

EVALUATING ECONOMIC POLICY IDEAS RECENTLY OFFERED TO THE LABOUR PARTY

William A. Allen

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Evaluating economic policy ideas recently offered to the Labour party

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Abstract

This policy paper reviews the report 'Financing Investment', commissioned by the Shadow Chancellor from GFC Economics and Clearpoint Advisors, and published on 20th June 2018. The authors say that the report 'should not be taken to represent the views of the Labour Party or the Shadow Chancellor.' Its evident purpose is to advise the Opposition and perhaps to elicit comments. It is ostensibly about investment and growth: in this, it echoes the concerns of the 1950s and 1960s. It argues that 'the UK has fallen too far behind in research & development and its commercial applications. Innovation is critical to wealth creation. Government support has been lacking.' In fact, its recommendations embrace the entirety of macro-economic policy. They include more government funding of infrastructure investment and research and development, and more direction of bank lending, towards industrial sectors considered critical to economic growth, and away from consumer and real estate lending. Its fiscal proposals are to eliminate the deficit on current spending over five years, to borrow only for investment, and to get the government debt/GDP ratio falling after five years.

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Note: *The views expressed in this paper are those of the author alone, who is a NIESR Visitor and not those of the National Institute for Economic and Social Research*

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1. Introduction

This policy paper reviews the report 'Financing Investment', commissioned by the Shadow Chancellor from GFC Economics and Clearpoint Advisors, and published on 20th June 2018.¹ The authors say that the report 'should not be taken to represent the views of the Labour Party or the Shadow Chancellor.'² Its evident purpose is to advise the Opposition and perhaps to elicit comments. It is ostensibly about investment and growth: in this, it echoes the concerns of the 1950s and 1960s. It argues that 'the UK has fallen too far behind in research & development and its commercial applications. Innovation is critical to wealth creation. Government support has been lacking.'³ In fact, its recommendations embrace the entirety of macro-economic policy. They include more government funding of infrastructure investment and research and development, and more direction of bank lending, towards industrial sectors considered critical to economic growth, and away from consumer and real estate lending. Its fiscal proposals are to eliminate the deficit on current spending over five years, to borrow only for investment, and to get the government debt/GDP ratio falling after five years.⁴

It recommends the setting up of new official bodies and expanding the role of the Bank of England. The new bodies include a Strategic Investment Board (SIB), a National Investment Bank (NIB) and a National Transformation Fund (NTF). The structure is illustrated in the diagram below, reproduced from the report.

¹ GFC Economics Ltd and Clearpoint Advisors Ltd (2018).

² The report is written by GFC Economics Ltd and Clearpoint Advisors Ltd.

³ P 103.

⁴ P 35.

