

A Conservative Economy

Building a fairer and more
productive nation

Gavin Rice & Nick Timothy
Foreword by Rt Hon Michael Gove

**FUTURE OF >
CONSERVATISM**

About Onward

Onward's mission is to develop bold and practical ideas to boost economic opportunity, build national resilience, and strengthen communities across all parts of the United Kingdom.

We are not affiliated to any party but believe in mainstream conservatism. Our vision is to address the needs of the whole country: young and old, urban and rural, for all communities across the UK – particularly places that have too often felt neglected or ignored by Westminster.

We believe in an optimistic conservatism that is truly national – one that recognises the value of markets, supported by a streamlined state that is active not absent. We are unapologetic about standing up to vested interests, putting power closer to people, and supporting the hardworking and aspirational.

Thanks

Onward is a small non-profit that relies on the generosity of our donors and patrons to do our work. We are indebted, in particular, to our Founding Patrons: Martyn Rose, Michael Spencer, David Meller, Bjorn Saven, Richard Oldfield, Robert Walters, Tim Sanderson, James Alexandroff, Jason Dalby, Graham Edwards, John Nash and Theodore Agnew. Without this philanthropic support, our work would not be possible.

We are deeply grateful to the Future of Conservatism steering group, who have helped to guide this research, and to all others who have lent us their time, expertise and advice. We would like to thank Jim Blagden, Francois Valentin, Jenevieve Treadwell, Shivani H Menon, Callum Newton and the Onward team for their support in researching and designing this report.

About the authors

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About the Project

In March 2023 Onward launched its commission on the Future of Conservatism. In the last five years since we were founded, Britain has faced the constitutional rupture of Brexit, the once-in-a-century devastation of the Covid pandemic, a severe energy crunch and inflation crisis, and a prolonged period of political turbulence. As successive Conservative governments have grappled with the hurdles of the moment, long-term challenges facing our country have continued to build.

While the Conservative Party faces the immediate pressures of government, we believe that conservatives also need fresh thinking about these longer-term questions and the wider future of British conservatism. This commission was formed to ask precisely these deep questions, and to seek answers.

The challenges of the next decade and beyond are not those of the beginning of the twenty-first century. Technological and social transformation, globalisation, the rise of China and the great Western slowdown in economic growth are profound changes any government will have to address in the coming years. These challenges cannot be easily or rapidly overcome by any government, Conservative or otherwise. But the search for solutions must begin now, not later, and these answers exist within the British conservative tradition of thought. There is a potential for a stable future voting coalition for the party, should it want to embrace it.

The project's steering group has been formed from across the centre-right, bringing together parliamentarians, respected journalists, pollsters and others to guide our work. Their expertise and ideas have informed our approach.

This report charts a future direction for conservative economic policy, seeking to respond to the long-term challenges facing the UK today. We would like to thank Sir Mick Davies, Nigel Gardner, Jonathan Kane, Bobby Vedral, Roger Pauli and everyone else whose support made this work possible.



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Foreword



Conservatism has always evolved. Thinkers from Michael Oakeshott to Sir Roger Scruton have painted conservatism as more of an attitude than a set of beliefs; an approach towards politics and the world, rather than a doctrinal set of policies.

In truth it is both a disposition and a set of core beliefs. A disposition towards pragmatism over ideology, established wisdom over rashness, respect for institutions over revolutionary upheaval, love of the local over the universal. But it also upholds core beliefs and commitments, such as the centrality of the nation state, the importance of place, private property, the dignity and value of work and the essential role of the family. These core values must guide us as conservatives when thinking about the future of the British economy.

In this second report in Onward's Future of Conservatism series, Gavin Rice and Nick Timothy make a rigorous and persuasive case for a new vision of economic policy that is both pioneering in breaking new ground and well-established in its heritage. As we consider how to build on the successes of the last 14 years, and address a world grown more challenging, their contribution to the debate merits serious consideration.

Gavin and Nick lay out a programme which distils conservative economic thinking from the level of principle and applies it to the world we live in today.

It calls for the boldness and innovation exemplified by Margaret Thatcher - but repurposed for new challenges. It identifies the problems Britain now faces in a fast-changing world, and offers solutions. These challenges are many, starting with accelerating growth, as Thatcher did so successfully. But the diagnosis and solutions to the growth challenges are - rightly - differently. The economic challenges ahead are those of the mid-21st Century, not those of 1975.

Thanks to Thatcher's reforms, Britain is no longer held back by inefficient nationalised industries, top income tax rates of over 80% or powerful and militant trade unions. Worryingly, Keir Starmer's Labour party appears intent on extending nationalisation, raising tax and handing more power to the unions to restrict employment flexibilities. So we need to make the case against the drift back to socialism and permanently lower growth with renewed vigour.

But we also need to renew the case for markets and capitalism, recognising there is more to do to bolster manufacturing, guarantee energy security,

incentivise investment in innovation and extend home ownership. We must argue for markets properly reformed so they work free of vested interest. Growth from productive investment, and the jobs this creates, are distinct from rentierism or the predatory capitalism of acquisition over production. Conservatives must always be the party of work, home and family - not the speculator, proprietor or rapacious asset manager.

Britain has some of the best companies, best universities, best innovation and the most talented people in the world. Much progress has been made on unleashing their potential over the last decade, but more progress is required as we level up our whole country.

We need more investment in infrastructure to better connect all our communities. We need to deal with the root causes of higher energy costs which erode real incomes. We need to go further in regenerating the great cities and towns of the North and Midlands. And build many more homes for the next generation.

Globalisation, for all its challenges, can be made to work better for Britain. As a source of positive, productive overseas investment, and as a source of markets for Britain's brilliant exporters of goods and services. It should advance the prosperity of our nation state, rather than being a force for its erosion.

With the right policies, we can go even further in generating productivity growth and rising living standards. We can strengthen energy security, geographically rebalance and increase the quality of jobs across the country. We can become the best place in the world to invest and grow a business, and most importantly of all somewhere where anyone can afford to put down roots and start a family.

And that means maintaining the fiscal discipline Rishi Sunak and Jeremy Hunt have delivered. We must ensure Britain continues to live within its means, rather than borrowing for day-to-day expenditure or to cut taxes. We need to fix our demographics, get inactive people back into work, boost our productivity and growth and reduce the demand for welfare spending. If more of our country can stand economically on its own two feet, the need for redistribution will fall.

Some of the most exciting economic thinkers and writers of our generation have outlined how we can develop a truly inclusive economic vision. In recent years Dani Rodrik, Angus Deaton and Oren Cass have all written brilliantly on how national political economy can once again be made to work for sovereign nations – placing growth and fairness together at the centre of democratic policy making.

Truly free and fair markets, operating under the democratic governance of nations operating in the interests of their citizens, are the surest route to prosperity. Democratic politics is on a constant mission to reform, refine and improve markets in the service of humanity. This has been true for all of modern economic history, and it's true now.

This report lays out a vision for a radical, reformed approach towards British economic policy. It makes an invaluable contribution to the conversation we need to have about Britain's next steps forward. I look forward to the debate it will stimulate.



Rt Hon. Michael Gove MP

Secretary of State for Levelling Up, Housing and Communities

Executive Summary



The United Kingdom's economy has many great strengths. It is the sixth largest in the world, despite being only the twenty-first most populous.¹ In many sectors it is world-leading – from information and communication technologies to financial and professional services, forms of advanced manufacturing, life sciences, pharmaceuticals and semiconductor design. The 'Golden Triangle' of Oxford, Cambridge and London is an enviable national resource for the knowledge economy and renowned for its innovation.

On custodianship of the economy, Conservatives have a proud record. The party has always championed the power of markets and private enterprise to drive growth, combined with national policy programmes to widen prosperity and advance the nation's common good. From Neville Chamberlain's mass house building in the 1930s to Margaret Thatcher's unleashing of popular capitalism through policies such as Right to Buy, Conservatives have always promoted prosperity across regions and classes.

Conservative-led governments have continued in this tradition since taking office in 2010. The Coalition Government steered Britain out of the financial crisis by restoring fiscal stability and credibility. It implemented successful reforms of education and lifted thousands out of poverty through welfare reform, the National Living Wage and the post-crisis burst of job creation. The party has extended English devolution, with mayors such as Andy Street and Ben Houchen leading transformative regional development programmes. It is the first major Western political party to have identified tackling regional inequality as a major priority with the pioneering Levelling Up agenda.

Britain's departure from the EU's regulatory orbit enabled its world-beating vaccine rollout, and due to newfound freedoms it is uniquely placed to grasp the opportunities of emerging technologies such as AI. Through pursuing responsible fiscal policies Conservatives have been able to give average earners a £2,000 tax cut in real terms since 2010.²

It is vital, however, that we look to our country's medium and long-term challenges. This report makes the case for the next stage of modernisation of conservative economic policy thinking, putting forward solutions to meet the needs of the future, not the past. The hurdles the UK must overcome are not those of the 1970s, 80s or 90s. In the conservative tradition of patriotic pragmatism we must adapt our thinking to meet the world as we find it, grappling not with questions of ideology but with reality.

New frontiers, new thinking

Both major parties have now admitted that a multi-decade economic consensus has run out of road.³ Some elements of the old orthodoxy remain correct: free markets provide the most efficient way to allocate resources and generate growth. Private enterprise is almost always more effective than state delivery. Widely shared growth is preferable to redistribution as a means of spreading prosperity. Open trade can improve our standard of living, providing export markets for British businesses and access to affordable goods for families.

Other aspects of the consensus, however, are no longer working for Britain.

GDP per capita is 30% lower than it would have been had the pre-2008 trend continued, and is lower than in 2019.⁴ Productivity growth has nearly stalled, falling behind the USA, France and Germany.⁵ The share of income and wealth going to the top 1% has continued to increase and the gap between regions has continued to grow. All but two English regions are net recipients of public spending, meaning the UK must operate an expensive transfer union. Taxes on average earners have been cut,⁶ but as a result taxes on higher incomes are at record levels.

While Britain's universities and innovation are at the cutting edge of research, the UK does not always benefit from their growth potential. Too often British intellectual property is bought and moved to the United States, or manufacturing production outsourced to China. High value-added industries like financial services are concentrated in the South East, but these cannot sustain the whole economy.

Our manufacturing base is now reduced to just 9% of GDP,⁷ with deindustrialisation hitting Wales, the Midlands, North West and North East especially hard.⁸ High energy costs have been particularly damaging for heavy industry with companies bearing the brunt of the costs of energy transition. Britain's universities are leaving the country with a deficiency in vocational skills and producing insufficient STEM graduates.

Capitalism is the greatest force the world has ever seen for driving up living standards through innovation, technology and growth. But aspects of its current form do not serve the economic goal of shared prosperity or serve the common good. Financialisation and rent-seeking have enriched overseas

investors and provided returns to financial capital, but often at the expense of the real economy.

Trade, capital and globalisation

At the core of many of Britain's economic problems is its comparatively weak productive capacity and net exports. We do not make or do enough goods and services the world wants and needs to buy. And where we do make things we often do so less productively than many other countries, due in part to a deficit in skills, infrastructure and fixed capital investment.

The comparative decline of production industries has led to a wide and persistent current account deficit, currently 3.1% of GDP.⁹ Britain is world-leading in high-value services but our trade surplus in services does not compensate for our large deficit in manufactured goods. This drives regional inequality as returns to UK exports tend to accrue in London and the South East. The trade deficit is therefore a symptom of poor productive capacity and a cause, with ever more capital sucked into one corner of the country, and invested in dormant assets rather than growing industries.

The need to finance the current account deficit leaves Britain dependent on selling overseas investors its housing stock, its equities and its debt. It must be constantly vigilant to the threat of capital flight, constraining policy choices and leaving it beholden to foreign ownership, even when it is undesirable. This can lead to underinvestment, irresponsible governance and the separation of risk and reward, as the Thames Water debt scandal exemplifies.

Eroding economic sovereignty

Britain's security has been eroded through overly stretched supply chains in areas from manufacturing components and rare earth minerals to semiconductors, pharmaceuticals and medical supplies. This left us short of essential goods and components during the pandemic.

Our national deficit in savings contributes to this import dependency model, with UK incomes being spent on imported goods rather than invested in productive industry. As a country the UK does not save enough, and its savings are ineffectively deployed. Regulation of pension funds has been catastrophic, pushing UK capital into low-return bonds and real estate. Around 60% of UK-

listed equities are foreign owned, indicating inadequate deployment of Britain's capital pools, with investment income accruing overseas. Overall UK investment lags behind the OECD in both the public and private sectors.¹⁰

Too much speculation has turned housing into a tradable asset, inflating the market and pricing families out of ownership. Britain's liberal M&A regime enables predatory asset-stripping, and our regulatory and tax regime combined with loose monetary policy have promoted debt financing and leveraged buyouts to the detriment of investment. Weak corporate governance rules have allowed executive pay to rise far above average salaries regardless of performance, and a fashion for share buybacks has sucked capital into inflating share prices rather than business growth.

New times, new deal

The overall "deal" facing British workers has become increasingly unfair. Poor growth performance and barriers to home ownership mean hard work and merit are no longer the guarantees of reward they once were. The price of housing has shot up to 8.3 times average incomes,¹¹ with Britain facing a four million home housing shortage.¹² Only 10% of under-35s are homeowners.¹³ Parents say they cannot have the number of children they want due to material barriers, pushing up Britain's already-high old age dependency ratio. Low growth and high spending commitments mean the tax burden on households only continues to rise.

Net migration is at an all-time high of over 700,000 per year.¹⁴ This should be seen as part of ultra-globalisation: it disincentivises investment in automation and paying UK workers properly. Wage arbitrage operates like a domestic equivalent to offshoring as employers seek to lower wage bills rather than invest in people.

The need for a new direction

Britain's economy therefore requires full spectrum reform. The state is too large, yet is absent where it should be more active. Instead of investing productively in creating the conditions for growth or fixing social ills, public money is spent compensating for failure.

Government must learn from international examples of proactive and targeted industrial policy where this will enhance growth and resilience. But it must relieve burdensome regulation where it holds back the market, in particular reforming our stifling planning laws. Whether it is homes, laboratory space or infrastructure, Britain is a country that seems unable to build.

We need to reshape the objectives of our economic thinking. We must put the national interest first, not the needs of global financial markets or hostile trading partners. The nation state provides the best social forum for the promotion of community, good work, solidarity and altruism; it is not a neutral entity to be bought and sold, or made the object of international rent-seeking. We should challenge the idea of maximal economic efficiency - or at least the kind of short-term efficiency as defined by the current economic consensus - at any cost. Instead, the flourishing of workers, families and communities should be our objective. We must restore the dignity and purpose of work.

Conservatives believe in capitalism - through achieving growth, by doing more with less, a rising tide can indeed raise all boats. But for capitalism to work for everyone it must operate within rules set by and for the nation state, democratically controlled, in service to the national community. Conservatives should favour production over extraction, investment over rent-seeking, rising living standards for all, not the ever greater accrual of wealth to the richest global elites. Conservatives should be the party of one nation.

This is a conservative vision. It favours work, the family and the nation state, and the economic policies that will put their interests first. This report makes the case for that vision. It makes a new case for economic conservatism.

Summary of recommendations

Throughout this report we make a series of proposals for long-term reform of the economy. These identify what needs to change and what governments should be seeking to achieve.

Improving productivity, growth and reindustrialisation

- The UK should use fiscal and regulatory policy to support growth in private sector high and mid-tech manufacturing output, reindustrialisation outside London and the South East and an increase to national exports in both goods and services.
- Rules for corporate governance, mergers and acquisitions (M&As), corporate tax, regulation of pension funds and personal savings should be reformed to increase the domestic savings rate and boost private sector investment – channelling more capital into UK equities and productive output in the real economy. Better regulation of overseas ownership of critical infrastructure and utilities should be implemented.
- Higher education should be reformed to place much greater emphasis on technical, vocational and applied education, with more public funding for apprenticeships. HE funding should focus much more on STEM, with support for purely academic subjects focused on high-quality institutions and provision. Skills planning should be more localised, with greater collaboration between education and industry to make training more demand-led so UK education can match the needs of employers.
- Energy policy should be much more strategic, calibrated to ensure household affordability, security of supply and the needs of industry. Public investment in renewable energy technology and infrastructure should be adequate to take pressure away from household bills and businesses, with measures taken to prevent “carbon leakage” of carbon-using industries overseas.

Improving economic security and trade

- The UK should establish new oversight bodies to direct public investment into industry-adjacent R&D, support high growth-potential industries, support UK innovation and increase investment in emerging technologies. Industrial policy should include objectives of place-based regional economic development.
- UK industrial policy should actively support exports and the growth of industries with export potential, especially in manufacturing, including growing embryo exporters and deployment of national savings into productive investment in export industries.

- The UK should much more tightly monitor insecure supply chains, industrial offshoring and overseas acquisitions, particularly in sensitive industries, technologies and critical assets, with stronger powers to intervene to prevent loss of industrial capacity or speculative acquisition of UK land when the national interest requires it. There should be stronger powers of veto over the acquisition of controlling interests in strategically significant companies by hostile trade partners such as China.

Creating a better deal for British workers and families

- Immigration rules should be radically reformed to lower net migration to a sustainable level, with visa rules prioritising only those with the highest skills and earnings potential. Low-skill, low-paid migration should be phased out, and only select high-performing universities should be able to issue visas.
- Fiscal policy should be adjusted to provide much greater support for families with children, including recognising children in the tax system, allowing couples greater flexibility, allowing childcare allowances to be spent in a greater variety of ways and extending paternity leave entitlements.
- Planning should be reformed, with a different system of rules for high-density urban areas such as inner London, Birmingham, Manchester and other cities, and discretionary planning more widely should be better balanced between local authorities, Combined Authorities and Metropolitan Mayors to ensure an adequate supply for housing. Tax policy should be used to deter overseas ownership and rentierism.
- Worker representation in corporate governance should be enhanced and measures should be taken to improve working conditions, reduce unstable, insecure and low-quality work and to give employees more certainty over hours and stronger rights.

Forging a good economy



Before it is possible to make decisions about good economic policy-making, it is necessary to explain what a good economy would look like. It is also necessary to consider the characteristics of the UK's present economy, and develop policy platforms that might move the country on from the status quo and towards more desirable economic conditions.

This report argues from a conservative perspective that some principles of the present economic consensus are wrong, and have failed to deliver a prosperous, stable economy. Or, at least, that they are not appropriate for the new economic age we are living in.

Some of the problems with current economic policy thinking lie with the assumptions of orthodox, classical economic theory, together with assumptions about what can and cannot be achieved.

The characteristics of the UK economy

The UK economy has some fundamental characteristics that have defined it at least since the financial crisis, with important trends emerging much earlier, from the 1970s onwards, and with many deepening significantly under New Labour.

The Growth Challenge. Real household incomes are not rising at anything like their pre-2008 rate, compare poorly internationally and remain below 2019 levels. Underlying productivity growth has been poor, with UK industries struggling to increase output per hour worked. UK investment public and private investment levels are too low and it does not have a healthy mix of industries with sufficient productive capacity. Regional divides are high, reflecting divergent productivity. Given Britain's rising spending liabilities, weak trend growth implies a higher tax burden and high public debt. Predatory asset-stripping and financialisation undermine investment in the real economy. Skills and training are not calibrated according to economic need.

The Globalisation Challenge. Deindustrialisation has been faster and deeper in the UK than the rest of the OECD. This has reduced productivity performance, especially outside the South East. Offshoring of industry has damaged employment and growth, with too much economic concentration in London. The large current account deficit must be financed, leaving Britain beholden to foreign investment of whatever kind and at the mercy of capital flows. It is

vulnerable to foreign acquisition of its assets and companies, including the buy-up of its innovation. It is hugely import-dependent, relying on stretched supply chains in critical industries, and is hence vulnerable to trade shocks or wars disrupting global supply. Control of emerging technologies by hostile states is an economic and a security threat.

The Fairness Challenge. The UK scores highly on measures of inequality relative to other developed economies, meaning high inequality combines with stagnant income growth. Wealth inequality has grown, with greater prosperity accruing to existing asset-owners. Inadequate housing supply is causing intergenerational unfairness by narrowing home ownership and pushing up rents. Regional divides create an incentive for talent and capital to move towards the South East, with opportunity unevenly distributed. The UK has been successful at redistribution, with the tax burden concentrated on higher earners, but this simply compensates for weak real wage growth in lower income groups.

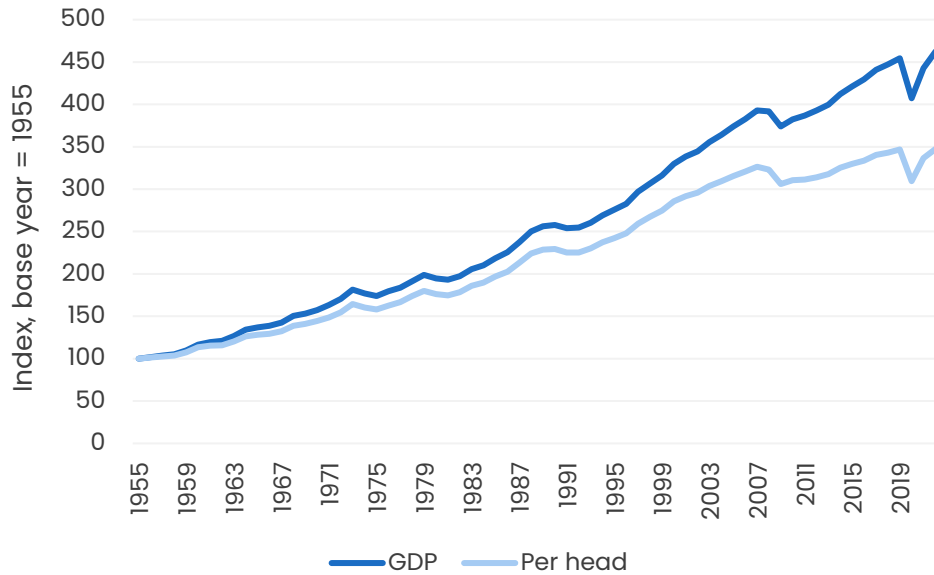
Parents are having fewer children than they would like, partly due to cost factors. The UK has too many low-quality jobs, especially in service sectors. Mass migration undermines the wages of resident workers, disincentivises automation, undermines the boundaries of the contributory welfare state and dilutes the capital stock. Social security is ungenerous in part because it is spread too thin; high welfare costs are symptomatic of deep social problems.

Struggling to achieve growth

While overall GDP has grown steadily (albeit at a much slower pace than the pre-2008 trend) over the last 15 years, GDP per head of population has not grown to the same degree.¹⁵ GDP is 4.6-times larger than it was in 1955. But GDP per capita is only 3.5-times larger. Since the mid-1990s, GDP growth and per capita growth have become increasingly decoupled. Much of UK growth can therefore be attributed to population growth rather than individuals or households becoming richer.¹⁶

Figure 1: GDP growth vs GDP per capita growth, 1955–2019

Source: ONS, *Onward analysis*



Lack of growth in GDP per capita

A rising population may give the appearance of growth, but the increase in economic activity is simply due to there being more people. Per capita growth is achieved by increasing output per person, meaning either longer working hours or by improvements to productivity. “Intensive” economic growth is the latter – when more is achieved with the same inputs, or when the same outputs are achieved with lower inputs of capital and labour.

Real per capita GDP is only 7.5% higher than in 2008, fifteen years ago – an annual growth rate of just 0.5%,¹⁷ as per capita growth has simply failed to recover since the great financial crisis.

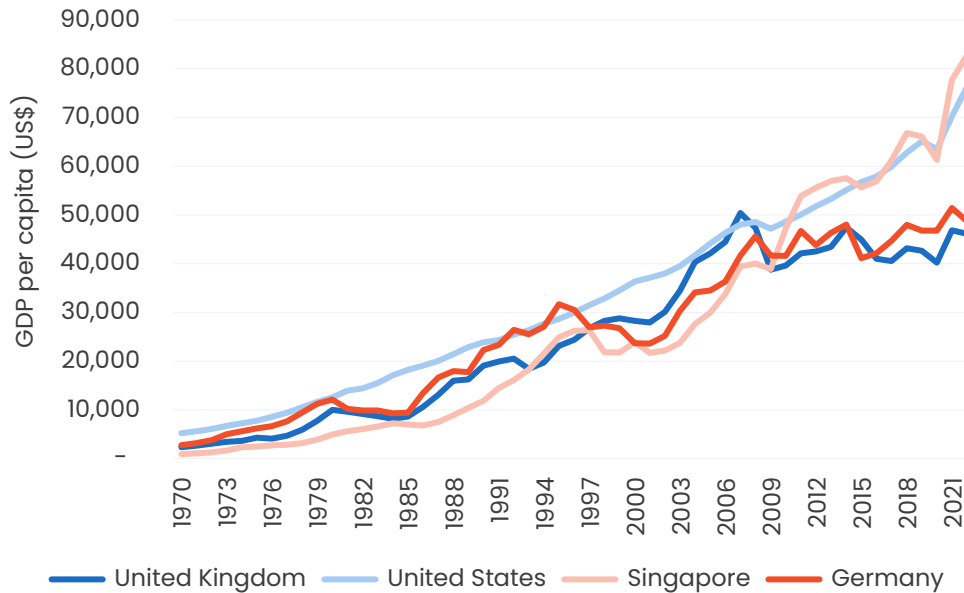
Britain compares poorly internationally

GDP per capita has grown in the US by 6.1 percentage points faster than the UK since 2006, Germany has grown 6.4 percentage points faster and the OECD average is 4.2 percentage points faster. UK performance is therefore not only weak relative to the US, but to other OECD comparators.¹⁸

This does not automatically translate into purchasing power; in Germany for example wages have historically been held down to improve industrial competitiveness.¹⁹ However, improving per capita growth is essential as a necessary if not sufficient condition for increasing real incomes.

Figure 2: GDP per capita (current US\$), select OECD comparators

Source: World Bank,²⁰ Onward analysis



Productivity determines living standards as well as per capita growth. The UK also compares poorly to the OECD in GDP per hour worked, outperforming Spain and Italy but lagging behind the USA, Germany, France and the Eurozone average.

Britain is a relatively low-wage economy

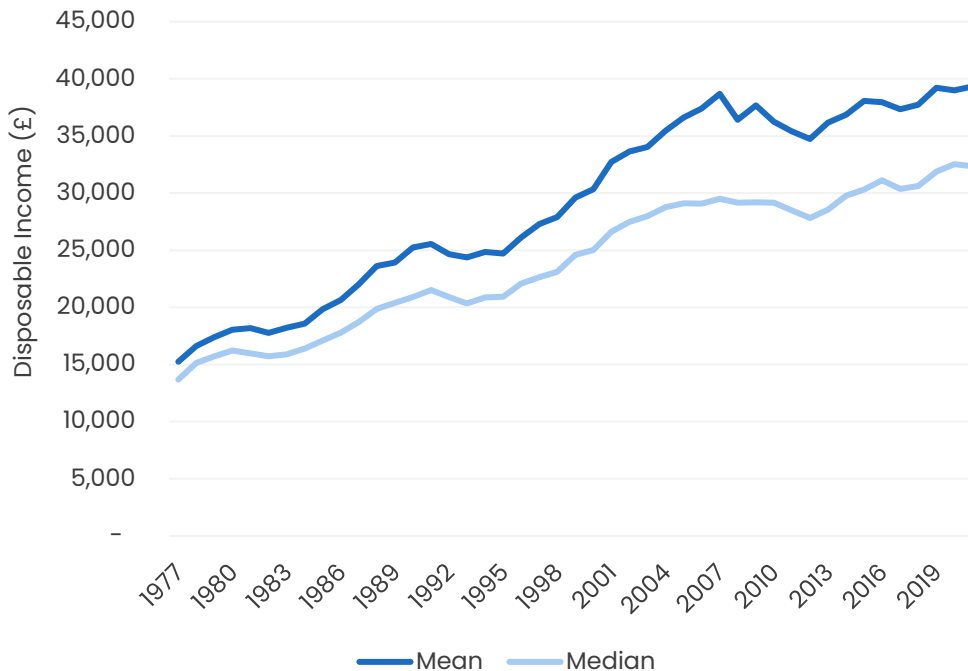
Average real weekly earnings in the UK remain below their 2008 peak.²¹ If pay had continued to grow at the pre-2008 trend, average annual pay would now be £10,700 higher per worker than now. The improvement to average incomes since the financial crisis has therefore been approximately zero. This contrasts with the 33% per decade increase in the thirty years from 1970 to 2017.²² Average household disposable incomes have failed to grow at anything like their rate prior to 2008, dropping after the financial crisis and only rising above their

2007-8 peak for the first time in 2014-15. Household incomes are now only 9.6% above their pre-recession peak in 2007-8.²³ Real disposable household income per person also remains lower than before the financial crisis.

