# UK Budget preview: Creativity versus stability

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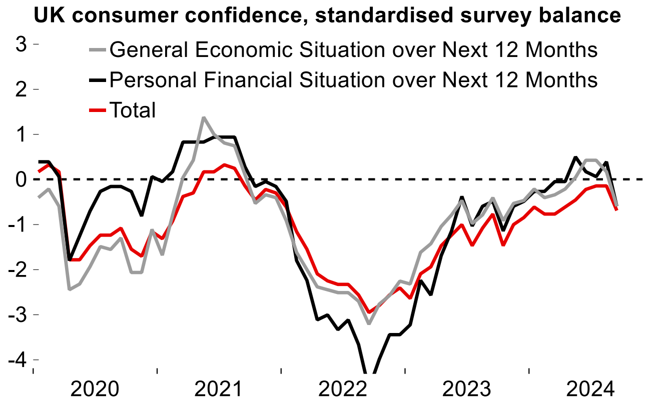
- **The first Labour Budget in 15 years looks hugely significant for the UK economy's medium-term outlook. The new government is looking to balance its core messages of stability and higher investment in a tight fiscal environment. That necessitates a creative approach.**
- **The broad story is likely to be some near-term fiscal consolidation through a range of tax rises which is offset by some more expansionary long-term capex. To do this the government is set to tweak the current fiscal rules to carve out more space for investment, but we expect officials will be mindful of rising borrowing costs and will resist the temptation to use up any extra headroom in its entirety.**
- **In terms of the broader growth outlook, the government's messaging around "painful" measures is unsurprisingly now weighing on sentiment indicators. The UK economy's fundamentals remain in reasonable shape, however, and we expect the steady expansion will continue once noise around the Budget fades.**

### The government is forced to be creative to increase revenues

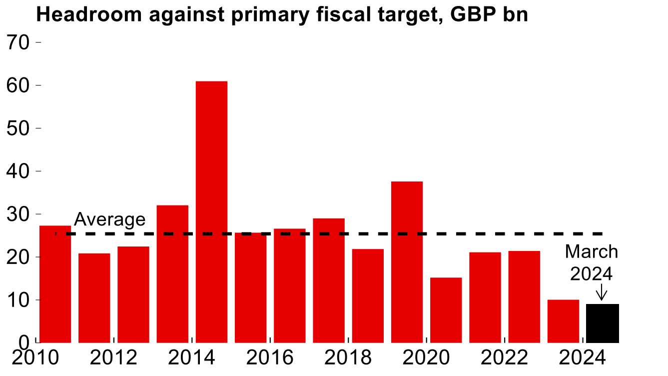
The UK's new government was elected in July with a large majority but relatively modest policy proposals (see here). Aside from an ambitious pledge to shake up restrictions around construction, there was not a great deal in Labour's manifesto which could be expected to directly boost the economy. Instead, the hope seemed to be that a return to relative calm and stability after the turbulence of the Brexit years would naturally provide better conditions for investment and activity more broadly.

**Chart 1**: Consumer confidence has weakened on the back of Budget speculation




Source: GfK UK, MUFG Bank Economic Research Office

**Chart 2:** The government has been left a tough fiscal inheritance



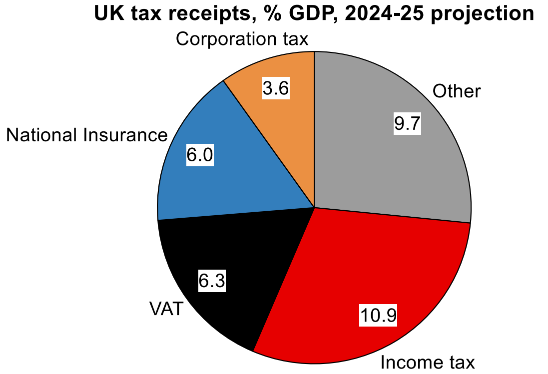

Note: Chart shows annual average headroom for years with multiple fiscal events.
Source: OBR, MUFG Bank Economic Research Office

But any hope for an immediate growth boost from a more stable business environment has been undermined by an extended period of uncertainty around the new government's fiscal policy. Soon after the election, the government announced that its first Budget would be held on 30 October and chancellor Rachel Reeves stated that there is a 22bn GBP gap in public finances. The prime minister, Keir Starmer, even gave advance notice that measures are likely to be "painful" in an attempt to pin problems on the previous administration. This has inevitably encouraged speculation around what the targets for revenue generation might be. To no great surprise, consumer confidence has weakened sharply (Chart 1) and business sentiment has also softened.

