The Road to Credibility

Conservative economic principles for the path ahead

Tim Pitt

Edited by Adam Hawksbee

ONWARD

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About the author

Tim Pitt is a Policy Fellow at Onward and a partner at Flint Global. He joined Flint from the Treasury where he was a senior adviser to both Philip Hammond and Sajid Javid as Chancellors. Tim provided advice across economic and fiscal policy, including on personal and business taxation, Industrial Strategy, energy, and productivity.

Before entering politics, Tim spent six years as a corporate lawyer at the City firm Slaughter and May, working on a broad range of M&A and equity capital markets work.

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Summary of the argument

It is easy to dismiss the failed experiment that was Trussonomics as a brief aberration, a moment when Conservative economics temporarily lost its bearings before Rishi Sunak returned to restore order. The truth is it was just the latest manifestation of a Conservative Party that has become unmoored from its economic foundations.

For the best part of four decades those foundations stood firm, best summarised by Nigel Lawson in his 1984 Mais Lecture: the British experiment, he argued, "consists of seeking, within an explicit medium term context, to provide increasing freedom for markets to work within a framework of firm monetary and fiscal discipline. It stands in contrast to the post-war trend towards ever more ad hoc interference with free markets within a context of increasingly financial indiscipline".[1]

Yet Conservative adherence to Lawson's creed has been fundamentally challenged over the last six years. This has been driven by a series of trends: lower growth; public discontent with the fairness of our economic model; austerity fatigue; a period of ultra-loose monetary policy challenging the primacy of fiscal concerns and driving up asset prices; Brexit and a worsening global trade environment; and, most recently, the extraordinary nature of Covid and energy-driven government economic interventions which have warped the public's expectations of the role of the state.

As a result, the Conservative Party has veered one way then another on economic policy, driven at different moments by political expedience, economic necessity and raw ideology – with Trussonomics simply the latest iteration. Since 2016, Conservative governments have overseen an expansion in the state's role in directing and regulating economic activity, with energy price caps and big hikes in the national minimum wage even before recent enormous Covid- and energy-related interventions. They have imposed new restrictions on foreign investment and erected trade barriers in return for sovereignty. And they have delivered a significant uplift in public spending, initially funded by a combination of higher borrowing and higher taxation, only for those tax rises to be reversed and all attempts at fiscal responsibility ostensibly abandoned at the most recent mini-budget. All of this has been accompanied by a greater readiness to challenge established institutions, a tendency that accelerated in recent months.

The arrival of the Truss administration at least put an end to the thousands of column inches bemoaning, attacking or celebrating the lack of a Conservative economic plan. The rationale behind the government's economic strategy was crystal clear, and parts of the right-wing establishment delighted in the fact that what they saw as Conservative economic thinking was back.

It did not survive contact with reality. Trussonomics was based on a superficial analysis of the challenges facing the UK economy and a highly partial interpretation of Thatcherism. Abandoning fiscal discipline, banking on as opposed to aiming for faster growth, and dismissing economic inequality are all fundamentally un-Conservative.

The immediate task facing the new Chancellor is to put the public finances back on a sustainable path. More broadly, it is to restore the Conservatives' shattered economic credibility.

The risk for a Conservative Party desperate for stability and yearning for a familiar economic narrative after years of uncertainty is that it simply reverts back to the comfort blanket of Lawsonian orthodoxy. That would be a mistake. For all its undoubted strengths, that orthodoxy was designed to tackle the economic challenges of half a century ago. And while some of them endure, the problems facing the UK economy in the coming decades will be fundamentally different. Our answers cannot simply be cut and paste from the specific circumstances that the governments of Margaret Thatcher faced.

This paper offers an updated framework for Conservative economics, grounded not in the battles of the 1980s but those of today, and drawing not just Thatcherism but on a much longer and richer history of Conservative thinking. In doing so, it is not designed as a detailed attempt to tackle the immediate fiscal challenge facing the Chancellor, though it includes some measures that would help. Rather, its aim is to set out an alternative longer-term framework as the Conservative Party looks beyond that immediate crisis to its economic approach for the years ahead.

Three long-term economic challenges

The starting point for any such framework must be a clear diagnosis of the challenges facing the UK in the coming decades and of their underlying causes, which are set out in Section 1. They are threefold:

1. **The growth challenge**. As Rishi Sunak said in his speech outside Downing Street on becoming Prime Minister, the Truss administration was right to focus on growth: higher economic growth is vital to drive up living standards and generate opportunity. But unless we understand the underlying causes of low growth, we risk overestimating the impact policy can have and therefore the extent to which growth can be the answer to the UK's wider economic challenges. The Truss government's anti-declinist narrative assumed the UK's growth problem was down to a failure of government ambition and policy. Yet the events following the financial crisis are only a partial explanation, exacerbating – albeit significantly – a decades-long trend in the

UK, common across advanced economies, of slowing economic and productivity growth. This has been driven by a range of structural factors, including the inexorable shift into lower productivity services and the impact of an ageing population. While policy can undoubtedly make a difference, particularly given the UK's relative under-performance compared to its peers since 2007 – these structural trends will continue to weigh on growth in the coming decades. It is therefore unrealistic and, because conservatism is inherently anti-utopian, un-conservative to think that any government holds within its power the ability to transform the UK's trend growth rate back to pre-financial crisis levels. As such, while a coherent plan for growth is essential, higher growth cannot be used as an excuse to ignore the two other major long-term challenges facing the UK economy.

2. **The inequality challenge**. In his mini-budget speech former Chancellor Kwasi Kwarteng said that "for too long in this country, we have indulged in a fight over redistribution. Now, we need to focus on growth." [2] In doing so, he echoed the words of Margaret Thatcher in a speech in New York in 1975, when she argued that a major part of what she termed the "British sickness" was down to the "progressive consensus" that the state should be active in redistributing wealth and income.[3] Yet the context in which the two statements were made could not be more different. When Thatcher was speaking, economic inequality – across income, wealth and regions – was at historically low levels, having fallen significantly over the preceding decades. By contrast, contemporary complaints about the obsession with distributional questions come at a time when economic inequality's rise since the 1980s has seen it hit levels that are now high by both historic and international standards. These high levels of inequality should be anathema to Conservatives, undermining as they do core Conservative values: not only social mobility and opportunity, but also political stability, with economic injustice at the heart of the populists' clarion calls in recent years. Furthermore, there is no evidence that higher inequality is the price that needs to be paid for higher growth – if anything, the reverse is true. Tackling economic inequality should therefore be a key aim of Conservative economic policy.

3. **The fiscal challenge.** The Truss administration might have been trying to draw on Thatcher in its approach to inequality. When it comes to fiscal policy, it was not even pretending to. Attempting the type of broad-based unfunded tax cuts announced in the mini-budget was never part of Thatcherite thinking, as borne out by the substantial tax rises delivered by Geoffrey Howe in the early 1980s. Reflecting on this period in later years, Thatcher said when her government could not get spending down as fast as it wanted, "we said we would not finance it by borrowing, we would finance it honestly, by taxation, and we did", describing this as the "honourable thing to do".[4] Further, recent calls from the right to restore fiscal credibility solely through significant spending cuts ignores the deep structural pressures on the state. On every occasion the Office for Budget Responsibility (OBR) has produced a fiscal

sustainability report since 2011, it has concluded the fiscal position is unsustainable over the longer-term. This is driven in large part by rising health and pensions spending as the population ages, technology improves and chronic conditions become more prevalent, while rising geopolitical tensions will likely add further pressure for structurally higher defence spending. The result is that – absent any policy changes – the UK's debt-to-GDP ratio will rise rapidly in the coming decades to levels never seen before in the UK.[5] This is unsustainable, and banking on higher growth to fix the problem would be deeply un-conservative. As Lawson himself said: "The notion that tax cuts, without any spending cuts or substitute source of revenue, will so stimulate the economy that the Budget balance will improve, enabling further tax cuts to be made…is a spurious kind of virtuous circle [and] emphatically not part of my thinking".[6] If the Conservative Party wants to remain honest and honourable, it needs to get real – and fast – about the fiscal challenge. That means accepting that the recent rise in the tax burden is not some temporary aberration that can be reversed in due course, but instead a necessary reality as the UK begins to deal with these structural pressures on the state

Four Conservative economic principles

Growth, inequality and fiscal: these are the three challenges that any Conservative economic strategy must address. In doing so, its approach must be grounded in enduring Conservative principles, which is covered by Section 2.

The debate we saw during the leadership campaign too often took a caricature of Thatcherism as the baseline for defining Conservative economics. Yet not only are the challenges facing the UK economy today very different to the ones Thatcher faced, but the perennial focus on her also ignores a much richer history of Conservative thinking. Conservative economics did not start in 1979, but rather has ebbed and flowed over the last two hundred years. The liberalising agenda of Robert Peel in the mid-nineteenth century was followed by a period of scepticism towards laissez-faire as the party embraced social reform to tackle the industrial revolution's worst excesses. That scepticism lasted well into the twentieth century, notably with a decades-long fight over tariff reform. With Labour's rise the party shifted to define itself against socialism, but the period after the Second World War nevertheless saw the Tories make peace with the welfare state and preside over a mixed economy. It was only with the advent of Thatcher that the roll back of the state became a key tenet of Conservative economics.

This evolution should not be confused with a lack of principles. As the late E.H.H. Green argued in his work on the history of Conservative thought, this continual adaptation is "not to deny [Conservatism's] existence as a constant or consistent political and historical entity".[7] Throughout, four enduring principles abide:

1. **Pragmatism**. Conservatism has tended to be pragmatic, sceptical and grounded in realism, eschewing the rigid ideological framework that socialism has provided the Labour Party. Experience shows that easy answers are hard to come by, and that radical new approaches are as likely to make things worse as to improve them. Indeed, the history of Conservative economics can partly be defined by opposition to ideology: to laissez-faire liberalism in the nineteenth century and to socialism in the twentieth.

2. **Stewardship**. Conservatism has welcomed economic change, both for the progress it can deliver and as necessary to ensure the political and social stability which Conservatives believe so important. The challenge is to manage it, gradually and sensitively, with proper appreciation of how people and communities need to be protected, and of the vital importance of institutions. The abandonment of protection in the nineteenth century and the adoption of the welfare state in the twentieth are both examples of Conservatism applying these first two principles, pragmatically adapting previously held positions in order to manage changing economic circumstances and ensure stability.

3. **One Nation**. Contrary to the contemporary perceptions of the left, the third key principle is a belief in the need for prosperity and opportunity to be shared broadly. This is a thread that runs from Benjamin Disraeli's recognition of the dangers of there being "Two nations", rich and poor, to Harold Macmillan's explicit declaration of Conservatism's "clear duty" to those sections of society not sharing in economic progress.[8]

4. **Empowerment**. Finally, there is the role of the state. Yes, Conservatives have always looked warily at an over-mighty government, rejecting the concept of the controlling and interventionist state that has been a persistent theme of the economics of the left. But this should not be confused with small state libertarianism. Thatcher agreed, saying, "we are not anti-State. On the contrary, we seek a proper balance between State and society".[9] The Conservative approach has been to see the state as an enabler, rather than controller, of economic activity, rejecting narrow and arbitrary limits on the size of the state in favour of a more sophisticated view of the functions it wants the state to perform and the state's capacity to deliver them.

Instead of an ideological approach, therefore, these four principles – the pragmatic principle, the stewardship principle, the One Nation principle and the empowerment principle – should be used to guide the Conservative approach to the three challenges ahead.

Conservative economic principles in practice

Having established these principles, Section 3 sets out how they might be applied in practice to a set of important – though by no means comprehensive – areas of economic policy.

1. **Macroeconomics**. Given the rapidly changing nature of the global economic environment, a Conservative approach to macroeconomics must be driven by the *pragmatic principle*, dealing with the world as it is, rather than a dogmatic approach that sees fiscal policy as a second order problem on the one hand or believes concerns about the public finances must trump all on the other. The UK's macro institutional framework has strong international credibility, and recent events have shown how dangerous it is carelessly to tamper with it. While those events also remind us that the aggressive use of fiscal policy carries dangers when inflation and borrowing costs are high, Conservatives should be prepared to use fiscal policy aggressively in downturns, particularly when monetary policy is at the zero lower bound. To build space for that, and to ensure the public finances are on a sustainable long-term path, the debt-to-GDP ratio should not just fall in good times, however; it should fall materially.

2. **Labour market**. As the UK economy prepares for significant structural shifts from Covid, Brexit, rising geopolitical tensions and technological change, the *stewardship principle* should shape the Conservative approach to the labour market, ensuring the workforce have both the skills they need to prosper and a sufficient safety net to ensure they are protected in a rapidly changing world. This means giving investment in human capital as much priority as investing in physical capital like infrastructure and R&D, and delivering on plans to end low pay by raising the national living wage to two thirds of median earnings. This should be backed by reforms to the social security system that restores the contributory principle that William Beveridge originally envisaged would be at the system's heart, as part of a package of reforms to better cushion the negative impact of economic shocks and support people back into work by increasing replacement rates and improving incentives.

3. **Supply-side reform**. While the Truss administration's fiscal policy was deeply flawed, it was right that supply side reform is vital to tackle the growth challenge and a coherent Conservative economic strategy should not abandon that agenda. The *empowerment principle* should guide this, with the state providing the enabling conditions for the private sector to thrive. It should reinforce the UK's existing institutional framework and complement it by going further on devolution and creating a new institutional framework to drive industrial policy. It should strengthen the UK's competition framework, focus the regulatory agenda on the next waves of innovation, pursue planning liberalisation, deliver existing plans on infrastructure and reform innovation policy to prioritise diffusion.

4. **Taxation**. There is no evidence that a higher tax burden need mean lower growth. The debate on tax therefore needs to shift from being one about the overall burden to one about reform, based on a neutral, simple and stable system. Making the system more efficient while improving incentives to support growth, as well as the basic task of raising revenue to tackle the fiscal challenge, are both important. But given the scale of the inequality challenge, the *One Nation principle* should be at the heart of tax reform. This does not mean every tax change need be progressive, but as a whole the system must become more progressive. A long-term tax strategy should be established, prioritising reforms across the taxation of earnings, business, property and wealth.

As Arthur Balfour, Conservative Prime Minister at the beginning of the last century, argued: "every phase of civilisation requires its own political economy".[10] The strength of Conservative economic thinking over time has been its ability to adapt to changing circumstances. The task for Conservatism now is to do so again to address the growth, inequality and fiscal challenges ahead, while staying true to its core principles. In doing so, it must be honest that there is no silver bullet and reject the idea that the Lawsonian orthodoxy must be completely overhauled. But this cannot simply mean a return to that orthodoxy.

The explicit recognition of economic inequality as a significant problem, as well as the acceptance that the tax burden must be permanently higher, will both be uncomfortable for many Thatcherite Conservatives. Addressing the challenges ahead will also require some significant policy departures: proposals for fiscal devolution, an overhaul of the taxation of property, inheritance and earnings, as well as the need for fiscal policy to be designed flexibly so as to support significantly more investment in human capital are just three examples of material departures from the status quo advocated by this paper. But any truly Conservative economic strategy must have evolution, not revolution, at its heart.

Above all, as Thatcher put it, "It will take time, patience—and leadership. It will need a Government that promises little—but does a lot".[11] But with a plan based on clear, enduring Conservative principles and determined delivery, these challenges can be tackled and with it a more prosperous, fairer economy can be built.

Challenges facing the UK economy

Section 1

In politics, acute short-term problems will almost always trump chronic long-term challenges. In the immediate term, the bandwidth of the new Conservative administration will understandably be entirely consumed by the highly challenging short-term outlook, with double digit inflation meaning the biggest squeeze on living standards in decades set against a backdrop of needing to set out a significant fiscal consolidation in very short order. Yet the starting point for establishing a durable framework for future Conservative economic policy must be a clear-eyed understanding of the longer-term challenges facing the economy.

This section will argue that the UK economy faces three interlinked challenges in the coming decades. First, lower growth than it experienced in the decades leading up to the global financial crisis, set against a backdrop of an increasingly uncertain geopolitical situation and sizeable structural economic adjustments due to Brexit, Covid, net zero and technological change. Second, dealing with historically and internationally high levels of economic inequality. And third, managing an increasingly difficult long-term fiscal outlook. It is these three challenges – the growth challenge, the inequality challenge and the fiscal challenge - that Conservative economic policy must have answers to.

The growth challenge

A narrative has taken hold about the recent travails of the British economy which, put simply, goes something like this: in the early years of this century, the UK economy was in decent shape. Then a combination of the global financial crisis, austerity, Brexit and Covid have resulted in a decade and a half of lost growth and stagnant living standards as productivity has flatlined.

There can be no denying that these events have had lasting economic impacts. Huw Pill, the Bank of England's chief economist, says the UK has "experienced three major waves of uncertainty" in the financial crisis, Brexit and Covid that have weighed on investment and innovation.[12] The OBR, the government's independent economic forecaster, currently assumes that Brexit will lead to a 4% reduction in the long-run potential productivity of the UK, while the economic scarring from Covid will reduce potential output by 2%.[13]

The conclusion often drawn from this explanation is that the problems facing the UK economy are essentially a combination of economic shocks and policy mistakes. If only the right policies were followed, some say, we can expect to return to the growth and productivity rates that we were used to in the run up to the financial crisis.

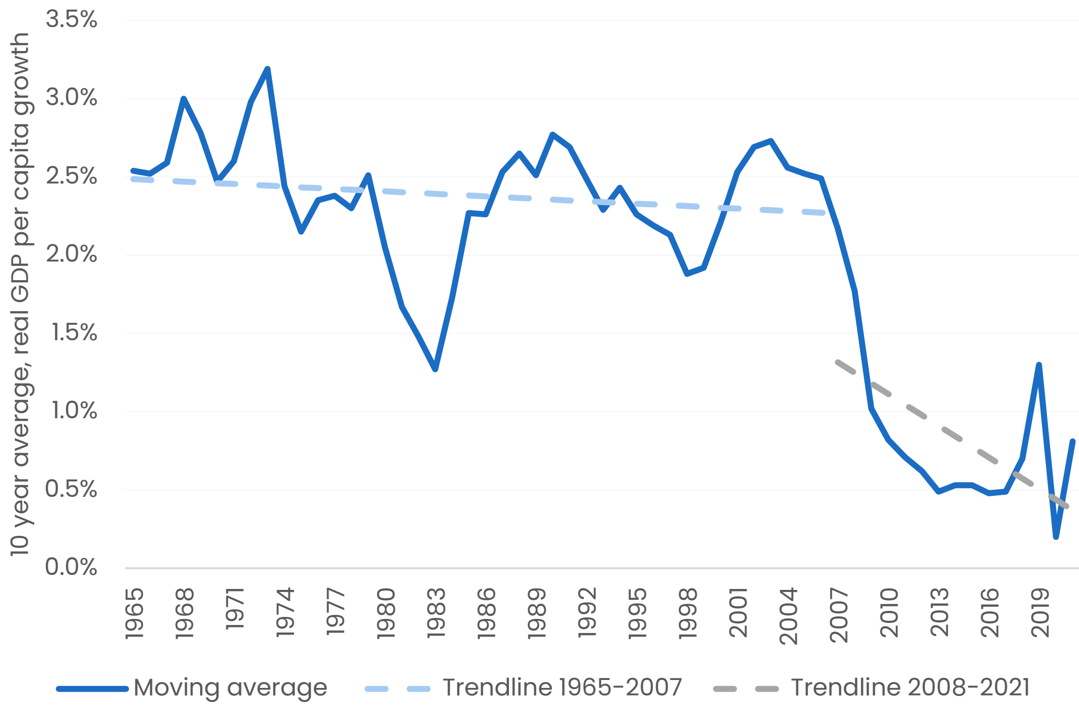
It is a narrative promulgated across the political spectrum. On the right, Liz Truss blamed the failed "Treasury orthodoxy" for an insufficient focus on economic growth.[14] On the left, Labour Shadow Chancellor Rachel Reeves makes the same point in more partisan terms: "how have we become trapped in this cycle of low growth, low pay, and high taxes? The answer is simple. It comes down to a decade of Conservative failure."[15]

Yet the events following the financial crisis – and the policy responses to them – are only a partial explanation of the UK's growth challenge. Driven by a range of structural factors, UK growth and productivity have in fact been slowing for decades, a trend that can also be observed across many advanced economies, which have been impacted to varying degrees by the financial crisis, fiscal tightening and Covid – and hardly at all by Brexit. The US, France, Germany and Japan have all seen GDP per capita growth slow gradually from about the 1970s, for example.[16]

Figure 1 shows real GDP per capita growth in the UK since the mid-1960s. While there has been significant volatility over time, and the impact of events since 2008 are clearly highly material, it paints a clear picture of gradually slowing GDP per capita growth over a number of decades. The slowdown long predates the financial crisis.

Figure 1: Real GDP per capita growth, 1965-2021. [1]

Source: ONS data on GDP average per head, Onward analysis

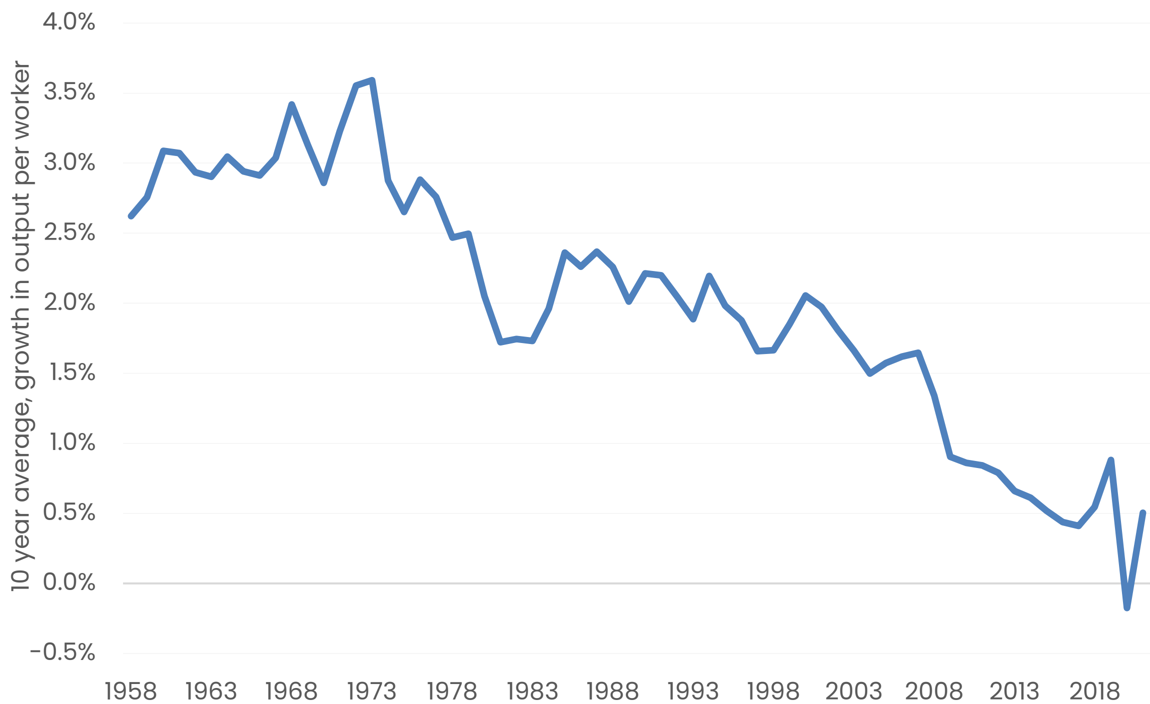


[1] This dataset measures real GDP per capita using the Chain Volume Measure. For further details on methodology see [here]

The productivity slowdown is similarly part of a much longer trend, as shown by Figure 2. Taking a ten-year average, UK productivity growth increased steadily from the end of the Second World War until about 1970, when it began declining gradually. Again, the financial crisis undoubtedly had a significant impact, hastening the decline, though revisions made by the ONS in 2021 have reduced its apparent impact on productivity.

