Global Macro Research

26 March 2025

7:43 minute read

#UK / #Fiscal Policy / #Politics

UK spring statement: back to black, for now

The government has restored its headroom against the fiscal rules via spending and welfare cuts. However, the UK fiscal position is still very vulnerable to domestic and international shocks to growth and interest rates. Meanwhile, structural demands on government spending are likely to increase, and the political appetite for further spending restraint is limited. So eventual tax increases remain likely.

Key Takeaways

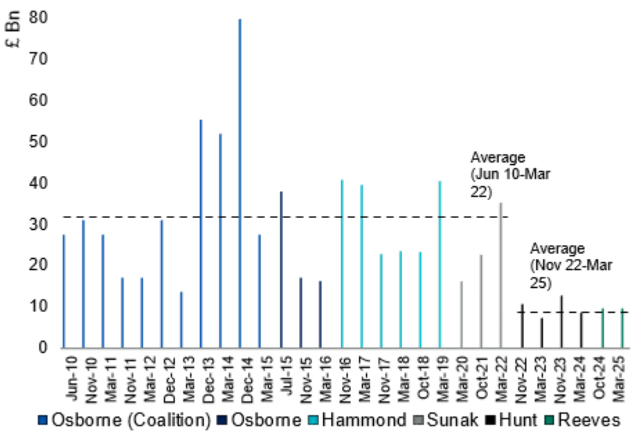
- UK Chancellor Rachel Reeves announced £14 billion of annual spending cuts today to restore the government's headroom against its fiscal rules.
- The OBR halved its 2025 growth estimate from 2% of GDP to 1% but increased its estimates from 2026 onwards on expectations of lower gas prices, easing monetary policy, and a return of productivity growth in line with historic trends.
- The combination of these changes to the economic environment and higher gilt yields would have left the government breaching its balanced current budget rule by £4.1 billion were it not for the measures announced today.
- The cuts to the welfare system are unlikely to be popular with Labour backbenchers. And the plans for day-to-day spending pencilled in from 2027 are unlikely to be deliverable given material and political constraints.
- So, should fiscal headroom erode again, Reeves has little room for manoeuvre. Indeed, the likelihood of further fiscal deterioration is high. The government has restored just £9.9 billion of headroom, which growth disappointments and adverse market moves could easily wipe out before the budget in the autumn.
- We continue to think the vulnerability of the fiscal position to shocks and demands on the public finances mean higher taxes are likely, while changes to the current fiscal rules are also possible.

As expected, Reeves was in the red

The Office for Budget Responsibility (OBR) found that UK fiscal policy was on course to breach the balanced current spending rule by £4.1 billion. As a result, the focus of the chancellor's spring statement was on restoring that headroom through announcing £14 billion of annual cuts to government spending, principally to welfare.

Reeves left £9.9 billion of headroom at the 2024 Autumn budget, low by historic standards (see Figure 1). Since then, a combination of higher gilt yields, and a halving of the OBR's 2025 GDP growth assumptions from 2% to 1% has eroded this fiscal space.

Figure 1: The chancellor has restored fiscal headroom against the rules, but this is still very tight



Source: Aberdeen, OBR, March 2025

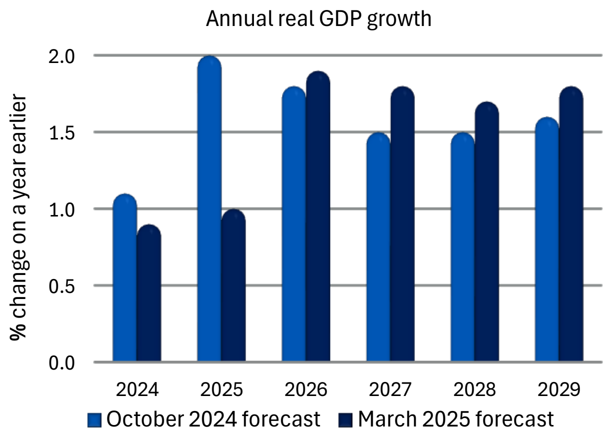
The OBR has halved its 2025 growth expectations

That the OBR has downgraded growth is no surprise, especially given the recent stagnation of the UK economy and the move in February by the Bank of England (BoE) to half its own 2025 growth projections from 1.5% of GDP to 0.75%.

One-third of the lower growth over 2025 is attributed to structural weakness in the UK economy, while the remaining two-thirds is due to what the OBR describes as “cyclical temporary” factors.

