UK ECONOMICS FOCUS

Should we fear a Labour government?

- Forget Brexit – the biggest thing to happen to the UK economy over the next couple of years could be the advent of a Labour government, and a particularly left-wing one at that. On the plus side, this could bring a small fiscal boost and a softer Brexit. But these benefits would probably be offset by the dent to private sector investment from Labour’s anti-business policies. And there is a risk that Labour would pursue a more aggressive agenda than that outlined in its manifesto, posing a more serious threat to the economy.

- Although the next general election is not technically due until 2022, it could happen sooner, possibly within months. Polls indicate a good chance of Labour gaining power, in coalition or even with a majority.

- There are several reasons why a Labour government would not necessarily lead the country to rack and ruin. First, Prime Minister Jeremy Corbyn would probably be constrained in what he could do by his (for now more moderate) parliamentary party, any coalition partners and the distraction of Brexit.

- Second, Labour plans to borrow only a bit more than the Conservatives. Even that is due to extra investment which many – on all sides of the political spectrum – have for some time been arguing for. And third, business would presumably welcome Labour’s softer approach to Brexit.

- There are nonetheless still reasons to worry. First, there is a big question mark over whether Labour would actually stick to its borrowing plans. And if financial markets doubted Labour’s commitment to keep borrowing under control, bond yields would rise, pushing up interest rates across the economy. Even if Labour kept a lid on borrowing, its nationalisation programme would push up public sector debt.

- The second cause for concern is Labour’s plan for a big increase in the role of the state, given that the public sector is generally assumed to be less efficient than the private sector. Under Labour’s manifesto plans, government revenues and spending as a share of GDP would both reach their highest level since the mid-1980s (leaving aside the rise in spending during the financial crisis).

- Third, while no single one of Labour’s policies would strike a death blow to the business sector, taken all together, they could make the UK a significantly less attractive place to invest. Corporate tax rates would rise and labour costs would increase due to plans to rescind Margaret Thatcher’s trade union reforms and to raise the Minimum Wage.

- What’s more, businesses would presumably look at the “direction of travel” and fear that things would only get worse. Indeed, the manifesto pledges might prove to be just the tip of the iceberg.

- Overall, if the manifesto were implemented in a sensible way and bond markets were in a forgiving mood, there is a chance that the economy would perform better under Mr Corbyn. But it seems unlikely that it would do much better; with the economy close to full capacity, any fiscal stimulus would be largely offset by higher interest rates, and Labour does not seem to have better answers than the Conservatives to the major issues of productivity, housing or the ageing population.

- And it’s more likely that the economy would fare worse under a Corbyn government. This would probably not have a huge impact in the first year or two, but the effects would build up over time. In an extreme scenario, with Labour implementing a full-scale assault on the free market and private property rights, investment would plummet and the downward pressure on sterling could result in exchange controls.
Should we fear a Labour government?

Forget Brexit – the biggest thing that could happen to the UK economy in the next year or two is a change of government. In particular, we could soon be looking at a Labour government, with Jeremy Corbyn as Prime Minister. Cripes!

Some claim that Mr Corbyn would boost investment and productivity, while reducing inequality. Others are worried that fiscal discipline would go out of the window, talent and investment would be driven out and the public sector would become bloated and inefficient. In this Focus, we look at what a Labour government would mean for the economy. Anything involving politics can obviously be emotive, but, rest assured, we stick here to the boring economics.

We start with the mechanics of how a Labour win could actually come about. We then discuss the ways in which a Labour government could help – or at least not hinder the economy – before moving onto the more troubling aspects of Labour’s agenda. We wrap up with some scenarios of how a Labour government could play out for economic growth.

When is a fixed term parliament not a fixed term parliament?

In theory, Labour shouldn’t stand any chance of being in power until the current parliament ends in 2022. The Fixed-term Parliaments Act, introduced in 2011 by the coalition government, was intended to take the politics out of the timing of general elections and prevent prime ministers from calling snap elections. Parliaments now last for exactly five years unless either i) at least two thirds of MPs vote for a motion for an early election, or ii) there is a vote of no confidence in the Government which is not overturned within 14 days.

However, the Act has quickly proved to be worth little more than the paper it was written on. In June 2017, Prime Minister Theresa May put forward a motion for a general election, just two years after the previous one in May 2015, in an attempt to increase the Conservatives’ majority and entrenching his own position.

Why on earth would the Conservatives do the same again? Surely it would be madness to risk an election now, having got their fingers burnt last time, and when their standing in their polls has fallen further since. Nonetheless, there are a couple of ways in which an election could come about. (See Box 1.)

Box 1: How could an early election come about?

There is a good chance that any election will be related in some way to the Brexit negotiations. The fact that the UK and EU have now agreed a draft withdrawal treaty removes one potential flashpoint. But it won’t be long until the next one. This might be when Parliament actually votes on the Withdrawal Bill later this year. Or it could be the vote on the Trade Bill on the UK’s future trading relationship with the EU. Any vote will be a close-run thing. The Government’s current plan is to take the UK out of the Customs Union. But most of the opposition supports staying in a customs union, as do a handful of pro-EU Tory MPs.

Losing either vote would not necessarily bring the government down. But Theresa May might frame the vote as a vote of no confidence, to boost the chances of it passing. (Under the Fixed-term Parliaments Act, a motion cannot be explicitly tied to a vote of no confidence.) If that gamble didn’t pay off, a proper vote of no confidence, and therefore possibly an election, would follow.

Alternatively, if Mrs May lost the vote, she might offer, or be forced, to stand down. Or she might accept the parliamentary consensus for staying in a customs union – prompting the hardline Brexiteers to rebel and force a leadership contest. Or she could stand down if the Conservatives get a drubbing in the local elections on 3rd May. Either way, a leadership contest would be unlikely to result in Mrs May remaining PM. Given its composition, the party membership might well elect a Brexit hardliner (e.g. Jacob Rees-Mogg) who would divide the party. The Tories would effectively lose their parliamentary majority – again, potentially leading to a vote of no confidence and a general election.
Indeed, betting markets think that the chance of a general election either this year or next is higher than the chance of one in 2022, when it is theoretically supposed to happen. (See Chart 1.)

And if there were an early election, there is a reasonable chance that Labour would take power in one form or another. As Chart 2 shows, the Conservatives and Labour are currently running neck and neck in the opinion polls.

Given that the opinion polls generally did not accurately predict the result in the last election, they obviously need to be taken with a pinch of salt. Indeed, it is quite possible that the Conservatives would simply get re-elected. Depending on exactly when the election took place, the planned boundary changes that would result in 50 fewer MPs and benefit the Conservatives may have been implemented. Moreover, consumer confidence is at a level historically consistent with a lead for the incumbent party. (See Chart 3.)

