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Brexit Britain
The poor man of Western Europe?

By Simon Tilford

CENTRE FOR EUROPEAN REFORM

Brexit Britain:
The poor man of Western Europe?

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★ The UK has economic strengths, such as a flexible labour market, which ensures that unemployment is low even in many of its economically struggling regions. But contrary to much of the received wisdom, Britain has not been one of Europe's economic stars over the last 15 years. And Brexit is set to exacerbate the economy's underlying weaknesses.

★ In terms of economic growth per head, Britain's performance has been in line with France, a country now synonymous in the UK with economic failure. The British are no richer relative to the EU-15 average than they were 15 years ago, and the average Briton has to work more hours than the EU-15 average to achieve that income.

★ Sustainable increases in living standards require economies to combine land, labour, capital and technology in ever-more efficient ways; Britain has made a poor job of this. The UK's productivity performance has been woeful, falling to just 90 per cent of the EU-15 average. This helps explain why Britons' wages have risen by much less than their French and German counterparts over the last 15 years.

★ Moreover, the UK is highly dependent on London and its environs. Apart from London, just one British region – the south-east of England – has a GDP per capita in excess of the EU-15 average, meaning that just 27 per cent of the UK population live in regions wealthier than that EU average.

★ Far from catching-up with the richer parts of the EU – as one might expect as they adopt technologies and working practices developed elsewhere – the UK's poor regions have fallen further behind.

★ Britain's problems lie mainly on the supply-side and in the structure of public spending. Three key issues stand out: poor skills among a sizeable chunk of the workforce; weak infrastructure and a lack of affordable housing; and the centralisation of political and commercial power in London.

★ Unfortunately, Brexit risks aggravating most, if not all, of these problems. And Britain's already startling regional imbalances are likely to worsen further, leaving much of the country's population living in areas considerably poorer than the EU-15 average.

★ The Conservatives will provide some fiscal stimulus to counter the weakening of growth caused by Brexit, but will not make the long-term investments in infrastructure and skills needed by the UK. They have few MPs in the poorer regions that would benefit most from such spending, while the resulting higher borrowing and/or taxation would be unpopular with their core vote in England's wealthy South.

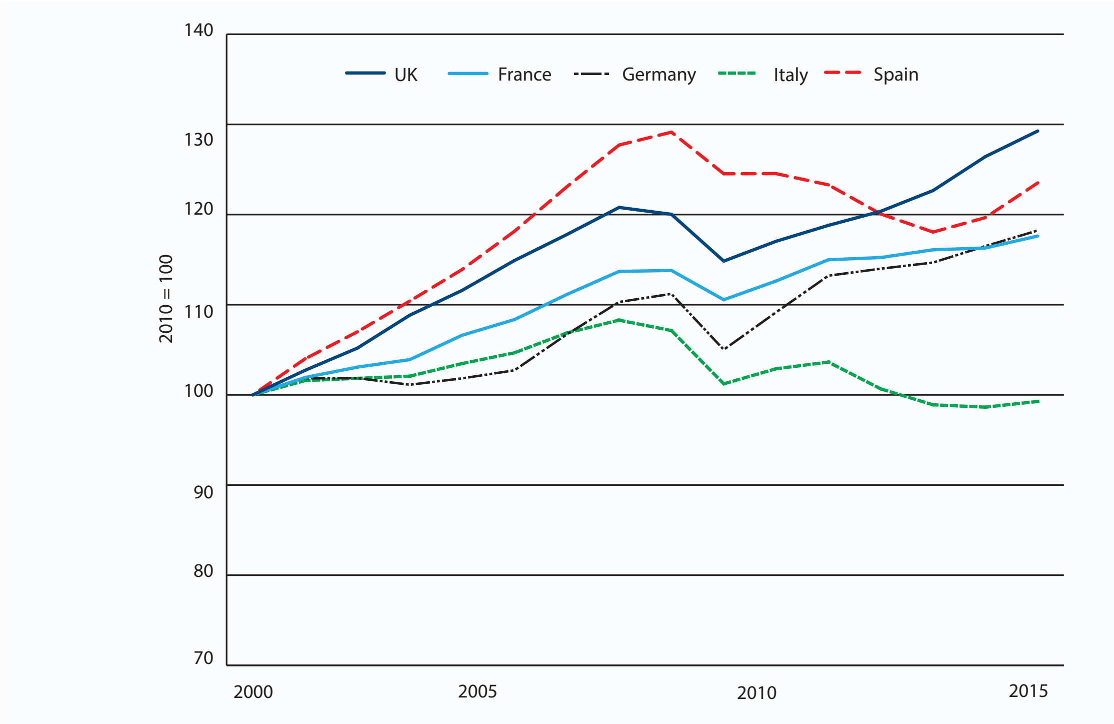
Britain: An 'average' economic performer?

An observer of Britain's Brexit campaign would be forgiven for thinking that the UK's economy had been one of the EU's star performers over the last 15 years or so. Much of the debate focussed on how EU membership was holding back the British economy. Boris Johnson, leader of the Out campaign, rarely passed up an opportunity to claim that the EU economy was the world's weak link, and that the UK's dynamic and flexible economy had little to risk from leaving it. Britain was – explicitly or implicitly – put in the same company as Germany, the Netherlands and the Nordics – reformed, flexible and dynamic. The reality is rather different. And Brexit will make matters worse.

On first inspection of the data, the UK economy does indeed appear to have performed well over the last 15 years. Growth in real GDP (that is, adjusted for inflation and calculated in Sterling), has indeed outpaced its EU-15 peers France, Germany, Italy and Spain (see Chart 1).

Chart 1:
On first inspection Britain's economic record looks good
(GDP, local currency, 2010 prices)

Source: Eurostat.



However, this measure of GDP can give a misleading picture of the supply of goods and services in one economy relative to others. To gain a more accurate picture of relative economic performance, we need a measure of GDP that adjusts for the different prices of goods and services across countries and for the impact of exchange rate movements.

This puts the UK's relative economic performance in a different light (see Chart 2). Indeed, between 2000 and 2014 UK growth lagged not only Spain and Germany, but also France, albeit only by a small margin in the last case.

But to get an even better picture of how an economy has performed we need to look at growth in GDP per capita, as this is what determines living standards (see Chart 3). And this further tarnishes the image of the UK as a strong performer. Indeed, Germany emerges as the EU-15 economy with by far the best record over the last 15 years, with the UK again lagging Spain and France. UK per capita GDP on this measure was no higher in 2014 than in 2007; a considerably worse performance than France or Germany.

Chart 2:
UK's record mediocre once adjusted for price differences
(GDP denominated in euro and deflated by purchasing power parities)

Source: Eurostat.

