Chapter Five

The returns to inclusive growth

Chapter summary

- Renewing the UK's economic strategy will be far from easy, economically or politically. But those questioning whether the gains will be worth it, given slowing growth at the global frontier, ignore the fact that the UK is a long way from that frontier.
- Australia, Canada, France, Germany and the Netherlands are not the richest, or most equal, countries in the world and would long have been considered the UK's peers. But we're now 21 per cent poorer than them on average, dwarfing the Office for Budget Responsibility's forecast of a 4 per cent hit to our long-run productivity from Brexit.
- These countries are also more equal than the UK, such that if we reduced inequality to the levels in the comparison group it would raise incomes for the poorest fifth of the country by more than 20 per cent while reducing them for the richest in society.
- If we were able to close the gap in income and inequality it would have a transformative effect, increasing incomes by over 40 per cent among the poorest fifth of the country, and around one third for the middle, without reducing incomes at the top (indeed, they would still rise slightly).
- This demonstrates the size of the prize available. A better future for the UK does not need global growth to suddenly accelerate, or Britain to match American levels of productivity and Scandinavian levels of inequality. It just requires us to catch up with similar countries who, in the scheme of things, are not so very different to us. There is a lot to play for, especially for those on low-to-middle incomes.
- The next step is to design the policies for us to achieve a richer and fairer Britain. The second phase of The Economy 2030 Inquiry will undertake this detailed work to contribute to debates on how Britain navigates the 2020s.

This book has shown why the UK requires a renewed economic strategy for the 2020s and has begun the task of outlining what a plausible one could look like. It has grappled with some of the constraints, pressures, and trade offs that make developing a new strategy such a difficult task for any government. Given the political and economic challenges involved, some will question how achievable a material increase in growth or reduction in inequality is for a relatively small and mature economy like the UK in the 21st century. Maybe the potential gains from the effort are too small to justify the difficult political choices that it would inevitably entail: perhaps muddling through with the current approach is the best that can be done?

In this final chapter of the book, we consider these arguments and try to give a sense of the potential gains from a return to inclusive growth in the 2020s and beyond. The conclusion is that the cost of stagnation is very high indeed and the plausible prize from ending it is well worth aiming for.

Growth at the productivity frontier may slow, but the UK is not at that frontier

Economic debates about the potential for growth often start from questions of whether developments in technology have slowed, arguing that this means a period of much weaker growth is the best that can be achieved. Developments at the productivity frontier (currently the US) are of course relevant for the UK. If growth for the leader slows, in the long run the potential for growth for the laggards – including the UK – is lower too.[1]

Turning points in growth at the productivity frontier are rare and very difficult to forecast. Some well-informed observers expect US productivity growth to remain slow, consistent with the idea that over the long term it is driven by episodic major innovations, such as steam or electricity, that rarely come along.[2] Others remain optimistic and view the current digital and low-carbon transitions as precisely such an opportunity for widespread productivity gains – for them, the current lull in performance stems from the fact that we are living in the lag between technological advance and widespread adoption (an

1 J Fernald & R Inkaar, The UK productivity 'puzzle' in an international comparative perspective, The Productivity Institute, April 2022.

2 R Gordon, The Rise and Fall of American Growth: The U.S. Standard of Living since the Civil War, Princeton University Press, August 2017; J Fernald & H Li, Is slow still the new normal for GDP growth?, Federal Reserve Bank of San Francisco, June 2019; T Philippon, Additive growth, NBER Working Papers No. 29950, April 2022.

echo of the Solow paradox in the 1980s when the gains from the ICT revolution were yet to show up in statistics).[3]

Crucially, however, the UK's growth prospects over the next few decades need not hinge on which of these views is correct. Even if the potential rate of growth for those at the productivity frontier slows, the gap between the UK and those at the vanguard will still be very large indeed. As discussed in Chapter One, productivity (measured by GDP per hour) in the US, France and Germany is between 15 and 18 per cent higher than in the UK. There is an awful lot of productivity 'catch-up' for us to aim at.

The hit to incomes from Brexit is much smaller than the gap with the frontier

To put the scale of catch-up growth into perspective, consider the single issue that has dominated economic policy discussions over the past six years: Brexit. The UK's withdrawal from the EU has raised the costs of international trade with our largest trading partner. The result, as discussed in Chapter Two, will be a reduction in the levels of productivity and incomes in the UK relative to where they would otherwise have been.

This will act as a significant headwind to growth rates in the years ahead as the UK shifts to a new, poorer, steady state. The OBR estimates that once this state is reached, UK productivity will be 4 per cent lower than if the country had remained in the EU.[4] This headwind is significant and it is right that it is highlighted and debated. But it is just a quarter of the size of the 16 per cent productivity gap with those nations at the productivity frontier: even accounting for any Brexit headwinds, the potential for considerable catch-up growth remains. Just as the country faced entrenched economic challenges before Brexit occurred, there still remains a huge amount of scope for improvement in its wake.

3 E Brynjolfsson, D Rock & C Syverson, Artificial intelligence and the modern productivity paradox: A clash of expectations and statistics, NBER Working Papers No. 24001, November 2017.

