Looking to the Future of Growth

Edited by Matthew Oakley

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Policy Exchange is committed to an evidence-based approach to policy development. We work in partnership with academics and other experts and commission major studies involving thorough empirical research of alternative policy outcomes. We believe that the policy experience of other countries offers important lessons for government in the UK. We also believe that government has much to learn from business and the voluntary sector.

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About this publication

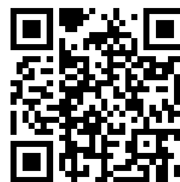
This publication is part of a large programme of work on growth that Policy Exchange is undertaking. The programme aims to set out a positive view about the future of the UK economy and to make recommendations for how we can return to a more structurally and regionally balanced model of growth in the future. This would be a model of growth that relies on entrepreneurs, businesses and individuals to drive growth and to deliver social gains to the wider economy.

This report is the culmination of our first six months of research, events and consultation with business and the academic community. Throughout the course of this work we have met many people with interesting and relevant views about the blockages to growth in the UK, policies that might help and where the UK's growth potential lies. We have asked a number of these people to contribute essays to this report.

The views of these authors are varied and wide-ranging. Some of them even work against each other. As such, Policy Exchange would not necessarily prioritise and certainly not endorse all of the policies that are put forward. Indeed, we even disagree with some. However, it is the spirit of debate that is important. Each of the contributors looks to the future of growth, rather than focusing on the short-term. It is this long-term approach that we think will foster growth in the UK. They start a debate over what we want the UK economy to look like and what government can do to help us get there.

Policy Exchange recommendations in the first chapter of the report build on that debate and we will be continuing over the next year to make recommendations for policies to push for growth and social improvement in the UK.

This report forms part of Policy Exchange's *Letting the Country Grow* programme of publications and events. The programme has brought together experts from across the country and from abroad to discuss the key challenges facing the UK economy and to set out a new set of growth ideas. To find out more, or to view videos of the programme's various panel events and keynote speeches, please visit www.policyexchange.org.uk/pages/growthseries.cgi or scan the QR code with your smartphone.



Contents

	Summary of recommendations	5
1	Policy priorities *Matthew Oakley*	10
2	The fiscal position: Plan A, Plan B…or something else? *Ed Holmes*	33
3	Monetary Policy and Credit Easing *James Barty*	45
4	Britain's productivity crisis *David Smith*	55
5	We need to focus on growth and being greener – not 'green growth' *Simon Less*	60
6	Tax and the future of growth *Will Morris*	69
7	Innovation *Matt Brittin*	75
8	Small businesses and the future of growth *Andrew Cave*	79
9	Housing and planning: rebalancing and renewing *Alex Morton*	84
10	Financing the future: the role of the City *Stuart Fraser*	93
11	Making it worse: why we need to look to the long-term *Matthew Oakley & Peter Cruickshank*	98

Summary of recommendations

This report is about starting an evidence-based and balanced debate around growth in the UK. It issues a call to action to politicians, the media, policy makers and the public to start to consider the long-term future of the UK economy, rather than focusing on short-term politics and policies. The report does not naively assume that the UK economy is performing well. We recognise the depth of the recent recession and the real dangers of a return to recession in the near future.

However, unlike others, we do not see this evidence as an excuse to return to more government spending and higher borrowing in order to somehow try to prop up the economy. Similarly, this report does not call for indiscriminate and large-scale deregulation and tax cuts. It brings together a number of essays from experts in Policy Exchange as well as from business and industry. Each lays out the author's views on the blockages to growth and makes suggestions for where government policy must focus.

While Policy Exchange would not prioritise all of the recommendations made, the tone is important. They each present options for reform that focus on the long-term prosperity of the UK. We build on these suggestions, the events and discussions we have held over the last six months and our own research to lay out where Policy Exchange believes policy for the government's Autumn Statement and 2012 Budget should focus. Implementing these policies would bring new certainty and confidence to business and would give a huge boost to businesses both small and large and the entrepreneurs, individuals and families that are the drivers of growth in the UK.

Our recommendations are as follows:

Fiscal position

Meeting the fiscal mandate

- **Recommendation 1.** At the Autumn Statement, the government must continue to commit to meeting its first fiscal mandate of eliminating the current structural deficit by 2015/16. There are two implications to this:
  a. We recommend that 2015/16 is explicitly targeted, rather than the current plans of meeting the mandate by 2014/15; and
  b. If, under current policy at the Autumn Statement, the OBR establishes that there is less than a 50% chance that the fiscal mandate will be met by 2015/16, policy must be reformed to put the UK back on course to meeting the mandate. This should include both further fiscal restraint and reforms to boost growth. These reforms must result in the OBR agreeing that there is a greater than 50% chance of meeting this fiscal mandate in 2015/16.

- **Recommendation 2.** Any flexibility in spending resulting from: the move to target 2015/16 rather than 2014/15; reduced debt financing costs; or better-than-expected fiscal circumstances should be shared between investment to reduce the current structural deficit faster and structural reforms focused on the long-term growth of the UK. Specific policies are recommended later in this chapter. Our belief is that no more than half of any additional funds should be targeted towards structural reform. This is in line with both allowing room to meet the mandate and our approach to stable policy making laid out in later recommendations.

Providing firms with certainty

Tax stability

To ensure that the tax system is no longer used as a political tool and that it becomes stable and predictable enough to give business confidence to invest:

- **Recommendation 3.** A tax roadmap for the whole tax system should be legislated for. This would require government to set out tax rates, allowances and rules, for at least the following four years, in each Finance Bill.
- **Recommendation 4.** Of course, it would still be possible for government to change these four-year plans in each year. To discourage such short-term decision making, the legislation would also require that any changes to the rates for the following three years (which had already been legislated for in the previous Finance Act) would require the government to make a statement to Parliament setting out in detail both the reasons for the change and the potential impact on business and investment.
- **Recommendation 5.** These two steps might deal with constant changes to existing taxes, but would leave longer-term, and fundamental, tax reform equally opaque. For this reason, the third element of this approach would introduce legislation requiring that within the first year of a new Parliament, the government must publish a tax reform Green Paper setting out its intended plan of tax reform for the remainder of the Parliament. This would provide public clarity over its priorities and intentions over the medium-term. Parliament and the public could then use this Green Paper to hold the government to account over its actual tax policy. **The first of these should be published alongside the 2012 Budget**. This would allow government to address a number of areas that are leading to distinct business uncertainty and that are detrimental to growth in the UK as well as its wider reform agenda. This should include: an analysis of the treatment of debt and equity in the tax system and implications for investment decisions and macroeconomic risk; a summary of its intentions on the taxation of land and property; and a summary of the potential for longer-term reform to the income tax and National Insurance systems to simplify the personal tax system while strengthening the functioning of the contributory principle.
- **Recommendation 6.** To ensure that the government looks to the long-term, any tax revenues in excess of those expected should not be allowed to be fully recycled into spending or tax cuts in future years. Instead, we believe that at least half should be invested into reducing the structural deficit. In the longer-

term, it should be used to reduce government debt. This requirement should be legislated for.

Supporting business growth

Encouraging investment through the tax system

- **Recommendation 7.** The government should extend its current NICs holiday for new workers in new firms (in certain regions) to cover all additional workers in all firms with less than ten employees (e.g. any firm moving from employing five employees to employing six employees). However, rather than being a temporary holiday, this should be piloted as a potentially permanent feature of the tax system. Similar policies are strongly advocated by many businesses and business representatives, including Andrew Cave in Chapter 8 of this report. We believe that this policy should be piloted for the remainder of this Parliament with a full evaluation plan implemented in order to inform future decisions over whether to make the exemption a permanent feature of the tax system. This is one area that we believe should be incentivised if, as we outline above, meeting the fiscal mandate a year later in 2015/16 and falls in debt servicing costs allow some financial flexibility.
- **Recommendation 8.** The government has confirmed that they see the 50p rate of income tax as a temporary feature of the UK tax system.[1] We do not believe that there is a strong case to remove the tax immediately, when other taxes have also been raised that hit other parts of the income distribution. However, by not outlining a timetable for its removal, the government is adding uncertainty and risk to business decisions. For this reason, we believe that the government must make the commitment to removing the 50p rate clear. This must include a set of criteria that would need to be met before the rate is removed. Recent research has shown that the top marginal rate of income tax does have a significant negative impact on entrepreneurship, productivity and growth.[2] A number of businesses that we have talked to have also argued that the rate is detrimental to their business. Providing clarity to these businesses will go some way to improving business confidence.

Easing finance to business

- **Recommendation 9. Credit Easing through the banking system:** the government should raise funds of up to around £25 billion and allow banks to apply for the funds. The banks in turn would lend the money onto businesses. Banks would have to return the funds if it had not been lent out within a fixed time period, say three months: ensuring that the programme is demand determined. This would have advantages at both stages: the government has a low cost of funding meaning that lower rates can be passed on through the banks; and the banks have the contacts, the credit assessment capability and the network through which to distribute the credit.

  If this was all new lending, it would potentially triple the amount of net new lending currently occurring. Even if we assume 50% of it is displaced lending it would double net new lending. In terms of details, we suggest that:

  - Tranches of two-, three- and five-year money should be raised and lent on.

1 http://www.number10.gov.uk/news/morning-press-briefing-for-7-september-2011/

2 Arnold, J.M., Brys, B., Heady,C., Johansson, A., Schwellnus, C., & Vartia, L., (2011). 'Tax Policy for economic recovery and growth'. The Economic Journal, *121* (February), F59–F80.

- The banks and the government should split both the risk and the return equally so that banks have the incentive to ensure that the loans are made on a commercial basis and the government would receive a share of the profits of any lending.
- The loans would be available to all banks, providing they lent it on to UK-based companies and, to protect against displacement, we suggest a minimum spread of 200 basis points. This should ensure that the banks did not merely lend on the money to large cap companies who can already tap the bond markets.

- **Recommendation 10. Credit Easing through the tax system – long-term**: the government should announce a new tranche of ISA allowance for individual investors (of say £5,000) specifically targeted at investment in small and medium sized firm debt. Such an approach would incentivise ISA providers to give access to this market to its retail customers and should provide a vital increase to the size of this market that could provide significant funds to mid-sized companies.

  We believe that the costs of this policy would be low. The low interest most investors are receiving, particularly on cash deposits, means that tax payments on this interest are also relatively small. This means that the costs of foregone tax would be low and could be afforded if, as we outline above, meeting the fiscal mandate a year later in 2015/16 and falls in debt servicing costs allow some financial flexibility.
- **Recommendation 11. Credit Easing through the tax system – short-term:** The Business Payment Support Service is an invaluable tool for business who, while profitable/viable, may struggle to meet their tax liabilities. For instance, this might be because of cash-flow problems. Between November 2008 and June 2011 the scheme granted nearly 450,000 Time To Pay arrangements, worth in total £7.71 billion. It is a measure of success of the scheme that, of that amount, over £6.69 billion has already been paid back.[3] However, current use of the scheme stands at just 37% of the level it was in 2009 and a number of businesses that we have spoken to were unaware of the scheme. Businesses are also complaining that the scheme has been reined back, with agreements much harder to obtain. For this reason, we recommend that the government explores what more might be done to advertise the scheme and whether it might be further expanded to provide help to more firms.
- **Recommendation 12.** The Bank should reconsider its decision not to rollover the Special Liquidity Scheme (SLS). Now is not the time to be withdrawing support from the banking system and the Bank has even acknowledged that this will put upward pressure on the price of credit. Allowing the SLS to expire has the potential to undermine the loosening of policy from QE since monetary policy and the financial system are inexorably linked.

Regulation

- **Recommendation 13.** The government should launch a review to assess the cumulative cost of: the Agency Workers Directive; changes to pensions regulations (the introduction of NEST); the existing system of and suggested changes to maternity and paternity leave; and health and safety legislation.

3 http://www.hmrc.gov.uk/stats/bus_pay_sup_serv/official-stats-july2011.pdf

This should inform an assessment of tools to mitigate these costs (including how to limit future increases in burdens) for businesses, while maintaining an appropriate level of protection for employees.

Tackling barriers to growth

Green growth

- **Recommendation 14.** The government should eschew the muddled concept of 'green growth' and the 1970s-style industrial subsidies for hand-picked future growth sectors which it leads to. The government should instead concentrate on policies to promote growth alongside other policies to go 'green' – reducing carbon emissions – as cost-effectively as possible. Key policy tools for this last objective will be to establish an effective long-term carbon pricing framework to guide markets, and to support innovation, for instance through the Technology Strategy Board, Energy Technologies Institute, Carbon Capture and Storage Demonstration as well as support focused on maximising learning and innovation.

Planning reform

As our recent report, *Cities for Growth*, outlines:

- **Recommendation 15.** The government should bring forward legislation to allow new Garden Cities to spur growth and housing construction in industries and areas that need it most; and
- **Recommendation 16.** The government needs to move as rapidly as possible from a plan-led system to an externality-led system of planning that breaks out of the 1940s strait-jacket our planning system imposes.

Public sector productivity

- **Recommendation 17.** The government must set out a stronger vision for new models of delivering public services in partnership with the private and third sectors. The Open Public Services White Paper failed to deliver the step change in approach that many were hoping for.[4] We have previously outlined how this might be done in the welfare system. Our approach would make use of up-to-date IT infrastructure and tailor support to individuals. It would allow the formation of mutuals and social enterprises to deliver essential public services. It is a model on which the future of many public services could be delivered.
- **Recommendation 18.** The government must consider how to devolve pay bargaining to a more local level and work constructively with the Unions to ensure that this model is sustainable. Our previous reports on public sector pay and conditions have highlighted the lack of incentives leading from the current system of National Pay Bargaining that exists across large parts of the public sector. Indeed, recent work has shown that problems of recruitment and low productivity caused by national pay bargaining in the public sector can lead to increased likelihood of deaths following admission to hospital.[5] By devolving pay bargaining to a more local level, pay would be allowed to match costs of living in local areas and be varied to effectively incentivise performance. This would raise productivity and growth.

4 http://files.openpublicservices.cabinetoffice.gov.uk/OpenPublicServices-WhitePaper.pdf

5 Propper, Van Reenen 'Can pay regulation kill?', Journal of Political Economy, 2010. http://www.bristol.ac.uk/cmpo/publications/papers/2008/abstract184.html

1

Policy priorities

by Matthew Oakley

A call to action on growth

This report is about starting an evidence-based and balanced debate around growth in the UK. It issues a call to action to politicians, the media, policy makers and the public to start to consider the long-term future of the UK economy, rather than focusing on short-term politics and policies. The report does not naively assume that the UK economy is performing well. We recognise the depth of the recent recession and the real dangers of a return to recession in the near future. The situation in the Eurozone and indeed the global economy more generally, make any other conclusion unrealistic.

> “It issues a call to action to politicians, the media, policy makers and the public to start to consider the long-term future of the UK economy, rather than focusing on short-term politics and policies”

That is why parts of this report paint a gloomy picture of the UK economy. Growth forecasts have been revised down by a range of organisations: from the Bank of England to the OECD and the CBI.[6] Recent labour market statistics show a total of over 2.6 million unemployed people and youth unemployment toppling through the one million mark.[7] Chapter 8 highlights that the Federation of Small Businesses' most recent quarterly survey showed small businesses across the country having a negative outlook, with a growing number laying-off workers. A range of other indicator surveys are looking bleaker than they have for some time.[8] However, unlike others, we do not see this evidence as an excuse to return to more government spending and higher borrowing in order to somehow try to prop up the economy. Similarly, this report does not call for indiscriminate and large-scale deregulation and tax cuts.

Both of these areas, characterised by statist versus free market approaches, focus too strongly on ideological stances and too little on policy that will set a positive and ambitious course for the UK economy. The former approach completely fails to acknowledge the structural problems that exist in the UK economy. It makes the argument that it is government who must drive the success of the UK economy, not the entrepreneurs, workers, families and individuals who are, in fact, the engines of growth. The latter approach fails to acknowledge that markets fail, that government does have a role and that we need to move to a model of growth that is more balanced structurally and regionally and that is accessible to all those who want it. It also fails to recognise that deficit-funded tax cuts can be as damaging as deficit-funded spending.

6 For a summary see HM Treasury, *Forecasts for the UK Economy: a comparison of independent forecasts*, No. 295, November 2011; Bank of England Inflation report, November 2011; OECD, *What is the Outlook for OECD countries: an interim assessment*, September 2011; Confederation of British Industry, Economic and Business Outlook, November 2011.

7 ONS, Labour Market Statistics, Statistical Bulletin, November 2011.

8 See for instance: http://www.rec.uk.com/press/news/1851 and http://www.markiteconomics.com/MarkitFiles/Pages/ViewPressRelease.aspx?ID=8738

Chapter 11 of this report outlines our frustration with these approaches and the damage that a focus on the short-term and ideology is having on the UK economy. This intellectual deficit in policy debate is not a problem that is confined to the UK. A recent book summarises the political debate around growth in the US:

> *The Democratic Party seeks to extend government spending even when the middle class feels squeezed, the public sector does not perform well and we have no good plan for paying for forthcoming entitlement spending. To the extent that the Republicans have a platform, it consists of unrealistic claims about how tax cuts will raise revenue and stimulate economic growth... Political discourse and behaviour have become increasingly polarised and what I like to call the 'honest middle' cannot be heard above the din.*[9]

It can easily be seen that this caricature fits much of the commentary and discussion held in the media, in Parliament and across think tanks in the UK. The problem is that this situation is damaging the confidence of business and the public. A recent survey of the public has shown that, while half of people think that the Coalition is not managing the economy effectively, only one in five think that the opposition would do a better job.[10] Another shows that business is worried that '...politics is getting in the way of economics' and that '…there doesn't seem to be a sensible plan for economic growth in the UK'.[11] In short, there is little confidence in the economic policy of either the government or the opposition. Given the short-term and politically based nature of much of the policy discussion, this is not surprising.

This report moves away these polarised short-term debates. It argues that the global economy and, that of the UK, is struggling. It then lays out a roadmap by which we can navigate ourselves back to growth, not next week or in time for the next set of quarterly growth figures, but for the next five, ten and 15 years. This road map is informed by people in the economy: the businesses, both large and small, that drive growth and employment; those advising firms on how to invest and grow; entrepreneurs looking to invest; academics and experts; and those who are at the heart of the policy making process.

A number of those people have contributed essays to this report. Not all of the policy recommendations in these essays are ones that Policy Exchange would prioritise, nor endorse. Indeed, there are even some that we do not agree with. But the spirit in which they are all written is key. A recurring theme across all the essays is that, while government can create the conditions for growth and certainly, with bad policy, it can stand in the way of growth, government cannot be a route for growth creation.

These are also views shared by others who have spoken to us, attended and spoken at our events or whose academic work has informed this report. Again, the overarching theme from the majority of these people is that with the right structures in place and the right level of stability and certainty in government policy, they can make business and the UK economy grow. Andrew Cave summarises neatly in Chapter 8: 'government ought to be ensuring that its actions serve to ameliorate an entrepreneur's relationship with risk; the rest will look after itself'.

In the remainder of this chapter and in the essays that follow, a number of areas are highlighted where decades of government intervention and subsequent

9 Cowen, T., (2011). *The Great Stagnation: how America ate all the low hanging fruit of modern history, got sick, and will (eventually) feel better.* Dutton, USA.

10 http://www.ipsos-mori.com/researchpublications/researcharchive/2875/ReutersIpsos-MORI-October-2011-Political-Monitor.aspx

11 CBI, *Economic challenges facing UK business: IPSOS/MORI survey – November 2011.*

reform have left significant barriers in the way of business growth. There are also places where business attitudes and the attitudes of many of us living in the UK may need to change in order to deliver sustained and balanced growth that is enjoyed by everyone, not just those at the top.

To tackle these areas the remainder of this chapter builds on the themes outlined in the chapters of this report to outline Policy Exchange's policy priorities for the Autumn Statement and Budget 2012. We also suggest some more general areas where reform will be needed in the future but where firm answers need to be developed.

A more positive future for the UK economy

Chapter 11 and the section above argue that we need a more positive discussion about the future of the UK economy. This must be based on evidence, not ideology and must focus on the long-term not the short-term: it must give business the confidence to invest some of the cash reserves of around 6.6% of GDP that they are currently holding; it must give foreign investors confidence to move business to and invest in the UK; and it must give the public the confidence to save, invest and spend in a way that maximises long-term growth.

The challenge with being more positive is that the UK economy is in a difficult place. Chapter 2 of this report highlights that growth is, at best, tepid and that many of the signs from recent confidence surveys suggest that the outlook for growth is not improving. The risk of a return to recession is real. In this context, how should we start to be more positive and try to provide business with the confidence it needs to invest?

First we should recognise that the government is doing one thing right. Chapter 2 outlines our strong belief that the government must stick to its course on deficit reduction. The plan it set out to remove the current structural deficit by 2015/16 is the right one.

This view is contested by others who argue that the government must act now to bolster demand in the economy. However, the chapter outlines views from a range of businesses and from academic research that all show that this would be the wrong course of action. To bolster growth, businesses and households need confidence to invest and consume. This confidence is given by certainty and long-term thinking, not knee-jerk politically motivated policy announcements. The CBI has recently argued that '...weak economic performance and growing fiscal instability in the Eurozone make it even more important that the government safeguards the UK's AAA credit rating'. The CBI Director General John Cridland went on to argue that:

> *'The government must stick to its plans to bring down the deficit to maintain confidence in the UK's public finances and keep the cost of borrowing down.'*[12]

Over 80% of business leaders surveyed by the CBI believed that the government must stick to its deficit reduction plans.[13] These are clear signs of what the business community feels about attempts to ease fiscal policy. Academic evidence also suggests that the sort of policies that are being recommended are unlikely to be effective. In particular, recent *Economic Journal* articles have summarised that 'reductions in sales taxes...would do little to speed the recovery'.[14] Another

12 http://www.entrepreneurcountry.com/news-features/item/1532-time-is-right-for-plan-a-plus

13 CBI, (2011). *Economic challenges facing UK business. IPSOS/MORI Survey – November 2011.*

14 Arnold, J.M., Brys, B., Heady,C., Johansson, A., Schwellnus, C., & Vartia, L., (2011). 'Tax Policy for economic recovery and growth'. The Economic Journal, *121* (February), F59–F80.

15 Akitoby, B., & Stratman, T., (2008). 'Fiscal policy and financial markets'. *The Economic Journal*, *118* (November), pp.1971-1985.

article found that increased debt-financed current spending significantly increase sovereign spreads.[15]

Chapter 2 also outlines that we recognise arguments that lower gilt yields are not just a reflection of lower risk sentiments in the market. We also agree that, in part, they reflect a weaker future growth outlook. However, we do not subscribe to the views of some that lower gilt yields have nothing to do with the decision to set the UK's public finances back on to a more sustainable footing.[16] Those making these arguments are not making the similar argument that high gilt yields in parts of the Eurozone are a reflection of an imminent boom. It is our view that there is a substantial risk that backing away from the consolidation plan would come with large risks of significant upward pressure on the cost of borrowing in the UK.

Overall, it is our view that short-term tax breaks are unlikely to be effective and debt-financed fiscal stimuli, and their potential impact on the UK's cost of borrowing, are a risk not worth taking.

The importance of avoiding this risk and of maintaining confidence in the security of the UK should not be underestimated. A clear example of the implications is that Citigroup estimate that the fall in gilt yields since Budget 2010 has resulted in debt servicing savings of £3.3 billion in 2012/13 alone and a massive £11.5 billion by 2015/16. Cumulatively, this amounts to almost £30 billion in that same period. With recent analysis suggesting that the OBR will downgrade its view of the government meeting its fiscal mandate this may prove to be important: coupled with the Chancellor's previous decision to target the removal of the structural deficit a year early, this 'windfall' could allow the Chancellor at least some room for manoeuvre at the Autumn Statement.

We will know the full extent of the figures on 29 November. Whether the government's fiscal mandate will be met and how the Chancellor responds to an assessment from the OBR that the likelihood of the fiscal mandate being met has changed, will be one of the big questions for the Autumn Statement. Our recommendations are as follows:

Recommendation 1

At the Autumn Statement the government must continue to commit to meeting its first fiscal mandate of eliminating the current structural deficit by 2015/16. There are two implications to this:

a. We recommend that 2015/16 is explicitly targeted, rather than the current plans of meeting the mandate by 2014/15; and
b. If, under current policy at the Autumn Statement, the OBR establishes that there is less than a 50% chance that the fiscal mandate will be met by 2015/16, policy must be reformed to put the UK back on course to meeting the mandate. This should include both further fiscal restraint and reforms to boost growth. These reforms must result in the OBR agreeing that there is a greater than 50% chance of meeting this fiscal mandate in 2015/16.

Recommendation 2

Any flexibility in spending resulting from: the move to target 2015/16 rather than 2014/15; reduced debt financing costs; or better-than-expected fiscal circumstances should be shared between investment to reduce the current

16 http://www.newstatesman.com/blogs/mehdi-hasan/2011/11/gilt-yields-low-economic-safe

structural deficit faster and structural reforms focused on the long-term growth of the UK. Specific policies are recommended later in this chapter. No more than half of any additional funds should be targeted towards structural reform. This is in line with both allowing room to meet the mandate and our approach to stable policy making laid out in later recommendations.

What needs to change?

Our first two recommendations focus on ensuring that the public finances are in a stable position. They aim to provide clarity and confidence to the markets that the UK is serious about delivering a stable and growing economy that is not dominated by public debt. However, as we have already outlined, the UK faces other, significant, challenges. The global economy is becoming more competitive, our historically dominant position in a number of sectors has been diminished and we also have significant social problems to tackle. To take a few examples:

- UK productivity lags the G7 average by 11 to 15% and productivity in the public sector has not increased for many years.
- Between 1995 and 2009, manufacturing collapsed from accounting for around 20% of GDP to accounting for just 11%;[17]
- The share of national income going to workers in the bottom half of the income distribution has fallen by a quarter in the last 30 years.[18] The share of those in the top 1% has increased by half. A clear indication of this is that while real incomes for most have fallen during the recession, senior directors at FTSE-100 companies saw a 49% pay rise;[19]
- The UK has 3.9 million working-age, workless households, with 5.5 million adults and nearly two million children living in these households. Even before the recession four million working age adults were dependent on benefits;[20]
- Unemployment also has huge regional variations. Unemployment rates in local authorities currently range from around 4% in Wokingham to over 15.5% in Middlesbrough. In some areas inactivity rates are approaching 40% and it is startling that 60% of all worklessness is in 10% of all wards.[21]

The crisis has clearly shown major structural problems in our economy, but we should be honest enough to admit that they are problems that have been present for a number of years: either ignored or papered over with short-term policies to tackle the consequences, but not the causes. It is now time to start an honest debate about these problems.

It is clear that the global economy is also becoming more competitive and, in places, we are not keeping up. In just one aspect, productivity, David Smith outlines in Chapter 4 Britain's challenge. He argues that while productivity has plummeted over the period of the financial crisis (at the time of writing, productivity in the UK is around 15% lower than it would be had productivity followed its pre-crisis trend), there is a more concerning trend that we have an historically poor productivity record compared to our competitors. As shown above, UK productivity lags the G7 average by 11 to 15%. If we were to look at the public sector alone, we would see an even more worrying picture. Chapter 4 summarises that in the pre-crisis period, 'public sector productivity has been at

17 *BIS Economics Paper NO10B, Manufacturing in the UK: Supplementary Analysis*, BIS, 2010

18 Savage, L., & Whittaker, M., (2011). *Missing Out.* Resolution Foundation.

19 Incomes Data Services, (2011). *Directors' Pay report 2011.*

20 ONS, (2010), *Work and worklessness amongst households.* http://www.statistics.gov.uk/pdfdir/work0910.pdf; DWP, (2010), *21st Century Welfare.* http://www.dwp.gov.uk/docs/21st-centurywelfare.pdf

21 NS Labour Market Regional Tables 12 & 13 (November 2011); Committee of Public Accounts (2008) Helping People from Workless Households into work, p. 7.

best flat, at worst declining' and this in a time when spending and employment were rising.

This is just one area where the UK economy is performing badly structurally. Other areas can be raised:

- Chapter 6 outlines that uncertainty and opacity in our tax system is confusing, costly and frustrating for business.
- Chapter 9 outlines how our planning system has led to some of the highest commercial and residential property prices in the developed world;
- Chapter 4 outlines that the growth potential of small business is still being restricted by a range of factors including regulation and difficulties in finding finance;
- Chapters 3 and 10 outline further problems with our financial and banking sector, which are not being helped by an unhealthy attitude towards one of the UK's strongest areas of comparative advantage;
- Chapter 7 outlines some of the key challenges in ensuring that the pace of innovation is maintained both globally and in the UK.
- Chapter 5 highlights that attempts to deliver growth and policies to tackle climate change have led to a 'green growth' policy that is both costly to deliver and may not lead to growth.

So what should government be doing? As a start, it must start to look to implement a longer-term growth policy. This must focus on policy that removes or mitigates risks of business decisions, while ensuring the progress we have made on delivering better social outcomes across society is not undermined.

One straightforward way for government to do this is to improve the certainty and predictability around the policy it is making. Providing more certainty around the future of government policy, whether that be planning, regulation, tax or indeed any policy that impacts on business, will reduce the risk associated with any given investment decision. It is one easy and costless way to encourage businesses to increase investment now and in the future.

A clear example is in the tax system. A recurring theme from conversations we have had privately and publicly across numerous events on growth and the economy in the last six months is that the costs to business of change in the tax system are high.[22] Chapter 6 highlights that stability and certainty, or at least predictability, are ultimately what businesses want so long as taxes are within international norms.

"So what should government be doing? As a start, it must start to look to implement a longer-term growth policy"

Certainty in policy making and supporting the economy, however, is not enough. As we argued above, there are also significant structural problems with the UK economy. Tackling these will require certainty to go hand in hand with fundamental reform across a wide range of government policy areas. The only way that this can be delivered is if government has a plan and is willing to articulate it.

The next sections lay out our proposals for delivering tax certainty and reducing risk before arguing that the government must also announce a fundamental and long-term strategy for growth in the UK economy.

22 See for instance: http://www.policyexchange.org.uk/events/event.cgi?id=388

Providing firms with certainty

The tax system

A key barrier to innovation, growth in mid-cap firms, business start-ups, investment in the UK from abroad and overall, growth, is policy uncertainty in the UK. Nowhere is this truer than in the system of taxation in the UK. As Will Morris lays out in Chapter 6, long-term business concerns with the tax system are not necessarily about rates, levels or allowances and how these compare with our competitors. That is not to say that these things are not important. However, more pressing in the context of our current tax system is that, given business investment decisions are usually made over a time horizon of at least three to five years, without stability and certainty or, at least predictability, business and individuals are unlikely to have the confidence to invest over this horizon.

The Coalition should rightly claim credit for the consultation and publication of *Tax Policy Making: a new approach.*[23] The principles within this, that tax policy should be predictable, stable and simple are the right ones. However, we already know that between April 2011 and April 2015, 76 tax policy changes have been, or will be, made, and no-doubt there will be more to come in future fiscal events.[24] Some of these changes were also unexpected (e.g. the levy on North Sea oil production). This has meant that, so far, the system has neither been stable nor predictable.

One positive aspect around predictability has been the Coalition's approach in introducing the corporation tax 'roadmap'. This set out plans for reform to corporation tax up to Spring 2014.[25] However, the problem is that the roadmap was broken when, in the next fiscal event, the Chancellor announced a further cut to the headline rate of corporation tax. Reducing the rate is a positive thing, but the process is important because either:

- The Coalition had always planned to reduce the rate further following the publication of the roadmap, but had held back the announcement to allow two separate announcements; or
- The Coalition had not planned to reduce the rate further following the publication of the roadmap but did so because finances allowed.

The first of these would be an extreme example of using the tax system as a political tool and is unlikely to be the case. In the second, more likely, case, given that businesses know that if finances allow, tax will be reduced, it also knows that if finances get tough, tax will be increased. This both reduces the impact of the tax reduction and re-introduces uncertainty into the system.

