Investment in Scotland
A Common Weal Approach

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Summary of Key Points

Introduction:

• Although investment can mean different things in different contexts, this paper is solely concerned with the process of allocating, lending or spending money on projects in such a way as to provide tangible economic, social and environmental benefits and which should provide a return on that money in future years.

Scotland must increase its investments:

• We challenge the myth spread by both the UK Government and the EU that government debt levels are a barrier to governments spending more on capital projects, that austerity and cutbacks in spending are necessary and that investment is best left to the private sector.

• This austerity narrative misleads in two ways:
  o Historical comparisons show that public borrowing levels in the UK are not excessively high.
  o Austerity is not a policy option which is effective at addressing government debt.

Historical comparisons:

• Taking a long-term look at UK debt, debt peaked at 260% of GDP in 1820 following the Napoleonic wars when the industrial revolution was in full swing. It exceeded 200% of GDP again in 1950 following the Second World War when major projects of national reconstruction were underway, but consistently fell thereafter until 1991, when it was 25%. Just before the financial crash in 2008 it was only 37%. After 2008, as a result of falling tax receipts, it rose to 76% of GDP in 2013 or 52% when Quantitative Easing is removed. It is therefore still historically very low.

Taking a look at UK debt over the long-term shows that it is historically at a very low level.

• It is also incorrect to claim that we cannot afford the interest on debt. In fact, in the 1930s the UK Government was paying over 9% of GDP in interest, it now pays around 3%. Historically the only time less interest has been due was under the last Labour Government.

• Hence, contrary to the austerity narrative, debt levels and interest on debt in the UK are both low by historical standards.

• The reality is that there has rarely been a more favourable time for the UK Government to borrow in order to invest in renewing its infrastructure and fostering new industries.
The effects of policy choices on GDP growth and debt reduction:

• In Greece EU imposed austerity measures clearly led to financial collapse and spiralling debt.

• Contrasting the UK and the US, the US stimulus package of May 2009 boosted US recovery, whereas the UK imposition of austerity in October 2010 stalled UK recovery.

• Taking a longer timescale, real GDP growth in the UK was highest in the ‘high debt’ decades of the 1950s, 60s and 70s, averaging 2.7% per year. This period, which was characterised by state ownership of vast swathes of the UK economy, an interventionist approach to the financial sector and strong trade unions, coincided with the sharpest reduction of debt in UK history.

It is testament to the outright failure of the Thatcherite project that the UK’s growth has declined every decade since the former Prime Minister began the process in the 1980s.

• It is testament to the outright failure of the Thatcherite project - the deregulation and privatisation of much of the UK economy and the increasing emphasis placed on the financial sector - that the UK’s growth has declined every decade since the former Prime Minister began the process in the 1980s.

• Putting these ‘economic’ considerations aside, austerity exacerbates social injustice. Cuts in government spending fall disproportionately on the poor. The life chances of a generation are being decimated through unemployment and a lack of rewarding employment opportunities.

• Austerity economics will not work to provide the necessities of life alongside decent jobs and full employment.

• Large-scale targeted investment is needed, not in banking, but in the production of the things we need in the 21st century, e.g. renewable energy sources and environmentally sustainable housing. Even Nick Clegg in 2013 admitted to the BBC:

“...We’ve all realised that you actually need, in order to foster a recovery, to try and mobilise as much public and private capital into infrastructure as possible.”

Shortcomings of the UK’s current investment structure:

• Our key areas of concern are the low level of investment and problems with relying on private finance.

• Total investment, by individuals, businesses and the public sector, in the UK is appallingly low. The percentage of GDP invested in the UK in 2012 - 14.2% - was the fourth lowest of the EU countries. Only Cyprus, Greece and Ireland, countries which were clearly in a state of economic distress, invested a smaller percentage of GDP. Germany, Italy, Spain and France invest between 17.6% and 19.8% of GDP. The 12 newest members of the EU all invest more than the UK.

• However, total investment includes simply replacing things which need replaced (depreciating assets). When the 11% required for this is removed, leaving 3.2%, and an increasing population is taken into account the UK does not invest anything at all.

• This situation arose because private finance is too expensive and too risk averse for the most innovative technologies and most private finance in the UK is channelled through financial markets and banks.

• The case of Private Finance Initiatives (PFI), which has dominated infrastructure investment since the 1990s, exemplifies how private finance provides poor value for money. In 2011 the House of Commons Treasury Committee found that “the cost of paying off a PFI debt would be over 40 percent cheaper if government funding were used”. They also found that there was no transfer of risk to the private sector.
Most of the technologies which have shaped the modern world, e.g. pharmaceuticals, the Internet or GPS, owe their origin to government funded research. In the US between 50% and 70% of R&D investment between 1950 and 1990 came from US government funding. Without this the US would not have maintained its lead in key industries like computers, semiconductors, life sciences, the Internet and aerospace.

The UK’s market-based financial system is dysfunctional:

- Financial markets provide little investment for the productive economy and instead market activity is devoted largely to speculation on the value of assets (including derivatives) and shares.

Financial markets provide little investment for the productive economy.

- Finance from shares results in the ownership of businesses by shareholders. The prioritisation of these shareholders’ returns disempowers employees, customers and other stakeholders, resulting in a democratic deficit in the economy.

- The profits generated by shareholder-owned businesses are extracted from the businesses by the shareholders, redistributing wealth to the already wealthy and increasingly in the UK to foreign individuals and institutions, leaving less money available for investment and other purposes.

- The rapidity with which shares change hands in financial markets, the payment of senior management in the form of share options, coupled with the lack of oversight of shareholders in the day-to-day running of businesses, result in short-termism dominating business decisions at the expense of investment targeted at increasing productive capacity over the long term.

- As market-based financial systems, like all markets, afford greater power to wealthy individuals they provide little scope for the promotion of economic democracy. Scotland should therefore move away from a market-based financial model and develop a bank-based financial system, built on a banking sector which is reformed along democratic lines.

- With 5 banks which collectively account for approximately 90% of banking, the UK has the least diversified banking sector in Europe. This has a variety of implications:

  - ‘Too Big To Fail’, these banks can act with virtual impunity with confidence that taxpayers will bail them out if things go wrong.

  - The wealth and power which they yield has raised concerns that they are able to exert too much influence on the political process.

  - Bigger banks allocate considerably less credit to the productive economy. Large banks prefer large deals, which often involve asset speculation, and have little incentive to do the labour intensive work of analysing the prospects of fledgling firms. Small banks, on the other hand, are prepared to do this work because the returns which these deals offer are significant relative to their size. The UK’s concentrated banking structure is therefore restricting productive investment.

  - A strategy to create greater banking diversity in Scotland would contribute greatly to increasing the allocation of investment to productive businesses while reducing speculation. Indeed, such a strategy would have a similar impact to ‘credit controls’, a monetary policy tool used until the 1970s by the Bank of England to direct commercial bank lending to the productive economy.

  - It is notable in the context of the current referendum debate on Scottish independence, which has focused much on issues of currency, that should Scotland adopt a strategy to promote greater banking diversity it will be able to develop a key aspect of monetary policy even while continuing to use Sterling, within or without a formal currency union.
The UK, like all modern economies, operates a privatised monetary system. 97% of the money supply is created by commercial banks through the act of lending, by effectively treating a future payment stream as an asset and issuing ‘money’ as a liability. As a result:

- When commercial banks charge interest for credit they are in effect charging rental on the money supply that the rest of the population must use. This results in a redistribution of wealth from the productive economy to the banking sector, from the indebted to the shareholders of banks and from peripheral economies to financial capitals such as Tokyo, New York and London.

- When banks increase the money supply to the economy but their credit allocation does not result in the creation of new goods and services then a consequence is inflation, as greater quantities of money chase after the same quantity of goods and services. This can have devastating consequences. The asset price bubble which precipitated the Great Recession is an example of this phenomenon.

- As banks create money by issuing loans but not the interest which must be paid on those loans, it is inevitable that there will be more debt in an economy than money. For this reason there must always be an increasing amount of lending so that debts plus interest can be paid off. This necessitates ever increasing economic activity (GDP growth) to generate ever increasing surpluses with which repayments can be made. Consequently, when growth stalls the result is financial crises, defaults, bankruptcies and rising unemployment. As importantly, concerns about the capacity of the Earth’s ecological systems to cope with ever growing economies have led to criticism of a financial system predicated on this “growth imperative”.

Common Weal approaches to investment:

- Three guiding principles of investment are identified:
  - Investment should be directed towards societal goals. It should result in tangible benefits to the public, in higher wages, more interesting work, in greater revenue for public services and should protect the natural environment.
  - Publicly funded revenue and maintenance investment should be separated from capital investment.
  - Deficits in revenue spending should cease.

- Scotland should aim to raise its total level of investment to at least the EU average, which would involve an increase of investment by over £78 billion over the next 15 years, including just over £26 billion devoted to energy. This investment would be channelled through a variety of mechanisms which would mean that government exposure to debt would be only £24.6 billion over this time period.

Scotland should aim to raise its total level of investment to at least the EU average.

- Taxation should be the primary source of revenue and maintenance investment. Sources of revenue could include measures to prevent tax evasion such as Unitary Taxation with Formulary Apportionment, wealth taxes such as a Land Value Tax and a new 60p tax rate for those earning over £150,000 per annum. However, the greatest improvements to public finances will be made by the creation of a high-skill/high-pay economy, which does not require government to subsidise low pay and generates higher taxable incomes.

- Scotland should pioneer the use of ‘tax backed bonds’ if it continues to use Sterling in the event of independence. These are bonds which can be used to pay state taxes in the event of government default. Tax backed bonds are designed to de-risk the bonds of governments operating in currency zones by ensuring that bonds remain ‘cash good’ during times of economic crisis, preventing the kind of pressures applied to countries such as Greece during the Eurozone crisis.
Three key approaches to borrowing are outlined:

- Where returns on investment may be indirect, traditional forms of government borrowing such as bond issuance at the national or local level should be considered.
- Major investment could be undertaken by national or local agencies which would borrow against future rents, e.g. to build new social housing.
- ‘New Investment Companies’ (NICs) could be created at the local or national level. An example might be a national mutual or local mutual company. This could be a company set up with investment from the public sector but would then be run like any other business, borrowing to invest on the basis of future profit. Every Scottish citizen (or community member in a local mutual company) could be given one non-tradeable share in that company and would have a democratic right to vote on how it is run.

Central to a Common Weal investment strategy would be a National Investment Bank.

- Central to a Common Weal investment strategy would be a National Investment Bank. This could be modelled on successful institutions existing elsewhere (such as the German KfW) which prioritise lending to promote societal goals, such as green energy production, SMEs and infrastructure development:
  - Drawing on the German example, a National Investment Bank in Scotland could access between £3.2 and £3.7 billion per year. As lending by such banks is profitable, this revenue would act to reduce any government deficit.
  - The National Investment Bank would also promote diversity in the financial sector by partnering with local banks, allowing community banks to compete with the large banks and, in so doing, promote diversity in the financial sector.

