

POLICY EXCHANGE

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# ECONOMICS MANIFESTO

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JONATHAN DUPONT



#ECONOMICSMANIFESTO

**“ After a decade in which real wages have fallen and unemployment soared, it is no surprise that many people have lost faith in the ability of markets to deliver for them. In the short term, Britain faces challenges: our productivity is stagnant, our savings too low and the deficit too high. Nevertheless the long term outlook for our economy remains bright. The combination of markets and technology is the most powerful engine we know of to increase prosperity, reduce poverty and create a better world. In this manifesto, we look at where our economy has been, where it is going – and how the Government can ensure the power of markets benefits everyone.”**

# THE NEXT GOVERNMENT SHOULD AIM TO...

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Create the most innovative and  
competitive economy in the world

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Build a capital-owning democracy

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Deliver a value for money government

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# ABOUT THE ECONOMICS AND SOCIAL POLICY UNIT

Policy Exchange wants to see a high growth, enterprise led economy in the UK with freer markets driving growth and opportunity. Where individuals, families and communities are encouraged to take responsibility and are able to flourish. We are optimistic about the country's future and the power of freedom and responsibility to improve people's lives.

For more information about our work visit: [www.policyexchange.org.uk/economics-and-social-policy](http://www.policyexchange.org.uk/economics-and-social-policy) or contact one of the team:

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# CREATING THE MOST INNOVATIVE AND COMPETITIVE ECONOMY IN THE WORLD

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Over the last few years, Britain's economy has prioritised keeping people in work over increasing wages. As the economy reduces unemployment, focus will switch back to how we can ensure more rapid growth.

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In order to keep improving living standards and cut the cost of living, Britain needs higher productivity, more disruptive innovation and greater levels of competition.

- **Introduce a new generation of government sponsored prizes for basic research and innovation.** In the past, prizes have sparked John Harrison's chronometer, Charles Lindbergh's flight across the Atlantic, and a new, accelerating private space industry. The Government should massively expand the current Longitude Prize programme, and catalyse a new generation of prizes to tackle our biggest challenges in energy, environment, health and education.
- **Regulatory policy should aim at enabling permissionless innovation, rather than trying to satisfy an unachievable precautionary principle.** The biggest dangers to our health, safety and environment do not come from making progress too quickly on self-driving cars, GM crops, new drugs or new energy supplies, but rather, progressing too slowly. Regulation is needed, but it should be aimed at actual harms not unlikely worst case scenarios.
- **Introduce a Presumption against Interference in the planning system with residents acting as quality control, rather than officials.** Change of Use restrictions should be limited to clear externalities, and local plans should be drastically stripped back – no density targets, or

top down regulation of minutiae like car spaces, bike standards or the number of hotel rooms. If less than half of the people in the immediate vicinity object, planning permission should automatically be granted subject to appropriate compensation.

- **Introduce a new supply side agenda to tackle monopoly rents, increase competition and cut the cost of living.** Network Rail, for example, could be broken into eight regional companies to increase competition and efficiency, while the franchising process should be reformed to start from 'zero subsidy' bids rather than tightly defined specifications. Rather than pick winners, the Government should bring forward auctions for mature renewable energy sources, and refocus resources on setting consistent carbon prices and supporting early stage sources. We should commit to building 300,000 houses a year, driving down rental costs, increasing housing supply and creating thousands of jobs in the construction sector.

- **Britain should aim to build on London's success as a world hub for trade, finance and talent, offering the most competitive business taxes in the G20.**

Building on the successful model of corporation tax, the Government should give businesses greater certainty by publishing a five year tax roadmap at the beginning of the Parliament. The next Government should commit to accepting the recommendations of the Davies review. Outside London, the Government should encourage new hubs through devolving further political, borrowing and economic powers, and increasing road and rail investment to create a new 'Northern Hub'.

# BUILDING A CAPITAL-OWNING DEMOCRACY

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In the long run, ownership of assets is as important as wages in generating inequality, but the distribution of savings is currently even less equal than income.

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We need to create a capital owning democracy, to ensure saving isn't only the province of the rich. Everyone should share in the benefits as the economy grows.

- **Introduce a Bonus ISA to give people more flexibility to build up their tax-free savings pots during the course of a lifetime.** People who experience a one-off financial windfall such as an inheritance, house sale or redundancy payment would benefit from being able to make a deposit into their tax-free account within a single year that is greater than the annual tax-free savings allowance (currently set at £15,000). People would be given the power to roll over any unused portions of their existing ISA allowances into their Bonus ISA account.
- **Introduce a new generation of private sector Premium Bonds. Originally introduced by Harold Macmillan, Premium Bonds remain** one of Britain's most popular savings products, while other examples of prize-like savings accounts have been shown to increase total savings by 12%. They are especially effective among those with already low levels of income and savings. The Government should encourage a new generation of Premium Bonds, allowing private organisations to experiment with different behavioural nudges, lottery-like mechanisms and different combinations of prizes and interest rates.
- **Allow taxpayers to buy a no risk stake in RBS and Lloyds.** Anyone who has an NI number and is on the electoral register should be given the opportunity to apply for shares at no initial cost, only paying



at the time of sale. The Government would retain the option of recalling the shares in the highly unlikely event that they never rise above a floor price, but the new shareholders would receive any upside.

- **End the opt-out for auto-enrolment in private sector pensions and gradually increase the contribution rate to 12%.**  
Under the current 8% rate, a worker earning £27,000 over 40 years would only save around 55% of what they need to generate the target replacement income. Increasing the rate to 12% and making it compulsory would match Australia's highly successful pension scheme, while ensuring that even the lowest paid are saving for the future.

- **Create a new system of personal 'MyFund' welfare accounts funded out of National Insurance payments.**  
Individuals should be able to add up to an extra £100 a week to their personal 'MyFund' account, which would fund the first three months of unemployment. In addition, the fund could be drawn on throughout the working life to support career transition and retraining; any remaining balance would be added to the pension on retirement.

# DELIVERING A VALUE FOR MONEY GOVERNMENT

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Fiscal consolidation remains only half-finished: our debt is too high and long term forecasts for the public finances unsustainable. However, taxes are already the largest bill most households pay, and raising them higher would threaten living standards.

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On the other hand, there remains considerable scope to increase the efficiency of government – allowing us to both, pay down debt and pass on the benefits as higher incomes for the low-paid.

- **After the deficit has been closed, introduce a new fiscal mandate targeting a zero structural deficit and the pay down of the debt-to-GDP ratio over the economic cycle.** Following the Swiss debt brake model, in the event of predictions proving overly optimistic, any unforeseen deficits would have to be repaid in five years. In the event of a budget breach 30 days prior to the beginning of a fiscal year, automatic freezes should be triggered to tax thresholds, public pay and welfare.
- **Improve the quality and access to data on comparative costs, public sector performance and official forecasts.** The Government should commission the rapid production of simple league tables on local public sector performance, with the results included in the new annual tax statement. The OBR should be given a new duty of reviewing and updating policy costings. New government sponsored prediction markets should be set up for growth, inflation, unemployment and tax revenues.

- **Cap the total public sector pay bill, but give public sector employers greater autonomy to link pay to performance and local labour market conditions.** As in Sweden, public sector employers should be allowed to choose the level at which negotiations take place. In some public industries, negotiations can take place between the employee and employer, while for others remaining at the level of the workforce.
- **Introduce a long term ambition to ensure every full time worker earn a Living Income.** A mandatory Living Wage would give the UK near the highest minimum wage in the OECD, and the majority

of the benefits would go back to the Treasury rather than to the workers in higher living standards.<sup>1</sup> By contrast, the difference between the current minimum wage and the Living Wage is largely accounted for by taxes on work such as income tax, employer's and employee's National Insurance Contributions. By 2025, it would be feasible to align the income tax and national insurance thresholds, which together with targeted increases in Universal Credit could ensure every full time worker took home at least a Living Income.

# INTRODUCTION

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The financial crisis revealed Britain's underlying weaknesses as well as its strengths: an overdependence on finance and debt, but also a flexible labour market that kept people in work.

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## Where We've Been

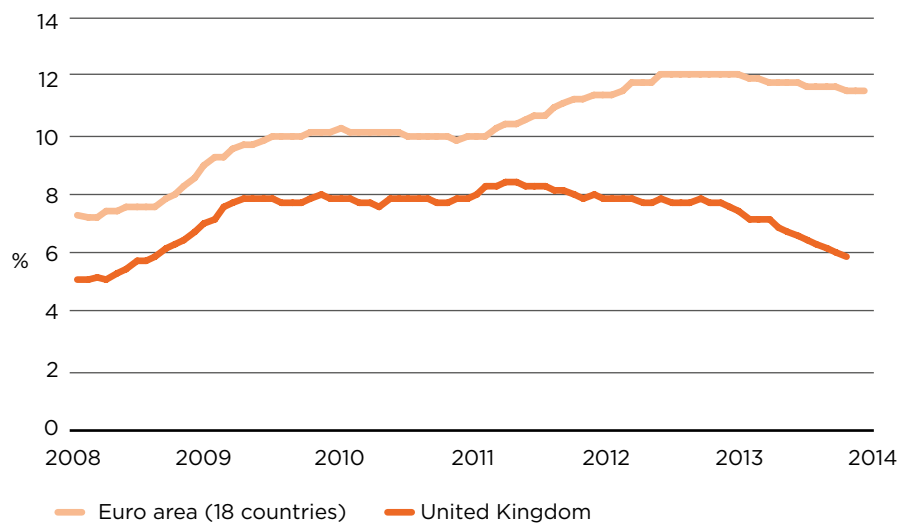
Britain has not had an easy decade. As home to the world's leading financial centre, Britain was at the forefront of the damage inflicted by the financial crisis, punching a 16% hole in the economy<sup>2</sup> and a 14% undershoot in tax.<sup>3</sup> While real public spending increased 59% between 1997 and 2010,<sup>4</sup> productivity in public services flatlined, showing no overall improvement.<sup>5</sup> The combination of the two left Britain with a 10% deficit-to-GDP ratio in 2009-10 the largest in its post war history,<sup>6</sup> second only to the US out of the G7.<sup>7</sup>

At the same time, a crunch in global commodity prices saw world food prices more than double between 2000 and 2013, and

energy prices rise by 256%.<sup>8</sup> As employers struggled to deal with the growing cost of an ageing population and unsustainable pension plans, workers saw more of their salary diverted out of their pay packet to make up for the shortfall. The net result was that real median employee earnings actually fell 1.9% between 2003 and 2013.<sup>9</sup>

But then Britain has seen recessions before – and aspirations to end boom and bust aside, likely will do so again. While the downturn has lasted far longer than most, the British economy is projected to recover the fastest out of the G7 in 2015.<sup>10</sup>

The fundamentals of the British economy remain strong. The UK enjoys one of the



**FIGURE 1**  
Unemployment rate since the financial crisis (Eurostat)

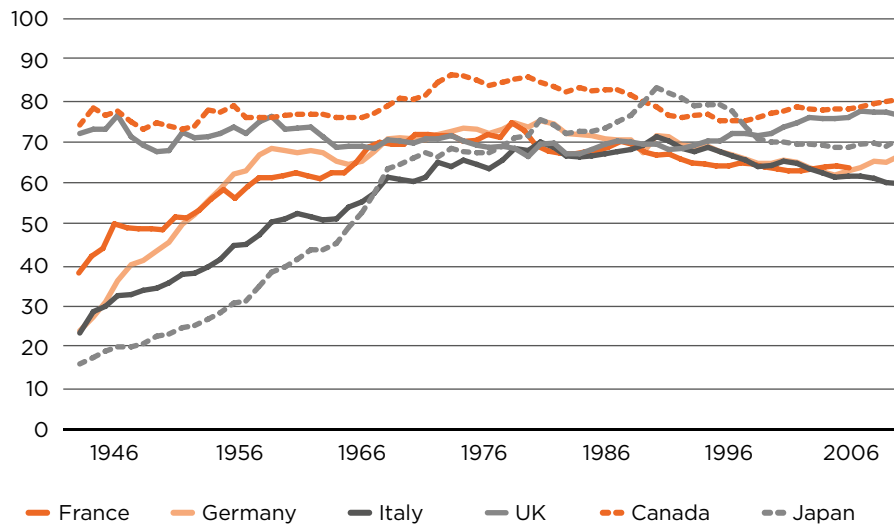
	GROWTH		UNEMPLOYMENT		DEFICIT REDUCTION	
	Percentage Change in Real GDP per capita	Rank	Percentage point fall	Rank	Percentage point fall in structural deficit	Rank
Canada	5.7	3rd	1.1	5th	1.9	7th
France	1.7	6th	-0.8	6th	3.2	4th
Germany	8.8	1st	1.8	3rd	3.0	5th
Italy	-4.8	7th	-3.6	7th	3.5	3rd
Japan	5.4	4th	1.3	4th	2.3	6th
<b>UK</b>	<b>4.9</b>	<b>5th</b>	<b>2.1</b>	<b>2nd</b>	<b>4.8</b>	<b>2nd</b>
US	8.1	2nd	3.7	1st	5.8	1st

**TABLE 1**  
The report card: The UK economy from 2010-2015 (IMF WEO)<sup>13</sup>

world's two most important cities,<sup>11</sup> two of the world's top five universities,<sup>12</sup> and a geography and historic heritage second to none. Decades of reform from political parties on both the left and right – increasing competition and helping people back into work – have left Britain with one of the most robust and flexible economies in the world. By maintaining its own currency and persuading bond markets that it was

serious about deficit reduction, Britain has kept its destiny in its own hands.

