Standard Life Aberdeen

UK Budget: SLA's plan for restoring prosperity

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Our Thinking:
Thought Leadership

Our thought leadership papers deliver thought-provoking analysis of key investment themes. Through focused and unique insights into topical issues, we aim to provide investors with a deeper understanding of the challenges and opportunities within global investment markets.

Executive summary

The UK's long-term prosperity is at risk. The country is facing numerous economic challenges many of which are made more difficult by Brexit. Meanwhile, the spread of the coronavirus represents an additional and potentially large economic shock. These issues require urgent and radical policy fixes.

The government's most pressing priority is dealing with the spread of the coronavirus and the associated hit to the economy. Clearly economic policy cannot stop the spread of the virus, but targeted measures can reduce the risk that it becomes an economic crisis. The timing of the budget is fortuitous in that respect, and the UK has a chance to be a global leader in developing appropriate public policy responses.

The response to needs to be three pronged. First, more resources are urgently required for the health service, probably of an order of magnitude larger than the £400 million provided during the last winter flu crisis. This money should be spent on a public health campaign raising awareness of preventative measures along with other crucial medical supplies.

Second, the government must support firms and households facing a shock to their incomes and cash flow. This is crucial to stop a temporary shock doing more lasting damage. The announcement to ease the requirements on statutory sick pay is welcome in this regard but further measures are required to ensure workers not covered by this scheme receive the help they need. Firms with a particularly high incidence of sick workers should also be helped.

Third, the Bank of England should ease monetary policy and provided targeted liquidity measures to businesses struggling to gain access to finance during this period. A short term liquidity problem cannot be allowed to turn into a solvency problem, tipping good firms into bankruptcy. A coordinated monetary and fiscal response will do more to support the economy than either acting alone.

While measures to tackle the spread coronavirus are crucial, the government must not lose sight of the longer term reforms required to ensure the future health of the economy. In the rest of this report we outline which problems are most critical and the policies we think the new Chancellor should announce in his forthcoming budget to tackle them. Our five-point plan would be a crucial first step to restoring prosperity.

The past 13 years have been very challenging for the British economy. In the wake of the financial crisis and the sluggish recovery, labour productivity has flat-lined and real wages have stagnated in the most prolonged bout of weakness since the industrial revolution.

During this time gains in output have been almost completely dependent on gains in population and employment. But with unemployment now very low and participation rates very high, increases in labour utilisation can no longer be relied on to sustain growth.

Indeed, with both potential growth and interest rates having dropped so far, we worry that the current monetary and fiscal policy framework is no longer fit for purpose, leaving the economy highly vulnerable to any new shocks that come along.

The United Kingdom is also beset by wide-ranging inequalities. The disparity between the country's least and most productive regions is high by OECD standards, which both reflects and reinforces large differences in access to services and opportunities.

With income, wealth and social inequalities also too high, the country is not living up to its potential, contributing to the resentment that is driving our increasingly fragmented politics.

Mitigating climate change is becoming more urgent as local and global weather patterns change in increasingly damaging ways.

Meanwhile, the UK's decision to leave the EU is exacerbating these problems.

In difficult times it is easy to retreat into caution and incrementalism. But just as the United Kingdom has been a beacon of radicalism in the past – whether building the post-war welfare state or the Thatcherite reforms of the 1980s – it can be so again.

We think there is an opportunity to restore and then increase the nation's broad-based prosperity if the Chancellor seizes the initiative and pursues a reinvigorated, more socially minded capitalism.

Thanks to weaker growth forecasts and coronavirus impacts, the Chancellor is now indicating that his March budget will be limited in scope, with bigger decisions put off until the autumn. This would be a mistake. With the economy at risk of stagnating and borrowing rates close to zero, now is the perfect time for the government to stimulate and reform the economy in a way that works for everyone.

Our bold reform plan is comprised of five key elements.

1. Re-invigorate the central bank and fiscal playbook to sustain full employment

Monetary and fiscal policy mistakes – including ill-timed fiscal consolidation – contributed to the UK's post-crisis economic woes. To reverse those errors and future-proof policy we propose:

- Lifting government spending by 2 percent points of GDP over the next two years, underpinned by a more generous debt servicing rule;
- Initiating a review of the Bank of England's policy framework to consider radical alternatives – like price level or nominal GDP targeting – to increase policy potency;
- Providing for an automatic trigger to ease fiscal policy when interest rates reach the lower bound, with an independent fiscal committee determining the size of the required fiscal stimulus; and
- Pursuing a high alignment strategy in trade negotiations with the EU to prevent further, unnecessary damage to the economy.

2. Build on HS2 and green the northern infrastructure gap

HS2 was not the nation's most pressing need. But the decision to proceed has now been made. The government must capitalise on that approval by launching an ambitious plan to build a properly connected and sustainable infrastructure network. We therefore propose:

- Strengthening the independence and powers of the National Infrastructure Commission (NIC);
- Widening the criteria used to assess proposals and relocating the NIC out of London; and
- Relaxing artificial constraints on the scale of public investment.

3. Liberate the regions as part of a smarter levelling up strategy

The economy must work for all its regions, with access to quality services and job opportunities no longer a postcode lottery. We recommend:

- Powering up devolution by giving local decision making bodies more power to set taxes including business and stamp duty;
- Reforming planning laws to make it faster and cheaper to construct residential and commercial property; and
- Raising investment in basic science and in cultural Britain, strengthening the country's comparative advantage in research, arts and tourism.

4. Seize the gains from the fourth industrial revolution by skilling the nation for the future

The third, information technology led industrial revolution benefited capital more than labour and high-skill workers over those with lower skills. To ensure that the benefits of the fourth industrial revolution are more widely shared we propose:

- Lifting spending on means-tested tertiary fee and cost of living grants;
- Creating a skills bond and expanding access to income contingent loans to fund greater investment in vocational education;
- Ensuring that the new post-Brexit immigration system is needs-based and addresses a wide variety of skill gaps; and
- Spending more on active labour market programmes to enable displaced workers to more successfully re-enter the workforce.

5. Ensure that no one is left behind by investing more in children

After declining sharply between 1997 and 2005, poverty is rising again. Disturbingly, 70% of children in poverty live in families where at least one parent works. To reverse these trends we propose:

- Lifting spending on primary and secondary education in disadvantaged communities;
- Reversing cuts to welfare and universal credit; and
- Expanding the Sure Start programme and access to affordable nursery and childcare places.

The major economic challenges facing the UK

The past 13 years have been very challenging for the British economy. The economy is around 20% smaller today than it would have been if growth had followed the pre-crisis trend, with the recovery from the crisis uniquely slow relative to history.

Much of this weakness has been due to extremely weak growth in productivity. Since the industrial revolution, productivity growth in the UK has averaged around 2% a year, but since the crisis, it has been barely positive.

The sustained weakness of productivity suggests that something fundamental might have changed about the structure of the UK economy, prompting many forecasters to revise down their estimate of long run potential growth. For example, the Bank of England recently revised its forecast for annual productivity growth down from 1.5% to 1.1% (see Figure 1).