Now, the government can rightly bemoan the lack of fiscal space it has inherited from the previous administration. Even with tax-to-GDP set to rise due to thresholds being frozen at current nominal levels rather than indexed to inflation, the previous administration's pre-election Budget in March left historically low headroom of just 9bn GBP against the primary fiscal rule that debt-to-GDP should be falling over the medium-term (Chart 2). As usual, this calculation assumes that the government would increase fuel duty in line with inflation, which no chancellor has done since 2011. The government also set out unspecified (i.e. unrealistic) plans for significant departmental spending restraint at the end of the forecast horizon.

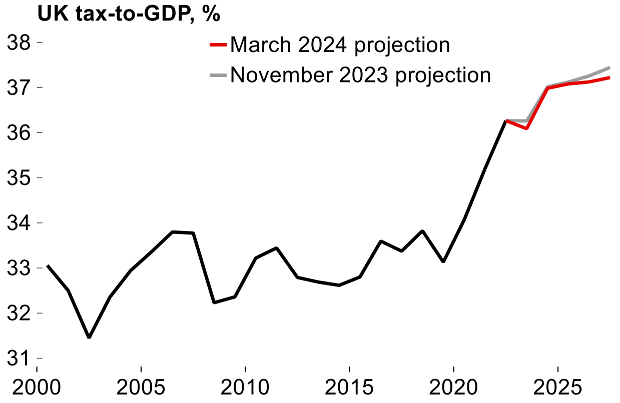
But much of the problem is of Labour's own making. During the election campaign, Starmer ruled out any increases in income tax, employee national insurance, VAT or corporation tax, which together provide the bulk of government tax receipts (Chart 3). As a consequence, the previous government's 2pp National Insurance cut in March – essentially a pre-election giveaway – can't simply be overturned. That move costs around 10bn GBP a year, and came on the back of a similar cut in the previous year. Reversing both of these would have immediately wiped out most of the 20bn GBP or so "black hole" announced by Reeves.

**Chart 3**: Labour has boxed itself into a corner by ruling out higher rates on the main sources of tax revenue




Source: Office for Budget Responsibility March 2024 Economic and Fiscal Outlook, MUFG Bank Economic Research Office

**Chart 4:** The UK's tax burden is on course to reach historic highs over coming years




Source: OBR, MUFG Bank Economic Research Office

This leaves the government scratching around to look for alternative sources of revenue. The reasonable assumption is that there will a piecemeal approach with a variety of adjustments in various areas such as employer national insurance, inheritance tax, capital gains and pensions, on top of some already-announced measures (e.g. VAT on private school fees, cuts to pensioners' winter fuel allowance). The government has remained tight-lipped and so the effect on confidence has been clear, as mentioned above, with consumers and businesses fearing that they will be heavily affected by new measures.

In total we expect there will be around 25bn GBP of revenue-generation measures to allow for real-terms spending increases in areas such as policing and education, which were both highlighted in Labour's manifesto (we have placed a summary table of that at end of this note). That would leave UK tax-to-GDP on course to reach around 38% by the end of the forecast horizon, a record high.

**Changing the rules to carve out more space for investment**

The likelihood of changes to the UK's fiscal rules provide another source of uncertainty. The rules are frequently changed – Table 1 details changes to the framework since the 2011 creation of the Office for Budget Responsibility (OBR), the UK's fiscal watchdog. Indeed, prior to the election Reeves acknowledged that the UK has "changed its fiscal rules more frequently than any other OECD economy, with the average lifespan of less than four years" and that this contributes to "instability and uncertainty" (see here).

