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The headroom bind:

Spring Statement 2025 preview

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Summary

The outlook for the economy has deteriorated since the Autumn Budget:

- In the short term, GDP is 1.2% weaker than expected, and the pace of employment falls points to a recession
- Inflation has proved stickier, with consumer prices around 0.4% higher than expected at the start of the year

This, combined with higher interest rates and weaker tax receipts, likely means headroom has been wiped out

The Chancellor should act decisively to meet the rules given the risk of rising borrowing costs

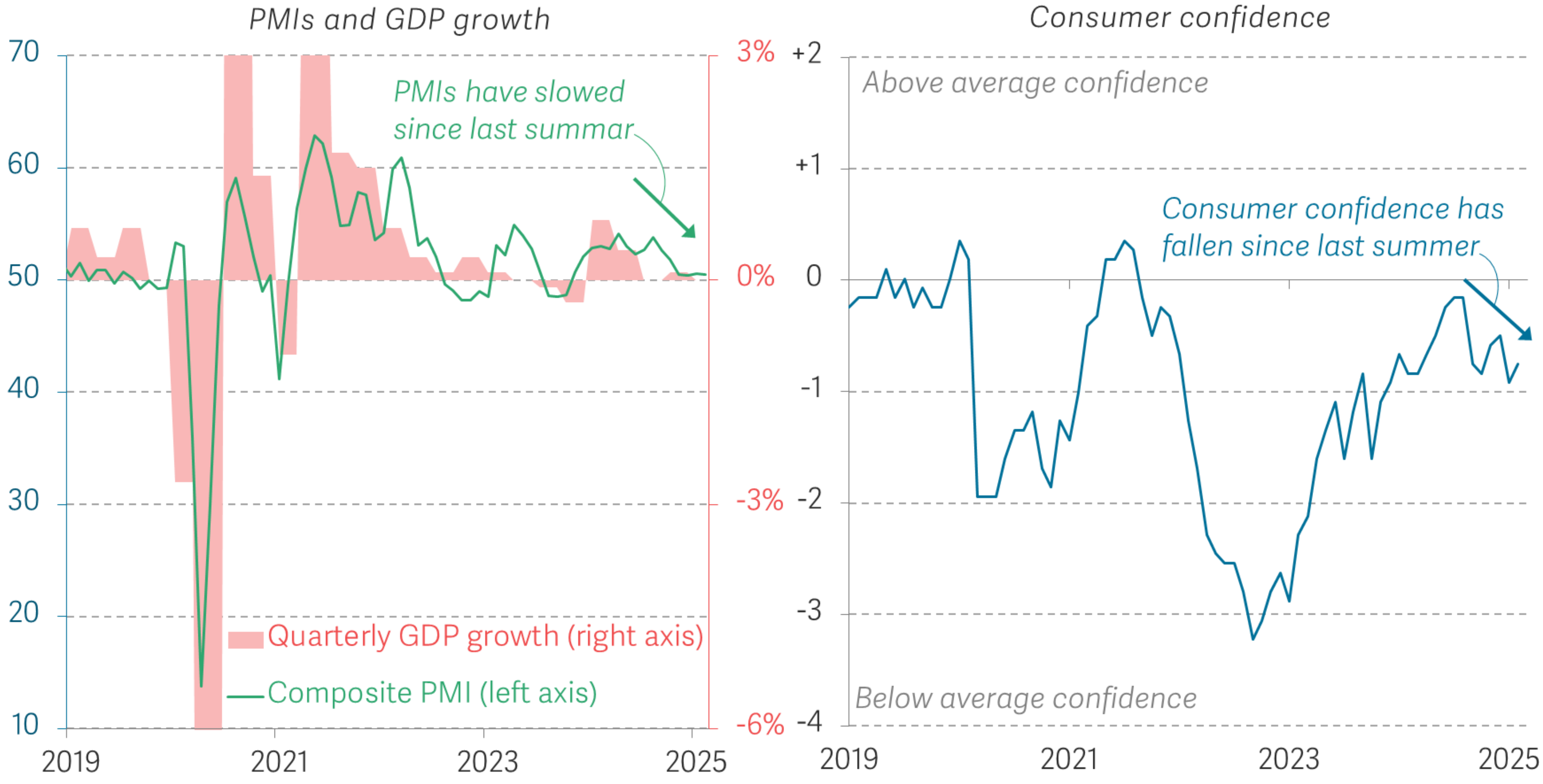
- This can be done by cutting spending on public services or welfare, or raising taxes
- The Government's approach appears to be to make straightforward cuts to Personal Independence Payment (PIP), which is paid regardless of income, by around £5 billion in 2029-30
- History tells us that rushed savings exercises in this area rarely achieve desired savings. 70% of cuts would fall on the poorest half of families with very large income losses for those deemed ineligible.
- With cuts to 'unprotected' departmental budgets of £10 billion already planned, and pressures to spend more than 2.5% of national income on defence, further spending reductions would be tough to deliver
- Tax rises should not be ruled out – extending threshold freezes is a progressive way to raise revenues that is consistent with manifesto promises

The Government should double down on efforts to increase growth by announcing new policy to boost business dynamism

The economic outlook has deteriorated

Growth and confidence have declined since the election

Composite Purchasing Managers Index (50 = no change on previous month) and quarterly GDP growth, left-hand panel, and consumer confidence (standard deviations from long-run mean), right-hand panel: UK



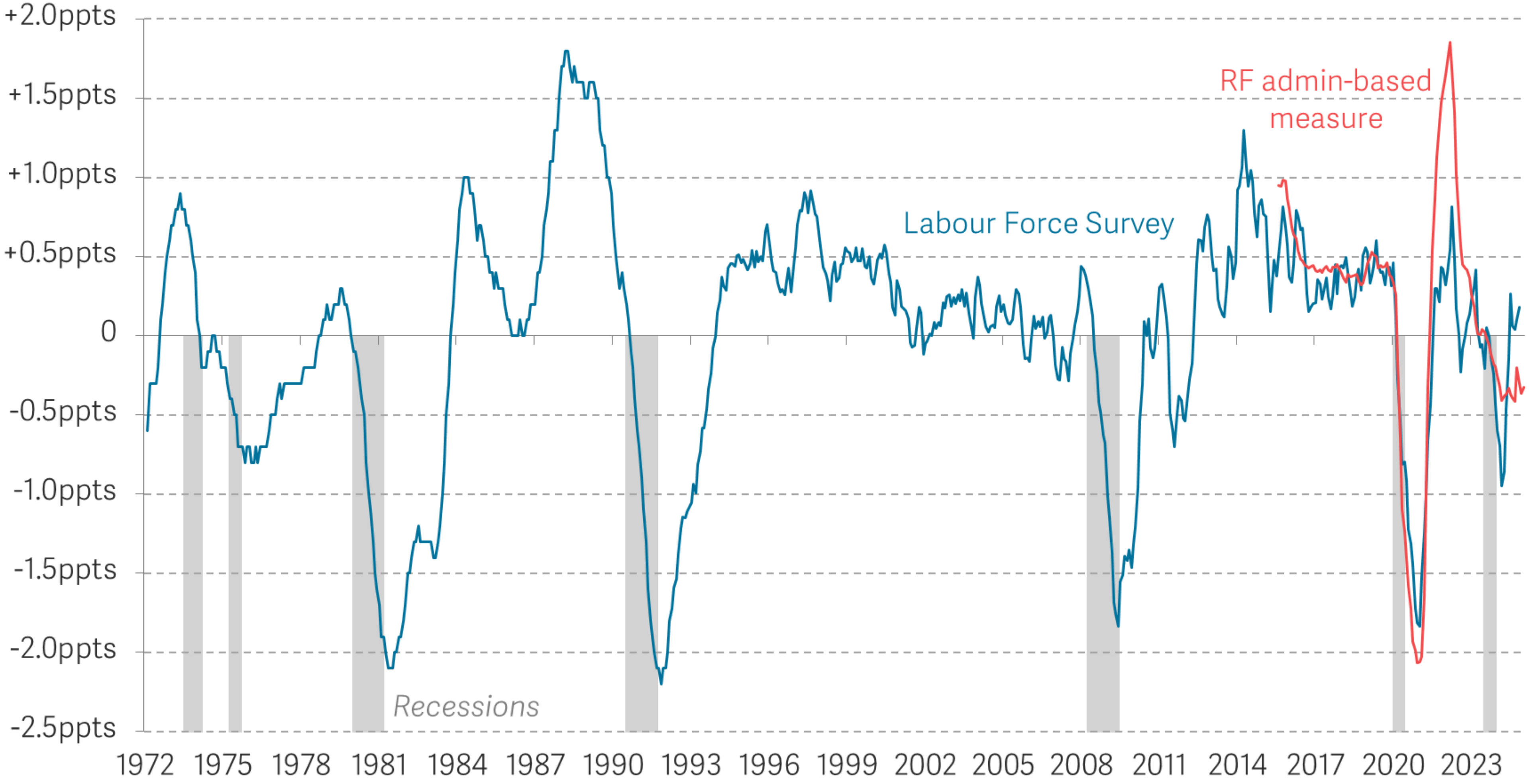
GDP growth has fallen from being the fastest in the G7 in Q1 2024 to being the among slowest by Q4

This slowing appears genuine given weaker indicators of economic activity (PMIs) and consumer confidence

Notes: Prior to 2018, consumer confidence data is sourced from Eurostat and is seasonally adjusted. From 2018 data is sourced from GfK and is not seasonally adjusted. Chart shows number of standard deviations from the series long-run average (since 1985). Source: RF analysis of GfK; Eurostat; and S&P Global, PMI.

And the labour market is in recession territory

Rolling 12-month change in 16+ employment rate: UK



Based on RF's admin-based measure, the number in employment fell by 0.5% in the year to January – a level only seen during recessions

This is consistent with the message from employment surveys

Notes: Latest LFS data point is the year to Oct-Dec 2024. Latest admin-based data point is the year to January 2025, using 'flash' RTI data. For recent population growth we use the ONS's 'migration category variant' population projection.
Source: ONS, Summary of labour market statistics, February 2025; RF analysis based on ONS Earnings and employment from Pay As You Earn Real Time Information, HMRC Income of individuals with self-employment sources, ONS National population projections: 2022-based.

Inflation is set to be higher than the OBR expected in October

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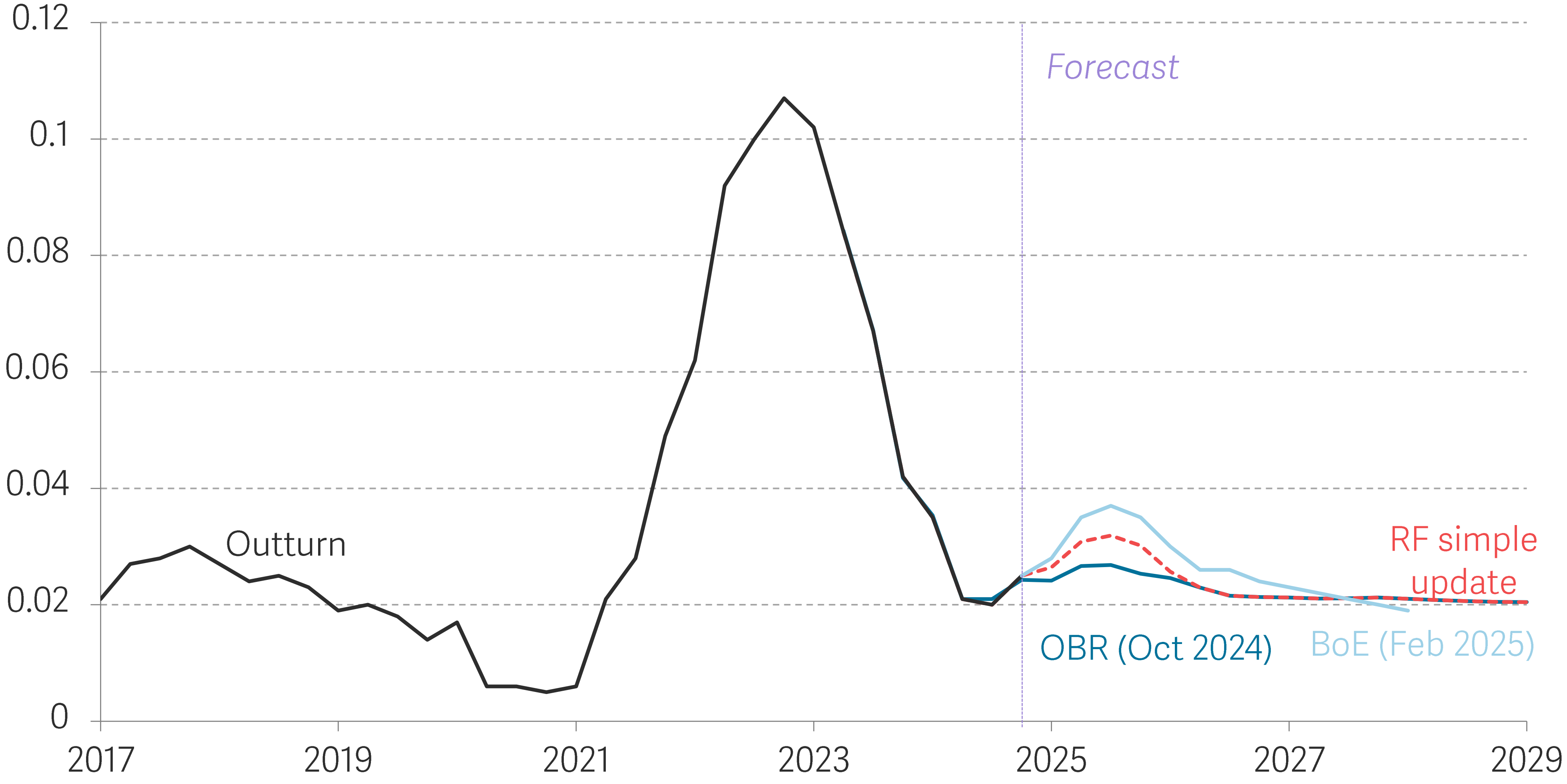
Outturn and forecasts for CPI inflation from the OBR and Bank of England: UK



