Centre for Policy Studies

Pointmaker

TAKE THE LONG VIEW

STEPS TO ENHANCE PRODUCTIVITY AND GROWTH IN BUDGET 2013

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SUMMARY

- The Coalition has replaced its original deficit reduction plan with a "protection of government spending plans plan". Both fiscal rules announced in the 2010 Emergency Budget have been abandoned.
- Despite falling over the first two years of this Parliament, the deficit is now rising again. In the year to December 2012, the current budget was in deficit by £103 billion, £12 billion higher than it was in December 2011 for the previous 12 months.
- With real GDP stagnant and the deficit rising, there have been siren calls for the Chancellor to change course.
- These suggestions have included:
  - those who believe the Government should spend more to try to stimulate the economy;
  - those who believe the Government should institute large tax cuts to stimulate the economy;
  - those who believe the Government should implement a more interventionist growth agenda; and,
  - those who want the Government to do more to cut the cost of living.
- However, borrowing significantly more would be a mistake when the deficit is still over 8% of GDP.
- In addition, the UK does not have a short-term growth problem which can be solved by short-term measures.
- The right strategy is improve the medium-term growth rate by reducing the burden of state spending and taxes while enhancing the productive potential of the UK economy through liberal supply-side policies.
- We make 20 recommendations across three broad areas:
  - ensuring cuts to current expenditure are seen through, alongside targeted tax cuts and a real programme of tax simplification;
  - speeding up deregulatory and supply-side reforms; and
  - adopting a robust pro-competition agenda in several major industries.

20 RECOMMENDATIONS

On fiscal strategy

1. Announce the remit of the 2013/14 spending review. This should include:
   - plans to cut government current expenditure substantially over the next five years with no ring-fences;
   - a programme of reducing entitlement eligibility;
   - a plan to raise retirement ages more rapidly than currently planned.
2. Widen the remit of the Office for Tax Simplification to establish tax reforms for the rest of this Parliament along the principles of base-broadening and lowering rates.
3. Pledge no new taxes or further net tax rate rises for the 2013/14 spending review period.
4. Set out a path to raise the threshold for the basic rate of Income Tax to the equivalent of the gross income of a full-time earner on the minimum wage.
5. Cut Capital Gains Tax immediately, as it is above the revenue maximising rate.
6. Commit to further reductions in Corporation Tax.
7. Re-open negotiations on public sector pensions.

Supply-side reform

8. Announce a Small Business Incentive Scheme to include a package of exemptions from regulations for very small businesses. This should include exemptions from: minimum wage legislation for those under 21; requests for time off for training; and pension auto-enrolment.
9. Adopt sunset clauses for all regulations with a post-implementation audit three years after enactment of each regulation; and bring more regulation into the scope of 'One-In Two-Out'.
10. Adopt a Consolidated Planning Act and repeal all existing legislation with a single rationalised Act.
11. Encourage neighbouring local councils to co-operate in identifying sites for new Garden Cities.
12. Abolish national pay bargaining in the public sector.
13. Ensure that the recommendations of the Davies Review of airport capacity can be implemented swiftly.

An agenda for competition

14. Adopt the "Fair Shares" scheme for the re-privatisation of Lloyds and RBS.
15. Reduce the regulatory burden on new banks.
16. Give the Financial Conduct Authority a competition mandate.
17. Require the legal separation of retail and supply arms of water companies, paving the way for the extension of retail competition.
18. Encourage far greater competition between operators on the rail network.
19. Lift the bar on profit-making companies running academies and free schools.
20. Abandon the planned unilateral carbon price floor and phase out subsidies for renewable energies.

UNPRECEDENTED CHALLENGES

The Coalition's fourth budget has been met with an even wider array of public suggestions than usual. The state of the economy makes this unsurprising. Even with the recent upward revisions to the 2012 figures, real GDP is stagnant and 2012 Q4 output was still 3.3% below the pre-crisis peak of 2008 Q1.[1] Inflation has remained stubbornly above target, and inflation expectations are now edging upwards.

Meanwhile, the Coalition's deficit reduction plan has faltered due to its over-reliance on unrealistic growth assumptions. The current budget deficit has been rising again over the past 12 months: for the year to December 2012, it was around £12 billion higher than the previous year. Overall borrowing is now forecast by the Institute for Fiscal Studies to be £65 billion higher in 2014/15 than planned in the 2010 Emergency Budget.[2]

1 *Some perspectives on GDP growth*, Ryan Bourne and Tim Knox, CPS, 2013.

