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GAUGING LABOUR'S ECONOMIC POLICY AGAINST A DIFFICULT FISCAL BACKDROP

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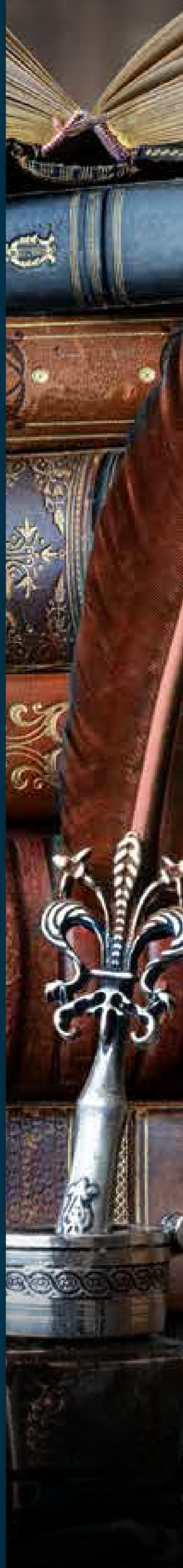
Polling data suggests the Labour party is in a strong position to win the UK general election on 4 July. It is possible that the polls will change once campaigning starts, but at this stage it appears prudent to anticipate a shift in UK policy in the months ahead. We examine this potential shift along with the challenges that would face whichever party wins.

EXECUTIVE SUMMARY

- Labour's economic policy appears to prioritise low-cost supply-side reforms in an attempt to promote private-sector investment and boost longer-term growth prospects. The strategy is based on a five-point plan for growth and the creation of a range of new institutions.
- Labour's goal is "the highest sustained growth in the G7". This is a noble long-term target, but is likely to prove difficult to achieve.
- To reassure markets, the party has committed to two fiscal rules under a strengthened fiscal framework:
  - A deficit rule, closing any day-to-day spending deficit over five years; and
  - A debt rule, ensuring that debt/GDP is declining in the fifth year of the forecast period.
- The emphasis on fiscal prudence is born from necessity – net debt is high, and the fiscal deficit is only expected to decline slowly. Although current forecasts would see both fiscal rules met, the margin for error is extremely thin, especially for the second rule.
- With meaningful tax rises difficult given the party's pre-election commitments, spending restraint will be necessary.
- There is a meaningful risk that whichever party wins will end up breaching their fiscal rules unless there is an upward surprise to growth. A Labour win would likely see higher government borrowing for investment, as this would boost long-term growth without breaching the party's fiscal rules.



ECONOMIC STRATEGY

The full details of Labour's economic and fiscal policy will only become clear when the party publishes its manifesto, but the party has given significant guidance via a range of speeches and publications as to its intended direction of travel.

ECONOMIC POLICY

In the annual Mais lecture, run by the Bayes Business School, Shadow Chancellor Rachel Reeves set out her view of how the Labour party should manage the UK economy. In her view there are three imperatives[1]:

1. Guaranteeing stability,
2. Stimulating investment through partnership with business, and
3. Reform to unlock the contribution of working people and the untapped potential throughout the economy.

Labour's goal is "the highest sustained growth in the G7 ... based on a powerful new approach called Securonomics".[2]

Securonomics appears to be heavily influenced by the modern supply-side economic agenda pursued by the Biden administration and would suggest a more state-backed industrial strategy than the UK has had for many decades. The basic idea is to improve the supply side of the economy without the need for significant government spending. This would be done by encouraging investment while at the same time reforming the planning system to make it easier to undertake housing and infrastructure projects.

To help achieve this objective Labour has developed a five-point plan for growth, outlined below[3].

1. Putting economic stability first by introducing a new fiscal lock.
2. Getting Britain building again by reforming planning laws to kickstart 1.5 million new homes, transport, clean energy, and new industries in all parts of the country.
3. Backing British business with a new industrial strategy created in partnership with business to maximise Britain's strengths in life sciences, digital, creative, financial industries, clean power and automotive sectors. Creating a National Wealth Fund to unlock billions of pounds of private investment.
4. Kickstarting a skills revolution with a new generation of Technical Excellence Colleges, offering more high-quality apprenticeships and training opportunities tailored to local jobs in all parts of the country.
5. Making Work Pay by introducing a new deal for working people and delivering a genuine living wage, banning zero hours contracts and ending fire and rehire.

A RANGE OF NEW INSTITUTIONS ARE TO BE SET UP

In order to achieve their goals, Labour are proposing to set up a range of new institutions[4].

