How the new UK government can tackle the public finances

The incoming Labour government has a mountain to climb with the public finances. Here's a guide to where it could find money relatively easily – and also crucially where it won't

The honeymoon for incoming Prime Minister Keir Starmer will be short-lived

Key points

- Ending planned spending cuts is likely to be Labour's first priority. A combination of tweaks to fiscal rules, exploiting flexibility in the existing rules and a collection of tweaks to minor taxes mean finding the £20bn per year needed may not be as difficult as some have assumed.
- This won't stem the longer-term pressure on the finances. More money will inevitably be needed to address ailing public services and the effect of an ageing population.
- Growing the economy will be difficult. Persuading the Office for Budget Responsibility that growth will be higher will be harder still. Existing forecasts are already pretty optimistic. Downgrades to these projections would limit Labour's room for manoeuvre even further.
- Further tax rises look inevitable. The UK's tax take is already the highest in decades as a share of GDP. But it's also noticeably below the European average.

- The Bank of England is poised to cut rates in August and that could spell a weaker pound. Read our initial election reaction for more on these topics.

Labour faces a tough inheritance

Britain is waking up to a Labour government for the first time in 14 years, and one that will command a significant majority in the House of Commons. But the honeymoon for incoming Prime Minister Keir Starmer will be short-lived.

Labour will already have its sights on the next election in 2029, far off though that now seems. Britain's First Past the Post election system has shown tonight how it can produce huge swings in an environment where the two major parties are getting an ever-smaller share of the overall vote. Labour won with just 34% of the vote, just a two percentage point increase from 2019 where it claimed half the number of seats.

The party will be taking nothing for granted and the pressure to hit the ground running will be enormous. But when it comes to the public finances, incoming Chancellor Rachel Reeves faces an unenviable inheritance. The UK is grappling with a 4.4% deficit and public debt that is fast approaching 100% of GDP.

Labour's first priority, we suspect, will be to find a way of ending the previous government's planned cuts to public spending. Labour has promised no "return to austerity".

Left unchanged, existing Treasury plans would see real-term cuts of at least 3% per year in government departments outside of "protected areas" like health or defence. Those plans have always looked challenging, particularly when you consider that several government departments have already seen real-term cuts in excess of 20% over the past decade.

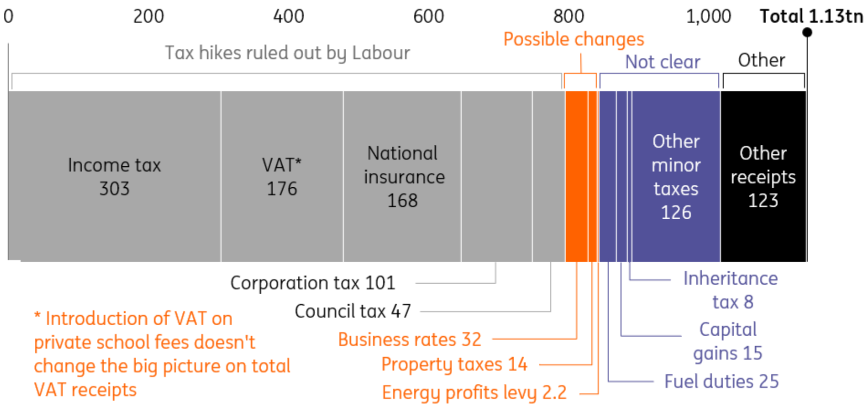
The price of ending those cuts is likely to be around £20bn per year by the end of this Parliament. Labour's manifesto, using its own costings, falls well short of this number. Revenue raisers amount to less than half a percent of GDP.

On the face of it, the choices look limited. Labour has ruled out raising taxes that account for 80% of the public revenue it can actively control – see the chart below. The party has pledged to keep the most important of the fiscal rules unchanged, and as it stands those rules will be met only by the thinnest of margins.

Even so, we think finding the money needed to reverse those planned spending cuts won't be as hard as it looks. Here are four options that Labour will be seriously considering in the run-up to its first budget.

Labour has ruled out rises in major taxes

UK government receipts (GBP billion, OBR 2024-25 forecast)



Source: Office for Budget Responsibility, ING analysis of Labour plans

1 Option 1: Tweak the fiscal rules to unlock more cash

Labour is already planning a bit of this. One of the three current rules dictates that the deficit should not exceed 3% in five years; Labour wants to tweak this to allow more room for investment.

