The Labour Budget

First of all, Labour has made two crucial changes to its fiscal rules[1]:

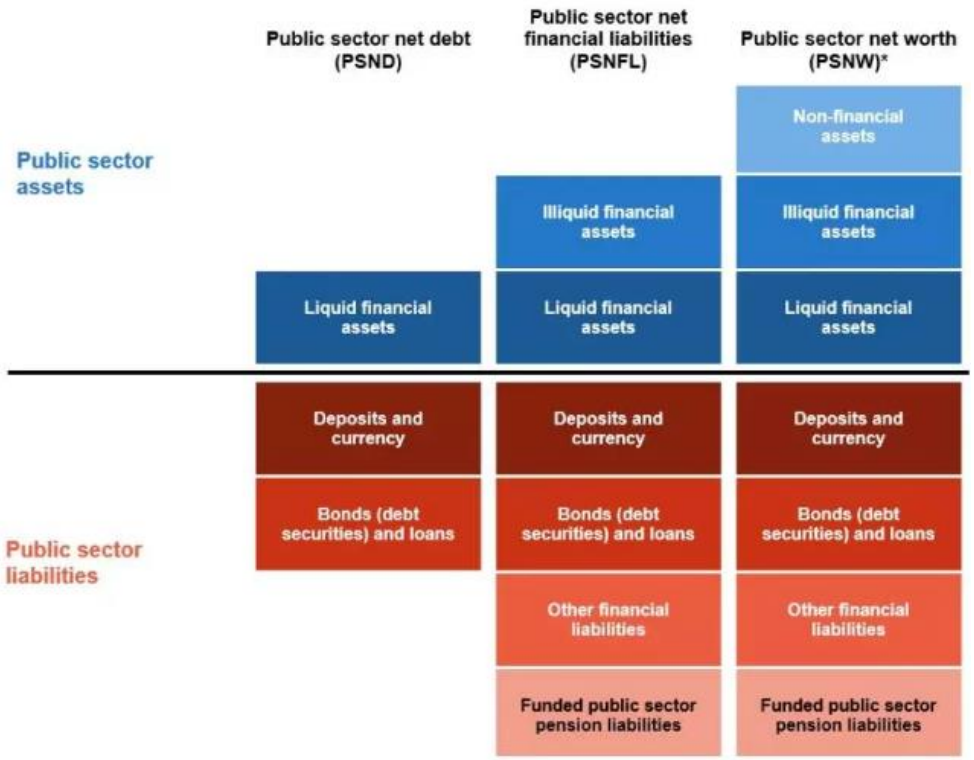
1. Stability rule: To move the current budget into balance, so that day-to-day spending is met by revenues
2. Investment rule: To reduce net financial debt (i.e. PSNFL) as a share of the economy

On the surface, this seems like a very responsible move. However, the key is "*net financial debt*". The prior government's debt target required public sector net debt excluding the Bank of England (PSND ex BoE) to fall as a share of national income between year 4 and 5 of the forecast. Another option would be to use Public Sector Net Financial Liabilities (PSNFL), which is slightly broader and includes illiquid financial assets (such as the student loan book, and the assets held by funded public sector pension schemes, which are less easy to convert into cash) and a broader range of financial liabilities (such as the liabilities associated with funded pension schemes). A final option would be to use Public Sector Net Worth (PSNW) as a measure, which is even broader by also including the estimated value of non-financial assets (such as buildings, roads and other transport infrastructure)[2]. The Labour government chose the middle, PSNFL, providing them an additional £53bn by 2028/29 or +1.6% GDP compared to the previous measure. However, despite this boost in additional headroom, the economic growth forecast is set to be lower than estimated in March, while government borrowing would rise over 43% compared to the prior March 2024 Budget.

[1] Autumn Budget 2024 – HC 295
[2] Fiscal rules and investment in the upcoming Budget | Institute for Fiscal Studies

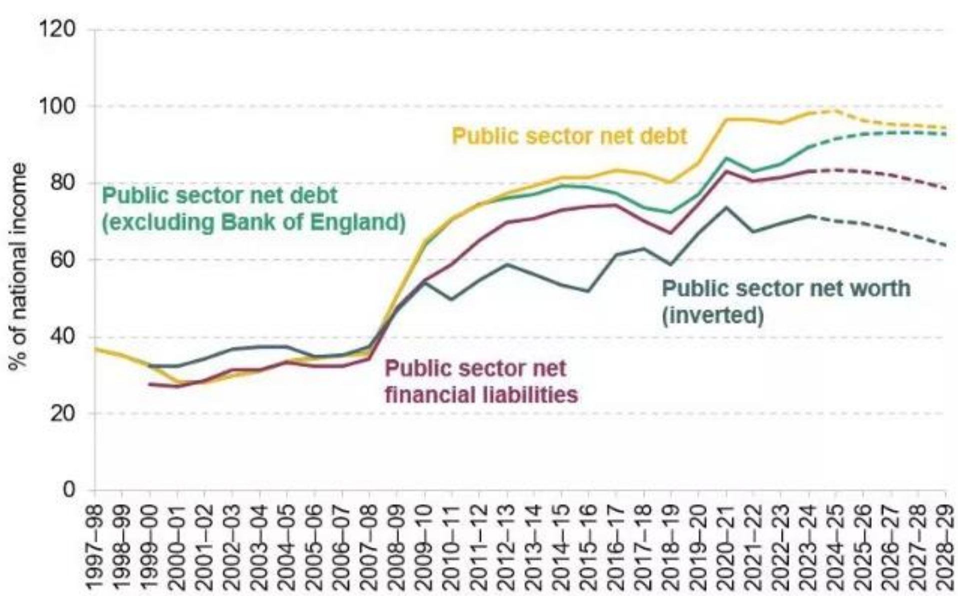
21 Knightsbridge, London SW1X 7LY
www.aozorastep.com · david@aozorastep.com

