Nature Positive Fiscal Policy

Policy Briefing 2: A nature positive fiscal framework

- The current fiscal situation in the UK is challenging but does not need to prevent critical investment in our natural infrastructure that brings benefits for nature, people and planet.
- Recognition of how previous fiscal rules have prevented essential investment in our infrastructure (including that in our natural environment) is needed and further reform to address short-termism and over reliance on debt rules is critical for economic sustainability and security.
- Public investment in biodiversity has suffered over the long-term and mirrors the wider problems of underinvestment in the UK economy.
- The new government's fiscal rules do not go far enough in correcting the problems with previous fiscal rules.
- Further reform to the fiscal framework is essential if we are not to risk our economic sustainability, security and stability. Four changes are required:
    - i. A new Green Golden Rule that would allow government to borrow to invest in net zero and nature positive.
    - ii. The intention to report on wider measures of public sector assets and liabilities at fiscal events must include natural assets. The new National Wealth Fund must also be able to take a holistic approach to national wealth and invest in natural infrastructure and nature-based solutions.
    - iii. All Spending Reviews must have a natural capital action plan with associated funding that sets out what is required to keep us on track to meet our international and domestic nature commitments.
    - iv. Independent input and oversight of our natural capital planning by a new UK Nature Positive Committee that advises governments across the UK on the priorities and funding needed to meet our nature commitments.

Introduction

Briefing note 1 in the Nature Positive Fiscal Policy series set out that:

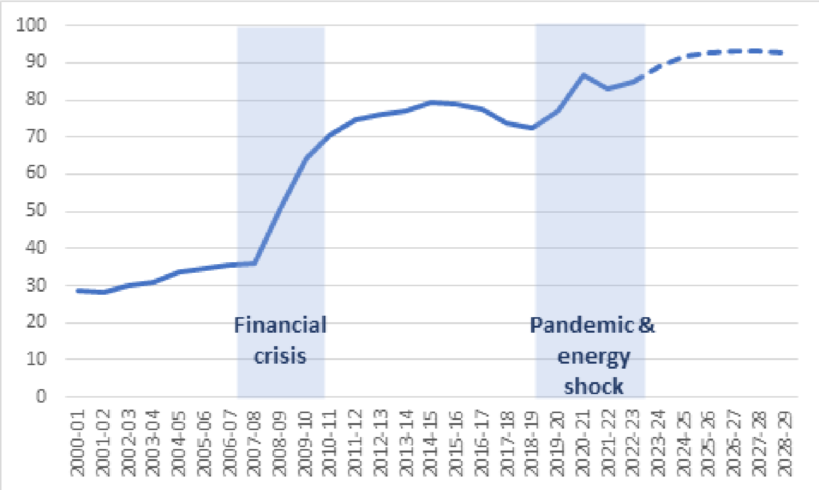
- The nature crisis is so severe in the UK that we are depleting our natural capital and reducing the essential services on which people and the economy depend.
- There is an urgent need to invest in nature's recovery, not just to meet our own and international commitments to halt the loss of biodiversity, but also for the benefit of people and the economy.
- Damage to the natural environment is already slowing the UK economy, and could lead to an estimated 12% reduction to GDP in the years ahead. This would be larger than the hit to GDP from the global financial crisis or Covid-19. We cannot have a secure, sustainable and growing economy without further investment in nature.
- Taking account of current levels of expenditure on nature, there is an estimated nature finance gap of £5-6bn p.a. in the UK, including a £2bn finance gap for biodiversity.
- Natural capital is an economic asset and a key component of national infrastructure and needs to be treated as such.
- In the UK the benefit-to-cost ratio of closing the natural capital gap to meet the nature-related SDG targets is 34.4, meaning that for every £1 invested in closing the natural capital gap will bring £34.4 in benefits. The total potential net benefit for the UK is estimated at close to £1trn over the period 2021 to 2030.
- Nature-based solutions provide a cost-effective means of addressing issues such as flood management, water purification, climate regulation and coastal protection, providing better value for money while providing multiple benefits for people and nature.
- There is a strong rationale for government intervention to invest in nature because many of the services provided by nature are public goods, information failures are often a barrier to nature investment and there is a need to address negative externalities such as pollution.

