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A tax and spend (and headroom) budget

The UK budget raises taxes, spending, and the headroom against the fiscal rules. Back-loaded tax increases mean the budget modestly supports growth in the near term, but this raises questions about fiscal credibility. The government is likely to remain under political pressure, and may not survive past the May elections.

Key Takeaways

- The (prematurely released) OBR forecasts downgraded UK GDP growth. But higher inflation and wage forecasts mean the projected deterioration in the overall tax take wasn't as bad as it could have been.
- This meant that – prior to the measures in the budget – the chancellor still had £4.2 billion of fiscal space.
- So, the budget was not about realigning fiscal policy to macro fundamentals but increasing taxes to make two political choices: doubling the headroom against the rules to £22 billion; and increasing spending.
- The budget increases taxes by £26 billion. This includes freezing income tax bands from 2028, and higher taxes on property, dividends, and savings.
- Spending increases included a £10 billion welfare reform package, the centrepiece of which was the lifting of the two-child benefit cap. Measures to reduce household energy bills were also announced.
- The budget will reduce inflation modestly in the near term, reinforcing our expectations for Bank Rate to fall to 3% next year.
- After some volatility, the market reaction is sanguine. This reflects the lack of surprises and the increased headroom. However, the very backloaded revenue raising may be a source of future market concern.
- Indeed, the budget will not have done much to assuage growing concerns within the Labour Party over Starmer and Reeves' leadership. A poor May local election result could trigger a leadership contest.

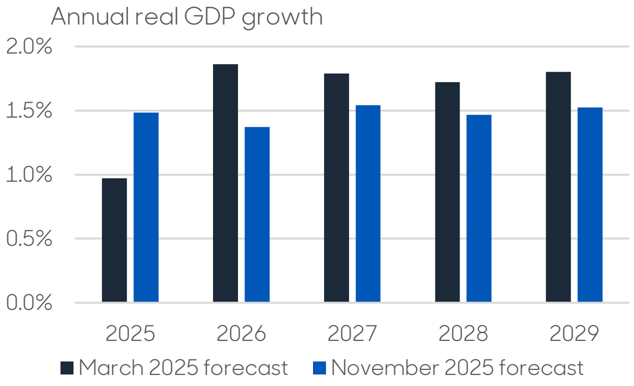
OBR downgrades less bad than they could have been

Leaving aside the snafu of the Office for Budget Responsibility (OBR) forecasts being mistakenly released early, the actual composition of the economic forecast changes could have been a lot worse for Chancellor Rachel Reeves.

As expected, the OBR's long-term UK productivity assumption has been downgraded by 0.3ppts to 1% per annum. We think that number is still too high, so further downgrades are likely coming at future budgets.

So, despite the *upgrade* to the 2025 GDP growth forecast on the back of the recent better performance of the UK economy, GDP growth over the rest of the forecast period has been downgraded (see Figure 1). Cumulatively, the OBR expects the real economy to be 1.3% smaller by the end of the forecast period relative to its projections back in March.

Figure 1: The OBR upgraded 2025 GDP growth, but lowered its forecasts over the full horizon



Source: Aberdeen, OBR, November 2025

But, at the same time, the OBR has raised its inflation and nominal earnings growth forecasts, reflecting greater domestically generated inflation pressures and strong wage settlements. This means the downgrade to the *nominal* size of the economy, which is what matters for the tax take, was less significant: about 0.9% smaller at the end of the forecast horizon relative to the March forecasts.

Moreover, the "tax richness" of the economy (the extent to which nominal GDP translates into tax receipts for the government) is expected to improve. Faster wage growth but lower productivity growth means that labour income is improving relative to corporate profits. Because labour income is taxed more than corporate profits (the average effective tax rates in the UK are about 40% and 17% respectively), that represents a rise in the tax take, all else equal.

Headroom against the fiscal rules doubled to £22bn

All this means that, despite widespread speculation before the budget that the chancellor's previous headroom of £9.9 billion against the fiscal rules was going to be wiped out, the net changes to the OBR's forecast left the chancellor with £4.2 billion of positive headroom come 2029-30.

