

LEFT
ECONOMIC
ADVISORY
PANEL

Alternative Pre-Budget
Report 2006

The Red Papers

Sponsored by the Labour Representation
Committee, New Left Unions and the
Socialist Campaign Group of Labour MPs

Introduction: Economics of the Real World

At times recitations by politicians of economic statistics to prove their successful management of the economy can come across as complacent and even unreal when matched against the day to day reality of most people's lives.

Undoubtedly in his Pre-Budget Report the Chancellor will lay claim to a series of data demonstrating the robustness of the UK economy and its underlying strength in meeting the economic challenges of the globalised economy. This is the traditional approach to economics.

There is another economics though. It is the economics of the real world, a world the majority of us inhabit. Real world economics tell a different story. Real world economics use alternative measurements to assess the success or failure of our economic policies. This basket of measurements comprises those elements which determine the quality of life families experience in modern day Britain.

In real world economics, budgetary decisions are assessed against a checklist, identifying basic benchmarks of life chances, including:

Child poverty: Currently, infant mortality is twice as high for children born to unskilled manual workers, and these children are five times more likely to die in an accident. Nearly 3.5m children remain in poverty, representing 27% of all children. Half of these children have at least one parent working. Nearly 100,000 families are living in temporary accommodation and one in seven children, about 1.6 million, are growing up homeless or in bad housing.

Unemployment: UK unemployment has risen to 5.6%. Over the past year, there are an extra 263,000 people out of work, and an extra 70,100 claiming Jobseekers' Allowance. Youth unemployment, whether measured by claimant count or by the ILO standard, is at its highest level since 2000 at 10% for the under-25s.

Income poverty: A full-time job at the minimum wage would mean an annual salary of just £6,435 for a 16-17 year old or £8,677 for an 18-21 year old. Even the minimum wage for those aged 22 and above equates to just £10,432. For working adults, the poverty rate is 19% - the same as in 1997. Women comprise two-thirds of income support claimants. The gender pay gap remains at 20% for full-time work, while women in part-time work receive 40% less. Ethnic minorities earn less than 16% than their white colleagues. Student debt has risen to an average of £13,501 upon graduation, and graduates pay 42% of their salaries in tax, compared with 41% for top rate tax earners. Personal debt is at unprecedented levels and personal bankruptcies and insolvencies are rising at an alarming rate.

Wealth and Tax Inequality: In 2005, FTSE 100 directors have grown by 28%, compared with average earnings increase of 3.7%. Earnings growth in the financial sector is running close to 7.0%, while for non-financial workers, real pay is falling sharply. The Chancellor's insistence of a public sector pay cap of 2% will result in a real terms pay cut for millions of public sector workers. By adhering to Thatcher's tax policies, the poorest fifth of the population are taxed more heavily than the richest fifth. The richest 1% own 34% of UK wealth and the poorest 50% own only 1% of UK wealth. The inevitable outcome is that social mobility has declined since 1997.

Health Inequality: Male manual workers are 40% more likely to suffer from chronic sickness than their non-manual counterparts. Life expectancy is 10 years shorter for the poorest.

Pensioner poverty: Nearly 20% of pensioners remain in poverty, and this is disproportionately women and ethnic minorities, whose lower pay throughout their working life results in poverty in their retirement. Due to means-testing many of the poorest pensioners are not receiving their full entitlement.

These are the startling everyday facts demonstrating that while by traditional economic standards the Chancellor will applaud himself for the prudent management of the economy, by real world economic standards the last 9 years have been an opportunity largely missed.

The Chancellor and commentators may claim that the fundamentals of the economy are sound. However, these are the fundamentals which affect the real world economy. They include a decent income, avoiding debt and poverty, having a decent roof over one's head. On these measurements of the basic fundamentals of life, for many families in Britain the picture is not so rosy.

They pose the question, what has New Labour been doing for all this time – the longest period of Labour Government.



John McDonnell MP
Chair, LEAP

Preface

If the Left is to be taken seriously in its critique of existing Government and opposition policies it is critical that its statements and policies are based upon sound research and professional advice. No more so than in the field of economics. It was for this reason that the Labour Representation Committee (LRC), the New Left Unions and the Socialist Campaign Group of Labour MPs established the Left Economics Advisory Panel (LEAP).

