

# Beyond levelling up

The Conservative case for tackling inequalities of income and wealth

Tim Pitt



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## ABOUT THE AUTHOR

### Tim Pitt

Tim Pitt is a partner at Flint Global. He joined Flint from the Treasury where he was a senior adviser to both the current Chancellor, Sajid Javid, and his predecessor Philip Hammond. Tim provided advice across economic and fiscal policy, including on personal and business taxation, Industrial Strategy, energy and productivity. Prior to that, Tim was a Special Adviser at the Ministry of Justice and the Cabinet Office.

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

Tim is writing in a personal capacity.

## FOREWORD by James Kirkup, SMF Director

The Social Market Foundation began life in 1989 with an essay, entitled The Social Market Economy, written by Robert Skidelsky.

He wrote:

*“...the market system is not a culmination of spontaneous social evolution, as Hayek believes. Despite its powerful intellectual supports, and practical achievements, it remains a fragile institution, not much loved.”*

*“Those who value the market as an institution must be concerned to keep its support system in good repair. The state's role is essentially threefold: (a) to create and maintain an appropriate legal framework for market exchange; (b) to limit and supplement the market where necessary; and (c) to ensure that the market is politically acceptable. A social market economy is, above all, one which is embedded in social arrangements regarded as “fair.”*

Today, as then, the SMF is a charity that works to “advance the education of the public in the economic, social and political sciences” with a particular focus on “the performance of markets and the social framework in which they operate.”

In pursuit of that charitable objective and consistent with Skidelsky’s thinking, the SMF has, in the last 30 years, published numerous essays and other writing by people who belong to all political parties, as well as those who have no party. Some of those authors have served in Parliament: Frank Field, Liam Byrne, Chris Leslie, David Willetts, Dominic Raab and Nick Clegg are just a few of the political actors whose ideas we have published in order to explore and illuminate markets and their social framework.

This essay by Tim Pitt is the latest example of this work and should be seen in the context of the Social Market Foundation’s history. These are the thoughts and recommendations of a member of the SMF’s Policy Advisory Board. We publish them here because we judge that doing so is consistent with our charitable purpose, and because we think Pitt’s ideas are an important contribution to the development of social market thinking outlined by Skidelsky. Such thinking is, I would argue, now more important than ever to British politics and policymaking, and to the British public. This essay should be read carefully by anyone involved in politics and policy in the wake of the 2019 general election, and the SMF is pleased to present it here. The views and recommendations expressed are, of course, those of the author alone.

## CHAPTER 1. INTRODUCTION

Boris Johnson's election victory has heralded much debate about regional inequality, with the new government determined to "level up" Britain's left-behind regions with a massive programme of infrastructure and R&D spending.

There is much to commend the new government's early intent in this area given the UK's high levels of regional inequality compared to other advanced economies.<sup>1</sup>

But talking about "levelling up" also conveniently allows a more difficult debate around inequality to be parked. If you "level up" the regions, you are not in theory creating any losers. Nobody is being told to contribute more or to see their earnings reduced – it's simply a question of helping lift up those areas of the UK that are less prosperous. It avoids the question of whether we think the gap between rich and poor is acceptable, and whether we are comfortable with the current levels of income and wealth accruing to the richest in society. This matters because so long as the focus is merely on "levelling up", the policy response will avoid the difficult measures needed to reduce inequality.

Barack Obama has described inequality as "the defining issue of our time"<sup>2</sup>, yet it is an issue many on the centre-right don't feel comfortable taking head-on.

Over recent years, many conservative commentators and politicians in the UK have talked about the need to refresh or reform capitalism, or to reinvigorate the free market for the twenty-first century, and the new government's focus on regional inequality and "levelling up" can be seen as part of this. Yet, with a few notable exceptions, most skirt around the issue of inequalities of income and wealth, focussing instead on equality of opportunity and talking generally about making sure all parts of society benefit from economic growth.

Partly this is because the issue is seen to be "owned" by the left. This is Ed Miliband and Jeremy Corbyn territory; at best, inequality is a defensive issue for the Conservatives.

But part of it, I think, is that there is not a clear consensus on the centre-right as to whether or not current levels of income and wealth inequality are a problem. This paper will argue that as Conservatives, we should be deeply troubled by them. It will start by briefly looking at some history of Conservative thinking on this issue, before going on to set out the three principal reasons why current levels of inequality are problematic: first, they hinder social mobility; second, they are a risk to long-term economic growth; and third, they undermine the stability of our political and economic system. It will then set out some proposals that should form part of a Conservative plan to reduce inequality.

## CHAPTER 2. HISTORY

Since the Second World War, the defining feature of Conservatism has been its opposition to socialism. Conservatives have opposed socialism's focus on egalitarian outcomes and, by extension, tolerated higher levels of inequality.

This scepticism about the need to tackle inequality has been grounded in a number of arguments: either as something to be tolerated as an inevitable outcome of natural differences in ability, with attempts to limit it running the risk of breaking the link between merit and reward; or even a necessary evil that provides economic incentives and drives economic growth.

This thinking reached its height under Margaret Thatcher's leadership in the 1970s and 1980s, but it has continued to dominate in the party ever since.