- Financial sector reforms should be undertaken to promote banking diversity in Scotland:
  - A change in legislation should be considered which would give authorities the right to break up banks and other financial institutions that are so large, leveraged and interconnected that their collapse would pose a systemic risk to the financial system as a whole. That way a government’s ability to act to break up banks would not be dependent on competition law but contingent on banks being ‘Too Big To Fail’.
  - Each of Scotland’s 32 local councils should establish its own bank.
  - Regulations governing the lending activities of credit cooperatives, small locally responsive and democratically run financial institutions, should be no stricter than those for investor-owned banks.

- To limit the creation of bubbles and channel far greater investment into the productive economy Scotland should revive the monetary policy tool of credit controls, through which a central bank applies caps on the allocation of credit to assets and quotas for productive lending.

- Reform of the debt-based monetary system should be considered. A system called ‘full reserve banking’ should be evaluated, in which the power to create the money supply would be taken away from commercial banks and placed in the hands of a central bank. Research by IMF economists suggests that granting central banks exclusive power to create the money supply could have numerous beneficial effects, such as dramatically reducing overall levels of public and private debt, eliminating bank runs and providing governments with considerable sums in seigniorage, which could be used for investment.
Introduction

Investment means many things.

We invest in people when we dedicate time and resources to improve their skills, knowledge and understanding, create security for them so they can flourish, improve their access to what makes them happy and fulfilled.

We invest in the household when we ensure economic security for families, affordable secure housing, proper time for family life, high-quality environments and strong communities.

We invest in the community when we improve the infrastructure (especially open space and places for play and recreation), improve transport links, create conditions for positive relationships, strengthen local economies.

We invest in our villages, towns and cities when we keep them alive with thriving high streets, great facilities, good public spaces, diverse economies and great transport links.

We invest in the economy when we support long-term improvements in skills, productivity, innovation and trade, when we build new productive economic infrastructure (especially technology and industrial plants), when we support export activity and diversification.

We invest in the nation when we build infrastructure, improve public services, increase democracy and support thriving arts, culture, sport and entertainment.

While clearly investment is by no means all about allocating, spending or lending money, it is this aspect of investment which this paper addresses.

This paper is divided into three main sections:

In Section 1 the current austerity narrative, according to which priority should be given to cutting public spending at the expense of borrowing to invest, is challenged.

In Section 2 the shortcomings of the UK’s investment structure are outlined.

In Section 3 Common Weal approaches to investment are presented.

1. The economic vandalism of austerity

In the UK, as in other countries across Europe, a crisis triggered by a dysfunctional financial sector and falling real wages has been blamed on excessive and irresponsible government spending and a ballooning of national debts. Europe is broke, so the story goes, and cannot recover until excessive borrowing is brought under control.

Central to UK and EU economic policy has been the oft repeated assertion that a government’s debt must be limited to a maximum percentage of GDP lest an unsustainable and inflationary expansion is generated leading to a downward economic spiral.

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precipitating economic catastrophe. This stance was given legitimacy when the Bank of International Settlements published a report in which it was claimed that when a country’s debt exceeds 90% of GDP this has negative impacts upon economic growth (Reinhart et al., 2011). According to this argument, in the event that debt is rising in a country due to a fiscal deficit at such a rate that this debt to GDP limit is threatened, then prudent stewardship of the economy mandates cutbacks in spending or sales of government assets. This certainly was the argument of The Conservative Party in the 2010 election:

“A Conservative government will act now on debt to get the economy moving. We will deal with the deficit more quickly than Labour, so that mortgage rates stay lower for longer with the Conservatives (The Conservative Party, 2010).”

In the EU and particularly the Eurozone, a more formal approach was taken. The Stability and Growth Pact which came into force in 1999, before the economic crisis, restricted EU states to debt to GDP ratios of 60% and annual fiscal deficits of 3%. Since 2013 a Treaty on Stability, Coordination and Governance effectively gives powers to representatives of the European Commission, the European Central Bank and the IMF, commonly referred to as ‘The Troika’, to enforce government compliance with these objectives.

Both in the Eurozone and in the UK government budgets have been slashed in order to ‘control the deficit’. This policy has become widely labelled ‘austerity’.

Most EU governments and parties have politically supported the principle behind these policies. Governments have requested visits from The Troika and endorsed the cutbacks recommended despite, in the cases of Greece, Spain and Portugal in particular, widespread civil unrest as a direct consequence of the austerity measures. In the UK the philosophy of austerity has not been seriously challenged by any mainstream political party. As a result most of the populace see no alternative and indeed trust the Conservatives with the economy far more than Labour, which is still perceived as creating the deficit in the first place. Rather than challenge this perception, Labour has now committed itself to accept not only the Coalition fiscal targets, but a cap on welfare for 2015 and forwards.

According to this logic, then, the priority for governments is cutting back on public spending, not borrowing to invest. In these circumstances investment is best left to the private sector.

This section challenges this ‘austerity’ narrative in two ways. First, it challenges the perception that public borrowing levels are excessively high. Second, it demonstrates that austerity is not a policy option which is effective at addressing government debt. In Section 2 the idea that leaving investment to the private sector is desirable will also be challenged.

1.1 How big a problem is government borrowing in the UK?

To put the UK’s current debt situation into perspective a longer term look at UK debt is illuminative. As we can see from Figure 1.1, which shows UK debt as a percentage of GDP since 1700, UK debt peaked at 260% in 1820 following the Napoleonic Wars when the industrial revolution was in full swing. Debt exceeded 100% of GDP in each of the 104 years from 1756 to 1859 and in each of the 43 years from 1918 to 1961. It fell each year from 1947 to 1975 when it reached 43%, dipped again to 25% in 1991 and in 2008, just before the effects of the financial crash, was 37%. As tax receipts fell and public spending rose as result of the crash, debt was 76% of GDP as of 2013.

To put the UK’s current debt situation into perspective a longer term look at UK debt is illuminative.
As such, even now debt levels are clearly not at an all-time high. In reality they remain relatively low in historical terms.

But debt levels are actually far lower once the effects of quantitative easing are taken into consideration. Quantitative easing describes the process by which government debt (UK gilt edged securities) has been purchased by the Bank of England using newly printed money. This began in 2009 in response to the financial crisis. The sums involved are significant. As of February 2013 the amount of debt purchased by the Bank of England was £375 billion (Bank of England, 2013). This constitutes 31.5% of total UK public sector debt (Cuthbert and Cuthbert, 2014). What this means is that the UK government actually owes around one third of the UK debt to itself and the interest the government pays on this proportion of the debt is returned to the treasury. It is, therefore, questionable whether this 31.5% can in any real sense be considered UK debt at all. If this sum is factored out, UK debt levels drop from 76% to 52% of GDP; debt levels which were already low in historical terms become even lower.

**Debt levels are actually far lower once the effects of quantitative easing are taking into consideration.**

Apart from the actual debt level, apologists for austerity also cite the 'high' level of interest that the Government pays for its debt. According to the Office for Budget Responsibility (OBR) UK debt interest will rise from £48.4 billion in 2013/14 to £75.2 billion in 2018/19. Whilst these seem enormous sums, as a percentage of GDP, again, they are in historical terms fairly low (refer to Figure 1.2).
Since the end of the First World War, the only period when the government paid a lower percentage of GDP in interest was under the last Labour Government up until the crash. And, again, it is worthwhile to remember that, as indicated above, around one third of the interest on this debt is actually paid to the UK Treasury.

Contrary to the austerity narrative, then, debt levels and interest on debt in the UK are both low by historical standards. The reality is that there has rarely been a more favourable time for the Government to borrow to invest in renewing its infrastructure and fostering new industries.

1.2 Austerity, debt and economic performance

Even if we were to consider the UK’s borrowing as a significant problem, austerity is not a policy option which is likely to assist in tackling it. As a means of reducing debt levels, the policy of austerity has been a singular failure. In Greece the debt to GDP figure averaged 104% during 1994-2009 and reached 148.3% in 2010, the year when the EU insisted upon the imposition of austerity in the country. Yet after three years of austerity, debt levels in Greece had actually risen to 176.2% of GDP in 2013 (The European Parliament, 2014).

Even if we were to consider the UK’s borrowing as a significant problem, austerity is not a policy option which is likely to assist in tackling it.

Putting aside the impacts of quantitate easing (discussed in the previous section), in the UK debt as a percentage of GDP has continued to climb despite - or, as we shall see, more accurately, because of - austerity measures, from 52% in 2009/10 (UK Public Spending, 2014) at the last election, to a projected 92.7% in 2015 (European Commission in Tagesschau, 2014). Austerity, there-
fore, is bringing the UK’s debt to GDP ratio ever closer to the 90% of GDP at which the Bank of International settlements claimed debt would start to impact future GDP growth (Reinhart et al., 2011).

Apart from factual errors in the report highlighted by the World Bank (Arthur and Inman, 2013) which have led the authors to subsequently revise upwards the percentage of GDP at which they claim impacts could occur, the whole analysis of causal links between debt and GDP growth has been challenged theoretically, e.g. by the Political Economy Research Institute (Herndon et al., 2013) and by Nobel laureate Paul Krugman (2013).

The whole analysis of causal links between debt and GDP growth has been challenged theoretically.

Krugman, for example, points out that the economic slowdown beginning in 2008 was not caused by the high levels of public debt; higher levels of borrowing resulted from the economic slowdown, not the other way around. He also draws attention to the fact that the UK’s high levels of debt post-World War II did not dampen Britain’s economic performance (Krugman, 2013). As Figure 1.3 indicates, real GDP growth in the UK was highest in the ‘high debt’ decades of the 1950s, 60s and 70s, in which annual growth rates averaged 2.5%, 3.1% and 2.4% respectively. Over these three decades annual real GDP growth averaged 2.7%. It is notable that this period, which was characterised by state ownership of vast swathes of the UK economy, an interventionist approach to the financial sector and strong trade unions, coincided with the sharpest reduction of debt in UK history. This was the era when the National Health Service was created, a massive rebuilding programme was in progress and a long sustained investment-led boom occurred. As a consequence, the growth of the economy far outpaced that of government debt and the debt as a proportion of GDP declined. In the following three ‘low debt’ decades, of the 1980s, 90s and 2000s, in which growth rates were 2.4%, 2.3% and 1.9% respectively, UK growth decreased to 2.2%.

![Average annual real GDP growth in the UK](https://example.com/figure1.3.png)

**Figure 1.3 - Real GDP Growth in the UK as a percentage of GDP (Source: Office For National Statistics in measuringworth.com, 2014)**

It is remarkable that the only full decade during the last thirty years in which economic growth matched that of any of the preceding three decades was the 1980s. This was a period in which the UK experienced an ‘oil boom’ due to the discovery of oil and gas reserves in the North Sea. Yet even during the 80s GDP growth only reached the 2.4% level of the 1970s, a decade in which the economy was blighted by a series of energy crises. It is testament to the outright failure of the Thatcherite project - the deregul-
lation and privatisation of much of the UK economy and the increasing emphasis placed on the financial sector - that the UK’s growth has declined every decade since the former Prime Minister began the process of neoliberalising the UK economy in the 1980s. A trend which is set to continue in this current decade. The historical record contradicts the argument that deregulated markets and financial markets are best placed to drive economic growth. It also contradicts the argument that high levels of government debt inhibit growth.