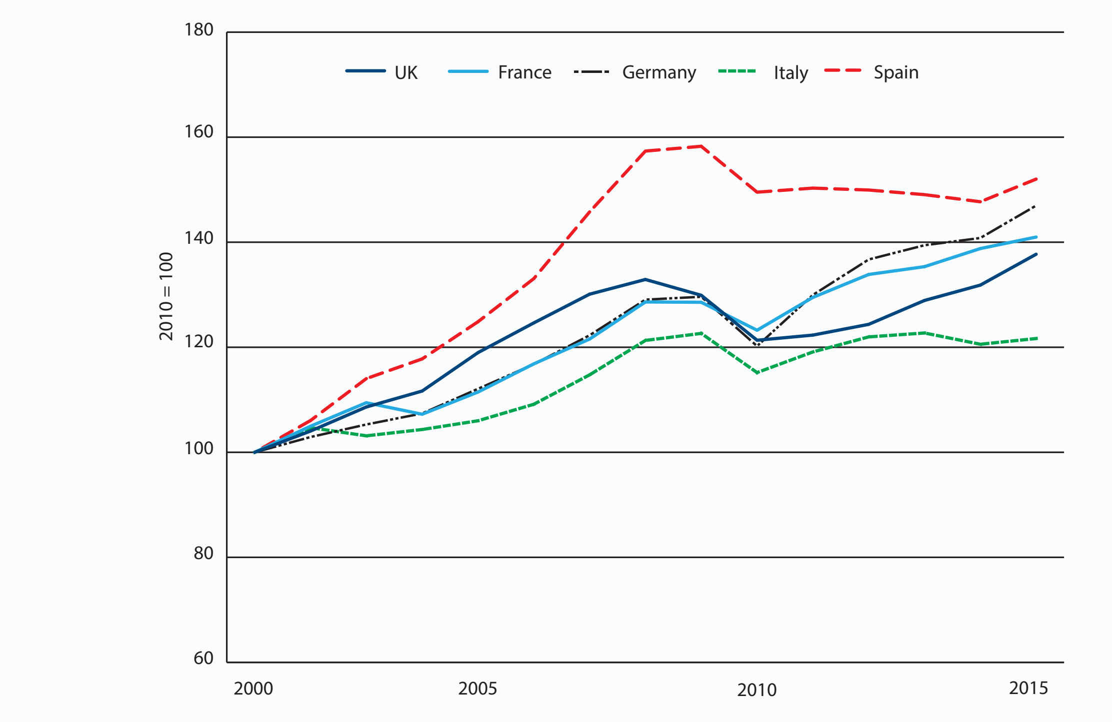
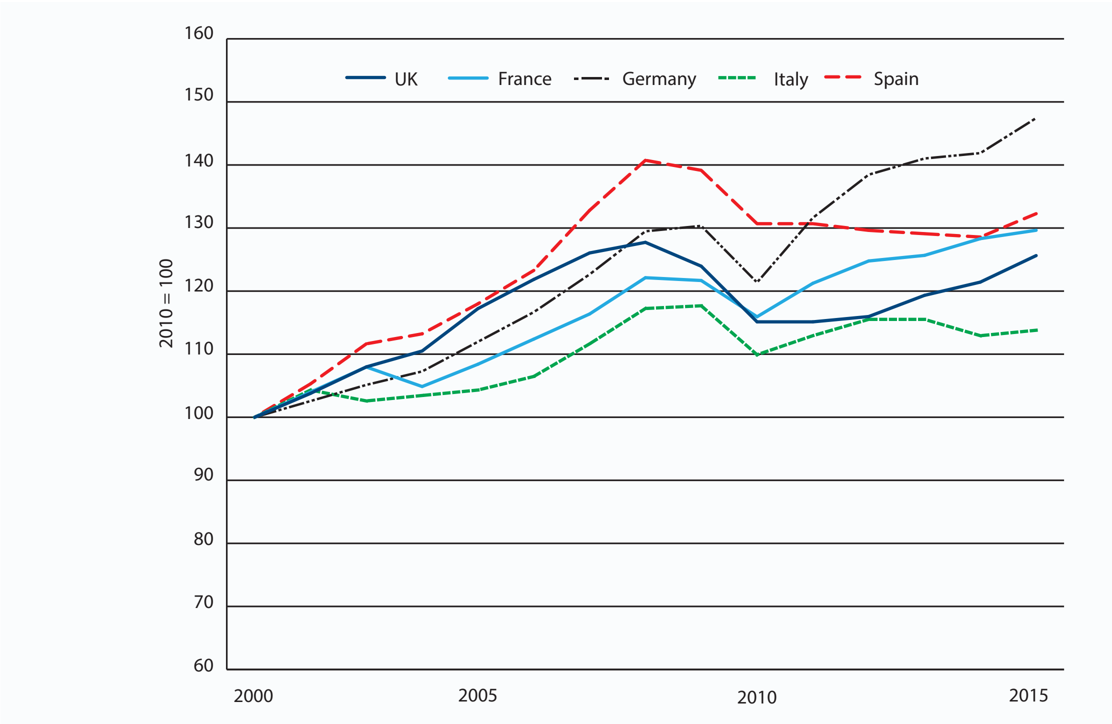


Chart 3:
Britain's growth in per capita GDP has been poor
(Denominated in euro and at purchasing power parities)

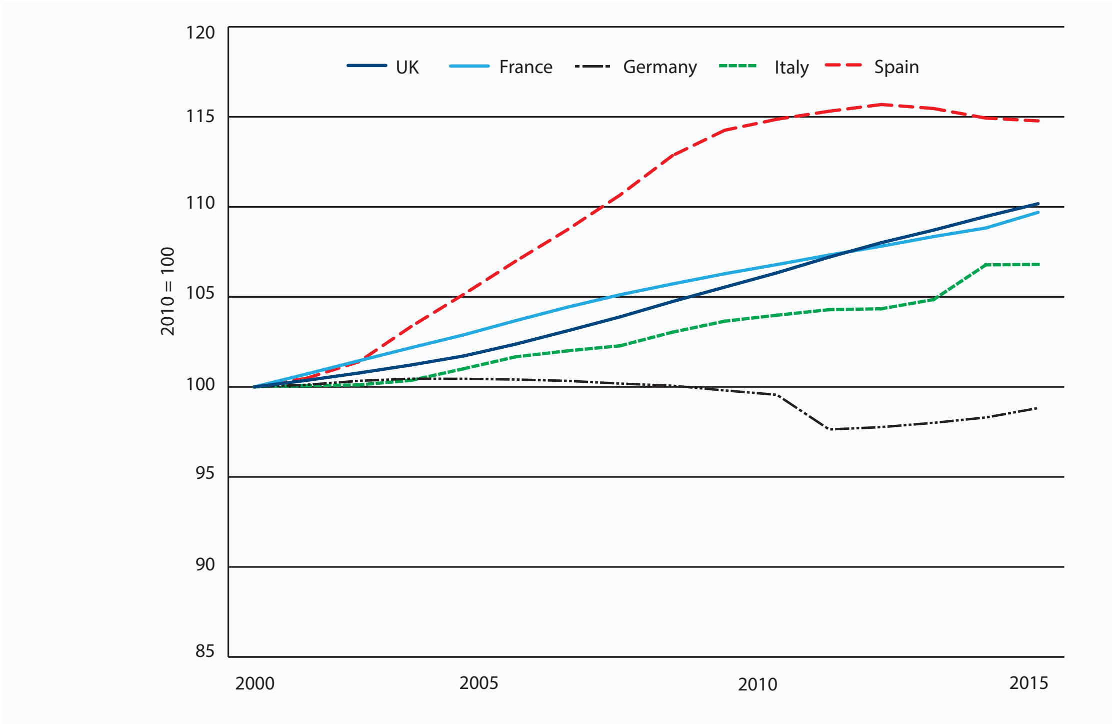
Source: Eurostat.



