

2025 Budget Briefing

Tax Policy Preview – Options and Possible Impacts

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Summary

- The Chancellor is facing a new financial hole of as much as £30 billion, which she will probably seek to fill with broad-based increases in taxes on income and from a dog's breakfast of smaller measures.
- This Briefing explains how that gap has opened up and assesses the Chancellor's options.
- The single largest part of the hole is likely to reflect a long overdue downgrade to the OBR's forecasts for productivity. But the rest would result from policy decisions made by the current government.
- In particular, the Chancellor looks set to spend the savings from any more favourable economic assumptions made by the OBR, rather than bank them to reduce borrowing. She also looks set to take some poorly targeted measures to lower household bills.
- More positively, the Chancellor is likely to increase the fiscal headroom, which would provide a larger buffer against future shocks. Many of the tax increases would also be 'backloaded' towards the end of the forecast period, rather than take effect straightaway.
- Households and businesses are already expecting a painful Budget, so an easing of the current uncertainty might at least be a relief. A fall in the cost of borrowing could help, too.
- However, any attempt to raise most of the money from a large number of small tax changes is bound to backfire. In particular, the likely behavioural responses mean that the revenues raised would be much less reliable than those from a simpler increase in broad-based taxes, notably income tax or VAT.
- Above all, none of this would be necessary if the current and previous governments had not allowed public spending to spiral out of control.

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Introduction

It has felt like an eternity, but Chancellor Rachel Reeves will finally unveil her second Autumn Budget on Wednesday 26 November. In the meantime, economic growth has stalled as consumers and businesses have put spending, hiring and investment on hold. Indeed, the latest official figures show that UK GDP fell (before some favourable rounding) in each and every month from July to September.

The early evidence for October suggests that activity remains weak, notably in sectors such as housing which are particularly sensitive to economic and policy uncertainty. The cost of government borrowing in the bond markets has also been volatile, driven in large part by Budget speculation. Most now expect another round of large increases to close an additional gap in the public finances which has opened up since spring.

This Briefing therefore addresses four key questions. How big is the new financial hole? How is the Chancellor likely to fill it? How are the markets and the wider economy likely to react? And last but not least, is there anything that she might have done (or could still do) differently?

For context, the Briefing begins with an explanation of how the Budget process works, which should help understand how we got here.

A primer on the fiscal framework

A good place to start is the government's two main 'fiscal rules' (for chapter and verse, see HM Treasury 2024a).

One is a 'deficit rule'. This is a target for the current budget, which is the difference between day-to-day spending and revenues (mainly from tax) in any one year. This measure of the budget is required to be in surplus in 2029–30, based on the forecasts produced by the independent Office for Budget Responsibility (OBR).

The other is a 'debt rule'. This is a target for the stock of debt, defined as Public Sector Net Financial Liabilities (PSNFL), which has to be falling as a share of national income (GDP) by 2029–30.

These rules are far from perfect, but they have a certain economic logic. The 'deficit rule' is designed to ensure that the cost of current spending is borne by current taxpayers, rather than passed on to future generations. The government can then only

borrow to invest. The 'debt rule' should prevent the overall burden of debt, including borrowing for investment, from spiralling out of control.

So far, every Chancellor has aimed to meet these targets (or their earlier versions) with something to spare – known as the 'fiscal headroom'. But this margin has recently been very slim. In particular, the current budget has been forecast to be in surplus by just £9.9 billion in 2029–30, which is a tiny amount in the context of overall taxation and spending (and only 0.3% of forecast GDP).

On average, the projected fiscal headroom under previous Chancellors (back to 2010) has been much larger – at around £30 billion – even when levels of borrowing and debt were much lower. Despite this, the targets were still frequently missed.

The OBR currently assesses performance against these targets twice a year, usually alongside the Chancellor's Spring Statement and the Autumn Budget. Each time, the OBR updates its Economic and Fiscal Outlook (EFO) to assess whether the fiscal rules are likely to be met. If the early forecast rounds identify any shortfalls, the Chancellor has time to take measures to fill the gaps, and these measures are then included in the final assessment.

For example, in the run up to the latest Spring Statement (March 2025), the OBR forecast that the current budget was on track for a deficit of around £4 billion in 2029–30. This was mainly due to a shortfall in tax receipts and to higher government bond (gilt) yields and inflation, which raised debt interest costs.

