

# NEW PRIORITIES

# FOR BRITISH ECONOMIC POLICY

REPORT

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## ABOUT THE AUTHOR

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## EXECUTIVE SUMMARY

The UK faces a triple crisis of stagnation (in economic growth and living standards), debt and imbalance. These are the direct result of policymakers' past adherence to the neoliberal economic paradigm. A new form of British capitalism is needed to deal with this crisis, based on greater collaboration between the state and the private sector. This paper looks at some of the policies that will be needed to tackle the economic crisis: policies to control debt, reform taxes and revitalise Britain's export industries and regions.

There will still be a sizeable fiscal deficit at the start of the next parliament (though it will be mostly cyclical in nature). The current fiscal rules, which are badly designed and have failed to impose the intended discipline on the chancellor, will be obsolete by then. New rules will be needed that constrain borrowing in the medium term, to a sufficient degree to put debt on a firm downward trajectory as a percentage of GDP, but also allow some flexibility in the short term to respond to fluctuations in the economic cycle.

Additional tax revenues will be needed to eliminate the fiscal deficit and, in the longer term, to enable the provision of public services to be maintained at current levels. New taxes should also facilitate a rebalancing of the economy and increase its stability. In the absence of political room to increase major revenue-raising taxes, such as income tax and VAT, and given the limited revenues that can be raised by taxes such as the proposed mansion tax, the government should examine seriously the feasibility of a land value tax and the option of following the lead of the 11 EU countries that are moving forward to implement a general financial transaction tax by extending the UK's current tax on share transactions to cover bonds and derivatives as well. Of these, the extended financial transaction tax has two major advantages: it could be implemented much quicker, perhaps inside a year, and it offers a significantly greater source of new revenue, assuming the land value tax would largely replace, rather than supplement, existing council tax receipts.

The UK's trade performance has been poor for the last three decades. Shifting to an export-led growth model will require intensive investment in infrastructure, skills and productive capacity. Government and private sector collaboration through an active industrial strategy will be needed to deliver this investment, which should be concentrated in the UK's areas of existing and potential comparative advantage as well as in areas where global demand is likely to grow relatively strongly over the next decade.

Rebalancing the UK economy and generating sustainable growth requires a revitalisation of the regions outside London and the South East. Government will have to collaborate with private sector agents to bring about the desired outcome. More powers and responsibilities need to be devolved from the centre to local authorities and local groups, such as local enterprise partnerships. This will require greater fiscal autonomy.

Underinvestment in infrastructure and the financing problems facing small and medium-sized firms have held back the UK economy for many decades. Private commercial banks have proved unwilling, or unable, to provide adequate funding in the areas. A British Investment Bank should be established with a specific remit to tackle these longstanding problems. Revenue from a financial transaction tax offers one potential means of capitalising this new institution.

Rather than the government standing to one side and leaving the private sector on its own to cope with the problems of deindustrialisation created by globalisation and rapid technological change, Britain needs government to work in collaboration with industry. This relationship must be central to Britain's new economic model.

We recommend the government should:

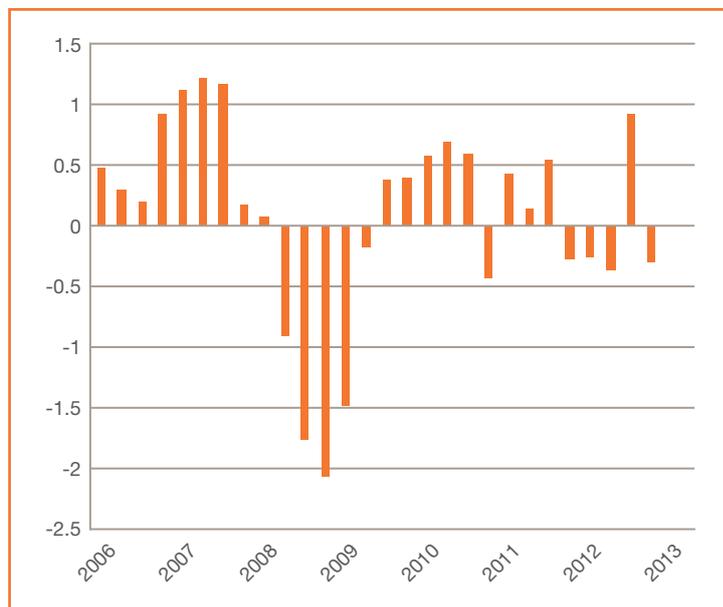
- Introduce new fiscal rules that ensure real constraint on deficits and debt in the medium term, while allowing policy to be more responsive to the economic cycle in the short term.
- Instigate a review to identify the practical hurdles to the introduction of a land value tax and ways that they can be overcome.
- Follow the lead of the 11 other EU countries that are moving forward to introduce a general financial transaction tax by extending the UK's existing tax on shares to include bonds and derivatives.
- Identify the UK's areas of existing and potential comparative advantage as well as areas where global demand is likely to grow relatively strongly over the next decade, and then adopt an active industrial strategy designed specifically to support the growth of firms in these areas.
- Devolve more powers from the centre to local groups, including local authorities and local enterprise partnerships, for skills and innovation policies.
- Set up a British Investment Bank, which could be capitalised using the revenues from a financial transactions tax, with a remit to bring about a step-change in the financing of infrastructure projects and lending to small and medium-sized businesses.

# INTRODUCTION

When, on 15 September 2008, Lehman Brothers – then the fourth-largest investment bank on Wall Street – filed for chapter 11 bankruptcy protection, many saw it as a watershed moment. Before Lehman went under, it was possible to imagine that a short recession would be followed by a normal recovery and that the world would go on much as before. But after its fall into bankruptcy, a severe recession quickly became inevitable and calls for a new economic paradigm – a new form of British capitalism – began to grow. Four and a half years later, with the British economy facing a triple crisis of stagnation, debt and imbalance, the need to rethink Britain’s economic model remains urgent.

It is now five years since the UK economy went into recession. Real GDP peaked in the first quarter of 2008 and subsequently fell by more than 6 per cent over the next four quarters. The following four years have seen a start-stop-start-stop economic recovery that has left GDP mired at a level still 3 per cent below its previous peak. In terms of economic growth, the last five years have been the worst in the UK since the 1930s. As a result, unemployment remains close to 2.5 million and living standards for the bulk of the population have fallen. Economic stagnation has led to misery for many.

**Figure 1**  
UK real GDP growth,  
quarterly change (%)

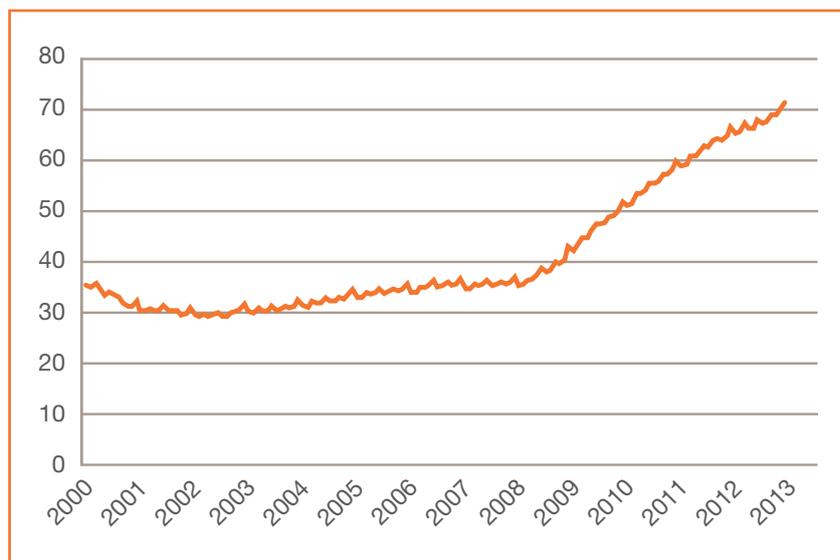


Source: Office for National Statistics (ONS)<sup>1</sup>

Meanwhile, public debt has doubled from £535 billion (37 per cent of GDP) at the end of 2007 to £1,111 billion (71 per cent) at the end of 2012. And the Office for Budget Responsibility (OBR) forecasts that it will continue to increase in coming years, approaching £1,500 billion by 2017 and peaking at 80 per cent of GDP in 2015/16 (OBR 2012a). Household debt also remains at very high levels. Having peaked at 170 per cent of disposable income in 2008, it has fallen only to 150 per cent – and then only as a result of income growth. The nominal value of debt has not fallen at all. Households have stopped – in aggregate – taking on more debt, but they have not yet paid any off and their debt ratio remains higher than in most other advanced economies.

1 <http://www.ons.gov.uk/ons/rel/gva/gross-domestic-product--preliminary-estimate/q4-2012/stb-gross-domestic-product-preliminary-estimate--q4-2012.html>

**Figure 2**  
UK public debt (% of GDP)



Source: ONS<sup>2</sup>

The third aspect of the triple crisis is gross imbalance in the economy. This manifests itself in a number of interrelated ways:

- growth has been too reliant on a narrow portion of the economy, particularly business services and finance
- growth has been too concentrated in the south east, leaving other parts of the country to rely on the public sector for jobs
- growth has been driven by strong consumer spending, while export growth has disappointed.

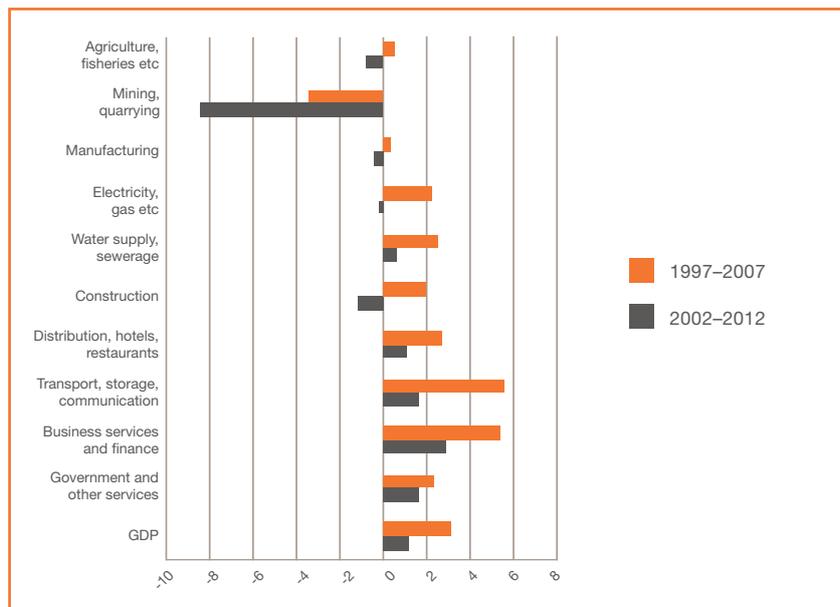
None of these imbalances are sustainable in the medium term if the British economy is to be revitalised.

British capitalism must be transformed if the country is to tackle all three elements of the triple crisis. It must deliver growth while allowing debt levels – in the public and private sectors – to fall relative to GDP in the medium term; and, crucially, it must deliver growth that is much better balanced.

In the future, growth in the UK has to be less heavily reliant on debt-financed consumption and more on exports and business investment. Remarkably, the UK has run a current account deficit in every one of the last 29 years (from 1984 to 2012). It has been able to do so because overseas investors have been willing to buy UK assets. However, at some point the UK is going to have to earn its way in the world by exporting more. If this adjustment is forced on the economy then it will necessarily involve a substantial fall in the value of sterling, which would result in higher inflation (and perhaps higher interest rates too) with all the attendant problems that these changes would bring. It is clearly preferable that this adjustment takes place ‘voluntarily’ – that is, while the UK is still able to attract capital from overseas. This will require a structural shift in the economy to deliver the investment that is needed now to develop export industries for the future.

