Global Counsel

What to expect from a first Labour budget: headline choices on fiscal policy

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DON'T EXPECT A "BIG BANG" FIRST BUDGET

A Labour victory at the next general election would bring expectations of a major change in approach to fiscal policy. However, there are economic, public finance and political reasons why this may be less marked than some expect.

First, the economics. Although inflation is expected to ease in 2024, it is still set to remain above the Bank of England's 2% target. That means some basic fiscal and monetary mechanics. The BoE may be in the early stage of a loosening cycle by next autumn — the most probable date of the election — but any such monetary policy pivot is likely to be cautious. In that context, a sudden dose of fiscal stimulus in the form of, say, large-scale public investment would be a gamble that risked jeopardising an improving inflation picture. It is unlikely that a Labour government would want to risk such an approach. Labour have also repeatedly cited the Truss administration as an example of the risks of fiscal irresponsibility, so will be conscious of the constraints imposed by global financial markets.

FIG 1: COMPARISON OF ECONOMIC AND FISCAL METRICS

METRIC	1997	2024 (F)
CPI inflation (previous three-year avg)	2.6%	5.9%
GDP growth (previous five-year avg)	1.9%	0.4%
Public sector net debt (ex BoE)	37%	96%
Debt interest (% of GDP)	3%	3.6%
Bank rate	6.25%	4.2%
Tax level (% of GDP)	30%	37%
Public spending (% of GDP)	36%	46%
Fiscal headroom (% of GDP)	1.4% (long-term avg)	0.2% (2027-28)

BETTER WORSE

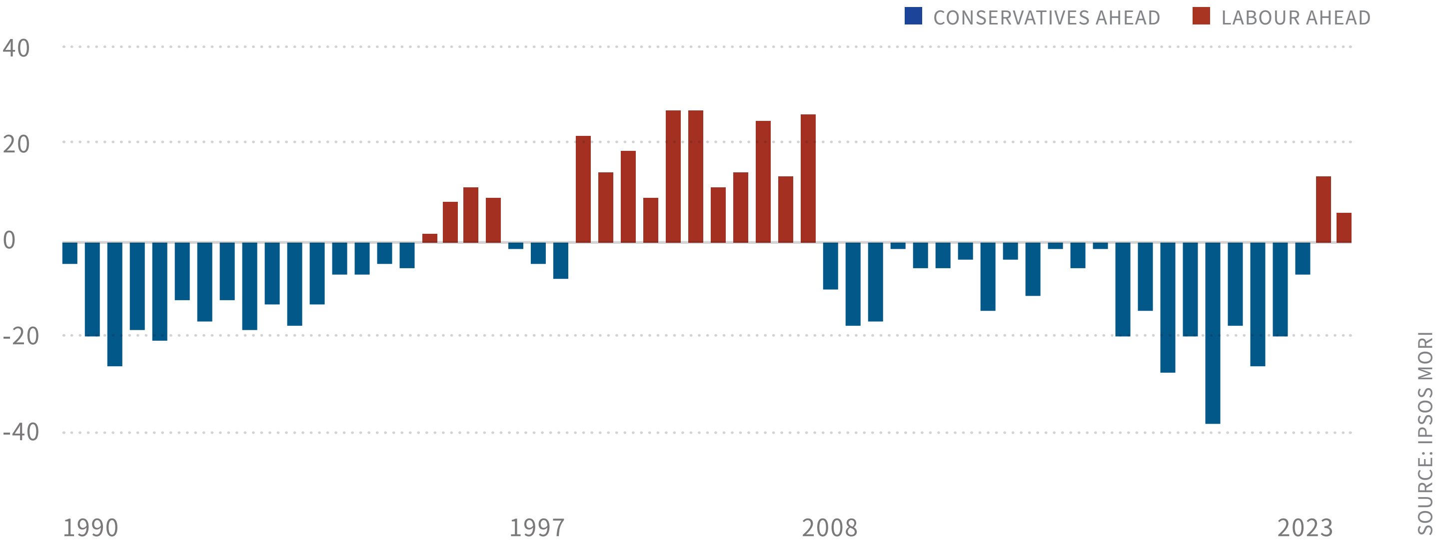
Second, the public finances. Labour have committed to fiscal rules that broadly mirror those of the current Conservative government. This means they would be operating under similar constraints. On borrowing, Labour are committed to balancing the day-to-day budget. They have also pledged to reduce government debt. On the revenue-raising side, the party is reluctant to propose raising personal taxes both because household finances are under pressure but also because the Conservatives are likely to repeat their pledge to not raise income tax, national insurance and VAT, which collectively make up around 60% of government tax revenue. All this points to a tight fiscal environment.

When Labour last entered government in 1997, they also took a cautious approach in their first budget. Having already committed to follow Conservative spending plans for the first two years pre-election, then Chancellor Gordon Brown tightened fiscal policy in July 1997 over fears of rising inflation. By comparison, the economic and fiscal landscape today is worse on almost every metric (see table below). Today, inflation is more than twice as high, growth has been anaemic, government debt has ballooned and the tax burden is heading for its highest level since 1948. The constraints would be even tighter than 1997.

Third, the politics. If and when inflation does subside, Labour would want to take credit for stabilising financial conditions. That would be harder to do if they introduced a major programme of public investment that might spark a countervailing response by the Bank of England. Monetary and fiscal policy working at cross purposes is rarely a recipe for success. Electoral calculations also

LABOUR HAS NOT BEEN SEEN AS THE BEST PARTY TO MANAGE THE ECONOMY SINCE IT WAS LAST IN GOVERNMENT

Best party at managing the economy



point towards moderation. Labour is now ahead of the Conservatives on public perceptions of which party is best to manage the economy (see chart) — a position it hasn't occupied since it was last in government in the late 2000s. Senior figures, including Keir Starmer, have already begun to lay the groundwork for such a moderate approach, repeatedly arguing that they won't be able to pursue many policies as a result of economic, fiscal and financial conditions.