In principle, then, the chancellor was not required to do anything to fiscal policy to meet the rules. So, rather than reflecting shifting macroeconomic fundamentals, the budget is actually being driven by two big political choices: first, to increase spending; second, to increase the headroom against the fiscal rules.

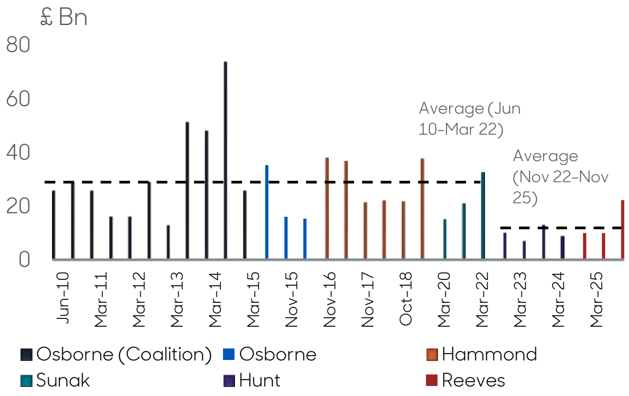
Following the budget measures, the headroom has been more than doubled to £22 billion (see Figure 2). This is still on the smaller side compared to the headroom left by previous chancellors. But it represents a significant increase from the historically very narrow room Reeves had previously (see Figure 3).

Figure 2: Reeves was able to widen her headroom to £22bn, mostly through tax hikes

Headroom from March	£10bn	
After OBR forecast changes, pre-measures	£4.2bn	
Cost of spending measures	-£3.9bn	**Removal of two-child limit**: -£3.0bn
Direct effect of taxes	£26.1bn	**Personal tax threshold freezes**: +£8.0bn **NICs on salary-sacrifice**: +£4.7bn **Dividend/property/savings tax**: +£2.1bn **Writing down allowances**: +£1.5bn **Mileage-based EV charge**: +£1.4bn **Gambling duty reform**: +£1.1bn **CGT on EOTs**: +£0.9bn **High value council tax surcharge:** +£0.4bn **Tax compliance**: +£2.3bn **Other tax changes**: +£3.7bn
Indirect effect of policy	-£4.7bn	
Total headroom after measures	**£21.7bn**	

Source: Aberdeen, OBR, November 2025

Figure 3: The chancellor has increased headroom against the fiscal rules, but this is still narrow



Source: Aberdeen, OBR, November 2025

The chancellor will hope this increased headroom serves several purposes.

The first one is that it helps reassure the gilt market about the fiscal outlook and so puts downward pressure on term premia. With limited headroom, gilt market volatility can have outsized influence on the need for future fiscal policy and potentially leave policy exposed to adverse feedback loops.

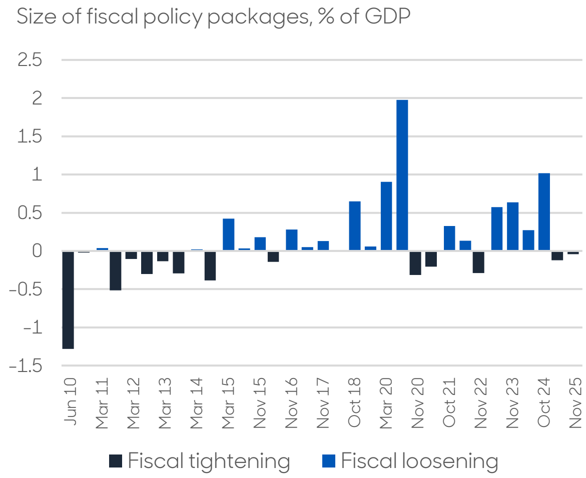
The second is that it increases her political breathing space, such that there is no longer a rolling cycle of speculation about how future rule breaches will be handled. This may help to improve sentiment and confidence in the real economy, if there is no longer a steady drip-drip of headlines about the prospect of future tax increases.

Finally, Reeves may also hope that, if the economy largely pans out as expected, the higher headroom can then be used to finance tax cuts or spending increases in the run-up to the next election.

