Resolution Foundation BRIEFING

Great expectations in hard times?

Previewing the big decisions for the Chancellor in the new Government's first Budget

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Summary

This month's Budget – the first delivered by a Labour Chancellor in nearly 15 years and the first ever by a woman – will be historic, revealing the new Government's priorities and setting its economic direction for the rest of this Parliament. But while it's all change in Whitehall, the problems of the country as a whole remain much the same: growth since the financial crisis has been weaker than in any comparable period since the Great Depression. The Chancellor has issued a bold diagnosis and prescription: "growth is the challenge and investment is the solution."

The public finances are looking more strained than at the Spring Budget

The Chancellor's difficulty in applying that argument is that those long years of anaemic growth have played havoc with the nation's finances: the public debt burden has roughly tripled since the early 2000s. Since the election the fiscal picture has only darkened with the new Government revealing that it expects to overspend by around £22 billion in the current financial year. While the causes of this are varied and disputed, all that matters for the Budget is that the overspend is real – its broad scale being confirmed in the unfolding month-by-month public finances data – and that the great bulk of it is likely to be sustained through this Parliament. Making allowances for the agreed compensation related to blood contamination, we estimate that a net £19 billion will persist to the end of the five-year forecast. This grim arithmetic, which applies before manifesto pledges are honoured or any other changes are made, explains why the mood music emanating from Whitehall has been so dark. The country has been primed for a myriad of 'difficult decisions.'

But not all the news has been bad for the Chancellor: the economy has evolved in ways that will offset much of the immediate hit to borrowing caused by this year's overspends. Growth this year is turning out to be higher than expected in March, and so too is inflation, both of which boost receipts. Even better, these positive developments for revenues have come about without substantially pushing up expected interest rates and thus debt servicing costs. Our best guess is that updating the central forecast would show debt falling by the fifth year – the target the Chancellor pointed to when in opposition – but with only a £0.5 billion margin for error. That is a tiny margin in terms of the public finances, where the gap between forecasts and outcomes is routinely many orders of magnitude bigger than that. Credible policy requires more of a margin for error, not less. And this is true in spades given the particular uncertainties surrounding the outlook for productivity, the most important determinant of general prosperity and tax revenues over the longer term.

The outlook, then, looks challenging even before any new decisions are taken. But the Chancellor has hinted strongly that public investment will rise, arguing that the value – as well as the cost – of public investments needs to be factored into the fiscal framework. For illustration, we assume the Chancellor resolves to keep net investment constant as share of national income, reversing a planned reduction. On top of this, both the Prime Minister and the Chancellor have vowed in more general terms that there will be "no return to austerity." Although there's no precise formula for translating those words into numbers, their pledge would surely ring hollow if the overall settlement for day-to-day public spending implied fresh cuts across the many 'unprotected' public services not shielded by express political commitments. These include courts, prisons and various aspects of public administration, all of which are still showing intense signs of strain after the original austerity era. Considering the unprotected departments' budgets reveals why: this year, for example, the operational arm of the Department for Work and

Pensions has 40 per cent less to spend per person than before the cutting started in 2009-10; the Department for Environment, Food and Rural Affairs is 30 per cent down on the same gauge. To avoid further cuts to these diminished 'unprotected' budgets, the share of day-to-day public-service spending in the economy will also need to be maintained, rather than – as under current plans – reduced. Even if this is done, meeting urgent pressures in some public services would still very likely require imposing very tight settlements on others.

Based on this, protecting public investment will require £30 billion of capital expenditure a year by the end of the forecast, while "avoiding austerity" in public services would cost the Treasury £21 billion (on top of the in-year overspends discussed above). The fiscal challenge is all the greater because of additional Labour commitments not to raise the rates of any of the biggest revenue raisers: Income Tax, National Insurance, VAT and Corporation Tax. Of course, more growth would help, but, in the short term there are only three ways to make ambitions on investment and "avoiding austerity" add up: more borrowing, cuts to spending outside of public services, or imposing tax rises consistent with the self-denying ordinances.

Taxes will have to rise to avoid a return to austerity

In opposition, Labour suggested that, when in office, it would constrain its own scope to borrow beyond what was prudent by following two fiscal rules: one commits to plan for a balanced current budget, which means that receipts cover all day-to-day spending by a particular year of the forecast. This rule implies that borrowing can only be used for investment at that point. The second, which it inherited from the previous Conservative Government, promises to get public debt falling relative to national income within five years. What makes this Budget so challenging for the Chancellor is that there is, even before any moves to raise investment or shore up public services, precious little margin for error in complying with either rule.

Each rule has important – but different – implications for tax and spending. The logic of a current budget rule is precisely that any ambitions for day-to-day spending, such as the avoidance of a return to austerity, should in general be covered by tax. With expenditure running well ahead of expectations, there is scope for only £13 billion more in day-to-day spending – half of what we estimate is necessary to avoid a return to austerity in public services – before this rule is 'maxed out'. So if the Chancellor is serious about this rule, savings will need to be found in (non-public service) expenditure or taxes raised.

The scope for benefits cuts looks limited. The Government has hinted it might seek to curb social security spending, but the strong political reaction against its early move to means-test pensioners' Winter Fuel Payments may give it pause for thought. Moreover, there are several benefit cuts already working their way through the system which the Government would ideally pause or even reverse. These include: the freezing of Local Housing Allowance rates, the two-child welfare limit, and an imminent tightening of the Work Capability Assessment to restrict entitlement to certain incapacity benefits. While the rising costs of the latter merits close attention, high rates of hardship among disabled people make a hasty dash to find savings dangerous.

So with borrowing close to the 'current budget' limit, and lacking acceptable social security cuts, avoiding a return to austerity in day-to-day spending probably requires tax rises of around £20 billion. This figure is a lower bound on what would be needed to avoid a further deterioration in the outlook for such spending, but more would be needed if the Government wants to address some of the long-standing problems facing public services. If – as would certainly be prudent – the Chancellor also wants to allow for a margin of error (or 'headroom') then more than £20 billion would be needed. Either way, this is over and above the £20 billion in total taxes, largely effected by the freezing of thresholds and allowances, that is already in the plans inherited from the last Chancellor, Jeremy Hunt.

If fresh tax rises in the Budget did total £20 billion, that would be close to the average rise imposed at Budgets following the past eight elections. The Labour manifesto already included a few relatively minor measures it hopes might raise £10 billion. It also has various options for bringing in the rest of the money without breaching its manifesto commitments on the main tax rates. Here, the Chancellor should aim for changes that make the tax system more efficient and ensure the burden falls on those with the broadest shoulders. Perhaps the most obvious areas for such improvements are: Inheritance Tax, Capital Gains Tax and taxes related to pensions, for example applying National Insurance to employer contributions. Reducing reliefs and exemptions and ensuring a more consistent approach to different sources of income across the tax system in these three areas could raise as much as £20 billion a year.

Investing to grow means rewriting the fiscal rules

As of the Spring Budget, the debt target was an even more restrictive borrowing rule. As currently formulated it allows almost no room for additional borrowing to invest. In principle, the Chancellor could instigate even larger tax rises to fund additional investment. But so long as the investments are sound – boosting output and in due course government receipts, which there is ample scope to do – this would be counterproductive. Some of the bills for the investments to create a stronger future economy can sensibly be paid by that stronger future economy. The Chancellor would appear to agree, which explains why she has been signalling openness to a rewritten (or at least revised) fiscal rule that allows her to take this approach.

A spectrum of reforms are possible. These range from technical tweaks (for example, including, rather than as currently excluding, Bank of England liabilities from the debt measure) to radically overhauling the whole aim, so that instead of simply targeting lower debt the Government would promise to improve its 'net worth'. The latter could be achieved by raising the value of its assets just as much as reducing its indebtedness. These alternative targets have different pros and cons, in terms of their technical economic coherence. But the practical decision about which target to shoot for is partly a judgment about how much debt-funded investment the Chancellor wishes to undertake, balancing the attractions of the extra investment with the exposure to borrowing costs which higher debt will bring.

On the assumption that the Chancellor retains the existing rule's focus on the end of the five-year forecasting period, the bolder conceptual changes will allow for more additional borrowing than the more incremental options. Adding in Bank of England liabilities into the target would expand the scope for borrowing by around £15 billion. Simply excluding the liabilities created by a couple of the new Government's signature initiatives – the National Wealth Fund and Great British Energy – would allow for additional investment on infrastructure, albeit on an arguably arbitrary basis. Ditching debt altogether for a rule based on public sector net worth (PSNW), which takes into account the whole public sector balance sheet, would allow for over £50 billion in additional borrowing, as would an alternative (easier-to-operationalise if less-conceptually satisfactory) measure, public sector net financial liabilities (PSNFL). In principle, a bold switch to the net worth measure would be preferable, doing most to facilitate and give credit to extra investment to create public value. But there are arguments about how exactly to measure and target this concept, and also political questions about reconciling such a change with the manifesto promise to bring down debt.

Fiscal policy is set to loosen at the Autumn Budget, but will still be tightening in the years ahead

If the Government does everything that a reasonable reading of the Chancellor's own words on investment and austerity suggest it will want to, then, even if the Budget raises £20 billion or so in new taxes, it will end up being a net giveaway overall, despite all the 'tough choices' rhetoric over the summer. Measured against the stringent inherited plans, fiscal policy will loosen. Because those inherited plans were so tough, however, the overall fiscal stance will remain tight by any ordinary standards – tighter than at any time since Gordon Brown was Chancellor. Such a stance may translate into political pressures on both the tax and the spending side, but for today's economy it is appropriate: the economy is operating close to full capacity, and with ample room to cut interest rates, something looser fiscal policy impedes.

The Labour Party claimed during the election that the fiscal position can be greatly improved over the medium term if it succeeds in boosting growth. But governments have to chart a way through today's challenges before they can enjoy the potential advantages of a more prosperous tomorrow. The immediate and inescapable balancing act for the Chancellor will very likely involve raising taxes by more than planned by Jeremy Hunt, while also presiding over both higher borrowing and tight day-to-day spending settlements, at least in some areas. Navigating all that will be anything but easy. In doing so, the Chancellor will reveal the relative weight placed on living standards, public services and reducing public debt. Ideally, however, she will do something more: show the country how, even in difficult times, she can mobilise funds for the investment that might, in time, allow Britain to grow its way out of trouble.

The Autumn Budget will be a defining event for the new Government

Less than four months on from an election landslide, the new Government faces an Autumn Budget that will shape its economic-policy approach for at least the rest of this Parliament. For the first time in nearly 15 years a Labour Chancellor will deliver a Budget speech. And remarkably this will be the first time such a speech has been delivered by a woman. So by any standards, this will be a historic event. But while it's all change in Government, the challenges we face as a country remain much the same. Growth since the financial crisis has been weaker than any comparable period since the Great Depression and this has wreaked havoc with the nation's finances as public debt has nearly tripled. None of this is lost on the Chancellor, who has repeatedly described this as the worst economic inheritance since the Second World War. Along with the Prime Minister, she has moved pre-Budget expectations management onto an industrial scale, with the country warned to expect a myriad of 'difficult decisions'.

The challenge in front of Rachel Reeves is not an enviable one: find a way to kick-start growth, put the public finances on a sustainable footing, but also keep manifesto commitments not to raise many of the major taxes or return to austerity. To make matters worse, the fiscal baseline on which the election campaign was fought – that from the Spring Budget – featured wafer-thin fiscal buffers, and that is despite the previous Chancellor pencilling in an increase in annual taxes of more than £20 billion; around £25 billion in growth-sapping investment cuts; and around £20 billion in cuts in day-to-day spending for unprotected departments.[1] So, in this briefing note we examine how that outlook has changed since the March 2024 Budget, focusing on the economy and the public finances. We then consider what that means for the policy choices faced by the new Government at this defining fiscal event.

New spending pressures have come to light since March

We start with the pressures on public spending. Here, the big change since the Budget has come in the form of the Chancellor's audit of short-term spending pressures which highlighted £21.9 billion of additional spending in 2024-25.[2] About one-third of these spending pressures are due to pay settlements recoected recovery in post-Covid railway services, military assistance to Ukraine, and the 'normal' draws from the reserves (i.e. those which are considered unforeseen, unavoidable and unaffordable), leaving just £2.5 billion remaining in reserves in July 2024.[3] These rises in spending are partially offset by

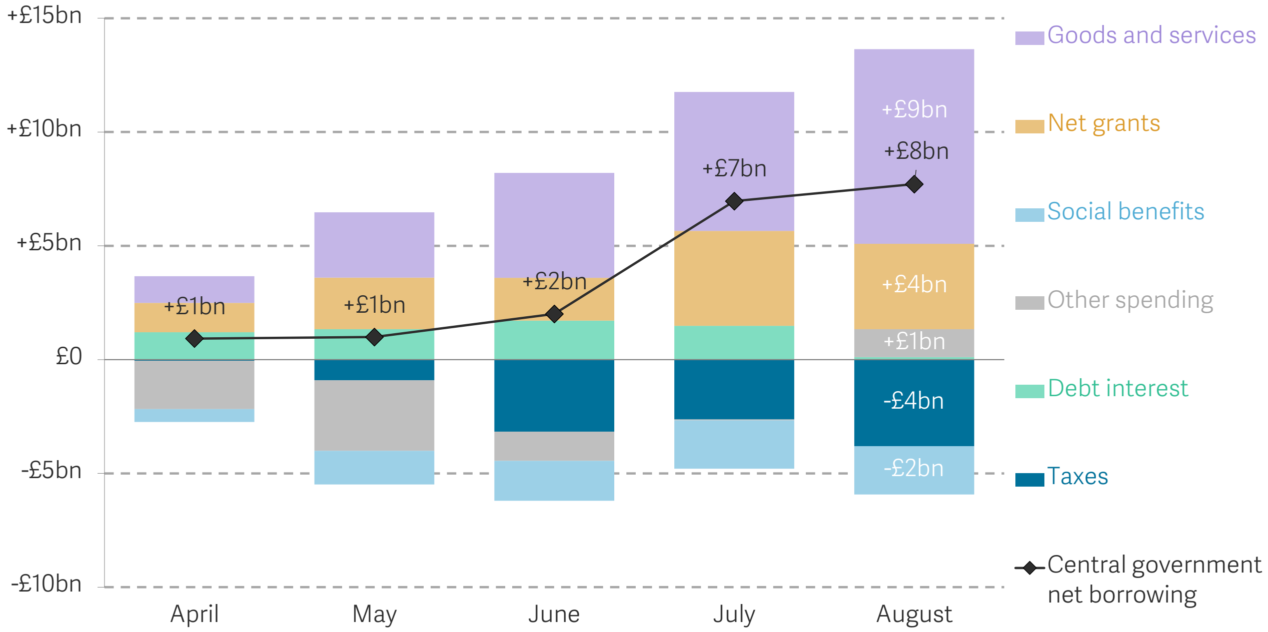
1 C McCurdy, C Pacitti & J Smith, Debt dramas: Putting the public finances in context ahead of general election 2024, Resolution Foundation, June 2024.
2 HM Treasury, Chancellor's statement ; Fixing the foundations, Public Spending audit, 2024-25, July 2024.
3 HM Treasury, Public Expenditure Statistical Analyses 2024, July 2024.

departmental savings, such as ending the Rwanda migration partnership, cancelling the adult social care charging reforms and cancelling other smaller policy announcements.

The overspends discussed in the Chancellor's document are consistent with the emerging outturns which show that significant in-year departmental overspend in the 2024-25 fiscal year is taking place. As shown in Figure 1 spending on goods and services to date is £8.5 billion above the OBR's forecasts from March. If we continue spending at this rate for the remainder of the financial year, the overspend would be around £20 billion.