But the relationship is not that close and perhaps other things (like Brexit) will play more of a role in people’s voting decisions. An outright Labour victory is therefore within the realms of possibility.

Indeed, to win, Labour only needs a uniform national swing in the vote against the Conservatives of about 5% (e.g. for its vote to rise by 2.5% while the Tories’ falls by 2.5%). As Chart 4 shows, that’s only a little bit bigger than the swing of 4% that won Tony Blair a majority for the Labour party in 1997.

In fact, the most likely outcome is that no party gets an outright majority. Taking the opinion polls at face values points to a hung parliament. (See Chart 5.)

Chart 5 suggests that the most viable partnership would be between Labour and the Scottish...
Nationalists. Neither party sounds overly keen on a formal coalition. But Jeremy Corbyn has not ruled one out. And SNP leader Nicola Sturgeon has said that the SNP could work with Labour on an issue-by-issue basis. So we could see a confidence and supply arrangement, rather than a formal coalition.

What is Corbynism?

So, that’s all a long way of saying that one way or another, Labour could soon be in power.

Of course, a change of ruling party per se is not a big deal; such changes have happened about once a decade on average since 1945. And there have been times when the change has not brought with it any major change in direction (e.g. from the Labour government – which had already kickstarted the austerity programme – to the Conservatives/Liberal Democrats coalition in 2010). What’s more, over the past few decades, the economy has not performed decisively better or worse under Labour or the Conservatives. Chart 6 shows that since 1960, GDP and employment growth have been lower on average under Labour, but not materially so. Inflation has been about the same. And under Labour, real wage growth has been higher, while real interest rates and public sector borrowing have been lower.

However, Mr Corbyn’s radical agenda means that this change of government has the potential to be a big deal. Labour’s 2017 manifesto was entitled “For the many, not the few” and certainly a key plank of “Corbynism” is standing up for the vulnerable and railing against a system loaded in favour of the rich. But he also opposes blind faith in the market; believes in a more co-operative economy that gives power to workers; and thinks that the government is better than business at things like providing energy and infrastructure. This contrasts clearly with the free market ideology underpinning recent governments. Indeed, given that the last Labour government – the Blair/Brown partnership of 1997-2005 – stood very much on the centre ground, this would be the first properly left-wing government since Jim Callaghan’s administration in the late 1970s. (See Table 1.)

Our more, ahem, experienced readers will remember that Mr Callaghan’s government resulted in the Winter of Discontent, an IMF bailout and inflation rates of over 20%. Perhaps it’s no wonder, then, that recent months have seen warnings that Labour will bankrupt the country and turn the economy to “rubble”.

Reasons not to worry

But how valid are such warnings? Let’s start with the good news. In some respects, Mr Corbyn’s agenda is unlikely to cause the economic damage that many fear and could even help the economy. There are three things to discuss here; the constraints on Mr Corbyn; Labour’s fiscal plans; and its view on Brexit.

1. Corbyn’s constraints

The first key point to make is that, even if he got into government, Mr Corbyn would be subject to a number of constraints, which mean that he might struggle actually to get much done in the first place.

### Table 1: History of British Governments

<table>
<thead>
<tr>
<th>Years</th>
<th>Party</th>
<th>PM</th>
<th>Majority</th>
</tr>
</thead>
<tbody>
<tr>
<td>1945-1950</td>
<td>Labour</td>
<td>Clement Attlee</td>
<td>146</td>
</tr>
<tr>
<td>1950-1951</td>
<td>Labour</td>
<td>Clement Attlee</td>
<td>5</td>
</tr>
<tr>
<td>1951-1955</td>
<td>Con.</td>
<td>Winston Churchill/Anthony Eden</td>
<td>17</td>
</tr>
<tr>
<td>1959-1964</td>
<td>Con.</td>
<td>Macmillan/ Alec Douglas Home</td>
<td>100</td>
</tr>
<tr>
<td>1964-1966</td>
<td>Labour</td>
<td>Harold Wilson</td>
<td>4</td>
</tr>
<tr>
<td>1970-1974</td>
<td>Con.</td>
<td>Edward Heath</td>
<td>30</td>
</tr>
<tr>
<td>1974</td>
<td>Labour</td>
<td>Harold Wilson</td>
<td>-33</td>
</tr>
<tr>
<td>1974-1979</td>
<td>Labour</td>
<td>Wilson/James Callaghan</td>
<td>3</td>
</tr>
<tr>
<td>1979-1983</td>
<td>Cons.</td>
<td>Margaret Thatcher</td>
<td>43</td>
</tr>
<tr>
<td>1983-1987</td>
<td>Cons.</td>
<td>Margaret Thatcher</td>
<td>144</td>
</tr>
<tr>
<td>1997-2001</td>
<td>Labour</td>
<td>Tony Blair</td>
<td>179</td>
</tr>
<tr>
<td>2001-2005</td>
<td>Labour</td>
<td>Tony Blair</td>
<td>167</td>
</tr>
<tr>
<td>2005-10</td>
<td>Labour</td>
<td>Blair/Gordon Brown</td>
<td>66</td>
</tr>
<tr>
<td>2010-2015</td>
<td>Con./Lib.</td>
<td>David Cameron</td>
<td>78</td>
</tr>
<tr>
<td>2015-2017</td>
<td>Con.</td>
<td>Cameron/May</td>
<td>12</td>
</tr>
<tr>
<td>2017-</td>
<td>Con.</td>
<td>Theresa May</td>
<td>-8</td>
</tr>
</tbody>
</table>

Arguably the biggest constraint is simply the reality of being in government. It is easy to promise all manner of things when in opposition. But when it comes actually to hammering out policy, paying for it and getting it passed through government, ambitions can quickly become curtailed. Indeed, Labour’s thinking has already “matured” a lot over the past two or three years alone, resulting in some of the most radical ideas being ditched. It wasn’t that long ago that Labour was saying that it would end the Bank of England’s independence, and introduce “People’s QE” (printing money to pay directly for infrastructure spending). And Mr Corbyn seems to have some sense of pragmatism, compromising when some of his personal views (e.g. on Trident or the monarchy) conflicted with the view of his party.

Indeed, we have seen “radical” leaders before who proved to be anything but. For example, Alexis Tsipras, the Greek Prime Minister, was elected on the basis that he would rid Greece of its hated bailout, but ended up committing the country to another austerity programme. Admittedly, there are also examples of socialist leaders who followed through on their plans – the most prominent example in recent decades being President Mitterand of France in 1981. He introduced wholesale nationalisation, tax rises for the rich and an expansion of welfare spending. Note, though, that he had backtracked on many of his policies within a couple of years.

