Insight INVESTMENT

GLOBAL MACRO RESEARCH
A UK FISCAL UPDATE

DECEMBER 2024

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EXECUTIVE SUMMARY

- The new fiscal mandate introduced by the Labour government under Chancellor Rachel Reeves aims to have the current budget in surplus by 2029-2030 and maintain it thereafter.
- The new fiscal framework expands the measurement of net debt to include public sector net financial liabilities (PSNFL), which significantly reduces the UK's debt-to-GDP ratio.
- Labour's first budget since the election includes a substantial increase in day-to-day spending, funded by higher taxes, and a rise in public investment spending.
- This budget is expected to boost GDP and CPI inflation in the near term, making it challenging for the Bank of England to deviate from its gradualist approach to interest rates.
- Longer-term risks remain in the small print, as the government has projected tight future spending plans to remain within its fiscal mandate. This would be politically challenging to implement and could result in large future deficits if the UK faces an unexpected economic downturn.

A NEW FISCAL MANDATE

The previous Conservative government ran two fiscal rules to manage the country's finances. These rules were designed to maintain fiscal discipline and ensure long-term economic stability.

- **Rule 1:** Public sector net debt, excluding the Bank of England, as a percentage of GDP to be falling by the fifth year of the forecast period.
- **Rule 2:** Public sector net borrowing not to exceed 3% of GDP, also by the fifth year of the rolling forecast period.

A NEW GOVERNMENT BROUGHT A NEW FISCAL FRAMEWORK

The incoming Labour government, under Chancellor Rachel Reeves, replaced the fiscal rules with a new fiscal mandate.

UK fiscal mandate: To have the current budget in surplus in 2029-2030, until 2029-30 becomes the third year of the forecast period. From that point, the current budget must then remain in balance or in surplus from the third year of the rolling forecast period where balance is defined as a range: in surplus or in a deficit of no more than 0.5% of GDP. If the range is used between fiscal events, the current budget must remain to surplus from the 3rd year at the following fiscal event.

Two supplementary targets:

- A new target to have debt, defined as public sector net financial liabilities (PSNFL), falling as a share of the economy in 2029-30, until 2029-30 becomes the third year of the forecast period. Debt should then fall from the third year of the rolling forecast period.
- A continuation of the previous government's target to ensure that expenditure on welfare (excluding the state pension and payments closely linked to the economic cycle) is contained within a predetermined cap and margin in 2029-30.

LOOSENING THE FISCAL PURSE STRINGS

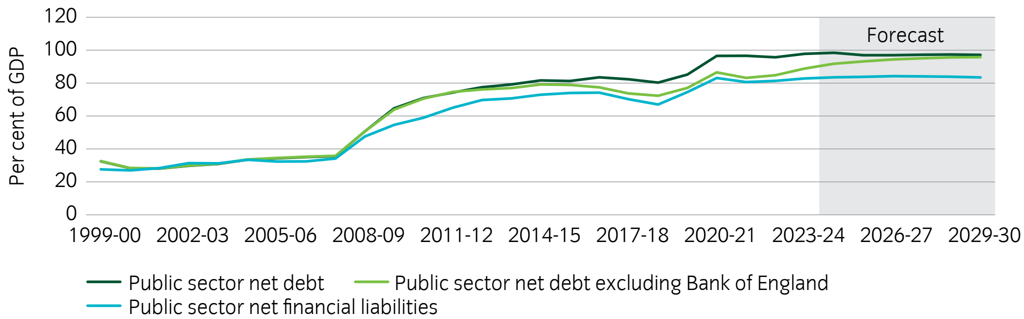
A critical element of the new fiscal framework was to expand the way that net debt is measured.

Referring to PSNFL widens the measure of the UK balance sheet relative to public sector net debt (PSND) and includes all financial assets and liabilities recognised in the national accounts.

Sources of differences between the two measures include illiquid financial assets, such as student loans and equity stakes in financial institutions acquired during the financial crisis, which net off against PSNFL but not PSND. Additionally, some liabilities add to PSNFL without affecting PSND, including net pension liabilities for funded pension schemes. The main drawback of PSNFL as a fiscal target is that it is subject to greater historical revisions due to the difficulty of calculating the value of illiquid assets and liabilities.

Using the PSNFL measure of debt is at the fiscally looser end of the market's expectations as, in effect, this significantly reduces the UK's debt/GDP, as outlined in Figure 1.

