Bounce back Britain

COVID-19 economic response and learning the policy lessons from the financial crisis

Andrew O'Brien

SMF Social Market Foundation

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ABOUT THE AUTHOR

Andrew O'Brien

Andrew worked as an advisor in Parliament for a Conservative MP between 2010-2013, before joining the National Council for Voluntary Organisations as a Senior Policy Officer. Andrew then worked as Director of Policy and Engagement for Charity Finance Group, moving onto to become Director of External Affairs at Social Enterprise UK in July 2018.

As Director of External Affairs for Social Enterprise UK, Andrew represents 100,000 businesses in engaging with government and developing policies to support the growth of better ways of doing business. Andrew has researched and written extensively on tax, the voluntary sector, business reform and public procurement.

FOREWORD

Business: what is it good for? To those of us who believe in an open market economy where private-sector actors trade and grow, the virtues of successful business can seem obvious: growth and innovation. But that open market system doesn't always live up to its potential as a device to allocate capital in the most productive way.

Too often, companies have fallen short of the ideal where far-sighted executives and investors deploy resources to maximise the company's long-term prospects, in preference for short-term gains. And when business doesn't invest in its people and its technology, we see underperformance, sluggish growth and, over time, public unhappiness with the whole economic model.

The Social Market Foundation is committed to a vibrant economy where business lives up to its full potential and operates in such a way as to generate profits for owners and a healthy return for society as a whole. It is only by having proper regard for the long-term interests of not just shareholders but the wider community that business will keep and renew the license to operate that is granted by the public.

Our belief in a better form of capitalism means we are natural partners for Social Enterprise UK, whose 100,000 members are the embodiment of that better way to do business. We are delighted to publish Andrew O'Brien's report here as a useful contribution to the debate around business in the age of the coronavirus.

In response to the virus and the economic damage done by the measures deployed to manage it, governments are using huge sums of taxpayers' money to support businesses. That is sensible and necessary, since it will support employment and productive capacity.

But it will also change the political landscape faced by business of all kinds. Simply put, the public, via its government, is offering a large helping hand to business. After the crisis, business must be seen to return that favour, or face malign political consequences.

The 2007/08 financial crisis offers a troubling template here. The financial services industry is still paying for the bailout of the banks – a price measured in public distrust and resultant political challenge. Voters just don't think the banks repaid the favour of that rescue. A decade of post-crisis corporate tax cuts that did not, as Andrew demonstrates here, lead to useful increases in business investment are surely part of that sad story too.

Anyone who believes, as I do, that Britain needs vibrant, profitable companies to lead us out of our current plight should pay attention to this report. Its ideas and analysis are a vital contribution to the task of finding ways for business to do even better in the hard times that lie ahead of us.

James Kirkup, SMF Director

EXECUTIVE SUMMARY

- A decade ago, the UK suffered its biggest recession since the Second World War. In response, the UK government embarked on an ambitious programme of business tax cuts to stimulate investment. Ten years later, it is clear that this programme of business tax cuts has not delivered results. Growth has been sluggish, investment has been low, and productivity has experienced the biggest slowdown since the late-Nineteenth Century. We need a new approach which looks at the structure of business.
- Analysing the impact of business tax cuts since 2010, there is no clear link between cutting taxes and increasing business investment. Business investment as a percentage of GDP was actually lower in 2017 than it had been in 2000. In only one year between 2011-2018 was the cost of corporation tax cuts matched by a similar increase in business investment. There was no multiplier effect on business tax cuts from business investment.
- To stimulate a fast recovery from COVID-19, the Government needs to embark on an ambitious programme of structural reform to business to improve its culture and encourage long-term investment. These reforms would spread best practice from high performing parts of our economy, such as the social enterprise sector, across the whole economy. This programme of reform could include:
    1. A new "Contract with Britain", with businesses and the state prioritising investment over the next three years to help the economy to bounce back quickly;
    2. A new "British Business Renewal Act" to reform company law and spread best practice across all UK businesses to raise standards and performance;
    3. A new British Business Tax Roadmap so that businesses are encouraged to invest and generate positive social and environmental impact;
    4. Showcasing British Business through a new National Awards Evening to give businesses, particularly SMEs, a positive platform and creating a better culture;
    5. Using social value in procurement to drive higher performance from British businesses and shape markets.
- We must learn from the mistakes of the past decade where the UK ignored the need to reform UK plc. A huge increase in infrastructure investment, more spending in Research and Development or further tax cuts are unlikely to generate results unless the UK improves the performance of British businesses. As the country has come together to tackle COVID-19, now is the perfect moment to use this sense of unity between government, business and society to embark on a programme of reform.

INTRODUCTION

It has been over a decade since the financial crisis. As we now face our next major economic crisis, due to COVID-19, enough time has passed to allow us to evaluate the Coalition and Conservative Governments' economic recovery policies. It is well documented that since the financial crisis, the UK has enjoyed one of the slowest recoveries from a recession in over a hundred years – even slower than the Great Depression.[1] It is vital that we learn the lessons from the past to inform future economic decision making and give the UK economy the best chance of a fast, strong recovery after COVID-19.

Already there have been some arguments that we should fall back on the approach taken after 2010, with significant tax cuts for individuals and businesses to stimulate demand.[2] As this paper demonstrates, there is very little evidence to suggest that this worked after the financial crisis, nor that it would work again after we exit lockdown. The UK spent close to £100bn in corporation tax cuts alone since 2010 and has little return to show for it.

The evidence suggests that there is something structural at the heart of the economy that needs to be fixed. UK businesses have repeatedly called for ever larger cuts in business taxation to boost investment and increase productivity, yet these gains have not materialised. We have seen a "jobs boom" but coronavirus threatens to undermine all the progress that has been made on boosting employment – with the OBR predicting unemployment could reach over three million this year.

If the UK government wants to see a quick and successful recovery from the COVID-19 recession, it needs to reform UK plc to improve the performance of British business. This will enable other policies such as tax cuts and infrastructure spending to fuel a quick recovery. We should spread best practice from parts of our economy, such as social enterprises, that have proved effective and can help to aid the UK's economic recovery.

Reform won't cost the state money, if anything, this is about "bailing in" the UK corporate sector which has received tens of billions of taxpayer money to get through this crisis. There are hundreds of billions of pounds of investment to be unlocked which could make the difference between a fast, resilient recovery and a slow, painful one. Related to this will need to be policies that encourage wage growth, reform public services, infrastructure spending and efforts to boost R&D.

There are concerns that UK debt will reach over 100% GDP by the end of this crisis and that the deficit will rise to over £300bn.[3] But the only way to significantly reduce this deficit without risking another decade of austerity and slow recovery is to boost growth as we did after the Second World War.[4] To boost growth, we need to improve the performance of British business. This is the central problem that we can no longer ignore.

This crisis provides an opportunity to build a new consensus on the future of British business and to reshape our economy. Learning from the evidence in the UK and around the world, we can transform our economy into a world leader in the recovery from COVID-19. A fast recovery, levelling up, delivering Net Zero and restoring the UK's global competitiveness all depend on learning the mistakes from the last recession. Quick fixes or superficially easy policies, such as untargeted business tax cuts, will only waste money and time. Now is the time to begin structural reform to British business. To borrow a phrase associated with the last reforming Conservative Prime Minister, Margaret Thatcher, there is no alternative.

EXPANSIONARY FISCAL EXPANSION – SPENDING REDUCTIONS AND TAX CUTS

After a public sector driven 'fiscal stimulus' by the Brown Ministry, a change in government brought a new approach. The Coalition Government from 2010 embarked on a policy of "expansionary fiscal contraction" – more commonly termed "austerity". This policy involved public sector austerity to enable looser monetary policy combined with tax cuts for businesses to increase investment and tax cuts for individuals to boost demand. At its base level, the belief was that reducing government expenditure would 'free up' room for the private sector to grow.

Monetary policy played a decisive role in the response in the early years of this period (particularly 2010-12), but as the recovery began to take hold, fiscal and tax policy took on a greater role. Fiscal and monetary policy were further interlinked as it was believed that austerity was necessary in order to give the space for loose monetary policy to be maintained.

Following the 2015 General Election, this policy was continued although with less emphasis on fiscal contraction and more emphasis on tax cuts for businesses and individuals to increase investment and demand. This policy approach continued after the 2016 EU Referendum. Following the 2017 General Election there was more of an emphasis on public investment and the need to increase spending on public services. However, the constant of regular tax cuts for businesses has been maintained throughout this period.

This policy approach of regular tax cuts for businesses in order to stimulate economic growth has been called into question by the decision of the Prime Minister during the 2019 election campaign to suspend a planned cut in corporation tax in order to invest in the NHS. The Labour Party also promised to reverse cuts in business taxation in order to fund higher levels of state investment – although they have subsequently changed leader. Arguably, this change in approach has been driven by a concern to fund public services, rather than a reflection on the economic impact of this policy approach.

Although reductions in personal taxation were outlined in the Coalition "Programme for Government", most notably increases in the personal allowance, these did not 'kick in' until later in the Government's response to austerity. They were also offset by large increases in VAT and National Insurance. Personal tax cuts and benefit changes did not impact all people equally, with analysis from the Institute for Fiscal Studies finding that those with "upper middle" incomes had benefited most from tax and benefit changes between 2010 and 2019.[5] It should be noted that this does not include the impact of changes to the National Minimum Wage which has disproportionately supported the lowest paid.

