Growth, growth, growth

New ideas for growth and prosperity in the 21st century

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INTRODUCTION

In May 2010, the Coalition came to office with the public finances shot through. Public and private debt were at unsustainable levels while economic growth had been built on debt rather than more solid foundations for almost a decade.

The first priority of the Chancellor has, rightly, been to stabilise the public finances. The deficit reduction plan has maintained Britain's credit rating and kept interest rates low. It has also seen Britain well placed to weather the economic storms now ravaging Europe.

Stabilisation is vital to the now. It is important to ensure our economy is based on true growth rather than debt. Yet it is widely felt that we need to look harder at rebuilding our national economy over the longer term and to build economic growth that will stand our future generations in good stead for a world moving East.

This paper considers measures that will help our country grow faster. We do not claim that we have all the answers. We do not look at every area. What we seek is to make a contribution to the growth debate taking place.

Many of the building blocks are already in place – enterprise zones, labour market reform, regional growth funds and LEPs as well as the protection for transport infrastructure investment. Others are being put in place – importantly the welfare reforms that will make work pay and encourage more employment. The Coalition deserves credit for its economic activism to date.

Much has been done – yet there is much more to do. A decade of economic failure takes more than 18 months to turn around. The proposals in this paper aim to encourage growth with lower business taxation, a radical reform of our banking system, further benefit reforms to encourage work, infrastructure investment incentives, international trade partnerships to boost exports and the reform of EU laws. Some proposals in this paper may be considered radical – the case made for substantial changes in the banking system are not for the faint-hearted. Equally, repatriating powers from the EU will not be straightforward. Yet the scale of the challenge is such that more far reaching policy responses should be considered if we are to succeed in boosting economic growth, jobs and money over the next few years.

The summary proposals are:

- For tax, bold cuts in business taxes will do far more to stimulate growth than cuts in indirect taxes or small tweaks to the tax system (which only add complexity and have unpredictable effects). Reducing corporation tax by an extra 2% a year, and reducing tax on capital gains can lead to the recovery that the Coalition desires.

- For the state-owned banks, £500 billion of further non-core assets should be identified and disposed of as a priority in order to cleanse their balance sheets. Private shareholders should be encouraged to take over the management of the nationalised banks in preparation for a stage return to the private sector at the rate of 20% per annum from 2014-2018. These measures will accelerate the return to “normal” banking behaviour, including lending funds to UK business, thereby accelerating economic growth. The Merlin Growth Fund should be floated, expanded and geared to provide £25 billion equity and intermediate capital to SMEs.

- For benefits, the UK should learn the lessons of benefit reform introduced by President Clinton in the US. This should include not increasing benefits in line with the number of children in benefit-dependent households and localising the level of benefits.

- For infrastructure, new pools of financing must be leveraged. For example, “New Infrastructure Bonds” could be issued to retail investors while core project management and negotiation functions should be centralised.

- For international trade, the problems of increasing exports to the BRIC countries must not be underestimated. But a commitment to an ‘enhanced partnership’ between the UK and India can be a model for Britain’s engagement with other fast-growing emerging markets. In relation to UK-India trade, the Coalition could do all it can to promote its interests in the EU-India FTA; should do more to encourage SME exports to India; should develop runway capacity in the south east to be able to improve transport connections with all BRIC countries; should develop a partnership relationship for aid policy; and should do more to build closer relationships with the élite, Indian students and large Indian companies.

- For the EU, the Coalition should encourage the EU to find ways of scrapping obsolete, unnecessary or inappropriate EU-inspired legislation. It should also seek to remove all legislation that hinders job creation and growth; and should ensure that EU impact assessments are of the highest quality and accuracy.

1. TAX AND GROWTH

Karen Bradley MP[*]

One of the few levers available to government to stimulate growth is tax. The right tax system can lead to increased tax revenues. For individuals and for businesses, tax is usually the single biggest bill and the difference between profit and loss, savings or debt. But for government, tax is the only way to fund public services.

The Coalition has been clear that it wants the recovery to be driven by private sector growth. The right fiscal environment can help by encouraging private sector businesses to grow and create more jobs. That means a tax system that is simple, certain and competitive. This approach should also raise more revenue for the taxman. But simply increasing the rate of tax to

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pay for public services is too simplistic. Mobile businesses and individuals will leave the UK if too much of their hard-earned income and profits are grabbed by the state. Conversely, lower, simpler tax rates can lead to increased tax revenues and the money saved can be invested or spent to boost the economy. Changing the tax system can stimulate economic growth – the question is how?

Over the decades, policy makers have made a host of changes, major and minor, to influence individual and corporate behaviour. But it is unusual for minor tinkering to drive behaviour in the way that policy makers desire. Constant tweaks to the system, often brought in on the basis of theory with little appreciation of the real world, add to complexity and uncertainty. For example, in its impact assessment on R&D tax credits for large companies HMRC itself admitted that: "The availability of R&D tax credits has little effect, however, on decisions to undertake specific R&D projects."

This well-meaning tax relief cost the exchequer £700 million in 2008-09, but had "little effect" on business decisions. It illustrates the futility of trying to tweak the tax system. For while businesses may structure projects to minimise the overall tax bill, tax is very rarely the *main* driver for the business decision.

Should we cut indirect taxes?

It is often suggested that cutting VAT would stimulate the economy by boosting consumption and reducing inflation. However, there are many good reasons not to use this tax to stimulate the economy: the extra administrative burden on business, the fact that a rate of 20% is broadly in line with the European average and that such a change would not create the private sector led recovery that the Government wants.

After years of state and personal profligacy, it would be foolish to seek to boost growth through lowering consumer prices, as this could potentially lead to increased levels of household debt. For too long, policy makers have relied on consumers to buy them out of economic problems. This cannot be the solution today.

Should we cut personal taxes?

If not indirect tax, then can changes to personal taxes provide a stimulus?

Because personal taxes are a fertile source of ideological differences, political interests can make it harder to employ them as engines of growth. So, this year's increase in the personal allowance by an extra £1,000, which is welcome, has been negated for higher earners by reducing the level of income at which higher rate tax starts. This may be an expedient way to tackle the issue of tax giveaways to the wealthy because it manages the needs and aspirations of the coalition partners, but it is a political manipulation – it fails the simplicity test as a stimulus. This means that more people are higher rate taxpayers; they must complete a tax return and will lose their child benefit in 2013.

The one area of personal tax that merits a change, sooner rather than later, to assist growth is the 50% top rate. It is undoubtedly a politically difficult issue, but there is no doubt that having the fourth highest headline rates of personal taxes in the EU, and in particular a higher rate than competitor locations for financial services, is affecting the UK's competitiveness. *Money Week* reported in February that the Swiss Federation Migration Office had seen a 28% increase in the number of bankers relocating from the UK to Switzerland following the introduction of the higher rate. Those bankers were generating wealth in the UK: paying taxes on that wealth, probably around £53m of lost tax. Similarly, in its most recent survey of UK tax competitiveness, KPMG found that one third of respondents cited the 50% tax rate as a reason for considering migration from the UK. So from the point of view of making the UK competitive and, perhaps more importantly, maximising overall tax revenues, the Coalition should review the 50% top tax rate and abolish it if it can be shown that there is less tax to spend on public services if the rate is maintained.

Taxes on business?

Only businesses can create economic growth. The economy will grow if existing businesses expand – creating jobs and paying more in tax on higher profits – and if new business is encouraged to invest in the UK from overseas, or if home grown entrepreneurs start new enterprises.

The principles of increased competitive, reduced complexity and giving taxpayers certainty are key in developing an effective business tax code for the UK.

Increase tax competitiveness

Low business taxes are essential for UK competitiveness. It is the headline rate of corporation tax that influences the decision of whether to site a business in the UK or maintain a UK base or head office. So the rate of tax is also a statement of intent about UK PLC's competitiveness and desire for investment.

In that context, the extra 1% reduction this year to 26% has provided a stimulus and the planned fall to 24% by the end of the Parliament is welcome. But it is long overdue: the UK's headline corporation tax rate is still high internationally – 12th highest out of 31 OECD countries. And in 2009, the average rate of tax in the EU was 23.2%, which is still lower than the UK's target rate for 2015. Here the Coalition can and should be bolder. A 2% per year reduction would lead to a rate below 20% by the end of the Parliament, giving the UK one of the five lowest corporate tax rates in the OECD.

