



**The Centre for Economic Justice**

# **THERE IS AN ALTERNATIVE**

## **ENDING AUSTERITY IN THE UK**

**Harry Quilter-Pinner  
and Dean Hochlaf**

July 2019

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# SUMMARY

## ENDING THE 'CONSOLIDATION STATE'

The global financial crisis of 2007/08 had a significant impact on the UK's public finances. Since 2010/11, successive UK governments have chosen to impose a programme of austerity in an attempt to reduce the budget deficit. This period of austerity is set to be the longest pause in real terms spending growth on record. As a share of GDP, spending has fallen from 47 to 40 per cent – a faster decline than comparable European countries (and from a lower base). This is what the sociologist, Wolfgang Streeck, calls the 'consolidation state'.

There is a growing consensus that austerity has failed:

- **economically** – by taking demand out of the economy, right at the moment when firms and individuals were also tightening their belts as a result of the 2007/08 economic crash, cuts in government spending have stifled economic growth. The New Economics Foundation finds the UK's economy is about £100 billion smaller today than it would have been without the cuts
- **fiscally** – while the government did meet its objective of delivering a surplus on its current spending in 2018, this was two years later than planned (Giles 2018), and it looks likely to miss its objective to deliver an overall budget surplus by the middle of next parliament (Whittaker 2017). Likewise, debt as a percentage of GDP has risen every year since the onset of austerity (ibid)
- **socially** – many types of crimes are increasing (ONS 2018), life expectancy has stopped rising and inequalities in health are growing again (Marmot 2019). Over a million people a year are now using foodbanks (Trussell Trust 2019), rough sleeping has more than doubled (Economist 2018), and poverty has started to rise once again: one in three children and around one in five pensioners have now dropped below the poverty line (DWP 2019).

As a result, there is now a growing consensus that it is time to 'end austerity'. The challenge going forward is defining what this means in practice. Some commentators have argued that it simply means stopping any future cuts (Emmerson et al 2019). Others have gone further in arguing for a reversal of some of the cuts (such as on welfare) (Whittaker 2018). In truth, these are both limited definitions of ending austerity. Instead, as a society, we must use this moment to create a more fundamental shift away from the 'consolidation state' towards an 'investment state'.

## CREATING AN 'INVESTMENT STATE'

The starting point for such a shift must be a clear understanding of what we want the state to achieve. Building on IPPR's Commission on Economic Justice, we argue that we want a society that simultaneously delivers both prosperity and justice for everyone (CEJ 2018). To do this, the state must have a bigger role – and must invest more – in four killer 'social deficits': care, focused on the young and the old; skills, addressing low pay and productivity; health, in particular inequalities and rising mental ill-health; and security, to end poverty, growing levels of debt and economic insecurity.

Closing these 'social deficits' will require significant investment in our social security system and public services. The international evidence supports this argument. When we rank comparable countries – who on average spend £1,600

per head more on health, education and welfare – we find that, in terms of their social outcomes, the UK lags behind on most metrics. Notably, we have lower levels of life satisfaction, poorer health outcomes, higher levels of poverty and inequality, and average educational outcomes. There is also a growing evidence base that suggests higher levels of social investment can act as a catalyst rather than a drag on economic growth.

We therefore call on the UK government to commit to matching European levels of social spending. This could be achieved through incrementally increasing the size of the state by 0.7 percentage points per year – which would see spending rise from around 43 per cent of GDP today (when we factor in private pension spending) to around 48 per cent of GDP by 2030. As a result we would be able to spend an extra £280 per head on education, £450 per head on health and £930 per person on social protection than under the status quo. This demonstrates that delivering higher social spending is not only desirable but also achievable. If other European countries can do it, so can we.

But if we want to move towards an ‘investment state’ we will have to pay more tax. We estimate that as a society, we need to raise an additional £66 billion per year by the end of this parliament, rising to £119 billion by the point of convergence in 2025 and £124 billion by the end of the next parliament (except in the case of an economic downturn) in order to meet the average level of spending of our European neighbours. This may sound like a lot of money but it is far from impossible. We know this because other countries achieve it: on average, comparable European countries currently pay 41.8 per cent of GDP in taxes compared to 33.3 per cent in the UK in 2018. This assumes that we balance current spending on an ongoing basis and maintain the proportion of investment spending funded through borrowing.

We argue that to achieve this, policy makers will have to make two key shifts in policy.

- **People on middle incomes will have to feel that those on higher incomes are paying their fair share of taxation before they are willing to pay more themselves.** We therefore call for increases in corporation, wealth and income tax on high earners – together raising as much as £57 billion in revenues per year – in the short run. This is crucial because to achieve the scale of revenue increases needed in the long term, the middle classes will ultimately have to pay more tax: an ‘investment state’ cannot be funded by taxes on the wealthy alone.
- **Everybody – including those on middle and higher incomes – will need to benefit from high quality public services in order to create a coalition in favour of the ‘investment state’.** This will require a shift towards more universalist public services and welfare provision. We therefore call for the additional funding raised in the short term to be invested in universal childcare, social care and mental health provision – as well as reversing cuts to universal credit, adult education and public health. These priorities should be funded before more regressive universalist policies such as free tuition fees are considered.

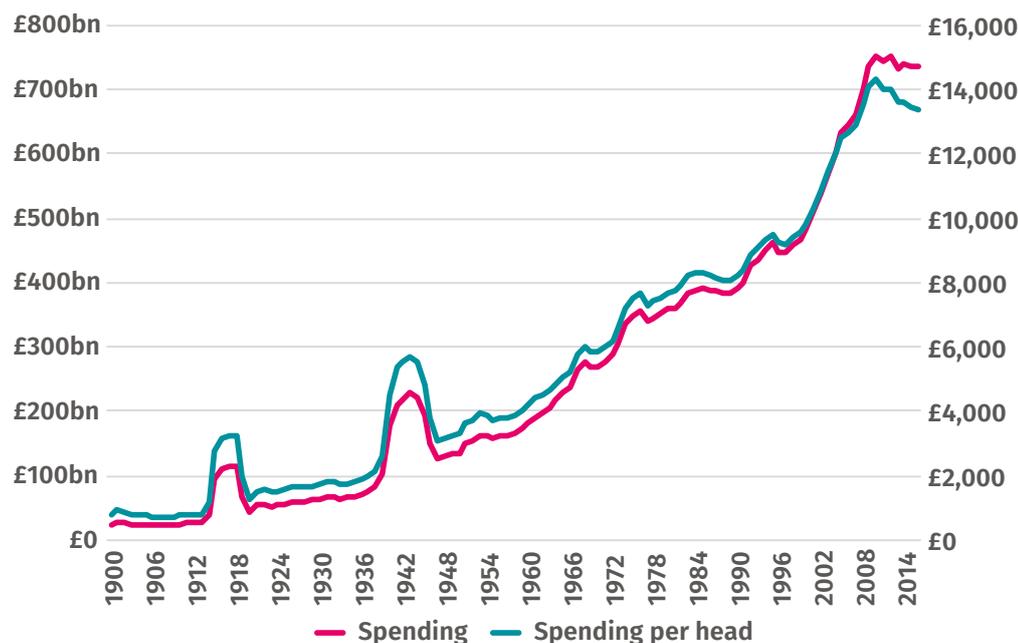
# 1. INTRODUCTION

## A BRIEF HISTORY OF AUSTERITY IN THE UK

The global financial crisis of 2007/08 had a significant impact on the UK's public finances, reducing tax receipts and increasing government expenditure on social security and bank bailouts. Since 2010/11, successive UK governments have therefore chosen to reduce the country's budget deficit – the size of government spending over and above its revenues – by imposing a programme of austerity: cutting government expenditure and, to a lesser extent, increasing taxes.

FIGURE 1.1

The UK has experienced the longest pause in real terms spending growth on record  
*Real terms government spending, total and per head*



Source: Bank of England (2019)

Overall this has not resulted in a dramatic decrease in public spending in absolute terms, which totalled just under £800 billion in 2010/11 and is forecast to be just over this figure in 2020/21 (see figure 1.1). However, this is still significant: post-2010 austerity is set to be the longest pause in real terms spending growth on record. Moreover, with the UK's population continuing to grow, spending per head has fallen, and is set to be 3.9 per cent lower in real terms by 2021/22 than it was in 2010/11. Likewise, as a share of GDP, spending has fallen from 47 per cent to 40 per cent.

The impact of this spending constraint has not been shared equally among government priorities and groups of people. Notably, successive governments have chosen to protect spending on the NHS, pensions and international development.

This has meant disproportionate cuts in public spending across other areas of government, notably, policing and prisons, local government services such as social care, public health and young people’s services, as well as most areas of education (see figure 1.2), with an average cut of 17 per cent across all departments between 2010/11 and 2019/20.

**FIGURE 1.2**

**Protection of some areas of spending have resulted in deeper cuts in other departments**  
*Cumulative real terms change in departmental spending, 2013–19*



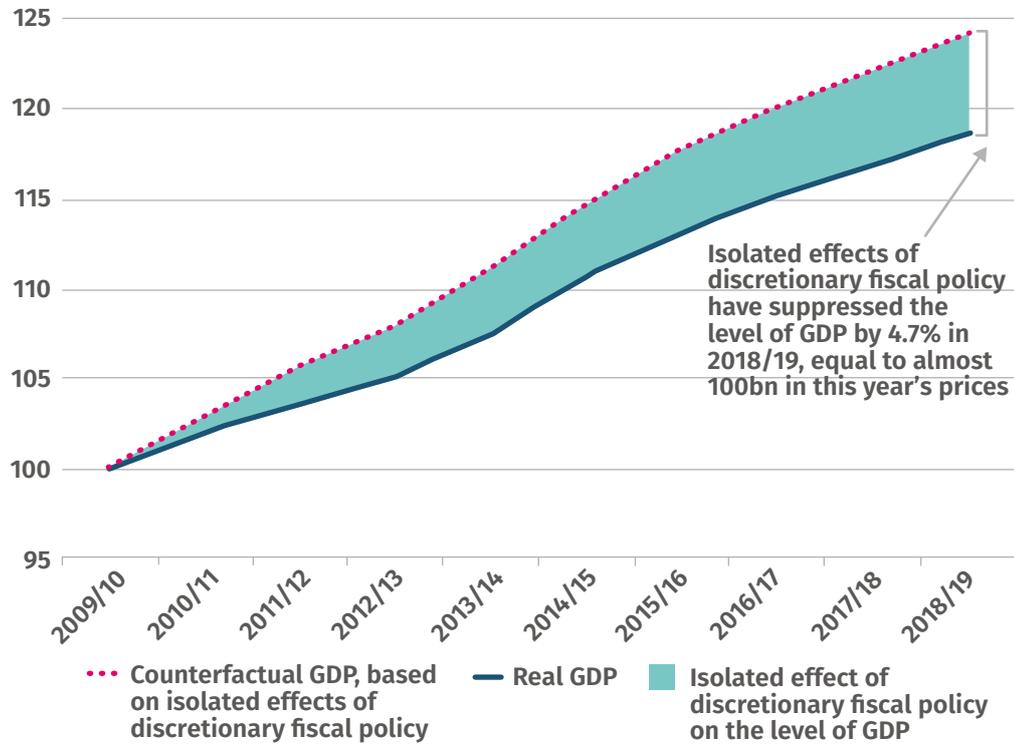
Source: HM Treasury (2018)

The evidence is increasingly clear that these cuts in expenditure have failed to deliver on the government’s original fiscal objectives. Notably, while it did meet its objective of delivering a surplus on its current spending (excluding capital spending) in 2018, this was two years later than planned (Giles 2018), and it looks likely to miss its objective to deliver an overall budget surplus by the middle of next parliament (already much later than originally planned) (Whittaker 2017). Likewise, debt as a percentage of GDP has risen every year since the onset of austerity (ibid).

This is unsurprising given the impact that austerity has had on economic growth. By taking demand out of the economy, right at the moment when firms and individuals were also tightening their belts as a result of the 2007/08 economic crash, cuts in government spending have stifled economic growth. Recent estimates from the New Economics Foundation – using numbers produced by the Office for Budget Responsibility – confirm this (Stirling 2019). They find that the cumulative effect of austerity has been to shrink the economy by £100 billion today compared to what it would have been without the cuts: that is worth around £3,600 per family in 2019/20 alone (ibid).

**FIGURE 1.3**

**Austerity has reduced economic growth since 2010 and every subsequent year**  
*GDP lost as a result of discretionary fiscal spending*



Source: Stirling (2019)

As lower growth has led to lower business profits and wages this, in turn, has resulted in less tax revenue, and has increased non-discretionary spending, such as unemployment benefits and tax credits (Krugman 2015). This has made reducing the fiscal deficit – the difference between what government spends and what revenue it raises – more difficult, even as discretionary spending has been cut. This lack of robust growth has also been one of the main drivers of the increases in debt as a percentage of GDP experienced over the last decade.

