The budget will stifle the ability of the private sector to boost the economy

Last week the first-ever female Chancellor of the Exchequer stood up in the House of Commons to deliver a budget that has resulted in the biggest tax rises in history while raising investment for public services.

While there has been considerable commentary on what the measures introduced by Rachel Reeves will mean for the economy, perhaps the most important report came from the Office for Budget Responsibility (OBR), which plays a crucial role in shaping the budget by providing independent economic and fiscal forecasts that guide government decision-making.

According to the OBR, the collective measures in the budget will inject an additional £70bn annually into the economy over the next five years, equating to 2.2% of GDP each year. This injection into government spending, especially on departmental resources and capital projects, brings a notable boost in public investment, particularly in areas such as public infrastructure, education, and health services.

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However, this shift toward a larger public sector could crowd out private investment, particularly in an economy where private firms may face tighter access to resources. With public spending expected to increase to around 44% of GDP, businesses may find themselves competing with government and other public bodies for available talent and investment opportunities.

With the Labour Government promising not to increase personal taxes, VAT, or national Insurance contributions(NICs), in their manifesto, the flexibility to raise revenue has been considerably constrained. In such circumstances, the majority of the £40bn being raised is coming, despite the above assurance, from significant changes to employer NICs which are forecast to raise £25bn in 2025-26.

These changes include increasing the employer NICs rate from 13.8% to 15%, which generates around £12bn annually, and reducing the threshold at which NICs is levied from £9,100 to £5,000 per year, adding approximately £18bn annually. Some of this is being offset by an increase in employment allowances from £5,000 to £10,500, which, if fully taken up by eligible employers, will cost the Treasury around £4 billion per year.

However, these changes are expected to impact 1.2 million employers, with 940,000 seeing a net increase in liabilities, translating to an average tax rise of over £800 per employee.

For many employers, particularly those with larger workforces, these changes mean significantly higher payroll costs, potentially requiring shifts in hiring, automation, or outsourcing strategies.

For each employee on median earnings, businesses will incur an additional cost of £900 per year and the OBR expects that 61% of this rise will come from reduced wages, 15% will lead to higher prices, and 24% will cut into profits.

This adjustment will likely prompt businesses to make strategic changes in wage management, pricing, and cost efficiency. With a significant portion of the new NIC costs expected to reduce wages, employers may limit wage growth or reconsider pay structures for lower-wage roles.

Additionally, some of these costs will likely pass on to consumers through higher prices, though this may prove challenging in highly competitive, price-sensitive markets and reduced profitability, particularly for businesses with tight margins, may necessitate cost-cutting measures or operational restructuring.

What is most concerning is that, according to the Institute for Fiscal Studies, these changes will have the greatest impact on those employing lower-wage workers. For example, employing someone earning £11,500 will now cost 5.4% more, compared to a 2.5% increase for a median earner. As a result, businesses with a large proportion of low-wage employees, such as in retail, hospitality, and care, will face disproportionately higher employment costs.

With the budget adding £32bn in annual borrowing, businesses may experience tighter credit conditions and fluctuating interest rates. For example, interest rates are anticipated to fall from their current 5% to 3.5% by 2029-30, but the increase in public borrowing could keep pressure on lending costs. For the UK’s debt-heavy sectors, including construction, property, and retail, these dynamics introduce a layer of uncertainty that could affect both short- and long-term growth strategies.

After a dramatic fall in inflation over the last twelve months, the OBR's forecast that it is set to increase again to 2.6% will be disappointing to both businesses and consumers. This rise will not only lead to price increases across input materials, wages, and logistics but also a slowdown in real income growth, which could lead to a flattening in household spending power over the next decade. If this is correct, businesses may pass on additional costs to customers as they try to balance competitiveness with maintaining profitability.

While the OBR expects the budget to reduce unemployment slightly to 4% by 2026, there is still some uncertainty over the impact of National Insurance rises and whether employers may cut jobs or stop hiring altogether. Although total employment is forecast to grow by 1.2 million people, this increase is expected to be driven by population growth rather than business expansion.

More relevantly, real wage growth is expected to flatline in 2026 and 2027, which, in turn, will limit consumer spending power and could further impact sectors such as retail, leisure, and hospitality, which have already faced challenging conditions in recent years. Indeed, it's been forecasted that real household income will rise by only 0.4% over this Parliament, which is the last thing the general public expected.

Therefore, while the billions of pounds in additional government spending are expected to temporarily boost GDP, there are growing concerns within the business community that the increase in employers' NIC contributions, combined with rising inflation and labour costs, will dampen confidence in the private sector.

The budget has set the tone for the next five years and the coming weeks will be crucial in determining whether businesses are ready to embrace a high-tax and high-spending approach or whether they will pull back on growth, potentially leading to serious consequences for economic growth.