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Economic Growth – Could the Government do more?

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Chancellor of the Exchequer, George Osborne, told the Conservative Spring Forum that his March Budget would be 'unashamedly pro-growth'. Here we make eleven policy recommendations that would be consistent with that aim. The first four would have an immediate impact and enjoy wide support but have been neglected so far.

Reduce company taxation

Corporate taxes are high compared with many of our rivals: Britain imposes the 13th highest tax rate in the OECD. The Government has announced the headline rate of 28% will be reduced to 24% but this reduction is too small to provide a real boost to growth. We should aim for a rate closer to the Republic of Ireland's 12.5%, which has allowed it to attract many potential investors away from the UK.

To a considerable extent international companies are able to choose in which country they pay corporation taxes. In 2008 it was estimated that £8.5bn was lost this way, often to offshore low-tax regimes. We should unashamedly make the UK the tax regime of choice. There is an international competition for the location of big-name companies and it is better to attract them by creating conditions favourable to all enterprise, rather than through selective assistance.

A headline rate of about 15% would be feasible. Within a short period it is likely that income from corporation tax would increase, more than making up for any temporary reduction that might initially result from lowering rates.

Capital allowances also need reform. The current proposal to reduce capital allowances claws back two-thirds of the cost of lowering the corporation tax rate. The plan is to reduce the main recovery rate from 20% to 18% from April 2012. Furthermore, the annual investment allowance is to fall from £100,000 to £25,000. If we are to increase exports and reduce manufactured imports, we need our companies to invest in plant and machinery. Reducing capital allowances penalises the very companies whose help we need most.

Eliminate unnecessary workplace regulations

The need for less regulation is widely accepted and the Government has already announced a 'one in one out' policy. On the surface this sounds like a good idea but the practical reality is very different. There are still out-dated regulations, some imposed in the 18th and 19th centuries. If they were replaced by new regulations, it would not cut red tape but merely substitute obsolete regulations that make no practical difference with new obstructions.

Unnecessary workplace regulations increase unemployment. Employers are generally more willing to take on extra staff if it is easy to dismiss them when necessary. The ideal would be to apply a moratorium to all new business regulations and abolish employment tribunals and all related laws. In the short run we could limit the application of regulations to companies with 50 or more employees. Or, we could place a cash limit of £5,000 on all unfair dismissal and discrimination compensation awards; exclude avaricious 'no win no fee' lawyers by transforming employment tribunals into mediation procedures; and require dissatisfied employees to make a small deposit of about £30 to reduce vexatious complaints. Instead, the Government imposed new sections of the Equality Act in October, significantly adding to the burden on employers and endangering jobs.

Reduce the cost of energy

A golden rule of policy is not to make matters worse. However, some climate-change policies are undermining the competitiveness of our companies by increasing the cost of energy relative to our main rivals. These policies are making some of our industries marginal. In one case, chemicals, we may drive overseas an industry that makes products that are essential to a low-carbon future.[1] This is despite the Government having singled the chemicals industry out for special attention in the *Growth Review* of November 2010. A policy that obstructs growth, increases unemployment and is also self-defeating is in urgent need of review.

The danger could be avoided by restricting all climate-related measures to those that are consistent with keeping the UK in the top three most competitively priced energy markets in the EU and the G20. This policy does not necessarily mean taking sides on the climate-change controversy. We could just slow down the rate of policy change so that we do not increase energy costs faster than our main rivals and commit economic suicide in the process.

In addition, it would make sense to build the cheapest possible power stations based on the current state of technology. That would mean nuclear, gas and one more generation of coal-powered stations without carbon capture. The UK's contribution to global emissions is about 2% and so our efforts are best spent producing and exporting emission-reducing products to help lower the other 98 per cent of emissions.

Cut personal taxes to make it easy to start new businesses

Mr Cameron recently said that for many who aspire to start a business there was one simple problem - 'they just don't have the money'. The government will help by providing up to £2,000 through the new enterprise allowance. But the scheme is only for people who are unemployed and will be of no use to the vast majority of potential entrepreneurs. 88% of start-up funding comes from personal savings or loans from friends and family; only 12% is from banks. People 'just don't have the money' because of high taxation, which is why our business start-up rate is half that of America. The best way to create a new generation of entrepreneurs would be to cut personal taxes, starting with the 50% rate.

Moreover, plans for higher capital gains tax (CGT) make no distinction between capital gains from short-term speculation and those that result from productive businesses. If an enterprise economy based on saving and investment is the aim, we should stop taxing gains that are the legitimate result of risky investments. People who have put their own money into productive ventures are public benefactors and taper relief is the tried and tested method of distinguishing between speculators and genuine investors. Its credibility was undermined by Labour's policy of permitting tax breaks after investments had been held for a mere two years. After about eight years we can safely say that investors are not pure speculators and a reasonable approach would be to reduce capital gains tax on productive assets held for eight years and cut the rate to zero after ten years.

