

FOUNDATION FOR EUROPEAN
PROGRESSIVE STUDIES
FONDATION EUROPÉENNE
D'ÉTUDES PROGRESSISTES



THE GREAT REBALANCING

**How to fix the
broken economy**

EDITED BY
Andrew Harrop

**FABIAN
SOCIETY**

The Fabian Society

The Fabian Society is Britain's oldest political think tank. Since 1884 the Society has played a central role in developing political ideas and public policy on the left.

Through a wide range of publications and events the Society influences political and public thinking, but also provides a space for broad and open-minded debate, drawing on an unrivalled external network and its own expert research and analysis.

The Society is alone among think tanks in being a democratically-constituted membership organisation, with almost 7,000 members. During its history the membership has included many of the key thinkers on the British left and every Labour Prime Minister. Today it counts over 200 parliamentarians in its number. Member-led activity includes 70 local Fabian societies, the Scottish and Welsh Fabians, the Fabian Women's Network and the Young Fabians, which is itself the leading organisation on the left for young people to debate and influence political ideas.

The Society was one of the original founders of the Labour Party and is constitutionally affiliated to the party. It is however editorially, organisationally and financially independent and works with a wide range of partners of all political persuasions and none.

www.fabians.org.uk

Joining the Fabians is easy

For more information about joining the Fabian Society and to learn more about our recent publications, please turn to the final page.

Foundation for European Progressive Studies

FEPS is the first progressive political foundation established at the European level. Created in 2007 and co-financed by the European Parliament, it aims at establishing an intellectual crossroad between social democracy and the European project. It puts fresh thinking at the core of its action and serves as an instrument for pan-European intellectual and political reflection.

Acting as a platform for ideas, FEPS relies first and foremost on a network of members composed of more than 40 national political foundations and think tanks from all over the EU. The Foundation also closely collaborates with a number of international correspondents and partners in the world that share the ambition to foster research, promote debate and spread the progressive thinking.

www.feps-europe.eu

You can also find FEPS on



Facebook



Twitter



Netvibes

FOUNDATION FOR EUROPEAN
PROGRESSIVE STUDIES
FONDATION EUROPÉENNE
D'ÉTUDES PROGRESSISTES



THE GREAT REBALANCING

How to fix the broken economy

Edited by Andrew Harrop

FABIAN
SOCIETY

FOUNDATION FOR EUROPEAN
PROGRESSIVE STUDIES
FONDATION EUROPÉENNE
D'ÉTUDES PROGRESSISTES



Fabian Society
11 Dartmouth Street
London SW1H 9BN
www.fabians.org.uk

Head of Editorial: Ed Wallis

Foundation for European Progressive Studies
Rue Montoyer 40
1000 Brussels, Belgium
www.feps-europe.eu

Senior Research Fellow: Ania Skrzypek

A FEPS/Fabian book
First published 2013
ISBN 978 0 7163 4118 5

Printed and bound by DG3

This pamphlet, like all our publications, represents not the collective views of the Fabian Society or FEPS but only the views of the authors. The responsibility of the Society and FEPS is limited to approving its publications as worthy of consideration within the Labour movement and the European progressive movement.

British Library Cataloguing in Publication data.

A catalogue record for this book is available from the British Library.

CONTENTS

Foreword	ix
Stewart Wood	
Introduction	xiii
Ernst Stetter	
1. Rebalance what?	1
Andrew Harrop	
2. Corporate Governance Reform	11
Maurice Glasman	
3. A Financial Transaction Tax	19
Stephany Griffith-Jones	
4. A Nation of Innovation	27
Chi Onwurah	
5. A Diverse Banking System	35
Duncan Weldon	
6. Lighting the Innovation Spark	42
Mariana Mazzucato	

7. Immigration as a Growth Strategy Jonathan Portes	54
8. Why Inequality Matters Vicky Pryce	62
9. One Nation Banking Chris Leslie	71

CONTRIBUTORS

Maurice Glasman is a Labour peer

Stephany Griffith-Jones is financial markets director at the Initiative for Policy Dialogue, Columbia University

Andrew Harrop is general secretary of the Fabian Society

Chris Leslie is MP for Nottingham East and shadow financial secretary to the Treasury

Mariana Mazzucato is RM Phillips professor in science and technology policy, University of Sussex

Chi Onwurah is MP for Newcastle Central and shadow minister for innovation and science

Jonathan Portes is director of the National Institute of Economic and Social Research

Vicky Pryce is a city economist and former joint head of the UK Government Economic Service

Ernst Stetter is Secretary General of FEPS

Duncan Weldon is an economist at the TUC

Stewart Wood is a Labour peer and shadow minister
without portfolio

FOREWORD

Stewart Wood

It is a truism to observe that the state of the economy is the dominant issue in British politics. At one level this debate is about the immediate questions of how to restore growth and jobs, manage the debt and deficit, and start to halt the slide in living standards. But beneath this debate lies a deeper question, about the way our economy is organised, whether it serves the interests of the majority of our country, and how desirable and feasible it is to change the rules of the game.

The 2008 financial crisis began the death-throes of Britain's post-1979 economic model. That model relied on a range of assumptions: a heroic hope that tax cuts for the richest would trickle down and raise living standards for all; a commitment to deregulation, particularly in financial, capital and labour markets; a reliance on the health of one sector (financial services) to drive investment and provide the tax revenues on which redistribution and public services depend; and a relatively casual approach to inequality as the necessary price of prosperity.

This model was brought crashing down by what Ed Miliband has called the loud crisis of the financial crash, combined with a quiet, longer-term crisis of a continuing decline in living standards. It is a model that stopped delivering system stability, consistent growth, or rising real incomes for the bulk of working families.

The biggest financial crash in a generation is reason enough to question fundamental assumptions about how our economy works. But for Labour, we have additional reasons to revisit the post-79 consensus. If Labour wins the 2015 election, the failure of George Osborne to restore growth and therefore control Britain's debt and deficit means we will find ourselves in office but severely cash-constrained. This forces us to put more emphasis than Labour has historically on supply-side reforms of our economy: changing the rules of the way markets work to improve not only their fairness but their efficiency.

The prize for Labour is that such a 'supply-side revolution from the left' offers the hope of changing the fundamentals of our economy in a way that, too often, we skated over during our time in office in favour of ameliorating the effects of low productivity and widening inequality. It also offers a chance to rethink the roles of the key institutions of our political economy – from banks, large firms and small businesses on the one hand, to unions, central and local government on the other.

The contributions in this volume cover a vast range of topics. But in different ways they address the central challenges facing those of us keen to build a new political economy for Britain.

First, how to encourage long-termism in "UK plc". Proposals for reform of our banking system, our corporate governance rules and industrial relations should be measured in large part by the extent to which they help promote long-term investment in companies and in human capital.

Second, how to meet the challenge of investing in the forgotten 50 per cent of students who do not go to university. Governments of all stripes have yet to crack the problem of Britain's comparative weakness in the production of technical skills, a weakness that has left our engineering, manufacturing, and industrial sectors hard-pressed to find the young talent they need to thrive.

Third, how to promote innovation and competitiveness. The days when the term ‘industrial policy’ was automatically associated with protectionism or propping up lame-ducks are over. A modern industrial policy must not be afraid to tilt the playing field in favour of firms who innovate, build sustainable value, and invest in people rather than poaching trained workers from others.

Fourth, how to pursue not just redistribution but also *predistribution* – Jacob Hacker’s term for “a more equal distribution of economic power and rewards even before government collects taxes or pays out benefits”. This calls for particular attention to the way Britain’s labour markets work – from finding ways to rein in the runaway rewards for the very few at the top, to tackling the insecurity, low pay and poor prospects enjoyed by too many with fewer qualifications.

Opposition has little to recommend it, but one opportunity it does offer is the chance to revisit our first principles, and find the courage to develop a genuinely radical response to the problems our country faces. The essays in this volume are imaginative and bold, and I hope they serve to stimulate both our thinking and further debate in looking to build a fairer and more sustainable economy for Britain.

INTRODUCTION

Ernst Stetter

The central message of this collection is that the ground has shifted. The financial crisis discredited the neoliberal agenda, which had been in the ascendant since the 1980s. European social democracy found itself on the back foot, having bought into the dominant paradigm through the centrist approaches of the third way and the *neue mitte*. The economic and political landscape has irrevocably changed and the most vital challenge for progressives is to lead a shift to a new paradigm, from a preference for financial capitalism to version of economic relations that benefits citizens. This is about establishing a new progressive narrative, which would pave the way to a better society.

It is high time we rethought European policies towards the crisis. Four years on we remain in an unacceptable situation. GDP and GDP per capita are still below the pre-crisis level. Unemployment remains at historically high levels: in September 2012 the rate in the eurozone was 11.6 per cent of the labour force. Even worse, youth unemployment increased dramatically, with 17.7 per cent of 15-to-29-year-olds now unemployed in Europe. There is a high risk that this will last and we will face a long-term high level of structural unemployment, which is affecting growth and public finances. The consequences are clear: increased poverty and a deepening social crisis.

We have a duty to address the manner in which we approach contemporary capitalism. The work of FEPS has sought to build a comprehensive narrative of how financial capitalism has reached its present predicament. Through co-operation with partners such as the Fabian Society, FEPS has aimed towards what Ed Miliband might call 'responsible capitalism'. It is for this reason that FEPS has been so pleased to co-operate on this pamphlet. The articles contained herein go right to the heart of the problems facing present day capitalism. However, they go further and offer routes out of the mire.

In the post-war years, European social democracy acted as a brake on capitalism, allowing the market to operate freely but responsibly, paying a social dividend. Thus, the welfare states of Europe served as a basis for decades of peace, prosperity and comparative equality. The monetarists and neoliberals of the latter part of the 20th century changed all of this, stripping back the social protections and allowing the captains of financial capitalism to act with impunity amid a regime of light touch regulation. This also altered the capacity of the welfare state to cope, based as it was on the administrative structure of the nation state.

Social democracy must face this reality in ways which do not simply involve bowing to the markets. In terms of the labour market, this collection makes a strong case for corporate governance reform, showing that, as Maurice Glasman writes, "labour is a source of value and its representation on the corporate body of the firm means that its value can be reproduced." Even in the age of globalised capitalism, it is possible to put traditional progressive values at the heart of the economy, making markets serve the people. The collection also looks at migration as a labour issue, which can be dealt with progressively.

Perhaps the most international solution to the international problems posed by the globalised nature of

financial capitalism is the financial transactions tax. Such a tax could strengthen public finances across European nations including the UK, as Stephany Griffith-Jones argues in her essay.

Of course, the proceeds from such fundraising measures can be used to stimulate more productive economic activity, and thus a smarter and more inclusive model of growth. Publicly funded investments in areas of potential productivity but relative uncertainty can stimulate further private investment and produce a substantial multiplier effect. It can produce further innovation and, if financial resources can be raised at EU level, this can be put to good co-operative use to gather the critical mass to make Europe a hub of innovation. At a municipal level, a localised banking sector can help stimulate economic recovery through local knowledge of small and medium sized enterprises.

Innovation is at the heart of the progressive paradigm shift. Innovation in economic and fiscal policy will produce the technical innovation required to bring growth and better living standards through the 21st century, both from social and environmental perspectives. Equality and sustainability must be at the heart of the progressive paradigm and policy interventions related to education, skills, taxation, and corporate governance should be core parts of this platform.

Europe is on the eve of important challenges, with elections in two 'founding' member states of the EU next year – Italy and Germany – and there is the need to prepare thoroughly for the next European elections in 2014. The challenges we face are profound and it is not simply a question of winning elections, it is a question of proposing real alternatives for social democracy after the crisis; framing a truly social contract with citizens, based on progressive values.

I am more convinced than ever that these times necessitate pan-European progressive answers. National

solutions cannot resolve the crisis. The questions facing today's society are not about the next set of elections or if a nation is for or against Europe. The questions are: what do progressives stand for? And what are the policies of Europe, and its member states, achieving?

Furthermore it is also about expressing a hope for the future – a chance to shape our 21st century Europe by assuring a solid and values-based economic and social alternative.

This pamphlet is a contribution to enhancing the debate about Britain's 'next economy', which in turn could help to shape the 'next Europe'. The future in the UK and in Europe lies in solid economic development. Without alternative economic policy approaches, high (full) employment cannot be guaranteed and this is the precondition for the wealth and prosperity of a nation and of our continent.

1 | REBALANCE WHAT?

Andrew Harrop

With a little over two years until the next general election, Labour's objectives for economic reform feel ambitious yet vague. Words like responsibility and rebalancing are used a lot, but they raise as many questions as they answer. We can all sign up to the UK being a bit less reliant on the financial sector, but then what? When the left talks about rebalancing the economy we need to understand what it is we are trying to rebalance and how – and say loud and clear why the right's version of rebalancing will fail. The scale of the challenge should not be underestimated, however: achieving 'one nation' capitalism will mean the UK turning its back on the mid-Atlantic experiment and transforming itself into a mainstream north European economy.

For George Osborne, rebalancing is all about the deficit. His overriding political goal is to rebalance Britain's public finances as soon as he can – and he's not even doing well at that, as the 2012 autumn statement revealed so clearly. Economists can now see the perverse effects of simultaneous pan-European austerity which has lowered UK growth and tax receipts and pushed up social spending so that the deficit is hardly falling at all.

But there is a more subtle objection to Osbornomics: that successful deficit reduction depends on a simultaneous rebalancing in the private sector (something which is

unlikely to be achieved to the Treasury's timetable). This view has been championed by Martin Wolf of the *Financial Times* and was the subject of a recent Fabian report *A New Golden Rule: Putting the corporate sector surplus at the heart of economic decision making*. The argument goes that since a public sector deficit is the mathematical inverse of a surplus in the rest of the economy, it can only fall when that surplus falls too. In the case of the UK it takes the form of a large corporate sector surplus and imports outstripping exports. Unless exports rise and the private sector stops hoarding so much cash, spending cuts just take you on a downward economic spiral.

So the first answer to what we mean when we talk about rebalancing, is that we need to unwind the economic forces which have led companies to accumulate so much cash. Above all this means finding ways to ensure that businesses prioritise investment over immediate profits. If the economy picks up, business investment may start to increase a fair bit, as it tends to oscillate a lot between good times and bad (for now businesses do not perceive domestic or export opportunities to justify much investment). But waiting for an upturn won't be sufficient, because there are broader structural reasons for the UK's weak investment performance. The short-termism of our financial markets has driven down investment by incentivising firms and their executives to deliver fast profits not long-term value. If the UK's investment rate of 15 per cent of GDP could be increased to match the eurozone's 19 per cent, our growth prospects would significantly brighten.¹

Meanwhile – and perversely – other parts of the private sector are starved of credit to invest in viable business opportunities, as Chris Leslie, Duncan Weldon and Chi Onwurah discuss elsewhere in this collection. In other words, in our unbalanced capitalism there is a massive disconnection between the supply and demand for capital itself. Banks should be playing a much bigger role in

transmitting money around the economy, but they remain fragile and undercapitalised. They're struggling even to pass on the billions of pounds pushed their way through quantitative easing. So thought should also be given to alternative non-banking routes by which cash-hoarding segments of the private sector, like large businesses and pension funds, might invest in areas such as high-growth enterprise and long-term infrastructure.