It is neatly encapsulated by Martin Feldstein, Chair of the Council of Economic Advisers under Ronald Reagan: "I believe that inequality as such is not a problem and that it would be wrong to design policies to reduce it. What policy should address is not inequality but poverty". He describes those with concerns about the accumulation of incomes at the top of the distribution as "spiteful egalitarians".<sup>3</sup>

This seems to be the attitude of the average member of the Conservative Party, only one in five of whom think ordinary working people aren't getting their fair share of the country's wealth, according to research published in 2018. For many Tory members, a government that focusses on tackling inequality would be seen as practising the politics of envy.<sup>4</sup>

Yet throughout its history, there has also been a strand within Conservative thinking that has seen inequality as a problem.

As far back as Robert Peel, Conservative governments have at times taken action out of a concern for economic injustice, often driven by a belief that a failure to do so could drive political and social instability. Peel's push towards free trade was in large part driven by his desire to reduce poverty. His Budgets of 1842 and 1845, combined with his abolition of the Corn Laws, liberalised trade through significant tariff cuts, reducing the cost of food for the poor while increasing competition – and therefore reducing profits – for landowners. The funding gap from the tariff shortfall was largely made up by the reintroduction of income tax paid by relatively higher earners.<sup>5</sup>

More recently, as the Second World War drew to a close, many Conservatives assumed Churchill's wartime leadership would be rewarded with victory in the subsequent election. Yet Labour won a landslide in 1945, driven in large part by the fact that, unlike the Conservative Party, it had a clear answer to inequality and social injustice: Beveridge and the welfare state.

Following that defeat, the Conservative Party set about refreshing its intellectual and policy platform. Several leading Conservative thinkers, notably R.A. Butler, Quintin Hogg, Ian Macleod and the future Prime Minister Harold Macmillan, argued under the banner of the Middle Way that the party had to respond to inequality, reconciling Conservatism with the welfarist ideas which were being implemented by Attlee's government. While rejecting collectivism, this Middle Way offered a critique of *laissez-faire* liberalism,

emphasising instead the value of social obligation and the need for institutions that nurtured co-operation among different sections of society. Thus Conservatism was able to endorse the advent of the welfare state, while rejecting ideological socialism.<sup>6</sup> This was classically Conservative: removing legitimate grievances in order to defend the existing order and enabling it to adapt to societal change. As Hogg put it in 1943:

*“If you do not give people social reform, they are going to give you social revolution”.*<sup>7</sup>

Historically, therefore, there is a strain of Conservative thinking that has concluded that certain types and levels of inequality are unacceptable and need to be tackled in order to maintain political and social stability – the platform upon which rising living standards are built.

But since Thatcher, this strain of thinking from the One Nation tradition, has been largely drowned out by the economically-liberal wing of the party, for whom inequality is much less of a problem.

This is not to say Conservative politicians are ambivalent about the distributional impact of its policies – the distributional analysis published at every Budget, for example, is always poured over by officials and advisers to ensure it is publicly defensible. In 2009, David Cameron criticised the rise in inequality under Labour<sup>8</sup>, and since 2010, Conservative-led governments have implemented numerous policies which point to an appreciation of public concerns about how economic returns are distributed – the significant increases in the minimum wage being the most obvious example.

Equally, however, there are a number of measures since 2010 – particularly welfare cuts – that have had the opposite effect. And the stock response from the Conservatives in recent years has been to bat away any questions on inequality and imply there is no problem, relying on statistics showing income inequality to have fallen very slightly since 2010 and that the top 1% are paying more tax now than in any year under Labour.

But there is very little debate among Conservatives about whether inequality is at a level that we think is acceptable or sustainable. The reality is that over the last forty years, income inequality has risen across advanced democracies, and particularly in the UK. There are a number of explanations for this increase, with some combination of globalisation, skill-biased technological change and domestic policy choices on regulation, tax and welfare being responsible. More recently, there has been a focus on the impact of quantitative easing and low interest rates in the aftermath of the financial crisis on wealth inequality.

Whatever the cause, the result is that, according to the ONS, the Gini coefficient – the most widely used measure of inequality – for income inequality has risen from 0.25 in 1979 to 0.33 today.<sup>9</sup> Nearly all of this increase happened during the 1980s – Gini has been broadly flat since then – but the UK is currently one of the more unequal countries in the OECD.<sup>10</sup> Digging a little deeper, the most striking feature of this rise is the proportion of income going to those at the very top, an increase that continued right through the 1990s and 2000s: the pre-tax share of national income going to the top 1% of earners has leapt from around 7% in the early 1980s to about 12% today; on a post-tax basis, the top 1% take home nearly 10% of national income.<sup>11</sup>

Wealth is typically distributed even more unequally than income. According to the ONS Wealth and Assets Survey, wealth inequality has risen slightly over the past decade, with the Gini coefficient increasing from 0.61 to 0.63. The richest 10% hold 45% of the UK's wealth; while the bottom half of the country hold less than 9% of it.<sup>12</sup>

So, there is no getting away from the fact that income inequality is significantly higher than it was forty years ago, and that wealth is distributed very unequally.

Going forward, there is no sign that these high levels of inequality are likely to reverse without significant policy interventions. Dramatic technological change may lead to a higher share of income accruing to capital at the expense of labour, while the network effects that accompany these technologies mean we are already seeing enormous concentrations of personal wealth in the hands of a few big winners. Throw in the potential distributional impact of tackling the twin challenges of decarbonisation and an ageing society, and the issue of inequality must be at the heart of policy and political debate over the coming years.

