# The Route Back to Growth

IoD POLICY PAPER

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## The Purpose

The purpose of the IoD's *Route Back to Growth* is to respond to political and media calls for a Plan B in fiscal policy – to boost short-term aggregate demand prospects so that consumers and companies spend more money. Clearly the deteriorating economic outlook in the wake of the Eurozone crisis requires a macroeconomic response in the UK, but the nature of this response must be right.

**Box 1**

### The Vision – Britain in business

We want to create an exciting set of policy proposals:

- Ambitious policy changes, which are achievable – with real political conviction.
- Aggressive proposals, which defy the current pessimism as to the UK's ability to respond to the global competitive challenge of the coming decades.
- Policies which if implemented could make the UK one of the most competitive advanced economies in the world by 2020-2025 – front of the grid status.
- Policies which if implemented could significantly raise the potential growth rate by 2020-2025.
- Proposals on which the IoD will campaign and become a rallying force for change.

The IoD's *Route Back to Growth* challenges the received wisdom of those calling for a fiscal Plan B:

- **It focuses on aggregate supply (the long-term future capacity of the economy over the next 5-10 years) more than aggregate demand (the short-term economic outlook over the next 12-18 months).**

- **Where it does focus on aggregate demand, the emphasis is on monetary policy (further quantitative easing) not fiscal policy (a slowdown in deficit reduction). In our view easing deficit reduction could do more harm than good in both the short term and the long term. In the short term it would have a negative impact on public debt and gilt yields. In the long term there would be a negative impact of a larger public sector on the private sector's incentives to work, save and invest.**

- **It is optimistic not pessimistic – and aims to raise the long-term potential growth rate of the UK economy. In the absence of reform we believe the underlying potential rate of GDP growth will fall to around 1.75 per cent over the coming years. With the proposed reforms we believe potential growth could be raised back up towards 3 per cent.**

## Fiscal Policy – Plan A is OK

We continue to strongly support the Spending Review and have opposed a fiscal Plan B for three reasons:

- **Fiscal** – The continued Eurozone crisis and bond market concerns over public debt means that backsliding over deficit reduction risks a spike in gilt yields, higher corporate bond rates and a decline in business confidence and investment. The UK is clearly not in the same situation as Greece, but the idea that gilt markets would quietly accept a return to the deficit numbers outlined in Labour's final budget is illusory. IoD GDP forecasts of 1 per cent growth this year and 1.5 per cent next, imply a considerably larger deficit than projected by the OBR. In other words the automatic stabilisers – lower tax revenues and higher welfare payments – are already beginning to increase the deficit. Additional discretionary relaxation is not sensible.

- **Monetary** – The Shadow Chancellor argues that monetary policy is impotent with near zero interest rates and the weak recovery therefore necessitates fiscal support – in this instance a VAT cut. This is looking through the wrong end of the telescope. In the wake of the financial crisis, with continued balance sheet reduction and de-leveraging in the banking system, the biggest policy mistake we can make at present is to ignore the money supply. With continued anaemic growth in the broad money supply we have called for the launch of QE2 – with an initial £50 billion injection. Aggregate demand management should focus on monetary not fiscal policy.

- **Supply-side** – We do not believe planning for growth should be confined to dealing with short-term aggregate demand (the current cycle). It should also address long-term aggregate supply and potential trend growth (structural reform). This is critical and risks being crowded out of the debate by demands for fiscal action now. Addressing future supply-side issues could also help boost aggregate demand now, if it raises business confidence and provides greater certainty for investment decisions.

  Long-term potential growth is a function of the quality and quantity of human capital, the quality and quantity of physical capital and the efficiency with which the two are brought together in the production process (total factor productivity growth). Six drivers of productivity performance impact on these three areas: competition, enterprise, education and skills, innovation, investment and the public sector (tax, regulation etc.). The IoD's policy proposals impact across all of these.

  Our analysis suggests that the underlying potential growth rate has fallen from around 2.5 to 2.75 per cent to below 2 per cent per annum over the past decade, owing to the negative impact of tax and spend and regulation. Government spending rose from 36.6 to 51.0 per cent of GDP over the last decade, and 7.5 percentage points of that increase was not related to the economic crisis, occurring between 2000 and 2007.[1] Recent studies have found a significant negative correlation between higher government spending and GDP growth – an increase in the size of government by 10 percentage points of GDP is associated with a 0.5 to 1.0 per cent lower annual growth rate.[2] Additional factors threaten to push it down even further – less inward labour supply from migration in the future – towards 1.75 per cent or less. The status quo is not good.