The three definitions of UK government debt



Source: [Fiscal rules and investment in the upcoming Budget | Institute for Fiscal Studies]

UK government debt/GDP over time for four different measures



Source: [Fiscal rules and investment in the upcoming Budget | Institute for Fiscal Studies]

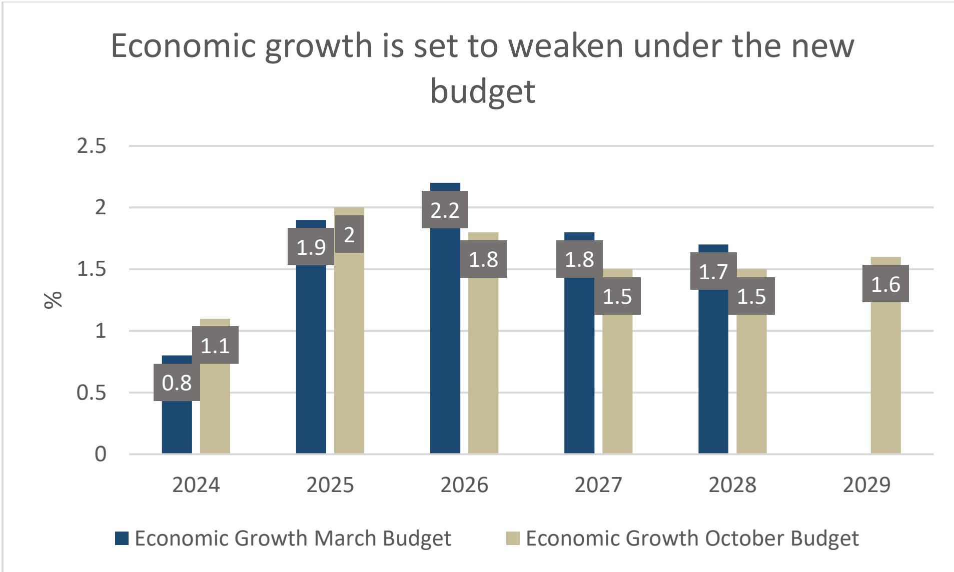
21 Knightsbridge, London SW1X 7LY
www.aozorastep.com · david@aozorastep.com

Different fiscal rules and result on GDP and borrowing headroom

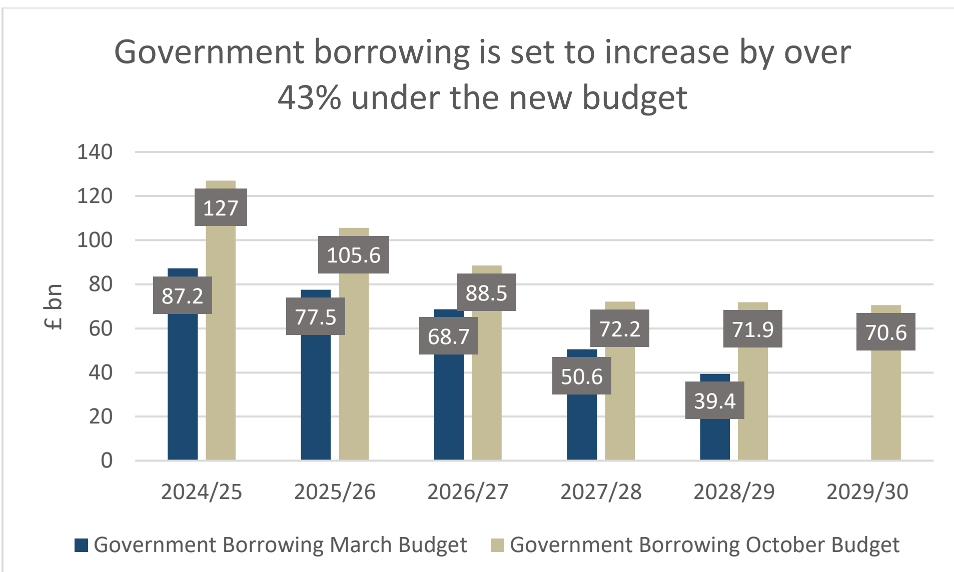
Fiscal rule	Margin ('headroom') against rule in March 2024 Budget	Difference in 'headroom' relative to previous debt target
PSND ex. BoE falling as a share of GDP in year 5 of the forecast (2028–29)	0.3% of GDP (£8.9 billion)	-
PSND falling as a share of GDP in year 5 of the forecast (2028–29)	0.8% of GDP (£24.9 billion)	+0.5% of GDP (+£16.0 billion)
PSNFL falling as a share of GDP in year 5 of the forecast (2028–29)	1.9% of GDP (£62.0 billion)	+1.6% of GDP (+£53.0 billion)
PSNW rising as a share of GDP in year 5 of the forecast (2028–29)	2.0% of GDP (£66.8 billion)	+1.8% of GDP (+£57.8 billion)
Memo: current budget balance in year 5 of the forecast (2028–29)	*0.4% of GDP (£13.6 billion)*	*+0.1% of GDP (+£4.7 billion)*