Despite the severity of the recession, Britain's flexible labour market adapted to ensure that the pain was spread out equally. In the past, less severe recessions have led to hundreds of thousands being thrown out of work: unemployment peaked at 8.5% in October 2011, compared to 10.7% in January 1993 and



**FIGURE 2**  
The post war UK economy (GDP per capita, US = 100, Maddison Project Database)

11.9% in March 1984.<sup>14</sup> The alternative to slow growth in wages would have been fast growth in unemployment; in France, average wages increased 1% in real terms between 2011 and 2013 compared to a 0.7% fall in the UK<sup>15</sup> – but the cost has been an unemployment rate that has stubbornly trended up to 10% and beyond. Meanwhile in Britain the continual falls in the unemployment rate are overtaking everyone's expectations. At 5.9%, the UK unemployment rate is now nearly half the Euro average (11.5%), or a quarter the rate of the countries struggling most from high debt and unreformed labour markets, such as Spain (24%) or Greece (25.7%).<sup>16</sup>

## Markets Work

**Since the birth of the Industrial Revolution, markets and technology have delivered at least a sixteenfold improvement in the standard of living.**

If you zoom out to look at the medium term, Britain is doing even better. In 1980, the UK

had the lowest GDP per capita of the G7 – a legacy of its post war stagnation. Between 1980 and 2007, the UK enjoyed the second fastest average growth in the G7. While other countries fell further behind America, the UK leapfrogged them, ending up third behind the US and Canada.<sup>17</sup> Much of this came from genuine innovation and efficiency improvements – since 1990, average Total Factor Productivity growth, the technical measure of this, has been second only to Germany.<sup>18</sup>

This was not just the result of an unleashed financial sector, riding on an unsustainable bubble of debt and credit: growth and innovation were broadly spread. Between 1998 and 2008, labour productivity grew by an average 4.4% in the financial and insurance sectors, but grew faster still in chemicals and pharmaceuticals (5.7%) and the information and communication sectors (6.4%).<sup>19</sup> The last thirty years have seen Britain develop the world's largest computer processor designer; continue its pre-eminence in aeronautics, oil and cars;

It was markets, not government, that has allowed households over the last sixty years to reduce the amount of the average household budget that goes on food by 71%

become a leading cultural centre with London regularly crowned fashion capital; Pinewood and Soho giving Hollywood a run for their money;<sup>20</sup> and, video game developers in Leeds and Edinburgh reaching £1 billion in revenue faster than any other entertainment product ever.<sup>21</sup>

Markets and technology are still working together to create a better world. This is the same recipe, unleashed first in Britain at the advent of the Industrial Revolution, that has delivered at minimum, a factor of sixteen improvement in the average standard of living.<sup>22</sup> It was markets, not government, that has allowed households over the last sixty years to reduce the amount of the average household budget that goes on food by 71%, clothing by 54%, and fuel by 27%.<sup>23</sup>

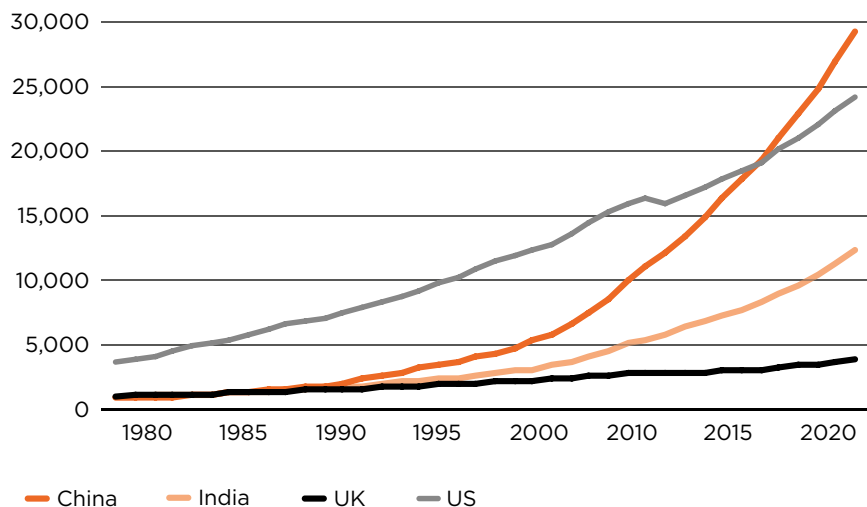
In the short term, markets reward entrepreneurs that create and distribute new products that consumers want. But in the long run, ideas are the ultimate shared resource, impossible to fully protect. Inevitably, new competitors emerge, bidding down profits and ensuring that the benefits are passed onto the many. Unlike some of the dire predictions from the economists of the day, wealth did not coalesce with the rich capitalists after the Industrial Revolution, leaving the workers on starvation wages. Since 1830, the real size

of the economy has increased by a factor of around thirty;<sup>24</sup> the population tripled and average earnings increased by a factor of ten.<sup>25</sup> Everyone has shared in the wider benefits of growth, from clean drinking water, indoor heating, abundant entertainment, doubled life expectancy (40 years to 80),<sup>26</sup> and an average working week half as long (60 hours to 30).<sup>27</sup>

## Where the Economy is Going

**Technology and trade will continue to revolutionise the world. As long as we remain friendly to businesses and workers, both domestic and foreign, Britain is well placed to prosper.**

This process is still continuing. Ten years ago, we did not have iPhones, Kindles, contactless payment, Bitcoin, the Tesla Model S, induced pluripotent stem cells, Google Maps, Twitter or YouTube. Despite its hardships, measured broadly, the last ten years was easily the greatest decade in human history. Between 2002 and 2011, the number of absolute poor in the world fell on net by 620 million, over a third. (Between 1981 and 1993, it fell by just 19 million.)<sup>28</sup> In the UK, the last decade or so has seen life expectancy at birth increase by another two to three years,<sup>29</sup> recorded crime



**FIGURE 3**  
GDP on PPP basis (Current International Dollar, \$bn, IMF WEO October 2014)

in England and Wales has fallen by over a third<sup>30</sup> and the number of days when air pollution is moderate or higher, halved.<sup>31</sup> For each of the successive three years that the ONS have so far been reporting data, Britons have reported being more satisfied with their lives and finding them more worthwhile, while the average day is happier and less anxious.<sup>32</sup>

Neither is this process likely to stop in the future. In the coming decades, technology looks set to drive our cars, personalise our medicine, and democratise access to the world's best teachers or doctors. While it is destroying old jobs, it has also created new roles, often better paid and more interesting. By taking over the routine parts of a job, it allows workers to be more autonomous, creative and social. Already, new technologies are making it easier for internet entrepreneurs to start new businesses from their bedrooms; to match the supply and demand for spare car rides, bedrooms, errands or tools in the Sharing Economy; to learn new skills from

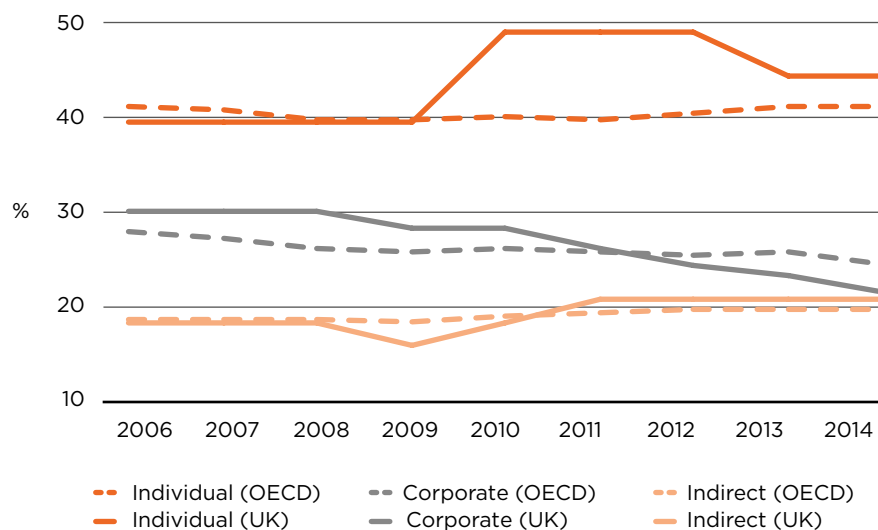
Udacity or Lynda. Despite many fashionable current fears, Britain is likely to continue to grow. Even if technology was to completely stagnate, we know that Britain could improve its productivity by about a quarter – the current difference with the US.

But technology is not the only thing changing the world.

This was the year, on the latest IMF data, that China finally overtook America to become the largest economy in the world. By the end of the next Parliament it will be 20% bigger than the US – or nine times larger than the UK.<sup>33</sup>

Even though average living standards will remain below those in the UK for decades, the sheer scale of the rise of the emerging economies and the growing middle classes within them will have a titanic effect on the global economy. China alone has five cities with over ten million people, 14 cities with over five million,<sup>34</sup> and 160 cities with more than





**FIGURE 4**  
Evolution of  
highest tax rates  
(KPMG)

one million.<sup>35</sup> Chinese consumers are already starting to have an impact, with Hollywood blockbusters shooting extra bonus scenes for them and 114 million Chinese tourists expected to travel abroad this year.<sup>36</sup> One recent estimate suggested that tourism from China would be worth £1bn a year to the UK economy by 2017 – approximately double its current value.<sup>37</sup> In the past, globalisation has increased the pressure for companies to outsource or replace their workers with machines. In the future, it is likely to create a boom in demand for British products from the emerging global middle class. It is a good time to be an exporter of high-end Scottish whisky, luxury Land Rovers or viewing rights to Premier League football.

By increasing the size of the market, the rise of the emerging economies is creating a more competitive world – but it is far from the only factor. The digital revolution, more integrated financial markets and cheaper logistics are

all continuing the (at least) two hundred year trend towards the death of distance. Companies are often as exposed to competition from a rival in a bedroom in Palo Alto or Bangalore as the next town along. Increased trade has increased consumer choice, driven up productivity in Britain and created a more equal world.

Governments are as exposed to these competitive forces as companies. Over the last decades, increasingly mobile workers and companies have forced down the top rates of income and corporation tax. While the fall in worldwide rates has levelled off in recent years,<sup>38</sup> there is still unlikely to be much scope to raise them back up. Governments are instead increasingly turning to indirect taxes such as VAT and property taxes to raise cash.

Tax competition is sometimes derided as ‘race to the bottom’, but you could argue that the opposite is equally the case. Increased consumption is forcing what good govern-

ments should be doing anyway: decreasing the tax on work, business and investment, and if necessary making up the difference with higher taxes on consumption. Just as in business, lower prices aren't everything, neither are lower taxes – California, for example, has among the least competitive taxes in the US<sup>39</sup> – but if you want to charge more, you have to make sure that you're worth it. If you want to have higher taxes, you have to have other reasons why your economy is more attractive than its competitors.

There is no reason why Britain cannot take advantage of this future and thrive. To repeat a familiar list, it still has advantages most other countries would kill for: historical global links, and a convenient geography, between the US and Asia; a highly skilled, creative and flexible workforce; a disproportionate share of the world's best universities, scientists, artists and entrepreneurs; a young, cosmopolitan and growing population; its own currency, low taxes and low corruption in government; and a reputation as the world's leading global city for finance or culture. Britain has always thrived best as a trading crossroads for the world; Hollywood may be shooting extra scenes for the audiences in Beijing, but it is Leicester Square where they put on their world premiere.

On the other hand, we shouldn't get too complacent. While we remain near the top of the league tables, most independent indices of economic competitiveness show stagnation, if not deterioration over the last decade: the Heritage Foundation's Index of Economic Freedom has the UK down from 77.7 to 74.9 between 2004 and 2014, the Fraser Institute's Level of Economic Freedom has the UK down from 8.1 to 7.81 between 2002 and 2012, and the World Economic Forum's Global Competitiveness Index has fallen from 5.6 in 2006–7 to 5.4 in 2013–14.<sup>40</sup>

In particular, the most recent Global Competitiveness Index gives a fair picture of the British economy's strengths and weaknesses. The UK is good with technology – it has the 2nd highest level of ICT uptake in the world and enjoys sophisticated businesses and a flexible labour market. It has good, if not great, infrastructure and goods markets, and lags a little in providing access to finance and the quality of parts of its education system.

In short, to take full advantage of the opportunities in front of Britain, future governments need to continue the hard work of gradual reform. Britain's tax system remains inconsistent and overly focussed on business. The regulatory, planning and financial barriers

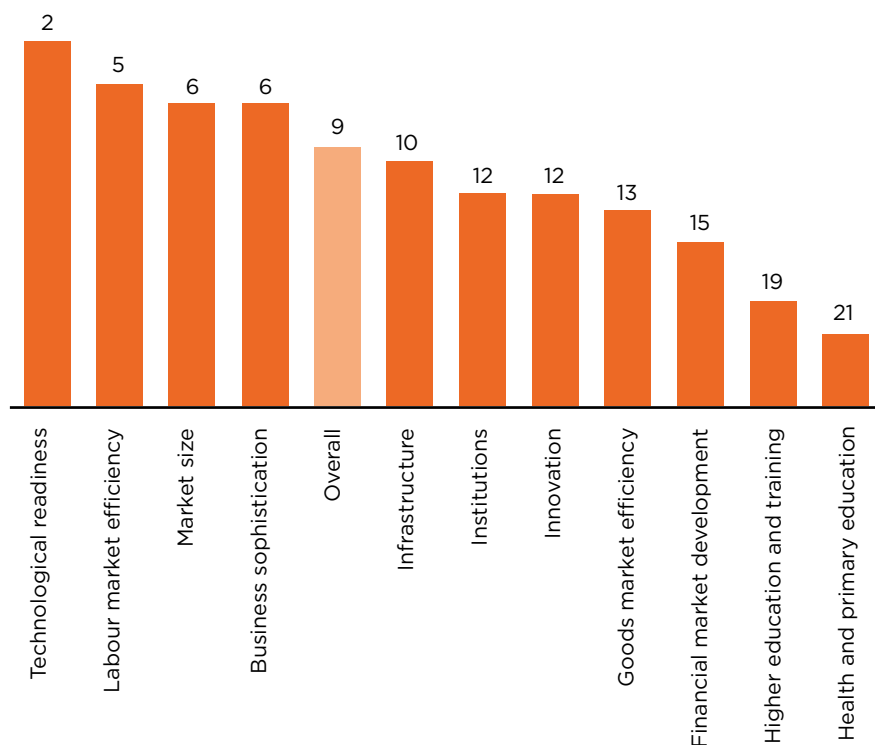


FIGURE 5

UK rank in Global Competitiveness Index 2014-15 (out of 144)<sup>41</sup>

to increased competition, better infrastructure and further innovation need to be tackled. We need a safer banking system, but not to go too far and smother one of Britain's leading industries. Foreign firms and workers need to feel welcome. Reform and innovation need to continue in education and skills to stop Britain slipping behind. Delivering a strong economy is the best way to ensure Britain continues to prosper in the future.

## Growth that Benefits Everybody

**In this manifesto, we look at what some of the next government's priorities in economic and financial policy should be. We need to ensure that the benefits of growth flow to everyone.**

The combination of markets and technology are the engine behind our current prosperity. While we have suffered a historic recession, there is no reason to believe that they will not continue to drive greater prosperity in the future.

But given stagnant wages, broken public finances and greater uncertainty, it is no surprise that many are increasingly concerned about the future. It is not irrational to worry that your job will be lost to a robot, an emerging market economy, or a newly arrived immigrant. Many people fear that even if they keep their job, they could be caught in a race to the bottom, with lower working standards and a less pleasant job. Markets may clearly be working for those with a fashionable tech job or owning a house in South Kensington -

## Technology, globalisation and longer life spans will create a better world – but policymakers need to ensure that growth does benefit everybody, delivering inclusive growth for all

but the benefits can be a lot more hidden for those who have lost their job in Britain's manufacturing heartlands or seen their income fall behind their friends who moved to London.

The last five years of economic policy were largely dominated by the aftermath of the financial crisis. Any party in power would have had to focus their energy on major spending cuts and reformed financial regulation. The Eurozone crisis delayed the eventual recovery that now seems relatively embedded, while the priority for policy had to be to reduce unemployment.

The next five years should see the focus shift towards preparing for the future. Technology, globalisation and longer life spans will create a better world – but policymakers need to ensure that growth **does** benefit everybody, delivering inclusive growth for all.

