JOBS & GROWTH

INSURANCE OFFICE
WHITE STAR LINE
Cruises

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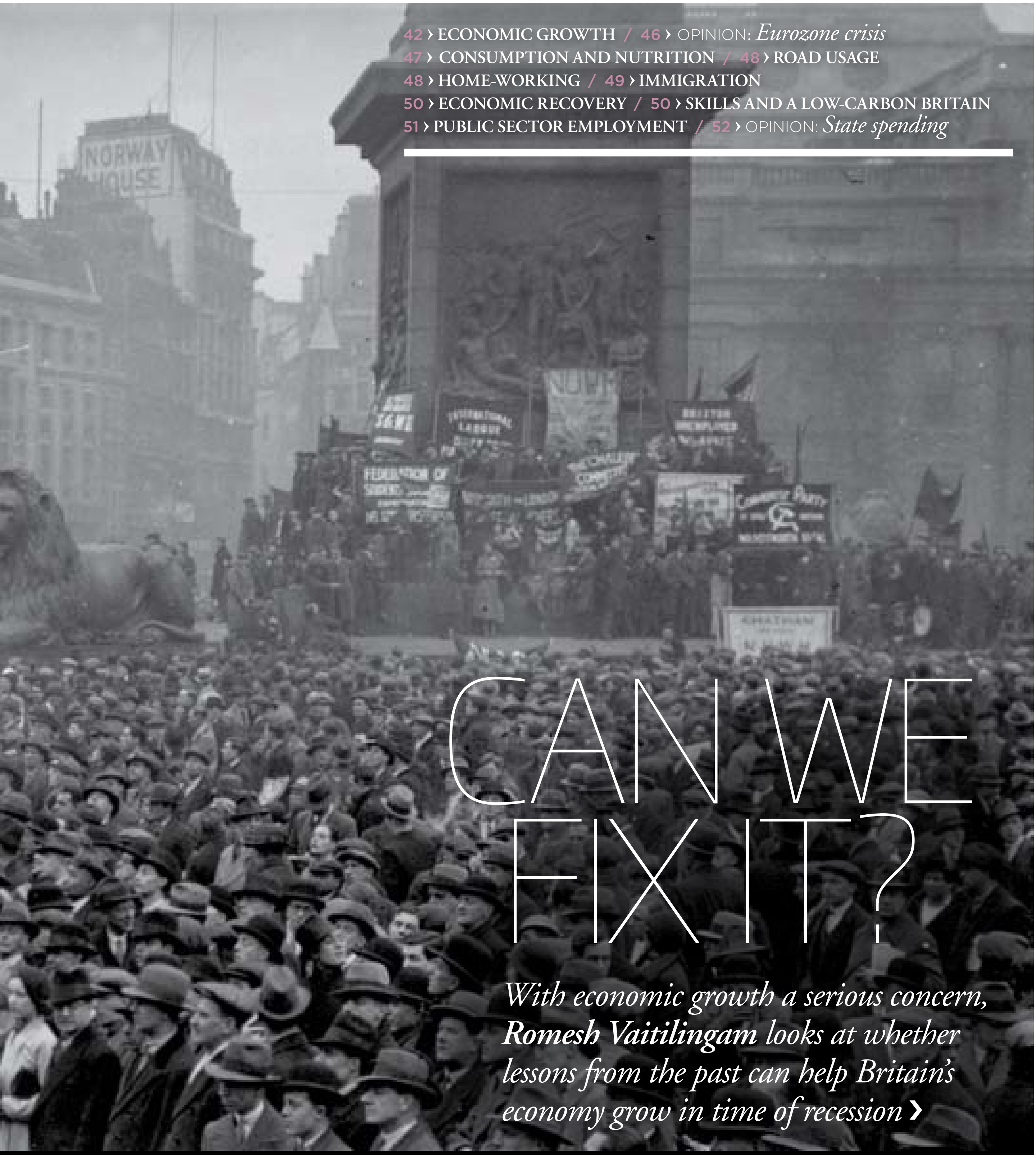

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CAN WE FIX IT?

*With economic growth a serious concern, **Romesh Vaitilingam** looks at whether lessons from the past can help Britain's economy grow in time of recession* ›

With the British economy struggling to escape from 'double-dip' recession, where next for the country's elusive quest for growth? Professor John Van Reenen, director of the ESRC-funded Centre for Economic Performance (CEP), has been prominent in debates about the government's austerity plan of tax hikes and public spending cuts, arguing that fiscal consolidation is being implemented too deeply and too rapidly – and is needlessly slowing growth. He is also co-chair with Professor Tim Besley of the Growth Commission set up by the London School of Economics in conjunction with the Institute of Government and supported by the ESRC. This was launched in January 2012 to inject fresh thinking into Britain's growth debate, in particular by moving beyond the austerity debate.

