

What could we see?

With the three above taxes ruled out, private wealth and businesses seem the obvious targets with capital gains and inheritance tax of particular interest to ministers (and the electorate).

Capital Gains Tax

In the run up to the election, Labour members were lobbying Reeves to align the capital gains tax to income tax rates. The Lib Dems announced a similar plan in their election manifesto and estimated such reforms would raise £5.2bn a year.

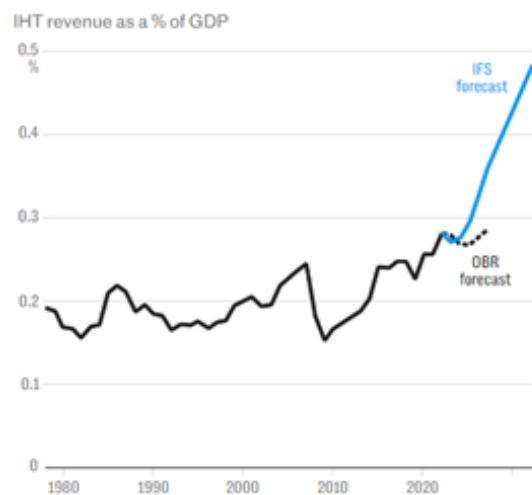
	Capital Gains	Income Tax
Basic	10%*	20%
Higher	20%*	40%
Additional	20%*	45%
	*excluding residential property	

When George Osborne raised the capital gains tax rate in 2010, it was applied only to disposals made from that point forward, with no retrospective effect. It is reasonable to anticipate a similar approach this time, meaning that disposals made before budget day should be taxed at the current rate.

Inheritance Tax

Despite already paying a 40% inheritance tax (IHT), one of the highest rates in the OECD, the IHT burden could increase further. The appeal for the Chancellor lies in bolstering what is already a sizeable contribution to the Treasury. Various changes may be considered, although a change to the tax rate itself has not been widely discussed.

1. The first option could be a reduction in the IHT free allowance which currently stands at £325,000, or £500,000 for homeowners, and potentially £1m if they are a couple.
2. A second option could be scrapping business relief on inheritance tax, which would raise £1.4bn a year.
3. A third option is to abolish inheritance tax relief for shares in fast-growing companies. This would raise an estimated £1.6bn a year.



Source: The Telegraph, 2024

Tax on Pensions

One potential approach to generating revenue is by adjusting pension tax relief, which could yield between £3bn and £15bn. Currently, pension contributions are eligible for tax relief at the pension saver's marginal rate of income tax, allowing high earners to receive significant tax relief. Proposals suggest capping this relief at 30% or even the basic rate of 20%.

Another potential change could involve lowering the annual allowance on pension contributions from

the current threshold of £60,000 to a lower value. The £60,000 allowance is already reduced by £1 for every £2 someone earns over £260,000. This proposal aligns with the broader theme of targeting the highest earners in society.

The Treasury could also reduce the amount pension savers can receive tax free when they begin withdrawing their savings. The current rules allow the withdrawal of a lump sum of up to 25% of the overall value of the pension fund (capped at £268,275) free from income tax. This costs the government around £5.5bn a year according to the Institute for Fiscal Studies. Limiting this to £100,000, for example, could raise around £2bn a year.

Government Borrowing

Reeves has said the Budget would include difficult choices on spending, welfare and tax. The government has already announced a big cut to the winter fuel allowance, and we've examined some of the options for increasing taxes. The other area is further reducing government spending to close the £22bn "black hole" in the government's finances.

The government has already identified cuts of £5.5bn for next year, rising to £8bn in 2025-26, but other areas of spending could be reduced to tackle the shortfall.

In addition, the government could change the way it accounts for the unwinding of the Bank of England's programme of quantitative easing.

Government bonds purchased by the Bank of England as a way of increasing liquidity in financial markets during recent crises are now being sold. Interest rates have risen significantly so gilt yields have also risen significantly since the Bank started buying them. Selling them now often involves a sizeable loss.

