SUPPORTING DYNAMIC ECONOMIC ADJUSTMENT

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Executive Summary

Economic policymaking in the UK has historically focussed more on the demand side than on the supply side of the economy. Yet it is on the supply side – the way in which an economy adapts to change while growing productive capacity on a sustainable basis – that medium- to long-term economic performance largely depends. There is an urgent need now to rebalance policy by focussing, in particular, on measures to enhance labour-force productivity, including radically enhanced support for training and skills development.

This does not involve wholesale structural reform of the economic framework. The UK benefits from having one of the most flexible economies in the OECD, with competitive product markets, relatively low labour costs and historically high employment levels, accompanied by a so-far-successful adoption of an escalating minimum wage. We suggest that in the post-Brexit era politicians would do well to avoid changes in the regulatory regime that would create undue misalignments with EU standards. Nevertheless, the concomitants of the UK's form of flexibility are a dismal performance on productivity and stagnating living standards. Productivity is now actually falling quarter on quarter ten years after the last economic downturn – a position unprecedented in the past 250 years. This problem must be addressed if the UK is to progress towards fulfilling its economic potential.

Central to this are both so-called Active Labour Market Policies (ALMPs) to provide people who have become unemployed with new skills that help them remain in the workforce, and investments in effective upskilling of mid-career and older workers. ALMPs can help raise average per capita income over time, yet UK spending on this area is well under half the OECD average and a fraction of the sums spent in the more successful Nordic economies, Germany, Austria, Switzerland, and Australia. The UK's many attempts to develop new training and apprenticeship schemes in recent decades have been dogged by poor quality and a lack of support from employers and labour unions. This needs to change: we propose a concerted effort to raise UK spending on ALMPs to the OECD average, especially for 16–24 year-olds. Improving labour-force mobility – for example by radically improving availability of affordable housing – is also critical. Structural reforms of this kind will require sustained political effort and support.

Introduction

Economic performance over the medium to long term – a period of say five to ten years – is determined largely by developments on the supply side.

That is not to dismiss the importance of (aggregate) demand (considered in the previous chapter). To the extent that aggregate demand can be maintained at, or at least close to, the economy's potential, the greater is the likelihood that businesses feel confident, not only about the present, but also about the future, and are thereby emboldened to engage in capacity-expanding investment. This both helps create and meet growing future demand, as well as generating strong employment.

UK policymaking, perhaps reflecting its intellectual heritage in this area, has been unduly impressed by the importance of the demand side, and has historically

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placed rather less emphasis on the supply side of the economy than have other countries, such as Germany or France. And when supply-side policy has been afforded a high degree of importance, as in the 1960s and 70s, it has veered between the merely indicative and the excessively interventionist.

Conceptually, there are two separate elements in securing good supply-side performance: first, adjusting constructively to economic shocks; and second, achieving a brisk and sustainable growth of productive capacity. In practice, however, the two issues, and hence the policies to promote them, are intrinsically inseparable.

Structural adjustment policies

Economies have to adjust continually to forces that emanate variously from home and abroad. These positive or negative forces can be gradual and persistent; or they can be sudden and dramatic. They can also operate on the supply side – such as oil or other commodity price shocks, or technological advances and demographic change; or they can hit the economy on the demand side – for example through a crisis in a close trading partner, the emergence of new competitors, or from the elaboration of supply chains.

The basic purpose of structural adjustment policy is to ensure that the range of government policies, enacted for whatever motive, at least do not hinder, and preferably actually facilitate, the adjustment of the economy to these different shocks, and that resources flow readily from low productivity to high productivity activities, and from declining sectors into growing sectors.
The weight of evidence, from the UK and other advanced economies, is that good structural policies, provided they are sustained, can do much to support constructive change, and thereby enhance economic performance.

At the same time, structural change is disruptive – socially, sectorally, and hence often politically. In extreme cases it can arouse widespread antagonism and opposition. Hence, to be accepted, structural adjustment policies have to be buttressed by other initiatives to ensure that the benefits of constructive change are shared fairly across society, and that the social costs of adjustment are as low as reasonably possible. Some of the policies for ameliorating the consequences of structural change are presented later in this paper, and in the subsequent paper on *Inequality*.