The commission held a series of public evidence sessions in 2012, drawing on the expertise of leading thinkers in academia, business and policy on skills, infrastructure, macroeconomic stability, science, engineering and innovation, management, trade and the tax and regulatory regime. Its final report will be published early in 2013, articulating a view on how to make a sustainable improvement in longer-term growth.

"STABILITY, TRANSPARENCY AND SIMPLICITY ARE IMPORTANT RATHER THAN OBSESSIVE TINKERING

In preparing to look forward, CEP researchers have looked back at Britain's growth record, focusing on key measures of business performance. Between 1870 and 1979, GDP per capita fell relative to the US, Germany and France. But over the next three decades, this trend was reversed. Since the mid-1990s, Britain's high GDP per capita growth was driven by strong growth in productivity (GDP per hour), which was second only to the US, and good performance in the jobs market (which was better than in the US). But was this growth of productivity all due to 'unsustainable bubbles' in such sectors as finance, property, oil and the public sector? In fact, the evidence shows that the expansion of property and the public sector both held back productivity. And the financial sector contributed only about 0.4 per cent of the 2.8 per cent annual productivity growth of the market economy between 1997 and 2010.

CEP analysis shows that much of the aggregate productivity increases was accounted for by business services and distribution – and they were generated through the increased importance of skills and new technologies. Other indicators of business performance support the view that the gains in productivity were largely real rather than just a statistical artefact. For example, skills, especially those developed through higher education, have grown rapidly, as has investment in information and communications technology. Spending on research and development (R&D) remains low by international standards, but it at least stopped falling in the 2000s after a long decline from the early 1980s. Intangible investments and entrepreneurship seem impressive. And while overall investment is lower than in continental European countries, foreign direct investment remains strong.

POSITIVE INFLUENCES

Professor Van Reenen believes that all this points to a more positive reading of the supply side of the economy than that of the current government. Although Britain still has some longstanding issues in terms of lower investment relative to comparable economies (especially in R&D and vocational skills), things have improved.

Did Labour's policies have any positive influence? Some have argued that Labour simply enjoyed a 'free ride' on the radicalism of Mrs Thatcher. Most analysis suggests that freeing up the labour market through breaking union militancy, removing subsidies for 'lame ducks' and implementing privatisation, lower marginal tax rates and cuts in benefits all boosted performance after 1979.

But the CEP research suggests that it is likely that some policies of the Labour government drove some of the productivity improvement. In particular, the strengthening of competition policy and utility regulation, the support for innovation and the expansion of higher education played a positive role.

PREVIOUS PAGE WITH UNEMPLOYMENT AND DEEP RECESSION IN THE 1930S, HOW CAN WE LEARN FROM PAST MISTAKES TO PROMOTE GROWTH? **BELOW** RBS' FRED GOODWIN WAS ONE OF THE KEY FIGURES AT THE CENTRE OF THE BANKING CRISIS **RIGHT, FROM THE TOP** FOREIGN STUDENTS SHOULD BE PART OF A GLOBAL GROWTH STRATEGY, ALONG WITH INVESTMENT IN COMMUNICATIONS TECHNOLOGY

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The policy area where Labour clearly failed was financial regulation. In addition, and more clearly with hindsight, public debt was allowed to rise higher than it should have done. Although these factors did not drive the boom and did not cause the global recession by themselves, the British economy was more vulnerable to the recession than it should have been.

So has the financial crisis and the recession permanently reduced the rate and level of productivity growth? There is an extreme 'supply-side pessimism' argument that because the recession was caused by a banking crisis, the fall in potential output has been so severe that the output gap – the difference between actual and potential GDP – is now close to zero and productivity growth will be permanently lower. Pessimists point to the fact that GDP is still around four per cent lower than it was when the economy first went into recession. It is likely that the recession has caused some permanent fall in output, but there is huge uncertainty over the size of the output gap. An alternative explanation to a supply shock that has permanently reduced the level and growth rate of potential output is simply that global demand is muted.

Several elements point in a more optimistic direction. First, the pre-2008 productivity growth rate suggests that the supply side made real improvements before the crisis. Second, the fall in productivity between 2008 and 2011 is broad based and not all due to specific sectors such as finance and oil. Third, none of the evidence put forward by the pessimists on inflation, jobs, capacity utilisation and trade makes a compelling case that the output gap is small.

Professor Van Reenen worries that policies based on an excessively pessimistic view of potential output can lead to needlessly slow economic growth. Indeed, pessimism over the state of the supply side can become self-fulfilling as ever-larger austerity programmes cause excess scrapping of human and physical capital.