It should also be noted that the gap between mean and median household incomes has gradually widened, signifying greater income inequality, with the gap peaking in 2007-8.²⁴

Figure 3: Mean and median equivalised disposable household income, in current prices, 1978-2021

Source: House of Commons Library, Onward analysis

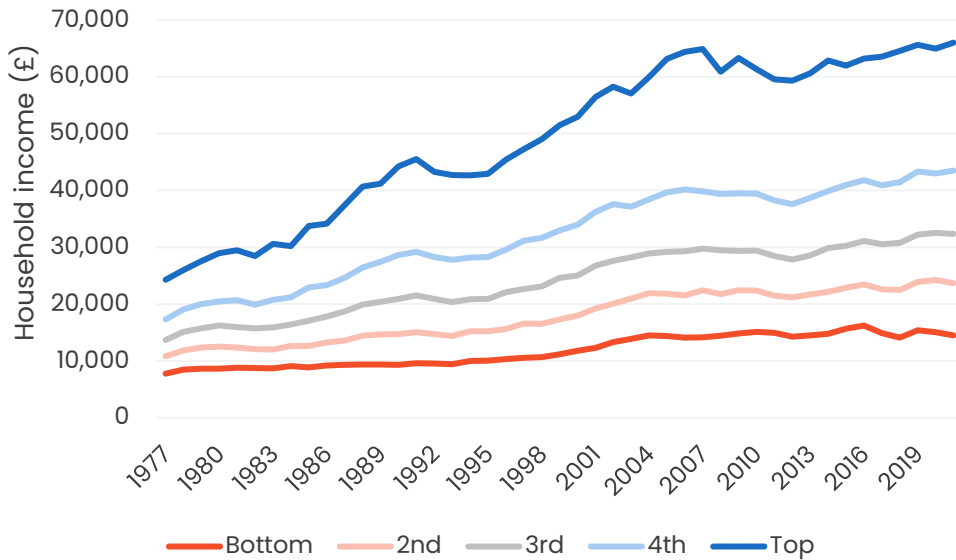


High inequality

In addition to weak growth in GDP per capita, disposable household incomes and real wages, the UK is increasingly unequal. The gap between quintiles in disposable household income has been growing over time.²⁵

Figure 4: Disposable household income by quintile, in current prices, 1977–2022

Source: ONS, *Onward analysis*



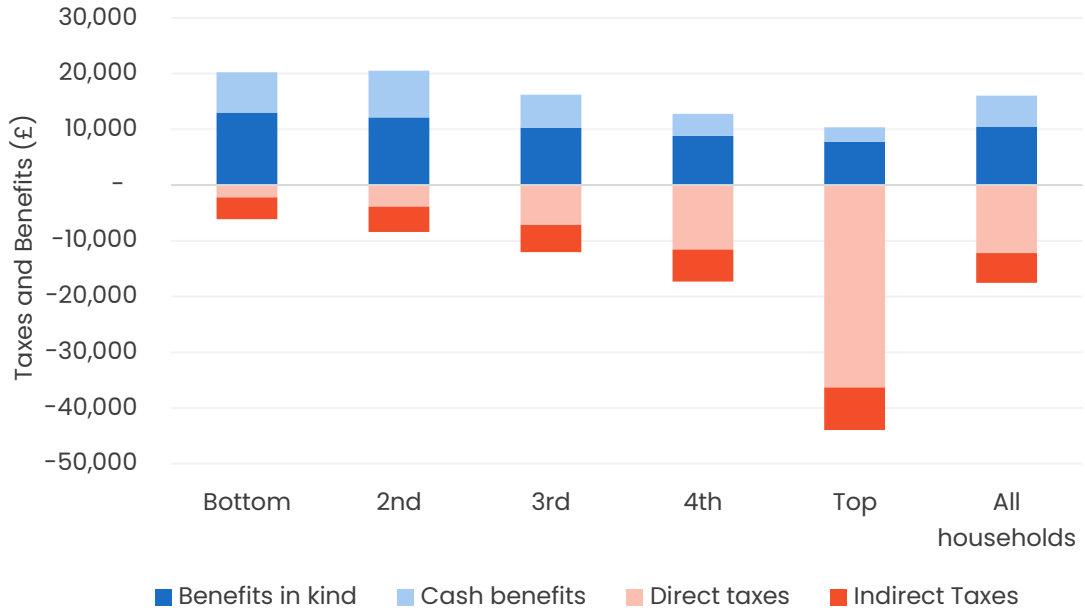
The UK is not an especially wealthy nation compared to other developed economies, as measured by average disposable household income, but is more unequal than most comparators in the OECD, as measured by the Gini coefficient of income inequality. Only the United States combines being richer and less equal than the UK.²⁶

The UK is relatively effective at mitigating the impact of weak wage growth in lower income deciles because it is fairly redistributive. A household with median income receives more in benefits and benefits-in-kind (public services and other social spending) than it contributes in taxes. The scale of UK income inequality is therefore mitigated quite heavily by fiscal policy, leaving Britain less unequal net of taxes and benefits.²⁷

However, this means that the UK subsidises the living standards of lower earners through fiscal policy, rather than improving them through real income growth. In 2022 the bottom, second and third quintiles of household income were net beneficiaries from the state, factoring in taxes paid, benefits received and public spending on services.²⁸

Figure 5: Effect of taxes and benefits on households by income quintile, financial year ending 2022

Source: ONS, Onward analysis

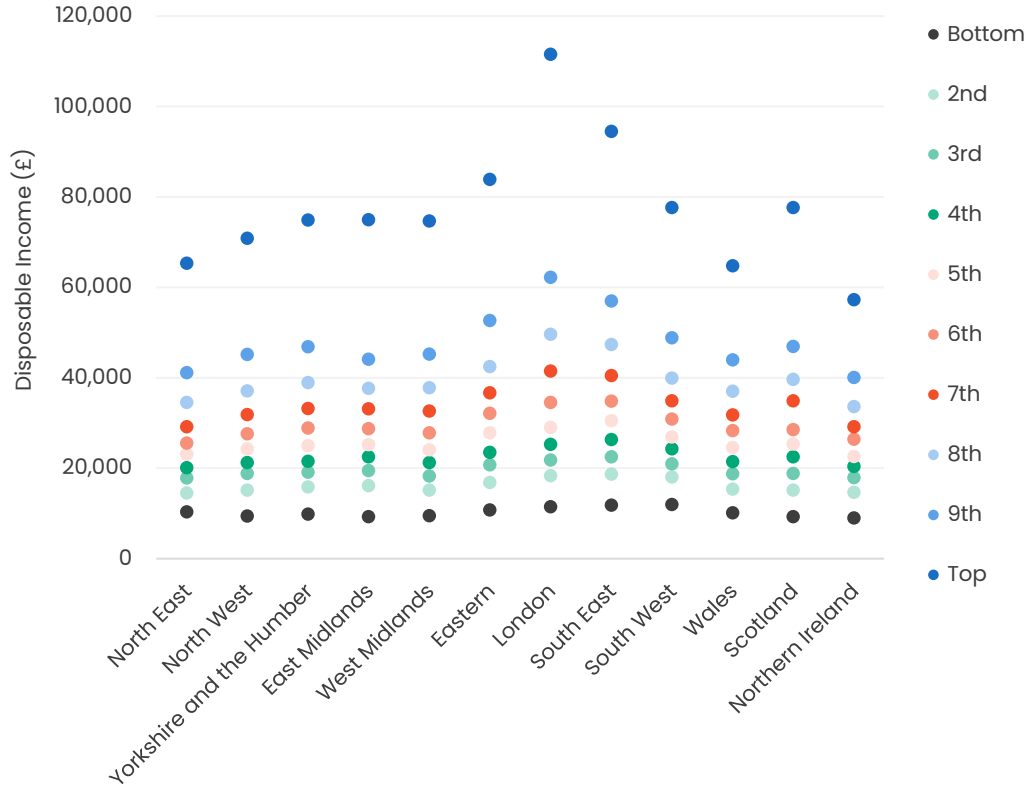


Regional inequality

The UK also has a high level of regional inequality, both in productivity and in overall living standards. In all ITL1 regions the real disposable household income of the top decile of earners is significantly higher than the 90th percentile, but there is also significant disparity between UK regions in real disposable income.

Figure 6: Mean equivalised disposable household income in 2018-19 prices by ITL1 region and income decile, 2018-19

Source: ONS, *Onward analysis*

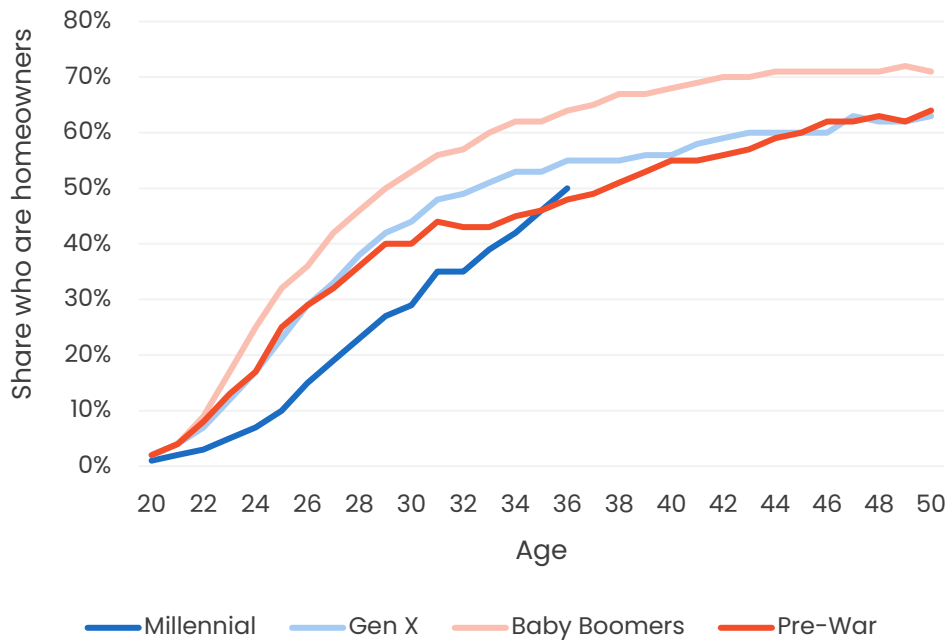


Wealth inequality

Britain has high wealth inequality. Income inequality is relatively stable, though still higher than the OECD average.²⁹ However, the increased barriers to obtaining assets - for most people, their primary asset is their home - have locked an increasing number of people out of home ownership, with UK wealth inequality now twice that of income inequality.³⁰

Figure 7: Home ownership by age and age cohort

Source: *The Times*, Onward analysis



Labour market insecurity

The UK does not have especially strong worker protections compared to other developed economies, including Norway, Austria, Sweden and the Netherlands. However, this is not compensated for by being particularly prosperous.³¹ There are important advantages to labour market flexibility - it is important for the UK's current economic model. It balances the rights of workers with flexibility for businesses, and Conservative governments have rightly restricted unfettered trade union power. It would be wrong to re-regulate the labour market in destructive ways.

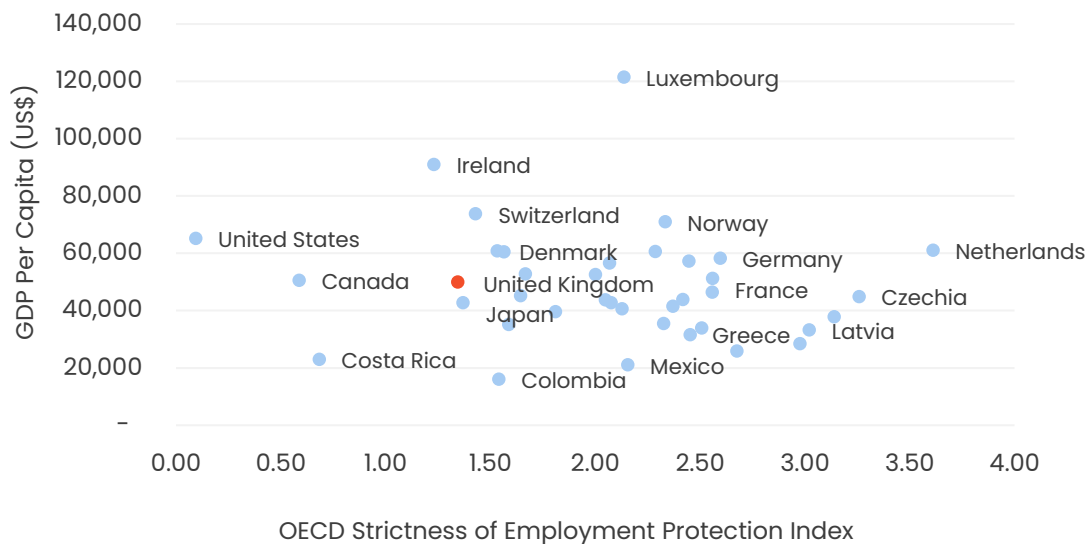
However, there has been growth in unstable work, legally ambiguous "gig" work which blurs the distinction between employment and self-employment, and definite cases of exploitation by companies operating contractor models for what is really employed work. There is therefore scope for improvements to UK workers' employment rights through corporate governance reform and greater legal protections for gig and agency workers, though not through a return to entrenched unionisation or the destruction of employment flexibility.

Ultimately, the UK should seek to move towards an economic model less dependent on poor quality or unstable work.

For workers to benefit from flexibility in the labour market there needs to be real wage growth. At present, there is neither significant wage growth nor strong employment protections.

Figure 8: OECD Strictness of Employment Protection Index, individual dismissals (regular contracts) and GDP per capita, 2019

Source: OECD, *Onward analysis*



High spending, weak investment

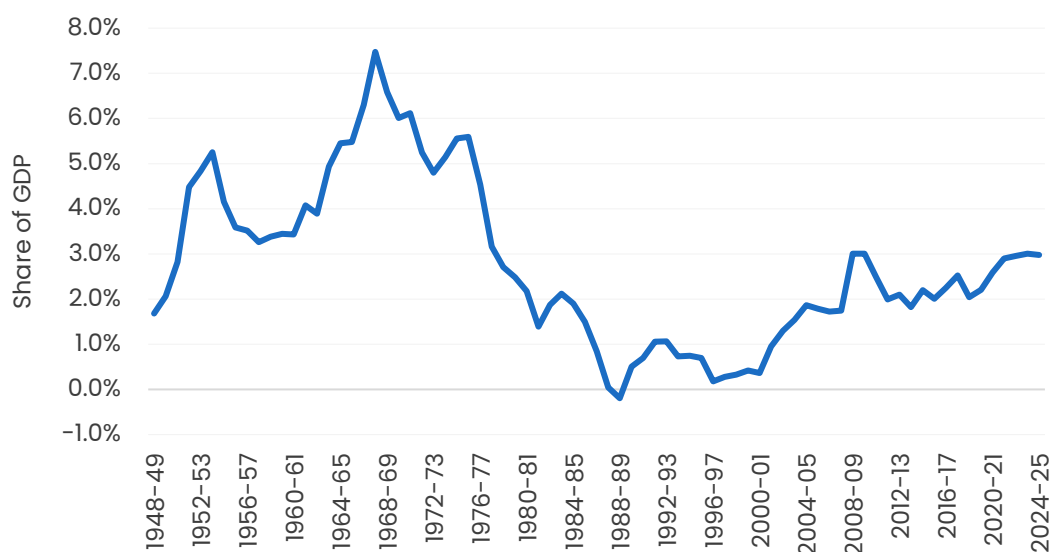
It is often simplistically claimed that taxes are “at an all-time high”. It is true that the “tax burden” - the percentage of national income taxed and spent by the state - is at a historic peak. In 2022-3, the UK Government raised £1,027 billion in receipts (taxes and other sources), or 40% of national income as measured by GDP, the largest percentage since the early 1980s.³²

However, taxation in the UK is structured in a relatively progressive way, with the top 50% of income taxpayers contributing 80% of the receipts,³³ and 29% of revenues supplied by just the top 1%.³⁴ Households on the median income (£35,000 per year) are net recipients of public spending.³⁵

The growth of the British state is primarily driven by revenue spending. This means day to day sources of spending on public services, working age benefits, pensions, grants to local authorities, defence and servicing the national debt. In contrast, capital spending has been consistently low relative to the OECD or G7. Public sector net investment peaked at 8% in 1967-8, but has been consistently below 5% for most of the post-War period.³⁶

Figure 9: Public sector net investment as % of GDP

Source: ONS



Conservatives are therefore right that public expenditure is high, but spending on investment is low. A higher than optimal percentage of UK expenditure is not in areas that will ultimately contribute to economic growth. This increase in per capita day to day expenditure is primarily caused by Britain’s ageing population. The Office for Budget Responsibility (OBR) predicts that in 2023-24, average government spending will be £23,700 a year for 75-year olds and £32,400 for 85-year olds. This compares to £19,100 for 15-year olds and £7,900 for 45-year olds).³⁷

Figure 10: Composition of public spending (total managed expenditure, current spending, public sector net investment), current prices

Source: IFS, OBR Public Finances Databank³⁸

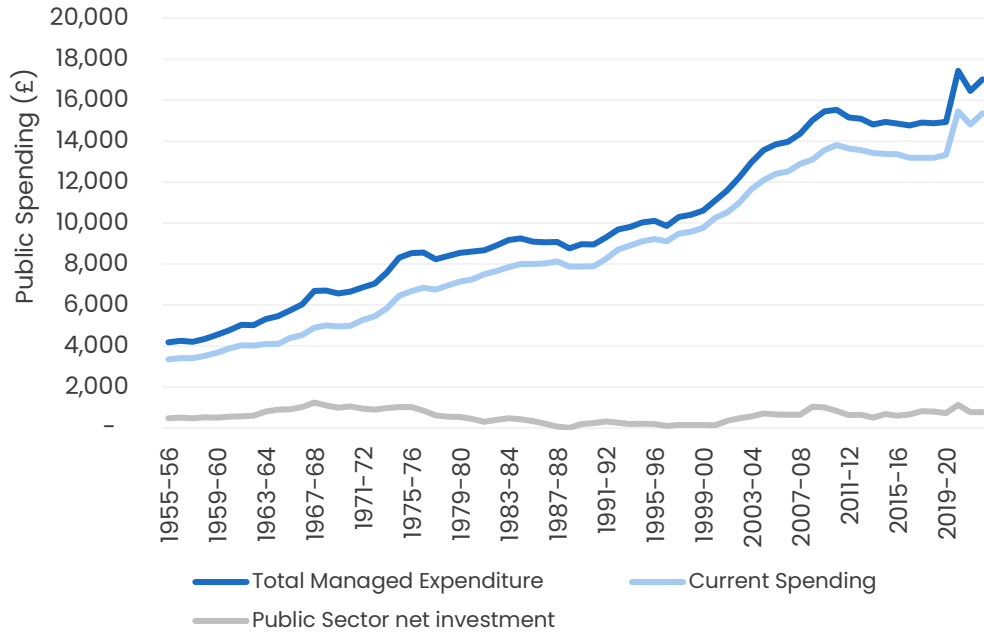
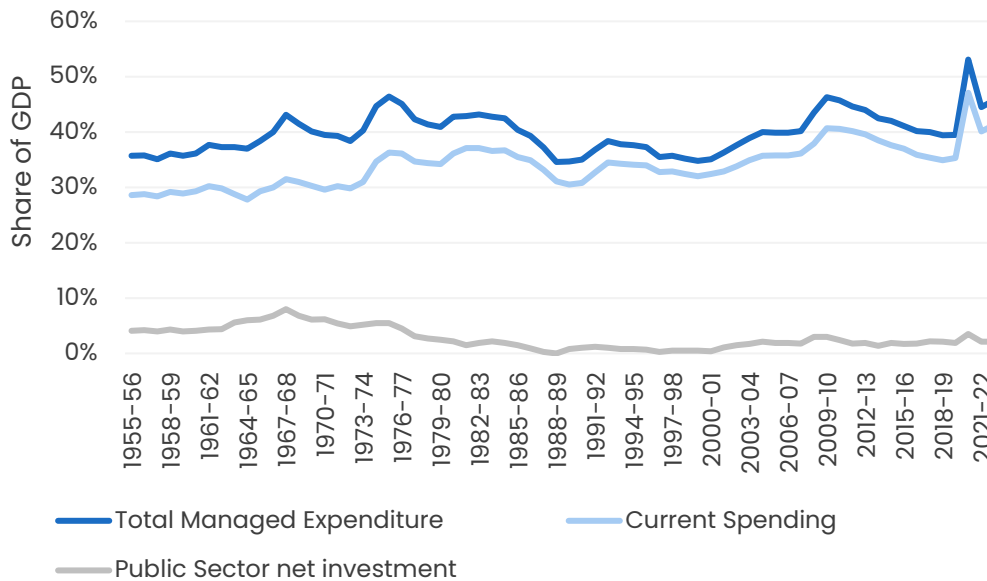


Figure 11: Composition of public spending (% of GDP)

Source: IFS, OBR Public Finances Databank³⁹



Economic exposure

The UK economy is exposed and lacking full “sovereignty” in various ways. Its supply chains in key strategic sectors such as automotive, aerospace, pharmaceuticals and electronics are heavily dependent on hostile economies such as China, or vulnerable exporters such as Taiwan. Just-in-time practices have prioritised efficiency over resilience and security as until the Covid-19 pandemic the ever deepening globalisation and access to tradable goods has been assumed.⁴⁰

The UK is also heavily dependent on foreign capital flows to sustain its large current account deficit. This constrains our freedom and room for policy manoeuvre, since we cannot risk the effects of capital flight. This means exposure to fluctuations in foreign interest rates, overseas investor confidence and desire to invest in UK assets.⁴¹

Finally, UK infrastructure assets such as Hinkley Point have been dependent upon capital from geopolitically hostile forces such as China, and UK utilities have gradually been acquired, with 70% of UK water being owned by overseas entities.⁴²

Principles of the current model

We argue that the outcomes facing the UK economy, including the challenges described above, are due in part to prevailing global conditions. But they are also the product of certain assumptions about policy-making and the principles these policy assumptions embody.

The orthodox model tends to make the following assumptions, which in this report we seek to contest:

Orthodox assumptions

The state should not seek to shape the structure of the economy. Government can correct for market failures by introducing environmental regulations, employment protections, monopoly controls and protections for intellectual property. They can also use fiscal levers to redistribute national income, provide a welfare safety net and subsidise regions. But the fundamental balance

of economic production between regions and the sectoral composition of the economy should be left to market forces to determine.

Optimal efficiency and utility should be the goal of policy. Pursuing liberal immigration or laissez-faire trade policies provide a net economic gain and are therefore desirable, even if they have regressive domestic effects such as undermining UK employment outcomes and the capital stock or eradicating productive and strategic industries.

The state cannot have any role in facilitating growth. Market-led growth is best achieved with as neutral and agnostic a policy regime as possible, without seeking to create (for example) pro-investment incentives, industrial policies, direct funding of applied R&D or industrial subsidies. Industrial strategies should be relatively neutral, sector-agnostic and supply-side, focusing on tax cuts and allowances.

Regional disparities are inevitable and can only be mitigated, not reversed. Regional policy is a damage limitation exercise. Economic centralisation is an inevitable consequence of development and globalisation, with an irreversible shift towards a services-based economy focused on London. It is not possible to shift more private sector economic activity outside the greater South East.

The march of hyper-globalisation cannot be reversed. Offshoring of industry is part of a market-determined process in which companies seek to minimise labour costs. Barriers between national economies will be unwound through international agreements and intergovernmental bodies. All forms of capital inflow are desirable regardless of their origin or purpose. Financialisation is never an extractive process, but only ever the efficient deployment of capital.

Britain has limited growth potential as a developed economy and must focus on fairer distribution. This “doomster” viewpoint - held by many in the Treasury - holds that there is limited scope for further growth given the UK’s advanced technological status and services-dominant sectoral mix. Economic policy should therefore focus on more just distribution, higher welfare spending or environmental goals, rather than increasing real incomes through better quality employment.

Automation will drive workless growth, driving a greater need for redistribution. It is frequently assumed that productivity growth from automation will destroy more jobs than it creates, meaning that in the long term the state will need to take a more redistributive role so that individuals and households benefit from automatically generated income, rather than being self-sustaining through work.

Flaws in orthodox economic approaches

Orthodox economic thinking has contributed to the current consensus. This approach assumes that economic actors are rational, that short-term material efficiency should always be optimised and that normative and qualitative concerns - such as the integrity of nation states, long-term prosperity and security, or the moral demands of social justice - are secondary. Issues such as the role of disparities of bargaining power between economic actors, such as employer and employee, or between domestic governments and multinational monopolies, are under-addressed.

Market forces are therefore often assumed to work for the common good by definition. In truth, they work best when calibrated towards the common good. Classical economic thinking only allows departure from market principles as a concession to voters, rather than because it is necessary to further moral or social ends, whether this is a fair distribution or stewardship of the environment.

The classical approach is blind to borders, assuming that improvements to global utility should be the goal of each individual government, rather than the welfare of its own citizens. Classical economics has been positive about the impact of globalisation, even when it has undermined national security or domestic fairness. And even Joseph Schumpeter, the early champion of what became neo-classical economics, accepted that capitalism unconstrained by the laws of nation states can sow the seeds of its own destruction by eroding non-market based social and public goods.

In the two decades since 1990, a huge amount of manufacturing was outsourced from the USA to China. Taking clothing as an example, brands such as H&M and Primark relocated their factories to this much lower-wage country, causing the price of clothing and footwear to halve. China benefited from export-led growth while Western consumers got cheaper clothes. But

retailers responded by launching new designs more frequently to make consumers buy more. More resources were consumed; apparel uses more resources than any global industry bar agriculture. Wastage is vast, before any ethical concerns about working conditions are even considered.

Classical economics is often blind to concerns of national security too. In orthodox thinking, the only difference between buying semiconductors from America or Europe on the one hand or from China on the other is the price. But the geopolitical reality is different: Britain is hugely reliant for essential supply chains on the West's largest global adversary. Again, in theory there is no problem with a country specialising wholly in one type of economic activity - Saudi Arabia exporting oil for instance.

But in truth this produces huge exposure to shocks and price fluctuations, and means a diminished industrial capacity. It matters whether countries as sovereign political entities have a diversified industrial base, to avoid the risk of rapid decline in one sector. The UK has suffered as a result of insufficient diversification, specifically due to the decline in productivity growth in financial services since 2008.

The integration of global labour markets through immigration in theory serves the classical goal of efficiency. If companies can find cheaper labour from overseas then using it is the optimal decision. Western workers who are "not productive enough" should in theory just move to a country where they can sell their labour for its global market value. But this ignores the fact that workers have ties to nations, families and communities.

We live in a world of borders where workers cannot simply move. A Swedish bus driver is no more productive than an Indian one, but he lives in Swedish prices, meaning it is necessary to protect his income through immigration control and minimum wage laws. Otherwise his wages will simply be undercut.

Orthodox approaches tend to ignore the difficult realities of political choices and trade-offs. In classical theory, an overseas purchaser buying UK housing stock is good; this is an investment in the country and the seller makes money. The theory is indifferent to the distributional impact (driving up house prices and rents for British people). It is open to governments to redistribute to compensate the "losers". But as the economist Dani Rodrik has pointed out, this part seldom actually happens, nor is it realistic to believe it would. Likewise

compensating workers who are displaced by offshoring or immigration is usually neglected, and the negative distributional impact of trade dynamics are treated as unimportant.

There is also an agnosticism about place. Local economies are assumed to be viable if they can compete in a global market. If not, their residents will have to move according to where the market creates work. Again, this ignores the reality of the place-based nature of human life, rooted as it is in the bonds of communities, families and local identity. If nation states are to have integrity, they must look after their less affluent regions. And geography matters to trade security - distance from end-of-line producers creates risk, as demonstrated by the blockages in Straits of Hormuz and the war in Ukraine.

To care about issues such as persistent current account deficits is now considered unfashionable. Why does a trade deficit in goods matter if the UK can attract foreign capital into its assets instead? But this does matter. Governments must be prepared to issue gilts to shore up demand for sterling, assuming that demand for UK debt is stable. And it constrains our policy choices by making us beholden to the risk of capital flight. This forces the UK to allow the purchase of its national assets, regardless of whether this is desirable. This results in Britain allowing unscrupulous investors to own utilities such as Thames Water, letting strategic rivals have a stake in nuclear power stations, or selling monuments like Admiralty Arch to international hoteliers. And this model entrenches regional inequality, with inward capital flows tending to accrue in London and the South East.

In reality, governments have always created the conditions for market-led growth, whether through legal systems, central banks, providing education or the building of railways. The state and the market are intertwined, and must remain so if we are to have sovereign nations. As Rodrik argues, it is not possible to sustain hyper-globalisation, democratic government and nation states all at once.

Finally, orthodox economists tend to see employment only as a cost, sidelining the downsides of reduced employment on regional economic performance and resilience and on people's livelihoods. The productivity growth that results in less need for labour but higher wages should be welcomed, but this still means displaced workers in need of a living, who may have families and roots in specific communities or be unable to reskill on their own. Decisions to allow

certain forms of employment to decline frequently do not factor in wider externalities, such as increased welfare spending or worse outcomes for the children of unemployed (or underemployed) parents. The non-economic aspects of work – dignity, purposes, status and health – tend to be treated as secondary.