Another key constraint that Mr Corbyn will face is his own parliamentary party. Obviously any of Mr Corbyn’s plans have to be passed by the House of Commons. And Labour’s MPs are, on the whole, considerably more moderate than Mr Corbyn. (Remember that a majority of them last year were planning to get rid of him!) Accordingly, Mr Corbyn might simply fail to get his more left-wing policies passed by government. Admittedly, the composition of MPs could change after the general election. (We’ll say more on this later.) But it would take a big shift for the parliamentary party fully to reflect Mr Corbyn’s socialist thinking.

If the general election resulted in a hung parliament, Mr Corbyn would also find himself constrained by a coalition partner – most likely the SNP. Admittedly, the SNP would be supportive of many of Corbyns’s policies. (See Table 2.) For example, they back a UK-wide 50p income tax rate, ending austerity and supporting those on low incomes. They have even proposed setting up a publicly-owned energy company to deliver lower prices. Nonetheless, Labour’s manifesto goes much further than the SNP on issues such as trade union rights and nationalisation. At the very least, the SNP might need to be “bought off” (as Theresa May did with the DUP), reducing the amount Mr Corbyn could spend on implementing his policies.

<table>
<thead>
<tr>
<th>SNP</th>
<th>Labour</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fiscal plans</td>
<td>Balance current budget by end of parl. &amp; borrow to invest.</td>
</tr>
<tr>
<td>Public spending</td>
<td>More money for the NHS, education and childcare.</td>
</tr>
<tr>
<td>Personal taxation</td>
<td>No increase in tax for the low paid. Raise top rate of income tax to 50p.</td>
</tr>
<tr>
<td>Corporate sector</td>
<td>No support for further reductions in corporation tax. Increase Investment Allowance.</td>
</tr>
<tr>
<td>Bankers</td>
<td>Reverse reductions to bank levy and introduce tax on bankers’ bonuses.</td>
</tr>
<tr>
<td>Minimum wage</td>
<td>Raise National Living Wage to slightly more than £10/hour.</td>
</tr>
<tr>
<td>Workers’ rights</td>
<td>Support repeal of the Trade Union Act 2016 and a ban on zero-hours contracts.</td>
</tr>
<tr>
<td>Welfare</td>
<td>Protect the triple lock on pensions and winter fuel allowance; reverse many of the Tories’ welfare cuts; and oppose further cuts to social security.</td>
</tr>
<tr>
<td>Brexit</td>
<td>Stay in the single market.</td>
</tr>
<tr>
<td>Utility companies</td>
<td>Create a public non-profit energy company.</td>
</tr>
<tr>
<td>Scottish independence</td>
<td>Second Scottish independence referendum at end of Brexit process.</td>
</tr>
</tbody>
</table>

Source: SNP, Labour Party
The Bank of England (assuming that Mr Corbyn did not take away its independence) would also act as a constraint. In particular, a very expansionary fiscal policy would just be offset by higher interest rates. Of course, this would help Mr Corbyn in the sense of preventing his policies from triggering runaway inflation and a true return to the 1970s. But at the same time, for example, rising interest rates could prevent the recovery in investment that Mr Corbyn is aiming for.

Another potential constraint is Brexit. In particular, Mr Corbyn and his government might get so bogged down in Brexit that they simply do not manage to get anything else done. After all, this is what appears to have happened to the Conservatives; analysis by The Times newspaper shows that the number of parliamentary votes held since last year’s election is lower than after every election won by Theresa May’s predecessors, David Cameron and Tony Blair.

Of course, much depends on precisely when Mr Corbyn got into power. If the election did not happen until after 2020, the UK would already have come out of its transition period and entered its new relationship with the EU, whatever that proves to be. In that case, Mr Corbyn might be free of Brexit distractions. That said, if by that point the UK had failed to conclude a deal and had simply left the EU, most of Mr Corbyn’s time would be taken up with dealing with the fallout – recreating trade deals with other countries, compensating those parts of the economy which had lost EU funds etc.

And it is much less likely that all Brexit-related issues will have been resolved if Labour takes charge within the next couple of years. Remember, after all, that there might only be an election in the first place if disagreement about Brexit effectively brings down the current government.

2. Investing more arguably makes sense
The second reason not to worry about a Corbyn victory is that Labour’s fiscal plans belie claims that Labour would send the public finances to ruin. In fact, as long as Labour just followed the plans outlined in its manifesto (we will come back to that “if” later!), the economy would probably benefit.

Labour intends to stick to the Conservatives’ plans for the current budget (which excludes investment spending), albeit by raising taxes in order to pay for higher day-to-day spending on things like the NHS. Instead, the key difference is that Labour would borrow more in order to invest more. Labour has said that it would undertake an extra £250bn of public sector investment spread over ten years, through a National Transformation Fund. It would also put £20bn of government capital into a National Investment Bank which would conduct annual bond issues with which ultimately to lend a total of £250bn through regional development banks.

This extra spending would obviously leave public sector borrowing higher than under the Tories’ plans, but the difference would not be large. For example, borrowing in 2018/19 would be 2.7% of GDP, rather than 1.8%. (See Chart 7.) So the big picture is that borrowing would remain significantly down on the levels seen in the early 2010s. Indeed, the upward revisions under Labour’s plan would be no bigger than those that occurred under the Conservatives in November 2016, when the OBR revised up its borrowing forecasts by around £20bn per annum in the light of its weaker growth forecasts following the EU referendum.

So on the face of it, there would be no reason for bond investors to run for the hills. After all, bond yields remained low even when public sector borrowing was running at much higher levels than Labour is planning. And the sanguine market reaction to the fiscal stimulus announced by US President Trump in February is potentially reassuring. The US fiscal deficit is now forecast to reach over 5% of GDP, significantly higher than borrowing is forecast to reach under Labour’s plans.

What’s more, many (on all sides of the political spectrum) have been arguing for some time that extra public sector investment is precisely what the
UK needs. Although Chart 8 shows that government investment as a share of GDP is already higher than it was for much of the 1990s, there is no shortage of decent projects for the government to invest in. And it makes sense to borrow to invest now while gilt yields are still so low.

Moreover, investment is the part of government spending with the biggest so-called “multiplier” and so most likely to boost the economy. The OBR assumes that a change in government investment spending feeds through one for one to GDP. So, leaving aside any microeconomic effects of Labour’s measures for now, or any offsetting effect of higher interest rates, the simple direct impact of the extra borrowing for investment would be to boost GDP by £25bn or 1.2% a year.

