

Global Vision Perspective

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What Can Britain Learn from Germany?

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Introduction

The effectiveness of the British government's promotional machinery since 1997, and the time it takes for the adverse supply-side effects of the government's tax-spend-and-regulate policies to come through, means that the popular view of the growth and employment prospects for the UK economy is almost certainly too sanguine. At the same time, people do not seem to have woken up to the remarkable turn round in Germany's economic performance in recent years – even if this achievement may now be threatened by the vagaries of coalition politics – and how seriously Britain's long-term supply performance appears to be deteriorating. The main purpose of this paper is to examine areas where Germany's arrangements appear superior to Britain's, in order to explore the lessons that this country can learn as a result. The analysis starts with a consideration of fiscal policy in the two countries, before moving on to a discussion of monetary policy, labour market reform, the relative strength of the two nations' commitment to their industrial sectors, and the advantages of Germany's explicit federal structure over Britain's current half-baked constitutional arrangements. The main conclusions appear at the end.

Fiscal Policy

Germany arguably pioneered the modern welfare state under Bismark in the late 19th Century. However, Britain was relatively quick off the mark in setting up an expensive welfare state shortly after World War II – at broadly the same time that Germany was implementing the de-regulatory Erhard reforms – and for a long time the UK had relatively high tax and spending burdens compared with other European countries, let alone the US (see: Tanzi and Schuknecht (2000) or Smith (2006)). However, the comparative fiscal discipline of the Thatcher years, when Britain broadly held the share of government spending in national output constant (albeit with very marked cyclical swings) at a time when its European neighbours were expanding government spending rapidly, meant that Britain had noticeably lower tax and spending burdens than was normal in Continental Europe by 1997, albeit well above those of the US and the South-East Asian 'tiger' economies. The internationally-comparable data supplied by the Organisation for Economic Co-operation and Development (OECD (2007)) show that

general government outlays accounted for 41.2% of the market-price measure of Gross Domestic Product (GDP) in Britain in 1997 compared with 48.3% in Germany, 49.4% in what was to become the eurozone, and 35.4% in the US. In the same year, total tax and 'other' receipts, such as interest, rents, and profits from public enterprises, amounted to 39.1% of GDP in Britain, against 45.7% in Germany, 46.7% in the eurozone, and 34.6% in the US. All four communities had noticeable cyclically-adjusted general government deficits in 1997, however, ranging from 0.4% of GDP in the US, to 1.7% in the UK, 1.9% in Germany and 2.1% in the eurozone. In considering these figures, one has to bear in mind the costs of German Economic and Monetary Union (GEMU) in 1990, which had seriously damaged the fatherland's public finances. Germany's government spending ratio rose by 5.2 percentage points between 1989 and 1997, its tax burden rose by 2.5 percentage points over the same period, while it had enjoyed a small structural budget surplus – and was planning supply-side orientated tax cuts – in 1989.

Ten years later the striking thing is how many Continental European countries have attempted to consolidate their fiscal positions, while Britain has gone the other way. Indeed, the UK is now increasingly looking like a foolhardy experiment to see how long one can drive against the general fiscal flow before an accident happens. Over the past decade, the share of government outlays in UK GDP has risen by 3.4 percentage points, to 44.6%, while Germany has cut by 4.4 percentage points to 44.3%, the eurozone has retrenched by 3 percentage points to 46.4%, and the US under the profligate Bush administration has seen a rise of 2 percentage points to 37.4%. The government spending burden in the aggregate OECD area was unchanged in the decade to 2007 but, at 40.6%, was still 4 percentage points below the figure for Britain. The OECD's statistics for total government receipts also portray Britain going against much of the rest of the developed world. The ratio of official receipts to GDP in Britain rose by 2.6 percentage points between 1997 and 2007 to 41.7%, while the corresponding ratio in Germany fell by 1.4 percentage points to 44.3%, and the equivalent figure for the eurozone eased by 1 percentage point to 45.7%. The US ratio was unchanged at 34.6%, however, and the OECD total barely moved from 38.8% to 38.9%.