We must fundamentally rethink the objective of economic policy. It should be orientated towards the achievement of growth, but in a way that prioritises the national community and its wellbeing, not global mathematical efficiency. Instead of cost reduction and the promotion of ever more consumption, our goal should be the creation of well-paid, stable and high-quality employment across most of our country. And it is the duty of the democratically elected representative government to put the economic interests of citizens first.

Crafting the alternative: conservative economics

It is not possible to divorce economic policy making from wider political, social and moral concerns. At all times, policy makers must consider what policies and economic outcomes will create a good society. For conservatives, a good society and a good economy will have particular characteristics. What are the economic “features” conservatives should value?

The security, strength and flourishing of the nation state. Conservatives believe nation states are the optimal unit of social and economic organisation, providing the best forum for solidarity, community, altruism, shared values and political accountability. Economic policies should therefore look to strengthening Britain as a nation, including its security, prosperity and constituent communities.

The welfare of workers and families. The goal of conservative economic policy should be to ensure that workers can through their labour acquire the benefits of growth through stable employment and steadily rising living standards. The incomes available to households should be sufficient to raise a family and to live a dignified life. Housing should be plentiful so families can enjoy the benefits of home ownership.

Opportunity for talent to thrive. Educational and skills policy can never completely eliminate inequalities without destroying property rights, but conservatives should deepen access to opportunity for a wider range of people

to ensure that socio-economic disadvantage does not prevent those with ability to achieve and benefit from their contribution. Social mobility should be available across regions and classes.

A just balance between regions. As believers in the national community, conservatives cannot be agnostic about place. It should be possible for people to ‘stay local and go far’, without being forced to move to the greater South East. More UK regions should be able to sustain themselves without large government subsidies, so the overall economy can be better balanced and the social fabric can be strengthened in underperforming areas, with less pressure on an overly dense South East with a declining quality of life.

The right conditions for market-driven growth. Britain should encourage the establishment and growth of businesses, a culture of innovation and the conditions for businesses to grow and create good quality employment, as markets are the best route to solving our biggest problems, from curing diseases to generating abundant energy and improving living standards. This means calibrating regulation in a way that is conducive to growth while providing the right incentives through tax policy, access to finance and where necessary industrial support.

A conservative vision for the economy is therefore different from an approach that is indifferent to the security and welfare of the nation state, the impact of economic trends on UK communities, the ability of workers to start and raise families, the form globalisation takes, mass immigration and economic dependency on large trade deficits and overseas capital.

Moving away from voters values

In 2019, research by Onward⁴³ examined voters’ relative levels of preference for freedom versus security across both economic and socio-cultural dimensions, using specific questions in a freedom-security index. It was revealed that the vast majority of voters favour either economic or socio-cultural security, or both. Only 7% of voters favour both greater economic freedom and more socio-cultural freedom.⁴⁴

Although this study was conducted in 2019 and voters’ values may have changed, there is little evidence to suggest that fundamental preferences have become either more socially or economically liberal.

Onward's research after the collapse of Liz Truss's brief government, *After the Fall*, showed that a libertarian policy agenda (prioritising both more social and economic freedom) would appeal to just 5% of the electorate. Research for the Centre for Policy Studies by Frank Luntz showed a strong general preference for security over freedom.⁴⁵

Previous research by Onward also showed comparative levels of support for the direction of the UK's cultural and economic values by region. The regions least satisfied with changes in the country's economic and cultural direction of travel are those outside the South East, with the North East the least satisfied. London has the greatest levels of satisfaction with the direction of both cultural and economic values.

Conservatives should instinctively support a model of economic arrangement that strikes a balance between economic freedom and security, growth and fair distribution, and widely spread opportunity. And even if growth were to be treated as the sole objective of economic policy, the existing approach has failed to deliver that meaningfully since 2008.

There is strong political support for a more rounded economic approach, factoring in the goods that matter to people. Economic freedom, markets and trade are all vital for a thriving economy, but economic policy in recent decades has prioritised openness at the expense of security and the wellbeing of communities.

There is a strong conservative case for a readjustment of economic priorities in favour of the welfare of the whole national community and the common good.

Making Britain productive again



The productivity challenge

Removing barriers to productivity growth, creating the right conditions for productivity to rise across more places in more industries and across employment types, is the key to improving incomes. But Britain seems to struggle compared to other advanced economies with its productivity performance.

Two factors determine labour compensation: labour productivity and the subsequent negotiation over where the proceeds of labour are allocated (between employer, employee, investors and the public sector, through tax). Of these, productivity matters most.

Poor productivity growth is causing flatlining real wages

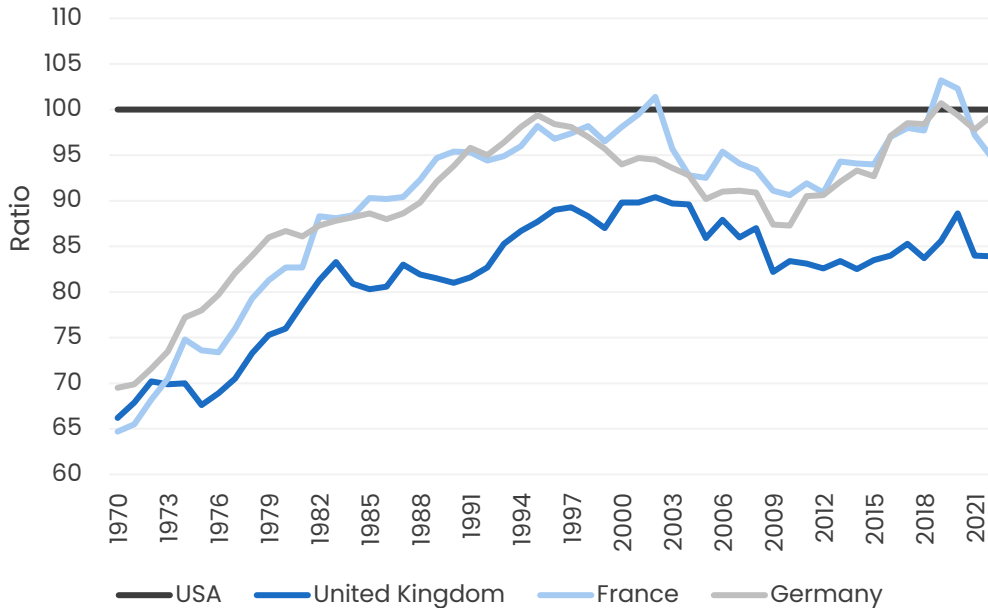
While in the United States wages and productivity have become decoupled, it is less true in the UK. The stagnation in wages and living standards is highly traceable to poor productivity performance. To improve UK real incomes, productivity performance must be improved.⁴⁶ This is not to say that labour representation does not matter, but improving worker bargaining power will be fruitless, and inflationary, without productivity growth.

The UK compares poorly to other countries in productivity

The UK compares poorly compared to the US and other European economies in productivity growth. UK labour productivity grew by just 0.4% in the twelve years after the financial crisis, compared to an average rate of 0.9% in the 25 richest OECD countries.⁴⁷ The UK's labour productivity gap with France, Germany and the US has since doubled to 18%.⁴⁸

Figure 12: Ratio of GDP per hour worked compared to US, current prices, current PPP, select OECD countries, (1970–2022), Index US = 100

Source: OECD, *Onward analysis*⁴⁹



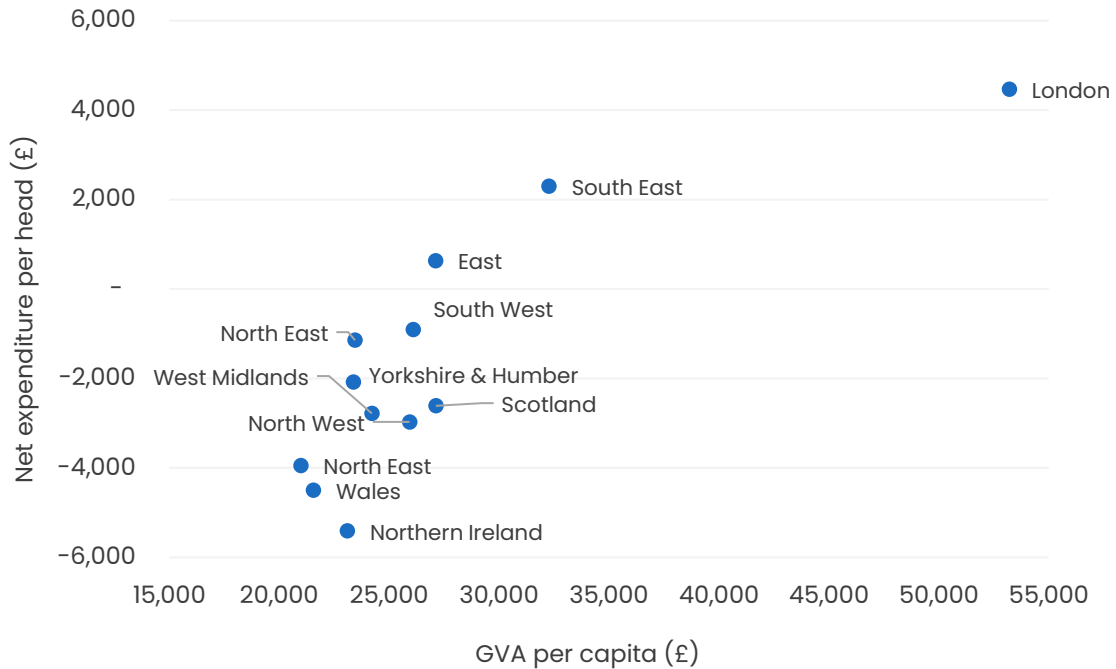
In addition to weak overall productivity growth, the UK suffers from an acute disparity in regional productivity performance. It is not enough to boost productivity further in the already relatively productive greater South East, as the majority of UK regions under-performing will simply act as a drag anchor on the wider economy.

Only London and the South East lie above the UK average in productivity. This gap is not just large; it is also growing, so over time regional divides are becoming more acute.

This gulf in economic performance takes its toll on the public finances, as every other region receives more in fiscal transfers than it receives; everywhere other than London, the South East and East of England is a net recipient from the Exchequer. It should be noted that per person expenditure includes spending on public services as well as any cash benefits.

Figure 13: GVA per capita (current prices) and net fiscal contribution per person by ITL1 region (2019)

Source: ONS, Onward analysis



Notes: Figures for 2019 have been chosen as regional gross value added (GVA) per head of population is unavailable after 2021 and 2021 revenue / expenditure figures are distorted by the pandemic. 2019 figures give a better picture of “ordinary” state of play pre-pandemic.

Those concerned about the continuous growth of state spending as a proportion of GDP should, then, be more concerned about improving the productivity performance of the UK outside the “Greater South East” than about general wastage in sources of revenue spending - important as that is. Regional underperformance is a major factor in accounting for high public spending.

Causes of the productivity problem

The main causes of the UK's productivity challenge are:

1. **Lack of productive private sector investment.** UK businesses do not invest enough in innovation, technology, fixed capital and business growth. Capital pools are not necessarily deployed most effectively for long-term productivity and growth.
2. **A poor balance of sectors.** The UK is strong in professional services but has too many sectors that by definition have limited scope for innovation and productivity growth. Deindustrialisation has been too deep with offshoring of productive sectors.
3. **A poor balance between regions.** This is a symptom of the UK's economic hurdles but it is also a cause as it becomes self-fulfilling: the UK's economic geography tilts towards London and the South East.
4. **Lack of public sector investment.** Public investment in infrastructure, fixed capital and R&D has not grown in the way that revenue spending has, making UK public spending low-return.
5. **Want of an industrial strategy.** While other economies increasingly engage in "vertical" industrial policies targeting high growth-potential technologies and sectors, the UK has remained comparatively agnostic. It has failed to reform planning or link infrastructure, residential building and commercial plant development as part of a combined package of planning reform. It does not have a clear export strategy and has allowed strategic sectors, such as steel, to wither.

The investment deficit

Investment lies at the root of all economic growth. Investments that build the stock of physical assets - structures, equipment, infrastructure, knowledge, technology and human skill - are the ultimate drivers of intensive growth.⁵⁰ These elements form the capital that make it possible to improve output per hour worked.

Since the 1970s investment as a share of UK GDP has declined, with brief spikes such as in 1988-91. Meanwhile, the percentage of total national income allocated to consumption has risen.⁵¹ And household consumption frequently relies on personal debt as real incomes are too low; our model is therefore to facilitate credit rather than to generate income growth.⁵²

This has led the UK to fall behind OECD comparators. The overall investment rate of the UK economy fell from a high of around 23% of GDP in the late 1980s to around 17% from 2000 onwards. Investment rates in other G7 countries remained in the range of 20-25%.⁵³

Total investment as a percentage of GDP has declined gradually. The overall national investment rate broadly tracks the trends in Gross Fixed Capital Formation (GFCF) in the private sector. But it is also important that public sector investment has declined significantly as a share of national income since 1960.

This is partly accounted for by the Thatcher government's privatisations; the transfers of ownership of significant public assets to the private sector meant that ownership of the relevant capital, and therefore responsibility for ongoing investment, was transferred to the private sector. The second factor is the cuts to capital expenditure entailed by moves towards greater fiscal restraint from 2010 onwards; while certain forms of public spending were (rightly) protected, such as pensions and the NHS, this meant that a greater share of spending cuts fell on capital expenditure.⁵⁴

International comparisons of capital investment

Britain's overall investment performance is weak relative to other advanced economies. In the 40 years to 2022, the UK averaged just 19% of GDP, the lowest in the G7. The UK's private sector investment rate as a percentage of GDP is also the lowest in the G7.⁵⁵

Total investment in the UK has been lower than comparator countries in the G7 for most of the post-1980 period. It fell more sharply than in these countries during the slowdown of the early 1990s, and has never regained its pre-1991 level as a share of GDP.⁵⁶

Figure 14: Gross Fixed Capital Formation (GFCF) as share of GDP, 1978–2021

Source: OECD, Onward analysis

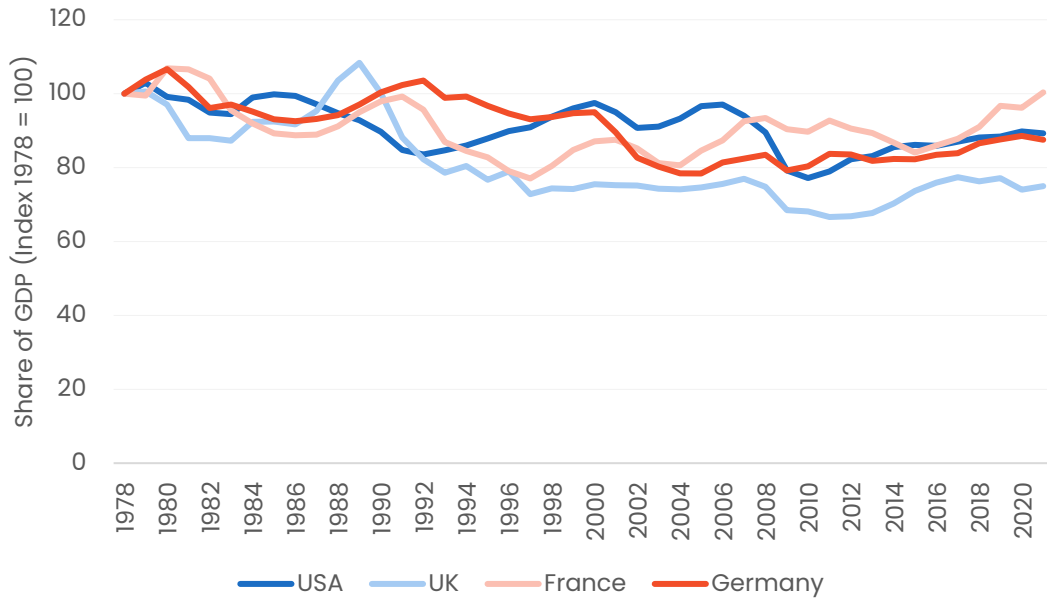
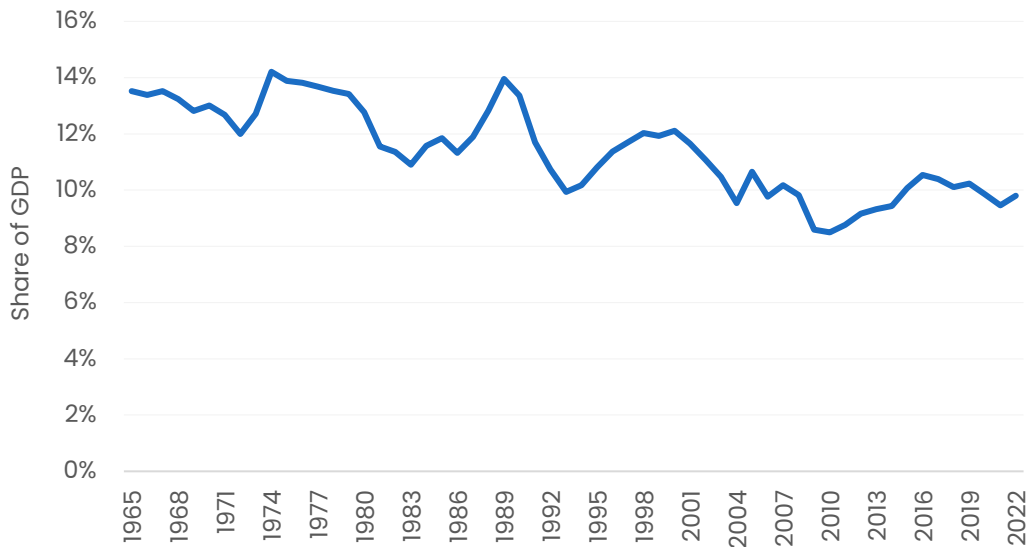


Figure 15: Business investment as share of GDP, 1965–2022

Source: ONS, Onward analysis



Business investment, a definition specific to the UK, includes both public and private corporations, but excludes government. It excludes investment in dwellings, including land and costs associated with transfer of ownership of non-produced assets. This has been relatively stable from 2016 onwards, but has never recovered since the spike in 1990-92 and remains consistently below the levels seen in the 1960s and 1970s.⁵⁷

The UK compares unfavourably with private sector investment rates, investing less than 11% of GDP consistently since 2005. The UK is one of the weakest investors in the OECD.

Those justifying the UK's low investment rates tend to argue that the UK is already an advanced economy where lower investment rates and higher consumption are expected, or that low investment is simply a feature of being a services economy.

This is implausible. The UK is not at the productivity frontier; it is closer to being a “catch-up” economy than a leader in productive innovation.⁵⁸ Far from having reached the limits of growth, as some have speculated, the UK is distinctly behind other advanced economies in both productivity and household incomes.⁵⁹

Why does Britain under-invest?

It is argued by some that the UK has a low investment rate (and hence productivity performance) due to factors it is difficult to reverse:

1. It is an advanced, developed economy with a smaller proportion of the economy accounted for by capital-intensive industries such as manufacturing
2. There is less scope for capital investment in services
3. Approaching the innovation frontier inevitably involves diminishing growth returns to investment and potential for productivity growth

These arguments are implausible:

1. The UK under-invests compared to other developed economies in the OECD such as France, Germany and the Scandinavian economies.

2. There is less scope for capital investment in services, but this is a cause for concern, not for complacency. Even in high value-added services, productivity growth has slowed.⁶⁰
3. The UK is sufficiently behind other developed economies that it is far from the innovation frontier; it is a “catch-up” economy.⁶¹

There must therefore be structural and incentive reasons why Britain chronically under-invests relative to its competitors.

Is weak investment due to excess taxation?

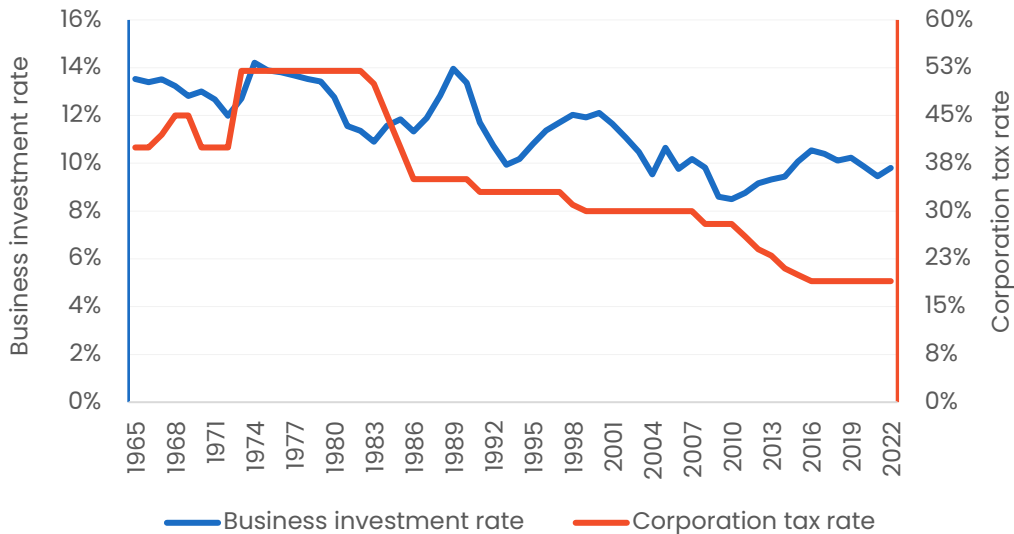
It is sometimes argued that a high burden of tax is responsible for Britain’s poor investment performance. On a simplistic level, it is true that profits collected through business taxation (whether business rates, employers’ National Insurance Contributions (NICs) or corporation tax) cannot be reinvested in business growth.

There is some evidence that headline corporation tax cuts can stimulate business investment.⁶² However, the evidence is mixed, and it seems they are not the best way to achieve this. The UK has experienced very low levels of business investment since 2008 despite cuts to the headline rate of corporation tax under George Osborne’s time as Chancellor.⁶³ There are multiple variables to be taken into account, but historically the business investment rate has not varied in accordance with the corporation tax rate.

Rather, increases to capital investment arise from incentives to invest, whether through capital allowances, regulation that is sympathetic to investment over other allocation of profits, or through provision of access to financial capital for the purposes of investment.⁶⁴ Recognising this, the budgets of Chancellor Jeremy Hunt have prioritised allowances for investment via the “Super Deduction” followed by “full expensing”.⁶⁵

Figure 16: Business investment rate and corporation tax rate

Source: ONS, Onward analysis



The headline corporation tax rate has historically borne little resemblance to the rate of business investment as a proportion of GDP. There is not a good reason, therefore, to think that further corporation tax headline rate reductions would necessarily cause a significant improvement to private sector investment, compared with investment allowances.

Given that taxation levels do not seem to be the principal barrier to the private investment rate, what are the incentives and disincentives driving low private sector capital investment?

Capital investment is unproductively deployed

In addition to Britain's general lack of investment in capital compared to other developed economies, one possible explanation for Britain's poor productivity growth and overall investment underperformance is that it does not allocate capital to the best places.

Investment in equipment and machinery has declined steeply from the mid-1980s to the present, while other capital investment categories as a share of GFCF have remained stable.⁶⁶

When GFCF is broken down by industry, it can be seen that by far the largest share of capital investment as a proportion of GDP goes to real estate - by definition, an economic sector that does not experience productivity growth as a result of investment.⁶⁷

GFCF in manufacturing has remained below 2% for most of the period since 1997, while GFCF in real estate has remained between 4 and 6% of GDP. The structural decline in manufacturing, which has strong productivity growth potential relative to other industries, has been noted by the Productivity Institute as one potential contributor to Britain's poor investment and productivity performance.⁶⁸

The decline in investment in equipment, machinery and weapons in the UK has been steeper than in any other country in the G7, falling below 6% of GDP in the late 1990s and to below 4% by 2021.⁶⁹

However, the UK has also experienced a decline in investment in other key sectors, notably those that replaced the structural decline in manufacturing as a share of the UK economy - finance and technology.

GFCF in finance and insurance as a percentage of gross value added (GVA) has remained low relative to other developed economies. It was much higher at 15% in 2000, falling to a low of 5% after the financial crisis; it has only recovered to around 10% now. In the 1990s GFCF in technology was over 40% of technology GVA, but it has struggled to rise above 20% since the financial crisis.⁷⁰

There is good evidence, then, that capital investment relative to the size of the relevant industry has failed to match OECD and G7 comparator economies. Specifically in the UK, technology and finance investment have failed to compensate for previous investment rates in manufacturing.

Improving private sector investment

There are structural and regulatory barriers to investment, as well as general trends in the functioning of UK companies away from reinvestment. There are important sectoral dynamics, with sectors that have become more important investing too little, while higher-investment sectors have structurally declined. But there are across-the-board problems with investment incentives, too.

Corporate tax and capital allowances

The UK has shifted towards a policy of base-broadening and rate cutting in relation to corporation tax. This may have been the wrong approach, with investment allowances historically among the least generous in the OECD.⁷¹ This means the effective tax rate on businesses is higher than frequently assumed.

But there is more the UK could do to promote investment through fiscal policy. For the majority of UK businesses the Annual Investment Allowance (AIA) is more than enough, as it makes qualifying plant and machinery investment fully tax deductible up to a limit of £1 million. However, the majority of UK business investment comes from a small number of very large companies. Plant and machinery is a major asset class, but other types of capital such as cars, intangible assets, buildings and assets used for R&D are treated differently. This different tax treatment of different asset classes may cause distortion and complexity.⁷²

A wider range of asset classes could be added to the eligibility criteria for the Super Deduction, including structures and buildings, long-life plant and machinery, and other intangible assets such as intellectual property (IP).

Furthermore, the fact that debt interest payments can be deducted from revenues when calculating taxable profits means that debt-financed investments are effectively subsidised relative to equity financed investments, potentially distorting investment decisions. Around 30% of investment is financed by debt.⁷³

In a 2016 report examining the relationship between tax, debt and macroeconomic stability internationally, the International Monetary Fund (IMF) said, “corporate debt bias, induced by deductibility of interest but not equity costs for the corporate income tax, remains a key [macroeconomic] stability concern”.⁷⁴

Fiscal reforms suggested by bodies such as the Institute for Fiscal Studies (IFS) include ending the tax-deductibility of debt interest payments, including taxing interest income for lenders (such as banks and bondholders), taxing borrowing on a cash-flow basis, and taxing recipients of “excess” interest payments above the level of a risk-free asset, such as a gilts.⁷⁵

Other countries have begun moving towards an allowance for corporate equity (ACE) to eliminate the bias towards debt finance in order to equalise the treatment of debt financing and equity financing to remove perverse incentives and reduce corporate debt exposure.

Reforming capital markets

Britain has the second largest pool of long-term capital in the world, yet it is not effectively deployed, and is increasingly divested from UK-listed equities.⁷⁶

Capital markets should be a source of finance for productive investment, which underpins long-term growth through better capital allocation. Capital markets in the UK have ceased to function in this way, with fund managers allocating very little to UK listed shares. The London Stock Exchange is increasingly a data-driven trading platform that does not raise capital from domestic investors.⁷⁷ The UK's diminished pool of domestic-equity investors has stunted the development of new companies and technologies that require long-term risk capital.

Technology companies are increasingly having to look overseas for capital investment, including in strategically sensitive sectors such as semiconductors, cybersecurity and AI, defence and biotech. Examples include Arm, DeepMind, Immunocore and Excscientia.⁷⁸

Deploying domestic capital more effectively – pension funds

Institutional investors – especially pension funds – have chronically under-invested in UK equities for around two decades. Between 2001 and 2022, UK private sector pension fund holdings of UK equities decreased from over 50% of the average pension-fund portfolio to just 4% today.⁷⁹

Over the same period, their holdings of fixed-income securities (mainly gilts and corporate bonds) increased from 15% of total assets to approximately 60%.⁸⁰ This shift in investment practice was in part the result of regulatory changes implemented under Tony Blair and Gordon Brown in the early-2000s.