Figure 1: The new definition of debt significantly reduces UK debt/GDP[1]



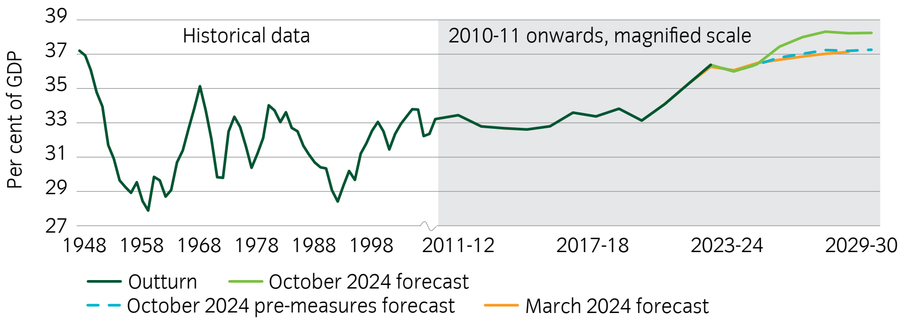
[1] Source: Office for Budget Responsibility economic and fiscal outlook – October 2024.

KEY BUDGET MEASURES

Labour's first Budget since the election announced several large policy changes to help shape its time in government.

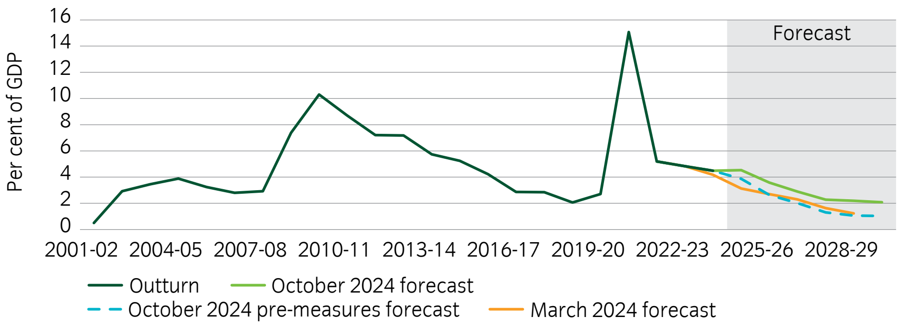
1. **A large increase in day-to-day spending:** This was broadly funded by an increase in taxation, taking the tax burden to the highest level since 1950 (see Figure 2). This significant rise in public spending is front loaded and dominated by non-investment spending.

Figure 2: Tax as a proportion of GDP will rise to the highest level since 1950[2]



2. **Borrowing to invest:** Public investment spending will increase from 1.7% of GDP to 2.5% rather than fall as per the previous government's plans. It is estimated that the budget adds net stimulus relative to the old plans of around 1% of GDP (see Figure 3). The structural primary deficit is still falling each year, but now at a slower pace. The headline budget deficit is now expected to be around 0.9% of GDP higher each year than previously forecast.

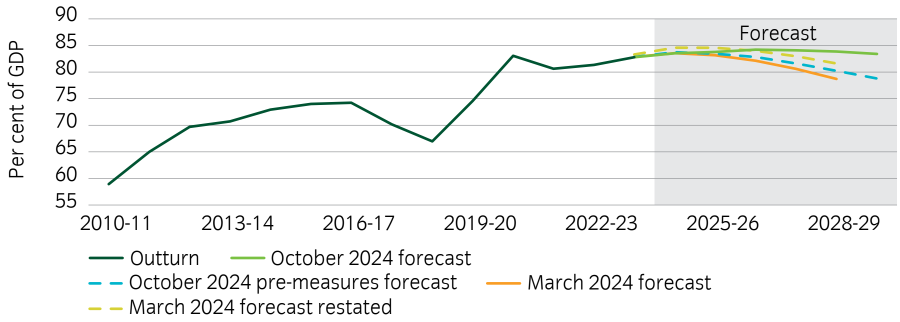
Figure 3: Borrowing for investment shifted upward[3]



3. **Pushing out improvements in debt/GDP:** The change in the fiscal rules created headroom for extra borrowing, and there were significant increases in tax, c.£50bn, designed to fund a revised path of public spending and £100bn of investment. This left overall fiscal headroom at £9.9 billion (0.3% of GDP) against the current budget target and £15.7 billion (0.5% of GDP) against the supplementary target for public sector net financial liabilities to be falling in 2029-30. In effect this pushed out the date at which public finances were expected to improve to the end of this parliament (see Figure 4).

[2,3] Source: Office for Budget Responsibility economic and fiscal outlook – October 2024.

