RECOMMENDATIONS FOR 'PHASE II' OF THE UK'S ECONOMIC RECOVERY: AN ALL-OUT OFFENSIVE TO DELIVER A BALANCED AND SUSTAINABLE ECONOMY.

Luke Springthorpe argues that the UK has been steered away from crisis, and the Conservatives must now be bold in leading the second phase of the recovery to make the UK one of the most dynamic, prosperous places in the world.

As the UK approaches the election of 2015 – almost seven years after the calamitous financial crash of 2008, resulting in the deepest post war recession in the UK – several key economic challenges remain.

The UK economy is still recovering from the damage that was inflicted on it by the last Labour government. The present government has done a commendable job at averting what could have become a full blown economic collapse and/or currency crisis, overcoming significant headwinds (and often popular opinion regarding what was possible) to deliver strong economic growth and falling unemployment. The challenge for the next Government will be to build on this success and make the UK a global economic powerhouse that is competitive across a wide range of industries and able to support the creation of high wage job opportunities for the next generation.

There are hurdles to clear in order to achieve this, however. To name but a few of the agenda items that will be in the in-tray of the next government; reducing the deficit in a fair and balanced manner,

averting the inflation of a housing bubble, rectifying the UK's current account deficit of trade position, securing a stable and affordable supply of energy and delivering meaningful productivity growth that can pave the way for sustained real wage growth.

It is a daunting and challenging list, but it is pleasing that the Chancellor has been as bold as to admit that these problems remain in his Autumn Statement of 2014 [92] even with an election looming. It is clear, however, that his ambitions to address these problems have at times been hindered by the coalition.

In this paper, I set out a number of measures that could go some way to solving each of these. None are intended to be a silver bullet, but each will help go some way to securing the next phase of UK's economic recovery.

The government must adopt a long term approach to the problems the economy still faces. It has so far done an admirable job of steadying the ship after nearing the edge of the precipice in 2008/9 after the financial crisis, but the next Government will be defined by its ability to secure the economy for the next generation.

This chapter sets out some solutions for the following areas:

- Cooling the housing market in a manner that does not stunt development
- Fixing the current account deficit by boosting exports
- Reducing the deficit in a fair and balanced manner
- Boosting productivity

[92] George Osborne, Autumn Statement, 2014

COOLING THE HOUSING MARKET IN A MANNER THAT DOES NOT STUNT DEVELOPMENT

The biggest risk to the UK recovery is that it becomes unbalanced and action is needed to wean the UK off credit driven growth fuelled by property.

The problem for the current Government and present policy makers is how to diffuse the bubble that was inflated during the later stages of the nineties until the crash of 2008. Although it has at times offered the economy a sugar high and easy tax receipts resulting from stamp duty and associated economic activity, the Bank of England and George Osborne have both admitted their concern at the property market overheating.

As a result of our findings, we believe that there are a number of worrying imbalances in the property market:

- London, the South East and South West take the smallest advances (deposits) as a percentage of the cost. In London, borrowing typically covers 62.6% of the purchase against 70.1% in the North East. This suggests a far larger deposit is required in London, which is pricing out younger buyers.
- In London, we see the biggest divide between the earnings of home buyers and median earnings. Although median earnings equate to 46.6% of the average home buyers earnings in the UK as a whole and 54.5% in the North East, median earnings are only 39% of the average earnings of borrowers in London. This suggests that home ownership is moving out of reach for typical Londoners taking home median earnings in the region (£35,069).

- A London borrower would be re-paying their mortgage for longer than anyone else in the UK. A worker on the average salary banks lend to would be repaying their mortgage for two years longer than a borrower in the North East or Northern Ireland for example, and a year longer than the average UK buyer.
- Incomes of home buyers becoming more and more stretched in order to take out a mortgage. The Advance/Income multiple – an important determinant of affordability – grew by 33.5% between 1997 and 2008, and has gradually returned to its 2008 peak.
- The pace at which advances have been increased has considerably outpaced the increase in the average earnings of borrowers. This pace was particularly noticeable during the ten years between 1997 and 2007 when the advance increase grew in double digits (in percentage terms) for six of the ten years. This had not been seen before or since.
- A return to normal mortgage rates would entail approximately a 3% increase in charges on mortgages in London. This would result in the average London borrower on a standard 20 year mortgage approximately £600 per month worse off.

