The fiscal rules;
taking advantage of new framework to help drive productivity

by Henri Murison and Andrew McPhillips

Introduction

In her first Budget, the Chancellor has rewritten the fiscal rules. She has separated day-to-day spending from investment, enabling a significant expansion in the UK's expenditure, particularly on infrastructure. If the promised guardrails are fully delivered, this will help improve productivity and, through this, reduce pressure on public spending, ultimately lowering long-term debt-to-GDP projections for the coming decades. If the promised guardrails are fully delivered, this will help improve productivity and, through this, reduce pressure on public spending, ultimately lowering long-term debt-to-GDP projections for the coming decades.

The most notable aspect of this decision is the acknowledgment that the long-term affordability of the welfare state, and the broader settlement between the British people and the government, must take precedence over short-term political considerations. The logical conclusion of this argument is that regional inequalities within the UK, which are not financially sustainable for government and also undermine the wider settlement between the respective places of Britian with each other and with their government, cannot be left to stand in perpetuity.

There are four key challenges that hold the North back, which could be addressed by changing the level of spending and investment. Firstly, poor performance of the persistently disadvantaged, referred to here as the long-term disadvantaged, has eroded the North East's historically better overall performance in particularly the North East in early years education, which previously offset the longstanding issues in the secondary phase of compulsory education.[1] Secondly, far too many people are unhealthy and therefore unable to participate in the workforce. Thirdly, the lack of efficient east-west

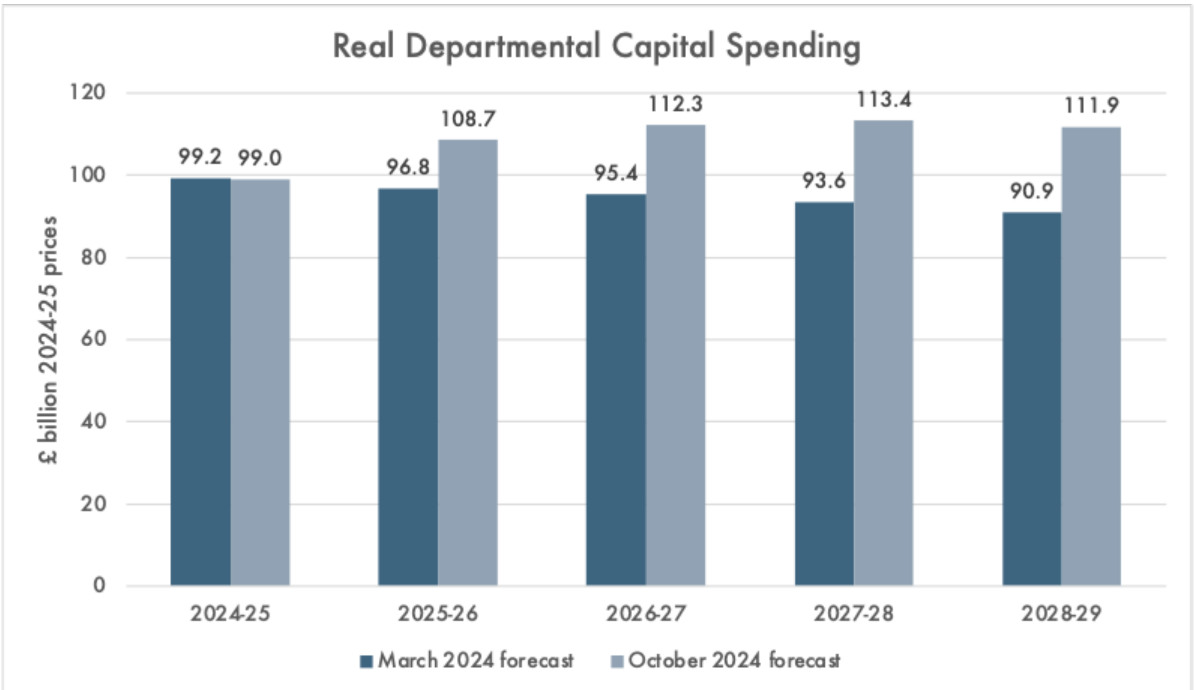
[1] Children's Commissioner for England (2018), Growing Up North, https://assets.childrenscommissioner.gov.uk/wpuploads/2018/03/Growing-Up-North-March-2018-2.pdf

transport between relatively close locations remains a significant issue. Remedying this has been a longstanding priority of the National Infrastructure Commission with Northern Powerhouse Rail being a key solution, appraised by NISTA. Fourthly, we have yet to fully tap into the potential of the transition to Net Zero. There is an outstanding risk that areas of historic strength, like our nuclear sector, could be decommissioned without a new-build sector to replace it. Similarly our industrial base could be offshored rather than decarbonised.