In this manifesto, we look at the three big areas that will determine our economic future:

- **Growth.** While markets have revolutionised large sections of our economy, delivering innovation and cheaper prices, too many other areas are protected behind regulation from effective competition. Many of the biggest items on household budgets have remained stagnant and expensive including energy, transport and housing. How do we take advantage of Britain's unique opportunities and introduce a supply side agenda to support innovation, competition and trade?
- **Savings.** Markets benefit not just workers, but savers and entrepreneurs too. Unfortunately savings are even more tightly concentrated than income in Britain, and a large proportion of them are being funnelled into ever rising housing prices and asset bubbles. How can we create a capital-owning democracy, ensuring that the benefits of growth are widely spread?
- **Government.** While markets and technology have revolutionised the private economy, they remain poorly utilised in government. In too many areas of the public sector, we do not know what we are getting for our money – and given that tax is the largest household bill for nearly everyone, that matters greatly for the standard of living. Considerable work is required to balance the budget, but even when that is achieved, how do we ensure it stays that way?

# GROWTH

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In order to keep improving living standards and cut the cost of living, Britain needs higher productivity, more disruptive innovation and greater levels of competition.

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## “Give the losers leave to speak”

For over a hundred years, the watermen of the Thames had enjoyed the exclusive right granted to them by Henry VIII to ferry London passengers up and down the capital's main artery.<sup>42</sup> Far from an easy job, new recruits were expected to undertake a seven year apprenticeship, learning the customs and currents of the Thames.<sup>43</sup> Fares were standardised to protect the public, and the watermen were expected to pay a quarterly fare to support their guild.

But by the beginning of the seventeenth century, the watermen were facing a new competitive threat to their ability to ‘ply for hire’: the arrival of the Hackney horse and carriage. As one waterman complained in a

pamphlet entitled *The World Run on Wheels*, “*they have undone my poor trade whereof I am a member: and though I look for no reformation yet I expect the benefit of an old proverb, ‘Give the losers leave to speak.’*”<sup>44</sup>

Trying to maintain their popularity, by 1635 the watermen had persuaded King Charles I to ban “any hired coach be used or suffered in London.”<sup>45</sup> But the new technology proved too popular with Charles’ subjects, and by 1637 he’d been forced to allow “a small competent number.”

Over the next two hundred years, this cap was gradually expanded, although fares remained fixed by an Act of Parliament. For eighteen years between 1833 and 1851, the total number of licences issued was uncapped – but then in 1851, believing that “too many of London’s

Cabbies did not have a good enough topographical knowledge of this great city”,<sup>46</sup> new licencing standards were introduced. The Knowledge was born.

Progress does not always depend on technological innovation. The arrival of the Hackney cab was less about any improvement in carriage design, and more about a few nobles wanting to make extra cash from hiring out the spare carriage they had lying around. Today, we’d call it an example of the Sharing Economy: disruptive start-ups undercutting an old monopoly.

In the long run, growth is the best way to raise living standards for everyone. But in the short and medium term, most innovations, even those coming solely from new business models, create losers. Often those losers seek to use a political process – either in government or simply within the bureaucracy of a large organisation – to halt change. The easiest way to do this is often to ban your competition.

But Britain cannot afford to stand still. Our productivity per hour remains around 20% below the G7 average.<sup>47</sup> Some of our leading industries like the North Sea Oil or the financial sector appear to be in a relative long term decline, while too many of our cities are dependent upon the public sector to prop

them up. We desperately need sustainable breakthroughs in renewable energy, cheaper healthcare and low carbon transport. While globalisation can serve as an enormous opportunity for British exporters, our current trade links with many emerging economies are weak.

How do we catalyse faster growth while ensuring the benefits go to everybody?

## The End of Invention?

**While not sufficient on its own, a thriving culture of science and technology is still necessary to drive higher productivity growth.**

For all the recent fashionable talk of stagnation in the wider economy, advances in basic science keep adding up. Over the last ten years, the cost of sequencing a genome fell by a factor of 4,000,<sup>48</sup> while installed capacity of solar photovoltaic capacity is up near forty times over.<sup>49</sup> 3D printing and UAV drones have become widespread, while ubiquitous access to personal computers, mobile broadband and GPS tracking have become old hat. In the last year, scientists have demonstrated, among other things, the reversal of ageing,<sup>50</sup> direct electronic brain-to-brain communication,<sup>51</sup> and a dishwashing robot.<sup>52</sup> We are a very long way from the end of invention.

## After the US and China, the UK has the third highest share of world research articles, around 6.4%

British science and engineering are at the forefront of many of these advances. A recent study for BIS concluded that the UK had overtaken the US to become number one amongst comparable countries in terms of ‘field-weighted citation impact’, a measure of research quality, while remaining also the most productive nation per amount spent on R&D. After the US and China, the UK has the third highest share of world research articles, around 6.4%.<sup>53</sup> The current Government has identified eight key technologies in which it believes Britain could develop world leading industries: big data and energy efficient computing; satellites and commercial applications of space; robotics; life sciences; regenerative medicine; agri-science; advanced materials and nano-technology; energy and its storage.<sup>54</sup>

Industrial strategy means different things to different people. Almost nobody, however, disagrees that there is a role for government in subsidising basic research and science; supporting research, investment, entrepreneurship and start-ups through targeted tax breaks and streamlined regulation; and providing platforms to bring together academia and business to discuss future trends and roadmaps.

While the state of British science and innovation is healthy, it is not perfect. Academia’s choice of research subjects remains largely autonomous. Under the Haldane Principle, politicians do not interfere with the allocation of funding, leaving the decision over what to research to researchers themselves. However, political autonomy should not be an excuse for a lack of accountability. Too much of publically funded research fails basic replication, with widespread evidence of confirmation bias in data selection and analysis (“p-hacking”).<sup>55</sup> Individual journals have little incentive to double-check attention catching, exciting results. Equally, while the Government is unlikely to do very well at picking winners, it could certainly do more to encourage the winners it wants through the wider spread and use of prizes.

Britain has still not fully addressed its weakness in transitioning from the lab to the market. There remains a ‘valley of death’ between science and eventual commercial application – the combined costs of capital and regulation make it much easier to start a web app or a marketing agency than build a new gadget. Britain lacks the strength of the American or Israeli Venture Capital industry, or the lenient bankruptcy law and tolerance of failure that has helped fuel Silicon Valley.

The good news is that new technology is helping to close the difference: it has never been easier to raise your seed capital through Kickstarter, use a 3D printer for your initial prototype and then outsource manufacturing through Alibaba. Nevertheless, the Government could arguably do more to help take new products to market.

For all the power of technology, it cannot automatically change the world on its own. For one thing, it is often blocked through a combination of public mistrust of the new and overzealous application of the precautionary principle: think bitcoin, GM foods, e-cigarettes or hydraulic fracking. Out-of-date regulation is used by incumbents as a barrier to block new competition. Equally importantly, technology needs to be paired with a market need, and continually refined to overcome implementation obstacles. In the entrepreneur cliché: good ideas are useless without execution.

To truly fulfil technology's potential, you need something else.

## Competition

**Competition is the most powerful tool we know to increase productivity, reduce the cost of living and tackle inequality. Too much of Britain's economy remains overly protected behind government created**

**barriers. The good news is that technology also offers the opportunity to spread competition to other sectors.**

The record of twentieth century Industrial Policy was, to put it mildly, far from an unqualified success. 1930s government encouragement for companies to merge into cartels led to inefficient firms, poor management and low productivity in the post war years. The more concentrated the industry, the more it was likely to be behind its American rivals, where competition policy remained stronger.<sup>56</sup> According to one survey, "industrial subsidies were an almost unmitigated failure". Post-war 'national champions' became international jokes (British Leyland), never achieved commercial success (Concorde) or saw efficiency fall by a third (the expansion of the machine tools company Alfred Herbert). Perhaps unsurprisingly, the main effect of creating new monopolies was to increase profits and raise prices for their customers.<sup>57</sup>

Where the old style industrial policy went wrong was not just that it tried to predict the future – but that it underestimated the importance of competition.

Competition matters for two big reasons.

The first is innovation. While there are some things you can test in a lab, there are many



## Competition, or the potential for it, is the force that ensures that the benefits of economic growth are widely spread

more that you can only work out with trial and error, rapid feedback and the incentives that markets bring. Academic experts can tell you the date of the next eclipse or the trajectory of a rocket, but they are far worse at predicting the success of a product, consumer demand or even the potential uses of a new technology. Worse still, confirmation bias and simple pride make it very hard for top-down hierarchies to change course after their underlying assumptions have been challenged. There is a reason that large, old monopolies keep getting disrupted by smaller, nimbler start-ups – the average life of a company on the S&P 500 has fallen by 70% in the last fifty years<sup>58</sup> – and this is not down to their lack of capital, long term plans or generous R&D budgets.

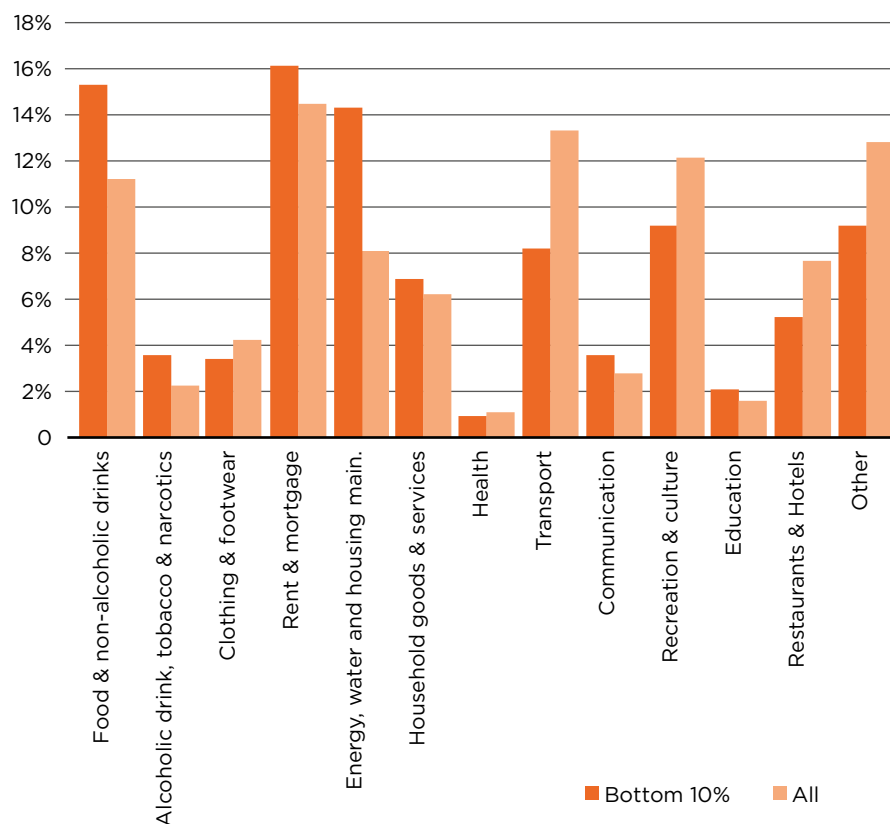
Competition keeps companies honest, encourages everyone to work hard and ruthlessly eliminates those who can't keep up. Abandoning the post-war cartels increased labour productivity by 20% in the subsequent decade.<sup>59</sup> It is estimated that 90% of the efficiency improvements in UK manufacturing between 1980 and 1992 came about from inefficient plants shutting down, which in turn was significantly influenced by external competition.<sup>60</sup>

But the second reason competition matters is just as important as the first: equality.

Competition, or the potential for it, is the force that ensures that the benefits of economic growth are widely spread. The threat of new entrants ensures that profits get bid down. No entrepreneur captures all, or for that matter, most of the value created by their innovation – one estimate put the proportion captured by innovators at 2.2%.<sup>61</sup>

Equally, competition ensures that everyone's wages rise. The technology and skills needed to be a barber have not changed significantly in hundreds of years, which is one reason why the average barber or hairdresser earns 41% of the median wage.<sup>62</sup> But equally, the potential for barbers to go find some other line of work ensures their wages keep going up. 41% of today's median wage still works out to be nearly four times the median wage of two hundred years ago.<sup>63</sup>

Arguably both the most important and successful supply side reform in the post war era came from the expansion of competition that began worldwide in the 1970s. Airline deregulation in America saw prices fall 20%, and opened the door for new, low cost operators.<sup>64</sup> Privatisation and the introduction of competition in energy and gas saw productivity rates spike, and helped electricity bills fall 25% in real terms between 1990 and 2004.<sup>65</sup>

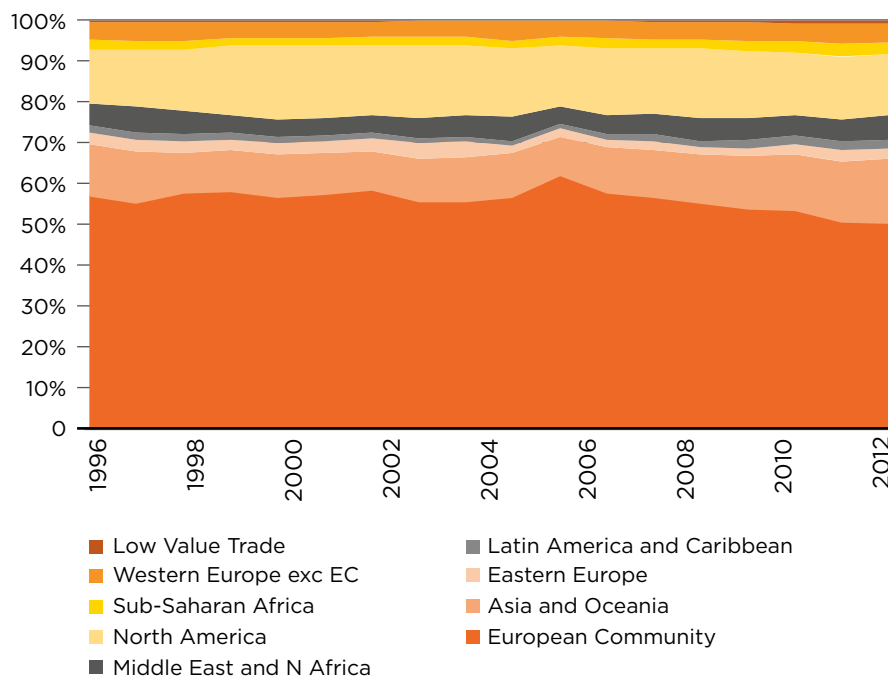


**FIGURE 6**  
Household  
expenditure  
(ONS)

While most economists now accept that the increase in product market competition was a key factor behind Britain's resurgence in the 1980s and 1990s,<sup>66</sup> it is less commonly recognised that competition is still the most powerful tool by which to increase productivity. A major reason the UK is often measured as having worse management than the US is a long tail of inefficient companies.<sup>67</sup> More effective competitive competition would drive these resources somewhere they could be better used.