Figure 1

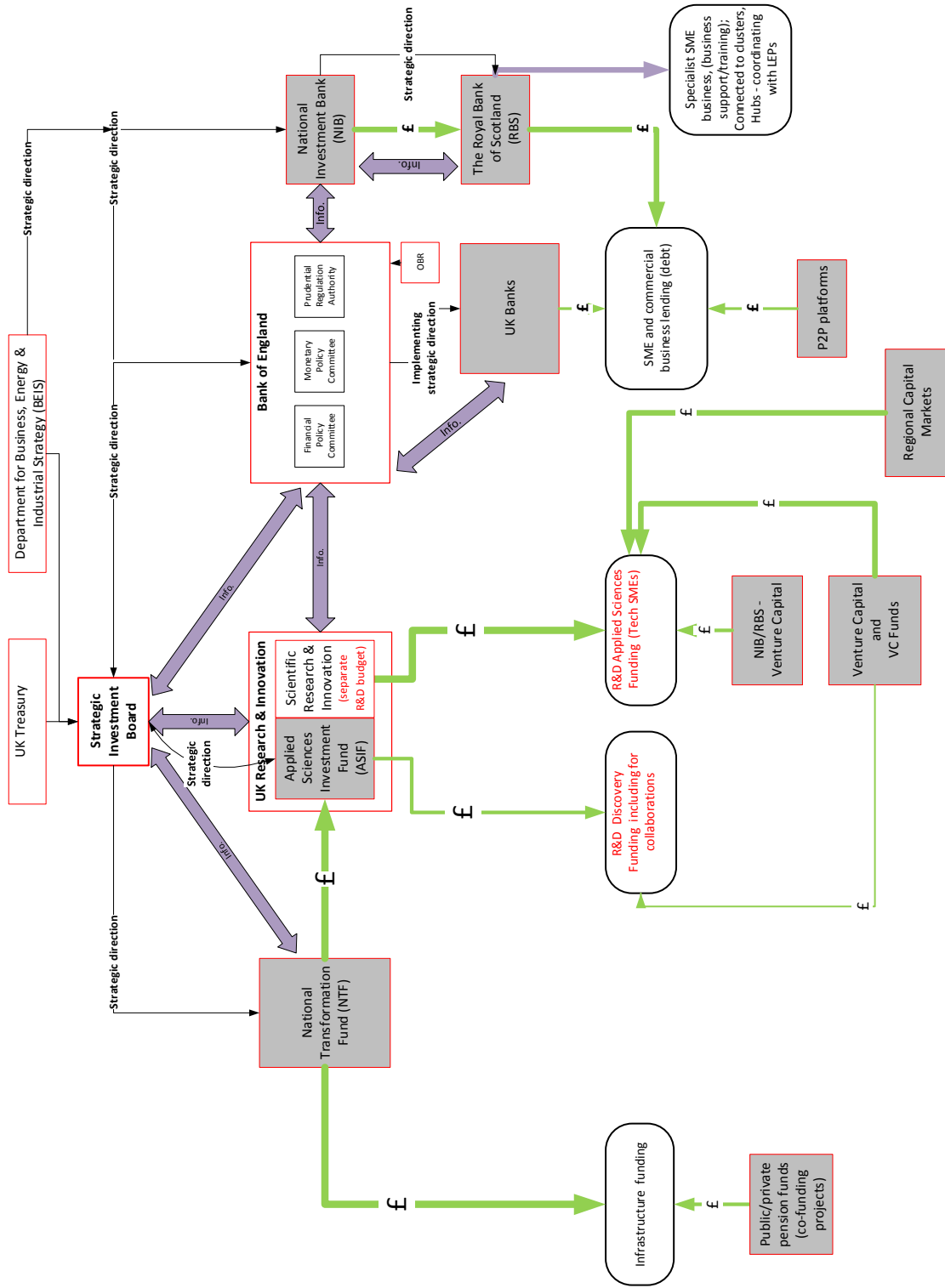


Chart 5.1, p.102, Financing Investment

The SIB, at the apex of the pyramid, would provide strategic direction, rather than money. Money for infrastructure projects would come from both public and private sources, NTF being the public sector source; and money for applied sciences, scientific research and innovation would also come from the NTF, through the intermediation of UKRI. The NIB would provide funding, via the Royal Bank of Scotland, if it is still publicly-owned, to small businesses, and the Bank of England would be required to ensure that the commercial banks provided adequate funding to ‘productive sectors of the economy’, using its power to set differential risk weights for different categories of bank lending and possibly to direct lending.⁵ The BOE would be set a target of 3% productivity growth alongside its inflation target and its financial stability objectives.

The strategy has an important regional dimension. The SIB, the NTF and the NIB would be located in Birmingham, and the BOE Monetary Policy and Financial Policy Committees would be relocated to Birmingham. The NTF would have regional offices. The Financial Policy Committee would have representatives from each region.

2. History

As already noted, the present anxiety about productivity growth echoes the anxiety that dominated British economic policy for nearly two decades from the late 1950s.⁶ The immediate cause of the concern then was the U.K.’s measured GDP growth rate, which was low relative to those of other European countries, though not the USA (Table 1).

Table 1

Growth rates of real GDP per capita, 1948 – 2016 (% , annualised rates).

	UK	France	Germany	Italy	USA
1946-60	1.8	4.8	9.3	6.7	1.6
1960-73	2.6	4.3	3.4	4.6	3.0
1973-88	2.0	1.8	2.0	2.6	2.0
1988-2007	2.0	1.6	1.3	1.4	1.9
2007-16	0.2	0.0	0.8	-1.2	0.5

Source: Maddison project database 2018,
<https://www.ruq.nl/qgdc/historicaldevelopment/maddison/releases/maddison-project-database-2018>

⁵ P 15.

⁶ Tomlinson (1996) discusses the origins and political significance of the notion that Britain was in decline, which he calls ‘declinism’.

