UK IN A CHANGING EUROPE

THE STATE OF THE UK ECONOMY 2024

FOREWORD

The state of the UK economy is always an important matter, but it is all the more so in what looks likely to be an election year. We can look forward to a polarised debate about where we are and where we might be headed. With this in mind, we at UK in a Changing Europe have put together this report on the UK economy. Drawing on contributions from a range of academic specialists, it is intended both as a stock take, and a discussion of what steps any future government might take to improve economic performance.

I would like to express my gratitude to Jonathan Portes who was responsible for putting the report together, and for writing much of the initial sections. Thanks to Sarah Hall and Stephen Hunsacker for their invaluable contributions. Thanks also to Joelle Grogan for editorial work, and to John Barlow, Anthony Broxton, and Alex Walker who checked the text and the graphics with their customary efficiency.

I hope you find what follows interesting and informative. Do get in touch if you have any comments or queries.

31 January 2024

Professor Anand Menon
Director, UK in a Changing Europe

CONTENTS

CONTRIBUTORS

Arun Advani, Associate Professor of Economics, University of Warwick

David Bailey, Professor of Business Economics, Birmingham Business School and Senior Fellow, UK in a Changing Europe

Ben Brindle, Researcher, Migration Observatory, University of Oxford

Simon Burgess, Professor of Economics, University of Bristol

Patrick Dunleavy, Emeritus Professor of Political Science and Public Policy, London School of Economics

Sarah Hall, Deputy Director of UK in a Changing Europe, and 1931 Professor of Geography, University of Cambridge

Christian Hilber, Professor of Economic Geography, London School of Economics

Stephen Hunsaker, Researcher, UK in a Changing Europe

Donald Houston, Professor of Regional Economic Development, University of Birmingham and Senior Fellow, UK in a Changing Europe

Ethan Ilzetzki, Associate Professor of Economics, London School of Economics

Sandra McNally, Professor of Economics, University of Surrey

Henry G Overman, Professor of Economic Geography, London School of Economics

Jonathan Portes, Professor of Economics and Public Policy, King's College London and Senior Fellow, UK in a Changing Europe

Huw Roberts, DPhil student, Oxford Internet Institute

Thomas Sampson, Associate Professor of Economics, London School of Economics

Andy Summers, Associate Professor of Law, London School of Economics

Madeleine Sumption, Director, Migration Observatory, University of Oxford

Philip R Tomlinson, Professor of Industrial Strategy, University of Bath

Tony Wilson, Director, Institute for Employment Studies

Ben Zaranko, Senior Research Economist, Institute for Fiscal Studies

INTRODUCTION

Jonathan Portes and Anand Menon

The last year seems to have crystallised two potentially dangerous tendencies in British politics. The first is to argue that our economic performance has been so bad that 'we can't go on like this'. The second is that our policy options are so constrained - by the fiscal position, by Brexit, by both domestic and international political economy - that nothing can be done. Taken together, they represent a doom loop.

This report attempts a more a constructive framing both of where we stand and what might be done about it. First, we discuss the UK's economic performance since the global financial crisis. While specifically British factors - notably austerity and Brexit - have contributed to our woes, other major European economies have also struggled, suggesting that monocausal explanations are insufficient as a diagnosis, and that there is therefore no silver bullet that could represent a cure.

We then consider the strengths and weaknesses of the UK economy, and - looking forward - the consequent opportunities that arise and threats we face. Perhaps the most important point here is that our weaknesses themselves, paradoxically, represent an opportunity. The UK's recent poor productivity performance means we have fallen behind peer countries. Significant gains could be made simply through catching up and adopting best practices. Given the 'long-tail' of relatively unproductive small and medium sized firms, and the poor performance of large cities outside London, just bringing productivity in these firms and cities up to the average would have a noticeable impact on economic growth, as well as reducing inequalities.

And - more good news - academic research in the UK and beyond gives us a reasonably good idea of the structural weaknesses that need to be addressed to make that possible. Our contributors synthesise the evidence across a range of topics, and make concrete policy proposals that could realistically improve things. It's hard to sum this all up - and, as noted above, there is no single silver bullet for the problems we face - but some themes do emerge.

One is the need for a longer-term, joined up approach in policy areas ranging from education to public services to artificial intelligence. The UK has long been plagued by short-termism, and the political instability of the past few years has considerably aggravated this already damaging tendency. Incrementalism, whereby further complications are layered onto existing systems to the point where they are no longer comprehensible to policymakers, let alone the public, also imposes considerable costs, the tax and planning systems being cases in point. Both a clearer vision of how systems should work, and a feasible plan for how to get there over the medium to long term, are required.

Second, we need to work both with our strengths and with the grain of technological progress. The UK is fortunate in that our most successful sectors - high-productivity tradeable services - are likely to represent a growing share of the global economy. But to make the most of that we need domestic policies that enable them to grow and to be more productive - in particular housing, planning, and transport policies that foster growth in our major cities. And we need trade and regulatory policies that make them globally competitive. Regulatory uncertainty and political short termism should not be allowed to undermine the obvious strengths the UK enjoys, for instance, around higher education and artificial intelligence.

Finally, economics is not, and should not be, separate from broader social policy concerns. The disappointing overall economic performance of the last fifteen years has also seen existing inequalities entrenched and in many ways exacerbated. There is no conflict between strategies to increase growth and those to reduce inequalities. Indeed, in areas ranging from education to tax to regional policy, they are complementary. The UK can be both a more prosperous and a fairer society.

None of which is to say that this will be easy. Yes, simplistic or single-source explanations - like austerity or Brexit - are insufficient, but there is no denying that both have worsened the problems we face and will make addressing them harder. Yet this is not a counsel of despair. What is needed, and what this report provides, is a clear-eyed and honest analysis of where we are, as a basis for planning how we might get where we want to be.

THE STATE OF THE ECONOMY

THE UK ECONOMY SINCE THE GLOBAL FINANCIAL CRISIS

Stephen Hunsaker

This section presents a descriptive analysis of the evolution of the UK economy at an aggregate level over the last 15 years. It highlights key macroeconomic variables such as growth in GDP per capita, productivity and investment.

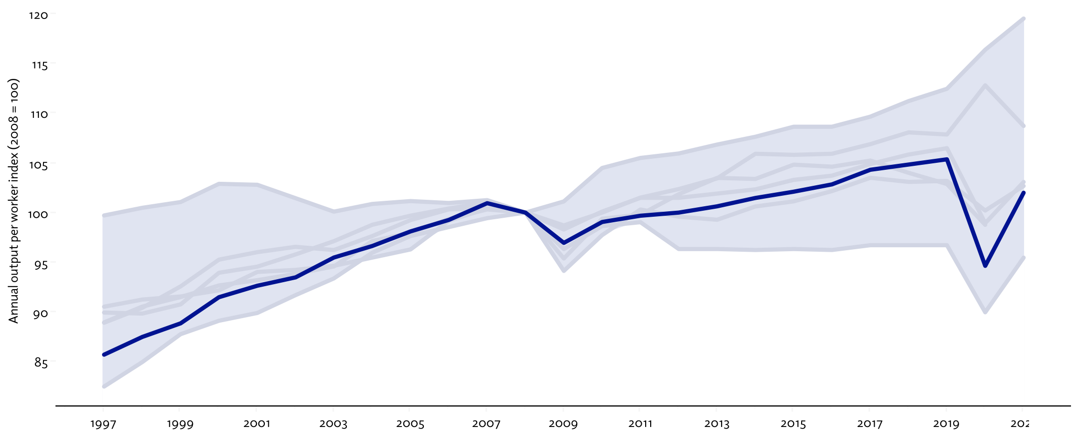
GROWTH AND PRODUCTIVITY

The UK's economic performance since the 2008 financial crisis has been extremely poor in historical terms, although in relative terms it is not that different from other large European economies, which have also seen relatively slow growth. It is therefore likely to be driven by a combination of UK-specific factors and broader European trends. By contrast, the gap between the US and advanced European economies, including the UK, has widened sharply.

Sluggish growth is largely the result of a sharp fall in productivity growth. This had averaged close to 2% per year before the crisis and fell to approximately 0.3% in the years after. This reflects an economy-wide slowdown, affecting both the private and public sectors (productivity growth has been particularly weak in the latter).

UK productivity growth has been weak

Annual output per worker indexed to 2008 = 100 for the G7. Dark blue line is United Kingdom

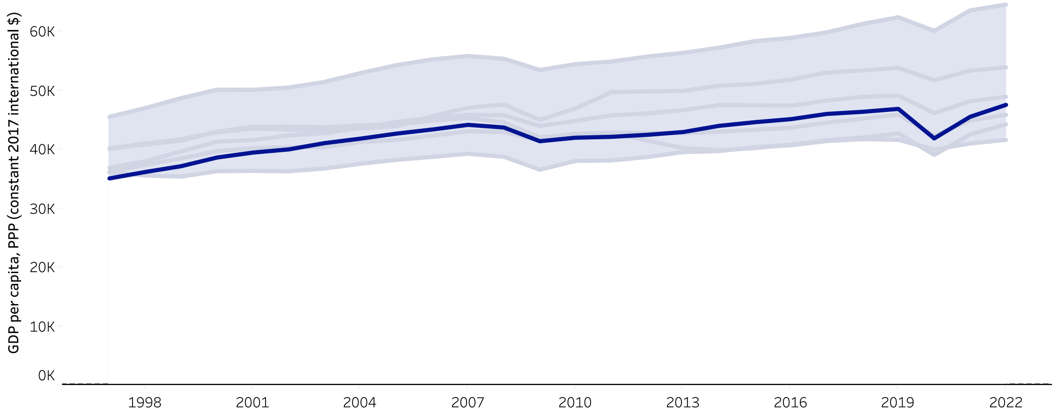


Source: OECD stats

Consequently, growth in GDP per capita has been low by historical standards. While recent data revisions mean that the UK's performance during and after the pandemic are not as bad as first thought, this does not alter the overall picture of low trend growth over the last 15 years. On real wages and living standards, our relative performance is poor even compared to other large European countries, with the exception of Italy, with middle and lower income households slipping well below their counterparts in France and Germany.

UK GDP per capita growth has been slow since the financial crisis

GDP per capita using purchasing power parity in constant international dollars per capita. Dark blue line represents United Kingdom



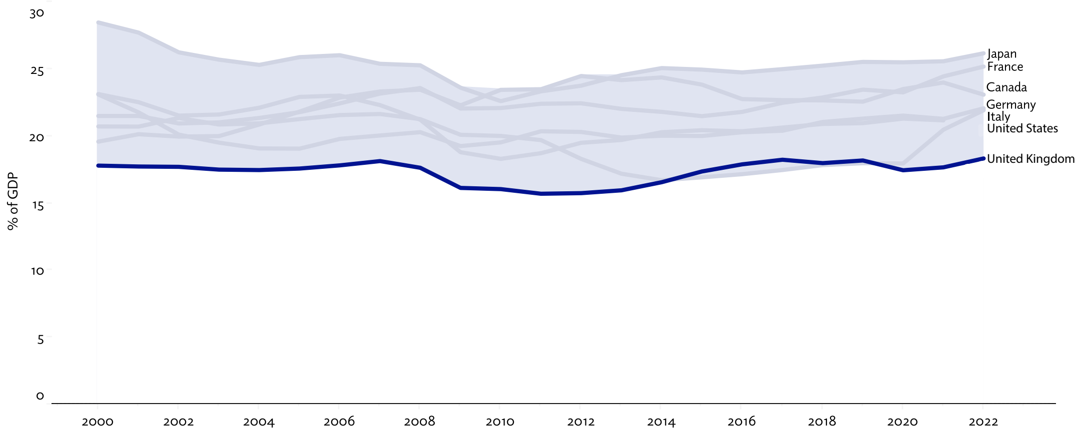
Source: World Bank. GDP per capita, purchasing power parity; constant 2017 international dollars per capita

INVESTMENT

There is a consensus that low levels of investment, both private and public, have held back productivity growth. The relatively low level of business investment in the UK pre-dated Brexit, but both aggregate data and survey evidence strongly suggest that Brexit is at least in part responsible for the particularly poor performance since 2016. Investment has perhaps been 10% lower than it would otherwise have been: that in turn might translate to a reduction in productivity, and hence output, of a little over 1% of GDP.

UK investment remains the lowest in the G7

Gross fixed capital formation (GFCF) as a percentage of GDP for G7. Dark blue line represents United Kingdom



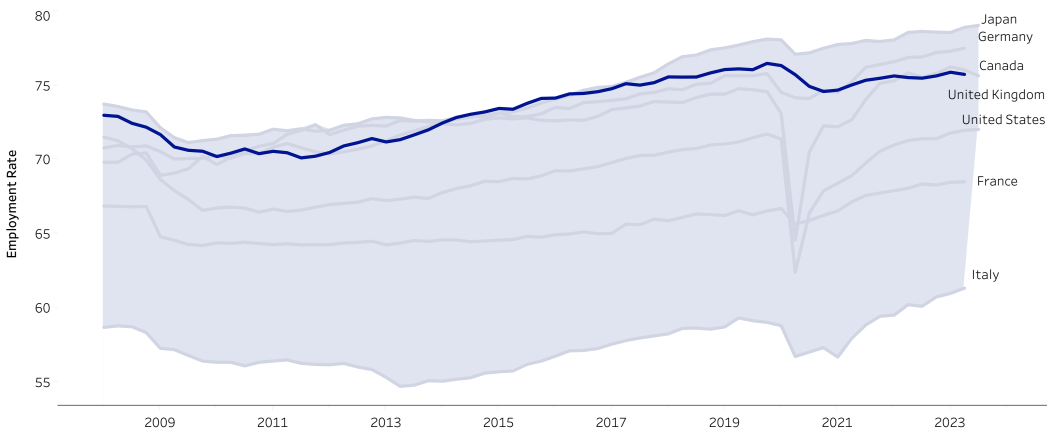
Source: OECD stats. GFCF.

EMPLOYMENT

In contrast to productivity, employment growth in the UK was strong throughout the 2010s. The UK entered the financial crisis with a relatively high employment rate, and the recession did not lead to anything like as large a fall as in previous downturns. Employment recovered quickly and reached record levels, both in rates and levels terms, immediately before the pandemic. This reflected a relatively flexible labour market, high levels of work-related migration, and some success in retaining older workers in the labour force.

Employment has grown strongly since the financial crisis and the employment rate remains high

Employment rate of the G7 from 2008 to Q3 2023



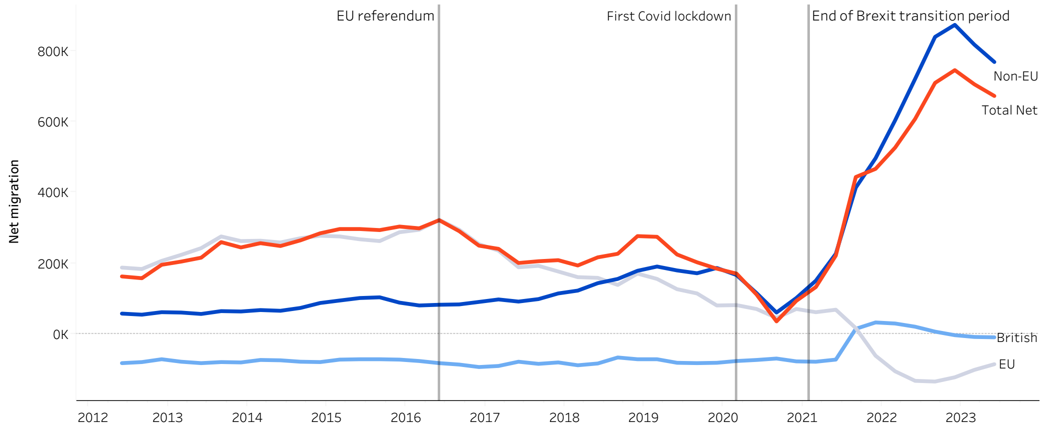
Source: OECD stats

IMMIGRATION

One of the drivers of rapid employment growth – along with increased labour market participation, especially among older workers – has been immigration. While migration fell during and after the financial crisis, as a result first of labour market weakness and then measures to restrict non-EU migration, EU migration rose sharply and remained at high levels until the Brexit referendum in 2016. After that, however, EU migration fell, but non-EU migration recovered. During the pandemic, migration slowed sharply, and many UK-resident EU migrants returned home. The introduction of the post-Brexit migration system in 2021 and the post-pandemic recovery saw a very sharp increase in non-EU migration, partly driven by refugee flows but mostly by increases in migration for work and study, leading to record net migration overall.