However, the most severe failings of austerity have not been fiscal or economic, but social. Many forms of crime are up (ONS 2018). Life expectancy has stopped rising and inequalities in health are growing again (Marmot 2019). Over a million people a year are now using foodbanks (Trussell Trust 2019), homelessness has more than doubled (Economist 2018), and poverty has started to rise once again: one-in-three children and around one in five pensioners have now dropped below the poverty line (DWP 2019). In the deluge of statistics, it is easy to lose sight of the fact that these are real people, families and communities, who rely on government support to get by.

Inevitably, these failures have also had significant political ramifications, with the general public appearing to have finally lost patience with austerity. The latest British Social Attitudes survey finds that support for higher taxes and spending has risen to 48 per cent, higher than at any time since 2004 (BSAS 2018). Eight in 10 people want more spending on the NHS, and seven in 10 on schools (ibid). Meanwhile, there is a growing academic literature linking the onset and impact of austerity with rising populism, including the Brexit vote in 2016 (Fetzer 2018).

As a result, there is now a growing consensus that it is time to ‘end austerity’. In the words of Theresa May, ‘the British people need to know that the end is in sight’. However, while the government has announced a new funding deal for the NHS, most other public services still face further cuts. For example, the Institute for Fiscal Studies (IFS) estimates that even if the government locks in a moderate overall spending increase over the next five years, because of commitments to protect certain areas of spending, the remaining ‘unprotected’ areas are facing an average annual cut of 0.4 per cent per year (Emmerson et al 2019).

The challenge going forward is defining what we mean by the ‘end of austerity’. Some commentators have argued that it simply means stopping any future cuts. For example, the IFS has argued that maintaining spending per head on ‘unprotected’ areas would cost around £5 billion by 2023–24, while maintaining these areas as a percentage of GDP would require £11 billion per year over the same time frame (ibid). Others have gone further, arguing for a reversal in some of the cuts (such as welfare) (Whittaker 2017). But in truth, these are both fairly limited definitions of ending austerity.

Instead, as a society, we must use this moment to have a more fundamental debate about the size and role of the state. And this must begin with an answer to a challenging but vitally important question: What do people want government, and in particular the welfare state, to achieve in the future? After all, no one wants more spending just for the sake of it; it is only desirable because it helps us deliver the investment, services and entitlements we need to achieve the kind of society we aspire to create.

Answering these questions will help us to understand what we want to spend on as a society. Historically, the NHS, schools and pensions have been the priority. As a result, they have been largely protected from austerity. But increasingly, people are also demanding high quality childcare, better access to social care, more police on the streets, greater investment in adult education, more affordable housing, better public transport and changes in university funding. Moving forward, we will have to make tough choices about which of these areas we want to prioritise and how much of our collective wealth we are willing to invest in them.

The most challenging questions in this debate will relate to how the welfare state should be funded in the future. The 2020s will see the number of people over 65 increase by 33 per cent and the number of over 85s will nearly double (Lawrence 2016). In this context, tax increases look inevitable, even just to maintain our existing services and entitlements. But which taxes should we increase, and by how much? How do we fairly share the cost of the welfare state between young and old, wealthy and poor, as well as individuals and corporations? What is our approach to the debt and the deficit? And, crucially, how do we win support for these changes among the general public?

This paper begins to answer some of these questions, with IPPR’s new Fairer Welfare Programme looking to build on this work in the future. We argue that for too long we have been told that there is no alternative (‘TINA’)<sup>1</sup>: that we cannot afford to spend more on the welfare state and that we must ‘tighten our belts’. But the truth is, with the mounting evidence that austerity has been bad for growth, bad for the deficit and bad for families and communities across the UK, we can hardly afford not to spend more. Instead, in the words of Wolfgang Streeck, we must make the transition from a ‘consolidation state’ to an ‘investment state’ (Streeck 2015).

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1 ‘There is no alternative’ (shortened to TINA) was a slogan used by Margaret Thatcher. The phrase was used to signify Thatcher’s claim that the market economy – including smaller government, lower taxes and free markets – is the only system that works.

## 2.

# THE 'INVESTMENT STATE'

### DELIVERING PROSPERITY AND JUSTICE

As the sociologist Wolfgang Streeck has argued, there have been three phases to welfare-capitalism across Europe and other Western nations in the last century. The first of these, known as the 'tax state', began after the second world war and saw the development of progressive taxation systems, Keynesian economic policy and the creation of the welfare state. The second, known as the 'debt state', began in the 1980s following the period of stagflation, and saw falling tax rates, reform and the privatisation of public services, and increasing levels of public and private debt in order to maintain living standards.

This phase ended as a result of the 2007/08 financial crisis and the 'Great Recession' which followed. It was replaced by the 'consolidation state'. As we set out in the introduction, this has seen governments cut back entitlements and public service spending, despite experiencing both growing and ageing populations, in a bid to reduce the debt and fiscal deficits. The UK has experienced one of the more severe fiscal contractions in the developed world.

In this chapter we make the case for a fourth shift away from the 'consolidation state' towards an 'investment state' which would see governments raise tax rates but also make the taxation system more progressive (ensure the wealthy contribute their fair share) to fund more generous social spending. This builds on the recommendations of IPPR's ground breaking Commission on Economic Justice (CEJ) (CEJ, 2018) which argued that we needed a shift to investment led growth in our economy.

The starting point for such a shift must be a clear understanding of what we want the state to achieve. Building on the work of the CEJ, we argue that we want a society that delivers both prosperity and justice for everyone. A shift away from a 'consolidation state' to an 'investment state' is a pre-requisite for delivering on these economic and social aspirations. In particular, we argue that we need sufficient investment in the welfare state in order to help us deliver four main objectives. These are as follows.

1. **Ensuring that everyone achieves a basic minimum standard of living**, meaning enough income to live, and access to the basic goods and services – such as housing, an education and healthcare – needed for a good life.
2. **Narrowing inequalities in wealth, income and power**, including redistribution across different geographies and groups of people (such as genders, races and classes).
3. **Unlocking the potential of all people and the wider economy** by maximising everyone's human capital and reducing barriers to people achieving their aims and ambitions.
4. **Creating a stable and cohesive society** by building shared spaces, institutions, identities and interests that enable relationships, trust and solidarity to develop.

There is now overwhelming evidence that we are falling short of these aspirations and that austerity has taken us further away from, rather than closer to, achieving them. Turning this around is no simple task. It will not happen overnight, but it is far from impossible. Over the last century humans have radically reduced poverty across the globe, cured some of the deadliest diseases and doubled life

expectancy, and invented the internet and other digital technologies that were previously unimaginable. Bigger and better government – through the funding of research and development (Mazzucato 2011), the creation of the welfare state (Deaton 2001), and by the setting of rules and regulations that shape and manage markets – has played a key role in all of these achievements.

As we look ahead to the challenges of the rest of the 21st century, we must once again fully marshal the power of government, alongside businesses and civil society, to deliver a more prosperous and just country. But to achieve this – and the four overarching goals of welfare policy set out above – we argue that the government must address four killer ‘social deficits’. These are the ‘care deficit’, the ‘skills deficit’, the ‘health deficit’ and the ‘security deficit’. These deficits (set out in more detail below) speak to the failings of our existing welfare state as well as the priorities for reform going forward. While politicians have been focused on the fiscal deficit, it is these social deficits that have been keeping most ordinary people up at night.

### THE UK'S FOUR SOCIAL DEFICITS

- 1. The care deficit.** Caring responsibilities in the UK, for both young and old, often fall to family or friends. Huge cuts in social care funding and underinvestment in childcare create inequalities in who receives care and the quality of that care, which reduces dignity and limits potential. There are 1.4 million people aged over 65 who face unmet social care needs, over double the number in 2010 (Age UK 2018). There are many more who rely on informal care – which is valued at over £132 billion annually (Buckner and Yeandle 2015) and has grown rapidly since the crisis – with the overwhelming majority of this care provided by women.
- 2. The skills deficit.** A combination of technological change and globalisation is fundamentally re-shaping the labour market, with polarisation of the workforce between high skilled, high pay and low skilled, low pay jobs. The latter are increasingly susceptible to automation, putting up to 44 per cent of jobs in the UK economy at risk (Lawrence et al 2017). Avoiding rising unemployment and loss of skills will require a significant investment in education, training and ongoing development to help people gain employment and progress in the labour market (Dromey and McNeil 2017).
- 3. The health deficit.** Life expectancy has consistently risen over the last century, but since 2010 this trend has stalled in the UK (Marmot 2019). Health inequalities are also growing, with the poorest in society living 8.4 years less than the richest. Meanwhile, on average, each of us will live nearly one fifth of our life in ill health (PHE 2017). A particular challenge is mental ill health which effects one in four of us every year and costs the economy nearly £100 billion per annum (OECD 2018a). We need more investment in prevention, public health, the social determinants of health and the NHS to address these challenges.
- 4. The security deficit.** Our social security system has become increasingly patchy with poverty for both children and pensioners rising again – poverty now encompasses 30 per cent of children (up from 27 per cent in 2010) and 16 per cent of pensioners (up from 14 per cent in 2010) (DWP 2019). Shockingly, a majority of people in poverty live with an adult in paid work. Work for many is increasingly insecure, with one in nine people in insecure work such as agency work, zero-hour contracts and low paid self-employment (TUC 2018). As a result, household debt has increased rapidly and more than a million people are now forced to rely on foodbanks to survive (Trussell Trust 2019). This is both morally wrong and economically costly and will require additional investment into our social security system.

Closing these social deficits will require significant additional investment to be made available to our social security system and public services, alongside bold reform to the workings of these institutions. We argue that, in terms of Gøsta Esping-Andersen’s ‘worlds of welfare capitalism’ framework, it will require the UK to move from a ‘liberal regime’ – that is, a modest and means-tested system aimed at providing a basic minimum – towards a ‘social democratic’ one. Usually associated with Northern Europe, this system provides more generous and more universal support aimed at delivering a more equal society (Esping-Anderson 1990).

The international evidence supports this argument. When we rank comparable countries in terms of their social outcomes<sup>2</sup> we find that the UK lags behind on most metrics (see table 2.1). Notably, though we do outperform our neighbours in terms of employment outcomes, we have lower levels of life satisfaction, poorer health outcomes, higher levels of poverty and inequality, and average educational outcomes.

**TABLE 2.1**  
Social outcomes rankings between comparator European countries

Social outcome	Ranking (out of 11)
Life satisfaction	8
PISA score	6
Educational attainment	6
Life expectancy	9
Preventable life years lost	9
Mental health prevalence (low income)	9
Poverty rate	9
Child poverty	7
Inequality (Gini)	11
Long term unemployment	2
Insecure employment	4

Source: OECD (2019a)

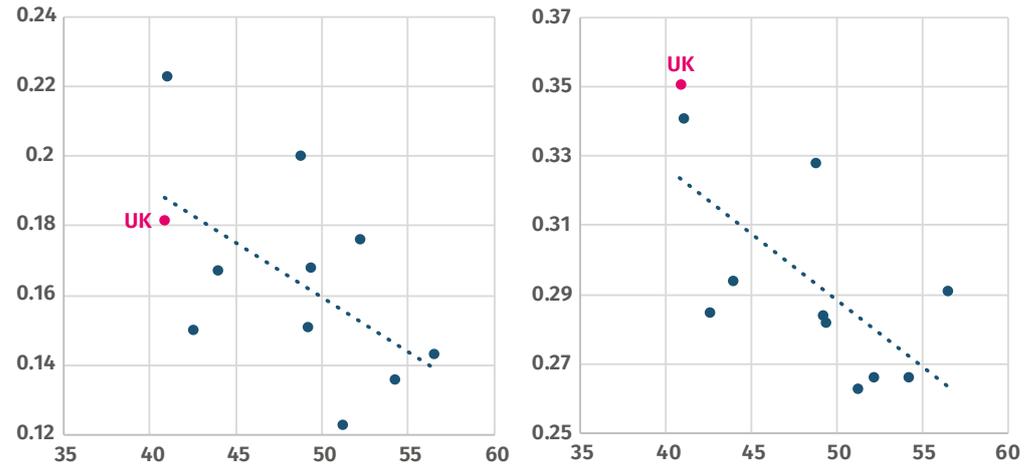
These outcomes are determined by a myriad of different factors which are difficult to prove. However, there is evidence that suggests that they are linked to the level of investment in public services and social security. Notably, we can observe a strong negative correlation between government spending as a share of GDP and both poverty and inequality rates across countries (see figure 2.1 and 2.2). This is likely to be because countries with higher levels of government spending redistribute that spending more between rich and poor (see figure 2.3). Similarly, there is a (less clear) positive correlation between government spending and educational

<sup>2</sup> We looked at three criteria: GDP per capital between \$30,000 and \$60,000; reasonable population size (more than 5 million people); and similar cultural and political histories (European, excluding ex-Soviet Union dominated countries).

outcomes (figure 2.4), and a negative link between spending and some health outcomes, particularly mental health (figure 2.5). There is no clear link between government spending or social security spending (as a percentage of GDP) and employment outcomes (despite economic theory suggesting that there should be) (figure 2.6).