So why should Conservatives care about inequalities of income and wealth?



## CHAPTER 3. WHY SHOULD CONSERVATIVES CARE ABOUT INEQUALITY?

### Opportunity and social mobility

The first reason is because it impacts opportunity. Conservatives care deeply about opportunity and social mobility: as much as possible, every child deserves the same chance at making the best of their talents, regardless of their background. It goes to Conservatives' conception of fairness.

Talk to many Conservative MPs and commentators and ask them if they care about inequality, they will say something to the effect of: "inequality of opportunity, absolutely; inequality of outcome, no. Our focus should be on making sure everyone gets the same opportunities in life, regardless of their parents' income or wealth, rather than on making sure that people end up with broadly similar amounts of material wealth". That is a very clear dividing line with the left, and part of what Thatcherism was all about: moving away from the perceived egalitarianism that dominated Britain's political economy in the 1970s. The argument, which has much instinctive appeal, is that for people who are willing to work hard, there should be no limit to the amount of wealth they can accumulate for themselves, as long as everyone has the same chance to reach those heights.

This is the argument Boris Johnson made in 2013 in a speech perhaps best remembered for his comments about 16% of the population having an IQ of lower than 85.<sup>13</sup> To be fair to him, while arguing (correctly) that some measure of inequality is necessary to incentivise economic activity, he acknowledged people's concerns about high levels of inequality, particularly in the aftermath of the financial crisis. However, he argued:

*"Though it would be wrong to persecute the rich, and madness to try and stifle wealth creation, and futile to try to stamp out inequality, that we should only tolerate this wealth gap on two conditions: one, that we help those who genuinely cannot compete; and, two, that we provide opportunity for those who can."*

He went on to bemoan the fall in social mobility since Thatcher, an argument he returned to at his speech to the Conservative Party conference in October 2019:

*"I believe that talent and genius and initiative and chutzpah are evenly distributed across the whole UK but it is also clear that opportunity is not evenly distributed and it is the job of this One Nation Conservative government to unlock talent in every corner of the UK."*<sup>14</sup>

In focussing solely on opportunity, however, he misses a key point: equality of opportunity cannot be detached from equality of outcome because there is a relationship between the two.

An OECD paper from 2011 found that rising income inequality "can stifle upward social mobility, making it harder for talented and hard-working people to get the rewards they deserve".<sup>15</sup> It found that intergenerational earnings mobility – the extent to which individuals can move up and down the income distribution compared with their parents – was much lower in countries with relatively higher levels of income inequality such Italy, the UK and the US, than in countries with lower levels of inequality, such as the Nordics.

Alan Krueger, Chairman of the Council of Economic Advisers under Barack Obama, has labelled this the “Great Gatsby Curve”.<sup>16</sup>

What does this mean? It means that the more unequal a country’s income distribution, the more likely it is that the children of poor parents stay poor, and the children of rich parents stay rich. According to the OECD, in an average developed country, it can take five generations for the children of poor parents to attain their country’s average income.<sup>17</sup>

In *Our Kids*, the Harvard political scientist Robert Putnam argues that rising income inequality in the US over recent decades has led to growing class gaps in areas such as family stability, residential segregation, school quality and community cohesion. The point is not simply that children of rich parents have more advantages, but that these advantages are significant and increasing. The bigger the gap in incomes, the more rich parents are able to embed higher opportunity for their children – particularly in education – and poor parents find it harder to give their children a shot at catching up.<sup>18</sup>

Now there is a legitimate debate to be had here about causality – is it income inequality which is actually driving lower social mobility, or are there other factors at play? But the existence of a link between higher inequality and lower mobility should be enough to concern Conservatives who care about opportunity and believe in merit and industry.

## Economic growth

A lack of mobility and opportunity is symptomatic of a society that isn’t operating fairly, but it is also an enormous waste of talent that will negatively impact on economic growth. And this is the second reason why high levels of inequality should worry Conservatives: it holds back growth, and has the potential to make our economy less stable.

Traditional centre-right thinking has been that there is a trade-off between inequality and growth. Two arguments put forward by American economists underpin this. First, in the 1950s, Simon Kuznets argued that as an economy develops, it will first become more unequal but become more equal again as average incomes rise, rendering policy interventions to tackle inequality unnecessary.<sup>19</sup> Second, in 1975, Arthur Okun published “Equality and Efficiency: The Big Tradeoff” suggesting that there was a trade-off between equality and growth, and that policies aimed at reducing inequality might therefore also reduce average incomes.<sup>20</sup>

These arguments were mirrored by Conservatives in the UK. Pursuit of egalitarian economic outcomes were seen by Keith Joseph, one of the main architects of Margaret Thatcher’s economic policy, as blunting incentives. Large financial rewards were needed to drive entrepreneurship and innovation, to incentivise people to excel and compete. As Joseph said in 1976:

*“An egalitarian policy squeezing differentials, high direct taxation on nearly all income levels, discouraging capital accumulation and transmission, narrowing the gap between the incomes of successful and unsuccessful, will discourage wealth-creators...The more government levels people and incomes down – by discouraging enterprise and initiative and squeezing differentials – the less productive the economy will be and the less income there will be for everyone, including those who need help.”<sup>21</sup>*

In her last Prime Minister's Questions, responding to a question from Simon Hughes about widening inequality during her time in office Margaret Thatcher drew on the same argument, saying:

*"People on all levels of income are better off than they were in 1979. The hon. Gentleman is saying that he would rather that the poor were poorer, provided that the rich were less rich. That way one will never create the wealth for better social services, as we have. What a policy. Yes, he would rather have the poor poorer, provided that the rich were less rich"*<sup>22</sup>

The assumption is that policies to tackle inequality would undermine wealth creation and therefore growth; and it is an assumption that continues to permeate through large parts of the Conservative Party today.