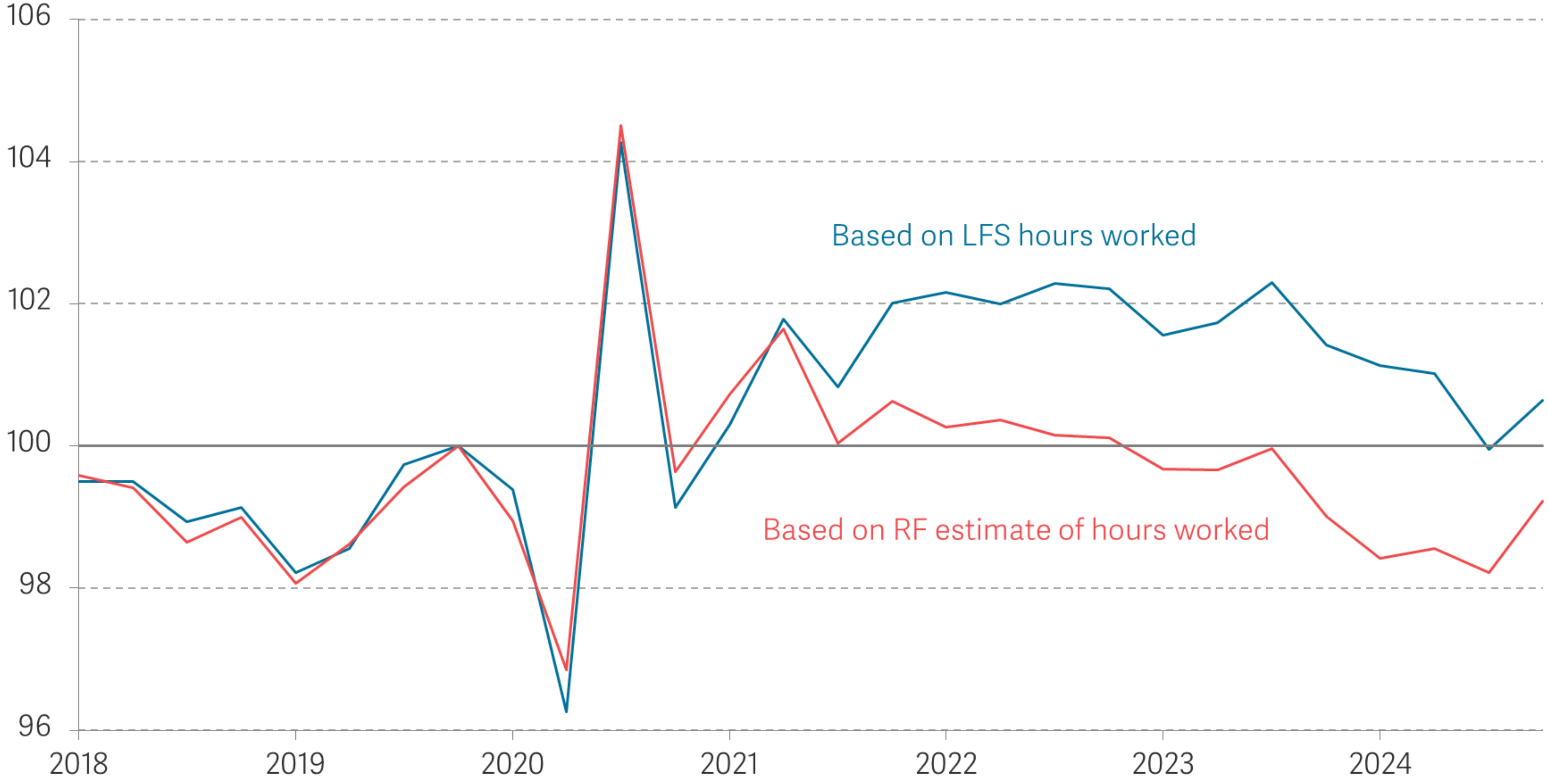
The OBR expected CPI inflation would be 2.4% in Q1 2024, but the latest BoE forecast is for 2.8%

Even though energy futures prices have fallen somewhat since the BoE forecast, a simple update of the OBR projection suggests the price level will be 0.5% higher than it expected in October by the end of this year

Source: OBR, Economic and Fiscal Outlook, various; Bank of England, Monetary Policy Report, November 2023; ONS, Consumer Price Inflation.

Productivity data continues to be dire

Indices of GDP per hour, by source of hours data (Q4 2019 = 100): UK



Source: RF analysis of ONS, National Accounts, Labour Force Survey, Workforce jobs & PAYE RTI; HMRC, Income of individuals with self-employment sources.

Productivity is now estimated to have flatlined since the pandemic based on Labour Force Survey data

But correcting for under recording using RF estimate of hours worked suggests the picture is even worse

We don't expect the OBR to reduce trend productivity forecasts

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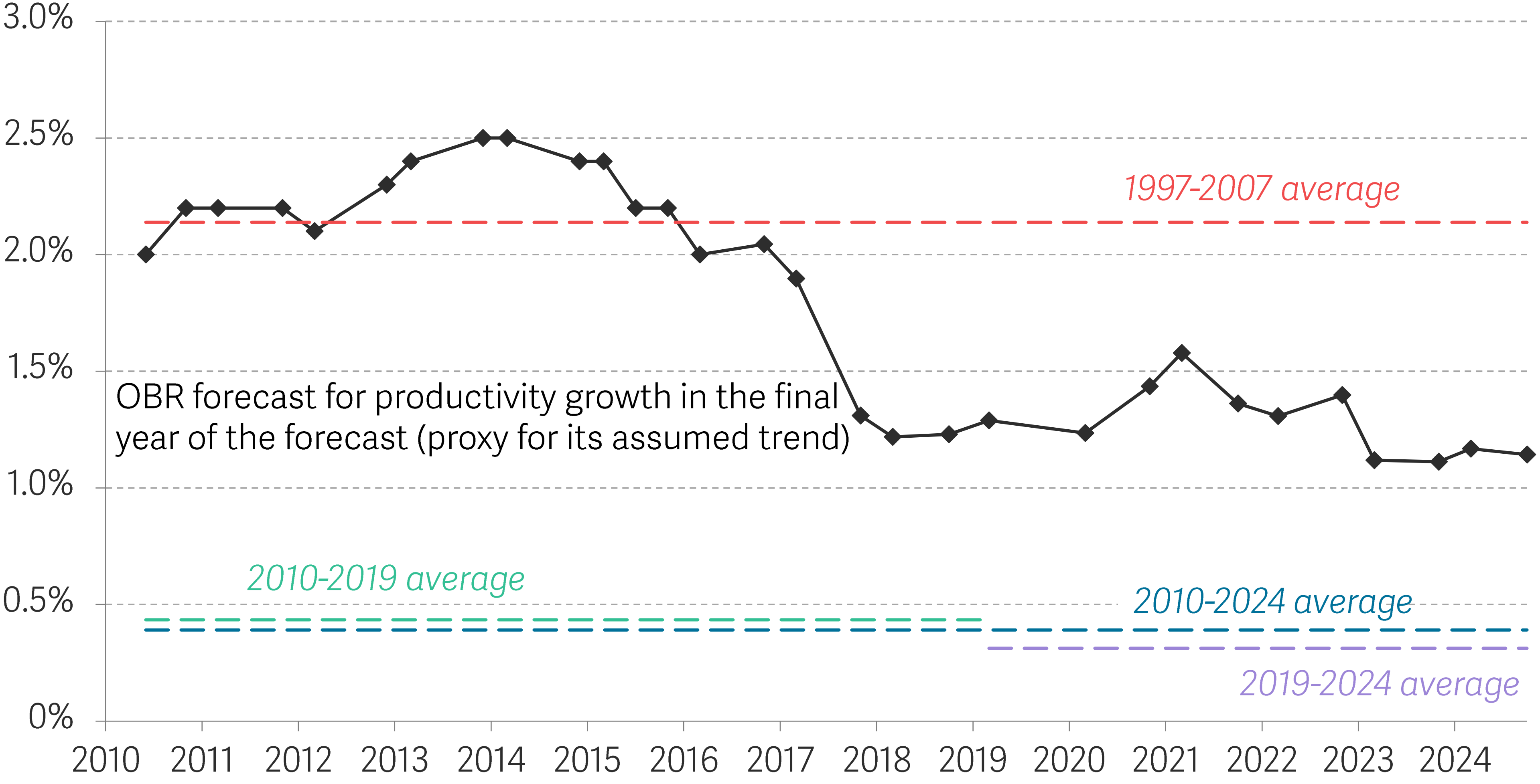
Annual growth in output per hour, historical averages and OBR forecasts: UK



Source: RF analysis of OBR, Historical forecast database & Economic and fiscal outlook, various; and ONS, National Accounts and Labour Force Survey.

There is a key decision for the OBR about whether it marks down **trend productivity growth**

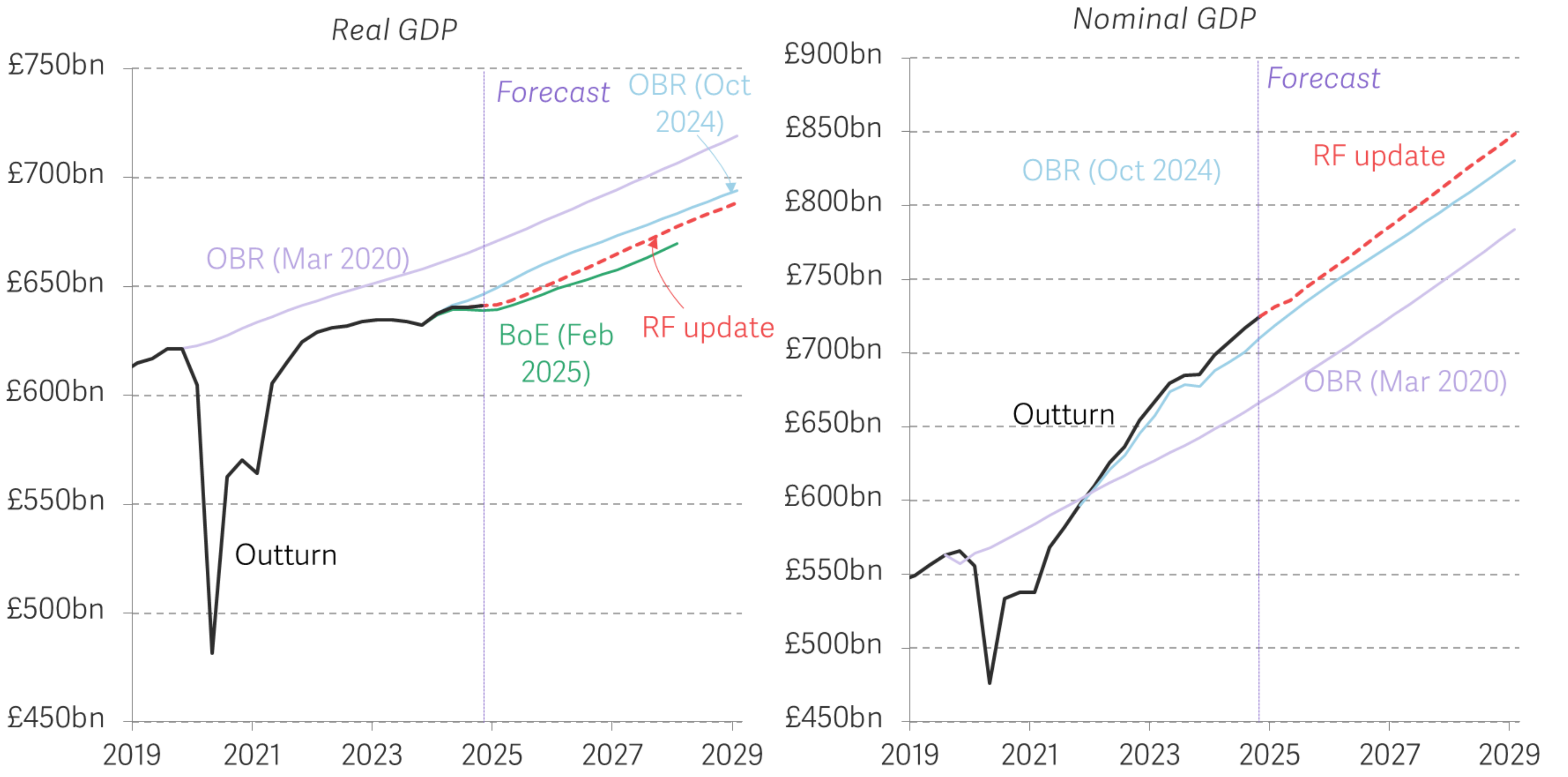
This would be a huge change: 0.2ppts reduction increases borrowing by ~£17bn