Export-led growth

Most nations hope for export-led growth. But we can't expect to increase our exports without a strong focus on manufacturing. Even at its maximum output in 2008, the financial services sector generated exports of £52.8bn, while British manufacturing achieved £194.2 bn.[2]

Exporting is risky and beyond the means of many companies.[3] The UK Government already provides some guarantees for exporters but our main rivals are far more supportive. We should aim to match the best overseas support regimes such as Germany.

It is generally accepted that the Government should be actively campaigning abroad on behalf of British companies. UK Trade and Investment (UKTI) was established to fulfil this role but has just had its funding cut by 25% when most foreign governments are backing their industries more than ever. In addition, UKTI's services used to be free but are now chargeable, putting some businesses, especially SMEs, off using them. Moreover, UKTI should help all businesses, not just high-tech companies. Low and medium tech companies account for 32% of UK manufacturing exports.[4]

Intelligent procurement

Procurement is already being reformed by the Government. David Cameron has announced that he wants at least 25% of government business to go to SMEs. Paradoxical regulations such as allowing only companies who have already supplied the Government to apply for certain tenders are widespread. While SMEs constitute 50% of the British economy, they only win 5%-10% of government tenders.[5] With an annual procurement budget of £191bn, there is huge potential to seed the growth of many more businesses.

A strategy for import substitution

The current trade in goods deficit is a huge -£97.2bn, a record high. The gap could be narrowed by increasing exports but it is far easier to reduce imports. Many goods, not just finished consumer goods but also the semi-manufactured goods required to build British products are imported when they could be made here.

In a forthcoming Civitas report, the distinguished entrepreneur Alan Reece argues that the Government should examine each sector of the economy to determine whether or not its own activities are putting companies at a disadvantage when competing with foreign rivals.[6] In the cement industry for example, Britain was a net exporter until high energy costs began to push production overseas. Now, cement has a trade deficit of -£87m in 2009 and firms are building importation docks in the UK rather than new kilns.

There is a significant import substitution market within supply chains. Many goods finished in the UK are made using components sourced from other countries. However, as increasing numbers of British companies are finding out, producing these commodities domestically can be advantageous. Some companies have found Chinese goods and services to be unsatisfactory and have resumed production in the UK.

Short-termism and bank reform

Short-termism has been a longstanding criticism. In the mid-1960s, the average holding time for investments was five years; by the 1980s, it was two years and in 2007, only 7½ months.[7]

Some companies are already committed to long-term development. Unilever, under the helm of Executive Director Paul Polman, is an upstanding example but still very much the exception. He recently said: 'we are moving our business model to the longer term. I tell our investors, if you don't like that, to be honest, then I fully respect you but look at other alternatives that might be better suited to your needs.'[8]

Two institutional changes would help. First, an Industrial Bank could be born out of the newly created Green Investment Bank, or by amalgamating the myriad of funds available for businesses into a single body.[9] The direct impact of the Industrial Bank, designed solely to inject funds into industry and live off the returns would be highly beneficial, but so would its indirect effect. Its very existence as competition for the commercial banks would force them to involve themselves in offering longer-term lending to retain their customers.

Second, the short-term culture might be endemic to the UK, but it is not a prerequisite of capitalism. Germany has managed to avoid it through local savings banks that account for 34% of German bank assets and increased their lending to small businesses during the financial crisis.[10] Cantonal banks in Switzerland have performed a similar role. Knowing their customers intimately, the local banks are a model for mutually beneficial lending.

An unbalanced focus on 'Advanced Manufacturing'

Current Government plans to 'rebalance the economy' suggest that Britain should support advanced manufacturing more than at present. The term 'advanced' is often and confusingly used interchangeably with 'high-tech'. Ministers appear to have assumed that the British industrial competitive advantage is based in research and development (R&D) centred activities. There are three problems with this argument.

First, it ignores the 86% of British manufacturing which is not high-tech. Low-tech does not mean low value. Second, it ignores the fact that sectors do not exist in isolation. And third, it ignores the reality that R&D is not synonymous with innovation, which is a key source of competitive advantage. The result is an unbalanced strategy that will hinder the economy more than it will help.

High-tech/advanced manufacturing as the Government understands it is defined by the OECD as spending over 5% of turnover on R&D. The case for supporting it was made last year in the Dyson Report, but neither this report nor any Government speeches since have made any mention of support for the low and medium-tech businesses that make up the majority of UK manufacturing. In 2007, high-tech companies employed just 12% of all workers involved in manufacturing and contributed only 14% of the total manufacturing output. Given the size of the British non-high-tech industries, Nick Clegg, the Deputy Prime Minister, was wrong to suggest 'a new economy might be able to rise, Phoenix-like, from the ashes of the old'. We are not starting again from scratch but should be building on what we already have.

The manufacturing Growth Review has identified seven 'successful UK Advanced Manufacturing sectors'. Each of these is important on its own, but the economy cannot be built on them alone. Nor indeed can these industries actually survive without wider British manufacturing providing equipment and components. We need to encourage all kinds of manufacturing, not just specific types that have come to the Government's attention.

