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**‘White Flag’ Labour?  
Fiscal policy for the UK’s  
next progressive  
Government**

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Twenty months into Labour's first period of opposition in over a decade, debate is raging over the direction the party should take to regain power – preferably in 2015, after only one term out of government. In November 2011 Compass published [Plan B](#), co-edited by Neal Lawson and myself, which argued for a range of bold and radical economic policy measures to secure the good society: an aggressive short-term fiscal stimulus in response to the current economic slump, coupled with longer-term structural reforms to the finance sector, industry, workplaces and public services. But *Plan B* is just one entrant in an increasingly crowded field. Advice for the Labour leadership is currently one of the UK's few growth industries, with think tanks and campaigning groups publishing thinkpieces and policy papers left, right and centre at a rapid rate. Two of the most high-profile contributions to the debate, both of which were published by Policy Network in December:

- [In The Black Labour \(ITBL\)](#) by Graeme Cooke, Adam Lent, Anthony Painter and Hopi Sen argues that to regain credibility with the electorate, Labour's economic strategy needs to be based around "fiscal conservatism" (with a small 'c'): an approach to the long-term public finances which is "careful, risk averse, and cautious."
- [Cameron's Trap: Lessons for Labour from the 1930s and 1980s](#), by Gregg McClymont and Ben Jackson, argues that Labour needs to learn important lessons from long periods spent in opposition in the 1930s and 1980s, largely due to voters' doubts about the party's economic competence. In each of these cases it took Labour well over a decade to get re-elected.

This report compares the recommendations from *Plan B* on what Labour's future economic policy should be with the recommendations from both of these recent Policy Network reports. I also draw on recent evidence from secondary commentary on the same themes in the media and the blogosphere, as well as recent keynote speeches from Ed Miliband and Ed Balls on the economy which represented changes in the emphasis of Labour's economic policy in favour of 'looking tough' on the deficit, and have been widely (although not universally) interpreted as a move in the direction suggested by *ITBL*. The report asks two central questions: firstly, does *In The Black Labour* represent a blueprint for the successful reinvention of Labour's economic strategy, or is it a misguided blind alley? Secondly, whatever strategy it adopts, can Labour avoid "Cameron's trap" to emerge victorious, or at least as the largest single party, in the 2015 election?

### **The gospel according to the Men In Black: misdiagnosing the credibility gap**

*In The Black Labour* starts with the observation that Labour lags well behind the Conservatives as the party most trusted to manage the economy. This is an unarguable fact, consistently confirmed by polling evidence over the last eighteen months. However, *ITBL* then goes on to argue that the main reason that Labour isn't trusted on the economy is because voters feel that the party has "a lack of commitment to addressing the fiscal crisis...it is precisely the vagueness of Labour's position over its short to medium term plans for the deficit that confirms the voters' worst suspicions".

I would argue that this argument is a fundamental misdiagnosis of Labour's economic credibility problem – for two reasons. Firstly, Labour has been very clear since late 2009 that it supports the “Darling Plan” of reducing the ‘structural deficit’ by half over a period of four years. This pace of deficit reduction clearly implies a path to fiscal balance over an eight year time period. Moreover, in his [2011 party conference speech](#), Ed Miliband made a clear commitment that, should Labour be returned to power with the public finances still in deficit, it would be a priority of the incoming Labour Government to clear that deficit. This commitment predates the publication of *In the Black Labour* and the subsequent shift in rhetoric on the deficit by the “two Eds” which I discuss in detail later in this report. There is no real evidence that Labour has been “vague” over its plans for the pace of deficit reduction at any point so far in this parliament.

Secondly, opinion polling (for example, from [YouGov regular tracking polls on the economy](#)) shows that while a majority of voters accept that spending cuts are *necessary*, a majority also believe that the cuts set out by the Coalition government are *too deep, too fast*, and are being implemented *unfairly*, as well as being *bad for the economy*. In other words, the majority of public opinion is closer to Labour's position on the cuts than it is to the Coalition's position. The unavoidable implication of this polling evidence is that, if the main criterion in voters' minds for evaluating the relative credibility of Labour versus the Conservatives were the pace and scale of the cuts, Labour would certainly be in the lead on economic competence. Therefore, “lack of commitment to addressing the fiscal crisis” cannot, logically, be the reason why voters are mistrustful of Labour on the economy. *In The Black Labour's* basic diagnosis of the credibility gap is wrong.

