RATHBONES

A SPRING STATEMENT ON FISCAL DISCIPLINE

26 MARCH 2025

In a deliberately low-key announcement, Chancellor Rachel Reeves today prioritised fiscal discipline, leaving intact the near-term outlook for positive, though weak, growth.

This doesn't alter our current view that it makes sense to stay invested in UK and global equities. Within UK government bond markets, we think global trade uncertainty and a trend of rising government borrowing across the world's major economies remain risks for longer-dated gilts.

While the Chancellor confirmed no new tax increases, many measures announced at the October Budget will come into force with the start of the new tax year on 6 April. These include higher Employer National Insurance Contributions and changes to tax relief on some disposals and Inheritance Tax for businesses and farms. With the end of the tax year looming, it's a good time to consider making the most of your £20,000 annual ISA allowance.

Meanwhile, with Income Tax thresholds still frozen to at least 2028, inflation is pushing more people into higher tax brackets. This can have significant impacts on how much tax you pay and any working benefits you receive, especially free childcare.

What has the chancellor announced?

In her Spring Statement, the Chancellor announced a net £3.4bn of cuts to the welfare budget and plans to reduce Civil Service running costs by 15% over the rest of this parliament. Meanwhile, she confirmed plans to increase defence spending to 2.5% of GDP by 2027, including a new increase of about £2.2bn next year, and an ambition to reach 3% of GDP in the next parliament. The initial increase will be funded by reducing the overseas aid budget. Markets have so far taken these changes, which were well trailed beforehand, in their stride.

Why has Reeves made these changes?

Labour's pitch to the public before the election was based on stability and responsibility, which from the Chancellor's perspective meant an ironclad commitment to fiscal rules. The shadow of the Liz Truss 'mini budget' debacle and the ensuing chaos in the government bond market, which clearly cost the Conservatives dear, loomed large. Reeves' changes this time around are designed to ensure that her plans still comply with fiscal rules set out in the Autumn.

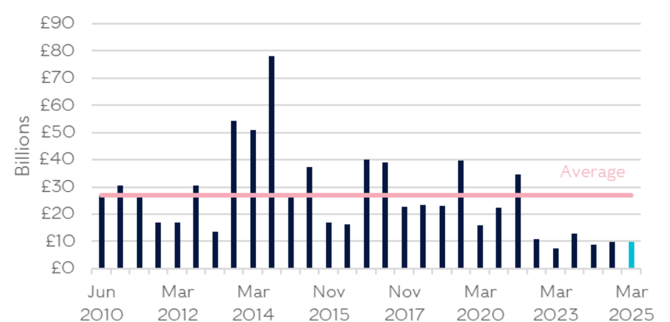
QUICK TAKE

- The Chancellor stuck to her fiscal discipline, announcing some spending cuts to make sure the sums still add up
- That leaves intact the near-term outlook for positive, though weak, UK economic growth
- Global forces will continue to create headwinds for longer-dated UK government bonds
- The Chancellor also confirmed no new tax rises

Since the Autumn Budget, things have changed to make the Chancellor's fiscal arithmetic tougher. Economic growth has been slower than expected, which is bad for tax receipts. And the government's borrowing costs, as measured by bond yields, have increased. The Chancellor didn't help herself in the Autumn by leaving very little 'headroom' against the first fiscal rule either – just £10bn compared to an average of nearly £30bn over the past fourteen years. That wafer-thin margin was quickly eroded, necessitating a course correction. Without an adjustment, the Office for Budget Responsibility's new forecasts would have revealed the Chancellor in breach of her rules.

In theory, the Chancellor could have chosen one of two other paths instead. But both of those alternatives appeared even more unpalatable. For example, Reeves

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

The value of investments and the income generated by them can go down as well as up and you may not get back what you originally invested.

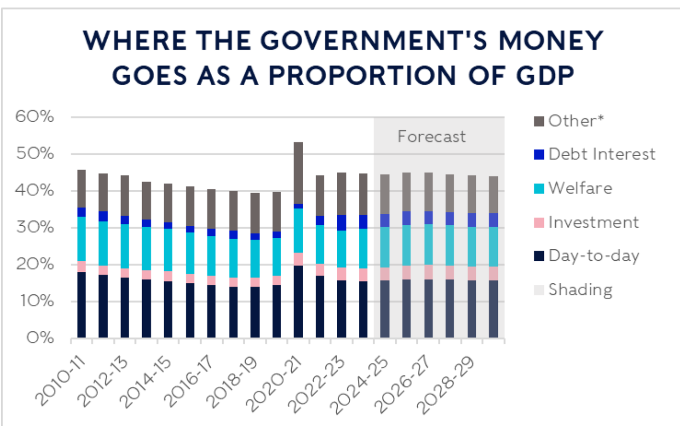
could have restored her fiscal headroom with tax increases rather than spending cuts. But that might have been politically impossible. Labour pledged in its manifesto not to touch the biggest revenue raisers, or to increase taxes on working people. And its efforts to raise revenues from business in the Autumn Budget via increased national insurance contributions have gone down like a lead balloon.

Alternatively, she could have taken a leaf out of German policymakers' books and changed, or found ways around, her fiscal rules. Until recently, Germany's fiscal policy has been restrained by the ultra-strict 'debt brake' enshrined in the country's constitution. Now, though, faced with the country's economic stagnation since the pandemic and the need to re-arm rapidly given the sudden reassessment of US military support, its new coalition has passed some huge exemptions to the debt brake.