On the other hand there is ample evidence that austerity policies damage growth. The drawbacks of austerity in this regard are illustrated in Figure 1.4, which compares the US response to the onset of the Great Recession with stimulus versus the UK response of austerity. The stimulus in the United States was derided by economists such as Joseph Stiglitz and Paul Krugman as being so small as to be almost wholly inadequate (Stiglitz, 2012; Krugman, 2012). Nonetheless, it led to a notable upturn in the US economy. In contrast, in the UK the impact of the Coalition’s austerity measures, commencing in 2010, can clearly be seen to have stalled the UK’s economic recovery.

The negative impact of austerity on economic growth, in turn, makes the reduction of debt more difficult. As Robert Reich, former US Secretary for Labor, explains:

“Instead of reducing the ratio of debt to the size of the overall economy, this strategy [austerity] increases the ratio because it causes the economy to shrink. Call it the austerity death trap. Under these circumstances, the harder a country works to cut its debt, the worse the ratio becomes - because the economy shrinks even faster” (Reich, 2011).

We can conclude that austerity cannot be justified by high levels of borrowing, nor can it be justified as a means to tackle government debt. It is bad economic policy.

We can conclude that austerity cannot be justified by high levels of borrowing, nor can it be justified as a means to tackle government debt. It is bad economic policy.
But even if we were to put these ‘economic’ considerations aside, austerity can be criticised on the grounds that is exacerbates social injustice. Cuts in government spending fall disproportionately on the poor. The life chances of a generation are being decimated through unemployment and a lack of rewarding employment opportunities. And quite literally austerity is making people ill and killing them. Stuckler and Basu (2013) have estimated that around 10,000 families were tipped into homelessness from 2010 by the Coalition’s austerity measures, leading to a spike in cases of tuberculosis and increased incidents of assault and rape. In spite of these genuinely horrific human consequences, the growth in inequality has been described by senior Conservatives as ‘natural’ and in consequence ‘a good thing’. (1)

We have been brainwashed into thinking that we have a mountain of debt that needs to be repaid and that we all have to ‘tighten our belts’ rather than question the Government’s austerity policy. Meanwhile the huge sums used to prop up the UK’s failed financial sector go largely unchallenged.

Austerity economic ideas are not new. They have been described as zombie economics: destructive ideas which keep coming back. The austerity economic policies in the 1920s and 1930s were abject failures. To proceed down the current austerity path is devastating.

Large-scale targeted investment is needed, not in banking, but in the production of the things we need in the 21st century - renewable energy sources, environmentally sustainable housing and so on.

In 2013 even the Deputy Prime Minister in the Coalition Government, Nick Clegg, admitted his government has made a mistake in neglecting investment:

“If I’m going to be sort of self-critical, there was this reduction in capital spending when we came into the coalition government… But I think we’ve all realised that you actually need, in order to foster a recovery, to try and mobilise as much public and private capital into infrastructure as possible” (BBC, 2013).

Investment in the UK has slumped under the coalition and needs to be massively boosted. Arguments that we cannot afford to do this through Government borrowing and public investment do not stand historical analysis. Debt interest is low, as is total debt as a percentage of GDP. Debt cannot, therefore, be considered a barrier to greater public investment in Scotland’s future.

Before turning to Common Weal approaches to investment in Section 3, the following section highlights the major areas of concern regarding investment in the UK and in Scotland.

2. Shortcomings of the UK’s current investment structure

In the previous section it was argued that neither overall levels of government debt, nor levels of debt interest justify a neglect of investment. In this section key areas of concern will be highlighted regarding investment in the UK and Scotland. Where separate figures for Scotland do not exist UK figures will be used to illustrate the challenges facing investment in Scotland. First, the overall low levels of investment in the UK will be illustrated and discussed. Second, the shortcomings of private finance will be highlighted. This will include the deficiencies of private finance in general followed by a discussion of the particular failings of financial markets and banking in the UK.

Key areas of concern will be highlighted regarding investment in the UK and Scotland.

(1) In his recent Margaret Thatcher lecture, Boris Johnston appealed to the much discredited Victorian idea that poverty is the result of biology or some other natural process (see Matthews-Jones, 2014).
2.1 The UK invests nothing in its future

![Figure 2.1 - Gross Fixed Investment in EU Countries (CIA World Factbook, 2012)](image)

Total investment (what is spent by individuals, businesses and the public sector) in the UK is appallingly low. The percentage of GDP invested in 2012, at 14.2%, was the fourth lowest of the EU countries (refer to Figure 2.1). Only Cyprus, Greece and Ireland, countries which were clearly in a state of economic distress, were lower. Of the larger countries in the EU, with which the UK compares itself, Germany invested 17.6% of GDP, Italy 18.2%, Spain 19.1% and France 19.8%. Of the 12 countries joining the EU since 2000 every one invested a higher percentage of its GDP than the UK.

**Total investment in the UK is appallingly low.**

But these figures do not tell the full story. The Office For National Statistics calculates Capital Consumption - i.e. the depreciation of existing assets - at just over 11% of UK GDP (Mills, 2014). When this ‘depreciation’ - the amount of money needed to be spent just to maintain things and keep them as they are - is allowed for we are left with only 3.2% of our GDP as net investment. However, when we also factor in an increasing population - which makes increasing demands on the infrastructure we have - Britain doesn’t invest anything at all (ibid).
Clearly a situation in which a country invests nothing in its future is untenable. To understand why this situation has arisen we must understand the impacts of allowing the private sector to dominate the investment landscape in the UK.

2.2 The failings of private sector finance

In the first part of this paper it was demonstrated that current levels of government borrowing in the UK provide no justification for neglect of investment. The previous section explains that investment levels in the UK are appallingly low. In this context, one might ask why the private sector cannot step in to provide investment.

This section seeks to address this question by outlining: first, the major problems associated with private investment in general, namely that private finance is too expensive and too risk averse for the most innovative technologies; and, second, the major shortcomings of the two major types of institution engaged in private investment as they are presently constituted: financial markets and banks.

2.2.1 Private investment is expensive (the example of PFI)

Lord Sassoon, former commercial secretary of the UK treasury, has commented that “the UK is one of the most expensive countries in which to build infrastructure” (HM Treasury, 2010:4). A major reason for these inflated costs is the Private Finance Initiative (PFI) model which, since the 1990s, has grown to dominate the UK’s infrastructure procurement process. PFI finance is expensive because projects are financed with private debt sourced from the capital markets or bank loans (Hellowell and Pollock, 2009), a source of finance which is “invariably more expensive than direct government borrowing” (The House of Commons Treasury Committee, 2011a:15). Government borrowing is cheap because lending to governments is less risky than lending to virtually any other institution. Governments can therefore borrow more cheaply than virtually any other institution.

The case of PFI exemplifies how private finance provides poor value for money.

The case of PFI exemplifies how private finance provides poor value for money. In 2011, the House of Commons Treasury Committee found that “the cost of paying off a PFI debt would be over 40 percent cheaper if government funding were used” (The House of Commons Treasury Committee, 2011a:18). Claims that the inefficiencies of PFI funding were offset by risk transfer to the private sector were also found to be foundationless (House of Commons Treasury Committee, 2011a).

While in opposition, the Scottish National Party was amongst the strongest critics of PFI (Scottish National Party, 2007). Due to the absence of borrowing powers for the Scottish Parliament, the party proposed the establishment of a Scottish Futures Trust (SFT) which, by pooling the borrowing powers of local authorities or issuing bonds in its own right, would “provide lower cost borrowing opportunities” for infrastructure projects (Scottish National Party, 2007:19). However, concerns were raised about whether the Scottish Parliament had the authority to proceed in this way (UNISON, 2007).

Since the SNP gained office in Scotland in 2007 there has been a shift in emphasis of the purpose of the SFT to one in which its “primary role” is seen as “the co-ordination of programmes of government investment” (Hellowell and Pollock, 2009:406). Central to this role is its involvement in delivering the Non-Profit Distribution (NPD) programme, the investment model which has now superseded PFI schemes in Scotland (Scottish Futures Trust, 2013).

While NPD does not include the small proportion of equity financing of PFI and private sector returns are capped, NPD is “not a ‘not for profit’ model” (Scottish Futures Trust, 2013). Financing is still undertaken through private loans with the expectation of a normal market rate of return. Although the Scottish Government have claimed that NPD will eliminate the ‘excessive profits’ of PFI, Hellowell and Pollock find that that assertion “is not supported by the evidence” (Hellowell and Pollock, 2009:416). For such reasons NPD has been described as “PFI-Lite” (Young in Watson, WWW). Indeed, the decision to pay for the planned Forth Road Bridge by bringing government spending forward has led to accusations that the Scottish Government is itself not wholly convinced of the efficacy of the NPD model (BBC, 2008).

2.2.2 Private investors are too risk averse

The most innovative technologies which are likely to produce the highest returns in the long term are often considered too risky for private investors. While large pharmaceutical companies, for example, justify exorbitantly high prices for drugs on the basis of
high R&D costs and associated risks, in reality 75% of new molecular entities (the genuinely innovative pharmaceuticals) owe their origins to publicly funded national institutes of health, such as the UK’s Medical Research Council (Mazzucato, 2013).

Similarly, truly ground-breaking technologies such as the Internet, GPS, the algorithm which powers Google and touchscreen technology, owe their origins to government investment (ibid). Indeed, despite the perception that US economic success has been led by the private sector the reality is that the technology on which US growth has been based has been funded to a large extent by the US Government (Chang, 2007). Indeed, US state funding constituted between 50-70% of overall R&D investment between 1950 and 1990, the highest proportion in the world. While this proportion has since declined, as Chang (2007: 56) points out:

"Without federal government funding for R&D, the US would not have been able to maintain its technological lead over the rest of the world in key industries like computers, semiconductors, life sciences, the internet and aerospace."

2.2.3 A dysfunctional financial system

Beyond the public sector, investment is dominated by two main types of institution: financial markets and banks. First we will address some of the shortcomings of financial markets before turning to the banking sector.

Beyond the public sector, investment is dominated by two main types of institution: financial markets and banks.

2.2.3.1 Financial markets

Much of what happens in financial markets has little to do with productive investment. Much trade takes place on the future price of commodities, such as precious metals or agricultural goods, which adds little to the productive capacity of economies. Indeed, speculation in these leads to price instability, making it more difficult for businesses which are dependent on their sale or purchase - in other words, businesses which are involved in the real economy - to plan ahead. Adding to the mix of investment opportunities on offer in financial markets are a bewildering array of financial instruments - such as Collateralised Debt Obligations (CDOs), securitized debt and derivatives, which Warren Buffet famously called 'financial weapons of mass destruction'. The capacity of such instruments to destabilise entire economies has been well documented. Moreover, the importance of financial instruments for banks’ profits, rather than traditional investment, led to the fixing of LIBOR rates and suspected manipulation of foreign exchange rates.

Securities, such as shares and bonds, traded in financial markets can be a source of productive investment. However, only larger entities, including governments, benefit from the issuance of bonds. They are little use to SMEs, particularly start-up firms.

A company wishing to expand or develop its business can sell shares to provide the investment capital. But there are major drawbacks to this approach.

2.2.3.1.1 A democratic deficit

Share purchases confer ownership and influence to the purchaser, who receive votes in the running of the company proportionate to their share of stocks (2). This is not a democratic way to run an institution: in investor-owned firms money buys votes. These purchasers, who are very often not involved in the day-to-day-running of the business, are inclined to prioritise returns on investments over other goals.

