What to expect from Reeves' Spring Statement as Britain braces for tax hikes

Britain's public finances are operating under increasingly fine margins and Chancellor Rachel Reeves faces tough spending decisions at the 26 March Spring Statement, amid rising debt interest costs. But cost cutting can only go so far and barring a surprise boost to UK growth this summer, we think further tax hikes look inevitable in the autumn

UK Chancellor Rachel Reeves is set to reveal significant spending cuts at the upcoming Spring Statement

Our key views on the Spring Statement and beyond

- The Treasury has likely lost all of the £10bn 'headroom' it had available under its fiscal rules last October, following a rise in government borrowing costs over the winter.
- Cuts to welfare and future departmental spending growth should be enough to regain that lost ground and meet the fiscal rules.
- The Office for Budget Responsibility is poised to lower its near-term growth forecasts but upgrade its inflation projections. Those forces more-or-less offset one another when it comes to fiscal headroom.
- We're sceptical that the government's recent economic announcements will have convinced the OBR to materially upgrade its view of the UK's future growth potential.

- Tax rises are unlikely this month, but look increasingly inevitable in the autumn.

Higher debt interest costs have wiped out the Chancellor's wiggle room

Europe is finally waking up to the fact it needs to spend more money. Germany may be the country in the headlines this week for its landmark spending boost, but it was actually Britain that first experienced this budgetary reawakening in October last year.

Back then, we saw substantial increases in spending – centred on health budgets and capital spending. That was only partially offset by what, in isolation, was a significant increase in taxation. Just as we've seen across the Channel, investors responded by anticipating higher growth and inflation, as well as extra bond issuance. Government bond yields rose, even as US rates slipped back, and Bank of England rate cuts have been priced out.

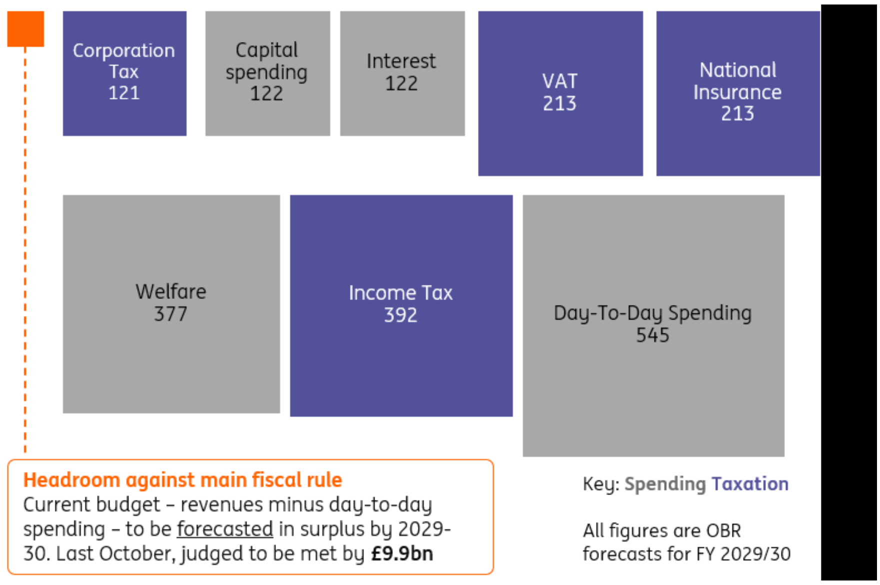
But higher yields mean higher debt servicing costs. And that's meant the already-limited breathing room the Chancellor afforded herself back in October has all but disappeared, despite making sweeping changes to the fiscal rules (sound familiar, Europe?).

Those rules dictate that the current budget – day-to-day spending set against taxation – must balance by the end of this decade, a hurdle that the Office for Budget Responsibility judged in October would be met by the skinniest of £10bn margins.

Fortunately for Rachel Reeves, the wider economic backdrop hasn't materially worsened since October, beyond those higher debt interest costs. Yes, growth has disappointed, and the OBR's 2% 2025 GDP forecast, frankly, always looked too optimistic. But at the same time, inflation is likely to be a fair bit higher than the OBR predicted back in October, on account of higher utility bills.

Lower growth and higher inflation largely net out, meaning nominal GDP forecasts shouldn't look too different to last October. And it's nominal GDP that matters for the OBR's key judgements on tax revenues.

'Fiscal headroom' in context



Source: Office for Budget Responsibility, ING

Cuts to welfare and government departments are likely

In short, the goal of next week's Spring Statement is to recoup that £10bn in 'headroom' lost to higher debt interest forecasts. And, on paper at least, that's not particularly difficult. For instance, simply extending the freeze on income tax brackets beyond 2028 for a couple more years could recoup most, if not all, of what the Treasury is projected to lose to higher debt interest costs.