Figure 4: Improvements in public sector net financial liabilities are no longer expected until 2028/29[4]



GILT ISSUANCE IS EXPECTED TO REMAIN ELEVATED FOR YEARS TO COME

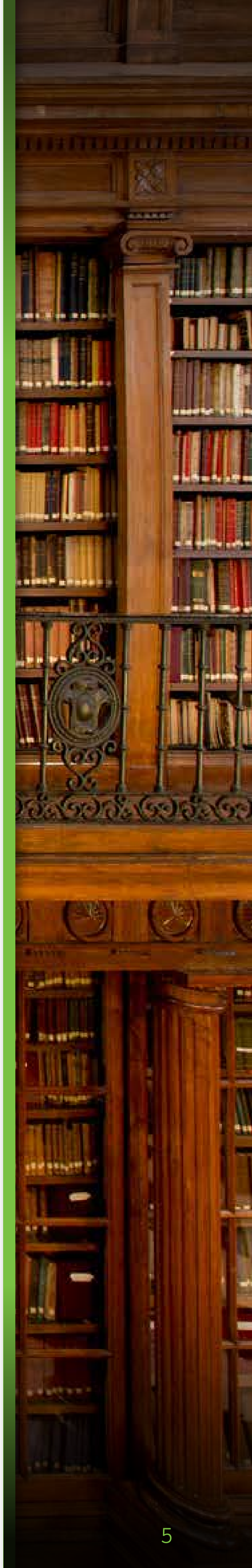
The cumulative change in the Office for Budget Responsibility's estimates of gross borrowing relative to the March budget is an increase of £142bn or an average of £28bn per annum over the course of the parliament. The Debt Management Office (DMO) does not forecast how much of the financing remit will be funded in gilts over future years, but it is not unreasonable to assume that expected total issuance for the next four years from the DMO is over £1,000bn, and over the full five year horizon an average gilt issuance of £248m per annum (see Figure 5).

Figure 5: A significant amount of gilt issuance ahead[5]

£ billion	2025-26	2026-27	2027-28	2028-29	2029-30
CGNCR (ex NRAM, B&B, and NR)	134.8	115.0	123.8	127.3	103.3
Gilt redemptions	164.7	141.5	109.1	146.6	75.2
Illustrative gross financing requirement (IGFR)	299.6	256.5	233.0	273.9	178.4

It is not unreasonable to assume that expected total issuance for the next four years from the DMO is over £1,000bn.

[4] Source: Office for Budget Responsibility economic and fiscal outlook – October 2024.
[5] Source: Economic and fiscal outlook – October 2024, 30 October 2024, Office for Budget Responsibility. Figures may not sum due to rounding.

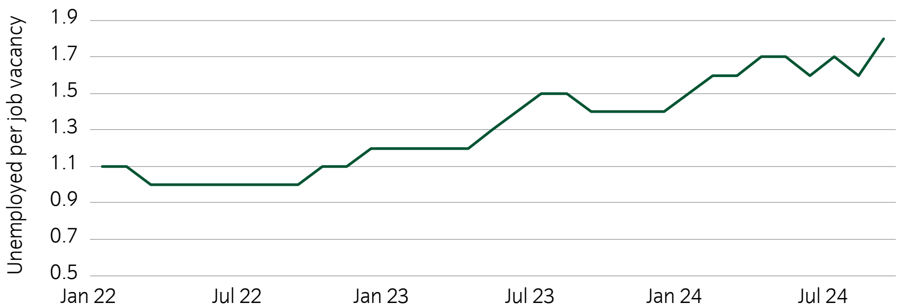


IMPLICATIONS FOR UK GROWTH

From the perspective of government spending, the composition of the budget is likely to be favourable for growth in the near term. While the average pace of annual fiscal tightening is similar to before, the overall level of government-led demand is higher due to the large £40bn upgrade to borrowing for 2024/25 and subsequent higher government spending. Public spending tends to have high growth multiplies compared to tax changes, and so both the scale and composition of the fiscal changes are likely to boost growth in the near term.

This may prove timely, as there is growing evidence that UK economic activity has already started to soften, with the ratio of unemployed persons to job vacancies weakening (see Figure 6). However, the rise in national insurance for employers (a payroll tax) appears unlikely to have helped the outlook for UK labour markets after the budget.

