2019 UK GENERAL ELECTION BRIEFING: THE MACROECONOMICS OF PARTIES' TAX AND SPENDING PLANS

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OVERVIEW

Most economic analyses of parties' tax and spending promises treat the government's budget like that of a household, ignoring the impact of proposed policies on the economy. This briefing aims to fill this gap by providing a macroeconomic assessment of announced fiscal policies. It focuses on:

- The impact of the parties' tax and spending plans on economic output and consumer prices.
- The combined impact of parties' Brexit policies and tax and spending plans on the economy.
- How monetary policy is likely to respond to prevent inflation rising above target.
- A discussion of economic policies beyond tax and spending and their effect on the economy.

KEY TAKEAWAYS

- With the economy operating near production capacity, the main impact of tax and spending policies is to shift resources from the private sector to the public sector, particularly in the case of the Labour Party and Liberal Democrat policies. The effect on aggregate output is small and estimated to boost GDP annually by 0.2 per cent (Conservative Party) to 0.4 per cent (Labour Party, Liberal Democrats) over the next Parliament, 2020-24.
- The economic impact of different parties' plans depends crucially on the outcome of Brexit. Even combined with the proposed fiscal stimulus, a UK-EU free trade agreement or customs union would leave GDP smaller than it would have been with continued EU membership.
- The economic impact of proposed fiscal policies also depends on the response of monetary policy and inflation expectations. If there were more economic slack, the proposed policies would provide a larger boost to economic activity (adding 3½ per cent to GDP over 2020-24).
- Economic policies beyond tax and spending are likely to have important implications for future economic prosperity but these will depend on how those policies are implemented.

Macroeconomic impact of proposed fiscal policies

- Table 1 summarises the tax and spending proposals set out in party manifestos as they are considered in the following analysis. We have adjusted the figures in the manifestos by stripping out the assumed second-round effects on government revenue that come from expected changes in the size of the economy. We have also ignored revenues expected to be raised by anti-tax avoidance measures. The direct effect of the proposals on the public finances is assessed in an accompanying NIESR Election Briefing (here).

Table 1 Major parties' tax and spending plans

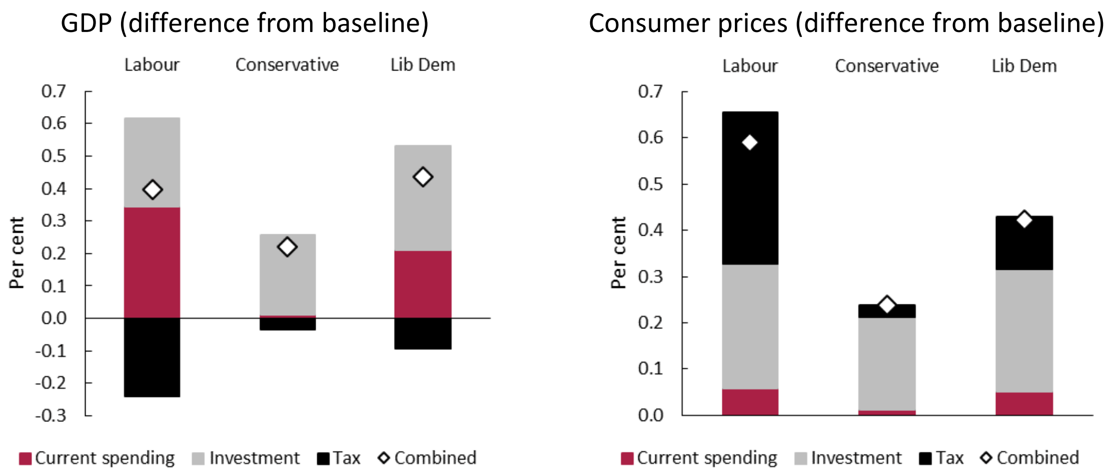
	Labour	*Conservative*	*Liberal Democrats*
Current spending	**+£83 bn pa** by 2023-24	**+£3 bn pa** by 2023-24	**+£50 bn pa** by 2024-25[c]
Investment	**+£40 bn pa** over 10 years	**+£20 bn pa** over 5 years	**+£26 bn pa** over 5 years
Tax revenue	**+£71 bn pa** by 2023-24[a]	**+£4 bn pa** by 2023-24[b]	**+£31 bn pa** by 2024-25[d]

Notes: *(a) excludes anti-tax avoidance measures, fiscal multiplier effect. (b) excludes anti-tax avoidance measures. (c) accounts for cancellation of 2019 Spending Round measures. (d) excludes anti-tax avoidance measures and Remain bonus.*
Sources: *Parties' costings documents.*

- We assess the **macroeconomic impact using the National Institute Global Economic Model NiGEM**. We first simulate the economic effects of changes to government consumption (current spending), government investment (capital expenditure), the income tax rate, the corporate tax rate and a residual tax revenue category against a **common baseline** that takes no account of the parties' different approaches to Brexit.

