Budget 2017: productivity is the focus, but 'fixes' are unlikely to be enough

Budget 2017 began with a bleak assessment of the UK's growth prospects. For those of us following the economic trends and policy debate, there was little surprise at the downgrade of future productivity growth by the Office for Budget Responsibility. Productivity has flat-lined since the financial crisis as successive budgets have failed to have much discernible effect on the key issues of underinvestment in innovation, skills and infrastructure. This has long been a concern because without productivity growth, living standards will continue to suffer and public services will continue to be squeezed.

In addition, there is the uncertainty surrounding Brexit, which has already had a damaging impact on living standards, and which poses a number of economic risks depending on the form it ultimately takes. Some of the costs of Brexit are short-term – for example, the costs of formulating new customs or regulatory arrangements (for which the Chancellor has put aside a further £3 billion), or the losses of trade that would be associated with increasing trade barriers. But from a productivity perspective, we must be mindful of the longer-term impacts of reduced trade, inward investment and access to international talent.

The current parliamentary arithmetic implies that the Chancellor's ability to do something really ground-breaking in this area is politically constrained. But there is a danger of missing the opportunity to make a real difference to productivity at a time when the country needs it more than ever. While Budget 2017 contained a number of promising policies, these 'fixes' are unlikely to be enough to address the underlying problem.

Innovation and business policies

There were a number of policies to support high growth businesses and innovation. The Chancellor announced that he would extend the National Productivity Investment Fund by adding another year to the programme. He also announced a rise in publicly financed research and development (R&D) as pledged in the Conservatives' election manifesto. Another encouraging sign was the increase in R&D tax credits, which research shows are effective at raising R&D and innovation. In addition, there were some policies to help high growth potential firms access finance, including a new fund in the British Business Bank, and increasing incentives in the Enterprise Investment Scheme. But much more can be done to address financial constraints on business growth, including more efforts to open up alternative sources of finance, reduce the debt bias in UK firms and increase competition in the banking sector in general.

While the Chancellor talked about high growth firms, there was little mention of policies to raise the performance of low productivity sectors and the long tail of unproductive firms that we know are a major drag on national productivity. In these cases, policies to encourage the adoption and diffusion of existing technologies, management practices and exporting capabilities are needed, and this could involve additional tax incentives or policies to remove information barriers. The Chancellor decided not to move the VAT threshold for small businesses, despite it being high by international standards – a decision that is most likely to have been motivated by political considerations. As he himself highlighted, there is evidence that these types of thresholds can reduce incentives for firm growth.

Education and skills

Budget 2017 contained some new support for further education, and increased funding for maths and computer science in schools. But the UK's skills problem runs far deeper, and it is unlikely to be solved through these measures alone. There is a long tail of underperforming students, often from disadvantaged backgrounds, and significant gaps in literacy and soft skills of school leavers. All of this is against a background of real terms cuts in per pupil spending in schools, which does not bode well in terms of raising the productive potential of future generations. There is evidence that school resources affect student outcomes, and the magnitude of these effects is larger for those from disadvantaged backgrounds. To truly seek solutions to the UK's productivity woes and invest in the future, we need to find more resource for schools, perhaps funded through a well-justified tax increase.

Moreover, there was no mention of the early years, another area that is experiencing funding pressures. There are two potential productivity effects of improving the UK's childcare and pre-school education system. First, there is extensive evidence that pre-school education has a large impact on individuals' future educational and labour market outcomes. Second, a more affordable childcare system will help to reduce the misallocation of female talent that occurs when mothers are unable to fulfil their productive potential.

Lifelong learning is becoming more important as rapid technological change drives the need for retraining or upskilling in a number of sectors. The Chancellor announced a new scheme to promote lifelong learning, focused on digital and construction skills. This is a wider issue. With the rise of self-employment and insecure working arrangements, companies increasingly have fewer incentives to train their workforces. The LSE Growth Commission proposed that introducing tax credits for training could help to address this.

Infrastructure and housing

Improving infrastructure is key to addressing both the aggregate productivity gap between the UK and other countries, and the wide disparities in economic performance within the UK. The Chancellor announced further support for devolved city regions, and will invest in the Cambridge-Milton Keynes-Oxford corridor as recommended by the National Infrastructure Commission.

The measures seemed rather half hearted. Support for electric vehicles was emphasised and a vehicle excise on the most polluting diesel cars announced, but there was no support for a diesel scrappage scheme and the freeze on fuel duties continues.

Budget 2017 was expected to focus on policies to make housing more affordable. It contained a promise to build more houses, via increased funding and regulatory changes to reduce the gaps between planning permissions and development. But this was accompanied by yet another demand-side policy: abolishing stamp duty for first-time buyers on properties up to £300k. Like its predecessor 'Help to Buy', this policy is most likely to feed into higher prices and therefore benefit existing homeowners, rather than first-time buyers as intended.

Industrial strategy and the future

Given fiscal targets and political pressures, one could hardly have expected larger increases in investment in Budget 2017. There was room for better prioritising the issues that are crucial for raising productivity, particularly in light of the new economic challenges posed by Brexit. While Budget 2017 sets the fiscal boundaries for investment, the government's eagerly anticipated Industrial Strategy, due to be published next week, will set out more detail on how this will be spent. Institutional reform to increase independence and transparency in industrial strategy is crucial to reduce the extent to which political pressures undermine the pursuit of long-run and sustainable productivity growth, and therefore maximise the chances of success.

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