Figure 2: Productivity slowdown over time, 1958-2021 [2]

Source: ONS



Explaining the slowdown

By focusing on more recent factors, therefore, we miss a much longer-term story about the trajectory of the UK economy. This is not to deny the impact of policy or the various events of the last decade and a half on both growth and productivity. But the timing of the slowdowns reveal that longer-term structural shifts are also an important part of the story.

[2] Figure 2 combines data from two separate ONS datasets: a historic dataset (from 1948 onwards, where Index 2015 = 100), and a July 2022 labour productivity publication (with data from 1960 – 2021, where Index 2019 = 100) that has revised data from 2008 following the June 2021 ONS announcement that the productivity slowdown post-2008 had been overestimated. To produce a consistent time series, data from 1960 – 2021 was re-indexed against 2015 values (with 2015 = 100) for this figure, following which annualised and 10-year rolling averages were calculated year

Instead, and in common with other advanced economies, a significant part of the UK slowdown can be explained by two factors: first, the inexorable shift of the economy into lower productivity services; and second, a slowdown in human capital growth. Looking at the US experience, Professor Dietrich Vollrath argues that a significant part of the slowdown can be explained by the shift out of higher-productivity manufacturing into lower-productivity services. Labour productivity is on average about 40% lower in services than manufacturing across the OECD, and has grown 1.7% points a year slower in recent decades.[17]

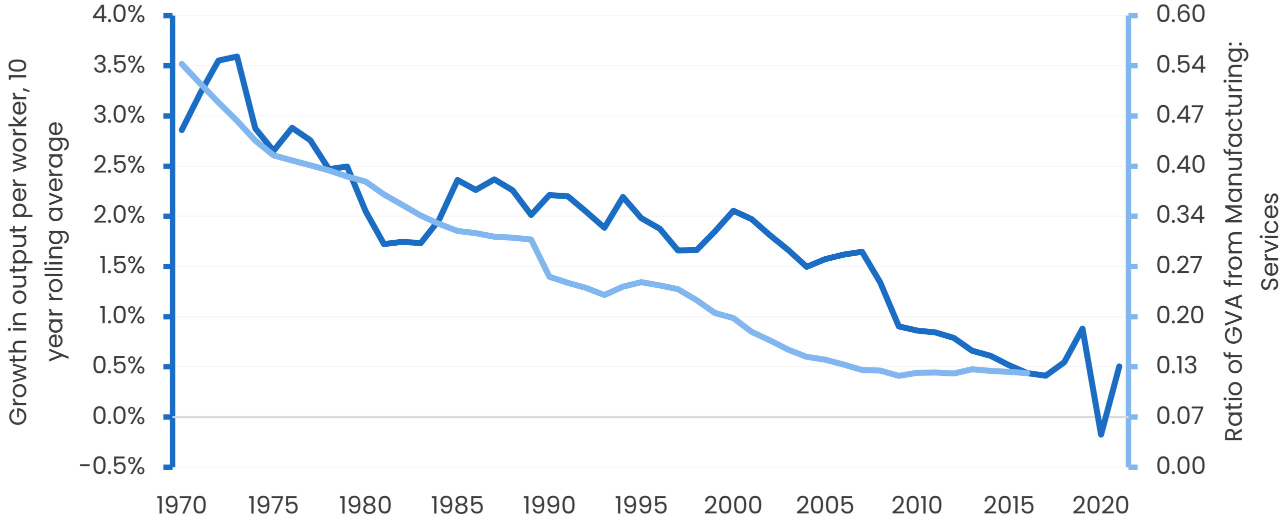
Crucially, this trend is not some problem that must – or can - be reversed. It is simply a naturally occurring phenomenon as economies grow richer, given productivity growth in services is inherently more constrained than for goods. Efficiency improvements for a haircut or doctor's appointment, for example, are more limited than they are for manufacturing a car, where automation and economies of scale can drive out productivity growth more easily.

With productivity higher for goods than services, the cost of goods falls faster than for services – meaning that, over time, services become relatively more expensive than goods. And because services are income elastic, as people become richer they tend to spend a higher proportion of their income on services than goods (if your income doubles, expenditure on things like cars and household appliances will not double, but spending on holidays or eating out might more than double). At an economy-wide level, this means a steady shift out of higher productivity goods into lower productivity services as economies grow and become richer.

Figure 3 shows how slowing productivity growth has been closely correlated with the UK economy's shift from manufacturing into services, with the services share of the economy rising steadily from 56% in 1970 to 78% by the time of the financial crisis.[18]

Figure 3: Growth in output per worker, and contribution of manufacturing and services to productivity [3]

Source: ONS historic data on labour productivity, ONS data on output per worker, ONS economic output and productivity data, Onward analysis



It therefore seems likely that part of the productivity puzzle is the result of slow, inevitable shift of the UK into a more services-intensive economy.

As well as shifting into lower productivity services, many advanced economies are also in the middle of a big demographic shift that is transforming the baby boomer generation from an economic tailwind to an economic headwind.

In the US, the working proportion of the population increased as the stock of workers exploded from 57 million in the 1940s to 150 million in 2015, with a big increase in the participation rate of women also a large factor.[19] These new workers joined the workforce with increasing skill levels as the number finishing high school rocketed. But those baby boomers are now retiring and living longer, and birth rates have fallen, slowing growth. In addition, the boost from steadily increasing high school graduation rates tailed off by about 1980. This means that growth in human capital per capita has slowed significantly over recent decades.

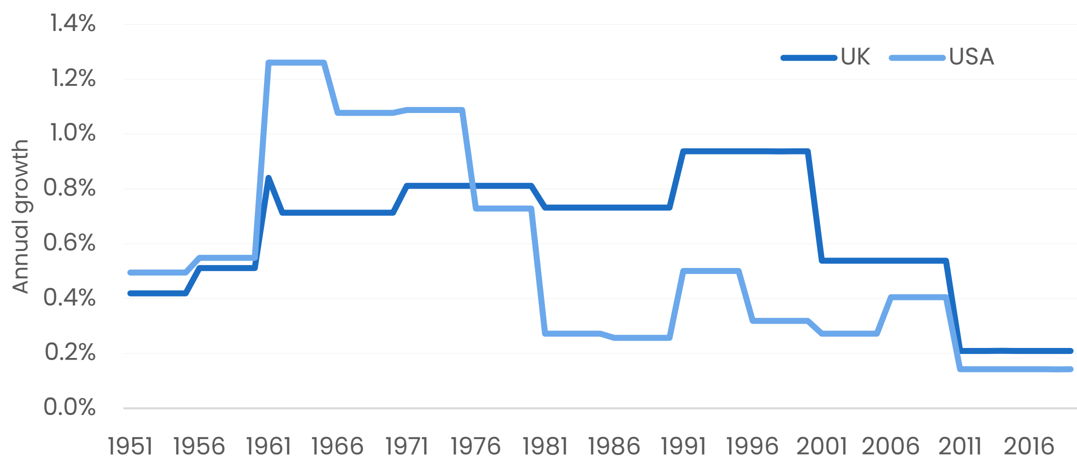
The story in the UK is not identical. As Jonathan Haskel, an independent member of the monetary policy committee, has said, high school expansion in the US was relatively early, which makes the story in the US different to those in the UK and Europe.[20]

[3] Contributions to productivity from the manufacturing and services sectors have been highly divergent. Figure 3 uses a ratio of gross value added from manufacturing to services (defined by the Standard Industry Codes) to the UK economy. From 1970 – 2016, GVA from manufacturing has fallen by 67%, and GVA from services increased by 42%.

Yet there can be no denying that the UK experienced a big increase in the education levels of its workforce in the second half of the twentieth century: between the 1950s and 2010s, the proportion of the population getting five or more O levels or GCSEs went from 11% to 80%, while the proportion of young people attending university went from 3% to 49%.[21] The UK is also facing a similar demographic shift as its society begins to age. The age dependency ratio – the number of dependent people below or above working age as a proportion of the working-age population – fell sharply from 1970 until the mid-1980s, then remained broadly flat until the time of the financial crisis when it began to rise steadily.[22]

As a result, although it occurred later than in the US, it does appear that the growth of human capital per capita began to slow in the UK at the start of this century, as evidenced by Figure 4.

Figure 4: Index of human capital per capita, annual growth in the UK and the US [4]
Source: FRED Economic data on the Index of Human Capital per capita



Other economists have put forward alternative structural explanations for the growth slowdown. Robert Gordon has argued that the diminishing returns to technological innovation are critical to understanding slower growth, particularly when comparing modern inventions to previous waves of innovation such as electricity and the internal combustion engine.[23] More recently, Thomas Philippon has argued that productivity growth does not actually grow exponentially but in a linear pattern, albeit with moments of temporary acceleration such as with the adoption of electricity in the interwar period, meaning that it slows in percentage terms over time.[24]

[4] Figure 4 uses the Federal Reserve Bank of St. Louis' (FRED) Index of Human Capital per capita, which uses data on years of schooling and returns to educational investments to measure human productivity, using raw data from the Penn World Tables. This is not to be confused with the World Bank's 'Human Capital Index,' which uses both education and health parameters to measure human productivity. Data for HCI is available only for select years, and therefore the FRED Index of Human Capital has been used.

Overall, the evidence suggests the growth and productivity slowdowns facing the UK are not simply a post-financial crisis phenomenon or the result of recent economic policy failures. Demographic tailwinds turning into headwinds combined with an ever-larger share of the economy being service-based are both long-term trends that began to weigh on the economy at different points in the decades leading up to the financial crisis, while other structural factors may also be at play. These trends do not explain all the slowdown, and the various shocks that the UK has faced since 2008 have clearly significantly exacerbated underlying weaknesses, but they are an important part of the story.

The implications for the formulation of economic policy are considerable. If these trends continue, it seems highly unlikely that the weak growth of the last decade and a half can be fully reversed simply by changing course on policy.

The prospects of future GDP and productivity growth

Most economic forecasts make depressing reading for developed economies.

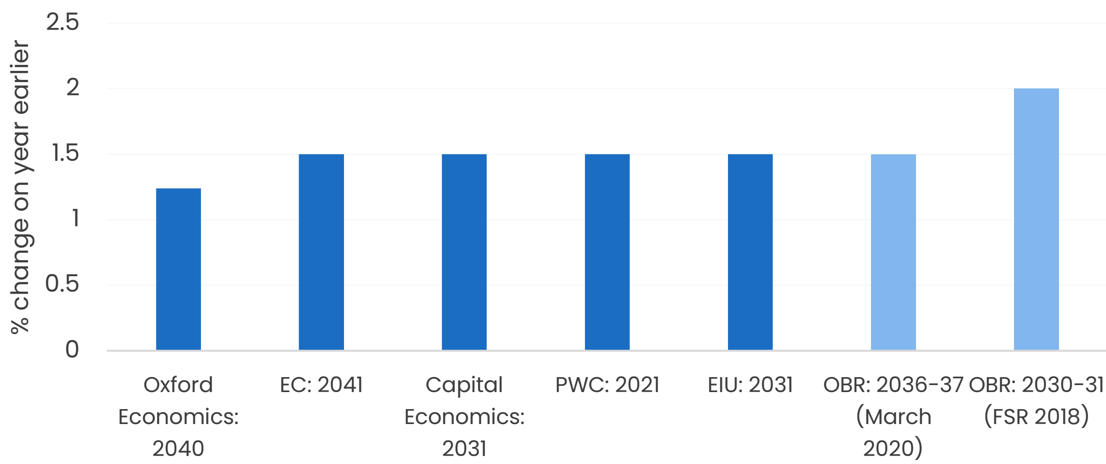
In terms of growth, the IMF forecast that advanced economies are set for a period of lower growth, with their latest medium-term forecasts projecting GDP per capita growth of 1.4% across advanced economies in 2027, the last year of their forecast.[25] In the UK, the OBR takes a similar view. Its assumption for long-term economic growth per capita is 1.5% - a percentage point lower than its average during the second half of the twentieth century.[26]

Demographics are likely to continue to weigh on growth over the long-term as the population ages – or at least no longer provide the tailwind that they did in the second half of the twentieth century. According to the latest projections from the ONS, for example, the old-age dependency ratio (OADR) – the number of people of pensionable age per 1,000 of working age – will increase from 280 in mid-2020 to 298 in mid-2030 and 341 by mid-2045.[27]

There is less certainty when it comes to productivity growth. In contrast to Robert Gordon's pessimism, techno-optimists such as Erik Brynjolfsson and Andrew McAfee argue that the technological advances we are now seeing – particularly in areas like digital technology and artificial intelligence – are set to have a transformative impact across the entire economy, pushing productivity growth back towards the rates we saw in the second half of the twentieth century.[28] While this is clearly possible, it cannot be counted upon, and would bring separate challenges in terms of managing the fallout from widespread automation. In addition, although there is room to increase productivity in services, the shift into lower productivity services will almost certainly continue given the structural causes behind it described above. Philippon's research on historic productivity levels also suggests that growth rates will continue to slow.[29]

The OBR has certainly become increasingly pessimistic about a return to higher productivity growth, consistently revising down its long-run estimate. It now forecasts UK labour productivity to grow by 1.5% a year long-term, which is broadly in line with other economic forecasters.[30] This is a sizeable increase from its recent levels, having averaged growth of just 0.3% a year from the financial crisis to 2020, but significantly lower than the 2.4% it averaged in the four decades leading up to the financial crisis.[31]

Figure 5: Projections of UK potential labour productivity growth
Source: OBR Economic and Fiscal Outlook, March 2020



This lower growth outlook will be accompanied by significant structural change. As well as the big demographic shift described above, the coming decades are likely to see the UK face at least four further shifts: permanent behavioural changes resulting from Covid; the impact on the UK's trade of both its changed relationship with the EU and rising geopolitical tensions; technological change; and the restructuring of the energy system and infrastructure to deliver energy security and meet net zero.

While uncertain, the net effect of these policies is likely to be a further downward pressure on overall growth rates. Russia's invasion of Ukraine along with rising tensions between the West and China serve as a reminder that increased geopolitical tensions may mean a partial reversal of the economic globalisation that has delivered significant gains since the end of the Second World War, weighing on growth.[32] While Brexit and Covid both bring opportunities in specific areas, at an economy-wide level the OBR is clear their overall impact will be negative for potential output.

Similarly, for all the talk of a green jobs boom, set against a baseline of not having to deal with climate change, delivering net zero will also likely be net negative for growth (though, given the reality of climate change, a net positive against not taking any action at all).[33] Technological change does bring with it the potential to have a sizeable positive impact, though with the caveats discussed above.

As with previous waves of structural change, these shifts will likely be accompanied by economic disruption for millions of people, from those whose jobs face extinction from automation to those whose communities have depended on oil and gas extraction. In addition, there is reason to suspect advanced economies may be increasingly exposed to the risk of large economic shocks, with a rise over the last twenty years in extreme weather events, infectious disease outbreaks and cyberattacks. These will pose challenges not just for growth and the public finances, but also in terms of supporting those negatively impacted.[34]

What role for policy?

The above analysis has attempted to show that structural factors are an important part of the explanation for the slowdown in growth and productivity in the UK. The point is not to say that policy does not matter, however. Accepting the reality that we cannot magic up growth to previous levels should not be confused with fatalism. Policy can undoubtedly make a difference. Vollrath himself argues 0.25% points of the growth slowdown in the US can be explained by what he describes as policy "failures".[35] It seems plausible that policy can have an even bigger impact in the UK, given the productivity slowdown since the financial crisis has been more marked here than in other advanced economies: in the twelve years running up to the financial crisis, UK labour productivity grew around the OECD average of around 2% a year; in the twelve years since it has been 0.4%, compared with an OECD average of 0.9%.[36]

Further, people like Sam Bowman have made the case that some of the growth headwinds may bite more for a country that is on the technological frontier, such as the United States, than the UK.[37] In 2019, the UK's productivity remained 17% lower than France, Germany and the United States and history suggests it should be possible to make up at least some of this gap.[38] As John van Reenen has argued, while the macro record of the Thatcher government is mixed, its product and labour market reforms, increased educational attainment and single market membership help explain why national income per head grew faster in the UK than in Germany, France and the US in the decades leading up to 2007.[39]

Policy can also make a material difference on the downside. The OBR has been clear in its view of the long-term impact of Brexit, and had the government not intervened on such a massive scale during Covid, the permanent economic damage from the pandemic would have been far greater.

So policy can make a difference, and there is also broad consensus about the areas where it should be aiming to have an impact. Bart van Aark, the head of the UK's Productivity Institute has argued that in order to address low productivity in the UK we must tackle "systematic under-investment" in both physical and human capital.[40] The Johnson administration's 2021 Plan for Growth found that much of the gap with France, Germany and the United States stemmed from historically lower levels of physical capital investment, including in infrastructure and business investment, with the UK suffering from the lowest investment rates in the G7 over the last two decades. The UK has also suffered from comparably low levels of basic and technical skills. Only 18% of adults have a vocational qualification compared to an OECD average of 27%.[41] In addition, management practices in UK firms lag behind our competitors, as does the diffusion of technology.[42] These are all weaknesses which policy could help turn around.

Yet the fact that policy can make *a* difference must not be confused with the idea that it can completely overcome the structural headwinds discussed above. Per capita GDP growth between 2008 and 2019 averaged just 0.6% a year, which means a significant improvement is needed just to hit the OBR's long-term forecast of 1.5%.[43] Even if policy could do even better than that and lift trend UK GDP per capita by a further 0.5% points a year, which would be an extraordinary achievement, this would still leave per capita growth around 0.5% points lower than in the second half of the twentieth century. While any coherent economic strategy must therefore absolutely have a plan to increase trend growth, it must also plan on the basis that an era of lower growth is nevertheless likely. That has challenging implications for living standards, for the distribution and for the fiscal position – and it means growth alone cannot be the sole focus of Conservative economic policy.

The inequality challenge

Driven by its new electoral coalition formed in the aftermath of the Brexit referendum, the Conservatives under Boris Johnson began to focus on one particular aspect of inequality – that across regions.

Over the last forty years, inequality between regions has increased in terms of output and living standards, first as former industrial areas in the North of England, Midlands, Scotland and Wales fell back compared with the southeast between the 1970s and 1990s; and subsequently as London outpaced the rest of the country.[44]

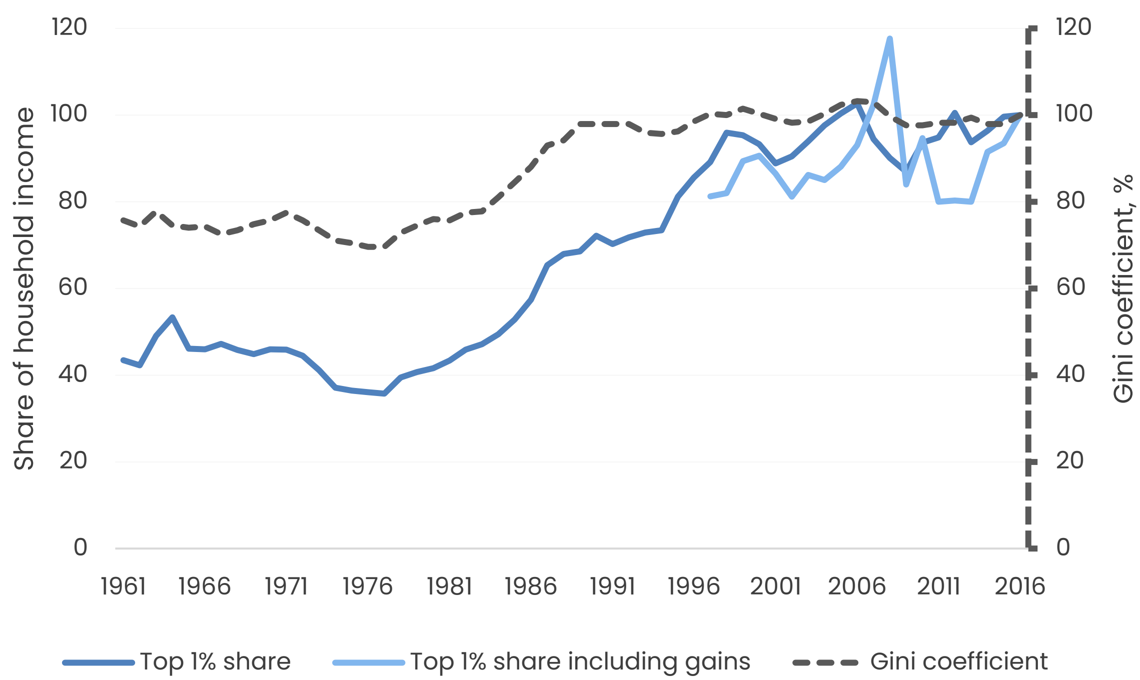
The result is the UK has among the highest levels of spatial inequality in the developed world across almost every level of geography or method of comparison, such that one of the UK's leading economic geographers, Professor Phil McCann, says the UK now resembles "Portugal with Singapore glued to the bottom right-hand corner."[45]

While the Johnson administration deserves credit for bringing renewed focus to regional inequality, however, it did not shine a light in the same way on other measures of economic inequality.

