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UK Spring Budget 2024: Still searching for a rabbit

Chancellor Jeremy Hunt left little in the way of surprises in a mostly pre-announced budget. The focus on voter-friendly tax cuts continues, with fiscal stimulus providing around a 0.3% boost to GDP growth through supply-side improvements. But little fiscal headroom and largely unrealistic assumptions of future spending cuts will create a very difficult fiscal inheritance for the next government.

Key Takeaways

- The centrepiece of Chancellor Jeremy Hunt's budget was a 2-pence cut in national insurance contributions. Alongside other smaller measures, this means roughly 0.3% of GDP per annum of fiscal loosening.
- There were some modest offsetting tax-raising measures, including abolishing non-dom status. But net tax cuts were mostly funded by running down headroom against the fiscal rules to a wafer-thin £9bn.
- The OBR's growth forecasts were revised up and inflation forecasts down. This came with a sting in the tail for the chancellor by lowering forecast nominal GDP and therefore fiscal headroom a touch.
- Planned real departmental spending growth was maintained at 1%. But future spending assumptions are not credible.
- Other sensible measures announced yesterday include raising child benefit thresholds and an extra ISA allowance for UK equity investment. The OBR estimates that measures in the budget will boost growth by 0.3% per annum.
- The broad focus on tax cuts may help boost support for the Conservatives from their core voters. But it is unlikely to fundamentally change the party's political fortunes.

Taxes at the heart of the budget

For a pre-election budget, this was a relatively subdued affair, with little in the way of surprises from Chancellor Jeremy Hunt. Many of the measures had been pre-briefed.

As expected, the main focus was on personal taxation. The chancellor announced a 2-pence cut to national insurance and stated his "long-term ambition" to continue to cut the tax, potentially hinting at the focus of the forthcoming Conservative manifesto.

As in recent budgets, fuel and alcohol duty remained frozen for another year. And the higher capital gains tax rate on property was cut to 24%.

The chancellor also announced several modest revenue raising measures. Much-trailed increases in the duty on non-economy flights, the introduction of a tax on vapes, and an increase in tobacco, will not move the fiscal needle significantly. However, the extension of the oil and gas windfall tax at current levels for another year and the abolition and replacement of the non-dom taxation regime represent more substantial revenue raisers.

Indeed, Labour, which had initially proposed both tax changes, will now need to plug that hole in its own fiscal plans some other way.

Changes announced to child benefit to increase the threshold from £50,000 to £60,000 and the taper to £80,000 are positive for UK labour supply, as was the proposal to move the threshold to a household income-based system by 2026.

Finally, the chancellor took the government's focus on UK equity investment further. A new British ISA will provide savers with an additional £5,000 of tax-free allowance for investing in British markets. And new regulations for certain pension funds will require them to disclose their levels of UK equity investment, potentially applying moral suasion to increase home bias.

OBR forecast changes look good for the chancellor, but the details are less helpful

At face value, the changes that the Office for Budget Responsibility (OBR) made to its economic forecasts look favourable for the chancellor. While growth was weaker than the OBR had previously expected during 2023 as the UK slipped into recession, it pushed up its GDP forecasts for 2024 and 2025 and lowered its inflation forecasts for those same years (see Figure 1). Indeed, the OBR expects UK headline inflation to fall below the Bank of England (BoE)'s 2% target as soon as the middle of this year.

Figure 1: Latest OBR forecasts see higher near-term growth and lower inflation, although net effect over the entire forecast period is little changed

(previous OBR forecasts in brackets)	GDP, %y/y	Inflation, %y/y	Debt, %/GDP
2024	0.8 (0.7)	2.2 (3.6)	91.7 (91.6)
2025	1.9 (1.4)	1.5 (1.8)	92.8 (92.7)
2026	2.0 (2.0)	2.6 (1.4)	93.2 (93.2)
2027	1.8 (2.0)	1.9 (1.7)	93.2 (93.2)
2028	1.7 (1.7)	2.0 (2.0)	92.9 (92.8)

Source: Office for Budget Responsibility, abrdn, March 2024

The higher growth forecasts over the next couple of years reflect the recovery from weakness in 2023, lower interest rate and energy assumptions, and, importantly, a higher projection for the UK population amid recent high net migration. But the latter means that the OBR's *per capita* GDP forecasts are actually lower than they were in the Autumn Statement.

However, under the surface, the net effect of these changes was actually somewhat unhelpful for the chancellor, as the level of nominal GDP at the end of the forecast period was revised down a touch. That means that the denominator in the debt-to-GDP calculation that the fiscal rules are based on was slightly lower, reducing the chancellor's room for manoeuvre.

