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BRITAIN

A lost opportunity

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A golden decade has transformed the economy less than it should have done

"IN 1997 the challenges we faced were essentially British," Tony Blair told the Labour Party conference last September. "Today they are essentially global...The question is not about our competitiveness in the last ten years but in the next ten."

To be fair, Gordon Brown, the chancellor and Mr Blair's likely successor as prime minister, has had his eye on global competitiveness all along, as a heap of initiatives attest. Macroeconomic stability, coupled with microeconomic measures such as tax incentives and a stronger competition regime, was to sort out the familiar British complaints of low productivity, low business investment in research and development (R&D) and fitful innovation. He largely achieved his macroeconomic goals and did well enough with his microeconomic policies, as far as they went.

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Mr Brown was lucky to inherit an economy in which much of the heavy lifting had already been done. The financial markets were flourishing. Margaret Thatcher's union-bashing in the 1980s had resulted in a more flexible labour market. Foreigners had responded to Britain's improved prospects by investing piles of money, which often lifted standards of management and productivity (as Japan's Nissan and Honda did in carmaking). And though the Conservatives failed to avoid two recessions and a humiliating eviction from Europe's exchange-rate mechanism in 1992, they learned from their mistakes. When Labour came to power, it took over a growing economy with a current account that was moving towards balance, a budget heading towards surplus, and a Treasury that had been using an explicit inflation target to steer monetary policy for five years.

Mr Brown built on that success. His boldest move was to give the Bank of England freedom to set interest rates to meet the government's consumer-price inflation target, currently set at 2%. He also managed to keep Britain out of the euro.

Average annual economic growth since 1997, at 2.8%, has been above its post-war trend rate of 2.5%, despite slowdowns in 2002 and 2005. Some 2.5m extra jobs have been created, pushing the proportion of the workforce in employment to its highest level since the 1970s (though the number of jobseekers has also increased with immigration and higher participation among older workers). Under the Bank of England's guidance, price increases were kept close to the Treasury's target, at least until dearer fuel helped to push consumer-price inflation to 3% in December. Confidence that inflation would be contained also muted pay rises. In his pre-budget report in December, Mr Brown forecast that growth in the coming fiscal year would be around 3% and that inflation would move back towards the target.

Temporarily supercharged

But the economy has been helped by three special factors that cannot be expected to continue indefinitely. The first is that the government has been spending well above the rate of economic growth since the end of its first term in office. Spending on education, transport and the National Health Service doubled. At first that did not

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The National Institute of Economic and Social Research published a report on the effects of immigration. See also the Treasury, the Bank of England and the Centre for Economic Performance.

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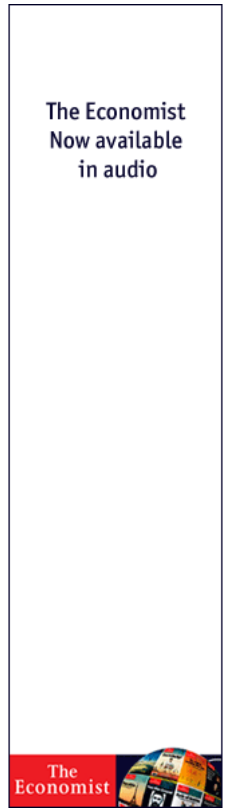


seem unreasonable, because the economy had been weakened by the collapse of the dotcom boom. But revenues repeatedly fell short of forecasts, so the public sector swung into a big deficit in the fiscal year to March 2002 and has stayed there ever since. Moreover, some big liabilities, such as private-finance initiatives to build schools and hospitals and prisons, are not fully reflected in the accounts. The same is true for public-sector pensions.

The second boost to growth has been a debt-propelled consumer boom sustained by house prices that have almost trebled in a decade. Household debt has leapt from around 100% of disposable income in 1997 to 160% in 2006. Interest rates have been raised three times in six months. At some point the consumer is bound to stumble.

The third factor has been an enormous influx of immigrant workers—around 600,000 from new members of the European Union alone since May 2004 (though some will have left again). The National Institute of Economic and Social Research, a think-tank, estimates that new immigrants have boosted output by more than 1% since 2004 (and by over 3% since 1997). But as other EU countries open their labour markets, the flow to Britain may dwindle.

Yet despite more than a decade of unprecedented stable growth, two problems in particular remain unresolved. One is productivity, about which more below. The other is the persistent deficit in the current account of the balance of payments.

Like most advanced economies, Britain has seen its share of world exports decrease as that of industrialising countries with lower costs has risen. It successfully sells high-value-added products such as pharmaceuticals, telecommunications and aerospace engines, but sterling's strength has not helped. The deficit worsened as Britain grew faster than its main trading partners in Europe. Exports began to pick up last year along with growth in Europe, but the deficit in goods topped £82 billion in the year to September 2006.

