The Great Economic Irrigation

In the previous two chapters we sketched out the process of localisation in the Great Transition and the reskilling needed to make this reality. We also put this in a regional, national and international context, to emphasise that we do not envisage closed self-sufficient local economies, but rather thriving and vibrant neighbourhoods that exist as part of wider regions and a broader national society, itself part of an interdependent world.

In the Great Transition, finance is fundamental to this. Finance *irrigates* local economies, facilitating sustainable economic activity and underpinning community life. Nationally, we need to finance a renewable energy and sustainable transport infrastructure, as well as private sector activities that extend beyond the local level, including to international trade. In the public sector, tax and spending is needed at both local and national levels to achieve shared, democratically determined goals and to support the provision of national and local public services.

Public financial irrigation

Tax

Nobody likes paying tax. But if we want good local and national public services, a stable economy and well-resourced public goods, these need to be properly funded. This raises two questions: first, what taxes should be raised and spent nationally versus locally; second, what are the most appropriate sources of these revenues?

Whether tax is raised national or locally, the Great Transition would see a major shift from taxing good things like investment and employment to bad things such as speculation and unsustainable consumption.

Given the roles of the national public sector we have described, key functions of the national tax-and-spending system are to maintain broad economic stability and prevent the re-emergence of wide regional inequalities. Three principles of national tax and spending policy are based on these goals in the Great Transition.

First, while income tax for most people would be abolished with the minimum threshold set at the median wage, *income inequality* would be kept within reasonable bounds through the levying of an income tax that rises progressively thereafter.

Second, *asset inequality* at the individual level would be primarily addressed through the inheritance-tax-funded Citizens' Endowment described in the Great Redistribution, but would then be held in check through a progressive capital gains tax, complemented with a national land value tax[87] to create a regional inequality reducing mechanism: if some areas grew more prosperous than others, this would be reflected in higher land values, generating higher tax revenues. Land in less prosperous areas, in contrast, would have lower values and so attract lower tax rates, providing incentives for investment and economic regeneration.

Third, while the tax measures targeting asset inequality would also be positive from general *economic stability* through their dampening effect on speculation in financial and property markets, this would be complemented with transaction taxes levied at a low rate on all financial transactions – including on international currency transaction through the introduction of a Tobin tax. Such taxes would discourage short-term speculation and high-frequency trading but not long-term investment, as the impact of the tax would be negligible in any longer-term investment, but would become progressively larger as the number of transactions rose.

As well as maintaining economic stability and broad levels of equality, the final role of the national tax system would be to discourage the production of environmental 'bads' and encourage the production of 'goods' through variable consumption taxes levied on goods produced outside of local areas. Phased-in in line with income redistribution to address the regressive nature of consumption taxes, the full environmental costs would be reflected in the tax rate levied, reducing demand for goods in direct proportion to the real costs associated with their production.

Environmental *benefits* would also be reflected, to the extent that consumption taxes could even turn negative and become subsidies, reducing the market price of goods with very high environmental benefits and increasing the demand for them in proportion to their ability to build real value.

The combined effect of these national-level tax measures would be to prevent the formation and growth of speculative bubbles in financial and property markets, thus ensuring broad economic stability, to maintain reasonable levels of individual and regional equality in terms of both incomes and assets, and to steer consumption away from things that are environmentally damaging towards those that produce real environmental value.

In the Great Transition, these goals are best pursued at national level for three reasons. First, national economic stability can, by definition, only be monitored and maintained at the national level. Second, a danger in a devolved and decentralised economy of the type set out in this report is that local regions start to diverge in terms of prosperity, and without any national level mechanisms to perform a rebalancing role, this divergence becomes ever more entrenched and pronounced over time. Third, the environmental problems we face are common to us all: things that degrade the environment in one part of the country do no differently in any other.

And spending

What about national level spending? Well, the obvious use to which progressive income tax should be put is in providing a national level safety net, which guarantees a minimum income to those unable to find work, as well as in providing a state pension for older people.

Revenues from capital gains and transaction taxes could be targeted towards providing national level public services, such as specialist larger hospitals and tertiary education institutions, which would require a certain economy of scale and so would be best funded and provided at national level.

The provision of national level public goods could then be funded through the proceeds from the land value tax, facilitating the development and maintenance of a national sustainable energy network to provide back up for local energy production, based on larger-scale facilities, such as offshore wind-farms, for example. Similarly, national transport networks of high-speed rail links integrated into regional and local rail systems and the national road network and could be part-funded and maintained in a similar way.

The purpose of national public spending in the Great Transition would therefore be to partly fund and maintain the things we need but which are best provided at a scale beyond that possible locally, and to provide a basic national income for citizens unable to work as well as a state pension for all.