The broad lines for structural adjustment policies are presented below. Many areas of policy inter-relate. Hence to achieve the maximum impact, structural policies need to be mutually reinforcing; and to achieve that they have to be coherent and consistent. Hence, while government initiatives are often presented individually or in batches, ultimately they have to be taken and evaluated as a whole.

To the extent possible we avoid advocating more expenditure by government as the answer. While government expenditure may not be quite as constrained by deficit and debt levels as was the case a few years ago, and the latest government seems effectively to have abandoned serious efforts at austerity, the scope for running persistent deficits is nevertheless limited. Furthermore, generally, an element of trade-off is involved in any policy that requires expenditure: more spending and tax incentives in one area generally imply less somewhere else. 'Throwing money at the problem' is often not a panacea.

The ability to engage in structural reform is also often constrained by electoral cycles being shorter than the time it takes for reform to bear fruit. It is an inconvenient fact that the costs of reforms are often immediate and narrowly focussed on powerful vested interests, but the benefits by contrast tend to be thinly spread and cumulate over time, perhaps failing to become fully manifest for a decade.

Activation policies

It is essential that people are able to move smoothly between jobs and tasks. For this, effective policies to promote upskilling in line with changing skill demands are essential. Policies that facilitate structural adjustment can target key labour market institutions and wage setting or seek to activate job seekers.

Policies targeting labour market institutions, wage setting, and the benefit system

The United Kingdom exhibits a high degree of labour market flexibility and dynamism, on a par with the two other major high-flexibility OECD countries, the US and Canada. However, the concomitant is weak employment protection.

It is striking that since the mid-1980s, the unemployment rate has been on a declining trend across a number of business cycles. A particular case in point is the resilience of employment after the 2008 global financial crisis, notwithstanding the deepest post-war recession and a relatively shallow recovery. The aggregate employment rate never fell below 70 per cent of the workforce, and is now historically high at some 76 per cent.

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While the result has been – by definition – slow productivity growth, that is in many respects preferable to the joblessness that would have occurred otherwise: a low-paid job is typically a better platform from which to transition to a well-paid job than is being unemployed. That said, the economy would have grown faster had investment been stronger; and this in turn would have enabled productivity to grow faster.

At least part of the UK's labour market flexibility can be attributed to a relatively successful 'activation regime' – most notably the way that the benefit system has maintained work incentives.

The cost of UK labour is also well under the OECD average, notwithstanding the progressive scaling up of the minimum wage over recent years. Introduced in 1999 at just over 45 per cent of median hourly earnings for those aged over 25, the UK minimum wage now stands at around 58 per cent of median hourly earnings. Coverage of workers has doubled since its introduction, and its effects have rippled up the pay distribution.

The minimum wage has increased faster than both average earnings and inflation, with hourly pay growing more rapidly for the lowest paid than any other group, and the oldest, youngest, and female workers benefitting the most. In real terms, the UK minimum wage is now in the group of high minimum-wage OECD countries.

On the other hand, UK coverage of collective bargaining agreements and trade union density rates are below the OECD mean. Initial net replacement rates[1] and tax wedges[2] are low, although the marginal tax wedge for those earning well above the average is an exception to this rule.

Although a longstanding cheerleader for the narrowing of gender gaps in earnings and employment rates, and a critic of labour market dualism, and the poor integration of immigrants and ethnic minorities into employment, the OECD offers few specific policy recommendations on these issues where the UK is concerned. The same is generally also true where matters such as social benefits, labour taxation, severance pay, the minimum wage, or the wage bargaining system are concerned, although it is possible to make a strong argument in favour of changing the law to make it easier and less costly for workers to contest unfair dismissals.

Policy proposal

- *Leave well alone*

Active policies

So-called Active Labour Market Policies (ALMPs) represent an important secondary strand of activation strategies. ALMPs provide people who have become unemployed with new skills that help them remain in the workforce, and find alternative employment. They also serve to support work incentives for the unemployed.[3] The evidence is that they contribute importantly to higher average per capita income in the longer term; but they are expensive in the near term.