This is the sort of unpredictability which Will Morris's chapter makes policy recommendations to try to reduce. It puts forward a number of options for reform that, if not delivering complete stability and certainty (for changing circumstances often need a changing tax system), would deliver predictability in the tax system. All are worth exploration and in particular, two areas deserve further consideration:

- Tax policy needs to be made by a more experienced and expert civil service. To achieve this, the chapter suggests that the tax directorate in the Treasury should draw more heavily on the private sector. It also suggests that a distinct

23 HM Treasury and HM Revenue & Customs , (2010). *Tax Policy Making: a new approach.* London.

24 See HM Treasury, Budget 2011.

25 HM Treasury and HM Revenue & Customs (2010). *Corporation Tax Reform: delivering a more competitive system.* London.

tax policy expert route should be introduced so that tenure and experience can be rewarded, rather than incentivising officials to move quickly around the department and civil service to gain promotion. We think this is a premise worth exploring and we will be considering this in the context of more general reform to the civil service in 2012.

- The chapter also raises the question of whether firms who have made investment decisions based on a particular set of tax incentives should receive protection from changes in tax law that are made after those decisions were made. This sort of 'grandfathering' has precedent in the welfare system in the UK. We recognise that there are more complex issues to consider here. These include: how to avoid forestallment and other tax-motivated behaviour; and how to ensure that predictability does not come at the expense of simplicity. Again, we feel that the thrust of this policy change is right. However, we also believe that, in practice, the application of grandfathering may prove too difficult and that a more straightforward reform could push the government to go further.

To deliver predictability we believe that the approach of the corporation tax roadmap should be rolled out more generally and aggressively. To ensure that the roadmap delivers real predictability that reduces risks to business and delivers increased confidence, it needs to have real 'teeth' that allow the government to be held to account over its decisions. For this reason, we believe that the roadmap should be made statutory. There are clearly a number of ways in which this could work. One possible way would involve three distinct requirements:

Recommendation 3
A tax roadmap for the whole tax system should be legislated for. This would require government to set out tax rates, allowances and rules, for at least the following four years, in each Finance Bill.

Recommendation 4
Of course, it would still be possible for government to change these four-year plans in each year. To discourage such short-term decision making, the legislation would also require that any changes to the rates for the following three years (which had already been legislated for in the previous Finance Act) would require the government to make a statement to Parliament setting out in detail both the reasons for the change and the potential impact on business and investment.

Recommendation 5
These two steps might deal with constant changes to existing taxes, but would leave longer-term, and fundamental, tax reform equally opaque. For this reason, the third element of this approach would introduce legislation requiring that within the first year of a new Parliament, the government must publish a Green Paper setting out its intended plan of tax reform for the remainder of the Parliament. This would provide public clarity over its priorities and intentions over the medium-term. Parliament and the public could then use this Green Paper to hold the government to account over its actual tax policy. **The first of these should be published alongside Budget 2012**. This would allow the government

to address a number of areas that are leading to distinct business uncertainty and that are detrimental to growth in the UK as well as its wider reform agenda. This should include: an analysis of the treatment of debt and equity in the tax system and implications for investment decisions and macroeconomic risk; a summary of the potential for longer-term reform to the income tax and National Insurance systems to simplify the personal tax system while strengthening the functioning of the contributory principle; and a summary of its intentions on the taxation of land and property.

We believe that such a system would introduce more certainty for firms, entrepreneurs and individuals while allowing the government flexibility to change the tax system at relatively short notice should the economic situation require. It would encourage long-term thinking about the tax system and go hand in hand with the vision of a more expert and experienced body of tax professionals within the Treasury. The process is outlined in the diagram below.

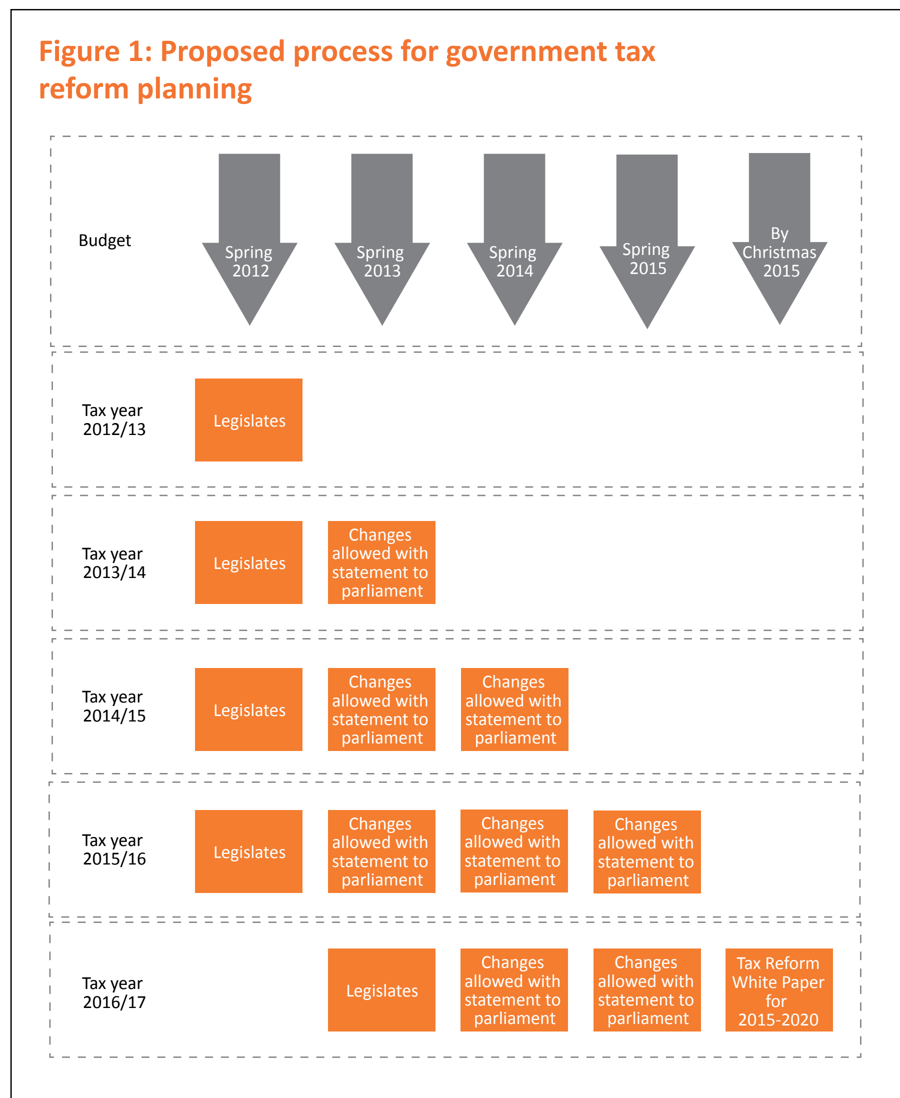


Figure 1: Proposed process for government tax reform planning

The box below gives further detail on how the approach would work and how it fits neatly with fixed-term parliaments.

A legislated tax roadmap

The approach laid out would fit well with the fixed term parliament. As an example of how the approach would work, consider the government coming to power in May 2015:

- Coming to power in May 2015 they would inherit a tax system from the previous government.
- By the Christmas of 2015 they would be required to publish a Tax Reform Green Paper laying out their plans and potential areas for reform for the remainder of the Parliament (to 2020).
- At Budget 2016 they would announce their tax plans and legislate through Finance Bill 2016 for the following four tax years (taking us to the end of the Parliament).
- At Budget 2017 they would announce and legislate for the next year of the tax system, 2020/21. They could change legislation in any of the preceding tax years if they submit a statement to Parliament laying out in detail the reasons for the change and the potential impact on business and investment.
- A similar process would continue until Budget 2020.
- Should the same government be re-elected, the legislation would remain as laid out in the Finance Act 2020.
- If a new government were elected, the assumption would be that they stick to the previous government's policies, unless the situation required an emergency Budget. In either case, they must publish a Green Paper by Christmas and legislate for the following four years in Finance Bill 2021.

The approach would also come with the potential for significant and positive announcement effects by allowing the government to articulate its intention for the tax system. Any government aiming to reduce rates, improve the balance of tax, simplify or overall just improve the tax system could use the Green Paper to announce its intention before the legislation came in. This would both give greater time for consultation and for appropriate (and effective) legislation to be drafted as well as announcing intentions in a more concrete fashion to those considering whether or not to invest in the UK economy.

We appreciate that this approach may lead to tax-motivated decisions (for instance firms or individuals bringing forward decisions to 'beat' tax changes) in response to pre-announced changes in rates and allowances. However, we believe that compared to the damage that an uncertain and volatile tax system has on growth, the potential revenue impacts of these issues are small. On one specific issue – that of avoidance and the closing of loop-holes that may be being abused – we anticipate that the greater time for consultation and drafting of legislation would make these issues less common. The government could also publish as part of the Green Paper a general strand of reform surrounding anti-avoidance measures. It could then legislate for these aspects in each Finance Bill, as it currently does.

As the final part of a new approach to tax policy making, which looks more to the longer-term, we also believe that the government must set guidelines on how tax revenues in excess of those expected should be spent. We believe that when times are better than expected, government must be incentivised to look

to the longer-term by improving the public finances. Thus, in keeping with our approach to removing the structural deficit we recommend that:

Recommendation 6
Any revenues in excess of those expected should not be allowed to be fully recycled into spending or tax cuts in future years. Instead, we believe that at least half should be invested into reducing the structural deficit. In the longer term, it should be used to reduce government debt. This requirement should be legislated for.

We believe this is the sort of certainty and long-term focus that, as a whole, businesses want and the economy needs. However, it will also mean that businesses will have to change their approach to tax policy making. It would encourage them to take the longer view and to engage with long-term consultation with government, rather than lobbying for tax cuts, breaks and allowances on a short-term basis. A tax system with a full roadmap for both current taxes and for fundamental reform would be a mature and growth enhancing one.

The future of the economy

We also believe that the government needs to provide more clarity over its intention for the future for the UK economy. Chapter 10 from Stuart Fraser outlines the vital role that the financial services sector plays in the UK economy: contributing to public finances; attracting foreign investment; and most importantly helping provide the finance and services that businesses need to grow and survive. As Chapter 3 outlines, without a fully functioning financial services sector, Quantitative Easing and plans for Credit Easing will fail.

However, the debate around the value of the financial services sector is still far too biased towards looking back at past mistakes rather than focussing on the opportunities for the future. In order for the UK to retain its advantage in this sector, this must change. The government must again start backing financial services more vocally and also supporting it in policy terms.

This is not to say that the sector does not need regulation: Chapter 10 also outlines the need for significant reform. It is clear that past mistakes need to be learnt from and that we need to create a system, particularly in the banking sector, where competition is high and where individual organisations are allowed to fail. Policy Exchange has previously published on these issues and will be following these up in the near future. However, without vocal support from government, it is likely that the sector will continue to have an uncertain future. This is bad both for the sector and for the economy.

Supporting UK business growth

The proposals we set out above will reduce the perceived risks of business investment in the UK by delivering greater certainty into policy making. On its own, we believe that this will increase business investment from within the UK and from foreign investors. However, we also recognise that there are wider blockages to business growth in the UK. These range from tax and regulatory barriers to problems with access to finance. This section considers policies that would support business growth in the UK.

26 http://www.ifs.org.uk/mirrleesReview

27 http://www.number10.gov.uk/news/morning-press-briefing-for-7-september-2011/

28 Arnold, J.M., Brys, B., Heady,C., Johansson, A., Schwellnus, C., & Vartia, L., (2011). 'Tax Policy for economic recovery and growth'. The Economic Journal, 121 (February), F59–F80.

Encouraging investment through the tax system

As well as being made more certain, the tax system itself also needs fundamental reform. It needs to become more efficient, less complex and better at promoting innovation and business growth.

It also needs to better reflect the changing structure of the UK economy. The Mirrlees Review represents a valuable contribution to the debate on many of these areas.[26] Some elements of their proposals may be accused of being too academic and too impractical or costly to implement, but it provides food for thought for the Treasury, the Office for Tax Simplification and the wider tax community.

To build on these ideas and to fully respond to the challenge the review lays down, we outlined above in Recommendation 5 that we believe that the government should publish a tax policy reform Green Paper alongside Budget 2012. As well as laying down its intentions on the areas we outlined above, we also believe that there are two specific policies that must be addressed in this Green Paper:

Recommendation 7

The government should extend its current NICs holiday for new workers in new firms (in certain regions) to cover all additional workers in all firms with less than ten employees (e.g. any firm moving from employing five employees to employing six employees). However, rather than being a temporary holiday, this should be piloted as a potentially permanent feature of the tax system. Similar policies are strongly advocated by many businesses and business representatives, including Andrew Cave in Chapter 8 of this report. We believe that this policy should be piloted for the remainder of this Parliament with a full evaluation plan implemented in order to inform future decisions over whether to make the exemption a permanent feature of the tax system. This is one area that we believe should be incentivised if, as we outline above, meeting the fiscal mandate a year later in 2015/16 and falls in debt servicing costs allow some financial flexibility.

Recommendation 8

The government has confirmed that they see the 50p rate of income tax as a temporary feature of the UK tax system.[27] We do not believe that there is a strong case to remove the tax immediately, when other taxes have also been raised that hit other parts of the income distribution. However, by not outlining a timetable for its removal, the government is adding uncertainty and risk to business decisions. For this reason, **we believe that the government must make the commitment to removing the 50p rate clear. This must include a set of criteria that would need to be met before the rate is removed**. Recent research has shown that the top marginal rate of income tax does have a significant negative impact on entrepreneurship, productivity and growth.[28] A number of businesses that we have talked to have also argued that the rate is detrimental to their business. Providing clarity to these businesses will go some way to improving business confidence.

Easing finance to business

In Chapter 3 James Barty outlines another key problem in the UK economy: providing finance to businesses. This is not a new problem. It has been a continual

subject of debate since the recession began. It has also been repeatedly raised as a major barrier to growth, in both smaller and larger firms, in the events we have held at Policy Exchange.[29]

The key problem is that attempts to solve this problem have fallen short of the mark. While the first round of Quantitative Easing (QE) was found by Bank of England analysis to have been a success (boosting the level of GDP by between 1.5 and 2%), these results are subject to significant uncertainty. There are also questions over whether the recently announced extension to QE will work in the same way as the first. Lower gilt yields suggest less room for reduced costs of borrowing and QE was aided last time by financial conditions easing around the world. This time global financial conditions are deteriorating as QE is implemented, primarily because of the Eurozone crisis.

Project Merlin has also been the subject of criticism. The agreement between the Chancellor and HSBC, Lloyds, RBS and Barclays included the banks stating that they had a 'capacity and willingness to lend £190 billion of new credit to business in 2011'. Around £76 billion was agreed to be targeted at small firms.[30] However, while the banks are collectively on target to meet this commitment (83% of the total had been lent out in the first three quarters of 2011), there has recently been criticism that the programme has not improved the availability and costs of credit for small firms.[31]

This is part of a wider debate about the willingness of banks to lend to small and medium sized firms. Small businesses are complaining of poor terms to funding that is available. For instance, some have complained of being asked for personal guarantees even when companies are consistently cash-flow positive. These criticisms appear to have a sound basis, however, we also have some sympathy with the banks. They are being asked with one hand to increase their lending to small, and potentially risky, businesses and on the other they are being asked to move to higher capital requirements. Clearly the two are somewhat incompatible. Chapter 3 also outlines that banks are facing pressures from a raised cost of wholesale funding and the need to rollover debt.

Within the context of this stand-off, it seems right that the government is exploring alternative policy options. We believe that a new Credit Easing scheme through HM Treasury is a significant opportunity both to tackle short-term problems with firms struggling with access to finance and to develop a larger and deeper corporate funding market via corporate bonds and commercial paper. To realise these opportunities, the Treasury's Credit Easing programme should consist of three main policies:

Recommendation 9

Credit Easing through the banking system: the government should raise funds of up to around £25 billion and allow banks to apply for the funds. The banks in turn would lend the money onto corporates. Banks would have to return the funds if it had not been lent out within a fixed time period, say three months: ensuring that the programme is demand determined. This would have advantages at both stages: the government has a low cost of funding meaning that lower rates can be passed on through the banks; and the banks have the contacts, the credit assessment capability and the network through which to distribute the credit.

29 http://www.policyexchange.org.uk/events/event.cgi?id=388; http://www.policyexchange.org.uk/events/event.cgi?id=389

30 http://www.bankofengland.co.uk/publications/other/monetary/additionaldata.htm

31 http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/8889611/Project-Merlin-fails-small-business-lending-test.html

If this was all new lending that would potentially triple the amount of net new lending currently going on. Even if we assume 50% of it is displaced lending it would double net new lending. In terms of details, we suggest that:

- Tranches of two, three and five year money should be raised and lent on.
- The banks and the government should split both the risk and the return equally so that banks have the incentive to ensure that the loans are made on a commercial basis and the government would receive a share of the profits of any lending.
- The loans would be available to all banks, providing they lent it on to UK-based companies and, to protect against displacement, we suggest a minimum spread of 200 basis points. This should ensure that the banks did not merely lend on the money to large cap companies who can already tap the bond markets.

We recognise the concern raised in Chapter 8 that delivering Credit Easing through retail banks may come up against barriers because of mistrust of the banking sector. However we believe that this should be easily overcome by the fact that government remains a key stakeholder in this process and that the costs of funding for small firms should be considerably lower.

Recommendation 10

Credit Easing through the tax system – long-term: the government should announce a new tranche of ISA allowance for individual investors (of say £5,000) specifically targeted at investment in small and medium sized firm debt. Such an approach would incentivise ISA providers to give access to this market to its retail customers and should provide a vital increase to the size of this market that could provide significant funds to mid-sized companies.

We believe that the costs of this policy would be low. The low rate of interest most investors are receiving, particularly on cash deposits, means that tax payments on this interest are also relatively small. This means that the costs of foregone tax would be low and could be financed if, as we outline above, meeting the fiscal mandate a year later in 2015/16 and falls in debt servicing costs allow some financial flexibility.

Recommendation 11

Credit Easing through the tax system – short-term: The Business Payment Support Service is an invaluable tool for business who, while profitable/viable, may struggle to meet their tax liabilities. For instance, this might be because of cash-flow problems. Between November 2008 and June 2011 the scheme granted nearly 450,000 with Time To Pay arrangements, worth in total £7.71 billion. It is a measure of success of the scheme that, of that amount, over £6.69 billion has already been paid back.[32] However, current use of the scheme stands at just 37% of the level it was in 2009 and a number of businesses that we have spoken to were unaware of the scheme. Businesses are also complaining that the scheme has been reined back, with agreements much harder to obtain. For this reason, we recommend that the government explores what more might be done to advertise the scheme and whether it might be further expanded to provide help to more firms.

32 http://www.hmrc.gov.uk/stats/bus_pay_sup_serv/official-stats-july2011.pdf

With the uncertainty surrounding the future impact of QE, we also believe that the Bank of England needs to be more imaginative in its monetary policy and, in particular, it should focus on more support for the banking system. For this reason, we also recommend that:

Recommendation 12
The Bank should reconsider its decision not to rollover the Special Liquidity Scheme (SLS). Now is not the time to be withdrawing support from the banking system and the Bank has even acknowledged that this will put upward pressure on the price of credit. Allowing the SLS to expire has the potential to undermine the loosening of policy from QE since monetary policy and the financial system are inexorably linked.

By implementing the full range of options for Credit Easing we have suggested above, the government can both ensure that QE has a much better chance of success in the short-term and also stimulate a vital element of corporate finance for the future. More details on each of the proposals can be found in Chapter 3.

Regulation

Andrew Cave summarises in Chapter 8 that 'government ought to be ensuring that its actions serve to ameliorate an entrepreneur's relationship with risk; the rest will look after itself'. In a large part we agree with this statement. Individuals, entrepreneurs, business and investors are the drivers of growth in the economy and as we have laid out previously, attempts from the government to try to drive, rather than facilitate, growth are likely to be doomed to failure.[33] In Chapter 5 Simon Less also makes this argument in the context of the government's attempt to introduce a 'green-growth industrial policy'.

However as Simon Less points out, we should also be sure that we are pursuing policies that are both good for society and good for growth. In some cases, these may be the same thing. However, in some cases we will need policies that are good for growth alongside other policies that are good for society.

Nowhere is this truer than in regulation. Matt Brittan rightly points out, regulation should not start from the question of 'how do we regulate this' but of 'how do we protect the space needed for innovation'. This is a clear signal that we have to be careful in ensuring that regulation, tax and legislation does not tie the hands of business and increase risk.

An obvious concern from many businesses and, in particular SMEs, is that of employment legislation. Recent arguments have correctly pointed out the risks to small business associated with employment tribunals[34] and the costs of new regulation including changes to pension rights and the rights of agency workers.[35] However, as John Philpott has recently outlined, the UK still has a relatively loosely regulated labour market and it is unlikely that immediate deregulation is likely to lead to a significant boost to growth in the short-term.[36] As we outlined above, we also need to be sure to balance business interests with the need to drive social progress. For this reason, those who call for wholesale deregulation[37] and, for instance, the suspension or complete removal of the National Minimum Wage or employment tribunals, are wrong.

That is not to say that reform is not desirable for long-term growth prospects in the UK. The recently launched consultation into the possibility of reducing

33 Policy Exchange, *The Budget 2011: Policy Exchange's Response*, 2011.

34 British Chambers of Commerce, *Business and the employment tribunal system*, 2011; BIS, *Resolving workplace disputes: a consultation*. 2011.

35 See British Chambers of Commerce, *Employment legislation: holding back recover?*, 2011.

36 http://www.peoplemanagement.co.uk/pm/sections/your-say/blogs/specialists/john-philpott.htm

37 See for example http://www.iea.org.uk/in-the-media/press-release/the-government-must-tackle-burdensome-regulations . Also see http://www.cps.org.uk/files/reports/original/111114155257-escapingthestraitjacket.pdf

the burden of dismissal rules for small firms is encouraging.[38] However, we must continue to ensure that we balance both the needs of business and employees. To some extent the consultation also misses the point. If reform is good for business, we should be rolling it out to all firms, not just small firms. We believe that to really tackle this issue the consultation must be extended to cover firms of all sizes and must ensure that evidence is taken from employee representatives.

It is also essential that we broaden out the assessment of the regulatory costs that are being placed on business. The steps the government has taken through the "red-tape challenge" and a general push for deregulation are in the right direction. They ask business about the elements of regulation that most damage their business and where appropriate take steps to remove these barriers. However, we believe that more must be done to protect firms, of all sizes, from some of the most costly regulations.

Clearly many of these regulations may come from abroad. This may then present a challenge in terms of easing the direct burdens placed on firms. For this reason it is also essential that consideration is given to more innovative ways of mitigating some of the costs to business. For example, one recent report starts a debate around how to both protect and support the rights of workers while delivering costs savings for business when employees are absent from work because of illness.[39] More discussion along these lines is needed.

For these reasons we recommend that:

Recommendation 13

The government launches a review to assess the cumulative cost of: the Agency Workers Directive; changes to pensions regulations (the introduction of NEST); the existing system of and suggested changes to maternity and paternity leave; and health and safety legislation. This should inform an assessment of tools to mitigate these costs (including how to limit future increases in burdens) for businesses, while maintaining an appropriate level of protection for employees.

Removing distortive government policy

The systems of tax and regulation in the UK are not the only areas where government has introduced significant distortions to business decisions. Three other areas where government could be accused of holding back growth are: through an attempt at picking winners in a 'green growth' policy; through a planning system that distorts property prices and investment decisions; and through policies to limit immigration into the UK. These are covered in turn below.

'Green growth' policy

Reducing carbon emissions has to be a key goal for the UK. However, as we argued earlier, policies to promote growth and policies aimed at promoting social goals are rarely the same thing. That is why in Chapter 5 Simon Less argues convincingly that muddling-up 'green policies' with 'growth policies' under 'green growth' is damaging to both the goal of reducing emissions and the goal of boosting growth.

The government's approach, under the promotion of 'green growth', has been to favour and subsidise selected 'green', usually renewable energy, industrial

38 http://nds.coi.gov.uk/content/detail.aspx?NewsAreaId=2&ReleaseID=422195&SubjectId=2

39 Wind-Cowie, M., (2011). *Of Mutual Benefit: personalised welfare for the many.* Demos, London.

sectors. However, the government's arguments seem less about subsidising the best way to reduce carbon emissions and more about attempting to boost predicted future growth sectors. In short, it appears to be an attempt at industrial policy interventions not often heard in the UK since the 1970s.

The truth is that renewable generation subsidies have proven an incredibly expensive way to meet 2020 carbon targets, and a poor way to prioritise resources for low carbon innovation. The cost to the UK economy of the EU 2020 renewable energy target has been estimated by the government at £66 billion. Part of this plan will deploy 13-18GW of mainly deep water offshore wind, at a current cost of around £300 per tonne of carbon dioxide saved. This is compared to saving the same emissions under the EU Emissions Trading System (ETS) 2020 carbon cap, where the carbon permit price is currently only around £10. It does not seem to be a price worth paying, particular as renewable generation subsidies deliver no more carbon reduction by 2020 than the ETS would do on its own.

"The truth is that renewable generation subsidies have proven an incredibly expensive way to meet 2020 carbon targets"

The government therefore plays up the industrial policy arguments for such subsidies. Part of the government's argument is that it believes that it can create UK comparative advantage in relation to offshore wind and service a large world export market in, particularly, marine renewables. The government is gambling £10s billions of public money on these beliefs. However, it is very far from clear that this gamble will pay off. There are huge unknowns about the development of global marine renewables – currently some of the most expensive forms of electricity generation – as well as the UK's ability to capture a significant proportion of any global export market in competition with other countries. And the opportunity cost of this public funding is huge: it is money that could be used for investment elsewhere in the economy.

With this in mind it is clear that the approach of picking winners is incompatible with our view, outlined below, of how government should be supporting innovation and technological progress, thus:

Recommendation 14

The government should eschew the muddled concept of 'green growth' and the 1970s-style industrial subsidies for hand-picked future growth sectors which it leads to. The government should instead concentrate on policies to promote growth alongside other policies to go 'green' – reducing carbon emissions – as cost-effectively as possible. Key policy tools for this last objective will be to establish an effective long-term carbon pricing framework to guide markets, and to support innovation, for instance through the Technology Strategy Board, Energy Technologies Institute, Carbon Capture and Storage Demonstration as well as support for focused on maximising learning and innovation.

Planning reform

One key area where government legislation is restricting growth is in planning. Chapter 9 by Alex Morton follows on from our recent report *Cities for Growth*. It sets out many of the less visible but damaging ways in which our planning

system holds growth back. To take just one key example, as house prices rise, UK bank lending becomes heavily distorted. By 2008 around 75% of all lending was property related. The credit crunch has not changed this and the situation is only getting worse; in the last six months bank lending for mortgages rose £0.8 billion a month while lending to non-financial businesses fell by £1.6 billion a month.

The planning system also raises the cost of non-agricultural land steeply and so discourages investment, particularly in sectors that have a low return per m^2 (essentially manufacturing and similar sectors). By pushing business towards sites that are not their first choice, but are instead where planners think that they should locate, productivity is lower than it otherwise could be.

Specific regulations also often have severe negative effects. For example, the 'brown field first' policy introduced in 1995 coincided with a major decline in manufacturing, as industrial sites were pushed by councils to become housing or other space, which was also often profitable for land holders in the short-term.

In short, the planning system has a major part to play in explaining the imbalances and structural problems in the UK economy that this chapter has laid out. The negative effect of planning on our living standards are large – in just one industry (retail) the LSE has argued that the loss of productivity due to land regulation are just 25%, and McKinsey argued that land regulation is one of two major reasons that UK productivity is lower than it otherwise would be.

There needs to be a clear change of direction. Our report, *More homes: fewer empty buildings*, argued that reforms were needed to the planning system so that it becomes easier to transfer between different uses of buildings (at the moment once a buildings use is set in the planning system, it can be difficult to change). This policy is essential, but we recognise the concerns of Stuart Fraser in Chapter 10, that this may encourage change of use to housing, where the shortage is greatest, which means that we must also allow more development overall as well. For this reason we recommend that:

Recommendation 15
Government should bring forward legislation to allow new Garden Cities to spur growth and housing construction in industries and areas that need it most; and

Recommendation 16
Government needs to move as rapidly as possible from a plan-led system to an externality led system of planning that breaks out of the 1940s strait-jacket our planning system imposes.

Our report *Cities for Growth* sets out our thinking in greater detail.

Longer-term policy directions

The previous sections have laid out our recommendations for where government must focus its attention at the Autumn Statement and Budget 2012. The following sections outline other areas where we believe significant reforms are needed but either on a longer timescale or after more work is done to consider the policy options.

Public sector productivity

Chapter 4 highlights some of the key productivity challenges in the UK economy. David Smith highlights that one of the main problems is:

> *Chronically weak public sector productivity. This was highly problematical during the years of plenty for public services. It is critical at a time when budgets are tight and greater efficiency is the key to public service delivery.*

We agree with this summary. While productivity in the private sector has not grown dramatically and still lags some of our competitors, it is far higher and has grown more strongly than that of the public sector. In fact, public sector productivity has, at best, flat lined over at least a decade.

This is not an argument that there is no role for the state to provide public services. Neither is it an ideological argument about the proper size of the state. Our argument here is that, whatever the size of government it must ensure that the expenditure is made the most of. That is, that it is used productively. There are clearly areas where this is not the case.

One significant barrier is the current procurement practice in government. This is often accused of freezing out small and medium sized firms; of stifling innovation both within government and in the private sector; and of not being joined up enough across government departments. One cannot underestimate the costs of some of these decisions. These are costs in terms of wasted money – with a recent PASC report highlighting that government spent an estimated £16 billion on IT in 2009 and that departments were spending an average of £3,500 on each desktop computer.[40] They are also costly to businesses across the UK: procurement was highlighted repeatedly in our events on mid-cap firm growth and on innovation as a key blockage to business growth.[41] This is particularly true for SMEs. The same PASC report highlighted that:

> *Procurements that go through the most rigorous process take an average of 77 weeks to complete in the UK. This length means that many small businesses cannot commit staff to work on a bid for the duration of the procurement process. The length of the process also makes it difficult for government information systems to keep up-to-date; as by the time a procurement cycle has finished both the policy and available technology may have changed.*[42]

This highlights the disadvantages that SMEs face and the wider productivity costs of poor public sector procurement practices. In Chapter 8 Andrew Cave also makes a strong argument that 'government should be looking to use its estimated £238bn public sector spending power to…[help] the smallest businesses grow.' We do not agree that government should necessarily favour small firms: sometimes economies of scale and the expertise and experience of large firms are essential. However, we do agree that current practices are biased against small firms and that more needs to be done to level the playing field. It is encouraging that Francis Maude has recently outlined potential steps to delivering improvement in this area.[43] However, it is likely that more will need to be done.

Another major issue relates to the way government collects, shares and uses data across the public sector. This administration has made good progress on a number of fronts, from opening up access to spending data and departmental

40 Those who have visited or worked in departments across Whitehall will understand that these costs are not matched by performance.

41 See http://www.policyexchange.org.uk/events/event.cgi?id=388

42 http://www.publications.parliament.uk/pa/cm201012/cmselect/cmpubadm/715/71502.htm#evidence

43 http://www.bbc.co.uk/news/uk-politics-15808796

business plans, to collecting more information than ever before together on a single data.gov.uk portal. More needs to be done, however, to drive economic value and public sector efficiency potential from public sector data. Within government, the combination of data and analytics can identify areas of waste and fraud, point up more efficient ways to run operations and help ministers make better, more informed decisions. And by opening up more public sector data – whist being mindful of privacy and security concerns – on clear and flexible terms the government can provide the essential data infrastructure for a modern, digital economy. Over the coming months we will be doing more work to explore the potential for developments on open data, personal data and big data to radically transform society, the economy and the state.

There are also much wider policy angles that should be explored more fully. David Smith summarised the key to improvement as being '...increasing choice and competition'. There are many ways in which this could be done. In particular we believe that:

"Another link between public spending and joint working between the private sector is the use of PFI initiatives"

Recommendation 17

The government must set out a stronger vision for new models of delivering public services in partnership with the private and third sectors. The Open Public Services White Paper, failed to deliver the step change in approach that many were hoping for.[44] We have previously outlined how this might be done in the welfare system. Our approach would make use of up-to-date IT infrastructure and tailor support to individuals. It would allow the formation of mutuals and social enterprises to deliver essential public services. It is a model on which the future of many public services could be delivered.