<sup>2</sup> <http://www.ons.gov.uk/ons/rel/psa/public-sector-finances/december-2012/stb---december-2012.html>

**Figure 3**  
Annual growth rates in  
real gross value added,  
by sector (%)



Source: ONS<sup>3</sup>

Growth must also be less narrowly concentrated in just a few sectors of the economy, particularly the financial sector. In the last decade, the UK was so dependent on financial services to produce growth that the share of financial and insurance services in total output increased from 5.4 per cent in 2000 to 9.1 per cent in 2008 and to 10.4 per cent in 2009 (when activity in other parts of the economy was hit harder by the recession than in the finance industry). Back in 2007 this expansion of finance was widely seen as the UK exploiting a competitive advantage; now – given the effect of the financial crisis on the rest of the economy – it looks more like foolish overreliance on a single sector. Furthermore, we can now see that much of the increase in the share of finance in the economy reflected ‘socially useless’ activities – not least due to the explosion in the creation and trading of derivative products<sup>4</sup> and greater rent extraction from the rest of the economy – rather than an increase in the level of services provided. There is no evidence that capital was being allocated more efficiently, or that investment returns were higher as a result of the expansion of finance. An attack on rent-seeking in finance will reduce that sector’s share in economic activity in the UK, but a structural shift is required to ensure other sectors expand to fill the gap.

One consequence of the economy’s reliance on the financial sector for growth was that economic activity increased more rapidly in London and the South East, which together account for over half of the contribution of financial services to UK output, than in the rest of the country. As a result, regional disparities in income increased. In the future, growth should be less intensively concentrated in the south-east corner of the country. Other regions should grow at least as rapidly as the south east, so that income gaps do not widen further; ideally, their growth should be more rapid. This might happen if the UK economy is rebalanced towards export and business investment and towards sectors

<sup>3</sup> <http://www.ons.gov.uk/ons/rel/gva/gross-domestic-product--preliminary-estimate/q4-2012/stb-gross-domestic-product-preliminary-estimate--q4-2012.html>

<sup>4</sup> According to Jeffrey Sachs (2010) the market in credit default swaps, for example, grew from nothing to over \$60 billion in the decade before the financial crash.

other than finance, but there is no guarantee this will be the case. A structural shift to support growth in the regions is needed.

This triple crisis of stagnation, debt and imbalance is the consequence of policymakers' adherence to the neoliberal economic paradigm: an extreme form of market capitalism. Ultimately, this paradigm was doomed to failure because businesses and senior managers – the very people it empowered – pursued behaviours that undermined it. Power became concentrated in the owners of capital and in the financial sector that backed them. Shareholder capitalism led to short-termism. Businesses favoured concentration and market dominance, which in turn lowered competition and increased the scope for short-term rent-seeking behaviour. The result was low investment (outside finance), increased inequality and higher debt, as well as financial bubbles and crashes.

There has not yet been any significant change in the dominant economic paradigm, but history shows that such changes take time. The onus is now on those who believe a different economic paradigm would produce a better set of outcomes to map out a new economic path. A new form of British capitalism – one that is capable of reversing the trends of the last three decades – should produce greater investment in the productive capacity of the economy, in infrastructure and in the skills of the workforce. History shows that the best economic outcomes are achieved when the state and the private sector work together, and this spirit of partnership should be at the heart of Britain's new economic model: not so much 'responsible capitalism' as 'collaborative capitalism'.

Collaborative capitalism foresees a change in the relationship between finance and the rest of the economy, more long-termist thinking on the part of investors, a better system for developing vocational skills, restraints on executive pay, and a breaking up of concentrations of private power. These changes will be difficult to bring about; significant shifts in economic paradigms are rare. The neoliberal paradigm has been dominant for over 30 years, and before that Keynesianism dominated for a similar period of time. IPPR has projects looking at a number of areas where British capitalism needs to change. As part of this broader work, then, this paper looks at some of the policies that are needed to control debt, reform taxes and revitalise Britain's export industries and regions. These are areas where policymakers will need to act to tackle the triple crisis and bring about a shift towards a more collaborative form of capitalism.

# 1. FISCAL RULES

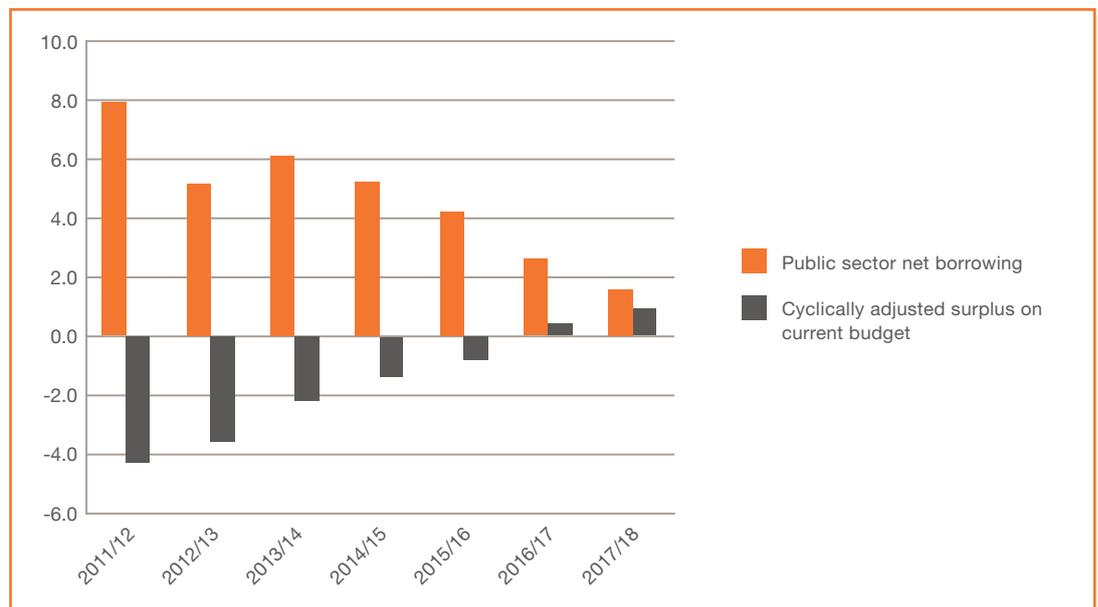
## Key points

- There will still be a sizable fiscal deficit at the start of the next parliament, though it will mostly be cyclical in nature.
- The current fiscal rules are badly designed and have failed to impose the intended discipline on the chancellor.
- New rules will be needed in the next parliament that constrain borrowing in the medium term but allow some flexibility to respond to the economic cycle in the short term.

The financial crisis and subsequent recession left the UK with a substantial fiscal deficit. Public sector net borrowing (PSNB) peaked at 11.2 per cent of GDP in 2009/10 and was still 7.9 per cent of GDP in 2011/12. Few believe that borrowing at this level is sustainable for anything but a short period of time, although there is a heated debate about how and how quickly the deficit should be reduced.

The OBR's latest projections (2012a), published alongside last year's autumn statement, suggest that PSNB will be 4.2 per cent of GDP in 2015/16, while the cyclically adjusted current deficit (the measure targeted by the government) will be 0.8 per cent.

**Figure 4**  
Key fiscal aggregates  
(% of GDP)



Source: OBR 2012a

The government is, therefore, planning a further £30 billion of deficit reduction measures, tilted mainly towards spending cuts, in 2016/17 and 2017/18. These measures will see the government meet (indeed overshoot) its main fiscal rule, which is to achieve a cyclically adjusted current balance by the end of a rolling, five-year forecast period.

However, on the latest projections, the government will miss its secondary fiscal rule, which is to see public sector net debt as a percentage of GDP falling at the fixed date of 2015/16. Net debt is expected to peak at 79.9 per cent of GDP in 2015/16 and start falling only in 2016/17. Although the government has no formal target for debt after 2015/16, its plans for the first half of the next parliament show it wants to keep cutting borrowing to a level sufficient to put debt on a downward trajectory.

The government's fiscal rules are intended to act as a constraint on the chancellor and to send a signal to financial markets about his commitment to deficit reduction. In fact, they have turned out to be unfit for either purpose.

The first rule is no real constraint at all. At the time of each budget and autumn statement, the OBR publishes an assessment of whether or not the chancellor's fiscal plans make it likely that the rule will be met. This creates the potential for political embarrassment if their verdict is unfavourable. But the chancellor only has to plan to eliminate the current deficit in five years' time; because of the rolling nature of the target, there is nothing to compel him to actually deliver a current balance. The date by which balance has to be achieved moves forward each year. The chancellor has already taken advantage of the leeway provided by this rule. His first budget in June 2010 envisaged a cyclically adjusted surplus on the current balance of 0.8 per cent of GDP in 2015/16 (and of 0.3 per cent of GDP in 2014/15, meaning the rule was to be met a year early). By the time of the 2012 autumn statement, however, the projection for 2015/16 had become a deficit of 0.8 per cent of GDP and the projected date for the first surplus had been moved back to 2016/17.

The second rule at least specifies a fixed date by which some target has to be achieved. But, as with the first rule, it gives the chancellor enormous leeway. He can borrow as much as he likes in every year up to 2014/15 (and as much as he likes in every year from 2016/17 onwards). Indeed, the autumn statement projections suggest that net borrowing, after adjusting for various special factors, will be around £150 billion higher between 2011/12 and 2015/16 than envisaged at the time of the June 2010 budget. All the chancellor has to do to meet this rule is to ensure that borrowing in 2015/16 is sufficiently low so that the debt ratio falls in that one year. Nonetheless, even that very specific target is now judged by the OBR as unlikely to be achieved. Even so, the chancellor has left the rule in place.

Clearly, new fiscal rules are needed, and the most important lesson from the last two years is that they should be more responsive to the economic cycle. The chancellor's efforts to cut the deficit have become self-defeating. Cutting public spending at a time when demand in the rest of the economy was weak further dampened confidence in the private sector, with the result that the economy slipped back into recession. As a consequence, underlying net borrowing in 2012/13 – after allowing for one-off factors – is unlikely to be lower than in 2011/12. It is not enough to target the cyclically adjusted current balance and to let the 'automatic stabilisers'<sup>5</sup> work. The extent of discretionary fiscal tightening should also be varied in tune with the strength of the economy. When growth is weak – or even worse, when the economy is in recession – discretionary tightening should be scaled back; when growth is strong, it should be speeded up.

This would increase the credibility of fiscal policy, compared to the current rules. Weak growth has meant that the date by which the deficit will be eliminated has already been pushed back by two years, at the chancellor's discretion. Having a set of rules that allowed for slower deficit reduction when the economy was weak would have the same effect, but the element of discretion would be removed. There would be no surprise for bond markets.

There is also a practical reason for thinking now about new fiscal rules for the next parliament, given the relationship between targets and timings. In its first year, if the current projections turn out to be accurate, the cyclically adjusted current deficit will be just 0.8 per cent of GDP. At that point, it will no longer be credible to have a rule that seeks to eliminate

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5 That is, not to take offsetting action when weak growth leads to lower-than-expected tax revenues and higher-than-expected spending in areas such as welfare payments.

such a small deficit over a period of five years. The debt target, which is for 2015/16, will be on the brink of being achieved or not – either way, it will be imminently irrelevant.

The question, then, is what the new rules should be. Over the medium term, the debt ratio will have to be cut, so as to create room for an easing of fiscal policy in a future downturn. The new target, therefore, should ensure that public debt is put on a downward trajectory as a percentage of GDP.<sup>6</sup> At the same time, there should be room for an increase in investment spending as a share of GDP. It is now widely accepted that the Coalition government is wrong to cut its capital spending by as much as it is planning to do in the current parliament because of the effect on the nation's infrastructure.<sup>7</sup> This will mean tougher targets for the current balance, if that is to be the main target variable.

The current balance was the preferred fiscal target measure of the last Labour government (before the crisis),<sup>8</sup> and is the main target of the Coalition government. It has the advantage, therefore, of familiarity. Both the Labour and Coalition governments have also had subsidiary targets for debt. One possibility would be to reverse the priority given to the current balance (deficit) and debt targets. Once the current balance is eliminated, the government could set a medium-term target for the debt ratio, together with short-term targets for the current balance that are consistent with this.

Whether these targets should be for the actual or the cyclically adjusted balance would also need to be decided. The advantage of targeting the cyclically adjusted balance is that it excludes the effects of fluctuations in the economy – the target does not prevent the automatic stabilisers from being allowed to work. The disadvantage is that the process of making the cyclical adjustment is approximate at best because it requires knowledge of how the economy is performing relative to its potential output, which cannot be measured directly.