FIGURE 1: **The estimated overspend in 2024-25 is in line with the rate at which spending outturns are outpacing expectations**

Central government net borrowing, cumulative difference between OBR March 2024 forecast and outturn by component: UK, 2024-25



SOURCE: RF analysis of OBR, Economic and Fiscal Outlook, March 2024; ONS, Public sector finances, UK: August 2024.

The key question is how much of this overspend will continue over the forecast period. It is clear, for example, that higher spending on pay this year will affect spending in the coming years. On the other hand, asylum support has ramped up in recent years, but policy changes could feasibly bring this down over time.[4] Overall our assessment is that the additional net departmental spending of £18 billion in 2024-25 is a permanent increase in resource departmental expenditure limit (RDEL) levels. Beyond that change

4 Asylum spending has increased from £0.5 billion in 2019-20 to £4 billion in 2023-24, and future estimates for spending are hugely variable, with one estimate that spending will reach as much as £11 billion by 2026-27. Policy – for example where asylum seekers are housed – will play a large role in how spending will evolve. Regarding the 2024-25 overspend for asylum seekers, the Home Office Select Committee wrote to the Chair concerned that the Home Office estimate lacked transparency in March 2024. For more discussion of Home Office asylum estimates see: J Tyler-Todd, Estimates Day debate: The spending of the Home Office on asylum and migration, House of Commons Library, March 2024.

in the near term, we assume that RDEL increases by 1 per cent per year in real terms this Parliament, in line with the assumption made at the Spring Budget. This leaves RDEL £20.5 billion higher by the end of the forecast period in 2029-30.

However, this is partly offset by savings in annually managed expenditure (AME) – principally the Winter Fuel Payments – leaving total manged expenditure (TME) higher by £18.9 billion by the end of the forecast period.[5] Included in this is a rise in capital spending to compensate those affected by the infected-blood scandal, which could cost the Government a one-off £10 billion over the Parliament.[6]

There has at least been good news for the Chancellor on the economy

The outlook for public finances that the Chancellor will face at her first Budget will also be influenced by changes in the economic outlook, and here the good news is that growth has been stronger than expected. The economy bounced back much more quickly from last year's recession in the first half of this year than the OBR had expected in March: growth in the first half this year was 1.2 per cent, double the OBR's March forecast and the fastest in the G7 (Figure 2). While short-term indicators point to a slowing since in the second half of the year, it's clear that the jumping off point for the OBR's updated forecasts is better than expected at the time of the Spring Budget.[7]

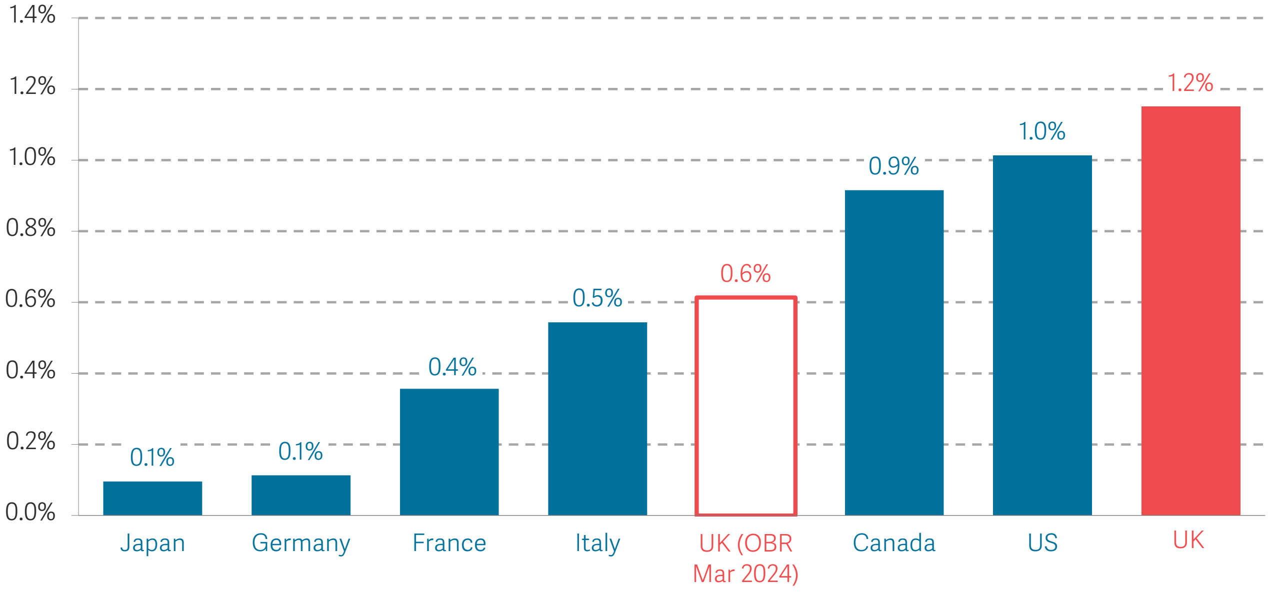
5 The largest recurring savings in AME are the £1.4 billion savings in 2024-25 by targeting Winter Fuel Payments. The capital cuts of £0.8 billion in 2025-26 are assumed to only affect that single year.

6 We expect the ONS to classify this compensation as capital transfers based on the treatment of similar transactions. N Triggle, Infected blood victims could get £2m compensation, BBC News, 21 May 2024. There are also likely to be additional costs recorded in future OBR forecasts in relation to the Post Office Horizon scandal, although these are likely to be much smaller cash flows than those relating to the Infected Blood Inquiry, so have not been reflected in the scenarios below. For more detail on these payments (and other policy risks to the fiscal position), see OBR, Economic and Fiscal Outlook, November 2023; Department for Business and Trade, Post Office Horizon financial redress data as of 1 March 2024, updated October 2024.

7 For example, S&P Global, Flash United Kingdom PMI, 23 September 2024.

FIGURE 2: **The economy has been going 'gangbusters' in the first half of this year**

Real GDP growth in H1 2024: G7 countries



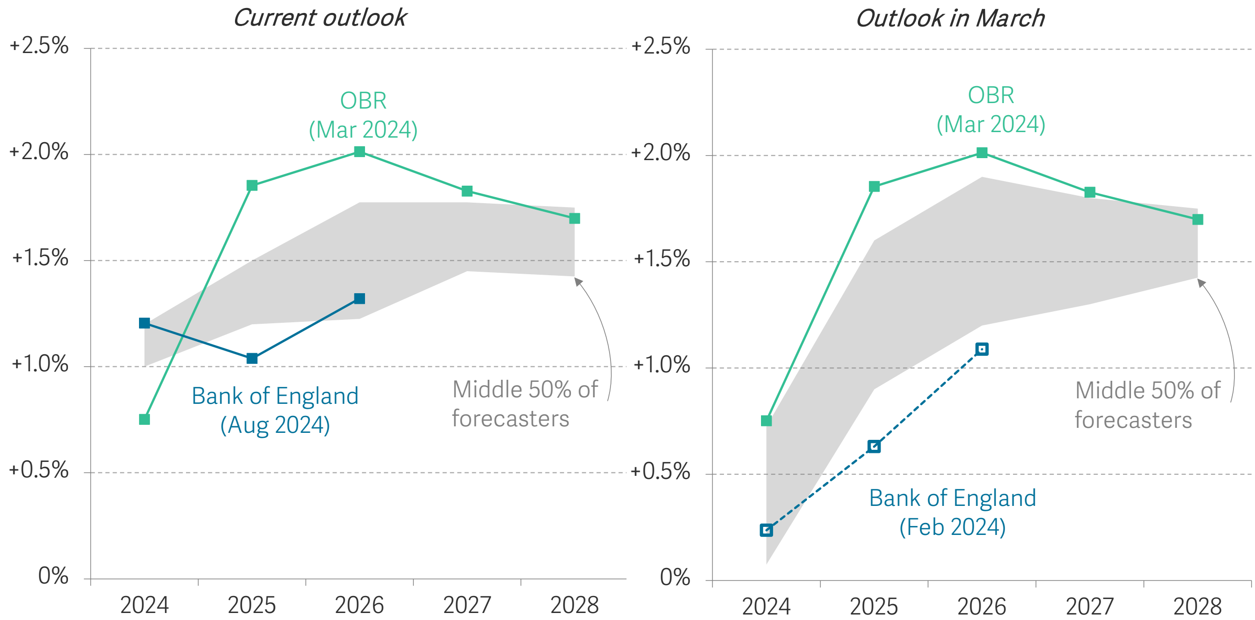
Source RF analysis of ONS, National Accounts; OECD, Quarterly GDP; and Japan Cabinet Office, National Accounts of Japan.

Our judgement is that the OBR will not increase its growth forecast further out, despite the Government making growth one of its missions. The key reason for this is that the OBR's March forecast for next year and beyond has always looked pretty optimistic. This is not a new phenomenon: there has been a big gap between the UK's official forecasters in recent quarters, with the OBR towards the top of the range and the Bank of England at the bottom.[8] As shown in Figure 3, though, better-than-expected growth outturns have prompted the Bank to become more optimistic, including for 2025 and 2026 (upgrading its growth forecasts from 0.6 and 1.2 per cent to 1 and 1.3 per cent respectively). But the OBR's March forecast still lies above the central range of forecasts, suggesting the it is unlikely to pencil in faster growth in the medium term. We discuss the risks around this forecast below, as well as what it might mean for how the OBR 'scores' the Government's growth policies.

8 C Aref-Adib et al., Back for more?: Putting the 2024 Spring Budget in context, Resolution Foundation, March 2024.

FIGURE 3: **The OBR's March forecast for growth in 2025 and beyond still looks optimistic**

Forecasts for calendar-year real GDP growth: UK



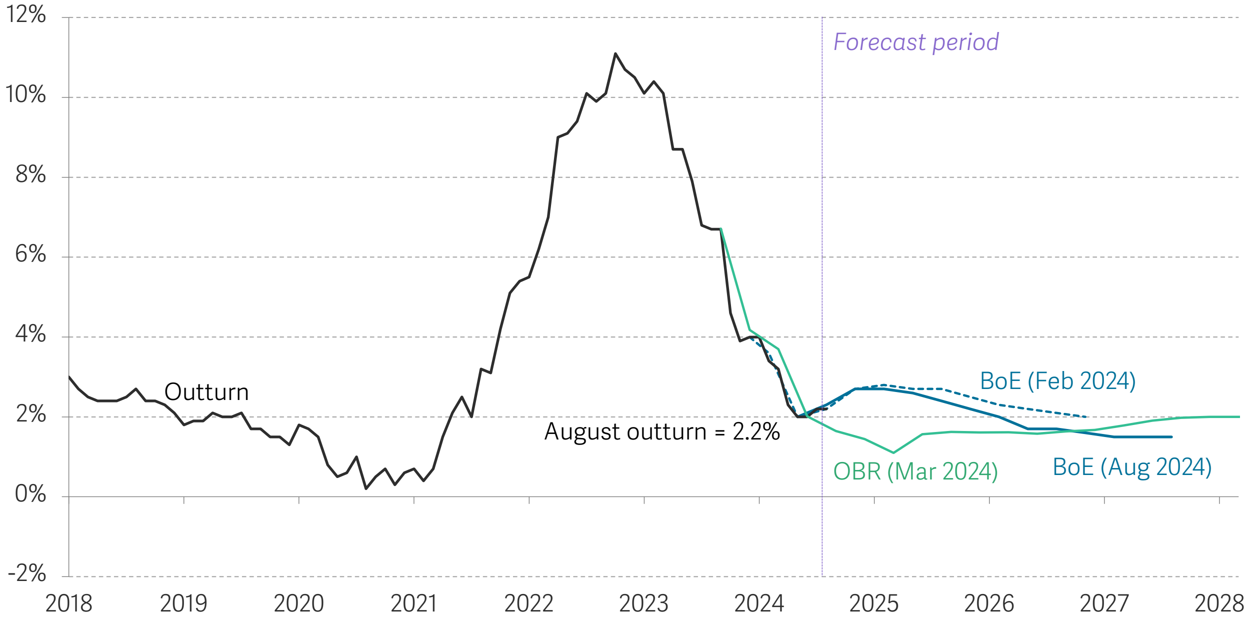
NOTES: External forecasters are those collated by HM Treasury. In 2024 and 2025, the swathes shown only include forecasts made within three months of the relevant forecast iteration. For later years, swathes include all forecasts.
SOURCE: RF analysis of OBR, Economic and Fiscal Outlook, various; HM Treasury, Forecasts for the UK Economy, September 2024; and Bank of England, Monetary Policy Report, various.

The other key moving part for the OBR's economic forecast is inflation. As shown in Figure 4, during the first half of this year inflation fell faster than the OBR expected back in March. But the OBR had also been assuming that inflation would continue to fall in the second half of this year and into next. Instead, inflation has started to rise as the large, downward contributions from falling energy prices have dropped out of the calculation, revealing sticky underlying domestically-driven inflation.[9] This was what the Bank of England was expecting at the time of the Spring Budget (Figure 4) and, given that we are now seeing inflation picking up, it is now likely that the OBR will move its forecast towards the Bank's. It probably won't go all the way, though, not least because, at 2.2 per cent in August, inflation was 0.2 percentage points below the Bank of England's August forecast. But the direction of travel for the OBR's inflation forecast is up. And any move in that direction is likely to feed through to the OBR's forecast for nominal wages and other price measures, such as the GDP deflator, which underpin its forecast for tax receipts. So, although stickier-than-expected inflation is bad news for living standards and mortgage holders, it is good news for tax receipts, which will be higher relative to spending, particularly that for public services where plans are fixed in cash terms.

9 Bank of England, Monetary Policy Report, August 2024.

FIGURE 4: **Inflation is falling more slowly than expected in March**

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



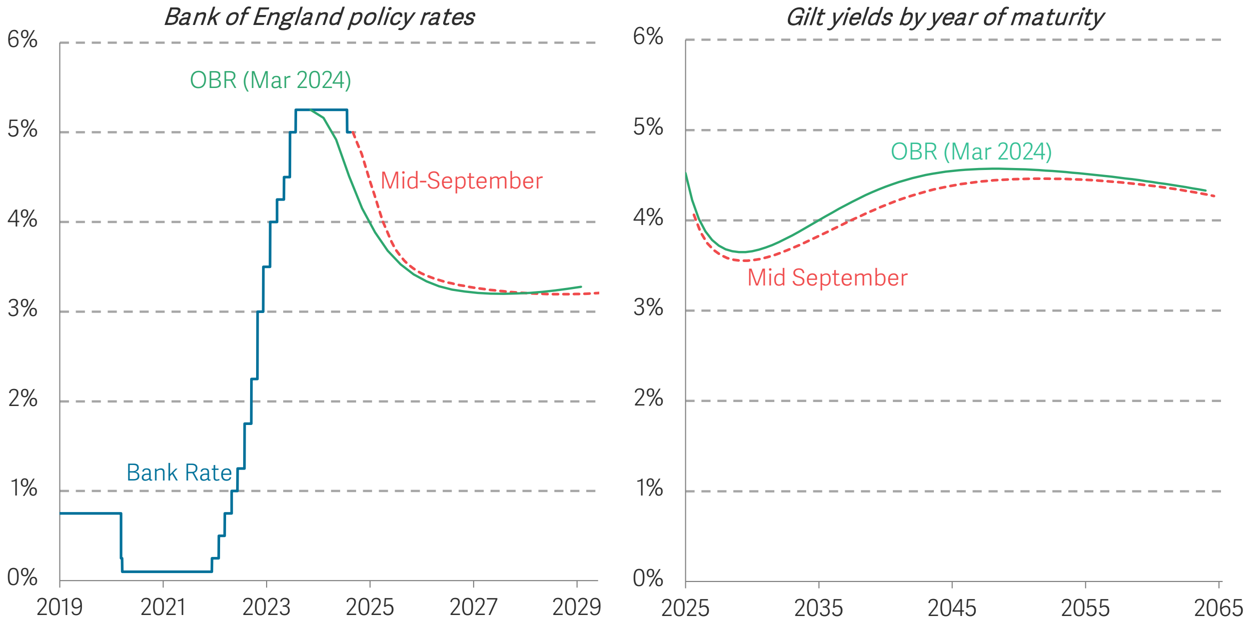
SOURCE: ONS, Consumer Price Inflation; OBR, Economic and Fiscal Outlook, March 2024; Bank of England, Monetary Policy Report, various.