Despite the halving of growth forecasts for 2025, forecasts for 2026 onwards been revised slightly upward (see Figure 2), in light of expectations of monetary policy easing and falling gas prices.

Figure 2: The OBR has halved its 2025 growth estimate, while revising up later forecasts



Source: Aberdeen, OBR, March 2025

A pick-up in productivity growth is a core driver of the OBR’s expected outlook. Trend productivity growth averages 1% a year in the current forecast, in part due to a positive assessment of the impact of planning reforms.

However, should productivity gains continue at their current pace of 0.3% per year, then output would be 3.2% lower by 2029 than the OBR's forecast. This pessimistic scenario looks more like our own base case.

The OBR also continues to highlight that the long-term fiscal outlook remains very challenging, with pressures on public finances stemming from an ageing population and rising global tensions likely to prevent any reduction in public debt levels.

Significant cuts have been made to restore headroom, with a few sweeteners

All told, Reeves announced £14 billion of cuts to restore the government’s fiscal headroom, principally through cuts to benefits and efforts to improve government efficiency via civil service reform. Additional efforts to tackle tax avoidance have also been projected to raise £1 billion over the forecast period.

The government has also announced an additional £6.4 billion of defence spending by 2027 and a further £2 billion of investment in social and affordable homes in 2025. In contrast to day-to-day spending, capital budgets were marginally increased by £2 billion per year.

Further announcements are expected in the coming months, with the Treasury confirming it will put together proposed reforms for tax-free Isa accounts, in addition to the ongoing pensions review.

Benefits cuts are politically challenging, and likely a one-off source of revenue

Welfare reforms are expected to reduce spending by £4.8 billion over the forecast. Within this, changes to incapacity and disability benefits reduce spending by £6.4 billion, though increases to universal credit partially offset this saving.

The government will likely face pushback on these proposals by its own backbenchers in coming weeks. These announcements are less focused on reforming the system, as the government would argue, but rather, in some places, simply on freezing thresholds to cut costs.

While the government is somewhat insulated from the risk of a consequential rebellion through the size of its majority, it may be politically unable to source cuts from welfare in the future should it need to find additional revenue. Additionally, using up political capital to pursue challenging cuts at this stage will limit Reeves’ room for manoeuvre further down the line.

The new fiscal plans are very sensitive to further growth, policy, and market shocks

The outlook for the public finances remains very vulnerable to both domestic and international developments.

First, the OBR notes that if productivity does not improve in line with its forecasts, then the current budget would be 1.4% in deficit by 2030. Given the persistent weakness of productivity growth, and the sense that the OBR remains on the more optimistic end of forecasters about the UK’s long-term productivity, then this represents a material risk.

Indeed, the possibility of a material downgrade in the OBR’s productivity assumptions at some future event remains the for-now unexploded bomb in the government’s fiscal plans. It could, on detonation, require material changes to tax and spending assumptions in the future.

Second, the OBR estimates that a 20ppt increase in tariffs between the US and the rest of the world would slow UK growth materially and essentially eliminate the current headroom against the rules. While a tariff increase of this magnitude is more than our baseline forecasts, there remains considerable uncertainty as to the tariff regime that will emerge following the US trade announcements due on 2 April.

We continue to think the UK is *relatively* well placed to avoid the worst of direct tariff effects from the US. but a global economic slowdown, especially if concentrated among the UK's biggest trade partners, would have negative spillovers to the UK and hurt the fiscal position.

It may also be that the UK has to make concessions to the US to avoid more stringent tariffs that have direct fiscal consequences. For example, the government may end up suspending the digital services tax, which the US believes disproportionately impacts US firms. This would leave the fiscal position worse off to the tune of around £1.2 billion per year by the end of the forecast period.

Finally, the OBR calculates that a 0.6ppt increase in gilt yields would eliminate the headroom against the current balance fiscal rule. We continue to think the BoE will deliver rate cuts in excess of what the market is pricing, which all else equal should lead to lower gilt yields. But the combination of higher US and European borrowing costs reflecting policy choices in these economies, and a higher term premium demanded by UK investors due to fiscal credibility concerns, could cause a sustained upward repricing in gilt yields.

All of this is to say that the £9.9 billion headroom the chancellor has restored today seems very small given these risks, and it is easy to envisage a scenario where the government is facing a similar problem come the budget in the autumn, and further fiscal tightening is required.