Crucially however, so that the government is able to respond to the economic cycle, the targeted balance should be allowed to deviate from its set path depending on the OBR's growth forecast, and not just to allow for the automatic stabilisers. When growth is forecast to be close to its trend rate, the balance should be expected to be at a level consistent with achieving the medium-term debt target. But in any year when the OBR is forecasting growth of, say, less than 1.5 per cent, borrowing should be allowed to be higher, to a predetermined degree; on the other hand, in any year when it is forecasting growth of, say, more than 3 per cent, borrowing should be lower. To underline the temporary nature of these shifts in borrowing, they should be implemented through one-off measures. For example, extra borrowing might be the result of additional infrastructure spending or a temporary tax cut, rather than incremental changes to existing, long-term measures.

Any new fiscal rule should place fiscal realism and fiscal flexibility at the heart of a new form of British capitalism. While growth and restructuring the economy are crucial for the medium term, they will only be sustainable if delivered alongside a reduction in public debt. All three elements of the triple crisis – stagnation, imbalance and debt – need to be tackled simultaneously.

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6 Better still would be to target general government debt, rather than public sector debt, as this is the common yardstick of fiscal policy used in most other countries and by bodies like the OECD and EU. As noted in chapter 5, this would also be relevant to any attempt to capitalise a British Investment Bank from government funds.

7 Nick Clegg, for example, accepted this in an interview in January: <http://www.bbc.co.uk/news/uk-politics-21190108>. The Labour government planned cuts on a similar scale, so it too was at fault.

8 The 'golden rule' said that it should average zero over the economic cycle. The problem was that no one could be certain when a cycle began and ended.

## 2. TAX REFORM

### Key points

- Additional tax revenues will be needed to eliminate the fiscal deficit and to enable the provision of key public services to be maintained at current levels.
- New taxes should also facilitate a rebalancing of the economy and increase its stability.
- The government should examine seriously the feasibility of a land value tax and a financial transaction tax.

The UK faces fiscal problems on a variety of time scales. As well as needing to eliminate the deficit and eventually to reduce public debt in relation to GDP, demographic pressures over the longer term will require public spending to rise relative to GDP just to maintain some public services, such as healthcare, at current levels. New sources of tax revenue are, therefore, likely to be needed.

During the financial crisis and subsequent recession, tax revenues in the UK fell further than in many other advanced economies – even after allowing for differences in the depth of recessions. As a result, the UK will have to take more discretionary action, in terms of spending cuts and tax increases, to eliminate its structural fiscal deficit. According to the 2012 autumn statement, total discretionary consolidation will have amounted to £131 billion by 2015/16 (HM Treasury 2012: 24) and there will still be around £30 billion of further consolidation needed in the following two years. This consolidation has necessitated painful tax increases and massive cuts in public spending, which have negatively affected the welfare of most of the population. In order to reduce the risk of tax increases and spending cuts on this scale in the future, the UK's tax regime needs to be made more resilient.

The Coalition government's plans for deficit reduction are based on an overall 80:20 ratio between public spending cuts and tax increases. However, most of the tax increases have been frontloaded and a much higher percentage of the adjustment still to come is in the form of spending cuts.

**Table 1**  
UK fiscal consolidation,  
2011/12–2015/16

	2011/12	2012/13	2013/14	2014/15	2015/16
Total discretionary consolidation (£bn)	41	69	84	106	131
Spending (£bn)	23	48	59	81	104
Tax (£bn)	18	21	26	26	27
Spending share (%)	56	70	70	76	79

Source: HM Treasury 2012

This situation might change after 2015/16. If £30 billion of further consolidation is required then an 80:20 split would imply £24 billion of spending cuts on top of those already announced (or, in the case of 2015/16, those to be announced later this year), leaving £6 billion in additional tax revenues. Alternatively, if the balance of total consolidation between spending cuts and tax increases was shifted to 75:25, an extra £13 billion in tax increases would be needed; if the balance was moved to 2:1, as originally proposed by the last Labour government, then tax increases would have to amount to £27 billion. In either case, the pressures on public service provision that the spending cuts are creating would be eased.

The problem with envisaging such a shift is that the tax increases that could most simply bring in the additional revenues are ruled out on political grounds. For example, a 1p

increase in the basic rate of income tax would raise £4.5 billion in 2015/16,<sup>9</sup> but the basic rate has not been increased since 1975. It will be a brave politician who snaps this streak. Likewise, increasing the standard rate of VAT by 1p would raise £5.5 billion and – following the hike in January 2011 – is perhaps more imaginable, but any political party going into the general election in 2015 with a promise to raise VAT is likely to damage its prospects. Indeed, this would be particularly difficult for the Labour party, as it has been arguing for a temporary VAT *cut* to stimulate the economy. Increases in fuel duty have also become politically problematic as global oil prices push up petrol prices at the pump. Inheritance tax allowances are now being frozen for longer than previously planned in order to raise revenues, but no one has raised the possibility that the allowance should be cut, or the tax rate increased. ‘Stealth taxes’ should not be an option because they are undesirable on democratic grounds. Raising extra revenues, therefore, will require new sources of taxation.

Beyond short-term consolidation, new revenue sources will also be needed to address longer-term pressures. The OBR’s projections show non-interest public spending increasing from 35.6 per cent of GDP in 2016/17 to 40.8 per cent in 2061/62, largely as a result of the ageing of the population and consequent pressure on spending on health, state pensions and long-term care costs (OBR 2012b: 66). While demographic trends will lead to a very small increase in tax revenues relative to GDP, there are other factors, including declining North Sea oil and gas production and changes in transport and environmental taxes due to decarbonisation, that could lower revenues by ‘up to 2 percentage points over the next 20 years’ (ibid: 114). Without new sources of revenue, therefore, the current level of social provision cannot be maintained over the long run.

Wealth taxes are increasingly seen as an alternative source of revenue – and one that would lead to greater economic equality and efficiency – although the only concrete proposal put forward so far is the ‘mansion tax’. The Liberal Democrats proposed in their 2010 manifesto to introduce a tax at an annual rate of 1 per cent on the value of properties in excess of £2 million (that is, the owner of a house valued at £3 million would pay £10,000 in tax). This, they estimated, would raise revenues of £1.7 billion.<sup>10</sup> More recently, Ed Miliband (2013) has also backed a mansion tax to finance the reintroduction of a 10p income tax band.

To a certain extent, this approach would find favour with the authors of the Mirrlees review of the UK’s tax system. They conclude that a general wealth tax would be ‘costly to administer, might raise little revenue, and could operate unfairly and inefficiently’ (Boadway et al 2010: 741). They also point out that most OECD countries that have implemented wealth taxes have subsequently abolished them. Instead, Boadway et al propose ‘an annual tax targeted at very high value residential property with no reduction for debt’, although they prefer an extension to council tax rather than a separate mansion tax.

The relatively small amount of money that would be raised by the mansion tax reflects the political obstacles to introducing a more broad-based wealth tax. There is only so much that can realistically be extracted from the very wealthy through taxation, because they are small in number. Raising substantial amounts of money from a wealth tax would require a wider tax base, but at the political cost of creating many more actual and potential payers. (The Liberal Democrats’ initial idea was to tax the value of properties in excess of £1 million.)

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9 <http://www.hmrc.gov.uk/statistics/expenditures/table1-6.pdf>

10 This figure was endorsed by the Institute for Fiscal Studies.

## Land value tax

Rather than taxing wealth in general, a better option would be taxing the ownership of land through a land value tax (LVT). As the Mirrlees review argues, the economic case for an LVT is ‘almost undeniable’ because it is the equivalent of taxing an economic rent and would not discourage any desirable economic activity (IFS 2010: 373). Land values are created not by the owner of the land, but by the community. Depending on the land’s use, these values reflect local amenities, access to transport infrastructure<sup>11</sup> and demand for natural resources, among other factors. This is why the idea has such a long pedigree; indeed, a land tax was one of the components of David Lloyd George’s famous ‘People’s budget’ in 1909.

An LVT would also have the benefit of encouraging the use of land that has permission for development. To illustrate, the tax paid on two adjacent plots of the same size, one with permission to build a house and one with a house built on it, would be the same, but the return on the latter would be much greater. To the extent that house price booms and busts in the UK are in fact fluctuations in land prices (the value of the bricks and mortar of a house being relatively stable), an LVT would also help to dampen future fluctuations in house prices. More generally, it would play a role in helping to rebalance the economy by encouraging a move away from receiving income through owning property to earning income through providing goods and services. An LVT would also help to reduce the north–south divide and the wealth gap between the ‘baby boomers’ and younger generations.

Offsetting this, there would be some disincentive to apply for planning permission to change the use of land in the absence of firm plans to carry through with developments, but the potential gains from developing land are so great that this is unlikely to be a significant factor.

Despite the strong economic case for an LVT, relatively few countries have one. Austria charges a 1 per cent tax on land without buildings and Denmark has a land value tax of between 1.6 and 3.4 per cent. Some states in Australia, Canada and the US also levy a land value tax, as do some Caribbean countries and a number of African countries, including South Africa and Kenya.

The main problems with an LVT are practical. In particular, an LVT requires an accurate estimate of the value of all land at a much disaggregated level and separate from what is built on it. Because the number of transactions in ‘bare’ land in any one year is very small, and in the case of other transactions it is hard to separate out the value of the land from the value of what is built on it, this is difficult to achieve. But these problems are not insurmountable, and the Mirrlees review suggests a number of solutions. In particular, it notes that much of the information needed to value land used by businesses is already collected for the purpose of calculating of business rates.

The tax could be applied to either the capital value of land or to its rental value. The capital value is probably easier to observe than the rental value, but it is also likely to be subject to greater fluctuation from year to year. Assuming the tax was set at a fixed rate, this would mean greater swings in revenues. Since one of the aims of tax reform should be to improve the resilience of the tax system, this is undesirable. As an alternative, then, taxing the rental value is the preferred option. Ideally, the tax should be applied to the

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<sup>11</sup> The construction of the high-speed rail link to the Channel tunnel boosted land values in parts of Kent, for example.

'bare' rental value of land, based on its optimum permitted use. The rental value of any development on the land would not be taxed but the effect on the land's rental value of planning permission for development would be taken into account (see annex 1).

Alongside the practical problems, there are bound to be political objections to a land value tax. Introducing any new tax that affects the bulk of the population is likely to make a government unpopular, and promising to introduce one in a general election manifesto will not increase a party's chances of winning. This is particularly true of a tax like an LVT that would affect the majority of the population. Even if an LVT was introduced in a cost-neutral way – most obviously as a replacement for council tax – there would be millions of 'winners' and 'losers'; while the winners would probably show little gratitude, the losers would be sure to kick up a fuss. Inevitably, people fear that they will be among the losers, and so balk at the idea of change.

However, if these (admittedly substantial) problems can be overcome, an LVT would be a very simple tax to maintain and administer. It would be applied at the same rate for every parcel of land across the UK. There would be no concessions, no allowances and no thresholds, since introducing a threshold would create an incentive to subdivide land to the point where individual lots were exempt. It would be progressive, as richer people are more likely to own expensive land, and probably more so than existing taxes. And it would be impossible to avoid. In many respects, an LVT is the ideal tax.

Ultimately, the economic case for a land value tax is so strong that at the very least there should be an investigation into the practical hurdles to its introduction and how they might be overcome. Then the political hurdles can be tackled. Initially at least an LVT might be unpopular, but additional revenues need to be found to fill the gap that will be left by falling revenues from North Sea and environmental taxes. It is an idea that must be given serious consideration.

### Financial transaction tax

Like the LVT, the idea of a general financial transaction tax (FTT) has a long pedigree, going back at least to the 1930s, when it was backed by John Maynard Keynes.<sup>12</sup> Unlike with the LVT, many countries have already introduced FTTs in one form or another (see annex 2). Globally, 13 of the top 15 financial centres<sup>13</sup> have an FTT, in most cases on trading in shares but in some instances on trading in bonds or derivatives as well. One of these 15 countries is the UK, of course, which charges 0.5 per cent stamp duty on purchases of UK shares. In 2011/12 this brought in revenues of £2.8 billion (down from a peak of £4.2 billion in 2007/08).

Now, 11 European countries are planning to introduce an FTT that would cover all trades in equities, bonds and derivatives in which at least one of the parties is a financial institution and either (a) at least one party is resident in one of the 11 countries or (b) the underlying equity or bond was issued by an institution resident in one of the 11 countries. This will mean that six of the G8 countries will have an FTT. Following the lead of these EU countries would offer the UK a way of raising substantial additional revenues.

The 11 countries are Austria, Belgium, Estonia, France, Germany, Greece, Italy, Portugal, Slovakia, Slovenia and Spain. Their proposal was approved by the EU's economic and financial affairs committee (ECOFIN) in January 2013, meaning it can now proceed to

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<sup>12</sup> Stamp duty in the UK dates back to 1694.