As long as huge swathes of the nation, not least across the North of England, are structurally unable to provide the same opportunities as are available in other parts of the UK, we will face the constant threat of populism politically and underperformance economically.

New fiscal rules

The result of the new fiscal rules will be significantly higher levels of spending across investment, including infrastructure. Comparing the levels of spending projected in March and last month, it equates to over £20bn extra a year, which could reduce the cumulative investment shortfall identified earlier this year by EY of £39bn a year up to 2040[2] (leaving cost efficiencies and differing forms of private finance could help address remainder of gap).



[2] EY Parthenon (2024), *Mind the (Investment) gap: Funding and delivering capital projects amidst fiscal constraints*

Previous work by those such as Metrodynamics[3] has identified the strong corelation between investment in public goods, including the tram in Greater Manchester, and productivity growth. The opportunity to leverage public investment to stimulate private investment is also key, with research by Arcadis showing that in Birmingham a huge growth in planning permissions in proximity to the HS2 station and depot sites.[4] However, to seek to demonstrate that growth can significantly be changed within the coming five-year period cannot be the primary test of this approach.

It has been well argued that the Office for Budget Responsibility (OBR) has underestimated the benefit economically of greater additional private sector investment as immediate stimulus, not least in the real estate sector, and it is only correct that the OBR modelling approach is open to debate and constructive challenge by those such as Carsten Jung.[5] However, looking at a ten year out turn position following the publication of a funded ten year infrastructure strategy, and the early implementation of planning and wider supply side reforms, will undoubtably give the OBR the detailed evidence to revise its judgement on these plans when it next has the opportunity.

Long term debt to GDP ratio

On 12th September 2024 the OBR published its Fiscal Risks and Sustainability report[6]. The headline released alongside the report makes for stark reading:

"Public debt projected to exceed 270 per cent of GDP by the mid-2070s. *Based on current policy and the latest demographic projections, public debt is projected to almost triple from under 100 per cent of GDP to over 270 per cent of GDP over the next 50 years. The estimated damage to the economy and public finances from a changing climate could add between 20 and 30 per cent of GDP to these pressures on debt, while improving the health of the population could reduce them by over 40 per cent of GDP by the mid-2070s."*

On first reading, this appears to show how misguided the focus on short term measures of public debt can be. The desire to meet a self-imposed fiscal rule and celebrating seeing debt fall from 93.2% of GDP to 92.9% of GDP as was the case in the Spring Budget 2024, appears particularly short sighted in light of the OBR's headline above.

However, one key phrase in the above quote is "based on current policy". In practice, this means that the government is assumed to stick with current policy plans and does not

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[3] Gilmour, James, Emmerich, Mike & O'Connell, Gillian (2023), *Growth and transport in Greater Manchester,* https://static1.squarespace.com/static/55e973a3e4b05721f2f7988c/t/6479ffbbbb19314e667c9c5f/1685716925211/Growth+and+Transport+in+Greater+Manchester.pdf

[4] 704,000 SQM of new commercial floorspace, 41,000 new homes and 30,885 new jobs to the region which will deliver an economic uplift of £10 billion over the next ten years.

[5] Jung, Carsten (2024), https://www.ippr.org/articles/second-round-effects

[6] Office for Budget Responsibility (2024) *Fiscal risks and sustainability.* London: HMSO.

react to a worsening debt situation. While this is unrealistic, it does highlight the challenges to the UK public finances over the next 50 years. Government receipts are expected to fall slightly over time from 40.4% of GDP in 2023/24 to 39.6% in 2073/74 as revenue raisers such as fuel duty and vehicle excise decline as the effect of the ban on the sale of petrol cars comes into effect along with other measures to achieve net zero ambitions.

