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ideas for economic growth

Economic recovery after the lockdown

David Green

What should the Government do to encourage rapid economic recovery from the lockdown, while continuing its one-nation commitment to spreading prosperity throughout the land? The coronavirus crisis has highlighted some structural weaknesses in our economic life that can't easily be overcome, not least the pursuit of cheap consumer goods regardless of the consequences for national security and economic independence. Reforms will need to confront these weaknesses. There are twelve policy recommendations:

1. **Renewal of cities: localising investment power**
2. **Retention of existing enterprises and reshoring production**
3. **Enforce international rules of trade**
4. **Ensure the exchange rate is competitive**
5. **Establish an agency to appraise foreign direct investment (FDI) – while strengthening the takeover regime**
6. **Extend the role of the British Business Bank**
7. **Abolish corporate taxation**
8. **Energy policy: carbon reduction or job creation?**
9. **Making companies committed citizens: company law and commitment**
10. **Increase defence spending**
11. **Link aid to trade**
12. **Create enterprise corporations**

1. Renewal of cities: localising investment power

Rebuilding productive capacity in towns such as Hartlepool, Middlesbrough, Sunderland and Newcastle upon Tyne cannot be achieved solely by allocating public funds from a central budget. A significant challenge during the lockdown has been inaccessible banking and investment systems. The primary objective should be to empower people who live locally to solve their own problems by restoring investment power to localities. We recommend that each area should have its own deposit-taking bank that can only lend locally, as described below. In addition, in order to encourage closer ties between councils and local businesses, and to promote civic enterprise, we recommend that councils be given the power to appoint local senators who can take part in decision making but without the power to vote (which should be confined to elected representatives).

German local savings banks (Sparkassen) hold about one-third of bank assets and about 40% of all customer deposits. They provide about 40% of all business loans, and their market share of business start-up loans is 56%. Sparkassen typically operate within the boundaries of a local council and can't lend outside. During the 2008 recession, German savings banks increased loans to business while the large commercial banks cut them. The significance of local relationship banks is that they put economic power into the hands of people in localities. People with energy, entrepreneurship and determination have the power to make a difference.

Losses are relatively low because customers are known by reputation. How is political corruption avoided? Sparkassen are legally required to act

according to sound business principles, but there is also central control. Loans are monitored by the national association, whose officials try to protect the Sparkassen brand. The USA also has numerous local banks that operate on similar lines to the Sparkassen, often confined to a federal state.

What would be the potential impact of local banking? Consider how it might affect an area like Tyneside. The average amount held in savings deposits by UK households is £42,000. On Tyneside there are about 400,000 households, and if 20% chose to deposit in a savings banks, that would add up to well over £4 billion, which could transform job prospects in the area. And it would not involve transferring funds from elsewhere in the UK. The people of Tyneside would have the institutions at their disposal to change their own life chances with their own money. At present they have no choice but to save with international banks who extract money from their region.

There are ambitious plans to establish regional mutual banks in three areas and they should be encouraged. Plans for the South West Mutual, the Avon Mutual and the Greater London Mutual Bank are well advanced. However, the proposed mutual banks are being expected to find about £20m, a big chunk of which must be Tier 1 capital. This challenge could be made easier if eligibility for the Enterprise Investment Scheme and Seed Enterprise Investment Scheme was changed. At present banks are excluded and the mutuals have proposed a change to the legislation along the following lines. Current law excludes 'financial activities such as banking, insurance, money-lending, debt-factoring, hire-purchase financing or any other financial activities'. The mutuals propose this amendment:

> *'financial activities such as banking, insurance, money-lending, debt-factoring, hire-purchase financing or any other financial activities unless operated by a co-operative with an intended purpose, written into the constitution of the company, to be a licenced deposit-taker serving a defined region of the UK with a population of no greater than 10 million people.'*

Another possibility is for the British Business Bank to establish a subsidiary. It already has two subsidiary companies, British Patient Capital and British Business Investments. It would be very easy to establish 'British Mutuals' to supply Tier 1 capital to partner mutuals.