The fiscal context

In its March 2024 Fiscal and Economic Outlook[1] the Office for Budget Responsibility set out that the "*fiscal position remains very challenging due to high debt, subdued economic growth, and the highest interest rates for over a decade*". The chart below shows that the UK government faces historically high debt which is forecast to rise from 88.8% of GDP this year to a peak of 93.2% in 2027-28, before falling slightly to 92.9 per cent of GDP in 2028-29. Debt has ratcheted upwards following the global financial crisis in 2008 and the combined impacts of the Covid 19 pandemic and the energy price shock. This means that the fiscal situation provides very little room for manoeuvre and that there is limited scope for any significant increase in public spending or tax reductions that are not funded by other compensatory measures (i.e. spending cuts or taxation increases elsewhere).

Chart 1: UK Public sector net debt*

% of GDP



*Excluding Bank of England

Source: OBR Economic and Fiscal Outlook March 2024

In addition, there are significant risks to the fiscal outlook and the OBR highlight two in particular:

- The tax-to-GDP ratio increasing by a further 1.1 percentage points from its current level to close to a post-war high of 37.1 per cent of GDP by 2028-29. This is driven by freezes to personal tax allowances and “the seldom-implemented indexation of fuel duty”.
- The lack of detailed department-by-department spending plans beyond the current Spending Review period, which ends in 2024-25.

The fiscal rules

The existing Charter for Budget Responsibility, set out by the previous Government, required the OBR to judge whether the Government has a greater than 50 per cent chance of meeting its fiscal targets under current policy. The first Charter was set in 2011 and it has been updated six times as governments have revised their fiscal targets. The latest version was approved by Parliament on 6 February 2023 and sets out three fiscal targets:

- A ‘fiscal mandate’ that requires public sector net debt excluding the Bank of England as a percentage of GDP to be falling by the fifth year of the rolling forecast period, which is currently 2028-29.
- A supplementary target that requires public sector net borrowing not to exceed 3 per cent of GDP, also by the fifth year of the rolling forecast period in 2028-29.
- An expenditure cap set by the Treasury that requires welfare spending (excluding the state pension and payments most closely linked to the economic cycle) to be contained within a predetermined cap and margin in 2024-25.

The Charter also identified a broader set of indicators that the Treasury will consider in its management of fiscal policy, but for which no explicit targets are set. These include:

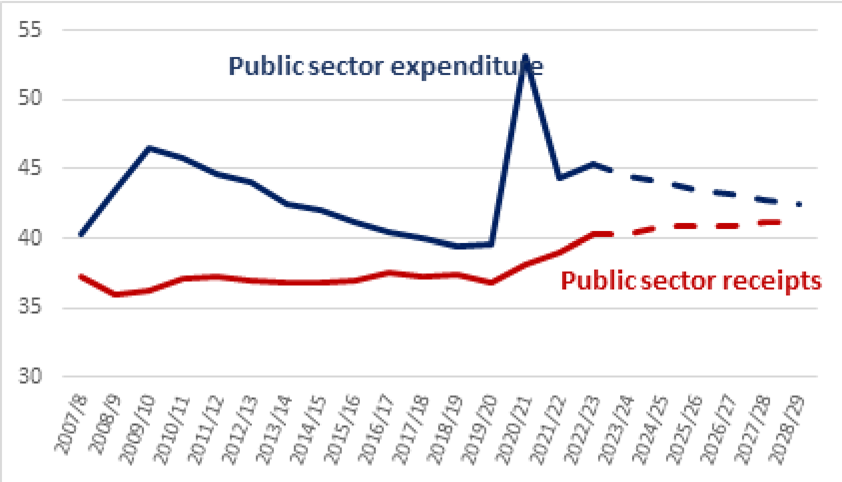
- Wider public sector balance sheet metrics beyond the narrower debt measure that is targeted in the fiscal mandate, including public sector net financial liabilities and overall public sector net worth.

- Cost of debt metrics that look at the cost of servicing the public debt and its sensitivity to changes in the economic outlook

To maintain these fiscal rules government has had to try and reduce government borrowing through reducing spending as a share of GDP and increasing government revenues.