Twice a year LEAP publishes the *Red Papers* – a set of short, sharp economic papers analysing the current issues facing our economy and setting the scene for the debate on economic policy for the Left. Publication of the *Red Papers* will be timed for immediately prior to the Chancellor's Pre-Budget Report and the Budget Statement.

LEAP comprises academics, economic practitioners, trade union policy advisers and MPs. The Group meets on a regular basis to provide advice on economic policy to the Labour and trade union movement.

For socialist MPs and trade unionists, LEAP serves as our own equivalent of the Bank of England Monetary Policy Committee, providing an overview of the performance of the economy and its long-term prospects whilst highlighting key issues to be addressed by the labour movement.

In this second edition of the *Red Papers* we focus on the underlying structural problems of the UK economy.

1. A Precariously Perched Economy

With real GDP expanding by 2.7% year on year in the third quarter, the Chancellor Gordon Brown will doubtless round on his critics and claim the economy is on track to meet his forecasts set out in the Budget earlier this year. But we should not be fooled. It was clear a year ago that the economy would start to strengthen again, because the pace of borrowing had started to bounce sharply in the early months of 2005. The Bank of England had averted a housing crash by capping the rise in rates at 4.75% and then proceeding with a cut in June that year to 4.5%. The stage was set for yet another debt-driven upswing in the economy.

There are several underlying economic factors that make UK growth precarious:

- Growth has been driven by excessive borrowing, with runaway house prices once again aggravating the divide between the haves and have-nots
- Excessive debt has been accompanied by a sharp slowdown in real wage growth, particularly for those out outside of the booming financial sector.
- The Chancellor's growth projections are predicated on an unsustainable rise in this country's debt burden, with personal bankruptcies now running at a record pace
- The boom in financial services, which currently underpins so much of the UK economy, has been fuelled by an explosion in credit growth and leveraged transactions
- The number of people out of work is at its highest level for seven years (1.7m) and manufacturing jobs are at their lowest since 1841
- A sharp fall in house prices, as has happened in the US, would seriously weaken UK consumer confidence

2. Issues and proposals

LEAP has identified six areas of the economy where there is an urgent need for the Government to change policy:

- a. Increasing Public Expenditure
- b. Tackling Income Inequality
- c. Rebalancing Taxation
- d. Lowering the Debt Burden
- e. Improving Pensions
- f. Reducing Unemployment

a. Increasing Public Expenditure

There is a growing myth that countries must compete to attract foreign investment by cutting tax rates for companies and by offering other tax-based incentives. There is no evidence for this claim, and in fact strong public investment in education and skills training, and in transport infrastructure are more important.

The 2005 OECD Economic Survey of the UK recommended that the government should “raise the general skill level of the workforce” and “improve transport infrastructure . . . an unreliable rail system, which may be holding back productivity”¹.

This analysis was echoed by the European Competitiveness Index, which found that the those regions ranked bottom “lacked the economic and industrial infrastructure that is a feature of Europe’s most competitive regions” and that the most successful region had “unique levels of public sector investment”².

Tax competition does not improve productivity, but simply increases the returns to capital by enabling companies to free-ride on public services. Business benefits greatly from public services: enjoying a healthy, educated and productive workforce with the financial means to buy the products of business.

As the table below shows, growth can be achieved by expanding public expenditure:

Public Expenditure and Economic Growth 2006

	Public Expenditure as % of GDP	% GDP growth 2006
Sweden	57.1	3.5
Denmark	53.8	2.7
Finland	50.6	3.3
UK	45.4	2.4 ³

¹ OECD. *Economic Survey of the United Kingdom 2005*.

² Huggins, R. *European Competitive Index 2006*. University of Sheffield / George Washington University

³ OECD statistics

Infrastructure spending has been increased over the last few years, but much more needs to be done. This cannot be through the PFI scheme in which the public have rightly lost confidence. There is an alternative. The Government should empower local authorities to issue bonds to finance infrastructure development, as was commonplace until 1981. These bonds should be linked to specific, identifiable projects or sectors (e.g. education, health etc) to encourage local accountability for the projects funded. Specific provision should be made that any pensioner should be able to choose part of their pension fund in such bonds. The economic lifecycle of many infrastructure projects makes them ideally suited to the pension lifecycle.