This is a particular problem for the establishment of social enterprises, which seek to prioritise improvements in human and environmental well-being over profit maximisation. Both the UK Government and Scottish Governments claim to be supportive of the employee-ownership sector, co-operatives and other more democratic (non-investor-owned) enterprises. But market-based finance offers little to this sector, as control via share ownership reduces the power of employees and customer-members to direct the activity of the business towards broader societal goals. At this current juncture, employees and other major stakeholders are

(2) Note that there exist a variety of stocks and shares which do not confer voting rights. These, however, are less significant and if anything contribute to making management less accountable.
not even able to realise their own interests against shareholder domination, as the well documented tradition of branch factories and industrial blackmail, seen most recently with the Ineos owned plant at Grangemouth, has shown.

2.2.3.1.2 The extraction of wealth from the economy

Share ownership also entitles share owners to a proportion of a company’s profits (through a dividend) commensurate with the proportion of stocks owned in a company. However, both the USA and the UK testify to the extent to which powerful and deregulated financial markets can lead over time to the development of a powerful rentier class, which is able to use the power that has come from the ownership of large swaths of the economy to accumulate ever increasing sums of wealth and influence, driving the growth of inequality (Piketty, 2014). The wealth that is, in effect, extracted from companies through dividends diminishes the resources enterprises have to invest in their development.

In the UK the major beneficiaries of the deregulation of financial markets and privatisations from the 1980s onwards have been foreign enterprises.

This can be particularly damaging to an economy when shares are owned by foreign individuals and enterprises as it results in the extraction of wealth from the national economy. In the UK the major beneficiaries of the deregulation of financial markets and privatisations from the 1980s onwards have been foreign enterprises, which, from possessing less than 5% of shares in public limited companies in 1980, had come to hold around 40% of UK shares by 2008 (refer to Figure 2.2). The formerly state-owned companies - energy companies, water companies, etc. - now send vast sums abroad in dividends, money that is lost to the Scottish and UK economies.

![Figure 2.2 - Ownership of share capital in the UK's quoted public limited companies, 1963-2008 (Source: derived from ONS 2010: Table A, p.4 in Cumbers, 2012)](image)

In terms of economic growth some countries, notably Ireland and Singapore, have benefited from inflows of foreign capital in share purchases, through what is called Foreign Direct Investment (FDI). However, the relative success of these countries in utilising FDI has been down to government regulations which have directed FDI towards strategically important industries (Chang, 2007). Importantly, other countries, notably Japan and Finland, have developed with only negligible amounts of FDI. (3) In truth, then, FDI is not needed for development. Given the democratic deficit and problems of wealth extraction outlined above (and other issues outlined below in Section 2.2.3.1.3) it is therefore recommended that other means of sourcing funds for investment are prioritised.

2.2.3.1.3 Short termism and shareholder value maximisation

When people talk about ‘investing in stocks and shares’ none of the money goes into the company, unless they are buying new shares issued by a company. So if a company was set up in 1900 and sold 1,000 shares at £1 each, the company would receive...
Financial markets operate not on the principle of ‘one person, one vote’ but on the principle of ‘one dollar, one vote’.

On the other hand, financial markets, like all markets, operate not on the principle of ‘one person, one vote’ but on the principle of ‘one dollar, one vote’, affording greater power to wealthier people and institutions (Chang, 2007).

A bank-based system presents the greatest opportunities for both more democratic management structures within the financial sector. The senior managers of companies could decide to ignore speculative investors’ desire for short term increases in the company share price (which the company doesn’t directly benefit from). They could decide to invest their profits in assets like new factories or in research and development which might make profits for many years to come. While investments in new factories might produce good profits in the longer run, they may not result in the kind of short term share price spikes from which institutional investors can profit. So, the directors of companies are encouraged to maximise short term share prices (even at the expense of longer term profitability) by being given ‘share options’ in their remuneration packages. These options allow directors to buy shares in their companies cheaply. So they have an incentive to try to push the short term share price as high as possible in order to maximise the amount of profit on selling their own shares. Directors personally can become very rich through their share options.

Consequently, companies act in order to maximise their share prices in the short term. For example, they downsize (sack workers) and ‘the market will respond well’ to anticipated temporarily improved margins, i.e. the share price will rise in the short term. Another tactic used to push up share prices is to buy-back shares. So if a company has a large amount of cash, rather than putting the money into new factories, research and development and so on, the money is used to buy back the shares of existing shareholders. Perhaps the most striking example of this is Apple. One would imagine that a technology company like Apple would have a policy of investing in technology for the future. Due to its past successes, at the end of its accounting year 2012, Apple had $121 billion which could be used for investment. But, in April 2013 the company committed to distributing as much as $100 billion to shareholders in stock buybacks and cash dividends by the end of the 2015 accounting year (Lazonick et al., 2013). When it made this announcement, its share price jumped 7% (Wakabayashi, 2014). For the workers of Apple, it would be better if this money was invested in research and development for the long-term prosperity of the company. Instead, companies are cannibalising themselves and are not investing for the long-term (Lazonick, 2008).

So, corporate investment decisions are currently made to try to maximise shareholder value in the short term. This means that companies pursue investment strategies which are aimed at making their share price as high as possible. This was seen very clearly in the myriad of privatisations in the UK. The general public were told, for example, that rail privatisation would bring ‘much needed investment’ into the UK railway infrastructure. After privatisation, the new management pursued a policy of ‘sweating the assets’- getting as much money as possible out of existing assets rather than investing.

2.2.3.1.4 Conclusions

Most countries have both financial markets and banks. However, in some countries, such as in Germany or Japan, banks play the dominant role in allocating capital, mobilising savings, overseeing the investment decisions of corporate managers, etc. In others, such as in the United Kingdom or the USA, financial markets exert greater influence in the allocation of funds and on corporate decisions. These two types of financial system are often referred to as ‘bank-based’ and ‘market-based’ financial systems (Demirguc-Kunt and Levine, 2001).

Banks may not be the most popular institutions at the current time. However, some bank-based financial systems, notably that of Germany (refer to Section 3.3.3.1), testify to the capacity for stability, public accountability and local responsiveness of the bank-based investment model. Banks need not be run as investor-owned enterprises. They can be established as mutuals, cooperatives, credit-unions, or municipality or state-owned enterprises. In other words, they can be run democratically.

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sector itself and in the broader economy. It has the capacity to ensure that overall investment decisions are as aligned as possible to the aspirations of individuals, communities and society. For these reasons, Scotland should move away from the market-based financial model which is operated by the UK and develop a bank-based financial system, built on a banking sector which is itself reformed along democratic lines (refer to Section 3.3.3.1). This transition could also be assisted by greater regulation of financial markets, including a ‘Tobin Tax’ (commonly referred to as the ‘Robin Hood Tax’) on financial transactions.

2.2.3.2 Banks

Banks hold a crucial position in the UK’s investment landscape. This section addresses two aspects of banking in the UK: the implications for investment of the domination of the financial sector by too few banks and the consequences of the current privatised monetary system.

2.2.3.2.1 The banking sector has too few banks

A significant problem with the financial sector both in Scotland and in the UK as a whole is that the banking market is dominated by too few banks. Before the onset of the financial crisis the UK had the least diverse banking sector of any major European country (Lahusen, 2004). But consolidation in the financial sector has since increased (House of Commons Treasury Committee, 2010). The result is a market which is dominated by five banks which account for approximately 90% of banking (House of Commons Treasury Committee, 2011b). In Scotland the banking market seems to be considerably more concentrated: 70% of the SME lending market is controlled by just two banks, Lloyds - owners of the Bank of Scotland - and RBS (The Scottish Government, 2013). This is not just a problem because of a lack of competition. The scale of these banks has meant that they have become “too big - or too important - to fail” (House of Commons Treasury Committee, 2010:87). The resultant ‘moral hazard’ can only encourage the kind of recklessness demonstrated by the ‘Too Big To Fail’ (TBTF) banks which precipitated the financial crisis. Moreover, the dominance of these banks has raised concerns about the influence they are able to exert upon the political process (Treanor and Watt, 2011).

But a further concern with the TBTF banks is less often addressed: the larger a bank becomes the less productive its role in the economy (Berger and Udell, 1996; DeYoung et al., 1999; Keeton, 1995; Peek and Rosengren, 1996). Statistics from the US Federal Deposit Insurance Corporation illustrate this point. As presented in Figure 2.3, in 2009 small US banks, which collectively had only an 11% share of total US bank assets, contributed 34% of total lending to small businesses. In comparison, the 20 largest US banks, with a share of total US bank assets of 57%, contributed only 28%.

![Figure 2.3 - Comparison of small, medium-sized and large US banks in terms of their share of total bank assets and their lending share to small businesses (in the 3rd Quarter of 2009) (Source: FDIC in Mitchell, 2010)](image-url)
Smaller banks are more likely to lend to SMEs because the smaller a bank is the more interested it will be in deals which may provide smaller absolute returns but which represent a greater return relative to its size. Small banks are therefore more willing to collect and act upon ‘soft information’ (Berger et al., 2005), which involves, for example, visiting premises or meeting with budding entrepreneurs. Large banks are more inclined towards making large financial deals because these are less labour intensive. Even when large banks do lend to SMEs it is more likely to be based on ‘hard information’ (Cartera and McNulty, 2005). This involves the use of standardised loans which are more likely to discriminate against fledgling firms with no financial record (Berger et al., 2005). The quantities of credit large banks are able to create and allocate lead to asset inflation when their deals involve loans to asset speculators driving cycles of boom and bust (refer to Section 2.2.3.2.2).

Smaller banks are more willing to collect and act upon ‘soft information’.

In the UK as whole in 2012 SMEs accounted for 59.1% of all private sector employment (Department for Business Innovation and Skills, 2012). Due to the significant role SMEs play in providing and creating employment, increasing the availability of credit to SMEs is a priority of the Scottish Government (The Scottish Government, 2012). But in a 2008 study, 39 of 51 Scottish SMEs surveyed reported that they had problems accessing bank finance (North et al., 2008). The problem was particularly acute for finance for development (especially in manufacturing) and for firms which lack a trading track record. Moreover, according to more recent data obtained by the Scottish Government, despite Scottish SMEs accounting for 6.4% of total UK SMEs, they received only 4.8% of UK bank lending (The Scottish Government, 2012).

It can be concluded that policies which can contribute to the reduction in the scale of the banks will also contribute to reducing lending for speculative purposes and increasing lending to SMEs. Such a policy would provide an independent Scottish Government an opportunity to pursue, even without its own currency, what would be in effect one element of an independent monetary policy. Indeed, until the early 1970s a central plank of the monetary policy of the Bank of England was ‘credit controls’ (refer to Section 3.3.3.2) which were deployed to achieve the same objectives (Ryan-Collins et al., 2011). Such a policy would also have the benefit of increasing competition in the banking sector, reducing dependency on TBTF banks and lessening the influence the banking sector exerts over the political process.