If you look at the average household expenditure, their largest categories of spending are in tax, food, housing, energy and transport. These are all also areas where prices are largely under the control of government,

rather than market competition. Excluding tax, these areas make up around 34% of the average household expenditure – or just under half for the poorest decile.<sup>68</sup> There are often good reasons why governments impose regulation, even if it has the downside of limiting competition. However, new technology also has the potential to sidestep many of these old trade-offs: opening up the potential for new entrants, defeating old barriers to entry and providing replacements for inevitably clunky regulation. Crypto currencies, Apple Pay and Kickstarter are more likely to revolutionise the financial sector than more nuanced capital requirements. Peer-to-peer online reviews, persistent GPS and constant communication do more to ensure online quality and



**FIGURE 7**  
Share of British  
exports (UK  
Trade Info, RTS)

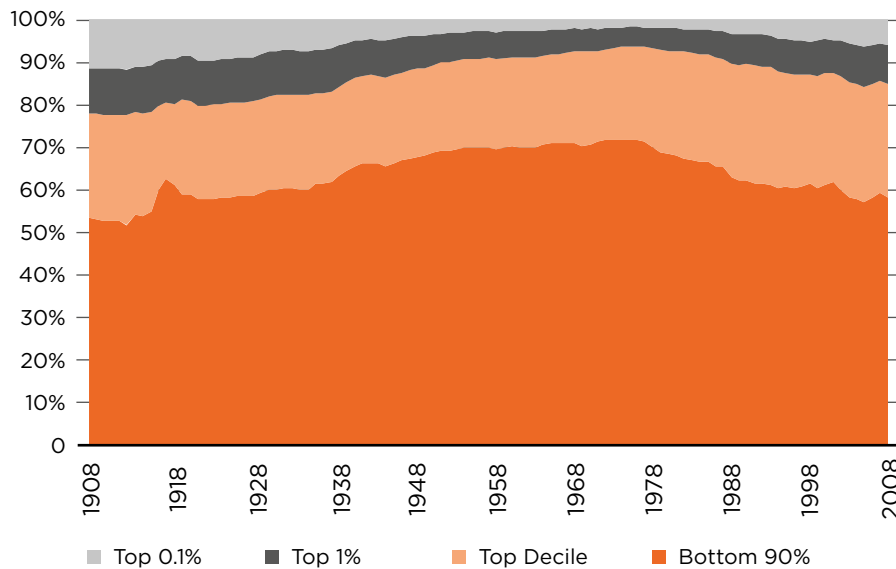
safety than regulatory standards. The rise of new technologies look set to increase competition and lower prices in finance, transport, logistics, health and more.

Perhaps the biggest overall systematic barrier to improved competition and productivity comes from our overly restrictive planning system. Planning makes it harder for new firms to enter a market and for infrastructure to expand rapidly to enable supply and for workers to go where the jobs are. Most obviously, it prevents the UK from fully capitalising on the success of Europe's most successful conglomeration in the South East. Just as important, however, is that it has almost certainly slowed growth in cities like Manchester through shortages in houses and office stock. The cost of regulation on office developments is equal to 250% of development costs in Birmingham, let alone London (400% to 800%), compared to only 0-50%

in New York.<sup>69</sup> One study found that since the 1980s, planning policies have restricted efficiency improvements in the retail sector by 25%.<sup>70</sup>

Competition doesn't have to be solely domestic. Often the most important competition comes through freer trade. The international sharing of ideas, businesses, capital, customers and workers has made us all richer. Much of the strength of economic hubs comes not from the inherent brilliance of the natives, but from acting as a crossroads and lodestar for the best and brightest from across the world.

While there has been progress in recent years, the UK's export market currently remains largely reliant on Europe – a significant reason why Britain got dragged into the fallout from the Euro crisis. The emerging markets present a huge opportunity for British firms in the future, with their collective growth



**FIGURE 8**  
Income share  
% (Piketty)

expected to outstrip that of the advanced economies.<sup>71</sup> In the first three quarters of 2014, 52% of British exports have gone to the European Community, compared to 15% for North America, or 1% for India. Over the last five years, the share of exports to China has roughly doubled from 2% in 2008 to 3.9% in 2013.<sup>72</sup>

## The 99%?

**Ensuring everyone feels they have a stake in the future is the best way to prevent new barriers to innovation from being created.**

If one group has done particularly well over the last few decades, it has been superstars. Together, technology and trade have made it easier than ever before to leverage your talents to a global audience. There has never been a better time to be a hedge fund analyst, Premiership footballer or entrepreneurial CEO. Since 1981, on economist Thomas Piketty's data, the top 1% has increased their share of

income share by eight percentage points, with half of that going to the top 0.1%.<sup>73</sup>

In fact, while the gains might not be quite as spectacular, anyone with high skills rewarded by the market has done pretty well. The share of the rest of the top 10% of incomes has increased by 2.5%.<sup>74</sup> Despite the proportion of graduates in the population more than doubling since 1992,<sup>75</sup> male possessors of undergraduate degrees are still expected to earn a 28% lifetime earnings premium over those with only A-Levels, while the female premium is 53%.<sup>76</sup> Unemployment rates for graduates are half than for those without a degree.<sup>77</sup> Jobs have become not just better paid, but often more pleasant with more flexibility and greater autonomy.

However, for those without the right skills, economic change has not been all unqualified good news. 'Routine' jobs, whether in clerical work or in industry, have increasingly become automated or outsourced. While

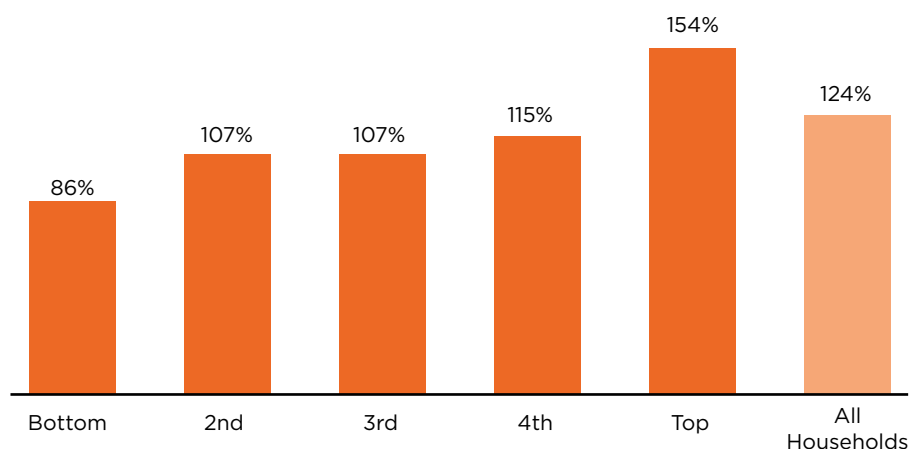


FIGURE 9

Increase in real household disposable income between 1977 and 2012-13 (ONS)

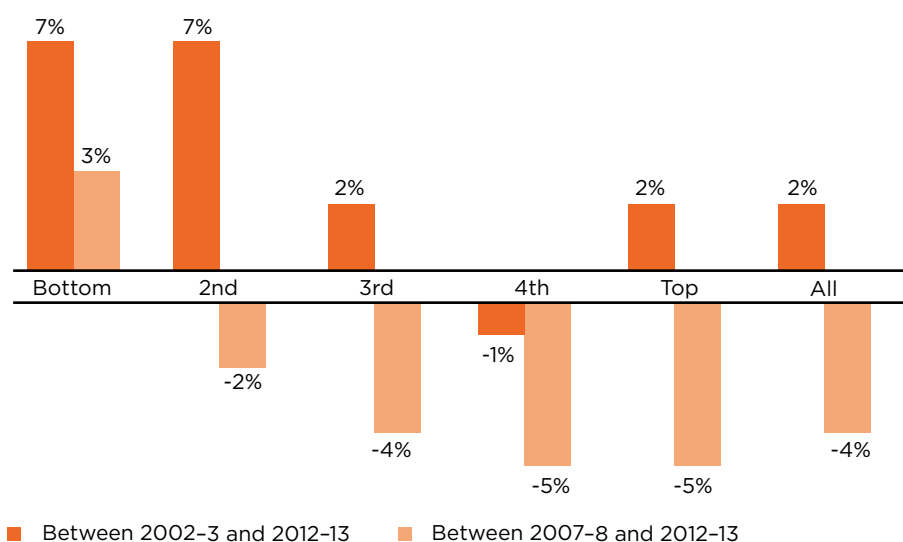


FIGURE 10

Recent changes in real household disposable income (ONS)

there is still an abundance of low skill jobs – say, bar staff, checkout operators or shelf stackers – between 1979 and 2007 the number of boring and drilling machine setters fell 94%, face-trained coal miners fell 93% and grinding machine setters and operators fell 86%.<sup>78</sup> Employment in manufacturing has been in decline since 1999, and is expected to continue to shrink by 1% a year until 2022.<sup>79</sup> That is not to say that the sector itself has been in decline. Manufacturing productivity has grown on average by 2.8% per year since 1948, but it is the labour markets of many

regions, from former industrial hubs to old seaside towns, that have yet to adjust to the structural transformations in the economy.<sup>80</sup>

All that said, the idea of ‘stagnation’ can be overstated. There is no long term decoupling between productivity improvements in the economy and average wages.<sup>81</sup> The top has benefitted most from the last few decades in terms of income, but the difference in growth between the top and bottom quintile is less than the overall improvement enjoyed by everyone. While many of the old “middle jobs”

have disappeared, they have equally been replaced by new jobs. Even if their old occupation disappears, the vast majority of people succeed in finding new work. You do not have to be a superstar to enjoy the best of today's technology (smartphone possession is already 90% for 18–24 year olds),<sup>82</sup> entertainment, medicine or education.

The most important reasons for recent wage stagnation are not long term structural flaws in the market economy, but instead short term blows: the impact of the financial crisis, the world commodity crunch and the transition to sustainable pensions. In other words, growth and improving productivity remain the best way to improve the living standards of the many.

However, the coming decades will put even greater pressure on our economy and welfare system to enable career transition for adult workers. One study estimated that 47% of US jobs were at high risk of being “automated relatively soon, perhaps over the next decade or two”.<sup>83</sup>

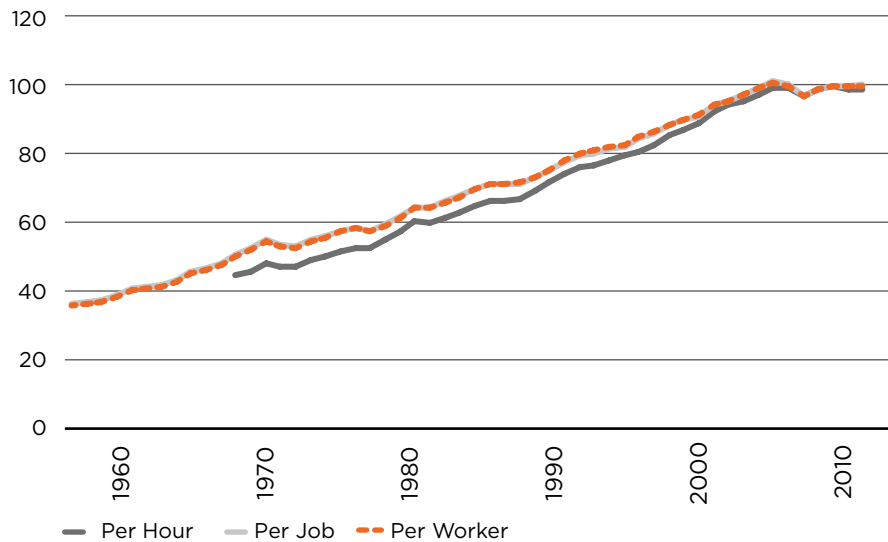
If we don't find ways of making everyone feel they have a stake in the future, we will end up with modern equivalents to the watermen – seeking to use politics to block new competition, and preserving the old careers they have become accustomed to.

## Recommendations: Creating the Most Innovative and Competitive Economy in the World

**In the words of Paul Krugman, productivity isn't everything, but in the long run it is almost everything.**

In the long run, the official economic forecasts from the OBR assume that our labour productivity will grow by 2.2% per hour – its historical average between 1971 and 2008.<sup>84</sup> The pause in productivity growth that we have seen since the financial crisis in 2008 will come to an end, and our economy will continue its upward progress. The optimistic gloss on this view is that even a once in a half century recession is unlikely to have permanently damaged our ability to improve. Growing by 2.2% a year is equivalent to doubling in just over thirty years.

The more pessimistic view is that politicians have little influence on productivity, either good or bad – but this interpretation is hard to believe. Almost every day we see the markets react as some initiative of a politician, or central bank alter the long term prospects of the economy. While remaining cautious and humble in our forecasts, we shouldn't simply accept 2.2% as a number impossible ever to better or improve. Raising this number is ulti-



**FIGURE 11**  
Labour  
productivity  
(2011 = 100, ONS)

mately the best and most sustainable way to achieve higher living standards, better public services and lower poverty. Britain remains around 25% less efficient than America<sup>85</sup> – there is still a lot of ground to catch up.

The best recipe for increased productivity is innovation, competition and trade. From Newton to Turing, Watt to Dyson, Britain has a long heritage of innovation and trade, punching above its weight on the world scene. There is no reason why this cannot continue throughout the twenty first century.

On the other hand, our economy is far from flawless. Our planning system is overly restrictive, our education has fallen behind the world's leader and our infrastructure can take decades to get renewed. Our entrepreneurs are often too risk averse, afraid of the failure that ultimately leads to start-up success, while we still do not trade enough with many of the emerging economies. We do a bad job at helping people who have lost their jobs to automation or trade to find new work.

The goal of politicians should be to unlock the barriers to innovation, trade and competition:

- **Introduce a new generation of government sponsored prizes for basic research and innovation.**

The world faces many fundamental challenges that will only be solved by new ideas: from better battery storage for renewable energy to educating the developing world or keeping ahead of antibiotic resistance. The Government's primary means of funding the future should remain subsidising education, science and research. However, top down attempts to solve specific problems often lead to the politicising of science or ineffective attempts at 'picking winners'. Prizes have a long history of generating innovation for problems that have proved difficult, if not impossible for the standard experts to solve. In the past, prizes have sparked John Harrison's chronometer, Charles Lindbergh's flight across the Atlantic, and a new,

## The biggest danger to our health, safety and the environment comes from too slow rather than too fast progress on GM crops, new drugs, or new energy supplies

accelerating private space industry. Instead of the top down process of grants, prizes are open, allowing a solution to come from any and often unexpected directions. The Government should massively expand the current Longitude Prize programme, and catalyse a new generation of prizes to tackle our biggest challenges in energy, the environment, health and education.

- **Regulatory policy should aim at enabling permissionless innovation, rather than trying to satisfy an unachievable precautionary principle.**

New technologies create new dangers. There is always a place for well-targeted regulation to increase consumer confidence, clarify standards and make fraud harder. However, the “precautionary principle” can all too often become an excuse for protecting incumbents, overly extreme risk aversion or sometimes just plain luddism. All too often, worst case scenarios get used as an excuse to block the entrance of new competitors, or create a bureaucratic chilling on a new innovation.