But recent evidence shows that, far from being a pre-requisite for growth, high levels of inequality act as a drag on it. Research by the OECD<sup>23</sup> and the IMF<sup>24</sup> – hardly bastions of left-wing thinking – suggest that the rise in inequality over the last few decades across most advanced economies has actually acted as a significant brake on long-term growth. In the two decades before the financial crisis, for example, the OECD estimates that rising inequality took nearly 9 percentage points off UK growth.<sup>25</sup> As a comparison, that broadly resembles the government's analysis of the relative long-term economic hit of a no deal Brexit compared to staying in the EU – and I invite you to consider how much Conservative intellectual firepower has been deployed talking about inequality compared to that spent talking about our relationship with Europe.<sup>26</sup>

How do high levels of inequality hold back growth?

The OECD says a main transmission mechanism is likely to be investment in human capital, finding that the gap in education outcomes across people from different socio-economic backgrounds is higher in high inequality countries. This under-investment in skills at the bottom of the distribution holds back growth, and reinforces the argument above on the link between inequality and mobility.<sup>27</sup>

Separately, Ben Bernanke and Larry Summers argue that higher inequality can reduce growth because the rich have a lower marginal propensity to spend: a rich person is less likely to spend an additional dollar than a poor person, instead directing that additional money to savings. As those savings increase and aggregate demand falls, interest rates fall and asset prices rise, encouraging borrowing.<sup>28</sup>

On a related theme, Raghuram Rajan, the former Governor of the Reserve Bank of India, has argued that higher inequality increases financial instability as poorer households borrow more to make up for a lack of real wage growth, financed by a savings glut accumulated by those at the top. Ahead of the financial crisis, for example, middle class Americans borrowed beyond their means to maintain a standard of living that their stagnant wages would otherwise not allow them; and it is certainly striking that inequality in the United States peaked in the run up both to the 1929 Wall Street Crash and the 2008 financial crisis.<sup>29</sup>

This is by no means to argue that some level of income and wealth inequality is not to be tolerated, or even encouraged – there can be no denying that economic incentives are important to drive growth; and as Conservatives, we need to champion wealth creation.

But clearly it is possible to believe that some level of inequality is acceptable and even desirable, while also being concerned that existing levels are too high – and perhaps significantly so.

Central to the Conservative Party's political offer has always been that the economy is safe in our hands. If Conservatives care about economic growth, they need to care about inequality.

## Stability

So far, I have argued that Conservatives should care about inequality because we care about opportunity, and because we know that high levels of inequality undermine growth.

There is also a third reason, which might be the most compelling. High levels of inequality are undermining the stability of our system of political economy. This is a direct challenge to the nature of Conservatism, defined by Edmund Burke as the “disposition to preserve”.

Over the last few years, the rise of populist parties in many advanced democracies, including France, Germany and Italy, along with a series of shock election results, ranging from the Brexit referendum to Donald Trump's victory to Jeremy Corbyn's unexpectedly strong performance at the 2017 election, have seen a narrative take hold that capitalism is in crisis.

Economic injustice is vital to the arguments made by populists on both sides. Trump, Farage and Corbyn have all argued that the economy is a “rigged” game where the rich always win and working people always lose. This political message resonates with many voters, because it does feel sometimes like the game is rigged.

There is a growing literature on the link between populism and inequality. Matthew Goodwin and Roger Eatwell, for example, argue that the rise of what they call “national populism” is driven by four factors, one of which they classify as “deprivation”, and particularly a growing sense of *relative* deprivation: the fear among people that they, and people like them, are losing out relative to others in society, and that social mobility and rising prosperity is not something that is available to them. This is not just about people on low wages, it also extends to many full-time workers and sections of the middle class.<sup>30</sup> According to the British Election Study, in 2015 72% of voters thought ordinary people do not get their fair share of the country's wealth.<sup>31</sup> Notably, the same year the British Social Attitudes survey also found that 76% of UKIP supporters endorsed that statement, even more than the 72% of Labour supporters who did so.<sup>32</sup>

David Goodhart has made a similar point: in categorising the divide today between “Anywheres” and “Somewheres,” he points to economic factors, including inequality, as relevant to the rise of populism.<sup>33</sup>

There also seems to be a direct link between high levels of inequality and another of the factors identified by Goodwin and Eatwell as driving populism: a collapse in trust of politicians and a perception of corrupt elites running things for their own benefit. There is a link to inequality here, particularly the accumulation of wealth and income at the very top. Martin Giles, for example, has shown that the US system is much more responsive to the policy preferences of the rich than to those of the middle and lower ends of the distribution<sup>34</sup>; while Paul Pierson and Joseph Hacker have written about a “Winner Takes

All” political economy in which the concentration of income at the top has led to a politics that reflects the interests of the wealthiest.<sup>35</sup>

We need to be careful drawing too many parallels with the US: levels of inequality are significantly higher there, and their political system is arguably more open to the domination of financial interests. But the argument has instinctive merit, and there is some evidence of it here in the UK.