<sup>13</sup> According to Long Finance 2012

implementation, probably in 2014. The FTT will comprise a minimum 0.1 per cent tax on the trading of bonds and equities and a minimum 0.01 per cent tax on the trading of derivative products.<sup>14</sup>

In most cases, the main rationale for pursuing an FTT is financial: to bring in extra resources to help reduce budget deficits. But its proponents also argue that it will help to avoid future financial crises and ensure that financial institutions make a fair contribution to clearing up the mess created by the last one (see, for example, European Commission 2012). For this reason, an FTT is likely to be more popular with the general public than an LVT – a YouGov poll in 2012 indicated 61 per cent support and only 19 per cent opposition to an FTT.<sup>15</sup> It would also be much less expensive to administer. A further advantage is that an FTT could probably be implemented within a year, whereas an LVT might take a number of years to put in place.

There is also a widespread perception that the City has not been making a sufficient contribution to tax revenues since the crash. The banking sector paid just £1.3 billion in corporation tax in 2011/12 (less than one-third the amount paid by the manufacturing sector). The bank levy on balance sheets, introduced in January 2011, is accruing less than the chancellor intended. The Mirrlees Review (IFS 2010) points out that financial services are exempt from VAT. Expanding the present stamp duty on shares to encompass other financial instruments, in line with 11 of our European partners, would help to redress the balance.

The European Commission has estimated that if FTTs of 0.1 per cent had been applied to trading in bonds and equities and 0.01 per cent for trading in derivatives across all 27 EU countries, revenues in 2010 would have totalled €37 billion (European Commission 2011: 44–45).

Based on this figure and the UK's share of total European trade in different assets, the Item Club (a group of economic analysts backed by Ernst & Young) has estimated that the UK would accrue revenues of €28 billion, or £23 billion at current exchange rates (Ernst & Young 2011). Assuming the FTT on share transactions replaced the existing stamp duty on shares, so doing away with the £3 billion that that tax currently raises, the potential net increase in revenues would still be £20 billion.<sup>16</sup>

Tax revenues in the UK are traditionally not hypothecated and there would be strong resistance from HM Treasury in particular to any attempt to allocate permanently the revenue from an FTT to a particular stream of spending. However, there are precedents for justifying a tax increase in terms of a particular spending pledge.<sup>17</sup> It would be possible, therefore, in the first few years of an FTT, to use some of the revenue raised – perhaps £10 billion a year – to capitalise a British Investment Bank (BIB). This, as discussed in greater depth in chapter 5, could be a key element in restructuring and

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14 For more, see [http://ec.europa.eu/taxation\\_customs/resources/documents/taxation/com\\_2013\\_71\\_en.pdf](http://ec.europa.eu/taxation_customs/resources/documents/taxation/com_2013_71_en.pdf)

15 [http://classonline.org.uk/docs/YouGov-Class\\_Polling\\_Results\\_120522\\_Economic\\_Policies.pdf](http://classonline.org.uk/docs/YouGov-Class_Polling_Results_120522_Economic_Policies.pdf)

16 An additional €13 billion could be raised if a spot currency transaction tax was introduced, but there are legal impediments to a subset of eurozone countries doing so and this is not currently under consideration. If the UK implemented a levy on sterling trades it could potentially raise over £7 billion. Contacts for difference are also excluded, but if these were brought within the ambit of the FTT then revenues would be higher still.

17 In its 2001 manifesto the Labour party said it would increase national insurance contributions by 1p and use the revenues to increase spending on health, a pledge it implemented after the general election. Although neither move has been reversed, there was never any formal link in the public finances between the extra revenue and the increased spending. As noted already, Ed Miliband has more recently linked the reintroduction of a 10p income tax band to revenues from a 'mansion tax'.

restoring balance to the UK economy. One of the most difficult questions for supporters of a BIB is where the funds will come from to capitalise it, particularly at a time when deficit reduction is requiring massive cuts to departmental spending and a squeeze on welfare payments. There is some logic in capitalising a BIB – which is needed because of failings of the private financial system – through a tax on financial activities. More generally, if the revenues from an FTT were spent in ways that promoted growth and job creation then the net effect of introducing an FTT could be positive for the economy.

Critics of a financial transaction tax have raised a number of objections to its introduction in the UK unilaterally or alongside other European countries. In particular, they suggest an FTT would hurt London's position as a leading financial centre, either because some activity would migrate to other markets (such as New York or Hong Kong) or because some companies or traders would leave the UK. This, they say, would hit output, exports, employment and tax revenues.<sup>18</sup> Other objections are that more trades would be conducted in forms of derivatives that would be hard to tax, and that financial firms would pass the burden of the tax on to their clients, including pension funds, so that the FTT would not be a tax on the City but on the population in general.

The best way of preventing activity from migrating to other markets is through the design of the FTT. Serving as cautionary cases, there are a number of historical examples of bad FTTs in this respect. Perhaps the most notorious is the Swedish FTT that was applied only to trades made through domestic brokerage services. Unsurprisingly, this led to trade in Swedish stocks (and in bonds, for the short time that the tax was applied to these trades as well) migrating to foreign brokerages. The Swedish FTT was simply too easy to avoid.<sup>19</sup> However, there are also examples of well-designed FTTs, including the UK's stamp duty on share purchases. This is very hard to avoid because the tax is paid when the change of legal ownership of shares is registered. If the tax is not paid, the purchaser does not legally acquire the shares. This principle can easily be extended to other assets, including government and corporate bonds. In the past, it would have been harder to apply it effectively to derivative contracts, but this is changing. The European Market Infrastructure Regulation (EMIR) will make it mandatory to report all derivative contracts, whether over-the-counter (OTC) or non-OTC, to trade repositories. This will create a record of trades that can be used for tax purposes to capture trades wherever they take place.

The idea that financial firms or their staff might leave because of increased regulation or higher taxes is frequently raised by senior City figures or lobbyists for the financial sector. For example, Terry Smith, head of Tullett Prebon, said in December 2009 that he would allow any of his London-based staff to move overseas when the 50p income tax rate came into force (see Teather 2010); in the event, it seems none took up the offer. From a firm's perspective, even just in narrow tax terms, an FTT would be only one consideration among many. Corporation tax, for example, is coming down to 21 per cent in the UK, but can be as high as 35 per cent in the US. The US also levies withholding tax on eurobonds – bonds taken out in a foreign currency on a US exchange – whereas the UK has elected not to do so.

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18 The European Commission's assessment of the macroeconomic effects of the FTT proposed by the 11 EU countries is that it would reduce GDP by 0.28 per cent by 2050, although even this very modest loss could be made up depending on how the revenues raised were spent: [http://ec.europa.eu/taxation\\_customs/resources/documents/taxation/other\\_taxes/financial\\_sector/fact\\_sheet/macroeconomic-effects.pdf](http://ec.europa.eu/taxation_customs/resources/documents/taxation/other_taxes/financial_sector/fact_sheet/macroeconomic-effects.pdf)

19 It was also set at a high rate, which encouraged avoidance, and covered only parts of the fixed income market, so making avoidance relatively simple.

More generally, London is a great place for wealthy financial sector employees to live. It also has many advantages as a place to conduct financial business, including all the service infrastructure of consultants, lawyers and so on that has grown up around the City. It would take a lot more than an FTT to cause people to leave in any significant numbers. Since the financial crisis, in addition to the 50p tax rate, a tax on bankers' bonuses has been levied by the last Labour government and the Coalition government has introduced a levy on banks' balance sheets (and increased it three times). This has not triggered a mass exodus, or even a trickle, of firms or people to alternative locations. Even the *Financial Times* (2011) has argued threats by banks to quit the UK 'should be faced down, not just because they are unreasonable but because they are of questionable credibility'.

Another argument deployed by opponents of an FTT is that it would be paid by pensioners, not bankers. The chancellor, George Osborne, said in November 2011: 'There is not a single banker in the world that is going to pay this tax. There are no banks that are going to pay this tax. The people who will pay this tax are pensioners.'<sup>20</sup> In fact, the issue facing pensioners is lack of transparency in the pensions market and the high cost of fees (eclipsing the cost of an FTT many times over). If anything, the FTT ought to benefit pensioners by encouraging fund managers to return to more traditional longer-term investment strategies, thereby reducing the attrition to pensioner returns created by the charges of financial intermediaries. In reality, the incidence of a broad-based FTT would be paid mainly by those on high incomes, especially bankers, and so it would be a progressive tax (Dolphin 2010).

FTTs are paid by those who trade in the financial instruments to which they are applied, so potentially by banks and hedge funds, pension and life insurance funds, companies and individuals. But while most domestically owned UK shares<sup>21</sup> are owned on behalf of individuals by insurance companies and pension funds and by individuals themselves, most trading in shares is not done by these institutions. Insurance companies, pension funds and individuals trade their shares relative infrequently, and so would pay limited amounts under an FTT. Investment banks' proprietary trading desks<sup>22</sup> and hedge funds trade very frequently and so would pay a high proportion of the FTT. The European Commission believes that 85 per cent of the transactions covered by the tax proposed by the 11 EU countries are between financial institutions.

Banks and bankers *will* pay FTTs. Banks will pay every time an employee conducts a trade on the bank's account. To the extent that this results in lower returns and profits for the banks, ultimately the cost of the FTT will fall on their shareholders. In addition, however, employees will pay because less profitable banks will mean smaller profit-related bonuses.

Hedge funds do most of their trading on behalf of their clients, so it is likely to be their clients who ultimately pay FTTs through lower returns (although lower returns will also mean fewer assets under management and lower fees in turn, so indirectly hedge fund managers will pay too). This has led to claims that the incidence of the tax would fall on future pensioners. In fact, according to the pension consultant Mercers, only 5.3 per cent of UK pension funds have direct exposure to hedge funds and 10.0 per cent to hedge funds of funds (some pension funds might fall into both categories), and in both cases their average allocation is 8.7 per cent (Mercer 2012: 8). Lower hedge fund returns as a result of an FTT would therefore have no effect on more than five out of six pension funds.

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20 Quoted in Waterfield 2011

21 The rest of the world now accounts for over 40 per cent of holdings.

22 Where employees of a bank trade on the bank's own account.

Those that do invest in hedge funds would have to decide how much they think returns would fall as a result of FTTs and whether it is worth continuing to pay hedge fund fees – typically 2 per cent of assets under management and 20 per cent of returns – for the likely returns. Given the recent performance of hedge funds – average at best<sup>23</sup> – they might decide not to bother.

Even if pension funds continue to invest in hedge funds and so pay relatively high amounts of FTTs, FTT payments made by pension funds will be progressive, because higher earners have bigger pension pots than lower earners. Similarly, FTTs paid by the other major hedge fund client group – individuals – will be very progressive, because only the extremely wealthy choose such investments.

Ultimately, an FTT is just one more element to be added to the cost of the transfer of the ownership of an asset from one agent to another – and, given the rates of FTT that have been proposed, it is not a major element at that. It is ironic that the financial institutions which already make money by charging investors fees for conducting transactions are the biggest opponents of plans for the government to also make a charge. Infrequent traders would barely notice the addition. Only frequent traders – hedge funds, the proprietary trading desks of investment banks and, of course, high-frequency traders – would be materially affected. If their business models are so fragile that a levy on trading on the extremely modest scale proposed by the 11 EU countries would wreak havoc, then perhaps those are not very good models.

As well as being a source of revenue, an FTT would have other benefits. It would lead to a substantial reduction in speculative high-frequency trading (the original rationale for the tax on currency trading proposed by James Tobin). No one should regard this as a loss. Adair Turner (2009) has described this type of activity as ‘socially useless’. It represents rent-extraction by the financial sector from the rest of the economy (Dolphin 2013). Furthermore, much of this high-frequency trading is conducted using leverage provided by banks. If there is less trading then banks will be lending less to other financial institutions; this should leave more funds available for lending to the rest of the economy. An FTT could therefore help to reduce ‘short-termism’ in the City and promote long-term investment. As such, it would be an integral part of efforts to rebalance the economy and to make finance better support the rest of the economy – which are key elements of a more collaborative capitalism.