In fact, a plausible case could be made for ending austerity more generally. Of course, the outstanding level of public sector debt is still high and ideally it would be a bit lower in order to create some more “fiscal space” to deal with both the next economic downturn and the financial burden of the ageing population. However, Labour would still have debt as a share of GDP falling by 2020/21. (See Chart 9, which is based on the OBR’s GDP growth forecasts. We discuss later how GDP growth and therefore the debt to GDP ratio might differ from this chart.) Note, too, that Japan manages with much higher government debt than the UK.

Admittedly, there is perhaps less of a case for ending austerity now that the economy does not have much spare capacity left. Extra government spending might just “crowd out” private sector spending and result in interest rates rising faster than they would otherwise do. That said, if the government is spending the extra money on investment (rather than day-to-day spending), then it should end up boosting the economy’s supply potential and, in the long-term, mitigate some of the inflationary effects of the higher spending.

And even if monetary policy does have to be tightened more quickly than otherwise, altering the fiscal/monetary policy mix in this way might be a good thing. Progress in normalising interest rates would give policymakers scope to cut rates again if needed (for example, if the Brexit negotiations were to take a turn for the worse). It could also ease some of the other negative side-effects of very loose monetary policy, such as the significant deficits of some defined benefit pension schemes.

3. A softer Brexit more likely

Another reason why a Corbyn government could give at least a short-term boost to the economy, is that it would probably lead to a “softer” Brexit than under the Conservatives. (Of course, this assumes that the election happens early enough to give the next government a chance to influence the Brexit negotiations). As things stand, the Tories are still planning to leave the Single Market and Customs Union, whereas Mr Corbyn announced in a speech this February that Labour now supports staying in a customs union with the EU.

Of course, people have big (to put it mildly) differences of opinion about whether a soft or hard Brexit is best for the economy. Those arguing for a soft Brexit point to the advantages of maintaining free trade with the UK’s biggest trading partner, while those arguing for a hard Brexit point to the potential gains through new trading agreements with other countries. However, the consensus seems to be that a soft Brexit would be better for the economy than a hard Brexit. Even if this turned out not to be true...
(although we will never know), a softer Brexit would presumably be better for business confidence and investment in the near- to medium-term.

**Admittedly, a softer Brexit under Labour is not a given.** For a start, the party has its own divisions over the issue (with Mr Corbyn himself rather less pro-EU than his party). And although Labour has recently firmed up its position on Brexit, the EU is unlikely to agree to its plan in its current form. In particular, Mr Corbyn said that Labour would support joining “a” customs union with the EU, rather than “the” current one, so that the UK can both enjoy tariff-free trade with the EU, while also having a say in new trade deals – Labour’s version of “have your cake and eat it”. Another sticking point for Labour with the EU could be state aid; the EU might refuse to grant Mr Corbyn his desired exemptions if the UK were part of a customs union.

But some sort of deal would probably get hammered out and the key point is that the UK would probably end up with a slightly closer trading relationship with the EU under Labour than the Conservatives. The UK could even end up staying in the Single Market – about 80 Labour MPs support the Single Market, while the SNP might make Single Market membership a red line of any coalition. That said, Mr Corbyn might find unacceptable the additional limitations that this would probably put on his domestic agenda. Staying in the Single Market would also bring other conditions (e.g. on free movement of labour) that would probably be unacceptable to an electorate that voted to leave the EU in order to gain greater control over such things.

A Labour government would also reduce the chances of the UK leaving the EU without any deal at all. Parliament will get a vote on the final deal and might in theory vote against it. The Conservatives have said that, in this case, they would be happy to walk away with no deal. But Labour has argued that no deal would be the worst outcome and so would presumably renegotiate. Note, though, that Mr Corbyn has ruled out a second referendum (for now).

**Reasons to worry**

So on the basis of Mr Corbyn’s fiscal plans and Brexit stance, we might judge that a Labour government would be good for the economy. However, let’s not be hasty! There are several factors that could offset these positives, namely the risk of a shaper rise in borrowing; a bigger role for government; anti-business measures; the risk to the City; and the possibility of a more radical agenda.

1. **Borrowing**

First, let’s go back to Labour’s fiscal plans. They might look good in theory – but would they actually work out in practice?

We pointed out earlier that Labour plans to raise borrowing by a relatively small amount, in part because it plans to pay for higher day-to-day spending with tax increases. (See Table 3.) **But there is a big question mark over whether Labour would manage to raise as much money from its planned tax rises as it claims.** For example, there are doubts that measures such as Labour’s excessive pay levy, or the corporation tax rises, would raise as much as it assumes. And Labour’s £4bn allowance for revenues lost as a result of behavioural changes from their tax rises looks conservative. Indeed, the IFS thinks that, at best, Labour will raise £41bn, rather than £49bn, leaving a “manifesto black hole” of nearly £10bn.

<table>
<thead>
<tr>
<th>Extra spending</th>
<th>£bn per annum</th>
</tr>
</thead>
<tbody>
<tr>
<td>NHS &amp; social care</td>
<td>7.7</td>
</tr>
<tr>
<td>Schools</td>
<td>8.8</td>
</tr>
<tr>
<td>Childcare</td>
<td>5.3</td>
</tr>
<tr>
<td>Removing university tuition fees</td>
<td>11.2</td>
</tr>
<tr>
<td>Social security</td>
<td>4.6</td>
</tr>
<tr>
<td>Lift public sector pay cap</td>
<td>4.0</td>
</tr>
<tr>
<td>Implied extra spending for</td>
<td>6.1</td>
</tr>
<tr>
<td>Scotland, Wales &amp; NI</td>
<td>0.9</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>48.6</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Extra taxes</th>
<th>£bn per annum</th>
</tr>
</thead>
<tbody>
<tr>
<td>Corporation tax rise &amp; review of tax relief</td>
<td>23.2</td>
</tr>
<tr>
<td>Income tax rise &amp; Excessive Pay Levy</td>
<td>7.7</td>
</tr>
<tr>
<td>Tax Avoidance Programme</td>
<td>6.5</td>
</tr>
<tr>
<td>Offshore Company Property Levy</td>
<td>1.6</td>
</tr>
<tr>
<td>Extension of Stamp Duty</td>
<td>5.6</td>
</tr>
<tr>
<td>VAT on private school fees</td>
<td>1.6</td>
</tr>
<tr>
<td>Reversing tax giveaways on capital gains tax, inheritance tax, bank levy and married persons' tax allowance</td>
<td>3.7</td>
</tr>
<tr>
<td>Other</td>
<td>2.6</td>
</tr>
<tr>
<td>Allowance for behaviour change</td>
<td>-3.9</td>
</tr>
</tbody>
</table>

**Total**                                                                 48.6

Source: Labour manifesto
Moreover, Labour’s fiscal forecasts are based on the OBR’s current forecasts for economic growth. Of course, if Labour’s policies resulted in stronger GDP growth, then borrowing would come in lower than currently forecast. Indeed, the OBR would probably initially revise up its growth forecasts, based on Labour’s planned rise in government investment. But if Labour’s policies ended up resulting in a weaker economic performance than currently forecast, then borrowing would be higher, and borrowing as a share of GDP doubly so.

