Briefing

The economic case for the Labour Party's Green Prosperity Plan

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Keir Starmer has put the economy and, specifically, a goal of the fastest growth of any G7 country, at the heart of his pitch to the British people, ahead of the next general election. We applaud this goal: it will lead to the transformative changes needed in our public services and to national infrastructure for a thriving economy. In this briefing, we set out why public investment at pace and scale, from day one of a Labour government, in its Green Prosperity Plan and clean energy missions, would be vital.

The economic case

There is a very strong economic case for a major slate of green investments: it will be pro-growth at a time of stagnating prosperity; is essential for meeting UK climate adaptation goals in the face of stalling progress; and it will reverse decades of under-investment which have left the UK with a severely depleted capital stock.

Starting with the growth impact, green stimulus policies are particularly effective in the short run when compared to a traditional fiscal stimulus. They create more jobs and have higher short run multipliers. In the long run, they create a virtuous cycle, as initial investments lower costs and help to accelerate innovation. This is particularly the case if the stimulus is frontloaded, as this helps to attract initial investment from the private sector and locks in efficiency gains for longer.

In line with the climate targets in the Climate Change Committee's (CCC's) sixth carbon budget (which has been accepted by the government and entails a reduction in UK greenhouse gas emissions of 78 per cent by 2035 relative to 1990, and a 63 per cent reduction from 2019) Cambridge Econometrics estimates a boost to the economy of around two per cent of GDP by 2030. For comparison, some estimates put the cost of Brexit as high as five per cent of GDP, so this would help to make up some of the loss.[1] Employment from a green investment boost would be about one per cent higher, equivalent to 300,000 jobs.[2]

These estimates are consistent with OECD and EU analyses which underline that green investment is net positive for GDP growth. UK investment is also likely to benefit sectors where the UK has actual or potential comparative advantage disproportionately, for example carbon capture and storage, green hydrogen, offshore wind and electric vehicles (EVs).[3]

What level of investment is needed?

To achieve this reduction in greenhouse gas emissions and lock in the accompanying economic benefits, the CCC estimates that UK low carbon investment each year will have to increase, from around £10 billion a year in 2020 to around £50 billion by 2030, continuing at around that level through to 2050. That compares to total investment in the UK of around £390 billion in 2019.

Much of this spending can be recouped through lower operating costs. The annual savings, many of which relate to reduced reliance on imported fossil fuels, will rise to around £35 billion by 2035 and £60 billion by 2050.

Delay, on the other hand, will be costly. The Office for Budget Responsibility (OBR) has set out the consequences.[4] It models a scenario in which firm action is put off to 2030, after which policy changes abruptly. In this instance, GDP is three per cent lower by 2050-51, while public spending is 50 per cent higher and public sector net debt (PSND) 23 per cent higher, raising net interest payments on the debt to ten per cent of GDP. This might seem a long way off, yet the CCC is already warning of sliding confidence in progress on meeting the sixth carbon budget (2033-37).[5]

Achieving this investment boost would also reverse a long stagnation in capital investment which is likely to be implicated in the UK's indifferent performance on growth and productivity over the past 15 years. The UK has lagged behind other G7 countries for investment as a proportion of GDP since the early 1990s. Public investment has never risen above the G7 average. The last time the UK was the median country for private sector investment was in 2005.[6]

The private finance multiplier

Like most programmes of public investment, Labour's plan would be expected to 'crowd-in' large amounts of private sector investment, so the overall economic impact is likely to be much greater than the initial public commitment. The ultimate size of the investment boost (public plus private) depends on the size of the multiplier for each area which can be difficult to estimate, leaving assumptions open to criticism.

But it is worth noting that Conservative's 2021 Plan for Growth assumed a significant multiplier effect, citing academic estimates that a ten per cent increase in the public capital stock (value of current infrastructure) was linked to a one to two per cent rise in GDP.[7] The Plan for Growth also claimed important spillovers from raising investment spending. For example, it implied that it would spur investment in digital technologies.

To maximise the impact, investment should ideally be targeted at areas where the private sector would like to invest but is hesitant because of high initial capital costs and uncertainties over the economic case; hydrogen and batteries are good examples. This requires close co-ordination with private firms.

But there is another proviso: credibility. For a large public-private investment programme to be effective, the authorities need to firmly signal the intention of the investment and make early funding commitments with a clear timetable of long term support. Otherwise, private actors (firms, consumers, providers of finance) may fail to respond.

For example, the building retrofit sector was unable to scale up in response to the introduction of the Green Homes Grant to help households pay for energy saving improvements, as it had already downsized in response to previous reductions in subsidies and repeated broken promises to increase them. When the grant was launched in 2020 the money came out of the blue, with zero forward visibility beyond a single year. The sector responded too sluggishly for the policy to be effective because it lacked the confidence to invest in staffing, training and other systems needed to grow. The moral of this story is: signal early, signal big and signal long term support for industry buy-in.

