# 1 | MEETING THE FISCAL CHALLENGE

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*The centre left will always see a role for public spending measures such as tax credits to secure public goods and ensure a fair distribution of wealth, power and opportunity. But a Labour government could achieve far greater leverage over social and economic outcomes at much lower cost to the taxpayer if it found ways of addressing the 'predistribution' of economic outcomes and opportunities.*

*Increasing the availability of high quality jobs offering decent pay and pensions, access to training and a proper work-life balance, could have a deep and far-reaching effect on household finances, as well as people's personal wellbeing and the strength of family and community life. Even when money is tight, there's much a Labour government could do to make Britain's economy fairer and stronger, and deliver 'fairness in tough times' by helping squeezed households without spending more money.*

Ed Miliband has come to the leadership of the Labour party at a time of enormous challenges and extraordinary opportunities.

The global financial crisis, and resulting global recession, raised fundamental questions about inequality, irresponsibility and Britain's future economic prospects. These questions have been sharpened by the government's failure to deliver the change that they promised, and their imposition of unfair tax rises and spending cuts which have choked off the recovery and pushed us back into recession. For the Labour party, this represents a rare opportunity to advance an alternative to austerity and an agenda for reform that answers popular aspirations for a fairer, stronger economy which works in the public interest. At the same time, however, Labour needs to be able to answer hard questions about its ability to deliver deeper social and economic progress in a post-crash era in which the deficit and debt bequeathed by the financial crisis, and now exacerbated by the coalition's economic failures, has to be dealt with.

Against this backdrop of hard economic constraints and new political opportunities, Ed Miliband has been leading a renewal of Labour's mission and its methods in a way that is re-energising our movement, both morally and intellectually, and increasingly resonating with the anxieties and aspirations of the British people.

This new agenda for Labour combines a strict focus on economic and fiscal credibility with a powerful argument for the growth and reform our economy needs if we are to raise living standards and expand opportunities for the majority. We are demonstrating that Labour is ready to take the tough decisions on tax, spending and pay that we need to get the deficit down, but also has an alternative plan to the coalition's self-defeating austerity policies; a plan that could secure the jobs and growth that are also essential to getting the public finances onto a sustainable footing. And we are showing that even when money is tight, there's much a Labour government could do to make Britain's economy fairer and stronger – with different choices on taxation and spending which ensure the broadest shoulders bear the biggest burdens; and economic reforms that can help hard-pressed families and business now, and build an economy for the future based on high quality jobs and sustainable long-term wealth creation.

## The challenge we face

There are three major reasons why the Labour party must take the task of repairing and rebalancing our public finances seriously.

First: the global financial crisis and resulting recession imposed significant costs on our public finances, along with those of governments around the world. Second: additional costs are now mounting as a result of the austerity and stagnation inflicted on our economy by the coalition government. Third: beyond and beneath these immediate pressures, there are deeper, slower, but equally powerful forces that have the potential to put our public finances under strain. These range from the erosion and narrowing of our tax base to the rising demands placed on public services arising from population ageing and medical advances, and the need for sustained investment in human and physical capital if we are to succeed in the global economy.[1]

So the fiscal challenge is real. But under Ed Miliband's leadership, Labour has been developing a compelling answer. Reforming and reprioritising how public money is spent will be a central part of our answer to the fiscal challenge we face. But Labour's agenda for growth and reform is just as integral to our commitment to deficit reduction and fiscal responsibility. A growing economy that works in the interests of the majority isn't only the best offer we can make to the British people at the next general election, it's also the best way of getting our public finances onto a sustainable footing. This is because the state's tax revenues and spending requirements are dependent on both the state of our economy and the health of our society.

## Securing the tax base

To see the link between economic growth and reform and the stability of our tax revenues, let's look first at why the UK deficit opened up in the way it did. It wasn't, as some seek to insinuate, because of excessive spending by the Labour government, or even for the most part a result of the fiscal stimulus implemented by Alistair Darling to avert a catastrophic slump. The increase in the deficit was primarily a result of a collapse in tax receipts. A recent IMF analysis shows that "accommodated revenue loss" accounted for by far the largest part of the increase in the UK's public debt between 2007 and 2011 – more than the financial sector bail-outs, the fiscal stimulus, and increased interest payments put together.