Of course, if tax receipts disappointed, either because of optimistic assumptions in the manifesto or a weaker economy, Labour could just tighten its belt in response. But can we really imagine Labour, the anti-austerity party, doing that? No. Accordingly, borrowing would probably take the strain. Admittedly, Labour has proposed a “Fiscal Credibility Rule” – to eliminate the current budget deficit over five years – that would in theory prevent borrowing rising in this way. However, the fact that Labour’s fiscal rule is based on a five year rolling period would allow it to repeat ex-Chancellor George Osborne’s trick of always forecasting meeting it, without ever doing so. And the experience of recent years has shown us how much fiscal rules are worth. Note, too, that even though Labour initially stuck to the Conservatives’ tough spending plans when it came to power in 1997, it later significantly loosened fiscal policy.

Say that borrowing rose by an extra £10bn per annum (enough to fill the manifesto black hole, or, based on the OBR’s multipliers, to offset the effect of GDP growth undershooting forecasts by around 0.7pps). That would raise annual borrowing by a further 0.5% of GDP. Admittedly, a small borrowing overshoot like this need not be a disaster. The Conservatives consistently overshot their forecasts and yet the financial markets stayed calm. However, Labour’s relatively poor record for deficit reduction means that the market could treat its extra borrowing differently to that undertaken by other parties. Indeed, the faintest whiff that Labour was not sticking to its plans and government bond investors might immediately take fright.

One factor that might make the markets nervier about the public finances is Mr Corbyn’s nationalisation programme. (See Box 2.)

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**Box 2: Labour’s nationalisation plans**

In some ways, Labour’s nationalisation plans are not that radical. The industries that it plans to nationalise – energy, water, rail and post – are often considered fair game for nationalisation due to their natural monopoly status (with high fixed costs stifling competitive forces). And rather than bringing all Private Finance Initiative (PFI) projects in house, as the Shadow Chancellor announced last year, Labour’s plan now is to review all projects and “if necessary” terminate these contracts. Indeed, Mr Corbyn’s nationalisation plans would still leave the UK’s degree of state ownership at a reasonable level compared to other OECD countries. (See Chart 10.)

**Chart 10: Employment in State-Owned Enterprises As a % of Total Employment**

What’s more, as far as we can tell from the manifesto, Labour intends to go about all this in a fairly sensible way and won’t just seize ownership on Day 1. For example, it will bring the rail companies into public ownership as and when their franchises expire (which in some cases is over a decade away). And as far as the energy sector goes, it plans to nationalise the transmission and distribution networks, but to leave the generation and Big 6 suppliers alone.

Nonetheless, there are still some concerns. The first is the degree to which current shareholders would be compensated. Labour has suggested that it might seek to buy the shares at a discount from shareholders. Although this would be subject to legal challenges and might not succeed, it would send a bad message to investors in UK assets. Second, there is a big question mark over Labour’s ability to run these companies better than the private sector. And third, the manifesto might just be the start of Labour’s ambitions. If Labour were willing to forcibly acquire industries such as water or rail, what would be next?
A widely quoted report by the Centre for Policy Studies suggests that the upfront cost of taking these industries into public ownership would be £176bn. (See Table 4.) Of course, the government would get the assets too. But only liquid assets (i.e. cash) are counted when calculating net government debt.

### Table 4: Estimated Upfront Cost of Nationalisations

<table>
<thead>
<tr>
<th>Sector</th>
<th>Plan</th>
<th>Cost (£bn)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Energy</td>
<td>Nationalise National Grid and the distribution networks.</td>
<td>55.4</td>
</tr>
<tr>
<td>Water</td>
<td>Replace the water system with a network of regional publicly-owned water companies.</td>
<td>86.2</td>
</tr>
<tr>
<td>Rail</td>
<td>Bring private rail companies into public ownership when their franchises expire.</td>
<td>-</td>
</tr>
<tr>
<td>Mail</td>
<td>Reverse the privatisation of Royal Mail at the earliest opportunity.</td>
<td>4.5</td>
</tr>
<tr>
<td>PFI Projects</td>
<td>Review &amp; possibly bring back in house</td>
<td>Up to 30</td>
</tr>
</tbody>
</table>

Source: Centre for Policy Studies

However, this is not as alarming as it first looks. For a start, the likely gradual nature of the nationalisation programme would mean that not all of this cost would be paid immediately. Second, the figure published by the (right wing) Centre for Policy Studies is at the top of the range of estimates. And third, even if it proved to be correct, its impact on debt as a share of GDP would not be fatal; **an extra £176bn would raise debt from 85% of GDP to 93% of GDP.** This would be well within estimates by the likes of the IMF of the UK’s “fiscal space” i.e. the room that countries have before their debt position becomes unstable. And it would still be far lower than some other countries. (See Chart 11.)

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![Chart 11: Net Government Debt (As a % of GDP)](chart11.png)

Sources: IMF, Capital Economics, Centre for Policy Studies. Based on IMF definition of government debt.

Admittedly, it would be breaking the 90% threshold at which debt was until recently thought to undermine economic growth. But this figure was based on a now largely discredited paper by Reinhart and Rogoff and other more recent research suggests that it is the trajectory of debt that matters more for growth. More important, then, is whether Labour managed to keep borrowing on a path that allowed the debt to GDP ratio to fall from this admittedly higher level.

Meanwhile, Labour has emphasised that the income stream from these nationalised industries would pay the interest on the debt used to acquire them. That said, Labour is also promising to use these profits to reduce annual household bills by £220. And of course it would need to continue investing in these industries. Labour squares this circle by arguing that public sector management of these industries would lead to greater efficiency. No-one who commutes on Southern Rail or queues for half an hour at the post-office at lunchtime would claim that any of these privatised industries is run perfectly. But the UK government does not have a particularly good track record of running nationalised industries, with underinvestment a big problem prior to privatisation.

