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IMMIGRATION AND THE UK'S PRODUCTIVITY CHALLENGE

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This is the second in a series of articles that looks at the role of the UK as a global trading nation. In this article Jonathan Portes looks at immigration policy, and the role it can have in helping - or hindering - the UK's efforts to address the productivity challenge.

What is the biggest single domestic economic policy issue for the UK over the next five or ten years? During the election campaign, the focus of the public policy debate was overwhelmingly on the deficit. But very few economists, wherever they are on the ideological spectrum, really believe the public finances are the UK's most pressing problem. Instead, overwhelming, it is the UK's abysmal productivity performance that is the biggest concern. Between World War 2 and the onset of the financial crisis, UK productivity rose pretty steadily at about 2 percent a year – occasional shortfalls around recessions were mostly recouped by catch-up growth. Not this time. UK productivity (measured by output per worker or per hour worked) is not only below its 2008 level but also about 15% where it would be if pre-crisis trends had continued. UK performance is also bad by international standards - only Italy is in similarly poor position among the major economies.

Although productivity did not really feature in the election, it was highlighted by the Chancellor in his recent Mansion House speech:

> ***"Britain must address its poor productivity. We don't export enough; we don't train enough; we don't save enough; we don't invest enough; we don't manufacture enough; we certainly don't build enough, and far too much of the economic activity in our nation is concentrated here in the centre of London.***
> ***We will tackle each and every one of these weaknesses with the same determination we have brought to tackling the deficit – and we'll draw the whole government effort together in a single plan for productivity next month."***

Meanwhile, on the very same day, the Prime Minister was also making an announcement of considerable relevance to this topic. He said

> ***"In the past, it has been too easy for businesses to recruit from overseas, undermining those who want to work hard and do the right thing. As part of our one-nation approach, pushed forward by my Immigration Taskforce, we have asked the Migration Advisory Committee to advise on what more can be done to reduce levels of work migration from outside the EU.***
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> ***In considering how to significantly reduce non-EEA economic migration, the MAC will advise the government by the end of the year on:***
>
> - ***restricting work visas to genuine skills shortages and highly specialist experts***
> - ***putting a time limit on how long a sector can claim to have a skills shortage***

- ***a new skills levy on Tier 2 visas to boost funding to UK apprenticeships***
- ***raising salary thresholds to stop businesses using foreign workers to undercut wages***

The irony, of course, is that the Prime Minister's proposals, designed specifically to reduce skilled migration from outside the European Union, are likely to have precisely the opposite effect to that intended by the Chancellor's "Productivity Plan". While the impact of immigration overall on productivity is uncertain theoretically and difficult to determine empirically, few economists would disagree that further restrictions on skilled immigration – designed explicitly to make it harder for businesses to recruit from overseas- are likely to damage productivity.

Indeed, just the next day, it was reported that – for the first time since it was introduced – the cap on Tier 2 visas for skilled workers had been reached, meaning the Home Office is rejecting all applications covered by the cap for the rest of June 2015. The BBC reported that "as well as nurses, doctors and teachers other visas refused were applications to bring in accountants, solicitors and management consultants."

As if that weren't bad enough, the following week it emerged that a different rule, this time on the length of time skilled migrants may remain in the UK, will mean that up to 30,000 nurses may have to leave the UK over the next five years, at a substantial cost to the NHS. When this policy was introduced four years ago, I and other economists warned that the policy could almost have been designed to deter the migrants the UK most needs; and, for those who do come, to expel many of those we would most like to remain; sadly, we were right.

Quite what the economic or social benefits – short or long term - to the UK of these policies is difficult to see. Skilled jobs will be left unfilled, and qualified and experienced NHS nurses will be kicked out. On the contrary, these restrictions, and even more so the further ones proposed by the Prime Minister, will reduce growth and make us poorer.

Yes, but does this matter very much? It is often argued that the economic impacts of migration - positive or negative - are likely to be small, with the main impact being to increase both population and GDP, but with little impact (over the medium to long run at least) on GDP per capita or unemployment and employment rates.

However, this is a very static view of the world; it does not reflect how economies actually work, or where growth really comes from, and in particular the wider economic benefits of an open economy, to movements of people as well as of goods, services and capital. To see this, we merely need to observe that exactly the same could be said of trade. But of course most economists believe that the economic benefits of trade are quite considerable, and that these static estimates are not the whole story or even the main point; the benefits are dynamic and arise from competition and specialization rather than simple static comparative advantage.

We do not gain from free trade in, say, cars with the EU because either we or the French or Germans have a fixed and static comparative advantage in different types of car, so we can produce one type of car better and they can produce another; rather, because trade increases competition between different producers, diversification of the supply chain across the EU, the incentive for technological innovation, and all sort of other difficult to measure but important effects that increase productivity in the medium to long term.