The introduction of the post-Brexit migration system has led to a sharp increase in non-EU migration

Net migration by region of origin from 2012 to June 2023



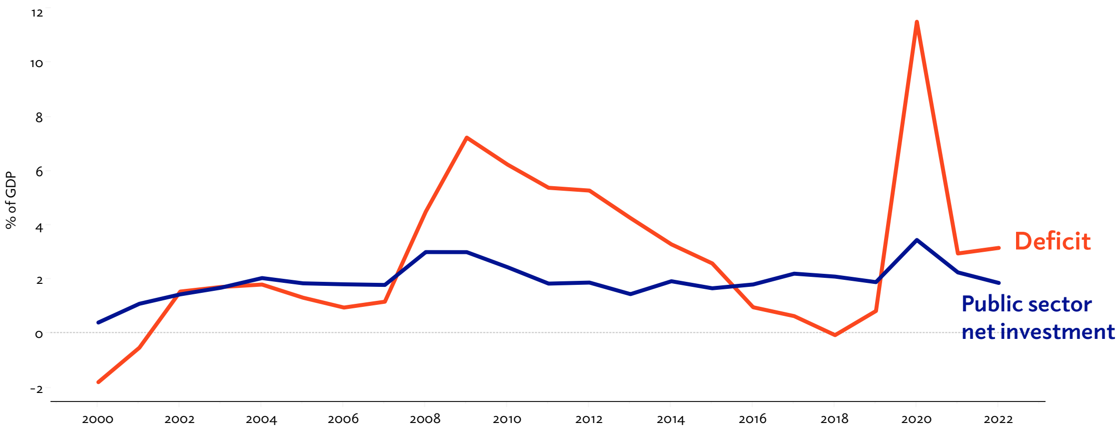
Source: Office for National Statistics

AUSTERITY AND FISCAL POLICY

The financial crisis resulted in a very large increase in the fiscal deficit, which peaked at about 10% of GDP. The Conservative-Liberal Democrat government planned to eliminate the current deficit (that is, excluding public investment) over a period of 5 years. This was to be primarily achieved by cutting spending, although VAT was increased by 2.5%. However, slow growth - arguably itself a result of excessively rapid fiscal consolidation - meant that deficit reduction was slower than intended.

The financial crisis and the pandemic resulted in very large increases in the fiscal deficit

Current budget deficit and public sector net investment as a percentage of GDP from 2000 to 2022



Source: Office for Budget Responsibility - Public finance databank - Nov 2023

Over the 2010-15 period, there were substantial reductions in public spending, with per-pupil school spending falling sharply, and cuts to some welfare benefits. Local government, responsible for delivering services such as social care and children's services, was particularly badly hit. Healthcare spending was protected in relative terms, but a surge in demand, fuelled by an ageing population and a salary cap on staff, imposed increasing strain on the NHS. Public sector net investment was also reduced sharply.

After 2015, and especially after 2017, while there were further large cuts to some welfare benefits, pressures to reduce spending eased somewhat. However, the delayed impact of earlier reductions, in particular underspending on capital (for example in repairs and maintenance in schools, hospitals and the justice system) and on workforce development and training is still feeding through into reduced service quality.

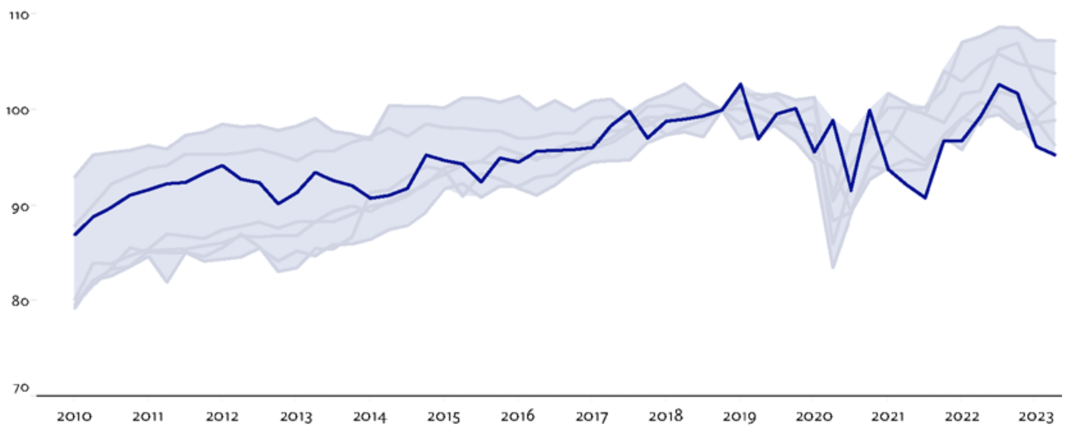
TRADE AND BREXIT

Over the past two decades, two key trends dominated UK trade: a slow but steady reduction in the relative importance of the EU as a trading partner, and a shift in UK exports from goods to services. The result has been a widening of the UK's goods deficit, especially with the EU, and a growing services trade surplus. Surprisingly, since Brexit, the share of UK trade that is conducted with the EU has actually risen. However, it may have further accelerated the shift to service exports, as goods exports have stagnated, while exports of services have continued to grow. Overall, the UK's 'trade openness' (trade as a proportion of GDP) has fallen significantly, and considerably more than in other advanced economies.

UK trade openness grew until Brexit, but has fallen back since the introduction of the TCA

UK IN A CHANGING EUROPE

Index of trade openness (trade volumes divided by real GDP) of the G7 between 2010 and Q2 2023 (Q4 2018=100). UK represented by dark blue line



Source: OECD Quarterly National Accounts data. Trade openness calculated as imports and exports in chained volume measure divided by real GDP (in US dollars, volume estimates, fixed PPPs, OECD reference year, annual levels, seasonally adjusted). Shaded area is G7 min and max range with dark blue line representing the UK.

DEVELOPMENTS SINCE THE COVID-19 PANDEMIC

As in other advanced economies, the pandemic resulted in an extremely large fall in GDP, the vast majority of which was quickly recovered as the economy reopened. However, disruption to supply chains, labour shortages in several sectors and sharp rises in energy prices, subsequently exacerbated by the Ukraine war, led to a surge in inflation. The Bank of England, like other central banks, responded with significant increases in interest rates, which, after 15 years below 1%, are now at a more 'normal', pre-financial crisis level of 5.25%.

In most respects, the UK's post-pandemic experience has again been broadly similar to that of other large European economies (and contrasts with that of the US), although it is possible that increased trade and labour market frictions resulting from Brexit have slightly exacerbated inflationary pressures. While other countries have also seen increases in immigration, the UK stands out for the magnitude of the increase in work-related migration. However, this has been offset by a drop in labour force participation, particularly relating to sickness and disability; it is unclear whether this is temporary. Overall, however, the pandemic does not as yet appear to have fundamentally altered the UK economic landscape, for good or ill.

THE CURRENT STATE OF THE UK ECONOMY: A SWOT ANALYSIS

Jonathan Portes and Sarah Hall

This is not a cheerful picture, but nor is it irremediably negative. And, as the last 15 years show, the past is not always prologue. Few would have predicted the outcomes described above, even after the financial crisis hit. A realistic assessment of how we ensure that the next decade looks better in terms of aggregate measures requires an analysis of both the UK economy's weakness and strengths. In this section, we provide such an analysis, in a standard 'SWOT' (strengths, weaknesses, opportunities, threats) framework.

STRENGTHS

> **The UK remains, by global standards, a large, advanced and prosperous economy, with a well-educated labour force, and clear comparative advantages in key sectors.**

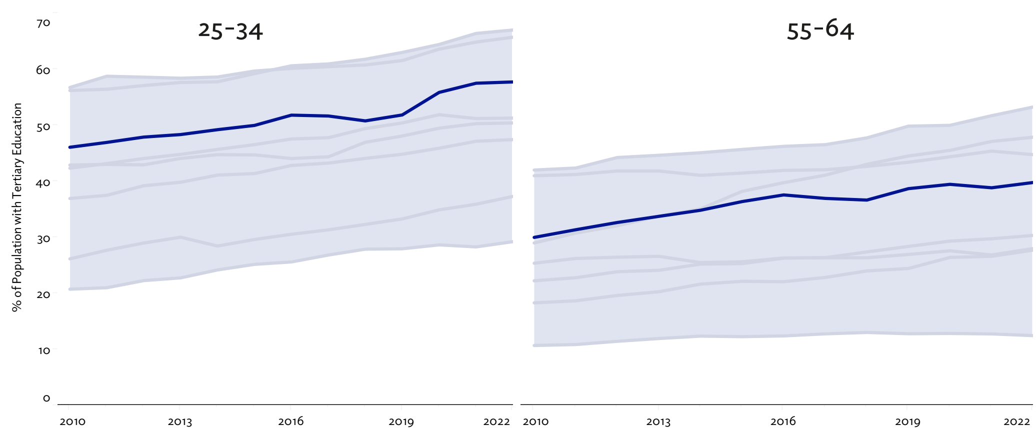
PEOPLE AND LABOUR MARKET

Any country's most valuable asset is its people – a truism that is backed up in economic terms by the ONS's valuation of the UK's human capital stock, which is about 5 times as large as the value of physical capital like buildings and capital. Overall, the UK has a skilled and flexible labour force.

The UK has high levels of tertiary education, especially among the young

UK IN A CHANGING EUROPE

Percentage of population with tertiary education for ages 25-34 and 55-64 for G7 from 2010 to 2022. United Kingdom in dark blue.



Source: OECD data - Population with tertiary education

UK schools have improved hugely over the past two decades, and the rapid widening of participation in higher education over the last 30 years means that the UK is now well ahead of the OECD average. And while the graduate wage premium may have narrowed somewhat in recent years, it remains substantial, indicating that businesses still see significant productivity advantages to employing graduates. Employment rates, especially for women and older workers, have risen steadily for the last few decades, and the UK now compares well to other large G7 countries, having overtaken the US. A flexible labour market means that employers find it relatively easy to hire and fire workers, and workers can move jobs. Unemployment remains very low.

INSTITUTIONS

There is ample evidence that governance and the quality of a country's institutions are crucial to growth and prosperity. Despite recent instability, the UK remains a stable democracy, with a tradition of generally good economic governance and institutions. This includes a strong independent central bank and independent regulators overseeing many key economic decisions with little scope for arbitrary political interference. While recent years have seen considerable political turbulence, this has not called into question these basic structures. Indeed the ill-fated Liz Truss premiership arguably strengthened the position of key economic institutions (the Treasury, Bank of England and the Office of Budget Responsibility). Others, such as the Competition and Markets Authority, are generally regarded as credible and independent, although there is a risk that Brexit may undermine this over time. More broadly, the UK's legal system is both business-friendly and sets international standards in a number of respects, while English remains the most important language for business globally.

SECTORS

The UK is particularly strong in some high-productivity services sectors, which have proved relatively resilient to the impact of Brexit so far. As well as financial services and insurance, the UK is strong in legal services, business, accountancy, and consultancy services more generally. All of these benefit from the fact that they are generally transacted in English and that London's geographical position, combined with its access to a large pool of skilled labour, both from within the UK and abroad, means that most major global firms regard it essential to have a significant presence there. The use of English Common Law within the UK is also frequently identified as an important element in the competitiveness and adaptability of UK financial and related legal services.

These sectors are also symbiotic with higher education, which helps to provide the skilled labour required. HE is of course a major and very successful sector -

not least in terms of exports - in its own right. The UK's vastly disproportionate share of successful global universities is also key to its strengths in other sectors that are complementary with university research, in particular tech/AI, life sciences and pharmaceuticals. And while manufacturing is considerably less important to the UK economy than it was in the 20th century, considerable strengths remain in advanced manufacturing, for example aerospace.

WEAKNESSES

As described above, the UK's economic performance since the global financial crisis has been at best mediocre. While this is partly the result of policies such as austerity, and while Brexit has reduced growth, it also reflects long-standing structural weaknesses, particularly around persistently low investment (both public and private), skills, and entrenched inequalities along several dimensions.

PEOPLE AND LABOUR MARKET

Despite increasing attainment overall, there are sharp divides in skills and qualification among the UK population. This begins at school, where attainment, particularly outside the large cities, is highly correlated with parents' socio-economic status. It continues when it comes to access to higher education. Meanwhile, for those - typically from lower income backgrounds - who do not go on to higher education, pathways to vocational and technical education are often confused and fragmented, whilst investment in non-university tertiary education remains low.

Educational inequalities are reflected in labour market outcomes, and exacerbated by continuing structural disadvantages relating to gender (especially motherhood) and race or religion. The result is high levels of inequality of income and, increasingly, wealth; low levels of social mobility; and, combined with very large cuts to working age benefits over the last decade, rapidly increasing levels of poverty and deprivation. Meanwhile, the recent expansion in higher education has not translated directly into higher productivity, possibly due to a shortage of graduate-level jobs outside London. The consequent failure to make the most of the country's human resources is a significant constraint on growth.

Looking at the longer term, in common with other advanced economies, fertility has fallen sharply, meaning that an ageing population will in time be combined with a shrinking workforce.

INSTITUTIONS

The UK is considerably more centralised than most advanced economies, and reductions in central government funding have further reduced the capacity of local authorities. The result is a vicious circle where central government is not willing to devolve power or financial autonomy to local authorities that are perceived as politically hostile or incompetent except under stringent and bureaucratic conditions, further exacerbating the lack of local capacity. The effects have been particularly severe for social care, contributing to the current crisis in the NHS, which in turn is likely to reduce productivity. While the devolved nations have considerably more autonomy, the relationship remains dysfunctional, and Scotland itself remains a highly centralised country.

Meanwhile, paradoxically, despite the centralisation of political, fiscal and legal power in Westminster and Whitehall, the planning and regulatory system privileges and entrenches local interests in ways which make it very difficult for central government either to build infrastructure in a quick and cost-effective way, or to address the UK's failure to build sufficient houses to meet the needs of a growing population. This in turn both exacerbates the inequalities of income and wealth described above, hinders the growth of high productivity businesses, and reduces the flexibility of the labour market, by making it much harder to move to a high-cost area. This in turn exacerbates the problem of realising positive agglomeration effects in some high-density areas.

More broadly, although hard to quantify, there has been a steady erosion in the quality of UK governance in recent years. Chronic short-termism - endemic in the UK and other advanced democracies, but worsened by the recent growth in political polarisation - makes it much harder to secure the necessary degree of consensus required to deal with longer-term structural problems, from social care to the planning system. Political instability, combined with an erosion in civil service capacity and frequent tensions between politicians and civil servants, has meant that policy-making has been at best erratic, with frequent changes of course or even reversals, as with corporation tax rates and the transition to electric vehicles. Such instability has economic impacts, particularly on long-term investments. When policies are enacted, they have often not been implemented or delivered as planned. As a result of bitter arguments over Brexit and the pandemic, policy making was, for a long time, effectively paralysed (though the latter of course applies to all countries). All this, combined with the ongoing impacts of austerity, mean that public services are - despite a relatively high tax burden by historic standards - visibly failing to keep up with demand, with public service productivity at best stagnant.

SECTORS

While the UK has many world-class firms, and not merely in the successful sectors described above, it also has a 'long tail' of unproductive firms. These are mostly small and medium-sized enterprises, variously attributed to a combination of low investment, poor management, and lack of access or uptake of leading edge techniques and technologies; all of which interact with each other. In many parts of the country, the decline of relatively high-paid, high-productivity employment in manufacturing has been offset, in employment terms, by growth either in relatively low productivity service sector jobs, or in the public sector. In the former, some sectors at least may be stuck in low wage/low skill and hence low productivity equilibria, where lack of competitive pressure, regulatory constraints or lax enforcement of labour law mean businesses see little or no incentive to improve productivity through investment, training and workforce development or better management.

OPPORTUNITIES

An increasing proportion of global economic growth is likely to come in high-productivity service sectors, where the UK has many areas of clear comparative advantage. More broadly there is considerable potential for catch-up growth.

CATCH-UP GROWTH

Paradoxically, the UK's recent poor productivity performance, and the gap between the best performing regions, sectors and firms and the rest could itself be an opportunity. It means we have fallen further behind the technological frontier, especially compared to US firms, and significant gains could be made simply through catching up and adopting best practices, without the need for any major technological leaps or leading edge innovations. Given the 'long-tail' of relatively unproductive small and medium sized firms in both the manufacturing and service sectors, and the poor performance of large cities outside London, just bringing productivity in these firms and cities up to the average would have a noticeable impact on economic growth.

HIGH PRODUCTIVITY SERVICES, TECHNOLOGY AND AI

There are obvious opportunities in further developing the competitiveness of existing strengths in financial and legal services, consultancy, including information technology, and the creative services such as marketing and advertising. Future areas of growth are likely to be focused on digital and technologically enabled services and those related to achieving net zero and green economic growth.