The rescinding of the loan to Sheffield Forgemasters was a huge error. Not only would it have allowed the firm to produce nuclear reactor casings, breaking Japan's monopoly, it would also have acted as a foundation for a British nuclear industry at a time when demand for it is rising.

Having a domestic supplier would have been a huge boon to the associated R&D sectors and fledgling industries.

Manufacturing sectors need to be taken as a whole – the end company is only as strong as its supply chain and over focusing support on finishing companies will create bottlenecks. If the Government is intent on supporting certain sectors, then it must do so throughout the wider supply chain, regardless of research intensity.

The Government's preoccupation with funding R&D appears dangerously close to the out-dated 'linear model' of innovation, a doctrine which assumes that investing in research leads to inventions that then need to be brought to market by an entrepreneur. For most companies, however, their competitive strength lies elsewhere. An EEF survey, found that only 2% of companies said research was their main source of competitive strength, as opposed to 30% who said their production processes gave them the edge.

This response reflects the fact that many British companies use high-tech processes to make low-tech products that are still demanded by customers. Any manufacturing firm that has survived to 2011 and retained UK production has had to transform its production processes. For example, JJ Churchill makes fan blades for Rolls Royce. They are fairly basic solid metal products, but have to be made with some of the most precise machines on the planet.

The Government should recognise that innovation occurs in many different and informal ways – sometimes employees discover inefficiencies or managers restructure production to deploy the very latest machines or reorganise the supply chain. Innovation and R&D are not synonymous. Research is only one facet of the innovation cycle.

Free trade, foreign investment and the common good

It has become an article of faith to pursue free trade. The basic idea is that, if we specialise, we become more productive per hour and if we trade with other specialists, we all gain. There is much to be said for free trade in goods and services but not in capital. Capital movements are often fickle and on a scale that can overwhelm real economies – something we learned from the financial crisis in several Far Eastern countries in the late 1990s.

Even in a mature economy like our own, it is questionable whether foreign investment, including foreign direct investment (FDI), is always favourable to competition. As guardian of our own national interest and the international community's public interest, the Government is entitled to ask whether or not specific investments are likely to increase or reduce competition. For example, the French company Alsthom took over Metro-Cammell, but after it had built the Pendolino train for Virgin, it closed the factory down. Similarly, Coles Cranes, a successful North-East company, was taken over by the American crane manufacturer, Grove, and closed down. The Government should apply a public interest test to all FDI. Until the 2002 Enterprise Act the Government had such a power. It could be repealed to allow the Government to protect the public interest by referring acquisitions and mergers to the Competition Commission if it fears that competition will be reduced.

Selective assistance and the public interest

After the disastrous industrial policies pursued from 1945 until 1979, proposals for a modern variant are often treated with scepticism. But during the Thatcher years much public money was awarded to nationalised companies such as British Steel, Rover, and Rolls-Royce. The aim was to prepare them to face their rivals in the market, but it was accepted that they needed a respite of a few years before they were ready.

There is a great danger of pouring money into bottomless pits or the pockets of people with good political connections. However, the countries that grew to prominence while Britain was declining, such as South Korea and Japan, successfully provided selective assistance.

In the 1960s and 1970s British governments pursued a policy of national champions, but both the Japanese and South Korean governments encouraged domestic rivalry. The first question to ask of any policy of selective assistance is: Does it promote pluralism or increase competition? If it increases competition there may be a public-interest justification.

In addition it is important to note that the successful industrial policies implemented overseas were based on objective tests of performance. For example, between 1945 and 1960 about 30 Japanese car companies were established. Most failed. Going to the Japanese Government with a hard-luck story didn't help. It supported only those firms that were able to demonstrate success on independent measures. The most significant was the ability to export, an objective test that is impossible to fabricate. If we were to assist companies in Britain, a similar objective test would be their ability to supply consumers who currently prefer to buy imported products. But all such policies should be temporary. The government would be 'buying time' to increase pluralism.

Notes

[1] David Merlin-Jones, *Chain Reactions*, Civitas, forthcoming.

[2] ONS, *The Pink Book 2010,* pp. 37 & 46

[3] British Chambers of Commerce, *Manufacturing for Export, Make or Break for the British Economy,* January 2011, p. 47

[4] OECD STAN Indicators, ed. 2009

[5] David Cameron speech, *PM Speech on Government Procurement,* 11 February 2011

[6] Alan Reece, *Reviving British Manufacturing*, Civitas, forthcoming.

[7] Andrew Haldane, *Patience and Finance,* September 2010, p. 16

[8] *The Telegraph*, 'Davos 2011: Unilever's Paul Polson believes we need to think long-term', 15 January 2011

[9] David Merlin-Jones, *The Industrial and Commercial Finance Corporation: Lessons from the past for the future* October 2010, http://www.civitas.org.uk/pdf/ICFC.pdf

[10] Stephen L. Clarke, *German savings banks and Swiss cantonal banks, lessons for the UK*, December 2010, http://www.civitas.org.uk/pdf/SavingsBanks2010.pdf