

26.7.2005

IT'S THE REAL ECONOMY, STUPID

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at Bloomberg, 39-45 Finsbury Square, London EC2

26th July 2005

I am very grateful to you at Bloomberg for hosting this event today. Your presence here in London tells us something very important about our country and our economy. I believe we are one of the world's most open and accessible economies. In fact this goes right back into our history. London grew not as a fortified capital but as the centre of a network of trade routes. Above all, London has always been a market place, and a market place that is open to all.

London is, I believe, at the moment the greatest city in the world. One reason is that so many people come here to do business and to trade. It is what makes London so diverse, so exciting, and so dynamic. I am sure that a vital ingredient that won us the Olympics in 2012 was the brilliant idea of London as the world in one city. And the day after that victory the terrible bombings confirmed the truth of that in a tragic way. Seeing the lists of victims I was struck by how young and how diverse they were. The victims came from so many different parts of the world, attracted by the vitality and vigour of London. And we are not going to let a few desperate suicide bombers destroy something so valuable.

It is the vigour of that market place and the real economy which surrounds it that I want to talk about today. I particularly want to focus on the real economy because that is after all what the Department I shadow, Trade and Industry, is all about. But it is also because the political debate on the economy is all too often about tax and spend. Gordon Brown's humiliating abandonment of his fiscal rule last week reminded us of the importance of controlling public spending and bringing down the burden of tax. But it would be wrong to focus exclusively on tax and spend when there is much else governments can do to create a framework to make us all more prosperous.

The Story So Far

There is an optimistic account of where our economy has got to. Let me begin with that. It would go roughly as follows. When we were in

government the Conservatives took some really tough decisions to reform the supply side of the economy. We reformed the trade unions and privatised the nationalised industries. They were the foundations for Britain's economic success. It is not easy to raise the growth rate of a mature economy. In fact many people believed it was impossible. The great political economist Mancur Olsen even came up with an explanation – in a mature society interest groups were so well established and powerful that economies gradually became less and less flexible. If you wanted to know our underlying growth rate you should follow the sentiments of the melancholy Russian peasant who when asked about the harvest said it was *'about average – not as good as last year but better than next year.'* We decisively broke with such pessimism and raised our growth rate by transforming the supply side of the British economy. I am proud that in the Treasury, in the Number 10 Policy Unit and as a Minister, I played my part in pushing forward those reforms which were very controversial then, even though they are part of the consensus now.

Then Gordon Brown, in what was by far the best single decision of his Chancellorship, gave independence to the Bank of England and thus ensured macro-economic stability as well. The combination of Tory reforms and an independent Bank has, so the argument goes, enabled the British economy to carry on growing when so many others have floundered.

The problem with this account is that it gives rise to a dangerous complacency. It suggests that the job of reforming the British economy has been done and now we can sit back and let the good times roll. Each political party feels it has its share of the credit for Britain's apparent success; and we settle for an argument about tax and spend. But you can never sit back when there are always new economic challenges. And both Parties need to think afresh about how best we can make the British economy stronger.

Gordon Brown may have delivered macro-economic stability but he has not used it as the base for further strengthening the supply side of the British economy. Where are Gordon Brown's big reforms that match our achievements? We are increasingly familiar with the judgement that Tony Blair has frittered away his extraordinary opportunities and failed to achieve something substantial. But I think the same criticism can be levelled at Gordon Brown. He enjoyed a big parliamentary majority, a stable economy and a budget surplus. Think what he could have done with that to continue with the reform of the British economy. He could have used this strong base to finance a major simplification of the tax

system but instead it is more complicated than ever. He could have tackled the pensions crisis, which he himself has contributed to, but it looks more serious as every day passes. He could have encouraged investment in energy for the future but instead more and more people are worried that we could face energy shortages, in the form of, very appropriately, brown-outs.

Gordon Brown claims to be committed to further reforms to strengthen the economy. He is endlessly coming up with new initiatives which are supposed to invest in human capital, raise our productivity, get more R and D, and increase the underlying growth rate. The trouble is that we get restless tinkering and fiddling instead of changes that are big, bold, and worthwhile. We can now measure his performance against the targets he set himself. When he came to office the crucial task he set himself was to increase our productivity. Already by 1998 the Treasury was claiming "*The Government ... has also introduced a wide-ranging programme of structural policy reforms designed to encourage work and raise productivity.*"

Let's look at the latest figures produced by the OECD in the Spring. They measure the value in dollars of what was produced in the year 2003 per hour worked in the world's major economies. In France, close to the top of the table, they produce \$47.2 of output for every hour they work. In the USA it is \$43.5. In Germany it is \$40.6 of output per hour worked. In Italy it is \$40.1. Across the G7 the average is \$39.8 of output per hour worked. What is the figure for the UK? We are way behind most of our competitors with a figure of \$37.7 of output per hour worked. Britain's output per hour is one of the worst among the major Western economies.