**Table 1**: A history of UK fiscal rules since the creation of the OBR

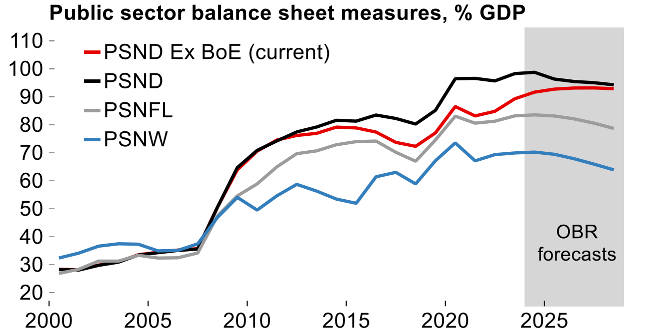
| Date | Targets | |
|---|---|---|
| **April 2011** | *Main:* | Cyclically-adjusted current balance at the end of a rolling five-year forecast horizon. |
| | *Supplementary:* | Public sector net debt (% GDP) to be falling by 2015-16. |
| **December 2014** | *Main:* | Cyclically-adjusted current balance by the third year of a rolling five-year forecast horizon. |
| | *Supplementary:* | Public sector net debt (% GDP) to be falling by 2016-17. |
| **October 2015** | *Main:* | Public sector net borrowing to be in surplus by end 2019-20. |
| | *Supplementary:* | Public sector net debt (% GDP) to be falling in each year to 2019-20. |
| **January 2017** | *Main:* | Cyclically-adjusted borrowing to be below 2% of GDP by 2020-21. |
| | *Supplementary:* | Public sector net debt (% GDP) to be failing in 2020-21. |
| **January 2022** | *Main:* | Public sector net debt ex. BoE (% GDP) to be falling by the third year of the rolling five-year forecast horizon. |
| | *Supplementary:* | Balanced current budget by the third year of the horizon. Public sector net investment to not exceed 3% of GDP on average during the forecast horizon. |
| **January 2023** | *Main:* | Public sector net debt ex. BoE (% GDP) to be falling by the fifth year of the rolling five-year forecast horizon. |
| | *Supplementary:* | Public sector net borrowing not to exceed 3% of GDP by the fifth year of the horizon. |

*Source: OBR and related legislation*

However, the indications are that Reeves will change the rules again in order to carve out more space for capital expenditure. The framework, as it stands currently, would not allow for any meaningful upshift in investment – which the government has said it aims to prioritise – without being offset by swingeing cuts to day-to-day spending.

The government has already announced that it will move away from the current 'supplementary' fiscal target which limits the deficit to 3% of GDP in the fifth year of the forecast. Instead there will be a shift to a balanced day-to-day budget while allowing borrowing for investment. That in itself won't afford much room for manoeuvre as Labour has said it will retain the primary fiscal rule that debt-to-GDP should be falling over the medium-term, with no distinction made for whether that debt was accrued through borrowing for current or capital expenditure.

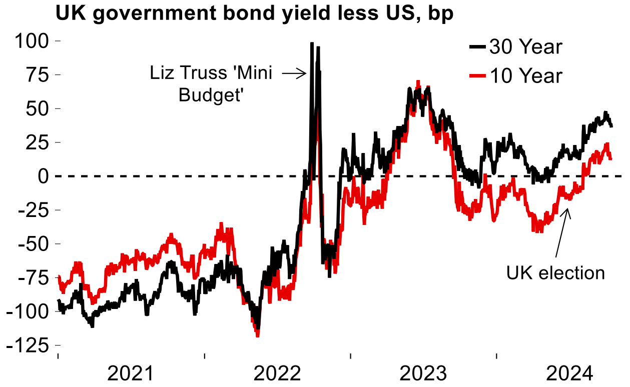
**Chart 5**: Targeting alternative debt metrics would free up more space for investment




Note: PSND = Public Sector Net Borrowing, PSNFL = Public Sector Net Financial Liabilities, PSNW = Public Sector Net Worth.