Source: Fiscal rules and investment in the upcoming Budget | Institute for Fiscal Studies

21 Knightsbridge, London SW1X 7LY
www.aozorastep.com · david@aozorastep.com



Source: OBR



Source: OBR

21 Knightsbridge, London SW1X 7LY
www.aozorastep.com · david@aozorastep.com

£53bn headroom vs. £142bn+ extra spending

The charts above are very important, because despite receiving the £53bn extra headroom with the debt definition change, economic growth is lower compared to the March 2024 Budget. But what's even worse, Labour is planning to spend £142bn more until 2028/29 compared to the plan of the Conservatives. And here is where the markets get jittery… after £40bn extra taxes, there is still an additional £142bn in government borrowing. Furthermore, the problem with this is that it was nowhere to be found in Labour's Manifesto[3] and effectively enables limitless borrowing, as long as it is invested. This can be done by lending money to a different vehicle, such as the National Wealth Fund[4]. In an extreme interpretation, one could say that the government in effect is turning into a hedge fund. The only difference between the 2022 Mini Budget is that the OBR is having to sign off on it, but in the detail, it is actually close to the 2022 Mini Budget, as with the debt definition change, it becomes much easier for the OBR to sign a balanced budget off. With an investment target yield of gilt yields or higher, one could say the investment returns are also quite risky. If gilt yields were to rise, these investments would immediately come under pressure. On the other hand, if gilts yields were to drop and we would again have negative long-end real yields, the pension liabilities would rise, turning the fiscal headroom into a deficit. On a positive note, if that happened, the UK could switch the interpretation again. The National Wealth Fund is seeded with £27.8bn. The debt definition change is also beneficial because student loans are assumed to be paid back.

DMO's Remit 2024/25: Autumn Budget 2024 (Source: https://www.dmo.gov.uk/media/4jlk3rxj/sa301024.pdf)

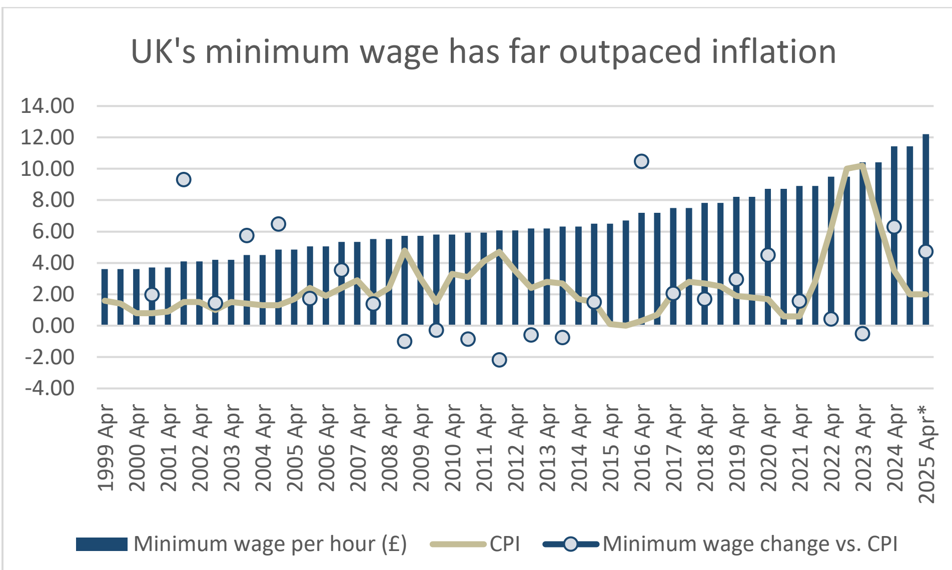
	2024-25					
	Spring Budget 2024	April 2024 revision	Issuance split prior to Autumn Budget	Autumn Budget October 2024	*Autumn Budget 2024 vs April 2024 revision*	*Autumn Budget 2024 vs Issuance split prior to Autumn Budget*
£bn						
Short	95.3	100.7	102.6	**103.8**	3.1	1.2
Medium (including green gilts)	82.1	86.0	88.4	**92.0**	6.0	3.6
Long (including green gilts)	49.0	50.0	52.0	**59.2**	9.2	7.2
Index-linked	28.9	30.0	31.6	**33.4**	3.4	1.8
Unallocated	10.0	11.0	3.1	**8.5**	-2.5	5.4
Total	265.3	277.7	277.7	**296.9**	19.2	19.2
%						
Short	35.9%	36.3%	36.9%	**35.0%**	-1.3%	-2.0%
Medium (including green gilts)	30.9%	31.0%	31.8%	**31.0%**	0.0%	-0.8%
Long (including green gilts)	18.5%	18.0%	18.7%	**19.9%**	1.9%	1.2%
Index-linked	10.9%	10.8%	11.4%	**11.2%**	0.4%	-0.1%
Unallocated	3.8%	4.0%	1.1%	**2.9%**	-1.1%	1.7%
Figures may not sum due to rounding.						