The primary driver of the increase in debt is increased government spending which grows from 44.5% of GDP in 2023/24 to 60.1% of GDP in 2073/74. An ageing population and worsening health lead to significant increases in spending on healthcare. The sensitivity analysis around these assumptions shows that if a ‘better health scenario’ could be realised through reducing the prevalence of chronic conditions and increasing healthy life expectancy, the primary deficit would be 2.1% of GDP lower than the baseline in 2073/74 due to combination of lower spending on healthcare and benefits, increased tax receipts and a larger economy. Debt as a percentage of GDP would consequently be 44 percentage points lower in 2073/74 than under the baseline scenario.

Why does this matter for the purpose of this paper? At present we would argue that significant infrastructure projects do not include within their cost benefit analysis the full impacts on aspects of health. For example, a new train line can give people access to higher paid jobs, in turn increasing their standard of living and likely leading to improvements in their health, therefore reducing spending on healthcare and welfare payments. These benefits should be captured and form part of each project's cost-benefit analysis. Ideally, they should also be considered across broader programmes to estimate the interactions between multiple interventions. For instance, inter- and intra-city connectivity projects can drive demand for one another—a city with a tram network is likely to make better use of improved links across the Pennines than one without mass transit.

The Financial Risks and Stability Report also offers an alternative productivity scenario for calculating the future public debt position. The baseline assumption that produces the headlines at the start of this section is for productivity to grow by 1.5% per year, above the rate witnessed over the past ten years or so. If however, productivity growth could be increased to 2.5% per year, the average rate of growth during the 1990s, receipts at the end of the OBR’s forecast period would be 55% higher than the baseline, spending would be 28% higher and net debt would fall to just 65% of GDP by 2073/74 (as spending falls as a percentage of GDP with the fiscal surplus used to pay down debt), not just significantly lower than the baseline scenario, but a reduction from current levels of just under 100% of GDP. This again highlights how critical investments that increase the rate of productivity growth can be in tackling our future public finance challenges.

Guardrails in infrastructure spending

In the specific context of infrastructure in particular, the previous government approach to developing and delivering major projects was problematic. In the case of HS2 for instance, key institutions like the Infrastructure Projects Authority, reporting through that period to senior civil servants at the Cabinet Office, and the Department for Transport and HM Treasury themselves were all heavily involved, and now implicated in the mistakes made. However, the issues highlighted by the National Audit Office give us lessons to learn and apply going forward not only to that project under its new incoming Chief Executive with the intensive oversight collectively by the Chief Secretary, Transport Secretary and Rail Minister, but also through the Office for Value for Money across the wider project portfolio.

The OBR has a high degree of independence, and NISTA needs to retain the constructive challenge provided by the National Infrastructure Commissioners currently. It would be advisable for the organisation to be co-chaired by the Minister responsible for infrastructure, the Chief Secretary to the Treasury, alongside a significant and well-respected figure who is above day-to-day politics as the NIC is currently. To demonstrate to markets that NISTA's plans for the next 10 years and beyond will positively impact the debt-to-GDP position over future decades, their recommendations should be assessed both individually and collectively by the OBR. Currently, so-called 'BCR figures' are often misused in Whitehall to compare vastly different projects. These figures are intended to evaluate alternative projects aimed at achieving the same stated goal or outcome, not to determine the relative merits or importance of entirely different projects.

Moving forward, the value of a new railway station in Bradford, for example, should be assessed in light of its contribution to the overall ambition to connect it to an upgraded network and new line to Huddersfield as part of Northern Powerhouse Rail. The higher cost of health and welfare benefits in the city today, and their future trajectory, alongside the wider contributors to the cities position of ongoing revenue fiscal deficit has an ongoing impact on the Public Sector Borrowing requirement. To illustrate, working age benefits per person of working age English average is £1,706 but in Bradford the cost is £1,966 per person. Comparing that with other cities in Yorkshire puts the Bradford costs into context with Leeds at £1,597 and York at £944. What both York and Leeds have over Bradford is good rail connections that have leveraged other investment and regeneration.

The opportunity for residents, and those who may come to work in the city, to contribute more in taxes in the future, require less in work-related and out-of-work benefits, and achieve better health outcomes as a result of higher productivity and wages should all be considered. The case for doing nothing, of failing to invest, has a huge cost in places where economic underperformance is built into the current state of affairs.

