Should we become more relaxed about government debt?

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As we are approaching elections, the focus has centred on examining where there might be differences in economic policy between the parties. Unfortunately for Labour, many of its distinctive tax ambitions, such as abolishing non-dom status and extending the windfall tax on oil and gas companies -have already been taken up and are being implemented by the Conservatives What is more is that future proceeds from these recently announced changes by Jeremy Hunt will be eaten up by the extra tax giveaways announced by Jeremy Hunt in the autumn statement and the March 6 budget. Only one signature Labour tax policy seems to be still there, namely the intention to exclude the supply of education by independent schools from the list of bodies eligible for VAT tax exemptions and expect them to start charging VAT on private school fees.

This has inevitably severely limited the room for manoeuvre for a possible future Labour government, especially given indications so far that the Conservatives tax cuts will not be reversed. Their green £28b a year extra investment pledge has already gone, replaced by a more general £5b a year additional net zero spending pledge. And it could get worse. Another tax giveaway fiscal event is being rumoured late summer/early autumn that could further limit options.

That leaves Labour with a serious dilemma. If tax cuts cannot be reversed, what can be done to correct what Labour refers to as the 'mismanagement ' of the economy since 2010. There is of course a lot that can be achieved through regulatory changes that don't require extra cash but could change the way the economy operates. That includes improving the way the private sector utilities are regulated, reforming the energy market and generally providing more certainty to business.

On the employee side, there is also the pledge to improve workers' rights, including tackling the exact way zero hour contracts operate and allowing right from day one of employment . Those are not costly for the government but could be costly for business, particularly for SMEs, and discourage investment, making the desired return to sustainable growth more elusive. It is indeed because of being mindful of impact on employers that there is still a lot of vagueness in relation to their exact implementation.

But pressures on finances there will be and those cannot be avoided. They range from the continued demands on the NHS, to heightened calls for expanding defence spending to 2.5% of GDP. The foreign aid budget should already have been restored to the promised 0.7% of GDP from the 0.5% it was cut to during Covid. The demands of doctors, train drivers and teachers will have to be addressed somehow. People's frustration with the deterioration of public services is palpable. Extra money will need to be found after the elections for levelling up and the promised extension of nursery education among others, neither of which is likely to have been resolved before the next election. HS2, even in its shortened form, will be eating cash. And companies in many areas will be knocking on the Treasury's door with special pleading – whether they are in the steel, green, rail , automotive, water, agricultural, retail, social or hospitality sectors.

What will give? Unfortunately relying on a resurgence of growth by itself won't do it. No respectable forecaster expects economic conditions to improve sustainably over the next few years. Trade intensity since Brexit has declined and if anything trade barriers between the UK and the EU are getting more visible, biting and increasingly costly. Geopolitical crises meanwhile continue and risks on the downside are higher now than they were a few months ago.

There are potential revenue gains of course from closing tax loopholes and greater equalisation of rates to avoid distortions in the system. The list of possible measures is quite long and eventual gains could be substantial but they take time to come in and in the meantime taxpayers will be gaming the system. And one can also carry on imagining that money can potentially be saved through public sector ‘efficiency improvements’. Many attempts have been made in the past- and are still being made, to get ‘more for less’ , more recently by expanding digitalisation and the use of AI. But it is generally understood that those improvements if they work take time will not in themselves solve any time soon the deep problem of what now looks like chronic underinvestment and deterioration in public service provision, at least in terms of voters’ perceptions.

That leaves two options- one is to ignore pledges and raise taxes , particularly on the wealthy, to increase available pots for redistribution and investment. There is already a suspicion among elements of the press that this is exactly what many of the newer Labour MPs will be asking for if the Labour landslide predicted at present materialises. That could of course undermine credibility with business for a long time to come and labour may be wary to go down that route, at least early on.

The other solution though, would be to rethink and be prepared to tweak what the Institute for Government(IfG)refers to as ‘a flawed set of fiscal rules’ and accept that larger deficits and higher debt for a while may be the solution. That would go beyond the promise to only ‘borrow to invest’. But in her Mais lecture last month Labour’s Rachel Reeves in fact outlined her intention to take away the ability of future Chancellors to scarp the fiscal rules unless the OBR declareda national economic emergency. How to get back from that straightjacket without panicking the markets may well be the first real test for Rachel Reeves , if she becomes the first ever UK female Chancellor after the elections .

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