- **Industrial Strategy Council:** a new statutory group to provide industrial strategy stability, replacing the previous non statutory Industrial Strategy Council set up in 2018 and closed down in 2021.
- **Council for Economic Growth:** to give business and union representatives a voice in macroeconomic policy.

[1] https://labour.org.uk/updates/press-releases/rachel-reeves-mais-lecture/
[2] https://labour.org.uk/missions/economic-growth/
[3] https://labour.org.uk/updates/press-releases/rachel-reeves-mais-lecture/
[4] https://labour.org.uk/wp-content/uploads/2024/02/A-Partnership-for-Growth.pdf

- **British Infrastructure Council:** to provide a way for key investors to have a dialogue on important strategic investments and to plan long term needs.
- **Great British Energy:** a publicly owned clean energy company that will invest in solar, hydro and wind energy with the aim of making the UK energy independent.
- **National Wealth Fund:** investing in jobs to rebuild UK industrial strength, including investing £1.8bn in port infrastructure.

The policy appears likely to prioritise low-cost supply-side reforms in an attempt to promote private-sector investment and boost longer-term growth prospects. These are noble long term aims but it is likely to prove challenging to deliver tangible results in the near term.

MONETARY POLICY

In the Mais speech, the Shadow Chancellor also confirmed that the Bank of England's inflation target would remain at 2% and that the Bank must continue to have complete independence in the pursuit of price stability. However, she also said that she would re-introduce the focus on climate change for both the Monetary Policy Committee and the Financial Policy Committee.

FISCAL RULES

There are two fiscal rules to which Labour would commit when in power:

1. **A deficit rule:** where Labour has pledged that when in government, it would close any deficit on day-to-day spending (the current budget) it inherits over the next five years. Any borrowing would only be for investment.
2. **A debt rule:** would ensure that government debt, as a percentage of GDP, would be declining in the fifth year of the forecast period.

There are also proposals to strengthen the fiscal framework. Chancellors would only be allowed to suspend the fiscal framework if the Office for Budget Responsibility (OBR) stated that the UK was in an "economic crisis".

Reinforcing this, Labour has signed up to the current government's relatively tight spending plans and pledged to not raise Capital Gains Tax, Income Tax or National Insurance. They have pledged to hold corporation tax at 25% for the duration of the next Parliament.

There is also an emphasis being placed on cost control. The party plans to set up a new "Office for Value for Money" to ensure "all taxpayers' money is spent wisely"[5], supporting a goal of halving government spending on consultancy fees and ending the use of hotels for asylum seekers.

THE EUROPEAN UNION

Labour has ruled out the UK either rejoining the EU or participating in its institutions. Single-market membership has also been ruled out because of the requirement for freedom of movement.

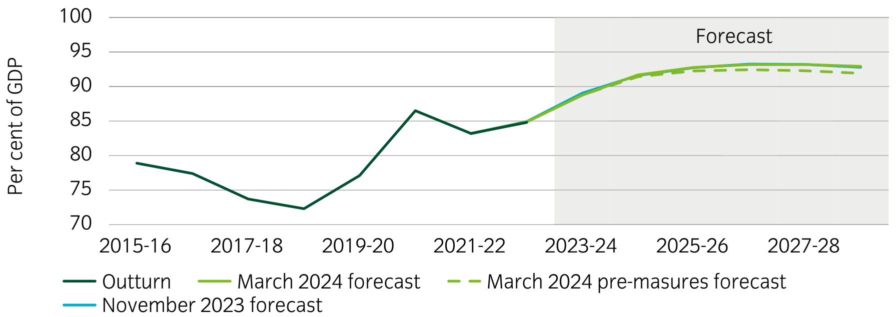
It is likely that the trend of improving relations between the EU and UK would continue, with Labour likely to try and use the 2025 review of the post-Brexit Trade and Co-operation Agreement to have a closer trading relationship with the EU. How much the EU itself will be prepared to move on this front is difficult to say, as the existing agreement appears to be working well.