Chart 2: Trends in public receipts and spending

% of GDP



Source: OBR

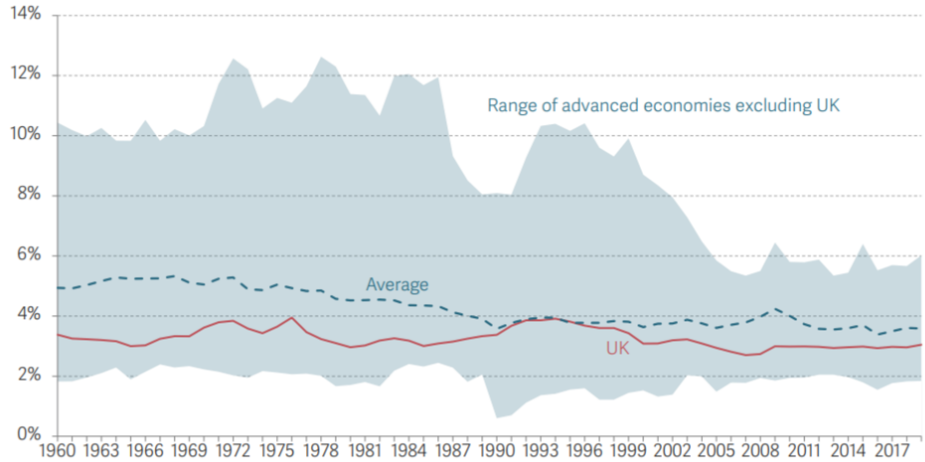
Fiscal decisions and rules have led to underinvestment across the UK

UK has a long track record of underinvestment, hindered by lack of public investment. The Resolution Foundation (RF) in its report[2] '*Cutting the cuts*: How the public sector can play its part in ending the UK's low-investment rut' sets out that 'Britain is a low investment nation' and that it has been one for decades. Total investment as a share of GDP has consistently been below the average of other rich countries for decades, concluding "That is a country living off its past, not prioritising its future". Although private investment vastly outweighs public sector investment (£4 of every £5 spent on investment) public sector investment is seen to have played a role – "far from 'crowding out' private investment, public investment is a key complement to it".

The RF concludes that the "UK Government has underinvested for years" as shown in the chart below where the OECD average is about 50% higher, with the UK consistently in the weakest third of countries.