At least if bond investors did take fright, the long maturity of UK government bonds means that the initial impact of a rise in bond yields on the public finances would be relatively small. But that effect would obviously rise over time. And a rise in bond yields would have a knock-on effect on other interest rates in the economy. **Indeed, we could see a vicious circle develop of rising bond yields hitting economic growth, which would make bond markets even more worried about the fiscal situation.**

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### 2. Big government

Even if Labour did manage to keep overall public borrowing under control, the economy might nonetheless suffer from the big expansion in the size of the public sector.

As well as its nationalisation plans, Labour has set out plans to increase both taxes and day-to-day spending by approximately £50bn, equivalent to 2.5% of GDP. **This would take government revenues as a share of GDP to the highest level since the mid-1980s.** Aside from the rise in government spending during the financial crisis, spending as a share of GDP would also reach its highest level since the mid-80s. (See Chart 12.) Table 3 on page 8 showed what these increases would consist of. On the tax side, the key measures would be higher income taxes and reversing the Conservatives’ cuts to inheritance...
tax, capital gains tax, corporation tax and the bank levy. On the spending side, more money would go to the NHS, schools, childcare and social security.

Chart 12: Government Revenues & Spending (As a % of GDP)

The obvious worry is that government spending is generally thought to be less efficient than private sector spending. Admittedly, evidence on this is not clear-cut. Moreover, government spending as a share of GDP would not look out of kilter with other countries. Indeed, there are examples of economies that do well even though government spending and taxation are much bigger as a share of GDP than they would be in a Corbyn-led UK. The obvious ones are the Nordic countries, which have high taxes and government spending, and yet the highest levels of GDP per capita in Europe. (See Chart 13.)

Chart 13: GDP Per Capita Relative to EU average & Government Spending As a % of GDP (2016)

However, this is partly because they have combined a big welfare state with free market capitalism. This is not what Mr Corbyn is suggesting. The public sector in the Nordic countries is successful in part because it introduces elements of the private sector (e.g. school vouchers) – precisely the opposite of Mr Corbyn’s “the state knows best” philosophy. The Nordics’ recent strong economic performance is also partly driven by the fact that the size of the public sector has been shrinking – although big now, it used to be even bigger. And the country with the highest share of government spending in Chart 13 is France – hardly the country with the strongest economic performance.

3. Anti-business measures; the straw that breaks the camel’s back

A further reason to worry about the impact of a Corbyn-led government on the economy is the potential effect of his anti-business policies.

Taken in isolation, no single measure looks devastating for business. Generally, the policies would incur some cost for business, but not a great one, and one that in some cases could easily be argued is worth paying. For example, banning zero hours contracts would raise business costs a little, but perhaps such contracts have taken labour market flexibility one step too far.

What’s more, many of Labour’s policies do not, on the face of it at least, look that different from the Conservatives’. Labour plans to raise the Minimum Wage, but it was the Tories that introduced the new Living Wage and they intend to raise it further. And making firms advertise for jobs locally first is surely no worse for business than the Conservatives’ plans to cut net migration.

Even some of the more radical policies are not as radical as they first appear. The planned rise in corporation tax perhaps sparks the most concern. Rather than cutting the main rate further as planned, from 19% to 17%, Labour would raise it to 26%. Yet this would only take it back to 2011’s level. (See Chart 14.) And it would leave it low by international standards. (See Chart 15.) The impact would be further cushioned by the fact that Labour would reinstate the lower small profits rate of corporation tax, so that companies with profits under £300,000 would pay a lower rate of 20%, rising to 21%.

In fact, some of the policies are even helpful for business. For example, Labour plans to give businesses more flexibility in how they use the Apprenticeship Levy, and to increase investment in skills.
However, some of Labour’s measures look significantly more onerous for businesses, especially those which boost labour costs. The plans to raise the National Minimum Wage are a good example. On the face of it, Labour’s plan to raise the Minimum Wage to £10/hour by 2020 for those over 18 years old does not look far off the Conservatives’ plan to increase their National Living Wage to around £8.75. But the Living Wage applies only to over-25s. Mr Corbyn’s higher Minimum Wage would apply to younger people earning the Minimum Wage of £7.05 for 21-24 year olds and £5.60 for 18-20 year olds. In total, it would mean that over a quarter of the workforce would have their pay effectively set by the Minimum Wage policy. (See Chart 16.)

Indeed, the IFS estimates that while the Conservatives’ plan would raise the cost of employing around 2.8 million workers by 4% on average, the Labour plan would raise the cost of employing 7.1 million workers by almost 15% on average. Other things equal, employers’ labour costs would therefore rise by £1bn per year under the Conservatives, and by £14bn per year under Labour – equivalent to 3.5% of firms’ annual gross profits. And the cost would be even bigger if it had a knock-on effect on workers higher up the pay scale. Firms might just pay for these higher costs by reducing employment or non-wage benefits – but that is hardly what Mr Corbyn is aiming for.

The plan to re-instate trade union rights is worrying for business too. In theory, the change in the structure of the UK economy since the 1970s limits the extent to which trade unions can regain relevance; centralised pay-setting is easier to implement in the (shrinking) unskilled manufacturing sector than in the diverse services sector. But Mr Corbyn plans to overcome this with various measures, such as only awarding public sector contracts to firms which recognise trade unions.

Admittedly, the effects of trade unions on the economy are much debated and in recent years, there has been no obvious relationship between trade union density and productivity growth. (See Chart 17.) Nonetheless, trade unions are often seen as acting as an obstacle to productivity-enhancing improvements, making it harder to hire and fire workers and boosting wages above market rates, all of which can raise the natural rate of unemployment.
What’s more, even if each of these policies in isolation is not too damaging for business, cumulatively it all adds up. Put it all together and you can see why profits and investment would not fare well under a Corbyn government. Indeed, you could hardly expect anything different given that Mr Corbyn’s whole philosophy hinges on reducing the profits share in order to boost labour’s share of income.

This would all point to stock markets doing worse under a Labour government – especially if a fiscal stimulus meant that interest rates were rising faster than otherwise. That said, any drop in the pound would help to cushion the multinational FTSE 100. Note that equity prices have underperformed notably under Labour governments compared to Conservatives ones – although this is partly because the bursting of the dotcom bubble and the global financial crisis happened under Labour’s watch, rather than just because corporate profits were squeezed by Labour governments. (See Chart 18.)

Admittedly, one explanation for the weakness of productivity growth in recent years is that firms have been reluctant to invest when the weakness of real wage growth means that they have been able instead just to employ more people relatively cheaply instead. On this reasoning, a pick-up in wage growth could increase the incentive for firms to invest in labour-saving technology instead. However, we doubt that this factor would offset all of the other disincentives to invest that Mr Corbyn’s policies would create.

