A strategy for economic growth: a modern industrial policy

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Foreword

In his March 2012 Budget speech George Osborne called some of his measures a 'modern industrial policy'. He even said that we should not be shy about identifying our successful industries and reinforcing them. Not long ago such policies were denounced as 'picking winners' but nevertheless he planned to champion life sciences and aerospace, even promising to establish a UK centre for aerodynamics. He also planned to make Britain Europe's technology centre, with subsidies for video games and high-speed broadband. He repeated his message with renewed enthusiasm in his October 2012 Tory conference speech, declaring 'That's a modern industrial policy, and I am its champion'.[1]

All governments claim to want a growing economy, but we don't say that they have an industrial policy unless they support specific companies or sectors. It is selective assistance that marks out an industrial policy from a plan for growth. Mr Osborne's strategy is unambiguously selective. Perhaps he has learnt from America – one country that has managed to secure reasonable economic growth since the crash of 2008. Some attribute its success to the unfettered free market, but a closer look reveals that America has had an industrial policy.

It is of great significance that the Government is now committed to industrial policy, but so far much of the detail is a bit hazy. This report suggests what a new strategy could entail. In particular it calls for reversal of two policies that are undermining the Government's own efforts to stimulate growth: over-enthusiasm for deficit reduction and blind commitment to reducing carbon emissions.

The massive de-industrialisation of our economy in the last 30 years has been a major cause of our high public and private debt. In particular, it has caused a huge trade deficit, which has been partially funded by borrowing. Moreover, the reduction in manufacturing has structurally weakened our economy and impaired the ability of the private sector to grow rapidly. The productive capacity that could be taken for granted in the economic downturns of the early 1980s and early 1990s is no longer there.

This means that tight control of fiscal policy of the kind currently in favour cannot be counted on to spark automatic economic growth in the private sector. Large scale investment, especially in new manufacturing capacity, is needed; and in the immediate future some of the cash will have to come from the public sector. That will inevitably mean adding to the national debt in the short-term. But it will be for a good reason. In current conditions, borrowing to invest in productive capacity is desirable, whereas borrowing to pay for consumption is not. The Government is rightly critical of past policies that borrowed to permit consumption, but has only partially recognised the important role it needs to play in rebuilding our national infrastructure. It is investing with great enthusiasm in one area, the building of highly inefficient wind turbines, but neglecting where it could do far more good, namely in manufacturing.

The argument is presented in four parts. The first outlines elements of American policy and argues that the USA has a selective industrial policy from which we could learn. The second identifies one government policy, the reduction of carbon emissions, that is making the economic crisis worse and suggests how it could be reversed. The third argues that Britain is now at a strategic crossroads and contends that we need to re-industrialise. And the fourth describes the conditions for enterprise that are the responsibility of government in all circumstances.

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Summary

Ultimately the prosperity of a society depends on the skills, ingenuity and determination of its individual members but, as Adam Smith recognised, the laws and policies of the government can make a vast difference. Adopting a clear strategy is not the same as framing a national plan for the efficient use of the nation's physical and human resources; it is creating a framework in which the members of society can create prosperity for themselves. It is widely accepted that international economic success depends on comparative advantages. More important, some such advantages can only be created by the State.

1. 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, such as insulating materials, that are essential for energy conservation. The danger could be avoided by restricting all climate-related measures to those that are consistent with keeping the UK in the top half-dozen most competitively priced energy markets in the EU and the G20. In October 2012 Mr Osborne announced a consultation on a new tax regime for shale gas. The sooner it is implemented the better. We should also delay the planned closure of coal-fired power stations. They are not at the end of their natural lifecycle, but rather are being closed to comply with misguided EU regulations. We should deliberately flout these requirements and remind the European Commission that the German Government is in the process of building new coal-fired power stations. The Germans have no intention of committing economic suicide merely to obey the requirements of fundamentalist officials in Brussels. If we follow the current policies of the UK climate change department it will amount to an act of national self-harm.

2. Reform unnecessary workplace regulations that 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 meantime, we could place a cash limit of £5,000 on all unfair dismissal and discrimination compensation awards; exclude lawyers by transforming employment tribunals into mediation procedures; and require dissatisfied employees to make a small deposit of about £50 to reduce vexatious complaints.

3. Reduce company taxation. Corporate taxes are high compared with many of our rivals. To a considerable extent international companies are able to choose in which country they pay corporation taxes. We should unashamedly make the UK the regime of choice. There is an

international competition for the location of big-name companies. It is better to attract them by creating conditions favourable to all enterprise, rather than through selective assistance.
(a) The headline rate could be lowered to about 15%.
(b) Capital allowances could be abolished as part of a process of simplification. They were only introduced in 1984. Before that capital expenditure was simply another business expense.
(c) R&D tax credits could be retained. Basic research is a public good and it is cheaper to give credits to private companies than to fund research through direct grants.

4. Cut personal taxes. We have half the new company formation rate of the USA. 88% of start-up funding is from personal savings or loans from friends and family; only 12% is from banks. Personal taxes, especially the 50% rate, should be cut to allow savings to be accumulated, thus permitting the emergence of a new generation of entrepreneurs. The hostility to 'private wealth' in recent years has paradoxically encouraged 'corporate wealth' and 'political wealth'.

US couples who file jointly pay the highest rate of 35% on taxable income above £242,000. No tax is paid on the first £12,200. Then 10% on the next £10,800, then 15% on the next £44,000. Rates increase slowly in stages to 25%, 28%, 33%, and 35%.

5. Manage the exchange rate to reflect the skill, ingenuity and relative success of exporters not the vagaries of the arbitrage-dominated foreign exchange markets. We should set an exchange-rate target consistent with a higher-level of exports, subject to a monetary policy aimed at achieving sound money.

6. Question whether foreign corporate takeovers are in the public interest. 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 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. 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 should 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.

7. Provide selective assistance, but only with strong safeguards. After the misguided 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 creating national champions. This was the strategy that gave industrial policy a bad name. In countries such as Japan and South Korea, where industrial policy was successful, domestic rivalry was encouraged and monopolistic national champions were avoided. 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.

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 fake. 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.

8. Encourage import substitution. This could be achieved by examining the main economic sectors and asking whether there is anything the Government could do to help. Frequently the help would not need to take the form of selective assistance, but rather of removing obstacles or government-imposed costs. The cement industry provides an example. Britain has already gone from being a net exporter to a net importer of cement. The latest official figures are for 2011. Before the recession in 2006 exports of cement were valued at £60m and imports at £77m. The volume of production for delivery to the home market peaked at 11.6 million tonnes in 2007. It had fallen to 8.3 million tonnes in 2011. The volume of imports fell from 1.38 million tonnes in 2007 to 1.26 million tonnes in 2011. In other words, production for the home market fell by nearly 29% whereas imports fell by only just over 8%.

It would be a simple matter to reduce imports by increasing home production. But, high energy costs are already driving the industry overseas and increasing imports. Without guarantees that the cost of energy will compare favourably with rival countries, home producers are reluctant to build the next generation of plants. In all other respects the UK is an attractive location but cement manufacturers are building specialist import docks instead of kilns.

9. Encourage saving and enterprise banks modelled on German savings banks. About half of German GDP is produced by small and medium-sized firms—the Mittelstand—often family owned and run, and savings banks and co-operative banks have played a vital part in sustaining them through the recession. Some three-quarters of German firms are clients of savings banks. The German savings banks increased lending volumes to local businesses by over €9 billion between the 3rd quarter of 2009 and the 2nd quarter of 2010. Their local roots make savings banks more efficient in certain respects than commercial banks. In particular, they have the major advantage of being close to borrowers and able to assess risk more effectively. The lack of knowledge possessed by shareholder-value banks tends to lead to the imposition of additional costs on borrowers. Because the deposits of small savers must be kept safe, loans by savings banks are linked to credit-guarantee insurance, thus permitting investment risks to be taken without endangering customer deposits.

10. Avoid putting too much faith in high-tech or advanced manufacturing. It is frequently argued that the key to prosperity is high-tech production. This reasoning starts with the proposition that knowledge is very important for growth. It then proceeds to the linear theory of innovation. Scientists discover and entrepreneurs or engineers implement. The conclusion is that we must increase scientific spending and improve the links between universities and business. This notion is connected to a second idea, that developed countries must focus on high-tech because it alone can generate the wealth to sustain current living standards. Some even say that low-tech is not worth having and that we should let it go to China or elsewhere.

A high-tech company is defined by the OECD as one that spends 5% or more of turnover on R&D. But some companies are knowledge intensive without spending much on R&D. A Government study found that R&D is only 25% of investment by manufacturers in intangibles (which also includes design, brands, software and human capital). More important, most growth in employment in the OECD comes from low-tech and medium-tech companies. One study of 11 OECD countries between 1980 and 1999 found that high-tech manufacturing as a proportion of GDP increased from 8% to 10%. Low and medium-low tech (missing out what the OECD calls high-medium) grew rapidly but fell slightly as a proportion of GDP from 66% to 64% - but still provided the vast majority of jobs. There was no correlation between the high-tech share of manufacturing value-added and the rate of GDP growth over the period.

Many successful firms are innovative and knowledge intensive but not high-tech. Low and medium-tech companies often depend on the personal qualities of their key staff, which can't easily be replicated. Frequently proximity to customers is important and also not easily replicated. A company may succeed because it organises its workforce flexibly, or brings out the best in its people, or restructures logistics (just-in-time methods for example). Skills are often unique or local. Knowledge is tacit or embedded. In such circumstances freedom to innovate and adapt is vital. It is surprisingly difficult to predict where the next innovations will come from and for that reason an open system is preferable – in which any company that can support itself is welcomed whether it is high or low-tech.