However, historically the Treasury has ignored this cost of inaction systematically in its dealing with departments and local government, and so has chased gains in areas of existing prosperity in the UK. These are not unworthy of being considered, but currently are systematically favoured due to certainty and predictability of addressing existing growing demand for services, rather than stimulating it. For example, the more people currently use a train currently, the higher the total value of the minutes saved using conventional journey time savings. If the influence of the OBR had extended further, with it previously having no remit to consider directly the NIC infrastructure recommendations as they were never necessarily adopted, then the undoubtably well intentioned Green Book reforms of the previous government would have had more effect. However, the impetus to take more account of the strategic case has been undermined by the limitations of how government departments have historically prepared their business cases methodologically.

Finally, one of the further strengths of the NIC has been to part base itself in the office of the UKIB (now the National Wealth Fund). It would be sensible to continue this arrangement and establish the NISTA headquarters in Leeds when a decision is made. This would enable the creation of a critical mass of expertise to support the government's efforts in attracting private investment into both infrastructure and the wider economy, which will be vital to the ongoing remit of both institutions.

Prioritising day to day spending

In the coming spending review, an additional consideration should be the long-term impact of both the revenue and capital budgets (including infrastructure) on the debt-to-GDP ratio. The direction of travel of a number of Secretaries of State, not least the newly appointed Health Secretary, shows an existing understanding of the need for prevention in public spending to avoid escalating costs of acute public services and the economic costs associated with poor outcomes.

At the beginning of this paper we outlines four challenges and opportunities; firstly, the disadvantage gap in the early years through to secondary education, as previous work we commissioned from Education DataLab demonstrated worse outcomes from education of the long-term disadvantaged from benefit dependency to prison.[7] Secondly, levels of unhealthy people out of the workforce, as both a result and a contributor to lower productivity. Thirdly, the key infrastructure enablers for northern agglomeration, notably Northern Powerhouse Rail. Fourthly, that we could fail to capitalise on the opportunity of decarbonisation, and instead only offshore jobs from heavy industry to nuclear supply chains abroad. Only transport and energy infrastructure are enabled by the change to the fiscal rules. In particular, regarding the transition to Net Zero, at the Northern Powerhouse Partnership, we have made our pitches, such as for the Small Modular Reactor competition concluding this December. However, it is for the new approach using the guardrails to make final determinations, considering evidence-based exercises like the Northern

[7] Education Datalab (2023), The long term consequences of long term disadvantage, https://www.northernpowerhousepartnership.co.uk/wp-content/uploads/2022/11/LTD-impact-report.pdf

Powerhouse Independent Economic Review. The previous NIC, now becoming NISTA, had a long history of conducting such exercises.

However, the first two of these issues are both dependant on prioritising the revenue budget in the upcoming spending review. The Office for Budget Responsibility will be key to interrogating how successful the new government is in moving expenditure to prevention despite the huge day to day wider spending pressures.

In terms of Mayoral developed single settlements, this process must act as a powerful ratchet for this approach, with places able to address their long-term opportunities rather than just deal with the acute pressures. It is both a principle of the devolution journey first embarked upon by Greater Manchester, and a response to the realities of the current state of the public finances, that places use flexibility to better allocate additional resources before receiving additional funding. This type of discipline can and should be applied to central government departments in those areas of the North and wider areas of England which will initially be outside the single settlement framework.

Conclusion

The North of England's aspiration—to emulate the success of cities like Leeds, which have been able to generate as much tax revenue as is spent on services, at least during certain periods in the recent past—is credible. Increasing capital budgets, appropriate use of private finance and the leverage achieved on both will generate significant private sector led activity, most notably in energy as shown by work by Cambridge Econometrics in the revised Northern Powerhouse Independent Economic Review Net Zero scenario which we commissioned earlier this year. That includes £4 leverage for every £1 in both industrial decarbonisation and retrofit of buildings.

Partnered with re-prioritising revenue budgets towards prevention, it is possible that in the longer term the current subsidies to the North in revenue terms can begin to reduce. The dependence on more productive parts of England to fund public services here can only be addressed by raising productivity in the North, while simultaneously constraining the growth of inequality-related costs. This is the only approach to sustainably increase the UK's tax base and end its over reliance on London and the South East, and reduce the ballooning cost of acute services, not least the NHS hospital based services and Children's Social Care.