Choices in a Tight Spot

PwC UK Economics Team

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Chief's Desk

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A Budget worth watching

This will be the second time the Chancellor is expected to stand at the Dispatch Box and announce that the buffer against her own fiscal rules has vanished, a casualty of downgraded productivity, undelivered spending cuts and higher funding costs than first envisaged.

The Chancellor now faces three vital choices.

First, how much fiscal headroom should she build for the future? This is the trade-off between a 'thick' buffer, which implies more economic pain now but greater certainty later, and a 'thin' buffer, which offers short-term relief but carries the risk of sharper tightening six to twelve months down the line. The former is a bet on patience, the latter, a gamble on luck. Recent experience suggests both are in short supply.

Second, what breadth of policy tools should she use? Some of the least distortive tax options could raise significant sums, but they come with political constraints. Conversely, the more distortive, specific taxes that raise less revenue and rely on a smaller tax base often cause more disruption.

Finally, how should she balance tax rises against spending cuts? So far, the Chancellor's fiscal tightening emphasised tax increases. But after the bruising experience of higher employer National Insurance contributions, both businesses and households remain wary.

In short, this will not be a Budget of numbers, but a Budget of choices: **how thin a cushion, how bold a move, and how balanced a mix.**

The Chancellor will also want to weave in an aspirational message, not an easy task given the current public mood. Households remain the largest spenders in the economy, so any move to energise them would be welcome.

This will no doubt be a memorable Budget. Success will be if the Chancellor can make them boring again.

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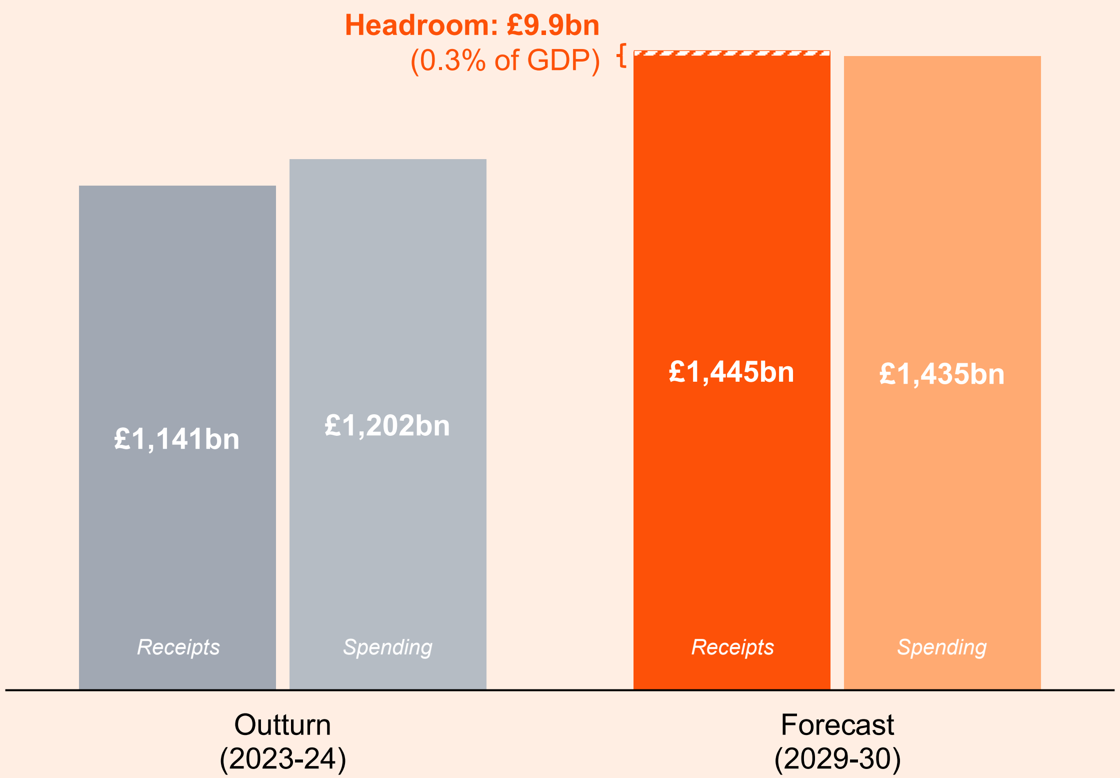
1

Context: Why has the fiscal headroom eroded?

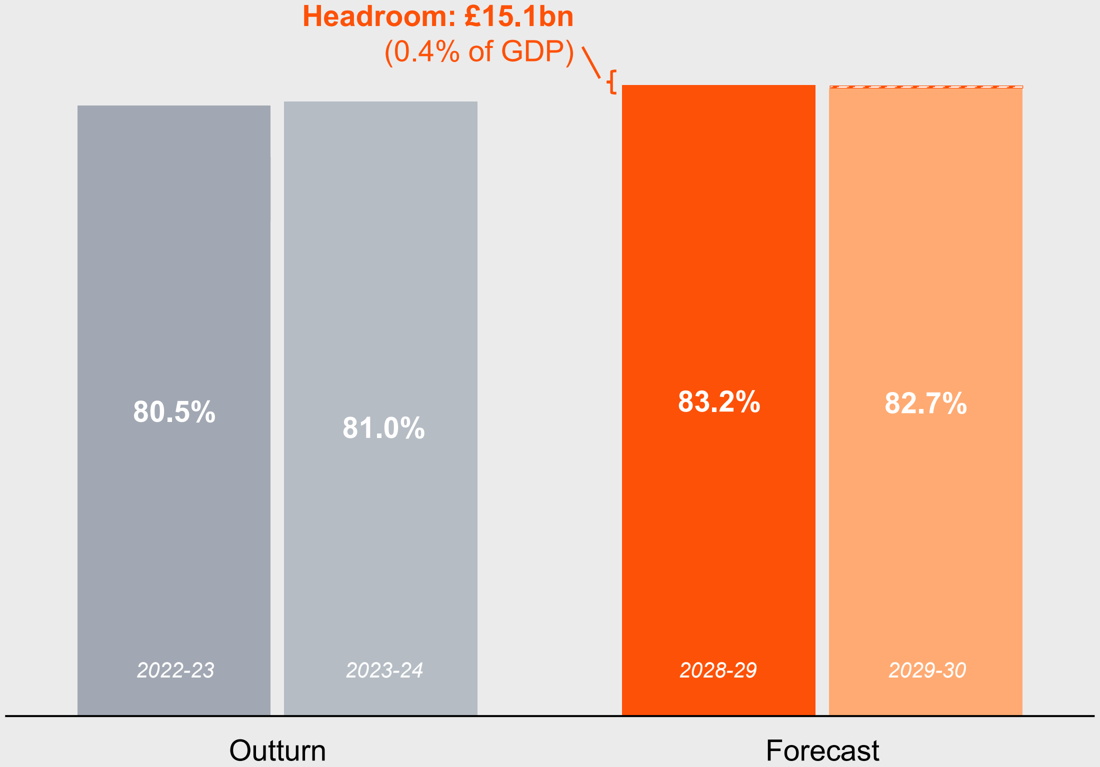
In the Spring Statement, the Chancellor pencilled in a very small margin of headroom of around 0.3 to 0.4% of GDP against the fiscal rules, providing little cushion for even routine shifts in the medium-term economic outlook.