At the root of the financial crisis was irresponsible behaviour by the financial sector, in particular the banks, and a bubble in the housing market. If a future government wanted to raise additional revenues from new sources, whether for the short-term purpose of cutting its debt, to finance additional spending (including to capitalise a British Investment Bank), or to replace other revenues that will be lost in the medium term, there is some logic in looking to the finance and housing markets. Two options with a long pedigree are a broad financial transaction tax and a land value tax. As part of rethinking the nature of British capitalism, the UK should examine the practical difficulties involved in an LVT and how they might be circumvented and also look to follow the lead of those European countries that are moving to implement a general FTT.

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23 See Economist 2012

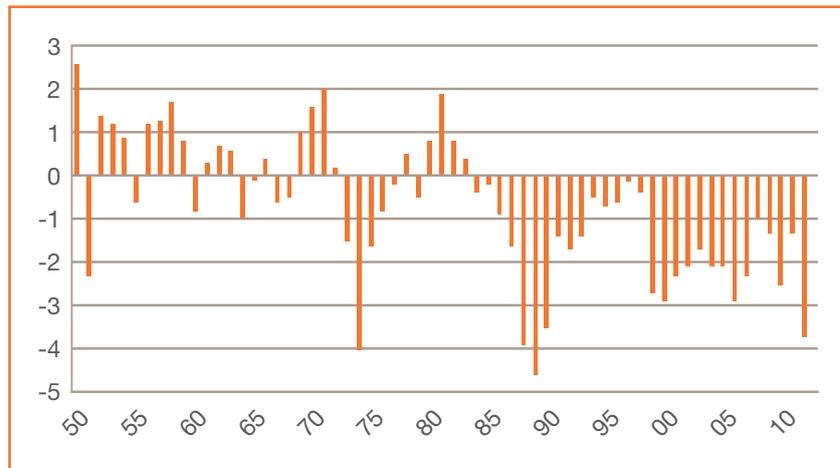
### 3. BOOSTING EXPORTS

#### Key points

- The UK's trade performance has been poor for the last three decades.
- Shifting to an export-led growth model will require intensive investment in infrastructure, skills and productive capacity.
- Government and private sector collaboration through an active industrial strategy will be needed to deliver this investment.

Any attempt to rebalance the UK economy must involve boosting exports. The UK has run a current account deficit in each of the last 29 years. After such a long run of deficits, this situation can hardly be described as unsustainable, but it does have a cost. Current account deficits have to be offset by capital account surpluses: that is, by the net selling UK assets. This increases our net external debt and means higher overseas payments of dividends and interest in the future. Any government that is concerned about reducing its fiscal deficit in order to cut the burden of debt interest payments that future generations will bear should be equally keen to eliminate the current account deficit in order to cut the payments future generations will have to make to overseas creditors.

**Figure 5**  
UK current account  
balance (% of GDP)



Source: ONS; figure for 2012 is for first three quarters only<sup>24</sup>

Taken at face value, trade statistics suggest that there is a potential conflict between the desire to rebalance the economy away from finance and towards other sectors and, on the other hand, the desire to see the UK run a series of current account surpluses. The tension arises because finance has been an important source of overseas earnings for the UK. In the last 10 years, the UK has averaged a surplus of 2.6 per cent of GDP in its trade in insurance and financial services. In 2011 the surplus was 3.0 per cent, while the rest of the economy ran a deficit in excess of 4 per cent of GDP.

However, there is a link between the growth of finance in the UK economy since 1986 (that is, since the 'big bang' in the City) and the UK's poor trade performance in other sectors, particularly manufacturing (Dolphin 2013). Manufacturing employment in the UK has been declining since the early 1980s, but throughout this period there is a correlation between the pace of decline and sterling's exchange rate. In the 1980s – when the government's experiment with monetarism led to very high interest rates – sterling's exchange rate index was very strong and the pace of decline in

<sup>24</sup> <http://www.ons.gov.uk/ons/rel/bop/balance-of-payments/3rd-quarter-2012/stb-bop-q3-2012.html>

manufacturing employment was steep. Similarly, in the period from 1998 – after sterling had appreciated by around 25 per cent – manufacturing employment fell rapidly, and far faster in the UK than in the other G7 economies.<sup>25</sup> But in the intervening period – the years immediately after sterling was ejected from the European exchange rate mechanism and fell in value by almost 20 per cent – manufacturing employment increased for four consecutive years. Thus the link between sterling and manufacturing employment is clear. When sterling is strong, UK manufacturing becomes uncompetitive, its exports weaken, output suffers, and employment is cut; when sterling is weak, manufacturing performs much better.<sup>26</sup>

There is also a link between the financialisation of the UK economy and the value of sterling. There is no way of saying exactly what represents ‘fair value’ for a currency, and exchange rates are determined by many factors, the relative importance of which can vary over time. However, one of the principal reasons for sterling’s high value between 1998 and 2007 was strong capital flows into the UK – and the financial sector received a large share of these inflows. The financialisation of the economy, therefore, can be said to have led to a large trade surplus for the UK in financial services and insurance, but at the cost of a significant loss of competitiveness for UK manufacturing and a wider trade deficit in goods. This has had negative effects on the regional balance of growth in the UK economy and has exacerbated the north–south wealth gap.

However, loss of competitiveness is only part of the story. There are also structural reasons for the UK’s poor export performance. UK exports of goods are too targeted at advanced economies. The most successful exporting countries in recent years, such as Germany, are much more focused on exporting to faster-growing developing economies. In part, this is because they manufacture the types of goods these economies need most at this stage in their development – machinery, tools and equipment – which the UK by and large does not.

It is argued in some quarters that the UK’s time will come when economies such as China, India and Brazil start to import more of the things that the UK is good at providing, including services such as finance, management consultancy and architecture. However, this is not the solution to the UK’s trade gap. First, levels of income in these economies are well below levels in advanced economies – and it could be a long wait. Second, in areas such as finance, competition with the UK is growing: in Asia, for example, Hong Kong, Singapore and Shanghai are all already major financial centres in their own right. Third, while UK firms might win business in developing economies, they are likely to do so, in many cases, by setting up local offices and employing local people. Some income from these activities will come back to the UK, but a lot will stay overseas. British management consultancy firms, for example, have already established offices in China. But they employ local people who understand local customs and traditions. To the extent that these ventures are profitable, some income – export earnings – will be remitted to the UK, but this is unlikely to occur at a level sufficient to close the UK’s current account gap or to create much in the way of new jobs domestically.

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25 In the 10 years to 2011, manufacturing employment in the UK fell by 3.8 per cent a year. Among G7 countries the next highest rate of decline was 2.3 per cent in Japan. In Germany manufacturing employment only contracted at a 0.4 per cent rate over this period.

26 See annex 3 for charts showing trends in sterling and manufacturing employment.

## Supporting exporters

Concentrating on those segments of manufacturing that the UK is already good at and waiting for the service sector to boost the UK's export performance are not solutions to the UK's poor export performance. Positive steps need to be taken. The Confederation of British Industry (CBI) and Ernst & Young together came up with a plan of action in 2011 that included proposals for companies and for the CBI itself, as well as for government. Their plan for government (CBI and E&Y 2011: 58) comprised:

- setting targets for the growth of exports
- bringing all the support government currently offers to exporters together in one place
- ensuring new legislation does not hinder export performance
- increasing hub airport capacity
- promoting the study of science, technology, engineering and maths (the STEM subjects) and language subjects in schools
- making more business appointments to UK Trade and Investment (UKTI); and
- increasing the availability of export credit by diversifying the ways firms can access Export Credits Guarantee Department (ECGD) products.

This is a sensible package of recommendations, but it is hard to see that it would make a huge difference to the UK's export performance. Only one – improving the performance of the ECGD – focuses directly on ways to support exporters.

UK Export Finance, the operating name of the ECGD, 'complements the private market by providing assistance to exporters and investors, principally in the form of insurance and guarantees to banks'.<sup>27</sup> It does this by insuring exporters against non-payment by overseas buyers, guaranteeing bank loans taken out by overseas buyers to finance purchases from British firms, insuring UK investors in overseas markets against political risk, and sharing credit risk with banks. In the 2011/12 financial year, UK Export Finance issued guarantees to a total value of £2.3 billion covering exports to 38 different countries (ECGD 2012). At first glance, this is an impressive amount. However, over £1.8 billion of this total was in connection with overseas purchases of Airbus aircraft; less than £500 million went to guarantee purchases from other exporters or other investments. (Although Export Finance points out that by helping Airbus it is also helping the numerous small and medium-sized businesses that make up its supply chain.)

More needs to be done to encourage greater take-up of UK Export Finance's services, in particular by small and medium-sized firms – something the Coalition set out as a priority when it launched its trade white paper in February 2011. Adam Lent and David Nash have argued that targeted information campaigns and a greater presence at trade fairs would help to raise awareness of how Export Finance can help (2011: 50). They also suggest that lessons can be learned from export credit agencies in other countries. Export Finance should bring together business and trade associations to exchange information on trade opportunities. It should also help provide information on the credit-worthiness of overseas buyers and offer assistance to exporters trying to recover bad debts. Almost all of the guarantees made by Export Finance cover the export of manufactured goods. Given the importance of services in total UK exports, Export Finance should explore how it can help service providers to sell into overseas markets.

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<sup>27</sup> <http://www.ukexportfinance.gov.uk/about-us/mission-and-principles>

UK Export Finance can, however, only help so much. It can support a limited number of existing companies in certain circumstances, but it cannot help the UK to develop a much bigger export sector. The same is true of other Coalition government initiatives, such as the eight trade envoys appointed in 2012 to promote trade for UK businesses in high-growth and developing markets, or the £8 million identified in the Department of Business, Innovation and Skills (BIS) budget to strengthen the capacity of business groups (such as chambers of commerce) in 20 key markets. And while the chancellor's decision in the 2012 autumn statement to increase the budget of UKTI by 25 per cent for the next two years is welcome, it only represents a temporary reversal of the cuts he announced in 2010.

Developing a bigger export sector will require more innovation, skills and investments that are geared specifically towards success in overseas markets. History shows the private sector will not generate this outcome by itself – and the chancellor is very naïve if he believes that his policy of cutting corporation tax rates will work in this regard.<sup>28</sup> If the UK wants to have a more export-orientated economy, it needs to have an active industrial strategy designed to develop one.

### Fostering an export economy

This does not mean 'picking winners', in the sense of identifying individual companies for support. And it should certainly not involve shoring up failing businesses, as was too often the case with industrial policies in the 1970s. Rather, it should mean identifying sectors and subsectors of the economy where the UK has a comparative advantage, or there is potential for rapid growth in overseas demand in the future, and then working out how the government can collaborate with industry to best promote an expansion of their productive capacity.

This is not a new idea. In the 1980s the Thatcher government used a range of incentives and support measures to encourage Japanese car manufacturers to invest in the UK. The result today is a vibrant industry that, according to the Society of Motor Manufacturers and Traders (2013), exported 1.2 million cars in 2012 – more than ever before. The UK's successful aerospace and aero engines industries were supported by 'Launch Aid' payments to fund research and development. And in 1986 the 'big bang' in the City was explicitly designed to secure London's role as a major global financial sector and source of overseas earnings for the UK economy. Today, it is the scale of effort that is the problem.

These examples show that government policy and actions can be integral to the success of UK businesses, but there is a widespread view that this is not the case. To bring about a new form of capitalism government must lead a change of opinion: away from deriding industrial policies as 'government meddling with the market' and towards regarding them as 'how government helps promote sustainable growth'. In particular, at a time of rapid change in the economy as a result of globalisation and technological progress, an active industrial policy needs to support the development of comparative advantages for the UK in new higher-value-added and tradable goods and services.

One potential problem is the need to comply with the EU's state aid rules. But, as Will Straw and Alex Glennie (2012) have pointed out, 'no state aid' is unlikely to be the

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28 For example, net foreign direct investment in the UK by foreign companies was unchanged in 2011 compared to 2010, while there was a substantial increase in foreign direct investment abroad by UK companies: [http://www.ons.gov.uk/ons/dcp171778\\_299174.pdf](http://www.ons.gov.uk/ons/dcp171778_299174.pdf)

optimal policy rule. If state aid is provided in a way that does not benefit one particular firm, or group of firms, over others in the same sector then it can play an important role in developing industries that can compete successfully in global markets, as well as supporting other aims, such as decarbonising the economy.