Rather than trying to offset plummeting business investment through public sector capital spending, both Alistair Darling and George Osborne exacerbated the problem by cutting it savagely. Even though investment is the area of public spending, which is most likely to stimulate economic growth, it has been cut from 4.8 per cent of GDP to 2.5 per cent of GDP between 2009 and 2017, notwithstanding the small adjustment announced by the chancellor in the 2012 autumn statement.² Little wonder that the breaks have been put on government support for house-building, public buildings and infrastructure, despite the obvious job-creation benefits.

A future government should think much harder about how to channel sufficient public spending to where it is most likely to boost growth, including research and education as well as capital investment. As Mariana Mazzucato shows in her chapter, publicly funded research and innovation is an essential platform for corporate success stories. Similarly, evidence from across advanced economies suggests that first-rate education systems are essential to drive growth, employment and earnings.³

If you believe that public spending matters for future growth prospects, however, you need to exercise extreme caution in paring it back. Major cuts make it very hard to sustain growth-oriented spending as well as the essential distributive roles of government, where the pressures continue to mount. George Osborne has traded one for the other in his eagerness to reduce spending, by maintaining

pensions and healthcare spending at a cost to everything else. His plan is for public spending as a share of GDP to shrink from the crisis peak of 47 per cent down to 39 per cent, deliberately overshooting the long-term British average of 42 to 43 per cent.

If we are to have both distributive and growth-orientated spending the left needs to argue for a different path that sustains Britain's post-1945 model. In our inward-looking UK debate, the terms of which have been successfully framed by the Conservatives, this sounds like a controversial proposition, but it would still leave Britain with a smaller state than the EU average. Nor would it mean deficit denial, for Osborne's 'overshooting' is not an inevitability of deficit reduction. Instead a future government would need to raise more taxes and cut more slowly in order to stabilise the public finances at a higher overall level of spending. The left needs to embrace this alternative version of fiscal rebalancing.

There are, however, areas of government spending where it is desirable for the market to take more of the strain, for we spend billions on people of working-age who are either jobless or on low pay. If fewer people were out of work, rents were cheaper and people were better paid, then demand for public spending would shrink. The UK's employment rate of 70 per cent is above the EU average; however we still under-perform five north European neighbours, showing there is room for improvement even during global economic gloom. Meanwhile the share of British workers who are poorly paid (below two-thirds of the national median) puts us right at the bottom of the EU15 league table. The exchequer would save huge sums in tax credits and other in-work benefits if rather than having 21 per cent of workers on low pay we could match Denmark's 14 per cent or Finland's 8 per cent.⁴

So reform of our labour market is the next priority for rebalancing. If we do nothing over the next decade,

employment is projected to slowly increase as the economy recovers⁵, however the incidence of low pay will grow worse because low paying sectors are expected to expand. Alongside benefit cuts this will more than offset the benefits of rising employment, leading to real living standards falling for the bottom half of the income distribution⁶. Indeed the Resolution Foundation suggests that the real income of a family 10 per cent of the way up the income distribution will fall to levels last seen in the early 1990s.

To avoid this predicament the left needs to embrace a radical agenda for the bottom half of the labour market. This will be no mean feat, for the low-skill service sectors will still grow. So we must work on making low paid work better and better paid. This comes down to a combination of economics and sociology. Jobs need to be designed and people trained so work is more productive and secure, which in turn can bring about better pay and progression. But labour market rebalancing also means reassessing the status and value of low paid 'women's work': for the huge disparities in pay across the EU for these service sector jobs (which are largely immune to the competitive forces of global competition) is about more than economics.

In his chapter, Maurice Glasman writes about the importance of corporate ownership and governance structures as a route to redressing the balance between labour, profit and investment. The lessons from Germany are highly instructive, although we should be wary of direct imitation and 'cookie cutter' solutions. Across most successful EU economies stronger institutions outside the firm also play an essential role, so that firms operate in a context where their peers set positive expectations regarding the design of jobs, training and rates of pay. Ideally the pressure to improve should be self-generated from within sectors and supply chains, including through the pressure of government procurement conditions such as living wage clauses. But new public institutions should be considered as a

fall-back along the lines of wage councils or the construction industry training levy.

We should also be relatively bullish about the potential for increasing the floor for low pay by raising the minimum wage. There obviously comes a point where raising the minimum wage will cost a significant number of jobs, but there is little to suggest we are near it yet, particularly as the national minimum wage has been losing value against inflation for more than five years. As the UK, we hope, moves towards recovery, in setting the minimum wage policymakers should err a little more than in the past towards improving pay rather than creating jobs.

There are three reasons for saying this: first, during the recession employment held up well at the expense of pay; second, it reflects the UK's relative strengths within the EU, since we do well on employment but very badly on low pay; and third because British policy makers have a far better understanding of how to improve employment than earnings, so if anything were to go wrong we could step-in with an established toolkit, including better incentives to make work pay and robust welfare-to-work programmes. Indeed the savings from spending less topping up pay could be ploughed back into improving universal credit or childcare provision to improve work incentives and boost employment, especially for working parents.

So the next government should not only push for sector-based initiatives on pay and conditions, it should also introduce a new 'escalator' for the minimum wage to take it, in small increments over a parliament, to the level of a living wage (which is £7.45 per hour outside London). This may sound like a bold step, but for the worst hit sector, hospitality, it would mean an increase in payroll costs of a little more than one per cent per year.⁷

Yet, the reforms best placed to both increase employment prospects and boost low pay would be measures to improve skills in the lower half of the labour market; the

'forgotten 50 per cent'. This was of course the theme Ed Miliband alighted on to bring to life his vision of a 'one nation' economy at the 2012 Labour party conference. He promised a new vocational qualification for 18-year olds, with English and maths, vocational skills, work experience and a respected school-leaving certificate. The detail may need some refinement (for example, a separate technical baccalaureate risks creating a new system of 'sheep' and 'goats') but the concept of a new 16-18 curriculum is essentially sound.

However, the flow of young people into the workforce is far too slow for this to be the only route to improving workforce skills. In office Labour tried and largely failed to engineer a leap in work-related learning especially for adults without intermediate skills. As with low pay, the next government needs to hold out both 'sticks' and 'carrots' to each sector so they develop and push robust qualifications which are useful to employers and stand individuals in good stead for the rest of their working lives.

But what about the top of the labour market? The changing profile of industrial sectors means we can expect continual growth in the number of professional jobs. But in their midst, Britain also needs more entrepreneurs and innovators of the sort Mariana Mazzucato and Chi Onwurah discuss in this collection. Meanwhile Jonathan Portes makes a convincing case for skilled migration to complement and boost home-grown sources of growth and innovation. It is an irony that most of the social anxiety about migration has been generated by unskilled migration from other European countries (over which the government has no control); but the coalition's response has been to rein in skilled migration from the rest of the world, which brings such obvious benefits.

Creating the institutions and culture for innovation and business growth is perhaps more important than picking out sectors or individual companies for special attention.

We need to be particularly careful about unthinkingly embracing calls for a manufacturing revival which, while desirable, will create far fewer jobs than broader-based growth in the non-financial service sector. If shifting the balance away from our shrinking financial sector means an increase in other services, with good jobs as a consequence, that is nothing to regret.

While rebalance between manufacturing and services should not be a priority, British policy makers should worry obsessively about geographical rebalancing. Between 2000 and 2010 regional economic disparities widened sharply, with every region and nation of the UK losing ground except for Scotland, the south-east and London.⁸ So we should be very wary of deliberately and rapidly drawing public money away from poorer regions. Yet at the same time regions outside south-eastern England need a fast-growing private sector. This could mean setting up a more diverse banking system with regional banks, as proposed by Duncan Weldon, as well as strategic bodies dealing with transport and infrastructure. At more local level city-regions should take over more powers, including economic budgets ranging from skills to housing.

Geographic rebalancing would also be given a big shove forward if Britain were to shift a little away from taxing incomes towards raising money from wealth and land, where the regional and socio-economic inequalities are much greater. Taxing assets better would enable the UK to raise more money from rich households and businesses without raising marginal tax rates, which can dampen growth. Just as importantly it would suppress the tendency for asset bubbles to inflate and burst, to everyone's cost. The taxation of land or housing wealth, alongside a massive housebuilding programme and reduced mortgage deposit requirements, would start to improve the affordability of housing for middle earners and lower the huge regional disparities in housing costs. Not only would

this increase labour mobility, in many places it is the only way to make homeownership an option for families who cannot call on inherited wealth.

If the Labour party is serious about a 'one nation' rebalancing of the economy, it needs to paint on a vast canvass, with the goal of creating of a more north European style of UK economy. A British rebalancing must be broad-based, for change on any single front could just be a pin-prick. But taken together a wide package of reforms really can change the character of UK capitalism. The left must develop plans to engineer a shift from business cash-hoarding to investment; from a shrinking state to pro-growth public spending and taxation that targets assets over incomes; from a low-pay economy to one where modern skills are distributed across the whole labour market; from economic policy run for finance to public policy that creates the foundations for broad-based innovation; and a government that tirelessly seeks to redress our deep-seated geographic inequalities. The list may be long and daunting, but rather than being a reason to walk away, it is a call to arms. We must make preparations for a radical government of the left which can take Britain back to the European mainstream.

Endnotes

- 1 National Accounts at a Glance 2011, OECD
- 2 HM Treasury Public Finances Databank and Economic and Fiscal Outlook, December 2012, Office for Budgetary Responsibility, 2012
- 3 *Going for Growth*, OECD, 2012
- 4 OECD employment database
- 5 Mike Brewer, Andy Dickerson, Lynn Gambin, Anne Green, Robert Joyce, Rob Wilson, *Poverty And Inequality In 2020 Impact Of Changes In The Structure Of Employment*, Joseph Rowntree Foundation, 2012

- 6 Gaining from Growth: the final report of the commission on living standards, Resolution Foundation, 2012
- 7 Calculations based on Figure 4.14, *Gaining from Growth: the final report of the commission on living standards*, Resolution Foundation, 2012
- 8 Regional, sub-regional and local Gross Value Added 2010, ONS, 2011

2 | CORPORATE GOVERNANCE REFORM

Maurice Glasman

The financial crash of 2008 will turn out to be the most important event in the politics of the next twenty years. It was the result of a failure of many things but one of them was corporate governance. The UK needs to learn the lesson of the German economy: that labour is a source of value and its representation on the corporate body of the firm means that its value can be reproduced.

It is two and half years since Labour's general election defeat and there's two and a half years to go until we face the country again. It seems that we are still torn between a defence of the New Labour record and the articulation of something different and better. The second option requires an explanation of what went wrong, particularly in relation to the growth of debt and the lack of genuine private sector growth or public sector reform. This also requires difficult conversations within the Labour movement, the re-evaluation of cherished dogma, the generation of new alliances, and the admission of complication; when it is so much easier to blame it all on the cuts and call for a stimulus package. We are also torn between fear and hope, between the demonisation of the Tories and the making of a constructive offer that challenges all sectoral interests to find a common good. One of the difficulties is that New Labour thinkers were essentially right in their

analysis of where we need to go and the conditions under which we can flourish in a competitive and globalised world economy; the problem was the means. They were right that we need to move to a high value economy, they were right to call it a knowledge economy and to view skills and education as a vital part of that. The problem was that their approach was based upon policy prescription rather than new institutions, on management rather than leadership and that meant the domination of a single interest in decision making.

The central insight of Blue Labour is that there was a fundamental problem with the political economy of New Labour. The assumption that globalisation required transferrable skills and not vocational speciality, and that tradition and local practice could be superseded by rationalised administration and production, both turned out to be mistaken. The denuding of the country and its people of their institutional and productive inheritance by the higher rates of returns found in the City of London, and then the vulnerability of those gains to speculative loss, is the story we confronted in 2008. It turns out that the German political economy, with its federal republic and subsidiarity, with its works councils and co-determination between capital and labour, with its regional and local banks and vocational control of labour market entry – a democracy locational and vocational – was much better equipped to deal with globalisation than we were with our financial services and transferrable skills. They generated value through pursuing a common good between capital and labour, which were both represented in the governance of the firm and responsible for the development of corporate strategy. They retained pre-modern artisan organisations and turned them into the foundation of their contemporary economic success. They entangled and constrained capital in a myriad form of localised arrangements and they emerged from the crash, virtually alone,

with a productive economy and a functioning democracy, with greater equality than us and more meaningful work.

The German political economy retained ideas of status that we discarded in favour of flexible labour markets and yet they proved better at adapting to the change in circumstances generated by new technology and financial innovations. They asserted that globalisation was not a fate that required a single response. Theirs was an Aristotelian conception of internal goods, of internal negotiation and co-operation, of a balance of interests within a corporation and not an exclusive assertion of external ownership and unilateral managerial prerogative. This characterised a system built upon strong, self-organised democratic institutions within the economy. The comparative superiority of the social market economy and the weakness of ours requires constitutional change and civic renewal as well as the creation of new economic institutions. In other words, the generation of a different system: a system that generates value rather than debt. We need changes to corporate governance that can correct an economic model with a bias towards immediate forms of financialisation. This means offering 'incentives to virtue' that can constrain the short-term imperatives of profit-maximisation within a set of institutional relationships. Corporate governance reform sounds boring but it is about the balance of power within the firm, and that kind of rebalancing has not been at the forefront of Labour's reasoning about industrial policy.

It is essentially a move towards the generation of value and away from an exclusive reliance on credit. Before moving to the changes necessary in corporate governance it is necessary to consider in more detail one aspect of the New Labour growth model: debt. It is not only that when it comes to the combination of household debt and those held by our financial institutions, we are indeed the world leader but that this comparative advantage has been building for a long time. It has attained the status of

a 'developmental pathway' and its maintenance is supported by the two dominant interests supporting the status quo: finance capital and the state. To resist the domination of society by these two forces it is necessary to decentralise democratic power to local institutions that can resist the concentration of power and ownership that are generated by state and market based economic systems.

The story presented here is that the combination of finance capital and public administration, which have been the dominant drivers of employment and growth over the past 30 years have not generated very much value. Of the 1.3 trillion pounds lent by banks in the British economy between 1997 and 2007, 84 per cent was in mortgages and financial services. Debt, with everything that means for people, families and businesses, was the great growth area so that an economy built on invisible earnings concealed the virulent growth of an invisible grief.

Neither a Keynesian nor a free market approach, state and market based strategies, can give any account of the societal conditions of economic success and yet they remain the fundamental choice we are forced to make. Neither model has the conceptual means of understanding the importance of institutions, of vocation, of virtue and value in generating competitive advantage. Neither has the ability to conceptualise the importance of long term stable relationships between capital, labour and locality in generating growth and innovation that are the fundamental condition of competitive advantage in the contemporary market economy.

An exclusively Keynesian strategy cannot effectively penetrate into the institutional mediation required for the renewal of skill, vocation and tradition within constantly transforming circumstances. Apart from the odd flashes of ambiguous insight in chapter 12 of *The General Theory* Keynes hardly touches on the firm, and what a good firm might be; there is no theory of the representation of the

interests within the firm and the institutions required to turn information into knowledge and the practices embodied in those institutions.

