

MNI: UK Fiscal Options if the Manifesto is Breached

29 September, by Tim Davis

We are now less than two months away from the UK Budget (26 November), an event that could have huge significance on many levels for markets. The measures could have significant long-term implications on UK growth (including both consumption and incentives for companies to invest), monetary policy, long-term fiscal sustainability as well as the amount of gilts that will need to be issued in coming years.

Chancellor Reeves already had a tough task to maintain her fiscal rules and placate the Labour backbenchers without breaching the manifesto commitments to not increase income tax, employee NIC or VAT. The August fiscal data make that task look even more difficult. As do the media reports recently that Chancellor Reeves wants to explore policies which lower inflation (but hence cost money!)

Recall that the government already had to water down its welfare bill and has partially rolled back on the winter fuel payment. Both of these are seen partially driven by a poor performance at the local elections and the rise of Reform UK in the polls.

GBP30bIn fiscal hole before the August borrowing data disappointed

Media reports suggest that the Treasury expects around a GBP30bIn fiscal hole that will need to be filled. And these reports came out before the August data which changed the picture from PSNB being broadly on track with the OBR forecasts (as reported in the July release) to a GBP11.4bIn year-to-date tracking error in August. These estimates are broadly in line with the around GBP25-30bIn needing to be raised that the sell side estimates we have seen are looking for (the IFS estimated more like GBP40bIn). Around GBP20bIn of the hole is expected to come from

The market wants more headroom so that we don't have repeated periods of fiscal uncertainty

The market was also not particularly content with the small GBP9.9bIn headroom left after the Spring Statement (which matched that of last year's Budget). The OBR noted at the time that it thought there was only a 54% probability that the stability rule would be met and a 51% probability that the investment rule is met. This is then feeding into markets: the acceleration of the fiscal deterioration, along with the risk of meaningful productivity forecast markdowns from the OBR, have promoted steepening on the gilt curve. And on the real economy, when speculation starts months before the Budget about which taxes will have to rise to plug another fiscal hole, that starts to damage confidence and potentially leads to lower investment overall.

Is it possible to do this without breaking a manifesto commitment (or big issues elsewhere)?

The question now turns to is how can the government satisfy markets, the electorate and its backbenchers (who have already shown their ability to block fiscal reforms and are far from toothless as had been thought originally based on the large Labour majority). It looks increasingly likely to us that one of the manifesto commitments needs to be broken. Income tax has a broader base than employee NICs (as it applies to pensioners and on unearned income) while VAT seems unlikely (as it would increase headline inflation at a particularly difficult time for the MPC and may even raise the possibility of hikes rather than cuts in 2026).

So an income tax increase seems increasingly likely to us (albeit not our base case at this point).

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Can the Chancellor (or indeed the government) survive breaking its manifesto commitment? If the alternative is that taxes are tweaked around the edges and indirectly cause discomfort to the electorate, it may be seen as a risk worth taking. However, we question whether the government thinks we have reached that juncture yet.

OBR timetable for the forecast round; first round Friday 3 October

There are three pre-measures rounds which incorporate updated economic and fiscal data and do not take into account new policies unless they have already been announced e.g. the winter fuel payments. Other policies are separately costed at first.

The first of these forecasts will be sent to the Chancellor on Friday 3 October (in the past this has led to increased speculation around the forecasts at this time and the increased possibility of media leaks).

The second forecast on 20 October will take into account the updated labour market data and August GDP.

The final pre-measures round we expect to include next month's public finance data as well as September CPI and that will be presented to the Chancellor on Halloween.

After that, the first round to incorporate proposed new measures will be on 10 November (but the November MPC decision will be past the cut off) and then the final major round will be sent to the Chancellor on Friday 21 November ahead of the Budget the following week - most proposed measures are in place by then but there is always room for last minute tweaks.

OBR Forecast Timetable and Major UK Data Releases



Date	Event
Tue 30 Sep	Q2 GDP revisions
Fri 03 Oct	Round 1 (Pre-measures)
Tue 14 Oct	Labour market data (including updated July AWE numbers used for pension triple lock)
Thu 16 Oct	August monthly GDP
Mon 20 Oct	Round 2 (Pre-measures)
Tue 21 Oct	September public finance data
Wed 22 Oct	September CPI (expected by the BOE and analysts to mark the peak; also used for uprating benefits)
Fri 31 Oct	Round 3 (Pre-measures)
Mon 10 Nov	Round 4
Fri 21 Nov	Round 5
Wed 26 Nov	UK Budget and OBR's EFO (Economic and Fiscal Outlook) published

Source: MNI, OBR, ONS

VAT increase impacts on fiscal, CPI, monetary policy

Chancellor Reeves seemed to commit a little more firmly against a VAT rise this morning in her Sky News interview (we will be watching closely her language at the Labour party conference where she is due to speak at midday - but probably with a more friendly audience).

In terms of the fiscal revenues, the Treasury's illustrative effects of a change indicate that a 1ppt increase in VAT would raise GBP8.8bln in 2026/27, GBP9.2bln in 27/28 and GBP9.55bln in 28/29.