Figure 6 shows trends in income inequality in the UK in recent decades on two different measures. The Gini coefficient, which is a measure of income inequality across the distribution, fell slightly in the 1960s and 1970s, rose sharply in the 1980s and early 1990s, and has been broadly flat since. The share of income going to the top 1% tells a similar but more nuanced story. Having fallen steadily throughout the twentieth century, it too rose sharply in the 1980s. But unlike the Gini measure, it did not level off in the late 1990s, instead continuing to rise all the way to the financial crisis. While it did fall around the time of the financial crisis, recent research shows that when investment incomes and capital gains are included, the top income share has again been rising again over the last decade.[46]

Figure 6: Change in top 1% income share and Gini coefficient

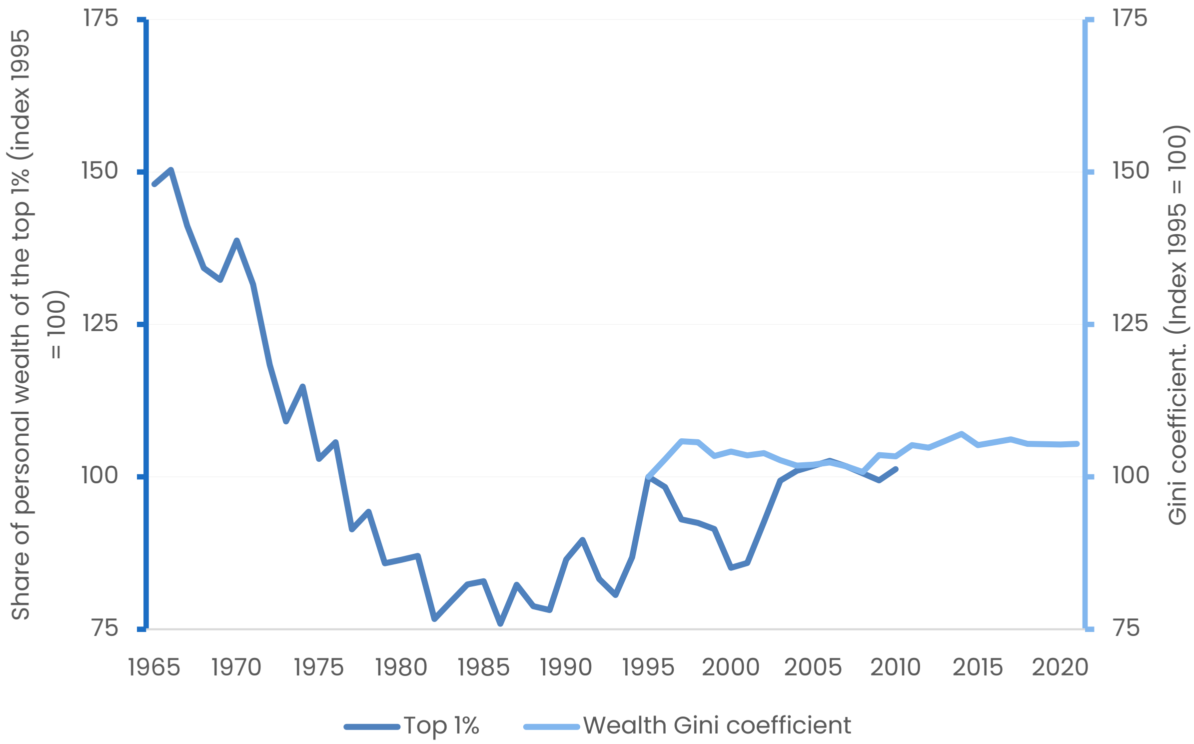
Source: IFS 2022, CAGE Working Paper 543, and Onward analysis



Having fallen markedly over the twentieth century, UK wealth inequality also began rising from the 1980s when measured both by Gini and the share owned by the top 1%, as shown by Figure 7. It has remained broadly stable since the financial crisis.

Figure 7: Wealth Inequality in the UK

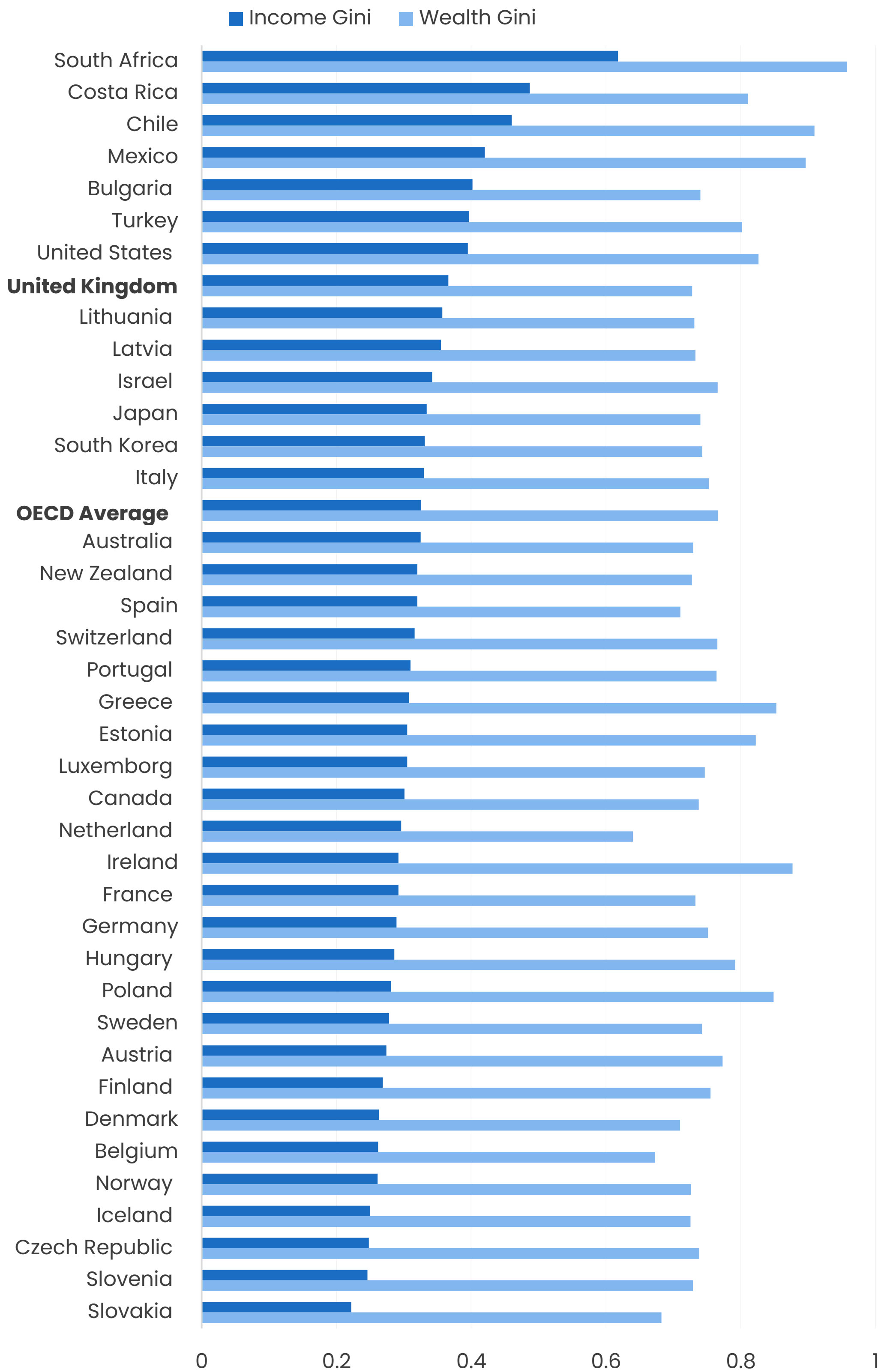
Source: World Inequality Database, Onward analysis



Looking internationally, Figure 8 shows that despite rising inequality across many advanced democracies, the UK remains one of the most unequal countries in the OECD when judged by levels of income inequality. Wealth inequality, while significantly higher than income inequality, is however below the OECD average.

Figure 8: Wealth and income inequality across the OECD, 2021

Source: OECD data on income inequality, World Inequality database



The drivers of increased inequality and the role of policy

There is an extensive literature covering the causes of rising economic inequality, particularly income inequality. Academics give two structural factors particular prominence in explaining higher earnings inequality: technology and globalisation. Technology has increased the demand for workers with higher skills that complement new technologies such as artificial intelligence, with the supply of such workers not keeping pace. David Autor has found that skills-biased technical change is responsible for between 40% and 60% of the rise in earnings inequality in the US over the last forty years.[47] Further, the automation of middle-income jobs has led to an increased pool of labour for the lowest paid, non-routine jobs which cannot be automated, as those middle earners are forced to compete for lower wage jobs. Similarly, increased trade with previously lower income countries, notably China, has reduced the demand for labour at the low- and middle-earner levels of advanced economies.[48]

Yet policy has also had a significant impact on inequality in the UK over the last forty years – often in countervailing directions.

First, policy changes to labour market institutions have impacted the distribution of pre-tax earnings. In one direction, the weakening of trade unions has reduced the bargaining position of middle- and lower-income workers; in the other, the introduction of the national minimum wage, and the subsequent significant increases to it, has boosted earnings at the bottom.[49]

Second, policy changes to the tax and benefit system have impacted the extent to which that system reduces earnings inequality. For example, research by the Institute for Fiscal Studies (IFS) found that between 1994 and 2011 working age tax and benefits played an important role in offsetting rising earnings inequality, primarily through the introduction of working family tax credits. By contrast, it found that after 2011 welfare cuts largely offset the falling earnings inequality which significant increases in the national minimum wage delivered.[50]

Policy can therefore have a direct and substantial impact on inequality. Given the challenges discussed above in significantly increasing trend growth, many economists believe questions around the distribution should be given more, not less, prominence. Making the case that growth needs to be more broad-based, Ben Bernanke, former Chairman of the Federal Reserve, has argued that while growth is vital: "as recent political developments have brought home, growth is not always enough".[51]

The outlook for economic inequality

It seems unlikely the structural factors that drove the increase in inequality over recent decades will reverse, certainly to an extent that will drive a significant reduction in inequality. It is possible that increased geopolitical tensions will continue to disrupt global trade patterns, and that we will see a rise in the relative power of labour as a result of tight labour markets. However, if anything the more significant technological drivers of higher inequality will likely intensify. Andy Haldane, for example, has argued that the displacement effects of the coming wave of technological change may be larger than previous waves because they may involve the hollowing out of cognitive as well as manual tasks.[52] Further, the initial evidence post-Covid is that earnings inequality is widening once more.[53] Absent a significant policy shift, therefore, high levels of inequality seems likely to persist.

Politically, questions around how the economic pie is distributed look set to stay, having returned to the forefront of the national debate in recent years – as the backlash over the Truss government's plans to abolish the 45p rate of income tax vividly reminded us. In his book charting two hundred years of UK economic history, Duncan Weldon has observed the link between eras of lower growth being associated with more intense fights over the distribution: "In simple terms: when the pie is growing quickly, there is less fighting over the shares". He argues that the low growth in the aftermath of the financial crisis resulted in renewed, intense political focus on the distribution, something which had parallels in the early-to-mid-nineteenth century, the decade before the First World War, and the 1970s.[54]

If, therefore the coming decades are likely to see a continuation of lower growth, it seems probable that questions around economic inequality will remain at the forefront of British politics. This would be true regardless of current levels of inequality, but it will be more so given economic inequality in the UK is high by historic standards. Any Conservative economic strategy must therefore have a clear approach to economic inequality – either with a plan to tackle it or a strong and well-argued rationale for not actively doing so.

The fiscal challenge

Lower trend growth will not only intensify the political debate around the distribution. It will also contribute to a highly challenging fiscal position. Further, while the new government has made its belief in a desire for a smaller state clear, those same demographic challenges that will weigh on growth will also make the prospect of a significant roll back of the state virtually impossible.

The immediate challenge

The state grew significantly as a result of Covid, peaking at 52% of GDP in 2020-21. At the time of writing, it is due to fall back to 42% by the time of the next election, though this is 1.2% points higher than the pre-Covid forecast.[55] A combination of the negative impacts of Covid, Brexit and growing underlying pressures in health and care led the government to announce large-scale tax rises in 2021. As a result, according to the last OBR forecast of the Johnson administration tax revenues as a share of GDP were due to hit 36.3% by 2026-27, its highest level since the 1940s.[56] The net effect of these changes was that, although the UK's debt-to-GDP ratio was forecast to peak at 95.6% in 2021-22, it was thereafter due to fall steadily to 83.1% by 2026-27. The deficit was also due to fall rapidly, from 15.0% of GDP in 2020-21 to 1.1% by 2026-27.[57]

Kwasi Kwarteng's decision to announce the Energy Price Guarantee scheme and permanent tax cuts in excess of £40 billion, combined with the significantly higher borrowing costs resulting from a combination of global trends and market concern about the new government's fiscal approach, fundamentally altered that picture. Despite the U-turns already announced on corporation tax, income tax and more, the new Chancellor Jeremy Hunt is still expected to need to find tens of billions of pounds of tax rises or spending cuts to meet the government's stated aim of having debt as a proportion of GDP falling in the medium term.

The long-term trajectory

Looking beyond the immediate term, the fiscal picture will continue to be highly challenging. Since it first did so in 2011, on every occasion the OBR has produced a fiscal sustainability report it has concluded the fiscal position is unsustainable over the longer-term.[58] A big driver of this is those same demographic factors that will weigh on growth, with the government spending significantly more on health and pensions as the population ages. In addition, health spending will come under pressure both from technological improvements and the increasing frequency of chronic health conditions.[59]

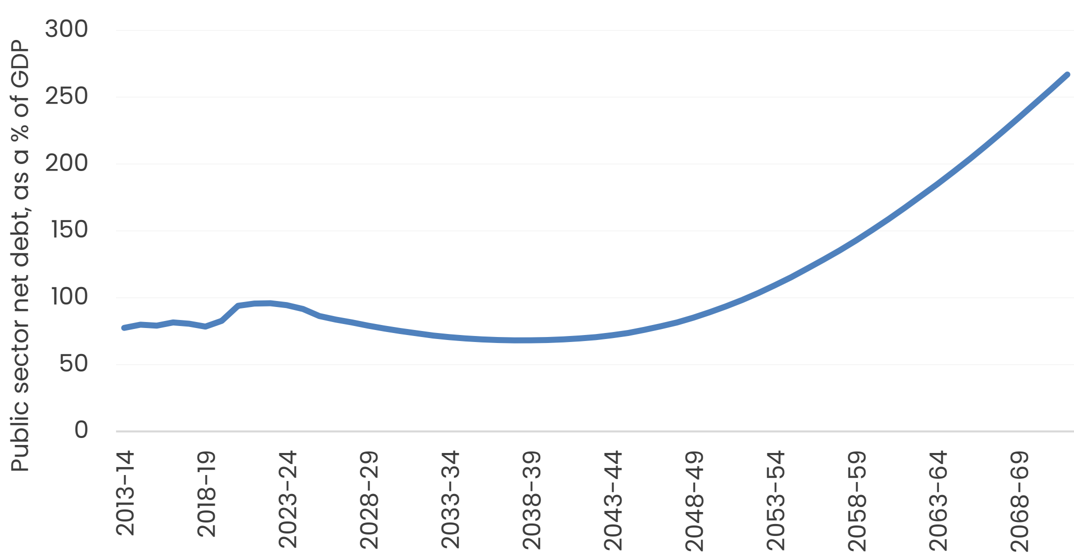
On the OBR's central scenario, health spending is due to rise from 9.1% of GDP in 2021-2 to 10.1% in 2041-42 and 15.0% in 2071-72 – more than double the 6.9% recorded in 1997; state pension costs will increase from 4.8% to 5.5% to 8.1% over the same periods; and adult social care costs from 1.2% to 1.8% to 2.5%. Those same factors do not have a significant impact on revenues, however, which remain roughly stable.[60]

Steps could be taken to mitigate these rises to a degree: the triple lock could be abandoned, the state pension age raised more quickly, and spending growth on public services in areas like health and education held below GDP growth. Given the scale of the pressures the UK faces, however, unless radical and politically extremely difficult policy measures are taken to counteract it – for example, a total overhaul of the funding of our pensions or healthcare systems – the state will grow in size over the coming decades, probably quite significantly. This is not the result of an active policy decision to push for a bigger state. It is simply the natural by-product of demographics and structural factors feeding their way into how the UK state currently operates, notably our publicly funded health system.

As a result, as shown by Figure 9, public sector net debt is due to rise rapidly over the coming decades to levels never seen before in the UK – and that is without taking into account the impact of further shocks like the financial crisis and Covid, more of which seem inevitable. It also takes no account of the impact of rising geopolitical risks which will have a direct fiscal implication if calls for ongoing increases in defence spending prove irresistible, reversing a long-term decline in recent decades. These geopolitical risks are also a likely source of future negative economic shocks.

Figure 9: Public sector net debt projections

Source: OBR Fiscal Risks and Sustainability report, July 2022



In order to counter these trends and ensure debt-to-GDP is at 75% of GDP by 2070 – still around double what it was going into the financial crisis, though slightly lower than it is today – the OBR projects a decade-by-decade fiscal tightening will be required of 1.5% of GDP, or around £37 billion in today's terms.[61]

There are clearly huge uncertainties in these projections: the latest OBR long-term forecast was materially impacted by changes to the latest ONS population forecast, for example. There may be further demographic changes, and growth may also surprise on the upside. But neither of these can be relied upon. Moreover, given the scale of the pressures that lie ahead, it would take an extraordinarily fortunate combination of upside surprises to make the fiscal problems go away entirely. As the OBR says, uncertainties in the long-term forecasts should not be used “as an excuse for ignoring the challenges that lie ahead”.[62]

Conclusion: The choices facing the Conservative Party

Good policy can make a difference to the UK’s growth rate. But we should be realistic about how much. A significant part of the growth slowdown is the result of long-term structural forces, forces which will likely continue to weigh on growth in the coming decades. Against this backdrop, even a successful pro-growth agenda is unlikely to return trend growth to its pre-financial crisis levels.

The implication is that, even if we succeed at raising the UK’s growth rate (as we must), policymakers will need to focus more on economic inequality and fiscal discipline, as previous Conservative governments have recognised at different points in the UK’s economic history.

On the former, the Conservatives must decide whether to acknowledge that existing high levels of economic inequality are a problem, and come up with a plan to address them; or convince the electorate that inequality does not matter. On the latter, lower growth combined with demographic and other long-term pressures will mean a formidably challenging fiscal position. And though it will be an uncomfortable fact for many Conservatives, an ageing population is likely to mean that the state will continue to grow, at least in some areas.

These are the challenges – the growth challenge, the inequality challenge and the fiscal challenge – that any credible Conservative economic strategy must have answers to. The starting point should be to ground those answers in Conservative principles. It is to this task that this paper will now turn.

A principles-based approach to Conservative economic policy

Section 2

Whether one agrees with it or not, for the best part of four decades, the foundation of Conservative economics stood firm. This was perhaps most succinctly put by Nigel Lawson in his 1984 Mais Lecture. The British experiment, he argued, "consists of seeking, within an explicit medium-term context, to provide increasing freedom for markets to work within a framework of firm monetary and fiscal discipline. It stands in contrast to the post-war trend towards ever more ad hoc interference with free markets within a context of increasingly financial *in*discipline".[63] No Tory Chancellor from Geoffrey Howe to Rishi Sunak disagreed with that worldview.

Yet the last few years have catalysed a crisis of confidence in Conservative economic thinking, even as the party has prospered electorally. Brexit, austerity fatigue, low growth post-financial crisis and Covid have all shaken the Lawsonian orthodoxy. The current energy crisis, the return of high inflation and the worsening geopolitical situation have caused yet further confusion. As a result, the Conservative Party has veered one way then another on economic policy, driven by a combination of political expedience, economic necessity, and raw ideology.

The Conservative Manifesto of 2017 explicitly rejected the ideological template of the libertarian right, instead embracing "the mainstream view that recognises the good that government can do".[64] Its author, Nick Timothy, has blamed an "ultra-liberal" economic agenda for Britain's poor productivity and regional inequality.[65] This thinking provided the basis for many of the more interventionist measures seen during the Theresa May era, such as the energy price cap.

When Boris Johnson succeeded May, he brought with him no fixed economic philosophy. Rather, the economic views of his government oscillated depending on the prevailing political winds. Part of this reflected the changing team around him. But it also reflected conflicting political concerns: the need for a strong regional offer to respond to the new Conservative electoral coalition combined with voters' desire for higher spending on public services on the one hand, tempered in the later stages of the administration by Johnson's weakening position and a desire to shore up support among right-leaning Conservative backbenchers.

The result saw Johnson espouse a wide range of economic views over time. In a speech on his long-term plans for the recovery in June 2020, for example, he declared: "I am conscious as I say all this that it sounds like a prodigious amount of government intervention. It sounds like a New Deal and all I can say is that if so, then that is how it is meant to sound".[66] Yet eighteen months later, he was telling the CBI of the importance of limited government: "government should make sure there is less regulation and indeed less taxation. And the true driver of growth is not government, it is the energy and dynamism and originality of the private sector".[67]

Despite this confusion, the Conservative Party did undoubtedly move – to some extent – away from the Lawsonian model post-Brexit. It expanded the state's role in directing and regulating economic activity; oversaw a significant increase in public spending, accompanied by both higher taxes and more borrowing; and imposed significant new restrictions on trade and foreign investment.

This provided the context for this summer's Conservative leadership campaign, which was dominated by clashes over competing economic visions. Both teams accused the other of being socialist: Liz Truss for borrowing too much, and Rishi Sunak for raising too much tax. The Prime Minister pitched herself as the heir to Margaret Thatcher, with promises to slash taxes to turbo-charge the economy – only to be told by Nigel Lawson himself that broad-based tax cuts in the face of soaring inflation is the opposite of what Thatcher would have done.[68] While Truss styled herself as the heir to Thatcher, therefore, at least in one respect – her seeming indifference to very high levels of borrowing – she too represented a sharp break from it, at least initially.

A proper debate over the direction of Conservative economic policy is therefore long overdue. Politically, a clear economic plan is required to maintain definition from Labour in what has – until recently – traditionally been the Tories' strongest area. Economically, clarity over policy can provide the certainty needed to maximise the UK's growth prospects. Yet the debate we saw over the summer too often took a caricature of Thatcherism as the baseline for defining Conservative economic policy, and in doing so implicitly assumed that the challenges facing the UK economy remain the same as those that she faced. The last year has shown that some challenges undoubtedly endure, with the return of double-digit inflation and widespread industrial action. Yet Thatcher was dealing with a fundamentally different underlying economic structure: high unemployment, a heavily unionised workforce, no independent central bank and swathes of industry in the hands of nationalised entities. Inequality was also at historically low levels and the national debt was falling sharply to its lowest level since before the First World War. Those circumstances were very different to the growth, inequality and fiscal challenges facing Britain in the coming decades.

Further – and more importantly - Conservative economic policy did not start in 1979. The perennial focus on Thatcher ignores a much richer history of Conservative thinking that should be drawn upon to address these challenges. Before turning to specific policy recommendations in Section 3, therefore, this section will do two things. First, draw on that longer history of thinking to establish a clear set of Conservative principles for economic policy; and second, apply those principles at an overarching level to the growth, inequality and fiscal challenges.

Conservative economic principles

Conservatism has always eschewed the rigid ideological framework that socialism has provided the Labour Party, with the result that its economic policy has ebbed and flowed over the last two centuries. Yet it would be a mistake to infer from this that Conservative economic thinking has lacked a coherent set of beliefs: across this period, a number of consistent values have endured. Before turning to these, however, it is worth briefly sketching out the evolution of Conservative economic policy.

A brief history of Conservative economics

The birth of Conservative economics in its current form starts with Robert Peel. Adam Smith's *Wealth of Nations* provided the intellectual foundation for the decline of the mercantilist system that had dominated economic thinking until the eighteenth century, and which saw economics as a zero-sum game where a positive trade balance was the way to enrich nations. Smith advocated the removal of tariffs and trading restrictions and its replacement by a more open, free market, free trade system as a means of enriching all individuals and countries.

Peel's adoption of these arguments to push through his liberalising agenda was the beginning of the Conservative Party's long – though by no means unbroken – association with the case for free trade and free markets. For while it was indeed Peel who, as Conservative Prime Minister, embarked upon the *laissez faire* approach that would dominate economic policy until the First World War, he also split the Conservative Party. His acolytes – including future Prime Minister William Gladstone – would end up in what would ultimately become the Liberal Party.