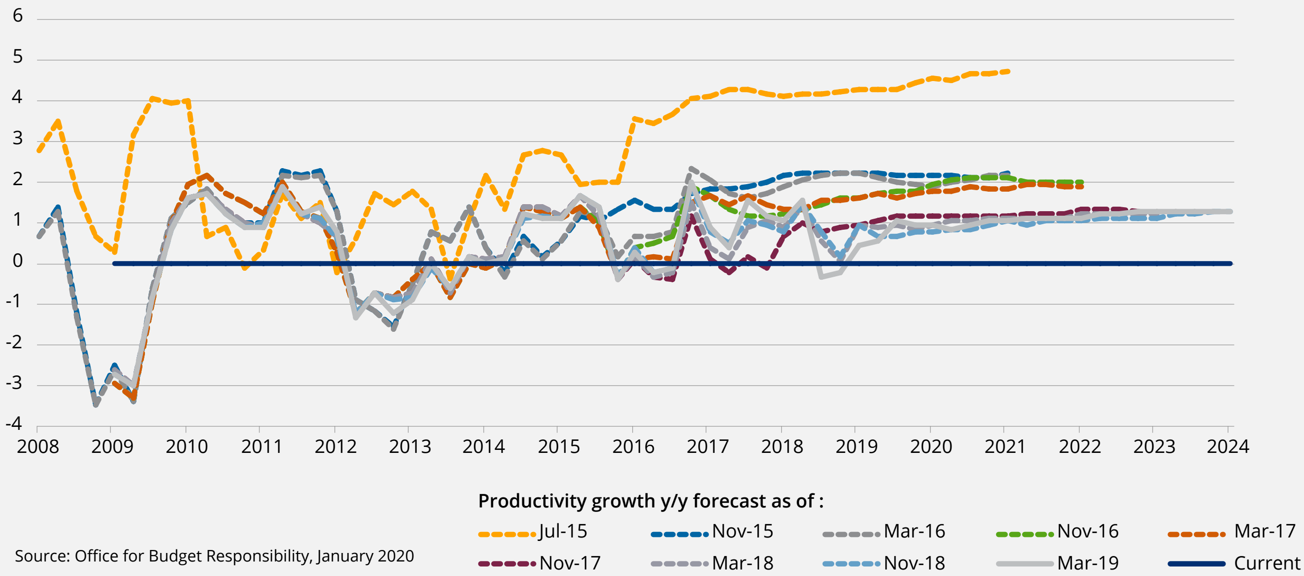
Over the long term, it is productivity growth that underpins increases in a country's standard of living and the real wages of workers. As such it is no surprise that median real wages have essentially gone nowhere over the last 10 years, and are still a little below the post-crisis peak.

Given the weakness of productivity, gains in output and household income have been completely dependent on gains in population and employment. No doubt the performance of the labour market has been impressive in many ways, with the combination of labour market flexibility and weaker earnings helping to boost labour supply. But with unemployment now very low and participation rates very high, increases in labour utilisation can no longer be relied on to sustain growth.

Indeed, with both potential growth and interest rates having dropped so far, we worry that the current monetary and fiscal policy framework is no longer fit for purpose, leaving the economy highly vulnerable to any new shocks that come along. In particular, the decline in equilibrium interest rates across the world means that the Bank of England is unlikely to have much scope to cut interest rates in the face of the next downturn.

Unconventional polices can help in this regard, but monetary policy is unlikely to be able to adequately stabilise demand under the current framework. This is in part because automatic fiscal stabilisers have been blunted over the last 10 years and discretionary fiscal policy cannot be relied on to deliver timely and adequate stimulus especially as fiscal rules have often targeted arbitrary surpluses and timescales.

Figure 1: Estimates of potential growth have fallen consistently over time



Source: Office for Budget Responsibility, January 2020

If that weren't bad enough, the United Kingdom is also beset by wide-ranging inequalities. The disparity between the country's least and most productive regions is high by OECD standards, which both reflects and reinforces large differences in access to services and opportunities.

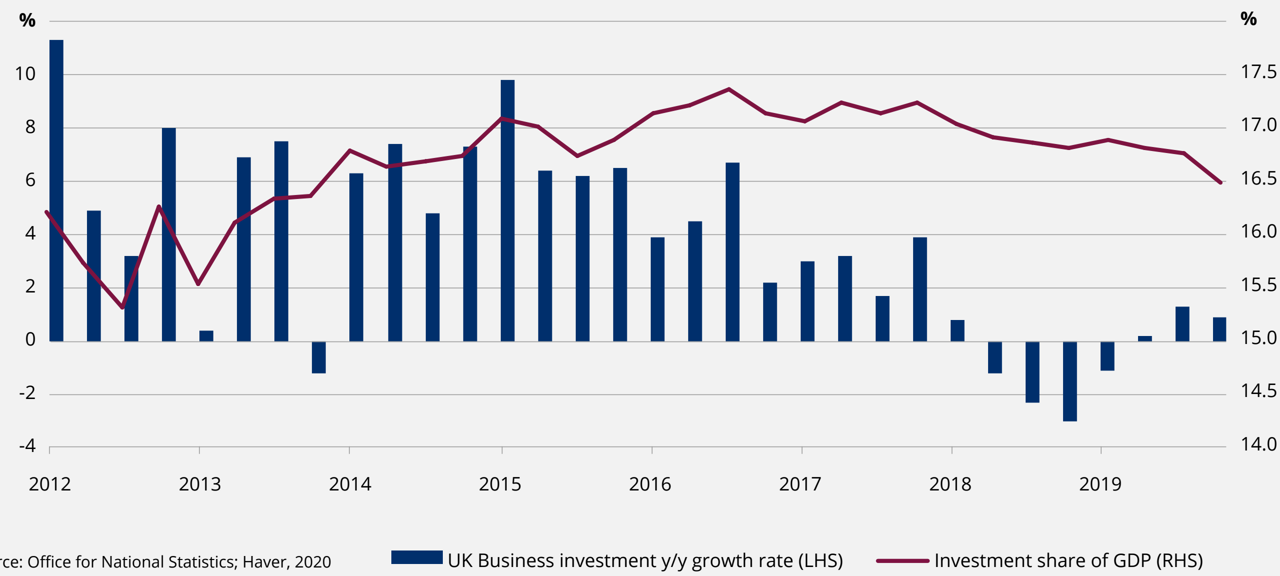
For example, in 2017, the most productive region in the UK was West Inner London, with productivity 2.1 times higher than Cornwall, the least productive region. In Germany this difference is 1.7, while it is 1.6 for France and 1.4 for Spain. With income, wealth and social inequalities also too high, the country is not living up to its potential, contributing to the resentment that is driving our increasingly fragmented politics.

The UK's decision to leave the EU is exacerbating these problems:

- The economy is already 2-3% smaller than it would otherwise have been. Private investment spending has been especially weak as uncertainty has reduced risk appetite and increased the value of waiting before committing to a project (see Figure 2). This has not only weighed on short term growth, but will have hurt long run growth as a smaller capital stock means a less productive economy.
- The Bank of England has had to abandon plans to lift interest rates as activity has underperformed and an output gap has opened up. This means rates remain extremely close to the effective lower bound and so there is even less scope for the Bank to cut than there otherwise would have been.
- The government's pursuit of a Brexit that allows for divergence will increase trade frictions with the EU. These trade frictions weaken competition and the incentives to innovate which will further weaken long run potential.
- Regional communities with high exposure to manufacturing will suffer more than most if trade frictions break up supply chains and see various industries relocate within the UK. These industries tend to be located in parts of the country that already have poorer infrastructure and less flexible labour markets, making them less robust to the shock of large employers leaving.

The March budget therefore comes at a crucial time. Urgent and radical reforms are needed to confront the country's economic problems. The UK needs to once again become a global leader across all facts of policy innovation, including: revamping the economic stabilisation framework, exploiting the low interest rate environment to invest in infrastructure and education, taking an active role in funding basic science and encouraging innovation, and tackling regional inequalities in line with mounting evidence of the importance of place within economic geography.

Figure 2: Investment has been weak since the referendum weighing on activity and potential



Source: Office for National Statistics; Haver, 2020

Re-invigorate the central bank and fiscal playbook to sustain full employment

The UK’s recovery from the financial crisis has been extremely sluggish, with the economy still operating somewhat below its potential more than 10 years later.

Credible estimates suggest the UK economy is already 2-3% smaller than it would have been had the country not voted to leave the EU, with private investment especially weak due to increased uncertainty. We do not consider the bulk of this lost output as permanent and thus see an important role for policy in making it up.

The Bank of England’s average policy rate in the 10 years before the crisis was around 5%. In line with the pre-crisis consensus that monetary policy should be the leading tool in managing and stabilising demand, it was left to the Bank of England to try to stimulate growth following the crisis.