Chapter One: Can we learn from America's longstanding industrial policy?

The dominant paradigm has long been neo-classical economics. Markets are seen as self-correcting systems unless they are distorted by political action. Consequently, some say that the primary policy challenge is to eliminate interference. Let's look at the most free-market nation, the USA. Does it owe its success to minimal state interference, or to industrial policy?[2]

Since the last World War the American federal government has usually funded half or more of American R&D. It selects the sectors most likely to add value and invests in them. State-funded research in the 1950s and 1960s was behind American success in computers and electronics and in his 2012 state of the union address, President Obama proudly claimed credit for government funding of hydraulic fracturing (fracking), which has permitted the exploitation of shale gas.

Successive American governments have been willing to bailout failing companies. Lockheed was rescued in 1971 and Chrysler in 1980. Most recently, $25 billion was spent to rescue the car industry, including Ford, Chrysler and GM. President Obama, in his state of the union address in January 2012 said: 'We bet on American workers. We bet on American ingenuity. Today, General Motors is back on top as the world's number one automaker. And together, the entire industry added nearly 160,000 jobs.'

American governments support sectors that can't attract private funds, especially SMEs. Since the 1950s the Small Business Administration (SBA) has supplied 20 million small businesses with financial help by supporting them when commercial banks would not. A small business is one with under 500 employees, 99% of American companies. The SBA does not make loans direct to customers, but guarantees private loans against default. Market fundamentalists dislike the SBA because it distorts the market, but the failure rate of SBA guarantees has not been excessive, suggesting that the unfettered market fails to back creditworthy businesses.

In May 2011 President Obama said: 'Small businesses are the backbone of our economy and the cornerstones of our communities. They create two of every three new jobs in America, spur economic growth, and spark new industries across the country'.[3] This statement was made during the launch of a US government report that highlighted the importance of the support it provides for small and medium-sized enterprises (SMEs). Between January 2009 and May 2011, more than $53 billion of government-guaranteed loans were issued to more than 11,300 SMEs, and over $221 billion of Federal Government contracts were awarded to SMEs.[4] The US has approximately 27.3

million SMEs, representing 99.7 per cent of employer firms,[5] compared with 4.5 million SMEs in the UK representing 99.9 per cent of British businesses.[6]

The CBI has recently estimated that if the conditions that enable medium-sized businesses to flourish elsewhere (for example in the US) were to be replicated in the UK, these businesses could contribute as much as £50 billion to the UK's economy by 2020 and create many job opportunities throughout the country, transforming the UK's economic health.[7]

Improving Businesses' Access to Finance

Bank lending to SMEs peaked in 2009 and has been declining ever since. In November 2011, the stock of bank lending was 6.1 per cent lower than it was one year previously. In 2010, 21 per cent of SMEs that sought finance in the UK were unable to obtain it from any source, a significant increase from the 8 per cent of businesses in the same situation in 2007.[8] Conversely, in the US, lending to small businesses increased by 20 per cent in October 2011, the fifteenth consecutive month of double figure growth.[9]

This increase is in part a consequence of the Small Business Jobs Act (SBJA), signed into law by President Obama in September 2010. Its provisions included: an extension of the government-backed loans to SMEs administered through the Small Business Administration (SBA); a new fund to encourage small banks to lend to small businesses; an initiative to strengthen state-based programmes of lending, and significant tax reliefs.[10] The SBJA has been hailed by the National Economic Council as the 'most significant piece of legislation to help small businesses in over a decade'.[11]

State-Backed Lending to Small Businesses

The SBA has been significantly revitalised in recent years, particularly through the provisions of the SBJA, which extended its brief, enlarged its budget, and made it better able to provide financial assistance.[12] The SBJA increased the maximum size of the loans that the SBA could guarantee, from $2 million to $5 million for the 7(a) Loan Program, which is the largest programme available from the SBA and is used by SMEs which are otherwise unable to obtain commercial loans. Similarly, maximum loan sizes were increased from $2 million to $5 million (or $5.5 million for manufacturing projects) for the 504 Loan Program, which is also available for SMEs unable to obtain finance but is targeted specifically at businesses and projects that encourage economic development at the community level.[13] Immediately following the introduction of these increased loan guarantees, the SBA saw an increase in the weekly volume of loans it guaranteed, reaching a peak of $2.2 billion, the highest weekly lending level since records of weekly volumes began. By the end of 2010, the SBA had approved more than $10 billion in loan guarantees that would not have been possible without the introduction of the SBJA.[14]

In addition to the provisions of the SBJA, the 2009 American Recovery and Reinvestment Act (ARRA) reduced the fees applicable to the borrowers of SBA-backed loans. Between the passage of the Act and September 2010, the SBA guaranteed $30.4 billion of lending to SMEs supported by the ARRA, and over 70,000 SMEs benefited from the fee reduction.[15] The combined impact of the ARRA and the SBJA has raised the volume of lending to small businesses supported by the SBA to over $70 billion to 150,000 businesses over the financial years of 2009, 2010 and 2011.[16]

The UK has the Enterprise Finance Guarantee (EFG) scheme, which was launched in January 2009. The Government provides a 75 per cent guarantee for loans to viable SMEs that are unable to obtain commercial finance, due to insufficient collateral, yet demonstrate the ability to service the loan. The maximum size of the loans to be guaranteed are, however, significantly smaller than those in the US, at only £1 million ($1.59 million).[17] The scheme is also not a long term measure: it is in place only until April 2015, by which time it is expected to have guaranteed approximately £2 billion in lending to SMEs.[18] Just over seven in ten of the loans guaranteed under the EFG scheme are for sums under £100,000.[19] Whilst the EFG scheme has had some success (the EFG supported loans to the value of £1.47 billion to 14,750 SMEs between January 2009 and April 2011[20]), demand for its guarantees has been declining, with lending through the EFG reaching a record low of £77.8 million in the final quarter of 2011 (24% lower than the same quarter the previous year).[21] Even after the Chancellor increased the threshold under which businesses were eligible for an EFG backed loan, the lending volume continued to fall.[22] This is partly attributed to a lack of awareness of the scheme: a study by BIS and the CBI found that only 22 per cent of SMEs are aware of the EFG.[23] Furthermore, the Government has been criticised for increasing the annual premium payable on the remaining balance of the loan from 1.5 to 2 per cent, and for placing a 'compensation cap' on the value of the loans of 9.225 per cent. This means that the participating banks are only entitled to a maximum 9.225 per cent compensation across their entire portfolio, that is, if a bank has EFG guaranteed loans outstanding of £1 million, they are only covered for £92,250 of loan losses.

A further scheme, the National Loans Guarantee Scheme (NLGS), was announced by the Chancellor in the 2011 Autumn Statement and was launched in March 2012. It allows banks to deliver up to £20 billion of funding to SMEs at a lower cost than a normal commercial loan.[24] The Government does not guarantee loans against default but rather ensures that the interest rate is a little lower. Following the announcement of the scheme progress appears to have been very slow and the scheme is expected to lead to a reduction in the cost of business loans of a maximum of only one percentage point, with the different participating banks setting their own rates. Between the launch of the scheme and August 2012, £2.5 billion of loans to over 16,000 businesses had been provided with the one per cent reduction in cost.[25] In addition, any business deemed to be 'in financial difficulty', possibly those most in need of finance, are not eligible for the scheme.

Encouraging Banks to Lend to Businesses

A further provision of the SBJA has been the introduction of the Small Business Lending Fund (SBLF) which has the objective of incentivising small banks to increase their lending to small businesses. $30 billion of capital is available to community banks and community development loan funds which have assets of under $10 million.[26] Small business lending is defined as a loan of under $10 million to a company with revenue of under $50 million.[27] The fund encouraged small business lending via community banks through an interest rate incentive structure – the more that the institutions increased their small business lending, the lower the rate of interest they would have to pay on the funds received from the government. The initial rate payable on SBLF capital was five per cent, but this declined to one per cent if the institution increased their small business lending by more than ten per cent on 2008 levels, decreasing on a sliding scale from two to four per cent for those banks that did increase their lending but by less than ten per cent, and increasing to seven per cent if no increase in small business lending was reported.[28] By September 2011, the SBLF had invested in 332 institutions across the US: 281 community banks which received $3.9 billion from the fund, and 51 community development loan funds, which received $104 million. The community bank participants increased their small business lending by an average of 9.8 per cent. Community development loan funds increased their lending to small businesses by an average of 11.1 per cent. More than 60 per cent of participants increased their small business lending by ten per cent or more.[29] In addition, it is to be assumed that since the institutions that received the funds supplement their capital from private sources, the actual volume of lending delivered to SMEs is likely to be many times the value of the capital provided.[30]

In the UK, a plan to increase lending to small businesses was introduced through the Project Merlin agreement, announced in February 2011. Part of the agreement related to lending to small businesses: the five big banks – Barclays, HSBC, Lloyds Banking Group, RBS and Santander – pledged to lend £76 billion to SMEs in the UK in 2011, an eleven per cent increase on the previous year's lending.[31] While the initial results of the scheme looked promising by the end of the year the target had not been reached and the actual figure was £1.1 billion short at £74.9 billion.[32] In fact, lending to businesses from all banks contracted by £9.6 billion in financial year 2011.[33] In spite of the widespread press coverage of the Project Merlin agreement, only 20 per cent of SMEs questioned by BIS and the CBI were aware of the commitment made by these banks to increase small business lending.[34] Following the disappointing results, the Government decided not to pursue any lending targets for 2012.