The replacement of ISA tax reliefs for saving, which currently support the stock market, with tax free returns on local authority bonds should be considered as a means of promoting direct investment by individuals into the communities in which they live at low cost to society.

Recommendations

- **The Government should embark on a major publicly financed national and regional infrastructure investment scheme – with particular focus on transport and renewable energy**
- **Empower local authorities to establish community bond schemes with tax free returns**
- **Increase investment in public comprehensive education**
- **Integrate rail franchises into the a unified public sector structure**

b. Tackling Income Inequality

Real average earnings have slowed sharply, and contracted in October, for the first time since 1995. These figures are even more shocking given that earnings growth in the financial sector is running close to 7.0%. For non-financial workers, real pay is falling sharply.

The minimum wage for young people is just £3.30 per hour for 16 and 17 year olds, and only £4.45 for those aged 18-21. Working a full-time 37.5 hour week, this would equate to an annual wage of just £6,435 for a 16-17 year old or £8,677 for an 18-21 year old. Even the minimum wage for those aged 22 and above equates to just £10,432.

Low pay is still a disproportionate problem for women. Full-time female workers on average earn 20% less than their male counterparts. For part-time female workers this increases to 40%⁴.

FTSE CEOs helped themselves to 30% more this year, while their directors took 28% (against an average pay rise of 2.8%). They now earn at least 76 times the average pay of their staff, when in 1980 it was just 10 times⁵. This is not just a recent phenomenon: over the past decade average earnings have grown by 45%, yet in the same period average earnings of the leading executives of the FTSE 100 companies have grown 288% - six times as fast⁶.

This excessive and widening disparity is not due to market mechanisms of supply and demand as the market does not set executive pay; remuneration committees do. Neither are

⁴ The Guardian 29/12/05

⁵ See Financial Times 23/11/06 and Guardian 28/11/06

⁶ Incomes Data Services, *Directors Pay Report 917*, November 2004.

such pay increases linked to performance – there is no evidence to link executive pay with corporate profitability.

Social Attitudes surveys consistently indicate that around 80% of people across all income groups regard the gap between rich and poor as unacceptably wide. A clear majority believes that the Government has a responsibility to reduce inequality⁷.

By adhering to Thatcherite tax policy, New Labour is the only post-war Labour government that has overseen an increase in inequality. Even with the various reforms, the poverty rate for working adults remains unchanged at 19%⁸

Recommendations

- **Immediately increase the minimum wage to £7 per hour with no age exemptions**
- **Introduce mandatory equality pay audits for all large employers**
- **Legislate to ensure that executive/senior pay rises are no higher than those for the average worker in that organisation**
- **Introduce a Trade Union Freedom Bill to increase the bargaining power of trade unions and their members to increase wage levels and to protect pensions and working conditions**

c. Rebalancing Taxation

It is generally assumed that our present tax system is progressive – in that it takes a higher proportion of the incomes of the rich than the poor. This is only true, however, of direct taxes on income and wealth, primarily Income Tax. Indirect taxes, such as VAT, or taxes on alcohol and tobacco, fall more heavily on the poor. In 2003-4 indirect taxes took 28 per cent of the income of the poorest fifth of households, but only 11 per cent of the top fifth. This more than offset the fact that the poorest fifth paid 10 per cent of their incomes in direct tax, as compared with 25 per cent for the top fifth. Over the income scale as a whole the tax system is at best proportional rather than progressive, as the table below illustrates:

Direct and Indirect Taxes as a percentage of income 2003/04⁹

Quintile:	1 st (poorest)	2nd	3 rd	4th	5 th (wealthiest)
Direct Taxes	10	12	17	21	25
Indirect Taxes	28	20	18	15	11
Total	38	33	35	36	35

(all figures rounded to nearest whole number)

We welcome the Chancellor's moves towards a tax regime which addresses the issue of climate change. There are a range of 'green tax' proposals including in particular taxing the aviation industry for the environmental damage it is increasingly causing. However, the fact that indirect taxes hit the least well off hardest, should make us cautious about calling for a variety of new indirect taxes to achieve objectives such as combating global warming or improving health. The present enthusiasm of all parties for 'green taxes' needs to be tempered by careful consideration of their distributional effects. In 2001-2 the poorest tenth of households paid 10.5% of their income in taxes on tobacco, alcohol, fuel and car tax,

⁷ National Centre for Social Research, *British Social Attitudes*, London, 2004.

