Economic Research Unit

UK Budget: A cautious package with slightly higher borrowing

Chancellor Healey's Budget aimed to balance continued fiscal consolidation with some support for households and businesses financed by targeted tax measures. Although borrowing is still expected to decline over the next couple of years, higher interest rates and associated debt service costs means that the deficit will be larger than previously projected. The budgetary plans meet the government's fiscal rules, albeit with slightly less headroom, though compliance is reliant on a slowdown in spending growth in the latter part of the forecast horizon which will be difficult to achieve. Overall, the Budget was broadly in line with market expectations, though some had hoped for more on the growth/productivity agenda.

OBR forecasts show a weaker near-term economic outlook: Although growth has surprised on the upside in 2026 so far, the economic landscape has deteriorated over the past few months. Escalating Middle East tensions have driven oil back above $110 and triggered a sharp rise in gas prices. Reflecting this energy shock, the OBR downgraded its 2027 growth forecast from 1.6% to 1.0%. Inflation is now projected to peak near 4% in Q1 2027 before gradually easing thereafter. Household real income growth is expected to be weak, holding back consumer spending. The OBR expects output growth to rebound in 2028 and by the end of the forecast horizon the level of real GDP is back close to what was assumed in the March projections. Unemployment is expected to tick up a bit and average 5.1% next year (from 5.0% this year) before falling back as the economy recovers. The US-Iran conflict remains a downside risk factor for the economic and fiscal outlook.

Government borrowing higher than previously projected: The OBR's 'pre-measures' forecast (before accounting for the effect of policy changes) showed a deterioration relative to the March position, with borrowing revised up by around 0.3-0.4% of GDP per year. The principal driver of the deterioration was higher gilt yields which pushed up projected debt service costs. Consequently, even before he put pen to paper, the Chancellor's starting point showed fiscal headroom down from around £24bn to £12bn, Rather than attempting to rebuild this buffer, the Chancellor largely accepted the lower headroom (bar a minor £2bn top-up) and introduced a modest discretionary package with front-loaded spending balanced by back-loaded taxation measures. These discretionary measures add modestly to the deficit in the near-term, and reduce it towards the end of the period. Overall, the fiscal deficit in 2026/27 is now expected to be 4.2% versus 3.7% previously. The deficit is expected to decline to 1.8% by 2030/31. Public sector net debt is projected to peak at 97.3% of GDP in a couple of years before gradually easing back to 95.6% by the end of the horizon. The government will technically meet both of its 'fiscal rules' in relation to balancing the current budget and setting net debt on a downward path. However, the forecasts assume that spending growth is kept quite low in the later years. To achieve this, assuming priority areas are protected, 'real-terms' spending cuts would be needed across many departments. As such the upcoming Spending Review will be very challenging.

Lots of small measures including 'cost-of-living' supports with increased taxes on savings and the banking sector: Cost-of-living supports were a focus of the Budget. The centrepiece was a £100 energy payment for up to 20 million households, costing £2.6bn, along with extensions of the electricity

VAT cut and the fuel duty reduction. Import tariffs were also scrapped on a range of goods. To help finance these measures the Chancellor announced higher taxes on savings and property income, while increasing the bank surcharge from 3% to 6% for 15 months. The Chancellor did however cancel the planned cut to the tax-free Cash ISA allowance from £20k to £12k. Headline rates of income tax, National Insurance and Corporation Tax were not changed, although frozen tax thresholds will continue to raise revenue through fiscal drag. Measures to support businesses included enhanced capital allowances, an electricity price cut for some firms and expanded business rates relief – CGT relief for company founders was also introduced. Some additional resources were allocated to housing, skills and AI safety. Funding for defence spending was provided and a roadmap towards a 3% of GDP target by 2030 was outlined. The minimum wage was increased by 3.9%. A new scheme to support First Time Buyers called 'Your First Home Scheme' was announced as well, with government backed equity loans of 20% for new builds. The government also directed Ofgem to remove fixed 'standing charges' on household gas bills - these will be shifted onto the unit rates. Overall, while the measures may provide some limited near-term relief, they arguably don't do much to boost productivity growth and add further friction to an already complex tax system.