The SBJA introduced yet another fund to encourage lending to small businesses in the form of the State Small Business Credit Initiative (SSBCI). This was intended to strengthen state-based programmes that assist small businesses. By providing $1.5 billion to state programmes that leverage private lending, the SSBCI was expected to support at least $15 billion of lending to small businesses.[35] The SSBCI is in place for seven years, during which time states may apply for a portion of the funding, which will be allocated on the proviso that the state demonstrates a reasonable expectation that for every $1 of funding received, they will generate a minimum of $10 in lending to small businesses.[36] The funds can be used by the state in any way it deems appropriate to fulfil these conditions. In Kansas, for example, $10.5 million from the SSBCI has gone to the Kansas Capital Multiplier Loan Fund, which provides matching funds with private sector investors to small businesses, and $2.6 million has gone to the Kansas Capital Multiplier Venture Fund, which provides new capital investments for second stage small businesses. This use of the funds is expected to result in more than $132 million of additional small business lending in Kansas, and the creation of many new private sector jobs.[37]

The UK government has also considered the importance of encouraging private investment in small businesses, and a new programme of Business Finance Partnerships was launched in January 2012. This entails an investment of £1.2 billion in loan funds to be used alongside private sector co-investors, and is available to medium-sized businesses with a turnover of up to £500 million. Its objective is to diversify the channels of finance available to SMEs and improve their financing options.[38] First round applications for the Business Finance Partnership funds were completed in February 2012 and the initial £700 million of investment was allocated to a shortlist of seven fund managers. A second round of applications, with a further £500 million of investment available, opened in June 2012.[39] The results are not yet clear.

Another Act is expected to come into force soon in America, aiming to further improve the availability of finance for SMEs. The Small Business Lending Enhancement Act aims to increase the lending of credit unions. At present some credit unions are only able to lend up to 12.5 per cent of their assets to businesses, but under the proposed law they would be able to lend up to 27.5 per cent of their total assets. As credit unions tend to supply loans under $1 million, increasing their lending abilities could have a significant impact upon the ability of small businesses to obtain the small loans that they are unable to get from commercial banks.[40] The Act is also expected to create 140,000 jobs across the US by targeting funds to small businesses.[41]

Improving Access to Export Finance for Small Businesses

Both the US and the UK have introduced programmes in an attempt to improve the access to finance for SMEs specifically for the purpose of exports. In the US, the National Exports Initiative (NEI) was established in March 2010 in an attempt to help meet President Obama's target of doubling US exports over five years, with the intention of creating millions of jobs.[42] SMEs face significant barriers and high risks when embarking upon exporting their goods or services, including a lack of knowledge of foreign markets, the necessity to develop a foreign customer base, lack of resources to address barriers to trade, being financially unable to wait any significant period of time for payment for exported goods, etc. The ability of exporting firms to obtain finance was improved through the extension of the Export Express Loan Program offered by the SBA. The programme provides 90 per cent Federal Government guarantees for an export loan of up to $350,000 and 75 per cent Government guarantees for an export loan of up to $500,000. In addition, the Export Working Capital Program (EWCP) and International Trade Loans had their maximum loan sizes increased to $5 million, and the State Trade and Export Promotion (STEP) Grants programme is being piloted, to enable the financing of $30 billion per year for the next three years to states, to enable them to assist business owners who wish to expand their exporting capabilities. Many of the SBA-backed programmes have been very successful: since 2005 the SBA has supported over 15,000 loans related to international trade worth over $4 billion.[43] Providing this kind of facility for SMEs has impacted upon US economic growth. In 2010, exports from US businesses, including SMEs, significantly contributed to economic recovery: US exports totalled $1.83 trillion, and supported 10.3 million jobs throughout the country.[44]

The Export Import Bank of the US (Ex-Im Bank) maintains a database of information about international trade and foreign markets. It is also able to finance both the exporter business and the foreign buyer.[45] Over 20 per cent of Ex-Im Bank financing authorisations in 2010 in value terms were for small businesses, worth $5 billion, a substantial increase on the $3.2 billion authorised in 2008. 85 per cent of the Ex-Im Bank's authorisations are for small businesses and the number of businesses benefiting has risen steadily from 2,328 in 2008 to 3,091 in 2010. Between 2009 and 2014, the Ex-Im Bank aims to add 5,000 new SMEs to the Ex-Im Bank portfolio; double its annual SME lending volume to $9 billion; and to approve $30 billion in total SME transactions.[46]

In the UK, the Government introduced the Export Enterprise Finance Guarantee Scheme (ExEFG) in April 2011 in order to facilitate the provision of export finance to viable SMEs that are unable to obtain such finance commercially. The ExEFG operates on a commercial basis because it is prevented from offering any assistance for exporting purposes due to restrictive EU State Aid Rules. The Government provides the lender of the loan with a 60 per cent guarantee, and the scheme is only administered by five accredited lenders, which are those large banks involved in the Project Merlin agreement. The borrower must pay a three per cent premium each year in order to cover the costs of the programme, and consequently the scheme is self-financing.[47] The guarantee is available to SMEs seeking export finance of between £25,001 and £1 million to be paid back over a term of up to two years, at three-monthly increments.[48] Between the launch of the scheme and the beginning of January 2012, only five SMEs had benefited from the ExEFG scheme, with loans totalling £2.9 million.[49] British SMEs are even less aware of the ExEFG scheme than they are of the EFG scheme, with only eight per cent of those responding to the BIS and CBI survey having any awareness.[50]

The schemes and programmes to assist businesses looking to export are significantly more numerous and wide ranging in the US, and this is perhaps why US businesses have managed more successfully than UK businesses to keep exporting and growing in the wake of the recession.

Supporting Businesses through Government Procurement

The US Government has not only been committed to making sure SMEs have access to finance, but also to business contracts. President Obama has prioritised government provision of federal contracts to small businesses.[51] Each year approximately half a trillion dollars is spent by the US government on goods and services. The Government committed itself under the ARRA to ensure 23 per cent of federal contracting dollars are awarded to SMEs. This goal was exceeded and by April 2011 32.6 per cent of federal contracting dollars had been awarded to small businesses,[52] totalling approximately $221 billion.[53] The ARRA also has a 'Buy American' clause, which states that:

'none of the funds appropriated or otherwise made available by the Act may be used for a project for the construction, alteration, maintenance, or repair of a public building or public work done unless all the iron, steel and manufactured goods used are produced in the US',

In April 2010 the Administration built upon the provisions in the ARRA by establishing an Interagency Taskforce on Federal Contracting Opportunities for Small Businesses, with the aim of training the acquisition workforces of government departments to understand the importance and benefits of awarding federal contracts to SMEs and to improve their relations with small businesses.[54] One recommendation of the Taskforce has been to create a portal providing easier access to procurement information, FedBizOpps.gov, which provides information on federal procurement opportunities.[55] The Government has also worked on reducing the length of time it takes federal departments to pay SMEs. Reducing the payment time from within 30 days to within 20 days impacts upon an estimated $60 billion of SME goods and services contracts.[56]

While the UK Government similarly set itself a target in the 2010 coalition agreement of 25 per cent of government contracts to be awarded to SMEs, that is, two per cent more than the US target, it has not done enough to ensure attainment of the target. By March 2012, the proportion of government contracts awarded to SMEs had increased to 13.7 per cent.[57] The government has created an online procurement portal, *Contracts Finder*, in some ways similar to FedBizOpps.gov, launched in February 2011 as a facility to enable SMEs to find government contracting opportunities of over £10,000.[58] Whilst this improves the transparency of government procurement practices, it does little to increase the opportunities available to SMEs. In addition, EU Procurement rules make it impossible for the British Government to create an explicit 'Buy British' clause like the one introduced in America.

Tax Relief for Small Businesses

By removing obstacles to SME growth, such as high taxes, small businesses have a better chance of growing and expanding without requiring external financing. The Obama Administration has gone a long way to reducing the tax burdens on small businesses and has enacted a total of 17 tax-cutting measures specifically for SMEs. The cuts, amounting to billions of dollars of relief for SMEs, have been introduced through the ARRA, the SBJA, the HIRE Act (2010) and the Affordable Care Act (2010). Obama's 2013 budget is committed to building on these tax cuts and introducing new ones.[59]

The ARRA eliminated 75 per cent of capital gains tax on certain small business stock, and the SBJA took this further by eliminating 100 per cent of the capital gains tax.[60] The potential deductions new entrepreneurs can claim for their start-up expenditures was doubled in the SBJA, from $5,000 to $10,000,[61] an immediate incentive for entrepreneurs to start-up a new business. The proposed 2013 budget would double the potential deductions of start-up expenses to $20,000.[62] The ARRA increased the amount that SMEs could deduct from their tax on the cost of machinery, equipment, furniture, vehicles and other property in 2009 from $133,000 to $250,000, and the SBJA extended this further to $500,000.[63]

The British Government has managed to implement some tax-related benefits for SMEs, although nowhere near on the scale of those in the US. Perhaps most significant of these measures is a reduction in the small profits rate of corporation tax from 21 per cent to 20 per cent in April 2011.[64] The main rate of corporation tax is being reduced from 28 per cent to 22 per cent by 2014.