The other piece of good news for the Chancellor is that faster growth and higher inflation have not come with significantly higher interest rates. This matters because higher interest rates put upward pressure on the cost of servicing government debt. And, as shown in Figure 5, while the stickiness of inflation has meant that the Bank of England has not cut its policy rate (Bank Rate) as quickly as expected over the past six months, longer-term interest rates are little changed from those used in the March forecast. It is worth noting that, since the mid-September data that OBR is likely to use as the basis of its forecast, longer-term interest rates are up by around 0.2 percentage points. This would add just £2.5 billion to debt interest by 2029-30 if the rise was sustained.[10]

10 We assume throughout this document that the OBR is likely to have used market data from mid-September for its upcoming forecasts, in line with the 'cut-off' point they used in the previous forecast. This would mean that recent changes to gilt yields would not be reflected in the forecasts accompanying the Autumn Budget.

FIGURE 5: **Interest rates are little changed from those underlying the OBR's March forecast**

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

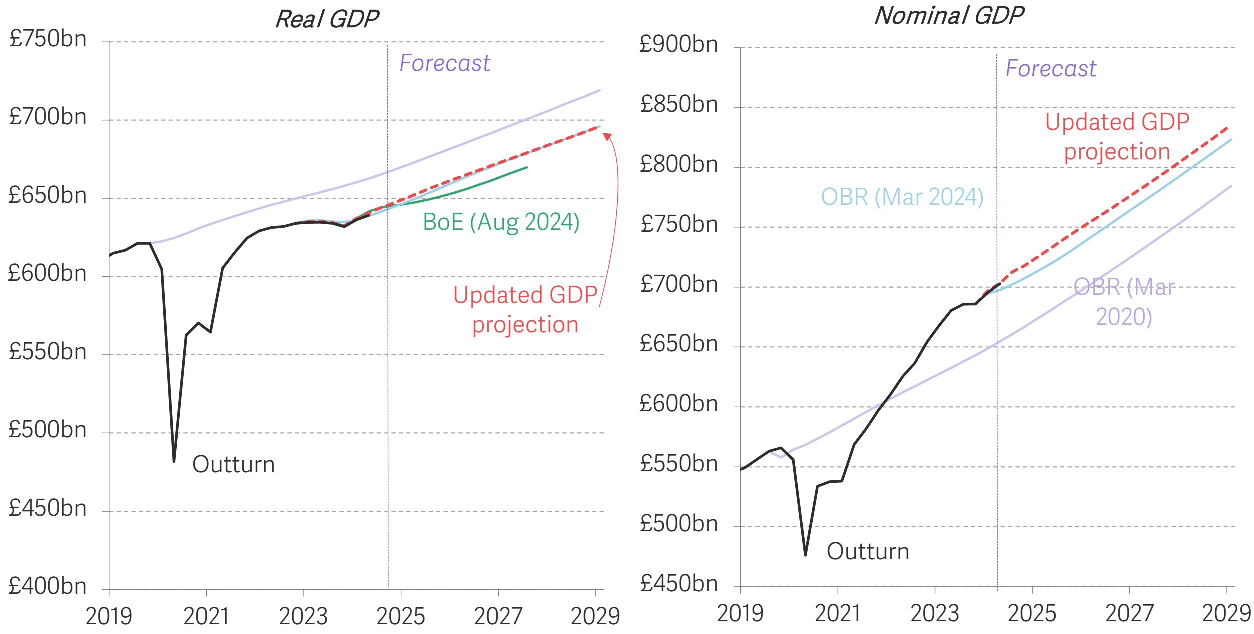


NOTES: Mid-September refers to an average of the rates prevailing between 4th September and 17th September.
SOURCE: Bank of England, Yield Curves; and OBR, Economic and Fiscal Outlook, March 2024.

So this improvement in the economic outlook should provide a boost to the public finances, offsetting some of the additional spending pressures. Higher inflation in particular means that the cash size of the economy is likely to be bigger. In Figure 6 we provide an illustrative update to the OBR's March forecast: real GDP is around 0.5 per cent stronger in the near term, although by the end of the forecast is little changed; but our best guess is that GDP in cash terms will be around 1.5 per cent higher on average over the forecast than it was in March. As we discuss in the next section, these developments will affect the public finances in a number of ways but, in net terms, will put downward pressure on borrowing making the Chancellor's life easier, at least to some degree.

FIGURE 6: **The OBR's GDP forecast is likely to be revised up, particularly in cash terms**

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



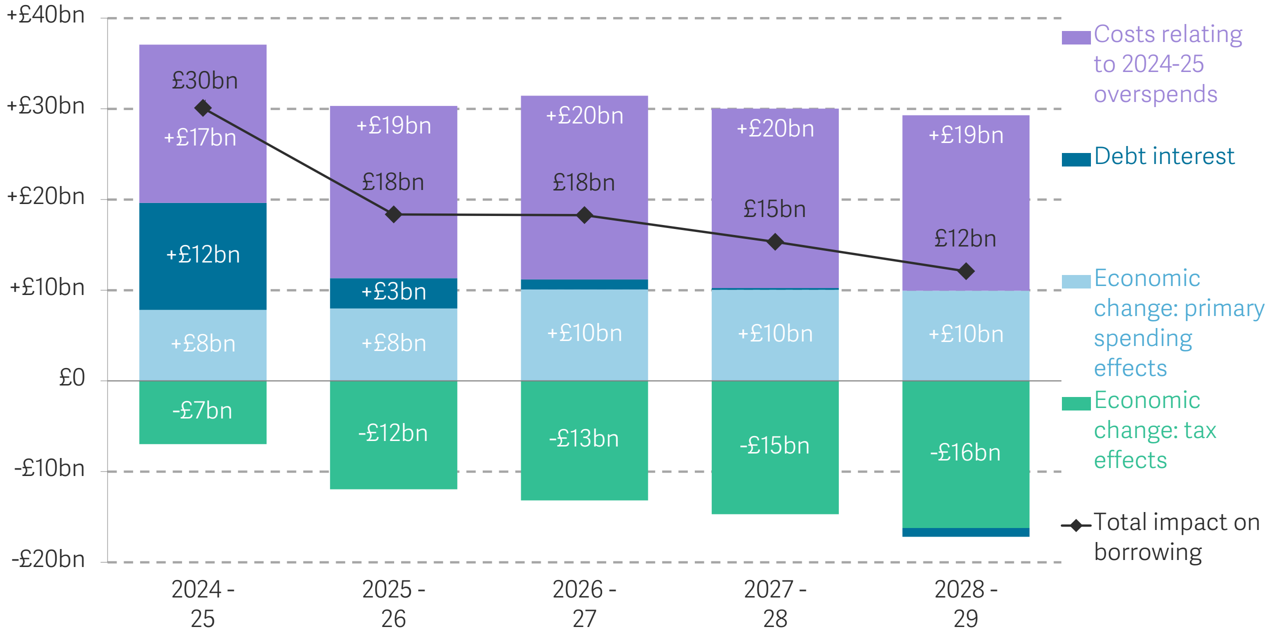
NOTES: All forecasts have been restated to be consistent with the latest vintage of National Accounts data.
SOURCE: RF analysis of ONS, National Accounts; Bank of England, Monetary Policy Report, August 2024; OBR, Economic and Fiscal Outlook, various.

Higher spending is partially offset by a stronger economy in our update of the Spring Budget fiscal forecast

From the point of view of the public finances, higher spending pressures are only partially offset by the impact of a stronger economy and higher inflation, leaving a mechanical, 'pre-measures' version of the fiscal forecast with marginally higher borrowing than expected. The additional spending, on public sector pay, asylum costs and other factors adds around £19 billion to borrowing relative to the OBR's March forecast by 2028-29 (the purple bars in Figure 7). Upward revisions to the OBR's inflation forecast also result in higher spending in some areas, for example on welfare payments. As a result, overall spending (excluding debt interest) is on average £9 billion higher across our scenario (light-blue bars in Figure 7). Higher inflation and slower falls in Bank Rate also increase debt interest costs this year and next, by £12 billion and £3 billion respectively (dark-blue bars in Figure 7). However, higher inflation also boosts tax receipts significantly, by £16 billion relative to the OBR's March forecast by 2028-29, offsetting a significant portion of these additional spending pressures. Overall, our simple update of the Spring Budget forecast suggests borrowing would be around £12 billion higher than the OBR forecast in March by the forecast horizon in 2028-29.

FIGURE 7: **Higher tax receipts are likely to offset some of the additional spending pressures that have materialised since March**

RF scenario impact on public sector net borrowing: 2024-25 to 2028-29



SOURCE: RF analysis of OBR, Economic and Fiscal Outlook, March 2024.

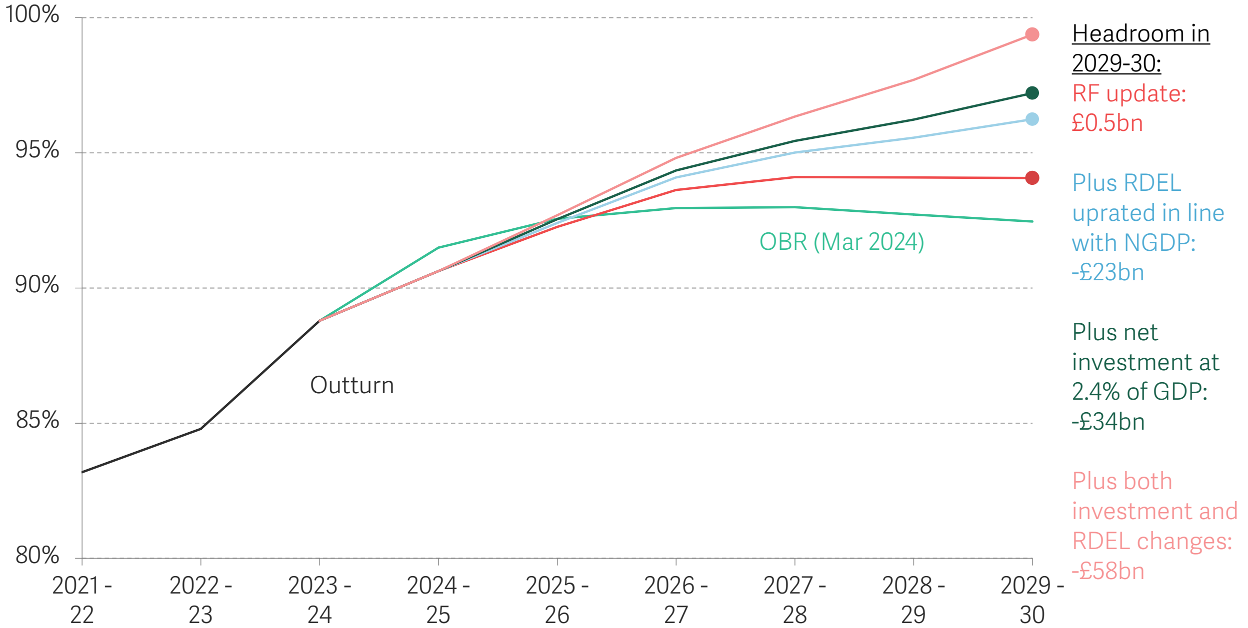
As a result, by the end of the forecast period (which will be rolled on to 2029-30 at the Autumn Budget), public sector net debt excluding the Bank of England is higher than the OBR's March forecast in our simple update (Figure 8). On this basis, debt would rise to nearly 94 per cent of GDP by 2029-30, significantly more than the OBR's March forecast. Public sector net debt is also falling more slowly between the fourth and fifth years of the forecast.[11] This metric was the binding fiscal rule under the previous Government, and, as discussed below, was expected to be adopted by the new Government too.[12] The slower fall in debt is despite stronger growth in nominal GDP, the denominator in the debt-to-GDP ratio. We estimate that the margin by which the Government would be meeting this target (so-called 'headroom'), falls from around £9 billion at the Spring Budget, to an extremely slim margin of just £0.5 billion, essentially leaving no headroom against this target.

11 In their Autumn forecast, the OBR will forecast the year 2029-30 for the first time. It is challenging to quantify the extent to which this will change the headroom available to the Government against existing fiscal rules. In these scenarios, trends in net debt as a share of GDP are assumed to continue in line with previous years in this new final year of the forecast with a similar level of headroom implied in our 'baseline'. In practice, 'rolling forward' the forecast to an extra year may give the Government significantly more (or indeed less) headroom.

12 R Reeves, Rachel Reeves Mais Lecture 2024, The Labour Party, March 2024.

FIGURE 8: **Headroom against the existing debt target is likely to be extremely slim**

Public sector net debt (excluding the Bank of England) as a share of GDP, outturn and scenarios: UK



SOURCE: RF analysis of OBR, Economic and Fiscal Outlook, March 2024.

It is important to stress that the fiscal outlook is inherently uncertain. Figure 9 provides a sense of that uncertainty. Here, even a moderate downgrading of the OBR's assumption for future productivity growth, which is the key moving part in its longer-term GDP growth forecast, would see the existing fiscal rules broken by nearly £20 billion.[13] And, as discussed in Box 1, recent productivity data have been weak, and look even weaker if employment is higher than suggested by the Labour Force Survey.[14] This case for a markdown to trend productivity is strengthened by the OBR's medium-term forecast lying above a range of external forecasts (Figure 3). But the recent strength of GDP data along with recent Government policy actions suggest now would be an odd time for the OBR to make a big judgement about trend growth.[15] So a plausible central case is that there is little change to the longer-term growth forecast, despite Government policy in this area. This is, however, a big call for the OBR and any change here would make a big difference to the outlook.