Borrowing rule: Current budget to be in surplus, where total revenues are higher than day-to-day spending, in 2029-30



Tax receipts & spending

Debt rule: Public sector net financial debt must be falling as a share of national income by 2029-30

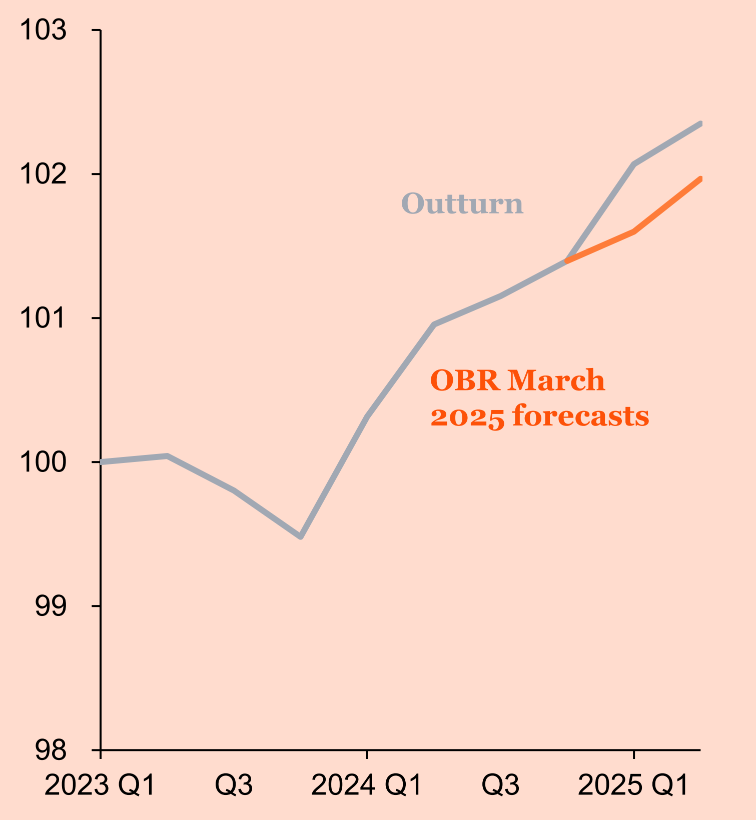


Public sector net financial debt as a % of GDP

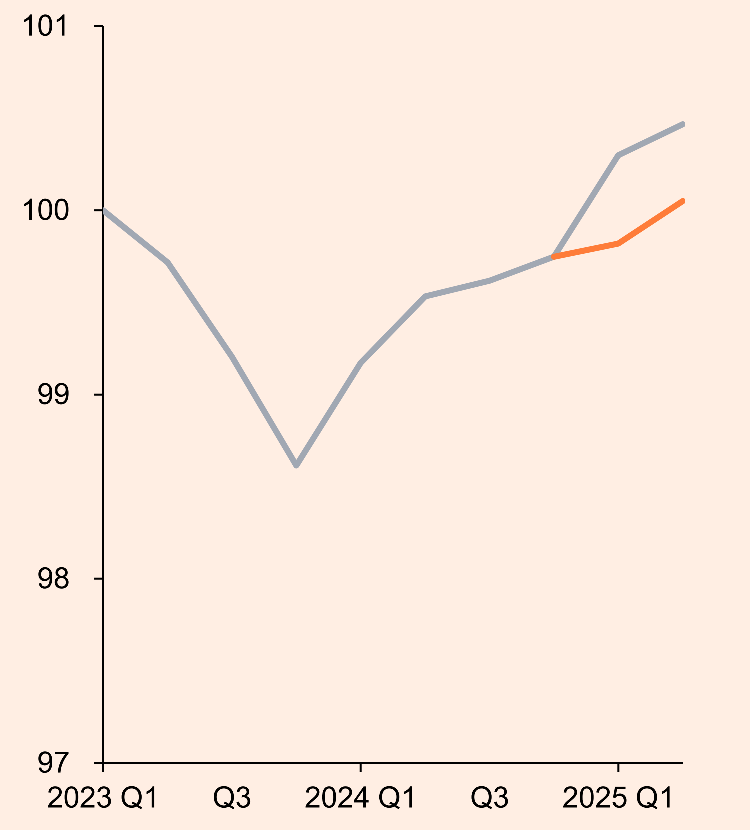
Sources: PwC analysis, OBR

The good news for the government is that the economy has, if anything, performed better than expected at the time of the Spring Statement, with both aggregate and per capita GDP growth exceeding the OBR's forecasts and inflation performing broadly as expected.

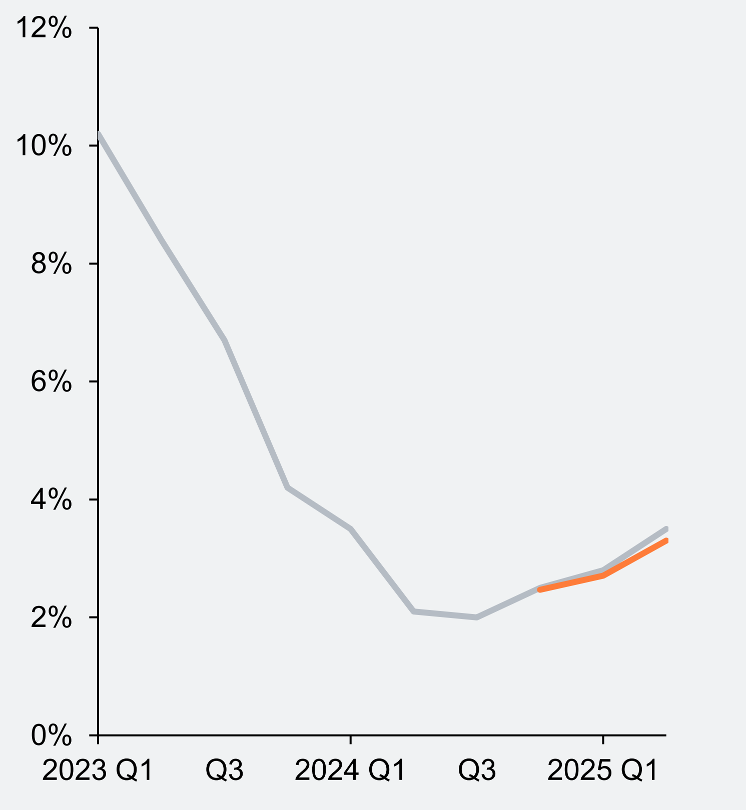
Real GDP (index, 2023Q1 = 100)