- Figure 1 summarises the impact of tax and spending proposals on economic output (GDP) and consumer prices over the next Parliament (2020-24). The **combined macroeconomic impact** arises from the individual impact of higher current spending, higher government investment and higher tax revenue, and feedback effects across policies.

Figure 1 Macroeconomic impact of tax and spending plans (2020-24 average)



Source: NIESR, NiGEM simulation.

- Overall, the **macroeconomic impact of proposed tax and spending measures is small**. This is because the economy is operating at close to full capacity and constrained by supply capacities. The economic backdrop is discussed more fully in an accompanying NIESR Election Briefing (here).

- **Labour policies are estimated to increase GDP by 0.4 per cent** over the next 5 years, with current spending plans making the largest contribution (0.3 percentage points). Assuming that public investments through the proposed National Transformation Fund impact the economy in a similar way to historical investment projects, this adds around 0.3 percentage points. Higher income and corporate tax rates dampen economic activity by 0.2 percentage points. With the economy operating close to its productive capacity, **higher spending puts upward pressure on prices**. While prices are estimated to be 0.6 per cent higher than otherwise over 2020-24, they are prevented from rising further by a monetary policy response discussed in the next section.

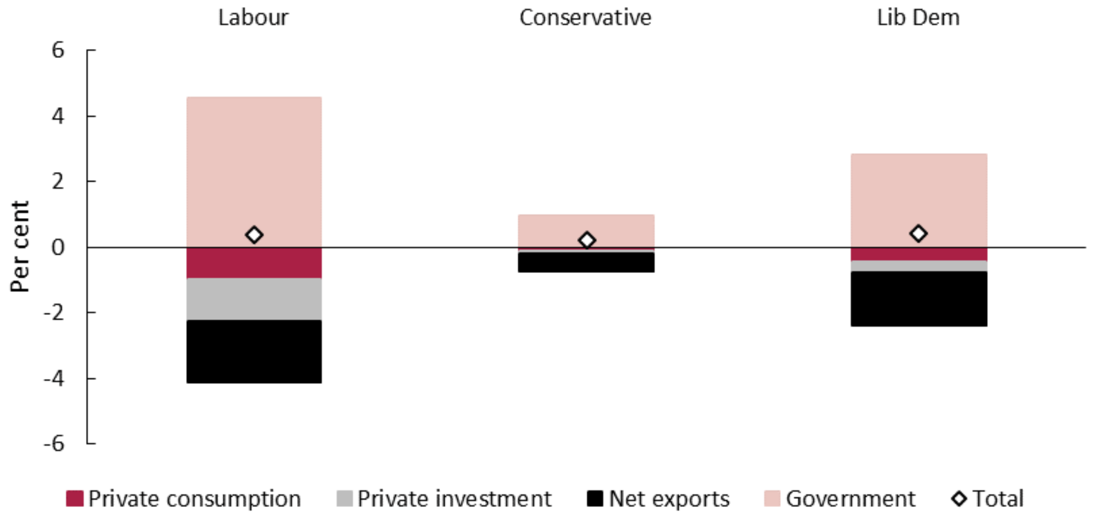
- The **Conservative manifesto** contains only modest current expenditure and tax measures in addition to plans set out for the 2020-21 financial year in the 2019 Spending Round. While most of the planned capital expenditure will still have to be allocated to specific projects, it is estimated to raise GDP by 0.2 per cent over 2020-24. This increases the consumer price level by 0.2 per cent.

- **Liberal Democrat proposals are skewed towards higher investment spending**, raising GDP by 0.3 per cent over 2020-24. Together with higher current expenditure and higher income and corporate taxes, the impact on economic output and prices is 0.4 per cent. This is **similar to Labour's policies**.