What has gone wrong? Why has Gordon Brown not achieved the transformation of the performance of the British economy that he hoped for? I think that at some point during his Chancellorship Gordon Brown changed strategy. He gave up on his hopes of transforming our productivity. Instead he decided to settle for us getting bigger, even if we weren't getting more productive, by big increases in the labour force, especially harnessing immigration from abroad. A crucial clue is to be seen all round London. It is a business which has reverted from being automated and high tech to being labour intensive. It is the emergence of the hand car wash. They are appearing all over London, at a cost not much more than the automated car wash. A team of young men descend on your car and within a few minutes it is spotless. When you talk to them you discover they come from Poland or Slovakia or Latvia, or

beyond. They are decent and hard-working. I do not resent them taking their opportunities here. 120,000 workers came here from the accession countries in the first year. They came to work, they drove down wages and, as the Governor of the Bank of England has pointed out, enabled the British economy to keep on growing without upward wage pressures. I sometimes think London would grind to a halt without its Polish plumbers, Slovak cleaners, and Latvian waiters. They certainly have transformed the domestic economy of many a middle-class household, even if it is at the expense of driving down wages of British workers who compete with them. But the enlargement of the EU and the free movement of labour from East Europe, is changing the British economy in a way very different from what Gordon Brown planned in 1997. We have not become an economy that uses high capital investment and high skills to squeeze extra output from a given workforce. Instead we have become an economy that grows as its workforce grows, partly through migration, but has done less well in increasing output per hour worked or per employee.

The trouble is this increase in the workforce has not been matched by an increase in business investment. The Chancellor claims that real business investment has been going up. In the 2005 Budget speech, he said

"The key to a sustained improvement in manufacturing is the rising level of business investment - which grew by five and a quarter per cent last year and is forecast to grow by four and a quarter to four and three quarters per cent this year."

But there is a fiddle here. Almost a fifth of all business investment is in IT and telecoms. The price of these goods is falling very fast. Instead of measuring cash spend on these services the Treasury tries to revalue them back to how much they would have cost in constant 2002 prices. So for example, replacing a 2002 vintage 2 gigahertz processor chip with a 2005 4 gigahertz processor chip for the same price is according to the Treasury a doubling of investment. If you try to measure IT investment in so-called volume terms you appear to get a big increase in investment. That is not because anybody is spending any more, it is because technology is changing fast. By revaluing IT back to prices in 2002 in a sector where technological change is so fast, Treasury figures for business investment are far too generous.

Unfortunately, it cannot be said that this is an innocent mistake. First of all, the Bank of England was aware of it and took counter-measures from 2003 to correct their statistics. Moreover, the ONS have also warned of this distortion. If instead we measure the proportion of GDP being put back into business investment each year, the picture changes dramatically. The usual pattern is that in years when the going is good, firms are willing to invest more to spur future growth. By contrast, during the bad times, investment falls away. Through the late 1980s, investment surged to a high of 14% of GDP in 1989 (2% above the historic average) from where investment fell away to 10% in 1993. Our recovery from there led to another high in 1998 of 12.5%. However, at that point the historic relationship breaks down. Since 1998 business investment has steadily fallen as a percentage of GDP. Despite all the macroeconomic stability, businesses and investors have not felt confident to put their money into business. Business investment now only represents 9.5% of national income, the lowest rate it has been since these records began in 1965. This is surely powerful evidence of what business really thinks of Gordon Brown. They aren't willing to invest their money in the economy as he runs it.

As if that was not bad enough, there is a further twist to this story of capital depreciation. If we were investing just 9.5% of our capital into business, but it was being spent on bridges, roads, and buildings whose values do not fall away very quickly over time, we might not have reason to worry as we would genuinely be laying down solid foundations for future growth. This is the inheritance of investment that we still enjoy from the Victorians. However, almost a fifth of this capital is being put into ICT and telecoms which have a very high depreciation rate. This investment will only last a few years when it will need to be replaced, so you have to run faster to stand still. The Treasury measures investment gross of depreciation and thus counts a computer that will last four years as the equivalent of a road that will last fifty years or a Victorian sewer that has lasted 150 years. It is little short of catastrophic that we are down to business investment at a historic low when so much of it also only has a short life. The best way to describe an economy that is growing with such low levels of investment is thin growth. It is growth but without the strength and the muscle to sustain us into the future.