The Chancellor then announced measures that the OBR judged would be sufficient to restore the current budget to a surplus of £9.9 billion (OBR 2025a). Importantly, these measures included a package of welfare reforms (mainly savings on Personal Independence Payments and health-related Universal Credit), which were estimated to reduce spending by £5 billion in 2029–30.

Put another way, the OBR identified a 'financial hole' of about £14 billion in the run up to the Spring Statement, assuming the Chancellor wanted to retain the existing headroom of just under £10 billion. This was then filled with planned spending cuts and some small tax increases.

Of course, this was dwarfed by the measures on both tax and spending announced in the October 2024 Budget. The economic and fiscal backdrop was largely unchanged since the previous forecast in March 2024 (the last under the previous government).

But in her first Budget, the new Chancellor added around £70 billion to annual public spending over the next five years. Of this, about two-thirds was on day-to-day spending and the other third on public investment (OBR 2024).

Just over half this increase in spending was funded by higher taxes, notably the increase in employer National Insurance (NI) contributions. In the final year of the forecast period, the October 2024 Budget increased the overall tax burden by about £40 billion. The rest came from even higher government borrowing.

While the Chancellor has never ruled out more tax rises if necessary to meet the fiscal rules, the hope was that the scale of the increases in her first Budget would be a 'one-off'.

In remarks to the CBI on 24 November 2024, Rachel Reeves said *'Public services now need to live within their means because I'm really clear, I'm not coming back with more borrowing or more taxes'* (BBC News 2024).

Moreover, Labour ministers (at least until recently) have consistently underlined the commitments on tax in the manifesto for the 2024 General Election. This stated that *'Labour will not increase taxes on working people, which is why we will not increase National Insurance, the basic, higher, or additional rates of Income Tax, or VAT'* (Labour Party 2024).

Nonetheless, in recent weeks the Chancellor has paved the way for broad-based tax increases. In particular, she used a 'Scene Setter' speech on 4 November to argue that *'if we are to build the future of Britain together, we will all have to contribute to that effort'* (HM Treasury and Rachel Reeves 2025).

How big is the new financial hole?

This prompts the question of what has gone wrong. This month's Budget may not have to repeat the full £40 billion of tax increases announced in October 2024, but another package of tax increases of at least £20 billion is now widely expected – and it may well be much larger.

Table 1 is an educated guess at the size of the hole to be filled – £30 billion – and the key components. This is a summary of how changes in the economy and fiscal backdrop since the OBR's previous forecast in March, as well as the impact of new policy measures, might affect borrowing and debt in 2029–30. All these numbers are

only indicative and there are many different ways of arriving at the same total, or a much higher or lower figure.

Table 1: A £30 billion financial hole?

Components	£bn
1. Productivity downgrade	20
2. Cost of borrowing	2
3. Other economic assumptions	-8
4. Net increase in welfare spending	8
5. Measures to cut household bills	3
6. Increase in fiscal headroom	5
Total (2029–30)	30

1. Productivity downgrade – £20 billion cost

The first line shows the biggest single element – the fallout from a long-expected downgrade in the OBR’s forecasts for trend growth in productivity. Depending on the context, productivity can be measured as output per hour worked, or as GDP per head.

Crucially, the OBR’s forecasts for productivity have proved to be too optimistic for many years. In fact, the Chancellor might be forgiven for feeling aggrieved that the latest downgrade is happening on her watch.

Ministers have suggested various factors to explain the timing of the downgrade. One is the claim that the initial impact of Brexit has been more negative than the OBR had already assumed – though there is little evidence to support this.

They have also emphasised the legacy of ‘austerity’ in the early 2010s (which is debatable) and the disruption to world trade from US tariffs (which is now fading). A much simpler explanation is that the OBR has been wrong on trend productivity for a long time and has decided to bring its estimates down in line with those of other forecasters, such as the Bank of England.

But whatever the precise reason, a downgrade to the productivity forecasts would mean that the UK economy is no longer expected to grow as much as before over the longer term. In turn, this is likely to reduce tax revenues and make it harder to meet the deficit rule. And while the deficit rule is still likely to be the one that bites, a larger annual deficit and a lower future path for GDP will make it harder to meet the *debt* rule, too.

Table 1 reflects this by assuming a £20 billion hit from this downgrade, though a smaller figure of around £14 billion is also plausible.

2. Cost of borrowing – £2 billion cost

The second element in Table 1 is the change in the government's cost of borrowing since March. The OBR's assumptions here are based on average market expectations for Bank Rate (the official interest rate set by the Bank of England) and gilt yields during an 'observation window' ahead of the final pre-measures forecast. Table 2 sets out the timetable for this Budget.

