THE TREASURY AND THE SUPPLY SIDE

John Kingman

Sagging productivity is the economic challenge of our age.

If we were able to ascend Mount Olympus, or at least go to Basel or Jackson Hole, and eavesdrop on any gathering of the central banking elite, very likely what we would witness is the wringing of hands. The central bank drugs successfully saved the patient in 2008. But they are not bringing the patient back to health. So what we need, everyone says, is concerted supply-side reform.

All true. My topic here this evening is specifically institutional – what, if any, is the right role for the Treasury in meeting this challenge?

For most of its life, that is to say hundreds of years, really the Treasury's sole purpose was to manage the public finances.

During the twentieth century, macroeconomic management became important as well.

More recently – for around 30 years - the Treasury has slowly grown a third limb. It has developed what has proved a sustained interest in microeconomics and the supply-side.

I want to home in on this "third mission". What has really been achieved? And should the Treasury have this third purpose at all?

These questions are not uncontested. I don't want to shock anyone, but there is a view held by some Treasury colleagues in private, that all this supply-side stuff is at best a waste of time – lots of gimmicks – or at worst actively damaging, corrupting of the Treasury's fundamental responsibility to grip the public finances.

Then there is a directly opposite challenge – which holds that actually this supply-side stuff <u>is</u> very important, in fact <u>too</u> important to leave to the Treasury. The Treasury is, this rival group holds, inherently conflicted. Its responsibility for the public finances means it will always self-censor. It will never be sufficiently radical when it comes to what is needed to fix the economy.

This group would like to see a separate Economics Ministry, perhaps a beefed-up Business Department, to take the Treasury on.

This is the hypothesis being examined, we are told, by Lord Kerslake in the review of the Treasury he is undertaking for Jeremy Corbyn.

Spoiler alert: I think both critics are wrong.

But before we get to that, I'd like to start with some history.

<u>History</u>

Department of Economic Affairs
[SLIDE]
A reasonable place to begin is 1964 with the creation by Harold Wilson of the Department of Economic Affairs – a deliberate counterweight to, and implicit critique of, the institutional power of the Treasury.

The slogan was "expansion rather than counting candle ends".

The context was ambitious: the Conservative party had promised 4% growth, a rate that had not actually been achieved since mid-Victorian times. Labour, for their part, ridiculed 4% as too timid.

They were both whistling in the wind. The DEA clearly failed. George Brown, the erratic Secretary of State around whom the Department was originally built, was moved to the Foreign Office. And the DEA lacked levers. The Treasury systematically clawed back its position over time and the DEA become moribund well before it was wound up in 1969.

There are some clear institutional lessons here. Though I actually don't think we should overdo them. The DEA wasn't really about supply-side policy in the way we would currently interpret it. It was more intended to be a rival pole of <u>macro</u>economic power, which is why it represented such a profound institutional threat to the Treasury.

Lawson
It was under Nigel Lawson that the Treasury started to evolve its own "third mission".

As a matter of intellectual history, I suggest this moment can be dated quite precisely to 18 June 1984 when Lawson gave his famous Mais lecture.

Lawson argued that, for the whole post-War period, economic policy had been governed by a massive intellectual mistake. This was to think that <u>macro</u>economic policy was all about the pursuit of growth. And that <u>micro</u>economic policy should be the tool to control inflation.

Lawson argued that this whole way of thinking had had to be turned on its head.
[SLIDE]

Lawson's proposition has proved impressively intellectually resilient. It describes pretty well an orthodoxy which still broadly holds, 30 years on.

Lawson's overall record in office was of course mixed. But he – and more generally, the Thatcher Government as a whole – still remains the poster-child for those who believe in the importance of supply-side reform.

The abolition of all sorts of regulatory controls (in his speech Lawson listed "pay controls, price controls, dividend controls, exchange controls, bank lending controls, hire purchase controls, industrial building controls"); a massive privatisation programme including the dismantling of several large monopolies; a systematic assault on the power of the trade unions; Big Bang in the City – these were landmark achievements.