So Gordon Brown is doing the opposite of what he claimed to be doing in 1997. Back then the aim was to invest in human capital, encourage business investment and so increase our output per hour. Instead, what has happened is that we are throwing more and more manpower at a low level of investment. Output does rise, as does GDP, but output per hour

worked does not do so well. Look at it this way. In Britain we work 47.1 billion hours per year. In France they work 36.2 billion hours. If the hours we worked were as productive as the hours they work in France our economy would therefore be half as big again as the French economy but it isn't. We are just ahead of them, despite putting in so much extra labour.

So as an economy we have now got business investment down at a record low. At the same time the amount households save is down at a record low of 4.2% in 2004. And the evidence is building up that attempts to invest in human capital for the future are not doing well either. Add in as well high Government borrowing financed by debts which the next generation will have to service and the picture of Brown's Britain becomes clear. We are not saving and investing for tomorrow, we are living for today.

Gordon Brown talks the language of prudence but actually is throwing a great big teenage party without worrying about the state of the house tomorrow. The only reason the Government gets away with it is that if people think that Labour are just living for the present, they fear that we Conservatives are stuck in the past. What we need to do is to focus instead on strengthening the British economy for the future. We can't just settle for an economy that grows as the total workforce grows. Instead we have once more to get back to difficult questions about how much we invest, and how we create the market environment in which we get the greatest possible output for our efforts. That should shape our economic policy for the future. The next election could well take place in 2010: and if we then put forward ideas for strengthening the economy over the coming decade it will be our 2020 vision.

What are the challenges that we will need to tackle? Let me now set out six areas where I believe we can push Conservative policy forward, way past where Gordon Brown has left us.

1. Investing in Human Capital

First, there is the catastrophic failure of education and training in this country. It now looks as if the Government's progress on achieving literacy and numeracy targets has stalled. The education and training option in the New Deal is the least successful. Only 31% of clients on the education and training option, which is by far the most popular of the four New Deal options, achieve a qualification, and only 26% find a job. And even more shocking is the scandal of NVQs. NVQ Level 2 takes

about 2 years to achieve. The evidence of the ineffectiveness of NVQ Level 2 is absolutely devastating. It suggests that getting this mainstream vocational qualification does not increase your wages at all. In fact researchers at the IFS found that people with NVQs at Level 2 actually have lower wages than otherwise similar individuals who lack NVQs – estimates varying the effect from 5% to 20% lower wages. Some of these NVQs are worse than useless – they actually reduce the value of a worker to an employer. However, we know what does work. We know that genuine school choice is a powerful way of raising standards across the educational system. We know as well that we have to make our NVQs more genuinely vocational and less theoretical and they will be worth more to employees and employers alike.

2. A Better Productivity Performance Especially in the Public Sector

It is not just a matter of increasing output by investing more in our human capital. We also have to create an environment in which people are used as productively as possible. If there is one area where Britain's productivity performance has been poorest, it is the public sector. It is ironically the Chancellor's refusal to countenance radical reform here which has led to his failure to achieve his wider objectives for productivity across the economy as a whole. The latest ONS figures for productivity across the health service shows it actually falling. They estimate that between 1995 and 2003 NHS output has grown by 28% yet its inputs were up much more than this by between 32% and 39%. Any business with such a poor performance would be in deep trouble. The figures for education must be pretty bad as well because their publication has been delayed. The best way to raise productivity of these public services is by a combination of good management within the public service and good buying from outside providers. I believe there should be open contracting so that any provider, public, private, or voluntary sector, could bid to deliver publicly financed services. With the public sector such a large and growing part of the British economy we just can't afford to tolerate absolute declines in its productivity.

3. A Better Framework for Investment

We are beginning to see the shape of the big challenges we face for the future. There is the challenge of raising skills and there is the challenge of raising productivity, especially in the public sector. There is a third challenge too. We need to get the framework right for investment. This is especially true for the big infrastructure of energy, transport and water. The Government has a key role here because it ultimately sets the

regulatory regime for many of our key utilities. You could argue that the regime we set up in the 1980s was very effective for maximising the output from what was if anything the excessive amounts of investment that had been put in to some nationalised industries in the previous 20 years.

