Agenda for Rebuilding Collective Prosperity

April 2009

Rebuilding Collective Prosperity

Preface

This paper, the fourth in the STUC's series of Economy Discussion Papers[1], is intended to contribute to the debate about Scotland's economic future after the global financial crisis of 2008. It argues that the 'financialised' economic model has failed and that the Scottish and UK economies require urgent rebalancing. An effective regulatory response is also urgently required to prevent a re-emergence of reckless behaviour in financial markets. Finally, it argues that building a new economic and social model, one that is truly sustainable, will require the creation and maintenance of equalising institutions deliberately designed to ensure that prosperity is widely shared across the population.

This will require action across Government at all levels and therefore the paper includes specific recommendations for both the Scottish and UK Governments.

Introduction

The ‘financialised’[2] economic model, pursued with particular vigour in the US and UK, didn’t lead to greater prosperity for all: it generated moderate GDP and productivity growth, an exponential rise in income and wealth inequality and a decline in social mobility.

The most disappointing aspect of the model’s implosion during late summer and autumn 2008 was its utter predictability. The past 15 years of growth have been built on rapidly rising household debt-income ratios and corporate debt-equity ratios and, as a number of commentators consistently warned, such debt constraints must eventually bite[3]. Widespread incentivisation of reckless behaviour only served to compound the model’s fragility. It is unacceptable that already hard-pressed working people now have to pick up the bill for its inevitable unravelling.

The impact of this unravelling on the Scottish workplace is now evident. Statistics reveal part of the story: claimant count unemployment rose by 43,600 in Scotland over the year to February 2009[4] and GDP fell by 0.8% over quarter 3 2008[5]. Although not always adequately reflected in statistical evidence, those who are lucky enough to retain employment face increasing levels of economic inequality and insecurity: real wages for ordinary workers continue to stagnate, there is a widespread lack of faith in the current model of globalisation to produce fair outcomes in both developed and developing nations and societal pressures associated with the rise of a super-rich class continue to grow.

Now for the good news: the global financial crisis of 2008 has blown away many of the orthodoxies (particularly around deregulation and the role of the state) which have underpinned economic policy for far too long. The crisis provides an opportunity to create a new economic architecture that reconnects a strong, flexible economy to the living standards of all, not just to residents of the penthouse. It is essential that governments at Scottish, UK and European level grasp this opportunity.

This paper focuses on three specific areas:

- **the ‘financialised’ economy**: why the demise of the financialised model was inevitable and what must be done to prevent its re-emergence;
- **rebalancing the economy**: what can be done to stabilise and grow manufacturing industry and generate jobs in renewable energy and environmental industries; and,
- most importantly, **tackling economic inequality and insecurity**: recognising that ‘sustainable’ growth is growth that broadly distributes its proceeds throughout the population.

PART 1 The Inevitable Demise of 'Financialisation'

Commenting on the financial crisis, Nobel Laureate Joseph Stiglitz argued that,

> *"It is hard to have a well-performing modern economy without a good financial system, but financial markets are not an end in themselves. They are supposed to mobilise savings, allocate capital and manage risk, transferring it from those less able to bear it to those more able. In America, and some other countries, financial markets have not performed these functions well. They encouraged spendthrift patterns, which led to near-zero savings. They massively misallocated capital. And they created risk, did not manage it well and left huge risks with ordinary Americans, who are now bearing huge costs because of these failures. These problems have occurred repeatedly and are pervasive. The failures in financial markets have effects that spread out to the entire economy".* [6]

Stiglitz's analysis, which would have been hotly contested little more than a year ago, is now widely shared by commentators across the political spectrum. The pace with which this post-crash consensus has emerged suggests that the intellectual basis for the 'financialised' economy must have been very weak indeed. So the question remains:

Why was the situation described above allowed to develop?

The Bank of International Settlements, is the one authority that can point to a consistent record in querying the value of financial innovation. In its Annual Report published in June 2008, well before the global crisis reached boiling point in September, it observed that, '*The duration of the turmoil, its scope and the growing evidence of effects on the real economy have come as a surprise to most commentators, private as well as public'*.

Adding that it 'is essential we understand what is going on', the BIS pointed out that the crucial question is: '*How could problems with subprime mortgages, being such a small sector of global financial markets, provoke such dislocation*?"[7]

The Financial Times Capital Markets editor, Gillian Tett, argues[8] that the answer lies in the widespread adherence to three assumptions that have underpinned the financial sector in recent years:

1. A belief that modern capital markets had become so much more advanced than their predecessors that banks would always be able to trade debt securities. This encouraged banks to keep lowering lending standards since they assumed they could sell the risk on.
2. Many investors assumed that credit ratings agencies offered an easy, cost effective and reliable way of navigating the ever more complex world of securitisation. Thus, many continued to purchase complex securities throughout the first half of 2007 - even though most investors barely understood these products. The ratings provided by these agencies turned out to be highly misleading.
3. Most crucially, there was a widespread assumption that the process of 'slicing and dicing' debt had made the financial system more stable. Policymakers thought that, because the pain of any potential credit defaults was spread among millions of investors, rather than concentrated in individual banks, it would be much easier for the system to absorb shocks than in the past.

The BIS warned that risk dispersion might not always be benign. As did the world's richest man, Warren Buffet, in his 2003 annual letter to Berkshire Hathaway investors in which he memorably described derivatives as *'financial weapons of mass destruction*'. In a less reported but even more revealing extract from the same letter, Buffet concludes:

"*No matter how financially sophisticated you are, you can't possibly learn from reading the disclosure documents of a derivatives-intensive company what risks lurk in its positions. Indeed, the more you know about derivatives, the less you will feel you can learn from the disclosures normally proffered you. In Darwin's words, "Ignorance more frequently begets confidence than does knowledge*[9].