Clarke

After Lawson the story goes a bit dead; Major and Lamont as Chancellors were understandably distracted. But Ken Clarke as Chancellor was interested – and actually created within the Treasury a Supply Side Unit. I remember this well as I happened to be Private Secretary to the then Financial Secretary, Stephen Dorrell, who took a close interest [SLIDE]. The unit was theoretically given a licence to roam – and it tried to – across big issues like education, welfare, corporate tax and housing.

The then official Treasury, I think it is fair to say, did not really buy in to this. If memory serves, the supply side unit consisted of two relatively junior policy officials, Bill Guy and Donald Franklin. I remember them as creative and energetic; but they got no traction.

In retrospect, I am afraid it seems slightly extraordinary – bordering on absurd – that anyone could ever have thought a unit staffed and equipped in this way could ever have made much impact.

Brown

Needless to say the Gordon Brown Treasury was an altogether different matter.

From before he became Chancellor, Gordon Brown was telling us all about neo-endogenous growth theory.

One of his early acts was to create a decently-resourced Enterprise and Growth Unit under the Directorship of my friend and former boss, the brilliant Harry Bush.

I joined Harry in 1998 when we set up the so-called Productivity team, affectionately (or not) known around the building as PROD, which I ran until I took over Harry's job as Director of the Unit in 2003.

One way and another, I held responsibility for these areas of policy, for all my Treasury time since then.

So at this point in the story - health warning - I lose all objectivity.

The Brown era had its hubris. At one point (2004) the Brown Treasury got into the vanity publishing business, releasing a 400 page volume - the so-called "Gold Book" - [SLIDE], with the gushing sub-title "Delivering Opportunities for All". The editors were Ed Balls, by then Chief Economic Adviser to the Treasury, though still of course a political adviser, standing shoulder to shoulder not just with my Treasury economist colleague Joe Grice but also Gus, now Lord, O'Donnell.

The coalition and the Conservatives

Then we come to George Osborne.

People sometimes forget that Osborne in opposition was a fierce critic of the way Brown had extended the role of the Treasury beyond its traditional remit [SLIDE]; in Government, Osborne proclaimed, "the micromanagement and empire building would stop … the era of the expanding Treasury empire is over".

In practice, of course, it didn't work out quite like that.

Hammond

Finally, Philip Hammond. [SLIDE]

The Hammond Treasury has not yet really showed its hand on the supply side - which makes this an interesting inflection point to reflect on where we are – though it is already clear, from what the new Chancellor has said, that he is a believer in the third limb in some form.

Resources and culture

Meanwhile, if we take a snapshot of the Treasury I left in June, it is worth getting a sense of the split of resources.

When I left, the Treasury had roughly 1,100 staff. Of these, about 80 work in the Treasury's Enterprise and Growth Unit. Maybe 20-30 or so work directly on supply side issues in other, mainly spending teams. So at a rough estimate, slightly fewer than 10% of staff in the Osborne Treasury at its height worked on supply-side policy.

Perhaps as important, I would say that as an institution the Treasury over my time slowly found a way to accommodate the "third limb" in a way that gave rise to steadily less internal friction.

This has not always been straightforward. From a growth point of view, the country does need a good education system, good infrastructure and so on; these things cost money; and whilst we can all agree on the potential for greater efficiency, in the end there will always be some tension between the supply-side-ists and those who need to make the spending numbers add up.

When I first worked on these issues in the late 1990s, managing this sort of issue was generally difficult. Arguments were often escalated to the Chancellor and his advisers; and it was all quite wearing.

But over the years, with the passage of time and the sustained interest of a number of Chancellors, the Treasury has gradually worked out how to take these debates in its stride, and even to internalise them within teams. Teams like (say) the Treasury's housing team now do a superb and apparently effortless job of straddling their spending and growth objectives.

In short, the institution has slowly but successfully learned how to walk and chew gum at the same time.

What has been achieved

So what has and hasn't been achieved?

I want to focus particularly on the the post-Thatcher years – those in which I had some involvement. What does the score sheet look like?

Fighting bad ideas

The first and most important point is that in my experience the Treasury's biggest contributions to good supply-side policy are negative, and very often completely invisible to the outside world.