But if not “lack of commitment to addressing the fiscal crisis”, what *is* causing Labour's credibility gap on the economy? I would argue there are two – intimately linked – problems. One is that Labour are seen as the *culprits of economic mismanagement*: the failed politicians who got the UK economy into its current dire state. Given that the current media consensus (driven by exceptionally well-disciplined messaging by Conservative and Liberal Democrat ministers and MPs) is that New Labour's economic strategy was a disastrous failure, allegedly combining huge overspending with grossly inadequate financial regulation, it is perfectly understandable that voters are hesitant, to say the least, to trust a Labour Party whose Shadow Chancellor was a key architect of the New Labour strategy on both “tax and spend” and financial regulation.

The second problem is that voters have scant reason to believe a future Labour Government would be any different next time round than last time, because Labour has given them hardly any information (thus far) about the economic strategy a future Labour Government would pursue. The problem is not that Ed Miliband is short of “big ideas”; for example his call for a more productive and less predatory capitalism in his 2011 conference speech set an agenda that both David Cameron and Nick Clegg have followed. But high ambitions for transforming capitalism are mere talk without well-worked-out proposals to achieve those ambitions. At the time of writing, all Labour has to show for eighteen months of opposition in terms of publicly announced economic policy – other than a continued commitment to the Darling plan on fiscal consolidation – is a five-point short-term fiscal stimulus plan, more transparency on executive pay along the lines suggested by the [High Pay](#)

[Commission](#), and some useful but limited commitments on taxation and utilities pricing. At a time when there has arguably never been a greater need for a powerful broad-brush narrative on how Britain would be transformed, economically, under the next Labour Government, these measures are no more than promising dabs at the canvas. And it is this policy vacuum – rather than any failure to commit to closing the ‘structural deficit’ – which is driving the current distrust of Labour on economic policy.

### **Surrendering the debate: from small ‘c’ to Big ‘C’ Conservatism**

But while *ITBL*’s misdiagnosis of Labour’s problems in winning the economic argument is unfortunate, the paper suffers from a much bigger flaw, from a progressive perspective: in making the case for ‘small c’ fiscal conservatism, the authors appear to have unquestioningly accepted the current Government’s ‘Big C’ Conservative interpretation of current macroeconomic trends. This is most obvious from the fact that there is almost no discussion in the paper of the (very powerful) economic case *against* the breakneck austerity measures currently being pursued, come hell or high water, by the Conservative-led government. Despite *ITBL* is almost a Keynes-free zone<sup>1</sup>. This is a severe problem for the credibility of the report, given how the economy has behaved since the Coalition Government came to power.

While Ed Balls was branded a scaremonger, and even a fantasist, by many right-wing and centrist commentators for warning in his Bloomberg speech of August 2010 that the coalition’s cuts programme would induce a severe slowdown in UK growth – and possibly even a ‘double dip’ recession – the evidence from the last eighteen months suggests that he was absolutely right. What we have seen so far is exactly what Balls feared: first, a huge reduction in real-terms consumer demand, actually predating the cuts programme, as confidence collapsed over the second half of 2010. This was then compounded by the depressing effects of large-scale spending cuts and tax rises in 2011 – much too far, much too fast. And George Osborne’s fiscal strategy for the next five years is simply more of the same.

The possibility that negative feedback effects from the rush to austerity might reduce growth was dismissed out of hand by the Coalition Government, but Keynes has had his revenge; the Government’s original fiscal plan has been blown out of the water. In the [Autumn Statement](#) in November 2011 George Osborne was forced to admit that the timetable for eliminating the ‘structural deficit’ had slipped by two years – to 2017 – only eighteen months after it was first set, because growth forecasts were falling well short of what the Office for Budget Responsibility had forecast in summer 2010. The OBR has, in my view, completely misdiagnosed this shortfall in growth, arguing that its *nominal* growth forecast was accurate, but that higher-than-expected price inflation caused a shortfall in *real* growth. This explanation is superficially correct but beside the point; the *real* growth rate is what matters for whether George Osborne’s austerity plans can succeed or not, and the UK Treasury’s macroeconomic model (which the OBR uses) appears to perform poorly in situations