In terms of digital growth and AI, the current government has set out clear ambitions for global leadership in this area, centred most recently around Rishi Sunak's hosting of the global AI summit. This event secured broad commitment from 28 countries to work collaboratively to address the significant risks associated with advanced AI. It was notable that despite global trade tensions, representatives from both the US and China were present.

The UK is particularly keen to use its post-Brexit freedom to tailor its regulatory regime to the specific needs of the UK economy to develop a liberal regulatory framework that would allow for a 'Big Bang' in AI and digital economic growth. This echoes the Big Bang in financial services under Thatcher in the 1980s that used deregulation to stimulate growth in financial services.

However, the Summit also pointed to some of the challenges facing the UK in this area. The presence of leading technology entrepreneurs and firms such as Elon Musk and Open AI reflects the dominance of the US in the tech sector globally. As a result, it is not surprising that the US is clear that it is leading the development of AI innovation and associated global regulatory standards. Given the different approach taken to AI regulation by the EU, the UK will need to consider how its own emerging standards sit alongside these two frameworks, and the implications of a different regulatory regime for export potential.

NET ZERO AND THE ENERGY TRANSITION

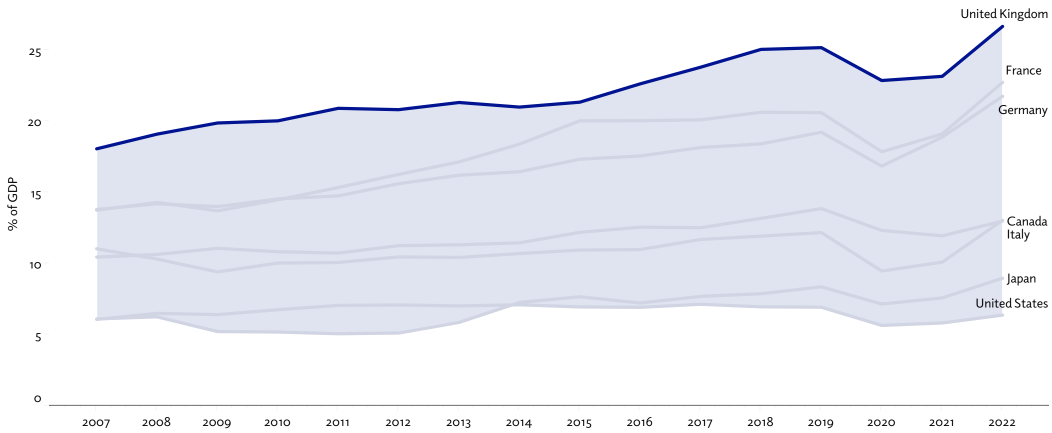
In common with other advanced economies, one important avenue for future growth for the UK is through the development of green industries as part of net zero and energy transition targets. The UK has been a leader both in overall progress towards decarbonisation and in several specific areas, for example the development of offshore wind. But while there are further opportunities for the UK, it will be important to consider how its approach sits alongside its international competitors, (particularly given the US Inflation Reduction and the EU's Net-Zero Industry Act and Critical Raw Materials Act). Without the same financial firepower, the UK will need to make a virtue of being smaller and potentially more nimble.

DEEPENING TRADE LINKS WITH HIGH GROWTH COUNTRIES

There are opportunities for the UK to foster deeper trade and economic relations with high growth economies, particularly those with which it has existing relationships, such as through the Commonwealth. The potential for further expanding trade, particularly in high value services, is substantial. high skilled services.

Service exports make up a greater share of GDP in the UK than in any other G7 economy

Trade in services as a % of GDP for G7 from 2007-2022



Source: World Bank Databank - World Development Indicators - Trade in services (% of GDP)

Clearly, given the increased geopolitical tensions with China, the UK will need to adapt its approach to focus on other countries. This approach has been developed post-Brexit through new trade deals with Australia and New Zealand. However, the success of these deals has been relatively limited to date, partly reflecting the large geographical distances involved which research shows typically reduce trade. For example, analysis shows that in the first 12 months of the Japan UK deal (which largely rolled over the existing EU-Japan FTA) coming into place, trade between the two countries fell.

In July 2023, the UK agreed to join the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP), most likely in 2024. This is a trade bloc of 11 other countries in Asia-Pacific, including high growth countries such as Malaysia, Mexico and Singapore. The UK's accession is important in signalling its ambitions to increase trade and economic relations with high growth economies beyond Europe and North America. While the government's impact assessment suggests that the long term increase in GDP would only be around £2 billion (equivalent to 0.06% of GDP), this could increase should the membership of the CPTPP widen to include high growth countries such as South Korea, with which the UK already has an FTA, and if the CPTPP itself evolves and deepens.

The UK is currently negotiating a trade deal with India. While this has been much delayed, and many were sceptical that it was possible at all given India's traditional reluctance to liberalise sensitive sectors, considerable progress has been made. A key UK objective is to secure access to the Indian market for UK high value service firms including law and accountancy, which would be potentially significant given the UK's strengths in these areas.

THREATS

The UK economy faces a variety of threats, both domestic and international. Some of these, such as demographic trends, political dysfunction and Brexit challenges reflect the continuation of existing trends, and will be manifested in ways that are mostly specific to the UK, although they may be mirrored elsewhere; others, such as a rise in protectionism and other geopolitical risks, are relatively new.

THE GLOBAL CONTEXT

While Brexit is now a fait accompli politically, its economic impacts have not fully materialised, especially in sectors like automotive where complex supply chains, which took decades to construct, may be dismantled - with the UK excluded - over a similarly long period. Meanwhile, hopes that these could be substituted with a less Eurocentric and more global trading model are threatened by the broader international and geopolitical environment. Increasing political tensions between the US and China (even short of a conflict over Taiwan, which would be a gigantic economic shock to the UK and all other advanced economies) along with the post-Covid trend towards reshoring, threaten the globalisation model of the last 30 years. Meanwhile the US and the EU are adopting more domestically focused approaches to industrial policy, especially in relation to the energy transition. The latter could leave the UK out in the cold, not being a member of any of the major global trading blocs.

INSTITUTIONS AND POLICY-MAKING

Domestically, while a modicum of political stability may have (at least relative to the last decade) been restored, there is yet little evidence that policy will not continue to be driven by short-term political considerations. And there is a vicious circle here; lack of sustained, broad-based growth itself leads to political short-termism, and to increasingly zero-sum, polarised politics. Combined with fiscal constraints - real or perceived - this may make it difficult to address pressures on public services: for example, the recent NHS workforce plan, strongly supported by both government and opposition, would require large increases in NHS spending if implemented in a credible fashion. Similarly, the UK's successful higher education sector is increasingly reliant on international students, since the erosion of the value of tuition fees paid by UK-origin students means that universities lose money on them. Addressing this would require either more public subsidy or loading young graduates with even higher debts. Addressing both these issues - as well as other long-standing challenges - such as the crisis in social care - require politically difficult and fiscally costly decisions in the short-term.

Other structural issues, in particular housing, planning and infrastructure, may not have such direct or large fiscal implications but require a combination of political will, long-term planning, and attention to implementation and delivery; these in turn necessitate a degree of political consensus within and across parties, and between central and local government. While these issues are hardly unique to the UK, the combination of the rise of populism with the UK's majoritarian political system makes them particularly intractable.

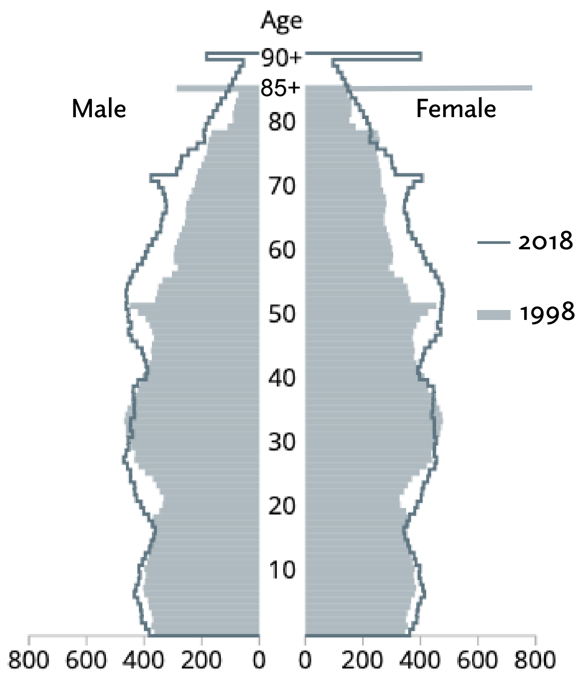
DEMOGRAPHICS

Looking longer term, the combination of an ageing population and falling fertility will lead to further increases both in the dependency ratio and demands on health, social care and pensions. Continued high levels of immigration of relatively skilled and younger workers is one obvious route to address this, but again faces political obstacles. To the extent that demographic pressures squeeze out - economically or politically - spending on education and benefits for working-age people, this will further entrench inequality, both inter and intragenerational, and hinder social mobility. It will also reduce productivity and economic dynamism. And given the political weight of older and middle/upper income voters, rebalancing the welfare state in favour of the young, the poor and those with children remains an uphill battle.

The UK population is ageing and fertility rates have fallen sharply

UK population pyramid for 1998 and 2018 by age band

UK IN A CHANGING EUROPE



Source: Office for National Statistics - UK population pyramid

ECONOMIC CHALLENGES TO THE UK

THE UK MACROECONOMIC FRAMEWORK AT 25

Ethan Ilzetzki

The UK fiscal and monetary policy framework has been in place for a quarter of a century; but the persistence of high debt and deficits, as well as the recent spike in inflation, mean now is a good time to re-evaluate it.

MONETARY POLICY

The UK has had a formal inflation target since 1992 and the Bank of England has been independent since 1998; this reflects a consensus among macroeconomists that such a framework would reduce the risk that policymakers would be tempted to loosen policy in the face of a negative shock and would therefore help 'anchor' public expectations about future inflation. Measured against the target, the Bank has performed well; inflation has mostly been close to the target, and less volatile than historically.

However, with CPI inflation peaking just below 10% in 2022, both the Bank's performance and the framework itself have been criticised. But while individual decisions can be questioned, there's little evidence of systemic failure. Inflation in the UK was roughly in line with similar economies and inflation expectations have remained stable, which was not always the case elsewhere.

Instead, the Bank faces three main challenges to sustaining low inflation. The first is political dominance. Political pressures on the Bank have intensified, with some voices in Westminster and elsewhere second-guessing the Bank's decisions. Fortunately, both political parties' platforms are unambiguous in their commitment to independence; the risk of political dominance is low.

The second challenge is financial dominance. The global financial crisis of 2007-9 led the Bank of England to intervene extensively to avoid a full-fledged financial panic. The Bank's response to the 2022 mini-budget crisis was time limited, but risked entering 'financial dominance' territory, as the Bank intervened in the market for longer-duration Gilts to contain an unfolding liquidity crisis in UK pension funds.

Third, and finally, is the challenge of fiscal dominance; that high levels of government debt would constrain how the Bank uses monetary policy. There's little evidence of this so far, but with public debt approaching 100% of UK GDP, the risk of fiscal dominance can't be dismissed.

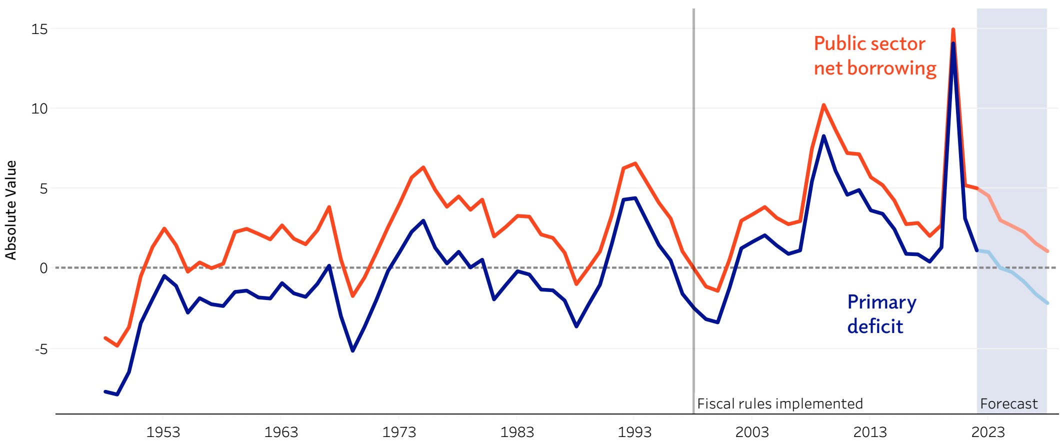
FISCAL POLICY

Fiscal policy is then a key to inflation and financial stability. Alongside central bank independence, UK governments have been in the vanguard of committing to specific debt or deficit targets. Like monetary policy rules, fiscal rules have been advocated to limit debts and deficits, but the rationale is not nearly as strong. There are two problems – first, fiscal rules may be too inflexible in the face of shocks; and second, precisely the opposite, that since fiscal policy remains under political control, they can be changed by the same politicians whose potentially irresponsible behaviour they are meant to constrain.

In the EU, inflexibility of fiscal targets has been a big problem as shown during the eurozone crisis; but in the UK the inverse has been the case; successive governments and Chancellors have repeatedly changed the rules. Primary deficits – that is, the deficit excluding interest payments – have been larger since the adoption of fiscal rules. This is true even taking account of the macroeconomic challenges of the global financial crisis and Covid-19.

The UK has consistently run large fiscal deficits even since the adoption of fiscal rules

Public sector net borrowing fiscal targets and primary balance of the deficit as a percentage of GDP for the UK



Source: Office for Budget Responsibility - Public finances databank - November 2023. Forecasts for 2023-2029. Inverse of sign for primary deficit.

Arguably, then, fiscal rules may make things worse rather than better; it looks like 3% of GDP has become a de facto floor, rather than ceiling. When times are bad and the economy is hit by a shock, the government relaxes the target; but when things get better the government declares victory and loosens policy. This is illustrated perfectly in the most recent budget where the first green shoots of fiscal stability were exploited to cut taxes, even though public debt is nearing 100% of GDP, one and half times higher than the original ambitions of the Blair-Brown framework. We are living in a far more turbulent time than the 1990s; we should be being more, not less, cautious about expanding the debt.

WHAT CAN BE DONE

Why did this happen? It's possible [fiscal rules reduce both market and political pressures to contain deficits] and by giving policymakers the fig leaf of fiscal responsibility, they replace the need for a credible long-term fiscal strategy.

UK budgetary institutions face few checks and balances relative to other democracies. The combination of a first-past-the-post electoral system and no real separation between the legislative and executive branches gives the ruling party nearly unrestrained budgetary powers for the duration of a Parliament. While violating their own fiscal rules may have some political cost, governments are free to change the rules to suit their political needs. The formation of the Office of Budgetary Responsibility in 2010 helped, and its role was highlighted during the mini-budget crisis of 2022. But it can only make forecasts of the impact of government policy - it cannot express a view on whether that policy is either sensible or credible as a consultative body, it has limited ability to constrain governments. The most important single reform the government could make would be to give the OBR greater powers and responsibilities in this area.

Sadly, fiscal profligacy has not extended to public investment, although this form of spending was originally exempt from the fiscal rule through the 'golden rule' that government should borrow only to invest and not to fund current spending. Public gross investment has been a full percentage of GDP point lower in the past 25 years than in the preceding 25. With UK growth slowing, and productivity stagnating, the need to use fiscal policy as a lever for growth has never been greater, while fiscal space has never been tighter in the modern era.

The author would like to thank Vahid Ahmadi for excellent research assistance.

INEQUALITY

Donald Houston

Inequality – the gap between those towards the top and bottom of the income distribution – has widened in most developed nations since the 1980s. Inequality is of obvious concern for social cohesion and wellbeing, but it can also have consequences for the economy. Social mobility can either increase or decrease inequality. Poverty and inequality are related but not the same.

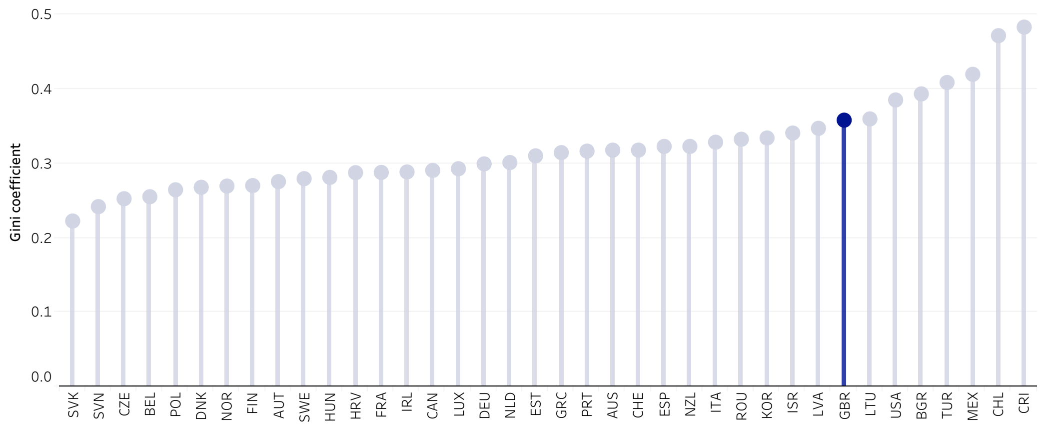
WHAT THE PROBLEM IS, AND WHY IT MATTERS

The Gini coefficient measures inequality on a 0-1 scale, with 0.0 representing everyone with the same and 1.0 representing a single person receiving all income. The latest internationally available figures show that the UK's Gini coefficient was 0.355 in 2020, corresponding to one of the highest levels of income inequality in Europe and the richest (G7) countries. Among these countries, only the USA had income inequality greater than the UK.