Source: OBR, MUFG Bank Economic Research Office

**Chart 6:** UK borrowing costs relative to the US have risen in recent months




Source: Macrobond, MUFG Bank Economic Research Office

However, there is much speculation that the definition of government debt will be tweaked to free up more space for investment. There are a range of credible ways to do this – Chart 5 shows various public sector balance sheet measures currently tracked by the OBR, all of which are set to fall more quickly over coming years than the current target measure of public sector net debt excluding the BoE (PSND ex. BoE).

The quirks of quantitative easing accounting mean that a simple move back to PSND, which was the debt target metric used until 2022, would increase the chancellor's headroom by 15bn GBP, according to our estimates. Broader measures of the public balance sheet such as public sector net worth or public sector net financial liabilities could increase headroom by around 50bn GBP.

**Table 2**: OBR projections of fiscal rule metrics – current and alternatives

| Balance sheet metrics (% GDP) | | | | | | | |
|---|---|---|---|---|---|---|---|
| | 2022-23 | 2023-24 | 2024-25 | 2025-26 | 2026-27 | 2027-28 | 2028-29 |
| **PSND ex. BoE (current target)** | **84.9** | **88.8** | **91.7** | **92.8** | **93.2** | **93.2** | **92.9** |
| Public Sector Net Debt | 95.7 | 97.6 | 98.8 | 96.4 | 95.5 | 95.1 | 94.3 |
| Public Sector Net Worth (inverted) | 69.7 | 69.5 | 70.2 | 69.5 | 67.9 | 66.0 | 63.9 |
| Public Sector Net Financial Liabilities | 81.4 | 82.9 | 83.6 | 83.2 | 82.1 | 80.6 | 78.7 |
| **Deficit metrics (% GDP)** | | | | | | | |
| | 2022-23 | 2023-24 | 2024-25 | 2025-26 | 2026-27 | 2027-28 | 2028-29 |
| **PSNB (current)** | **5.0** | **4.2** | **3.1** | **2.7** | **2.3** | **1.6** | **1.2** |
| Current budget deficit (new target) | 3.2 | 1.7 | 0.7 | 0.6 | 0.3 | -0.2 | -0.4 |

*PSND = Public Sector Net Debt. PSNB = Public Sector Net Borrowing. Under the current fiscal rules, PSND ex. BoE should be falling by the end of the rolling forecast horizon (i.e. between 2027-28 and 2028-29) and PSNB should not exceed 3% by the end of the horizon. Labour will change the latter so that the current budget (i.e. excluding investment spending) should be balanced. Source: OBR March 2024 projections.*

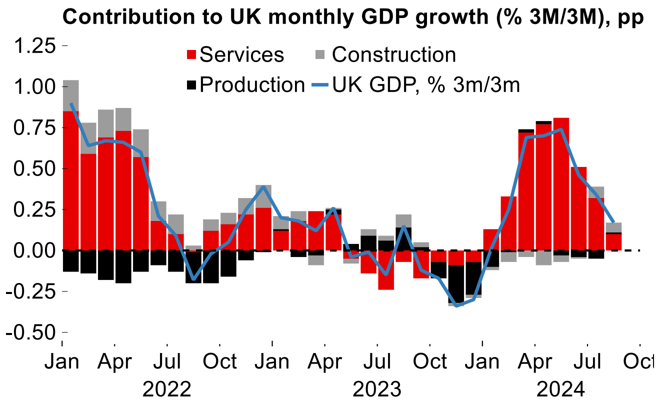
Our base case is that the chancellor will indeed shift to an alternative debt metric, with PSND the most obvious, but that she will only introduce relatively limited capex plans at this stage and not use up the entirety of any extra headroom. Since entering office, the government has already cancelled various road and rail plans, which does not suggest a significant loosening of the purse strings ahead. With the Liz Truss debacle still fresh in memories, we think policymakers will be sensitive to the risks of spooking market participants. UK yields have risen in recent months (Chart 6) and officials' talk of a "black hole" in public finances may have been a factor in that. That said, there is a general acceptance that the UK has underinvested in infrastructure since the GFC. Our sense is that a limited expansion of government investment would be tolerated by markets provided that plans look credible and productivity-enhancing.

