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TIME FOR A PLAN C?

SLOW GROWTH AND LIVING STANDARDS

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Time for a Plan C?

In October 2010 the Chancellor, George Osborne, presented what we might want to think of as 'Plan A'; the government's Spending Review, which fixed budgets for each government department up to 2014/15.[1]

The review announced an £81 billion cut in public spending in the remaining years of this parliament, with average departmental cuts of 19%.

Since the start of the spending review period there have been numerous calls for a 'Plan B'. This included a letter published in October 2011 and signed by 100 economists, which argued:

> "It is now clear that plan A isn't working… We urge the government to adopt emergency and commonsense measures for a Plan B that can quickly save jobs and create new ones. A recovery plan could include reversing cuts to protect jobs in the public sector, directing quantitative easing to a green new deal to create thousands of new jobs, increasing benefits to put money into the pockets of those on lower and middle incomes and thus increase aggregate demand."[2]

Since then in its annual green budget, the IFS Green Budget warned that however painful cuts had been to date, they amount to less than a tenth of what is planned by the 2016/17 fiscal year and that 88% of the cuts to benefits and 94% of the cuts to current public spending are still to come.[3]

Most recently data from the Office for National Statistics (ONS) showed the economy shrank by 0.2% in the first quarter of 2012 putting the UK into recession.

With increasing commodity prices, an ageing population, and an on-going crisis across the Eurozone affecting exports many now believe the UK should not expect to return to an economy growing consistently at faster than 2% a year for the foreseeable future.

The Plan C challenge is for policy makers, opinions formers and ordinary citizens to examine how we would cope, and even thrive, with long term slow growth. How can we adapt to a period of low growth very different from the era of high growth that we have recently experienced? Is there any way in which we can plug this gap? What can we do differently and are there are new things we should be doing?

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It is not difficult to list the problems arising from slow growth ranging from high unemployment to falling living standards and declining public service entitlements. Slow growth will mean more hard choices about public service and welfare entitlements. Faced with further retrenchment, will it be possible through public service reform to protect the most vulnerable and universal service standards and if so how?

Does slow growth require a more profound shift in policy, expectations and culture?

Might it even be possible for some things about our economy, society and culture to improve despite (or even because of) slow growth? This paper forms part of the RSA collection – Time for Plan C? – which will explore the implications of, and responses to, slow growth from the perspective of a highly respected and influential set of thinkers.

- **Paul Johnson**, Director of the Institute for Fiscal Studies on what will slow growth mean for fiscal policy.
- **Gavin Kelly**, Director of the Resolution Foundation on the implications of slow growth for living standards.
- Journalist **Deborah Orr** on the values that will get us through a sustained period of low growth.
- Economist **Vicky Pryce** on the implications of slow growth for the overall shape of the economy and particularly regional economies.
- **Nick Seddon**, Deputy Director of Reform on the implication of slow growth for public service reform.
- **Julian Thompson**, Director of Enterprise at the RSA on how we need to change the way we see the relationship between human capital and economic recovery.

Slow growth and living standards

There is an increasingly rich intellectual debate about the risks, or for some the reality, of an extended period of low growth; a so called great stagnation. Some provide technologically anchored accounts of problems in advanced economies that highlight the role of a decline in the pace of innovation (Cowen 2011).[4] In contrast others claim that the real threat we face is an acceleration of technological change (Brynjolfsson and McAfee, 2011).[5] Another argument, made in popular vernacular, points the finger at the rise of intense competition from emerging markets (Friedman, 2011). Above all there are highly influential accounts from macroeconomics that focus on the growth-sapping consequences of high levels of private debt which could bear down on living standards for years to come as households strain to strengthen their balance sheets (Reinhart and Rogoff, 2009).[6]

But, for all this intellectual ferment, there is, alas, only a stunted discussion about what we can do to overcome this challenge, and even less of one about the likely distributional consequences. If we do face a prolonged stagnation – and it's still far from clear that we will – then any so-called Plan C certainly does not come pre-cooked.