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[1] *OECD Economic Outlook*, No.89, June 2011, Annex Table 25.

[2] Bergh and Henrekson, *Government Size and Growth: A Survey and Interpretation of the Evidence*, Research Institute of Industrial Economics Working Paper No.858 (2011).

## The Plan

The 15 key *Route Back to Growth* proposals are shown in Table 1 below. The launch of QE2 is the most immediate priority for the economy.

| Table 1<br>**IoD's *Route Back to Growth* – The Top 15 Proposals** | |
|---|---|
| 1. | **Monetary policy** – Quantitative easing; launch QE2 in October with an initial £50 billion |
| 2. | **Fiscal rules** – A new 35 per cent of GDP public spending target by 2020 |
| 3. | **Taxation** – Remove the 50 per cent top rate of Income Tax |
| 4. | **Taxation** – Extended Corporation Tax cuts to 15 per cent by 2020 |
| 5. | **EU policy** – Use future Treaty and/or budget negotiations to repatriate key employment powers |
| 6. | **Infrastructure** – Ring-fence transport, energy and ITC infrastructure spending |
| 7. | **Energy policy** – Do no harm – don't sacrifice UK competitiveness for green credentials |
| 8. | **Education** – Further expand free school provision with profit incentives |
| 9. | **Taxation** – End the £100,000 personal allowance anomaly |
| 10. | **Competition policy** – Intensify competition policy both domestically and within the EU |
| 11. | **Regulation policy** – Radical civil service reforms to promote de-regulation |
| 12. | **Employment Law** – Nine major changes to free up the labour market |
| 13. | **Planning** – Incremental 'Green Belt' and developer rights to propose, and reduce political influence over infrastructure planning |
| 14. | **Public sector performance** – Greater decentralisation of public sector pay |
| 15. | **Public sector performance** – No watering down of reforms to unfunded public sector pensions |

**1. Launch QE2.** As previously stated, we believe the biggest threat to the economy comes from a mistake in monetary policy, given that broad money supply growth has been close to zero over the past year. There has been a slight improvement in the growth rate of broad money recently, but the outlook remains very weak. In addition, the continued Eurozone crisis risks further balance sheet reduction in the UK banking system. Ordinarily it would be the commercial banks that financed economic recovery, but in this extraordinary post financial crisis period, the job of pumping money falls more heavily on the central bank. Consequently the IoD is calling for the Bank of England to launch QE2 with an initial £50 billion injection of quantitative easing, centred on buying gilts as in QE1.

We need to be very careful regarding the imposition of increased capital controls on the banking system. We support the implementation timescale outlined in the Vickers Report (by 2019). Early implementation risks further balance sheet contraction and even weaker growth in the money supply, constraining economic recovery.

**2. A new 35 per cent of GDP fiscal rule.** In the short term the *Spending Review* and deficit reduction plans provide clear fiscal control. However, beyond the 2015-16 forecast period, there needs to be continued strong downward pressure. We think the Government should introduce a 35 per cent of GDP public spending target by 2020 – with the OBR's remit amended to monitor progress towards this target. This would help make the UK one of the most competitive economies in the world, measured by the size of the state. The OBR projects that public expenditure will fall from 47.1 per cent of GDP in 2010-11 to 39.9 per cent in 2015-16.[3] A further fall of around 5 per cent of GDP by 2020 is eminently possible. Big reductions in the size of the state have been successful – the Scandinavian economies reduced public spending by an average of 15 percentage points of GDP between 1993 and 2007, albeit from a higher starting point and under more benign global conditions.[4]

The additional 5 per cent of GDP reduction post 2015-16 could potentially add up to 0.5 per cent per annum to underlying trend growth.[5] Combined with measures to reduce the regulatory burden (to reduce the Total Intervention Index), and other supply-side measures outlined below, this could potentially raise trend growth towards 3 per cent.