The BoE will also be watching with interest. Its current projections from August do assume some fiscal tightening, but the government may go further. At any rate, the likely scattergun targets for tax rises will make the impact and any associated behavioural changes hard to model. Further ahead, a significant increase in capex over the longer-term would add even more uncertainty to estimates of 'neutral' and bolster arguments for a higher terminal rate, or at least a more cautious approach to easing as upper estimates of that rate are approached.

**The bigger picture: the UK economy is in reasonable shape**

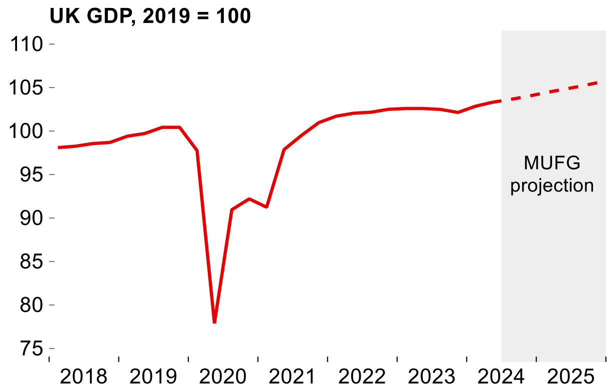
In terms of the growth backdrop, the UK economy started the year with a bang but momentum has faded since the summer. Monthly GDP is estimated to have expanded by 0.2% in the three months to August, in line with expectations. That marks a clear slowdown on average quarterly growth of 0.6% across Q1 and Q2. However, stronger growth earlier in the year was supported by one-off factors such as the decrease in public sector strike action. Our view is that UK growth is converging towards a more sustainable pace rather than stagnating again. The latest figures showed that the expansion, while slower, was broad-based across sectors with particularly encouraging signs of stronger construction activity.

**Chart 7:** UK growth has slowed markedly in recent months




Source: ONS, MUFG Bank Economic Research Office

**Chart 8:** Our view remains that the economy has exited its period of stagnation and will continue to expand




Source: U.K. Office for National Statistics (ONS), MUFG Bank Economic Research Office

We'd stress that the overall extent of any fiscal consolidation remains unclear. Yes, it looks like the government will implement a range of tax rises to balance day-to-day spending requirements, but it also seems set to carve out extra space for investment expenditure. If the government can navigate this without spooking market participants then the pledge to restore stability will become more plausible – a steady policy environment for the next four-and-a-half years until the next election would certainly be welcome after the turbulence of the Brexit years.

Looking ahead, we still believe that the GDP acceleration at the start of the year marked an inflection point after an extended period of stagnation. Taking a step back from Budget-related noise, the UK economy remains in reasonable shape. Business surveys, while softer, are still consistent with growth at around potential rates (~0.35% Q/Q) through the second half of the year. The fundamentals for households remain particularly encouraging with headline inflation likely to fall below target next week, well below nominal wage growth. Savings buffers have been replenished which also provides scope for a pick-up in spending. Meanwhile, the BoE has indicated that it might take a more active approach to rate cuts, which could provide another tailwind to growth. Overall, we are tracking annual average GDP growth at around 1% in 2024 and 1.5% next year.