A significant amount has been written about the merits and demerits of reducing public spending sharply after the recession. Some have claimed that austerity policies did work and freed up space for economic activity in the private sector.[6] Others, notably Professor Simon Wren-Lewis have argued that austerity did not work and has significantly undermined the UK's economic recovery.[7] Whether austerity has worked or not, there is general agreement that the UK recovery has been slower than expected and expectations for growth and increases in productivity have been missed.

The effectiveness of looser monetary policy has been much debated and does not need to be covered in this paper. In short, defenders say that it bought breathing space for the economy to recover at a time when the state was not in a position to spend significantly

to prop up the economy. Opponents would say that loose monetary policy merely inflated asset values, benefiting primarily the richest, and left many "zombie companies" on the books which have dragged down productivity.

This paper will also not seek to go over old ground on whether austerity should have been pursued or whether monetary policy should have been tighter or looser. Rather it will focus on a smaller but critical part of the government's economic recovery policy – significant and far reaching tax cuts for private businesses to boost demand and growth.

Policies to boost business activity, particularly around investment, were a core and consistent part of successive governments' economic recovery package over the past decade. Unlike proposed public spending cuts (which fluctuated significantly over time, with Chancellors being less inclined to cut as time went by) or changes to personal taxation (which were also subject to signification variations), the government's overall tax cutting approach to business remained consistent over time.

Moreover, COVID-19 has been a significant shock to UK businesses outside of the financial sector. Arguably, this means that focusing on business policy has even greater significance than in the wake of the financial crisis, which led to a more concentrated focus on one part of the economy.

The political dynamic has also changed. The Prime Minister has outlined a "boosterist" vision of increasing economic growth, reducing regional inequality and improving the UK's international competitiveness. There is likely to be a focus, therefore, on a growth-led approach to recovering from the recession rather than trying to focus on austerity and public spending reductions to immediately reduce debt. Understanding how government policy has impacted on business is even more important.

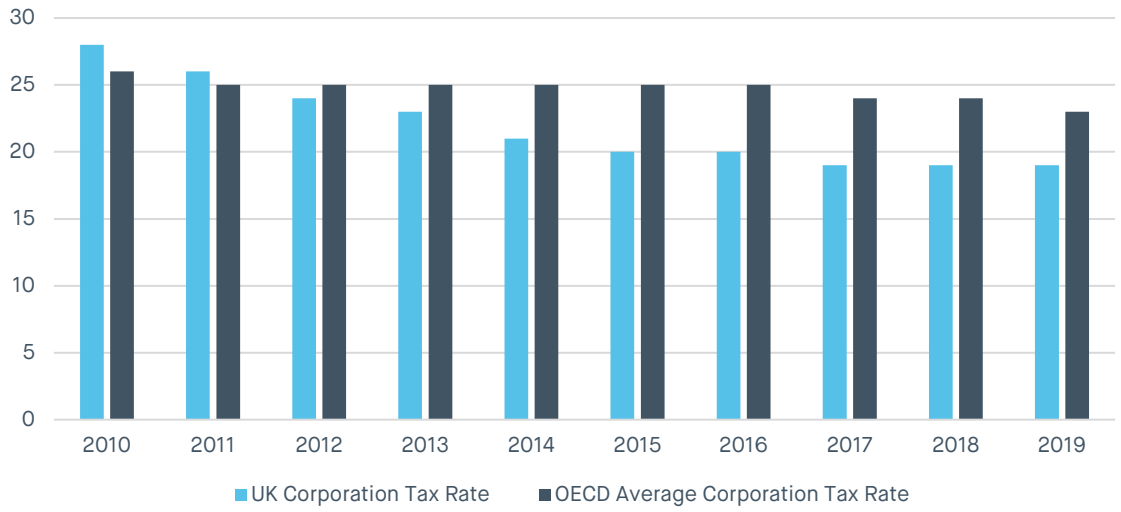
In any case, it is the actions of the UK corporate sector through investment decisions, employment decisions and wage policy that will have the most significant impact on the UK's economic response. This justifies a much more focused look at business taxation and the structural weaknesses of UK plc.

Large tax cuts for UK businesses – a policy experiment?

As noted above, business taxes have been repeatedly cut by governments since 2010.[8] The mainline corporation tax rate has been cut from 28% to 19% over the past nine years (see Figure 1). This is line with a general lowering of corporation taxes across the OECD, however, the UK has been a leader in this process and now has one of the lowest levels of corporation tax in the developed world.

Historically this approach was not unique. The Thatcher Ministry tried a similar approach in the 1980s with the main rate of corporation tax falling from 52% in 1979 to 34% in 1990 when she left office. Interestingly, as we will find later in this paper, the impact of this cut was similar to the present day with significant increases in profitability but business investment remaining low compared with other OECD countries (gross investment was 18.5% of GDP during the 1980s compared with 21.7% in France and 21% in Germany, for example).[9]

Figure 1: Main corporation tax rates in the United Kingdom and OECD



Sources: HM Treasury, KPMG

The cost of these tax cuts has been significant. The Institute for Fiscal Studies has estimated the cost per year of corporation tax cuts between 2010 and 2016 at £12.4bn, taking into account anti-avoidance measures.[10] This would bring the cost of corporation tax cuts over that period to around £74.4bn. Assuming a £6.2bn cost per year in subsequent years, as estimated by the HMRC ready reckoner, this would bring the total to £93bn by 2019. Revenues did increase slightly during the period, at around 3% a year between 2010-2018, offsetting some of the cost. The total cost of corporation tax cuts would be £72.5bn between 2010-2018. There is no evidence, therefore, that cutting the rate of corporation tax generates more revenue for the state, as some have argued in the past.

To put this into context, this total cost is akin to the estimated cost of High-Speed Rail 2 – a project which has courted considerable controversy about its costs and supposed benefits. Significant reductions in corporation tax and business taxes more broadly have not encountered a similar level of public interest nor investigation of effectiveness by the government. High-Speed Rail 2, for example, has undergone seven business cases and reviews since 2011. The government's Corporation Tax and Business Tax Roadmaps, by contrast, have not been reviewed – at least publicly – since they were published.

Corporation tax is not the whole story and there have been increases in other forms of taxation. Business rates, for example, have brought in additional revenue around £34bn according to research by the IFS.[11] There have been slight increases in Insurance Premium Tax, Climate Change Levy and other forms of business taxation. However, there have also been increases in tax credits in various areas including the Annual Investment Allowance, R&D Tax Credits and National Insurance Allowance to name a few. Taking everything in the round, with the most generous estimates, we have still seen an overall reduction in business taxation of around £40-50bn over the decade.

It could be argued that these numbers are not significant in the grand sweep of government fiscal policy, with the UK Government budget estimated to be £928bn in 2020-21.[12] However, when compared to other measures, the significance of this approach becomes more apparent. Between 2010-2017, for example, the IFS estimates that departmental spending was cut by £48bn.[13] Social security spending is also £39bn lower

than it otherwise would have been.[14] Although it is not possible to prove what would have had happened if business taxes had not been reduced, it is true to say that without the cuts to business taxes, the government would have had significantly more room to invest in public services and capital spending during this period. Cuts in other areas could have been avoided. This makes considering the utility of these tax cuts important.

Although COVID-19 will significantly increase the budget deficit, even before the crisis, the UK was running and was planning to run with a budget deficit. The Office for Budget Responsibility has estimated that Public Sector Net Borrowing (PSNB) would be between £55-67bn over the Parliament.[15] Again, it is impossible to know what would have happened if business taxes had not been significantly cut during this period. However, it is reasonable to assume that without reducing business taxes, the government would have been much closer to running a balanced budget by 2020.

The scale and consistency of the UK Government's approach in business tax cuts to stimulate the economy and reduce the deficit over the long-term was a policy experiment that must be properly evaluated. This is even more timely given the current economic situation. As noted above, the UK Government will be focused on policies to boost economic growth and an obvious, and traditional, measure pursued by governments is to reduce business taxation. As this paper will demonstrate, the results of these tax reductions have not been close to generating the returns that advocates have claimed.

THE EFFECTIVENESS OF UK BUSINESS TAX CUTS

The logic of the government's tax cutting policy was that reducing taxation would increase levels of business investment. This in turn would stimulate economic growth, increase in wages and in the long-term lead to higher tax revenues. There is little evidence that these tax cuts have been successful in achieving these goals.

Economic growth has been weak during the period 2010 to 2019. Some of this has been due to the unique impact of the financial crisis, with economic literature indicating that financial crises are harder to recover from than "normal" recessions.[16] The Great Depression, for example, cast a similarly long shadow. There has also been additional political uncertainty due to the Scottish and EU Referendums in the UK. However, bar a short period between 2013-2015, the UK economy has failed to achieve levels of economic growth higher than 2% which was the pre-crisis trend. According to the IFS, the economy is over 20% smaller than it otherwise would have been if we had been able to achieve growth at pre-crisis level. In terms of overall debt and deficit levels, that level of growth would have greatly reduced the size of the deficit and brought debt levels back down towards historic norms.

Tax receipts overall have risen substantially during this period, but most of this growth has come from outside of the corporate sector. Increases in VAT and income tax as well as National Insurance contributions have driven the bulk of tax receipts.