However, limits on the efficacy of monetary policy, combined with other policy mistakes, including ill-timed fiscal consolidation, meant that this was insufficient to engineer a sufficiently robust recovery. The secular decline in equilibrium interest rates across the world means that this problem is unlikely to get better in the future.

Interest rates are unlikely to be anything like as high as the pre-crisis average in the medium to long run, perhaps stuck around 1% (see Figure 3). Lower rates mean there is less scope to cut in the event of future downturns because it is difficult to interest rates significantly below zero.

Large scale asset purchases (QE) eases this constraint somewhat, as it allows the Bank to push down on longer term rates, and it should be fully institutionalised as part of the Bank’s toolkit in the future. But there are also limits on how low long rates can go, and therefore how effective QE can be in future downturns.

To reverse those errors and future-proof policy we propose:

1. Lifting government spending by 2 percentage points of GDP over the next two years

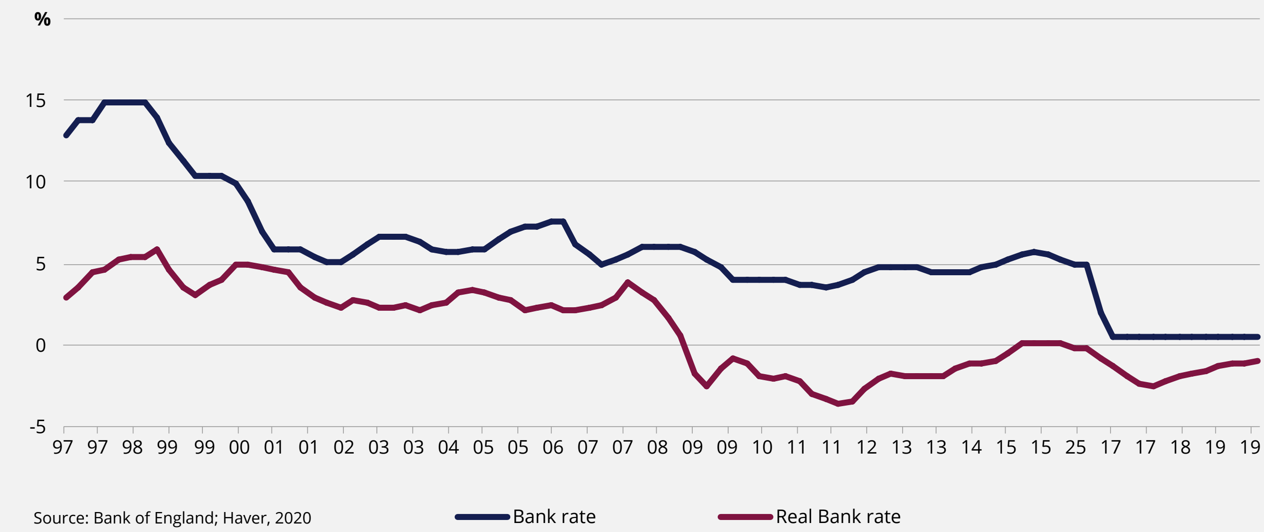
Government spending should be increased by 2 percentage points of GDP over the next two years to replace this lost output. Because large infrastructure projects often have long lag times between being announced and the money being spent, we recommend the bulk of this extra spending come from increased current spending and government consumption over the short term.

Unlike investment spending which can be indefinitely debt financed so long as the return on the asset is greater than the cost of capital, higher current spending eventually needs to be paid for through higher taxation. However, because this spending is explicitly intended as fiscal stimulus designed to close an output gap, there is no issue with it being deficit financed in the short to medium run.

Indeed we propose a new set of fiscal rules which abolish the quest for a balanced budget over arbitrary time periods and instead focus on the cost of the debt, not its level or growth. Such debt cost rules are countercyclical because they allow spending to increase precisely when interest rates are low, while still maintaining fiscal credibility as they rule out explosive debt dynamics.

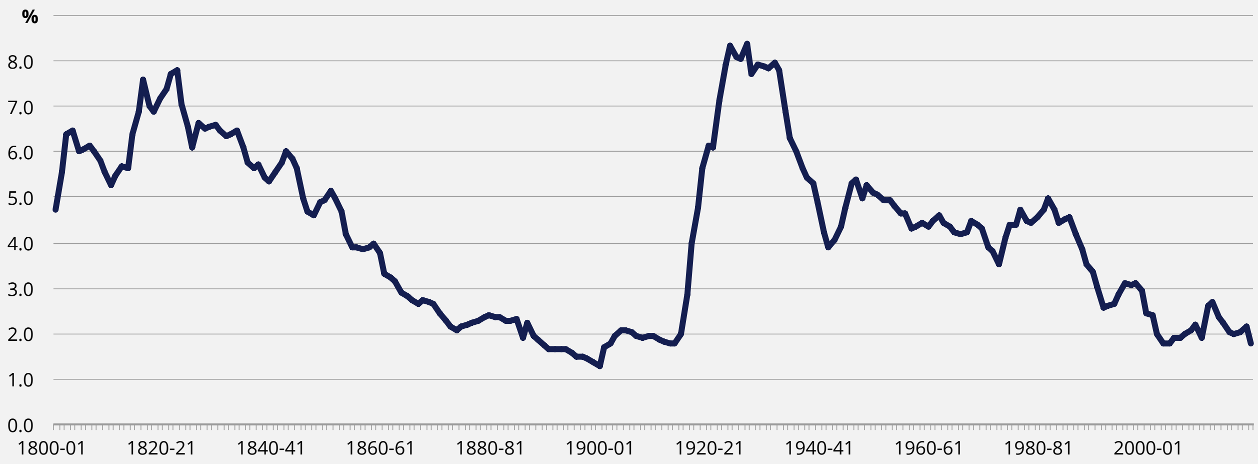
The current rules cap the debt interest cost at 6% of tax revenues, which is a step in the right direction. However, we suggest formulating this rule in terms of debt interest cost as a percentage of GDP, as this is a better measure of the resources available to service debt. We suggest setting this cap at 3.5% of GDP (see Figure 4). This level translates to a somewhat easier rule than the government’s and is broadly in line with the rule envisioned in the Labour manifesto. We consider it to be consistent with providing ample space to ease policy during downturns, being robust to upward shocks in interest rates, and consistent with a level of debt servicing the UK has sustained in the past.

Figure 3: The decline in interest rates means there is limited space to cut rates in the future



Source: Bank of England; Haver, 2020

Figure 4: A debt servicing rule would open up a significant amount of fiscal space



Source: Office for Budget Responsibility, 2020

In so far as possible, capital expenditure should be excluded from this rule, with the test for investment projects based on the extent to which they improve the public sector's net financial position. This rule reflects the fact that debt incurred to finance an investment also generates an asset which can produce future income streams to service the liability.

These new rules should allow for the stimulus we recommend along with the broader package of infrastructure investing without requiring the future fiscal tightening that the balanced current spending rules currently force on the government.

2. Initiating a review of the Bank of England's policy framework to consider radical alternatives – like price level or nominal GDP targeting – to increase policy potency

We suggest a review of the Bank of England's target, with an explicit mandate to consider a price or nominal GDP target rather than the current 2% target. The virtue of a level target is that it forces the central bank to make up for past misses. For example, if inflation has spent several years below target, the Bank will need to engineer a stronger recovery and higher inflation in the future to make up for this miss. This automatic catch-up means the Bank has more credibility in committing to easier policy, and should help to anchor inflation expectations at target over time

3. Providing for an automatic trigger to ease fiscal policy when interest rates reach the effective lower bound, so that monetary and fiscal policy works hand in hand

In future downturns fiscal policy must play a more formal role in supporting demand even if monetary policy remains an important stabilisation tool. To start with, automatic stabilisers, like welfare and unemployment benefits, should be enhanced. These are policies that kick in mechanically when the economy weakens without the delay or discretion of policy makers and are particularly powerful in confronting downturns. This is because they put money directly in the hands of households facing severe cash constraints, and so have a very high marginal propensity to spend.