What do I mean by this? It is generally understood that the Treasury's main contribution to public spending control is to stop things happening. It is less well understood that exactly the same is true of growth policy. This is because it is far, far easier for a Government to harm growth than to promote it. At any one time there is never any shortage of policy ideas and proposals which, however well-intentioned, would do some damage to the economy.

For a start, all Governments actively limit growth the whole time. They operate complex systems whose purpose is to do that. The planning system – a system of *development control* – is precisely that. So is the migration regime.

Meanwhile. all sorts of regulation can easily inhibit competition and innovation, either because regulation is badly designed, or because stopping competition and innovation is actually what the regulation is intended to do.

Moreover, we know that the single best way to undermine productivity is to prop up failing and unproductive businesses – yet I have never known a Government of any complexion which wasn't frequently struggling with pressure to do just that.

(I have occasionally wondered quite what Margaret Thatcher, whose portrait Sajid Javid made a point of keeping on his wall as Business Secretary, would have made of the endless meetings he had to hold under instructions from David Cameron to do "whatever it takes" to save one of the world's least productive steel plants in a massively oversupplied global market.)

Then there is openness to foreign ownership. There is overwhelming evidence that openness to international ownership is good for economic performance and productivity. And the UK's consistent track record on this point has been second to none internationally over many years.

Nevertheless, protecting this crucial openness, in which the Treasury has always been the firmest institutional believer, is hard work. Every year in my experience, there are cases where, for one reason or another, powerful people in Government are susceptible to, and have to be persuaded off, some sort of supposed case for "protecting" one usually underperforming British corporate treasure or another.

The late, great Treasury Second Permanent Secretary Leo Pliatzky once famously compared dealing with spending departments in the Treasury to animals herding around a waterhole: "You beat them off, and beat them off, and in the evening, back they come".

In my experience exactly the same is true of policies which would harm the economy.

Fighting these arguments, and winning a decent share of them, is the Treasury's most important – but often invisible - contribution to the health of the supply-side.

Labour markets

The second major point relates to the vigour and flexibility of the UK labour market. I don't propose to talk at length on this; it is a big subject and I do not personally pretend to be expert in it. Nevertheless it is the clearest single success story of sustained British microeconomic policy. [SLIDE]

The best testament to this achievement was the shape of post-crisis recession – the drop in output was both longer and deeper than the recession of the 1930s, but with unemployment on nothing like such a horrific scale.

Competition

The third area is competition. The fight for the cause of competition, like the fight for free trade, is always a struggle. There is a constant tension between the interests of millions of consumers, highly dispersed and generally passive and disengaged, against the interests of well-resourced incumbent vested interests.

The Treasury is not strictly responsible for competition – the Business department is. But I hope my friends in that department will not too much mind my asserting that in reality the Treasury is, and has for a long time been, the most powerful and consistent champion of competition in Government – not least because the Business department is always at least to some extent institutionally conflicted by its natural role as the advocate for big business incumbents.

This matters. We know for instance that the biggest productivity gains from decades of privatisation did not come not from moving businesses to the private sector *per se* – though this did have some benefits. The big gains came from the (often subsequent) break-up of monopolies and the introduction of competition.

Or take a reform like Big Bang – blowing apart a sleepy oligopoly – a conscious and brilliantly successful act of Government policy, probably the single most successful piece of British industrial policy ever.

I am proud that the 2002 Enterprise Act was designed in this building. The Enterprise Act took the UK competition regime from international laggard to one generally recognised as among the best in the world. Gordon Brown and Ed Balls took two big decisions: to introduce criminal penalties for cartels; and, critically, a self-denying ordinance to take Ministers out of almost all merger and market-shaping decisions.

Without this latter change, I very much doubt that the OFT and Competition Commission would have been successful in cracking the London airports monopoly - something that Ministers, particularly in a captured transport department, had long shied away from.