GLOBAL GROWTH

The structural improvement in Britain's relative performance since 1979 contains several lessons. The most important is to try and get the policy environment right in terms of the physical and human capital infrastructure, including the 'e-infrastructure' of telecoms and the internet. Strong product market competition, openness to foreign investment, flexible labour markets, an effective welfare-to-work system and smart regulation (especially of finance) are all major factors in promoting growth.

Government has a role in all of this, but stability, transparency and simplicity are important, rather than obsessive tinkering. This will ensure that when opportunities do arrive, the private sector is in good shape to take advantage of these new (and often unforeseen) chances. Beyond this, Professor Van Reenen argues, there is a case for a more pro-active growth strategy. The starting point of this is to examine areas where global growth is likely to come from and where Britain has some comparative advantage.

A specific example is higher education, where foreign students are an export industry of global growth and where Britain has very successful elite science. Restricting immigration is hugely damaging to this sector. The same immigration policy also hampers business services, which have been an engine of productivity growth since the mid-1990s.

A second example would be software, where planning restrictions are holding back the development of high-tech clusters. And a third would be biomedical research where regulation is accelerating the loss of clinical trials in Britain's leading high-tech manufacturing sector. Such a modern 'industrial policy' is not about picking winners, but rather a way of thinking about growth that is much better than the current confusion. ■

cep.lse.ac.uk/LSEGrowthCommission
cep.lse.ac.uk/pubs/download/special/cepsp24.pdf

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"The phone that has changed phones forever."
Time Magazine, 2

GETTY; ALAMY

PROFESSOR
KAREL WILLIAMS
Director of the ESRC Centre for Research on Socio-cultural Change (CRESC) and co-author of *Deep Stall? The Eurozone Crisis, Banking Reform and Politics*, CRESC Working Paper No. 110

OPINION: EUROZONE CRISIS

DEEP STALL

Professor Karel Williams uses an alarming aircraft analogy for the eurozone crisis that offers no comfort but some hope for understanding

Media coverage of the eurozone crisis has become rather like a long-running TV soap opera, with dramatic cliffhanger developments sustaining an endless series of episodes without any final resolution. As long as the drama in mainland Europe carries on in this way, most of us in Britain will tend to stifle a yawn.

We have been living with the global financial crisis since 2008 and living with Europe's part of it since 2010. This makes it difficult for ordinary people to see how it all really matters. Most of us will only pay attention and start taking the problem seriously if Europe's troubles have domestic implications – or when they end badly in some kind of crash. So it is important to understand how and why the crisis threatens us all. The German government and allied northern European creditor countries tend to represent the eurozone crisis as a southern European sovereign debt problem. On the other side, commentators such as Martin Wolf of the *Financial Times* argue that it is a problem of north-south trade imbalances. Neither account engages with the way in which this crisis is also – perhaps even primarily – a banking crisis, one that is rooted in the design characteristics of the European financial system.

It is also very difficult to explain all this to non-specialists, most of whom have never heard of such arcane terms as 'rehypothecation' and 'balance sheet interconnections'. This is part of a larger problem in mobilising public opinion and engaging people with the political process over hard-to-understand technical issues.

CRASH AND BURN

My colleagues and I have tried to find a new way of making the crisis intelligible and politically actionable. We suggest that the dangers of Europe's financial system are best understood by analogy with the problems that the British aviation industry encountered 50 years ago when it made the transition to jet aircraft.

In October 1963, a BAC 1-11 prototype in routine stall testing for airworthiness certification fell out of the sky and crashed disastrously. The problem was a 'deep stall' that could not be recovered by the pilot using the standard drill of stick forward, elevators down and add thrust. Deep stall was the unintended consequence of a change in the design configuration when jet aircraft with T-tails were introduced. In some stalls, the turbulent air from the stalled wings could spill up and prevent the elevators at the top of the tail from working.

The banking system's equivalents of the T-tail are twofold. First, there is rehypothecation (the serial reuse of collateral in a chain of transactions), which means that the European banking system has huge liquidity requirements as soon as things go wrong. Second, there is the web of interconnections between bank balance sheets caused by cross-border lending, which ties all the northern European countries together in 'mutually assured destruction' in the event of a major insolvency. In eurozone banking, as with the T-tail jet, not every stall ends in disaster. But if an aircraft or banking system with this configuration is close to stalling, there is a danger that it will go into a deep stall. In the event of a chain of southern European defaults, there is no political mandate for the injection of tens of trillions of euros of liquidity into the European financial system. Nor is there any plan for dealing with bank insolvencies arising from cross-border lending, which could induce large-scale bank failure both within and beyond the eurozone.

> “IN EUROZONE BANKING, AS WITH THE T-TAIL JET, NOT EVERY STALL ENDS IN DISASTER

DAMAGE LIMITATION

The analogy we make is not reassuring. If European finance were an aircraft, then fear of flying would be entirely reasonable and few of us would consent to fly as passengers. But there is one massive difference between T-tail jets in the 1960s and European finance today that makes things even more alarming.