The Republic of Ireland is an example – admittedly not a perfect one – of the success of the principle. In 1987 the Irish Financial Sector Centre (IFSC) was established in the Dublin Docks. This super-enterprise zone had a corporate tax rate of 10% for businesses that set up within the IFSC. The principle was extended in the late 1990's and the Irish Government reduced the rate of corporation tax for manufacturing across the country to 10%. This was raised in 2003 to 12.5% for trading activities, with a 25% rate on profits from non-trading activities, following an agreement with the EU.

The success of these measures in increasing employment and foreign investment is clear. The Republic was able to attract several US head-quartered businesses to move much of their European manufacturing and head office functions to Ireland. A common language and, initially at least, membership of the Eurozone were attractions, and combined with low tax rates, compelling ones. Nowadays, nine out of the ten biggest pharmaceutical companies have manufacturing facilities in the Republic, accounting for 30% of total exports. Many of the jobs created in the boom years have been maintained due to the fact that they rely on foreign investment not affected so much by the problems within the Republic. And foreign investment continues to grow. During 2010, Foreign Direct Investment (FDI) increased significantly. Almost 11,000 jobs were created; the recovery is described as being export led; companies investing in Ireland for the first time were up 20% and over €500 million were invested in RD&I. This is surely the sort of recovery that the Coalition is aiming for.

Undoubtedly the Irish model had defects and it was sadly clear with hindsight that the Celtic tiger bubble would burst. While membership of the Euro was attractive to foreign investors, the strictures of the Stability and Growth Pact and Eurozone low interest rates being imposed on an Anglo-American economic model, coupled with almost Scandinavian levels of public sector spending, was never sustainable. But the chaos of the Eurozone we see today does not negate the benefits of low corporate taxes. The UK is in an entirely different position. Lower corporate taxes will stimulate business growth, encourage new investment and raise employment.

It is not just large businesses that require a competitive environment. One phenomenon of Britain's economy today is the role of serial entrepreneurs. Business angels and dragons – not just of TV fame – are key to growing smaller businesses, and the tax system should work to encourage them. The days of businesses passing from parent to child are rarer and rarer – research suggests that only 24% of family businesses survive to the second generation. Today's entrepreneurs want to grow a business and make a capital gain which they may then invest in new ventures. Increasing and extending the relief from capital gains tax for entrepreneurs to allow serial entrepreneurs to keep more of their gains will lead to increased investment in more new businesses with the consequent new jobs and taxes these create.

Reduce tax complexity

The UK tax code today runs to over 11,000 pages. Complexity has a price to both government (it is no coincidence that HMRC employs over 80,000 people) and to business. For any business, the total cost of tax is not just the amount paid to HMRC but also the administrative costs: the costs of running an in-house tax function and fees paid to external advisors. This is why making taxes simpler can lower a company's overall tax bill even if the amount of tax paid to HMRC actually goes up.

The welcome introduction of the Office of Tax Simplification (OTS) by the Government has generated a large number of ideas about how business taxes could be simplified. Their interim report details a thorough review of the many reliefs and allowances available to businesses and how they could be simplified to reduce the overall cost of tax to business, even if they could appear to be increasing taxes. For example, removing a tax relief could lead to increased tax bills but savings in the administrative costs of qualifying for the tax relief could mean that the overall impact is neutral. By removing many reliefs and allowances, further tax cuts could be achieved without an overall detrimental effect on business.

Certainty

Along with simplicity, certainty about tax is particularly important for small businesses. A constantly changing tax regime only creates uncertainty and reduces confidence in investing in small businesses. It is striking that 89% of enterprises in the UK employ fewer than 10 people and 98% had fewer than 50. These businesses are the bedrock of the economy and the UK needs more start-ups and more investment by existing small businesses to help the economy grow. Recent changes welcomed by small business, such as the introduction of a 0% tax rate for the smallest businesses in 2002 and the complicated but tax efficient taper relief on capital gains introduced in the late 1990s, were relatively rapidly reversed. The 0% rate lasted for fewer than ten years, with a threat that incorporated businesses could be taxed more heavily than identical but unincorporated ones by 2010, whilst taper relief was replaced in 2008 with a flat 18% rate but much less generous reliefs for entrepreneurs.

This lack of clarity about what policy makers are looking for from small businesses and entrepreneurs was unsettling. Why would someone invest in a new business, making decisions based on the current tax regime, if it is possible that within a few years tax will make the business uneconomic and it will fail? Tax is enough of a problem for the smallest businesses – managing payroll taxes, dealing with VAT and business rates – before other decisions such as location, whether to incorporate or not and dealing with employment law are taken into account. It is easy to see why many would decide to invest in other areas, such as property, rather than risking all in a new business. We're back to the original contradiction: for government tax is the only revenue raiser, for business it's a hindrance.

A tax code based these three principles of simplicity, certainty and competitiveness can help provide an impetus to growth.

2. FINANCING GROWTH

Charlie Elphicke MP*

To grow the economy, it is necessary for good businesses to have access to finance. That finance can be internally generated, but more frequently requires loan or equity finance.

Following the financial crisis, it has been reported by the Bank of England that some businesses – especially smaller businesses or SMEs – have found it hard to obtain loan finance. Indeed, overall the net lending of funds to business has been falling since 2010. The latest Bank of England figures for the first half of 2011 show that £7.2 billion more funds were recalled by banks than lent to business.

SMEs have been most affected by bank lending turning negative. Unlike larger businesses, SMEs can struggle to find anywhere else to go. Larger businesses do have alternatives –

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they have stronger cash balances, can raise money in the syndicated lending markets and issue quoted bonds on the markets. In addition, the cost of finance has been increasing for SMEs. Bank of England data indicate that SMEs had been paying around 2% over base rate in 2008 – they are now paying 3% over base rate, with the smallest SMEs paying around 4% over base rate.

SMEs also struggle to raise equity finance. This so called "equity gap" is variously put between £250,000 and £15 million. SMEs are rarely quoted and so cannot tap capital markets in the way larger businesses can. A key issue for policymakers is whether greater access to equity or intermediate capital can be made possible.

Why are banks failing to lend?

The financial crisis was several years ago now. Many therefore wonder why banks are still failing to lend funds and why the banking system as a whole is still struggling. The blunt answer is that banks are being forced to hoard cash in order to prevent a repeat of the 2008 financial crisis. The result is that they are simply unable to lend new money unless they raise fresh capital or scale back their balance sheets to a size that is sustainable over the longer term.

To date, the focus of regulators has been on forcing banks to increase capital. Some might say that it makes little sense to force an increase in capital at the bottom of the market, as it simply removes liquidity and exacerbates the downturn. Be that as it may, capital has increased from around 6% in 2008 to 10% now. Of the major UK banks, RBS has a capital (core tier 1 ratio) ratio of 11.1%, Lloyds 10.1%, Barclays 11% and HSBC 10.8%. This is considered sufficient by the regulators. It might therefore be expected that these banks would now increase their lending.

Yet that has not happened for a number of reasons. First, banks are expected to maintain these higher amounts of capital. Second, UK banks are concerned by their over exposure to Europe – especially lending to the French public sector and banks on the one hand, and the private sector in Ireland and Spain on the other.

Third, UK banks are still overly reliant on wholesale funding as their balance sheets far exceed their base of depositors. Bank of England figures show that 40% of total UK bank funding still comes from the wholesale debt markets – compared to less than 20% for US banks.

Until the issue of balance sheet size and the stability of financing is dealt with, banks will be reluctant to lend new money, however much policy makers, business groups or members of the public may castigate them. It is essential that finance for business expansion is available for good businesses once confidence returns. But this will be hampered while banks seek to ensure they have the cash to manage unwieldy balance sheets that exceed the available cash resources needed to resume “normal” banking behaviour.

Data from the 2011 budget indicate that the total debt of UK banking and financial companies is around 250% of GDP (equivalent to £3.5 trillion). In comparison, in 2002, the debt was 150% of GDP. If 150% of GDP were to be seen as sustainable over the longer term, it would mean that UK bank balance sheets would need to be reduced by more than £1 trillion. This is the scale of the challenge to return to normality.

Banking reform

Progress has been made reducing the level of the declared “non-core” assets held by the nationalised banks from £558 billion in 2008 to £333 billion at the end of 2010. At this rate, these declared "non-core" assets will not be cleared until 2013. Moreover, if bank balance sheet debt were to be reduced towards 150% of GDP, a further £500 billion of additional assets would need to be sold off. Would the markets have indigestion from loan portfolio and other assets being sold off in such a way?