This should be of concern to policy makers for a number of reasons. First and foremost, by lending people more as a proportion of their average income, there is an increased risk that the Bank of England becomes a hostage to low interest rates. It should be of concern that whatever the case may be for raising rates in the future, the damaging effect this would have on a housing market so reliant on high levels of debt will skew the decision of policy makers.

Additionally, home ownership is becoming out of reach for the average earner. This is especially the case in London where the earnings of the

average buyer is 2.6x higher than the median earnings for the region. This is not sustainable in the long run.

In order to begin remedying this, the next government should acknowledge that the biggest barrier for first time buyers is fast becoming overall affordability and not just the size of the required deposit, and withdraw government support designed to encourage the take up 95% Loan to Value mortgages. Although there was a case for 'Help to Buy' as a means of enacting a demand stimulus to the UK economy at a time of fiscal constraints and slow growth in the UK's exports markets, the UK's recovery is now on a firm enough footing that the next Government should seek to desist from government intervention in a manner that may distort prices in the property market.

Although ending Help to Buy will help withdraw a form of distortion in the property market, it is important that planning rules are relaxed simultaneously in an effort to boost supply. One benefit of rising prices has been that the price signal has been a valuable signal to incentivise construction, but freeing up more land for construction would encourage land presently held by developers to be put to productive use. What's more, as discussed in more detail later on in this chapter, moving business rates away from taxation of property (a productive asset) and on to the value of land (an unproductive asset when left unutilised) would also discourage land suitable for residential construction to be left undeveloped.

It is, however, important to realise that are two facets to the issue of housing which require different approaches. Clearly, the problem faced by London is unique to the rest of the country where the main problem is not finding places to build (as it often is in London), but overcoming the opposition to building on the land that is appropriate to build on.

A novel idea to encourage supply increases is the creation of Community Land Trusts, as discussed by Tom Hunt in an earlier chapter, whereby the community retains a degree of control over who occupies the properties. This is a creative way to encourage, rather than force, communities to develop their areas whilst retaining a degree of control over how that development is managed. The localisation of financial benefits resulting from development would also boost incentives for local councils to approve development whilst helping to fund the infrastructure required to accommodate a growing population. Localising receipts of stamp duty would be one effective way of doing so.

In London, the challenge is one of freeing up sufficient land for development. Although government plans to build 50,000 homes on brownfield sites will assist in this, even building on all the available brownfield sites in London would only accommodate 365,000 new homes while the Department for Communities and Local Governments 'Household projections' forecasts a requirement for 788,000 new homes to be built in the next fifteen years alone.

In the long term, the policy of urban containment via the greenbelt should be relaxed by selectively liberalising planning constraints against developing greenbelt land. Given that only 22% of London's Green Belt is public access land or land that has an environmental designation, this can be done without impairing public access to greenspaces.

FIXING THE CURRENT ACCOUNT DEFICIT BY BOOSTING EXPORTS

The UK's current account deficit remains a cause for concern. It is not for lack of effort on the current government's part, but the UK has in a sense been a victim of its own recovery which has resulted in a sharp appreciation of Sterling, especially against the Euro. Whilst services continue to be a healthy boost to the current account, a combination of a protracted spell of decline in the UK's major Eurozone export destinations and increased energy imports following a sharp drop in supply from the North Sea has meant the UK remains in a perilous situation with regards to its current account deficit. The current account deficit now equates to 6% of GDP (as of Q3 in 2014), which has actually worsened throughout 2014. This almost mirrors the budget deficit, which is running at 5.8% of GDP.[93]

George Osborne has himself acknowledged that "we need our businesses to export more, build more, invest more and manufacture more"[94], and has taken measures to boost export potential of businesses. He deserves credit for setting an incredibly bold target to double exports, but it is clear that only radical measures will achieve this growth and cure the UK of its current account deficit.

Although the government has successfully engineered a demand led recovery domestically through creating an environment of long term confidence, global growth has slowed down. This has seen the UK absorb more imports both from EU and Non-EU trade partners between 2009 and 2013.

The recurring trend has been a worsening on both sides of the European trade balance equation. Not only have imports from the Eurozone increased, but exports have actually been in decline since

[93] Heath A, 'It is truly shocking that our already huge budget deficit is still growing', *The Telegraph* 21 Oct 2014

[94] 'Budget 2014: UK firms get tax relief and export boost' *BBC News* 19 Mar 2014

2011, with a 6.6% decline in overall exports to Europe in the two year period alone. Although full 2014 data is not available at the time of writing, it appears this trend has continued. By contrast, non-EU exports have increased by almost 6% over the same period.

