THE FIFTH WAY

Another way to grow Britain

By Dr. Madsen Pirie

BRIEFING PAPER

EXECUTIVE SUMMARY

- British finances are tight, real wage growth is poor, and there is a perception that not everyone is benefiting from a weak post-recession recovery.

- Austerity seems to have fallen by the wayside politically—whether or not the intellectual arguments against it were successful.

- Funding the deficit takes money, but extra tax means poorer citizens and lower growth; extra borrowing means less private investment and a burden on future generations; and printing money creates inflation, reduces confidence in macro-economic authorities, and eventually comes out of households' pockets anyway.

- Extra growth is a win-win solution, but tax cuts on businesses make the short-term deficit worse and hard to defend politically.

- The solution is a fifth way—privatization. The government should let councils buy land, grant it planning permission, and then sell it off, increasing its value many times.

- Not only will this create growth, but it will overcome the "NIMBY" objections to development by making new housing work for both existing homeowners and those suffering from the housing crisis.

- The government should pilot this scheme with 12 councils in high-demand areas before rolling it out over the entire country.

INTRODUCTION

Some commentators suggest that the British are tired of austerity. People could accept the combination of stagnating living standards, or even a modest decline in real spending power, combined with state spending restraint, for a few years, but not for another decade. It seems that Fiscal Conservatism must be put on hold for a few years. If we aren't to continue cutting the deficit towards George Osborne's intended surplus, this raises the question of how deficit spending is to be funded.

ADAM SMITH INSTITUTE – THE FREE MARKET THINKTANK
23 Great Smith Street,
London, SW1P 3DJ
+44 (0)20 7222 4995
www.adamsmith.org

There have been four classic ways of doing this. The most obvious is increased taxation, but this would be massively unpopular because it would eat further into spending power. The idea that it could be levied on businesses is economically naïve, in that all taxation comes from someone's pocket somewhere. Taxes on 'business' are expressed in higher prices paid by customers, lower wages for employees, or smaller dividends for shareholders, and therefore less job-creating investment. None of these present attractive options.

The second method sometimes used by government has been printing money. This funds government at the expense of everyone else, in that it leads to price inflation which in turn also erodes spending power. Its advantage is that it is 'stealthy,' rarely attracting to government the blame for causing it. Sooner or later, however, and usually sooner, it stunts investment and erodes the confidence needed to sustain economic progress. Therefore, in the modern world it is used only by basket case countries like Zimbabwe and Venezuela.

The third method, made into an art form by Gordon Brown, is borrowing. Current spending can be financed by borrowing from the future. The advantage for politicians is that the spending is now and rewards the current electorate. The bill has to be picked up by future taxpayers who do not currently vote. By the time the burden falls on the next generation, the current crop of politicians will have gained the rewards and gone, leaving it as someone else's problem. This is an irresponsible option, but often a politically successful one.

When the government issues extra government bonds (called "gilts" in the UK), it has another underappreciated effect. In order to get people to invest in gilts, instead of the other assets, like stocks, corporate bonds, and bank deposits (which are invested in bank loans) they already have their money in, they must offer a slightly higher return, relative to their risk. This means extra borrowing cannibalises investment elsewhere in the economy—the very investment that leads to higher productivity and living standards in the long run. This is widely borne out by economic research.[1,2]

A fourth method, and the one that does least economic damage, is growth. If measures can be implemented to promote expanded economic growth, the additional economic activity will bring higher revenues to the Treasury without the need to impose higher rates of taxation. A greater tax base will bring in more revenue to finance the spending. A problem this brings is that measures to promote growth often involve lowering tax burdens on business activity, difficult to gain political support for at a time when ordinary people face stagnant or declining spending power. They also reduce tax receipts in the short run, necessitating extra tax, borrowing, or inflationary printing.

1 Alexander, G., & Foley, M. (2014). On the Nominal Interest Rate Yield Response to Net Government Borrowing in the US: An Empirical Analysis with Robustness Tests.

2 Cebula, R. (2014). The Nominal Interest Rate Yield Response to Net Government Borrowing: GLM Estimates, 1972-2012.

The Labour manifesto called for both the first method—big tax hikes to fund extra spending—and the third method, spending now, with the tab to be picked up by the next generation. The present government will probably look at a combination of a little extra borrowing to provide short-term funding for pro-growth measures, a combination of methods three and four.

PRIVATIZATION AS A FIFTH WAY

There is a fifth method, one discovered during the Conservative governments of the 1980s. It is to use the revenue from privatization sales to fund current spending. Under arcane Treasury rules the proceeds from the sale of state industries was counted as 'negative spending' and could be deployed to fund current spending. The disadvantage was that each sale was a one-off, whereas current spending had to be financed for year after year.