[3] https://labour.org.uk/change/labours-fiscal-plan/
[4] https://www.ft.com/content/4a7b6b30-63e7-4c55-b87f-481ce6c63051

21 Knightsbridge, London SW1X 7LY
www.aozorastep.com · david@aozorastep.com

What about the £22bn black hole? The Budget in numbers

The "black hole" was not necessarily a black hole. It was known in the Spring Budget 2024 that around £16.3bn is needed mainly for public sector pay rises and asylum seekers. This figure increased to £21.9bn as wage growth surprised to the upside due to higher wage growth (public sector pay rises amounted to £9.4bn), departments had a "pay-overhang" from previous awards (£1bn), additional support for Ukraine (£0.3bn) and additional costs of implementing the Illegal Migration Act (total asylum processing costs amounted to £6.4bn) and rail services maintenance pressures (£0.7bn)[5]. The £11.8bn to compensate victims of the infected blood scandal and £1.8bn for the wrongly prosecuted Post Office sub-postmasters might also be part of this black hole. The Minimum Wage was now hiked by 6.73% to £12.21 per hour starting in April 2025, which could result in further high public pay hikes next year. On top of that, Labour is committing over £100bn in additional investments across roads, rails, schools and hospitals over 5 years, boosting departmental spending. The question is: Is this a "reckless" budget as the 2022 Mini Budget was?



Source: Office for National Statistics

[5] CP 1187 – Government response to the OBR review of the March 2024 forecast for departmental expenditure limits (DEL) p. 6

21 Knightsbridge, London SW1X 7LY
www.aozorastep.com · david@aozorastep.com

AozoraStep

Key additional government expenditures: Autumn 2024 Budget

Policy	Additional annual cash outflow (£bn)	Comment
Day-to-day spending for Department of Health and Social care	22.6	
Capital investment for roads, rail, schools and hospitals	13	Total £131bn
Improving education facilities, including £2.3bn for core schools	4	
Asylum processing and smashing gangs	4	over next 2 years
SME and Build to Rent sector	3	
Defence spending	2.9	
40% relief for retail, hospitality and leisure	2.4	up to £110k per business over next 5 years
New surgical hubs, diagnostics and beds for the NHS	1.5	
School rebuilding programme	1.4	
Extra funding for local councils	1.3	
Support bus services including £3 bus far cap	1	
Improving transport in towns, villages and rural areas	0.65	
Fix 1mio potholes a year	0.5	Total £1.6bn
Project Gigabit and Shared Rural Network	0.5	
Affordable Homes Programme	0.5	Total £3.1bn affordable homes and £5bn total housing investment
Local transport for Metro Mayors	0.2	Total £1.3bn
200 GP estate upgrades	0.1	
High R&D levels to be maintained		Kept at current £20.4bn level

Source: [Chancellor chooses a Budget to rebuild Britain - GOV.UK]

21 Knightsbridge, London SW1X 7LY
www.aozorastep.com · david@aozorastep.com

Additional government tax receipts: Autumn 2024 Budget

Policy	Additional annual cash inflow (£bn)	Comment
Employer NIC to increase by 1.2% to 15%	25	Liability will start from £5k instead of £9.1k
Capital Gains Tax hike from 10-18% to 20-24%	2.5	
Inheritance tax on pension changes	2	Inherited pension pots to be subject to inheritance tax
Air passenger duty changes	0.5	£2 for short haul, £12 for long haul, £450 for private
Residence based non-dom changes	12.7	Over 5 years
VAT to be added to private schools	9	Over 5 years
Cracking down on fraudsters	4.3	Savings
HMRC systems improvement, higher interest rates on late tax payments	6.5	Over 5 years
Stamp duty changes, duties on vapes, tobacco and soft drinks		

Source: Chancellor chooses a Budget to rebuild Britain - GOV.UK

Relatively speaking, the UK is not as bad as it seems

When the Mini Budget was announced in 2022, I initially thought it could work[6]. However, the unusual move to not let the Office for Budget Responsibility (OBR) sign off on the budget was likely the main reason behind the sell-off back then. And here is where I see the problem. The OBR forecasts that the BOE Bank Rate will be around 3.5% by end of 2026 and that 5-yr gilt yields will rise to above 4% over the coming years[7]. However, if rates were to come down and bring the yield curve down with it, this would drastically change the forecast. Similarly, the OBR assumes that net migration will come down very quickly. What if net migration continues to climb? A 5-year forecast is in probably all cases wrong in the end. At the same time, the UK is still charging lower taxes as percentage of GDP than most other advanced economies and capital gains taxes are also to a large degree lower than in other advanced countries. At 4.4% fiscal deficit of GDP, the UK is also lower than the 6-9% deficit the US is expected to settle in. Whilst this all appears less bad than what you read, the fiscal loosening, i.e. overspending, is set to be the largest since the Pandemic. And this worries bondholders. If the market gets jittery, what would Mrs. Reeves do? The

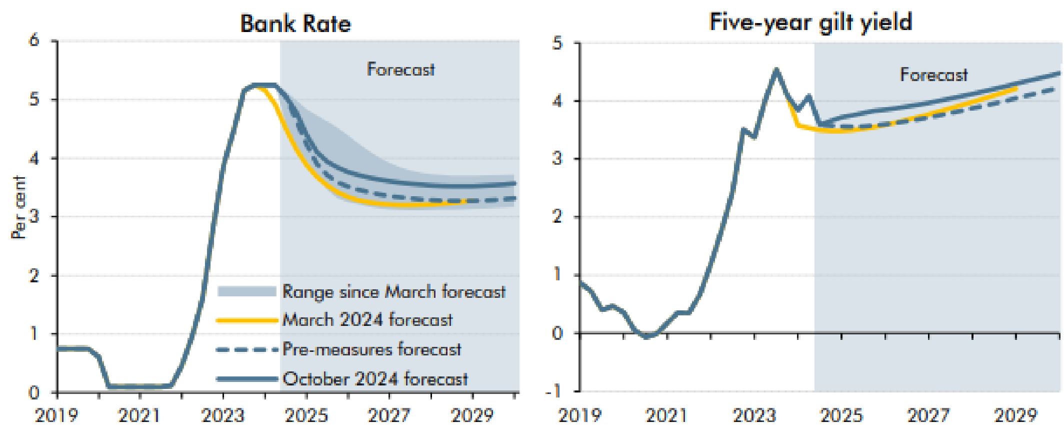
[6] https://www.aozorastep.com/Market%20views%20episode%2017.pdf
[7] https://obr.uk/docs/dlm_uploads/OBR_Economic_and_fiscal_outlook_Oct_2024.pdf