2. Retention of existing enterprises and reshoring production

If we want everyone to share in prosperity, we need industries that add value and pay good wages. There will inevitably be occasions when a company, even a whole industry, is not viable, but when a company is struggling we should ask first whether it is because of its own failings or because government policies have made matters worse and they alone tip the competitive balance. For example, energy policy has put energy-intensive sectors, including steel, ceramics and chemicals, at a disadvantage. The Government has put the steel industry in a weak position not only by imposing costs but by failing to enforce the rules of international trade. The same can be said about aluminium. Climate-change policies have already destroyed a thriving aluminium industry in England (a factory remains in Scotland because of nearby hydro-electric power). Until recently, we exported aluminium. Now we depend on imports. It will also be clear to many that we went headfirst into the Covid-19 crisis without a large-scale domestic protective equipment and medical device manufacturing industry to draw on.

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The second question to ask is whether the industry is retainable. If there are economies of scale and high start-up costs, markets entrench the position of existing producers and deter rivals. Consequently, the competitive advantage of some producers is not the result of being the most efficient producer but of having started early. When these conditions apply, industries are capable of succeeding in many locations. The list includes automobiles and steel.

In such cases, public policies should examine whether or not an industry is 'retainable'. It may or may not be 'high value' but if it is profitable and retainable it is worth keeping. If an industry is 'retainable' but not currently located in the UK it is worth substantial investment to establish it in order to gain the advantages of high-entry barriers and economies of scale.

3. Enforce international rules of trade

When we resume membership of the World Trade Organisation (WTO) in our own right, we should make full use of our powers to uphold competition. The most urgent issue is not only evaluating China's role in the global trading regime after the Covid-19 crisis but how to respond to hidden subsidisation and dumping by Chinese companies.

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Some have argued that we should lower tariffs unilaterally, but this approach fails to take into account the extent of subsidisation and dumping by other countries. Lowering UK tariffs to zero will mean having to accept world prices when they are not market prices. Companies competing as independent producers will, therefore, be at a permanent disadvantage, which they can't overcome however efficient they are. We need a strategy that recognises the competitive conditions that we actually face; and one that avoids assuming that utopian economic theories are accurate descriptions of reality. As it happens, the basic WTO rules are wisely framed to discourage aggressive trade wars, as discussed below.

The Government has said that it favours a rules-based international trading order. We recommend that the Government should emulate the USA and make full use of our WTO powers. America, for example, makes constant use of its rights to retaliate against foreign subsidies and dumping. It recently added tariffs adding up to over 500% to Chinese cold-rolled steel, the kind used in car manufacture, with the full approval of the WTO. Most recently America has imposed tariffs on EU members in retaliation for Airbus subsidies, again under WTO rules. If we do not use the powers permitted by WTO rules, we will effectively uphold Chinese protectionism and allow concealed subsidisation to prevail over genuine competition.

At present laissez-faire economists argue that sectors such as steel are dominated by selfish protectionists who want to impose high prices on the many other consumers for the benefit of the few. The Adam Smith Institute has argued: 'If we bail out industries that are unprofitable in the long term, we're locking capital and labour into unproductive work. If you bail out these firms, where do you stop? Basically, you'd have given up on capitalism.' But industries such as steel are not calling for protection from the results of their own inefficiency. They are calling for action against overseas protection.

If the aim is to encourage labour and capital to find their most productive outlet, is that happening in China? The WTO has accepted that China sells overseas at below the cost of production, something it can do because its companies are largely state owned, and its banks are state dominated. Moreover, there is no free bargaining for wages. This is not a fair fight to discover who is the most efficient producer of steel. It is a geo-political strategy for economic domination. As soon as Britain's steel industry has disappeared, the price will go back up again and major steel consumers like the construction industry and car manufacturers will have no escape from higher international prices.

The current approach is the moral equivalent of doing nothing about athletes who take performance-enhancing drugs, thereby allowing them to defeat honest competitors. The Government is rigorous in its support for drug-free athletics because it does not want drug cheats to win all the medals. The rules of international trade raise similar questions.