TAX, SPEND, BORROW, REPRIORITISE – NOT MUTUALLY EXCLUSIVE CHOICES

So, in highly constrained circumstances, what would Labour actually do?

Much of the debate on Labour's fiscal options is often characterised simplistically as a choice between tax and spend or effective austerity. But the reality would be more complicated. All governments deploy a mix of the fiscal levers available to them: tax, spend, borrow, reprioritise. It is a question of how each would be weighted, not a choice between them.

On tax, Labour has identified some targeted — albeit modest — revenue-raising measures, including eradicating non-domiciled status, removing private schools' VAT exemption and changing rules on carried interest. These might raise something like £5bn a year, or around 0.5% of forecast government tax receipts in the first full year of a prospective Labour government. This would hardly transform the fiscal picture, but it would allow Labour to slowly shift the government's priorities. It could fund, for instance, the start of a recruitment push for more specialist school teachers, healthcare professionals and frontline police officers, as the party has pledged.

Another target for a Labour government might be applying "fiscal drag" to the top-rate tax threshold while releasing it at lower thresholds. This would raise much less than the c.£25bn a year of full fiscal drag across all thresholds, but it would pull several hundred thousand taxpayers into the top bracket and raise useful sums. At the same time, it would provide relief for basic-rate taxpayers, several million of whom would not be pulled into the higher rate if fiscal drag continued across the tax system. At the autumn statement in 2022, Rachel Reeves criticised the use of fiscal drag as a stealth tax, but her concerns were about the impact on "ordinary working people", not top earners.

Further windfall taxes are also likely to be another appealing option for a Labour government. Labour has consistently called for the windfall tax on North Sea energy producers to go further by removing some of the investment incentives (what Labour describes as "loopholes"). Doing so might raise £3bn — again not a game-changer, but useful. Labour may also be tempted to reach back into the financial services sector with another windfall tax, given the discrepancy between interest income and the pass through to savers. According to the Bank of England, major banks' net interest income in Q1 2023 was 30% higher than a year earlier, at £21bn, reflecting in part a rise in the base rate over this period from 0.5% to 4.25%. Labour has form on windfall taxes. In 1997, a windfall tax on privatised utilities was used to fund some of its spending commitments. It is not inconceivable that they may look to this mechanism again.

On spending, Labour's biggest commitment was its £28bn a year green investment pledge. This has been walked back to being an ambition for the second half of the next parliament. Within this pledge, Labour have talked about two specifics: first, a £6bn 'Warm Homes Plan' to improve energy efficiency in homes; and, second, an £8bn National Wealth Fund over the course of the next parliament. Labour has also committed to a range of rail projects that broadly align with the Integrated Rail Plan for the midlands and north of England. Delivery in full would cost £96bn over 30 years (or £3.2bn a year on average). Beyond these capital-heavy commitments, Labour's main pledges currently are to invest more in the public-service workforce.

On borrowing, despite its fiscal rules, Labour would want to create some space to fund additional public investment. They have committed to reducing government debt but haven't yet clarified a timeline over which to do so. There are several options, moving from the most to least restrictive:

1. Debt falling by the end of the next parliament;

2. Debt falling in the final year of the five-year rolling forecast period, i.e. 2027/28 (government policy);

3. Extend the forecast period to, say, a ten-year outlook and have debt falling in the second half of that period.

Part of the dilemma Labour is grappling with is fiscal accounting. It is accepted that increasing public investment would likely have a positive impact on productivity and growth over the medium term. However, because the benefits accrue largely beyond the current five-year forecast period, public investment appears in OBR forecasts as an increase in debt with little positive economic impact. For instance, in March 2020, Boris Johnson's government planned to raise public investment by 30%. The short-term impact on productivity was assessed at only 0.1 percentage points a year, whereas its long-term impact was 2.5%. We could expect similar forecast impacts under a Labour government. For these reasons, Labour is considering options for extending the accounting period so that some of the growth effects show up in the numbers, albeit with significant uncertainty attached. It would also mean that if governments decided to cut public investment thereafter there would be a visible negative impact on medium-term GDP.

Finally, on reprioritisation, it is easy to see how some existing government spending could be repackaged by Labour. When the party first announced its £28bn commitment in 2021, it talked about this as "additional" capital investment. However, in its green energy mission document this year, it only refers to "a total of £28 billion". There is little doubt Labour would like to increase public investment by making additional commitments, but this may not be necessary to meet the £28 billion pledge as currently defined. For instance, the government's Social Housing Decarbonisation Fund — a £3.8bn scheme over ten years — would comfortably fit within Labour's 'Warm Homes Plan'. Equivalents of ECO4 and the Boiler Upgrade Scheme would also slot easily into this programme. It is also conceivable that funding such as the £1bn Automotive Transformation Fund, which supports manufacturers to transition to electric vehicle production, could be categorised as part of this overall figure.

In sum, because of Labour's fiscal rules, tax and spend would likely be broadly balanced, fairly moderate in size but also likely bigger than under the Conservatives. Labour would want to create more space for public investment, which may mean some expansion of borrowing (subject their finalised fiscal rules and accounting approach). Finally, there is enough ambiguity in their language around the £28bn commitment that some, if not much, of that may be made up by reprioritising existing spending.

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