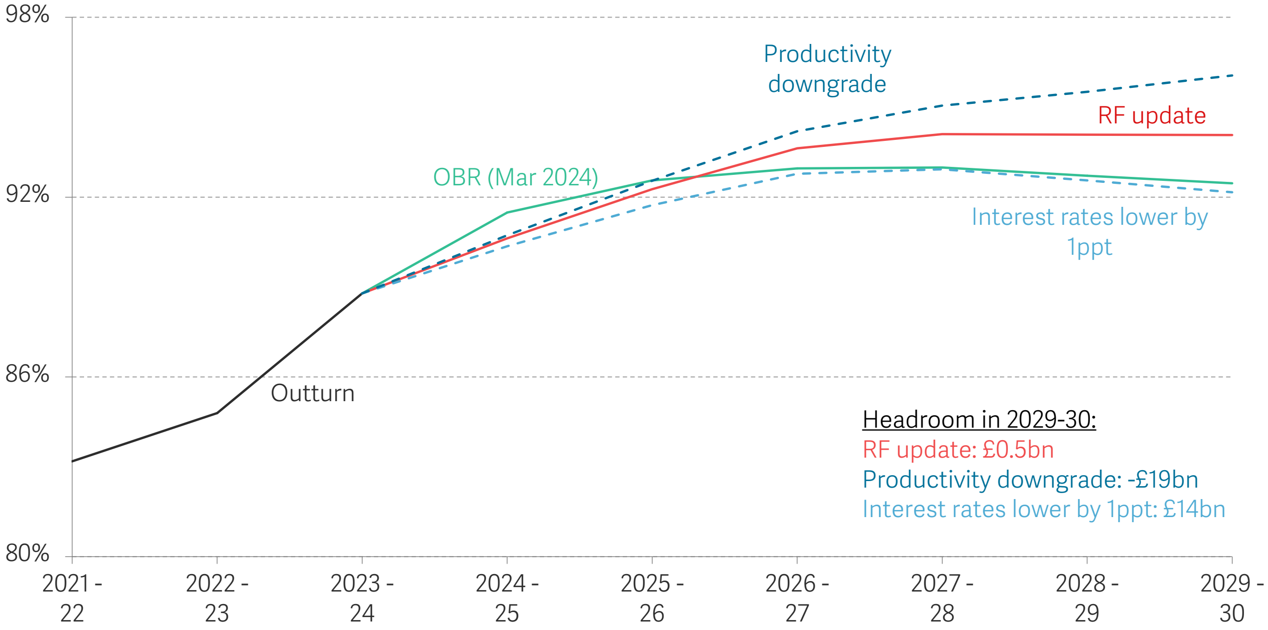
But not all risks point in the direction of higher borrowing. Interest rates remain volatile, and a shift downwards in interest rate expectations by one percentage point across the forecast would result in much lower debt interest costs over the next five years. This

13 C McCurdy, C Pacitti & J Smith, Debt dramas: Putting the public finances in context ahead of general election 2024, Resolution Foundation, June 2024.
14 A Corlett & H Slaughter, Measuring up? Exploring data discrepancies in the Labour Force Survey, Resolution Foundation, August 2024.
15 E Fry & G Thwaites, The growth mindset: Sizing up the Government's growth agenda, Resolution Foundation, September 2024.

scenario would see borrowing around £15 billion lower in 2029-30, with headroom against existing fiscal rules expanding to £14 billion.

FIGURE 9: **There is considerable uncertainty around the economic and fiscal outlook**

Public sector net debt (excluding the Bank of England) as a share of GDP, outturn and scenarios: UK, 2021-22 to 2029-30



SOURCE: RF analysis of OBR, Economic and Fiscal Outlook, various.

BOX 1: **Recent productivity data have been weak and could be even weaker if data on employment is revised up**

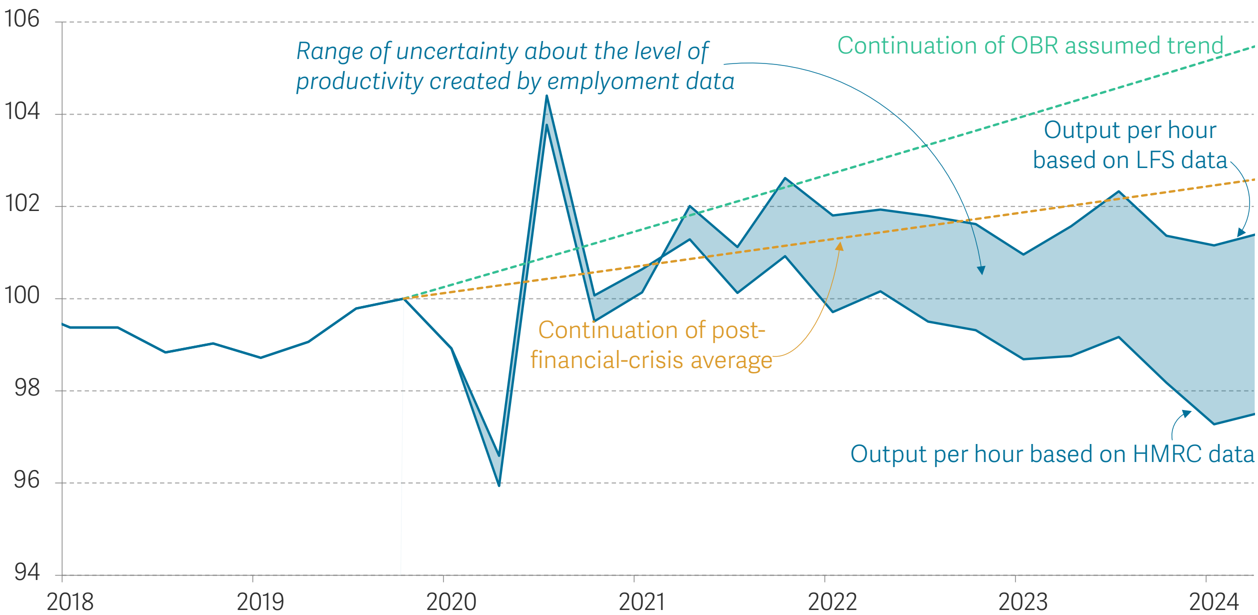
A key assumption underlying the OBR's fiscal forecast is its assumption for trend productivity growth.[16] In that context, as shown in Figure 10, it is worrying that recent productivity data have been weak. This comes despite much faster-than-expected GDP growth in H1 2024 and reflects the strength of the growth in average hours. But official data on productivity are based on employment from the Labour Force Survey (LFS). And in recent months, worries about the quality of the LFS data have become apparent.[17] These concerns go in the direction of suggesting that employment has been underestimated since 2019. In previous work, we've found that data on employment collected for tax purposes suggests the number of people in

16 Office for Budget Responsibility, Forecasting potential output – the supply side of the economy, Briefing Paper No.8, November 2022.
17 Office for National Statistics, Impact of reweighting on Labour Force Survey key indicators: 2024, 5 February 2024.

employment could be more than a million higher than suggested by the LFS.[18] If that was the case, productivity data would be much weaker. An upper bound for the extent of this measurement problem is shown in Figure 10 and suggests that the level of productivity would be around 3.8 per cent below that based on the LFS with that gap opening up since 2019. This estimate suggests that the level of output per hour is more than 7 per cent below a continuation of the OBR's assumed trend growth rate from just prior to the pandemic (Q4 2019), which itself lies above the post financial-crisis average. So, while there is considerable uncertainty about the productivity data at the moment, the data suggests that the OBR assumed trend for productivity growth is looking optimistic, suggesting the risk of downgrade to trend growth and significant deterioration in the outlook for the public finances.

FIGURE 10: **Recent productivity data looks weak, especially based on employment measured by tax data**

Index of output per hour worked, Q4 2019 = 100: UK



NOTES: OBR assumed trend is for growth in output per hour of around 1.2 per cent, consistent with the final year of the OBR's March forecast. Post-financial-crisis average growth in output per hour is 0.6 per cent (2010 to 2023).
SOURCE: RF analysis of ONS, Labour Market Statistics & National Accounts; and OBR, Economic and Fiscal Outlook, various.

18 A Corlett & H Slaughter, Measuring up? Exploring data discrepancies in the Labour Force Survey, 13 August 2024.

The public finances are under significant pressure and the new Government has big policy ambitions

This fiscal outlook is undoubtedly a difficult one. The combination of public-service overspends and the encouraging economic news leaves the overall picture barely changed since the March Budget. This means that all the difficulties that faced the previous Government – large planned tax rises, spending plans that look undeliverable, and big cuts to public investment – remain. On top of this, the new Government has been clear about its ambitions: to achieve the fastest sustained growth in the G7, with a strong focus on boosting investment; to avoid a return to austerity; and to keep to its manifesto pledges not to increase the rates of Income Tax, National Insurance, VAT or Corporation Tax. Achieving all this against a backdrop of such stretched public finances is clearly very challenging. So, below we attempt to quantify the impact of these ambitions for the public finances, setting out a range of scenarios for investment and day-to-day public services spending.

Investment is the key to growth, so the Chancellor must reverse steep investment cuts

Britain's public sector net investment (PSNI) is on a worrying path. Current forecasts imply that PSNI will fall from 2.4 per cent of GDP to 1.7 per cent of GDP by 2028-29 – a steep decline which would threaten growth and the quality of public services provision.[19] There is no low-investment route to sustained prosperity: public investment can support production of public services (e.g. expanding the number of hospital beds) and provide vital inputs into other industries (e.g. connecting firms, workers and consumers to each other via roads and railways).[20] So, a Budget that sought to target growth should avoid cuts to investment. To assess the impact of higher investment for the public finances we consider a scenario in which investment remains at its current level of 2.4 per cent of GDP, which would cost £30 billion in additional gross investment in 2029-30 (see Figure 11).[21]

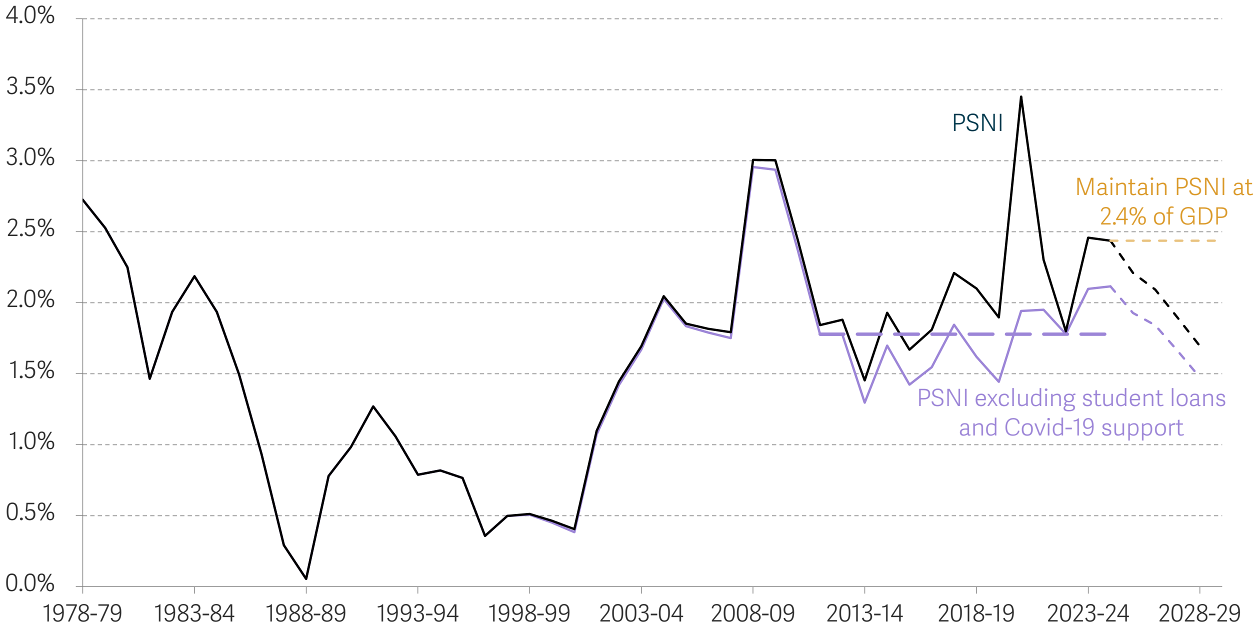
19 When this boosts productivity, it does so either directly in the public sector, or indirectly through the effects of better public services on the workforce (such as through better health or education).

20 F Odamtten & J Smith, Cutting the cuts: How the public sector can play its part in ending the UK's low-investment rut, Resolution Foundation, March 2023.

21 The Government's initial announcements take it part of the way. These include establishing Great British Energy, and aiming to leverage private finance through the creation of the National Wealth Fund, a vehicle for combining public and private finance for infrastructure. These pledges – if additional to the current PSNI trajectory – would get the Government to 1.8 per cent of GDP by the end of the forecast.

FIGURE 11: **Cuts to public sector investment are baked into the current forecast**

Public sector net investment as a proportion of GDP: UK



NOTES: Includes 'Fixing the foundations' cuts to A roads in 2025-26, and capital AME infected blood compensation.
SOURCE: RF Analysis of OBR, Economic & Fiscal Outlook, various, Public Sector Finances Databank; Bank of England, A millennium of macroeconomic data for the UK, 2020; HM Treasury, Chancellor's statement; Fixing the foundations, Public Spending audit, 2024-25, July 2024.

The Government vows "no return to austerity", but delivering this for unprotected departments would be expensive

The Chancellor has said that "there will be no return to austerity", but it is not clear what this means in practice.[22] The new Government would like to draw a clear line under the post-2010 cuts when total manged expenditure (TME) declined as a share of the economy for nine consecutive years, the longest such pause on record.[23] The bulk of these cuts came from slashing day-to-day public service spending (RDEL) which fell as a proportion of GDP from its peak of 18.3 per cent in 2009-10 to a low of 13.9 per cent in 2018-19.[24]

In interviews, the Chancellor has suggested that her definition of avoiding austerity means real-terms increases in spending, a relatively narrow definition of the term.[25] This was, however, also true of the previous Government's plans, which were for RDEL to increase by around 1 per cent in real terms over the forecast period. Nevertheless, those

22 R Reeves, Speech at the Labour Party Conference 2024, September 2024.
23 During this time, TME fell from 46.5 per cent as a share of GDP to 39.5 per cent of GDP, equivalent to £1,500 per household in 2024-25 prices.
24 In real, per-person terms, RDEL spending fell by 15 per cent between 2009-10 and 2018-19 (on average, a cut of 1.8 per cent each year) before ticking up to 14.4 per cent in 2019-20 after Prime Minister Theresa May declared an end to austerity. For more discussion of austerity and its consequences see: C McCurdy, C Pacitti & J Smith, Debt dramas: Putting the public finances in context ahead of general election 2024, Resolution Foundation, June 2024.
25 The Guardian, Reeves pledges increased government spending and no return to austerity, accessed 9th October 2024.

plans would be extremely difficult to deliver.[26] If we take account of commitments on the NHS, schools, childcare, defence, and aid, then the other 'unprotected' services – including flood defence maintenance, police, criminal courts, and social care – are facing real-terms per capita cuts of 15 per cent on average between 2024-25 and 2029-30, worth £23 billion in 2029-30 (Figure 12). This is equivalent to three-quarters of the rate of cuts to unprotected departments during the austerity years, with annual cuts of 3.2 per cent between 2024-25 and 2029-30 compared with 4.3 per cent between 2009-10 and 2018-19. Cuts on this scale would come at time when many public services are already in a very difficult position.[27]

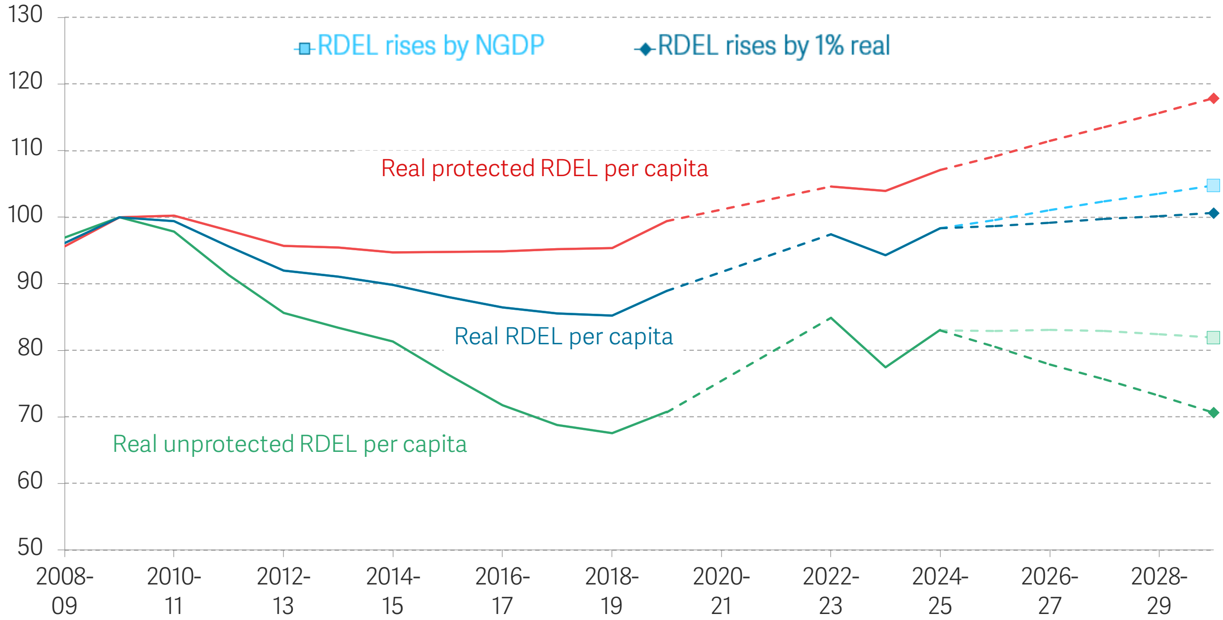
To protect public services from further cuts, the Government would need to raise total RDEL at faster rate than pencilled in by the previous Government. In modelling what this would take, we assume RDEL is raised in line with nominal GDP. This implies reversing almost all of the per capita cuts in unprotected departments pencilled in by 2029-30 and would cost around £21 billion by that year, as shown by the light-blue and light-green dotted lines in Figure 12. This can be interpreted as going further than Chancellor has suggested, but it would still leave the level of real, per-capita RDEL for unprotected departments at 2016-17 levels, meaning that meeting urgent pressures in some public services would still very likely require imposing very tight settlements on others.