Long-term spending plans lack credibility

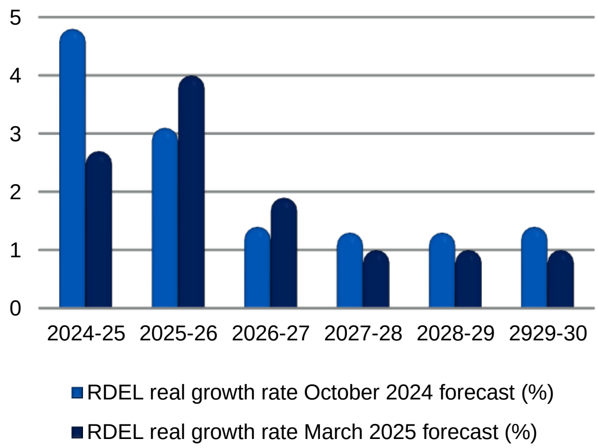
Not only are the current fiscal plans vulnerable to new shocks, but they also depend on some rather heroic assumptions about long-term spending plans.

A big question heading into the statement today was how much the chancellor delivered day-to-day spending cuts that were focussed on the near-term or further along the forecast horizon.

In the end, the chancellor delivered overall departmental spending plans that allocate additional cuts to the final two years of the forecast horizon, leaving overall departmental spending increasing by just 1% per year from 2027 onwards (see Figure 3). This would mean unprotected government spending faces significant, and likely unrealistic, cuts.

The spending plans at the back-end of the horizon were already thought to be both materially and politically undeliverable as they involved a cliff-edge drop in real-terms spending, especially for unprotected departments. Given the growing demand on public services and the likely political opposition among Labour backbenchers to delivering such spending restraint, it is very likely that the spending plans for these years will require topping up with additional spending as they roll closer to the present.

Figure 3: Government spending decisions have reinforced the unrealistic cliff edge in departmental forecasts



Source: Aberdeen, OBR, March 2025

This additional spending will almost certainly require additional taxation unless the government gets extremely lucky on growth and broader macroeconomic developments. So, we continue to think that higher taxation in this parliament is likely.

Fiscal rules are made to be broken?

The intermediate step the government could take to free up some fiscal space for extra spending before turning to higher taxes is to tweak the fiscal rules. While there are solid technical reasons to prefer the government's fiscal rules to what came before, they are becoming a serious political burden.

The difficulty for the government is that the chancellor has staked a significant degree of her own personal credibility on the rules, and the government ran its 2024 election campaign pledging no changes. The government could try to argue that the significant changes to the global economic and geopolitical environment since the election require new rules, which may provide some political space for manoeuvre. But it also faces the risk of losing credibility with gilt investors if reforming the rules is seen as an attempt to find space to borrow more.

So, if the fiscal rules are to be changed, the government will likely have to spend some time preparing investors beforehand. But if the time between now and the next budget is spent discussing what further fiscal tightening will be required to again restore lost headroom, then reform of the rules may become a more pressing matter for the government.

Authors:

Lizzy Galbraith & Luke Bartholomew

Important Information

For professional and Institutional Investors only – not to be further circulated. In Switzerland for qualified investors only.

Any data contained herein which is attributed to a third party ("Third Party Data") is the property of (a) third party supplier(s) (the "Owner") and is licensed for use by Aberdeen*. Third Party Data may not be copied or distributed. Third Party Data is provided "as is" and is not warranted to be accurate, complete or timely. To the extent permitted by applicable law, none of the Owner, Aberdeen* or any other third party (including any third party involved in providing and/or compiling Third Party Data) shall have any liability for Third Party Data or for any use made of Third Party Data. Neither the Owner nor any other third party sponsors, endorses or promotes the fund or product to which Third Party Data relates.

*Aberdeen means the relevant member of the Aberdeen Group, being Aberdeen Group plc together with its subsidiaries, subsidiary undertakings and associated companies (whether direct or indirect) from time to time.

The information contained herein is intended to be of general interest only and does not constitute legal or tax advice. Aberdeen does not warrant the accuracy, adequacy or completeness of the information and materials contained in this document and expressly disclaims liability for errors or omissions in such information and materials. Aberdeen reserves the right to make changes and corrections to its opinions expressed in this document at any time, without notice.