The sizeable gap between the growth in UK GDP and GDP per capita is accounted for by demographics: the UK's population expanded by around 10 per cent, similar to France's, but by much more than Italy's or, in particular, Germany's (see Chart 4). Different rates of population growth lead to divergent trends in working age populations, which are a major determinant of economic growth. Britain's expanded by 10 per cent between 2000 and 2015 (only Spain's grew more rapidly), whereas France's grew by 8 per cent, Italy's flat-lined and Germany's shrank by 3 per cent. Indeed, taking this into account, Germany's growth in real GDP over the last 15 years is impressive.

Chart 4:
Britain's working age population has expanded sharply
(16-65 year olds)

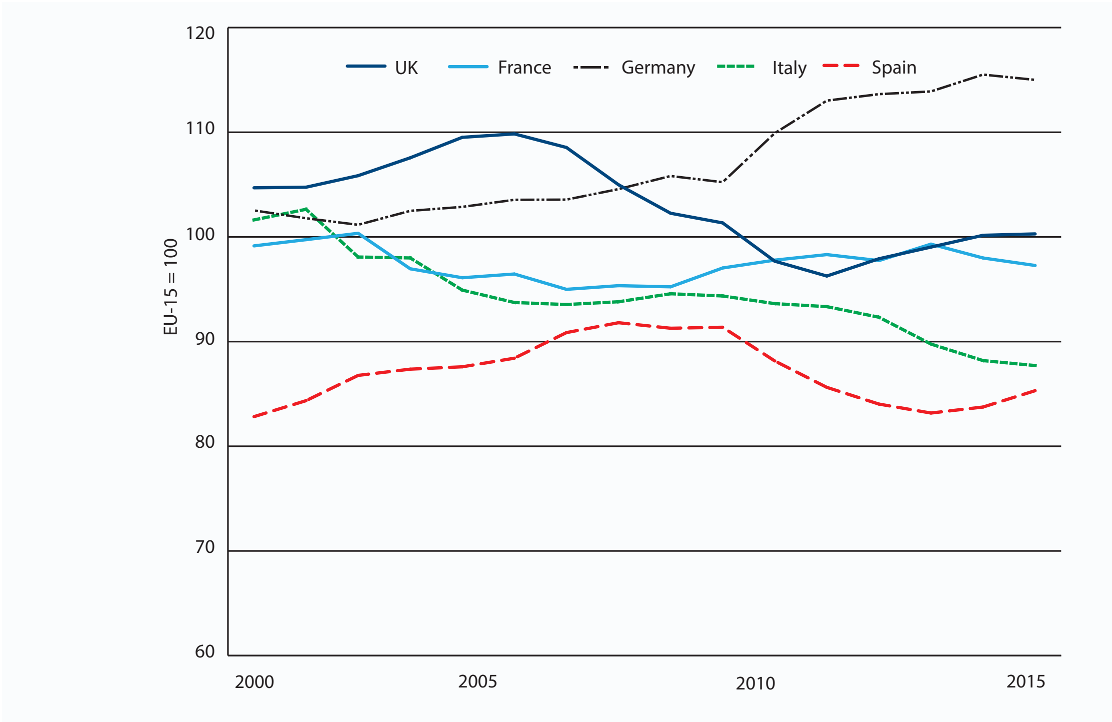
Source: Eurostat.



In summary, if we adjust for differences in living costs and take into account demographic trends, the UK's performance relative to its EU-15 peers since 2000 looks anything but impressive. Indeed, Britain is now poorer relative to the EU-15 average than it was in 2000 (see Chart 5). Its performance has been in line with France, and far worse than Germany's.

Chart 5:
Britons poorer relative to the EU-15 than in 2000
(per capita GDP, EU-15=100)

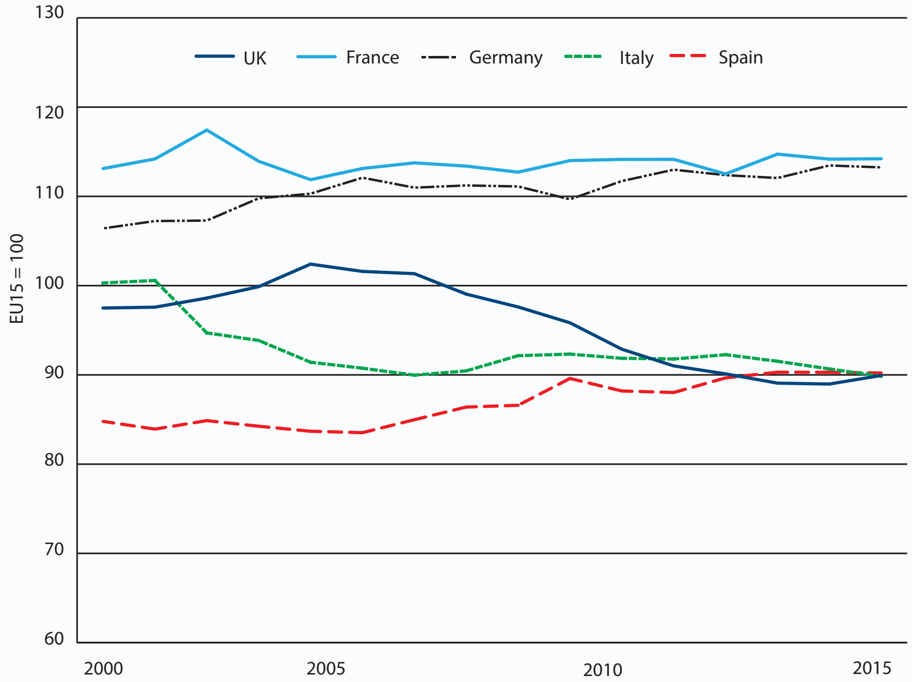
Source: Eurostat.



However, it is when we turn to productivity that the UK's status as a strong economic performer is most clearly exposed as wishful thinking. Sustainable increases in living standards require economies to combine land, labour, capital and technology in ever-more efficient ways; Britain has made a poor job of this. Britain's productivity (output per hour worked) briefly exceeded the EU-15 average in the early 2000s, but has since deteriorated continuously, standing at just 90 per cent of that average in 2015 (see Chart 6). This meant that output per hour worked in the UK was the same as in Italy and Spain, and a full 25 per cent below French and German levels.

