

MNI POLITICAL RISK ANALYSIS-UK Spending Review: Analyst Views

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Credibility Concerns On Health, Defence & Administration

On our first 24-hour read of the Spending Review details, we are most concerned about the credibility of health productivity and spending (despite the headline increases), the future increases in defence spending and the ability to deliver admin cuts on the scale suggested. Together with higher bond yields and inflation remaining relatively sticky as well as global growth forecast downgrades, and the April monthly borrowing figures coming in GBP3.5bln above the OBR's forecasts, it **looks as though there will be a sizeable requirement for Chancellor Reeves to increase taxes in the Autumn Budget if she is to meet her fiscal rules.**

- Despite health and social care spending making up the largest part of the budget and being discussed as one of the big winners, all of the increase in the budget in real terms is in current spending. Health and social care real spending will average 2.8% in real terms between FY25-26 and FY29-28 (NHS England 3.0%).
- However, the Institute for Fiscal Studies (IFS) had estimated ahead of the event that this would need to rise by 3.6%p.a. in order to keep up with the ageing population - and this was based on the same optimistic 2%p.a. healthcare productivity target that the NHS has held since the Conservative government. The latest NHS productivity figures refer to FY22/23 (so are very stale) but show that productivity was 7.8% below the FY17/18 peak (and 5.3% below the largely pre-Covid FY19/20. There is therefore some scope for a catch-up but annual average healthcare productivity growth in the first 20 years of the decade was below 1%. It is therefore **questionable whether the current spending on health is realistic or if it will need to be increased further.**
- Also, growth on capital spending on health and social care will average 0.0% in real terms between FY25-26 and FY29-30. There was an increase in capital spending in recent years, but with a number of hospitals requiring rebuilds due to RAAC safety issues, this **won't leave a lot to spend on extra equipment (which would help with the increased productivity targets).**
- Defence spending has been confirmed to be increasing to 2.6% of GDP by 2027 with a commitment to increase this to 3% in the next parliament. Note that the **3% figure is not currently costed in any plans by the Office for Budget Responsibility (OBR)** (as they only consider plans in the current parliament). The NATO plan of 3.5% of GDP (plus 1.5% on defence-related spending like cybersecurity, defence infrastructure etc) looks likely to be agreed to at some point - but that is not costed at all at present.
- The increase in the police budget will be partly funded through the increase in the police council tax precept - and it looks increasingly likely that the 5% cap on annual council tax increases (which would of course be a real terms increase) will be utilised by almost all councils to help fund this in future. This technically isn't a tax rise as it

was already allowed under current rules, but makes smaller increases increasingly unlikely.

- Admin budgets are being cut by an average of 11% between FY25-26 and FY28-29 - and cumulatively by 16% in the five years to FY29-30. **Admin budgets are always a target of successive governments but seldom delivered on in full.**

Analyst Views

Deutsche Bank

- As expected, the Spending Review delivered on some difficult trade-offs. And what was widely evident was that the success of today's Spending Review will rest on departments' abilities to navigate tight fiscal envelopes, while allowing capital spending to deliver growth.
- Such tight spending envelopes likely won't continue. Politically, the pressure to raise spending will only increase into the next spending round. The Government will likely rest its hopes that its capex bonanza pays off - allowing the next multi-year spending review to come with more generous allocations across departments.
- With capital projects now earmarked – and slightly raised relative to the Spring Statement, the OBR can start to score capital-spending policies more easily. Given its updated framework, we expect to see more supply-side gains emerge in the tail end of the OBR's forecast horizon. Every year pushed forward will likely see more growth gains accumulated, giving the next Government additional headroom to manage the public finances.
- Today's Spending Review rests on the Government's ability to cut costs and trim spending across government bodies and the civil service...How are departments finding these efficiencies? Digital and artificial intelligence, for one. Two, civil services job cuts. And three, streamlining of government estates.
- Tax rises, in our minds, remain inevitable in the autumn. More will need to be done to convince the OBR on growth - at least in the near term, including how sustainable the Chancellor's fiscal plans are as they currently stand

Goldman Sachs

- ... the long-run implications of higher public investment for the deficit and debt are highly dependent on whether the additional investment is spent productively, and there is evidence that "core" infrastructure including transport provides a notable boost to supply capacity over time. However, much of the real-terms growth in the capital budget over the Review period is taken up by the increases in defence capital spending announced at the Spring Statement. That is less likely to generate growth without spending being more skewed towards R&D.
- While the Prime Minister has set out an ambition to raise defence spending to 3.0% of GDP in the next Parliament, we think that the government is likely to come under pressure to further increase expenditure before the next election. But funding additional spending through spending cuts elsewhere would be challenging. Departmental budgets are now set for the next several years. [...] That makes it increasingly likely that, to stick to its fiscal rules, the government would have to fund higher defence spending with tax changes.

- The government is likely to face other pressures at the Autumn Budget; the OBR had not accounted for the impact of trade tensions in its Spring Statement forecast, and there is also some risk that it could moderate its optimistic trend growth estimate. That further increases the chance of an adjustment on the tax side. We view an extension of tax threshold freezes as the most likely option, raising up to £10 billion. But if the government is both hit with a growth downgrade and needs to spend more on defence, then further adjustments may well be required.