Counter-cyclical reflation has been practiced since Athens and Rome as a means of preserving the status of citizens and society and was the primary political economy of each city state in the era of the medieval communes. It is one of the essential tools of statecraft. However, in order to avoid the partnership of finance capital and the state, and build an alternative growth strategy it is not helpful to adopt an explicitly Keynesian method of stimulus. The practices of the social market economy in Germany and the theoretical framework given by Karl Polanyi in *The Great Transformation* are perhaps a better guide. Both stress the importance of preserving internal goods and practices within decentralised institutions as a core feature of contemporary economic success, which has to have a relationship with quality and excellence.

The financial crash of 2008 will turn out to be the most important event in the politics of the next twenty years. It was the result of a failure of many things but one of them is corporate governance, and most particularly, accountability. The shareholder system is built upon the maximisation of returns so there is no reason for it to constrain the sovereignty of fund managers in their pursuit of maximisation and that led to cheating, exaggeration and extreme forms of speculation. This lack of accountability is seen as an important problem within the business elites and is precisely where a new consensus is possible relating to internal forms of accountability which combines interests with expertise. There is a growing realisation that the workforce has interests in the flourishing of the firm and an internal expertise in what is going on and how it is done. The complement of workforce to shareholder accountability strengthens the honesty and durability of the firm. It establishes a form of relational accountability.

A comparative analysis of corporate restructuring strategy in Germany and Britain tells the story clearly. The resilience of German industry was based upon two fundamental differences with Britain, both relating to corporate governance. The first was that each stakeholder interest – capital, labour and region – has access to the same information about the state of the firm and the sector and could negotiate a common response and bring people with them. The great unanswered question of British trade unionism is why did German car workers take a pay cut in a boom? The answer is to be found partly in the co-determined pension scheme which is partly based on the health of the sector, but more on the internal understanding of the long term changes required to compete effectively in a globalised economy within a national framework in which workers had some power over their destiny. Power and responsibility are mutually supportive concepts. German workers could make an informed internal judgement as to their long term interests and negotiated a strategy of renewal with owners that could achieve the mutually beneficial result of a more competitive industry.

The second reason relates to the common good. The recognition of complexity within the corporation, the recognition that it is a body constituted by complex and mutually dependent functions and the representation of that in the corporate governance model meant that a common good of the firm could be negotiated. German industry works within a legal framework that is based upon the 'equalisation of the burdens'. In this the burdens of decisions must be agreed to be balanced between owners and workers. This meant that there could not be the imposition of a strategy that was based upon the interests of only one party. The result is predictable: fewer increases in managerial pay, a far greater retention of workers within a framework of greater flexibility, and a shared concern for the renewal of competitiveness. Capital was constrained

from taking a predatory form, a financialised form, and retained its productive status through being embedded in the corporate governance of the firm.

Corporate governance reform asks a lot of capital. It relinquishes its ultimate sovereignty and recognises the workforce, and a skilled and powerful workforce at that, as a necessary part of the generation of value. It recognises the inability to hold itself accountable and recognises its common interest with labour in disciplining its tendency to be too generous to itself. It also asks a lot of labour, and of the unions. The German and British trade unions took different pathways in 1945. The British trade unions went for the Keynesian state model in which nationalisation, the welfare state, statutory wage settlements and collective bargaining were the mainstay. In West Germany, in contrast, they went for a worker representation model within the economy within a decentralised political system in which labour market entry was regulated by vocational qualification and the financial system was far more decentralised, with regional and sectoral banks playing a far more significant role. While the British model was faster out of the blocks in 1945 it turned out that the German model won the race. They retained far higher trade union membership, lower wage differentials, fewer job losses and a vocational status for labour within the economy. One of the consequences of corporate governance reform is the requirement for trade unions to seek the common good and that is a conversation that has barely begun.

Worker representation on remuneration committees is a step in the right direction but needs to be extended into wider reform of the governance of any firm above fifty employees. A third of the seats on the supervisory board should be elected by the workforce. The energy, skills and commitment of the workforce is of fundamental importance to the good of any company and how that feeds into decision making and product innovation is a matter

of institutional design. Corporate governance reform is not a stand-alone policy and requires new regional banking institutions and a renewal of vocational training and status. It is, however, the most fundamental for it restores a dignity to labour, a value, that has been for too long neglected in our economy. The lesson of the German economy is that labour is a source of value and its representation on the corporate body of the firm means that its value can be reproduced. It is a fundamental part of the institutional ecology of a sustainable economy.

3 | A FINANCIAL TRANSACTION TAX

Stephany Griffith-Jones

At a time when many European governments face large deficits, partly as a result of bailing out the financial sector, it seems reasonable to expect the financial sector to support the balancing of the books. To hundreds of economists, the evidence is clear: a financial transactions tax would help strengthen the public finances across European nations including the UK, reduce the likelihood of future financial crises, and provide a new source of finance for European and UK growth.

There is growing support in continental Europe for the approval of a financial transaction tax (FTT). This support has moved from just civil society and progressive political parties, as had been widespread in the past, to concrete support by the governments of 12 countries, including most of the major European economies (such as Germany, France and Italy) as well as Austria, Belgium, Greece, Holland, Portugal, Slovenia, Slovakia and Estonia. These twelve governments are close to agreeing a formula for the FTT similar to that proposed by the European Commission, of a 0.1 per cent tax on bond and equity transactions, and 0.01 per cent on derivatives. This would be achieved under a mechanism called the 'enhanced co-operation procedure', which allows some member states to move ahead when not all EU member states agree a

measure. It will require the European parliament to give its consent, which it is likely to do by December 2012, and the European Council would then hopefully adopt the authorisation decision under qualified majority voting of all 27 member states in early 2013.

The German government is already assuming this will happen and has budgeted small resources for FTT implementation for 2013, and income from its revenue starting in its 2014 budget. Though the main push has come from social democratic parties, it is interesting that several conservative governments, like the German and Spanish ones, have committed to approve and implement the FTT. A clear exception is the UK Conservative-led government, which has opposed this tax, even though the UK is one of many countries implementing a very successful stamp duty on sales of stocks and shares. It is widely seen that the position of the UK government is based on a narrow defence of the short-term interests of the City, and of high income individuals in the financial sector, rather than of the interests of the broader UK economy as well as people more generally. Even the financial sector itself would benefit in the long-term from the additional stability and growth that an FTT would bring.

It is important for the UK Labour party to join other progressive European parties in supporting an FTT. At this stage, it could put pressure on the coalition to at least support the enhanced co-operation of other EU countries to implement the FTT, to ensure that this is approved by the European Council early in 2013.

In the future, a Labour government should itself use the enhanced co-operation procedure to join other European governments in implementing the FTT along the lines the European Commission is suggesting, and the European parliament is backing. There is very strong support amongst British people (at over 70 per cent in recent polls¹) for a financial transaction tax. The revenues of FTT could

be for example partly used to capitalise a British investment bank (BIB), which is one of the visionary proposals of the Labour party to help restore growth to the British economy. According to an IPPR report on the British investment bank, a £40 billion capitalisation over four years would allow the institution to immediately raise funds on capital markets by issuing bonds up to a leverage ratio of 2.5:1, which would mean the BIB could have a balance sheet of £140 billion within four years. In fact, this is a conservative estimate as the European Investment Bank (owned by all European Union governments), which is increasing its capital by around 10 billion euros, is estimating a much higher leverage ratio of 8:1.²

BIB funds could be used to increase lending for commercially viable infrastructure investment and for lending to SMEs. These are very much needed, especially at a time, when private lending is still falling, due to the deleveraging linked to the financial crisis. This lending would not just help boost growth and employment in the short term, but – as or more important – also increase supply in the UK economy in the medium and long term, and facilitate the necessary restructuring of the British economy towards internationally competitive and more dynamic sectors.

Preliminary estimates for the annual income of an FTT in the UK vary in the range of £9 billion³ to much higher amounts.⁴ If the latter estimates were more correct, in the first few years of the tax part of the funds could go to capitalising the British investment bank, and the rest could go to budget consolidation. When these urgent needs are met, then in later years, some of the resources could be channelled to financing climate change prevention, especially in the developing world, that would both help the world's poorest people and help protect the planet.

In the first phase, financing the BIB capital and budget consolidation would have clear positive macroeconomic impacts. Taxing mainly the most speculative frequent

financial transactions, (such as 'high frequency trading', which has no socially useful effect on the economy, but with potential serious negative effects on financial stability) could actually boost future levels of UK GDP, mainly by reducing somewhat the likelihood of future financial crises. Raising this tax, which would be paid mainly by very high income people with high propensity to save, would in the short-term not reduce aggregate demand too much. If the additional tax income went to financing the capital of the BIB, its lending would clearly boost investment, growth and employment. Even if part of the revenue went for budget consolidation, this would lower borrowing costs for the government, as well as increase future debt sustainability of the UK government.

Before the great contraction began in 2007, bankers had succeeded in painting financial transaction taxes as the idea of naïve idealists who knew little about the real workings of finance. This was absurd given that the idea had towering intellectual credentials. Keynes had recommended it in *The General Theory* and Nobel prize winner James Tobin later developed it. Many leading economists, like Joseph Stiglitz, now support the idea.

Before the financial crisis, rather than looking to "throw sand in the wheels of finance", in James Tobin's colourful phrase, the story propagated by the industry was that those wheels should spin ever more quickly. The faster money moved, and the larger the financial sector, the more efficiently savings would be allocated, we were told. Bankers and hedge fund managers would grow super-rich, but that was a minor distraction because the economy would be stronger and jobs more plentiful. That story has been knocked down by the financial crisis. Recent empirical studies by the IMF, including in its 2012 Financial Stability Report, and by the Bank for International Settlements, conclude that increasing the size, and pace of growth, of the financial sector is good for economic growth – up to a

point. Beyond this point, a larger financial sector seems to reduce growth, as well as increase its volatility.

In this context, FTTs are no longer ridiculed; how could they be when the world's most dynamic economies – like Brazil, South Korea and India – use them? When in 2011 approximately \$38bn was raised by FTTs in the 40 countries that have them? When Europe's most successful large economy, Germany, wants to adopt one, along with eleven other EU states? Since 1986, and before in other forms, the UK government has unilaterally, without waiting for others to follow suit, levied a stamp duty reserve tax of 0.50 per cent on transactions in UK equities. Despite not updating this tax to take into account derivatives and other innovations, nor taxing other instruments like bonds, it still raises \$5bn per year.

One of the key reasons why these FTTs work is that they are stamp duties, on the transfer of ownership, and are not based on tax residence. If the transfer has not been 'stamped' and taxes paid, the transfer is not legally enforceable. Institutional investors who hold most assets around the world do not take risks with legal enforceability. 40 per cent of the UK stamp duty reserve tax receipts are paid by foreign residents. Far from sending tax-payers rushing for the exit, this tax gets more foreigners to pay it than any other. It is very encouraging that the latest version of the FTT, being discussed in the European parliament, incorporates positive lessons from the UK stamp duty on stocks and shares and proposes that both residence and place of issue should be taken into account. This combination will make it far harder for evasion of this tax to occur by trading in other centres, such as the US or Asian ones.

An incorrect argument, promoted by the City of London, is that it is necessary for all major financial centres to impose an FTT, to avoid the risk of relocation; this is used as a deterrent for governments not to join the FTT. However, FTTs have always been levied unilaterally to

date. The argument that the UK would have to wait on the US or any other financial centre to introduce a broad based FTT flies in the face of the global experience. As pointed out, over 40 unilateral FTTs have been levied – either temporarily or permanently – to date, including leading nations such as South Africa, India, and Brazil, not to mention UK stamp duty and the small levy that funds the Securities and Exchange Commission in the United States. An FTT can also be designed – as with the European legislation – to tax transactions wherever in the world they take place (residence principle) as well as to tax transactions issued in a particular country (issuance principle). The relocation argument is therefore a mirage, one which does not stand up to the close scrutiny of FTTs in either theory or practice.

Having lost the argument on feasibility, the financial sector and their political friends are now vigorously opposing FTTs with ever more outlandish claims about their negative impact on the wider economy. In fact, the European Commission model estimates in its latest iteration that a 0.1 per cent FTT on equities and bonds could reduce GDP by just 0.1 per cent. This takes into account that the overwhelming majority (85 per cent) of investment is financed from retained earnings or bank loans not subject to FTTs. Furthermore the proposed FTTs would apply only to transactions between financial institutions and would not cover companies issuing new shares.

But this is not the complete story. It is necessary to add that the tax would fall heaviest on short-term holders of securities like high-frequency traders, hedge funds and the banks' proprietary trading desks and fall least on long-term holders like pension funds, life insurance companies and private equity firms. This would likely trigger a shift away from short-term trading in favour of long-term holding that will reduce misalignments in markets and their subsequent abrupt adjustments or crashes. FTTs

would therefore somewhat decrease the likelihood of future crises and indeed those countries that have FTTs were disproportionately amongst those least affected by the crash that started in 2007. If we conservatively estimate that the probability of crisis would decrease by only 5 per cent as a result of the FTT, which is very low, and we take into account that on average financial crises lower GDP by around 7 per cent, we would have a positive impact of 0.35 per cent of GDP due to smaller likelihood of future crisis. The total net effect of an FTT would be an estimated boost of European GDP by 0.25 per cent, not a reduction.⁵

At a time when many European governments face large deficits, partly as a result of bailing out the financial sector, it seems reasonable to expect the financial sector to support the balancing of the books as well as adopting measures to help reduce the likelihood of future crises, and, perhaps most urgently, helping finance measures that lead to the promotion of European growth. To hundreds of economists, the evidence is clear that an FTT would help to strengthen the public finances across European nations including the UK, reduce the likelihood of crises, and provide a new source of finance for European and UK growth. Then as the crisis recedes a proportion of FTT revenues can in the future be ear-marked for helping to finance solutions to some of the world's most difficult international problems like poverty and climate change.

Endnotes

- 1 www.ituc-csi.org/g20-told-voters-want-banks-to-put.html
- 2 Griffith-Jones, S., Kollatz-Ahnen, M., Andersen, L., Hansen, S. (2012) "Shifting Europe from Austerity to Growth: A Proposed Investment Programme for 2012–2015" FEPS – IPD – ECLM Policy Brief www.feps-europe.eu/uploads/documents/shifting-europe-from-austerity-to-growth-FEPS-IPD-ECLM-3.pdf
- 3 Persaud, A. (2012) The Economic Consequences of the EU

Proposal for a Financial Transaction Tax, Intelligence Capital
www.stampoutpoverty.org/download.php?id=444

- 4 Ernst and Young (2011) Outlook for Financial Services, Issue number 3, Winter 2011/12 Forecast [www.ey.com/Publication/vwLUAssets/ITEM_Club_Financial_Services_Winter_2011-12/\\$FILE/EY_ITEM_Financial_Services_Winter_2011-12.pdf](http://www.ey.com/Publication/vwLUAssets/ITEM_Club_Financial_Services_Winter_2011-12/$FILE/EY_ITEM_Financial_Services_Winter_2011-12.pdf)
- 5 A more detailed version of this analysis can be found in Griffith-Jones, S. and Persaud A. (2012) Financial Transaction Taxes, Report presented to the European Parliament. http://policydialogue.org/publications/network_papers/financial_transaction_taxes

4 | A NATION OF INNOVATION

Chi Onwurah

We are on the brink of another industrial revolution, as we deal with the carbon legacy of the last one and emerging markets industrialise. We need to make sure that the rewards of this revolution's innovations are distributed more fairly than the last, by democratising our science talent base and enabling small and medium sized enterprises to take advantage of the opportunities on offer. We can improve the financing of small, innovative businesses, through commercial bank lending, procurement and public investment.