Now may be a time to do it. At the moment, investors have more appetite for debt than equity. The price for selling a loan book may well be rather more attractive than the issuance of new equity by a bank.

The reduction of balance sheets should not just apply to RBS and Lloyds. All UK banks need to return to normality and to have balance sheets that are possible to sustain over the longer term. This could be achieved by setting a regulatory incentive or limit to the reliance on the wholesale debt market for funds: 20% as in the US might be too great a stretch; 25% to 30% would be more feasible and provide greater stability.

As the nationalised banks in particular are unlikely to return to "normal" banking behaviour until excess or bad assets are cleared, the priority given to the asset disposal programme now should be similar to that given to forcing increases in capital immediately following the initial banking crisis. The financial markets will not have positive sentiment towards the nationalised banks until there is greater clarity around the quality of the entire stock of loans and trades of these banks. Total transparency is an essential part of the recovery process.

Between 2002 and 2008, lending to businesses did not rise substantially in real terms. A substantial boom occurred in real estate lending, but not in lending to business.

In view of the foregoing, it is recommended that a clear plan is adopted based on making the UK banks fit for the future. This should include:

- A programme for the disposal of all non-core assets by nationalised banks by the end of 2012. The target should be to identify £500 billion of further additional assets. This could include disposals of assets such as Scottish Widows and Direct Line. Regulatory targets and limits should be introduced over to reduce the reliance of all UK banks on the wholesale debt markets, to ensure that the debt and assets of all UK banks are sustainable over the long term. In addition, regulatory incentives for lending to business should be considered in order to encourage lending to active investment that drives our economy over passive investment.

- An immediate and objectively assured policy of transparency on the condition of the loan and trading books at the nationalised banks, with all assets valued on a mark to market basis – including sovereign debt. No losses should be hidden in subsidiaries or otherwise. Any further assets determined to be poor, or generating an income less than the banks' costs of funds, should be earmarked for swift disposal – also with a target of the end of 2012.

- Encouragement for the private sector to manage the nationalised banks instead of the Government in preparation for their re-privatisation. This to be achieved by a trustable assurance to allow only privately held shareholdings to vote following implementation of the strategy above.

- If new capital is required, funds should only be raised from the capital markets – not Government.

- From a date of, for example, 2014, 20% of the Government holdings should be sold each year so that divestment is complete by 2018 at the latest.

By cleaning up the balance sheets of nationalised banks quickly, new money will be available for business lending to resume when there is demand from good businesses. It should also enhance the value of these banks so that the taxpayer return will be greater once the banks are sold back to the private sector.

SME equity finance

The Merlin Growth Fund could be floated on the London Stock Exchange. This would allow pension funds and private interests to invest and have greater exposure to UK smaller business investment and returns in a liquid setting.

The money that could be raised by such a fund could make a greater difference. It would help put SMEs more on a level playing field with larger businesses – no longer would only larger businesses be able to tap the equity markets.

If pension funds and private investors matched the current investment of £2.5 billion, the capital could be in the region of £5 billion. If such an organisation were geared just four times, the fund for equity and intermediate investment could total £25 billion (on the basis of £5 billion raised and a gearing of four times). This would be a substantial engine for growth in the coming years.

3. WELFARE AND GROWTH

Harriett Baldwin MP*

The complexity of the benefit system inherited by the Coalition is well known. For example, it can take a Job Centre plus advisor 45 minutes to calculate whether a claimant would be better off in work or on benefits. The welfare system also creates a range of further deterrents to work: currently, in some cases, a single mother would be 4 pence better off for every additional £1 she earned. The welfare system also micro-manages the amount of work that makes economic sense, with a leap from 0 hours to 16 hours being rewarded, while work for less than 16 hours does not make sense and a change from 16 hours to 17 hours is not worthwhile.

Housing security is another factor. The benefit recipient has the comfort of knowing that the rent is going to be covered each month. With the sharp withdrawal rates once work starts under the current system, there would be a real fear of the risk of

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arrears if the move into work turned out to be unsuccessful and the tenant had to go back and reapply for an increase in housing benefit.

In 2013, the rollout of the Welfare Reform Bill will start sweeping all of this away. It is the biggest shake up in the system for 60 years and it is estimated by the government that it will make 2.7 million households better off and lift 1 million people out of poverty, including 350,000 children. From 2013 onwards, all new claimants for Jobseeker's allowance, Housing benefit, Child Tax Credit, Working Tax Credit, Income Support and Employment Support Allowance will receive a single Universal Credit. Each hour they work and each pound they earn will have a clear, direct link with additional net income. Over the course of the years following 2013, Universal Credit will be rolled out to cover everyone who currently receives any of these benefits.

Growth through welfare reform will reduce child poverty

Ronald Reagan once said: "If you pay people to be poor, you will have a lot of poor people." One could add that: "If you pay poor people to have children, you will have a lot of poor children." The previous Government's approach to child poverty was to pay low income parents when they have a child or additional children. Between 2004 and 2010, £150 billion was spent on tax credits, mainly for families with children.

Child Tax credits of £2,555 per child are paid to all households with incomes under £16,000. This is in addition to £700 a year of tax free child benefit for each additional child and an entitlement to a larger home through the housing benefit subsidy. This system did help the last Government reach its child poverty targets which measure the number of children growing up in households where the income is lower than 60% of median earnings, since 60% of median earnings is lower than

£16,000. Child Tax Credits at least always have a linear withdrawal rate. They are withdrawn at 39 pence in the pound in a way that is similar to the future treatment of the Universal Credit. They therefore reach households with incomes as high as £40,000.

Income choices for a 16 year old girl

From a behavioural point of view, the availability of benefits could be seen as an attractive incentive to a 16 year old, who might not otherwise have many ways of earning more than £150 a week (based on 40 hours at the minimum wage of £3.64).

Consider the choices facing a 16 year old girl. If she were to get a job for 40 hours a week at the minimum wage for her age group, and if she were to move out of the family home and takes a room as a lodger, paying £50 a week for rent and all utilities and council tax, her net disposable income would be under £100 a week.

Working 40 hours at minimum wage of £3.64	£7,570
Minus room rental of	£2,600
Net take home disposable income	£4,970
Net cost to the taxpayer	NIL

Note that no income tax is payable and that this teenager would potentially be entitled to housing benefit for a room in a shared flat, should she apply for it.

However, if the same girl becomes pregnant, her income increases dramatically:

Income support	£2,779.40
Dependent child income support	£3,241.16
Child tax credit	£2,555
Child benefit	£1,055.6
Gross income	£9,631,16

As a lodger with a tenancy agreement, our 16 year old should be entitled to housing benefit to cover her £50 a week rent. As she has a baby she will also almost certainly become a priority case on the housing association's waiting list and she will be entitled to subsidy for two bedrooms, up to the new limits brought in by the Coalition, which are up to £250 a week for a one-bedroom flat and up to £290 per week for a two-bedroom flat. Rents vary dramatically by area, so the cost of this benefit to the taxpayer will be very dependent on where our 16-year old lives.

Once our 16 year old has moved into her flat, she will become responsible for paying council tax on it too and this once again will be covered by benefits. This could be £1,000 per annum. Now let's look at the household's financial situation after the baby.

Gross income	£9,631.16
Rent (paid for by housing benefit @ £250/week)	£12,000
Council Tax	£1,000
Net cost to the taxpayer	£23,631.16

per annum for a child who is still living in poverty.

This example is exaggerated to make a point, but it illustrates how the incentives to work at the point where a young woman leaves education are not strong enough.

In 2009, 38,259 young women in England and Wales had teenage pregnancies, the highest level in Europe. Half of all under 18 conceptions occur in the 20% most deprived wards. One fifth of births among under 18s are repeat pregnancies.

The Universal Credit will change the economics of work for the existing single parent, since she will now know that should she move into work there will be a linear increase in the household income. However, this change in economic incentives may not be enough to change the behavioural incentives. The benefit system, even after Universal Credit, will give a strong behavioural incentive for more children to be born into households which do not have the financial capacity to raise them outside poverty.

Changing the incentives

What can be done to change these perverse incentives for a mother to have more children when she cannot raise them outside poverty?

The incentives are completely different for a family that is not in the benefit system. Most young people accept that when they leave education they will start at the bottom of the career ladder and their salary will be low. They realise that they will have to share a flat with others for some time before they are able to take on their own tenancy or put down a deposit on a home of their own. Buying their own home and getting on to the housing ladder is an aspiration that can take many years, certainly longer than in the social rented sector.