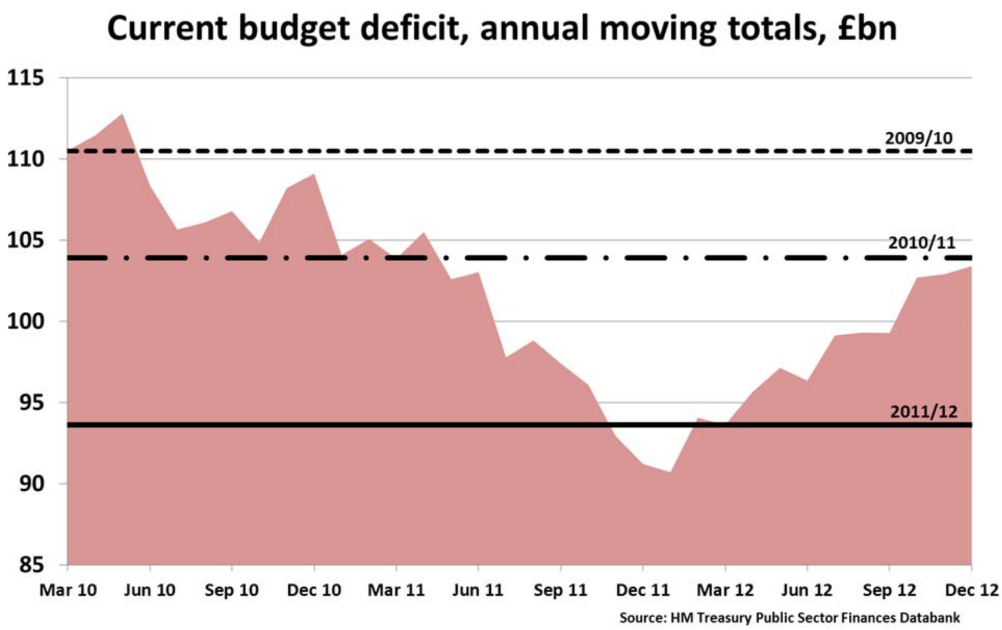
2 IFS, Green Budget 2013.

Is there a deficit reduction plan?

In this context, the debate over appropriate fiscal policy has grown more heated. But this exchange generally takes place on a false premise – namely that the Coalition has committed itself to an extremely fast, deep, inflexible deficit reduction programme. In fact, even on the current forecasts, there will be no balanced budget until well into the next Parliament. Overall government spending in 2014/15 will just be 3% smaller in real terms than spending in 2009/10 (after a 62% rise between 1997/98 and 2009/10 under New Labour).[3] And a look at the history of the Coalition's budgets shows that there is not in fact a "deficit reduction plan" at all, but a "stick to government spending plans plan".

In the Emergency Budget of 2010, the Chancellor was understood to have set himself two fiscal rules:

3 Figures from HM Treasury Public Sector Finances Databank.



Note: the chart shows the current budget deficit for the previous 12 months. Hence, in December 2011, the current budget deficit for the 12 months from January 2011 and December was £91 billion; while from January 2012 to December 2012, it had risen to just below £103 billion.

- to eliminate the structural current deficit within five years; and,
- for net debt to be falling by the end of the Parliament.

The spending plans announced in the 2010 Comprehensive Review were designed to meet these rules, using assumptions about the expected growth of tax revenues.

Yet tax revenues have significantly underperformed expectations. The charts below show that, on unchanged policies, the targets which the Coalition set itself will now not be met. Faced with the choice of more cuts and more debt, the Coalition has opted consistently to roll-over their deficit target further into the future and take more debt today. Furthermore, in the 2012 Autumn Statement, the Coalition decided to not adjust spending plans to ensure that its firm target for net debt would be falling by the end of the Parliament.

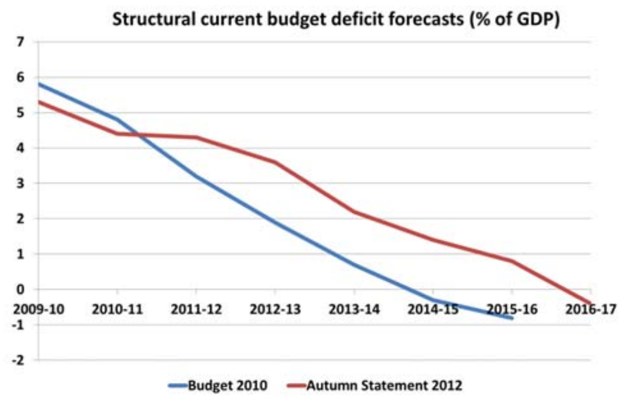
So while notionally the Coalition expects to balance the cyclically-adjusted current balance within five years, the credibility of its aims have been undermined by the continual rolling forward of the target year after year in reaction to deteriorating forecasts.

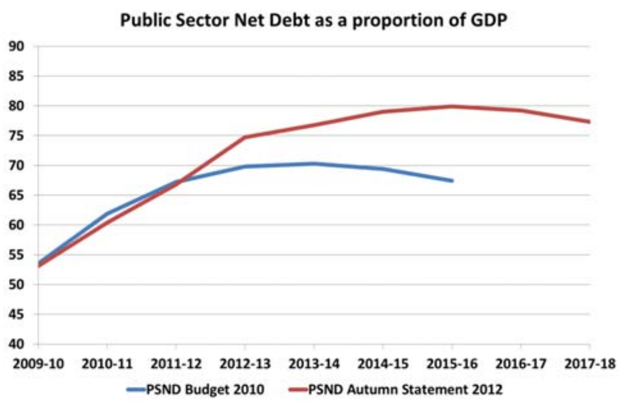
WHAT HAS HAPPENED?

