The roots of Brexit lie in Britain's broken economic model: we now urgently need a new social settlement

The roots of Brexit lie in Britain's broken growth model. This was acknowledged in the immediate aftermath of the 2016 vote but British negotiators have since acted as if the only goal in their dealings with the EU is to preserve the status quo. ***Chris Bickerton*** *(Cambridge) argues that Britain's consumption-driven growth model needs to change and whilst Brexit is not a sufficient condition for this change, it is probably a necessary condition for it. This is most visible in the way that the EU's rules of free movement have interacted with the UK's open and flexible labour market. This blog is based on a longer essay written for the think tank Policy Exchange.*

At the time of the referendum result in June 2016, many prominent figures spoke about how this surprise outcome was proof that something fundamental had gone wrong in the British economy and the social contract that went with it. In her first speech as Prime Minister, Theresa May promised that Brexit would give those who are "just about managing" more control over their lives. Since then, the connection has been lost. The UK government's negotiations with the EU lack any positive economic strategy. We are left with the impression that the government feels it is caught between a rock and a hard place, between economic disaster and English nationalism, and that all we should be aiming for is to preserve the status quo as much as possible.

But the 2016 vote told us that the status quo is not working for many people. The UK economy faces grave problems. We have historically low productivity growth, low wage growth, and a broken housing market where there is no connection any longer between average earnings and house prices. Regional disparities are so great that it is difficult to think of the UK as having anything like a "national economy".

The UK's negotiations with the EU should be based on an economic strategy geared towards addressing *these* problems. The goal should be to change the British economy, not to preserve the status quo as much as possible. The problems of the British economy were not offset by EU membership and indeed, membership aggravated some of them. This should give pause for thought for those who argue that they can be solved by giving up on Brexit altogether.

Where might a positive strategy come from? First of all, we need a certain idea and framework for thinking about the British economy. There are many different sorts of frameworks, each relying on a certain conception of the macro-economy. Looking at GDP by expenditure, we can see that in the UK household spending is dominant, far more than business investment or net exports. Growth in consumption was most noticeable in the 1990s, where it expanded at the expense of government spending. Then the relationship between consumption and government spending stabilized in the 2000s. Colin Crouch called this privatized Keynesianism: a system of demand-driven growth where the main driver is household spending, not government spending. Financial deregulation has entrenched this consumption-driven growth model, as has the role of rising house prices in financing new rounds of consumption by homeowners.

This model has shaped the UK labour market – a sign of how sustained patterns in aggregate demand can reshape the supply side of the economy. We have seen a hollowing out of the labour market, with the expansion in low and unskilled work and that of high skilled work, but with the erosion of middle skill levels. Some of this is due to technological change but some of it is endogenous to a growth model that sustains high demand for low skilled service sector employment. After the economic crisis of 2008, the door on new entrants to this model was shut by making it more difficult to borrow to finance house purchases. But house prices remain far in excess of average earnings. The result has been 10 years of simmering inter-generational warfare between the baby boomers and the millennials, exacerbated by very poor wage growth and an increasingly dualized labour market. This is the broken British growth model that provided the context for the Brexit vote 2 years ago.

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Why has EU free movement been so much of an issue in the UK? There is a definite puzzle here.

EU free movement was a major factor behind the vote. But many studies conclude that there was no obvious downward pressure on wages due to EU immigration into the UK. How to reconcile these two findings? Many have concluded that the British working class is xenophobic and that the Brexit vote had a powerful nativist character to it. This is unconvincing. The country does not have a solid radical right component to its politics – nothing like the Front National in France, the Lega in Italy or even now the AFD in Germany.

One reason that EU free movement has been a problem in the UK is that it has exacerbated the structural imbalances and distributional inequalities of our consumption-driven growth model. One of the transmission mechanisms between free movement and bad outcomes for many people in the UK is through the impact upon training and skill formation. To be clear, the UK's poor record on training is not *caused* by EU free movement. It is caused by the fundamental difficulty capitalist economies have of providing collective goods in the absence of direct state provision. Skill formation is such a collective good: the costs are to the employer but gains are quickly socialized as a worker moves jobs. As a result, economies based on wage labour will systematically under-invest in skills.

EU free movement of labour rules have provided employers in the UK with a way of escaping the financial burden and risk of investing in skills. Without institutional remedies of the sort that exist in more regulated and institutionalized labour markets, the impact on training is severe. The latest official figures for apprenticeships makes for grim reading: a 31% drop in the number of people in in-work training schemes between last August and May of this year. On the very same day, newspapers were reporting that universities were unable to fill their places.

Another transmission mechanism is the factor mix. High levels of net migration into the EU have encouraged businesses to pursue labour-rich extensive growth strategies. Employing more people is one way to gain a competitive edge, especially in some service sectors, but over time its drags down productivity as firms invest less in new technology and in the training required to enable existing employees to get the best out of this technology. There are some small signs that a tightening labour market is beginning to stimulate a move to intensive growth strategies, which would mean more capital investment, but UK productivity growth is as flat as ever.

So where do we go from here? The British growth model needs to be reformed in three different ways.

We should move our economy away from extensive growth to intensive growth strategies. This means rebalancing growth away from reliance upon household spending, and towards business investment and net exports. Some of this requires a change in the macroeconomic framework. There is a place for a depreciated Pound, though a weaker Pound on its own will not rebalance the UK economy at all. We also need an industrial policy that focuses not just on hi-tech innovation hubs but on building more domestic supply chains so that gains from a weaker currency would not all be lost through the rising prices of components. Capital controls can ease the burden of a strong Pound and can help rebalancing towards productive investment by making it more difficult to rely on the UK as a magnet for international capital flows.

We also need to focus on skills and training in new ways. We should introduce a statutory obligation to train for employers. We should create an Institute of Work, whose purpose is to investigate the complex relationship between skills, labour markets, and productivity. We should create a Royal College of Child and Adult Care, on the model of the Royal College of Nursing, to improve the skill level and status of these critical but undervalued professions.

We need to move away from our asset-based society, where wealth accrues through the ownership of assets rather than through wage income.

This will involve weaning the economy off its reliance upon the wealth effects of rising house prices. Some of this can come from building more houses but we also need to change the wider financial framework which has encouraged the transformation of houses from places where we live into assets and investment vehicles.

Finally, and most importantly, we need to find a new social settlement for the UK, one that is national in character and that can create new ties between individuals, the market and the state. A key legacy of Thatcherism was that institutions of this kind are seen as no more than selfish rent-seekers. In fact, without a social settlement, it is impossible for capitalist societies to overcome the problem of collective goods provision. We should not try to reinvent the old corporatism of the post-1945 era because this kind of industrial relations will not map onto 21st-century British society. But a new social settlement is needed urgently.

Any program for change is likely to create huge amounts of resistance. It would terribly naïve to think that you can change the British economy without coming up against the power of entrenched interests. Faced with these interests, we need to build a political majority in favour of a rebalanced British growth model. If we do not do this, then particular interests will always win out against the common good. Brexit is not a sufficient condition for this kind of change, far from it. But it is probably a necessary condition given the way EU membership has interacted with and shaped the British growth model.

This post represents the views of the author and not those of the LSE Brexit blog, nor the LSE. It is based on a longer essay written for the think tank Policy Exchange.

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