Finding £20bn: The UK's hunt for cash as fiscal headroom evaporates

Wednesday's Spending Review will epitomise just how tight things look for UK government departments. And life is only going to get harder for the Treasury in the autumn. We think the government's 'headroom' will fully evaporate and that tax rises look increasingly inevitable later this year

Rachel Reeves may be smiling now, but the real challenge lies ahead as she hunts for extra cash in a tight fiscal landscape

The Spending Review is set to be tough

UK Chancellor Rachel Reeves sets out her Spending Review on 11 June. It's the process of divvying up money across government departments. And we already know what it will say: there isn't enough money to go around.

Day-to-day departmental budgets will rise by just 1% per year in real terms over the next three fiscal years. We know this already from the Spring Statement in March. They are rising even less quickly in per-capita terms.

Much of those annual increases will be eaten up by health, defence and education, leaving other areas of government facing up to potentially sizable real-terms cuts in spending. We think the Treasury may have little choice but to top up these budgets at a later date, given the government's various manifesto commitments.

That won't happen at this Spending Review. It's not a budget, and doesn't come with a forecast from the Office for Budget Responsibility, a prerequisite for making major changes to tax and spending. But tax increases are inevitable later this year, we think. And not just because of departmental spending pressures.

The scenarios for government 'headroom'

Remember that as of the Spring Statement, the government had just £9.9bn 'headroom' against its main fiscal target. This self-imposed rule requires the current budget (day-to-day spending vs tax receipts) to be in surplus by the end of this decade.

Given that the government spends more than £1.5tr a year, £9.9bn looks like a rounding error. And it means that small changes in the OBR's economic forecasts can – and likely will – wipe out the limited headroom available.

A lot hinges on the OBR growth forecasts, which are likely to be revised down. Its 2026 growth projection of 1.9% looks optimistic, given the wider global environment. We expect annual growth at around 1% for both this year and next. The OBR might not turn that gloomy, but taking the forecast down to 1.5% for next year would halve the government's headroom.

Three scenarios for the Autumn budget and fiscal 'headroom'

How OBR economic forecast changes could affect 'fiscal headroom' (currently £9.9bn)

	OBR March forecast	**Most likely** scenario	**Good news** scenario	**Bad news** scenario
Bank Rate Next 5-year average	3.9%	3.5% **(+2bn)**	3.0% **(+4.5bn)**	4.0% **(-0.5bn)**
10-year yields Next 5-year average	4.8%	4.7% **(+1.2bn)**	4.2% **(+7.5bn)**	5.2% **(-5bn)**
2026 GDP growth	1.9%	1.5% **(-6bn)**	1.9% **(0bn)**	1.0% **(-13bn)**
Trend productivity growth 2027-30 average growth	1.2%	1.1% **(-6bn)**	1.3% **(+5bn)**	0.9% **(-18bn)**
Net migration in 2029/30 Change vs OBR baseline*	340k	-100k **(-5bn)**	Same **(0bn)**	-200k **(-10bn)**
Total 'headroom' Current budget surplus/deficit	**£9.9bn**	**-£3.9bn**	**£26.9bn**	**-£36.6bn**