Indeed, although the Conservative Party abandoned protectionism in 1852, for most of the second half of the nineteenth century, the Conservatives were positioned as the more interventionist of the main two political parties.[69] On gaining its first majority since Peel's of 1841, Benjamin Disraeli's government in the 1870s delivered a range of social reform measures that saw the government intervene to protect workers and improve their living conditions, legislating across labour relations, housing and sanitation.

As the twentieth century dawned, this scepticism of laissez-faire continued, notably with an intense internal debate over tariff reform which would consume the party on and off for three decades. In part, this was driven by the Conservative Party's acknowledgment that it needed its own response to the social problems arising from industrialisation that the New Liberal government was looking to address in the years running up to the First World War, notably through David Lloyd-George's 'People's Budget' of 1909.

Against this backdrop, the First World War transformed the role of the state. Britain came close to being a command economy. In many ways the 1920s saw a return to more traditional economic policy, notably with the UK's return to the Gold Standard. With the rise of the Labour Party, the Conservative Party increasingly began to define itself against socialism, and the statist model that entailed. Nevertheless, in the interwar years the Tories under Stanley Baldwin accepted an expanding role for the state in parts of the economy and began to move away from the pre-existing economic orthodoxy. It extended old age pension benefits, oversaw a significant increase in housebuilding, embarked on a programme of "rationalisation" of big firms to drive efficiency, and re-introduced protective tariffs in 1932.

The Second World War ushered in another enormous expansion in the role of the state, though this time it would lead to a more permanent change. The Beveridge Report set the scene for the introduction of the welfare state by Clement Attlee's Labour government immediately after the war, along with a wave of nationalisations. At a macro level the government adopted the demand management policies and targeting of full employment advocated by John Maynard Keynes, whose work provided the intellectual foundation of the post-war economic order. When the Conservative Party returned to government in 1951 it continued to project itself as the antithesis of socialism and did reduce the state's role in some areas. It privatised steel, abolished a range of restrictions, including rationing, and cut personal tax. But there was no fundamental roll back of the state: many industries remained nationalised, and the new welfare state was broadly accepted. If anything, towards the end of the Conservatives' twelve-year period in government, it moved towards more economic intervention, with Harold Macmillan's establishment of the National Economic Development Council in 1962 as a vehicle for greater economic planning.

The next Conservative administration led by Edward Heath initially wanted significant reform. The party's 1970 'Selsdon Man' manifesto advocated many of the policies that Thatcher would ultimately pursue: privatisation, deregulation, cutting subsidies and taxes, restricting trade unions and joining the European Community. But Heath's now famous U-turn in 1972 led to most of these policies being dropped, with spending increases designed to kickstart the economy, failing companies bailed out and statutory control of prices and incomes re-introduced.

Heath's government did however set the stage for the reforms of the Thatcher era. The primary macro aim switched from delivering full employment to controlling inflation, and it was accompanied by wide-ranging supply side reforms: sweeping privatisations, significant trade union and labour market reforms, deregulation of the City and the liberalisation of capital markets, and major tax reforms - including big cuts in the rates of income and corporate tax. It is this approach that would, broadly speaking, dominate Conservative economic thinking for the best part of four decades until the recent shifts discussed above.

Four Conservative economic principles

This evolution of Conservative economics over time reflects both the broad church the party has always been and the changing nature of the challenges facing it. In his work on the history of Conservative thought in the twentieth century, the late E.H.H. Green argued that "at no point in 'the Conservative century' was there a definite Conservative theory of the State: there were many which overlapped, competed, and often conflicted. In particular, the Conservative position on State intervention in the social and economic sphere underwent periodic re-examination".[70] However this "is not to deny [Conservatism's] existence as a constant or consistent political and historical entity".[71] An analysis of the history of Conservative economics throws up four principles that – broadly speaking – have endured. These are not intended to be a comprehensive list of every strain of Conservative economic thinking, but the elements that have most consistently permeated that thinking over time.

1. The pragmatic principle

First, Conservative economic policy has tended to be pragmatic, sceptical of ideology and grounded in realism. The conservative philosopher Michael Oakeshott argued that Conservatives tend to "prefer the familiar to the unknown, the tried to the untried, fact to mystery, the actual to the possible, the limited to the unbounded, the near to the distant, the sufficient to the superabundant, the convenient to the perfect".[72] Conservative economics has, for the most part, adopted this approach. It has been willing to make difficult trade-offs, been realistic about the impact that government policy can have, and adapted its beliefs to tackle the problems of the day. In particular, it has tended to be sceptical of grand theories. Indeed, the history of Conservative economics can in part be defined by opposition to ideology: to laissez-faire in the nineteenth century and to socialism in the twentieth.[73] Instead it has consistently evolved over time to meet the economic challenges of the day: the abandonment of protection in the nineteenth century and the adoption of the welfare state in the twentieth are both examples of the Conservative Party applying the pragmatic principle, adapting previously held positions to changing circumstances.

This flexibility should not, however, be confused with a lack of interest in ideas. Whenever Conservative economic policy has significantly shifted – under Peel, Macmillan and Thatcher, for example – it has always been backed by a firm intellectual case. Rather, Conservatism has been sceptical that a set of economic laws exist to be universally applied. As Arthur Balfour argued "the field of economic theory…depends for its content on such variable elements as custom, law, knowledge, social organisation; nay on human nature itself which…is not necessarily the same from generation to generation…Every phase of civilisation requires its own political economy".[74]

The exception to this is, arguably, Thatcher, for whose administration free market ideology was clearly important. Famously, she is alleged to have banged a copy of Friedrich Hayek's The Constitution of Liberty on the table and said, "This is what we believe".

But a reading of Conservative manifestos since 1945 reveals that in many ways Thatcherism did not represent a radical ideological departure. Instead, it simply marked an extension of the socialist antithesis that the Conservative Party had made one of its core selling points since the rise of the Labour Party. Furthermore, in truth she moved cautiously and non-dogmatically, was willing to compromise, accept trade-offs and adapt to changing circumstances: raising taxes in the early 1980s to try to control inflation, abandoning monetarism and delaying conflict with the coal miners are just three examples of her pragmatic approach. It is also noteworthy that she did not attempt or achieve a significant reduction in the tax burden, nor the marketisation or privatisation of key public services like health or education. While there was of course an ideological core, therefore, Thatcher was also a pragmatist.

2. The stewardship principle

Secondly, Conservatism has tolerated and even welcomed change, both for the progress it can deliver and because it is necessary to ensure the stability and maintenance of established customs and institutions which Conservatives believe so important. The intellectual foundations of this principle derive from Edmund Burke, who argued that "a state without the means of some change is without the means of its own conservation".[75] For Conservatives, the task has been to manage change to allow the economic progress vital for stability while ensuring such change is not so abrupt as to undermine that stability.

Peel's repeal of the Corn Laws had a firm intellectual basis through the work of Smith and Daniel Ricardo, but the case for repeal was also based on the Burkean idea that reform would preserve Britain's existing political, economic and constitutional system. Defending the policy in 1846, Peel told parliament: "I have thought it consistent with true Conservative policy to promote so much of happiness and contentment among the people that the voice of disaffection should be no longer heard, and that thoughts of the dissolution of our institutions should be forgotten in the midst of physical enjoyment".[76]

Disraeli, despite previously being one of Peel's fiercest critics, shared the same view. He believed that "the programme of the Conservative party is to maintain the Constitution of the country", and that social reform and the improvement of the living conditions of the working classes played an important role in creating the stability needed to do so.[77] Speaking nearly a century after Peel, Quintin Hogg, who served as a minister under six Conservative Prime Ministers, made a similar case: "if you do not give the people social reform, they are going to give you social revolution.

The maintenance of our institutions has been one of the principles of the Conservative Party from time immemorial. The wise man who said that the maintenance of our institutions was the first Conservative principle made the improvement of the condition of the people the third".[78]

Throughout, the Conservative way has tended to mean moving gradually. Peel brought in reform in stages – his 1842 Budget moved towards trade liberalisation, but it was only once he had seen the results of these reforms that he pushed for full repeal of the Corn Laws, for example. Similarly, Thatcher's trade union and the privatisation agendas were implemented in stages.

Despite this gradualism, one of the most valid criticisms of the Thatcher administration is that it nevertheless paid insufficient attention to managing the change it unleashed. Contemporary critics such as Ian Gilmour argued that by forcing the state to retreat too far from social and economic spheres, peace and stability were being undermined.[79] Green argues that "whether as a consequence of a mismatch between intention and outcome, or as a result of a failure to anticipate where a liberal market strategy could lead, Thatcherism stretched organicism to breaking-point".[80]

Many of the reforms her administration delivered were necessary and effective. But by failing to provide sufficient support to those whose lives were disrupted by a mix of domestic policy, technological change and globalisation, her administration arguably pushed the stewardship principle to breaking point.

3. The One Nation principle

The contemporary, caricatured view of Conservativism promulgated by many of the left is of it being an unsentimental, almost cruel ideology that self-interestedly preserves existing unfair social structures at virtually any cost. It takes post-1979 Conservatism at its worst, characterising it as a time when economic efficiency has been allowed to trump all else, in particular allowing or even rejoicing in a massive rise in economic inequality.

Not only does this mis-characterise Thatcherism, it totally ignores a much longer Conservative tradition. Taking that longer view, the third enduring principle of Conservative economics has been a belief that economic prosperity and opportunity should be shared broadly across all sections of society, and that it is the job of government to look after the poorest in society.

Again, the starting point is Peel, who made the case that the better off should shoulder the burden of taxation to support the poorest: "I have a strong belief that the greatest object which we or any other government can contemplate would be to elevate the social condition of that class of the people with whom we are brought into no direct relationship by the exercise of the elective franchise. I wish to convince them that our object has been so to apportion taxation, that we shall relieve industry and labour from any undue burden, and transfer it, so far as is consistent with the public good, to those who are better enabled to bear it."[81]

It is a principle that has stayed at the heart of the Conservative cause. In 1846, Benjamin Disraeli recognised the issue of "Two nations; between whom there is no intercourse and no sympathy…and [who] are not governed by the same laws: the rich and the poor".[82] While less explicit about the need for the richest to contribute more, he believed that it was the job of government to improve the condition of the working classes.[83]

The best part of a century later, Harold Macmillan made the case that prosperity should be broad-based, telling the Conservative Party Conference, in his first speech as Prime Minister, that "we have a clear duty to those sections of people who have not shared in this general prosperity and that duty we intend to discharge".[84] The February 1974 Conservative manifesto pledged to ensure the burden of dealing with the economic challenges then facing the country were shared out fairly: "What we must continue to ensure is that any sacrifices are shared equitably and that hardship does not fall on those least able to bear it."[85] A similar tone was adopted when it came to the challenge of fixing the public finances under David Cameron, with his Chancellor George Osborne arguing that "those with the broadest shoulders are bearing the greatest burden".[86]

This One Nation principle is borne of two underlying Conservative values.

First, the belief in the importance of political and social stability. High levels of inequality have the potential to undermine the stability of the political and economic system, the maintenance of which has been at the heart of Conservative economic thinking, from Peel's reforms through to Macmillan's Middle Way.

Secondly, the importance of opportunity. Margaret Thatcher explicitly rejected the pursuit of greater economic equality. But she still argued that it was vital for prosperity and opportunity to be broad-based. As she noted, "Socialism is two nations. The rule of the privileged rulers and everyone else…But what I am desperately trying to do is create one nation by having everyone being a man of property or the opportunity to be a man of property."[87] This is central to the Conservative conception of fairness: the idea that every child deserves an equal chance at making the most of their talents, no matter what their background.

While concerns about how the economic pie is shared tend to be much more associated with Labour, there is therefore a consistent strand of Conservative thinking has believed in the importance of economic prosperity being broad-based; that those who are least well off should be supported; and that the wealthiest should bear the greatest burden for providing such support.

4. The empowerment principle

The final principle pertains to the role of the state. The stereotype is that Conservatives are hellbent on reducing the state's size and removing its influence from as much of the economy as possible. There has undoubtedly always been a strand of deep scepticism in Conservative thinking around the dangers of an over-mighty state. But this should not be confused with small state libertarianism. Conservatives have consistently viewed the state as having a vital role, but as an enabler – rather than controller – of economic activity, and – closely linked to the One Nation principle – in ensuring that mechanisms exist for the provision of certain services and support across society, particularly for the poorest.

This has been evident throughout the history of modern Conservatism. In one of the earliest examples, the Conservative Opposition attacked the Liberal government's response to the Irish famine in the late 1840s, condemning the reductions of rations to the Irish poor and the government's refusal to intervene more in the provision of food importation.

Just over half a century later, the Unionist Social Reform Committee set up by the Conservative Party Chairman, Arthur Steel-Maitland, proposed a range of social reforms aiming to improve labour market conditions, including extending old age pension rights, introducing minimum wages in certain occupations and providing housing schemes for the working classes. Similarly, an active state was seen as necessary to deliver the programme of rationalisation in the 1920s aimed at improving the competitiveness of British firms, while still rejecting the idea that the state would control or manage business as socialist. In both cases the state had a role to play, but it was seen by Steel-Maitland as enabling rather than controlling.[88]

The Conservatives accepted an even greater role for the state after the Second World War, including some level of nationalisation. But the central idea that the state should be an enabler rather than controller remained. 'Set the People Free' was a Conservative slogan at both the 1950 and 1951 general elections, and the Conservative manifesto that helped secure Anthony Eden's sole election victory in 1955 provided a clear depiction of an enabling state. "It is for the State to give a lead, to provide incentive, support and advice, to protect the public interest and to restrain abuse. But it is certainly no proper function of the State in normal times to go into trade itself, to interfere in the day-to-day running of business, or to tell housewives how to do their shopping."[89]

Macmillan is seen as the most interventionist of all Conservative Prime Ministers, and he certainly rejected laissez-faire doctrinaire liberalism for too often meaning "the defence not of freedom but of privilege"[90] But even for him the state should only intervene directly where industry had failed to organise itself properly and with the aim of allowing the private sector to operate at full efficiency. Commenting on Macmillan's thinking in the interwar years, John Maynard Keynes saw Macmillan as wanting to "minimise the part which the state must play".[91]

This view survived the introduction of the welfare state. In the 1950s, Macmillan argued that the Conservatives' task was to remove "from off the back of the trader, the farmer, the businessman and the private citizen the whole Socialist paraphernalia of burdensome and complex controls."[92] Where the state had a more direct role was in tackling other social problems, like health, poverty and old age. But as Green argues, the pitch was about reducing controls, cutting taxes and spending, and freeing up the private sector – it was not "the welfare state mixed economy is safe in our hands".[93]

The conventional wisdom is that Margaret Thatcher changed all this, and there is no doubt that the Thatcher administration explicitly aimed to reduce the size and scope of the state significantly. But it was not a return to *laissez faire*. As Thatcher herself said: "we are not anti-State. On the contrary, we seek a proper balance between State and society".[94] A wave of liberalising reforms were passed, but the state still had an important role to play. Keith Joseph, one of the key intellectual drivers of Thatcherism, described the expansion of social services as a "highly desired" objective.[95]

Speaking in 1978, Geoffrey Howe, who would become Thatcher's first Chancellor, proposed a "libertarian" approach as the antidote to the failed socialist one. Yet he was clear that "this does not imply a flat rejection of a role for public authority. There are many things that can be undertaken only by Government".[96] Expanding on that theme in his 1980 Budget, he explained: "Our choices have been guided by the belief that the Government should provide efficiently and realistically those services that they alone are able and best fitted to provide. The role of the State can sensibly be reduced where it has taken over what private initiative can better achieve, and where it has been reducing incentives, increasing bureaucracy and distorting markets".[97]

While the exact nature of state involvement in the economy has varied significantly over time, therefore, the empowerment principle has been a consistent presence in Conservative thinking. At its heart has been the idea of a strong state acting to enable private enterprise and provide social support. There has been debate, of course. The twentieth century witnessed almost constant tension between the libertarian and paternalistic wings of the Conservative Party, over both the level of state intervention in economic activity and how much welfare to provide. As Lord Beaverbrook put it in 1945, "the battle within the party is a fight between the Tory individualists who follow ironically enough the creed of nineteenth century Liberalism, and the Tory reformers who raise the banner of Disraeli's Young England".[98]

Yet these have, by and large, been debates over degree, not principle. The basic concept that the state should seek to enable and not control economic activity – and that it has an important role to play in supporting the poorest and ensuring the provision of certain social services – have not been in doubt.

In summary, therefore, four consistent, inter-linked principles have endured in Conservative economics over the last two centuries: a belief in the politics of pragmatism not dogma; in the politics of stewarding change, not resisting it; in the politics of building one nation not two; and in the politics of an empowering state, not a controlling one.

These four principles – the pragmatic principle, the stewardship principle, the One Nation principle and the empowerment principle – should be the guiding principles for the Conservative approach to the economic challenges ahead. This section will conclude by applying them at a high level to the growth, inequality and fiscal challenges set out in Section 1.

Applying Conservative principles to the three challenges

1. A Conservative approach to the growth challenge

Given the UK's recent anaemic growth rates, tackling the growth challenge should clearly be a central focus of Conservative economic policy.

The empowerment principle means private enterprise should be at the heart of a Conservative plan for growth. As Douglas Hogg argued, individual enterprise "is at the very heart and origin of progress".[99] Or, as Margaret Thatcher put it, "Since when have Government Departments won medals as entrepreneurs?".[100]

For Conservatives, the starting point is that markets generally work. Private enterprise through the market mechanism is the bedrock of economic progress, and a necessary – if not sufficient – condition for delivering higher living standards. The private sector should lead, and market forces should be allowed to operate, allowing the economy to deploy its resources in the most efficient way.

This belief in an enabling state is consistent with what is needed to tackle today's low productivity. According to Bart van Aark, Director of the UK's Productivity Institute: "Productivity is done by the private sector…the role of the government is not necessarily to lead productivity growth — they should give businesses the opportunity to do".[101]

This does not mean that Conservatives believe in *laissez faire*, which Hogg noted "has never been good Conservative doctrine".[102] The pragmatic principle means that scepticism about intervention must be weighed against the reality of government's necessary footprint in the economy: setting the laws, regulations and standards that govern economic activity; taking in tax revenue to provide public services and social

security; and shaping economic activity in an effort to correct market failures – from information asymmetries to externalities to the under-provision of public goods – and ensure the benefits of the market are broad-based.

But the bar for intervention should be high. It is not good enough simply to identify the market failure; the challenge is to be confident that government intervention will fix it. As Nigel Lawson put it, "for intervention to be justified, it must be demonstrated that the imperfections of government action are less serious than the imperfection of the market that the intervention in question is intended to correct. And this is not an easy condition to satisfy".[103] Government lacks the information needed to substitute for market signals, cannot adjust instantly to new information and suffers from optimism bias.[104] It is also prone to economically sub-optimal decision-making in the pursuit of political goals.

Unlike public services, which will inevitably have to grow to cope with demographic pressures, it is therefore not inevitable that the state needs to increase in size or scope to tackle the growth challenge. Rather, the primary focus of the state must be to ensure that the right framework is in place to provide private enterprise with the certainty necessary to maximise growth, based on clear, transparent and easily understood principles that will guide the government's approach to intervention.

Crucially, that framework must be underpinned by strong institutions and a focus on aligning incentives. Countries with high-quality institutions tend to have higher growth than those that don't, because institutions help insulate the economy from potentially damaging political meddling and provide the certainty that private enterprise need to invest.[105] Similarly, ensuring the right incentives are in place are vital to maximise growth. A consistent theme of Conservative manifestos since the Second World War has been the importance of incentives, often with reforms to the tax system placed at its heart. As the 1970 manifesto put it, "Our theme is to replace Labour's restrictions with Conservative incentive".[106]

2. A Conservative approach to the inequality challenge

Both the pragmatic principle and the One Nation principle means that the pursuit of growth, while essential, cannot be used to ignore the inequality challenge.

In his mini-budget, Kwasi Kwarteng argued that "For too long in this country, we have indulged in a fight over redistribution. Now, we need to focus on growth".[107] But relying on government being able to boost economic growth so materially as to make distributional concerns irrelevant runs counter to the pragmatic principle. That principle dictates that while believing policy can help boost trend growth, given the structural headwinds facing the UK Conservatism must be sceptical of the government's ability to transform growth back to the levels seen in the decades

before the financial crisis. As Keith Joseph said in 1974, "During 30 years we have tried to force the pace of growth. Growth is welcome, but we just do not know how to accelerate its pace".[108]

Any Conservative worth their salt should be deeply sceptical that any person or institution – especially the government – has within its power the ability to utterly transform Britain's growth prospects. This is particularly true when such plans are based on simple sounding, sweeping policy changes, whether radical tax cuts or billions more in spending.

Further, the One Nation principle dictates that when inequality is high, as it is now, Conservatism must seek to reduce the gap between rich and poor.

In a speech in New York in 1975, Margaret Thatcher attacked the "progressive consensus" that the state should promote equality and be active in redistributing wealth and income. The relentless pursuit of equality, she said, was "not the sole cause of what some have termed the 'British sickness' but its is…a major one".[109] This dismissal of economic inequality has been the mainstream Conservative view ever since. While poverty must be addressed, inequalities of income and wealth in particular are seen as the inevitable result of natural differences in talent, and necessary to provide the incentives that drive prosperity. Attempting to reduce economic inequality risks breaking the link between merit and reward, the argument goes, and undermining our growth prospects.

Yet, as we have seen, there is a long history of thought in the Conservative Party, from Peel and Disraeli in the nineteenth century to Macmillan and Hogg in the twentieth, which has acknowledged, either explicitly or implicitly, that economic growth must be broad-based and that high levels of economic inequality can be problematic.

How can the circle be squared between these two apparently contradictory positions? Some of it, of course, boils down to genuine philosophical differences. But the approaches are not as contradictory as they at first appear. Opposing egalitarianism is not the same thing as believing inequality is never a problem: it is possible to believe both that the pursuit of egalitarianism can be hugely damaging, as the history of the twentieth century showed, and that high levels of inequality must be tackled because they undermine political stability and social mobility – which, as outlined above, are two deeply and long held Conservative values.