4. Ensure the exchange rate is competitive

The exchange rate has been ignored for decades, but an over-valued currency can wipe out all the efforts of our companies to reduce prices by improving their efficiency. The eurozone is our biggest export market and the European Central Bank is currently manipulating its exchange rate downwards at our expense. We have a large trade deficit with the EU and we are entitled to ensure that the exchange rate stays low to restore balance. The IMF has regularly reported for several years that the pound is over-valued, which not only puts exporters at a disadvantage but weakens home producers who face import competition.

To boost our economic competitiveness after lockdown, one approach would be to widen the goals of monetary policy. The American equivalent of our Monetary Policy Committee is charged with maximising employment as well as keeping inflation within certain bounds. One approach would be to declare three overlapping policy

goals: low inflation, maximum employment consistent with low inflation, and to prevent the exchange rate from being over-valued according to independent measures such as the Real Effective Exchange Rate (REER) published by the World Bank. Each goal is intimately related to the others, but the balanced pursuit of all three would be more consistent with the inclusive raising of prosperity than inflation targeting alone.

Once the exchange rate is competitive, the national challenge will be how to encourage business investment aimed at either increasing exports or producing goods at home that are currently imported. We should avoid repeating mistakes made after 2008, when the pound fell in value. It did not lead to a surge in exports or import substitution chiefly because businesses expected the pound to rise in a year or two. As a result, they did not invest. The Government could do what America has always done and offer generous support for exporters. And to reassure companies that invest in either exports or in home production, it should introduce a currency hedging service to guarantee that they will not lose if the pound rises during the lifecycle of their investment.

But we should not focus on exports alone. It is much easier for existing firms to increase output for the home market. The Government already has a supply-chain initiative for the car industry that encourages businesses to manufacture vehicle components in the UK. It has had considerable success and the low exchange rate will give it a boost. There are strong environmental reasons for reducing the transportation of raw materials and parts within a supply chain. Home production would reduce carbon emissions and create jobs.

It is fundamental that there are competitive advantages that the government alone can create. To succeed in world markets, companies need competitive advantages. Some are the result of their own inventiveness and ingenuity, but many are created by the government and, vitally, can only be created by the government. The doctrine of non-interventionism should not be allowed to prevent the government from performing those duties that it alone can carry out. The most obvious are an honest civil service, independent courts, and accountable, democratic government, but also vital are low-cost energy, low taxes, sound money, and a stable and competitive exchange rate.

5. Establish an agency to appraise foreign direct investment (FDI) – while strengthening the takeover regime

The Covid-19 crisis has generated a growing public and parliamentary scepticism about Chinese business investment and asset-stripping of UK firms. Foreign Directive Investment (FDI) is considered a good thing, and the official statistics distinguish between portfolio investment and FDI, which is defined as a holding large enough to give some control of management. However, a holding of only 10% is assumed to grant control, when it may be no more than a large portfolio stake. Moreover, some FDI is no more than a takeover of an existing company, which adds little or nothing to our economic prospects. We should aim to ensure that inward investment adds to our productive capacity. Mrs Thatcher was well aware of this distinction and supported the Invest in Britain Bureau, which promoted the kind of FDI that added to our total potential output. Japanese companies of that era, for example, brought management know-how and good industrial relations as well as money. Nissan famously revived volume car production in the UK.

Some investors are intent on extracting what they can and will usually have an exit strategy before they buy. Even the IMF, which has promoted free movement for capital for decades, is having second thoughts. Senior economists at the IMF have recently called for capital controls based on a distinction between 'hot money' and productive capital investment. If we examine countries that have successfully attracted beneficial FDI we do not need to look further afield than Ireland. For many years their Industrial Development Agency attracted inward investment that added to productive capacity. Essentially, this agency has differentiated between the private investments it wanted and those it preferred to do without.

Three economists at the IMF have recently called for a more nuanced view of what economic policy can achieve and they argue for institutions like the IMF to 'be guided not by faith, but by evidence of what has worked'. Jonathan Ostry, deputy director of the IMF's research department and the article's lead author, voiced concern about two main components of economic orthodoxy: removing restrictions on capital flows across borders; and reducing fiscal deficits and national debt. These policies had not produced growth in several countries.