Source: Office for Budget Responsibility, ING analysis

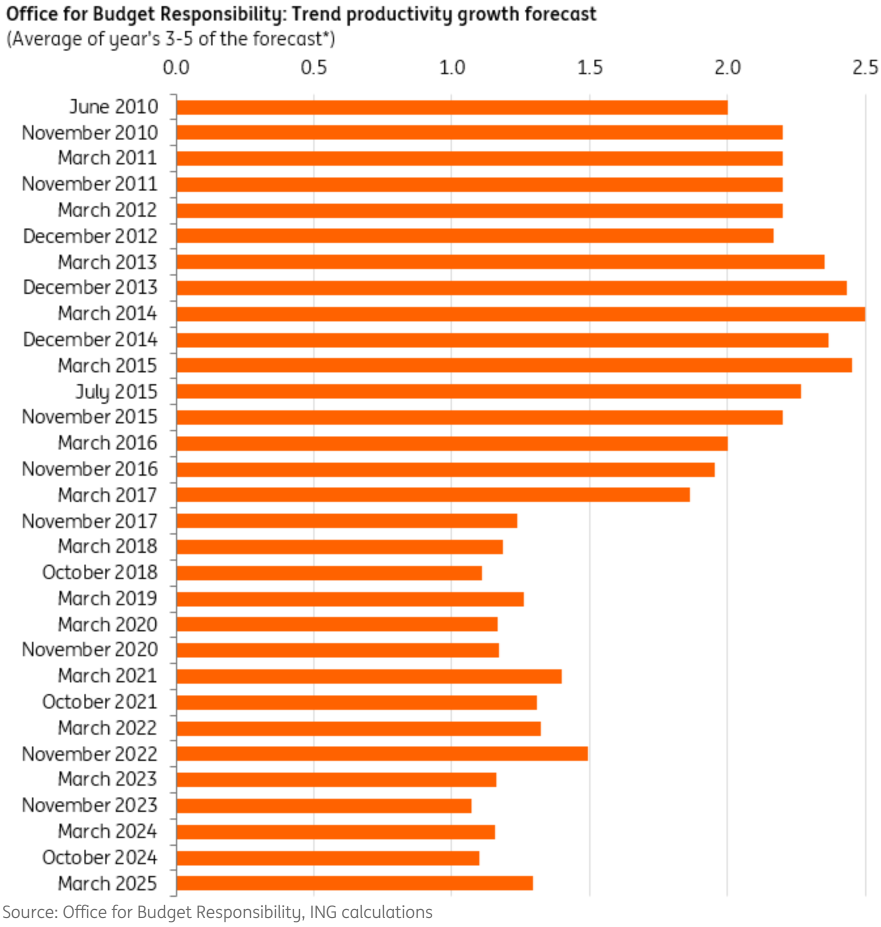
Migration assumption based on OBR March 2024 analysis. We have tempered the impact slightly, assuming the government strikes a youth mobility deal with the EU

Then there's productivity growth. This heavily determines how quickly the economy will grow over the medium term, and the recent news isn't good. Output per hour worked is down a percentage point since 2022.

That makes the OBR's forecast, which sees annual trend productivity growth returning to 1.2% later this decade, look increasingly unrealistic. Indeed, the OBR has gradually revised down these forecasts over the past 15 years.

The Treasury knows this and is doing everything it can to stop these forecasts being revised down dramatically again later this year. This explains the flurry of announcements on the economy so far this year, which have yielded some success. Back in March, the OBR boosted its medium-term productivity forecasts on the back of the government's planning reforms.

The OBR has revised down trend productivity over time



*Where the forecast only goes out four years, we've taken the average of years 3 and 4.

The Chancellor hopes to achieve a similar victory via closer EU ties. The recent deal, which will reduce cumbersome checks on food imports, is a helpful start. But it isn't a game-changer. And unless the UK pushes much closer to single market and/or customs union membership, which at this stage looks unlikely, any boost to growth will be modest.

This task is also complicated by the government's recent commitment to lowering net migration. Typically, the OBR views migration as a net positive for public finances via higher tax revenues. Based on previous OBR analysis, the government's drive to consistently reduce net migration by 100,000 a year would shave up to £7bn off its fiscal headroom – though the OBR may decide that efforts to agree a youth mobility deal with the EU will offset some of that.

If there's one silver lining, it might come from financial markets. We think financial markets are under-pricing the Bank of England's interest rate cycle. And we think gilt yields could ultimately come a bit lower too, relative to what the OBR had assumed in March. Taken together, that could add £3-4bn back into the government's headroom, via reduced debt interest projections.

Spending pressures are growing

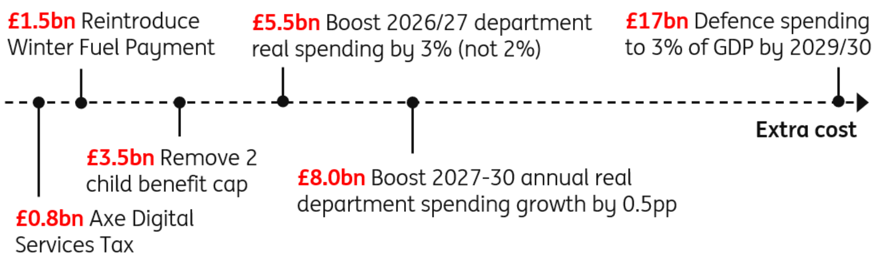
Still, the Chancellor is likely to be in the red in the autumn. Our scenario analysis above shows that she could face a shortfall of £4bn simply as a result of economic headwinds, and perhaps much more than that if the OBR's forecast shifts are more substantial.