Aircraft that fall out of the sky can be re-engineered as the BAC 1-11 was. The problems with T-tails could be fixed because we had the relevant engineering knowledge. What's more, the private interests of aircraft makers and airline operators coincided with the social interests of regulators and the flying public. But European banking is not fixable – first, because our technical knowledge is rudimentary; and second, because the basic political condition that private and social interests must coincide is not satisfied. The problem is that the private interests of bankers in the profitability of the financial system will obstruct the necessary reforms.

If the eurozone is to be maintained in anything like its present form, we can envisage a list of reforms to reduce cross-border lending or make it less dangerous – for example, by promoting cross-border bank mergers of low-profit utility banking. But none of these fixes are at present within the realm of the politically possible. Maybe the crash has to happen before we can mobilise the political will to restrain finance. ■

www.cresc.ac.uk/publications

ALAMY

Food shopping changes in a recession but is it for the better?

CONSUMPTION AND NUTRITION

Recession and diet

Household consumption has changed in the recession with people eating fewer and 'cheaper' calories

SINCE THE BRITISH ECONOMY first went into recession in 2008, the fall in household spending has been deeper and lasted longer than in either of the previous two recessions – in the early 1980s and early 1990s. Cormac O'Dea and Kate Smith of the Institute for Fiscal Studies (IFS) have compared the changes in consumers' purchasing behaviour in the three recessions. They find that in each, there were large falls in the average purchases of luxury items (such as alcohol and eating out) and household durables (such as kitchen appliances). There are good reasons why such items bear the brunt of consumer cutbacks: by definition, people can do without luxuries more easily than necessities; and they can often delay buying durables.

But in the latest recession, food purchases have also fallen dramatically, something not seen in the previous recessions. Food can be thought of as the most necessary of necessities and the most non-durable of non-durables. So the fact that purchases fell illustrates the stress on household budgets. Part of the explanation lies in the large rises in food prices that accompanied the recession. But how exactly did households manage to reduce food purchases? Did they end up consuming fewer calories or cheaper calories? And did it lead to increased consumption of less healthy food?

Part of the decline in food spending came from people consuming fewer calories. Between 2006 and 2009, there was a decline in average calories consumed (per person per day) of four per cent, continuing a long-running trend of falling calorie consumption. But people also switched to cheaper calories (eating more grains and vegetables and less meat) as well as buying cheaper food products within each food group – so cheaper grains and cheaper vegetables. The result was a fall in the real price per calorie consumed of seven per cent at a time when real food prices increased by eight per cent. This bucked a long-term trend: the real price per calorie consumed had increased significantly from the mid-1970s up until the recession.

KEY FACT

BETWEEN 2006 AND 2009, THERE WAS A DECLINE IN AVERAGE CALORIES CONSUMED (PER PERSON PER DAY) OF 4%

DIET VARIATION

Simultaneous price rises and income falls led to changes in the composition of household diets. People reduced the quantity they bought of every type of food. But the average share of the total from grains, cheese and prepared food increased, while the share of calories from fruit, meat and fish fell. The complicated nature of diet means that it is hard to quantify the overall effect on nutrition. The bad news is that calories from fruit and vegetables fell. The good news is that calories from cakes and fizzy drinks also fell and, on average, people cut back on salt and saturated fat.

An important question is whether these trends will reverse once the economy returns to growth. The IFS researchers will be tracking whether the popularity of cheaper calories continues or households return to their pre-recessionary trend of buying ever more expensive calories. ■

www.ifs.org.uk

This research was funded by the *ESRC*, the *European Research Council* and the *IFS Retirement Savings Consortium*

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ROAD USAGE

DRIVING TEST

Charges for road use could replace higher taxes on fuel as a more financially effective way to control congestion

More efficient cars, like the Volkswagon XL1, will use less fuel and incur lower rates of vehicle excise, reducing government revenues

BRITAIN'S HIGH TAXES on petrol and diesel are not economically efficient and may not be fiscally sustainable, according to research by Paul Johnson, Andrew Leicester and George Stoye at the Institute for Fiscal Studies (IFS). In a report supported by the RAC Foundation, they recommend moving towards taxing road use directly.

Driving has several costs for the car owner, including fuel, vehicle excise duty and the time spent travelling. But other costs of driving are borne by society as a whole rather than the motorist. If these 'externalities' are not factored into motorists' decisions about how much to drive, the true cost of driving is underestimated. Taxes on motoring are one way to correct this problem.