2.2.3.2.2 A privatised monetary system

The contemporary monetary system is characterised by two key aspects. First, money creation is a privatised industry (Douthwaite, 1996; Wolf, 2010). Second, conventional money is “credit money” (Keen, 2007: 13), in that it is lent into existence by banks when they issue credit (Wolf, 2010).

It is an underappreciated fact that in a modern economy the money supply is created by the commercial banking sector. Central banks create only the notes and coins which circulate in an economy (Ryan-Collins et al., 2011; McLeay et al., 2014). The remaining 97% is created by commercial banks through the act of lending - by effectively treating a future payment stream as an asset and issuing ‘money’ as a liability. As Martin Wolf, chief economics commentator at the Financial Times puts it:

“The essence of the contemporary monetary system is creation of money, out of nothing, by private banks’ often foolish lending” (Wolf, 2010).

Various issues result from this configuration of the current monetary system, including the following social, political, economic and environmental concerns.

First, the conventional monetary system promotes inequality and geographical concentrations of wealth and power (see Sassen, 1991; Kennedy, 1995; Lee, 1999; Hodgson, 2013). As money is only created at interest, banks in effect charge rental on the money supply that the population must use. This results in a redistribution of wealth from the productive economy to the banking sector, from the indebted to the shareholders of banks and from peripheral economies to financial capitals such as Tokyo, New York and London (Sassen, 1991; Kennedy, 1995; Lee, 1999; Ryan-Collins et al., 2011). This is a factor which may help explain why countries with larger financial sectors have more inequality (Galbraith, 2012). These societal divisions are accentuated as those least able to afford credit often constitute more of a repayment risk to the banks and so are charged a ‘risk premium’ (higher interest rate) for accessing money from banks. This disadvantages the most vulnerable groups, such as minorities or women. As Lee (1999: 208) puts it “[c]onventional money seems to be misallocated at source, it goes disproportionately to those who already have lots of it.”
Second, as private companies, banks have an obligation to maximise shareholder returns. Investment decisions are not made democratically but dictated by private interests and are therefore often not directed towards the public good (Johanisova and Wolf, 2012). One consequence of this, as explained in Section 2.2.3.2.1, is that in the UK's highly concentrated financial sector the UK's banks engage in little productive investment. But in fact the nature of risk as experienced by banks provides a disincentive for all banks to engage in productive investment. If banks lend money for the purchase of assets, such as houses, and the recipient of the loan defaults, then the bank can seize the asset to mitigate their loss. Business lending, on the other hand, is less attractive because, especially with start-up companies, there may be no assets to claim if a loan goes bad. But when we consider that bank lending produces the money supply this is clearly a dangerous system. If banks increase the money supply to the economy but this does not result in the creation of new goods and services then the result will be inflation, as greater quantities of money will be chasing after the same quantity of goods and services. But as we have just seen, banks would much rather invest in existing assets than invest in creating new assets.

The conventional monetary system, then, is a recipe for financial instability (see Fisher, 1936; Lee, 1999; Keen; 2007; Ryan-Collins et al., 2011; Benes and Kumhof, 2012). The banking system drives cycles of boom and bust because of banks' ability to swell the money supply in times of boom and contract it in times of bust (see Fisher, 1936; Werner; 2005; Ryan-Collins et al., 2011). The present crisis provides a pertinent example. This is illustrated in Figure 2.4, which shows the money supply in the UK between 1997 and 2012 as well as the sectors of the economy to which this money was allocated by the banks. The banking sector created around a trillion pounds between 2000 and the onset of the financial crisis in 2007. Only around 13% of this money was allocated to productive activity, which here includes manufacturing, construction, communications, distribution, retail, wholesale and so on. 40% was pushed into property, creating inflation in the housing market, i.e. the housing bubble which eventually burst, summoning the crisis. Another 37% was allocated to financial markets which collapsed when the bubble burst. When the crisis began, banks lost confidence in each other and, ultimately, the UK economy. As a consequence, lending decreased, which led to a sharp contraction in the money supply. With too little money to facilitate the effective demand for all of the goods and services in the economy the UK experienced a ‘credit crunch’ recession.

Figure 2.4 - UK Bank Lending by Sector (Positive Money, WWW)

Another consequence of banks lending to each other was when they sought to get their cash back, it was not available. Huge sums amounting to several times world GDP were simply cancelled. When people ask the seemingly simple question ‘where did...

(4) Note that lending abroad even for non-productive investment results in foreign exchange imports mitigating balance of payments issues in the short term without inflationary effects. Over time, however, lack of internal investment increases both inflation and balance of payments issues. This was one of the effects from round one of quantitative easing: money went off-shore.
the money go or who has it now? the truthful answer is it ceased to exist. Money was created by banks and written out of existence by banks. A portion was, however, retained by bankers and speculators through bonuses and dividends, particularly in very large banks.

A further disadvantage of a credit-based monetary system is that it makes it impossible to avoid high levels of indebtedness (Fisher, 1936; Werner; 2005; Ryan-Collins et al., 2011). Indeed, as banks create money by issuing loans but not the interest which must be paid on those loans, it is inevitable that there will be more debt in an economy than money (Bendell, 2013; Ryan-Collins et al., 2011). For this reason there must always be an increasing amount of lending so that debts plus interest can be paid off. This necessitates ever increasing economic activity (GDP growth) to generate ever increasing surpluses with which repayments can be made (Douthwaite, 2012; Johanisova and Wolf, 2012; Bendell, 2013). Consequently, when growth stalls the result is financial crises, defaults, bankruptcies and rising unemployment. As importantly, concerns about the capacity of the Earth’s ecological systems to cope with ever growing economies (Jackson, 2009) have led to criticisms, in particular from the green movement (North, 2007), of a financial system predicated on this “growth imperative” (Kallis, 2011: 873). Because the ecological damage done by extractive industries, e.g. mining, oil and gas etc., is not charged for directly, or deducted from GDP, much GDP growth comes from expansion of these industries rather than sustainable development. If social justice and the environment are to be prioritised over GDP growth, reform of the debt-based monetary system must therefore be considered. As is discussed in Section 3.3.3.3, monetary reform not only promises to eliminate some of the serious failings of our current privatised monetary system, but also presents opportunities in providing a source of public investment.

3 Common Weal approaches to investment

This section describes a Common Weal approach to investment. First, the guiding principles of that investment are outlined. Second, the extent of the investment required to bring Scotland into line with the EU average levels of investment will be provided. Third, three key areas which should be addressed in order to achieve strong and stable investment in a Common Weal economy will be discussed: taxation, borrowing and reform of the financial sector.

3.1 Guiding principles of Common Weal investment

Several key guiding principles are proposed to guide investment in a Common Weal economy. First, investment should be directed towards societal goals. It should result in tangible benefits to the public, in higher wages, more interesting work, in greater revenue for public services and should protect the natural environment.

Investment should result in tangible benefits to the public, in higher wages, more interesting work, in greater revenue for public services and should protect the natural environment.

Second, publicly funded revenue and maintenance investment should be separated from capital investment. To use an analogy, it is fine that we use a mortgage to make investments in infrastructure or to stimulate the economy in a way that will repay the borrowing. However, it is not healthy to seek to run our day-to-day expenditure by running up a credit card bill. In this way, revenue investment, that is, the recurring money spent on wages, etc., and investment in maintenance must be kept separate from capital investment which induces returns. Here ‘induced returns’ is investment which develops the capacity of the economy.

The objective of this, which can be seen as third principle, should be to end deficits in revenue spending. To ensure this, investment expected to induce returns should be ‘ring fenced’ and monitored against the level of induced returns which result. This means that revenue spending must over a financial cycle be funded from taxation (refer to Section 3.3).

With these principles in mind, this paper outlines the extent of investment recommended, before turning to the mechanisms for achieving this level of investment.
3.2 Extent and nature of investment proposed

A reasonable target for an independent Scotland determined to compete in the world by investing in emerging industries and conforming to its desire to be a good citizen by combatting climate change would be to raise its investment levels over 5 years to that of the EU average and to retain that level for a further 10 years. This would, based on our assumptions, require the level of investment to be raised to 17.8% from 14.2%. This increase in the level of investment, if achieved, would increase both the number and quality of jobs, increase overall GDP and, provided it was carried out with a view to long-term Common Weal objectives, increase the prosperity and prospects for Scotland over coming decades. It should be noted that by investments we mean activities that anticipate the sum invested to be repaid over time, as opposed to general government expenditure which requires taxation to balance expenditure.

Scottish GDP was £144.67 billion in 2012/13 (The Scottish Government, 2014). To increase productive investment from 14.2% to 17.8%, an increase of 3.6% would require an increase in investment of £5.21 billion a year, to £25.75 billion from £20.54 billion or an additional £78.12 billion over 15 years, ignoring inflation and GDP growth compounding. The vehicles for delivery of this additional investment will be a mix of existing financial institutions, public sector bodies including new entities, private investment from commercial concerns and Government intervention in setting priorities, goals and plans (refer to Section 3.3).

3.2.1 Investment in climate targets

A significant proportion of investment will be required in the energy sector where plans and roadmaps either exist or are in the course of development. For the purposes of this study, we are assuming that one third of investment over the next 15 years will be allocated to ensuring that climate change targets are met for business energy efficiency, housing energy efficiency, electricity generation, replacing gas with alternative forms of heating, etc. The payback for this expenditure will of necessity mainly come from rents, council tax, and business charges and heating and electricity charges, although transfers between central and local expenditure will be required to moderate the effects on individual households.

A significant proportion of investment will be required in the energy sector where plans and roadmaps either exist or are in the course of development.

Based on the above target, an estimated £1.74 billion a year additional investment will be required in this area, £26.04 billion over 15 years. The remainder of the investment will be in securing the development of essential infrastructure changes and new industries, a total of £3.47 billion or £52.08 billion over 15 years as a target.

In a previous paper, Repossessing the Future (Cumbers et al., 2013), we showed that public sector investment in the renewable energy sector could achieve significant savings in consumer and business charges compared to a purely private approach reliant on tariffs set for 15 years. Although not applicable to all technologies, the annual saving was estimated at over 20%. For this reason, the paper recommended the establishment of local energy companies run by housing associations, community organisations and local authorities and backed by Government financial guarantees.

Given the need to use the experience of commercial developers in certain areas and the time required to develop ‘in-house’ expertise, it is assumed that over the next 15 years, only 50% of new renewable energy investment would be directly attributable to public bodies and that commercial interests would fund the other 50%. This would therefore require an on balance sheet debt of £870 million a year each year for 15 years, the expected life time for many technologies, e.g. wind farms. It should be noted that after 15 years sufficient income would be generated annually to replace the investment, which in any case at that stage would have a lower replacement cost. Thus, the maximum public sector or investment bank debt exposure to this aspect of investment would be somewhat less than £13.02 billion.

3.2.2 New technology

For new technology investment, it is assumed a mixture of infrastructure investment, R&D support and direct equity investment (or share apportionment) will be required. Here it is assumed that after the initial seedcorn investment, around two thirds of the investment will come from equity and traditional funding mechanisms. This would amount to Government backed investment of £1.16 billion a year for 15 years. However, the payback period for commercial investments is normally less than for purely infrastructure investments, typically 7 to 10 years. As these are newer technologies we make the assumption that 10 years will be required to recoup the investment on average. Thus a Government investment exposure of a maximum of £11.57 billion would be required.
3.2.3 Summary

Summarising the above (refer to Table 3.1), the assumption is that increasing the percentage of Scottish GDP spent on investment to the European average would require the Government to establish investment vehicles capable of providing an additional £2.03 billion a year of funding with the total exposure gradually increasing over 15 years to a maximum of £24.59 billion.