Chart 3: UK Government investment relative to other countries

Government gross fixed capital formation as a % of GDP

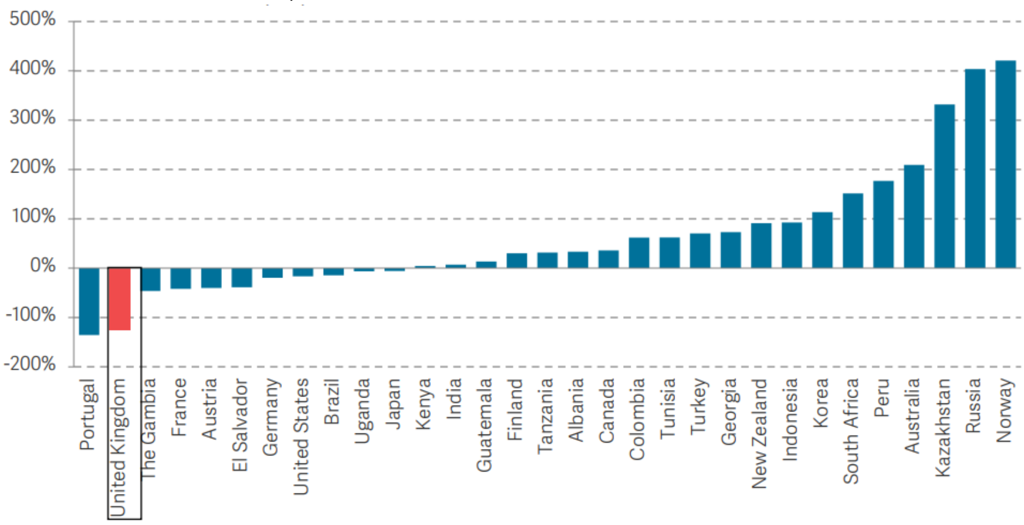


Source: Resolution Foundation

The UK's low level of public investment is seen to have contributed to a decline in public sector net worth of more than 50 per cent of GDP since the turn of the century and has been on a consistent downward trend since its peak in the 1970s. The dwindling in the UK's stock of public capital has left it now lower than all but six OECD countries (see chart below) and with a negative net worth position of around 90% of GDP (including state pension liabilities). As the Resolution Foundation concludes " This is worrying not only because a small capital stock means lower output, but because countries with higher net worth are found to recover faster in the aftermath of recessions and experience shallower economic downturns".

Chart 4: UK public-sector net worth relative to other countries

net worth as a % of GDP, 2018



Source: Resolution Foundation/IMF estimates

The RF's explanation for these trends is striking:

- **Political short termism:** it's easier to cut investment projects that people are less aware of than to reduce funding for more visible public services or increase taxes. "*Cancelling a bridge tomorrow is far easier than firing a nurse today*".

- **Debt-focused fiscal rules:** a narrow focus on public sector debt as the key target for fiscal policy makers does nothing to distinguish between investment spending (and the assets it creates) and current spending on the running of public services
- **A lack of buffers against those rules:** Chancellors leave too little room for manoeuvre and are required to make fiscal tightening in the face of relatively minor economic shocks. "*This narrow room for manoeuvre means Chancellors are often left scrambling to meet their own fiscal rules, and, in that situation, cutting public investment often looks like the easiest option*".
- **The highly centralised system for setting public investment levels**: "*This high level of centralisation means the Treasury can – and does – use public investment for the purpose of fiscal fine tuning, playing a key role in low and volatile public investment levels."*
- These factors are seen to combine to "*give politicians and the Treasury **strong incentives to opt for cuts**, while highly centralised control of public investment means those incentives are easily actioned*".

In terms of potential solutions, the RF consider changes to the fiscal framework. Firstly, fiscal objectives could treat investment spending differently from current spending by changing the the 3% deficit rule to a current budget target that excludes capital spending. Secondly, the net debt target (which is currently more binding) could be replaced with a target to see net worth increase (a fiscal rule that would treat the value of the asset acquired by an investment differently and more favourably than current spending on public services which is consumption spending). The RF concludes that these changes "would materially reduce the temptation for the Treasury to cut investment". Moving to a net worth target would come with its own challenges, including the need to develop the data and institutional monitoring of net worth.

The RF consider that institutional changes are needed. They include decisions about the level of public investment being set by Parliament, on a parliament-by-parliament basis, rather than by Treasury. Also greater fiscal devolution to give lower tiers of government more control in in setting their own investment levels. This intends to address a key problem where Treasury ministers announce headline public investment plans for future years which are subject to no immediate parliamentary approval but which become binding in practice. Instead RF propose that Parliament should set the overall level of investment spending by departments on a multi-year basis, with the Treasury focused on how best to spend those resources.

RF propose a new Public Investment Act at the start of each parliament, enshrining the headline levels of investment planned for a period running at least a year into the following parliament. Parliament should receive statutory independent advice from the National Infrastructure Commission (NIC), about the implications of different choices. A key benefit is seen to be the fact it would take decisions about the long-term path of public investment out of the twice-yearly fiscal event cycle.