To be fair, the Treasury has itself been known to fail. In a classic case of successful industry capture, we allowed 15 years of persistent lobbying, obfuscation and procrastination to stave off Don Cruickshank's proposals to take on the oligopoly payment networks, the vital plumbing of the banking system, before they were belatedly but quite rightly implemented by George Osborne. Despite countless studies, no-one in the Treasury or anywhere else has yet found any way of cracking the retail and SME banking oligopoly - if anything a frightened Treasury made the problem worse by permitting the disastrous Lloyds/HBOS merger in 2008. In other markets, the fundamental conflicts embedded in BT's corporate structure remain an unresolved challenge; there are big public service markets where competition could play far more of a role; and as we increasingly see with disruptive businesses like Uber, there is a constant need to ensure that regulation is not allowed (deliberately or otherwise) to ossify inefficient market structures. So I am afraid there remains plenty to do.

Science, innovation and the universities

My next topic is science and innovation. You need to aim off here; I speak now as chair of UK Research and Innovation, which will oversee the £6bn annual research budget. So I am deeply conflicted.

Nevertheless, it is a fact that – after the US – by any measure Britain has the best science on earth and the best research universities on earth.
[SLIDE]

There are at least three different ways of judging the world's top academic institutions (academics do love methodological debate). On all these lists, the US (in green on the slide) has the lion's share of the top 25. But the UK (in red) then comes indisputably next. Far more, on any measure, than the whole of Continental Europe. And far more – for the moment at least – than the whole of Asia.

These institutions are extraordinary *factories* – twenty-first century factories, whose products are skilled people, knowledge and ideas.

Any other country in the world besides the US would kill to have what we have.

If you ask yourself – what, honestly and objectively, are the truly world-class economic assets that Britain has? It is a short list. Our strong science base would self-evidently be on it.

This is why the Treasury has invested in this agenda, consistently now over a long period – as well as constantly pushing for, and achieving, real progress on improving commercialisation.
[SLIDE]

That is on top of brave decisions taken on student fees – with, in the round, a transforming effect on the finances of Britain's universities.

This is all, I would argue, smart microeconomic policy.

Finance for growing business
Slightly more speculatively, I believe something is now finally going right in an area that long proved intractable – the supply of venture capital for new and growing business.

This British problem is as old as the hills, going back at least to the so-called "Macmillan gap" of the 1930s. It is an odd paradox that an economy which specialises in financial services, has plenty of long-term risk capital (from a funded pension system) and hosts the world's leading international financial centre, has long been so weak in this area.

An awful lot of Government money has been wasted in flawed attempts to fix this problem.

But the evidence is finally showing positive signs. The best data suggests that provision of external equity finance to SMEs has been growing quite sharply in recent years – more than doubling since 2011.

And just as important, the infamous “valley of death” between start-up finance and a stock market listing is finally attracting “smart money” - for the first time in my career we are seeing quite big patient capital funds, particularly in technology, focussed on this area. For the first time we are seeing significant successful fund raisings particularly by UK life sciences firms of real size, without their having to leave for the US.

This funding ecology matters; it is hugely shaped by Government policy, especially tax policy; we are still miles behind the US and there is a lot further to go; but we are finally seeing at least some apparently green shoots.

City devolution

A late entrant in the potential success list, and a tentative but intriguing one, is City devolution.

To some, the Treasury’s belated conversion to the cause of devolution and the so-called Northern Powerhouse was (to put it mildly) quite surprising. I had some entertaining meetings with Michael Heseltine as he sought to come to terms with this bewildering late twist in his extraordinary crusading career.

Leaving aside whatever political objectives George Osborne may have had - if you care about the growth potential of the British economy, there is hard logic in what he sought to do.

The underlying point is that the gap in productivity and output between the London penumbra and other second-tier British cities is very large by international standards. [SLIDE]

In one sense we should celebrate this. London and the wider South East are of course a set of exceptionally successful clusters, set within a country whose *overall* economic performance is at best mediocre. Clearly we should nurture this great success story as much as possible, and we do the rest of the country no favours to the extent that we choose to suppress it.

Equally, though, it is perhaps hard to imagine a transformation in Britain’s *overall* growth potential which could rely solely on yet further leaps forward in London. Almost as an arithmetic fact, if we want a further step-change in the UK's growth performance, we simply have to make progress in our underperforming secondary cities.