ALMPs are a particular feature of the Nordic countries, where they are judged to have been particularly successful; whereas in the US, such programmes are not generally regarded as an appropriate activity for the state. The UK's approach is closer to the US than the Nordics. In significant part this is the result of deliberate political choice.

UK government spending on ALMPs is only 5 per cent of GDP per capita, which is well under half the OECD average, and a fraction of that spent in the Nordic economies, Germany, Austria, Switzerland, and Australia. The evaluation literature suggests that a judicious increase in public spending on ALMPs that work could yield significant private and social gains.

The UK can be criticised particularly for the low quality of its training policies. For one thing, it has not proved possible to generate the degree of employer-union commitment to apprenticeships that so characterises the successful systems developed in Germany, Austria, Switzerland, the Netherlands, and Australia.

Many unsuccessful attempts have been made to implement a modern apprenticeship system in the UK, and yet another relaunch is currently underway including an apprenticeship levy. It remains to be seen whether it will do any better than previous attempts. The omens are not encouraging. The number of apprenticeship starts has dropped sharply since the relaunch, and fewer than one-third of employers who paid the levy increased spending on apprentices. Employers complain that the levy is too rigid and not well adapted to their skill needs, which is a pity given that it is a step in the right direction.

Furthermore, the UK has always tried to do apprenticeships on the cheap – the influence of the Treasury may be important here. The successful countries all spend (proportionately) much more on apprenticeships than does the UK. Australia is an obvious apprenticeship success story, yet it is revealing that in 2008–9 the public purse contributed the equivalent of GBP 18,500 for an average 4-year apprenticeship.

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This is several multiples larger than the equivalent public subsidy in the UK.

It is also essential, in an economy subject to continual change, that workers, and not least mid-career and older workers, are equipped with the requisite skills and competences they need to remain in work, often in new activities. The UK faces a major challenge in this respect. It does not have a good track record, and there is a strong case for developing more effective incentives for both employers and workers to invest in upskilling. This could include individual training accounts for workers, which would be portable between employers: several OECD countries have innovated with some success in this area. There is a particular problem with ensuring greater access to upskilling opportunities for low-educated/low-skilled workers.

This point was emphasised in the recent report by the LSE Growth Commission (2017). The Nordics certainly do much better than the UK on this front. But once again, these countries spend much more, and have a strong social commitment to lifelong learning via their collective bargaining systems.

Policy proposals

- *Move progressively to the OECD average on ALMPs, especially for 16–24-year olds and low-educated/low-skilled job seekers.*
- *Remedy the weaknesses with the apprenticeship levy.*
- *Invest more in lifelong learning initiatives, with a special focus on upskilling needs for low-skilled workers.*

Another area where the UK could do better is in regard to general labour mobility. There is a high implicit tax rate for second earners returning to work, and child-care costs are also elevated. Labour mobility is, of course, further constrained by the high cost of housing, which has been exacerbated by a lack of social housing supply, and overbearing planning and construction regulations, in particular around Green Belts. This matter is taken up in the chapter on housing.

Policy proposal

- *Improve general mobility – especially housing.*

A related question is whether minimum wage legislation, and collective bargaining should be strengthened in an effort to address income inequality. The government reviews the National Minimum Wage annually, and retains plans for further increases. It currently stands at £8.21 an hour, and is due to rise to £8.60 an hour or 60 per cent of median income in 2020. The government has also commissioned a study to be conducted by US academic Arin Dube to look into whether yet further increases should be employed as a means 'to end low pay' and in-work poverty. One proposal under discussion is to push it up to 66 per cent of median earnings, which would mean as many as a quarter of the workforce would have their wages dictated by the minimum wage. The Labour Party has announced similar plans.

So far, increases in the minimum wage have been popular, attracting both cross-party support and the backing of both employer and worker representatives. Contrary to the fears of many, and notwithstanding increasing employers' wage bills, it has had surprisingly little impact on employment growth, as firms have responded by reducing profits, increasing prices, cuts to non-wage costs, the restructuring of workforces and pay structures, and increased output through productivity increases. However, the Office for Budget Responsibility has warned that setting the minimum wage at 66 per cent of median income could cost 140,000 jobs.