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<sup>1</sup> While it is true that *In The Black Labour* opens with the (correct) observation that “while there is a major absence of private sector demand, the government must fill the gap: not just to keep the economy growing but to protect long-term fiscal sustainability”, unfortunately the rest of the discussion of fiscal policy in the paper proceeds as if in complete ignorance of this fact.

such as we are facing now, where the UK economy is in a depressed state, and conventional monetary policy has ceased to work properly because interest rates have almost hit zero. This economic situation is likely to persist for some time yet, and hence I would expect the OBR's growth forecasts to continue to be overoptimistic because there are fundamental problems with the operation of its forecasting model in the current situation. Given this, it would be no surprise at all if, for example, in the 2014 Autumn Statement, George Osborne were to announce that his plan to eliminate the 'structural deficit' has been pushed back to 2020.

There is a wider point to be made here about which party is the true custodian of fiscal responsibility (a less politically loaded term than "fiscal conservatism".) The authors of *ITBL* argue that "certainty and stability are genuinely prized economic possessions which HM Opposition should uphold as much as the Government": - a view it would be hard to disagree with. However, far from it being the Labour opposition which is "fiscally irresponsible", it is actually the Coalition Government which is creating additional uncertainty and instability on a grand scale. George Osborne has been forced into a major extension of his deficit reduction timetable only 18 months after taking office; and the co-ordinated austerity drive which David Cameron and Nick Clegg have enthusiastically recommended to other European governments as the solution to their fiscal woes has, instead, vastly exacerbated them. In this situation, it would be completely irresponsible for Ed Miliband, Ed Balls and the rest of the Labour front bench suddenly to endorse the Coalition's wrongheaded and counterproductive macroeconomic approach. Rather, Labour has a clear duty to the British public to highlight the manifest flaws of George Osborne's approach to economic management while providing a clear explanation of how Ed Balls would do things differently, and better.

### **Clouding the issue: Has *In the Black Labour* confused Labour's economic message?**

Given the trouble that the Coalition's deficit reduction programme has run into, it would seem ludicrous for Labour to jump on board the austerity bandwagon at just the point it seems to be coming off the rails. Until recently it was clear that both Eds realised this. For example, Ed Miliband said in his speech on 10<sup>th</sup> January:

*"As Ed Balls said, if there's a global hurricane brewing, you don't rip out the foundations of your house. But that's what George Osborne has done... We warned that trying to cut spending and raise taxes too far and too fast would make it harder to get that deficit down."*

However, Ed Balls's speech to the Fabian Society on 14<sup>th</sup> January featured an apparent shift in his position: still attacking the Coalition for cutting "too far, too fast", but also emphasising the need for tough measures on tax and spending. In particular Balls [argued very strongly](#) that Labour would not be able to reverse the Coalition's spending cuts if coming to power in 2015:

*"My starting point is, I am afraid, we are going to have to keep all these cuts. There is a big squeeze happening on budgets across the piece. The squeeze on defence spending, for instance, is £15bn by 2015. We are going to have to start from that*

*being the baseline. At this stage, we can make no commitments to reverse any of that, on spending or on tax. So I am being absolutely clear about that."*

There has been substantial debate in the Labour movement about how much of a concession to *ITBL* this new stance by Ed Balls is. On the one hand, one could argue that all Balls has done is spell out the reality of the situation Labour will inherit if it wins the 2015 election; with an economy damaged by five years of Coalition austerity measures, there will be very little spare money available for reversing spending cuts. On the other hand, it is not clear why Labour should have to take the particular distribution of spending cuts across departments and functions – or the particular balance of tax rises and spending cuts that the Coalition will bequeath to them in 2015 – as a given, rather than something that can be reworked and altered by an incoming Labour Government. Ed Balls' new strategy of accepting Coalition spending cuts as a *fait accompli* risks making it look like Labour has wholly accepted George Osborne's fiscal strategy – demoralising Labour Party supporters who are fighting against them while allowing the Conservatives to dictate the terms of the economic debate. The gleeful reaction from Conservative sources to Balls' speech on 14<sup>th</sup> January underlines this danger; the line coming out of Tory Press HQ was that Labour had, after a long period of denial, fallen in with the Government's line on the economy. Meanwhile, Balls' rhetorical shift angered key financial backers such as Unite's Len McCluskey, whose support Labour will need if it is to have any hope of fighting an effective election campaign in 2015. Labour now seems to be in a confused position in terms of its attitude to Coalition spending cuts, and to the extent that *In the Black Labour* precipitated Balls' change of emphasis, it has probably done more harm than good.