However, such warnings went unheeded. Governments and regulatory authorities – and in this the UK and US are particularly culpable – joined in the belief that financial innovation had changed the system in a fundamentally beneficial way. Regulators didn't only fail to enforce a safety net of higher capital reserves but actually allowed banks to reduce their capital.

Given the belief in the assumptions outlined above, it is hardly surprising that markets assumed that sub-prime losses would be absorbed without too much pain. Perhaps this complacency would have been justified if many banks had not been wholly ignorant of their level of exposure.

It is clear that this ignorance was a consequence of the hubris which until summer 2007 had characterised the financial community and the authorities which might, in normal times, have been expected to scrutinise their activity. This state of affairs was described by Kenneth Rogoff, Professor of Public Policy and Economics at Harvard:

> "*By helping to spread risk, high-tech finance could help economies grow faster. Macroeconomists celebrated the 'great moderation' of the global business cycle, with recessions seeming to become milder and less frequent. And, of course, the financial community was making money hand over fist, creating scores of millionaires and even billionaires worldwide.*
>
> *"Governments were cheerleaders too. In Anglophone countries, presidents and prime ministers, not to mention some leading central bankers, boasted of superior financial systems that were the envy of the world. When French and German leaders complained that the sprawling and unregulated tentacles of the new finance posed huge risks to the global economy, they were derided as sore losers. Small countries, such as Iceland decided to get in on the action by privatising their banks and setting up their own financial centres. If you cannot be Silicon Valley, then why not create a mini-Wall Street?"*[10]

Some economists and commentators have argued persuasively that the 'financialised' economy found widespread political support because governments felt they had to inflate bubbles in housing and credit to fill the wealth gap left by stagnating wages.[11]

Deregulation

International institutions, such as the World Bank, IMF and WTO, have over recent years widely promoted the substantial deregulation of finance as a prerequisite for competitive success in an increasingly integrated global economy[12]. The benefits of deregulation are held to be self-evident: financial innovation has a hugely beneficial impact on the wider economy by, for instance, extending credit to those previously denied it and by enabling risks to be more widely shared than in the past.

The problem is however, as the events of the past year have amply demonstrated, that policies over the past 15 years have resulted in a shadow financial system, consisting of innovative products such as credit derivatives, options, swaps and stock lending for short-selling. High street banks 'innovated' by creating subprime loans and 125% mortgages.

Far from helping to maintain stability through the sharing of risk, financial innovation has helped to embed major structural weaknesses in the UK economy. And of course, despite lighter regulation, the UK financial sector has become no better at providing patient and dedicated capital to the productive sector.

The Alchemy of Incentives

Another factor underlying the crisis is the remuneration packages and related incentives in the financial sector, which have encouraged a culture of short-termism and irresponsibility. Simon Caulkin, the Observer's management editor captured the essence of the problem when describing the failure of Anglo-Saxon business orthodoxy which has sought to align executive pay with shareholder interests:

> *"If, after 30 years of effort, the only solution on offer to a problem is to 'try harder', you know there's something wrong with the premise. So it is with City pay. The credit crunch has written it out in huge red letters: incentive pay may work for Chinese peasants, but in situations of any complexity, and especially where the quality of the decisions made is only apparent in the long term, pay that truly reflects performance is not only unachievable: the attempt to make it so is catastrophically counterproductive[13].*

Last year, FTSE 100 CEOs' pay climbed by a 'gravity-defying' 11.5 per cent, according to IDS[14]. Their counterparts in the 250 firms below the FTSE averaged increases of 10.4%. Chief executives in top finance firms received average earnings of almost £3.5 million last year, while their FTSE 250 colleagues received almost £2.3 million. These rises were announced even as the softening of performance targets ahead of the downturn was being widely reported in the financial press.

The Government was correct to extract commtiments from the Banks on pay and bonuses before confirming its rescue package although it has since been worrying to note the shamelessness of the banks in trying to wriggle out their responsibilities[15].

Government at all levels should treat with the contempt it deserves the proposition that a massive upwards redistribution of wealth is a necessary component of a ‘competitive’ model and, if necessary, legislate to change practices. Free market fundamentalists will continue to argue that government interference is bound to be damaging but their warnings are absurd. As Caulkin concludes:

> *“If companies and shareholders really are ‘better at setting salaries than bureaucrats’, as The Economist affirms, given that ‘better’ has resulted in the almost complete meltdown of the global financial system, what, please, would ‘worse’ look like?”*[16]

Advocates of incentive pay systems rely on a crude logic to support their prejudices: people will work harder if incentivised to do so. Peer reviewed research demonstrating the value of incentive based pay systems is conspicuous by its absence whilst a substantial body of research highlights the damage wrecked by simplistic incentives[17]. We have witnessed that performance related and externally benchmarked pay does change behaviour – it encourages bankers to disguise risk as value creation. It does not help achieve sustainable growth.

In short, the financial crisis is attributable to:

- Complacency within the sector, Government and regulators over the aggregate impact of deregulation - this stemmed from a **wholly unrealistic view of the value of the financial industry to the economy as a whole in terms of employment, growth and stability**;
- The **failure of real wages in developed nations (particularly in the UK and US) to keep pace with productivity growth**. This led to the creation of housing and credit bubbles to fill the wealth gap;
- Wildly optimistic expectations in relation to the impact of more widely dispersed risk - far from making markets less risky, **by spreading risk, the banks only managed to globalise the consequences of reckless lending in specific markets**; and,
- The gargantuan **incentives provided to those working in the industry,** which inevitably helped to embed a culture of recklessness. It is particularly frustrating that the largest rewards were provided to those who specialised in shifting or extracting value rather than creating it.

Re-regulation

Effectively regulating the financial markets is not easy and the case of the US post the stock market crash 2000-01 is instructive. Remarkably few lessons were learned following the stock market crash of 2000-01. No sooner had some modest reforms been enacted than banks and corporations invested in finding new ways to disguise damaging financial manoeuvres. While doing so, they lobbied hard against timid post-crash accounting reforms.