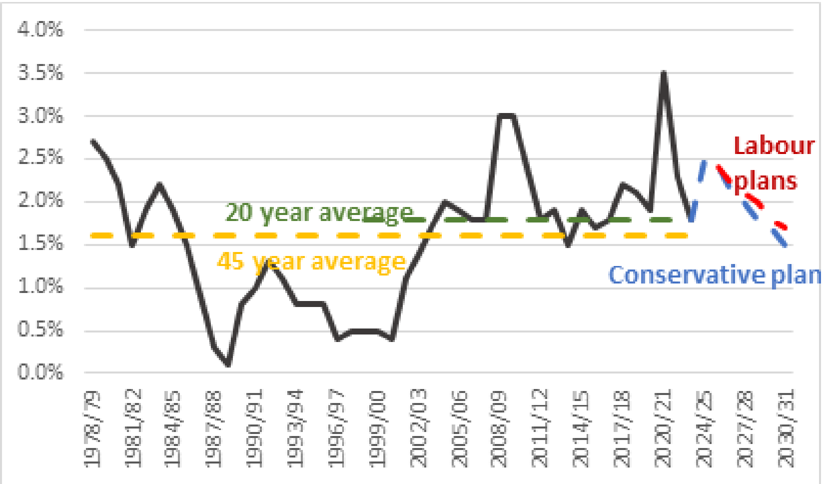
IFS analysis

The Institute for Fiscal Studies (IFS)[3] estimated prior to the election that the previous government policy was for gross investment spending to be broadly frozen in cash terms after this year. After factoring in higher levels of depreciation (a result in part from higher levels of investment in recent years) Public Sector Net Investment was therefore set to decline from £66.6 billion in 2024–25 to £53.1 billion in 2028–29. After adjusting for inflation this meant PSNI would fall by about round 7% per year in real terms and with a growing economy a sharp decline as a share of GDP from 2.4% in 2024/25 to 1.7% in 2028/29. On the assumption that gross investment was frozen in cash terms for another year, PSNI would fall further to 1.5% of national income in 2029–30, below the average level over 1978–79 and even further below the average since 1998–99.

The plans from the Labour party at that time were for an additional £23.7 billion of investment spending over the next parliament and this additional investment would not be enough to offset the falls in the current government plans and PSNI would still fall sharply as a share of GDP.

Chart 5: Public sector net investment future plans

% of GDP



Source: IFS calculations using OBR data

The IFS consider whether these cuts are being driven by the fiscal rules. Firstly, in terms of the level of debt both parties were committed to a fiscal rule that requires government debt to be falling as a share of national income by the fifth year of the forecast and is seen as the rule that binds, constraining ability to cut taxes and/or increase spending. The debt target makes no distinction between borrowing for investment or day-to-day funding and both parties had effectively pencilled in large cuts to public investment set out above.

The IFS points out that these cuts to public investment are not a result of the debt rule in itself – a government "*could maintain or even boost investment spending and stay within its fiscal rules if it were willing to finance the extra investment through (further) tax rises or cuts to day-to-day spending*". That is "*those cuts are only 'required' to meet the fiscal rule because of an unwillingness or political inability to prioritise investment over spending on consumption and/or an unwillingness to raise taxes*".

The IFS do point out that the debt target does, however, constrain the government's ability to borrow to invest. With very little 'headroom' in government plans a significant increase in borrowing for investment (as would be the case for borrowing for any other purpose) would be likely to put debt on an upward path and breach this rule. The debt target is self-imposed and the IFS point out that it is a poorly designed fiscal rule and highlight three points:

- debt dynamics in the UK are increasingly unfavourable and there are good reasons not to be too relaxed about debt-financed public investment
- not all investment is productive and not all investment will enhance the supply side of the economy and be 'growth enhancing'.
- any increase in investment however financed should be coupled with "a greater focus on ensuring that it is well executed, realistic and economically worthwhile".