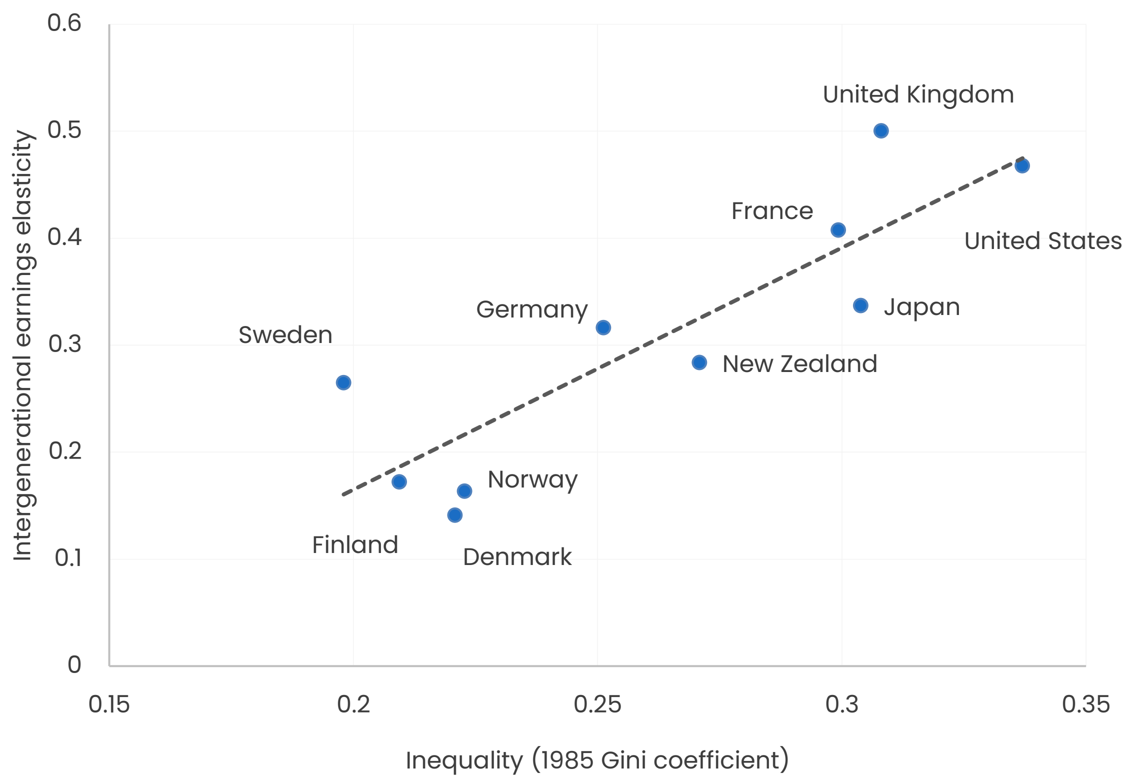
Drawing on the pragmatic principle, the question for Conservatives must be which of these two concerns is greater in any given circumstances, mindful of Balfour's warning that each generation has its own political economy. When Thatcher became

Conservative leader, economic inequality was at historically low levels, with the top 1%'s share of income having fallen from 12% in the early 1930s to 4% by 1972.[110] Wealth inequality had seen a similar trend, as shown by Figure 7 in Section 1. Faced with spiralling inflation and unemployment, a crisis of industrial relations and a tax system that clearly disincentivised enterprise, it is no surprise that she did not view economic inequality as the issue of the day.

Today, a different set of facts present themselves. Economic inequality has risen from historically low to historically high levels, undermining social mobility and opportunity. This is because inequalities of outcome for parents lead to inequalities of opportunity for their children, particularly where parents spend significant amounts on their children's education.[111] The OECD has found that intergenerational earnings mobility – the extent to which individuals can move across the income distribution, compared to where on that distribution their parents were – is lower in countries with higher levels of income inequality.[112] Alan Krueger, Chairman of the US Council of Economic Advisers under Barack Obama, has described this as the "Great Gatsby Curve", which is illustrated by Figure 10.[113]

Figure 10: The Great Gatsby Curve

Source: Alan Kruger for the Council of Economic Affairs, 2012



The upshot is that the higher a country's level of income inequality, the more likely it is that the children of rich parents stay rich, and those of poor parents stay poor. No Conservative should therefore feel comfortable with currently high level of inequality in the UK: it is today's version of Disraeli's Two Nations.

As well as undermining opportunity, high inequality is also undermining political stability. Economic injustice has been a central argument deployed by populists of left and right across advanced democracies in recent years. According to the British Social Attitudes survey, around 80% of the public think income gaps in the UK are too high.[114] Separate research has found that perceived income inequality can have a negative impact on social cohesion.[115]

Higher levels of income inequality also undermine resilience. Average incomes in the UK, France and Germany are similar, but because of higher inequality in the UK, the poorest have 20% lower incomes than in France, and the richest 17% higher incomes. That means poorer households in the UK are less well equipped to cope with economic shocks and disruption when it arrives.[116]

The case that Conservatives should actively seek to reduce inequality is further reinforced by the fact that Thatcher-era concerns that tackling inequality undermines growth no longer appear to hold. Based on the work of people like Arthur Okun, Conservatives in the 1970s feared a trade-off between equality and growth, worrying that policies aimed at tackling inequality, such as progressive taxation, would undermine growth and therefore lower average incomes.[117] Yet contemporary evidence suggests that at least at current high levels of inequality, this should not be a concern. Research from the IMF and OECD even suggest that the rise in inequality in advanced economies in recent decades has slowed growth.[118] Various mechanisms as to how inequality might undermine growth have been put forward, from the effect on human capital investment to increases in financial instability and the impact on demand.

This is not to suggest that, at a certain point, policies designed to tackle inequality will blunt incentives and weigh on growth, as was the case in the 1970s. Nor is it to suggest that any level of inequality is undesirable from a fairness point of view: a link between contribution and reward should remain. But when levels of inequality are as high as they are now, they hold back social mobility and threaten stability.

Conservatives have historically understood this. Talking of Beveridge's proposals for a welfare state in 1944, Douglas Hogg described it as "a scheme for the abolition of want by the instrument of a redistribution of wealth. There is no burking that fact. That is what it is, and that is what seems to me to constitute its very great value".[119] Reducing inequality must once again become a key aim of Conservative economic policy, and it can be done so in a way that does not undermine growth.

3. A Conservative approach to the fiscal challenge

Grounded in the stewardship principle and the idea that every government must ensure it pays its way and does not duly unburden future generations, a belief in sound money has been one of the most consistent Conservative economic beliefs. Furthermore, just as the pragmatic principle means Conservatism must not allow a necessary focus on growth to crowd out distributional concerns, such a focus cannot be used as an excuse to duck the fiscal challenge.

2021 saw Rishi Sunak announce the biggest tax rises in a generation, taking the tax share of GDP to its highest level since the 1950s.[120] These were denounced across the Tory right, with former Brexit minister David Frost describing them as “fundamentally un-Conservative”.[121] Liz Truss put her fierce opposition to them at the heart of her successful campaign to become Prime Minister, and she initially planned to reverse many of them. The Treasury was painted as the bogeyman, with the Prime Minister repeatedly attacking what she called the abacus economics driven by Treasury orthodoxy.[122]

The argument is simple: the Treasury’s short-sighted fiscal hawkishness has been holding back the growth needed to deliver sustainable public finances. These attacks represent a strand of Conservative thinking that prioritises tax cuts above all else, and which believes that the government has within its power the ability to improve the UK’s growth prospects to such an extent that the fiscal position will take care of itself. Such thinking did not survive contact with reality, with the recent mini-budget precipitating a fiscal crisis.

Rupert Harrison, former chief of staff to George Osborne, has described the idea of basing fiscal plans on the ability to unlock higher structural growth as “fantasy economics”.[123] This view was shared by Nigel Lawson, often held out as the greatest of Tory tax-cutting chancellors, when he was at the Treasury: “The notion that tax cuts, without any spending cuts or substitute source of revenue, will so stimulate the economy that the Budget balance will improve, enabling further tax cuts to be made…is a spurious kind of virtuous circle [and] emphatically not part of my thinking”.[124]

As well as being fantasy economics, such thinking is a fundamental misunderstanding of Conservatism. The Conservatives have always pitched themselves as the party of low taxes, but that goal has consistently been secondary to the need for sound money. Robert Peel was the Prime Minister who made income tax a permanent feature of the tax system, having been first introduced on a temporary basis by the Tory Prime Minister Pitt the Younger. In the aftermath of the First World War, Chancellor Austen Chamberlain agreed on the need for spending restraint but saw a high tax burden as an inevitable result of restoring Britain’s national credit, introducing an Excess Profit Tax and Corporation Tax.[125] The 1955 Conservative manifesto, while warning of the negative impact on enterprise if taxes are too high, argued that "in an armed Welfare State the demands on taxable resources cannot be light".[126] Twenty years later, the manifesto for the second election in 1974 stated: "our general objective for taxes is simple: we aim to lower them... Nevertheless, we give warning that in the present economic climate it might prove necessary to raise some taxes in order to pay for immediate objectives".[127]

Thatcher's administration is often seen as a tax-cutting one, but the reality is that the tax take under Thatcher remained broadly flat, with many of the eye-catching personal tax cuts facilitated by increases in North Sea Oil revenues and a big increase in VAT.[128] The early part of her administration in particular saw some big tax-raising budgets, notably Geoffrey Howe's in 1981. Reflecting on this period in later years, Thatcher said: "When we could not get down our public expenditure in the early 1980s as quickly as we wished, we said we would not finance it by borrowing, we would finance it honestly, by taxation, and we did...We said we will do what is right for the long-term because that is much the more honourable thing to do".[129] More recently, Norman Lamont, Ken Clarke and George Osborne all delivered significant tax rises in attempts to control borrowing. Far from being 'un-Conservative', therefore, Rishi Sunak's tax rises drew on a rich Conservative tradition.

This does not mean that Conservatism believes tax rises alone must bear the responsibility for the sustainability of the public finances. Every Conservative manifesto since the war has contained pledges to improve the efficiency of the public sector and root out waste. Significant spending cuts have also been delivered with regularity, from the Geddes Axe in the 1920s to the cuts of the Osborne era. Yet just as true Conservatism, underpinned by the pragmatic principle, rejects the idea of tax cuts being self-financing, it must also reject the fantasy idea that the state can be radically pared back to avoid raising taxes.

It is true that the size of the state did ostensibly fall under Thatcher, from 44% of GDP in the mid-1970s to just under 40% in 1990. But between the mid-1970s and 1990, government spending on goods, services and staff actually increased from 18% to 22% of GDP, with the size of the central government civil service increasing.[130] Moreover, the headline fall in the size of the state came almost entirely from a wave of privatisations combined with real terms cuts in benefits. The former trick cannot be repeated, while the latter had damaging impacts on those suffering from the economic dislocation of the 1980s.

That Conservative economics must not duck the fiscal challenge should not be controversial. There will of course be a need for spending restraint, including efficiency and public service reforms. But given the scale of these pressures, it seems highly unlikely – or desirable – that we will be able to avoid some increase in the size of the state: we are simply dealing with the costs of having better healthcare as we grow richer and of offering people dignity in retirement. That being so, it seems highly unlikely that further tax rises can be avoided medium-term, let alone the radical reduction in the size of the state that would facilitate sustainable broad-based tax cuts. The task, as Ken Clarke put it in his 1993 Budget, is simple: "I need to raise revenue, but to do so in a way which does least damage to the economy".[131]

Conclusion

Conservatism has a rich history of economic thinking to draw on as it approaches the growth, inequality and fiscal challenges, from which four principles endure.

First, the pragmatic principle. Conservative economics has been pragmatic, sceptical of ideology and grounded in realism. It has rejected intellectual rigidity, instead adapting to address the issues of the day.

Second, the stewardship principle. Conservatism has embraced change, both for the progress it delivers and as necessary for political and social stability. The task has been to manage it carefully, taking action to protect disrupted people and communities.

Third, the One Nation principle. Prosperity and opportunity should be broadly shared across society, with the poorest in particular supported.

Fourth, the empowerment principle. The size of the state should derive not from any arbitrary metric but from a clear conception of its role in enabling – rather than controlling – economic activity, and in ensuring the provision of certain services and support across society.

Applying these principles to the growth challenge, the inequality challenge and the fiscal challenge, this section has argued that increasing the UK's trend growth must be absolutely central to Conservative economic policy. The empowerment principle dictates that strategy should be based on the concept of an enabling state setting the conditions for growth, acknowledging the need to step in to correct market failure but with a high bar for intervention.

The pragmatic principle demands that such a strategy also needs to be grounded in realism, however. A proper Conservative must acknowledge that even a perfectly executed growth plan may nevertheless not return growth to previous levels given the structural headwinds the economy faces. The pursuit of growth cannot, therefore, be used as cover to ignore the inequality and fiscal challenges.

The One Nation principle means that currently high levels of economic inequality must be reduced, both by reducing earnings inequality and redistributing more through the tax and benefit system. Done well, this need not weigh on growth. Further, the stewardship principle means the long-term fiscal challenge cannot be avoided by relying on the myth that tax cuts can be self-funding or the state can be radically reduced in size. Efficiency and public service reform must be a key part of controlling long-term spending pressures, but artificial limits on the size of the state must be rejected as unachievable. Tax rises in the medium term will be required; the challenge will be to do them in the fairest and least economically damaging way.

The final section of this paper will now apply this principle-based framework to provide specific proposals to tackle these three challenges.

Conservative economic principles in practice

Section 3

The first section of this paper set out the three main challenges – growth, inequality and fiscal – that any Conservative economic policy will need to address over the coming decades. Drawing on the history of Conservative economic thinking, the second section then established a set of enduring principles that should be applied to these challenges: pragmatism, stewardship, One Nation and empowerment.

This final section applies these principles to specific policy areas and begins to provide a practical framework for Conservative economics. For illustrative purposes, one main principle has been focussed on for each policy area, even if multiple principles are applicable.

The policy areas covered are broad, looking at many of the main economic levers government has at its disposal: macroeconomics; the labour market; supply side; and tax policy. But it is not exhaustive and should not be read as a manifesto containing extensive lists of detailed policy proposals. Little attention is given to crucial issues such as public service reform, the net zero transition, immigration, international trade or regional policy, for example. Rather, the aim is to use a key area of policy to explore how each of the four principles should apply in practice, and to give a flavour of the direction of travel required and the key priorities in each area.

Although some of the proposals below are significant, particularly on tax and social security, much of the approach outlined involves an evolution rather than revolution in policy. This reflects both a stewardship approach that change must be gradually managed and the fact that, while new thinking is always required, what the UK economy currently requires above all is a combination of certainty and a resolute focus on delivery.

Macroeconomic policy: the need for pragmatism

A coherent macroeconomic policy can respond to the inequality challenge by supporting the most vulnerable during economic shocks and downturns; the growth challenge by limiting the permanent economic damage from such events and by helping to provide the funding framework for government to tackle market failures; and, most obviously, the fiscal challenge by ensuring the public finances remain on a sustainable footing irrespective of the economic backdrop.

This means that all four principles are relevant: stewardship to smooth economic change and ensure the right institutional framework is in place; One Nation to ensure the most vulnerable are protected from economic shocks; and empowerment to ensure that the tax and spending frameworks are designed to maximise private sector led growth. But if recent years have taught us anything, it is the need for macro policy to be able to adapt to changing economic circumstances: the financial crisis, Covid and the war in Ukraine have all delivered huge shocks to the UK economy, but each has posed different challenges and therefore required different macro responses. Pragmatism, in particular, is therefore vital.

In the post-war era, the cross-party consensus was that fiscal policy should be used to manage the economic cycle, fine-tuning demand to achieve full employment. Monetary policy's role was primarily to keep interest rates down to ensure the UK could service the historically high debt levels it emerged from the Second World War with. Beginning with Thatcher, however, this thinking was flipped on its head. The focus of macro policy became controlling inflation rather than pursuing full employment, the target for which was dropped. The roles of fiscal and monetary policy also shifted: fiscal policy increasingly focused on managing the public finances, with monetary policy working to manage the economic cycle and control inflation. This was accompanied from the late 1990s with a new institutional framework.[132]

This institutional framework has had strong international credibility, at least until recently. The independent Bank of England setting monetary policy, the OBR producing independent forecasts, and the government setting out clear fiscal rules have all been vital components of that framework.[133] The recent market reaction to the government's fiscal approach has served as a stark reminder that this credibility cannot be taken for granted.

That reaction was not the result of a failure of the government to communicate properly its economic strategy, nor simply part of a global trend, as the Truss government tried to argue. Anyone watching gilt yields during August saw them rising sharply as it became increasingly clear that Liz Truss was going to be Prime Minister, what her plans for the public finances would be and what her attitude to the UK's institutional framework was. The market reaction to the mini budget should not, therefore, have taken the government by surprise: all the warning signs were there. The yield on 10-year UK gilts rose from 1.9% at the beginning of August when Truss became favourite to become Prime Minister, to 3.8% even before the mini-budget statement pushed them even higher. This compares to much smaller moves in other countries over the same period, a clear sign of markets looking nervously at the UK and deciding to apply a significant risk premium to its borrowing costs.[134]

A combination of a leadership campaign that saw question marks raised over the independence of the Bank of England; the sacking of the Treasury permanent secretary; the huge fiscal loosening announced at the mini-budget with no indication as to how the government would meet its fiscal rules; and the lack of independent scrutiny for the government's fiscal plans from the OBR all contributed to that nervousness. These events serve as a reminder that the risk premium attached to UK debt by investors – and therefore how sustainable a particular level of debt is – is shaped to a large degree by confidence in that framework. Conservatives' belief in the importance of institutions, underpinned by the principle of stewardship, means the starting point for any macro policy approach should be wary of radical departures that could undermine confidence in that framework and destabilise markets.

This is not to say the UK's institutions should be above criticism or reform. The Bank of England has been admonished recently for being behind the curve on inflation. In the immediate term, it should be left to focus on getting inflation back to target in a way that does the least economic damage. In due course lessons should be learned around what the current inflationary spike can teach us about future monetary policy. In particular, there are legitimate questions to be asked about some of the Bank's forecasting, its communications and the role that quantitative easing has played in monetary policy. But since Bank of England independence in 1997, inflation has averaged very close to the 2% target.[135] Any changes that come from an analysis of the Bank's recent performance should not undermine the principle of independence, and any reform to its remit must be weighed pragmatically against the risk of further unnerving international investors and undermining the UK's institutional credibility.

Fiscal policy

In a paper co-authored before taking up his current role as Chairman of the OBR, Richard Hughes set out three primary objectives for fiscal policy: to support monetary policy in stabilising the macroeconomy and managing the economic cycle; to ensure the sustainability of the public finances; and to support long-run growth and social welfare.[136] The challenge for policymakers is to balance these three objectives.

1. Managing shocks

A pragmatic approach to economic crises means that each shock must be confronted on its own terms. For example, the persistently low interest rate environment in the 2010s reduced both the ability of monetary policy to support the economy through downturns and concerns about the serviceability of high levels of national debt. This clearly put the onus on fiscal policy to do more when Covid struck. More recently, however, fiscal concerns have returned to the fore through a combination of the damage done to public balance sheets by Covid, the risks of fiscal policy adding to inflationary pressures, and the impact that looser fiscal policy and sharply rising borrowing costs have had on the sustainability of the public finances. This means a different set of concerns have confronted policymakers during the current energy price shock.

During post-war UK recessions, the Bank of England base rate has been cut by an average of 5 percentage points. With that rate below 1 per cent, monetary policy's firepower was clearly constrained when Covid struck.[137] Further onus was put on discretionary fiscal policy by the weakening in recent years of the economy's automatic stabilisers, that part of the tax and social security system that automatically fluctuates over the economic cycle.[138] The aggressive use of fiscal policy to support the economy through Covid this necessitated – the UK's initial stimulus was the third largest across advanced economies, and many multiples greater than Alastair Darling's financial crisis stimulus – was a huge policy success, limiting Covid's permanent economic damage.[139]

When monetary policy is constrained, fiscal multipliers will likely be large – and fiscal policy is therefore particularly effective at boosting economic activity when demand falls.[140] In line with a One Nation approach, fiscal policy can also be more targeted at those who need support the most. For these reasons, when monetary policy is at the zero lower bound fiscal policy should be used aggressively to limit scarring during recessions, with short-term concerns about the public finances put to one side. This does not, however, mean a carefree approach. In particular, careful thought must be given to ensure that stimulus can in fact be temporary. The experience of Covid was largely successful in this regard, with the temporary universal credit uplift and VAT and business rate cuts successfully ended.

But when – as now – the economy's number one problem is a period of sustained high inflation, the pragmatic principle means a different approach is required. In these circumstances, broad-based fiscal loosening, particularly when permanent, is exactly the wrong approach. Temporary support can still be appropriate, and worth the trade-off of both the extra inflation and the higher debt it may bring. Given the scale of the energy price shock, there was clearly a very strong case for fiscal policy cushioning the blow, at least in the short-term, for households and for business, though in an ideal it would have been better targeted at lower- and middle-income households. But as we have recently seen all too clearly, large, broad-based, and permanent packages of fiscal support risk unnecessarily exacerbating the inflationary problem, simply forcing the Bank of England to raise interest rates more aggressively and thereby causing significant problems for mortgage-holders and weighing on investment by sharply raising the cost of capital for businesses.

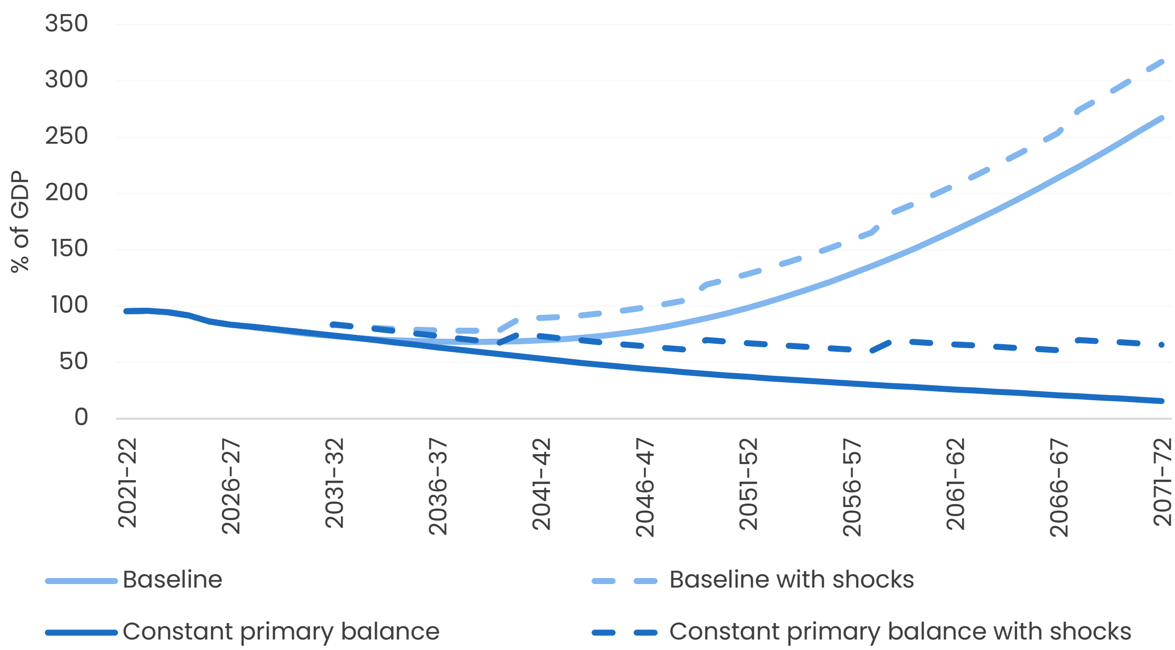
2. Delivering the consolidation

Permanent, unfunded fiscal loosenings are not, however, primarily an inflationary problem given the Bank of England has the tools to counteract their impact. More fundamental is the risk they pose to the long-term fiscal position. The acknowledgment that fiscal policy should sometimes be used aggressively during downturns should not be confused with a belief that fiscal sustainability has become a second-order problem. In fact, the reverse is true.