The regulatory response to the current crisis is bound to be imperfect. However, it stands a better chance of succeeding if:

- **Politicians end their auction of virtue on deregulation** – a very clear signal must be sent out from Government (and the Scottish Government has a role here despite not having direct responsibility for regulation of finance) that financial markets work most efficiently when they are carefully but effectively regulated. It is worrying that Scottish and UK ministers have sought to respond to the crisis by promising to reduce 'red-tape' and 'business burdens'. Events of autumn 2008 have only served to highlight the vacuity of the anti-government crusaders on the fringes of politics and media. The free-market economy is a myth. Regulation is a public good. Business regulation cannot remain static and must adapt along with the economy but *efficient economies require appropriate Government oversight and intervention*;
- **Regulators are sufficiently resourced to retain key staff and prevent regulatory capture**; and,
- **Regulation is kept as simple and straightforward as possible** – complex regulation is a gift to those seeking to avoid it.

The tripartite method of regulation involving the Treasury, Bank of England and Financial Services Authority failed its first big test i.e. the credit crunch and Northern Rock. Root and branch reform is required. In particular, regulators must take a far tougher line on renumeration and the security of new financial products. Specific measures should include:

- **Capital reserves** - As a minimum, banks must be forced to boost their capital reserves;
- **Separation of retail and investment banking** – the STUC does underestimate the difficulties in achieving this aim and recognises that breaking up banking conglomerates could provide a convenient excuse to further embed failed management practices. However, for the longer-term stability of the economy, separation is essential;
- **Securities trading** – The recent focus on short selling removed the spotlight from the irresponsible lending and securitisation that precipitated the 2008 crisis. This should be the first area for effective re-regulation. As Will Hutton18 has recently argued, all financial securities should now be traded in licensed exchanges by organisations whose accounts are subject to regular inspection and where bargains are routed through a central clearing house;
- **Renumeration** – as a first step, the Government must use the leverage provided by the bank rescue package to instigate real culture change in the banking sector. The era of excessive bonuses and rewards for failure must end now. It is wholly unfair that those least able to cope are left to bear the brunt of excessive risk-taking. If the culture doesn't change quickly, the Government should consider regulation to curb the excessive rewards which create dangerous and destabilising incentives. Other European countries, such as the Netherlands, Germany and France are considering legislating in this area.

But the wider culture of performance related pay and simplistic incentives must change. As noted above, the evidence stubbornly refuses to support the claims made for such systems. On the contrary, research continues to support the findings of one of the most influential management studies of all time carried out 50 years ago of psychologist Frederick Herzburg. Studying motivation at work, Herzberg concluded with the famous dictum: if you want people to do a good job, give them a good job to do.

PART 2 Rebalancing the Economy

Manufacturing

For the last decade, those who have spoken up for manufacturing have risked ridicule as conventional wisdom dictated that Government was impotent in preventing the loss of manufacturing jobs. Nevertheless, there is no denying the ongoing importance of manufacturing to the Scottish economy in terms of exports, direct and indirect employment and research and development[19]. Government is not powerless to prevent the decline of manufacturing employment and lessons must be learned from Germany and Sweden: high wage economies with a recent track record of successful investment in the productive sector.

The STUC believes that manufacturing – especially high value-added manufacturing – offers important benefits to society. Manufacturing:

- Creates wealth and drives further wealth creation;
- Drives innovation;
- Enlarges the pool of skills and good jobs;
- Is spread throughout the country (unlike financial services, concentrated in the major urban centres) and cements communities with many middle income/middle status jobs. Manufacturing is a force for social cohesion in a way that services are not; and,
- Encourages and supports local supply chain industries and services.

Oxford Economics has calculated that the external return – the return not captured by the company making the investment – from the £149bn R&D spending by British manufacturing is almost 30%. The external return from aerospace R&D is almost 60%. The social benefit is considerable. Therefore, there is a very strong case for further tax breaks for high-technology R&D.[20]

The share of domestic lending going to manufacturing fell from 5.2% in 1999 to an even lower figure of 2.3% in 2007 while the share going to other financial intermediaries rose from 25% to 31%[21]. Today patient investment in the companies of the future is an increasingly fringe activity compared with speculating on share prices, interest rates and currency movements. The Anglo-Saxon model continues to favour merger and acquisition over organic growth.

This structural problem is reflected in an interview with a City Analyst in a study by Manchester Business School: "*When I talk to the corporate managers of large German and Japanese companies, they speak of products, quality, customers and costs. They assume that if they produce innovative, high quality products at a competitive cost, they will do well and be profitable. With UK and US managers the opposite applies…many of them seem to be a million miles away from the real business*"[22].

Government must accept that it has a role to play in boosting manufacturing. The Scottish Government should:

- **Provide vision** – Ministers must talk about manufacturing more; making it a fundamental part of the Scottish Government's vision for a growing, vibrant Scottish economy;

- **Provide the Scottish Manufacturing Advisory Service with sufficient long-term funding** to achieve its ambitions. It is widely recognized that productivity must improve and SMAS is delivering demonstrable benefits in this regard;
- Establish a **Scottish Investment Bank** to provide patient, committed long-term capital to growing Scottish companies. This should build on the success, and seek to extend the work, of the Co-Investment Fund. The failure of Scotland's financial sector to support emerging Scottish industries[23] constitutes a structural problem and should be addressed as such;
- Working with stakeholders and using all the levers available to it, design and implement **a low carbon industrial strategy for Scotland**. This should be considered a key test of the Government's ambition;
- following the recent publication of the **UK Government's Manufacturing Strategy**, there should also be a thorough consideration of whether Scotland requires a stand alone manufacturing strategy or whether the Government's Economic Strategy and priority industry sectoral plans are sufficient in this regard;
- Building on the success of the Defence Industrial Strategy, **support industry through sectoral public procurement strategies**;
- Ensure that, where appropriate, Scottish firms are able to **derive** a **premium from Scottish production** (textiles, food and drink etc); and,
- **Boost skills by investing in STEM** (Science, technology, engineering and maths). This will also require a focus on in-work training.