- By focusing on the economy as a whole, our analysis abstracts from **distributional and compositional effects** which vary across party manifestos. Another NIESR Election Briefing focuses on regional inequalities (here). To illustrate compositional effects in the economy as a whole, Figure 2 breaks down the GDP impact of tax and spending plans into effects on the components of aggregate demand. It shows that all parties' plans involve a **reallocation of resources from the private sector to the public sector**, which is substantially larger for Labour Party and Liberal Democrat plans compared to Conservative proposals. While higher public spending and investment increase the share of the government in the economy, a higher interest rate and exchange rate make private sector investments more costly and exports less profitable (**'crowding out effect'**).

- **Conservative Party investment plans would increase the size of government by 1 per cent of GDP** while reducing the private sector component in aggregate demand by 0.7 per cent of GDP. Liberal Democrat measures increase government consumption and investment by nearly 3 per cent of GDP. **Tax and spending plans set out by the Labour Party** squeeze the size of private sector investment by 1.3 per cent of GDP, net exports by 1.3 per cent of GDP and private consumption by 1 per cent of GDP, offset by an increase in the size of government by 4 ½ per cent of GDP. This does not account for **nationalisation plans** which would further reallocate private sector demand to the public sector.

Figure 4 Macroeconomic impact on components of aggregate demand (2020-24 average)



Source: NIESR, NiGEM simulation.

The combined effect of fiscal and Brexit policies

- The impact of tax and spending plans depends crucially on the **economic environment** in which they are implemented. Over the next Parliament, the UK's economic environment heavily depends on the **outcome of Brexit**.

- For the present analysis, we assume that a Conservative majority would ratify the Brexit deal negotiated by Prime Minister Johnson and establish an **EU-UK free trade agreement** (see NIESR's economic analysis here). Labour's manifesto stresses the ambition to negotiate a **customs union with the EU** and to continue the UK's participation in main funding programmes (NIESR's analysis of a customs union deal is here), subject to a confirmatory referendum. The Liberal Democrats are campaigning to revoke Article 50 and continue the UK's EU membership.

- An accompanying NIESR Election Briefing (here) summarises our estimates of the **economic and fiscal impact of different Brexit outcomes**. Table 2 compares the impact of the parties' preferred Brexit outcome on economic activity and fiscal revenue with the impact of proposed tax and spending policies. The impact is shown relative to a neutral scenario of continued EU membership without proposed additional fiscal measures.

- A UK-EU free trade agreement is estimated to reduce UK GDP by around 2 per cent relative to what it would otherwise have been over the next 5 years. This is explained by additional regulatory barriers to trade compared to continued EU membership. Combined with the small economic benefit that Conservative Party investment plans yield, the **combined impact of Conservative Brexit and fiscal policies is estimated to reduce GDP by around 1½-2 per cent** relative to continued EU membership and without additional fiscal measures. Should a future Conservative government fail to negotiate a free trade agreement with the EU and **leave without a deal**, GDP would be around 3 per cent smaller than otherwise.

Table 2 The economic and fiscal impact of Brexit and fiscal policies (2020-24 average)

	Labour	***Conservative***	***Liberal Democrat***
Assumed form of Brexit	Customs union (EU membership)	Free Trade Agreement (No deal)	Continued EU membership
GDP impact (per cent)			
Brexit	-1.6 (0.0)	-1.8 (-2.9)	0.0
Fiscal policies	0.4	0.2	0.4
Combined effect	-1.2 (0.4)	-1.5 (-2.7)	0.4
Revenue impact (£ bn/year)			
Brexit (effective shortfall)	-5.1 (0.0)	-4.0 (-12.5)	0.0
Fiscal policies (budget)	-52.5	-21.8	-43.5
Combined effect	-57.6 (-52.5)	-25.8 (-34.3)	-43.5

Source: NIESR, NiGEM simulation.

- The customs union deal proposed in Labour's manifesto would have a similar effect on GDP as a result of regulatory barriers inhibiting services trade. Only partly offset by higher public spending, the **combined macroeconomic impact of Labour policies is to reduce GDP by around 1 per cent of GDP** relative to continued EU membership and without additional fiscal measures. Should a **second referendum** result in a decision to continue EU membership, only the fiscal boost of 0.4 per cent of GDP would materialise.

- The **Liberal Democrats policy of continued EU membership** combined with fiscal stimulus leaves a positive net effect of 0.4 per cent of GDP.

