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RESEARCH HIGHLIGHT
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What You Need To Know About The U.K. Budget And Fiscal Outlook

- Public sector borrowing, not the mandate, is the key for fiscal policy.
- More adjustment will be needed to restore fiscal sustainability.
- Bringing down the debt/financial liabilities ratio requires faster economic growth.
- Bond investors are the final arbiter of fiscal policy.
- A challenging year looms for gilts.

Chancellor of the Exchequer Reeves faces a daunting test in presenting the Autumn Budget this week. The new Labour government under Prime Minister Keir Starmer has gotten off to a rough start since taking office in July. Starmer himself has been criticized for accepting expensive gifts from donors, and his government's message has been both muddled and highly cautious.

More importantly for Reeves, the U.K.'s fiscal situation is extremely challenging, as has been the case for several years[1]. There is a large public sector borrowing requirement, taxes as a share of GDP are high by historical standards, and after more than a decade of austerity, public services are in desperate need of additional funding. Meanwhile, public sector debt relative to GDP is also high, the cost of servicing the public sector debt is rising, and economic growth has been tepid.

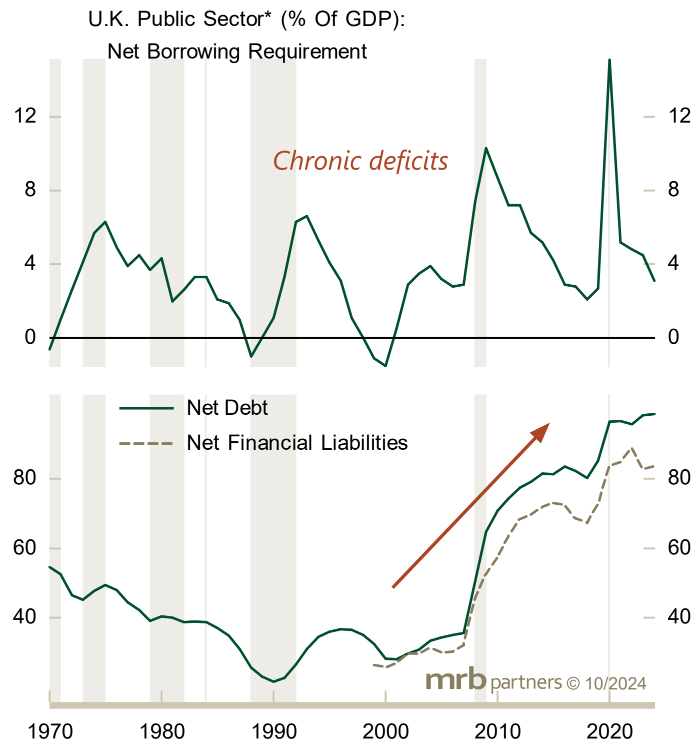
The U.K.'s fiscal situation is extremely challenging

The Autumn Budget will include a mix of tax increases, spending cuts, changes in accounting, and some increases in public investment. It inevitably will be a disappointment to members of the two main parties, with Labour ministers disappointed about select austerity measures and overly cautious tax increases on higher-earners, and Tories disappointed about any tax hikes and the lack of more aggressive spending cuts.

[1] **MRB:** "*The Treacherous Path To U.K. Fiscal Sustainability*", March 18, 2021

Public Sector Borrowing, Not The Mandate, Is The Key For Fiscal Policy

Chart 1 A Big Surge In Debt Since The Great Recession



* Fiscal years; source: Office for Budget Responsibility
Note: Shaded for U.K. recessions

The Chancellor's shift of the fiscal debt constraint from the public sector's net debt as a share of GDP to its net financial liabilities does not fundamentally change the reliance of the government on investors to absorb increasing government liabilities[2]. The fresh £50 bn in borrowing capacity ostensibly provided by the shift to net financial liabilities simply indicates £50 bn in additional borrowing by domestic and/or foreign investors.

The *Office for Budget Responsibility* (OBR) will update its forecasts following the budget release, but the main tenets of the fiscal outlook are unlikely to deviate markedly from its most recent projections. Reeves has indicated that the expected public sector net borrowing requirement for the fiscal year ending next March will be some £22 bn larger than previously forecast, or about 4% of GDP (**chart 1**)[3]. The OBR's last forecasts showed public sector net debt projected to be 99% of GDP, which would be the highest since the early-1960s when the post-war fiscal consolidation was still underway. Public sector net financial liabilities, which subtract public sector financial assets from debt, were approximately 84% of GDP in the prior forecast.

Ongoing public sector deficits imply that net public sector liabilities will continue to rise

Ongoing public sector deficits imply that debt and net liabilities will continue to rise in absolute terms, and that primary surpluses (receipts minus expenditures excluding net interest payments on the debt) will be required to stabilize or reduce public sector net liabilities. Stabilizing or reducing the net liabilities-to-GDP ratio in the future will require a public sector net borrowing requirement relative to GDP equal to or less than nominal GDP growth (or alternatively, the net interest rate paid on the liabilities will need to be equal to or less than nominal GDP growth).

[2] There are several historical net debt or net financial liability measures that include or exclude public sector banks and the Bank of England. We refer to the commonly-cited net debt/liabilities excluding public sector banks but including the Bank of England.