Those urging the Chancellor to change course – to indulge in more "stimulus spending" – should therefore accept that current policy has already been particularly accommodating in fiscal terms. In fact, although most of the public remains in the dark, the Coalition is planning to add over £600 billion to the Public Sector Net Debt by the end of this Parliament. The deficit – at around 8% of GDP this year – is still forecast to be above 5% of GDP in 2014/15. Never has a peacetime British government run such large deficits for such a sustained period.

That is not to say that there has been no attempt to close the deficit. In fact, there have been significant tax rises and cuts to investment expenditure so far in this Parliament. Analysis in the IFS Green Budget 2013 shows that tax increases and investment spending cuts have been front-loaded while cuts to welfare and ordinary government consumption spending have been pushed back to later in the Parliament. By the end of 2012/13:

- just under 80% of planned tax rises (VAT, Capital Gains Tax and various other duties) set since March 2008 will have been implemented;
- 67% of the planned cuts to investment spending will have been realised; but





- only 32% of the benefit cuts and 21% of the cuts to other government current spending will have been achieved.

Much of the austerity seen so far then could best be described as private sector austerity, with the squeeze induced on that sector imposed by higher taxes and high borrowing. Yes, infrastructure spending has been cut, but current government expenditure has continued to grow.

The Coalition has not therefore followed through on what is widely regarded as the best practice of previous fiscal consolidations. This suggests that limiting tax rises, with significant public consumption cuts, and few reductions in public investment tend to produce the least short-term distortions to output and tend to result in a better fiscal position.[4] It would be bizarre then to completely abandon the implementation of the policy – as the unions suggest – when the Coalition is just about to accelerate cuts in the right areas.

In fact, the real concern is that current expenditure cuts are not seen through. The political difficulty of imposing cuts to public spending could mean that this or future governments will abandon the broad strategy started by the Coalition and instead try to close the deficit through further damaging tax rises.

It is also important here not to over-egg the mistakes of the policy implementation. The Office for Budget Responsibility still estimates that the main causes of our slower-than-expected growth have been the Eurozone crisis alongside high commodity prices which pushed up input costs and led to a damaging bout of imported inflation.

On top of that, there is good evidence to suggest that the financial system is unable, at present, to allocate credit effectively.[5] With these headwinds, it is perhaps unsurprising that growth has been poor, and the fiscal outcomes have been worse than expected.

THE SIREN CALLS

The loss of the AAA rating from Moody's and continued slow growth means the Chancellor is being urged from the Opposition and some members in his own party to change course. These suggestions have tended to come in five forms:

a. Those who believe the Coalition should spend more now in an effort to stimulate the economy, in the hope that a short-term spending splurge would be enough to push the economy into a self-sustaining recovery.

b. Those who believe the Coalition should seek to institute large tax cuts to stimulate the economy and improve the supply-side – with deep cuts to Corporation Tax and Capital Gains Tax to boost business confidence, and pave the way for significant inward and business investment.

c. Those who believe the Coalition should augment current policy with a more interventionist growth agenda – by setting up state-led institutions, such as Business Banks, a National Growth Council and centrally-planned infrastructure bodies.

d. Those who believe that this Budget should focus on the cost of living squeeze, through reducing certain duties or directly intervening in certain sectors.

e. Those who believe that the Coalition should cut deeper and cut taxes at the same time – arguing that diverting more resources

[4] See for example, Alberto Alesina, Carlo Favero and Francesco Giavazzi. *The Output Effect of Fiscal Consolidations*, 2012.

[5] *Productivity and the allocation of resources*, speech by Ben Broadbent

from the public to the private sector through reduced current expenditure would be one means, alongside other supply-side changes, to improve the medium-term growth rate of the economy.

Which of these policy options you support will ultimately depend on your diagnosis of the problems facing the UK economy. Options a) and d), for example, share the characteristic of believing short-term measures are necessary to either attempt to kick-start the economy or temporarily ease the burden of current economic conditions.

But there is little evidence that a one-time shot-in-the-arm, as many claim, would led to a 'self-sustaining recovery', particularly for countries with already high deficits and debts (see Japan). This unreconstructed Keynesian approach also ignores both the dangerous effects of increasing public debt at an even faster rate than we already are, as well as overlooking the distortionary effects that high government spending has on the private sector in the medium term.[6] While there may be a case for additional spending on certain public goods infrastructure, such as certain rail improvements or to unlock road bottlenecks, this activity should be judged exclusively on the rate of return of the project in question, its effect on the supply-side of the economy, rather than a need to spend to "stimulate the economy" per se, and it doesn't negate the need for spending restraint overall.

We should also heed the experience from the stimulus in the US: there, some of the money set aside for capital projects has been pushed into political spending streams which could actually undermine the economy in the medium term (such as economically inefficient energy sources or expensive white elephant projects).[7]

Large tax cuts which significantly add to borrowing today would also bring significant short-term risks. Deliberately increasing the structural budget deficit would undermine the perception that the UK is willing to tackle its debt burden, particularly with an election, and the subsequent policy uncertainty this brings, looming in 2015. That would risk losing the confidence of the bond markets – with potentially devastating consequences. Whilst many argue that a country with an independent currency could always print money, this in itself brings with it negative consequences and risks for sterling.