Given data uncertainty, <u>we don't expect the OBR to change its trend assumption this time</u>…

…<u>but we expect the OBR to treat recent economic weakness as a hit to the level of supply</u> given weak higher inflation and weak productivity

We expect the OBR to mark down its real GDP forecast…

Real GDP (left panel) and nominal GDP (right panel), outturns and Bank of England and OBR forecasts: UK



Real GDP is set to be around 1.2% weaker by Q1 2024 than the OBR's October forecast

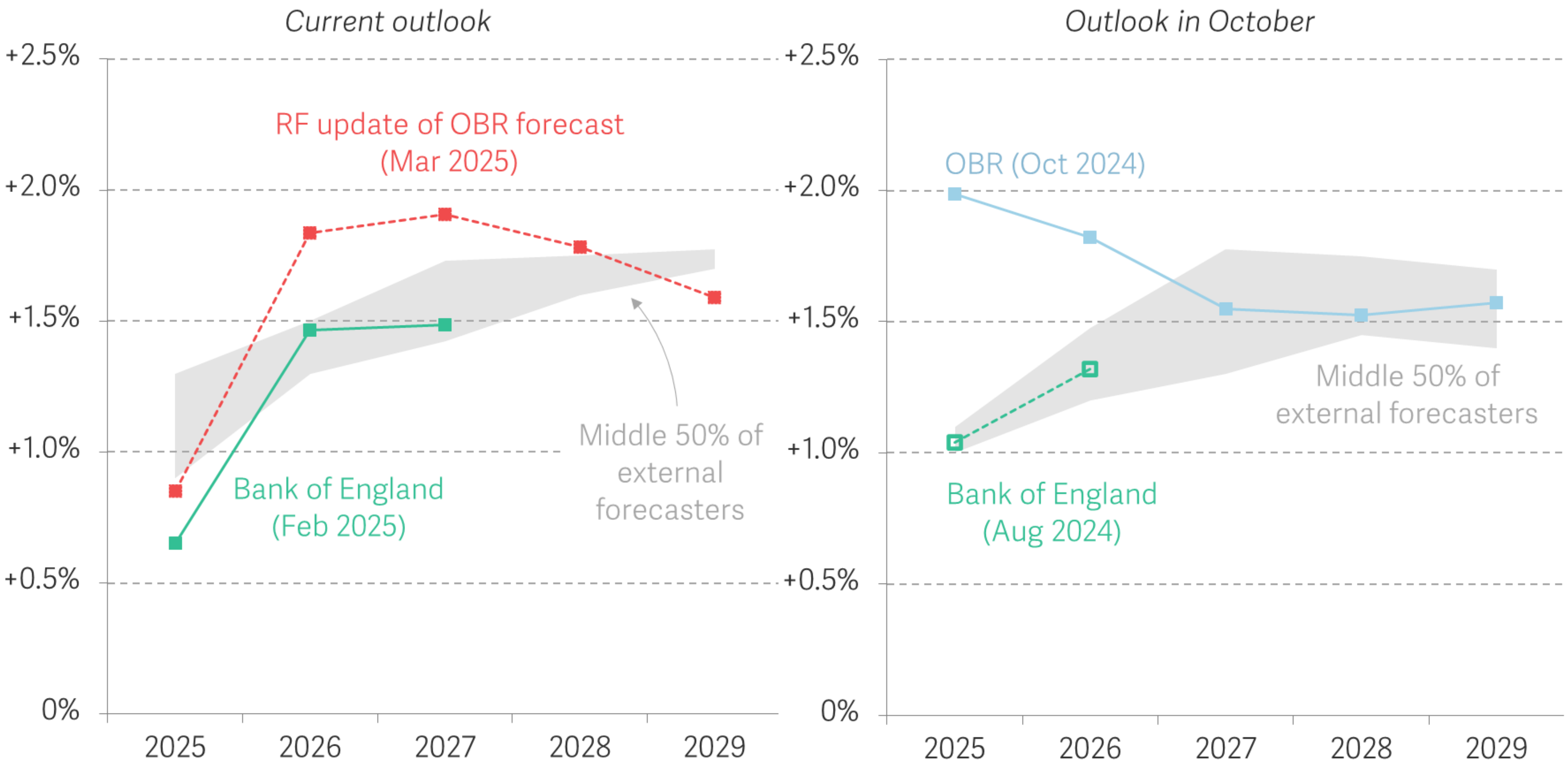
We expect the OBR to mark down the level of real GDP by around the same amount by the end of the forecast period, given signs of weaker supply

Nominal GDP has been revised up, but we expect little change to the OBR's forecast for growth over the next 5 years

Notes: All real measures are rebased and re-referenced to 2022.
Source: RF analysis of ONS, National Accounts; Bank of England, Monetary Policy Report, various; OBR, Economic and Fiscal Outlook, various.

…but this would leave OBR still at the optimistic end of forecasters

Forecasts for annual real GDP growth: UK



Our simple update of the OBR's October forecast points to weaker near-term growth than at the Autumn Budget

This would be consistent with it remaining one of the most optimistic forecasters for 2026, 2027 and 2028

Notes: External forecasters are those collated by HM Treasury. In 2025 and 2026, the swathes shown only include forecasts made within three months of the relevant forecast iteration. For later years, swathes include all forecasts. The IMF's medium-term forecast has been added manually from the October 2024 WEO database.
Source: RF analysis of OBR, Economic and Fiscal Outlook, various; HM Treasury, Forecasts for the UK Economy, various; Bank of England, Monetary Policy Report, various; and IMF, October 2024 WEO database.

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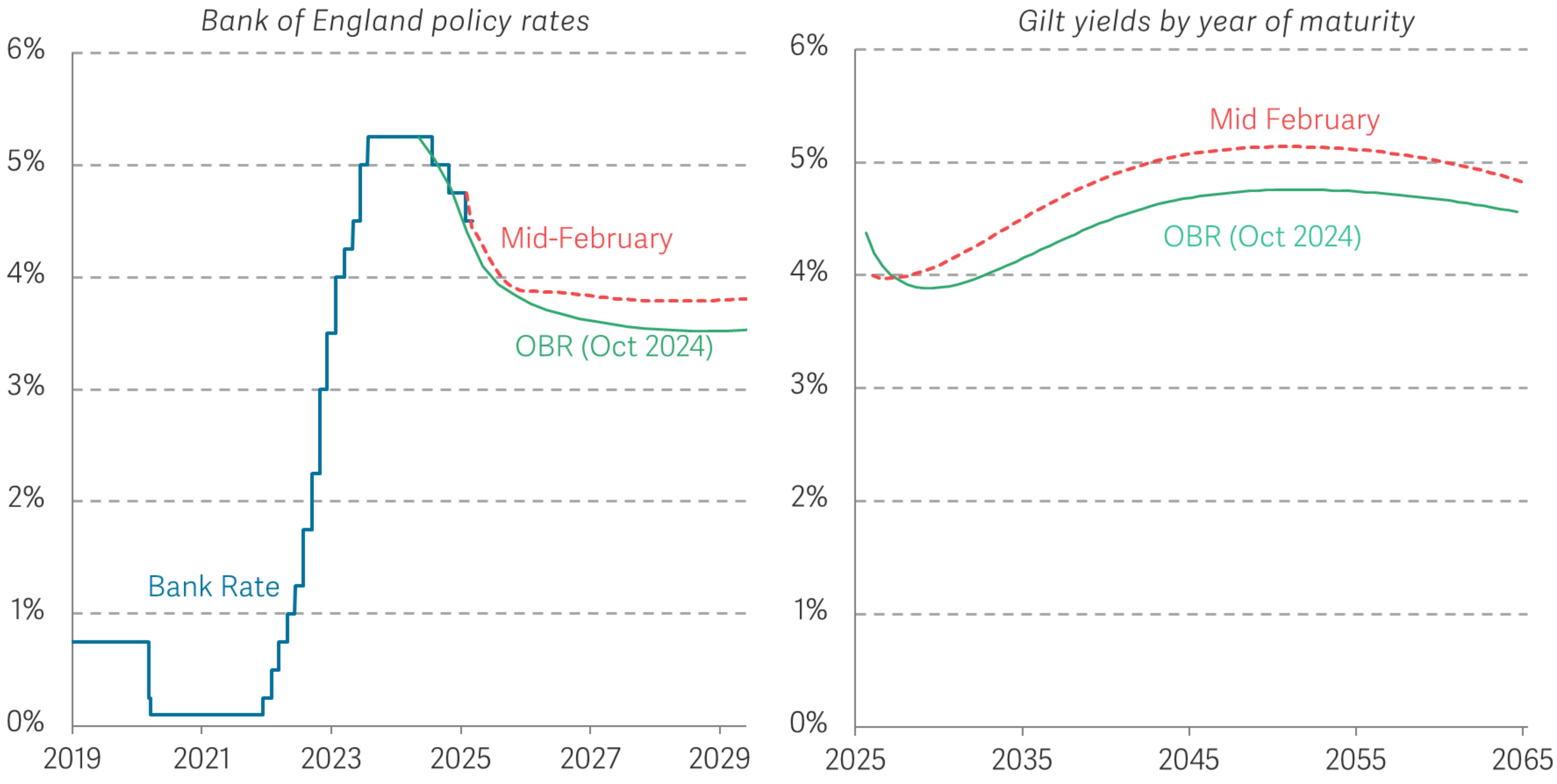
Headroom is likely to have been wiped out

Interest rates are higher than expected

Bank of England policy rate and market expectations (left panel) and gilt yields by year of maturity (right panel): UK



Given signs of weaker supply side and higher inflation, short- and longer-term interest rates are 0.25-0.5ppts higher than the OBR forecast

This partly reflects the impact of the Budget itself but also broader global trends

Notes: Mid February rates refers to an average of the rates prevailing between 5 February and 18 February.
Source: Bank of England, Yield Curves & Market Participants Survey; and OBR, Economic and Fiscal Outlook, October 2024.

Receipts are slightly weaker than expected

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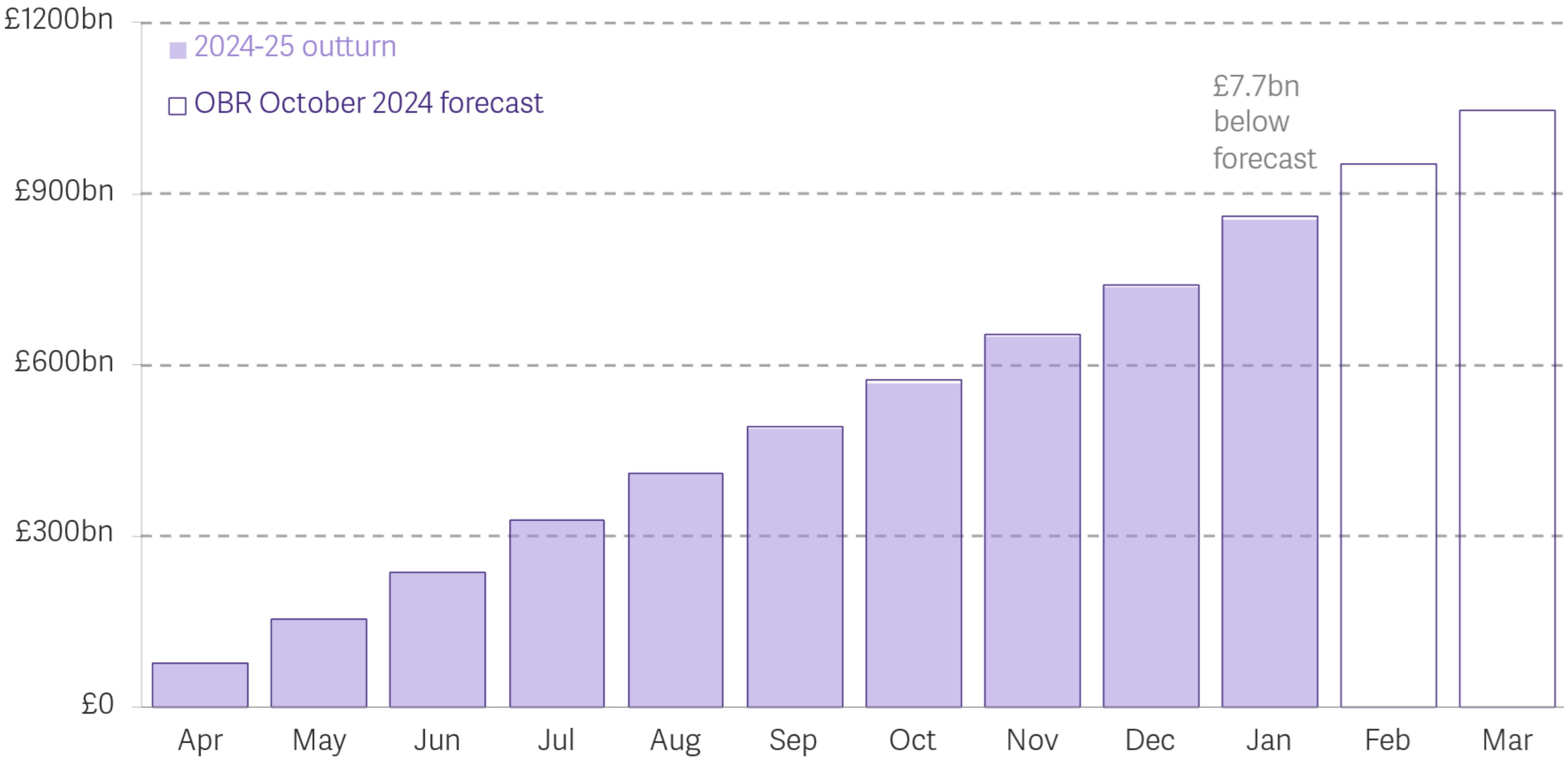
Cumulative central government receipts in 2024-25, outturn and October 2024 forecast