There is broad agreement among economists about many of the areas where the UK already has a comparative advantage. Most lists would include finance and business services, tertiary education, the creative industries, ICT, pharmaceuticals and medical devices, aerospace, and automobile production. In some cases – the financial sector, for example – there is probably little that government needs to do to help firms develop this advantage further. In others, such as tertiary education, it may primarily be a case of ensuring that policies do not negatively affect a sector that is already doing well. (In this respect, the current government's immigration policies are a good example of what not to do.) But some sectors will need support to ensure that the infrastructure they require is in place, that the education system is producing people with the skills they need, and that finance is available when they look to innovate, exploit new products and ideas, and expand into new markets.

Comparative advantage is not static. As emerging economies move up the value chain and as new products and services emerge, countries will gain and lose comparative advantages. The countries that cope best with change are those with a strong innovation culture. It is important, therefore, for the government to have a national strategy to support and encourage the development of innovative industrial clusters, such as Tech City in London and the maritime cluster centred on Southampton. It should also be possible to identify major trends in the global economy that will persist for many years and to define policies in a way that supports industries that can exploit the opportunities these trends present. In global terms, the rapid growth of demand in emerging economies is an obvious trend that the UK has so far been relatively bad at exploiting. Policies need to support a shift of emphasis for UK exports away from our traditional markets in the United States and Europe towards more dynamic markets in Asia and Latin America.

Some industrial policies were implemented badly in the UK in the 1970s (but not all – see Bailey 2013). As a result, there is a general belief in this country that industrial strategies do not work and that markets should be left largely to their own devices. This is a delusion shared by few other countries: governments elsewhere, including in supposedly free-market economies like the US, have successfully implemented a variety of industrial strategies during the last three decades. The UK's poor export performance over this period is, in large part, the result of neglect. It is time to develop an active industrial strategy focused specifically on reversing the country's recent record.

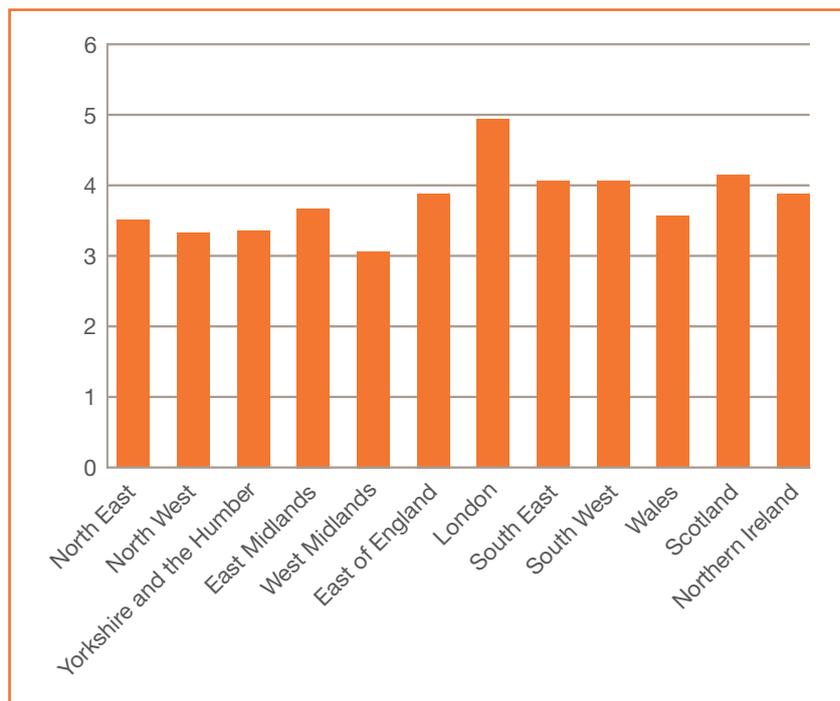
## 4. REVITALISING THE REGIONS

### Key points

- Rebalancing the UK economy and generating sustainable growth requires a revitalisation of the regions outside London and the South East.
- Government will have to collaborate with private sector agents to bring about the desired outcome.
- More powers and responsibilities need to be devolved from the centre to local groups, such as local enterprise partnerships; these groups will require greater fiscal autonomy.

In recent years, economic growth in London and the South East has been significantly faster than in the rest of the UK. Over the decade to 2011, gross value added (GVA) in London and the South East increased at an annual rate of 4.6 per cent, compared to an increase of just 3.7 per cent in the rest of the country. The relatively poor performance of the 'regions' (that is, in the UK other than London and the South East) is a drag on national prosperity. Strong growth in the economy as a whole, which is needed to bring down unemployment and increase revenues to pay for vital public services, requires greater prosperity in the regions.

**Figure 6**  
Annual growth in gross value added, by region, 2001–11 (%)



Source: ONS<sup>29</sup>

Furthermore, the overall figures for output growth do not tell the whole story. In many of the regions, economic growth has been heavily reliant on the state. The divergence between private sector growth in London and the South East and in the rest of the country is even greater than the GVA figures show.

29 <http://www.ons.gov.uk/ons/rel/regional-accounts/regional-gross-value-added-income-approach-/december-2012/stb-regional-gva-2011.html>

## The employment split

This is most apparent from the employment data, particularly if we look at a broad definition of public sector employment that includes state employees plus ‘para-state’ employees – those working in the private sector but reliant on the state for their job, such as construction workers building new roads or refuse collectors working for a private company with a local authority contract (Buchanan et al 2009). More than half the jobs created in the UK between 1998 and 2007 were in the state and para-state sectors; in some regions – particularly the North East, Yorkshire and the Humber, and Scotland – the proportion was much higher. In the most extreme case, in the West Midlands, private sector employment actually contracted and state and para-state employment more than accounted for all the increase in total employment. Only in London, the South East and the South West did the private sector account for more than half the increase in employment.

**Table 2**  
Private and public sector  
employment

	Change in employment, 1998 to 2007 ('000s)			Share of employment in state and para-state, 2007 (%)
	Private sector	State and para-state	Total	
North East	18	66	84	33.1
North West	107	142	250	28.7
Yorkshire and the Humber	61	130	190	29.5
East Midlands	72	88	161	27.4
West Midlands	-37	105	68	27.5
East	79	111	190	26.9
London	194	120	315	23.0
South East	171	136	307	26.6
South West	161	125	286	29.7
Scotland	77	168	246	32.1
Wales	67	82	149	34.3
<b>Total</b>	<b>972</b>	<b>1,273</b>	<b>2,244</b>	<b>28.1</b>

Source: Buchanan et al 2009

Furthermore, some of the jobs created in the private sector between 1998 and 2007 – for example, in retailing – will have been created only as a result of the extra spending of those employed by the state and para-state. Over this period, outside London and the wider south there was ‘at best modest autonomous private sector job creation, and at worst no autonomous private sector job creation’ (ibid: 23).

Proponents of a ‘small state’ will argue that this data is consistent with a view that state employment was ‘crowding out’ private sector employment in the regions during this period. However, this hypothesis does not fit the other facts. It is far more likely that weak growth in private sector employment was the *result* of the UK’s transition from its industrial past, which made it necessary for public sector employment to ‘fill in’. In most of the country, the private sector has not been able to adapt quickly enough to the effects of rapid technological change and globalisation, which have caused job losses in some industries and the closing down of production capacity, and more job losses, in others. The overall result was a policy – probably unwitting, and certainly unheralded – of using employment funded by the public purse to fill the gap left by a contracting private sector.

Following the financial crisis, recession and consequent leap in government borrowing, such a policy is not tenable for long. Public spending and public sector jobs are being

cut (by 288,000 in the UK over the last two years<sup>30</sup>). Instead, the Coalition government has favoured a range of supply-side measures to support growth in private sector output and employment in the regions. These include the establishment of the Regional Growth Fund, the re-creation of enterprise zones, ‘city deals’, and the creation of local enterprise partnerships (LEPs), all of which see some of the responsibility for growth distributed outwards from the centre to the local level.<sup>31</sup> These policies do not always support the regions: the Growing Places Fund to stimulate private investment allocated resources, in part, based on population, and so it favoured the south. Other measures, such as support for key sectors like the car industry and offshore wind generation, do tend to favour the regions. However, like earlier attempts at ‘regional policy’, the current package of measures is unlikely to be successful in reversing the growth gap between the south and the rest of the UK. The scale of the problem is a huge one; the resources and attention devoted to dealing with it fall well short of what is needed.

Rebalancing the economy is often interpreted as returning to the sort of economy the UK had 30 or 40 years ago, with a much smaller financial sector and a much bigger manufacturing sector. The revival of the regions that were traditionally strong in manufacturing is expected to follow as a consequence. However, there can be no going back to the past. Since 1998, employment in manufacturing in the UK has contracted at an annual rate of 3.6 per cent. True, this is, in part, the result of ‘crowding out’ by financial services, but most of the decline is due to the forces of globalisation and technological change. These trends are not going to stop, so halting the decline in manufacturing employment would be a massive achievement – reversing it is most unlikely. Rebalancing the economy away from finance must mean achieving more rapid growth in other parts of the private service sector. There is no guarantee that these will be located outside the South East. Reviving the regions will require specific policy action.

### Targeting regional growth

The current consensus in academic and other circles favours a regional policy based on ‘localism’: devolving power and resources to the regions so that they can deal with local barriers to growth and stimulate their economies by supporting innovation, investment and upgrades to infrastructure. Elements of government policy are in sympathy with this approach, but others display a centralist tendency. For example, when regional development agencies (RDAs) were abolished much of their functionality reverted to central government. At the request of the government, Lord Heseltine recently published a review of policies to boost growth in the UK (Heseltine 2012). In it, he urges greater localism: 15 of his 89 recommendations explicitly involve the devolution of power from the centre or making local government and other local agencies function more effectively.

The Northern Economic Futures Commission (NEFC), organised by IPPR North, which also published its report late in 2012, came up with fewer, more focused recommendations (IPPR North and NEFC 2012). As its name suggests, the commission’s focus was on the economy of the north of England, but most of its recommendations are valid for regional policy more generally. Following an approach set out by the OECD, these can be grouped under five headings:

- Getting the right institutions and leadership in place
- Supporting innovation and business growth

30 September 2010 to September 2012, excluding financial corporations as well as English further education and sixth form college corporations, which were transferred from the public to the private sector during this period.

31 For a full list of government initiatives see Heseltine (2012: 33-6)

- Improving the quality of jobs and skills
- Investing more in infrastructure
- Ensuring sufficient finance is available for business investment spending.

Since the same elements will be vital to producing a substantial improvement in the UK's export performance, it should be clear that an active industrial policy needs to be designed to support both the regions and exporters. As well as focusing on support for the UK's export industries, industrial strategy should incorporate a national spatial plan (or plans), particularly around infrastructure assets such as transport, energy, water and land. Only greater collaboration between government and the private sector can ensure the necessary rebalancing of the economy.

The ability of the UK's regions to respond to the rapid pace of change in the economy has been hampered by uncertainty about the way they are governed and shifts in responsibility for economic development. In the latest change, the Coalition government abolished regional development agencies and introduced local enterprise partnerships. While there are considerable doubts about the LEPs' ability to make a huge difference to their local economies, given their limited responsibilities and even more limited resources, the LEP framework should be retained in the interests of stability and built on as necessary.

One of the big risks of the LEP structure is that individual LEPs, wittingly or unwittingly, compete with each other, to develop particular industries, for example, or to attract certain investment from overseas. Such behaviour is counterproductive. Far better would be for LEPs to work together within their regions towards common goals, in terms of attracting new businesses, increasing the demand for skills and ensuring that potential barriers to growth, such as shortages of finance, are circumvented.

Working together LEPs could, for example, create regional innovation councils. These would bring together leading universities and employers to encourage greater university–business collaboration, applied research and innovation support. Research has shown that industrial clusters (in the service sector as well as in manufacturing) lead to strong networks, knowledge spillovers and increased research and development (R&D) and innovation (OECD 2007). Regional innovation councils, if adequately resourced, could help to nurture nascent clusters and support established ones.

To encourage innovation and business growth in the regions, and to improve the UK's chances of boosting its exports, the NEFC made two further recommendations (2012: 9–10). First, it said that UKTI, the government body that supports businesses hoping to compete in international markets, should take a less sectoral, more regional approach. Second, it proposed the formation of a Northern Investment and Trade Board to develop key priorities for the north of England and to improve coordination between local authorities, LEPs and UKTI sector specialists (an approach that could be followed by all regions).