It remains to be seen whether the overwhelmingly positive judgement on the minimum wage will endure through further increases and the next downturn but, assuming that it does, it should in our judgement remain, as representing a good balance between labour market and redistributive policy. That said, while the minimum wage is an effective instrument to tackle earnings inequality and in-work poverty, it is much less effective as an instrument in cutting overall poverty rates since many minimum-wage earners live in multiple-earner households. To tackle poverty effectively it is necessary to consider the minimum wage strategy together with the entire redistributive impact of the tax-transfer system – see the paper on *Inequalities*.

Turning to collective bargaining, less than a third of all employees in the UK are today covered by collective bargaining. In the private sector, coverage is lower at around one-sixth and the key bargaining level is the company or the workplace. In the public sector, where almost two-thirds of employees are covered, industry level bargaining is more important.

In its latest Jobs Strategy, published at the end of 2018, the OECD concluded that: collective bargaining could be an effective means to reduce inequality,

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raise productivity, manage industrial change, and raise employment, and generally improve labour market resilience.

In this context, it could be argued that some rebalancing of the worker-employer relationship in the UK would be appropriate, and in particular that a broadening of the coverage of collective bargaining should be encouraged.

That said, Britain does not want to return to excessive, and destructive, trade union power of the 1960s and 70s, which was characterised by the 'closed shop', an absence of pre-strike ballots, unofficial and secondary industrial action, mass picketing, immunity from actions in tort, and politically-motivated strikes.

Policy proposal

- *Maintain something like the present policy settings as a good and workable balance between labour market and redistributive policy.*

Product market and competition policies

These are judged by the OECD to be the most important element of structural policy after those relating to the labour market. Competition raises product awareness, keeps prices down, raises real incomes, encourages differentiation, encourages the more efficient use of resources, and increases consumer satisfaction. There is also for the most part a strong positive correlation between competition and productivity, and especially for firms either far from, or close to, the technological frontier.

The UK is one of the most lightly regulated economies in the world, scoring well below average in almost all of the analytical categories established by the OECD. This applies in the energy, transport, and e-communications sectors, and in retail and especially professional services. Public ownership is strictly limited, there are generally few distortions to the private sector induced by state involvement, and barriers to domestic and foreign entry into UK industry and entrepreneurship are low.

The only areas where the UK scores below the OECD average are: the complexity of some regulatory procedures (although this has declined significantly over the past decade); and the governance of the residual state-owned enterprises. Even then, the UK performs significantly better than those at the bottom end of the OECD scale.

Of course, low regulation does not necessarily mean good regulation, but it is noteworthy that, notwithstanding its poor recent productivity performance, the OECD's structural policy recommendations for the UK are confined to areas other than the product markets.

Meanwhile, however, there is mounting evidence across the globe of growing industrial concentration, not least as a result of the activities of the so-called FANGS, which are cash-rich, avoid taxation, and whose business strategy is to buy up serious competitors. The fear is that this could lead to oligopoly, or even monopoly, which over time would slow investment spending, and productivity. Hence, the UK badly needs to sustain a serious, toothsome, competition policy. But if it acts alone too aggressively, it risks the distributive consequences of untrammelled market forces.

This is a rapidly changing area, and it is important to follow and be aligned with best practice. Hence the UK should in general act in concert, in international fora (principally the OECD) with other countries. The implication is that the UK policymakers should: prioritise the preservation of its existing regulatory advantages; and resist infractions to the existing structure, unless there is a strong national security, or distributional rationale for doing so.

This may be easier said than done, however. The disruptive implications of Brexit, climate change and technological progress, together with the threats posed by protectionism and bilateralism, suggest that there will be strong pressures for greater levels of intervention.

Policy proposal

- *Align with the policies of the EU, except where the UK wishes for a (generally stronger) alternative.*

The political-economy challenge of policy reform

There should be no illusion about how hard it is to effect structural change.

Nor is change easy to effect. Experience of policy reform (de Serres *et al.*, 2011) in advanced countries offers a number of pointers that, properly taken into account, can contribute importantly to the success of such reform efforts.

Evidence based. Policymaking needs wherever possible to be evidence-based. Starting with a blank sheet of paper can be dangerous – it is almost impossible to foresee all the likely consequences. Often it is appropriate to learn from best practice in other countries.