The question for the Treasury's growth theorists is: what, if anything, could policymakers do which could make such a shift more likely?

To be clear, no-one really knows the answer. But it is at least plausible that handing these cities greater control of their own destinies is worth a try.

It may not work. At best, some cities are bound to make more progress than others.

But I do draw some comfort from London. Before Sadiq Khan, London has now had two long-serving Mayors who are about as different from each other, politically and personally, as it is possible to imagine. Yet it is striking that they have both been in their different ways exceptionally pro-growth, particularly in their crucial planning decisions. I very much doubt anyone could become Mayor of London who did not have a strongly pro-growth vision for the city.

Maybe – just maybe – it is not a complete coincidence that their collective terms in office have coincided with an extraordinarily gilded phase in London's economic life.

Business tax

Finally, I cannot finish the successes list without a nod to the microeconomic policy measure of which I suspect George Osborne is proudest: his determined and relentless cutting of the corporate tax rate.

[SLIDE]

A remarkable, even astonishing set of decisions, particularly given the wider fiscal environment.

As Osborne likes to say, this does grab peoples' attention in boardrooms in Los Angeles or Shanghai.

<u>What hasn't been achieved</u>

So that's, as it were, the good stuff.

But there are also some big areas where we have achieved much less, or simply failed.

I offer this personal failure list, if nothing else, as a “to do” list for my outstanding Treasury successors.

Planning and housing

The first critical outstanding supply-side challenge for the British economy relates to land-use and housing.

For this audience, I don’t need to rehearse the grisly facts.
[SLIDE]

Real house prices have increased five-fold since 1955, much faster than any other OECD country over the past 40 years.

This reflects an extreme imbalance of supply and demand.

Residential investment as a share of GDP in the UK has averaged around one-third lower than other advanced economies over the long run.

With a similar population, France builds on average 200,000 more houses each year than England.

The UK builds 30% fewer houses per person than the similarly densely-populated Netherlands.

British houses are the smallest in Europe - almost 40% smaller than in the Netherlands.

This all represents a colossal failure of political economy, which harms millions of people.

But under successive Governments the Treasury has simply failed to win the argument, that the British people and the British economy would be better off, both in living standards and economically, with a marginally different approach to land use.

I’ll leave you with a nice picture [SLIDE] of a bit of our totemic Green Belt, which incidentally covers 1.5 times as much land as all of England’s towns and cities put together – and which has also been remorselessly growing since the War.

Education and skills

The second big area of failure relates to education and skills.

The UK spends more on education than the OECD average, but despite this we only secure mediocre educational outcomes.

Our education system is not by any means all bad – but it works far better for the slice of the population which goes on to Higher Education than the slice that does not; and of course a child's chances of getting into that higher slice are still depressingly closely correlated with social background.

We have particular weaknesses in so-called STEM subjects (science, technology, engineering and mathematics), due to continuing appalling shortages of qualified teachers in these subjects in state schools.

And our education system is uniquely specialised; the "A" level is a weird international outlier, and we are the only country in the developed world which thinks it is a great idea to let students give up maths at 16.

Moreover, these facts all relate to the <u>flow</u> of skills out of the education system into the workforce. But even if we magically transformed the performance of schools, it would still take a very long time for that improved flow of skills to reshape the <u>stock</u> of skills in the population – a population in which 49% of working-age adults have numeracy levels at or below those supposedly expected of an 11 year old. Yet the only arm of the state which reaches into, and is supposed to do something about, adult skills – the Further Education sector – has been chronically neglected under successive Governments, Conservative and Labour.

These are self-evidently not easy problems to crack. And any approach which could make a difference requires a degree of consistency over time which has always been elusive in education and skills policy.

Nevertheless, I do question whether it is right that the Treasury, at least in my time (which is to say, since the early 1990s) has never developed any meaningful agenda in this area. Of course, I should take as much of the blame for this as anyone else. But even from a narrow finance ministry perspective, let alone an economics ministry one, getting more value out of our education and skills spend is self-evidently desirable.

