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“OPEN FOR BUSINESS?” THE UK’S FUTURE AS AN OPEN ECONOMY

This article is the first in a series of articles commissioned by NASSCOM, the premier trade body and the chamber of commerce of the Indian IT-BPM industries.

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This is the first in a series of articles that looks at the role of the UK as a global trading nation. What are the challenges, and what are the key decisions facing policy makers, particularly in the first few months of the next Parliament? In this first part Jonathan Portes introduces some of the themes that he will be exploring over the coming months.

By most measures, the UK has long been one of the most open economies in the world. The origins of this openness go back a long way. Intellectually, to Adam Smith and even before; historically, first to our maritime prowess and then to the Empire. In the 19th century, Britain was by far the most important exporter of manufactured goods in the world. By fair means (the rapid improvements both in the technology and organisational aspect of production) and foul (the use of tariff barriers to cripple and ultimately destroy the Indian textile industry as a competitor in the UK and global markets) Britain became the "workshop of the world." Of course that dominance is long past, but the UK remains the world's fifth or sixth largest exporter. But what does being an "open economy" mean in the 21st century - and how does the UK make a success of it?

The first and perhaps most important point to make is that openness is no longer primarily about trade in goods. This may come as a shock to those who think that exports are mostly about making physical things, putting them on trains, ships or planes, and then selling them in a foreign country. That still happens of course - indeed, one of our major success stories of the past few years has been the resurgence of the British car industry. We now export more cars than ever before. But this is far from being the rule; at least in relative terms, the importance of manufactured exports is shrinking and is likely to continue to shrink. The UK was the first country to transition from being primarily agricultural to primarily manufacturing, and similarly the first large economy to move to being mostly service based. The same thing is now happening with exports. Goods exports currently make up a little more than 20 percent of GDP, but that proportion has not changed that much in the last 20 years. Meanwhile, service exports have grown at a rapid pace - service exports now amount to more than 13 percent of GDP and the long-term trend is still sharply up. It is a question of when, not if, exports of services will eventually surpass exports of goods.

But the "service sector", as it is generally referred to, isn't really a sector of the economy. It makes up almost 80 percent of GDP - so, effectively, it **is** the UK economy. And it covers everything from hairdressing to management consulting, from architecture to street cleaning. So what are the key services sectors for the UK in an international context?

The first one that occurs to most people is financial services - the City of London. And it is true that financial services is a significant UK export and the City is a major export earner. But it dwarfed in size by the admittedly broad category of "business services", which covers everything from advertising and legal services to activities within multinational companies (which can relate to everything from IT services to

intellectual property). Meanwhile, computing is about the same size as financial services; and the digital economy, broadly defined, makes up an ever increasing share of UK output: and is likely to continue to grow.

Interestingly, two of our biggest service exports never actually leave the country, except in the minds of foreigners - education and tourism. Money spent by foreign residents who visit the UK temporarily, or come here to study (including student fees) counts as "exports" - purchases of services from UK residents by foreign residents. Higher education "exports" have been one of the largest growth sectors in recent years.

The good news for the UK is two-fold. First of all, we do much better at trading in services than in goods - we run a large deficit in the latter, but a large surplus (although not yet anywhere near as large) in the former. So, as other countries pass through the same transition as we and other developed countries have to a largely service-based economy, we should benefit. Second, most of the sectors listed above are relatively high value - we can charge premium prices for them, and they require highly paid, highly skilled workers, meaning they generate good quality jobs.

Of course "openness" is not just about trade. Over the last two decades, in particular, it has also become about people - immigration and emigration. The proportion of the UK workforce born abroad has roughly doubled over that period, with that growth occurring in both EU and non-EU immigrants.

Interestingly, from an economic perspective, the case for a relatively liberal approach to the movement of people is very similar to the case for a relatively liberal approach to trade. Just as the UK benefits from free trade, through the mechanism of comparative advantage, we will also benefit if people come here because they perceive that that is where their own personal comparative advantage makes them better off. Of course, in practice it is not as simple as that - people move for lots of reasons other than economic, and the long-term economic and social consequences of migration are extremely complex. But the economic benefits of immigration, while very controversial politically, are one thing that tends to unite economists across the ideological spectrum. A recent survey of prominent UK economists found almost unanimous agreement that immigration raised UK productivity and that excessive restrictions on immigration, of the type imposed by the current government, were economically damaging.

