

# The Labour Party's landslide victory will soon collide with the UK's fiscal constraints

By Angelo Katsoras

The Conservative Party's high-risk gamble to call an early election in the hopes of winning voter approval on the back of cooling inflation and recent modest growth has failed spectacularly. In the end, its 14 years in power marked by anemic economic growth, inflation, high taxes, scandals, and unresolved issues, such as immigration and declining public services (e.g., overcrowded hospitals and ageing schools), could not be overcome.

But it will not be easy sailing for the Labour Party. Once the euphoria of the massive victory wears off, it will face a very sobering reality. On the one hand, it has presented an ambitious agenda to improve public services and advance the transition to green energy, all the while promising no major tax increases for the middle class and no return to austerity. On the other hand, this agenda will inevitably collide with the UK's historically high debt and interest costs. Labour will in fact have to choose who to disappoint: its supporters or the financial markets.

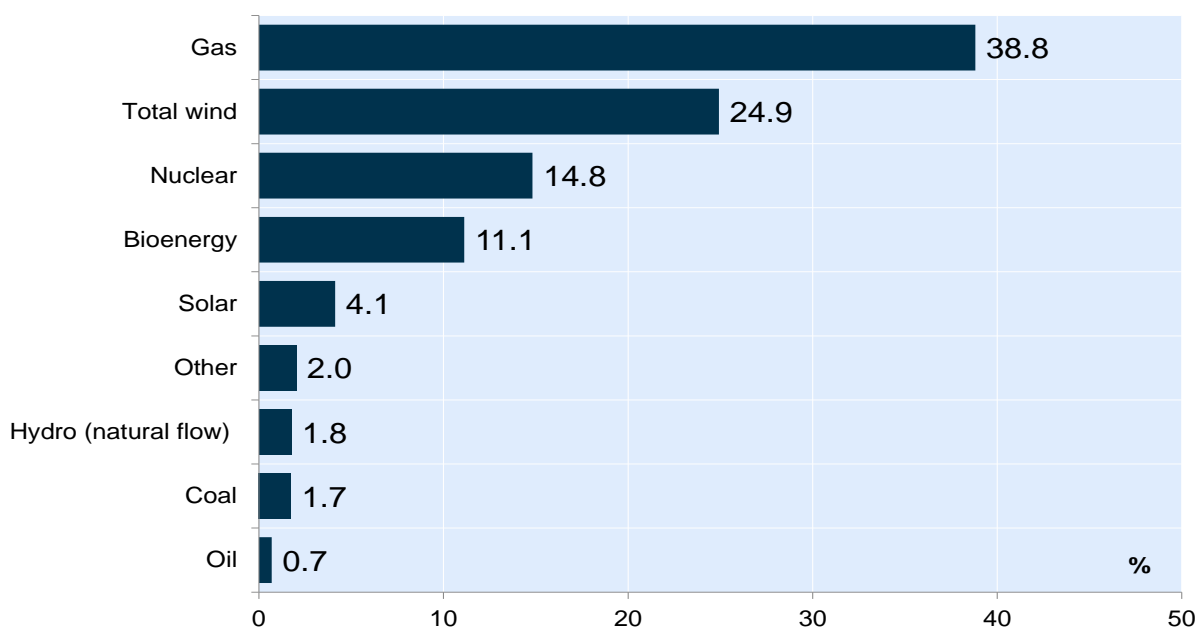
## Promises, promises

Below are some of the key promises made by the Labour Party:

- Create a publicly owned company called Great British Energy—backed by £8.3 billion in government funds—that will invest in clean energy. Overall, Labour has committed to spending an additional £23.7 billion for green measures over its term in office.<sup>1</sup>
- Create a National Wealth Fund backed by £7.3 billion to be invested alongside private capital. This includes £2.5 billion to rebuild the steel industry, £1.8 billion to upgrade ports and expand supply chains, and £1.5 billion to help the automobile sector.<sup>2</sup>
- Decarbonize the electricity sector by 2030, five years ahead of the current target. In 2022, over 40% of the electricity in the UK was generated from fossil fuels, primarily natural gas. Any remaining fossil fuel use would have to be offset by carbon capture technology. UK-based Aurora Energy Research estimated that it would cost £116 billion to make the new deadline.<sup>3</sup> AER also found that supply chain constraints, skills shortages, and lead times made this new target virtually impossible to achieve, even with adequate funding.