When I was growing up the north east was the UK's industrial powerhouse. Quite literally: the coal which fed the power stations which fuelled our industry was beneath our feet. Across Newcastle, the end of the school year would see thousands of school leavers walking straight into apprenticeships in the shipyards or the factories. At the Armstrong site in Elswick in my constituency 23,000 were employed during its heyday in the early 1900s, Swan Hunters in Wallsend employed 11,500 shipbuilders in the 1970s.

Those days are gone and with them the structure of employment in the region. The north east is still a manufacturing centre, but automation and huge productivity gains mean that manufacturing is no longer the leading

employer in the region. That title has passed to the public sector where one quarter of the region's workforce are employed. The government's current targeting of public sector employment is hitting the region hard.

A one nation economy requires jobs, good jobs; not minimum wage or dead-end jobs but the sort of productive and well-remunerated employment that young people want to aspire to and will help close the income inequality gap which has widened so much since the sixties.

Government needs to nurture the businesses who will provide these jobs. We are often told to focus on building UK Googles and Facebooks. The UK economy would certainly benefit from new media giants – as long as they pay their taxes – but let us not forget that for every £700,000 of sales revenue Google employs one person whilst Rolls Royce employs three.

So while we want new media giants we need a range of growing innovative companies in different sectors, including manufacturing, to provide the good quality secure and flexible jobs that a fairer, more productive economy needs.

Napoleon called us a nation of shop keepers – he meant it as an insult, we took it as a compliment. Now we need to become a nation of innovative businesses. A whole nation of innovative businesses that is. Not a cluster in east London and another on the M11, but a nation where a new, innovative, business could be started over a coffee in any city.

Unlocking the small business innovation potential is the achievement which I believe would do the most to guarantee our economic prosperity in the future. And if we have the right approach to skills, risk and reward it will also contribute to a more equal society.

Innovation is not necessarily a force for a fairer society. It is important to remember that the first industrial revolution actually led to increased inequality as crafts jobs were lost and industrial magnates made fortunes they did not share. Economists William Lazonick and Mariana

Mazzucato showed in a recent paper how the rewards of innovation are not always fairly shared by those who take the risks, especially employees.¹

We are on the brink of another industrial revolution, as we deal with the carbon legacy of the last one and emerging markets industrialise. We need to make sure that the rewards of this revolution's innovations are distributed more fairly than the last, by democratising our science talent base and enabling small and medium sized enterprises (SMEs) to take advantage of the opportunities on offer.

SMEs account for almost half of UK economic output and almost 60 per cent of private sector employment. There are 4.8 million SMEs² in the UK and 1.6 million³ on job-seekers allowance. If only one third of SMEs took on one more person the battle against unemployment would be won. That's why Labour set up a small business task-force to look at how we can create the best environment for SMEs to start, grow and develop through every stage of their business life cycle

Now most economic literature agrees that innovation is a critical driver of growth. One study analysed by the Harvard Business School professor Josh Lerner in his book *Boulevard of Broken Dreams* estimated that 80 per cent of growth is due to innovation – that is innovation in the broadest sense, covering new processes, business models and materials as well as products. NESTA more recently put the figure at 63 per cent.

Unlocking the innovation potential of small businesses in a fair and equitable way will not be the result of any one policy. There are many different factors that need to be addressed, from the perception of business and innovation in our culture to the relationship between universities and small and medium enterprises. Perhaps most importantly the financial environment needs to be considered.

In this chapter, I want to focus on three potential ways to improve the financing of small, innovative businesses,

through commercial bank lending, procurement and public investment.

Despite many, many warm and occasional angry words on the subject, this government has not succeeded in significantly improving bank lending to small businesses. Indeed there is considerable evidence, both anecdotal and quantitative, that lending to small businesses has declined as banks become more risk averse and seek to rebuild their balance sheets. Businesses in my constituency complain that they have been forced from existing loans onto new overdrafts at higher rates which are then counted as 'new' lending. The most recent figures from the Bank of England show that lending to businesses has contracted in nine out of the past twelve months and fallen by more than £13 billion over this period, while the ITEM (Independent Treasury Economic Model) club has predicted that bank lending is falling to its lowest level since 2006.

Nick Tott's recent report for Labour's policy review – *The Case for a British Investment Bank* – gives a detailed analysis of the small business lending failure. One of the key challenges is knowledge and support – understanding the small business and supporting it as it grows.

Banks may lend to businesses they know well in recognised market segments with plenty of fixed assets. When it comes to markets with which they are less familiar they turn the business away. New innovative businesses often add technology risk to the mix, engineering businesses require significant capital investment. What these businesses need is finance which is knowledgeable and patient, and that is all too rare.

Knowledgeable finance not only provides money but support, helping upskill small businesses to meet the demands that growth places on them. For example, fast growing SMEs have a great need for skilled, innovative people but do not have large human resources departments to help attract, retain and manage them.

Equally as our own economy bumps along somewhere between recession and sluggish recovery, growth opportunities are increasingly likely to be found abroad but many SMEs do not have the right overseas contacts or knowledge to exploit them, or the influence to win a place on a prime ministerial trade mission.

Some commercial banks are developing programmes to bridge the gap. One such is Santander's 'Breakthrough' programme which aims to help the UK's fastest growing SMEs achieve their full potential through intensive, hands-on support. So the bank funds business workshops with successful companies, networking conferences and international trade missions as well as internships to match university graduates with small businesses.

And of course it provides finance, £150m from Santander and £50m from the regional growth fund. One year in, Santander Breakthrough report they have invested £5m in four companies, created over 200 new jobs, taken 30 SMEs on three trade missions (including one all women trip to the US) and are offering 500 internships through 65 universities.

Feedback from the small businesses on the programme is universally positive, in contrast to the criticism I hear all too often in my surgeries. It is early days but such programmes would seem to suggest that when the right incentives are in place, and the will is there, high street banks can make a difference.

The Santander Breakthrough program is clearly having some success but it lacks scale and, critically, businesses need to have revenue of £500,000 to reap most of the benefits. It is not going to help start-ups that have yet to make their first big sale.

But there is a programme designed to do exactly that – and Labour introduced it. The Small Business Research Initiative (SBRI) is based on a long running, highly successful US programme which helps smaller businesses develop new technologies for public sector customers.

A public organisation identifies a specific challenge and in an open competition small businesses submit their ideas for innovative solutions. Those showing promise are awarded initial development contracts up to £100,000. After assessing the results, the most successful may be awarded a further contract worth up to £1 million to develop the product to commercial viability.

In one example a Scottish company developed software to translate sign language into text to help hearing impaired people use smart phones. The device camera captures a video stream which is then processed by the software to recognise sequences of user gestures through a locally stored 'library' of core concepts or words. These are then assembled into sentences, which are outputted as text in real time.

With fewer than 10 employees but £150,000 of SBRI phase 2 funding, Technabling Ltd is now working to extend the image recognition technology to capture the whole of British sign language enabling a fully fledged, affordable product which could transform the way 100,000 British Sign Language users communicate with other people. 'Assistive technology' is a growing field bringing technology to the assistance of those who need it most.

SBRI offers many advantages to Technabling Ltd compared with conventional grants programmes, which can only fund a proportion of total costs. SBRI provides 100 per cent funded procurement contracts and the funding goes directly to the small business; it is linked to a real customer need, and it provides a track record for subsequent customers and investors. For public sector customers, the phased approach helps to manage the risk so evident in many public IT procurement programmes.

But despite its popularity with SMEs total SBRI spend is still only around £20 million per annum. Taking into account the relative size of the UK economy, this is about one tenth of US spend on its equivalent program and is

less than a tenth of the amount Eric Pickles planned to spend promoting weekly bin collections. There have been calls to expand this and Labour is looking at this as part of our policy review. We are clear that we need to have the right programmes and institutions that can help unlock the innovation potential at different stages of the business cycle.

So getting commercial lending right and driving innovative procurement through schemes like SBRI could help make knowledgeable and patient finance more available. Success breeds success and a vibrant environment of growing, innovative small businesses will encourage tech entrepreneurs and academics to take their ideas to market. But innovation needs to spread beyond those who are already in the sector. It needs a public face and a way of engaging people more directly in the highs – and lows – of the innovation process.

Part of this should be through our culture and the media – sharing more of the stories of the great small innovative businesses across the country. But some have made proposals for how high street savings and investments schemes could play a greater role in promoting innovation. One existing scheme is the Individual Savings Account (ISA) which uses tax benefits to encourage savings and investment in certain types of stocks and shares.

In France however an ISA-type product is used to encourage innovation. The Fonds Commun de Placement dans l'Innovation (FCPI) scheme raises investment funds from the general public to finance innovative technology companies in France and abroad. This has proved very successful in raising funds – over €6 billion since 1997. By the end of 2010, FCPIs had invested in over 1,150 companies through 300 funds run by nearly 40 asset management companies. Comprehensive analysis of the data available indicates that FCPI funds have had a demonstrably positive effect on their target market of innovative SMEs.

One sector of our economy which is characterised by small growing companies is biotech. Their industry group, the BioIndustry Association (BIA) is calling for a form of innovation ISA – Citizens’ Innovation Funds (CIFs) which, they argue, would ‘provide a practical way of unlocking the patriotic potential of a large number of Britons to support the innovative businesses which are essential for our nation’s economic future’. Their analysis suggests that the costs of the tax relief would be returned to the treasury within three years through increased corporation tax, employee income tax and national insurance tax receipts, but detailed modelling would be required before this could be confirmed.

Investment in innovation is risky. As the advertisements say ‘investments can go down as well as up and you could get back less than you have paid in’. But investment in innovation is also exciting and productive, leading to new applications and medicines, better ways of communicating and cleaner sources of energy, which touch all of our lives. If the risks are clearly communicated and managed through appropriate investment vehicles, knowledgeable and patient finance and supportive procurement programmes, many more British businesses and individuals might be inspired to share in the adventure. Investment in innovation is wealth creating. We need to expand the opportunities to share in that wealth and build a nation of innovation.

Endnotes

- 1 The Risk-Reward Nexus in the Innovation-Inequality Relationship, www.finnov-fp7.eu/publications/finnov-discussion-papers/risks-and-rewards-in-the-innovation-inequality-relationship
- 2 www.fsb.org.uk/stats
- 3 1.58 million as of October 2012 (Office of National Statistics, www.ons.gov.uk/ons/rel/lms/labour-market-statistics/november-2012/table-cla01.xls)

5 | A DIVERSE BANKING SYSTEM

Duncan Weldon

The UK has an unusual triple cocktail of banks that are very large, very concentrated and are central to financing British businesses. A diverse banking system - such as Germany's - with many more players focused on different geographies, different sectors and different types of banking would be more supportive of the real economy, less at risk from the failure of any one institution and probably marked by less excessive remuneration.

Ever since the failure of Northern Rock in 2007, it has been clear that the UK's banking system is not working. A crisis in the banking system led to a collapse in GDP, a large rise in unemployment and the ballooning of the government's deficit. The recovery is being held back by tight bank credit with the existing system seemingly unable to provide enough finance to small and medium sized enterprises (SMEs) or long-term finance to fund infrastructure projects. But the problems in the UK banking sector did not suddenly emerge five years ago and they are not just a reflection of the weak state of the economy; instead the UK is faced with a deep structural problem in how its banking system operates.

There are three distinct issues facing policymakers dealing with the UK's broken banking model: the challenge of making it safer to avoid a repeat of the crash; the

problem of excessive remuneration, which is highlighted with each passing bonus season; and the underlying question of how the banking system can be made to support the real economy.

Much of the policy discussion since the crisis has been focussed on the first of these issues, indeed the Independent Commission on Banking (ICB) looked at little else. The ICB's recommendations (primarily around the need for a firewall between retail and investment banking) go some way towards making the system safer but they do little to ensure we have the banking system that the wider economy needs.

The scale of the challenge is best seen by looking at lending figures. £1.3 trillion of loans were extended to British residents by UK banks in the 10 years before 2007, around 100 per cent of GDP, and 84 per cent of this went into either property or to financial companies. The banking system's focus on property and finance contributed to regional inequalities, to the UK's low level of investment and to the asset price boom, which sowed the seeds of the crisis.

This is an old debate in the UK. The failure of banks to support growth businesses was identified by the Macmillan Committee in 1931 (the so-called 'Macmillan gap') but complaints that the UK's banks were not supporting industry can be found as early as the 1890s when industrialists glanced longingly across the Channel at the German Reichsbank.

Whilst the failure of banks to lend enough has featured heavily in the news in recent years, the deeper issue has been debated for over a century.

The fact that UK banks have been so poor at supporting the real economy may seem somewhat paradoxical given the UK's global reputation as a centre for financial services. However, the globally focused international wholesale market, based around the City and Canary Wharf, actually has very little to do with real the UK economy. The

UK's domestically-focused financial markets – the actual business of extending finance to companies that need it – is both bizarrely underdeveloped and oddly concentrated.

There are many ways that a company can access the finance it needs to invest and grow, the most straightforward being the reinvestment of retained profits. In terms of equity finance the UK has large and well-developed equity markets but access to the stock market is only really an option for larger firms. The UK's venture capital markets are small by international standards and, whilst the UK has a large private equity sector, this is not effective in supporting growing companies – indeed it often seems more preoccupied with buying out existing companies and selling off many of the assets.

As a result of the lack of equity finance, UK companies that need external finance (i.e. that cannot finance themselves from their existing resources and profits) are reliant on debt finance. The UK's bond markets (only really an option for larger companies anyway) are the smallest in the G7, meaning that it is traditional loans from banks that many companies rely on.

The banks therefore play a very important role in the UK economy: if a company wants to expand and cannot fund itself through retained profits then, in the absence of a larger venture capital sector or bond market, it is to the banks that a company has to turn.

The UK's banking sector is not only of vital importance to growth but is also highly concentrated and very large. The top 10 British banks in 1960 represented 69 per cent of the banking sector and their combined total assets were equal to 40 per cent of GDP. By 2010 the top 10 banks represented 97.3 per cent of the sector and their total assets stood at 459 per cent of GDP.

The UK then has an unusual triple cocktail of banks that are very large, very concentrated and are central to firm finance.

The concentration of the sector causes a multitude of problems, the first of which is the 'too big to fail' problem. When Barclays assets have reached 110 per cent of GDP it is almost inconceivable that it could ever be allowed to fail – the implications for the wider economy (and the rest of the financial system) would be catastrophic. The markets, knowing this, sense that Barclays will never be allowed to fail and hence the perceived credit risk of lending to it falls. In effect the implicit public backing lowers a large bank's borrowing costs and gives it a competitive advantage over smaller competitors.