It is not only the total amount of public spending which matters for growth prospects. The nature of that spending matters as well. There needs to be a clear shift in emphasis away from unproductive (e.g. welfare payments) towards productive (e.g. infrastructure) expenditure. Key to this would be a clear classification of all items of public spending as to whether they were productive or unproductive in this sense i.e. growth enhancing in the long-term. Consequently the 35 per cent of GDP target has two key characteristics – lower public spending as a proportion of GDP, which is also of a higher quality – more bang for our tax buck.

**3. Abolish the 50p additional rate of Income Tax.** The top Income Tax rate should be restored to 40p and the Government must not introduce an offset that raises the overall tax burden. The 50p rate marks the UK out as a high-tax country, unattractive to the talented entrepreneurs and highly-skilled professionals who can create new job opportunities for everyone. We set out the case against the rate in detail last year.[6]

The 50p rate almost certainly raises very little and may even be a revenue loser. Consequently, politically inspired new property taxes are likely to increase the overall tax burden, if they are introduced as a counter to the removal of the 50p rate. We are therefore opposed to such offsetting measures.

**4. Corporation Tax reduction to 15 per cent.** The Government should declare that the Corporation Tax rate will be reduced to 15 per cent by 2020. The Government

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[3] Office for Budget Responsibility, *Economic and Fiscal Outlook*, March 2011, Table 4.14.
[4] *OECD Economic Outlook*, No.89, June 2011, Annex Table 25.
[5] See: Bergh and Henrekson, *Government Size and Growth: A Survey and Interpretation of the Evidence*, Research Institute of Industrial Economics Working Paper No.858 (2011). Bergh and Henrekson found that "an increase in government size by 10 percentage points [of GDP] is associated with a 0.5 to 1.0 per cent lower annual growth rate".
[6] IoD, "The folly of the 50 per cent rate", *Big Picture* Q1 2010.

says it wants the most competitive tax system in the G20, with a low Corporation Tax rate, and a regime that will bring corporate headquarters to the UK, with a tax system characterised by simplicity and certainty.[7] These are the right ambitions, but it will take more than existing Government plans to achieve them. Bringing the Corporation Tax rate down to 23 per cent, as the Government plans, is not enough. In 2011, the 34 OECD countries have rates ranging from 39.5 per cent (Japan) down to 12.5 per cent (Ireland).[8] Cutting the UK's rate from the current 26 per cent to 23 per cent will only advance us from nineteenth place to thirteenth place, and then only if other countries do not cut their rates. A 15 per cent rate would put us in second place, a major competitive advantage. This would be affordable on the basis of the spending restraint outlined in the 35 per cent of GDP fiscal rule.

**5. Repatriation of EU employment powers.** William Hague, in a recent interview,[9] suggested that the UK should seek the repatriation of powers: "I don't think there's any doubt about the long-term orientation of the Conservative Party on this. We would like to see powers returned from the EU to the United Kingdom."

In the past, we have stated that we would be pleased if a UK government managed to find an opportunity to take the UK out of the employment and social powers in the EU treaties. These powers have allowed the EU to introduce damaging laws like the Working Time and Agency Workers directives.

In the early 1990s, during the Maastricht Treaty negotiations, the last Conservative government negotiated a UK opt-out from the social and employment powers. Other member states adopted these new powers as part of the Maastricht Treaty change – the UK stayed out. When Labour took office in 1997 it opted in at the first opportunity.

Since then additional social and employment powers have been added through more treaty changes and, as a result, we have had a string of regulations that have eroded UK labour market flexibility. These regulations have not been particularly helpful to other EU member states' competitiveness either. However, since most EU member states have more rigid labour markets than the UK, they have probably not been damaged as much as the UK.

We know that it would be a challenge for the UK to restore something akin to the opt-out. It would require the agreement of all member states. However, this does not mean that the UK has no negotiating leverage. It would be possible for the UK to make its agreement to any new treaty change or a new EU budget contingent on a restoration of the opt-out.

Arguably the next EU budget round, which will shortly commence (the round sets an EU budget framework for the next seven year window), is an ideal opportunity for the UK to press its case for an opt-out. No budget can be agreed without member state unanimity. Similarly, the continued Eurozone crisis may well result in new treaty negotiations, which would also require unanimity. The UK is in a strong negotiating position – it should be using this to improve the competitiveness of the UK's labour market.