It would be one thing if the Treasury had tried and failed – my self-critical observation is that, perhaps daunted by the scale of the challenge, it has not really even seriously tried.

Infrastructure

Then there is infrastructure.

This was of course a huge personal focus for George Osborne, rarely seen in public without his hi-vis jacket. It was also a big personal focus for me as Second Permanent Secretary.

We did make some steps forward – particularly the priority we rightly placed on ambitious growth in the roads programme.

But the list of failures is all too depressing.

All credit to Theresa May if speculation is correct that we may finally get a decision on Heathrow. But it has been an excruciating and surely inexcuseable saga.

Our broadband and telecoms infrastructure is resolutely second-rate.

We got nowhere on addressing the absurd cost of building any kind of infrastructure in Britain.

We have made only very limited progress on simplifying and speeding up decision making and planning.

Our approach to compulsory purchase is timid, meaning that it is impossible to capture any meaningful slug of the large land-value uplifts that flow to private developers from big projects like Crossrail.

And we got nowhere on road pricing.

We did create the new National Infrastructure Commission, with a view to trying to introduce more of a long-term focus on big infrastructure decisions. But the May Government has decided not to legislate to establish the Commission's independence; so whilst the Commission remains, and remains an offshoot of the Treasury, its standing is rather unclear at this point.

Meanwhile there is a crucial unresolved policy question about what infrastructure we need.

[SLIDE]

This is from Rod Eddington's review, commissioned by Gordon Brown a decade ago. "Small is beautiful; many of the very high-return schemes are small projects … returns drop off sharply beyond the £1bn point … do not be seduced by *grands projets* with speculative returns".

This was not George Osborne's view. If you dared mention Eddington to Osborne (I wouldn't particularly have recommended it as a career-enhancing move) he would tell you - with relish - that the Treasury just wanted to plaster the country with hundreds of roundabouts.

Osborne was right that the Treasury is instinctively Eddingtonite, and I do think much of the evidence is on Eddington's side.

Equally, it must be acknowledged the Eddington philosophy is not always and everywhere right – I don't know whether Osborne was right to taunt me the whole time that the Treasury opposed the M25, though he probably was. I do know that the Treasury strenuously opposed the Jubilee Line Extension (this was my second job in the Treasury, in 1992) – every time I use it I reflect that with hindsight we were surely wrong; without the new line we could never have had the extraordinary success that is today's Canary Wharf.

But Eddington's challenge cannot just be swept under the carpet. What we need is some really clear, balanced and convincing thinking in this area. How should one think about big projects vs small? How should they be evaluated against one another? What does differentiate a good *grand projet* from a turkey?

To come up with truly convincing answers to these questions is an obvious task – and test – for the Infrastructure Commission.

Migration
Finally on the big failure list, migration. Self-evidently, this is a huge issue for the British people and British politics.

Probably on no subject, including the green belt, does the instinct of technocrats diverge more fundamentally from the views of many British people.

I have heard it forcefully argued that if a more cautious policy course had been charted on migration, particularly through the Blair/Brown years, we would not have subsequently reaped the whirlwind.

Actually though, I am not sure this is really correct – at least from the narrow perspective of a critique of the Treasury. In my experience, the Treasury has always been mainly focussed on high-skill migration. And I do not personally believe that high-skill migrant flows have been the main drivers of public opinion on this issue.

If anything, the big fear and frustration for Treasury technocrats in recent years has really been around the danger that an undifferentiated focus on reduction of overall net migration numbers could lead to perverse decisions. It is not clear that public anger around migration – which is all too vividly real – will be remotely sated, or in any way affected, however many brilliant Indian PhD students we manage to exclude or deter.

<u>Brexit</u>

This is also a policy area is already being profoundly reframed by Brexit.

The challenge is entirely one of political economy (emphasis on the political). We plainly need a new migration policy which is sustainable and commands public acceptance, and which nevertheless maximises that potential for the right people to come and work and study here. Devising such a policy will require subtlety, imagination and canniness. But it really ought not to be impossible, and if Treasury brains can help construct a sensible and balanced answer, so much the better.