[5] https://labour.org.uk/missions/

POLICY BORN FROM NECESSITY

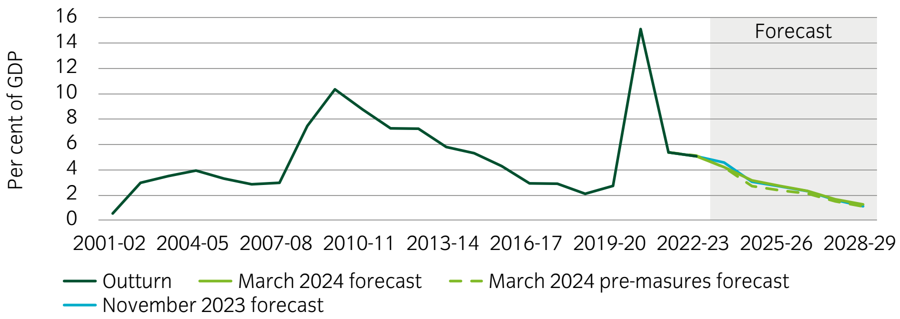
There is good reason for Labour to be emphasising fiscal prudence and focusing on growth via supply-side reforms. UK debt has risen substantially, with net debt as a percentage of GDP (excluding Bank of England holdings), estimated to reach 88.8% in the 2024/25 fiscal year, and projected to rise to a peak of 93.2% in 2027/28 (see Figure 1).

Figure 1: Public sector net debt is unlikely to peak until 2027/28[6]



Following the Spring Budget, the OBR updated its assessment of the UK's fiscal position, forecasting that the fiscal deficit would fall from 4.2% in 2023/24 to 1.2% in 2028/29 (see Figure 2). The deficit at the forecast horizon was revised up slightly from its forecast at the time of the Autumn statement.

Figure 2: Public sector net borrowing is expected to slowly decline[7]



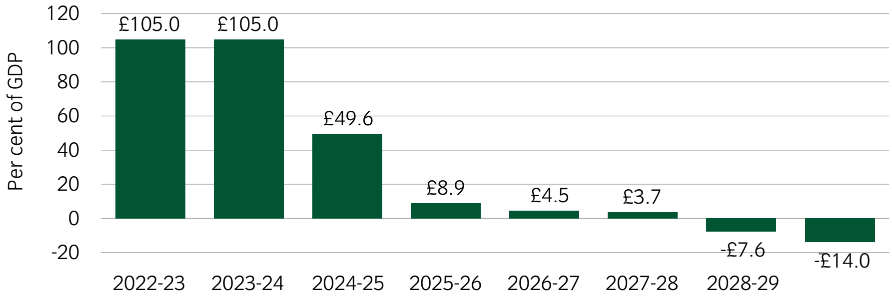
LITTLE ROOM FOR ADDITIONAL BORROWING

Were Labour to be elected at the general election, based on current OBR forecasts:

- the first fiscal rule – to close any deficit on day-to-day spending over the next five years – would be met, with headroom of £14bn in 2028/29 the fifth year of the forecast (see Figure 3); and
- the second fiscal rule – to ensure that debt will be falling as a share of GDP by the fifth year of the forecast horizon – would also be met, but the OBR observes that the fiscal margin is historically relatively low and only equates to about £8.9bn.

[6] OBR, Economic and fiscal outlook, March 2024.
[7] OBR, Economic and fiscal outlook, March 2024.

Figure 3: OBR projections for current, cyclically adjusted government budget deficit, £bn[8]



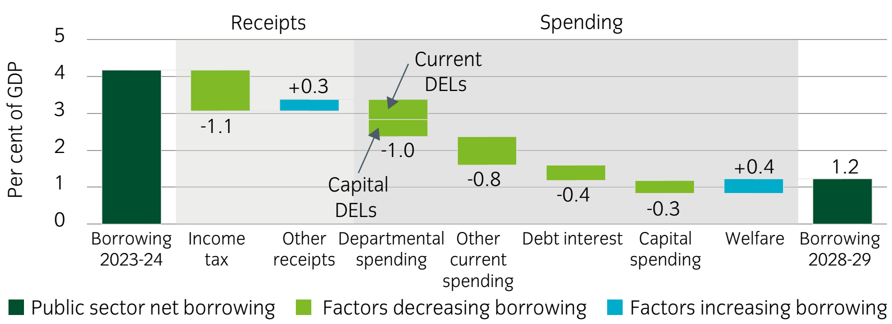
EVEN PRESERVING CURRENT BUDGETS WILL BE A CHALLENGE

Unless there is some upward surprise to growth, or the OBR has underestimated the tax take per unit of GDP (the tax multiplier), it is hard to see how Labour could stray far from current spending plans.

As noted above, the OBR is projecting that the fiscal deficit declines from 4.2% in 2023/24 to 1.2% in 2028/29. These fiscal forecasts are conditioned on spending plans which broadly assume no real growth in public spending per person over the next five years, (although it does rise a little in 2024/25).

With spending on health, education, defence, aid and childcare protected, this would require substantial cuts elsewhere. Investment spending is forecast to inch lower in cash terms over the forecast period from £99.2bn in FY2024/25 to £97.4bn in FY2028/29.