As such, it is necessary for the UK to move to a situation whereby its export strategy is focused on areas of growth (ie, the non-EU component). With the Eurozone seemingly unable to solve its currency crisis and potentially heading for a deflationary spiral exacerbated by population decline, it appears the EU's long term growth potential is weak.

In an attempt to boost exports, there are a number of measures that can be employed.

This can be achieved by:

Regaining control over our ability to negotiate trade tariffs, and pursuing free trade agreements with the world's largest and fastest growing economies (such as India, China, the US and Brazil) rather than being tied to the shrinking EU single market at the expense of having the flexibility to negotiate our own free trade agreements. This would also allow the UK to diversify its trade, which is currently weighted heavily towards Europe.

Is it especially concerning to note that the balance of trade in goods outside of the EU has worsened between October 2013 and 2014 by £500m (from -£3.1bn to -£3.6bn). Remedial action is required to address this, and there are examples of numerous small states that have the nimbleness required to adapt to the rapidly changing balance of economic power by negotiating their own free trade agreements. Placing the long term health of the UK economy in the hands of

European Union negotiators seeking agreements that are palatable to all 28 member states is no longer delivering in the interests of the UK.

It is regrettable that EU negotiations on free-trade agreements with the US (TTIP) and China have both encountered considerable obstacles over vested interests from trade bodies of other European countries. There is a clear case to be made by the UK that its situation with regards to addressing its current account deficit is now critical, and that the excessive delays encountered by pan-European negotiation has failed to advance talks at the pace the UK requires for its own export-focused economic policies to have any chance of success. In the instance of TTIP, every year long delay costs the UK approximately £10bn annually, and up to 0.35% of additional GDP growth is lost. What's more, exports would also increase by up to 2.9% were TTIP in place.[95]

In addition to this, the British Chambers of Commerce have found in a survey of exporters that tariffs and the regulatory environment are the most common barrier for exporters who want to increase their sales in the fast growing 'BRIC' countries.[96] It is unfortunate that the present framework does not allow the UK government to overcome this particular barrier, no matter who is elected.

Nurturing the UK manufacturing supply chain by cultivating business clusters. Over the period from the mid-1990s to 2008, the strength of sterling and low costs in emerging markets put UK producers at a disadvantage. Over this time, the UK supply chain has become 'hollowed out' to the extent whereby even the manufacturing that does exist often relies on importing various components to complete the process.

---

[95] ''Final Project Report', *Centre for Economic Policy Research* Mar 2013
[96] 'Business is Good for Britain' *British Chambers of Commerce*

That said, the success of a cluster will ultimately come down to local networks and an ability for the local authority to develop the local infrastructure to accommodate the needs of emerging business needs.

In this regard, local devolution would be an effective way of encouraging councils to foster growth in their areas as well as giving power to the local level where decisions can better be affected. Although business rate retention is a start, there is scope for it to be more ambitious.

In order to assist with this, the business rates structure should be fundamentally reformed. First and foremost, it should be altered away from levying taxation on buildings, which are for many businesses a vital form of capital, and instead be based on the land. This would have the doubly beneficial effect of encouraging land to be immediately put to productive use, whilst avoiding penalising the business for adding to the value of the property they place on the land. That said, exemptions should be made for necessarily land intensive industries such as agriculture whereby the land they cultivate will never be built on.

Secondly, just as councils collect the revenues of council tax in order to provide services for their populace, it is equally important that they are able to collect a greater share of the revenues from business rates to properly finance the needs of local businesses. There are a number of good reasons for this: First of all, it will afford local councils greater resources to mould the local infrastructure to adapt quickly to changing business needs. Secondly, the localised incentives to boost growth will be more keenly felt if growth in revenues from business rates contribute to local budgets as well as providing incentives to adopt a 'business friendly' approach to planning considerations.