Tax increases, but spending comes first

Despite headline tax increases, the budget does not imply a significant fiscal tightening (see Figure 4).

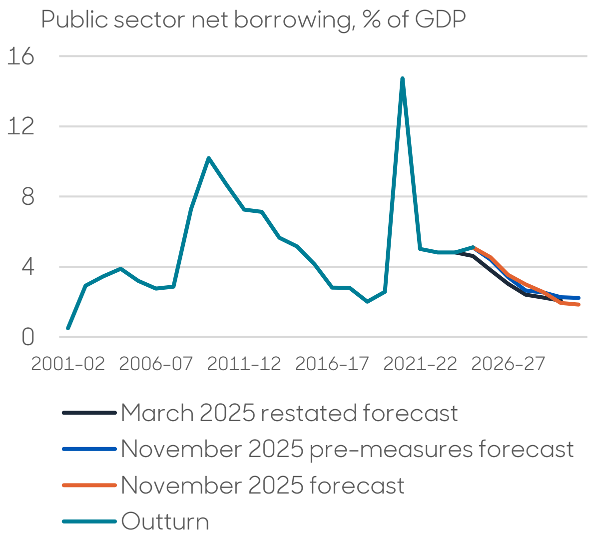
Figure 4: There is actually very little fiscal tightening in this budget, because of the temporal spread of tax and spend measures



Source: Aberdeen, OBR, November 2025

While taxes are forecast to rise by £30 billion per year by the final year of the forecast horizon, this is partially offset by £12 billion in additional public spending. And Reeves has front-loaded the spending increases and backloaded the tax increases. So, the OBR judges that government borrowing will actually increase relative to previous forecasts up to 2027-28, before then falling (see Figure 5).

Figure 5: The deficit will be pushed up in the near term, despite the overall increase to fiscal headroom



Source: Aberdeen, OBR, November 2025

The long lead time to implementation for some significant revenue raisers reduces their credibility, give the scope for behavioural changes to erode the actual tax take, not to mention the possibility of political change before then.

Spending increases focus on welfare and energy

One of the worst kept secrets ahead of budget day was the government's intention to scrap the two-child benefit cap. This came as part of an additional £10 billion in welfare spending.

Other measures focused on addressing cost of living (and by extension, inflation expectations). Regulated rail fares were frozen, as were prescription costs. And the government announced the end of the Energy Company Obligation on bills, as well as funding 75% of the cost of the Renewables Obligation to households up to 2029. Taken together, these measures will reduce average household energy bills by £150 per year.

Notably, all spending increases are scheduled for implementation from April 2026, well ahead of announced tax increases, which are phased in from 2028 onwards.

Personal tax changes are skewed to middle and high earners

The chancellor froze personal income tax bands for an additional three years from 2028-29, raising £8 billion.

But further changes to personal taxation were also announced.

National insurance will be applied to salary sacrificed pension contributions above £2000 from 2029, raising £4.7 billion.

And income tax rates on dividends, property and savings will all increase by 2ppts from 2027, raising £2.1 billion.

A new high value council tax surcharge will be introduced from 2028, ranging from a £2,500 annual charge on properties worth over £2 million, to £7,500 on properties worth over £5 million. The government has announced a consultation on the details of the reliefs and exemptions, which the OBR notes could "materially affect the yield" of the changes.

Business taxes increase at the margin

Business taxation is not the principal focus on this budget, but some notable changes have been made.

The government has announced it will introduce a higher bracket of rates for properties over £500,000 and increase the rates multiplier by a further 10.2 per cent next year. Overall, business rates revenue will raise an additional £10 billion annually by 2030.

The application of employer National Insurance to employee salary sacrifice pension contributions above £2000 may also have the effect of changing workplace policies in the run up to its implementation.