Chart 6: Britain's awful productivity performance (GDP per hour worked, EU-15=100)

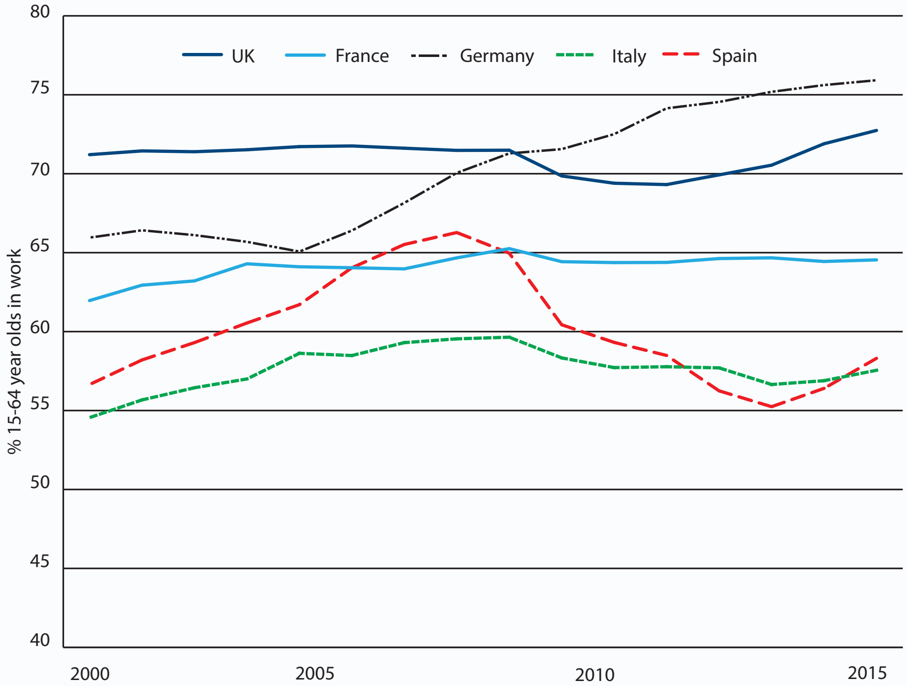
Source: Eurostat.



The discrepancy between the UK's respectable growth in GDP per capita and its awful productivity performance is accounted for by differences in employment rate (the proportion of the working age population in employment) and the number average of hours worked per employee. Britain's employment rate is far higher than France's, Italy's or Spain's, though it has been overtaken by Germany (see Chart 7). The latter, incidentally, has managed this feat while simultaneously delivering decent productivity growth, at least compared with the other four big EU-15 economies.

Chart 7: Employment rates vary widely (Proportion of 16-65 year olds in employment)

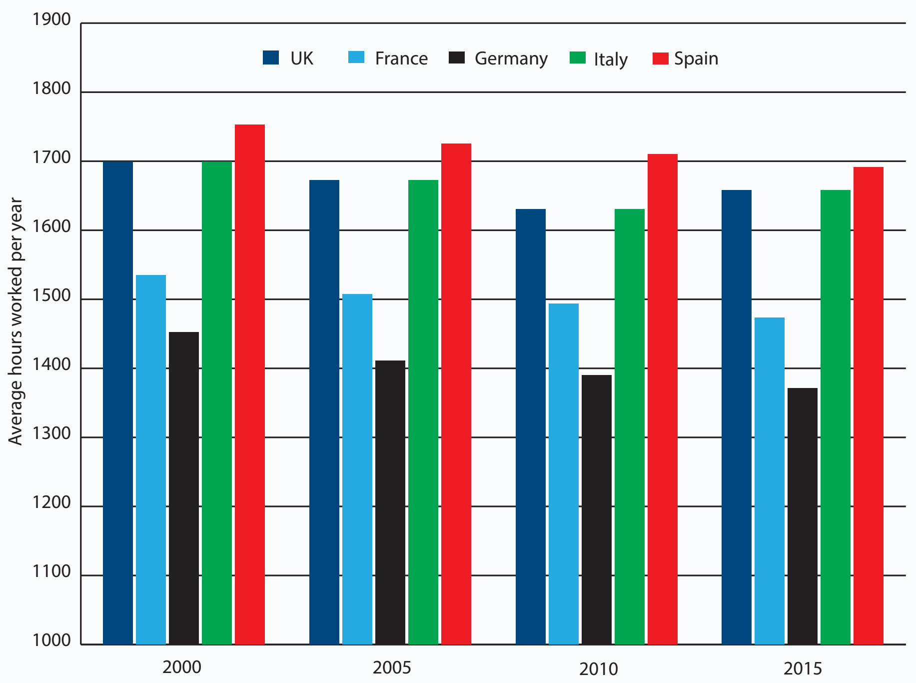
Source: Eurostat.



The British also work long hours, at least relative to the French and the Germans (see Chart 8). And whereas the average number of hours worked in France and Germany has fallen sharply over the last 15 years, this is not the case in the UK. In short, the British have to work a lot more hours to achieve a similar amount of income. So in effect their living standards are lower, unless they prefer work to play, which few people do.

Chart 8:
Britons work more hours than the French and Germans
(average per year, per employee)

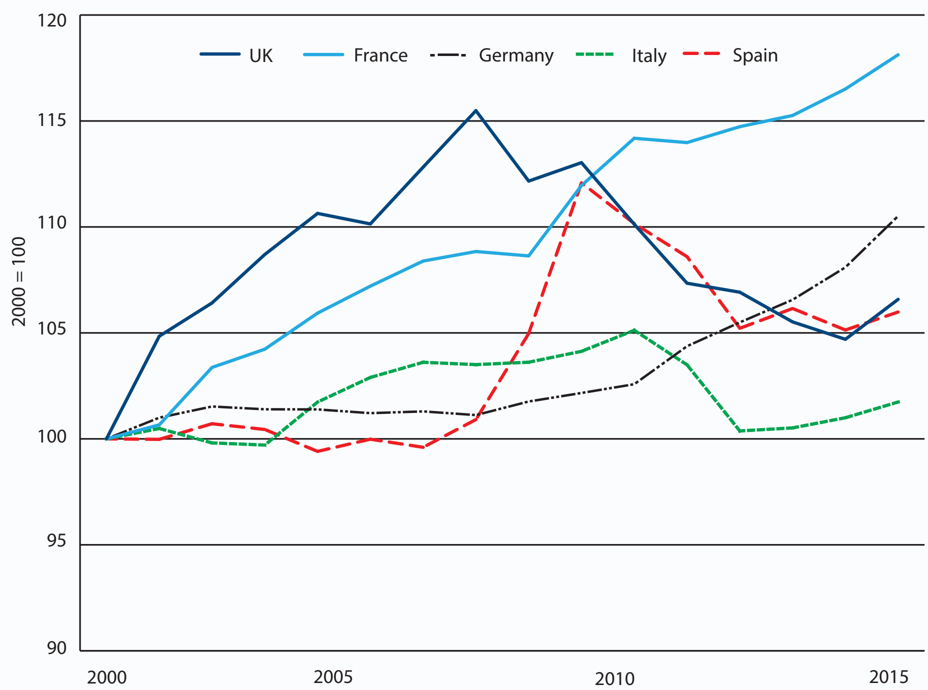
Source: Eurostat.