These figures are worth emphasising because there still seems to be a lack of popular awareness of the fact that Britain no longer possesses the mid-Atlantic economy bequeathed by the Conservatives in 1997 (but see Hartwich, Briar and Schmieding

(2007)) that had tax and spending burdens part-way between the US and Continental Europe but is now tending towards being a fully fledged member of the Euro-sclerosis club. Britain has also enjoyed an unusually favourable economic background where the public finances have been concerned over the past decade, with no major recession to cut receipts and boost welfare costs, rapid population growth from immigration, and a domestic credit boom that has helped to stimulate asset prices and government receipts from housing and the financial sector. The OECD anticipate that the cyclically-adjusted general government deficit will have represented 3.1% of national output in Britain in 2007, against 0.1% in Germany, 0.6% in the eurozone, and 3.0% in the US. These figures suggest that the British budget deficit could balloon, if economic growth slows over the next few years, just as it did in the recession of the early 1990s when the Public Sector Net Cash Requirement (PSNCR) deteriorated by 8 percentage points of the basic-price measure of UK GDP between 1990-91 and 1993-94 and Public Sector Net Borrowing (PSNB) worsened by 7.6 percentage points. A similar deterioration from today's pre-existing deficits would take both measures of the fiscal deficit to just over 11% of basic-price GDP or some 9.5% of the officially preferred market price measure of national output.

The fiscal background in Continental Europe is certainly not ideal, particularly if one believes that the welfare optimising share of government spending in GDP is little more than one-third or so (see: Tanzi and Schuknecht (2000)). However, government spending is now so profligate in Britain – and likely to become more so as what increasingly looks like a lame-duck Labour administration tries to buy votes in the long run up to a postponed general election – that the country could benefit from lessons in fiscal continence, even from the spendaholics of the eurozone.

Monetary Policy

Most of the leading central banks are now committed to targeting some measure of consumer price inflation using a short-term rate of interest as their main policy instrument, although the US Federal Reserve is mandated to give equal priority to activity and employment as it is to the control of inflation. Both the ECB and Britain's Monetary Policy Committee (MPC) have been given simple inflation targeting mandates, however, so the main differences between the two appear to lie in the areas of economic

philosophy and operational techniques. Strictly speaking the ECB is a pan-European institution. However, its theoretical approach and its operational practice have been so closely modelled on that of the old Bundesbank that it can be considered ‘German’ for the purposes of this paper. An excellent, and highly readable, account of the Bundesbank-inspired structure of the ECB can be found in Issing (2004), while a more detailed account appears in European Central Bank (2001).

The two main areas where British monetary practice can learn from that of the ECB are the importance that the ECB still attaches to its second monetary pillar – which involves a close monitoring of broad money and credit growth (European Central Bank (2007)) – and the use of minimum reserve requirements to amplify the ECB’s grip over market interest rates. The monetary second pillar remains controversial, even within the ECB itself, and big spending Continental politicians have made frequent attempts to get the second pillar toppled. This may be because they want to use the ‘inflation tax’, having reached the political and economic outer limits to conventional taxation. The essential justification for continuing to attach importance to the growth of broad money in the second pillar is that the conventional non-monetary forecasting methods, which constitute the first pillar, give little warning of major sea changes in inflationary conditions at time horizons beyond a year or two. There is considerable evidence that long-term movements in the price level are dominated by broad money on a longer-term horizon, although this may be as long as seven or eight years, according to the statistical evidence (see: Assenmacher-Wesche and Gerlach (2006)).

Britain has experienced unusually rapid broad money and credit growth in recent years and also has shown signs of a suppressed – or, possibly, just delayed – inflation, including large trade deficits, buoyant property prices, and strong financial markets until recently. There is now room for serious debate as to whether Britain should adopt a second pillar approach, and also consider a more active use of reserve asset ratio requirements to enhance the Bank of England’s control over the creation of broad money and credit. Mervyn King’s May 2007 speech to the Society of Business Economists (King (2007)) seems to have conceded that the MPC should have paid more attention to the monetary aggregates and committed the Bank to a research programme in this area. The only possible comment is better a decade late than never.

More recently, the Northern Rock affair, and the large liquidity injections made by the ECB since the late summer of 2007 in an attempt to cap three-month interest rates, have focussed attention on the central bank's role as lender of last resort. The Bank of England has not emerged with glory from the Northern Rock bail out. However, it can be argued that the cumbersome tripartite regulatory structure established in May 1997 was an accident waiting to happen, because of the opaque chains of command involved in a lender of last resort situation. (Smith (2007a) made this point well before Northern Rock got into difficulties, so this is not just arguing from hindsight). Unfortunately, these weaknesses are exacerbated in the Continental European context, because the supervision of commercial banks is carried out at national level, not that of the eurozone, and in the case of Germany supervisory responsibility is split between the Bundesbank and the Federal Financial Supervisory Authority (see: Wiesman and Simensen (2007) for an account of Germany's equivalent of the Northern Rock affair). There must be concern that the Northern Rock episode could be repeated on an enhanced scale in a eurozone context, or that the ECB over-supplies liquidity with all the attendant inflationary dangers, because it does not know the true situation on the ground. Some might argue that this has happened already, with the ECB's monster liquidity injections since the late summer of 2007.