The size of this implicit public subsidy is disputed but recent work by the Bank of England puts the figure in the UK somewhere between £6bn and over £100bn annually – with the strong suggestion that is likely to be towards the higher end of this scale. As the paper concludes, "all measures point to significant transfers of resources from the government to the banking system."

This public subsidy would be almost defensible if it was passed on to consumers in the form of lowering borrowing costs but there is little evidence that this is the case. Instead the subsidy seems to find its way into higher pay packages and larger bonuses.

Another problem with excessive concentration is that it makes the whole system less resilient. If a country has dozens of banks and several run into problems, there will still be healthy banks capable of lending to support the real economy. Whereas, if a country has only a handful of large lenders and they all run into trouble, then that country will experience very weak credit growth, holding back any recovery.

Finally there is a powerful argument that a finance sector which becomes too large has a negative impact on the rest of the economy. As the Bank of England's Andy Haldane has argued, this is "because human and financial resources are drained from elsewhere in the economy. The sectors hardest-hit by this financial vacuum-cleaner effect

are research and development-intensive businesses (who might otherwise have attracted the scarce, skilled labour that flowed into finance) and businesses reliant on external funds (whose financial cake was instead being eaten by the banking system). These are the very businesses that today we are seeking to re-nurture.” Haldane goes on to argue that this changed the nature of the offer banks made to customers: “The humble, regional loan officer was pensioned-off, replaced by a centralised credit risk model which neither answered back nor required a pension ... Banking became a transactional business, underpinned by a sales-driven, commission-focused culture.”

There is no question that the UK’s banking system requires serious reform, as politicians from all the major parties appear to be realising. Two such reforms can be identified, the first of which is now seemingly supported by all the major parties, the second of which has yet to enter mainstream political debate.

The first reform is the vital need for some kind of state-backed credit provider, focused on making sure credit gets to SMEs and infrastructure projects. As Nick Tott’s report for the Labour party noted, the UK is the only G7 economy without such a body.

In Germany the development bank KfW, established in 1948, has long been an important driver of Germany’s industrial success. In 2010 it extended a record €28.5bn in loans to SMEs as well as supporting infrastructure, housing, energy efficiency and new environmental technologies. By using the government’s AAA rating to raise funds, KfW can borrow at a lower rate than many other banks and passes these savings onto customers. In addition the bank can act counter-cyclically, extending its lending when other banks are pulling back and helping to smooth some of the volatility out of the credit cycle.

Successful state-owned credit providers such as the KfW, the Nordic and European investment banks and the

US Small Business Administration provide a model that the UK should seek to emulate. All three major parties now back some form of state-owned lender.

But there is a bigger debate to be had. The question becomes: would a state-owned investment bank alone be enough to make a serious difference to the UK's banking structure? As the IPPR's recent report on the case for a British investment bank (BIB) noted: "The BIB should also offer long-term loans and should seek to adopt an on-lending model¹, though a key challenge would be how to tailor the KfW's on-lending model to fit within the context of the UK's commercial banking structure."

This touches on an important issue – one reason that KfW works so well in the German context is the existence of a very different banking system, one that is markedly different to the UK's highly concentrated structure.

Whilst the UK relies on a handful of big commercial banks, Germany has a 'three pillar system' with over 400 municipally-owned savings banks (Sparkassen) and 1,100 co-operatives operating alongside the commercial sector. These banks have weathered the crisis in much in better shape.

Most of these banks are constrained to lend within a certain geographic area – something which astonishes many Anglo-Saxon bankers.

The IMF, in their most recent assessment of the German banking sector explained that in Germany "the contraction of bank lending during the financial crisis was mostly demand-driven and was significantly explained by real economic variables. In particular, the decline in bank lending was more evident for large banks, whereas Sparkassen and co-operative banks typically lending to SMEs have provided stable supply of loans, and they managed to expand their retail lending throughout the crisis."

The IMF concludes that as a result "German intermediaries may be able to increase social welfare through

the provision of services and intertemporal smoothing of returns that a more short-term oriented market has limited incentive to provide.”

Germany’s diverse banking ecology has allowed a more long-term focus by industry, has supported a higher level of investment and, perhaps crucially, has allowed Germany to avoid many of the stark regional inequalities that mark the UK economy.

The primary problem facing the German banking sector according to ratings agency Moody’s is a “lack of profitability”. If only the UK had such problems with its banking system.

Establishing a state investment bank is a necessary but insufficient step to ensuring the banking system supports the real economy. What is really required is a more diverse banking system in the UK. More mutually-owned banks, for example, would help address some of the issues around short-termism and corporate governance.

A diverse banking system with many more players focused on different geographies, different sectors and different types of banking would be more supportive of the real economy, less at risk from the failure of any one institution and would likely be marked by less excessive remuneration.

Endnotes

- 1 When an organisation lends money they have borrowed from another organisation or person

6 | LIGHTING THE INNOVATION SPARK

Mariana Mazzucato

Growth depends on public and private investments in innovation. In places like Silicon Valley, private finance worked well when riding on a wave of state funded investments in areas of high technological and market uncertainty. But today we face decreasing government budgets able to play this leading role, and too little direct return for the state on its risky investments in innovation—with the private sector collecting all the rewards. Governments must be able to retain ownership over a small proportion of the value they create, which over time can be reinvested into innovation-led growth. We must also foster ‘eco-systems’ that are less parasitic, increasing rather than decreasing the incentives of the private actors to up their game in investing in areas that promote long-run growth.

It is often argued that what is missing in Europe is the availability of private finance – of those willing to fund radical technologies and the risk associated with developing them. Yet what is not said is that private finance works well especially when it rides a wave of state investment, as it has done in the USA. All the major technologies that make the iPhone so ‘smart’, for example, are funded by public sector organisations: GPS, the internet, touch screen display, and even the latest voice activated SIRI personal assistant – all owe their funding to the state. ‘Geniuses’ like

Steve Jobs, and the presence of private venture capital, are fundamental, but without the state funding of both basic and applied research in the core radical technologies, it is not clear whether the venture capital model would work at all, and whether individuals like Jobs would have much to add their design talent to.

Economists have relied on the 'market failure' approach to understand the state's role in the economy. This assumes that the state is limited to correcting and fixing problems in the market rather than actively shaping and creating the market. Thus, 'externalities' and problems of capturing profits generated by innovation are used as the reason why the state should fund areas like 'basic' research. However, the mission-oriented investments, which make up about 75 per cent of public sector investments in innovation in many advanced economies, cannot be understood within the market failure perspective. Missions, such as putting a man on the moon to developing the internet (which was done in DARPA, an agency of the US Department of Defense) involve both basic and applied research, and are driven not by the dynamics of the private-social 'wedge' but by direct objectives of the government. Indeed, the very heavy funding of the US pharmaceutical industry arises from the US government mission, through its National Institutes of Health (NIH), to "seek fundamental knowledge about the nature and behavior of living systems and the application of that knowledge to enhance health, lengthen life, and reduce the burdens of illness and disability". The budget of the NIH has reached \$400bn over the last decade, with \$31bn in 2012.

At a more micro level, between 1971 and 2006, 77 out of the most important 88 innovations (rated by *R&D Magazine's* annual awards) were found to have been fully dependent on federal support, especially, but not only, in the early phases¹. And all the major 'general purpose technologies', from aviation to the internet, owe their core funding to the public sector².

And it is not just about research. While many associate risk capital with either 'business angels' (affluent individuals who provide capital for a business start-up) or venture capital, the reality in many countries and regions, including in Silicon Valley, is that it has been public not private funds which have filled the high-risk funding gap. In the USA, the Small Business Innovation Research (SBIR) programme, which began in 1982, provides almost \$2.5 bn annually to small firms. And as venture capital has become increasingly short-termist, pursuing returns in a three to five year period, the SBIR programme has found itself stepping up, often funding firms that venture capital is too risk averse for. Indeed, Gary Pisano has argued that the short-termism of venture capital makes it an inappropriate model to drive innovation in science-based sectors, such as biotech, nanotech and today's clean-tech, which require much longer time horizons³. The fact that the innovation process is uncertain, collective (with the state playing a leading role), and also cumulative (innovation today builds on innovation yesterday) means that when venture capital eventually enters, it manages to reap a far greater return than just its marginal contribution⁴. And this has not helped science-based sectors like biotech, which due to the long innovation cycle require patient finance, but being dominated by venture capital finance have ended up with a plethora of venture backed product-less initial product offering (PLIPOs). No products, no jobs: little value to the economy.

Interestingly, one of the results of this eco-system in which the state plays a leading role beyond that which has been attributed to it by the market failure perspective has been a fall in the investments actually made by private firms in the innovation process. As argued by Marcia Angell, the NIH has been much more 'risk-taking' than private large pharmaceutical companies, with up to 75 per cent of the most radical new drugs (new molecular entities with 'prior-

ity' rating) coming out of public not private labs⁵. Yet, as the NIH has been spending more and more on the knowledge base that underpins the biotech and pharmaceutical industry, the large pharma companies themselves have been spending an increasing amount on repurchasing their own stock. Over the past decade, Pfizer, a company that benefits immensely from government spending on life sciences research and subsidies of drug development, squandered \$56bn on buybacks, equivalent to 59 per cent of its profits (99 per cent of its research and development (R&D)) with another 64 per cent going to dividend payouts – a total payout to shareholders of 123 per cent of net income.. Amgen, the largest dedicated biopharma company, has repurchased stock in every year since 1992, for a total of \$42.2bn through 2011, including \$8.3bn in 2011. Since 2002 the cost of Amgen's stock repurchases has surpassed the company's R&D expenditures in every year except 2004, and for the period 1992-2011 was equal to fully 115 percent of R&D outlays and 113 percent of net income⁶.

But the question arises whether this heavy funding has allowed big corporations to think they can earn the same or even higher profits while themselves putting in fewer resources into innovation. Indeed, pharmaceutical companies have publicly announced their rethinking on whether they need to be doing basic research at all, given that most of their knowledge comes from either small biotechnology or publicly funded labs (or publicly funded research in private or public universities). And they react with their feet, with companies like Pfizer closing down labs in countries where there is less public R&D (for example the UK where the R&D/GDP spend is low, and also recently in Sweden), going to countries where there is more (US, with a 2.7 per cent R&D/GDP and heavy NIH).

We must also build the right 'eco-systems', less parasitic and more win-win. This requires measures which incentivise the different actors to invest in the eco-system,

rather than take but not give. Currently, in many industries it appears that while risk is increasingly socialised – through ‘open innovation’ systems’ in which the public sector plays an increasingly important role, the returns are increasingly being privatised⁷.

So given the state’s important role in funding high risk investments in innovation, which the private sector fears, and given the commonly accepted relationship between risks and returns in finance, it could be argued that more thinking is required on whether, and how, the state should earn back a more direct return on its risky investments. That is, rather than worrying so much about the ‘picking winners’ problem, more thinking is needed about how to reward the winning investments so they can cover some of the eventual losses, which are inevitable as innovation is so deeply uncertain.

Put provocatively, had the state earned back even just 1 per cent from the investments it made in the internet, there would be much more today to invest in green technology. Or put another way, is it right that the National Science Foundation which funded the algorithm behind Google, received nothing back when Google made billions⁸?

Many argue that it is inappropriate to consider direct returns to the state because the state already earns back for its investments, indirectly via the taxation system. There are three arguments against this reasoning: firstly, tax evasion (legal and illegal) is common and realistically will not disappear; secondly, global movements of capital imply that the particular region funding the innovation might not reap the benefits in terms of local job creation, meaning the taxation question remains an open one. And thirdly, investments in innovation are different from spending on, say, education. The former embodies a great degree of risk, similar to that experienced by private venture capital, with one in 10 investments earning a return. If the state is being asked to make such investments (which it undoubtedly

has been making and increasingly so), it is necessary for it to cover its inevitable losses when those arise.

Apple computers is a case in point. Apple received its early stage funding from the US government's SBIR programme; yet Apple have used common practices, which have resulted in a much lower tax bill for the US government. Furthermore, according to a *New York Times* investigation, Apple formed a subsidiary in Reno, Nevada, where there is no corporate income or capital gains tax, in order to avoid state taxes. Creatively naming the company Braeburn Capital, Apple used it to channel a portion of its US profit, instead of including them in the profit reported in California, where its headquarters are located. Since 2006, Apple reportedly earned \$2.5bn in interest and dividends, and to avoid capital gains tax in California, the interest and dividend earnings have been reported in Nevada. In other words, California's huge state budget deficit would have been significantly reduced if companies such as Apple had fully reported its US revenues in the state where a significant portion of its value (discovery, design, sales, marketing, etc.) was created and achieved. The tax system is not one that can be relied on for recouping investments in risky innovation.

Where technological breakthroughs have occurred as a result of targeted state interventions, there is potential for the state, over time, to reap some of the financial rewards, by retaining ownership over a small proportion of the intellectual property created. This is not to say the state should ever have exclusive license or hold a large enough proportion of the value of an innovation that it deters a wider spread of its application – the role of government is not to run commercial enterprises, but to spark innovation elsewhere. But government should explore whether it is possible to own a sliver of the value it has created, which over time could create significant value and then be reinvested into growth generating investments.

For example, as discussed briefly above, three-quarters of the new molecular bio-pharmaceutical entities owe their creation to publicly funded laboratories. Yet in the past 10 years, the top 10 companies in this industry have made more in profits than the rest of the Fortune 500 companies combined. The industry also enjoys great tax advantages: its R&D costs are deductible, and so are many of its massive marketing expenses, some of which are counted as R&D⁹. After taking on most of the R&D bill, the state often gives away the outputs at a rock bottom rate. For example, Taxol, the cancer drug discovered by the National Institutes of Health (NIH), is sold by Bristol-Myers Squibb for \$20,000 per year's dose, 20 times the manufacturing cost. Yet, the company agreed to pay the NIH only 0.5 per cent in royalties for the drug. And while in this case the state was able to reap back a small share, in most cases the intellectual property rights are outright given away.

Similarly, where an applied technological breakthrough is directly financed by the government, it should be able to extract a small royalty from its application in return. Again, this should not be sufficient as to prohibit its dissemination throughout the economy, or to disincentivise the innovators from taking the risk in the first place. Instead it makes the policy of spending taxpayers' money to light the innovative spark more sustainable, by enabling part of the financial gains to be recycled directly back into the programme over time.

There are various possibilities for considering a direct return to the state for its investments in innovation. One is to make sure that the loans and guarantees handed out by the state to business do not come 'no strings attached'. Loans, as well as grants, could have conditions, like income contingent loans, similar to that of student loans. If and when a company makes profits above a certain threshold, after it has received a loan or grant from the state, it should be required to pay back a portion. This is, of course,

not rocket science but it goes against some deep-seated assumptions. And currently, with budget deficits under so much pressure, it is no longer possible to ignore the issue.