The same is, in principle, likely to be true of immigration. Immigration is likely to have impacts on productivity and growth over the medium to long term in a number of ways. Immigrants bring different skills and aptitudes, and transmit those to non-immigrant colleagues (and vice versa); they increase competition in particular labour and product markets, increasing the incentive for natives to acquire certain skills;

So what does the evidence say? Well, in contrast to the well-established economic literature on the impact of migration on labour markets, we have much less quantitative analysis on these topics. What there is does suggest that immigration is associated with increased innovation (for example, that that immigrants are more likely to register patents, and that this in turn leads to an increase in patent activity on the part of natives); and with international trade and knowledge transfer, particularly in high-tech industries. Overall, the impact of migration - and of skilled migration in particular – appears to be positive. Recent NIESR research found that industries and sectors with higher concentrations of migrants had higher productivity – and not just because the migrants themselves were on average more skilled.

Against these positive impacts, what about the argument made by the Prime Minister that immigration reduces the incentive for employers to train native workers? In fact, the evidence for this proposition, particularly as it relates to highly-skilled immigrants, is painfully thin. Indeed, research by NIESR for the Migration Advisory Committee found that employers of highly skilled migrants typically also invested considerably in training UK workers. Research in the US found that skilled immigration, by increasing competition and hence incentives, actually improved the educational attainment of native workers. The proposal that there should be a "time limit" on how long a sector can claim to have a skill shortage justifying skilled migration is equally unsupported by economic theory or evidence.

Indeed, the government's general approach in this area is completely at odds with the market-oriented approach generally espoused by UK governments in other economic policy areas for the last three decades. It assumes that bureaucrats in Whitehall can, with the help of "expert economic advice" determine what skilled workers the country needs, in what sectors, now and in the future; and exactly who, at what salaries, companies should be able to employ to fill skilled jobs. For obvious personal reasons, I have nothing against either Whitehall bureaucrats or economists. But we don't decide now how many cars the UK should produce in five years and what colours they should be, or how many insurance companies we will need in ten and what products they should offer; any attempt to do so would rightly be ridiculed as a throwback to the worst excesses of central planning. Why would we try to do the same for people?

So what would an immigration policy that actually sought to increase productivity look like? If the Chancellor actually wants to make his "Productivity Plan" a reality, here are three suggestions:

First, the restoration, at least in part, of the Post-Study Work Route (PSWR), which allowed foreign students to stay on after graduation to look for a job. This initiative was introduced by the previous government, based on two observations.

- the success of Silicon Valley, in particular, and high-tech US companies in general, relied heavily on individuals who came to the US to study but stayed on to work (and in some cases, set up their own businesses)
- that, for the brightest and most motivated foreign students, the possibility of being able to remain in the country for a period after graduation to work was a significant draw.

The abolition of the PSWR was a major own goal; it means that foreign students who want to stay on here and try to build a career or a business find it much more difficult, if not impossible. Since such people are, almost by definition, likely to be relatively well educated and motivated, English speaking, at least partly integrated into UK society already, and so on, they are precisely the sort of people we want on both economic and social grounds. Of course, some will fail; they will end up unemployed or doing low-skilled jobs. That is the nature of immigration in a market economy; not all immigrants succeed, just as not all native-born entrepreneurs do either. Partial restoration of the PSWR would send a hugely important signal to potential students that the UK does want to attract them and, if they think they can make a success of it, keep them.

Second, reform of the cap on Tier 2 visas for skilled worker with a job offer. The cap is of limited political salience – even relatively well-informed analysts often confuse it with the overall net migration target. It should not be hard for government and business to explain that deliberately excluding skilled workers who meet the official criteria, simply because the economy and labour market are performing well again, is economically self-defeating.

Third, a regional approach. The Chancellor has rightly identified boosting growth outside of London as a priority. But the current immigration system favours immigration to London: salaries are much higher, so thresholds are easier to meet, and many large companies, who find it easier to deal with the system, have headquarters there. And London is hugely dependent on immigration for its success. But other parts of the UK arguably need skilled migrants more. In some areas, the main constraint on economic development is the ability to attract or keep skilled workers. Partial devolution of immigration policy – with city-regions being able to lower salary thresholds or skill requirements for those willing to commit to a region for an extended period of time – could provide an immediate boost to growth and jobs in such areas, and would fit neatly with the Chancellor's commitment to growth-friendly devolution.

Wouldn't these policies directly contradict the government's policy objective of reducing net migration? They certainly might lead to some increase at the margin, but the impact would be unlikely to be very large, particularly given the substitution effect – that firms who can't hire non-EU skilled migrants are very likely to hire EU migrants instead, with no impact on the migration figures. And in any case skilled migrants and students are hardly top of the public's list of concerns when it comes to immigration.

Of course, even more important than specific policy changes is the general stance o policy. As set out in the introduction to this article, there is a sharp conflict between those in government who, like economists, regard productivity as the UK's key economic challenge, and one which skilled immigration can help to address; and those who think that reducing net migration is a higher priority. If the latter prevail, the UK's medium-term economic prospects are bleak.