**6. Ring-fence infrastructure.** Spending on transport, energy and ICT infrastructure needs to become a key priority in a way that it hasn't been in the past, given the investment in new infrastructure by our competitors. Key infrastructure spending

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[7] HM Treasury, *Plan For Growth*, March 2011, pp.15-17.
[8] *OECD Tax Database*, table II.1.
[9] *The Times*, 14 September 2011.

declines significantly in the Spending Review, with overall public sector gross investment falling from £59.5 billion in 2010-11 to £47.1 billion in 2014-15,[10] a decline of 20 per cent in cash terms. We have argued that this is one of the key areas of public spending which should be ring-fenced, given its positive impact on long-term potential output growth, and there is a great range of improvements that could and should be made to Britain's road and rail networks,[11] as well as vital energy upgrades. The focus of spending reductions should be on current expenditure.

**7. Energy policy: do no harm.** We need to adopt a multilateral as opposed to unilateral stance. The UK's target of a 34 per cent cut in $CO_2$ emissions from the 1990 level by 2020 is far larger than the EU's overall target of 20 per cent, and is likely to mean that part of the UK reduction is offset through the EU ETS by lower reductions elsewhere in Europe. Perhaps more seriously, the world's biggest emitter – China – does not have a carbon reduction target, merely a plan to lower emissions intensity, while the US target is for a 17 per cent reduction on 2005 levels by 2020.

By promising uniquely aggressive reduction targets, the UK is risking the loss of manufacturing jobs with little or no environmental benefit as emissions are simply transferred to other countries. There should be a comprehensive review of all aspects of climate change policy in order to assess whether they place the UK at a competitive disadvantage.

**8. Profit incentives for free schools.** Free schools/academies are a big step in the right direction, but the policy needs to become more radical if it is to deliver a genuine boost to competition and fulfil its potential in driving up educational performance. In particular, we should introduce the profit motive to schools. This is a key lesson to learn from international experience. Evidence from Sweden, where more than half of free schools are run on a profit-making basis, shows that whilst for-profit schools benefit students from all socio-economic backgrounds, they produce the largest benefits for students from less privileged backgrounds. School competition in Sweden has increased levels of educational achievement. Free schools enjoy higher levels of parental satisfaction than government schools. Competition from free schools has also improved conditions for teachers.

The key issue here is the scale of reform. The profit motive provides strong incentives for entrepreneurs to enter the schools market and to expand their businesses. Conversely, barring school sponsors from making a profit reduces the pool of organisations which want to set up schools, grow and repeat their success. Banning for-profit schools therefore risks dramatically reducing the number of free school places that are created, thereby limiting the benefits of competition. The development of the free schools concept is one of the most significant education policy changes in a generation. It really could transform the education system but we need more providers and a much more contestable market. Planning reform is also required, together with the recognition that schools need to be allowed to fail. Ultimately we need greater entry and exit potential, difficult though this is politically.

**9. End personal allowance withdrawal at £100,000.** The gradual withdrawal of the personal allowance as income rises from £100,000 to £114,950 creates an absurdly high 62 per cent tax rate on each extra pound earned by an employee within that band. The rate then falls back to 42 per cent once one gets above this band. This

[10] HM Treasury, *Spending Review 2010*, Table 1.1.
[11] The 2006 Eddington Review made a number of very good suggestions in this area.

spike in the marginal rate makes it barely worthwhile to put in extra effort, if it would generate income within this band.[12]

**10. Intensify competition.** Both domestically and within the EU, the Government needs to become more aggressive in pro-competitive policies. Within the EU a more aggressive stance by the UK Government could include greater emphasis on liberalization of the single market, particularly with regard to the energy and service sectors. Domestically we need a far greater emphasis on competition policy, with rigorous five year reviews of entry and exit barriers and the degree of competition across all sectors. Within the UK, potential areas of focus could include energy, with concerns as to how the Electricity Market Reform will deliver greater competition in practice, and high street banking, as evidenced by the fact that Metro Bank was the first new high street bank in a century.

