

Opinion

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The Observer view: sticking to fiscal rule will imperil Labour's future

Observer editorial

Cutting public spending to satisfy an arbitrary financial rule conceived in opposition will confine the UK to sluggish growth

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Britain's public finances are in a desperate state. That is the key message the chancellor, [Rachel Reeves](#), will deliver in a speech on Monday, which she will use to draw attention to a £20bn black hole in the tax and spending plans bequeathed to her by the last government.

Critics will say that this should not be news; it was patently obvious that the Conservatives cooked the books before the last election, baking in impossible-to-achieve spending cuts in order to make their plans for the next five years seem plausible. That did not stop Labour adopting the Tories' projections as its baseline, because it suited the party politically. However, Reeves would be entirely correct in arguing that the unenviable inheritance is as much a product of Conservative neglect and incompetence as it is of external shocks, and that Labour could not know the full extent of the fiscal gap until it was in government and had the opportunity to examine the books carefully.

The most important question is what she will do about it. She faces a toxic mix: an economy characterised by sluggish productivity growth, weakened by decades of insufficient business investment, and made worse by the uncertainty, and the trade barriers, occasioned by Brexit. Meanwhile, Britain's public services are in urgent need of investment: from the NHS, plagued by [record waiting lists](#), to schools struggling to close the attainment gap between poor pupils and their peers that was widening even before the pandemic, to services for vulnerable adults and children struggling to meet demand. There are examples of crumbling infrastructure everywhere, from railways and roads to hospitals and schools. [Child poverty has risen](#) as a product of cuts in financial support to low-income parents. Pay bodies have reportedly recommended [a 5.5% pay rise for public sector workers](#), estimated to cost an extra £10bn a year. A record proportion of working-age people are [economically inactive](#).

There are also significant one-off costs to the state, which have not been properly accounted for, that will fall due in the next few years, including compensation in the Post Office and infected blood scandals.

There are worrying reports that Reeves's planned response involves [cutting back on infrastructure investment](#), including in new roads and hospitals. The argument for doing so is that such inherited commitments are "unfunded, with unfeasible timelines". It may be true that they have not been properly accounted for, but the last thing the economy needs is further reductions in the public investment critical to encouraging the private investment that is so important to boosting growth. While in opposition, Labour already scaled back green investment plans in a way that significantly reduced its public investment plans.

To react to this fiscal crunch by cutting public spending - both capital investment and current - is the wrong approach macroeconomically. It risks making the problem worse: depressing growth further, and reducing tax revenues and hence the resources available to improve public services. The economy will not sufficiently grow while people sit for months on NHS waiting lists unable to work; while children from poorer backgrounds are held back from achieving their full potential at school; and while the housing market is so dysfunctional that lack of affordability prevents people taking up economic opportunities.

There are two other options available to Reeves other than cutting spending. First, she must look to increase tax revenues in her autumn budget by addressing the fact that the wealthiest find it all too easy to avoid wealth taxes. As we report this weekend, the Resolution Foundation estimates that scrapping reliefs that allow wealthy people to unfairly minimise their inheritance tax bills would raise an extra £2bn a year. Aligning the rate of capital gains tax on shares and dividends with the equivalent income tax rate on earned incomes for employees, even while indexing further increases to inflation, would raise up to £7.5bn a year. The proceeds of these taxes should be earmarked for alleviating child poverty, including but not limited to lifting the two-child benefit cap. Over the longer term, Labour should look at council tax: it is the main form of property taxation in the UK, yet the average effective tax rate for properties worth £500,000 is less than half that for those worth £100,000.

Second, the unfunded liabilities that Labour will have to meet justify a reconsideration of Reeves's fiscal rule that the government debt to GDP ratio must be falling in five years. By accepting this arbitrary rule in opposition, she effectively adopted the Conservative macroeconomic worldview: that growth can be achieved alongside fiscal conservatism. But this approach comes with significant risks; a failure to borrow prudently to invest consigns the UK to sluggish growth for at least another decade.

Labour's electoral strategy was hyper-cautious, shaped by the need to convince the public it could be trusted with the public finances. The problem is that if Keir Starmer and Reeves remain as risk-averse in government as they were in opposition, the approach that delivered them a handsome and well-deserved majority could end up impeding them from making enough difference to the country to convince voters to endorse them in five years' time. Britain's economic problems should prompt a reappraisal.

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