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<td>Maximum annual government exposure to proposed increase in investment</td>
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<td>Total government exposure over 15 years</td>
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Table 3.1 - Existing (assumed) and proposed levels of investment in Scotland.

It should be noted that an increase of expenditure of these levels would expand the country’s GDP and skilled employment, and that taxes on salaries and companies would increase along with that. Moreover, these are investments, not grants. Provided the investments are prudently made in areas which will benefit the country and are competitive and expand the income base of the public sector then the overall increase of notional debt should be irrelevant.

3.3 Mechanisms for sourcing funds for investment

Three possible sources of money for investment can be identified: taxation, borrowing and a reformed financial sector. This section takes these areas in turn.

3.3.1 Taxation

As was indicated in Section 3.1, the source of revenue and maintenance investment must be taxation. The definitive study into the UK tax system was carried out in 2011 by Nobel Prize winner Sir James Mirrlees. That study concluded that tax in the UK is "inefficient, complex, and unfair" (2011:20). In fact, the study derided the overall tax system as ‘absurd’. Clearly, then, there is great scope for Scotland to do better.

In a previous report, Investing in the Good Society, a Common Weal approach to taxation was outlined (for full details see Danson et al., 2013). A central argument is that the key to fixing public finances is fixing the economy, by moving away from the low pay and inequality characteristic of the UK. A model of the Scottish economy was created which demonstrated that by reconfiguring the economy so that it had the same levels of inequality as Nordic countries Scotland would raise £4-6 billion more in tax without changing tax rates at all, virtually wiping out the deficit. Notably, this model did not even include savings that would be
made by avoiding paying the huge sums the UK currently spends subsidising low pay through benefits and tax credits. In this context, a Common Weal approach to investment can lead the drive towards fixing Scotland’s public finances by contributing to a more equal distribution of income through the prioritisation of strategic industries capable of delivering high skill and high pay employment in Scotland.

Another key approach to delivering sustainable public finances for Scotland is to stop allowing private companies to capture the value of the country’s natural resources.

Another key approach to delivering sustainable public finances for Scotland is to stop allowing private companies (usually foreign-owned) to capture the value of the country’s natural resources. It is counterproductive to permit virtually all of the profits of our wind and tidal energy resources, for example, to flow straight into multinationals who immediately extract it from the Scottish economy. Instead of merely claiming a proportion of these profits back through corporation tax, Scotland must developed its big renewable energy projects in collective ownership so all the profits flow back to the public, creating a rapid new source of income. Funds for the establishment of these public bodies can be sourced using the more accountable and cost effective borrowing mechanisms outlined in this paper.

Short of the benefits to the public purse derived from this restructuring of the Scottish economy, Investing in the Good Society highlights other key measures to address public finance. These include measures to prevent tax evasion, such as Unitary Taxation with Formulary Apportionment, wealth taxes, such as Land Value Tax and a new 60p tax rate for those earning over £150,000 per annum. The combination of these measures provides a path towards Scotland creating a strong and efficient tax base without harming competitiveness or economic security. These also ensure that day-to-day expenditure can be fully and sustainably met so that mechanisms for investment which induce returns can be fully targeted at delivering a Common Weal economy.

3.3.2 Borrowing

In this section borrowing to invest in a Common Weal economy will be explored. First, some of the supposed threats to Scotland of remaining in a currency union with the rest of the United Kingdom will be challenged. Second, three constructive approaches to public borrowing will be identified. Third, the benefits of the creation of a National Investment Bank will be highlighted.

3.3.2.1 Borrowing and currency union

As is testified to by the Troika imposed ‘austerity max’ in the so called PIIGS countries (Portugal, Ireland, Italy, Greece and Spain), sovereign debt in a currency union comes with risks. Unable to artificially create demand for their government bonds through quantitative easing like the UK, each of these countries’ borrowing costs rose to unsustainable levels as a result of the financial crisis. Because high costs of borrowing meant that many governments could not refinance debts, they were driven to seek assistance from the Troika, which responded by demanding austerity(5) and a fire sale of nationalised industries and assets.

It is the proposition of the Scottish Government that Scotland should retain a currency union with the rest of the United Kingdom in the event of independence. Concerns arise, therefore, that Scotland could find itself in a similar position to Greece in the event of another financial crisis, with the Bank of England taking the place of the ECB in demanding austerity of an independent Scottish Government in exchange for injections of liquidity.

Putting aside the Scottish Government’s view that such a situation is unlikely to occur due to Scotland’s relative economic strength in relation to the rest of the UK, this argument is flawed in a number of ways. First, an independent Scottish Government could threaten to withdraw from a currency union if austerity measures were demanded of it, an option which is not open to the current Scottish Government, which has little scope to defend the country from the current period of austerity.

Short of this, an independent Scottish Government could adopt more creative means of government borrowing. One such measure has been suggested by Philip Pilkington and Warren Mosler (2012) of the Levy Economics Institute. The authors suggest that a clause could be entered into government bonds which states that if, and only if, a government defaults on its debts its bonds...

(5) In this context it is notable that the Eurozone sovereign debt crisis was brought under control not by austerity but by the Outright Monetary Transactions (OMT) of the ECB, instigated in 2012, through which the ECB ‘prints euros’ to purchase the bonds of troubled governments in the Eurozone. Sadly the ECB did not see this as confirmation that austerity measures are actually unnecessary, as it offers OMT on the condition that governments continue with austerity. The ECB is also discriminatory in its application of such policies as Germany consistently fails to meet its own financial targets.
can be used to pay the country’s taxes. These ‘tax backed bonds’ would reassure investors that even during the worst crisis bonds would be ‘money good’ as they could always be sold on to individuals or institutions who could use them to pay their taxes. This de-risking of bonds would lead to the reduction in the risk premium which investors demand during times of crisis of governments in currency unions, which would result in a reduction of the interest governments in these circumstances are required to pay to manageable levels.

Ultimately, however, the argument that austerity is an appropriate response to a financial crisis must be contested. As is demonstrated in Section 1.2, austerity is a bad policy; it is not even capable of addressing the problems of government borrowing which it is supposed to address. Its imposition should therefore be resisted by all members of a currency union, as a policy of ‘beggar-thy-neighbour’ will only succeed in damaging the prospects of all of the members of that union.

To conclude, providing an independent Scottish Government was prepared to be creative in its approach to finance and borrowing to invest, there is no reason why being in a currency union should threaten the country with austerity in times of financial crisis. However, key reforms of the financial and monetary system (such as those recommended in Sections 3.3.3.2 and 3.3.3.3) would require Scotland to have a separate currency for a Scottish Government to proceed without the consent of the rest of the UK. Moreover, it is possible that a Sterling currency union may come with arbitrary limits on debt and deficit to GDP ratios. For these reasons, a future independent Scottish Government would be well advised to consider whether a currency union is in the country’s long-term interests.

3.3.2.2 Three key Common Weal approaches to borrowing

Borrowing for investment can be undertaken in a variety of ways. In this section three key approaches are outlined while a fourth, a National Investment Bank, is discussed in the following sections.

Where returns on investment may be indirect, traditional forms of government borrowing such as bond issuance at the national or local level should be considered. An example of indirect returns would be an investment in childcare, such as that proposed by the Scottish Government, which would lead to greater economic participation on the part of women. This would, in turn, create sufficient tax receipts to pay for the initial investment and to maintain the revenue costs of the service going forward. Other labour market interventions (investment in workers and the workforce to increase growth) may be approached in a similar way.

An example of direct returns could be housing, where major investment could be undertaken by national or local agencies which would borrow against future rents.

A second approach can be taken with investments when direct returns are expected, i.e. income generating investment. An example of direct returns could be housing, where major investment could be undertaken by national or local agencies which would borrow against future rents.

A third approach is ‘New Investment Companies’ (NICs), which could be created at the local or national level. A NIC would be a kind of accounting structure which enables public money to be invested while risk is contained so that if anything goes wrong it is not the public who must bail out the failed enterprise. An example might be a national mutual or local mutual company. This could be a company set up with investment from the public sector but would then be run like any other business, borrowing to invest on the basis of future profit. Every Scottish citizen (or community member in a local mutual company) could be given one non-tradable share in that national company and would have a democratic right to vote on how it is run. Citizens would also get a dividend from any profits. It would be a limited company and not owned by the government so neither citizens nor the government would be liable. These would be particularly useful for ‘special projects’ which may offer a real opportunity for Scotland’s future but which do not fall under the normal responsibilities of government. An example of this might be where collectively we decide we want to try and stimulate a large-scale industry sector, e.g. for hydrogen-powered ships or energy storage technology.

3.3.2.3 A National Investment Bank

One well established means of promoting productive investment is a National Investment Bank. In Scotland it could be built upon the foundations and assets of existing bodies owned or jointly owned by the Scottish Government, such as the Scottish Investment Bank (SIB), the Green Investment Bank (GIB), the Scottish Futures Trust (SFT) and the Royal Bank of Scotland (RBS), which could be transformed into one unified investment bank. In addition to existing assets, the Scottish Government could issue bonds
In terms of how the bank would operate, the Scottish Government could draw on the experience of successful National Investment Banks in other countries: such as the Bank of North Dakota (BND), owned by the US state of North Dakota; the Nordic Investment Bank (NIB), joint owned by Finland, Sweden, Norway, Denmark, Iceland, Estonia, Latvia and Lithuania; and the Kreditanstalt für Wiederaufbau (KfW), 80% owned by the Federal Republic of Germany and 20% owned by the Länder (German federal states).

To understand the potential of a National Investment Bank as a source of funding for investment in Scotland we can take KfW as an example. The bank raises around €60 to €70 billion each year by issuing bonds, “which makes it the fifth-largest capital markets issuer in Europe after the Italian, German, French and UK governments” (Stevens, 2010:1). This is between 2.2% and 2.6% of German GDP.(6) If a National Investment Bank in Scotland was able to source funds of between 2.2% and 2.6% of its GDP this would provide the bank with a sum of between £3.2 and £3.7 billion per year.

To further explore the potential of National Investment Banks, using the aforementioned banks as models, in the following sections four key benefits of these institutions are highlighted. National Investment Banks: provide inexpensive long term investment in infrastructure; substantial profits to the states which own them; promote diversity in the banking sector; and dedicate investment to promote societal goals.

3.3.2.3.1 Investment in infrastructure

In 2012 the Nordic Investment Bank arranged a €44 million low interest long-term loan to Lyse Energi, a municipality-owned energy company in Norway, for an electricity grid expansion (NIB, 2012). Earlier, in the spring of 2009, the KfW announced an “infrastructure investment offensive” (KfW, 2009). Targeting what it called “structurally weak regions” in Germany, the KfW invited municipal authorities and companies run and owned by these authorities to take advantage of €3 billion in long-term, reduced-interest loans (ibid). These are just two examples of the ways in which existing National Investment Banks have recently been deployed to provide finance for public infrastructure.