- The negative fiscal consequences of Brexit would only materialise gradually over time as EU-UK trade and migration links loosen. In contrast, the impact of higher public investment financed by higher public borrowing will widen the public deficit immediately over the next Parliament. The **fiscal impact of tax and spending proposals overshadows the fiscal impact of Brexit by far**.

- Prime Minister Johnson's negotiated Brexit deal would lead to an estimated **average government revenue shortfall of £4 billion** per year over 2020-24 as the result of a smaller economy. A no-deal Brexit would squeeze revenues by £12 ½ billion a year. Assuming continued participation in various EU programmes, as envisaged in the Labour Party manifesto, a **customs union deal would squeeze revenue by around £5 billion** a year. In other words, the fiscal benefit of continued EU membership (**'Remain bonus'**) is £4-5 billion per annum, a little smaller, but in the same ball-park, than the assumed £10 billion per annum budgeted by the Liberal Democrats.

- The support to the economy from more day-to-day and investment spending itself increases the government's revenue base (**'fiscal multiplier effect'**). We estimate that current and investment expenditure proposals put forward by the Labour Party and the Liberal Democrats generate an additional £5 ½ billion per year over 2020-24, irrespective of the parties' other tax-raising policies. The fiscal multiplier effect of the Conservative Party's proposals is much smaller at £0.3 billion.

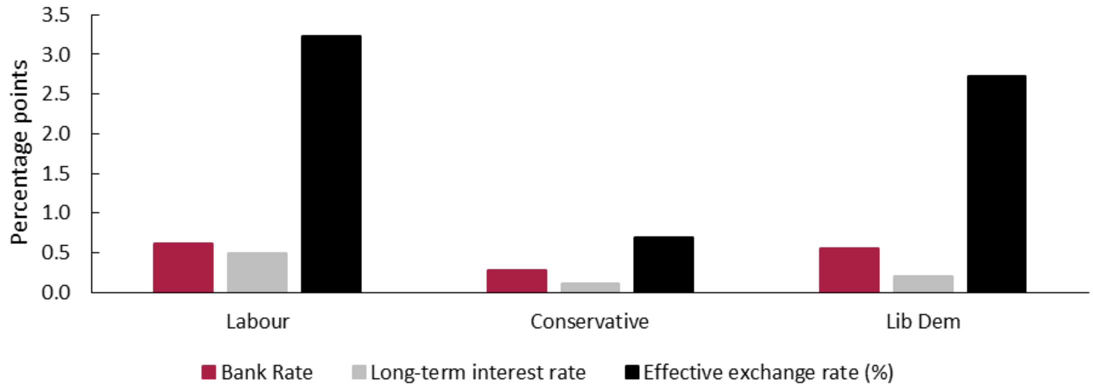
Monetary-fiscal interactions

- The macroeconomic impact of the parties' tax and spending proposals largely depends on the **response of the Bank of England's Monetary Policy Committee** and **market expectations of future interest rates**.

- Our analysis assumes that monetary policy reacts to deviations of inflation from the Bank of England's target by raising Bank Rate by 0.3-0.6 percentage points (figure 3). Forward-looking financial markets respond by **increasing long-term interest rates that are also associated with an exchange rate appreciation**, in the Labour and Liberal Democrat scenarios of around 3 per cent (½ per cent for Conservative Party plans).

- A fiscal expansion that adds to inflationary pressure would soon be offset by tighter monetary conditions. This explains the small size of macroeconomic effects, despite plans of historically large fiscal interventions. It is consistent with the **view that the economy currently operates near full capacity** (see also NIESR's latest UK economic forecast here).

Figure 3 Financial market response to tax and spending plans (2020-24 average)