One new scheme enacted by the UK Government which may well have a notable impact upon the finances of SMEs is an increase of the point at which employers must begin to pay National Insurance contributions for their employees from £110 to £136 in 2011.[65] This is estimated to save employers, including SMEs, up to £3 billion per year.[66]

Incentives for Increasing Employment

Both the US and the UK governments have introduced measures to encourage small businesses to take on new employees, particularly targeting those who would otherwise be out of work. In the US, the HIRE Act provides a financial incentive for small businesses to employ previously unemployed workers. A payroll tax credit of $1,000 is provided for each new employee who was previously unemployed for 60 days or more and is retained in employment for at least one year.[67] The tax credit could provide up to $10.4 billion in tax relief to small businesses,[68] and between February and August 2010, SMEs across the US took on 8.1 million workers who had previously been unemployed.[69]

The UK has a similar but much narrower scheme. The Youth Contract, announced in 2011 and launched in April 2012, is a system of wage subsidies for businesses which offer work placements to unemployed 16 to 24 year olds. Any business taking on an unemployed 16 to 24 year old for at least six months will receive a subsidy (from a pot of £1 billion) of £2,275. It is hoped that the scheme will provide opportunities of work for 500,000 unemployed young people over three years. [70] The Government has also made available additional financial incentives worth £1,500 for businesses that agree to take on an apprentice.[71] As part of the Youth Contract, a further scheme worth £126 million was announced in February 2012 which specifically targets 16 and 17 year olds who are not in full time education, employment or training (NEETs). Charities and small businesses will be able to bid for a contract of up to £2,200 for every 16 or 17 year old, without any GCSEs grade C or above, who can be kept in education, employment or training for one year.[72] The businesses that are awarded the contracts are then free to use the money as they see fit to keep that person in employment. The payment of the financial incentive will be staggered through a results based system so that the full amount is only available once the business has kept the NEET in employment, education or training for one year. At least 55,000 NEETs across the UK are expected to benefit from the scheme. However, the House of Commons Work and Pensions Committee concluded that the scheme was inadequate given the scale of the UK's unemployment problem.[73]

To sum up: the economically most successful nation ever, has an extensive industrial policy designed to encourage American enterprise, especially manufacturing. Our economy is stagnating, while America's is growing. Perhaps we could learn from them.

Chapter Two:

Stop making matters worse

Reduce the cost of electricity

Some policies intended to combat climate change are undermining the competitiveness of our companies by increasing the cost of electricity relative to our main rivals. These policies are seriously threatening the existence of Britain's energy-intensive industries, including the steel, glass, paper, chemical and ceramics industries. Together they account for one per cent of Britain's GDP and employ 225,000 people. These figures do not include the broader contribution such industries make to GDP and employment via other sectors reliant on their products.[74] Taking the chemicals industry alone, Oxford Economics found that 15 industrial sectors in 2007 were reliant on products of the chemicals industry as a necessary condition for their operation.[75] These 15 chemistry-dependent industries contributed £222 billion to GDP or 18% of the UK total. Altogether, the chemicals industry was found to support six million jobs.

Despite this considerable benefit to the economy, the average energy-intensive company could be forced to pay nearly £20 million in costs by 2020 as the result of the Government's climate change policies.[76] The misguided 'green' policies of the current Government have already caused job losses. In May 2011 Tata Steel cut employees at two of its UK plants in response to 'uncertainty about the level of further unilateral carbon cost rises that the UK government is planning'.[77] Some of these workers have since been reemployed at the blast furnace in Redcar. And in May 2012 the aluminium smelter at Lynemouth was closed largely because of rising energy costs.[78]

Domestic consumers are also adversely affected. The Government commissioned Professor John Hills, director of the Centre for Analysis of Social Exclusion at the London School of Economics, to investigate the impact of higher fuel bills on the poor. His report concluded that an estimated 2,700 people die each year because of health conditions, such as respiratory infections or cardiovascular problems, linked to fuel poverty, which is defined as occurring when fuel costs more than 10 per cent of income.[79]

Even more perplexing is the fact that driving key industries out of the UK would contradict the Government's declared aim of reducing carbon emissions. Total world emissions would not be reduced, but rather re-located outside the UK. In the case of the chemicals industry, we may drive overseas an industry that makes products, such as insulating materials, that are essential to a low-carbon future.[80] This is despite the Government having identified the chemicals industry as deserving of support in the growth review of December 2010.[81]

The Coalition's energy policies are obstructing growth and increasing unemployment. They are also self-defeating. The Government has been made aware of the harm it is doing and, in his speech to the annual Conservative Party conference in October 2011, George Osborne said: 'We're not going to save the planet by putting our country out of business.' He went on: 'So let's at the very least resolve that we're going to cut our carbon emissions no slower but also no faster than our fellow countries in Europe'. If the Government's policies were to be based on this principle, it would be a significant step in the right direction, but it would be better still to restrict all climate-related measures to those that keep the UK among the most competitively priced half-dozen energy markets in the developed world.

In the Autumn Statement of November 2011, Osborne claimed that the Government intended to 'reduce the impact of policy on the costs of electricity for the most electricity-intensive industries',[82] amounting to a £250 million commitment from 2013. For example, the Climate Change Levy discount on electricity for those companies with Climate Change Agreements would be improved from April 2013. There have been some desirable policy changes, including reductions in feed-in tariffs and the emphasis on gas investment. Mr Osborne was right to point out in the March 2012 Budget that 'gas is cheap, has much less carbon than coal and will be the largest single source of our electricity in the coming years.'[83] He set out plans to ensure that the key advantages of gas will be maximised.

However, many current Government policies are not consistent with Mr Osborne's declared objective. If the Government truly wanted the UK to remain competitive, we would aim to produce the cheapest possible electricity attainable using the best technology now available. Both economic and environmental goals could be satisfied in the short term by relying on zero-carbon nuclear power and comparatively low-carbon gas power as our main fuel sources for the next few years.

Moreover, Mr Osborne's commitment is not consistent with the May 2012 draft energy bill, which the Energy secretary Ed Davey described as intending to 'to make sure the bias towards gas is dealt with… and that low carbon sources can compete on a level playing field'.[84] Above all, pursuing Mr Osborne's objective would mean ending the huge waste of money on wind farms, especially those offshore, and wholly abandoning feed-in tariffs that pay households well over the commercial rate for electricity. With a fifth of power capacity expected to shut down in the next ten years as a result of EU regulation, this is not the time to be worrying about renewables having a share of the energy mix.

Instead, we should be ensuring the UK has the capacity to meet future demand through gas, nuclear power and coal. Public policies have yet to reflect fully the discovery of shale gas in Lancashire. The development of shale gas in America has transformed the market there, leading to a dramatic fall in the price of natural gas. We should develop our reserves at the fastest possible rate in order to develop gas-powered energy without jeopardising energy independence.[85] In

October 2012 Mr Osborne announced a consultation on a new tax regime for shale gas. The sooner it is implemented the better. We should also delay the planned closure of coal-fired power stations. They are not at the end of their natural lifecycle, but rather are being closed to comply with misguided EU regulations. We should deliberately flout these requirements and remind the European Commission that the German Government is in the process of building new coal-fired power stations. The Germans have no intention of committing economic suicide merely to obey the requirements of fundamentalist officials in Brussels. If we follow the current policies of the UK climate change department it will amount to an act of national self-harm.

Mr Osborne's objective also calls into doubt the Government's plans to impose a carbon price floor to supplement the EU's Emissions Trading System (EU ETS). The current expectation is that a minimum price of £16 per tonne will be imposed from April 2013, increasing to £30 by 2020. At the time of writing the market price was about £6, which would mean imposing a crippling burden on our companies. The Government has given a concession to high-energy users, which is fine as far as it goes, but the policy ignores the hidden effects on SMEs and prospective businesses not covered by the opt out. Tim Yeo MP, chairman of the Climate Change Select Committee noted in January 2012 that 'the Treasury's decision to set a Carbon Price Floor could result in industry and electricity production relocating to other EU countries. Unless the price of carbon is increased at an EU-wide level, taking action on our own will have no overall effect on emissions other than to out-source them.'[86] The foolish unilateral imposition of costs is a silent killer of enterprise, and plans for a carbon price floor should be abandoned.

Chapter Three:
Britain's strategic position and why we need to re-industrialise

Britain was the first country to industrialise and among the first to experience a shift to a service economy, but now we need to be the first to re-industrialise. During the last 30 years, de-industrialisation was assumed to be the fate of all advanced nations. We would evolve inevitably from smokestack industries to a service economy. The champions of de-industrialisation theory were not completely wrong, but they made the mistake of thinking that the shift to services would continue permanently and could increasingly provide growth and jobs. It turns out that we can't pay our way in the world with manufacturing at only about 11 per cent of national economic output.

The gravity of our situation is inescapable. We last had a trade surplus in goods in 1982.[87] It's true that services made up for the deficit for several years, but the last time we had a surplus in goods and services combined was 1997. The deficit in goods for 2011 was a record £99.6 billion, following a previous record deficit of £98.5 billion in 2010.[88] Many hoped that manufacturing could rescue us from the recession, and initially the trend looked good, but ONS figures show that manufacturing output is about eight per cent below its pre-recession level.

We need to become the pioneers once more, discovering through the innate energy, inventiveness and drive of the British people how best to take the next steps in economic development. We can learn much from other countries but, as we have so often done in the past, we must be prepared to cut our own path to prosperity through the uncertainties of the new economic world order. Two important structural forces are at work. First, economic success depends on having 'retainable' industries, and not merely specialising in any sector in which a company or nation has a comparative advantage at any one time. Second, human capital is now more important than physical capital.