4. The City
One part of the economy that looks especially vulnerable to the risk of a Corbyn government is the financial sector.

Mr Corbyn and his Shadow Chancellor, John McDonnell, have made no secret of their dislike for the City. In November last year, Mr Corbyn said: “When bankers like Morgan Stanley say we’re a threat, they’re right”. In terms of specific policies targeted at the financial sector, Labour plans to reverse recent reductions in the bank levy and widen stamp duty into a broader financial transactions tax, covering all debt and equity trades. What’s more, it seems unlikely that Mr Corbyn would stand up as strongly for the financial sector in Brexit negotiations as the Conservatives would.

The City would also be disproportionately affected by the tax increases on the highest paid. Mr Corbyn
plans to reduce the threshold for the 45% tax rate from £150,000 to £80,000 and re-introduce a 50% rate for incomes over £123,000. Labour would also introduce an Excessive Pay Levy to be charged to employers on employees earning more than £330,000. Although Labour has not specified how much this would be, its manifesto cites a proposal from the Centre for Labour and Social Studies for a levy of 2.5%.

At least we are not talking about a return to the 1970s when the top rate of tax was 83% (or as much as 98% on certain types of unearned income). And remember that there was also a 50% tax rate under the Conservative-led coalition between 2010 and 2012.

Nonetheless, there has to come a tipping point where tax rates start to have a significant adverse impact on work incentives and therefore undermine economic growth and tax revenues. The fact that the introduction of the 50p rate in 2010 neither raised nor dented revenues significantly suggests that this marks the peak of the so-called Laffer curve (i.e. the revenue-maximising rate of tax) and that significant tax rises above this would start to become self-defeating. In that regard, note that the marginal tax rates for those earning between £100,000 and £123,000, when the personal allowance is withdrawn, would be some 67.5% under Labour. (See Chart 19.) Note, too, that when President Hollande of France introduced a 75% income tax on people earning more than 1m euros in 2012, tax revenues declined (and he reversed the tax rise in 2015).

Nonetheless, coming on top of Brexit, they could be enough to tip the balance for some firms. At the very least, a gradual trickle of jobs to other financial centres like Frankfurt or Zurich is quite plausible. Meanwhile, even if it accounts for a relatively small proportion of the economy, the financial sector makes a disproportionate contribution to tax revenues. Moreover, any loss of financial institutions would have knock-on effects on the sectors that depend on it such as legal or accountancy services. Note that the wider business and financial services sector accounts for a third of the UK economy.

5. The manifesto might be just the start…

Finally, we have assumed so far that Labour essentially sticks to the thrust of its manifesto. But what if that turns out to be the tip of the iceberg? Having waited decades to get a socialist government in power, Mr Corbyn and his Shadow Chancellor have softened their rhetoric somewhat recently, with John McDonnell telling members of the London Chamber of Commerce and Industry in February that “there’s nothing up my sleeve, there will be no surprises”.

Indeed, we doubt that Labour’s policies would be drastic enough to prompt a sudden mass exodus of financial institutions from London. Nonetheless, coming on top of Brexit, they could be enough to tip the balance for some firms. At the very least, a gradual trickle of jobs to other financial centres like Frankfurt or Zurich is quite plausible. Meanwhile, even if it accounts for a relatively small proportion of the economy, the financial sector makes a disproportionate contribution to tax revenues. Moreover, any loss of financial institutions would have knock-on effects on the sectors that depend on it such as legal or accountancy services. Note that the wider business and financial services sector accounts for a third of the UK economy.

Of course, the financial sector is just a small part of the economy. Financial services account for about 6.5% of GDP and wholesale finance services – “the City” – just a small part of that. What’s more, Mr Corbyn and his Shadow Chancellor have softened their rhetoric somewhat in recent months, with John McDonnell telling members of the London Chamber of Commerce and Industry in February that “there’s nothing up my sleeve, there will be no surprises”.

What’s more, although he has seemed more pragmatic recently, Labour’s Shadow Chancellor John McDonnell is rather more ideological than Mr
Corbyn. Indeed, this is one major difference with the Mitterand presidency we mentioned earlier. Then, it was the centrist finance minister, Jacques Delors, who persuaded Mitterand to accept a programme of austerity a couple of years into his presidency when things had begun to go wrong.

Meanwhile, even if Labour got bogged down with Brexit during its first few years in office, perhaps it would win a second term, which could give it a mandate to pursue a more aggressive agenda, especially if the Conservatives descended into civil war over Europe in the meantime.

**So what would a more extreme Corbyn government look like?** At best, we might just see a more aggressive version of the manifesto. It is easy to imagine, for example, a wider increase in taxes on the rich. Conspicuous by its absence in the manifesto is any plan for a wealth tax, on housing for instance. Similarly, surely Labour would consider reversing more of the Conservatives’ welfare cuts. Meanwhile, income taxes for the wealthy could rise more sharply.

But at worst, there could be a full-scale assault on the free market. Alarm bells already began to ring on this front when Jeremy Corbyn said that Labour would give local authorities the power to take over deliberately kept vacant properties, in order to help solve the housing shortage. And Labour is considering forcing landowners to sell sites to the governments at the (much lower) pre-planning permission value. Meanwhile, Mr Corbyn has suggested extending the right to buy to the tenants of private landlords – would this force property owners to sell at a discount too? And if people tried to take their money out of the UK, they might be unable to. McDonnell has suggested that a run on the pound would prompt Labour to reinstate capital controls.

We also discussed earlier in Box 2 how Labour could go further on nationalisation than its manifesto suggests. A Labour party document published in 2017 called “Alternative Models of Ownership” hinted at what might be come, saying that the public sector would be better at modernising infrastructure and providing health, social care, internet and telecoms. The document also talks about ensuring that the benefits of the increasing levels of automation in the economy are widely shared. One example given is establishing a sovereign wealth fund where FTSE listed companies are required to issue a percentage of stock on incorporation.

We might see Labour shake up monetary policy too. John McDonnell has committed to keeping the Bank of England’s operational independence “sacrosanct”. But he might change his mind on that. Even if he retained the Bank’s independence, he could alter its remit. In 2015, he wrote an article saying that the MPC’s remit should change as economic circumstances demand, which meant considering moving the inflation target up or down or more radical ideas such as a nominal GDP target.

**Some scenarios**

The upshot is that there is a variety of ways in which a Corbyn government might play out. We’ve sketched out four main scenarios in Table 5 overleaf, along with a rough – and unavoidably subjective – probability of each happening (all within the context of a Corbyn-led government having been elected).