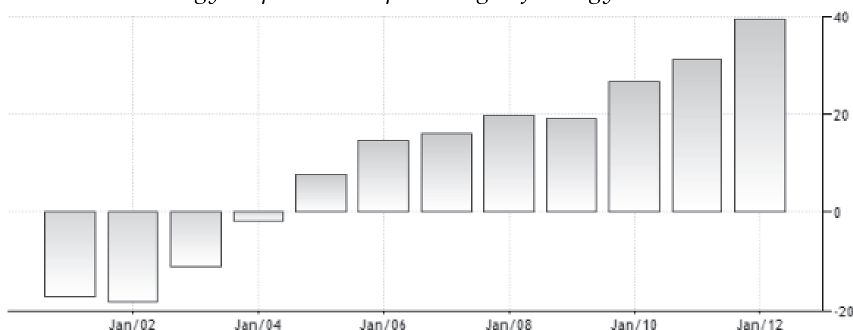
A mechanism has been provided by the current rate retention policy from the Government, which accepts the need for local authorities to be incentivised to boost growth. The problem is that this incentive is made stronger for certain areas than others by having a focus on ensuring 'fairness' in the distribution of rates via its 25% and 50% ceiling on the fraction of additional revenues that can be kept. This is peculiar, given that no such focus on the distribution of revenues exists with council tax. Moreover, there may be very logical reasons for businesses choosing to concentrate in a particular area- for example, the necessity for financial services to concentrate in an international city such as London, or the desire to join a pre-existing cluster.

By choosing to make fairness, rather than localism, a focus of business rates, the government is unintentionally penalising clusters of high business activity that are in fact our most productive areas. It would be more logical for these rates to both be set, collected and retained at a local level whilst using income taxes and VAT as the centralised pots which are available for redistribution as the central government sees fit.

The government should also make small business rate relief permanent in order to continue to encourage fledgling businesses that can in time grow to become exporters and/or an integral part of their supply chain. Given that this has already been extended several times, this would be a symbolic gesture in terms of its impact on government revenues but would give small businesses the confidence that a cost they have grown used to operating without will not return in upcoming years.

Paving the way for the UK to import less of its energy. Increasing reliance on imported energy has been a significant drag on the UK current account. It is becoming clear that the supply of oil from the North Sea is in an inexorable decline even despite tax cuts on investment, and the UK has been importing an ever growing share of its energy supply for over a decade now as the figure below illustrates. This trend has worsened despite billions of pounds of subsidies being spent on renewable energy[97] and the government has forecast that imports will account for 70% of the UK's energy consumption by 2025 if the UK does not exploit shale. [98]

Above: UK energy imports as a percentage of energy use (Source: World



Bank)[99]

[97] Mason R, 'Britain imports almost half of fossil fuels from abroad', *The Telegraph* 25 July 2013
[98] 'Developing Onshore Shale Gas and Oil' *DECS* Dec 2013
[99] *Trading Economics*

REDUCING THE DEFICIT

With the deficit still standing at approximately £100bn, it is necessary for the cuts to be evenly distributed. There are a number of areas where this can be achieved without imposing lopsided cuts that begin to affect the ability for services to be delivered effectively.

In order to achieve this, the government should get spending on the state pension & other retirement benefits under control.

In nominal terms, expenditure on the state pension alone is forecast to rise from £87.1bn in the current financial year of 2014/15 to £97.9bn by 2017/18. The total spending on all benefits for pensioners is forecast to rise even more by 2018 from £111.2bn at the end of the current Parliament (2015) to £125.4bn in 2018.

Although working age benefits still exhibit some scope to be reduced, these are falling in real terms. What's more, with expenditure on working age benefits only representing £50bn – around half of the deficit – we are faced with a scenario where even completely withdrawing any entitlement to working age benefit - something no party proposes – would still not erase the deficit. As such, it is essential that pension benefits are placed on the table.

That said, it is important that it is done in a fair and equitable way that brings the system under control but does not unfairly disadvantage todays pensioners who have paid worked hard and paid their taxes.

As such, there are a number of proposals that could bring the spending on pensioner's benefits under control to the extent where a gradual, real term decrease in overall expenditure could be achieved:

RECOMMENDATIONS FOR 'PHASE II' OF THE UK'S ECONOMIC RECOVERY

1) **An ending of the triple lock.** In an environment where inflation is running at 0.5% and the Bank of England's target rate of inflation is only 2%, it is hard to justify the government committing itself to annually increasing the state pension by 2.5% (or inflation, if it is higher). Instead, the increase should be linked to the factors that influence the affordability of pensions. Logical indexes that could provide an alternative benchmark would either be annual increases in labour productivity or the annual increase in average earnings.