But these Treasury brains are going to be awfully busy – because the list of policy areas which must necessarily now be rethought as a consequence of Brexit is very long.

In fact, Brexit is going to throw up many big policy questions which may in themselves have very little to do with Brexit.

Take just one example: competition policy. There is no great outcry for a fundamental revamp of UK competition policy. But much current UK competition law derives from and mirrors EU law. Clearly that must now change; and that change will inevitably prompt a set of choices around what we want a future UK competition regime to be. Do Ministers (to take just one instance) want to take the opportunity, as they have hinted, to reverse the Enterprise Act and put politicians, not competition technocrats working to clear criteria, back into the driving-seat on individual merger decisions? Do we really want every major M&A deal to become an uncertain political bunfight, and to provide the protectionists with the great opportunity that presents? Do we really want to add yet more time and uncertainty onto what is already one of the slowest decision-making processes in the world? This is a big decision about what kind of economy we want to be. It is really not directly Brexit-related. But it is a decision which the fact of Brexit puts onto the table.

The wider point is that there will be a huge number of these choices to be made in the coming months and years. Questions like these will be replicated across huge swathes of policy and legislative terrain – and these are all over and above the first-order Brexit questions around market access, free movement and so on.

These will all in turn present innumerable threats and opportunities for the Treasury's growth gurus to tussle with.

I emphasise threats <u>and opportunities</u>, because there really are both.

It is not obvious that Britain, once freed of the EU, will necessarily naturally embrace some imagined libertarian economic utopia. It is not just the EU which wants to protect wetland birds or clean beaches. In fact in our new liberated mode we already seem to be paradoxically using our new-found sovereignty voluntarily to adopt some distinctly Continental practices, like workers on boards.

But there are some real potential prizes to be had. In my post-Treasury life I have two roles – chairing UK Research and Innovation, and in due course chairing Legal and General. It is interesting that in both these worlds, as it happens, I can see some post-Brexit opportunities. In the world of science, whilst there are serious and real concerns about movement of people and access to EU research funding, there may also be a genuine opportunity from reframing a more UK-focussed regulatory regime on topics potentially ranging from clinical trials, stem cell research to GM crops. Or with my L&G hat on, that company's ability to invest in infrastructure and other opportunities is profoundly shaped by an EU regulation, Solvency 2; post-Brexit, the British authorities should now be able to consider in a less constrained way what prudential regime they believe is most appropriate.

<u>Challenges of political economy</u>

So these are the challenges. Two general observations about them strike me.

First, if one compares the list with Lawson's reforms, the challenges of today do take the Treasury into areas which are much further outside its formal responsibilities and its natural province – areas like land use, transport, skills or migration. And these policy areas are generally longer-burn, and much less susceptible to binary black-and-white decisions, than (say) getting rid of exchange controls. This makes change, and the campaign for change, an intrinsically longer-term proposition.

Second, the challenges we face now divide sharply into two distinct types: some are essentially <u>policy</u> challenges; some are essentially <u>political</u>.

This is an important distinction because the two different kinds of problem require very different kinds of solution.

In areas like: how to turn around underperforming cities, or how to upskill the stock of the population, it is really not at all obvious what is the right policy approach that will work. That of course makes for the sort of policy debate and analysis which Treasury technocrats revel in.

But in areas like: building a new runway for the South East, or road pricing, or skilled migration, or developing the Green Belt, we <u>do</u> know precisely what should be done, and what the benefits would be – what we don't know is how to sell it. As Jean-Claude Juncker supposedly once remarked about Ministers discussing structural reform in Europe: we know exactly what needs to be done; we just don't know how to get elected once we've done it.

That is an altogether different kind of challenge, one which probably plays less to the Treasury's strengths but which the Treasury nevertheless simply cannot avoid.

<u>Implications for the Treasury</u>

Finally, to come back to my initial question: <u>do</u> we want the Treasury involved in these questions, or not?

I hope I have made the case that there are more than enough substantial supply-side battles to be fought, for 100 or so people in the Treasury to earn their keep.