### U.K.: Electricity generation

Share of total generation by fuel type in the UK, 2022 (in percentage terms)



NBF Economics and Strategy (data via UK Department for Energy Security and Net Zero)

<sup>1</sup> "How do the parties' policy proposals fit in with their fiscal rules?" Institute for Fiscal Studies, June 4, 2024

<sup>2</sup> "The Labour Party General Election manifesto at a glance," PA Media, June 13, 2024

<sup>3</sup> "Labour's net zero plans 'will cost £116 billion'," Telegraph, March 25, 2024

- Reduce hospital waiting times by providing 40,000 additional appointments each week, hiring 8,500 health workers to treat patients with mental health issues and doubling the number of cancer scanners.
- Recruit 6,500 new teachers, create 3,000 new nurseries, and have free breakfast clubs at every primary school.<sup>4</sup>
- Increase defence spending from 2.1% to 2.5% of GDP. Although the Labour Party has not specified a timeline, achieving this target by 2030 would entail boosting UK defence spending from its current £64.6 billion to £87 billion by 2030-31.<sup>5</sup>
- Build 1.5 million new homes over five years. This challenge is all the more daunting in that fewer than 150,000 homes have been started in the past 12 months, well below the annual average of 300,000 completions needed to meet this target.<sup>6</sup>

## How will Labour pay for agenda?

The Labour Party has pledged not to raise income tax, value-added tax, or national insurance rates. They have also promised to maintain corporate tax at its current rate of 25%. Together, these taxes account for over 70% of government revenue.<sup>7</sup>

However, Labour is committed to tax increases targeting higher income earners. It intends to eliminate a 20% tax break for private schools in order to fund new teachers in the state sector, close remaining tax loopholes that allow non-domiciled residents to shelter some overseas income from taxation and raise more money from private equity firms. It also plans to crack down on tax avoidance and increase taxes on oil and gas companies.<sup>8</sup>

The Labour Party estimates that these measures will raise an additional £8.6 billion, most of which is to be used to fund social spending initiatives in education, health, and housing.

On the environmental front, Labour has stated that it will borrow £17.5 billion over five years to fund green energy projects.<sup>9</sup>

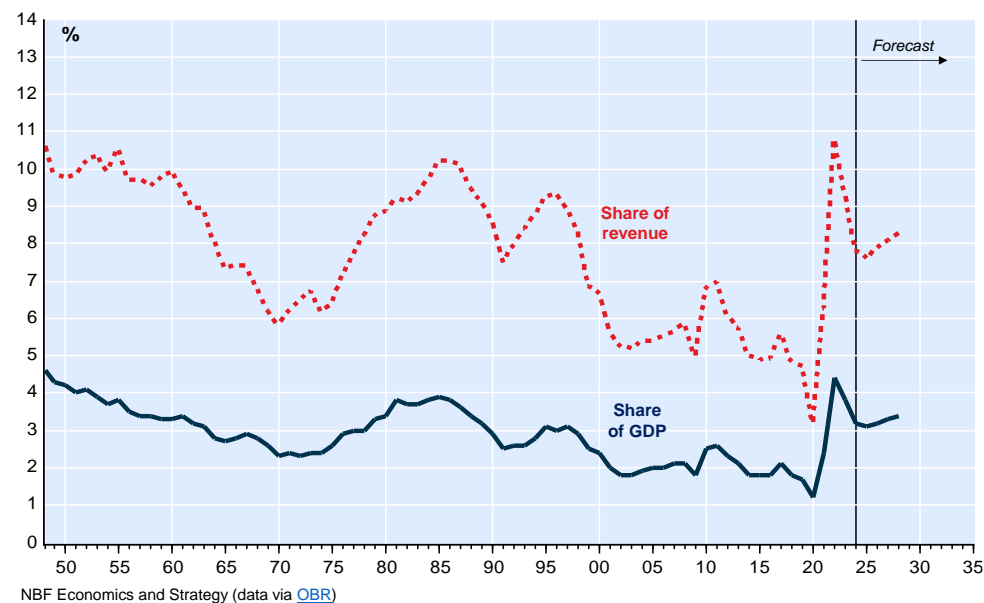
According to Labour Party Leader Keir Starmer, the agenda does not need further tax increases because his policies—such as investing in clean energy—will generate sufficient economic growth to significantly increase revenue.<sup>10</sup>

