



Finance and education: the twin peaks of government-led growth

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Feb 2010

Sustainable growth requires well-regulated, stable financial markets, but it also needs human capital investment

There are two outstanding challenges which are fundamental to the future of the British economy and society – the regulation of both finance and of education. Whilst apparently unrelated, both would benefit from cultural change in wider society, and reforming the regulation of these sectors is essential if long-term economic growth is to be encouraged.

The global financial crisis called into question existing approaches to financial market regulation. Regulation has always been subject to a challenging power dynamic, with a tension between increased lending and investing on the one hand and holding greater reserves on the other. Holding reserves is not profitable, particularly if the competition is not doing so, and often the national interest can be presented as requiring higher profitability in the financial sector as this can boost tax receipts and employment.

Any regulator who wants to reduce profitability by enforcing greater reserves and less lending will therefore encounter powerful forces. In addition national constraints on profitability could lead to migration of financial “talent” to more “enlightened” locations, so it is generally conceded that effective prudential regulation must be agreed between major financial economies.

But this was exactly what the Basel agreements on capital adequacy ratios for banks were about. They did not prevent the crisis because they were avoided by the rise of an unregulated, parallel banking sector. An obvious solution is thus to enforce the spirit of the rules by insisting that the off-balance sheet activities of this parallel banking system be backed by the same capital as required for the regulated banking sector.

To the same end, a more accurate reporting of profits could be achieved by adequate recording of bad loans held by banks. Banks should be allowed and compelled to take into account that in a recession, defaults will be higher. This would create a financial cushion against non-payment in bad times, and perhaps bonuses might be slightly constrained by the lower profits.

Both these rules would only help if there was tougher bank regulatory enforcement to prevent circumvention. A cultural change would facilitate this process. The authority and vigour of the regulatory process would be buttressed if British society placed a lower value on high earning, especially when regulators are paid significantly less than those they are regulating. By ensuring financial stability these regulatory changes would create some foundations for future prosperity.

Whilst financial market regulation currently receives considerable attention, “human capital” investment receives considerably less. The regulatory framework for human capital provision is of even more fundamental importance for the education of a highly skilled, motivated and innovative population. Here the state has no less vital a role to play than in the regulation of business – as the doyen of the market, Adam Smith, pointed out.

When making decisions about human capital investments, individuals are inherently disadvantaged by the fact that, until they acquire a minimum level of education, they lack the ability to assess the different options and pathways available to them. In addition, most people are unlikely to be able to borrow the funds in the market in order to pay for education and training. So the state must at least subsidise, if not supply, education but also perhaps require people to obtain a threshold level of education before they enter the workforce.

In order to achieve this objective, legislation was passed in 2008 which raised the minimum age at which young people leave education or training. Whilst voluntary compliance with the legal requirements is preferable, disaffection at earlier stages of education will almost certainly necessitate some form of stricter enforcement. Apart from the reduction in life opportunities that is a consequence of prematurely leaving school, disaffection with the education system also has a pervasive effect within the state school system, in particular through disruption of learning for whole classes. A recent study has shown that over 40 per cent of students experienced disruption of half or more of their classes by other students so as to adversely affect their learning. Such disorder has proven a significant predictor of the rate of improvement of individual student exam scores.

The education system needs more and better ways of addressing disaffection and tackling indiscipline. Unfortunately, the introduction of teaching assistants has not been particularly effective in this regard. Excessively large schools may simply exacerbate the challenges of maintaining order, and privatisation is unlikely to be an effective solution even though private schools generally perform well, because unlike state schools, private schools can select and reject students.

A basic difficulty faced by state schools is that the balance of power between pupil and adult/teacher has shifted over half a century. Indiscipline is now more common, and worryingly this can translate into youth crime. Schools are expected to deliver educational outcomes, and

maintain discipline, but family and community support is limited. A cultural change in favour of tighter discipline for children would improve educational performance, but, in any case, more initiatives are needed to build education partnerships. Education, broadly interpreted, cannot be solely delivered by schools. Instead provision must be shared and coordinated with families and the community.

In this respect, a particularly valuable approach currently operating is to identify areas where complaints of youth misbehavior and petty youth crime are rife – schools serving these zones can safely be reckoned to experience related problems. Community youth workers then organise constructive activities and clubs for young people in the area. In some cases success has been marked but community teams are often poorly resourced and there currently appears to be no mechanism for sharing information nationally about good practice.

Sustainable growth requires stable financial markets, but it also needs human capital investment. If governments can improve regulation of both these fields, the path towards long-term growth after the crisis will become much clearer.

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