



Global Macro Research

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Unpacking the UK budget: first reactions

The budget increases day-to-day spending and investment, funded by higher taxes and changed fiscal rules that will increase borrowing. These measures should boost near-term growth but may only modestly improve potential growth. With the fiscal rules only narrowly met, further tax increases are possible in the future.

Key Takeaways

- The chancellor introduced two new fiscal rules: a stricter “stability rule” that requires the current budget to balance within three years, but a looser “investment rule” that requires public sector net financial liabilities to be falling as a share of GDP in three years.
- Meeting the former rule meant a larger-than-expected £40bn of tax increases, the biggest tax-raising budget in 30 years, which will increase the UK tax take to an all-time high of 38% of GDP by 2029/2030.
- The biggest measure was an increase in employer national insurance contributions, which may damage the chancellor’s credentials with business. But there were several other tax increases including to capital gains and inheritance tax.
- These funds a roughly similar rise in day-to-day spending, which will increase 1.5% annually in real terms. But after accounting for protected departments such as the NHS and defence, this will feel tight.
- The latter rule allows for around £100bn of additional investment spending over the forecast horizon, funded by higher borrowing, while still leaving modest headroom for future increases.
- While higher investment spending has the potential to increase UK trend growth in the long-run, the Office for Budget Responsibility judged that the combined effects of the measures in this budget were only a modest boost to the level of GDP at the end of the forecast horizon. Meanwhile, the gilt market reaction has been negative.

Higher tax, higher borrowing, more investment, a bigger state

The budget increases government spending by around 1.8% of GDP a year over the next five years, two thirds of which is accounted for by current spending, and one third by capital spending. Half of this is funded by borrowing.

The size of the state will increase to 44% of GDP by the end of the forecast horizon, while tax take as a percentage of GDP will increase to 38%. This represents an historic high in the tax burden, with previous governments struggling to make an increase above 35% stick.

With the chancellor having largely pre-briefed the main changes to the fiscal architecture before the budget, the initial market reaction as the budget was delivered was relatively muted. However, gilt yields have subsequently risen quite sharply, with the move concentrated after the OBR released its report. This might reflect the fact that the fiscal rules are only narrowly met while the growth boost is judged to be modest, so there is a significant risk of fiscal slippage or higher taxes in the future.

An effective relaxation in the debt rule, but a tougher stability rule

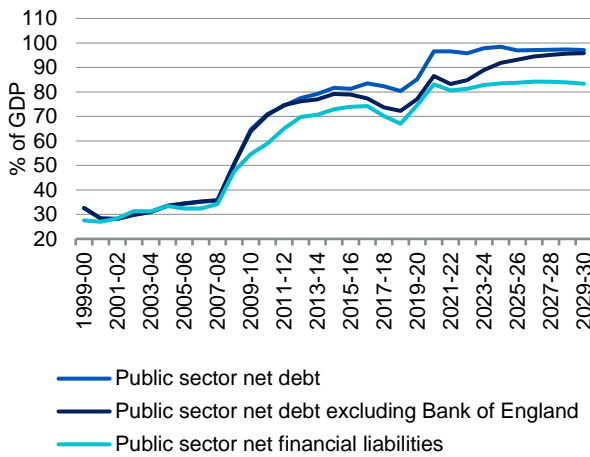
The chancellor announced the government will adhere to a new set of fiscal rules designed to increase its ability to borrow for capital spending. The budget sets two new fiscal rules: to deliver a current budget balance, and for net financial liabilities to be falling as a share of GDP by the end of the third year of the forecast.



The debt rule will now be based on public sector net financial liabilities (PSNFL), which account for some government assets, like student loans (see Figure 1).

Reeves has also announced the rule will be measured against a three-year rolling target, rather than the previous rule's five-year horizon. Headroom against the new rule is £15.7 billion, higher than recent budgets but significantly lower than expected.

Figure 1: The new measure of debt in the fiscal rules gives the chancellor extra fiscal space for investment



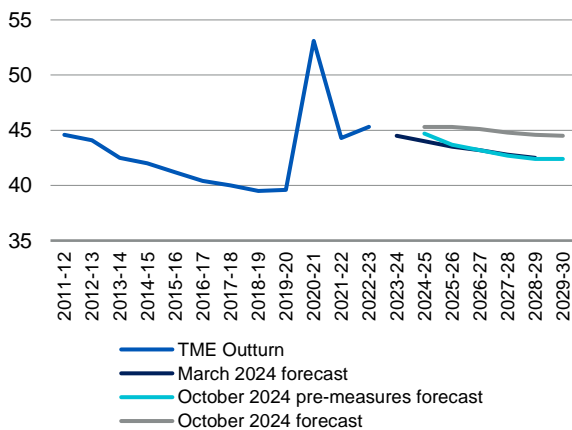
Source: OBR, abrdrn, October 2024

Day-to-day government spending requirements must still be met by government revenue, but the measure has been tweaked. The current spending budget will now be balanced in the third year of the forecast, which is stricter than the previous five-year target.

