Economic Research Unit

Economics Weekly

Bank of Ireland

UK Budget leaves difficult questions unanswered

Yesterday's UK Budget left many questions unanswered. The additional £70bn of public spending will provide a stimulus to the UK economy in 2025, even after £40bn of tax rises. The Office for Budget Responsibility estimates the net £30bn giveaway (1% of GDP) will add 0.5 percentage points to GDP growth in 2025, but the overall impact is uncertain. Given the £25bn rise in employer national insurance contributions, firms will scale back employment and investment plans, push back against wage increases or raise their prices. It may also take longer than expected to deploy additional funds for public capital expenditure.

After near-term stimulus, Labour's plans to rein in public sector borrowing from 4.5% of GDP this budget year, to 2% by the end of the decade, rely on spending restraint from 2027 onwards. The Institute for Fiscal Studies (IFS) has already said these spending plans look unrealistic. For now, bond investors have given new Chancellor of the Exchequer Rachel Reeves the benefit of the doubt, albeit with UK 10-year gilt yields rising to 4.5% and sterling depreciating sharply to 84.3p against the euro, today. However, yesterday's Budget is clearly far from a transparent deficit reduction plan.

Substantial fiscal loosening announced in UK Budget: Yesterday's UK Budget announced an additional £70bn of current and capital spending per annum. This expenditure will be financed by tax measures of £40bn, principally changes to employers national insurance contributions (NICs), but also plans for £32bn of extra public sector borrowing. Whilst tax rises will clearly not be welcome, the Office for Budgetary Responsibility (OBR) described the Budget '*as one of the largest fiscal loosenings*' seen in recent decades (see chart below).

£40bn tax rises focused on employer NICS: The key tax raising measures were focused on employer NICs, increasing the rate to 15%, and lowering the income threshold to £5,000, and expected to raise £25bn. However, after accounting for the likely negative impact on wages and employment, the OBR expect the net gain to be only £16bn. Capital gains, inheritance tax and non-domicile reforms are forecast to raise another £7bn. One concern is that the expected £5bn yield from anti-avoidance/compliance measures may not fully materialise. Remarkably, the overall UK tax-take is expected to rise to its highest level on record, surpassing levels seen in the 1940s (see chart below).

Day-to-day spending stills faces medium-term challenges: Current spending is expected to rise by 4.6% in real terms in 2024/25, and by 2.6% in 2025/26. The £26bn of extra day-to-day spending this year, partially reflects that the Conservatives' plans for a 0.5% real cut were never realistic, but also discretionary choices by the new Labour government. Local government, the Home Office and the Department of Work and Pensions all saw sharp rises in their budget. Nonetheless, the Institute for Fiscal Studies (IFS) has already questioned the budget assumption that real spending only rises by 1.3% per annum from 2027 onwards, to help to rein in public sector borrowing, as too optimistic.

Borrowing to invest: A key feature of yesterday's Budget was the decision to raise borrowing by £28bn in 2025/26, of which the bulk, £19bn was accounted for by additional public capital expenditure. This means real public capital expenditure is expected to rise 6.6% this Budget year and a further 10% in 2025/26. The extra £100bn of investment over the next five years will mean public capital expenditure will rise to a peak of 2.7% of GDP, vs the cut to 2% planned by the Conservatives. However, it remains to be seen if the additional funds for investment can quickly be deployed into new projects, or if delays will inevitably occur, diluting the short-term stimulus to the UK economy.

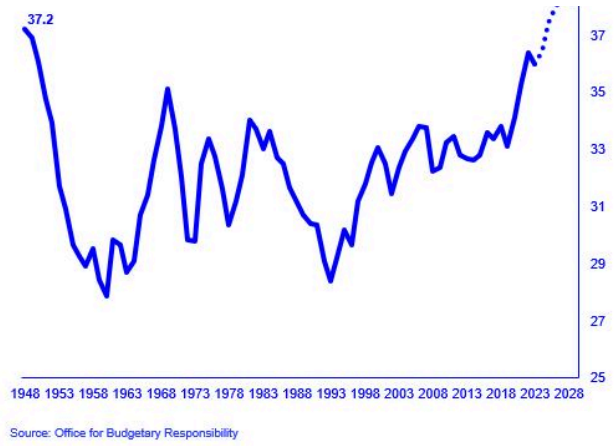
OBR projections for UK economy look optimistic: The OBR's projections that underpin the budget are for 2% GDP growth in 2025 (vs consensus 1.3%). This reflects the OBR's view the fiscal loosening of £30bn (circa 1% of nominal GDP) will add 0.5 percentage points to GDP growth next year. This assumption could be too optimistic on several fronts. The private sector could scale back investment and employment plans more aggressively, due to the increase in employer NICs. Also, the OBR expect UK exports to grow by 0.6% in 2025, after two successive years of contraction. Here, the OBR may be understating the headwind from Brexit. Also, the consumer-led recovery envisaged in 2025 is far from certain, despite real income gains.

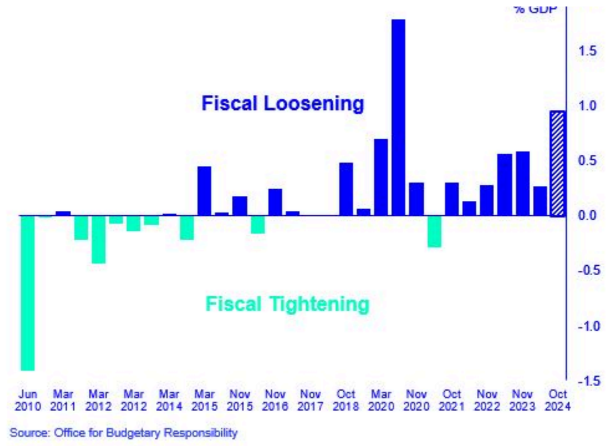
Public finances still in precarious position: The Chancellor's new plans are that public sector borrowing will equal £409bn over the next 5 years, £142bn higher than planned in the March Budget. Of course, through this period borrowing is expected to fall from £128bn (4.5% of GDP) in 2024/25 to £71bn (2.1% of GDP) by 2029/30. However, this narrowing of the deficit relies on the assumption spending growth is restrained from 2027 onwards. The IFS has already said these plans look unrealistic. For now, bond investors look to have given the Labour party the benefit of the doubt, albeit with UK 10-year gilt yields rising to 4.5% today and sterling depreciating to 84.3p against the euro. However, yesterday's Budget is clearly far from a transparent plan to rein in borrowing.

Chief Economist: Conall Mac Coille

Taxes as % of nominal GDP

Budgetary Packages since 2010





Contact Us at economics@boi.com

Update My Preferences