However, recent work by the Resolution Foundation has shown that over the last 10 years changes to welfare policy and taxation have weakened the UK's automatic stabilisers. This direction of travel should be immediately reversed, with an explicit goal to enhance the stabilisation properties of the UK's welfare policies, although this should be done in a way that avoids raising effective marginal tax rates or discourages labour supply.

On top of that, we propose further automatic triggers to ease fiscal policy when interest rates have reached the effective lower bound. For example, an independent fiscal committee – similar to, and indeed perhaps identical to, the Bank's Monetary Policy Committee - could decide how much fiscal stimulus is required in the event of a shock that pushes interest rates to the lower bound. The government could then decide how to allocate this "fiscal window" under the constraints of standard political oversight. This policy is aligned with our proposed changes to the Bank's mandate, as the commitment to allow the economy to catch up on past undershoots will stop monetary policy tightening in response to this easier fiscal policy. Monetary and fiscal policy will be complements not substitutes.

4. Pursuing a high alignment strategy in trade negotiations with the EU to prevent further, unnecessary damage to the economy

There is overwhelming evidence that openness to trade and high economic integration boosts long run growth. Trade improves productivity growth by allowing for greater specialisation, increased competition, greater innovation, and a larger market allowing firms to exploit economies of scale. That is why various studies show that a no trade deal Brexit will be the most costly to the economy, costing up to 8% of GDP per capita compared to remaining in the UK. Therefore, to avoid the disruption of breaking up existing supply chains and trading relations and to minimise the costs to productivity from Brexit, the government should pursue a relationship which prioritises high alignment and minimal trade frictions with the EU.

Build on HS2 and green the Northern Infrastructure Gap

Government funded infrastructure spending has been badly neglected over the past 40 years. Net public investment has averaged just 2 per cent of GDP, less than half of what was achieved during the 1960s and 1970s, though there has been a recovery from the 1990s nadir (See Figure 5). Meanwhile, the stock of infrastructure has fallen to below 60% of GDP. Both place the UK towards the bottom of the OECD league tables.

As the quantum of investment has declined, so too have indicators of quality and adequacy. Much of the public transportation system suffers from overcrowding. Bottlenecks on roads are common. Interconnectivity of the train system is weak outside of London and the Southeast. As a result, the World Economic Forum ranks the UK just 24th in the world on the quality of its infrastructure, well below that of most other wealthy countries (see Figure 6).

Steps have been taken to address the infrastructure shortfall over recent years. The Cameron government established a quasi-independent National Infrastructure Commission (NIC) tasked with identifying the country's most pressing infrastructure needs, making recommendations to government and reviewing government progress. Scotland and Wales have followed the same path. Meanwhile, the new government has said that it will increase net public investment by £22 billion pounds per annum over the course of the current parliament within a fully developed national infrastructure strategy (NIS).

But though the prioritisation of infrastructure is welcome, there is still considerable room for improvement. For a start, the NIC is not sufficiently independent of the government and is not empowered to direct public investment spending to where it most needed. This in turn means that spending decisions are still too politicised, and often biased towards high profile projects rather than those with the greatest payoff to the broader public.

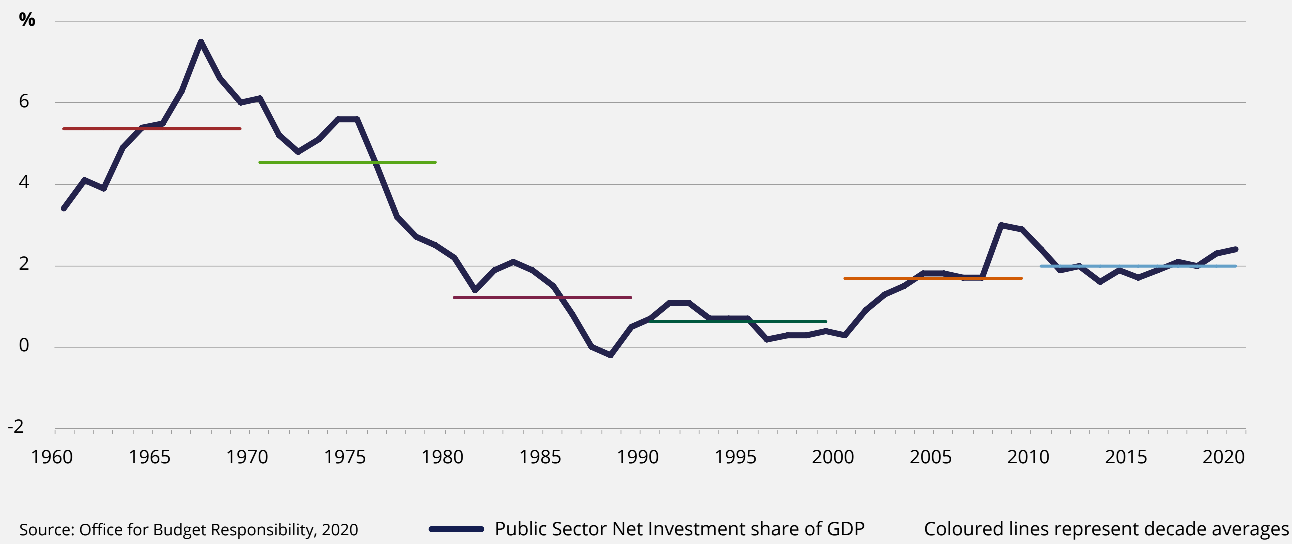
In addition, the criteria that are currently used to assess the costs and benefits are too focused on narrow efficiency objectives. Equity considerations are afforded insufficient weight, biasing projects towards the largest and wealthiest communities. And though social and environmental externalities are taken into account, infrastructure spending is not fully aligned with the government's goal to achieve net zero carbon emissions by 2050.

Meanwhile, there is still too much focus on numerical targets for spending, rather than simply approving any project that delivers benefits that exceed the costs and can be implemented within existing capacity constraints.

The decision making around the HS2 project is symbolic and reflective of all of these weaknesses. But it has now been made. As such the goal should be to make the enormous investment a success by ensuring that it does not drain resources from other projects with even greater benefits and that the governance around future infrastructure decisions is stronger.

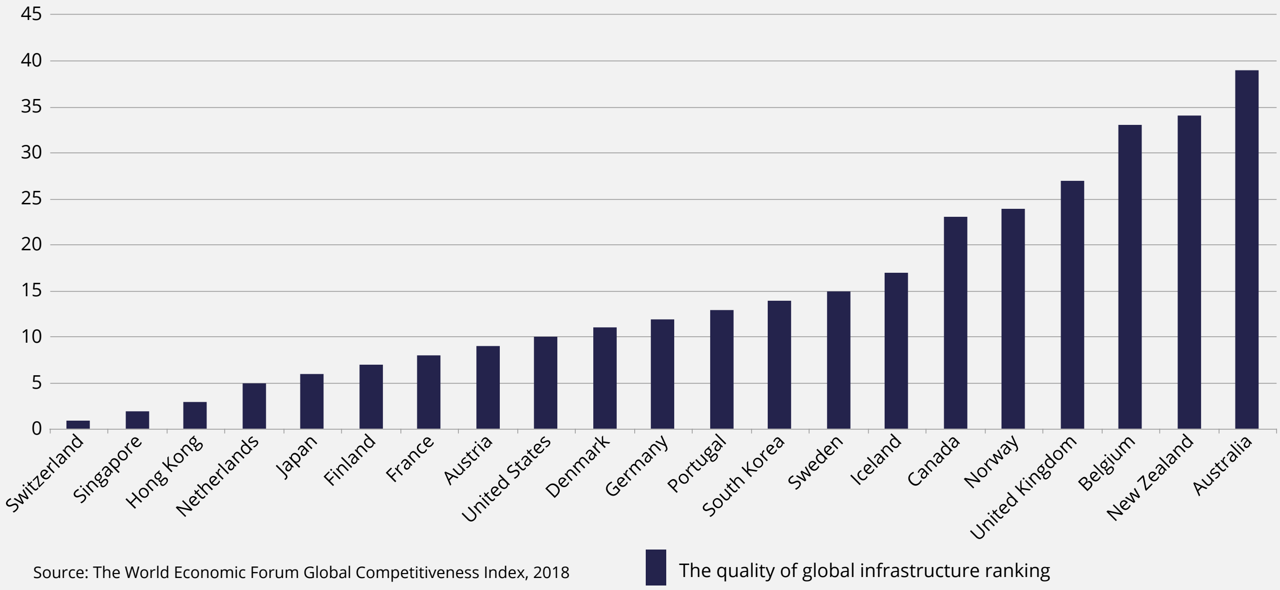
To address the weaknesses in the current system we propose three major reforms:

Figure 5: More scope to lift public investment spending



Source: Office for Budget Responsibility, 2020

Figure 6: Infrastructure quality towards the bottom of the OECD pack



Source: The World Economic Forum Global Competitiveness Index, 2018

1. Strengthening the independence and powers of the NIC

Greater independence can be achieved by making the NIC a non-departmental public body. Additional powers – to be instituted over time - would include the remit to assess, procure and then oversee the delivery of a long-term infrastructure pipeline, in consultation with all relevant stakeholders.

Critically, while the government would determine the aggregate budget available for public investment, projects would only go ahead if approved by the NIC.

2. Widening the criteria used to assess proposals and relocating the NIC out of London

The criteria used to assess infrastructure projects are heavily tilted towards economic efficiency. But though it is necessary for projects to have long-term economic benefits that exceed their costs, it is not sufficient in the presence of unacceptable regional productivity and access gaps, or the climate emergency.

We would therefore mandate the reconstituted NIC to more explicitly and rigorously account for environmental and social externalities in their assessments. In particular, projects should not go ahead unless they are consistent with the commitment to reduce the UK's net carbon emissions to zero by 2050.

In addition, where two projects have similar aggregate economic and environmental cost-benefit profiles, priority should be given to those that will benefit disadvantaged communities, and especially the Midlands and North. This should include giving higher weight to smaller projects with more immediate and certain payoffs.

Relocating the NIC outside of London will reinforce the message that excessive regional differences in access to quality infrastructure will not be accepted.

3. Relaxing artificial constraints on the scale of public investment

If projects are chosen more appropriately, with regard also given to the capacity to deliver those projects within budget, it should no longer be necessary to impose artificial constraints on the aggregate scale of public investment activity.

With the scale of investment dependent on need, and with projects only going ahead if they deliver long-term benefits that exceed their costs, the net public financial position will improve in the wake of additional investment rather than weaken.

Liberate the regions as part of a smarter levelling up strategy

The UK is beset by very large regional disparities both in absolute terms and in comparison with other similar OECD countries. For example, in 2017, the most productive region in the UK was Inner London, with productivity 2.1 times higher than Cornwall, the least productive region. In Germany this difference is 1.7, while it is 1.6 for France and 1.4 for Spain (see figure 7).

Broadly speaking, cities tend to be the most productive areas while coastal areas the least. However, it is important to stress that within regions there are sometimes even more striking differences in economic and wellbeing outcomes than between regions. It is therefore important to focus policy at the right level of devolution, and not assuming that resources targeted at the poorest regions are necessarily best targeted to help the poorest people.

As the UK's Industrial Strategy Council points out:

"High-productivity regions tend to have a better-skilled workforce, better local governance and management culture, attracts more investment, and is more likely to be specialised in high-value economic activities. This makes it difficult to trace their success to any one local characteristic"

There are a number of interwoven causes of these deep differences. But a key idea that emerges from economic geography is that there are large positive externalities and feedback effects that can lock in regional performance gaps. Critically, even small differences in fundamentals can lead to reinforcing employment and activity cycles due to the network benefits of agglomerations or clusters of specialisation.

So it is perhaps unsurprising that UK has a long history of divergence productivity across the country, with regional differences in income and productivity about the same today as they were in 1901. However, there was a period of regional convergences through the middle of the 20th century which started to reverse in the 1980s. This suggests while the challenges are great, they are not insurmountable and thus an integrated and patient approach to the economics of place can lead to productivity turnarounds.

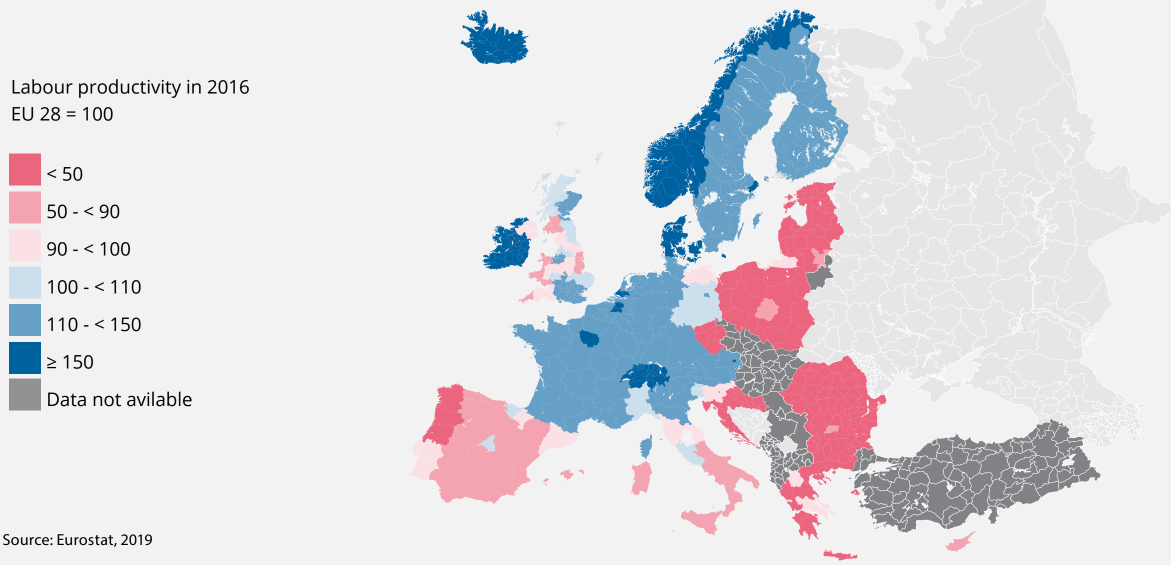
It is therefore welcome that the government is prioritising tackling regional differences through its levelling up agenda. However, it is far from the first government to have attempted to address these issues and indeed the relatively constant churn in policies, targets and institutions that have been launched and subsequently abolished as part of various different regional strategies has made a long term approach to tackling these problems more difficult.