UK pension funds are a small percentage of GDP compared to other developed economies, and now offer some of the weakest returns in the industrialised world.⁸¹

The removal of the dividend tax credit for pension schemes by Gordon Brown had an unforeseen consequence of discouraging UK pension funds to hold shares in UK listed companies. The hardening of contractual obligations on employers, shifting pension fund obligations into a hard liability, forced the inclusion of pension fund assets and liabilities onto corporate balance sheets. Assets would appear at annual prevailing market value, and total future pension liabilities would be discounted at (in effect) a long-term bond rate.⁸²

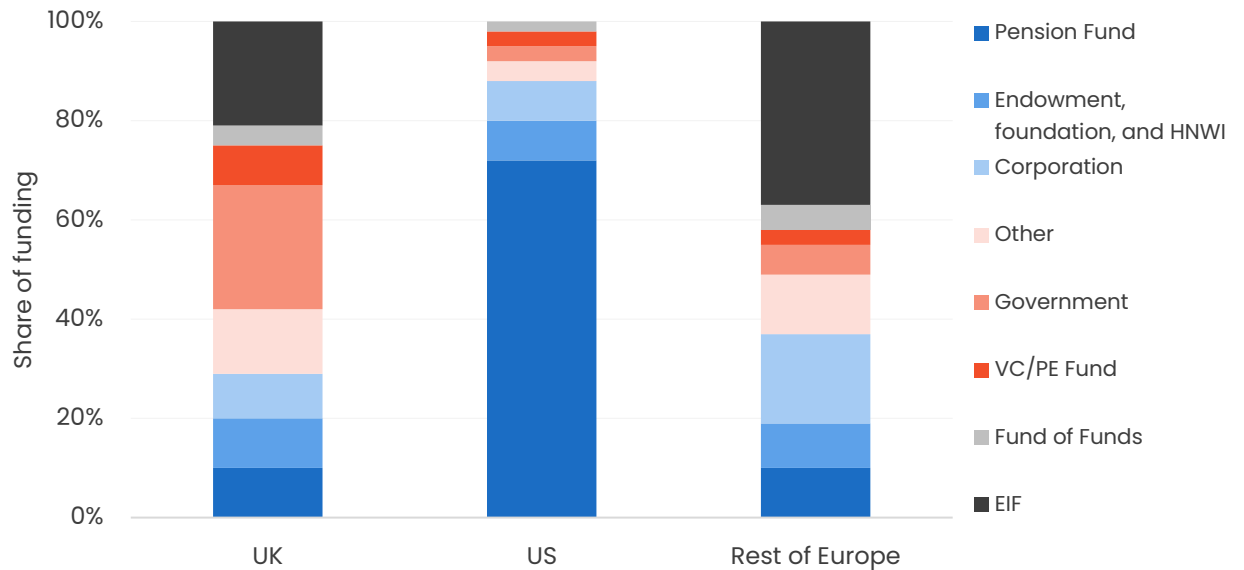
The monetary policy landscape contributed to structural problems. Historically low interest rates did not prompt defined benefit (DB) funds to reassess their bond portfolios, as their overriding objective was to reduce risk for corporate sponsors. Rather, funds turned to leveraged LDIs to generate increased returns given the low interest rates on bonds.⁸³

The House of Lords Industry and Regulators Committee found in February 2023 that accounting standards had contributed to the post-2022 mini-budget LDI crisis.⁸⁴ In particular, calculating the present value of future pension liabilities according to a low-interest market rate, disregarding the possible upsides of more diversified portfolio investment created incentives to invest in bonds and LDIs rather than equities.

The percentage of UK equities held by UK pension funds was 18% in 2000. This had declined to 6% by 2010, and is now just 2%. In 2000, 48% of UK pension fund assets were invested in UK equities. This was down to 21% in 2010 and is just 4% now. In the average developed economy pension funds are 2,089% overweight in domestic equities. UK pension funds are 41% underweight.⁸⁵ No other country does this.

Figure 17: UK and US proportion of commitments made venture capital by funding source, 2017 – 2021

Source: British Business Bank, Onward analysis



An international comparison of pension funds shows that UK defined contribution (DC) funds underinvest in venture capital. Of the five largest Canadian and US funds, 21% and 13% of their assets were allocated to growth capital (private equity and VC) respectively. For Australian pensions, the figure was 4.6%. But for the very largest UK DC pension schemes, just 1.4% was allocated to growth capital.

Data published in 2021 shows that roughly two-thirds of all UK DC pension schemes had no investment from their main funds in this category at all,⁸⁶ with an industry-wide average across the largest pension schemes of just 0.3%.⁸⁷ Overseas pensions invest 16 times more in British venture capital and private equity than domestic public and private pensions do.⁸⁸

The UK currently has one of the largest pension markets in the world, but it is ineffective at deploying available capital. The UK's DB pension industry is fragmented, with more than 5,200 schemes with an average size of £330 million.⁸⁹ The disparate market would benefit significantly from consolidation, drawing on the example of the existing Pension Protection Fund (PPF).

As Onward has previously recommended, a UK super-fund could be brought under the jurisdiction of the British Business Bank (BBB), to provide venture capital investment expertise.⁹⁰

At the 2023 Spring Budget, Chancellor Jeremy Hunt announced the introduction of an additional £5,000 tax-free ISA allowance for investment in UK equities.⁹¹ This reflects an important principle; while individuals are free to invest their savings wherever they choose, there should be a return to the country if they are in receipt of a tax exemption from the Exchequer. There is scope to entrench and deepen such policies. For example, stamp duty could be removed from UK shares, or a much larger proportion of the tax-free ISA allowance should have to be in UK shares.

Charles Hall, head of research at Peel Hunt, has suggested that 800,000 savers filling their ISAs under Hunt's scheme would result in an extra £4 billion into UK equities.⁹² An expansion of UK share-focused tax relief could therefore be transformative for UK domestic investment.

Growth capital

In the US, the most significant source of funding for startups is pensions. They are the source of 72% of all venture capital cash. In the UK, they are the source of just 10%.⁹³

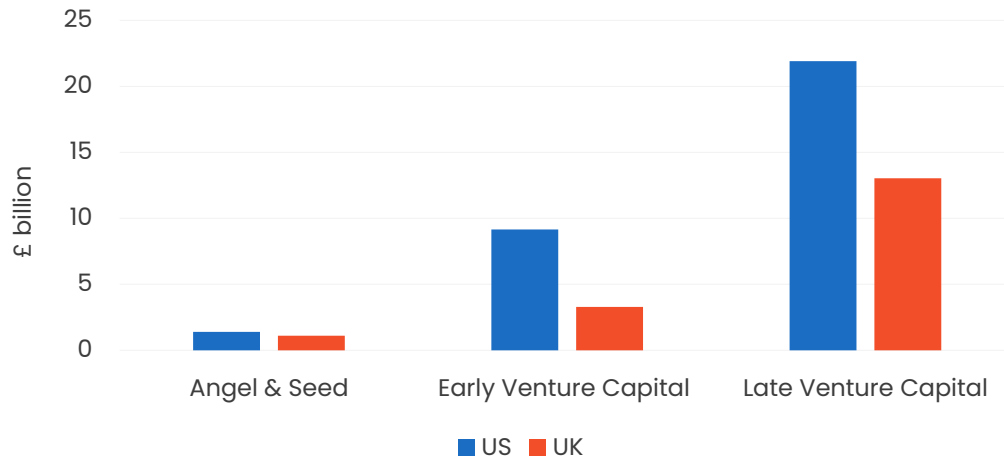
Government funding is important in bolstering many aspects of the research ecosystem, but financing high-risk commercial ventures is dominated by private money like private equity and venture capital (VC), often termed collectively as “growth capital”. Adding up the various initiatives across Government to support high-risk commercial ventures – including the annual budget of Innovate UK, the multi-year Long-term Investment for Technology and Science (LIFTS), the British Business Bank's Life Science Investment Programme and the one-off Future Fund: Breakthrough – amounts to around £1.5 billion. Private funding, on the other hand, was £18.1 billion in 2021 alone.

In 2022, although the UK venture capital sector raised £25.3 billion of capital, slightly above the 10-year average, only 15% of this total was invested in the UK.⁹⁴ The UK largely keeps pace with the US on early-stage investments (adjusted for economy size), but is far behind when it comes to later-stage firms that are scaling up.

For firms this means that the UK is, on the whole, just as successful as the US at finding money for newer, less-developed businesses, but far less so when it comes to financing more advanced companies, especially those that are in the process of scaling up activity such as hiring or building new facilities.

Figure 18: UK and US investment by stage, £ billions, scaled to UK GDP

Source: British Business Bank, Onward analysis



Inadequate access to investment is causing too many firms to fail, move abroad or be bought out by competitors. There are recent high-profile examples of UK firms finding other ways to secure funding, including being acquired by foreign companies. The AI firm Deepmind was bought by Google in 2014 and the semiconductor firm Arm was bought by Japanese conglomerate Softbank in 2016. Others have listed on non-UK stock exchanges, such as Oxford vaccine firm Vaccitech (listed on the Nasdaq in 2021).

According to British Patient Capital, less than half of Britain's most innovative firms reach their second funding round, compared to 63% of American ones.⁹⁵

Venture capital

At present, the UK venture capital (VC) sector receives state support through three tax reliefs: the Enterprise Investment Scheme (EIS), the Seed Enterprise Investment Scheme (SEIS) and Venture Capital Trusts (VCTS). British Business Bank (BBB) funding schemes also support British VC.

Recent evidence to the Treasury Select Committee that the support schemes are internationally competitive and a significant draw, but are due to expire in 2025.⁹⁶ However, the VC sector received criticism for its failure to invest in regions outside the South East.

Reforming mergers and acquisitions

A further element of the UK's productivity and investment challenge is the scale and type of mergers and acquisitions activity the UK experiences. M&As can have a positive role in improving efficiency and providing growth capital. They can contribute to scaling up economic activity and enhance corporate agglomeration effects. But they can also represent little more than a proprietary acquisition by another UK company or overseas entity.

The UK is a leading target for overseas acquisitions. Despite being only the fifth largest economy in the world, the UK ranks fourth for M&A activity by volume, and third by value, globally.⁹⁷

The UK operates a liberal M&A regulatory regime. Under the New Labour government the Enterprise Act 2002 vastly limited the grounds for intervention in M&As by the Competition and Markets Authority (CMA). Prof. John Kay, commissioned to review short-termism in UK equity markets, concluded that the rules were “extraordinarily permissive.”⁹⁸

Impact of the UK's liberal M&A regime

Although mergers and acquisitions are a natural part of capitalism and bring many positives to a healthy economy, M&As can harm productive investment and productivity growth. M&A activity geared towards cost-saving or in anticipation of a sell-off can result in a reduction in corporate investment, the closure of facilities, cutting back on R&D and winding up core business activities.⁹⁹

Mergers and acquisitions are often debt-financed, such as through leveraged buy-outs. Debt financing contributes to the overall buildup of corporate debt in the economy and cause funds to be divested from productive activities and into

paying down debt.¹⁰⁰ This is compounded by the incentive provided by writing off debt against tax.

M&As can also integrate competitors, reducing competitive intensity and diversity within the market. They can contribute to short-termism,¹⁰¹ deterring companies from focusing on productive investment or long-term R&D; improving dividend performance may become more important to managers in order to stave off hostile takeovers, and acquisitions that do occur can be orientated towards asset-stripping rather than ongoing productive business activity.¹⁰²

Reforming share buybacks and executive compensation

Share buybacks and executive pay have risen regardless of actual business performance or growth, reaching record levels in 2023.¹⁰³ These are an aspect of corporate short-termism, facilitating enrichment or even wealth transfers from workers rather than investment in business growth.

Share buybacks also incentivise the taking on of corporate debt, as buyback schemes are often financed by borrowing, transferring stock ownership to executives as part of their compensation. This culture has been incentivised by loose monetary policy, which has driven the cost of borrowing down to nearly zero or even below.¹⁰⁴

The UK suffers from a dependency on dividends rather than share value growth for investor returns,¹⁰⁵ resulting in a culture of chronic under-investment and short-termism.

Divestment from UK listed equities has contributed to a complete reversal in M&A flows. The annual average net value of outward M&A acquisitions was positive each year from 1988 to 2003.

In every year since, there has been an annual net outflow measured by value, meaning more foreign companies are acquiring UK companies than vice versa.¹⁰⁶ This represents not just a loss of control, it also indicates a lack of dynamic business growth among UK-listed companies. In sectors that have strategic significance, or which involve strategic assets - rail, utilities, nuclear facilities, AI and compute, and semiconductor design and manufacture - there

are potentially national security implications, with critical infrastructure subject to majority foreign ownership.

The UK is therefore highly reliant on foreign direct investment (FDI) and does not effectively marshal its domestic capital reserves into companies seeking to pioneer innovation or to grow commercially.

Steps could be taken to improve policy to incentivise a much more investment-orientated economy.

Pension fund regulation should be reformed to enforce international benchmarking and incentivise investment in higher-growth assets, particularly UK-listed equities, with appropriate tax reliefs and reform of accounting regulation to remove the incentive towards de-risking.

The UK should follow Australia and New Zealand in increasing default pension contributions to increase national savings and investments relative to consumption in order to boost domestic industry and exports.

A greater proportion of UK ISA savings should be required to be invested in UK equities if they are to qualify for tax exempt status.

Corporate Equity Allowances (CEAs) should be introduced to move towards the equalisation of the taxation of debt and equity financing.

Oversight of M&As via the Competition and Markets Authority (CMA) should be expanded to go beyond issues of competition, the free press, national security and financial stability and should include protecting core R&D capabilities, manufacturing capacity, security of strategic intellectual property (IP) and employment outcomes.

Stricter transparency and notification requirements for acquiring companies should be implemented to declare intention when conducting a takeover so that intentions to sell assets, impact on workforce and R&D expenditure and other strategic decisions are made clear.

Leveraged buy-outs should be disincentivised by introducing a claw-back for debt finance tax deductions if acquiring companies engage in certain activities,

such as asset-stripping, or if they sell the acquired company in less than a minimum period of time.

Buybacks funded by new debt issuance should be prohibited to prevent the undercutting of investment through corporate leverage.

American-style defensive measures against hostile M&As should be put on a statutory footing, including the ability of company management to require super-majorities of shareholders to approve an acquisition. This could be limited to companies with an important R&D or manufacturing capability as designated by the CMA.

The unbalanced economy: sectors

One of the barriers to UK growth is the sectoral make-up of the economy. It is often assumed that the “correct” sectors to operate in the UK will be determined purely through market forces, with businesses establishing, investing and growing in the UK as and when they have a comparative advantage relative to the rest of the world.

However, the sectoral composition of economies is as much a product of public policy choices (and policy choices made in other countries) as of natural advantage.

Although Chinese manufacturing has struggled most recently, it still accounts for over 28% of global manufacturing output.¹⁰⁷ This is partly due to China’s relatively low labour costs compared to those in Europe and the United States. However, the Chinese government allocates somewhere between 1.7% and 5% of China’s total GDP to industrial subsidies.¹⁰⁸ So the policy choices of other governments affect industrial competitiveness on a global scale. In contrast, the UK chooses to adopt a relatively laissez-faire approach towards its industrial base.

The current shape of the UK economy is one with too many industries with weak productivity growth (and potential growth) representing too large a proportion of the economy.¹⁰⁹ Manufacturing industries, for example, are often those with the strongest record of total factor productivity (TFP) growth, yet

manufacturing has declined as a share of the UK economy from over 25% in 1970 to 15% in 2000 and under 10% now.¹¹⁰

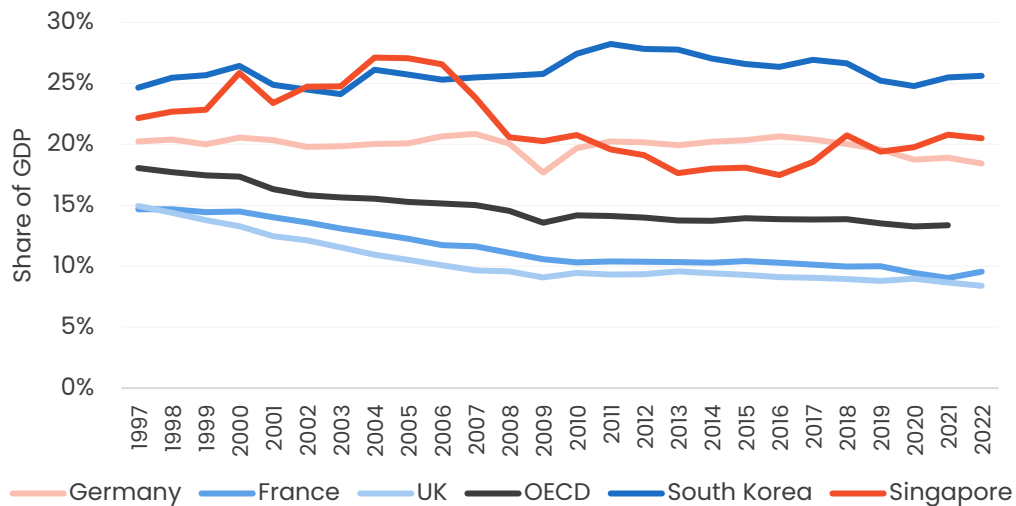
There are particular sectors that have grown most in TFP since the mid-1990s, and these include information and communication technology (ICT), finance and insurance, manufacturing and professional, technical, scientific and administrative services.

Manufacturing has experienced higher levels of productivity growth than the UK economy as a whole. However, its growth in gross value added (GVA) has struggled relative to the rest of the economy, indicating that it has struggled to grow as a share of the economy as its productivity has improved.

Manufacturing has declined in its contribution to national GVA, in spite of recovering steadily after the 2008 financial crisis. It has failed to keep pace with the wider economy. This does not signify a lack of productivity or productivity growth in manufacturing. Rather, it shows that the quantity of manufacturing output relative to the output of the wider economy has fallen.¹¹¹

Figure 19: Manufacturing gross value added (GVA) as share of GDP, 1997–2022

Source: World Bank, Onward analysis



It is frequently suggested that manufacturing decline in an advanced economy like Britain's is inevitable. However, this is not a convincing argument to be sanguine about its decline. First, this does not account for the UK's more rapid deindustrialisation relative to the OECD.

Secondly, if manufacturing decline is a significant part of the UK's stagnation in productivity, there is a strong case for adopting industrial policies to improve manufacturing investment, output and performance, if this will in turn lead to growth, a reduction in the current account deficit and greater national supply chain security.

Thirdly, manufacturing provides a well-paid source of employment, particularly for non-graduate workers outside the greater South East, offering a 12% pay premium even when controlling for qualification level and seniority.¹¹²

The UK should not conduct industrial interventions to save industries that are economically non-viable, have been superseded or could never be successful in the UK. But there is a difference between a non-viable industry and one which could be viable with appropriate levels of state support, even if temporarily, in line with what has become international norms.

Why does manufacturing matter?

Manufacturing is important because it contributes disproportionately to productivity growth, with a high level of growth in output per hour worked relative to other sectors. It also tends to export, bolstering the UK's global trading position. This is because manufacturing industries benefit from investment in innovation and technology to become more productive.

Manufacturing output therefore contributes to overall national productivity in two ways:

1. By innovation and technology meaning more and more valuable goods can be created more efficiently
2. Even with existing manufacturing technology, given that manufacturing more productive than average, pursuing a greater quantity of it will tend to improve national productivity

Low-value services struggle to experience productivity improvements. Fast food restaurants can use automated ordering systems, but it is difficult for hospitality, retail, domestic and cleaning services or cosmetic services such as hair dressers to improve output per hour. Rather, their prices rise in line with inflation and the growth rate set by the wider economy. Rising incomes must come from somewhere so that consumers can afford to pay for these services.

Higher-value service industries such as law, financial and professional services have experienced a growth in total factor productivity through better utilisation of ICT. However, their productivity growth curve has seen a significant taper.¹¹³ Furthermore, these industries tend to be strongly based in London and the South East; they cannot necessarily provide good quality employment to the rest of the country.

From 1997 onwards productivity in financial services grew from around twelve percentage points above the whole economy to around forty percentage points higher.¹¹⁴ It was therefore growing much faster than the economy as a whole in output per hour.

However, from the financial crisis onwards its productivity growth has flatlined. It is unlikely therefore that financial services will be able to sustain the levels of consistent productivity growth needed to achieve rising living standards across the UK. Productivity growth must come from somewhere, then, and this means a stronger and growing industrial base.¹¹⁵

The value of manufactured goods and the “productivity curse”

An argument advanced by some is that manufacturing productivity growth inevitably leads to cheaper manufactured goods and hence a decline in the value of manufactures, meaning a reduction in manufacturing value as a share of the economy. The more productive manufacturing is, the less valuable its output becomes.

However, this assumes that manufacturing output remains the same (while productivity rises and prices fall). Manufacturing as a share of the economy could remain stable or even increase if output increased, even if the price of goods falls.¹¹⁶

Manufacturing employment and R&D is also concentrated disproportionately outside the South East, and therefore provides an important source of investment, innovation and work in regions which, without it, would fare even worse.

The Government should create a new National Manufacturing Taskforce to oversee renewal of private sector manufacturing industry. Its remit should include output and productivity targets, export benchmarks and identification of critical industries for ringfenced treatment through funding and governance oversight, looking to industrial policy exemplars such as South Korea and Singapore.

The British Business Bank should be expanded into a fully-fledged Industrial Bank for harnessing UK capital markets including pension funds with a statutory remit for providing finance to UK manufacturing and export industries and for investing in technologies as laid out in the Science and Technology Framework.

The Department for Business and Trade should go beyond identifying critical technologies and designate particular industries of strategic significance when considering match funding and subsidy decisions, taking into account growth and export potential, security considerations and concerns such as control of new innovation and technology. This should focus on high-growth sectors such as information and communication technology and AI, semiconductor design and manufacturing, life sciences, telecommunications and pharmaceuticals as well as infrastructural capacity such as steel.

The unbalanced economy – regions

The UK suffers from a high degree of spatial inequality. This problem has been comprehensively identified and explained by the Conservative Government's 2022 Levelling Up White Paper, which laid out the UK's geographical disparities in detail.¹¹⁷

Regional inequality is not uncommon across global economies, and especially in advanced economies where agglomeration effects make high-skilled urban hubs centred around the knowledge economy significantly richer than national averages. However, the UK fares poorly on measures of regional inequality

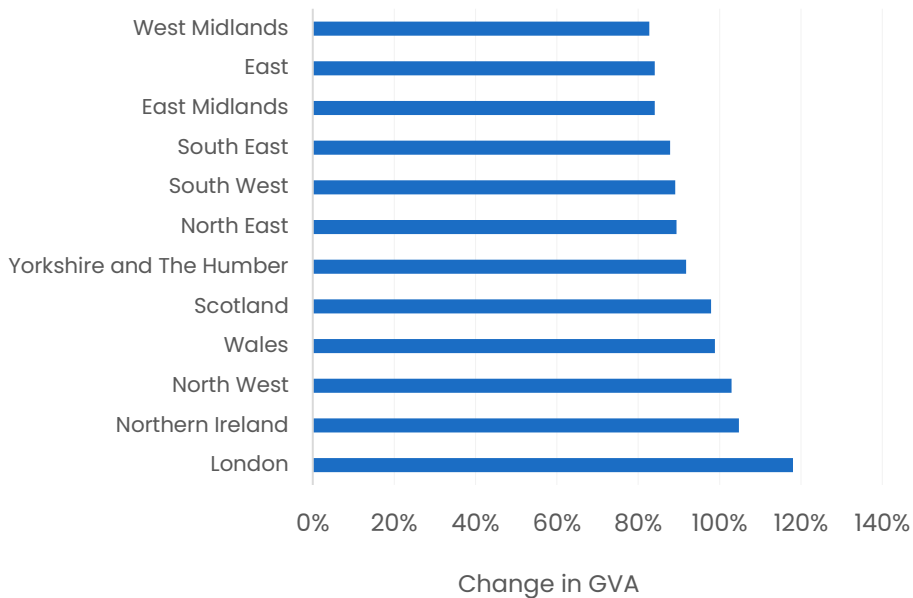
relative to OECD comparators.¹¹⁸ Notably the UK is more regionally unequal at International Territory Level (ITL) 2 than the United States.¹¹⁹

Medium-term trends since the start of the New Labour era show that disparities in productivity, the ultimate driver of living standards, have increased rather than decreased over the last two and a half decades.

GVA per capita in London has grown faster and from a higher baseline, increasing by nearly 120% since 1998. GVA has grown across UK regions, but at a very different rate and with a high degree of initial inequality.

Figure 18: Percentage change in GVA per capita by ITL1 region, 1998–2021

Source: ONS, *Onward analysis*



One of the main drivers of relative regional decline is the disappearance of higher productivity industries from outside the South East. The UK's trade dynamics play a part here, too; Britain operates a trade surplus in services and a deficit in goods, but it is London and the South East that tend to be net exporters of services. Regions outside the South East are therefore more reliant on fiscal transfers to finance the imports they buy from the rest of the world, rather than funding consumption through productive industrial output.

Within frameworks laid down by the National Manufacturing Taskforce and R&D investment rules, certain fiscal and economic policy levers should be devolved to a regional level. There should be greater responsibility on Combined Authorities and Metro Mayors to achieve local economic growth, grow tax revenues and allocate resources, including greater tax-varying powers within nationally defined parameters.

Treasury funding rules should be amended to consider long-term returns from improvements to productivity and employment on a regional basis so that public investment outside the South East can facilitate a “crowding in” effect of private sector investment.

Business rates should be reformed and replaced by a local system of commercial taxation reflective of profits rather than premises. Increases to business taxation should where possible be diverted away from bricks-and-mortar businesses, which have historically borne a disproportionate share of the business rate “burden”.

Public investment – infrastructure and R&D

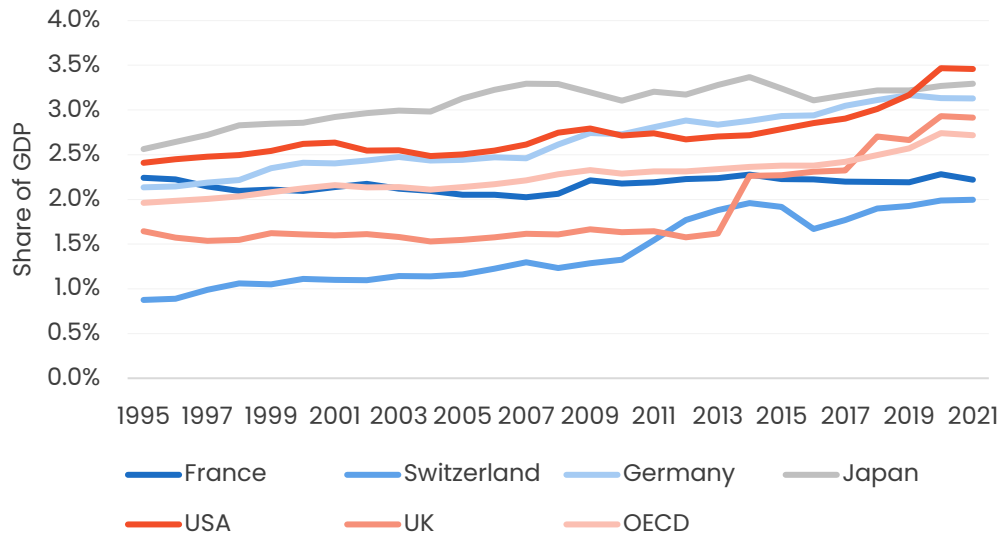
The UK has experienced a long period of disinvestment in R&D, in both the public and private sectors, with R&D intensity reaching a low point in 2005. This went hand in hand with a slowdown in productivity in the mid-2000s.¹²⁰

Between 1980 and 1995 there was a significant fall in the UK’s R&D intensity, in line with a shifting ideological approach from governments. Science policy shifted away from “near market” and translational research in the public sector, and the view prevailed that government support for applied science had a crowding-out effect on private sector R&D.¹²¹

The link between R&D and productivity performance is not entirely straightforward, but UK R&D relative to the size of the economy has tended to trail OECD comparators, with an uptick in recent years.

Figure 19: R&D Expenditure as a share of GDP, 1981–2021

Source: OECD



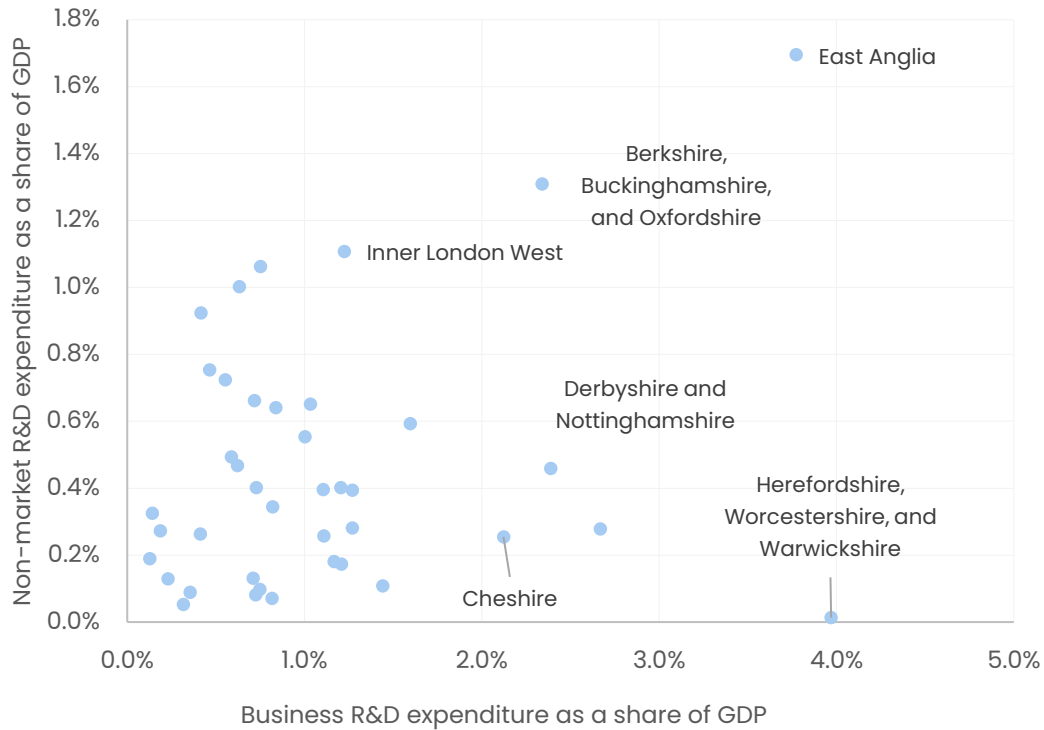
There was a substantial increase in R&D spending in UK universities in the late 1990s and 2000s. However, this was offset by a continued drop in R&D investment by the rest of the UK government. The Productivity Institute notes various explanations, including more short-term attitudes among firm managers as part of the “shareholder value” movement,¹²² pressure on the manufacturing sector due to a strong pound and the behaviour of the privatised utilities. In 1994 the privatised utility sector spent £170 million on R&D, but by 2005 this was down to just £15 million.¹²³

R&D is not well distributed geographically. Public sector R&D is concentrated in London and the South East, the most productive parts of the UK. This runs counter to the objective of improving the performance of areas where productivity is weakest.

