Nicholas Barr November 4th, 2024

Reeves' Budget is right on strategy and objectives

Rachel Reeves' Budget included higher spending for public services, and higher taxes as well as borrowing in order to fund it. ***Nicholas Barr*** *argues that given the inheritance of this Labour Government, the Budget demonstrated that the Government has the right strategy and objectives, even though the policies contain an element of unpredictability and risk.*

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The inheritance

The new government came into office facing a large annual budget deficit, high cumulative national debt and run-down public services. That inheritance explains why this a BIG budget and a major break from the Conservative governments of the past 14 years. Taxes will rise by £40bn, borrowing by £28bn and spending by £70bn.

According to the Institute for Fiscal Studies, "It does bear repeating that the fiscal inheritance is truly dire. The spending plans inherited from the last government were never likely to survive contact with a Spending Review."

> *The public service inheritance is also dire – record NHS waiting lists, crumbling schools, over-crowded prisons,*

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In guarded officialese, a report by the independent watchdog, the Office for Budgetary Responsibility (OBR), stated that had they been fully informed about the then government's spending plans, "a materially different judgement about … spending in 2024-25 would have been reached".

The public service inheritance is also dire – record NHS waiting lists, crumbling schools, over-crowded prisons, polluted rivers, potholes. Of these perhaps the most salient is the NHS.

Some of these outcomes are due to outside events, but others are self-inflicted: Brexit, the mini-budget of September 2022, and austerity (i.e. many years of spending cuts), excoriated by Nobel Laureate Paul Krugman and, in more measured language, by the *Financial Times*.

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The strategy behind the Budget

A strategy is a series of policies designed to be mutually reinforcing in pursuit of stated objectives. The government is right in recognising the need for a strategy.

The government is also right in its overarching objective, higher growth, mainly through increased investment in public services and policies to foster private investment. As I argued in a previous blog post, productive public investment is an essential complement to productive private investment.

Another correct choice is to finance investment in part through borrowing. Predictably, markets reacted violently to the mini-budget of September 2022 because borrowing was to finance tax cuts. What this budget proposes is very different: borrowing is to finance investment; and the budget is underpinned by OBR analysis, hence the initial market response has been mild.

It is also right to adjust the rules so that borrowing to finance investment is treated differently from borrowing to finance consumption, though with room for argument (somewhat technical) of how the new rules are defined. Previously, public spending pressures could fall on investment, risking lower growth, hence slower growth of tax revenues, hence further problems of financing investment.

The breakdown of higher spending

The full details are in the Budget "Red Book" together with an official summary.

In bare outline

NHS current spending will rise by £22.6bn, plus £3.1bn for capital spending; and next spring the government will publish a 10-year plan for the NHS.

Education spending will rise by £2.3bn and capital spending by £6.7bn, including rebuilding 500 schools and dealing with crumbling concrete.

- Spending on housing will rise by £5bn.
- Additional infrastructure spending includes improvements to the rail system and road network.

The budget also sets aside £11.8bn to compensate victims of the contaminated blood scandal and £1.8 bn for the Horizon scandal.

Additional announcements concerned increases to the minimum wage and the state pension; and the amount that carers are allowed to earn will rise to £195 per week (previously £151), though without addressing the problem of overpaid carer's allowance.

Not mentioned, but also part of the package, is the abolition of winter fuel payment for all but the poorest pensioners. Many commentators argue that the cut should have been better targeted by gradually withdrawing benefit for pensioners beyond the poorest. Though desirable, past under-investment means that such tapering exceeds administrative capacity.

> *Effective reform cannot do everything, everywhere, all at once.*

How will the extra spending be paid for?

These changes will be financed from a mix of higher taxes and higher borrowing.

Higher taxes include:

- A 1.2 per cent increase in the employer national insurance contribution together with a reduction in the threshold at which contributions start;
- Higher rates of capital gains tax;
- Freezing the threshold of liability for Inheritance Tax till 2030 (previously 2028) and reducing concessions for farmland;
- Charging VAT on private schools;
- Abolishing the non-dom tax regime;
- Increasing taxes on tobacco and most alcoholic drinks;
- Increasing the annual tax on petrol and diesel cars to encourage moving to electric vehicles but, in apparent contradiction and highly criticised, continuing the freeze on fuel duty.