[3] The public sector includes the central and local governments, public sector pensions, and financial and non-financial corporations, including the Bank of England.

Forecasts from the OBR based on the prior Budget indicated an increase in public sector ***net financial liabilities*** of £78 bn in FY2024-2025 and £284 bn over the 5-year forecast period, which we assume will be moderately higher under the new forecast. By comparison, the OBR was forecasting an increase in ***net debt*** of £93 bn and £379 bn over the same periods. Both measures were expected to show modest declines as a share of GDP over the next five years, albeit only back to levels well above those immediately preceding the pandemic and still very high by historical standards.

More Adjustment Will Be Needed To Restore Fiscal Sustainability

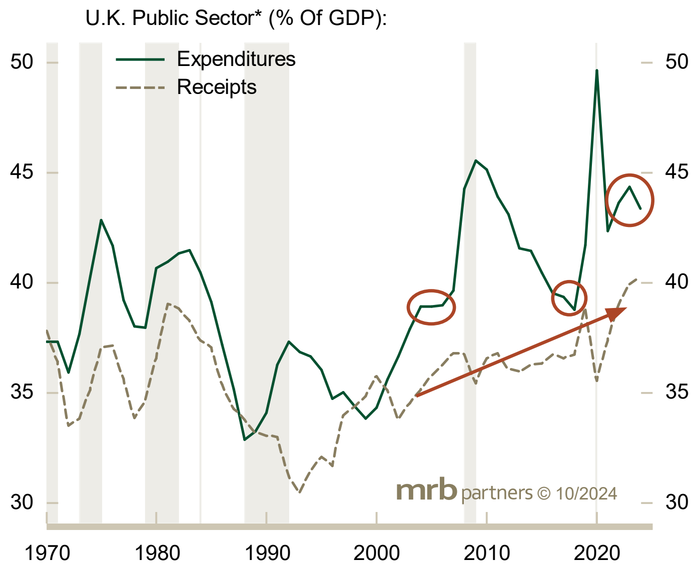
More significant tax and/or spending changes will be required to restore fiscal sustainability, with spending likely accounting for the bulk of the adjustment, barring much better economic growth than seems achievable (see below).

Public sector expenditures and revenues relative to GDP are high by historical standards (**chart 2**). Expenditures in the current fiscal year are projected to be approximately 44% of GDP, well above the level just prior to the pandemic and toward the upper range of the post-war period. Meanwhile, public sector receipts are projected to be 41% of GDP, the highest in more than four decades.

Spending

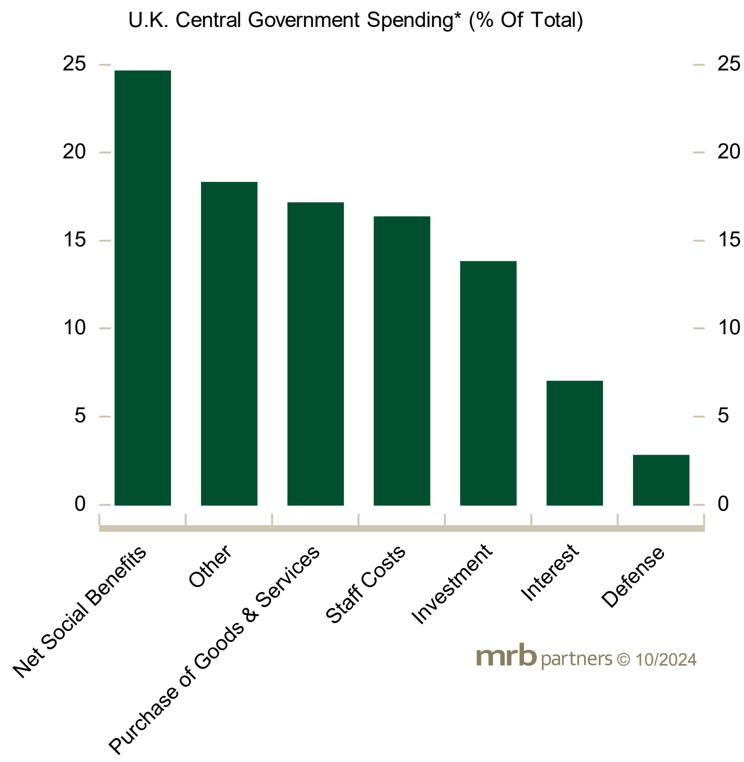
Public spending is dominated by outlays for social benefits, purchases of goods & services, and staff costs, which together comprise nearly 60% of the total (**chart 3**). Investment, interest and defense spending account for a large share of the remaining outlays, and are set to rise in the coming years.

Chart 2 **Historically High Spending And Taxes**



* Fiscal years; source: Office for Budget Responsibility
Note: Shaded for U.K. recessions

Chart 3 **Social Benefits The Largest Public Sector Cost**



* Fiscal year 2024/2025; source: Office for National Statistics

The austerity of the 2010s and the subsequent sharp rise are evident in select spending categories (**chart 4**). Central government purchases of goods and services were largely flat in ***real*** terms from 2010-2019, but are now some 15% above the immediate pre-pandemic level. A decade of stagnant real staff costs from 2005-2015, albeit after a huge surge in the early-2000s, has given way to a steady rise, only partly reflecting salary adjustments for many public sector employees. It will be difficult for a Labour government to press for job or salary cuts for public sector employees, but this appears to be an obvious source of cost savings.

