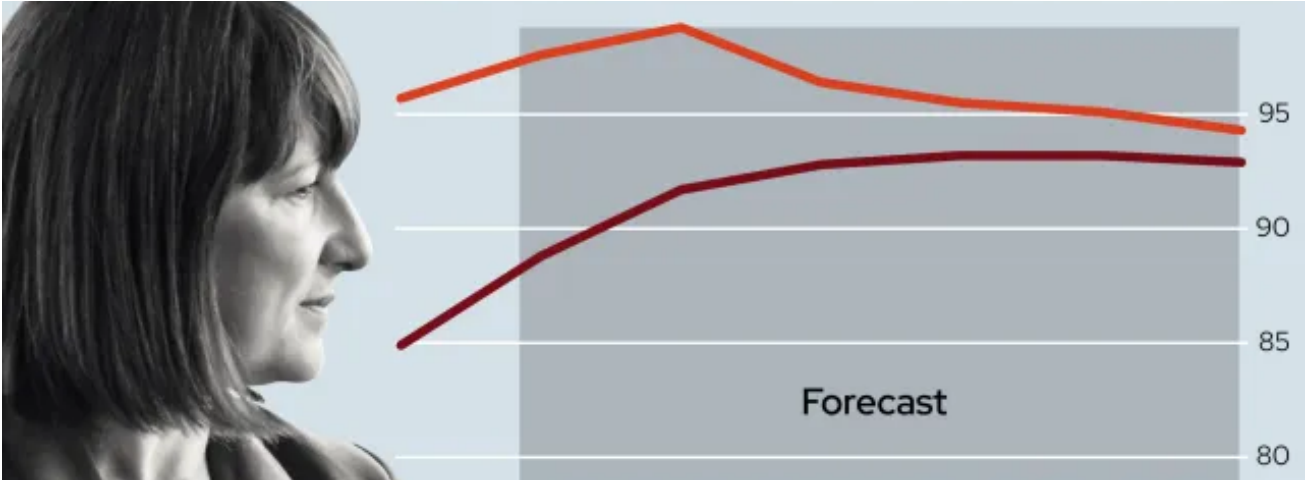




Labour government could spend extra £16bn without raising taxes

EXCLUSIVE

Shadow Chancellor Rachel Reeves has left scope to borrow more money by changing how debt is measured, economists say



Rachel Reeves will be responsible for public spending if Labour wins power

By Alexa Phillips

June 23, 2024 10:00 am

A Labour government could borrow an extra £16bn to fund public services without raising taxes or spooking markets, economists have told **i**.

The party has been accused of leaving a black hole in its spending plans, which will force it to raise taxes – but senior economists back changes to “fiscal rules” that would allow the party to borrow more money.

Since Liz Truss provoked market backlash and interest rate rises by failing to get her borrowing plans checked by the spending watchdog, the Office for Budget Responsibility (OBR), both parties have worked hard to present themselves as financially responsible.

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For **Shadow Chancellor Rachel Reeves**, this has included outlining a set of iron-clad public finance targets known as fiscal rules, which are overseen by the OBR and designed to reassure international investors who back the UK economy.

A Labour Government will stick to Prime Minister Rishi Sunak's current rule that debt should fall year-on-year as a share of gross domestic product (GDP) by the fifth year of official forecasts produced by the OBR.

Ms Reeves wrote in the *Financial Times* last week that a “robust fiscal and monetary framework is non-negotiable if we are to retain market confidence, keep borrowing costs down, and provide the stability business investment requires”.



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Economists told **i** the Conservatives' fiscal rules have hampered investment and economic growth, costing the country more in the long run.

In the March Budget, the debt rule left the Government with only £8.9bn of "fiscal headroom" – the amount by which it can increase spending or cut taxes, according to the OBR.

Chancellor Jeremy Hunt wrote in the *Financial Times* last week that "if you want lower taxes and good public services – as both parties do – you have to explain how to live within the current very tight fiscal envelope".