Whatever the pluses and minuses, such a change currently looks irrelevant. That's because it's a different rule that currently binds the public finances.

This rule dictates that debt should start falling as a share of GDP in five years' time. Currently, the OBR judges that this rule will be met by the thinnest of margins. Labour is promising to keep this rule as it is but the temptation for change will be enormous.

Simply tweaking the definition of debt used in this rule could unlock in excess of £20bn per year. The current metric is being adversely affected by the Bank of England's quantitative tightening, artificially making the public finances appear tighter than they actually are. Switching back to the more conventional definition of public debt would single-handedly unlock the money needed to end those spending cuts.

2 Option 2: Exploit flexibility in existing fiscal rules

If Labour doesn't want to make changes to the rules, then remember that the rules already grant the Treasury a surprising amount of flexibility. Successive chancellors have found that spending increases (or more recently, tax cuts) are possible under the fiscal rules if they are made temporary.

That might sound cynical, and it isn’t ideal. But it’s a tactic that’s far from new, and it’s one that doesn’t seem to have overly fazed investors in the past. Just take the previous government’s policies to incentivise business investment. The so-called “super-deduction” was initially billed for two years, before ultimately being made permanent when the public finances allowed.

It would be a surprise if the incoming chancellor didn’t make use of this flexibility too.

Option 3: Raise taxes

In its first budget, potentially as soon as mid-September, many suspect Labour could make a large number of small changes to lesser-known taxes and associated tax reliefs. That may well include changes in areas like Capital Gains Tax and Carried Interest.

Such changes aren't going to change the game, given they make up a relatively small share of overall revenue. But dozens of minor tweaks could still raise a reasonable sum of extra cash. In addition to Labour's existing manifesto pledges, this might be just about enough to boost spending and end those planned cuts.

4 Option 4: Borrow to invest

Extra borrowing is not a viable route to ending those cuts to day-to-day public spending in and of itself. But Labour is also looking to boost public investment, which as a share of GDP, is set to fall under existing budget plans.

This is an area where the party has dipped its toe in the water in its manifesto with a promise to borrow £3.5bn. That's a drop in the ocean, but is perhaps a statement of intent. Assuming the borrowing is done within a credible framework and is intrinsically linked to productive infrastructure investment, debt markets are unlikely to balk in the way they did in 2022.

These options are only short-term fixes

Some combination of the above would probably enable Labour to drop the planned spending cuts without having to do more radical changes in its first budget and spending review due later this year.

The problem is that none of this is a long-term fix. It may simply delay the need to revisit more substantial tax rises. Take healthcare, where existing funding is likely to fall well short of the previous government's plans to grow the NHS workforce – an ambition that Labour shares. Doing so will likely cost tens of billions; Labour's manifesto commits less than £2bn for health.

Labour will hope that some of this can be achieved by simply growing the economy. That would increase tax revenues and help fund public services. And fortunately for the new chancellor, some of that is happening already.

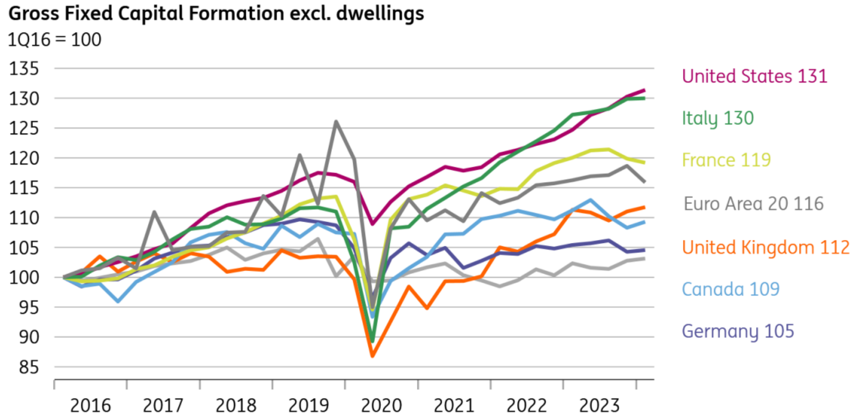
First quarter growth came in at 0.7% and the economy will likely grow by 0.4-0.5% in the second, having entered a very shallow technical recession last year. Strong real wage growth should allow the economy to grow further, albeit at a slightly slower pace, in the second half of the year. The economy is belatedly feeling the benefit of lower gas prices.