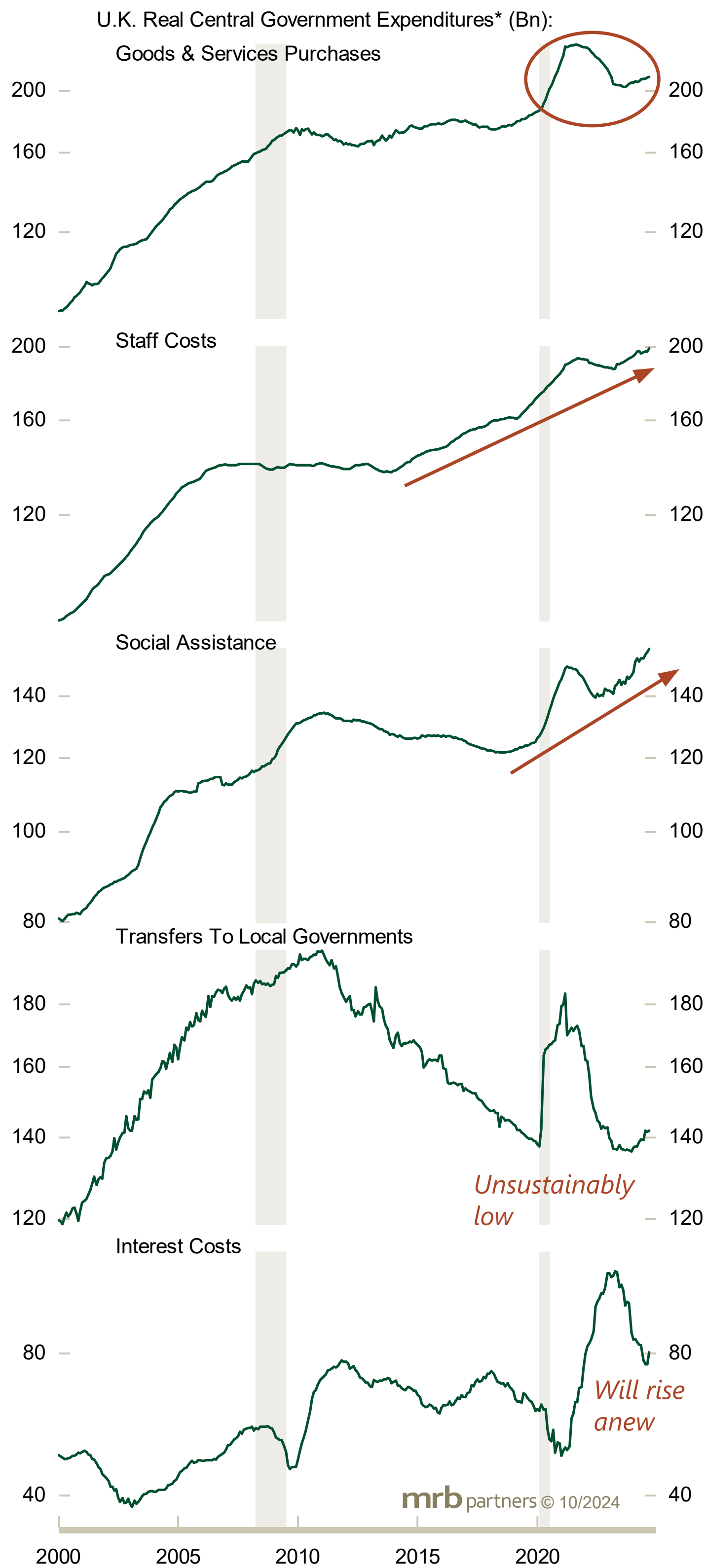
The increase in real outlays for social assistance since the start of the pandemic has also been pronounced, more than offsetting the protracted decline during the 2010s. Schemes to get people off public benefits and to, or back to, work, would produce moderate savings over the next few years, if the economic expansion is sustained. Such schemes have been repeatedly proposed in the past, without demonstrable success.

Conversely, there has been a dramatic decline in central government transfers to local governments over the past 15 years, albeit with a huge rise when the pandemic began. There is intense pressure on the new government to restore funding to local governments, several of which are in severe financial difficulty.

It is also noteworthy that central government interest costs have come down in real terms over the past year, which is misleading given the still rising level of debt and flat profile of gilt yields[4]. These costs will inevitably rise for the foreseeable future.

[4] The decline should be temporary and partly reflects an adjustment to the retail price inflation adjustment to inflation-linked bonds.