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8%

by 2015

What is in store?

We can start by tracing the immediate prospects for low to middle income households (broadly defined as those in work in the bottom half of the income distribution): even if the Office of Budgetary Regulation (OBR) assumptions for growth are met, disposable household income for this large swathe of Britain is set to fall 8% by 2015 (from just under £22,000 in 2007-08 to just over £20,000).[7]

To get a sense of what could happen to living standards over the next parliament the best we can do is draw on different periods from our recent past as alternative guides to the future. A nice scenario, based on the strong growth in household income experienced during the first half of Labour's period in office (until 2003), would see low to middle income households regaining the living standards they reached in 2007-08 by 2020. A nasty scenario would see low to middle income households not really sharing in rising prosperity, reflecting the wage stagnation that occurred between 2003 and 2008, leaving disposable household income at around £20,000 in 2020, much the same as it was in 2001. And just to repeat: both these scenarios are premised upon the OBR's assumptions for GDP growth until 2016 (with growth at 2.7% in 2014, and 3% in 2015 and 2016). These were made before the recent return to recession. Of course, it's possible things could turn out better than this. Sooner or later forecasters who have been too cheery will end up being too gloomy. Inflation might, for instance, fall more sharply than expected though that doesn't currently look likely. Certainly, no one should rely on this.

Sources of rising living standards

Before we can think about how to improve living standards, or at least how best to protect them, during an extended period of low growth, we first need to understand the relationship between economic growth and rising prosperity, and critically how this link may have changed over recent years.

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Economics textbooks show that in the long run rising living standards are driven by growth, with higher productivity ultimately feeding through into higher wages. At a macroeconomic level this explanation generally holds true. However, this grand narrative tells us little about how the fruits of growth are distributed. For any given household there are not many sources of higher living standards: hourly real wages (and productivity) could rise; people could work longer hours; employment levels could increase; and the state could to do more to lift living standards (among low and middle income households). In a prolonged period of low growth these four motors of living standards – already under threat or in retreat – are likely to head further in the wrong direction.

First, changes to the tax and benefit system – which played such a vital role in propping up living standards over recent years when wages have been flat or falling – will compound the problems faced by low and middle income households in the period ahead. Sharp reductions in tax credits are set to grow, and support in-kind through spending on education, healthcare and other public services will not play the role it previously has. And that is all before we get to the next Spending Review.

Second, the immediate outlook for wages is hardly encouraging. Real wage increases for the ordinary worker are not expected until 2013/14, and earnings growth will almost certainly be more muted in the lower parts of the pay spectrum. Moreover, we can no longer even assume that strong GDP growth would feed through to workers in the form of higher wages. In the five years before the 2008-09 recession the UK economy grew by roughly 10% yet median wages flat-lined. The question is whether this weakening in the link between growth and wage gain is set to become the new normal.

Third, it is hard to predict what will happen to *hours worked* especially for low earners. In the UK 1.9 million people want to increase their hours, the highest figure since records began in 1992.[8] Low growth and resulting slack demand for labour will hit vulnerable parts of the jobs market hardest. And past evidence suggests that it is higher earners who tend to work longer hours.

Fourth, over the short term the outlook for employment remains bleak despite the recent overall improvement. Looking to the longer term we need to consider structural trends. The rise of women in the workforce over the last 40 years – with participation rates rising from 59 to 74% of working age women – has been a powerful force propelling the rising prosperity of low to middle income households, but this has plateaued in recent years. Meanwhile over the last 40 years male participation rates have fallen from

95 to 83% (most of the decline took place in the 1970s and 1980s). More recently, earnings from male employment in the typical low and middle-income household fell by £610 between 2002-08 (by £600).[9]

