SPRING FORECAST: THE BEST LAID PLANS

18 MARCH 2025

Will economic reality drag the UK government into changing its Budget only six months after delivering it? Here's a quick summary of what's looming over the Spring Forecast on 26 March.

QUICK TAKE

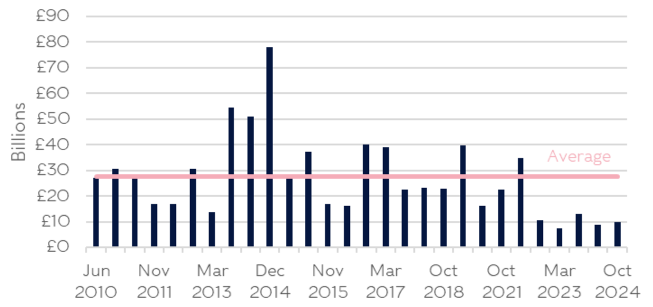
- On 26 March, the Chancellor may have to tinker with her Budget if the government's fiscal watchdog thinks the sums no longer add up
- Higher borrowing costs and disappointing GDP growth may have wiped out the razor-thin £9.9 billion of headroom
- An ongoing departmental spending review aims for efficiency savings of 5%

Since before the election, the government has insisted that it plans to hold only one Budget each year. That would take the UK back to the old days when the government would set out its tax and spending plans in the Budget and only gave an update on the year's progress six months later. Over the years, the need to tinker has been too great, leading Chancellors to chop and change every six months. But Chancellor Rachel Reeves says returning to one Budget each year will give households and businesses more stability and certainty.

However, when the government took office, it didn't change the Office for Budget Responsibility's (OBR) legal requirement to give six-monthly updates and forecasts on the public purse. That means the OBR must deliver a report card on the government's progress in spring – the government has set the date for 26 March. This may leave the government in a difficult position. If the report shows a big hole in the government's books, it seems politically difficult to shrug it off and say nothing will be done for six months until the next Budget.

Therefore, keeping the promise to simplify the Budget process very much depends on the OBR's report. Now, there are many moving parts in the OBR's work. Firstly, much of it is an outlook and sensitive to assumptions. You could find or lose billions of pounds by making slight adjustments to forecasts for economic growth, productivity (how efficiently resources are used) and inflation.

UK'S FISCAL HEADROOM IS RAZOR-THIN VS PAST FORECASTS



Source: OBR; past headrooms standardised against forecast GDP at the time and then calculated as if the economy was the size expected at the end of 2029-30

Running out of headroom?

The government has two important self-imposed fiscal rules that it must abide by: first, by 2029/30 day-to-day spending (excluding interest payments) must come from tax revenue only – not borrowing; second, public debt must fall as a percentage of GDP in the same year. At her first Budget in the autumn, the Chancellor chose to leave herself very little headroom against the first rule – just under £10bn.

That's razor thin – the average headroom from the past 14 years was just shy of £30bn. As for reducing debt-to-GDP, the government made some changes to how public debt is calculated which reduced its size and gave it more flexibility. But extra spending offset much of that. The OBR put the headroom for this goal at £15.7bn.

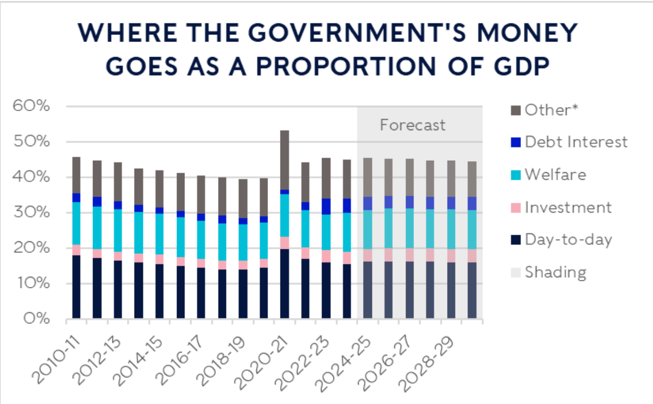
In October, the OBR put the probability of the government meeting its debt-to-GDP target at 50/50. The chance of hitting the day-to-day spending goal was better at 62%. But a whole bunch has changed since then.

Economic growth has been dismal: GDP rose by just 0.1% in the second half of last year, according to preliminary figures, which puts UK growth at just 0.8% for the whole of 2024. In October, the OBR believed GDP growth would be 1.1%. That's about £9bn less economic activity that would have been taxed to help fund spending plans, and which would have helped keep the debt-to-GDP ratio in check. The roughly £3.2bn less tax received would be a third of the headroom for the current budget already.

Borrowing a future

But fluctuating borrowing costs have by far the biggest influence on the sums. Using the measure deployed for the borrowing fiscal rule, the UK's public debts are equivalent to roughly 83% of its GDP after a big lurch higher during the pandemic. UK government bonds make up the mainstay of this. As they mature they must be replaced by new ones at the new prevailing rate of interest, which is much higher today than for decades. Not only that, but because the UK still spends and invests more than it receives in taxes to the tune of about 5% of GDP, this shortfall must also be funded by issuing yet more government bonds. This has pushed the forecast interest bill for the current five-year Parliament much higher than it has been in the past.

Exactly how much the nation will need to spend servicing its debts of course depends on that prevailing rate of interest and how it might change over the coming years. At the end of February, the five-year UK government bond yield – what the market charges the UK to borrow for five years – was 4.2%. Back in October, the OBR thought that yield wouldn't rise above 4% until 2027.



Source: Office for National Statistics, OBR; *Other Spending includes redress schemes, Scottish govt. expenditure and unfunded pension costs

The fiscal situation is further complicated by Prime Minister Keir Starmer responding to US pressure by raiding the foreign aid budget to transfer to military spending. By 2027, that would leave foreign aid at roughly 0.3%, down from 0.5%, and the defence budget at 2.6%. If this is a straight swap, it may not require movement in March, especially as part of the boost to defence spending is by recategorising intelligence and security services to be part of the defence apparatus. Also, rumbling in the background is the second phase of a government spending review that aims to set departmental budgets for the next three to five years. This is due to conclude in the late spring.

Spending cuts?

The government may try to plug any fiscal gaps by cutting spending instead of breaking its promises on hiking taxes. A review of departmental spending has been rolling through Whitehall in the months since the Budget. Recent news reports suggest that the welfare budget is in the government's sights, particularly the long-term sickness benefit.

The proportion of Brits on the long-term sickness and disability benefit has soared since 2016 and is on track to hit an all-time high of 7.9% in 2029. Working-age claimants are driving most of the growth, and payments to this group are set to balloon from almost £50bn this year to £76bn by April 2030. The government will hope that reducing these payments will encourage more people into work, simultaneously reducing government spending and increasing its tax take.

All other departments are also tasked with finding "efficiency and productivity" savings of roughly 5%, which is usually easier said than done. Public services have been cut quite a bit in the years since the global financial crisis, so there's not exactly too much visible fat left.

It's difficult to know what will come out of the Spring Forecast announcements. It might all be fine: nothing to see here and no changes of note. Or the government may be forced by political and fiscal reality to change its Budget after just six months. If so, there could be big implications for taxpayers, investors, the economy and the cost of borrowing for everyone. We'll be watching closely and will keep you informed of what it means for you.

Interested in investing with us? Get in touch to see how we can give you peace of mind and help you grow your wealth.

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