### Sharpening workforce skills

The current and previous governments' approaches to skills policy have been determined largely by their preference for 'horizontal' industrial policies: those that do not favour any particular industry or sector. Rather than focus resources on developing the skills that certain parts of the economy might need, they have instead emphasised increasing the level of skills in the economy generally. They have done this by targeting those with few or no qualifications. The hope has been that an increase in the supply of people with qualifications

will increase the average level of skills in the workforce, which in turn will lead to an increase in the demand for skills. This approach has not worked (Lanning and Lawton 2012). Certain sectors of the UK economy appear to have settled into a low-skill, low-productivity equilibrium and firms in these sectors have not increased their demand for skills.

The problem, therefore, is not just how to further increase the supply of skills in the economy: it is how to encourage firms to increase their demand for skills. This will not be easy: across large parts of the economy, and particularly in areas such as retailing, hospitality and distribution and storage, there are many firms that rely on low-skilled staff on low wages to keep production costs down. The answer might be found by looking at the experience of European economies, such as Germany, the Netherlands and Denmark – there, many jobs that in the UK are regarded as low-skilled instead require a higher level of skills. Firms in these countries provide more training because they compete on quality, not on production at the lowest cost. Employer associations and unions work together, supported by state-backed finance, to create networks of support and to regulate training. The result is a much more highly trained and skilled workforce than exists in the UK.

Lanning and Lawton (ibid) argue that firms in the UK should have access to comparable networks, offering the kind of active and tailored business support that encourages more firms to adopt competitive strategies, which in turn support better job quality, including higher levels of training. To achieve this, they propose substantial reform and upgrading of sector skills councils as the best way forward within the UK's current institutional set-up.

### Local powers to match local responsibilities

The experience of other countries with markedly more highly skilled workforces than the UK also suggests that a more localised approach to skills policy delivers the best results. A skills policy designed to revitalise the regions would, therefore, include the devolution of a proportion – perhaps a significant proportion – of skills funding to local authorities and their partners in city-regions. These bodies would then be responsible for ensuring that there was no mismatch between skills supply and the demands of employers, which can only be done effectively at a local level.

More generally, if responsibility for revitalising the regions is going to be placed with local authorities, LEAs and other local bodies, they need to be given greater fiscal autonomy. Subnational agencies in the UK control just 12 per cent of their revenues, compared to an EU average figure of 40 per cent (NEFC 2012: 139). Aligning spending decisions about economic development with revenue-raising powers would create the right incentives: successful policies to boost growth would result in enhanced revenues and so more funds with which to boost future economic performance.

A successful industrial strategy to revitalise the UK's regions will also require increased investment in infrastructure and ensuring businesses have the funds they need to invest, innovate and expand. Both problems can be tackled by the creation of a British Investment Bank. This is the subject of the next chapter of this report.

The future prosperity of the UK depends on stronger economic performance in the regions. If the UK wishes to rebalance to an export and business investment-led model of growth, one that results in higher-productivity jobs being done by a better-skilled workforce, it must find a way of revitalising the regions. This is not a task that can be left to the private sector alone: it requires collaboration between government, the appropriate local institutions and the private sector in the form of an active industrial strategy.

## 5. BRITISH INVESTMENT BANK

### Key points

- Underinvestment in infrastructure and the financing problems facing small and medium-sized firms have held back the UK economy for many decades.
- Private commercial banks have proved unwilling to provide adequate funding in these areas.
- A British Investment Bank should be established with a specific remit to tackle these longstanding problems.

The British economy has been hampered in the past by many structural problems. Among them is the failure of the private financial system to provide adequate funds for investment in infrastructure or sufficient finance to small and medium-sized businesses. As part of an active industrial strategy, a British Investment Bank (BIB) could tackle these financing gaps.

The Coalition government has acknowledged the need for a substantial improvement in the UK's infrastructure. In its *National Infrastructure Plan* it says that although the UK compares favourably to other OECD countries in some areas, there are serious concerns: 'many power stations are ageing, road congestion is a growing concern, train punctuality in the UK is worse than in other parts of Europe and in the longer term there will be an airport capacity challenge in the South East of England' (HM Treasury 2011: 6). Business leaders agree. A survey conducted in 2011 found that half felt the UK's transport infrastructure had deteriorated over the preceding five years and two-fifths felt that the energy network had got worse (CBI and KPMG 2011). Britain's infrastructure was said to compare unfavourably with that of other EU countries, and this finding was supported by the World Economic Forum's latest global competitiveness index, which shows the UK ranking only 24th on quality of overall infrastructure – well behind France (fifth) and Germany (ninth) (WEF 2012: 359).

### The role of the British Investment Bank

A British Investment Bank would help to finance a major upgrading of the UK's infrastructure. It would do so by investing in 'marketable assets' – those that provide a stream of income in the future from which the BIB could be repaid. Possible examples include low-carbon, renewable energy generation, upgrades to the electricity grid, high-speed rail, toll roads and affordable housing.

The problem of inadequate bank financing for British small and medium-sized firms (SMEs) is a longstanding one. Indeed, it is often known as the 'Macmillan gap' after the head of a 1931 commission that identified the root cause of the problem as an 'information asymmetry'. This can be thought of as a kind of catch-22. In order to make loans, banks have to conduct due diligence on the companies that they might lend to. This is an expensive exercise, which means that they have to charge high fees and interest rates on loans. These fees and rates make the finance unaffordable to companies. To break this impasse, banks sidestep the due diligence process by lending only to companies that meet certain criteria. Some lending gets done under this regime, but many companies – especially start-ups – are excluded.

This problem was highlighted more recently in Don Cruickshank's report on competition in the UK banking industry (2000). He found that the concentration of bank lending to SMEs among a handful of large banks was detrimental to SME performance and called for an investigation into the existence of complex monopolies. Little has changed in the ensuing 13 years: retail banking in the UK is dominated by just five firms. The

introduction of ‘challenger banks’ is unlikely to make much difference. A BIB would, however, provide real competition for the large commercial banks.

SMEs financing problems are likely to get worse in the next few years. Bank of England figures<sup>32</sup> show that bank lending to SMEs has been falling since 2009, but there is a debate about whether this weakness is due to credit constraints imposed by the banks or a lack of appetite for borrowing among companies. In all probability both factors are at work. Business confidence is low, and worries about the economic outlook and the sluggish nature of the recovery must have had an effect on the demand for credit. But anecdotal evidence of tightened lending criteria on banks’ part is so rife that it seems clear supply is constrained as well.

However, once the economy starts to recover – and SMEs’ need for finance picks up with it – then credit availability is certain to become a chronic problem. New regulations, write-downs of their assets and recognition that their capital ratios were allowed to drop to unacceptably low levels in the 2000s together mean that banks will continue to be reluctant lenders so long as they are rebuilding their capital bases. Furthermore, the introduction of a new risk weighting system for bank assets under the Basel III regulations makes it even more likely that banks will not increase their exposure to the SME sector, because it will be subject to high risk premiums.

The BIB could fill the gap left by commercial banks and bring about a step-change in finance for British SMEs. In particular, a BIB could be a source of patient, long-term capital for SMEs. To the extent that they are still undertaking some lending, the BIB could also provide competition for commercial banks. The government is encouraging challenger banks to provide more competition in bank lending, but they are too small to break the effective oligopoly enjoyed by the major banks – an oligopoly that allows them to make substantial profits from lending.

### **Establishing the British Investment Bank**

Once the need for the BIB has been accepted and the broad parameters of its remit have been agreed – to lend for infrastructure projects and to SMEs – there are a number of hurdles to be cleared before it can become operational. These have already been discussed in some detail (see for example Dolphin and Nash 2012, Skidelsky et al 2011 and Tott 2012).

One is securing EU state aid approval. This would require the UK government to demonstrate that the BIB’s lending would be additional. Given the longstanding nature of the two problems that the BIB would be set up to solve, this should not ultimately be a problem, although BIS’s experience with the Green Investment Bank, which received state aid approval in October 2012, suggests it will not be a quick process.

More generally, the Green Investment Bank process shows that a UK government can set up, staff, capitalise and give a mandate to a new financial institution that has specific lending aims. There is no reason why the Green Investment Bank could not continue to operate alongside the new BIB. Alternatively, it could become a division of the larger BIB, or its operations could simply be folded into those of the BIB. There is no reason to fear that this would lead to fewer resources for green investment projects. The scale of the BIB would be many times larger than the Green Investment Bank and government ministers would be in a position to ensure that a proportion of the BIB’s lending was directed to ‘green infrastructure’.

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32 <http://www.bankofengland.co.uk/publications/Pages/other/monetary/trendsindelending.aspx>

The ownership, structure and governance of the BIB would also be important. The BIB should be 100 per cent state-owned but it would act as a fully commercial entity. It would be expected to make a profit, though not necessarily to maximise profits. The BIB should be governed by a board of governors that would include key government ministers and a number of outside appointments (approved by the Treasury or BIS select committees). A separate supervisory body would oversee the work of the BIB's executive board and be responsible for appointing its senior members. But there would be a clear dividing line to show where the input of government ends and the work of bankers begins. Government could legitimately set the broad parameters of the BIB's lending programme – for example, it could specify that a minimum proportion of lending for infrastructure should be designed to assist the UK's transition to a low-carbon economy, or it could require a particular regional allocation of funding to ensure the BIB was explicitly supporting efforts to revitalise the regions. But it would have no say in individual lending decisions: these would be the prerogative of the bankers alone.

### Raising capital

One set of crucial decisions would be about the financial scale of a BIB: how and to what level it was capitalised and whether it would be allowed to raise additional funds on the capital markets. If a BIB is to make a real difference to the UK economy then it would have to produce a step-change in finance both for infrastructure projects and for lending to small businesses. To do this, it would have to operate at scale. This calls for an initial capital injection of as much as £40 billion, spread over a number of years, which at a conservative leverage ratio of 2.5:1 would allow the bank to build a balance sheet of around £140 billion.

Various suggestions have been made as to where this initial capitalisation could come from, but the most transparent approach would be to use government funds. This is not without its problems; the OBR's latest projections<sup>33</sup> suggest that the earliest date at which the government's deficit is likely to be eliminated is 2017/18. However, there is a strong case to be made that government borrowing to capitalise a BIB that invests in the future growth of Britain is a legitimate reason for delaying deficit reduction. Putting aside the ludicrous comparisons between the UK and Greece that are used in some quarters to justify rapid deficit reduction, one of the main arguments of its supporters is that excessive borrowing now leaves future generations with an unreasonable debt interest burden. But to the extent that borrowing is used to capitalise a BIB that in turn lends in a manner likely to boost future growth and incomes, that argument falls away.

Alternatively, the government could look for new sources of tax revenues to capitalise a British Investment Bank and, since it is required to compensate for a failure of the banking industry, it is logical to look to finance to produce these revenues. One option would be to make the commercial banks pay a levy – although to the extent that this impedes the ability of banks to rebuild their capital bases, and thus makes it harder for businesses to borrow in the traditional fashion the money they need, it would be somewhat self-defeating. A better idea might be to bring in a financial transactions tax (see page 14) and to use some or all of the proceeds from it – at least in the initial years after it is introduced – to capitalise the BIB.

The BIB should also be allowed to raise additional capital in the financial markets by issuing bonds. Under current accounting rules, this would count as public sector borrowing and score against the government's efforts to put its debt on a downward

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33 <http://budgetresponsibility.independent.gov.uk/economic-and-fiscal-outlook-december-2012/>

trajectory. But there is a material difference between, on one hand, the government having to borrow because its current spending commitments are greater than the sums it is prepared to raise in taxes and, on the other hand, a BIB raising funds to use to finance infrastructure projects that will generate a stream of income in the future – money that can be used to repay the BIB with interest. This should be recognised by switching the focus of fiscal policy in the UK away from public sector measures and towards general government measures (see note 6), which would largely exclude the activities of a BIB. The majority of countries use general government measures of borrowing, which include central, state and local government but exclude public sector institutions. General government borrowing is also the standard measure of the fiscal stance used by international bodies such as the IMF, OECD and EU.

There are, then, many hurdles to be overcome before a BIB could be up and running, but these are not insurmountable – as the Coalition government has already demonstrated. In less than three years as business secretary Vince Cable has launched the Green Investment Bank and announced the establishment of a British Business Bank. Both are small in scale and will not provide the step-change in financing that the economy needs, but they show that it is possible for the government to set up new financial institutions. What is needed now is the vision to realise that a much bigger institution – a British Investment Bank – would make a real difference to the UK economy by enabling a substantial increase in the availability of finance for major infrastructure projects and for lending to small and medium-sized businesses.