Economic orthodoxy assumes that free movement of capital is always economically beneficial. When FDI leads to transfers of

technology and know-how it may well benefit the recipient economy, but the movement of 'hot money' in and out of an economy in quick succession has been harmful. The IMF authors favour capital controls. The orthodox assumption has been that free movement of capital allows money to find its most productive outlets. But some investors are not looking for productive outlets; instead they want returns unencumbered by commitment. The Government should scrutinise FDI to ensure that it is beneficial, as the Invest in Britain Bureau did, and as Ireland's Industrial Development Agency continues to do.

The takeover regime should also be strengthened. Mergers and acquisitions are not necessarily beneficial. For example, a good case can be made for preventing foreign investment when a foreign company plans to take over a domestic rival, close it down, and thereby reduce competition. There have been beneficial foreign takeovers in recent years. The takeover of Jaguar Land Rover by Tata, for example, was followed by significant new investment in the company. In other cases, the motive of investors was to weaken competition from a British rival or to strengthen monopoly. For example, the French company Alstom took over Metro-Cammell in 1989, but after it had completed its main contract, the factory was closed in 2005 and manufacturing transferred to France.

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Some critics say that the 'national interest' is 'completely indefinable' and fear that the government is about to adopt 'nativist protectionism'. But the issue is not about nationality as such. Proposed foreign takeovers should all be referred to a competition regulator to ensure that the outcome will not reduce worldwide competition. Until the 2002 Enterprise Act the Secretary of State could intervene to prevent actions detrimental to the interests of consumers. This general 'public interest' test should never have been abolished and should be reinstated.

As guardian of our own national interest and the international community's public interest, parliament is entitled to ask whether or not specific investments are likely to increase or reduce competition. And it is entitled to ask whether sectors should be declared of strategic importance and protected from foreign takeover. A National Security and Investment Bill was included in the Queen's speech of December 2019 but its proposals need to be enhanced. We should be especially wary of allowing foreign governments to buy companies. Our ability to defend freedom and democracy throughout the world could be compromised, a danger that applies especially to takeovers by authoritarian regimes such as China.

6. Extend the role of the British Business Bank

It is notable that the Coronavirus Business Interruption Loan Schemes, managed by the British Business Bank, were designed to support UK businesses whose revenues were interrupted by the lockdown. The British Business Bank has been operating since 2014 but its role is limited and should be extended. It operates through intermediaries and does not lend directly to businesses. It would be more effective if it were permitted to invest directly in private enterprise. The usual model for an industry bank is the Industrial and Commercial Finance Corporation (ICFC), which was founded by the Bank of England and the major British banks in 1945 to provide long-term investment for small and medium-sized enterprises. During the 1950s and 1960s it became the largest provider of capital for unquoted companies in the United Kingdom. We urgently need a similar bank today.

Regular criticism of 'selective assistance' or 'picking winners' should not mask the requirement for government to create the conditions for discovery. From 2012, the Government adopted a 'modern industrial policy' and backed eleven sectors and eight technologies. They were wisely chosen, but it is very important that industrial strategy should not proceed as if decision makers can pick winners or foresee all future developments. Room must always be left for the unexpected. The market is above all a process whereby we discover what we do not already know. It is not obvious in advance who will have the new ideas that become popular, or who will discover how to cut costs or raise standards. A primary task of government, therefore, is to create the fertile soil in which unanticipated discoveries can grow.

7. Abolish corporate taxation

Corporation tax is already being lowered, but we should consider its complete abolition. It is a tax on company profits and globalization has meant that it is a simple task to understate income, exaggerate expenses, and relocate profits to tax havens. Our Government is now engaged in a war with international businesses to force them to pay tax where they earn their profits. But it involves a vast expense in civil servants who check and supervise companies and fight a constant war against international firms of accountants. Abolishing the taxation of profits would also create equality between international corporations and British-based businesses that can't hide their profits overseas. Taxing profits is a bad idea anyway. It is far better to allow companies to retain profits for reinvestment. Of course, when companies pay dividends then they are taxed as individual income and if individuals make capital gains they too are taxed. But if companies retain their earnings to develop new products or improve their performance, it is right that no tax should be paid.