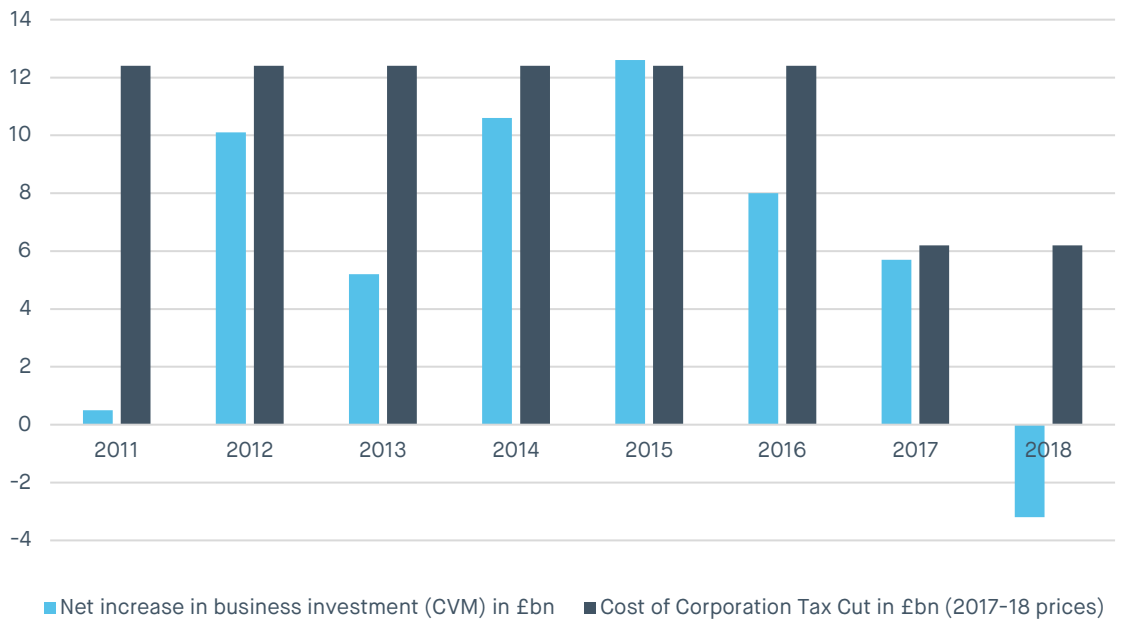
One of the key arguments behind reducing corporation tax was to increase business investment. This was referenced by the Coalition Government's Corporation Tax Roadmap and the 2010 Conservative Party Manifesto committed the government to creating conditions to enable a "new economic model" based on exports and higher levels of business investment.

This logic was best encapsulated by George Osborne's 2012 Budget Speech [emphasis added]:

> *"Mr Deputy Speaker, this is how Britain will earn its way in the world:* ***with far reaching tax reform****.*
>
> *With a simpler tax system, where ordinary taxpayers understand what they are being asked to pay.*
>
> *With a tax system that is more competitive for business than any other major economy in the world.*
>
> *A tax system where millions of the lowest paid are lifted out of tax altogether, while the tax revenues we get from the wealthiest increase.*
>
> *But reforming tax is only part of the story.*
>
> *We will earn our way in the world by saying to all businesses – large and small: We will provide you with the modern infrastructure; new growth-friendly planning rules and employment laws; the kinds of schools and universities and colleges our future workforce needs.*
>
> ***And in return, you, British businesses, have the self-confidence to: invest, expand, hire, innovate and be the best****."*

The evidence that there has been a significant increase in business investment is mixed. The Institute for Public Policy Research's Economic Justice Commission found that business investment as a percentage of GDP was lower in 2017 than it was in 2000, falling from 10% to 9%.

Figure 2: Business investment (excluding exceptional transfers) since 2010



Sources: ONS, Institute for Fiscal Studies

There has been some growth in business investment over this period, with the trend rate of growth in business investment slightly higher than the trend before the financial crisis – although the increase is not significant and could be explained by other factors, such as UK businesses having to replenish capital and stock after running them down during the recession, in line with previous economic shocks. The net increase in business investment over the 2010-2018 period was £49.5bn. This compares to the cost of corporation tax cuts of £87bn over the same period.

Moreover, annual business investment took until 2015 to recover to levels it achieved before the financial crisis despite significant tax reductions in the previous five years. Taking a less generous view of business investment over this period, annual business investment is only £17bn a year higher than its peak before the financial crisis. This is despite tens of billions worth of tax cuts during this period. This works out at an increase of 57p in business investment for every £1 of corporation tax cuts.

Supporters of business tax cuts could add to this figure additional taxes paid by businesses to this figure to get a higher figure, although it is not clear whether business tax cuts have boosted wages or employment. Overall, the idea that there is a "multiplier" between business tax cuts and investment does not appear to exist in a UK context. It is certainly not clear that UK businesses are "overtaxed".

Even excluding the post-referendum period (2016-2019) where the effectiveness of tax cuts may have been reduced due to general economic uncertainty, total investment increased by a net £47bn. This is significantly less than the £74bn cost of corporation tax cuts over the period 2010 to 2016. Some have advocated tax cuts in the past on the

assumption that during periods of economic instability, tax cuts would encourage investment that otherwise would be deferred. Whilst it is hard to prove a counter-factual, the fact that business investment did not significantly increase during this period despite large tax cuts does not support this thesis.

Sam Bowman and Stian Westlake have also argued, with some merit, that the nature of corporation tax cuts has also undermined incentives to invest. Reductions in the value of deductions of machinery and property have meant that businesses cannot write off the value of their investments. Reforming taxes to create the right incentives and targeting them effectively, rather than cutting headline rates, is on paper a better policy.[17]

Productivity growth has also been notably poor. The UK suffered from what economic commentators have called a "productivity puzzle". Labour productivity growth has been low and is around 40% lower than it would have been if the UK had continued on its pre-crisis trend.[18] Cuts in corporation tax have had no clear effect on levels of productivity, which is not surprising given that business investment and wages have not grown substantially during this period. As noted above, one of the key arguments for business tax cuts was to boost productivity and to contribute towards the economic recovery.

During the same period, wages have taken over a decade to recover. According to the ONS, average weekly wages for the private sector were £512 in real terms at their peak in 2007. At the end of 2019, average weekly earnings for the private sector had finally recovered to the same level – around £512 a week. This is despite significant increases in the minimum wage over this time. The link between tax cuts and wage increases is hard to see. It also interesting on this case to look at the Trump Administration's business tax cuts announced in 2017. Despite promises from businesses to use the tax cuts to increase wages, there has not been a significant increase in wages during the period.[19] Interestingly, the then Chancellor George Osborne did link the increase in the National Living Wage to cuts in corporation tax as a justification for why businesses could afford the NLW.[20]

Employment has risen consistently over the period, and the "jobs boom" has been the main economic success of the government's recovery response. Employment was at its lowest rate in over 40 years before COVID-19. Unfortunately, coronavirus looks likely to undermine this jobs-based recovery: unemployment could be over three million in the wake of the crisis.[21] Some would argue that business tax cuts have helped fuel the jobs boom. The creation of a National Insurance Allowance, for example, was an example of tailored tax cuts supporting job creation. The Coalition Government also reversed a 1p increase in the rate of National Insurance for employers that had been put forward by the previous Labour Government.

The literature indicates that there are likely to be stronger factors behind the jobs boom than corporate tax reductions. Concerningly, it could be the flip side of the lower level of investment that has been seen over the past decade rather than because of business taxation. According to Jan Vlieghe of the Bank of England's Monetary Policy Committee, hiring people has been used by businesses to meet demand rather than increasing investment spending because it is more easily reversible.[22] Workers can be dismissed if there is a downturn, whereas investments in capital are generally fixed.

The supply of labour has also been more flexible than in previous downturns and businesses have made the most of this. Research by the Resolution Foundation has identified that higher levels of supply have driven higher levels of employment, with more people seeking work and willing to work longer hours. This has enabled people to

effectively price themselves into employment. This has had the knock-on effect of suppressing wage growth, as there is greater competition for work.[23] Even supporters on the Right argue that it was reductions in *personal* taxes and welfare reform rather than business taxes that has made work more attractive.[24]

It could be argued, therefore, that business tax policy has not been the primary driver for higher levels of employment, but rather economic uncertainty, cheap labour, lower income taxes and welfare reform have made employment more attractive. It also not clear whether exclusively focusing on employment rates is thing for the economy overall. Although more people in work is positive, if this leads to lower levels of productivity, it could see living standards stagnate over time. This is arguably what we have seen in the previous decade.

Interestingly, efforts to increase the National Minimum Wage/National Living Wage have been put forward as a way to boost wages and increase productivity rather than relying on business tax cuts in recent years. Although there is strong evidence that increasing the National Minimum Wage can lead to productivity increases,[25] early research has found that UK businesses have not taken advantage of those potential increases.[26] This is undoubtedly linked to the above issue of a lack of business investment. Increases in human capital need to be matched with similar investment in physical and technological capital.

Despite economic uncertainty, the rate of return for business has remained constant. Between 2009-2019, the average rate of return on capital for business has been between 9-11%. Net operating surplus for non-financial corporations, not adjusted for inflation, has increased by a net £65bn over the period 2010 to 2018.

Interestingly, this undermines another key argument behind business tax cuts that reductions in taxes can drive higher productivity and investment leading to higher returns to the taxpayer. Although business taxes did increase, profitability has not substantially increased which would drive higher revenues. This is linked to the issues of productivity and lack of investment raised above. If businesses are not boosting their productivity through investment, they are unlikely to raise their profitability over time which would in turn generate a wider tax base for the state.

