



Institute for Fiscal Studies briefing

IFS Green Budget

October 2025

Edited by

Carl Emmerson
Kate Ogden
Ben Zaranko

In association with Barclays and funded by the Nuffield Foundation



IFS Green Budget 2025

In summary

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Welcome

Welcome to the IFS Green Budget 2025.



This year's edition will be the first produced under my tenure as Director of IFS, and the first with Barclays since 2011.

The fiscal outlook has worsened since the spring. Rising market expectations of long-term interest rates will push up forecast debt interest spending. Policy reversals by the government will mean higher spending on working-age and pensioner benefits. And the Office for Budget Responsibility is widely expected to downgrade its forecast for productivity growth, which would bring it closer to independent forecasters and the Bank of England. Given the Chancellor was already meeting her 'iron-clad' fiscal rules by only an extremely small margin in

March, continuing to meet them will require tax rises or spending cuts.

Pencilling in unspecified cuts for the final year of the forecast would stretch credulity. Making meaningful cuts to departmental spending would require reopening budgets only set in the June Spending Review. But the government's ability to deliver its desired public service improvements within those budgets already hinges on ambitious improvements in public sector productivity. A sensible path for defence spending to 2035, consistent with honouring the UK's latest commitments to NATO, could well see defence spending plans for 2028–29 topped up. And there are areas where spending is increasing fast – not least spending on children receiving support for special educational needs and disabilities (SEND) in schools and through the benefit system, which we forecast could increase by a further £5 billion by 2029.

On benefits too, the government is facing pressure to spend more, not less, with speculation it will abolish the two-child limit and the household benefit cap. The government's proposals to replace two existing contributory benefits with one new 'unemployment insurance' benefit could deliver fiscal savings by time-limiting the new benefit for those with health conditions – but announcing cuts and again failing to deliver them would further erode the Chancellor's credibility. Gilt markets will be watching closely.

The Chancellor is widely expected to raise taxes. But she has a choice not only over how much tax to raise, but over how to raise it. Simply raising rates of existing taxes might appear easier, but relying on badly designed taxes to bring in additional revenue will bring unnecessary economic damage. There is an opportunity here to be bold and take steps towards a system that does less to impede growth and works better for us all. Setting out a plan to replace declining revenues from fuel duties would reinforce that ambition – and her credibility.

Harder choices now – through larger tax rises or deeper spending cuts – would make it less likely that the government finds itself confronting the same difficult position again in the spring.

This year, we are delighted to collaborate with Barclays. We are grateful both for its financial support for the Green Budget and for its chapters on the outlook for the UK economy and on the gilt market. These contributions, drawing on Barclays's own research, provide superb insights and vital context for the rest of the Green Budget's analysis.

We are also very grateful to the Nuffield Foundation for the ongoing funding it has provided to support the Green Budget. Our principal aims for the Green Budget are to influence policy and to inform the public debate. It is particularly appropriate, then, that it should be supported by the Nuffield Foundation, for which these are also central aims.

The continuing support that the Economic and Social Research Council (ESRC) provides for our ongoing research work via the Centre for the Microeconomic Analysis of Public Policy at IFS (ES/Z504634/1) underpins all our analysis in this collection and is gratefully acknowledged.

Data from Understanding Society are available from the UK Data Service. Access to the Longitudinal Education Outcomes (LEO) data and data from the National Pupil Database (NPD) was provided by the Department for Education. This work contains statistical data from the Office for National Statistics (ONS), which are Crown Copyright. The use of the ONS statistical data in this work does not imply the endorsement of the ONS in relation to the interpretation or analysis of the statistical data. This work uses research datasets which may not exactly reproduce National Statistics aggregates. The work was carried out in the Secure Research Service, part of the Office for National Statistics. The data owners and suppliers bear no responsibility for the interpretation of the data in this report.

As with all IFS publications, the views expressed are those of the named chapter authors and not of the Institute – which has no corporate views – or of the funders of the research.



Helen Miller

Director, Institute for Fiscal Studies

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Foreword from the Nuffield Foundation

The Nuffield Foundation is an independent institution that funds and undertakes rigorous research, encourages innovation and supports the use of sound evidence to improve people's lives.

A key part of our purpose is to help build a society that is prosperous and fair, where people are secure and can fulfil their potential, supported by institutions that are effective and trustworthy. The IFS Green Budget advances these interests by providing forensic, independent and timely analysis of the UK's fiscal position and some of the central social and economic choices facing the government.

Over the years the Green Budget has become a highly respected – and much anticipated – point of reference for assessing the key fiscal decisions facing any British government. By supporting it, the Foundation helps ensure that fiscal policy is guided by the best available evidence and that public debate on key policy choices is rooted in rigorous analysis. It is a publication that matters, and our national conversation would be poorer without it.

This year's edition – not surprisingly – explores key options for raising additional revenue at the same time as improving the efficiency of our creaking tax system. But it also illuminates some of the other underlying social and economic challenges of our time: for instance, the challenges facing support systems for children with disabilities and special educational needs; how best to provide security and opportunity for the unemployed; and the urgent need for improved public sector productivity. All these topics strongly align with our mission.

The Green Budget continues to play a vital role in informing and scrutinising government decisions, equipping not just policymakers but also those in politics, media, business and civil society with new insights, and thereby promoting transparency and accountability.

As the nation's fiscal challenges become starker, and our governing institutions are put under pressure, this external scrutiny is perhaps more vital than ever. We are proud to continue to support it.



Gavin Kelly
Chief Executive
Nuffield Foundation

Foreword from Barclays

It is an honour to be partnering with the IFS on its iconic and influential Green Budget this year, for the first time in 14 years. The timing could not be better. The eyes of global markets, as well as households and businesses up and down the United Kingdom, will be on the Chancellor when she stands up to deliver her Budget on 26 November. As a global bank that has been a part of the UK economy for more than 300 years, Barclays is uniquely placed to bring our insights and analysis to complement IFS's world-renowned fiscal expertise.

Chancellor Reeves faces a challenging task with this Budget. She must find a way to meet her fiscal rules and maintain the confidence of financial markets without derailing a plan for growth that will raise productivity and deliver sustainable long-term increases in living standards for the UK. This is made no easier by a backdrop of high inflation and decelerating economic growth. In that context, it is hard to overstate the importance of this Budget in setting the UK on the right path and avoiding the potential pitfalls on either side.

In the two chapters we have contributed, our expert economists and researchers lay out what they see as a realistic path to a positive medium-term outlook being achieved and the risks along the way. They stress the importance of adhering to the current fiscal rules and not conducting any consolidation through levers that will add to inflation. They highlight the need for the UK's private sector, its consumers and businesses, to take the baton as the drivers of growth, spurred by productivity rather than solely population growth. In addition, they demonstrate that the UK's underlying fiscal fundamentals are in good shape, and can continue to be so if the Chancellor is able to make the difficult decisions required on 26 November. In a world of heightened global uncertainty and political and economic volatility, we recognise that these are not easy choices for the UK, but demonstrate that they can provide measurable benefits.

I would like to thank Jack Meaning, Moyeen Islam and Cian Hennigan for their work in putting these chapters together and leading Barclays' research on the UK economy. And I would like to thank IFS for the opportunity to collaborate with them at such a pivotal moment.



Brad Rogoff
Global Head of Research
Barclays

1 | Economic outlook: navigating narrow paths

Jack Meaning (Barclays)



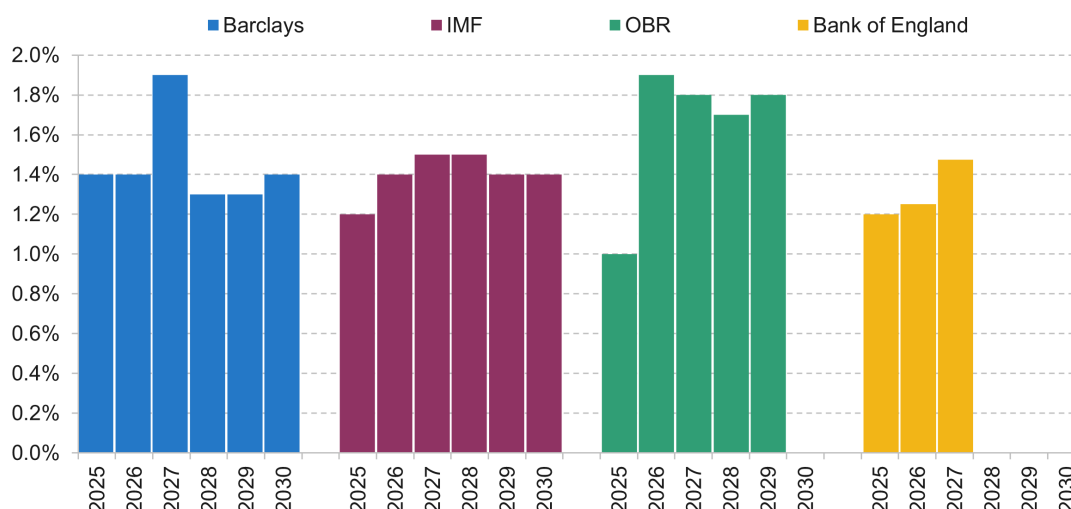
The UK economy stands at a pivotal juncture. Growth is decelerating and expected to slow further in the second half of the year, and unemployment has been on an upward trend since mid 2022. Meanwhile, inflation remains considerably above the Bank of England's 2% target, making the Monetary Policy Committee cautious about cutting rates for fear of de-anchoring expectations and embedding structurally higher inflation. A substantial fiscal consolidation will very likely be needed at this Autumn's Budget if the Chancellor is to continue to meet her fiscal rules.