### **The rise of the technocracy? Rewriting fiscal rules and the role of the OBR**

To be sure, part of Labour's task in opposition must be to set out a credible alternative fiscal framework to be implemented on its return to office. *ITBL* argues that New Labour's "Golden Rule" on the public finances – that current spending in the public finances should be in balance over the business cycle – was insufficiently rigorous because the Treasury decided on the definition of the cycle, and this allowed Gordon Brown to fudge the rule. This is certainly a valid criticism of New Labour's approach. However, the loophole could easily be closed by handing responsibility for the definition of the cycle to the Office for Budget Responsibility. Once the scope for fudging the rule has been eliminated in this way, the "Golden Rule" looks like a sensible approach, and crucially, one which allows the Government to borrow to invest in infrastructure and capital projects – which is essential if sustainable economic prosperity is to be achieved in the UK.

In particular, I would argue that a cycle-based rule like the Golden Rule is more sensible than 'balanced-budget' rules which completely ignore the natural pro-cyclicality of the government's fiscal position. The Golden Rule is also preferable to rules which focus directly on avoiding a 'structural deficit.' As explained in *Plan B*, the structural deficit is something of an economic "will-o-the-wisp" – there is huge debate at the moment about how large the UK's structural deficit actually is, and in recent Budgets, estimates of it have varied drastically from year to year. This makes the 'structural deficit' an ill-suited target against which to measure fiscal rectitude.

Besides the choice of fiscal rules, *ITBL* suggests that the next Labour Government should greatly expand the powers of the OBR, allowing it to audit the government's tax and spending plans and produce warnings about whether the government is on target to meet its fiscal rules, as well as producing alternative proposals for securing fiscal targets and to make recommendations about these. There is certainly merit in producing an independent audit of the government's fiscal plans, and this is preferable to the opacity of the Treasury's internal forecasting procedures under previous UK governments including New Labour. I would recommend that the next Labour Government "open sources" the OBR, making its macroeconomic forecasting model and the microsimulation models it uses to forecast the fiscal effects of tax and benefit reforms available to outside researchers<sup>2</sup>. This would allow complete openness and transparency in the policy-making process, as well as exposing the OBR modelling to commentary and criticism from experts in academia and other policy analysis networks.

As for whether the OBR should produce its own set of alternative fiscal proposals, I would argue that this is dangerous because it risks elevating the OBR to a technocratic "alternative government" producing fiscal policy very much along the lines of what we are currently seeing in Greece and Italy, where fiscal policy is made by unelected experts who bypass democratic safeguards. Instead, it would make more sense for the government to allow the OBR's modelling facilities to be used by outside researchers to run simulations of alternative policies. This would be "open government" in the best sense of the term.

### **Structural reform *plus*' tax and spend' equals the good society**

Moving beyond the immediate argument about the fiscal deficit, *In the Black Labour* and *Plan B* both agree that structural economic reforms are an essential part of delivering the good society. *ITBL* states that:

*"in the coming decade, the extra resources New Labour found to compensate for market-based inequality won't be available. So deeper and more ambitious reforms must be confronted to ensure the economy works for working people."*

In this context, *ITBL*'s suggestion that public spending should be subjected to an across-the-board "zero budgeting" process, whereby each item of spending is evaluated from scratch according to its merits, is certainly preferable to the Coalition's "salami-slicing" approach. However, the metric by which spending is evaluated needs to be progressive, not regressive. I disagree strongly with the *ITBL* authors' view that public spending measures should be evaluated solely, or even primarily, in terms of their impact on growth and jobs. One of the key messages of *Plan B* was that policymakers need to consider the impact of policy measures on wellbeing and the quality of life and work, as well as taking into account environmental constraints and the pressing need to move quickly towards a low-