As should be clear, many issues of taxation and spending are increasingly decided at the local level in the Great Transition. Granting genuinely democratic local government powers to tax and spend – as well as the ability to borrow for local investment – is a vital part of the reinvigoration of local public engagement and participation.

Local authorities have become increasingly marginalised and distant from the lives of people living in local communities. What steps would be taken to reverse this in the Transition? First, local authorities would be freed from the straightjackets imposed by central government and able to borrow to invest in their areas through the issuance of local – or municipal – bonds. Initially focusing on regenerating and retrofitting the local housing stock, it would become possible for local government to provide ongoing investment to maintain a sustainable and stable mix of social, private and rented housing, tailored to the needs of different areas.

Council taxes would become Local Services Taxes and replace income tax for most as their primary means of contributing to the provision of good public services in their areas. Much of this would be dedicated to funding local schools, local preventative health services and community hospitals to treat all but the most severe conditions.[88] Services would become increasingly responsive to democratically expressed local opinion, with a reinvigorated sense of civic pride inspiring much greater participation through volunteering in nurseries, schools, hospitals and care centres for the elderly.

While sustainable locally produced goods would be generally exempt from environmental consumption taxes levied at national level, thereby providing an economic incentive for local production, variable consumption taxes would also be applied locally. Rather than discouraging environmental 'bads' and encouraging 'goods', here the focus is on the social. Reflecting the fact that different communities have different priorities, we would see real participation of local people in priority setting: which social 'goods' do they want to encourage and which discourage? Building the results into local consumption taxes would reflect these priorities in prices and so incentives, but also provide a revenue stream to augment Local Services Taxes in funding services and other local priorities.

After the Great Transition much energy will be produced locally. The introduction of feed-in tariffs[89] at an early stage is crucial to kick-starting this process, but the result would be a far more decentralised, self-sufficient and so resilient energy infrastructure. Connected to and so backed by the national network, this relationship will be mirrored in the transport sector, with local branch networks connected to a high-speed rail system. Many towns would also choose to become pedestrianised, re-establishing affordable trams and other forms of sustainable travel to replace the need for motorised transport in local areas.

Private financial irrigation

In the Great Transition, the perceived divide between the public and private would become far less pronounced. The financial crisis has made it obvious that this was never so clear-cut as had been thought anyway, and the need for a fundamental restructuring of the national banking system – an essential precondition for the transition set out in this report – is clearer than ever. Instead of going back to business as usual we need to build an ecology of financial institutions, established to provide funds to achieve national and local priorities: to irrigate the Great Transition.

Big irrigation

At national level, a Green Industrial Bank would be created to channel public and private funds to build countrywide sustainable energy and transport infrastructures. Rather than relying on private banks as the sole source of money creation, much of this function should be taken back under public control for public benefit, with the Government determining the level of public money that is created annually to maintain a stable money supply. As we have seen with the programme of 'quantitative easing'. the Government can create money at will. Historically, however, it has largely outsourced this job to private banks to create credit, varying interest rates to alter the incentives for banks to do and for borrowers to want to borrow.

The current crisis has made it very clear that this certainly does not guarantee that created credit is put to productive use. Given the huge capital investment required to fund sustainable infrastructure in the Great Transition, taking a proportion of the responsibility for money creation back into the public sector is essential. It would enable large-scale direct public investment to achieve the rapid progress that an uncoordinated market system cannot.

Social challenges are also immense, and addressing these should form a complementary and central role of the new industrial policy. Disproportionately focusing investment in deprived areas, the policy would become a highly effective tool of economic and social regeneration.

As well as the Green Industrial Bank, a national Post Bank would be built out of the existing Post Office system. The Bank would be charged with maintaining a public benefit component in the provision of finance, whether to reduce and eliminate financial exclusion, or to finance small businesses in local communities. The high levels of trust and affection with which the Post Office is held would enable it to rapidly grow its depositor base with new savings, and its extensive branch network would help it to work closely with local businesses and entrepreneurs to provide finance on fair terms.

An existing national institution – perhaps Northern Rock – could be transformed in to a new national Housing Bank, offering people the opportunity to transfer a portion of their mortgage debt into equity and paying social rent on the balance. As well as addressing the millstone of unsustainable personal debt, this would lead to a more balanced tenure distribution across the UK and encourage institutional investment in rented housing, improving the quality of the private rented sector and giving pension funds, for example, an attractive long-term and in many cases local investment opportunity.

