PROMOTING
GROWTH AND
SHARED PROSPERITY
IN THE UK

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10 WAYS

TO PROMOTE GROWTH

BRIEFING

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ABOUT PROMOTING GROWTH AND SHARED PROSPERITY

This major programme of work aims to identify public policies that will promote the economic growth needed to return the UK to full employment and ensure that the benefits of future prosperity are more equally shared.

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The UK economy has not delivered the growth hoped for by the Coalition government. Provisional estimates show real GDP increased by just 0.5 per cent over the year to Q3 2011, and it remains 4 per cent below its peak level of Q1 2008. The Office for Budget Responsibility (OBR) will revise its estimates for growth in 2011 and 2012 down significantly when it publishes its latest forecasts alongside the chancellor's autumn statement on 29 November. The new figure for 2011 is likely to be 1 per cent or less, down from 1.7 per cent forecast in March, and 2.6 per cent before the June 2010 budget. There could be a bigger cut to the 2012 forecast, which currently stands at 2.5 per cent.[1]

As a result of weaker growth, employment is falling again and unemployment increasing. In the three months to September, employment was 197,000 lower than in the previous three months, while unemployment was 2.62 million – its highest level since 1994.

There are a number of reasons for this underperformance and the precise apportionment of blame is hotly disputed. Our view is that the slowdown in growth is the result of a mix of domestic factors – particularly the effect of the chancellor's tough fiscal plans on confidence in the private sector about future demand – and global factors – higher oil and food prices and perhaps, more recently, the worsening situation in the eurozone. The effect of longer-term structural negatives, including the overhang of debt in the household and banking sectors, has also been underestimated. It is well documented that recoveries from recessions caused by the bursting of debt and asset bubbles (so-called balance sheet recessions) tend to be followed by weaker growth than 'normal' recessions, but economists in the UK seem reluctant to accept this will be the case over the next few years. A longer companion piece to this paper – entitled *The state of the economy*[2] – discusses the outlook for the economy, its strengths and weaknesses, and the opportunities and threats that it faces.

The reasons for the slowdown are less important than the fact of it. If there is a role for policymakers to play in responding to fluctuations in growth – and we think there is – then action is needed now. This is true whether the slowdown is the direct result of government policy or due to factors and events completely outside its control.

In the short term, the priority is simply to achieve more growth to reverse the recent rise in unemployment and set the economy back on the path to full employment.[3] In the medium term, the need is to ensure that any growth is sustainable and that the benefits of increased prosperity are broadly shared. First put out the fire, then rebuild the house.

In this spirit, here are 10 ways in which policymakers could act now to promote growth in the UK. Some are concerned with the lack of demand in the economy right now; other focus on what needs to be done to address the long-term structural weaknesses in the UK economy and to enable it to adapt to a low-carbon future.

Some of these policies require additional spending in the short term. Eventually, this will require offsetting action to make the deficit-elimination arithmetic add up. Now is not the time for tax increases or new spending cuts, but some options for additional revenues are

1 On 9 November, the CBI cut its growth forecasts to 0.9 per cent for 2011 and 1.2 per cent for 2012: http://www.cbi.org.uk/media/1151947/cbi_economic_forecast_nov_2011.pdf. The Bank of England is forecasting growth of around 1 per cent in both years: http://www.bankofengland.co.uk/publications/inflationreport/irlatest.htm

2 Available at http://www.ippr.org/publications/55/8255/the-state-of-the-economy

3 An employment rate of around 73 per cent.

the abolition of the winter fuel allowance and free bus passes, replacing inheritance tax with a capital receipts tax, and restricting tax relief on pension contributions to the basic rate of income tax.

1 Adjust the pace of fiscal tightening in response to growth in the economy[4]

In framing his plan for eliminating the fiscal deficit, the chancellor was too focused on financial market confidence and too blasé about his plan's effect on consumer and business confidence. While the 'automatic stabilisers' will be allowed to operate (that is, discretionary policy will not be changed to reflect any shortfall in revenues or additional spending as a result of the growth undershoot), the reduction in the cyclically-adjusted deficit will continue as planned, despite developments in the economy.