Given the very substantial spillovers from investment in manufacturing R&D;

- the UK Government should provide **extra assistance through R&D tax credits**. It should also seek to establish fair international trade agreements that do not discriminate against indigenous production.

Green Jobs

To date, maximising the wider economic and employment benefits from developing Scotland's renewable energy sectors has appeared to be an afterthought to, rather than an integral component of, energy policy.

Given that Scotland's renewable energy resources are widely recognised to be the most abundant in Europe, our performance in generating jobs has been disappointing. Denmark, Spain and Germany have all built large, job-rich renewable sectors through a variety of means. The STUC believes that the UK and Scotland's poor performance in this respect reflects an unwarranted faith in markets to deliver socially beneficial outcomes and a deeply embedded antipathy to anything that smacks of industrial policy – other countries better understand that intervention is required in the early stages of development in order to secure technologies and ensure that employment is created.

Maximising industrial opportunities from the development of Scotland's energy sectors should be a core strand of economic strategy. Some initial actions could include:

- Using business support mechanisms (such as RSA and innovation support programmes) strategically to help develop technologies and secure these technologies within Scottish industry;

- A comprehensive research project to learn the lessons of other European countries;
- Within the context of the Planning Bill, and working within EU Competition Law, consider ways in which developers can be encouraged to use local content; and,
- Improve links between developers and Scottish manufacturers – we are not convinced FREDS or the Energy Community are effective mechanisms for this activity.

On 16 October 2008, the UK Government unexpectedly announced that it intended introducing a 'feed-in tariff' guaranteeing rates for renewable energy production. Perhaps surprisingly the US government announced that $16bn of the $700bn bank bail out would provide new green tax breaks for renewable energy, cleaner fuels and energy efficiency. The United Nations Environment Programme (UNEP) published a report calling for a Green New Deal that would not only cut emissions but help revive flagging economies. It cited five areas offering the best payback in terms of economic returns:

- Environmental sustainability and job creation;
- Clean energy and new technologies;
- Rural energy including renewables and biomass; sustainable agriculture including organic cultivation;
- Ecosystem infrastructure and reduced emissions from deforestation; and,
- Sustainable cities including green building and transport.

Given its resources, Scotland should endeavour to be at the forefront of the green industrial revolution. Scottish and UK administrations have a role to play in establishing an appropriate legislative framework backed by price signals adequate to accelerate the shift to a low carbon economy. This will include an appropriate price for traded carbon and massive investment in energy infrastructure.

However, much more can be done now within existing budgets to address the main barriers to growing environmental industries:

- The low price of environmental impacts;
- Weak investment and demand for green products and services;
- System failures that slow green transformation.

For instance, the Scottish Government should examine:

- Creating lead markets through '***Forward Commitment' procurement initiatives*** – learning from examples in Sweden and the US, the Government can play a key facilitatory role in developing programmes to design and sell innovative green products. Forward Commitment programmes draw together a group of organisations to define a need (i.e. a more energy efficient IT system). Bids are then sought to deliver a product or service that meets this need. The specification of the need will include a range of criteria that must be met and the procurement group commits to purchasing a minimum amount of the new product or service provided these criteria are met;
- Developing markets through ***public procurement*** – there are currently good initiatives at national and local authority level but these are often implemented in a piecemeal way and more needs to be done to ensure consistent use of environmental criteria in purchasing decisions;

- ***Better integration of public policy priorities*** to boost job creation – for example, Scotland could aim to develop an indigenous hydrogen economy for promotion at the Commonwealth Games in 2014: hydrogen facilities linked to Scottish wind farms could generate the power for a fleet of hydrogen fuelled buses for use at the games. With the appropriate level of ambition and support, there is no reason why these vehicles should not be designed and manufactured in Scotland.

PART 3 A Fair and Secure economy

Since the Thatcher and Reagan years, there has been what Robert Kuttner the US writer, academic and founder of *The American Prospect* describes as a steady and effective '*depoliticisation of economic ills'*[24]. The public has been conditioned to accept that the invisible hand of the global economy is behind growing economic inequality and insecurity and that there is little or nothing national governments can do to reverse these trends - even if they so desired. Individuals may bemoan the adverse impacts on their own lives brought about by the 'financialised' system but they don't believe that politics can provide a remedy.

Contrary to prevailing myths, there is nothing about the structure of the new economy to prevent the development of an economy where prosperity is more broadly shared.

Common explanations for widening inequality include skills biased technological change (SBTC), immigration and trade. Some find the SBTC hypothesis particularly convenient: the timing appears to work with inequality growing alongside the expansion of trade; economists are attracted to an explanation based on supply and demand and politicians can plausibly argue that growing inequality isn't their fault.

But, as Paul Krugman[25] recently awarded the 2008 Nobel Prize for Economics has pointed out, these explanations, at best, suggest a rising gap between less-educated and more-educated workers. What has actually happened to wages in the US and to a lesser extent the UK over the past 30 years is that the big gains have gone to a narrow group of extremely well paid people.

The intellectual tide is turning against the Skills Biased Technological Change thesis and instead researchers are increasingly producing work that explains growing inequality in terms of changing norms and institutions. Krugman points out that:

> *"The observation that even highly paid educated Americans have, for the most part, seen their incomes fall behind the average, while a handful of people have done incredibly well, undercuts the case for SBTC as an explanation of inequality and supports the argument that it's largely due to changes in institutions, such as the strength of labour unions, and norms, such as the once powerful but now weak belief that having the boss make vastly more than the workers is bad for morale"[26].*

The idea that changes in institutions and norms, rather than anonymous SBTC explain rising inequality has been gaining growing support among economists; for two main reasons: first an institutions and norms explanation of rising inequality today links current events to the dramatic fall in inequality – the Great Compression[27] – that took place in the 1930s and 1940s. Second, an institutions and norms story helps explain American and UK exceptionalism. No other advanced country has seen the same kind of surge in inequality that has taken place in the US and UK

The greater equality that western economies experienced in the post War 'great compression' was not the automatic result of high growth rates and relatively tight labour markets although the latter were helpful. Rather, economies benefited from a variety of deliberate equalising institutions – such as strong trade unions, redistributive taxation and high minimum wages - that moderated the tendency of a laissez faire economy to produce an income distribution of extremes.