Ms Reeves accused the Tories of a "short-termist approach that disregards the importance of public investment" and pledged to axe his fiscal rule that the deficit, including investment, must not exceed three per cent of GDP in five years' time. Instead, Labour will borrow only to invest.

James Smith, research director at the Resolution Foundation think-tank, told **i** this change gives Labour "scope" to invest more but added the party appears constrained by the target to get debt falling.

However, he pointed out that Labour "have not said what measure of debt they will get falling" in their manifesto, which gives them an opportunity to redefine it.

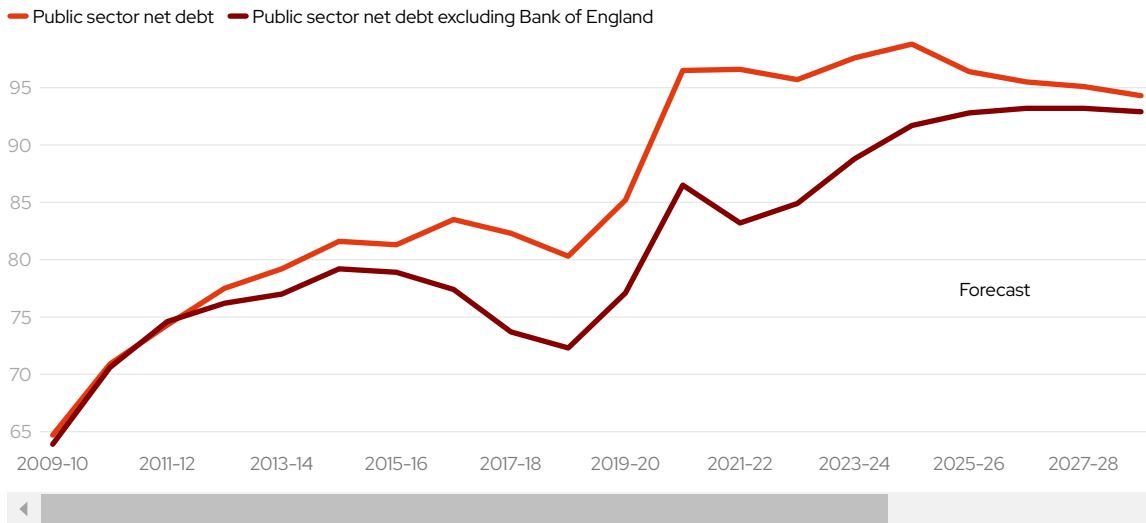
The Government currently uses a measure of debt that does not include the Bank of England's debt, which has been decreasing.

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If the Labour party could change the debt target to be based on the overall total, including the Bank of England's debt, Mr Smith said it would give them more fiscal headroom.

Debt falls more sharply when Bank of England is included

Measures of debt as a percentage of GDP



However, he said it would not be a "substantive" change "in terms of fiscal policy".

The modification would give Labour an extra £16bn for spending or tax cuts, according to analysis by the Centre for Economics and Business Research, shared with **i**.

Ashley Webb, an economist at Capital Economics, a research consultancy, said the Government cannot really control the Bank's debt, which is why it "seems sensible" not to use it in the debt target.

But he said the total debt figure "provides a more honest assessment" of the Government's debt.

"When it comes to the bottom line of what the UK Government owes, this is what matters," he told **i**.

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Former Bank of England economist backs another change that could give Labour as much as £20bn



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TO COMBAT INFLATION, THE BANK OF ENGLAND HAS BEEN CUTTING ITS DEBT. IN A PROCESS KNOWN AS QUANTITATIVE TIGHTENING, THE BANK HAS BEEN SELLING BONDS TO INVESTORS AND LETTING BONDS MATURE WITHOUT REPLACING THEM. BONDS ARE ESSENTIALLY IOUs ISSUED BY THE GOVERNMENT AND BUSINESSES AS A MEANS OF BORROWING MONEY.

This process is a reversal of the quantitative easing – informally referred to as ‘money printing’ – that happened during the pandemic and was introduced in 2009 to pump billions into the UK economy.