There was much debate recently that the country faced a choice between a no deal Brexit or Jeremy Corbyn as Prime Minister. The Conservative Party’s line was that the message from business was that Corbyn was more of a threat. This is, broadly, true: that is the message I often heard from business while in government. But as one chief economist at a major bank recently disclosed in private, that may well have been because Corbyn’s policies, particularly on personal taxation, would have directly impacted the senior management of businesses, who are the ones that ministers tend to engage with, whereas a no deal Brexit was less likely to impact their personal finances in the same way.

High levels of inequality feeds a narrative that our politics and our economy is rigged in favour of a wealthy elite, undermining our democracy and belief in the market economy. People will not support free markets and open trade if they feel they are losing out while a small group at the top take all the gains, instead opening the door to populism whose simple-sounding solutions would ultimately cause significant damage to our economy and our institutions: things Conservatives have traditionally cared passionately about.

Conservatism at its heart should be viscerally opposed to populism: the notion of easy answers, of undeliverable promises and reckless policymaking, dealing with the world as it is wished to be rather than as it is. The way to defeat populism is to understand its causes and come up with solutions that address them. That means reforming the system to bear down on high levels of inequality and show people that our model can evolve to share the proceeds of growth more fairly. This in essence is a core Conservative argument: stable institutions and practices are essential to human progress. If reform is required to ensure stability, to preserve, then so be it.

## CHAPTER 4. RECOMMENDATIONS

There is nothing inevitable about high or rising levels inequality, and tackling inequality should be a key focus over the coming years for the Conservative Party. There is an enormous literature on policy interventions and their impact on inequality. I could not hope to cover it all, but it is worth identifying some key areas where thinking should be focussed. This is by no means an attempt to set out a holistic economic plan for the Conservatives to tackle the key challenges facing the UK economy, ranging from addressing low productivity and regional inequality to adapting the economy to technological change and de-carbonisation. But addressing inequalities of income and wealth, including looking at some of the proposals below, should be an integral part of that plan.

Suffice to say this won't feel comfortable for many Conservatives: while there are some proposals which are relatively politically straightforward, others, particularly around tax reform, will be less so.

### Tax and welfare

The most difficult area for the Conservative Party will be tax and welfare reform.

“Redistribution” is not a popular word in Conservative circles. But there is no reason for that to be the case.

According to Hogg, the Beveridge welfare state was:

*“A scheme for the abolition of want by the instrument of a redistribution of wealth. There is no burking that fact. That is what it is, and that is what seems to me to constitute its very great value”.*<sup>36</sup>

Redistribution through tax and welfare schemes plays an essential role in reducing inequality and, according to the IMF, it is only in extreme cases that it is likely to impact growth negatively. In fact, the IMF has found that the combined direct and indirect impacts of redistribution are a net positive on growth.<sup>37</sup> The UK has one of the highest levels of pre-tax income inequality in the OECD, and it redistributes less than the OECD average for a country with its level of inequality.<sup>38</sup> Put simply, our tax and welfare system should redistribute more from the wealthiest to the less well off.

Although some of the ideas below will be politically difficult, the fact that the government's new fiscal rules are in any event likely to force it to raise some tax can help provide political cover. The 2019 Conservative manifesto commits to balance the current budget on day-to-day spending, but by historic standards there is very little headroom against this rule (around £5 billion a year).<sup>39</sup> This could easily be wiped if the OBR downgrade its forecast for the economy or public finances, and there will no doubt be further public spending pressures coming down the line.

### Taxes on capital

Perhaps the most philosophically difficult aspect of this agenda for Conservatives is the taxation of wealth. There are strong reasons to be cautious in this area, not least that with internationally mobile capital it would be very easy to avoid poorly designed wealth taxes.

But with wealth highly concentrated – much more so than income – any effort to tackle inequality needs to look seriously at it. There are two areas where we should look carefully.

First, the taxation of property. Since the late 1970s, house prices in this country have nearly tripled in real terms.<sup>40</sup> Much has been made about how difficult this has made it for young people to buy a house, but it has also contributed to increasing wealth inequality.<sup>41</sup> In many cases people have accrued significant wealth simply by dint of the fact that they bought a house decades ago and house prices in their area exploded. I do not begrudge them that, but is this really the type of “wealth creation” that Conservatives should champion? Taxing increases in land value that are unassimilated with work, effort or skill must be right, yet in many cases these people will have paid very little tax at all on this accumulation of wealth, with council taxes capped at the top end based on decades-old revaluations and no capital gains tax on primary residence sales. It therefore seems perfectly reasonable to expect more expensive homes to face a higher annual levy, either through inserting new upper bands to council tax or introducing a new annual percentage levy on homes above a certain value. It would be progressive and a sensible piece of tax reform. To help smooth its introduction politically, and as another piece of sensible tax reform, some of the revenue could be used to cut stamp duty, an inefficient tax whose high rates at the top end are having a distortionary impact on the market.

If we are going to talk about the taxation of wealth, we cannot avoid talking, secondly, about inheritance tax. Along with stamp duty, this is one of the most unpopular taxes in the UK, for two reasons: first, because people see it as “double taxation” (you pay income tax during the course of your life, and then are taxed again at death on assets bought using taxed income). This is true but not unique: I’m double taxed when I buy a pint of beer: I have paid income tax on the money I am using to pay for it, and then pay beer duty on top of that.