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<sup>2</sup> Due to data confidentiality issues, any outputs based on individual data would of course have to be anonymised.

carbon economy. Furthermore, an equitable distribution of wellbeing and work is as important – indeed, more important – than simply increasing its overall quantity. This has to include narrowing the gap between rich and poor, and reducing gender inequalities. Simply calling for “more growth” and “more jobs” would do nothing to differentiate Labour from the right wing of the Conservative Party – or indeed the far-right Tea Party in the United States, all of whom say they are in favour of both these things, while caring little if at all about increased inequalities or environmental degradation.

Sadly, environmental constraints do not feature in *ITBL* at all, and distributional issues almost not at all. While the paper’s title refers to “social justice”, two of the areas of current spending which are most pro-poor in distributional terms – healthcare and social security – are most in line for being heavily squeezed under *ITBL*’s recommended approach. It is extremely hard to reconcile *ITBL*’s spending priorities with a left-of-centre conception of social justice.

It is also important to be clear about the limitations of what structural reforms “to ensure the economy works for working people”, as *ITBL* and *Plan B* both argue for, can achieve. For example, it is true that one of the key drivers of increased inequality in household disposable incomes since the 1970s has been a huge increase in the inequality of earnings. But even if a future Labour Government is able to reduce gross earnings inequality substantially – for example, by implementing a living wage to increase earnings at the bottom, and building on the High Pay Commission recommendations to reduce unjust rewards at the very top – the UK tax and benefit system will still have a lot of work to do to temper huge raw market inequalities to reach an acceptable level of inequality in net incomes. An important and unavoidable reason for this is that *large numbers of the poorest people are not able to work*, even if and when the economy reaches full employment. This includes retired people, the severely disabled and children (of course, the parents of children are often able to work, but low wages mean that many working families with children are still in poverty, even at wages above National Minimum Wage – a key reason why New Labour’s tax credit and childcare subsidies programme, now being gutted by the Coalition, was introduced.)

*ITBL* states that “welfare mechanisms are never preferable to a genuinely productive and balanced economy that raise the living standards of those on low and middle incomes.” This seems to suggest that if a future Labour Government got the economy right, the need for “welfare” would disappear. But this is a mirage. Any social democratic society – indeed, even the society the Coalition Government is trying to create – will rely substantially on redistribution via the tax-benefit system to secure social justice for pensioners, unemployed work-seekers, the sick and disabled, children and low-income working households. To suggest otherwise is disingenuous.

One important point to note in passing is that committing to a “zero budgeting” process, while an excellent idea, would make it much harder for Labour shadow ministers to produce, before the next election, a fully detailed and specific list of areas where they would make spending cuts if elected. This is because Labour’s recommendations for spending cuts would depend to a large extent on the findings of that zero-budgeting exercise, which would produce the first Comprehensive

Spending Review under an incoming Labour Government. However, this is not necessarily a bad thing – in fact, promising a full review of public spending as an alternative to “salami slicing” could be a very good way for Labour to neutralise the charge that it has been insufficiently rigorous about identifying cuts in advance of an election. It gives a clear and compelling reason for not pre-empting the findings of such a fundamental spending review. In addition, it would give Ed Balls an alternative to saying that Labour’s starting point is that all the Coalition cuts have to be kept – instead, Labour could argue that the Coalition’s current allocation of spending cuts is grossly inequitable and pledge to re-examine spending on different departments from scratch.