Tax receipts are running £7.7bn below forecast for the first 10 months of 2024-25

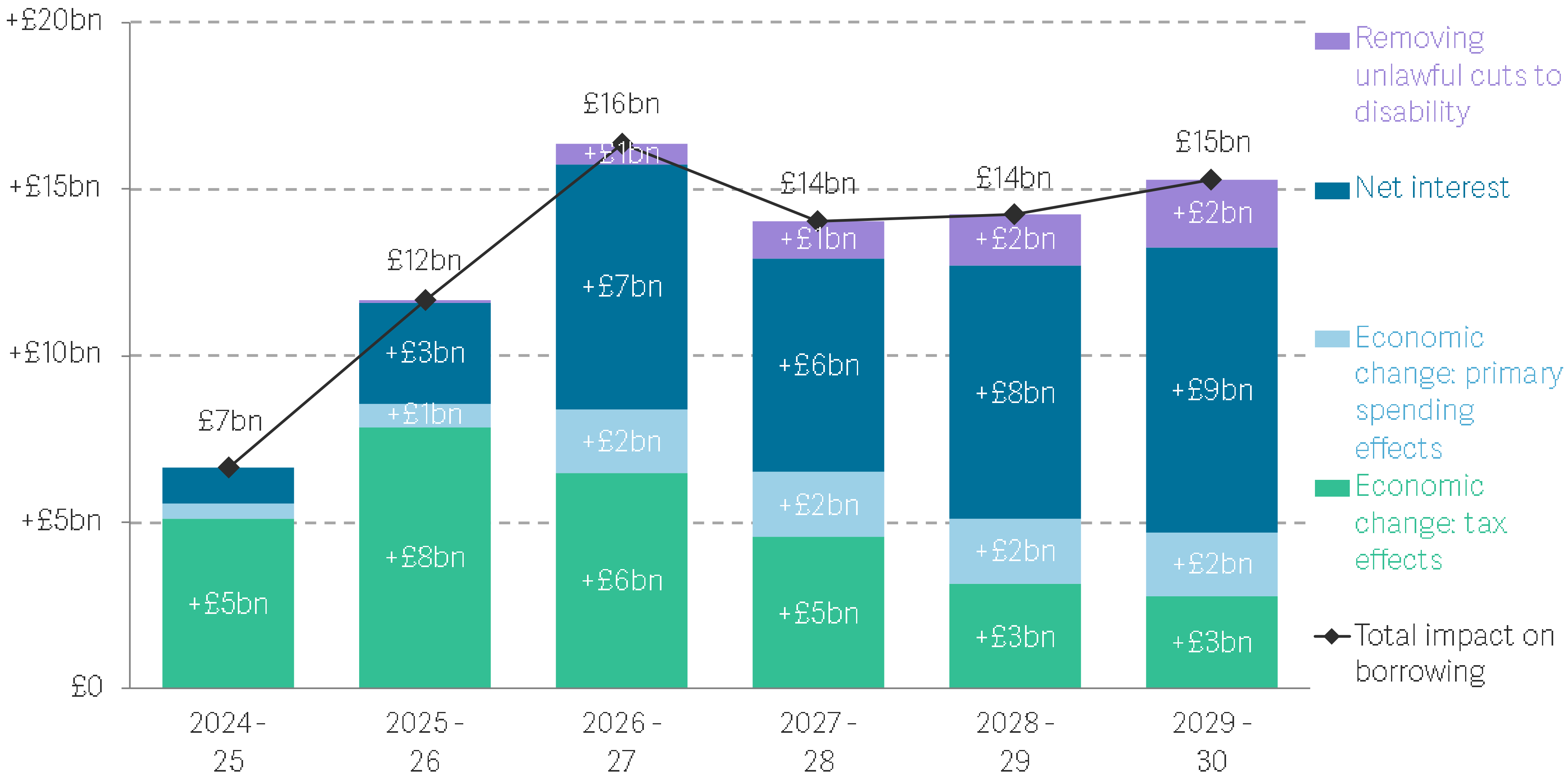
Some of this is explained by weaker than expected economy…

…but there appears to be additional weakness which we expect the OBR will forecast to continue

Source: RF analysis of ONS, Public Sector Finances; OBR, Economic and Fiscal Outlook, October 2024.

Higher interest rates are the main driver of higher borrowing

Impact of revised forecast on public sector borrowing, £ billion



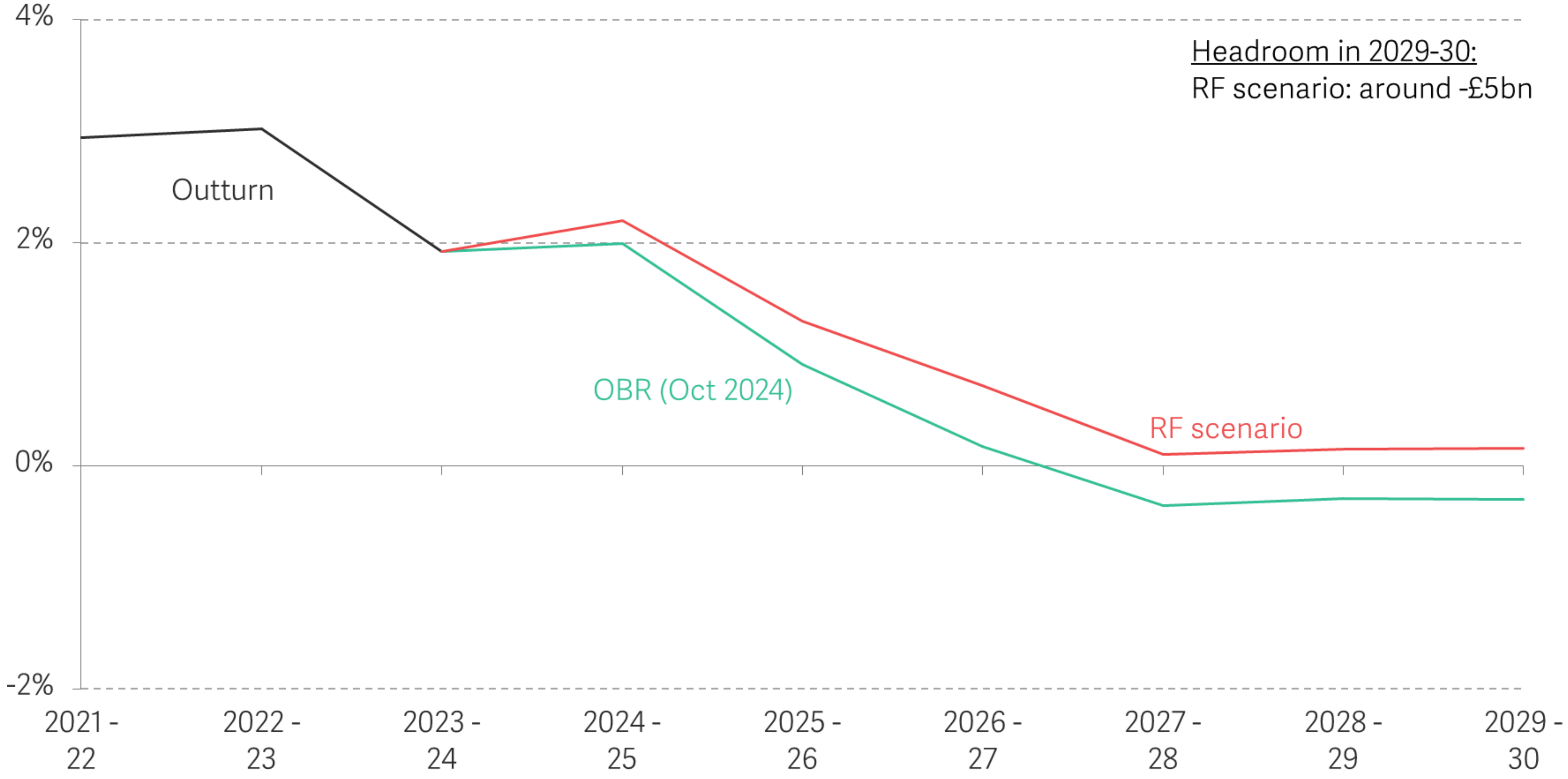
A worse economic outlook, higher interest rates, the impact of higher inflation on welfare spending and lower tax receipts (plus the removal of disability cuts the process for which was ruled unlawful) mean the OBR is likely to forecast higher borrowing in its spring forecast

We estimate borrowing will be roughly £15bn higher by 2029-30

Notes: Components may not sum to total because of rounding.
Source: RF analysis of OBR.

This would leave a current deficit of around £5 billion

Public sector current budget deficit, as a share of GDP: outturn & forecast



Source: RF analysis of OBR, Economic and Fiscal Outlook, October 2024.

The worse outlook is estimated to more than wipe out headroom against the Government's binding 'current balance' target

Absent policy changes, we estimate that the OBR forecast will be for a current deficit of around £5bn

Meeting the fiscal rules is key, but headroom is less important

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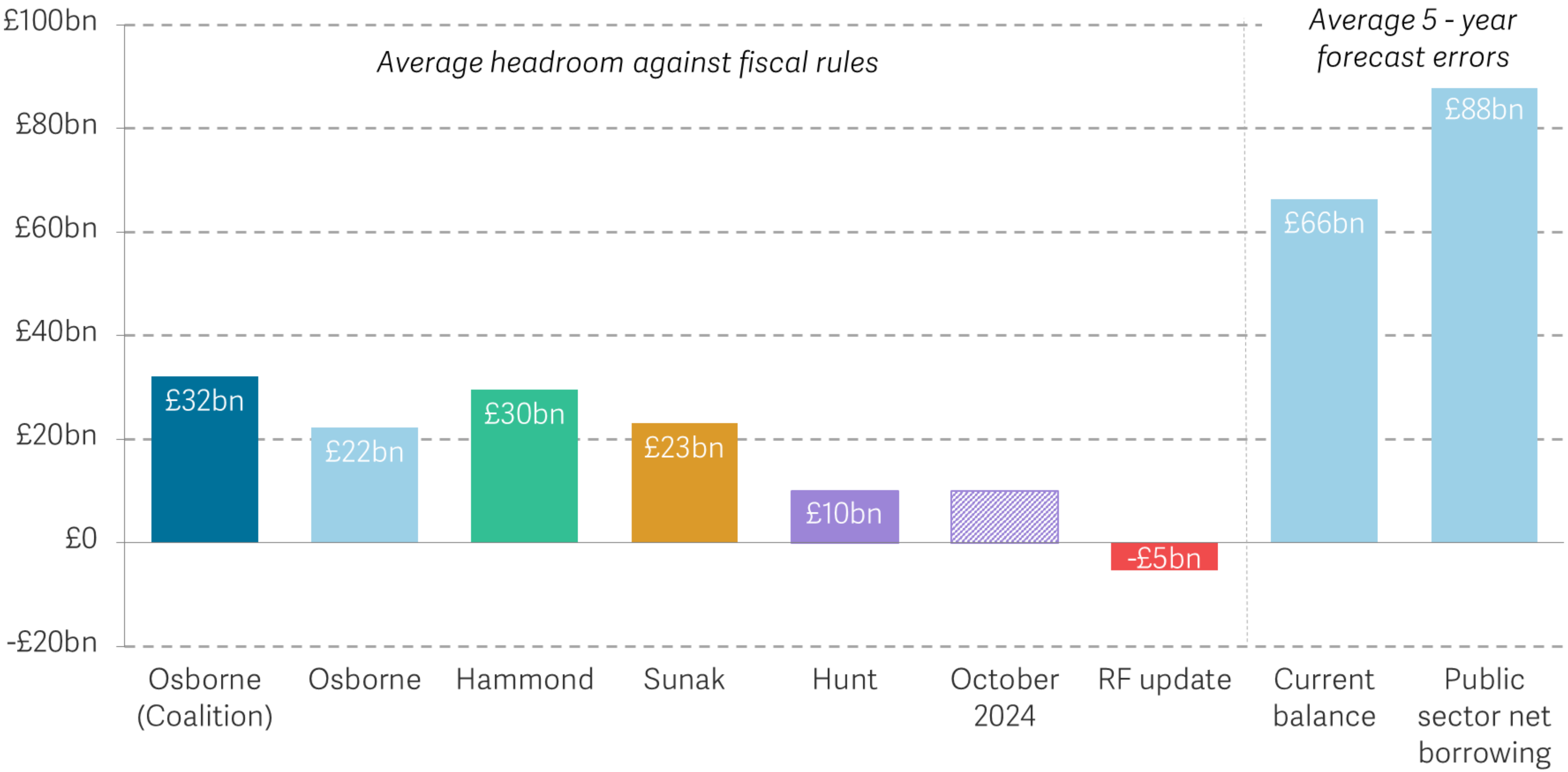
Average forecast headroom against their respective fiscal rules by Chancellor, and projected March 2025 forecast headroom