**FIGURES 2.1 AND 2.2**

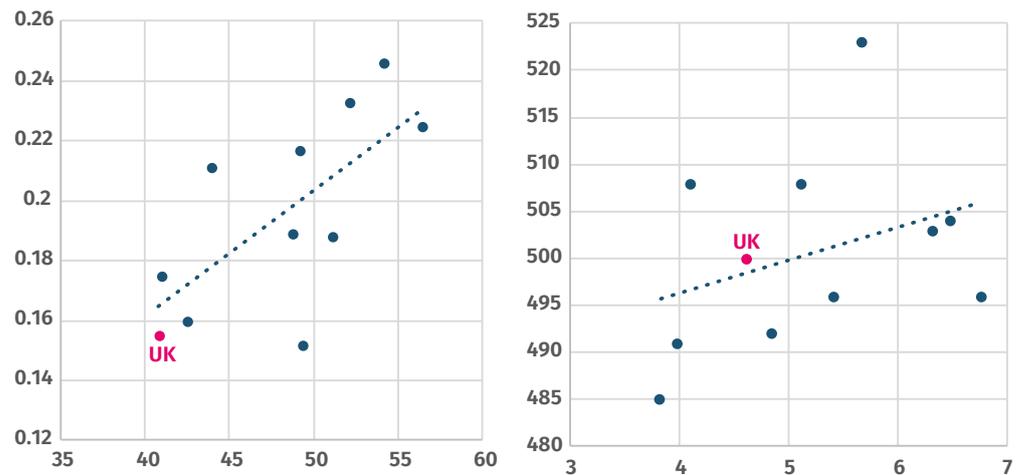
**Government spending (% of GDP) against poverty rates (% , left) and inequality (Gini, after tax and benefits, right)**



Source: OECD (2019a)

**FIGURES 2.3 AND 2.4**

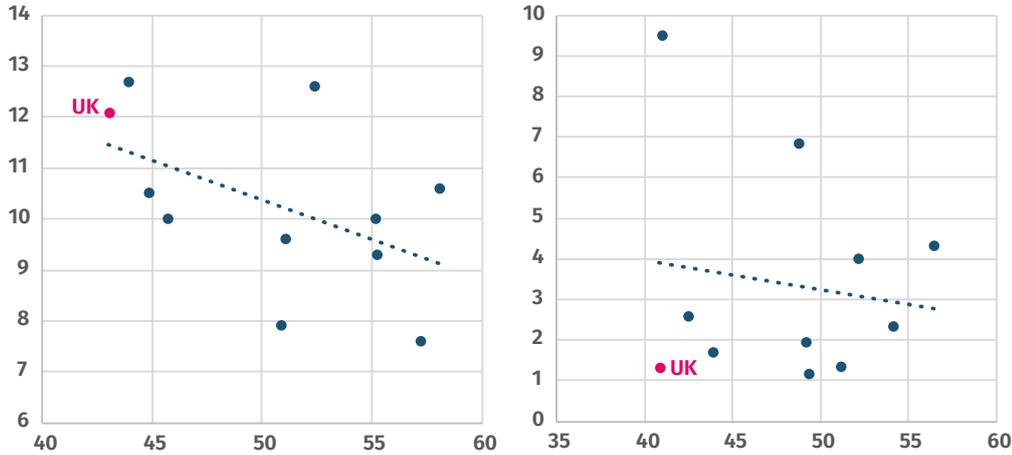
**Government spending (% of GDP) against level of redistribution (difference between market and post redistribution Gini, left) and education spending (% of GDP against PISA outcomes, right)**



Source: OECD (2019a)

**FIGURES 2.5 AND 2.6**

**Government spending (% of GDP) and mental health prevalence (% of low income people, left) (2014 data) and long term unemployment rates (% of total labour force, right)**



Source: OECD (2019a)

This all implies that more government spending could help deliver a more socially just society. However, the case for higher levels of social investment is not just about social justice – it is about economic prosperity too. While historically, economic theory has claimed that more government spending leads to lower economic growth by reducing the incentive for people to work and crowding out private sector investment (Bergh and Henrekson 2011), there is growing evidence which suggests that this is not a universal rule. Notably, it is increasingly clear that funding care, skills, health and welfare – what is often jointly called ‘social infrastructure’ – is an investment like any other, with an economic return which can drive improvements in growth.

In the long run there is a strong supply-side effect of this investment. Spending on education (Barro 2001), adult skills (Aznar et al 2015) and health (Cylus et al 2018) is an investment in human capital which drives higher productivity and therefore higher economic growth. There is also evidence that investments in care – in particular childcare – can improve outcomes for children (also an improvement in human capital) and increase female labour force participation: both of which should drive increases in economic growth (Brewer et al 2016; Ben-Galim 2011). Moreover, a recent IMF study suggests that investments in social security may be beneficial for growth (given growing evidence of the negative link between inequality and growth) (Ostry et al 2014).

If we combine these effects, there is evidence to suggest that a 1 percentage point increase in ‘social infrastructure’ (public spending on health and social care and education as a ratio to GDP) increases productivity (output per hour) in the rest of the economy by 3.3 per cent in the medium term (Onaran et al 2019). Of course, this does not imply that all social investment will always be productive: it must be well targeted and invested in efficient delivery systems, and it is likely to deliver diminishing returns. But it does suggest that social investment can be a crucial element of an effective growth and productivity strategy, particularly in circumstances where there is strong evidence of weak social and human capital linked to underinvestment, as there is in the UK.

There is also growing evidence that higher social investment can drive economic growth in the short run when the economy has insufficient demand (defined as an 'output gap' in economic literature – meaning a gap between actual and potential output). Notably, the Women's Budget Group demonstrates that investment in social infrastructure, just like spending on physical infrastructure, is associated with a positive multiplier and job creation (particularly for women) (De Henau et al 2016). Given that most reputable sources argue that the UK is still facing a negative output gap (HM Treasury 2018), this implies that more spending on social investment could drive increases in growth now and in the future.

### 3.

## PUBLIC SPENDING IN THE 2020s

As we established in the previous chapter, higher levels of social investment are not just desirable, but is also achievable. However, determining the ideal level of government spending to address the social deficits set out earlier is a tricky task, requiring a fully costed manifesto for each of the four areas of policy. Over the coming months, this is what IPPR's new Fairer Welfare Programme will look to do. But in the meantime, we can get a sense of the scale of spending that might be necessary by looking at other developed economies.

Using three main criteria – GDP per capital between \$30,000 and \$60,000, reasonable population size (more than 5 million people), and similar cultural and political histories (European, excluding ex-Soviet Union dominated countries) – we can identify a group of European countries broadly comparable to the UK. This comprises Austria, Belgium, Denmark, Finland, France, Germany, Italy, Netherlands, Spain and Sweden. We can then isolate their spending patterns, in terms of both quantity and allocation, and compare them to the UK. The results, as set out below, are illuminating.

Government spending has faced a turbulent few decades. The advent of the millennium kick started a steady and sustained increase in spending in the UK. As a proportion of GDP, government spending rose from 35.4 per cent in 2000 to 41.2 per cent by the end of 2005 (see figure 3.1). The financial crisis and severe recession which followed several years later caused spending as a proportion of GDP to rise further and faster. In part, this was a consequence of a shrinking economy, but also as a result of an increase in spending in the form of bank bailouts and automatic stabilisers, such as unemployment benefits.

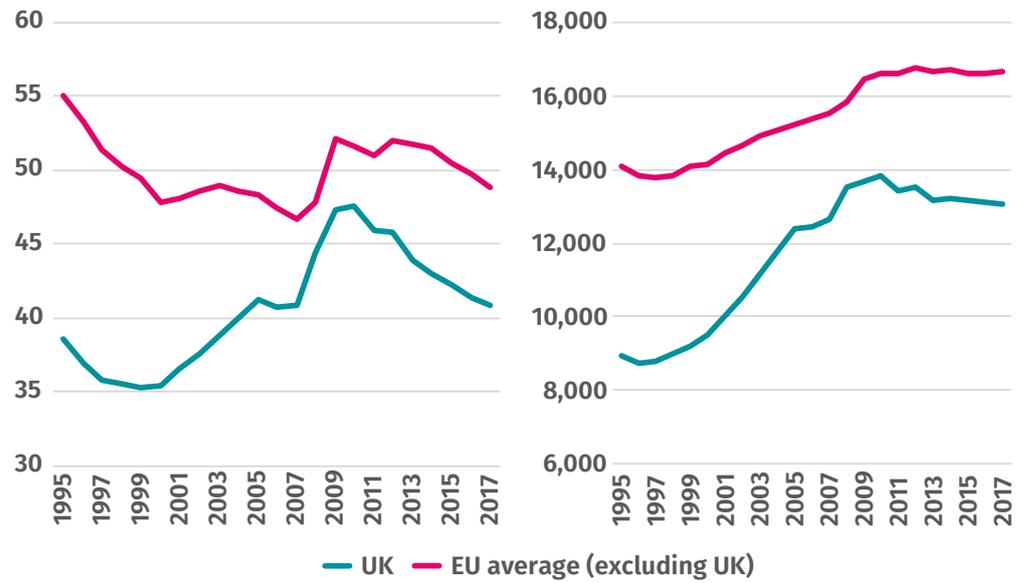
This increase in spending – as well as the fall in economic growth – contributed to a marked rise of the national debt as a proportion of GDP, which became the focal issue of the 2010 general election. A programme of austerity to reduce the fiscal deficit and national debt followed, and as a result, spending as a proportion of GDP has consistently declined since 2010, falling from around 48 per cent in 2010 to around 41 per cent as of 2017. This has also led to declines in spending per head which is £200 lower in 2017 than it was back in 2010.

Before the Great Recession, the UK was converging on levels of government spending with comparable European countries. This was partly the result of reductions in their spending – average spending across Europe fell sharply from 55 per cent in 1995 to 47.8 per cent in 2000 – but also increases in ours. However, since the recession, both Europe and the UK have followed a broadly similar pattern. The core difference is that in the UK, spending has declined at a much faster rate. Between 2010 and 2017, the size of the state shrank by 5.2 per cent on average in our comparator countries, compared to a 14.1 per cent reduction in the UK.

**FIGURES 3.1 AND 3.2**

**Government spending has been reduced more quickly in the UK than in comparable countries since 2010**

Government spending as % of GDP, UK vs comparator European countries (left) and government spending per head in £ (2019 prices), UK vs comparator European countries (right)

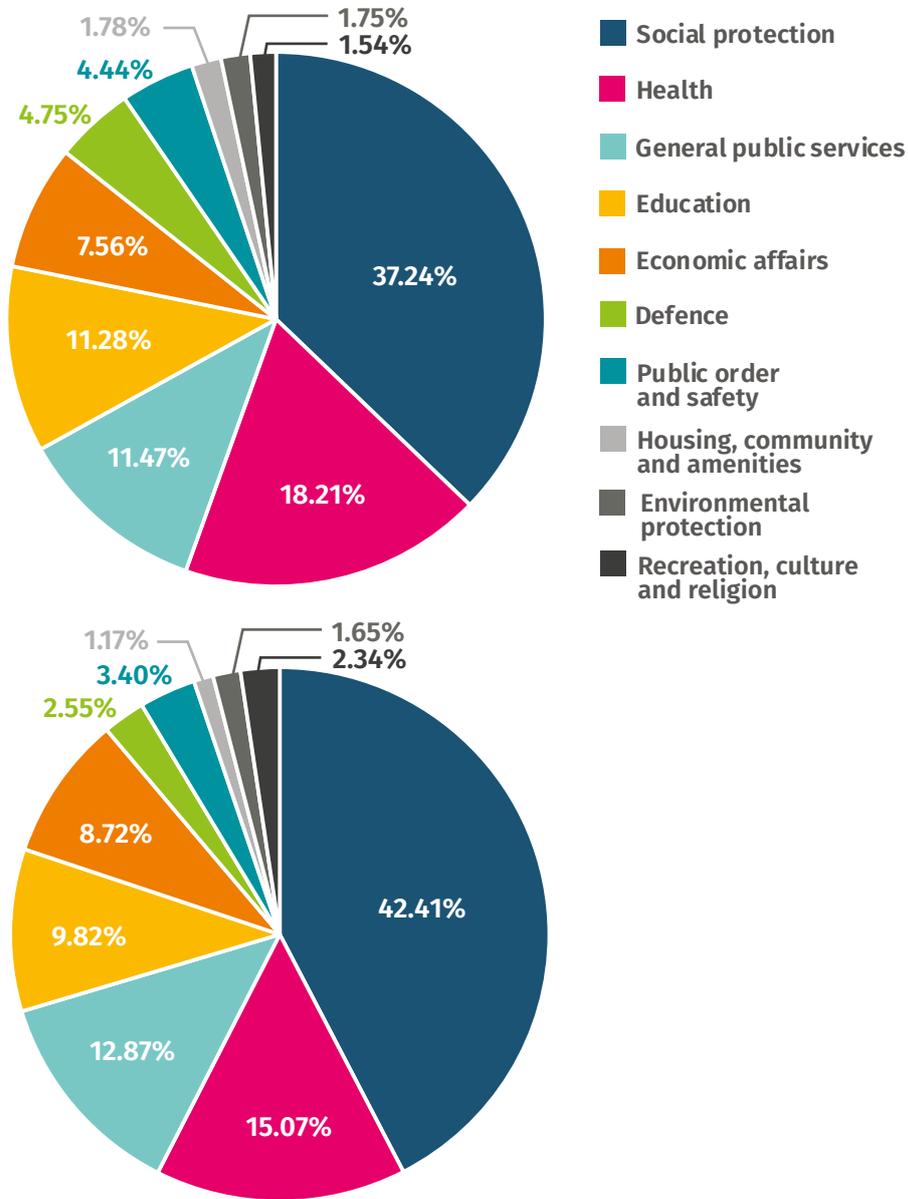


Source: OECD (2019c)