National Investment Banks source funds in the same way governments do: by issuing bonds.

As was indicated in the introduction to this section, National Investment Banks source funds in the same way governments do: by issuing bonds(7). These bonds are guaranteed by the governments which own the banks and as a result are considered as safe as government bonds themselves (KfW, 2013). Not only does this allow the banks to provide inexpensive loans but it also ensures a stable supply of long-term financing.

This proposal for the creation of a National Investment Bank does not seek to challenge the traditional public sector finance model. Instead, the authors envisage direct public investment taking place alongside the investment of a state-owned bank. However, National Investment Banks can be seen to have several advantages over direct public investment.

Firstly, the creation of an institution with a designated goal of channelling resources towards infrastructure development could promote the kind of expertise in this area attributed to such institutions in other countries. Secondly, because the goal of a National Investment Bank is ‘investment’ it helps to separate revenue expenditure from capital expenditure (refer to Section 3.1). Thirdly, National Investment Banks provide diverse services for which direct public investment may be ill-suited, such as providing loans or loan subsidies to private banks or businesses in order to promote social goals. Such activity may also be profitable, which leads to the fourth advantage. Provided that the bank’s investments provide returns, the investment bank will not contribute to the government deficit (Cox, 2012). Indeed, any profits will help to reduce government deficits.

3.3.2.3.2 Profitability

The use of a National Investment Bank allows for any profits to be returned to the state as a dividend which can be used for investment in public services, to reduce taxes or the national debt. These sums may be considerable. Since 1945 BND has contributed $555 million to the revenue of the State of North Dakota (BND, WWW), a significant sum for a state with a population in 2012 of just over 690 thousand (United States Census Bureau, 2012). The scale of the operations of the NIB and KfW has insured that the returns are more impressive; in 2011 alone NIB made a profit of €194 million (NIB, 2011) and KfW €2.6 billion (Cox, 2012).

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(6) German GDP is $3.747 trillion (IMF, 2014), or around €2.74 trillion.

(7) The Bank of North Dakota’s (BND) deposit base is unique. All of the state’s funds must be deposited with the bank by law. BND’s deposits, together with the bank’s own capital, provide the basis by which BND issues credit. As in Scotland such an arrangement may create conflict with the existing Government Banking Service it is not proposed that this model is adopted.

w w w . a l l o f u s f i r s t . o r g 29
Conversely, it is true that should a publicly-owned bank run at a loss then it would contribute to government deficits. However, while there will almost inevitably be periods of loss, such a bank would provide substantial returns to the taxpayer in the long term. All of the model banks have consistently been highly profitable. The BND, for example, has been in profit every year since 1971 and “has consistently produced high returns on its assets compared to similarly sized private banks” (Kodrzycki and Elmatad, 2011:8). The records of the NIB and KfW are equally if not more impressive (Moody’s, 2012; KfW, 2013).

The 2008 bank bailouts have shown that the activities of commercial banks may pose a greater risk to government finances. The cost of support to the UK banking sector through the ‘financial stability interventions’ of the UK Government, undertaken in response to the financial crisis, was £456.33 billion as of March 2011 (HM Treasury, 2011). The creation of a National Investment Bank will ensure that taxpayers share not just the risks of banking but also the profits.

### 3.3.2.3.3 Helping to create diversity in the banking sector

By partnering with community banks a National Investment Bank can promote diversity in the banking sector. In so doing it can reduce an economy’s dependence on ‘Too Big to Fail’ banks.

Typically KfW, NIB and BND make loans to the private sector through financial intermediaries (Stevens, 2010; Matthews, 2013). This is accomplished by providing an interest rate subsidy, which can be directed at small community banks. The arrangement benefits both parties. By partnering with a National Investment Bank smaller commercial banks are able to extend loans for which they would otherwise struggle to find capital (Kodrzycki and Elmatad, 2011). In return, the National Investment Bank is able to take advantage of the local knowledge of community banks who deal with borrowers directly. This partnership also creates diversity of risk (Cox, 2012).

The example of North Dakota suggests that this can also be a successful strategy for promoting banking diversity. According to Dēmos, a public policy research and advocacy organisation, “BND has helped carve out and protect a free and competitive market for community banks and borrowers that would otherwise have been lost to big banks” (Judd and McGhee, 2010:3). A glance at data on the North Dakotan banking sector supports this argument. North Dakota has both less consolidation in the banking market and more bank offices per capita (about double the US average) than any other comparable US State (Center for State Innovation, 2010:3).

### In Germany the relationship between the KfW and community banks has been described as “symbiotic”.

In Germany the relationship between the KfW and community banks has been described as “symbiotic” (Cox, 2012:3). And again, banking diversity is characteristic of the system. Of the major European economies Germany has the highest number of banks per capita; 3.1 per 100,000 inhabitants compared to the 0.6 of the UK, about twice as many banks per capita than the EU average (Lahusen, 2004).

Notably, within the NIB countries the situation is different. Nordic countries have banking systems which, like the UK’s, are highly concentrated (Lahusen, 2004). However, the BND and the KfW are not comparable to the NIB on this point. While diversity within individual NIB member countries may be concentrated, banking is diverse across the eight states which own the NIB. In this sense, the relationship between the KfW and the German states may be no different from the relationship between NIB and its member states. While in Germany banking is highly diversified it can be as concentrated by region as is the UK as a whole (House of Commons Treasury Committee, 2011b). This may be an argument for a country to have its own investment bank rather than sharing it with others. The case of the NIB should also be a reminder that a National Investment Bank will not guarantee a diverse banking system if other strategies are not also deployed (refer to Section 3.3.3.1).

### 3.3.2.3.4 Lending to promote societal goals

National Investment Banks direct resources in order to promote societal goals. Amongst the goals which have been targeted by National Investment Banks have been the creation of employment, the promotion of technological innovation and the improvement of the environment (KfW, WWWa).

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Together with investment in public infrastructure, one of the key strategies deployed by National Investment Banks to create employment has been channelling investment to SMEs (KfW, WWWa; NIB, WWWa). By promoting a more diverse banking sector National Investment Banks indirectly promote a greater proportion of credit allocation to SMEs. However, the model National Investment Banks also take a more direct approach to SME lending.

By offering interest rate subsidies (refer to Section 3.3.2.3.3) to commercial banks for specific purposes, National Investment Banks have helped facilitate lending to a variety of projects which would have been unlikely to receive funding if left to commercial banks alone. One possible example is the NIB’s loan programme for female entrepreneurship in the Baltic countries (NIB, 2003).

The BND also has several schemes for promoting small businesses, including the ‘Beginning Entrepreneur Loan Guarantee Program’ (BELGP). Through the BELGP the bank guarantees 85% of loans for business start-up financing in the state (BND, WWW). While it is difficult to evaluate the overall impact of such programmes, it is notable that North Dakota has had a lower unemployment rate than the USA as a whole every year since the late 1970s (Kodrzycki and Elmatad, 2011).

SMEs also play a part in strategies for promoting technological innovation and environmental improvement. NIB devotes the largest proportion of its lending (33%) to the ‘Energy and the Environment’ sector through SMEs, which includes both small-scale environmental and renewables programmes (NIB, WWWb). KfW’s involvement in the renewables sector also constitutes a key focus of their activity. According to Dr. Ulrich Schröder, Chief Executive Officer of KfW, one of every three euros of the bank’s business volume is channelled into Germany’s ‘energy turnaround’, the title given to the objective of the German Government to source all of the country’s energy requirements from renewables by 2050 (KfW, WWWb).

KfW’s activity also demonstrates how the objectives of employment, innovation and environment can be combined. Through a €23 billion investment in renewable energy, energy efficiency in housing and directly in SMEs, the KfW created around 52,000 jobs in 2011 alone (Cox, 2012). Around 38,480 of these jobs (74%) were in SMEs. Such commitments to broader societal goals distinguish National Investment Banks from commercial banks.

3.3.3 Reform of the financial sector

This section addresses three key areas of reform of the financial sector: bank diversity, credit controls and monetary reform.

3.3.3.1 Creating banking diversity

As was discussed in Section 2.2.3.2.1, the UK’s banking sector is characterised by the domination of just five Too Big To Fail commercial banks and low levels of credit allocation to the productive economy. In Section 3.3.2.3.3 it was demonstrated that one approach to promoting diversity in the banking sector is the establishment of a National Investment Bank. A Scottish National Investment Bank should be constituted with the specific goal of the promotion and maintenance of community and small cooperative banks. In this way, it will be an important part in the framework of a more diverse banking sector. But, as was also indicated in Section 3.3.2.3.3, the establishment of such a bank is insufficient to ensure a diverse banking market. This section proposes other approaches to promoting diversity in banking.

The UK’s banking sector is characterised by the domination of just five Too Big To Fail commercial banks.

Recently the idea of placing a cap of 25% on the market share of UK banks was floated by the opposition Labour Party (Wintour and Treanor, 2014). According to this proposal, banks exceeding this limit would be forced to reduce their scale and sell off branches. This was swiftly criticised by the Governor of the Bank of England, Mark Carney, who pointed out that it would not necessarily create greater competition in the banking sector (Mason, 2014). This may be true. It would do nothing, for instance, to prevent 4 banks, each with a 25% share, dominating the market. And currently such a proposal may only directly affect Lloyds Banking group, which is the only bank in the UK with over a 25% share of current accounts (BBC, 2014). A better proposal was suggested by Stephen Mihm and Nouriel Roubini (2010), a former senior economist in the US Council of Economic Advisors during Bill Clinton’s administration. The authors suggest a change in legislation which would give the authorities the right to break up banks and other financial intuitions that are so large, leveraged and interconnected that their collapse would pose a systemic risk to the financial system as a whole. That way a government’s ability to act to break up banks would not be
dependent on competition law but contingent on banks being Too Big To Fail. It would therefore impact upon all of the UK’s big banks.

Another suggestion is to demand higher capital adequacy ratios of larger banks. Capital adequacy ratios are the ratio of capital to risk a bank must hold. While according to the Basel III Accords the proportion of capital to risk must not fall below 10.5%, national regulators can increase this level for specific banks. Indeed, Switzerland has recently doubled the capital requirements of its two biggest banks, UBS and Credit Suisse. Mihm and Roubini suggest increasing these ratios to 20% or more for the largest banks. Such an approach would decrease their leverage and, as a result, profits for TBTF banks. The hope is that by “sending the message that bigger isn’t better would lead these firms to break themselves up” (Roubini and Mihm, 2010: 253).

But even these proposals do little to point the way to creating more democratically accountable financial institutors. A truly diverse banking sector does not mean that many investor-owned commercial banks compete with each other. It means that cooperatives, such as credit unions, and municipality or state-owned banks and other financial organisations, take their place alongside commercial banks in the investment landscape.

Again Germany provides a model from which Scotland can draw. As indicated in Section 3.3.2.3.3, Germany has the highest ratio of banks per citizen of any European country. Moreover, unlike the UK, where 90% of banking is dominated by just five investor-owned commercial banks, 70% of the German banking sector is run on a not-for-profit basis. This not-for-profit sector includes 417 Sparkassen (public savings banks), which are typically owned by the regional governments, as well as 1,258 credit cooperatives which are protected by local laws (Deutscher Sparkassen, 2013; Cox, 2012) (refer to Figure 3.1).