There is, however, little evidence to suggest bond investors would take fright if the chancellor's plans were adjusted in the short term, provided a credible medium-term strategy remained in place. Indeed, bodies like the IMF now favour such a move.[5] Parallels between countries like Italy and Greece, which have very high levels of government debt generally issued at short maturities, and the UK, which has a relatively low level of debt issued at the longest average maturity of any government debt in the world, are false ones.

The chancellor should announce that the cyclically-adjusted deficit will be eliminated over six years, not four as currently planned – something that recent economic weakness may in any case force on him. In addition, he should set out rules that allow him to reduce the pace of deficit reduction when the economy is growing slowly and constrain him to increase the pace when growth is stronger. If the economy is growing at an annual rate of less than 1.5 per cent and expected to do so in the near future, then deficit reduction should be scaled back. If it is growing at 3 per cent or more, then deficit reduction should be faster.

The OBR would have the final say on when the pace of deficit reduction should be changed, but it is clear that now would be such a time. This would free the government to announce temporary increases in public spending or tax cuts designed to boost demand in the economy. The nature of these spending increases or tax cuts should be based on their impact on the economy and the ease with which they can be reversed, once the economy is doing better.

2 Guarantee the young long-term unemployed a job by injecting up to £2 billion into the Green Deal

The chancellor should take advantage of the flexibility provided by changing the deficit reduction plan to announce an immediate injection of extra funds into the Green Deal. This should build up over the next three years to an additional spend of £2 billion.

The Green Deal aims to make it easier for homeowners and residents to have energy efficiency measures installed in their properties. Under the Green Deal framework, organisations will be able to offer energy efficiency improvements to homes, community spaces and businesses through loans involving no upfront charge. Costs will be recouped through a charge added to energy bills. This charge will be less than the savings made, so energy bills should be lower than or equal to what they would otherwise have been.

4 This idea was developed by IPPR earlier in 2011, before the extent of the slowdown in growth was clear. See *Deficit Reduction Averaging: A plan B for fiscal tightening* at http://www.ippr.org/publications/55/1831/deficit-reduction-averaging-a-plan-b-for-fiscal-tightening

5 See for example: http://www.imf.org/external/pubs/ft/survey/so/2011/NEW092711A.htm

The extra money should be used to link the Green Deal to a job guarantee scheme for young people. Latest figures show that there were 1,016,000 people aged 16 to 24 who were unemployed in the UK in the three months to September, and that 259,000 of these young people have been unemployed for more than 12 months. Around half the extra funds could be used to help take the scheme to scale by subsidising charges for installing energy efficiency measures and to help tackle fuel poverty; the other half could be allocated to subsidising the employment of young, long-term unemployed people to work on installation and other work opportunities that could be created through the scheme.

Long periods of unemployment affect unskilled and older workers disproportionately, as well as young people. Young unemployed people risk permanent 'scarring' (doing less well than their contemporaries throughout their working lives); older workers who are made unemployed find it very difficult to get back into employment as their skills become less useful to employers, and they are at risk of drifting out of the labour market; unskilled workers simply cannot compete with other workers when times are tough.

To counter these effects, the government should introduce a job guarantee scheme.[6] This would guarantee a job, paid at the minimum wage or above, to anyone who has been out of work and claiming jobseekers' allowance (JSA) for more than 12 consecutive months. The guarantee would be matched by an obligation to take up the offer or to find an alternative that does not involve claiming JSA. The job should be for no more than 30 hours a week, to allow a reasonable amount of time for job search, and should last for a maximum of six months. Jobs could be provided by the third sector or government.