21 Knightsbridge, London SW1X 7LY
www.aozorastep.com · david@aozorastep.com

employer NIC charge came in higher than expected (due to the threshold changes), but there was no fuel duty rise and pensions, capital gains taxes and inheritance taxes were all less raised than in the worst-case scenario. I'd doubt that spending is being cut in a worst-case scenario, likely there will be more taxes. However, if illegal migration is not stopped, there might need to be an adjustment to Social Protection (Welfare) spending (as many of these asylum seekers will need to be financially supported), which makes up nearly 20% of public sector expenditures[8]. And this year alone, the UK is spending nearly £8bn on prisons and another £9bn on police services – both double that of pre-pandemic times, before the rise of illegal migrants[9].

OBR Bank Rate and 5yr gilt yield assumptions

Chart 1.5: Bank Rate and five-year gilt yield



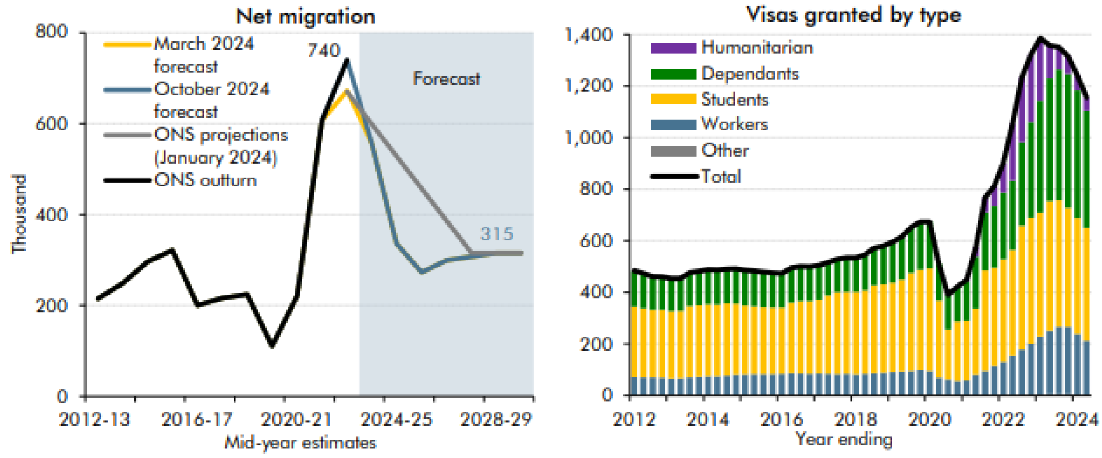
Note: March 2024 forecast is the average of 10 working days to 23 January. Pre-measures forecast is the average of 10 working days to 12 September. Range is the minimum and maximum daily value between our March forecast and 23 October.
Source: Bank of England, OBR

[8] How public spending was calculated in your tax summary - GOV.UK

[9] https://assets.publishing.service.gov.uk/media/66a8dd93ab418ab055592fb9/E03149684_PESA_2024_Web_Accessible.pdf p. 86

OBR net migration assumptions

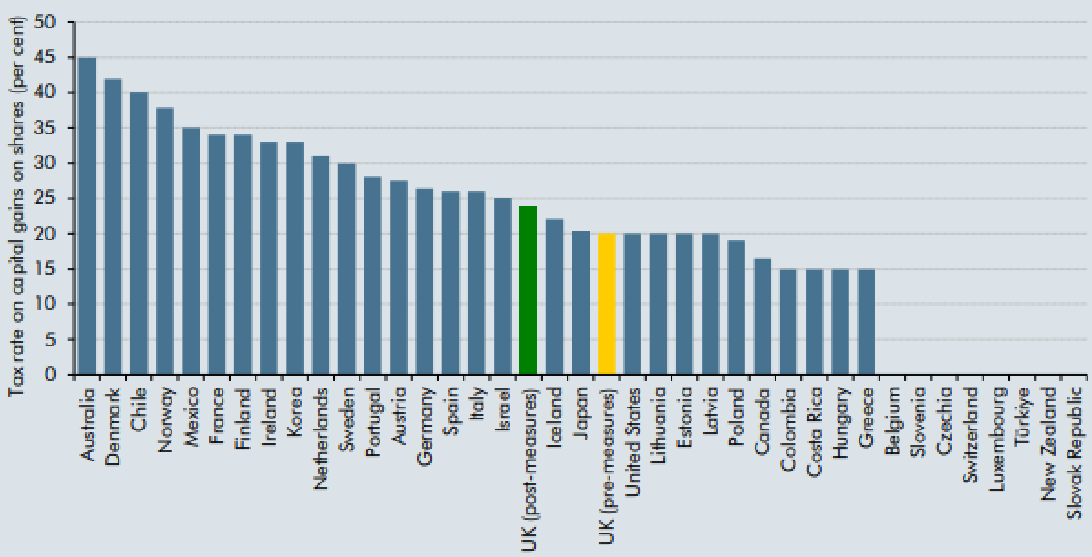
Chart 2.4: Net migration forecast and visas granted