George Osborne has since choked off the recovery that had begun in 2009–10, with slowing growth and rising unemployment forcing the Treasury to borrow a £150 billion more than it had planned, largely as a result of drastic write-downs in expected tax revenues. But the devastating impact of weak or negative growth on tax receipts goes beyond these immediate effects. The permanent dent to our productive capacity and future prosperity resulting from firms' missed investment opportunities and the deterioration of the skills, motivation and employability of those struggling to find work, will have a negative impact on the Treasury's revenue streams for decades to come.

But as well as stimulating the growth that our tax revenues depend on, it's also essential to effectively regulate and rebalance our economy to ensure that growth, and those tax revenues, are stable and sustainable. Analysis of the impact of the global financial crisis by the OBR has highlighted the fact that the immediate fall off in tax receipts was particularly sharp for those revenue streams accruing the housing market and financial services sector. The figures dramatise the fact that, especially for an economy like the UK's with high levels of home ownership and a key comparative advantage in financial services, effective financial regulation is essential – not only for maintaining the health of our household and corporate sector, but also for securing the stability our public finances. The lesson of the crisis is that the valuable tax revenues that the financial and housing sectors generate can't be taken for granted but need to be underpinned by robust rules to manage risk and ensure those revenues are stable and sustainable.

As Ed Miliband has argued when talking about responsible capitalism, we need an economy that is "diverse enough to protect Britain against external and fiscal shocks". We should be clear that banking and financial services are and should remain a vital strength for the UK economy, employing thousands of people not just in the City but around the country. But it cannot be our only strength. In government Labour did much in areas such as competition policy, skills development, and investment in science and research to develop Britain's productive capacity in areas such as advanced manufacturing, pharmaceuticals and biotechnology, and the creative industries. And, contrary to common assertion, during that period Britain's economy recorded significant gains in productivity and growth potential which were not reducible to the financial services boom or a property price bubble.[2] But as technology advances and global competition intensifies, the role of government in supporting business growth and job creation across a range of sectors becomes more important. So the active industrial policy discussed by Chuka Umunna in chapter 3 is vital – not only to securing the rising living standards and expanding economic opportunities that can fulfil what Ed Miliband has called "the promise of Britain", but also to building the diverse and resilient tax base that our public finances depend on.

## Cutting the costs of failure

Economic growth and reform is also essential to containing some of the costs that can put our public finances under strain. An economy that isn't offering people a chance to make a decent living or live healthy and fulfilling lives is one that places extra burdens on the Treasury and taxpayer.

Under the coalition's economic mismanagement, unemployment has soared and wages have stagnated. This means the state has to do more work to support household incomes. The latest figures confirm that, as a result of the deteriorating economic outlook its policies have resulted in, the government is now on course to spend £35 billion more on social security and tax credits between 2011 and 2015 than it had originally planned. But as well as a plan for growth, we need regulation and reform to reduce the need for the state to spend money on correcting or compensating for the outcomes of unfair or unbalanced markets. Research by the Institute for Fiscal Studies commissioned by Ed Miliband as part of his leadership campaign suggests that the government would save between £6.8bn and £7.3bn in reduced spending on benefits and tax credits and increased income from taxation and national insurance if all employees were paid at least a living wage. Meanwhile the UK's historically low saving rate, declining occupational pension coverage and discouragingly complex and costly personal pension provision is a major contributor to the increasing reliance of millions of older men and women on over £8 billion in annual spending on means-tested pension credit.[3] And Liam Byrne has highlighted the fact that much of the £22 billion housing benefit bill serves to subsidise private landlords who "make enormous profit on properties often in a very poor state of repair".