But this is ultimately a short-term cyclical story. In the longer term, Labour is hoping to leverage private investment, particularly in green sectors, to boost productivity and growth. Rachel Reeves has, rightly, pointed to initiatives such as Contract for Difference auctions which have helped substantially increase investment in offshore wind over recent years.

These have shown the merits of a reliable and well-structured policy framework to generate long-term investment. The systematic underperformance of UK business investment relative to its peers post the Brexit referendum can often be traced back to policy uncertainty and political volatility.

More recently though, that trend has reversed and the UK has outperformed its G7 peers on investment over the past two to three years. Some of that will be linked to the tax incentives mentioned earlier. But greater certainty on the EU trading relationship will undoubtedly have helped, even if the deal itself involved more red tape than businesses were previously used to.

Investment underperformed pre-Covid but has outperformed more recently



Source: Macrobond, ING calculations

Persuading the OBR to upgrade growth forecasts is key

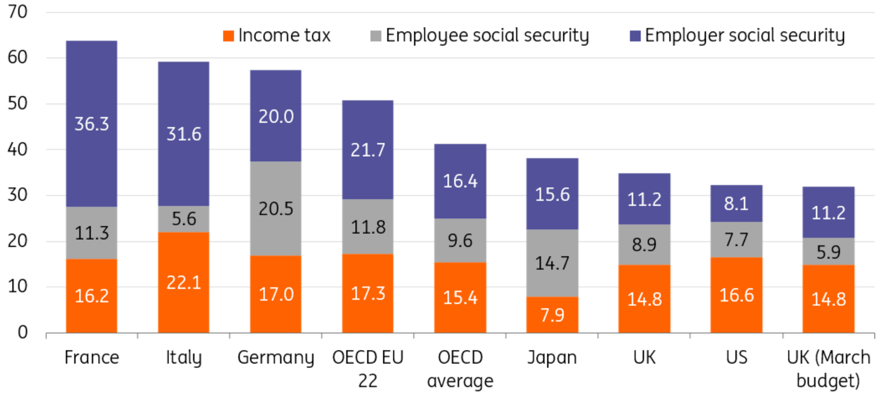
Still, politics is far from the whole story and when it comes to weak investment, several roads lead back to the UK's planning system. For instance, the UK's most recent high-speed rail project saw costs per mile spiral to several multiples of what is typically paid elsewhere in Europe. Planning issues have also constrained development of the National Grid, which in turn has caused severe delays in connecting those new offshore wind farms.

Labour has acknowledged changes are needed to promote affordable housing and infrastructure development, amongst other things. But this is easier said than done and crucially, it will take time.

In the much shorter term, Labour's task is to convince the OBR that its plans for the economy will permanently lift productivity growth. That's the key to unlocking more cash under the fiscal rules. The OBR would likely look at investment reasonably favourably, though it has warned that this isn't necessarily the case for all types of green investment.

The biggest challenge for Labour here is that the OBR's growth forecasts already look optimistic. They assume that the UK will achieve growth of close to 2% consistently across the medium-term. That's not inconceivable; this was what growth averaged in the 2010s, albeit with much lower interest rates, fewer constraints on labour supply and a less protectionist world order. Downward growth revisions shouldn't be ruled out and that would limit the chancellor's room for manoeuvre yet further.

Income and social security as a percentage of an average single-person's income (2023 data)



Source: OECD, ING calculations

Note: National Insurance was cut by four percentage points for employees across the November 2023 and March 2024 budgets

Tax rises may become the only option

If Labour can't generate the sort of growth rates it is hoping for, then more significant tax rises may become the only option.

Labour's opponents will point to the fact that taxes are already historically high. As a share of GDP, revenue is the highest since World War II, in no small part because of recent freezes in income tax brackets and the impact of higher inflation.

But maybe history isn't the most reliable guide. The tax burden is inevitably rising given the UK's ageing population and other structural challenges. And when you compare the situation to overseas, the UK's tax take doesn't look so significant.

That's particularly true if you look at social security payments. Following recent cuts to National Insurance, employee social security contributions make up less than 6% of average wages by our estimations. The EU average is closer to 12% according to OECD data, and the differences are bigger still when you look at employer contributions. That's not to say this is a model that the UK should necessarily emulate, but it is a stark comparison nonetheless. And a reminder that higher taxes may be needed to achieve similar levels of public service provision seen elsewhere in Europe.

Whatever happens, the challenge facing the new Labour government is enormous. Investors, though significantly more relaxed about the UK's public finances than they once were, will be watching closely.

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