Some support for UK equities

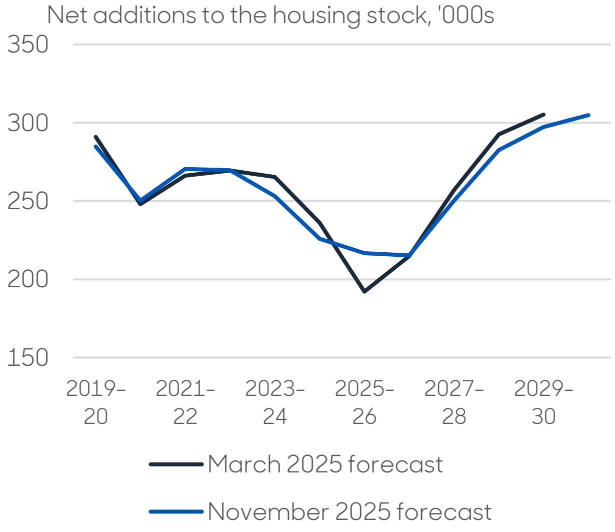
Reeves announced a three-year stamp duty holiday for shares of newly listed UK equities.

And there was an ISA reform package, the most notable component of which is lowering the ISA cash limit to £12,000, though the overall ISA limit will remain £20,000. Over 65s are exempt from the change. The government will also consult on a new ISA product to replace the Lifetime ISA for first time home buyers.

Reeves talks up growth, but with limited impact

The effect of the government's planning reforms can be seen in the final years of the OBR forecasts, though in the near term, net housing stock additions are expected to fall to 215,000 in 2026-27 (see Figure 6).

Figure 6: Planning reform appears to be underperforming previous expectations



Source: Aberdeen, OBR, November 2025

Its updated forecasts imply fewer houses built over the full forecast horizon than previously assumed. The OBR has judged that changes to the planning system in the Planning and Infrastructure Bill, and an additional £48 million announced at the budget to increase planning capacity, are unlikely to have any significant impact.

While business rates have increased elsewhere, Reeves has also announced reform to lower retail, hospitality and leisure (RHL) business rates multipliers, which will lower rates for some retail, hospitality and leisure properties.

And customs duty relief for low value imports will be removed, to increase competitiveness of domestic retailers.

But overall, the OBR has judged the budget to have done little to affect the growth outlook despite government rhetoric.

Budget measures push down on inflation in the near term

A key priority for the chancellor in this budget was to put downward pressure on inflation.

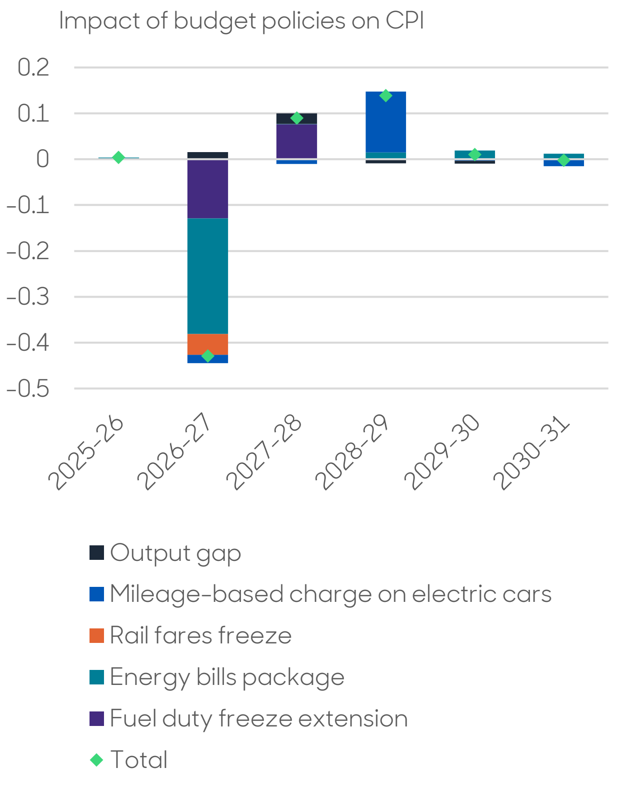
This follows criticism that the previous budget kept inflation elevated via large administered cost shocks, including the increase in employer national insurance contributions.

This higher inflation kept Bank Rate higher than it otherwise might have been, which then fed back negatively into the fiscal outlook via higher gilt yields.