Finally, it is important to remember there are two ways to close a fiscal deficit when the economy is operating at full potential – one is to cut spending, the other is to raise taxes. *ITBL* appears to assume that cutting spending is always and everywhere the preferred route to fiscal balance, rather than raising more revenue via the tax system. But in fact, as [Nick Pearce of ippr](#) has pointed out, when last in Government “Labour got the tax – not spending – side of the tax-spend equation wrong”; for the most part its spending measures were highly effective at advancing social justice, but tax revenues came up persistently short. *Plan B*, and [earlier work by Compass](#), has identified plenty of options for raising revenue in a progressive and effective manner, thus showing how the next Labour Government could avoid New Labour’s under-taxation problem and in the process, achieve fiscal responsibility. It is therefore essential that the tax system is reviewed alongside spending commitments as part of an incoming Labour Government’s economic programme, and not treated as a separate, unconnected issue. As [Gavin Kelly of the Resolution Foundation](#) has recently pointed out, this means that distributional questions are going to be a central part of political discourse in a way in which they weren’t, mostly speaking, during the New Labour years. Today’s Labour politicians will need to navigate “a new and far harder course -- one which accepts, sooner or later, the need for clarity about who will be the winners and losers from Labour’s fiscal decisions, and the need to build widespread public consent for these choices.” This applies equally to the Conservatives, Liberal Democrats, Greens and Nationalists too. But once again, this isn’t a bad thing for Labour – provided it can frame the distributional questions on terms that are amenable to an inclusive discussion about what a modern social democracy should look like, rather than the minimal-state rhetoric of the neo-Thatcherite Conservatism, Orange Book Lib Dems, and the outer fringes of the Labour Party’s neo-Blairite hard right.

### **Avoiding the Tory trap by focusing on economic renewal**

Going beyond public spending, what should Labour’s wider economic strategy be for the next general election? The other recent Policy Network report, *Cameron’s Trap* by Gregg McClymont and Ben Jackson, makes an important contribution to the debate over wider economic strategy. It draws on evidence from the 1930s and 1980s to argue that, despite the current economic failure which the Conservative-led Government is presiding over, it is entirely possible for the Tories to win the 2015 election if they manage to convince the public that Labour would do an even worse job, with a negative campaign focusing on Labour’s economic shortcomings. This is

the strategy that worked all too well for the Tories in 1983, 1987 and 1992 – but McClymont and Jackson argue (rightly in my view) that the best way for Labour to rebut Tory attacks on the party's economic competence is to build credibility through a well-worked out, and activist, economic strategy:

*If Labour builds economic credibility it can mount an appeal that focuses on economic underperformance and squeezed incomes – and which, by focusing political argument around an activist state, forces the Conservatives away from talking about public spending on to less hospitable political terrain. This can prevent the Conservatives from succeeding in confining Labour to its core geographical and class constituencies, and allow the party to fashion an optimistic national appeal – based on hope and economic modernisation as opposed to the Conservatives' division and economic stagnation.*

Showing how an alternative progressive government – either a majority Labour government or Labour in coalition with the Lib Dems and/or other smaller parties – could deliver a clear alternative to Coalition economic failure was a key objective of Compass's *Plan B* report, which called for a short-term fiscal stimulus to prevent a double-dip recession and a self-defeating “downward spiral of austerity”, coupled with comprehensive reforms to the financial system, industrial policy, tax and benefit systems, and public spending. *Plan B* is very much in tune with the economic renewal theme of McClymont and Jackson's paper, but would also add the themes of environmental sustainability, equalities and social justice to the policy mix.

By contrast, although *In The Black Labour* contains some promising ideas in places, its core suggestion – that Labour accepts, in full and seemingly without question, the economic fallacies of “Osbornomics”, risks gifting the Tories an easy win at the 2015 election by allowing them completely to dictate the terms of the economic debate. To the extent that Ed Balls's recent shift in rhetoric on cuts looks like a concession to the Coalition, this process has already begun. Indeed I would go so far as to say that *In the Black Labour* is actually “White Flag Labour”; a tame surrender to the misguided economic policies currently wreaking havoc on the UK's economic and social fabric, rather than the well-worked-out and comprehensive fightback we so desperately need. At the moment Labour has an excellent critique of the deficiencies of George Osborne's economic strategy, but vanishingly little in terms of a positive alternative. Throwing away the critique, as *ITBL* recommends, would be silly. Instead, Labour desperately needs to build on it – and build on it in a progressive direction that puts equality, environmental sustainability and economic renewal centre stage. *Plan B* provides a good starting point for policy construction; as we head through 2012, Compass and other progressive organisations will be building on it.

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