Besides income contingent loans there is the possibility of the state retaining equity in the companies that it supports. Indeed, this does occur in many countries, such as Finland, where SITRA, one of Finland's public funding agencies, retained equity in its early stage investments in Nokia. This is exactly the type of early stage investment that venture capital has increasingly shied away from. Yet state equity in private companies is feared in countries like the USA and the UK (and those countries copying the Anglo-Saxon model) for fear that the next step is... communism. Yet the point is that the most successful capitalist economies have had active states, making such risky investments, and we have been too quick to criticise them when things go wrong (e.g. Concorde) and too slow to reward them when things go right (e.g. the internet).

Other than income contingent loans, and retained equity, there is of course a more direct tool, which is a state investment bank. Indeed, while many have argued the importance of a state investment bank for the needs of counter-cyclical lending, another reason why they are important is precisely to reap back a return in order to fund future investments. In 2012 KfW, the German state investment bank, reported £2bn in profits, while most private banks are in the red, with many experiencing falling profits. And indeed, if and when the state institution is run by people who not only believe in the power of the state but also have the expertise around innovation, then the result produces a high reward. A perfect example is the Brazilian state development bank BNDES, which has been actively investing in innovation in both clean technology and biotechnology, and making hefty profits from the investment. In 2010 it made 21 per cent return on equity (ROE), most of which was reinvested by the Treas-

ury into the economy (e.g. in health and education). The percentage retained by BNDES was reinvested in key new sectors, focusing specifically on the 'death valley' stage of biotechnology - the funding gap between laboratory discovery and commercialisation, in which private venture capital is so absent.

As well as looking at new thinking about how the state can earn back a direct return for its active risk taking in innovation, the UK and EU should learn the right lessons from Silicon Valley. Companies might ask for tax cuts but this is not what drives their spending on innovation. There is even little evidence that R&D tax credits make R&D, which otherwise would not have done so, happen. Innovation is driven by companies' expectations of technological and market opportunities. These require large amounts of public investment in uncertain areas that the private sector is too fearful to fund¹⁰. Focusing too much on 'commercialisation' and intermediary institutions in countries, which have a low R&D/GDP ratio (including the UK's 1.8 per cent compared to Finland's 3.5 per cent or Germany's 2.5 per cent), is a bit like 'pushing on a string'.

Critically, more solidarity is needed in Europe so that competitiveness becomes less, not more, skewed. The current austerity recipes given to the 'periphery' countries will not allow them to make the kind of investments that have driven competitiveness in countries like Germany and Finland. This requires increasing spending on areas like R&D (which all the PIGS – Portugal, Italy, Greece and Spain – invest very little in) and education (currently being cut by all the austerity regimes) – and also creating institutions that nurture innovation. The latter includes lending institutions that provide 'patient' long-term finance (as in Germany's KfW), and well funded institutions that create dynamic links between the science and industry base (such as the Fraunhofer Institutes). This does not mean that all EU countries need a state investment bank, but if

not they need something else, such as the state agencies in the US which provide direct funding in areas that the private sector fears. Having neither, at a national level, means remaining behind¹¹. At the EU level, the European Investment Bank should become more active, guiding productive investments in the peripheral countries, possibly co-financed with European Central Bank bonds, with attention, by policymakers, on governance issues. If technocratic presidents, such as Mario Monti in Italy, can be installed overnight, why not pay more attention to making the agencies in the periphery responsible for the 'smart' investments (the equivalent of the Department for Business, Innovation and Skills in the UK), manned by high level experts, rather than political cronies?

Other key policies should include:

1. An innovation strategy. Rebalancing the economy after the financial crisis means creating an innovation strategy that can steer activity towards new emerging areas like the green economy (which will soon be earning high returns for those countries making a head start). It is also fundamental to make sure that value creation activities in all sectors are rewarded above value extraction activities. This means making sure that taxation policies do not reward quick trades more than long run investments. Capital gains tax is, in this respect, too low.
2. Preventing stock buybacks. In the US, especially, stock buybacks have been at the expense of investments in innovation. Prime beneficiaries have been top executives with their 'unindexed' stock options that enable them to gain from stock market speculation and manipulation. For the sake of innovation, the EU must ensure that this highly financialised business model does not take root in Europe.

3. Create support for SMEs. Innovation eco-systems must not be based on myths about the different actors but on evidence. In the UK, small and medium sized businesses (SMEs) are not under-financed: they receive close to £8bn per year, more than the police force¹². The question is how to steer that support to those SMEs that actually create value for the economy.

4. Target finance on growing companies. Similarly, in many cases, the problem is not one of lack of the supply of finance, but lack of demand. Most companies are content with the status quo. How to target finance to those companies that want to grow is key, and here it is fundamental to create not more 'impatient' finance, as that which drives the venture capital model (that requires returns in three to five years), but more long-term finance. Indeed, the myth about the role of venture capital in Silicon Valley has underpinned bad policies in Europe, such as in 2002 when the UK Labour party reduced the time that private equity has to be held from 10 to two years, only increasing the short-termism of the venture capital industry.

Understanding the state as lead risk-taker, opens the question about how such risk-taking can reap back a return. While many have been quick to blame the government when it fails to 'pick winners', they have been much less quick to reward it when it succeeds. It is argued here that a framework is required both for understanding the risk-taking (beyond the risk-averseness argument in the market failure approach) and for understanding how the collective system of innovation maps also into a system of rewards. Getting the balance right will make the objective of smart and inclusive growth less about spin, and more about concrete mechanisms.

Endnotes

- 1 Block F and Keller M (eds), *State of Innovation: The US government's role in technology development*, Columbia: Paradigm, 2011.
- 2 Ruttan V, *Is War Necessary for Economic Growth?: Military procurement and technology development*, New York: Oxford University Press, 2006.
- 3 Pisano GP. (2006), 'Can science be a business? Lessons from biotech', *Harvard Business Review* 84, no 10.
- 4 Lazonick, W. and Mazzucato, M. (2012), *The Risk-Reward Nexus in the Innovation-Inequality Relationship Who Takes the Risks? Who Gets the Rewards? Forthcoming in Industrial and Corporate Change*
- 5 Angell M, *The Truth Behind the Drug Companies*, New York: Random House, 2004.
- 6 Lazonick W and Tulum O, 'US biopharmaceutical finance and the sustainability of the biotech business model', *Research Policy* 2011 (forthcoming).
- 7 Lazonick and Mazzucato, 2012
- 8 Block F and Keller M (eds), *State of Innovation: The US government's role in technology development*, Columbia: Paradigm, 2011
- 9 Angell M, *The Truth Behind the Drug Companies*, New York: Random House, 2004.
- 10 Mazzucato, M. (2011), *The Entrepreneurial State*, DEMOS, London. http://www.demos.co.uk/files/Entrepreneurial_State_-_web.pdf
- 11 Mazzucato, M. (2012b), The EU needs more investment not less, *The European*, Issue 34, Oct. 2012 http://www.euromove.org.uk/fileadmin/files_euromove/EMiL/The_European_-_issue_34.pdf
- 12 HUGHES, A. (2008), Entrepreneurship and Innovation Policy: Retrospect and Prospect. *The Political Quarterly*, 79: 133–152.

7 | IMMIGRATION AS A GROWTH STRATEGY

Jonathan Portes

Immigration rules are not generally what either economists or policymakers think of when they talk about labour market regulation. But restrictions on those who want to come here to take up employment are exactly that. We should make clear that immigration, like trade, is central to making the UK open for business; and examine each aspect of immigration policy with a view towards reorienting them towards growth.

What forms of supply-side reform would do most to boost UK growth over the medium to long term? Bizarrely, much of the recent debate has concentrated on reducing various forms of labour market regulation (procedures for unfair dismissal, health and safety, etc). The evidence base supporting such proposals is remarkably thin. The UK labour market, as many have observed, is doing surprisingly well. Hiring – given economic conditions – is pretty healthy, and employment is rising, despite weak or no growth. Labour market economists, and international organisations like the OECD, agree that three decades of successful reform have given the UK a flexible and generally well-functioning labour market, by international standards. There is no reason to believe labour market regulation is currently a significant

barrier to job creation. This suggests that – while doubtless there are improvements that could be made around the edges – there is little to gain from further wholesale deregulation. Spain and Italy need radical labour market reform; we don't.

But, looked at in a broader perspective, there is one aspect of labour market regulation where sensible deregulation is urgently needed, and could genuinely boost UK growth over the medium term. This is immigration for people with high skills. Now immigration rules are not generally what either economists or policymakers think of when they talk about labour market regulation. But of course restrictions on those who want to come here, or stay here, to take up employment or to look for a job are exactly that: they are government regulations that change the way the labour market functions.

So the changes to skilled migration introduced by the government – a set of new burdensome and bureaucratic rules and regulations, including a quota on skilled migrants – are new labour market regulations. Indeed, in contrast to almost all other such regulations, which are at least designed with an eye to ensuring that the benefits to employers and employees outweigh the costs, these changes were designed expressly to make it more difficult for businesses to employ the workers they want.

As a consequence, they will reduce growth and make us poorer. And these impacts, even according to the government's own estimates, are potentially very large. As I said in my testimony to the Treasury select committee after the 2011 budget: "The extra employment regulation that the government has imposed on employers wishing to employ migrant workers – the cap on skilled migration – will, using the government's own methodology, reduce UK output by between £2 and 4bn by the end of the parliament."

This is not just a result of the reduced size of the population; since the regulations are designed to exclude skilled

migrants, who tend to be more productive, they also reduce average productivity and hence GDP per capita. None of this is news to economists; most of us, wherever we are on the political spectrum, think that well-functioning markets usually do a pretty good job of allocating resources. That goes for the labour market too, so it is no surprise that liberal (in the true sense of the word) immigration policies are good for the economy, and restrictive ones are not. So simply reversing the new regulations introduced by this government, let alone further deregulation, could yield large gains. Moreover, in contrast to some other policy changes that might promote growth, the fiscal impact would be positive, not negative.

But this is not the end of the story by any means. The estimates above of the economic impacts, while significant, are still not that large relative to the size of the UK economy. And on one level, this is not surprising; in standard 'static' economic models, the impact of immigration is positive – to the extent that immigrants are complements to natives – but relatively small. And to the extent that immigrants are substitutes for natives then the impact is essentially zero.

So it is often argued that the economic impacts of migration – positive or negative – are likely to be small, with the main impact being to increase both population and GDP, but with little impact (over the medium to long run at least) on GDP per capita or unemployment and employment rates.

However, this is a freeze-frame view of the world; it does not reflect how economies actually work, or where growth really comes from. To see this, we merely need to observe that the same modest benefits are predicted for freer trade. This is not surprising, since the underlying mathematical structure of the basic models economists use to model trade and immigration is identical. So, for example, estimates of the benefits to the UK of complet-

ing the Doha round of multilateral trade liberalisation are typically no more than 0.1 per cent of GDP.

But of course most economists believe that the economic benefits of trade are quite considerable, and that these static estimates are not the whole story or even the main point; the benefits are dynamic and arise from competition and specialisation rather than simple static comparative advantage. We do not gain from free trade in, say, cars with the EU because either we or the French or Germans have a fixed and static comparative advantage in different types of car, so we can produce one type of car better and they can produce another. Rather we gain because trade increases competition between different producers, diversification of the supply chain across the EU, the incentives for technological innovation, and all sort of other difficult to measure but important effects that increase productivity in the medium to long term.

The same is, in principle, likely to be true of skilled immigration. Immigration is likely to have impacts on productivity and growth over the medium to long term in a number of ways.

- immigrants could bring different skills and aptitudes, and transmit those to non-immigrant colleagues (and vice versa);
- immigration could be complementary to trade in goods and services (because of immigrant networks or for other reasons);
- immigrants could increase competition in particular labour markets, increasing the incentive for natives to acquire certain skills;
- similarly, immigrant entrepreneurs could increase competition in product markets;

- workplace diversity (across a number of dimensions) could increase (or decrease) productivity and innovation

Not all of these impacts are necessarily positive: for example, it is well known that immigrants are substantially more likely to be entrepreneurs or self-employed. This could be because of self-selection, so enterprising people are more likely to migrate; but exclusion or discrimination might also force some migrants into low-productivity self-employment. So what does the evidence say?¹ Well, in contrast to the well-established economic literature on the impact of migration on labour markets, we have much less quantitative analysis on these topics. What there is does, however, support the arguments above. There is a considerable body of evidence in the US that suggests that immigration is associated with increased innovation (for example, that immigrants are more likely to register patents, and that this in turn leads to an increase in patent activity on the part of natives); and with international trade and knowledge transfer, particularly in high-tech industries. Here in the UK, Max Nathan has written a number of papers for the National Institute of Economic and Social Research (NIESR) on similar topics, particularly focusing on the impact of diversity on innovation, patent behaviour, and other measures of firm performance. This, and work in other European countries, suggests that similar effects are at work.

It is often hypothesised that immigration reduces the incentive for employees to train native workers. However, in the US, Jennifer Hunt shows that immigration increases the educational attainment of natives; she hypothesises this is because of increased competition in the labour market. Meanwhile, NIESR research for the Migration Advisory Committee found that “rather than migrants substituting for home-grown talent, there is evidence of

complementarities between skilled migrants and skilled resident workers". Looking at the macro-level impacts on growth, and explicitly putting the impact of immigration in the same analytical framework as that of trade, a recent paper by Francesc Ortega and Giovanni Peri found that, looking across countries, the positive impact of immigration on growth has been very large. Indeed, they find that it is considerably larger than trade. Crucially, the channel through which immigration increases growth is through its impact on productivity, which would not be expected from standard models.

This research agenda is still in its infancy; we still do not know precisely the channels through which immigration impacts on growth. Nor will we ever be able to put precise numbers on it, any more than we can identify the contribution of Britain's history as a trading nation to our current prosperity. But we do know enough to set a clear direction for policy.

So what should we do? It is simply not credible for the prime minister to claim that the UK is 'open for business' and for the chancellor to say that he is prepared to take the 'difficult decisions' to boost growth, while at the same time making the primary objective of immigration policy the reduction of net migration; and putting the implementation of that policy entirely in the hands of a department – the Home Office – which has no interest whatsoever in growth or productivity. The fact that the immigration minister regards a fall in the number of student visas issued – that is, a fall in British exports – as a policy success, is a damning indictment of the administration of current policy.

So the first priority should be simply to make clear that immigration, like trade, is indeed central to making the UK open for business, and hence to our growth strategy. The next step would be then to examine each aspect of immigration policy – but in particular those relating to

students, skilled workers, and settlement – with a view towards reorienting them towards growth.

We should start by reversing the most obvious policy errors made by this government. The most egregious of this was the abolition of the ‘post-study work route’, which allowed foreign students to stay on after graduation to look for a job. This initiative was introduced by the previous government, based on two observations: the success of Silicon Valley, in particular, and high-tech US companies in general, who relied heavily on individuals who came to the US to study but stayed on to work (and in some cases, set up their own businesses); that, for the brightest and most motivated foreign students, the possibility of being able to remain in the country for a period after graduation to work was a significant draw.

The abolition of the PSWR was a major own goal; it means that foreign students who want to stay on here and try to build a career or a business find it much more difficult, if not impossible. Since such people are, almost by definition, likely to be relatively well educated and motivated, English speaking, at least partly integrated into UK society already, and so on, they are precisely the sort of people we want on both economic and social grounds. Of course some will fail; they will end up unemployed or doing low-skilled jobs. That is the nature of immigration; not all immigrants succeed, just as not all native-born entrepreneurs do either.