Other Coalition MPs are demanding that the Chancellor focuses on the cost of living in the Budget. This is understandable and noble, given the squeeze on real incomes. But whether this focus is effective or not depends on what particular measures the MPs have in mind. Merely changing the odd duty here and there or directing the government to put pressure on certain industries would amount to dealing with the symptoms of our current stagnation as opposed to doing something to lift us out of it. Instead, measures to improve our medium-term growth rate, supplemented with pro-market reforms rather than short-term fixes, seem the order of the day.

In this regard, the Chancellor also finds himself under pressure to adopt a more long-term interventionist government economic agenda. The back-drop has been provided in Michael Heseltine's report, *No Stone Unturned*.[8] This, for example, calls for a return of a National Growth Council, and greater powers to Local

6 See Ken Rogoff, *Austerity and debt realism*, Project Syndicate 2012.

7 *President Obama's Taxpayer-Backed Green Energy Failures*, Heritage Foundation, 2012.

8 Lord Heseltine, *No Stone Unturned*, 2012.

Enterprise Partnerships and Local Growth Teams. Sold as a radical devolution of power to the localities, the agenda (as one reviewer put it) expects "the government to adopt a central strategy for growth and then to invite LEPs to bid for central funds to help deliver that strategy." The centralising tendencies go further, with demands to move away from horizontal "industrial strategy" in which the framework for all industries is improved, and instead for "sector specific" industrial policies. These calls, which often contain the whiff of mercantilism and manufacturing nostalgia, have not been successful through the post-war period.[9]

In fact, the recent London School of Economics Growth Commission displayed clear evidence that Britain's more robust economic performance since 1979 had occurred at a time when the economy was being liberalised under the reforms of Margaret Thatcher's governments.[10] The development of a more flexible labour market, the more efficient resource allocation developed following the ending of many industrial subsidies, the expansion of competition and the greater openness to international business and foreign talent all helped in improving the UK's growth performance.

PRINCIPLES FOR OUR RECOMMENDATIONS

For the reasons outlined in the previous section, we believe that measures which add significantly to borrowing in the short-term should be avoided. Given that the UK has a medium-term growth problem, the 2013 Budget should be used as an opportunity to introduce and implement measures which will raise the UK's potential growth rate. Short-term attempts to stimulate the economy should be spurned, in place of supply-side measures to improve underlying growth: and in line with the evidence presented by the LSE Growth Commission, liberal economic reforms offer the best hope of achieving this ambition.

Three groups of recommendations are set out:

- proposals to cut government current consumption expenditure and to cut taxes to enhance the economy's medium-term growth rate – *without increasing overall borrowing* – whilst suggesting some first steps at meaningful tax reform.[11]
- deepening and broadening the scope of existing supply-side reforms.
- adopting a robust supply-side pro-competition agenda in many industries which are having a strong influence on rising living costs - to enhance productivity, choice and consumer power.

A. FISCAL POLICY

The 2013/14 spending review

In the 2013/14 Budget, the Chancellor should announce the scope of the next spending review. This should set out the cuts to government current expenditure required both to close the deficit by the end of the review period and to provide the scope for permanent, enterprise-enhancing tax cuts. A worthy medium-term ambition would be to balance the books at somewhere between 35% and 38% of GDP.

9 Stephen Broadberry and Tim Leunig, *The Impact of Government Policies on UK Manufacturing since 1945,* 2012.

10 LSE Growth Commission, *Investing for Prosperity,* 2013.

11 The Chancellor, however, is said to be "bemused" by this argument. See Ryan Bourne, Janan Ganesh's worrying insight into 'the Treasury view, CPS, 2013.

In order to make this exercise credible, the current ring-fencing arrangements will have to be abandoned. Spending on health, welfare, education and debt interest now accounts for over 70% of total departmental spending – leaving these largely untouched while meeting a cogent deficit reduction plan will necessitate crippling savings elsewhere.

One area of particular focus within the Spending Review should be eligibility for government benefits and benefits-in-kind. Over the past ten years, the proportion of households becoming net beneficiaries of the state has increased from 43% to 53%.[12] This is partly due to the effects of an ageing population, but the same trend has also been observed for non-retired households (where the proportion has increased from 29% to 39%). Over 44% of working age households, for example, now receive a benefit other than child-benefit.

The next spending review should therefore:

- prioritise improving the UK's medium term economic growth rate;
- not ring-fence departments;
- take account of relative prices to see how spending limits will affect government output.

There should be a particular focus on the eligibility for government transfers, including both working age and retirement benefits and education and health provision. This could include reviewing:

- the state retirement age: in particular, how this might be linked to life expectancy to make the public finances more sustainable;
- eligibility for non-retirement pensioner benefits (for example universal winter fuel allowance, free TV licenses and bus passes);
- the tax credits system: in particular, the potential to reform towards a US-style earned income tax credit system;
- access to NHS treatment for non-British nationals;
- prescription drugs provision within the NHS.