Current government accounting methods mean the Bank of England is being indemnified by the Treasury as it incurs these losses. Other countries, including the US, are not recognising losses in this way and the UK government also has the option of scrapping the indemnity completely. The Office for Budget Responsibility says the overall cost to the Treasury under the current rules could be £104bn so changing accounting rules could save the Treasury significant sums in the short term.



Source: *The Economist*, 2024

Other Options

The Chancellor has committed to capping corporation tax at the current rate of 25% and maintaining full expensing for businesses, so we are unlikely to see any changes here. However, other options include increasing fuel duty, which has been met with resistance due to potential inflationary pressures and increased costs for businesses and consumers. Another possibility apparently up for consideration is the introduction of a bank levy, although banks have been lobbying against it due to concerns over its impact on their profits. A higher windfall tax of 78% on fossil fuel producers has already been planned, which would align the UK with Norway's tax regime but may deter investment in renewable energy. The government could also bring in taxes on vaping products earlier or at higher rates to generate additional revenue.

What could the impact of such changes be?

Changes to capital gains tax and inheritance tax will have significant implications on personal finances when realising a capital gain or passing on an inheritance. These measures primarily target the wealthy, who typically have a lower propensity to consume. Consequently, changes in their income or wealth levels are unlikely to significantly impact their expenditure levels. Therefore, one could infer that GDP would remain unaffected as consumer spending levels would stay the same.

Impact on financial markets

It is not often that a budget has a direct effect on financial markets. Liz Truss and Kwasi Kwarteng's 'mini budget' is very much an exception. However, the increase in taxes and reduction in government spending could lead to a more cautious market sentiment. Investors might anticipate slower economic growth due to reduced fiscal stimulus, which could dampen consumer and business confidence. This cautious sentiment could lead to increased market volatility as investors react to the potential economic slowdown and adjust their portfolios accordingly.

In terms of asset classes, equities might experience heightened volatility. Sectors that are more sensitive to economic cycles, such as consumer discretionary and industrials, could see more significant fluctuations. On the other hand, defensive sectors like utilities and healthcare might be less affected as they tend to be more resilient during economic downturns.

Government bonds could see increased demand as investors seek safer assets amidst the uncertainty. This increased demand could drive bond prices up and yields down. However, the extent of this effect would depend on the overall market perception of the government's fiscal health and the potential for future interest rate changes by the Bank of England.

Above all, it's crucial to remember the importance of diversification within a portfolio. Any market fluctuations following the budget will primarily affect UK markets, particularly equities. However, in a well-diversified portfolio that spans various regions and asset classes, the impact of changes in CGT or IHT on financial markets should be minimal. Diversification helps mitigate risks and ensures that the overall portfolio remains resilient despite localised market movements.

Conclusion

The impact of the autumn Budget on the economy and markets will largely depend on how investors perceive the balance between fiscal consolidation and economic growth prospects in the UK. While there is a general understanding that the current level of spending is unsustainable, Chancellor Reeves must carefully manage the fiscal challenges without stifling future growth prospects.

Market expectations for the upcoming budget are notably subdued. Pre-budget communications have explicitly stated that it will be a painful budget. However, there is potential for some flexibility through adjustments to the debt rule. Additionally, Rachel Reeves has reiterated her commitment to growth at the recent Labour Party conference, stating, "Growth is the challenge and investment is the solution". If the budget turns out to be less severe on personal taxes than anticipated, it could foster a sense of relief in the markets and improve overall sentiment.

It could be a case of Starmer aiming to under promise and over deliver. The Prime Minister has been

persistent with his messaging, both through the election campaign and since he gained power, of bringing a strong period of growth back to the economy. As recently as this week he has reminded us of this aim, and in relation to the upcoming budget itself he said “If it promotes economic growth, it’s in the Yes column — if it is inhibiting growth, it’s in the No column”.

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