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A number of lessons can be drawn from experience in OECD economies:

- *Good policy or good economics involving reform is not necessarily bad politics*. While there have been important exceptions, many governments that successfully adopted and implemented reforms for which they had prior electoral mandates subsequently went on to win re-election.[4]

- *More haste can lead to less speed*. While governments need to be prepared to exploit political windows of opportunity for reform, those that are embarked on hastily can prove difficult to sustain. Making use of political diversions to mask or hide controversial reform is also less effective for a long-term gradualist reform. Successful reforms often have relatively long gestation periods, involving considerable study and consultation.

- *Positive momentum needs to be sustained*. In today's circumstances, a gradual approach is unlikely to succeed. While there can often in theory be an optimal sequence for a range of reforms, in the real world this is often impractical.[5] The sense of national crisis over Brexit needs to be turned to good account.

- *Creating 'early winners' can help to change expectations* and build interest in pressing for completion, thereby generating momentum for reform. That said, 'low-hanging-fruit' strategies can also pose problems of their own. Actions that start with certain sectors, and are seen as a harbinger of deeper reforms, may lead opponents to adopt an intransigent position to stall the process, even over relatively minor measures.

- *Policy needs the broad support of the people*. While policy has to have at least tacit acceptance by a majority of the people, in some cases it needs to be driven by the public will. The classic historical example is the development of the UK welfare state during and after the Second World War. At that time, popular support for a concerted effort to slay the 'five giants' of squalor, ignorance, want, idleness, and disease was sufficient to overcome government misgivings about cost and broader feasibility.

- *There has to be a broad political constituency for reform*: in addition to popular support, political support has to be broad-based (preferably cross-party) and from the top of government down. Disunity can lead to incoherence of the measures proposed: compromises adopted to appease various stakeholders complicate reform.

- *Social media can complicate the process of garnering public support*. It is noteworthy how in France the '*gilets jaunes*' used social media to whip up opposition to government reforms. That said, President Macron, in response, launched a national dialogue on the reform process, and participated actively in debates at the local level. He listened and this process helped to buy off much of the *gilet jaunes* movement. This provides an interesting example of how a political leader can lead the process of reform.

- *Strong institutions are needed to support reform*: the ability, credibility, cohesion, and firmness of purpose of the political structure has to be emulated throughout the country's institutions (legislative, operational, and informational). Political systems and institutions that allow the fostering of opposing powers to go unchallenged, and that cannot effect change quickly enough, often damage reform processes.

- *Strong leadership*: policy has to be led by a well-trained, respected, committed, and cohesive team which includes technocrats and 'technopols'.[6]

- *Agents of change at all levels*: it helps considerably if there are agents of change –'points of light' – throughout society, ranging from business people to journalists to NGOs. These people provide vocal, local, and credible support, which aids the communications process.

- *Policies have to be both concrete and feasible*. The agenda has to be easily understandable to the general public. While institutions can be changed, when designing policy due account has to be taken of a country's history: the issue of 'how to get from here to there' is real.

- *Ability to assess and credibly demonstrate progress* – both quantitatively and qualitatively. Maintaining policy momentum is aided considerably if the public can see progress being made. Making this visible, credibly, may require institutional change – including perhaps creation of independent bodies with power of oversight.

- *Policies inter-relate:* hence it is often counterproductive to consider them individually, in isolation from one another. Generally, all major areas of policy have to be considered together.

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NOTES

1 Defined as the proportion of expected earnings after tax which is replaced by benefit payments.
2 Defined as the ratio of the amount of tax paid by an individual worker, and the total labour cost to the employer of that worker.
3 Part of the role of ALMPs is to serve as a 'threat effect' to maintain work incentives among the unemployed. This occurs as continued receipt of unemployment benefits is conditional on participation in an ALMP if a slot is offered.
4 See for example de Serres *et al.* (2011), *op. cit.* and the references contained therein.
5 OECD and IMF econometric evidence supports the view that the most promising time for reform is immediately after a recession or election. In reality, however, there is rarely a good time to implement reform, and economies often have to live with the consequences that emerge from sub-optimal policy sequencing.
6 See for example de Serres *et al.* (2011), *op. cit.* and the references contained therein.

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