![Figure 3.1 - Banking in Germany (Source: Werner, 2012).](image)

Each of Scotland’s 32 local councils should have its own bank. This would create one such bank for every 165,000 citizens (not too dissimilar from the 1: 196,000 ratio of Sparkasse to German citizen). Scotland would not have to start from scratch; five local authority banks already exist in Scotland, namely Clydebank, East Dunbartonshire, North Ayrshire, North Lanarkshire, and West Lothian. These existing institutions should upscale their operations. New banks could be set up fairly inexpensively by the issuance of local authority bonds. But the bulk of the funds for investment would be derived from customers’ deposits. A National Investment Bank (refer to Section 3.3.2.3) would work with and support this network of publicly-owned banks which would help identify and implement infrastructure investment priorities in their areas as well as investment in SMEs.

German credit cooperatives are financial institutions which are owned and run democratically in the interests of their members. They are comparable to the 397 credit unions which exist in the UK (WOCCU, 2012). However, while in Germany these have a 26.6% market share, in the UK this figure is just 1% (Birchall, 2013). A key reason for their relative lack of success in the UK has been the severe restrictions placed upon the operation of credit unions. These include quantitative restrictions, which have resulted in
few being able to accept deposits of over £10,000 or provide loans of more than £15,000 (Werner, 2012). They also include restrictions on who can become a depositor, the purpose of loans and the extent of business lending.

There are 56,000 credit unions worldwide serving 200 million members in 101 jurisdictions (WOCCU, 2014). As the former president of the World Association of Credit Unions, Pete Crear, has said:

“[N]ot a single credit union, anywhere in the word, has received government recapitalisation as a result of the financial crisis ” (Crear, 2009:1, in Birchall, 2013: 109).

Yet despite their stability regardless of regulatory frameworks, the UK has chosen to place a tremendous burden of regulation on these more sustainable, socially useful, locally responsive and democratic financial institutions while turning a blind eye to the at times outrageous behaviour of investor-owned banks, even after many have collapsed under the weight of toxic assets created by irresponsible lending. While many aspects of the regulation of credit unions may be desirable, including regulations which embed them in local communities by restricting the membership to limited geographical areas, there is no reason for overall regulations for member-owned financial institutions to be stricter than those for investor-owned banks.

At this juncture it is certain that if municipality and member-owned banks were properly founded that they would attract a great number of customers dissatisfied with the conventional banking system. A Common Weal approach would ensure that when savings are attracted they are directed by democratic forms of management towards investments aimed at realising common goals. These common goals will include productive investment, as in Germany, whose not-for profit oriented financial sector is ranked number one out of 27 EU countries in the provision of finance to SMEs (European Commission, 2014).

3.3.3.2 Credit controls

In Sections 2.2.3.2.1 and 2.2.3.2.2 it was explained how the commercial banking sector, especially one dominated by just a few large banks, tends to over-allocate credit for speculative purposes and into assets rather than invest in the real economy. This drives cycles of boom and bust and starves the real economy of investment. One tried and tested method of combating this is credit controls. Through credit controls the central bank directs the flow of commercial bank credit away from assets and speculation and towards investment in the real economy. This tool was widely used by most central banks until the 1980s when it was abandoned as part of financial deregulation. However, it is still used in East Asian economies and is arguably the central mechanism for China’s long and stable growth (Werner, 2005).

Through credit controls the central bank directs the flow of commercial bank credit away from assets and speculation and towards investment in the real economy.

Credit controls work as follows (ibid). First the central bank establishes the overall lending requirements for the economy as a whole for a given quarter. Then quotas are allocated to individual banks. Bank officials are then instructed of their loan allocation for the coming quarter. Deviation from the quotas is punished by, for example, reducing the next quarter’s quotas, applying unfavourable conditions to transactions or cutting rediscount quotas. Another possible weapon which central banks could deploy could be the raising of the reserves which a bank must hold against certain types of assets, such as real estate. Often, however, banks are kept in line by appealing to the moral responsibilities of the bankers. As such, credit controls have been referred to as ‘moral suasion’ (Ryan-Collins et al., 2011) in the UK and, in the US, ‘jawboning’ as it often involved the power of ‘talk’ more than legislation (Wikinvest, 2012). It should be noted that the recent guidance to banks over mortgage lending constitutes a partial reintroduction of this concept by the Bank of England.

Because guidance on credit can be specific to institutions or types of lending, different guidance can be issued to commercial banks and national and local publicly owned banks. Thus the amount of investment in infrastructure or new industries could rapidly be adjusted to meet local and international requirements. Credit controls provide a means of taking control of the money supply back into public hands. In Finland, Norway, Austria and Japan credit controls were used to great effect by governments to

(8) While this is true for community credit unions, it may not be strictly true if ‘centrals’ are included. Centrals are bodies which provide services on behalf of credit union networks (Birchall, 2013).
(9) For example, the rate of interest charged by credit unions in the UK is currently capped at 2% per month. This could be raised to 3% or more and still provide a far better deal than that of other investor-owned financial institutions (Perman, 2014).
(10) Despite the restrictions placed on credit union development the credit union movement is experiencing considerable growth reportedly due to bank scandals (Meyer, 2013).
direct the flow of credit to strategic industries (Chang, 2007; Werner, 2005). Particularly in Finland and Japan, credit controls allowed these countries to experience rapid economic growth with little Foreign Direct Investment.

Considering the disadvantages of FDI discussed in Section 2.2.3.1.2 credit controls should therefore play a central part of an investment strategy in a Common Weal economy.

Complementing credit controls, a further idea that might be considered to incentivise banks to allocate credit for productive purposes is Asset-Based Reserve Requirements (ABRRs) (Palley, 2004). Here a central bank would raise the reserve requirements for certain assets, such as real estate. Not only, it is argued (ibid), might ABRRs discourage excessive risk taking but may also help to combat asset price inflation.

### 3.3.3.3 Monetary reform

One promising source of substantial sums for public investment which is underappreciated could be derived from reform of the monetary system, by establishing a system called full reserve banking. In this system the power to create the money supply would be taken away from commercial banks (refer to Section 2.2.3.2.2) and placed in the hands of the central bank. This would mean that commercial banks would no longer be able to ‘lend’ money into existence. Instead they would have to lend from the money deposited by customers.

One promising source of substantial sums for public investment which is underappreciated could be derived from reform of the monetary system.

Full reserve banking has been advocated by a great many renowned economists and, most recently, has been championed by the monetary reform campaign group Positive Money, Professor Richard Werner and the IMF’s Michael Kumhof and Jaromir Benes (2012). Considering the problems, outlined in Section 2.2.3.2.2, with the contemporary debt-based monetary system this could be a hugely positive step for an independent Scotland to take.

Full reserve banking has been identified as having many potential benefits. These include reducing overall levels of public and private debt, preventing commercial banks from fuelling cycles of boom and bust (by swelling the money supply in times of boom and contracting it in times of bust) and eliminating bank runs (Benes and Kumhof, 2012). As the banking sector would be more stable it would also require less regulation, making it easier for new banks to be established. This would help to increase banking diversity. Also, unlike the current debt-based monetary system, full reserve banking does not depend on continual monetary and economic growth for its stability (Douthwaite, 2012; Johanisova and Wolf, 2012). As such, it has the potential to provide the basis for an economy which allows the prioritisation of social justice and the environment over GDP growth.

Full reserve banking could also provide a substantial source of funding for public investment. It would do this by increasing the amount of money the government can gain from seigniorage. Seigniorage here means the gains a government derives from printing money (such as notes and coins) at minimal cost and introducing them into the economy at face value. Between 2000 and 2009 the UK Government collected around £18 in billion in this way, or about £2 billion per year (Positive Money, WWW). This is £2 billion pounds the government has been able to spend without raising taxes or borrowing. It is both debt free and interest free money. Yet, as we saw in Section 2.2.3.2.2, only 3% of the money supply is issued by the Bank of England while 97% is issued by commercial banks. As full reserve banking means providing the central bank with the exclusive right to create the entire money supply this would mean that the state would collect the gains from the creation of 100% of the money supply in the economy. This money could then be targeted at investment.

Because of the numerous benefits with which full reserve banking has been attributed, careful consideration should be given to the development and implementation of this approach to the monetary system.
Conclusion

Whenever proposals are advanced for transformational change along progressive lines one response is common:

“This sounds all very well, but where is the money to come from?”

While, particularly in this economic climate, one can easily understand that an individual or a household can be short of cash, the idea that we can be short of money as a society is absurd and should be challenged. A society can no more be short of money than it can be short of miles. Money, like measurements of distance, is an abstraction. Not something concrete that can be considered scarce. The very real perception of a ‘lack of money’ in the UK testifies to a faulty financial and monetary system.

The financial system in the UK, as this report has shown, which by its nature distributes wealth from the productive economy to the financial sector, from the indebted poor to the wealthy shareholders of banks and from regions to financial centres, is not capable of delivering the kinds of economic and social outcomes people have a right to demand. Moreover, it threatens to create a kind of ‘perpetual state of crisis’ which acts as a justification for the utterly destructive rounds of austerity to which all mainstream parties at Westminster have committed.

This report shows another way forward.

Governments and central banks must once again regard monetary policy as being about more than merely the quantity of money in an economy, which is supposedly controlled by the price of money (i.e. interest rates). Governments and central banks must also be concerned with the ‘quality’ of money in the economy, i.e. for what purposes the money is allocated, how it is allocated and what kind of institutions allocate it.

Central bank credit controls or guidance is a tried and tested method of improving productive investment while reducing speculation.

Also at the national level, a National Investment Bank should be the central component of a new and accountable financial architecture. But the financial sector must also be remodelled around democratically accountable, locally responsive banks and credit co-operatives, run by communities for communities.

Investment is what the UK lacks, not money.

Not only will this create stability in the financial sector. It will be a huge boost to the productive economy, including for co-ops and social enterprises which seek to put people before profit. It is self-evident that if we are to have an economy which is run in the interests of communities rather than shareholders, communities must be in control of directing the flow of financial resources towards their chosen outcomes.

Our current economy - characterised by low-skilled work, disempowered employees and enterprises concerned almost exclusively with profit - is to a large extent a reflection of the priorities of a financial sector which itself is dominated by the desire for profit above all else.

A Common Weal society needs a Common Weal financial sector. And considering the current debate about Scotland’s constitutional status, it is worthwhile emphasising that viewing monetary policy in these broader terms would allow Scotland, even without its own currency, to pursue its own independent monetary policy through the strategies outlined in this paper, which promote diversity in the financial sector.

Finally the austerity narrative must be challenged. The current rounds of austerity in the UK are justified neither by the level of debt nor the rate of interest paid on that debt, both of which are currently low by historical standards.

Investment is what the UK lacks, not money.
Ultimately, money gets its value from the goods and services traded in it – our capacity to provide for one another based on what we do and produce from the natural resources available to us, which Scotland has in abundance.

The idea that we should destroy these things of real value through the vandalism of austerity is both obscene and an act of economic self-destruction.

Future governments of Scotland should reintroduce the principle of investing for societal goals, challenge the failed policies of austerity and wrest monetary policy from the financial sector. These are prerequisites for a socially just and prosperous Scotland.

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