We do expect economic activity to pick back up, providing a bounce in 2026 and early 2027, as the global trading order (re)finds its equilibrium, uncertainty diminishes and the impact of recent monetary policy easing feeds through. Inflation should fall back to target relatively quickly as recent price-level shocks dissipate against a backdrop of both a loosening labour market and broader economic slack. This should allow for the further monetary easing that is required to bring down unemployment and maintain inflation at 2% over the medium term.

The economy's medium-term prospects hinge on the successful transition from growth driven by the public sector and net trade to a more dynamic private sector, alongside improvements in productivity. Indeed, productivity growth and household saving behaviour will be decisive in shaping the trajectory of real incomes, investment and consumption over the latter half of this parliament. On these, our assessment is for improvement from the status quo of the last decade, but still short of the Office for Budget Responsibility's forecasts from March. The risks associated with global trade uncertainty, productivity and demographic shifts remain significant, but so too do the opportunities for resilience and renewal if the right policy choices are made.

The Chancellor must tread carefully, balancing the imperative for fiscal discipline with the risks of stifling recovery and undermining living standards. In particular, our analysis shows she would be well advised to avoid policy levers that add to near-term inflation in making the required consolidation at the dispatch box come November. It would not take much in terms of additional near-term inflationary pressure to derail a Bank of England easing cycle, even if the inflationary impulse were one that in other circumstances might be considered temporary. There are risks on both sides, and the policy path ahead is narrow – but it is ultimately navigable.

Annual real GDP growth (% year on year)



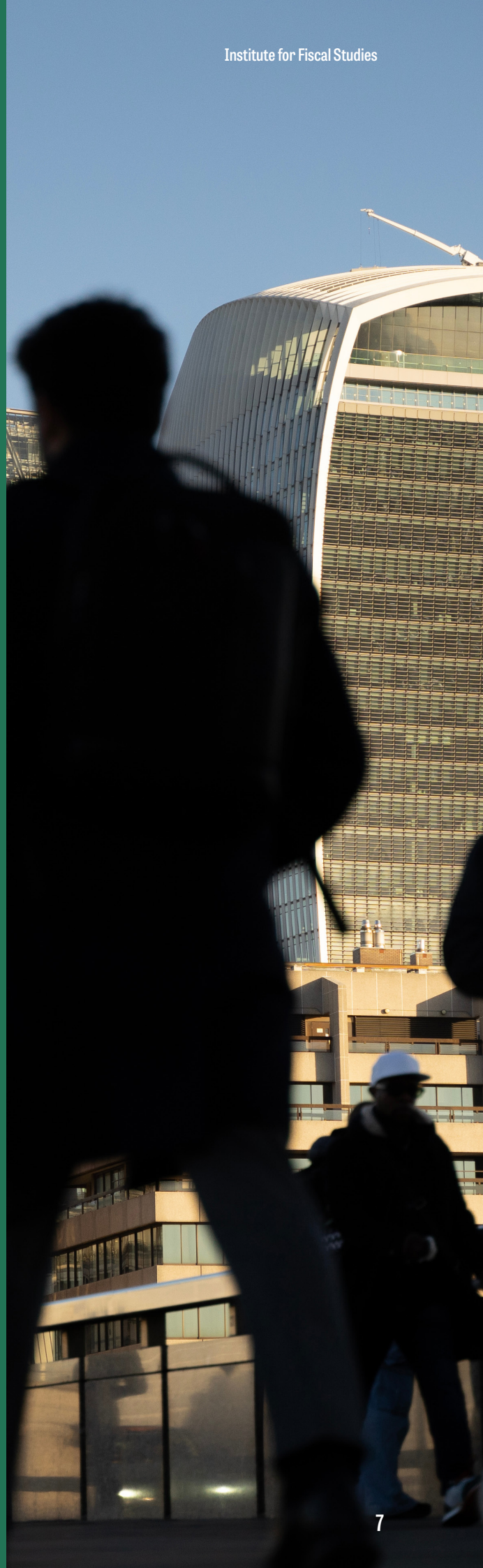
Note: Forecasts are only available from the Office for Budget Responsibility up to 2029–30 and from the Bank of England up to 2027–28.

Source: Office for Budget Responsibility, Economic and Fiscal Outlook, March 2025; Bank of England, Monetary Policy Report, August 2025; International Monetary Fund, World Economic Outlook update, July 2025; Barclays Research.

Key findings

- 1 The economic backdrop to this Budget is a difficult one.** Following a positive start to the year, growth is decelerating, and the growth we have seen has been driven disproportionately by the public sector and net trade, as opposed to private domestic demand. The unemployment rate has risen 0.5 percentage points in the past 12 months and is now the highest it has been since 2016, outside of the COVID-19 pandemic. While the official Labour Force Survey suggests that employment growth has been strong, we think a broader set of indicators points to a much weaker assessment. Meanwhile, inflation remains well above the Bank of England's 2% target, and higher than that of international peers. This is making the Monetary Policy Committee cautious about further cuts to interest rates, which remain in restrictive territory. Against this backdrop, the Chancellor is likely to need to find a sizeable fiscal consolidation at the Budget to meet her fiscal rules.
- 2 The outlook in the very near term is one of economic softening.** We forecast growth will decelerate further in the second half of this year, with the economy growing at half the rate it did in the first half. Consumption and business investment will likely be muted, as uncertainty remains elevated, monetary policy has remained in restrictive territory and households continue to build savings. Surveys suggest businesses remain cautious, and dissuaded from investing by squeezed margins and high financing costs.
- 3 We expect the Bank of England to continue reducing interest rates to the point where they are no longer acting as a headwind to the economy.** Our forecast assumes Bank Rate reaches 3.5% in the first half of 2026. Inflation is likely to have peaked already in September 2025, spurred by a combination of energy price base effects, food price inflation, and changes in taxes and prices set by government. Headline CPI inflation should drop back to target in the first half of next year as the effect of the tax changes announced in last October's Budget drops out of the calculation. As monetary policy easing starts to feed through more meaningfully, we should see a cyclical rebound in activity in 2026 and 2027 as the economy starts to absorb existing slack. In

continued overleaf



our baseline scenario, the unemployment rate is forecast to peak at 5.1% in 2026 before gradually falling.

- 4 The medium-term outlook for the UK economy will be defined by three trends: the extent to which increasing productivity growth can offset slowing inward migration and population growth; the ability of the domestic private sector to take the baton from the public sector and net trade as the key driver of growth; and the success or otherwise of policymakers to navigate the narrow path in the transition.
- 5 In our forecast, annual growth in total factor productivity increases gradually and reaches 0.4% by 2030. This would be high by the standards of recent history, but falls short of the 1% growth assumed by the Office for Budget Responsibility (OBR) in its March forecast. **We expect the OBR to make a downward revision to its own productivity growth assumption of between 0.1 and 0.2 percentage points per year, and this is perhaps the single biggest forecast judgement the OBR will make.** Such a downgrade would still leave the OBR more optimistic than our own baseline forecast. We also explore a scenario in which our forecast is surprised to the upside by a larger and faster improvement in productivity, more aligned with the OBR's from March, and find it suggests the level of real output would be 2% higher by 2030.
- 6 **Beyond the near-term fiscal implications, productivity growth will likely be the single biggest determinant of living standards over the longer run.** In our baseline forecast, increasing productivity enables real wage growth over the medium term. Despite falling average hours, total hours worked increase and real incomes grow at an average of 1.1% annually. Alongside a gradual reduction in the savings rate from 10.8% in June to 9.3% in 2030, we expect this to lead to household consumption growth of 1.4% per year in the medium term. **The path of household savings**

is another key judgement, and our modelling suggests savings will stay higher for longer than was assumed in the OBR's March forecast.

If the OBR had instead assumed the savings rate followed the path suggested by our modelling, it would have forecast real consumption to be more than 2% lower by 2030.

- 7 **Rising productivity and lower interest rates will enable businesses to invest over the medium term, raising the level of investment as firms rebalance their capital-to-labour ratios in favour of capital.** Acting in the other direction, we expect fiscal policy to be a headwind to demand throughout the forecast, as we move from a cyclically adjusted primary deficit of 1.5% in 2025 to a surplus by 2030. This continued fiscal consolidation means that the negative output gap does not fully close by the end of our forecast horizon.
- 8 **We expect the Chancellor to be able to make the required consolidation at the upcoming Budget with relatively limited damage to real GDP growth (–0.25% at peak) and mild disinflation.** However, this is predicated on her doing so without applying measures that, mechanically or otherwise, add substantially to near-term inflation. We model a scenario in which the Chancellor delivers a fiscal consolidation through an increase in VAT, raising inflation at a point when inflation is already high enough – and central bank credibility under enough scrutiny – that monetary policymakers are not comfortable looking through the temporary price-level shock for fear of second-round inflationary effects. In this scenario, we find that the negative effect on GDP would be twice as big at its peak as if the same consolidation was done through non-inflationary taxation, and interest rates would remain higher for longer, requiring a more aggressive easing cycle in 2027.