While preserving high standards of safety, we should aim to enable permissionless innovation, creating contained areas where innovators can experiment. The biggest danger to our

health, safety and the environment comes from too slow rather than too fast progress on GM crops, new drugs, or new energy supplies. Self-driving cars will almost certainly create new types of accidents – but they will also save thousands of lives.

- **Introduce a Presumption against Interference in the planning system, with residents rather than officials acting as quality control.**

Property is not a perfect free market: the decision to build a new housing estate or open a 24 hour club can affect others’ quality of life too. However, our seventy year strategy of trying to resolve these trade-offs through top down planning has not only failed, it has had much wider knock-on effects on our economy. Our restrictive planning system has led to smaller and more expensive houses, higher living costs, and a less dynamic economy.

Instead of trying to plan an inevitably unknowable future, we should rely on local residents rather than bureaucrats to act as the quality control. We should introduce a Presumption Against Interference that people are free to do as they will with their property except where clear justification or requirement for intervention exists. Change of Use



restrictions should be limited to clear externalities, and local plans should be drastically stripped back: no density targets, or top down regulation of minutiae like car spaces, bike standards or the number of hotel rooms. If less than half of the people in the immediate vicinity (numerically or in terms of floor space) object, planning permission should automatically be granted subject to appropriate compensation.

- **Introduce a new supply side agenda to tackle monopoly rents, increase competition and cut the cost of living.**

In the long run, by driving innovation, greater supply and higher efficiency markets drive down prices and bring about a lower cost of living for consumers. The 2000s saw a temporary reverse of this long term pattern, as the world as whole experienced a boom in commodity prices. The good news is that in many areas this is already going into reverse, with oil prices having more than halved over the last year and the savings starting to feed through to household bills.

Nevertheless, while markets often get unfairly blamed for things that are beyond their control, we could still do more to ensure greater competition and lower costs for consumers. Too many areas of the UK economy

remain dominated by cosy oligopolies and restricted supply. Network Rail, for example, could be broken into eight regional companies to increase competition and efficiency, and the rail franchising process should be reformed to start from 'zero subsidy' bids rather than tightly defined specifications. Rather than pick winners, the Government should bring forward auctions for mature renewable energy sources, and refocus resources on setting consistent carbon prices and supporting early stage sources. We should commit to building 300,000 houses a year, driving down rental costs, increasing supply and creating thousands of jobs in the construction sector.

- **Britain should aim to build on London's success as a world hub for trade, finance and talent, offering the most competitive business taxes in the G20.**

The expansion of global capitalism in the last thirty years has seen a historic reduction in poverty, but it has also created a more competitive world. Britain cannot afford to drive away high-end firms or talent with high tax rates, or to keep our trade narrowly dependent on the old Eurozone. The good news is that Britain is also uniquely positioned to benefit from the rise of the new global middle class. Just as London has become

the world city, Britain can make better use of its unique talents, geography and heritage to become one of the most open and richest countries in the world.

Building on the successful model of corporation tax, the Government should give businesses greater certainty by publishing a five-year tax roadmap at the beginning of the Parliament, aiming to offer the most competitive regime in the whole G20. In order to maintain

world links, the next Government should commit to accepting the recommendations of the Davies review of aviation capacity, and begin exploring options now for further expansion. Outside London, the Government should encourage new hubs through devolving further political, borrowing and economic powers, and increasing road and rail investment to create a new 'Northern Hub'.

# SAVINGS

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In the long run, ownership of assets is as important as wages in generating inequality. We need to create a capital-owning democracy, and make sure saving isn't only the province of the rich.

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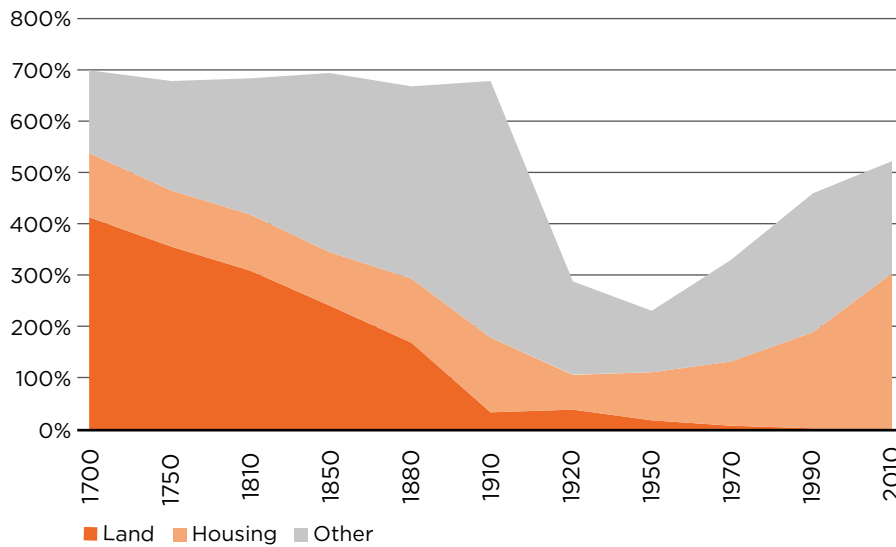
## Rise of the Robots

It was a “very important book”,<sup>86</sup> “a publishing sensation”,<sup>87</sup> “lightning-in-a-bottle”,<sup>88</sup> a “magnificent, sweeping meditation”,<sup>89</sup> a “tour de force”,<sup>90</sup> a “watershed”,<sup>91</sup> a “triumph”.<sup>92</sup>

Thomas Piketty's *Capital in the Twenty-First Century* was inarguably the economic publication sensation of 2014. At its heart was an argument that capitalism itself contained a central contradiction: “the entrepreneur inevitably tends to become a rentier, more and more dominant over those who own nothing but their labour. Once constituted, capital reproduces itself faster than output increases. The past devours the future.” In other words, those with wealth and savings would see it increase faster than they could spend it – we

were heading towards a new gilded age in which inheritance beat out entrepreneurship.

Many complaints were made about the book. The central model seemed to ignore many of what we already knew about the relationship between capital and labour income, while the choice and interpretation of data was at best questionable. Technology and globalisation have so far proven to be much more important causes of inequality than capital, while even in Piketty's worst case scenario, a growing share of growth going to capital owners could only be sustained by higher wages for workers. If you looked at Piketty's own data for Britain, the story of the twentieth century looked nothing like the aristocratic age. Returns to land had continued to fall, while returns to housing massively increased.



**FIGURE 12**  
Capital stock in  
Britain (% GDP,  
Piketty-Zucman  
2013)

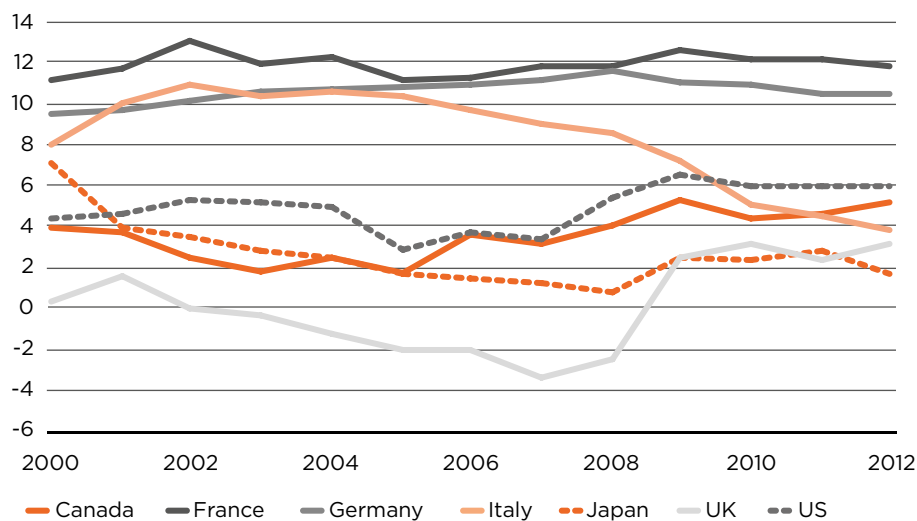
But what if Piketty was right? More than one economist has sketched out a future in which the forces of AI and automation become so powerful that they put nearly everyone out of work. If robots have taken all the jobs, only the owners of the robots benefit from future growth. Even if you don't want to take such a dramatic view, Piketty is at least right that there is no guarantee that all the gains of growth go to the workers. (This, by the way, is a good thing – it is how markets reward saving or risk taking – or, more practically, how people save for an emergency or their retirement).

Equally though, 'owners of capital' are not the same as the rich, either in theory or in practice. The central dynamic of Piketty is that interest rates tend to be positive – saving money today allows you to be richer tomorrow. The more we think Piketty is right, and that capital will disproportionately benefit in the future,

the more we should seek to create a capital-owning democracy to spread the benefits of growth. We all can be owners of a robot, so to speak.

Unfortunately, we are a long way from this rosy vision. Household savings rates have recovered a little since their trough just before the recession, but they are still a long way from the 11–12% we see today in France or Germany, let alone the levels saved by much poorer Chinese households. Making matters worse, wealth is far more unequally distributed than income. The ratio between the 90% decile and the 10% decile is ten times larger for wealth than for income.<sup>93</sup> Around 11 million people are not saving enough to achieve the recommended replacement income for retirement,<sup>94</sup> and almost a quarter of households own no private pension wealth at all.<sup>95</sup>

Why are we so bad at saving?



**FIGURE 13**  
Net household savings (% of household disposable income, OECD)

## It's Complicated

**There are many reasons why Britons save so little, including short termism, our welfare system, global imbalances and our broken housing market.**

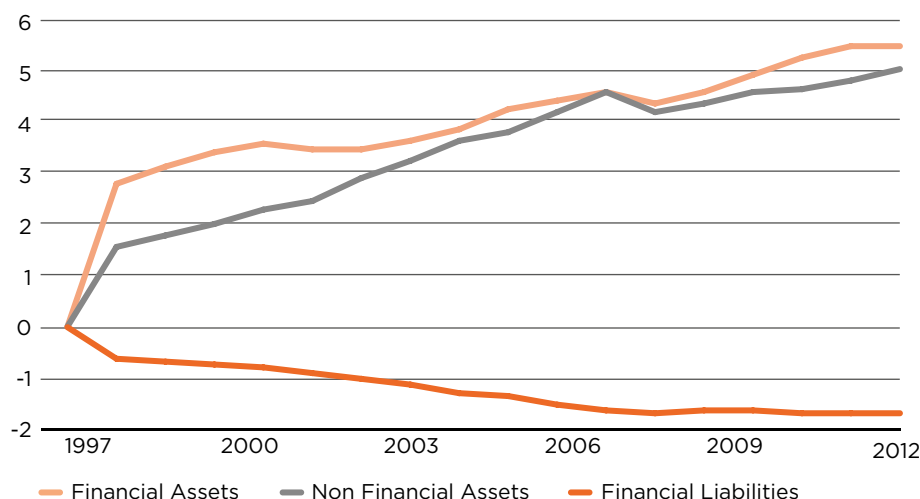
It is not difficult to think of possible explanations, but much harder to judge their relative weight.

The ageing population has made generous pension schemes unaffordable, with Defined Benefit schemes now a distinct minority in the private sector.<sup>96</sup> A liberalised financial system has made it ever easier to borrow. Over the very long term, the tax system has continually punished income and savings, while the welfare system encouraged an expectation that the state will look after us in our old age. Human instincts aggressively discount the future, calibrated to an age of much lower life expectancy, while equally there also seem to be long lasting cultural differences in attitudes

to saving and thrift. As we grow wealthier, the attraction of saving for yet more wealth naturally shrinks – the triple lock, after all, guarantees that a pensioner with no savings will still always see their earnings grow with whichever is higher: inflation, earnings or 2.5%.

Whatever the long term reasons for low saving, the problem grew distinctly worse in both Britain and the US at around the turn of the millennium.

Ironically, the chief cause of low savings rates in parts of the West were high savings rates abroad. The increase in savings in Asia after the 1997 Asian Financial Crisis led to, in Bernanke's phrase, a "global savings glut", driving down interest rates worldwide. If this extra funding had gone into productive investments like roads or railways, this would have not mattered much. Instead, much of it was funnelled by the financial system into flat screen TVs and a housing bubble.



**FIGURE 14**  
Household wealth  
(£m, ONS)

The increase in borrowing showed up as a fall in the household savings rate – but from the perspective of the time, this did not look so unreasonable. After all, net household wealth was still growing strongly: an average of 7% in the five years running up to the financial crisis.<sup>97</sup> While the ratio between assets and liabilities did fall, households as a whole were a very long way from being in debt. It was only when much of this wealth was shown to be illusory that the problems began.

Why did the financial system fail so badly?

One reason was flaws in the banking system itself. The combination of poor regulation, weak corporate governance, misaligned pay incentives and ultimately the Too Big to Fail implicit backstop from the taxpayer all encouraged the banks to take on too much risk.

But another was the difficulty in finding enough low risk opportunities to invest in the real economy. Slowing economic growth, some argue, has led to fewer investment opportunities, forcing financial institutions

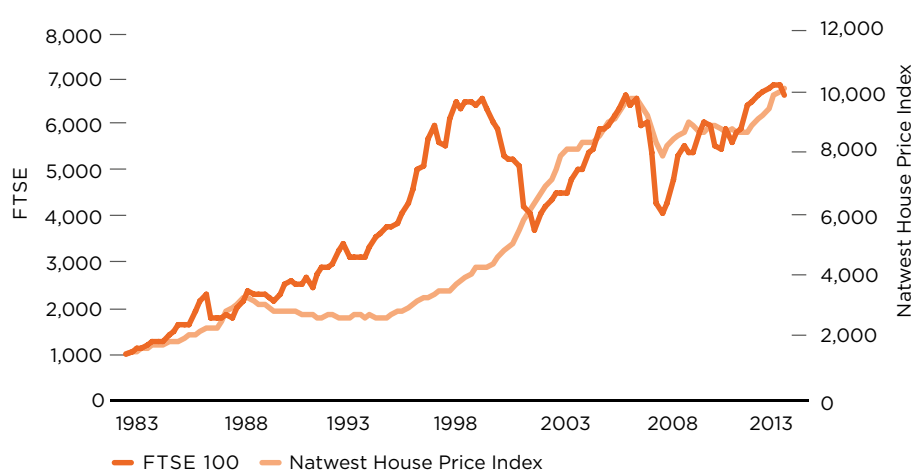
desperate for yield to take more and more risk, inevitably blowing up bubbles.

Another more mundane explanation is simply the difficulty of building in Britain. Nowhere was this more true than in the housing market. Between the beginning of 2000 and the end of 2007, the average house price increased by 137%,<sup>98</sup> compared to an 18% increase in CPI or 39% increase in total average weekly earnings. Is it any surprise that so many people chose to save through their house rather than their bank account?

