The UK government and intervention

(Gerard Lyons)

21 July 2021

Should a government provide subsides and intervene in the economy? This is an area of focus and some controversy following the recent decision to provide a government subsidy to Nissan and intervention to aid the steel sector.

One could be forgiven for thinking that the biggest criticism of such government intervention was from those arguing to reduce the size of the state. Government spending is, after all, at high levels, and the tax take, in relation to the size of the economy, at an all-time high. In fact, the biggest criticisms appeared to be from those wishing we were still in the EU, or so it seemed. Notwithstanding that, what is the issue?

Here, above all areas, there is a need to watch what governments do and why, as opposed to listen only to what they say. A commitment to free and open markets does not seem to stop governments intervening when domestic politics dictates that they should. That is always a challenge.

Outside the EU, the UK has the ability to set policy to suit its domestic agenda. This allows scope for deregulation. It also allows scope to intervene more, subject to the terms of the Withdrawal Agreement with the EU that impose constraints particularly with respect to Northern Ireland. Whether it should want to do so is another issue.

The fact that the Government provided a subsidy to Nissan recently to help ensure it proceeded with a new gigafactory in the north-east should not be viewed as the new normal or undermining the significance of the announcement of Nissan's investment. Perhaps it a reflection of this policy area where China, Japan and South Korea lead in such battery technology and that governments across western Europe are reaching out with large subsidies to attract such gigafactories. Indeed, earlier this year it was reported that the German central and regional governments provided subsidies totalling around £880 million to Tesla[1] to build a gigafactory near Berlin. Official subsidies seem to play a role in attracting the growing number of such factories across western Europe. Such official subsidies by other countries has been somewhat overlooked in this debate and highlights how this is not an issue based on economics alone.

The question then, should be, what was the purpose of the intervention? If it is part of an industrial strategy then it immediately becomes vulnerable to the criticism, why should governments be able to pick winners? They can't. If it is part of job creation, then that too tends to be vulnerable to criticism, for it were to be the thin end of a policy of constant interventions that the costs of all these policy interventions have to be borne by raising taxes across the wider economy, which would tend to dampen economic activity and likely job creation elsewhere.

Such subsidies can be criticised for a number of reasons. They reflect decisions made by politicians.

They may reflect lobbying pressure by the firms involved, although in this case we do not know whether that is the case. Of course, though, the more that firms become aware of such subsidies the more likely they are to push for them, and it becomes harder for the government to resist.

They may be unneeded and thus wasteful, costing the taxpayer money while helping boost the profits of the corporate that receives the subsidy. The latter is all the more ironic given the recent official focus on higher corporate tax rates.

In the case of electric cars, notwithstanding the fact that most governments in western Europe seem to be providing subsidies, it can be legitimately asked, would not the firms invest in this area anyway? Such interventions appear rarely justified on economic grounds alone.

The challenge for the government is for the assistance to Nissan to be seen as a specific case to stop pressure building across the board for handouts. Of course help need not be direct subsidies but could include other help such as agreeing to provide better local infrastructure. There is an incumbency effect with Nissan; as the firm is already based in the north-east, with skilled workers, so why risk losing it. In that case, not only is this investment in Sunderland a positive in its own right, but it also has wider strengths in terms of the regional supply chain. It will lead to increased localisation, with higher local content.

As for the intervention in steel, it is far from clear what is the aim. As my colleague Warwick Lightfoot points out, “There is a rump of specialist steel manufacturing that may well be needed as part of defence procurement and technology innovation.” Moreover, this is a different era to the past, and thus, “these ad hoc emergency decisions are being made in a context where there are no proper nationalised industries as such on the British Steel, British Gas or BT whole industry command and control model run by the Secretary of State with external financing limits wholly controlled and decided by the Treasury expenditure white paper.” Indeed, we are a long way from that.

Such state help should not be the norm, but it is hardly new to UK governments, of all persuasions. For instance, help to Nissan is not new. As Nigel Lawson explains in his memoirs, ‘*The view from No. 11’*, “We therefore had to devise a general alteration to the (Finance) Bill which would have the effect of exempting Nissan, while exempting as little else as practicable”. He was referring to his decision to phase out first-year capital allowances in his first Budget as Chancellor in 1984.

In 1981 it had been announced that Nissan would establish an assembly plant in County Durham. As Lawson pointed out, “Among the factors they had taken into consideration was the prospect of enjoying the 100 per cent first-year capital allowance, and the Chairman of Nissan had a letter from Margaret (Thatcher) alluding to this carrot. But by the time they came to build the plant these allowances would have disappeared under my Budget plans.” Thus, he had to find ways to get around this. This took the form of exempting from the phased withdrawal of capital allowances, investment projects in development areas, providing they had already been announced. The arcane language in which Finance Bills are drafted, as Lawson notes, allowed this clause to proceed without it being realised and thus preventing a barrage of claims for special treatment.