Interestingly, research by the TUC and High Pay Centre has also found that during the shorter period of 2014-2018 shareholder returns by FTSE 100 companies grew by 56%.[27] Around £442bn was returned to shareholders over this period, a significant level of return despite weak levels of economic growth. Further research by Common Wealth has found that shareholder buybacks and dividends from the largest 100 UK companies have grown from 43% of profits in 2011 to 103% by 2018, with a peak of 150% in 2015.[28] This raises the possibility that UK businesses are comfortable with their current levels of productivity and their ability to reward their shareholders, leading to less pressure to use tax cuts to invest and grow their businesses over time. This could partly explain why business tax cuts have led to poor returns.

In conclusion, whilst business investment has increased, it has not increased substantially compared to the cost of corporation tax cuts. In only one year during the period 2010 to 2018, was the level of business investment higher than the cost of corporation tax cuts. There does not appear to be any link between cuts in corporation tax, or business taxes more broadly, and increases in business investment. There is no clear multiplier effect on such tax cuts. The only argument that can be made is a counter-

factual that if they cuts had *not* been made, things would have been worse. Although this is impossible to disprove, it is also impossible to prove.

Productivity has not grown substantially and is significantly below pre-crisis trends. Wages have also not grown substantially during this period, although employment has. Levels of profitability have remained relatively constant. Tax receipts from business have not increased substantially and overall corporation tax receipts have not offset the costs of cutting the tax.

In sum, there is no strong evidence that persistent cuts in corporation tax, or any untargeted significant reduction in business taxes, offer value for money when it comes to strengthen the UK economy, boosting productivity or increasing wages.

WHY HAVE BUSINESS TAX CUTS BEEN INEFFECTIVE?

Concerns about British business are not new. The "National Efficiency" movement which sprung up in the 1890s was a recognition that British business and society was slipping behind that of continental competitors and the United States. These concerns have continued ever since. Although the UK has always been proud of its place as the "birthplace" of the Industrial Revolution, lurking behind this pride is the suspicion that this first mover advantage has in some way hindered the UK's later progress.

Economists such as Joel Mokyr have argued that it was the social and cultural institutions created in the Sixteenth and Seventeenth Centuries which gave Britain the economic edge in the Eighteenth and Nineteenth Centuries.[29] Scientific societies, religious toleration, secure property rights, patents, the development of stock markets, a central bank and limited liability all helped to protect and incentivise entrepreneurial activity. This created the foundation on which technological risks could be taken and profitable businesses created. Having the right institutions was central to the UK's early industrialisation. But this has also created a path dependency which has left the UK struggling to compete with further changes.

Ever since the Industrial Revolution, British business has been typified by hyper-competitiveness. The UK has an "hourglass" economy, with concentration at the top of the economy and a very large number of small and micro-businesses. The "middle" is much smaller than in competitor nations such as Germany. Economic historians have characterised the UK economy as being populated with a large number of businesses which are focused on taking marginal action to maintain market share and profits, rather than expansion.

Institutional economists such as William Lazonick and Bernard Elbaum have showed that hyper-competitiveness has been the British historical norm. This has left the UK unable to keep up with the bigger, managed corporate capitalism which emerged in the late Nineteenth and early-Twentieth Century.[30] This was the kind of capitalism required to make the transformative capital investments which would develop new economic powerhouses. Even in the Twenty First Century, the UK has arguably failed to create its own versions of "platform businesses" (e.g. Amazon, Google, Facebook, Apple etc.) which look set to dominate the coming decades.

Interestingly, this "hyper-competitiveness" may explain why the UK is seeing consolidation in consumer markets.[31] Although it may seem odd to have both a hyper-competitive economy and highly consolidation markets, in an economy where it is hard to outcompete because of the maturity and flexibility of the market, consolidation and merger is the most obvious way to protect margins and profitability. This helps to explain why the UK has one of the most "dynamic" economics in the world, but also has a worrying level of concentration.

Identifying what is *not* wrong with the UK economy

The problems of British business have been well documented by government reviews, think tanks and economists in recent years. The first thing to consider is what definitely is not the cause of the UK's economic weaknesses.

Firstly, UK plc does not have a profit problem. UK businesses are not, not investing in the future because of a lack of profit. Profits have risen, despite Brexit. The net rate of return on capital in the UK for private non-financial corporations has risen slightly from 12% in

2010 to 12.6% in 2017.[32] This is a healthy rate of return by historic standards. When you consider loose monetary policy has meant that putting money in the bank is not attractive, this rate of return is even more impressive. The problem is what is done with those profits and how profits have been shared.

Tomorrow's Company has calculated that the profits distributed to shareholders has risen from 14% of Gross Value Added (GVA) in 1990 to 18% in 2014.[33] As noted above, research from the TUC and Common Wealth has further identified the trend towards increasing distribution of profits and resources to shareholders, sometimes in excess of profits, rather than using them to invest in the future. IPPR's Economic Justice Commission referenced that just one in four businesses now prioritise investment within internal funds.[34]

The same is true if we consider access to finance. The British Business Bank's regular analysis of SME borrowing has found that even before COVID-19, 34% of businesses are "contented" not looking to grow.[35] There is also a historic unwillingness of UK businesses to borrow to invest, which is also likely to undermine any recovery and long-term boosts to productivity. In part this may be because of the struggles that UK businesses have historically encountered in accessing finance. But the historic nature of the problem does point to cultural challenges.

Secondly, the UK does not have a problem when it comes to regulation. There may be isolated regulations which should be scrapped but the UK remains a very flexible economy. The UK is ranked 8th in the world of "ease of doing business" according to the World Bank.[36] There have also been large reductions in regulation under previous Coalition and Conservative governments. The Coalition Government alone removed or reformed over 3,000 out of 21,000 statutory regulations and generated over £850m of savings per year for business.[37] The "one in-one out" rule has saved businesses an estimated £2.2bn a year.[38] Even Economists for Free Trade, a pro-Brexit group, estimated that a mass of deregulation and greater competition would only boost UK GDP 0.5% per annum over 15 years. This would be significant, but not game changing and it is hard to know if these proposed benefits would not be offset by higher costs elsewhere. A recent cross-party "Red Tape Initiative" chaired by Sir Oliver Letwin only found 39 regulations to cut and a number of those related to historic buildings. This hardly indicates a large-scale problem of overregulation.

Barriers to growth

At root, the UK has a problem with productivity, with lower productivity creating slower growth and lower pay for workers. There are several ways to boost productivity, but the critical issue is the lack of investment by UK businesses and the public sector. The government is now addressing the latter through large scale investment in infrastructure, but this will on its own solve nothing if it is not matched by increases in the corporate sector.

Increased investment is critical to increasing British productivity which will drive much higher levels of growth and, crucially, sustain increases in living standards over the long-term. NEISR's analysis of investment and productivity has showed how the UK investment and productivity has gone hand in hand.[39] In short, there is no way of avoiding the investment challenge.

What we can learn from the past decade is that simple solutions, such as tax cuts, without structural reforms will not deliver results. Tax cuts to stimulate business or deregulation

to free up business will not work if the aim is a faster, strong, sustained recovery. We must not repeat this mistake after COVID-19.

The Government has to confront the big structural challenges facing the UK economy and reform British business so that it can deliver sustained growth and improvement in the UK's economic competitiveness.

Public attitudes on business and business taxation

At this juncture it is interesting to consider public attitudes to business and business taxation. As noted in the introduction, some organisations claim that the public wants to see further decreases in business taxation and there is a view that cuts to business taxation are electorally successful. This creates a cycle where governments, particularly Conservative governments, tend to start any new recovery response with a focus on tax cuts or deregulation. Tax is also seen to be easier for the public to understand, rather than structural reform of business. While this is undoubtedly true, it does not mean that structural reform is unpopular or out of sync with the public.

Regular research has found that the public are concerned about British capitalism and business. The Legatum Institute's *Public Opinion in the post-Brexit era: economic attitudes in modern Britain* in October 2017 found that there were far higher levels of support for more regulation of business, increased taxation to pay for public services and more intervention by government in the marketplace.[40] People associated capitalism as it currently operates with values such as "greedy", "selfish" and "corrupt". This was particularly true for those who voted Labour in 2017 and appear to have decisively shifted towards the Conservatives or stayed at home during the most recent General Election.

Centre-right think tank Onward issued a report in October 2019, just before the General Election, called the *Politics of Belonging* and found more support for economic reform across large swathes of the population.[41] This security desire manifested itself in support for more government intervention in the market and more interest in reducing inequality rather than seeing higher levels of economic growth. Adding up those portions of the electorate in favour of greater "economic security" rather than greater market freedom, we cover approximately 71% of the electorate.

There is no clear case that the public is more favourable to political parties that "back business" as usual. It is important for politicians to take note of this as they consider responses to COVID-19. Getting the economy back to where it was before the crisis as quickly as possible is unlikely to be popular and given the fiscal demands of COVID-19 could build up resentment to UK businesses if there are not significant returns. This would be similar to the hostility directed towards the banking sector after the financial crisis. Advocates of the status quo or simplistic cuts to business taxation are also not helping their case for capitalism and market-based solutions.