Labour Market Reform

Germany still possesses a relatively rigid labour market by global standards, but has at least attempted some modest de-regulation at a time when the British government has been adding to the burdens on employers and signed long-term commitments to the European Union (EU), which will lead to even greater losses of flexibility in the future. The seriousness of Germany's labour market problem can be seen from the recently published *Global Competitiveness Report 2007-2008* by Lopez-Claros, Porter, Schwab and Sala-i-Martin (2007). Germany scores an abysmal 115th place in the rankings of 131 countries based on labour market flexibility, mainly because it was dragged down by inflexible wage determination and prohibitive cost of firing, while the UK scores a respectable 10th place. Restrictive labour regulations are unequivocally the most problematic factor in doing business in Germany.

Nevertheless, while the British government has been piling ever more pressures onto UK employers, Germany had been showing that it understood its labour-market handicap and seemed determined to deregulate and improve, at least until recently, when the vagaries of coalition politics appear to have led to some significant backsliding. The most important reforms were implemented from 2003 onwards under the label of ‘Agenda 2010’, aka ‘the Hartz laws’. These measures were introduced by the former Social-Democrat Chancellor Gerhard Schröder in an endeavour to reduce Germany’s then rising unemployment rate by increasing the flexibility of the labour market. The Hartz reforms: reduced the maximum duration for which individuals can receive unemployment benefits to 12 months, although the long-term unemployed can qualify for an additional means tested flat benefit of around €340 once the 12 months are up; tightened the requirements for benefit claimants to seek a job; and tried to ease the regulations on companies hiring and firing employees. Another reform was the reorganisation of the *Federal Job Agency* (or *Bundesagentur für Arbeit*, formerly known as the *Federal Labour Office*) along lines that are similar to the UK’s *Jobcentre Plus*, the main responsibilities of the agency being managing unemployment benefits and finding job placements. It should be said that, by comparison, the UK benefits regime still appears more parsimonious. However, Germany’s welfare regime makes that of its neighbour France, which has benefits replacing a high proportion of wages for an average entitlement period of thirty months, appear positively spendthrift (Deutsche Bundesbank, 2007). Having been 7.4% when ‘Agenda 2010’ was introduced in 2003, Germany’s structural unemployment rate is now down to 6.8%, according to the OECD, roughly midway between Britain’s 5.3% and France’s 7.8%.

The German reforms have yielded results: though lower than Britain’s employment rate of 71.1%, Germany’s employment rate had reached 69.1% in the second quarter of 2007. This is 1.7 percentage points up on the year, the highest level since German unification, and much better than the eurozone average of 65.6%. (Office of National Statistics, 2007). Germany’s unemployment rate had fallen to 7.9% in November 2007, and is now at a 15 year low, while Britain’s unemployment rate on the same International Labour Office (ILO) definition was 5.3% in August-October. Large numbers of temporary jobs have been created in Germany – a development which has attracted some criticism – but the number of full-time jobs, defined as employees subject to social security

contributions, has been recovering since 2005, even if it remains below its late 1990s high point (Deutsche Bundesbank, 2007). This is a tremendous achievement, even though it is difficult to know how much of this improvement is down to the cyclical upswing in German output, where 2003 is considered as the trough in the current cycle.

Since the 2005 election, Germany's political coalition has been trying to further labour market reform by drastically cutting payroll and corporate taxes – as an extra incentive for job creation – and was prepared to raise Value Added Tax in January 2007 in order to do so. Additionally, Germany still has no statutory minimum wage, unlike Britain, which has the second highest minimum wage in the EU after Luxembourg (Eurostat (2007b)). Britain's minimum wage is also twice that of the US, despite Britain's much lower productivity, and is arguably pricing out less productive workers, especially in the cheaper areas of the country, because of its failure to allow for the marked regional differences in median earnings and living costs (Smith (2007b)). The absence of a minimum wage in Germany is probably a blessing, considering the adverse effects of its other restrictive labour policies. Unfortunately, Chancellor Angela Merkel's decision to impose a minimum wage of €8 - €9.80 per hour in the postal sector, in order to protect Deutsche Post from competition, looks like the thin end of a potentially damaging wedge, while the instability of the governing coalition has induced the Social Democratic Party to support both a partial roll-back of their own 'Agenda 2010' policies and the introduction of a minimum wage. The Bundesbank (2007) has warned against the adoption of the widely proposed figure of €7.50 per hour and the ECB's President, Jean-Claude Trichet, stated on 5 December 2007 that Germany's move to create "unnecessary minimum wages" in the services sector will act as a "brake on employment".