Recommendation 18

The government must consider how to devolve pay bargaining to a more local level and work constructively with the unions to ensure that this model is sustainable. Our previous reports on public sector pay and conditions have highlighted the lack of incentives leading from the current system of National Pay Bargaining that exists across large parts of the public sector. Indeed, recent work has shown that problems of recruitment and low productivity caused by national pay bargaining in the public sector can lead to increased likelihood of deaths following admission to hospital.[45] By devolving pay bargaining to a more local level, pay would be allowed to match costs of living in local areas and be varied to effectively incentivise performance. This would raise productivity.

Another link between public spending and joint working between the private sector is the use of PFI initiatives. These have recently come under fire for providing poor value for money for the taxpayer.[46] It is however, massively important that private sector expertise and finance is leveraged into public services and assets, and in particular into significant infrastructure projects. For this reason it is to be welcomed that the government has launched a review to be led by the Treasury on how to reform the PFI model.[47]

44 http://files.openpublicservices.cabinetoffice.gov.uk/OpenPublicServices-WhitePaper.pdf

45 Propper, Van Reenen 'Can pay regulation kill?', Journal of Political Economy, 2010. http://www.bristol.ac.uk/cmpo/publications/papers/2008/abstract184.html

46 See for instance: Hansard: Parliamentary debate 23rd June 2011, Westminster Hall

47 http://www.hm-treasury.gov.uk/iuk_pfi_reform_call_for_evidence.htm

Innovation

It is clear that technological progress marches on. But when we take a closer view, we see that the picture may not be so positive. Our ability to drive incremental efficiencies is as good as it ever was – viz Moore's law for microprocessors, fuel efficiency of motor vehicles, advances in food production technologies. However our ability to generate and commercialise truly radical, groundbreaking, disruptive innovations has not kept pace.

Speaking recently at Policy Exchange, Tim Harford illustrated the point with the example of the Boeing 747. This is, by the metrics of modern life, an ancient technology, and destined to still be flying even 80 years after it first took to the skies.[48] He put forward the explanation that innovation is getting harder: the more advanced we become, the more specialism, education, time and money it takes to make the next truly radical leap. Tyler Cohen puts forward a similar argument. Using evidence from Jonathan Huebner he argues that the rate of innovation (relative to population growth and expenditure on innovation) has been slowing since the late nineteenth century.[49]

This latter point is controversial and perhaps a little extreme, for the precise definition of innovation is up for debate. Nevertheless it does underline the real importance of ensuring that we are doing all we can to promote innovation.

One area where the UK appears to be lagging behind is around skills, talent and drive to form an enterprise economy. Good work is being done: Wendy Purcell talks about the work her team have done at Plymouth University to convince small businesses to take on recent graduates, and to convince recent graduates to consider work in small firms;[50] and the work being done at Entrepreneur First is another great example.[51] However, we need to consider what more we can do.

Another key part of boosting innovative capacity in the UK is to nurture the creation and growth of small firms. In the essays from Matt Brittin and Andrew Cave in this report, and in numerous NESTA publications, these firms are highlighted as the innovation and job creation engines of our economy. For this reason, government must do all it can to remove barriers – both regulatory and tax-based – to their growth. Our recommendation for exemptions to employer NICs for new workers in small firms in the first year of employment is one small step in the right direction. However, much more needs to be done. We will continue to focus on this issue in 2012.

Finance is of course also a major factor in the commercialisation journey. Too much of the current debate is focused on the narrow issue of bank lending to small businesses and on business start-ups. In Chapter 8 Andrew Cave outlines that since 1980, 75% of large firms founded in the US had grown from scratch. In the UK and Europe, over 80% were a result of mergers and acquisitions of existing firms. This points toward his conclusion that 'the conveyor belt that takes our smallest businesses to become medium and large businesses is broken'. The problems that UK firms are facing go beyond start-ups and beyond just bank lending. The truth is that a whole ladder of financing activity is needed to take innovations through to commercial success. Business owners, business angels, venture capital, debt and equity investors, banks and building societies all have a role to play.

The government needs to find more imaginative ways to unlock potential investment in innovation, where the stakes are higher than banks are typically

48 See http://www.policyexchange.org.uk/events/event.cgi?id=393

49 Cowen, T., (2011). *The Great Stagnation: how America ate all the low-hanging fruit, got sick, and will (eventually) feel better.* Dutton, USA.

50 See http://www.policyexchange.org.uk/events/event.cgi?id=389

51 http://entrepreneurfirst.org.uk/

prepared to deal with. Our suggestions on Credit Easing above will help. Increasing investment in corporate bond markets will give private, retail investors access to markets that they have not previously had on a widespread scale and could increase interest in funding growing and potentially riskier businesses. But this must only be the start of the discussion.

Equally importantly, in a world of scarce resources it is more important than ever that the public money that goes into innovation is used in the most effective way possible. This will mean importing some of the characteristics of private funding like a proper appreciation of sunk costs and cutting losses, the ambition to bet on the things that no one has ever tried rather than the safe / incremental bets, and the use of prizes and glory to catalyse efforts all merit further attention.

This government, and the last, have already taken small steps in the right direction. The Technology Strategy Board is a good example.[52] They are working as a conduit to innovation: bringing key players together, building and sharing knowledge and leveraging in private sector finance with relatively small amounts of public money. The Technology Strategy Board Chief Executive, Iain Gray also highlights another key element to consider: the role of 'government as a lead customer'. Moving towards a situation where this was a reality would involve better procurement. It would mean asking the private sector to deliver solutions not dictating what the answer should be. Finally it would mean being more focussed on how procurement and outsourcing can promote innovation in both the public and private sectors. This is also highlighted by a recent report from the House of Lords Science and Technology Committee. They summarised that:

> *It appears to us that when procurement decisions are being taken, either insufficient or, worse, no consideration is being given to whether an innovative solution would be preferable, not only in terms of achieving better value for money but also in terms of wider benefits such as the potential to promote economic growth through stimulating new and commercially significant ideas in industry or encouraging the translation of scientific research into innovative goods and services.*

This is clearly a worrying situation, but across all these areas, the positive point is that there are huge gains to be realised. However, much work needs to be done to deliver these.

Our future work, reporting early next year will consider the success factors for innovation in small, digital and high-tech businesses, the specific pools of innovation potential in the UK, and of course also what role the government has to play in both financing and promoting innovation.

Conclusion

This chapter has laid out Policy Exchange's policy priorities for the Autumn Statement and 2012 Budget. It has also outlined key areas where we feel further reform will be needed to boost growth in the long-term and to ensure that growth is balanced and sustainable. There are many others that might be added to this list. Our other work has focussed on welfare reform and on reform to education policy. These two areas are essential to ensuring that our labour market is functioning effectively and that our children have the skills to succeed in the future economy. We will consider these areas in more detail in future reports.

52 http://www.innovateuk.org/

The following chapters lay out some of the arguments in more detail and present other views of what is needed. We hope that this can be the start of a more evidence-based and ideology-free debate on growth and the future of the UK economy.

Matthew Oakley is Head of Enterprise, Growth and Social Policy at Policy Exchange

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The fiscal position: Plan A, Plan B...or something else?

By Ed Holmes

It is now some 17 months since the 2010 Emergency Budget, just over a year since the Spending Review and eight months since the Coalition announced its 'Plan for Growth' in the 2011 Budget. It is growth that is now dominating discussion. Hardly a day passes without the government being called to reverse decisions made in the Emergency Budget and Spending Review and in particular, to spend more now in an attempt to boost growth in the UK.

We should be clear from the start that Policy Exchange called for an Emergency Budget.[53] Our previous publications have called for a ratio of spending cuts to tax increases of around 80:20 as the optimal composition of a fiscal consolidation[54]. We argued that only by cutting public spending, would the country be returned to more stable and sustainable growth and we outlined how the cuts could be delivered.[55] In the round, these proposals have been adopted, which is welcome.

However, with many commentators and organisations now arguing that the Spending Review has damaged economic growth, the question arises: are these policy responses still appropriate *even in the event* of a renewed UK recession?

It is certainly true that the global economic outlook has worsened significantly. In the UK, growth has failed to return to strong levels and this has led to unemployment rising. It remains painfully high. But while we recognise these facts, we still believe that the fiscal mandate established in the Emergency Budget was sound and should continue. This is also the view held by business leaders in the UK. A recent CBI survey showed that 82% of those they surveyed felt that the Coalition's deficit reduction plan should continue.[56]

In fact, a renewed recession would increase the importance of fiscal consolidation, since a double dip would raise the burden of already-excessively-high spending and rising debt upon the economy, placing further pressure upon the UK's ability to service its debts over the medium-term. Taking action while it was possible has put the country in a stronger position to tackle future crises.

Indeed, it may yet prove necessary to go further. The prospect of ongoing recession coupled with further fiscal tightening is an unpleasant one, but it is one we may have to face. This chapter re-states our belief that the Emergency Budget and Spending Review were necessary before turning to assess the impact that consolidation might have had on demand and considers the argument

53 Lilico A, O'Brien N, Atashzai A, 'Controlling public spending: the scale of the challenge', Policy Exchange 2009, http://www.policyexchange.org.uk/images/publications/pdfs/Pub_spend_3Jun.pdf

54 Lilico A, Holmes E, Sameen H, 'Controlling Spending and Government Deficits Lessons from History and International Experience', Policy Exchange 2009, http://www.policyexchange.org.uk/images/publications/pdfs/Controlling_Public_Spending_-_Nov_09.pdf

55 Lilico A, Holmes E, Sameen H (eds), 'Controlling Public Spending: How to Cut 25%, Policy Exchange 2010, http://www.policyexchange.org.uk/images/publications/pdfs/How_to_Cut_25_-_Oct__10.pdf

56 CBI, *Economic challenges facing UK business: IPSOS/MORI survey – November 2011.*

that fiscal policy should be loosened. It concludes by assessing what more government can do now and what it might do in the event of further external shocks.

Why the Spending Review was necessary

The 'Great Recession' was not a normal business cycle downturn. It was a severe asset-price bubble crash combined with, in the words of Bank of England Governor Mervyn King, 'the most serious financial crisis we've seen at least since the 1930s, if not ever'.[57]

Most commentators will continue to describe an unremittingly gloomy outlook for the UK economy. However, without action, things might have been worse. To mitigate overleveraging it was necessary to restore the medium-term growth prospects of the UK economy. The most straightforward way to do this was to reduce the scale and scope of government spending.[58] A wide body of academic evidence suggests that a one percentage increase in spending as a proportion of GDP reduces the growth rate of the economy by about 0.15 percentage points.[59],[60]

This finding becomes especially important when we consider that UK public spending has expanded significantly. Between 2006/7 and 2009/10 total public spending rose from 40.9% of GDP to 47.6%,[61] while over the same period tax receipts fell by two percentage points. Most of this rise in spending was due to continued implementation of the 2007 Comprehensive Spending Review and, as such, was largely unrelated to the recession. It contributed to a budget deficit that was as high as 11% of GDP in 2009/10. Of this more than four-fifths – or 9% of GDP – was structural rather than cyclical.[62] This means that it would not disappear automatically when the economy recovered. It also meant the UK would be paying more than £60 billion a year by 2014/15 in debt interest. Left unchecked, public debt would have reached 89% of GDP by 2013/14.[63]

With this in mind, the rise in public spending we saw running up to the recession could reasonably be thought to have reduced the growth rate of the economy by between 1 and 1.5 percentage points in the medium term (even excluding the indirect and permanent damage inflicted on potential output by the financial crisis). The downward pressure that this would have put on an already low growth rate would likely have further reduced real wage rises. This would have brought greater risks of widespread household default, with the potential to undermine the creditworthiness both of the financial sector and the state.

The consolidation announced in the Emergency Budget avoided this scenario. Its composition (£103 billion of spending cuts to £26 billion of tax rises) was around 3:1 in favour of spending cuts, creating less concern that new taxes would be imposed in the future to deal with the deficit.

As well as making economic sense, this also made intuitive sense. Productivity in the public sector is substantially below that in the private sector and marginal increases in government expenditure yield less returns the larger is government. Thus, one could easily make the argument that this money would have been better spent or invested by those in the private sector.[64]

In short, the fiscal consolidation implemented in the Emergency Budget and Spending Review was a vital and necessary step to restore the UK's sustainable growth rate and allow households to service their debts and deleverage successfully.

57 Mervyn King, 7th October 2011, http://www.bbc.co.uk/news/business-15210112

58 Afonso A, Furceri D, 'Government size, composition, volatility and economic growth', ECB Working Paper Series No 849, January 2008, http://www.ecb.int/pub/pdf/scpwps/ecbwp849.pdf

59 Afonso, A, Furceri D, 'Government size, composition, volatility, and economic growth', European Central Bank working paper 849, January2008: *'a percentage point increase in the share of total revenue (total expenditure) would decrease output by 0.12 and 0.13 percentage points respectively for the OECD and for the EU countries'.*

60 Mo, P , 'Government expenditure and economic growth: the supply and demand sides', Fiscal Studies 28 (4), 2007, pp. 497-522: *'a 1 percentage point increase in the share of government consumption in GDP reduces the equilibrium GDP growth rate by 0.216 percentage points'.*

61 Or over 50% on the standard OECD measure.

62 Public sector net debt, cyclically adjusted treaty deficit, Emergency Budget 2010.

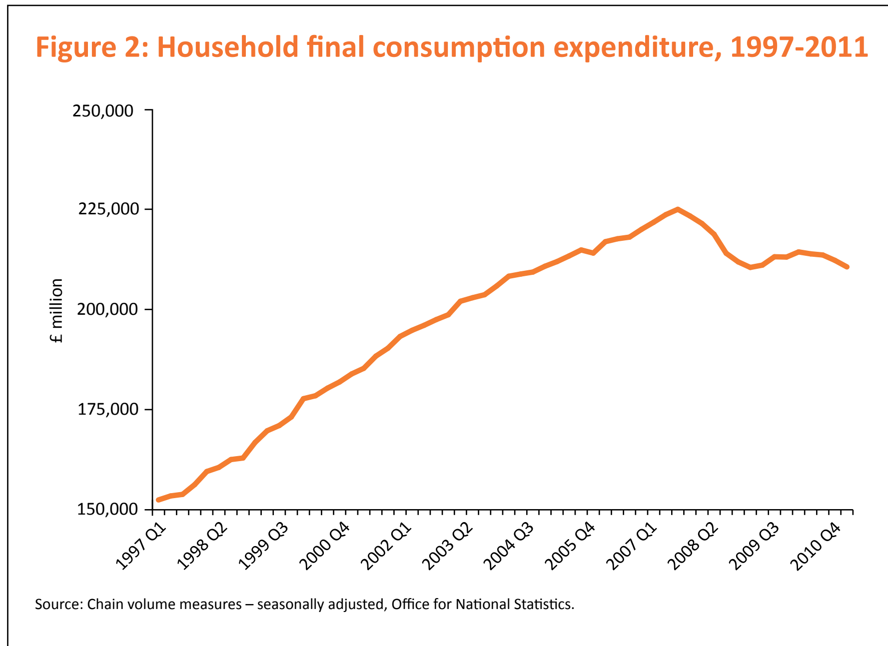
63 March 2010 Budget.

64 Cowen, T., (2011). *The Great Stagnation: how America ate all the low hanging fruit of modern history, got sick, and will (eventually) feel better.* Dutton, USA.

The impact on demand of reducing the deficit

We have argued above that delivering a permanent, credible reduction in public expenditure should boost household incomes (and hence demand) over the medium term. However, many will argue that government should step in to manage demand since the financial crisis has had a profound effect on household consumption. Certainly, household consumption has fallen. Figure 2 shows that it is barely higher than where it was at the end of 2004/5.

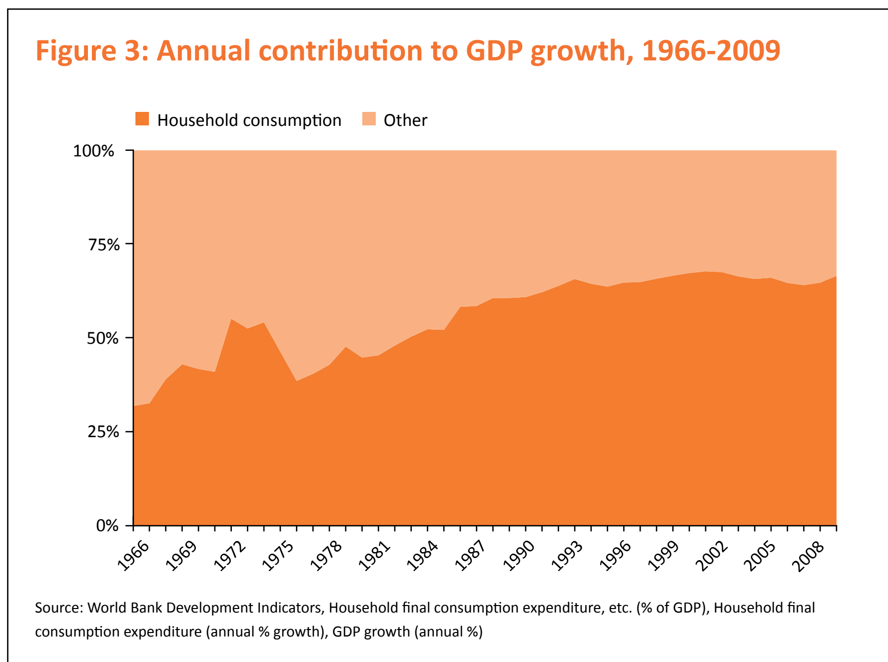
Figure 2: Household final consumption expenditure, 1997-2011



Source: Chain volume measures – seasonally adjusted, Office for National Statistics.

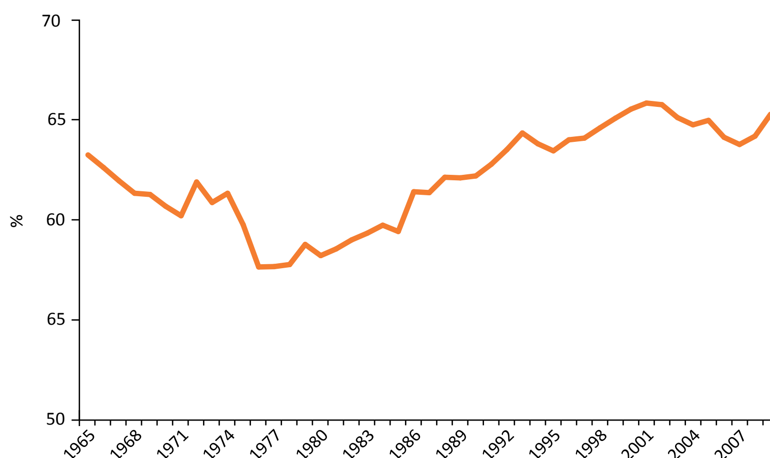
This problem is particularly acute considering the high proportion that household consumption contributes to UK GDP growth. Figure 3 shows that household consumption now makes up around two-thirds of UK growth and Figure 4 shows that is accounts for almost two thirds of total GDP.

Figure 3: Annual contribution to GDP growth, 1966-2009



Source: World Bank Development Indicators, Household final consumption expenditure, etc. (% of GDP), Household final consumption expenditure (annual % growth), GDP growth (annual %)

Figure 4: Household final consumption expenditure, etc. (% of GDP), 1965-2009



Source: World Bank Development Indicators, Household final consumption expenditure, etc. (% of GDP), Household final consumption expenditure (annual % growth), GDP growth (annual %)

It is also true that that these challenges are likely to persist. Household debt is forecast to remain at an historic high of 106-175% of disposable income[65] and incomes are not rising as fast as anticipated when the debt was undertaken. However, it must also be remembered that these falls in consumption factor in government spending decisions. It is impossible to know what consumption would have been like if government had not acted. The counterfactual is impossible to create, but there are good reasons to believe that without action from the government to deliver permanent, credible reductions in public spending, consumer spending could have been even lower.

The first, oft-rehearsed argument here is that of Ricardian Equivalence: that is that households and business understand that if the government borrows extra (or cuts taxes without cutting spending) today, it will have to raise taxes tomorrow to pay off that borrowing. In anticipation of those extra taxes tomorrow, households will save extra today and firms invest less or choose to invest elsewhere. This sounds like academic nonsense – but it makes intuitive sense. Businesses plan their investment decisions over many years, meaning that they care about the future tax system, as well as the one that is in place now. If they think that in future taxes will rise, this will change the risk / reward balance of any given investment and make them less likely to invest than would otherwise be the case. Less investment leads to less employment, less wages and ultimately lower consumption.

While we believe the thrust of this argument is sound, there are clearly limitations to its application: full Ricardian Equivalence is unlikely to hold. Periods of financial crisis or severe recession can be periods in which financial markets cease to work well. They can also be associated with future job prospects of households becoming so uncertain that workers become severely credit constrained (e.g. during a credit crunch).

65 Office for Budgetary Responsibility, March 2011 economic and fiscal outlook supplementary economy table.

This means that there may be some impact of spending cuts on private consumption. This might also imply that in such circumstances some sort of Keynesian stimulus action, even if debt-financed, might have non-trivial positive impacts in the real economy.

However, we do not believe that this argument stands up to scrutiny. We believe that there is a strong impact of reducing, or limiting the increase in, interest rates. If debt is high, public debt will face an interest rate premium associated with inflation or default risks (as seen in the Eurozone). A fiscal consolidation, if perceived as permanent and successful, can bring about a sustained and material reduction in real interest rates, reducing the burden of debt servicing and promoting investment across the economy.

Recent studies have shown that debt-financed public spending increases sovereign debt spreads[66] and the current low gilt yields in the UK (UK ten-year gilts were around 2.2% – down from 3.5% at the time of the Emergency Budget, against a French rate of 3.1% and an Italian rate of 8.1%) are, at least in part, a testimony to the approach taken. Last year, 23% of government spending was financed by borrowing. With a quarter of UK debt held by foreigners, the UK's borrowing costs are directly determined by the confidence that the global bond market has in its policy. The approach to consolidation has now been endorsed by the IMF[67] and the OECD.[68] Credit rating agencies have also reaffirmed the UK's AAA credit rating status[69] – in contrast to their more ambiguous position before the fiscal target was set.[70]

Gilt yields: low-risk or low-growth?

There has been much debate in recent months over whether the fall in gilt yields should be attributed to 'flight to safety' following the Coalition's credible consolidation, or whether they simply reflect the wider economic situation. To our mind it is a function of both. Clearly the reaffirmation of the UK's AAA rating and a clear target to eliminate the structural deficit within a fixed timeframe can only help lower gilt yields. It is not entirely a function of this as fiscal tightening elsewhere in the world has not always been greeted with such enthusiasm by markets, particularly in the eurozone.

It is also for that reason not entirely a function of reduced growth expectations as some would have us believe, as weaker growth expectations have led to higher yields in some Eurozone countries. There is likely to be some impact from the weak outlook for growth as markets expect interest rates to remain low, which is why gilt yields sit well below those of Australia for example. Nevertheless, to our mind the overwhelming factor is the combination of a credible fiscal policy with the UK having its own central bank who can provide a monetary offset to any fiscal squeeze.

The Bank of England has already shown a willingness to do this with the Quantitative Easing programmes announced and their research suggests this has probably had a significant downward effect on yields. This marks the UK out as different from the Eurozone countries because gilts are seen to have a backstop in the Bank of England. Eurozone countries do not have this so their bond yields become much more reflective of their stand alone credit, with the ECB consistently reluctant to provide that lender of last resort function. This underpins our belief that the Coalition is right to stick to its fiscal programme but look to leverage the Bank of England's monetary easing to provide credit to the economy. That way you can have stimulus and low yields together.

66 Akitoby, B., & Stratman, T., (2008). 'Fiscal policy and financial markets'. *The Economic Journal*, 118 (November), pp.1971-1985.

67 http://www.ft.com/cms/s/0/224391c4-ca48-11df-a860-00144feab49a.html

68 http://www.bbc.co.uk/news/uk-politics-13558997

69 http://www.bbc.co.uk/news/business-15151005

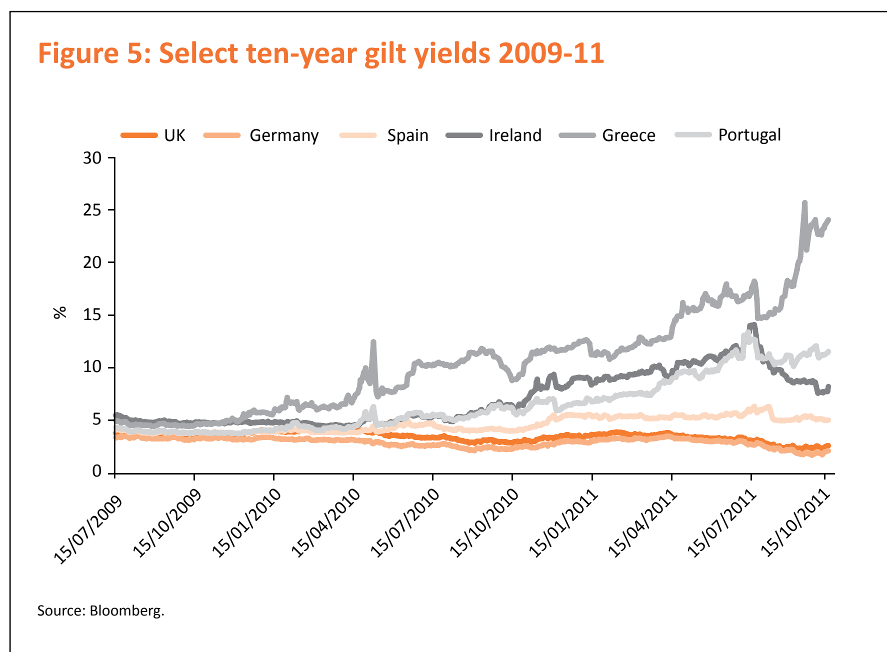
70 http://www.telegraph.co.uk/finance/recession/5360783/Britains-prized-AAA-rating-under-threat-as-SandP-issues-stark-warning.html

71 European Commission, (2003). Descriptive with model simulations (QUEST), 14 EU countries over 33 years (1970 – 2003).

The box above considers this argument in more detail. Without this fall in borrowing costs, future taxes would be higher and private sector consumption lower, because of the increased cost of servicing public (and private) debt. A study by the European Commission also found that of 74 consolidations examined, in 43 cases growth accelerated.[71]

Whatever the cause, the impact of reduced borrowing costs should not be underestimated. The fall in gilt yields the UK has seen can be compared (see Figure 5) to other economies who have seen far higher spreads over German bonds from relatively similar levels just two years ago:

Figure 5: Select ten-year gilt yields 2009-11



Source: Bloomberg.

This situation also puts current debt interest costs and forecast yields significantly lower than the OBR's original assumptions.[72] One estimate puts the cumulative saving at £28.8 billion by 2015/16.[73] In some respects, we should anticipate this windfall being taken up by additional costs associated with lower growth than anticipated through the functioning of automatic stabilisers. The OBR's new forecasts on 29th November are likely to confirm this. The windfall then provides an unexpected cushion for meeting the fiscal mandate.

If the situation is better than many economists and commentators believe, it could also be used to deliver structural reforms to boost growth or as part of package that re-profiles and re-allocates spending. Of course, the windfall also comes with a health warning. The present bull market in sovereign debt relies on markets continuing to accept negative real interest rates. Ultra-low base rates cannot be sustained forever. The savings glut in emerging economies – which push down yields in the developed world – may come to an end as investors seek alternative assets and retain greater capital domestically and aging populations run down their pension assets. The risk of a sovereign debt crisis from contagion from the Eurozone, causing gilt yields to spike remains non-trivial. For these reasons, we are cautious about relying on these savings to finance policies that might boost growth in the medium term.

72 Office for Budget Responsibility, Fiscal sustainability report Annexes, http://budgetresponsibility.independent.gov.uk/wordpress/docs/FSR2011Annexes.pdf

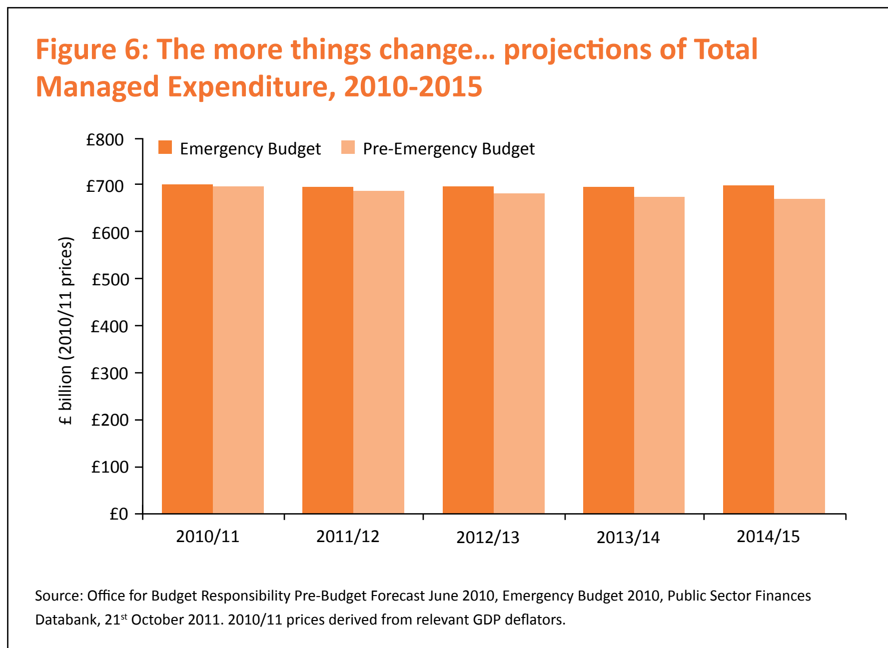
73 Citigroup, Sterling Weekly, 14th October 2011, p. 4.

The scale of spending reduction

As well as these arguments surrounding the positive impact of credible and permanent cuts to public spending, one must also consider the actual extent of the spending reductions that we have seen. A key factor is that the government has chosen to target a fiscal mandate of removing the current structural budget deficit by 2015/16. This means that spending based on cyclical factors, for instance unemployment benefit payments, are not subject to this restraint. In short: automatic stabilisers are free to function.

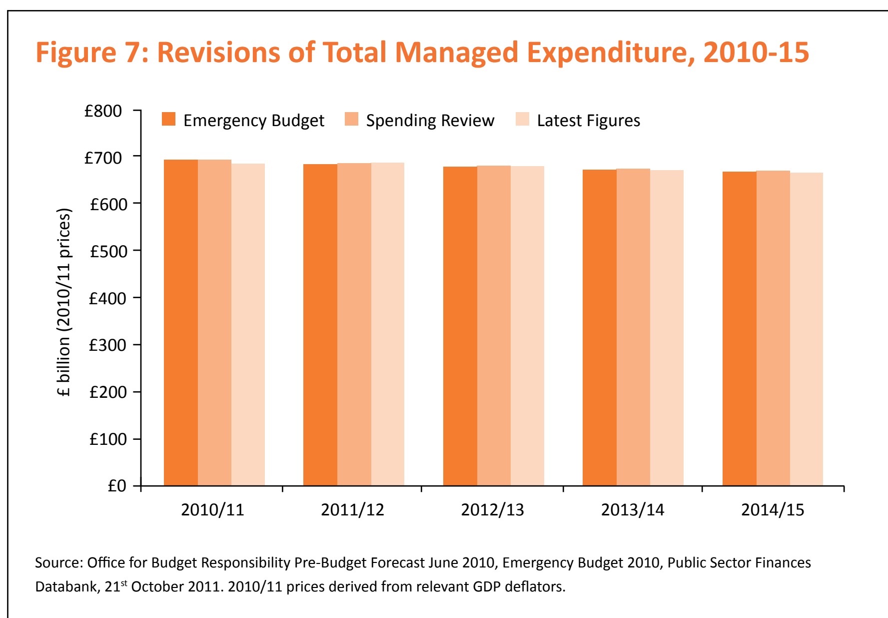
The overall size of the spending cuts can be seen by comparing forecasts for Total Managed Expenditure from before and after the Emergency Budget. Figure 6 does this and shows that the difference in forecasts is actually relatively small: just £23 billion of a total spend of around £700 billion. Figure 7 shows that the situation changed little in the Spending Review, or indeed since then.