The UK has one of the highest levels of income inequality in Europe and the richest (G7) countries

Income inequality average between 2019 and 2021, measured by Gini coefficient - 0 = complete equality; 1 = complete inequality

UK IN A CHANGING EUROPE



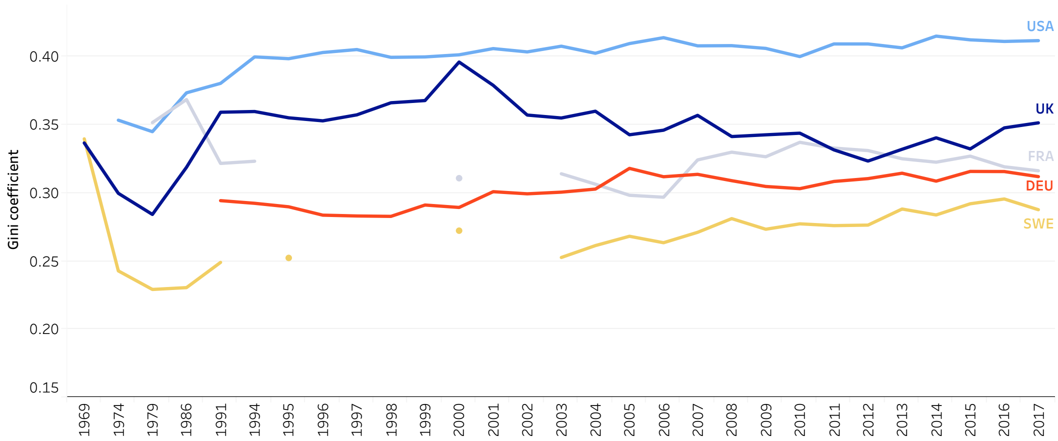
Source: OECD. Income inequality Gini coefficient, 0 = complete equality; 1 = complete inequality, 2022 or latest available

Income inequality significantly rose in the UK during the 1980s and 1990s with the 'hollowing out' of middle-income jobs vulnerable to deindustrialisation and automation. At the same time, competition rose from the liberalisation and globalisation of markets, squeezing employer training provision and driving pay up in some sectors and down in others. These trends were exacerbated by changes to the tax and benefit system, making it less redistributive.

Since 2012, income inequality in the UK has risen, mostly because of further cuts to benefit levels

Gini coefficient index of household income from 1969 to 2017 by country

UK IN A CHANGING EUROPE



Source: World Bank. Gini index - 0 = complete equality; 1 = complete inequality

Between 2000 and 2012, income inequality in the UK fell, supported initially by a period of jobs growth, the introduction of the National Minimum Wage and a system of Tax Credits to support those on low earnings. The Great Recession following the Global Financial Crisis of 2008 also reduced inequality, as earnings growth stagnated, especially in some high-earning sectors. Since 2012, income inequality in the UK has risen, mostly because of further cuts to benefit levels and restrictions on eligibility, although these trends were partially offset by jobs growth and large increases in the National Minimum Wage.

It's important to note that while technological change and globalisation affected all advanced economies, this does not mean that trends in inequality are similar; inequality has increased steadily in the US across this entire period, while the experience of France has been very different. Policy matters.

Nor is income all that matters. Returns on financial investments have run above GDP growth since the 1980s, leading to a declining share of GDP to be paid out as wages and opening up new forms of inequality based on wealth as well as income. While data is much scarcer, the available evidence suggests that wealth inequality in the UK has become a serious concern.

Inequality harms the economy through a number of mechanisms. First, insufficient job opportunities in some places, low wages and poor prospects for progression at the bottom end of the labour market reduce incentives to train as some people conclude they will remain in low-paid work in any case. Second, low incomes reduce consumer spending, which inhibits jobs growth and investment. Third, the full productive potential of under-utilised and marginalised groups and places limits productivity and growth. Fourth, the social costs of entrenched poverty on health, education, offending and family outcomes over time become financial costs as pressures on public services rise. On the other hand, collective bargaining in unionised sectors appears to have benefits for equality - but at the expense of growth. More broadly a widening disconnection between economic growth and population wellbeing observed in rich countries has fuelled calls to broaden the definition and measurement of economic success beyond GDP to include inequality (as well as wellbeing and sustainability).

WHAT CAN BE DONE

In crude terms, increasing taxation towards the top and/or reducing taxation and/or increasing benefits towards the bottom will, at least in the short run, reduce inequality. Raising the National Living Wage would also reduce income inequality, but benefits most those in full-time employment presently on the current minimum level, rather than those out of work or working part-time, who are more likely to be poor.

Some of these changes may come with economic costs. It is often argued that executive pay needs to be high, and taxes low, to attract global talent. At the other end of the income spectrum, it is difficult to convincingly argue that more generous benefits would have much, if any, negative impact on incentives to work after decades of tightening restrictions on benefits eligibility and payment levels.

Looking at the USA, one might conclude that inequality is an inevitable consequence of a successful economy. Looking at Sweden, one might rather conclude that keeping inequality low benefits the economy. It would thus be naïve to assume that there is a predictable relationship between growth and inequality. But so too would it be simplistic to assume that there was no relationship between them, or to adopt a fatalistic view that inequality is inevitable. Inequality is both cause and consequence of how the economy is run and regulated.

Specific policy areas that will simultaneously benefit both economic growth and social inclusion identified in the 'inclusive growth' literature include affordable childcare, vocational education and training and local transport, particularly concessionary travel for young adults. The broader economic policy challenge is to create the conditions in which public and private investment co-ordinate and coalesce around a balanced portfolio of growth sectors that require a range of skilled jobs - not only high-paying skilled sectors. Raising wages for skilled work is the best way to incentivise training and employment. At the same time, the growth in low-paying service jobs needs to be carefully managed with appropriate workforce planning to ensure adequate labour supply, pay and predictable and adequate hours of work.

Public investment has a role in ensuring appropriate infrastructure, R&D and skills are in place to enable private investment to create jobs, grow the economy and raise productivity and wages. Raising productivity and wages is a necessary starting point to bring down inequality – there cannot be inclusive growth without growth. But on its own productivity cannot tackle inequality, which needs investment in schools, apprenticeships, colleges and universities, not only to help foster productivity growth in the first place but also to ensure it is widely shared, giving confidence and incentives to people to invest in skills, training and businesses.

PRODUCTIVITY DISPARITIES AND LEVELLING-UP

Henry G Overman

WHAT THE PROBLEM IS, AND WHY IT MATTERS

Productivity varies widely across the UK. In 2019, London produced £76,000 of gross value added per job, more than twice that produced in Powys and Torbay. These disparities are also persistent. London's productivity was 40% above the national average in 2002 and 50% above in 2019. By contrast, Powys and Torbay were 20% less productive than the national average in 2002 and were 30% less productive in 2019.

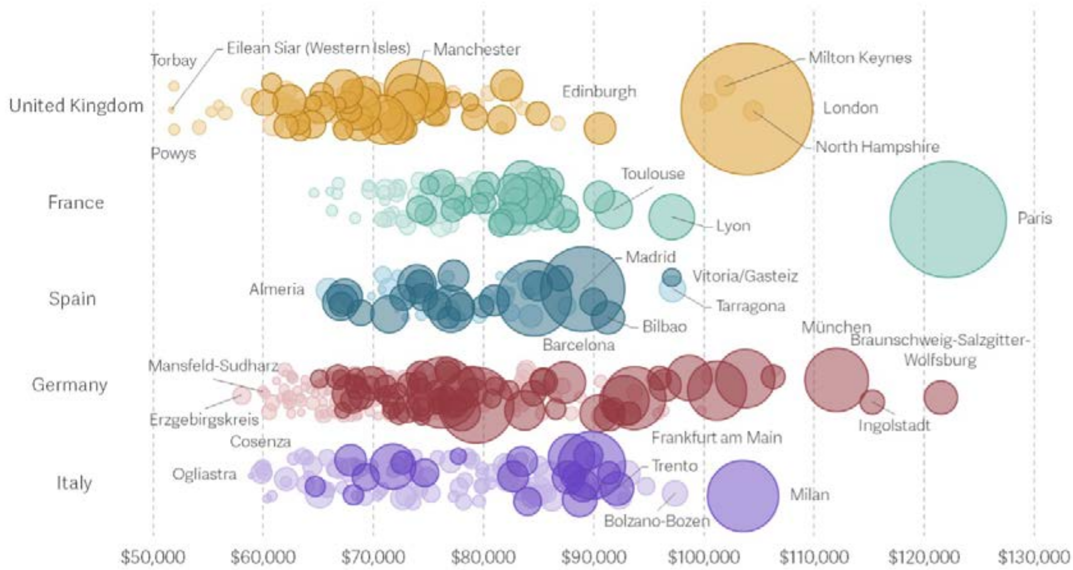
Across the UK, few areas have seen large changes in their relative positions over the past twenty years. And, while income inequality has been broadly static, productivity gaps rose in the 2000s, although they have been broadly stable since. A small number of the best-performing areas have pulled away further, while a handful of struggling areas fell even further behind.

It's difficult to compare these disparities across countries - the chart below plots them for the UK and three similarly sized EU economies - but if we focus on an appropriate measure of productivity and broadly comparable areas, the UK performs badly, but not exceptionally so. But, regardless, they matter.

Economic activity in France and the UK is more concentrated than in Germany and Italy

Gross value added (GVA) per worker (PPP adjusted), by country and area in 2018

UK IN A CHANGING EUROPE



Source: Economic 2030 Inquiry Bridging the Gap, based on analysis of OECD Regional Economy Database
Notes: Metro areas are shown in darker bubbles. Foreign and extra-region territories have been dropped. Bubbles proportional to number of workers in each area.

In part, this is because of the impact on local incomes - although the strength of the link between local productivity and income varies, it is strong at the broad regional level. Here the correlation between productivity and incomes is 0.96. High productivity London has high incomes and vice-versa for low productivity Wales. But this correlation is much weaker when looking at metro and non-metro areas (i.e. cities, towns and rural areas) because productive workers, and the owners of firms that employ them, often live and work in different places. The extent to which households rely on income from work, as opposed to pensions or benefits, also varies across places. All this implies that improving productivity might help narrow differences in income between our cities, towns and rural areas, but it won't eliminate them.

More important is the drag resulting from under-performing places, especially major cities, on national productivity. For example, with populations of around 2.8 million each in Birmingham and Manchester, their productivity matters not just for local prosperity but also for Britain's.

WHAT CAN BE DONE

Given the consensus that these gaps are large and undesirable, the challenge is to understand the underlying economic fundamentals that drive differences in productivity and what this means for policy. Analysis for the Economy 2030 inquiry suggests that four key factors can explain over half of the observed differences in area-level productivity: the size of the local economy (as measured by employment), levels of human capital (as measured by graduate share), and levels of physical and intangible capital. As the UK's specialism in high-value tradable services has grown so too has the importance of size and skills and the role of intangibles (such as research and development capital) and information and communications technologies (ICT) equipment. These changes are consistent with what we might expect given recent technological change favouring higher-skilled workers in an economy that is highly specialised in services.

This specialism matters. The UK is a services 'superpower', exporting more in this category than any country in the world save the US. This makes productivity gaps inevitable because tradeable service sectors - such as law, design, accountancy and creative industries - benefit considerably from dense locations with a large pool of highly educated labour to draw upon. No wonder Germany, with its specialisation in advanced manufacturing, has more even economic development (as can be seen in the chart above). But given the strong persistence of specialisms we should not expect the underlying patterns of specialisation to change soon - 'be like Germany' is not a basis for UK policy.

So improving the UK's productivity means bigger high value-added services sectors, and a wider range of cities succeeding with them. This doesn't mean giving up on the objective of narrowing productivity disparities. France is also strongly specialised in services but as illustrated in the chart above, it has narrower productivity disparities. But it does mean being honest about the implications - more uneven development on some dimensions, not less - and the scale of change required.

Take Greater Manchester (GM) as an example. GM may have grown faster than many other large cities in recent years but in 2019, average gross value added (GVA) per worker in GM stood at £50,505, way below the UK average of £58,871. GM remains 35% less productive than London, a much larger gap than between France's second city, Lyon, and Paris, which stands at just 20%.

If we wanted to 'be like France', what would it take to reduce GM's productivity gap with London to 20%? Analysis for the Economy 2030 inquiry shows that this would require increasing GM's business capital by 15%, or £30 billion, and its graduate workforce by as much as 180,000. This would raise the graduate share of employment in GM (currently 37%) by 6 percentage points, bringing the city region in line with the likes of Glasgow and Southampton. Increased higher education participation and upskilling of existing residents could support a rise in the graduate share. But a graduate workforce increase on this scale cannot happen without significant inflows of highly skilled people from elsewhere in the country or abroad.

Not all of this investment would need to be done by government, but policy support is required. The task is to make GM function as an effective city region, with different parts playing different roles that, in combination, support and attract high-value tradeable service firms and higher-skilled workers. GM has already made strides in this direction, but the productivity gap with London shows it is nowhere near there yet. Making this a reality will require action on many fronts: Tough decisions about how land is best used; stepping up improvements to the intra-city transport system; and decisive planning when it comes to housing. In turn, these changes will increase productivity for firms able to access improved office space and a larger pool of high-skilled workers, encouraging them to invest and increasing capital per worker.

All of this requires large spatially-focused investments - a difficult political proposition. The alternative is to spread investment more widely. However, there are many small towns, investment in infrastructure and innovation is costly, and for towns the self-reinforcing effects of size, skills, and capital are limited by the scale of the local economy. Of course, there will still be many projects that are worth pursuing outside of the UK's major cities, but a strategy that focuses too much on towns will not scale up to produce large productivity improvements across lots of areas for lots of workers.

Policymakers need to be realistic about the economic forces polarising the UK. Understanding these, and dealing with the resulting trade offs, will be key to a successful economic strategy that improves aggregate economic performance while offering a hard, but plausible, path to closing regional inequalities.

TAX POLICY

Arun Advani and Andy Summers

WHAT THE PROBLEM IS, AND WHY IT MATTERS

Political debates around tax are highly focused on how much we tax: both Chancellor and Shadow Chancellor have emphasised their desire to reduce the 'tax burden'. By contrast, there is almost no debate about how we tax: who pays, and on what. This is unfortunate, as the current system is poorly designed, and however much we want to raise, we could do it better.

The system is rife with problems, from the cliff edges and very high marginal tax rates that result from the treatment of child benefit and student loan repayments to the distortions resulting from the VAT threshold. But amongst the most egregious is the way in which we tax wealth. The current taxation of wealth - and the returns on wealth - fails essentially every test for an effective tax: it creates unfairness, it leads to artificial avoidance, it distorts real behaviour, and in doing all this raises very little revenue.