Motoring produces a variety of externalities. Some, such as carbon emissions, depend on the amount of fuel used and so can be well targeted by a tax on fuel. Others, notably congestion, vary enormously depending on where and when someone drives: driving in central London at peak times imposes a much larger cost on others than driving in rural areas at night. As fuel taxes are constant, they cannot capture this variation in congestion costs. Road pricing – with per mile charges depending on time and location – would better target the externalities. And since congestion is by far the largest external cost of motoring on average, this could lead to substantial gains in economic efficiency.

> ROAD PRICING COULD WELL PROVIDE A MORE SUSTAINABLE REVENUE BASE FOR THE FUTURE

The IFS study shows that taxes on fuel amount to just under six pence per kilometre for a car of average efficiency. But the costs of externalities vary considerably: from less than a penny to almost £2.50 per kilometre. So around half of kilometres driven are taxed too heavily, a quarter at roughly the right level and a quarter too little, often drastically so. By providing the right price incentives for motorists and helping to reduce congestion levels, road pricing could generate substantial economic benefits. To compensate, taxes on fuel should be reduced. Many motorists, particularly in rural areas, would be better off.

The case for road pricing is strengthened by a second argument. Taxes on fuel and car ownership together raise around £33 billion annually. But rapid improvements in the efficiency of cars mean that drivers need to buy less fuel and pay lower rates of vehicle excise duty. This could reduce government revenues in the future: the Office for Budget Responsibility forecasts that receipts from these taxes will fall by 0.9 per cent of GDP by 2029/30, equivalent to more than £13 billion in today's terms.

PAVING THE WAY FOR SUPPORT

Options such as higher income taxes, VAT or fuel taxes to plug this gap would not be very palatable. Road pricing (with offsetting reductions in fuel taxes) could well provide a more sustainable revenue base for the future: the Committee on Climate Change projects that the total distance driven will increase by 23 per cent between now and 2030.

The economic case for road pricing is clear, the IFS researchers conclude. Substantial gains could be realised through reduced congestion and the increased sustainability of revenues, without increasing the amount of motoring tax paid on average. Of course, the political case is more difficult, but policymakers should start taking action now to pave the way for reform by winning public support. ■

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Toll booths could become more common on British roads in the future

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HOME-WORKING

WORKING OR SHIRKING?

The effects of home-working on staff performance

FIRMS AROUND THE world have been slow to encourage home-working. Until now, there has been little evidence of a positive impact on productivity and employee satisfaction – or of whether fears are justified that rather than 'working from home', staff might be 'shirking'.

So when CTrip – China's largest travel agent – decided to experiment with the practice, its chairman invited economists to join in a detailed evaluation of outcomes. The team included Professor Nicholas Bloom of Stanford University, who has long worked on management practices with the ESRC's Centre for Economic

IMMIGRATION

NEW ARRIVALS

How do migrant workers support the economy?

Chinese immigrants make up a big proportion of recent arrivals

THERE IS LITTLE DOUBT that the share of immigrants in Britain's working age population is now considerably higher than in the past. By early 2012, 14.5 per cent or 5.9 million adults had been born abroad, up from around eight per cent in 1995.

Professor Jonathan Wadsworth, senior research fellow at the ESRC's Centre for Economic Performance, has sifted the evidence on the characteristics of immigrants, the drivers of immigration and the impact on Britain's labour market. He finds that immigrants are, on average, younger and better educated than their counterparts born in Britain. The most recent immigrants are better educated still. Around ten per cent of all migrants are in full-time education. Immigrants are over-represented in the very high-skilled and very low-skilled occupations.

WHO IS COMING FROM WHERE?

Immigrants are arriving from many more countries than in the past. Poland, India and China are currently the countries that contribute the biggest proportion of new arrivals. Immigrants are, on average, less likely to be in social housing than people born in Britain, even when the immigrant is from a developing country. The stock of immigrants is influenced both by Britain's economic performance relative to other countries and by immigration policy. The country now has a points-based immigration system, which seeks to restrict immigration from outside the European Union (EU) to skilled individuals.

In practice, the number of arrivals from outside the EU to study or for family reunion still exceeds the arrivals for work-related reasons.

> “THERE IS LITTLE EVIDENCE OF AN OVERALL NEGATIVE IMPACT ON JOBS OR WAGES

Wadsworth notes that there are several potential economic benefits associated with migration, especially to fill gaps in the labour market – where there are shortages of workers, whether high- or low-skilled. While there may be costs to particular groups, there is little evidence of an overall negative impact on jobs or wages.

But there have been some effects. The less skilled may have experienced greater downward pressure on wages and greater competition for jobs than others. But these effects still appear to have been modest. At present, not much is known about whether the effects of immigration are different in downturns. And more needs to be understood about how capital and sectoral shifts in demand respond to immigration over the longer run.