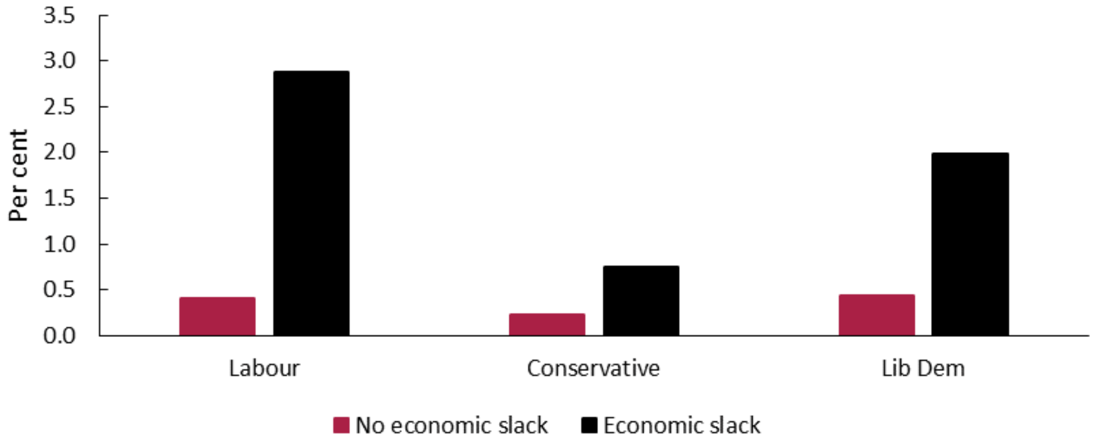
Source: NIESR, NiGEM simulation.

- The macroeconomic effect would be much larger if the economy were operating with **substantial amount of slack**. In this alternative case, a fiscal expansion would increase economic output without putting upward pressure on wages and prices.

- As an illustration, we present an **alternative scenario** in which wages do not respond to the fiscal stimulus, in other words the wage Phillips curve is very flat. As a result, the price response to fiscal policy measures is muted. This would be consistent with a **positive output gap**. It would allow the Bank of England to maintain the pre-stimulus path for Bank Rate. We also assume that financial markets do not respond to higher debt and deficit levels by pricing higher long-term interest rates. All major parties justify borrowing-financed public investment with the fact that long-term rates are at historical lows and appear unlikely to move up soon.

- Figure 4 illustrates that if there was sufficient economic slack and wage and price inflation did not pick up in response to parties' proposed fiscal measures, **fiscal stimulus would be substantially more powerful**, with Labour policies adding an estimated 3 per cent to GDP over 2020-24, Liberal Democrat measures adding around 2 per cent, and Conservative policies boosting economic output by just under 1 per cent of GDP (black bars).

Figure 4 Macroeconomic impact of fiscal plans in alternative scenarios (2020-24 average)



Source: NIESR, NiGEM simulation.

- The reason for larger output effects in the presence of economic slack is the assumed **absence of a monetary policy response** and the **muted response of long-term interest rates**. If interest rates do not respond to higher government spending, this supports borrowing and investment. It also means that the sterling exchange rate remains flat compared to the main case in which it appreciates in line with interest rates, supporting export activity.

Economic policies beyond tax and spending

- We have assumed that the impact of current expenditure, public investment and tax on the economy is similar to the impact of comparable policies in the past. While it is possible that a rapid expansion of demand could encourage productivity growth by incentivising better use of existing resources, we have not allowed for such effects in our analysis.

- We have also not considered any **direct effects of proposed policies on productivity**, which could potentially be quite large but are difficult to assess without more detail. For instance, all three major parties propose higher funding for education and skills training. If successful, these measure might make the UK's labour force more productive and thereby increase the output potential raising welfare in the long run. The effect of education policies on productivity is discussed more fully in an accompanying NIESR Election Briefing (here).

- We have not included in our analysis spending promises that were made **outside of published manifestos**, such as Labour's promise to compensate women born in the 1950s whose pension age was raised in 1995 and again in 2011.

- The main parties' manifestos include various **other economic policies** beyond tax, spending and plans for future EU-UK trade and migration. These policies are likely to have additional implications for the economy and long-run prosperity.

- Examples include **Labour Party plans to nationalise** rail, mail, water, energy and broadband provision. Our analysis assumes that productivity in these industries remains unaffected by ownership. Historical evidence suggests public ownership and reduced competition may lower productivity in these sectors. A full assessment would have to take into account how nationalisation is implemented.

- There are other risks associated with large scale reforms of the economic system, including the possibility of a loss of confidence in government administration that could impact on the value of sterling and financial markets.

- Other examples include **climate policies** which in our analysis feature through their immediate impact on public spending and investment. By potentially mitigating the future economic impact of climate change, their long-run macroeconomic impact may be larger. Similarly, minimum wage and migration policies may not only have direct effects on those affected, which are discussed in dedicated NIESR Election Briefings here and here, but are likely to feed back to the macroeconomy.