Underpinning these trends in wages and employment in the UK (along with a number of other advanced economies) is the fact that the labour market has become more polarised; as the phrase goes we have more lovely jobs, more lousy jobs and fewer in between. The leading explanation for this phenomenon is that new technologies are very good at replacing repetitive 'routine' tasks but are not very good at replacing 'non-routine' tasks.[10] Available UK employment forecasts to 2020, however imperfect, suggest that this trend will continue, with the UK losing 400,000 skilled and semi-skilled jobs, whilst gaining two million high-skilled white-collar jobs and 400,000 further very low-skilled jobs.[11] And we need to add to this outlook an understanding of how trends in global trade could amplify technological change and impact on the UK jobs market. For instance, some think the exponential growth of high-skill service sectors in emerging markets, together with advances in ICT, could potentially expose many previously sheltered service sector jobs to harsh competition.[12]

So there are grounds for questioning whether even in good times, our established pattern of economic growth is sufficient to deliver steadily rising living standards for low to middle income households. All of which only serves to ratchet up the challenge faced if growth falls short of current projections.

A 'plan C' for living standards?

The first and most important thing to say – and repeat – is that we need to do everything possible, particularly in terms of active macro-economic policy, to minimise the chances of prolonged stagnation. Not just because of the immediate consequences of another recession, but because short and medium term loss of output and employment will also have adverse long-term consequences for both the economy and society. The default setting of our economy is for low or no growth to result in entrenched hardship, with those on low to middle incomes bearing the brunt of the pain. And, low or no growth *overall* in the economy means that some communities and sectors will actually experience permanent recession.

There are, however, steps we can take to help deliver rising living standards for low to middle income households; if we find ourselves in a low growth environment then it will inevitably force new issues and approaches onto the agenda, shifting the balance of risk between action and inaction, and possibly necessitating short-term measures to minimise the difficulties facing households.

Tackling fair pay

We may need to think about how we address low pay differently. Periods in which living standards rise steadily for all groups seem to also be those when concerns about overall inequality diminish. When living standards flat-line it is sometimes asserted that people care more about relativities. Hence the outburst of public and media interest in runaway rewards at the top has sparked hopes among those who campaign on inequality that there will be a wider public awakening about differentials in income, and in particular pay. As yet these hopes have not been borne out: there is little evidence that public outrage over high pay is trickling down into that on low pay too.

The UK's recent track record on the national minimum wage has been a tale of cautious success. 'Success' because the approach has resulted in major increases in low pay, been driven by evidence and avoided pretty much all of the negative consequences that were widely predicted by many commentators, the business community and some politicians only a decade or so ago. 'Cautious' because the initial national minimum wage was set at a pretty low level, and the key question asked of any subsequent proposed rise has been whether is it likely to cause adverse employment problems in any sector or any region. The forward march of progress on pay has, perhaps understandably, proceeded at the pace of the slowest. Over recent years the minimum wage has fallen to the level it was at in 2004 once inflation is taken into account.[13]

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A prolonged era of low growth would mean strong business pressure to avoid real terms increases in the national minimum wage at the same time as those on low wages will be even more in need of support; not least the five million employees paid more than the legal minimum but less than the living wage. Moreover, if the economy continues to be characterised by relatively high levels of corporate profitability and weak consumption then in some sectors at least a higher wage may seem desirable. Making progress in difficult times may, however, require us to consider new approaches to raising low pay: less cautious, but more targeted.

Different options can be considered. To achieve an increase whilst minimising the employment risks some have proposed varying the minimum wage by age, sector or region.[14] All of these would be problematic, which is why they have not been adopted hitherto, but they at least merit debate. A potentially fruitful approach is for the Low Pay Commission to use its authority to establish non-binding pay norms for the level of wage that each sector could bear. At the moment the only pay benchmarks we have are blunt: a one size fits all legal minimum and a living wage which is set without regard to what employers in a given sector might be able to pay. It's also the case that new research has shown us that the living wage looks affordable in some important sectors, even if it is more challenging in others.[15] Overall, low growth, together with declining tax credits, might push us towards a more differentiated, but still concerted, plan for raising low pay.

Supporting and spreading employment

We may also need to think differently, and a bit more creatively, about the distribution of work across different households, which, of course, matters greatly to living standards. Boosting employment in low to middle income households should anyway be a long-term priority, but will be particularly important if we face prolonged stagnation.