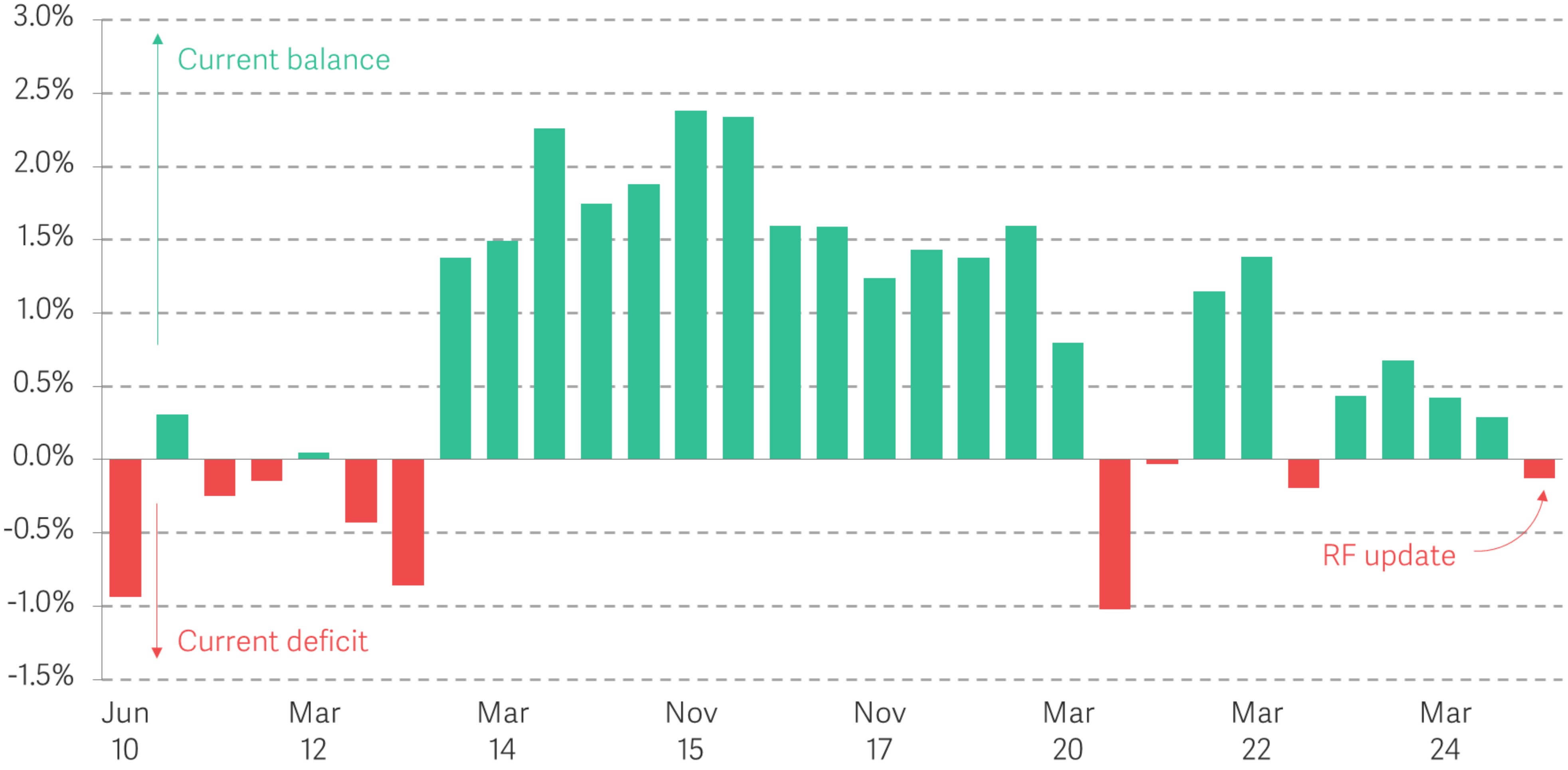
The Chancellor had headroom of just £10bn at the Autumn Budget, very low by historical standards

Meeting the fiscal rules should be the priority

Notes: Average headroom relate to the following past fiscal targets: 'Osborne (Coalition)' fiscal targets relate to balancing the cyclically-adjusted current deficit in three years; 'Osborne' relates to balancing public sector net borrowing in five years (original rule required this to be met in 2019-20, and then in each subsequent year); 'Hammond' relates to cyclically adjusted public sector net borrowing being less than 2 per cent of GDP in three years (rule referred to a fixed target year while it was in place, so comparison uses the average time left to reach the rule over the term it applied); 'Sunak' relates to public sector net debt (excluding the Bank of England) falling as a proportion of GDP in three years. Source: OBR, Economic and Fiscal Outlook, various.

Achieving current balance in five years is a lax fiscal target

Current budget deficit/surplus in final year of forecast at recent fiscal events, per cent of GDP: UK



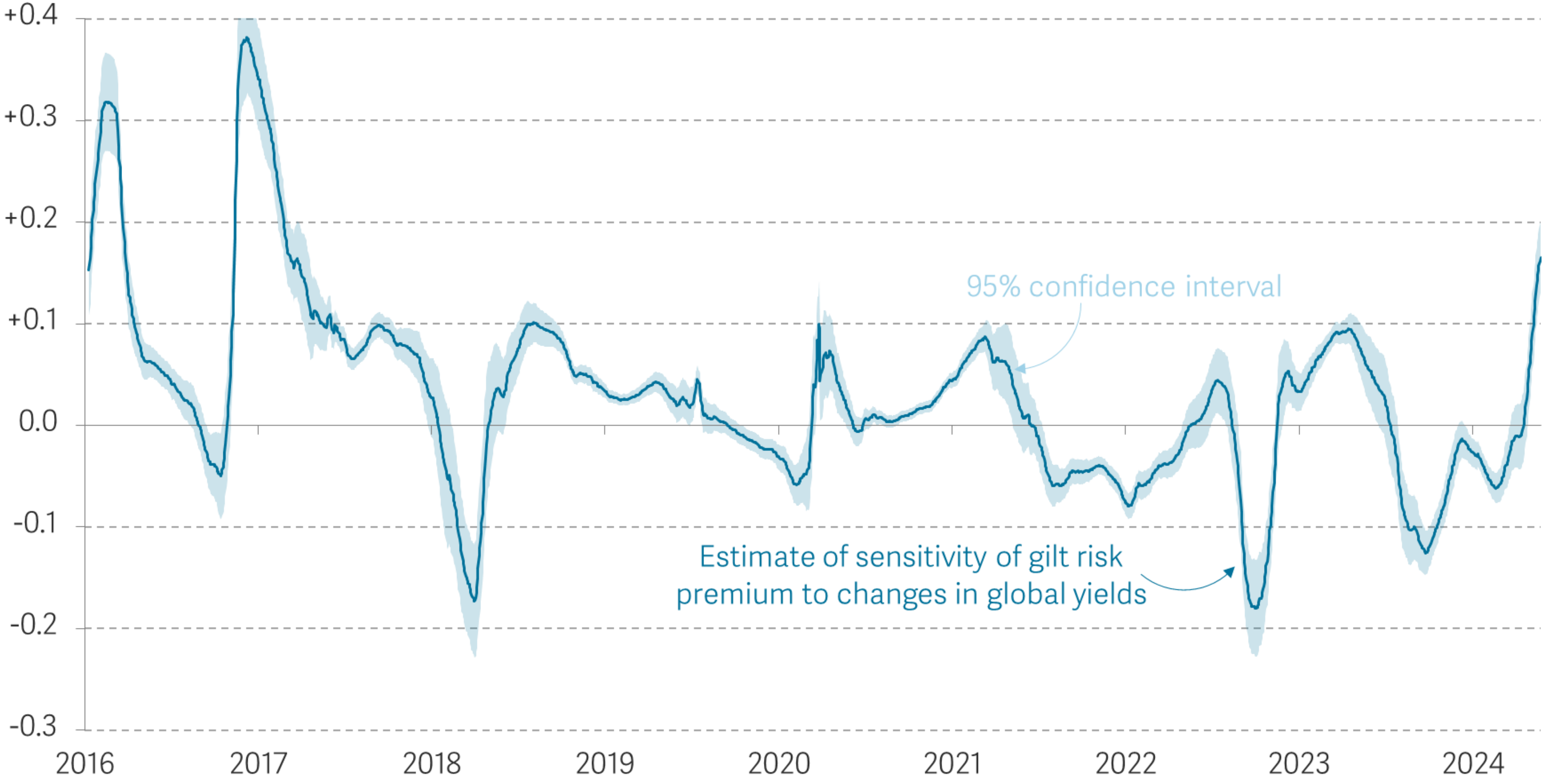
The UK has run a current surplus only once in the past 20 years, but the Government is targeting a forecast surplus, which is much more common

Source: OBR, Historical official forecasts database.

The Government should respond decisively to any shortfall against its fiscal rules

Not responding to any shortfall against fiscal rules is risky

Rolling regression sensitivity of gilt-Overnight Index Swap spreads to changes in Treasury yields



Notes: Dark blue line depicts rolling 180-day regression estimates of the sensitivity of UK gilt-OIS premia to changes in US Treasury yields. Light blue swathe shows a 95 per cent confidence interval. Source: RF analysis of Bank of England, Yield curves; and Federal Reserve Bank of New York.

The OBR's spring forecast not designed not to be a policy event

So the Government could wait until the autumn 2025 Budget to respond to any shortfall against the fiscal rules

But such an approach would be risky amid signs that the risk premium on gilts has become more sensitive to changes in market sentiment

There are four ways governments can tighten policy:

1. Cutting spending on public investment

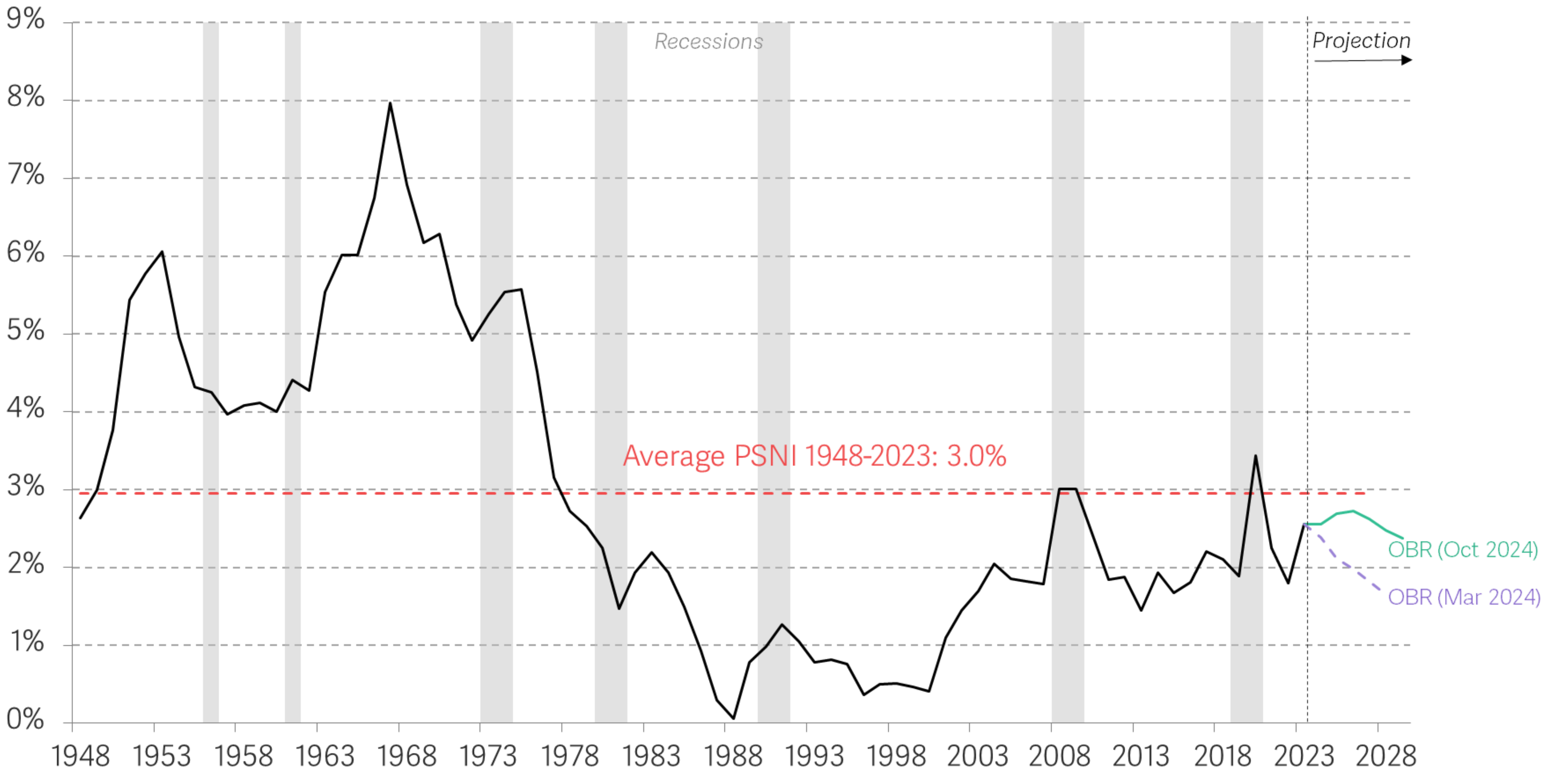
2. Cutting other spending (for example, welfare)

3. Cutting spending on day-to-day public services

4. Raising taxes

New fiscal rules mean that cutting investment will not help

Public sector net investment, as a proportion of GDP: outturn & forecast



Source RF Analysis of OBR, Economic & Fiscal Outlook, various, 2024.

In the past, governments have made growth-sapping cuts to investment when belt-tightening is required…

…but as the current balance target excludes investment, there is no incentive to make the same mistake this time

Working-age health-related benefit spending is rising

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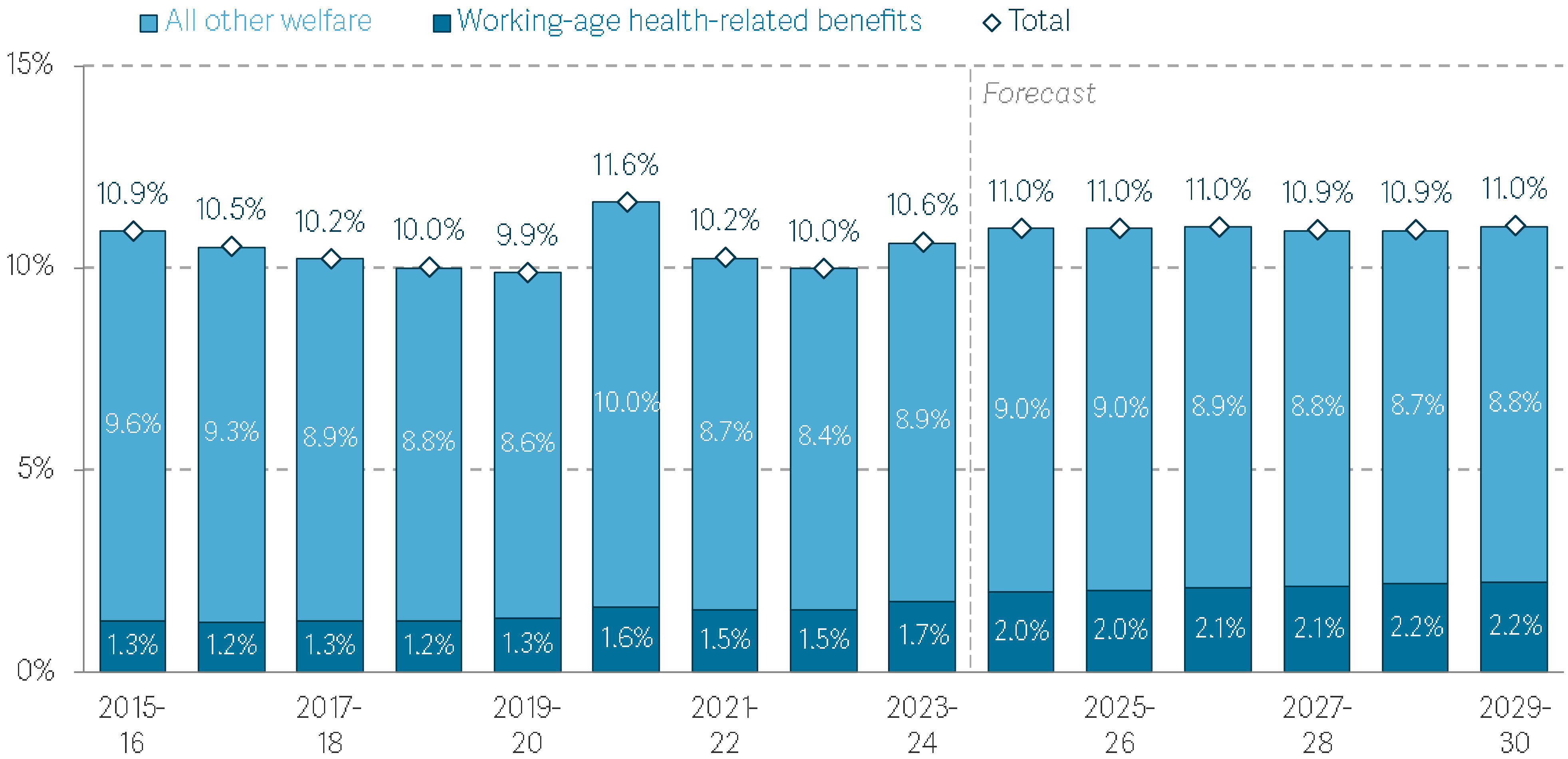
Social security spending as a proportion of GDP, by category: Great Britain



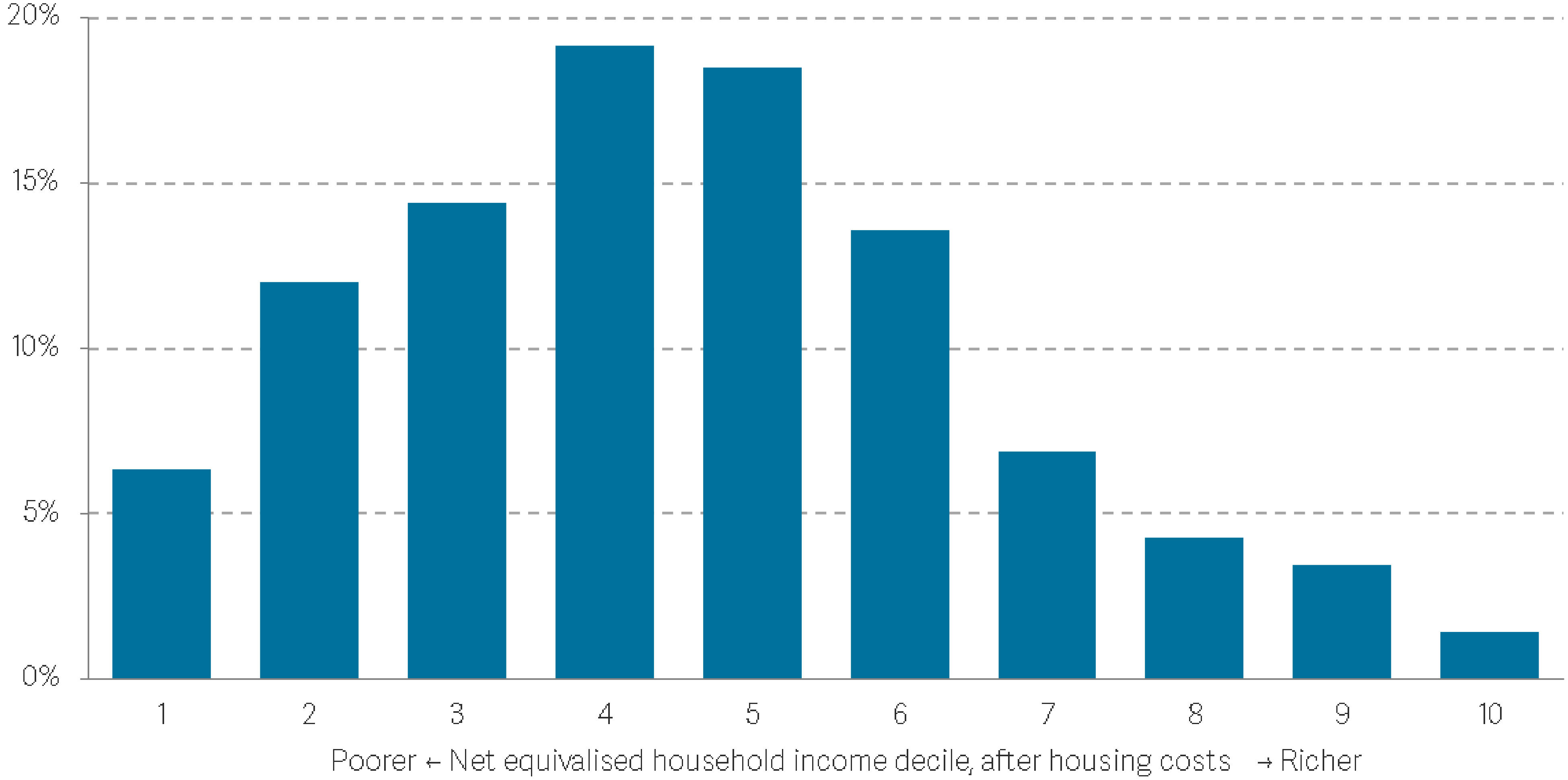
Working-age health-related benefit spending up £19bn in real-terms between 2019-20 and 2024-25 – and set to rise by a further £12bn by 2029-30

But total welfare spending is to stay flat as a % of GDP from now until 2029-30, as other non-pensioner benefits are cut

Notes: 'Working-age health-related benefits' includes working-age incapacity and disability benefits. 'All other welfare' includes all other spending aimed at children, working-age adults and pensioners, including the State Pension.
Source: RF analysis of DWP, Benefit expenditure and caseload tables, Spring Budget 2024; Scottish Fiscal Commission, Scotland's Economic and Fiscal Forecasts, various.

Big cuts to PIP are expected – but (1): this hits low-to-middle income households hardest

Distribution of working-age PIP claimants across the household income distribution: UK, 2022-23



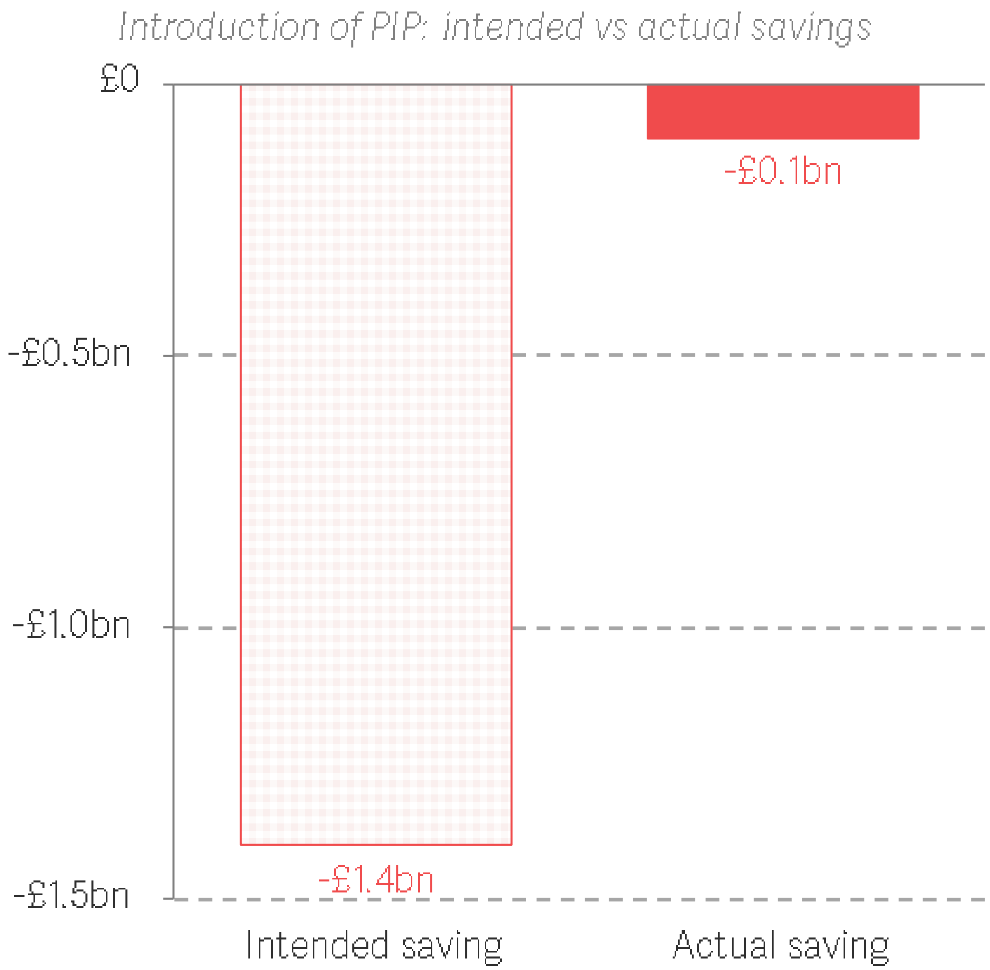
£5bn PIP cuts expected by the end of the decade, achieved by making it harder to qualify for the benefit. Also expecting PIP payments to be frozen in 2026-27