Spending more of the fiscal headroom, although the fiscal rules are a work of fiction

Indeed, these changes meant that the OBR gave the chancellor "pre-measures" fiscal headroom of £12bn, a touch below what he had coming out of the Autumn Statement.

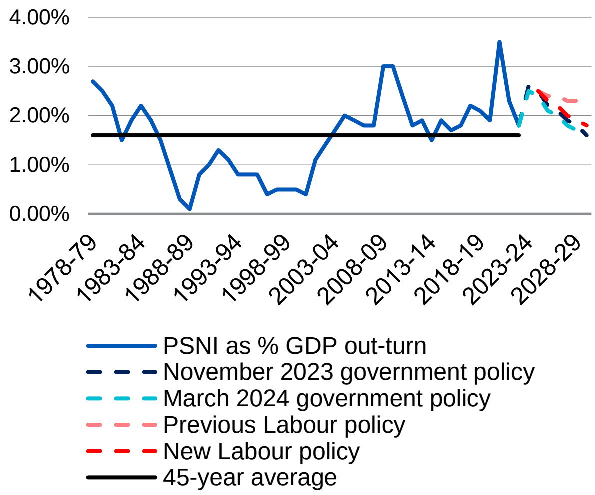
And because the budget measures added up to a fiscal loosening of about 0.3% of GDP per annum on average, "post-measures" fiscal headroom is £9bn.

That's wafer-thin, with the OBR noting that it's a "small fraction of the risks around that central forecast". Relatively small movements in interest rates, labour force participation, or nominal GDP relative to the forecasts would wipe out that headroom.

In any case, the fiscal sustainability calculations are based on somewhat implausible future spending plans. The chancellor announced that overall public spending would continue to increase by 1% annually, though this figure conceals steep spending cuts for unprotected departments. Alongside this is a new push to improve public sector productivity, and additional funding for the NHS.

Public sector productivity, despite being a core feature of Hunt's budget thesis that government departments could make long-term efficiency savings…, appears to be a problem for the next government. The Treasury has confirmed that the "robust and comprehensive strategy for improving public sector productivity" will be implemented only after the next general election, making any short-term announcements unlikely.

Figure 2: Public sector net investment now forecast to fall slightly further

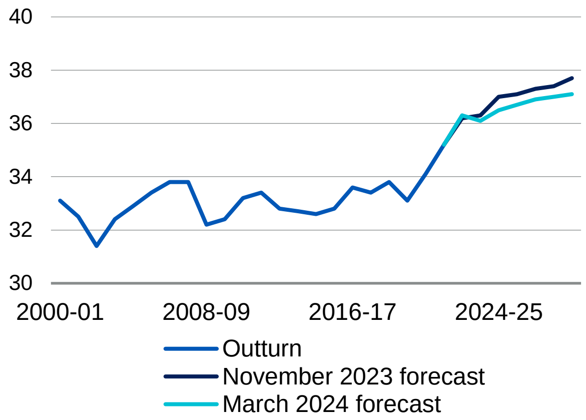


Source: abrdn, Office for National Statistics, March 2024

Despite the tax cuts announced in the budget, which follow on from the previous 2-pence cut to national insurance in November, the tax burden is still forecast to rise to a historically high level (see Figure 3).

According to the OBR, tax as a share of GDP will rise in every year of the forecast, to 37.1% of GDP in 2028-29, which would be the highest level since 1948. Political pressure for tax cuts to go further to reverse this trend will remain high, particularly among the Conservative backbenches.

Figure 3: Despite national insurance cuts, tax as a share of GDP will still increase to a post war record



Source: Office for Budget Responsibility, abrdn, March 2024

What does it all mean for the economy?

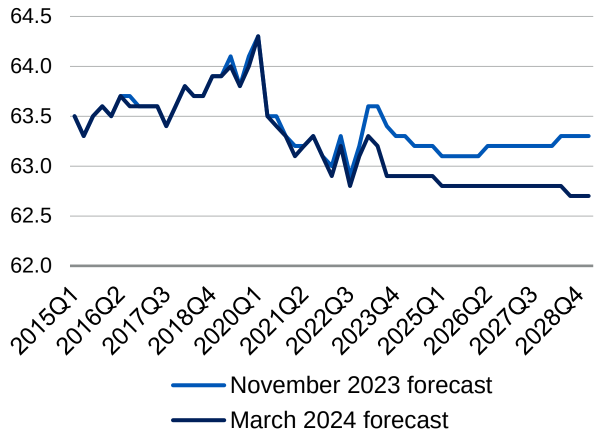
The 2-pence cut in national insurance contributions is both cheaper than an equivalent cut in the basic rate of income tax, and potentially more helpful for the supply-side of the economy. National insurance falls on earned income, while income tax can also fall on rents, dividends and pension income.