To maximise the possibility of addressing this long running problem, we recommend:

1. Powering up devolution by giving local decision making bodies far more power to set taxes including business and stamp duty

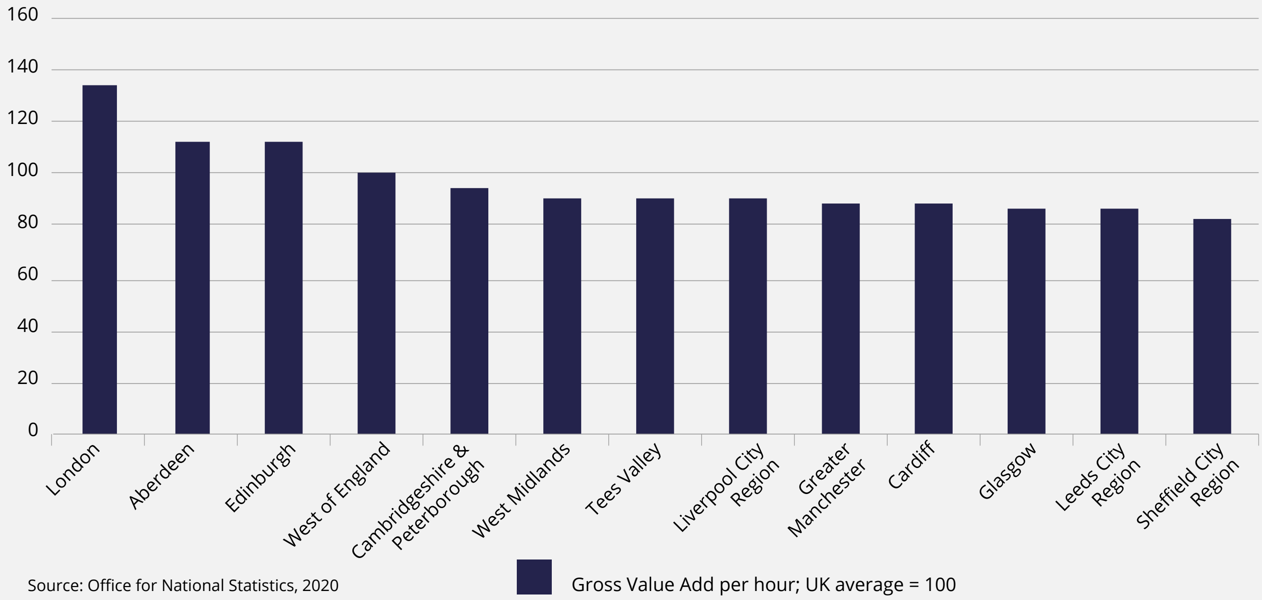
Despite attempts to increase regional devolution under the Cameron government, with the creation of combined authority mayors for various English regions, England remains a highly centralised country by international standards, with many policy decisions taken in Whitehall. This often leads to policy decisions that bias already productive regions, and does not allow for experimentation or the tailoring of policies to particular local needs (see figure 8).

Figure 7: Regional productivity differentials vary widely across Europe



Source: Eurostat, 2019

Figure 8: Productivity varies widely across the UK



Source: Office for National Statistics, 2020

However, it is important that power is devolved to the appropriate level, as ineffective devolution can worsen regional differences if there are large differences in the quality of governmental institutions and ability to make use of the newly developed power. On the whole, the combined authority mayors meet this test, representing large enough areas to benefits from economies of scale while also reflecting people's existing sense of place, which is necessary for the sustained popular buy-in required for effective political oversight.

We propose further power should be devolved to the combined authorities including the ability to set business rates and stamp duty. If local authorities can keep this revenue it incentivises them to attract business investment and construction activity. It will also encourage them to weigh demand for local services against their capacity to raise revenues, based on local preferences.

2. Reforming planning laws to make it faster and cheaper to construct residential and commercial property

Britain has accumulated a housing shortfall of around 3 million units over the last 15 years. Too little land is released for development, and planning laws increase the cost of development. On top of this, government housing policy has generally been focussed on the demand side, which in the context of large supply side constraints, has mainly served to put upward pressure on house prices.

The focus must instead be on reforming planning laws to tackle these supply side issues via targeted land release, green belt land swaps, and reclassification of local authority borrowing to allow for public sector driven housing investment

3. Raising investment in basic science and in cultural Britain, strengthening the country's comparative advantage in research, arts and tourism

The government appears to be committed to delivering a "high risk high reward" research organisation – a UK Advanced Research Projects Agency (ARPA) – accompanied by a doubling of the science budget. The task of this research organisation would be to invest in potentially transformational technologies to tackle big, pressing economic and social challenges.

This is to be welcomed. Work by Mariana Mazucatto, among other economists, has demonstrated the importance of the public sector in financing and driving through innovations that later go on to have significant private sector applications. However, what is crucial is to develop an entire landscape of innovation that covers everything from basic science all the way through to commercial development; it would be a mistake to think investment in science alone is enough to drive productivity enhancing innovation.

We also welcome the government's commitment to host this agency outside of London, as it should help to anchor a new cluster of innovation and productivity and so also help with the government's levelling up agenda.

Along with this investment in science, we would also encourage the government to invest more in cultural development, strengthening the country's comparative advantage in arts and tourism. Cultural emphasis complements a focus on the economics of place, allowing regions to develop and sustain distinctive identities which help to attract and retain people, business and tourists.

Seize the gains from the fourth industrial revolution by skilling the nation for the future

There is a wealth of evidence connecting the accumulation of skills, education and human capital to long-term productivity growth. Those with higher levels of human capital are more likely to become innovators themselves. Innovations stand a greater chance of being commercialised and diffused when complementary skills are present. And a better educated workforce will be more able to absorb and adapt to the disruptions that accompany technological change.

One of the most important tasks facing the education and skills sector today is preparing the workforce for the challenges that will come from the fourth industrial revolution, which the World Economic Forum has defined as the "fusion of technologies that is blurring the lines between the physical, digital and biological spheres".

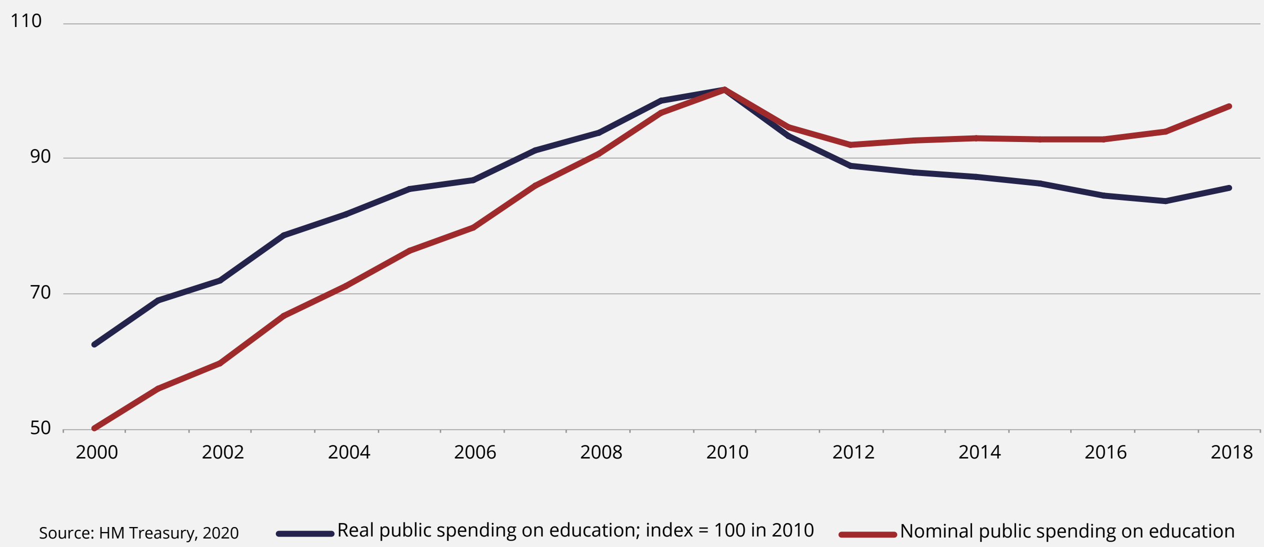
Like the third, electronic and information technology revolution that preceded it, the next wave of change has the potential to further displace or lower the incomes of workers who lack the skills demanded by changing production and consumption patterns. Delivering a better and more flexibly skilled workforce is a key way that policy can help avoid that outcome.

The UK will enter the next industrial era with some important advantages. Aggregate public and private spending on educational institutions is high by international standards. Almost 95% of women are expected to complete upper secondary school in their lifetimes. And only 7 countries in the world have a higher proportion of 25-34 year olds with a university degree.