Table 2: The OBR forecast timetable

Friday 3 October	Round 1
Monday 20 October	Round 2
Friday 31 October	Round 3 (final pre-measures forecast)
Monday 10 November	Round 4 (first post-measures forecast)
Friday 21 November	Round 5
Wednesday 26 November	Budget, EFO published

The OBR decided right at the start of the process that it would take a later reading of market expectations for Bank Rate and gilt yields for the final pre-measures forecast, with this window covering the ten working days to 21 October (OBR 2025b).

As it happens, market expectations were a little lower in this period than in the previous ten working days (partly due to growing expectations of tax increases in the Budget). But more importantly, they were still a little *higher* than in the 'observation window' for the March forecasts. To reflect this, Table 1 assumes a £2 billion hit.

However, the OBR could still adjust these assumptions if the final budget package differs significantly from what the markets are expecting – in either direction. Indeed, in the October 2024 Budget, the OBR made the judgement that the additional borrowing was unlikely to have been fully anticipated by market participants, so added a quarter percentage point to the forecasts for the Bank Rate and gilt yields. This is yet another example of how, even at this late stage, nothing is guaranteed.

3. Other economic assumptions – £8 billion savings

This component has a great many moving parts and is even more uncertain. It has been widely reported that more favourable assumptions – perhaps about inflation, wage growth and associated tax revenues – could reduce the size of the financial hole by several billion pounds.

It is also possible that the OBR might give a little more credit for the supply-side measures and other policy changes since the March forecast, such as planning reforms or new trade agreements.

However, the OBR could also take a less favourable view of other policies, such as the Employment Rights Bill, which is likely to reduce labour market flexibility, or the knock-on effects of further increases in the National Living Wage, especially on the employment prospects of younger people.

The OBR is unlikely to ignore the persistent weakness of housebuilding, which suggests that the planning reforms are set to disappoint. And the EU 'reset' is also far from a done deal, making it difficult for the OBR to incorporate any benefits (even if the UK does not have to pay a high price for them).

A net saving of £8 billion has been pencilled in here, but this could be way off in either direction.

4. Net increase in welfare spending – £8 billion

Moreover, the government is likely to increase public spending even further relative to the March forecast. The earlier welfare package saving £5 billion has already been abandoned, and winter fuel payments for pensioners have been partially reintroduced. Other possible new commitments, such as the tapering of the two-child cap on working-age benefits, could add to the overshoot, perhaps taking it to £10 billion. This is likely to be only partially offset by some small savings elsewhere, such as from the Motability scheme.

For simplicity, Table 1 assumes that all the £8 billion that might be saved from more favourable economic assumptions is spent, rather than banked.

5. Measures to cut household bills – £3 billion cost

The Chancellor has also signalled that she wants to do something to reduce household bills directly. One frontrunner is the removal of the 5% VAT from domestic energy bills. This tax break might be popular, but it would also be poorly targeted – some of the biggest winners would be richer households who use more energy. It would also do nothing to address the fundamental reasons why the cost of energy is so high in the UK.

Moreover, the loss in revenues would need to be offset elsewhere, most likely now from increases in direct taxes. So, while cutting VAT on domestic energy bills might reduce headline inflation (temporarily), real disposable incomes could be little changed.

These points would also apply to transferring some green levies and other policy costs from household bills to general taxation, though a scaling back of some green subsidies would be a net benefit to the taxpayer.

6. Increase in fiscal headroom – £5 billion cost

Finally, the Chancellor has signalled that she wants to increase the fiscal headroom to provide a bigger buffer against future shocks. This is a good idea.

For a start, it should reduce the need for constant tinkering with tax and spending, sometimes within the year, providing some stability. It may also give households and businesses a little more confidence that the Chancellor will not have to come back again with another round of tax increases any time soon.

Ideally the Chancellor would at least double the headroom – to about £20 billion. But larger tax increases now could also risk a bigger hit to the economy. Table 1 therefore assumes that she increases the headroom by a modest £5 billion, to about £15 billion. This would be better than nothing, but still only a small step in the right direction.

How is the Chancellor likely to fill the financial hole?

