Insights
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UK Autumn Budget Signals Fiscal Expansion

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On October 30, the UK government announced the Autumn Budget. The highly anticipated budget pits the political priorities of a new Labour government against narrow fiscal space. In our third Focus on Fiscal article, we discuss the UK government's objectives with its fiscal program, its likely impact on policy, and importantly, what this means for markets and investors. In sum, we see a short-term boost to the UK economy, alongside elevated medium-term risks that justify a higher term premium for UK assets, as well as a tailwind for the pound.

New Fiscal Rules and Budget

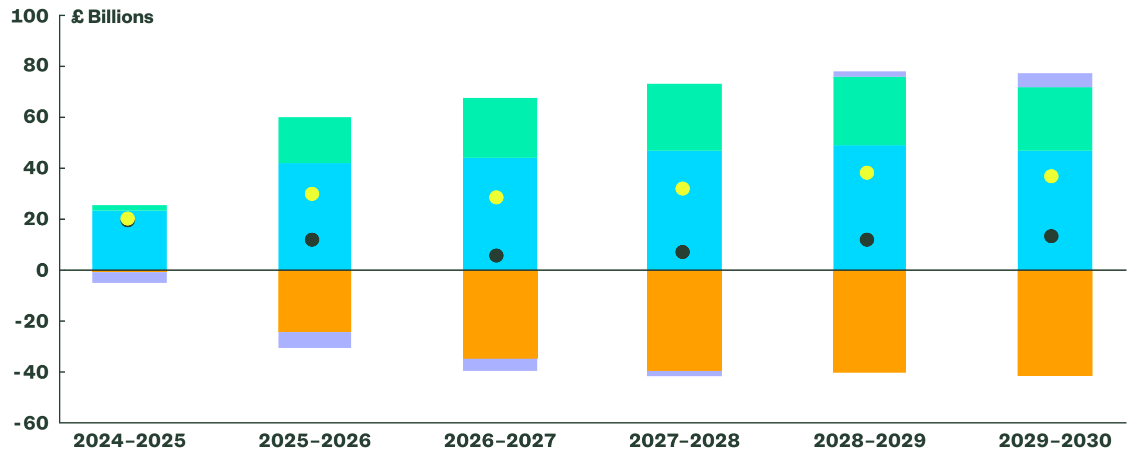
As part of the Autumn Budget, the government unveiled two new fiscal rules: a balanced *current* budget and a move to decrease government debt as a share of gross domestic product (GDP) — both cited as medium-term goals. The first rule requires the government to fund current spending out of existing revenues (but allows for borrowing for investment). The second aims to limit overall indebtedness.

Broadly, the new rules materially depart from the ones they are replacing, which reflect both practical needs and longstanding criticism of the fiscal framework. The budget rule is more narrowly focused on day-to-day finances.[1] The debt rule is similar to the last one, except that it targets a broader measure of debt,[2] which allows for greater room to borrow (for investment, as per above). The new rules also take a *nearer* view of "medium-term," i.e. three years instead of five.[3] The rolling nature of the target still makes it possible for a government to meet the rules by assuming fictitious future tax and spending plans. However, the tighter time frame narrows the scope for fiscal manoeuvring.

In line with the newly announced guidelines, the government announced a new budget (Figure 1) which includes a £70 billion rise (~2% of GDP) in government spending every year on average. Around half of this increase will be funded by new taxes, two-thirds of which will come from employers' national insurance contributions (NICs).[4] Across all measures, this announcement is a clear fiscal expansion with implications for the economy and markets.

Figure 1
Autumn Budget (Net Changes), £ Billions

- Change in Current Budget
- Capital Spending Measures
- Current Spending Measures
- Receipts Measures
- Indirect Effects
- Change in Net Borrowing (i.e. Overall Budget)



Source: Office for Budget Responsibility, as of October 31, 2024.

Short-Term Boost

The economic backdrop of the new budget is an ongoing cyclical recovery, which surprised on the upside in the first half of 2024. Another tailwind arises from the government's efforts to court the private sector. Along with the central bankers' move to monetary easing, this macro backdrop makes for a good starting point.

In the Autumn Budget, the government is essentially asking to give growth a chance. We think that it will deliver over the short term. The new budget is front-loaded. In other words, the spending increase is immediate (by £60 billion in 2025), while the new taxes will take time to materialize (only by £25 billion in 2025).[5] It is highly likely that this timing mismatch will boost demand and add to growth momentum over the near term. The Office for Budget Responsibility (OBR) forecasts an additional 0.6% of growth in 2025 and 2026.[6]

Medium-Term Uncertainty

This momentum is unlikely to be maintained over the medium term for a number of reasons. One reason is the drag on demand from higher taxes and tighter regulations. In addition to raising employer national insurance contributions, the government also increased the minimum wage and reinforced its commitment to worker protection. All of these actions raise the cost of employment. In our view, the burden will ultimately fall onto consumers by way of higher inflation, higher unemployment, and lower wage growth, relative to the pre-budget expectations — in turn, becoming a drag on aggregate demand.