Some of the information in this document may contain projections or other forward-looking statements regarding future events or future financial performance of countries, markets or companies. These statements are only predictions and actual events or results may differ materially. The reader must make his/her own assessment of the relevance, accuracy and adequacy of the information contained in this document, and make such independent investigations as he/she may consider necessary or appropriate for the purpose of such assessment.

Any opinion or estimate contained in this document is made on a general basis and is not to be relied on by the reader as advice. Neither Aberdeen nor any of its agents have given any consideration to nor have they made any investigation of the investment objectives, financial situation or particular need of the reader, any specific person or group of persons. Accordingly, no warranty whatsoever is given and no liability whatsoever is accepted for any loss arising whether directly or indirectly as a result of the reader, any person or group of persons acting on any information, opinion or estimate contained in this document.

This communication constitutes marketing, and is available in the following countries/regions and issued by the respective Aberdeen Group members detailed below. The Aberdeen Group comprises abrdn plc and its subsidiaries: (entities as at 12 March 2025)

United Kingdom (UK)

abrdn Investment Management Limited registered in Scotland (SC123321) at 1 George Street, Edinburgh EH2 2LL. Authorised and regulated in the UK by the Financial Conduct Authority.

Europe[1], Middle East and Africa
[1]In EU/EEA for Professional Investors, in Switzerland for Qualified Investors - not authorised for distribution to retail investors in these regions

Belgium, Cyprus, Denmark, Finland, France, Greece, Iceland, Ireland, Italy, Luxembourg, Netherlands, Norway, Portugal, Spain, and Sweden: Produced by abrdn Investment Management Limited which is registered in Scotland (SC123321) at 1 George Street, Edinburgh EH2 2LL and authorised and regulated by the Financial Conduct Authority in the UK. Unless otherwise indicated, this content refers only to the market views, analysis and investment capabilities of the foregoing entity as at the date of publication. Issued by abrdn Investments Ireland Limited. Registered in Republic of Ireland (Company No.621721) at 2-4 Merrion Row, Dublin D02 WP23. Regulated by the Central Bank of Ireland. **Austria, Germany**: abrdn Investment Management Limited registered in Scotland (SC123321) at 1 George Street, Edinburgh EH2 2LL. Authorised and regulated by the Financial Conduct Authority in the UK. **Switzerland:** abrdn Investments Switzerland AG. Registered in Switzerland (CHE-114.943.983) at Schweizergasse 14, 8001 Zürich. **Abu Dhabi Global Market ("ADGM")**: abrdn Investments Middle East Limited, Cloud Suite 205, 15th floor, Al Sarab Tower, Abu Dhabi Global Market Square, Al Maryah Island, P.O. Box 5327224, Abu Dhabi, United Arab Emirates. Regulated by the ADGM Financial Services Regulatory Authority. For Professional Clients and Market Counterparties only. **South Africa:** abrdn Investments Limited ("abrdnIL"). Registered in Scotland (SC108419) at 1 George Street, Edinburgh EH2 2LL. abrdnIL is not a registered Financial Service Provider and is exempt from the Financial Advisory And Intermediary Services Act, 2002. abrdnIL operates in South Africa under an exemption granted by the Financial Sector Conduct Authority (FSCA FAIS Notice 3 of 202 2) and can render financial services to the classes of clients specified therein.

Asia-Pacific

Australia and New Zealand: abrdn Oceania Pty Ltd (ABN 35 666 571 268) is a Corporate Authorised Representative (CAR No. 001304153) of AFSL Holders MSC Advisory Pty Ltd, ACN 607 459 441, AFSL No. 480649 and Melbourne Securities Corporation Limited, ACN 160 326 545, AFSL No. 428289. In New Zealand, this material is provided for information purposes only. It is intended only for wholesale investors as defined in the Financial Markets Conduct Act (New Zealand). **Hong Kong:** abrdn Hong Kong Limited. This material has not been reviewed by the Securities and Futures Commission. **Japan:** abrdn Japan Limited Financial Instruments Firm: Kanto Local Finance Bureau (Kinsho) No.320 Membership: Japan Investment Advisers Association, The Investment Trusts Association, Type II Financial Instruments Firms Association. **Malaysia:** abrdn Malaysia Sdn Bhd, Company Number: 200501013266 (690313-D). This material has not been reviewed by the Securities Commission of Malaysia. **Thailand:** Aberdeen Asset Management (Thailand) Limited. **Singapore:** abrdn Asia Limited, Registration Number 199105448E.

AA-310325-191364-32

aberdeen
Investments