In addition, borrowing will be £28bn more in 2025-26 than previously planned.

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Is all this a good idea?

Effective reform cannot do everything, everywhere, all at once. Restoring public services needs to co-ordinate across Ministries and to align urgent action with a coherent long-run plan. Thus it is mistaken to judge the specific policies in the budget in isolation, rather than as part of a strategic whole, i.e. as early moves in Rachel Reeves' long chess game. It is beholden on people who support the strategy (higher spending to finance higher investment) but criticise particular elements to say how they would finance that investment.

That said, some of the decisions are controversial and subject to revision and refinement as the Finance Bill goes through Parliament.

The increase in employer NICs will mostly negatively affect wages but could also fall on profits, risking lower business investment, and/or on prices. A 2-3 per cent increase in the basic and higher rates of income tax would have a similar yield and would cover all forms of income. As a good economist, Rachel Reeves would recognise the advantages of a broader tax base and might well have preferred the income tax option but clearly regarded it as politically toxic given the manifesto pledges. Note, however, that income tax also falls both on workers and on businesses in that workers would have lower take-home pay and therefore spend less.

It can be argued that the previous government set a political bear trap, irrespective of the long-run good of the economy.

The back story is that the previous government committed not to increase the rates of income tax, NICs or VAT, pressuring the Labour party to do the same. Given the major uncertainties facing any incoming government, economists regard such pre-commitments as unwise. It can be argued that the previous government set a political bear trap, irrespective of the long-run good of the economy. The announcement of a two per cent cut in workers NICs to take effect after the election can be argued to be of the same ilk.

Also controversial are some of the changes to inheritance tax, particularly as they affect farmland – clearly a topic for the Finance Bill.

Missing from the budget is the finance of social care. Given the direct links with NHS capacity, that aspect must be part of next year’s 10-year NHS plan.

Higher investment spending, though essential for growth, has to be well directed and well implemented – compare the *problems of HS2 with the highly successful Elizabeth Line.*

Taken as a whole, the budget seeks to rebalance between the baby boomers (often homeowners, often with good pensions) and younger workers (a higher national living wage, improved worker rights, plans for more affordable housing).

That the policies make strategic sense does not mean that they are without risk, most obviously how financial markets might react.

The other big risk is whether investment spending will pay off. Higher investment spending, though essential for growth, has to be well directed and well implemented – compare the problems of HS2 with the highly successful Elizabeth Line. The strategy stands and falls on successful investment.

Initially low growth but on a path to higher growth

According to the OBR, growth over the next 5 years will remain relatively low. That, however, is only part of the story. First, much investment spending today (e.g. improved education) impacts growth only in the medium term, Second, the OBR projections do not include other pro-growth policies such as the government's industrial strategy and the intended reform of planning laws. The OBR 10-year projection (an innovation introduced by the government) includes effects beyond the life of the current Parliament and, over that longer time horizon, without including measures like reform of planning laws, estimates that the budget measures will add 1.4 per cent to the growth rate from 2032. In part for that reason the IMF backs the budget as sustainable.

The budget could have had lower tax increases and less borrowing but that would mean lower investment spending, lower growth and – given the accumulated backlog of underinvestment – the greatly feared doom loop.

The opposition argues that achieving this growth did not require tax increases, but could have been financed by cuts elsewhere. That approach is highly implausible given the scale of the necessary investment and cost pressures from child poverty, hence pressures to remove the two-child benefit limit and the overall benefit cap.

Nobody likes to pay higher taxes. The budget could have had lower tax increases and less borrowing but that would mean lower investment spending, lower growth and – given the accumulated backlog of underinvestment – the greatly feared doom loop. Whatever one thinks about the specific proposals, on the strategy the government had no choice.

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