Possible further reforms

How can the incentives be reformed so that fewer choose to have children at a point when they cannot support them? The following reforms would be controversial, but there is evidence from other countries that they can work.

President Bill Clinton brought in the Personal Responsibility and Work Opportunity Act in 1996 which allowed the US states to impose “family caps” on children born to families on welfare. The Coalition has started a system of “caps” on benefit payments. For example, housing benefit rates have been capped for each size category and the size of property has been limited to four bedrooms. A further reform that would address this in the UK is to prevent anyone who is receiving housing benefit in a workless household from having an entitlement to a larger property by increasing family size. Once the family has a working family member, this could then change, as a way of increasing the reward for work. At the moment, in a country where social mobility is not as strong as we would like, our benefit system says to a young workless parent that if you have more children, you may move to a larger property. Compare that to the incentives for a working family, where they will only be able to afford a larger home if they pay for it themselves.

Some US states used the “family cap” rules to rule that any family on state welfare is not eligible for any additional support for children conceived while on state benefits. 22 states have those rules in place today. It would be a powerful message if those who are in a workless household were told that they would not receive additional benefits for any new babies until such time as the household has a wage-earner.

Perhaps the child tax credit element itself should be limited to a finite number of children in a workless household? For example, should non-working parents be able to claim child tax credits for an additional child if they already have four children? These are clearly controversial questions.

US welfare reform also ended the legal entitlement to benefits. Welfare became more of a privilege rather than a right. For parents under 18 with children, there was a requirement to live with adults and stay in full time education in order to receive benefits. In 2009, Gordon Brown announced that teenage mothers aged 16 and 17 should not be entitled to council flats but should be sent to live in supervised homes. This provoked an outcry at the time, but schemes like the Barking Foyer have been shown to deliver excellent outcomes. The social enterprise Save the Family, based in Flintshire, also shows the advantages of a supported approach to helping families at this stage in their lives.

US welfare was also localised. This seems important because the economics of being on benefits will varies across the UK, as average wages are so different. With median weekly earnings of £432 in Jarrow and median earnings of £733 in Chelsea and Fulham, the benefits of working relative to one national rate of benefit is much clearer in Chelsea.

Finally, social housing and housing benefit generally act as a significant deterrent to mobility around the country. The Coalition has been developing policies that would make it easier for social tenants and those receiving housing benefit to become more mobile so that those seeking work can move more readily between different local authority areas.

Once the Universal Credit is in place, localising benefit rates relative to a labour market's median average wage would be a sensible next step as it would mean that there is a common incentive to take on work across the whole country.

4. INFRASTRUCTURE AND GROWTH

Claire Perry MP*

Many countries all around the world are "going for growth" with rapid and substantial infrastructure spending. In 2009, China invested $103 billion into its railways. The Brazilian Government recently announced a $560 billion programme of investments in infrastructure for 2011 to 2014. The United States Federal Government has announced plans for a $50 billion, 6-year infrastructure investment plan that includes rebuilding 150,000 miles of roads, construction and maintenance of 4,000 miles of railways and rehabilitation or reconstruction of 150 miles of runway. It is not surprising, therefore, that the calls for investment in UK infrastructure are becoming louder – particularly given the poor state of much UK infrastructure.

From 2000 to 2007, the UK invested less in infrastructure than any other OECD country. Even with an increase in relative

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investment from 2005, the UK still ranked 21st out of 25 OECD countries for infrastructure spending between 2004-2008. This reflects the fact that, under New Labour, we were repeatedly told that the “Golden Rule” meant that any borrowing would be funnelled into “investment”. But this was defined too often as investment in schools and hospitals. By contrast, tough decisions on road construction, road pricing, new rail links or investment in new generating capacity were delayed.

Hence the weakness of much UK infrastructure. The UK’s motorway network is less extensive than European competitors, even when adjusted for population and density. Heathrow operates at 98% of capacity compared to 73 to 74% capacity levels at Charles de Galle, Frankfurt and Schipol airports. Commuter train routes into London are over-crowded while the rest of the country (apart from Kent) lacks high-speed rail connections with Europe. Indeed, with only 70 miles of high-speed track, the UK lags behind Morocco (422 miles) and Saudi Arabia (342 miles). Japan, the first country to have high speed rail, will have almost 4,000 miles of HSR track by 2025.

Not only are we under-invested, but what we have is old. For example, 40% of London’s water mains are over 100 years old, and 12% are more than 150 years old; while the average age of sewers in England and Wales is 63 years.

It is not surprising, therefore, that the relative quality of our infrastructure has steadily fallen over the last decade to the point where the World Economic Forum ranks us 33rd for out of 139 countries in terms of the quality of our overall infrastructure, despite the UK being the 6th largest economy in the world. A recent CBI report highlighted a bleak picture of the state of our energy infrastructure, citing the potential loss of secure energy supply as the biggest concern among businesses in Britain and warning that that we could lose energy supply in our homes and offices and bring the economy to a standstill unless something is done about modernising our energy networks.

And businesses notice. In 2005, the CBI found that 70% of senior business figures consider Britain's infrastructure to be poor, while 85% of respondents said that this had affected their investment decisions.

Without action, things will only get worse. Existing networks are being put under ever increasing strain. For example, road traffic in Great Britain has grown by 85% since 1980 with the majority of the growth coming from car traffic. On current trends traffic congestion is predicted to rise by up to 30% by 2025.

Hurdles to be overcome

There are two substantial hurdles which must be overcome if the Coalition is to justify greater spending on infrastructure.

First, the UK is one of the most expensive countries in which to build infrastructure with civil engineering works costing about 60% more than in Germany due to a combination of planning sclerosis, poor contract structuring and material costs.

Second, for the last 20 years, the public sector has become reliant on the Private Finance Initiative as the preferred contract model for the construction and operation of critical infrastructure developments. Introduced in 1992 it was initially used to transfer some or all of the risks associated with public capital spending into the private sector by contracting out both the construction and operation of an asset, with a single bundled unitary payment, spread over the life of the asset. Under Gordon Brown, Labour treated the borrowing commitments made under this model as off-balance sheet which meant it could be used to reconcile the tension between promises of infrastructure investment and supposed fiscal prudence. As a result, the structure meant for specialized, long term financing was applied to all forms of capital spending. From 1992 to 1997, 26 PFI projects were signed with a total value of £10 billion. Under Labour, annual commitments rose 10 fold and more than 640 PFI contracts were signed between 1997 and 2009 with the taxpayer now committed to repaying almost £206 billion of gross PFI liabilities over the next 40 years.

During the construction phase of an asset, PFI can deliver more reliable results and assets with simple cash flow structures. In addition, predictable operational costs and uncomplicated public sector sponsorship (such as toll-roads and bridges) can be managed successfully under this contract model. However, the fundamental failure to transfer risk away from government, the application of the model to assets with more complex operating models such as schools and hospitals, the asymmetry in contract negotiation and management skills between the public and private sector and the opacity of the "whole of life" benefits have shown the PFI model to be a poor way to achieve value for money for tax-payers. Additionally, the private lending market for PFI deals which collapsed in 2008, has still not recovered with the consequence that private financing has become more expensive than public. Sorting out new financing mechanisms is a key challenge for the Coalition.

Current Coalition infrastructure plans

Key commitments made by the Government to date include:

- Creating a Green Investment Bank with £3 billion of public capital and leverage headroom of up to £15 billion for carbon-reducing infrastructure development.

- Committing £1billion for one of the world's first commercial scale carbon capture and storage demonstration projects and facilitating a new generation of nuclear power stations built without public subsidy.

- Maintenance and replacement of assets in the sewage and water sector.

- Investing in road network pinch points and areas of stress including £10 billion to be invested over the Spending Review period on maintenance and investment in new high value road, regional and local transport schemes.

- Providing £2 billion of investment in flood and coastal erosion risk management leading to better protection for 145,000 households.

- Confirming £16 billion of funding for Crossrail and proceeding with plans for a new high speed rail network.

- Investing over £500 million to deliver the best superfast broadband in Europe by 2015.

- Maintaining a science budget of £4.6 billion to ensure that the UK remains a world leader in science and research

Restoring investment to international levels after lost years of wasteful spending are made even more difficult given today's straightened fiscal circumstances. But can more be done to leverage the planned investment and maximize its contribution to balanced, long-term economic growth in the UK?