Growth became a major political priority in the late 1950s.⁷ This was a time when the UK's post-war inflation seemed to have ended; the government debt/GDP ratio, which had been an unsustainable 259% in 1946, had fallen to 117% in 1958: still very high, but not as intimidating. The pound had been devalued by 30% in 1949, and although relatively high inflation in the UK had eroded competitiveness, there was a current account balance of payments surplus of 1.6% of GDP in 1958. In the same year, however, unemployment had risen to 2.1% from an average of 1.4% in 1951 – 57.

Growth was pursued in several ways.

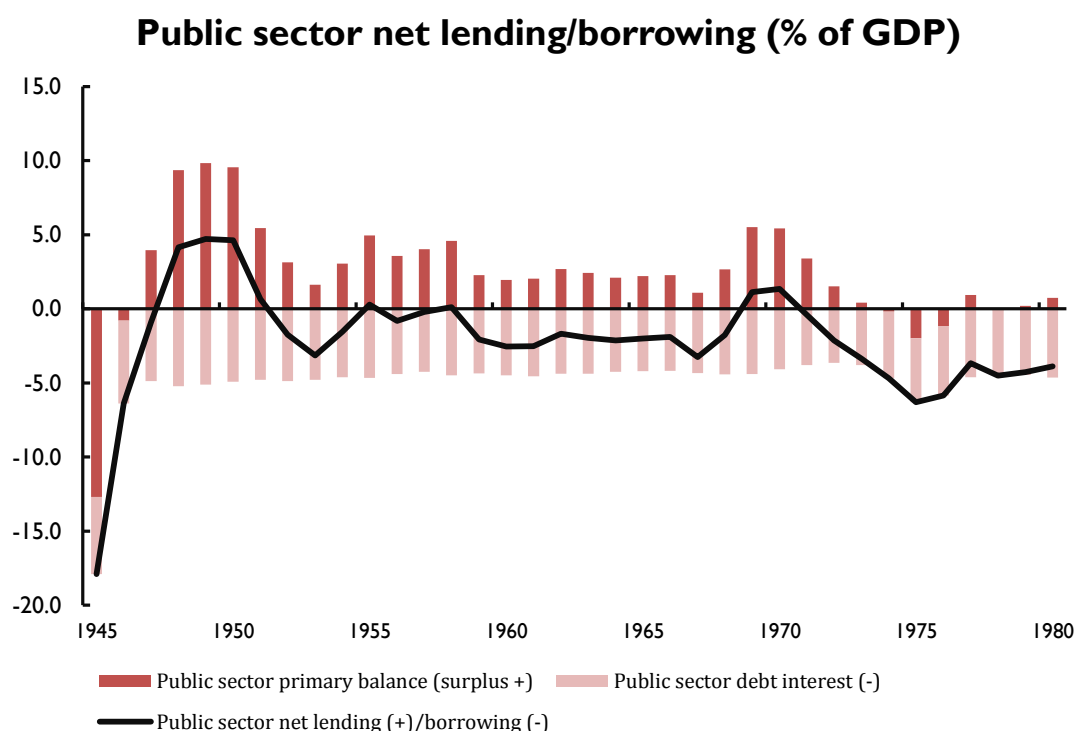
- Expansionary monetary and fiscal policies in 1958 – 59. The fiscal easing was not reversed until the late 1960s (Figure), and short-term interest rates were maintained as low as was considered compatible with maintaining the Bretton Woods exchange rate parity. In 1959 and in 1962 - 63, public debt management policy aimed at getting long-term interest rates down, in the interests of promoting investment.
- Indicative planning. In 1962, the Conservative government set up a National Economic Development Council and established an objective for growth of 4% a year. The Labour government elected in 1964 set up a Department of Economic Affairs, as a counterweight to the Treasury, and published a National Plan, which was intended to facilitate growth averaging 3.8% a year between 1964 and 1970.
- The Selective Employment Tax. SET was introduced in 1966 on employment in service industries, with the intention of shifting surplus labour out of service industries into manufacturing, which was thought to enjoy dynamic economies of scale.
- Fiscal incentives for investment.
- In 1966-70, government encouragement of industrial mergers thought likely to increase efficiency.
- Official sponsorship of individual projects, notably Concorde.
- Preferential treatment of specific categories of bank lending. When lending ceilings were reimposed on the clearing banks in December 1964, the banks were told that they should prioritise advances that promoted exports, manufacturing industry, and the government's regional development policy. Those to be avoided were property development, personal and professional uses, and advances for hire purchase.⁸ This ended in 1971 when lending controls were withdrawn.

⁷ Tomlinson (1985, ch 4).