So where do we stand? We continue to have a large trade deficit, and our productivity performance has been abysmal for the past few years. This is perhaps the central economic dilemma for the next government. But our exports are growing in high performance, high productivity sectors - and if we get things right there is no reason that should not continue. The glass is (or at least can be) half full. But what do we need to do? I would identify four broad (and partially overlapping) economic challenges:

- boosting and broadening our exports in high value services. The key here is likely to be people. As noted above most of what we produce here is knowledge-based in one way or another. The vast majority of value added in the digital economy, business services, computing and the other services listed above comes from labour input - people - rather than capital (machines or buildings). So a high skilled workforce is crucial. And this isn't just about postgraduate degrees in STEM subjects, important as they are in some sectors. Tourism, for example, doesn't require just people with academic degrees, but also good managers, and motivated workers at all levels with a positive attitude.
- There is also a key role for government intervention, not in "picking winners" but in ensuring that, in these important sectors, there is a thriving "ecosystem" that facilitates skills development, infrastructure and so on. For example, both tourism and creative industries are largely private sector. But their success relies heavily on indirect support of one kind or another from the state: the BBC, the subsidised theatre sector, museums, the Heritage Lottery Fund and so on. We are hugely fortunate that Shakespeare was born in Britain. But the substantial contribution to tourism earnings that accrues because London has the best theatre in the world isn't luck: it is largely because the state subsidised theatre sector churns out large numbers of talented and capable actors and directors.
- capturing the benefits of trade and foreign investment. Returning to Adam Smith, he identified the key benefit from trade as that of "comparative advantage" enabling countries to specialise in things they were (relatively) good at. But, while this is still important, we now know that trade, especially in advanced economies, has other benefits. It increases competition, helping to increase productivity in domestic firms as well. It promotes knowledge transfer and both incentivises innovation and makes it easier for innovation to diffuse throughout the economy. Again, this is likely to be particular true of high-value services.
- remaining open to immigration. It is not just that these sectors often need workers with particular skills and sometimes that means recruiting from outside the UK; it goes broader than that. Immigrants bring different skills, backgrounds, attitudes, and knowledge, and transmit them to non-immigrant colleagues; they increase competition in particular labour markets. Workplace diversity, particular in knowledge-based industries, may well boost productivity. The government has repeatedly stated that it wants the UK to be "open for business" - but that is impossible if the UK is closed to immigration. Recent changes have made the UK less hospitable to skilled immigration, both temporary and permanent. It will be important for the next government to set out a positive agenda, both for the principles of the system for skilled

migrants, intra-company transfers and students, and for the way the bureaucracy operates in practice.

Finally, and perhaps most importantly, all this needs to add up politically. The rise of the UK Independence Party means that much of the debate in the election campaign will focus on the UK's membership of the EU, and in particular on free movement of workers within the EU. Now, paradoxically, many of the parts of the country where UKIP is strong have relatively few immigrants. Nor is immigration the underlying cause of the very real economic concerns of much of the British electorate: economic analysis confirms what most non-economists probably could have guessed anyway: that it's not immigration, but much wider economic forces, that is responsible for the underlying problems of people and places that have been "left behind" by economic growth.

But that doesn't mean those problems aren't real, or that many of our fellow citizens aren't facing real genuine hardship. Real wages are still well below their pre-crisis level, while many of the poorest have been hit hard by cuts to benefits and other services. Areas where Ukip is doing well are often places that suffered most during the recession, and have not seen recovery reflected in pay packets or living standards. They have not benefited from openness as London and some other areas (for example Cambridge, or York) have. They have relatively low-achieving schools, and on average the workforce has significantly lower qualifications. For openness - to trade, technological progress, immigration and innovation - to be a successful economic strategy for the UK, it has to be politically sustainable. To do that we need to find real answers to these problems.