It is perfectly natural that people want to pass on some of what they have to their children and grandchildren, and as Conservatives, we believe they should be allowed to do so. At the same time, there is no getting away from the fact that inheritance entrenches inequality and reduces mobility, giving a large leg up to the children of richer parents. As John Stuart Mill wrote in *Principles of Political Economy*:

*“I see nothing objectionable in fixing a limit to what anyone may acquire by the mere favour of others, without any exercise of his faculties, and in requiring that if he desires any further accession of fortune, he shall work for it”.*<sup>42</sup>

In Britain today, many very rich people pay little or no tax on huge inheritances through a myriad of reliefs and exemptions. The Office for Tax Simplification has found that the average effective rate of inheritance tax paid for on estates between £2 and £3 million is – at 20% – *double* the effective rate on estates valued above £10 million.<sup>43</sup>

So there is a very good case for looking at inheritance tax again, with a view to abolishing it and replacing it with something fairer. If you care about opportunity, it is the income of the recipient, rather than the deceased, that matters. This argues for abolishing inheritance tax and replacing it with a lifetime gift allowance, as advocated by the Resolution Foundation and others, whereby instead of taxing the deceased’s estate, you tax the person receiving the inheritance. Each person will have a lifetime gift limit of, say £200,000. They will be able to be gifted that amount of money tax-free. Above that

amount, they would pay either a flat tax on everything they receive, or there could be lower and higher rate thresholds, akin to the income tax system. The system of reliefs should be reformed at the same time.

People will scream this is a Labour policy. It is. But so were the establishment of the NHS and the introduction of the national minimum wage. The Conservatives have wholeheartedly adopted both. Further, as with the high value property levy, the lifetime gift allowance is a sensible tax reform: it was proposed in the non-partisan Mirrlees review into the characteristics of a good tax system.<sup>44</sup> It is also in place in many other countries, including in Ireland, hardly a country drowning in socialism. And it would have huge symbolic importance: what more powerful signal could there be that a Conservative government was taking the issue of inequality seriously?

Taxing wealth is not a comfortable thing for Conservatives to do, and it is by no means a silver bullet. But done correctly, it has the potential to raise revenue to pay for public services and, by increasing the progressivity of our tax system, play a part in a holistic plan to tackle inequality.

### **Taxes on income and universal credit**

When it comes to taxes on income, it may sound like a statement of the obvious, but the starting point must be to avoid any tax cuts that overwhelmingly favour higher earners, such as the Prime Minister's pledge in the leadership campaign to increase the higher rate threshold to £80,000. This would have cost £9 billion a year, with three-quarters of the benefit going to the top 10% of households.<sup>45</sup> It was a sensible decision not to include this policy in the Conservative Party's 2019 election manifesto.

Similarly, we should not go any further on the personal allowance, which long ago ceased to help the lowest earners. Raising the NICs threshold, which the Conservatives have committed to do, is a more sensible policy, though as the IFS have shown, even here the majority of benefits accrue to the top half of the distribution.<sup>46</sup> A better plan would be to increase the generosity of universal credit. Putting money into either increasing the work allowances or lowering the taper rate effectively has the same effect as a tax cut and will much more effectively target lower earners, while strengthening work incentives to give more credence to the Conservative mantra that work should always pay. The IFS have shown that putting £3 billion into increasing work allowances, for example, would give a cash boost to the lowest third of earners that would dwarf any benefits they would receive from raising the NICs threshold.<sup>47</sup>

Our system of pension reliefs is also regressive. The current system provides individuals with income tax and NICs relief on pension contributions, which is estimated to cost roughly £40 billion a year in foregone revenue,<sup>48</sup> but by providing it at an individual's marginal rate, there is significantly more incentive for higher earners to save than people on low incomes – and no incentive for anyone earning under the tax free allowances to do so. This system should be replaced by a flat tax relief. A rate of 30% would be revenue neutral (and perhaps even provide the Treasury with a small saving), and according to the RSA would mean that three-quarters of people would be better off.<sup>49</sup> If Conservatives are, as we say, a party that supports financial responsibility, prudence and self-sufficiency, we should want to back everyone in building up funds for later life, and not favour the wealthy minority.



## Human capital

But there is also a limit to what the tax and welfare system can do to reduce inequality. Given that the UK has a very high level of inequality before taxes and transfers, any plan to tackle inequality must also look at what can be done to ensure a more equal distribution of income and wealth in the first place.

The inability of individuals from poor backgrounds to access quality further and higher education and develop their human capital is a key part of the story of why high levels of inequality limits both growth and opportunity.

Much has been written about the types of interventions that might be needed: a renewed emphasis on early years care; ensuring our schools are well-funded, that we have high-quality teachers and that resources are targeted effectively at children from poorer backgrounds; improving basic numeracy and literacy, as well as digital skills; a rebalancing between higher and further education, with more focus on technical and vocational skills; and a major expansion of retraining to help deal with the repercussions of potential high levels of automation.