⁸ Palmer, G, MacInnes, T and Kenway, P. *Monitoring Poverty and Social Exclusion*. JRF, York, 2006

⁹ Adapted from House of Commons Library Research Paper 15/68. *The Burden of Taxation 2005*.

whereas the richest tenth only paid 1.7%¹⁰. We need to find alternative ways of achieving such objectives, which may include reducing VAT (a regressive tax) on 'green products'.

Another highly regressive tax is Council Tax, which LEAP advocates should be abolished and replaced with a Land Value Tax (LVT). The poorest 10% of the population currently lose 9.1% of their income to Council Tax, whereas the wealthiest 10% lose only 1.5%. LVT would replace Council Tax and national non-domestic rates, at a rate of approximately 1% of capital value – the revenue going to local authorities. Owner and tenant occupied homes will be entitled to a home allowance, setting a threshold before LVT is charged.

It is also estimated by HMT Treasury that organised tax avoidance is costing the UK Exchequer between £97 and £150 billion each year – equivalent to between 8 and 12% of UK GDP¹¹.

Recommendations

- **Reduce the 10% starting rate of income tax to 5%**
- **Institute two new tax rates of 50% at £60,000 and 60% at £100,000 – these changes would mean a tax cut for all workers earning less than £62,000**
- **Employ extra staff at HMRC to deal with VAT fraud, and corporate and high level tax avoidance**
- **Support for green taxes including taxation on aviation fuel**
- **Reduce VAT on green products to incentivise environmental behavioural changes**
- **Introduce an annual land value tax in 2009/10. This will require unregistered land to be registered by beneficial owner by April 2008 to allow time for all land in Britain to be valued, disregarding buildings and other capital investments**

d. Lowering the Debt Burden

Data from the Office of National Statistics shows that the debt to disposable income ratio hit 161% in the second quarter of this year, 30% higher than the corresponding figure for the US. Based on the current trends in mortgage approvals, that looks set to surpass 165% by the year-end. Without this rise in borrowing, the UK economy would be in recession. Indeed, average levels of debt servicing as a percentage of disposable income are as high as they were in 1991.

Unsurprisingly, this has led to a surge in personal bankruptcies and insolvency – up 55.4% over the year, with mortgage repossessions having risen by one-fifth¹². In total, the UK accounts for one-third of all unsecured debt in Europe¹³.

Events in the US show how wrong it is to mortgage the country's future in this manner: house prices there are now falling at their fastest rate since the 1930s. With a US\$ crisis looming, US house prices could fall much further in 2007. That in turn could provide a real threat to much of the corporate finance business which underpins the UK's excessive reliance on the financial sector to drive growth. Both directly, and indirectly through the City,

¹⁰ See Hills, J. *Inequality and the State*. OUP, 2004

¹¹ The Sunday Times 04/06/06

¹² Reuters, 3rd November 2006

¹³ The Guardian 12/07/06

the UK economy has become hooked on borrowing. For a Chancellor that came to office proclaiming “no more boom bust”, that is a worrying indictment of “prudent” or “stable” economics.

Recommendations

- **Introduce tougher regulations on credit cards and debt financing – capping interest rates (with retrospective effect)**
- **Through an increased minimum wage and lower taxation for the poorest ensure that fewer people are forced into debt**

e. Improving Pensions

The UK state pension was worth 23.3% of average male earnings in 1979, but following the break with earnings its value had dropped to just 15.4% by 1997. Today it is just 14%. If the link had not been broken, by 2006 a single pensioner would receive an extra £53 per week¹⁴.

The Turner Commission drew attention to fundamental problems with the basic State Pension. It is too low, it does not rise in line with earnings, and has to be supplemented by means-tested payments. It had been the clear intention of successive governments to allow the basic State Pension to continue to diminish as a proportion of earnings and to be replaced progressively with means-tested payments. Turner’s conclusions and recommendations were inadequate, but at least signalled a change of policy direction – which the Government has broadly accepted, if grudgingly.

The UK basic state pension is the lowest in Western Europe, below those of continental countries from Italy to Sweden¹⁵. The Chancellor should therefore start now to put things right by immediately raising the basic State Pension to the Pension Credit level and re-establishing the link between pensions increases and earnings – eliminating means-testing. The State Pension should rise to at least 25% of average earnings, phased over a parliament, to restore the ratio that existed a quarter of a century ago, and significantly raising the living standards of all pensioners.