Figure 6: The more things change… projections of Total Managed Expenditure, 2010-2015



Source: Office for Budget Responsibility Pre-Budget Forecast June 2010, Emergency Budget 2010, Public Sector Finances Databank, 21st October 2011. 2010/11 prices derived from relevant GDP deflators.

Figure 7: Revisions of Total Managed Expenditure, 2010-15



Source: Office for Budget Responsibility Pre-Budget Forecast June 2010, Emergency Budget 2010, Public Sector Finances Databank, 21st October 2011. 2010/11 prices derived from relevant GDP deflators.

Thus, in fact, the scale of spending reduction envisioned is actually quite small. It now equates to just 2.9% by 2015/16 (down from 3.3% as forecast at the time of the Spending Review and 3.6% at the time of the Emergency Budget). Even this may be revised downward significantly should the OBR's growth forecasts follow that of the Bank of England and independent forecasters.[74] These spending plans will also mean that spending will be 1.5% *higher* in real terms than spending in 2008/9. The latest figures project that overall spending will actually increase (albeit by only 0.3%) in real terms between 2010/11 and 2011/12 (which will likely prove to be too low an estimate).

It cannot be denied that this is an unprecedented change in the direction of public spending. We recognise that it will feel painful. Governments very rarely cut public spending in real terms, and some departments have been far more protected than others, meaning that cuts are not evenly spread. However, the cuts are not as large as some would argue and, as we highlighted above, have been essential in maintaining market confidence in the UK economy.

What does this mean for a tax or debt financed fiscal stimulus?

The preceding sections outlined that government spending has actually changed by much less than one might have assumed given the rhetoric. They also argued that we should not expect fiscal consolidation to reduce private sector demand even in the short-term (though they are often associated with rising unemployment). Indeed, permanent and credible consolidations can lead to higher demand than would otherwise be the case. This section now considers what these arguments mean in the context of calls for the government to introduce a significant fiscal stimulus to boost the UK economy.

Before turning to wider effects, an immediate concern around the suggestions which tend to form part of the call for fiscal stimulus is that previous initiatives have failed to have a significant impact. For instance, two often cited suggestions are to: introduce temporary, targeted, reductions to the costs to firms of hiring workers; and boost the labour market for young workers. Both are understandable, however evidence has shown that National Insurance 'holidays' and changes to employer's labour taxes are ineffective in both theory and in practice. For example, the government's flagship £940 million scheme for NI holidays for new businesses outside London until September 2013 has had just 6,000 applications against a projected 132,000, with some estimates claiming the scheme has cost more to run than it provides in economic benefits.[75]

Large scale job-creation from the government is also likely to be both extremely costly to run in practice and ineffective in boosting the life-chances for young people (the Youth Training Scheme in the 1990s, for example, hindered rather than helped young people, with more than half leaving the scheme early, without a job and with no qualifications).[76]

We must also then consider where the money comes from to finance these schemes. If funded through extra borrowing, the arguments we made above are key: the credibility and market confidence that the commitment to fiscal consolidation has brought to the UK is vital to ensuring low borrowing costs and future growth. This is particularly important in light of recent research that has indicated that a debt burden above around 90% of GDP is associated with a reduction in median growth of one percentage point. The concern is that the UK's debt level is already

74 http://www.bankofengland.co.uk/publications/inflationreport/ir11nov.pdf

75 http://www.hm-treasury.gov.uk/press_75_11.htm; http://www.ft.com/cms/s/0/fe079302-bb67-11e0-a7c8-00144feabdc0.html#axzz1dfsNuI6S

76 S Bradley, 'The Youth Training Scheme:A Critical Review of the Evaluation Literature. Forthcoming in International Journal of Manpower', Working Papers ec12/94, Department of Economics, University of Lancaster, http://www.deepdyve.com/lp/emerald-publishing/the-youth-training-scheme-a-critical-review-of-the-evaluation-KHQee302EQ; http://www.independent.co.uk/news/youth-training-scheme-a-failure-and-a-disgrace-labour-says-1572820.html

84% and due to rise to over 87% in 2013/14 on current projections (which are likely to rise), meaning that there is little or no room for manoeuvre.[77]

This is all the more concerning when we consider off balance-sheet liabilities. For instance, when factoring in PFI contracts, public sector pensions, and guarantees to financial institutions the total is much higher. Recent research from McKinsey found that the UK is more leveraged that any other major economy: a total of 469% of GDP in 2008. This is second only to Japan after adjustment for London's status as a global hub for financial institutions.[78]

If expenditure was to be financed through tax, there are equally concerning conclusions. The first and 5 chapters of this report argue that tax instability and uncertainty undermine both business confidence and, ultimately, growth. Other chapters also highlight that we should be valuing and promoting all sectors of our economy. This means that implementing surprise taxes which move the goal posts for investment decisions taken by both UK and international companies over many years, can be extremely damaging to the reputation of the UK as a good place to do business.

For this reason, while one may find taxes on bankers bonuses politically attractive and even, for some, attractive as a long-term part of the tax system, they should not be introduced to finance a particular policy whim. Doing so signals that businesses in the UK will be asked to fund government spending whenever they are running short of other tax revenue and adds more risk and uncertainty to an already precarious investment climate.

It is our belief that temporary tax cuts – however well targeted – will not achieve the credibility and permanency needed to bolster growth. For example, we reject the notion that a temporary VAT cut would boost demand or speed economic recovery. This point is supported by a recent *Economic Journal* article that concluded '…reductions in sales taxes…would do little to speed the recovery'.[79] As chapter 1 outlines, longer-term structural reform to the tax system is needed and any reform to the tax system must be made with the objective of allowing the economy to grow in the long-term.

Overall, no-one can be completely sure of the impact that stepping back from the commitment to fiscal consolidation might have. A number of reports have used standard macroeconomic models to claim that increased spending might boost the UK economy – but this analysis cannot factor in the non-Keynesian impacts of perceptions, confidence and ultimately the potential impact of a loss of appetite for investment. The last thing that the UK economy needs is a large knock to investment in innovation and business growth and a potentially large and rapid increase in the cost of borrowing. In short, debt-financed fiscal stimuli are a risk not worth taking.

The role of government without fiscal stimulus

Our belief that fiscal consolidation should be adhered to implies that there is no role for government in the current circumstances. However, we do not believe this is the case. Monetary policy is an obvious way in which the government can try to influence the economy, if only in the short-term. Indeed, the next chapter argues strongly that monetary policy has a role to play.

We also still believe that changes to fiscal policy may be needed. The impact of a potentially major crisis in the Eurozone following a Greek exit, or an implosion

77 General government gross debt measured on a Maastricht basis. Public Sector Finances Databank, 09/ 2011.

78 'Debt and deleveraging: The global credit bubble and its economic consequences', McKinsey Global Institute 2010, p. 18, 20, http://www.mckinsey.com/mgi/reports/freepass_pdfs/debt_and_deleveraging/debt_and_deleveraging_full_report.pdf

79 Arnold, J.M., Brys, B., Heady,C., Johansson, A., Schwellnus, C., & Vartia, L., (2011). 'Tax Policy for economic recovery and growth'. *The Economic Journal*, 121 (February), F59–F80.

of the European Financial Stability Facility make it more desirable to implement spending cuts before the crisis hits. Indeed, the CBI has recently argued that '... weak economic performance and growing fiscal instability in the Eurozone make it even more important that the government safeguards the UK's AAA credit rating'. The CBI Director General John Cridland went on to argue that:

> *The government must stick to its plans to bring down the deficit to maintain confidence in the UK's public finances and keep the cost of borrowing down.*[80]

We agree with this position, which means that our belief is that, between the two broad paths widely touted: 'Plan A' (the fiscal target of eliminating the structural deficit by 2015/16 set out in the Emergency Budget); or 'Plan B' (delaying or not following through spending cuts and/or making temporary tax cuts), ***Plan A is the best path for the UK fiscal position to maximise the sustainable growth rate – even in the event of recession***.

This means that, should the OBR assess that the public finances are not on course to meet this mandate, further reforms to fiscal policy will be needed. And there is substantial evidence from the data that this may be the case. For example, recent upward revisions of GDP by the ONS would suggest the UK's output gap – the difference between the actual size of the economy and the size it would be if the economy were on the sustainable growth path – may be smaller than thought.[81]

"In recent weeks, many forecasters have also revised their growth forecasts for the UK downwards, including the Bank of England and NIESR to around 1%"

In recent weeks, many forecasters have also revised their growth forecasts for the UK downwards, including the Bank of England and NIESR to around 1%. This alone will have a large impact on the government's fiscal targets, but if it knocks through to the estimates of the sustainable growth rate (which some commentators have suggested may be as low as 1.1% as opposed to the 2% mark considered previously by many forecasters[82]) the impact on the chances of meeting the fiscal mandate will be large.

In either case, revisions to government policy will be needed. This should come both in terms of supply-side reforms to increase the sustainable growth rate and also more directly through changes to spending plans. It is also important to note that in the longer term, we believe that a more ambitious target of eliminating the structural deficit as a whole (rather than the current, non-capital structural deficit) should be met. The approach of focusing on current spending, and placing no significance on total structural deficits (including capital spending) continues that approach of the previous government's 'Golden Rule', and over time we should move away from this. The correct approach is to eliminate the structural deficit as a whole, not merely the 'current' part.

There are a number of options for ensuring that policy leads us back to *Plan A*. Policy Exchange has already outlined several ways to make broad cuts to departmental budgets not all of which were implemented in the Spending Review; we shall not rehearse them here.[83] Other chapters in this report outline ways in which growth could be boosted through supply-side reforms and ways in which money could be saved through increased productivity. For example, if

80 http://www.entrepreneurcountry.com/news-features/item/1532-time-is-right-for-plan-a-plus

81 'Impact of changes in the National Accounts and Economic Commentary for 2011 quarter 2', Office for National Statistics.

82 http://blogs.telegraph.co.uk/finance/andrewlilico/100011056/how-fast-can-the-british-economy-grow/

83 Lilico A, Holmes E, Sameen H (eds), 'Controlling Public Spending: How to Cut 25%, Policy Exchange 2010, http://www.policyexchange.org.uk/images/publications/pdfs/How_to_Cut_25_-_Oct__10.pdf

public sector productivity growth merely matched that of the private sector, this would improve the sustainable growth rate by 0.5%. This is not an unrealistic goal given that public sector productivity fell behind by a third between 1997 and 2007.[84]

It is also our belief that the composition of public spending is sub-optimal for the objective of maximising economic growth in the long-term – but this need not remain the case. Adjustments to the composition and methods of public spending which seemed politically impossible in May 2010 may not be so today when growth is at the top of the agenda. Filling the lack of demand created by public and private deleveraging requires new thinking about the purpose of public spending. Still almost half the UK's GDP, its role will be a key issue for the future of the UK economy. Difficult global economic conditions may also prompt some fresh thinking on old problems, taking reforms 'further, faster' than was thought previously possible. For example:

- Transferring spending from current to capital spending in departments with historically high or ring-fenced budgets (such as the Department of Health and International Development);
- Switching some cash benefits into department programmes which maximise labour market participation and growth potential along the 'DEL/AME switch' model (child cash benefits into childcare provision, for example); and
- Discontinuing ill-targeted programmes which add little to growth (such as the winter fuel allowance, which recipients often do not need and save rather than spend).

Light at the end of the tunnel?

If the government sticks to its guns on deficit reduction and implements reforms outlined in Chapter 1 of this report, it seems likely that the UK will emerge from the current Parliament with a small structural deficit and a level of public spending reduced to around 40% of GDP –the level which prevailed in the 1990s. This should restore the level of government expenditure to one that is more compatible with sustainable growth of the economy and the solvency of the public finances. It would also deliver this within a timeframe acceptable to the financial markets and political constraints.

Credible barriers to growth abound. For instance: unstable commodity prices; persistent global instability; the difficulty of unwinding quantitative easing; and the effects of deleveraging on consumption. However, credible market expectations of the fiscal mandate being met puts the UK economy in a far stronger position than many of its peers.

This adds weight to argument that the Coalition were right in their approach to the Emergency Budget and Spending Review. They achieved the core objective of giving policy substance and credibility to the fiscal mandate. However, we argue that modifications may be necessary to meet the fiscal target and have outlined a number of areas where further savings could reasonably be made. This should be informed by analysis from the OBR. There is also an option to go further in order to deliver efficiency savings and move toward removing the total structural deficit.

Of course, any changes to expenditure should also go hand in hand with bolder, faster reforms to increase the productivity of public sector expenditure

84 Phelps, M., 'Total Public ervice Output and Productivity', UK Centre for the Measurement of Government Activity, Office for National Statistics, 2009.

to ensure that the long-term growth in the economy is faster than it would otherwise have been.

We believe this approach is right, even in the current difficult economic climate. Evidence from business and academia suggests that temporary tax cuts or temporary fiscal stimulus funded by unsustainable government borrowing will never be enough to give us the confidence and credibility the UK economy needs. They will not boost growth. Consequently, we reject the calls from several think-tanks and journalists to implement such measures.

However, we realise this is only part of the picture. Public spending alone cannot address the underlying structural factors limiting long-term growth. government must create a framework to enable the private sector to drive innovation and growth. These aspects are considered in later chapters in this report and recommendations from Policy Exchange outlined in Chapter 1.

It seems fitting to finish with a quote from a former Prime Minister of the UK:

> *We used to think that you could spend your way out of a recession and increase employment by cutting taxes and boosting government spending. I tell you in all candour that that option no longer exists, and in so far as it ever did exist, it only worked on each occasion since the war by injecting a bigger dose of inflation into the economy, followed by a higher level of unemployment as the next step.*[85]

We agree and hope that this lesson has been learned.

Ed Holmes is Senior Research Fellow, Economics and Welfare at Policy Exchange

85 James Callaghan. Speech at the Labour Party Conference, 28 September 1976.

3
Monetary Policy and Credit Easing

By James Barty

The previous Chapter highlighted that fiscal policy is rightly focused on delivering medium to long-term growth by reducing the structural deficit. With this in mind, much of the burden for stimulating growth in the short-term falls on monetary policy. This support for growth has been made more difficult in the last year or so as inflation has consistently exceeded the Bank of England's 2% target. However, we believe it is to the Bank's credit that it resisted pressure to tighten policy in order to bring inflation back to target more quickly. There is a strong argument to support the Bank's assertion that the bulk of the reported inflation is due to one off (largely external) factors. The lagged effect of weak sterling should largely be in the past by now, since the currency has been stable for the best part of three years, and the surge in commodity prices associated with the second round of quantitative easing in the US (QE2) last autumn and the VAT increase in the UK will also start to drop out of the calculation in the months ahead.

For these reasons, the Bank's action so far has been broadly on the right track: targeting medium-term inflation by providing monetary support to the economy. It is also encouraging that, given the prospects for both growth and inflation in the coming year, they have shown a willingness to resume quantitative easing (QE). The government should also receive some credit for supplementing this with a resumption of credit easing through the Asset Purchase facility.

Nevertheless, we believe that there are real questions over the likely impact of QE this time around. For this reason we argue that there is both a need and scope to take more aggressive steps and to place an increased focus on the transmission mechanism for monetary policy. We will also argue that much of the focus of the last few years on preventing a repeat of the financial crisis may well be impeding the recovery of the economy.

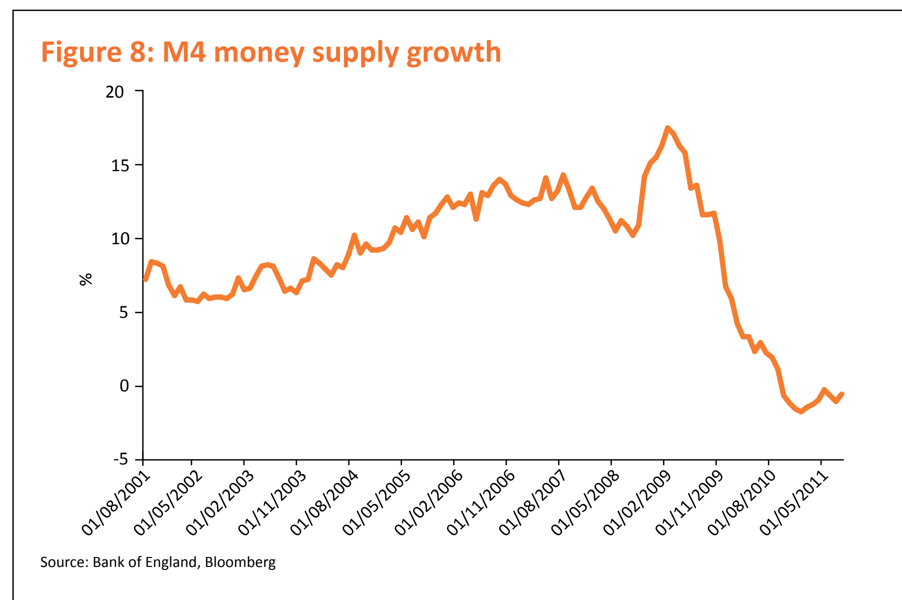
Credit growth and growth

With inflation above target and the economy continuing to grow, albeit at a slow rate, it was understandable that even the doves on the MPC felt they could at best keep policy on hold earlier this year. However, it is now becoming increasingly evident that policy has, if anything, been too tight rather than too loose.

This is best illustrated by the charts below of M4 money supply growth (Figure 8) and net lending by financial institutions (Figure 9). Since the crisis, net lending has just about been positive but it has been as little as 10% of pre-crisis levels. M4 growth has been in negative territory for many months. With this in

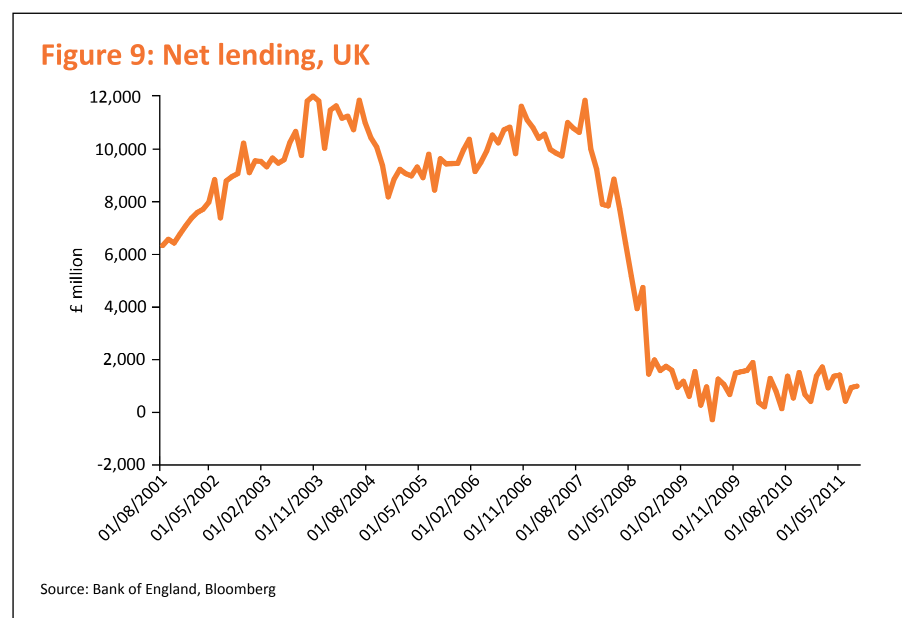
mind, it is unsurprising that growth has been tepid. Equally in the run up to 2008 it was clear that credit growth was rampant with M4 growth running well into double digits from 2005 right through into the middle of the crisis. Yet at this time, policy stayed relatively accommodative and the Bank was, arguably, too slow to raise rates. Then, while M4 growth initially stayed high, net lending started to slow sharply in 2008 providing clear evidence of a problem at the time when some members of the MPC were still considering further interest rate increases. Thus it seems that, if there has been an error in the Bank of England's approach to monetary policy in recent years, it has arguably been to focus too much on actual inflation, which of course is the Bank of England's mandate, rather than the underlying causes of that inflation. In particular, we believe that the importance of credit growth has been significantly underestimated. It is a lesson learnt most recently by those hawks advocating rate rises of late. Even a cursory examination of the lending statistics would argue that such a move would have been, and still is, unwarranted

Figure 8: M4 money supply growth



Source: Bank of England, Bloomberg

Figure 9: Net lending, UK



Source: Bank of England, Bloomberg

The key problem is that, if there is insufficient credit growth in the economy then there is unlikely to be enough GDP growth, particularly when fiscal policy is restrictive as it currently has to be. This means that it is essential that monetary policy and, in particular, any attempt at monetary stimulus bears in mind the need to stimulate credit growth.

Indeed, in the aftermath of financial bust it is more important than ever to understand the transmission mechanism by which monetary policy can stimulate credit growth and demand. It is in this context that we need to judge the current efforts of the Bank of England and the Treasury and examine alternatives. We believe that insufficient attention has been paid to the disincentives to lend caused by the high cost of wholesale funding, the need to rollover debt and the prospect of increased capital constraints.

Notwithstanding the fact that banks and bankers have never been less popular we should also bear in mind that in the UK economy the banking system is by far the most important conduit for monetary policy. If we place too many constraints on its ability to function then we severely impair our ability to stimulate the economy.

Will quantitative easing work this time round?

Before we move on to outline areas where we believe more steps will need to be taken, it is important to lay out the evidence on the impact of the first round of quantitative easing (QE) and prospects for impacts of current, and any future, easing.

The Bank of England is currently undertaking a new round of QE adding an extra £75 billion of purchases, taking its total QE to some £275 billion. Research carried out by the Bank has suggested that the last round of QE boosted the level of GDP by around 1.5-2%, the equivalent of a cut in Bank rate of 150-300 basis points.[86] Those effects, it was argued, were likely generated by a number of factors since purchases of financial assets by central bank money:

> *'…should initially increase broad money holdings, push up asset prices and stimulate expenditure by lowering borrowing costs and increasing wealth. Asset purchases may also have a stimulatory impact through their broader effects on expectations and by influencing bank lending, although this channel would not be expected to be material during times of financial crisis.'* (our underlining).

However, these estimates of the impact have to be treated with a good deal of caution. Firstly, as MPC member David Miles noted in a recent speech (10th October 2011), such estimates are bound to be subject to significant uncertainty as the Bank has not carried out such large scale purchases before. In other words we have a sample size of one. Secondly, the Bank was very much leaning with the wind at the time of the last QE. Other central banks were also easing policy and risk appetite was starting to return with the equity markets having bottomed in March 2009, very close to the time that the Bank announced its QE programme. This means that it is difficult to know how much of the improvement in the economy was a function of the Bank's QE or a function of improving global financial and monetary conditions.

What we do know is that gilt yields did fall. The Bank put the decline at 100-125 basis points around the time of the announcement, but even there it is

86 See Quarterly Bulletin, Q3 2011

far from clear what the pure QE effect was as other bond yields were falling at the same time. The narrowing of the spread between gilts and bunds around the announcement (perhaps the cleanest estimate of the effect of QE) was a little over 60 basis points, so even in the clearest area of impact QE may have only half the impact the Bank has suggested.

This is important because the decision to implement QE rather than other measures this time is based to a large extent on the Bank's research work. Uncertainty surrounding its estimates suggests an even greater uncertainty around the potential impacts of this current round of QE. This is particularly true since gilt yields have much less potential to fall and, unlike last time, the Bank is not leaning with the wind. Equity markets are extremely volatile and while they could continue to rally back from the sell-off of recent months, there can be no certainty of this given the uncertainty about growth in the developed world and, in particular, the problems in the Eurozone.

This is not to say that QE was not important or indeed effective but instead to warn that there has to be considerable uncertainty even about the estimates of its efficacy last time round. This means that to ensure the greatest likelihood of success this time, it is also vital to consider the channels through which further easing could boost credit growth and demand. In the same speech quoted above, David Miles argued that he thinks that there is a good chance QE will work well again. He argues that the key channels are through: portfolio effects, where gilts bought by the Bank are replaced with other financial assets; lower interest rates in other areas such as corporate bonds; and the bank funding channel (where excess cash is deposited with banks improving their funding). He also makes the legitimate point that although gilt yields are lower and therefore the impact on those yields is likely to be less, there could still be a sizeable wealth and portfolio effect because the rise in gilt prices for a given fall in yields is considerably higher at gilt yields of 2.5% than 3.5%.

Monetary Policy will not work without a functioning financial sector

Nevertheless, despite all of the calculations and theoretical underpinnings the MPC is largely guessing at the impact of QE. For example with five year gilt yields at just 1.2% it can be legitimately argued that cash is the closest comparable asset class, rather than equities or even corporate bonds. While higher cash reserves may well help the banks since they have been struggling to raise wholesale deposits, it is far from clear that at this stage they would lend that money out.

The constraints on their ability to do so stem not just from a lack of wholesale deposits but also a rising cost of capital, both in the debt and equity markets. Lower gilt yields might help bond debt issuance by the banks, but with five year CDS spreads for RBS around 325 basis points (see Figure 10) at the time of writing compared to an average of under 200 basis points since the Bank's first round of QE it is far from clear that it is yet doing so. Note too how the cost of term funding in the interbank market is also rising (see Figure 11 of 12 month libor).

This shows the higher risk premium the market is putting on bank risk in general at the moment largely as a function of the ongoing euro crisis but probably also reflecting weaker growth around the world. In short, banks are finding it hard to borrow. This is similar to what happened in 2008 and 2009

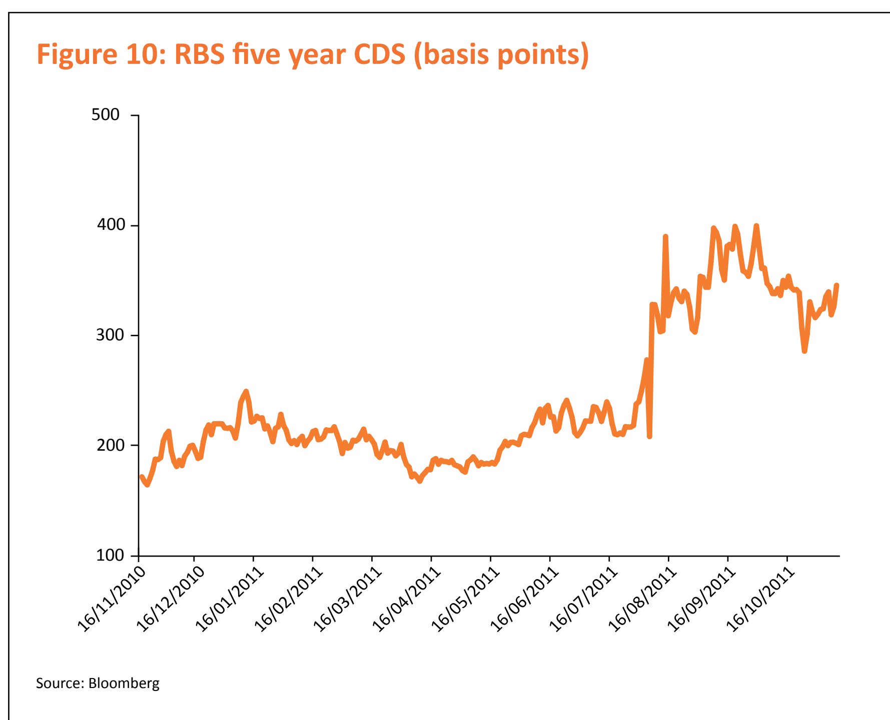
before and especially after the Lehman failure. All bank funding and in particular inter-bank funding depends on confidence. If banks do not know which one of them may be at risk then they are likely to withdraw lending from all but the safest banks. We are seeing this again at the moment. The effect is that the ECB, in particular, has to step in to be the middle man, accepting deposits from all banks and then onlending it. The Bank of England may well find itself having to do the same.

It is not just in the debt market that funds are expensive to raise for the banks. Equity is incredibly expensive and with RBS and Lloyds subject to large government stakes there is little desire to issue more equity. While understandable in ensuring that the banking system cannot require taxpayer support again on the scale of this financial crash, the recommendations of the Independent Commission on Banking do also run the risk of encouraging the banks to rein in their lending. The natural reaction of any financial institution to higher equity capital requirements in the future is to start moving there today.

> "It is not just in the debt market that funds are expensive to raise for the banks"

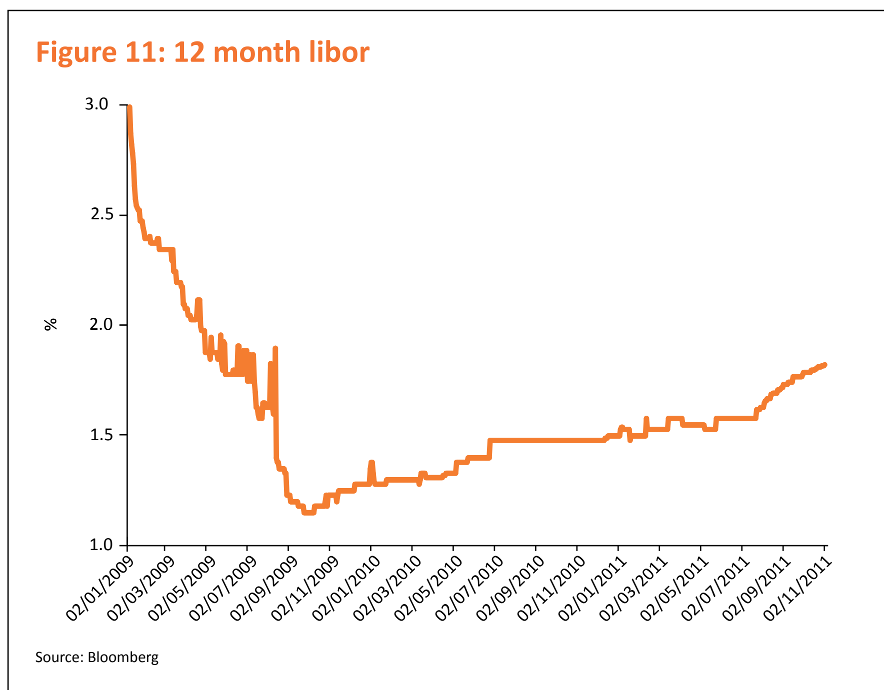
Then, if they cannot raise capital in the markets, there are only two ways to improve capital ratios. First, to wait for profits to increase the capital (which takes time) or, second, to shrink lending books. One way banks have done this is to sell government bonds, which is one reason why yields are under so much upward pressure in the Eurozone. The other is to restrict lending or focus lending on loans, which have a lower risk weight. The way risk weights work is that the lower the perceived risk of a loan the smaller the amount of capital a bank has to hold against it. So loans secured on property would for example attract a lower risk weight than unsecured loans. This may explain why banks are asking for more security than in the past.

Figure 10: RBS five year CDS (basis points)



Source: Bloomberg

Figure 11: 12 month libor



Source: Bloomberg

With these issues in mind it seems that, while QE is not quite hit and hope from the Bank, it should not be the only plan on the table just in case it does not work. Indeed, we believe the Treasury's announcement of a Credit Easing programme alongside QE is particularly important, if implemented well. The next section lays out our contribution to the debate around how the Treasury's Credit Easing should work. But first, it is important to lay out what else the Bank could do.

In general, we think that the Bank of England needs to be more imaginative in its monetary policy and, in particular, it should focus on more support for the banking system. While the Bank is right to argue that its long-term role should not be to support the private sector banking system, our view is that in the short-term, following a financial crash, it has to take on such a role.

For this reason, we believe that it is not the time to be withdrawing support from the banking system and we would urge the Bank to reconsider its decision not to rollover the Special Liquidity Scheme (SLS). The Bank has even acknowledged that this will put upward pressure on the price of credit. It resembles the attempt by the ECB to pull liquidity support earlier this year, which it subsequently had to reverse. Since the very start of the financial crisis the Bank has consistently failed to appreciate the full extent of the need to support the credit channel for its monetary policy to be effective. Allowing the SLS to expire has the potential to undermine the loosening of policy from QE since monetary policy and the financial system are inexorably linked.

This is particularly the case when the banks are struggling to obtain term funding from the market and are paying rates well above base rate or the equivalent gilt yield to obtain term deposits from retail investors. However, if the Bank does not want to extend the SLS then it should instead consider extending the term of the financing it provides the banking sector. At a minimum we believe it should be offering one year money to banks in exchange for collateral, similar to the ECB's practice, and preferably for longer terms than that.