Private sector investment broadly correlates with public sector investment, as public investment and private investment tend to be mutually reinforcing.¹²⁴

Figure 20: The distribution of public and private R&D in the UK

Source: Onward (2021), *Levelling Up Innovation*



R&D tax credits are an important part of the incentive structure for improving private sector R&D intensity in the UK. Research by the IMF showed a “strong increase” in R&D spending in qualifying categories in response to tax relief policies.¹²⁵

However, the UK is an outlier in its reliance on tax credits over direct investment. It invests 4.1 times more in R&D tax reliefs than it does in direct investment. Across the OECD, the average is 1.5 times more.¹²⁶ In the US this is 0.9 times more due to high levels of direct investment in strategic opportunity areas like defence and aerospace.

There is potential for a greater role for direct R&D subsidies to bring the UK into line with other economies. Tax credits could also be expanded to include cash awards for businesses that are not profit-making, to provide R&D capital to growth businesses make long-term commitments to R&D.

Scope for expansion

In other jurisdictions, such as France and the Netherlands, R&D expenditure can be offset against other corporate liabilities, including payroll taxes, but it is most commonly redeemable against corporation tax, as in the UK.¹²⁷

There is scope to expand the remit of R&D tax credits. Research and Development Capital Allowances (RDAs) could be extended so that capital expenditure is eligible for a cash credit for loss making firms. So-called ‘sticky spending’ in research capital is precisely the kind of spending that will help ensure long-term benefits from investments in R&D.

Categorising plant, machinery and buildings bought or constructed for R&D purposes as expenditure eligible for a cash credit will help growing firms to invest more in the equipment they need to drive innovation. This would keep the UK’s R&D capital incentives competitive with other countries which currently offer a cash credit for capital spending. Particularly our close neighbours, France, Belgium, Ireland and the Netherlands, which offer this kind of support for loss-making firms at a rate of 25%, 6%, 24% and 11% respectively.¹²⁸

Innovation and science policy

It is not possible or realistic for the UK to do everything everywhere all at once, given the far greater size and existing progress of economies such as China and the US. Rather, it needs to specialise. In 2012 David Willetts identified “eight great technologies”. However, despite fairly constant agreement that the UK needs to focus, it has struggled to settle on a set of priorities.

The technologies identified as critical for the UK economy have fluctuated significantly since 2010. Professor Richard Jones of Manchester University summarises the changes.¹²⁹

The 2014 Science and Innovation Policy endorsed the eight great technologies, adding quantum technology. During the 2015 Conservative Government there were significant cuts to Innovate UK, the national innovation agency, and a broader hesitancy about industrial strategy. The May Government oversaw the creation of the Department for Business, Energy and Industrial Strategy and the

2017 Industrial Strategy, which was phased out two years later under the Johnson government. The most recent iteration is the 2023 Science and Technology Framework under Rishi Sunak,¹³⁰ which identified “five critical technologies”: artificial intelligence, engineering biology, quantum technologies, future telecommunications and semiconductors.¹³¹

The recent Willetts Review¹³² noted the long lead-in time for research and innovation plans to be operationalised to a commercial outcome. This is impractical when the lifespan of a government innovation strategy is so short. Establishing long-term consistency and stability in sectoral and technological choice should therefore be a top priority for any future-facing UK industrial strategy.¹³³

Direct funding of R&D

Theresa May’s Conservative government identified the UK’s deficit in R&D spending relative to the OECD as a national priority, setting a target that the UK should spend 2.4% of GDP on R&D. This was achieved, and it is estimated that in 2020 the UK spent up to 3%, exceeding the OECD average.¹³⁴ This measure refers to the combined public and private sectors.

As the historian Jon Agar has noted, before the Thatcher governments the UK operated a principle of funding “near-market” research, such as the Microelectronics Industry Support Programme. However, there was a turn against such policies for coming too close to “picking winners”, reflecting the belief that public investment too close to the market would crowd out investment that should rightly come from the private sector. Instead, funding of science and innovation became more agnostic and “curiosity-driven”.

However, research for the then Department for Business, Innovation and Science (BIS) showed that public R&D investment in fact “crowds in” private sector investment.¹³⁵

The UK scores highly for academic citations, but it is less successful at deploying its scientific research for economic and social gain.¹³⁶ Many universities have demonstrated their adaptability and their power as clusters of innovation in specific fields, such as the Sheffield Advanced Manufacturing Research Centre in the UK, Oxford Science Innovation in Oxford, and Stanford University’s School of Engineering. But those examples also demonstrate that

such a model does require universities to change their operating model, by working more directly with private investors and companies.

The UK's Catapult Centres were modelled on Germany's much-admired network of Fraunhofer Institutes, but the scale of funding of the latter is much greater. In 2018 Germany spent £2.2 billion on Fraunhofer Institutes, while UK catapult funding remained below £1 billion for a number of years, only recently being increased to £1.6 billion.¹³⁷

University-based R&D funding should be targeted rigorously at technologies with applied potential to drive economic growth, with all UK universities linked to enhanced industry-adjacent Catapult Centres representing local businesses, with ringfenced funding for manufacturing-linked technologies. These should be modelled on international exemplars such as Germany's Fraunhofer Institutes and Taiwan's Industrial Technology Research Institute (ITRI).

R&D capital allowances should be expanded to include a cash credit for loss-making companies to provide growth capital for long-term R&D commitments.

A new, combined body responsible for allocating R&D funding and industrial subsidies in areas of critical strategic need should be created, replacing UKRI, Innovate UK and other research funding bodies. Subsidy should be focused on supply chain resilience, national security, boosting exports and overall economic return.

Infrastructure and place

Lack of infrastructure and place-based economic policies are a major hurdle to geographically balanced growth. Obstacles to local economic development in relation to building and infrastructure include:

- General housing shortages and opposition to planning approvals, particularly in Britain's most productive places (London, Oxford, Cambridge), stifling agglomeration effects and access to skilled workers for high-value businesses

- It is difficult to capitalise on the UK’s world-class innovation and research universities because of a shortage of commercial laboratory space
- Cities outside the South East (Manchester, Birmingham, Liverpool) struggle to capitalise on the productivity benefits of their size due to lack of public transport
- The UK is exposed to risk of energy shortages and there has been insufficient investment in nuclear power, wind, solar and grid infrastructure¹³⁸

“Nationally Significant Infrastructure Projects” (or NSIPs) have their own planning process, which bypasses the planning processes of local authorities. The lawyer Matthew White described the process of securing planning approval for Heathrow Terminal 5, which took eight years, involved 37 different applications across seven pieces of legislation and cost £84 million, with £18 million borne by local and central government.¹³⁹

Britain Remade examined the approval process for all NSIP applications over the last decade and found that 29% were delayed. From 2017 onwards this figure has been 43%.¹⁴⁰ A greater number of decisions are facing judicial review (JR). Environmental Impact Assessments (EIAs) are longer than ever before.

A significantly more streamlined approval process, independent of local authorities and with much greater immunity to JR, is needed, at least in designated areas of high economic need and strategic importance. There is a need to link infrastructure approvals with place-based industrial policy decision-making by linking infrastructure planning approval processes to policy considerations around regional growth and sectoral support.

Areas of “productivity need” should be identified for commercial plant and laboratory development with streamlined rules and a strong statutory override.

A new statutory framework should be adopted for approving Nationally Significant Infrastructure Projects (NSIPs) and commercial planning applications within identified areas of “growth need” with the power to override local planning authorities and national targets for approval times and waits, with strict time limits and restricted grounds of local appeal.

Powering the economy: energy security and supply

The UK was the first major economy to enshrine its commitment to net zero in law through the 2008 Climate Change Act. Several strategies have been published by the Government laying out a roadmap to achieve this goal, including the 2017 Clean Growth Strategy¹⁴¹ and 2021 Net Zero Strategy.¹⁴²

Specific policies to deliver net zero include the UK Emissions Trading Scheme, which places a price on carbon, allowances for industry and a trading mechanism so that carbon allowances can be bought and sold, establishing a “market price” for carbon. This primarily affects energy-intensive industries. There is also a Climate Change Levy, introduced in 2001, affecting fossil-fuel using industries, with certain exemptions where Climate Change Agreements have been negotiated.¹⁴³

The Government has also pledged £12 billion of funding through its Plan for the Green Industrial Revolution.¹⁴⁴ This provides direct public funding for developing offshore wind capacity, hydrogen production, storage and distribution facilities, nuclear power, charging infrastructure for electric vehicles (EVs), housing decarbonisation, carbon capture and storage, skills and R&D in low-carbon technologies. Finally, the Government has pledged to ban new internal combustion engine-based vehicles by 2035.¹⁴⁵

Successes and challenges

Between 1990 and 2021 the UK reduced carbon emissions by 48%.¹⁴⁶ The UK has reduced coal production and usage more rapidly than other European economies and has increased capacity in offshore wind more quickly. It has therefore made rapid progress towards its net zero target.

However, some of this has been achieved as a result of the offshoring of industrial production. If carbon-intensive industries simply move abroad, this does not contribute to global decarbonisation, but does result in the loss of manufacturing capacity and jobs in the UK; this is called “carbon leakage”. Concerns about the impact of net zero policies on UK industrial production and carbon leakage were expressed in the 2017 Helm Review and in other reports since. The UK has recently announced a new carbon border adjustment mechanism (“CBAM”) to level the playing field, but UK companies still face

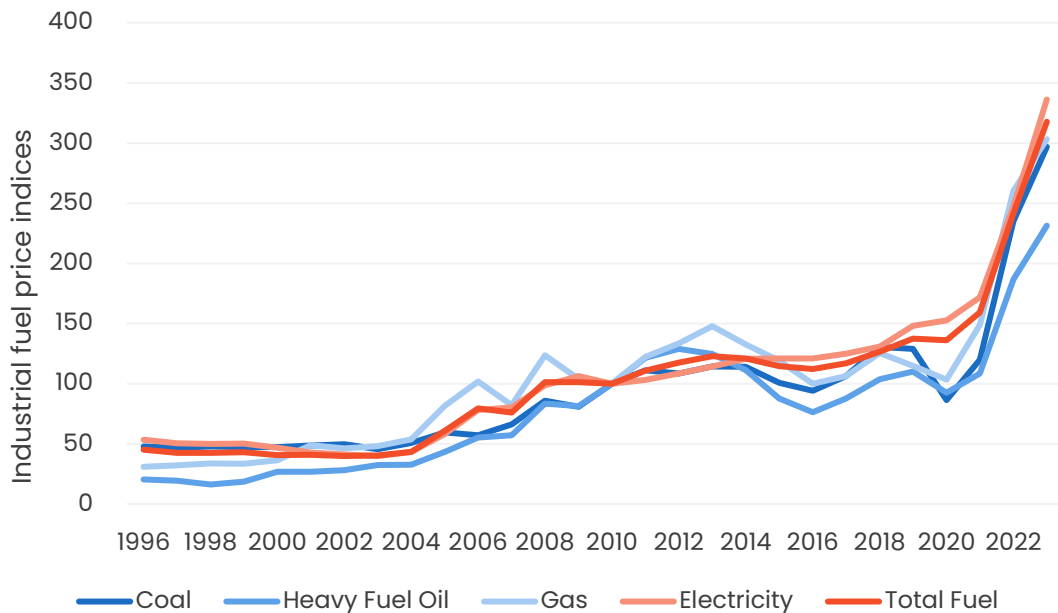
significant extra costs as a result of climate change policies and restricted supply of existing fossil fuels. And existing CBAM proposals do little to help British companies in export markets who face rising energy costs.¹⁴⁷

The Helm Review also expressed general concerns about the costs of energy transition, estimating the total cost (public and private) of reaching net zero by 2050 to be between £1-2 trillion. The Review stated that while successful completion of energy transition may result in cheap, abundant energy for households and businesses, the up-front costs of energy transition will push up household and industrial household energy costs. The Review suggested that much greater funding out of general taxation will be required to alleviate pressure on bills and UK businesses.¹⁴⁸

Since lower-income households spend a higher proportion of their income on fixed costs such as energy, all increases to energy bills are by definition regressive. Distributional impact is therefore vital when considering energy policy. And while UK households have benefited from state-guaranteed energy price caps, there is not a direct equivalent for industry.

Figure 21: Industrial fuel price indices (excluding CCL) in real terms, 1996– 2023 (Index 2010 = 100)

Source: ONS, *Onward analysis*



It is vital that UK energy policy achieves a balance between the objective of achieving net zero, towards which it has made rapid progress, and the imperative to achieve both growth and a fair distribution, as laid out in this paper.

If decarbonisation is to be delivered, it should be achieved through innovation, investment in new technologies and infrastructure and responding to changes in global market demand. It should not be achieved by offshoring high-carbon production to other countries through carbon leakage, closing down productive industry or making unilateral undertakings domestically without reciprocation abroad. The UK needs to pursue an energy transition approach consistent with the needs of a reindustrialisation strategy.

The costs of energy transition should be managed in a sustainable and non-regressive way, in line with the recommendations of the Helm Review, with fewer direct costs for households and production industries.

More generous exemptions from net zero-related policy costs should be rolled out for manufacturing industry and exporters, with more direct support and preventative measures against carbon leakage.

Long-term investment in energy infrastructure, particularly nuclear power, should be significantly increased.

The Great Rebalancing: Reforming Tertiary Education

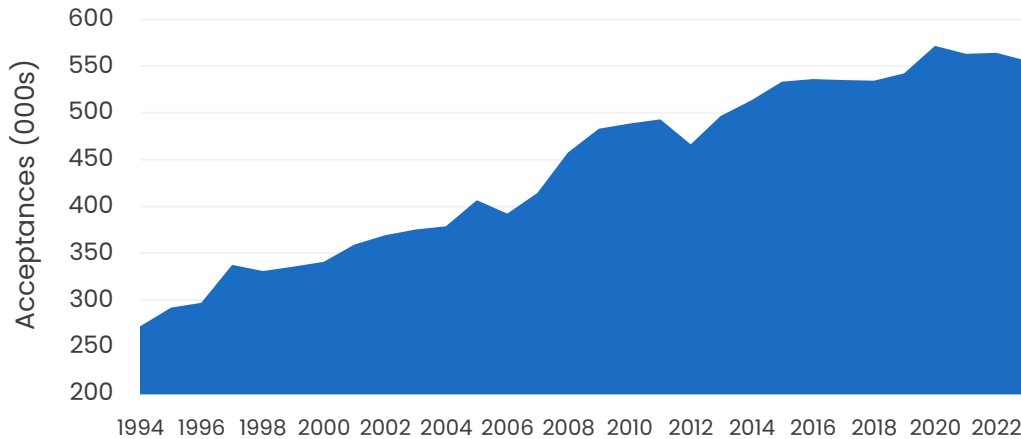
One of the most profound changes in UK society and the domestic economy since the Second World War has been the expansion of formal tertiary education. In 1960, just 5% of the UK population attended an institution of Higher Education (HE).¹⁴⁹

A core objective of the New Labour government was for half of young people to go to university. This target was surpassed in 2019 for the first time.¹⁵⁰ Increased participation in HE has undoubtedly had many profoundly positive effects both socially and economically. A more educated workforce is strongly

correlated with stronger economic growth, with the OECD estimating that every extra year in education boosts growth by 3-6%.¹⁵¹

Figure 22: Higher Education Acceptances, 1994 – 2022

Source: Department for Education, Onward analysis



There are clear social and cultural benefits to achieving a more educated society, with a far greater proportion of the population able to attain a higher level of knowledge about the world and to achieve specialisation in a given topic of study.

At the same time, there is some evidence to suggest that attending university has become a cultural divider, playing an outsize role in determining political outlook, cultural attitudes and personal relationships.¹⁵² However, for the purposes of the present report we will focus on economic factors.

A good deal for graduates?

In 2020 the Institute for Fiscal Studies conducted a study of the impact of university attendance on lifetime earnings.¹⁵³ It found that median earnings for male graduates grow strongly throughout their 30s, outstripping that of non-graduates. This was more moderate for female graduates, but still above non-graduates.

However, it also found that the subject studied is hugely important. Net discounted lifetime returns for women are close to zero on average for creative

arts and languages, but more than £250,000 for law, economics and medicine. Men studying creative arts have negative financial returns, while men studying medicine or economics have average returns above half a million pounds.

Some 15% of undergraduates would have been better off financially had they not gone to university and this does not fully reflect opportunity costs – such as the chance to train in something else with a better return.

Dropping out

In 2021-22, there were 2.86 million students enrolled at HE institutions in the UK.

Between August 2022 and August 2023, over 40,000 students dropped out of HE courses.¹⁵⁴ An estimated 900,000 students graduate from UK institutions with undergraduate degrees each year.¹⁵⁵ Some of these are overseas with the majority being domestic.

With an average of 20% of graduates failing to attain a lifetime earnings premium and actually being financially worse off than if they had not attended – that is to say, they are underemployed – this means that approximately 80,000 graduates each year end up worse off.

If the 40,000 dropping out are added, this is 120,000 students each year who have ended their period in HE who do not attain any tangible benefits and (given those dropping out will incur loan repayments for no financial benefit) who will find themselves net worse off and underemployed.

This is a poor deal for students themselves and damaging for economic performance. In economic terms it is a misallocation of human capital, in addition to the social injustice of enrolled students being mis-sold the benefits of HE (or otherwise failing to attain the benefits).

The UK skills gap

Britain suffers from a widely-reported skills gap, particularly in sectors such as engineering, construction, mechanical and electrical work, healthcare and information technology.¹⁵⁶

As a society the UK has overly emphasised academic education over vocational pathways compared to other developed economies such as Germany, Switzerland and the Netherlands.¹⁵⁷

The UK, therefore, suffers from a skills mismatch.¹⁵⁸ Two in five (40%) UK workers are employed in an occupation for which they do not have the correct qualifications. This is the fifth-worst skills mismatch among 30 countries analysed by the OECD. Of those mismatched to their jobs, the OECD Skills for Jobs database indicates that 28% of the UK workforce is underqualified for their occupations, while 13% is overqualified.¹⁵⁹

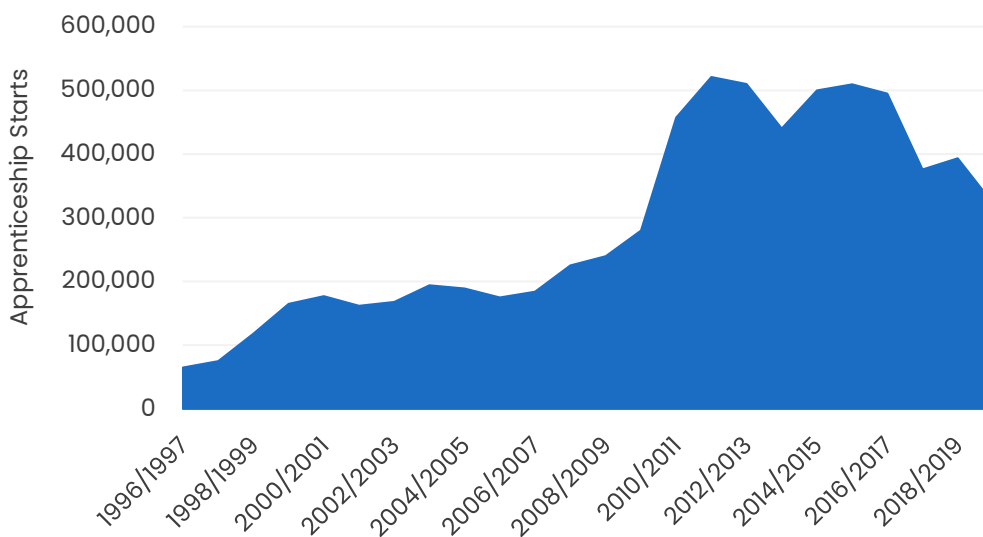
Of those with a bachelor's degree, nearly one in three (31%) work in roles that do not require these qualifications. Meanwhile, vocational training among UK employees is consistently lower (39%) than the EU27 average (49%).¹⁶⁰

UK apprenticeships policy

The objective behind the Apprenticeship Levy, introduced in 2015, was to create a clear financial incentive for employers to offer training. However, the UK has experienced a rapid decline in apprenticeship participation.

Figure 23: Total apprenticeship starts (1996 – 2018)

Source: *Onward, Course Correction* report



Therefore, formal work-based training has declined while numbers enrolling in universities have remained very high.

In 2022-3 the Government spent £22 billion funding the higher education of England-domiciled full-time undergraduate students (480,000 students),¹⁶¹ 27% of which will not be repaid.¹⁶²

As noted by the IFS and the 2019 Augar Review into post-18 education, there is no cap on the number of subsidised places, which takes financial pressure off universities but can make planning difficult for the Government. Furthermore, the cost of delivering teaching in different subjects varies significantly, with lab-based subjects in science, technology, engineering and mathematics (STEM) usually much more expensive to run. This creates an incentive for universities to offer more places to students taking lower-cost courses, which tend on average to be lower-return.¹⁶³

In contrast, the 2022-3 Department for Education budget for apprenticeships was £2.55 billion, of which 4% was not spent, with the underspend being returned to HM Treasury.¹⁶⁴

The Centre for Business and Economic Research conducted a study of the earnings premium of graduates and apprentices and found that the lifetime earnings gap between the two was just 1.8%,¹⁶⁵ and that in some sectors apprentices enjoy a higher earnings premium than graduates.

The key finding of the study was that the subject studied contributed more heavily to variability in lifetime earnings than whether someone was an apprentice or a graduate.¹⁶⁶

Does Britain need lower-quality universities?

Institution quality is also very important for lifetime earnings prospects. While attending higher-quality institutions may improve career outcomes even if less economically valuable subjects are studied, it is less clear that studying an economically less valuable subject at a lower quality institution improves graduate outcomes.

Drop-out rates also vary widely. A 2020 study of universities with the highest and lowest drop-out rates showed the lowest-ten universities had drop out rates of below 3% while the ten with the highest rate had rates above 12%.¹⁶⁷

It is important to note that HE itself is not necessarily the problem, but rather its quality, focus, investment and reward, and take-up. There are positive trends towards institutions offering high value-added HE-level apprenticeships, for example. However, there is a problem with low-quality traditional undergraduate degrees that do not add value to the graduate or to the economy.

A model of reform

To avoid misallocating public resources and human capital in ways that can undermine life chances and leave young people worse off, reform of the quality and quantity of HE institutions with a focus on a more economically optimised functionality should be a priority.

Public subsidy of HE should better reflect the government's strategic priorities, including expanding the STEM skills pipeline, responding to economic demand in the labour market and providing graduates with a return on their investment - as well as value for the taxpayer.

Governments should support HE as a vehicle for social mobility and not cut off pathways to advancement for less privileged pupils; students from poorer socio-economic backgrounds are less likely to attend higher-ranked institutions, even if they have the relevant grades, according to a study published by University College London (UCL).¹⁶⁸ But it should do so only where there is genuine value added.

Lower-quality institutions should be repurposed to focus on vocational, technical and applied learning with appropriate public funding, such as through a lifetime learning allowance. While universities are legally independent in their governance and in what courses they can offer under the Higher Education Reform Act 1988 and Further and Higher Education Act 1992, it would be open to the Government not to underwrite loans or provide public funding for ineligible courses.

Subsidy for purely academic subjects at academically highly performing institutions (those with high UCAS tariffs) should be retained, since academic subjects at high-quality providers still tend to provide added value.

Meanwhile, apprenticeship funding should be much more generous, with a Skills Tax Credit operating like capital allowances, if employers can provide concrete evidence of appropriate training and study, as an alternative to the Apprenticeship Levy.

Higher education course funding should be reformed. Universities with a high UCAS tariff should continue to receive public subsidy for all courses through the student loan system but lower quality universities should be reformed into technical and vocational institutes offering only courses with added value. These should be funded either through the student loans process or a lifelong learning guarantee.

Local Skills Improvement Plans (LSIPs) should be reformed into hubs for local employers to plan training and skills need with local tertiary education providers offering primarily STEM and TVE courses, with a much greater role for in-course work placements and co-ordination between providers and employers. These should be integrated into joined-up regional industrial strategies embedded within Combined Authorities and overseen by Metro Mayors.

Securing the national economy

Globalisation, capital, and trade



Trade and the domestic economy

Trade patterns and the productivity slowdown

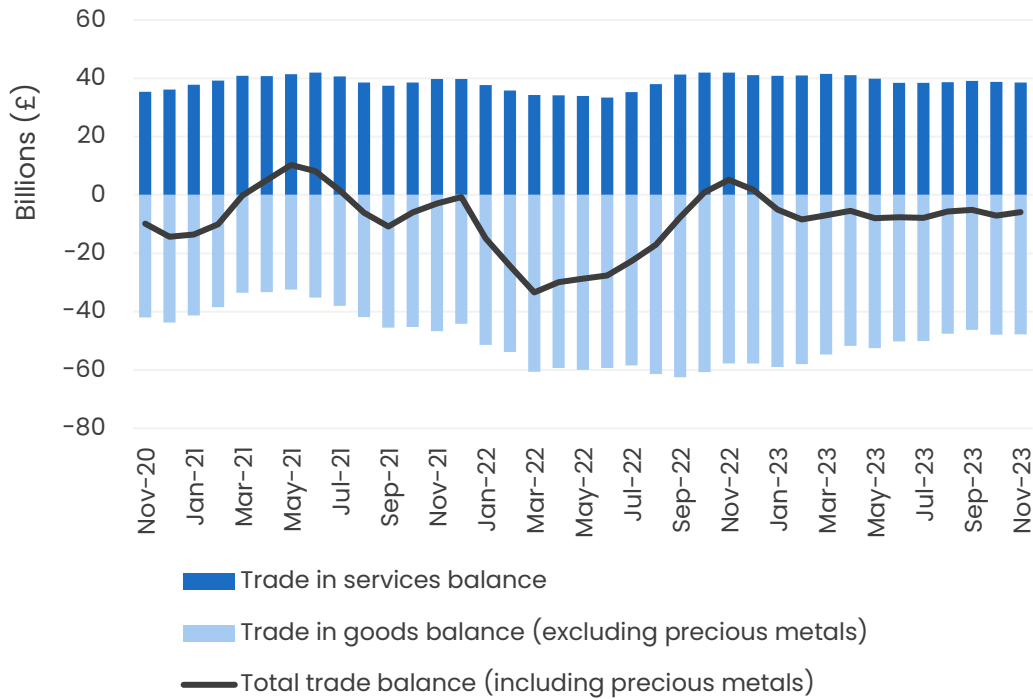
The UK operates a large and persistent total trade deficit, operating a deficit in goods, a surplus in services and a surplus on its capital (or “financial”) account which measures transfer of asset ownership between the UK and overseas.

The current account deficit in 2022 was £77 billion, with a trade deficit of £67 billion and a trade in goods deficit of £187 billion¹⁶⁹), or 3.1% of GDP.¹⁷⁰ The UK operated a current account surplus or a small deficit until 1998, when a large and persistent deficit emerged that has never been reversed.¹⁷¹ This makes the UK a net borrower from the rest of the world, as the amount spent in the UK exceeds national income. It must run a financial account surplus to finance this, meaning that assets must be sold or external liabilities to the rest of the world accrued.

The scale of the current account deficit means household savings are considerably lower than may be prudent;¹⁷² as the national economy is highly reliant on foreign investors being willing to lend to the UK. At the time of the 2022 mini-budget crisis, investors cited the large and persistent current account deficit as an additional factor amplifying the risks associated with large fiscal deficits.¹⁷³ In historical terms the UK is an outlier relative to the OECD in the scale and persistence of the current account deficit.