Some saw this as an advantage, in that it impelled governments to seek ever more sales of state assets to provide continued funding for their programmes. Harold Macmillan, a former Tory Prime Minister likened it to "selling the family silver to pay the butler's wages," though since most state industries were decrepit and loss-making, it was more like offloading the family junk. In any case, the analogy was unlikely to resonate with most households that had no silver and employed no butlers.

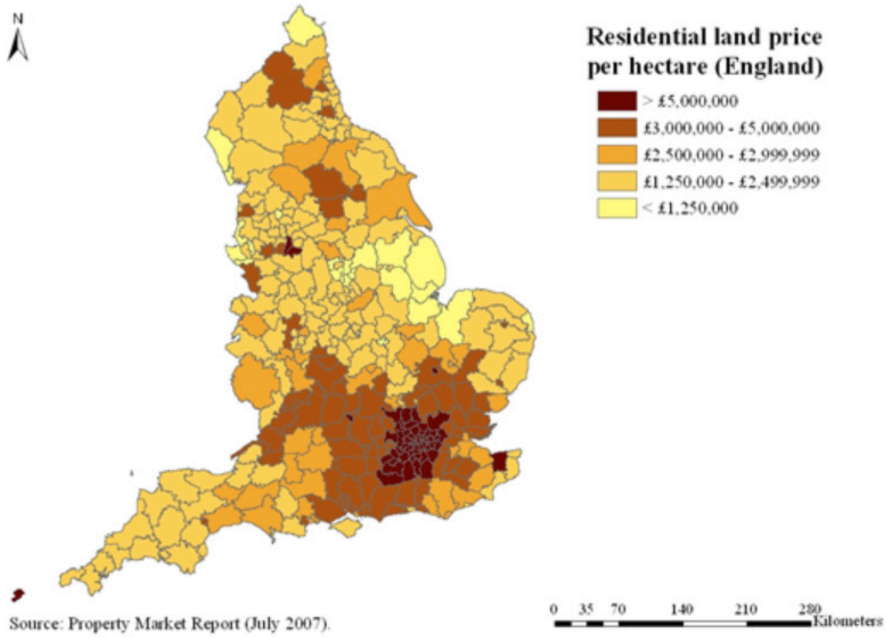
This method might seem to have little traction today, in that most state industries have already been sold off. But this is not the limit of UK state resources they might conceivably sell: a 2013 ASI report found that the government owned around £600bn of assets, including £73bn of roads.[3] And there is another, perhaps greater, source of fifth way finance that has not yet been tapped. Local authorities could be empowered to buy land in their vicinity, land that has no planning permission for development. Some of it would be intensive farmland, with little amenity value, and negative environmental benefit, some would be damaged or distressed land such as disused gravel pits, abandoned factories, and overgrown car parks. It would involve giving local authorities, rather than the national government, control over green belt land.

Local authorities would be allowed to grant planning permission for such land once they had bought it, and sell it for housing development at many times the price it had cost them. This process could well yield billions of pounds that could be used to fill in potholes, run extra bus and train services in underserved areas, pay for parks and playgrounds, and even cut council tax. This could replace part of the system of central allocation of funds, and the whole community would benefit from the process. It would be a boon for devolution of powers from central government to local authorities. Representatives of local people would acquire the right to decide on appropriate development and to set it in motion. Furthermore, it would be up to communities, through their local authorities, to decide how the funds raised could be spent.

---

3 Hawkins, N. (2013) Cash in the Attic

Even in the late 1990s and early 2000s, since which house prices have risen very significantly in the South East of the country, an acre of land with planning permission in the London commuter zone could fetch £4m.[4] By contrast, farmland fetched £2,500 per acre. In total, land makes up a very high fraction of property values. Certainly Reading is not entirely comparable to the rest of the country—house prices there average around £300,000, versus £230,000 across the country as a whole. But nor is it the most expensive location: prices in Cambridge, London, and Oxford are far higher.

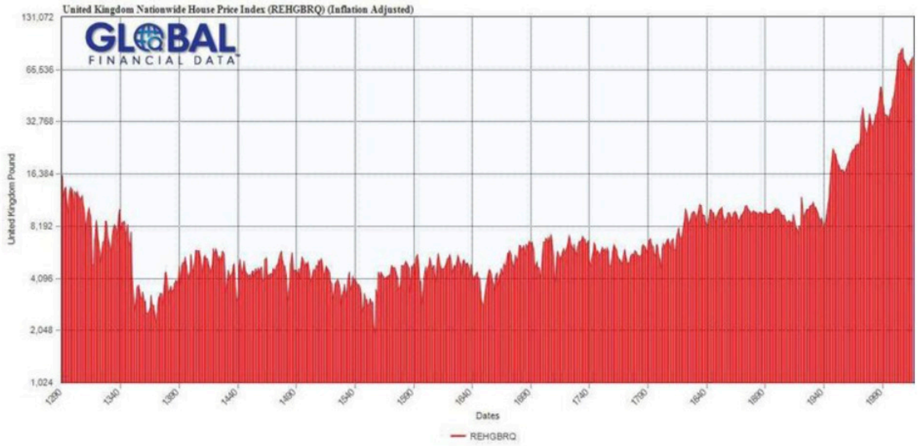


Source: Property Market Report (July 2007).