Industrial Commitment

Because of their global trading background as the world's largest exporter, German businessmen and women generally appear less *dirigiste* than the country's political and bureaucratic classes and make natural allies for market liberals in Britain. It is this huge export trade, backed by voluminous investment, which has pushed the German economy to expand at its highest rate in six years (International Monetary Fund (2007)). One

reason why Germany is the world's largest exporter is the fact that German businessmen appear to be seriously committed to improving their companies' commercial competitiveness. Despite its labour market shortcomings, Germany has made steadfast improvements in its global competitive position compared with Britain in recent years. In 2001, Britain ranked 12th out of 75 countries in the *World Economic Forum's* growth competitiveness index compared with Germany's 17th (World Economic Forum, 2001). Today, according to the 2007-2008 rankings, Britain's rank of 9th trails behind Germany's 5th out of the 131 countries now included (Lopez-Claros Porter, Schwab and Sala-i-Martin, 2007).

In particular, while Britain excels at financial market sophistication, where it is ranked 2nd, Germany is unquestionably superior when it comes to: firstly, innovation indicators; and, secondly, the sophistication of its business community – these attributes are widely considered to be the key drivers of economic growth for advanced economies – where it is classed 1st and 7th in the world, respectively. In addition, German companies benefit from clusters (1st rank), strong competitive advantages, export focus and extensive international markets. German business also gains from an excellent legal and regulatory framework, intense university/industry collaboration and a good availability of skilled labour. In contrast, Britain fails badly by international standards when it comes to related and supporting industries and promoting and sustaining entrepreneurship.

Studies analysing the recent rebound in German exports recognise that the country has been lucky to have specialised in the types of goods, particularly capital goods, that are enjoying an ever increasing demand from emerging markets. But the studies also clearly identify the role played by its improved cost competitiveness, with gains stemming from new off-shore-based production processes and moderate collective wage agreements (Danninger and Joutz, 2007).

German companies have also taken advantage of the opportunities presented by the European integration process to lower costs. In 2005, Germany was the main holder of Foreign Direct Investment (FDI) stocks in the new EU Member States (Eurostat, 2007a) while British direct investment was noticeably absent. The OECD's figures show that British unit labour cost grew at an annual average rate of 2.3% between 2003 and 2007, while Germany's labour costs fell by an average of 0.5% each year over this period.

Perhaps part of the credit for the successes of German business in regaining its competitiveness rests with the country's political process. The primacy of consensus politics and social stability has meant involving companies in the legislative process as traditional social partners, along with other interest groups. Their customary involvement in the decision-making process, combined with the size of the small and medium enterprise sector and the vital role played by the large corporations have made lobbying more effective. This contrasts with the situation in Britain where some of the large employers' organisations have only recently raised a bat squeak of protest against the rapid rise in the tax and regulatory burdens over the past decade.

Proper Federal System versus Devolution Hotch Potch

In its Victorian heyday, the British used to take pride in the claim that Westminster was the Mother of Parliaments. In practice, the Westminster model has proved highly vulnerable to subversion by unscrupulous politicians or military elites, with the result that a distressingly small proportion of the Westminster constitutions left behind in the former colonies during the 1940s, 1950s and 1960s have survived as fully functioning parliamentary democracies under the rule of law, India being one shining exception.

In contrast, contemporary Germany's *Grundgesetz* or basic law (the term *Verfassung* (constitution) was not employed because the arrangements were regarded as provisional) was designed by the victorious Western allies in 1948 to make the re-emergence of dictatorship virtually impossible – because of the large numbers of checks and balances built into it – and has clearly succeeded in this aim. Modern Germany is a good example of a well functioning, decentralised structure of government consisting of a federal system and a bicameral (two-chamber) Parliament, in which the lower chamber, or *Bundestag*, is elected directly through a mixture of proportional representation and direct mandate. While the federal government has power over the treasury, the 16 federal states (*Länder*) have significant autonomy over taxation and complete control over local issues such as education, regulation and law enforcement.

The *Länder* are also responsible to a degree for health provision, where the German system is far more decentralised – and appears to provide far better clinical outcomes –

than the British set up (see: Lawlor, Baum, Beaud de Brive, and Lal (2004)), although neither country is untroubled by issues of cost control, to put it mildly. In addition, the upper chamber of the German parliament (the *Bundesrat*) is made up of *Länder* representatives, who have the power of veto over federal legislation. While this ensures that policies adopted are suitable to a wide range of groups, it also leads to drawn out debates and stalemates, as the *Länder* are able to block more than 60% of federal legislation. Another important check on the untrammelled power of the executive arm in the German system is provided by the Federal Constitutional Court – or *Bundesverfassungsgericht* – which can declare statutes as null and void if they are in violation of the basic law.