Capital expenditure increases are front loaded

Under plans set out by the previous government, capital investment was set to drop to 1.7% of GDP by 2029. Plans announced today will increase public sector net investment to 2.4% of GDP by 2029-2030.

Figure 2: Investment spending will increase relative to previous forecasts



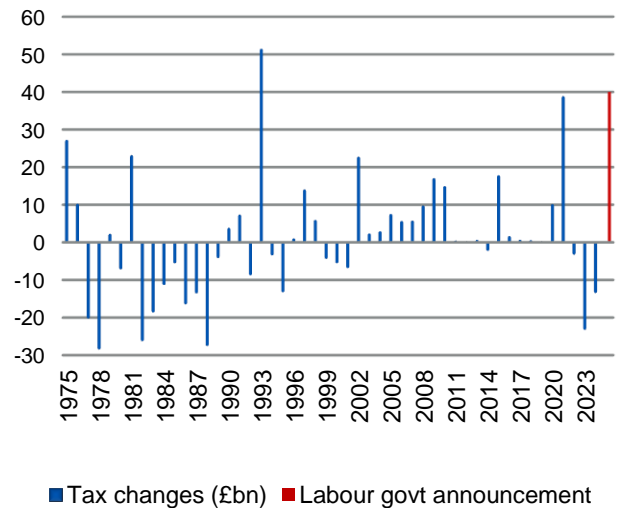
Source: OBR, abrdrn, October 2024

Reeves has announced £100bn of additional capital investment over the next five years, particularly targeting transport and housing. The majority of this spending is front loaded, with increases up to 2026-2027, followed by flat spending in real terms (see Figure 2). Such a short, sharp spending increase may raise concerns the government will struggle against capacity constraints to deploy planned spending in line with current estimates.

A substantial increase in taxation, particularly for businesses

The chancellor announced tax increases of £41.5 billion by the final year of the forecasts, above 1% of GDP per year (see Figure 3). Overall, the tax burden will increase to a historic high of 38.2% of GDP by 2029-2030, up from previous estimates of 36.4%.

Figure 3: The tax increases announced at this budget are large by historic standards



Source: OBR, abrdrn, October 2024

Prior to the budget, the government had already announced plans to introduce VAT on private school fees, reform the tax system for non-domiciled residents and increase the oil and gas windfall tax to 38% and extend it to 2029-2030. The chancellor confirmed these will all go ahead.

Most significantly, the chancellor announced a 1.2% increase in employer National Insurance contributions from 13.8% to 15%, while lowering the threshold to £5,000 from £9,100, a measure expected to raise £25 billion. The final incidence of this increase is likely to largely fall on employees, with the OBR estimating the 2% increase in payroll costs will lower real wages and profits and reduce labour supply by around 50,000 average hour equivalents.

However, in a slight surprise to expectations going into the budget, the income tax and national insurance thresholds freeze will not continue past 2028.



The lower rate of Capital Gains Tax (CGT) will increase to 18% from 10%, while the higher rate will increase from 20% to 24%. CGT on carried interest will increase to 32%.

While CGT on residential property remains unchanged, the government has announced a 2% increase in stamp duty on second homes.

Inheritance tax thresholds will be frozen for a further two years. Inheritance tax will now be paid on inherited pensions from 2026. Agricultural Property Relief and Business Property Relief will also be reformed, raising £2bn a year.

Minimum wage will rises substantially

Ahead of the budget, the chancellor pre-announced a 6.7% increase in the minimum wage to £12.21. The hourly minimum wage for 18- to 20-year-olds will increase to £10-an-hour, in line with the government’s ambition to create a single adult minimum wage rate in due course.

Following previous large increases in the minimum wage, there have been concerns that broader wage growth would see material upward pressure as firms and workers sought to keep in place existing wage differentials across different employees. On the whole, these fears have not crystallised, with aggregate wage growth continuing to trend lower this year, in line with broader labour market conditions, even as the minimum wage was increased significantly at the start of April.

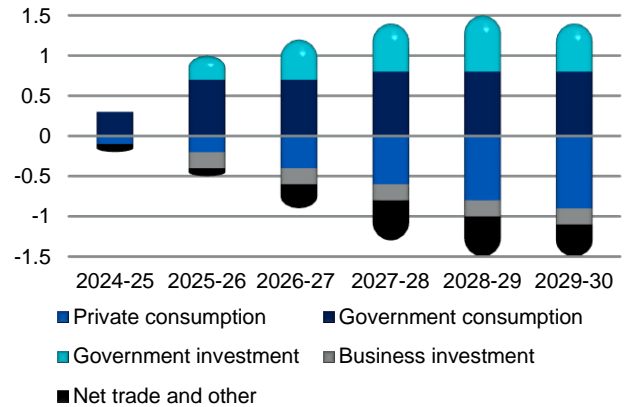
However, it is certainly plausible that there are non-linear dynamics around this effect, and, at a certain point, the increase could have a much larger impact on aggregate wages. Certainly, the Bank of England (BoE) will watch this dynamic closely, and the wage data in months around the minimum wage increase will have particular significance.