The allocation of these funds has remained relatively constant over the years. The largest component of spending by far is social protection, with spending on pensions, unemployment and other welfare benefits making up 37.2 per cent of total spend. Following this is health spending, which has risen from 13 per cent of total spending in 1995 to 18.2 per cent in 2017. This is in part driven by greater demand for health services, increasing costs associated with more advanced treatments and popular support. General public services and education follow, each making up 11 per cent of total spending as of 2017.

**FIGURES 3.3 AND 3.4**

**Breakdown of government spending by function in the UK (top) vs comparator European countries (bottom), 2017**



Source: OECD (2019c)

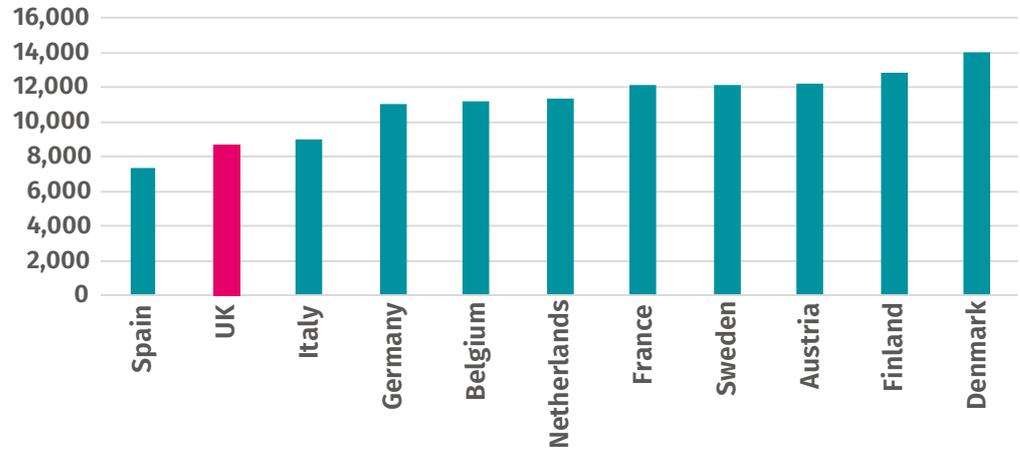
Our analysis shows that the UK has also fallen behind its comparators in terms of social spending which can be defined as social protection, health and education. In real terms<sup>3</sup> the UK spent approximately £8,710 per head on these three areas in 2017. This is more than Spain and comparable to Italy but significantly behind the other countries in this group. Indeed, there is a considerable jump of over £2,000 additional spend in the next lowest country, Germany, with eight countries spending in excess of £10,000 per head. If the UK were to match the average level of social spending across this group of comparator countries as a whole it would increase spending by £2,100 per head today.

3 Estimated valued based on 2019 prices.

**FIGURE 3.5**

**Social spending in the UK is lower than comparable countries in Europe**

*Social spending per head in real terms in the UK and comparator countries, 2017 (2019 prices)*



Source: OECD (2019c)

**PRIVATE SOCIAL SPENDING**

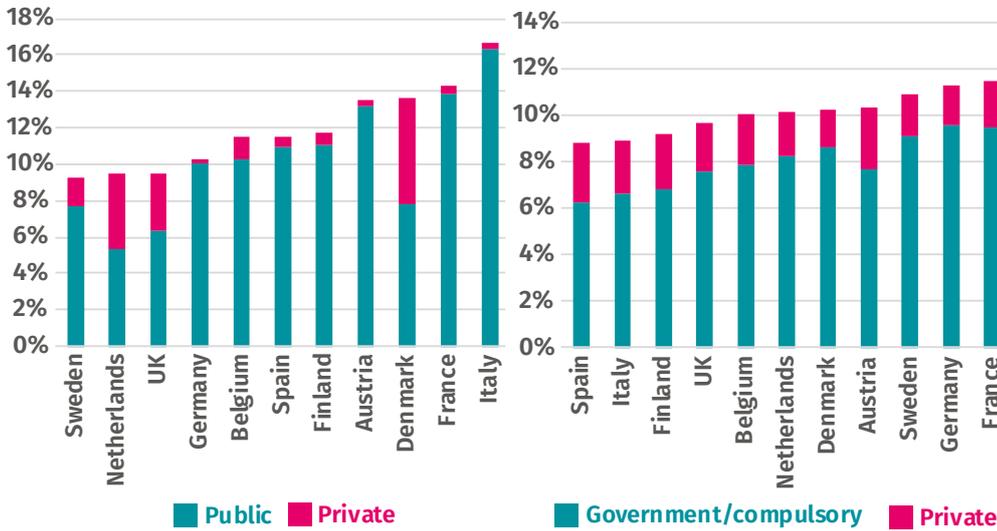
In most advanced countries, the state is the largest contributor to the provision of welfare and public services. However, there are many examples of private contributions being used to supplement public funding. This is particularly the case for pensions, healthcare and higher education:

- **Pensions:** In the UK, 76 per cent of UK employees are members of a workplace pension scheme as of 2018. This has a substantial impact on overall social protection funding. The latest data shows that the UK is one of the few countries in our sample where private contributions represent a substantial portion of total pension spending. Private contributions for pensions are equal to over 3 per cent of GDP in the UK. Bar the Netherlands and Denmark, this is much higher than other European nations where pension spend is exclusively dominated by the government (see figure 3.6).
- **Healthcare:** There is less variety when it comes to the provision of healthcare. Most countries have elements of private coverage, but they are relatively small and in proportion to government expenditure on health. However, it should be noted that some countries require compulsory contributions which are not recognised as government expenditure. Unlike the provision of pensions, where the UK has a far larger private market than comparable European nations, health provision and spending is predominantly the responsibility of government (see figure 3.7).
- **Higher education:** Tertiary education, which includes university education and apprenticeships, is funded predominantly through private contributions in the UK. This reflects the student loan system which has been adopted in the UK, where individuals are expected to borrow to finance higher education. Almost 75 per cent of tertiary education spending in the UK comes from private sources, in stark contrast to comparable European nations, where the average private contribution to tertiary education is only 17 per cent in total.

**FIGURES 3.6 AND 3.7**

**The UK has higher levels of private spending on pensions but lower on health relative to comparator countries**

% of GDP on public vs private spending on pensions (left) and healthcare (right) in the UK and comparator European countries

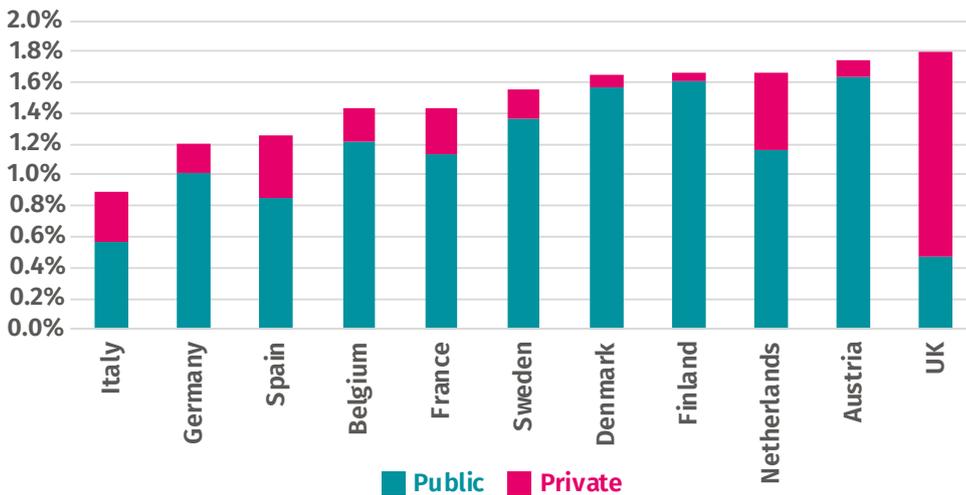


Source: OECD (2019c)

**FIGURE 3.8**

**The UK has higher levels of private tertiary education spend than comparator countries**

% of GDP on public vs private spending on higher education in the UK and comparator European countries



Source: OECD (2019c)

This raises questions about the aspirations for future UK spending. Given the existence of a developed private pension and higher education system in the UK, matching our comparator countries in terms of publicly funded social spending would mean spending more on social spending in total (both public and private) as a percentage of GDP than other countries. This implies that we should either

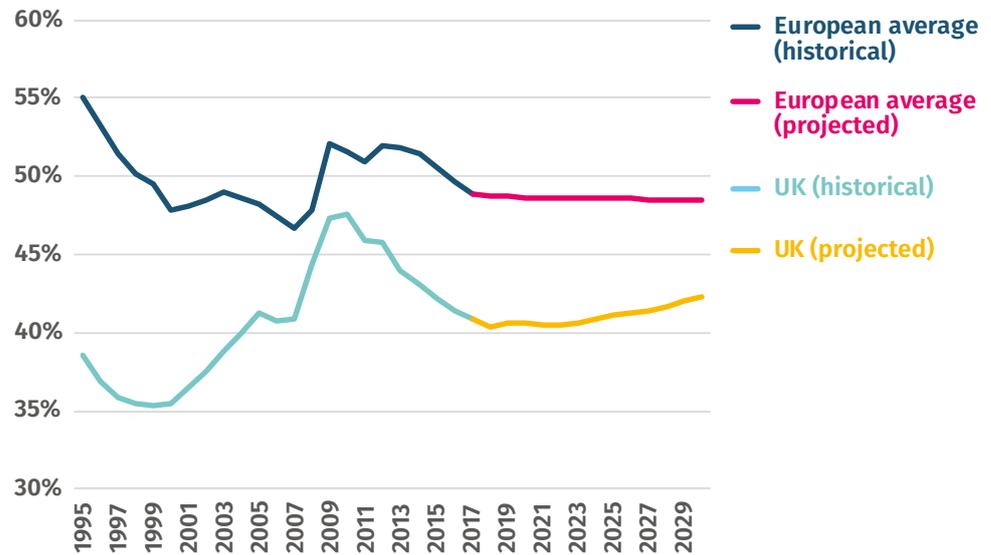
reduce publicly funded social spending to compensate for this, or reform our pensions and higher education system to match our European neighbours.

Based on existing government policy and the demographic pressures expected in the 2020s (which will particularly drive growth in pensions and healthcare), the Office of Budget Responsibility forecasts that spending in the UK will decrease further, to a low of around 37.9 per cent of GDP in 2021, before rising from 2021 onwards. Similar forecasts by the IMF for our comparator European countries suggest that spending will initially fall before rising very slowly, meaning that by 2030, we do not expect to see any significant change in the size of the state. This will see the gap between the level of spending in the UK and our European comparator countries narrow very slightly over the next decade.