More than any other post second world war UK administration those decisions in the mid-80’s were made by ministers who were committed to, and understood the market economy but it did not obscure them from necessary public intervention.

The aid to Nissan now has also been tied up with the post Brexit debate too. There has also been some recent debate that the UK could have intervened had it stayed in the EU, as France and Germany do. The answer to that is that there are many things the UK could – and indeed

should – have done while in the EU, just as there will be much it can do outside. It seems like a superfluous argument.

Outside, the UK will be bound by WTO rules, which in this area prohibit subsides that cause harm across countries. In theory the EU rules were tougher but in reality it is hard to say. State aid was not allowed when the UK was in the EU, being seen as anti-competitive across member states. Yet, there was significant state aid, even pre-pandemic, with an Institute of Government analysis last September, based on the latest available data for 2019, for instance showing Germany fifth highest spender in this area.[2] The UK was low down the list. The Commission also imposes fines but that does not stop countries who flout the rules.[3] Within the EU, state aid was allowed when there was a market failure, among others. Market failures are a notoriously troublesome area as the market outcome is compared with a hypothetical text-book example, often of free competition, that may not exist. Often the better economic solution would be to remove distortions or barriers, not to intervene further.

In all these examples of state aid, or potential government help, it is important to compare interventions with realistic alternatives not with text-book situations that may not exist. That argues for a degree of pragmatism.

A genuine commitment to the use of markets, with firms facing a high degree of competition and the price mechanism does not, of course, require a loss of perspective about market externalities and benign as well as beneficial outcomes, including the under provision of certain types of goods. These are issues.

The challenge though raised by recent policy decisions is twofold: how we emerge from the pandemic; and the longer-term direction of travel.

The last eighteen months have been exceptional because of the pandemic. The unpreparedness of the U.K. and the ad hoc nature of the policy response in health and economic terms were not unique to us but evident across all western economies. Decisions had to be taken quickly and some were right, as the vaccine roll-out testifies in health terms while in economic policy the furlough scheme prevented sharply higher unemployment, and some undoubtedly wrong, as a subsequent inquiry will no doubt show.

There will be lasting legacies in many areas of health and economics. The crisis has also led to unconventional monetary and fiscal policies, with a significant increase in the role of the state, in the UK and globally, too, with public debt at its highest share of global GDP. This has led to an unprecedented expansion of the balance sheets of central banks as they have bought sizeable amounts of debt as public sector debt has risen sharply.

Such a situation should not lead to the perception that there is magic money tree, with debt able to rise constantly, nor to the idea that in the future state intervention can be justified always. There is a role for fiscal policy to play, particularly in response to economic shocks. Indeed, the excessive reliance on monetary policy as a shock absorber over the last decade, or so, has fed asset price inflation, and could be feeding wider inflationary pressures now while also resulting in financial markets not pricing properly for risk. Also, the set of circumstances of low inflation, rates and yields has allowed room for fiscal manoeuvre, justifying the attraction of public investment in infrastructure where returns exceed borrowing costs. But the debt still has to be repaid, ideally through stronger economic growth that boosts tax revenues, and allows the ratio of debt to GDP to be reduced gradually, over time.

In all of this to criticise the government for its interventions recently in areas such as car manufacturing and steel would seem low down on the list of areas of concern. There is also a need to differentiate between near-term tactics and the longer-term vision.

If one was to criticise it would not be about help to Nissan or to steel, but top of the list would be the absence of any clear economic vision. A pro-growth strategy is needed. Governments should not micro-manage, deciding on a case-by-case basis where to give industrial handouts, but they should have a clear policy direction, underpinned by the right incentives such as tax as low as possible and by smart, not unnecessarily burdensome regulations.

With the right policy, in my view, the U.K. could hope to raise its economic growth rate, perhaps significantly. At Policy Exchange, last year, we argued for a pro-growth market friendly economic strategy predicated on the three arrows of: a policy of monetary and financial stability; credible fiscal activism aimed at reducing the ratio of debt to GDP; and a supply side agenda based on innovation, investment, infrastructure and incentives centred around low taxes and appropriate regulations.