Proposal 1: Announce the remit of the 2013/14 spending review. This should include:

– ***plans to cut government current expenditure substantially over the next five years with no ring-fences;***

– ***a programme of reducing entitlement eligibility;***

– ***a plan to raise retirement ages more rapidly than currently planned.***

Tax simplification

In opposition, the Chancellor George Osborne established the Tax Reform Commission under Lord Forsyth to recommend how to improve the economic efficiency, transparency, simplicity and fairness of the system. Though many of the proposals have been adopted, the radical simplification of the tax system promised alongside the creation of the Office for Tax Simplification (OTS) has so far yet to materialise.

There are now 18,500 pages in Tolleys Taxes, an increase of 68% in only seven years. The draft legislation and explanatory notes issued in December 2012 for the 2013 Finance Act are 1,074 pages long.[13]

[12] Ryan Bourne, *The progressivity of UK taxes and transfers,* CPS, 2012.

[13] Figures taken from a forthcoming CPS paper *Tax Simplification – how and why it is not happening.*

The need for deep reform of the tax system is widely acknowledged. In the past decade, the Tax Reform Commission, the CBI Tax Task Force, the Mirrlees Review by the Institute for Fiscal Studies and the Taxpayers' Alliance/ Institute of Directors 2020 Tax Commission have all highlighted clear steps to simplify the tax code. All have argued clearly that such reform could enhance our economic prospects. Yet, except for a variety of small measures, little substantive progress has been made.

Given the lack of the progress in tax reform so far, it is clear that a new approach is necessary. As a start, the OTS should be better staffed and funded to a level commensurate with that needed to tackle the problem. The 2005 Tax Reform Commission had suggested that the OTS should contain 20 HMRC staff and 15 secondees, at an annual cost of £2.3 million per year. In contrast, the OTS was set up with a Chairman and Tax Director who are each only expected to work for about one day a week, and approximately half a dozen unpaid secondees, served by a secretary supplied by the Treasury. If we are serious about tax reform, we need to better equip the Office for Tax Simplification and give it a more strategic role for the remainder of this Parliament in pushing for base-broadening, rate cutting tax simplification.

Proposal 2: Widen the remit of the Office for Tax Simplification to establish tax reforms for the rest of this Parliament along the principles of base-broadening and lowering rates.

Taxes and the deficit

The UK public finances are in a bad state because the Government spends too much, not because it taxes too little. But this does not prevent the continual public debate about the introduction of new, highly targeted wealth taxes.

In order to show that this Government is committed to closing the deficit through spending cuts, the Budget should contain a pledge for no new net tax increases or no new taxes over the next spending review period. This would provide businesses and households with certainty over the coming years, and would demonstrate a determination to cut wasteful government expenditure.[14]

Proposal 3: Pledge no new taxes or further net tax rate rises for the 2013/14 spending review period.

Taxes to cut

Some taxes – particularly those which reduce incentives for businesses – could be cut today without particularly adverse revenue consequences, and these would have the largest benefit for our medium-term growth prospects. The Government should avoid short-term wheezes, but set out its intentions for a competitive, principled approach.

For example, the Treasury's justification for raising the top rate of Capital Gains Tax to 28% was that this was the revenue-maximising rate when the top rate of income tax was 50p. But this will no longer be the case when the top rate of tax is reduced this year to 45p. In fact, the Treasury's own model now suggests that the tax is above the revenue maximising rate.[15]

Proposal 4: Cut Capital Gains Tax immediately, as it is above the revenue maximising rate.

The recent increases in stamp duty are another example of a policy which has largely proved self-defeating, with the *Financial Times*

[14] Roger Bootle, "We need a strategy we can believe in, not Mr Micawber's blind optimism", *Daily Telegraph*, 10 February 2013.

[15] Oliver Latham and Lord Flight, *The case against CGT*, CPS, 2012.

reporting that the number of sales of luxury homes in London having declined dramatically since March.[16] And a recent study by PwC into the economic impact of air passenger duty (APD) found that abolishing APD could pay for itself, due to the improvement in investment and the impact on the ability of business to trade.[17]

There are other tax cuts which the Coalition has embarked on, which whilst not self-financing, should continue to be pursued. The significant raising of the personal allowance (as first advocated by Maurice Saatchi and Peter Warburton[18]) has helped to boost work incentives for low income workers in particular, and reduces the tax-and-benefits churn which many people on low incomes face.

Some Conservative backbench MPs and the Labour leadership have suggested that further progress could be made in achieving the ambition of cutting taxes for the low-paid by re-introducing the 10p income tax on a small band of income above the personal allowance, rather than raising the personal allowance further. This would be a mistake – continuing to raise the personal allowance to the same cost in terms of lost revenues as the 10p introduction has a more targeted benefit to low income workers without further complicating the tax system.[19]

The question is: what is the appropriate level for the personal allowance given that increasing it has the inevitable consequence of narrowing the income tax base? It would seem sensible, and make philosophical sense, to set out an ambition to raise the allowance to the level of gross income of someone earning the national minimum wage through incremental steps.