However, there are important gaps that also need to be addressed:

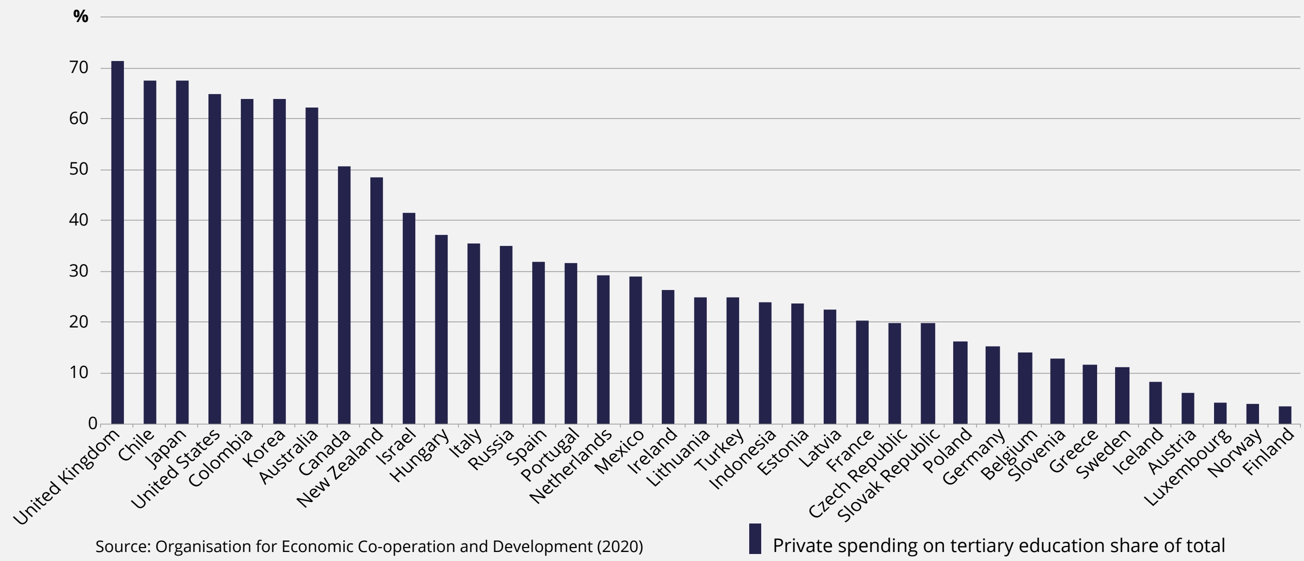
- Real central government spending on education has declined by more than 10% since 2010 and in 2018 was lower than it was even in 2006 (see Figure 9).
- The UK's heavy reliance on private funding for tertiary education (see Figure 10) lowers the net return to a university degree compared to most other OECD countries;
- University graduation rates in engineering and manufacturing fields have fallen significantly over the past few decades (see Figure 10);
- Funding support for vocational education is harder to access than for university education, with real spending on vocational education down 45% since 2010;
- Male lifetime expected upper secondary graduation rates are well below the OECD average;
- There are around 9 million working age adults with inadequate literacy and numeracy skills;
- The immigration system is not sufficiently pointed at filling current and future skills gaps; and
- Government spending on active labour market programmes is low by OECD standards.

Figure 9: Austerity hit real education spending hard



Source: HM Treasury, 2020

Figure 10: The UK is heavily reliant on private funding for universities



Source: Organisation for Economic Co-operation and Development (2020)

To address the weaknesses we propose four major policy shifts:

1. Lift spending on means-tested tertiary fee and cost of living grants

The introduction of income contingent loans to cover tertiary fees has succeeded in helping to fund the expansion of England's tertiary education system. And because much of the return to higher education accrues to individuals, income contingent loans are also progressive.

However, there are still large tertiary access gaps for the most disadvantaged students, with the current system acting as a barrier for at least some able students to carry their studies on university.

We think the system could be made fairer by significantly expanding mean-tested tertiary fee and cost of living grants for students from disadvantaged, low-income families.

2. Create a skills bond and expand access to income contingent loans to fund greater investment in vocational education

Overhauling England's vocational education system is an even bigger priority. As the Augar Review argued, post-secondary education for the 50% of students who do not go on to university is both under and unfairly funded.

This can be addressed in two ways. Access to income-contingent loans should be expanded through the introduction of a life-time allowance that can be used to pay for accredited vocational education programmes and skills development. And because vocational education should still be subsidised, additional financing should come in the form of a new 'skills bond'. These bonds, which would carry a modestly higher yield than regular government bonds, would give the private sector a greater stake in the nation's skills development.

3. Ensuring that the new post-Brexit immigration system is needs-based and addresses a wide variety of skill gaps

Brexit will almost certainly be accompanied by the end of the free movement of labour from the EU. But it will also likely see the maintenance of relatively high rates of immigration, both from European and non-European countries. This affords an opportunity to deliver a more holistic immigration system that better matches incoming workers to the skills needed in a rapidly changing economy.

The government has announced that there will be a number of changes to the system from January 2021. The centre-piece of its strategy will be the introduction of an Australian-style points system, which tilts visa more heavily towards skilled migrants, accompanied by a reduction in the salary threshold for those with job offers and a relaxation in education qualifications.

A detailed white paper setting out the plans is due to be released in March, followed by legislation to support the proposals. To ensure that the new system is as effective as possible, and in sympathy with the views of other expert bodies like the Institute for Public Policy Research and the Migration Advisory Council we recommend:

- Replacing aggregate numerical targets with separate targets for different types of migrant - those with job offers, skilled migrants without job offers, entrepreneurs, and humanitarian migrants;
- Ensuring that the new points system is genuinely needs-based. Skill shortages can occur in low wage and high wage sectors. And though it is not unreasonable to expect firms to try to fill jobs from the domestic labour pool before looking abroad, those traditionally more reliant on lower skilled migrants must also still able to access staff at a reasonable cost.
- Devolving some powers to the UK’s nations and regions to reflect local needs and preferences. If that proves too difficult, consideration should at least be given to different regional requirements;
- Introducing a new Global Talent Visa to recruit highly skilled individuals for those sectors of the economy most critical for driving innovation, in line with the Government’s intentions; and
- Providing additional support services to existing and future migrants to promote integration.

4. Spend more on active labour market programmes

Periods of labour market inactivity are inevitable in a market economy. But skill gaps can contribute to unemployment while inactivity itself can lead to skill atrophy. There is thus a role for government to provide programmes facilitating the return to employment. Indeed, evidence shows that countries that invest more in such assistance have better labour market outcomes.

The UK has a low incidence of long-term unemployment thanks to the relative flexibility of its labour market. But it does have a bigger problem matching people with secure jobs accompanied by high enough hours and pay to avoid in-work poverty. An expansion of well-targeted Active Labour Market Programmes would help address this problem.

Ensure that no one is left behind by investing more in children

Channelling more and better targeted resources into post-schooling skills acquisition will be critical if the UK is to fully capture and broadly distribute the benefits of future technological changes.

However, decades of research demonstrates that it is equally important to invest in the first years of a child's life. Gaps in cognitive ability and achievement can open up at very early stages of development; with effects persisting right through a person's life. The payoff to early intervention is especially high for children from low income families living in disadvantaged neighbourhoods.

The UK has been more successful than most other OECD countries in keeping those with fewer skills and lower educational attainment attached to the workforce. However, that is not true of its record on alleviating poverty. At 22%, the poverty rate is higher today than it was 15 years ago. More than half of those in poverty now live in a household where at least one person works, including close to 70% of children. And in-work child poverty rates are only at acceptable levels in households where both parents work (see Figure 11). Single-parent households are especially vulnerable to poverty (see Figure 12).

Like many of the UK's largest economic and social challenges, child poverty is also geographically concentrated. In contrast to common perception, poverty rates are actually much higher in London than in other regions. But outside of London rates are higher in the North and Midlands than they are in the South.