4 OBR, Brexit analysis, May 2022. According to the OBR, 0.4 per cent of the 4 per cent productivity hit is related to lower EU migration (which is partially compensated for by non-EU migration to the UK). The smaller working population implies that 3.6 per cent of the productivity reduction is equivalent to a fall in GDP per capita. The OBR estimates that two-fifths of the productivity effect had already taken place by January 2021, largely driven by falls in investment due to uncertainty post-referendum.

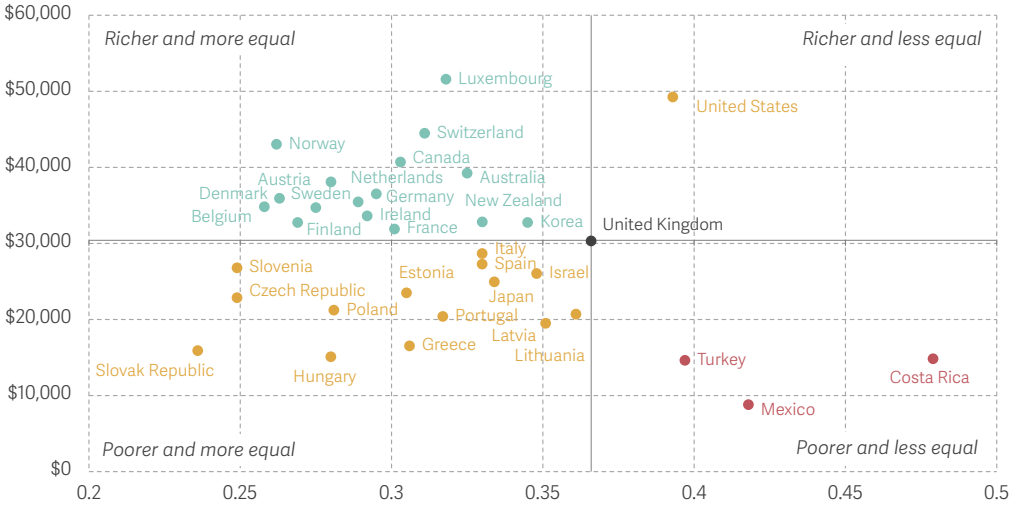
The UK is a long way from best in class on both prosperity and inequality

The other key dimension of the UK's stagnation is high inequality. As detailed in Chapter One, the gaps between places and households are large in the UK – and larger than in many comparator countries. But just as catching up with the US's productivity levels is a very tall order – Britain was last at the productivity frontier at the start of the 20th century – so too would dragging UK income inequality down to the level of Norway any time soon.[5]

Rather than focus just on the 'leading' countries when it comes to growth and equality, we can instead compare ourselves to a broader range of economies that more closely resemble the UK to gauge what the potential for improvement might be. When we do so, as Figure 36 shows, we see that the UK has average household incomes but relatively high income inequality when compared to similar advanced economies.

Figure 36: Compared to other OECD countries, the UK is relatively unequal with unexceptional average incomes

Gini coefficient and average disposable income per capita: OECD countries, 2018



Notes: Income is equivalised and PPP adjusted.
Source: OECD, Income Distribution Database.

5 A Bergeaud, G Cette & R Lecat, Productivity trends in advanced countries between 1890 and 2012, Review of Income and Wealth, September 2016.

Some countries, such as the US, have higher average incomes but much higher inequality. Others, such as Poland, have the opposite, and others still are very small (e.g. Luxembourg) or have large resource endowments (e.g. Norway), making them unhelpful benchmarks for the UK. However, there are several comparably sized countries with incomes that are both higher on average and more evenly distributed than the UK's – we focus on a set of similar comparator economies: Australia, Canada, France, Germany, and the Netherlands.

Converging towards the frontier would raise incomes for everyone, but especially those on low and middle incomes

The existence of a cluster of other countries with incomes that are both higher and more evenly distributed than the UK's suggests that there could be scope for 'catch-up' on both these fronts – that is, for the UK to move to average incomes and inequality levels more in line with the countries in the top-left of Figure 36.

These gaps with other countries are sufficiently large that success in closing them would make a very material difference to UK living standards, especially for those on low incomes. We do not even have to compare ourselves to the highest-income places (such as the US) or the most equal (such as Norway) to see just how far behind the 'frontier' on both growth and inequality the UK is.