Not only are Britons now working more hours per week relative to their French and German counterparts than they were 15 years ago, their wages (adjusted for inflation) have risen by much less (see Chart 9). While British workers saw their earnings rise rapidly in the run to the 2007 financial crisis, they subsequently shrank by 10 per cent between 2008 and 2014. Indeed, the UK's relatively strong employment growth since the crisis must be seen in the context of stagnant productivity and big falls in real wages.

Chart 9:
British wages have lagged French and German ones
(local currency; adjust for inflation)

Source: OECD.



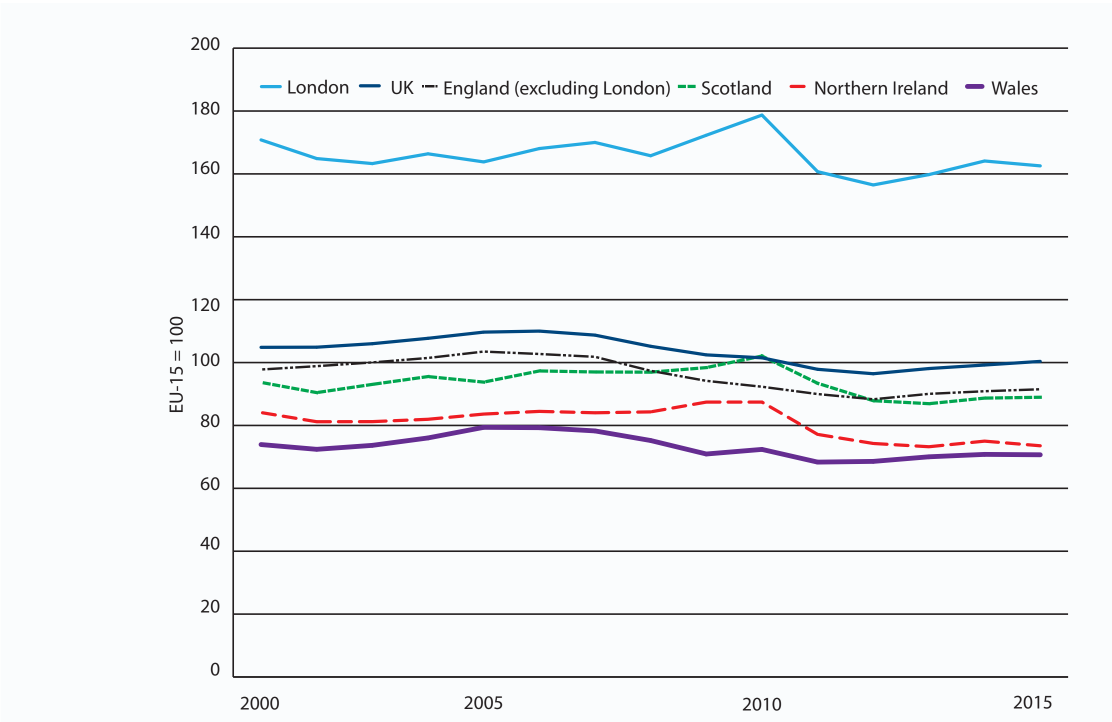
In summary, contrary to much of the received wisdom, the UK's economic performance has been mediocre in an EU-15 context over the last 15 years. The country is no richer relative to the EU-15 average than it was in 2000, and the average Briton has to work more hours than the EU-15 average to achieve that income. To an extent, the UK's dire productivity performance is the flipside of a high employment rate; by contrast, France has high productivity and a relatively low employment rate. But there is more to it than this. For example, Germany manages a higher employment rate than the UK and dramatically higher productivity. Indeed, for UK productivity to worsen relative to the EU-15 at a time when productivity across the currency union has itself been hit hard by the eurozone crisis suggests that the UK is the victim of major policy failures and/or home-grown supply-side problems.

London über alles?

Not only is the UK's performance mediocre, it is highly skewed by London and its environs. Indeed, no big EU-15 economy is as dependent on one region as the UK. Per capita GDP in London is almost two-thirds higher than the UK average, and almost 2.5 times that of Wales, the UK's poorest region. Apart from London, just one British region – the south-east of England – has a GDP per capita in excess of the EU-15 average, meaning that almost three-quarters of the UK population live in regions poorer than that average. And far from catching-up with the richer regions of the EU – as they adopt technologies and working practices developed in more successful regions – the UK's poor regions have been falling further behind (see Chart 10).

Chart 10: Britain's poorer regions have fallen further behind (GDP per capita; EU-15 = 100)

Source: Eurostat.

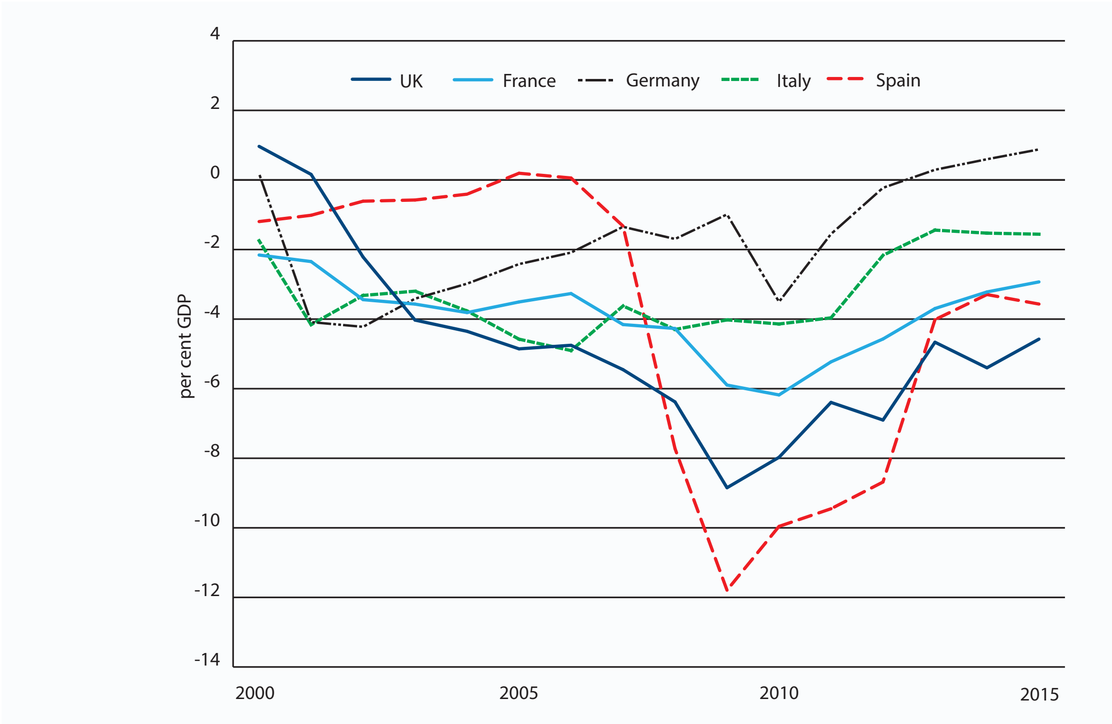


Why has the UK been at best an average performer within the EU-15 over the last 15 years? To understand this we need to look at macroeconomic policies – the fiscal and monetary policies used to ensure an adequate degree of spending in an economy – and the 'supply-side' policies needed to ensure the supply of goods and services needed to meet that demand.