The upshot is that, based on some reasonable assumptions, the Chancellor could have to find another £30 billion from tax increases. It is hard to see how this can be done without touching the big revenue raisers – namely income tax, NI (again) and VAT. Indeed, earlier this month the Chancellor reportedly asked the OBR to assess a plan to raise the basic, higher and additional rates of income tax by 2p, partly offset by a 2p cut in employee NI (the ‘two up, two down plan’ originally proposed by the Resolution Foundation).

This could have raised about £6 billion, mainly from those with non-employment income and those above the state pension age. This figure could have risen to about £10 billion if the cut in employee NI had been limited to people earning below the Upper Earnings Limit (currently just over £50,000).

However, this plan now seems to have been dropped. The official explanation is that more favourable OBR forecasts mean that it is no longer necessary to raise income tax rates. But that explanation does not stack up. Any more favourable assumptions – including on borrowing costs and on the tax revenues from wage growth – would normally have been included already in the final pre-measures forecast on 31 October. The ‘two up, two down’ tax plan reportedly came later.

It is more plausible that the decision to dump the plan to raise income tax rates was based on fears about the political fallout from such a clear breach of the manifesto commitments.

Nonetheless, the Chancellor could still raise a similar amount of money (relative to existing plans) by extending the current freeze on personal tax thresholds beyond 2028, which would drag even more people into paying higher rates of tax.

Extending the freeze would still breach the spirit of the manifesto, even if not necessarily the letter. Rachel Reeves herself described this option as a tax on 'working people' when ruling it out in her first Budget speech in October 2024 (HM Treasury and Rachel Reeves 2024b).

However, this alternative could also raise at least £8 billion and perhaps as much as £10 billion. Extending the freeze beyond 2028 would also at least delay the pain for taxpayers, compared with the alternative of raising tax rates now.

But this could still leave about £20 billion to be raised from other taxes. This has been described as a 'smorgasbord' of measures, which might appeal to some, but it would be more accurate to call it a 'dog's breakfast'.

It is probably still safe to assume that the Treasury will continue to reject calls for a new annual 'wealth tax'. This is for the simple reason that, based on the experience of other countries and on the evidence from smaller changes in taxes on capital here, an annual 'wealth tax' is unlikely to raise a significant amount of money.

But there are many other ways in which the Chancellor could try to find another £20 billion. There is a large menu of individual options, each of which might raise about £2 billion.

Other taxes on 'wealth' will surely be raised, perhaps by:

- 1) increasing Council Tax on higher value properties (a simpler option than creating a new Mansion Tax, though with similar effects)
- 2) closing Capital Gains Tax 'loopholes' (e.g. by imposing a new 'exit charge' on unrealised gains from business assets, or an additional levy on death)
- 3) further changes to Inheritance Tax (such as targeting the tax-free gift period)
- 4) reducing tax breaks on savings (such as lowering the amount that can be saved in cash ISAs or imposing a new cap on the amount that can be saved in pension salary sacrifice schemes without paying NI on the contributions).

Taxes could also be raised on some forms of income that the government believes are undertaxed, perhaps by:

- 5) imposing NI on certain types of partnerships (LLPs) widely used by lawyers, doctors and other professionals
- 6) levying NI on rental income.

There are also likely to be new or increased taxes on some forms of expenditure, perhaps including:

- 7) a new pay-per-mile tax on Electric Vehicles from 2028 (partly to replace the loss of revenue from fuel duty on petrol and diesel cars)
- 8) ending the temporary 5p cut on fuel duty (though this is already factored into the OBR's forecasts)
- 9) an increase in so-called 'sin taxes', notably on gambling (excluding horse racing) and 'sugary drinks' (such as milkshakes)
- 10) extending VAT to more goods and services that are currently exempt or zero-rated, such as some forms of passenger transport (though this would be even harder to square with the stated intention to keep household bills down).

Businesses are also unlikely to be spared. Leading options here include:

- 11) the VAT threshold could be lowered, from £90,000 to perhaps £30,000
- 12) there could be a further but temporary increase in the Bank Levy.

Of course, this is not an exhaustive list. Indeed, the Treasury is said to have considered more than 100 options. But there are three key takeaways.

Firstly, and just about the only positive, some of these tax increases would take time to be implemented, delaying some of the economic hit. Combined with the likely extension of the freeze in personal allowances, this means that at least half of a £30 billion package of tax increases could be 'backloaded', rather than taking effect straightaway (or in April 2026).

Secondly, though, many of these changes could have large and unintended consequences for the economy, especially if they discourage savings and investment, further gum up the housing market, or drive more entrepreneurs overseas.