2 | The Budget and bond markets: ‘when you’re in a hole, stop digging’

Moyeen Islam (Barclays)

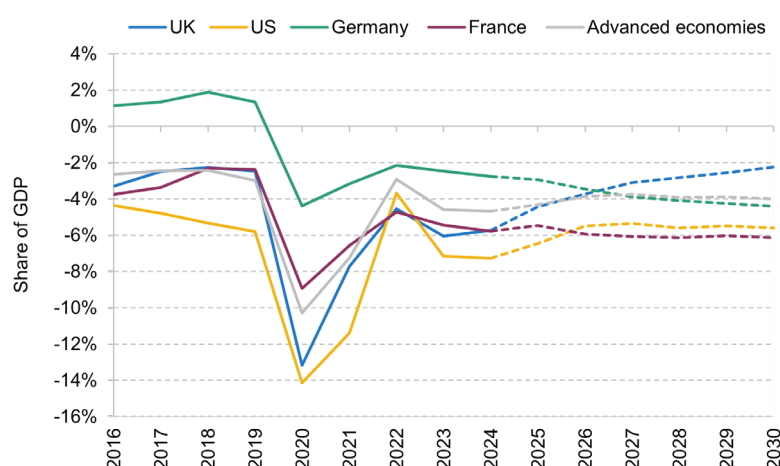


Governments globally are discovering that bond vigilantism is alive and well. The age of tolerance of high deficit financing without credible fiscal consolidation plans is behind us. The UK had a taste of this in Autumn 2022 that led to the liability-driven investment (LDI) crisis, but across developed markets, governments are experiencing a rapid rise in borrowing costs as the combination of monetary policy tightening, higher inflation and elevated borrowing needs drives yield curves steeper. This has raised wider questions relating to the sustainability of sovereign debt levels, the appropriate balance between taxation and spending, intergenerational equity in the face of an ageing population and myriad other complex policy issues.

It is against this backdrop that the Chancellor will present her Budget, including updated plans for gilt supply for 2025–26 and beyond. Perhaps the most important immediate outcome of this will be the market reaction to the near-term fiscal forecasts and the outlook for government borrowing. The government now finds itself in the unenviable position where the reaction of the bond market is increasingly becoming the constraint on fiscal policy.

The UK is not a fiscal outlier internationally. Nor is it the only country to have seen rising yields on government bonds. But the gilt market does face unique challenges. The supply of gilts that the private sector is being asked to absorb is high, and this is expected to persist. The demand side of the market is also changing. For over two decades, regulatory and demographic factors had created strong demand for long-dated government assets, but pension funds are now buying less and domestic financial institutions are demanding short-term gilts. At the same time, the Bank of England has shifted from buying to selling gilts. The government must adapt to this new world.

General government fiscal balance as a percentage of GDP in the UK and comparator countries



Note: Figure for advanced economies is a weighted average for 41 advanced economies. Negative values denote a budget deficit.
Source: IMF World Economic Outlook April 2025 and Haver Analytics.

At the upcoming Budget, the credibility and deliverability of any fiscal consolidation is key. This is how the bond market will judge it – not just in terms of the size of consolidation, but its composition, with particular importance attached to spending reform and the signal that this would send about the government’s willingness to tackle politically difficult issues. Credibility-enhancing policy measures are crucial to ensuring that discretionary macro investors feel confident enough to be comfortable in owning gilt risk.

Key findings

- 1 **The UK is not a fiscal outlier among advanced economies when measured by traditional debt and deficit metrics.** Projections from the International Monetary Fund show that the stock of UK government debt as a share of GDP and the UK's fiscal balance are relatively favourable compared to peers, with projections indicating that the UK will undertake a larger fiscal consolidation (2.2% of GDP) between 2025 and 2030 than the average across advanced economies (0.3%). The UK is also expected to see a smaller rise in gross government debt (2.2% of GDP) than most advanced economies (3.2% on average).
- 2 **Gilt yields have risen sharply, with 30-year yields rising from 4.5% a year ago to reach 5.7% recently, their highest levels since 1998.** Yields on 10-year gilts rose sharply from 1.0% to 3.7% over 2022, and are now close to 4.7%. This increase in the cost of borrowing is an important contributor to the difficult outlook for the public finances.
- 3 **An increase in yields on government bonds has been seen across advanced economies,** partly as a result of a higher expected path for central bank policy rates. That yields on longer-maturity gilts are higher than in other countries partly reflects a consensus that the neutral policy rate is higher in the UK than in the US or Euro Area. An even more significant factor in the global increase has been rising term premium, reflecting global trends such as the normalisation of interest rates, higher inflation and rising sovereign bond supply.
- 4 **The gilt market faces unique challenges.** There has been a step change in the supply of gilts that the private sector is being asked to absorb, with net supply now averaging 4% of GDP. As a result of the Bank of England's balance sheet reduction, private sector holdings are set to rise even more quickly, by 6% of GDP on average over the next four fiscal years, compared with an average of 2.5% in the two decades up to 2019. This structural increase in supply is forecast to persist, placing ongoing pressure on yields and challenging the market's absorption capacity.

5 The government no longer enjoys ‘borrower’s privilege’ and instead faces the challenge of recalibrating supply to match a more elastic and less predictable demand base.

For over two decades, regulatory and demographic factors had created strong demand for long-dated government assets and compressed the 30-year term premium, reducing yields. But in the post-quantitative-easing and post-defined-benefit-pension world, demand for long-dated gilts has waned. While domestic financial institutions, especially banks, are buying more, this is primarily sub-15-year gilts. This shift in demand has led the UK Debt Management Office (DMO) to rotate issuance toward shorter maturities. We forecast that the weighted average maturity of primary gilt supply – which was more than 20 years in 2016–17 – will dip below 10 years in 2025–26. This reduction is a trend that is likely to continue given the elevated levels of long yields and the DMO’s focus on value for money in terms of the cost of supply.

6 The identity of the marginal buyer is less important than the need for credible fiscal and monetary policy to reassure a more discretionary investor base.

The credibility of the government’s fiscal consolidation plan is paramount to delivering bond market stability. Changing the fiscal rules or tinkering with the existing fiscal architecture would likely be seen as self-serving and could generate an adverse market reaction. In the extreme, such changes run the risk of catalysing a gilt crisis.

7 The bond market will judge the upcoming Budget by whether its consolidation measures are credible and deliverable, not just by the headline savings but in their composition.

This is a political choice, but the market perspective is that both revenue-raising and spending-reduction measures will have to play their role. In particular, market participants have come around to viewing spending reform as a critical signal of intent. A credible attempt to reduce spending would demonstrate that the government has the political will and ability to deliver on its fiscal

objectives. The signal this would send could be equally, if not more, important than the amounts any reforms actually saved. Welfare spending reform, in particular, has become a bellwether for the government’s willingness to tackle politically difficult issues. Without reductions in spending, to deliver the sums required solely via tax increases could require breaking manifesto promises – not something done lightly. Should the Chancellor raise the basic rate of income tax, it would be the first rise in over 50 years and would demonstrate a willingness to spend significant political capital in order to support fiscal stability. Again, the signal is crucial.

8 This Budget will be a key moment to announce measures needed to maintain and bolster market confidence.

The crucial task for the UK government is maintaining both monetary and fiscal credibility, such that discretionary macro investors feel confident enough to be comfortable in owning gilt risk. The government’s focus on stabilising the bond market – sometimes at the expense of its broader policy goals – reflects the increasing constraint that market sentiment places on fiscal policy. That need for credibility-enhancing policy choices is the price that the government must be seen to be paying in order to provide reassurance to a wary market that has been quick to move sharply on any perception of rolling back on fiscal policy choices. With that in mind, this Budget needs to be seen as part of a sequence of steps towards the goal of enhancing market credibility.

3 | Risks and challenges for the public finances

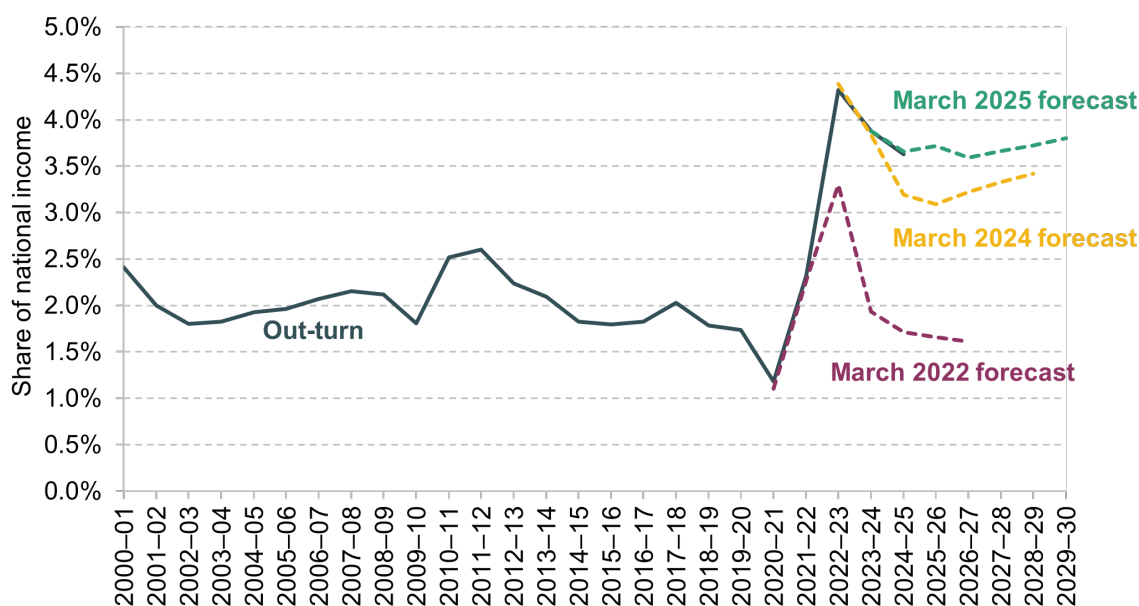
Carl Emmerson, Nick Ridpath and Isabel Stockton (IFS)

The Chancellor faces significant challenges in the run-up to the Autumn Budget. The stock of government debt has grown dramatically since the turn of the century, and it is not set to fall substantively over the next five years under the government's plans. Combined with higher government borrowing costs, this means the UK is spending more than twice what it did pre-pandemic on debt interest. At the Budget, the Office for Budget Responsibility (OBR) is widely expected to downgrade its productivity forecast, increasing the forecast level of borrowing, and in turn the level of fiscal tightening needed for the Chancellor to continue meeting her fiscal rules.