A combination of the financial crisis and Covid has seen the UK's debt-to-GDP ratio more than double since 2007, from below 40% to over 90%.[141] Furthermore, as the OBR has pointed out, "the experience of the past two decades makes it hard to escape the conclusion that the world is becoming a riskier place".[142]

If fiscal policy is to be used more aggressively during downturns, and those downturns happen more regularly, a pragmatic approach means that the pace of consolidation during good times must adapt and become faster than previously contemplated. As illustrated by Figure 11, if all policymakers do in good times is stop debt rising – or at best get it falling gently – they are consigning the national debt to ratchet up over time with each downturn, adding to the already unsustainable long-term fiscal position set out in Section 1. It would also undermine the ability of fiscal policy to respond to future downturns by reducing fiscal space which, according to the OBR, "in the absence of perfect foresight…may be the single most valuable risk management tool".[143] This would be in clear contravention of the stewardship principle outlined in Section 2, passing unsustainable burdens on to future generations.

Figure 11: Sensitivity of net debt projections to stylised shocks
Source: OBR Fiscal Risks and Sustainability report, July 2022

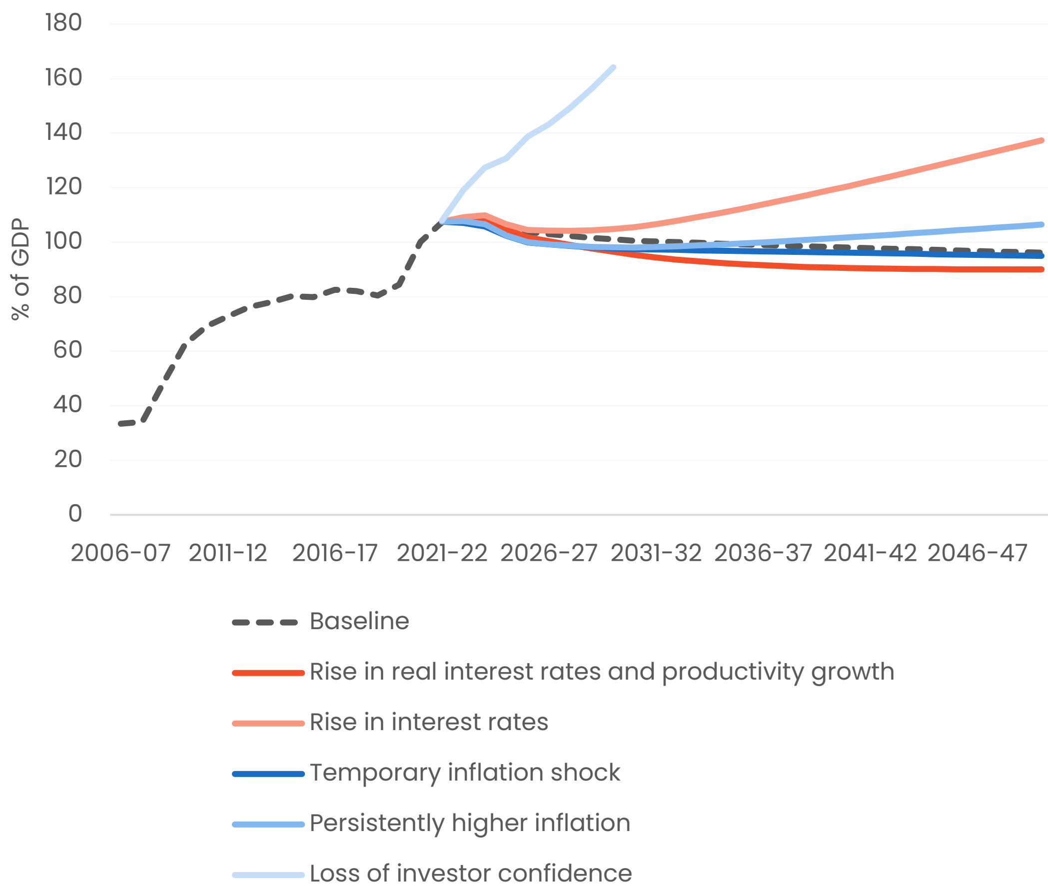


Furthermore, the combination of the significant recent increase in the UK's debt stock and the shorter effective debt maturities that have resulted as a by-product of quantitative easing leaves the public finances more exposed – and more quickly – to rises in interest rates.[144] The first-year fiscal cost of a one percentage point increase in interest rates is now six times what it was before the financial crisis.[145]

The extent of this exposure depends on the nature of the interest rate rises, of course. While it is true that interest rate rises accompanied by inflation are likely to have a minimal impact on fiscal sustainability, the OBR is also clear the increases in index-linked gilts and the shortening of debt maturities means that inflation is no longer an effective way to reduce the debt-to-GDP ratio. Further, while it is also true that where higher interest rates are driven by higher growth, this may in fact improve the sustainability of the public finances, there are also scenarios in which interest rate rises have a significant and negative impact on the sustainability of the public finances: for example because of a global shift in investor confidence away from government bonds towards riskier assets, or a complete loss of investor confidence in the UK's creditworthiness.[146] Recent events serve as a stark reminder that such scenarios are a genuine and serious risk.

Figure 12: Cost of public debt scenarios: public sector net debt

Source: OBR Fiscal Risks and Sustainability report, July 2022



Despite recent events, the central scenario is that, driven in large part by demographics, global interest rates remain at historically low rates over the medium-term.[147] But a pragmatic approach needs to plan for tail risk and the path is uncertain, with some economists arguing that Covid will mark a turning point as we see a permanent return to higher inflation, driven by globalisation going into reverse and labour forces suffering demographically-driven declines.[148] This only adds weight to the argument that the UK's debt-to-GDP ratio should fall swiftly in good times.

Between 1956 and 2019 there was on average a recession every nine years, with each one adding ten percentage points to debt-to-GDP.[149] Assuming each one lasts three years, in order to prevent the ratcheting up effect described above, as a broad rule of thumb the government should have debt-to-GDP falling by around 1.5% points per year on average in normal times. By building up fiscal space, this will allow aggressive support in downturns while limiting exposure to future interest rate rises.[150]

In terms of timing the transition from fiscal support to consolidation, there are risks both ways: consolidate too quickly, and it risks an unnecessarily sharp adjustment before the economy has fully recovered; leave it too late, and the political moment to consolidate may have passed, while the time to build fiscal space before for the next crisis is more limited.

Balancing these risks, an approach rooted in Conservative pragmatism should see fiscal policy erring on the side of withdrawing support too slowly than too quickly, maximising the chances of limiting economic scarring. While the major consolidation carried out after the financial crisis was always going to have been required, one of the legitimate lessons from that episode is that we should not rush to consolidate until the recovery is secure. Concerns about ensuring time to build up fiscal space can be addressed by ensuring the consolidation, when it comes, is sufficiently tight. The exact timing will vary from crisis to crisis. But as a broad rule of thumb, the consolidation should not kick in until the year the OBR forecast the economy will return to full capacity.

3. Promoting growth

The new government's relentless focus on the role tax cuts might play in unlocking growth has dominated the recent economic debate in the UK. That debate has, however, drawn little distinction between temporary tax cuts aimed at supporting the economy in the short-term; broad-based, permanent personal tax cuts to support individual prosperity or reduce hardship; and targeted tax cuts aimed at improving the supply side of the economy.

This distinction is worth pausing on. We have seen above the vital role that temporary fiscal support plays in stimulating demand during economic downturns. It would be economically unorthodox, however, to suggest that permanently looser fiscal policy driven by unfunded broad-based personal tax cuts – or indeed unfunded broad-based spending increases – will expand the productive capacity of the economy.

This orthodoxy has been challenged recently by those who argue that sluggish demand – in part driven by overly tight fiscal policy – has constrained supply. This was a view put forward by Janet Yellen, former Chair of the Federal Reserve and current US Treasury Secretary, in a 2016 lecture, and has been part of the thinking behind the economic approach taken by the Biden administration.[151] Yet recent high inflation serves as a painful reminder of how real supply constraints are, which is part of the reason why the broad-based permanent fiscal loosening announced at the mini-budget was so problematic.

Where fiscal policy does have a role in promoting growth – in addition to minimising scarring from recessions – is in funding targeted interventions to improve the supply side of the economy, creating the conditions for private sector led growth in line with the Conservative principle of empowerment. Both well-designed spending and tax policies should be part of this mix. The challenge, however, is that there is a clear trade-off with ensuring fiscal sustainability.

In recent decades that trade-off has been managed by designing a set of fiscal rules that outside of downturns has debt declining, but still allows a certain amount of borrowing for investment purposes. The current fiscal rules commit to balancing day-to-day spending and having debt falling on a three-year forward look, but within that allow borrowing for investment purposes of up to 3% of GDP.

There is merit to this framework. Where spending today provides benefits in the future – such as infrastructure – it is fair that future generations should contribute to that spending. But it also creates problems. Not all investment will provide significant benefits to future generations, particularly when politically driven. Further, the government currently uses a definition of capital that is investment in fixed assets less depreciation, in line with international accounting standards for private companies. But some day-to-day spending – notably education and training – provides future benefits.[152] A rigid fiscal framework that only allows borrowing for investment in physical capital risks leading to under-investment in human capital at a time when one of the UK's main productivity challenges is poor skills.

As Chris Giles has argued, we have become too focused on the idea that we only borrow for investment purposes. A pragmatic approach should only see that as a rule of thumb; what ultimately matters is whether the public finances are on a sustainable path.[153] With a capital budget already at its most generous sustained level since the 1970s, and with government struggling to spend all of it, there is a strong case for transferring some of it into delivering an uplift in spending on human capital.

There is therefore a clear need for a pragmatic approach to fiscal rules. They are a crucial part of a credible macro framework but, as former Treasury Permanent Secretary Nicholas Macpherson has argued, there is "a risk that economic policy makers become so fixated by the intricacies of targetry, that they cease to see the woods for the trees".[154] Fiscal rules should therefore be seen as broad targets rather than strict rules: this will both prevent perverse incentives like the one described above, and also unnecessarily sharp and potentially damaging adjustments in response to inevitable forecasting changes.[155]

Labour markets: the need for stewardship

As set out in Section 1, the slowdown in human capital growth is one of structural headwinds now weighing on UK growth, while skills-biased technical change has contributed to rising inequality. Labour market policy therefore has a crucial role to play in tackling both the growth and inequality challenges. In the coming years the UK labour force will also need to adapt to significant structural shifts resulting from Covid, Brexit and rising trade and geopolitical tensions. Perhaps most significantly, it will need to deal with the challenge posed by automation and the diffusion of technology throughout the economy.

In thinking about how labour market policy should respond to these challenges, all four principles are once again relevant. Labour market and social security policy will need to deal pragmatically with the specific changes to the nature of work. A One Nation approach will value investment in human capital as part of a strategy to ensure growth is broad-based and that the vulnerable are supported. An empowering state would recognise the benefits of the UK's flexible labour market and the need for labour market policy to be designed with the needs of the private sector firmly in mind. But given the scale of the economic change coming, labour market policy is an area which above all illustrates the importance of stewardship: acknowledging that change is both inevitable and welcome, but that the disruption it will bring must be managed carefully so as not to undermine stability.

Skills

To prepare the British labour force for the changes ahead, the stewardship principle means we must invest more in human capital.

Low skills are a problem for employers, employees and the UK economy alike, and a big part of the UK's productivity underperformance compared to some of its peers. UK workers have comparatively poor basic and technical skills, and literacy and numeracy among young people have slipped compared to previous generations.[156] Yet, as discussed above, the UK's fiscal rules have incentivised investment in physical capital spending, paving the way for sizeable increases in infrastructure and R&D spending but weak investment in human capital.

By 2030, official estimates suggest that 7 million additional workers – 20% of the current workforce – could be under-skilled for their work, with the most acute issues in digital and managerial skills.[157] Workers will also need to change the types of skill they need. One McKinsey study identified 56 core transferable skills that workers across the economy will need to prosper in an increasingly automated economy: cognitive skills, such as communication and critical thinking; digital skills; interpersonal skills, such as empathy and teamwork; and self-leadership, including entrepreneurship.[158]

This is by no means exclusively a challenge for the knowledge economy. Low-skilled workers in routine occupations are more likely to be affected by labour market change: over a quarter of low-skilled workers are employed in an industry which is declining or reducing its workforce, work in an occupation that is slowly becoming defunct, or have a job with a high likelihood of automation. Workers with fewer than four GCSEs are more than one and a half times more likely to be in jobs at high risk of automation compared to workers with degrees, and more than twice as likely to be in an occupation which is declining.[159]

These multiple forms of disruption require a considered approach centred on stewardship. The possibility for large parts of the labour market to suffer long-term scarring if policy does not manage the transition could be considerable. This puts a premium on both vocational and technical education, where there is a large, relatively fresh set of policies comprising apprenticeships, in-work learning, new Institutes of Technology, T-levels, the Lifelong Loan Entitlement and more. But it is an area which has been consistently underfunded for several decades: what is now needed is proper funding and delivery.

The focus on further education must not, however, come at the expense of higher education. The high skilled jobs of the future will require higher technical skills, but they will also need more highly skilled graduates. While there are some degrees at universities which clearly offer no value and should be clamped down on, the UK has world-class universities, and for the vast majority of people getting a degree will lead to them being more productive and earning more than people with similar characteristics who do not get degrees.[160] There is also no sense that the UK has reached saturation point in terms of people going to university, with a number of OECD countries having higher participation rates than the UK's 53%. Ireland and Japan both have rates above 60%, for example.[161]

Similarly, while focus on skills provision post-18 is essential, evidence from the OECD suggests that those adults who take part in education and training tend to be those who already have at least a basic level of skills. The adult skills system simply cannot close the gaps that develop during the early years of childhood or at school.[162] More needs to be done, therefore, on early-years interventions, which are particularly effective at helping those with below-average performance improve. The school system – by far the biggest plank of any government's skills policy, in numerical and budgetary terms – also needs to evolve to equip young people with the skillset needed for tomorrow's labour market.

Above all, the UK needs to invest properly in its present and future workforce. According to the IFS, despite recent increases, by 2024-25 spending on adult education and apprenticeships will still be 15% below 2009-10 levels.[163] Schools' spending on a per pupil basis will be 3% lower.[164] Given increasing human capital can play a big part in tackling both the growth and inequality challenges, investing in it at all ages should be an absolute priority. If tough choices are required to ensure tackling the fiscal challenge is not undermined, then investing in human capital should be prioritised over funding in infrastructure and R&D given those areas have seen much bigger funding uplifts in recent years.

Minimum wage

One of the best examples of successful regulatory intervention over the last two decades has been the introduction of, and regular increases to, the national minimum wage. It has allowed the UK to retain the benefits of a highly flexible labour market while simultaneously moving aggressively to boost the wages of low earners. This serves as a clear example of where government intervention has been entirely justified.

While underpinned by One Nation principles, the policy on the national minimum wage is also a textbook example of the Conservative party applying the pragmatic principle. Having initially opposed the policy's introduction under New Labour, the party shifted its position as the fear that it would lead to a swathe of job losses failed to materialise. Ultimately it was a Conservative government that has moved to end low pay by the middle of this decade by setting a target for the minimum wage to reach two thirds of median earnings. The result will be that the UK will have one of the most generous minimum wage levels in the OECD.[165]

While we are likely reaching the limits of how much further minimum wage policy can go, this policy should remain an important plank of tackling the inequality challenge. Flexibility in the timing of implementation may be needed if unemployment unexpectedly rises sharply, but any ideological attempt to halt it as part of a deregulatory agenda should be firmly resisted.

Social security reform

The Conservatives need to move on from the divisive politics that have pitched the debate on welfare as a false dichotomy between those who want to be in work and those who "choose" to be on welfare. The welfare system has always been there to complement the world of work, both by stewarding workers through the negative impact of economic shocks and, in line with the empowerment principle, by ensuring the UK economy has the labour force it needs.

Covid brought into sharp view the strengths and weaknesses of the UK's social security system. One of the most impressive aspects of the state response to the pandemic was that Universal Credit, which had been beset with delivery challenges over the previous decade, withstood unprecedented pressure. The system handled 100,000 claims on one day alone, and a million in the fortnight following the first lockdown in March 2020.[166] The scale and speed with which the furlough scheme was rolled out was also hugely impressive.

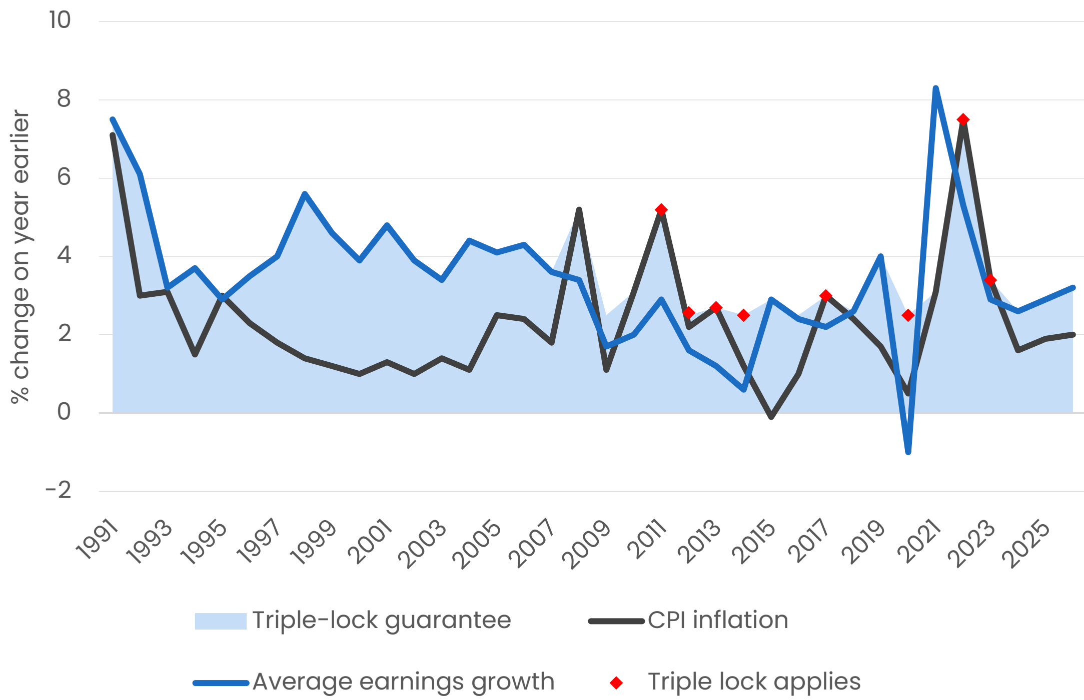
However, the fact that the government had to introduce large scale and significant support, almost overnight – most notably with the introduction of furlough and the £20 uplift to Universal Credit - was an acknowledgment of the limits the current social security system, even taking into account the historic size and nature of the economic shock. Other countries, such as Germany, whose social security systems provide more generous safety nets, did not have to take such a radically different approach when confronted with the same shock.

Going forward, therefore, the social security system needs to do two things. First, in line with the stewardship principle, it must be reformed to ensure that it provides a better safety net, fit for an era in which both significant economic restructuring and more regular economic shocks are expected. Second, drawing on the empowerment principle, it should further incentivise people into work to ensure the private sector has a bigger pool of available labour to draw on to drive growth.

When it comes to social security, it is important to distinguish between pensioner and working-age benefits. As illustrated by Figure 13, a desire to reduce pensioner poverty has seen pensioner benefits rise by above earnings over the last twenty years thanks to the triple lock, which sees the state pension increase by the highest of earnings, inflation and 2.5%. Given the fiscal challenge, it will be increasingly hard to justify the continued special treatment of pensioners over the longer-term, particularly as the UK faces up to the reality of funding an increasingly elderly population.

Figure 13: Triple lock premium

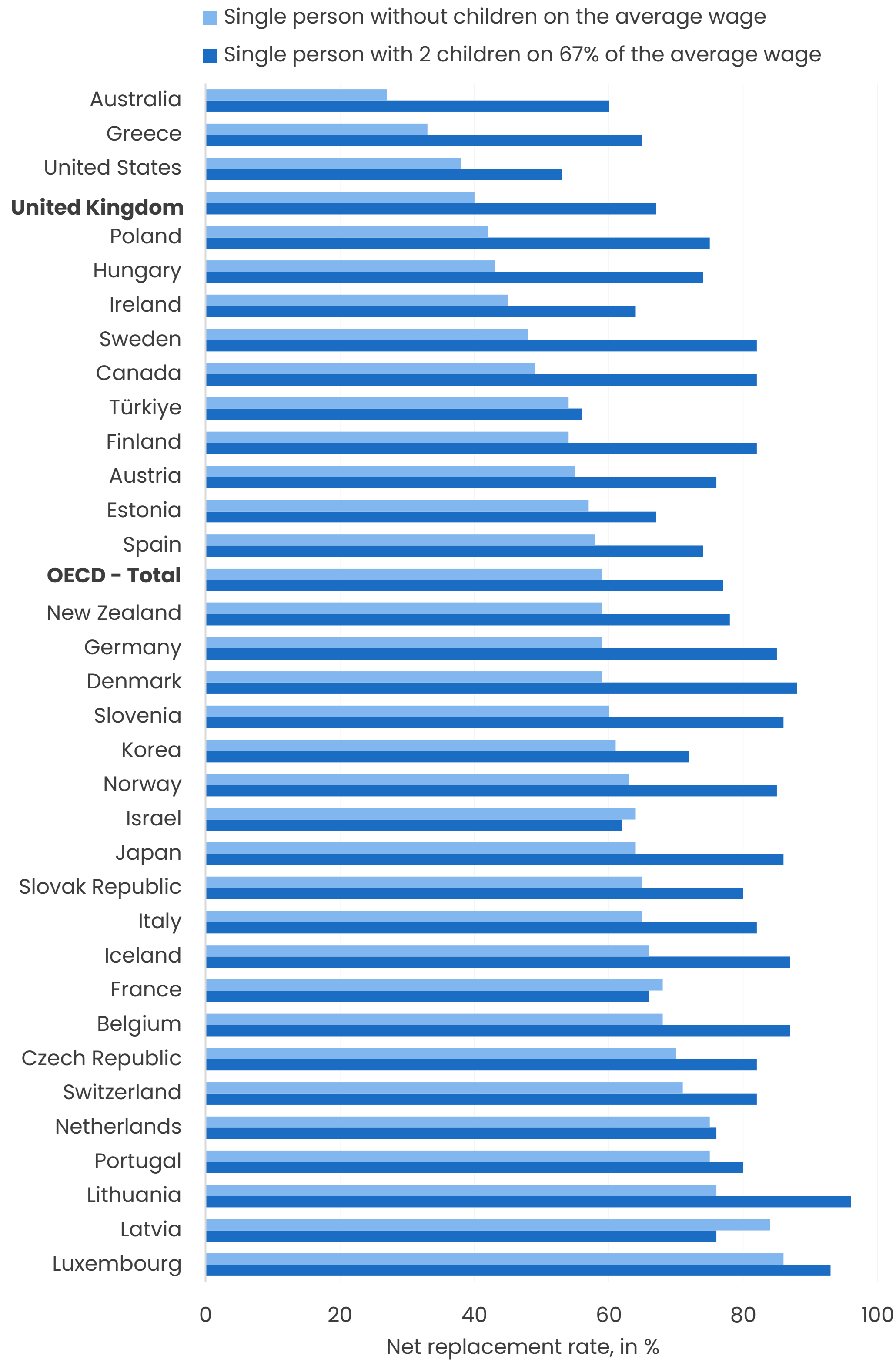
Source: OBR Fiscal Risks and Sustainability report, July 2022



By contrast, the working-age benefits system provides a low level of basic support which is then significantly topped up by a range of specific measures, notably around housing, children and ill health. Sharp rises in housing costs and disability and ill-health caseloads mean that, despite the UK spending marginally more than the OECD average on working-age benefits as a share of GDP, unemployment benefit in the UK is the lowest in the OECD, is at its lowest level in thirty years and represents just 14% of average earnings.[167] The result is that the UK has much lower levels of income protection for workers when they lose their jobs than other OECD countries, as demonstrated in Figure 14.