**11. Radical civil service reforms.** Radical reform of civil service rewards and progression needs to be undertaken in order to increase the incentive to de-regulate and reduce gold-plating. Areas to be considered should include salary, bonuses, assessment criteria, career and promotion structures. In each area new incentives to reduce the red tape burden need to be introduced.

**12. Nine major employment law changes.** These proposals are domestic and in addition to the EU repatriation proposal above. The Government's employment law review lacks any real ambition in freeing up businesses from regulatory burdens. Suggested changes include:

- **Given the disruption caused by strikes, the bar for strike action should be raised.** The IoD believes that when strikes can have such significant impacts on people's lives and economic productivity it is only fair that the means of securing industrial action are robust, modern, transparent and democratic. That is why the IoD proposes that a simple majority of those balloted as well as those voting should be necessary in order for strike action to take place.

- **We need to make employment tribunal reform really deliver for business – currently the system is weighted against employers, particularly small firms.** We want to see pre-vetting of tribunal claims to exclude invalid ones, stronger powers/obligations for tribunals to strike out unmeritorious claims, user charges for employees bringing a claim to deter weak or vexatious claims, and more done to promote consistency of tribunal decisions. The Government's proposals lack ambition, as they stand.

- **Pursue micro business exemptions from the following European Directives in Brussels:** Temporary and Agency Workers Directive (2008/104), Acquired Rights (Transfer of Undertakings) Directive (2001/23), Information on Individual Employment Conditions Directive (91/533), Parental Leave Directive (96/34), Posting of Workers Directive (96/71) and Working Time Directive (2003/88).

- **Introduce "no-fault dismissal" so that employers can create opportunities for more competent employees and more chances for the unemployed.** "No-fault dismissal" would work as with UK divorce law. By recognizing that a work relationship has broken down in a way that is not a

[12] The cost of removing this anomaly could be up to £1.5 billion (HM Treasury, *Budget 2009*, p.11).

single person's fault, employer and employee can agree to part company in a civil and relatively simple manner. As part of a "no-fault dismissal" package, an employee would receive a level of statutory compensation. Making it straightforward for employment to be terminated, and for employees to move on to work to which they may be better suited, can be in everyone's interests.[13]

- **Allow employers to exempt from 2012 all newly taken-on employees from being covered by non-EU employment regulation outside sensitive areas** such as Maternity/Paternity, Discrimination and Health and Safety. This would be a reasonable measure to promote growth in the short run. Areas for exemption might include the Right to Request Training, Right to Request Flexible Working, Dispute resolution rules, Right to be accompanied by a union representative, Time off for public duties and Written Statement of Reason for Dismissal.

- **Introduce legislation that would ensure that all maternity leave employees are required to give at least 3 months' notice of their intended departure.** This would make it easier for employers to plan.

  At present, an employee who takes maternity leave is required to return to active work at the end of a 26 to 52 week period. If the employee decides that they do not wish to return to work, they simply have to offer the relevant notice period in advance of the return date. This means that an individual can notify an employer roughly one month before they are due to return to work that they have no intention of doing so. The problem with this is that employers typically replace staff (temporarily) or reallocate duties to others, assuming that a given member of staff plans to return. With the short notice, employers can find they are notified of no intended return to work of staff, but have also lost their replacement staff member to another post elsewhere (because the assumption was the post would only last for the duration of maternity leave). Our proposal is that legislation should ensure that all maternity leave employees are required to give at least 3 months' notice of their intended departure. The IoD believes this would allow more employers to make satisfactory plans for replacement of staff, but would remove the need for an employer to place all their staff on 3 month notice periods in order to achieve the same end.

- **Remove the unfairness of accumulated annual leave allowance at the end of a period of maternity leave.** This is as an extension to the period of employee absence and is now required by European Court of Justice case law. The Government should push for this to be overturned in the forthcoming revision of the Working Time Directive.

- **Remove the need to pass on organisational bonuses to maternity leave staff.** These bonuses will be linked to the performance of active employees or the company as a whole and as such should not be payable to absent staff. Maternity pay for the initial 6 weeks is calculated using a 3 month reference period, and if a bonus happened to be paid during that period, it would be included in the calculation of maternity pay. This is a lottery and unfair to employees going on maternity leave who do not happen to get a bonus during the reference period.

[13] In a survey conducted in February 2009, 66 per cent of IoD members thought it was too hard to dismiss staff for poor performance.