If increasing inequality is the inevitable result of globalisation then it is reasonable to assume that similar trends should be apparent in all developed economies but this isn't the case. Researchers[28] looking at patterns of inequality in western democracies found that there are considerable differences in the level of disposable income inequality across rich countries: Mexico and Russia have the most unequal distributions followed by English speaking countries. Other European countries come next and the Nordic nations show the lowest level of inequality. This clustering 'owes much to the national tax and benefits systems which have a considerable role in narrowing the original market income distribution'.

The researchers conclude that:

> *"Changes in inequality do not exhibit clear trajectories but rather irregular movements, with more substantial changes often concentrated in rather short lapses of time. Together with the lack of a common international pattern, this suggests to look at explanations based on the joint working of multiple factors which sometimes balance out, sometimes reinforce each other, rather than to focus on explanations centred on a single cause like deindustrialisation, skills-biased technological change or globalisation. Identifying and characterising episodes and turning points in the dynamics of inequality may reveal more fruitful than searching for overarching general tendencies"*[29]

MIT economists Frank Levy and Peter Temin have led the way in explaining how changes in labour market instituions and social norms have worked to increase inequality. Their study of inequality and institutions in the US, concluded:

> *"…. that the current trend toward greater inequality in America is primarily the result of a change in economic policy that took place in the late 1970s and early 1980s. The stability in income equality where wages rose with national productivity for a generation after the Second World War was the result of policies that began in the Great Depression with the New Deal and were amplified by both public and private actions after the war. This stability was not the result of a natural economy alone: it was also the result of policies designed to promote it"*[30].

What policies are required to ensure that Scotland's citizens benefit from a fairer share of the economic cake?

Taxation

The STUC believes that the current crisis provides an opportunity to address the complexity and manifest unfairness in the UK taxation framework. A fair and progressive tax system must be a key element of any viable attempt to address the massive inequality that persists in the UK and Scotland. The failure to collect a fair tax contribution from super-wealthy individuals and corporations[31] is unsustainable if sufficient investment in public services is to be maintained.

The success of corporations and the super rich in convincing Governments around the world that increasing the concentration of wealth in their hands benefits all of us is extraordinary. The durability of the trickle down philosophy is attributable to a radical but cleverly managed partnership between sections of the political and media classes particularly in the US and UK. It is certainly not attributable to a sound evidential base – academic economists have thoroughly debunked the case for continuing tax cuts for the wealthy as an economic stimulus[32].

At a time when the income of ordinary people is being squeezed in every direction, it is right to seriously examine just what has gone wrong with taxation policy in the UK. Wages have barely kept pace with the rate of inflation. The pre-tax annual median income of full-time UK workers is around £23,674 and some 25% of full-time employees earn less than £17,000 a year. Millions of workers are not even paid the minimum wage that they are entitled to. Buying a house is a virtual impossibility for many if not most workers. The poorest fifth of UK households pay 36.4% of their income in taxes: 9.5% in direct taxes and 26.9% in indirect taxes. The top fifth pay 35.5% of their income in taxes: 24.7% in direct taxes and 10.8% in indirect taxes[33].

It is disappointing if not, sadly, too surprising that despite the super-rich continuing to accumulate wealth on a monumental scale, mainstream political efforts to curb this massive upwards redistribution are conspicuous by their absence.

The fair taxation of corporations and wealthy individuals is consistently ruled out on the grounds of ‘competitiveness’. This reflects a worrying fracture in the relationship between state and markets. In the past, it was widely accepted that a balance could be struck between the demands of economic growth and of social protection because the nation state was in a powerful position to impose effective regulation. But globalisation is generally believed to have shattered that balance. The consequence is that the benefits of growth increasingly accrue to corporations whilst responsibility for funding vital public services increasingly falls on the ordinary worker.

Fairness and Business Taxation

It is frustrating that in the early years of the 21st century, the case for fair taxation of business still has to be made. The global drive to reduce corporate taxation has the most powerful of supporters but is not widely perceived to be a threat to the sustainability of mature western democracies.

Those who campaign for reductions in business taxation are guilty of displaying hypocrisy and inconsistency. The 2007 PBR’s plans for simplification of CGT met with unfounded and often quite hysterical objections. Exaggeration and distortion of the nature and scale of business taxation is endemic and the positive case for business taxation is hardly ever promoted in the public realm.

As Richard Murphy, Director of Tax Research LLC, succinctly puts it:

"*Tax is not a cost to a company. It is a distribution out of profits. That puts tax in the same category as a dividend - it is a return to the stakeholders in the enterprise….This reflects the fact that companies do not make profit merely by using investors' capital. They also use the societies in which they operate, whether that is the physical infrastructure provided by the state, the people the state has educated, or the legal infrastructure that allows companies to protect their property rights. Tax is the return due on this investment by society from which companies benefit*."

Tax avoidance is a major and growing problem in the UK. Those who deliberately avoid paying fair taxation are guilty of ignoring basic standards of fairness. Corporations are able to generate profits because they have access to our markets, and make use of our workforce, legal system and transport system. Basic fairness therefore dictates that corporations have responsibilities to society, and the very minimum of meeting those responsibilities should be meeting the full tax contribution.