## CONCLUSION

Adherence to the neoliberal economic model has created a triple crisis in the UK economy: one of stagnation, debt and imbalance. A new form of British capitalism is needed to tackle these crises simultaneously. Defining and implementing a new economic paradigm is, however, a major task. In this paper we have looked at only a few aspects of the British model that need to change: sound fiscal rules, a reformed tax system, and an active industrial strategy to revitalise Britain's export industries and regions.

Specifically, the government should:

- Introduce new fiscal rules that ensure real constraint on deficits and debt in the medium term, while allowing policy to be more responsive to the economic cycle in the short term.
- Instigate a review to identify the practical hurdles to the introduction of a land value tax and ways that they can be overcome.
- Follow the lead of 11 other EU countries that are moving forward to introduce a general financial transaction tax by extending the UK's existing tax on shares to include bonds and derivatives.
- Identify the UK's areas of existing and potential comparative advantage as well as areas where global demand is likely to grow relatively strongly over the next decade, and then adopt an active industrial strategy designed specifically to support the growth of firms in these areas.
- Devolve more powers from the centre to local groups, including local authorities and local enterprise partnerships, for skills and innovation policies.
- Set up a British Investment Bank, which could be capitalised using the revenues from a financial transactions tax, with a remit to bring about a step-change in the financing of infrastructure projects and lending to small and medium-sized businesses.

Rather than the government standing to one side and leaving the private sector on its own to cope with the problems of deindustrialisation created by globalisation and rapid technological change, Britain needs government to work in collaboration with industry. This relationship must be central to Britain's new economic model.

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## ANNEX 1

### LAND VALUE TAX

Without a firm estimate of the capital or rental value of all land in the UK, it is impossible to be specific about the likely parameters of a land value tax (LVT). The *2012 Property Data Report*<sup>34</sup> gives the following estimates for the capital value of UK property:

- Commercial property: £717 billion
- Other non-domestic buildings: £103 billion
- Residential: £4,224 billion

These figures, however, comprise the value of land and the buildings that sit on the land. They also exclude agricultural and vacant land (though the value of these will be small in relation to the other categories). The respective value of the land and building components will vary widely. For purely illustrative purposes, if the value of land accounts on average for one-half of the total value of land and buildings in the UK, this would probably amount to somewhere between £2.5 and £3 billion. An LVT tax set at 1 per cent of land capital values would, therefore, raise revenues of £25–30 billion. This compares with projected council tax receipts in 2012/13 of £26 billion (OBR 2012a).

In theory, as the amount of land available is fixed, people would not be willing to pay more for it after the introduction of an LVT. The present value of future LVT payments should, therefore, be reflected in a one-off fall in the value of land.

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34 [http://www.bpf.org.uk/en/files/reita\\_files/property\\_data/BPF\\_Property\\_Data\\_booklet\\_2012\\_v8\\_-\\_11790.pdf](http://www.bpf.org.uk/en/files/reita_files/property_data/BPF_Property_Data_booklet_2012_v8_-_11790.pdf)

## ANNEX 2

### FINANCIAL TRANSACTIONS TAX

It is often suggested that financial transaction taxes (FTTs) can only work if introduced globally, or at the very least at G20 level. However, this flies in the face of the empirical evidence showing that an array of FTTs already exist, ranging from the tiny levies on equities and futures in the US that raise \$1.1 billion a year to pay for the Securities and Exchange Commission to the numerous FTTs levied in Brazil raising \$15 billion annually.

Currently, more than 30 nations have implemented various forms of FTT. The IMF has produced a list of G20 nations levying FTTs<sup>35</sup> and many countries outside the G20 also levy such taxes.

**Table A1**  
Financial transaction  
taxes, international  
comparison

Country	Assets taxed and rates
Argentina	Equities, corporate and government bonds and futures (all 0.6%)
Australia	Equities (0.3%) and corporate bonds (0.6%)
Austria	Equities and corporate bonds (both 0.15%)
Belgium	Equities (0.17%) and corporate and government bonds (both 0.07%)
Brazil	Equity issued aboard (1.5%), bonds (1.5%), foreign exchange (0.38%) and capital inflows to equity and bond markets (2%)
Chile	Equities and corporate bonds (18% VAT applied)
China	Bonds (0.5% or 0.8%)
Finland	Equities (1.6%), real estate (4%) and shares in housing (1.6%)
France	Equities (0.2%)
Greece	Equities and corporate bonds (both 0.6%)
Hong Kong	Equities (0.3%)
Indonesia	Equities (0.1%)
India	Equities and corporate bonds (0.5%)
Ireland	Equities (1%)
Italy	Equities (0.12%) and derivatives (proposed, no rate yet set)
Malaysia	Equities (0.5%), corporate bonds (0.5%), government bonds (0.015%) and futures (0.0005%)
Morocco	Equities (0.14% plus 7% VAT), corporate bonds and government bonds (7% VAT on both)
Pakistan	Equities and corporate bonds (both 0.15%)
Peru	Equities, corporate bonds and government bonds (all 0.008% plus 18% VAT on trade costs)
Portugal	Equities (0.3%)
Russia	New equity and bond issues (both 0.2%)
Singapore	Equities (0.2%)
South Africa	Equities (0.25%)
South Korea	Equities and corporate bonds (both 0.3%); derivatives (proposed)
Switzerland	Equities, corporate and government bonds (all 0.15%)
Taiwan	Equities (0.3%), corporate bonds (0.1%) and futures (0.05%)
Turkey	Equities (0.2%) and bond issuance (0.6-0.75%)
UK	Equities (0.5%)
United States	Equities (0.0013%) and securities futures (flat fee of \$0.004)

When the 11-nation European FTT is introduced, the above list will expand to include Estonia, Germany, Slovakia, Slovenia and Spain.

It is also said that an FTT applied to derivative trades would be easily avoided. However, recent European legislation makes the taxation of derivative instruments far easier than in the past. First, MiFIR2 – the Markets in Infrastructure Regulation (which amends previous MiFID legislation) – will mandate that derivative transactions take place on registered exchanges, where they can be easily monitored and therefore taxed. Likewise, EMIR –

<sup>35</sup> <http://www.imf.org/external/pubs/ft/wp/2011/wp1154.pdf>

European Market Infrastructure Regulation – will ensure that from 1 July 2013 centralised reporting of credit and interest rate derivatives will be mandatory, to be extended to all other derivatives classes.<sup>36</sup> The rationale for EMIR and MiFID/MiFIR2, in part, was to facilitate an FTT.

There have been several estimates for the revenues resulting if the UK was to adopt a 0.1 per cent tax on shares and bonds, and a 0.01 per cent levy on derivatives (as per the European Commission’s proposals).

**Table A2**  
UK FTT, survey of estimates

	Shares revenue	Bonds revenue	Derivatives revenue	Total revenue
Ernst & Young (2012) <sup>A</sup>	€1.4bn	€7.4bn	€19bn	€27.8bn
IMF (2011) <sup>B</sup>	€3.411bn	€3.126bn	No estimate	€6.537bn plus unspecified derivatives revenue
Avinash Persaud (2012) <sup>C</sup>	No estimate	£8.4bn additional revenue across bonds and derivatives	£8.4bn additional revenue across bonds and derivatives	£8.4bn plus unspecified shares revenue

Sources: <sup>A</sup> [http://www.ey.com/Publication/vwLUAssets/ITEM\\_Club\\_Financial\\_Services\\_Winter\\_2011/12/\\$FILE/EY\\_ITEM\\_Financial\\_Services\\_Winter\\_2011/12.pdf](http://www.ey.com/Publication/vwLUAssets/ITEM_Club_Financial_Services_Winter_2011/12/$FILE/EY_ITEM_Financial_Services_Winter_2011/12.pdf); <sup>B</sup> [http://stampoutpoverty.org/wf\\_library\\_post/taxing-financial-transactions-issues-and-evidence/](http://stampoutpoverty.org/wf_library_post/taxing-financial-transactions-issues-and-evidence/); <sup>C</sup> [http://www.stampoutpoverty.org/wf\\_library\\_post/the-economic-consequences-of-the-eu-proposal-for-a-financial-transaction-tax/](http://www.stampoutpoverty.org/wf_library_post/the-economic-consequences-of-the-eu-proposal-for-a-financial-transaction-tax/)

The UK would also have the option open to it that the 11 European countries do not – taxing currency. This would produce significant annual revenue: £7.7 billion (according to the Institute for Development Studies) and, if currency derivatives are also included, £13.7 billion (according to Ernst & Young).<sup>37</sup>

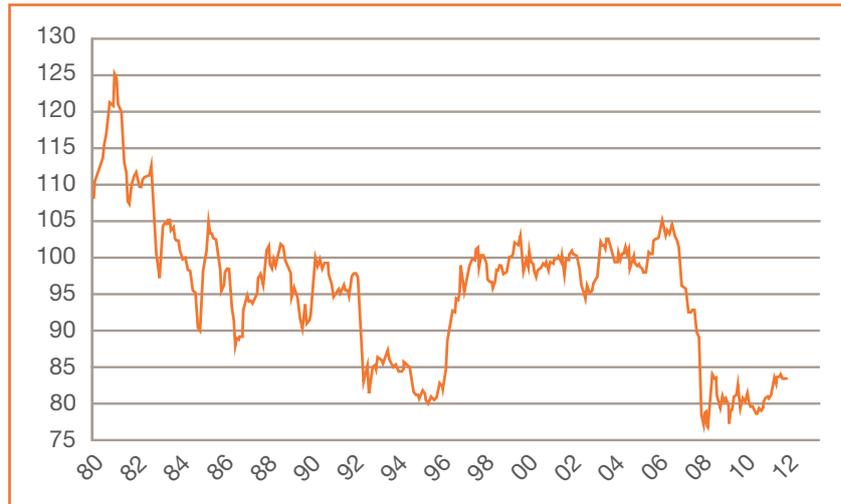
<sup>36</sup> [http://www.fsa.gov.uk/smallfirms/resources/one\\_minute\\_guides/eu\\_legislation/emir.shtml](http://www.fsa.gov.uk/smallfirms/resources/one_minute_guides/eu_legislation/emir.shtml)

<sup>37</sup> <http://www.ids.ac.uk/publication/is-a-financial-transaction-tax-a-good-idea-a-review-of-the-evidence>

## ANNEX 3

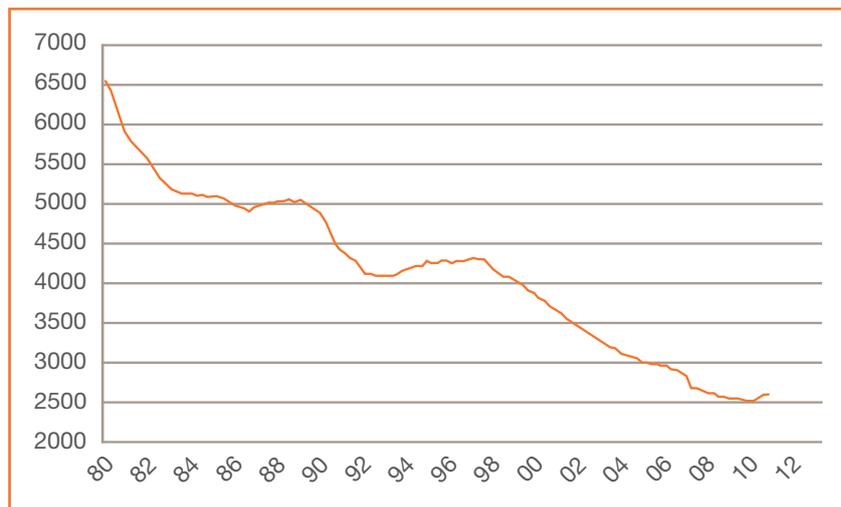
### TRENDS IN STERLING AND MANUFACTURING EMPLOYMENT

**Figure A1**  
Sterling effective  
exchange rate index,  
January 2005 = 100



Source: Bank of England: <http://www.bankofengland.co.uk/boeapps/iadb/Index.asp?first=yes&SectionRequired=!&HideNums=-1&ExtraInfo=true&Travel=NIx>

**Figure A2**  
UK workforce jobs in  
manufacturing, '000s



Source: ONS – Labour Force Survey: <http://www.ons.gov.uk/ons/rel/lms/labour-market-statistics/january-2013/statistical-bulletin.html>