JP Morgan

- Strong real terms growth at the start of this parliament has already been a feature for many departments. As such, some of the spending figures mentioned today sound quite large. But from 2026/27, real spending growth slows dramatically and averages 1.4% overall.
- Departmental spending plans have now been locked in for the next three years (with the capital budget set for four years). Any further changes to the overall fiscal stance will hence need to come in other areas. A shortfall around the fiscal rules, for example, would either need to be met by a loosening in the rules, higher taxes or changes to annually managed spending such as welfare.
- The Chancellor today said the rules are non-negotiable. Welfare may see further reform but is politically challenging. That suggests the burden of a further adjustment, for example if the OBR makes further growth downgrades, will fall more heavily on taxation. [...] At the next Budget, we see a good chance that the freeze on income tax thresholds will be extended beyond 2027/28.

Natixis

- While the Chancellor suggested that the review includes efficiency savings, these may not be adequate to offset higher expenditures, especially in the face of economic shocks. This situation could lead to more constraints on day-to-day spending in other areas or prompt the Chancellor to consider further tax increases in the autumn budget to adhere to her “non-negotiable” fiscal rules.
- In late May, the International Monetary Fund (IMF) warned that the UK’s limited budgetary flexibility might require additional taxes or spending cuts “if shocks arise,” urging the Chancellor to maintain tight control over spending. Additionally, the Organisation for Economic Co-operation and Development (OECD) highlighted earlier this month that Rachel Reeves’ constrained fiscal flexibility poses a significant downside risk to the UK economy, emphasizing the need to strengthen public finances as a priority. Overall, given the limited fiscal space, further tax increases in the autumn budget remain a possibility.

Société Générale

- In the end, the spending review wasn’t too far from expectations. Most of the 1.2%/year real terms day-to-day increase was allocated to health, as it is the largest department, and the government is committed to cutting the NHS waiting list.
- Putting the spending review into context, it clearly isn’t the austerity of the Conservative years, as real-terms spending was cut in the 2010 and 2015 spending

reviews. Nonetheless, the quality of public services was at a much healthier starting point back then and years of austerity have seen their performance notably decline, putting most in a poor state.

- So far, it appears the large cash injection into public services in FY24 has failed to result in a notable performance improvement in public services... Therefore, the 1.2%/year increase in day-to-day spending may not be enough for voters to see an improvement in public services... therefore, it seems likely that budgets may need to be topped up.
- To help improve services within these modest spending plans, the government introduced a number of efficiency drives to improve public sector productivity. [...] If public sector productivity were to return to its pre-pandemic level, it would be equivalent to a monetary gain of £20bn/year (0.6% of GDP).
- Time will tell whether these efficiencies materialise, but one key point to note is that the Institute for Fiscal Studies finds that productivity gains typically improve the performance of public services rather than result in monetary savings.
- Not only do we believe that these spending plans are likely to be topped up at some point, but the Chancellor faces two major headwinds: Firstly, the OBR may revise down its optimistic trend productivity forecast... Secondly, political pressure has forced the government to row back on its cut to pensioners' Winter Fuel Payments. [...] Internal party pressure is also likely to force the government into ending the two-child benefit cap...
- We remain concerned that the government may need to raise taxes, possibly as soon as the Autumn Budget... These tax hikes could include extending the freeze on income thresholds, changes to council tax, or imposing National Insurance on pension contributions. The government is likely to avoid raising income tax, employee NICs, or VAT because of its pre-election commitments.

TD Securities

- Chancellor Reeves delivered the first Spending Review of Labour's parliament. There was little new information on either the messaging or the breakdown of spending and investment allocation. As expected, the Chancellor focused on investing in the economy, with increases in Defence, Healthcare, and Energy spending getting the most attention. In order to make up for these increases, spending was cut most markedly from Foreign Office and Transport up until 2029.
- Regarding the autumn budget, though she mentions that the government will not have to make changes in the same magnitude as last year, she did not commit to no tax increases outright.

UBS

- Overall, the outcome of the review did not provide major surprises with health care, defence and security expected to see the fastest growth over the next four years. In contrast, the budgets of the Foreign Office, Treasury and Revenue and Customs departments are expected to contract in real terms over the coming years.
- Importantly, today's announcements do not ease fiscal pressures that the Treasury will likely need to address at the Autumn Budget. We expect weaker growth, potential

downgrades to the OBR productivity growth assumption and the recent reversal in some welfare cuts to significantly eat into the already very narrow £9.9bn (0.3% of GDP) fiscal headroom.

- What are the available options if the Treasury is in breach of fiscal rules at the time of the Autumn Budget? Overall, the Treasury has three options - 1) temporary deviation from fiscal rules; 2) more spending cuts; and 3) tax increases. Given the Chancellor's repeated comments that fiscal rules are "non-negotiable" and likely concerns about a potential loss of fiscal credibility and subsequent negative market reaction, we view the first option as unlikely. The second option (spending cuts) would likely be difficult too, given that this would come only 4-5 months after difficult negotiations with all government departments for today's Spending Review. Against this backdrop, the option of further tax increases looks increasingly likely, in our view.
- Commentary around the spending review may generate unfriendly headlines for gilts, suggesting future spending pressures that may need lead to upside borrowing risks. But the outlook actually may be improving. If revenue shortfalls do mean there are hard decisions for the Chancellor this autumn, and we are right that she will chose tax increases, it would both show commitment to fiscal discipline, which the market wants to see under pressure, and it would impose a tightening which would be expected to bring forward monetary easing.

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