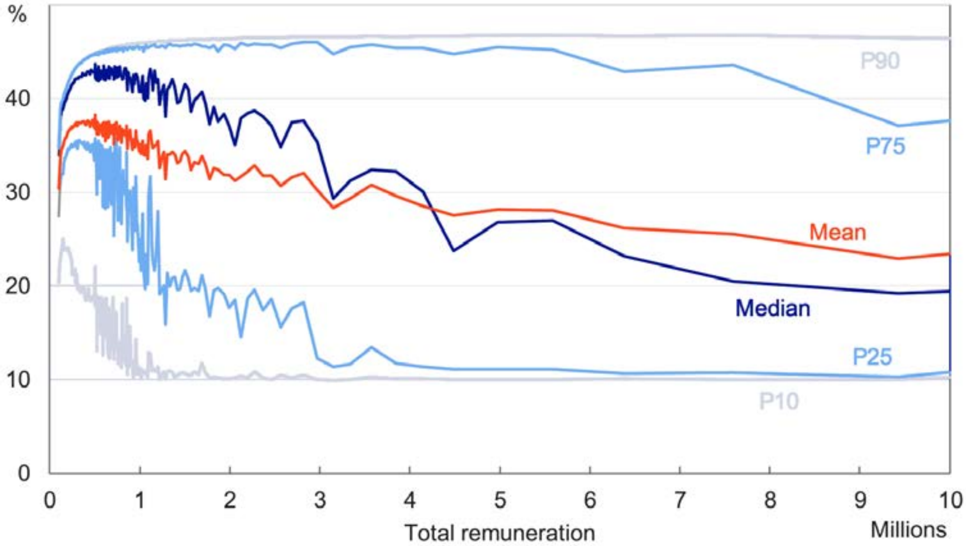
The unfairness created is both between poor and rich, and between people at similar income levels. It hardly seems reasonable that someone working full time on the minimum wage should have to pay Income Tax and National Insurance Contributions (NICs), and then pay rent to a landlord who only has to pay Income Tax on that rent. Nor is it easy to explain why Rishi Sunak should have a tax rate of just 21% when he takes home £2 million a year. This is the same tax rate as someone earning £30,000; it is also less than half the tax rate that would be paid by someone earning £2 million from working in finance. The lower taxation of income from wealth, relative to income from work, explains this difference. And Rishi Sunak is not alone: in 2018 a quarter of people taking home £2 million paid at least 45% of their income in tax, while another quarter paid less than 20%. One in ten paid only 10% - less than someone on the minimum wage.

The second problem is the incentive to engage in purely artificial avoidance. If you run a small business that is making a fair bit of money, it is better to pay yourself in dividends than to pay yourself as an employee. Better yet, you should loan yourself money from the business, and when you want to get out, ultimately 'liquidate' the business, to get the money out as a capital gain. If all income were taxed in the same way, there would be nothing to gain from this 'repackaging', with the side effect that we'd need fewer lawyers and accountants.

One in ten with total remuneration over £1 million pay a lower tax rate than someone earning just £15,000

Distribution (mean and percentiles) of effective average tax rate by total remuneration, 2018

UK IN A CHANGING EUROPE



Source: Advani, Hughson and Summers, 2023 "How much tax do the rich really pay?" Oxford Review of Economic Policy. HMRC administrative datasets
Note: Constructed using data on income and capital gains going to individuals with over £100,000 in income or total remuneration (income plus gains) in 2018.

Even more costly than artificial avoidance are the ways in which people change their actual behaviour. Brilliant consultants working for a large employer quit to go solo, not because they want to build their own growing organisation, but because it reduces their tax bills, even at the cost of inefficiently taking on additional admin hassle. Company owners hold on to their business past the point they can manage it well, because increases in company value are not taxable if they hold the company until they die. And older people with high incomes who are still some way from retirement age look at the pot of wealth they've built up, which is taxed much more lightly than income from work, and decide maybe they'll retire early.

After all this, the taxation of wealth raises relatively little money. Only 4% of government revenue comes from taxes on wealth, with as much again from Council Tax, which could be - but is not currently - structured as a tax on property wealth. This is despite the rapid rise in asset prices over the past forty years, which have raised the level of national wealth relative to national income (GDP). Over that period the tax rate on wealth has actually fallen, from a rate of around 1.6% between 1965 and 1980, to less than 1% since the mid-1990s.

WHAT CAN BE DONE

Labour have announced some small-scale tweaks to taxation should they win the election, removing tax breaks for non-doms, private schools, and private equity managers. These are all reasonable steps, but will not fix the more fundamental problems we face. Four obvious reforms would greatly improve the taxation of wealth.

First, we should return to the structure of Capital Gains Tax (CGT) first introduced by Nigel Lawson in 1988. This taxed capital gains – income from the increase in the value of an asset – at the same rate as income. It allowed a concession for inflation, so that only increases in actual purchasing power were taxed. Additional tweaks could be introduced, to account for the 'lumpy' nature of gains, which are often received infrequently. People leaving the UK should pay CGT on gains made during their time in the UK, to remove the incentive to leave before making a large gain, and conversely gains made before someone arrives in the UK should not be taxable here. On death, the CGT due should be paid before the asset is passed on, rather than being wiped out as currently.

Second, we should extend NICs to income from wealth. Previously income from wealth instead faced a (higher) 'investment income surcharge'. That was abolished in 1985, making income from wealth taxed more lightly than income from work. Meanwhile, successive Chancellors of all stripes increased NICs, raising the main rate for employees from 6.5% in 1979 to 12% by 2011, although this was cut to 10% in the 2023 Autumn Statement.

Third, Inheritance Tax should apply to all assets equally – cash, housing, farmland, businesses, pensions. It should cover gifts made over a much longer period than just the seven years before death. The current structure means some of the most consequential gifts influencing social mobility – whether parents can help children onto the property ladder – are outside the scope of the tax because they occur much earlier in life. Reform would prevent the wealthiest from benefiting from arrangements, and raise money which could, if it made things politically easier, be used to raise the threshold above which the tax is paid.

Finally, Council Tax is currently based on property values which are three decades out-of-date. Current rates do not reflect the subsequent rapid rise in house prices and are highly regressive. The new system should be structured as a proportional property tax, with regular revaluations. It could still have valuation bands, to avoid needing precise valuations for most houses, but there is no need for a top band – as we have now – after which increases in value have no impact on tax. Reform will need to go hand-in-hand with a redistribution mechanism between local areas to account for differences in average house price: without this much larger tax rates would be needed in Burnley than Kensington for the council to get the same revenue.

PUBLIC SERVICES

Ben Zaranko

WHAT THE PROBLEM IS, AND WHY IT MATTERS

The government spends over half a trillion pounds each year on the provision of public services. The biggest and most attention-hogging of these is the National Health Service. This bucket also includes the police, schools, childcare, social care, prisons, courts, plus a whole swathe of things we might not necessarily think of as a 'service' but which represent core state responsibilities (such as the armed forces, the diplomatic service, and HM Revenue and Customs).

The problem is that lots of these services aren't performing as well as we might like. It matters because these are services on which millions of people rely. They are important to the quality of people's lives. In many cases, they are also important to the wider economy.

Consider first the NHS. The waiting lists for pre-planned treatment in England has soared to 7.8 million in September 2023, versus 4.6 million at the start of 2020 and 2.3 million at the start of 2010. Almost 400,000 people have been waiting for more than a year. Waiting time targets for cancer treatment and diagnostic tests continue to be missed, waiting times in Accident and Emergency departments are through the roof, and patients are finding it harder to get a GP appointment.

The evidence suggests that performance has similarly suffered across most other services. The Institute for Government's 'Performance Tracker' examines nine separate public services and concludes that all are performing the same as or (in most cases) worse than before the pandemic. With the exception of schools, all are judged to be performing worse than they were in 2010.

It wasn't supposed to be this way. Public services were promised, and were provided, a genuinely big funding injection at the start of the current Parliament. Departmental funding has continued to rise since then. There has been, as yet, no return to the austerity of the 2010s. The government promised, and has delivered, large increases in the number of police officers and nurses. So why has public service performance suffered?

Two big challenges have got in the way. The first is the Covid-19 pandemic. This exacerbated existing backlogs in the NHS and courts system, added to the demand for many services, and seems to be having all sorts of lingering adverse effects on service performance.

The second is the recent energy price shock and associated surge in costs for public services. There's no single measure that perfectly captures changes in the costs facing public services. The measure of economy-wide inflation typically used as a proxy for these costs is called the GDP deflator. At the point when detailed departmental budgets were set out in the 2021 Spending Review, the GDP deflator was expected to grow by a cumulative 13.3% over the five years from 2019-20 to 2024-25. The latest official forecasts now suggest an increase of 20.4%. In other words, by 2024-25, costs (as measured by the GDP deflator) will be around 7% higher than expected when budgets were set. One big component of that is public sector pay, which has risen much more quickly than originally budgeted for (albeit less quickly than public sector workers might have liked). There has been a bit of extra cash provided, but not enough to compensate. Instead, inflation has eaten into the 'real' value of public service budgets. These budgets have still - for the most part - risen over this Parliament, but by less than originally intended and in many cases by less than the demands being placed upon those budgets. The real-world impact can be seen in the number of councils reportedly in dire financial straits, the number of schools in financial deficit, or the NHS being forced to pare back its efforts to cut waiting lists for want of funding.

That squeeze looks set to continue. In the Autumn Statement, Jeremy Hunt chose to use a modest improvement in the government's fiscal position (driven almost entirely by higher inflation) to 'fund' tax cuts, rather than a top-up for public service budgets. Higher inflation means government departments will be around £13 billion worse off next year, in real terms, than where they expected to be.

After that point, day-to-day funding (for pay, administration and running costs) is set to grow by around 1% per year, over and above inflation. Overall spending will go up, not down. But those plans almost certainly imply cuts to some areas, after we allow for the near-inevitable increases to the NHS, defence, overseas aid and childcare budgets. For the unlucky or 'unprotected' budgets, the cuts would be on a similar scale to those enacted in the early 2010s.

The outlook for investment spending is even tighter. Capital budgets have been frozen in cash terms from 2025 onwards, in order to meet the government's promise to have debt falling as a fraction of national income (a target which makes no distinction between day-to-day and investment spending). Under these plans, investment is set to fall sharply and steadily in real terms and as a percentage of national income. Even Labour's £20 billion-a-year green investment plan wouldn't be enough to offset these planned cuts.

WHAT CAN BE DONE

The backdrop here is the difficult economic and fiscal situation we find ourselves in. The scope for meaningful funding increases without (further) increases in tax is limited by a toxic combination of weak growth prospects, an elevated level of government debt, and higher interest rates. The last of these means the government debt servicing bill is expected to settle around 2% of national income higher than we had become accustomed to pre-pandemic. That's 2% of national income extra - roughly £50 billion, or the entire defence budget - spent on debt interest and therefore not available to be spent on the NHS, schools, or prisons.

Funding is, of course, not the be-all and end-all. Some parts of the public sector - NHS hospitals and the crown courts spring to mind - appear to have a concerning productivity problem post-pandemic. Improving public sector productivity could help improve service quality (even if it doesn't end up saving the Treasury vast sums) and the government is absolutely right to focus on it. This is a deep-seated problem, however, and not one unique to the UK. Achieving meaningful improvements is likely to require up-front investment, whether in system reform or in equipment and buildings. The weakness of the public finances, the extremely limited room for manoeuvre against the government's debt target (whether any additional borrowing is for current or capital spending), and the many competing demands on services in the here-and-now make this difficult. In any case, the returns on such investments would be uncertain and extremely unlikely to materialise immediately, and so we would be wise not to bank on them.

The question of 'what should be done' is ultimately a political one. Meeting the pressures of an ageing population will almost certainly mean more spending on health, pensions and social care. Continuing to meet our international commitments on defence and aid would mean spending more there, also. For everything else, the question becomes: are we willing to pay more in tax to maintain the current range and quality of services? If not, what are the things the state currently does that we think it should stop doing?

PUBLIC SECTOR PRODUCTIVITY

Patrick Dunleavy

WHAT THE PROBLEM IS, AND WHY IT MATTERS

The public sector currently employs one in six people in paid work. That alone means that public sector productivity - how well the public sector produces outputs from inputs - matters hugely both to the overall economy and to the quality of individual public services. But even this understates its importance.

Informal estimates suggest that around a quarter of all final consumption is undertaken by state agencies and the wider public sector, because much public services production is now outsourced to the private and third sectors. For example, the public sector spent £10.5 billion with 150 'facilities management' firms in 2021-2. A further £29 billion was spent on construction, mostly for contracts from central government and local councils.

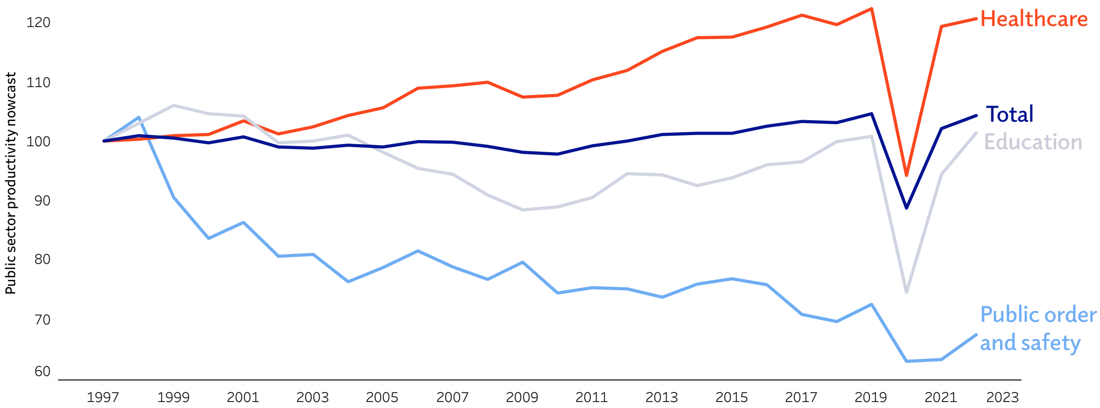
Meanwhile, in most UK cities and towns outside London, public sector agencies dominate the local large-organisation landscape. As Rossiter *et all* write, 'These types of organisations are often thought of as "anchor institutions" that underpin local employment and support economic development through a wide range of activities including their investment in the fabric of our towns and cities.'

How can we measure public sector productivity, given that most of the outputs of the public sector do not have a market value? Historically, the ONS simply assumed that the value of outputs was equal to inputs so that state productivity never went up or down, an almost farcically inaccurate solution. However, since the Atkinson Review, we have a method to measure the outputs of most key public services, in particular health, social security and education. We start by counting how much key outputs they produce (e.g. how many operations, benefit payments and GP appointments are achieved) and weight this by how much they cost to produce. Where possible, we also assess the quality of those outputs (e.g. perhaps using graded exam results from schools, or operations in hospitals weighted by quality stars or the incidence of complaints).

By these measures, public sector productivity rose in the 2010s but in some areas has fallen sharply since around 2018, especially since the Covid 19 pandemic.

Public sector productivity rose in the 2010s but in some areas has fallen sharply since the pandemic

Annual public service productivity data for selected service areas in the UK from 1997 to 2020



Source: Public service productivity, Office for National Statistics. 2021-2022 dynamic regression nowcast estimates for annual public service productivity

Yet appearances can be deceptive. 'Cramming' of facilities, 'managerial opportunism' and under-investment (e.g. 95% bed occupancy in the NHS, cutting bed and reducing NHS pay across the board) may seem to produce a completely 'fake' productivity increase for a few years. But this illusion can then often tip over into crisis as in the NHS since Covid 19. Somewhat more NHS staff have been hired but output has fallen as the service infrastructure has crumbled around them and staff goodwill has withered, so productivity has fallen back again. This slump has been driven not by the failings of public service workers, but by damaging cuts to public sector pay and investment, and the relentless opportunism of ministers and top public sector managers alike, who take any savings achieved and convert it into a lower budget for the agency that did the improvement.

WHAT CAN BE DONE

Solutions are not easy to come by. The next government will be financially constrained. It will desperately need across-the-board major productivity-growth strategies and new investment to begin restoring public service capabilities over the next Parliament. Rectifying decades of neglect will not be easy. But with good information to guide reforms, it could be a realistic task – with tremendous benefits not just for the government sector, but for the thousands of firms across the UK's economy that supply it, and all the others that rely on state services to sustain a trained and healthy workforce and provide access to essential transport and digital infrastructures.

In order to analyse the problem, we need to look at outputs/inputs at the granular level of single agencies or organisations. Only then can managerial attention be effectively targeted on increasing whole-organisation productivity and safeguarding output quality, necessarily a process that will take five to ten years. Unfortunately, relevant data currently is not officially produced by ONS nor published by the government. Yet all the materials needed to collect 'total factor productivity' actually exist in every state agency. But officials will probably need a bit of outside academic or statistical help to be able to produce genuine productivity (output/input) numbers over the long run of years needed. There are some hopes that this situation might be addressed from the recent launch of The Productivity Institute (prominently including the public sector in its remit), and some belated recognition within the Treasury and other Whitehall departments of its importance.

Research suggests that only some large-scale reorganisations around new buildings and digital change are likely to move the dial. Across government, it is the latter that offer the biggest potential for productivity gains. This is made all the more urgent by the huge landscape of potential advances in public sector productivity opened up by the 'third wave of digital era governance'. As government agencies 'digital offers' have matured, and the potential of data science/artificial intelligence/big data (DSAI) change has begun to be recognized, big opportunities for productivity gains have emerged, along with pressing needs to reorganise who does what in terms of IT, online and digital automation.