Although the natural response is to think of VAT as a retail tax, it is much broader than that, also applying to hospitality and construction as well as across a number of other sectors (see more below).

Looking at the impact on CPI, the standard rate of VAT is not paid on "essential" goods or household energy. It does apply to vehicular fuels (although this could be offset by a VED reduction) and also does apply to non-essential foods (confectionary, crisps, ice cream) as well as mineral waters and soft drinks.

We estimate that around 60% of that CPI basket would be directly impacted by a VAT increase. So a 1ppt increase in VAT from 20% to 21% would increase headline inflation by around 0.5ppt if fully passed through.

The last increase in VAT was implemented in January 2011 (2.5ppt increase from 17.5% to 20%). The timing of this - just after the Global Financial Crisis - makes it hard to use this as a basis for comparison (and VAT eligibility has changed somewhat since then too) but we note that Y/Y CPI rose from 3.26% in October 2010 to 4.35% by February 2011 (an increase of 1.09ppt), and continued to rise to a peak of 5.18% in September 2011.

We do not think that the MPC would be able to fully look through a VAT increase and continue to cut Bank Rate. It would likely lead to a pause, in our view, and even by placing a question mark over the feasibility of a VAT hike over the weekend might be enough to spook the MPC's swing voters to vote to keep Bank Rate on hold in November (albeit there is not much priced for this prospect by markets anyway - and we still think the chance is under-priced even given the weekend's news).

The MPC is very focused on where headline CPI goes in the short-term and its impact on inflation expectations, noting that there are non-linear effects particularly when headline CPI reaches around 3.5-4.0%. The MPC is very focused on food prices which have increased notably and there has been continued commentary that the weekly supermarket shop, household energy and petrol prices have an outsized impact on inflation expectations. We estimate that of the "food and non-alcoholic beverages" category around 20% is subject to VAT. For the broader "food, alcohol and tobacco" category this rises to around 40%.

So if there was a VAT increase the MPC may want to wait to see how higher CPI data in Q1 filter through to inflation expectations and potentially even wait for more hard data on wage settlements in Q1 / April 2026. This could potentially even push a cut even later than April (as a lot of the wage data will not be fully available until June). Terminal rates may not be impacted, but timing almost certainly would be, in our view.

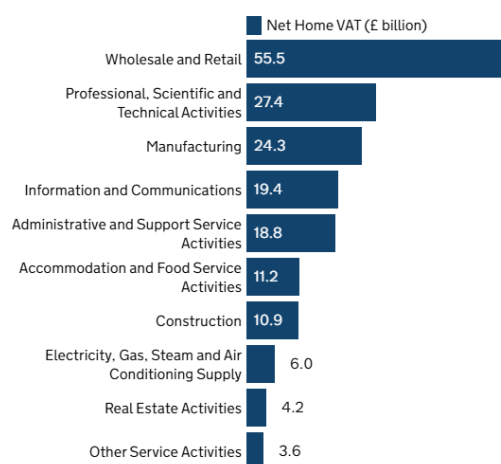
The MNI Markets team thinks that an increase to the basic rate of income tax would be more appropriate for the economy than an increase in VAT. And despite this increasing tax on "working people" it may also be better than the alternative of constant tinkering around the edges and only leaving another small c. GBP10bIn of fiscal headroom, which would be vulnerable to more speculations over more tax increases next year.

Just under 1/3 of VAT revenues come from retail / wholesale

- UK retail sales / consumption data have been holding up pretty well so far this fiscal year, so there seems to be some surprise that VAT can be one of the contributors to the overshoot in the August fiscal data.
- We would note, however, that while VAT is often thought of as a consumption tax it has a much wider base than just retail goods.
- The below chart shows the contribution of different sectors to VAT (on the latest data for the fiscal year 2023/24).
- Wholesale and retail trade account for 32% of total net home VAT liabilities in 2023/24 - just under a third of the total.
- Manufacturing is the third largest category accounting for almost 15% (and has been soft this year) while construction makes up 6-7% of liabilities.

Figure 9: Contribution to net Home VAT liability from the top 10 trade sectors for the financial year ending March 2024.

[Change to table and accessible view](#)



- There is also a huge amount of services sectors here.
- Note also that the OBR noted in its monthly commentary that people may be spending more on food (which is VAT exempt) as food prices have increased, and reducing consumption of other goods.

Income tax options for the Treasury

The costings in this note are estimated based on the Treasury's ready reckoners (prior to the Spring Statement measures being introduced).

Increase income tax

This was ruled out in Labour's manifesto but we think that there is an increasing probability that there is an increase in income tax. A 1ppt increase in the basic rate from 20% to 21% (which is payable from GBP12,570-50,270) is estimated to raise GBP6.9bln in 2026/27, rising to GBP8.25bln in 2027/28. However, if the higher rate (applicable from GBP50,270 to GBP125,140) was increased it would need to be increased by around four times this amount to yield the same amount with a 1ppt increase from 40% to 41% expected to raise GBP1.6bln in 2026/27 and GBP2.15bln in 2027/28. Raising the additional rate (applicable above GBP125,140) from 45% to 46% would only raise GBP145mln.