There are many other sensible changes, major and minor, that are required. But more important than specific policy changes is a change of attitude and mindset on the part of government and policymakers. If we want to be serious about growth, we will need to be positive about migration.

Endnotes

- 1 The economic literature is reviewed in a much more comprehensive fashion by my colleague Max Nathan in his paper: "Ethnic Inventors, Diversity and Innovation in the UK: Evidence from Patents Microdata", SERC Discussion Paper no. 92, October 2011.

8 | WHY INEQUALITY MATTERS

Vicky Pryce

At present, growth is all, particularly in the short-term. But inequality can make a difference to how long a country can sustain growth once a recovery starts. Tackling this requires a broad range of policy interventions, from skills and tax, to corporate governance and innovation. In particular, non-cash benefits such as education and health are the main contributors to reducing inequalities.

A return to growth is essential; but the mix of policies required to get us there could make a considerable difference for the longer-term health of the UK economy. For recent evidence suggests that pursuing policies which support a more equal distribution of income could ensure that the next growth spurt, when it finally comes, lasts a long time – so as to get us back and well beyond where we were at the beginning of the crisis. While the rate of inequality itself does not seem to make much difference when you compare countries' growth, the IMF has concluded that growth periods tend to be shorter the more unequal the income distribution in a society.

If this is correct then short-term policies need to take inequality into account. For example investing in infrastructure and housing can improve equality as it has a direct impact on jobs and on regions that need this devel-

opment while also helping lower income groups that benefit disproportionately from these 'public goods'. In the medium to longer-term, policies need to focus on skills, ensuring equality of opportunity, creating 'good' rather than 'any' jobs and changing incentive structures to guarantee openness and transparency, and with it fairness.

How we move from the current stagnation to sustained growth will therefore be important for shaping the UK in the medium to long-term and needs to be analysed with care. At present, growth is all; particularly short-term growth to get the economy moving again, certainly in time for the next election in 2015. But it is clear that at a time of fiscal retrenchment the room for manoeuvre is limited. We also now know that austerity can easily have adverse consequences, with the pursuit of fiscal consolidation seeming to lead to a greater downward pressure on output than economic models have previously predicted. As a consequence receipts are lower and expenditures, including on welfare and unemployment benefits, higher than originally envisaged.

So the path to deficit reduction can, at times, have the perverse effect of lowering a country's ability to reduce the deficit and can result in the debt to GDP ratio exceeding expectations. If governments then feel compelled to slash spending further – including on welfare – in order to improve their worsening fiscal position then, if the new thinking is correct, the country can get into a vicious circle of even lower growth and worse rather than better deficits as a result. This seems now to be the view of the International Monetary Fund following its recalculation of the 'fiscal multipliers'. For some of us who have been saying this for some time, it is a case of 'better late than never'

The current slow growth of the UK economy has required a continuous downgrading of economic forecasts (the official ones always trailing the slightly more accurate private sector ones). The disappointing results owe a lot to

the austerity measures of this government but also to the austerity measures elsewhere in Europe, which are threatening to plunge the whole eurozone into recession again. Expect panic, and probably misdirected efforts to encourage investment and growth, with fingers kept crossed. Meanwhile money will remain tight and the main fiscal consolidation measures will begin to bite. The longer the deficits and high debt levels persist, the more attempts will be made by governments to rein in public spending which will have significant impacts on people's purchasing power as living standards are squeezed by the lowering of benefits and tax credits.

But are there other reasons why growth has been sluggish? Could the increased inequality witnessed over the last couple of decades have been the reason? There is an increasing preoccupation with this, as data from across many countries suggests a disproportionate benefit during the boom years accruing to a tiny fraction of the people at the top of the income scale. For example, median incomes in the US hardly rose in the past 30 years while the benefits from economic growth went mostly to the top 1 per cent of the population, whose percentage share of total pre-tax income rose from 13 per cent in the 1990s to just under 20 per cent before the financial crisis. In the UK the rise was from 9 per cent to 15 per cent, the second highest in the OECD. Moreover the share claimed by the top 0.1 per cent quadrupled in the US over the 30 years to 2008 to 8 per cent of total pre-tax incomes and rose to around 4 to 5 per cent in the UK. According to the OECD, in the developed countries as a whole, the standard measure of inequality, known as the Gini coefficient, had risen by 10 per cent between the mid-1980s and the late 2000s and this was particularly pronounced in English speaking countries such as the UK and the US.

Nevertheless, the evidence on the impact of inequality on growth from international data is inconclusive. The

academic work suggests that the correlation could in fact go either way. Greater inequality normally indicates that a greater share of income is held by the very wealthy who tend to spend a lot less of their incomes on consumption of goods and services. As a result, the country's savings are higher than they would otherwise have been and hence potentially investment levels are higher – thus boosting productivity and growth. But others argue that investment may be going into areas favoured by the elite groups which leads to a misallocation of resources. A more equal distribution of incomes would allow whatever small savings there may be to be spent more evenly on investments that could benefit productivity across most areas, particularly on skills for the population at large, which would have more sustainable impacts on growth. In addition the wealthy spend a much smaller percentage of their incomes on local goods and services which may diminish the multiplier effects of their incomes; and they tend not to use public services as much so are more indifferent to their quality. The implication then is that the way income is distributed in a country may indeed affect patterns of tax collection, government spending and the structure of the economy.

What you measure therefore matters a lot. Is the GDP we calculate for cross-country comparisons the correct way to get to grips with relative prosperity? For example, if inflation is properly adjusted to better reflect what lower income groups spend their money on, rises in real household incomes may turn out to have been overstated. Academics like Tony Atkinson are now arguing that inequality adjusted growth could tell a different story about long run trends than what we see at present, with countries like the UK possibly being shown to be doing less well than a traditional calculation of GDP would suggest. Furthermore according to Joseph Stiglitz's latest book *The Price of Inequality*, substantially 'unequal' economies could

well see many more conflicts between various classes of society protesting against unfairness and this could result in less confidence of investors in those countries and in greater volatility and crises than in a more 'equal' society. The effect then is that productivity and hence competitiveness gets undermined and growth distorted.

But the cross-country data still does not amount to a completely bullet-proof case to link inequality and foundering growth, and if employment still seems to be high nevertheless, why do we care as economists except in relation to justice and fairness? We should do because there is increased evidence that inequality can make a difference to how long a country can sustain growth once a recovery starts – and given that we are still way behind where we were before the financial crisis started and the economic recovery is very anemic, being able to sustain growth will be paramount. An IMF study in 2011 found “a large and statistically significant association between low income inequality and growth duration”. So if one is interested in ensuring faster and sustainable growth in the medium to long-term, which puts a country on a higher growth and productivity path, then inequality, according to the study, is the area to address as it is “among the variables with the economically strongest effect on predicted (growth) spell duration.”

So reducing inequality is a must but what is the best way of achieving it? The IMF study warns that different measures may be needed according to the reasons for this inequality. Less developed nations have specific causes of inequality to deal with in each case and the appropriate correcting remedies would thus vary significantly from country to country. This is still true but much less the case in most developed countries and some general prescriptions can therefore be offered. An OECD study in 2011 gave some pointers on what the main issues to address may be as well as warnings of potentially damaging policy inter-

ventions, which could lead to lower sustainable growth even if they achieve greater equality.

The key here is to look at which factors are most likely to lead to greater wage dispersion (the widening of the gap between top earners and middle to low earners) as left unchecked this seems to be the main determinant of increased inequality. However, if the cause of the widening dispersion also drives rising demand for labour and higher employment, the effect on inequality overall can be partially or even wholly offset.

There are some interesting lessons for policy. Non cash benefits for example such as education, health and social care seem to be the main contributors to reducing inequalities, by about one fifth in the UK, from what they would otherwise have been. They do this both by redistributing 'capital' to the most needy who cannot afford to pay for it but also by providing the health and skills that allow for these people to progress, thus reducing initial inequality as well.

The effects of labour market policy are more ambiguous. Employment protection which is always championed by the trade unions does not necessarily assist in reducing inequality because it may result in employment demand falling while any increased cost to employers will be passed on to consumers in higher prices. Conversely with labour market deregulation and reduction in union activity, and hence less protection, the employment and direct wage disparity effects tend to cancel each other out as lower initial wages are offset by greater demand for labour. Obviously this is a generalisation but does seem to be true when using cross country comparisons. Much will of course depend on how any employment protection policy is put together but policy makers rarely get it absolutely right so that it can be a win-win for all, particularly in a globalised environment where companies can easily locate elsewhere.

Meanwhile, the rise of part-time workers, seen to have been very significant in the UK in keeping employment levels high, adds to wage disparity, as they tend to earn less, receive less training and have fewer career prospects. Self-employment does the same, as most people in this group are at the lower end of the income scale and additionally are mostly working only part time.

Attention also needs to be paid to the tax and benefit system which has contributed to the inequality by being less redistributive over time. There must be ways to make the tax system more redistributive and in particular to find additional ways of extracting money from the very rich, who now form such a big part of the economy, without creating disincentives to save and invest (though it is worth noting that the top one per cent of the income distribution in the UK already contribute some 30 per cent of income tax).

But what about forces outside the direct control of a single nation? Should we fear globalisation and the growing internationalisation of our economy? Clearly short-term issues such as the eurozone debt crisis are having a negative impact on growth. But for the longer-term the answer is not protectionism and isolationism. According to the OECD study, globalisation itself, if explained as financial openness and changing trading and supply-chain patterns, does not appear to have made much difference on levels of national inequality: some of the direct wage effects are often cancelled out by greater overall number of people in work, which tends to reduce inequality. But increased financial flows and technological change do make a major difference by putting extra demand on the higher skilled and lead to greater disparity if the supply of skilled workers is limited. To take advantage of technological progress requires a continued up-skilling and if this is not met by the wider population it can lead to serious distortion, low productivity and a sustained loss of competitiveness for any advanced economy.

So assuming that reducing inequality matters for extending the duration of growth, what are the first steps we should take? To tackle the issue government should:

- Eliminate some of the abuses of the executive pay system: control bonuses, change incentives, outlaw stock options and stock repurchases, instil a sense of belonging and corporate social responsibility on organisations, either voluntarily or through regulation, so that excessive executive pay is controlled and seen as fair;
- Make the tax system more redistributive for example through the taxing of wealth;
- Ensure that the cash benefit system encourages and supports people to return to work
- Embrace technological change, as it is vital for growth and productivity, but offset the wage disparity which might ensue through continuous up-skilling in co-operation with business;
- Ensure access to credit across the economy and not only to a select few – competition and transparency in the financial sector is key;
- Continue with the process of globalisation and trade openness but also ensure transparency in the process;
- Work towards achieving better jobs, including for part-time and self-employed workers. ‘Good jobs’ that provide training and career prospects rather than ‘any jobs’ can only be achieved in partnership with the private sector;

- Preserve benefits-in-kind such as health and education that contribute hugely to reducing inequalities. If we forget their impact on reducing inequality at times of hardship we will widen disparities. Indeed, education is key: this is the best leveller. Not appreciating that this is a 'public' good which has to be nurtured and treasured would be a sure way of increasing rather than decreasing inequality and pushing the UK further down the competitiveness scale.

In general, therefore, an economic policy for sustainable growth should focus on not 'picking winners' but on improving the 'horizontal' aspects of policy – better education and skills; widening worker participation; reduction in regulatory protection for powerful industries; encouragement of innovation and entrepreneurship through a proper and fair financial and educational system; greater corporate governance and transparency over executive pay and remuneration arrangements; and a serious look at tax and incentive structures that have led to increased inequality, encouraged short-termism and threatened the UK's long-term prosperity. This would ensure that there are few blockages ahead as we move back to growth so that the economy can enjoy a period of long and sustainable expansion with the benefits accruing to all rather than just a select few.

9 | ONE NATION BANKING

Chris Leslie

A sustainable recovery needs a fundamental shift in the way banks work. Labour will continue to push for a cheaper, fairer banking system that uses local links to make informed decisions on lending to small and medium-sized enterprises and to stimulate the economic recovery which this country so desperately needs.

George Osborne arrived at the Treasury in May 2010 vowing to slash borrowing, get banks lending again and boost economic growth. Two-and-a-half years on, after the longest double recession since the second world war, it is clear he has neither the ideas nor the attitude to make this happen.

That's why Britain is more in need than ever of genuine economic and financial reform. The government has never produced a serious plan for jobs and growth and has instead thrown a series of *ad hoc* measures at the nation's hard-pressed businesses.

All too often we have seen the chancellor reluctantly forced to act after the emergence of bad news on the recovery, rather than setting out balanced plans based on economics instead of politics. The result is that measures to stimulate bank lending to small and medium-sized enterprises (SMEs) have had a back-of-the-envelope feel to them.

Project Merlin was supposed to boost business lending but the government's agreement with the big five banks certainly lacked magic. Its targets applied to 'gross' rather than 'net' lending and it failed to take into account the cost or terms on which finance was offered. It was therefore no surprise when the largest participants – Lloyds, RBS, HSBC, Barclays and Santander – met their overall commitments last year but missed their targets for lending to small business.

And so it was that the chancellor's second attempt at the issue – the £20 billion national loan guarantee scheme – proved also to be a letdown. George Osborne claimed the scheme, known as credit easing, would provide a "real boost to British business" but it only offered around £2.5 billion in loans to firms before it was superseded after just eight months of operation.

These failures help explain why net lending to businesses fell every month during the coalition's first two years in office. That's why I hope the government will be luckier on its third attempt and that its 'funding for lending' scheme gets banks working for SMEs and the wider economy once again. This latest effort will see the Bank of England lend money at below market rates to financial institutions over an 18 month drawdown period. But the jury's still out on whether we will finally see a boost in new lending rather than simply 'churn'.

It would be wrong, however, to simply sit back in Downing Street, wait and hope for the best, as Osborne and David Cameron seem so content to do, even though the economy has hardly grown over the last year. Instead we need more action to get us out of the rut. That is why funding for lending should be urgently reformed to help boost corporate lending.

The scheme's current rules allow for the Bank of England to approve the participation of banks according to a 'base stock' of eligible loans, which are linked to the

cost of borrowing. Under international regulations banks are required to hold more capital against corporate lending compared to that required for mortgages, which means they are receiving far greater returns from non-corporate lending arrangements.

The chancellor should review the funding for lending rules to either make the pricing mechanisms around corporate lending more effective, or alternatively look at the total mix of lending offered by those banks involved and ensure there is a greater weighting towards SME loans.

One of the few positive side-effects of the government's series of half-hearted interventions is that more people now understand the importance of bank lending to SMEs. These firms are the lifeblood of the real economy and make up 99 per cent of all private sector businesses in the UK, according to the Federation of Small Businesses.

They also provide nearly 60 per cent of all private sector jobs – a figure that could increase if the sector is given the right support so firms can take on new workers. At a time when major corporates are sitting on surpluses and watching the euro crisis unfold just over the water, Britain's SMEs are crying out for backing so they can invest in their staff, in new technologies and in exports to the emerging markets.