Most analysis relies on HMRC costings, which do at least attempt to account for the effect of behavioural changes on the tax base in question (see HMRC 2025). The OBR then attempts to add other effects on the wider economy in its macro forecasts. But this is hard to get even vaguely right, especially when there is such a large number of moving parts.

Thirdly, and related to this, the revenues raised from a dog's breakfast of smaller tax increases are relatively uncertain, and any figures are more likely to be over-estimates. This is a particular problem with new measures that are as yet untried, and where the costings might unravel as more details emerge.

The taxation of wealth rather than income is inherently more difficult because it is harder to value assets than it is to observe a cash payment. Increased taxes on, say, property may pose additional challenges when dealing with 'asset-rich' but 'income-poor' households, who may struggle to pay a larger tax bill straightaway.

A particular problem with 'sin taxes' is that they aim to discourage an activity while still raising money from it – and can end up doing neither. There is ample evidence that ever higher taxes on gambling or tobacco encourage illicit activity and actually reduce revenues, though this may not be immediately obvious.

In short, it would be far better to try to raise more money in a simple way from a larger number of people, rather than try to raise the same amount from a smaller number of people in a variety of different ways.

How are the markets and the economy likely to react?

This all makes it very difficult to gauge how the Budget will go down. But the immediate reaction will be seen in the financial markets, and here we already have some clues.

Bond markets reacted badly on Friday 14 November when the government appeared to U-turn on the plan to raise the rates of income tax. Rightly or wrongly, there was a widespread perception that the government was too weak to make tough choices on tax, as well as on spending. Other ways to raise revenue are also thought to be less reliable. Finally, there was a perception that the resulting uncertainty made a challenge to the position of the Prime Minister more likely, increasing political uncertainty.

The flipside is that if the Chancellor can deliver a more credible plan on 26 November, borrowing costs could fall back again. It is possible, too, that the Bank of England will cut interest rates by more than previously anticipated, meaning the additional fiscal tightening from tax increases is at least partly offset by looser monetary policy.

The political fallout is also uncertain. But much could hinge on whether the freeze on personal tax allowance is indeed extended. If the size of the financial hole can be capped at, say, £20 billion, it may still be possible to stick to both the letter and the spirit of the manifesto commitments.

As for the reaction in the wider economy, the impact on confidence will be key. Most households and businesses surely now expect a tight Budget, so the actual measures may not be as bad as feared, especially if many taxes do not go up straightaway.

A significant increase in the 'fiscal headroom' could also reassure some people that the latest round of tax increases could really be the last for a while, especially if combined with some tweaks to the fiscal framework that reduce the pressure for more frequent policy changes.

In any event, some of the uncertainty will have been lifted, which might allow spending, hiring and investment to resume. Remarkably, some surveys suggest that households and businesses are still fairly confident about the longer-term outlook.

Nonetheless, it would be unwise to bank on this. The Chancellor faces an unenviable balancing act – only partly of this government's making – and the risks of a fall are high.

Is there anything else that she might have done differently?

Clearly, no one would want to start from here.

The root of the problem is that successive governments have failed to control public spending. However, the Chancellor might still be able to keep the size of the tax increases below £20 billion if she were to bank any savings from more favourable economic assumptions, rather than spend them, and find other savings from the welfare bill to replace those lost since spring.

As it stands, current (day-to-day) spending is forecast to rise from about £1,150 billion in 2024–25 to £1,350 billion in 2029–30 – an increase of £200 billion. Reducing the growth of spending would save a large amount of money, without having to make outright cuts. Simply restoring productivity in public services to its pre-Covid level would be a good start and could allow the same services to be provided for 4% less money.

But if spending cuts are off the table, there are still three other steps the government could take (though these may be forlorn hopes, too).

One would be to revisit some of the policy choices that are likely to make the underlying problems worse, including in the housing market (rental reforms), the labour market (the Employment Rights Bill) and energy policy (the rush to 'net zero').

The next step would be to undertake a fundamental reform of the tax and benefit system, with the aim of simplifying everything and reducing some of the disincentive to work, save and invest created by high marginal tax rates.

Finally, if it is still necessary to raise a lot more in taxes (a big 'if'), at least it could be done in the simplest possible way. Some combination of increases in income tax rates and in VAT, perhaps including an extension of the VAT base, would be the cleanest option in economic terms and received best in the markets. Politically, though, this may be nigh on impossible.

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