Real GDP per capita (index, 2023 Q1 = 100)



CPI inflation



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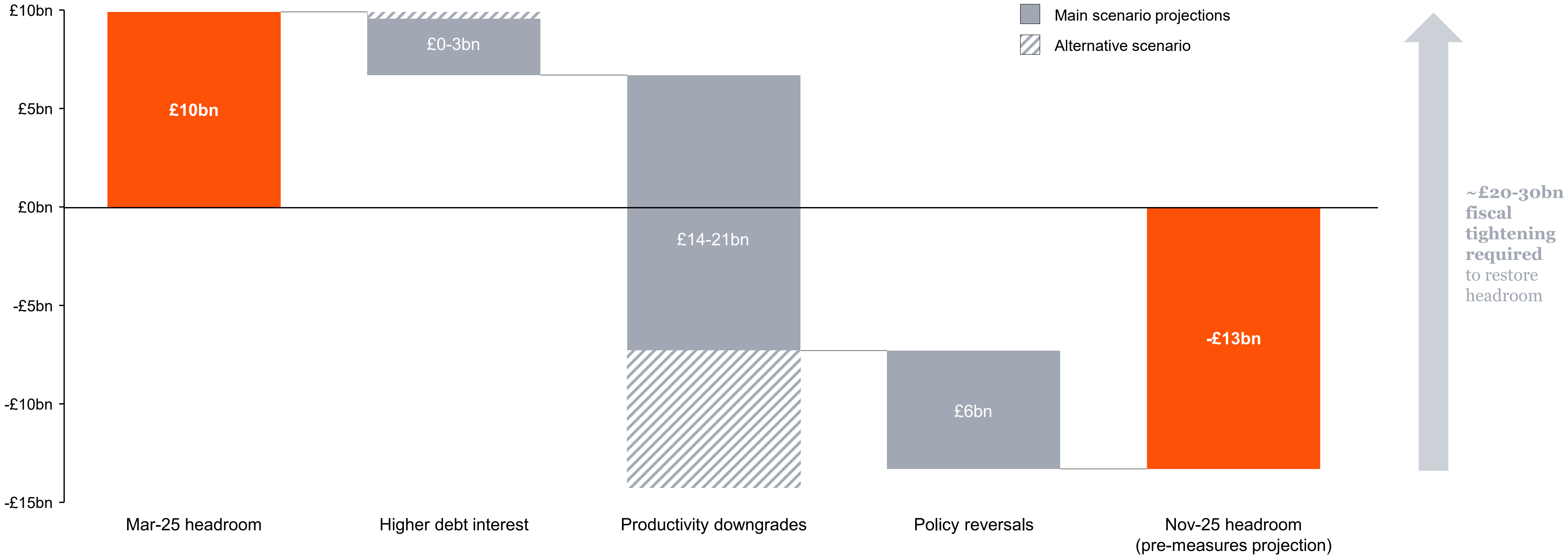
Sources: PwC analysis, ONS, OBR

However, it is the medium-term outlook that determines the fiscal headroom, and that picture has deteriorated. Higher projected borrowing costs, weaker productivity growth, and policy reversals have together eroded the fiscal buffer pencilled in at the Spring Statement.

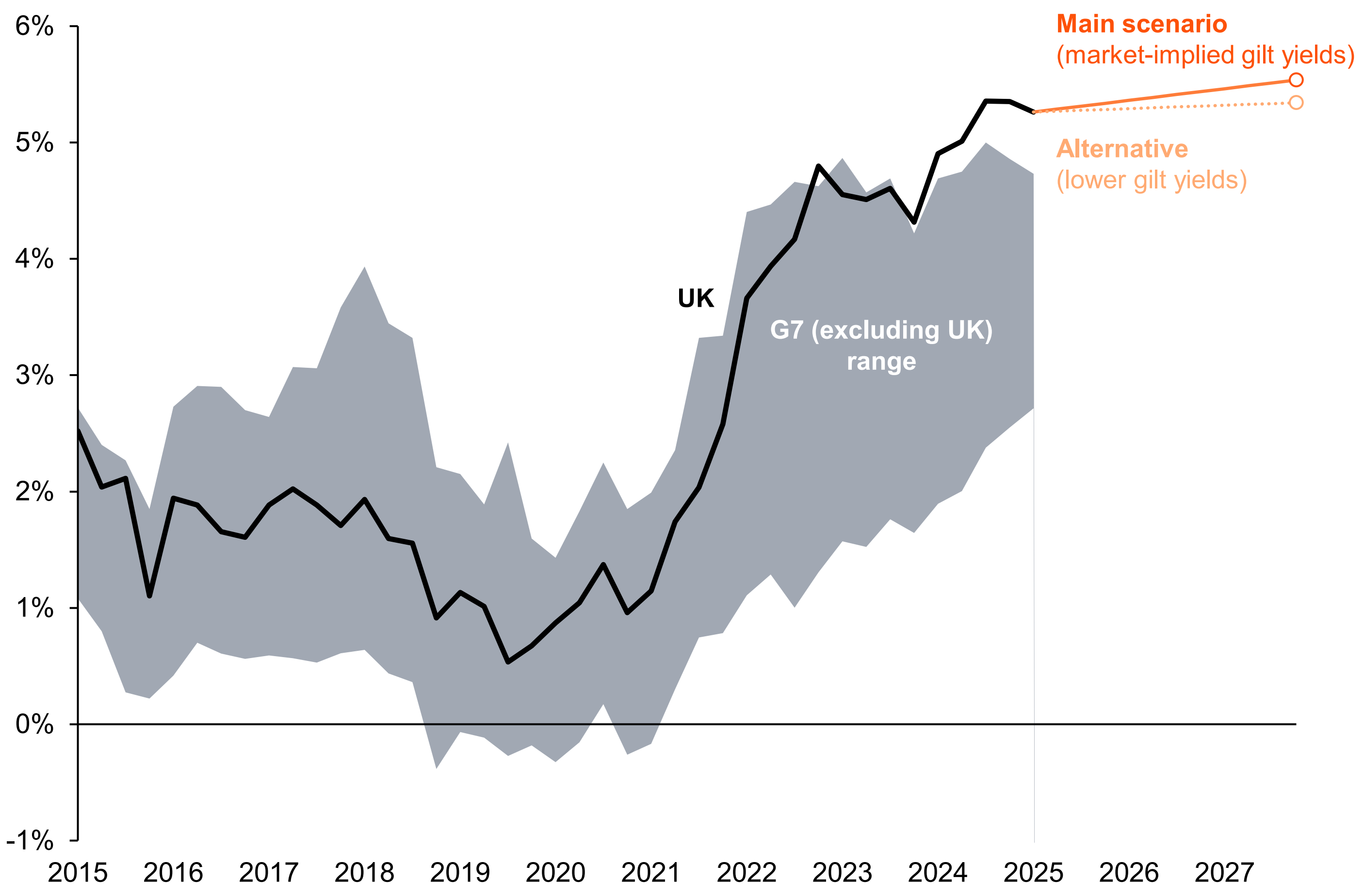
Projected change in the fiscal headroom against borrowing rule, from March to November 2025



