating innovation, creating a competitive spur to existing businesses to increase their own productivity; and by making a disproportionate contribution to job creation.[22]

Figure 1: Early stage entrepreneurial activity[23]



The UK currently outperforms most G7 countries in terms of entrepreneurial activity, including Germany and France **but still trails the US and many other international competitors, so there is scope for improvement.** There are four main priorities in this area:

- A more targeted and efficient model of business support delivery, including a greater focus on management and strategic capacity.
- Increasing the strength of enterprise culture.
- Ensuring that businesses with export potential can access overseas opportunities and optimise that potential.
- Improving access to finance for businesses with growth potential.

Pillar 4: Supporting Individuals to Fulfil their Potential

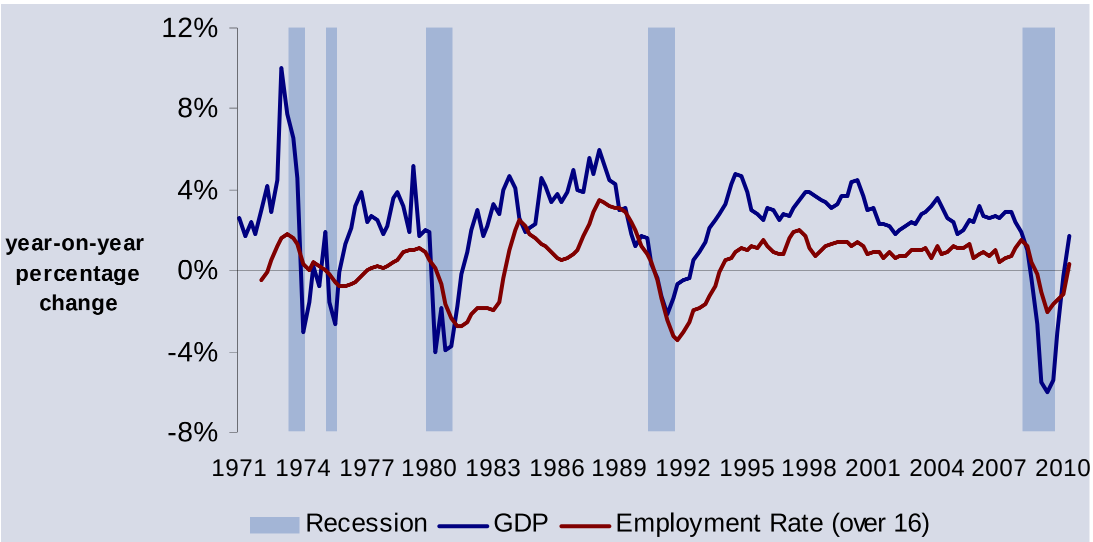
Achieving sustainable growth will ultimately be dependent upon maximising the potential of the labour force. This means both creating the incentives for people to enter employment, and helping ensure that people have the skills they need to maximise their productive potential. Where clear skill shortages exist, migrant labour has an important role to play through complementing local skills. There is also evidence on the relationship between inequality and growth, and the potential role that improving equality of opportunity can play in driving growth.

Employment

Although the exact relationship depends on a range of factors such as the benefit system and labour market regulation, it is clear that **employment and economic growth have a close relationship**.

In the recent recession, there was a smaller fall in employment relative to the decline in GDP than in previous recessions and compared to other countries. This is partly due to the willingness of more workers to reduce hours or accept pay cuts and freezes.

Figure 2: The co-movement between growth in UK GDP and employment since the 1970s[24]



Benefits system and active labour market policies

Both the incentives provided by the benefit system and the quality of direct help provided through active labour policies can have a strong impact on employment rates and levels, potentially supporting growth in the economy.

There has also been a long-term shift towards inactive benefits, notably the proportion of people claiming incapacity benefits. The latter remains much higher now than at any point during the 70s or 80s, and accounts for the majority of people claiming out-of-work benefits.[25] In addition, **the UK has one of the highest rates of children living in workless households in Europe**. Addressing these issues are the main challenges for the UK.

Labour market regulation

Although the UK performs well against international comparisons, and especially against other European economies, there remain concerns about the cost and complexity of the UK employment law system.[26] The future challenge is to provide maximum flexibility and promote competition without compromising fairness.

Skills

Education and skills make a positive contribution to growth through opening up new employment opportunities and raising productivity.[27] They also help promote fairness and reduce inequalities, which often appear at an early age; by enabling individuals to access higher education and the most highly skilled jobs in the economy.