Credit Easing – It must go further and deeper than before

Given the Bank of England's reluctance to entertain credit risk, the Chancellor's decision to reopen Credit Easing through the Treasury is to be commended. The question is how to make this effective. Our strong belief is that this is a real opportunity to improve the functioning of the credit markets in both the short and long-term. For this reason, we think that Credit Easing should in fact cover a range of specific policies.

Having a range of tools is particularly important since some of the most attractive options can only be delivered in the longer-term. For instance, the Bank's last attempt via asset purchases in the corporate bond market was rather ineffective largely because there was little corporate paper available for purchase. In fact, outside of large companies the UK corporate sector has little tradition of tapping the capital markets for borrowing and has instead tended to depend on bank financing. This means that, while it is laudable to try to develop broader and deeper commercial paper and corporate bond markets like in the US, this cannot happen overnight.

Thus, with the Chancellor trying to stimulate credit growth as quickly as possible, a large part of Credit Easing must be delivered through other means.

Credit Easing through the banking system

The obvious way is through the banking system. A common argument of recent months has been that SME's are stating that funding is not available, at least not on the right terms (there are stories of banks, for example, asking for personal guarantees even when companies are consistently cashflow positive). On the other side of the argument, the banks argue that funding is there but that companies are reluctant to take it. The data does suggest that this, to some extent, is true. Of course, the banks also have to cover their cost of funding which as we have noted above is often well above bank rate particularly for longer term funding.

Clearly, a solution is needed in order to improve the terms on which banks can fund SMEs. Our proposal is for the government to raise the funds and then lend it on to the banks. The banks in turn would lend the money onto corporates. This would have advantages at both stages: the government has a low cost of funding meaning that lower rates can be passed on through the banks; and the banks have the contacts, the credit assessment capability and the network through which to distribute the credit. We believe the guaranteed source of funds and lower cost of those funds would give the banks a greater incentive to lend since that lending would be both more profitable and lower risk with the security of funding guaranteed by the government.

Since the government can access term money, the loans can also be term loans, getting away from one of the key concerns of SME's that they would be vulnerable to banks pulling lines of credit. We suggest that tranches of say two, three and five year money should be raised and lent on. To address issues of moral hazard and ensure that there is significant additional credit being made available we believe that the banks and the government should split both the risk and the return equally. Banks would then have the incentive to ensure that the loans are made on a commercial basis and the government would receive a share of the profits of any lending. By getting the government to take on 50% of the risk, banks should be able to lend more without unduly threatening their ability to meet the rising capital requirements they are facing.

The loans would be available to all banks, providing they lent it on to UK based companies. If this were to be perceived to be breaching EU rules, this could be extended to cover EU companies providing it was in sterling.[87]

To protect against risks that this lending simply replaces lending that would have otherwise have taken place, we suggest a minimum spread of 200 basis points. This should ensure that the banks did not just lend on the money to large cap companies who can already tap the bond markets.

Banks would apply for loans in tranches and would have to return the funds if it had not been lent out within a fixed time period, say three months. That would allow the programme to be demand determined with say an upper cap of perhaps £25bn to start with (equivalent to one third of the Bank of England's QE programme). If this was all new lending that would potentially triple the amount of net new lending currently going on. Even if we assume 50% of it is displaced lending it would double net new lending.

By choosing a minimum two year term it would be hoped that the worst of the current economic difficulties would be in the past by the time refinancing became necessary. It would also give time for the development of corporate bond and commercial paper markets. If it was felt appropriate, this could also be rolled out to the mortgage market, although our inclination would be to target the corporate sector first. The Treasury could either choose to hold onto the loans themselves or even package them up for onward sale to financial investors. Such loan packages would potentially be attractive to investors as they would offer a significant yield premium to investment grade or government debt and yet represent a balance portfolio of loans. That in turn reduces the need for detailed credit assessment. Securitisation of the loans would have three potential advantages. First it would limit the impact on the government's balance sheet, which has to be important given the sensitivity of investors to the strength of government credit ratings. Secondly, it would help develop a non-bank corporate funding market. Thirdly it would further distance the government from any credit decision. The reason we advocate the banks making the credit decisions is so that it cannot be politicised. Having the markets take on the eventual risk rather than the government will help to ensure that this remains the case.

We also suggest that as an emergency measure the Treasury considers reinitiating the Credit Guarantee Scheme whereby the government guaranteed Bank debt issuance in exchange for a fee (50 basis points plus the average five year CDS spread in the 12 months up to July 2008) to ensure that banks are able to issue debt to fund any upcoming redemptions. The banks have considerable refinancing of such debt to undertake over the next couple of years. If they are unable to issue the debt then they face the choice of either issuing more equity (where for the part owned banks the government would have to subscribe) or shrink their balance sheets.

If they can only issue it expensively, then they would likely have to pass that cost on to their customers making their credit more expensive. Since the Treasury is a major shareholder in Lloyds and RBS and is not going to allow them to go bust, then it makes no sense to force them to issue debt with a CDS spread of 300 basis points or more. The alternative to a restart of the Credit Guarantee scheme is to become a buyer in the secondary market, so that the government could compress spreads and hopefully comfort the market that they can buy the debt safe in the knowledge that there is a backstop. Any debt bought would in current conditions offer a

87 The total amount available to lend would remain unchanged.

considerable pick up over the government's existing cost of funding. It is, however, less clean than the restarting the Credit Guarantee Scheme, which would be our preferred option. Both though are likely to prove profitable for the government.

Credit Easing through the tax system – long-term

In the longer-term we believe that a larger and deeper corporate funding market via corporate bonds and commercial paper should be encouraged. The demand for interest bearing paper offering a yield well above that of gilts should be a real one given the low level of gilt yields and interest offered on bank accounts. The pension and insurance market has started to move into this area but it has largely been confined to large corporates and banks. There may even be a market for banks to securitise lending in a similar way to the scheme suggested above with the government, just on selling it to the market. That would enable them to lend without keeping all of the risk on their own balance sheet, which was the original idea behind the US collateralised debt market. However, there needs to be more demand in this space as well as more supply. The obvious place to start is through the domestic savings market and ISAs. We believe that the government should offer an additional allowance for individual investors (say up to £5,000) providing it was invested in small and medium sized corporate debt.

We believe that the costs of this policy would be low. The interest most investors are receiving, particularly on cash deposits, mean that tax payments on this interest are also relatively small. This means that the costs of foregone tax would be low and could be financed through the potential windfall from lower than expected debt interest costs. However, if the costs were thought to be prohibitive, we recommend that a smaller amount (say £2,500) is ring-fenced out of the existing ISA allowance.

Credit Easing through the tax system – short-term

The Business Payment Support Service is an invaluable tool for business who, while profitable / viable, may struggle to meet their tax liabilities. For instance, this might be because of cash-flow problems. Between November 2008 and June 2011 the scheme granted nearly 450,000 with Time To Pay arrangements, worth in total £7.71 billion. It is a measure of success of the scheme that, of that amount, over £6.69 billion has already been paid back.[88] However, current demand for use of the scheme standing at just 37% of the level it was in 2009 and a number of businesses that we have spoken to are unaware of the scheme. For this reason, we recommend that the government explores what more might be done to advertise the scheme and whether it might be further expanded to provide help to more firms.

What if the euro area falls apart?

It is important to say that these are measures which we think are appropriate at the moment. However, we recognise the risks in the Euro area. The fall out of a significant worsening of the situation in the Euro area on financial markets would imply that both the Bank and the Treasury would need to be prepared to be much more aggressive. The Bank of England's pretence that monetary policy and support for financial institutions can be separated would have to be immediately jettisoned.

These circumstances would make it even more important for the Special Liquidity Scheme to be immediately restored. Term lending facilities for the banks

88 http://www.hmrc.gov.uk/stats/bus_pay_sup_serv/official-stats-july2011.pdf

should also be introduced. We believe that, in extremis, the Bank should also be prepared to undertake a much more aggressive form of QE.

As an example, all bonds issued through QE are due to be redeemed and the money eventually repaid to the Bank. One suggestion would be that the government be prepared to issue irredeemable gilts to fund capital expenditure projects that would be bought by the Bank. Such purchases are normally only carried out in time of war but a collapse of the euro area would arguably pose the biggest threat to our economy since either of the last two world wars. Any long dated gilts could, of course, be sold into the market eventually but there would be no time scale on any such sales.

The Treasury and Bank may well have to step in to buy bank debt directly rather than in the secondary market as well. The Credit Easing that we suggest would likely have to be extended substantially since it is highly likely that wholesale funding to banks would cease to exist. Ultimately the Bank might have to fund both the government and the banking system for a period of time. The normal risk for the economy, inflation, would likely be very low because of the deflationary forces unleashed in such an outcome. These are only a selection of ideas and even more radical solutions may well be necessary in such circumstances. It is to be hoped that they are not needed.

Conclusion

Overall, it is our belief that a combination of QE and Credit Easing has much more chance of succeeding than QE on its own. Through QE the Bank of England makes it easier and cheaper for the government to issue debt. The government can take advantage of that to ensure that cheaper credit is available to both banks and borrowers. If QE has portfolio substitution and bank funding benefits as well that is an additional positive.

There have obviously been questions as to whether Credit Easing is necessary and that, if the demand for credit was there, the market would supply it. In normal circumstances that would indeed be true. However, following a financial crash the situation is different. Banks are under enormous pressure to reform and rebuild themselves and it is very difficult to lend enough when you are trying to shrink your balance sheet. It is also difficult to lend when you have to pay a premium for funds because there is still a mismatch between loans and deposits and this is coupled with huge uncertainty and a lack of trust amongst banks. Ideally the central bank should intervene in such circumstances to aid the banks and absorb some of the credit risk. The Bank of England, however, does not seem willing or able to do so. The government therefore needs to step into the breach. The Bank is helping through quantitative easing and we propose that the government uses some of this purchase of gilts to help fund the banking system. We also suggest they look to facilitate change in the way corporates raise funds, ease bank capital raising costs and extend credit to SME's through the tax and NI system.

By implementing the full range of options for Credit Easing we have suggested above the government can both ensure that QE has a much better chance of success in the short-term and also stimulate a vital element of corporate finance for the future.

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4

Britain's productivity crisis

By David Smith

When, in October 2011, the Office for National Statistics produced revised data for gross domestic product during the recession, the hope was that it would solve one aspect of Britain's productivity puzzle. GDP had fallen very sharply from the spring of 2008, with the ONS suggesting a 6.4% peak-to-trough fall. Employment, however, dropped by much less, by around 2.5%. The result was a sharp drop in productivity (output per worker). In the absence of a rebound during the recovery, Britain appeared to have suffered a permanent productivity loss.

The hope was that the ONS would revise away some of that productivity fall with data showing the recession had been less severe than feared. Instead, the numbers went the other way. The GDP fall from peak to trough was 7.1% and productivity fall was made much greater.

The result is that, at time of writing, output per worker is between four and five% below pre-recession levels, and 14 to 15% lower than it would be had productivity followed its pre-crisis trend. It may be that Britain never attains productivity levels consistent with the maintenance of that pre-crisis trend.

This, of course, matters. Paul Krugman's 'productivity isn't everything but in the long-run it is almost everything' captures it well. Productivity drives prosperity and living standards. Without productivity growth we stagnate. So the drop in UK productivity equates, over time, to a fall in living standards.

However, this large fall in productivity stemming from the recession is not the only source of the UK's productivity woes. The productivity problem has three dimensions, all of them serious. They are:

- Persistently low growth in productivity, even during periods of relatively strong economic growth;
- Significantly lower levels of productivity than in our competitor economies, a gap that appears to have widened sharply in the past three or four years; and
- Chronically weak public sector productivity. This was highly problematical during the years of plenty for public services. It is critical at a time when budgets are tight and greater efficiency is the key to public service delivery.

A weaker trend

Let me take these in turn. For years the search has been on for ways of boosting Britain's underlying productivity growth rate. Successive governments have tried

to boost growth, competitiveness or, in the case of the Labour government from 1997-2010, implemented an explicit productivity agenda.

The fact is that Britain has had modest productivity growth for many years. Past explanations for this included disruptive industrial relations and a volatile, ineptly managed, economy. Yet in the "Great Moderation" period of 1997 to 2008 with growth, if not asset prices, apparently assured and inflation under control, whole economy output per worker grew by a little less than two% a year. In what should have been ideal circumstances, in other words, productivity growth was subdued.

Even that may not tell the full story. Spencer Dale, the Bank of England's chief economist, in a speech in September, noted that two sectors in particular had boosted measured productivity in the decades ahead of the global financial crisis. As he put it:

> *In the twenty years prior to the financial crisis, productivity in the energy sector grew at an average annual rate of over 3%. But the pace of productivity growth slowed markedly in the past decade or so as North Sea oil fields aged and energy extraction became more difficult. Indeed, since the mid-2000s, productivity has actually been falling. In contrast, productivity growth in the financial services sector increased very sharply in the 10 years prior to the financial crisis, underpinned by the process of financial liberalisation and strong growth in financial sector balance sheets. It does not seem sensible – certainly with the benefit of hindsight – to think that this strong growth would continue indefinitely.*[89]

The Bank, in its August Inflation report, also listed reasons why productivity growth in the recession and subsequently has been weak. It said:

> *There are several channels through which underlying productivity growth may have been lower following the recession .... Lower levels of business investment will have reduced the growth rate of the capital stock somewhat. And some companies and some of their capital were liquidated during the recession — although the rise in formal liquidations was more moderate than in previous recessions. At the same time, tighter credit conditions may have prevented some more productive businesses from entering markets or expanding. And a higher cost of working capital may have restricted some businesses' ability to meet demand. Additionally, the decline in hours worked during the recession may have impaired productivity growth through reducing the opportunity for employees to acquire skills on the job, or undertake workplace training. Overall, these channels suggest that productivity growth is likely to have been impaired in recent years.*[90]

Not everybody is so downbeat about the longer-term impact of the crisis and recession on productivity. Bill Martin of the University of Cambridge, in a paper 'Is the British economy supply constrained? A critique of productivity pessimism', challenged the argument that Britain had suffered a permanent loss of productivity, Even so, productivity optimists have a tough task on their hands.

The international gap

What about Britain's second problem, the productivity gap in relation to competitor economies? Some may be surprised to hear that on one measure of productivity, GDP per worker in 2010 was more than 10% higher than Japan and similar to both Canada and Germany. Italian GDP per worker was, however, 8% higher than the UK, while in the case of France the gap was 10% and US

89 Spencer Dale, 'Productivity and Monetary Policy', speech delivered at the South Tyneside Manufacturing Forum, September 21 2011.

90 Bank of England, Inflation report, August 2011.

productivity was a full 34% above that in the UK. The US-UK productivity gap, in fact, was the biggest since 1994.[91]

On another measure, output per hour worked, Britain was similar to Canada and Italy and 19% higher than Japan. But French productivity was 16% higher, that of Germany 18%, and America 23%.

The figures are sometimes hard to disentangle, but it is clear that overall, UK productivity is significantly below some competitors and lags the G7 average by 11 to 15%. Nor does this fully capture the international challenge. Keeping up with the slow-growing G7 is one thing, challenging the low-cost, rising productivity nations of the BRIC economies (Brazil, Russia, India, China), as well as other emerging nations, is arguably a more daunting prospect.

"The Coalition government has listed five "drivers" of productivity; investment, innovation, skills, enterprise and competition"

An absence of public sector productivity growth

Thirdly, there is the problem of low public sector productivity. Public sector productivity is difficult to measure, and the ONS has been carrying out a programme of quality-adjusting public service output to derive more accurate productivity estimates. However, its conclusions are not reassuring.

For healthcare, the ONS concluded in March 2011 that:

> *...productivity change was close to zero most years, but fell by more than 1% in 1996, 2002 and 2003. The falls were partially offset by growth of more than 1% in 2001 and 2006 and growth of 0.7% in 2009. Overall, from 1995 to 2009, productivity fell by 2.7%, an average annual fall of 0.2%. On average, quality-adjusted healthcare output increased by 4.4% a year but inputs grew more rapidly, by 4.6% a year.*[92]

The picture for education, with broadly flat productivity over a 12-13 year period, was little better, though rather more variable. AS the ONS put it in 2010:

> *From 1996 to 2009, publicly funded education productivity in the UK declined by 0.1%. But this marginal fall overall masks three periods of greater change: from 1996 to 1999, productivity grew by 7.1%, with an annual average increase of 2.3%. In this period there was strong output growth, due to growth in the school age population, but only weak growth in inputs; from 1999 to 2007, productivity fell by 9.4%, an annual average fall of 1.2%. Growth in school attendance, once adjusted for quality, was outstripped by a sharp rise in inputs, mainly through the employment of more school support staff; from 2007 to 2009, productivity grew by 2.9%, with an annual average increase of 1.4%, as output grew faster than inputs, due mainly to relatively large improvements in pupil attainment at age 15/16 in England and Wales.*[93]

These precise details can be, and indeed are, debated. However, the big picture is not subject to debate. That is that public sector productivity has been at best flat, at worst declining. During a period in which inputs, including employment, rose very sharply, outputs at best only kept pace. The implications for an era of much tighter control of inputs, and falling public sector employment, are potentially worrying for service delivery.

91 International Comparisons of Productivity – First Estimates for 2010, Office for National Statistics, September 2011 (http://www.ons.gov.uk/ons/dcp171778_232305.pdf)

92 Public Service Output, Inputs and Productivity: Healthcare, Office for National Statistics, March 2011.

93 Public Service Output, Inputs and Productivity: Education, Office for National Statistics, November 2010.

A more productive future?

These are major challenges for the UK economy. Many governments have tried to tackle these issues, but largely failed. So what can be done now?

Tackling the public sector

Tackling the problem of weak public sector productivity should in theory be easier during a time of retrenchment. The big expansion of state employment from the late 1990s was an example of politicians focusing almost exclusively on inputs, without regard for outputs or outcomes.

Ministers boasted of the number of extra NHS staff, or teachers, or support staff, without regard for the productivity of those additional staff, or public services as a whole. Reversing these increases – a 900,000 rise in public sector employment between 1999 and 2009 – should produce some mathematical improvement in productivity. They will not, however, solve the underlying problem.

Poor public sector productivity reflects a range of factors that are in many respects the general productivity problem in microcosm. Weak management, lack of accountability and lack of competition can all be included on the list of explanatory factors. The details of boosting the productivity of the public sector would require another chapter in themselves. The key, however, is increasing choice and competition. We know, though, what a fundamental challenge that has proved to be.

Boosting private sector productivity

There is a lot of motherhood and apple pie in traditional solutions to weak private sector productivity growth. The Coalition government has listed five "drivers" of productivity; investment, innovation, skills, enterprise and competition. A typical list of the most important factors, carved out of any number of government-commissioned reports over the decades, would include the following:

- Boost education and skills, particularly intermediate skills. That may mean encouraging more apprenticeships; it certainly means lifting school standards. Though the UK ranks 12th out of 30 OECD economies in tertiary education, it is only 19th when it comes to upper-secondary education;
- Improve managerial skills. Research by Bloom and Van Reenen at the London School of Economics, amongst others, suggests strongly that management skills in Britain are poor in comparison with other countries. Comparisons with French, German and US firms point to a significant managerial 'deficit'. One practical consequence of this is that UK managers are relatively poor at implementing productivity-enhancing investment, such as in information technology;
- Increase levels of business investment, the biggest reason for the productivity gap between Britain and other countries, particularly France. Low levels of business investment have been a perennial problem for the UK economy. Relatively low levels of UK business investment in comparison with competitors were reversed in the second half of the 1980s and during the 1990s. In the period leading up to the crisis, however, 2000-2008, UK business investment averaged just 10.5% of GDP, lower than France, Germany, the United States, Italy and Canada. Britain was the only G7 country apart from Japan which saw its business investment share decline between the 1990s and 2000s; and

94 Department for Business, Innovation and Skills (2010), Economic Growth: Executive Summary, BIS Economics Paper No. 9.

- Increase R & D spending. Business R & D is roughly 1% of GDP in the UK and has been declining gently since the 1980s, according to a 2010 report, Business Innovation Investment in the UK, from the then Department of Innovation, Universities and Skills. In France, Germany and the United States, in contrast, it is between 1.5 and 2%, and in Japan 2.5%.

There is nothing mystical or magical about these standard solutions to low productivity growth. One set of ideas targets human capital, the other physical capital. Improve or increase both and you should boost productivity. There is also something missing, however, in the growth accounting approach to productivity. If we think back to Britain's productivity renaissance in the 1980s, it was based on de-regulation, particularly of the labour market, and lower business and personal taxation, none of which was easily measurable under the growth accounting framework. As the late Sir Alan Walters wrote in his book, *Britain's Economic Renaissance*:

> *We are left with no simple explanation of Britain's productivity. There must be some missing factor – a Thatcher factor? – which explains this dramatic reversal in Britain's performance. The changes in attitude in management and labour which many have noted does seem to be a reality which may explain the remarkable record of the 1980s.*

Competition is also a key factor. Research for the Department of Business, Innovation and Skills, suggests that 42% of productivity improvements come from reallocation of economic activity between firms, with 37% from the exit of poorly-performing firms and the entry of new ones, and only 22% from productivity improvements within firms.[94]

So what do you need to boost productivity? Plainly you need competition, which means low barriers to entry, ease of merger and takeover activity and so on. You also need a combination of incentives and de-regulation to unleash the animal spirits that drive productivity improvements. Thus, while Labour from 1997 to 2010 preached a productivity agenda, it practiced policies of high taxation and re-regulation that undermined that aim. Though the Coalition has announced a reduction in corporation tax rates, it is presiding over a general increase in the tax burden. It is also yet to make serious inroads into the re-regulation of the economy that occurred after 1997.

A meaningful productivity agenda for Britain's private sector has therefore to be based on competition, taxation and de-regulation. Nor is this a one-off exercise. Boosting productivity means pushing these buttons repeatedly. Achieve that and the "growth-accounting" aspects of productivity fall into place. Business will give its workers the skills they need, will improve its managerial game – or get people in who can – and invest enough, both in physical capital and R & D. There has to be a reason for doing so, however.

The productivity hangover from the global financial crisis reflects the damage inflicted on the economy and the altered prospects for what were high productivity sectors. But it also reflects much more than that; the apparent acceptance by government of high levels of regulation and taxation and the absence of the buzz – the energy and drive – characteristic of successful economies. Until that changes we will continue to bemoan our productivity failings.

David Smith is Economics Editor of the Sunday Times

5

We need to focus on growth and being greener – not 'green growth'

By Simon Less

"Renewable energy technologies will deliver a third industrial revolution … At a time when closures and cuts dominate the news cycle … [r]enewable energy is surging out across the United Kingdom, blazing a trail of start-ups and jobs. … Our … priority is … ensuring more clean technologies are designed and manufactured here … We're missing a trick unless we start supporting low-carbon manufacturing here in Britain – and grow the green supply chain: locking in profits and expertise, and creating the exports that will keep Britain competitive … [T]his government has resolved that we will be the largest market in Europe for offshore wind … We will not heed the … green economy deniers."

Chris Huhne MP, Secretary of State for Energy and Climate Change, Renewable UK conference, 26 October 2011

The risk of dangerous levels of climate change is a major threat to the world's ecosystems and its prosperity. The current scientific consensus is clear about the role of human greenhouse gas emissions in driving this risk. Helping to stem the rise in global emissions and to reduce them substantially must therefore be a UK policy priority, to sit alongside the priority to stimulate UK economic growth.

It is possible to have both economic growth – to benefit from new innovations and improved productivity – and at the same time to reduce carbon emissions.

Moreover, strong UK growth is needed to pay for the costs of policies moving us to a low carbon economy. Growth is needed to fund sustained, long-term investment in low carbon research and development, upgrading the energy efficiency of the UK's housing stock, and to support early stage deployment of low carbon technologies that are still more expensive than their high carbon alternatives. As the UK reduces its own carbon emissions, the economy will contain a larger proportion of jobs in so-called green sectors, such renewable generation and installation of household insulation, as well as in many other industries steadily reducing their carbon emissions.

We need growth and we need to become greener. But is this what is meant by those promoting 'green growth' and the 'green economy'?

The Secretary of State for Energy and Climate Change, Chris Huhne, argues for large subsidies for selected UK 'green' industrial sectors, particularly types

95 M Pollitt (2011), *Some inconvenient economics of Energy and Climate Policy,* EPRG-Centrica-CEEPR Conference, London, 22 September.

of renewable generation such as offshore wind, as a key way to boost growth and employment in the UK economy. He is supported by those representing commercial interests in the subsidised renewable energy sector. The subsidies are paid by the rest of UK economy, largely through increased energy prices.

The argument – under the term 'green growth' – is not that subsidies for such selected sectors are the best way to reduce carbon emissions, but that a principal objective of these public subsidies is to promote UK growth, exports and employment. Chris Huhne thus makes a clear political pitch for the sort of industrial policy interventions to boost predicted future growth sectors, not often heard in the UK since the 1970s.

Chris Huhne has recently criticised as 'green economy deniers' those who question this approach, even conflating them with those who reject the scientific consensus about the risks from climate change.

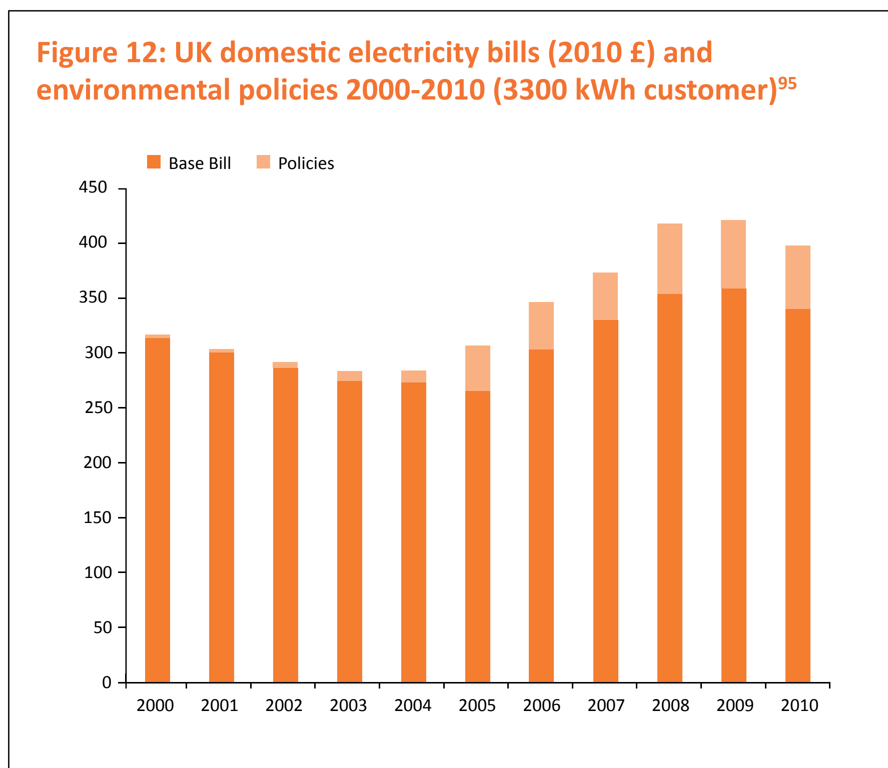
This chapter explores the likely impact of such 'green growth' policies, both for economic growth and emissions reduction.

Economic costs of reducing emissions

As the UK economy grows, its carbon emissions must decline, as part of the UK's contribution to international action. To achieve this requires appropriate government policies to promote emissions reduction measures.

Some emissions reduction measures are financially beneficial – so are both green and directly good for economic welfare. If householders take measures, such as loft insulation, which save them more money in reduced energy consumption than they cost, they have larger disposal incomes. If businesses can reduce their energy input costs, then they can become more competitive. But most of the carbon reduction measures that will need to be taken over time have net costs.

Figure 12: UK domestic electricity bills (2010 £) and environmental policies 2000-2010 (3300 kWh customer)[95]



Already the costs of climate-related policies have had a significant impact on electricity bills. According to research at Cambridge University, policy costs made the greatest contribution to the increase in a typical domestic customer's electricity bill between 2000 (when climate policies essentially began) and the last full year, 2010 (see Figure 12).[96] Policy costs in electricity prices are set to continue to rise, so that in 2020 prices will be around 30% higher for domestic customers – and 40% higher for business customers – than they would have been in the absence of climate-related policies.[97]

Increasing energy costs (particularly the cost of electricity – two-thirds of which is consumed by businesses and the non-household sector) has the potential to slow growth, in the same way as increases to other input costs. Higher energy costs:

- reduce the resources otherwise available to businesses to invest for long-term growth;
- reduce the disposable income of consumers; and
- reduce competitiveness, where they place UK businesses at a competitive disadvantage to foreign competitors subject to lower policy costs (see box below).

Competitiveness impact of climate policies

To the extent that climate-related policies increase the energy input costs of UK businesses above their competitors in other countries, this raises a concern about UK 'competitiveness'.

Nevertheless it needs to be recognised that exchange rates adjust, broadly, to mitigate the average effect of differential input costs between different currency areas. So higher energy costs would show up as reduced national incomes rather than inability to export. But this is a general – and long run – effect, and particular firms or sectors could lose or gain in competitiveness. High energy costs could in particular lead to loss of competitiveness in energy intensive industries,[98] such as aluminium, steel and concrete manufacturing. Energy-intensive manufacturers, consuming at least 100GWh of electricity per year and with energy comprising over 20% of their costs, employ around 700,000 people in the UK, and tend to be concentrated in more deprived areas, such as the north-east of England.[99]

There is no sense in climate policies causing such sectors to close and move elsewhere – or to cause them to choose to open new plants elsewhere. This would not only damage the UK economy but also the environment. If an energy-intensive industry chose to locate in, say, China and export their goods back to the UK, then they would still be emitting carbon – and more of it – since China's electricity is more carbon intensive than the UK's.

Policy Exchange's report *Carbon Omissions*[100] showed that while the UK's production of carbon emissions within its borders has fallen, its carbon *consumption*, including carbon embedded in the manufacture of imported products – have shot up (by perhaps 30% 1990-2006). It makes no environmental or economic sense for environmental policy to accelerate this trend.

So it is vital to tailor environmental policy appropriately to these selected energy-intensive sectors. We want these sectors to be as energy efficient as possible, but not to drive them offshore.

Measures to help energy-intensive manufacturers are expected to be announced soon by the government.

96 Between 2000 and 2010 the average bill for a 3300 kWh customer rose 24% in real terms, but would have risen only 8% in the absence of climate-related policies. Electricity prices moved both up and down over the 2000-2010 period: If the price trough in 2004 is taken as the starting point, then real bills rose 40%, and would have risen only 25% without policies. These figures do not take into account the latest price rises in 2011.

97 Chris Huhne has said that climate related policies will not raise domestic energy *bills*. This statement is justified by estimating how much an average householder will reduce her consumption (including as result of policies like the Green Deal) and offsetting this against energy *price* rises. The existence of cost-effective policies, like the Green Deal, which help householders reduce energy consumption does not alter the fact that a range of expensive climate and renewable energy policies will push up energy *prices* – with a substantial impact on the economy.

98 UK Green Fiscal Commission (2009), The *Case for Green Fiscal Reform – Final report of the UK Green Fiscal Commission.*

99 D Blair (2011), UK manufacturers to bear greater *energy costs, Financial Times, 27 October.*

100 A Brinkley (2010), *Carbon Omissions: Consumption-based accounting for international carbon emissions, Policy Exchange.*

Of course, the key approach to reducing carbon emissions is to price carbon effectively. This means that energy prices will need to rise.

But it is important that the economic costs of climate policies are no higher than needed to achieve carbon reduction targets, and that the revenues generated from the higher carbon prices are used cost-effectively to promote growth and carbon reduction.

The box below discusses how green taxes, or carbon permit costs, may be offset by reduced taxation elsewhere. The next section discusses some of the policies currently driving up energy prices and the uses made of the funding raised.

Green tax shift

The UK Green Fiscal Commission looked at the scope for increasing 'green' taxes while using the revenues raised to reduce taxes elsewhere, such as taxes on employment.[101]

They cited research, carried out as part of the European research project 'Competitive effects of environmental tax reforms' (2004-06), which found that increasing green taxes and using the revenues to offset taxes elsewhere (and also making provisions for energy intensive sectors) actually led to a small increase in economic growth rates. The revenue recycling effect plays a part in compensating for increased energy costs.