The key changes happening now that make the potential for productivity gains really substantial:

- Advances in data science and artificial intelligence (DSAI) drawing on multiple areas of tech progress have created a new potential to 'de-compress' government data in ways that facilitate rapid policy monitoring and responses.
- A rapid expansion of services industry robotics with huge implications for the public sector - already evidenced in defence, fixed robots (e.g. passport gates), mobile robots in logistics handling (e.g. in hospitals, see below), but also likely to include social robots soon.
- Strong efficiency pressures to centralise almost all digital delivery in the central state. For instance, for libraries, it would recommend a single national eBooks scheme, not the current fragmented delivery by 75 local authority coalitions in England.
- Other pressures to devolve delivery of all in-person, physical world, 'last mile delivery' services to local agencies. E.g. employment and public health services provided badly by Whitehall should move to local agencies.

The joining together of modern DSAI, real time comms tech, and massive data capabilities has also opened a big potential role for robotic automation in improving public services, For instance, logistics operations in hospitals to move around materials, drugs, medicines, equipment, meals, laundry and waste currently account for between 30-40% of costs, and lag 20 years behind the best practice in site-logistics specialist firms like Amazon, Ocado, etc. But that gap can be reduced now. For instance, load-carrying autonomous guided vehicles (AGVs) or autonomous personal robots (APRs) are already able to navigate the current crowded, multi-use hospital corridors. But they could operate even more effectively in new hospitals (with separate people and robot circulation systems), or even in existing hospitals retro-fitted. Yet NHS construction investment was just £1 billion in 2021-2 (a third of that in the railways).

What will be needed for public sector productivity to grow is a strong commitment to patiently pushing through a sustained, long-run digital (and other) change programme in every public agency and department. There must be continuously evaluated by good productivity numbers, and accompanied by a substantial effort to raise the morale and involvement of public sector professional staff and all other workers - who alone can affect improvements.

EDUCATION

Simon Burgess and Sandra McNally

WHAT THE PROBLEM IS, AND WHY IT MATTERS

One of the most fundamental drivers of social and economic progress is the level and distribution of skills. Skills matter for growth and therefore prosperity. While England's performance in the recent international comparison of schools systems is good, and has improved over the past two decades, there is scope for improvement. Scotland, Wales, and Northern Ireland also participated but lag behind England.

And progress has been set back considerably by the Covid-19 pandemic. The extended school closures and patchy online provision meant very significant loss of learning time, and the consequent loss of skills has a powerful impact on economic growth and on future income, as well as widening inequalities. The cost of lost growth is measured in trillions of dollars (and pounds). This is a quiet and hard-to-measure crisis, which does not help the cause of trying to remediate it, but in countries where it can be measured, the scale is huge.

In particular, rates of persistent pupil absence have greatly increased. This is urgent and important because attending school is crucial for learning: missed school equates to more skills lost. Before the pandemic, persistent absence (defined as missing at least 10% of school in a year) was fairly constant at around 13% in secondary schools in England. This rose dramatically with the onset of Covid-19, but even now more than a quarter of secondary school students are persistently absent. Furthermore, the data shows that for disadvantaged students, the rate is 46%. The fact that almost half of disadvantaged students are missing at least 10% of their schooling is extremely worrisome for their future qualifications and life chances.

The most urgent challenge is the crisis in teacher recruitment. The number registering for Initial Teacher Training (ITT) in 2022/23 was around 20% lower than the pre-pandemic years, for both primary and secondary schools. Most subjects at secondary level were below target, and some of the subject specialism shortages were dramatic: for example, the shortfalls were biggest in physics (recruitment was only 17% of target), computing (30%), modern languages (34%). This pattern continues with the latest report that ITT 2023/24 recruitment for secondary schools is just half of target. The problem of teacher shortages and low pay is, if anything even stronger in Further Education colleges, with median pay 17% lower in the latter and staff turnover 16% higher.

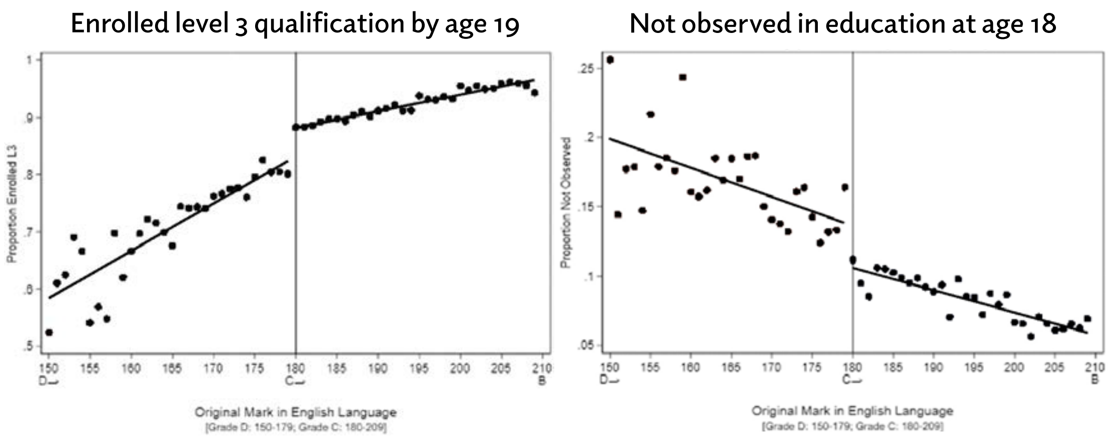
Students are supposed to stay in some form of education or training to age 18 (as is fairly standard across developed countries), yet education from 16-18 receives less funding than 11-16 education or universities and has seen greater declines since 2010. There is no pupil premium. As further education is supposed to prepare people for tertiary education and/or the labour market, this is odd and short-sighted. Failure to invest sufficiently in further education over many years may be a reason for why Britain is the only OECD country where the literacy and numeracy of 16-24 year olds is no higher than 55-65 year olds even though average performance at age 15 is more favourable.

For those who do well at GCSEs, the post-16 academic route is easy to follow and often leads to university. For those who miss out on a 'good grade' (Grade C/4) in a core subject like english - even by a few points - chances are much reduced of receiving an upper secondary qualification and there is a greater probability of dropping out of education by age 18 (see the charts below). This is because opportunities in post-16 education narrow according to GCSE exam results. It also illustrates the absence of coherent ladders of opportunity between levels of education.

Missing out on a 'good grade' (Grade C/4) leads to a greater probability of dropping out of education by age 18

Relationship between outcomes and original marks in English language with threshold for Grade C

UK IN A CHANGING EUROPE



Source: Machin, McNally and Ruiz-Valenzuela (2020). Note: The figures show how outcomes for students 'jump' at the threshold for Grade C in English language.

The range of vocational opportunities available in post-16 education can be difficult to navigate. Also, whether choosing academic or vocational options, many students can simply give up numeracy or literacy in their post-16 education because the system facilitates a narrow breadth of curriculum. The debate about broadening the post-16 curriculum to facilitate general, transferrable skills is very important.

The UK economy needs more skilled people educated to tertiary level, including university degrees. This is important for productivity. But there is too little available at sub-degree level, despite high wage premiums for the few people who pursue this. Also, the pathways from further to tertiary education (apart from university degrees) are not at all clear. Policies to stimulate provision at sub-degree level are needed. Apprenticeships are an excellent vehicle for the school-to-work transition. Opportunities to gain an apprenticeship need to be greatly expanded for young people.

WHAT CAN BE DONE

Faced with persistently low productivity and high inequality, improving education and skills is a vital part of any strategy for a more prosperous and fairer society. Urgent challenges are to tackle the crisis in teacher recruitment and the problem of persistent pupil absence. The pandemic has created a need for more investment and effective remedial measures as students and their families continue to cope with the learning loss that happened over that period. This need for greater investment is also apparent in further education, as the demands on that sector have risen. There is a need for better ladders of opportunity within vocational education and beyond, including expanding opportunities at tertiary level and greater provision of apprenticeships for young people.

All this will require a joined-up approach that considers how the system interrelates at different stages. Education funding needs to be more consistent between age 11-16 and 16-18 if the curriculum is to be similarly challenging. Teacher shortages are common across phases and this needs to be urgently addressed through policies such as higher teacher pay and targeted training bursaries. There also needs to be more provision at sub-degree level and specifically greater availability of apprenticeships for young people.

While greater funding from government is essential to deliver all this, a coherent strategy also requires a reorientation and levelling up of existing funding, and strong incentives for higher education institutions and further education colleges to work together.

THE LABOUR MARKET

Tony Wilson

As Jonathan Portes and Anand Menon set out in the opening essay in this collection, the performance of the labour market has arguably been one of the UK's success stories in recent years. However, while we have had the wind at our backs in recent decades, we are now facing headwinds that mean that for the first time since the 1990s the performance of the labour market risks holding back economic growth rather than supporting it. This is shaping up to be one of the key challenges for the next Parliament, and we need a new approach that can meet the challenges and opportunities that we now face.

WHAT THE PROBLEM IS, AND WHY IT MATTERS

The UK has challenges on both labour demand and supply. Changes in labour supply have got the most attention, and with good reason: after twenty-five consecutive years of growth, we saw the labour force shrink in 2020, shrink again in 2021 and then in 2022 record its lowest growth since the late 1990s. This turnaround is all the more stark because of the scale of increases that we saw between 1994 and 2019 - with annual labour force growth of nearly 250,000 people, equivalent to adding a city the size of Southampton in each and every year. It has been this continual growth, through recession and recovery, that has helped to pull up economic growth even as productivity has stagnated.

Clearly the Covid-19 pandemic has played a part in precipitating this reversal, but it has not caused it. Rather this is being driven by longer-running changes. The first, is that our population is getting older. This has been a key part of the UK's success over recent years, with older people accounting for three quarters of all employment growth this century. However with the 'Baby Boomers' now in their mid-70s and virtually all retired, their children are now increasingly in their 50s and over the next decade or so will also be leaving work.

Linked to this, we have seen a rapid growth in the number of people out of work with long-term health conditions, from two million people before the pandemic to more than 2.5 million people now. In part this reflects more people having chronic conditions, but before the pandemic this was translating into higher employment among those with long-term ill health - whereas since the pandemic it has led to higher worklessness. Our analysis suggests that this is particularly explained by those who were already out of work for some time, and so are finding it far harder to get (back) into work than in the past.

The impacts of our ageing workforce are being felt at the other end of the labour market too, with the generations leaving the labour force being replaced by successively fewer younger people. Over the last decade alone, the youth labour force (aged 16-24) has shrunk by half a million - from 4.7 to 4.2 million - driven by a combination of lower birth rates and young people staying in education for longer.

To some extent, the impact of these demographic changes were offset by free movement within the European Union, with the number of UK workers who were born in the EU rising from around 700,000 at the turn of the century to 2.3 million at the time of the 2016 referendum. However since then, we have seen no growth at all in EU-born workers, with this only partially replaced by employment growth among those born in other parts of the world.

It is the cumulative impact of these changes - an ageing workforce, with fewer young people replacing them, in poorer health and with lower labour market migration - that has driven the falls in participation that we have seen since 2020, and these will continue. We estimate that over the next two decades, employment growth will more than halve to, on average, 120,000 a year - with nearly half of this accounted for by higher employment among those in their late 60s and 70s.

At the same time, labour demand is changing too: with advances in technology, demand for public services and the transition to net zero driving more need for specialist skills while demand for lower-skilled tasks will continue to decline. So as well as having to get far better at raising participation in work, we also need to help people to upskill, help workplaces to be more productive, and try to spread these benefits more fairly.

WHAT CAN BE DONE

Addressing these challenges will require action on a number of fronts, but at IES we have been particularly focused on our approach to employment support. Over the last year, in partnership with abrdn Financial Fairness Trust, we have been running a Commission on the Future of Employment Support and consulted widely on what a better system would look like. We will be setting out detailed proposals in the next stage of the Commission's work, but four clear themes have emerged so far.

The first is that support needs to be more accessible and inclusive - for people, employers and wider partners. Jobcentre Plus is open only to a fraction of those who are out of work and focused mainly on ensuring that benefit claimants comply with the requirements of their claims. As a result, OECD analysis has shown that a smaller proportion of unemployed people in the UK use their public employment service than in any other country in Europe. However this has not always been the case (as recently as 2009, half a million people visited Jobcentre Plus offices without an appointment every week), and in the coming years we will need to do far better at reaching people who aren't in the labour force.

Secondly, our services need to focus on what people can do rather than on what they must do. Time and again, the Commission has heard that the current approach – focused on telling people what they must do and threatening sanctions when they fail – disempowers jobseekers, alienates employers, stigmatises support and therefore discourages others who could most benefit from help from accessing it.

Thirdly, our approach needs to be better tailored to the needs of the individuals, employers and communities that it serves. This means joining up far better across services like skills, careers and health; working more effectively with local partners; and reaching individuals and employers where they are with the support that they need.

Finally, the system needs to be more sustainable. Investment has fallen significantly in the last decade, but we still have a network of around 600 jobcentres, over 13,000 work coaches and at least £1 billion a year spent on employment support. So while we need to invest more in the long run, in the short term we can make better use of what we have got – and then reinvest some of the gains that will come from helping more people to get into (and stay in) better work.

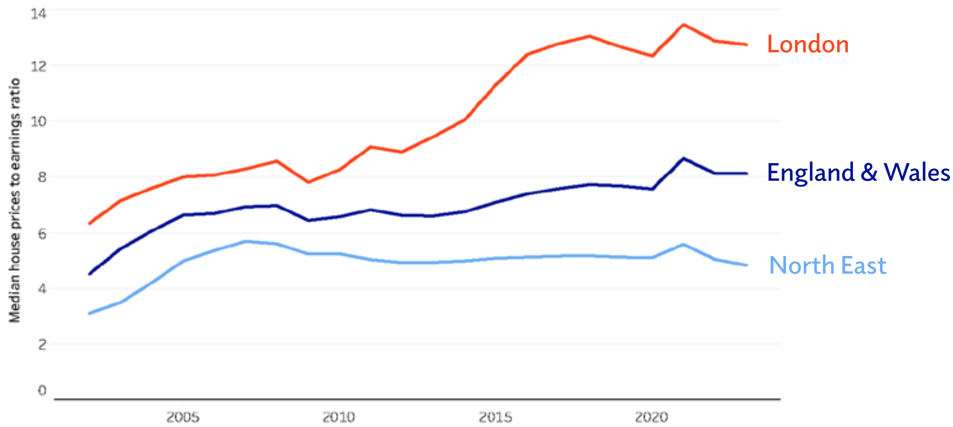
A more inclusive, empowering, personalised and sustainable system. In short, we need a more active approach to labour market policy than we have been used to in recent years, so that we can make the most of our workforce strengths, open economy and flexible labour markets. The challenges that we are facing in the labour market are becoming clear, but the opportunities are there too – and in the next Parliament we need to make sure that we can take them.

HOUSING AND PLANNING

Christian Hilber

The house price to earnings ratio for England and Wales has nearly doubled since 2002

Median house price to annual earnings of full-time worker (2002-2023)



Source: Office for National Statistics - Annual Survey of Hours and Earnings. House Price Statistics for Small Areas.

WHAT THE PROBLEM IS, AND WHY IT MATTERS

Housing in Britain has become seriously unaffordable. Houses are typically considered affordable if median prices are no more than three times median salaries. In England and Wales in 2022, the median annual earnings for someone on a full-time salary was £33,400. This implies an affordable home costs £100,000. Instead, the median price of a housing unit was £270,000.

The chart below shows the price-to-income ratio in England and Wales, London and the North East of England, respectively, since 2002. In England and Wales, the ratio nearly doubled between 2002 and 2021 from 4.5 to 8.7. In the least affordable region - London - affordability deteriorated from a multiple of 6.3 in 2002 to 13.5 in 2021. Even in the most affordable region - the North East - the ratio increased from 3.1 in 2002 to 5.6 in 2021.

Affordability has seriously deteriorated even when taking interest rates into account and the problem is not just confined to house prices and leveraged would-be-buyers: private rents are also seriously unaffordable relative to earnings.

Younger people are worst hit. For decades, the homeownership rate has been increasing steadily for over-65-year-olds. Among 25-34-year-olds it peaked during the late 1970s and fell by half over the period from 1989 to 2016. The number of adults living with their parents in England and Wales rose by 700k in a decade to 4.9 million in 2021.

Why has housing become so unaffordable? Put simply, there is a major housing shortage. The main explanatory factors are a combination of severe supply constraints in desirable cities working in conjunction with growing demand for housing in these locations. Stagnant supply, together with surging demand puts continued upward pressure on prices. Importantly, surging demand is chiefly driven by rising real incomes: population growth (including that resulting from immigration) plays a comparably smaller role.

But rising demand alone does not necessarily decrease affordability; it is the UK's failure to build more houses to respond to that rising demand. Between 1970 and 2023, house prices in the UK increased in real terms by 422%, yet construction fell by 46%: from 378,320 to 205,340 units.