Note: Visas granted by type excludes visitors and temporary visas.
Source: Home Office, ONS, OBR

The UK still charges amongst the lowest capital gains taxes in the world

Chart A: Highest marginal capital gains tax rates on shares by country

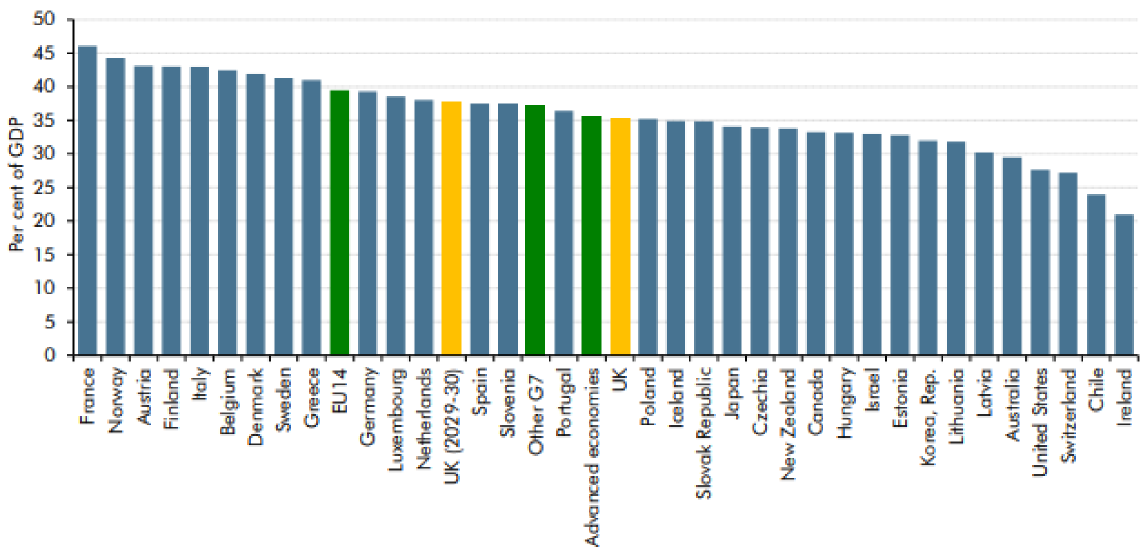


Note: This chart shows the highest marginal combined national and state capital gains tax rate on shares faced by individuals, based on analysis conducted by Tax Policy Associates in February 2024. In practice, the effective marginal rate may vary depending on specific national and state rules, exemptions, and reliefs, holding periods and other local factors. Some jurisdictions do not levy capital gains tax on shares.
Source: Tax Policy Associates, OBR

21 Knightsbridge, London SW1X 7LY
www.aozorastep.com · david@aozorastep.com

Despite the largest tax as % of GDP in UK's history, at 38% it is still close to advanced economies average

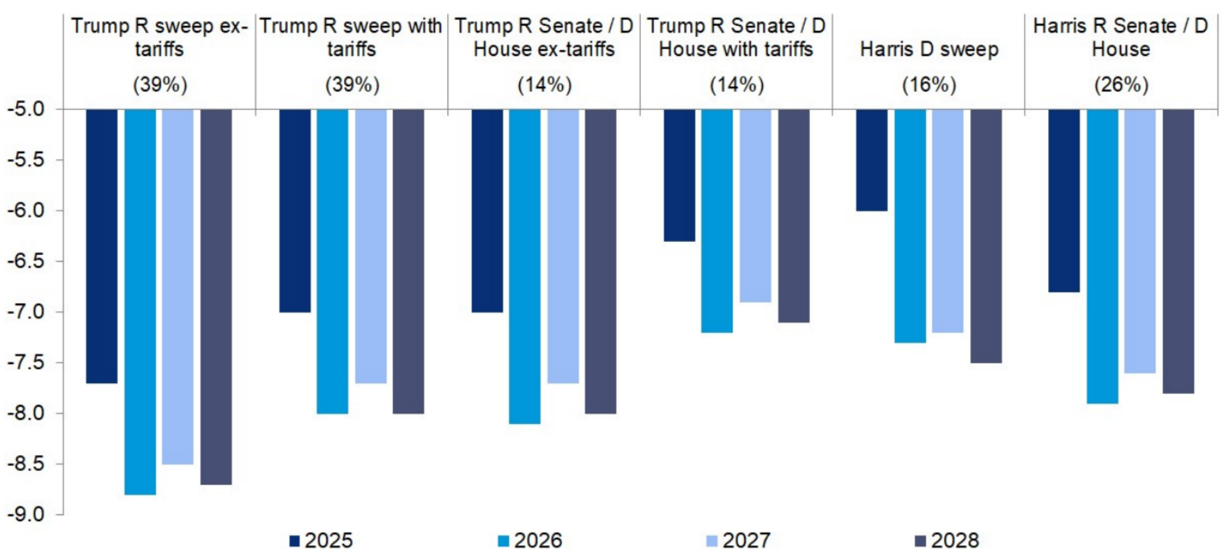
Chart 4.3: Tax take in the advanced economies in 2022



Note: Implied tax take for the UK in 2029-30 is based on our latest forecast adjusted for the historical difference in outturn between the ONS and OECD since 2010. 2021 data are used for Japan and Australia.
Source: OECD, ONS, OBR

US fiscal deficit assumptions by Presidential Candidate

Figure 1: DB's US deficit scenario analysis under different US election outcomes with current Polymarket probabilities of these occurring.