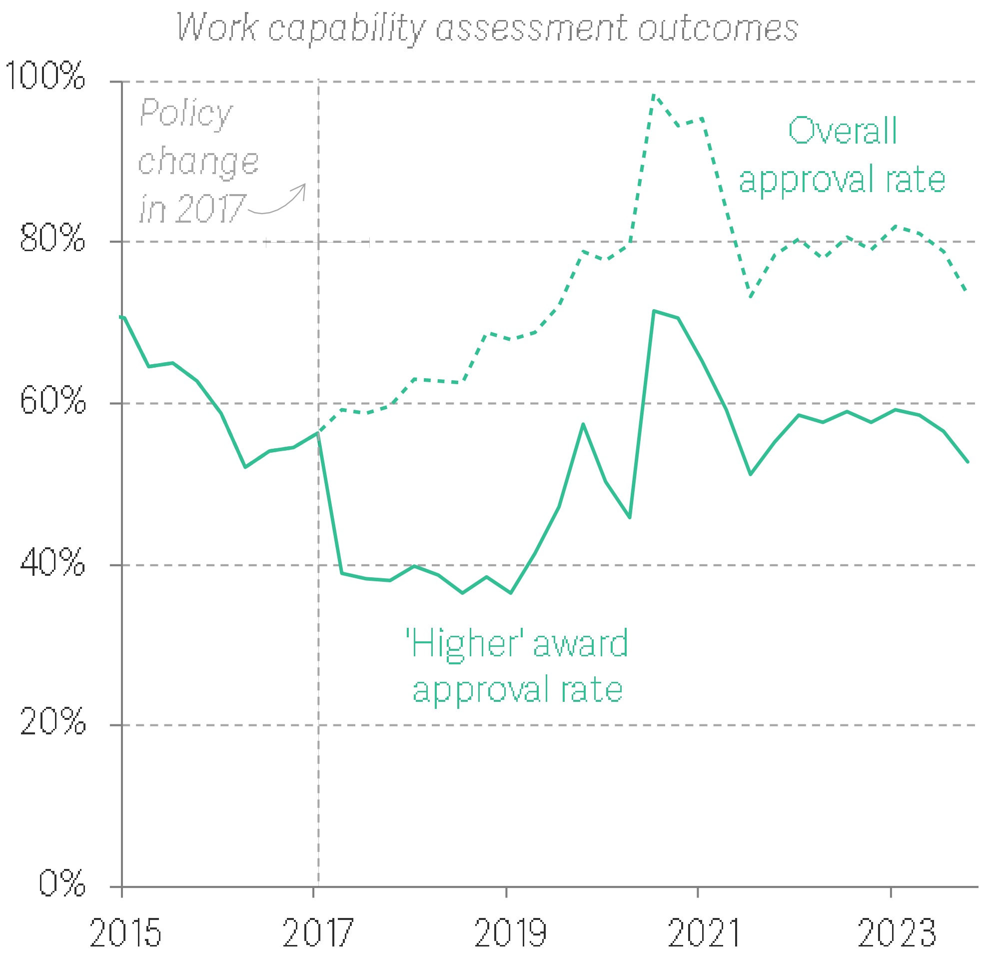
This would hit low-to-middle income families: seven-in-ten PIP recipients are in the lower half of the income distribution

Source: RF analysis of DWP, Family Resources Survey; DWP, Households Below Average Income.

But (2): history tells us that rushed cuts should be avoided

Intended and actual savings from introducing PIP (left panel) and work capability assessment outcomes (right panel): Great Britain





Savings don't always materialise, as shown by shift from DLA to PIP or removal of UC LCW element

Reforming the system carefully for long-term gains is more important than securing short-term savings

Notes: PIP intended and actual savings refer to the savings by 2015-16 factored into the OBR June 2010 forecast, compared to the actual saving in 2015-16. 'Higher award approval rate' refers to the share of WCA awards that result in a claimant receiving an additional cash payment relative to those found fit for work. Following policy change, for new onflows from April 2017, there was no additional cash award to being placed in the less severe incapacity (LCW) group.
Source: RF analysis of OBR, Welfare Trends Report, October 2016; OBR, Welfare Trends Report, October 2024.

Spending could also be cut – but plans are already very tight

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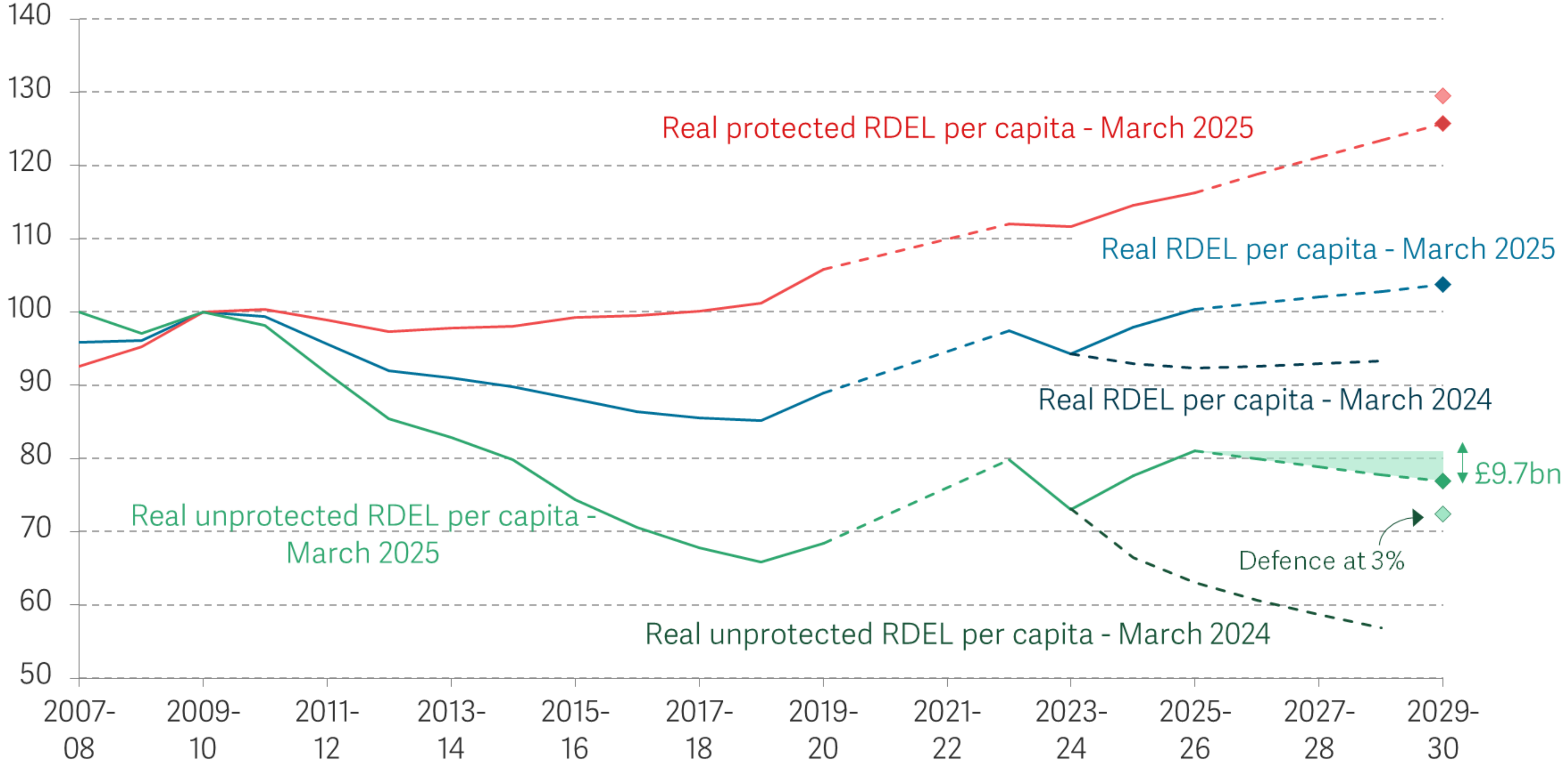
Indices of real (government-expenditure-deflator-adjusted) per-capita resource departmental expenditure limits (RDEL), 2009-10=100, all departments, 'unprotected' departments and 'protected' departments



Departments with spending protection (NHS, schools, defence and overseas aid) are set to grow in the coming years.

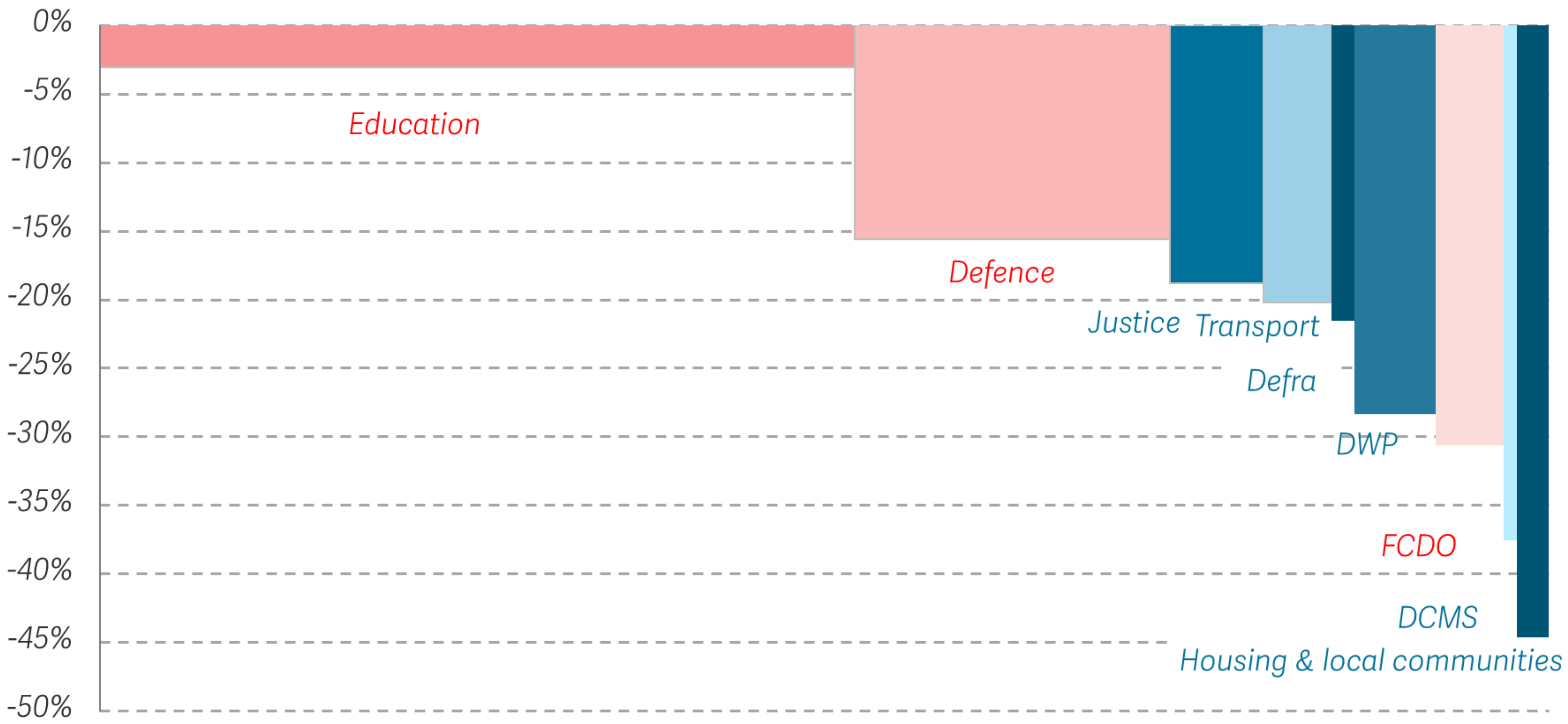
This means other ('unprotected') departments facing £9.7bn of implied cuts given the overall spending envelope

Maintaining previous RDEL real growth rates (1.3%) would cost £500m in 2029-30 given higher inflation

Notes: Deflated using the OBR forecast for the GDP deflator to 2025-26 cash terms. Protected budgets include NHS, core schools, defence and ODA.
Source: RF analysis of OBR, Economic and Fiscal Outlook, November 2023/ various.; HM Treasury, November/ various and PESA tables.