26 C McCurdy, C Pacitti & J Smith, Debt dramas: Putting the public finances in context ahead of general election 2024, Resolution Foundation, June 2024. By the end of 2028-29, total Government spending was expected to expand from £1.22 trillion to £1.26 trillion, including a modest increase in RDEL from £427 billion to £445 billion.

27 S Hoddinott et al., Fixing public services: Priorities for the new Labour government, Institute for Government, July 2024.

FIGURE 12: **Unprotected depts face steep cuts of 15 per cent by 2029-30**

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



NOTES: Deflated using the OBR forecast for the GDP deflator to 2024-25 cash terms. Protected budgets include health, education, defence and foreign, commonwealth and development office. Health budget is assumed to grow by 3.6 per cent a year in real terms; education budget is assumed to be flat in real terms and topped up for projected costs of childcare policies; defence is assumed to grow with nominal GDP; and foreign, commonwealth and development office budget is assumed to grow in line with 0.6 per cent of GNI. Figures include the impact of Barnett consequentials. An additional £17.85 billion of net RDEL is added to the total in 2024-25 from 'Fixing the foundations' and uprated in line with 1 per cent real growth.
SOURCE: RF analysis of OBR, Economic and Fiscal Outlook, various; HM Treasury, Budget and Spending Review documents, various; HM Treasury, Chancellor's statement; Fixing the foundations, Public Spending audit, 2024-25, July 2024.

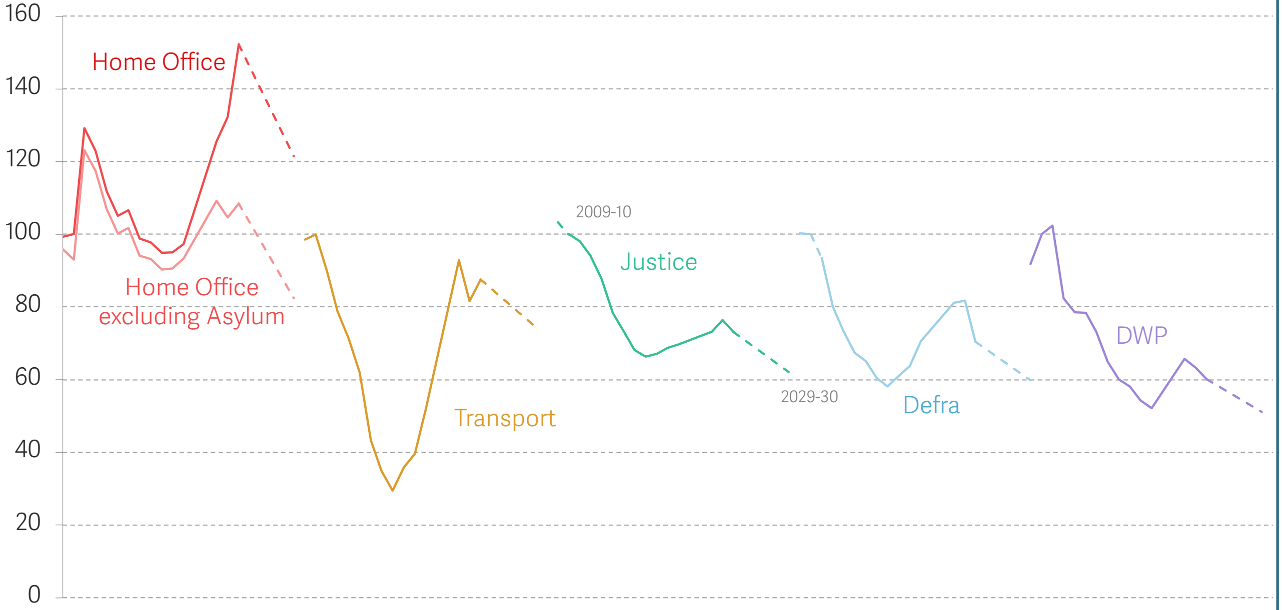
BOX 2: **Public services are under severe pressure in many areas**

Many unprotected departments have never recovered from the austerity of the 2010s. By 2024-25, the departmental spending budgets of both the Department for Work and Pensions and the Department for Environment, Food and Rural Affairs were still well below their pre-austerity budgets per person - down by 40 per cent and 30 per cent respectively (see Figure 13). The Ministry of Justice, meanwhile, is down by 27 per cent per person, which has coincided with a palpable deterioration in measurable aspects of its performance. Consider the handling of crown court cases: the cases not seen in six months has rocketed, doubling from 22 per cent to 48 per cent between 2019 and 2023.[28]

28 Institute for Government, Public Services Performance Tracker; ONS, Crime Survey for England and Wales.

FIGURE 13: **Many departments facing fresh cuts have already been cut dramatically**

Change in real, per-person resource departmental expenditure limits between 2009-10 and 2029-30 (2009-10 = 100): UK



NOTES: FCDO (Foreign, Commonwealth & Development Office), DWP (Department for Work & Pensions). Note that change can be driven by policy (e.g. FCDO via overseas aid cut to 0.5 per cent of GNI in 2021-22) and classification changes (e.g. large increase in Transport driven by reclassification of Network Rail from AME to DEL in 2019-20).
SOURCE: RF analysis of OBR, Economic and Fiscal Outlook, various; HM Treasury, Budget and Spending Review documents, various, Home Office, Cost of processing asylum applications from 2010 to 2013; Home Office Supplementary Estimates, various.

These pressures are particularly visible in local government, where total 'spending power' per person stands, in 2024-25, down by an average of 23 per cent on 2010-11. And that austerity hit hardest in the most deprived areas, which had relied relatively more on grants from Central Government and relatively less on local tax receipts.[29] Warnings of financial difficulties are crystallising into hard realities: since 2020, nine councils – including Birmingham and Nottingham – have issued Section 114 notices, the local government equivalent to declaring bankruptcy.[30]

Meanwhile, even 'protected' departments are also exhibiting serious strains. The share of healthcare, for example, in total public service spending has risen markedly since 2009-10, but the patient experience often belies that.[31] The proportion of

29 G Atkins & S Hoddinott, Local government funding in England: How local government is funded in England and how it has changed since 2010 , Institute for Government, March 2020.
30 M Sandford & P Brien, Why are local authorities going 'bankrupt'?, House of Commons Library, July 2024; National Audit Office, The local government finance system in England: overview and challenges, November 2021.
31 C McCurdy, C Pacitti & J Smith, Debt dramas: Putting the public finances in context ahead of general election 2024, Resolution Foundation, June 2024.

A&E patients not seen and discharged within four hours has soared from 5 per cent in 2010 to 22 per cent in 2019 and 42 per cent by 2023.[32] Meanwhile, some 7.6 million people were on waiting lists for treatment in England as of July 2024, up by more than 3 million people over the last 5 years.[33]

The upshot is that there is less scope than there otherwise might be to protect the budgetary 'losers' from the last round of austerity by rebalancing resources from the relative 'winners' like health. The sums get even trickier when we factor in the £4.5 billion of the Government's manifesto commitments, such as 40,000 more scans, spending on dentistry, breakfast clubs, new teachers, teacher training, and legal aid.[34] Tellingly, £4-in-£5 of the Government's manifesto commitments are to protected departments, which – if delivered - would lead to even more pressures on unprotected areas, if spending is not raised further beyond nominal GDP. Unless the Government wishes to rethink or even stop what various unprotected departments provide, in a way it has as yet shown no appetite for doing, it will have little choice but to raise the inherited plans for day-to-day public service spending, so as to address their brutal logic for unprotected services.

Where does this leave the Chancellor at the Autumn Budget?

If the Government dealt with the big spending pressures we have identified and did nothing else, there would be an increase in borrowing. Regardless of whether that's desirable, the Chancellor would face a particular challenge in reconciling that outcome with rules she has promised will restrict borrowing to a prudent level. But over the past weeks, it has become clear that the Chancellor is considering revisiting those rules.

In general, stability in fiscal rules is preferable, so as to give markets a clear and consistent indication of the government's understanding of the limits of prudent borrowing. Recurrent rewriting of rules has been an unwelcome feature of the UK's fiscal policy over the past decade, with twenty-six different sets of rules adopted since 1997.[35] However, that desire for stability does not mean that different governments can't take different approaches to fiscal policy and have different priorities, so it makes sense for the new Chancellor to set out a new framework that reflects her priorities and approach. The desirability of doing so will depend on the detail of the change, the extra freedom of manoeuvre it gives, and the risk any new rules run in terms of exposure to borrowing costs.

32 Source: RF analysis of NHS England, A&E Attendances & Emergency Admission statistics.
33 Source: RF analysis of NHS England, Referral to Treatment (RTT) Waiting Times.
34 Labour Party, Labour Party Manifesto 2024, June 2024.
35 T Pope & P Hourston, Fiscal rules in the UK since 1997, Institute for Government, March 2022.

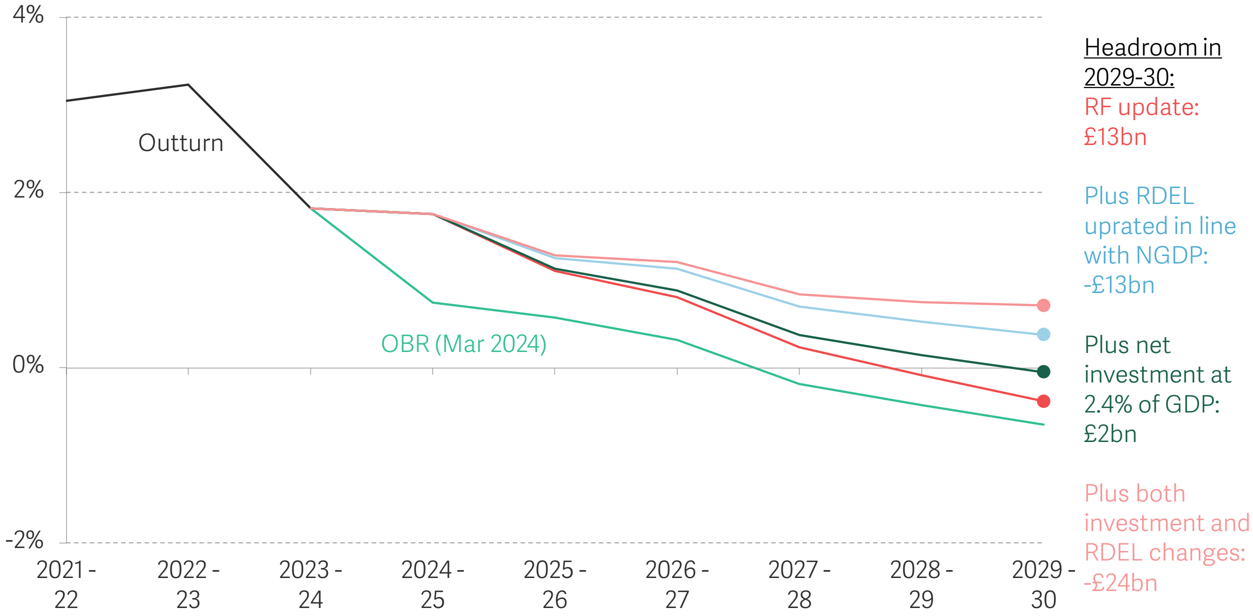
In opposition, Labour said that it would have two fiscal rules in Government. The first – a 'debt falling rule' – was a promise to get public debt down as a proportion of national income between the fourth and fifth year of the forecast. This is essentially the same rule that proved to be the binding constraint on the previous Government's policy. The second – a 'current balance rule' – committed to achieve a current-budget balance, with tax receipts covering all day-to-day spending (this implies that borrowing can only be used for investment). As we have already shown, even before any moves to raise investment or shore up public services, the Chancellor has precious little margin for error in complying with either rule. The two rules have important – but different – implications. We consider these in turn, starting with the current balance rule.

The current balance rule means protecting public services will require at least £20 billion of tax rises

The Government's current balance rule requires fully funding day-to-day spending with Exchequer receipts. Although the current balance position improves across the forecast, as shown in Figure 14, there's relatively little scope for additional non-investment spending at any point. Based on our simple update of the Spring Budget forecast, the Government would start off with headroom of just £13 billion (assuming it was aiming to reach the target of a balanced current budget by 2029-30). But adding the £26 billion of additional day-to-day spending we have suggested would be required to avoid "returning to austerity" (including £5 billion in extra debt interest if this is debt-funded) would immediately flip that into the expectation of missing the rule by £13 billion. Although this rule doesn't directly restrict investment spending, if the current plans for cuts to investment were reversed in the way we have suggested, increased depreciation on a larger capital stock (which counts as current expenditure) and higher debt interest on the extra borrowing would make that miss even bigger, raising it to £24 billion.

FIGURE 14: **The new Government's 'current balance' rule precludes saving public services from 'austerity' via borrowing**

Public sector current budget deficit as a share of GDP, outturn and scenarios: UK, 2021-22 to 2029-30



SOURCE: OBR, Economic and Fiscal Outlook, March 2024.