- **De-Gold-Plate EU Regulation in UK Law.** The Government should commit to full reviews of the stock of domestic transpositions of EU regulations. Immediate reviews should be undertaken to remove known gold-plating from the UK interpretations of the following EU Directives:

  Working Time Directive
  Pregnant Workers Directive
  Part-Time Work Directive
  Fixed-Time Work Directive
  Agency Workers Directive
  Posting of Workers Directive
  Collective Redundancies Directive
  Information of Individual Employment Conditions Directive
  Equal Opportunities and Treatment of Men and Women Directive
  Equal Treatment Irrespective of Racial or Ethnic Origin Directive
  Framework for Equal Treatment in Employment Directive

**13. Residential and infrastructure planning reforms.** In the UK 90 per cent of the population live on 9 per cent of the land. We are too congested in the South East in particular, but there are large areas of protected land at present, which could be released, without detrimental environmental consequences, because developments would be small scale and incremental – thousands of small developments.

Developers hold 2-5 year-plus land banks but our proposals, applied over the whole country, could potentially massively increase available land and drive down the price. It is simply absurd that agricultural land on one side of a road may be worth £10,000 per acre and land with planning consent on the other side sell for up to £2 million per acre in the South East.

The importance of such a change is made more urgent in the wake of the financial crisis with mortgage lenders demanding significantly higher deposits of up to 20-25 per cent of house values. With the land price around 40 per cent of the house cost, lower land prices could free up the housing market and kick-start activity. Potential lower land prices in the future would also provide an incentive to developers to build now – helping the recovery – in order to maximise the return on their existing land banks.

One additional solution centres on a “Developer Right to Propose”. Rather than just simply being able to partner community organisations, house-builders should be able to bring forward plans themselves, which should be put to a local referendum.

Under the Community Right to Build, provisions for which are contained within Schedule 11 of the Localism Bill, community organisations (which have a specific designation in the Bill) will be able to bring forward plans for small-scale developments in their area. The government envisages developments will typically be of 5-10 homes, and there would be a threshold on how much development could be brought forward under CRB orders in a given period (the Government proposes no more than 10 per cent of existing stock over 10 years).

In the draft National Planning Policy Framework, the Government has proposed to allow new development on Green Belt land if it is brought forward under a CRB order, and approved by the community in a referendum. This gives the CRB a unique position in planning law. We propose that house-builders should also be able to bring forward plans themselves. These developer-sponsored projects should apply to Green Belt land in the same way as CRB orders.

With respect to infrastructure planning, political approval for major projects is given at an early stage in the process with the ratification of *National Policy Statements* in Parliament. There is no need for Secretary of State approval at the end of the process too. Nowhere is the need for speed in planning decisions more vital than when it comes to energy infrastructure. By failing to give the green light to new generating capacity, governments have jeopardised the long-term energy supply of this country.

It is also crucial, following the abolition of the Infrastructure Planning Commission, that the transition to the new system for major infrastructure applications is as smooth as possible, and particularly that the 12-month application to decision timeline is maintained. There is private investment waiting; there is no reason to delay and every reason to move quickly in giving the green light.

**14. Public sector pay decentralisation.** Decentralise public sector pay so that a headmaster or NHS Chief Executive decides pay scales outside of national agreements. Clearly decentralisation couldn't work in many areas e.g. armed forces, but in health and education it could be beneficial to both the public and private sectors. In many regions private companies can't compete with national public sector rates of pay.

**15. Public sector pensions.** The Coalition Government must not give in to union demands to water down planned reforms to public sector pensions, despite the likelihood of extensive strike activity later this year. The Hutton Report proposals to move public sector pensions from a final-salary to a career-average basis for new accrual and to increase the normal pension age to the state pension age (apart from the police, fire and armed forces schemes), together with the Government's move to CPI-indexing and plans to increase employee contributions, will help to make public sector pensions more affordable and sustainable. Even after the reforms, they will remain far more generous than in the private sector, where defined benefit pensions have all but disappeared.[14]

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[14] This is also true of IoD members. A Policy Voice survey of 980 IoD members in February 2009 found that just 12 per cent were members of defined benefit schemes, and the figure is almost certainly lower today.