3 Introduce tax reforms to promote private sector growth and employment creation

The chancellor has pinned all his tax reform hopes for boosting private sector growth on cuts in corporation tax rates (with the large company rate set to come down from 28 per cent to 23 per cent over the space of four years), funded in part by reductions in tax allowances. However, there is not strong evidence that lower corporate tax rates lead to higher employment growth, relative to other tax changes. Indeed, there is a range of other measures that the chancellor could adopt.

He should heed the CBI, which has suggested introducing capital allowances for future spending on infrastructure projects, to cover the 28 per cent of private sector infrastructure spending not eligible for tax relief under the existing regime, and extending the research and development tax credit to all non-profitable companies, while at the same time widening the definition of the scheme to include design.[7] Together, these measures would cost about £450 million a year. As well as offering support for growth in the short term, they would also bolster long-term growth by increasing spending on innovation and infrastructure.

The chancellor should also reverse his plans to cut capital allowance rates (from 20 per cent to 18 per cent for general plant and equipment and from 10 per cent to 8 per cent for integral features and long-life assets) and the maximum annual investment allowance (which offers 100 per cent capital allowances for qualifying plant and machinery in its first year) from £100,000 to £25,000 from April 2012. These measures will hit

6 This idea is developed more fully, along with other recommendations to speed the return to full employment in the UK, in an IPPR paper by Tony Dolphin, Kayte Lawton and Clare McNeill, *Jobs for the Future: The path back to full employment in the UK*, available at: http://www.ippr.org/publications/55/7938/jobs-for-the-future-the-path-back-to-full-employment-in-the-uk

7 See http://www.cbi.org.uk/media-centre/press-releases/2011/11/time-is-right-for-plan-a-plus-cbi/

manufacturers particularly hard, and so make it more difficult for the UK economy to be rebalanced.

The economy would also benefit if ‘patient capital’ – investing in companies with a longer time horizon – could be encouraged. One problem in the UK appears to be the favourable tax treatment of debt, relative to equity. The chancellor should ask HM Treasury to examine ways of redressing the balance.

4 Announce an immediate £5 billion increase in infrastructure spending, rising to £10 billion in 2012/13

The chancellor’s deficit reduction strategy focuses primarily on the cyclically-adjusted current balance, so he has scope to increase capital spending even within the restrictions of his current plans (although too much extra spending could affect his ability to start to reduce the debt-to-GDP ratio). He should announce an immediate increase in infrastructure spending – in areas such as social housing and transport – of £5 billion for 2011/12. This should be increased to £10 billion in 2012/13 and subsequent years. Even with this additional spending, total public sector gross investment would fall, in nominal terms, from £61.6 billion in 2009/10 to £60.7 billion in 2012/13.

Spending more money on infrastructure projects may not be the quickest way to boost the economy (a cut in VAT could be implemented more quickly), but it is one of the most effective. In its June 2010 budget forecast, the OBR published ‘impact multipliers’ showing the effect of changes in different taxes and types of spending on growth.[8] Capital spending had the highest multiplier. Some of the benefits of a VAT cut are lost if people save more or spend the money on goods and services with a high import content. Extra infrastructure spending directly benefits the economy.

Estimates of fiscal multipliers

Changes in personal tax allowance	0.3
Change in VAT	0.35
AME welfare measures	0.6
Current spending	0.6
Capital spending	1.0

Extra infrastructure spending also has the advantage of adding to the UK’s productive capacity over the longer term. The government is currently able to borrow at rates that are the lowest it has ever been able to borrow at. Rather than cutting investment spending, it should be taking advantage of these low rates. There is no question that doing so would ‘crowd out’ spending by the private sector. Companies are sitting on billions of pounds of capital which they are unwilling to spend because the demand outlook is so uncertain. Some of the extra investment could go into revenue-producing schemes, such as toll roads.

An additional £10 billion of spending is a relatively small amount in an economy where nominal GDP is likely to total around £1.6 trillion in 2012/13. However, announcing additional spending may boost household and business confidence. Businesses in particular may be more likely to increase their spending if they see that the government is not determined to pursue a path of austerity come what may.