⁸ Capie (2010, p 292).

- Notwithstanding the high debt/GDP ratio, fiscal policy was more expansionary in the 1960s than in the mid-late 1950s, and it became more expansionary still in the 1970s (Figure 2).
- The National Enterprise Board, set up under the Industry Act 1975 with objectives similar to those which the report envisages for the National Investment Bank.

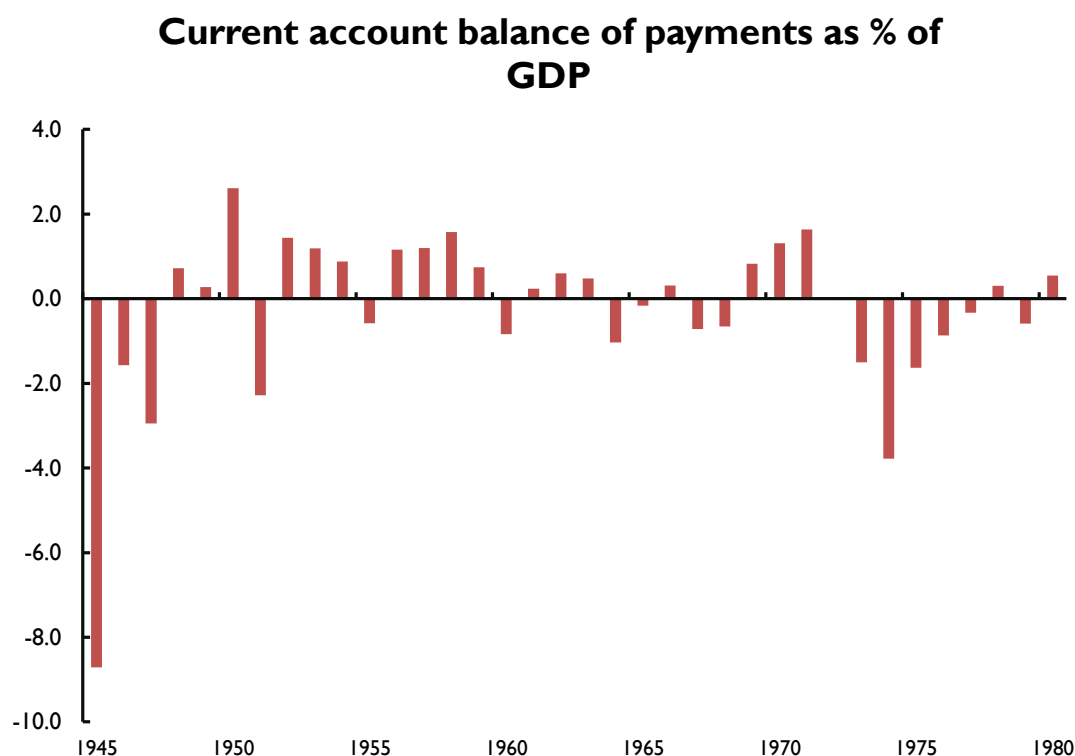
Figure 2



Source: Bank of England, 'A millennium of data', author's calculations.

From the late 1950s onwards, there were persistent market doubts about the sustainability of the Bretton Woods exchange rate parity of £1 = \$2.80, which had been established in 1949, and for a time about the lower parity of £1 = \$2.40 established after the devaluation of 1967. The doubts were related both to the U.K.'s overhang of external debts, mainly incurred in wartime, and, in the 1960s, to the current account of the balance of payments, the surpluses of the mid-late 1950s having more or less disappeared (Figure 3).

Figure 3



Source: Bank of England, 'A millennium of data', author's calculations.

Episodes of exchange rate weakness and rising inflationary expectations forced governments to tighten policy abruptly on several occasions, by increasing Bank rate, tightening exchange controls and tightening domestic monetary controls. Repeated attempts were made to contain inflation without restricting demand by means of incomes policies. It was hoped that incomes policies could be agreed with trade unions, but when that was not possible, they were then imposed by statute. They were ineffectual.⁹ The measures generally failed to convince financial markets, and the government and the BOE went to enormous lengths, and took massive financial risks, to borrow in a wide range of ways in the struggle to maintain the \$2.80 parity. They lost the struggle in 1967, and were for a time engaged in another struggle to maintain the new parity of \$2.40. There was a substantial tightening of fiscal policy in the late 1960s, which led to a strengthening in the balance of payments (Figure 2, Figure 3).