The Housing Bank could purchase equity stakes at a reduced market rate, reflecting the future decline in the value of housing because of the introduction of higher inheritance taxes, as well as the puncturing of the credit-fuelled housing bubble. As they would have to book a loss on these sales, other private banks that owned these assets would therefore share the burden of reducing debts, just as they shared in the profits that were made in supplying them. The impact of reducing debt to sustainable levels would be shared by individuals, the public sector and the private sector.

An ecology of irrigation

But the new ecology of finance needs to look beyond crisis management and be varied in scale as well as ownership, form and function. Recognising the importance of financing different activities with institutions dedicated to specific purposes, retail banks should be separated from investment banks. The long-standing tradition of mutual ownership in the UK could finally achieve its potential with many institutions becoming mutually owned, made possible if central government uses its equity stakes acquired in 2008 to hand back ownership to citizens.

At local level, this would see a flowering of local, mutually owned financial institutions, providing a safe home for local savings, but also a source of local investment funds to complement those of the Post Bank.

Privately owned banks complete the ecosystem, with some focusing on particular sectors such as agriculture or providing wholesale banking services at national level, while others provide a wider range of financial services locally.

What these banks would have in common would be new requirements on credit creation. In the Great Transition, public money creation would be a vital tool of the Green Industrial Policy at national level. For non-publicly owned banks, the Government would reintroduce 'fractional reserve requirements'[90] as an active tool of economic policy, with the default level being set at 100 per cent, making credit creation impossible. In practice, however, this percentage would vary to allow credit to be created, but only under strict conditions.

The fractional reserve requirements facing banks would become a direct function of the ability of the investment being financed by the loan to create social and environmental value. As we saw in previous sections, the consumption tax system would be applied differentially to different products to reduce the price of goods in proportion to their social and environmental benefits but to increase prices in relation to costs. This same measurement system could be applied to the financial sector, such that investments that would generate the most value in these areas cause reserve requirements to fall to their lowest possible level of 10 per cent. Where investments would lead to social and environmental costs on a net basis, in contrast, fractional reserve requirements remain at 100 per cent, so that no credit could be created.

As the net social and environmental benefits of projects rise, so fractional reserve requirements fall, ensuring that credit is only created for net positive investments, and the more positive these are the more credit would be available. Keeping interest rates in place makes sense here. Many have criticised the role of interest in driving unsustainable growth and there is much in these arguments. However, when profitability is linked to sustainability and real value, having to earn sufficient profits to service a loan becomes a positive thing: the more social and environmental value is created, the more profitable the investment. Incentivising firms to maximise this value in order to pay interest on their loan reverses today's outcomes, driving sustainability not undermining it.

The result would be a highly effective combination of direct public investment in large sustainable infrastructure projects, and a race to the top in the private sector as reformed financial institutions, at both national and local levels, sought out investment projects that would generate the most social and environmental value. The fact that the money supply could only increase as real value was created would keep supply and demand in balance, preventing inflationary pressures emerging.

Financial institutions in the Great Transition would function within a stable regulatory framework that also encompassed the capital markets. As before the Transition, large liquid bond and equity markets would exist, but would be greatly changed in their approach and impact. Once company profitability becomes directly linked to social and environmental value, share prices for listed companies would reflect this.

The composition of the FTSE 100 would change rapidly in some instances, as ethical and environmentally sustainable companies replaced unsustainable incumbents which were unable or unwilling to change their business practices and so saw their market shares and profitability plummet. In other cases, large companies would change direction and focus on building sustainable social value, while for a few it would be a continuation of their existing good practice, but now they would be rewarded for it and encouraged to go further, rather than facing a financial penalty as had been the case.

The introduction of financial transaction taxes would encourage stability in the stock market, which would be further enhanced by the more long-term, sustainable approach taken by companies to their business activities. This would prove a boon for institutional investors such as pension funds, with their inherently long-term perspective. Pension fund members would also be given a far greater say in the investment decisions of their funds. Given the shift from growth to sustainability in the Great Transition, pension funds – and other investors – would look not to capital gains but to acquiring income streams from sustainable businesses, and to holding a genuinely diversified portfolio of assets with a range of local, national and international investments.

One new area focuses on local investments. As local government becomes able to issue bonds to fund local investments in housing and other areas of social priority, local pension funds would emerge to enable people in communities to invest directly in the future of their areas. Over time, local pensions would begin to be paid on the steady income streams these investments produced, diversified with equity holdings in local companies and perhaps linked to local energy production.

Financial irrigation is essential to kick-starting key components of the Great Transition at both national and local level, but that is only the start. The remodelled public and private financial systems would then help to progressively build value, based on local democratically determined priorities in the public sphere, and the dynamism of financial institutions, now harnessed in the pursuit of social and environmental returns rather than short-term commercial returns, in the private sphere.