On business taxation, Social Enterprise UK commissioned research from YouGov during General Election 2019 to understand public attitudes to business taxation, on which there has been little recent research. This nationally representative poll of the public asked them about their views on how business would spend any tax cuts from government.[42] This was after a debate in the media about business taxes and the Prime Minister's announcement that he would delay a planned cut in corporation tax. It was also before COVID-19 which gives an insight into public attitudes before we saw a major economic crisis.

Overall, the poll found that the public believed that businesses would do two things with extra money from tax cuts. Firstly, they expected them to keep some of the money in the form of dividends for owners in shareholders. 65% of respondents thought that businesses would use the extra money to pay out bigger dividends. Secondly, they expected that some of this money would be reinvested back into the business. This was the most popular response, with 74% of respondents believing that businesses would increase investment with the extra funds. This is interesting as publicly available data on business investment, as noted above, has not shown a significant increase despite previous cuts in corporation tax.

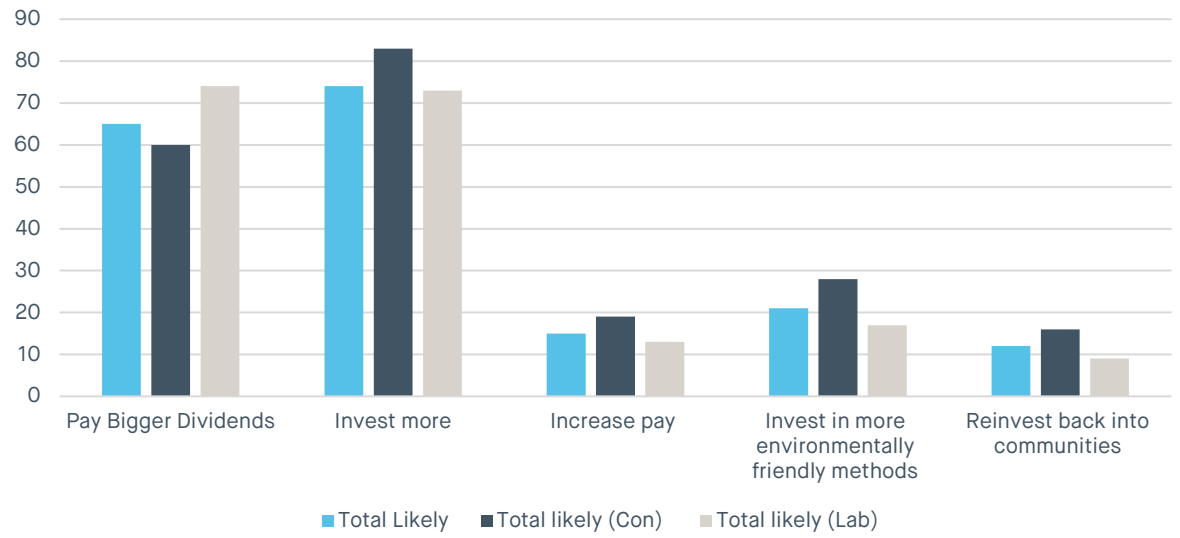
Few respondents expected that the extra tax money would be used to boost pay for workers or to reinvest back into communities. Just 15% of respondents believed that tax cuts would be used to increase wages. Only 12% of respondents believed that tax cuts would be used to reinvest in communities.

Around one in five respondents (21%) expected that the tax cut would be used to pay for investment in more environmentally friendly methods. This is important for the future as the climate emergency has been steadily rising up the political agenda and some policymakers may seek to support the transition to a decarbonised economy through reductions in taxation for business. It seems that the public is sceptical that money released through tax cuts would be used to deliver a greener agenda.

The current evidence on emissions since 2010, when the government began a programme of major business tax cuts, business has not drastically reduced its carbon emissions. According to the latest UK data, UK business emissions fell by 1.8% in 2019.[43] This is positive, but when you consider that the UK needs emissions to fall by around 4% in order to meet the IPCC's recommendation for emissions to be 45% lower than their 2010 levels, then UK businesses are way off the pace. UK businesses' fall in carbon emissions has also been slowing. Between 2005-2010, emissions fell by around 4.2% a year – in line with the IPCC target. During the period we are concerned with when major business tax reductions were introduced, between 2010 and 2018, the pace of reductions fell to 2.1% a year – half of what we need to achieve if we are to have a realistic prospect of hitting the IPCC's target.

The public are, therefore, broadly right on the evidence, bar views on business investment. Based on the available evidence, tax cuts are likely to be distributed to shareholders with minimal impact on wages or benefits to the community/environment. Interestingly, as Figure 3 indicates below, there is a general consistency across supporters of the Conservatives and Labour showing that there is an opportunity to build a cross-party consensus on the future of business taxation.

Figure 3: Imagine the government cut business taxes. How likely or unlikely do you think it is that businesses would do each of the following with the extra money?



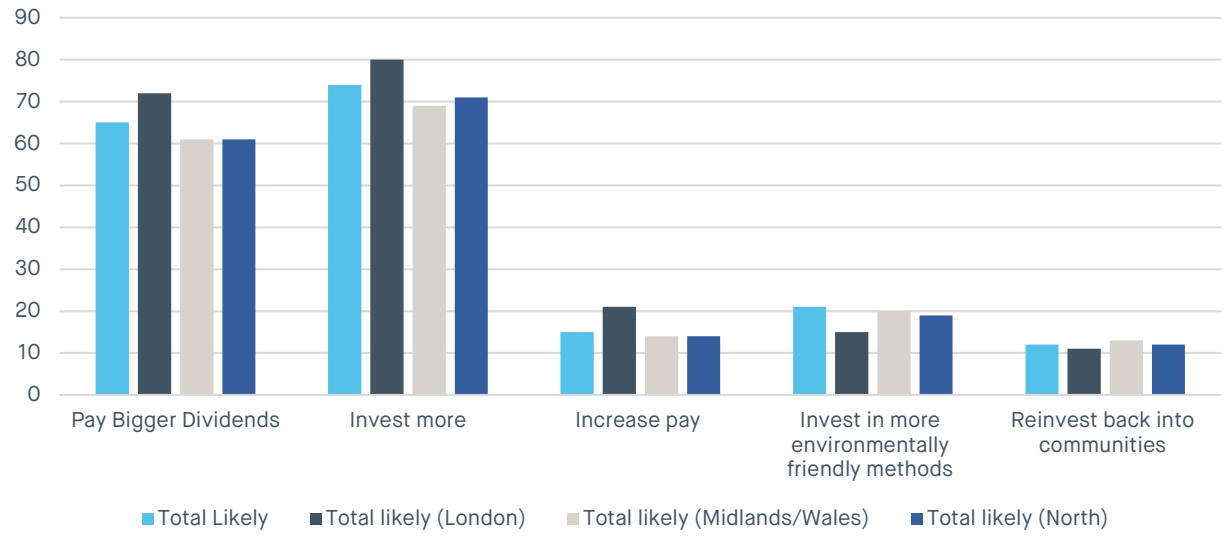
Source: YouGov, 26-27th November 2019

Generally speaking, Labour supporters could be seen as slightly more pessimistic about how business would use the money and Conservative supporters were slightly more optimistic. Both are sceptical that tax cuts will be used to benefit people as a whole through higher pay, tackling climate change or investing in communities.

There was also consistency across Remain and Leave supporters. No government can take it for granted that people will associate tax cuts for business as good news for the country as a whole.

There was also some level of regional difference in responses although overall the general picture was the same.

Figure 4: Imagine the government cut business taxes. How likely or unlikely do you think it is that businesses would do each of the following with the extra money?



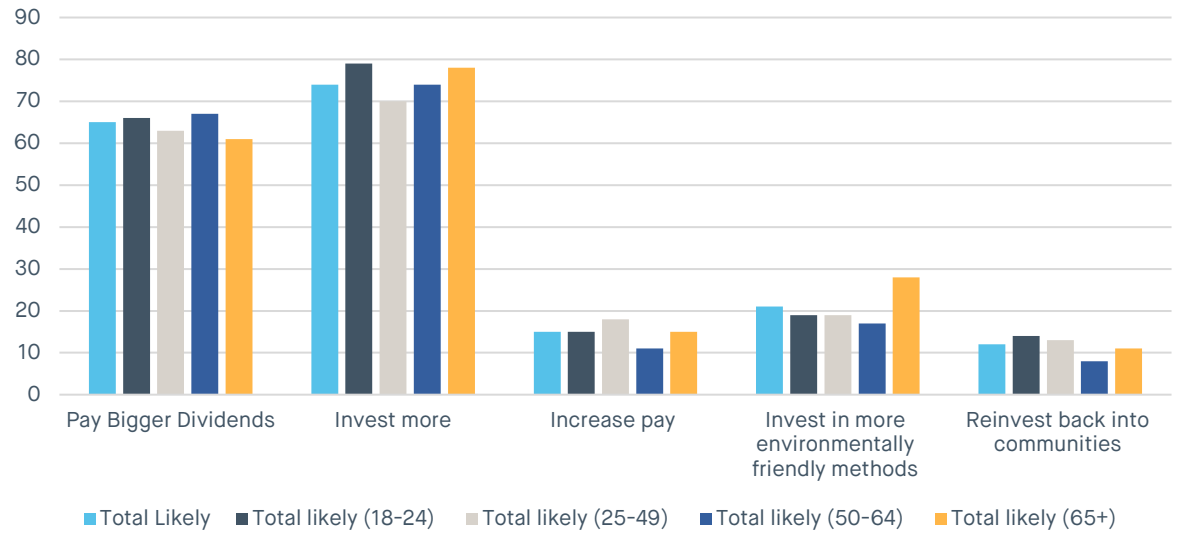
Source: YouGov, 26-27th November 2019

As with the public as a whole, in every region most people believe that additional tax cuts for businesses will be used to pay bigger dividends and increase investment. People in the Midlands, Wales and the North are slightly more sceptical than Londoners that tax cuts will be passed down in the form of pay rises. 21% of respondents from London said that they thought that tax cuts would be used to increase pay for workers. This compares with 14% in Midlands/Wales and the North.