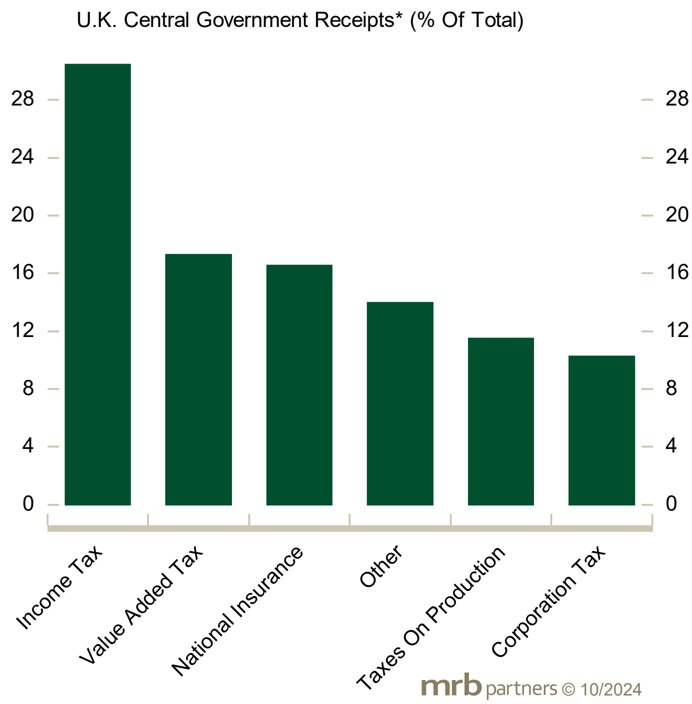
Chart 4 Key Spending Pressures Have Intensified



* 12-month rolling sum; deflated by CPI and rebased to latest month; source: Office for National Statistics
Note: All panels shown in log scale; shaded for U.K. recessions

Much of the emphasis of the Autumn Budget will be the need to increase public investment, which is widely agreed upon. That said, public sector investment as a share of GDP in both net and gross terms has been relatively steady since the Great Recession, and it is notably low in real terms (**chart 5**). Reeves will establish the dubiously-named "Office of Value for Money" department ostensibly to help ensure that increased capital outlays are invested wisely. A one percentage point of GDP increase in public sector investment is equivalent to approximately £28 bn and is not beyond the country's fiscal capacity, but a permanent lift will require cost savings elsewhere and must clearly show positive economic growth benefits, neither of which is a given.

Chart 5 **Income, VAT and National Insurance Taxes Dominate**



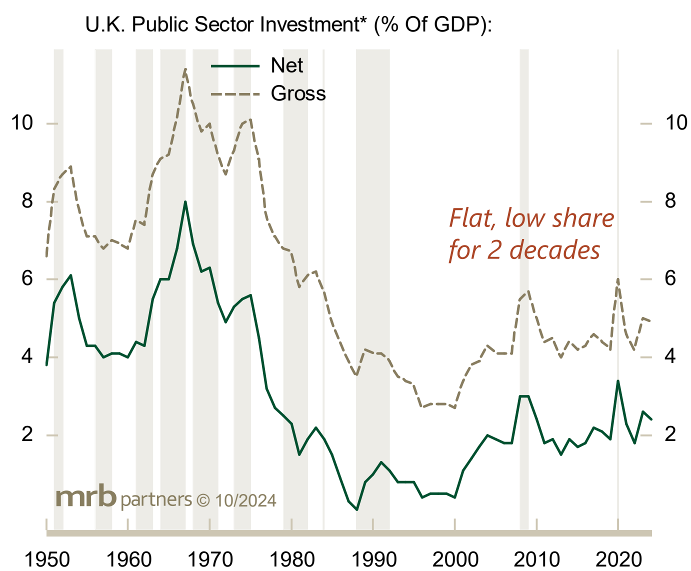
* Fiscal year 2024/2025; source: Office for National Statistics
Note: Taxes on production includes fuel, alcohol, excise and other duties

Receipts

With taxes already high, and the government pre-committed to not raising taxes on "working people", there is limited scope for significant new government receipts to strengthen the fiscal situation.

Income and value-added (VAT) taxes and national insurance contributions (NIC) are the largest sources of government revenue, collectively accounting for some 64% of the total tax and levy receipts (**chart 6**). Corporation taxes are approximately 10% of the total, with taxes on production (including fuel and other levies) accounting for approximately 12%.