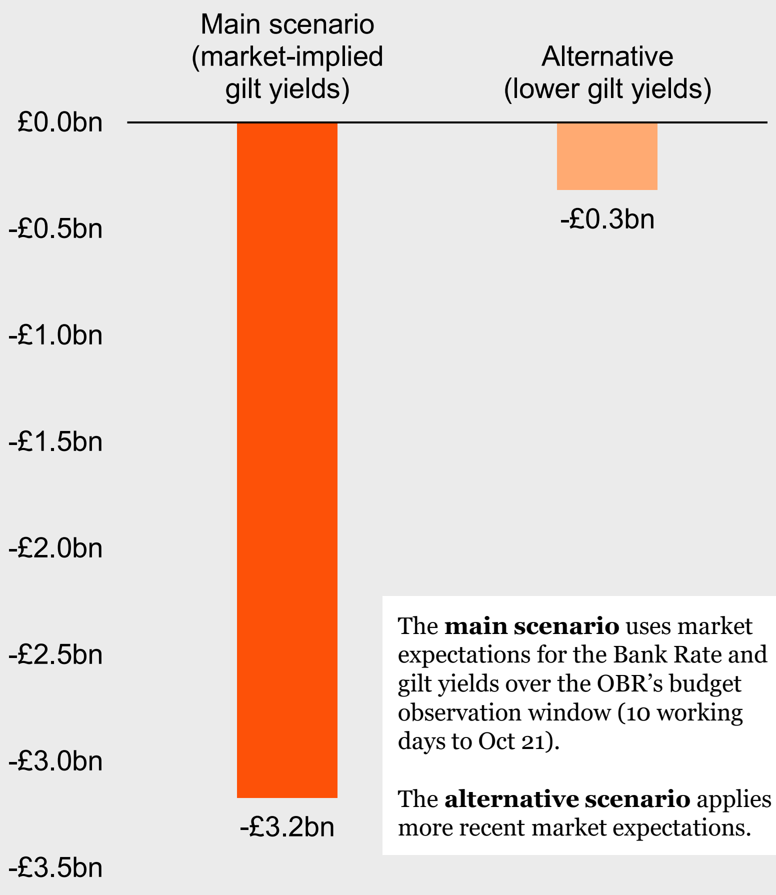
Sources: PwC analysis, OBR. Notes: The main scenario projection for the impact of higher debt interest is -£3.2bn, the alternative scenario is -£0.3bn (see next slide).

A shift in financial markets' expectations for UK government borrowing costs is likely to have added up to £3bn to spending by 2029-30. While other advanced economies have seen similar movements in gilt yields, the UK gilt market faces distinct pressures.

UK 20-year gilt yields compared to the rest of the G7



Impact of higher debt interest on headroom



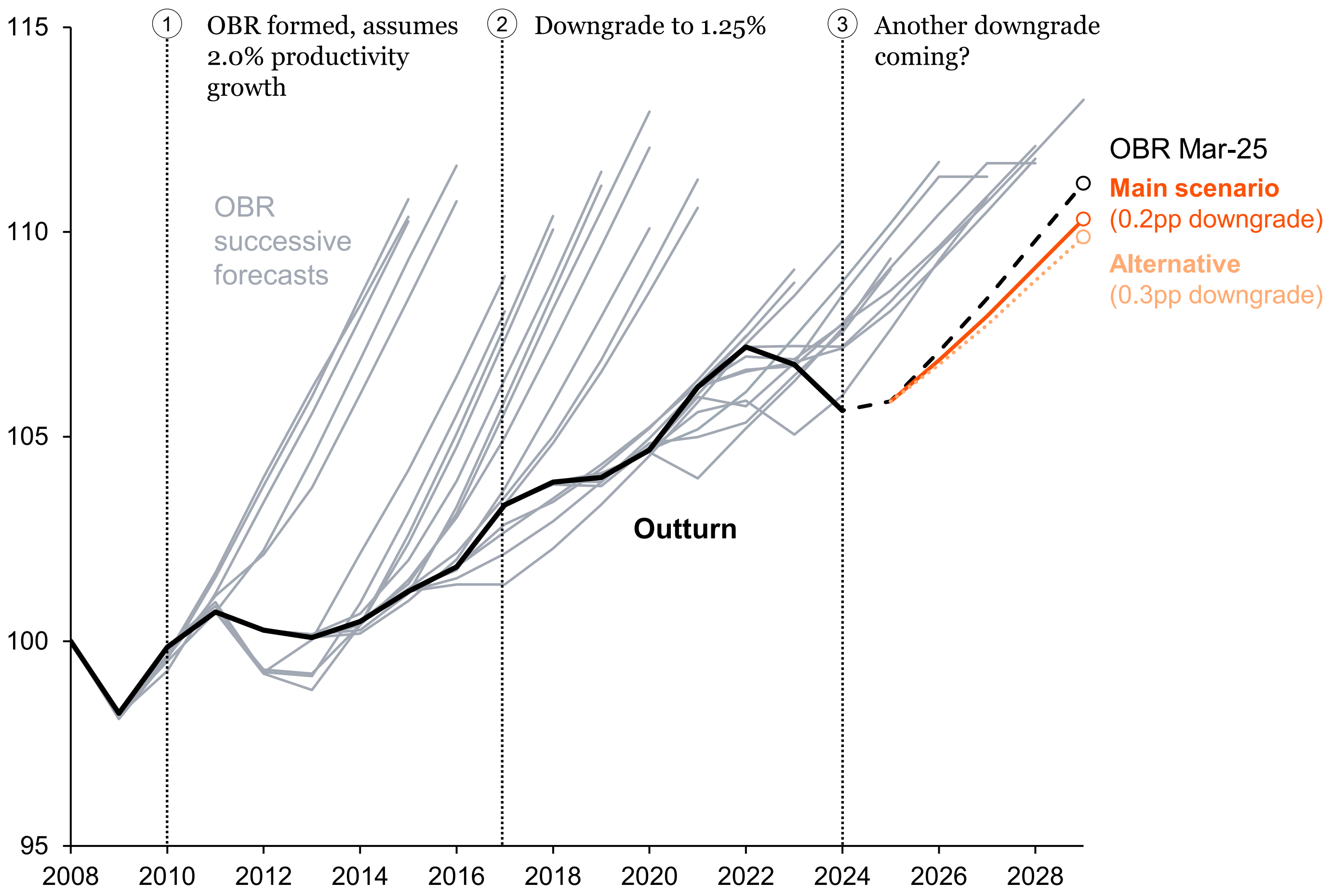
The **main scenario** uses market expectations for the Bank Rate and gilt yields over the OBR's budget observation window (10 working days to Oct 21).