**FIGURE 3.9**

**The gap between UK spending and comparator countries is set to narrow slightly over the coming years**

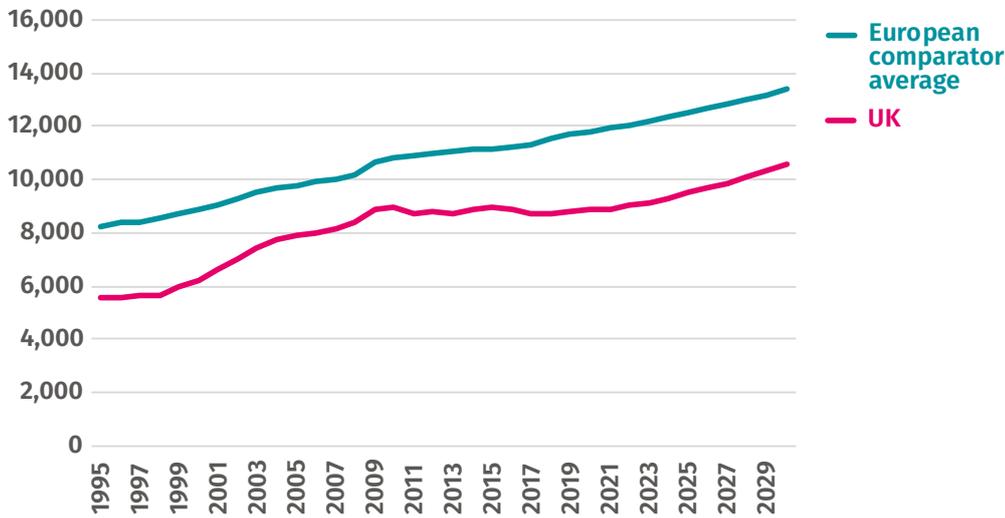
*Government spending forecasts under the status quo in the UK and European comparator countries as a percentage of GDP*



Source: OECD (2019c), OBR (2018) and authors' calculations

**FIGURE 3.10**

**The spending gap in the UK and comparator countries is set to remain fairly consistent**  
*Publicly funded social spending per head forecasts in the UK and comparator European countries*

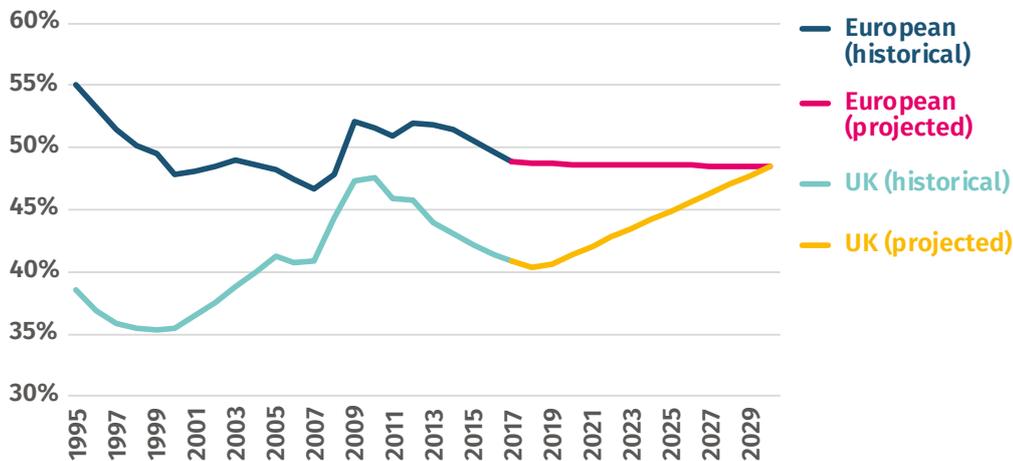


Source: OECD (2019c) and authors' analysis

However, as set out in the previous chapter, this status quo scenario is neither economically nor socially desirable. It doesn't have to be like this: there is an alternative. Our modelling shows that incremental increases of just 0.7 percentage points a year in the size of the state would close the gap by 2030. This would still see growth in government spending below the level seen under New Labour (2001–05). It would see spending hit 42.7 per cent of GDP by the end of the parliament in 2022, 46.3 per cent by 2027, and match the comparator levels of spending (48.4 per cent of GDP) by 2030 (see figure 3.11 below).

**FIGURE 3.11**

**The UK could match European levels of government spending in a decade**  
*Post-austerity government spending as a percentage of GDP forecasts in the UK and comparator European countries*



Source: OECD (2019c) and authors' calculations

As mentioned previously, the UK has a significant private pensions market which provides social support in lieu of government payment, which we might want to factor into our spending forecasts and target. Data between 2001 and 2013 suggests private pension contributions as a percentage of GDP rose at an average rate of 1.2 per cent. Assuming this growth continues and including private pension contributions, increasing government spending in line with GDP growth could see the UK and EU converge with European levels of spending as early as 2025.

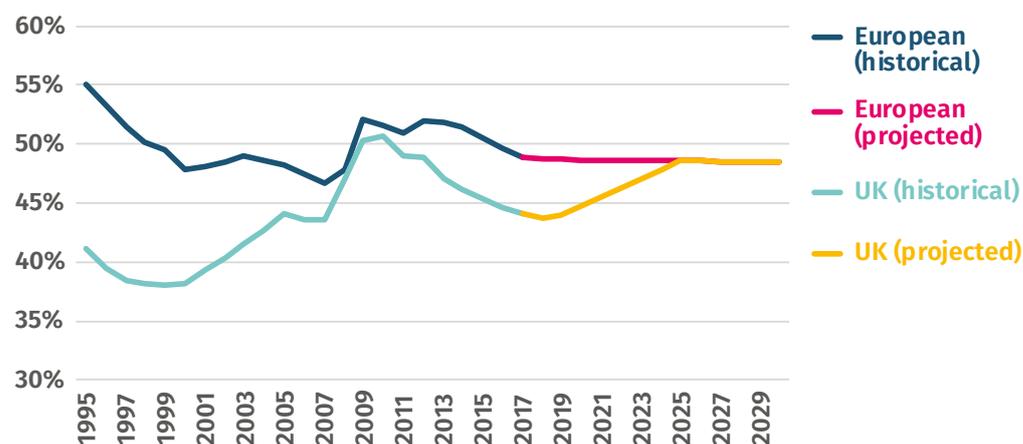
### INVESTING IT WISELY

The modelling above showing potential future spending increases set out the earliest possible date spending could be achieved based on realistic assumptions (such as incremental increases of just 0.7 percentage points a year). However, policy makers may want to ramp up additional investment more slowly to ensure that it is efficient, effective and equitable – so that additional spending really does deliver value for money for the tax payer. This idea is supported by evidence that some of the investment made during the New Labour years failed to deliver a fundamental transformation in outcomes and may have resulted in declines in public sector productivity (Toynbee and Walker 2011). Furthermore, there is likely to be numerous areas of public delivery where bottlenecks in delivery capacity – particularly regarding workforce numbers (in the health, education and caring sectors for example) – will constrain the pace at which new investments can be made.

**FIGURE 3.12**

**If private pensions are factored in this could be achieved even sooner**

*Post-austerity government spending as a percentage of GDP forecasts in the UK and comparator European countries, factoring in private pension spending*



Source: OECD (2019c) and authors' analysis

Achieving this increase in government spending would result in a significant boost for overall spending and social investment. If we factor in private spending on pensions as described above, we estimate that education spending would rise from £1,470 per head in 2018 to £1,755 by 2025 at the earliest possible point of convergence. Similarly, health spending would rise from £2,380 per head to £2,830 during the same period, while social protection spending would increase from £4,860 to £5,790 per head.

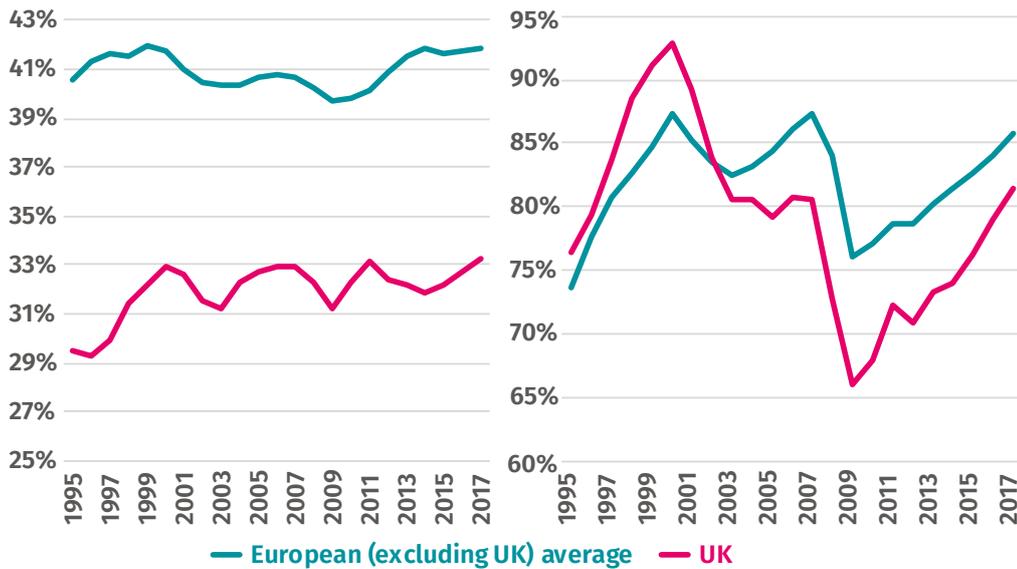
# 4. TAXATION IN THE 2020s

In the words of Benjamin Franklin, ‘nothing can be said to be certain, except death and taxes’. But actually, governments have – and consistently use – a range of methods for raising the revenue they need to fund public expenditure. Taxation is just one of four options available, the others being debt-financing, earned income, either through the return on or sale of assets, and money-financing. This chapter will focus on the first two policy levers – taxation and debt-financing – as these tend to make up the majority of government revenue (see figure 4.1). (An overview of the other funding channels is included in the information box below.)

**FIGURES 4.1 AND 4.2**

**Taxation has been and remains the main source of funding for the UK government**

*Tax as share of GDP (left) and as a share of total government spending over time (right) in the UK and comparator European countries*

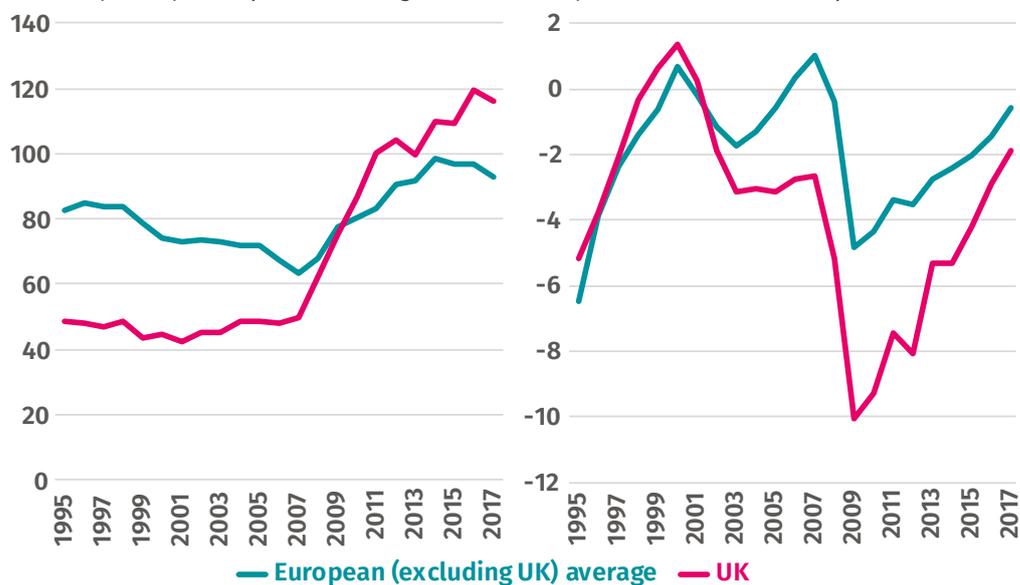


Source: OECD (2019c)

**FIGURE 4.3 AND 4.4**

**While the fiscal deficit has shrunk, debt has continued to rise over the last decade**

*Fiscal deficit (left) and public debt (right) as a share of GDP in the UK and comparator countries*



Source: OECD (2019c)

### EARNED INCOME

Government can fund spending through earned income. In recent decades the most obvious form of earned income has been privatisation, defined as the transfer of ownership of a company from the public to the private sector. From the 1980s until the mid-1990s, privatisation was an important component of economic policy (with some continuation of this in more recent times). Notable examples of privatisation include British Telecom (BT) and British Gas in the 1980s, British Rail in the 1990s and in more recent years, Royal Mail.

The main purpose of privatisation is not usually considered to be revenue raising. Instead, proponents have argued that privatisation – through the profit motive – makes organisations and services more efficient (though there is some controversy over whether this is really the case). However, privatisations do increase government revenues: between 1970 and 2015 major privatisations raised up to £11.8 billion per year (at their peak in 1991) (Hough et al 2014). However, this is dwarfed by the sale of land – with over 10 per cent of the UK’s total land changing hands from state to private since 1978 – worth up to £400 billion in total (Christophers 2018).