Using the Barclays central economic scenario, in combination with the cost of announced policy reforms and changes to market expectations of government borrowing costs since March, we forecast that borrowing in 2029–30 could be £22 billion higher than forecast in March. This scenario would leave the Chancellor needing a fiscal tightening of at least £12 billion to meet her fiscal rule to run a current budget surplus by 2029–30, and of £22 billion to restore the current budget surplus she chose at the Spring Forecast. Under this scenario, the Chancellor would need £17 billion of fiscal tightening (i.e. £5 billion more than the £12 billion needed to meet the borrowing rule) to meet the debt rule, which is to have public sector net financial liabilities (PSNFL) falling as a share of GDP in 2029–30.

If the Chancellor were to leave £10 billion of headroom against her fiscal rules at the Budget, as she did at the last two fiscal events, we estimate that there is a one-in-three chance that she would not meet her fiscal rules in the Spring without needing to make further policy adjustments. Leaving such a narrow margin increases the possibility of further policy changes and generates significant uncertainty. There are multiple ways the Chancellor could avoid this damaging policy volatility, the most straightforward of which would be to build a larger amount of headroom, although this would require larger tax rises or spending cuts at the Budget. The Chancellor could choose other routes to avoid volatility. The blunt instrument of asking the OBR to produce only one forecast a year would sacrifice transparency and end half a century of (what the International Monetary Fund describes as) best practice.

Debt interest spending as a percentage of national income compared with past forecasts



Source: Office for Budget Responsibility, Public Finances Databank, July 2025, and Economic and Fiscal Outlooks, March 2022, March 2024 and March 2025.

Key findings

- 1 The stock of government debt has grown consistently over the last 25 years, and is not forecast to fall substantively over the next five. Debt has risen in other countries too, but the increase in the UK has been bigger than most. **Since the start of the century, the UK has gone from having the 21st-largest debt among advanced economies – below the average – to having the 5th-largest.**
- 2 Much elevated debt, combined with higher government borrowing costs, has pushed up debt interest spending. **It is forecast to be £111 billion this year, which is £64 billion – roughly equivalent to the entire core schools budget – higher than forecast just three years ago, and it is not expected to fall over the medium term.** High debt interest spending leaves a smaller share of the pie for other, more attractive types of spending. This is one of the key reasons the government's fiscal bind feels so unforgiving.
- 3 A crucial determinant of the fiscal tightening needed at the Budget in November will be the Office for Budget Responsibility's productivity forecast. Productivity growth has fallen short of the OBR's forecast since the COVID-19 pandemic, and its growth expectations in March 2025 were above those of all independent forecasters surveyed by the Treasury. **A forecast downgrade bringing the OBR more closely in line with independent forecasters and the Bank of England is widely expected. As a rule of thumb, we might expect a 0.1 percentage point downgrade to the annual productivity growth rate to increase public sector net borrowing by £7 billion in 2029–30.**
- 4 **Under the Barclays central economic scenario, we forecast that borrowing in 2029–30 could be £22 billion (0.7% of national income) higher than forecast in March.** In this scenario, the additional borrowing would be caused by higher interest rates (£5 billion), additional social security spending stemming from recent policy reversals (£6 billion) and other changes to the forecast, most notably a weaker growth outlook (£8 billion). Notably, though, Barclays is still relatively optimistic on growth and the cost of borrowing relative to other forecasters, and a larger fiscal downgrade is entirely possible.

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- 5 **The central Barclays scenario would leave the Chancellor needing a fiscal tightening of at least £12 billion to meet her fiscal rule to run a current budget surplus by 2029–30.** This would leave no headroom at all. A tightening of £22 billion would be required to restore the £10 billion forecast current budget surplus she chose at the Spring Forecast.
- 6 Under the same scenario, without a fiscal tightening, the government would also be missing its second fiscal rule – to have debt, as measured by public sector net financial liabilities (PSNFL), falling as a share of national income in 2029–30 – by £17 billion, i.e. by more than the forecast current budget deficit in that year. This is driven by lower forecast growth reducing the rate at which the existing stock of debt falls as a share of national income. **To continue meeting her debt rule under this scenario without building in any amount of headroom, the Chancellor would therefore need to enact a fiscal tightening of at least £17 billion,** some of which could come from cuts to (or a reprofiling of) investment spending.
- 7 If the Chancellor left herself the same £10 billion margin against her fiscal rules in the Budget, then, taking the history of forecast-to-forecast revisions since 2010 as a guide, **we expect the Chancellor to have only a two-in-three chance of meeting her borrowing rule in the spring without new tax rises or spending cuts.** A narrow margin against the debt rule, which may well become the binding rule at the Budget but is more sensitive to the precise profile of economic growth, would have no better chances of making it to the spring. Over three years, with £10 billion of headroom, Ms Reeves would have just a one-in-five chance of meeting her fiscal rules at each forecast without the need for policy adjustments.
- 8 Leaving minimal headroom against pass-fail rules undermines the Chancellor's stated objective of securing policy stability, **creating damaging uncertainty and impeding good policymaking. There are multiple ways the Chancellor could try to reduce such policy volatility.** Implementing a larger fiscal consolidation than strictly necessary, in order to build in a larger amount of headroom, is the most straightforward one. It has much to commend it: it would likely be well received by bond markets and would help to secure policy stability beyond just the spring – but would have the unavoidable downside of requiring larger tax rises or spending cuts than otherwise.
- 9 **Another option would be to ask the OBR to produce only one forecast a year,** thereby avoiding the possibility of missing the rules in the spring. This would have the benefit of simplicity, but would be **the fiscal equivalent of throwing the baby out with the bathwater** – sacrificing transparency and potentially exacerbating the damaging effect of speculation in the (then longer) run-up to a new forecast. Nor would it prevent the Chancellor from finding herself in exactly the same position in a year's time. Other options – such as specifying ahead of time which tax or spending levers the Chancellor would pull in the event a tightening becomes necessary, or expanding the use of ranges on the fiscal rules – could also be promising avenues. But the key question is whether they could be implemented in a credible way.
- 10 **Reducing planned spending is one option for reducing borrowing – whether required to meet the fiscal rules or desired to build in more headroom – though a difficult one.** Future spending on support for those with health conditions and disabilities is highly uncertain, cuts to planned social security spending lacked sufficient support in parliament, and simply pencilling in lower departmental spending in 2029–30 lacks credibility. There are also clear pressures to spend more – for example, on social security through the removal of the two-child limit and the household benefit cap or on defence.
- 11 **If the government chooses to raise more in taxes instead, there is a very strong case for combining revenue-raising measures with well-designed tax reform** that reduces some of the many unwelcome and unnecessary distortions caused by the present tax system. If they are not, then fiscal stability will come at a greater economic cost than it needs to – something we can ill afford.

4 | Options for tax increases

Stuart Adam, Isaac Delestre and Helen Miller (IFS)

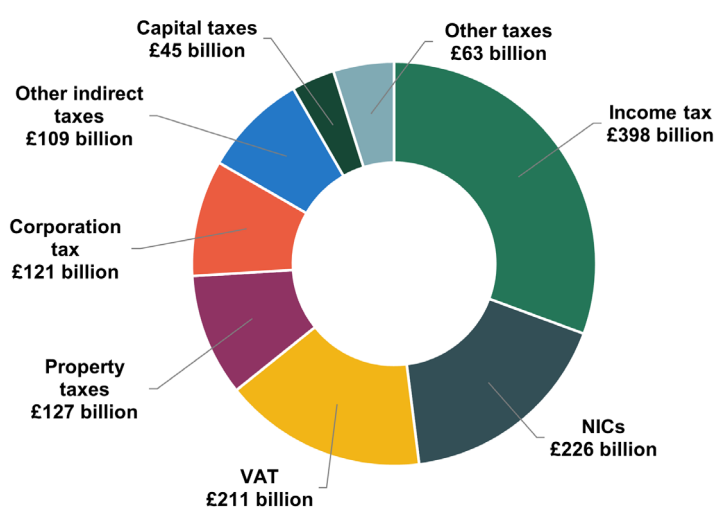
The Chancellor, Rachel Reeves, is likely to raise taxes in the upcoming Budget. While tax increases are not inevitable, this chapter sets out the options the Chancellor has if she does wish to raise large sums, as well as the other important issues to consider when changing tax policy, not least the effects of tax on outcomes other than revenue.

The most straightforward way to raise large sums of revenue would be to increase the main rates of income tax, National Insurance contributions (NICs) or value added tax (VAT), the three largest taxes which together account for two-thirds of total tax revenue. Ms Reeves's ability to raise these taxes will be seriously hampered by Labour's (self-imposed) political constraints. What is perhaps less well known is that Ms Reeves also faces significant constraints if she wants to raise money from any of the next four largest taxes – corporation tax, council tax, business rates and fuel duties. She has made pledges that rule out raising the main corporation tax rate and has signalled an intent to make revenue-neutral reforms to business rates. Council tax and fuel duties are already assumed to rise significantly across the parliament,

meaning that even greater increases would be needed to improve the public finances. This is not to say that the Chancellor cannot raise significant sums without raising the 'big three' taxes. But if she wants to raise large sums – and wants to do so without having to raise many smaller taxes – she will likely need to turn to a tax on a large base and therefore break, at least in spirit, her previous pledges.