Of course such macro-economic modelling is fraught with difficulties. Nevertheless this work highlights the scope for increasing carbon prices whilst minimising the impact on growth.

It should be noted that this is not the main thrust of the current UK policy approach, where the majority of projected policy levies on energy bills over the next decade or so are set – not to be recycled in lower taxes elsewhere but – to be spent on subsidies for particularly expensive ways to decarbonise, such as deep-water offshore wind.

Climate policy design

The design of climate-related policies is important – both to promote success in delivering carbon reduction *and* in minimising impact on growth. Fortunately policy design principles that are likely to lead to successful long-term global decarbonisation are also, in the main, likely to be friendliest to growth:

- The first principle is that policies should promote lowest cost carbon reductions. The lower their cost, the more likely policies are to be politically sustainable and so to successfully reach long-term emissions reduction targets. Cheaper UK decarbonisation processes also set a more compelling example to other countries, helping to stimulate the global emissions reduction needed to mitigate climate change. And the lower costs of decarbonisation, the smaller the impact on incomes and growth.
- The second principle is that UK policies should focus on promoting the innovation needed to achieve cost-competitiveness in those low carbon technologies with the potential for greatest global deployment. Prioritising research, development and demonstration also plays to the UK's historic strengths and comparative advantage.
- The third principle is that climate policies should exploit the potential for markets, steered by a neutral long-term carbon price, to innovate and

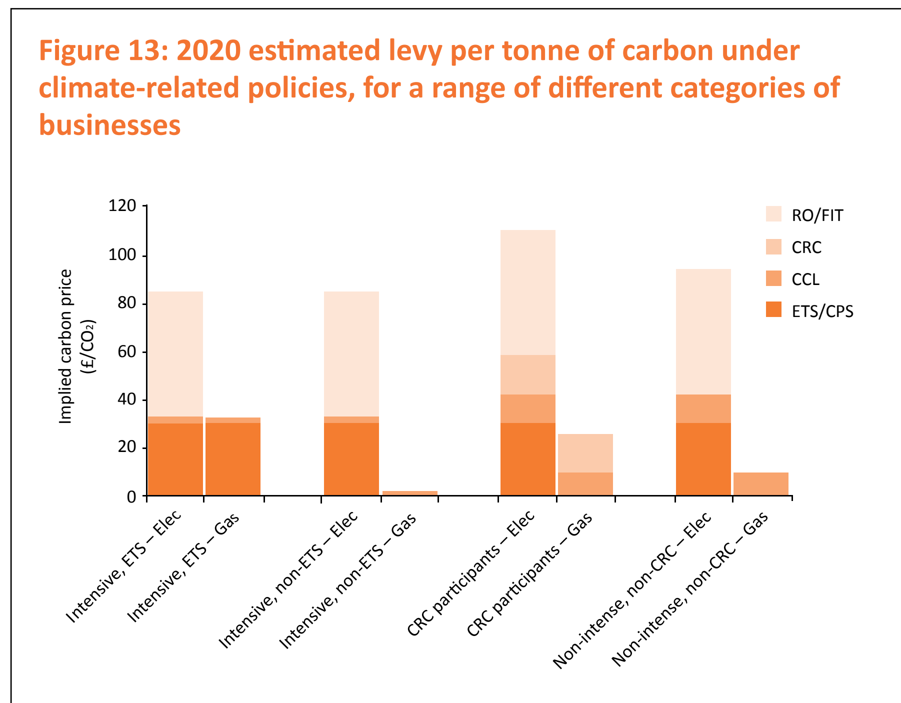
101 UK Green Fiscal Commission (2009).

discover the best, lowest cost, ways to decarbonise. A focus on carbon pricing also generates revenues which can be used to mitigate growth impacts of decarbonisation.

The UK has a number of policies that, broadly, reflect these principles. The Green Deal targets low cost carbon reduction potential in improving household energy efficiency; the EU Emissions Trading System (ETS) and Carbon Price Floor focus on giving the market a carbon price; and budgets for demonstrating Carbon Capture and Storage and for low carbon research and development focus on stimulating low carbon innovation.[102]

There has been much discussion about the impact on UK businesses of the UK's Carbon Floor Price. It is not an ideally designed instrument. It would be better if the EU ETS could instead be reformed to operate more effectively, or the floor price applied across the EU. The floor price starts unnecessarily early in 2013, the commitment to it should be firmer, even contractual, and should go well beyond 2020 if it is give effective investment signals. Nevertheless, it is at least a technology-neutral carbon price and has the potential to be built-on. And it should also be recognised that its projected impact on electricity prices is much less than the impact of the UK's renewable subsidies. Figure 13[103] shows relative costs of climate-related policies on electricity (and gas) prices by 2020, for different categories of business, expressed as pounds per tonne of carbon dioxide. It highlights that the renewable subsidies ('RO/FiTs') are the largest policy driver for increased electricity prices, with much greater costs to energy customers than the Carbon Floor Price/EU ETS.

Figure 13: 2020 estimated levy per tonne of carbon under climate-related policies, for a range of different categories of businesses



The UK's renewable generation subsidies, currently mainly delivered through the Renewable Obligation (RO), are driven by the need to meet the EU 2020 Renewable Energy Target.

102 Policy Exchange had argued for a Green Deal-style policy (*Warm Homes*) and a broad-based, long-term carbon price floor (*Greener, Cheaper*). More recently, Policy Exchange has argued for mandatory carbon reporting to stimulate cost-effective energy efficiency measures in organisations, and more effective carbon pricing in relation to heating (*Boosting Energy IQ*).

The UK's renewable generation subsidies are the most important example of policies that fail in relation to the principles set out above. They privilege expensive decarbonisation approaches, are focused on deployment targets not stimulating innovation, weaken the carbon pricing framework and disrupt the effective operation of the energy market. The renewable generation subsidies unnecessarily add to electricity prices, act as a drag on economic growth, and achieve no additional carbon reduction while arguably damaging the future prospects for decarbonisation.

The cost to the UK economy of the Renewable Energy Target has been estimated by the government at £66 billion.[104] As part of meeting the target, the government plans to deploy 13-18GW of mainly deep water offshore wind by 2020, at a current cost of around £300 per tonne of carbon saved. Yet, the Renewable Obligation saves no more carbon emissions by 2020 than would have been saved under the EU ETS carbon cap (where the carbon permit price is currently only around £10, and the floor price rises to only £30 by 2020).

Of course there is a strong case for public support for promising new low carbon technologies. The UK has historic strengths in research and development. Much R&D spending is likely to be positive for growth, and is one of the key ways the UK could contribute to global emissions reduction. There also a good case for appropriate support for early commercialisation of technologies with global potential to help improve their cost-competitiveness, focused on maximising learning-by-doing. But the UK's current renewable generation subsidies are not focused on this. Instead, the Renewable Energy Target commits the UK to roll-out out of particular short-term deployable technologies on a pre-determined and massive scale, whatever is discovered about the success and cost of those technologies. It seems inconceivable that spending tens of billions of pounds on deploying offshore wind by 2020 is the best use of available resources for low carbon innovation, given offshore wind's high costs, no guarantee that it will become cost-competitive and its limited global deployment potential.[105]

Given such wasteful policies, there is scope both to better promote more carbon reduction *and* to reduce the energy policy cost burdens on the economy, promoting growth.

Policy Exchange (2020 *Hindsight*)[106] has recommended renegotiating the 2020 Renewable Energy Target, focusing instead of improved long-term carbon pricing and genuine support for innovation. Carbon prices would probably be higher – but even doubling the expected carbon price in 2020 would add less to electricity prices than the expected subsidies for renewables. And the revenues from carbon pricing would be available to offset other taxes on the economy, rather than wasted on unnecessarily expensive technologies. A focus on simple, neutral carbon pricing would also avoid other costs on the economy from the current approach to climate policy – from complexity, distorted price signals, rent-seeking and regulatory uncertainty.

However, it is to the most wasteful policies – for subsidising favoured technologies – that 'green growth' industrial policy justifications are most commonly attached. This may be because these policies cannot be justified in terms of carbon emissions reduction at least cost to the economy. So do the 'green growth' industrial policy arguments stack up an alternative case for these policies?

103 G Newey (2011), *Boosting Energy IQ: UK energy efficiency policy for the workplace*, Policy Exchange.

104 DECC (2008), Renewable Energy Strategy Impact Assessment.

105 Offshore wind has only 1% of the global potential of solar PV.

106 S Moore (2011), *2020 Hindsight: Does the Renewable Energy Target help the UK decarbonise?*, Policy Exchange.

'Green growth' industrial policy

'Green' policies – to promote reduced carbon emissions – and growth policies – including to help pay for carbon reduction – are both important priorities. But muddling them up in the concept of 'green growth', or worse 'green jobs', is damaging to the goals of both emissions reduction and growth.

Under the concept of promoting 'green growth', the government favours and subsidises selected 'green' – usually renewable energy – industrial sectors, for the purpose creating the growth and export sectors of the future. This is reminiscent of government industrial policy interventions in the UK's economic history where particular industrial sectors – for example, advanced gas-cooled nuclear reactors (AGRs), British car manufacturing or supersonic civil aviation – were favoured with generous subsidies in the hope that they would power future growth and exports.

Following one recent adjustment to renewable subsidies levels, in which offshore wind had its long-term subsidy levels increased still further, Climate Change Minister, Greg Barker, was quite explicit about this being "ambitious green industrial policy in action."[107] 'Green growth' industrial policy arguments are strongly supported by those lobbying for subsidies – exploiting the rent-seeking opportunities – such as the organisations representing offshore wind interests.

The problem with such a policy is that there is no reason to believe that subsidising any one industrial sector can increase *overall* UK growth or employment levels. Overall UK employment levels and growth rates depend on fundamental economic factors such as skills levels, the functioning of labour markets, competition and overall investment levels.

Successful export sectors are based on comparative advantage. The government believes that it can create UK comparative advantage in relation to offshore wind, and potentially other marine renewables, based on the UK's offshore deployment potential and North Sea engineering expertise. It also believes that there will be a large world market in marine renewables that the UK will then be in a good position to export into. It is committing tens of billions of pounds to these beliefs.

Yet it is very far from clear that this will be true. There are huge unknowns about the development of global marine renewables – currently some of the most expensive forms of electricity generation – as well as the UK's ability to capture any significant proportion of any global export market, in competition with other countries. The government is taking a huge gamble, directing massive levels of resources here, which cannot therefore be used for investment and spending elsewhere in the economy.

Moreover, the history of government taking such industrial policy gambles is a stark warning. There is no reason to believe that government has any special ability – over and above the market – to pick winners. Major failures of the past, such as AGRs, British Leyland or Concorde, bear this out.

Where there is real comparative advantage, markets are better able to develop these than government.[108] Both markets and governments may fail. But in markets – better at discovering and responding to new information – failures happen more quickly and cheaply.

The arguments outlined here – and, worse, the potential for EU countries to get into damaging subsidy competition with each other – are the reasons why, in most sectors, the EU prohibits state aid. However renewable energy carries certain exemptions to these rules.[109]

107 J Murray (2011), *Marine and offshore wind big winners in renewables subsidy review*, Business Green.

108 In the case of low carbon sectors, the government has a clear role. This is to ensure effective pricing of carbon and to address market failures in relation to low carbon innovation, not to gamble on picking future growth and export industries.

109 It may that this exemption should be narrowed so that renewables subsidies are tightly focused and justified on the basis that state support is necessary to achieve innovation.

Industrial policy subsidies to selected sectors are paid for by the rest of the economy, and so reduce the investment and spending in *other* sectors. For example, the cost to the German economy in subsidies for each job in its solar industry has been estimated at 175,000 euros.[110] An optimistic outcome is therefore that such policies simply shift jobs around the economy, with no overall jobs and growth impact.

Securing energy supplies

Security of energy supply is an important issue for growth, separate from the arguments about 'green growth'.

The government makes further arguments for high subsidies for certain energy technologies, in particular renewables, that they deliver economic benefits through reduced exposure to 'volatile' gas prices and to 'foreign' energy sources. David Cameron and Chris Huhne recently said 'We are … taking steps to deal with our exposure to volatile world energy prices and promote more sources of energy generated at home.'[111] Are the government's measures to promote energy security a benefit to economic growth?

It is far from clear that energy being foreign is a strong predictor of its insecurity. The UK has historically suffered most energy insecurity as a result of domestic events such as outages, strikes and protests. Moreover, recent global energy market developments have much increased the prospects for secure gas supplies. While the UK's North Sea gas has declined, the UK gas market has itself developed large new infrastructure to tap the burgeoning global Liquid Natural Gas market. This ensures that the UK can secure gas in a relatively liquid market supplied by a wide range of countries. In addition, Norway will remain a key gas supplier. Coupled with recent global developments in shale gas – particularly in the US, but also a recent, potentially huge, gas find in north west England – mean that gas looks more secure as an energy source for the UK economy. We cannot know future gas prices, but it is far from clear, as some confidently predict, that future gas prices will be very high. So supply security concerns do not appear to justify the high costs to the economy of subsidies for domestic energy, such as renewables.

Nevertheless, gas prices are likely to continue to fluctuate based on the global supply and demand balance. Would the UK see higher overall economic growth if we were somehow able to insulate ourselves from such price volatility? For this to be the case, the economic damage from gas price volatility would need to be clearly greater than the damage from paying the guaranteed high price of, for example, offshore wind.

Clearly gas generation emits carbon. While gas is likely to play an important role as a transition fuel to a low carbon economy, having half the emissions of coal, unabated gas emits carbon at levels inconsistent with meeting the UK's 2050 carbon target. But the way to address gas's future role in the process of decarbonisation is through having an effective long-term carbon-pricing framework, and in particular an effective long-term EU Emissions Trading System cap.

A more pessimistic – and more likely – outcome is that growth is lower than it would otherwise have been, as a result of resources being diverted by government away from industrial sectors with *greater* growth and export potential than, for example marine renewables. It is the economic activity, entrepreneurship and innovation that *never happened* which is the major cost of the government directing massive resources to its preferred sectors. And this is not only detrimental growth,

110 M Frondel (2010), *Economic impacts from the promotion of renewable energy technologies*, Ruhr Economic Papers 156, Ruhr University.

111 D Cameron and C Huhne (2011), Our Plans to Tackle Rising Energy Costs, *MoneySavingExpert.com, 17 October.*

but also to emissions reduction. Muddled 'green growth' industrial policy objectives mean resources are squandered that could otherwise have been used to deliver greater emissions reduction, to strengthen the EU carbon cap and to stimulate genuine low carbon innovation.

Recommendations

The government should eschew the muddled concept of 'green growth' and the 1970s-style industrial subsidies for hand-picked future growth sectors which it leads to. The government should instead concentrate on policies to promote growth alongside other policies to go 'green' – reducing carbon emissions – as cost-effectively as possible.

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6

Tax and the future of growth

By Will Morris

Much as we tax people might occasionally like to claim it, there is no silver tax bullet that is going to restore growth and lift us out of our current troubles. Tax will no more drive growth than it will drive a deal or investment. It is Keynes' 'animal spirits' that will do that. But, if the recovery is to be business-driven, then tax does have a role.

Business people make their initial decision based on the business case. Is there a market? Is there a winning product or service? Is the business climate favourable? But once that initial case has been made, then tax comes into play. For example, tax can impact the decision as to the precise location between countries once a more general business decision has been made to invest in a region such as the EU. Perhaps more importantly, however, tax can kill a deal. If the tax impact means the numbers won't add up, the deal won't happen. And even if the hurdle rate is met, if the tax environment is too risky to meet investment criteria, that can also kill the deal. Finally, even if the investment meets all of these requirements and is actually made, tax will still play a part in the ongoing decision of whether to maintain an investment – and whether to shrink it or to grow it. Walter Wriston, the former head of Citibank once put it like this: 'Capital goes where it's welcome, and stays where it's well treated'. So tax won't drive growth, but it definitely can impact it.

So what is it that makes for good tax policy in these circumstances? Put differently, what tax policy might facilitate growth? Before answering that question, it is important to note that there is now a tension at the heart of tax policy making. It used to be a given that tax policy making was all about 'collecting the revenue the government had decided it needed in the least distortive way' (even if politics often led to a different outcome). However, in the past 10-20 years, the tax system has increasingly become the delivery mechanism of choice for a whole range of government policies. As well as making the tax system more complex (and, thus, more open to abuse), it does also mean that the rate of change in the tax system has accelerated as it expands to do more. As a result, more complex and quite often unconnected changes to various parts of the system multiply unintended consequences. And as this change accelerates, it seems that sometimes the last policy question asked is 'what does this change do to the structure of the tax system?'

Returning to the question of what would make the UK tax system more 'competitive', well, it is not just about lowering taxes, or handing out credits.

To be truly competitive a tax system certainly needs to have taxes that are within international norms, but they don't necessarily have to be the absolute lowest/best/most relaxed. What matters much more than a penny or two off the rate, is how the system works, and, just as importantly, how it changes when it needs to. When asked what they want, tax people (and business people for that matter) often say 'stability, certainty and simplicity'. However, sometimes the last element of this trilogue is replaced with 'predictability'. Stability and certainty are essential. Businesses make their investment decisions generally based on a three to five year projection. Anything that upsets that projection could affect both the maintenance of that investment, and the direction of future ones, with a very clear effect on growth. Now, obviously, economic conditions can change, and business does recognise that politicians will sometimes need to pull certain economic levers. But policy makers need to acknowledge that of all the policy levers that they control, it is a change to the tax rules that can have some of the most significant adverse effects. For example, changes that lead to something being taxed that was not previously taxed, or an increase in an existing tax can both significantly affect investment decisions. But, at the same time, things are always changing, and the tax system will need to change with them. So how can we marry 'stability' and 'certainty' with inevitable change?

Predictability – the friend of growth

The answer to balancing these competing pressures, I believe, is to build in 'predictability'. It is this predictability that may turn out to be the greatest friend of growth.

To be clear, this is not 'predictability' in the sense of a mathematical formula, but, rather, in the sense of a known process for managing inevitable change. What does that mean? Well, there are two elements. First, it means making sure that those who made their business decisions based on a reasonable expectation of the tax law remaining the same for a three to five year period do not suffer economic disadvantage as a result of any changes. Second, there needs to be a transparent, methodical process for changing the tax law on a prospective basis in a way that follows certain procedures intended to engage all stakeholders, minimise surprise, and ensure 'stress testing' of legislation before enactment.

The first of these is not a difficult concept. If a business has invested based on a certain set of tax assumptions and the law is subsequently changed, then, despite that change, the business should be able to continue to rely on those assumptions. I am not talking about very aggressive tax schemes, but I am talking about changes to things such as capital allowances, depletion, or interest deductions. There will still be questions as to what is abusive; there will be questions as to which taxes are central to the business development decision; and there will be issues about not rewarding any rush to market to beat a legislative deadline. But the general principle seems relatively simple and unexceptional.

At the same time, it seems reasonable that in most cases such grandfathering only apply for the period in which the tax was included in making the investment decision (three to five years). So, if we were to adopt a principle that non-abusive transactions or structures would continue to be taxed under existing rather than new rules for a certain period, that would be an important part of improving stability and certainty though predictability.

And what of the second prong: a transparent, methodical process for changing the law? Put slightly differently, how can we structure our tax policy making process with 'predictability' at its core? Last year the Coalition government published a consultation document on the tax policy making process which contains some important first steps. It dealt with the necessity of spelling out in advance what policy underlies a change; with the benefits of advance publication of statutory language; and with the importance of consultation with affected taxpayers. All of this is good, but there is still more that could be done.

In order to secure growth-enhancing predictability, the process of policy formation inside the government is crucial – and there are some parts of that process that could be improved. In 2004, following the O'Donnell report, the UK tax policy making process was changed, taking direct responsibility away from Inland Revenue, and constructing something closer to the US model. Policy formation was now to be handled directly by the Treasury, with an assist on 'policy maintenance' (a term whose parameters were never completely clear) from the Revenue/HMRC.

This system works generally quite well in the US because the US Treasury is staffed up with experienced private sector lawyers doing a stint of government service. They have the expertise to deal as technical equals with IRS experts, while having the detachment from day-to-day revenue concerns that is necessary to think about the 'right' answer. But that didn't happen in the UK after O'Donnell.

In fact, things went in the wrong direction despite the best efforts of those involved. Without a dedicated tax career path in the Treasury, clever generalists would cycle through relatively short-term 12 to 18 month placements on a particular area of tax before moving on to the next or moving from the Treasury completely. With a system of tax that is, sadly, largely unintuitive, this would mean officials taking almost all of their rotation to get up to speed. Some officials were lent from HMRC – but going back to an organisation where policy had been effectively downgraded as a result of O'Donnell did not make this the most attractive of career options. There is now a small (and very good) core in Treasury, but retention beyond that nucleus has also been an issue. As a result, the policy teams change over quickly, wiping out history and making policy continuity difficult.

Meanwhile, dedicated experts in HMRC who had previously been required to think wearing a policy hat, now had to swap that for more of a revenue collector's hat – but they were still the ones with the expertise. On top of all this, there was the constant squeeze on resources (i.e., jobs). The result of this sorry litany was good people working in the wrong places in a dysfunctional system at precisely the time when they were being asked really big questions. A number of projects have turned out well (one or two not) but not without some heart-stopping moments for taxpayers along the way. Heart-stopping moments do not add up to predictability.

Delivering predictability

My view is that, despite significant strides made recently (including as a result of the excellent tax policy making Consultation Document), predictability will not improve until the institutional problem within the tax policy making function is addressed.

So, how might this be done? Well, in one sense – at least in a non-budget constrained world – some of the answers are quite simple. Make the tax policy function in the Treasury an attractive place to work so that expertise can be built up, and turnover kept down. Part of that may well involve hiring people in from the private sector for a period of time, and they may need to be paid above the standard Civil Service pay scale (although at less than private sector rates).

These people will bring familiarity with the tax law, and the way that tax people think. They will also bring knowledge as to how the tax law really works in practice – and, yes, where some of the loopholes are. They would be full-time civil servants, but relatively short service (three to five years) employees. If Treasury generalists also decided that they wanted to stay in tax policy, then the normal civil service rules might have to be changed to construct an attractive career structure just within tax policy (rather than the normal rotation through departments in order to get promotion). This private sector experience, in particular, would allow a practical input into policy at its very early stages. It might also allow more fruitful exchanges with the private sector later on in the process, as there would be more of a shared language. This strengthening of the tax policy structure in Treasury would clearly be an important aid in strengthening predictability in the management of change.

But the other crucial part of the equation relates to how to re-empower experts within HMRC. The re-formation of a policy department inside HMRC might be one way; or, perhaps, an explicit acknowledgment that a stint in 'policy' would be career enhancing. The key thing would be (as does happen – but not always) to have the product experts approach legislative change wearing a policy hat, rather than simply a revenue collector's hat. Almost by definition, if legislation is driven by revenue protection concerns it is much less likely to foster other government aims – including growth. And predictability will suffer if these policy aims must always be viewed through a revenue-tinted lens. It must be possible to do something. None of these proposed solutions is terribly radical, or terribly expensive, and a more cooperative and stable structure involving both Treasury and HMRC where both institutions feel empowered would greatly aid the cause of predictability in tax policymaking.

The role of business

Additional business input may also improve predictability. This will sound strange, given the vast (and welcome) increase in consultation, but, again, the question is how to build a process around this so that that it can consistently help to shape the tax policy framework. The current consultations are, by definition, very focussed and very ad hoc. Once we're finished with CFC reform, for example, those consultative groups will be disbanded. When that happens the common experience and understanding, not just of the details, but also, and just as importantly, of the process, will be lost. So we need more of an on-going business/government process to consider tax reform – but if we do then build a dialogue around it, how do we prevent the process from consuming more time than the substantive work? (The process of drawing up agendas, getting clearance, writing papers for discussion, briefing the principals, writing up minutes, etc., is not always conducive to real – and certainly not speedy – progress.)

The answer may lie in a group of taxpayers and government officials that doesn't have power, and, thus, the need for all the administrative process, but that does have credibility. Perhaps a group that reports to the Office for Tax Simplification? You would not want a group as formal as the Law Commission – perhaps something more like IFS's Tax Law Review Committee, but with a heavier weighting towards on-the-ground business input. So, perhaps oxymoronically, there could be a Standing Ad Hoc Group on Tax Reform. Its remit would be to consider how to make the corporate tax system more coherent (and stable and certain), and to suggest changes large and small. But it would not be a governmental body, so could maintain some flexibility.

Tax legislation and scrutiny

Continuing the theme of enhancing the predictability that may facilitate growth, what about the actual process of drafting tax legislation? A couple of thoughts. First, why can't tax drafting be repatriated into the Treasury? The interchange between HMT/HMRC and Parliamentary Counsel doesn't always seem entirely fruitful – especially in the time straightjacket of the Finance Bill process (see below). Second, and more substantively, however, might we have a new convention for drafting anti-avoidance legislation? These types of rules have proliferated in recent years, and on a number of occasions governments have made a rod for their own back (not to mention for taxpayers' backs) by drafting intensely complicated blanket anti-abuse rules, which then have to have numerous exceptions.[112]

It is precisely those types of rules that the inventive tax specialist adores on the basis of *inclusio unius est exclusio alterius* (in English: 'All the gaps we can find in your very detailed legislation are now completely in legislation). Other taxpayers are understandably sympathetic to government attempts to prevent aggressive avoidance of rules, but often such rules drag in 100% of taxpayers, to catch the, say, five% who should really be the targets.[113] The problem is then that, when you have general rules that unintentionally drag in vast swathes of taxpayers, while also create subterranean levels of detail, then no one has much sympathy with the anti-abuse aims. Even putting aside the economic inefficiency of all that unnecessary compliance, such rules deeply damage business confidence in the tax system as a whole. Again, if this part of the process can be reshaped so that taxpayers know, as a result of a predictable process, that such rules will be focussed, that would be a significant step forward.

Finally, if we are looking to increase growth-enhancing predictability, it is difficult to avoid discussing the parliamentary stage of tax policy making. The chance for a second, informed, look at tax policy changes is valuable but – let's be honest – rarely happens. If this stage could be improved then, again, predictability might benefit. This ground is already well-ploughed, particularly by Lord Howe, but there is certainly a case to be made for the Treasury Select Committee to play a much more central role in both the development and scrutiny of tax legislation.

Alternatively, perhaps there should be a proper (and properly staffed) Joint Committee on Taxation involving both Commons and Lords. (In the interests of a better legislative process we need to put aside the sterile constitutional arguments on Money Bills, now dating back a century.) Absent these fairly major structural changes, however, one practical suggestion might be to change the timing of tax legislation. The current straightjacket of the Finance Bill serves nobody's purposes.

112 The informed reader should consider the worldwide debt cap, or the disguised remuneration rules.

113 The informed reader should consider transfer pricing rules.

A false deadline means that all activity has to be shoehorned into a few months of the year around the time of the autumn statement and the budget. Always, it seems, as the deadline approaches the draftsman cannot keep up with the timetable and something gives – the 'something' normally being the legislative language itself ('Don't worry, we'll sort it out in guidance').

The publication of draft clauses in advance has clearly somewhat mitigated this difficulty, but the obvious fact remains: there is no need for all tax legislation (or indeed any, other than the required reauthorisation of rates) to be placed in the annual finance bill. The need to produce items for an annual round of tax legislation both distorts the tax policy making process, as well as probably encouraging more legislation than is really necessary. Of course, anti-abuse measures may require speedy action to prevent forestalling (i.e., a rush to market), but such abuse situations could be dealt with by announcing immediate effective dates. Why not have a tax Bill every few years when either enough small items have mounted up, or when there is a major change that must be legislated? In other words, allow the time to get the legislative language right so that it can carry the burden imposed on it, rather than settling for a less perfect product produced to a false deadline. It is bad legislation that is one of the greatest enemies of predictability.

“Why not have a tax Bill every few years when either enough small items have mounted up, or when there is a major change that must be legislated”

Conclusion

If the UK wishes to use the tax system to facilitate growth, there need to be two elements to that. One certainly relates to making sure that tax rates, and incentives such as the R&D credit, and the patent box compare favourably with other countries. But the other relates to creating stability and certainty for investment – and, just as importantly, how to maintain those through periods of inevitable change. This writer finds 'process' no more exciting than anyone else, but it seems clear that predictability in change is crucial; that at the moment we are not achieving it; but that – and here's the good news – some straightforward and not very expensive changes could make a significant difference.

Will Morris is the Global Tax Policy Director of GE, and Chair of the CBI Tax Committee

7
Innovation

By Matt Brittin

Innovation is the key to growth in businesses and the wider economy. That is why innovation matters so much to us. It has been at the heart of how we've grown over the last 13 years from two guys in a garage to a global company with over 26,000 employees.

In this essay, I will outline some of the principles we have, and still do, rely upon and reflect on how they might help stimulate growth in the UK. From the outset let me be clear that we don't pretend to know everything about innovation. Innovation is about doing new things. It's about being disruptive (sometimes to the point of being unreasonable), breaking with expectations and upsetting norms. No two innovations or the precise routes to them will ever be the same; the thoughts in this article are just my take on how we try to be innovative rather than a set of rules to work by.

In terms of hard facts, the last decade has seen some ground-breaking innovations. At Google, we're best known for our search engine but we've pushed the boundaries elsewhere: from Gmail, which revolutionised email services by offering free and virtually limitless storage space, to Android, which is helping to transform mobile phones. And we're not the only ones. Disruptive innovations from companies like Facebook, Amazon and Apple, rank up there among the great digital innovations that are now part of the fabric of life for hundreds of millions of people around the world.

But that's just the stuff that everyone knows about. Behind the scenes we're continuing to push boundaries. Take, for example, the self-driving cars that are now being let loose on the streets of California, which use video cameras, radar sensors and a laser range finder to "see" other traffic. Some day this technology might be in every car, helping to cut road deaths and congestion. Of course putting yourself in a car with no driver that is able to take you around the M25 at 70 miles per hour is probably at the edge of most people's expectations. But without this kind of ambition, groundbreaking innovations are likely to always stay out of reach.

Indeed, this is perhaps one of the biggest challenges in innovation: ensuring that audacious solutions to global problems are given the space to develop, particularly when there is a high risk of failure. This is the challenge of R&D and a reason why we have invested heavily in R&D – with annual growth of more than 80% per year over the last ten years. It also helps that we are a company led by engineers. They have faith in their ideas and they invest heavily in backing them.

This must be the first guiding principle of innovative companies: think big ideas and back them up with substantial investment.

But ideas and investment are not uncommon in Silicon Valley. So, drawing on our experience I see a number of principles that may help translate ideas and investment into a thriving culture for innovation.

The value of data

A lot of discussion about innovation is related to how companies approach making decisions based on data. At Google we treat designing web based products more as a science than an art. In our business having a strong hunch isn't enough to base a decision on. You need to test it and get the data to back it up. In that sense that points to the importance of having a very scientifically oriented culture.

Let me give you an example. The colour of the links that appear in our search results was chosen very carefully and precisely. Most companies would just go with a designer's opinion but we decided with data. We ran tests with 42 different shades of blue. When the data came back, we compared which links were clicked on the most. If we had just chosen any colour, we might have lost the company hundreds of millions of dollars in reduced clicks. So shades of blue can make a difference: and data can help you make the best decision.

The importance of sharing

Although data is a hugely valuable element, it is not the only thing when it comes to setting off that initial flash of inspiration. Highly innovative companies tend to thrive with an open-minded and collaborative culture. In many companies I've encountered, there's the sense that knowledge is power, so people don't share more than they need. Whereas at Google, it's the reverse... the default is to share everything unless there's a reason not to share. A great and routine example of this is diaries and documents – our default is to have them open to everyone, from the top down. It's a subtle but fundamental shift in mindset.

Taking sharing seriously means that good ideas can bubble up to the top quickly – and bad ideas, no matter who has them, can get tested and shot down just as quickly too. This helps build a strong team spirit in which people are not afraid to speak up – but also increases the company's velocity and ability to move quick on smart ideas.

Good ideas alone are not enough

You can have all the brilliant insights and creativity in the world, but it will come to nothing if you aren't able to follow it through and implement.

A couple of years ago Sergey Brin gave an interview to the Guardian and what he said then about what follows a good idea really helps explain why his great idea became a great business: "It's important not to overstate the benefits of ideas. Quite frankly, I know it's kind of a romantic notion that you're just going to have this one brilliant idea and then everything is going to be great. But the fact is that coming up with an idea is the least important part of creating something great. It has to be the right idea and have good taste, but the execution and delivery are what's key".