By specifically reducing the tax burden on earned salaries, the chancellor may be hoping to boost labour force participation, a notable weakness for the UK economy in an international context. Indeed, the OBR estimates that, alongside the national insurance reduction in the Autumn Statement, this will add the equivalent of an additional 200,000 workers to the UK labour market. The changes to the child benefit threshold also encourage higher labour force participation and hours worked.

Taken as a whole, the loosening in fiscal policy resulting from the budget measures adds up to a 0.3% of GDP per annum. And because of the mix of policies, the multipliers look relatively high. Most of that boost comes from the supply side by increasing labour supply, so it need not be inflationary.

That said, the OBR's assessment of the medium-term outlook for the economy continues to be fairly downbeat. The OBR highlights "higher and rising" levels of economic inactivity over the forecast period partly as a result of changing migration patterns and despite the measures in this budget (see Figure 4), which will leave GDP per capita slightly lower than previously forecast in five years' time.

Figure 4: Economic participation rate expected to fall further, despite helpful measures in the budget



Source: Office for Budget Responsibility, abrdn, March 2024

What does it all mean for markets?

The modest additional fiscal stimulus from these announcements will be one driver of the upward revisions to our UK GDP forecasts. We are also likely to incorporate a slightly slower path of BoE rate cuts than previously.

However, outside of specific beneficiaries from particular measures, financial markets appear little moved by these announcements, which were almost entirely trailed ahead of time.

The chancellor's tax cuts support the supply side, so they have limited inflationary impact. But we also suspect that investors are well aware of increasing tax burden that is almost certainly coming after the election. Markets are likely reserving judgement until the next government announces its fiscal plans.

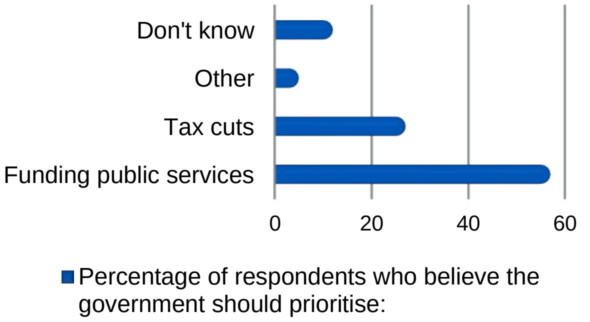
The budget does not change our 2024 election base case

The government's focus on voter friendly tax cuts may help increase the support from its core voters and encourage wavering former Conservative voters to return to the party ahead of the election. But it's unlikely that tax cuts will fundamentally change its political fortunes.

Polls have remained steady since the Autumn Statement last November despite the earlier national insurance cuts announced at that time. Indeed, national insurance cuts have less political cut-through than income tax cuts.

Additionally, there is some evidence in polling to suggest that a majority of voters would prefer to see improvement in public services rather than a reduction in the tax burden (see Figure 5).

Figure 5: Voters would prefer public spending increases over tax cuts



Source: abrdn, Yougov, March 2024

Compounding this, after previously hinting at greater tax cuts, including to income tax, the government's announcements risk falling short of the expectations of the right wing of the party, further inflaming tensions.

Difficult choices for Labour ahead

In choosing to raise some taxes in line with Labour's proposals, the chancellor has left the opposition with additional challenges. Labour was planning to use revenue raised from scaling back the non-dom tax regime to fund several pledges, notably free breakfast clubs for school children, additional dental appointments, and measures to reduce NHS waiting lists.

It had also planned to use revenue raised from an extension of the oil and gas windfall tax to fund its updated green investment policy, including the creation of a sovereign wealth fund. Funding for these policies is now in doubt, with Labour likely to have to find additional, and probably more unpopular, revenue raising measures, or announce spending cuts to fund its proposals.

Labour has been avoiding announcing major tax rises ahead of the general election. Indeed, it's said it is supportive of the cuts to national insurance. But it will now face even more questions about the viability of its policies in the wake of this budget.

The budget has arguably exacerbated Labour's already extremely poor fiscal inheritance should it enter government. A weak growth outlook, high debt interest spending, a high tax burden, and implied cuts to unprotected government spending will combine to require some extremely difficult trade offs. A change to the fiscal rules, most likely the debt rule, is likely, but it is probable Labour will announce tax increases early in its term to offset planned spending cuts and fund its own policy proposals.

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