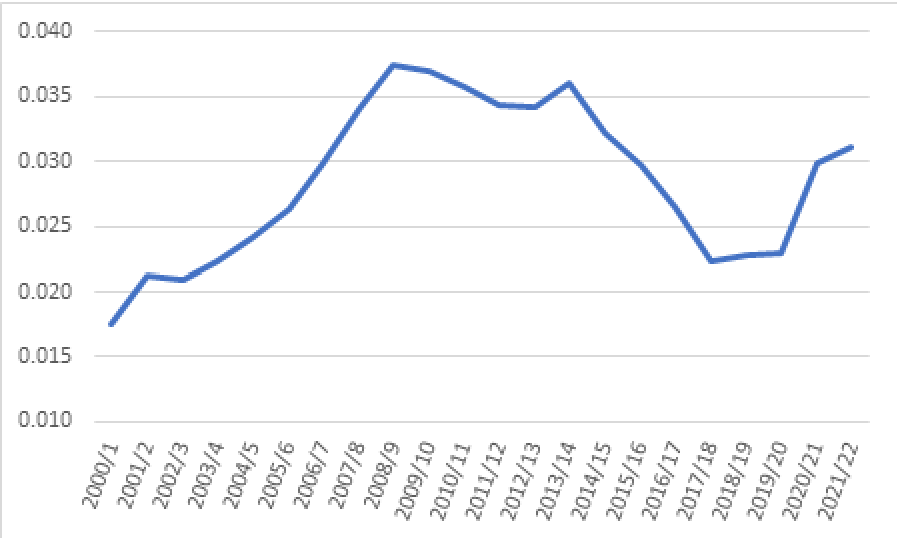
Public expenditure on biodiversity

The JNCC provide estimates of public sector investment in UK biodiversity, although given the uncertainties and complexities involved in both defining and identifying such expenditure, the figures are likely to be an underestimation of total UK public biodiversity spending4 . They are however, seen as providing a trend of expenditure on biodiversity. The indicator includes direct expenditure on nature reserves and conservation measures together with spending on relevant research and development and generally exclude expenditure on administration and training. Public sector funding for UK biodiversity relative to GDP has followed a very similar pattern to that of total public sector expenditure. The measure peaked before the onset of the financial crisis at 0.037% of GDP before falling to 0.022% in 2017/18 and has increased slightly in recent years. However, if public biodiversity expenditure had maintained its share of GDP then in 2021/22 it would have been nearly £150m higher.

Year-on-year changes in the indicator can be influenced by a range of factors, not always reflecting the underlying trends. The increase in recent years has been driven by agri-environment scheme funding (which has increased due to an increase in the number of agreements and the land managed under the schemes and accounts for 52% of public sector spending on biodiversity). The remainder of the increase is largely due to increased spending by the Forestry Commission.

Chart 6: Public expenditure on biodiversity

% of GDP



Source: JNCC

New government’s fiscal rules

Prior to their election the new government set out in their manifesto[5] that their fiscal rules are “non-negotiable” and will apply to every decision taken by government. There are two parts to the rules:

- The current budget must move into balance, so that day-to-day costs are met by revenues.
- Debt must be falling as a share of the economy by the fifth year of the forecast.

In her Mais lecture[6] the then shadow Chancellor Rachel Reeves, repeated these commitments stating that in government they would “not waver from strong fiscal rules”. In addition, there were three further commitments to:

- Strengthen the OBR, with a new fiscal lock, guaranteeing in law that any government making significant and permanent tax and spending changes will be subject to an independent forecast from the OBR.
- Ask the OBR to report on the long-term impact of capital spending decisions.
- Report on wider measures of public sector assets and liabilities at fiscal events.

In addition to the above rules the new government has also set out plans to establish and a new **National Wealth Fund** which will align the UK Infrastructure Bank and the British Business Bank to invest in the new industries of the future. £7bn of additional funding has been allocated with the intention to unlock equivalent funding from the private sector. It is described as a green catalytic fund that will "create markets for investment into new technologies and infrastructure which drive economic growth, job creation and ensure food and energy security for the UK". The reason for its establishment is that the Climate Change Committee has estimated it will cost £50 billion for the UK to reach net zero and the significant opportunity this provides to transform the economy. The initial priority sectors are green steel, green hydrogen, industrial decarbonisation, Gigafactories and Ports. The IFS point out[7] that the fiscal rules are very likely to act as the binding constraint on the ability of the new Chancellor to avoid tax increases or spending cuts in the October Budget/Spending Review. However, there remains some ambiguity about how these rules will be designed in practice and in particular over what period the current budget must balance and which definition of debt is used?

There have been other criticisms of the new framework. Iain Begg[8] (Professorial Research Fellow at the London School of Economics) has suggested that it "*is time to jettison the austerity-era fiscal framework, to learn from what works elsewhere and to devise solutions tailored to the distinctive circumstances of the UK"*. In particular, accepting higher debt in the short-term may be preferable than the constraints imposed by the fiscal rules (although a medium-term strategy to lower the debt to GDP ratio would still be required) and consideration of rules governing the medium term evolution of public expenditure ("*There is no magic number of an optimal level of public expenditure, but the total has to represent a political choice about how much a country is prepared to tax its citizens and businesses*".)