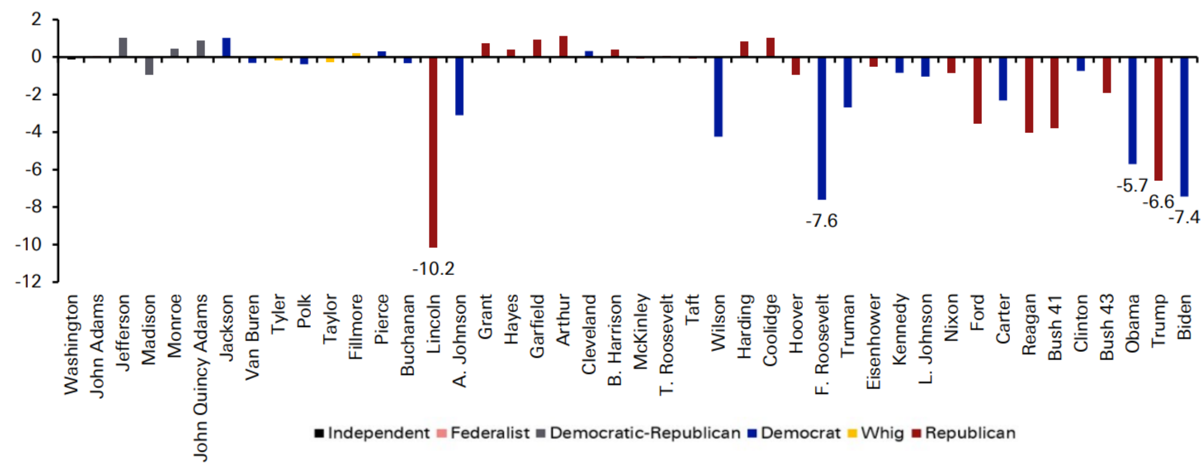
Source : CBO, Penn-Wharton, Tax Foundation, Urban-Brookings Tax Policy Center, Polymarket & Deutsche Bank

Source: DB

21 Knightsbridge, London SW1X 7LY
www.aozorastep.com · david@aozorastep.com

US fiscal deficits by President

Figure 1: Average annual US budget deficit (% of GDP) under each President since George Washington. Colour coded by party and with top 5 annotated

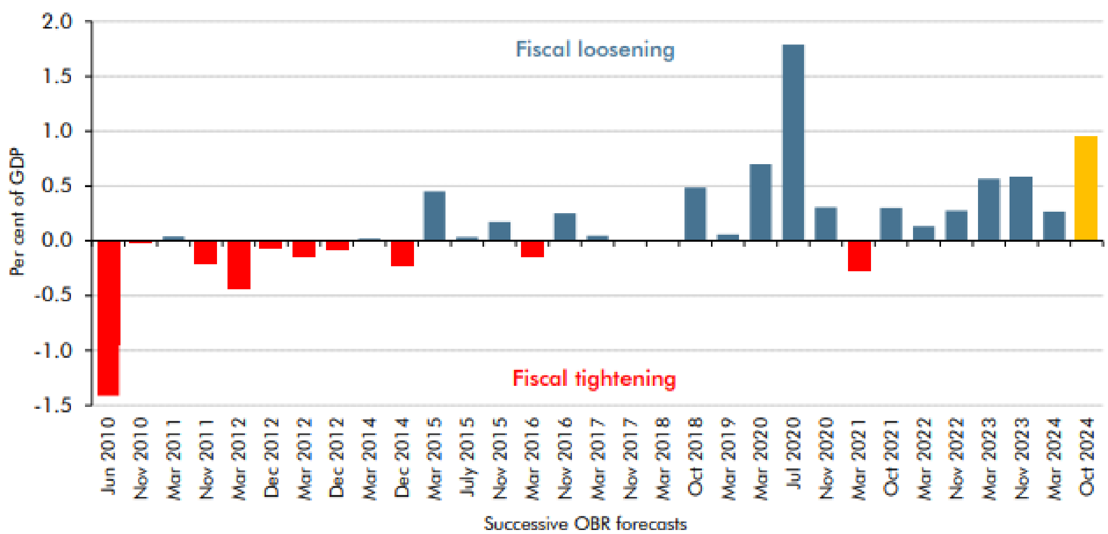


Source : GFD, FRED, Deutsche Bank
Note: Each year's annual deficit assigned to the President who was in office for the largest part of that year. William Henry Harrison excluded as President for only 31 days. Grover Cleveland's non-consecutive terms both included as one. Data for George Washington only available from 1791.