Yet the absence of such a strategy owes as much to the aftermath of the 2026 Referendum, the unwillingness of many across Whitehall and Westminster to accept the result and move on, and a subsequent political crisis that led to an EU exit strategy that has tied our hands somewhat on domestic policy. Now that needs to be unravelled. The U.K. has left the EU and it is time to move on. Subsequently, the pandemic has absorbed the focus of policy since last spring.

I am not surprised by the PM's belief in public investment. In 2014, in '*The consolations of economics'*, I outlined the drivers for the world and UK economy and one of a number of conclusions was the important role that the public sector can play in a successful economy.

A successful economic vision needs to reflect the reality of where we are: the UK is an imbalanced economy, hence the focus on levelling up although that is not the only answer, and an ever changing global economy, including the need to focus on the IndoPacific and on our science and technology bases, among others. There are many more areas besides. These issues should help put in context the present concerns about necessary public intervention.

As Geoffrey Owen has pointed out in his forthcoming Policy Exchange paper on innovation[4], "Basic research has to be financed mainly by government because there is little incentive for private sector firms to invest in it. The role of government is all the more important in the light of the decline or disappearance of many of the large industrial companies, such as Bell Laboratories and Xerox in the US, or lCI in the UK, which in the earlier post-war years had the financial resources to invest in long-term speculative research."

National security is also an issue here. This is evident most recently in the decision of the PM to refer to the National Security Adviser a buy-out by a Chinese firm of a semi-conductor plant in Newport, which in turn has halted the Welsh Government's existing plans to invest in it.[5]

As with this whole area, it argues for greater clarity about policy. In the case of relations with China, for instance, the argument is in favour of clearer red-lines, with defence, security, intelligence as well as strategic areas like technology on one side, and not permitted, while on the other, businesses and financial firms may be free to engage in business in non-strategic areas. More generally, the aim is for greater clarity aimed at minimising uncertainty. When, for

instance, the National Security Adviser reports on the Newport plant, it would be helpful it was outlined in this case why Chinese ownership does, or does not, affect national security.

The issue of state aid and subsidies also has a local dimension to it that could become more important in the context of fiscal devolution. In the past, the question was whether to comply with state aid rules, regeneration projects were awarded to national contractors, rather than permitting local contracts to local business. However, the so-called Preston Model has evolved[6] aimed at boosting local procurement. Writing in 2018, Aditya Chakrabortty cited research that for every pound spent with a small or medium-sized firm, 63p is respent locally, dropping to 40p if given to a large or multinational company.[7]

Tactically, and strategically, the state always has a role to play in an economy. It is never a case of thinking state good private sector bad. Neither is it always the opposite, although market driven solutions are nearly always preferable to those determined by bureaucrats. The market mechanism works but that is not the same as having unfettered capitalism where it is always the market that is allowed to dominate – and significantly in my view there is a case for stakeholder over shareholder capitalism and that the environment has moved on from Milton Friedman's view that the only duty of business was to deliver money to shareholders with the market expecting firms to be acutely aware of the wellbeing and training of their staff, which admittedly good firms usually are, and of the social impact of their activities. In part, the absence of a clear economic strategy and vision has raised this issue to centre stage, in the context of what is the role of the state in the economy.

There is always a role for the public sector to play in any economy. This should not be at the expense of the private sector. It does not justify increased higher government spending and taxes as in fact the opposite is called for. A vibrant private sector is necessary for any economy to succeed. Even China is demonstrating that, as it opens-up. The most successful economies, where income standards rise and tax revenues help fund public spending are driven by the private sector.

[1] Reuters, 1st February, 2021, 'Tesla set for at least 1 billion euros in German subsidies – Business Insider', https://www.reuters.com/article/us-germany-tesla-funding-idUSKBN2A12SF

[2] Institute of Government, 'State aid rules after Brexit', 17th September, 2020 https://www.instituteforgovernment.org.uk/explainers/state-aid

[3] Accountancy Daily, 31 May 2019, 'France tops list for providing unlawful tax breaks using state aid' https://www.accountancydaily.co/france-tops-list-providing-unlawful-tax-breaks-using-state-aid

[4] See Geoffrey Owen, 11th July, 2021, 'Innovation Policy' via the Policy Exchange website

[5] See BBC news https://www.bbc.co.uk/news/uk-wales-57796440

[6] See Preston City Council, 'The definitive guide to the Preston model' no date, 2021 https://www.preston.gov.uk/article/1791/The-definitive-guide-to-the-Preston-model-

[7] See Aditya Chakrabortty, *The Guardian* 31st January 2018, 'In 2011 Preston hit rock bottom. Then it took back control'

https://www.theguardian.com/commentisfree/2018/jan/31/preston-hit-rock-bottom-took-back-control