If Ms Reeves limits her ambition to collecting more revenue – from increasing existing taxes or designing new ones – she will have fallen short. The UK tax system is in dire need of reform and there are clear steps that could be taken in November that would leave the UK tax system both looking fairer (in the sense of not treating similar people or activities very differently) and impinging less upon the economic growth the government seeks. Fixing the current taxes that are levied on stocks of and flows from capital would mean that the government could – if desired – raise more revenue from those at the top. This would be preferable to introducing an annual wealth tax, which we caution against. If the Chancellor chooses to raise more from taxes on property, they should be better-designed taxes on property than we have now. Increases in stamp duties and the insurance premium tax, both taxes to which cash-strapped Chancellors have turned in recent decades, would be particularly harmful and should be resisted.

Forecast composition of UK tax revenue (2029–30)



Note: See note to Figure 4.1, Chapter 4, IFS Green Budget 2025.
Source: Table A.5 of Office for Budget Responsibility, Economic and Fiscal Outlook, March, 2025.



Key findings

- 1 **Tax revenue as a share of national income is set to reach a UK record high of 37.4% in 2026–27.** This is still lower than in many other Western European countries. It would be feasible for the Chancellor to raise more tax revenue if desired.
- 2 **Raising the rates of income tax, National Insurance contributions (NICs) or VAT – the three largest taxes – could straightforwardly raise large sums,** but break Labour's manifesto promise not to 'increase National Insurance, the basic, higher, or additional rates of Income Tax, or VAT'. Extending the ongoing freeze in personal tax thresholds would also raise a significant amount but (if it included a freeze to NICs thresholds) would also break the manifesto pledge and would leave real-terms tax thresholds – and the size of the tax rise – to be determined by the vagaries of future inflation.
- 3 **A new tax on income, hypothecated to a particular spending stream,** may be a more politically attractive way to increase tax on a large tax base, but would **add unnecessary complexity to the tax system.** Hypothecation would either be unjustifiably restrictive (such that spending on a particular item was tied to a specific revenue stream) or economically meaningless (in the sense that the amount raised from the tax bore no direct relation to the amount spent on an area).
- 4 **Restricting income tax relief on pension contributions would raise large sums but should be avoided.** It would be unfair and distortionary to restrict up-front relief but continue to tax pension income at the taxpayer's marginal rate. It would also be practically very difficult to attribute employer contributions to defined benefit arrangements to specific individuals so that they could be taxed. There are better options for increasing tax on pensions, including levying some NICs on employer pension contributions and/or reforming the 25% tax-free element of pension income.
- 5 Labour's pledge not to raise the biggest three taxes, if adhered to, seriously constrains options. **Raising significantly more revenue from the next four largest taxes – corporation tax, council tax, business rates and fuel duties – would also bring challenges.**
- 6 **The government has ruled out increasing the main or small profits rates of corporation tax or reducing the main corporation tax reliefs.** It has previously stated

- its intention to shift some business rates from small retail properties to large properties, in the context of the Labour party manifesto's intention to 'raise the same revenue but in a fairer way'. Making tweaks to the current system rather than moving to a land value tax for commercial property is a missed opportunity.
- 7 Council tax rates are already assumed to rise by 4.3% per year for the rest of the parliament; larger increases would be needed to bring in additional revenue. An alternative to raising all rates further would be to **increase rates on homes in higher value bands. This would make council tax less regressive.** But because council tax bands in England and Scotland are still based on 1991 valuations, the increases would not accurately target the properties that are most valuable today. A sensible goal would be to move to a tax that is proportional to up-to-date property valuations.
 - 8 Current forecasts assume that rates of fuel duties (which are lower in cash terms than they were in 2009) will in future keep pace with RPI inflation and that the current 'temporary' 5p per litre cut will come to an end – a combined cash increase of more than 20% by 2029–30 on current forecasts. **Anything less than that would lose the government revenue** relative to current forecasts.
 - 9 Higher tax rates on income from capital – including rental income, dividends, interest and self-employment profits – could raise money. So too could removing capital gains forgiveness at death. **But simply raising rates would discourage saving and investment.** The case for genuine reform is clear: improving the design of the tax base (entailing some giveaways) and then more closely aligning overall tax rates across different forms of income and gains would produce a fairer and more growth-friendly system.
 - 10 We caution against introducing **an annual wealth tax, which would face huge practical challenges.** It would also penalise saving and, the more it was concentrated on the very wealthy, the more it would incentivise them to leave (or not come to) the UK. It would not be a well-targeted way to tax the large returns that wealth can generate and, as such, would be no substitute for well-functioning taxes on capital income and gains. **If the Chancellor wants to raise more from the better-off,** a better approach would be to fix existing wealth-related taxes.
 - 11 The Chancellor should not increase **stamp duties** (because they **lead to asset misallocation and lower labour mobility, dragging on growth in the process**) or **insurance premium tax (which creates damaging distortions to production decisions** that weigh on productivity).
 - 12 The overall tax gap (between taxes owed and revenues collected) has fallen, but **the tax gap for small companies has ballooned; reducing it should be a priority.** The approach should include compliance activities and improving policy design.
 - 13 **It would be difficult, but not impossible, for the Chancellor to raise tens of billions of pounds more revenue without breaking Labour's manifesto promise** not to increase National Insurance, the basic, higher or additional rates of income tax, or VAT. Just because large sums could be raised elsewhere does not mean it would be sensible. Many of the tax-raising options outside the 'big three' would have particularly damaging effects on growth and welfare.
 - 14 However much revenue she seeks to raise overall, **the Chancellor could create a fairer, simpler, more growth-friendly tax system.** That means grasping the nettle and pursuing genuine tax reform (property and capital taxes would both be good places to start). At a minimum, the Chancellor should avoid measures that worsen the design of the tax system.

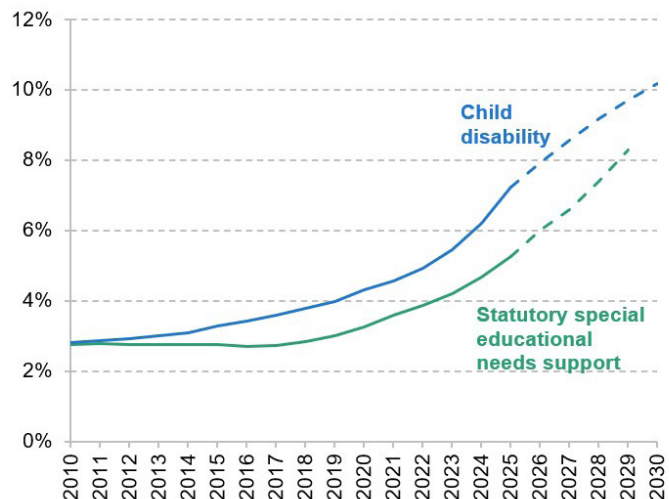
5 | Support for children with disabilities and special educational needs

Eduin Latimer, Luke Sibieta and Darcey Snape (IFS)

The question of how best to support children and young people with special educational needs and disabilities (SEND) in schools in England is rising up the government's agenda. The share of pupils under 16 with statutory support for SEND doubled from 2.7% in 2016 to 5.2% in 2025. This has pushed up related spending from £7½ billion in 2016 to over £12 billion in 2025. In response, the government has made clear its ambitions to reform the system of support for young people with SEND in England. It plans to publish a White Paper in Autumn 2025.

The share of children receiving disability benefits has also doubled over the same period – from 3.4% in 2016 to 7.2% in 2025 – but this has received much less attention. The growth in uptake of the two types of support are closely related. The two systems support children with similar types of need and it is common for the same child to receive support from both systems.

Share of pupils under 16 with statutory special educational needs support and share of children under 16 receiving child disability benefits, out-turns and forecasts



Note: See note and source to Figure 5.1, Chapter 5, IFS Green Budget 2025.

We forecast that if current systems of support remain unchanged then numbers and spending across both systems will continue to rise up to 2029 with potentially 8% of pupils receiving statutory educational support and 10% of children claiming disability benefits. This would come at a combined forecast cost of over £21 billion across the education and child disability benefit systems, up from £16 billion in 2024.

Later-life outcomes for children who receive support for special educational needs and disabilities tend to be poorer than for their peers. At age 22, those who had received both forms of support at age 15 were three times more likely to be not in education, employment or training than their peers (50% relative to 16%). There is little evidence on the impact that childhood support has on these longer-term outcomes. It is important for children's long-term well-being that the government provides support that gives them the best chance possible of thriving in adulthood. This may also have benefits for the public finances as the long-run fiscal costs of someone being out of work and on health-related benefits for much of their adult life will outweigh the costs of providing high-quality support to them in childhood.

In this chapter, we document the rise in numbers and spending on support for children with special educational needs and disabilities across the education and benefits systems. We break down the demographic differences between those who receive support and their peers and look at how a range of later-life outcomes compare. Finally, we consider some options for reform and provide some recommendations to government.

Key findings

1 Recent years have seen a dramatic increase in the number of children receiving support in schools for special educational needs and through the benefit system for disabilities.

The share of pupils under 16 in England with Education and Health Care Plans (EHCPs) – the highest level of support for children with special educational needs – almost doubled from 2.7% in 2016 to 5.2% in 2025. Over the same period, the share of children receiving child disability living allowance (CDLA) – a cash benefit for children with disabilities – has more than doubled from 3.4% to 7.2%. Forecasts suggest that, absent reform, uptake of both forms of support will continue to grow.

2 Spending on educational support for children with high needs has also increased dramatically, putting pressure on local and central government finances.

High-needs spending by councils, which predominantly covers additional support for those with EHCPs, has increased by 66% from £7½ billion in 2016 to at least £12 billion in 2025, after adjusting for inflation. We forecast that spending on high needs will rise by a further £3 billion by 2029 without any reforms, taking it above total day-to-day spending by the Ministry of Justice.