Chart 6 **Focus On Increasing Public Sector Investment**



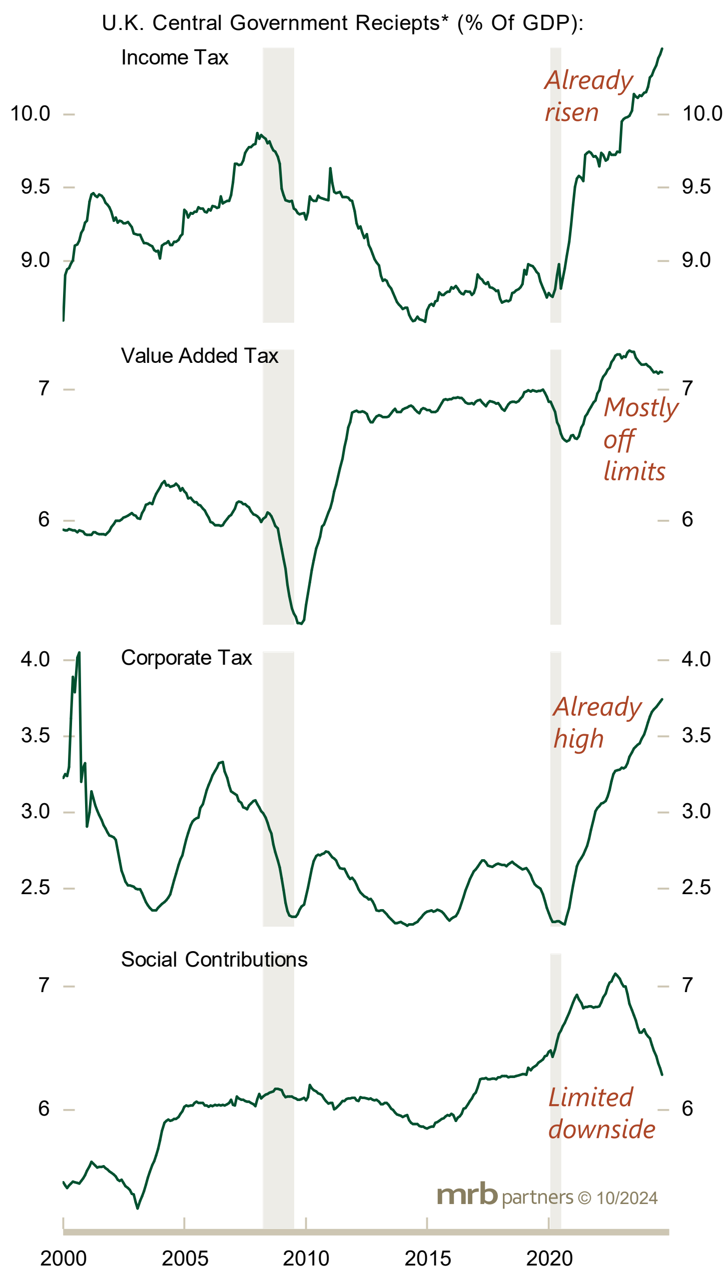
* Fiscal years; source: Office for Budget Responsibility
Note: Shaded for U.K. recessions

There have been dramatic changes in the composition of central government revenues in recent years (**chart 7**). Personal income taxes as a percentage of GDP have risen dramatically in the aftermath of the pandemic, after a pronounced decline during the first half of the 2010s. They are also well above the peak during the boom in the first-half of the 2000s. The profile is broadly similar for corporate tax receipts, albeit at a much lower level. Despite the Chancellor's determination to raise taxes on upper-income individuals and corporations, the already high levels relative to GDP suggest that only relatively modest increases are likely sustainable. Corporate taxes are highly cyclical and thus not reliable as a sustainable source of materially greater government revenue.

The government has ruled out any broad-based increase in VAT (mainly national insurance) although Reeves will increase the corporate component of national insurance contributions. Together, those are equivalent to approximately 13% of GDP and more roughly one-third of total tax receipts so any increase will be marginal[5].

Against a backdrop of an aging population, a significant need for public investment and struggling local governments, the upward pressure on spending will remain intense for the foreseeable future. The flipside is that finding additional resources will also be difficult, with taxes already historically high as a share of GDP. Tinkering at the edges might be useful, but more radical fiscal surgery eventually will also be required absent a significant and sustained increase in economic growth.

Chart 7 Limited Scope For Tax Hikes



* 12-month rolling sum; source: Office for National Statistics
Note: Shaded for U.K. recessions

Bringing Down The Debt Ratio Requires Faster Growth

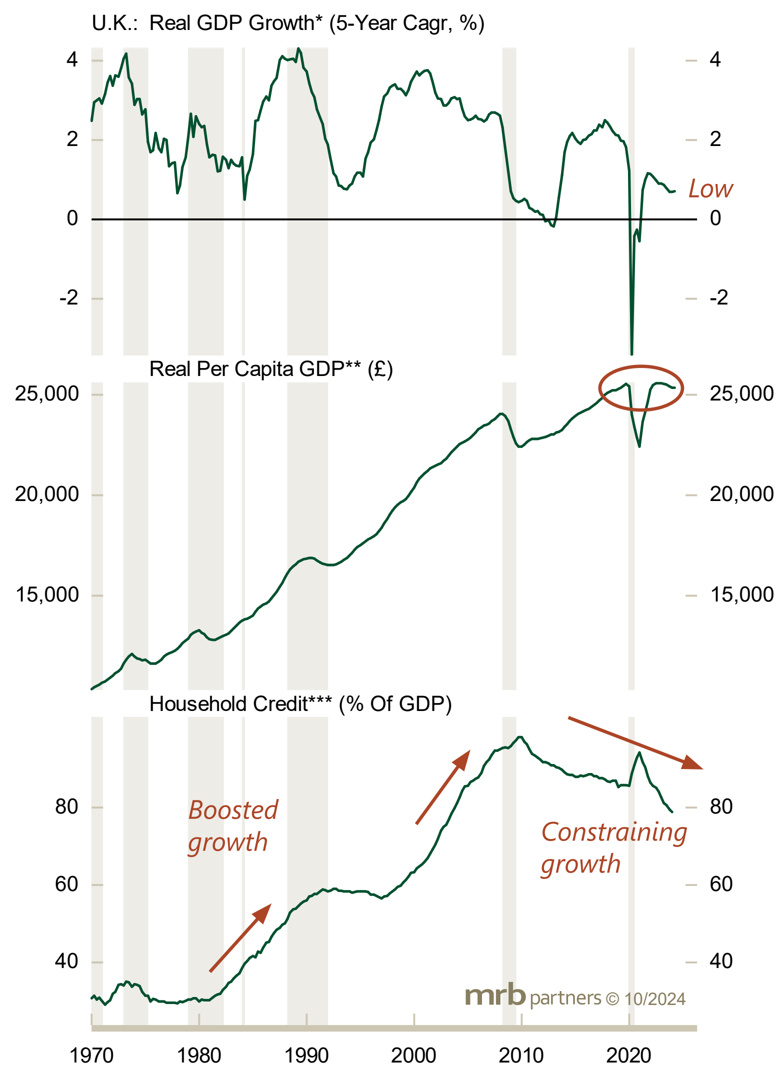
In the end, faster trend GDP growth is critical to restoring the U.K.'s long-run fiscal stability. Greater public investment should play a role, but revitalizing private sector dynamism is the biggest challenge, especially in the aftermath of Brexit.