But the debate thus far has, truth be told, been relatively modest in relation to quantum. For too long, governments have focussed on investing in things rather than people, and there is a danger the current government falls into the same trap. More investment in infrastructure is welcome, and there are strong arguments for using the flexibility provided by record low interest rates to do so now. But in the context of permitting extra borrowing of up to £20 billion a year on infrastructure and R&D, the manifesto commitment to a £600 million a year National Skills Fund seems pretty modest.

If we care about increasing productivity and tackling inequality, we need to give investment in human capital the same status that we give investment in physical capital. And history shows that eras of significant technological changes require major reforms and investment to ensure the benefits can be spread across society: Carl Frey, for example, has shown how during the second industrial revolution, the mass rollout of high schools in the US during the first half of the twentieth century laid the groundwork for a post-war fall in inequality by compressing the skills premium.<sup>50</sup>

This requires a step change in skills funding, and a serious conversation about how to pay for it. The tax ideas set out above could be used to pay for some of this increase, but this can't just be about the allocation of state funding. Businesses are the ultimate beneficiaries of a skilled workforce, yet for too long they have under-invested in their workers' skills. Part of this results from a culture that drives a short-term approach to shareholder value, pushing money to be spent on maximising the immediate bottom line rather than long-term investment in training. But part of it stems from a collective action problem: in a flexible labour market, while all businesses benefit from a skilled workforce, individual businesses may be reluctant to invest in their employees because they worry that they will take their skills elsewhere, rendering their investment wasted.

Businesses have some understandable concerns behind the operation of the apprenticeship levy, but ultimately the principle behind the design is right: trying to solve this collective action problem by forcing businesses to invest in skills. To deliver a step

change in skills funding, businesses – as well as the general taxpayer – will need to pay their fair share.

## Labour market

As Conservatives, we believe in the market economy as the best system yet developed to improve people's standard of living. But we spend too much time assuming the only way to reform the market is to make it "freer": less state, less regulation. In some cases, this will be the right course of action. But there are other areas in which the market isn't currently working and requires intervention to tackle inequality.

The introduction of the National Minimum Wage is a case in point. It was originally opposed by the Conservatives in 1997. As John Redwood, the then Shadow Secretary of State for Trade and Industry put it: "Legislation cannot create prosperity in the way that the Government naively believe".<sup>51</sup> Interfere with the market, and job losses would inevitably follow, the argument went. Yet in hindsight, the minimum wage has been one of the most successful economic policy interventions of the last two decades, so much so that the Conservative Party has tried to make it its own, pledging to end low pay in the UK by 2024 by raising the minimum wage to two thirds of median earnings. This is not risk free, but the government has sensibly decided to make the commitment subject to broader economic conditions. It is exactly the type of policy that a Conservative Party committed to tackling inequality should pursue; and it is also a clear acknowledgement that the state has a role to play, where necessary, to help ensure markets function in a way that is seen to be fair.

Of course, there remains an issue at the top end of the income distribution. For too many people, it feels like the gains from private enterprise are going to overpaid executives. The average FTSE CEO now earns 117 times what the median worker does, up from 47 times in 1998,<sup>52</sup> with the average FTSE 100 CEO earning £3.5 million a year.<sup>53</sup> This is not suggestive of a market that is working efficiently, fairly or sustainably. Nor is it defensible: if there is one thing that makes it difficult to defend the existing system, it is this. It is a notoriously tough nut to crack, and there is a significant disconnect between what the public think is an acceptable level of executive pay and what might be deliverable, but a Conservative Party committed to tackling inequality needs to show that it understands that excessive executive pay is a real problem.

It is too early to tell if recent reforms in this area have had any impact – most notably the requirement for large listed companies to publish pay ratios – but there is more that could be done. The government could start by following the US lead and removing executive pay above a certain threshold – say £1 million – from corporation tax deductibility, increasing the cost to the business of such pay by 19%; it could even go further and add a tax premium to any pay above that level. This should be accompanied by corporate governance reform: the transparency requirements on pay ratios could be extended to more businesses, while remuneration committees of boards could have workers added as ex officio members, as suggested by the BEIS Select Committee report into executive pay.<sup>54</sup> Perhaps most impactfully, it is an established principle in company law that some shareholder votes require a 75% majority to be binding: this could be extended to shareholder votes on executive pay, which currently only require a simple majority.

## Competition policy

In a report on competition policy in 2018, *The Economist* described competition as “an elixir”:

*“It spreads wealth today by lowering consumer prices and giving workers more choice of jobs, reducing firms’ monopsony power over them. It boosts productivity tomorrow by pushing firms to create better products for less...Without competition, capitalism is torpid and favours the few, not the many”.*<sup>55</sup>

The magazine also found that, in common with trends in Europe and the US, competition has been on the decline in the UK over recent decades, with the majority of the sectors of the British economy having become more concentrated, leading to concerns that margins are artificially high and excess profits are not being competed away.<sup>56</sup> There has also been increasing concern over recent years in the UK and elsewhere about the rising market power of the big global tech giants and the creation of “winner take all” digital markets, where one firm can quickly come to dominate entire markets, buy up any emerging competitors and create high barriers to entry.