3 Councils have little control over this spending as it is determined by the statutory provision set out in EHCPs. Since the cost of provision has exceeded funding provided by central government, local authorities have faced large annual shortfalls.

The resulting debts are forecast to reach £8 billion by 2028. This is not financially sustainable. Local authorities are not normally allowed to borrow for day-to-day spending and a 'statutory override' of these rules for school spending is set to expire in 2028. If left unchecked – and without top-ups to school spending plans – these spending pressures will likely imply real-terms cuts to mainstream school spending per pupil. **Given the scale and growth of spending, and the risks that they pose, the Office for Budget Responsibility**

should produce and publish annual forecasts for high-needs spending and high-needs deficits.

4 Spending on CDLA doubled from £2 billion per year in 2016 to over £4 billion in 2025.

The government spends another £4 billion on means-tested benefit payments – carer's allowance, universal credit disabled child element and universal credit carer's element – to the families of children with qualifying disabilities. Official forecasts suggest that spending on CDLA in England will grow by a further £1.8 billion (41%) in real terms over the next five years without reform and we might expect similar growth in related means-tested benefit payments. Together with rising spending on EHCPs, this will put increasing strain on the government's finances.

5 There is substantial overlap between children receiving special educational support and children receiving support for a disability through the benefit system.

Of the 141,000 12- to 15-year-olds who received CDLA in England at the start of 2020, 84% had an identified special educational need and 52% had an EHCP. Of the 95,000 12- to 15-year-olds in England with an EHCP, 77% received CDLA. This overlap suggests common factors are driving the large rise in identified need seen for both.

6 Growth in the number of children receiving support relating to autism and to ADHD (attention deficit hyperactivity disorder) can explain much of the rise in both EHCPs and CDLA claims.

The number of children with EHCPs for autism spectrum disorder has almost tripled from 54,000 in 2015 to 149,000 in 2025, accounting for 40% of the total increase in EHCPs. The number of children with EHCPs for 'social, emotional and mental health needs', which includes ADHD, has also more than doubled, from 28,000 to 71,000. Similarly, most of the increase in CDLA claims

is due to increased claims in three categories of conditions: learning difficulties (including autism), behavioural disorders and ADHD. A large part of this increase in recognised need is due to increased awareness of these conditions, although there may also be increases in underlying prevalence of the conditions. Past squeezes on school budgets may also have acted as an incentive for parents and schools to seek EHCPs in order to access extra resources.

7 Those who received support for their special educational needs and disabilities as children are likely to be out of work and to receive additional state support when they reach early adulthood. At age 22, those who had received both CDLA and an EHCP at age 15 were three times more likely to be not in education, employment or training than their peers (50% relative to 16%), four times more likely to be on out-of-work benefits (60% relative to 16%) and 23 times more likely to be on adult disability benefits (76% relative to 3%). In part, this will be due to many disabilities enduring into adulthood. But it is also possible that greater numbers of children with identified needs through EHCPs or CDLA will directly lead to greater numbers of young adults out of work and/or on health-related benefits. The evidence base here is worryingly thin, but this is a big risk: it would make it harder for the government to hit its 80% employment rate target and add to the government's spending pressures. The government should review which forms of support aid young people to thrive in adulthood.

8 Boys, older children and children from poorer families are more likely to receive additional support in the education and benefit systems. More than two-thirds of children with EHCPs or CDLA are boys, making boys twice as likely to get support. Nearly 6% of 15-year-olds have an EHCP compared with 3.6% of 4-year-olds. An even steeper age gradient exists for CDLA: 9.6% of 15-year-olds receive CDLA compared with 5.7% of 4-year-olds. In 2020, around two in five 12- to 15-year-olds with an EHCP or receiving CDLA

were eligible for free school meals, twice the average rate among this age group. Any change to the health-related support system will have big impacts on the distribution of support by gender, age group and income.

9 There are big differences across ethnic groups in the share of children receiving support relating to a special educational need or disability. Among those aged 12–15 in 2020, 2.0% of pupils from the Indian ethnic group had an EHCP compared with 4.3% among the White British population and 5.7% amongst the Black Caribbean population. Some of these differences can be explained by different levels of income across groups, but there remain large ethnicity gaps when looking only at children who are eligible for free school meals. These stark differences likely reflect a combination of different levels of needs across different ethnic groups and differences in norms, awareness and access to services.

10 There is a strong case for the government to review all systems of support for children with special educational needs and disabilities. It has already committed to reviewing and reforming the special educational needs system; it makes sense to review other forms of support for children with disabilities at the same time. There is a particularly strong case for reviewing CDLA, which has remained broadly unchanged since its introduction over 30 years ago in 1992, despite large changes in the health of young people, to healthcare and to the broader benefit system. The government should also investigate how it can improve support for children with autism and ADHD in mainstream schooling.

6 | The outlook for public sector productivity

Olly Harvey-Rich and Max Warner (IFS)

The government has wide-ranging ambitions to improve the performance of many public services over this parliament. Yet the relatively tight departmental budgets set at this year's Spending Review mean that delivering these improvements will require substantial productivity increases in the public sector. The government has therefore set out detailed plans and targets for where it intends to find productivity gains in each department.

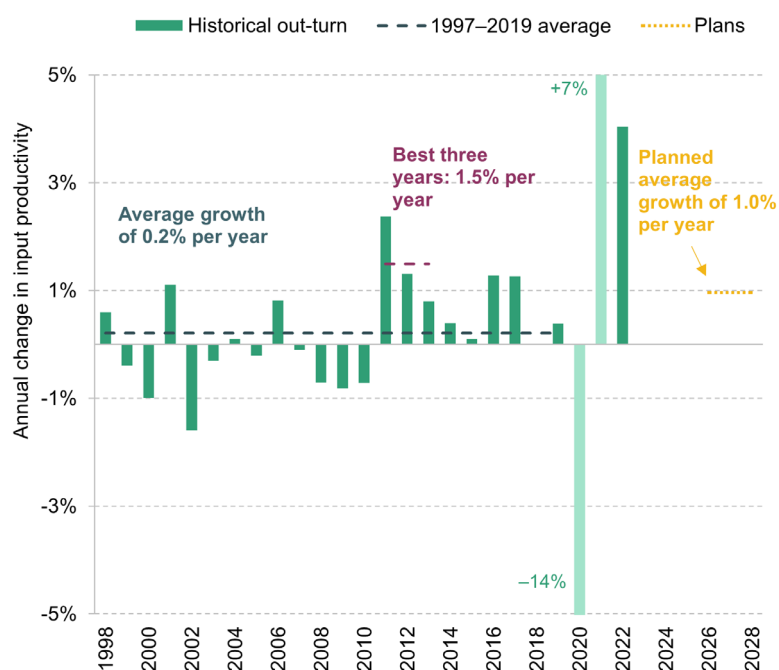
We estimate that achieving the government's plans for productivity would increase public sector productivity by an average of 1.0% in each year of this parliament, more than four times its longer-run average of 0.2% seen between 1997 and 2019. The targets are therefore ambitious but not unprecedented: in the first three years of the coalition government, public sector productivity grew at an average of 1.5% per year, for instance.

Indeed, there are some good reasons to think that there could be scope for higher public sector productivity growth in this parliament than seen previously. In the English NHS, where more than half of the planned improvements are intended to be found, meeting these productivity targets would only mean restoring 2019 levels of hospital productivity by 2029. And it is possible that artificial intelligence will increase the productivity of many tasks, though there remains considerable uncertainty around this. However, weighing against this optimism, it is notable that many of the intended reforms have been considered before by previous governments also in search of waste and inefficiency, and it is conceivable that productivity growth will be lower than planned.

Since spending plans have been made on the assumption that these gains can be achieved, the possibility that public sector productivity growth falls short is an important fiscal risk. If productivity growth does disappoint, the government will be faced with the choice of topping up departmental budgets, potentially by tens of billions, or accepting a lower level of public service performance than it currently plans.

In this chapter, we examine and evaluate the government's ambitions to improve public sector productivity. We estimate what these could mean for total public sector productivity growth, and then consider what different scenarios for public sector productivity could mean for public service performance, public spending and the wider economy.

Historical and planned productivity improvements, 1997–2029



Note: Productivity changes in 2020 and 2021 were very large – so that changes in other years are visible, we cap the bars at -5% and +5%; the light green labels give the change in those years. Final figures for productivity changes in 2023 and 2024 have yet to be produced by the Office for National Statistics. Government plans for productivity are in fiscal years, while the historical data are in calendar years.

Source: Office for National Statistics, Public Service Productivity Estimates; authors' calculations using HM Treasury, Departmental Efficiency Plans and Office for Budget Responsibility, Economic and Fiscal Outlook – March 2025.