Proposal 5: Set out a path to raise the threshold for the basic rate of Income Tax to the equivalent of the gross income of a full-time earner on the minimum wage.

Another area where the Coalition has made substantial progress is in reducing the main rate of Corporation Tax. Previous OECD analysis has shown that taxes on corporate profits have the largest effect on medium-term economic growth. Therefore the Coalition's steps to lower the rate to 21% are welcome. Yet they could push even further on this – setting out a medium term ambition for matching Ireland's 12.5% rate. This would require detailed planning to reduce opportunities for tax avoidance but could probably best be done by introducing a "Further Corporation Tax" so that when dividends were paid by a company, the effective tax rate would remain at 20%. Business owners would then have a further significant incentive to reinvest profits, thereby creating a virtuous cycle of higher investment and higher profits. Some of the gains from this move, mainly in terms of business location decisions, could be achieved today if the Coalition were to announce a plan to achieve this goal.

Proposal 6: commit to further reductions in Corporation Tax.

Public service pensions

The rapidly escalating cash-flow shortfall between contributions and pensions in payment for public sector pensions must be addressed.[20]

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16 *Financial Times*, "London luxury house sales hit by tax change", 2012.

17 PwC, *The economic impact of air passenger duty*, 2013.

18 See Maurice Saatchi and Peter Warburton, *Poor People! Stop Paying Tax!*, CPS, 2001.

19 Ryan Bourne, *Is it time to re-introduce the 10p income tax band?*, CPS, 2013.

20 Michael Johnson, *The approaching cashflow crunch: why Coalition reforms to public sector pensions will not hold*, CPS, November 2012.

In 2005-06, that shortfall was an irrelevant £200 million. But for 2010-11 this had grown to £5.6 billion. By 2016-17 (i.e. *after* the current reforms recommended by Lord Hutton have been implemented), the OBR expects the shortfall to have increased to £15.4 billion – and rising. With employers' contributions of an extra £17.2 billion, the annual burden on taxpayers will be over £32 billion – the equivalent of £1,230 for every household in the country.

On top of that, the DWP's recent White Paper[21] outlining a new single tier state pension, introduces huge additional costs that should be directly attributed to the on-going provision of public service pensions: perhaps some £9 billion a year. The annual bill, ultimately to be borne by the taxpayer, could be at least £41 billion – the equivalent to £1,600 a year for every household in the UK, comprised of:

- at least £17 billion in employer contributions;
- a cashflow shortfall of at least £15 billion as forecast by the OBR between pensions in payment and pension contributions;[22]
- at least £9 billion in additional costs.[23]

This level of subsidy to public sector workers is neither affordable nor sustainable.

Proposal 7: Re-open negotiations on public service pensions.

[21] DWP, *The single-tier pension: a simple foundation for saving*, 14 January 2013.

[22] Note that the estimates for employer contributions and the cashflow shortfall are for 2015/16, while the £9 billion estimate of additional costs is for the early 2020s. As the first two estimates are expected to increase significantly by the early 2020s, the £41 billion total cost in the early 2020s could be considered as low.

[23] See Michael Johnson, *A Toxic Tangle: The Public Service Pensions Bill and The DWP's White Paper,* CPS, 2013.

B. SUPPLY-SIDE POLICIES

Deregulation

The burden of excessive red-tape is cited as one of the three major impediments for small business start-ups and expansion (the others being the difficulty in securing finance and the burden of taxation).

The Coalition has made some noteworthy reforms in this area – but more can be done with targeted exemptions for small businesses which could be packaged into a 'Small Business Incentive Scheme'.

Proposal 8: Announce a Small Business Incentive Scheme to include a package of exemptions from regulations for very small businesses. This should include exemptions from: minimum wage legislation for those under 21; requests for time off for training; and pension auto-enrolment.[24]

Alongside continuing work to identify and remove regulations on an on-going basis, through initiatives such as the Red Tape Challenge, the Coalition should also break the ratchet of ever-greater regulation. In the immediate term this could mean a broader scope for the One-In, Two-Out regulatory rule, (at the moment, around half of regulation does not fall within its remit). Tax law, for example, could be brought within the programme's scope. But it should also entail the rolling out of a comprehensive system of sunset clauses for new regulations – with a post-implementation audit three years after enactment.

Proposal 9: Adopt sunset clauses for all regulations with a post-implementation audit three years after enactment of each regulation; and bring more regulation into the scope of 'One-In Two-Out'.

[24] For more details, see Dominic Raab MP, *Escaping the Strait Jacket,* CPS, 2011.

Planning in particular is an area where regulation has stifled development. A more market-orientated approach is required to meet the pressing demand for housing of all types and to give the currently stagnant construction industry the best hope for revival. The nationalisation of development, first introduced under the Town & Country Planning Act 1947, should be abolished. In its place, a new Consolidated Act should be adopted which rationalises all the 100+ Statutes that impact on planning and development. Incentives should also be provided for neighbouring local councils to come together to identify potential sites for new Garden Cities.