Higher interest rates have driven down bond prices, so the Bank is recording losses on those sales.

The Treasury gives payments to the Bank to compensate it for these losses, which are then included in the public debt figures.

Mr Saunders said these losses "are significantly constraining fiscal space" and increasing the "fiscal tightening" – spending cuts and/or tax rises – "needed to meet the debt rule".

Changing this could give Labour an extra £20bn for spending or tax cuts, according to Oxford Economics, where Mr Saunders is now a senior adviser.

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“Monetary policy is accidentally constraining fiscal policy,” he told **i**.

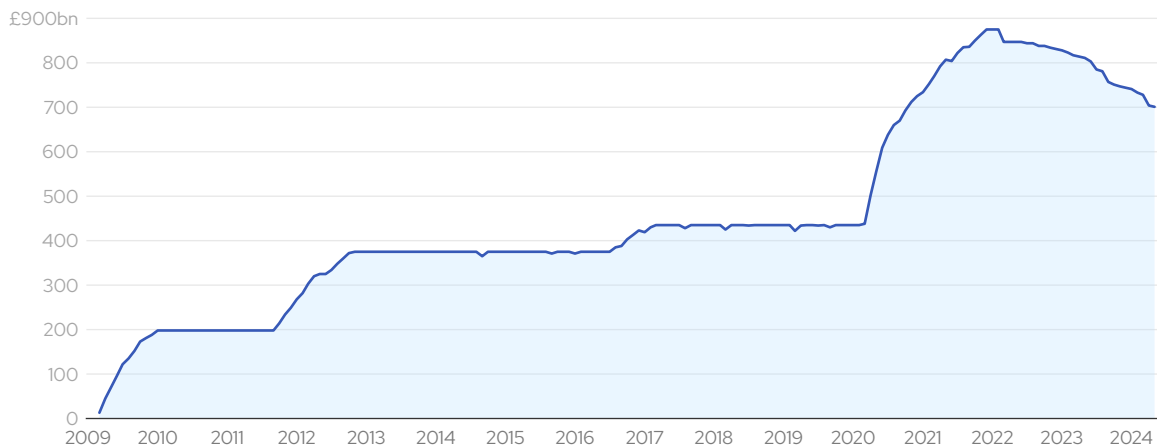
“This spillover from quantitative tightening to fiscal policy is accidental but means that quantitative tightening is significantly dampening the economy via its effect on fiscal policy.

"The monetary policy committee do not take this into account when deciding the appropriate pace of quantitative tightening.

“It would be better to exclude these losses from the debt measure so the monetary policy committee can do whatever pace of quantitative tightening they desire, without this affecting fiscal policy.”

The Bank of England has been selling off bonds

Gilt holdings



Source: Capital Economics

Fiscal rules 'lead to problems with public services'

Mr Smith warned that Labour could still be forced to cut investment to get debt falling and called for them to go further to promote growth.

Focusing on the public "net worth" rather than debt could allow for billions more to be borrowed to invest in infrastructure, he said.

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The proposal, which he initially outlined in a paper co-authored with Richard Hughes before he became OBR chair, would factor in the positive value of assets created by investment, such as railways, wind farms, roads and infrastructure.

The International Monetary Fund also backs the idea. New Zealand has already adopted a "net worth" target of around 40 per cent of GDP and has more flexible economic targets. It also assesses the "well-being" impact of its budget.



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"We have a poor record in terms of how much investment we do relative to other countries, but it also creates all sorts of problems," he said.

"If you're doing investment you don't know whether it's going to go ahead or get cut. We see lots of chopping and changing of plans – HS2 was a manifestation of that – which means it's more expensive to invest."