Avoiding austerity in public services, then, means either reducing spending outside of public services, or increasing tax. The former would mean reducing so-called Annually Managed Expenditure (AME) – the more unpredictable and less controllable Government spending. Unfortunately, the scope for cuts here appear limited. Indeed, there is, again, a strong case for increasing spending here too relative to previous plans. For example, the previous Government included savings in AME of £1.3 billion in the final years of the forecast, from changes to incapacity benefits through the Work Capability Assessment.[36] By tightening eligibility for the 'Limited Capability for Work Related Activity' element of Universal Credit, currently worth £416.19 a month, the previous Government said it would be able to tackle the rising welfare bill and reduce economic inactivity.[37] But these plans look risky to implement on the timelines previously envisaged, meaning that the new Government would be wise to at least delay them.[38] And while the previous Government committed to uprate Local Housing Allowance (LHA) to match local rents in April 2024, the current forecast assumes that rates will be frozen for the following five years. Failing to uprate LHA rates in April 2025 would expose privately-renting households claiming housing support as rents inevitably continue to rise.[39] Furthermore, there is a growing consensus that abolishing the two-child limit and benefit cap would be an effective

36 See HM Treasury, Table 5.1 Autumn Statement 2023 Policy Decisions, November 2023.
37 Universal Credit, What you'll get; L Murphy, Reassessing the Work Capability Assessment: What might the proposed changes to the Work Capability Assessment mean for low-to-middle income families?, Resolution Foundation, September 2023.
38 M Brewer & L Murphy, Cutbacks ahead, Resolution Foundation, October 2024.
39 RF analysis of English Housing Survey, FT3231 (S427): trends in households saying that they receive housing support, 2022-23.

part of the Government's Child Poverty Strategy, with Resolution Foundation forecasts suggesting this could lift nearly 500,000 children out of poverty.[40] Ending the benefit cap and re-pegging the Local Housing Allowance to the 30th percentile of local rents would each cost around £0.5 billion next year, with abolishing the two-child limit costing a further £2.5 billion, bringing the total from these three welfare changes to £3.5 billion next year.[41]

So, with no margin for reducing other spending, avoiding a return to austerity means the Chancellor would require tax rises to meet a current balance rule at the Autumn Budget. These would need to amount to around £20 billion a year to allow the Government to increase departmental spending and invest.[42] But it would also be prudent to allow a margin of headroom against this target – to avoid policy needing to tighten whenever the forecast deteriorates. As discussed in Box 3, headroom has been set at historically low levels at recent fiscal events. Increasing headroom even to such low levels would mean that the tax rises would need to be closer to £30 billion. Nonetheless, as shown in Figure 15, post-election tax rises on this sort of scale are not out of the ordinary, with average tax rises over the first two fiscal events after the past eight elections amounting to around £21 billion (on a comparable basis).[43] And any such tax rises would be in addition to around £24 billion a year of increases scheduled to happen between 2025 and 2027, which are already baked into fiscal plans. These include a continuation of Income Tax and National Insurance threshold freezes, an end to pandemic business rates relief for hospitality, increases in Fuel Duty and a planned reduction in the Stamp Duty threshold.[44]

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40 Prime Minister's Office, Ministerial taskforce launched to kickstart work on child poverty strategy, July 2024; Resolution Foundation, Almost two-in-five large families are now affected by the two-child limit – and the majority are set to fall into poverty when the policy is fully rolled out, July 2024.

41 The cost of removing the benefit cap would rise in subsequent years (as the level of the cap is currently assumed frozen) and the cost of uprating the LHA in subsequent years would be dependent on rent growth at the 30th percentile. For more discussion of these policies, see: A Clegg & A Corlett, The Living Standards Outlook 2024, Resolution Foundation, August 2024.

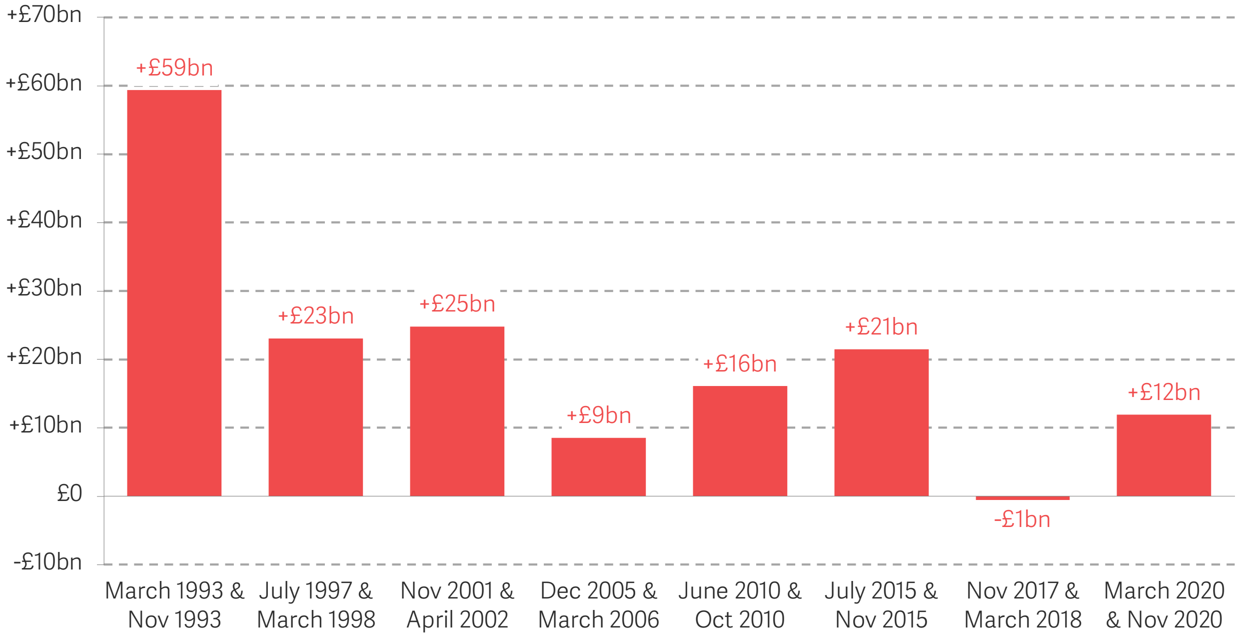
42 This figure is calculated as the £21 billion cost to update RDEL budgets in line with NGDP (excluding debt interest given this spending is no longer debt-funded), plus £5 billion of extra depreciation relating to additional capital spending to keep public sector net investment constant as a share of GDP and £7 billion of additional debt interest related to this capital spending. Netting off existing headroom (£13 billion) against this extra spending would leave around £20 billion of tax rises required.

43 A Corlett, Hiding in plain sight: The Government's record on taxes and the challenges ahead, Resolution Foundation, June 2024.

44 A Corlett, Hiding in plain sight: The Government's record on taxes and the challenges ahead, Resolution Foundation, June 2024.

FIGURE 15: **Post-election tax increases have become the norm**

Net long-term annual impact of tax policy announcements at the two fiscal events after general elections: UK



NOTES: Historic values grown to 2028-29 in line with nominal GDP. Based on forecasts from the time of each fiscal event (actual impacts on tax revenue may have differed).
SOURCE: RF analysis of OBR, Policy measures database, March 2024.

The challenge of raising such amounts is also made more difficult by the Government's commitments to not raise the rates of any of the biggest revenue raisers: Income Tax, National Insurance, VAT and Corporation Tax. But Labour's manifesto contained five specific tax measures that together might raise around £4 billion a year: higher taxes for private schools; closing further 'non-dom' tax loopholes, including for Inheritance Tax; 'carried interest' reform; a small Stamp Duty rise for non-UK residents; and extensions to the North Sea 'windfall tax'.[45] In addition – and potentially bigger than all of those combined – was an intention to raise £6 billion a year extra revenue through targeted HMRC spending.

So how might the Chancellor go about raising another £10-20 billion in tax revenue? As discussed in our previous work, the aim here should be to find tax rises that move the tax system in a more efficient direction – that is, reduce distortions to economic decision making introduced by the tax system – and fall on those with the broadest shoulders.[46] Perhaps the most obvious area for such improvements would be the Capital Gains Tax (CGT) system, which deserves a major overhaul – seeking to align marginal CGT rates for shares with those on dividends (and with taxes on employees for other assets), ending forgiveness at death and for those who have moved abroad, but reintroducing inflation indexing so as to only tax real gains. Increases in rental income and basic-rate

45 Labour Party, Labour Party Manifesto 2024, June 2024.
46 A Corlett, Revenue and reform: What tax changes could – and should – we see in Autumn Budget 2024?, Resolution Foundation, September 2024.

dividend taxes would similarly bring greater consistency between different forms of income. Inheritance Tax is also ripe for reform, and some of its key reliefs and exemptions should be reduced or ended, including those for pension pots, business and agricultural assets and potentially main residences. [47] Meanwhile, extending employer NI to cover employers' pension contributions – whether at the full rate of 13.8 per cent or a lower figure – should be seen as a key way to raise substantial revenue while reducing often arbitrary tax differences between taxpayers. In total, these options could raise as much as £20 billion a year.[48]

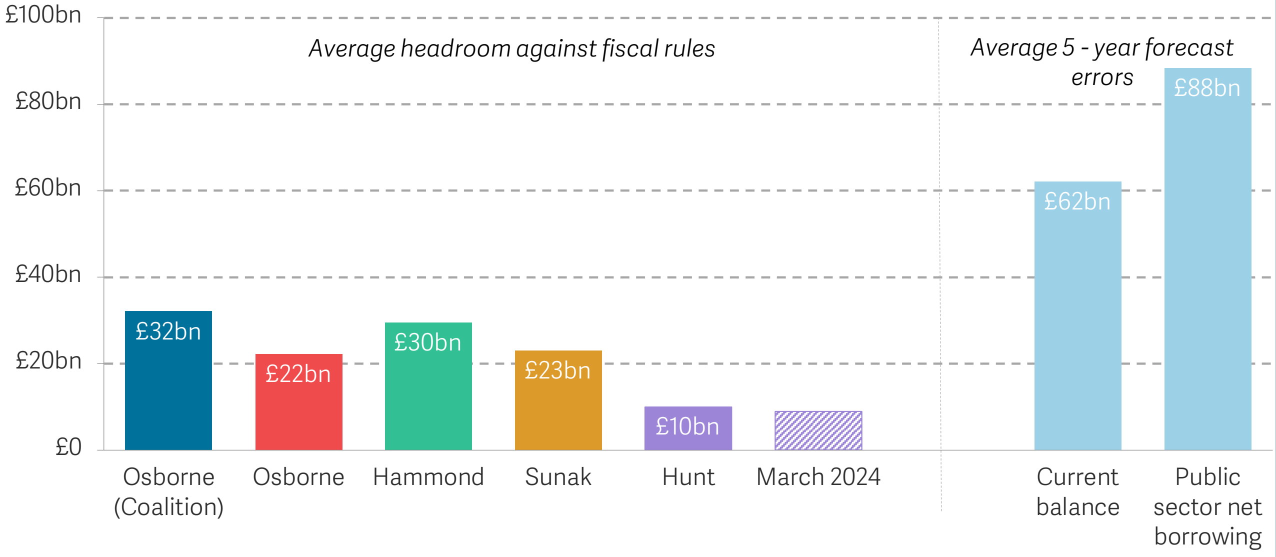
BOX 3: **The Chancellor should also aim to hold adequate headroom against the fiscal rules**

The available 'headroom' against a given fiscal target is sometimes interpreted as the amount available for the government to spend. However, in practice there are very good reasons for Chancellors to preserve some of this breathing space against their fiscal targets. In the face of considerable economic uncertainty (as set out in Figure 9), it is prudent to hold headroom in reserve for unexpected economic shocks, especially for fiscal targets which bind in a whole five-years' time. As shown in Figure 16, the OBR's average forecast error at the five-year horizon for common fiscal measures since the financial crisis (excluding pandemic years) has sat at six- to eight-times the existing headroom. And previous Chancellors chose to hold much higher levels of headroom than the government has inherited, holding an average of over £26 billion against the various fiscal rules held since the Coalition government. In this context, it would be prudent for the Chancellor to try to increase the margin by which she meets her fiscal rules from the £9 billion chosen by Jeremy Hunt, and maintain as much as possible of the £13 billion headroom that she is likely to have against the current balance target.

47 M Broome, An inherited problem, Resolution Foundation, 7th June 2024.
48 For further detail on all of these proposals, see: A Corlett, Revenue and reform: What tax changes could – and should – we see in Autumn Budget 2024, Resolution Foundation, September 2024; and M Broome, A Corlett & G Thwaites, Tax planning: How to match higher taxes with better taxes, Resolution Foundation, June 2023.

FIGURE 16: **Average headroom held by previous Chancellors against their fiscal targets amounts to over £26 billion**

Average headroom held against fiscal rules, by Chancellor (left panel) and average OBR forecast errors at a five-year horizon by fiscal measure (right panel): UK, June 2010 – March 2018



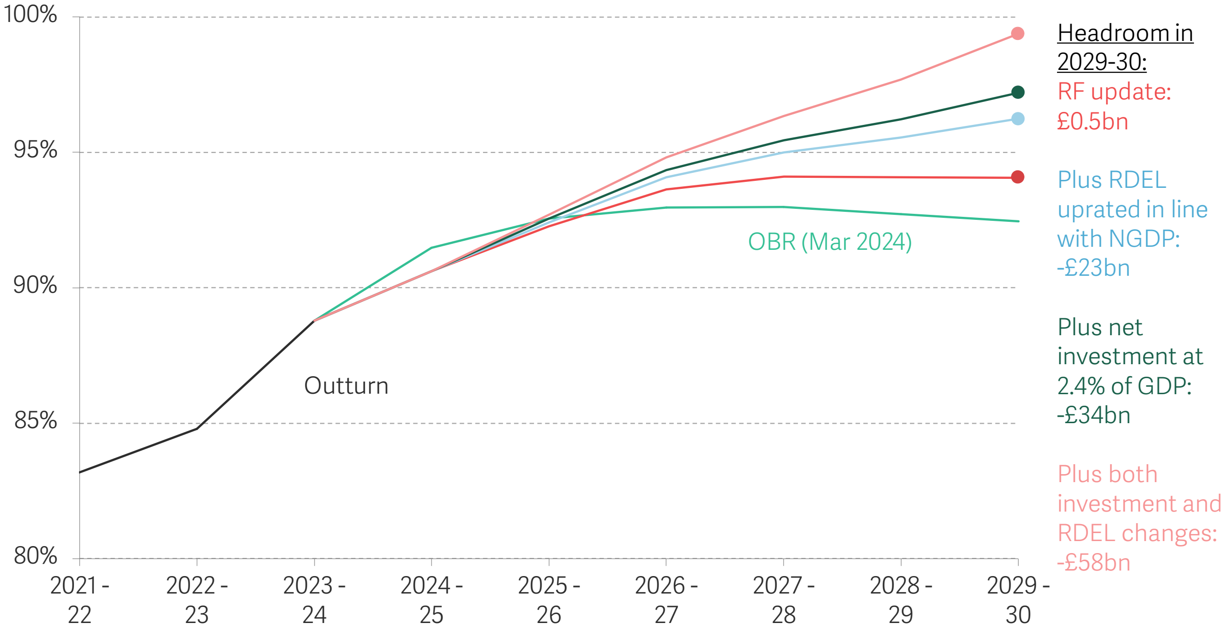
NOTES: Average headroom relates to the following past fiscal targets: 'Osborne (Coalition)' fiscal targets relate to achieving cyclically-adjusted current balance by the end of the rolling, five-year forecast period; 'Osborne' relates to balancing public sector net borrowing in five years (original rule 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. Historical headroom is here presented as a percentage of GDP, multiplied by March 2024 NGDP in 2028-29 for comparability with this forecast. 'Hunt' relates to all budgets since November 22, including March 2024. Five-year forecast errors exclude the year 2020, to remove the effect of large pandemic-related forecast errors.
SOURCE: RF analysis of OBR, Economic and Fiscal Outlook, March 2024; OBR, Historical official forecasts database.