There is a marked contrast between the explicitly Federal German arrangements, with their many checks and balances, and the half-baked dog's breakfast left behind by the present British government's so-called constitutional 'reforms', in which it is hard to see any coherent principles, other than a desire to remove all checks on the absolute power of the executive and to see off the threat posed to the Labour vote by the nationalist parties in Scotland and Wales. It may be already too late to prevent the break up of the UK, given the extent to which the Scottish Nationalists now appear to have the wind behind their sails. If not, one might do worse than consider adopting a modified form of the German constitution, while maintaining the monarch as head of state rather than having a president, possibly using the official Nomenclature of Units for Territorial Statistics (NUTS) categories to define the appropriate *Länder* equivalents.

The main 12 'NUTS1' regions are probably too large for this purpose, and treat each of Scotland, Wales, and Northern Ireland as one unit, so would not help staunch the separatist tendencies unleashed by the present devolution botch job. However, using the finer NUTS2 categories, which disaggregate the UK into 37 areas, would mean that these putative British '*Länder*' would break Scotland, for example, into four parts and probably provide enough separate local entities to allow for both effective local democracy and a properly manned second chamber, perhaps selected by proportional representation, unlike the Commons which should continue to use the present 'first past the post' system. These local units could then be given far more authority over the provision of health, education, and policing than they have under the present system, while also being made responsible for raising much of the revenue needed to fund these services. It was argued in Smith

(2007b) that the ‘money illusion’ in the current over-centralised British system, which ignored the very large differences in regional living costs and median earnings, was not only a source of substantial injustice but also served to price people out of work in the cheaper and less productive parts of the country.

Conclusions

The slightly surprising quasi-hero that emerges from our analysis is Gerhard Schröder, whose labour-market reforms under his ‘Agenda 2010’ programme, announced in 2003, may have been limited but were well crafted. The efforts of German industry, which has worked hard to bring its labour costs back into line with its international competitors, also deserve commendation. The main concern for Germany now is that the vagaries of coalition politics, and the Social Democratic Party’s lurch to the left, will cause a reversion to the superficially appealing, but intensely damaging, big welfare policies that preceded the Schröder reforms. It is too early to reach a firm conclusion on where Angela Merkel would take Germany if she had a majority in the *Bundestag* or was in coalition with the pro-market Free Democratic Party. However, the evidence so far suggests that she is closer to the ‘big government’ Conservatism practiced by George W. Bush, or even to populist interventionism, than she is to the market liberalism of Lady Thatcher and Ronald Regan.

If there is a villain it must be Gordon Brown, who – having inherited a healthy mid-Atlantic economy with tax and spending burdens low by Continental standards, and a de-regulated labour market – has spent the past decade inexorably forcing the British economy into the high spending and regulatory straight jacket that has so crippled the performance of ‘Old Europe’, while dissembling about Prudence, fiscal responsibility, and the need for a globally competitive economy. In 1997, the UK had a tax burden some 7.6 percentage points lower than that of the eurozone, the strongest pension system in Europe, and a far less complex and distortionary tax and benefits system than it has today. There is still a popular misconception that Britain still enjoys these advantages, and that one can be fairly sanguine about the possible adverse consequences of further rises in the tax and regulatory burdens. This is no longer the case and a Britain rapidly going in the

wrong direction may now face worse structural problems with respect to its supply potential and ability to maintain high levels of employment than a Germany that was, at least until recently, slowly and cautiously moving in the right one.

The British can learn both from Germany's mistakes – for example, the danger of imposing national labour costs on regions with abnormally low productivity such as East Germany or Britain's North East – and also from the successful, albeit surreptitious, way in which Germany has improved its competitiveness through labour market deregulation, aggressive management of wage costs, and some very limited rolling back of the share of national output absorbed by the state. In 2003, the Bundesbank set out its own programme for the reforms that it considered essential to reverse the long-term decline of the German economy (Bundesbank 2003). Their well considered proposals provide a remarkably apt template for the reforms Britain will almost certainly need in the next Parliament, if this country is not to end up a Euro-sclerotic basket case.

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Global Vision is a new campaign group backed by economists and business leaders that argues for a looser British relationship with the EU, based on free trade and mutually beneficial cooperation, whilst opting out of economic and political union. Global Vision believes that this is the right relationship for Britain in the 21st century's rapidly changing world. For more details on Global Vision please visit our website: www.global-vision.net.