This contributes to UK workers having lower financial resilience and being more exposed to economic shocks. For example, the share of UK households who experience a substantial fall in income – defined as 25% or more – when a household member loses their job is 41%. That compares with 20% in France and 28% in Germany.[168]

Figure 14: Net replacement rates in the event of unemployment, 2020
Source: OECD Social and Welfare data



The UK's low replacement rates are linked to the social security system having become increasingly means-tested over time. Beveridge put the contributory principle at the heart of his vision: "Benefit in return for contributions, rather than free allowances from the State, is what the people of Britain desire".[169] But the contributory principle is now almost completely missing from the system, in contrast to the European welfare models that have higher replacement rates. This has partly been driven by the desire to save costs, but also by a broader economic rationale: providing sharp incentives to find work in order to maximise the chances of people moving back into the workforce quickly.

Yet two problems persist. First, for certain groups, the basic level of unemployment benefit is very low. Second, while long periods out of employment are clearly undesirable, providing higher unemployment benefit – at least for a time-limited period – allows people either to take the time to find a job that better matches their skills, or undertake some form of retraining. Both of these may deliver wider economic benefits.

There is therefore a compelling case to strengthen contributory benefits to provide higher replacement rates. By significantly uplifting the basic rate of unemployment benefit for a time limited period for those who have been in work for a certain period previously – for example six months – the safety net can be expanded while striking a better balance between the risk of blunting work incentives and allowing people the time to find the right job or upskill. Putting the contributory principle back into the heart of the social security system would also help to build public support for it: there is a link between countries which have contributory systems and public support for the social security system.[170] It would also be consistent with the Conservative belief that fairness is about rewarding hard work and effort. The cost of such a measure will depend on the exact design, but in normal times need not be above low single figure billions.[171]

Incentives could also be improved in other ways, with the state acting to empower the private sector by expanding the pool of available labour.

The cutting of the taper and work allowances announced at the October 2021 Budget significantly reduced the marginal effective tax rate for someone on Universal Credit and is expected, according to the OBR, to increase the labour supply, with the most significant effects likely to be in bringing non-working mothers into the workforce.[172]

These effective marginal rates remain much higher than those paid by the highest earners, so there remains a case for going further on cutting the taper rate.

But taper rate cuts push the eligibility for Universal Credit claimants ever further up the income scale: a one earner couple can earn nearly £60,000 before losing all of their Universal Credit.[173] A more targeted approach would be specifically to target second earner households, who face particularly steep disincentives to work because

Universal Credit is calculated on a household basis, so once one person is earning above the work allowances threshold, the second earner immediately faces the taper. Introducing a second earner allowance in Universal Credit should therefore be prioritised over further cuts to the taper, with second earners likely to be highly responsive to improved incentives.[174]

Improving incentives should not be limited simply to the social security system. More can be done to incentivise the participation of both older and female workers in the labour market. For example, increasing from 55 the age at which pensions can be accessed without incurring a tax charge should be looked at in order to disincentivise early retirement, as should the reform and expansion of childcare support to improve incentives for mothers to return to the workforce.

Supply-side reform: the need for an empowering state

The Truss government rightly made supply side reform central to its economic plans. Supply side reform is key to addressing the growth challenge, notably by tackling historic under-investment in both physical and (as discussed above) human capital. It can also help address the inequality challenge. In addition to education and skills there are a range of areas of supply side reform, including housing and competition, which have the potential both to support growth and reduce inequality.[175]

While pragmatic, stewardship and One Nation principles are all relevant to supply side reform, the key issue is around the role the state should play in directing economic activity. A Conservative approach must be much more nuanced than the simplistic view of some on the right who believe the state should simply get out of the way. Instead, such an approach should be centred on the concept of an empowering state setting a clear and certain framework for government's role in the economy, with a high bar for intervention based not just on the identification of market failure but on a conviction that government intervention will improve things. The state should seek to enable, not control, economic activity.

Scepticism towards intervention that lies at the heart of the empowerment principle should not be confused with a lack of strategic thinking, however. Acknowledging that government has *a* role in directing economic activity means it should be uncontroversial to believe policymakers should think strategically about that role. A whole range of policies are available to the government to influence economic activity. If these tools are not used strategically, resources will be wasted and in many cases policy challenges made worse. It will also create uncertainty for businesses and investors, holding back growth.

Whether it is called an industrial strategy or not, a coherent framework is therefore needed to guide government's role in directing economic activity, even if that framework's starting point is sceptical of intervention. A Conservative strategy should focus on two areas: first, ensuring the right competition and regulatory regime is in place, including strong state aid rules and a robust competition regime; and second, on the provision of public goods which will be under-funded by the public sector – notably infrastructure, innovation and skills – or uncoordinated without government helping to align the public and private sectors around common goals.[176]

Based on this framework, the aim of supply side reform should be to unlock capital in the economy – whether human, physical or intangible – and to increase dynamism through the competition and regulatory regime. Proposals for how some of these issues should be approached are set out below. But the starting point must be the right institutional framework.

Institutional framework

Cross-country and historical experience show that longevity, along with scale and policy co-ordination, is vital for government policy to have any sustained impact on productivity.[177] A vital part of the state's empowering role is therefore to provide that longevity by ensuring the right institutional framework is in place.

A Conservative economic strategy must be underpinned by a commitment to the importance of independent institutions. This has historically been a UK strength, with a robust set of independent economic institutions including the Bank of England setting interest rates; the OBR producing economic and fiscal forecasts; and a set of economic regulators overseeing the UK's regulated utilities sectors.

This does not mean that the regulators should not be accountable, or indeed reformed where there are issues that need addressing. But they must be free from direct political interference. There is a reason why these independent institutions were created in the first place: they emerged out of a recognition that the political process was leading to suboptimal policymaking. Anyone who thinks we should take more political control over interest rate-setting, for example, should look at how the politicisation of the central bank is working out in Turkey.

In addition to reaffirming the independence of existing institutions, the UK's institutional framework needs strengthening in new ways. While by no means an exhaustive list of the reforms that might be undertaken, there are three specific areas where reform is required.

First, a proper institutional framework needs to be put in place around the UK's industrial policy. To date, industrial policy has tended to be politically driven, haphazard, and characterised by regular cycles of new policy announcements that are then rolled back or de-prioritised when administrations change, with the absence of a rigorous system of economic evaluations making it easier for political considerations to drive policymaking. In just six years in the UK, the government has had an Industrial Strategy replaced by a Plan for Growth and then a Growth Plan, all with very different economic philosophies behind them. The result has been a lack of consistency and co-ordination that has undermined UK industrial policy.[178]

In order to address these issues, arms-length, independent oversight is needed. The National Infrastructure Commission and Climate Change Commission both fulfil these functions in their respective areas, but the UK does not currently have one covering supply side policy and the approach to productivity.

Theresa May's government tried to create such an institution – the Industrial Strategy Council – but it was abolished by the Johnson administration in what has been described as "a case study in how to waste business efforts and create greater unnecessary uncertainty".[179] A version of it should be reintroduced. A range of models are available, including Australia's Productivity Commission or South Korea's Korea Development Institute. The OECD has set out some principles of best practice: independent governance, research capacity, transparency, broad economy-wide frames of reference and linkages into government policymaking mechanisms.[180] Above all, it needs to be put on a statutory footing to ensure longevity.

Second, devolution.[181] Co-creation between the private sector and local leaders and institutions should be central to any efforts to tackle supply side reform. The UK is more centralised than virtually any other advanced economy when measured by both tax raised and public money spent locally. Yet the evidence shows that England's mayors are having a positive impact in many areas, from transport to skills to local investment.[182] As the Industrial Strategy Council concluded before its abolition: "Sustained local growth needs to be rooted in local strategies, covering not only infrastructure but skills, sectors, education and culture".[183] Devolution can help achieve policy certainty by ensuring local buy-in; it can allow for more experimentation, providing the evidence base for effective policies to be rolled out more broadly; and it can ensure the necessary coordination between private and public sector to maximise the chances of success. Further devolution should be a key part of Conservative economic strategy, starting with mayors being given more fiscal freedom in exchange for greater accountability.

Third, there is the role of the Treasury. As it so often does, it has recently found itself in the firing line, with the Truss administration blaming "Treasury orthodoxy" for Britain's current economic woes. Stian Westlake, chief executive of the Royal Statistical Society, believes that breaking up the Treasury "would fix many of the UK's problems". He argues that "government by accountant" has created a culture of under-investment and short-termism, as well as an addiction to policy wheezes driven by the media focussed nature of fiscal events.[184] His proposal is to hive off the economics side from the finance side and create a new Department for Economic Growth.

This is not the right answer. Attacks on the Treasury are often just cover for those frustrated with the trade-offs inherent in economic policymaking which result in their pet project not getting the funding they think it needs, and recent events have starkly illustrated the dangers of dismissing Treasury advice on the importance of have credible fiscal plans. Attacks on the Treasury also implicitly ignore the risks of government failure. The Treasury shuts down new ideas not just because of affordability concerns but because so many of them lack any evidence that they will improve things, often failing to think through a whole range of issues: distortionary impacts, deadweight costs, opportunity costs, delivery challenges and more. In the private sector, the market weeds out the bad ideas. That option does not exist in government, so it falls to the Treasury to do it.

Further, many of the most-pro growth policies that could be pursued – some of which are explored further below – are the definition of Treasury orthodoxy. The reason they do not happen is because their political masters put them in the too difficult box, not because of the Treasury's institutional reluctance. Planning, immigration and tax reform all sit within this category.

Yet it is also true to say the Treasury can be too defensive; and the critique that the economic side of the department gets drowned out by the fiscal side has merit. The answer, however, is not to split the department and pretend that trade-offs do not exist. Instead, the economic side of the department should be empowered. Leading thinkers from academia and the private sector should be brought into the department to work on the growth agenda. The department should be tasked with positioning itself at the cutting edge of the debate on economic growth, publishing position papers and leading thinking across Whitehall as well as academia and business. Much of this thinking it does already, but too little of it makes its way to the Chancellor of the day, let alone a wider audience.

Competition and regulatory regime

Recent years have seen an obsession in government with announcing ever more pots of money to tackle policy issues, with new announcements often defined as significant or not by whether they include "new money". This obsession has contributed to a lack of political focus on the UK's competition and regulatory regime. But competition and regulatory policy should be at the heart of any Conservative government's supply side reform plans, setting the enabling framework within which the private sector can drive growth. Leaving the EU presents an opportunity to reinvigorate that regime to ensure it is resolutely forward-looking.

There are numerous benefits to renewed competition. A special report by the Economist in 2018 described competition policy as an "elixir" which spreads wealth today by reducing consumer prices and increasing choice, and increases productivity tomorrow by driving businesses to be more efficient.[185] Research by the

OECD has found that lower competition may contribute to inequality through consumers paying higher prices and by business owners not having economic rents competed away.[186] It can therefore play an important role in tackling both the growth and inequality challenges.

In recent years, however, there are signs that competition has been on the wane. Much of the focus has been on competition in digital markets. But the issue is broader than that. Thomas Philippon has found that competition has declined in most sectors of the US, contributing to lower growth and higher inequality.[187] Recent work by the Competition and Markets Authority (CMA) has found signs of similar trends in the UK, illustrated by Figures 15-17. Levels of concentration and profitability – static indicators of competition – have both increased over recent years across the economy. In addition, measures of firm entry and exit – a dynamic measure of competition – show that the likelihood of the biggest firms becoming entrenched in a sector have increased.

Figure 15: Average market share of the 5 largest firms in each industry
Source: State of the UK Competition report, April 2022

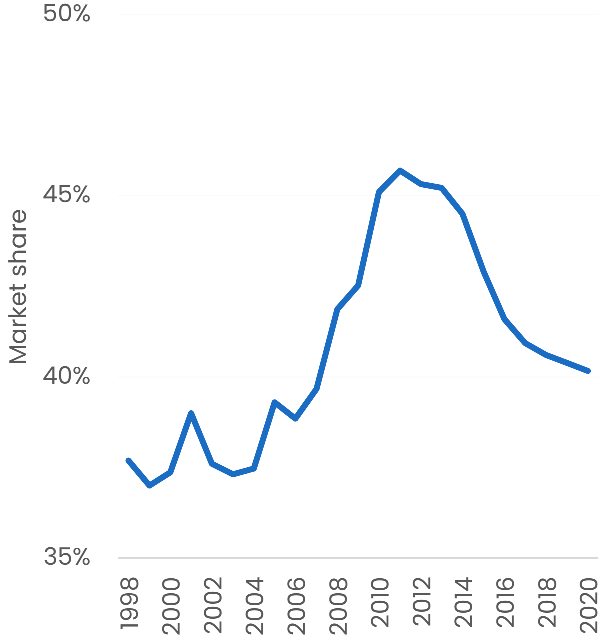


Figure 16: Price-cost markups since 2000
Source: State of the UK Competition report, April 2022

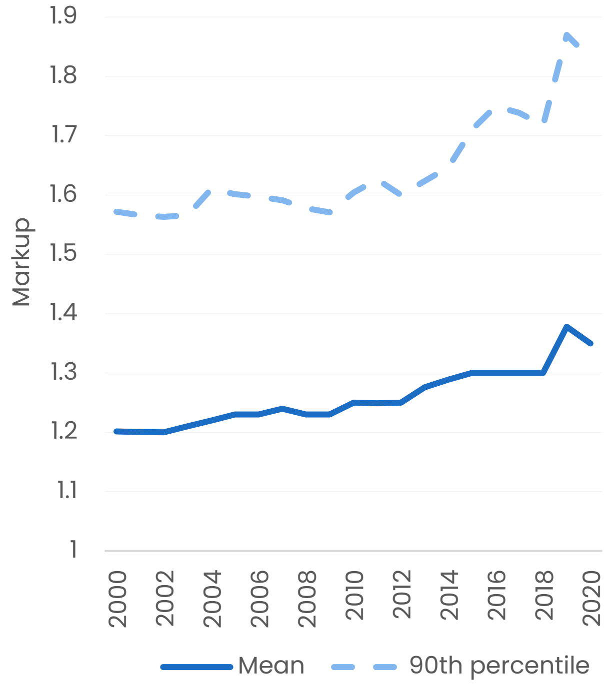
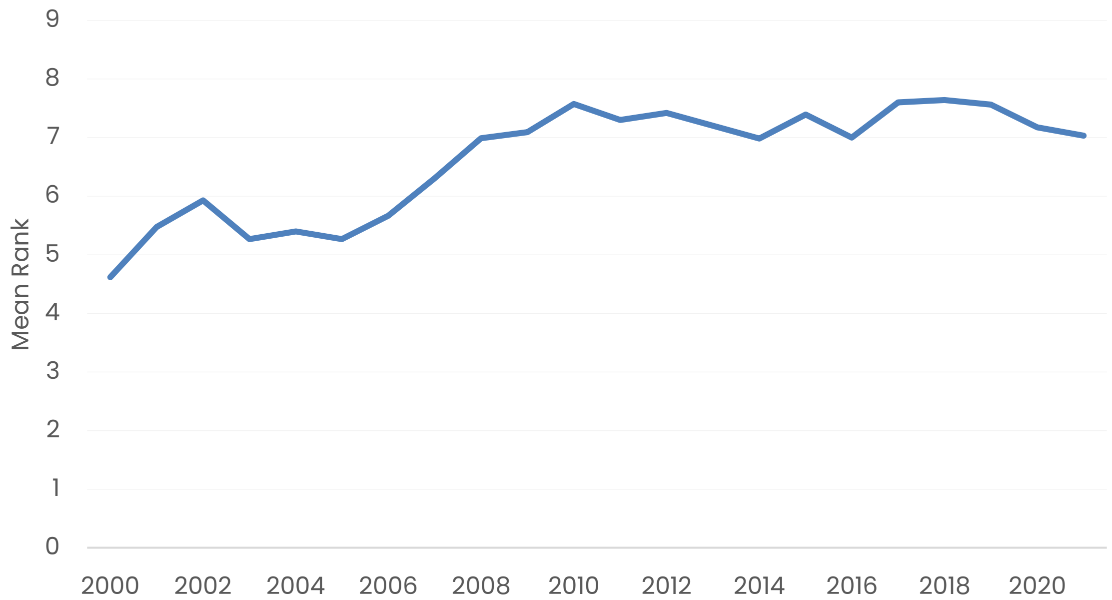


Figure 17: Rank persistence, averaged across industries [5]
Source: State of the UK Competition report, April 2022



[5] Rank persistence is a dynamic measure of competition in the market that measures how many of the top 10 firms in an industry were also in the top 10 three years ago

It would be wrong simply to put this trend down to a failure of policy. A range of possible explanations exist, from technology-based theories around network effects creating winner-take-all markets and the slowing of technological diffusion, to the role globalisation may have played in strengthening the market position of multinationals by allowing them to reap greater efficiency gains through global supply chains.[188] Yet even if competition policy is not responsible for the decline, it must nevertheless respond to these trends.

The UK's post-Brexit competition regime must do two things. In line with the One Nation principle, it must remain absolutely focussed on protecting consumers and rooting out anti-competitive behaviour. This means the CMA should be given stronger enforcement powers to tackle anti-competitive conduct and protect consumers. Second, it should be a central part of the institutional structure needed to drive growth and productivity. The CMA should therefore be given a new, additional statutory duty to promote innovation, productivity and growth, on top of its existing duty to promote competition for the benefit of consumers.

This should be accompanied with a deliberate strategy to expose UK firms to international competition, as long as it is on a level-playing field. Firms which export have on average around a third higher productivity than domestically oriented firms; and foreign-owned firms have average productivity twice that of domestically oriented ones.[189] That means focusing trade policy on services liberalisation, given the strengths of the UK economy; building a more positive relationship with the EU which might ease trade burdens; and supporting firms to export, in turn improving the UK's current account balance.

A rigorous focus on competition needs to be accompanied by a clear-eyed view of what the UK's future regulatory system should look like. Regulation is necessary to deal with a range of market failures, from information asymmetries to natural monopolies, but the burden of regulation lessens competition by raising barriers to entry and weighs on economic growth.

The debate in the UK, however, often falls into simplistic generalisations about the need to slash red tape, particularly that emanating from Brussels. The truth is that the UK is the second-best global performer as measured by the OECD's product market regulation indicators, behind only the Netherlands.[190] Given the service-dominated nature of the UK economy, pragmatism would dictate that the focus be on ensuring regulatory barriers aren't increased in the service sector. In particular, the UK must be wary of going down the US route of ever more occupational licensing: around 30% of the US workforce is covered by occupational licensing, compared with just 5% in the 1950s. The result has been a 10-15% price differential between licensed and unlicensed services, with no evidence of significant quality improvements.[191]

More broadly, the focus of the regulatory agenda should be but on changing the way the UK regulates as the economy evolves, in line with Conservative principles of stewardship. As Professor Christopher Hodges, global regulatory expert at Oxford University, has argued, the regulatory benefit of Brexit means moving from a rules and sanctions-based approach to one based on trust where all participants – business, regulator and consumers – are working towards common goals.[192] The UK should take advantage of no longer needing to harmonise rules across all EU member states to become a leader in the regulatory fields of the next waves of innovation, including robotics, artificial intelligence and cutting edge healthcare. The UK approach to fintech in recent years serves as an example of how to do this. While specific policies such as the use of regulatory sandboxes matter, above all what worked was that the message came loud and clear that the UK wanted to be a hub for fintech. The regulator and government wanted to make it work, and were willing to be nimble and flexible to do so. That approach needs to be adopted more broadly.

There is one area of regulation, however, where significant liberalisation should be a priority, and that is the planning system. Very high land and property prices divert investment away from more productive uses, create high barriers to entry for new businesses because of high rents, and reduce labour market flexibility. They also exacerbate inequality by skewing the gains from growth to property owners, in contravention of the One Nation principle.

There is a lively debate about how much impact planning liberalisation and the resultant increase in housing supply can have on this issue. Research from 2014 found that around 35% of the price of a house in England is directly attributable to planning constraints.[193] Ian Mulheirn, however, has argued that removing supply constraints would have only a small impact on prices, with low interest rates and easy credit having been much bigger drivers of sharpy increasing house prices.[194] Yet the debate is primarily one about the scale of impact that planning reform would have, rather than the principle of it. Given the big increases in UK house prices in recent decades, and the negative impact this has had on growth and inequality, planning liberalisation should be pursued wherever possible. The fraught politics, however, mean the stewardship principle's classically Conservative approach of gradualism is the right one.

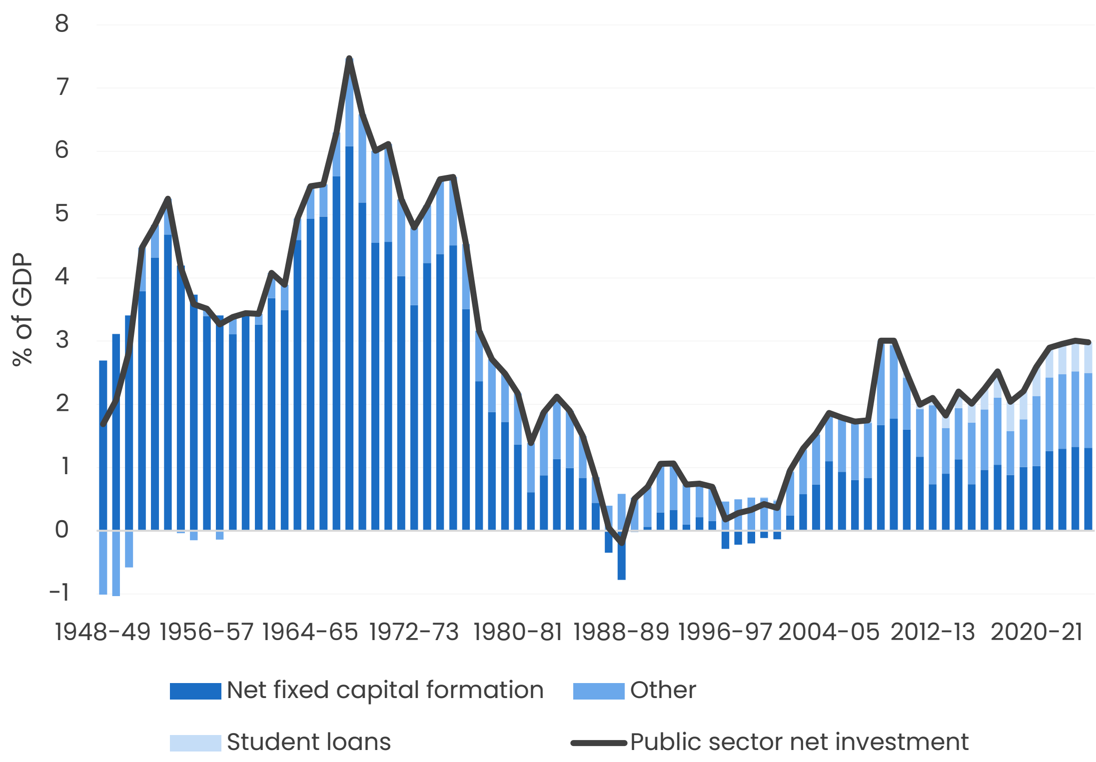
The provision of public goods

The provision of public goods is a key area where both pragmatism and empowerment are critical. Set against the risks of government failure and the trade-offs to be made with the fiscal challenge, Conservative economics should not enter into an arms race on government spending. But it must recognise the empowering role that the state must play in providing the funding to address market failures.