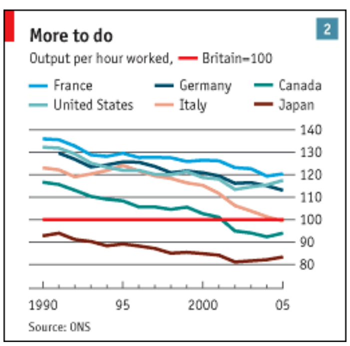
The surplus on services filled more than a third of that hole, and net investment income from abroad about another third. The question is whether this bonanza can continue. Britain's liabilities abroad officially exceed its assets, to the tune of 18% of GDP in the 12 months to September, and the gap was bigger than the year before. Are British investors just better at wringing a return from their money?

Stephen Nickell, until last year one of the economists on the Bank of England's Monetary Policy Committee, puts forward a couple of explanations. One is that the British tend to go for equity-type investment whereas foreigners go for debt. Equity investment is riskier, so returns tend to be higher. Second, much of British investment abroad is direct—ie, buying companies, starting new ones, reinvesting the profits—and that is harder to value than portfolio investment. He thinks that if official figures reflected the market value of direct investments, Britain's assets would be worth a lot more than its liabilities.

Reasons not to be complacent

The dangers are that returns on equity may not always exceed returns on debt as handsomely as they do now; that the continuing appreciation of sterling will diminish the value of British assets abroad and increase that of its liabilities; and that as Britain itself attracts more foreign direct investment, its traditional surplus on that score may be eroded. Foreigners are buying British firms in droves. The cheekiest offer has come from NASDAQ, an electronic exchange in America, for the heart of the City, the London Stock Exchange.

Productivity, the biggest single component of competitiveness, is a second area where progress has been disappointing. Historically labour productivity has been low in Britain: on average, its workers turn out less per hour than their opposite numbers in France, America or Germany (see chart 2). Though the gap has narrowed in recent years, the differences remain large.



Source: ONS

This is puzzling, because Britain's steadily growing economy, stable prices and competitive markets ought to have brought substantial gains in the past decade. The most important reason may be poor skills. Yet it is not the only one: the British workers who make cars at Honda's plant in Swindon are as productive as their opposite numbers in other countries.

Another factor is the increasing weight of the state. The current Labour government has added around 700,000 public-sector jobs to the economy—just over a quarter of all the new jobs created. Productivity in the public sector is hard to measure and often poor.

Fairly full employment may also play a role. If almost everyone is working, less skilled and motivated people also get jobs, reducing overall productivity. That might explain some of the differential with France and Germany but not with America, which also has high employment.

Another explanation is that productivity is usually higher in businesses where employees work with machines or technology. The service sector, which is less capital-intensive, employs a bigger share of the workforce in Britain than it does in Germany, for instance—but again that does not explain the gap with America.

However, two other things might. First, America has made particularly big productivity strides in retailing, where big firms such as Wal-Mart have been able to open sprawling warehouses and superstores around the country. Britain's shopkeepers do not have the luxury of space and looser planning rules to put a handful of workers in charge of acres of goods, so retail productivity gains have been much lower. Second, British companies operate with lower capital stocks than many of their competitors, and their lorries have to drive on heavily congested roads. They often invest respectable sums in computers and information technology but do not seem to reap the same productivity gains from it as many American firms, according to John van Reenen and Nick Bloom of the Centre for Economic Performance at the London School of Economics.

In a study with John Dowdy of McKinsey, a consultancy, Mr van Reenen concluded that British managers are partly at fault. Britain has a lot of family-owned and family-run businesses, more than Germany (where family-owned businesses are usually professionally managed) and many more than America. Britain's multinational companies have good productivity levels, and the best domestic firms are not far off, but smaller ones often struggle.

Perhaps because of blinkered bosses, Britain has a history of underinvestment by both business and government, especially in research and development. Again, that may reflect the sort of businesses that dominate the economy rather than a lack of spending by specific firms (GlaxoSmithKline, for example, is the world's third-biggest pharmaceutical investor in R&D). But it does affect overall productivity.

At the same time heavier taxes and more regulation are beginning to weigh on firms. In the past ten years the tax burden has risen from 34.8% to 37.3% of GDP, higher than in America, Japan or even Germany. And the British Chambers of Commerce estimate the direct cost to businesses of complying with rules brought in since 1998 at more than £50 billion.

Britain is never far from the top in various league tables that measure competitiveness, but it has recently slipped a bit. The World Economic Forum in Switzerland demoted Britain from ninth to tenth last year, citing the burden of government compliance among other weaknesses. Such slight slippage does not constitute a trend. But more red tape and higher taxes, if unchecked, risk clipping the wings of Britain's high-flying firms.

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