[5] The VAT could be expanded to include some additional services (e.g. on private school fees starting January 1, 2025), but the impact would likely be modest.

U.K. economic growth has been lackluster in the aftermath of the pandemic and since the Great Recession in 2008-2009 (**chart 8**). Over the past five years, real GDP growth has been an anemic 0.7% annually and real per capita GDP is unchanged, which has undermined the fiscal position and public confidence in the government. The OBR estimates that potential real GDP will grow by about 1.7% annually over the next five years. Such an outcome is not a stretch, but is slightly above the estimate that underpins our long-term returns for U.K. equities and bonds[6].

In gauging the economic growth outlook and implications for net financial liabilities, it is important to recognize the role of credit over the past several decades. U.K. real GDP and real GDP per capita rose sharply during the 1980s and from 2000-2008 on the back of massive, and ultimately unsustainable, increases in household debt relative to GDP. While the household sector deleveraging of the past 15 years may moderate, consumer spending growth will not be able to catalyze materially stronger real GDP growth in the medium term.

Chart 8 **Tepid Growth Is A Problem**



* Source: Office of National Statistics
** Local currency; current prices
*** Source: Bank for International Settlements
Note: Shaded for UK. recessions

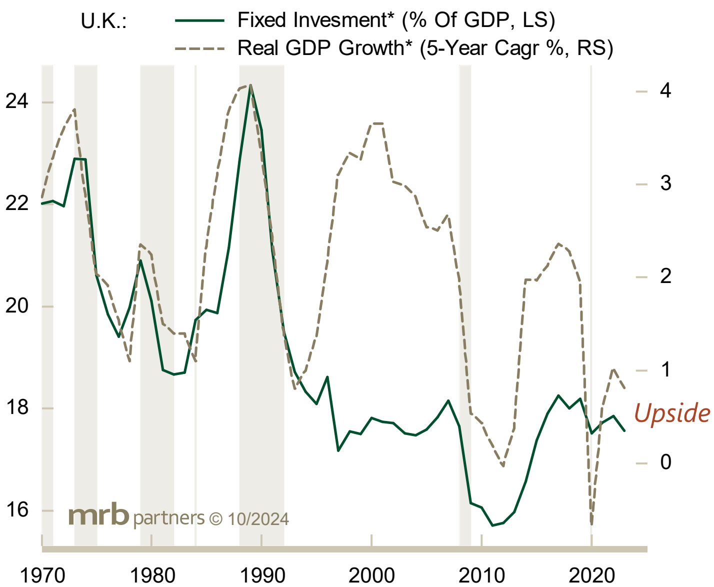
Compounding the challenge is that exports, which account for nearly one-third of GDP, have disappointed in recent years and will likely continue to be constrained in the aftermath of Brexit.

Augmenting public sector investment has merits

From this vantage point, augmenting public sector investment has merits if done properly, especially if it also helps catalyze private investment, which is historically low (and low relative to that in other G7 economies). Past upcycles in fixed investment have generally correlated with stronger underlying real GDP growth, in a self-reinforcing manner (**chart 9**). It remains to be seen whether an increase in public sector investment will spur a rise in national investment.