## Bricks and Mortar

**Britons' reliance on their house to save for the future is a bad idea – even if house prices continue to go up, in practice, equity tends to get trapped.**

If this massive increase in prices had led to a surge of house building, that would have been one thing. But while starts of private dwellings did increase – by around 20% between 2000–1 and 2006–7<sup>99</sup> – this was nowhere near



**FIGURE 15**  
Comparative  
returns of stocks  
and houses

enough to tackle escalating prices. Extended back over the last fifty years, house prices have increased by a factor of around 100,<sup>100</sup> compared to a sixty-fold increase in earnings<sup>101</sup> and 25-fold increase in inflation.<sup>102</sup>

Besides making it harder for first time buyers and leading to low quality housing for everyone else, this is massively unfair, randomly redistributing income from poor to rich and from young to old.

In theory, your house can act as your primary savings vehicle. A mortgage has the virtue of being the ultimate nudge, forcing you to put some money aside every month. Over the last thirty years, the proportional increases in the average house price have been roughly equivalent to the increase in the FTSE 100.

In practice, using your house as your main savings vehicle is incredibly illiquid, undiversified and with absolutely no guarantee that overall prices will continue to go up. Investing in an Index Fund gives you a share of the overall economy's future growth and pros-

perity. Investing in housing is a bet against planning reform ever gaining traction.

Even worse, given stigma, social habits and inadequate financial vehicles, housing today is often a one way hole for savings. Net property wealth is the largest component of overall household wealth for the bottom 80% of households, and significantly larger than private pensions for the bottom 70%.<sup>103</sup> In theory, using this capital could make a significant difference to pensioner incomes, but at present equity release remains a niche product, used by under 2% of households.<sup>104</sup>

The ultimate cause of house price hyperinflation is a lack of housing supply, which in turn is the result of restrictive planning law. However, the costs of bad planning law to the British economy and saving go far beyond housing. When you look at intangible investments in things like research, training, design or branding, Britain is actually a world leader.<sup>105</sup> It is only when it comes to building physical things that require land and the complex weighing up of wider and local interests that

Britain falls behind. Between 2000 and 2009, Britain opened only 46 new miles of motorway compared to 850 in France.<sup>106</sup> The last full-length runway was built in the South East in 1946,<sup>107</sup> while Heathrow is already full and Gatwick is the busiest single runway airport in the world.<sup>108</sup> Failure to replace old energy supply has the predicted margins of capacity over demand potentially falling to just 2% next year, significantly raising the chance of industrial users being asked to cut down on their power usage.<sup>109</sup>

## Recommendations: Creating a Capital-Owning Democracy

**We need many different types of savings for retirement, insurance and wealth. A one-size-fits-all policy will not be enough.**

For the last thirty-five years, interest rates across the world have fallen. Much of this is the result of the decline in inflation from the high of the 1970s, but even after you strip this away, there has been a definite decline in real interest rates since at least the turn of the millennium. Long-term bond yields suggest that markets barely, if at all, expect interest rates to make a return to previous levels for decades to come. Economists such as Larry Summers or Paul Krugman argue that we may

have entered an era of ‘secular stagnation’ with permanently low interest rates.

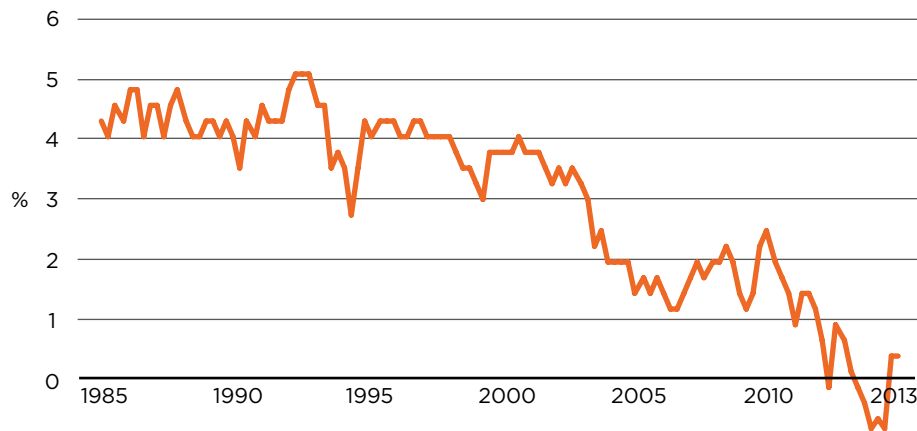
Why has this been happening?

There are many possible suspects, from changing demographics in the western world to a lower risk premium as investors grow used to a world of low inflation. Some worry that growth itself is slowing, or that a lack of investment opportunities in the western world gives nowhere for savings to go without inflating a financial bubble.

On the other hand, it is also possible that what we have seen is a short-term phenomenon – one more relic of the one-two punch of the world commodities crunch followed by the financial crisis. As the world economy and demand recover, interest rates could start rising again. Sustained negative real interest rates create many implausible predictions which are hard to swallow in a world of positive growth. The decline in real interest rates began roughly at the same point as China massively expanded its own savings in 2000 in the wake of the earlier Asian financial crisis, but at some point China is likely to have to rebalance its own economy away from saving and investment and towards greater consumption.

Whatever happens to our future economy,





**FIGURE 16**  
Weighted real world interest rate (Mervyn King and David Low)

for ordinary households, more saving will almost certainly be a good idea. Perhaps Piketty will be right, and returns in the future economy will increasingly go to the owners of capital rather than wages. Or maybe the world really has entered a period of secular stagnation, where negative real interest rates will eat away at capital and we'll all need to save more to achieve a desired retirement income. In either extreme, we'll need to save more – alternatively to take advantage of the benefits or to compensate for expected lower returns. Whether for a comfortable retirement, to protect us from risk, to fund investment in the economy or just to get rich, more saving rarely hurts.

Widening the ownership of capital is one of the best ways to spread the benefits from growth. In the long run, the impact of inequality in incomes is dwarfed by the impact of inequality in saving and returns. Of course, it is easier to save more when your income is higher in the first place – but equally important are culture and habits. You should not have to be rich to want to invest in a stock market index fund.

Recent policy moves under successive governments have helped. The introduction of the universal state pension, auto-enrolment into state pension schemes and the 2014 Budget liberalisations have helped make it easier and more attractive to save. If we are truly to overcome current low savings rates, however, still more will have to be done – and especially to help the lowest paid get into the habit of saving.

The government should encourage a capital-owning democracy by:

- **Introducing a Bonus ISA to give people more flexibility to build up their tax-free savings pots during the course of a lifetime.**

ISAs have proved to be extremely popular since their introduction in 1999. However, the current ISA regime fails to recognise that income patterns and the ability to save is not consistent over a lifetime. People who experience a one-off financial windfall such as an inheritance, house sale or redundancy payment would benefit from being able to save a much greater amount into a tax-free account within a single year.

## Re-privatising the banks offers a once in a generation chance to spread ownership and better align the interests of the public with the financial system

The Bonus ISA would be offered to anybody who is unable to use their full annual tax-free savings allowance (currently set at £15,000). People would be given the power to roll over any unused portions of their existing ISA allowances into their Bonus ISA account. There would be a cap – initially £10,000 – on the total amount that customers could roll over into their Bonus ISA, allowing the Exchequer to control the cost of introducing the new scheme.

- **Introducing a new generation of private sector Premium Bonds.**

In the long run, higher savings are one of the best ways to share out the benefits of growth – but today savings and wealth are even more unequally distributed than income. Behavioural nudges that rely on defaults and opt outs appear to be less powerful for low income households, and few at the bottom are close to using their full ISA allowance. Prize Linked Savings accounts offer the chance to randomly win a set cash prize alongside, or in some cases instead of, a fixed interest rate. These have been shown repeatedly to increase the rate of saving – in one study, for example, total savings went up by 12% – including among those with low levels of income, and already have an extensive track record in Britain.

Originally introduced by Harold Macmillan, Premium Bonds remain Britain's most popular savings product. The Government should encourage a new generation of Premium Bonds, allowing private organisations to experiment with different behavioural nudges, lottery-like mechanisms and trade-offs between set interest rates and prizes.

- **Allow taxpayers to buy a no risk stake in RBS and Lloyds.**

Six years after the financial crisis, the government still owns substantial holdings of RBS and Lloyds. Understandably, the Government wants to maximise its return from selling the banks back into fully private ownership, but the longer the banks remain in public hands, the greater the danger of political interference.

Re-privatising the banks offers a once in a generation chance to spread ownership and better align the interests of the public with the financial system. Anyone who has an NI number and is on the electoral register should be given the opportunity to apply for shares at no initial cost, but only to pay at the time of sale. The Government would retain the option of recalling the shares in the highly unlikely event that they don't exceed the floor price after ten years, but the new shareholders would enjoy any upside.

- **End the opt-out for auto-enrolment in private sector pensions and gradually increase the contribution rate to 12%.**

Once fully phased in in October 2018, nearly every full-time employee will be automatically enrolled in an 8% occupational pension unless they explicitly choose to opt out. So far, automatic enrolment has been a significant success, with around 5 million workers enrolled and just 10% choosing to opt out. However even when the system is fully in place, it will not guarantee that workers save an adequate amount for their retirement.

Under the current 8% rate, a worker earning £27,000 in a forty-year career would only save around 55% of what they need to generate the DWP's recommended target replacement income. In order to achieve this level, the contribution level would need to be gradually raised to at least 12%. However, raising the rate this high runs the risk of increasing the level of opt-out, and so there is a good case for making saving compulsory, as under the highly successful Australian model.

- **Create a new system of personal 'MyFund' welfare accounts funded out of National Insurance payments.**

Contributory Jobseekers Allowance should be replaced by a new system of individual accounts, with a 2% reduction in the main National Insurance rate to offset the impact on workers. This would allow individuals to build up a specific 'pot' which belongs to them and represents their contribution into the system.

Individuals could add up to an extra £100 a week to their personal 'MyFund' account, which would fund the first three months of unemployment. In addition, the fund could be drawn on through the working life to support career transition and retraining, while any remaining balance would be added to the pension on retirement.

# GOVERNMENT

## A Disagreeable Task

**Taxes are the largest bill most households pay. Passing on the benefits of stable public finances and higher government productivity is the best way to tackle low pay.**

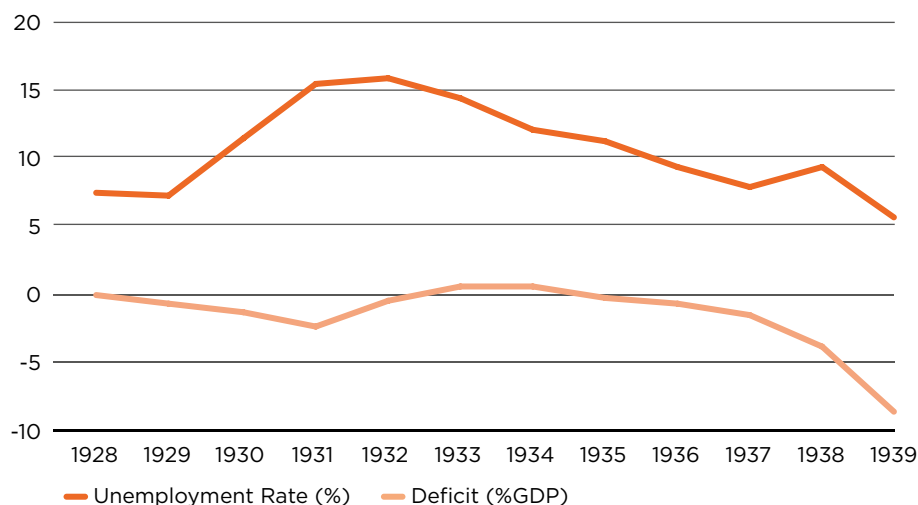
On the 10th of September 1931 Philip Snowden stood to give his first Budget as the Chancellor of the Exchequer for the new National Government coalition: “I rise to discharge,” he said, in his opening words, “one of the most disagreeable tasks that has ever fallen to my lot”.<sup>110</sup> It was a Budget that was to go down in history.

The world depression had seen unemployment double over the last two years to a near terrifying 15%,<sup>111</sup> while financial markets continued to put pressure on Sterling. Earlier that year, an independent committee had suggested that austerity measures worth around £120 million were needed to bring the budget back to balance – and the latest budget forecasts suggested the deficit could now exceed £170 million. Snowden did not shirk from the task: income taxes were raised by the modern equivalent of 2.5p, while public

sector pay and unemployment benefits were immediately cut by 10%.<sup>112</sup>

In the interpretation that was to go down in popular history, the 1931 budget was a colossal mistake. The insistence of the 1930s governments on balanced budgets prolonged the recession, stoking up unemployment and taking demand out of the economy. It was too far, too fast. The day was only saved with the arrival of John Maynard Keynes and Roosevelt’s New Deal. The simple lesson: never try to reduce the deficit in a recession. As Keynes warned in the budget’s wake, “its direct effect on employment must be disastrous. It is safe to predict that it will increase the volume of unemployment by more than the 10 per cent by which the dole is to be cut”.<sup>113</sup>

But the actual reality is much more complicated than that. It is perhaps true that Snowden did not need to return the budget to balance so quickly, and could have spread out the pain differently – but the actual knock on effects on the wider economy were minimal. What mattered for recovering from the Great Depression was not the degree of



**FIGURE 17**  
Unemployment  
in the 1930s  
(Bank of  
England)

austerity pursued by the Government, but the speed that it came off the Gold Standard. The intense argument over fiscal policy was largely a distraction.

Keynes was wrong. Unemployment did not increase 10%. It actually went up half a percentage point in a year – compared to over three the year before – and then from 1932 dropped like a stone. Britain’s coming off the Gold Standard, the devaluation of Sterling and cuts to interest rates were what made the difference.

Over the last seven years, we have once again seen an argument about how best to close the hole emerging in the public finances after a major financial crisis. If anything, the scale of the challenge faced by Britain was far bigger than Snowden: his £170 mn deficit was still only equal to 4% of the day’s GDP, compared to today’s 10%. While Snowden led the road to a surplus in two years, Britain today will be lucky to do the same in ten. Two years after the 1931 budget, growth in the UK roared back

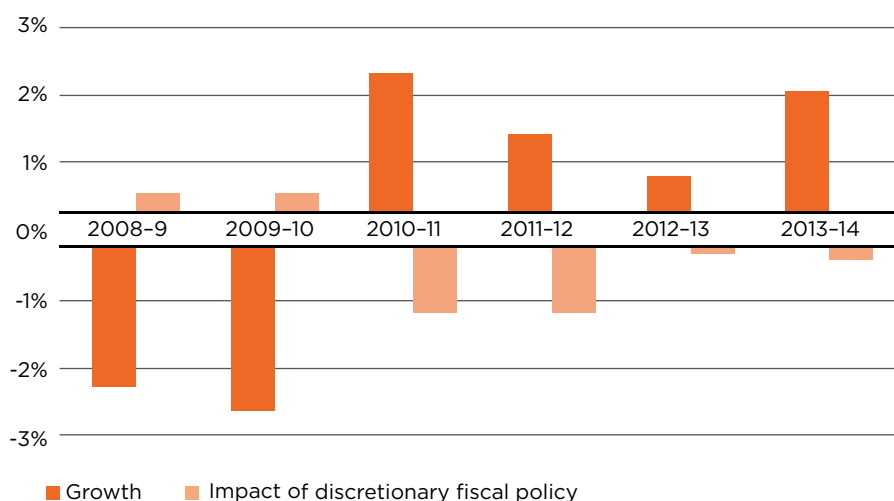
to over 3%, and then 6% the year after. Two years after the start of consolidation today, growth was just 0.7%.