Additional tax bands

However, alternatives could include adding additional tax bands. For example a 25% marginal rate from GBP40-50k and/or lowering the additional tax rate to start at GBP75k rather than GBP125k (between GBP100k-125k there is currently already an effective marginal tax rate of 60% as the personal allowance is lost). These options would likely appeal more to Labour's core voters and fit in with the argument that those with broadest shoulders should pay the most. The former policy is not costed in the document but reducing the higher rate allowance by GBP3,770 to around GBP46.5k would raise GBP5.4bln, so we would estimate that introduced a 25% marginal rate from GBP40-50k would raise somewhere between GBP4-5bln.

Lowering personal allowance

Lowering the personal allowance by GBP100 would raise GBP810mln in 26/27 and GBP1.05bln in 27/28 – but this seems very unlikely as it would penalise the lowest earners. A longer freeze for the personal allowance seems a likely policy, however.

Simultaneously lower employee NICs and increase income tax

An alternative proposed by the Resolution Foundation would be to simultaneously reduce employee NICs and raise the basic rate of income tax for example by 2ppt. It was suggested that this would raise around GBP6bln per year. Using the Treasury estimates in 2026/27 it would raise GBP3.1bln in 2026/27 increasing to GBP5.9bln per year from 2027/28. This would be particularly unpopular with those aged 65+ who currently do not have to pay employee NICs, but would help Labour's pledge to help working people.

Increase employee NICs

The alternative to a change in income tax (but also ruled out in the manifesto) would be an increase in national insurance. We think that an increase in the main employee rate from 12% by 1ppt would be unlikely with an income tax rise more probable given the wider base and NIC explicitly hitting working people. A 1ppt increase is estimated to yield GBP5.3-5.4bln across each of the next three years.

A 1ppt increase in the higher rate (which is aligned with the higher rate of income tax at just over GBP50k) would yield GBP2.0bln and be more likely than an increase in the main rate.

Changes to eligibility for employee national insurance (NICs)

However, the main changes that are seen as much more plausible for national insurance are changes to eligibility. There have been media reports suggesting that there is the possibility of NIC being applied to rental income. This

may be tricky to implement in a way in which would sustainably raise revenue, as it may make it even more advantageous to hold property in a limited company rather than outside of this.

August Fiscal Data Update

The August fiscal data showed an upside surprise versus consensus expectations both on an individual month and year-to-date basis. Looking more into the tracking for PSNB versus the OBR forecasts: GBP5.5bln of the GBP11.4bln YTD overshoot is from the August data while the remaining GBP6.0bln was from the Apr-Jul period (which was previously seen as tracking in line). It is also tracking GBP16.2bln above the same period last year. Central government (CG) borrowing accounts for GBP6.3bln of the overshoot, local authorities GBP2.8bln and public corporations GBP2.3bln.

- August's fiscal YTD central government net borrowing stands at GBP85.4bln (vs 79.1bln forecast). This had been tracking less than GBP1bln away from the OBR's forecasts in last month's published numbers. CG expenditure is still on aggregate tracking in line with the OBR's forecast (GBP0.2bln higher) but CG current receipts are now GBP6.1bln below the forecast YTD - of which £1.8bln was in August and the remainder is revisions from previous periods.
- Looking at CG receipts: More than half of the undershoot is from VAT. The OBR notes that "it is also possible that it could reflect the composition of spending if higher-than-expected food prices has led to more spending on zero-VAT rated items." VAT YTD receipts are now running GBP3.5bln below forecast, largely due to revisions.
- Income tax / NIC receipts combined are broadly tracking in line with the OBR's forecast while onshore corporation tax is GBP1.4bln higher YTD. The rest of the miss is from "other taxes and receipts". None of these alone are huge but combined there is a GBP4.1bln YTD undershoot (GBP1.2bln in August, GBP2.9bln in Apr-Jul revised from GBP2.2bln).
- Local authorities net borrowing YTD is GBP1.6bln, but this compares to an estimated GBP1.1bln surplus for Apr-Aug, so is now tracking GBP2.8bln above forecast, but previously this was tracking GBP3.3bln below forecast, a swing of GBP6.1bln versus last month's estimate. Of the updated GBP2.8bln overshoot, GBP2.7bln is higher borrowing in August and around GBP3.4bln is from revision from the Apr-Jul numbers. The OBR wrote that these figures are typically "revised significantly ... through the financial year and in subsequent years." Even so, this is a notable revision today.
- Public corporations net borrowing is GBP-3.2bln YTD, GBP2.3bln above forecast - but it was already tracking GBP2.6bln above forecast, so didn't contribute to the overshoot of the OBR's forecast in the latest release.
- From the March 2025 profiles, the OBR expects lower borrowing in the second half of 2025-26 (compared to 2024-25), "reflecting a sharp rise in capital gains tax expected around the end-January due date, lower debt interest payments in the second half of the year, and lower growth in central government net social benefits which were unusually backloaded last year." The OBR's commentary also noted a GBP2.0bn downward revision to 2024-25 borrowing.

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