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There will no doubt be objections from overseas governments if corporation tax is abolished completely, entailing drawn out discussions at the OECD and the G20. In the meantime, corporation tax should be cut to 10% or less.

The time has also come to abolish capital allowances. From 1984 capital expenditure was treated less favourably than other business costs. Until that year 100 per cent of investment in plant and machinery was a business expense that could be deducted from taxable profits, but it was replaced by a 25 per cent per year deduction on the declining-balance. Since then, the system has been subject to frequent revisions. From 2016 to 2018 the annual allowance was £200,000. At that time a company investing, say, £500,000 could treat £200,000 as a business expense in year one, and the remaining £300,000 went into a pool from which 18% could be deducted as a business expense in each successive year. The effect was to discourage capital investment, which should be treated like any other business cost. No doubt in recognition of this problem the Government temporarily increased the annual allowance to £1,000,000 from January 2019 until December 2020.

8. Energy policy: carbon reduction or job creation?

A serious challenge in creating favourable conditions for enterprise is to recognise that policy since 2008 has made matters worse. Carbon reduction often destroys jobs and a wealth-creation strategy will have to choose between jobs and carbon reduction. After the 2008 Climate Change Act, the Government's climate-change policies have added to the cost of electricity and destroyed thousands of high-paid jobs. Between 2010 and 2015, two aluminium smelters closed because of the Government's energy policy. The closure of the Lynemouth aluminium smelter led to over 300 lost jobs in the North East, plus an estimated 3,500 more in the supply chain.

Policies intended to combat climate change are undermining the competitiveness of our companies by increasing the cost of electricity relative to our main rivals, and threatening the existence of Britain's energy-intensive sectors, including the steel, glass, paper, chemical and ceramics industries. Together they employ 225,000 people. In the case of the chemicals industry, we are in danger of driving overseas an industry that makes products, such as insulating materials, that are essential to energy conservation.

Worse still, the unilateral imposition of higher energy costs is a silent killer of enterprise. Fearing higher costs in the future, companies stop investing in Britain. Major closures are reported by the media but decisions to invest overseas instead of in Britain are largely hidden from view. We experience the results later in lost growth and lost jobs.

The steel industry has suffered closures and job losses because of the cost of energy, among other things, and remains under threat. It is true that Germany, our main European rival, has also adopted a costly energy policy but it compensates its industries so that German steel producers pay about half as much for electricity as British companies. There is a compensation scheme in the UK, but it is too small and leaves our manufacturers at a competitive disadvantage.

The strategy since the 2008 Climate Change Act has been to give carbon reduction priority over jobs. No such policy has ever been explicitly stated, but it is the real policy. Climate campaigners should be required to explain the true impact of their

measures. We have to choose between middle-class faddism and inclusive prosperity. Climate-change policies have not reduced world emissions but transferred them to other countries.

Two main policies could be adopted immediately: encourage fracking; and develop nuclear power by building small modular reactors (SMRs). There will be many occasions when job creation clashes with carbon reduction and, when such conflicts arise, policy makers should adopt a simple tie-breaker rule. Priority should always be given to inclusive prosperity: that is, existing jobs should be retained, and new ones encouraged. This would not mean abandoning carbon reduction altogether, but it does mean we should not be callous towards people who lose their jobs.

9. Making companies committed citizens: company law and commitment

A free society is a political achievement that requires constant support from its citizens. This allegiance must involve more than minimal obeying of the law. Companies too should act like citizens. If international corporations conduct themselves as if they have no commitment to the free and democratic institutions of the nations in which they are based, freedom will be undermined, perhaps fatally. There is more at stake than the efficient use of capital.

It is possible that modern arms-length shareholding has become dysfunctional. Shareholders now have only a superficial link with the companies they nominally own. As Martin Wolf, chief economics commentator at the *Financial Times*, has argued, the 'core institution of contemporary capitalism' the limited liability shareholder corporation has 'inherent failings', the most important of which is that companies are not effectively owned. As a result, they are vulnerable to 'looting' by executives. Shareholder control, he said, was often an illusion and maximisation of shareholder value 'a snare'. Remuneration schemes reward increases in share value, ostensibly to align their interests with those of shareholders, but executives have found ways of inflating share prices without adding to real productive capacity. This kind of problem can't be solved easily, but it would be worthwhile reviewing company law to increase genuine proprietorship, as discussed below.