The unspoken background assumption of policy makers is that 'the market' allocates capital in such a way as to winnow out high-cost producers and leave behind only the efficient ones. When this happens we are all better off. If China can make things for less, then we must accept our fate and allow whole sectors to close: it will be hard on the displaced workers in the short run, but they will soon move to higher-value activity. The trouble is that there is now a substantial economic literature questioning this orthodoxy.[89] One respected study by Ralph Gomory and William Baumol has shown that if there are economies of scale and high-start-up costs, markets entrench the position of existing producers and deter rivals.[90] Consequently, the competitive advantage of some producers is not the result of being the most efficient manufacturer but of having started early.

When these conditions apply, industries are capable of succeeding in many locations. The list includes automobiles, shipbuilding and steel.

In such cases, public policies should examine whether or not an industry is 'retainable'. It may or may not be high in financial 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. On this reasoning, for example, it would be worth Britain developing the manufacture of civil aircraft.[91] A generation ago Brazil had no aircraft industry, but today it is a market leader in short-haul aircraft. If Brazil can do it from a standing start, there is no reason Britain cannot utilise its aviation heritage and do likewise. The skilled workforce is still here (but only just) and once lost, it will be nigh on impossible to reconstruct.

A recent BBC television documentary argued that 'brains not hands' were the way to go. The future lay in using our brains to contribute to design, marketing, branding and high-tech innovation. But the real challenge is to discover what makes for success and the key force is constant improvement or innovation of any kind. It is a mistake to associate innovation solely with 'ideas' that are found in realms separate from manufacturing plants, such as science labs or design suites. It is crucial to realise that the changes that defeat rivals could be in the process of production, or the way components are stored or supplied, and that these ideas can be found as often on factory floors as in design departments.

Professor Gary Becker has estimated that 70 per cent of all capital deployed by companies is human capital, a term which includes the know-how and skills of production workers.[92] Nor is the distinction between high-tech and low-tech the key difference. It's staying ahead of rivals by constant improvement of any sort. If human capital is more important than it was even 30 years ago, it may explain why unemployment in the current recession has not been higher. The skills of the workforce are not easily replaced and employers have been keen to hang on to them. Compared with the recession of the 1980s, a trained workforce is often the main asset of a company, a fact not fully captured in balance sheets.

Nor does it necessarily matter if a manufacturer supplies low-priced products. Manufacturers of low-cost parts, perhaps involving welding, casting or forging, are frequently supplying a high-value primary producer. They may be part of the supply chain and within a cluster. Their competitive advantage may be that they are local, which makes it easier to maintain an intimate knowledge of their customer's requirements and provide a custom service. Or a few key staff may have unique expertise. As the distinguished analyst of city economies, Jane Jacobs, has long argued, 'economies of location' can sometimes be more significant than 'economies of scale'.[93] Moreover, the same process of continuously searching for improvements is found in firms making low-price products. Being profitable is the main test of success.

The dramatic decline in manufacturing from over 20 per cent of GDP as recently as 1997 to about 11 per cent in 2011 means that the policy instruments that worked in the economic downturns of the 1980s and 1990s no longer have the same power. In particular, surplus capacity that can quickly be expanded is not there to a sufficient extent, as the Bank of England's Monetary Policy Committee has acknowledged. It expressed surprise that manufacturers were not seizing the opportunities presented by the favourable exchange rate. The April 2011 minutes said it was 'puzzling that import growth had remained so robust, despite the substantial depreciation of sterling'. It concluded that this was probably because 'domestic substitutes for some imported goods and services were not available'. Moreover, it was 'possible that UK firms in some industries lacked the plant or capacity to expand production rapidly in response to the past depreciation of sterling and it would take time for them to install it'. Consequently, 'a lack of domestic alternatives had been a significant factor' reducing the substitution of home-produced goods for imports.

As a result, our economic revival now depends to a greater extent than in the past on investment in new capacity. This requirement puts the spotlight on another problem. We do not have financial institutions well suited to large-scale re-investment in productive enterprise. Again, in Mr Osborne's October 2011 speech we find recognition of the importance of manufacturing but as yet, the necessary reforms have not happened. This is despite the 2012 Budget that Mr Osborne declared was supposed to 'repair the disastrous model of economic growth ... A model that saw manufacturing almost halve as a share of our national economy, while the national debt doubled.'

Chapter Four: The conditions for enterprise

Chancellor of the Exchequer, George Osborne, described his March 2011 Budget as 'unashamedly pro-growth' and his March 2012 Budget as one that 'unashamedly backs business'. Unfortunately, since both Budgets, growth has varied from slow to non-existent.[94] It is all too clear that more needs to be done, despite Mr Cameron's statement at the Conservative conference in October 2012 that Britain must 'sink or swim, do or decline'. The Government should be straining every sinew to provide the most favourable conditions for enterprise that are within the gift of government. In particular we should aim to provide better conditions than any of our main economic rivals.

Reduce company taxation

Corporate taxes in Britain are high compared with those of many of our competitors. In 2012 12 countries out of the 34 members of the OECD had a lower corporation tax rate.[95] The Government plans to reduce the headline rate of corporation tax to 22 per cent by 2014 but this reduction is too small to provide a real boost to growth. We should aim for a rate much closer to the Republic of Ireland's 12.5 per cent, the lowest in the OECD, which has allowed it to attract many investors away from the UK.

To a considerable extent, multinational companies are able to choose in which country they pay corporation taxes. In 2008, it was estimated by the Commons public accounts committee that because of this £8.5bn had been lost, mostly to offshore low-tax regimes.

We should unashamedly make the UK the tax regime of choice. There is international competition for the location of major companies and it is better to attract them by creating conditions favourable to all enterprise, rather than through selective assistance. Mr Osborne announced his hopes for corporation tax in his speech to the *Telegraph* Festival of Business in September 2011, when he said, 'we want Britain to have the most competitive business tax system of any of our major competitors'.

To achieve that aim, we have a long way to go. A headline corporation tax rate of about 15 per cent would be feasible. Within a short period, it is likely that income from the tax would increase as more companies installed themselves in the UK. This would more than make up for any temporary reduction that might initially result from lowering rates.

While accommodating the needs of companies, the UK should also make sure that the abuse existing within the current system is ended. At present, 98 of the FTSE 100 companies utilise offshore tax havens. If Britain were drastically to reduce its corporation tax rate, the *quid pro quo* should be the closure of these tax loopholes.

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, achieved by reducing the main recovery rate from 20 per cent to 18 per cent that commenced in April 2012. 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.

Some commentators have blamed economic stagnation on the failure of large corporations to invest their huge cash reserves. According to one survey by Deloitte, companies in the UK are holding over £60 billion in excess working capital on their balance sheets.

Some say that companies will not invest until consumer demand picks up. Perhaps so, but the Government is not powerless. It could make a big difference to boardroom calculations by scrapping capital allowances. This would permit companies to deduct investment in plant and machinery from profits, potentially revolutionising private investment.

We know that the Government understands the power of abolishing capital allowances because many enterprise zones have been granted 100% capital allowances in the first year, a measure which has a similar effect to abolition.

Boosting economic confidence is not an easy task when market sentiment is as much an emotional state of mind as the result of objective conditions. A change of policy could be combined with a major commitment to declare the whole country an enterprise zone. Currently we have a few enterprise zones dotted here and there in disadvantaged areas, but very often their main effect is to displace investment from other parts of the UK.

There would be an additional advantage. Making everywhere in the UK an enterprise zone would bring us into confrontation with the European Commission, which will undoubtedly insist that under state-aid rules we would need its permission to go ahead. But we should not allow rival nations to prevent us from renewing the spirit of enterprise in Britain. The European Commission is dominated by our main economic competitors who will want to prevent us from gaining a new competitive advantage. Instead, we should pick a fight with the European Commission and insist on our right to declare every part of the UK an enterprise zone without their approval – akin to a unilateral declaration of economic independence.

How do capital allowances work at present? When new factories are built or upgraded the cost is not treated as a normal business expense and deducted from profits but subject to the capital allowance regime. This means that, after adjusting for a small initial allowance, from April 2012 only 18% of the amount invested can be deducted from profits in the first year, followed by 18% of the outstanding balance in subsequent years. It can take a couple of decades before large investments are recouped. Scrapping the whole regime, which was only introduced in 1984, would create a surge of investment and simplify the tax system, significantly reducing the workload faced by both company accountants and HMRC.

Abolishing capital allowances could potentially set free billions in company cash reserves. A surge of investment in plant and machinery would set off a rebound effect that could ricochet throughout the whole economy. There would be a cost to the public purse, but it would be smaller than the outlay from a major surge in public sector capital programmes.

Establish an industry bank and encourage local relationship banks

In December 2011, the Government accepted most of the recommendations of the Vickers' Report on banking. However, this was primarily aimed at addressing the potential failure of retail and investment arms of banks via ring-fencing. It did not solve the more pressing concerns relating to businesses lending. Despite the Vickers' Report and Government promises, our existing commercial banks are not focused on the development of manufacturing but rather on short-term trading gains, starving many SMEs of the necessary funds to invest in their businesses and maintain jobs. Five large banks established the Business Growth Fund in February 2011, with capital of £2.5 billion. This was a step in the right direction but on a scale far below what is required. We have long argued for the foundation of an industry bank to invest in productive enterprise, perhaps called the Enterprise Bank to emphasise that it would promote enterprise in all areas of the economy. There is a precedent to build on.[96] In post-war Britain, the Industrial and Commercial Finance Corporation was established and proceeded to invest effectively in businesses until the 1980s, when it was privatised.[97] It was charged with selecting promising business ventures and backing them for as long as necessary. Germany's KfW and America's Small Business Administration are alternative models for overcoming the present lending crisis. These successful models are described in a separate report.[98]

The Business Bank announced in September 2012 is a step in the right direction. However, nothing much is likely to happen for a couple of years and an increase in business lending is urgently needed now.