Londoners were also more likely to say that businesses would pay out bigger dividends for shareholders and owners with tax cuts, with 72% of Londoners believing that this is what would happen. People from the Midlands, Wales and the North were also more sceptical that tax cuts would be used to increase in investment. 69% of respondents from the Midlands and Wales believed that this would be the case, compared to 74% across the UK.

There is also consistency across age groups (Figure 5). Younger voters are slightly more likely to believe that businesses will use tax cuts to invest in their business and older voters are more likely to believe that businesses will use tax cuts to invest in environmentally friendly methods.

Figure 5: Imagine the government cut business taxes. How likely or unlikely do you think it is that businesses would do each of the following with the extra money?



Source: YouGov, 26-27th November 2019

Taking the evidence base as a whole, there is no evidence that the public will penalise a government which decides to look at structural reform to business over tax cuts. If anything, people are concerned that the economy is heading in the wrong direction. On business tax cuts specifically, people do not link reductions in business taxation to positive change for workers and the communities that they live in. There is not, therefore, likely to be a political cost to pursing a different agenda.

STRUCTURAL REFORM TO UK BUSINESS TO FUEL GROWTH

A common Western cultural phrase is "dangling the carrot". The theory is that dangling the carrot incentivises the donkey to move forwards. Classical economics tells us that the profit motive is the carrot that drives British business forward. It is the desire for profit which encourages people to innovative, invest and take risks. In a competitive economy, creating a profitable business is challenging and staying ahead of rivals requires continuous improvement. But what if once you have got a slice of market share, you don't need to innovate but you can find other measures (e.g. squeezing pay, cost cutting, taking on cheap debt etc.) to maintain your position and maintain profits. Where is the incentive to innovate and produce?

Taking the donkey analogy one step forward, what if the stick is too short? What if you can achieve sizeable returns without straining your business to innovate and invest. This is the historic problem for British business as noted above. Hyper-competitiveness has reduced the incentive to innovate, scale and continuously boost productivity (i.e. achieving a dominant market position in the UK or global market has been too challenging to achieve) whilst a flexible financial and regulatory environment has made it easier to cut costs and maintain market position without investing in the future. Moreover, businesses have found it easier to "grow" through merger and concentration rather than through productivity increases. This helps to explain the paradox of hyper-competitiveness with increased concentration in key markets.

This might seem theoretical, but the problem of motivation and incentives is critical as we consider economic responses to COVID-19. If British business is not motivated to invest and support the UK through the coming crisis, then a swift bounce back is impossible. Instead, we will likely see a long and slow recovery as we saw after the financial crisis in 2008/09. This could be compounded if the government puts limited public resources into reductions in business taxation that do not lead to significant improvements, as we saw during the period 2010-2020.

At a UK level and at a global level, the evidence suggests that to re-motivate and incentivise business involves not merely tweaking with tax rates, but structural changes to business itself. Government should focus less on the "carrot" but look at the animal that it has been, relatively unsuccessfully, trying to motivate in recent decades and most notably after the previous financial crisis.

How could the UK improve British business?

Behavioural economics has showed that people are more motivated by loss than they are by profit. This is contrary to the dominant economic paradigms of the Nineteenth and Twentieth Centuries. But beyond this, research has also showed that those businesses that have a purpose beyond profit perform better than businesses that are focused on profitability. This is not a new insight. Jim Collins and Jerry Porras found that "visionary companies" (guided with a purpose beyond making money) returned six times more to shareholders than explicitly profit-driven rivals.[44] A survey of business executives in the Harvard Business Review's *The Business Case for Purpose* found 53% of executives that said their organisation had a purpose beyond profit, reported greater success with regards to innovation and transformation efforts compared to 19% of executives who said that their business did not have a purpose beyond profit.[45]

Once an economy or business has reached a certain level of maturity, it appears that the profit motive alone, does not work in the long-term. Providing additional motivations,

through the structure of business and the cultural norms around British business is critical to deliver better results not only for business themselves, but also the economy and society.

If we accept that profit should no longer be queen, what do we replace it with? Purpose is often used (as above) as an alternative, but what does purpose mean in this context? Facebook, for example, has a vision to connect people together. But as we have seen from recent years, this alone is not enough to sustain good performance (or even good behaviour). There needs to be a stronger institutional framework. Purpose must be more than just a mission statement or a few buzzwords at the annual general meeting if it is going to stimulate action. It has to permeate all aspects of the business and influence decision making.

Lessons from social enterprise

Fortunately, British entrepreneurs have been experimenting with different business models combining financial sustainability (i.e. surviving without handouts) and delivering positive social and environment benefits. These have been termed "social enterprises". The UK has been a world leader in developing these business models. They give us a useful insight into how reforms to business can change behaviour and boost economic performance.

In board terms, social enterprises are businesses which have a *legal obligation* to create a positive social and/or environmental impact and reinvest or distribute their profits back into achieving their mission. Many have asset locks which prevent their assets being stripped out if they are bought by a competitor. Others have a cap on the level of dividend that their owners can receive in any one year.

This approach ensures that they are not able to shear themselves of their mission, as a Facebook may choose to do so. It acts as a check on asset stripping and other unsocial behaviour. It forces businesses to look towards long-term growth and sustainable activity, rather than "getting rich quick" which is a particular feature of UK business behaviour.

Social enterprise has been a part of the modern British economy since the beginning, but it has been overlooked compared to profit-focused business models. New Lanark, pioneered by Robert Owen, emerged in the early 1800s as a commercially successful business which also provided high quality care to workers and helped the most disadvantaged in society. Sadly, New Lanark's approach (beyond a few Quaker businesses) was the road not taken in the Nineteenth Century.

In recent years, particularly since the 1990s, there has been a significant upturn in social enterprise and "social entrepreneurs". People increasingly want to create a business which are able to improve society as well as provide a financial return to their owners.

According to the latest research, *The Hidden Revolution*, there are over 100,000 social enterprises in the United Kingdom (including cooperatives and companies which are registered as charities, but which make the majority of their income through trading). This is up from 70,000 social enterprises identified by government back in 2013.[46]

These businesses are also outperforming their peers which lack a social or environmental mission. 47% of social enterprises grew their turnover in the last 12 months compared to 34% of UK businesses. Not only that, but 93% of social enterprises delivered a surplus or profit compared with 73% of small and medium sized business employers. This provides

the basis for future investment which is necessary to reverse the chronic underinvestment which has undermined the UK economy.

The government's own Advisory Panel to the Mission-Led Business Review in 2016 found on average that businesses which embrace social priorities "perform better, reflect people's ideals and ambitions and so are primed for success".[47] But there is more to their success than their growth. Social enterprises also display the characteristics required to boost the UK's productivity which will fundamentally improve the quality and quantity of UK growth.

Social enterprises are more innovative than traditional businesses, with 50% of them introducing a new product or service compared with 33% of small and medium sized businesses (a figure which has fallen in recent years).[48] Innovation is important in driving up productivity through improved uses of labour and capital.

The imperative to deliver a social and environmental benefit encourages long-term thinking. Tackling climate change, reducing inequality or supporting a particular community is not something which can be solved in 12-18 months. The aim is not to pilot an idea and sell the business on with a profit for the owner, but to create a lasting legacy. Unsurprisingly, long-termism breeds success. Research by the McKinsey Global Institute found that firms that had demonstrated focus on the long-term in the United States grew 47% more on average than other businesses. They also added more than 12,000 jobs than their competitors which if replicated to across the US economy would have seen more than five million new jobs created. Long-term businesses also invested 50% more in R&D than their peers.[49] Although this research is based on the United States, the principles are equally applicable to the UK. This is an indication of what a more socially driven economy could achieve, with its focus on long-term transformation.

British governments have asked for businesses to think "long-term" for decades but the bully pulpit is not enough. Government cannot manage every business and force it to invest in the future. Embedding a social and environmental mission, beyond profit, into the fibre of the business is critical to encouraging businesses act in their long-term interests. It changes the dynamic by adding a new factor into decision making which is inherently long-term in scope.

Changing the culture through changing institutions is a transformative approach. As noted above, it was institutional reform which paved the way for British success through the Industrial Revolution, not just a quest for profits. Importantly, the benefits of this approach would be felt across the UK economy in more jobs, higher pay and higher levels of productivity.

Increasing diversity is also critical to increasing the quality and quantity of UK businesses. In short, UK businesses are failing to use talent effectively and this is limiting innovation, undermining the ability of businesses to deliver better and sustained economic growth. Research by MCSI has found that gender-diverse boards, for example, experienced an increase in productivity of 1.2% above the median between 2012-2016.[50] Some of this can be explained by these businesses adopting better talent management, but women in leadership positions contribute far more than just improving HR practices. Research by McKinsey found that advancing women's equality would be worth around $5.1 trillion to GDP in Western Europe, with the UK receiving a significant portion of that increase.[51]

Social purpose and diversity come together when you consider that "social businesses" are more likely to be diverse. For example, 89% of social enterprise leadership teams have

a female director and 41% of leaders are women, significantly ahead of both mainstream SMEs (20%) and big business (7% of FTSE 100).[52] The same is true in terms of BAME leadership where 34% of social enterprises have BAME representation on their boards and 12% are led by BAME citizens.[53] This is double the level in SMEs. Social enterprises are also paying the Real Living Wage with 78% reporting that they pay the Living Wage, far higher than the level of the rest of the private sector.