The UK's poor performance does not seem to be down to poor macroeconomic policies, at least in comparison to the other countries in the study. There is little doubt that the British government overdid austerity in the 2010-12 period, but not by as much as the French, Italian or Spanish ones. Indeed despite the Conservatives' austerian rhetoric, they have adopted a relatively gradualist approach to reducing the country's structural budget deficit since 2012 (see chart 11). Nor is there any evidence that government borrowing is 'crowding out' private sector investment; interest rates are extremely low, pointing to a surfeit of savings over profitable investment opportunities. And while it is far from ideal for official interest rates to be so low for so long, not least because of the implications for the banking sector, there is little evidence that low interest rates are deterring investment, although they may be allowing uncompetitive firms to remain in business rather than go under.

Chart 11:
Rhetoric aside Britain has not been a ruthless austerian
(Government budget balances adjusted for the economic cycle, per cent GDP)

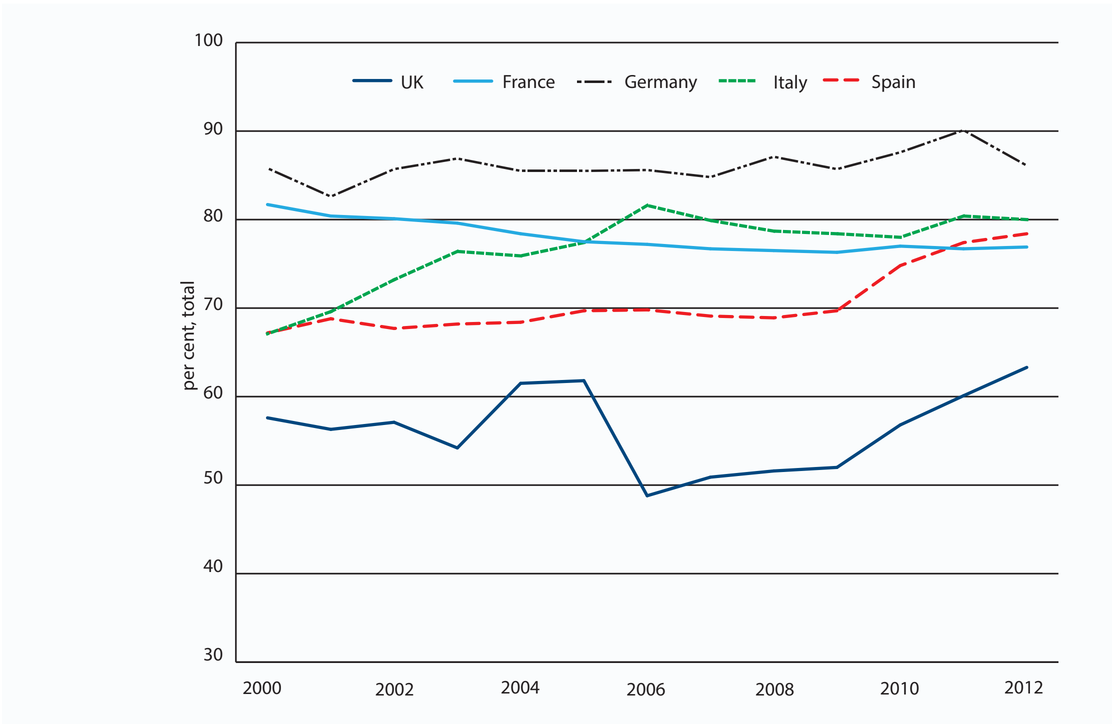
Source: Eurostat.



That leaves supply-side failures. The UK is generally perceived as a liberalised economy. And in terms of some measures of labour market flexibility, this is no doubt true: non-wage labour costs are low and it is easy to lay off workers, which together reduces the costs of taking them on in the first place. But labour market performance is about more than the freedom of firms to hire and fire workers easily; it is about skills and the efficiency of the housing market. And here the UK has some real weaknesses. For example, the proportion of British 18 year-olds in full-time education is much lower than in comparable EU-15 countries (see Chart 12).

Chart 12:
Too many British 18 year-olds are not in education*
(Per cent, total)

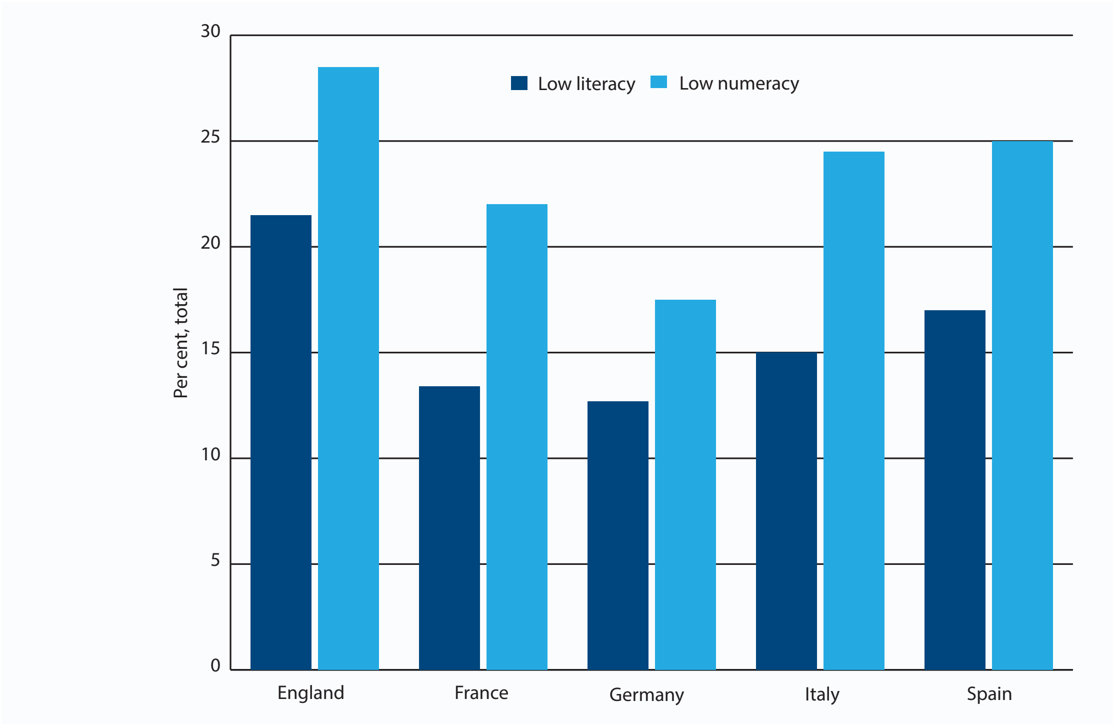
*Source: Eurostat, * 2012 latest available.*



Partly as a result of this, a much higher proportion of British 16-19 year-olds suffer from low literacy and numeracy (see Chart 13). Indeed, the striking thing about skills in the UK is that young Britons (18-24 year-olds) have similar skills to 55-65 year-olds, whereas in our comparator countries the young have better skills than the old, in the case of Italy and Spain, dramatically better.