8 See http://www.hm-treasury.gov.uk/d/junebudget_annexc.pdf

5 Move quickly to implement ‘credit easing’ and to establish a National Investment Bank

George Osborne announced in his Conservative party conference speech that the Treasury was exploring the option of ‘credit easing’ to help companies that are unable to raise finance through traditional routes. Few details have emerged subsequently to help us understand exactly what this might entail.

The government will not want to be in the business of making loans directly to companies, so credit easing is likely to involve the Treasury (or the Bank of England acting as the Treasury’s proxy) buying corporate bonds. However, while this would be a useful mechanism to have in place should the corporate bond market freeze up again (as it did during the financial crisis), large companies currently appear easily able to access finance by issuing corporate bonds, and at relatively low yields.

Financing problems are much greater for small and medium-sized companies that do not have the scale to issue corporate bonds and so have to rely on bank lending. To increase the flow of finance to these companies, the Treasury should encourage banks to securitise (bundle up) small company loans and overdrafts. These could then be bought as part of the credit easing programme.

At the same time, more finance is needed for large infrastructure projects, including those that will help the UK economy reduce its carbon emissions, and for social housing. The government has recognised this need and there have been suggestions it wants to wield private sector money, held by pension funds and insurance companies, to fund infrastructure projects. As with credit easing though, the details of how this might be achieved are vague for now.

The government is setting up a Green Investment Bank, which is welcome, but it could do more by establishing a full-blown National Investment Bank. The Green Investment Bank is due to open for business in April 2012. The government should aim to have a more comprehensive National Investment Bank (into which the Green Investment Bank might be rolled) operational by April 2013. This bank would be able to borrow funds, not just use capital injected into it by the government and, if the UK adopted the same public sector accounting rules as most of the rest of Europe, this borrowing would not count against the government’s deficit target. There are plenty of international examples of similar banks, such as Germany’s KfW Bank, but whatever model is followed, it would be for the government to set the bank’s lending guidelines but for banking executives, not politicians or civil servants, to make the lending decisions.

6 Create sector-specific ‘innovation zones’[9]

Innovation is crucial for growth and employment in the UK. The fastest-growing firms are those that innovate the most. They are also responsible for a disproportionate share of job creation.

Government efforts to support innovation tend to be piecemeal. It should develop a more strategic approach centred on the idea of ‘innovation zones’, which would offer greater government support for research and development (R&D) and start-ups in key, high-value-added sectors. These would differ from enterprise zones, which use generalised

9 This recommendation and the following one draw heavily on the analysis in *Surviving the Asian Century*, an IPPR paper by Adam Lent and David Nash published earlier this year, available at: http://www.ippr.org/publications/55/7872/surviving-the-asian-century-four-steps-to-securing-sustainable-long-term-economic-growth-in-the-uk

tax relief and will not necessarily incentivise innovation. In many cases, innovation zones could be based on existing geographic clusters or university centres of excellence. Within the zones, businesses, private stakeholders, researchers, local community groups and councils would work together to identify barriers to growth – such as planning processes that inhibit the expansion of science parks – and to break them down.

Better-targeted tax incentives – for instance, higher R&D tax credits – to spur innovation and lighter regulation for high-growth firms working within innovation zones should also be introduced. However, support of this nature should be kept under review, in consultation with the companies, to identify what works and what does not. It should also be time-limited and dependent on performance.

The government should also make greater use of its procurement process to support innovation. The Technology Strategy Board's Small Business Research Initiative (SBRI) is designed to help innovative companies develop and commercialise new ideas, while responding to the needs of government departments. This scheme should be massively scaled up over the next few years.