## Appendix: Labour Party's pre-election manifesto and plans

| Topic | Labour Party policy proposals |
|---|---|
| **Economy** | Set strong fiscal rules which govern every decision made:<br>• The current budget moves into balance, so that day-to-day costs are met by revenues<br>• Debt must be falling as a share of the economy by the fifth year of the forecast<br>Strike a balance between prioritising investment and the urgent need to rebuild our public finances with no return to austerity. Every significant change to taxation or spending will be subject to an independent forecast by the Office for Budget Responsibility. End the link between access to minister and an inside track for public contracts. |
| **Tax** | Will not raise taxes on working people – no increase in National Insurance, the basic, higher or additional rates of Income Tax or VAT. Abolish non-dom status and replace it with a scheme for people in the country for a short period of time. End the use of offshore trusts to avoid inheritance tax. End the loophole in private equity where performance-related pay is treated as capital gains. Modernise HMRC to tackle tax avoidance, focusing on large businesses and the wealthy. Cap corporate tax at the current 25% for the entire parliament. |
| **Businesses & Industries** | Ensure a pro-business environment with a competition and regulatory framework that supports innovation, investment and high-quality jobs. Create the conditions to support innovation and growth in financial services by supporting new technology and a pro-innovation regulatory framework. Create a National Wealth Fund that uses public investment to encourage private investment in industries such as steel and green technology. Reform the British Business Bank to allow easier access to capital for SMEs. |
| **Financial Services** | Growth of the financial services sector, especially outside London. Take an innovation-centred approach to regulation and supervision to increase competitiveness. Explore alternative models for increasing financial resilience such as longer-term fixed rate mortgages. Make the UK a global hub for green finance. Embrace innovation and fintech and deliver the next phase of Open Banking. Review the pensions and retirement savings landscape to enable greater consolidation of schemes and allow the British Business Bank to investment more in growth capital. |
| **Infrastructure** | Develop a 10-year infrastructure strategy aligned with the industrial strategy to create new roads, railways, reservoirs and other infrastructure. Update the national planning policy to make it easier to build laboratories, digital infrastructure and gigafactories. Make a renewed push to fulfil the ambition of full gigabit and national 5G by 2030. Bring railways into public ownership as contracts expire. |
| **Trade** | No return to the single market, the customs union or freedom of movement with the EU. Improve the UK's trade and investment relationship with the EU by reducing trade barriers such as negotiating a veterinary agreement. |
| **Climate & Energy** | Restore the phase-out date of 2030 for new cars with ICE. Create 650,000 jobs by 2030 as part of the Green Prosperity Plan to invest in future industries. Work with the private sector to double onshore wind, triple solar power and quadrouple offshore wind by 2030. Extend the lifetime of existing nuclear power plants and complete Hinkley Point C, as well as developing new nuclear power stations. Work with industry to upgrade the UK's national transmission infrastructure. Mandate UK-regulated financial institutions and FTSE 100 companies to develop and implement credible transition plans that align with the 1.5°C goal of the Paris Agreement. |
| **Defence** | Conduct a Strategic Defence Review within the first year and set out the path to spending 2.5% of GDP on defence. Update rules on counter-extremism to stop radicalisation. Rebuild relationships with allies such as the US and EU. Seek a UK-EU security pact to co-operate on threats. Launch a Strategic Defence Review to assess threats. Bring forward a defence industrial strategy aligning security and economic priorities. |
| **Health** | Cut NHS waiting times with 40,000 more appointments every week by incentivising staff to carry out additional appointments out of hours and pool resources across neighbouring hospitals. Introduce a new Dentistry Rescue Plan to provide 700,000 more urgent dental appointments and recruit dentists to areas most in need. Hire an additional 8,500 mental health staff. |
| **Welfare** | Review Universal Credit so that it makes work pay and tackles poverty. Develop an ambitious strategy to reduce child poverty by working with the voluntary sector, faith organisation, trade unions, business and local governments. Retain the triple lock on state pension. |
| **Employment & Education** | Support people into work by providing a national jobs and careers service. Ensure the minimum wage is a genuine living wage. Remove age bands so all adults are entitled to the same minimum wage. Open an additional 3,000 nurseries. End the VAT exemption and business rates relief for private schools to invest in state schools. Recruit an additional 6,500 teachers and get more teachers into shortage subjects. Guarantee training, an apprenticeship or help to find work for all 18- to 21-year olds. |
| **Immigration** | Create a Border Security Command which hundreds of new investigators, intelligence officers to work internationally to pursue, disrupt and arrest criminal gangs. Restore order to the asylum system so it operates swiftly, firmly and fairly. Hire additional caseworkers to clear the backlog of claims. Set up a new returns and enforcement unit to fast-track removals to safe countries. |

*Source: Labour Party manifesto, MUFG Bank Economic Research Office*

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**Definitions**

**Positive:**

Credit: We expect the credit spread to tighten, on an interest rate hedged basis

**Neutral:**

Credit: We expect the credit spread to remain stable, on an interest rate hedged basis