Figure 24: UK balance of trade in goods and services (£ billions)

Source: ONS, *Onward analysis*



A majority of UK regions operate an overall trade deficit, with only London, Scotland and Wales running a surplus. This means that only these two regions are economically sustaining themselves in trade terms relative to the rest of the world. It should be noted that Scotland and Wales run budget deficits and so are internally subsidised.

The domestic impact of regional trade deficits is important: the trade surplus operated by London, which is driven principally by service exports, will not return to regions operating a trade deficit without redistribution. A large internal transfer union is therefore made necessary partly by virtue of the UK's regional deficits in traded goods and services.¹⁷⁴

Figure 25: Total imports and exports by ITL1 region, 2021

Source: ONS



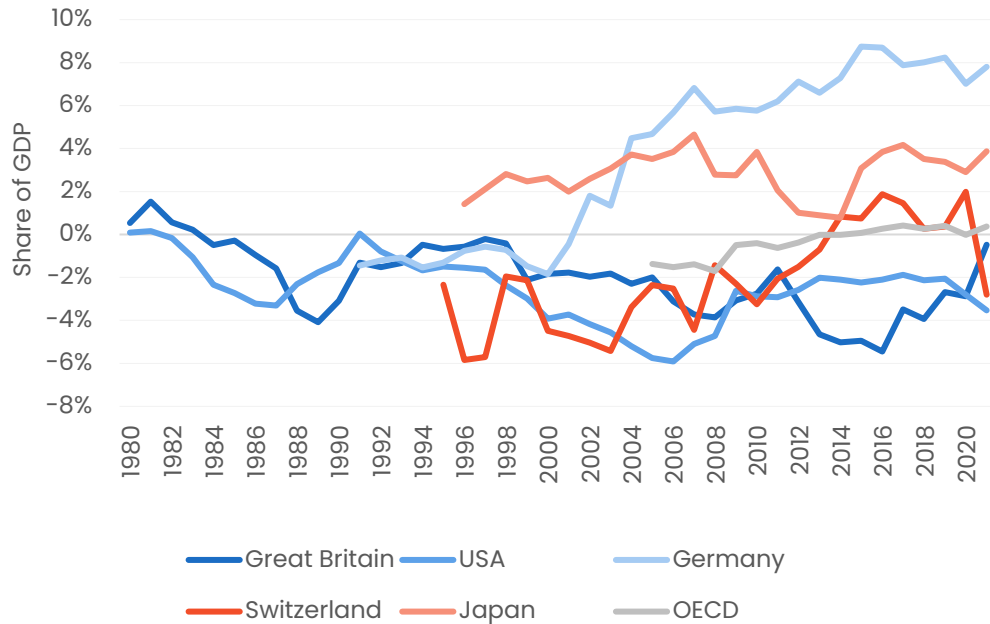
It would not be sensible for the UK to try to run a current account surplus. This is achieved by economies such as China by artificially keeping wages down. By incentivising earnings into domestic savings rather than consumption, surplus economies also reduce their citizens' standard of living.

However, the UK is an outlier in the scale and consistency of its current account deficit, and this has corrosive domestic effects: the offshoring of national productive capacity, the loss of well-paid manufacturing jobs, a domestic savings deficit and entrenched regional inequality, as regional deficits outside the South East are larger.

It also leaves the UK exposed to a drop in the valuation of its currency if it cannot attract enough investment to finance the deficit in the current account.¹⁷⁵

Figure 26: Current account balance as percentage of GDP, select OECD countries, 1980–2021

Source: OECD, Onward analysis



Offshoring of productive businesses - patterns

Is the offshoring of industry inevitable and desirable?

Uncritically embracing the benefits of any and all trade tends to make the error of assuming that the countries to which production is offshored must simply be more efficient and productive in their relevant sector than their competitors here in the UK.

Firms from abroad can obtain a competitive advantage because they can prevent their workers from collective bargaining, because they have to comply with lower health and safety standards, or they are the beneficiaries of subsidies. It is therefore not automatically true that a business being offshored must be an economically “optimal” outcome.

Redistributive effects of trade

It is often assumed that trade deepening, whether through an increase in imports relative to domestic production or through offshoring of productive capacity, is economically efficient. Classical economic theory would hold that this is not only true holistically, but also optimal for both sides, due to the “gains from trade”.

There is some truth to this, but it ignores distributive effects domestically. A net gain from trade to the whole UK economy due to the cost-saving effects of more efficient production overseas (for example) does not mean that every involved party (employer, employee, consumer) benefits, or even that a majority of those affected benefit. It only means there is a net quantitative gain.

Who benefits?

Income losses for those in sectors that shrink as a result of trade have been estimated to lie between 8 and 25% of pre-displacement earnings in the United States.¹⁷⁶ Stolper and Samuelson have shown that some groups will necessarily lose out as a result of free trade. These are likely to be unskilled and lower-skilled workers.¹⁷⁷

According to US economist Dani Rodrik, if tariffs were to be completely eliminated across the US economy (where average tariffs are less than 5%), there would be \$50 worth of income redistribution for every \$1 of aggregate gain from trade. He says: “It is unlikely that we would countenance so much redistribution in other policy domains without at least some assurance that the process conforms with our conceptions of distributive justice.”¹⁷⁸

A further dynamic policy makers must consider is that the marginal net gains from trade diminish with ever more trade liberalisation; the net gain from a reduction in a tariff from 50% to 5% is far greater than from 5% to 0%. As the net gains from further liberalisation become less significant, the distributional impact on wages, employment and household incomes matters more.

Impact on displaced workers

Trade liberalisation also functions differently from technological change. With technological improvements, producers linked to old technologies may lose their employment, but will be the beneficiary of the new technology. The same is not true for trade, where the displaced worker tends to lose again and again.

Economists frequently assume that domestic displacement or distributional impacts of offshoring will be compensated for through tax-benefit transfers. However, such compensation does not necessarily occur, especially when free-market arguments are advanced against greater social security spending. The decline in UK manufacturing employment, for example, has gone hand in hand with consistent real terms benefit cuts.¹⁷⁹

Recognising the importance of job displacement, a 2019 World Bank report noted the need for active labour market policies and strong social security provision to compensate workers who have lost.¹⁸⁰

Does free trade benefit all?

Automation has benefits to domestic productivity and wages when workers can be upskilled to use machinery, especially if this leads to higher wages arising from improved output per hour worked. Workers themselves are also beneficiaries of more efficient production of goods and services.

The same is not true for job displacement through free trade, where there is not necessarily a concrete benefit for displaced workers. As Oren Cass has argued, the employment displacement effects of automation in fact take a long time to occur, and automation tends to create new jobs to replace those it destroys. The same is not true of the employment displacement effect from trade.¹⁸¹

Offshoring and foreign acquisitions

The loss of domestic industrial capacity and the acquisition of key economic assets by overseas owners both contribute to the UK's overall economic exposure and loss of control. Examples of loss of capacity and control include:

- Railway and utilities ownership: 70% of rail routes are now wholly or partly owned by foreign states.¹⁸² 71% of Britain's nine privatised water companies are owned from overseas.¹⁸³
- Heathrow Airport: Heathrow Airport Holdings is a consortium, 42% of which is owned by the sovereign wealth funds of Singapore, China and Qatar.
- Sale of ARM to Softbank: this semiconductor designer was initially listed on the London Stock Exchange before being taken into private ownership by Japanese tech giant Softbank. When regulators intervened to stop it selling to US rival Nvidia it was listed on the US-based Nasdaq Stock Exchange for more than double its previous value, and the Government did not take a stake in it.
- Hinkley Point C: the nuclear power station is being developed by EDF Energy, a subsidiary of the French state-owned utility company Electricité de France (EDF). Chinese involvement in the Hinkley Point project came through a partnership between EDF and China General Nuclear Power Corporation (CGN), a state-owned enterprise from China. Despite security concerns the project was approved by the UK Government.
- Sale of DeepMind to Google: What was then a small London-based AI company was sold to Google for around £600 million. In 2020 it turned its first profit of £43.8 million, rising to £100 million in 2021 and £102 million in 2022.¹⁸⁴

Who owns Britain?

It is frequently assumed that any foreign direct investment (FDI) is good. In reality it depends on the nature of the investment. Investing by financing productive economic activity is distinct from simple foreign ownership.

For example Nissan building a car manufacturing facility in Sunderland, which supports 30,000 jobs across the UK supply chain,¹⁸⁵ is wholly positive. The sale of Arm to Softbank was an acquisition not necessarily resulting in improvements to productive output within the UK.

In January 2024 Bloomberg reported on the workings of Sisse, a French watchdog which advises on foreign takeovers. An attempt by Flowserve Corp, a Texas-based firm, to acquire a Canadian company with a French subsidiary, was blocked by the agency on security grounds. The Canadian firm's manufacturing capabilities for submarines and nuclear reactors were considered too sensitive.

The agency advises the French government on the usage of its Blocking Statute, which prevents French citizens or companies from disclosing information sensitive for national security purposes to a foreign entity.¹⁸⁶

China and UK corporate assets

In 2021 the Sunday Times compiled the China List, a detailed analysis of more than 200 British assets snapped up by Chinese and Hong Kong-based government agencies, companies and investors, worth more than £135 billion.¹⁸⁷

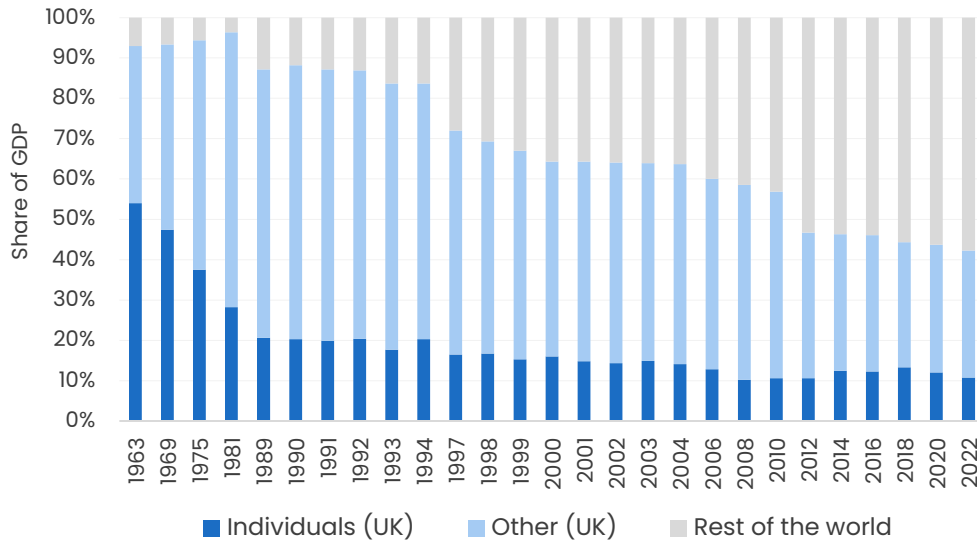
The updated list, published in 2023, puts the UK assets held by the Chinese state at £45 billion and the total held overall by Chinese and Hong Kong investors at £152 billion.¹⁸⁸

The China Investment Corporation (CIC), Beijing's sovereign wealth fund, owns significant holdings in a wide range of UK companies including infrastructure assets and core utilities. It has an 8.7% share in Heathrow Airport, a 10.5% share in Cadent Gas, Britain's biggest gas network, and an 8.7% share in Thames Water.¹⁸⁹ The Sunday Times calculated that dividend payments to Beijing in the five years to 2023 totalled £1 billion.¹⁹⁰

The majority of UK equities are now held by overseas individuals or entities:

Figure 27: Beneficial ownership of UK quoted shares by subsectors, 1963–2022

Source: ONS, *Onward analysis*



Intelligence firm Datenna collects data on Chinese acquisitions through FDI, developing country-specific profiles. It identifies 120 acquisitions in the UK since 2011, classifying 34% of these as “high risk” and 12% as “medium risk”. Energy and business and financial services are listed as the two most exposed sectors.¹⁹¹

Control of strategically significant industries and supply chains

Since the Covid-19 pandemic, governments worldwide have been paying much more attention to issues of security of supply and integrity of the domestic industrial base. Shortages of pharmaceuticals, PPE, energy and semiconductors presented serious threats to national supply chains throughout 2020–2022.¹⁹²

It is not feasible for every country to become self-sufficient in all strategically sensitive sectors, especially in an era of fast-moving technological change driven principally by the private sector. This stands in contrast to the post-war period, where state nuclear programmes and the Space Race were directed by state governments.

However, the strategic importance of developing economic alliances to guarantee security of supply is now of critical importance, also called “friendshoring”.

UK Hamilton Index performance

The Information, Technology and Innovation Foundation (ITIF), a US think tank focusing on technology and industrial policy, runs the annual Hamilton Index. This monitors global performance of nations in designated strategic industries.¹⁹³

The Index describes the UK’s performance as underperforming in many industries except transportation and IT and information services.

The UK has declined in its performance in Index industries over time. Almost all its Index industries are in the “weak, decliners” quadrant relative to the other Hamilton Index economies. These industries are pharmaceuticals, basic metals, electrical equipment, computers and electronics, chemicals, machinery and equipment, and fabricated metals.

How is the UK “exposed”?

Many of the UK’s major industries are heavily reliant on the import of materials and components from overseas, including from a tight concentration of economies within the orbit of China. This is particularly true of automotive, aerospace and electronics.

The more exposed an economy is to geopolitical and economic shocks through offshoring, “lean stocks” (lack of stockpiling),¹⁹⁴ just-in-time supply chains and sudden losses of capacity, the greater the risk to core capabilities, ability to respond to emergencies and capacity to meet basic needs.

It would be completely unrealistic - and undesirable - for the UK to attempt to become an economically self-sufficient state. It is not even feasible to engage in the type of macro-scale reshoring of domestic production currently being attempted by the US with the Inflation Reduction and CHIPS Acts, by the EU and by China’s reciprocal industrial strategic endeavours.

However, the UK has an almost uniquely eroded manufacturing base and particularly long and insecure supply chains. There are some positive signs, including an increase to manufacturing output since Brexit, with supply chains shortening and in some cases reshoring.¹⁹⁵ However, there are steps that Britain can take to improve its economic security, and to benefit from the productivity and growth potential of this process, too.

The UK Government passed the National Security and Investment Act in 2022. This created a notification requirement for investors acquiring assets or entities in 17 sensitive sectors and a five year right of call-in for acquisitions if they are considered to breach an expansive definition of national security.¹⁹⁶ This is a positive step towards stronger monitoring of M&As in areas where defence and security considerations may apply.

The legislation does not, however, extend supervisory powers on the grounds of wider economic security, such as supply chain integrity, protecting early-stage and high growth-potential intellectual property in industrial strategic sectors and mitigation of shock risks. Other Western states are increasingly adopting wider-ranging capabilities to link M&A regulation to national economic security and industrial strategic goals, beyond security defined purely in defence terms.

The UK Government should as part of its diplomatic strategy engage in preferential bilateral agreements with other economies to guarantee vital supply chains where possible, focusing on pharmaceuticals, semiconductors, rare earth minerals, medical supplies and components for defence manufacturing.

The UK should follow France in creating a bespoke agency, modelled on Sisse, for monitoring acquisitions and advising on decisions under the National Security and Investment Act. The definition of strategically sensitive should be broader than defence and security technology and capabilities and should include foundational and frontier technologies, sectors where supply chain insecurity may apply, the nature of the acquirer (if state owned enterprises), and UK infrastructure assets and utilities.

This body should monitor critical supply chains and impose de-risking requirements on companies operating in strategically sensitive areas to incentivise supply chain shortening, “friend-shoring”, diversification, developing “choke point” domestic capacity and stockpiling requirements.

The British Business Bank should have a remit beyond managing pension fund investments and channelling them into UK equities; it should have a specific UK export finance functionality with a percentage of assets allocated to equities in export-heavy industries (both goods and services).

Domestic preference and regional levelling up objectives should be written into the UK’s post-Brexit procurement rules to ensure a preference for supporting UK production and suppliers outside the greater South East, with economic objectives taking priority over others within the rule framework.

A small range of industries such as GM technologies, energy infrastructure such as gigafactories, AI and frontier forms of advanced manufacturing should be identified for “embryo growth” regulation, where infant companies are protected from overseas buy-out and have access to public subsidy until the scale-up stage, after which benchmarking against growth, profitability and export targets would determine eligibility for continued funding.

Reflecting the critical need to protect and grow the manufacturing base, existing environmental levies and the carbon cap-and-trade mechanism should be removed for designated strategic manufacturing industries.

A country that works

A better deal for workers
and families



The rise of two nations: work and inequality

The UK has enjoyed notable labour market successes under recent governments. Unemployment has been historically low, having been reduced from a post-financial crisis high of 8.3% in 2011 to just 3.8% at the end of 2023.¹⁹⁷

Both the minimum wage and National Living Wage have been success stories in reducing UK income inequality and reducing poverty. The net effect of tax and benefit policy change has been to the benefit of the lowest income decile largely due to these measures, and to the recent unfreezing of Universal Credit (while tax thresholds have remained static).¹⁹⁸ Median earners have benefited from a near £2,000 per year real terms tax cut since 2010 due to the personal allowance and cuts to National Insurance.¹⁹⁹

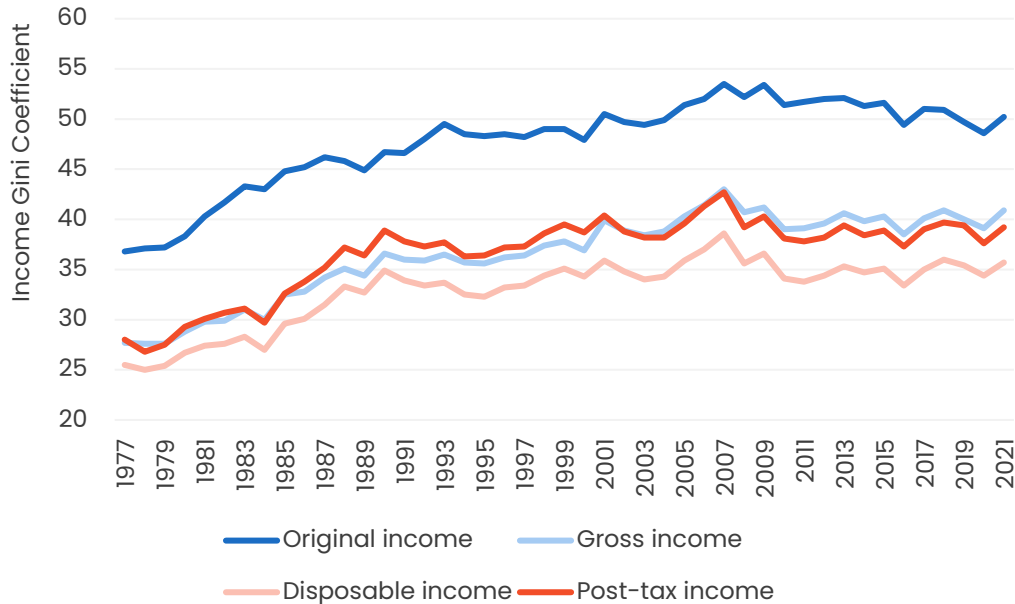
Average wages, however, have remained relatively static since the financial crisis. The UK remains one of the more unequal economies in the OECD in terms of income inequality. On the face of it, income inequality has been relatively stable - in fact, slightly lower - since the 2008 crisis. This is because those on higher incomes were hit hardest proportionally, while the incomes of the poorest were comparatively protected due to social benefits.²⁰⁰

But looking at income ratios reveals a higher level of inequality, especially after housing costs. The ratio of incomes at the 50th percentile and 10th percentile hit a record high of 2.54 in 2018-19 after housing costs, showing a growing gap between those on median incomes and those in the top 10%.

The UK has to engage in redistribution to make up for the lack of “predistribution” (stronger growth of lower and median deciles, prior to transfers).

Figure 28: Gini coefficients for disposable household income (original income, post-tax income, disposable income), 1977 - 2021

Source: ONS, *Onward analysis*



Wealth inequality is more pronounced in the UK than income inequality, with the wealthiest top 10% owning 43% of the country's wealth.²⁰¹

The percent of wealth owned by the richest 10% is comparable to the OECD average, but comparing the top decile of households to the bottom 40% of households, the UK is second only to the US in wealth inequality.²⁰² This is also due to experiments with ultra-loose monetary policy which has enabled debt-fuelled asset value inflation, enriching those who already own the most.

Regional income inequality

There are wide disparities in disposable household income between regions, too. For most UK regions the 90th percentile of disposable household income is below £40,000 per annum.

There is a wide gap between the 90th and top percentiles across all UK regions, with London far ahead of the rest of the country in disposable income.²⁰³

Weak social mobility

The UK performs poorly on international measures of social mobility. Its intergenerational elasticity of income (IEI), which measures the persistence of income between generations, the UK fares better than Switzerland and the United States but more poorly than Spain, France, Italy, Japan, Sweden, Denmark or Norway.²⁰⁴

Looking at developed economies according to their income inequality and their social mobility, the UK fares poorly on both measures relative to comparator countries. This comparison of inequality and income mobility has been referred to as the “Great Gatsby” Curve, a term coined by former US presidential adviser Alan Krueger in reference to the novel depicting large wealth inequality in 1920s America.²⁰⁵

It is sometimes argued among conservatives that inequality does not matter so long as social mobility is strong or, less commonly, that social mobility is less important if there is a high degree of equality.

What the “Great Gatsby” chart shows is that in fact a high level of inequality is correlated with a low level of mobility, and vice versa.

The Low Pay Commission found in 2020 that in any given year approximately half of minimum wage workers transition to higher pay, but the vast majority of these transitions (four fifths) are to low-paid employment.²⁰⁶

Unstable work

There has been a growth in the use of “zero hours” contracts within the UK labour market. In 2000, just 0.8% of jobs were of this kind. In 2023 this had jumped to 3.6%.²⁰⁷ The UK has experienced a growth in insecure work more generally, too. According to the Work Foundation, at least one in five (20-25%) of workers will have experienced “severely insecure” work in the last two decades.²⁰⁸ The risks associated with job insecurity do not fall evenly, with lower-paid workers and women more likely to experience insecure work.²⁰⁹

According to the Trades Union Congress (TUC), there were 3.6 million workers in insecure work in 2021, defined as workers on zero-hours contracts, in agency

work, self-employed workers below the national minimum wage and casual and seasonal workers.²¹⁰

According to the OECD index, the UK has few labour protections for contractually employed workers relative to OECD comparators.²¹¹ In 2019 the UK had a labour market protection score of 1.35 compared to an OECD average of 2.06. In contrast, France scored 2.56 and Germany scored 2.6. But the UK also scores lower than Australia (1.67), New Zealand (1.64), Denmark (1.53), Norway (2.33) and Switzerland (1.43).²¹²

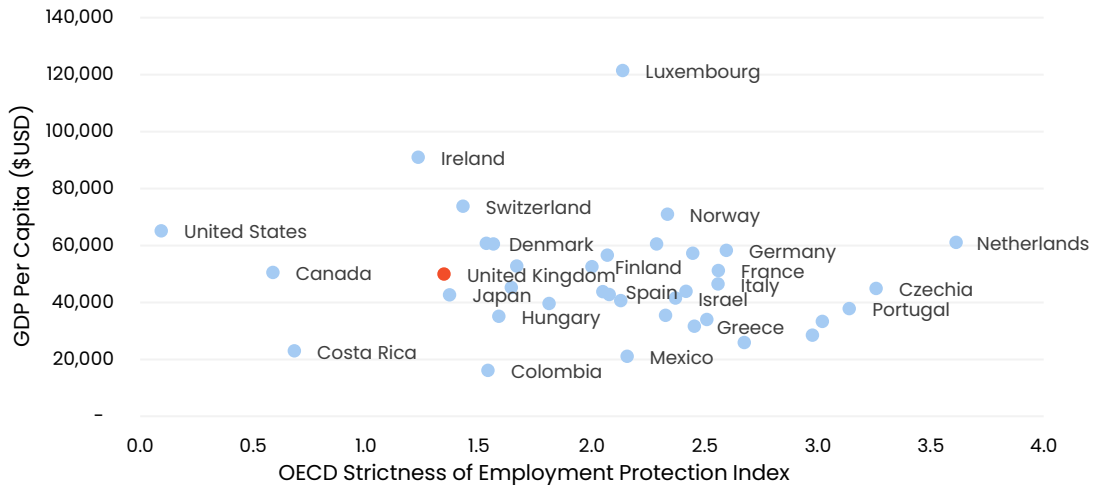
The 2017 Taylor Review of Good Work²¹³ expressed particular concern about the ambiguous status of “gig” economy workers, who are frequently treated as independent contractors (i.e. self-employed) rather than employees. This means they do not enjoy certain basic employment rights such as the minimum or National Living Wage, the right to statutory sick pay or the right to paid holiday.

The review recommended creating a category of “dependent workers”, and extending basic employment rights to those who are technically self-employed but effectively in a state akin to employment. It suggested that gig workers or those on zero-hours contracts should have a right to request a full employment contract after a period. The Review also highlighted that the definition of employment is different for the purposes of tax law and employment law, with an intermediary legal category of “worker” sitting between employees and the fully self-employed.

Taylor recommended harmonising these definitions to avoid exploitation by employers wanting to avoid granting full employment rights to workers in a de facto position of employment. The Review also made recommendations to improve conditions for agency workers, who can face up-front charges even before employment has been secured, or be treated unequally for pay relative to full-time employees.

Figure 29: OECD employment protection index and GDP per capita (US\$, PPP adjusted)

Source: OECD, *Onward analysis*



There is not a clear correlation between OECD economies' levels of labour protection and their GDP per capita, indicating an unclear relationship between weaker employment protections and growth rates. The UK economy may have fared even more poorly without its flexible labour market, and given its high level of dependence on services that seems likely.

Labour market flexibility is a requirement of the UK's current economic model. But this model is not delivering rising living standards, meaning the UK is at present offering neither high levels of job security nor high wages. It is therefore key to ask how this can be improved, and the role regulatory flexibility plays.

Is worker compensation fair?

In the United States, productivity growth and wage growth have decoupled, indicating workers are not receiving the benefit from their higher output. In the UK productivity and wages have tracked each other more closely. At its root, the UK wage problem is a productivity problem.²¹⁴

However, at the same time that business investment levels and average wages have stagnated, executive compensation has continued to rise. This is not a

problem if higher executive pay reflects higher business performance arising from more productive output. It is a problem, however, if it simply represents a wealth transfer from workers to management.

The National Living Wage has been highly successful at improving real incomes for lower income groups.²¹⁵ This has had a significant mitigation effect on inequality. This can help higher earners, too, by pushing up the earnings distribution. However, middle-income groups do not directly benefit from it, and the gap between average earners and those with the highest incomes has risen.

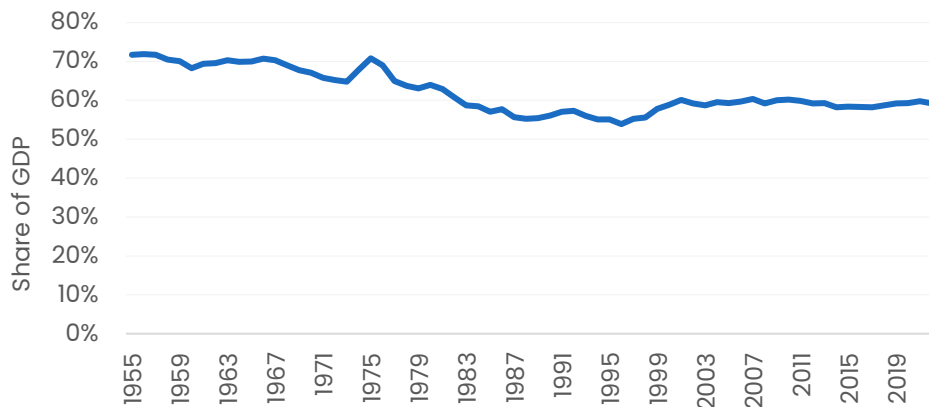
It is not the only factor. There is no point from a worker's perspective in improving productivity if there is no guarantee it will result in better compensation and rising living standards.

The "labour share of GDP" - the percentage of national income that goes towards wages - has been relatively stable since 2000, dipping a little in the years following the financial crisis. It is now significantly lower than it was in the 1950s, 1960s and 1970s.²¹⁶

There were significant problems with union-driven wage inflation in the 1970s. Mass union power is something the governments of Margaret Thatcher rightly disbanded. However, mass de-unionisation, especially in the private sector, has not been replaced by an alternative mechanism of collective representation or bargaining, as exist in other economies.

Figure 30: Labour share of GDP (1955 – 2019)

Source: ONS, *Onward analysis*



Growth in low quality work

Britain enjoys near-full employment, but it faces challenges with job quality. In addition to flatlining average wages there has also been an expansion of low-income work compared to middle-income and high-income jobs. This is linked to the UK's reliance on low-growth sectors; 60% of employment growth in lower-paying sectors since 2008 has been in hospitality.²¹⁷ By any economic measure this is not a sector the UK should wish to expand.