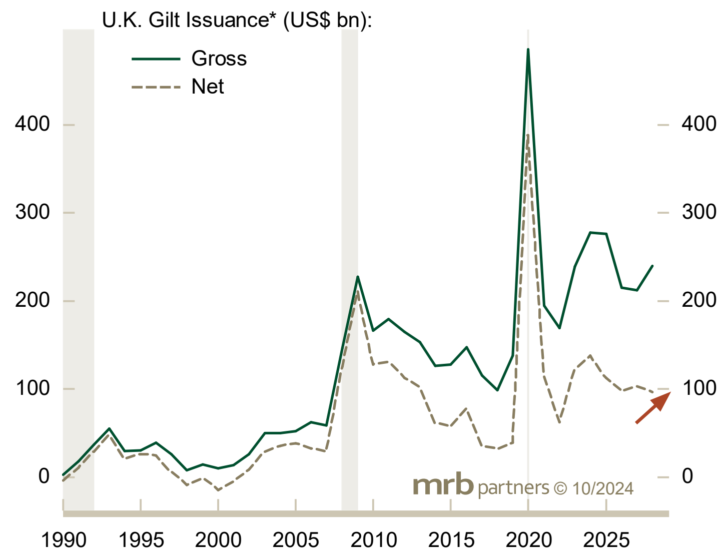
[6] **MRB**: "***Long-Term Returns: A Reckoning Is Inevitable***" May 30, 2024

Chart 9 Stronger National Investment Needed



* Source: Office of National Statistics
Note: Shaded for UK. recessions

Chart 10 Ever More Debt To Absorb



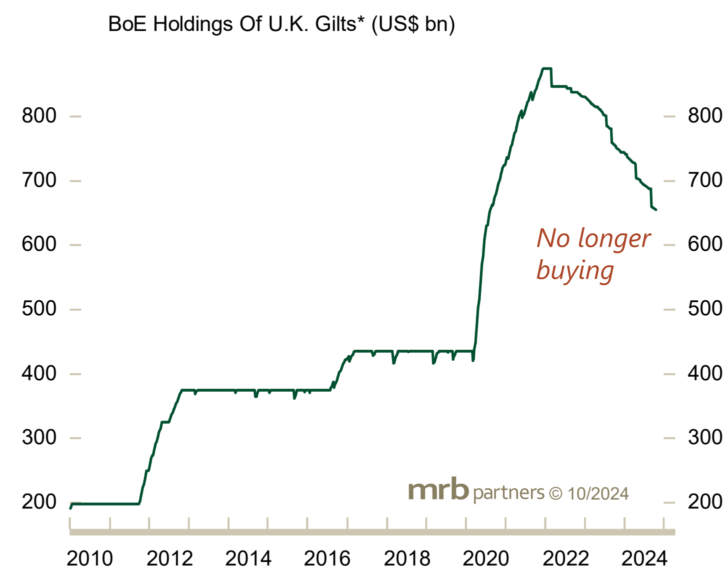
* Includes forecasts; source: U.K. Debt Management Office
Note: Shaded for U.K. recessions

Bond Investors Are The Final Arbiter Of Fiscal Policy

As former prime minister Truss discovered to her dismay, the market rather than any specific mandates or the imprimatur of the OBR is the ultimate arbiter of fiscal policy.

The additional borrowing capacity from the change in the fiscal mandate will significantly add to the burden of domestic and/or foreign investors to absorb government debt. Net gilt issuance for the fiscal year to next March was previously projected to be £138 bn, with an average of approximately £100 bn in the subsequent four years, based on the last OBR budget forecasts (**chart 10**). Those will rise once the OBR updates its projections following the Autumn Budget.

Chart 11 BoE Demand Will Need To Be Replaced



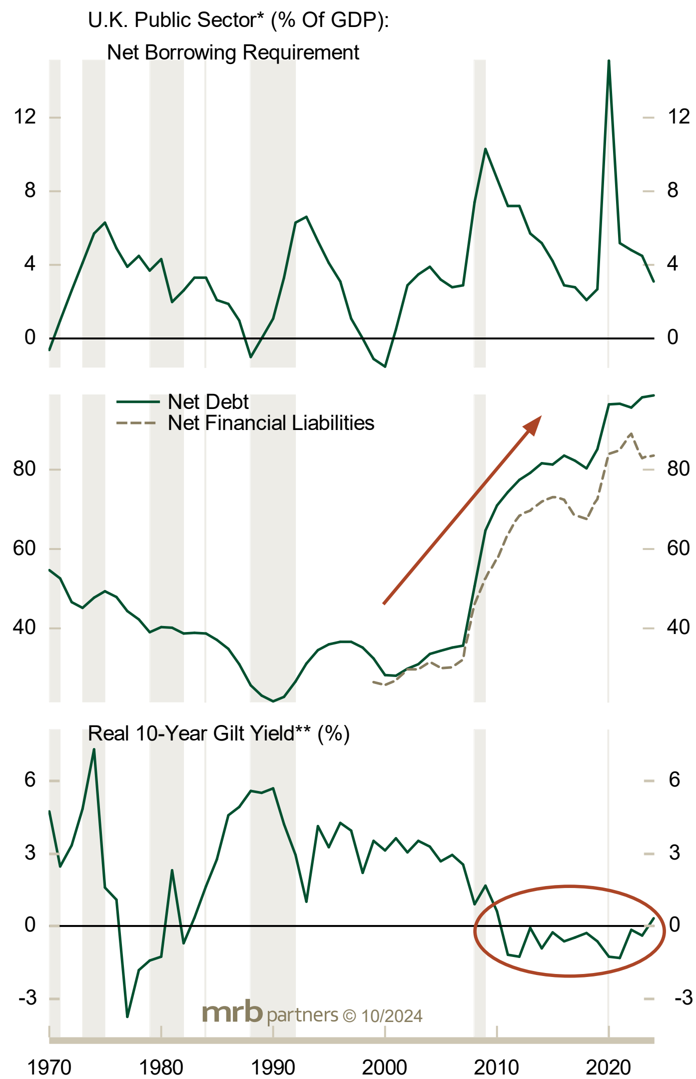
* Under the Asset Purchase Facility; source: Bank of England

The ongoing decline in BoE holdings of gilts increases the burden on the private sector to absorb new government bond issuance. BoE holdings have declined by approximately £200 bn over the past three years as the use of the Asset Purchase Facility winds down following the pandemic (**chart 11**).