Figure 4: How the UK is projected to reduce its fiscal deficit in the years ahead[9]



> These fiscal forecasts are conditioned on spending plans which broadly assume no real growth in public spending per person over the next five years

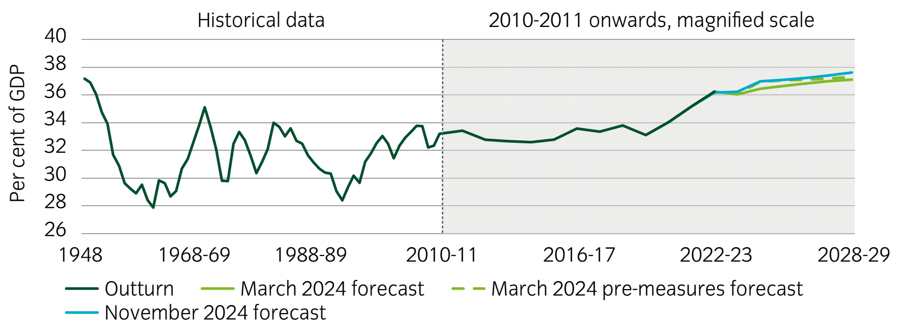
[8] OBR, Economic and fiscal outlook, March 2024.
[9] OBR, Economic and fiscal outlook, March 2024. This chart does not include the effects of changes in our underlying forecasts for most environmental levies, VAT refunds or depreciation, as each change both receipts and spending by equal amounts and therefore do not change borrowing.

TAX RISES ARE A DIFFICULT OPTION

Given the expectation that a Labour government would improve public services, the party would likely be under significant pressure to increase spending above the assumptions being made in current OBR forecasts.

With additional borrowing difficult, any increase in current spending would almost certainly need to be financed by additional tax increases. But, with commitments not to increase any of the major sources of tax revenue, the party would have to rely on finding a range of new marginal revenue streams. Notably, even without new taxation measures, the tax take is expected to rise to a new high as a percentage of GDP over the course of the Parliament (see Figure 5).

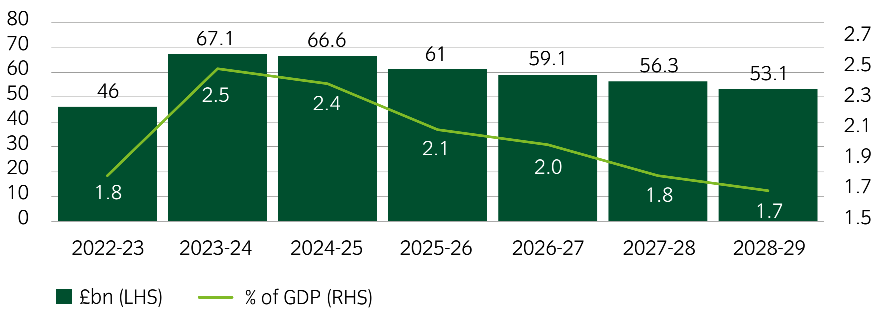
Figure 5: National Accounts taxes as a share of GDP are set to rise to a new high over the Parliament[10]



There is also the issue of government plans announced but not implemented. The OBR assume that there will be an annual increase in fuel duties because that is stated government policy – a policy which has not been implemented since 2011. This measure alone is forecast to add approximately £5bn (0.2% of GDP) to annual revenues each year of the forecast period.

One way that a new Labour government could borrow more, markets allowing, and still meet its fiscal rules would be for investment, as this would be possible within the two fiscal rules. With the latest profile of investment spending falling in both nominal and real terms over the horizon (see Figure 6), it seems highly likely that should Labour win the election it would seek to borrow more to increase investment. Unfunded government investment spending could promote near term growth but any improvement in the supply side of the economy would only be noticable in the longer-term.

Figure 6: OBR projections for public sector net investment (£bn and % of GDP (RHS))[11]



[10] OBR, Economic and fiscal outlook, March 2024.
[11] Source: OBR Spring Budget 2024 update.

CONCLUSION

Whoever wins the next election is going to be faced with a series of difficult choices. There is no easy path for a new government faced with taxes at all-time highs, high levels of debt and a deficit-reduction plan which relies on fiscal restraint. The only potential way to escape this predicament would be if the UK economy grew more rapidly than currently expected. But there are no short-term fixes to the low growth and demographic headwinds facing most developed markets. There is a meaningful risk that the elected party, be that Labour or the Conservatives, breaches its fiscal rules in the years ahead.

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