Economic Research Unit

Economics Weekly

Bank of Ireland

UK Budget delays tax hikes but difficult questions unanswered

Today's UK Budget put-off difficult tax increases until late-on in the life of the parliament. The plan to gradually reduce public sector borrowing to 1.9% of GDP by 2029/30 still relies on relatively optimistic assumptions on UK GDP growth and that the Labour government sticks to spending restraint in the run-up to the next general election. Remarkably, the Budget represents a net loosening of fiscal policy in 2026 & 27, additional expenditure offsetting muted tax rises. This is positive for UK GDP growth next year, but leaves many difficult questions on fiscal sustainability unanswered. Hence, UK gilt yields, swap rates, expectations for official Bank of England rates and sterling have shown a muted reaction to today's announcements.

OBR revises down outlook for UK GDP growth, but still looks relatively optimistic: The OBR's updated forecast is for 1.4% UK GDP growth in 2026 and 1.5% per annum thereafter (vs 1.8% on average previously). This downward revision reflected a 0.3pp reduction in the OBR's assumptions on labour productivity growth. Nonetheless, the OBR's projections still envisage an improvement in productivity, above the post-GFC trend. The OBR's GDP growth projections are also above the Consensus average for 2026 (1.1%) and the Bank of England (1.25%) - so are still relatively optimistic.

A more favourable starting point for the Chancellor: Media had reported the OBR's GDP growth revisions were likely to lead to a £20bn hole in the budget plans - contributing to an overall required adjustment of £30-£40bn (1%-1.3% of UK GDP) vis-a-vis the Chancellor's fiscal rule to balance the current budget by 2029/30. However, the OBR's pre-budget forecast for borrowing was far more favourable, indicating only a £6bn deterioration in borrowing in 2029/30. This was explained by offsetting upward revisions to the OBR's forecasts for both CPI inflation and pay growth, leading to more '*tax rich'* GDP growth - which seems questionable - but made the Chancellor's task easier.

Substantial tax rises put off until late in the life of the parliament: Rachel Reeve's November 4th speech had been interpreted as signaling difficult 1p increases in the basic, higher and additional income tax rates might be likely. This has turned out not to be the case. Instead, the key tax raising measures were to extend the freeze on income tax bands beyond 2028 and raising national insurance contributions (NICS) from pension contributions. However, neither of these measures will kick-in, hurting household disposable incomes, until the 2029/30 budget year, raising £13bn. A range of other tax measures are expected to boost revenues by £26bn in total by 2029/30; on property, savings and dividends, a gambling tax, a mansion tax on expensive homes and tax compliance.

Additional spending means Budget represents fiscal loosening in 2026 and 2027: So UK households will not face higher taxes next year in 2026. Rather, today's Budget raised spending by £7bn in 2026/27 and £16bn in 2027/28. Here, the key measures were the reversals on welfare reform during the summer and the removal of the two-child benefit cap. So, remarkably the OBR estimate today's Budget actually represents a fiscal loosening of £7.5bn (0.2% of GDP) over the next two years, but then offset by a fiscal tightening of £13bn (0.4% of GDP) in 2029 and 2030. So the Budget will actually help UK GDP growth next year, before a planned squeeze late in the life of the parliament.

Borrowing only set to fall gradually in the OBR's projections: The Labour government's decision to loosen fiscal policy next year is clearly positive for UK GDP in 2026, but leaves many difficult questions on the UK's fiscal position unanswered. Public sector net borrowing is forecast to fall from 4.5% of GDP in 2025/26 to 1.9% by 2029/30. However, this deficit reduction plan relies on the OBR's optimistic GDP growth forecasts but also that Labour stick to spending restraint in run-up to the next general election. The Institute for Fiscal Studies (IFS) has already suggested the spending plans may be unrealistic, especially for non-ring fenced departments outside of education, health and defence.

Muted market reaction to UK Budget: At face value there wasn't much for UK gilt investors in today's budget, with the key deficit reduction measures put off well into the future. Public sector borrowing is now expected to be £112bn (3.5% of GDP) in 2026/27, £15bn higher than forecast in March. Nonetheless, UK 30-year Gilt yields are 5.23%, down by 8bps today. Similarly 3-year Sonia swaps have fallen by 4bps to 3.52%. Options are almost fully pricing in two 25bp rate cuts from the Bank of England by April, most likely starting in December, with a 60% probability of a third cut to 3.25% by end-2026. Sterling is trading a little stronger against the euro at 87.6p this afternoon.

However, the big picture is that today's Budget was not the sharp, painful, up-front fiscal adjustment that might have substantially changed market expectations for Bank of England rate cuts or helped to stimulate demand for long-dated UK gilts. Far from it, instead borrowing will be higher in 2026, 2027 and 2028.

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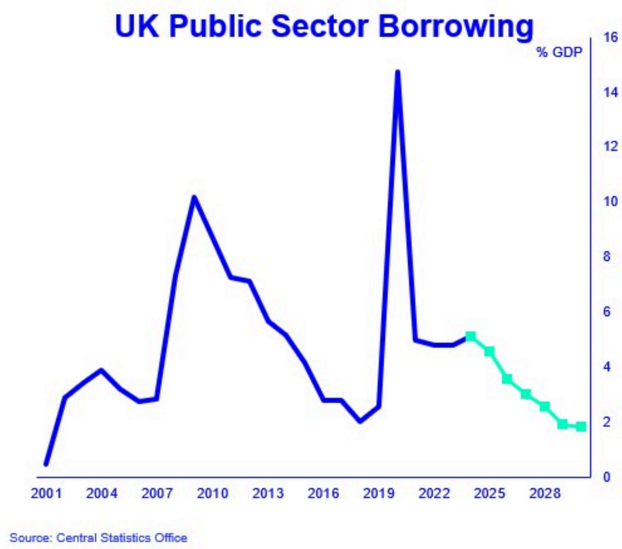

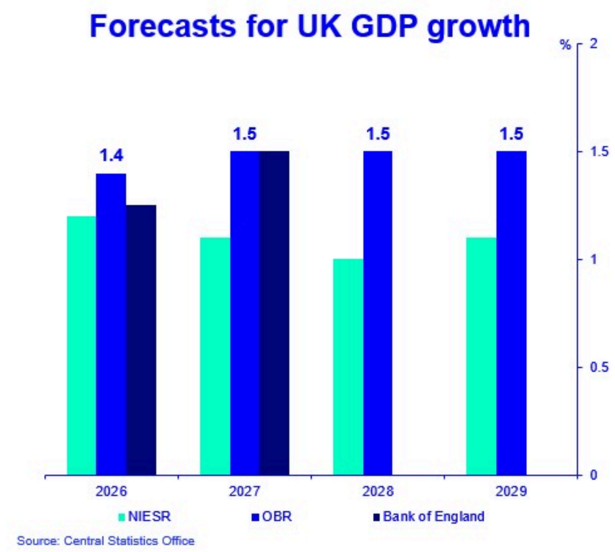

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