Five proposals

First, investment plans can be accelerated. The Treasury should be urgently investigating which projects can be pulled forward and assessing whether longer-term projects could begin work now.

Second, new financing pools should be tapped. The Localism Bill contains provision for new Tax Increment Financing where local authorities can borrow against predicted growth in their locally raised business rates to fund key infrastructure projects. This will further support locally driven economic development and growth and also give local authorities some much needed involvement in decisions such as parking charges or tolls that affect the health of the local business economy.

But more can be done. With Bank of England base rates held at historic lows for the foreseeable future, retail investors are desperate to find higher rates of return. The Coalition could offer National Infrastructure Bonds to retail investors as has been done in Australia, with a guaranteed rate of return over the life of the project. This could be a cheaper source of capital than traditional private methods of finance and could prove attractive to those looking to invest for the long term.

Third, the legacy of poor contract management, particularly around PFI must be tackled. The Coalition has already promised more transparency over risk and has said it will treat these liabilities in public accounts like any other form of public borrowing. The Treasury has also ordered individual reviews of certain types of PFI contract to see where savings can be made and publicised the findings across the public sector, and set up Infrastructure UK to consolidate and lead expertise in contract negotiation and management.

However, it remains the case that PFI contract management across the public sector is weak. For example, one of the supposed benefits of PFI was to tap into the competitive nature of the private sector. But almost a third of PFI contracts let between 2003-2006 attracted only one or two bidders. Similarly, just two firms won ten out of 18 projects let in the specialized waste market. As a result, returns for PFI suppliers have remained high: construction companies have admitted that they expect to make between three and ten times as much profit on PFI deals, compared to their traditional construction portfolio.

The Coalition should therefore centralise most PFI management expertise within Infrastructure UK. Financial managers should be given explicit incentives to re-negotiate existing contracts.

Fourth, a longer-term investment horizon should be encouraged. Infrastructure planning needs to extend forward over decades (with sufficient room for flexibility) and this timetable sits uncomfortably with the Parliamentary timetable.

Fifth, the proposals to simplify planning frameworks and encourage local "ownership" of development proposals must be implemented. The delivery of effective, timely and high value for money infrastructure projects requires a transparent planning and consents regime which is able to respond quickly to the need for new infrastructure at both the national and local level.

5. INTERNATIONAL TRADE AND GROWTH

Jo Johnson MP[*]

For a country banking to a great extent on exports (and business investment) to speed recovery, the September trade figures were undeniably disappointing.[†][i] The sharp widening in the UK's trade in goods deficit, from a revised £8.6bn in August to £9.8bn in September, took it to its biggest on record. The

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[†] See George Osborne's speech at the Emergency budget 22 June 2010: "The forecast shows a gradual rebalancing of the economy, with business investment and exports playing a greater role and Government spending and debt-fuelled consumption a smaller role-a sustainable private sector recovery built on a new model of economic growth, instead of pumping the debt bubble back up." See also his speech at the Spending Review, 20 October 2010: "Crucially, the OBR forecasts a gradual rebalancing of the economy as we move away from an economy built on debt to one in which we invest and export-again, something that some people said would not happen. It expects more demand to come from business investment, which is set to grow by over 8% for each of the next four years, as well as exports, which are expected to grow on average by over 6% per year."

overall trade deficit in goods and services stood at £3.9 billion, an 11-month high. A sharp rise in imports was a factor, but small when compared to a 3% fall in exports to the EU. The downturn in the survey measures of export orders points to further falls in exports over coming months. With the eurozone's problems still unresolved, the UK's external sector is yet to serve as a motor for recovery, as the government had hoped.

Yet in a two-speed world, there is no nothing to dictate that Britain must stay in the slow lane of economic recovery. The government is determined to do all it can to reorient the economy towards booming emerging markets that will account for the bulk of global growth over the next few years. The IMF forecasts the world economy will expand by $20,000 billion over the next five years, with advanced economies contributing around $8,500 billion, while faster-growing emerging and developing economies contribute around $11,500 billion.

The idea that the crisis in the eurozone, the exceptionally weak performance of the US economy and sluggish growth in the domestic economy should encourage UK firms to lift their horizons from traditional trade partners in Europe and North America to tap growth in new markets has been a recurring theme of set-piece Downing Street speeches on the international economy. Most recently, David Cameron, in his speech on November 10 at the launch of the BFI's film export fund, urged British business to take advantage of growth in the world economy that was "not in the eurozone, but in huge modern cities from Bogotá to Istanbul", where "people [were] hungry for the skills and services Britain is best at."

George Osborne, in Davos this January, for example, said that "an enterprising Britain is one that sees a world with a resurgent China, a booming India, a thriving Brazil and understands that it is an opportunity not a threat.' Although by instinct suspicious of the Heseltinian tradition of herding businessmen onto aeroplanes bound for faraway countries, Cameron and Osborne have consistently led from the front what has been a concerted cross-government effort to boost Britain's commercial diplomacy. The creation of a new Trade and Investment cabinet subcommittee for Economic Affairs, chaired by Lord Green, previously Group Chairman of HSBC, was an early and welcome indication of resolve in this respect.

As the latest trade figures underline, this will be a marathon not a sprint.

First, the UK's track record of achieving export-led growth is strikingly poor. Trade over the past 30 years has been a consistent drag on growth. The Pink Book shows that the value of imports has exceeded the value of exports in all but six years since 1900, none of them recent. The UK has recorded a current account deficit in every year since 1984. On the positive side, the UK has run a surplus in its trade in services in every year since 1966. This has failed, however, to compensate for the deficit shown in its trade in goods. The last time the UK registered a fleeting surplus on its trade in goods was in 1982, but only thanks to North Sea oil. In 2010, the current account deficit was £46.3 billion, equivalent to -3.2% of GDP, not far off the 1989 record of -4.9%.

Second, over the past 60 years, the UK has steadily lost share in global exports. This would be understandable were it just due to the emergence of competitive low-cost exporters from the developing world that are gaining market share, such as China. But that is not the case: the UK has seen its share of global exports fall more rapidly than other developed world competitors have seen their shares of global exports fall. The share accounted for by the developed economies has fallen from 73% in 1950 to 59% in 2009. The UK's decline has been sharper, from 10% of global exports in 1950 to just under 3% in 2009.

The same trend is manifesting itself in the post-recession recovery. The fall in the external value of sterling has had less of a positive impact on exports in the last few quarters than anticipated. The UK has not benefited from a post-recession rebound in world trade to as great a degree as important competitors. In volume terms, measured from the cyclical trough, German exports are up 23%, US exports are up 18%, French exports are up 14%. The UK is lagging behind, with export growth of about 10%, according to data analysed by Oxford Economics.

Third, UK trade is facing the wrong way. Re-orienting existing UK trade patterns towards higher growth markets will take longer than a political cycle. They have been shaped by distance, market size and cultural, linguistic and historical ties. The European Union 27 member bloc remains the UK's most important market, as the destination for 48% of exports in 2009. The EU will be Britain's major market for at least the next ten to 20 years. But it is likely to be a relatively slow growth region. A further 29% of the UK's trade is with developed countries outside the EU: the US, Canada, Japan, EFTA (including Switzerland) Australia, New Zealand and Israel.

Nothing is forever, however, and Britain's trade patterns have demonstrated remarkable adaptability in recent years, due in part to the post-war winding down of Commonwealth preference and membership of the European Economic Community. In 1973, the year Britain joined the EEC, just 36% of UK trade was with other Common Market states. By 2000, this figure had risen to 58%. Since then, however, there has been momentum moving in the other direction, with the rate of growth of exports to European Union countries, at around 2.6% a year, barely more than half that of export growth to non-EU countries over the last decade.

Notwithstanding this more rapid growth, currently only a relatively small share of British trade is with the big and fast-growing emerging economies. These new emerging markets are therefore unlikely to be any quick fix for growth within the term of this parliament. The base of our economic engagement is still too small to make any noticeable difference to the overall picture. China accounted for about 1.5% of total UK current account credits in 2009, India and Russia for barely 1.1% each, and Brazil for 0.7%. In total, the four BRICs accounted for current account credits worth £25.7 billion in 2009, 4.4% of the UK total.

This is certainly useful, but it has to be put in the context of total UK current account credits in 2009 of almost £580 billion. The UK notches up more credits on the current account with Ireland (£28.7 billion) than it does with the four BRICs, Indonesia and Mexico combined.