‘Unprotected’ departments have already faced significant cuts

Percentage change in real per person departmental spending, 2009-10 to 2025-26, sized by department: UK



Note that despite receiving £1.4bn in 2025-26, the Ministry of Justice is still 19% smaller than in 2009-10; DWP is 28% smaller than in 2009-10; and housing and local communities is 46% smaller

Notes: Selected departments shown. DHSC and Home Office are excluded from this chart: both grew during this period.
Source: RF analysis of PESA tables and HMT, various.

Better approach is to raise tax – with various plausible options

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Policy option	Revenue impact in 2029-30
Extend the IT/NI threshold freezes by two years	£8 billion
End possibility of paying zero CGT after death or emigration	£2 billion
Cut the VAT registration threshold from £90,000 to £30,000	£2 billion
Cut annual ISA contribution limit from £20,000 to (say) £10,000	£1 billion
Un-cancel this Spring's Fuel Duty increases	£1 billion
Raise the basic rate of dividend tax from 8.75% to (say) 12%	£0.5 billion
Add (say) 2% National Insurance to rental income	£0.5 billion

If major tax rate increases are off the table, and major changes to business tax base or sin taxes unlikely, then a threshold freeze extension (for 2028-29 and 2029-30) is a proven and delayed way to raise a lot. However, a balanced package might also ask more of the top, or try to improve the tax system, noting that capital gains, dividends and rental income can face much lower tax rates than wages.

Notes: RF analysis. See Ending Stagnation for further discussion. Approximate ISA costing is conservative compared to costings of previous changes to contribution limits. Approximate CGT costing is conservative compared to detailed static analysis.

A 2-year freeze extension would be broadly progressive – except for the highest-income households – & raise around £8bn

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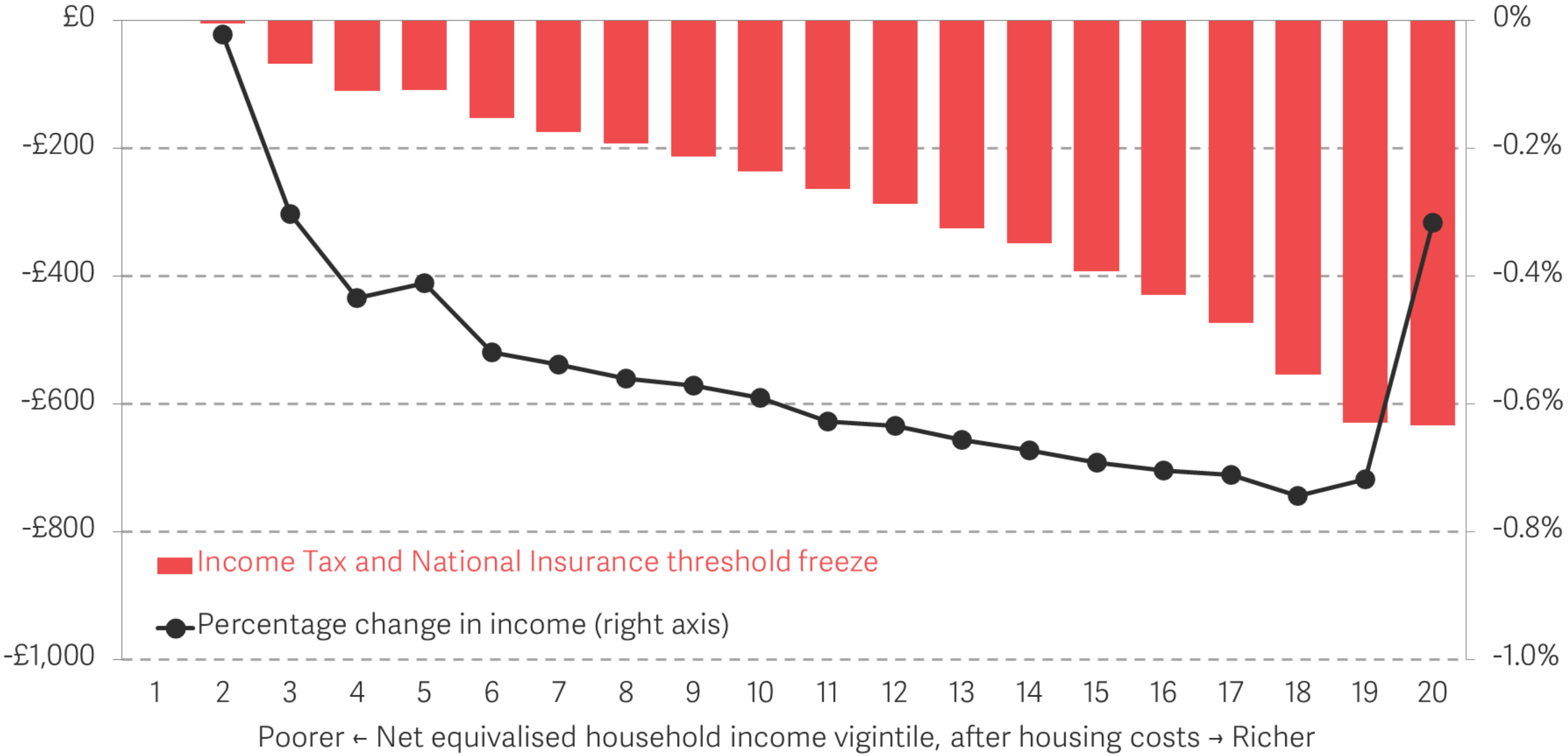
Impact of a two-year freeze to Income Tax and National Insurance thresholds: UK, 2029-30



Threshold freezes in 2028-29 and 2029-30 would not have an immediate impact on households

Employee impacts in 2029-30:

Basic rate: -£150

Higher rate: -£450

Additional rate payer: -£350

(Less for UC households)

Notes: Data is in 2025-26 prices. Tax threshold freeze assumed to apply to 2028-29 and 2029-30. Shows change in unequivalised household income per person after housing costs. People are sorted into income vigintiles by equivalised household income after housing costs, before any policy changes. We exclude the bottom 5 per cent, due to concerns about the reliability of data for this group. Source: RF analysis of DWP, Family Resources Survey using the IPPR tax-benefit model; OBR, Economic and Fiscal Outlook - October 2024.

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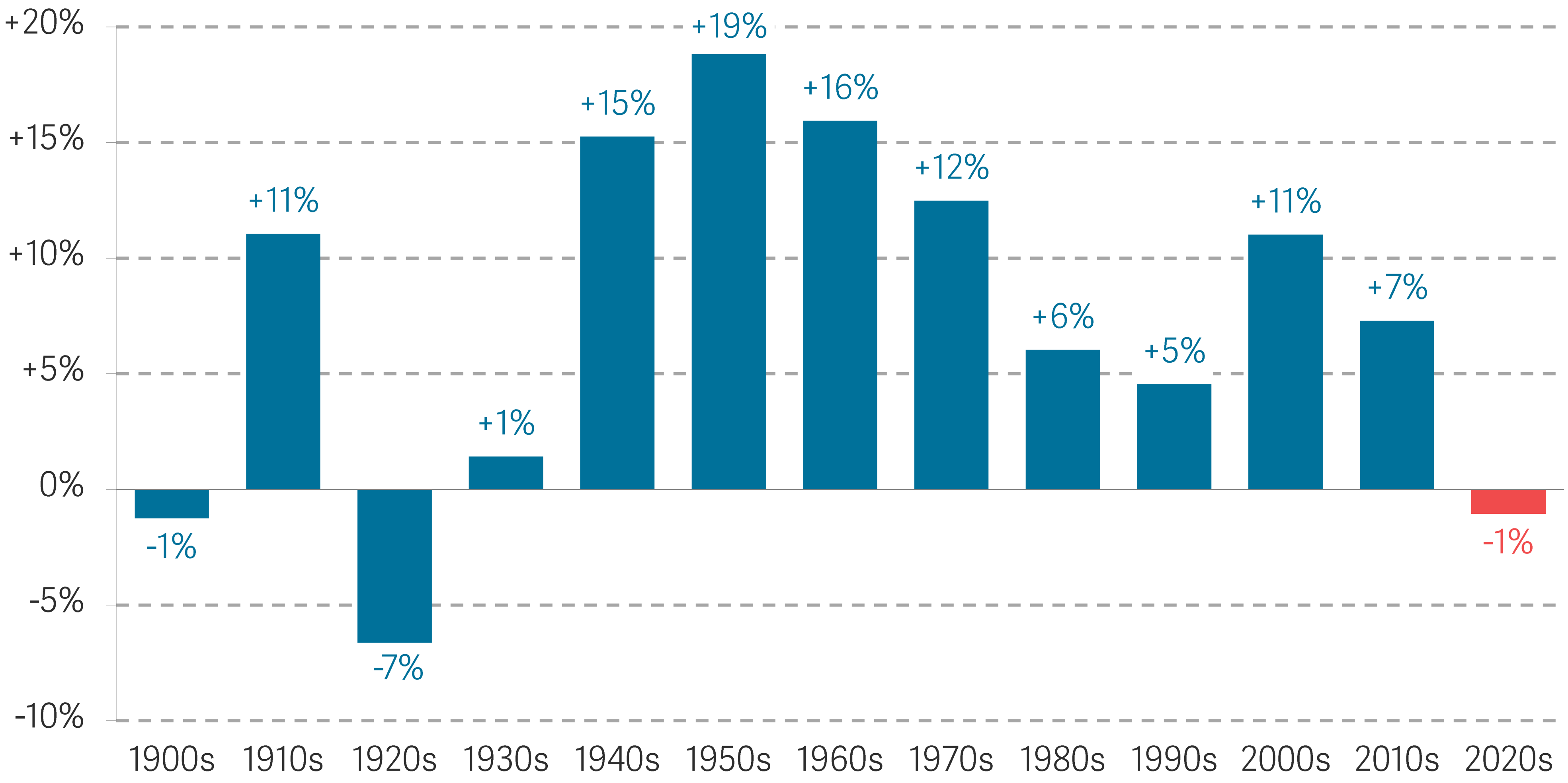
Growth should remain the key policy focus

Dire growth performance still the key policy challenge

Cumulative growth in GDP per capita over the first half of each decade: UK



Growth in the first half of this decade is set to be the weakest of any comparable period in a century

Notes: From the 1960s onwards, growth is calculated between the final quarter of the previous decade and the final quarter of the fifth year of the decade (i.e. Q4 2024, Q4 2014 etc,). In prior decades where only annual data is available, it refers to the last year of the previous decade and the fifth year of the decade (i.e. 1954, 1944 etc.). Source: RF analysis of ONS, National Accounts; Bank of England, A Millennium of Macroeconomic Data.

We are expecting more growth policy from the Government

- There have been policy announcements on:
  - Increased house building, which could add 0.1-0.2ppts to GDP growth
  - More investment in infrastructure and reductions in the cost of building, which could boost growth by about the same amount

- But there is much more policy coming in the next few months:
  - Industrial strategy
  - Trade strategy
  - Infrastructure strategy
  - Pensions reforms
  - Skills consultation (for England)

Increasing business dynamism should be the priority

- Developing a durable industrial strategy that focuses on innovation, not incumbents, should be top priority
- More ambitious housing and infrastructure plans to boost our second cities, coupled with incentives and co-ordination for businesses to relocate
- Skills: 'Apprenticeship Guarantee' for all qualified under-25s
- All this should be supported by a tax reform agenda:
  - Stamp Duty cuts/abolition to increase labour mobility and business reallocation
  - Business rates reform to remove tax on new buildings and improvements
  - Corporation Tax reform to remove remaining penalties to investment
- Trade strategy should be much more ambitious – a 'UK protocol' with goods in the EU Customs Union and Single Market remains the most effective route to substantially lower trade costs for the UK

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- The Government's approach appears to be to make straightforward cuts to Personal Independence Payment (PIP), which is paid regardless of income, by around £5 billion in 2029-30
- History tells us that rushed savings exercises in this area rarely achieve desired savings. 70% of cuts would fall on the poorest half of families with very large income losses for those deemed ineligible.
- With cuts to 'unprotected' departmental budgets of £10 billion already planned, and pressures to spend more than 2.5% of national income on defence, further spending reductions would be tough to deliver
- Tax rises should not be ruled out – extending threshold freezes is a progressive way to raise revenues that is consistent with manifesto promises

The Government should double down on efforts to increase growth by announcing new policy to boost business dynamism