Boosting investment significantly will likely require a change in the debt rule

Tax rises would help the Government to address the departmental spending pressures we set out above, but additional spending relating to the Government's investment ambitions is likely to require higher borrowing. Borrowing for investment has only small effects on the current balance rule, but it poses much more of an issue for the Government's expected debt target, where – as shown in Figure 17 – we estimate that spending pressures will more than offset improvements in the economy to leave headroom against public sector net debt (excluding the Bank of England) falling close to zero before any additional spending pressures. We estimate that layering higher investment spending onto the increases in day-to-day spending discussed above would lead to the Government breaking its debt-falling rule by a margin of £58 billion. This would mean tax increases on a scale that would be very difficult – if not undesirable – to achieve without breaking manifesto commitments on tax. It is therefore likely that this rule will be replaced, with the intention to borrow to invest likely to shape the Government's choice of replacement in its set of fiscal rules.

FIGURE 17: **A rule that targets falling debt between the fourth and fifth year of the forecast rules out extra borrowing to invest**

Public sector net debt (excluding the Bank of England) as a share of GDP, outturn and scenarios: UK, 2021-22 to 2029-30



SOURCE: RF analysis of OBR, Economic and Fiscal Outlook, various.

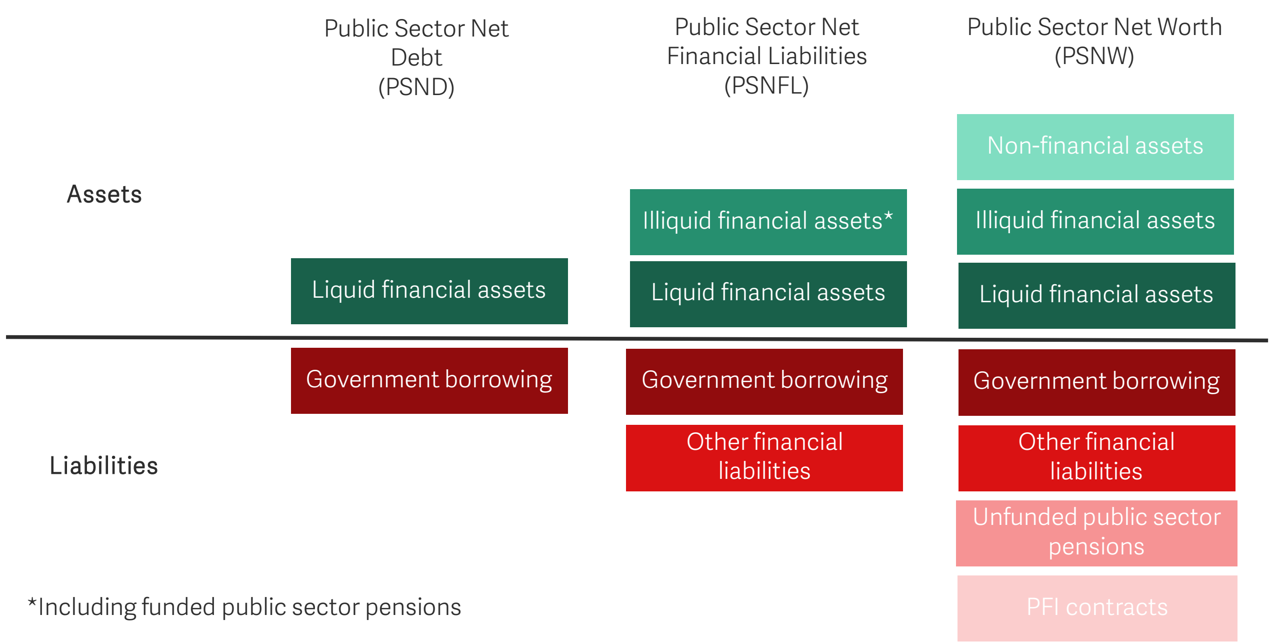
The hints made by the Chancellor at her speech at the Labour Conference suggest that three options are on the table.[49] The first two involve changes to the definition of the 'public sector' the Government uses to set their fiscal rules: either expanding the definition currently used to include the Bank of England; or narrowing it, to exclude the National Wealth Fund and GB Energy, the Government's new vehicles for infrastructure investment.[50] The third, more radical, option instead involves broadening the measure of the balance sheet that is being targeted to include a wider range of assets and liabilities – targeting either public-sector net worth (PSNW), as we have previously argued for, or public-sector net financial liabilities (PSNFL).[51]

49 A Toth, How Rachel Reeves might unlock £57 billion at the budget with a 'simple' fiscal rule change, The Independent, 9 October 2024.
50 For more on the treatment of the National Wealth Fund, see A King & D Jameson, Designing a UK fiscal framework fit for the climate challenge, CETEx and Grantham Research Institute on Climate Change and the Environment, London School of Economics and Political Science, 2024.
51 R Hughes et. al., Totally (net) worth it: The next generation of UK fiscal rules, Resolution Foundation, October 2019.

As illustrated in Figure 18, PSNFL is a more comprehensive measure of the government's financial balance sheet, including some assets and liabilities not considered 'liquid' enough to be included in measures of net debt.[52] The key assets and liabilities included in PSNFL are those related to government loan schemes, where the assets created when a loan is issued are included on the government's balance sheet, as well as the liabilities incurred. This means that the issuing of e.g. student loans, which looks costly in public sector net debt, is fiscally neutral under PSNFL. PSNW is a further step more comprehensive as a measure of the balance sheet, including non-financial assets, such as roads and buildings, as well as the liabilities relating to the government's obligations to pay public sector pensions, and public-private finance arrangements.

FIGURE 18: **There are broader measures of the public sector balance sheet the Chancellor could target**

Various public sector balance sheet measures by component assets and liabilities



SOURCE: RF analysis.

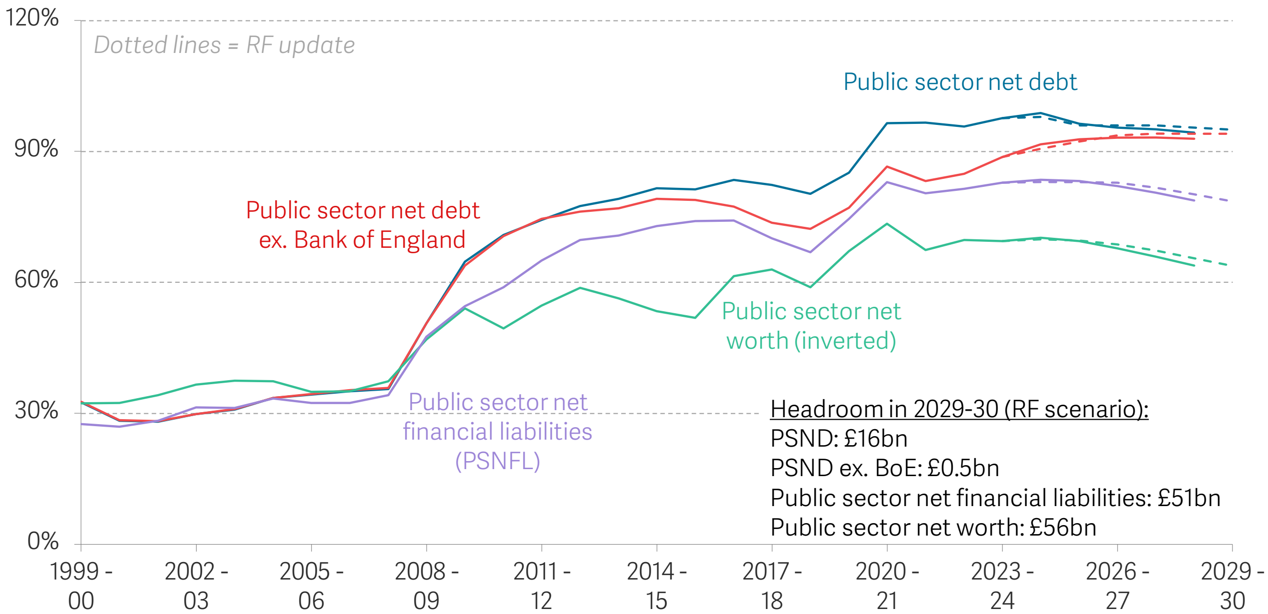
Making one of these possible changes to the fiscal rules would significantly increase the amount that the Government could borrow while meeting them. As illustrated in Figure 19, due to flows relating to quantitative easing, public sector net debt is falling more

52 This draws on C Pacitti & J Smith, Over-ruled? Assessing the options for changing the fiscal rules, Resolution Foundation, October 2024.

quickly than the equivalent measure excluding the Bank of England by 2029-30.[53] This creates headroom of £16 billion against a public sector net debt target in our scenario (compared to just £0.5 billion against the same measure excluding the Bank of England). That extra headroom would be the upper limit on any increase in public investment under a debt rule. Excluding the National Wealth Fund and GB Energy would increase the scope for using policy to increase investment, although this would not strictly speaking be public investment. Allowing more room for public investment would require a bigger change. In this context, primarily due to their capturing of the assets created when student loans are issued, PSNFL and PSNW fall even more rapidly than public sector net debt over the forecast. So, moving to one of these measures would leave over £50 billion of headroom in our scenario. These measures of 'headroom' assume that these fiscal rules are applied in the same way as the previous Government's debt rule, which focused on debt falling between the fourth and fifth years of the forecast. Instead moving to a (more sensible) target of the balance sheet improving over the entire forecast period would likely result in even larger scope for borrowing against these rules.

FIGURE 19: **Headroom would be much larger against alternative balance sheet targets**

Public sector net debt, public sector net debt ex. Bank of England, public sector net financial liabilities and public sector net worth as a share of GDP: UK



SOURCE: OBR, Economic and Fiscal Outlook, March 2024.

53 These 'flows relating to quantitative easing' relate to costs associated with the Bank's quantitative easing programmes carried out during the financial crisis and covid periods. High Bank rate and low gilt prices have resulted in significant 'losses' relating to the scheme from both high interest payments due on Bank reserves and losses from gilt sales (as quantitative tightening is carried out), meaning the Treasury is now forecast to transfer over £104 billion to the Bank of England over the lifetime of the scheme. These fiscal flows affect the annual changes in public sector net debt excluding the Bank of England much more than public sector net debt given the timing of how these costs are recorded, as set out in Box 4.5 of OBR, Economic and Fiscal Outlook, November 2023.

In previous Resolution Foundation work, we have argued that the government should adopt a public sector net worth target.[54] Of the balance sheet measures reportedly under consideration, this is the one that would most clearly align with the Government's policy ambitions with respect to borrowing to invest. Targeting a rise in public sector net worth incentivises the government to create public value through the assets it invests in, by explicitly recording their value on the public sector balance sheet. It also disincentivises the erosion of the public sector capital stock through sales of those assets below their value (as occurred throughout the 1980s).

On the other hand, there are practical issues with the implementation of targeting such a broad measure – including the extent to which data on net worth may be revised in future as asset values change (see Box 4). Also, such a target would, on its own at least, provide little or no constraint on the level of debt-funded investment, because any increase in investment would likely lead to roughly offsetting increases in assets and liabilities (a current-balance rule, though, would prevent debt-funded increases in day-to-day spending, or in tax cuts).[55] There is, therefore, a risk that a PSNW target would be seen as a weakening of the fiscal framework, and that might lead to the Government paying more to borrow so as to compensate investors for the greater risk associated with investing in our debt. This possibility may be playing particularly strongly on the Chancellor's mind given recent rises in gilt rates, which some commentators have suggested may be a reaction to the perceived likelihood that the government may be about to spend more freely.[56] At the very least, particularly given there is a clear case for building fiscal policy space for future downturns, if the Treasury wanted to adopt a PSNW target then it would be wise to complement this approach with a rule for investment spending (as we have previously called for), that limits total investment spending and reinforces the Government's commitment to sustainable public finances.

BOX 4: **Practical challenges in targeting public sector net worth**

Public sector net worth is the broadest metric of the public sector balance sheet that is currently forecast by the OBR, and is also the newest, first published in October 2021. As a result of both the relatively recent development of public finance statistics to calculate net worth, and its comprehensive scope, criticisms have been levelled at the practicality of including this

54 R Hughes et. al., Totally (net) worth it: The next generation of UK fiscal rules, Resolution Foundation, October 2019.
55 This draws on C Pacitti & J Smith, Over-ruled? Assessing the options for changing the fiscal rules, Resolution Foundation, October 2024.
56 G Smith, First FT: Wild day for Chinese stocks after weeklong holiday, Financial Times, 8 October 2024.

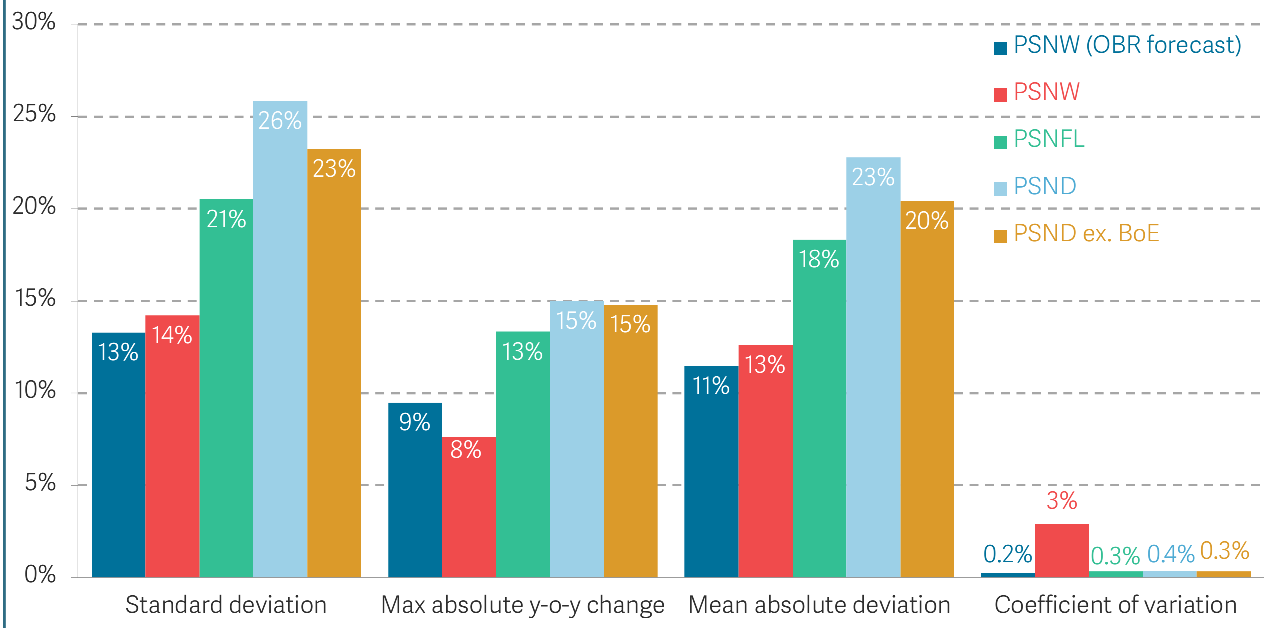
measure of the balance sheet in the Government's set of fiscal rules.[57]

The main criticism levelled at net worth is that it is hard to value the non-financial assets included in the measure (i.e. roads, building etc.), and that re-valuations of these assets can cause the measure to be volatile. It is true that establishing the value of the existing stock of non-financial assets is an accounting challenge. But forecasting the change in their value over time is a much simpler exercise. The OBR currently forecasts the net capital stock, which includes many of these non-financial assets, as a key part of its depreciation forecast, which already feeds into, among other things, their forecast of the current balance (the government's other stated fiscal target).[58]

And similarly, while is true that re-valuations could cause the level of net worth to fluctuate, given any fiscal rule is likely to target a change, or improvement in net worth, this is unlikely to have a large impact on fiscal headroom. While re-valuations might occur between forecasts, on a year-to-year basis, public sector net worth is actually a much less volatile public finance metric than many narrower balance sheet measures, as shown in Figure 20.