The Winter Fuel Allowance (WFA) has proved very popular with pensioners, but has not kept pace with fuel costs¹⁶. It should therefore be substantially raised. It is also recommended that the WFA be integrated into the basic State Pension and making it taxable so that the rich do not benefit unnecessarily and their tax contribution on the allowance can be recycled to help offset its additional cost. This would also save substantially on administrative costs and ensure that every pensioner gets the WFA as of right without having to claim, and could be done by having the WFA paid in one or two additional payment weeks in November or December.

These pension increases would of course have a significant cost and additional Exchequer Revenues will be necessary to pay for them. We therefore recommend that the Upper

¹⁴ Mitchell, A & Sikka, P. *Pensions Crisis: A Failure of Public Policymaking*. AABA, Basildon, 2006

¹⁵ This is mainly due to lower than average NI contributions from UK employers, who pay only 9.6% of labour costs, whereas in Italy it is 24.9% and in Sweden 24.5%. The EU average is 17.8% - according to OECD. *Taxing Wages: 2004- 2005*. Geneva, 2006

¹⁶ A parliamentary question tabled by Jim McGovern MP showed that the WFA paid 43% towards fuel bills in 2003-04, but is only estimated to cover 30% of fuel bill expenditure this year. See Hansard 23 Oct 2006 : Column 1554W, question number 93776

Earnings Limit on NI Contributions be removed – raising approximately £8bn¹⁷ – so that National Insurance is paid in future as a percentage of income all the way up the income scales. There is also a substantial surplus in National Insurance Fund¹⁸ and this should be used progressively to help fund the proposed better pensions. A third source of additional revenues should be tapped by reducing the tax relief on savings currently enjoyed by those on higher incomes, equivalent to £20 billion a year¹⁹.

Raising the pension age is unsustainable and will severely disadvantage skilled and unskilled manual workers, who will be unable to work until 68. People in manual jobs already have a lower life expectancy than those in professional jobs²⁰.

Shifting the pension burden towards individuals is also unsustainable. Those young people who have gone to university are now saddled with a tax burden that exceeds that of a fat cat CEO – as a recent graduate on average earnings will be paying a marginal tax rate of 42%, compared to 41% for someone earning at the top tax rate²¹. Student debt leaves little scope for savings towards a pension or a deposit for a house, and is reflected in the fact that now only 20% of homeowners are in the 20-24 age group compared with 30% a decade ago²².

Company pension schemes are also in crisis, but this is not a crisis of inadequate funding or increased longevity. It is a crisis caused by the £18bn²³ in pension holidays taken in the 1990s that was shared among executives and shareholder and is now being passed on to workers in diluted pensions. This 'crisis' is easily resolved. For FTSE 100 companies pension scheme deficits represent just three months of pre-tax profits or nine months of dividends²⁴.

Recommendations

- **Immediately restore the earnings link to the basic state pension and immediately increase to the Pension Credit level, and over the course of a Parliament increase its value to 25% of average earnings**
- **No rise in the state retirement age**
- **Substantially increase the WFA and integrate into the basic state pension**
- **Make it a requirement that 50% of company dividends must be used to close pension fund deficits, and that all company employees are in the same pension scheme with the same terms and conditions**
- **These reforms to be paid for by removing the upper limit on National Insurance (NI) and using the NI Fund surplus**

¹⁷ Delegated Legislation Committee - Draft Social Security (Contributions) (Re-rating and National Insurance Funds Payments) Order 2005

(<http://www.publications.parliament.uk/pa/cm200405/cmstand/deleg18/st050310/50310s01.htm>)

¹⁸ The current National Insurance Fund surplus is estimated to be approximately £19.5bn

¹⁹ 55% of this tax relief (about £11bn) goes to higher rate taxpayers, who make up only 10% of all taxpayers.