Future migration trends will, as ever, depend on relative economic performance and opportunity. But more evidence is needed on the effects of rising immigration beyond the labour market in such areas as prices, housing, health, crime and welfare. ■

cep.lse.ac.uk/pubs/download/pa014.pdf

Performance. CTrip ran a nine-month experiment with two divisions in its Shanghai HQ. Employees with their own room at home were offered the option to work there for four days a week. Of 508 eligible staff, 255 asked to work from home and after a draw, those with even-numbered birthdays were selected for home-working. Those with odd-numbered birthdays stayed in the office as a 'control group'.

DRAMATIC IMPROVEMENTS

Both sets of employees worked the same shifts under the same manager as before, and logged on to the same computer system with the same equipment and the same work order flow. The only difference was where they worked.

What were the results? First, employee performance went up dramatically, increasing by 13 per cent over nine months. This improvement came mainly from a reduction in the number of breaks and sick days taken. The home-workers were also more productive per minute worked, presumably because of quieter working conditions. Second, there were no negative effects on the employees left in the office: their performance was unchanged. Third, staff turnover fell sharply for the home-workers – and they reported substantially higher work satisfaction and less 'work exhaustion'.

CTrip's management team were so impressed by the success of home-working that they decided to roll it out to the entire firm. They also offered both the original home-workers and the control group a fresh choice of working arrangements. To their surprise, half of the home-workers changed their minds and returned to the office. At the same time, three-quarters of the control group – who had initially all requested to work from home – decided to stay in the office.

This highlights the fact that before the implementation of new management practices, their likely effects are as unclear to employees as they are to managers. It also helps to explain the typically slow adoption of such practices. ■

www.stanford.edu/~nbloom/WFH.pdf

Home-working is efficient, but do all employees want to do it?

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ECONOMIC RECOVERY

BACK TO THE FUTURE

Delivering growth while reducing deficits in 1930s Britain

ABOUT 80 YEARS AGO, in mid-1932, the outlook for the British economy seemed bleak. After a brief recovery from a severe recession in which real GDP fell by seven per cent, the economy had lapsed into a 'double dip'. The world economy was in turmoil. Britain's public finances were in a parlous state and fiscal retrenchment was the order of the day, while interest rates were close to zero and could not be cut to deliver monetary stimulus. Yet between 1933 and 1937, the economy enjoyed a strong recovery. In a report commissioned by the thinktank CentreForum, Professor Nicholas Crafts notes that over those years, annual growth averaged nearly four per cent, the budget was balanced in 1933 and the ratio of public debt to GDP fell subsequently. There was no resort to a 'plan B' and stimulus from rearmament came only at the end of the period.

PARALLEL UNIVERSE

The parallels with today are clear. So Professor Crafts, director of the ESRC Centre for Competitive Advantage in the Global Economy (CAGE) at the University of Warwick, asks the obvious next questions: How did the policymakers of the 1930s deliver this outcome? And if they could do it, why can't we do something similar? Economic historians describe the successful policy as one of 'cheap money'. A target of raising the price level was adopted. This was underpinned by Treasury bill rates at 0.6 per cent and an exchange rate target that locked in a 25 per cent devaluation compared with the gold standard parity that Britain had been forced to abandon in 1931.

The implication was that people expected prices to rise and by cutting the cost of borrowing in real terms, monetary policy was able to offset the deflationary impact of fiscal consolidation. The policy was credible because it was clearly in the Treasury's interests, delivering stimulus while reducing the debt-to-GDP ratio. What's more, the Treasury rather than the Bank of England was in charge.

The monetary stimulus had strong effects through its impact on private housebuilding. Around one million houses were built in the first four years of the cheap money policy. In the early stages of the recovery, housebuilding made up a quarter of the rise in GDP. A side effect of the cheap money policy was the ready availability of mortgage finance as building societies increased their advances by 50 per cent between 1932 and 1935. Together with smaller deposits and extended repayment

Why was recovery from recession in the 1930s much quicker than today?

Large-scale development of wind farms can lead to local skills shortages

TRAINING

A greener vision

Skills shortages and a lack of commitment to training could hold back the transition to a greener, low-carbon Britain

THERE IS A DANGER that skills shortages will make it difficult to achieve a rapid transition to a low-carbon economy, one that creates jobs and keeps costs under control. Research by Nick Jagger, Tim Foxon and Andy Gouldson of the ESRC Centre for Climate Change Economics and Policy has examined how the problem might be addressed.

The study identifies four reasons why the provision of skills may be too low for the implementation of any new technology, green or otherwise. First, short-term attitudes and an absence of long-term vision mean that employers are unlikely to invest in the necessary recruitment and training.

Second, a lack of labour market flexibility could be significant – for example, in the construction sector, where the presence of many small operators employed through subcontracts leads to lower levels of training. Third, since skilled employees can leave to work elsewhere, firms are often reluctant to invest in training them. Finally, competing technologies, sectors or countries might require the same skills at the same time.