But why is supply so unresponsive to rising prices? The main culprit is the UK's highly restrictive and dysfunctional planning system, which controls development in all directions. Large cities in England cannot grow horizontally because they are surrounded by massive green belts that are off-limits for residential development. Height restrictions and view corridors prevent vertical expansion. Furthermore, preservation policies (Conservation Areas and Listed Buildings), which are ubiquitous in central parts of cities, prevent more energy efficient and higher density redevelopment.

In contrast to zoning or master plan systems (prevalent throughout most of the developed world), where planning decisions are rule-based, in the British system, planning decisions are discretionary, making them unpredictable (Commonwealth countries that copied elements of the UK system have similar problems). This adds risk and costs to the development process. The planning decisions also involve an elaborate consultation process, giving undue political weight to local NIMBY (Not In My Backyard) residents.

To make matters worse, the benefits associated with permitting residential development and the costs are not spatially aligned. Planning decisions in England are made by local authorities. They face the brunt of the cost of providing additional infrastructure and services but reap few of the benefits in the form of additional local revenue through council tax. Moreover, even this extra revenue is redistributed away again in future years through the central government grants system, which allocates resources based on needs. So local authorities have both strong fiscal and political incentives to restrict large scale residential development.

Conservative estimates suggest that if the South East (the most restrictive region in England) had the same levels of restrictions as the North East (the least restrictive region, but still highly restrictive by international standards), house prices in 2008 would have been 25% lower. This gap is likely even larger today.

High planning-induced housing costs also discourage skilled workers from moving to the most productive cities. And, because productivity is itself driven by agglomeration economies, this reduces economic growth.

WHAT CAN BE DONE

Resolving the affordability and productivity crisis would require far-reaching reforms. Policymakers would need to reform the planning system away from the extraordinarily restrictive and idiosyncratic development control system towards a rule-based zoning system, as with New Zealand's seemingly successful reforms. The system should be redesigned to cater less to NIMBY residents and focus more on its core purpose - correcting market failures. Policymakers should require horizontal and vertical planning constraints and preservation policies to undergo social cost-benefit considerations. This should, for example, render intensive agricultural land near existing transport stations in the green belt 'developable'. It would also for example ensure that planners have to consider the energy cost of Conservation Area designations.

The highly inefficient stamp duty land tax should be phased out and replaced - ideally in a revenue-neutral way - with a much-reformed council tax. The latter should become a proper local annual tax on property values, and local authorities should be allowed to keep the revenues, creating incentives to permit larger scale residential developments. Replacing so-called Section 106 agreements with a Developer Levy could reduce uncertainty in the development process.

But these reforms are politically difficult: they are complex, they have an implementation cost, and the benefits accrue only in the future. Further, the pivotal voter in the UK is likely an existing homeowner who believes her or himself to be a beneficiary of the status quo with rising house prices. This belief, however, is flawed for at least three reasons. First, existing homeowners can only actually unlock their housing wealth if they sell and move to a much less desirable place or leave the country. Second, our wellbeing is driven by the quality, size and location of our homes, not by how much our house is worth. The sad truth is that many people live in cramped and sub-par housing too far from the workplace, precisely because it is so limited in supply and, therefore, expensive. Third, many existing homeowners are older and have children who are themselves desperately looking for adequate housing. Parents may not realise that their opposition to reform indirectly hurts the prospects of their offspring.

Solving the conundrum requires two things to happen. First, it is crucial to persuade the median voter that they may not benefit from the status quo. Second, the young and their YIMBY movement ('yes in my back yard') do not have a political majority. To succeed, they must persuade altruistic parents and grandparents that radical reforms are desperately needed. What is needed is a coalition across generations.

MIGRATION

Ben Brindle and Madeleine Sumption

The post-Brexit immigration system was widely expected to mean lower migration to the UK. It didn't. While EU migration did decline, non-EU migration has hit record levels. A boom in work visas and international students drove the increase, coupled with substantial numbers of people coming from Ukraine in the immediate aftermath of the Russian invasion.

The political backdrop to the current debate about the economics of migration in the UK is thus the numbers, although migration experts are unanimous that targeting overall numbers is impractical. Politicians from both major parties have said that they want migration levels to come down (something that is quite likely to happen anyway in the coming years). In December 2023, the government announced substantial restrictions to come into force in 2024.

Some simply reverse, or partially reverse, liberalisations the same government made over the past few years. For example, care workers became eligible for skilled work visas in early 2022 but will now no longer be able to bring their partners or children to the UK. Most master's students will not be able to bring family with them either (announced earlier in 2023). The main salary threshold for skilled work visa holders will increase from £26,200 to £38,700.

In perhaps the most significant departure from previous practice, British citizens or settled residents who marry non-UK citizens will no longer be able to live with them in the UK unless they also earn £38,700.

Against this background, what are the key questions facing economic policymakers thinking about migration in the UK?

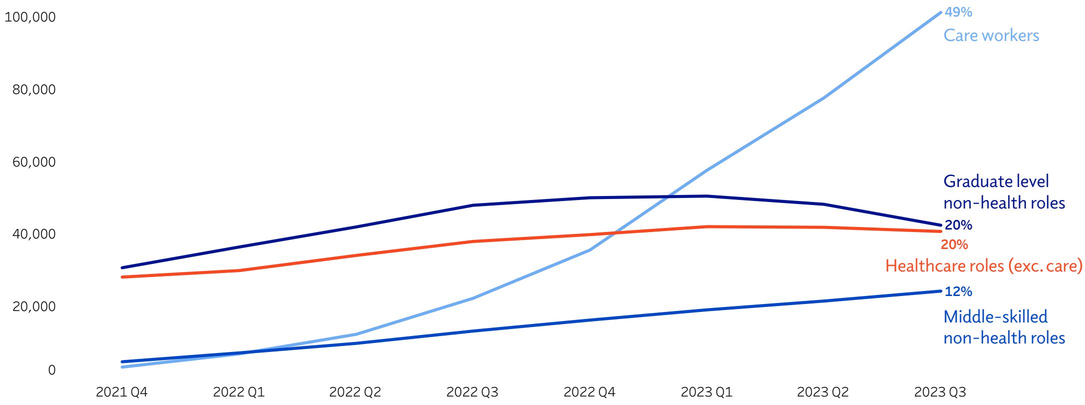
WHAT IS DRIVING INCREASES IN WORK MIGRATION?

Even since free movement ended, the scale and profile of the work visa route has changed substantially (see chart below). Almost half (49%) of main applicants getting Skilled Worker visas in the year ending September 2023 were care workers - up from just a few thousand in 2021. Another 20% were in healthcare roles. Only 20% of Skilled Worker Route visas in the year ending September 2023 were for graduate jobs outside of health and care, with another 12% in middle-skilled non-health jobs such as butchers or chefs.

Since free movement ended, the scale and profile of the work visa route has changed substantially

Skilled worker visa grants, by occupation type. Year ending Q4 2021 to year ending Q3 2023; main applicants only

UK IN A CHANGING EUROPE



Source: Migration Observatory analysis of Home Office Immigration Statistics, Table_OccD02. Note: excludes some skilled work visas, e.g. intracompany transfers

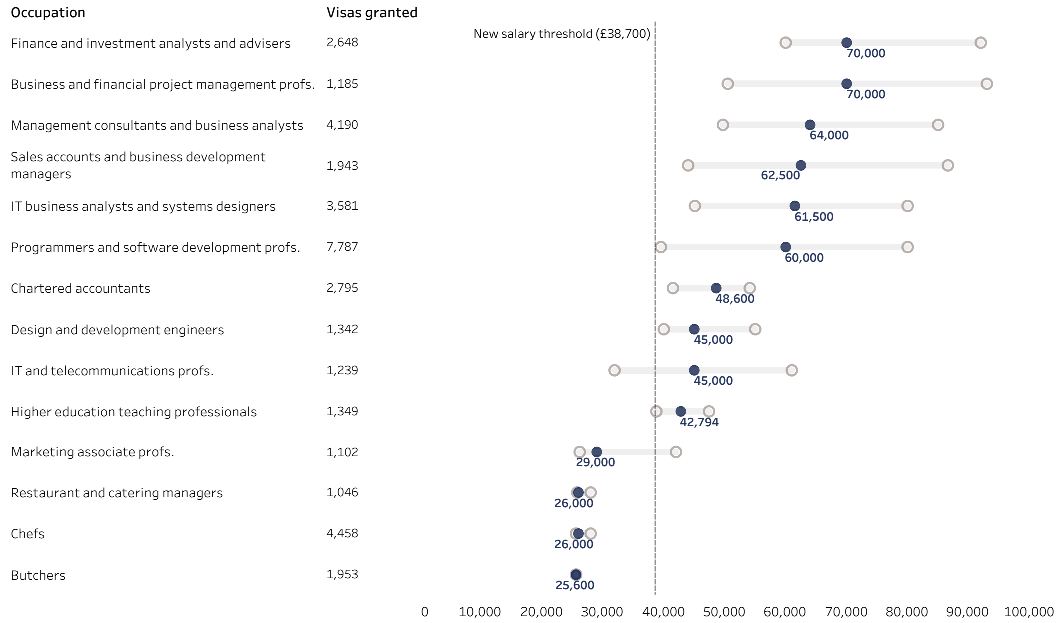
The increase in the main salary threshold from £26,200 to £38,700 sounds like a big increase, but care work and public sector jobs paid using nationally agreed pay scales are exempt. This means that the salary threshold only affects a small proportion of work visa recipients – roughly 30% of people coming on long-term Skilled Worker Route visas in the year ending September 2023. Most of these will still qualify even with the higher threshold.

When the government released its plans for the post-Brexit immigration system in early 2020, it told private-sector employers they would have to adjust to a more restrictive work visa system, shifting 'away from a reliance on cheap labour'. But this has so far not happened in the way policymakers envisaged. That's because main applicants on work visas make up a minority of immigration. In the year ending June 2023, only around 17% of non-EU citizens coming to the UK long-term were main applicants on work visas, while non-EU immigration in categories such as the Ukraine schemes and family members of workers and students soared. As a result, the migrant workforce has grown even in the industries that were expected to be hit by the end of free movement, such as hospitality.

Lower Ukrainian migration and newly announced restrictions on family members of workers and students may make this cushion thinner in the coming years. In addition, the £38,700 salary threshold will squeeze middle-skilled private-sector occupations that have started to use the immigration system in meaningful numbers, such as butchers and chefs (see chart below). This will affect some employers significantly, but is not likely to have a large impact on the overall economy.

The new salary threshold for Skilled Work visas will squeeze middle-skilled private-sector occupations

Earnings distribution of top occupations receiving Skilled Work visas, year ending June 2023. 25th, 50th and 75th percentile of earnings; non-healthcare occupations



Source: Migration Observatory analysis of Home Office Immigration Statistics, Freedom of Information request 78407 and table Occ_D02.
Note: The 25th, 50th and 75th percentiles indicate the share of migrants granted visas in the year ending June 2023 to work in the relevant occupation (25%, 50% or 75%) whose earnings are below that number.

IS THE PUBLIC-SECTOR TAKEOVER OF THE UK'S WORK VISA SYSTEM A GOOD IDEA?

By sparing the health and care sector from salary increases, the new measures look likely to further skew the distribution of skilled worker visas in favour of publicly funded jobs.

Is this sensible? On one hand, migration undoubtedly benefits the health and care sector, particularly in the short term. For example, care has suffered serious staff shortages and early evidence suggests that the new route is helping care organisations to function effectively. On the other hand, heavy reliance on overseas recruits also brings risks. Growing evidence suggests that exploitation of migrant care workers has been a major problem. And immigration policy does not address the underlying driver of shortages in the care sector, namely poor pay and conditions that result from limited funding.

Of course, improving pay and conditions in health and care would bring substantial costs at a time when neither local nor national government are awash with money. But while the government has dodged the issue for now by focusing its migration-reducing energies on family members and the private sector, it is hard to see that ever increasing numbers of overseas workers is a sustainable strategy to address this. Brits still make up the large majority of workers in the sector (81% in England in 2022/3). If conditions for workers remain miserable, employers will struggle to retain them.

WHAT WILL BE THE IMPACT OF NON-WORK ROUTES?

Work visas are not the only show in town. In the long run, how migration affects the UK economy will also depend on people not admitted as workers -including Ukrainians, Hong Kong British Nationals (Overseas), refugees, and those family members who still qualify under the proposed system. Their economic impacts will depend in large part on what share find work and at what skill and salary level, but their outcomes remain quite uncertain. For example, emerging evidence suggests that many Hong Kongers have struggled to get a foothold in the UK labour market, at least so far, and that an increasing share of international students are staying in the UK to work after their studies. Trends such as these will affect the economic impacts of migration in ways that are difficult to predict with confidence.

WILL THERE EVER BE POLICY STABILITY?

Migration policy appears to be in a state of perpetual change. Over the past 15 years, policy changes have been introduced, reversed, introduced, and reversed again. This may result from the trade-off between the desire to take liberal choices on individual migration routes and the desire to restrict migration levels overall - both ideas tend to receive political support but they are incompatible. Instead of finding a stable compromise between these two positions, the pendulum swings between them. In addition, big changes often generate unintended consequences, requiring further modifications - especially if there has been limited consultation or analysis. All this may be inevitable to some extent, but it also imposes costs on the employers, universities and individuals constantly adapting to new rules.

TRADE

Thomas Sampson

WHAT THE PROBLEM IS, AND WHY IT MATTERS

Brexit marked a fresh start for UK trade. After nearly fifty years under the EU's common policy, Britain was free to set its own tariffs and strike its own trade deals. Theresa May declared the era of 'Global Britain' - a country committed to free trade and determined to broaden its horizons away from Europe towards faster growing economies in Asia and the Americas. Newly recruited trade negotiators criss-crossed the globe seeking ambitious deals with the United States, India and any other country willing to talk.

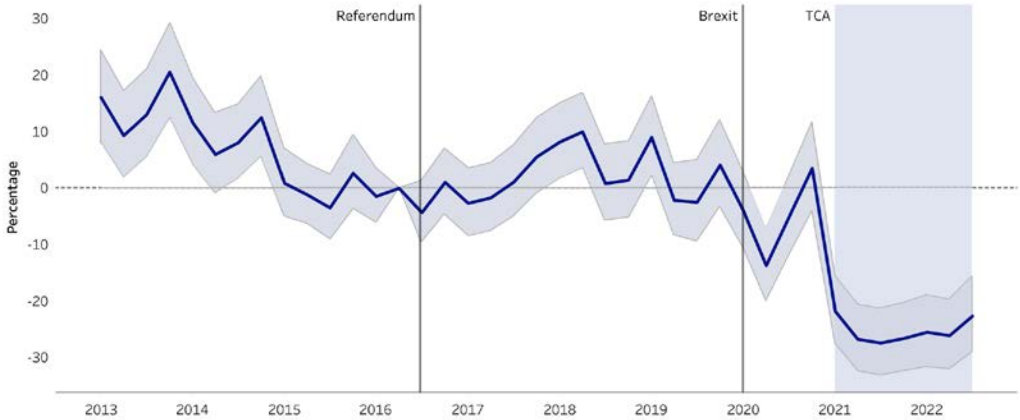
It is time to concede that May's vision has failed. Brexit has not turned Britain into a global trading superpower. The much hoped-for deal with the US, the UK's second biggest trade partner after the EU, has failed to materialise. Negotiations with India are ongoing, but any agreement that does emerge will be limited in scope and bring only minor changes. New deals have been struck with Australia and New Zealand, and the UK has joined the CPTPP - a free trade agreement between 11 Pacific Rim countries. But these economies are too small and too far-away to matter much for UK trade. Even the government's own analysis suggests that the economic benefits of these deals will be minor, with each agreement expected to increase UK GDP by less than one-tenth of 1%.

At the same time, under the Trade and Cooperation Agreement (TCA) that now governs UK-EU trade, Britain sits outside of the EU's Single Market and Customs Union. This change has resulted in the re-introduction of customs red tape and regulatory barriers, leading to higher trade costs. And although services trade has proved surprisingly resilient so far, these costs have sharply reduced goods trade. The TCA has caused goods imports from the EU relative to the rest of the world to fall by around 20%, as shown in the chart below. Likewise, many small exporters, who cannot afford to hire new staff simply to complete customs forms, have seen their exports to the EU collapse.

Far from boosting trade, Brexit has left the UK less open to the world. Growth in goods exports and imports since 2019 has been the weakest in the G7. And less trade has contributed to the ongoing stagnation of the UK economy. Barriers to trade increase import costs, leading to higher consumer prices. And on the export side, making it harder to access EU markets takes opportunities away from UK firms, leading to fewer good jobs and lower wages.

The TCA has caused goods imports from the EU relative to the rest of the world to fall by around 20%

Estimated effects of the Brexit referendum and the introduction of the TCA on UK goods imports from the EU relative to the rest of the world.