Other developed countries have re-oriented their export profiles more effectively than Britain has done, proving that trade relationships are not necessarily dependent on geographical or historical factors or indeed, for that matter, membership of the European Union. The proportion of Germany's goods exports going to the BRIC countries, which are showing strong demand for its capital goods at this stage in their development, is more than twice ours, having more than doubled from 4.5% in 2000 to 10.6% in 2009, while the share of Japan's goods exports to the BRICs, at 21%, is more than four times greater than Britain's.

Furthermore, it is worth noting that the UK runs a big current account deficit with the BRICs of about £17 billion, which represents a drag on UK growth. This is principally because of the UK's current account deficit with China, which, at £17 billion in 2009, is the largest of any individual country. The UK runs a small current account deficit with India (£1.5 billion), and modest surpluses with Brazil (£1.1 billion) and Russia (about £320 million). More trade with the BRICs on this imbalanced basis will do nothing to enhance the UK's growth prospects. It is essential that the UK rapidly becomes more engaged with these markets, as they will, as noted above, be the principal sources of global growth over the next five years. China and India are likely, given their current growth rates, to develop into economies that are the size of the US and EU today.

This will not be easy. Penetrating difficult and distant markets will be a marathon, not a sprint. But government can have an important part to play in encouraging new firms to export and in facilitating the re-orientation of existing exporters towards emerging markets. Breaking down non-tariff barriers and other regulatory hurdles to trade is just one important role for government. The Foreign and Commonwealth Office's decision to create 30 new posts in India and 50 new positions in China, roughly a 7% increase in each mission's manpower, at a time of severe budgetary restraint, underlines the seriousness of the Coalition's intent to boost its commercial diplomacy in BRIC countries.

India as a case study of UK engagement with the BRICs

India and the UK are re-connecting at an unprecedented rate, forging a partnership of equals that is no longer overshadowed by their colonial history. The Coalition has stated its determination to forge a 'new special relationship', an ambition that is finding an echo in India as it prepares to play a bigger role on the global stage. Key figures in the British Government have made a personal investment in the relationship. In opposition, David Cameron, accompanied by George Osborne, made India his first major foreign port of call in 2006. Post-May 2010, planning for a visit started the day the new team took office. It took Gordon Brown 10 years to visit India from the moment he first entered Downing Street as Chancellor of the Exchequer in 1997; it took George Osborne 10 weeks.

The urgency is more than justified. The UK had slipped down the rankings of India's trading partners over the last decade. In 1999, Britain was India's fourth most important source of imports. By 2009, it was its 22nd. Germany, by contrast, has made phenomenal progress in penetrating the Indian market and is now easily the largest goods exporter to India among the EU27. It is meeting a massive demand for the capital goods needed to plug India's various infrastructural deficits. Even Belgium exported more goods to India than Britain managed in the first nine months of 2010.

Part of the explanation for this relative underperformance vis-à-vis Germany and others is that the UK economy is heavily tilted towards services, to which the Indian market remains to a great degree closed. Our economies have not been evolving in a complementary fashion over the last 15 to 20 years and the UK has been ineffective at persuading India to open up the sectors of its economy where we are most competitive. Retail is shut to multi-brand retailers in the FDI channel, even though allowing in the likes of Tesco and Sainsbury's would do wonders for reducing food price inflation in India, which has been running at high levels for many years. A kilo of onions in Tesco is cheaper than a kilo of onions in Bombay.

Financial services liberalization is also proceeding at a glacial pace. Banks continue to find it difficult to open up branches in any meaningful scale across India. Insurance FDI is capped at 26%, for example, even though the Indian Government promised nearly a decade ago to lift the cap. The legislative logjam in the Indian parliament, which has been paralysed by a spate of corruption scandals, is holding up passage of a key measure that would hike upwards the foreign direct investment cap in the insurance sector. The financial crisis has also reinforced what was already a very conservative mindset at the Reserve Bank of India. So the prospects of the UK being able to achieve its market access goals in financial services have suffered.

The Indian economy is much more open in sectors where the UK's competitive advantage is less obvious, notably in infrastructure, capital goods, project engineering and manufactured products. This pattern has played particularly favourably to the strengths of countries such as Germany that have larger and more competitive manufacturing sectors. Machinery and vehicles and other manufactured goods account for almost 80% of EU27 exports to India. Britain's services exporters, particularly those of financial services, have historically encountered major obstacles to effective market entry in India.

The two-way flow of investment between India and the UK has also been somewhat patchy. There have been some sizeable mergers and acquisitions, notably the Tata Group's acquisitions of Corus and Jaguar Land Rover, which, strikingly, has made Tata the largest single corporate employer in the UK. Vodafone's purchase of Hutch Essar, the mobile operator, and BP's partnership with Reliance Industries, India's foremost oil, gas and petrochemicals group, were major ventures in the other direction. But, in general, notwithstanding the significance of these big tie-ups, there is an acknowledgment in both countries that the potential for more intensive economic cooperation remains to a great extent untapped.

Less tangibly – but no less importantly – the UK is not just losing market share in terms of trade and investment, but is losing share of mind among opinion-formers. With the next generation of Indian political and corporate leaders more Americanised and looking for opportunities in all parts of the world, 'Britishness' is a currency of depreciating value and Britain a receding cultural reference point. The new India, whose companies are snapping up British rivals, whose economic growth exceeds anything achievable in Europe and which is looking forward to helping shape this young century, is certainly far more confident of itself than can be said today of Britain. Millions in India might be striving to learn the English language but, in a country re-embracing 'Indianness' as an identity, few now try to be English.

The good news is that there is considerable scope for India and the UK to become more interdependent as economies and as societies. For all India's bubbling self-confidence, the reality is that it is barely a lower-middle income economy, with a nominal per capita income little above a thousand dollars and with more than 300 million Indians living in absolute poverty. It faces a huge challenge in generating the jobs necessary to absorb the rising numbers of entrants to the country's workforce. To meet global expectations and to achieve its development targets, India will have to focus on a few critical drivers.

The first is to abandon the notion that a demographic dividend will materialise mechanically from its vast young population and accept the hard reality that it will have to be earned, via a human resources and skills revolution. The second is to jettison the myth that the economy and the private sector can continue to grow 'despite the government'. The third is to overcome energy shortages and to provide sufficient capacity, preferably from renewable sources, to meet the needs of its fast-growing economy. The fourth is to make agricultural modernisation and the boosting of income levels of those engaged in agriculture a priority. Finally, India should recognise that its breakneck urbanisation has hitherto been largely unplanned and that this has to be urgently rectified.

India is rising, but not yet risen. It now faces many potential futures, not all of them rosy, and cannot make the fatal mistake of being complacent. As the UK is still the sixth-largest economy in the world and one of the most open, it is an attractive partner to India in this process. Its capabilities in education and skills development, in retailing, banking and insurance, in pharmaceuticals and life sciences, to name just a few promising sectors, are relevant to India's needs. It is in India's interests, as much as Britain's, for the two countries to engage more intensively.

Six policies for expanding UK-India trade

The Coalition can strengthen an already strong economic and political relationship by focusing on a few core areas where it needs revitalising.

First, as trade is an exclusive EU competence, the Coalition must maximize Britain's influence in Brussels so that the Commission reflects UK interests to the greatest extent possible in the negotiations over the long-awaited EU India Free Trade Agreement (FTA). A comprehensive FTA that addresses considerable remaining tariff and non-tariff barriers, particularly on the services side, could deliver significant economic benefits, estimated at an eventual €27bn, as well as helping to reduce poverty in India. The Coalition, on a bilateral basis, through the ongoing Economic and Financial Dialogue and other mechanisms, must also continue to encourage further liberalisation of Indian markets, particularly for financial and professional services and for goods, including wines and spirits, defence, chemicals and automotive parts. The conclusion of an ambitious FTA (and, of course, of the Doha Round, in which India is a key player) would make it considerably more likely that the UK will achieve its objective of doubling trade with India by 2015.

Second, the Coalition must encourage businesses to rise to the challenge of exporting to a country rightly seen as 'difficult'. India never scores highly in surveys measuring the ease of doing business. In the World Bank's 2011 survey of 183 countries, India ranked 134th, behind Brazil (127th), Russia (123rd) and China (79th). In terms of enforcing contracts through the court system, a critical attribute of any market economy, India scores appallingly, coming 182nd. The World Bank estimates going to court to enforce a contract involves 46 procedures, takes an average of 1,420 days and consumes 40% of the value of any claim. Obstacles such as this explain why surveys consistently show that UK firms are wary of proactively seeking out business opportunities in these priority markets.

