Trains and brains would put Britain on the right track

Richard Freeman on ways to close the productivity gap

Special report: Budget 2001

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Gordon Brown justifiably proud of his prudent stewardship of the British economy when he presented his pre-election Budget last week.

The Government's achievements are real. Inflation is negligible, thanks in part to his early delegation of responsibility for interest rates to the Bank of England and its Monetary Policy Committee. The proportion of the adult population in work is well above the EU average. Economic stability has replaced the stop-go cycles of the past 50 years.

The UK ranks among the top handful of economies in terms of how its market-friendly policies have affected economic outcomes. By most measures, it is just behind the US and way ahead of Germany or France. Its product markets are the least regulated of all the economies in the Organisation for Economic Cooperation and Development, compared with sixth place for Germany and fourteenth for France.

The Fraser Institute's index of 'economic freedom' ranks the UK in fifth place (Germany 22, France 24) and the Heritage Foundation's equivalent puts it seventh in the world (Germany 20, France 39). It is easier to form a new business in the UK than in almost any other advanced country.

You may have thought that the combination of macro-stability and 'supply side' reforms would have put the UK among the top advanced countries in productivity and standards of living. At a minimum, the reforms of the past two decades should have lifted the country in the league tables of output per head and per person. But it has not.

In 1980, before Margaret Thatcher started her programme of pro-free market reforms, the UK was ranked number 15 among advanced countries in per capita GDP. Twenty years later it was at 17. Productivity per employee and per hour are still 20-30 per cent below the US, Germany, or France. GDP per employee is 26 years behind the US, 12 years behind France, and nine years behind Germany. The UK is no longer falling behind these countries, but it has barely gained on them.

So the big economic question Brown has to face is what can be done to close the productivity gap and create an economy where living standards can rise more rapidly.

A policy that relies on still more liberation of market forces - more privatisation, more market deregulation, yet lower tax rates - is unlikely to do the trick for two reasons. First, so much has already been done in making the UK market-friendly that the return on further moves in the same direction will be increasingly marginal.

Second, more private ownership does not by itself guarantee greater economic efficiency. On average, private markets are better at allocating resources than the state, but not in all cases.

For the UK to move up the economic league tables, the next government will have to develop policies that advance beyond the now orthodox 'free market' mantra. Here are some suggestions:

•• The Government must improve the UK's infrastructure and bring the performance of public services up to world standards. Anyone who uses UK public transport knows that it is a barrier to productivity. Workers who spend hours travelling to work under appalling conditions cannot possibly be as productive as they could be with a proper public transport system.

Most UK privatisations have improved economic performance. Rail privatisation has not. Rethink this one fast, Messrs Blair and Brown. If the Tube becomes the next decade's Railtrack, we are all in big trouble.

•• Analyses of the productivity gap between British and German workers show that 20-30 per cent of it results from UK workers having lower skills. This is particularly marked in the bottom half of the skill distribution.

Measures such as literacy and numeracy hours in schools have improved primary school performance, but in the long run it will be difficult to improve education without improving the quality of teachers; and difficult to improve teachers without raising pay. Raising productivity involves more than just investing in human and physical capital. The best companies motivate and reward their workers in ways that give them a personal stake in improved performance.

Brown's Treasury has developed tax policies that encourage the granting of options or shares to workers and for them to hold those shares for extended periods. The TUC has developed a partnership strategy to help firms raise productivity, including the creation of a new Partnership Institute to consult with unionised companies and unions on ways to improve productivity. No other trade union movement has taken such a bold step. These efforts should be expanded to target companies with low productivity.

•• Historically, one of the UK's great weaknesses has been its failure to adopt and exploit new advances in science and technology, even though it has often pioneered them. While Brown was much mocked for once talking in public about 'endogenous growth theory', in fact encouraging the development and use of science is critical for a premier league economy.

In 2000, the UK Government increased public investment in the nation's science infrastructure, boosted research in key areas and gave top scientists more pay. There needs to be more targeting of public research and development support in terms of sectors or specific technologies. This targeting should be based on the economic potential of the R&D just as much as on its scientific potential.

•• The US, Canada and Australia all view immigration policy in terms of increasing the supply of skilled workers and thus increasing economic growth. The US grants visas to people in occupations in short supply. Germany is introducing a programme to bring in software engineers. Canada makes a person's occupation a key element in immigration policy. The UK should look upon its attractiveness to immigrants as a comparative advantage.

There is a triple litmus test that should be applied to policy initiatives of this kind. First, they must not put at risk what has been achieved in terms of economic stability and flexible markets, because those achievements are a necessary, though not a sufficient, condition for higher productivity.Second, they should be conceived on a large enough scale to matter in an economy the size of the UK's, but they should begin modestly and be geared up only after there is evidence that they are working. Government (and private) programmes that make a splash by starting big risk failing big. Third, they must be promoted and judged pragmatically, not ideologically. The Thatcherite legacy of 'public sector bad, private sector good' is damaging.

An economy that is in the top ranks in terms of economic stability and market freedoms has nothing to fear from well designed policy ini tiatives that seek to guide, augment or reinforce. Without such initiatives, the UK will not make it to the top of the league tables in productivity and living standards.

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