The introduction of a new additional higher rate of income tax of 45% for those with incomes above £150,000 from April 2011 in the 2008 Pre-Budget Report signalled a welcome if long overdue change in direction. This must be built upon with the aim of establishing a fair fiscal framework which:

- Is truly progressive, ensuring that all income taxes have progressive rates and that indirect taxes operate with exemptions to assist the poor;
- Ensures that the capital gains tax regime does not offer significant tax incentives when compared to income taxes;
- Includes fair and proportionate inheritance taxes;
- Removes allowances only available to the wealthy; and
- Seeks to apply the mantra of global solutions to global problems to the issue of corporate taxation and tax avoidance.

The current downturn has prompted numerous demands for business taxation to be cut, but as far as we can ascertain, not a single demand for benefits to be increased despite the proven effectiveness in raising demand.34

The STUC repeats the recommendations included in our earlier discussion paper Supply Side Scotland?

- Scotland desperately requires a mature debate on taxation – particularly the tax levelled on business. Scotland's political parties must recognise supply-side economics for what it is. Scotland has nothing to gain from adopting policies that have achieved nothing for the US economy apart from to redistribute wealth to the already super-rich.

- Scotland's political parties must start to articulate why it is appropriate for business to pay its fair share of taxation. Similarly, they should strive to be balanced about what cutting taxes for business in Scotland is likely to achieve. This will require commissioning the appropriate empirical work and working to improve the quality and breadth of Scottish economic statistics.

- The UK and Scotland require a fair fiscal framework – one that is truly progressive, ensuring that all income taxes have progressive rates and that indirect taxes operate with exemptions to assist the poor; ensures that the capital gains tax regime does not offer significant tax incentives when compared to income taxes; Includes fair and proportionate inheritance taxes and removes allowances only available to the wealthy.

- Tax avoidance by UK business is a serious problem. Recent estimates put the cost of avoidance at around £40bn a year – enough to wipe out public sector debt. The STUC supports the recommendations of the TUC report, The Missing Billions – the UK Tax Gap including the introduction of a new law called a 'general anti-avoidance principle' that treats all tax avoidance as unacceptable and therefore open to challenge.

- A National Commission on the Distribution of Wealth and Income should be established to consider the type of fiscal framework necessary to fund the requirements of a mature western democracy in the 21st century.

- The UK Government should act to increase cooperation on tax internationally to ensure companies are held to account for where and how they operate and are required to act as good corporate citizens, including payment of their dues to society as a whole.

- The impact of new policy instruments – such as the Scottish Government's Small Business Bonus Scheme – must be effectively monitored and evaluated.

The STUC supports the recommendations on tax reform included in the Green New Deal report[35], published by the New Economic Foundation in July 2008:

- We must do away with the overly generous UK tax relief on the interest paid on money borrowed in the UK but used to finance a foreign business. This is simply using the UK tax system to subsidise foreign operations, and that is absurd.

- We need to commit to working with the EU on the Common Consolidated Corporate Tax Base. This should include moving towards agreed methods of apportioning profits that eliminate most profit being artificially relocated to tax havens from consideration when allocating profits to countries. It has been shown that the UK would be eight per cent better off if it used such a system of apportionment.

- We need to know where companies are, and what they are doing in each location in which they operate. The UK must back a call for country-by-country accounting, which can provide enormous benefits by showing what global companies are doing and where in order to facilitate appropriate taxation. At the moment this kind of accountability of corporations to their host countries is absent. The tendency of capital to roam unfettered around the world has to be challenged.

- We need a general anti-avoidance provision in UK law, to provide the flexibility to neutralise the more esoteric forms of tax planning as they happen, and not retrospectively.

- We need to strengthen transfer pricing provisions on payments to offshore havens if it cannot be demonstrated that the intellectual property located there was generated in the place to which payment is made. This is key: intellectual property is not created offshore, it is relocated there. If intellectual property cannot be shown to have arisen in the place in which payment is to be made, then the UK should not allow tax relief.

Trade Union Rights

Reflecting a stunning shift in the intellectual climate in the US, 40 prominent economists including 3 Nobel Laureates have signed up to statement[36] supporting the Employee Free Choice Act which, if implemented, will make it easier for trade unions to organise in US workplaces.

The statement includes the following line: ‘A rising tide lifts all boats only when labour and management bargain on relatively equal terms’. This simple statement undermines the orthodoxy that has underpinned economic policy for 3 decades.

President Obama shares the views of liberal Democrats that the best way to address stagnating real incomes is to strengthen the bargaining power of organized labour which is why he is supporting Employee Free Choice. As Will Hutton[37] recently noted, the ideology that led to US officials vetoing OECD reports that dared question the merits of flexible labour markets has evaporated with the new administration.

Given the influence that the US continues to exert over policymaking in the UK, the STUC is hopeful that progress can be made on trade union rights. We believe that the moral and intellectual case for a new deal for unions in the UK and Europe is now overwhelming and therefore support:

- the repeal of all anti-trade union laws.
- the introduction of new laws which enshrine instead:
  - the rights of workers, without penalisation, to take industrial action (including solidarity action and action to secure recognition) and to be represented by their unions; and
  - the rights of unions to draw up their own constitution free from state and employer interference and to be recognised by employers for collective bargaining where workers so wish it; so fulfilling the Uk’s international law obligations under UN Covenants, the ILO Conventions, and the Social Charter of the Council of Europe.
- workers and unions penalised or threatened by the anti-union laws or which adopt a policy of non-compliance with those laws.
- anything lawful intended to further these objects or ancillary to the furtherance of them.

The STUC also supports trade unions in different parts of Europe involved in legal conflicts, where fundamental labour rights and the free movement provisions for the single market collide. The first and best-known case is the Laval case (also known as the *Vaxholm* case). Four other cases – Ruffert in Germany, Viking in Finland, Irish Ferries in Ireland and Luxembourg have similar dimensions.