Key findings

- 1 At the 2025 Spending Review, the government set out plans for all government departments to deliver at least 5% 'savings and efficiencies' by 2028–29. This includes making **almost £14 billion of efficiency gains in the delivery of public services by 2028–29 (£9 billion of which are planned to be from the NHS) and cutting central administration budgets by another £2 billion**. This government is far from the first to set out such ambitions – the 2021 Spending Review, for example, also planned to make 5% departmental efficiencies over a three-year period.
- 2 Cutting central administration budgets could improve productivity – but it will not automatically do so. **Administration budgets are a small part of what government spends its money on – making up 1% of total public spending and 2.0% of departmental spending in 2024–25. A risk is that seeking savings from (relatively small) administration budgets could prove counterproductive, if those cuts have adverse consequences for broader public service performance.** Reductions in the quality of central IT or procurement systems, for example, could easily restrict what front-line services can deliver. Delivering this scale of cuts to administration budgets is certainly possible: the coalition government delivered larger cuts in the early 2010s. **But the plans to make almost identical cuts across departments make little sense, and will likely make it more difficult than is necessary to deliver the savings.**
- 3 **There is much more scope to improve public sector productivity by improving the day-to-day delivery of public services.** It makes sense, therefore, that the government has provided detailed implementation plans and targets for public services. The government's plans include a Transformation Fund for up-front investment in specific productivity improvements: a welcome step. **It may be that artificial intelligence – an area of focus for the government – will deliver productivity improvements, though there is considerable uncertainty around how big these will prove to be.** But many of the other themes in the government's plans, such as digitising services or reducing the size of the government estate, have appeared in numerous similar strategies under recent governments.
- 4 **Almost two-thirds of the planned public service productivity gains are set to come from the NHS in England, where plans imply that hospitals will only return to pre-pandemic levels of productivity by 2028–29.** The fact that productivity remains below pre-pandemic levels for many services would indicate there is still some scope for catch-up growth, though provisional Office for National Statistics (ONS) productivity data for recent years suggest that catch-up growth has stalled, or at least slowed down – raising the fear that the pandemic dealt an enduring hit to public service productivity. **It is notable that these plans do not include targets for some important public services, such as schools and local government in England.**
- 5 **If the government can deliver its productivity plans, we estimate that public service funding productivity – the ratio of the outputs of public services to funding – will be 2.3% higher by 2028–29. In other words, providing the same level of public services will be 2.3% cheaper than if the plans were not delivered.** That would be a big change from the historical pattern, where estimates suggest that between 1997 and 2019 public services tended to become more expensive to provide over time, not less (i.e. funding productivity was falling).
- 6 This 2.3% improvement in funding productivity in 2028–29 – like all of the numbers in the government's productivity plans – should not be directly compared to the ONS measure of public sector productivity, which is a measure of input productivity – the relationship between public service inputs (such as staffing and equipment) and public service outputs. **We estimate that by 2028–29 the government's plans imply a 2.9% increase in input productivity, equivalent to**

1.0% per year. That is more than four times faster than the estimated average annual growth rate between 1997 and 2019 (0.2% per year). It is closer to, but still significantly faster than, the average annual growth rate between 2009 and 2019 (0.7% per year). The government's plans are therefore ambitious compared with the recent past.

- 7 If the government fails to achieve its planned increase in public service productivity, it would face a choice between settling for public service performance falling short of plans or topping up spending plans.** If it decides to maintain current spending plans, this would increase the risk of falling short of ambitious targets for improved service performance. If the government instead decides to top up spending, this would need to be financed, with potential consequences for adherence to the fiscal rules. **If the government only delivers half of its planned productivity improvements, then achieving the same level of public sector performance as currently implied would require a £9 billion top-up to spending in 2028–29. If funding productivity stays flat, this would double to an £18 billion top-up.**
- 8** Public sector productivity also matters for economy-wide growth. **Higher public sector productivity can increase GDP, via an increase in the production of public services, a sizeable chunk of the economy.** The direct benefits to the exchequer from this increase in GDP would be limited, at least in the short run, because it would not lead to higher tax revenues (unlike a similarly sized boost to private sector productivity).

7 | UK defence spending: composition, commitments and challenges

Bee Boileau and Max Warner (IFS)

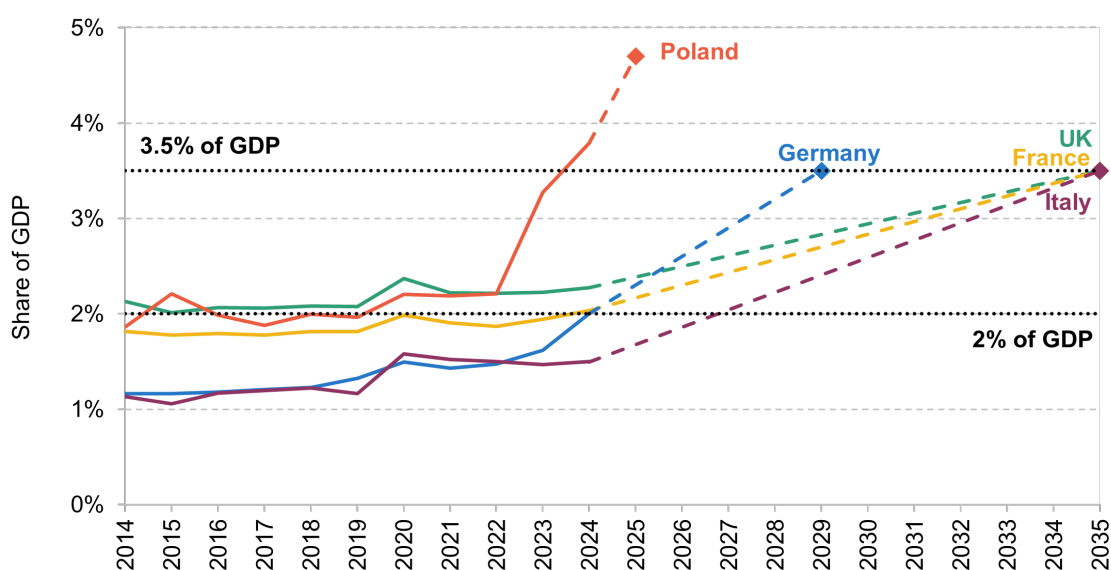
The UK, alongside NATO allies, has committed to increasing core defence spending as a share of national income from 2.3% of GDP – its level in 2024–25 – to 3.5% of GDP by 2035. This increase would be equivalent to £36 billion, or £500 per person, in current terms, and would mark the end of the post-Cold-War ‘peace dividend’, whereby spending a declining share of GDP on defence has allowed for higher spending on the welfare state without similarly sized tax rises. This reversal is a major fiscal issue: it will add to the numerous pressures on the public finances, both within this parliament and in future parliaments. When defence spending was last at 3.5% of GDP, in 1987–88, health spending stood at 4.0% of GDP. We project that by 2035 – when defence spending is planned to return to 3.5% of GDP – health spending could stand at 9.2% of GDP.

Funding additional spending on defence through cuts to other areas of public spending would require a significant change to what the state currently does: ‘salami slicing’ areas to make small savings, without paring back what those services are expected to deliver, will likely not be sufficient. If future governments instead decide to increase taxes to fund additional spending, the changes that would be needed are also substantial, likely requiring broad-based tax rises rather than small tweaks. Borrowing could help smooth the path to a new equilibrium – especially if spending needs to rise much more quickly than currently anticipated – but permanently increasing borrowing to fund a permanent increase in defence spending is unlikely to be sustainable. The shape or size of the state – or both – are likely to change if the NATO commitment is to be met.

Some countries – notably Germany and Poland – have set out plans to increase defence spending as a share of GDP further and faster than the UK, often from lower starting points. Indeed, Poland has already achieved in two years what the UK has committed to doing in ten, having increased defence spending from 2.2% of GDP in 2022 to 3.8% in 2024.

In this chapter, we examine the past and future of defence spending – in the UK and elsewhere – and consider the fiscal and economic consequences of the UK government’s commitments. We discuss the challenges involved in ensuring higher planned defence spending translates to higher defence capabilities, and the links between higher defence spending and economic growth.

Defence spending out-turn and commitments for the UK, France, Germany, Italy and Poland



Note: Dashed lines connect current spending and the planned end point, rather than showing planned paths.

Source: Authors’ calculations using: NATO, Defence Expenditure of NATO Countries (2014–25); International Monetary Fund, GDP forecasts; and Office for Budget Responsibility, Databank August 2025.

Key findings

- 1 In 2024–25, the UK spent £66 billion (2.3% of national income) on defence. **Defence spending has risen substantially in real terms over time, but by less than economic growth, and so has declined as a share of national income in the decades after the Second World War – a decline often referred to as the ‘peace dividend’.** In 1955–56, for example, the UK spent 7.6% of GDP on defence, and in 1990–91 it spent 3.2%. A sustained increase in defence spending as a share of national income would be a break from this historical decline.
- 2 The composition of the defence budget is changing. **The proportion of funding allocated to capital investment, rather than day-to-day spending, stayed constant at around 25% between 2002–03 and 2019–20. It then climbed to 35% in 2023–24, and is set to rise to 43% by 2028–29.** This is reflected in the growing share of total funding allocated to military equipment and the declining share going towards personnel.
- 3 **For a long time, the UK had the second-largest defence budget in NATO, but in 2024 the UK was overtaken by Germany.** The US spends around ten times more than the UK or Germany: US spending represented almost two-thirds of the total amount spent by NATO allies in 2024. The UK spent a larger share of GDP on defence (2.3%) than France (2.0%), Germany (2.0%) and the non-US NATO average (2.0%) in 2024. The UK also spends a larger share of its defence budget on major equipment than many countries – including the US – though this is in part due to the costs of the nuclear deterrent. Around half of spending on defence equipment was on the nuclear deterrent in 2023–24. The UK spends a smaller share of its defence budget on personnel than many other countries.
- 4 The government has committed – as part of a NATO agreement – to increasing defence spending to 3.5% of GDP by 2035, and has already set out the path to hit 2.6% by 2027. **This increase is equivalent to £36 billion, or £500 per person, a year in current terms.** The Strategic Defence Review, published in June, set out a number of ambitions to improve and reform military capabilities, arguing that they could be delivered within this planned increase in defence spending. Many European countries – including Germany and Poland – have set out plans to increase spending as a share of national income further and faster, often from lower starting points.
- 5 At the Spending Review (before the 3.5% commitment was made), the government set out plans for the level of day-to-day defence spending to 2028–29 and capital spending to 2029–30. **Current plans imply that defence spending will stay flat as a share of GDP (at 2.6%) between 2027–28 and 2028–29. There is a case for continuing to increase defence spending steadily towards the 3.5% target for 2035 over time, rather than delaying any further increases until the 2030s** – not least due to the higher perceived risk of conflict and the challenges of ramping up spending very rapidly. That would, however, add to the government’s fiscal challenges during this parliament.
- 6 Falling defence spending in recent decades has allowed spending to increase in other areas – such as health and social security – without the size of the state increasing as much as it otherwise would have. But we are now likely to see health and defence spending rising simultaneously. When defence spending was last at 3.5% of GDP, in 1987–88, health spending stood at 4.0% of GDP. **We project that by 2035 – when defence spending is planned to return to 3.5% of GDP – health spending could stand at 9.2% of GDP.**
- 7 Future governments have three broad options to pay for higher defence spending by 2035. The first is to reduce spending on other areas, in order to limit the increase in the overall size of the state. The second is to increase tax revenues to fund the increased spending. The third option is to borrow to fund the increased spending on defence. **Borrowing**



for a permanent increase in defence spending is unlikely to be sustainable, and would be hard to justify on the grounds that defence spending will boost long-term economic growth. There could be a case for using increased borrowing in the short term as a means of delivering immediate increases in spending while more gradually increasing taxes or cutting non-defence spending, but this would need to be weighed against the risks of borrowing more in a delicate, febrile fiscal environment. Alternatively, future governments may decide to scale down plans for defence spending.