OVERCOMING CONSTRAINTS

The researchers identify four further constraints specific to low-carbon technologies. First, the uncertainty surrounding a low-carbon transition creates risk for green investments, which reduces firms' incentives to invest, including in skills. Second, the novelty of the technologies and of the associated combinations of skills required means that on-the-job training strategies can be limited.

ALAMY; GETTY

periods, this attracted many first-time buyers. Planning controls were virtually non-existent.

Replicating the recovery of the 1930s is not possible today – and not only because of the obstacles to housebuilding. Households then had far less debt and were more inclined to spend as confidence returned and falling food prices boosted disposable incomes. The eurozone may well deliver a bigger adverse shock than anything Britain faced after 1932.

> REPLICATING THE RECOVERY OF THE 1930S IS NOT POSSIBLE TODAY

But according to Professor Crafts, it may yet be possible to follow the logic of the 1930s recipe. More emphasis should be placed on reducing real borrowing costs for the private sector. This could entail instructing the Bank of England to introduce a higher target rate of inflation, the modern equivalent of the 1930s price-level target.

It is also vital to take measures that improve the responsiveness of private investment to monetary stimulus. In this context, given that Britain has not been building nearly enough houses to match the rising number of households, housebuilding could once again play a very important role. That requires action to increase the supply of mortgages and reform the planning system. ■

www2.warwick.ac.uk

Third, issues associated with the scale of the transition – for example, the construction of several offshore wind farms or nuclear power stations in a short period – can cause localised skill shortages and a greater requirement for labour mobility. Finally, inertia seems likely to be a significant factor as training provision and the associated institutions are often oriented towards known technologies, leading to shortages for innovative low-carbon technologies.

The research identifies several potential policy responses. These include the standardisation of funding for training; formalisation of transferable qualifications; the adoption of framework agreements between actors in key sectors; and the promotion of licensing and accreditation schemes for key technology sectors.

The study also highlights the potential for the provision of government support for low-carbon skills academies and training centres, as well as for first movers in specific niches. With some or all of these policies in place, Britain could hope for a faster and cheaper transition to a low-carbon economy that creates more jobs. ■

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PUBLIC SECTOR EMPLOYMENT

After effects

How does the job market affect local services and manufacturing?

THE GOVERNMENT WORRIES that public sector jobs 'crowd out' private sector jobs, while the opposition thinks it should boost local economies through public investment. Research by Dr Giulia Faggio and Professor Henry Overman of the ESRC's Spatial Economics Research Centre (SERC) seeks to find out who is right.

Their study finds that growing public sector employment has little overall impact on private sector employment. But it does have some effects: every 100 extra public sector jobs in a local authority 'create' 50 additional jobs in services but 'destroy' 40 jobs in manufacturing. In short, increasing public sector employment is bad for local manufacturing, good for local services. This difference makes sense. Local restaurants and shops benefit from money spent by public sector staff and local cleaning firms benefit from demand from public sector organisations. But public sector employees and organisations do not buy much from local manufacturing firms.

> GROWING PUBLIC SECTOR EMPLOYMENT HAS LITTLE IMPACT ON PRIVATE SECTOR EMPLOYMENT

What explains the negative effect on manufacturing? There are two possible channels. First, increasing local public sector employment pushes up wages and house prices, which is bad news for a local manufacturing firm trying to compete with China. Second, higher public sector pay attracts away good administrators, accountants and entrepreneurs who would otherwise work in the private sector.

BENEFITS FOR ALL

Looking over a longer time period, the SERC researchers find that the negative effects on manufacturing are even stronger: about 80 jobs are lost for every extra 100 public sector staff. Again, this makes sense: the channels through which manufacturing gets hurt take time to work through.

What about local services? Over the longer time period, the loss of local manufacturing employment offsets the increase in public sector employment, so there is no longer a beneficial effect on local services. In short, over longer time periods, public sector employment does crowd out private sector employment.

In terms of politics, there is something in this for everyone. The opposition can point to the short-run effects of public sector job cuts: they will be bad for total employment in affected areas. The government can point to the crowding out of manufacturing and the longer-run crowding out of total private sector employment.