Chart 13: Britain faces a serious skills challenge (Proportion of 18-24 year-olds)

Source: OECD.



The UK's housing system is another major factor behind its poor economic performance.[1] The supply of new housing is almost entirely unresponsive to rising demand for it; despite strong population growth and rapid price increases, the UK is building little more than half as many houses as in the 1970s. Moreover, the supply of subsidised (or social) housing has pretty much dried up, making it hard for people to move to where the work is. Successive reforms of the planning system and an enquiry into the construction sector by the competition authority have had no discernible impact on the rate of housebuilding. The UK will need radical reform of its land market to bring about real change.

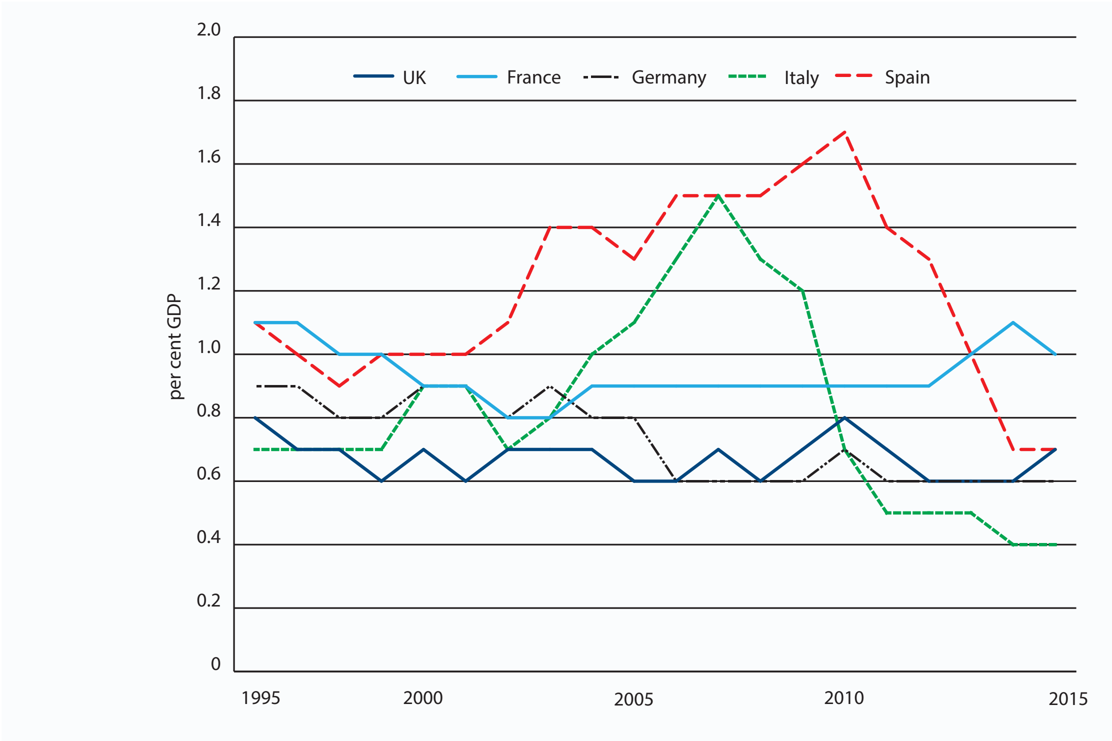
Another serious supply-side problem is Britain's physical infrastructure: road network, railways and air transport. Infrastructure can raise the productivity of labour and other inputs to the production process, raising the return on investment and boosting foreign trade.[2] It can play a major role in addressing regional disparities in productivity. The UK has persistently spent less on infrastructure than the other large EU-15 economies (see Chart 14).

Although the gap between the UK and other countries has narrowed in recent years, this reflects falling investment elsewhere rather than increasing investment in the UK. The level of infrastructure investment in the UK is especially inadequate given the years of underinvestment and the country's rapid population growth. Moreover, much of the investment that is being made is concentrated in London and the south-east.[3] While this is necessary to sustain the dynamism of this region, the UK needs to bring about big improvements in infrastructure in the rest of the country if it is to bring down the cost of doing business in its poorer areas and prevent a further increase in its already startling regional disparities.

1: Andrew J Oswald and David G Blanchflower paper, 'The dangers of high home ownership: greater unemployment', the CAGE-Chatham House Series, No. 10, October 2013.
2: Mauro Pisu, Barbara Pels and Novella Bottini, 'Improving infrastructure in the United Kingdom', OECD Economics Department working paper No. 1244, July 2015.
3: Ed Cox and Bill Davis, 'Still on the wrong track: an updated analysis of transport infrastructure spending', IPPR, June 2013.

Chart 14:
Britain has failed to invest in infrastructure
(Road, rail, air)

Source: OECD.



Two further factors help explain the UK's mediocre performance: political centralisation and corporate governance. The UK is one of the most politically centralised democracies in the world. Regions as economically diverse as the north-east of England and London are essentially run as if they have similar economic structures and face the same challenges. Scotland aside, British regions have scant scope to tailor policies to their own particular needs. A striking example of this is public sector national wage bargaining: public sector wages are little different in the north-east of England and London despite dramatically different levels of productivity and living costs in the two regions. This makes it harder for the private sector to compete with the public sector for skilled workers in the poorer areas, while the reverse is the case in London and the south-east of England.

Despite some modest reforms of corporate governance in recent years, listed British firms are still under too much pressure to maximise their short-term profitability, which can often impair their ability to create value in the long-term. For example, manufacturers can only flourish by taking a long-term view, but such long-term investment often depresses their short-term profitability. The excessive emphasis on the short-term is reinforced by executive pay being too closely linked to share performance, in particular short-term share performance. Finally, the UK is arguably too relaxed about ownership of firms: large swathes of the UK are now denuded of corporate headquarters because firms have either moved their headquarters to London or because they have been taken over by foreign firms. This deprives regions of significant numbers of well paid jobs and of corporate elites able to push for sensible regional policies.

Could Brexit force Britain to address its supply-side failures?

Britain needs a concerted drive to improve skill levels and infrastructure, especially in its poorer regions, radical reform of its housing market and further reforms to corporate governance. Ideally this would take place in the context of a constitutional settlement in the UK devolving power from Westminster to regions. Does Brexit make this more or less likely?

Brexit will weaken Britain's economic growth and tax revenues, as the UK Treasury acknowledges.[4] In the absence a change in fiscal policy and spending priorities, this suggests cuts in education spending and infrastructure (relative to where they would have been had Britain voted to stay in the EU). This will lower the UK's economy growth potential and aggravate the country's regional disparities.