²⁰ See: Department of Health. Tackling Health Inequalities: status report on the programme for action. London, 2005

²¹ Above £15,000 a recent graduate will pay 22% in income tax, 11% in National Insurance and 9% in student loan repayment; whereas a top rate tax earner will pay 40% income tax and 1% in National Insurance

²² Research by Nationwide Building Society, July 2006

²³ Guardian 08/01/06

²⁴ Mitchell, A & Sikka, P. Pensions Crisis: A Failure of Public Policymaking. AABA, Basildon, 2006

f. Reducing Unemployment

The number of people out of work in the UK has risen to 1.7million – its highest level since 1999²⁵. The number of people working in UK manufacturing has fallen to just over 3 million – the lowest level since records began in 1841.

UK unemployment stands at 5.6% - up 0.8 over the year. To put this in clear figures, there are an extra 263,000 people out of work, and an extra 70,100 claiming Jobseekers' Allowance. Youth unemployment, whether measured by claimant count or by the ILO standard, is at its highest level since 2000²⁶, with an unemployment rate among under-25s of 10%²⁷.

Rising unemployment in an increasingly polarised economy requires an opening up of educational opportunities – however, university admissions are falling due to the excessive debt burden.

The lack of sufficient housing supply means that the poorest are increasingly living in temporary accommodation and cannot afford to enter the housing market.

The Government has failed to establish a clear regional economic strategy or to invest sufficiently in transport infrastructure outside of London. A carefully co-ordinated public infrastructure and house-building programme could reverse the rise in unemployment and the decline in UK manufacturing jobs – and thus generate economic growth while reducing benefit payment and increasing tax revenue.

Recommendations

- **Make high and stable employment one of the key objectives of the Bank of England Monetary Policy Committee**
- **Regional economic strategy of public infrastructure projects, including transport, renewable energy projects and housing**
- **Remove tuition fees and restore the student grant to encourage access to further and higher education**

²⁵ ONS, November 2006

²⁶ See HM Treasury answer to parliamentary question 64116 *24 Apr 2006 : Column 880W*

²⁷ Palmer, G, MacInnes, T and Kenway, P. *Monitoring Poverty and Social Exclusion*. JRF, York, 2006

3. Conclusion

There is a clear recognition that a successful modern economy must be built on firm foundations of public expenditure and investment. There is also increasing awareness that inequality is both socially *and economically* inefficient.

To tackle the current structural problems in the UK economy, LEAP makes the following proposals:

Increasing Public Expenditure

- The Government should embark on a major publicly financed national and regional infrastructure investment scheme – with particular focus on transport and renewable energy
- Empower local authorities to establish community bond schemes with tax free returns
- Increase investment in public comprehensive education
- Integrate rail franchises into the a unified public sector structure

Tackling Income Inequality

- Immediately increase the minimum wage to £7 per hour with no age exemptions
- Introduce mandatory equality pay audits for all large employers
- Legislate to ensure that executive/senior pay rises are no higher than those for the average worker in that organisation
- Introduce a Trade Union Freedom Bill to increase the bargaining power of trade unions and their members to increase wage levels and to protect pensions and working conditions

Rebalancing Taxation

- Reduce the 10% starting rate of income tax to 5%
- Institute two new tax rates of 50% at £60,000 and 60% at £100,000 – these changes would mean a tax cut for all workers earning less than £62,000
- Employ extra staff at HMRC to deal with VAT fraud, and corporate and high level tax avoidance
- Support for green taxes including taxation on aviation fuel
- Reduce VAT on green products to incentivise environmental behavioural changes
- Introduce an annual land value tax in 2009/10. This will require unregistered land to be registered by beneficial owner by April 2008 to allow time for all land in Britain to be valued, disregarding buildings and other capital investments

Lowering the Debt Burden

- Introduce tougher regulations on credit cards and debt financing – capping interest rates (with retrospective effect)
- Through an increased minimum wage and lower taxation for the poorest ensure that fewer people are forced into debt

Improving Pensions

- Immediately restore the earnings link to the basic state pension and immediately increase to the Pension Credit level, and over the course of a Parliament increase its value to 25% of average earnings
- No rise in the state retirement age
- Substantially increase the WFA and integrate into the basic state pension

- Make it a requirement that 50% of company dividends must be used to close pension fund deficits, and that all company employees are in the same pension scheme with the same terms and conditions
- These reforms to be paid for by removing the upper limit on National Insurance (NI) and using the NI Fund surplus

Reducing Unemployment

- Make high and stable employment one of the key objectives of the Bank of England Monetary Policy Committee
- Regional economic strategy of public infrastructure projects, including transport, renewable energy projects and housing
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