Labour's investment pledge

There is no reason to suggest Labour's investment pledge is inconsistent with its fiscal rules. Labour pledges to close the deficit on current spending over the five years of a parliament but will exclude from this investment spending in "capital projects which over time will pay for themselves". The GPP s described as investment (and the measures announced largely fit this description) so would, therefore, not fall foul of this rule.

Labour also has a rule to have debt falling as a percentage of GDP over the parliament. In the short term, the £28 billion of extra borrowing raises debt, potentially jeopardising the rule. But if, as planned, the investment boosts growth then that would leave the debt to GDP ratio largely unchanged and hence the rule would remain intact. There is some uncertainty over the timing. It might take longer than the forecast period for this to happen, particularly if the investment is backloaded over the parliament, so adherence to this rule might be more open to question.

Risks of the investment plan

Will it crowd out private investment?

A potential objection to using public spending to crowd in private investment is that the opposite might happen: public investment could crowd out private spending, leaving net investment unchanged or lower.

The extra borrowing is expected to raise gilt yields, making capital more expensive for the private sector at a time when borrowing costs are rising anyway. The question is whether this outweighs the positive effect of government investment.

Given the strong business case for more investment, there are good reasons to believe the effect will still be strongly positive. Both America's Inflation Reduction Act and the EU's Net Zero Industry Act assume initial public investment will draw in large amounts of private capital as they will stimulate economic sectors that have the potential to be highly profitable.

UK businesses will be most likely to invest more in the green transition if they have confidence that the government has a credible long term plan for the green economy, supported by appropriate institutions, such as the UK Infrastructure Bank, perhaps a revamped green investment bank, and strong local mechanisms for co-ordinating local growth plans which bring business and policy makers together.

Could it be inflationary?
Closely related to the crowding out issue is whether the GPP will fuel inflation, which is already at a 40 year high. It is possible that the extra spending will fuel competition for resources, including workers, pushing up prices.

However, the Bank of England and most other forecasters expect inflation to fall to below the two per cent target by 2025, the first year of the GPP, which might provide a timely fiscal boost to the economy. The current bout of UK inflation is rooted in supply side problems which will ultimately be resolved, not exacerbated, by more investment.

Forthcoming Green Alliance analysis shows that, if the UK rapidly decarbonises its power system along the lines proposed by Labour, it will need 24 per cent less natural gas by 2030. Inflation would have been ten per cent lower over the past year, if we had a decarbonised power system, like the one the CCC's Balanced Net Zero pathway envisions for 2035.

Managing investment expectations
The CCC recommends a move away from public subsidy over time, as reliance on subsidies will not inspire confidence in low carbon markets. This implies frontloading the investment to crowd in the private sector in the first instance, then reducing it over time.

However, this may conflict with the apparent strategy to shift more of the projects originally covered in the £28 billion plan to the National Wealth Fund (NWF), a UK sovereign wealth fund (SWF). Most SWFs, such as Norway's, are funded by budget or balance of payments surpluses. Lacking either of these, the NWF will inevitably have to start more gradually by ploughing profits from initial joint ventures with private firms back into new investment projects. This implies spending should be backloaded, by starting gradually and building up. If the CCC is right, this may create expectations among investors that subsidies will rise over time, reducing incentives to invest. Delay will also reduce the efficiency savings accruing over time. It may, therefore, be necessary to time limit investments and indicate this to investors.

Public sector capability
Finally, doubts remain over the ability of the public sector to manage such a large injection of spending effectively, given the recent difficulties with public management and procurement projects, eg the Carillion and PPE scandals, and HS2. Creation of durable and effective institutions to project manage the investments will be necessary, as will co-ordination between civil service departments to deliver cross departmental spending targets.

Recommendations

Should Labour win the 2024 general election, we recommend that it takes the following actions in support of its Green Prosperity Plan:

1) Commit to a period of high investment in the green economy early in the parliament, consistent with the party's fiscal rules.

2) Ensure public investment crowds in private finance with clear signalling of the government's intentions through a long term and credible industrial strategy.

3) Provide good governance and effective oversight of the spending through institutions such as the UK Infrastructure Bank, a revamped green investment bank and mechanisms for local economic co-ordination.

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Endnotes

[1] Centre for European Reform, 9 May 2023, *Are the costs of Brexit big or small?*
[2] Climate Change Committee. 2020, *Sixth carbon budget*
[3] CCC, 2019, *Net zero report*
[4] Office for Budget Responsibility. 2021, *Fiscal risks report*
[5] CCC, 2023, *Progress in reducing emissions, 2023 report to parliament*
[6] IPPR, 2023, 'Now is the time to confront the UK's investment phobia'
[7] HM Treasury, 2021, *Build back better: our plan for growth*