The STUC believes that the core issue raised by these cases, the balance between the economic and the social aims of the European Union, impacts on the future orientation of the EU. Thus, the rulings have far-reaching implications for trade unions and workers in Europe, and for fundamental workers' rights, collective bargaining and industrial action in the Member States. They are closely linked to issues such as the Services Directive.

Decisions by the European Court of Justice (ECJ), in December 2007 and April 2008, have been largely negative for trade unions. Therefore the STUC supports the ETUC's demand for a "Social Progress Clause" to be linked to the Lisbon Treaty, firmly establishing that the Treaty and especially its fundamental freedoms shall be interpreted as respecting workers' rights and collective action.

Globalisation

Interestingly, as the Harvard economist Dani Rodrik[38] has recently pointed out, the intellectual consensus has started to turn against the model of globalisation promoted by international institutions over the past couple of decades. Distinguished mainstream economists, such as Paul Samuelson, Larry Summers, Paul Krugman, Alan Blinder and Martin Wolf have all expressed disappointment with aspects of globalisation; particularly its failure to raise living standards in both the developed and developing world. Whilst none of the above argue for trade barriers, they do wish to see the creation of new institutions and compensation mechanisms that will render globalisation more effective, fairer and more sustainable.

Globalisation as currently practiced is politically unsustainable for reasons Rodrik outlines in the same article:

> "*Unlike national markets, which tend to be supported by domestic regulatory and political institutions, global markets are only "weakly embedded." There is no global monopolies authority, no global lender of last resort, no global regulator, no global safety nets, and, of course, no global democracy. In other words, global markets suffer from weak governance, and therefore from weak popular legitimacy".*

Even Jagdish Bhagwati, Professor of Economics and Law, Columbia University one of globalisation's most passionate and effective advocates is arguing for changes to national institutions in order to develop a free trade compatible approach to deal with what he identifies as the overriding economic problem facing the US: the long-standing stagnation of workers' real wages. He therefore supports the Employee Free Choice Bill arguing that it is critical to both rebuilding the US economy and strengthening its democracy[39].

The mantra of 'global solutions for global problems' was often heard during the financial crisis. It is time we seen this applied to a range of measures which would help to equalise the benefits and disbenefits of globalisation. As a start, as proposed by the World Commission on the Social Dimension of Globalisation[40], minimum labour standards should be rigorously enforced as part of trade agreements. This is not about introducing protectionism by the back door by insisting through trade agreements that labour standards in developing countries must match standards in the developed world.

But it is about recognising that the conditions and pay of ordinary workers in developing countries will not improve if trade agreements continue to insist on standards in environmental and property rights whilst completely overlooking labour standards. It is essential that respect for core labour standards forms part of a broader international agenda for development and that the capacity of the ILO to promote them is reinforced. This will involve mobilising the multilateral system as a whole and strengthening this goal in the actions of governments, enterprises and other the actors concerned:

- First, all relevant international institutions should assume their part in promoting the core international labour standards and the Declaration on Fundamental Principles and Rights at Work. They should ensure that no aspect of their policies or programmes impedes implementation of these rights.

- Second, where the failure to realize these fundamental principles and rights at work is due to a lack of capacity rather than political will, existing technical assistance programmes for the implementation of standards should be stepped up, including the strengthening of labour administrations, training, and assistance to the organization of workers and enterprises. This should include reinforcement of existing action to eliminate child labour.

- Third, the ILO itself should be strengthened by increasing the resources available for fair and appropriate supervision and monitoring, for promotional assistance, and for the Follow-up to the Declaration on Fundamental Principles and Rights at Work and other procedures established in the ILO's Constitution.

- Fourth, where persistent violations of rights continue despite recommendations of the ILO's supervisory mechanisms, enforcement of these labour standards could be pursued through Article 33 of the ILO's Constitution, which in the event of non-compliance with a ratified Convention authorizes the ILO to take action to secure compliance[41].

<u>Conclusion</u>

The STUC believes that the financial crisis and subsequent recession represent a failure of politics on a grand scale. The parties will argue over who is to blame for what but it is clear to Scotland's trade unions that all Scotland's political parties were complicit in propping up the failed economic model. All bought into the myth that wanton deregulation and low business taxes are a prerequisite for economic success. All failed to recognise that the weakening of the economy's equalising institutions would have a profoundly detrimental impact on equality, social mobility and cohesion. Most importantly, all failed to recognise that their often laudable social objectives could not be reconciled with a growth model that inevitably concentrated wealth in the hands of a tiny portion of society.

In our submission to the Scottish Government in advance of its new Economic Strategy, the STUC quoted Mica Panic, Cambridge economist and ex MPC member on modern economies requiring a highly complex collective effort to function effectively:

"To achieve important economic and social objectives under these conditions requires solidarity, widespread commitment to the same goals and an equally widespread commitment on how to realize them. None of this is possible without a collective 'harmony of interests' – achieved by a high degree of social inclusion and a distribution of the benefits from economic progress which is generally regarded as fair. People will give full support to economic change when they have a stake in it. An economic system designed specifically for the benefit of a privileged minority is bound to be sub-optimal and ultimately fail"[42]

The economic model pursued by the UK government and global institutions over the past two decades has singularly failed to achieve a 'harmony of interests'. Indeed it has led to greater economic risk to the system and greater disparity in the allocation of risks and rewards for individuals.

Policies which have been generally prejudiced in favour of the market, valued services over production and 'light touch' regulation of finance appear to have left the UK particularly exposed to current global pressures. The relaxed attitude, some would say complacency, towards the staggering accumulation of debt in the economy has also been a salient feature of economic management over the past decade.