Expansion of employment at the lower end of the income spectrum also pushes up demand for in-work benefits. In February 2024, approximately 2.1 million people were claiming Universal Credit while working.²¹⁸

Representation for workers

Britain achieved progress in the 19th and 20th centuries in improving working conditions, limiting working hours and improving workers' rights. In the decades following the Second World War, however, the militancy of Britain's unions and the disproportionate power of inefficient, nationalised industries tilted the balance much too far away from capital and consumers towards organised labour – often purely protecting its own interests.

Since Thatcher's much-needed reforms, there has been a significant decline in private sector unions, with only 12% of private sector workers now unionised.²¹⁹ Unlike countries such as Germany, the UK does not provide for worker representation within corporate governance structures. Worker bargaining power in the labour market has been reduced, especially in the private sector. The ability of employees to challenge executive decision-making over compensation, investment or deployment of capital is therefore limited.

A return to mass unionisation is undesirable. The UK should therefore consider a non-adversarial approach towards worker representation through revised corporate governance regulation.

Corporate governance rules should be reformed to implement worker representation in publicly listed companies above a given size, to provide adequate employee bargaining power outside of adversarial, union-based labour representation methods.

The recommendations of the Taylor Review of working practices should be implemented, including greater clarification of who is employed and self-employed within the modern gig economy, baseline rights for gig economy workers, a strengthened right of contractors and gig workers to request direct employment after a period of time, and improved rights for agency workers.

A new deal for parents

The UK is unusual in how it treats families in its fiscal system. For most people, the family is the basic social unit, with work and care responsibilities divided between couples as preferred.

Since the reforms implemented by Chancellor Nigel Lawson to move away from household taxation and individualised taxation, the UK tax system has had little recognition for the family or for care responsibilities. Transferable tax allowances were originally part of the Lawson plan, but were never implemented. The UK is therefore an outlier in its lack of differentiation between household types in how it applies income tax.²²⁰

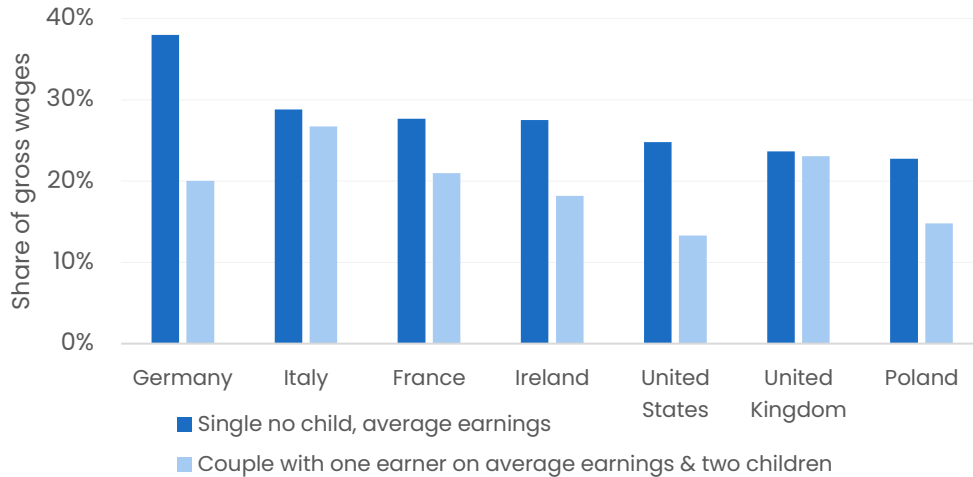
Britain's tax system therefore fails to reflect the costs associated with having a family. At the same time, the availability and cost of housing have become steadily more prohibitive over time, the UK struggles with low pay and stalled social mobility and people are incentivised to delay having children.

But the purpose of supporting families further goes beyond cost alleviation. There is a social and economic good in family formation and facilitating higher birth rates, for the sake of the future labour force and tax base and because families pool risk that would otherwise have to be absorbed by society or the state.

As it is now more usual for both parents in a two-parent household to work – something that has increased family incomes and made rewarding careers a reality for many women – modern house prices not only reflect constricted supply, but also an economy of dual incomes. This is sometimes called the “two-income trap”.²²¹ According to one recent study, a 10% rise in house prices was associated with a 1.3% fall in births.²²²

Figure 31: Income tax and employee contributions as percentage of gross wages, 2022

Source: OECD Taxing Wages 2023



The next effect of the current tax-benefit system is that the costs of having children are not offset by current support for children. Children are more likely to be in poorer households, meaning that tax policies targeted at households with children are more likely to be progressive than less targeted tax cuts. The UK tax and benefit system does not therefore support children as much as other countries.

There are irrationally high marginal tax rates for some households

In the 2024 Budget, Chancellor Jeremy Hunt announced changes to the High Income Child Benefit Charge that reduced the top marginal rate of “tax” (including withdrawal of Child Benefit) from 71% to 57%. The taper of the benefit withdrawal is now lower but affects more people. This was a very positive step towards eliminating irrationally high marginal rates.

The UK suffers from a negative birth rate at just 1.55 children per woman.²²³ For the population to be stable without immigration, this must be 2.1. The average number of children desired by UK women, according to polls, is higher at 2.35.²²⁴

Other jurisdictions do more than the UK does to support families with children, and there is a growing evidence base that such policies do work when the underlying desire to have children is there.²²⁵ While there is an ongoing debate about whether “pro-natalist” policies work to increase the birth rate, research by Duke University has shown that birth rates fell drastically in France when child allowances for higher income couples were removed.²²⁶

The study found no impact on the decision of couples to become parents who did not have children prior to the reform, but it did affect existing parents’ decisions over whether to have another child.

Countries such as France and Canada operate versions of early years “allowances” that new parents have the option of taking. So far, the UK has confined direct support for families – beyond Child Benefit and the Child Element of Universal Credit– to expanding childcare entitlements. The UK supports families fiscally through the benefits system rather than through tax, which is arguably more redistributive. However, Child Benefit is less likely to have an enabling role for higher income families making different choices given that their fixed costs tend to be higher.

The UK also supports families through a relatively generous childcare offer, expanded by Hunt to include 30 hours of free childcare for parents with children from nine months to five years.²²⁷ This is useful for parents who wish to place children in formal childcare settings, but provides no support for parents who would prefer to make more use of informal carers or provide more care themselves.

The UK support system is therefore prescriptive and inflexible compared to other jurisdictions who do more to support families through the tax structure and through more neutral allowances.

Recognition for children should be introduced into the tax system to reflect the extra costs associated with having a family, as in jurisdictions such as Germany and the USA, with a transferable personal allowance for resident parents and legal guardians who have registered to be treated as a couple with one or more dependent children.

The system of childcare funding should be significantly liberalised to allow childcare allowances to be spent on childminders, informal carers or taken as a

parental allowance, as is available in Canada or France, so that the state payment to families is fully neutral. There should be an expanded and reformed formal childcare offer for working parents.

Statutory paternity leave should be paid for six weeks with entitlements equalised with maternity leave pay.

Priced out: the housing crisis

The UK housing shortage is one of the greatest economic and social challenges facing the country, and many reports could be (and have been) written solely on this question.

The upshot is that the UK has been estimated to have a four million home housing stock shortage²²⁸ through failure to build in line with population growth, particularly over the last two decades.

Figure 32: Housing Completions in England, 1946 - 2022²²⁹

Source: Department for Levelling Up, Housing and Communities

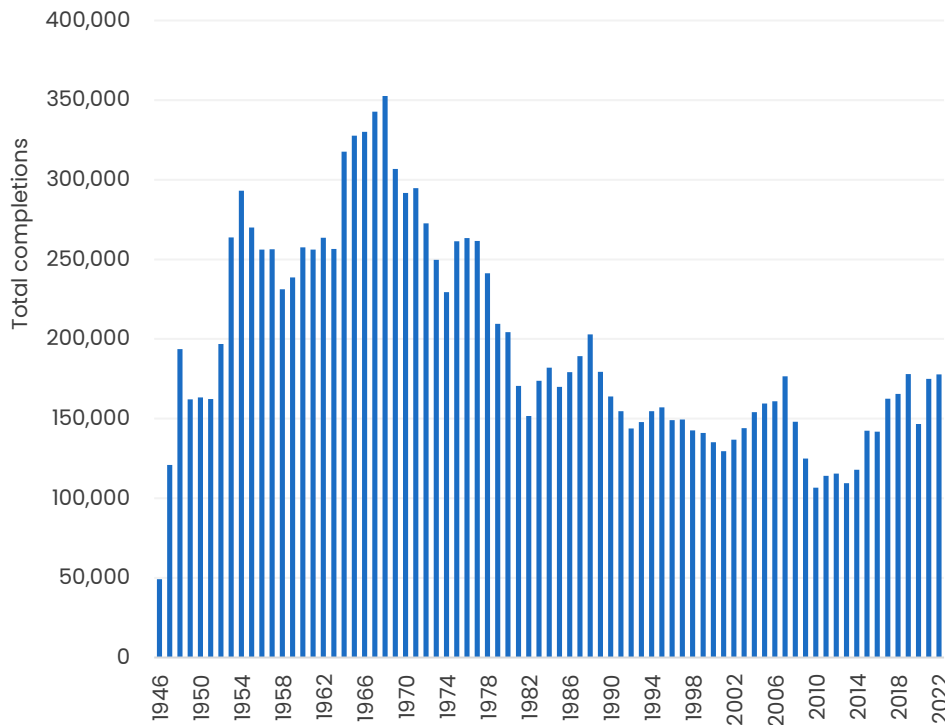
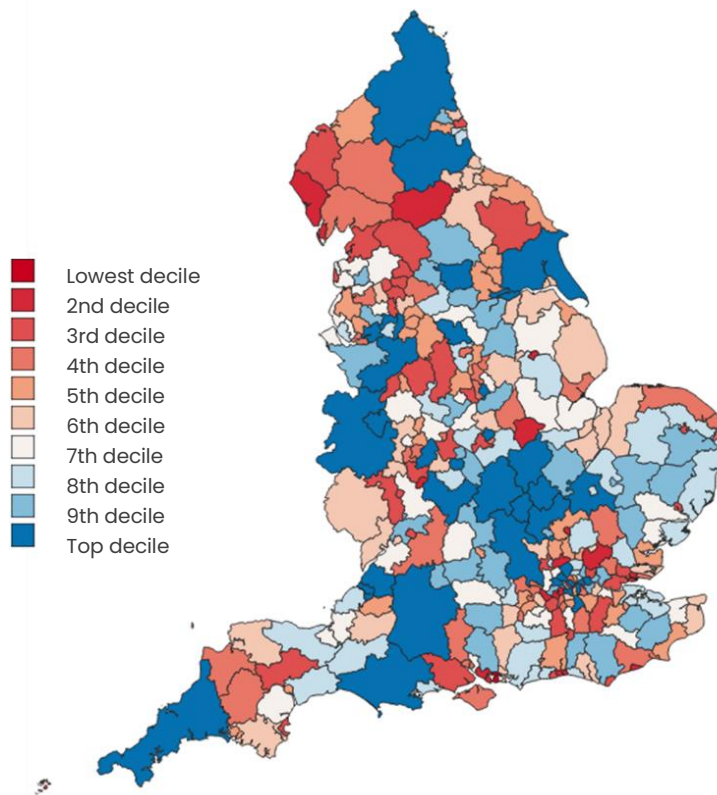


Figure 33: Net additional dwellings in English local authorities, 2022/23

Source: Department for Levelling Up, Housing & Communities, Onward analysis



Since the UK's housing supply peak in 1967, the country's population has increased by 22.6%,²³⁰ due to a combination of mass migration and natural growth, and is expected to reach 72 million by 2045.²³¹

As the population increases, so too does demand for housing. On the UK's current population trajectory, the number of households in England alone is expected to rise to 26.9 million by 2043, representing an average increase of 150,000 new homes each year,²³² while new housing supply is set to decline to record lows of 120,000 per annum.²³³

Increased demand for housing reflects the changing composition of households as well as raw population growth, with most of the projected growth in households between 2018 and 2028 coming from one-person and multiple adult households without dependent children.²³⁴

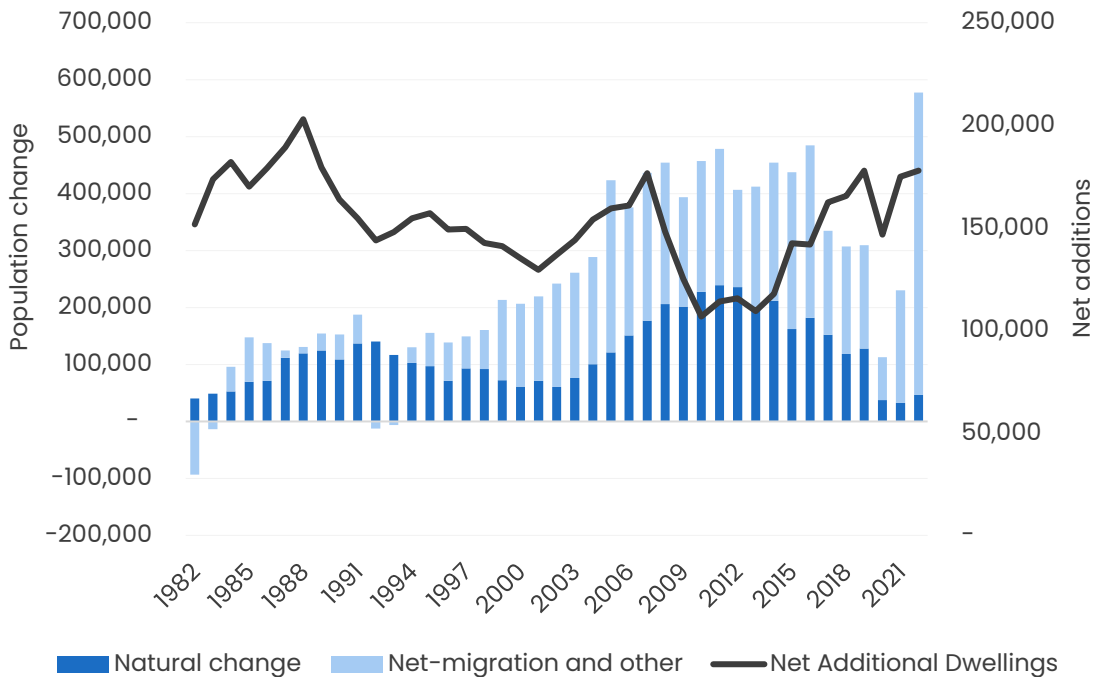
Impact of immigration

The UK's current migration trajectory is also expected to apply increasing pressure on the UK housing market in the immediate term, with research conducted by the Migration Observatory finding 'that a 1 percentage point increase in the UK's population due to migration alone has increased house prices by 1%'.²³⁵

International migration also impacts the UK's rental market, with a record surge in net migration in 2022 translating into a potential 7% increase in UK rental prices.²³⁶ It also increases demand for social housing; people not born in the UK are slightly more likely to be in social housing than those that are (18% versus 17%).²³⁷ Some of these people will have indefinite leave to remain (ILR) or have acquired citizenship, but it is still worth noting that relatively uncontrolled movement into the UK is raising demand for social housing, which has a finite supply.

Figure 34: Change in population and dwellings completed in England and Wales, 1982 – 2022,

Source: ONS, *Onward analysis*



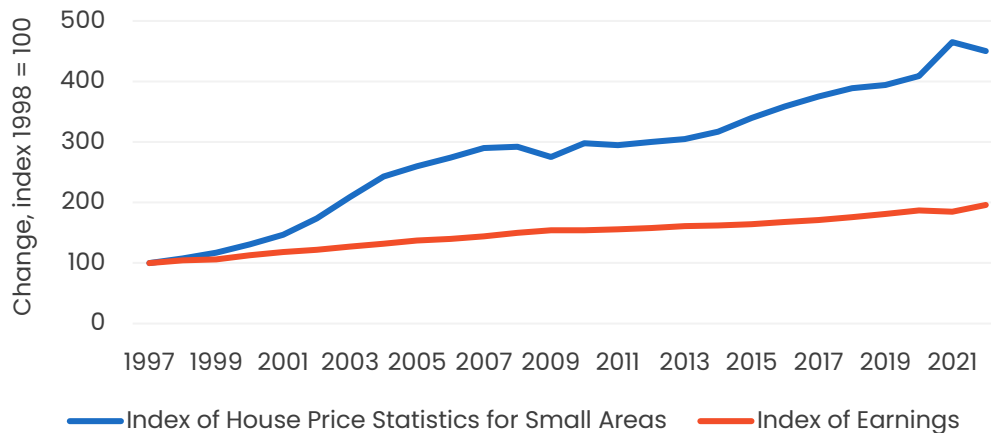
The majority of year on year population growth is attributable to immigration and has been since 1999.

Rising house prices across the UK

Chronic under-supply and a rising population have resulted in house prices rising significantly across every English region since 1997.²³⁸ Housing has become increasingly unaffordable, with the ratio of average earnings to average house prices increasing from 3.5 in 1997 to 9.1 in 2021 - the highest ratio since 1876.²³⁹ Mortgages at the median house price now exceed 4.5 times household income in 48% of postcode districts.²⁴⁰ Supply shortages were significantly exacerbated by the expansion of mortgage credit in the pre-financial crisis period, and the pursuit of historically loose monetary policy since.

Figure 35: Housing and earnings indices, 1998 = 100

Source: ONS, *Onward analysis*



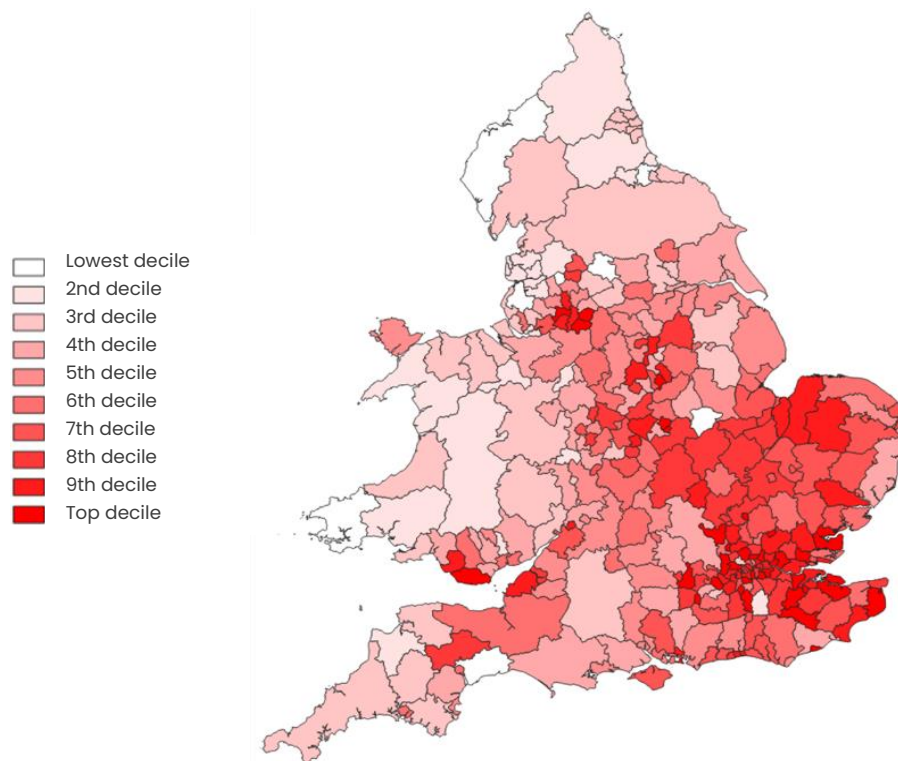
While earnings have doubled since 1997, house prices have risen 4.5 times.²⁴¹ This growing disparity has not affected all parts of the UK equally. In developing areas of high economic potential such as Camden (19.40), Hackney (14.55) and Wandsworth (14.51) the chasm between median household prices and salaries is even higher than the national average²⁴².

In parts of Northern England and the Midlands such as Copeland (3.59), County Durham (3.97) and Burnley (4.17) this disparity is significantly lower, but still higher than rates recorded in 2003 - the peak of homeownership in the UK.²⁴³

It is not simply that more expensive local authorities reflect the higher purchasing power of their more affluent residents. Rather, areas of high-demand have seen increases in house prices far in excess of their local wage growth. The most acute increase to the wage-price ratio are in Greater London and the South East.

Figure 36: Increase in English local authority median house price to salary ratio, 2012 - 2022

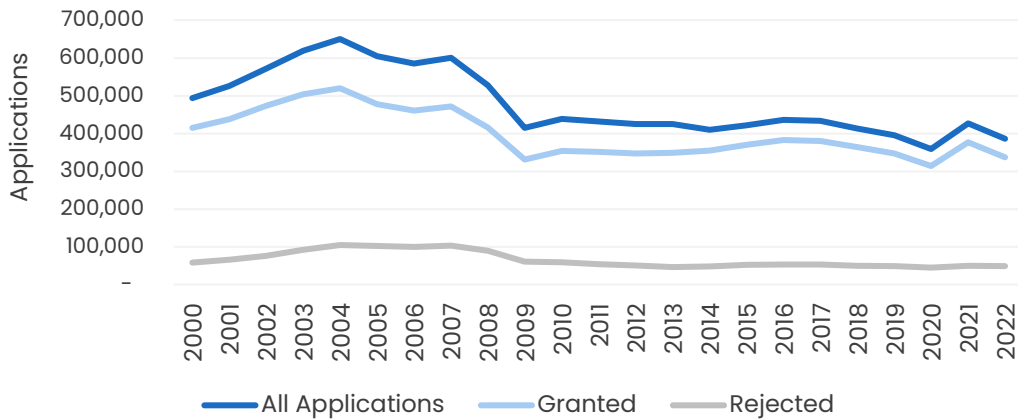
Source: ONS, *Onward analysis*



The number of years for a typical first-time buyer to save for a deposit is now 19. In 2021-22, 27% of first-time buyers received help from family or friends, with 8% using an inheritance.²⁴⁴ Family assistance is becoming more important in determining young people's ability to get on the property ladder. This will lead to a growth in the beneficiaries of inheritance being able to afford houses, but this will also increase wealth inequality. Meanwhile, the number of housing projects approved in England has slumped.

Figure 37: Number of planning applications received, granted and approved (2000 – 2022)

Source: Department for Levelling Up, Housing and Communities, Onward analysis



What is the problem?

The UK planning system is discretionary and to a degree arbitrary, stemming from the 1947 Town and Country Planning Act.

Approval for new developments is not consistent. New housing supply in cities and large towns is usually concentrated in very specific locations, with just 4% of all suburban neighbourhoods in England and Wales from 2011 to 2019 providing 45% of all new suburban homes. Half of all suburban neighbourhoods built less than one house a year or no houses, providing only 2% of all new suburban homes.²⁴⁵ Housing shortages are most pronounced in the South East, which has the least affordable homes relative to earnings in the UK.²⁴⁶

In contrast, half of all suburban neighbourhoods built less than one house a year, or no houses, over this period, and provided only 2% of all new suburban homes.²⁴⁷ Urban economists have observed that England’s planning system is unusually restrictive, and all the devolved administrations have a similar discretionary element in their planning systems.²⁴⁸

The Local Government Association says that 10% of all planning applications are rejected, either by planning officers or by councillors at planning committee stage. The rejection rate will not tell the whole story, as planning rules create a deterrent effect against application, too.²⁴⁹

Uncontrolled uncertainty and market distortions

The UK's highly discretionary process creates uncertainty for developers as the success or failure of applications becomes hard to predict; this incentivises “land banking”, in which developers purchase more land with planning permission than they require in anticipation of future demand increases, to reduce the effect of “planning risk” on their ability to meet demand.

Distortions in the market occur given the large increase in land value pursuant to a grant of planning permission. As Kate Barker has observed, in 2010 agricultural land without planning permission around Cambridge was worth roughly £18,500 per hectare. Once it received planning permission for housing, the value per hectare increased to £2.9m.²⁵⁰ This is known as a “planning gain” and acts as a windfall for the landowner. The cost must be absorbed by the developer, pushing up its overheads.

Speculation, financialisation and monetary policy

The chronic shortage in turn fuels speculation in property assets as a form of investment rather than for residential purposes, also known as “financialisation”. The constant inflation in Britain's housing market makes it a safe bet for institutional and individual investors, sucking potentially productive capital from the real economy.²⁵¹ Even for owner-occupiers, incomes are sucked into high mortgage costs and are hence absorbed into real estate, rather than being invested in productive assets like equities.

Given the enormous investment potential of UK land, real estate has increasingly become securitised and treated as a safe asset. Overseas ownership is not a major feature of the wider UK housing market but is significant in London, which in turn generates a ripple effect on prices throughout the South East. According to a 2017 study a 1% increase in residential transactions to overseas companies led to a 2.1% increase in house prices.²⁵² The amount of annual overseas investment in the UK housing market

increased from around £6 billion in 2009 to £32 billion by 2014, making up 17% of all foreign direct investment in the UK.²⁵³

Monetary policy has also played its part, driving up mortgage debt and inflating house prices, in particular following the 2008 financial crisis.²⁵⁴ Planning reform alone is not enough, as reform to financial and investment incentives will be needed to stem the demand side.

Changing the system

There are short-term solutions that can increase development in specific areas using existing statutory powers, Development Corporations and Local Development Orders. However, ultimately the ultra-discretionary system itself is the problem. The UK will need some radical reform, implementing “zoning” practices in dense urban areas of high demand and economic need, and rebalancing discretion over residential planning approvals between local authorities and Combined Authorities as part of wider English devolution.

Zoning: Learning from the Anglosphere

In February 2024 the Competition and Markets Authority called for “substantial intervention” following claims the current “complex and unpredictable” discretionary system is responsible for the “persistent” under supply of new housing stock.²⁵⁵

Under a zoning system, much of the planning processes is “front-loaded” into strategic land use plans which outline the scope of permissible development within specific zones of cities (i.e. industrial, residential and mixed use)²⁵⁶. The function, shape and density of permissible developments within each “zone” needs to be set centrally so there are clear rules regarding design, construction, urban layout and infrastructure.²⁵⁷

Once zoning codes have been agreed the right to develop is embedded within the plan.²⁵⁸ Although proposals are often subject to a light-touch examination by the local authority,²⁵⁹ zoning provides greater certainty to developers for if a proposal meets the specified zoning requirements it should be given planning permission.²⁶⁰

There are numerous advantages to a zoning planning system for ultra-dense areas. First, the certainty afforded to development grants an assured value for land within each zone reducing the risk of land banking by removing the hope value associated with prime real estate assets.²⁶¹

Second, zoning systems should lead to faster planning decisions by removing the need to grant permission to individual applications. The “as-of-right” development approach also removes the legal requirement for public consultation which frequently undermines housing supply across the UK.²⁶² Both factors have an abject impact on housing delivery. In the UK most planning decisions are determined within 8 weeks.²⁶³ In Texas, building permits are usually issued within three days.²⁶⁴

The UK’s nationwide, discretionary, case-by-case planning system is an outlier among advanced economies - especially within the Anglosphere. Research conducted by the Urban Institute found that US cities experienced a 0.8% increase in housing supply and greater densification following the introduction of zoning reforms.²⁶⁵ The introduction of zoning laws has radically increased supply within individual cities over the last decade. In New Zealand, the implementation of new zoning mechanisms through the Auckland Unitary Plan saw the number of issued housing permits double within five years leading to a 4% increase in the city’s total housing stock.²⁶⁶

Furthermore, upzoning has been used to successfully support the gentle densification of Washington D.C. and Seattle through transit-oriented development²⁶⁷. As a result, both cities had the highest housing supply elasticity rates in the US between 2000 and 2020 - with prices rising at slower rates than Los Angeles and San Francisco which experienced significantly lower rates of housing output over the same period²⁶⁸.

The UK currently operates a “quasi-zoning system”²⁶⁹. Under the Town & Country Planning Order (2015), local authorities can issue Permitted Development Rights (PDR) enabling developers to ‘make certain changes to buildings or land without the need to apply for, and obtain, planning permission’²⁷⁰. Over 102,000 new homes were delivered through PDRs between 2015 and 2023, 89% of which were created ‘through the conversion of offices and other commercial, business and retail units’.²⁷¹

However, PDRs have received criticism for building in “isolated” or “unsuitable” locations. Research conducted by University College London found that only 5% of PDR homes had ‘access to a private or community amenity spaces compared to 23% of homes which required full planning applications - and that they were more likely to be located in industrial and commercial sites.²⁷² PDR is an effective tool for increasing supply, but the UK should replicate the success of other Anglophone economies by using zoning more effectively to facilitate better gentle-densification in Britain’s cities.

Combined Authorities

The inability of devolved authorities to exercise greater discretion over planning approvals for both commercial and residential developments creates a further barrier to developing local economic plans. The UK is unusual in the weakness of its intermediary political governance bodies relative to the OECD, as noted by the Productivity Institute.²⁷³ Instead, planning decisions are taken by local planning authorities (LPAs) at the LA level.