Smaller and innovative firms have in the past experienced disproportionate barriers to exporting to India. Recent surveys show that only 23% of UK SMEs export, compared to an EU average of 25%, a shortfall of 100,000 firms that could deliver a potential £30 billion to the UK economy if they rise to the challenge. This is a legitimate area for vigorous government intervention, and the drive to reform the Export Credits

Guarantee Department (ECGD), is welcome. Take up of ECGD products aimed at SMEs has been disappointing, with the UK's official export financing arm underperforming comparable bodies such as France's Coface and Germany's Hermes. The ECGD's chief executive, Patrick Crawford, is now explicitly targeting "the many small exporters who have never heard of us" and it will be important for that organisation to be held to account for its progress in this respect.

Third, we must overhaul connectivity to the big emerging markets. While London has excellent direct connections to its traditional business partners, it lags behind European competitors in serving the BRICs. It has 215 departures a week to New York, for example, but only 31 a week to two destinations in mainland China (compared to 64 to three such cities from Paris Charles de Gaulle and 56 to four such cities from Frankfurt). UK-India air traffic has trebled in the last five years, due to the liberalisation of the UK-India market, but this rate of growth will be hard to sustain given the UK's historic failure to make long-term provision for runway capacity in the south-east. This will be a major brake on our ability to capitalize on the commercial opportunities presented by growth in India, as well as other fast-growing emerging markets, and is expected to cost the UK economy up to £14 billion over the next decade.

Runway utilisation at Heathrow is operating at 98.5%, compared to 70% to 75% at other big European airports, such as Paris Charles de Gaulle, Amsterdam and Frankfurt. This is causing delays and reliability problems that are damaging Britain's attractiveness, and restricts London's ability to expand to new markets without sacrificing existing ones. Jakarta, Osaka, Caracas and Bogotá have all been removed from Heathrow's destination boards in recent years, while Lima, Manila, Panama

City and Guangzhou have never been available. They are all served by London's three main rivals. Building a new hub airport, possibly in the Thames Estuary, would be an infinitely better long-term solution to UK needs than the piece-meal expansion of existing airports in densely-populated residential areas of outer London.

Fourth, we need to overhaul an anachronistic donor-recipient aid relationship, after a decade in which the UK sharply increased its aid to India to make it DfID's single largest country programme. The tide is now turning. DfID is freezing aid to India, while shifting it towards investment in private enterprise, focusing it on states that need it most and measuring its impact more systematically. A new era of partnership in international development is emerging and Britain and India have an opportunity to be in the vanguard of this process. In February 2011, Andrew Mitchell, Secretary of State for International Development, described a future in which the UK and India could work together, as equal partners, to reduce poverty in other developing countries. Whether or not India chooses to partner with the UK in this way remains to be seen, but, in the meantime, India is now emerging as an aid power in its own right. In July 2011, India announced that it intended to set up its own $11 billion development agency.

Fifth, we must embrace global talent, which is in superabundance in India, not repulse it. Britain has a strong base on which to build. It is the preferred launch-pad for Indian firms hoping to conquer European markets, with more companies headquartered here than in all other EU member states combined. London has an unrivalled place in the hearts of the Indian wealth-generating class. Le tout Delhi is in London in June, drawn by the mild climate, Wimbledon and the cultural activities the British capital has to offer. It still remains the preferred place for the affluent to buy their first home outside India. These ties form a powerful emotional connection between the two countries that should not be underestimated. Of the roughly 29 million people in the UK labour force, 2.5 million were born overseas. Of that figure, more than 600,000 originate from the Indian subcontinent. That is almost as many as both the 631,000 from the 14 pre-enlargement members of the European Union and the 625,000 from the enlarged EU-10 that began to arrive after 2004.

But links between students, especially through universities, are not as strong as they could be. Indeed, British universities attract more people from China than they do from India, despite our stronger historical and cultural links with the subcontinent. A 2010 British Council report based on market research confirmed a widely-held belief that “students tend to choose a country first before choosing a university, meaning that it is crucial to build a national brand showing the UK as a safe and exciting place to study, offering a rich life experience and enhanced career prospects.” Students invest in British education both to improve their job prospects back in their home country and to find post-study work in the UK. If the UK signals that it is no longer ‘open for business’, students will quickly choose countries they think are, such as Australia, Canada and the US. Australia is especially keen to earn its slice of the market: in October 2011, its Government announced sweeping reforms to liberalise its student visa system.

Policy-makers in the UK should recognise that students prize the “option value” of post-study work in the UK even though the great majority will have no intention to stay in the UK permanently. If we no longer provide the option, they will tend to favour other countries that do. Of course, bogus colleges must be closed down. But the populist rhetoric against “benefits-claiming foreign students” is counterproductive. Tapping top-flight student talent globally will not just mean the UK gains in terms of innovation, research and a broader science and skills base. Greater exchange of students now will mean stronger relationships later. The announcement of a new Chevening Science and Innovation Leadership Programme, is a step in the right direction, as are plans to help top UK universities partner with the new Innovation universities India plans to create.

Lastly, the UK needs to have more confidence in itself. We self-deprecate too much. The Indian strategic élite is not as confident in itself and in the idea of the country’s “inevitable rise” as appearances suggest. Even if Anglophilia is waning in India, there is still enormous respect for British institutions, which, in relative terms, are bastions of incorruptibility. India has been beset by corruption scandals – 2G, the Commonwealth Games, land sales – and there is a real fear of institutional collapse in Delhi, with the prime minister openly referring to concerns that his government is seen as the “most corrupt”. It is in the UK’s interests to support the ongoing middle class-led anti-corruption movement. Crony capitalism is not yet reaching Russian levels, but with many commercial decisions taken for political reasons, there is often no level playing field on offer for foreign firms. It will also be important for the UK government to undertake an assessment of the impact of the Bribery Act on appetite for engaging with India and vice versa, as well as of any evidence that law-abiding UK companies are systematically losing out to bribe-paying competitors from other countries.

These are extremely difficult markets for British entrepreneurs. But there is no alternative. The emergence of new powers in the east and south must lead to a shift in our focus from the Euro-Atlantic world towards a more G20, multipolar world. Progress in forging an “enhanced partnership” with India over the last 18 months has been significant and welcome, but there is much more to be done.

6. THE EU AND GROWTH

Chris Heaton Harris MP*

Most countries in the EU, including the UK, have a massive debt problem.

Just as the Coalition is taking tough action to tackle the UK's massive deficit, Europe needs quick and drastic action to solve its debt crisis. To do this, it is essential that governments spend less so they can reduce borrowing and pay down debt. At the same time, there is a need for policies to kick-start growth in the economy.

Politicians across the EU have been demanding more growth from their economies, only to realise that many of the regulations they have put in place hinder the growth they seek. As a huge percentage of the regulation that is holding back private sector growth now comes from Europe, this is where we must look for a solution. The Coalition Government in the UK scrapped over £3 billion worth of unnecessary regulation in the

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first half of 2011 and has imposed a moratorium on new regulations on small businesses. Not a bad start; but, realistically, the real battle here is with the EU, the origin of so much red tape. As the Chancellor of the Exchequer said recently: “We need to get them to stop and realise that if they carry on regulating, then they will eventually price the entire continent out of the world economy.”

Solving the problem

Eurocrats have excelled when talking about growth, but have not done so well on the delivery. The Lisbon Strategy was meant to deliver “the most competitive and dynamic knowledge-based economy in the world capable of sustainable economic growth with more and better jobs and greater social cohesion” by 2010. You can make your own call on how well they did.

To see how you can stimulate growth you need to understand what gets in its way. Last year the British Chambers of Commerce estimated (using government figures) that EU-driven regulation introduced in the period 1998-2009 had cost British business alone an astonishing £60 billion.

Also last year, Open Europe published a comprehensive study of the cost of most regulations to the UK economy. Based on over 2,300 of the government’s own impact assessments, the study found that regulation has cost the UK economy £176 billion since 1998, a sum roughly equivalent to the UK’s entire budget deficit. Of this amount, £124 billion, or 71%, had its origin in EU legislation. Whilst the study stated that the UK Government and the EU have taken positive steps to make the laws they pass less burdensome, regulation has kept adding costs to business and the public sector. In 2009 the annual cost of regulation was estimated to be £32.8 billion, 59% of which stemmed from EU legislation.