It has also been pointed out[9] that at times it could make economic sense for the debt to GDP ratio to rise. One example considered is that of climate change which has very similar properties to the nature crisis. If a green transition requires temporarily higher public and private spending, even if that spending lasts for a decade or so, it is not necessarily the case that taxation needs to rise and/or spending needs to be cut and a rise in the ratio of debt to GDP could be justified.

In addition, the fiscal rule that debt to GDP has to be falling by the end of five years is seen to have reduced plans for public investment[10] and that "the falling debt to GDP fiscal rule could reasonably be called the 'reduce public investment' rule". If governments have robust means of deciding whether individual public investment projects are good value for money, it is argued that there can be little benefit in constraining public investment. If public investment projects are worth doing, the case it made that this can be paid for by borrowing and compared to the example of an individual borrowing to buy a house or a business borrowing to invest. Quite importantly such investment by borrowing will benefit future generations and any debt is matched by useful assets. This example holds true for investment in nature, which clearly benefits future generations and involves the acquisition of valuable natural assets. It is therefore vital that any debt related fiscal rule does not constrain public investment in natural capital.

A group of leading economists published an open letter in the Financial Times[11] on 16 September setting out that "*a consensus is emerging that under-investment is a central cause of the UK's poor recent economic performance and the root of many of the problems we now face as a country*". They go on to argue against further cuts in public investment and call for "*a strategy for substantially increasing public investment*" and a process for a "*pro-investment fiscal framework that focuses on long-term fiscal sustainability*".

Should we have a broader definition of 'investment'?

If one of the reasons for treating investment differently in the fiscal framework is that it brings additional benefits in terms of supporting longer-term economic performance and for future generations then this applies to natural capital as well as more traditional forms of investment. This could mean that a broader definition of public investment is required but there are other examples such as education spending where spending outside of current definitons of capital expenditure brings wider economic benefits. There is an official internationally agreed accounting definition of investment and rather than changing definitions the fiscal framework should treat investment in nature equally with that of more traditional investment.

As the IFS point out "*There is nothing to stop a Chancellor designing a set of fiscal rules that allow for borrowing to pay for only 'growth-enhancing spending' or 'spending that benefits future generations'*".

A Green Golden Rule?

The Green Alliance[12] have considered a number of reforms to the fiscal framework and in particular the use of a 'Green Golden Rule' which would allow government to borrow to invest in net zero and nature positive. This clearly has a number of merits as it would help facilitate the vital investment that is needed in nature restoration that will deliver economic security, sustainability and benefits for future generations.
This is not a panacea as such borrowing, if unfunded, will still add to government debt and could be restricted by the overarching rule on the level of debt. In addition, just allowing such borrowing to take place, does not mean that it will as government could still decide that it has other political and fiscal priorities.

Public sector net worth

The Green Alliance also suggest that an alternative approach could be to introduce a fiscal rule to increase public sector net worth (PSNW). PSNW aims to provide a more comprehensive picture of public finances covering all assets and liabilities held by government. This includes both financial and non-financial assets, such as roads, schools etc and quite importantly covers natural assets. The IFS[13] point out that this has some advantages:

- It attempts to provide a broader and more comprehensive picture of the public finances than commonly used measures of debt and borrowing.
- PSNW is a valuable addition to the existing set of information about the financial position and assets of the government.
- A PSNW might be preferable to a simple target for public sector net debt. As it captures a more comprehensive range of liabilities and assets.
- It could strengthen the incentive for governments to focus on investing in high-quality projects and could provide a framework for holding the government to account when it promises to 'borrow to invest'

However, the IFS also point out that there are "good reasons to be cautious, and to suppose that – whatever its theoretical attractions – a public sector net worth target might work rather less well in practice" and in particular highlight the following issues:

- A PSNW target will not necessarily highlight the government's ability to access capital markets or service its debt, particularly where the change in net worth is driven by a change in the value of non-financial assets which may be difficult to sell.
- Choices over definitions and modelling assumptions can vastly alter estimates of PSNW.
- Whichever measure of PSNW is used, it would be complex and difficult to communicate.
- It might reduce incentives for certain types of 'bad fiscal behaviour' but would not completely remove incentives for Chancellors to engage in 'short-termism'.
- The fiscal fundamentals would remain unchanged and there would be a need for an escape clause for counter-cyclical fiscal policy.