More likely though, the Treasury will have to curtail its future spending ambitions. We already know that the government hopes to save £5bn/year on welfare. The remaining savings would presumably come from trimming departmental budgets.

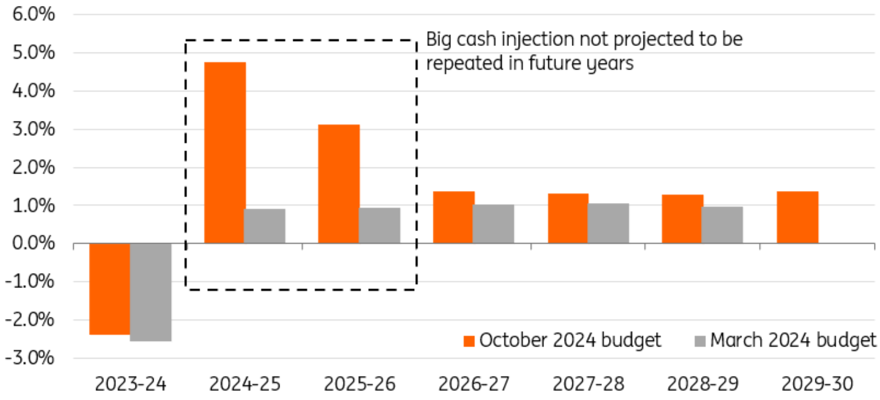
As things stand, those budgets are set to rise by an average of 1.3% per year in real terms beyond the next 12 months. To save £10bn/year by the end of the decade, that yearly growth would need to fall to 0.8%, and perhaps lower still if the OBR makes big upgrades to its inflation forecasts.

Crucially, we're assuming that the government clings onto its sizable 3% real-terms cash injection in the next fiscal year. The logic is simple: push the pain into the future in the hope that improved economic fortunes mean the cuts never need to happen in practice.

Reeves certainly wouldn't be the first Chancellor to use this tactic, but it's a risky move. Investors are already twitchy about the UK's fiscal numbers, given that gilt issuance is slated at £300bn over the next 12 months.

Real terms spending set to rise by 1.3-1.4% after the next fiscal year

Projected real-terms growth in Public Sector Current Expenditure (RDEL) %



Source: Office for Budget Responsibility

Spending cuts can only go so far

Whatever happens, there are enough options here to get the Treasury through the Spring Statement, without having to enter into a fraught debate about further tax rises. But it's a debate that can only be avoided for so long.

The public finances are operating on increasingly fine margins, at a time where spending pressures are far from diminishing. Defence is unlikely to be the only department that requires a fresh cash injection over the next few years. And redirecting spending from one area to another – as we've seen with the foreign aid budget being tapped to fund higher military spending – can only go so far.

Even before any cutbacks, per-capita real terms spending on public services is already projected to increase by less than one percent a year from 2026 onwards, assuming annual population growth of half a percent. Were we to see the sort of cuts discussed earlier, per capita spending would stay near enough flat.

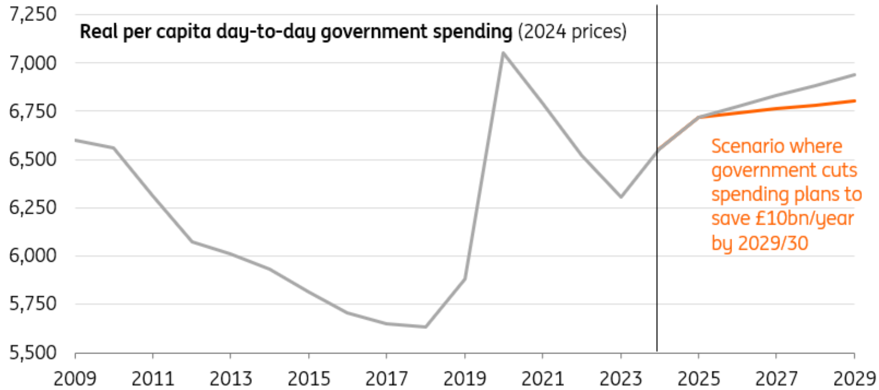
Bearing in mind that day-to-day health spending – roughly £200bn/year – is set to rise more than 3% per year, that implies that other government areas would be facing up to sizable budget cuts in per capita terms.

How practical that is, given the multitude of spending pressures, is questionable. Nor is it likely to be politically palatable, either. The fierce debate surrounding the welfare cuts this week shows just how politically challenging it would be to make cuts on a deeper scale. And ultimately Labour is likely to be much less inclined to cut the size of the state than the previous Conservative leadership. This summer's spending review, which allocates money for individual government departments, has the potential to be particularly fraught.

Some of these challenges are also of the Treasury's own making. For several years, the government has centred its fiscal rules on a rolling five-year horizon, affording it plenty of flexibility to play around with future tax and spending assumptions to make the numbers add up. But in October, the Treasury committed to gradually moving to a three-year horizon.