The **alternative scenario** applies more recent market expectations.

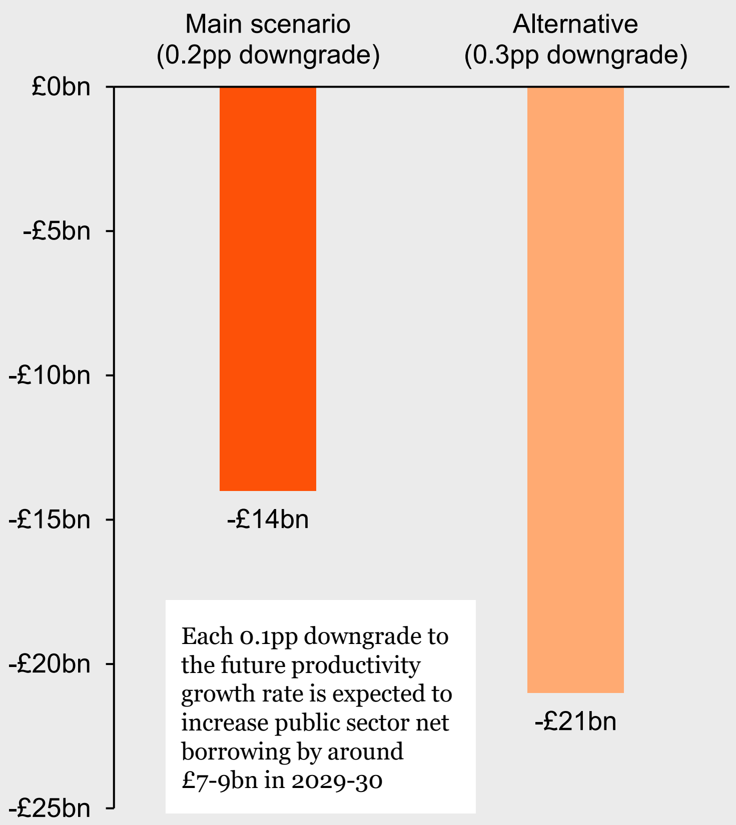
Sources: PwC analysis, LSEG Datastream

The OBR is also widely expected to downgrade its judgement on future productivity growth rates. This alone could add around £14–21bn to spending in 2029-30, making it the single biggest driver of the hit to the fiscal headroom.