Was this time truly different? Did we finally go too far, too fast?

## Too Far, Too Fast?

**The balance of the evidence suggests that the Eurozone crisis and world inflation were far more important causes of the 2012 slowdown than fiscal consolidation. We should continue to rely on monetary policy to manage demand.**

Away from all the sound and fury of the political debate, the real question at the heart of the debate over the speed of spending cuts came down to how much you believed monetary policy could limit any economic fallout from cutting the deficit. Some, such as was implicit in Ed Balls’ position, believed that we were in a ‘liquidity trap’, with the Bank of England no longer able to steer the macroeco-



**FIGURE 18**  
Modelled impact  
of austerity on  
growth (OBR)

nommy. With interest rates close to zero, it was as if we never left the 1930s Gold Standard—the situation Keynes feared when he argued government should expand its borrowing to stimulate the economy. Others argued that there was no actual evidence that the Bank of England had lost its ability to manage the economy.

So, which was it? Did monetary policy offset the roughly £100bn consolidation undertaken by the Coalition over the course of the Parliament, or did it prove to be ‘too far, too fast’?

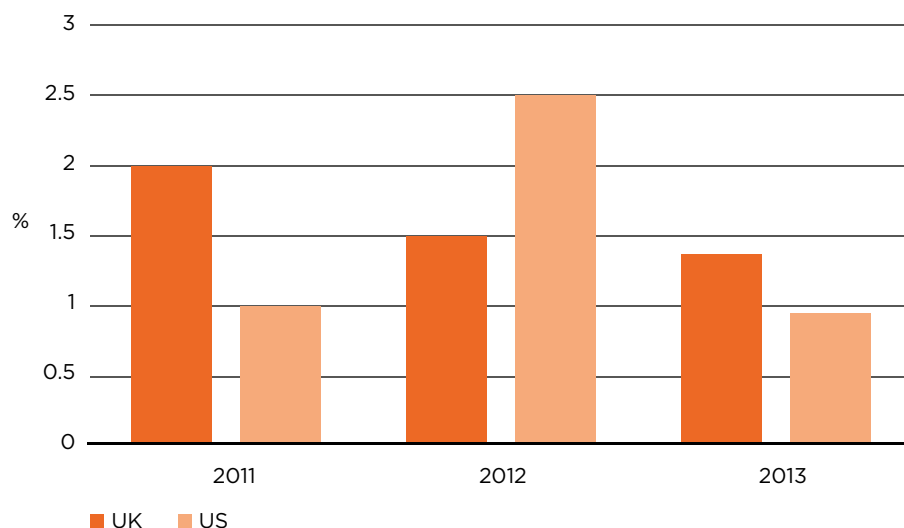
As with any issue involving the economy as a whole, there is no way to perform a definitive test that will persuade everyone.

However, it is difficult to square the idea of western central bank powerlessness with many other lines of evidence: the continual strength in the employment rate and falls in unemployment; the repeated papers demonstrating the impact of Quantitative Easing;<sup>114</sup> the repeated market reactions to central bank announcements;<sup>115</sup> the power

of Mario Draghi’s promise to “do whatever it takes”, single-handedly turning around the Euro crisis; the failure of the much hyped ‘fiscal cliff’ in the US to actually hit growth, suggesting the Fed was still in overall control of the economy;<sup>116</sup>

So, what does explain the unexpected ‘pause’ in growth between 2011 and 2013?

According to the latest OBR Forecast Evaluation Report, the most plausible explanation for the economy not hitting expectations is that, “In 2011, high commodity prices ate into disposable incomes and the euro area crisis damaged credit and confidence. In 2012, the euro area crisis intensified again. In 2013, credit conditions eased and confidence rebounded as the European Central Bank reduced tail risks in the euro area and the Bank of England’s Funding for Lending Scheme reduced bank funding costs in the UK... An easing in the pace of fiscal consolidation – and the lagged effects of prior years consolidation – also reduced the drag on growth from fiscal policy in 2013. But that



**FIGURE 19**  
Planned UK and US consolidation compared (change in Cyclically Adjusted Primary Balance as % potential GDP, IMF Fiscal Monitor, November 2010)

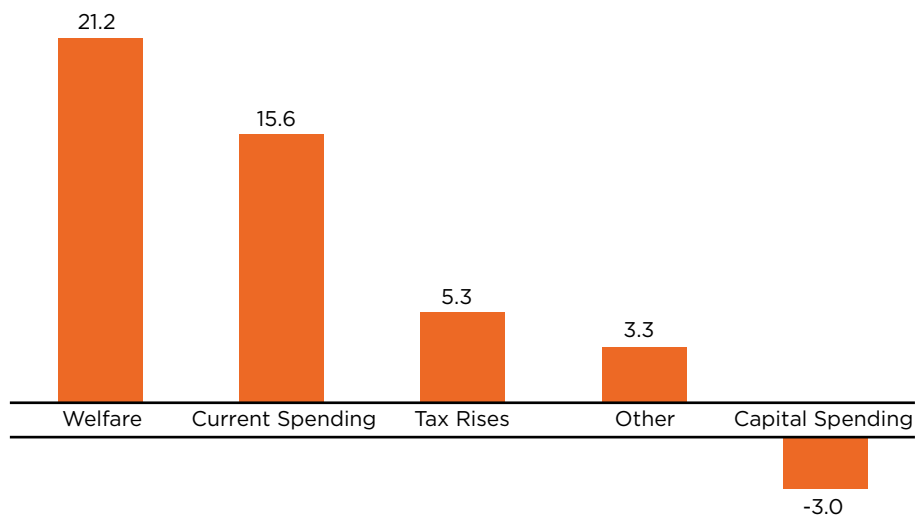
looks to have secondary importance relative to confidence and credit channels.”<sup>117</sup>

If you use the OBR’s assumed multipliers for fiscal policy (the impact of a change in Government spending on the level of GDP), the implied effect on growth in 2012–13 is just 0.1 percentage points. It is of course possible that the OBR is wrong in its estimate of the multipliers. Widespread disagreement exists amongst economists about their scale, timing and even existence, which decades of empirical research have been unable to solve. Nevertheless, as the OBR notes, if multipliers were much larger than they assumed, it is strange that growth in 2010–11 was not disappointing – when in reality, it exceeded their expectations. With enough assumptions, it is possible to make the Keynesian narrative work (that the size of the fiscal consolidation acted as a big drag on economic growth), but it is not the obvious story that jumps out of the data.

As the OBR state, the Euro explanation does a much better job than fiscal consolidation

in explaining the timing of the differing paths of the US and UK. The most significant divergence for the two came in 2012, where US growth was 2.3% and UK 0.7%. If you compare their plans from the perspective of late 2010, the US actually had significantly more consolidation pencilled in than the UK.<sup>118</sup> The UK has not significantly altered its discretionary fiscal consolidation plans since this point – subsequent Budgets and Autumn Statements have been largely fiscally neutral over this time period.

In short, the balance of evidence suggests that at least on this matter, the pre-crisis consensus was right: we can leave the job of managing demand and the business cycle to the central bank and monetary policy. Within reasonable limits, we don’t have to worry that cutting the deficit too fast will hurt the wider growth of the economy. Governments are free to focus solely on the classical questions of public finance: how much should they spend, and how should they pay for it?



**FIGURE 20**  
Savings introduced under the Coalition (£ bn, OBR)

## Half Way There

**Considerable savings will continue to need to be found in the upcoming Parliament. However, while difficult, the task is far from impossible.**

By the time of the next election, the OBR predicts that the deficit will be 4% of GDP or £76bn, down from 10% and £153bn at its peak in 2009–10.<sup>119</sup>

Some of this has been achieved by growth naturally boosting tax revenues – in cash terms, public spending has actually increased 10% over the period – but the vast majority has come from deliberate policy action.

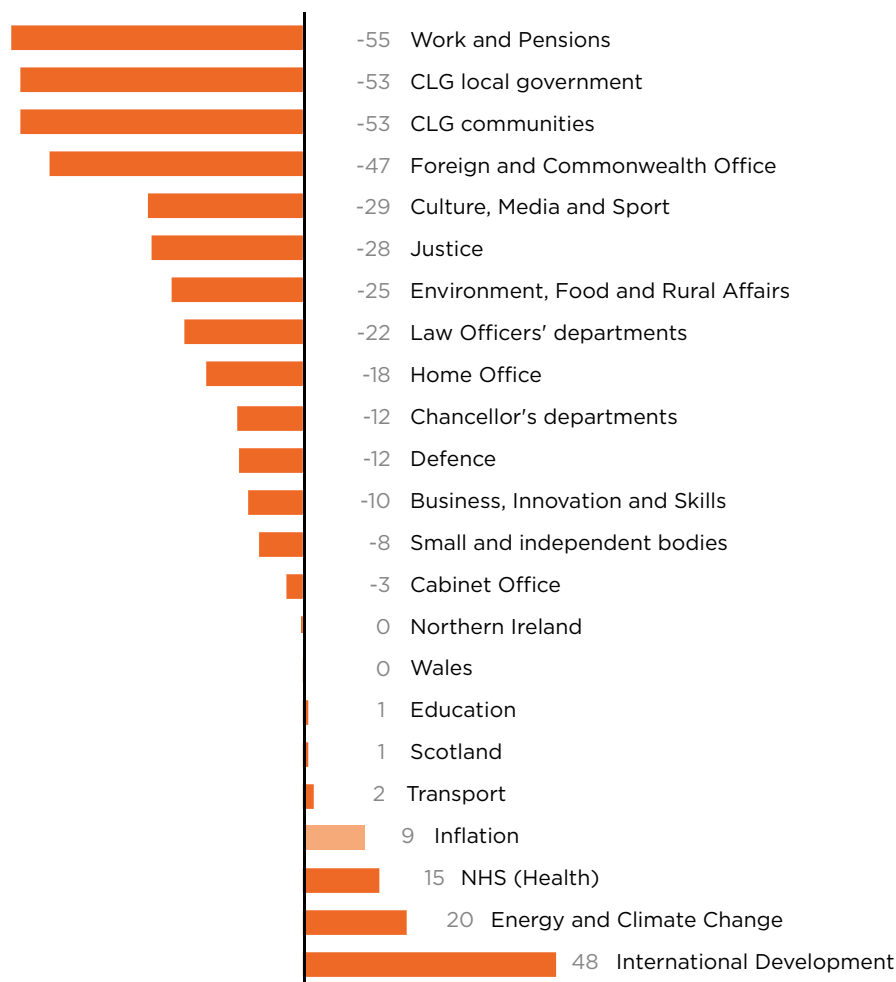
Since 2009–10, the Coalition has introduced £43bn in additional fiscal consolidation measures, with around half of these savings coming from welfare and the majority of the rest from current spending. However, these savings came on top of the savings already announced by Labour. (In total, the Coalition's

measures increased the amount of consolidation between 2009–10 and 2015–16 by 38%, or 1.8% of GDP).<sup>120</sup>

Adding together Labour and the Coalition's spending choices, total departmental spending has been cut by £67.2bn.<sup>121</sup> Around £18bn of these cuts have come from capital spending, although much of this was simply the natural rundown of the short term stimulus introduced by Alistair Darling in response to the crisis.

The largest savings from Departmental spending came from CLG Local Government (£15.6 bn), CLG Communities (£8.5 bn), Work and Pensions (£7.3 bn) and Defence (£3.8 bn). Proportionally, however, the Foreign Office; Culture, Media and Sport; Justice; Environment, Food and Rural Affairs; Law Officers Department and the Home Office were also big losers. Meanwhile both Health (£16.7 bn) and International Development (£4.4 bn) saw big increases.<sup>122</sup>



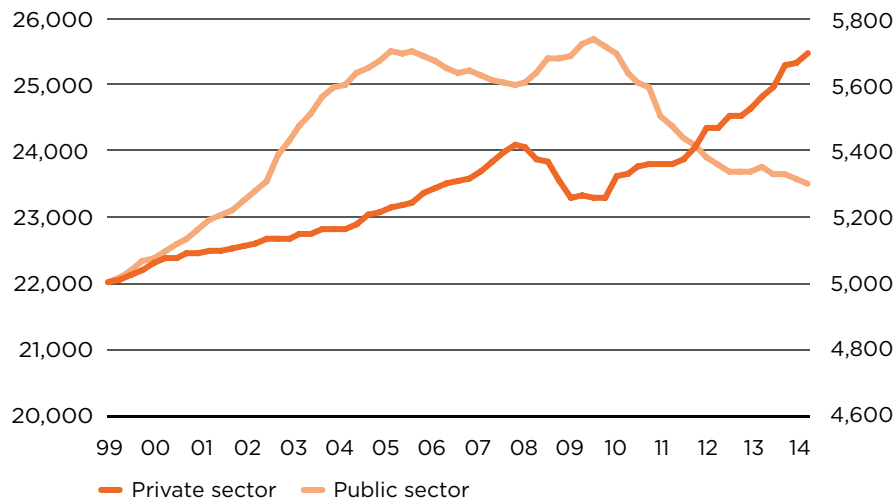


**FIGURE 21**  
% change to department budgets between 2010-11 and 2015-16 (PESA)

In the welfare budget, the biggest changes have come from changing the way benefits are indexed to inflation. The five biggest savings over the Parliament have been: switching from RPI to CPI indexation for benefits, tax credits and public services pensions (£4.5 bn); removing child benefit from higher rate taxpayers (£2.7 bn); reducing time limits for some Employment and Support Allowance claimants (£1.6 bn); capping working age benefits and tax credits to 1% for three years from 2013-14 (£1.4 bn); reforming

the Disability Living Allowance reform gateway (£1.1 bn).<sup>123</sup>

Another way to look at these changes is through the net effect on the public sector workforce. Over the last five years, the public sector has shed around 430,000 workers, or around two thirds of the workers it has gained since 1999. On the other hand, there has been little to no sign of the closing of the gap between public and private sector annual median earnings.<sup>124</sup>



**FIGURE 22**  
Public and private sector employment (ONS, excluding effects of major reclassifications)

Whoever wins the next election, the hard choices will continue. The structural deficit remains uncomfortably high (3.6% of GDP in 2015-16), while at around 80% of GDP, public debt is higher than is probably optimal in the long term.<sup>125</sup> All three parties have committed to start paying down debt in the next Parliament, implying that without significant tax rises there will be little room for the continual real increases in spending the public sector has become used to.