Which of these is more important depends on what policymakers want to achieve. But the SERC results do suggest that for parts of the country currently experiencing large public sector job cuts, things are likely to get worse before they get better. ■

www.spatialeconomics.ac.uk

Private sector businesses like restaurants benefit from public sector workers' buying power

GETTY

PAUL JOHNSON
Director of the Institute for Fiscal Studies. He previously worked in senior posts at the Department for Education and Skills and the Financial Services Authority

OPINION: STATE SPENDING

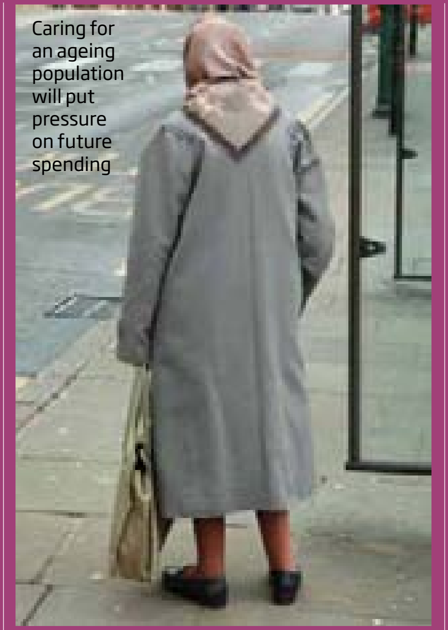
THE MONEY MERRY-GO-ROUND

Paul Johnson looks at the tough choices Britain faces about taxation, pensions and health care, and what fiscal adjustments will be necessary for a secure future for all

Britain's national income took a dramatic plunge in the recession of 2008-09, and it has continued to underperform to expectations. The Office for Budget Responsibility (OBR) expects the economy to be 13 per cent smaller in 2016 than the Treasury forecast in 2008. As a result, even in the face of unprecedentedly tight public spending plans, the fiscal deficit remains very large.

The challenge of fiscal adjustment is huge, but the size and immediacy of the task are in danger of blinding us to two big issues. First, the shape and role of the state is changing over time, much more dramatically than its size. Second, population ageing will ensure that fiscal pressures do not disappear with the current deficit.

The size of the state will not be much different in 2016 to its size in 2000. It has hovered around the same share of the economy for several decades, increasing in recessions – very dramatically recently because the economy shrank so much – and falling back again in recoveries. But its shape is changing and current policies are mostly consistent with those pursued over the past 30 years.



Caring for an ageing population will put pressure on future spending

ALAMY

Although total spending on public services is being cut by more than ten per cent during this Parliament, spending on health is protected. In fact, health spending will grow as a share of the total, just as it has for decades. Spending on health and social care accounts for more than one pound in every five spent by government. This proportion has nearly doubled from one pound in every ten in the late 1970s.

> BY THE MIDDLE OF THE CENTURY, HALF OF EVERYTHING THE STATE SPENDS COULD BE ON HEALTH AND PENSIONS

Health is the second biggest element of spending. The biggest is spending on social security (including pensions), which accounts for about 30 per cent of all spending, up from 23 per cent in the 1970s. Health, social care and social security account for over half of government spending. Add education and the 'core' welfare state accounts for nearly two thirds of state activity, up from a half a generation ago.

WHO TAKES THE STRAIN?

Other spending areas – notably defence, housing, transport and support for industry – have had to take the strain. The biggest losers over this spending review period include local government, housing, transport and law and order. This implies that, consciously or not, we have taken some big decisions about what we think the state should do.

And there lies the genesis of the second issue. An ageing population, resulting in increasing pressure on health and pension spending, means that we have further big choices to make, this time over both the size and the role of the state. We may be right to focus on the immediate and urgent question of how to sort out the current deficit, but we should not forget to plan for the future. In 2011, 17 per cent of the population was aged over 65. That share is expected to reach 26 per cent by 2061. The rate of change for the over 85s is more dramatic: their population share will go from 2.3 per cent to 7.3 per cent over the same period. This has direct consequences for spending on pensions and health.

PROVIDING CORE SERVICES

The OBR predicts that state pension spending will rise from 5.5 to 7.9 per cent of national income between 2015 and 2060 – despite a planned increase in the state pension age to 68. Health spending is less predictable, but demographic change alone is expected to push it from 7.4 per cent to 9.8 per cent by 2060. If, as past experience suggests, health spending (other than that caused by the ageing population) rises by one per cent a year faster than national income, Britain would be spending 15 per cent of national income on health by 2060.

So we will have some choices to make. We could simply increase taxes to pay for these additional costs. That would require, at the very least, an additional five per cent of national income to be raised from taxation. And that at a time when tax revenues from North Sea oil and motor taxation are set to fall substantially.

Alternatively, we could reduce other budgets further to accommodate the cost pressures, which would mean substantial cuts in most other areas. On this scenario, by the middle of the century, half of everything the state spends could be on health and pensions. Going in this direction would require us to redesign how we deliver other core services and to consider the further use of private contributions in such areas as education.

The third option is to reduce spending on health and pensions. There is no comfortable choice, but we will have to choose. And the sooner we know which path we are taking, the sooner we will be able to prepare and the more likely we will cope effectively with the transition. ■

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