If land makes up half the value of property price then we might assume that councils could capture £115,000 per house, averaged across the country. However, that value is derived from the current point, where land with planning permission is extremely scarce. If, say, 1 million extra permits were issued every year, then that value would fall. But even assuming it falls to, say, a quarter of that value on average, that is almost £30bn for the first million permits—excluding all of the large knock-on effects of such a significant building boom. And a million permits, even issued in a single year, would not nearly satisfy housing demand near major expanding areas.

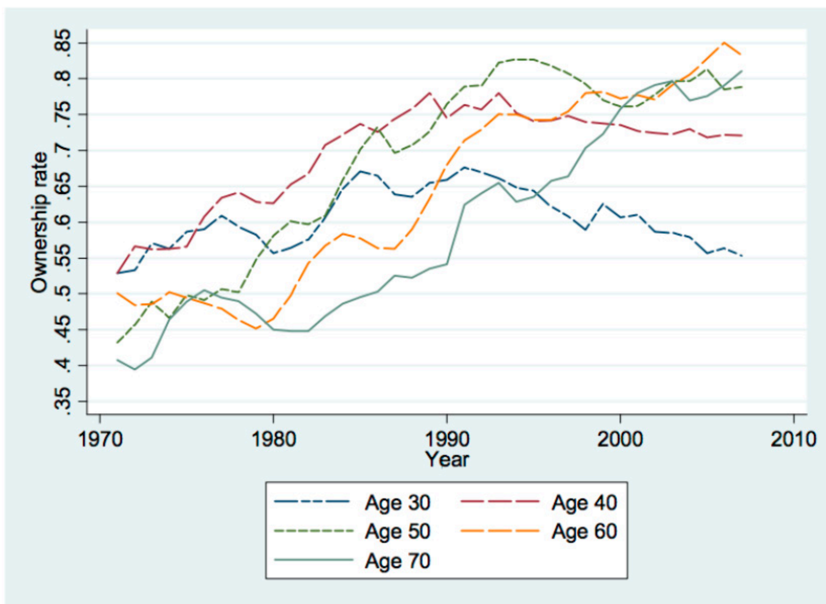
This closely resembles the key housing proposal in the 2017 Conservative manifesto, differing in one key respect. That scheme required councils, when they bought land without planning permission, to then build on it themselves and provide council houses. But the history of government-provided social housing in Britain is a litany of disasters, and examples like Japan, not to mention Britain before the second world war, prove that markets are perfectly capable of keeping housing affordable. Under our proposal local communities enjoy the monetary reward, but leave the price system and private firms to decide on what to build, where to build, and how much.

4 Cheshire, P., & Sheppard, S. (2005). The introduction of price signals into land use planning decision-making: a proposal.



A further advantage of this new 'fifth way' finance is that it would clear the way for many new houses to be built where people wanted them relieving the pressure on the housing market and enabling young people once again to aspire to home-ownership. Home-ownership has been getting progressively worse every generation for decades, preventing many from living near the best jobs, or affording enough space to have the family they want.[5] In the five years before 2013 twice as many houses were built in Doncaster and Barnsley than in Oxford and Cambridge—and that was an improvement on the past.[6] This is despite the far higher prices in the university towns.

Ownership rates at different ages by year: all individuals, England



5 Bottazzi, R., Crossley, T. F., & Wakefield, M. (2012). Late starters or excluded generations? A cohort analysis of catch up in homeownership in England. Koç University-TÜSİ AD Economic Research Forum Working Paper Series.

6 Cheshire, P. (2014). Turning houses into gold: the failure of British planning. British Politics and Policy at LSE.

It would impose no new taxes, create no printed money to fuel inflation, and it would not borrow to place a burden on future generations. It would, however, boost growth, in that the accelerated house-building programme it facilitated would create jobs and augment pay packets. This in turn would increase tax revenues without the need to increase rates.

CONCLUSION

Government should seriously consider allowing local authorities to use fifth way finance. They might even pilot the scheme for a year in selected areas to test its viability in practice. The odds are high that other councils would soon be clamouring to acquire the same powers.

Given the perceived need to fund programmes without the cuts previously planned, and the disadvantages which lie with each of the traditional four methods of funding deficits, this might be an opportune time to try a new approach. Fifth way finance would raise funds in benign ways that do not damage the economy or hit the pockets of the citizenry. It might be appropriate to introduce it and to do so rapidly.