Reforming the structure of business to focus on purpose encourages business to change for the better. A focus on structural reform to business, embedding purpose into the heart of UK plc, to give new motivation and drive to business is essential for a stronger, faster recovery from the current crisis. Purpose is a tool for embedding within UK businesses those characterises which combine greater levels of innovation, long-term thinking, higher levels of diversity as well as fairer contribution to taxation overall, leading to much greater levels of economic growth for the UK. Reforming business combined with tax reform, infrastructure investment and a "green recovery" is the roadmap to Britain building back faster.

Potential of British business reform to boost UK recovery

It is impossible to reform an entire economy overnight. However, it is important to consider the size of the prize that may be available to the UK economy if we are able to successfully reform British business. According to the ONS, profits generated by UK non-financial private corporations (excluding oil and gas) were around £203bn in 2018.[54]

If UK corporations adopted a "social enterprise" approach to profit reinvestment (and assuming a similar level of performance, not a higher level as is indicated by the data that we have on the sector compared to traditional private sector peers), this would lead to the reinvestment of around £100bn either back into businesses or back into communities per annum. This would be akin to an injection of around 5% of GDP back into the UK economy.

This is equal to the entire amount that the UK committed to invest in economic infrastructure over the 2016-2021 National Infrastructure Commission. If distributed in the form of wages, it would be enough to give every UK employee a £3,000 pay rise. In terms of investment and R&D it would be akin to quadrupling the UK's current R&D spending or a ten-fold increase in the UK's training and development budget.

In short, unlocking this level of reinvestment would be a huge boon to the UK economy. This significant boost to UK corporate spending could lead to higher levels of investment in new R&D, purchasing new equipment, upskilling and hiring new staff. Even taking a portion of that profit reinvestment model, even just 10%, would provide a significant jolt into the arm of the British economy.

Moreover, it is estimated that UK businesses are sitting on cash piles of over £700bn.[55] This will be significantly lower due to COVID-19, although in the early days of the crisis, evidence suggests that businesses are holding back cash for the future.

COVID-19 will dent the profitability of many UK businesses, but trend profitability remains high and once economic activity returns, profitability is likely to bounce back strongly as we have seen in previous recessions. However, with corporation tax on a long-term downward trajectory and with speculation that business tax cuts may be introduced to stimulate demand, it perversely makes sense for businesses to continue to hold off investment with the prospect of further support to come. It is vital that the government

sends the right signals to the economy - that holding cash today and not reinvesting it will not be rewarded with a more favourable tax treatment in the future.

An interesting parallel is the Trump Administration's business tax cuts and repatriation of profits overseas. Corporate tax reductions in the United States with the aim of bringing money back from overseas into the US have seen some success, but far less than expected. Instead of the estimated $4 trillion that the US Government predicted, the true figure has been less than $500bn.[56] It is hard to identify exactly why US firms continue to keep cash overseas, but expectation of further tax cuts is likely to be a contributing factor.

UK businesses are far more likely to be holding cash than their peers. For example, 31% of UK non-financial corporations assets are in the form of currency and deposits, compared to just 6.8% in France and 12.4% in Germany. This is not because UK companies are holding more loans or investments in other businesses. Only 13% of UK corporate assets are loans compared to 19.8% in France and 12.5% in Germany. Equity is also lower than in Germany and France, with 45% of assets in the form of equity compared to 58% in France and 46.8% in Germany. Although holding some deposits is essential, the UK has an unusually high amount for a large developed economy.[57]

The impact on wages through a purpose driven model could also be significant. Evidence suggests that social businesses are more likely to pay higher wages, particularly for the lowest paid. 76% of social enterprises pay the Living Wage, as defined by the Living Wage Foundation. If this was replicated across the UK, it would improve wages for close to four million people.[58]

The government needs to resolve the 'collective action problem' which could hold back recovery efforts. Business investment is important for sustaining a strong UK recovery, but if one business acts alone, it is unlikely to move the economic needle enough and could be wasted if general demand does not increase. The most important thing is to encourage a collective wave of investment at the same time. The UK corporate sector working together could have a significant impact, likely to be in excess of what the UK state could provide. We can learn lessons from the Great Depression, where the British Government did recognised this challenge. Encouraging the formation of "cartels" to boost prices, wages and economic activity – recognising the importance of corporate investment to recovery.[59] Unfortunately cartelisation has other negative characteristics that it is best to avoid, whatever the short-term benefits.

Corporate governance reform, by contrast, is a way that the government can encourage significant collective action by the UK corporate sector whilst maintain competition and innovation within the UK economy. If carried out in the right way, this could lead to changes on a much quicker basis.

Encouraging profit investment and unlocking corporate cash stockpiles would do far more than anything that the UK government can do on its own. Even if only 10% of this cash was invested in its first year, this would unlock £70bn - double the current government's own "productivity fund" which was announced two years ago. The impact on the UK's economic growth would be considerable.

Reform to business would have significant and positive long-term consequences of the UK's economic performance. As we have noted above, companies which think longer term, with a social purpose and appropriate consideration of diversity are more innovative and profitable. This could create a virtuous cycle, whereby increased investment encourages greater economic activity, boosting profitability and further increasing scope

for investment. It would also create a larger tax base which could in turn increase potential for government to invest long-term in the UK economy and society, further boosting prospects for growth.

Although some would raise concern that reduced shareholder returns would negatively impact households or the taxpayer, the key is to consider the long-term benefits to the economy rather than the short-term reduction in returns to pension funds or institutional investors. Most institutional investors are dependent on long-term returns to their portfolios rather than short-term payouts in dividends. Failure to boost the UK economy through increased investment, productivity and returns is more likely to negatively impact household savings and living standards. Moreover, low growth and the need to keep interest rates low is dampening savings and returns to households.

In conclusion, instead of looking at individual responses (tax cuts, infrastructure spending, personal tax cuts) as potential cheap "silver bullets" for resolving the economic crisis, the government should look at rewiring the British economy, so that UK businesses are incentivised to act in their own and the public interest over the long-term. The final section of this report considers what this could look like.

REFORMS TO CREATE "BOUNCE BACK BRITAIN"

In order to enable Britain to bounce back effectively from COVID-19, the UK government needs to change the engine of the UK economy.

This should come in the form of short-term measures to encourage British businesses to invest and support the UK economy; medium-term measures to reform British corporations and spread best practice; and long-term measures to encourage the growth of successful British businesses which combine profitability with delivering on the UK's economic, social and environmental policy objectives.

Five examples of this approach would be:

1. A new "Contract with Britain" with businesses and the state prioritising investment in the next three years to help the economy to bounce back quickly;
2. A new "British Business Renewal Act" to reform company law and spread best practice across all UK businesses to raise standards and performance;
3. A new British Business Tax Roadmap so that businesses are encouraged to invest and generate positive social and environmental impact;
4. Showcasing British Business through a new National Awards Evening to give businesses, particularly SMEs, a positive platform and forge a better culture;
5. Using social value in procurement to drive higher performance from British businesses and shape markets.

Recommendation 1: A COVID-19 Recovery Business "Contract with Britain"

In the immediate aftermath of COVID-19, the UK government will need to encourage British businesses to come back strongly and invest in themselves, their staff and the national recovery. James Kirkup of the Social Market Foundation has called for a new "social contract" for business, for example, as a way of getting UK businesses to return the favour for the significant public support that the UK taxpayer has given to the corporate sector.[60]

Building on this theme, **the Government should ask UK businesses to sign a new "Contract with Britain".** In return for the significant economic support that the UK state has provided to the economy, British businesses should be asked to pledge that they will reinvest at least 10% of their profits (or if they are not making profits, prioritise) into:

- Investing back into their own business;
- Providing equity or quasi-equity into other businesses so that they can grow;
- Increasing training and welfare of their staff (through increases in pay or one-off bonuses).

This pledge would last three years to support the UK economy through the worst of the COVID-19 economic impact. Based on corporate profit data before the financial crisis, this could unlock up to £60bn for UK plc and support the UK's recovery plan over the next three years – equivalent to 1% of GDP per year.

It would also provide breathing space for the UK to consider wider issues of corporate governance reform and see potential impacts of a "purpose" driven approach to UK business policy. A successful take up and implementation of this pledge would further strengthen the evidence base for reforming British business. A lack of interest or support would show that a much tougher approach is required to motivate UK corporations.

Recommendation 2: British Business Renewal Act

As this paper has discussed, comprehensive corporate governance reform is essential to improving the function of UK businesses. Measures should be introduced to encourage long-term thinking which aid company performance.