1. **Good**

Let’s start with the most positive scenario – the economy actually does better under Mr Corbyn. (In the first three of our four scenarios, we assume that Labour follows its manifesto plans, but with different effects on the economy in each case.)

In this positive scenario, Labour sticks to its fiscal plans and financial markets give the party the benefit of the doubt. So the economy receives a modest fiscal boost from higher government investment without the public finances spiralling out of control. Lower corporate profits and investment are offset by higher consumer spending. And Labour manages the Brexit process successfully. **The economy ends up doing a bit better under this scenario than under a continued Conservative government.**

Unfortunately, we put the chances of this scenario at only 10%. **And when we say a bit better, we imagine only boosting annual GDP growth by say 0.2% or 0.3%, as it is hard to argue that the economy would do a lot better under Labour.** With the economy already near full capacity, the additional government spending would probably be largely offset by higher interest rates.
And more fundamentally, Labour does not seem to have any better answer than the Conservatives to the economy’s major issues relating to the weakness of productivity, the housing “crisis” and the long-term impact of the ageing population on the public finances.

Labour has said nothing convincing about how it will actually achieve its plan to build one million new homes over the parliament. It has said that it will guarantee the Help to Buy Funding Scheme until 2017 – but that is likely just to push up prices further, exacerbating the problems in the housing market. Meanwhile, its policy not to raise the state pension age beyond 66 will make the cost of the ageing population even worse. And its business policies are more likely to hinder, than to promote, the private sector investment which is ultimately needed to boost productivity.

It is possible to imagine a more optimistic scenario if Labour is right that the public sector is better than the short-termist private sector at investing, as well as that boosting wages is the way to encourage firms to invest in labour-saving, productivity-enhancing equipment.

However, the UK government has not done a particularly good job of managing companies in the past; the nationalised companies in the 1970s had a record of under-investment and poor service. Meanwhile, even if rising wages offset the other disincentives to invest from Labour’s policies, the squeeze on firms’ profits will reduce the money they have available for capital spending in any case.

2. Ok

Our second scenario is that the “UK does ok under Labour”. Modest meddling in business damages business investment a bit, but does not materially alter the UK’s perceived benefits as a place to invest, and is offset in any case by the likelihood of a softer Brexit. Slightly higher interest rates offset the fiscal boost, but there is no blow-out in government bond yields. In this scenario, the economy performs more or less as well as it would have done under a continued Conservative government. We put the chances of this scenario at about 30%.

3. Bad

More worrying is our third, and in our view most likely, scenario – the UK fares worse under a Corbyn government, although not devastatingly so. Growth of business investment and productivity is materially lower. The government fails to get public sector debt as a share of GDP on a downward path and the resulting rise in bond yields is significant. Official interest rates also rise fairly sharply in response to the effect on inflation of sharp rises in public sector wage growth. The pound falls and – although this would have the benefit of boosting exports – is a signal of deteriorating confidence in the UK. We estimate a 50% chance of this scenario.

What sorts of growth rate are we talking about? One possible benchmark is other European countries. Over the past 20 years, the UK has outperformed the euro-zone, with growth averaging 2% compared to the 1.5% euro-zone average. If Mr Corbyn’s reforms resulted in the UK losing this advantage, annual GDP growth would be 0.5pp lower. This would not be a particularly big deal in any one year, but obviously

<table>
<thead>
<tr>
<th>Scenario</th>
<th>% chance</th>
<th>What happens</th>
<th>Average GDP growth relative to continued Conservative gov.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Good</td>
<td>10</td>
<td>Extra government spending boosts economy and bond markets take it in their stride. Business investment buoyed by soft Brexit.</td>
<td>Up to 0.5% p.a. higher</td>
</tr>
<tr>
<td>Ok</td>
<td>30</td>
<td>Higher interest rates offset fiscal boost but no blow-out in bond yields. Stronger consumer spending offsets lower business investment.</td>
<td>About the same</td>
</tr>
<tr>
<td>Bad</td>
<td>50</td>
<td>Investment and productivity growth materially slow. Bond yields rise significantly and improvement in public finances reverses.</td>
<td>Up to 0.5% p.a. lower</td>
</tr>
<tr>
<td>Very bad</td>
<td>10</td>
<td>High taxes deter activity. Business investment drops sharply. Public sector debt rises as a share of GDP. The pound plummets and bond yields soar.</td>
<td>Over 0.5% p.a. lower (but full-scale capital flight and crisis unlikely)</td>
</tr>
</tbody>
</table>

Source: Capital Economics
the cumulative effect over one or two parliaments would be significant.

4. **Very bad**

Finally, there is the “very bad scenario” for the economy, in which Labour implements anti-capitalist policies far beyond just its manifesto. We’d say there is about a 10% chance of this. Labour fails to keep borrowing under control and bond markets take fright, sparking a vicious cycle of deteriorating public finances and rising bond yields. Rising interest rates across the economy dent activity. Personal taxes are raised to the point that they reduce both tax revenues and economic growth. Investors fear that the government will not respect private property rights and flee the UK. Sterling plummets, as does business and international investment.

There is a wide range of outcomes within this scenario, from a “mere” sharp slowdown in economic growth to full-scale capital flight and a financial crisis. The latter is possible, but seems unlikely given the UK’s flexible exchange rate. Indeed, although a “run on the pound” is commonly viewed as the biggest danger of a Labour government, sterling would act as a crucial safety valve. And the Bank of England – assuming that its framework was left intact – would provide the discipline to prevent runaway inflation.

That said, it means that there would be no external constraint to stop Labour continuing to pursue a damaging course of action. Note that the franc’s peg to the Deutschmark was a key constraint on Mitterand’s socialist experiment in the 1980s. Speculative attacks on the franc forced a series of devaluations, with the third being accompanied by the stabilisation policies that marked the end of the two year expansionary programme.

Rather than a total crisis, then, the very bad scenario is more likely to involve a gradual erosion of the UK’s competitive position and a significant reduction in the UK’s growth rate over the medium term. Perhaps one benchmark is the UK’s “sick man of Europe” days in the 1970s. Real GDP growth back then – of 3.7% between 1960 and joining the EC in 1973 – was in fact very good by recent standards. But it was 1 to 2pps lower than other European countries. A similar underperformance now would leave UK growth close to zero.

**Conclusions**

Neither those who think that Jeremy Corbyn would be the economy’s saviour nor those who think that he would completely destroy it are likely to be right. Most likely is that Mr Corbyn would pursue a relatively moderate socialist agenda that would perhaps erode the economy’s competitive edge a bit. This would probably not have a huge impact in the first year or two, but the effects would build up over time. It is perfectly plausible that before too long, the UK would once more become the “sick man of Europe”.

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