The STUC believes that:

- The economic and social model pursued by successive UK governments over the past twenty years has failed;
- Contrary to popular perception, structural changes have not readied the UK for the global downturn - rather, they have weakened our ability to cope;
- Growth must be inclusive; at the very least a majority of citizens must benefit. Trickle down economics do not work: an increase in GDP can leave most people worse off. Recent growth has not been either economically sustainable or sufficiently inclusive;
- A modern economy also requires risk-taking. Individuals are more willing to take risks if there is a strong safety net. The lack of such a safety net will increase pressure for protection from foreign competition. Social protection is more efficient and just than trade barriers; and
- The period of broadly shared growth post-second world war was underpinned by strong trade unions, sharply progressive taxation and controls on the free movement of capital - there is no reason that similar policies cannot ensure that growth is once again more broadly shared.

STUC April 2009

(Endnotes)

[1] http://www.stuc.org.uk/policy/economic-industrial-policy/discussion-papers-series

[2] The US economist Thomas Palley describes the principal impacts of financialisation as (1) elevating the significance of the financial sector relative to the real sector; (2) transferring income from the real sector to the financial sector; (3) contributing to income inequality and wage stagnation. *See Financialisation: what it is and why it matters*, Thomas Palley, Political Economy Research Institute, November 2007

[3] During the banking crisis it was often argued that 'no-one saw this coming'. In fact, countless articles and books were written about the inevitably of a crash. Palley's article above is one such example as are Larry Elliot and Dan Atkinson's books Fantasy Island (2007) and the Gods that Failed (2008).

[4] http://www.scotlandoffice.gov.uk/scotlandoffice/11521.html

[5] http://www.scotland.gov.uk/Publications/2009/01/GDP2008Q3

[6] http://www.guardian.co.uk/commentisfree/cifamerica/2008/oct/22/economy-financial-crisis-regulation

[7] Pg 3, BIS Annual Report 2008 http://www.bis.org/publ/arpdf/ar2008e1.pdf

[8] The big freeze: A year that shook faith in finance, Financial Times, August 3 2008

[9] http://www.berkshirehathaway.com/letters/2003ltr.pdf

[10] http://www.guardian.co.uk/commentisfree/2008/aug/04/economicgrowth.useconomicgrowth?gusrc=rss&feed=worldnews

[11] See for instance, The Credit Crunch, Graham Turner, Pluto Press, 2008

[12] The most authorative account is provided by Stiglitz in Globalisation and its discontents and Making Globalisation Work

[13] High Earners Need to be Brought Down to Earth, Simon Caulkin, Observer, October 19 2008 http://www.guardian.co.uk/business/2008/oct/19/banking-salaries

[14] http://business.scotsman.com/royalbankofscotland/Fred-Goodwin-The-boy-from.4587548.jp

[15] See for instance, http://www.dailymail.co.uk/news/article-1079277/Lloyds-TSB-staff-WILL-bonuses—bank-5-5bn-Government-bail-out.html

[16] See (10) above

[17] See for instance Hard Facts, Dangerous half Truths and Total Nonsense, Jeffrey Pfeffer and Robert Sutton a forceful plea for evidence based management or the psychologist Frederick Herzberg's classic study on motivation at work.

[18] http://www.guardian.co.uk/commentisfree/2008/oct/12/marketturmoil-creditcrunch

[19] The STUC published an Economy Discussion Paper, The Future of Manufacturing Industry in Scotland in April 2008: http://www.stuc.org.uk/policy/economic-industrial-policy/discussion-papers-series/the-future-of-manufacturing-industry-in-scotland#introduction

[20] Pg 8, The Return of Manufacturing in Britain, Prospect magazine supplement, September 2008

[21] Pg 15, Do the Super-Rich Matter, Stewart Lansley, TUC Touchstone Pamphlet 2008

[22] Froud, Johal, Leaver & Williams; Financialisation and Strategy, Routledge 2006

[23] Renewable energy is a case in point. See STUC Manufacturing Discussion Paper cited above for examples.

[24] Pg 45, The Squandering of America, above citation

[25] See pgs 124-152 in Paul Krugman's, The Conscience of a Liberal (2008) for a discussion of this issue.

[26] Pg 136 above citation

[27] The phrase used by economists Claudia Goldin and Robert Margo to describe the deliberate creation of a more equal society in the US through the politics of the Roosevelt administration.

[28] Pg 22, , Inequality Patterns in Western-Type Democracies: Cross Country Differences and Time Changes, Brandolini and Smeeding 2007

[29] pg 23, above citation

[30] pg 41, Inequality and Institutions in 20th Century America, Levy and Temin, MIT Department of Economics Working Paper 2007

[31] See for instance Public Accounts Committee Report 'Management of Large Business Corporate Taxation' October 2007& TUC Touchstone Pamphlet, The Missing Billions – the UK Tax Gap.

[32] See STUC Discussion Paper, Supply Side Scotland? Published in April 2008 http://www.stuc.org.uk/policy/economic-industrial-policy/discussion-papers-series/supply-side-scotland-taxation-fairness-and-the-scottish-economy

[33] http://www.guardian.co.uk/commentisfree/2008/jan/20/howtoavertarecessioncuttaxes

[34] Brookings Institute http://www.brookings.edu/~/media/Files/rc/papers/2008/0110_fiscal_stimulus_elmendorf_furman/0110_fiscal_stimulus_elmendorf_furman.pdf

[35] http://www.neweconomics.org.uk/gen/uploads/2ajogu45c1id4w55tofmpy5520072008172656.pdf

[36] http://epi.3cdn.net/1eb9aba51935a5b82b_13m6iixpt.pdf

[37] http://www.newstatesman.com/north-america/2008/11/obama-american-british-pro

[38] http://www.guardian.co.uk/commentisfree/2008/jul/31/economy.globalisation

[39] http://www.tnr.com/politics/story.html?id=a4edc34f-7670-4e85-a43d-16f3023f2b35

[40] A Fair Globalisation – creating opportunities for all, World Commission on Globalisation, ILO 2004

[41] Ibid pg 91

[42] Pg 151, Does Europe need neoliberal reforms? Mica Panic, Cambridge Journal of Economics 2007, 31