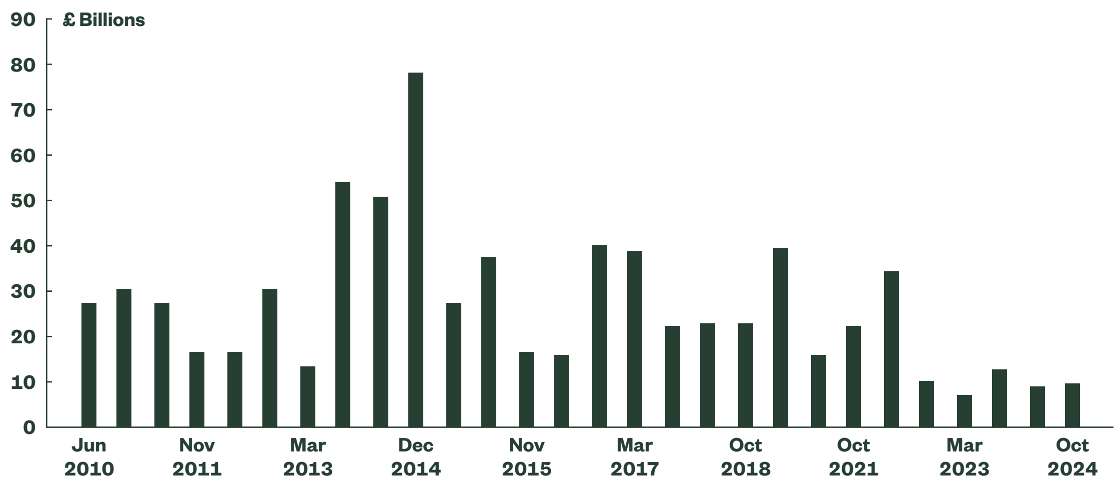
Another deterrent is the effect of the new policy mix on investments. The government actively courts new investors. However, the policy blend it delivers is often in practice a mixed bag. Among the list is an increase on capital gains and carried interest taxes.[7] Therefore, investors not only face the prospect of lower earnings from the businesses they invest in, but they also face a larger tax burden on the returns they receive. On balance, we still think there is a tailwind to investments, but the strong preference for labor over capital in policy-making acts is a constraint.

Lastly, not all investments are made equal. The link between investments and economic growth is a common assumption. This holds true, except that there are different types of investments. Some investments create sustainable growth, because of increased labor productivity, while others do not because they reflect non-economic priorities, or the economic impact is distributional. The UK government's priorities include both, but with a heavy dose of the latter — for example in renewable energy, where the case for productivity growth is unconvincing. Hence, we expect little additional effect from the fiscal program in the medium term.

High Fiscal Slippage Risk

Indeed, risks are high. Chief among them is fiscal slippage. Some new sources of tax revenue, such as attempts to rein in tax-avoidance, are uncertain. Additionally, spending choices are asymmetrical. The increase in departmental spending is heavily skewed toward the National Health Service (NHS) and, to a much lesser degree, defense, education, and transportation.[8] Beyond these core functions, funding will remain tight. In other words, the government may be forced to raise taxes again in subsequent years to the detriment of economic growth. Indeed, the UK government has left itself little headroom should anything go awry. (Figure 2)

Figure 2
Fiscal Headroom Shrinks



Source: Office for Budget Responsibility, as of October 31, 2024.

Market Implications

Yields on gilts, or government bonds issued by the UK Treasury, spiked following the announcement. This jump was partly due to the view that a loosening of fiscal policy implies inflationary pressure and, hence, more gradual interest rate cuts from the Bank of England (BoE) over the medium term. Furthermore, this development echoes concerns over larger-than-expected supply of gilts in the coming years. There was no shock to the market, as was the case during the 2022 crisis over Liz Truss' "mini-budget," due to the well-telegraphed nature of the new budget and fiscal rules — even if investors were ultimately surprised by their extent. Going forward, the UK term premia is likely to remain structurally higher, but falling inflation and a more dovish BoE should help lower yields again.

The Bottom Line

The higher term-premium creates a slight headwind to UK equities in our view, though a number of specific sectors, like construction and energy, could benefit from greater government spending and reform efforts. Similarly, higher employer NICs and minimum wage will increase costs for companies that employ a large number of workers, especially in lower-wage sectors.

The new budget is positive for the pound, which already has the potential to strengthen given the current overvaluation of the US dollar, and will probably outperform the euro, given Europe's current struggles with competitiveness.

Endnotes

1 The previous budget measure was a limit in net borrowing (which includes investment) of 3% of GDP. The new measure also eliminates a cap on certain welfare payments.

2 The previous debt measure was Public Sector Net Debt Ex BoE (PSND ex BoE) — essentially the gross debt of the public sector less cash, excluding the Bank of England on the logic that its balance sheet activity is outside the scope of fiscal policy. Public sector net financial liabilities (PSNFL), the new measure, takes a broader view of the public balance sheet. It includes all financial assets and liabilities of the public sector (including the Bank of England (BoE)) and also includes other less *liquid* assets and liabilities, such as the government's ownership of NatWest bank and student loans. However, it still excludes illiquid assets, such as buildings.

3 The previous rules required the targets to be met by year five of the forecast. The new rule will gradually reduce the time-frame such that by the 2026–2027 fiscal year, the requirement shortens to year three.

4 The main rate of employers' NICs went up by 1.2ppts to 15%, while the threshold at which companies must start paying lowered to £5,000 from £9,100.

5 Spending includes both investment (£18 billion) and current expenditure (£41 billion). Source: OBR.

6 OBR. Economic and Fiscal Outlook. October 2024.

7 Capital gains tax was increased from 18% to 24%. Carried interest will be taxed at a flat rate of 34.6%.

8 Departmental spending will rise by an average of 1.5% a year in real terms, compared to 0.9% previously. The NHS will receive the majority of the extra new funding (£22.6 billion).

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* Pensions & Investments Research Center, as of December 31, 2023.
†This figure is presented as of September 30, 2024 and includes ETF AUM of $1,515.67 billion USD of which approximately $82.59 billion USD in gold assets with respect to SPDR products for which State Street Global Advisors Funds Distributors, LLC (SSGA FD) acts solely as the marketing agent. SSGA FD and State Street Global Advisors are affiliated. Please note all AUM is unaudited.

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