That is before you consider the wider tax and spending pressures the Chancellor is facing. After Nigel Farage's Reform Party's strong showing in recent local elections, MPs from the governing Labour Party are becoming more vocal about the need to boost public services and reverse recent changes to the welfare system.

The prime minister has already confirmed a U-turn on last year's decision to remove winter fuel payments to pensioners, at a likely cost of £1.5bn. Removing the two-child benefit cap would reportedly cost an extra £3.5bn/year. The UK is also under a lot of pressure from the Trump administration to scrap the Digital Services Tax on tech firms, albeit this is a relatively small revenue raiser.

How spending could rise at the Budget

Cost of potential tax/spending changes at the Autumn Budget



Source: Office for Budget Responsibility, UK Government, IFS, ING analysis

All of those changes look likely. And as we said earlier, we think the Treasury will come under a lot of pressure to boost departmental spending further in the next fiscal year. If real-term day-to-day departmental spending rises to 3%, rather than the budgeted 2% next year, it could cost an additional £5-6bn per year.

The real unknown though is defence. The government's recent commitment to reach 2.5% of GDP is already in the budget. But NATO members are under pressure to take that to 3%, or even 3.5%. Achieving the former by the end of the decade would cost an extra £17bn/year.

Admittedly, a lot of any extra defence boost would be done via capital spending, which is purposefully excluded from the main fiscal rule. There is a secondary rule, based on a slightly obscure measure of government debt, which permits a little more breathing room when it comes to investment. Even so, boosting defence spending to 3% of GDP or above would, in the absence of any changes to the fiscal rules, require capital spending to be cut elsewhere.

Even without any changes to defence spending, the combination of other spending pressures and economic forecast downgrades means the chancellor may need at least £10-15bn simply to break even under the fiscal rules – and more still, if she wants to leave a modest buffer.

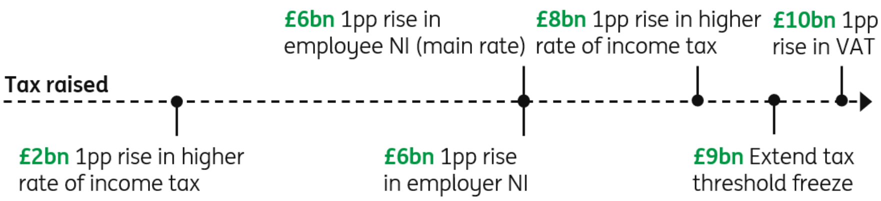
How to find £20bn

For argument's sake, let's say the government needs to raise £20bn this autumn (£10bn to recover the shortfall, £10bn to rebuild some fiscal headroom) – how does it do it?

The simple option is to change the fiscal rules. It could make them more flexible, perhaps by temporarily allowing small deficits in future years. Or by pushing back the date by which the fiscal rule needs to be met. But having already made big changes to the rules last October, the optics of changing the goalposts again 12 months later don't look great, not least given financial markets are still sensitive about UK public finances.

That leaves tax rises. And here the government is constrained by its self-imposed commitment not to raise income tax, employee national insurance (social security) or VAT. Most of the "low-hanging fruit" – making lots of small changes to minor taxes that collectively raise a decent sum of money – was picked in the October budget last year.

The chancellor's tax-raising options



Source: HMRC, IFS, ING analysis

Figures are rounded

But there is one juicy apple left on the tree, so to speak. And that is to extend the freeze on tax thresholds. These thresholds are already frozen in cash terms until 2028.

As a result of wage inflation, extending that freeze to the end of the decade would add £9bn back into the public finances, according to the Institute for Fiscal Studies. Given that this very much exists on paper and makes no difference to fiscal policy today, it's surprising that the chancellor hasn't already done this.

That still leaves another £10bn or so to find, which will be difficult without touching the major revenue raisers. A further rise in employer National Insurance (NI) feels likely, though less severe than the increase back in April. Back then, the Treasury increased this tax rate by a percentage point, but also drastically lowered the threshold at which employers start paying NI. The latter is hard to do again. Lifting employer NI by a further percentage point would raise roughly £6bn – not enough to meet the shortfall in our scenario. Of course, the list of revenue raisers isn't limited to national insurance, but it is also increasingly likely that the government will also need to revisit its red lines on personal taxes.

Whatever happens, tough decisions loom in the autumn.

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