7 Expand the Export Credit Guarantee Scheme

The short-run outlook for the UK's export sector is not good. More than half of the UK's exports go to other European countries and demand is unlikely to grow much until the crisis in the eurozone is resolved. But, having run a trade deficit in 23 of the last 25 years, the UK needs strong export growth if it is to rebalance its economy. Over the longer-term, this can best be achieved by reorienting the UK's export efforts away from Europe and towards emerging economies like Brazil, China and India.

A significant increase in exports will only take place if companies are prepared to invest more in innovation, capital equipment and workforce skills, so many of the other measures set out here would also have the effect of improving the UK's trade performance. But the government could do more to support business efforts to break into emerging markets by expanding the Export Credit Guarantee Scheme.

This scheme insures exporters against non-payment, guarantees bank loans for overseas purchasers of British goods and insures UK investors in overseas markets. Earlier this year, the government broadened the remit of the scheme, but more needs to be done to encourage take-up, for example through greater presence of the Export Credit Guarantee Department (ECGD) at trade fairs and via targeted information campaigns. Efforts should focus in particular on encouraging small and medium-sized businesses across a range of industries to make use of the scheme.

Furthermore, the ECGD's mandate should be broadened to include advising businesses on the credit-worthiness of overseas buyers and assisting exporters to recover bad debts. And, given that services account for a large proportion of the UK's exports, the government should explore the possibility of introducing tailored export credit guarantees for service industries.

The fall in sterling's exchange rate in 2008 and 2009 has probably been supporting the UK's exports in the last few years but the experience of the mid-1990s suggests such support is likely to prove short-lived. Before its stimulus runs out, the government needs to promote the development of a more innovative and productive export sector.

8 Ensure industries can recruit the skilled workers they need to expand and to lift productivity levels

Government strategies to improve productivity rely heavily on delivering a more qualified workforce. The number of people with no qualifications has declined significantly in recent decades but whether or not workers' skills translate into productivity increases depends on how they are used and managed by firms. Demand for skills and decisions about how work is organised rest heavily on a firm's overall business strategy, with demand likely to be higher when competition on price and cost is less important than professional competence, product specification and quality. This in turn creates more opportunities for employees to develop their capabilities: an important goal of growth.

The Growth and Innovation Fund was established by the Coalition government to finance innovative projects that will increase the contribution skills make to productivity and growth within UK firms. It is designed to help tackle the longstanding problem of low productivity among the many British firms that operate at the low-skill, low-cost end of their market, and to help British businesses compete in new, higher-value markets. However, at just £50 million a year the fund's impact is likely to be limited given the scale of the problem.

Previous attempts to use skills to promote growth and productivity gains have failed because they have not considered the ways in which skills are used in the workplace. The Growth and Innovation Fund is England's first attempt at doing this – it should take centre-stage in the government's skills policy, rather than be simply an add-on. For real impact on growth and productivity in the UK, a much-expanded fund – £200 million a year – should be backed up by an ambitious programme of research, pilot projects and learning networks to inspire innovative ideas and practice across the economy.

The government also needs to ensure that the parts of the economy the UK will rely on for growth in the future – such as the creative industries, advanced manufacturing and low-carbon industries – are able to recruit the skilled workers that they need.

9 Expand free childcare places to make it easier for parents to return to work

Work incentives are not just about the gap between what people can earn and what they receive in benefits; other costs associated with working are important too, including transport and childcare costs. The high cost of childcare, which has been rising faster than wages and the general rate of inflation in recent years, can be a significant disincentive to returning to work. As a result, new parents – particularly mothers – find it increasingly difficult to keep in touch with the labour market.