- 8** In practice, the government may struggle to spend all of the announced increase in defence budgets – and particularly may struggle to spend it well given past procurement challenges. **Ultimately, the goal is an increase in defence capabilities, and the link between an increased budget and the resulting capabilities is not automatic.** Increased international competition, as other countries simultaneously increase their own levels of defence spending, may mean that prices for defence procurement increase if production capacity cannot increase sufficiently fast.
- 9** The government has emphasised the growth opportunities from higher defence spending. These could come through higher spending on defence research and development (R&D), or – given that the UK is a major defence exporter – higher overseas demand for UK defence firms' output. But given the size of defence R&D and exports relative to the total size of the economy, neither of these channels is likely to be transformative for growth. Some regions might particularly benefit: the South West, South East and North West of England currently receive the highest per-person levels of UK defence spending with industry. **But it is far from obvious that defence spending is more growth-friendly than other areas where public money could otherwise be spent, such as transport or education. Impacts on growth will also depend on how higher defence spending is funded.**

8 | Options for unemployment insurance

Martin Mikloš and Xiaowei Xu (IFS)

The government plans to introduce a new ‘unemployment insurance’ (UI) benefit to replace the two current contributory out-of-work benefits: new style employment & support allowance (NS ESA) for those with health conditions, available indefinitely for most claimants; and new style jobseeker’s allowance (NS JSA), available for up to 6 months for those actively looking for work. The new UI would be time-limited and paid at the higher NS ESA rate, currently £140.55 a week, a significant boost from the current NS JSA rate of £92.05 a week.

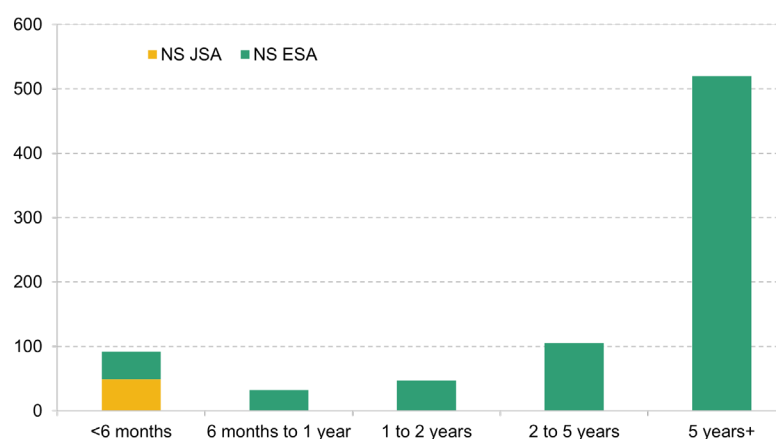
With the proposed reform, people who are unemployed for short periods (currently eligible for NS JSA) would gain from the higher rate. However, those with long-term health conditions (currently eligible for NS ESA) stand to lose out from time-limiting, as they tend to stay on the benefit for a long time – although low-income households could continue to receive the same level of support through universal credit.

Taking NS JSA and NS ESA together, four in five claimants (673,000 individuals) have claimed for at least a year, and nearly two-thirds (520,000 individuals) have claimed for at least five years. Spending is even more skewed towards long-term claims, with 88% of current spending on NS benefits going towards claims lasting at least a year. Because of this, the fiscal savings from time-limiting the new UI will outstrip the cost of the higher benefit level.

The key outstanding choice for the government is how long the benefit will be paid for. Most European countries provide unemployment insurance for 12 months or more. A longer benefit duration would better protect people who take longer to find re-employment, though there is little empirical evidence that it would lead people to find higher-quality jobs.

We estimate that a 12-month UI benefit would cover the entire out-of-work spells of around half (53%) of those who lose their jobs, and still save around £0.6 billion a year in the long run, after any transitional protections are exhausted. The magnitude of the fiscal saving is sensitive to the post-reform take-up rate and potential effects on the duration of out-of-work spells, but the expectation that the reform would represent a fiscal saving overall is fairly robust to plausible behavioural responses. Savings would take much longer to materialise if the policy only applied to new claimants, as NS ESA claimants tend to stay on the benefit for a long time.

Number of new style benefits claimants by current duration of claim, thousands



Note: New style jobseeker’s allowance figures are a forecast for 2025–26. New style employment & support allowance figures are the latest available data for February 2025 and include contributions-based claims and both income- and contributions-based claims. Figures exclude Northern Ireland.

Source: Department for Work and Pensions, Benefit Expenditure and Caseload Tables, Spring Statement 2025; DWP Stat-Xplore.

Key findings

- 1 The UK social security system offers relatively little income protection after job loss.** Across all OECD countries, single homeowners who have just lost their jobs retain 55% of their in-work incomes on average, falling to 22% five years into unemployment. In the UK, this 'replacement rate' is 12% in both cases, as means-tested benefits (available for those on low incomes) are low relative to average earnings and non-means-tested contributory benefits (available to those who have previously 'paid in') are not set at a higher rate. The UK system is slightly more generous for renters with children, but still has the (joint) fourth-lowest replacement rate immediately after job loss among OECD countries.
- 2 At the same time as taxes have risen to a post-war high, and are expected to rise further, spending on contributory benefits has fallen to just 0.3% of national income and to 6% of the working-age benefits bill.** This is down from 1.3% of national income and 41% of working-age benefits in 1978–79. Contributory benefits have become less generous relative to means-tested benefits, eroding the link between contribution and reward that originally underpinned the welfare state.
- 3 The government proposes to introduce a new 'unemployment insurance' (UI)** that would replace the existing working-age contributory benefits for those not in paid work, new style jobseeker's allowance (NS JSA) and new style employment & support allowance (NS ESA). The new UI would offer time-limited support at the higher NS ESA rate, currently only available to those assessed to have work-limiting health conditions.
- 4 The government's proposed UI would still offer little income protection by European standards.** The proposed rate of £140.55 a week, up from £92.05 a week for NS JSA, amounts to an increase from 12% to 19% of average (mean) earnings, equivalent to a third (33%) of full-time earnings on the National Living Wage. This is a very big increase. But most European countries have graduated UI schemes that replace around 60–80% of previous earnings up to a cap, which generally exceeds a third of average full-time earnings.
- 5 The government has yet to decide on how long individuals will be able to claim the new benefit for.** NS JSA is currently available for up to six months, and NS ESA is available indefinitely for most claimants. Taking NS ESA and NS JSA together, **four in five current benefit claimants have been in receipt of the benefit for at least one year, with 88% of NS benefit spending going towards these long-term claims.** Nearly two-thirds of claimants have claimed for five or more years.
- 6 Because there are so many long-term claimants, fiscal savings from time-limiting the new UI benefit are likely to offset the cost of higher benefit levels and extending the benefit to the self-employed.** We estimate that replacing NS benefits with a 6-month UI would reduce spending by around £1.4 billion a year in the long run, after any transitional protections are exhausted. A 12-month UI would reduce spending by around £0.6 billion in the long run.
- 7 If the reforms only applied to new claimants, with existing NS ESA claimants unaffected, savings would take many years to materialise. One option is to 'reset the clock' for existing NS ESA claimants, moving them onto the new UI and allowing them to claim for up to the new maximum benefit duration, to give them time to adjust to any falls in income.** Low-income households should be protected, as they would be able to claim universal credit at the same rate as the NS ESA Support Group rate. For a 12-month UI, this would mean a fiscal cost of £1.5 billion in the first year (from higher rates and expanded eligibility), with savings only materialising in the second year.

- 8 Estimated fiscal effects are sensitive to assumptions on the post-reform take-up rate, though the overall take-up rate (across all individuals with sufficient contributions) would have to exceed 90% for a 6-month UI to result in a fiscal cost rather than a saving; for a 12-month UI, take-up would have to exceed 50%.
- 9 **Given the likely fiscal savings from the reform, the government could choose to be bolder on benefit duration** – for example, by offering the new UI for 12 months rather than 6. Just over half (53%) of workers who lose their jobs find another job within 12 months, so a 12-month UI benefit would cover about half of workers for their entire out-of-work spells.
- 10 **The reform offers an opportunity to improve some of the policy design issues in the current system** – for example, the time period used to assess an individual's National Insurance contributions record and the treatment of earnings whilst on the benefit. It will be important that the new UI is closely integrated with universal credit, to ensure that low-income households who have made sufficient contributions also benefit from higher rates and to avoid unintended effects on work incentives.



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