While the pattern of employment and how it varies in difficult economic circumstances is affected by all manner of factors, policy choices are directly relevant. It is, for instance, absolutely clear that youth unemployment is a deeply entrenched problem that will not go away without aggressive policy action.[16] And we know the recent recession was less harsh than many expected not just in terms of job loss, but also in terms of the creation of workless households compared to the 1990s downturn.

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It seems likely that a factor in this was the nature of tax and benefit reforms over the last decade which made it far more worthwhile for a previously dual earning household to keep a single earner in work if their partner becomes unemployed (Harkness and Evans, 2011).

We need to ensure that our welfare system and the move to Universal Credit encourages work (including for second earners) at the same as we look to our public services to play a more central role in supporting living standards. In an era of stagnant growth the social wage may have to contribute more directly to enhancing the economic wage. Those public services that should come to the front of the queue for any available resources (even if funded by deeper cuts elsewhere), as well as for reform, would be those that can play a direct role in boosting employment levels. Childcare is an obvious case. Despite all the progress we have made over decades, female employment in the UK ranks just fifteenth in the OECD, behind Slovenia, and second earners in the UK face some of the highest effective tax rates in the world. Comparing our performance to the best performing countries, almost a million women are missing from our workforce.[17] Addressing this deficit will involve many things, for instance further bending corporate culture towards quality part-time jobs.[18] But it will need a large-scale expansion in, and reform of, childcare provision, not least so it fits with the hours that people actually work.[19]

Beyond public services and the welfare system, however, we have far less experience of governments intervening directly trying to encourage particular working patterns (though the right to request flexible working is an important exception). In a world of flat growth, and resulting highly fragile jobs market, we may have to think about measures that can help tilt the labour market towards sustaining a high, and more progressive distribution of, employment than would otherwise be the case. The recent German experience of the *Kurzarbeit* programme is an interesting case in point. It entailed a concerted effort by the government to encourage firms to cut hours worked by employees rather than jobs by offering tax incentives for firms and topping up the pay of workers to partially compensate them for wages forgone. It seems to be one of the reasons why the German economy performed so well – the success of the policy has been 'astounding' in the words of the IMF – in terms of avoiding job losses given sharp falls in GDP. There has been a recent policy discussion in the US, which already has 22 state level programmes to encourage work sharing, on whether such an approach could help protect jobs there.[20]

The point is not that work-sharing arrangements create new jobs. They won't. Nor is it that there is a fixed lump of labour; clearly there is not. It is that over the short to medium term these approaches might just help minimise the risk of employees falling out of work into long-term unemployment, and maximise the attachment of workers to the labour market. The aim is a better distribution of the pain of adjustment to weak demand, with fewer long-term casualties. In the UK we have generally been reluctant to think about encouraging this sort of thing, though there have been plenty of localised examples of it happening at a firm level. If low growth and a deteriorating labour market were to take hold over the medium term then policy makers might need to rethink this.

Sharing the pain

Who pays for the cost of fiscal adjustment in an era of stagnant growth is currently a key issue in the UK; one which is set to grow if stagnation persists, and with it our fiscal problems. One of the lessons of the Japanese lost decade(s) was the way in which generational politics can aggravate underlying macroeconomic and fiscal problems: in short, and to simplify a bit, the older generation's political power resulted in the younger generation paying a disproportionate price.[21] In the UK we are seeing sharp reductions in the housing, educational and welfare position of many young people and families with young children, at the same time as the tax structure and benefits that disproportionately benefit affluent baby boomers are being vigorously and successfully protected. The March 2012 Budget will stand out as the moment when fiscal austerity first hit the older generation in the form of a stealthy move against pensioners' personal tax allowances, but the coalition was unwilling to make a principled argument for this, preferring to present it in the technocratic language of tax simplification. The handling of this is likely to have made it harder to start the desperately needed debate about how to achieve a fairer distribution of the pain of adjustment across generations. No political party has yet directly challenged the generational settlement and there are, of course, very obvious risks to doing so. But a fairer adjustment to a period of low growth would demand exactly this, and sooner or later this generational debate will become more central to our mainstream politics.[22]

A housing policy fit for difficult times

There are many faults with the UK housing market, and a prolonged period of low growth could provide new impetus for rethinking flawed assumptions. It is an area of UK policy which both helped cause some of our current problems, and which can have a particularly large bearing on living standards given how high housing costs are in relation to disposable incomes. Two issues stand out: one an opportunity, the other a lurking iceberg.