Competition law has a history of being used to tackle the concentration of wealth and power: in the late nineteenth century, following concerns about the near-monopoly of Standard Oil and the railroad cartels and the concentration of wealth in the hands of men such as JD Rockefeller, Senator John Sherman introduced the world’s first competition policy legislation declaring that:

*“If we will not endure a king as a political power, we should not endure a king over the production, transportation, and sale of any of the necessities of life”.*<sup>57</sup>

Rather more recently, research by the OECD has shown that market power, defined as being able to drive returns and prices above competitive levels, is a contributing factor to inequality.<sup>58</sup> There are two ways it does this: first, by allowing business owners (who tend to be at the top of the distribution) to receive economic rents in the form of abnormally high profits that haven’t been competed away; and second, through consumers paying higher prices. Looking at eight advanced economies including the UK, they find that market power can lead to significantly higher wealth inequality. The paper notes that not all forms of market power are illegitimate – intellectual property protection is needed to drive innovation, for example – but many are: breaches of competition law, government-erected barriers to entry or natural monopolies being three examples of market power that increase inequality without an innovation benefit.

A renewed focus on competition policy should therefore form part of a plan to reduce inequality, and it should be bread and butter for Conservatives: boosting competition was at the centre of Margaret Thatcher’s plan to revive the UK economy.

Jason Furman’s review into competition in digital markets is an important contribution to this debate, which the new government will need to engage seriously with. Some of these recommendations are specific to digital markets, particularly on giving consumers greater ability to transfer their data between providers, and forcing big tech companies to open up their data on an anonymised basis to potential competitors. But others have wider economy-wide applicability, including strengthening the CMA’s merger control powers

and its ability to clamp down on anti-competitive behaviour, as well as improving the way in which it is run to ensure quicker decision-making.<sup>59</sup>

## CHAPTER 5. CONCLUSION

Conservatism has traditionally been about evolution not revolution, about managing change to embrace the future while preserving the best of the existing system. It has at its core a belief that a strong economy is the foundation of a strong society; and that every individual should have the opportunity to make the most of their abilities. Belief in stability, enterprise and opportunity all point to the need to address high levels of economic inequality, ensuring the sustainability of our system of political economy by seeing off the populists in the medium term and restoring people's faith in the existing system.

The fact that the current Prime Minister is willing to get into the debate about regional inequality is a sign that the Conservatives are beginning to understand the importance of economic inequality, but talk of "levelling up" avoids asking some of the difficult questions, and essentially says that we do not think there is an issue with the levels of wealth and income accruing to the richest in society. Yet if people think capitalism isn't working and some people aren't getting their fair share, then by definition some people are getting more than their fair share. For example, if executive pay is acknowledged to be too high in this country, it surely follows that there should be at least some element of "levelling down" too. And as long as the focus is merely on "levelling up", the policy response is likely to avoid some of the difficult but necessary measures needed to reduce inequality: the main response currently seems to be borrowing to invest in R&D and infrastructure across the UK, which creates no immediate losers and will be resisted by no one except a few fiscal hawks sitting in the bowels of the Treasury. While there is a coherent rationale for this approach in its own right, it will go nowhere near solving the problem of ensuring the benefits of growth are shared fairly across society. To do that, the government must go much further and be willing to take on some difficult measures – for example around tax and welfare.

Some of the proposals I have set out here to tackle inequality will not be comfortable for many Conservatives. Not all of them will be popular when polled individually. Most of these policies will create losers as well as winners, but that is true of almost any substantial policy change. Better to be honest with the electorate about the trade-offs and hard choices that are the foundation of all politics than to tell fairy-tales. Margaret Thatcher understood this: she was willing to do deeply unpopular things in the short-term to deliver for the long-term. Honesty will help ensure that in time, many policies that look controversial at first glance will find broad support amongst the public. And winning that support could not be more important, for unless the issue of inequality is addressed, the things Conservatives hold dear will be under threat.

While some in business may not like some of the specific measures proposed, tackling inequality should also be something all businesses should support. Dissatisfaction with the existing economic system is driving an anti-business mood among the general public, something that the business community increasingly realise they need to address, and an economy where the proceeds of growth are spread more evenly will be a more stable and sustainable one for businesses to prosper in. Much better to have the Conservatives tackling inequality than populist governments implementing highly anti-business agendas. While the views of the Conservative membership may not see inequality as a problem, Conservative voters – new and old – will, I think, be willing to listen to those

arguing we need to reduce inequality. This is particularly true if the changing nature of the Tory voter-base that we seem to be witnessing solidifies: an agenda that targets inequality will be politically easier to deliver for a Conservative Party whose voter base seems to have shifted towards people who are relatively less well-off. In December 2019, the Conservatives won seats in places where most voters are poorer than the national average, and much poorer than those at the top of the scale. Keeping those seats will require the party to do something about those gaps.

Conservatism has always evolved. In 1945, Conservatives failed to champion effectively the Beveridge Report and the creation of the modern welfare state, and lost a general election even under the leadership of the man who secured victory in war. The party then embraced, defended and improved that welfare state, and returned to power. In 1997 the Conservative Party vehemently opposed the introduction of the national minimum wage. Last year a Conservative Chancellor announced that Britain would raise the minimum wage so as to become the first major economy to end low pay.

Historically, Conservatism has been so successful because at critical junctures it has accepted the need to adopt new means to achieve its ends. The time has come for another Conservative evolution to tackle the issue of inequality, yet unlike in 1945 and 1997, this time the Conservatives have the opportunity to do so from a position of strength. If it has the political will to do so, this government now has the mandate and the majority to do the difficult things needed to deliver a fairer and more sustainable economic system.

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