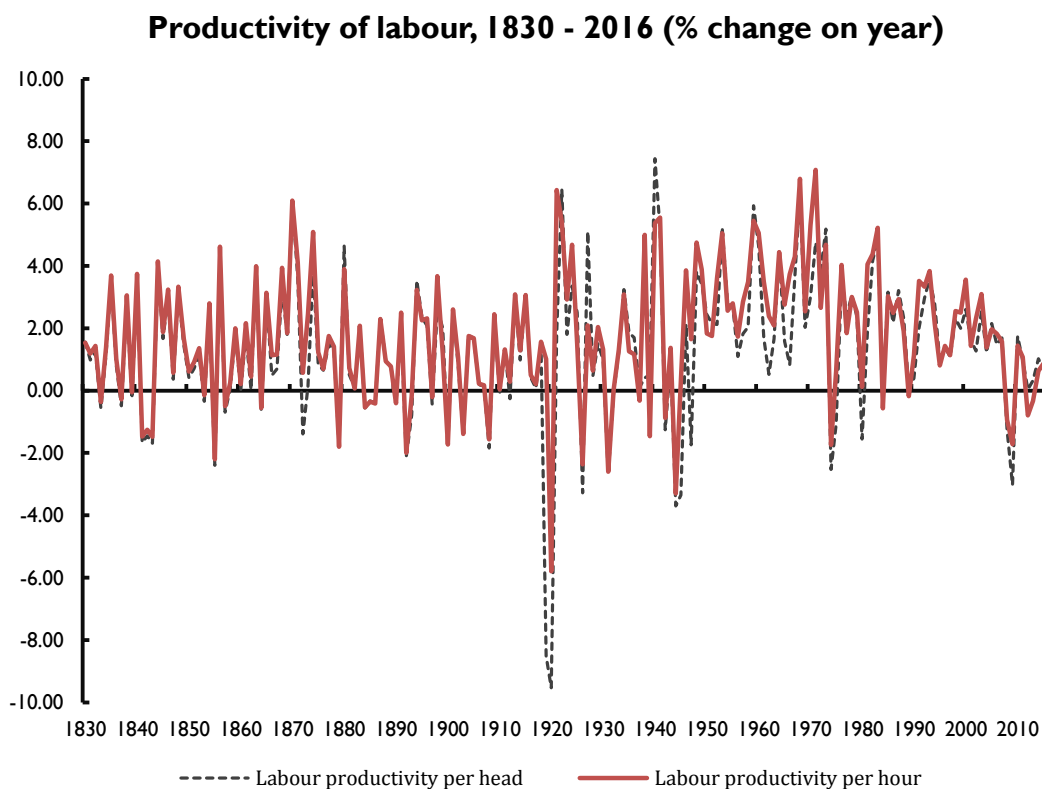
The general advent of floating in the early 1970s was initially hailed as a liberation from exchange rate constraints on growth. In its early days, the Conservative government of 1970 - 74 pursued growth through a strategy of not intervening in industry and setting markets free, but non-intervention proved short-lived. Its main macro-economic actions were to remove controls on bank lending, which had in any case become ineffectual (see below), to allow real interest rates to become negative,

⁹ Henry and Ormerod (1978).

and to reverse Labour’s fiscal tightening, admittedly in the difficult circumstances created by the rise in oil prices. In the event the pound was persistently weak and inflation and inflationary expectations took off. In an inflationary global environment and with the floating of sterling having left incomes policy as the only nominal anchor for the economy, U.K. inflation reached 25% in 1975. After the exchange rate had collapsed in 1976, the U.K. approached the IMF for a standby loan, and embarked on a change in economic objectives in which the subduing of inflation, and later price stability, had overriding priority. Severe curtailment of demand was needed to break inflationary expectations. Productivity growth slowed down (Table 2), and faster growth was not sustained.

U.K. productivity growth was distinctly higher in the period 1946-73 than it had been before or has been since (Figure 4). And it accelerated after growth became a policy objective in the late 1950s (Table 2). U.K. growth did not, however, reach the National Plan’s objective for 1964 – 70: the actual annual average growth rate in those years was 2.8%. Crafts (2017) provides a detailed and coherent analysis of why growth was slower in the U.K. than in other European countries in the years up to 1973: he identifies lack of competition in the U.K. as a major factor. And he argues (2016) that stronger competition after EU entry in 1973 led to a substantial increase in UK productivity growth after a long period of decline relative to other European countries.