Withdrawing from the EU's single market will damage Britain's trade, and as John Springford has shown this will hit the UK's poorer regions harder than its richer ones.[5] The reason for this is that the poor ones tend to rely more on trade with the EU than the richer, mainly because they are more tied into EU-wide supply chains. Less trade will also reduce the level of competition in the

4: 'The immediate impact of leaving the EU' HM Treasury, May 2016.

5: John Springford, 'Disunited Kingdom: Why Brexit endangers Britain's poorer regions', CER policy brief, April 2015

UK economy and hence the pressure on firms to boost productivity. Moreover, contrary to the claims of many British eurosceptics, there is no reason to expect Brexit will succeed in boosting trade with the rest of the world, hence compensating for the reduction in EU trade. There is also little evidence that single market membership holds back British exports to non-EU markets and no reason to expect that the UK will be more successful at negotiating free trade agreements with non-EU markets than the EU is.[6] Indeed, the UK is likely to find it harder to strike deals, as shown by the lukewarm reaction Britain has received to its tentative approaches since the Brexit vote.

The loss of unimpeded access to the EU's single market will reduce the attractiveness of the UK to foreign investors. While this will damage the growth potential of the country as a whole, it is Britain's poorer regions which have most to lose.[7] They rely more than the wealthy south of England on the skills and capital that foreign investment brings. But they are likely to find it harder to win the competition for such investment against Eastern and Southern members of the EU which in many cases have comparable (or better) skills and infrastructure and, crucially, will have unimpeded access to the EU's single market.

Could Brexit, by hitting growth and exacerbating regional disparities, force the British authorities to get serious about dealing with the country's supply-side problems? There is little doubt that a sense of abandonment and economic insecurity was a factor in the high levels of support for Brexit in the UK's poorer regions. As Brexit further saps the economic dynamism of these regions, political populism – from the left and right – could take hold.

In an attempt to address this threat, the UK government could easily double public investment in infrastructure and plough funds into improving skills, either by borrowing more (which it could very cheaply), or by increasing income and wealth taxes. But there is little to suggest that the Conservatives will embrace such a shift. They have few MPs in the poorer regions that would benefit disproportionately from such spending, while the resulting higher borrowing and/or taxation would be unpopular with their core vote in the wealthier southern regions of the country.

Successive UK governments have promised to address Britain's housing crisis, and David Cameron's government was no exception. The unfolding scale of the housing crisis may prompt the government to step up efforts to free up more land by giving local governments financial incentives to allow more house-building. But it will in all likelihood step back from radical steps such as the introduction of land taxes. Land taxes would lead to land being used more efficiently by encouraging mainly Conservative-supporting landowners and construction firms to develop land rather than sit on it (and profit from rising prices). Nor are the Conservatives likely to reverse their long-standing opposition to the building of social housing. For them, the belief that housing must be provided by the private sector is an article of faith.

A convincing case can be made for the Brexit vote being a rebellion against globalisation; and one of the most glaring symptoms of globalisation is rising inequality – symbolised by excessive board room pay and stagnant or falling real wages for much of the workforce. Unlike spending more in poorer regions or taking on the vested interests that profit from Britain's rigged property market, the Conservatives have less to lose politically from pushing through reforms of corporate governance and executive pay. Should they opt to do so, such reforms could pay dividends, at least in the medium to long-term.

Another driver behind the Brexit vote appears to have been anger at an allegedly remote and unaccountable political elite based in London. On the face of it, this should act as a catalyst for broader political decentralisation in the UK. But this is unlikely. The lesson that the Conservatives have drawn from Sottish devolution is that it encourages the creation of rival centres of power to Westminster. While the Conservatives are well-placed to dominate Westminster politics, they would fare much less well in most regional elections, not least because the latter would be likely – as in the Scottish case – to be held under proportional representation.

Conclusion: Britain's economic record was average even before Brexit

Boris Johnson is right: the EU has performed poorly for many years now. But contrary to conventional wisdom in the UK (to which Johnson subscribes) Britain has – on the most pertinent economic measures – managed to underperform even the EU. This failure is especially striking as the UK – by virtue of its decision to stay out of the euro – has been free to tailor macroeconomic policies to its particular needs: by contrast, eurozone countries must contend with a one-size-fits-all interest rate and tight limits on their freedom to use fiscal policy to stimulate their economies.

Why is there such a disjuncture between the perception of the UK as a one of Europe's star performers and the mediocre reality? It is partly because of a widespread failure to take into account the impact of population trends on economic growth. Britain's population expanded rapidly over this period, not least because of

6: Simon Tilford, John Springford and Christian Odendahl, 'The economic consequences of leaving the EU: The final report of the CER Commission on Brexit', CER report, April 2016.

7: John Springford and Simon Tilford, 'The great British trade-off: The impact of leaving the EU on the UK's trade and investment', CER policy brief, January 2014.

relatively high levels of immigration, underpinning a sizeable expansion of is working age population. More workers produce more GDP, but this tells us little about per capita income. And partly because of the flexibility of the UK labour market: unemployment is lower in the UK than in most other EU countries, and substantially lower than in France, Italy and Spain. Indeed, this has encouraged a rising number of people to move from these countries to the UK, reinforcing the perception of UK as a dynamic performer.

There is no doubting the flexibility of the UK labour market: unemployment is low even in many of its economically struggling regions. But Britain's economic growth performance – at least when adjusted for purchasing power and demographics – has been no better than the EU-15 average over the last 15 years. And the country's productivity performance has been worse than that average, falling to just 90 per cent of it in 2015, in line with Italian and Spanish levels and around 25 per cent below French and German ones. Indeed, the UK only manages to achieve a GDP per capita at around the EU-15 average by working long hours and by having a high proportion of its working age population in employment.

The origins of Britain's problems lie predominantly on the supply-side and in the structure of public spending. Three key issues stand out: poor skills levels across much of the country; inadequate infrastructure and a lack of affordable housing; and the centralisation of political and commercial power in London. Unfortunately, Brexit is likely to exaggerate most, if not all, of these problems.

There is little reason to believe that Brexit will force the British government to address the country's supply-side weaknesses. The government will no doubt provide some fiscal stimulus to counter the weakening of economic growth caused by Brexit. But it is unlikely to be the kind of long-term investment in infrastructure and skills needed by the UK, for ideological and political reasons: the Conservatives do not have enough to gain politically from doing so. Similarly, ideology and political expedience mean the Conservatives are poorly placed to confront the UK's other glaring supply-side failure: its inefficient housing market. The government will no doubt take some steps to address the short-termism encouraged by Britain's system of corporate governance. But it will shy away from political devolution that brings an end to the one-size-fits-all labour, tax and industrial policies that have contributed to such a concentration of commercial activity in London.

The result is that the UK economy is likely to remain at best a mediocre performer in EU-15 context, notwithstanding the challenges faced by the eurozone. And Britain's already startling regional imbalances look set to worsen further, leaving much of the country's population living in areas considerably poorer than the EU-15 average.

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