The IFS conclude that more traditional measures of debt, debt interest and borrowing will remain important for fiscal policy, and ought to be considered alongside any target for public sector net worth when setting policy. In their view, the benefits of moving to PSNW target might be insufficient to justify the potential costs involved there might be simpler ways of achieving some of the benefits. Although there is **"***a strong case for considering public sector net worth as part of a broader suite of fiscal metrics*".

It also important to recognise that from a nature positive perspective a PSNW target would not necessarily provide the incentives needed to invest in nature recovery. It would be unlikely to reflect the long-term decline in our natural capital base and incentivise its reparation. There is also a risk that declines in the natural asset base could be 'hidden' by changes in other parts of the asset base which would not provide incentives to invest in the natural capital base itself.

A Green Golden Rule and wider consideration of PSNW together would help to ensure that nature is treated more fairly in fiscal policy decisions. However, more is needed to ensure that we invest in our nature positive economy to deliver economic security and sustainability.

It is also vital that the National Wealth Fund is focused on a holistic measure of national wealth like that for PSNW that includes natural assets and that it can work to address the nature and climate crises together. It must be able to invest in natural infrastructure and nature-based solutions that are vital for economic security, stability and sustainability. If not, it will fail to achieve its objectives around economic sustainability and security.

A natural capital plan

The existing Green Finance Strategy from the previous Government set out to mobilise £1 billion per year, of private finance into nature's recovery in England by 2030, which is a welcome commitment. However, the strategy was lacking in setting out a clear plan of how it would address the full nature finance gap (estimated by the Green Finance Institute to be between £5-6bn a year) and quite importantly the scale and timing of public funding needed.

The Natural Capital Committee (NCC) was an independent advisory committee which ran from 2012 to December 2020. The NCC advised the government on natural capital, such as ecosystems, soils, freshwaters, and oceans. One of the reasons that the NCC was disbanded was that it was seen that many of the functions of the NCC were transferred to the Office for Environmental Protection.

The Environment Act, which became law in 2021, is the UK's new framework for environmental protection since withdrawing from the European Union. Several regulatory bodies were set up at this point, including the Office for Environmental Protection (OEP) for England and Northern Ireland, Environmental Standards Scotland (ESS), and the Environmental Protection Assessor for Wales. These bodies are still establishing their roles of ensuring public authorities’ compliance with laws and standards.

The Office for Environmental Protection (OEP) was legally created in November 2021, under the Environment Act 2021 to protect and improve the environment by holding government and other public authorities to account. They cover England and Northern Ireland and also reserved matters across the UK. The Environment Act sets out their 4 activities given their powers and duties:

i. Scrutinising Environmental Improvement Plans and targets

ii. Scrutinising environmental law

iii. Advising government on environmental law

iv. Enforcing against failures to comply with environmental law

The OEP in its latest report[14] set out that “*Government remains largely off track to meets its environmental ambitions and must speed up and scale up its efforts in order to achieve them”.* The report identifies a number of factors impeding progress and in particular that resources *“are not always allocated as needed, even when tools and actions are well understood”* and references inadequate resources for tackling invasive non-native species and a lack of urgency in tree planting rates which need to substantially increase to achieve woodland creation goals.

Despite the existence of the fiscal rules, Green Finance Strategy, Environmental Improvement Plan and the OEP and related bodies there is still a gap in our framework in terms of assessing and allocating the scale of public investment needed to meet our environmental targets.

It is for these reasons that the fiscal framework needs to be improved so that all Spending Reviews have a natural capital action plan with associated funding that sets out what is required to keep us on track to meet our international and domestic nature commitments. In particular, the level of and priorities for public investment that is required to deliver on these. This needs to have independent input and oversight which requires a new independent body which can fill the gap in the existing framework. This would be closer to the model of the UK Climate Change Committee and would be a UK Nature Positive Committee that advised governments across the UK on what was needed at the UK and devolved level both in terms of priorities and funding.

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Together we can save it.

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