Figure 4



Source: Bank of England, 'A millennium of data', author's calculations.

Table 2 **Productivity growth, 1946 – 2016 (% pa)**

	Annual average productivity growth	
	GDP per person employed	GDP per hour worked
1946 - 60	2.7	3.3
1960 - 73	3.0	4.0
1973 - 88	1.8	2.2
1988 - 2007	1.6	1.9
2007 - 16	0.1	0.1

Source: Bank of England, 'A millennium of data', author's calculations.

Interventionism in the economy had a mixed record. The maintenance of controls on clearing bank lending, inadequately supported by interest rate policy, suppressed competition and diverted credit flows into other channels, e.g. fringe banks, where they were unobserved and unregulated, and the lending ceilings imposed on the clearing banks were tested to destruction: in 1969, the clearing banks exceeded the ceilings, which were evidently ineffective as an instrument for restraining the growth of money and credit at a time of rising inflationary expectations. Selective industrial intervention had some notable and expensive failures: the costs of Concorde were nearly twenty times the original budget, and it was delayed; and the National Enterprise Board was used to prolong the lives of declining industries.

In his assessment, Blackaby (1978, p 429) aptly commented that 'it is very difficult to see how one could successfully disentangle the consequences of the various policies whose objective was to raise the rate of economic growth.' Nevertheless, it seems clear that maintaining high domestic demand was inimical to sustained growth, because it led to macro-economic instability, and that selective industrial intervention was in at least some cases very poorly judged.

3. Analysis and commentary

The report does not attempt a full diagnosis of the recent slowdown in productivity growth. It points to a lack of support from the government and from banks for investment and research and development, and past over-eagerness on the part of companies to pay dividends rather than invest. It is implicit in its recommendations that the new institutions that it proposes would provide a cure. The report acknowledges the great difficulty of measuring output and therefore productivity as technology develops (p 20), but is not thereby inhibited from proposing a quantitative target for productivity growth.

In trying to account for past growth, economic historians stress the importance of institutions, such as law and contract enforcement. That suggests that new institutions set up by the government to support economic growth should be very carefully designed.

New institutions

The recommended Strategic Investment Board is to be at the apex of the growth-promotion pyramid, but the report is vague about what it is to do. The clearest statement is on pp 104 – 105:

‘The Strategic Investment Board will oversee and support investment, coordinating input from the Bank of England, the National Investment Bank, the National Transformation Fund and UK Research and Innovation... Government-led strategies have already been successful in the US, Singapore, South Korea, China and Japan.’

In particular, the SIB would ‘provide direction for the Bank of England in respect of credit guidance.’¹⁰ It is not clear whether ‘provide direction’ means ‘issue detailed instructions’ or ‘make general suggestions’, and what accountability the SIB would have for the results of credit guidance.

The ill-defined functions of the SIB, and the failure to articulate its responsibilities, suggest that it would not be a useful or effective body. And the report does not acknowledge the fact that a co-ordinated industrial strategy, built on consistent assumptions determined by a central body, concentrates risk and can be very costly if the assumptions prove to be mistaken.

It is entirely plausible that more investment in infrastructure, e.g. for transport and electronic communication, would facilitate faster economic growth; and this is implicitly recommended. The report says that ‘the selection of infrastructure investment projects will be driven by the Strategic Investment Board’, but it is not clear whether this means that the SIB would actually make the selection: this is one aspect of the general lack of clarity about the SIB.¹¹ The NTF’s head office (in Birmingham) ‘will allocate funding for infrastructure spending.’¹² Its regional offices ‘will be involved in the research and identification of infrastructure investment within respective regions. They will be directly involved with managing infrastructure projects – with large or complex projects led or supported by the NTF head office.’¹³

Private finance is attracted to stand-alone infrastructure projects by the lowness of long-term interest rates, and the secure returns that many of them offer. And there is no apparent need for an official body to help with project management: indeed the public sector’s record in project management suggests that it might hinder rather than help. There are, however, at least four serious problems: first, the occasional paralysis of the political process for making decisions about large infrastructure projects, such as enlarging airport capacity in the London area;

¹⁰ P 14.

¹¹ P 108.

¹² P 109.