2) **Index the pension age to life expectancy.** In order to ensure that there is not a continually growing disproportionate number of people in receipt of pension benefits who are funded by tax receipts from the working age population, it is important to ensure that the number of people eligible for pensionable benefits is kept relatively constant as a proportion of the population. Indeed, the Chancellor has already alluded to the importance of this.

   It would be beneficial and fair to immediately link the retirement age for those currently at the age of 65 to life expectancy. Given that the rise between 2007 and 2012 was approximately two years (from 79.45 years to 81.50 years), this would begin to have a real impact by the end of the Parliament.

   It is, however, a fair criticism that life expectancy does not rise evenly and that in some cases, health can deteriorate very rapidly after the age of 66. As such, there should be an option for a medical assessment- not entirely dissimilar to that already undertaken for incapacity benefits- to assess whether a person is capable of working beyond the present retirement age.

3) **Curtail the entitlement of those who don't need state support.** Whilst introducing means testing is not the answer, there is a rather

straightforward way in which individuals could be voluntarily 'opt out' of the receipt of all pension age benefits.

In order to create a meaningful incentive to do this, the government could revise down the tax free lifetime limit on pension contributions from the current limit of £1.25 million to a significantly reduced level of £500,000 and £30,000 a year. If, however, an individual wished to 'opt out of' their state funded benefits upon retirement, they could have an increased allowance of £2 million at a rate of £50,000 per year. This would create an effective incentive to save privately for those at the upper end of the spectrum whilst ensuring that state provision is maintained for those that need security in retirement rather than maintaining an expensive universal provision

Although these measures are bold, it is essential that welfare reform is seen to be fair and equitable across generations. If the axe only falls on working age benefits, there are very real risks that the system not only becomes unmanageable as the retired population continues to grow, but that generational tensions also increase. Although solving the problem is likely to cause a degree of political tension, avoiding the problem is only to defer its resolution.

- **Scrap or merge government departments:** The focus of government should become more streamlined and concentrated on delivery of core services and the next spending review should also feature a review considering which departments can be abolished with their 'core' functions to be reassigned to other departments where they are deemed necessary. For example, the functions of the Ministry for International Development could merge with the Foreign office, Energy & Climate Change should be refined as a Department for Energy which would come under the remit of the

Department for Business, whilst the Department for Culture Media and Sport can be fragmented and assigned to different departments. This will help save on overheads and operational costs, but should also come alongside a review of each function that is transferred to another ministry and whether it is necessary for the state to continue to spend taxpayers money on it.

- **To remove the 'ring-fence' of foreign aid and link to trade:** At a time the budget remains deeply in deficit, it is unjustifiable to have a capped amount on a non-essential service of any description. Although the DfID budget is not colossal (£10.5bn), this does amount to almost 10% of the deficit. The next government therefore needs to ascertain whether this is delivering any meaningful return for Britain at a time our borrowing requirements are so high. What's more, the arbitrary cap of 0.7% of GDP spend on overseas aid appears unjustifiable at a time the UK's peers such as the US (0.2% of GDP) and Germany (0.4% of GDP) allocate significantly less of their national product.

Although the UK should continue to support countries that have been hit by famine and natural disasters, aid for this purpose should be assigned on a case by case basis. Where aid is to be spent to assist in the development, this should be caveated as part of a wider trade deal that assists in opening up new markets for UK businesses with a view to making development aid as 'cost-neutral' as possible. What's more, we should not lose sight of the fact that the UK is an incredibly generous nation that did in fact donate close to the equivalent of the DfID budget in charitable giving in 2012/13 giving £10.4bn to charities. This makes the UK the sixth most charitable country on the planet.[100] The rate of

[100] Christian Aid Foundation Newsletter Jan 2014

participation in donating in the UK is also incredibly high, with 76% of people engaging in donating money – the second highest in the world. The government should not seek to 'nationalise' this charitable generosity and should instead adopt a co-ordinated strategy to ensure that voluntary giving continues to be incentivised as much as possible via the tax code and that the work of charities is effectively co-ordinated.

BOOSTING PRODUCTIVITY GROWTH TO PAVE THE WAY FOR AN INCREASE IN REAL WAGES

One weakness of the recovery is that the productivity gap has grown relative to other G7 countries.