Figure 6: The UK labour market is starting to soften[6]



IMPLICATIONS FOR THE BANK OF ENGLAND

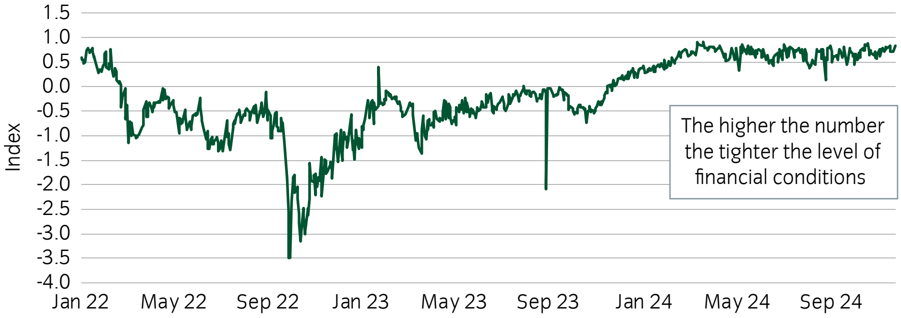
Compared to the previously announced government plans, demand and inflation will now be higher than previously forecast over the Bank of England's two-year forecast horizon. In its November Monetary Policy Report[7] the Bank noted that:

"The combined effects of the measures announced in Autumn Budget 2024 are provisionally expected to boost the level of GDP by around ¾% at their peak in a year's time, relative to the August projections. The Budget is provisionally expected to boost CPI inflation by just under ½ of a percentage point at the peak, reflecting both the indirect effects of the smaller margin of excess supply and direct impacts from the Budget measures."

This will make it harder for the Monetary Policy Committee (MPC) to deviate from its gradualist mantra on rates. The MPC will also want to consider international developments when processing its forecast and will also reflect the level of gilt yields prevailing at the time in its forecast. The back up in gilt yields over recent months has left financial conditions at still restrictive levels, despite the rate reductions implemented by the Bank so far.

[6] Source: Insight and Bloomberg. Data as at 31 October 2024.
[7] Source: Monetary Policy Report (PDF), November 2024, Bank of England.

Figure 7: UK financial conditions remain tight, supporting further rate cuts[8]



LONGER-TERM RISKS REMAIN IN THE SMALL PRINT

As with previous UK governments, one way that the incoming Labour government has been able to increase current spending and remain within its fiscal mandate is to project a very low level of spending growth in future years. After the 2025/26 fiscal year, real government spending is projected to drop to just 1.3% per annum thereafter. Given the protected spending for some departments such as the NHS, this would in effect likely require cuts to budgets elsewhere. This is also noted by the Bank of England in its Monetary Policy Report[9]:

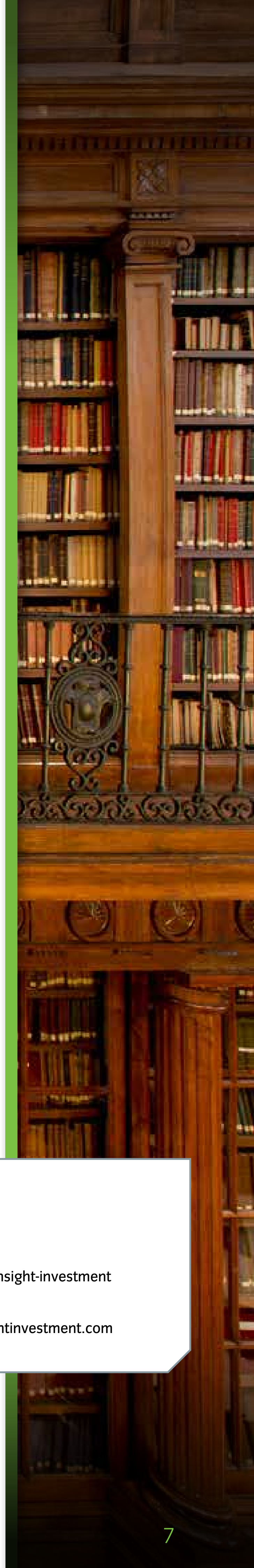
"Aggregate demand and supply are judged to remain broadly in balance over the coming year. Demand growth is then expected to be weaker than potential supply growth during 2026, such that a margin of economic slack is projected to emerge. That in part reflects the overall tightening in the stance of fiscal policy that is assumed to occur following the Budget, and also the continued restrictive stance of monetary policy. The margin of aggregate excess supply is expected to reach around ½% of potential GDP in the medium term."

We believe that this is clearly a long-term risk as it would be politically challenging for the government to stick to these plans, given the overall tax burden is already at the highest level in decades and further tax rises could be problematic. This increases the risks that future financing needs will be higher than currently expected. By leaving little fiscal headroom, it could also result in large deficits in the event that the UK faced an unexpected economic downturn.

CONTRIBUTORS


David Hooker
Senior Portfolio Manager
Insight Investment


Simon Down
Co-Head of Investment Content
Insight Investment



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[8] Source: Insight and Bloomberg. Bloomberg UK Financial Conditions Index. Data as at 31 October 2024.
[9] Source: Monetary Policy Report (PDF), November 2024, Bank of England.

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