Both the May and Johnson administrations recognised the importance of the state's role in this regard. The three pillars of the Johnson government's Plan for Growth were infrastructure, skills and innovation,[195] which the Industrial Strategy Council described as "necessary ingredients for growth".[196] All three have positive spillovers that without significant government funding mean they would be under-funded. And through a series of uplifts since 2016, Philip Hammond, Sajid Javid and Rishi Sunak raised capital spending to its highest sustained level since the 1970s, as illustrated by Figure 18. This is in fact arguably an unflattering reflection on current plans given the last time capital spending was as high as it is now on a sustained basis a swathe of nationalised entities sat on the government's balance sheet.

Figure 18: Historical trends in public sector net investment

Source: OBR Economic and Fiscal Outlook, March 2020



This approach should continue. As set out above, there is a need for investment in human capital to be increased significantly.

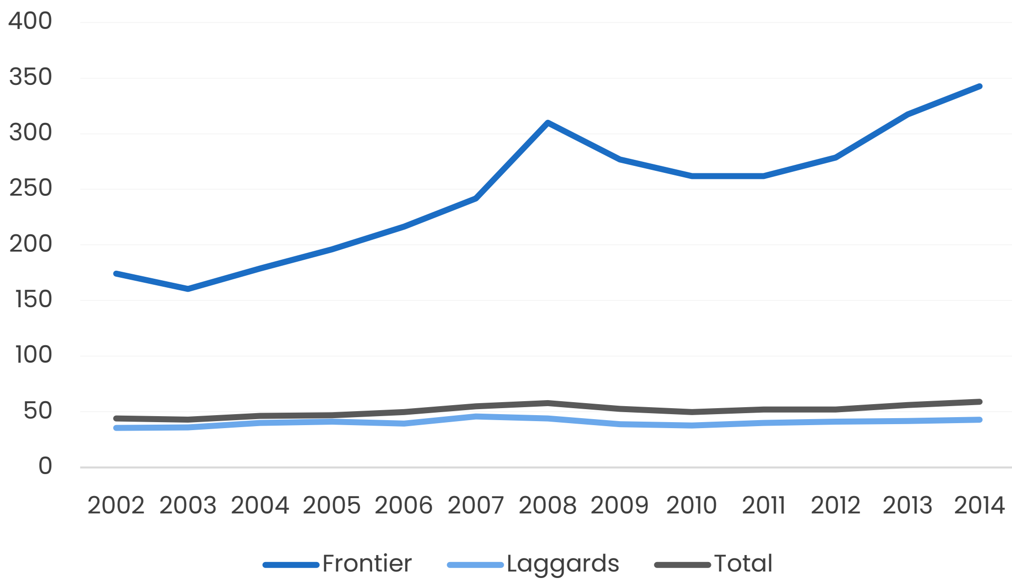
In relation to physical capital, infrastructure investment is essential to boost productivity, tackle regional inequality, de-carbonise the economy and boost the UK's energy security. Significant investments in transport, digital, energy and utility networks are all needed over the coming decades, in response to which the government has already outlined record levels of investment in railways, strategic roads, broadband networks and flood defences, as well as big investments in a range of energy technologies.[197] The Industrial Strategy Council called these plans a "role model" for how industrial strategy should be pursued. It was of the scale needed to address the challenge; had a clearly articulated vision in the form of the National Infrastructure Strategy; and through the National Infrastructure Commission and UK Infrastructure Bank, had the institutional framework to provide the necessary external scrutiny and evaluation to help ensure both longevity and co-ordination of policy between public and private sectors.[198] The challenge on the infrastructure side, therefore, is now primarily about delivery.

Innovation spending is also set to increase significantly. While recent statistical revisions have cast doubt on the size of the gap, having historically suffered from below average investment in R&D, the UK now aims to increase overall R&D spending to 2.4% by 2027, close to the OECD average of 2.68%.[199] This will see public R&D spending rise by a third over this parliament.[200]

The risk, however, is that we confuse the eye-catching with the impactful. Too often policymakers and politicians focus on the need for Britain to lead the world in frontier technologies of the future, accompanied by often vague references to the link between cutting edge innovation carried out in the UK and the nation's growth prospects. Innovation policy is vital for growth. But domestic R&D spending should not be seen as meat going into a sausage machine, which will inevitably spew out higher UK growth at the other end. Most UK scientific discovery will have more impact in other countries; similarly, most of the science applied commercially in the UK will have originated elsewhere.

Instead, as Tera Allas, Research and Economics Director at McKinsey, argues: "we need diffusion more than invention".[201] Figure 19 shows how the key issue for the UK economy is not that of slowing frontier innovation, but that of innovation diffusion, from the most innovative firms to the least.[202] In growth terms the big gains are to be had by ensuring more firms adopt existing, often quite basic, innovations. Compared to their international competitors, UK firms are middling when it comes to digitisation, and perform worse than firms in Germany and the US when it comes to management practices.[203] Shifting the dial on both of these will likely have more of an impact on growth than moving the frontier further forward. This does not mean abandoning the UK's ambitions at the frontier. But it does mean pragmatically shifting the focus to put diffusion at the heart of UK innovation policy.

Figure 19: Productivity among frontier and non-frontier companies [6]
Source: Andy Haldane, 'The productivity puzzle,' Bank of England, 2017



Tax reform: why One Nation matters

There is one glaring omission from the above discussion on supply side reform, and that is the role of the tax system.

The tax system will need to play a part in addressing all three of the challenges set out in Section 1: over time, it will need to raise more money to tackle the fiscal challenge; through specific and targeted reforms that improve incentives and the efficiency of the system, it can help with the growth challenge; and, working in tandem with the social security system, it will need to redistribute more to tackle the inequality challenge. This does not mean that every tax measure must be progressive. The tax system should be seen as just that – a system. But it does mean that, overall, the system will need to become more progressive.

In doing so, any reform will need to balance the principles set out in Section 2. By providing the right incentives it can empower the private sector as part of a coherent supply side strategy, minimising the extent to which the tax system distorts economic activity. Set against that, the current state of the public finances means that a pragmatic approach will inevitably mean raising taxes further. A pragmatic approach must also be realistic about both the necessary complexity of the tax system and the political challenges of reforming it. But tax policy plays a fundamental role in how the proceeds of economic activity are shared across society.

[6] Frontier companies are defined as the top 5% of firms by GVA per worker in a given year and sector, according to the 2 digit SIC 2007 industrial classification

This is especially important when structural factors mean that high inequality is unlikely to come down significantly solely through a more equal distribution of pre-tax income. A One Nation approach to tax reform is therefore essential to ensure that a broad base of society can contribute to, and benefit from, the UK economy.

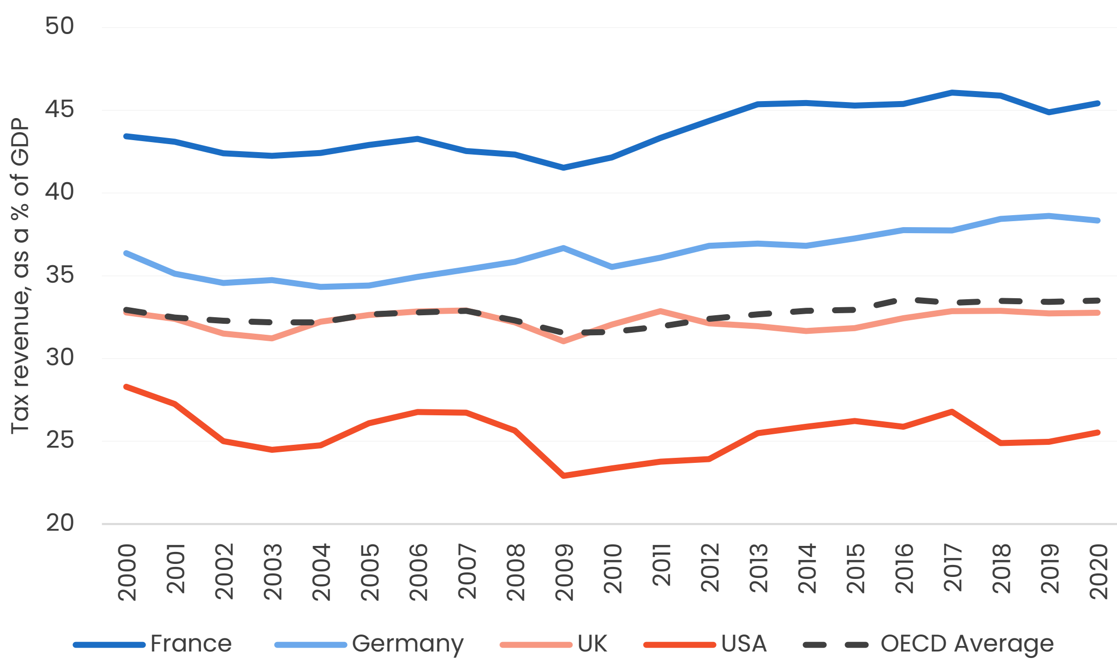
The UK tax burden

Tax policy was the defining issue of the recent Conservative leadership election. The debate almost exclusively centred on the idea that the UK's rising tax burden – projected before the mini-budget to reach its highest level since the 1940s – is stifling growth.[204] The Truss administration made cutting taxes the central element of its growth plan, announcing £45 billion of permanent personal and business tax cuts at the mini-budget.[205]

Virtually absent from the debate, however, has been any discussion about either why the tax burden is rising – in large part to deal with the fiscal pressures discussed in Section 1 – or what the evidence is that the UK's tax burden is acting as a major drag on growth. Looking at France, Germany and the US, the three countries the UK is most often compared to unfavourably on productivity, one cannot conclude that the overall tax burden has much to do with explaining the productivity gap: Figure 20 shows that while the US does have a lower tax burden than the UK, both France and Germany have significantly higher ones.

Figure 20: Tax revenue as a share of GDP

Source: OECD Tax revenue data, 2000-2020



It is therefore clearly possible to have a higher tax burden than the UK, and higher levels of productivity.

The current debate has also completely ignored a much more important agenda. The tax system is riddled with unfairness and inefficiency. Instead of obsessing over cutting the tax burden, Conservative economic policy should focus above all on reforming the tax system.

The Mirrlees Review, which took a comprehensive look at how to reform the UK tax system for the twenty-first century, argued that policymakers should be steered by three instrumental guidelines when approaching the task of tax system design and reform.[206]

1. **Neutrality**. The tax system should treat similar activities in similar ways. For example, all income should be treated the same regardless of the form it is received in. This will minimise the tax system's distortionary impact on behaviour and avoid people wasting time and effort structuring their activities in response to the tax system. There are clear exceptions to this rule: the desire to tax environmental bads or incentivise the provision of public goods such, for example. But the UK tax system is also riddled with hard to justify non-neutralities, from distorting the choice between debt and equity finance to the different treatment of remuneration from work. In many cases, regulation, competition and direct government investment will be better tools to achieve specific policy outcomes.[207]
2. **Simplicity**. A simple tax system should be transparent and have low administrative costs. Complexity creates compliance costs and incentivises avoidance. In reality, given the breadth of issues it covers the tax system can never be truly simple, but complexity should be kept to a minimum.
3. **Stability.** Constant tweaking of the tax system increases compliance costs and undermines the certainty businesses need to make long-term plans and invest. This is not an excuse for inaction, but reform should be carefully thought through and part of a clear long-term strategy.

Priorities for tax reform

To work towards the type of tax system outlined above, and balancing the need to raise revenue, improve incentives and redistribute more, four areas should be prioritised.

First, taxation of earnings.

The Truss administration initially prioritised reversing the new health and social care levy, bringing forward the planned 1p cut in income tax announced by Rishi Sunak and abolishing the additional rate of income tax. The abolition of the 45p rate was clearly a direct contravention of the One Nation principle, particularly during the biggest cost of living crisis in decades and at a time when the personal allowance threshold remains frozen. But the broader personal tax cuts also contravened both the pragmatic and stewardship principles, making inflation worse and putting the public finances on an unsustainable path. These tax cuts were highly unlikely to have any material impact on trend growth, and would have made the inequality and fiscal challenges harder.

More broadly, the existing taxation of income is unfair, forcing employees to pay a much higher rate of tax than other types of worker. An employee earning £40,000 a year pays £3,300 more in tax than someone who is self-employed, and £4,300 more than an owner-manager. This is not only because employees' salaries are subject to employer National Insurance contributions, but because capital gains tax is lower than on earned income: the top tax rate on earnings for an employee is 47%, compared to 20% for capital gains on most assets.[208]

This is both unfair and inefficient, contravening Conservatives' One Nation instincts and undermining the empowerment principle. Unfair, because it means people doing similar work are paying very different rates of tax – a large share of capital gains are "repackaged income";[209] and inefficient, because it encourages people to work through their own businesses rather than as employees, distorting economic decision-making.

Addressing this issue is central to tackling top end inequality. More than 90% of all taxable gains go to people with total remuneration above £100,000.[210] Further, the self-employed make up 10% of the top 1% of earners - but just 6% of the bottom 90%. Similarly, owner-managers make up 10% of the top 1%, but only 2% of the bottom 90%.[211]

The result is that average tax rates vary significantly within the top 1% of earners. Analysis of HMRC data shows that above earnings of £250,000 a year, the tax system becomes regressive. In addition, prior to the reduction in the generosity of entrepreneur's relief, a quarter of people earning between £5 million and £10 million a year were paying a lower effective tax rate than someone on £15,000 a year.[212]

The challenge, of course, is that increasing rates on capital gains and dividends risks disincentivising savings and investment. But the existing preferential tax treatment for capital gains and dividends is not well targeted at incentivising risk-taking and investment, with the biggest giveaways going to those who make significant profits without investing much capital, while those who risk making a loss or make substantial investments for a modest return are penalised.[213]

A better system would be to raise tax rates on capital gains with an indexation or rate of return allowance so only returns above inflation or a risk-free amount are taxed, with adjustments made to rates to reflect corporation tax already paid. Capital losses should also be allowed to be offset against income, rather than just capital gains, in a broader set of circumstances, though with relief restricted to the capital gains tax rate and for a time limited period.[214]

Given how hard it is to predict behavioural change, it is very difficult to cost accurately the amount of revenue this would raise. On a static basis, up to an additional £12-14 billion could be raised if all income and gains were taxed at the same rates that apply to earnings, with an indexation allowance introduced but most deductions and reliefs removed.[215] In practice, behavioural change combined with the cost of offsetting losses would significantly reduce the revenue. But such a package would almost certainly raise billions of pounds; it would increase the progressivity of the tax system; and it would remove distortionary incentives, more efficiently incentivising savings and risk-taking.

Second, business tax.

Low business investment in the UK is a significant part of the explanation for the productivity gap to France, Germany and the US. In 2019, UK business investment was 10%, compared to an average of 13% across those three countries.[216]

Addressing this issue requires a multi-pronged approach, based above all on providing businesses with the certain and stable environment needed to give them the confidence to invest. Put simply, there is no silver bullet.[217] But, consistent with the broader strategy of supply side reform based on the empowerment principle set out above, a competitive business tax system designed to enable private sector investment has an important role to play.

The Truss administration focussed on the headline rate of corporation tax, initially spending £18 billion on cancelling the proposed rise of the rate to 25% from April 2023 before U-turning. Yet while headline rates are important, as Prime Minister Rishi Sunak has previously argued, persistent rate cuts did not lead to a step change in business investment in the 2010s.[218] The priority should be more targeted and strategic measures.

Specifically, the UK corporation tax system is much less generous than the OECD when it comes to capital allowances, ranking 30th out of 37 OECD nations.[219] Although the under-performance of the super-deduction against forecasts should give pause for thought, it was a temporary measure and has been in place against a highly uncertain economic backdrop. A range of studies in the US and UK have found that increasing the generosity of capital allowances can have a significant impact on business investment.[220] There is therefore a strong case to move towards full expensing, allowing businesses to deduct the cost of investment from their corporation tax bills immediately. The policy would be expensive, peaking at £11 billion according to the Treasury.[221] But in steady state the cost would be significantly lower. Further, some of the cost could be offset both by eliminating the tax deductibility of corporate interest expenses, ending the illogical bias in the tax system towards debt over equity finance, and by reducing the generosity of the £11 billion worth of business tax reliefs the currently exist, many of which are of questionable value for money.[222]

Third, property tax.

Recurrent taxation of immovable property has merit from a pragmatic perspective: it is one of the least distortive taxes, and therefore the least harmful to growth.[223] It is also has merit from a One Nation perspective: housing wealth is a big driver of the UK's economic inequality, and is closely associated with income and wealth over people's lifetimes.[224]

But the UK's current system of property taxation is sub-optimal. Council tax is raised based on property valuations from 1991, and is highly regressive. The average tax rate paid on a house at the mid-point of the lowest council tax band is 1.65%. By contrast, a house at the bottom of the top band attracts an average tax rate of just 0.2%.[225] Significant reform is needed. Ultimately the goal should be a proportional council tax based on up-to-date valuations. This could reduce net council tax bills for those in the bottom half of the distribution by 0.5% to 0.9% on average, while increasing average bills by 0.7% for the top 10% of households.[226] Clearly, a reform of this scale would be highly controversial, and significant transitional relief would be required, particularly for the small proportion of people in the lower half of the distribution who would lose out. Provision would also need to be made for those who are asset rich and cash-poor to roll up their tax liabilities until the underlying property is sold. If full reform proves politically impossible, an alternative would be to introduce new higher council tax bands.

While we should make the recurrent taxation of property wealth more progressive, the taxation of property transfers – while highly progressive – is hugely inefficient. Stamp duty was introduced over three hundred years ago when revenue raising was administratively much more difficult and taxing transactions was one of the easiest ways to collect tax. It disincentivises transactions from taking place, driving an inefficient allocation of the UK's housing stock and hampering labour market flexibility. Further cuts to stamp duty should be made when the fiscal situation allows.

Fourth, taxation of wealth, which has not kept pace with increases in wealth over recent decades. Household wealth has risen as a share of GDP from 300% in the 1960s to 700% today, but wealth related taxes have remained broadly stable at 2% of GDP.[227] With wealth highly concentrated, a Conservative strategy based on One Nation principles must take this issue seriously.

Reforms to property taxation can go some way to addressing this, but the issue of inheritance cannot be ignored. Conservatives believe it is perfectly right that people should be able to pass some of what they have on to their children and grandchildren. But as we saw in Section 2, that must be weighed against the fact that inheritance entrenches inequality and reduces social mobility, with those who are wealthier to begin with more likely to inherit.[228] This is particularly acute because the significant increase in the stock of wealth has made inheritances a bigger proportion of lifetime resources.[229]

The system of inheritance tax in the UK today is economically, and inefficient tax planning to take advantage of various reliefs allowing the very richest often to pay little or no inheritance tax. The result is that the effective inheritance tax rate paid on estates over £10 million is double that paid on those between £2 million and £3 million.[230]

For Conservatives who care about opportunity, it is the amount received by an individual that matters, not the estate of the person passing on the wealth. Ultimately, abolishing inheritance tax and replacing it with a lifetime gift allowance would be a much fairer way of taxing inheritances. At a minimum, however, the system of reliefs should be reformed. In particular, the existence of reliefs for agricultural and unlisted business assets pushes up the price of agricultural land and distorts decision-making over the most efficient way to run family businesses. These reliefs should either be scrapped or tightened.[231]

Talking about taxing wealth is a deeply uncomfortable prospect for many Conservatives. But unless it is taken seriously, progress in tackling inequality – and the consequences that has for social opportunity and for economic and political stability – will remain hampered.

The above is by no means an exhaustive list of sensible tax reforms: replacing business rates with a commercial land value tax and merging income tax and national insurance contributions are both examples of further significant reforms that should be pursued. But balancing the needs to tackle the growth, inequality and fiscal challenges, the above four areas should be the priority.

Delivering tax reforms of the scale described above will require both huge amounts of political capital and will. But politically difficult tax reform is achievable: think of the VAT rises and base expansion of the 1980s, or the abolition of mortgage interest rax relief in the early 1990s. To maximise the chances of success, what is needed is a clearly articulated long-term vision for the tax system, coupled with an ability to pounce on political opportunities for reform – specifically by using the aftermath of crises to justify difficult decisions, or to capitalise on periods where the public finances exceed expectations (however distant a prospect that currently seems) to compensate the losers from any reforms.

Conclusion

This paper has aimed to root Conservative economic strategy not in the ideological fashions of the day but the economic challenges we face as a country and the enduring philosophical traditions of Conservatism. In doing so, it has attempted to set out a programme for Conservative economic reform that is both intellectually consistent and likely to be economically effective. There are, in particular, four areas of priority.

First, given the rapidly changing nature of the global economic environment that we have seen over recent years, a Conservative approach to macroeconomics must be driven by pragmatism, dealing with the world as it is, rather than a dogmatic approach that sees looser fiscal policy as a second order problem on the one hand or one that believes the state of the public finances must always trump all on the other. Second, as the UK economy prepares for significant structural shifts in the coming decades from Covid, Brexit, rising geopolitical tensions and – most importantly – technological change, the stewardship principle should shape the Conservative approach to the labour market, ensuring the workforce have both the skills they need to prosper and a sufficient safety net to ensure they are protected in a rapidly changing world.

Third, a justified focus on supply side reform must be based on an empowering state providing the enabling conditions for the private sector to thrive. Conservatives should reinforce the UK's existing institutional framework and complement it by going further on devolution and putting in place a new institutional framework to cover industrial policy. It should strengthen the UK's competition framework, focus the regulatory agenda on the next waves of innovation, pursue planning liberalisation, deliver existing plans on infrastructure and shift innovation policy to prioritise diffusion.

Finally, the Conservative debate about tax needs to shift from being one about the overall tax burden – and how to reduce it – to one about reform, and how to make the system both more efficient and more progressive. Given the scale of the inequality challenge, One Nation instincts should be at the heart of these efforts. A long-term strategy based on clear principles should be established, prioritising reforms across the taxation of earnings, business, property and wealth.
There is no silver bullet to tackle the growth, inequality and fiscal challenges the UK faces. Above all, as Thatcher put it, "It will take time, patience—and leadership. It will need a Government that promises little—but does a lot; that looks ahead instead of being endlessly preoccupied with tomorrow morning's papers".[232] But with a plan based on clear, enduring Conservative principles and determined delivery, these challenges can be tackled and with it a more prosperous, fairer economy can be built.

Endnotes

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