In the short-medium term, low interest rates has resulted in jobs being retained but there remain concerns over the productivity of the labour employed in some of these jobs, and their ability to remain productive in an environment either of lower growth or higher interest rates.

Despite the fact the UK has had economic growth that has ranked as the fastest in the G7 group of economies, the impact of this has not manifested itself in a real rise in wages (increases above the rate of inflation) for a prolonged period of time. This has largely been down to sluggish growth in productivity. Politically, this manifested itself in, what Labour has termed, the 'cost of living crisis.' It was essentially a bet that although unemployment was falling and growth was materialising, it would not result in a rise in real earnings and that job creation would be primarily in low-paid, part time jobs.

Unfortunately for the Labour party, both of those hypothesis are now in tatters. The latest earnings figures released by the ONS revealed an average increase in wages of 1.8% (excluding bonuses) whilst inflation in December ran at a 14 year low of 0.5%. Hence, real incomes are finally rising.

Excellent news though this is, it should not lead to complacency. The fall inflation that the UK has seen is largely a result of falling gas and electricity prices as well as a continued drop in motor fuel prices. Given that these components of inflation have proved to be erratic and beyond the control of government policy, we should all be wary that inflation may increase if oil begins to return to its medium term average price in excess of $100 a barrel. With a number of major oil producers announcing cuts in production that will likely take effect at the tail end of 2015, a rise in oil prices from their current lows should not be ruled out.

Ultimately, the only way to sustain real wage growth over the long term is to deliver productivity growth. It is only by ensuring that there is meaningful output growth per hour worked that wage growth will be sustainable for the businesses having to pay the wages- whether that may be above or below inflation.

This has been the one laggard indicator, with any meaningful improvement yet to be sustained. Productivity still remains 2% below its level prior to the economic down turn, and around 16% below what is termed the 'pre-crisis trend'.

For some time now, there have been a series of cyclical explanations for why productivity growth has struggled, with many falling down to the structure of the labour market and increased rates of retention. One unique factor of the recession was that many companies held on to workers even in the face of weak demand and lower levels of

utilisation. This manifested itself in an increased use of forbearance rather than outright closure of businesses, which saw a high number of firms with declining output hold employment flat - rising from 11% to 20%.

The fact that productivity is now showing signs of picking up suggests that the decline may have been cyclical and that increased demand will see higher rates of labour utilisation. Although another contributory factor has been the decline in business lending, there are signs that this too is set to turn a corner with business lending predicted to turn a corner with a forecast £66bn boost to business lending forecasted over the next 4 years.[101]

Additionally, we have the essential structural reforms that have been delivered by the coalition government. This has in part manifested itself in a sharp rise in self-employment following mechanisms that have encouraged small businesses during their start-up phase, such as national insurance exemptions for small businesses. Even as inflation begins to return to more normal levels of 2%, the foundations have been laid for productivity growth that can outpace it and allow business to increase their wages. Education reform aimed at improving standards will also improve the productivity of the next generation over workers.

That is not to say that the UK is completely out of the woods. One element of concern that is yet to be addressed is effectively boosting capital investment. One reason that unemployment has fallen so sharply is owing to the relative decline in the price of labour relative to capital.[102] Given the important causal relationship between capital

---

[101] Chan SP, 'Billions more in business lending as corporate risk appetite grows' *The Telegraph* 02 Feb 2015

[102] Barnett A et al, 'The UK Productivity Puzzle', *Bank of England Quarterly Bulletin* Q2 2014

available per unit of labour, it should be of concern that there has been a decline in already low rates of capital investment with the UK having one of the lowest gross fixed capital formations in the developed world.A key determinant of success here will be in boosting the more capital intensive export industry, although it is pleasing to note that the Chancellor has already acknowledged this problem exists as well as passing measures intended to tackle it.[103]

Time will tell if he can succeed in the face of strong headwinds created by anaemic growth from the UK's largest export partner - the Eurozone. In the face of this, George Osborne should make his tax allowance on investment permanent (it is currently due to expire at the end of 2015.)[104] As already discussed, shifting business taxation away from productive assets (property) to the unproductive asset (land) will also remove the disincentive to increase value in capital assets.

[103] Halligan L, 'Budget 2014', *The Telepraph* 19 March 2014
[104] 'Budget 2014: UK firms get tax relief and export boost', *BBC News* 19 March 2014