The simplest method of funding the new Enterprise Bank would be to allocate about £10 billion from the latest tranche added to the money supply by the Bank of England under its Quantitative Easing programme. Buying treasury bonds from the financial services sector in the hope that the banks will increase their lending to businesses is not working rapidly enough. Moreover, under current conditions the main banks are incapable of altering their behaviour.

A national industry bank could play a vital role, but local banks are also important. Germany has numerous local savings banks that account for 23 per cent of German bank deposits and 20 per cent of all business loans.[99] They have an even larger market share of loans to SMEs and households. They are only permitted by law to invest in local businesses or mortgages, thus preventing local deposits from being siphoned off by casino banks. Local banks proved their worth during the financial crisis by increasing their lending to small businesses. Whereas the big commercial banks saw a net reduction in lending volumes of €9 billion since the third quarter of 2009, the savings banks increased lending by €18 billion.[100]

Similarly successful during the recession were the Cantonal banks in Switzerland, which have a similar business model of taking local deposits and lending to local businesses. Between 2006 and June 2011 the Swiss Cantonal banks increased total lending to Swiss businesses by 29 per cent. By contrast, UBS and Credit Suisse reduced lending by 15 per cent.[101]

Along with encouraging the creation of effective local banks, and setting up an Enterprise Bank, the Government also needs to ensure that it disposes effectively of its stakes in Royal Bank of Scotland (RBS) and Lloyds Banking Group. At present it appears that UK Financial Investments Ltd (UKFI), the company that holds and manages the assets of RBS and Lloyds, is prioritising price when selling the shares of these state-owned firms, rather than ensuring that any sale improves competition in the market for financial services. At present the banking market in the UK lacks competition but there is little in UKFI's mandate to tackle this weakness. Although the framework document[102] states that the role of UKFI is to sell the public stakes 'in a way that promotes competition', it is just one of three goals and one that is secondary to the goal of 'maximising the realisation of value for the taxpayer as shareholder'. In fact promoting competition is only a consideration 'if another incumbent bank was seeking to acquire a controlling stake in one of the businesses'.[103]

The sale of the public holdings in Lloyds and RBS should, as far as possible, help create or increase the market share of banks that demonstrate a willingness and an ability to serve SMEs more effectively. RBS is about 85 per cent owned by the government and its existing network of branches and trained staff could be converted into branches of an industry bank.

Proposing an industry bank inevitably raises questions about selective assistance. After the heavily criticised 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.

One of the mantras that gets repeated when the possibility of taxpayer support for enterprise is discussed is that governments should not 'pick winners'. In reality, every government throughout history has assisted business enterprises and our current Government is no exception. At present it has a Regional Growth Fund with a budget of £1.4 billion and an advisory committee chaired by Lord Heseltine that selects the investments (picks the winners). As the Public Accounts Committee discovered, it has gone about its task rather incompetently.[104] The Government has also invested huge amounts in wind turbines, both onshore and offshore, and in carbon capture and storage. These too are examples of the government trying to pick winners.

The usual argument against government investment decisions is that the decision makers do not personally bear the losses and are inclined to make irresponsible decisions. They may invest in grand prestige projects (sometimes named after political leaders), or in projects that benefit their own political party (crony capitalism), or take decisions without giving the necessary careful and detailed consideration, knowing that they will not lose anything in the event of failure. Civil servants, too, may lack the sense of personal responsibility of an investor who stands to lose everything.

It is sometimes said that it is presumptuous of governments to assume that politicians will make better decisions than private investors. Or, as the Institute of Economic Affairs has been quoted as saying, government – and the taxpayer – should not be taking the risks from business lending that banks are not willing to bear themselves. But banks reject applications from creditworthy businesses and when governments have assumed the risk, the failure rate has been low.[105] The default rate for SBA loan guarantees has been about 12%. This attitude suggests a rather naïve faith in banks, which as we have learnt face their own perverse incentives.

It is now a commonplace that some banks were seen as 'too big to fail', which meant that they could count on the taxpayer to pick up any losses. Profits were private; but the losses were public. It is now widely accepted that this awareness encouraged them to take greater, often reckless, risks. Their position resembles that of political leaders or civil servants who invest public funds. What they have in common is the moral hazard that arises when individuals have control of other people's money while being aware that they will not suffer personally if they make bad decisions.

For this reason it is desirable for the investment of public funds to be conducted at arms length from political leaders and civil servants with lifetime job security. Of equal importance, we should ensure that non-government organisations never have claims on the public purse regardless of their success or failure. Other countries have developed systems that mitigate against these potential flaws.

The countries that grew to prominence while Britain was declining, such as South Korea and Japan, successfully provided selective assistance. They tried to overcome the risk of pouring money into bottomless pits, or the pockets of people with good political connections, by devising objective tests of performance that were not easily manipulated. 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 fake. 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, in any event, channelling investment through an industry bank is not the same as directing investment via political leaders (whose priorities may be distorted by the needs of their party) or civil servants (who lack full personal responsibility for outcomes). Nor is it re-creating the perverse incentives of commercial bank executives who know that costly mistakes will make no difference to their personal remuneration.

The primary justification for the use of some public funding is that the benefits of new investment are not restricted to the people who put up the money. When a new venture is established there will be a rebound effect on the wider community in the vicinity of the factory; and there will be a national benefit if the balance of payments is improved. New jobs will reduce unemployment, which will benefit not only the immediate employees, but also the other taxpayers who will be able to spend less on out-of-work benefits.

There is an underlying assumption that the market allocates efficiently and that the public sector does not. However, as we have become aware since the Great Recession of 2008-09, banks can often make more money through arbitrage than by selecting which manufacturers have viable business ideas. Many creditworthy projects do not receive support, as a recent ONS survey found. Banks have argued that reduced lending reflects a fall in demand from businesses, but an ONS survey of small and medium-sized enterprises (SMEs) found that demand rose between 2007 and 2010: 35 per cent of businesses sought finance in 2007, rising to 42 per cent in 2010. Over the same period there was a fall in the number of businesses that were successful in securing loans: 65 per cent were successful in 2010, down from 90 per cent in 2007.[106]

If we assume that private investors seek the highest return, and they can make more money by buying and selling securities or foreign exchange for its own sake, they will do it. The full benefit of the transaction returns to them, whereas if they invest in a factory the return to capital is only one small part of the overall benefit. One way of avoiding the partiality of private investors is to increase investment by taxpayers. If the funds are provided through an industry bank that is legally obliged to invest in commercially viable enterprises, then the risks of political distortion are much reduced.

Encourage import substitution

Our massive current account deficit could be narrowed by increasing exports, but it is far easier to reduce imports. Of course, increasing exports is desirable too, but it requires significant investment in overseas infrastructure and local contacts. In the short term, it will be faster and easier for UK-based firms to increase their output for the home market, especially now that the lower exchange rate has made imports more costly. 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 Civitas report, *Reviving British Manufacturing,* 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.[107] In the cement industry, for example, Britain was a net exporter until high energy costs began to push production overseas. Cement had a trade deficit of £57m in 2011 and now firms are building import docks in the UK rather than new kilns.[108]

There is significant potential for import substitution within supply chains. Many goods finished in the UK are made using components from other countries. However, as many British companies are finding out, producing these commodities domestically can be advantageous and foreign goods and services can be unsatisfactory. To encourage domestic production, the Government needs to be more aware of successful sectors of the British economy which provide employment and reduce our reliance on imports. For instance, an investment by the German firm Palm Paper in 2009 reduced Britain's reliance on newsprint imports by one third. Inward investment in the glass industry has recently turned the UK from a net importer to a net exporter of fibre glass.[109]

There has already been a small trend towards bringing work back to the UK and a major trend has been noticed in the USA, described recently by the Boston Consulting Group.[110] A Civitas report, *The Boomerang Economy*, shows the UK's recent success in 'onshoring' industry and how this can be encouraged.[111]

Mundane jobs are worth having too

Current Government plans to 'rebalance the economy' partly rely on the argument that Britain should support advanced manufacturing. The term 'advanced' is often and confusingly used interchangeably with 'high-tech'. Ministers appear to have assumed that Britain's competitive advantage needs to rely on ventures based on research and development (R&D). There are three problems with this argument.

First, it ignores the 86 per cent of British manufacturing which is not high-tech. Moreover, low-tech does not mean low value.[112] 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 of over-emphasising high-tech industry has been an unbalanced strategy that will hinder economic development.

High-tech/advanced manufacturing, as the Government understands it, is defined by the OECD as spending over five per cent of turnover on R&D. The case for supporting it was made in 2010 in the Dyson Report, but this report and ministerial speeches that followed paid little attention to the low and medium-tech businesses that make up the majority of UK manufacturing. In 2007, high-tech companies employed just 12 per cent of all workers involved in manufacturing and contributed only 14 per cent of the total manufacturing output.[113] Given the size of Britain's non-high-tech industries, Nick Clegg, the Deputy Prime Minister, was wrong to suggest that 'a new economy might be able to rise, phoenix-like, from the ashes of the old'.[114] We are not starting again from scratch but should be building on what we already have.