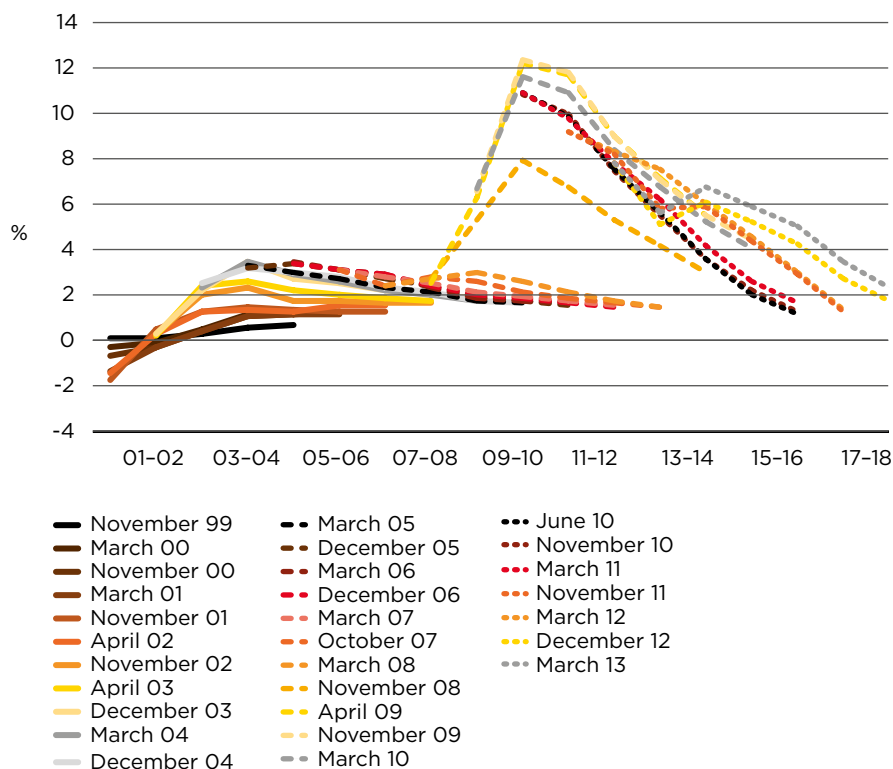
However, the scale of the choices is significantly different for the Conservatives, Labour and the Liberal Democrats. In order to achieve a current surplus by 2019-20, Labour needs to find in the order of just £5bn in savings from either spending cuts or tax rises, while the Liberal Democrats need around £7.5bn.

By contrast, the Conservatives have committed to achieving an absolute surplus, and on top of this £7.2bn in tax cuts by 2019-20. This requires them to find around an additional £33bn in savings.<sup>126</sup>

This is challenging, but not impossible. The Conservatives have already pledged to find around £12 bn in further savings from welfare, while in this Parliament, the Cabinet Office's Efficiency and Reform Group managed to find £25 bn in efficiency savings out of just the third of public spending under central control.

However, balancing the budget is only the beginning. Balancing the budget in one year is not very helpful if subsequent recessions send it straight back into the red.

Nobody believes any more that we have succeeded in abolishing boom and bust. As the failures of the public sector finance forecasts from 2008 and 2010 demonstrated vividly, we are not very good at predicting the future. This is not a new disease. Official forecasts have persistently optimistically predicted that the budget deficit will start to fall in a few years, ignoring the fact that it has persistently disappointed in the years beforehand. One recent study found that UK official forecasts for the deficit are positively biased



**FIGURE 23**  
Official forecasts  
of the deficit  
(PSNB, % GDP,  
OBR)

by around 3% of GDP, roughly equal to the average deficit.<sup>127</sup>

The OBR has helped improve the transparency of public finance forecasts, but it neither has magic powers to forecast the future nor the ability to truly constrain governments. When the public forecasts deteriorated in 2011, putting adherence with the Government's second fiscal rule to cut debt in doubt, it simply chose to ignore the rule. Whether or not you think this was economically a right decision, it is hardly a great advertisement for the current system.

Overall, the current framework remains far too exclusively forward looking. Plans are based on forecasts, but when those forecasts prove wrong there is little mechanism to change the plans. The slate is wiped clean every year, giving little incentive to struggle to meet a rule. Policy costings and evaluations are often based on assumptions that are impossible to empirically test – but then rarely updated after a few years of evidence has congregated.

In the long run, however, the biggest problem with public sector spending is not missing a fiscal rule or inaccurate forecasts – it is value for money.

## Why We Reform

**The fiscal consolidation programme has revealed many efficiencies that Departments didn't know they could find. Even once the budget is balanced, we can't go back to the old way of continual spending increases alongside little accountability.**

The public sector is the largest bill for almost all households. For the average household, even after you've included payments from benefits, paying taxes makes up 34% of their gross income, while for the bottom decile it is near half, or 47%.<sup>128</sup> Delivering a smaller state isn't just some libertarian mantra – it is about freeing up money to reduce the cost of living, either through tax cuts or higher benefits.

Instead of stagnating, imagine as a thought experiment, if between 1997 and 2010 Department Spending had matched the productivity improvements that were seen in the market sector of the economy of 31%,<sup>129</sup> that would have seen total departmental spending (DEL) lower by around £120 bn in 2010, enough to roughly alternatively:

- Close the structural deficit (£122 bn).<sup>130</sup>
- Abolish PAYE income tax (£130 bn) or NICs (£98 bn) or VAT (£99.6 bn).<sup>131</sup>
- Triple the level of benefits paid to children and working age people (£49.7 bn).<sup>132</sup>

There are many reasons why, in practice, it is hard for the public sector to match private sector productivity. However equally, there is no reason why public sector productivity needs to be zero. Even when the deficit is closed, the public services cannot go back to a lazy model where new money is added with little transparency or guarantee of improvement.

In order to create innovation in the state, we need the same combination that has delivered prosperity in the private sector: markets and technology. The good news is that new and upcoming technologies offer many opportunities to fundamentally reshape the way public services are delivered. This is already happening. The movement of many of the transactions between citizens and government from face to face or paper to online is expected to save £1.7 bn a year from 2016.<sup>133</sup> Hospitals and residential homes in Airedale are using video chat to keep in contact with patients – whether they are at home, in a hospital or in residential care, at the press of a red button they can be talking to a consultant or nurse. The new Government Digital Service – GDS – has replaced the failed top-down “waterfall” method of commissioning IT projects with all its attendant cost and schedule overruns with a more agile approach. Rather than try to guess the unknowable ahead of time, iterative design allows us to evolve the policy and

In a world of MOOCs, flipped classrooms, personalised genetics, tricorders, PatientsLikeMe and so on, our public services are unlikely to look the same in fifty years

IT systems as our knowledge comes better into focus. Replacing the old model of big IT and big fixed contracts is expected to save £4 bn a year by 2019–20.<sup>134</sup>

In the future, new technologies will make it easier to scale up the expertise of star lecturers or doctors; passively monitor and check billions of data points for correlations; offer intense personalisation and instant feedback. In a world of MOOCs, flipped classrooms, personalised genetics, tricorders, PatientsLikeMe and so on, our public services are unlikely to look the same in fifty years.

Reform of public services is a process, not a goal. It does not just save money, but offers better services. The 2011 Open Public Services White Paper set out the principles that citizens should be given as much individual choice and control as possible, with public services themselves open to a range of competing providers. In education, the Academies programme has been massively expanded, and Free Schools introduced, while the 2012 Health and Social Care Act devolved funding to clinical commissioning groups, and allowed patients to choose from ‘any qualified provider’.

The next stage of this process should be to improve transparency over the performance of public services, while legally guaranteeing

rights to choice and ‘purchaser-provider’ splits wherever practical.

The most pressing area of reform, however, is public sector pay. Even after you control for higher levels of education, public sector pay remains 5% higher than that in the private sector – or 17% if you include pensions.<sup>135</sup> On its own, this is unfair and expensive, but it also masks deeper problems with national pay bargaining. One-size-fits-all systems make it harder to link pay and performance; overly politicise sensitive decisions, and offers little differentiation for differing living costs across the country.

## Recommendations: Delivering Value For Money Government

**Reform of the public sector is the only way to deliver sustainable public finances – and gives us the power to keep increasing the standard of living of low paid workers.**

Imagine a not unrealistic scenario, in which improvements to the annual productivity and efficiency of the health sector remains at its average between 1979 and 2010: just 1% a year. According to the OBR, if you project this scenario forward fifty years with no changes to tax policy, our deficit would spike to 16% of

## Stagnating productivity is a bigger longer term threat to the health of the NHS than short term austerity or even an ageing population

GDP and the debt a colossal 205%.<sup>136</sup> In reality, the government would have to raise taxes much earlier than this to prevent the build-up of debt – but while this would prevent the interest bill from climbing so high, we would still need to find a way to pay for the predicted 10–11% of GDP increase in the cost of health, long-term care and pensions.

Stagnating productivity is a bigger longer term threat to the health of the NHS than short term austerity or even an ageing population. Some health care experts argue that even the OBR's forecasts do not provide enough money for the NHS and that it would be 'affordable' in future decades to spend 20% of GDP on health and social care. This is equivalent to more than doubling the amount of income tax currently paid.<sup>137</sup> Trying to raise taxes this high is a recipe for decades long stagnation in living standards and slow growth.

There is no long run alternative to reform to ensure the quality and sustainability of public services. Higher spending can at best ease the transition or fill a small proportion of the shortfall. We are going to have to get better at doing more for less.

Moreover, there are other reasons why we need to err on the side of austerity. Given uncertainty about the future and its current

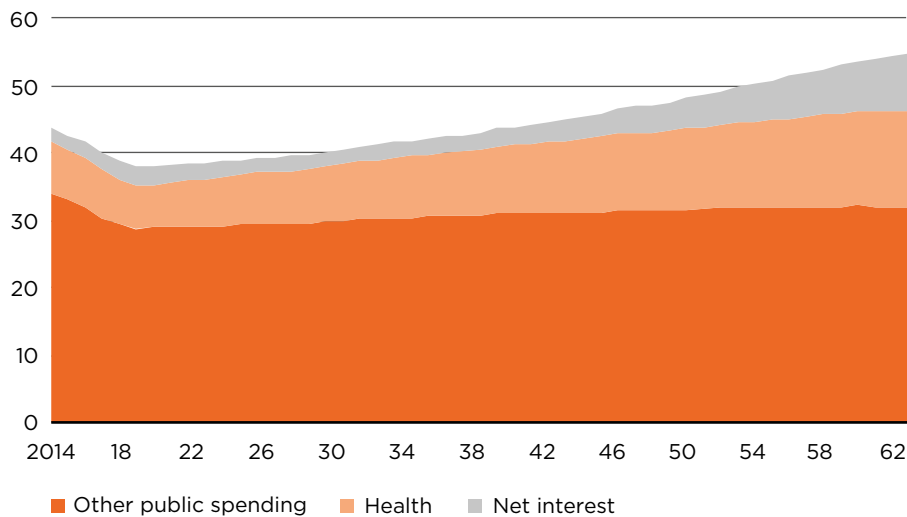
high levels, we need to pay debt down more aggressively than was the norm before the crisis. A more efficient state gives us the room to ensure that everybody benefits from growth and allows us to offer more generous benefits and keep cutting taxes for the low paid.

We should aim to deliver value for money government by:

- **After the deficit has been closed, introduce a new fiscal mandate targeting a zero structural deficit and the pay down of the debt-to-GDP ratio over the economic cycle.**

At around 80% of GDP, public sector net debt remains too high for comfort for long term fiscal sustainability. High levels of debt reduce the room for manoeuvre in future crises, risk slowing growth and raise costs for future generations. Unfortunately, past fiscal rules have proved ineffective at constraining governments or forcing them to pay down debt in the good years. By trying to maintain flexibility for governments to actively manage the business cycle, they have proved vulnerable to overly optimistic forecasts and political procrastination.

We should leave the job of supporting demand in the economy to monetary



**FIGURE 24**  
Lower health  
productivity  
growth forecast  
(% GDP, OBR)

policy, and focus fiscal policy on value for money and paying down debt. The government should target a zero structural deficit and the pay down of debt-to-GDP ratio over the economic cycle. This would still allow the automatic stabilisers to operate, while removing political discretion for fiscal irresponsibility. Following the Swiss debt brake model, in the event of predictions proving overly optimistic, any unforeseen deficits would have to be repaid in five years. In the event of a budget breach 30 days prior to the beginning of a fiscal year, automatic freezes should be triggered to tax thresholds, public pay and welfare.

- **Improve the quality and access to data on comparative costs, public sector performance and official forecasts.**

The first step towards more effective government is better data: new forms of measurement, more accurate forecasting and a revolution in transparency and openness. While government is now

releasing more data than ever before, little is being done with it: data is too often dumped on obscure websites. Much of the existing policy process relies on opaque, Whitehall-know-best top-down assumptions, with little opportunity for learning through iterative policy design.

The Government should commission the rapid production of simple league tables on local public sector performance, with the results included in the new annual tax statement. The OBR should be given a new duty to review and update policy costings, with sanctions imposed for costings that are found to be systematically biased. New government sponsored prediction markets should be set up for growth, inflation, unemployment and tax revenues.

- **Cap the total public sector pay bill, but give public sector employers greater autonomy to link pay to performance and local labour market conditions.**

Even after controlling for the higher levels of skills in its workforce, public sector compensation remains significantly more generous than in the private sector. Much of the public sector workforce has its pay set in a highly political, centralised process of national pay bargaining. The combination of the public sector pay premium and national pay bargaining creates a system that is expensive, unfair, and often makes recruiting and retaining the best staff more difficult.

Instead, we should move towards a system where control over pay is more closely linked to performance and local living costs. As in Sweden, public sector employers should be allowed to choose the level at which negotiations take place. In some public industries, negotiations can take place between the employee and employer, while for others remaining at the level of the workforce will be most appropriate.

- **Introduce a long term ambition to ensure every full time worker earn a Living Income.**

In the long run, greater efficiency will create not just a more sustainable state, but offer money to spend on tax cuts or more generous benefits. Increasing the minimum wage to the level of the living

wage would pose an unacceptable risk of higher unemployment or other negative side effects. A mandatory Living Wage would give the UK near the highest minimum wage in the OECD, and the majority of the benefits would go back to the Treasury rather than to the workers in higher living standards. However, as the Adam Smith Institute has long argued, the difference between the minimum wage and the higher Living Wage is largely accounted for by Income Tax, employer's and employee's National Insurance.

The current Coalition government has already raised the Personal Allowance from £6,475 to £10,500, while both the Conservatives and Liberal Democrats have committed to raising it further to £12,500 by the end of the next Parliament. However, this would still leave low paid workers paying the other taxes on employment from a much lower level than Income Tax.

After balancing the budget, the government should continue to grow public spending slower than growth of the economy as a whole. By around 2025 it would be feasible to align the thresholds for Income Tax and National Insurance, which along with targeted increases in Universal Credit could ensure that everybody in full time work earns at least a Living Income.



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## Growth

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## Government

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**Jonathan Dupont** joined Policy Exchange in April 2014 as a Research Fellow in the Economics & Social Policy Unit. Prior to joining, he has worked as a parliamentary researcher, an independent economic researcher and an analyst for the There is Nothing British about the BNP campaign.

He has co-written multiple books on public policy, and a paper on fiscal rules – Binding the Hands of Government – for the Institute of Economic Affairs. Jonathan read Philosophy, Politics and Economics at the University of Oxford.

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