No one doubts the commitment of America to a market economy and that is perhaps why its company law (which varies from state to state) allows companies a variety of devices to make corporations more closely resemble an individual with a strong sense of personal responsibility. For example, when some private companies decide to go public, they issue A and B shares, with one class typically having ten times more votes than the other. This allows founders, executives or other large stakeholders who are the custodians of the ideals of the company to prevent hostile takeovers by companies who may be asset strippers or monopolists intent on buying and then closing down their rivals. When Google went public in 2004, it issued a second class of shares to ensure that the firm's founders could keep control. Class B shares had 10 votes, while ordinary A shares had just one. In most cases, enhanced voting shares are not publicly traded. Ford also has two share classes to allow the Ford family to control 40% of the votes with only about 4% of the total equity. Berkshire Hathaway, led by Warren Buffett, also has shares with different voting power.

Companies can also use 'poison pill' strategies to discourage hostile takeovers. A 'flip-in' allows existing shareholders to buy more shares at a discount when a bidder reaches a trigger point, such as owning 20% of the shares. By purchasing more shares at below the market price the long-standing shareholders are rewarded for their loyalty and simultaneously dilute the shares held by the acquirer.

Companies often register in states that frown on takeovers, which explains why Delaware is a popular choice. Its courts have supported 'poison pill' defences so long as boards act in keeping with their fiduciary duties. The top Delaware court commented in one leading case that some shareholders were arbitrageurs who would have taken the offer price regardless of the long-term value of the company. Because they had no genuine commitment to the company, the court refused to support their ambitions.

10. Increase defence spending

We should signal to the world that we are committed to full international engagement by increasing defence spending to well above two per cent of GDP. The world has become more dangerous recently and we should play our part in resisting the new threats. As an essential part of this strategy we should increase our defence-industrial capacity. It would make us both safer and generate high-skill, well-paid jobs. Above all the Government should invest in shipbuilding, aerospace and space technologies.

11. Link aid to trade

In international development, we should keep the commitment to spend 0.7% of GDP on overseas aid but link all development assistance (not to be confused with emergency aid) to trade with Britain. In many parts of the world we could act as a friendly alternative to the neo-colonialism of China. We should offer aid that is mutually beneficial, and not merely a one-sided economic exploitation of the third world's natural resources.

12. Create enterprise corporations

The Government provided considerable support for businesses affected by the lockdown, but some argued that companies that made use of tax havens should not be eligible. Rather than penalise companies that have taken advantage of tax havens, it would be more effective to encourage a new kind of enterprise that is UK-based and invests its profits locally.

For most of the post-war period American companies have been able to register with the tax authorities as a 'C' corporation or an 'S' corporation. A 'C' corporation pays corporation tax, but an 'S' corporation does not. All profits and losses 'pass through' to the shareholders who must not exceed 100. If shareholders take profits in the form of dividends, then ordinary income tax is due. This provides an incentive to keep profits invested in the company.

The UK Government could establish a new corporate structure – an enterprise company. Such companies must be headquartered in the UK and would not be liable for corporation tax so long as profits were retained in the business as reserves or reinvested in the production of goods and services. Without corporation tax there would be no need for capital allowances. However, enterprise companies should still be eligible for research and development tax credits. Profits could only be distributed as dividends, in which case recipients would be liable for income tax as individuals. The use of tax havens would be prohibited and companies must be involved in producing goods and services. No organisation that bought and sold shares, commodities, currencies, property, or anything else merely to make money from the transaction would be eligible. Shareholders must all be individuals. No other corporation could hold shares in an enterprise company. Finally, as Hayek proposed, all shareholders should have an annual opportunity to decide whether their personal share of the profit is ploughed back or taken as income. This would not be a majority decision. It would be a personal choice exercised by each shareholder. Knowing that they could take their share of the profits out would encourage individuals to invest. And it would incentivise managers to come up with better ideas for investment than buying back the company's own shares.

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