For this to happen, the government needs break its cycle of ill-thought-out fiscal choices and budget U-turns and begin to think about the long-term. A sustainable recovery needs a fundamental shift in the way banks work – remembering their obligations to customers, as well as to shareholders.

For too long bank customers have faced a range of difficulties from disparities from region to region, and even neighbourhood to neighbourhood, in the availability of credit and other financial products. The time has come for more transparency and for the big banks to be more open about what they are lending, and where.

This approach has already worked in the US, where banks publish lending data and work with community banks, credit unions and charity banks to ensure all of the areas in which they operate have fairer access to financial services.

We should now consider this approach in Britain – not just for personal account holders but for businesses too. Identifying the parts of the country being neglected by banking policy could help local and national authorities shape support for small and medium-sized businesses more effectively.

The publication of anonymised data on what banks lend, to whom and where, as well as stronger incentives to operate right across the country, including with community banks, would help banks be more accountable to local customers. It could end discrimination against individuals and small companies in more deprived areas of Britain and put pressure on the financial services industry and government to plug the gaps in the market.

It should be possible to improve the connection between small businesses and community banks, but it is not something that can happen overnight. I was encouraged to see the Community Development Finance Association has formed a partnership with the British Bankers' Association to develop a pilot referral scheme, in which companies whose application for a loan was turned down will be put in touch with the most appropriate community lender. The scheme will concentrate on SME lending for loans of up to £50,000 initially, but figures of that kind can still make the difference between survival or closure for small or early stage businesses.

The state also has a responsibility to deliver value for money from its stake in the banks. For all its current problems, the financial sector has stabilised, due in part to the bold action taken by Gordon Brown and other world leaders at the height of the crisis.

So now, with business confidence in the doldrums and Britain facing the prospect of years of low growth, it is worth reviewing how well the government uses its bank shareholdings for the benefit of all in society.

The apparent unwillingness of the major banks to engage in normal lending practices is a matter of daily concern for small businesses. Yet the banks seem impervious to the entreaties of ministers to change behaviour.

The major banks are, of course, engaged in recapitalisation efforts and it is widely suspected that this trumps new lending when it comes to their core priorities. Nevertheless, it is legitimate to ask: should the government be a more active shareholder and encourage the banks it owns to change their practices?

While ministers have been relying on the dictum that any 'intervention' may jeopardise a return to the market of these state-owned banks, there are increasing voices calling for proximate stewardship by the shareholder.

It is reasonable to dialogue between the shareholder and executives on overarching business strategy – as any good investor would do with its portfolio companies. Given the significant role that banks play in society at large, I believe that it is perfectly acceptable for ministers to engage in such dialogue.

There is still more to be done, however, because our drive for growth must be relentless and co-ordinated – a fact the government has failed to grasp with its piecemeal approach.

The current redrawing of the banking landscape provides a chance to create a British investment bank. The concept has worked in the US, for example, where a similar institution lent money to a young Steve Jobs in the 1970s when ordinary bank managers struggled to understand his ideas, which ultimately led to the creation of Apple.

Today Britain is the only one of the G8 countries not to have a dedicated institution dealing with SME financing

issues and initiatives, which is why Labour commissioned Nick Tott, a former partner in a City law firm, to examine the arguments for a new bank. He presented a strong case, yet so far the government has resisted. Instead Vince Cable has thrown his weight behind a new business bank – and I fear if reports are right it will really be a repackaging of existing schemes, will take 18 months to get started and will not actually provide any loans itself.

A national investment bank that is genuinely new would be able to channel finance to Britain's army of SMEs to help them to make the sustainable investments that are vital to their future and to that of the entire country.

Increasing choice in this way would benefit both business and personal customers. That has begun to happen already, with the Co-operative Group's acquisition of 632 'Project Verde' branches from Lloyds, propelling the mutual to be Britain's sixth-largest bank. Sealing the deal has been a remarkable success for the Co-op, but the Treasury can take little credit because Lloyds was forced to sell under EU state aid rules.

Even more choice on the high street is needed however. Ed Miliband has spoken of his desire to see seven big banks, rather than the current five, and for that to happen it is vital that Royal Bank of Scotland presses on with its attempts to sell 316 branches, after the recent collapse of a deal with Santander.

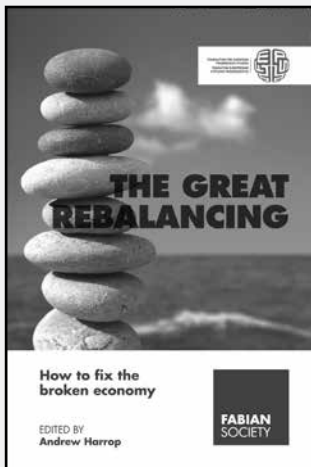
This is not just about change for the sake of change. Increased competition would prompt banks to provide cheaper and simpler products and would disrupt the old model, where lenders relied on the lack of information and the lack of alternatives to eke out steady profits from personal and business customers year after year.

There are choices for government policy here, and there are numerous ways to tackle the shortcomings in the banking system and create the conditions for a sustainable recovery. Many of these present opportunities to get a

better deal for the taxpayers who stumped up to support the financial sector during the crisis.

Success requires a government which takes an active approach to the banking industry, can demonstrate a clear understanding of the challenges facing personal customers and small businesses and has a credible plan for nationwide economic growth.

This current coalition falls short in all these areas which is why Labour will continue to push for a cheaper, fairer banking system that uses local links to make informed decisions on SME lending and to stimulate the economic recovery which this country so desperately needs.



Discussion Guide: The Great Rebalancing

How to use this Discussion Guide

The guide can be used in various ways by Fabian Local Societies, local political party meetings and trade union branches, student societies, NGOs and other groups.

- You might hold a discussion among local members or invite a guest speaker – for example, an MP, academic or local practitioner to lead a group discussion.
- Some different key themes are suggested. You might choose to spend 15–20 minutes on each area, or decide to focus the whole discussion on one of the issues for a more detailed discussion.

A discussion could address some or all of the following questions:

1. There are three distinct issues facing policymakers dealing with the UK's broken banking model: the challenge of making it safer to avoid a repeat of the crash; the problem of excessive remuneration; and the underlying question of how the banking system can be made to support the real economy. What progress has been made in tackling these challenges? How can a more diverse banking system with many more regional and mutually-owned players be created?
2. To hundreds of economists, the evidence is clear: a financial transaction tax would help strengthen the public finances across European nations including the UK, reduce the likelihood of future financial crises, and provide a new source of finance for European and UK growth. Why has the Labour party resisted this and how could advocates argue more effectively for it?
3. Private companies often benefit greatly from public investment in risky innovation. Are the taxes generated by private profit reward enough or should the state benefit more directly from its investments – retaining ownership over a proportion of the value created, for example?

Please let us know what you think

Whatever view you take of the issues, we would very much like to hear about your discussion. Please send us a summary of your debate (perhaps 300 words) to debate@fabians.org.uk.

The new FEPS scientific magazine **Queries** is now available



DEMOCRACY: TAKING THE NEXT TURN

One topic, one issue, readable in a user-friendly electronic FluidBook® or on your iPad via the novel FEPS app – download Queries and share it in a few clicks.

www.feps-europe.eu

- 8 THE NEXT MISSION OF COSMOPOLITAN SOCIAL DEMOCRACY**
- 7 THE NEXT WOMEN'S MOVE**
- 6 ASIA: WHAT'S NEXT? AN INDIAN PERSPECTIVE**
- 5 NEXT LEFT: SOCIAL PROGRESS IN 21ST CENTURY**
- 4 THE NEXT GLOBAL DEAL**
- 3 WHAT COMES BEFORE, WHAT COMES NEXT**
- 2 THE NEXT WAVE OF EMANCIPATION**
- 1 NEXT EUROPE, NEXT LEFT**



Queries is one of FEPS' tools to promote a true European space for political reflection. Academics, politicians, journalists and other actors are invited to contribute with their visions and ideas on the Europe we live in today.

FOUNDATION FOR EUROPEAN
PROGRESSIVE STUDIES
FONDATION EUROPÉENNE
D'ÉTUDES PROGRESSISTES





FEPS together with Renner Institut and Institute of Global Law and Policy of Harvard Law School is proudly presenting the 5th volume of the successful FEPS "Next Left" Book series.

NEXT LEFT V BUILDING NEW COMMUNITIES

Opening with forewords by **Dr. Alfred GUSENBAUER**, Chair of the FEPS Next Left Research Programme and **Dr. Ricardo LAGOS**, former President of Chile, the edition encompasses contributions by 15 outstanding scholars and intellectuals. Their deliberations reflect the two year long academic exchange on how to shape the future of progressive movements worldwide.

Next Left vol. 5 "**Building New Communities – Notes from the Transatlantic Dialogue of Dialogues**" is edited by Dr. Ernst STETTER, Mag. Karl DUFFEK and Dr. Ania SKRZYPEK in collaboration with Professor David KENNEDY (IGLP Harvard Law School) and Professor Michael KENNEDY (Brown University), and from **20th June 2012** may be ordered via FEPS website: www.feps-europe.eu



This book is published with the financial support of the European Parliament



FRESH THINKING is the magazine that stimulates European debate.

Founded by FEPS and produced by an independent board of journalists with their hearts to the left Fresh Thinking reaches 10,000 progressives in the EU four times a year. Each issue of the English-language magazine is dedicated to one subject and discussed in depth with a progressive perspective.



Contributing authors of the first four issues included Will Hutton, Laurie Penny, Francois Hollande, Jens Stoltenberg, Lynsey Hanley, Tanja Busse, Katrine Kielos, Martin Schulz, Ian Traynor and Ece Temelkuran.

www.feps-europe.eu

JOIN BRITAIN'S ONLY MEMBERSHIP THINK TANK

Members of the Fabian Society receive at least four pamphlets or books a year as well as our quarterly magazine, 'Fabian Review'. You'll also receive invitations to special members' events and regular lectures and debates with leading politicians and thinkers.

For just £3 a month you can join now and we'll send you two pamphlets and the latest magazine free.

Call 020 7227 4900, email us at info@fabian-society.org.uk, or go to www.fabians.org.uk for more information





The Shape of Things to Come

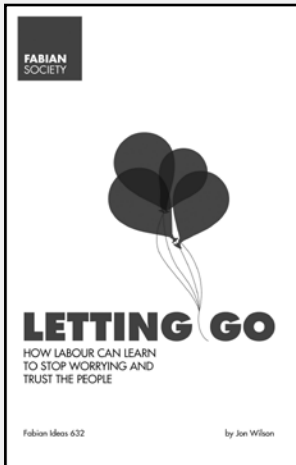
Labour's New Thinking

After the 1970s it was inevitable that the Conservative party would move away from the postwar consensus, but it was Margaret Thatcher who made it Thatcherite. In the 1990s Labour was bound to be centrist; but Blair and Brown gave New Labour its distinctive shape.

After the banking crisis Labour was bound to reflect a public mood more critical of neo-liberal economics, and less confident about big state spending, but Labour in 2012 will also be shaped by the particular politics and personality of Ed Miliband.

Since becoming Labour leader Ed Miliband has successfully opened several new national political debates, from the 'squeezed middle' to 'responsible capitalism' and concern about diminishing opportunities for the rising generation.

These essays explore where this politics could take Labour – and there is a striking coherence, radicalism and optimism about the future they see..



Letting Go

How Labour can learn to stop worrying and trust the people

If you get people in a room together, if people have the freedom to meet, talk and argue, they'll make better decisions about the things which affect their lives than anyone else.

In 'Letting Go: How Labour can learn to stop worrying and trust the people' Jon Wilson argues that Labour needs to become a movement rooted in people's experience, not be the party of the central manager. Above all, it needs to trust people again. The politician's vocation should be to create institutions where those conversations happen, not determine what they decide.

This doesn't mean Labour should abandon its faith in the state. Indeed, that faith needs to be renewed, because our public institutions embody Labour's sense of the purpose of politics: to protect and care, and provide a basis for us to lead good lives together. But the argument in favour of the public sector should be an argument for local control and popular ownership.



The Fairness Instinct

How we can harness public opinion to save the environment

"This research makes a major intervention and deserves a wide readership."

Anthony Giddens, author of *The Politics of Climate Change*

Responding to innovative new Fabian Society research conducted for the Joseph Rowntree Foundation, Tom Crompton, Lord Deben, Huw Irranca-Davies, Caroline Lucas, Ben Page and Baroness Worthington explore how this fairness instinct can be harnessed in order to tackle perhaps the toughest political challenge of our time: climate change.

Politicians need not fear public opinion when it comes to designing policy; they just need to understand it. The research shows people are prepared to act to change their behaviour and consume more sustainably, but this is dependent on the cooperation of others. The public may not like the idea of having to make lifestyle changes, but are prepared to do so once they understand the broader social issues at stake. Politicians need to recognise this and set a credible policy framework that can foster a shared sense of environmental citizenship, rather than attempting to sell policies by appealing to consumer self-interest.

JOIN THE FABIANS TODAY

Join us and receive at least four pamphlets or books a year as well as our quarterly magazine, 'Fabian Review'.

I'd like to become a Fabian


Standard Rate: £3 per month/£36 per annum

Reduced Rate (unwaged): £1.50 per month/£18 per annum

Name	Date of birth
Address	
	Postcode
Email	
Telephone	

Instruction to Bank

Originator's ID: 971666

Bank/building society name	
Address	
	Postcode
Acct holder(s)	
Acct no.	Sort code

I instruct you to pay direct debits from my account at the request of the Fabian Society. The instruction is subject to the safeguards of the Direct Debit Guarantee.

Signature	Date
-----------	------

Return to:
Fabian Society Membership
FREEPOST SW 1570
11 Dartmouth Street, London SW1H 9BN

THE GREAT REBALANCING: HOW TO FIX THE BROKEN ECONOMY

Across Europe, the left is attempting to reformulate its approach to the economy following the 2008 financial crisis. In the UK, Labour's objectives for economic reform feel ambitious yet vague. Words like responsibility and rebalancing are used a lot, but they raise as many questions as they answer. We can all sign up to the UK being a bit less reliant on the financial sector, but then what?

In 'The Great Rebalancing: How to fix the broken economy', senior economists and policy experts set out significant and specific new proposals for what rebalancing the British and European economy actually means in practice. It seeks to put flesh on the bone of calls for a more 'responsible capitalism', spelling out in more detail what the left's next economy could look like.

The scale of the challenge should not be underestimated: for Labour, achieving 'one nation' capitalism will mean the UK turning its back on the mid-Atlantic experiment and transforming itself into a mainstream north European economy. A British rebalancing must be broad-based, for change on any single front could just be a pin-prick. But taken together, the wide package of reforms offered in these essays really can change the character of UK capitalism.

Published with the financial
support of the European
Parliament

feps-europe.eu
fabians.org.uk
A FABIAN BOOK
ISBN 978 0 7163 4118 5
£9.95

Edited by Andrew Harrop
Foreword by Stewart Wood
Introduction by Ernst Stetter

With chapters by Maurice
Glasman, Stephany Griffith-Jones,
Chris Leslie, Mariana Mazzucato,
Chi Onwurah, Jonathan Portes,
Vicky Pryce and Duncan Weldon