

## UK tax rises grow ever more likely, boosting case for rate cuts

Political drama in Westminster has only raised the probability of fresh tax rises. We think it will be hard to bridge the fiscal shortfall – likely to be in excess of £20bn/year – without raising at least one of the major taxes



UK Chancellor Rachel Reeves has some tough choices to make

### The Treasury faces at least a £20bn shortfall

One of our big calls this year has been that further tax rises are unavoidable. And after another tumultuous month in UK bond markets, that looks even more likely than it did before.

Remember that Chancellor Rachel Reeves has just £10bn of error margin against her main fiscal rule, mandating a balanced current budget by the end of the decade. In the context of upwards of £1 trillion of public spending, that is really just a rounding error. It means that small changes to the Office for Budget Responsibility's economic forecasts can tee up very difficult decisions at the Treasury, and that's exactly what we expect this autumn.

We expect the OBR to downgrade its projections for 2026 growth, trend productivity and net migration. Even if market rates eventually settle a little lower than they were ahead of the Spring Statement in March, reducing forecasts for debt interest, we still think that the combination of

forecast downgrades will land the Treasury with a shortfall of at least £4bn to be made up.

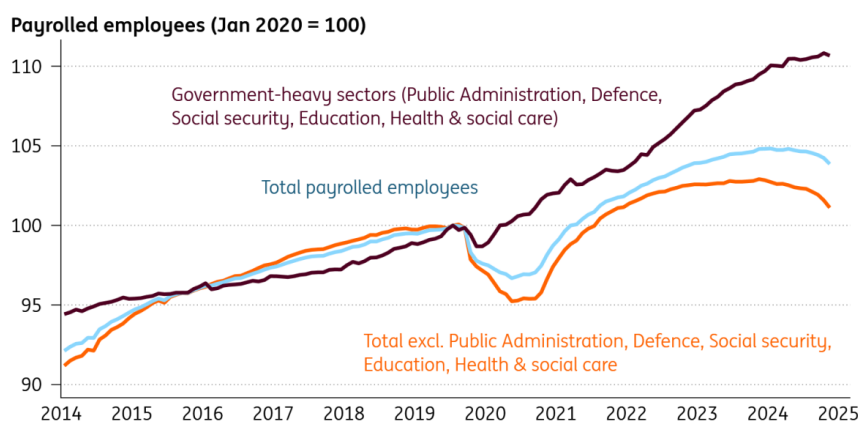
That's also not a huge number, but crucially that is before we consider the mounting list of pressures on public spending. The recent U-turns on welfare spending and Winter Fuel Payments may well have to be followed by further top-ups to departmental budgets later this year. In short, we think the Treasury will have to find at least £20bn/year, just to get back to the level of fiscal headroom it had in March.

Addressing that by spending cuts looks like a non-starter. The political will simply isn't there. Changing the fiscal rules again, to free up some more breathing room, looks difficult too. One option would be to bring forward a planned tweak in those rules to allow a small 0.5%/GDP deficit, a change that is already set to kick in next year. This would represent a subtle change, but one which could unlock £17bn of additional headroom.

However, scarred by the events of the 2022 mini-Budget crisis, the Treasury is going to be very wary about upsetting financial markets. The 20bp spike in 30-year government bond yields we saw on mere speculation about Rachel Reeves being replaced as Chancellor is a reminder that fiscal policy is still a big topic for investors.

That leaves tax rises. The good news is that there's one obvious piece of low-hanging fruit, and that's to extend the freeze on tax thresholds beyond 2028. That may sound very academic, but because the fiscal rules are all about what happens by the end of the decade, this would buy the government an extra £9bn of spending room.

## Payrolled employee numbers are falling more quickly



Source: Macrobond, ING

But that still leaves a sizable hole to fill and it is hard to see how this will happen without raising one of the major taxes. The Treasury may well opt to lift employer national insurance (social security) again, though that is complicated by the softer jobs market backdrop that has emerged over the past couple of months. While the data may ultimately be revised up, the most recent monthly fall in payrolled employees was the biggest on record (since 2014), outside of the Covid-19 pandemic.

This story matters not just for the Treasury, but is key for the Bank of England too. If we see this pace of job losses accelerate over the next couple of readings, we think the BoE will have to

seriously consider speeding up the pace of rate cuts. For now though, we expect quarterly cuts to continue in August and November. The prospect of tax hikes – and the slower economic growth that entails – reinforces our view that the Bank will cut rates a little further in 2026 than markets now expect.

## Author

### James Smith

Developed Markets Economist, UK

[james.smith@ing.com](mailto:james.smith@ing.com)

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