More generally, it is also possible that higher employer national insurance contributions combined with a higher minimum wage create strong incentives for firms to automate certain low-skilled work. This has the potential to catalyse productivity growth, but also to raise the natural rate of unemployment.

The OBR thinks the budget does little to boost long term growth

The OBR has upgraded its near-term growth forecasts, in part reflecting recent growth dynamics but also the increase in near-term fiscal spending, but downgraded medium-term estimates. Indeed, the OBR forecasts seem to imply the higher government consumption and investment will be more than offset by crowding out private consumption, business investment and trade as the forecast horizon progresses (see Figure 4).

Figure 4: A bigger state crowds out the private sector in the OBR’s forecasts



Source: abrdn, OBR, October 2024

The OBR also reports that the announced policies push up CPI inflation by 0.5 percentage points at the peak, although presumably the BoE will form its own assessment of these and calibrate policy accordingly (see Figure 5)

Figure 5: The OBR has upgraded near-term growth forecasts but lowered them further out

Previous OBR forecasts in brackets	GDP %/y	Inflation %/y	Public Sector Net Debt % GDP
2024	1.1 (0.8)	2.5 (2.2)	98.4 (98.8)
2025	2 (1.9)	2.6 (1.5)	96.6 (96.4)
2026	1.8 (2)	2.3 (1.6)	97.0 (95.5)
2027	1.5 (1.8)	2.1 (1.9)	97.2 (95.1)
2028	1.5 (1.7)	2.1 (2.0)	97.3 (94.3)
2029	1.6	2.0	97.1

Source: abrdn, OBR, October 2024

Strikingly, the growth forecasts are well below Labour’s stated target of 2.5% growth, with the OBR continuing to forecast potential growth of around 1.6%.



If the higher investment spending is sustained beyond the forecast horizon, that has the potential to eventually boost potential growth.

But more fundamentally, if Labour is to get anywhere close to reaching its target – which we continue to view as not particularly credible – then it will be via supply side reform rather than fiscal policy.

Indeed, the OBR forecasts do not currently include assessments of the majority of the government’s announced supply side reforms. These include planning reform, where policy remains relatively vague and seemingly on the less ambitious side of expectations, closer trading relations with the EU, and the formation of GB Energy and its partnership with the Crown Estate to co-invest in energy projects.

On balance, we don’t think the budget materially changes the outlook for the BoE, with a cut in November looking nailed on but the path of rate cuts beyond then likely to remain gradual. However, with growth and inflation slowing quite aside from the budget, the risk of a more rapid cutting cycle is increasing.

Relatively low fiscal headroom will create the possibility of further tax rises

Despite the changes to fiscal rules and significant tax changes announced at this budget, Reeves has been left with relatively low fiscal headroom against the borrowing rule of £15.9bn and £9.9bn against the current spending rule (see Figure 6).

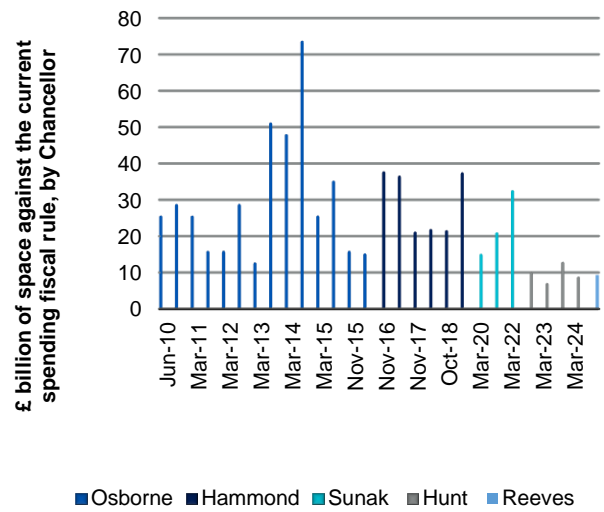
In fact, because market interest rates have already increased somewhat since the OBR locked in its forecasts (largely reflecting global factors), this headroom has probably already shrunk somewhat.

The projected headroom also bakes in an increase in fuel duty after next year, in line with the current stated plans. But as today’s budget shows, the political incentive to continue to avoid implementing this change is strong, and it is reasonable to think this projected revenue will in fact never appear.

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Figure 6: The Chancellor has very little headroom against the fiscal rules, especially for the start of a Parliament



Source: abrdn, OBR, October 2024

Since the projected spending increases for the second half of the parliament are small, and leave unprotected government departments facing significant funding squeezes, it is not unreasonable to think that there will be political and material pressures on increasing day-to-day spending as parliament progresses. Indeed, Labour’s spending plans are not entirely dissimilar to the previous government’s plans, which were widely seen as lacking credibility.

Taking all this together, the government may be required to raise taxes at future fiscal events, especially given the sensitivity to gilt yields with debt levels so high.



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