Moreover, because it runs a chronic current account deficit, the U.K. government is also dependent on foreign funding to complement gilt purchases by domestic investors.

While the ongoing budget deficit and rising debt pose potential risks to gilts, there is no clear historical relationship between the ***near-term*** fiscal outlook and real bond yields, and we do not expect the fiscal position to be the primary driver of gilt yields in the next 6-12 months, with BoE policy and the global backdrop implying looming challenges (**chart 12**).

Chart 12 No Clear Link Between Debt And Yields



* Fiscal years; source: Office for Budget Responsibility
** Nominal yield minus CPI inflation rate; smoothed; source: Bloomberg

A Challenging Year Looms For Gilts

An anticipated rise in U.S. and global bond yields in the year ahead points to a challenging climate for gilts. Periodically, there could be added upward pressure on gilt yields given the inherent uncertainty about the implications of U.K. fiscal policy for short- and long-term inflation and economic growth.

Our base-case scenario is that over the next year the Fed will cut interest rates less than markets are currently expecting (**chart 13**). If so, that would imply that the BoE would follow suit, especially if the U.K. economy firms in the year ahead, as we anticipate. As we have argued, given the economic backdrop, the BoE has greater capacity to cut interest rates in the next year than the Fed[7]. Still, it will be difficult to diverge directionally with the Fed unless the U.K. economy weakens rather than firms in the next 6-12 months.

We expect higher gilt yields, but the odds of another "Truss" spike are low

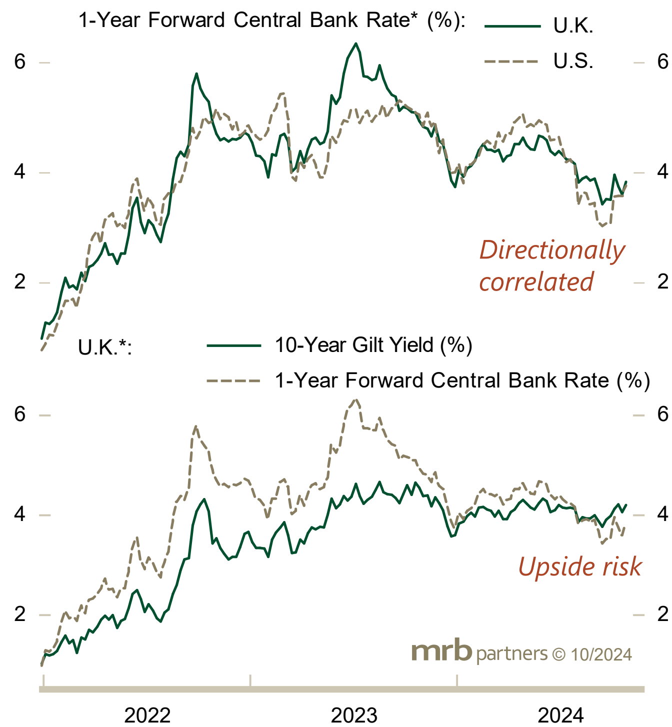
Any upside to BoE rate expectations would exert upward pressure on gilt yields, albeit will likely be offset by at least somewhat better economic growth. Despite the upside risks to gilt yields, we view the probability of another "Truss" spike as low absent an external shock or some other self-inflicted action.

[7] **MRB**: "*Divergence Re-Emergence: Opportunities In Regional Bond Markets*" October 1, 2024

Final Word: *The Autumn Budget will provide few surprises with Chancellor Reeves already having laid out many of the main elements. The shift in the fiscal target to the public sector's net financial liabilities from net debt may provide her additional borrowing capacity for investment, but it will simultaneously increase the gilt supply that the private sector will have to absorb. Ultimately, that shifts the supply-demand balance for gilts less favorably and toward higher yields. Whatever the fiscal target, the bond market will be the final arbiter of fiscal sustainability, which is uncertain given the already high tax levels and demand for increased public services. We expect gilt yields to rise modestly over the course of the next year, albeit less than in the U.S.*

Peter Perkins
Partner, Global Strategy

Chart 13 Can The BoE Diverge From The Fed?



* Source: Bloomberg

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London
24 Old Bond Street, 3rd Floor,
London, W1S 4AP, United Kingdom
Tel (+)44 (0) 20 3523 9618

Montreal
1275 Ave. des Canadiens-de-Montréal, Suite 500
Montreal, Quebec H3B 0G4, Canada
Tel +1 514 558 1515

New York
1345 Avenue of the Americas, FL 2
New York, NY, 10105, United States
Tel +1 212 390 1148

For more information, please contact:
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clientrelations@mrbpartners.com

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