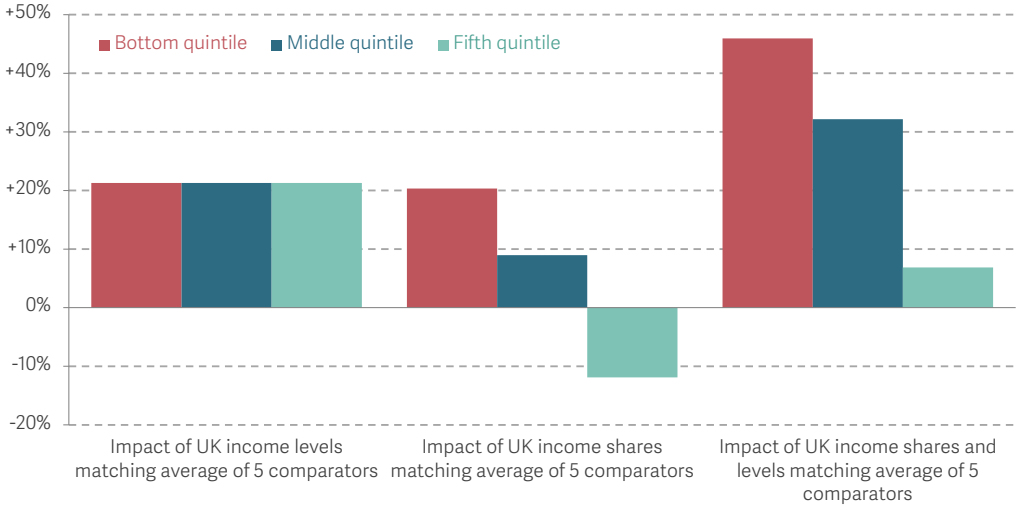
For example, there is a 21 per cent gap between average disposable incomes in the UK and our set of similar comparator economies. What closing this gap might mean for household incomes depends, among other things, on distributional outcomes. Figure 37 helps us think about this. It shows what UK convergence on the levels of inequality and incomes per capita in our comparison group of nations, both separately and together, would do for different types of UK households.[6] Raising average incomes by 21 per cent, holding inequality constant, would have the same effect across the board. And reducing inequality to the levels in the comparison group would, in isolation, raise incomes for the poorest fifth of the country by 20 per cent while reducing them for the richest in society. But combining the two impacts together – that is, closing the gap on growth and inequality – would have huge effects at the bottom and middle of the income distribution, increasing incomes by more than 40 per cent among the poorest fifth of the country, without reducing

6 This analysis extends the international comparisons shown in: A Corlett, F Odamtten & L Try, The Living Standards Audit 2022, Resolution Foundation, July 2022.

incomes at the top (indeed, they would still rise slightly).[7] This distribution of gains – bottom heavy but widely shared – is hardly without precedent. But it is unlikely to occur without a deliberate strategy.

Figure 37: Raising and equalising incomes in line with five similar countries would boost incomes in the lowest quintile by over 40 per cent

Effect on incomes of moving to the average levels of inequality and incomes in Australia, Canada, France, Germany and the Netherlands, by income quintile



Source: Analysis of OECD, Income Distribution Database.

We are not arguing that this sort of shift is easy to achieve. This is a heavily stylised example – a thought experiment – to illustrate the order of magnitude of the gains that could arise from a sustained improvement in performance on growth and inequality in the decade ahead. It will be the job of the final report in The Economy 2030 Inquiry to advance a policy agenda capable of realising at least some of these potential benefits.

What this illustration brings home is just how much difference it would make to households in Britain if we could get even part of the way towards the levels of prosperity and equality in similar countries, in the same way that Chapter One set out the costs of our recent relative decline. The potential size of the prize is enormous. To put it another way, these figures highlight what

7 The gains for the very lowest income households would be even larger than those shown here, just as the impact of making the UK as equal as the average across comparator economies would have a larger effect on the highest income households. The top 10 per cent of UK households have an income share of 29 per cent, compared to 24 per cent across the five comparator economies.

we are giving up if we continue to stagnate. They should serve to harden our resolve when confronted with the all-too-common suggestion that improved economic and social performance is just too difficult. A better future for the UK does not need global growth to suddenly accelerate, or for Britain to achieve American levels of productivity, never mind become the most equal country on earth. It just requires us to have the resolve to do what is necessary to converge with nearby countries that, in the greater scheme of things, are not so very different to us.

Towards a plausible economic strategy

This book comes at the mid-point of The Economy 2030 Inquiry, bringing together our evidence on the persistent economic problems facing the UK and how recent shocks and transitions – Brexit, Covid-19, and net zero – will play out over the 2020s. It has argued that Britain's fundamental problem (which these changes will mostly compound rather than ameliorate) is economic stagnation characterised by persistent low growth and high inequality. The risks of continuing down the current path for another decade are very real: not just in terms of further relative economic decline and faltering living standards, but also in relation to our capacity to make a success of the transition to a low-carbon future and, ultimately, the stability of our democracy.

The analysis presented here confirms the scale of the challenge but also demonstrates the difference that good policy can make. It provides confidence that the many economic challenges we face – whether longstanding or those coming down the track – are capable of being tackled and that the UK faces them with many strengths. But this will require a reset of our economic strategy. And that, in turn, demands not just a long-term commitment to new policy agendas but also a shift in governing mindset. We need to reject the tendency towards either fatalism or complacency that characterises far too much of the national conversation about Britain's economic future, and replace it with a seriousness of purpose that is all too often lacking.

This book has outlined the contours of an economic strategy that could provide a plausible route out of stagnation. The second half of The Economy 2030 Inquiry will undertake the detailed work of developing this outline into a comprehensive and integrated set of policies and institutional reforms that, taken together, add up to a new economic strategy to help guide Britain through the 2020s and beyond to a richer, fairer, and greener future.