OBR forecasts for productivity and actuals, indexed where 2008=100



Impact of weaker future productivity on headroom

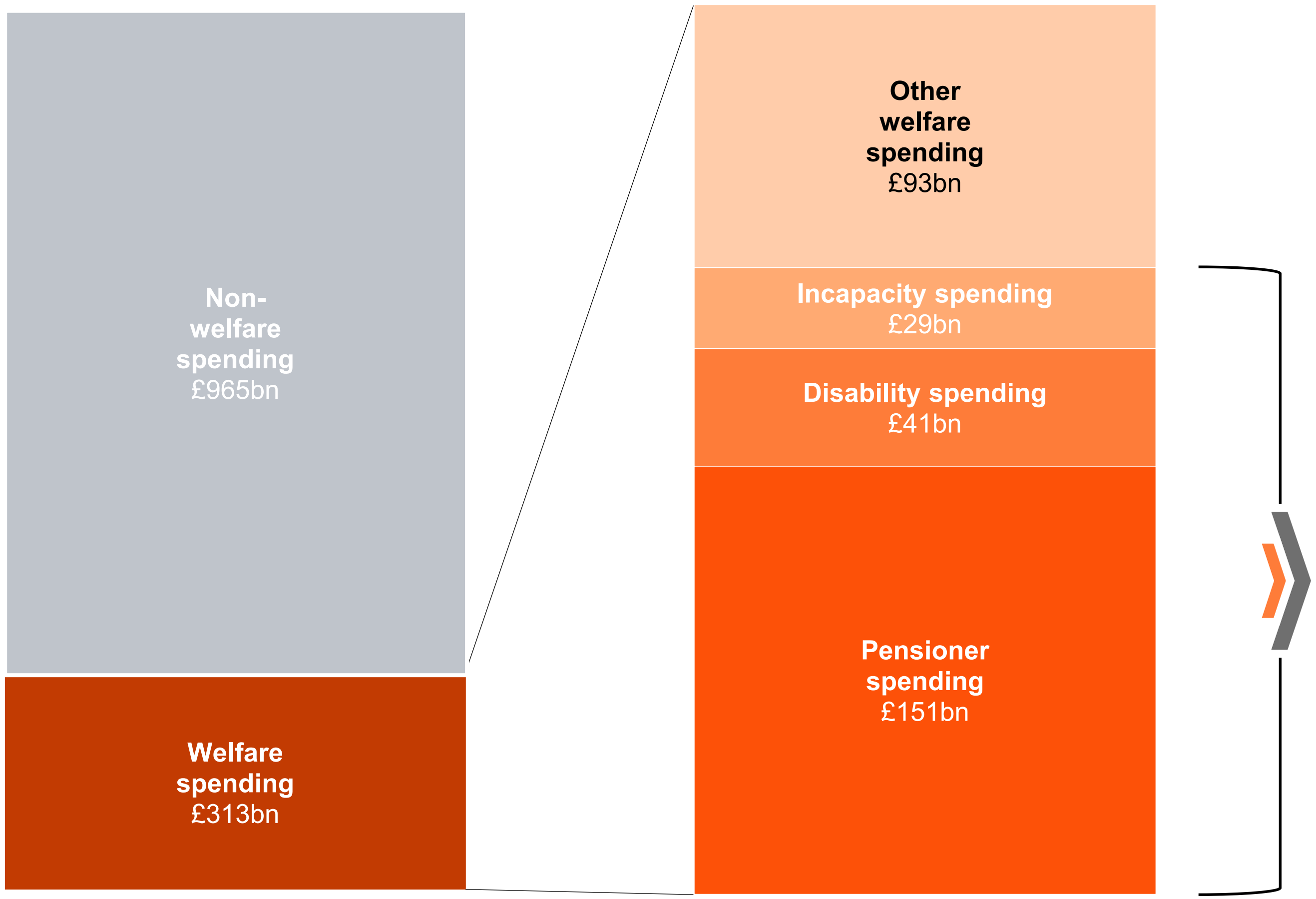


Each 0.1pp downgrade to the future productivity growth rate is expected to increase public sector net borrowing by around £7-9bn in 2029-30

Sources: PwC analysis, OBR, IFS

At the same time, two partial reversals on welfare policy mean spending in 2029–30 is now expected to be about £6bn higher than the OBR projected in Spring.

UK public sector day-to-day spending breakdown, 2024-25 forecast

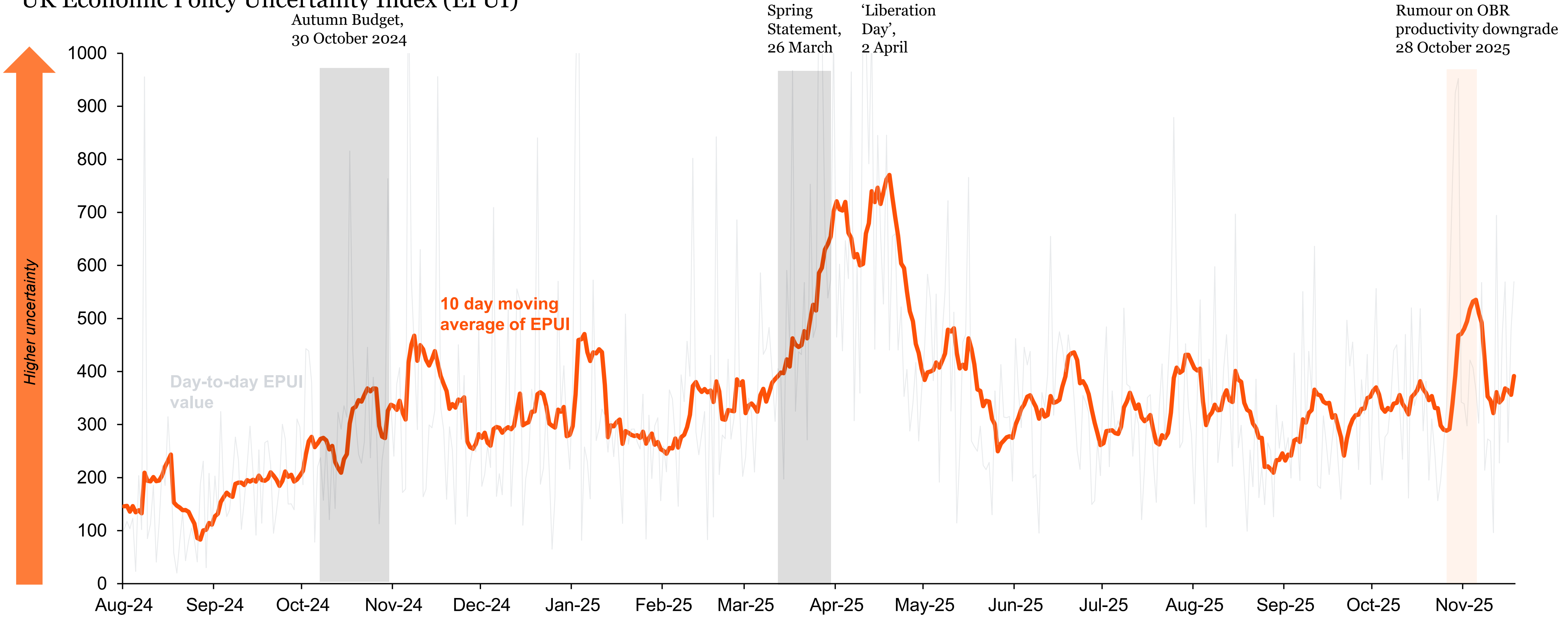


£6bn Estimated rise in social security spending in 2029-30 due to the two policy reversals, relative to the OBR's Spring forecast.

- **Policy reversals:** Since the Spring Statement, the government has partially reversed its changes to winter fuel payments for pensioners and scaled back plans to narrow eligibility for personal independence payments.
- **Fiscal impact:** Without new offsetting reforms in the Autumn Budget, these reversals are expected to increase social security spending in 2029-30 by roughly £6bn compared with the OBR's Spring Statement forecast.
- **Budget implications:** The government's difficulty in delivering welfare reforms that generate relatively limited fiscal savings underline how hard deeper spending cuts would be. This strengthens the case that the Chancellor is more likely to turn to tax rises rather than spending reductions, especially since significant departmental cuts would require reopening budgets agreed only in June (see next section).

The erosion of the headroom has led to endless speculation of what is likely be included in the Autumn Budget. Speculation has given rise to uncertainty about future policy. Business and households have deferred their spending decisions, particularly for big ticket items.