In practice this points to companies taking more of an iterative and experimental approach. We believe it is much better to get a prototype out there fast, than to

spend months at the drawing board trying to design the perfect model. Not only does this get innovations out the door more quickly, seeing how prototypes get used will teach you far more than any amount of business planning. You can then iterate to improve based on real experience rather than just assumptions.

Just as importantly, prototypes are also a crucial tool in helping to get others to buy-in and contribute to your ideas – which is half the battle sometimes, given that usually no one can singlehandedly take an innovation from idea to implementation.

Innovation in the UK

I now want to turn from our experiences to look more closely at Britain, and to think about how some of the principles I've outlined above might help stimulate innovation in the UK.

It's easy to think that the kind of ideas and energy that helped create engines of innovation like Google, Apple, Amazon and Facebook are somehow exclusive to a small corridor of big companies in California. But there is nothing stopping Britain from being home to the next generation of big ideas.

I said at the start that I didn't want to prescribe rules for innovation. So instead to end this essay here are five insights to help frame the debate about nurturing innovation.

1. Small business drive innovation

If you look at where growth in the UK has come from over the last few years, it has been from a small group of innovative companies. According to research by NESTA, half of all jobs in the UK were created by just 1 in 20 companies. What they had in common was that they were small and highly innovative.

These highly innovative small businesses are in turn being powered by the new internet economy. According to a report by the Boston Consulting Group, smaller companies who sell goods online have grown over four times faster than those offline. So if we're looking to power growth, we need to be creating the right conditions for small and highly innovative companies.

2. Lower the barriers to innovation

Secondly, lower the barriers to innovation. It's no coincidence that so many of the well-know stories of companies with rapid ascents begin with people who had the freedom to follow their own ideas. Today we still encourage that as a company, with engineers able to use 20% of their time to pursue their own projects. This attitude to innovation is one that governments can borrow too: the starting point for every new piece of legislation should not be 'how do we regulate this' but 'how do we protect the space needed for innovation'. In the UK, the recent Hargreaves Review is a good example of how we could make some relatively small changes that will create the space for new innovations and new businesses that could add £8 billion to the UK economy.

3. Think global

You don't need to be a big company to compete on a global scale but you do need to be competitive and you have to be outward-looking. The same is true of countries. From the outset, your approach needs to be internationalist and you

need to ask how what we do can compete with the likes of India and China. We know Britain has what it takes: for every £1 imported, the UK exports £2.80 in e-commerce goods and services. It's important that business can be easily exported. But it's equally important that global talent can be welcomed in. Companies should be able to bring truly talented people into the UK. If we want Britain to be a global hub for jobs, growth and innovation, we should be welcoming to the world's talent.

4. Be open

Being open and transparent is a powerful default option. At Google, everyone in the company can see each other's diaries, documents, and key objectives. A strong culture is one in which good ideas can grow fast, resources are shared, and useful information is easy to find, not hoarded away. These same principles can help make a country more innovative: share data, open up the information that is hoarded away, and let others do things with government data that the traditional data owners would never have dreamed of doing. I'm pleased to say the UK government is already leading the way in this space and that's to be applauded.

"Being open and transparent is a powerful default option"

5. Value your talent

If anyone ever asks us what they should do to be the next Google, we tell them to invest in engineers. In our company, engineers are treated like rock stars. As a country, we need to invest in that talent. As one of the companies involved in the Tech City initiative, we are doing our bit by investing millions of pounds in setting up a hub for the developer community in East London to ensure local start ups can share ideas and grow their businesses. But we also need to show as a country some of that rock star esteem for our scientists, engineers and inventors. We need to fire the imaginations of talented people to think big and take risks. Britain has a great history in computing and data innovation, from Alan Turing and Bletchley Park to Tim Berners-Lee and the World Wide Web, and it's really important we celebrate them.

That feels like a fitting note to end on: Britain has a history of great innovation it can be proud of and, if we get the conditions right, a great future ahead of us too.

Matt Brittin is Vice President, Google Northern & Central Europe

8

Small businesses and the future of growth

By Andrew Cave

The facts underpinning the importance of the small business community to the UK economy are compelling. Despite the recession, there were an estimated 4.5 million small and medium sized enterprises in the UK at the start of 2011. They make up 99.9% of all enterprises, account for 58.8% of private sector employment and 48.8% of private sector turnover. Between 2002 and 2007, 84% of all new private sector jobs were created by SMEs.

Research undertaken by Westminster Business School has revealed that small businesses are the most likely to serve as a bridge into the mainstream workforce for the under-skilled and those who find themselves on the periphery of the workforce.[114] The nature of small businesses, their connection to local communities and their less formal recruitment processes mean that they are more likely than larger businesses to employ the young, the under-skilled and long-term unemployed. As we enter into a challenging period of tackling unemployment and avoiding the re-emergence of structural unemployment, the role of small business is more critical than ever before.

So where does the small business community find itself today? The Federation of Small Businesses undertakes a quarterly survey of its membership to take the pulse of the small business community and the latest data make for depressing reading. The most recent Small Business Index fell into negative territory;[115] the lowest reading since the fourth quarter of 2010, perhaps hinting at weak growth figures later in the year. All regions of the UK now report a negative outlook, up from just over half in the previous survey, and the revenue of small businesses has been falling on balance for the three months to September. Expectations for the coming three months have become negative as the tentative optimism of the June survey has turned into pessimism

Contrary to previous expectations, a growing number of small firms have been laying off workers and a significant number of firms are looking to cut staff over the coming three months, suggesting potential further increases in the national unemployment rate. On a positive note, financial, business and personal services and also computer-related services have maintained a positive outlook. However, more widely, most business areas have deteriorated and industries reliant on discretionary spending, such as hospitality, were hit especially hard. Spare capacity has been on the increase and is expected to remain above the survey average for the coming quarter.

114 Small Businesses in the UK – New Perspectives on Evidence & Policy, 2008, Dr Peter Urwin

115 FSB – CEBR Small Business Index, Q3 2011 results

Even when businesses spot opportunities to grow, this is not necessarily translating into job creation. During the recession many jobs were saved by business owners moving staff to part-time working. Our flexible labour market cushioned the blow of economic downturn with firms cutting down on hours rather than staff. Unfortunately, we are now starting to see this flexibility turn to rigidity as firms tap into their existing workforces rather than recruiting new staff. Flexibility strongly favours an incumbent workforce, but combined with a sluggish recovery, it also serves as a barrier to those on the periphery of the workforce and now increases the risks of structural unemployment.

Understanding the problems we need to address

Given the forces of global economic meltdown currently ranged against the UK economy there are limits to what the government can do to help small businesses in the short term. This is not to say that many of the problems businesses face are not home grown and cannot be tackled by government, but first we need to understand the nature of the problem.

A quick comparison with the US illustrates the overarching problem we face. Since 1980, 75% of large firms founded in the US grew from scratch. By contrast, more than 80% of the large UK and European firms created since 1980 were the result of mergers and acquisitions of pre-existing firms.[116] In short, the conveyor belt that takes our smallest businesses to become medium and large businesses is broken. The recent obsession by government with boosting business start-ups misses the point. It is relatively easy to start a business in the UK but growing a business is much more challenging. In a country where the average business employs four people, a more useful growth orientated aspiration would be to increase the size of the average business from four employees to six and beyond.

> “… the conveyor belt that takes our smallest businesses to become medium and large businesses is broken”

If our current fixation on business start-ups is a distraction, our expectation that the government should deliver economic growth is simplistic to the point of being unhelpful. Whilst it is not unknown for government to establish the right conditions for economic growth to occur, government itself does not create growth. Economic growth is the by-product of a business or individual taking a risk to turn a good idea into a successful business venture. Everything that flows from that act, jobs, innovation, growth and increased living standards, is the by-product a risk being taken. Instead of focusing on measures to deliver growth, government ought to be ensuring that its actions serve to ameliorate an entrepreneur's relationship with risk; the rest will look after itself.

This fairly obvious fact is well understood by some ministers, but not by the government collectively. Why else would we have seen the scrapping of the default retirement age, the introduction of the Agency Workers Directive and the extension of the right to request flexible working, together with the promise of more to come, at a time when the government professes to be promoting growth and job creation? These measures have massively altered a business owner's relationship with risk when considering business growth and job creation with many deciding to err on the side of caution and be risk averse. The business might not suffer, but when tens

116 European Union Research Advisory Board, report and Recommendations on SEMs and ERA, May 2004

of thousands of businesses make the same judgement, our economy takes a hit and the jobless figures creep up. Potential reforms to employment tribunals are a step in the right direction, but for many employers and potential employers, the damage is done and the perception of risk is too great to make taking on staff worth the hassle.

Without a better understanding of how economic growth materialises, government is doomed to introduce measures that contradict each other and confuse the rest of us; and ultimately undermine their stated goals of boosting growth and job creation. But assuming that the foundations of a rigorous understanding of growth might soon be in place, what more can government do to help the small business community?

Making the most of government spending

The biggest concern for business at the moment is the plummeting level of demand. When the FSB asked business owners what factors dominated decisions over employing and growing, insufficient work and uncertainty over contracts, together with access to finance, were key. Whilst there is little room for stimulating demand through tax cuts, the government should be looking to use its estimated £238 billion public sector spending power to kick-start the UK's business growth 'conveyor belt', helping the smallest businesses grow.

Earlier this year, the Prime Minister announced measures simplifying the public procurement process, as well as setting a target of 25% of contracts going to small business. So far this has failed. Since the PM's announcement, the central government stationary contract has gone to two large suppliers and its print contract, which had previously consisted of 140 contracts, has been aggregated into a single contract and single supplier. Recent figures indicate that the government has a long way to go to meet its 25% aspiration. For the 2009/10 financial year the data shows that in that only 6.5% of government spend was with SMEs, representing only £3.11 billion of government spend.

This fails the first priority of helping our smallest businesses grow, but the picture is even worse with public procurement at the level of local government and with public bodies like the NHS, where the process of qualifying to bid for a public procurement contract involves forms adding up to hundreds of pages. Even for businesses experienced in bidding for contracts, the recent increase in red-tape makes the associated costs and risks unprofitable. In the Autumn Statement, government should scrap the Pre-Qualification Questionnaire process for public procurement contracts with public authorities and local government. This will be criticised as meddling in the affairs of local government, but at a time when there is little demand and no money spare to stimulate demand with tax cuts, there are few other options open to the government for action.

The Green Deal could give government the opportunity to channel business to thousands of small businesses and help them grow. But here again, we risk missing a fantastic opportunity by excluding from new and existing work the very businesses on which our recovery will depend. It is expected that energy companies, major contractors, big retailers and other large businesses will be the only ones likely to take on the role of the Green Deal Provider. The initial costs of setting up as a Green Deal Provider will be a major barrier to entry for most businesses. It will be extremely difficult for SMEs to access Green Deal finance directly, and without an alternative finance mechanism in place businesses that

are not tied to Green Deal Providers will be unable to offer their services. The potential exclusion of small businesses from Green Deal work would be hugely detrimental to the construction sector and the wider economy.

Incentivising job creation

After demand, the biggest challenge is job creation. The government has already accepted the logic that lowering Employer's National Insurance Contributions (NICs) boosts the prospects of job creation, but the current offer to start-ups in certain parts of the country barely scratches the surface. Recasting the policy and directing it at existing businesses with zero to four employees, making the NICs holiday available for the next three employees hired would, based on the average weekly salary, save a small business £7,567 a year. Over £10,000 would be generated for the Treasury for every three jobs created. If this led to the creation of 60,000 jobs, it would generate £350 million for the Treasury, as opposed to £900 million being paid out in benefits for the same number of jobseekers.

The NICs holiday is not the only policy where the good intentions of the Coalition risk falling short of the mark. Nearly half of all positions beginning with a Work Trial have led to a permanent job but its current scope limits its chances of success. FSB research has shown that up to 46,000 jobs could be created if the government extended its current Work Trials scheme. Work Trials are beneficial for both the employer and the employee as they offer key skills to help businesses move forward while at the same time ensure the person on the work trial is learning new skills.

Specific measures should also be adopted to tackle graduate unemployment. It is difficult to understand the thought process in government when they removed of the Graduate Internship Scheme earlier this year. The scheme had placed over 8500 graduates in small businesses, exposing them to work, helping to build their CVs and also leading to fulltime employment for roughly 25% of participants. The argument that this scheme was too expensive missed the point. An extension of the scheme would have reduced benefits payments by at least £1.5 million instantly and by a further £3.37 million over the course of a year. Furthermore, our estimates suggest that revenue to the Treasury would have increased by over £5.4 million.

Financing economic recovery

It has become impossible to talk about the fortunes of small businesses without referring to the future of the banking industry in the UK. The Governor of the Bank of England said in October 2011 that SME lending contracted by £5 billion, or five%[117] from the same period 12 months ago. The recent *Trends in Lending* report showed that as lending stock reduced, indicative interest rates for smaller businesses continued to rise when compared to medium sized businesses, and the difference between the two is growing. Between January 2010 and August 2011, indicative interest rates on small business finance were 4.39% compared to midsized businesses (between £1 million and £25 million turnover) that paid 3.30%. This is particularly surprising as the Credit Conditions survey showed that default rates among both small and medium sized businesses have not changed in the past six months and the banks suggest that there is little evidence of further deterioration in their SME credit portfolios.

It is perverse that during a period in which the government has encouraged banks to lend to businesses through its Project Merlin lending targets, more than 30% of

117 Mervin King speech to the IOD, October 2011http://www.bankofengland.co.uk/publications/speeches/2011/speech523.pdf

small businesses missed their growth opportunity due to banks failing to lend. During this period Natwest transferred £79bn from its retail brand to parent bank RBS for its investment division; money that would have been available for lending to small and medium sized businesses if an effective ring-fence had been in place.

Whilst the UK financial services sector has grown bank assets to more than four times British GDP, UK corporates constitute only 5% of lending.[118] The medium to long term health of the UK economy now depends on the government not only enacting but implementing the Independent Commission on Banking's recommendations. However, these will do little to ease the short-term problems for businesses seeking finance and this is why we need to see an application of Credit Easing that reaches the smallest businesses. This will not be easy but any attempt by government to address a lack of supply of credit to small businesses should have at its core the following principles:

1. *Competition:* In keeping with the ICB report's recommendations, government intervention should encourage competition in the market and aim to address the market dominance of a few large players;
2. *Increasing access to credit for the smallest companies*: A scheme should have as a key objective improving the supply and price of credit to the lower end of the market i.e. below loan values of £25,000, where the majority of demand lies and where firms have had particular problems raising finance; and
3. *Community development*: Where possible, government intervention should aim to improve credit flows to 'hard to reach' sectors of the economy such as rural areas and areas that have experienced industrial decline.

With their extensive nationwide networks, retail banks and especially those where the tax payer is the majority shareholder is one delivery mechanism for a government-backed scheme in whatever form it might take. At first sight this option appears attractive, building on existing infrastructure and being quick to implement. However, the concern, as noted by the Bank of England Agents' report is that banks are still perceived negatively by SMEs[119] and a scheme run through the banks may not receive the necessary demand. Moreover, such a delivery mechanism would be unlikely to pass the competition test: using the banks as the primary delivery mechanism for 'credit easing' runs the risk of reinforcing their dominant market position. Instead, credit easing offers the perfect opportunity to foster the emergence of credit unions and peer-to-peer lending.

Conclusions

Setting up and running a business can be a daunting prospect. But the spirit of entrepreneurship that accompanies every business can lift people out of poverty, create wealth and put our economy back on track. It can be a catalyst for the resurgence of civil society and transcend class, gender, age and every other social divide; entrepreneurship can be found anywhere. In short, turning a good idea into a business venture is one of the most positive acts an individual can perform for themselves and the community in which they live. The role of government is to make this a risk worth taking.

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118 Interim ICB report, April 2011

119 Agents Summary of Business Conditions Oct 2011, Bank of England http://www.bankofengland.co.uk/publications/agentssummary/agsum11oct.pdf

9
Housing and planning: rebalancing and renewing

By Alex Morton

> *The United Kingdom currently lies bottom of the G7 league in terms of output per capita…the most pervasive explanation lies in the effect of regulations governing product markets and land use on competitive behaviour, investment and pricing.*
>
> McKinsey[120]

Our planning system is failing our society and economy. It has been for decades. Based on a template created in the 1940s, it distorts the land market and investment decisions and is a huge drag on productivity and growth. Land is the third essential factor of production. It lacks the visibility of the capital or labour markets but is just as critical. We should not underestimate the terrible economic effects of our distorted land market and the fact that, while they hurt everyone in our society, they hit the poorest the most.

Our planning system has rationed land for decades and massively underprovided for residential, commercial and industrial purposes. Land for agricultural purposes in Oxford/Oxfordshire costs £20,000 a hectare, whereas land for industrial purposes costs £1 million a hectare and, for residential purposes, £4 million a hectare.[121] This drives up housing and business costs as, in the most basic terms:

Cost of a property = the cost of land with planning permission + cost of building

If too little land is released with planning permission for a particular use, the cost of property for this use increases. This is not just true for new property, but also for existing property. The price of all property is the price of land with planning permission plus the cost of construction. The only difference is that some homes and offices were built some time ago and for others construction was only just completed.

We cannot go on like this. The Coalition government realises this. However, suggested reforms will not move the system on from local authority planning based on 1940s Britain and have overestimated the impact that local authority incentives are likely to have (discussed in our recent report *Cities for Growth*).[122] Over the last ten years Policy Exchange has also done a great deal of work on planning. Our latest report, *Cities for Growth*, noted that there is clear evidence our planning system is:

120 *Driving Productivity and Growth in the UK Economy*, McKinsey, 1998

121 *Property Market report 2011*, Valuation Office Agency, 2011

122 Specific references are made in this chapter to our reports *Cities for Growth*, 2011, *Unaffordable Housing: Fables and Myths*, 2005, *Making Housing Affordable*, 2010, *The Best Laid Plans*, 2007. These and various others are all available on the Policy Exchange website (www.policyexchange.org.uk)

- The main driver of large scale internal migration away from our major cities, totaling almost 900,000 between 2000 and 2008. Given economists believe urban population doubling raises the productivity of all workers in an urban area by 6%, this will drag our economy down;
- Thwarting specific growth centres, such as Leeds, Cambridge and London. These cities are where future growth industries need to expand. If they cannot, investment and jobs leave our country;
- Slowing regeneration, with provincial cities in the North and Midlands suffering from higher office costs than Southern centres and often ranking in the top 50 most expensive cities in the world for commercial space (Manchester is more expensive than Manhattan).

Past reports (including *Unaffordable Housing: Fables and Myths, Making Housing Affordable, Cities for Growth*), highlighted how the planning system has created a housing crisis. Two key negative effects are:

- The social effects caused by our planning system, including; prohibitively expensive family homes in much of England; falling home-ownership for the first time in 80 years; and increasing wealth inequality (already one of the largest inequalities in the UK); and
- Higher costs to government; higher taxes are needed to fund a housing benefit bill set to hit £22.5 billion by 2015/6, and social housing waiting lists stand at 1.7 million households. Waiting lists would be even higher but many do not join as the wait is so long that they see no point.

It is clear that the planning system is holding back economic growth and not delivering the social outcomes we need. This chapter expands on some of the more hidden negative effects of the planning system – on top of the points above. It argues, in particular, that our planning system:

- *Reduces domestic investment in business by skewing lending toward property;*
- *Blocks many key opportunities for business growth and development;*
- *Heavily reduces inward investment and manufacturing investment;*
- *Sharply increases high skill emigration; and*
- *Increases regional inequality.*

The effect of this is a very substantial loss of productivity and much lower living standards.

Reduces domestic investment in business by skewing lending toward property

Banks ultimately have a choice with lending and they will rationally choose to put it where they maximise profits, whether that be through lending to businesses or households. As house prices have risen steadily year after year, we have seen the negative consequence; more and more lending for mortgages (both owner-occupiers and buy-to-let landlords). This means that, all else equal, there will be less investment in new companies, ideas and technologies as funds go to property instead.

This is clearly shown by the data. By early 2008, lending to individuals for mortgages ran at over £20 billion a month, versus around £10 billion to companies, and corporate borrowing was often used for commercial development or speculation.[123] Our economy had become unbalanced.

This imbalance in lending toward property and away from business investment is getting worse, despite the Coalition's goal of rebalancing the economy. Figures from the British Banking Association in September 2011 show that in the previous six months, average net mortgage lending rose by £0.8 billion a month, yet lending to non-financial businesses fell by £1.6 billion a month.[124]

The failure to lend to business for investment is often seen as a banking failure. But even if banks worked perfectly, they would only lend money to the most profitable ventures. Given that housing is a necessity, if we refuse to build enough homes, prices rise steeply and lending goes to mortgages. At present, planning laws are so restrictive that higher prices for homes do not necessarily mean increased output, so higher mortgage lending does not even boost construction, but are largely just recycled within the system.

Government is sensibly trying to encourage more lending to productive businesses and infrastructure. One of the most effective ways to achieve this would be to act to free up the planning system and thereby incentivise increased lending to business.

While some may argue that this would just see capital move abroad, the huge 'home bias' of domestic investors suggest that this is unlikely to be the case. While the UK makes up 7% of global stock market capitalisation, 65% of UK equity portfolios are UK equities. Investment is ten times as likely to be in UK equity as foreign equity.[125] Similar bias exists in bond investments.[126]

Blocks many key opportunities for business growth and development

The planning system also restricts the potential number of profitable ventures companies can undertake. A McKinsey report from 1998 found that in the UK economy:

> *"low capital investment ... is largely the result of the lack of opportunities for profitable investment: new retail or hotel formats, say, may suffer from a dearth of access to sites on which to build, as well as high construction costs when sites are available."*[127]

They noted that land and property restrictions caused distortions across the entire UK economy, touching on sectors as diverse as software, banking, and airlines, as well as more typically cited areas. In hotels:

> *"Regulations governing land use and planning mean building or refurbishing a hotel in the United Kingdom is up to 40% higher than in the United States... It is often difficult for a UK hotel operator to obtain permission to build on the sites that offer the best prospects of high occupancy ... High barriers to entry and exit combine to create a vicious cycle. Although the country is home to several of the world's leading hotel operators, much of their investment is going abroad."*[128]

The barriers that planning creates go some way to explaining why UK companies are sitting on cash reserves of around 6.6% of GDP.[129] By restricting

123 *Trends in Lending, April 2009*, Bank of England, 2009. Also see BoE inflation reports from mid-2000s

124 *High Street Banking, September 2011*, British Banking Association, 2011

125 *Home Bias in International Equity Portfolios: A Review*, Sercu and Vanpe, 2007

126 *Home Bias in Global Bond and Equity Markets*, ECB Working Paper Series No 685/October 2006, 2006

127 *Driving Productivity and Growth in the UK Economy*, op cit

128 *Driving Productivity and Growth in the UK Economy*, op cit

129 *ITEM Club Spring 2011 forecast*, Ernst and Young, April 18th 2011

the number of productive investment opportunities, the planning system is a key factor preventing these reserves from being reinvested sensibly. Removing these barriers would create both short-term investment and long-term rebalancing and productivity gains.

One way to target this would be to tackle the unhealthy nature in which planning decisions are made. The interventions of both Margaret Thatcher and Michael Heseltine were necessary to create the Docklands. The recent decision on Broadgate Market, where Jeremy Hunt intervened to push through, echoed this. If we are serious about growth, we cannot base our competitive future on sign off from individual ministers and the power of lobbying campaigns, rather than responding to real economic and social needs.

All of these problems are exacerbated since the slow, unwieldy nature of the planning system is a particular issue for smaller firms. Given the importance being placed on small firms as the drivers of growth and innovation (see elsewhere in this report), this is a major problem for the UK economy. However, this does not have to be the case. In Preston, where a more liberal approach was taken to planning, one side effect was the significant expansion of many small indigenous business.[130] Our planning system both raises rents, which is hardest for small businesses to cope with, and also makes it hard for them to expand as they can lack the legal expertise, ability or resources to push change through.

Heavily reduces inward investment and manufacturing investment

The high land costs coming from our planning system also dent our international competitiveness. For firms making a decision over where to locate their business, the high price of land and property is a negative compared to a country with low land costs (e.g. Germany or the southern USA).

In 2008, eight out of the top 20 most expensive cities in the world for industrial space were in the UK. No other country had more than two.[131] This is, as ever, not about space; researchers found that the tiny city state of Singapore was cheaper than all these cities, and only 10% of England is built up.[132] It is about an extremely poor planning system. *Cities for Growth* showed that we also have expensive office space on an international basis. Both of these factors point towards a significant comparative disadvantage in the UK. The high cost of locating a business in the UK decreases the likelihood of firms doing so. The high cost of housing is also a barrier: this is considered later.

Investment in land intensive industries is at a particular disadvantage in the UK. At least office workers can generate higher revenues per m2, which can offset high land costs. With industry, the revenue per m2 will tend to be lower and higher land prices are more problematic. This skews our economy as land intensive firms tend to be manufacturers.

This also brings us to the critical point about ‘brownfield first’, created by the last Conservative government in 1995 and retained in a modified form in the current reforms. Manufacturing in 1995 was around 20% of GDP, and had been steady since 1990. Between 1995 and 2009, manufacturing collapsed to just 11% of GDP. This is often ascribed to ‘global trends’ yet Japan and Germany saw no fall at all while France and the US saw only moderate declines in manufacturing’s share of GDP.[133] But between 1995 and 2009 the government did achieve

130 *Why Preston Works*, Regeneration and Renewal, 9th August 2010.

131 *Global Industrial and Office Rents Survey 2008 Q2*, King Sturge, 2008.

132 *Land Use Statistics, Generalised Land Use Database*, 2005, ONS.

133 *BIS Economics Paper NO10B, Manufacturing in the UK: Supplementary Analysis*, BIS, 2010

its targets of 'reusing' industrial land for housing, with this hitting 80% by 2009, and the proportion of previously developed land changing to residential land moving from 44% to 69% of all residential land.[134]

> "The high land costs coming from our planning system also dent our international competitiveness"

This points towards 'brownfield first' being a contributor to manufacturing being driven out. With the planning system pushing for sites to switch to housing, and the value of residential land so high, this meant offices, industrial land and other sites that were best suited to commerce were instead switched to homes. To continue to focus all new homes on brownfield sites will only make things worse.

Steeply increased high skill emigration and increased regional inequality

In 2007, at the height of the housing bubble, around 200,000 Britons were emigrating. While this has now fallen back to 120,000 a year,[135] emigrants tend to be highly skilled, and many never return. In 2008 the OECD noted that 1.1 million UK born people educated to degree level were living overseas, more than any other country and substantially more than other countries such as France (370,000), and the USA (410,000).[136] Whereas just 20% of the UK population is educated to degree level, over 50% of those moving abroad were educated to degree level.[137]

There is evidence that our high living costs, largely caused by high land costs, drive people away. Surveys throughout the 2000s revealed the high cost of living was a major push for emigration. YouGov polling in 2007 found that around a third of Britons considered leaving, with financial worries caused by the high cost of living driving this. It also found Londoners aged 25-34, who struggle most to afford a family home, were most likely to consider leaving.[138] Polling for Policy Exchange in 2010 revealed that 89% of finance professionals, cited the high cost of living as a major reason for leaving the UK, much higher than political flashpoints such as a bad education system (33%) or the 50% rate of tax (18%).[139] Highly skilled workers without property gain most by emigrating, as they will earn high wages abroad and are more likely to be able to own a family home: an appealing mix.

In addition to high housing costs helping to increase emigration of those we would wish to retain, our planning system also drives regional inequality. As noted in *Cities for Growth*, office space is more expensive in many Northern cities than Southern ones. Our Northern cities are also internationally uncompetitive. The creation of huge green belts around Northern cities and excessive brownfield bureaucracy holds back their regeneration.

Restricting housing in booming areas also increases regional inequality in two ways. Firstly, limiting housing supply simply means London and other high cost areas slowly become prohibitively expensive for low paid UK workers. The table below shows how many UK residents of each skill level moved into London for each person of that skill level moving out. For each high skilled worker moving out, 1.33 high skilled workers moved in. For each of the lowest skilled workers moving out, 0.7 workers moved in to replace them.

134 *Land Use Change Statistics in England: 2010 Provisional Estimates,* DCLG, 2011

135 *Migration Statistics Quarterly report August 2011*, ONS, 2011

136 *A Profile of Immigrant Populations in the 21st Century*, OECD, 2008

137 *A Profile of Immigrant Populations in the 21st Century*, ibid

138 *One in three Britons dream of emigrating to ease financial worries*, Daily Mail, 3rd October 2007

139 *Not with a Bang but a Whimper*, Policy Exchange, 2010

In/out internal migration ratio across skill groups for London[140]

Higher Managerial & Professional	Lower Managerial & Professional	Intermediate skill	Low skill
1.33	1.21	0.99	0.71

The simplistic view that 'high house prices deter people from moving' completely ignores the fact that different people have different incomes and so different ability to cope with higher prices. Higher earners are much less discouraged than lower earners. As discussed in *Cities for Growth*, higher housing costs do not promote economic rebalancing. Instead they promote increased regional inequality on a per capita basis, as high skill workers move and congregate together, leaving low skill workers behind.

A very substantial loss of productivity and living standards

The effects of these distortions can be very serious. Within just one sector, retail, our planning system imposes very substantial penalties in terms of lost productivity. Recent LSE work noted, erring on the side of caution, that current planning laws cause a loss of ***at least* 25%** in terms of store productivity.[141] This can, absurdly, be greeted with a shrug and the view that retailers are profitable enough. Yet the 25% productivity lost falls on customers via higher costs, workers via lower wages, shareholders via lower dividends, and the exchequer via lower taxes.

Planning is having a major impact on the growth potential of the UK. To consider the lost opportunity that it brings about, one needs only to consider the cumulative negative effects that planning has on a UK company considering a major investment:

- The planning process is long and complex and has an uncertain outcome;
- Land costs are higher than in almost any other country;
- Potential workers face huge costs of buying a family home;
- Firms may find it difficult to get the funding;
- Where funding is available, the interest rate charged is much higher than it would otherwise be;
- Location decisions are biased towards sub-optimal locations and locating in or near a successful cluster may be difficult; and
- The scale of sites may need to be changed.

Unsurprisingly this doesn't encourage investment. The planning system significantly reduces the UK's growth while incurring huge social and aesthetic costs.

Fixing the planning system and increasing growth in a politically sustainable way

The UK's planning system is not a functioning system in need of a few tweaks. It is a fundamentally flawed system that needs a systemic overhaul. This might not come in an immediate 'big bang' but it needs a medium-term strategy that takes

140 *Migration and socioeconomic change*, Joseph Rowntree Foundation, 2007

141 *Evaluating the effects of planning policies on the retail sector: or do Town Centre First Policies deliver the Goods?*, Cheshire et al, LSE Spatial Economics Research Centre, 2011

us from the very dysfunctional, centrally planned system currently in place to a much more liberal system that allows greater development in a way acceptable to local people and that is politically feasible.

Local authority master planning has had six decades of failure and need to be rolled back. Current reforms, by removing national targets and emphasising local involvement are a move in the right direction, but are both tinkering around the edges and will rapidly run into difficulty, as *Cities for Growth* discusses. At present, planning is about local authorities, with businesses (including architects and developers) and local people very weak within the system. This needs to be reversed. The government will not succeed on planning unless it breaks out of the local authority planning system. At present the government is arguing the local authority plan led system is fundamentally sound. It is not. In both the 1980s and 2000s attempts to force more development through local authority planning were a disaster, failing both politically and in terms of increasing development.

In essence, as *Cities for Growth* argues:

- Business should be free to build as it sees fit – unless 50% of those in the immediate vicinity oppose such development, or in the case of high quality amenity land (e.g. National Parks or Areas of Outstanding Natural Beauty).
- Quality has to become part of the argument – and local people are best placed to enforce this. We built much better quality homes before the 1947 Town and Country Planning Act.
- This allows a democratic check on development plans while massively liberalising planning rules.
- Green belt policy needs to be reformed to give control to local people and allow some development in return for upgrading the vast majority (e.g. parks, access rights and so on).
- Rules around change of use and other areas should be reduced to a more proportionate level.
- Compensation should go to those in the immediate vicinity of new development.