These exempt most military spending and a €500bn investment fund from the fiscal rules. But there are clear reasons why Rachel Reeves might not want to do the same. Relaxing her 'non-negotiable' fiscal rules just months after establishing them would be a political embarrassment. And she doesn't have the luxury of Germany's strong starting fiscal position. Compared to the UK, Germany's debt-to-GDP ratio is far lower (roughly half on the IMF's net debt measure) and its structural budget deficit is much smaller (0.7% of GDP on the IMF's measure in 2024 compared to 1.8% in the UK), leaving much more room for manoeuvre.

How do these changes affect the outlook for the public finances and the UK economy?

The spending changes announced by Rachel Reeves amount to a small belt-tightening compared to previous plans and make virtually no difference in the next fiscal year. At the margin, the cuts to welfare spending may weigh on economic growth and inflation thereafter, but the magnitude of the change is likely to be small. It will also be partly offset by changes in the composition of spending,



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

and this seems to be the OBR's judgement. Shifting funds from overseas aid and the Treasury reserve to defence is likely to mean more spending at home, for example.

Overall, then, the Spring Statement doesn't dramatically alter the near-term economic outlook in the UK. Growth is likely to remain positive but weak, not helped by tepid global growth and the threat of much higher US tariffs. Inflation fell last month but is heading back above 3% in the near term – due to a combination of factors including the increase in Ofgem's energy price cap in April, various other regulated prices including water bills, and the increase in the minimum wage and employers' national insurance contributions. It should start to fall again from the fourth quarter of this year.

More generally, this Statement highlights the post-pandemic structural challenges faced by Rachel Reeves and most other European finance ministers. Population aging and the legacy of the pandemic have created structural pressure on health, incapacity-related welfare and pension spending. And the low levels of defence spending which have prevailed since the end of the Cold War now appear unsustainable in the face of Russian revanchism and US isolationism. At the same time, government debt-to-GDP ratios jumped during the pandemic and government borrowing costs have subsequently increased from the ultra-low levels of the 2010s.

This is a difficult mix for any politician to manage. This time the Chancellor has opted to trim spending outside the priority areas of health and defence. But there are clear limits to that strategy in the UK, with public services already creaking and the government elected on a pledge of 'no return to austerity'. Although they didn't find favour this time, the Chancellor may eventually feel compelled to turn to the alternative options of raising taxes (even those protected by manifesto commitments) or circumventing the fiscal rules (which have changed nine times already since the Global Financial Crisis).

Finally, this tough fiscal arithmetic adds to the incentive for the government to pursue measures designed to support economic growth (and therefore tax revenues) without incurring a direct fiscal cost. Planning area is one relevant area where reform is long overdue, given the evidence that the UK's complex and often arbitrary system has contributed to the country's chronic failure to build houses and infrastructure. The government's Planning and Infrastructure Bill has now been through its second reading in the House of Commons. It includes measures to streamline the approval process for key infrastructure projects, to ensure that local planning authorities operate more effectively, and to reform compulsory purchase powers. Given the government's large parliamentary majority, it should have little difficulty passing significant changes here.

Chancellor Reeves was keen to highlight the OBR's assessment that these reforms will eventually add 0.4% to the UK economy. Otherwise, the government is likely to press ahead with its nascent 'regulating for growth' agenda, in which it aims to address the 'complexity and burden' of regulation and to challenge 'excessive risk aversion' from regulators. These changes are commendable in principle, but their ultimate impact on growth is uncertain and won't be evident for years.

What it means for your investments

Ordinarily, the government prioritising fiscal discipline as we've seen today might be a positive for longer-dated government bonds (gilts), whose prices tend to be particularly influenced by the fiscal outlook. They performed very well through the fiscal consolidation of the early 2010s. But this time we remain cautious. We're sticking with our structural preference for shorter-dated bonds in multi-asset portfolios.

Admittedly, the Debt Management Office published bond issuance plans for 2025/26 alongside the Spring Statement which may work in the opposite direction in the short term. Overall planned issuance was a little lower than expected at £299bn. And the share of long-dated issuance fell significantly too, from 21% to 13%, which may temporarily favour longer-dated gilts. But economic forces may ultimately work in the other direction, for two key reasons.

First, the scale of the changes announced by the Chancellor today is comparatively small. This is still a far cry from the austerity of the Cameron-Osborne era. Given what was announced in the Autumn, government spending is on track to stay roughly flat as a share of GDP over the next few years, not contract as it did then. And as discussed above, there are good reasons to think that the political will to maintain this level of fiscal discipline will weaken over the course of this parliament, given the size of the structural spending pressures in health and defence. There's also ongoing uncertainty about the inflation outlook, including the impact of the changes to minimum wages and national insurance contributions announced in the Autumn Budget, which matters a lot for long-dated gilts.

Second, in our view the global economic backdrop continues to favour short over long-dated bonds – and that matters for the UK. Germany has just transformed its previously strict 'debt brake', allowing itself to run far larger budget deficits for years to come, while the EU plans to exempt defence spending from its own fiscal rules and to launch €150bn of new defence-focused joint borrowing. Meanwhile in the US, the Trump administration talks a good game about reining in government spending and bringing Treasury yields down, but House Republicans have passed a budget plan which would keep fiscal policy very loose. China announced at its recent National People's Congress that it plans to loosen the purse strings too. In other words, the world's largest economies plan to keep on borrowing, or to borrow even more. That adds to the uncertainty around longer-dated debt in the UK, which is significantly influenced by these global factors.

If you would like to hear more, give your Rathbones contact a message or a call. 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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For specialist ethical, sustainable and impact investment services
Greenbank
0117 930 3000
enquiries@greenbankinvestments.com
greenbankinvestments.com

For offshore investment management services
Rathbones Investment Management International
01534 740 500
rathboneimi.com

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