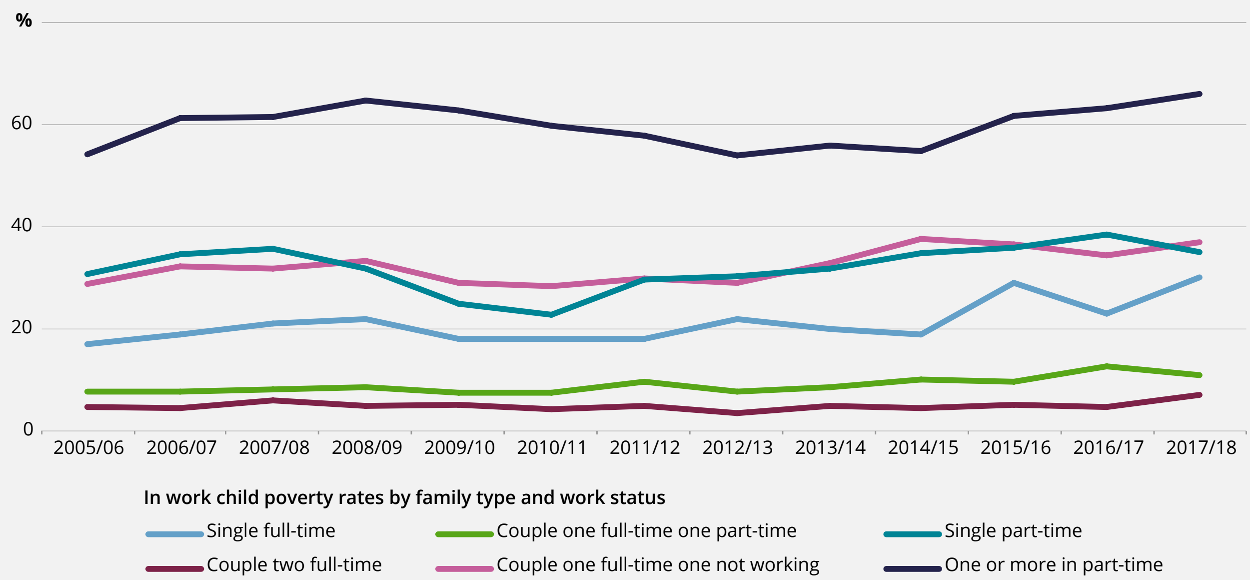
The ramifications are significant. Children living in poverty are less likely to do well at or even complete school. They tend to suffer from more health problems. And they stand a greater chance of being caught in cycles of crime and unstable living.

Public policy is a contributor to trends in child poverty. Over the past 10 years government spending on income support, welfare and early intervention programmes has been cut significantly in real terms. Indeed, according to IFS research, cuts to universal credit work allowances will account for a third of the projected increase in child poverty in working households between 2014/15 and 2021/22.

Steps have been taken to increase access to subsidised child care and nursery places over recent years. But funding cuts elsewhere in the system have lowered providers' willingness to supply the necessary additional places.

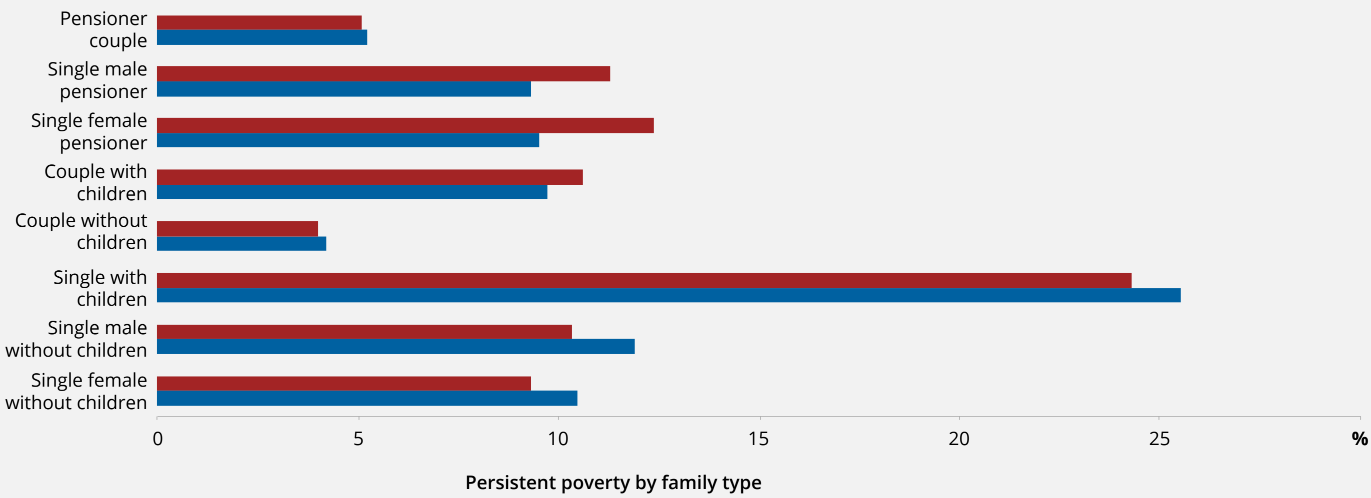
The imperative and space to loosen fiscal policy, combined with the government's own stated goal of reducing regional income and opportunity gaps, offers a chance to reverse a decade of poverty failures. In particular, we think there are three urgent priorities for government action:

Figure 11: In-work child poverty unacceptably high



Source: Households Below Average Income, 2020

Figure 12 Single-parent households especially vulnerable to poverty



Source: Understanding Society, 2020

1. Lifting spending on primary and secondary education in disadvantaged communities;

High quality schooling for students regardless of their means, ability or location, is one of the pillars of successful economies and societies. The UK's total spending on primary and secondary education is higher than the OECD average. But like many areas of the budget, spending has fallen in real terms over the past decade - in this case by 8%.

England is currently in the process of moving to a new National Funding Formula (NFF) for primary and secondary schooling, aimed at ensuring similar schools receive similar amounts of funding. However, the new formula appears set to deliver less new funding for schools with a relatively high proportion of children receiving free meal compared to schools with fewer disadvantaged students. Moreover some disadvantaged schools will see outright cuts to spending.

In our view the government should ensure that no school sees a cut to real funding over the lifetime of the current parliament and ideally modest increases. To the extent that it does deliver real cuts in the aggregate, disadvantaged schools should be excluded from the cuts, with pupils living in the most deprived parts of England receiving the largest gains.

2. Reversing cuts to welfare and universal credit;

Cuts to welfare spending and universal credit have meant that the country's most vulnerable children have borne too much of the burden of the decision to prioritise deficit reduction. Similarly, the high incidence of child poverty in working households demonstrates that work is not paying for enough people.

The government should therefore commit to progressively reversing the past decade of cuts to real spending on welfare, including universal credit, over the course of the current parliament. Targeted increases for working families that also lower effective marginal tax rates should be a particular priority. This would complement increases in minimum wages, increase incentives for workers to take on more hours, and ensure that in-work poverty declines over time.

This extra, targeted spending would also be expansionary for the economy because welfare spending has a high multiplier and because stronger work incentives boost potential growth.

3. Expanding the Sure Start programme and access to affordable nursery and childcare places;

Sure Start is a programme offering educational, health and employment services to disadvantaged English families with children under the age of 5. From its beginnings in 1999 the programme expanded rapidly, with funding peaking in 2010/11 with almost 3000 centres.

Since then the programme has been one of the largest victims of a decade of austerity. Total funding has been cut from £1.8 billion in 2010/11 to just £600 million in the most recent fiscal year. That is despite strong evidence that it had a significant positive effect on children's health and, if international evidence is anything to go by, likely positive effects on school readiness and cognitive development as well.

Given the comparatively small budgetary requirements, especially compared to aggregate education or welfare spending, it should be straightforward for the government to reverse the past decade of cuts and rebuild the programme.

Similarly, although the last government doubled the entitlement to free child care for working parents of three and four year olds in England to 30 hours a week take up has been lower than hoped. That is because nurseries and other childcare providers have seen funding cuts at the same time; making it expensive to provide the additional care and leading some providers to either not participate in the scheme or close their doors. These gaps should be addressed so that all eligible parents can access the services they need.

Standard Life Aberdeen