The UK Treasury's tax and spend tightrope

UK Chancellor Rachel Reeves has little choice but to scale back spending plans when she presents her Spring Statement in March. But faced with weaker growth forecasts and investors that are more alive to the UK's fiscal challenges, the Treasury may be forced to raise taxes again in the autumn

UK Chancellor Rachel Reeves faces some tough choices ahead of her Spring Statement in March

The government has run out of fiscal 'headroom'

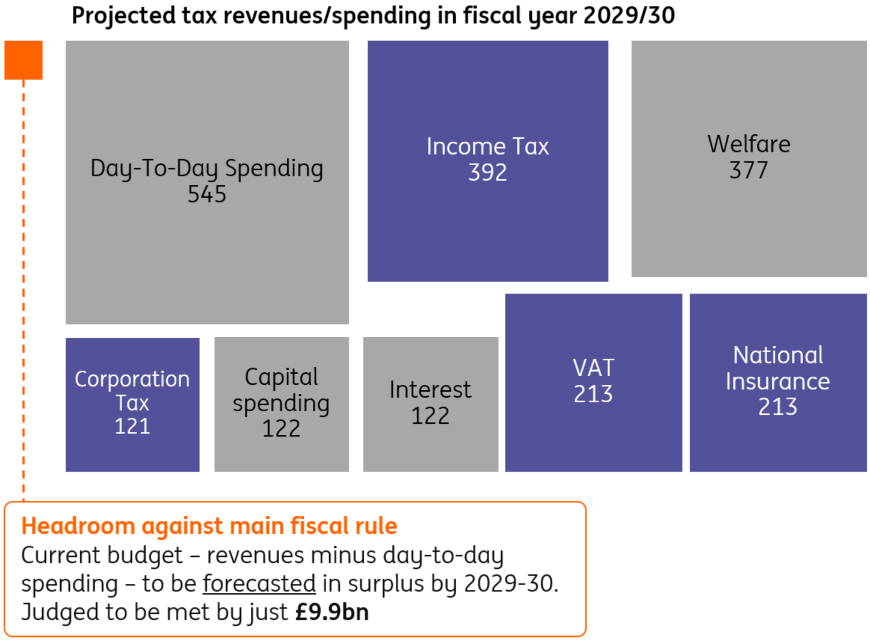
Not for the first time, the UK started 2025 in the headlines for all the wrong reasons. Britain bore the brunt of last month's global bond sell-off, thrusting Chancellor Rachel Reeves back into the limelight ahead of her Spring Statement in March.

At issue is her inaugural budget from last October, which saw big tax hikes coupled with considerably larger spending increases. Back then the Treasury left itself with very little room for manoeuvre under its fiscal rules, rules which by historical standards, are not particularly restrictive. Though UK markets have calmed since mid-January, we think that all of the modest £9.9bn fiscal 'headroom' – money that is left over once the fiscal rules are met – will have been eradicated by higher debt-interest forecasts.

On paper, that's not as troublesome as it sounds. £10bn here or there are not earth-shattering numbers in the context of more than a trillion pounds worth of spending/taxation. Remember too that the UK's fiscal rules do not mandate fiscal surpluses today, but instead concern project levels in 2029/30. That means the Treasury can – and often has – relied upon the promise of future spending cuts to make the numbers add up while avoiding pain for households and government departments today.

But this is a risky strategy. January's sell-off showed that investors are alive to the UK's fiscal challenges. Regardless of how the Treasury makes the fiscal rules work, the simple fact is that the UK is headed toward 4% fiscal deficits and circa £300bn borrowing needs over the next financial year.

£9.9bn fiscal 'headroom' is not much



Source: Office for Budget Responsibility, ING

Further tax hikes are likely in the autumn

The Chancellor will hope that her recent Growth Strategy will encourage the Office for Budget Responsibility (OBR) – the government's independent forecaster and arbiter of the fiscal rules – to upgrade (or at least not downgrade) its GDP forecasts. That would give the Treasury more breathing space and limit the need for painful tax or spending measures. But the long-term nature of that strategy, which included some major infrastructure projects, means the OBR may be reluctant to make substantive changes to its numbers.

The bigger issue is that the OBR's 2025 growth forecast – pitched at 2% – looks wildly optimistic in light of a weaker run of data and mounting economic headwinds. While the jury's still out on the government's tax hike on employers, the impact looks more likely to manifest itself in lower hiring rather than higher prices for consumers. Employment, excluding government-dominated sectors, fell by almost one percentage point in 2024, while vacancy rates in most sectors are comfortably below pre-Covid averages.

Weaker growth, higher market rates and relatively limited scope to credibly trim public spending projections suggest further tax hikes are inevitable in the autumn. A more fragile jobs market and the prospect of better news on services inflation in the spring should also help cement a gradual string of rate cuts from the Bank of England this year.

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