¹³ P 108.

second, the political attraction of spectacular but relatively unrewarding projects; third, a disinclination to embark on lower profile but nonetheless very useful projects such as improvements to existing infrastructure, e.g. roads; and fourth, a marked tendency for project costs to be seriously underestimated and for deadlines to be missed.¹⁴ The report gives no reason to think that the official agencies that the report proposes would be able to overcome the first, second or fourth of these problems; it might, if well managed, overcome the third.

The Bank of England

The report has a surprisingly large amount to say about the BOE, even though it would be subordinate to the SIB in the growth policy hierarchy, and perhaps as regards some aspects of bank regulation. The report nevertheless proposes large increases in the scope of the BOE's power and responsibilities.

The main points are:

- i. The Bank would have a new role in fiscal policy:

'the Bank of England and the Government sign a fiscal policy accord. This agreement would mandate the Bank of England to formally comment on Government fiscal policy. Using input from the Office for Budget Responsibility, the Bank of England will be tasked with providing a detailed critique of the spending and taxation decisions of the Government, and how these impact on productivity and the potential growth path of the UK economy....

Nevertheless, as part of the accord, the Bank of England must pledge to respect the Government's manifesto commitments, and the democratic vote. In other words, the Bank of England must consider the Government's wider economic objectives and social objectives upon which it was elected. The Government will ultimately decide on the level of spending between departments and on the level of taxation.' (pp 33 - 34).

- ii. Investment through the NTF would increase public debt, and the BOE would be required to assess its impact on productivity.
- iii. The 2% inflation target for monetary policy would remain (p 4). The report is however strangely unconcerned about the possibility of periods of mild deflation as long as productivity is growing, despite the malign effects of deflation on debt burdens and spending decisions (p 5).

¹⁴ Crafts (forthcoming), Flyvbjerg (2009). The final report of the Airports Commission, published in 2015, has failed to settle the debate on how to expand London's airport capacity, which therefore remains inadequate.

- iv. The BOE would be assigned a target of 3% a year productivity growth (p 4). The definition of productivity to be used is not specified. The Bank would achieve the target by directing bank lending in productive directions, by manipulating the risk weights applied to various categories of lending, and perhaps by direct instructions to the banks. Credit should be allocated to industrial sectors according to a formula based on how important they are deemed to be to productivity growth (p 17).

The fiscal policy proposal addresses an important aspect of macro-economic stability, and a perennial latent source of conflict between governments and central banks. Central banks may be in some senses independent, but they cannot refuse to make payments ordered by their governments. Even the supra-national and super-independent European Central Bank has gone to great lengths to avoid such a refusal ('everything it takes'). Yet they cannot maintain price stability if governments behave in a fiscally irresponsible manner.

Therefore central banks have an inescapable interest in fiscal policy. For many years it was customary for the BOE to write a letter to the Chancellor of the Exchequer before each year's Budget giving advice about fiscal policy. The letter was not published, and it was of course open to the Chancellor to ignore the Bank's advice. More recently, the Office for Budget Responsibility has been created in order to provide independent and authoritative analysis of the UK's public finances. The report proposes in effect to reassign to the BOE the job currently done by the OBR, though it curiously does not propose to abolish the OBR. Reassigning it serves no obvious purpose.

It would be very surprising if Labour adopted the procedure that the report recommends. Taken at face value, it amounts to out-sourcing all of the main features of macro-economic policy to the BOE. It is eerily reminiscent of the relationship in which the Labour government found itself in August 1931, when it had to negotiate, via the BOE, with the bankers who lent it money to support the vain effort to keep sterling on the gold standard, and which destroyed the government. Hugh Dalton, who nationalised the BOE in 1946, would turn in his grave.

If such a procedure were nevertheless adopted, it is possible to imagine that governments, anxious to elicit a favourable critique of their decisions and supported by a democratic mandate, would put pressure on the BOE to express public support for them, whatever they might be. In the 1970s, the contents of the Bank of England Quarterly Bulletin were routinely subject to negotiation with the Treasury lest it say anything that the government found inconvenient. Since the 1980s, there has been less tension between the BOE and the government over fiscal policy but in other countries differences between governments and central banks about fiscal policy are widespread. There is a risk that the BOE would not be free to express its views

candidly, and that its intellectual integrity would be compromised. Too much power could be bad for the BOE.¹⁵

Of course, the OBR is subject to the same kind of pressure. But the OBR is a single-purpose organisation, and if such pressure were to be put on it, its *raison d'être*, and perhaps the organisation itself, would be easily destroyed, and its conflict with the government laid bare.