The UK has a relatively high proportion of individuals who only hold low-level qualifications compared to other OECD countries. Employers report that a significant proportion of school and college leavers are poorly prepared for work and almost 10 per cent of 16-18 year olds are not in education, employment or training.[28] Compared to other countries, employer-provided training is of a lower quality and the lack of managerial capability amongst UK firms may hold back competitiveness and fail to make the best use of the human resources available to them.

Migration

Evidence suggests that **migration has contributed to GDP growth in the UK through the expansion of employment**. Being able to draw on a pool of labour enables employers to fill vacancies and respond to short-term needs. In some sectors, however, firms are heavily reliant on migrant labour which presents a longer-term challenge if the flow of labour is reduced. Although some recent research suggests there is the possibility of migrants displacing resident workers in the short-term, there is no evidence that migration from the A8, for example, has displaced UK-born workers.

The impact of migration on GDP per head, however, remains unclear. Migrant labour, and particularly the highly-skilled, may generate benefits across all workers in the economy if they bring new skills and innovations or promote trade and investment. Negative externalities could emerge though as population size increases pressure on public services and social cohesion.[29]

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[1] Note data not available for Italy.

[2] Over the period 2000-2007 48% of UK Real GVA growth came from these sectors, compared to an average of 33% in the US and 25% for the major European Economies.

[3] BIS analysis of UN COMTRADE and IMF Balance of Payments data.

[4] BERR (2008) Cross Country Productivity Performance at the Sectoral Level: The UK Compared with the US, France and Germany.

[5] BIS Calculations based on data from OECD STAN database.

[6] BIS Calculations base on data from World Intellectual Property Indicators (2009). Note results may in part reflect different IP protection strategies in the UK compared to our international counterparts.

[7] OECD (2010) 'Education at a Glance'.

[8] Reinhart, C. & Rogoff, K. (2009) 'The aftermath of financial crises', American Economic Review Vol. 99(2).

[9] See, for example Kose, M, Prasad, E. and Wright, P. (2005) 'Growth and Volatility in an era of globalization', IMF Staff Papers, Vol. 52

[10] Krussell, P. & Smith, A. (2002) 'Revisiting the welfare effects of eliminating business cycles', Carnegie-Mellon University Working Paper.

[11] Barlevy, G. (2004) 'The cost of business cycles under endogenous growth', American Economic Review Vol. 94(4).

[12] Harris, R. & Li, Q.C. (2007) 'Firm level empirical study of the contribution of exporting to UK productivity growth', Report submitted to the UKTI.

[13] See for example Harris, R. (2009) 'The effect of foreign mergers and acquisitions on UK productivity and employment', report submitted to the UKTI.

[14] Source: World Economic forum Global Competitiveness Report 2010/11, World Bank Doing Business Report 2011, OECD Product Market Regulation Index 2008.

[15] OECD (2008) 'Do tax structures affect aggregate economic growth? Empirical evidence from a panel of OECD countries', OECD Economics Department Working Paper No. 643.

[16] BERR (2009) 'Rowlands Review: The provision of growth capital to UK small and medium sized enterprises'

[17] IMF (2010) 'Public Capital and Growth', IMF Working Paper No 10/175.

[18] Crafts (2009) 'Transport infrastructure investment: Implications for growth and productivity', Oxford Review of Economic Policy Vol. 25(9).

[19] For a useful survey of the literature Welcome Trust (2008) 'Medical research, what's it worth?'.

[20] OECD (2008) 'Science and Technology Outlook'.

[21] NESTA (2010) 'Innovation Index', forthcoming.

[22] See for example Robinson, C. O'Leary, B. & Rincon, A. (2006) 'business start up, closures and economic churn' Report prepared for the Small Business Service.

[23] Defined as proportion of working age population involved in starting or running a new business under 42 months old. Source: Global Entrepreneurship UK Monitor Report.

[24] Source: ONS and National Accounts Data.

[25] Source: ONS Labour Force Survey population statistics, DWP benefit statistics.

[26] OECD (2006) 'Employment Outlook'.

[27] OECD (2009) ' Education at a Glance'.

[28] UKCES (2010) 'National employer skills survey'.

[29] See for example Riley, R. & Weale, M. (2006) Immigration and its impacts', National Institute Economic Review No. 198.

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