Proposal 10: Adopt a Consolidated Planning Act and repeal all existing legislation with a single rationalised Act.

Proposal 11: Encourage neighbouring local councils to co-operate in identifying sites for new Garden Cities.

National pay bargaining

There is a clear negative correlation between the size of the state in particular UK regions, and the relative prosperity in those regions.[25] One of the major distortions caused by the state has been the means by which pay and conditions are determined via national pay bargaining, which entrenches regional inequalities and leads to inefficiency in the provision of public services. The Coalition floated the idea of pay determination at local market levels, but now appear to have backed off the idea, though they are still trying to liberalise pay determination for teachers.

National pay bargaining has two significant distortionary effects. First, it damages private enterprise in poor regions: Poor areas which suffer from high unemployment, in the absence of national pay bargaining, would tend to have a cost advantage over other national regions. Provided there are reasonable skill levels, this should encourage private sector companies to locate there and, over time, create jobs. But national pay bargaining means private sector firms have to pay a wage premium that can result from above-average wages on offer in the public sector in poor areas, therefore undermining any competitive advantage.

Second, it limits flexibility for poor localities. It is obvious that sometimes it will be necessary to pay more to attract the best public servants, for example, to teach in the most difficult localities in poor regions. But national pay bargaining prevents this.

The Coalition should follow Alison Wolf's recommendations and abandon national pay bargaining, with the potential for the Swedish individual contract model being rolled out in its place.[26]

Proposal 12: Abolish national pay bargaining in the public sector.

Aviation policy

For many years, successive governments have put off decisions on airport capacity. By establishing the Davies Review (due to report in 2015), the Coalition has now also ducked out of taking a difficult decision on an important issue.

As a result, the UK is falling behind our competitors: the number of destinations served by Heathrow, our only hub, has fallen from 227 in 1990 to 180 today. Far more Chinese tourists visit France than Britain. British business travellers flying indirectly are now as likely to go via Schiphol as via Heathrow.

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[25] See Ewen Stewart, *Masking the Symptoms: why QE and Huge Deficits Are Not The Cure*, CPS, 2013.

[26] Alison Wolf, *More than we bargained for*, CentreForum, 2010.

Heathrow is now full, while demand in the South East is set to outstrip the facilities of all the region's airports by 2030. 59% of IoD members believe that lack of capacity at Heathrow is harming our prospects of inward investment.

It is essential that, should the Davies Review recommend expansion of airport capacity in the South East (and it is difficult to see what else it could do), then all possible obstacles to their implementation should be cleared in advance.

Proposal 13: Put in place the necessary measures so that the recommendations of the Davies Review can be implemented swiftly.

C. AN AGENDA FOR COMPETITION

Banking

Rescuing Royal Bank of Scotland and Lloyds in 2008 was necessary: their failure would have endangered the entire financial system, and with it, the real economy up and down the land. Taxpayers were the unwilling investors of £66 billion in the banks. But long-term public ownership is not attractive.

The government owns 84% of RBS and 43% of Lloyds, and is said to be looking at options for re-privatisation. The problem with selling huge stakes like this is that investors will want a large discount to ensure that they make a profit.

One solution to this share overhang problem is to distribute the shares free to all in the population with a National Insurance number, and when they are sold, part of the sale price in the form of a floor price is returned to the Treasury. All the post-tax profits would remain with the individuals.

This means that there is a floor under whatever price the Government sets. Below this price, no-one has an incentive to sell – and above this, the incentive increases slowly. Taxpayers will thus get any resulting profits – rather than the City or a foreign sovereign wealth fund, thus avoiding a Gordon Brown-style 'selling the gold cheap' scenario.[27]

Proposal 14: Adopt the "Fair Shares" scheme for the re-privatisation of Lloyds and RBS.

The number of major UK banks halved between 2000 and 2010 from 41 to 22 and the Big 4 of RBS, Lloyds, HSBC and Barclays have 78% market share. The rules for market entrance need to be changed to make it easier for new entrants to establish themselves.

The first change needs to be to the licencing regulations that are imposed on new entrants which are currently too cumbersome and a significant barrier to entry. They contain opaque and moving deadlines that create too much uncertainty and which impose too many costs on possible new entrants. The FSA also prefers business plans with a strong High St presence, even though the trend among existing banks is away from the high street, increasing start-up costs at a time when innovation is to be found in online and telephone services.

Proposal 15: Reduce the regulatory burden on new banks.

The Financial Conduct Authority should also be given a specific competition objective.[28] It should actively seek new ways to remove barriers to entry (promote new competition); to take steps to permit the orderly exit of failed institutions (break up institutions that are 'too big to fail'); and to ensure products and services offered are themselves subject to competition.

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27 James Conway, Toby Fenwick and Michael O'Connor, *Give Us Our Fair Shares*, Centre for Policy Studies, 2011.

28 Andrea Leadsom MP, *Boost Bank Competition*, Centre for Policy Studies, 2011.

To fulfil this aim, the FCA should establish a Financial Competition Commission (FCC) that would carry out investigations of individual firms or of product areas. It would make recommendations to the Bank of England to promote competition between banks.