Implementing these reforms would bring huge economic and social advantages. They could seriously raise short- and long-run growth. Planning reform could boost long-run productivity. It could also give a large increase in immediate construction and economic activity.

Some of this could be immediate. Altering the regulations that govern use classes (e.g. requiring a site is used for office, industrial or residential use) could spur construction on brownfield sites and reforms could be completed within six months. Changing permitted development (what can be done without planning permission) could ease extending and renovating properties and be done equally rapidly. Real planning reforms would reshape the UK economy, increasing living standards, while also improving the quality of new construction and allowing more public spaces and parks. As *Cities for Growth* sets out, the shoddy quality of development is a result of the existing flawed planning system and its creation of high land prices, trapping us in a cycle where development is unattractive and so unpopular, leading to less land being released, meaning ever higher land prices and less attractive development.

Planning for growth

There are increasing calls for a Keynesian-style investment package to 'stimulate' the economy. Other parts of this report have argued that it would be a mistake to try to boost demand through an increase in government spending or a through temporary tax cuts.

In the 1930s a boom in construction helped pull the UK economy out of the Great Depression. Housing construction almost doubled from well under 200,000 in the 1920s to over 350,000 by the mid 1930s.[142] Estimates are that each new home built creates at least 1.5 jobs,[143] meaning a rise from the 2010 figure of 100,000 to 350,000 homes (as we managed in the 1930s) would create around 400,000 direct jobs.

Given the wider construction industry employed 1.1 million in 2010,[144] allowing the construction of enough homes, industry, commercial space and additional infrastructure, including new Garden Cities as set out in *Cities for Growth* would boost growth and employment.

The appalling example of Japan, where construction projects of dubious value were consistently sponsored by government yet GDP failed to recover, saddling it with a debt-to-GDP ratio of over 200%, warns against direct intervention by government. Far more preferable would be allowing private sector developments to proceed as they would anyway by removing the barrier the planning system creates.

If the Coalition are serious about both promoting sustainable growth and rebalancing the UK economy they will need real planning reform to allow more development as set out in *Cities for Growth*. Without such reform the social, aesthetic and economic crisis our planning system is creating will only deepen.

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142 *A Century of Change: Trends in UK Statistics since 1900;Research Paper 99/111*, House of Commons, 1999

143 *The Labour Needs of Extra Housing Output: Can the house building industry cope?* M Ball, 2005

144 *Employee jobs by industry, United Kingdom, seasonally adjusted*, Office for National Statistics, 2010

10

Financing the future: the role of the City

By Stuart Fraser

The Coalition government has, quite rightly, identified the creation of jobs and growth across the UK as its top priority. In so doing, the government has also made clear that it wants to promote greater diversity in the UK economy, and to reduce our dependency on financial and professional services.

Of course we must work to promote diversity within our economy; this will not only help to create jobs and growth, but it will also provide a safeguard against futures crises. We should also be clear that mistakes have been made in the past and that reform will be needed to make they are not repeated.

> "The Coalition government has, quite rightly, identified the creation of jobs and growth across the UK as its top priority"

However, we must be careful that in both striving to grow other industries and in correcting the mistakes of the past, we do not slow the growth of the UK financial and professional services industry – the broader 'City', which the City of London Corporation has been tasked to promote both at home and overseas.

It is not just London's geographical location or the fact that English is the international language of business that makes the UK the ideal bridge between Asian and American markets and the ideal gateway to Europe. It is also the City's unrivalled commitment to openness and the UK's long-standing reputation for creating a stable and predictable business environment in which international firms want to invest.

The UK is a leading global provider and sits firmly at the heart of the world economy:

- UK-based banks originate more loans than those in any other country.
- The UK is home to the world's third largest insurance industry.
- The London Stock Exchange has more listed companies than any other exchange.
- The UK foreign exchange market is the largest in the world – more than New York and Tokyo combined.
- London is the foremost global centre for international bond trading.

- London is Europe's largest centre for commodities trading, with around 15% of the global market.
- UK fund managers look after more than £1,400 billion of assets on behalf of overseas clients.[145]

This is why, in spite of the recent financial crisis, the City continues to attract the top firms and the top talent from around the world. These firms and individuals and the skills and investment they bring are vital to the UK economy. This essay builds on this theme by laying out some of the contributions the City makes to the UK, before turning to address the some of the challenges of the future and what reforms may be needed.

Direct contributions

As one would expect, the City makes a huge direct contribution to the UK economy. However, the indirect benefits generated through its support for other sectors as well as for households and individuals are myriad and, if anything, even more significant.

This financial and professional services industry is responsible for 14% of our national output, contributing more than £170 billion in 2010. It also pays a huge amount of direct taxation with the Treasury receiving in excess of £53 billion in 2009-10; enough to cover government spending on public order and safety, industry, agriculture and employment put together.

£1 in every £9 collected by the Exchequer, including 16% of the corporation tax and 15% of income tax, comes from the financial and professional services industry.

In addition to these economic benefits, City business also employs more than 1.9 million people across the UK, more than half of whom work outside London and the South East. In fact, this industry provides one in every 12 private sector jobs in Scotland, the North West and Yorkshire.

Contributing to the wider economy

It is clear that, even in terms of its direct contributions, the UK financial and professional services industry is vital to the UK economy. These benefits are multiplied when one looks at the central role it plays in the daily lives of people and businesses throughout the UK. Only when viewed from this wider perspective can the City's real impact on jobs and growth be properly assessed.

This means that the success of financial and professional services does not have to come, as some have suggested, at the expense of other sectors. The City does not operate in a vacuum.

All industries, including those in which the UK already excels – information technology, biotechnology, pharmaceuticals, aerospace and sophisticated engineering – rely heavily on financial and professional services and the way in which it allows for the mobilisation of capital through equity and bond markets and venture capital.

Accounting for almost 60% of private sector employment, the UK's Small and Medium-sized enterprises (SMEs) will clearly be vital drivers of the UK economy, not only in terms of job creation and growth but also through their flexibility, capacity for innovation and geographical spread.

145 City of London, 2011, *An indispensible industry: financial services in the UK.*

UK banks cater for around 3.9 million small businesses whose current and deposit accounts held almost £57 billion at the start of 2011 and whose bank borrowing was hovering just under £50 billion. Each month, another 50,000 or so small businesses open their first business account.

Lending data published by the bank of England in August 2011 shows that the four UK-based banks involved in Project Merlin are on target to meet their commitment to lend UK businesses at least £190 billion in 2011, at least £76 billion of which must go to SMEs. And it is not just the banks which are providing the financial support that is so important if these businesses are to survive and grow.

Firms of all sizes often need to raise money in order to fund their business activities and the City is home to a range of markets that can facilitate such activity. In total, there are 1,088 UK companies on the LSE main market, 929 on LSE's AIM market for high-growth companies and 131 on PLUS-SX which caters for smaller growth companies.

These firms derive huge benefits from London's position as the world's leading global financial centre, gaining access to huge pools of capital held by international investors. In 2010, companies raised more than £31 billion on the two LSE markets whilst the Exchange also launched a new retail bond market providing individual investors with direct access to corporate bonds.

One of the things common to both the City and to other successful industries in the UK is their commitment to enterprise and innovation. If the UK is to retain its position as a leading player in the global marketplace, we must embrace innovation and use it to drive forward future growth.

Many new and innovative enterprises start with finance from business angels with an estimated £1 billion being invested in 2010. In parallel with such investment, venture capital firms will also raise funds for bright ideas and intelligent entrepreneurs, investing £313 million in 397 companies in 2010 as well as a further £1,653 million of expansion capital.

Households and individuals are also reliant on financial and professional services on a daily basis, whether it is to store their money in their bank accounts, to save and invest for old age, to buy a home or a car, to protect their belongings against damage or theft – the list is endless.

Challenges and reform

There is no doubt that the UK financial and professional services industry is vital to the UK. However, it is also clear that serious mistakes have been made in the past. That is why it is incumbent upon all of us employed by the industry to work with regulators and politicians to learn from these mistakes and to put in place a framework that prevents them being repeated.

Most importantly, never again should the UK taxpayer be put in a position where they have to prop up a financial institution.

Going forward, no firm should be considered 'too big to fail.' That is why the Coalition tasked an independent commission, led by Sir John Vickers, to look into precisely this issue.

Clearly any legislation underpinned by the recommendations contained within this report will have a major impact upon the international competitiveness of the UK financial and professional services industry in the years to come. I

am pleased to note that UK firms have already taken some significant steps to eradicate the practices that might encourage excessive risk-taking within their business models.

The concept of a 'guaranteed' bonus has largely disappeared with any such remuneration increasingly geared towards long-term profitability and composed largely of shares and options rather than cash. Many UK-based banks are also now holding far greater reserves of capital than many of their foreign counterparts. Some have also started drawing up 'living wills' outlining measures that would allow them to be taken into administration whilst safeguarding investors, the financial markets and, most importantly, UK residents.

However, in implementing such reforms and designing a new regulatory structure, we must be careful not to throw the baby out with the bathwater. There are a number of issues that remain of concern to the City, particularly with regards to how they will impact upon our international competitiveness.

Perhaps most pressing of these concerns is the government's plan to make it easier for developers to convert unused offices into residential space. Whilst the City appreciates the need to deliver more housing nationally, the empty office space in the Square Mile deliberately provides flexibility to meet the needs of current business occupiers looking to expand or consolidate their operations, while also accommodating new businesses looking to move here.

This flexibility is vital to the City's international competitiveness and the default assumption that offices will always be more lucrative than residential space in a business concentration such as the Square Mile is flawed. There will always be a time in the economic cycle when residential is more attractive for developers and, once an office has been converted, it is unlikely to be changed back – even if the developer wishes to do so – because residential leases are often significantly longer than their business equivalents.

We believe that, if these plans are enacted without exemptions or reliefs, as much as 13 million square feet of office space could come under threat in the Square Mile during the next five years

Another strategic concern that is already on firmly on the government's radar is the issue of the 50p rate of income tax. The decision to implement this tax increase was taken in the heated political climate in the run up to last year's General Election and doubtless appealed to some voters. However, many economists and commentators, including the Institute for Fiscal Studies have argued that the introduction of a 50p rate may not actually increase revenue collected and indeed could lose the tax revenue.

In addition to the uncertainty regarding revenues, we must also factor in the undoubted damage that the introduction of the rate has done to the UK's reputation for certainty and stability amongst the international business community. If we are truly to demonstrate that the UK remains 'open for business' then the Chancellor must make good on his pledge to abolish this measure sooner rather than later.

The financial capital of Europe

London is also undoubtedly the financial capital of Europe and is as much an asset for the EU as it is for the UK. With 80% of our regulation now emanating from Brussels, we must ensure European policy-makers understand that maintaining

a thriving financial services industry and a network of global financial centres generates huge benefits for each of the 27 Member States.

The EU is the world's leading exporter of financial services whilst the industry employs nearly 10 million people and accounts for six% of the Union's total economic output. In addition to these direct benefits, it also has an important role to play in facilitating the broader economic growth that every European leader has identified as a priority.

> "... London is a truly global financial centre which is home to many of the world's premier financial markets"

Unfortunately, it is our view that many recent European proposals have been underpinned not by a desire to support the financial services industry but by protectionism and national self-interest. The European Commission's proposals regarding an EU-wide financial transaction tax (FTT) are a case in point.

The Commission's own impact assessment demonstrated that a European tax on financial transactions could lose more money as a result of 70% – 90% of all derivatives trading – much of which takes place in London – moving outside of the EU than it would raise in revenues.

By unilaterally pursuing policies such as this EU-wide FTT, European policy makers are pricing all of the EU's financial centres out of the global marketplace.

What is the use of creating a level playing field within the EU, if we can no longer compete with other financial centres outside the Union? European policy-makers need to reassess their priorities and focus instead on furthering the development of the single market which provides huge benefits for EU member states both in terms of removing barriers to European trade and in helping individual countries to compete in the global marketplace as part of a significant trading bloc that can go toe-to-toe with the US and the emerging Asian powers.

Global significance and the way forward

It is not just the UK and Europe that benefits from the success of the City. As mentioned earlier in this essay, London is a truly global financial centre which is home to many of the world's premier financial markets.

The UK is also home to 241 foreign banks with branches or subsidiaries in the UK and which employ 160,000 people, 40,000 of whom have a foreign passport. In total, there are 1,117 financial services firms from 78 countries that are based in the UK and are majority foreign-owned.

The financial crisis made clear the sheer level of connectivity and inter-connectedness that exists within the global marketplace. If we truly want to build a stable, predictable framework, the general principles must be agreed on a global basis through organisations such as G20 and the Basel Committee on Banking. Indeed, significant progress has already been made in recent years, particularly with regard to living wills and capital barriers but there remains much work to be done.

As important players within the marketplace, it is quite right that the UK and the EU take a leading role in setting new regulatory standards in the wake of the financial crisis. However, with so much competition from rival centres overseas, it is equally important that we do not sacrifice our international competitiveness by acting out of step with the rest of the world.

It would be unthinkable to allow our competitive advantages in financial and professional services to slip away at a time when demand for such services in growing right across the globe.

In short, the City is vital, not just for the UK, but also for the European and indeed the global economies. Policy makers must bear this in mind so it can continue to generate jobs and growth for decades to come.

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11

Making it worse: why we need to look to the long-term

By Peter Cruickshank and Matthew Oakley

Above all, at home and abroad, we must counsel against the pessimism and fear that can become self-fulfilling prophecies in global markets

David Cameron[146]

This chapter looks at what is driving recent falls in consumer and business confidence in the UK. It asks whether the media and their portrayal of the economic situation is having a significant negative impact on the economy. Concluding that there is little that we can do to influence reporting and that, in a large part, the media is reporting the economy as they see it, we turn to the role of politicians, policy makers and think tanks in influencing confidence. We argue that short-termism in policy and politics is detrimental to our economy and issue a call to drop ideology and turn to evidence in order to look to the longer-term growth and prosperity of the UK.

Media to blame?

The Daily Telegraph's Jeremy Warner wrote of the economy on the 4th November 2011:

> *the sense of impending disaster is tangible…everywhere companies and consumers are battening down the hatches, cancelling spending, cutting costs, storing cash…The process is self-fulfilling. Never mind talking ourselves into a recession; fear of the future is creating one before our very eyes.*[147]

His argument was that a pervasive climate of fear was doing active damage to the economy. The quote from David Cameron at the top of this chapter points to that same argument and it is an argument that Policy Exchange has been making for the last few months.[148]

We have not been trying to say that the economy is not in a precarious position. With unemployment tipped to reach three million,[149] growth and wages stagnant and pressures from the Eurozone and wider global economy bearing down on the UK, to deny that we are in a difficult position would be foolish. Instead, our argument is that the only way we can move ourselves out of this situation is if

146 David Cameron in the *Financial Times*. 'A three pronged plan to revive Britain's economy'. October 30th 2011.

147 'Willie Walsh is Right', 05/10/11, http://www.telegraph.co.uk/finance/

148 http://www.policyexchange.org.uk/events/event.cgi?id=370 ; http://online.wsj.com/article/SB10001424052970203554104577001592490387970.html . financialcrisis/8808746/Willie-Walsh-is-right-were-talking-ourselves-into-a-crisis.html

149 http://www.cipd.co.uk/pressoffice/_articles/

150 See for instance: http://www.dailymail.co.uk/news/article-2059756/Britain-prepares-economic-Armageddon-European-Union-warns-UK-double-dip.html?ito=feeds-newsxml ; http://www.guardian.co.uk/commentisfree/2011/oct/09/observer-editorial-economic-recovery

151 CBI, *Economic challenges facing UK business: IPSOS/MORI survey – November 2011.*

business, entrepreneurs and families have the confidence in the future to invest and consume. This confidence will not come amid constant prophesising over the imminent downfall of the UK economy.[150]

So where does that confidence now stand? A recent business confidence survey published by the CBI highlighted that over recent months, '...economic optimism has fallen significantly among top British business leaders'.[151] The latest *Reuters/Ipsos MORI Political Monitor* paints a similar story for the general public, with economic optimism falling to its lowest level since December 2008 and just 16% of people thinking that the economic situation will improve in the next 12 months.[152]

The former of these surveys was also revealing about some of the drivers of this downturn in confidence. Quotes from business leaders included:

> *Watch any TV programme or pick up any newspaper, the economic forecasts are all negative and the level of activity is decreasing.*
>
> *Reading in the media on a daily basis that things are going from bad to worse.*
>
> *We're told this is the worst economic situation since the 30's.*
>
> *The overall Euro situation, the risk of a double dip recession and pretty worrying outlook, and a negative news flow all the time.*[153]

Other concerns were voiced, but these indicate that many businesses do feel that the media is having a significant impact on business confidence. Indeed, this is not a new idea: a large amount of research has previously been undertaken in this area.

The first clear conclusion of this research is that that negative news coverage occurs much more frequently than positive.[154] Recent research has shown that over the period of the recession, 'as the news about the economy seemed to improve, the amount of coverage of the economy... dropped off substantially'. In February 2009 coverage of the economy occupied 46% of news items, but only 16% in August.[155]

Of course, if no-one believed anything they saw in the media, then we might be unconcerned by this result. However, this does not appear to be the case. It seems possible that, in fact, bad news can negatively affect the real economy.

The most immediate effect may be through impacts on consumer sentiment. A number of reports have, unsurprisingly, found that the positivity of news coverage can be used to predict a rise or fall in how people felt about the economy. One study found that the high volume of articles in the 1990's downturn that mentioned 'Recession' or 'layoffs' in the headline led to '...various measures of sentiment [being] 3 to 10 points lower than otherwise would have been the case'.[156] Other reports have claimed that news accounts for around a third of consumer sentiment fluctuations[157] and that negative news can increase 'pessimism' by 16%.[158] Of course, behavioural economics would also suggest that, since individuals tend to be 'loss averse', negative information has a much greater impact on individual attitudes than positive information.[159]

There seems to be a relatively straightforward logic at work: if media messages create a state of fear about both personal and national economic future, people

152 http://www.ipsos-mori.com/researchpublications/researcharchive/2875/ReutersIpsos-MORI-October-2011-Political-Monitor.aspx

153 CBI, *Economic challenges facing UK business: IPSOS/MORI survey – November 2011*, p.6.

154 For example see: Boomgaarden, H et al (2011), 'Covering the Crisis: Media coverage of the economic crisis and citizens' economic expectations'. *Acta Politica* (2011) *46*, 353–379; Soroka, S., (2006), 'Good News and Bad News: Asymmetric Responses to Economic Information', *Journal of Politics*, Vol 68, No 2, p372-385. Starr, M (2008), *Consumption, sentiment and economic news*, Department of Economics Working Paper Series, No. 2008-16, American University Washington. Goidel and Langley (1995), 'Media coverage of the economy and aggregate economic evaluations: Uncovering evidence of indirect media effects', *Political Research Quarterly* 48(2), p313-328.

155 Online at http://www.journalism.org/analysis_report/covering_great_recession

156 Doms, M., Morin, N., (2004), *Consumer Sentiment, the Economy and the News Media*, Federal Reserve Bank of San Francisco Working Paper; Tims, A., Fan, D., Freeman, J., (1989), *The Cultivation of Consumer Confidence, A Longitudinal Analysis of News Media Influence on Consumer Sentiment*. Advances in Consumer Research Volume 16, p758-770.

157 Starr, M (2008), *Consumption, sentiment and economic news*, Department of Economics Working Paper Series, No. 2008-16, American University Washington.

158 Soroka, S., (2006), *Good News and Bad News: Asymmetric Responses to Economic Information*, in the Journal of Politics, Vol 68, No 2, p372-385.

159 Soroka, S., (2006), *Good News and Bad News: Asymmetric Responses to Economic Information*, in the Journal of Politics, Vol 68, No 2, p372-385. Also argued by De Vreese (2011), *(In)direct framing effects, the effects of news media framing on public support for Turkish membership in the EU."*, Communication Research.

simply invest less and consume less.[160] A number of studies give factual backing to this idea: positive shifts in consumer sentiment improve economic conditions, boost spending and decrease unemployment.[161] Business confidence improves as consumers shop that little bit more, businesses then hire and consumer spending increases, while banks lend more as confidence rises. The economy grows.[162]

So might we blame the media for the current economic situation? The arguments above certainly suggest that the way in which they report economic matters could have a significant impact on the economy. If that were found to be the case, what then would the policy implication be? There is clearly very little that might be done if the media are simply reporting what we all see around us: low growth, increasing unemployment and falling living standards. This leaves us with a dilemma that the *Financial Times* tackled recently.[163] Michael Skapinker argued persuasively that it was the responsibility of the media to report the situation as it was, rather than try to convince people that 'things weren't all that bad'. It is hard to disagree with this line of argument.

"The arguments above certainly suggest that the way in which they report economic matters could have a significant impact on the economy"

The article also argued against some of the evidence cited above. The criticism was that while people may respond to consumer confidence surveys in ways that suggest they has been affected by the media, other evidence suggested that their actual behaviour remained closely tied to the underlying economic trends. Indeed, this is also what the CBI survey of business confidence implied. This found that while respondents showed significant falls in economic confidence, less than a third of respondents actually felt that the prospects for their own business had deteriorated. Over 10% felt that prospects had increased.[164]

One can sympathise with this line of argument. But with business views diverging so far from the reporting in the media and such extreme language being used in many articles and reports, it does seem likely that the media is negatively impacting on confidence in the UK. However, our view is that it is a more general form of short-termism that is doing more damage to confidence than media reporting.

Short-term focus is damaging the UK

A quote from the Bank of England's Governor, Mervyn King may be illuminating:

> *There is weakness over the next few quarters. No one can know what precisely the outcome will be... In the last three years, we have seen extraordinary events. Who knows what's going to happen tomorrow, let alone next month?*[165]

It is extraordinary that such a senior figure in the UK economy should inject such uncertainty into the public debate around the economy. This criticism does not stop at the Bank of England. It can just as easily be levelled at members of the opposition and, indeed, members of the government. Figures on the following page show 'word-clouds' that we created from four public speeches in the last six months from George Osborne and Ed Balls. In these, the larger the word, the more it has been used. Clearly it is hard to draw firm conclusions from these, but they do demonstrate a number of general points. The choice of words points

160 DeFleur, M., & Ball-Rokeach, S. (1982). *Theories of mass communication* (4th ed.). New York: Longman, Inc.

161 Starr, M (2008), *Consumption, sentiment and economic news*, Department of Economics Working Paper Series, No. 2008-16, American University Washington.

162 Saghafi, T. (2009), PHD Thesis: *Consumer Sentiment, The Economy's Crystal Ball*, online at: http://hdl.handle.net/1961/9409

163 *Financial Times*, 03/11/11 'A positive press can't brighten the gloom'.

164 CBI, *Economic challenges facing UK business: IPSOS/MORI survey – November 2011.*

165 http://www.telegraph.co.uk/finance/financialcrisis/8895337/Sir-Mervyn-King-Britain-on-the-brink-of-second-credit-crunch-Bank-of-England-Governor-warns.html

towards a distinctly negative tone for both Osborne and Balls. Given the current situation, this is unsurprising. However, more concerning (from both the word-clouds and analysis of the full speech) is a lack of a long-term perspective or plan. Indeed, the words 'long-term' and 'future' do not feature in Osborne's cloud and 'recovery' is used infrequently. Most of the discussion is focussed on the short-term and on political point scoring. Indeed, the Shadow Chancellor uses the Chancellor's name more than the words 'confidence', 'credibility' and 'balanced'. One can just as easily see this short-termism from both sides of the House in recent Prime Minister's Questions in the Commons, or in interviews with key political figures.[166]

Figure 14: Word cloud for Ed Balls speeches

Source: Speeches on 26/09/11, 16/06/11, 06/06/11, 01/05/11

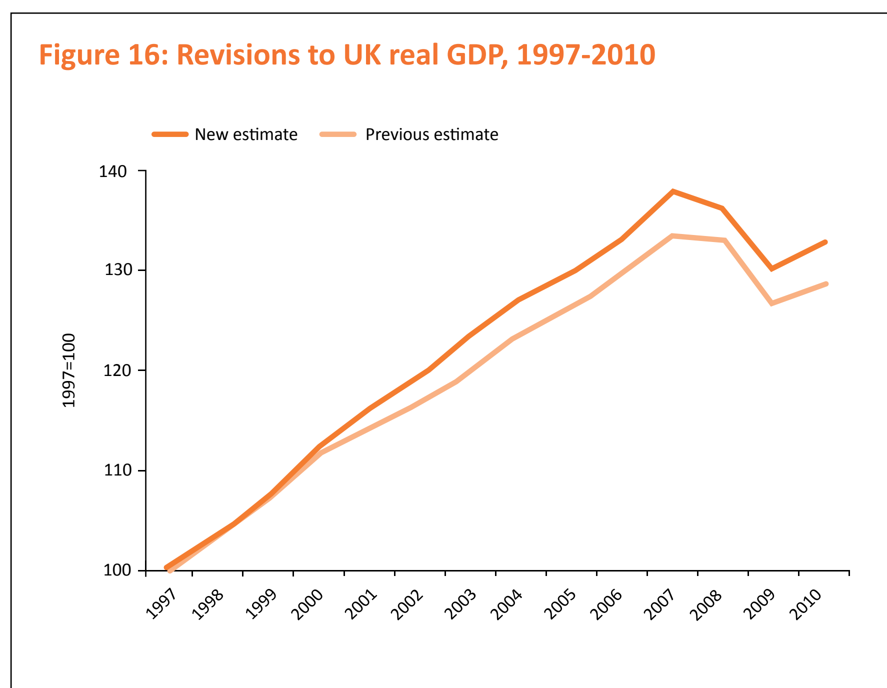
Figure 15: Word cloud for George Osborne speeches

Source: Speeches on 08/11/11, 02/10/11, 16/09/11, 15/06/11.

166 http://www.parliament.uk/business/news/parliament-government-and-politics/parliament/prime-ministers-questions/

A key example of this short-termism is also seen at each publication of provisional quarterly GDP figures from the Office for National Statistics. We have previously outlined our view of the futility of focussing on these figures.[167] The first estimate of GDP is just that, an estimate. It takes into account just 40% of the data that the final figure will use. This means that it is revised continually until all the data have been collected. The ONS also improves its methodology over time, meaning that revisions are made because of this as well.[168] These revisions can be large. Figure 16 shows the impact of a recent revision that the ONS published.

Figure 16: Revisions to UK real GDP, 1997-2010



It shows that the UK economy grew by 37.8% between 1997 and 2007 rather than 33.2% as originally estimated. This is largely due to an upward revision of GDP growth – from 17.9% to 21.1% between the first quarter of 2001 and the fourth quarter of 2007. Individual revisions to quarterly figures were as large as 0.7 of a percentage point.

Put in context, similar revisions (because of new data coming in and because of methodological changes) to the first estimate of Q2 2011 GDP growth from the ONS (0.5%) would mean that GDP in Q2 2011 could be as low as -0.2% and as high as 1.2%.

This is not a criticism of the ONS, or their approach to estimating GDP. We agree with the broad conclusions of their recent work that suggests that this is a sensible way to conduct the process.[169] However, each publication of this statistic in recent years has been greeted with discussion of the downfall of the UK economy and calls for the government to adopt short-term policy wheezes. These include calls to: temporarily reduce VAT; introduce another 'Banker's Bonus Tax'; abolish the National Minimum Wage; allow firms to freely hire and fire as they choose; and more often than not – roll back the deficit reduction plan and spend more now. In turn, the government has responded by arguing that deficit reduction is essential to maintain market confidence in the UK.

167 http://online.wsj.com/article/SB10001424052970203554104577001592490387970.html

168 ONS (2009), *Understanding the quality of early estimates of Gross Domestic Product.*

169 ONS (2009), *Understanding the quality of early estimates of Gross Domestic Product.*

There are three main problems with this debate. First, as we have previously stated and many others have noted, it is unwise to make knee-jerk policy based on one (uncertain) data point. The second problem is that the debate it is based almost entirely on rhetoric and ideology rather than an analysis of policies which might actually drive growth.[170] On the one hand, 'the Left' argues that more spending is needed and the re-distribution from rich to poor will boost consumption. On the other hand, 'the Right' argues that firms need more freedom and less regulation and that tax must be cut. Chapters 1 and 2 of this report outline our arguments against these short-term policy responses. The final problem is that there is no consideration of the long-term by either side. There is no long-term plan for growth.

The impact of this absence is clearly outlined in surveys of business leaders and the public. The CBI's recent survey included the following responses:

> *Politics getting in the way of economics – it is very clear what the government has to do but politics is getting in the way of action.*
>
> *The domestic party conference season demonstrated that there is little desire on the part of the Coalition parties to actually tackle any of the issues*
>
> *…there doesn't seem to be a sensible plan for economic growth in the UK*[171]

This clearly demonstrates that the business community are worried about the lack of coherent long-term growth strategy. The *Reuters / Ipsos MORI Political Monitor* then highlights that over half of the public think that the government is doing a bad job of managing the economy. However, only 20% of people think that a Labour government with Ed Miliband and Ed Balls as Prime Minister and Chancellor would do a better job.[172]

In short, a focus on short-term politics is damaging confidence in both the business community and in the public. Businesses and the public realise things are bad, but generally feel better about their own prospects and circumstances than they do about the rest of the economy. Overall, it does not seem to be the current situation that is causing most worry, it is the lack of a vision for the future and how things will improve.

Looking to the future

Our view is that while the media is presenting the economic situation in a negative fashion, there is very little that can be done to influence this. Much more disturbing is the short-termism and political point scoring that has led to an intellectual deficit in policy debate around growth. There are too many calls to implement policy based on ideology and short-termism and too few arguments in favour of empiricism and a long-term strategy.[173]

Businesses and consumers want to know that the future will be better than the situation we are in now and they need to understand how we might get there. They understand that short-term policy just papers over the cracks and does not tackle the deeper problems in our economy. Other parts of this report also outline the damage that such policies can do to both the stability and certainty in policy-making that are essential to providing businesses and consumers the confidence to invest and spend.

170 For an assessment of short-term tax breaks see: Arnold et al, (2011). 'Tax Policy for economic recovery and growth'. The Economic Journal, *121* (February), F59–F80. For an assessment of deregulation see: http://www.peoplemanagement.co.uk/pm/sections/your-say/blogs/specialists/john-philpott.htm

171 CBI, *Economic challenges facing UK business: IPSOS/MORI survey – November 2011.*

172 http://www.ipsos-mori.com/researchpublications/researcharchive/2875/ReutersIpsos-MORI-October-2011-Political-Monitor.aspx

173 http://www.thisislondon.co.uk/standard/article-24007841-politics-must-not-be-blind-to-the-facts-of-life.do

With this in mind we hope that the government does move away from *Plan A*. This would not involve stepping back from meeting its fiscal mandate, but would require them to set out a firmer plan for the future on top of meeting its fiscal mandate. The public and both foreign and domestic investors need to know how the UK will move to growth, not over the next six months, but over the next ten years. This means an economy based on investment and growth not borrowing and debt. It means an economy where growth is more balanced both across the country and across the income distribution. It also means an economy where the needs and concerns of both business and workers are balanced.

To do this, tax and regulatory policy should be made more certain, fundamental reforms must be pushed through in planning, monetary policy must be flexed to boost growth in small businesses and new ways of protecting the rights of both workers and business must be explored. The first Chapter in this report lays out Policy Exchange's proposals in these and other areas.

They are all policies based on evidence, not rhetoric and ideology. Indeed, they are not policies about politics. Many of them could be supported by both sides of the House. We hope that they can help to move the debate on from short-termism in order to start to consider the future.

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This report is about starting an evidence-based and balanced debate around growth in the UK. It issues a call to action to politicians, the media, policy makers and the public to start to consider the long-term future of the UK economy, rather than focusing on short-term politics and policies.

The report brings together a collection of essays from experts in Policy Exchange as well as from business and industry. Each lays out the author's views on the blockages to growth and makes suggestions for where government policy must focus.

While Policy Exchange would not prioritise all of the recommendations made, the tone is important. They each present options for reform that focus on the long-term prosperity of the UK. We build on these suggestions, the events and discussions we have held over the last six months and our own research to lay out where Policy Exchange believes policy for the government's Autumn Statement and 2012 Budget should focus. Implementing these policies would bring new certainty and confidence to business and would give a huge boost to businesses both small and large and the entrepreneurs, individuals and families that are the drivers of growth in the UK.

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