Putting aside the merits and disadvantages of privatisation in terms of ownership and efficiency, it is clear that it is not a sustainable way of resourcing the state. Once the revenue from an asset is spent it cannot be spent again, and the state’s stock of assets is limited and declining. However, this does not mean that earned income cannot contribute to how we fund government spending in the future. Some have proposed that revenues from nationalised industries or, more radically, the creation of a sovereign wealth fund – potentially capitalised through (desirable) asset sales, borrowing or taxation – could provide a sustainable source of revenue generation for the state (Roberts et al 2018).

## MONEY-FINANCE

There has been a growing debate amongst economists about whether money-financing – government spending funded not by issuing debt (government bonds), but simply by increasing the monetary base ('printing money') – is desirable. This can be achieved in a number of ways, each with varying degrees of risk and complexity (Turner 2015). One of the most talked about is helicopter money (sometimes referred to as 'people's quantitative easing'). In the modern context, this would see the central bank directly credit the government's account by creating a non interest bearing and non-redeemable asset 'due from government' on the other side of the balance sheet (ibid).

However, there are risks involved in this kind of money-finance: notably it could drive up inflation if people lose faith in the government's management of the currency and therefore the value of the currency, with opponents citing previous examples such as the Weimar Republic and Zimbabwe. However, a number of notable mainstream economists, including Adair Turner and Martin Wolf, have argued that money-finance can help stimulate aggregate demand in the economy, particularly in the context of the zero-lower bound on interest rates, and should therefore be part of our policy armoury. They argue that the risks could be managed if the use of money-finance were constrained by a robust institutional framework.

The balance between these two revenue sources has changed over time, with taxation declining as a proportion of total spending and debt rising since 2002 (though the real change occurs in 2007/08 and is associated with the financial crisis). This trend is more pronounced in the UK but is consistent across most of the countries we looked at. In the UK, this shift is a consequence of increased public spending – with pressures created by rising public expectations, changing demographics, new technologies and scientific advancements (particularly in health) – and tax revenues stagnating, having remained between 30 and 35 per cent of GDP for most of the last five decades.

While the size of the deficit has been reduced significantly since 2010 – and debt as a percentage of GDP is forecast to decline over the next two years – the fiscal challenge is due to re-emerge in the 2020s. Projections by the OBR show that without significant policy change, the primary budget deficit<sup>4</sup> will grow significantly over the coming decades which will also see debt as a percentage of GDP increasing again over the long run. This is primarily driven by an aging population, which increases both the cost of welfare and public services, but also by a declining share of working age people who contribute more in terms of tax. The OBR warns starkly that this is "an unsustainable fiscal position over the long term" (OBR 2018).

This all suggests that, regardless of any additional public spending as proposed in the previous chapter, we need a public debate about how we fund public spending. This was one of the key messages set out in IPPR's Commission on Economic Justice (CEJ 2018). The aim of this chapter is to start this debate by setting out the scale of the tax increases needed – and the shift in the make-up of the tax base desired – to address the fiscal challenges set out above, move towards an 'investment state' and fund the additional public spending that we argue is desirable in the coming decade.

This debate must begin by determining our approach to debt and the deficit: we need a set of fiscal rules that help us determine how much of the funding gap described earlier should be funded by taxation vis-à-vis debt. IPPR's recent

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4 The difference between non-interest revenues and spending.

Commission on Economic Justice report argued that our fiscal framework should include four main components (Stirling 2018a).

- **A current spending rule:** Under normal circumstances, averaged out over the economic cycle or a period of five years, governments should not borrow to pay for current spending (the so-called ‘golden rule’).
- **An investment rule:** Investment spending should be treated separately to current spending in deficit estimates, with borrowing levels determined by an assessment of how far the outlay will contribute to growth.<sup>5</sup>
- **A total debt rule:** A rolling five-year target for government debt as a proportion of GDP which is based on a longer-term target to maintain adequate ‘fiscal space.’<sup>6</sup>
- **A fiscal and monetary policy co-ordination rule:** The previous three rules should be temporarily suspended when monetary policy is constrained by the effective lower bound of interest rates.

What these rules imply for taxation and debt depend in part on how we define ‘investment’. Traditionally, investment has been synonymous with capital expenditure, which is primarily physical infrastructure (buildings, roads and so on). But as set out earlier, in a modern economy it is not only physical infrastructure which increases productive capacity and therefore supports future growth. This is also true of intangible investments, in particular the early years and education element of ‘social infrastructure’. In future, some proportion of this social infrastructure could therefore be classified as a form of investment, allowing government to fund it from borrowing instead of taxation (though this is not required in order to make the shift we are discussing in this paper).

### HOW MUCH IS TOO MUCH DEBT?

A number of influential studies have suggested that, beyond a certain level, government debt is unsustainable. Notably, renowned economists Kenneth Rogoff and Carmen Reinhert proposed that when debt exceeds 90 per cent of GDP it acts as a drag on growth and could result in a sovereign debt crisis (Reinhart and Rogoff 2009). However, there is a growing consensus that this theory is not correct (at least not universally). In fact, there is no correct level of debt: debt sustainability is determined by a range of factors including its maturity, who it is owed to (and especially what currency it is owed in) and which country is borrowing it (in particular the country’s historical record on borrowing and default) (Reinhart et al 2003).

More fundamentally, debt sustainability is determined by the difference between the interest rate paid on that debt and tax revenue growth. As long as the latter is higher than the former, debt is sustainable. This further highlights the point that what borrowing is spent on is also important for debt sustainability: it is desirable if it is invested productively and the rate of return is positive (higher than the interest rate). Economists are now therefore recognising that higher levels of debt may not be as concerning as we once thought, with even the IMF arguing that the UK has more ‘fiscal space’ to borrow (Ostry et al 2010).

For the purposes of this paper, we will adopt a more traditional definition of investment. This would put the burden of revenue raising onto the taxpayer, and we would estimate a revenue gap (the gap between our desired spending level

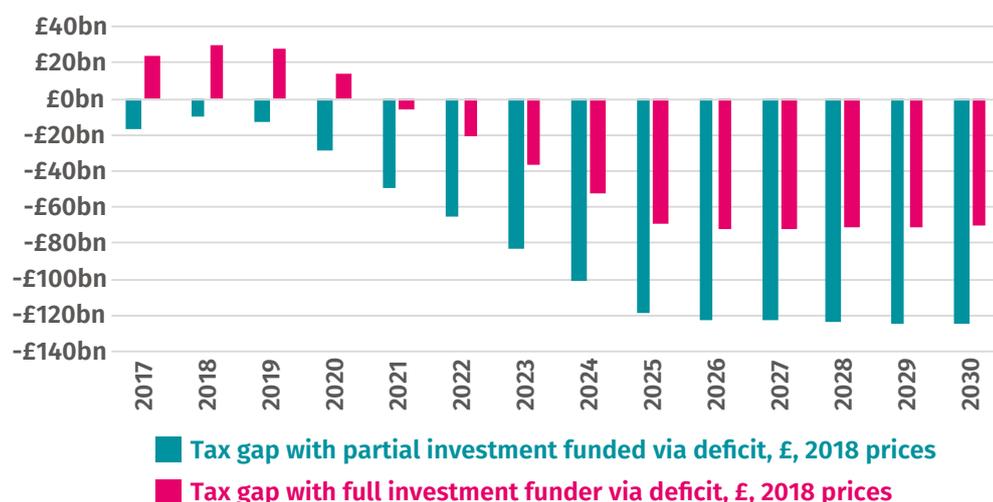
5 The extent to which the return on investment will exceed interest rate repayments.

6 Fiscal space is the difference between the debt limit historically experienced by a country and its current debt.

and status quo tax and other revenues) of £66 billion per year by the end of this parliament, £119 billion by 2025 – at which point we will meet the average level of spending of our comparator countries – and £124 billion by the end of the next parliament. Under this scenario, the UK would maintain a balance in terms of day-to-day spending and maintain the current proportion of investment spending funded through borrowing which would mean net debt could rise to 107 per cent of GDP, providing growth projections remain unchanged.<sup>7</sup>

We also estimate two further scenarios, where all expected investment spending is funded via the deficit and where we add primary and secondary education into investment spend (e.g. shifting some social investment into borrowing). In the former scenario, the tax gap by the end of this parliament would be £20 billion, by 2025 it would be £70 billion next parliament in 2027 would be £72 billion, with net debt rising to 117 per cent of GDP by this time. In the latter scenario, the UK would consistently run surpluses on day to day spending, but would run consistently high deficits and this would lead to net debt reaching 154 per cent of GDP by 2027.

**FIGURE 4.5**  
Revenue gap on day-to-day spending 2019–30 under two definitions of investment



Source: Authors' estimates

Our calculations demonstrate that, regardless of our definition of investment, as a country we will need to raise more tax in the future. The numbers set out above may sound unachievable, but comparisons with our European neighbours are once again informative. As we set out earlier (figure 4.1), comparable European countries raise significantly higher levels of taxation than the UK does, at 41.8 per cent of GDP compared with 33.3 per cent in the UK in 2018. Moving towards a higher tax, higher spend state is therefore achievable – and, as set out earlier, without an obvious trade off with economic growth.

Looking at other countries can also be instructive in terms of where this revenue is raised from. On average, across comparator countries, we find that the UK has significantly lower levels of taxation on labour (employee taxes). In fact, the UK is rare among comparable countries – and is the only country in the G7 – to have seen

<sup>7</sup> These projections assume that investment spending grows at the same pace as our overall spending settlement (eg 0.7 per cent per year). This is a smaller increase in investment than that recommended by the CEJ – an extra £15bn by 2022 (equivalent to an extra 0.8 per cent of GDP). Further increases in spending would need to be achieved on top of the settlement set out in this paper.

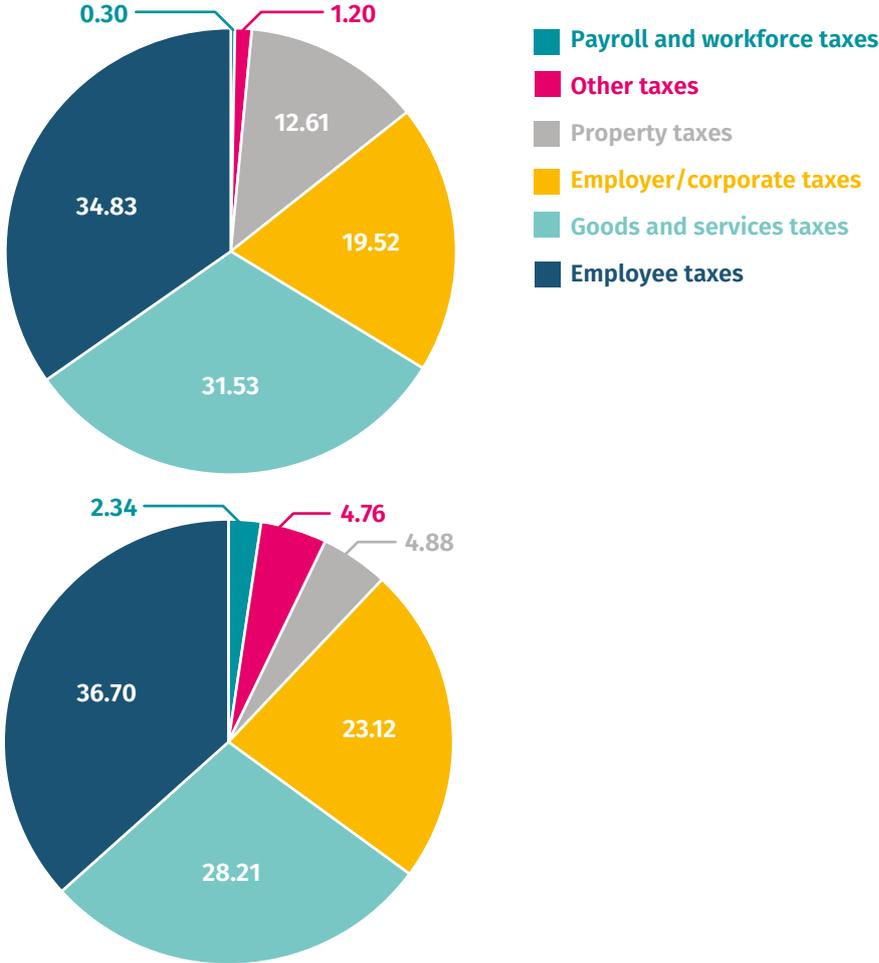
taxes on individuals' earned income fall as a proportion of all tax receipts over the past 50 years. This is partly a result of lower top rates of taxation (see figure 4.6), but is also due to more generous exemptions in the UK (notably personal allowance which has grown from £6,475 in 2009 to £12,500 today). Other countries also raise significantly higher rates of labour taxation through higher social contributions (not just on higher earners but also middle and lower earners as well).