Several studies have showed that inserting purpose into the heart of the company encourages long-term thinking, whereas an exclusive focus on financial performance and profitability encourages short-termism, which is detrimental to the wider economy and corporate performance.[61]

The UK Government should introduce a "British Business Renewal Act" which would have at its centre reform of the Companies Act. This would need to be done in consultation with stakeholders, but the core elements would include:

- Obliging every UK business to have a social or environmental purpose beyond purely acting in the best interests of the members of the business;
- Making every business accountable for delivering that purpose;
- Making every business report on its efforts to deliver that purpose;
- Including a new duty on businesses to contribute to Net Zero carbon target;
- Asking companies to report on how they have balanced sharing profits with shareholders/owners with efforts to deliver on their purpose.

Companies could still refuse to have a purpose, but as an incentive to have a purpose, those companies that refused to have a purpose would lose access to "limited liability" under the law. This would be in recognition that there is a social contract between businesses and society, that businesses receive legal privileges in return for the contribution that they make to the UK economy. Unlimited companies do currently exist in the UK, although these do not have report to Companies House in many cases, so it is hard to know exactly how many there are.

Other countries around the world are exploring these reforms. In France, President Macron has created a new form of business, "L'entreprise à *mission*" which has now been embraced by Danone – one of Europe's largest businesses.[62] Central to keeping the UK competitive is improving the structure of British business.

Recommendation 3: A New "British Business Tax Roadmap"

Although this paper has found that tax cuts without reform are not effective in delivering results, tax reform combined with structural reform can be an effective tool. Tax is a useful way of incentivising businesses to do the right thing and encouraging the development of businesses which demonstrate the right characteristics (i.e. long-term focus, investment-led approach). Reform of corporate governance and structure without support through the tax system will increase the time it takes for reforms to be effective in shaping markets.

The government's Corporate Tax Roadmap was published in 2010 and the latest Business Tax Roadmap in 2016. **Now is a useful time to revive the Roadmaps and give businesses certainty about the future of the tax system**. This could be tied into an existing review of business rates to provide a more comprehensive solution.

As well as providing certainty about rates of taxation, the roadmap should also give a timeline for tax reforms to support a fast, equitable and sustainable recovery. Proposals could include:

- Reforms to encourage investment, for example, allowing the cost of capital investment to be 100% deducted from corporate tax rates;
- Reform to carbon price and carbon taxes to bring consistency across all fuels and business models to encourage substantial carbon reductions;
- Reductions in corporation tax for those businesses which reinvest the majority of their profits back into their communities or demonstrate pro-social behaviour, recognising that this saves the taxpayer money in the long-term;
- Reform to National Insurance to incentivise businesses to carry extra costs in employing people furthest from the labour market (such as ex-offenders, care leavers, homeless) and those with physical or learning disabilities.

The aim of the British Business Tax Roadmap would be to create a business tax system which encourages businesses to work in the national interest, supporting a strong recovery and long-term aspirations such as the 2050 Net Zero Carbon Target. The UK could also explore corporate tax credit approaches, such as in the Netherlands, where taxes are increased but tax can be claimed back if businesses make appropriate investment into green technology.

Increasing the mainline rate, whilst using these reforms to reward effective behaviour would not only enable these reforms to be fiscally neutral but also to further strengthen the power of the incentive.

Recommendation 4: Showcasing the Best of British Business

British business generally only reaches the front pages if there is a scandal and, as noted above, the public perception of business and our economic system has become dangerously warped around concepts of greed and corruption. There are tens of thousands of good businesses in the United Kingdom but many of these businesses do not get the attention that they deserve.

This creates a vicious cycle, where businesses that do the right thing feel that they are not recognised and rewarded. Those that do not seek to positively contribute to society do not see any loss or pressure to alter their behaviour.

The creative industries, charities and media have showed the power that televised awards can have in shaping public perceptions and encouraging social action.

The Government should work with business representatives and broadcasters to develop a National Awards evening for British Business.

Rather than reinventing the wheel, the Government should look to use the Queen's Awards for Enterprise as a model that can be showcased and expanded. The Royal Family have a tradition of showcasing and leading British business, most notably with the Great Exhibition driven by Prince Albert. Using the profile of the Royal Family, Government and celebrity to showcase the best of British Business would be a powerful platform to push for cultural change in the UK corporate community. It would also provide a platform to promote the characteristics of British business which are essential to long-term growth.

The Queen's Awards could be expanded to cover new categories, such as investing in deprived communities and green growth. Although the Queen's Awards makes on average around a hundred awards every year, judges could be asked to pick a lead example within each category for any televised ceremony. The aim would be not to limit the number of Awards, but to showcase the very best examples. Special consideration could also be given to promoting BAME and women-led businesses to encourage diversity in the UK

corporate sector. A televised awards ceremony would also give valuable profile to SMEs which can often struggle to compete with larger businesses because they lack the advertising budget.

Where possible, this Awards Evening would seek to complement existing awards which will continue to be necessary to showcase best practice within particular sub-sectors. The aim of this new National Business Awards Evening would be to inspire entrepreneurs, showcase the power of business to do good and support the UK and to provide incentives for businesses to the right thing in the hope of gaining attention. A set piece opportunity to instil new values and approaches in British business.

Recommendation 5: Using public procurement to encourage good business

The UK has an opportunity following Brexit to further adapt procurement rules to back good British businesses and encourage socially and environmentally responsible behaviour. The UK public sector currently spends close to £300bn a year on procurement of goods and services – equivalent to 13.4% of UK GDP.[63]

Unfortunately, the power of procurement is underused to shape business. According to former Conservative MP Chris White's report into public procurement, only £25bn of this spending is currently being used to champion socially and environmentally responsible business practices.[64] This may increase to close to £100bn following recent changes announced by the May Ministry, but this would only cover a third of all UK public spending.[65]

A common term for this holistic approach to public spending is "social value". This means considering not only the financial cost but also the added social, economic and environmental impact of spending. For example, one company may produce stationary through offshore production for the cheapest price. Another company may manufacture stationary in the UK, using green products and providing jobs to those that are long-term unemployed. The latter may be marginally more expensive financially, but when taken in the round, the UK taxpayer will get more value from using the second business. This is an example of considering "social value".

Research has also showed that using procurement to encourage responsible practices saves the taxpayer money in the long-term. The Government's own review of the Public Services (Social Value) Act which encourages this approach found that "where it has been taken up, it has had a positive effect, encouraging a more holistic approach to commissioning which seeks to achieve an optimal combination of quality and best value."[66]

Yet we are not currently using the power of the purse effectively enough. Taking the issue of tax avoidance, a textbook example of anti-social behaviour, research by Demos found that 25 out of 34 of the government's thirty four Strategic Suppliers (73.5%) are part of a corporate group including one or more subsidiaries in 14 tax havens (not including US mainland, EU or Single Market jurisdictions), according to public records. Seventeen of those (50%) were part of a corporate group with subsidiaries in British Overseas Territories or Crown Dependencies, such as the British Virgin Islands and Guernsey. Twenty of the 25 tax-haven-linked Strategic Suppliers show that they were awarded more than £41 billion worth of government contracts between 2011 and 2017.[67]

The social and environmental returns to the economy through effective procurement are potentially game changing. The Star Procurement in Greater Manchester, a strategic partnership between Rochdale, Stockport, Tameside and Trafford has generated £21.6m

in social value based on £78m on contracts. This is a 28% return based on the contract values.[68] This social value can come in a variety of forms from providing apprenticeships to young people, to investing in local community projects, buying locally or investing in low carbon initiatives.

If this approach from the "best in class" in the UK was replicated across the UK public sector as a whole, we could generate £84bn in additional social value across the economy every year. This would be equivalent to an extra 2.8 million apprenticeships every year[69] or planting 8 billion trees.[70] This would be a transformative level of investment not only improving economic performance but strengthening communities and increasing the pool of social and cultural capital.

Procurement is a way that the UK government can shape markets and encourage positive behaviour in businesses, creating real incentives for businesses to adapt their behaviour.

CONCLUSION

The UK is experiencing another major economic shock, far larger than the one experienced in 2010. It is vital that we learn the lessons of the last decade to make sure that we do not repeat the same mistakes.

We know what a recovery which assumes that the British economy is essentially strong and does not require structural reform looks like. It is a weak recovery. It is also, given the scale of borrowing due to COVID-19, an expensive recovery. Costly not only in terms of lost opportunities, low wages and low investment but also to the Exchequer. Tax cuts, as has been shown above, are not cost-free.

Britain can pursue a different path and the evidence suggests that there is a public consensus behind a change in direction. The only thing that can hold us back is a lack of political will and imagination.

What would this different path look like? It would be one where the UK learns the lessons from corporate success, both in the UK and around the world, and pursues structural changes that embed social and environmental purpose in UK business to encourage long-term thinking and investment. It would combine this structural reform with tax reform which rewards businesses and demonstrates that the right kind of behaviour could be game changing. The UK government also needs to recognise its own power to shape business culture. By saying little and doing nothing to address structural weaknesses in the UK economy, it encourages UK businesses to carry on as usual.

This may seem like an esoteric discussion to have in the midst of a crisis, but the evidence suggests that the structure of business is critical to the kind of recovery that the UK will experience after COVID-19. Without reform, we are likely to see a long, slow, painful recovery for Britain as we experienced after 2010. A change in approach, with the right combination of governance reform, tax reform and cultural change will increase the chance of a recovery which is faster, stronger and more sustainable. Importantly, this would be a recovery in which every part of the country would benefit not just those at the top. This stuff really does matter.

As we use the coming weeks to begin planning what the UK's economic recovery plan should be post-COVID, we should use that time wisely. The evidence in this paper suggests that the direction we choose today could define the coming decade.

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