But that does still leave my two groups of critics.

First, the insider's complaint that the growth function corrupts what should be the Treasury's core role of being sceptical about <u>all</u> forms of public expenditure.

And second, those who argue that the job would be done better by some sort of separate Economics Ministry.

Taking the first objection, I do think one must concede that there <u>have</u> been some gimmicks over the years, including some that have been expensive and wasteful. It is also true that the nature of the Budget and Autumn Statement/Pre-Budget Report processes creates pressure for these.

But as I always used to say to the Treasury teams: gimmicks are <u>our</u> failure. Gimmicks are what we get if we fail to come up with – and find ways to sell - better, more substantive ideas. I don't believe politicians like gimmicks *per se*; they resort to them when the Treasury fails to produce something better and more substantive.

As to the charge that the growth agenda is fundamentally at odds with the Treasury's public finance responsibilities, I just don't think the numbers stack up. It is true that the Treasury's growth side would probably generally be sympathetic to the case for more public spending on science and innovation (total spend £6bn a year) and roads (total spend £3bn a year). That is, in total, just over 1% of public spending.

The growth side also ought to be more focussed than it generally has been on education and skills spending (£55bn a year, or roughly 7% of public spending) – though it has never, I think, argued for more spending in this area and I am not at all sure it should.

I cannot think of any other areas where any meaningful tension arises between the Treasury's supply-side and public spending objectives.

The Treasury should, and in my experience can, easily take this not very challenging level of internal debate in its stride.

But what of the other challenge: would we not be better to separate out a separate Economics Ministry from the Finance Ministry? Each would each have a clearer mission and focus, so the theory goes, and to the extent that there is tension between them, this can be better argued out properly and openly, in Cabinet if necessary.

Plainly this could be done. Plenty of other countries organise themselves this way, though I am not aware that there is any convincing evidence that they have a stronger track record of supply side reform than we do.

But there are three downsides, all I think serious.

First of all, the supply-side mission is – take it from me – hard work. It makes a huge difference to have a very senior Minister on your side. It is striking that in the past, the Business department <u>has</u> made an impact on the occasions when it has had a Secretary of State with real political heft – Heseltine and Mandelson's two spells are the obvious cases in point. But these are the historical exception. Whereas the Chancellor is almost aways a Big Beast. Losing his (or one day, her) voice would be a big loss.

Second, having financial control is important. It is not so much that there are lots of areas we need to splurge money on - more that holding the purse-strings gives the Treasury a direct institutional locus on all sorts of policy issues. An Economics Ministry would have to give this power up and rely solely on persuasion. The big risk is that it becomes a sort of impotent Think Tank bleating from the sidelines.

Third, I do not think the Business Department can be the right answer. If the Treasury has its conflicts, so does the Business Department – because whatever its name (I think it has had five names in my time) the reality is that pretty much every Secretary of State it has ever had has expected it to be the voice of business in Government, which I am afraid does tend to mean the voice of incumbent business. In practice this does make it very hard to be the natural voice of the disruptive innovator.

For me the thought experiment goes as follows: had British governments over 30 years embraced the philosophy of Lawson's Mais lecture but created an Economics Ministry to do the job instead of the Treasury, do we think the track record would have been stronger? I am personally certain the answer is no.

<u>Conclusion</u>

I said at the beginning that the Hammond Treasury has not yet shown its hand.

I hope it is evident from what I have said that I hope very much that the new Chancellor does decide that the Treasury should have another very serious burst of energy on the supply-side – particularly as we define our economic future post-Brexit and, working with Greg Clark's

Department, shaping the new industrial strategy Theresa May has called for. It is precisely because the stakes are high now that the Treasury and its heft, rigour and creativity are needed.

As I have described, there is much for my former colleagues to do:

- To seize what are some genuine opportunities presented by Brexit
- To make a fresh and persuasive case for openness and competition
- To achieve far more than I ever could on infrastructure, planning, housing, skills and migration
- And to continue the real God's work - stopping bad things happening.

I wish them heartfelt good luck and every good wish.

Thank you very much.