Likewise, taxation on businesses in the UK are also lower than those on many of our European neighbours. This can be seen in terms of corporation tax, with the rate in the UK falling from 30 per cent in 2007 to 19 per cent today (with a further 2 percentage point decrease still planned), making it the lowest rate of all the countries in this study. Unsurprisingly, UK corporation tax receipts have been consistently lower than the OECD average since the early 2000s. However, employer contributions to social insurance are also lower, at 3.9 per cent of GDP in the UK compared to 6.8 per cent in comparable European countries. The UK also raises marginally less from consumption taxes but marginally more from wealth taxation; however consumption tax constitutes a larger proportion of UK tax revenue.

**FIGURES 4.6 AND 4.7**

**The UK raises a smaller share of taxation from labour and business than comparable European countries**

Share of taxation revenue by source in the UK (top) and comparator European countries (bottom) in 2017



Source: OECD (2019c)

These findings corroborate trends identified in the wider literature which suggest that countries with larger welfare states, notably the Nordic states, tend to have less progressive taxation systems (Steinmo 1993). Notably, numerous studies note that people on middle and lower incomes in these countries tend to make relatively higher contributions through labour taxes (especially social contributions) and consumption taxes on a wider set of goods (extending VAT on staple foods, for example, which are often exempt in the UK). In terms of a government's revenue raising objectives this makes a lot of sense: the wider the tax base (the more taxes are spread across a larger population or on a wider array of goods and assets), the more stable and sustainable revenues are likely to be.

However, replicating such a system, as it currently stands, in the UK would be a mistake. This is because taxation is also a key tool for achieving distributional objectives. A less progressive taxation system – and one that in particular asks middle class people to contribute more – can be justified in Nordic countries, where existing levels of inequality are low and where the revenue raised is used to invest in more universal services and social security systems which benefit not just those on low incomes, but those on middle incomes as well. In the UK, where neither of these two conditions hold – inequality is higher and more services and benefits are means tested – it would be both regressive and unpopular (at least in the short to medium term).

Instead, building on the work of the Commission for Economic Justice, we argue that significant additional revenue could and should be raised by ensuring that those with a greater ability to pay – people on higher incomes or with higher levels of wealth, and larger corporations – contribute their fair share (CEJ 2018). This recognises the scale of inequality in this country: there is a six-fold difference between the incomes of the top 20 per cent of households and those of the bottom 20 per cent, with inequalities in wealth even larger (CEJ 2018). Furthermore, such a system is also likely to win support for more social investment and a bigger state: polling consistently shows that people feel that those on higher incomes do not pay enough.

# 5.

## CONCLUSIONS

### ENDING AUSTERITY: A HOW-TO GUIDE

There is growing consensus that, after a decade of cuts to public services and social security, it is time to ‘end austerity’ in the UK. But with the country facing significant economic, social and political challenges this cannot mean tinkering at the edges. Instead, policy makers must use this juncture as an opportunity to re-evaluate the role of the state in the decades to come. This means tackling some big questions. What do we want the welfare state to achieve? How much do we want to spend on it? Where should we get the funding to deliver this? What reform is needed to win support for this?

This paper has attempted to begin addressing some of these questions. We have demonstrated that the state has a pivotal role to play in ensuring everyone has a basic standard of living, that power, income and wealth are fairly distributed, that everyone has the opportunity to fulfil their potential, and that we have a cohesive society. In particular, we have argued that the state has a crucial role to play in addressing deficits in care, skills, health and security. This shift towards a greater investment in ‘social infrastructure’ will require a larger state than we have traditionally had in the UK.

But, contrary to received wisdom, this does not have to mean lower economic growth. While on average, countries with higher levels of government spending tend to have lower economic growth, there is no reason this has to be the case. The real question is not the amount of government spending but its effectiveness. If additional spending is invested into ‘social infrastructure’ such as education, health or childcare – which drive improvements in human capital – this can lead to higher economic growth in both the short and long term.

Meanwhile, the evidence suggesting that higher spending will lead to better social outcomes is hard to dismiss. The UK currently has lower levels of life satisfaction, poorer health outcomes, higher levels of poverty and inequality, and average educational outcomes when measured against comparable European countries, all of which spend more on ‘social infrastructure’ than we do. The data is particularly clear that, as we would expect, more spending on social security and public services lead to lower levels of both poverty and inequality.

Many will argue that higher spending is not possible. But our European neighbours show that this is simply not true. Committing to the creation of an ‘investment state’ is not a move away from the international norm but a move towards it. Such a commitment would see total government spending rise by around 5 percentage points by 2025 and would allow (after factoring in spending requirements for existing commitments) for £46 billion per year of additional spending by the end of the parliament, £105 billion by 2025 - when we would deliver on the objective of matching our European competitors - and £125 billion by 2027.

Some of this could be funded by debt. Contrary to popular opinion, additional debt is not unsustainable as long as interest rates are low, rates of return on investment are high and debt is denominated in domestic currency. Even the IMF argues that the UK still has the capacity to increase debt (should we wish to) without any negative consequences. However, creating an investment state

does not depend on higher debt: much of this extra spending will need be raised through additional taxation. We estimate the total tax gap will be £66 billion by the end of the parliament, £119 billion by 2025 and £124 billion by 2027.

These are significant sums of money. But as we have demonstrated, other European countries manage to raise similar amounts (or more) every year to fund better and more complete social safety nets. The challenge is therefore more likely to be political rather than technical. Can we really win support for significant increases in taxation? There are promising signs. The political winds are changing: the general public appear to have finally lost patience with austerity. The latest British Social Attitudes survey finds that support for higher taxes and spending has risen to 48 per cent, higher than at any time since 2004 (BSAS 2018).

However, to deliver the scale of shift in public taxation and spending over the coming decade, policy makers will need to grow and maintain support for a higher tax, higher spend economy. We argue that two key shifts in policy will be needed over the remainder of this parliament and beyond in order to achieve this. These are as follows.

- People on middle incomes will have to feel that those on higher incomes are paying their fair share of taxation before they are willing to pay more taxes themselves, which will be necessary in order to deliver an ‘investment state’.
- Everybody – including those on middle and higher incomes – will need to benefit from high quality public services and the social security system in order to create a coalition in favour of the ‘investment state’.

We investigate both of these conditions in the rest of this chapter.

## **NEXT STEPS: THE POLITICS OF TAXATION**

The scale of the additional spending required to deliver an ‘investment state’ is such that it can only be raised in the longer term by widespread tax rises across all forms of taxation and the majority of the population – including those on middle as well as higher incomes. This is one of the key lessons from the Nordic countries, which have consistently managed to maintain higher levels of spending on public services and social security with robust economic growth (Steinmo 1993).

There are two main reasons for this. Firstly, although we are likely to be some way off the peak of the laffer curve,<sup>8</sup> beyond a certain level, higher taxes on businesses and the wealthy will lead to a reduction in revenue and economic growth. And, secondly, it is because, even if we could continually raise the tax rate paid by higher income earners, there is simply not enough of them to sustain the welfare state: the UK is already more reliant on the wealthy for its tax revenues than other countries (Miller et al 2017, Corlett 2018a). The most sustainable welfare states rely on the broadest possible tax base to sustain revenues.

That said, given the relatively low levels of taxation in the UK – including on businesses and high earners – as well as higher levels of both income and wealth inequality, there is significant scope to increase taxes on the wealthy before we reach this point. Indeed, doing so is not only an economic but a political necessity: creating a coalition in favour of an ‘investment state’ and support for more widespread increases in tax depends on it.

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8 The laffer curve suggests that as taxes on corporations or higher earners increases, its relationship to revenues follows a U-shape (Mankiw et al 2009, Martin 2012) – that is, it declines at higher rates. This, they argue, is because, in the context of high levels of international capital and labour mobility, businesses and high earning individuals will ‘shop around’ for the most competitive tax rate. Furthermore, they argue that higher rates disincentivise work, innovation and investment which lead to a reduction in growth and therefore tax revenues.

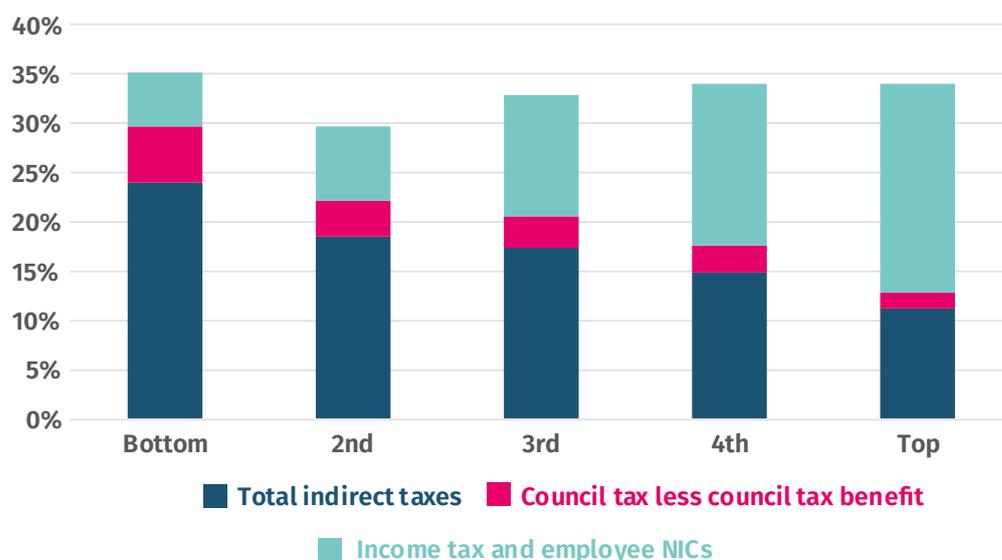
This is because, while the narrative that people resent paying taxes is inaccurate – most people feel proud to contribute to society and recognise it as a crucial part of citizenship (Williamson 2017) – tax morale (people’s willingness to pay their taxes) depends on their perception of the fairness of the taxation system. People must feel a sense of fellowship with, and trust between, other taxpayers and users of public services and the wider social security system if they are to support higher taxes.

In the UK, this sense of fellowship and trust has undoubtedly been eroded in recent decades (Edelman 2018). On the one hand this has been driven by perceptions – fuelled by the political rhetoric surrounding ‘workers and shirkers’ – that those on low incomes are not paying their fair share. However, the evidence does not support these claims: in the UK those in the bottom decile pay a higher share of their income in tax than those on the top decile. Meanwhile the evidence is clear that on average, immigrants, who are usually of working age, are net contributors to the state.

**FIGURE 5.1**

**As a proportion of income, the poorest 20 per cent of households in the UK have the highest overall burden of tax**

*Total average tax liability by equivalised household income quintile as a proportion of gross income, 2015/16*



Source: Stirling (2018b)

On the other hand, this loss of trust has also been driven by perceptions that the wealthy have been finding ever more elaborate ways to avoid paying tax. There is more evidence to substantiate this claim. Despite contributing a significant proportion of total tax revenue, the wealthy (Roberts and Lawrence 2018) and big multinational businesses (Blakeley 2018) pay significantly lower shares of their income or profit in taxation than those on lower incomes or smaller businesses. Public awareness of these inequalities in the tax system have been growing as a result of numerous high profile tax scandals such as those involving Amazon, Starbucks and Google.

Given this, it is unsurprising that support in the UK – as in other OECD countries – for higher taxes on the wealthy and companies has been growing (OECD 2018b). It seems clear that to win support for the ‘investment state’ – and higher taxes on a wider range of actors within society – the wealthy must pay their fair share first.

We therefore reiterate a number of the main recommendations of the Commission for Economic Justice,<sup>9</sup> including the following.