Muted market reaction: The Chancellor and PM will no doubt be relieved that market reaction to the Budget was subdued. Gilt yields edged very marginally lower, while sterling was little changed. Bank stocks gained as tax increases were less than feared. Homebuilders did however struggle amidst OBR downgrades to new home construction forecasts. Overall, the measures are unlikely to change the near-term outlook for growth or inflation materially and will probably not significantly impact the Bank of England's assessment ahead of its upcoming Nov 5th rate decision, when it is expected to increase Bank Rate by 25bp to 4.0%.

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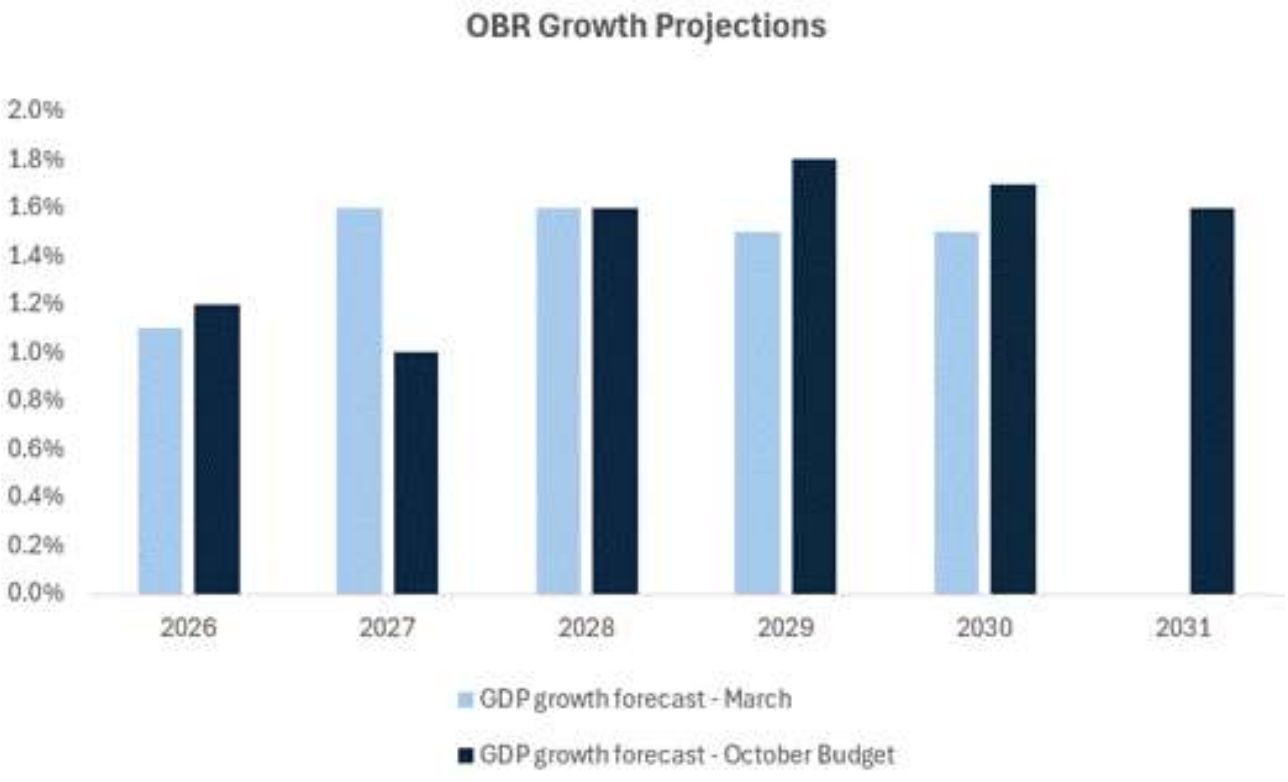

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