By contrast, the OBR estimates that measures in the budget reduce headline inflation by a little over 0.4ppts in the fiscal year 2026/27.

This includes the impact of temporarily taking some of the cost of the renewables obligation into general taxation rather than on households. Other disinflationary measures include freezing certain rail fares and (once again) extending the fuel duty escalator (see Figure 7).

Figure 7: The budget pushes down on inflation forecasts, but only temporarily



Source: Aberdeen, OBR, November 2025

At the margin, these measures should make it easier for the Bank of England (BoE) to deliver further rate cuts next year, especially if weaker sentiment from the budget also weighs on demand growth. We continue to expect Bank Rate to fall to 3% next year.

However, the budget measures actually push up on inflation from 2026/2027 in the OBR's forecast. But, contra the OBR's formal assumptions, it stretches credibility that the fuel duty escalator will be allowed to operate from then. So that notional inflationary pressure is unlikely to ever materialise.

Moreover, the national living wage is set to increase by 4.1% next year, which could trigger second round price shocks. But given the recent deterioration in the labour market, the policy may be more likely to be felt in weaker labour market hiring rather than higher prices.

Market reaction sanguine, but there may be trouble ahead

Gilt yields were initially volatile following the leaked OBR documents, with the 30-year first rallying, then selling off sharply, before broadly returning to its original level.

A relatively sanguine market reaction was probably to be expected given that the broad contours of the budget were well understood in the run-up to the announcement (even if some of the forecasts were not quite as expected).

The market may take some comfort from the increased fiscal headroom. But the fact spending increases are front-loaded while tax increases are back-loaded (indeed are due to kick in around the time of the next election) may be a source of concern from now on.

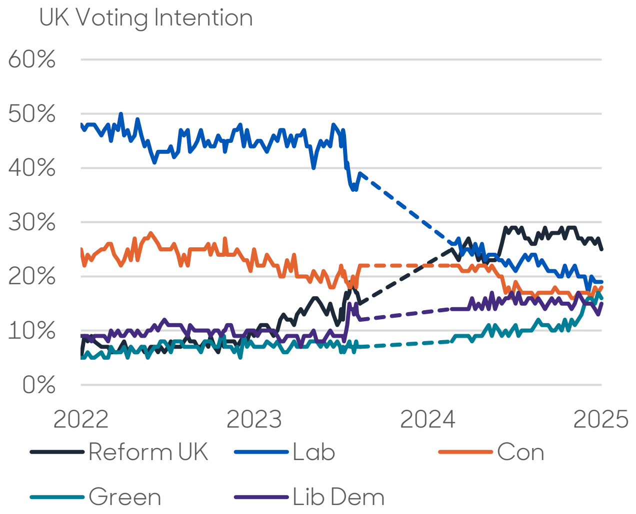
Indeed, we continue to think that the medium run spending forecasts look too conservative given political and material pressures on government spending, and the OBR productivity forecasts still look too strong. So, there is likely to be upward pressure on spending, and potentially borrowing, in the future, especially if the chancellor is replaced by the time of the next budget.

Storm clouds gathering for Starmer

Stepping back, Prime Minister Keir Starmer and Reeves went into the budget with historically low approval ratings. With this budget unlikely to revive their political fortunes, internal party discontent will rise.

Over 2026, we expect that the key moment of danger for the Labour leadership will be the May local elections, which include 4,411 council seats, Welsh Senedd and Scottish parliamentary elections. On current polling, prospects in these elections look extremely poor for Labour, and it appears increasingly likely Starmer will face a subsequent leadership challenge (see Figure 8).

Figure 8: Starmer-Reeves are unpopular, and Labour is trailing Reform in the polls



Source: Aberdeen, YouGov, November 2025

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Our expectation is that if a leadership challenge does occur, it is likely to be successful. Any subsequent leader is likely to be from the left of the party, with frontrunners including Angela Rayner and (should he secure a seat in parliament) Andy Burnham.

A new leader would see a change in fiscal strategy, though maintaining the confidence of markets will remain a consideration. More generous government spending, combined with increased taxes on corporations and high earners, could be in store.

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