Source: Freeman, R., K. Manova, T. Prayer, and T. Sampson. 2022. "UK Trade in the Wake of Brexit". CEP Discussion Paper No. 1847.
Note: Updated through 2022 Q3, shaded area shows 95% confidence intervals.

WHAT CAN BE DONE

What should be the future of UK trade policy? The first step is to ditch the myth of Global Britain. The EU is far and away the UK's most important trade partner, accounting for around half of all UK trade. At a time when advocates for globalisation are on the defensive, there is little opportunity to strike transformational trade deals outside Europe. Instead, attention needs to shift closer to home. A stronger trade relationship with the EU should be the number one priority. This does not mean ignoring the rest of the world; the UK should be alive to opportunities wherever they emerge. But from now on officials should be taking more trains to Brussels and fewer planes to Tokyo, Canberra and other far-flung locales.

It would be comforting to think that a renewed willingness to engage with the EU will lead to the dismantling of those trade barriers created by the TCA. Comforting, but wrong. Unless the UK rejoins the EU's Single Market, there will always be regulatory barriers to UK-EU trade. And unless the UK rejoins the Customs Union, cross-channel trade will always be subject to customs red tape. If the goal is simply to boost the economy - by around 4% of GDP according to the OBR - rejoining the Single Market and Customs Union would be the best option. But absent a political consensus to take this step, a judicious combination of negotiations and unilateral actions could still mitigate some of the costs of Brexit.

Building upon the recent agreement to rejoin the EU's research funding programme Horizon Europe, objectives for negotiations with the EU should include: an agreement on animal and plant health standards to ease the flow of agricultural goods across the channel; improvements to labour mobility to facilitate short-term business trips and give young people opportunities to live and work in Europe, and; rejoining ERASMUS to allow students to study in the EU. These steps would deliver tangible benefits to some of the groups hardest hit by Brexit. Helpfully, the UK Trade and Business Commission has compiled many more suggestions for improving UK trade policy. A key priority should be to support small and medium-size firms in exporting to the EU under the TCA.

But the most important short-term goal should be to avoid regulatory divergence that creates further barriers to trade. And this goal can be achieved without the need for negotiations. First, any proposed change to UK regulation should be subject to a cost-benefit test that accounts for how differences between UK and EU regulations affect trade. This test would prevent active divergence that is not in the UK's interest. Second, the UK needs to tackle the passive divergence that occurs when EU regulations change. New or updated EU regulations should trigger a review of whether the UK would benefit from aligning with EU policy.

Shadowing the EU in this way - for example, by linking the UK's carbon price to the EU regime to ensure that UK exporters are exempt from the EU's carbon border tax - may be less glamorous than rhapsodising Global Britain. But the time for grand visions has passed. Now is the time to focus on the nitty-gritty of rebuilding UK trade.

INDUSTRIAL POLICIES AND NET ZERO

David Bailey and Philip R Tomlinson

WHAT THE PROBLEM IS, AND WHY IT MATTERS

Recent shocks, including the Covid-19 pandemic and the energy price spike induced by the war in Ukraine, led to both supply chain disruption and inflation. In Europe and the US, these shocks also exposed a lack of resilience in areas such as energy security and the supply of medical equipment.

Governments have reconsidered the role of industrial policy in (re-)building domestic manufacturing capacity to safeguard against future crises, to reduce reliance on China, and - critically - to get to Net Zero more quickly than the market seems able to manage.

As a result, industrial policy is back, and in a big way, although whether one policy can hit multiple targets is open to question, especially for a small open economy like the UK

The United States is the 'flag-bearer' for new industrial policy. President Biden's Inflation Reduction Act (IRA), and CHIPS and Science Act add up to over $2 trillion of industrial policy support for green manufacturing, reshoring and decoupling from China. These have provided a range of subsidies and tax breaks to foster investment in and take-up of low carbon technologies, such as battery electric vehicles (BEVs), heat pumps and carbon capture as well as semi-conductors.

The IRA alone has stimulated some $278 billion of new investment, creating some 170,000 new jobs. Not surprisingly, the European Union (EU) has grown concerned over the IRA's impact on the EU's own green manufacturing base, particularly in terms of diverting investment away from the EU, especially on battery making for BEVs. And looking East, the EU has launched an investigation into Chinese subsidies for battery electric vehicles. Yet China has of late re-emphasised its focus on industrial policy, while South Korea has just unveiled a $29bn boost for its EV battery industry.

In response,the EU has announced a €250 billion Green Deal Industrial Plan, along with a relaxation of EU 'state aid' rules to allow member states to use fiscal incentives to fast-track investment in green sectors, with an emphasis - at a high level at least - on skills, supply chains, funding and smart and simple regulation such as cutting red tape for new net-zero manufacturing projects and accelerated permitting rules for renewables.

This has all led to concern that a green subsidy race will stifle competition, raise global trade tensions, and reduce opportunities for developing economies to grow their own clean-tech sectors. New policies could also challenge the existing multi-lateral trade framework and WTO rules. Indeed, this could be a major moment for reset at the WTO, especially when both the EU and UK are introducing Carbon Border Adjustment Mechanisms.

But both the US and EU subsidy schemes should help accelerate a much-needed green transition. That will accelerate decarbonisation and the move to Net Zero. This is needed as the market, left to its own devices, is not moving quickly enough.

And what of the UK? The UK had several industrial strategies after 2010, with the most recent, developed by Greg Clark, scrapped under the Johnson government. In its place came a plan to 'Build back better' with a new focus on levelling up. Yet funding for local industrial strategies, in which Local Enterprise Partnerships (LEPs) and Combined Authorities had invested significant time and resources, was scrapped.

More recently LEPs were also culled in further institutional churn at the regional level. 'Build back Better' was followed by Liz Truss' short lived Growth Plan, and most recently Rishi Sunak's Growth Areas. At the time of writing there is no industrial strategy as such. This constant stop-start is indicative of the UK approach, in contrast to experience elsewhere, and has been criticised by a number of employers' associations such as MAKEUK.

In particular, there has been little in the way of a policy response to either of the US and EU subsidy schemes. Indeed, existing UK initiatives to net zero have generally lacked sufficient funding, been haphazard and sometimes conflict with other policies.

For instance, the Green Alliance has argued that there is a £14 billion shortfall in low carbon infrastructure investment in the UK. Moreover, the windfall tax on North Sea oil and gas firms oddly covers some wind and solar electricity generators, thereby discouraging investment in renewables. This is counter-productive as the UK has a competitive advantage in the generation, storage and low-carbon technologies and processes, especially in nuclear and offshore wind. Sadly, it has yet to leverage this into building a stronger supply chain in such areas, which has been something of a missed opportunity.

WHAT CAN BE DONE

Having a policy would be a start.

Jeremy Hunt said he would wait and see what the EU will do on its green industrial policy before responding. But why? One argument put forward for Brexit was that EU State Aid rules allegedly stifled the ability of the UK to support industry.

Yet the UK position since Brexit has been to largely scrap industrial policy and pretty much stand on the sidelines while the action unfolds elsewhere, for example on attracting investment to build battery giga-factories in stark contrast to the US and EU.

In 2023 the government did - finally - set out five 'growth areas' for the economy. This was followed up in late 2023 by extra support for the automotive industry (previous funding pots had been spent on Nissan, MINI and TATA). And there was the start of a much-needed battery strategy. But the sums on offer are a fraction of what is available in the US, EU and China, and there is a lack of an overall industrial strategy.

Labour had previously promised a £28 billion a year green transition programme - through a dedicated green investment fund - a proposal which was cautiously welcomed by climate experts. But in 2023 it rowed back on the policy, downgrading it to an aspiration over two parliaments and only if its fiscal rules allowed. Labour may also initiate a 'Buy British' procurement policy, though this could fall foul of existing WTO rules, and possibly the EU-UK Trade and Co-operation Agreement.

While Labour's fiscal caution is understandable in the run up to a General election, the UK needs substantial investment, for example to deliver energy security on the way to net zero. To do this, Labour needs a clear and credible plan that the money will be well spent if financial markets are going to finance borrowing.

Despite Labour's caution, there are some major opportunities for the UK to push forward on net-zero by capitalising on its existing strengths and capabilities, such as those in nuclear and off-shore wind. Progress depends on new investment in low carbon infrastructures - electric vehicle charging points, high-speed broadband and hydrogen technology - and working closely with local businesses to identify the best projects to support. This is not about 'picking winners' but rather nurturing the 'stables' from which winning low carbon technologies can emerge. Moreover, many of these opportunities reside in the North of England, and so an industrial policy supporting such sectors would also assist with 'levelling up'. Indeed, there are several 'shovel ready' low-carbon projects that could boost local growth.

In short, the UK needs to get serious about a 'Green New Deal' if it is to meet its own net-zero commitments, build low-carbon resilience in its own energy supply, re-shore critical manufacturing and compete with the US, EU and China.

AI POLICY

Huw Roberts

AI is increasingly being integrated into all aspects of our lives. It is used to recommend what products to buy, to analyse X-ray images, and to commit sophisticated forms of fraud. While the potential benefits and risks of AI have long been recognised, the release of OpenAI's ChatGPT in late 2022 has pushed these technologies to the forefront of policy and public discourse.

The UK is well-placed to benefit from AI. By most metrics it is highly ranked with strong foundations in talent, investment, and innovative new start-ups. The country also has robust regulatory institutions with a track record of effective governance. For instance, regulatory sandboxes - now common in the suite of tools used by regulators globally - were first pioneered by the UK's Financial Conduct Authority (FCA) in 2015.

In 2018, the government singled out AI as one of four policy areas where the UK could be world-leading following Brexit. A £1 billion investment in AI was announced in the same year, including funding 1000 AI PhDs in the UK. In 2023, the UK committed to improving the infrastructure underpinning AI through £1.5 billion in investments for compute, with a further £2.5 billion pledged by Microsoft to build AI datacentre infrastructure.

The UK has also been developing governance mechanisms to support AI innovation and mitigate risks. The government released an AI White Paper in March 2023 outlining the country's approach to governance. Shortly after, the Foundation Model Taskforce - now rebranded as the AI Safety Institute - was established to develop governance mechanisms for cutting-edge AI systems. Internationally, the UK hosted an AI safety summit in November which resulted in 29 governments signing the Bletchley Declaration that acknowledged the risks of these technologies and promoted cooperation.

Despite these strong foundations and positive steps, the UK faces significant challenges in maximising the economic benefits of AI, including from job disruption, access to talent, and how government is organised. Here we focus on two: scale and regulation.

SCALE CHALLENGES

The performance of latest generation AI models is highly correlated with their size, making them extremely expensive to develop. Training OpenAI's GPT-4 cost an estimated $100 million, with it not unreasonable to expect these costs to continue increasing for the foreseeable future, even as systems become more efficient. High costs are also no guarantee of profitability, with OpenAI's losses doubling to $540 million in 2022.

US and Chinese tech companies can raise the capital needed to compete in this market. OpenAI alone received a recent investment of $10 billion from Microsoft to support its AI developments, with some reports suggesting that OpenAI's CEO Sam Altman aims to raise as much as $100 billion in the coming years. But the costs associated with cutting-edge AI systems are prohibitive for UK companies, with total private capital investment in UK AI standing at £3 billion in 2022. Some companies with more limited resources, notably France's Mistral, are attempting to compete by open sourcing their models and using novel techniques. Yet, the degree to which these workarounds will allow smaller organisations to succeed is unclear.

An inability to compete at scale is important because the latest generation are 'foundation models': systems trained on vast quantities of data that can perform a range of tasks, such as the generation of text, images or audio. The general-purpose nature of these models means that companies pay for API access to build downstream applications 'on top of' foundation models. Numerous companies are already doing so because outcomes are often better and cheaper than developing or purchasing 'narrow AI' systems. The UK therefore risks missing out.

REGULATORY CHALLENGES

Despite the strength of its existing institutions, the UK is increasingly becoming a regulatory outlier. The EU has reached provisional agreement on a cross-cutting AI regulation, the US recently published an executive order focused on regulating AI, and China has introduced several laws targeting specific AI technologies.

The UK, meanwhile, argues that 'premature regulation' will hinder innovation. But good regulation provides businesses with clarity and the UK's ecosystem is currently failing to provide this. The AI White Paper promotes a sector-based approach to governance that relies on individual regulators applying existing powers to AI. However, little detail has been provided about additional resources to support regulatory efforts and coordination between regulators. This risks a confused and overlapping regulatory environment, which businesses and researchers have warned would be detrimental.

In parallel, over the past 18 months the government has u-turned over what risks should be focused on. In Summer 2022, policy documents stated that regulators should not focus on 'hypothetical risks'. By Autumn 2023, the government's central focus was on exactly these hypothetical risks. Statements from Labour politicians indicate that the regulatory emphasis could change once again to mitigating more immediate-term harms if they succeed in the next General Election.

These factors, combined with wider pressures being placed on regulators due to Brexit and revisions to AI-adjacent legislation, such as data protection laws, creates significant uncertainty for both regulators and businesses. The lack of a solid legal foundation risks undermining business confidence, in turn impacting investment and adoption.

POLICY CHOICES

The UK has several policy options for addressing these economic challenges. Mitigating regulatory uncertainty is a relatively low-hanging fruit. There have been several calls for a new AI-specific law like the EU's AI Act, which would provide greater clarity for businesses. However, this approach also risks creating rigidity which could negatively impact governance efforts due to the speed at which AI technologies are developing.

An alternative approach is to improve support for regulators and improve coordination amongst them. There are early signs of progress on this, including establishing a central government function to monitor risks and inform regulators, but details on this body have been scarce. Further progress could be made by placing the Digital Regulators Cooperation Forum (DRCF) on statutory footing to support a meaningfully joined up governance approach by the UK's main digital regulators.

Improving UK AI competitiveness requires a more complex set of interventions. At present, UK AI policy announcements are largely ad-hoc, with the country's National AI Strategy, published in 2021, providing little in the way of a strong long-term vision for being economically competitive in an era of foundation models. A clearer vision for where the UK aims to be competitive is needed.

In practice, such a strategy will need to include continued investment in national compute capacity, a focus on developing downstream applications in areas of existing specialism like fintech and cybersecurity, the promotion of new industries like AI auditing that build on the UK's national strengths, and continued R&D into foundational research that could give the country a head start in commercialising the next wave of technological innovation. Together, this could allow the UK to develop a strong AI ecosystem with its own unique value-added propositions.

UK ECONOMY SWOT ANALYSIS

STRENGTHS

The UK is a large, advanced, and prosperous nation, with particular strengths in high productivity service sectors, from financial and business services to its world-leading universities. It has a flexible labour market and a relatively highly-skilled workforce: UK schools have improved hugely over the past two decades, and the rapid widening of participation in higher education over the last 30 years means that the UK is now well ahead of the OECD average. And despite recent turbulence, the UK remains a stable democracy, with a tradition of generally good economic governance and institutions.

WEAKNESSES

The UK's economic performance since the global financial crisis has been mediocre. While partly the result of austerity and Brexit, this also reflects long-standing structural weaknesses, including persistently low investment, skills, and entrenched inequalities along several dimensions. Political and economic power is considerably more centralised than most advanced economies, but the planning and regulatory system privileges and entrenches local interests. And the quality of governance has eroded steadily in recent years. Public services are – despite a relatively high tax burden by historic standards – visibly failing to keep up with demand, with public service productivity at best stagnant.

OPPORTUNITIES

An increasing proportion of economic growth globally is likely to come in high-productivity service sectors, where the UK has many areas of clear comparative advantage: financial and legal services, consultancy, and creative services such as marketing and advertising. Other opportunities include digital and technologically enabled services, particularly if the UK can leverage its regulatory autonomy post-Brexit, and those related to achieving net zero. More broadly, recent poor performance means there is considerable potential for catch-up growth. Deepening trade links with high-growth countries, reflected in joining the CPTPP and negotiations with India, present opportunities beyond Europe and North America.

THREATS

Brexit's full economic impacts have yet to be felt, especially in sectors with complex supply chains. Meanwhile, hopes that these could be substituted with a less Eurocentric and more global trading model are threatened by the broader international and geopolitical environment. Domestically, while politics may be less stable, policy may continue to be short-termist, potentially leading to a vicious circle of low growth and zero-sum, polarised politics. Population ageing and falling fertility will lead to further increases both in the dependency ratio and demands on health, social care and pensions, and the scope to address this via immigration is politically constrained.

UK in a Changing Europe promotes rigorous, high-quality and independent research into the complex and ever changing relationship between the UK and the EU. It is funded by the Economic and Social Research Council and based at King's College London.

020 7848 2630
info@UKandEU.ac.uk
@UKandEU

www.ukandeu.ac.uk