- **Making taxation on labour more progressive.** This can be achieved by aligning the tax rate schedule for all sources of income (national insurance and income tax) to make it simpler and more progressive, replacing tax bands with a ‘formula-based’ tax schedule, and increasing the top rate of tax back to 50 per cent. Modelling these changes for the CEJ, we found that this could raise an additional £16 billion per year, while ensuring that the bottom 40 per cent of taxpayers are still better off.
- **Treating income from wealth the same as income.** Income from dividends and capital gains should be incorporated into the income tax schedule. All exemptions, allowances, and reliefs that currently exist for both taxes should be reversed. Estimating the fiscal effect of this is challenging but it is likely to be substantial. Removing the exemption of capital gains tax on death alone would raise an estimated £1.2 billion, and simply restoring the pre-2016 capital gains tax rates would raise a further £800 million in 2020/21 (Corlett 2018b, 2017).
- **Abolishing inheritance tax and introducing a gift tax.** A donee-based gift tax would be levied on the gifts received by an individual above a lifetime allowance of £125,000. When this lifetime limit is reached, any income from gifts would be taxed annually at the same rate as income derived from labour under the income tax schedule. Resolution Foundation have modelled this proposal using the Wealth and Assets Survey and find that this would raise £15 billion in 2020/21, £9.2 billion more than the current inheritance tax system (Corlett 2018b).
- **Replacing council tax and stamp duty with an annual property tax.** This should be proportional to the present day value of homes. Such a tax would be far more progressive than council tax and would effectively capture increases in house prices in a way that the current system does not. Research undertaken by the Resolution Foundation suggests that an annual charge of 0.7 per cent of property values would increase revenues by £12.7 billion (Corlett and Gardiner 2018).
- **Increasing corporation tax from 19 to 24 per cent.** A rate of 24 per cent would be at or below the average of competitor countries. In the CEJ, we recommended using this revenue – equal to about £9.5 billion per year today and £13.5 billion per year by 2020/21<sup>10</sup> – to reduce employers’ contribution to national insurance. However, this revenue could be used instead to invest in public services and the welfare state.
- **Creating an alternative minimum corporation tax.** This is a tax rate levied on a company to ensure a minimum corporate tax liability. It would be done by apportioning a firm’s global profits to the UK based on its sales or turnover in the UK. Based on estimates of the ‘corporate tax gap’ (uncollected corporate taxation), it is likely to raise somewhere between £3.3 billion (HMRC 2017) and £12 billion per year (TUC 2010).

Together these proposals – even taking the most conservative revenue raising options – could raise up to £57 billion per year more by the end of this parliament (£43 billion per year if the additional corporation tax revenue was used to reduce

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<sup>9</sup> The revenue raising numbers quoted in this section come from a variety of sources and are modelled in different ways and for different time periods. They are therefore indicative of the scale of revenue raised – rather than a precise summary of the fiscal impact – by these measures.

<sup>10</sup> It is important to note that these figures are simple estimates of the first-round effects of the tax changes, which don’t take into account potential behavioural changes. Each percentage point increase in corporation tax is likely to bring in marginally less revenue, so the actual increase may be smaller than that modelled here. Moreover, the changes may lead to changes in investment by companies of different kinds, which may affect their profitability and therefore revenues.

employer contributions to national insurance as recommended by the CEJ). This would be achieved without requiring those on low or middle incomes to pay higher levels of taxation, and would mean that no further taxation increases were needed until 2024/25 under our modelling.

However, this is not to say that those on middle incomes will be able to escape tax rises indefinitely. By the point of convergence in 2025, significantly more than this would be needed. With increases in wealth tax and corporation tax already delivered, we would be approaching the limits of revenue raising potential on higher earners. This means that future governments will have to think seriously about higher rates of labour taxation – not just on the wealthy but the middle class too – alongside other proposals such as environmental and sin taxes.

### **THE ‘INVESTMENT STATE’: THE FIRST PARLIAMENT AND BEYOND**

Winning support for the ‘investment state’ will also require changes in how public funding is spent. This is because people’s willingness to pay more tax is determined, not by the absolute level of taxation, but by the level of taxation *relative* to the goods and services the government provides (Ross 2004). However, taxpayers do not have perfect information about spending and services, nor the opportunity to fully conduct a cost-benefit analysis. Their perception of value is instead derived through the aggregate of micro-level perceptions and experiences of state institutions: ‘Are we getting what we deserve?’

This is why the breadth and quality of public services and benefits are so important. If people feel that their tax contribution and access to services and benefits is unfair in comparison to public expectation, then increases in taxation will be harder to justify. Indeed, there is a growing evidence that tax morale increases when political institutions have higher legitimacy (Torgler 2007). Likewise, support for public services or welfare is also likely to be higher if more people – particularly people on both low and middle incomes – benefit from them (Korpi and Palme 1998). This suggests that universal services are more likely to command public support than means tested ones.

These conclusions are demonstrated by the support for more spending and taxation for the UK’s universal public services compared to more means tested areas of expenditure (BSAS 2018). Indeed, while support for more spending on schools and the NHS is high, support for more spending on benefits has been declining steadily for over two decades (Hills 2015). Interestingly though, public support for more universal benefits – and those less associated with the ‘them’ and ‘us’ divide (such as pensions and child benefit) – has been more resilient (BSAS 2018).

Again, the Nordic countries such as Sweden, Denmark and Finland provide a key lesson here, with numerous studies suggesting that in these countries, the popularity of universal services helps to create both trust and self-generated momentum behind further investment (Partanen 2016). This suggests that expanding the coalition of people who benefit from public services and social security in the short term to more of the middle class in the UK – and ensuring those services are of a high enough quality to hold this coalition – will be crucial in gaining support for higher spending and higher taxes in future parliaments (as well as for winning support for greater redistribution to those on lower incomes).

We therefore argue that the revenue raised in the remainder of parliament, by the measures set out above, should be invested in measures to make means tested support more generous (to relieve immediate hardship and reduce insecurity) but also to extend the principle of universalism to win support among the middle classes for additional investment in the future. In particular, we argue that action should be taken on all four of the ‘social deficits’ set out in this paper:

- **The ‘care deficit’:** Unpaid and informal care is both economically and socially problematic. It simultaneously holds carers – who are overwhelmingly women – back in the labour market and creates huge inequalities in the level and quality of care for children and older people. Building on previous IPPR recommendations, we argue that we should move towards universal free childcare. We have previously estimated that £2.5 billion<sup>11</sup> (Lawton et al 2014) would meet the cost of guaranteeing an affordable childcare place for all parents of preschool children from the age of one, with a universal entitlement to free, part-time, year-round care for all those aged between two and four (though others have estimated a significantly higher cost for a truly universal childcare system [De Henau 2016]). We also reiterate calls for personal and nursing care for older people to be made free at the point of need, which by the end of the parliament would cost around an extra £8 billion (Quilter-Pinner et al 2019).
- **The ‘skills deficit’:** The 40 per cent of young people who do not take A-levels and go into higher education is served poorly by our country. One third of 16-year-olds do not reach Level 2 standard in their GCSEs<sup>12</sup> and even fewer catch up to Level 2 by the age of 19. But little funding or support is available for this group, leaving them few second chances. In the UK, spending on education has declined as a share of GDP since the mid-1970s, from around 5.5 per cent to 4.3 per cent today (though it briefly returned to its previous high between 1998–2010) (Belfield et al 2018). This suggests that all areas of education could benefit from additional investment. However, further education (which has fallen by 15 per cent in real terms since 2010) and adult skills (which has fallen by 45 per cent in real terms since 2010) (ibid) have been particularly under-invested in (OECD 2019b). A shift to an investment state would at least reverse these cuts but also go beyond. We estimate that an additional £2.7 billion is required to reverse further education spending cuts and adequately fund the sector going forwards.
- **The ‘health deficit’:** While the NHS has recently received a new funding settlement, other parts of the health and care system are still starved of funding, including those parts with the highest long-term return on investment. Notably, public health has been cut significantly over recent years despite the fact that for every £1 spent on public health, the median return is £14 (Masters et al 2017). Building on recent IPPR recommendations, we call for at least an extra £1 billion per year to be spent on public health by the end of the NHS’s settlement in 2023/24 (Hochlaf et al 2019). Another example of under-investment is mental health where, despite a recent cash injection, we are still some way off delivering parity of esteem. We argue that we need to invest an extra £2 billion per year by 2023/24 (and rising significantly beyond that) to be on track to deliver parity of esteem (Quilter-Pinner et al 2018).
- **The ‘security deficit’:** Working age people on work and out of work benefits have suffered disproportionately under austerity, particularly lone parents, those with disabilities and families with children. Around three quarters of the rise in child poverty, for example, has been driven by benefit changes (Hood et al 2017), underlining how policy responsive poverty rates can be. Priorities for the next parliament should therefore be to reverse existing cuts and significantly reform the now toxic Universal Credit policy – including by cutting the taper rate, increasing the child element and introducing a second earner work allowance. These changes could cost as little as £1.6 billion per year or as much as £10.5 billion a year depending on design and generosity (CPAG and TUC 2019). As well as additional funding, reform to the design of Universal Credit will also be needed, including rebalancing conditionality with demand-side reforms to improve opportunities for low paid workers.

11 Note these estimates are in 2015/16 prices.

12 At least five grade Cs or 4s.

As part of the shift to an investment state, more investment in these policy areas – alongside other capital investment projects such as public transport (in particular buses) and housing (in particular council housing) – should be undertaken as a matter of priority in the remainder of this parliament and the beginning of the next. Future parliaments may want to go further by considering more radical reforms to the social security system (partial universal basic income, for example) or less progressive forms of universalism (such as free tuition fees). But these should only be considered once these priority areas have been properly resourced. Furthermore, policy makers should go beyond public spending in trying to address these ‘social deficits’, also utilising economic levers and broader social policy interventions such as the minimum wage, collective bargaining and worker entitlements. These will all form part of IPPR’s new programme of work – the Fairer Welfare Programme – which will report over the coming year.

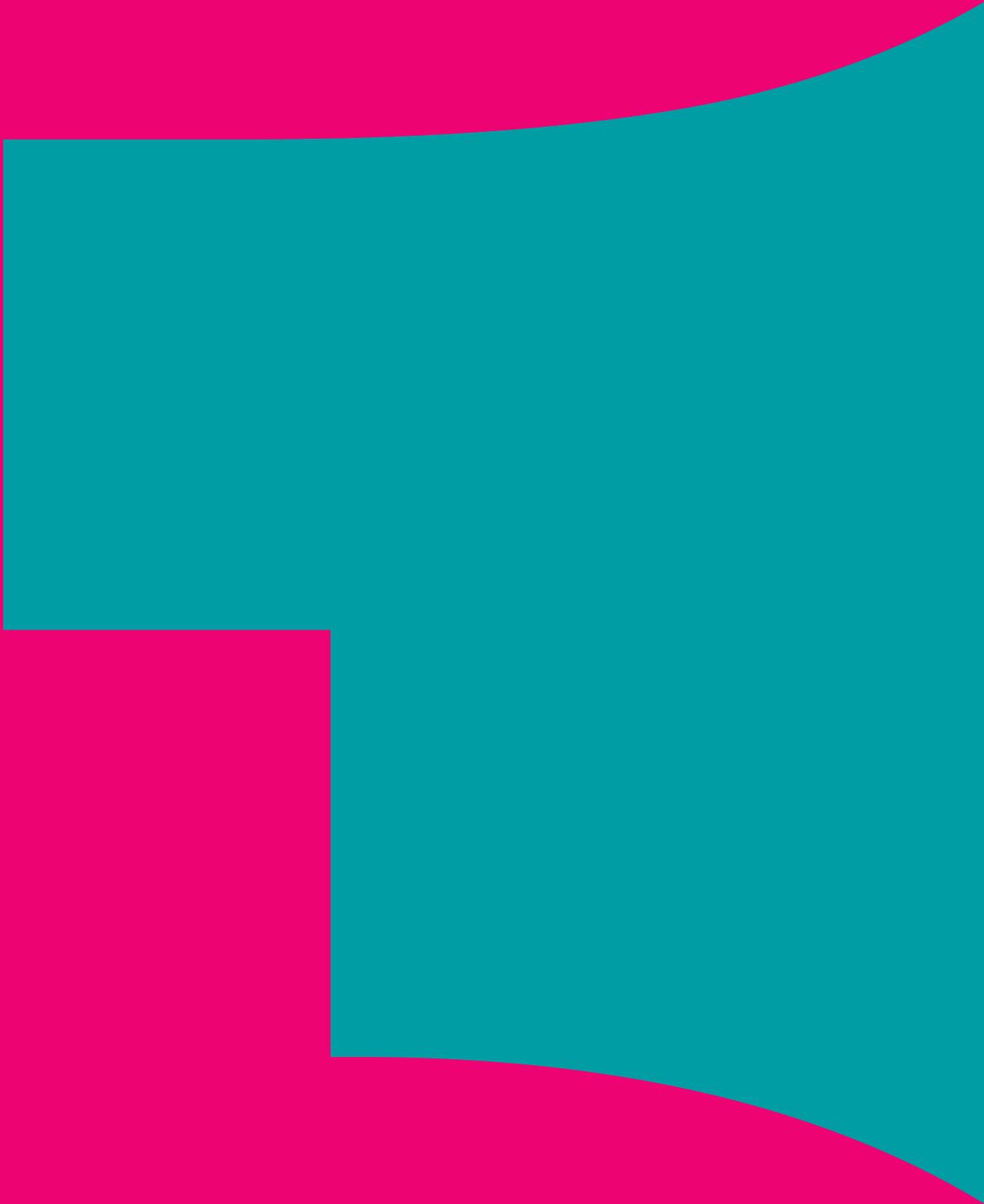
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