UK Economic Policy Uncertainty Index (EPUI)



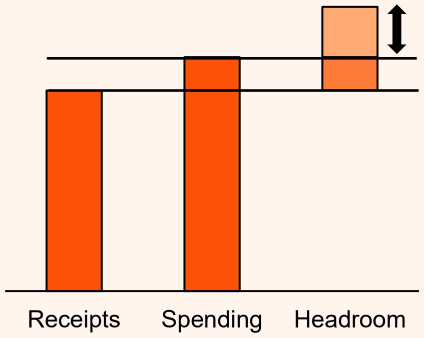
Notes: The UK Economic Policy Uncertainty (EPUI) Index is built from the *daily* digital archive of about 650 UK newspapers in the NewsBank database. It counts articles that contain one term related to the *economy*, one to *uncertainty*, and one to *policy* (e.g., spending, deficit, regulation, budget, tax, policy, Bank of England). The index is normalised to 100 which corresponds to 2015 uncertainty levels. | Sources: PwC analysis, Economic Policy Uncertainty Index

2

The **three choices** the Chancellor will have to make on Budget day

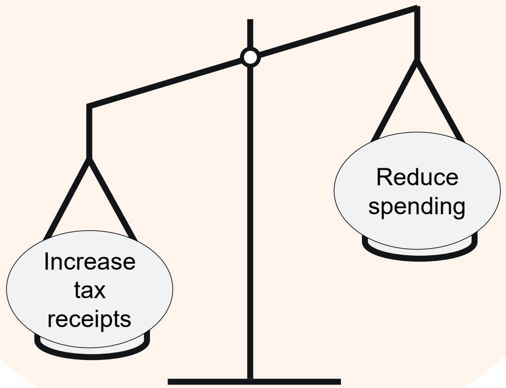
The Chancellor has three main choices to make in this Budget: The extent to which she rebuilds the fiscal headroom, how far to lean on tax rises rather than spending cuts, and how to raise large sums without breaking manifesto commitments.

Thick or thin headroom?



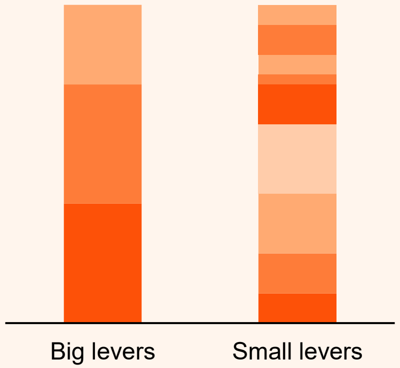
After filling the fiscal gap created by weaker economic conditions, the Chancellor must decide whether to rebuild the £10bn headroom or expand it. A 'thicker' buffer will carry political and economic costs, but it reduces the risk that global shocks or routine downgrades force further tightening in the next Budget.

Tax or spending?



Given the government's commitment to its fiscal rules, the Chancellor will have to choose between raising taxes and cutting spending to fill the fiscal hole. Tax rises are likely to do most of the heavy lifting, as reopening departmental budgets agreed earlier in the year looks unlikely, and recent policy reversals show how hard welfare cuts are to deliver.

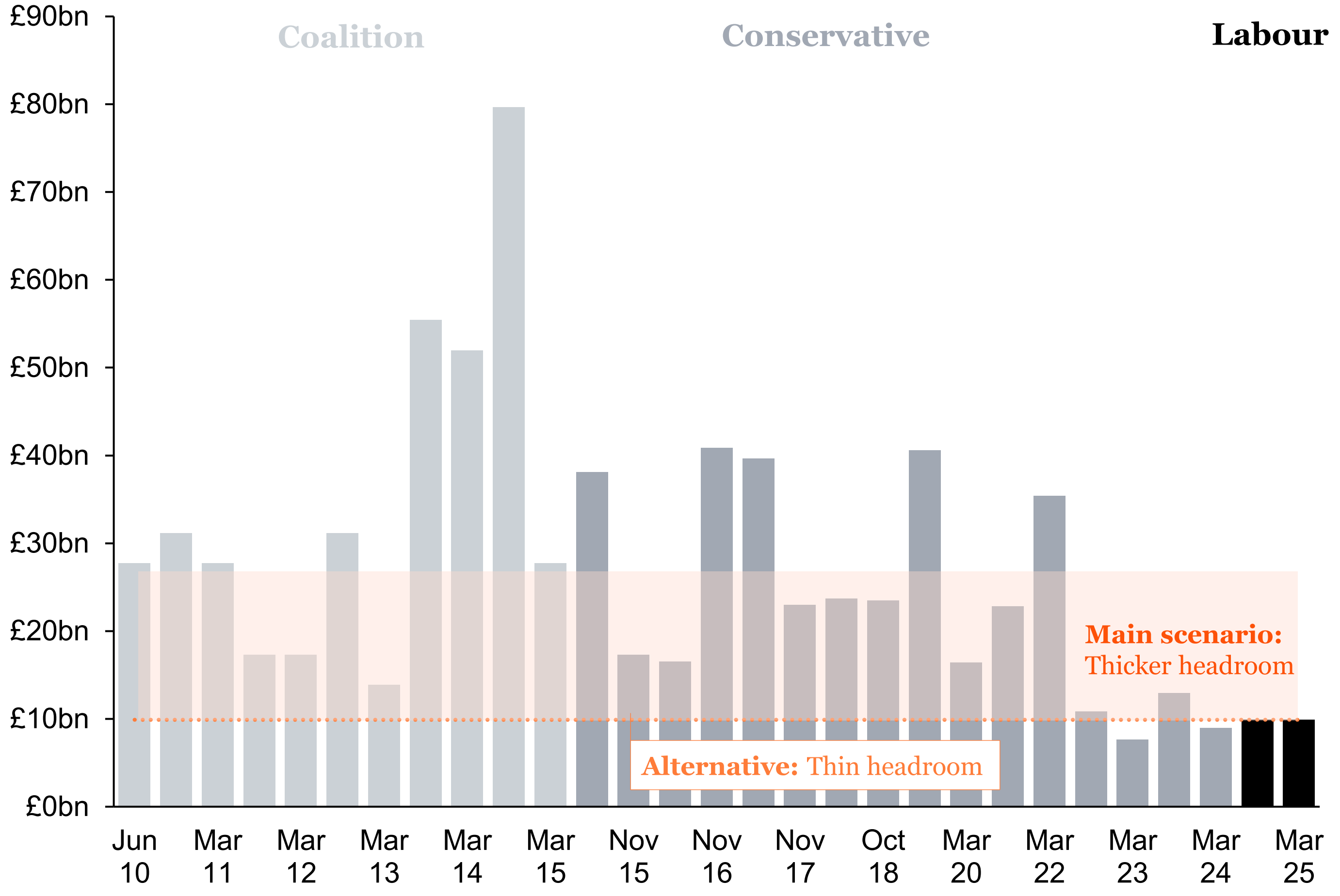
Broad or narrow?