This could result in a profound cultural change in the financial services industry. Over time the focus on competition would improve customer service, restore free market principles and may even reduce the risk of bank failure and the need for the implicit taxpayer guarantee.

Proposal 16: Give the Financial Conduct Authority a competition mandate.

Water[29]

The water sector is one of the least open and competitive sectors in the UK, consisting of 21 regional monopolies with rates controlled by an independent regulator (OfWat). OfWat estimates that between seven and eleven of these companies to be operating 'below minimum efficient scale' and the last government considered the system to be working so badly that they conducted a review of the whole sector. The Cave Review concluded that upstream services (such as water sourcing) needed to be reformed by increasing competition to improve efficiency. He suggested that there needed to be changes to the licencing so that upstream providers were not required to provide retail services. He also wanted the reverse to be true for retail licences. The increased competition is estimated to benefit the economy by as much as £3.4 billion and retail savings could be as much as £600 million over 30 years for non-households. Retail competition has been in place in Scotland since 2008 and has resulted in savings estimated to be worth £110million over the next decade. However, the licencing changes shouldn't only apply to non-household consumers; increased competition here would produce significant saving for households' water bills. Alongside the new licences needs to be a strict separation of upstream and retail services to prevent incumbent water companies form blocking competition by favouring their own infrastructure to competitors. Without this separation, moves to increase competition will have limited effect.

Proposal 17: Require the legal separation of retail and supply arms of water companies, enabling the extension of retail competition.

Railways

Twenty years after privatisation, rail passenger traffic has doubled; and is expected to double again by 2030. More people are now travelling by train than at any time since 1929 on a rail network half the size.[30]

Yet the public subsidy required to run the railways has doubled in just over ten years (to £4.16 billion in 2010/11). The cost of tickets is the highest in Europe.

The 1992 rail privatisation White Paper anticipated "more competition, greater efficiency and a wider choice of services more closely tailored to what customers want." But these principles have been betrayed: today, franchised rail operators have an effective monopoly on the core long-distance routes which has restricted any significant on-rail competition from developing.

Yet in some areas of the network, competition has been successfully introduced – with beneficial results: rail freight, for example, is open for competition. This has seen significant

29 Dominic Raab MP, *Capitalism for the Little Guy*, Centre for Policy Studies, 2013.

30 Detailed recommendations on this policy will be outlined in a forthcoming CPS paper by Tony Lodge.

investment in new rolling stock, high levels of productivity and reduced costs to satisfy customer demand: between 1998/9 and 2008/9, freight operating companies *reduced* their unit costs by 35%, while the passenger operators *increased* costs by 10%.

A small part of the passenger rail network is also open to competitive pressures. On the East Coast Main Line (ECML), two operators – Grand Central and First Hull Trains – have shown that competition can lead to more journeys, higher revenues for the train companies, lower fares, more and even happier passengers: in the official rankings of passenger satisfaction of the 31 main train companies, the companies that came first and second were those which are running competitive services.

Following the West Coast Main Line fiasco, the model for awarding rail franchises is now in disarray. Ministers should seize the opportunity to restructure new franchises to enable far greater competition to flourish across the UK rail network.

Proposal 18: Encourage greater competition between operators on the rail network.

Schools

Since their introduction in 2005/06, academies have improved educational standards and pupil attainment relative to other schools. The greatest success has been in academies with external sponsors, businesses and charities, and these schools have improved at a substantially faster rate than other schools, including other academies.

However, the lack of a profit incentive has limited the amount of external investment in academies. Swedish Free Schools and US Chartered Schools both allow profit making companies to operate the schools and this is credited with their improved performance, with the evidence particularly strong for schools in poorer neighbourhoods.

Three safeguards would need to be introduced: a requirement that 50% of any profit is reinvested into the school, a requirement the dividends are only paid if educational standards are met, and a bar on any sale of school assets for commercial gain as opposed to reinvestment.

Proposal 19: Lift the bar on profit-making companies running academies and free schools.

The carbon price floor[31]

The Coalition is set to introduce a unilateral carbon price floor this April. This will more than double the price paid for carbon from the current level of £6.30/tonne to £16/tonne in 2013 – an increase of 156%. By 2020 UK electricity generators would be paying nearly twice as much for its carbon emissions as its EU counterparts.

This cost will have to be paid in the end by households and industry. The Coalition's own figures estimate that the carbon price floor will add between 1% and 2% to electricity bills in 2013, rising to around 6% by 2016.

The carbon tax will clearly reduce UK competitiveness and raise the number of households in fuel poverty – with very little impact, if any, on overall level of carbon emissions. The unilateral carbon price floor should be abandoned in the upcoming budget.

Similarly, subsidies paid out to renewable energy producers should be phased out.

Proposal 20: Abandon the planned unilateral carbon price floor and phase out subsidies for renewable energies

[31] Tony Lodge, *Why the Chancellor must abandon the Carbon Price Support*, CPS, 2012.

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