As a result of our reforms of the 1980s we gave Britain a competitive advantage by, for example, creating what was described as the world's most competitive energy market. But Dieter Helm argues that now we need a new paradigm. Now what we need is a regime that will encourage the next generation of investment that we need, not just in energy but in transport and water as well. This means that we Conservatives have to think hard about the best framework of regulation when the problem is rather different than in the 1980s. And it means the Government must recognise there needs to be a neutral framework that treats all different providers of capital fairly. But instead the Government has become a player interfering in particular decisions on the use of capital. So Ministers are as obsessed with wind farms as Don Quixote was with windmills. And there is no worse example of Ministers intervening in the regulatory framework than what has already been revealed in the Railtrack court case. What should have been impartial regulation instead appears to have become biased intervention. Picking winners, and indeed picking losers, is not the right way to get the best framework for infrastructure investment.

4. Extending European Markets for Services

I have talked about investing in human capital for the future and also about ensuring that investment markets work well. But there are product markets that need to be helped to work as well. Free trade is a vital component of our future sustainability. However, five years after the Lisbon agenda was set out, we are if anything further away from a genuine internal market in services. It was envisaged that the EU would be a free trade area for goods and services, but it is neither and we are not doing enough with our presidency to press this agenda. Pushing the EU Services Directive forward should be a particular priority. Two thirds of the EU economy, the enormous and growing services sector, is constrained by its national borders. It is absurd that the UK has a services deficit with the EU, whereas it has a surplus with the USA. If we were able to apply our international-level expertise and comparative advantages in this high value-added field to the rest of Europe it would be good for us, good for the European consumer and good for the sector as a whole.

It really should be a priority in the UK for the Government to push forward the current EU Directive to liberalise the services in the EU but they haven't done so. I believe that rescuing this Directive should be a priority of the British Presidency.

5. Free Trade Not Expensive Jeans

The situation is not so much better for goods trade. Whilst Mr Blair was quite rightly pressing an economically liberal agenda, warning that "huddling together" would lead to "failure on a grand strategic scale" to our European partners, Peter Mandelson nonetheless pandered to the fears of the French about free trade. Within a few weeks of the demise of the old Multi-Fibre Agreement, the EU reached a new supposedly voluntary agreement with the Chinese to restrict their exports of textiles to Europe. But the OECD has shown that only a tiny fraction of European unemployment can be linked to trade liberalisation. Enabling the poorest citizens in Europe to buy their jeans and t-shirts at lower prices is not a threat to the fundamentals of European civilisation. It is scandalous that once more the EU retreated into such protectionism at a cost to the European consumer. We need to have the confidence to pit our industries against Asia's industries without fear. And it is above all the interests of the consumer which should come first.

6. New Markets on the Web

There are also exciting opportunities for new markets. I am thinking here particularly of the web. When the web first emerged, it was hoped that we would be able to cut out the middle man and buy everything at wholesale prices. As it happens, the most exciting new direction for the web is the eBay model.

However, eBay is just the start of the use of this model. We should think about the capacity of the web as a forum for the exchange of all sorts of services and goods. We already have online betting and lending exchanges, where a central intermediary links backers to layers and lenders to borrowers. One of the most successful of British companies in the last year or so is an online poker exchange linking players together from across the world. The next stage in the development of this model might be the online labour exchange. People could sell their services through an auction system. Imagine that you are desperate for someone to help out with your family for a week and could visit a website where you could inspect cvs, find out who lived nearby, and check with

previous references. This has enormous potential to match available labour and unmet needs. This is a small but growing part of the web and may need some basic legal protections, set out by government, before it can really take off.

As the other overheads of some of these online models are so low, it is also more important than ever that government-imposed burdens on businesses are as small as possible. A given regulation or a small complication may impose only a slight burden on an online business, but where consumers can so easily compare costs of a wide range of providers from around the world, the market mechanism is very powerful and over-regulation will penalise our businesses more here than anywhere else.

Conclusion

Gordon Brown claims to have achieved macro-economic stability. But it should be macro-economic stability for a purpose. That purpose is to transform the supply side of the British economy. That is what Gordon Brown has failed to do and why our growth performance is once more declining. We Conservatives should once more be the Party of brave, bold, economic reform. There can never be any let up in the battle to make markets work.

David Willetts MP
26 July 2005