It was a move designed to make the rules more credible in the eyes of investors, limiting the scope for future Chancellors to game the system. But the flip side of that is that it does increasingly limit the Treasury's ability to avoid painful decisions on spending this year.

Cuts could see per capita, real terms spending stay broadly flat



A bigger Bank of England cutting cycle could unlock extra cash

One way or another, we think the Treasury will have little choice but to inject more cash for the 2026 fiscal year, when it unveils its next budget in the autumn. Allowing spending to grow by 2% in real terms, up from current plans of 1.4%, we think would potentially add another £10bn/year to the current budget deficit by the end of the decade.

If that's the case, then it comes back to the simple question: how to pay for it?

The government could simply get lucky. The previous Conservative government benefited from higher inflation, which pushes up tax revenue but doesn't automatically lift expenditure, and latterly, a sizable dovish repricing in the Bank of England's hiking cycle. Both of those factors enabled tax cuts ahead of last year's election.

Between now and the autumn, we think the Treasury will benefit from a repricing in Bank of England expectations, if we're right that it cuts rates further than financial markets currently expect. That could gift Reeves with £2-3bn in extra headroom. But a similar windfall from lower gilt yields is less likely, given our house view that both US and German yields rise through 2025.

Convincing the OBR to lift growth forecasts will be challenging

Luck aside, the government is pinning all its hopes on boosting economic growth. Remember the money available under the fiscal rules is hugely sensitive to what the OBR predicts for the economy. And a lot of that hinges on productivity growth, which unfortunately has been negative for some time.

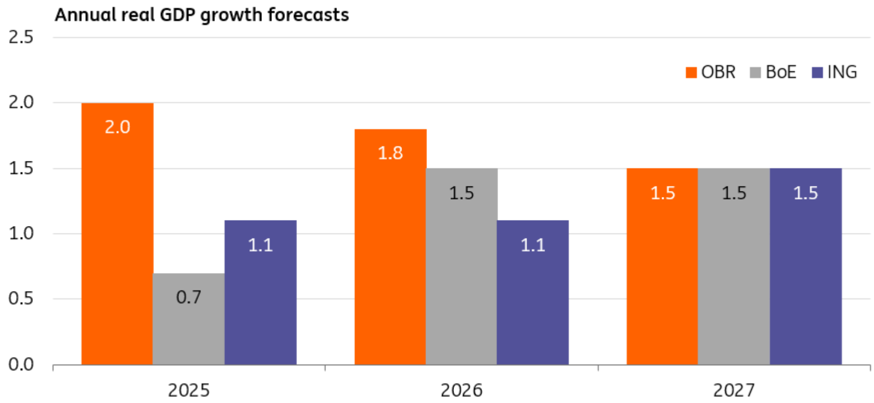
Though not a new phenomenon, the longer this trend continues, the more it makes the OBR's forecasts on productivity look too optimistic and the more likely it has to revise them down. And that would lower its estimates of medium-term GDP growth.

That's unlikely to be a story for this month's Spring Statement, but it's a threat that the government appears well aware of. It helps explain the flurry of business-friendly announcements this year, covering everything from planning reform to airport expansion.

We'll learn from the Spring Statement whether these plans have succeeded in convincing the OBR to upgrade its forecasts in any way, though we suspect it will be reluctant to do so. Many of these announcements, though positive for the UK economy, simply won't have a discernible impact over the relatively short horizon relevant to the fiscal rules.

There is one possible exception: Brexit. We wrote recently about how closer alignment with the EU, which the government is openly seeking, could unlock some genuine upgrades to the OBR's forecasts, albeit not in a way that significantly increases the fiscal headroom.

The OBR's 2025 growth forecast looks optimistic



Source: Office for Budget Responsibility, Bank of England, ING

Further tax rises look inevitable

If the scope to cut public spending becomes more limited, the Treasury struggles to convince the OBR to upgrade its growth forecasts, and it is reticent to make further changes to its fiscal rules, then that leaves one final option: raise taxes. Indeed we think that's now inevitable in the autumn, and the only question is which taxes will end up rising.

In October, the Treasury centred its tax rises on businesses via a sizable increase in employers National Insurance, in part because Labour had ruled out changes to income tax or VAT at last year's election.

We wouldn't be surprised if a similar strategy is repeated later this year. The Chancellor might point to the fact that by European standards, employer social security contributions are still relatively low as a share of an average worker's salary.

Of course much depends on how impactful the current round of tax hikes, which come through in April, are on the jobs market. So far the evidence is mixed; surveys point to much weaker hiring appetite, but so far the official employment data hasn't worsened. If that changes, then that might be what forces the government to rethink its aversion to lifting income tax or employee National Insurance.

Whatever happens, the decisions are only going to get harder for the Treasury as the year wears on.

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