The proposal to make the BOE responsible for achieving a productivity growth target makes no sense, for the following reasons:

- i. The proposed SIB is to be the leading official authority in the growth policy hierarchy, and the BOE just one of its subordinate agencies. It is doubtful whether setting a productivity target makes any sense (see above), but if there is to be a target, it should in logic be assigned to the SIB.
- ii. The distinction that the report wishes to draw between speculative and productive projects is easy to make after the event, but not before. Speculative projects can be productive, while apparently productive projects – such as Concorde - can end in massive waste and financial losses.¹⁶
- iii. Centralised allocation of bank credit to favoured industrial sectors is unlikely to affect productivity growth. There is no evidence that investment is constrained by lack of access to finance; and it is not necessarily bank credit that is used to finance investment. Moreover, the proposed formula for credit allocation is absurdly mechanistic, and unlikely to succeed in directing credit in the desired directions: borrowers with easy access to finance can pass the proceeds on to others with less easy access. The BOE has no power to influence or direct asset managers, private equity or venture capital investors, either in the UK or overseas.
- iv. Promoting economic growth is not the same as promoting financial stability. If the BOE were to manipulate risk weights or direct bank credit for purposes other than financial stability, it would create additional moral hazard and make it more likely that the public would be obliged to bail out more insolvent banks. This time, though, the public would be able to blame the government rather than the bankers.
- v. The report calls for a shift in bank credit from lending collateralised by real estate, which it claims is overvalued, to lending collateralised by intellectual property (p 16). It does not, however, adequately address the consequences for the supply of housing; nor does it address the difficulty of valuing intellectual property, which can lose all its value if a new and superior piece of intellectual property appears.

¹⁵ Tucker (2018).

¹⁶ Crafts (forthcoming) warns of the hazards of selective industrial policies.

- vi. Any serious attempt to increase productivity growth would have to address infrastructure needs. As already noted, the BOE would lack the power to do this.

It is highly likely that the proposed 3% productivity growth target would be undershot. Productivity growth over the three decades 1986 – 2016 averaged only 1.3% (GDP per person employed) and 1.5% (GDP per hour worked), and the BOE would lack the instruments needed to increase it. Such a 'failure' would create an opportunity for pressure to be put on the BOE to keep demand strong and run greater risks of overshooting its inflation target, in the hope that strong demand would stimulate longer-term growth and correct the productivity undershoot. In that event, macro-economic stability would be compromised and we would be on the way back to the 1960s and 1970s.

There may be a case for an independent agency to scrutinise the productivity implications of supply-side policies including, but going well beyond, fiscal policy, but it would not be a good fit with the BOE's skills and other responsibilities.

The report suggests that the use of short-term interest rates as the main instrument of monetary policy has created economic instability, and that more use of credit controls would be preferable (p 13). Credit controls were used as a substitute for short-term interest rate policy in the 1960s and 1970s and tested to destruction. They could not be the main instrument of a successful monetary policy.

The regional aspects of the proposals call for comment. The BOE already has a network of regional agencies which maintain contact with local industries and convey information to the head office in London. The report's proposals to relocate the Financial Policy Committee to Birmingham, and appoint regional representatives to it, are in themselves a threat to financial stability. London dominates the UK's financial markets and the risks to financial markets arise mainly in London. Moving the FPC away from London, and appointing regional representatives to it, could only diminish its awareness of what is going on, and impair its effectiveness.

Concluding remarks

The World Bank Commission on Growth and Development notes that there are certain points of similarity among countries which have achieved sustained growth. They include openness to the world economy, macroeconomic stability, high levels of saving and investment, market-led resource allocation, and committed, capable and credible governments.¹⁷

¹⁷ Commission on Growth and Development (2008, p 21).

The GFC/Clearpoint report's recommendations reject market-led resource allocation, and offer diminished assurance of macroeconomic stability. Some of them – e.g. eliminating the deficit on government current spending, stabilising the government debt/GDP ratio, and increasing infrastructure spending, are likely to help to promote growth. The attempt to direct bank credit could not be expected to achieve anything useful. And the proposed new bureaucracies lack clearly defined responsibilities and objectives. The restructuring of the BOE, if implemented, could threaten price stability but would do nothing for economic growth, and it would in any case be unwise to extend the BOE's powers and responsibilities yet further. Promoting growth is a highly respectable objective, but it needs a stronger intellectual foundation and a more coherent organisation. Labour will need better advice if it is to achieve either.

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