Source: DB

Autumn 2024 Budget is the largest fiscal loosening since the Pandemic

Chart 3.1: Size of fiscal policy packages since 2010



Note: This shows the total impact over the first five years of each forecast of policy decisions (including 'non-scorecard' policies and indirect effects, with the exception of the June 2010 event) on borrowing as a share of contemporaneous GDP for each fiscal event. It is based on our forecast revisions database. July 2020 reflects the Covid-related policy announcements between the March 2020 forecast and the July 2020 Summer Economic Update. The OBR did not produce a forecast alongside the September 2022 Growth Plan, so this is not included.
Source: ONS, OBR

21 Knightsbridge, London SW1X 7LY
www.aozorastep.com · david@aozorastep.com

AozoraStep

Worst-case scenario tax hikes (assumptions before Budget was announced)

Policy	Annual cash raise (£bn)	Currently (£bn)	Explainer	Source
NICs from employer to rise from 13.8% to 15.8%	18	108.5	Employers(13.8%) and employees (8%) pay NIC, which is used to fund the NHS. The rate for employees has been lowered, which could now be undone by increasing NIC for employers	https://www.bbc.co.uk/news/articles/c9wrkngvyx4o
Cut employer pension contributions not subject to NICs	17	-	Levied at full 13.8% rate would result in £17bn savings	https://ifs.org.uk/articles/raising-revenue-reforms-pensions-taxation
Up-front income tax relief for pension contribution	15	-	Cash raise is assuming relief from basic rate of income tax contributers much more could come from higher rate of income tax contributers	https://ifs.org.uk/articles/raising-revenue-reforms-pensions-taxation
Capital gains tax hike from 10-28% to income levels (up to 48%)	10	15	Capital gains taxes for residential property and stocks	https://www.shoosmiths.com/insights/articles/upcoming-budget---potential-changes-to-capital-gains-tax
25% tax-free pension withdrawal cancelled	5.5	-	25% of pension withdrawals with limit of £268k are currently tax free	https://ifs.org.uk/articles/raising-revenue-reforms-pensions-taxation
Inheritance tax (40%) threshold lowered from £325k to £0	3	7.6	Only 4% of families are paying it due to higher threshold, not charged to spouse/partner	https://www.independent.co.uk/news/business/inheritance-tax-budget-2024-reeves-threshold-rise-iht-b2636733.html
Fuel duty rise by 7p (currently 52.95p)	3.3	24.7	Fixed tax in GBp added to each litre of diesel/petrol	https://www.theguardian.com/politics/2024/oct/18/fuel-duty-expected-to-rise-by-up-to-7p-per-litre-after-the-budget
Eliminate the non-dom status	3	8.5	All income earned abroad is not taxed	https://www.gov.uk/government/publications/spring-budget-2024-non-uk-domiciled-individuals-policy-summary/spring-budget-2024-non-uk-domiciled-individuals-policy-summary
Lower NIC threshold on worker's earnings	2	-	From the current >£175/week (£9,100 pa) to >£123 a week (£6,400 pa)	https://www.gov.uk/national-insurance-rates-letters
Energy Profit Levy increase by 3% and no 91% investment allowance	2	3.6	Together with other taxes, UK oil and gas producers will pay 78% effective tax	https://www.bbc.co.uk/news/business-60295177
Make pensions subject to inheritance tax	2	-	Pensions can be transferred to non-spouses/partners at 0% tax	https://ifs.org.uk/articles/raising-revenue-reforms-pensions-taxation
Stamp duty changes	2	13	From £250k/£425k to £125k/£300k and from 2% to 3% for non-UK residents	https://www.bbc.co.uk/news/business-53319433

21 Knightsbridge, London SW1X 7LY
www.aozorastep.com · david@aozorastep.com

VAT on private schools	1.5	-	VAT to be introduced on all private school fees	https://lordslibrary.parliament.uk/independent-schools-proposed-vat-changes/
Winter fuel for pensioners cut	1	-	10mio pensioners will not receive up to £300 in heating support each year	https://www.mirror.co.uk/news/politics/budget-2024-everything-rachel-reeves-33991135
Private equity carried interest tax at income level	1	-	Currently private equity gains are taxed as capital gains	https://www.ft.com/content/d20b67f2-9d2b-42ea-bbb8-9680d9f716d3

21 Knightsbridge, London SW1X 7LY
www.aozorastep.com · david@aozorastep.com

Legal Disclaimer

The contents of this publication have been prepared solely for the purpose of providing information about AozoraStep Capital LLP and the services and products it is intending to offer, which are targeted for professional investors only. The opinions and views expressed are those of AozoraStep Capital LLP, may change without notice and should not be construed as investment, tax, legal or other advice. AozoraStep Capital LLP does not guarantee the completeness and accuracy of the information provided and all content can become out of date. Products or services mentioned in this publication are subject to legal and regulatory requirements in applicable jurisdictions and may not be available in all jurisdictions. Accordingly, persons are required to inform themselves and observe any such restrictions. In respect to investments described in this document, past performance is not a guide to future performance. The value of investments and the income of any financial instruments mentioned in this document may fall as well as rise and may have tax consequences. The performance of the investment strategy of AozoraStep Capital LLP is based on a personal track record of its managing partner and approved by Sedulo for the time period Q1 2019 - Q1 2021 and by HiCloud Accounting for the time period 2020 - 2023, only with further examinations being done on an occasional basis. AozoraStep Capital LLP is currently not authorized and regulated by the FCA, and therefore, is not allowed to provide financial products and services. AozoraStep Capital LLP is registered in England and Wales with registered number OC436835. Registered Office: 21 Knightsbridge, London SW1X 7LY, United Kingdom. Reproduction or distribution of any materials obtained in this publication or linking to this publication without written permission is prohibited.