The manufacturing growth review conducted by the Government in December 2010 identified seven 'successful UK Advanced Manufacturing sectors'.[115] 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 equipment and components from other British manufacturers. We need to encourage all kinds of manufacturing, not just specific types that have come to the Government's attention. 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 two per cent of companies said research was their main source of competitive strength, as opposed to 29 per cent who said their production processes gave them the edge.[116]

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. 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 element in the continuous search for innovation. Public policies should aim to create favourable conditions for any productive business that can support itself, whether it is high-tech or not.

A recent report by Manchester University has highlighted the importance of mundane jobs in maintaining full employment. We will only be able to reduce our import dependence and provide jobs for the full ability range in society if we manufacture more mundane products. The Manchester University study found that in the last ten years we have gone from 80% self-sufficiency in pig meat to about 50%.[117] It is not being supplied by low-wage economies but by northern European countries where wages in meat processing are nearly double those in the UK. The underlying problem in the UK has been that many supermarkets have a transactional relationship with suppliers and force down prices in order to extract value from other people in the supply chain, including the workforce, whose wages are suppressed. Morrisons, however, has an integrated system that allows pig farmers and meat processors to be certain of demand and thus able to operate at full capacity. Prices are low due to efficient production rather than slashing wages. A wise government would encourage such integrated and sustainable methods through tax concessions.

Declare an exchange rate target

We usually think of international trade as a competition to discover who is the most efficient producer and consequently able to charge the lowest prices. Trading success in world markets is the deserved reward for efficiency. If a firm in a foreign country can make cars more cheaply than our own manufacturers, then good luck to them. Today it is often said that cheap labour is the main factor in producing goods at low prices, and consequently we must accept that our jobs will travel east to countries such as China. But how valid is this line of reasoning?

Economists frequently debate the merits of protection versus free trade and tend to argue in favour of free trade because consumers will benefit from low prices. Import tariffs would preserve jobs for a minority of home producers at the expense of higher prices for the far larger number of consumers. However, the main problem for any producer of internationally tradable goods is that the exchange rate can wipe out the efforts of even the most diligent of companies. A firm may have the most up-to-date equipment, the best attainable labour productivity, and offer excellent quality, reliability, and prompt delivery, but prices matter most and often the margin between the lowest price and that of the nearest rival is small and easily overwhelmed by the exchange rate.

The exchange rate was a major explanation of the success of nations that grew to prosperity in the 25 years after the Second World War, notably Japan and Germany. They both enjoyed favourable exchange rates until the collapse of the Bretton Woods agreement after 1971. When its exchange rate became less favourable, Japanese growth slowed dramatically. Japan enjoyed a very fortunate exchange rate until 1971 when it was 360 yen to the dollar. By 1985 it was 285, and then it fell sharply to 145 by 1987. In 1995 it was just under 100, increasing to 131 by 1998. Without the exchange-rate advantage, its export success diminished and economic growth slowed.

We can see the size of the benefit by comparing domestic price increases in Japan with its export price increases from 1952 until 1979. Over that period the general price level in Japan rose by 364 per cent whereas the average price of Japanese exports rose by only 33 per cent. In Britain over the same period the general price level rose by 442 per cent and export prices by 380 per cent.[118]

The importance of the exchange rate can also be seen by comparing the different policies pursued by Britain, France and America in the 1930s. From 1929 until 1931 Britain had a minority Labour Government that pursued a balanced budget and public spending cuts. The Government fell in 1931 and its successor left the gold standard, which resulted in the pound falling in value by 24 per cent. An Exchange Equalisation Account was established with resources of five per cent of GDP to keep the pound at its new level. In addition, the money supply expanded by 15 per cent from 1931 to 1932 and another 19 per cent in 1933. Interest rates were close to zero. Manufacturing output increased by 48 per cent from 1932 to 1937. The workforce increased from 18.7m to 21.4m between 1931 and 1937 and unemployment fell from 3.3m to 1.8m. There was no inflation.[119]

France initially followed a different path. It stayed on the gold standard until 1936 and between 1930 and 1936 GDP fell 17 per cent in total. Unemployment increased dramatically. When the exchange rate fell from 1936 the trend was reversed.

In America from 1929 to 1933 GDP fell by 30 per cent. Industrial output fell by nearly half and by 1933 25 per cent of the workforce was unemployed, with 13m out of work. In 1934 the dollar was devalued by 41 per cent and credit was increased. The money supply (M1) rose from $20bn in 1933 to nearly $30bn in 1936.[120] Between 1933 and 1936 GDP rose 32 per cent. Unemployment fell from 25 per cent to 17 per cent. There was little inflation. Then in 1936 the policies were partially reversed and federal spending was cut and GDP fell four per cent between 1937 and 1938. Unemployment rose to 19 per cent.[121] It is not easy to separate the impact of lower exchange rates from the effects of increasing the money supply, but it seems highly likely that the exchange rate had a significant effect.

The other fundamental dimension in any debate about the exchange rate is the extent to which trade should be seen as a method of gaining advantage at the expense of other nations, or as a way of securing mutually beneficial increases in prosperity. If any government sets an exchange rate target, then it is important that it should choose a figure that is consistent with a current account balance. The rate should be chosen to avoid not only persistent deficits but also persistent surpluses.

If our ultimate aim is a free society in which everyone has a chance to succeed, then governments play a decisive part in creating favourable conditions. Foolish policies can eliminate the potential gains from individual hard work and inventiveness. In an age of fiat money, the money supply and the exchange rate are vital elements in the creation of the conditions for personal responsibility. Above all, under modern conditions, if we want significant economic growth it can’t be accomplished by supply-side measures alone.

An exchange rate target should be set to give potential exporters the confidence that investment is worthwhile. We urgently need to increase manufacturing capacity but few will take the risk of investing in costly productive infrastructure if the low prices achieved through higher productivity could be swamped in a year or so by fluctuations in the exchange rate. The broad aim should be to maintain the exchange rate within well-defined narrow bands that allow the current account to be in balance. Policy should not seek to gain at the expense of other nations, nor meekly to accept that we can’t compete with cheap Eastern labour. We should plan to maintain an exchange rate that is advantageous for all trading partners who play by the rules of mutual benefit from trade. Of course, there are implications for monetary policy, especially if bank rate is used as the chief policy instrument. A high interest rate may squeeze out inflation, but at the expense of attracting foreign money and pushing up the exchange rate. For this reason, the central bank should make greater use of more direct quantitative measures and credit controls to manage the money supply.

Eliminate unnecessary workplace regulations

The need for less regulation is widely accepted and as part of the Coalition Agreement a 'one in, one out' policy was introduced. On the surface this sounds like a good idea but the practical reality is different.

In September 2011 the Government published its statement of progress for the 'one in, one out' policy and was keen to emphasise the fact that the net annual regulatory cost to businesses had fallen by £3.2 billion by June 2011.[122] However, a closer look at the figures reveals that the Government was expecting a net increase in business costs of £45.2 million between June and December 2011. Moreover, the vast majority of the reduction in costs was the result of a change in pension indexation, which allowed companies to pay less to their defined-benefit pensioners. Furthermore, Whitehall officials calculate that the implementation of the EU's Agency Workers Directive will cost British businesses £1.8 billion a year.[123]

In October 2010 additional parts of the 2010 Equality Act were introduced. The previous Government had produced an 'impact assessment' making immense claims about the financial benefits of the Act. There were a few initial costs, followed by massive annual gains; social evils were to be reduced while contributing to the economy at the same time. However, Civitas statistician Nigel Williams has re-examined the figures and found that the surplus of benefits over costs vanishes when looked at more closely.[124] Annual benefits in excess of £62 million are described as a benefit to society resulting from greater equality. However, there is no factual basis for this figure, which comes only from a series of contestable assumptions. £62 million represents a notional value that the assessment's authors placed on equality, before making the further assumption that the Act's measures contribute to it. The costs of the Act, on the other hand, are very real. The impact assessment sets the first year's cost in a range from £240.9 million to £282.6m.[125]

In March 2011 the Government published *The Plan For Growth* in which it voiced concern about the cost of regulation and declared its ambition to eliminate excessive red tape. The aspiration has often been repeated since. In his September 2011 speech to the *Telegraph* Festival of Business, Mr Osborne said that it was the Government's ambition that 'Britain should be the best place in Europe to start, finance and grow a business'. Over the last decade the UK had fallen behind in the Global Competitiveness Index, going from 4th in 1998 to 12th in 2010. Britain, he said, 'is becoming once again a competitive place to do business' because the Government was 'tackling the suffocating burden of red tape'. Britain had recovered to 8th in the 2012 Global Competitiveness Index. In the first half of 2011 he claimed to have scrapped over £3 billion worth of 'unnecessary regulation' and imposed 'a moratorium on new regulations on small businesses'. In addition the

Government was 'battling with Europe – the origin of so much new red tape – to make them stop and realise that if they carry on then they will price our entire continent out of the world economy'.

Mr Osborne's heart is in the right place, but a more concerted effort to reduce regulatory red tape is needed. The ideal would be to apply a moratorium to all new business regulations and radically transform employment tribunals and related laws. In his speech to the Conservative conference in October 2011, Mr Osborne announced that the Coalition will 'double to two years the amount of time you can employ someone before the risk of an unfair dismissal claim' and introduce a fee for taking a case to a tribunal, returnable if complaints are upheld. So far so good, but the Government should go further and impose a cash limit of £5,000 on all unfair dismissal and discrimination compensation awards. At present some awards have no set limit. Above all, the Government should exclude avaricious 'no win no fee' lawyers by transforming employment tribunals into mediation procedures.