FIGURE 20: **Public sector net worth is less volatile than narrower measures of the balance sheet**

Measures of volatility, by balance sheet metric: UK, 2000-01 to 2028-29



NOTES: 'PSNW (OBR forecast)' illustrates the OBR's published time series of net worth, which is published on an ESA10 basis with the addition of public sector pension liabilities. 'PSNW' illustrates the ONS' fully ESA10 compliant series which does not include public sector pension liabilities.
SOURCE: RF analysis of ONS, Public sector finances; OBR, Economic and Fiscal Outlook, March 2024.

57 See, for example, see B Zaranko, We should not focus on public sector net worth as a fiscal target, Institute for Fiscal Studies, October 2023.
58 J Ebdon & F Khatun, Forecasting the balance sheet: Public sector net worth, Office for Budget Responsibility, October 2021.

A larger problem with a net worth target based on the OBR's current forecast of net worth are public sector pension liabilities, which fluctuate with interest rate changes in a way that might create adverse fiscal incentives. When interest rates rise, the value of these liabilities fall, creating larger headroom against a public sector net worth target at a point where government borrowing has just become more expensive. However, the OBR currently do not forecast net worth in a way that is fully consistent with the accounting system (the European System of Accounts) that they use to forecast all other fiscal measures. Moving to a consistent measurement of net worth based fully on this accounting treatment would exclude public sector pension liabilities entirely.

A more relevant critique of a public sector net worth target is that valuing the non-financial assets created by public investment at 'replacement value' (i.e. what it might cost to replace the asset) doesn't reflect their value in a way that is relevant to fiscal sustainability, by measuring their economic value or the returns the government can hope to receive from them. However, arguably even this flawed metric of the value of non-financial assets remains preferable to excluding their value entirely from the public sector balance sheet, at the cost of incentivising the erosion of the public sector capital stock in the way that we've seen play out across the 2010s.

As mentioned above, a PSNFL target would also almost certainly allow more room for investment now. Loans made through, for example, the National Wealth Fund to fund investment would essentially be fiscally neutral. Further investment would also be possible due to rapid falls in this measure across the forecast, driven by a tight current balance which is not off-set in this measure by liabilities from the issuance of student loans (as in public sector net debt). However, PSNFL has none of the additional benefits of PSNW in recognising the ongoing value of non-financial assets created by investment, or disincentivising their future sale.

Finally, the problem with excluding specific types of debt (such as the National Wealth Fund and GB Energy) from the measure being targeted is that it gives future Chancellors an incentive to expand the use of that type of debt purely to get around the rules. This is similar to how the rush for public finance initiative (PFI) contracts in the 1990s and 2000s was motivated by the desire to keep liabilities off the government's balance sheet.[59] So, although excluding the National Wealth Fund and GB Energy from the measure of debt or adopting a PSNFL rule would almost certainly lead to more much-needed infrastructure investment, those rules would not necessarily incentivise good policy making in future.

59 This draws on C Pacitti & J Smith, Over-ruled? Assessing the options for changing the fiscal rules, Resolution Foundation, October 2024.

Despite the 'difficult choices' mood music, fiscal policy is likely to be loosened at the Budget

If the Chancellor is able to borrow more for day-to-day and investment spending, the Autumn Budget will be a net 'giveaway', meaning that fiscal policy will be looser than at the Spring Budget. This might seem surprising given that the Government has been managing expectations around the 'difficult choices' it faces at this fiscal event.

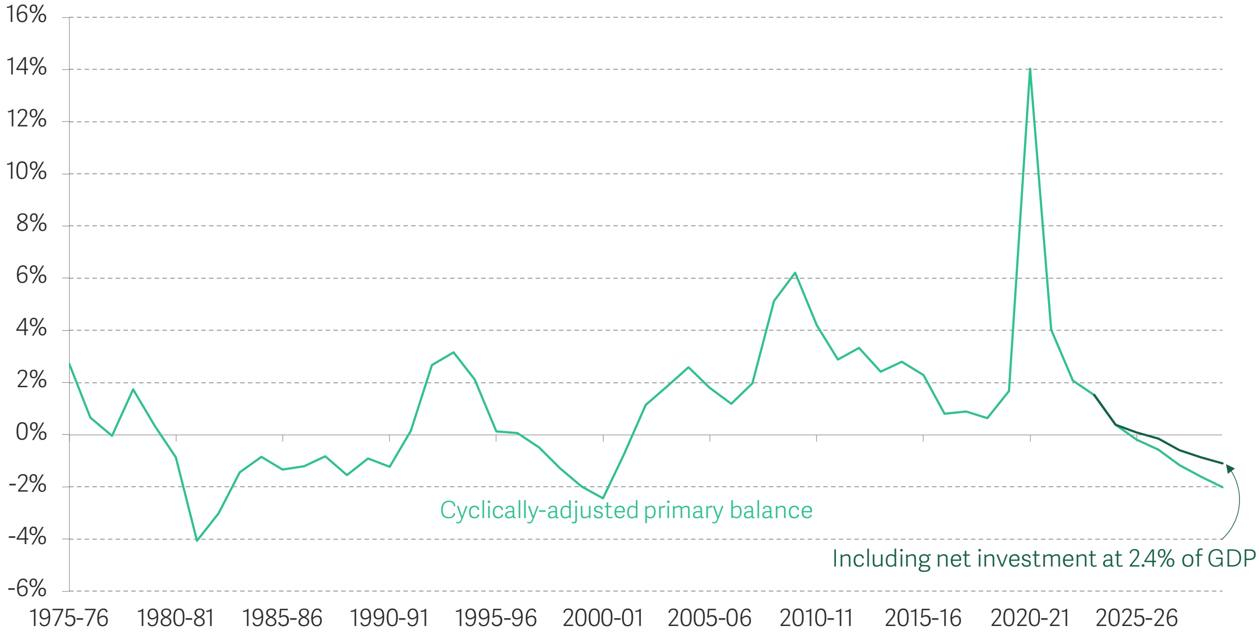
On the face of it, looser policy is hard to justify given a stronger economy and higher inflation – a fundamental principle for fiscal policy is that it should adjust to dampen changes in the economy rather than amplify them. Looser policy will add to inflationary pressure and will mean the Bank of England does not cut interest rates as quickly. To give a sense of the orders of magnitude here, an extra £10 billion (around 0.3 per cent of GDP) in current spending (to 'max out' the current balance rule) and around £30 billion (around 1 per cent of GDP) of investment spending (to keep PSNI at 2.4 per cent of GDP), might have a peak effect on GDP of just over 1 per cent,[60] pushing up inflation by around 0.6 percentage points. If the Bank of England were to fully offset the impact on inflation that could mean interest rates that are, for a time, around one percentage point higher than they would have been otherwise.[61] But, as shown in Figure 21, measures of the stance of fiscal policy suggest this would still leave fiscal policy tightening rapidly given plans inherited from the Spring Budget. And the fiscal stance will still be at its tightest since Gordon Brown was Chancellor – meaning that fiscal policy will be dragging down on the level of aggregate demand by more than at any time since then. Such a stance of fiscal policy is appropriate in the context of an economy operating close to full capacity and with ample room for cuts to interest rates but it will put the onus on the Bank of England to ensure that growth does not fall below levels that can be sustained in the medium term.

60 Fiscal multipliers are taken from: Office for Budget Responsibility, Economic and Fiscal Outlook, Box 3.2, Fiscal Multipliers, July 2015.

61 Interest rate multipliers are taken from: S Burgess et al., 'The Bank of England's forecasting platform: COMPASS, MAPS, EASE and the suite of models', Bank of England Working Paper No. 471, 2013.

FIGURE 21: **Measures of the stance of fiscal policy are tightening in the coming years but will be somewhat looser if the Government increases spending**

Cyclically-adjusted current budget balance and cyclically-adjusted primary balance as a share of GDP: UK



NOTES: Extra investment spending is assumed to structural rather than cyclical.
SOURCE: OBR, Economic and Fiscal Outlook, March 2024.

But success on its growth ambitions will require the Government to look beyond a short-term loosening in fiscal policy

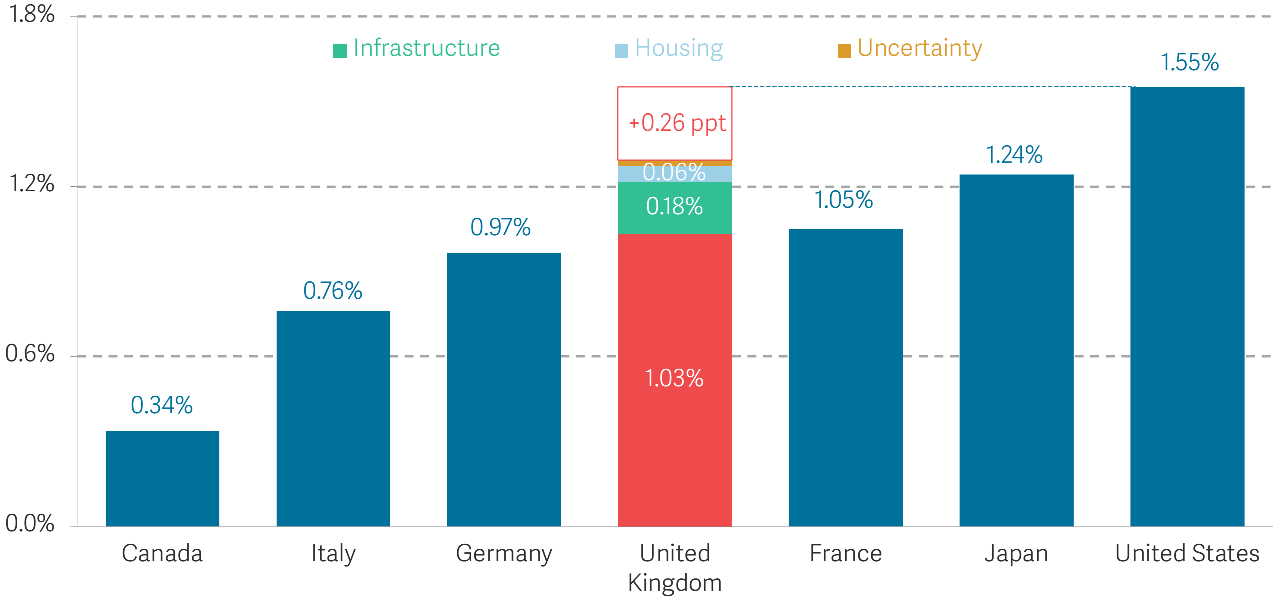
With both the Bank of England and OBR estimating that the economy is operating close to its long-run sustainable level, the new Government will need to look beyond short-term fiscal loosening for growth. So how successful might policy announcements since the election be in terms of raising supply-side growth? Policy so far has concentrated on two areas: infrastructure investment and house building. In past work we estimate that measures to reduce the costs of building infrastructure (through planning reform, repealing the onshore wind ban, and setting up the National Infrastructure and Service Transformation Authority), and boosting the flow of infrastructure investment (through the National Wealth Fund, Great British Energy and the Green Prosperity Plan), could boost annual growth by up to 0.2 percentage points over the next decade, in part by 'crowding in' private-sector investment.[62] New housing targets which require a rapid acceleration in building could add another 0.06 percentage points to growth' as shown in Figure 22. These are likely to only have a small (if any net effect) on the OBR's growth or productivity forecasts, however. They lie outside the type of policy change for which

62 E Fry & G Thwaites, The growth mindset: Sizing up the Government's growth agenda, Resolution Foundation, September 2024.

the OBR has a track record of feeding into its estimate for longer-term growth.[63] And, as discussed above, the weak productivity data and strength of the OBR's GDP forecast relative to other forecasters do not suggest that there is a compelling case for a more optimistic projection.

FIGURE 22: **Government plans to boost infrastructure and build more homes could get Britain halfway towards having the strongest economic growth in the G7**

Annual GDP per capita growth, and impact by measure within this Parliament: G7



NOTES: This chart combines IMF forecasts for average GDP per capita growth for 2024 to 2029, with estimates of the maximal growth impacts from infrastructure and housebuilding given that these take time to ramp up.
SOURCE: RF analysis of IMF, World Economic Outlook Database April 2024; ONS, MCHLG.

But the Budget will set the stage for the Government's broader growth agenda, including an industrial strategy.[64] In a services-dominated economy, such an industrial strategy should focus on addressing regional inequalities, notably the fact that every major English city outside London has productivity levels below the national average, as much as supporting advanced manufacturing. And tackling regional inequalities will need focussed investment and a coordinated strategy across policy areas. For example, narrowing Birmingham's productivity gap with London to match the 27 per cent difference between Toulouse and Paris would require an additional £1.3 billion in

63 For example, the OBR has published how it plans to estimate the impact of higher public investment on growth with five years of investing an additional 1 per cent per year estimated to increase the level of GDP by just 0.5 per cent. OBR, Public investment and potential output, Discussion Paper, August 2024.
64 Labour Party, Jonathan Reynolds Speech at Labour Party Conference 2024, September 2024.

inter-city public transport investment and 170,000 new homes.[65] Current housing targets prioritise building in the least affordable areas (measured by the ratio of house prices to earnings), resulting in proportionally less construction in more affordable cities, such as Birmingham. Indeed, under the Governments housing targets, it would take more than 19 years for Birmingham to deliver enough homes to support a serious growth strategy.[66]

Further ahead, the Government should also consider how it might encourage shifts from low-productivity sectors and firms to high-productivity ones. This includes enabling firms and workers to take risks.[67] It might also focus on how to boost engaged ownership from the only plausible source of large, long-term, domestic capital – pension funds. And we will expect clarity to emerge on the Government's trade priorities within the UK-EU reset.[68] Framing these efforts within a broader strategy allows us to recognise trade-offs and understand where we are – and aren't – maximising growth.

The Autumn Budget will reveal the new Government's priorities

Coming just less than four months after its landslide election win, the Autumn Budget will be a defining – and historic – event for the new Government. The aims are clear: find a way to boost growth; avoid a return to austerity and keep to manifesto commitments while raising tax. It's certainly the case that faster growth can have a transformative effect on the public finances. But even the most successful growth policy will not reap benefits for some time. For now, then, the Chancellor must navigate through a difficult outlook for the public finances. This means higher taxes and some tight day-to-day public-service spending settlements, leaving a number of departments facing a huge delivery challenge. In doing so, the Chancellor is likely to face trade-offs between improving living standards, bolstering flagging public services and bringing down Government debt. How these are resolved will reveal the importance attached to these priorities by new Government. But the Chancellor should also use this pivotal first Budget to show the country that, even against a backdrop of stretched public finances, investment can be raised, and a path can be set towards Britain growing its way out of trouble.

65 P Brandily et al., A tale of two cities (part 1) A plausible strategy for productivity growth in Birmingham and beyond , Resolution Foundation, September 2023.
66 RF analysis of live tables on housing supply from Ministry of Housing, Communities and Local Government, ONS UK GVA and productivity estimates for other geographic areas, ONS Housing Affordability in England and Wales, and the formulas for the Government's housing targets.
67 Resolution Foundation & CEP, Ending Stagnation: A New Economic Strategy for Britain, December 2023.
68 S Hale, EU-turn: Resetting the UK-EU relationship through strategic dynamic alignment, Resolution Foundation, October 2024

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