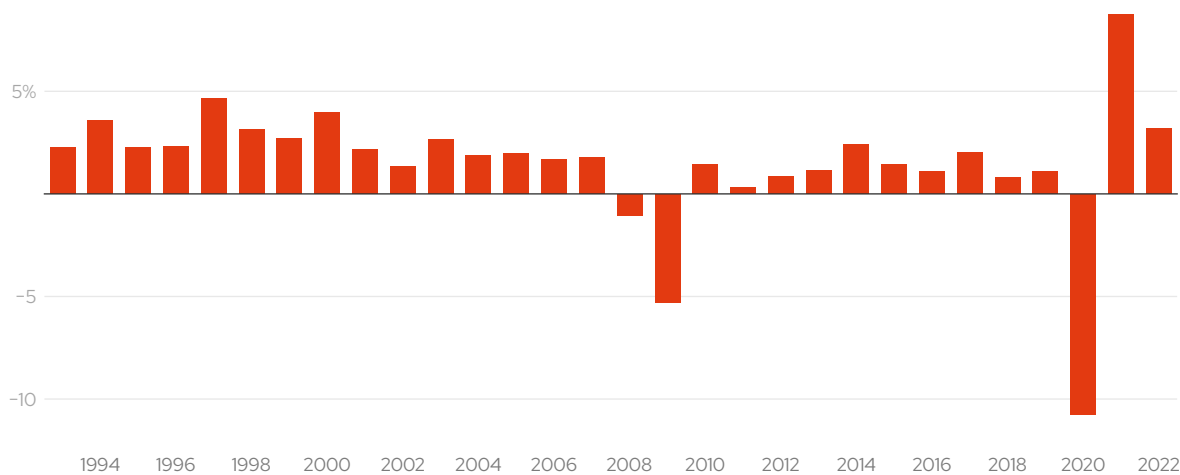
He said there was a "very sharp trade-off" for failing to invest, adding that the UK is "spending lots on the NHS, but we still have a really big problem with waiting lists and other measures of performance".

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Mr Smith said this was a "more recent phenomenon" since the size of the state shrunk during the aftermath of the financial crisis.

Economic growth per person slowed after the 2008 financial crisis

Annual growth in GDP per capita (%)



Does the UK need fiscal rules?

Dominic Caddick, an economist at the New Economics Foundation think-tank, said cutting investment to meet fiscal rules has ended up costing taxpayers more in the long run.

"That's the spending that is the best for growth – the best for getting the return from your government spending," he told [i](#).

"It therefore leads to situations where growth is down and you have to spend more in the future fixing things because you don't have the infrastructure for it.

"If you think back to 2010 when we first started really going for austerity and really focusing on meeting our fiscal rules, since then debt has increased massively because there's a false economy in always trying to cut spending to cut debt. It just doesn't work."

He called on the future government to get rid of fiscal rules and replace them with "fiscal referees": a committee of independent experts such as OBR members who can advise on the economy, adapting to changing conditions while reassuring markets.

A similar concept of having flexible fiscal "standards" overseen by independent advisers was proposed by Olivier Blanchard, a former chief economist of the International Monetary Fund.

Labour and the Conservative were approached for comment. [i](#)

A brief history of fiscal rules in the UK

Fiscal rules were first introduced in the UK under the Labour government, which took power in 1997.

Then-chancellor Gordon Brown introduced a rule to borrow only to invest and have day-to-day spending covered by revenues – similar to what Ms Reeves has proposed.



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describes as among the loosest fiscal rules the UK has had.

Because the five-year forecasts are revised with every Budget and Autumn Statement, the Institute for Fiscal Studies think-tank has pointed out that the Government can keep rewriting its plans so that debt is rising every year – except after the fourth year, which is effectively continually pushed into the future.

Mr Caddick said it was a "silly rule that encourages bad decisions". For instance, if debt decreases for the first four years and then increases in the fifth year, the rule can still be broken even if debt has declined. It also means Governments can cut a tax but then plan to raise it in four years' time to "make the debt rule look better", he said.

If Governments ignore fiscal rules, there is a risk of spooking markets, as Liz Truss did when she failed to commission independent forecasts from the OBR to accompany her mini-Budget.

"What your fiscal rules are doing is saying to the market, this is my fiscal policy for the next few years, so you understand I have a strategy," said Mr Smith.

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