Beyond the immediate costs to the taxpayer of unemployment, low or stagnant earnings, under-saving, and inadequate housing provision, the impact on individuals, families and communities of economic and social exclusion creates further knock-on effects for the state in terms of demands on public services and lost economic potential. Analysis by the Joseph Rowntree Foundation suggests that the problems and disadvantages suffered by people growing up in poor households adds, on a cautious estimate, £12 billion a year to spending on education, housing, criminal justice and social services. The impact of unemployment on young people, in particular, has been shown to have a permanent negative impact on their future employability and earnings potential – as well as their wellbeing and happiness.[4] Meanwhile the work of Richard Wilkinson and Kate Pickett has highlighted the impact of widening income inequalities on health and wellbeing at all levels of society – something that has enormous consequences for public spending. Accumulating research into the 'social determinants' of poor physical and mental health suggests that much of the NHS and social care budget is spent on coping with the consequences of detrimental living and working conditions as well as strained or dysfunctional personal and social relationships. Michael Marmot's review of health inequalities suggested that, in England alone, socially determined inequalities in physical and mental health account for £5.5 billion a year in additional healthcare costs.

The Labour governments of 1997–2010 took important steps towards making our economy work in a way that was fairer and allowed more people to live healthy and fulfilling lives – complementing its investments in public services and tax credits with structural reforms such as the minimum wage and enhanced rights to parental leave. But overall, OECD statistics show that while the state in the UK does as much to reduce inequalities as the state in Germany or Sweden, and less than in Japan, we still end up with more unequal outcomes because initial market inequalities are so high. Work by the Early Action Taskforce suggests that as much as 40 per cent of local public expenditure is devoted to "dealing with the consequences of problems rather than preventing them occurring".

We on the centre left will always see a role for public spending to secure public goods and ensure a fair distribution of wealth, power and opportunity. Tax credits, for example, have been and will continue to be critical in supporting the living standards of lower income families and ensuring that work pays. But a Labour government could achieve far greater leverage over social and economic outcomes at much lower cost to the taxpayer if it found ways of addressing what Jacob Hacker has called the "*pre*-distribution" of economic outcomes and opportunities, or what Philip Collins has called "gross inequality".

We could have a deep and far-reaching effect on household finances, as well as people's personal wellbeing and the strength of family and community life, if we succeeded in increasing the availability of high quality jobs offering decent pay and pensions, access to training and a proper work-life balance. There are no magic bullets to achieve this, of course, but a great many levers that a smart, active industrial policy might use to shift more companies out of a low pay, low skill, low productivity cycle. This could involve structuring the tax regime to support investment in physical and human capital; using procurement policy to incentivise innovation and encourage apprenticeships; improving competition in the banking sector so that growing firms can access the finance they need; or supporting pay and remuneration frameworks that enable shareholders and employee representatives to play their part in ensuring rewards are fairly distributed.

Taxpayer funded transfers paid to support the living standards of pensioners, families with children, and those on low or modest incomes, would also go a lot further if we simultaneously took steps to reduce the costs that such households face. Ed Miliband has illustrated his argument about "fairness in tough times" – how a Labour government could help squeezed households without spending more money – by pointing out that, for example, even while we cannot promise now to reverse cuts to the winter fuel allowance, we can commit to ensuring energy providers to offer older pensioners the cheapest tariffs. There are numerous other ways a Labour government could help hard-pressed households by taking on vested interests – such as preventing rail companies from using their monopoly power to impose unlimited above-inflation fare increases; empowering the Finance Services Authority to stop banks imposing unfair charges; or building on the introduction of auto-enrolment to ensure people have access to affordable pension schemes where their savings aren't eaten up by hidden fees.

## Conclusion

As the years of austerity stretch further into the future, people will wonder if there is any light at the end of the tunnel. The great danger is that the government's refusal to take responsibility for the state of the economy, and insistence that the demands of deficit reduction mean there's nothing else they can do, will lead people to give up on the idea that active government or democratic politics can answer their problems or address the real challenges of the twenty-first century.

But under Ed Miliband's leadership, the Labour party is beginning to offer people hope – hope that we can take action to turn our economy around, to get it growing and working for ordinary people. And by demonstrating that this will help us deal with the deficit and manage longer term pressures on the public finances, we can show that this is not only consistent with real fiscal responsibility, it's a requirement of it.

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### Endnotes

1 Final Report of the Commission on 2020 Public Services, September 2010.

2 Dan Corry, Anna Valero, and John Van Reenen, 'UK economic performance since 1997', Centre for Economic Performance, November 2011.

3 National Audit Office, *Means Testing*, September 2011.

4 David Bell and David Blanchflower, 'Young people and recession. A lost generation?', June 2010.