It has been reported that the government is considering making childcare fully tax-deductible (though there are no details yet and any move is unlikely in the next year or two).[10] This would be a regressive move, benefiting most those who pay tax at the higher rate and can already best afford the most expensive childcare. A better idea would be for the government to reverse its decision to reduce support through the childcare element of the working tax credit from 80 per cent to 70 per cent and to develop a single, integrated funding system for childcare that merges tax credit provision and the tax relief provided for childcare vouchers.[11]

10 See Forsyth J (2011) 'Cameron must offer women more than an apology', *The Spectator*, 8 October 2011. http://www.spectator.co.uk/politics/all/7289398/cameron-must-offer-women-more-than-an-apology.thtml

11 See Ben-Galim D (2011) *Parents at the Centre*, London: IPPR. http://www.ippr.org/publications/55/1835/parents-at-the-centre

Expanding the number of free childcare places would be a first step. However, ultimately, the government's aim should be to build on its policy of providing 15 hours a week free childcare for disadvantaged two-year olds by introducing universal childcare. This would have a number of benefits: reducing child poverty, increasing maternal employment rates, reducing gender inequality and enabling families to better balance work and caring responsibilities. Analysis suggests that, even in the worst case, it would also be self-financing for the government, as the extra childcare costs would be offset by higher tax and national insurance revenues. More likely, this policy could generate additional revenues for government, as well as better outcomes for children. Research from Canada also suggests that spending on childcare outside the home has a very high output effect, because of its low import content, and is the most effective means of increasing spending to lift employment levels, because it is labour-intensive.[12]

10 Back universities' attempts to attract overseas students and businesses' need for skilled migrants

The government is committed to reducing the level of net migration into the UK to 'tens of thousands'. But it is unable to control some of the biggest drivers of net migration, including British emigration from the UK and immigration to the UK from the EU. As a result, it is clamping down hardest on those categories of migration that are the most economically valuable, in particular students and skilled migrants from outside the EU.

This risks hitting parts of the economy where the UK appears to have a comparative advantage: higher education and the business service industries that say they need highly skilled migrants. By the government's own estimates, its policies on reducing skilled migration will reduce GDP by between £3 billion and £4 billion by the end of the parliament, and its policies on reducing student numbers will cost between £1 billion and £3.5 billion.

Our competitors in the international market for students are taking the opposite approach to the UK – not least because they have realised the value of education to exports, particularly in a global downturn when other sectors are suffering. The government should concentrate on more targeted action against visa scams and bogus colleges, which undeniably exist. This would enable them to take overseas students out of the immigration numbers game, and move back to a policy that supports rather than penalises one of our most important industries and sources of growth and global influence.

A wide range of employers have objected to the closing of the vast majority of Tier 1 of the points-based system (under which highly qualified migrants could come without being tied to a particular job or employer), to the 'cap' or quota on Tier 2 and to the government's plans to severely restrict the right of migrant workers to stay permanently. The government's response is that it will attempt to identify the most valuable migrants. But it is not possible to identify the next generation of entrepreneurs or Nobel laureates – certainly not by looking at how much they are currently paid, which is the single criterion the government is emphasising across different areas of immigration policy.

The economy cannot be 'open for business' but closed to those who want to study and do business here.

The government has published a *Growth Review* and a *Plan for Growth*, which it is now reviewing. But the economy is barely growing. Each of these documents suffered from

12 See http://www.oise.utoronto.ca/atkinson/UserFiles/File/EarlyLearningEconomicForum_Fairholm.pdf

the same basic weakness. Each started from a set of measures agreed between the coalition partners – cuts in corporate tax rates, an increase in the personal tax allowance, aggressive budget deficit reduction – and attempted to build a growth plan around them. This is the wrong approach.

A plan for growth should start by identifying what is needed for the economy to grow. Growth in the short-term requires additional demand and only the government is in a position to provide it. Growth in the medium term requires increasing supplies of capital, labour and land, and better ways of utilising them.

A plan for growth should therefore be a plan for:

- Increasing demand in the economy in 2012
- Increasing the supply of physical capital through greater investment
- Increasing the supply of human capital by expanding the size of the workforce and increasing the average level of skills
- Improving productivity and the efficiency of firms through innovation and greater competition.

It will not be easy. The 10 measures set out here would represent a start, but more will need to be done to promote growth and ensure that the UK returns to full employment as soon as possible.