Devolved authorities should have greater responsibility for co-ordinating urban planning with economic development, infrastructure and local industrial strategies to help overcome the lack of co-ordination and hyper-localised decision-making that characterises the planning system. This would mean that responsibility over planning approvals could be linked to local growth targets and political responsibility for the cost of living.

In designated geographical areas of very high demand, determined by the housing affordability ratio and wider economic importance, the UK should replace the discretionary residential planning approval elements of the Town and Country Planning Act. These should be converted into “Development Zones” with presumptions in favour of development, with strict planning criteria for linking residential development to public infrastructure and strong controls for aesthetic compatibility, with discretion in the hands of central government. It is not suggested that the TCPA should be repealed more widely.

Non-resident foreign nationals and companies listed overseas should pay a much higher rate of Stamp Duty, and a higher rate of Capital Gains Tax on sale, reflecting the fact that a non-resident is purchasing limited housing stock. There should be a “right to buy” for UK residents currently renting from an

overseas landlord, including a right for leaseholders to purchase a freehold held overseas.

Greater discretionary powers over residential planning approval should be allocated where appropriate to Combined Authorities and Metro Mayors, consistent with envisaged greater responsibilities for local economic development, spending power and revenue-raising responsibilities. As with Development Zones, these discretionary powers should be governed by strict rules over design and construction set centrally.

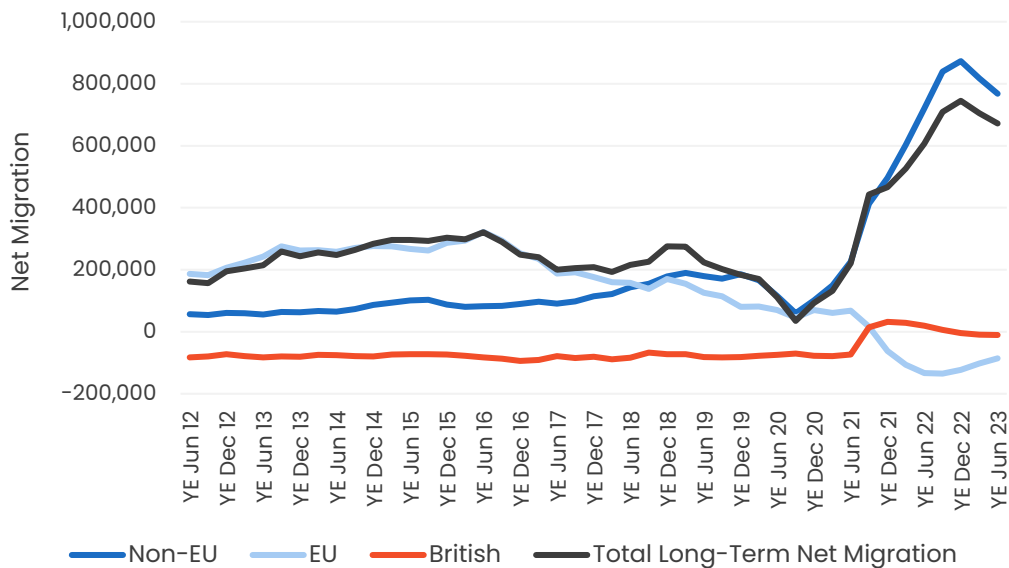
Borders, citizenship and belonging: a new direction for immigration

A very high level of net migration is now a feature of British society and the UK economic model, with net migration over 200,000 in every year since 2003, with the exception of the pandemic period in 2020.²⁷⁴

In the eleven years from 2012 to 2023, 3.3 million people have been added to the country's population.²⁷⁵

Figure 38: Net migration to the UK, June 2012 – June 2023

Source: ONS, *Onward analysis*



High net migration was one of the major political factors behind the 2016 EU membership referendum, with Leave voters listing immigration as one of the two most important motivations for their voting intention (alongside sovereignty).²⁷⁶ Every election from the Thatcher-era onwards has been won on a platform of promising more control.

However, the post-Brexit 2021 points-based immigration system has resulted in a much higher level of net migration to the UK, with the net emigration of EU migrants and a huge increase in non-EU net migration.

One of the main justifications for such high migration levels is economic: it is typically argued that high migration levels are needed to fill the UK's skills gap, to compensate for a labour shortage, or to bolster the tax base, helping the government to meet fiscal targets. The OBR's forecasting model assumes a net positive fiscal contribution from migration, with stronger tax receipts in high-migration scenarios.²⁷⁷

There are economic benefits to some level of carefully selective migration: high-skilled migrants bring competencies to the UK, earn above the median salary, contribute to the Exchequer in taxation and (if they are an above-average productivity worker) contribute to UK productivity performance.

Economic drawbacks

However, migrants do not bring their own housing, schools, infrastructure or healthcare provision. In this sense, high net migration has the effect of diluting the capital stock of the country. This dynamic has recently been noted by the IFS, which has forecast falling per capita spending as a consequence of population growth.²⁷⁸

It is sometimes argued that short-term migration is fiscally net positive since recent migrants tend to be younger, may not yet have children or have children not yet in school, and suffer fewer health problems than the average UK citizen (again, provided they are younger). However, it is also true that migrants who stay will get older, their children will attend school, they will use the NHS and will (if they achieve Indefinite Leave to Remain, or ILR) be able to claim means-tested benefits.

There is not yet a conclusive answer to the question of whether the migration experienced by the UK since 2021 is or will go on to be fiscally net positive in the long term. However, it will vary widely based on a number of factors and international evidence suggests some cohorts will be significantly fiscally negative.

Studies conducted in various EEA countries including the Netherlands and Denmark have concluded that non-EEA migrants are much less likely to be net contributors than EEA migrants.²⁷⁹ In the UK, the Office for National Statistics is moving the other way, ceasing to publish data on net fiscal contribution by nationality or migration status. Jan H. van de Beek at the University of Amsterdam calculated that non-Western migration cost the Netherlands 17 billion euros a year.²⁸⁰

In recent evidence to the Treasury Committee, David Miles of the Office for Budget Responsibility said that persistently high levels of net immigration may not necessarily generate fiscal improvements. While new arrivals tend to be in work, have relatively good health and are less likely to have children in school, migrants who stay will eventually make more use of schools and hospitals and will ultimately retire.²⁸¹ The value of the basic state pension for the average claimant is £250,000.

Labour market impact

Regardless of the fiscal impact, immigration affects the domestic labour market. Given that it increases the supply of labour it can lower overheads for employers, and as such tends to have the effect of compressing wages.

The flipside of this is that it reduces wage growth for local workers competing for jobs in the same industry. Economic migrants are more dependent on their job for their place in the UK and are therefore less likely to leave or be demanding, making them more attractive to employers - they may be less likely to seek to negotiate over pay or to strike, for example, thus making local workers less attractive.

The Oxford Migration Observatory found that the impact of immigration on real incomes is marginally positive for above-average earners but marginally negative for below-average earners. This is logical if immigration keeps the price of goods and services low (due to lower labour costs for producers and

service providers), but presents wage competition to those who might otherwise be performing these roles.²⁸²

Economists differ as to immigration's impact on wages, as the studies provide conflicting evidence. However, economists and economic authors including Dani Rodrik, Ha-Joon Chang, Michael Lind, Oren Cass and Angus Deaton (only one of whom, Cass, hails from the political right) have all suggested that on a first-principles basis immigration must undermine working-class salaries.²⁸³ And analysis of the impact on wages does not take account of dilution of the capital stock, whereby infrastructure and public services stretched over more recipients.

In a piece published in March 2024 by the International Monetary Fund Deaton, Emeritus Professor of Economics and International Affairs at Princeton University and a 2015 Nobel Laureate in economics, said (writing in an American context): "I used to subscribe to the near consensus among economists that immigration to the US was a good thing, with great benefits to the migrants and little or no cost to domestic low-skilled workers. I no longer think so...Inequality was high when America was open, was much lower when the borders were closed, and rose again post Hart-Celler (the Immigration and Nationality Act of 1965) as the fraction of foreign-born people rose back to its levels in the Gilded Age."²⁸⁴

Increases in the supply of labour are ultimately likely to reduce its market value, with migrants originating from poorer economies likely to accept lower wages. Indeed, when policy makers argue that (for example) migrant workers are needed to undertake jobs British workers will not do for the salary (such as in care work), they implicitly admit that high migration lowers pay.

Previous Chancellors have even suggested increasing migration specifically to lower inflation (by lowering the cost of labour),²⁸⁵ again implicitly accepting the "prior" that migration means lower wages.

Skilled work?

The definition of "skilled work" for the purposes of the UK visa rules is applied liberally, with a very wide range of occupations and of skill requirements included within the list. This has effectively reclassified unskilled work as skilled.²⁸⁶ And until changes to the salary threshold were announced in 2024,

the minimum salary requirement just £26,200 per annum,²⁸⁷ significantly below the UK median salary. In some categories it is lower, such as care work.

Furthermore, the 2021 shortage occupation list allowed employers to issue visas in multiple categories of occupation in which the salary threshold would be waived and workers could be employed at a minimum of 80% of the “going rate” for their role.²⁸⁸ However, in 2023 the Migration Advisory Committee advised that the shortage list should be abolished.²⁸⁹

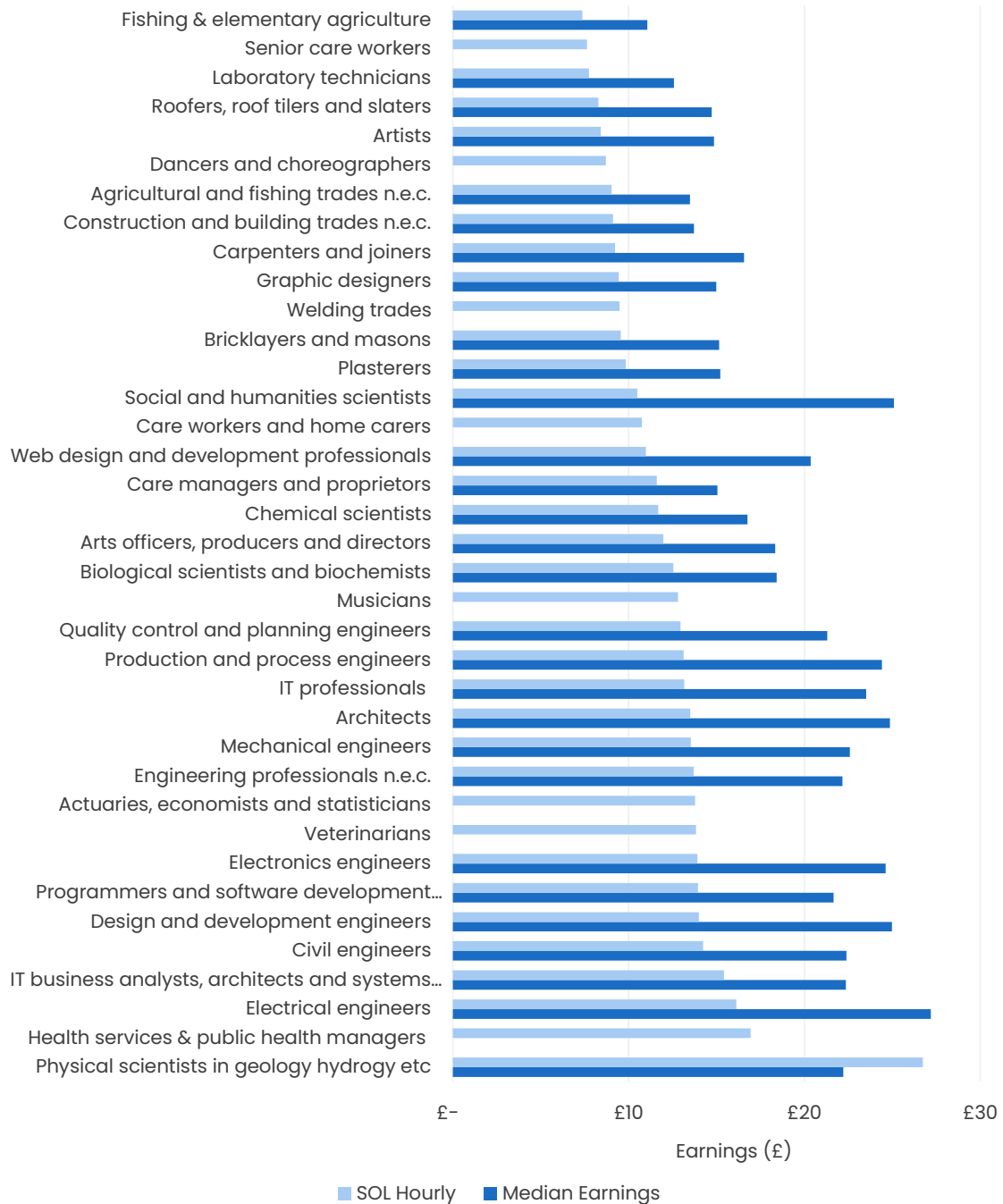
Social care in particular has been a major driver of net migration numbers, with 106,000 visas issued in 2023, excluding dependents. 350,000 “Health and Care” visas were issued altogether, which includes both care workers and their dependents (the right of care workers to bring dependents has now ended).²⁹⁰

Employers in certain limited sectors where visa rules have been tightened have had to adjust to a reduced availability of overseas labour by hiring UK workers, increasing pay or reducing overall employment. London bar staff have experienced above-inflation wage growth, for example.²⁹¹

This has not happened in the public sector. However, the Migration Advisory Committee advised in its 2023 Annual Report that increasing hourly pay in the social care sector by £1 could solve the workforce shortage without necessarily resorting to migration as a solution.²⁹²

Figure 39: Shortage occupation hourly salary thresholds and median hourly salary, 2023

Source: Home Office, Onward analysis



There has also been a large increase in the number of student visas issued by universities since the visa rule changes, with 486,000 student visas issued in 2023, plus 152,980 issued to dependents.²⁹³

Figure 40: Student visas, 2015–2023

Source: Home Office, Immigration Statistics

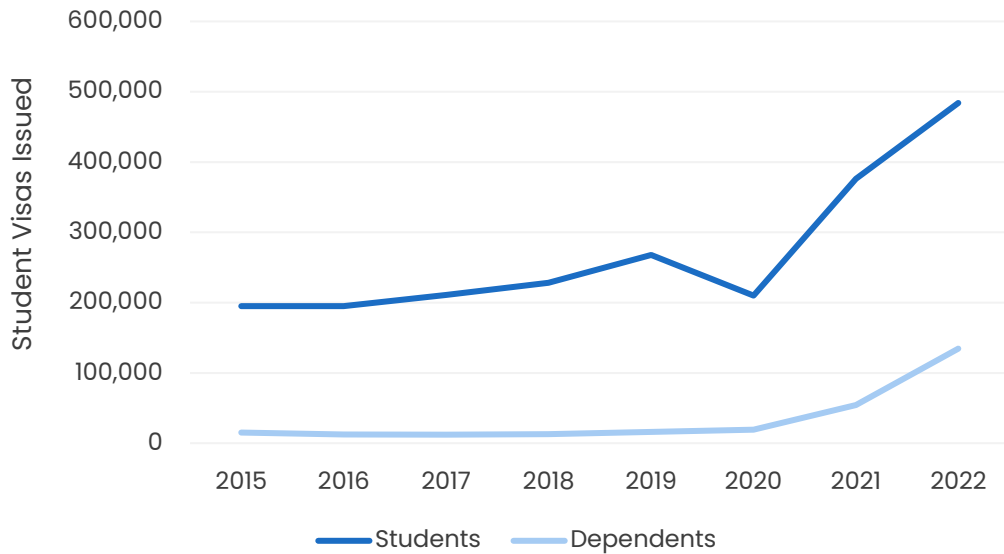
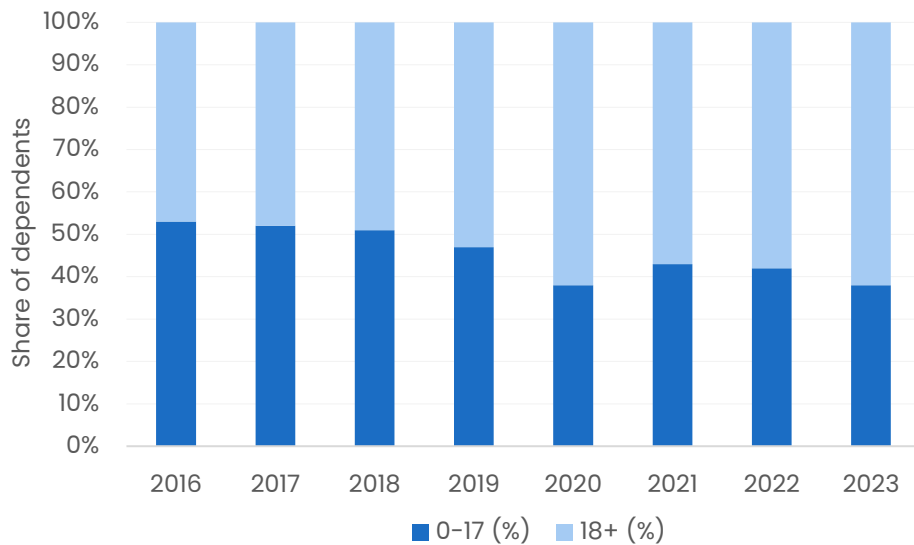


Figure 41: Age breakdown of student dependant visas, 2016–2023

Source: Home Office, Immigration Statistics

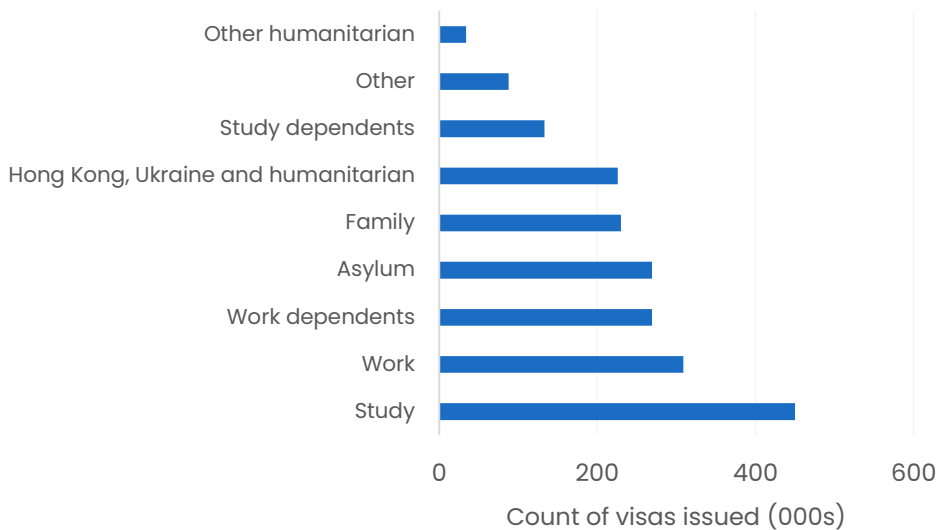


An important further feature of the post-2021 migration system is the Graduate visa, which allows those completing university courses to remain in the UK to work on conditions more liberal than those of the Skilled Worker Visa (the salary threshold is just £24,220, or 70% of the “going rate” in your chosen occupation).²⁹⁴ The Graduate visa therefore provides a route for entry to the UK who would not meet the criteria for Skilled Work visas. This in turn distorts incentives for HE institutions, who can capitalise on demand for an easier-access pathway to the UK as part of their financial model.

Looking at recent immigration trends, Neil O’Brien MP notes that over the course of the last five years net migration has summed to 2,008,000, with only 15% of visas being issued for the primary purpose of work.²⁹⁵ The Office for National Statistics breaks down arrivals as follows:

Figure 42: Count of visas by category, June 2019–June 2023

Source: ONS, *Long-term international migration statistics*



Does it matter?

Much has been written on the difficulty of combining a social welfare state with relatively open borders. As the social scientist Robert Putnam has shown, voters are less supportive of redistribution of their tax money towards people with whom they have less connection, or if there are not clear boundaries about who is eligible for social entitlements.²⁹⁶

It can also be argued that uncontrolled immigration undermines the contributory principle of the welfare state. While migrants initially pay an NHS surcharge and pay tax like existing residents, it is not clear that a majority are net contributors. The intergenerational aspect of the social model is also undermined; if a young worker needs expensive medical care early in their career they will not be a net fiscal contributor, but their parents are likely to have paid tax and National Insurance Contributions for most of their lives, which will not be true of a recent arrival in the UK.

It is sometimes argued that migration from less developed countries is good for the migrants themselves. However, this should not be the primary concern of the UK Government, which is charged with promoting the interests of its own citizens and residents first. Secondly, it is not always good for migrants' own countries of origin, which may suffer from depopulation or "brain drain".²⁹⁷

Finally, the distributional impact of migration on wages and through dilution of the capital stock through demand for housing, infrastructure use and services must be taken seriously.

A new approach is therefore needed.

The Government should set out a plan to reduce overall net migration to the tens of thousands per year. This should be achieved through a combination of visa caps and higher salary thresholds to ensure migrants make a net fiscal contribution, with very limited exceptions for ultra-high skills and areas of critical need, such as engineers, doctors and researchers in strategic skills deficit areas such as science and technology. The current Shortage Occupation List should be abolished.

The number of HE institutions with the ability to issue visas should be reduced, with only the highest-performing institutions (measured by UCAS tariff) able to sponsor foreign students. Only those studying funded PhDs at qualifying institutions should be able to bring dependents. The current Graduate Visa should be abolished, with those completing UK HE courses able to apply for a Skilled Worker visa or an ultra-high skills visa (as described above).

The UK Government should establish an Office for Migration, like the OBR, to monitor population movements, collect and publish data on the economic impact of migration and the net fiscal contribution of migrants, factoring in public

services and pension entitlements. It should scrutinise annual migration policy and numbers with reference to factors such as housing supply and the wider capital stock.

Post-18 education should be reformed so universities and colleges are not dependent upon overseas students for income, and the country is no longer left with the skills shortages it suffers today.

Reforming welfare

Welfare reform has been one of the great successes in public service delivery of the Conservatives' period in government. Previous welfare policies, implemented under Tony Blair and Gordon Brown, created a “poverty trap”, with effective marginal tax rates so high people were disincentivised returning to work.²⁹⁸ Old “legacy” benefits were also irrationally allocated, not reflecting the earnings of a whole household.

This system was replaced by Universal Credit (UC), a dynamic, digital and household-based system. The UC “taper” (the rate of benefit withdrawal as a claimant returns to work) has been cut to 55p as originally recommended, improving work incentives and allowing those receiving in-work benefits to keep more of their earnings. UC included stricter conditionality about searching for work, with a sanctions regime for those failing to comply with their claimant contracts.

Yet since the Covid pandemic there has been a significant expansion in the numbers claiming working-age benefits, reaching 7 million including legacy benefits in 2023-24. Analysis by the Office for Budget Responsibility (OBR) shows that the biggest increase has been in the numbers claiming sickness benefits, who therefore have “No Work Requirements”.²⁹⁹ Of this, the largest growth area is mental health-related ill health.

A challenge in the system is that mental ill health can be hard to diagnose objectively as it is based in part on subjective reporting of symptoms. It is therefore hard to reconcile with the process of Work Capability Assessments (WCAs). Furthermore, as those with work requirements have been subject to the benefit cap, so the “incentive” to claim sickness benefits rather than be a jobseeker is increased.

Figure 43: People receiving means-tested benefits, 2015-15 – 2023-24

Source: DWP StatXplore, Onward analysis

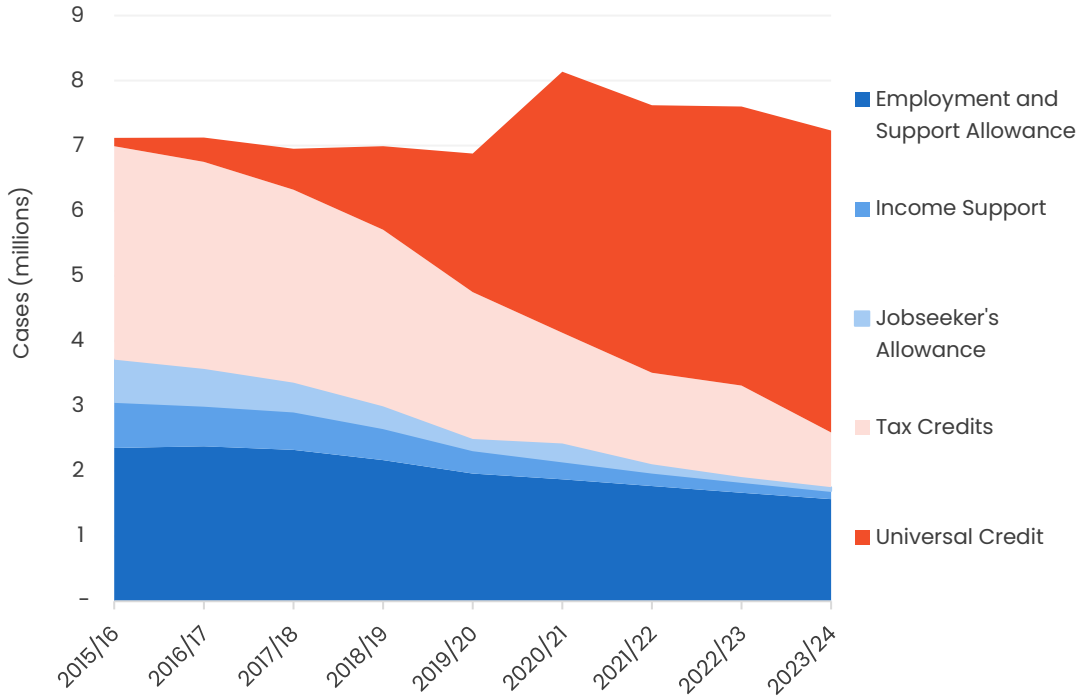
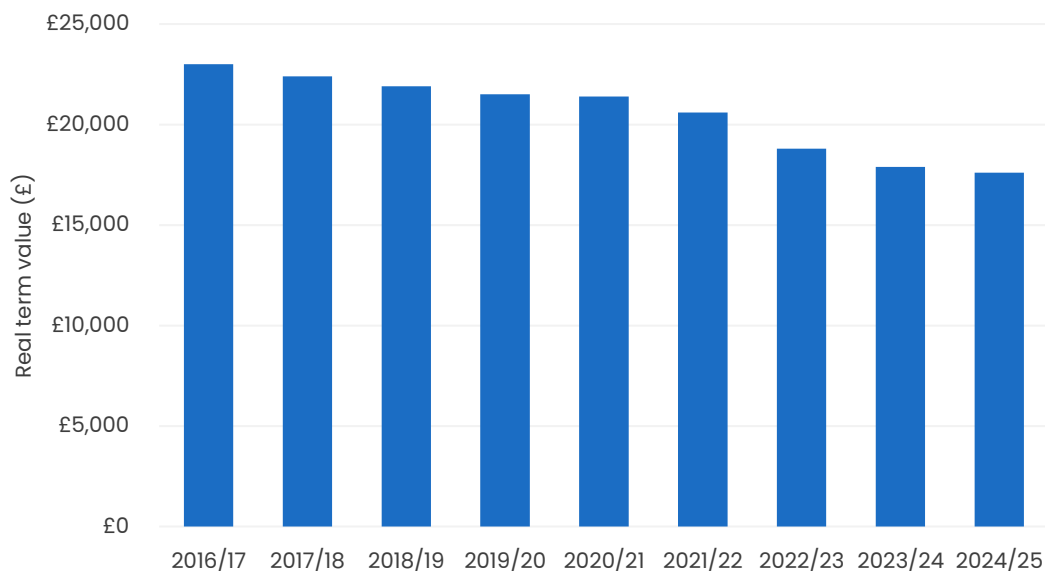


Figure 44: Real terms of value of the benefit cap, 2017-17 prices

Source: House of Commons Library, Onward analysis



The increase in spending on working age welfare is not because Britain’s social security model is generous. In fact, we have a below-average income replacement rate by European standards. The real terms value of benefits has been eroded through successive benefit freezes since 2012.

Rather, the problem lies in the volume of claimants. The size of the UK’s welfare cohort has become unsustainable. And there is emerging evidence on the “medicalisation” of negative human experience.³⁰⁰ This process can, when it interacts with the benefits system, leave those who could be capable of work with the right help left without access to employment support.

Therefore an overhaul of the treatment of mental ill-health in the welfare system is needed, with a much greater focus on the work that claimants suffering from mental health problems can do. Governments should take steps to ensure potentially productive UK workers who are currently claiming out-of-work benefits return to the labour force, and should incentivise employers to draw on this supply of labour rather than relying on immigration.

Mental ill health should be looked at differently through the welfare system, with much greater levels of employment support combined with mental health support and treatment, and a default expectation of being in work where possible.

Claimants with treatable mental health difficulties should not be classified as having “No Work Requirements”.

The Government should develop an employment support programme to continue helping those with mental health difficulties who have moved into work, and to support employers who employ them.

The available domestic workforce who are currently not in work, but could be with the right support, should be considered when deciding questions of immigration policy.

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