Indeed, since the previous UK Government launched its Better Regulation Agenda in 2005, the annual cost of regulation has doubled (the annual cost of regulation in 2005 was estimated to be £16.5 billion). This was in no small part due to a failure to stem the flow of new, costly EU regulations. Quite obviously, if 60% to 70% of new regulation is coming from the EU, this should be the major focus of future deregulatory reform.

When it comes to impact assessments that quantify the purported benefits of regulation as well as the costs (which by no means applies to all regulation), Open Europe also estimated the benefit/cost ratio of EU regulations at 1.02, while the ratio of UK regulations is 2.35. In other words, for every £1 of cost, EU regulations introduced since 1998 have only delivered £1.02 of benefits (where official figures for benefits are given), meaning that it is over twice as cost effective to regulate nationally than via the EU. Domestic regulation is closer to the people it affects, typically making it both cheaper, as it can be tailored to particular needs, and more democratic, as it is easier for citizens to scrutinise.

Open Europe's conclusion was simple and is even more relevant today than it was then: "Fewer and better regulations would give Europe a massive economic boost, at a time when it is facing high unemployment, low growth and a declining share in world trade."

It is only fair to say that the European Commission has tried pursuing some worthwhile initiatives to cut regulation. However, it is telling that between 2003 and 2009 the Commission only dropped four proposals following a cost-benefit analysis. Indeed, in some respects the financial crisis and economic adversity have created greater political pressure for rushed regulation, which threatens to roll back the positive steps the Commission has previously taken.

There are a number of areas where EU laws are causing (or about to cause) more harm than good.

Employment Legislation

In concluding its study last year, Open Europe found that EU labour market laws introduced since 1998 accounted for 22% of the total cost of new regulation in the UK in the period 1998-2009. EU employment legislation cost the UK economy £38.9 billion.

Many of these provisions were originally introduced into the EU treaties through the 'Social Policy Agreement' (more commonly known as the Social Chapter) contained in a Protocol to the Maastricht Treaty, but did not at that point apply to the UK at the insistence of the last Conservative Government. However, the Labour Government signed the Amsterdam Treaty, making the Agreement's provisions fully applicable to the UK.

It should be noted, though, that after the entry into force of the Single European Act in 1987 there was a dedicated "legal base" allowing the EU to legislate on the health and safety of workers, which always applied to the UK. This is now subsumed into more substantial social policy section of the treaties. This power over health and safety was what the EU used to adopt the original Working Time Directive in 1993, so that it applied to the UK.

One of the most onerous employment Directives is the Working Time Directive; the British Chambers of Commerce put the cost of that to business between 1999 and 2010 at over £19.5 billion.

On top of that, of course, is the cost and disruption to the public sector, particularly the NHS, where the Working Time Directive has caused huge problems for, among others, trainee doctors seeking to build up clinical experience. When EU regulation adds costs to the public sector it effectively raises our taxes, reduces the quality of our public services, or both.

The Coalition Government has pledged to work to limit the application of the Working Time Directive to Britain. How far this will be possible, given the fierce support often shown for the Directive in Brussels remains to be seen.

Another onerous Directive is the Temporary Agency Workers Directive (which came into effect on 1 October this year). Adopted in 2008, it creates a legal principle of equal treatment, when it comes to “basic working and employment conditions”, between those working for an organisation on a temporary basis and placed there by an agency, and those permanent employees hired directly by the organisation to do the same job.

“Basic working and employment conditions” means pay, working time, overtime, breaks, rest periods, night work and holidays. The Directive allows the Member State to define pay, and in Britain it will not include notice pay, redundancy pay, benefits in kind, financial participation schemes (such as subsidised share ownership) or occupational social security schemes. As permitted by the Directive, in May 2008 the TUC and CBI, as the UK’s national ‘social partners’, agreed that a qualifying period of 12 weeks would be applied before agency workers would get equal treatment.

The presumption in the Directive is that equal treatment applies from day one of an agency worker’s stint at the hiring organisation, which in many cases in the UK will be a small business tentatively taking on new staff members. Be it after one day or 12 weeks, the bureaucratic burden this places on many small businesses will doubtless make them think twice before increasing their workforce.

The impact assessment produced under the previous Government estimates that implementation of the Directive will cost employers almost £2 billion a year, with its provisions applying to around 520,000 agency workers (about 40% of the total). Naturally, the concern is that employers will simply not hire as many temporary workers and scale back. Thus this Directive will almost certainly take employment chances away from students, those seeking to return to work after illness, and mothers after a temporary job to fit in with their children's schooling.

Financial Services Legislation

The City is still by far and away the pre-eminent financial centre in Europe. It generates great wealth for our country and contributes very large tax revenues – crucial as we get the Government's books back in balance.

In the wake of the banking crisis, the EU has approached regulatory hyper-drive when it comes to financial services, which tends to impact Britain far more than anyone else, given the great concentration of financial services in London. Three new EU financial supervisors were established at the start of this year, which may well start spewing out new rules and regulations and, in certain situations, issuing orders to the UK's financial supervisor and individual British firms.

In the UK's relationship with the EU, it is imperative that we protect the City's global competitive position, to keep jobs and wealth in this country.

Ensuring that we have regulations that work and do not hinder UK businesses in these two areas is vital. There are also many other policy areas where the same arguments can be made, for instance, one only has to look now at the costs to the UK taxpayer and all UK businesses that the unrealistic targets for renewable energy use, set at the EU level, have produced.

Three policies for growth

The current crisis in the Eurozone means that it is now vital for every country across the EU to develop policies that engender economic growth. Without such an approach, the economic calamity that is currently unfolding will be so much worse.

Impact Assessments

The European Commission currently produces impact assessments with estimates on how much its proposals might cost business. However, the Commission would be the first to say that some of these impact assessments in the past have not been of the quality they would have wanted.

The UK Government should, for newly proposed legislation, use its own impact assessments in the negotiations that take place at EU level. We should refuse to negotiate EU proposals where the costs and benefits have not been properly quantified. Where an impact assessment produced in the UK and the one produced by the European Commission find different conclusions, the legislative proposal should be halted until agreement on the costs and benefits can be found.

Find a simple method of scrapping EU laws

One of the main problems regularly identified as slowing down regulatory reform and deregulation in Europe is that changing EU law involves a lengthy process and often fraught negotiations between the Council of Ministers, the European Commission and the European Parliament.

The EU needs to find a method whereby it is relatively simple to suspend or remove legislation that is deemed too expensive or which turns out to be best enforced at national level. Member States should be encouraged to bring forward ideas where legislation already passed is no longer required and perhaps a simple majority vote in the Council should be enough to remove a piece of EU legislation.

Get rid of laws that hinder job creation and economic growth

Perhaps it is time to ask whether, now that all countries in the EU have a solid raft of social and employment legislation, there is a need for the EU to keep control of this policy area. If we are going to have a multi-speed gearbox for Europe, it should have a reverse, and one area where this reverse pedal could be applied is within EU social and employment policy. Most EU legislation in this area is based on Title X (Articles 151 – 161) of the Treaty on the Functioning of the European Union. Article 153 (which was Article 137 before the Lisbon Treaty) is the foundation stone of the current Working Time Directive and a host of other health and safety and labour laws.

It is here that the UK should look at being the most radical; if the opportunity arises, we should aim to repatriate social and employment legislation. This was of course Conservative Party policy at the last General Election. To do this, we would need to achieve the disapplication of Articles 151 -161 TFEU to the UK, and we would also need to go through the other articles of the

Treaties that have been used as a basis for EU social legislation, or could give rise to such legislation, to ensure that they could not in the future be used to adopt EU laws binding Britain in this policy field.

This would not remove the costs of this legislation overnight, and any UK Government would want to keep some of these regulations; but returning these to the control of Westminster would both empower MPs and, crucially, the voters that elect us. Indeed, if we were to do this, the UK Government should make it clear that the main objectives of this change are to amend these laws so that they fit better within the UK's labour market model, and help build growth in the UK economy, by significantly cutting costs for both business and the public sector.

There is broad agreement throughout the political and business worlds that both the UK and the EU need to bring to the table new measures that will encourage sustainable growth. There is a great deal to be done on the supply-side of the economy to stimulate this growth, tackling unnecessary regulatory barriers that get in the way. Hopefully the ideas above would be a great step forward in stimulating economic success both here in the UK and across the continent.

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