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'.[126] The Government has therefore set up the new enterprise allowance, providing up to £2,000 to those who wish to start their own business. But the scheme is only for people who are unemployed and will be of no use to the vast majority of potential entrepreneurs: 88 per cent of start-up funding comes from personal savings or loans from friends and family, whereas only 12 per cent is from banks.[127] At the moment people 'just don't have the money' because of high taxation.

The best way to create a new generation of entrepreneurs would be to cut personal taxes, starting with the 50 per cent rate, whose economic benefit have been accepted by the IFS to be extremely uncertain.[128] The planned reduction to 45 per cent is a step in the right direction, but not adequate.

A survey by the University of Warwick, found that over 80% of business start-ups were funded by personal savings. Only 12% were supported by banks. If we want to reinvigorate entrepreneurship we need to allow individuals to become wealthy.

But, any plan to increase private wealth instantly runs into a contradiction in our political culture. The political class wants more wealth creation, but dislikes rich people. This attitude prevailed for much of the 20th century and continues today.

Perversely, it has led to the concentration of wealth in the hands of two groups: ruling politicians and corporations. In any event, a class of super-rich people have hung on to their money by escaping the control of all national jurisdictions.

We have squeezed out middle-class wealth. There are not enough people with the spare cash to back businesses. When we have been at our best as a people, we have had a large economically independent middle class. If we aspire to compete with countries such as America we need to have American income tax rates, which start at 10% and peak at 35%. US couples who file jointly pay the highest rate of 35% on taxable income above £242,000.No tax is paid on the first £12,200. Then 10% is paid on the next £10,800, 15% on the next £44,000, followed by a steady progression through 25%, 28%, 33%, and finally to 35%.

In October 2011, Mr Osborne repeated his view that you can't borrow your way out of debt. However, you can borrow your way to economic growth, which will reduce total national debt as a proportion of GDP. Mr Osborne is fearful that cutting taxes will increase borrowing and force up interest rates, but economic growth will be more likely to achieve his ambition of keeping interest rates low. Bond markets fear default, and if national debt is a lower proportion of GDP then the chances of default are lower, leading to lower interest rates.

The main asset a nation has is its people and the first aim of policy should be to engage as many as possible in productive work, through which they make a net addition to national economic output. Keynes made this case effectively in the 1930s, but idleness is even more costly today because welfare provision is now so much more generous. There is a grave danger that high levels of personal taxation will subdue consumer demand and increase the number of people no longer adding to output.

Raising capital gains tax (CGT) for higher-rate taxpayers targets those most likely to invest their savings in productive ventures. Although the Government is concerned that wealthy individuals use capital gains to reduce their tax burden, this ignores the 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 investments. People who have put their own money into productive ventures are public benefactors and taper relief is one long established 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. At present the normal rate is 18 per cent, but a lower rate is available to owners of a business. Entrepreneur's relief applies to gains arising on disposals of the whole or part of a trading business (not including a property letting business other than furnished holiday lettings) carried on by an individual, either alone or in partnership. Gains are taxed at an effective rate of 10 per cent, compared with the normal 18 per cent.

Export support

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 £52.8 billion, while British manufacturing generated £194.2 billion.[129]

Exporting is risky and beyond the means of many companies.[130] Furthermore, the risk involved in exporting increases in times of economic uncertainty as banks and insurers become wary about issuing guarantees or insuring transactions because of the increased possibility that overseas buyers or sellers will default. Economic uncertainty has plagued the world economy since the financial crisis and British exporters have suffered from reductions in the coverage of export insurance and increases in its cost. In March 2010, the British Chambers of Commerce carried out a survey of exporters in the Greater Manchester area which indicated that one in eight exporters had reported problems with their trade financing arrangements over the previous 12 months.[131]

In response, the British Government set up a number of schemes, such as the letter of credit guarantee scheme, providing reinsurance or counter-guarantees encouraging banks and insurance companies to be less risk-averse. The problem with such interventions is that they are reactive and so may go unnoticed by the firms in need of them. Moreover, businesses are also still reliant on banks and insurers who retain the final say over whether cover is granted and at what price.

The case for government involvement in trade finance is not just limited to periods like the present when private provision is constrained. The majority of governments recognise that in some markets or for some time-periods, there is a shortage of private provision of trade finance. Unfortunately the British Government is far less supportive of its exporters than other governments, as Chapter One showed.

It would be of great value if the Government also provided an exchange-rate hedging service. It should cover, not only imports of raw or semi-finished materials for use in industries that will add value, but also exports of goods and services. Commercial banks already provide hedging but it can be expensive for small businesses and is not available for all risks.

Unlike most of our rivals, the British Government does not run a state-backed export insurance agency for short-term, non-capital goods financing. In contrast, the governments of many other developed countries run export credit agencies, often in partnership with private firms. Such agencies, as well as providing long-term financing for capital and semi-capital goods, also provide short-term financing for firms trading non-capital goods in risky markets, the market segment that is least likely to be served by private providers.[132] Compared with other OECD countries, the current level of provision places British exporters at a severe disadvantage. Most importantly, the Government needs to create a permanent, publicly-backed, insurance scheme that provides short-term, non-capital goods financing for trade in risky markets.

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 had its funding cut by 17 per cent when most foreign governments are backing their industries more than ever. In addition, UKTI has altered its fee system. Whereas previously a fee would be charged for a physical product or service, there is now a policy of charging for UKTI time and resources.[133] In itself this need not be a problem, but many companies have expressed concerns about the clarity of the new system; businesses need to know what they are paying for and to be reassured that their money is being spent wisely.

This is also important because more needs to be done to ensure that UKTI is operating as effectively as possible. In a recent analysis by the National Audit Office, nearly 50 per cent of respondents felt they would have achieved similar results without UKTI assistance or would have achieved the same end but not as quickly.[134] This result masks the fact that some UKTI services and some UKTI offices are more effective than others. Rather than cutting funding, the UK Government should ensure that UKTI funding is being used in areas where it is having the greatest effect, and that under-performing UKTI offices are improved. The evidence suggests that UKTI adds the most value to a company's efforts to expand its business when that company has no export experience. A company's need should be the main factor in any decision by UKTI to provide assistance, and arbitrary considerations such as whether the business is high-tech or an 'advanced' manufacturing firm should play no part. Low- and medium-tech companies account for 35 per cent of UK manufacturing exports.[135]

Intelligent procurement

In March 2011 the Government promised to reform procurement. David Cameron has announced that he wants at least 25 per cent of government business to go to SMEs. [136] While SMEs constitute 50 per cent of the British economy, they only win about 14 per cent of government tenders. With an annual procurement budget of £191 billion, there is huge potential to seed the growth of many more businesses.

The Government must ensure that public procurement supports British companies and the British economy. The failure of the Government to do this was glaringly obvious in the recent decision to award the £1.4 billion Thameslink contract to Siemens rather than domestically-based Bombardier.

Make the most of European Union state aid rules

Both Labour and Conservative politicians blamed one another's interpretation of EU rules for the failure to award the Thameslink contract to Bombardier. The reality is that successive British Governments are to blame for failing to make the most of European Union rules on procurement and state aid.

Other European countries dedicate more public resources to supporting their industries, especially their manufacturing industries. Between 1992 and 2007 the UK Government spent less than one per cent of its state aid on manufacturing; the German, French, Italian and Spanish Governments spent an average of 15.2 per cent.[137] Historically, the British Government has dedicated less public spending to specifically supporting British industries and British businesses, choosing instead to concentrate on pan-European objectives endorsed by the European Commission. Other EU Governments have seldom been as keen to place European objectives above national ones. Since 1992 Britain has only spent 18.7 per cent of its state aid specifically supporting British interests while France, Germany and Spain have all spent over 40 per cent supporting domestic firms and industries.[138] A close examination of the state aid measures scrutinised by the European Commission in the last three years indicates that the British Government used state aid to support the growth of the green economy, but failed to support specific firms, industries or underdeveloped regions.[139] In its relations with the EU, the UK must take a firmer stance towards the European Commission and push for the abolition of the state aid rules.

Free trade, foreign investment and the common good

Even in a mature economy like our own, it is questionable whether foreign investment, including foreign direct investment (FDI), is always favourable to competition. Clearly, the UK must remain a world-beating location for inward investment. The investments made by Japanese car companies in the 1980s and 1990s, and more recently by firms such as Tata Steel and Bombardier in Belfast, represent a real attempt by businesses to locate production in the UK. However some investments are made simply to 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. 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. The Government should apply a public interest test to all FDI. Until the 2002 Enterprise Act the Government had such a power. The Takeover Panel has proved to be a rather weak instrument, and it would be more effective to empower the Government to protect the public interest by referring acquisitions and mergers to the Competition Commission if it fears that competition will be reduced.

Conclusions

The Government is aware of the need for growth but lacks urgency and consistency. GDP is about four per cent below its peak in the first quarter of 2008 and manufacturing output is over eight per cent below its pre-recession level. In these circumstances, a government that acknowledged the long-term value of industry would have prevented the Thameslink contract from going to Germany at the expense of jobs at Bombardier in Derby, it would have moved heaven and earth to prevent the loss of skilled manufacturing jobs at BAE, and it would have prevented the closure of the Lynemouth aluminium smelter. Instead, it has failed dismally. Above all, the Government continues to make matters worse by pursuing a misguided energy policy and persists in denying itself some of the most effective policy measures, not least an exchange-rate strategy and a functioning well-funded industry bank. It has not even been resolute in pursuing deregulation or other widely accepted supply-side measures. There is a long way to go.

Notes

[1] This is an updated edition of a report first published online in November 2011. Some of the original text has been retained.

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