The *opportunity* is to shift the debate on tenure.[23] It is of course crucial to increase housing supply for owner-occupation. But we should not neglect the rental market. So long as disposable incomes are under pressure, the mortgage market remains tight, and supply restricted, then we can expect an extended period of high prices and fast growing numbers of working households unable to buy, at the same time as they have no prospect of entering social housing. Currently there is a policy desert on this pressing social and political problem. Those relying on the rented sector face a buy-to-let market characterised by inadequate supply, insecure tenancies, and amateur management. Given that we are not going to see any large-scale public investment to expand social housing it is imperative that we attract in private capital to increase rental supply by finding a deal which both benefits tenants and offers stable, long-term returns to investors.[24] At the moment the Whitehall response to this pressing problem is somewhere between indifferent and lethargic.

The risk we face concerns whether or not households can run down their debts – including housing debt – in an orderly and sustainable manner. If we find ourselves in a position where household incomes

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gently climb in the years ahead as the squeeze eases, and interest rates only rise incrementally, then it is possible – just – to foresee a manageable adjustment in which high levels of household debt relative to income are gradually reduced. But if household incomes continue to fall or stagnate then mortgage repayments could become a dramatically bigger issue than they have so far, especially when interest rates eventually rise. Over recent years repossessions have remained very low not just because of record low interest rates but also due to the growth in the number of agreements (known as forbearance) that have been struck between mortgagors and their bank, which allows repayments to be rescheduled. Forbearance usefully buys time; it does not however solve the underlying problem. It is estimated that 5% to 8% of mortgages are subject to forbearance, suggesting there may be a large pent-up problem in the future.[25] A prolonged period of stagnation may force us to think again about how we best manage debt and mortgage distress in an orderly way that avoids triggering a rash of repossessions.

Conclusion

As well as taking action to ensure a fairer adjustment to a potential era of slow growth we also need to avoid making some major mistakes. Prolonged stagnation could easily spark greater pressures for a more restrictive approach to immigration than we currently have. This risks shutting out key workers who can help increase productivity or holding back vital sectors like higher education, which we need to thrive. We could also see a backlash against one of the positive developments of recent years: the growing number of older workers (which should be further spurred by the Coalition's commendable decision to abolish the default retirement age). If we are to make a successful adjustment to becoming an ageing society over the next few decades, without today's younger generation being hit disproportionately, this is exactly the sort of trend we need to be supporting. And there are crucial long-term investments that must be sustained if we are to emerge from this difficult decade in a strong position for the future: from early years education to big infrastructure investment we must avoid cutting those things that will lift our productive potential.

Just as the crisis has turned upside down conventional thinking on macro policy, the same may have to go for other elements of our policy discourse if we have to navigate our way through what could be a stagnant post-crisis decade whilst minimising the social fall out. As things stand we are a long away from being prepared for this. For all the frothy talk about reforming capitalism, today's political orthodoxy is not that malleable to some of the challenges that prolonged stagnation would pose. The prevailing view is still to be very cautious in our efforts to tackle low wages or the distribution of employment. It persists in lionising a model of housing policy that still has its roots in the bubble years. It focuses our policy thinking (or at least rhetoric) overwhelmingly on supporting sectors like manufacturing rather than the opportunities (and threats) facing our service sector. It protects at all costs affluent baby boomers from the pain of fiscal adjustment leaving the young and families to take the strain. If we really do find ourselves in need of a plan C. Then these, along with many other assumptions, will need to be turned on their head.

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