## Labour's agenda to run into fiscal straitjacket inherited from previous government

However, the feasibility of this agenda must be measured against UK's fiscal position. Public sector net debt will amount to 98% of GDP this year, up from 35% in 1996 and the highest level since the early 1960s. The interest on this debt is currently £60 billion a year—a sum comparable to what is spent on defence.<sup>11</sup>

### U.K.'s soaring net interest payments

As a share of revenue and of GDP



<sup>4</sup> "Who should I vote for? The main parties' policies at a glance," The Telegraph, June 16, 2024

<sup>5</sup> "Rishi Sunak pledges big boost to UK defence spending by 2030," Financial Times, April 23, 2024

<sup>6</sup> "Labour manifesto 2024: 12 key policies analysed," BBC, June 13, 2024

<sup>7</sup> "UK politicians' election pledges can't stop rising tax burden," Reuters, June 14, 2024

<sup>8</sup> "Millionaires are fleeing Britain in their thousands," CNN June 18, 2024

<sup>9</sup> "Labour Party manifesto: an initial response," Institute for Fiscal Studies, June 13, 2024

<sup>10</sup> "Labour's Cautious Pitch for UK Power Ducks Hard Economic Choices," Bloomberg, June 13, 2024

<sup>11</sup> "UK Debt Hangover Ties Next Government's Hands, Whoever Wins," Bloomberg, June 2, 2024



The IMF recently warned that the UK Treasury will need to find £30 billion in tax increases and/or spending cuts to stabilize the debt burden.

All of these spending and debt related challenges will make it very difficult for Labour to honour its commitment to lower public debt as a share of GDP by the fifth year of its term.<sup>12</sup>

## UK's new geopolitical landscape

The Conservative's worst electoral performance in its 190-year history has thrown the party into disarray. The strong showing from the Reform Party led by Nigel Farage, in particular, bled support from the Tories.

It has been reported that Farage's goal is to replace the Conservatives through a merger or takeover in the next five years. He has cited the Reform Party of Canada's success in the 1990s, when it became the country's main conservative party and eventually forced the Progressive Conservative Party of Canada to agree to a merger.<sup>13</sup>

## Conclusion

Until recently, Western governments have been able to increase spending without overly worrying that borrowing costs would rise significantly. This is no longer the case. The actions of the short-lived Liz Truss government stand as a stark warning in this regard. Her administration's unfunded tax cuts in 2022 unsettled financial markets and caused borrowing costs to temporarily surge.

With the Labour Party now in power, the longer-term risk lies in over-borrowing to implement its agenda. This could come from underestimating the cost of implementing infrastructure and energy projects and new social programs. Indeed, it is not hard to find examples in the West of major projects going over budget. Labour's super majority could also lead to pressure from members and the temptation to go beyond its formal agenda by spending on additional policy initiatives.

But without a surprise surge in economic growth, Labour may eventually have to backtrack on some policy goals and raise taxes on the middle class and businesses, angering voters across the political spectrum. (The Bank of England forecasts that economic output will grow just 0.5% this year and 0.75% in 2025.).

**Bottom line: The era of borrowing without worrying about the cost of interest payments is over. Adapting to this new reality will be particularly challenging for political parties accustomed to promising more and more to win elections. If the Labour Party attempts to fully implement the costliest parts of its agenda, expect volatile UK financial markets in the coming months.**

<sup>12</sup> Change — Labour Party Manifesto 2024

<sup>13</sup> "Once-fringe agitator Nigel Farage returns to U.K. election fray in serious threat to ruling Conservatives," The Globe & Mail, June 19, 2024



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