The Chancellor's main difficulty is that its main tax policy tools are politically constrained. This makes a patchwork of smaller, narrower measures more attractive. However, this approach is likely to be more economically distortive, more disruptive for certain segments of business and society, and focused on a much narrower tax base, which calls into question the extent of its revenue-raising capacity.

The Chancellor is likely to increase the fiscal headroom relative to Spring. Adopting a thicker buffer comes with more short-term economic pain but reduces the likelihood of more fiscal tinkering in the medium-term, providing more certainty to businesses and households.

Successive forecasts for headroom against fiscal rules



Main scenario: Thicker headroom (over £10bn)

- The Chancellor opted for £9.9 billion of headroom against the borrowing rule for the Autumn Budget last year and the Spring Statement this year.
- Revisions to the OBR's judgements, combined with external and domestic developments, have required fiscal policy to be adjusted in line with the fiscal rules.
- To reduce the risk of this happening again, our main scenario assumes the Chancellor will choose a thicker buffer, likely around £10–20 billion.
- For context, previous Chancellors have typically targeted around £27 billion, but the OBR's median five-year current budget forecast error is roughly £45 billion, excluding FY 2020/21.

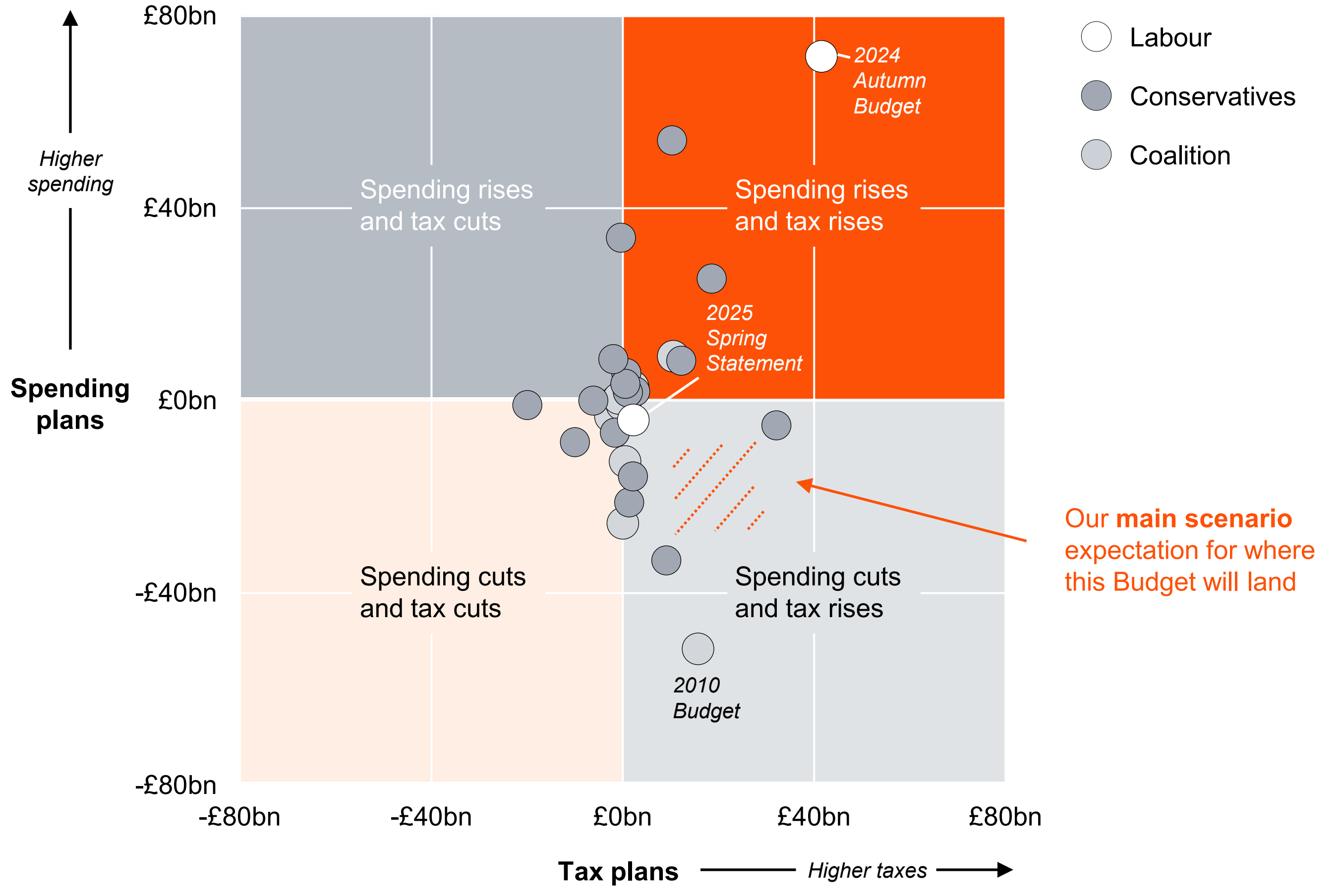
Alternative: Thin headroom (£10bn)

- The Chancellor could again opt for a circa £10 billion headroom against its borrowing rule.
- A thin headroom comes with the risk of yet more fiscal 'fine-tuning' in the next Budget, which could lead to yet another round of uncertainty for households and businesses.

Sources: PwC analysis, OBR. Note: For comparability with headroom against the current fiscal mandate, past headroom has been calculated in terms of per cent of GDP, as forecast at the time, and multiplied by our in-house forecast for nominal GDP in 2029-30.

The Chancellor's fiscal consolidation is likely to be dominated by tax rises rather than spending cuts, given that departmental budgets were only set in June and recent reversals show how hard welfare or spending cuts are to deliver.

Distribution of tax and spending changes in UK Budgets, 2010–25



Main scenario: Tax-led

- Given the deterioration in the economic outlook, the Chancellor faces three options: borrow more, cut spending, or raise taxes.
- Increasing borrowing would breach the Chancellor's fiscal rules and risk pushing government borrowing costs higher, given already fragile gilt markets, making it the least plausible option.
- Large scale spending cuts also look unlikely. There's probably little appetite to reopen departmental budgets agreed only in June, and recent policy reversals show how hard welfare cuts are to deliver. If anything, welfare spending could increase if the government scraps the two-child benefit cap.
- Tax rises are therefore likely to do the heavy lifting, even if there are likely to be productivity savings and spending cuts at the margins. In the next slide, we set out a range of plausible options.

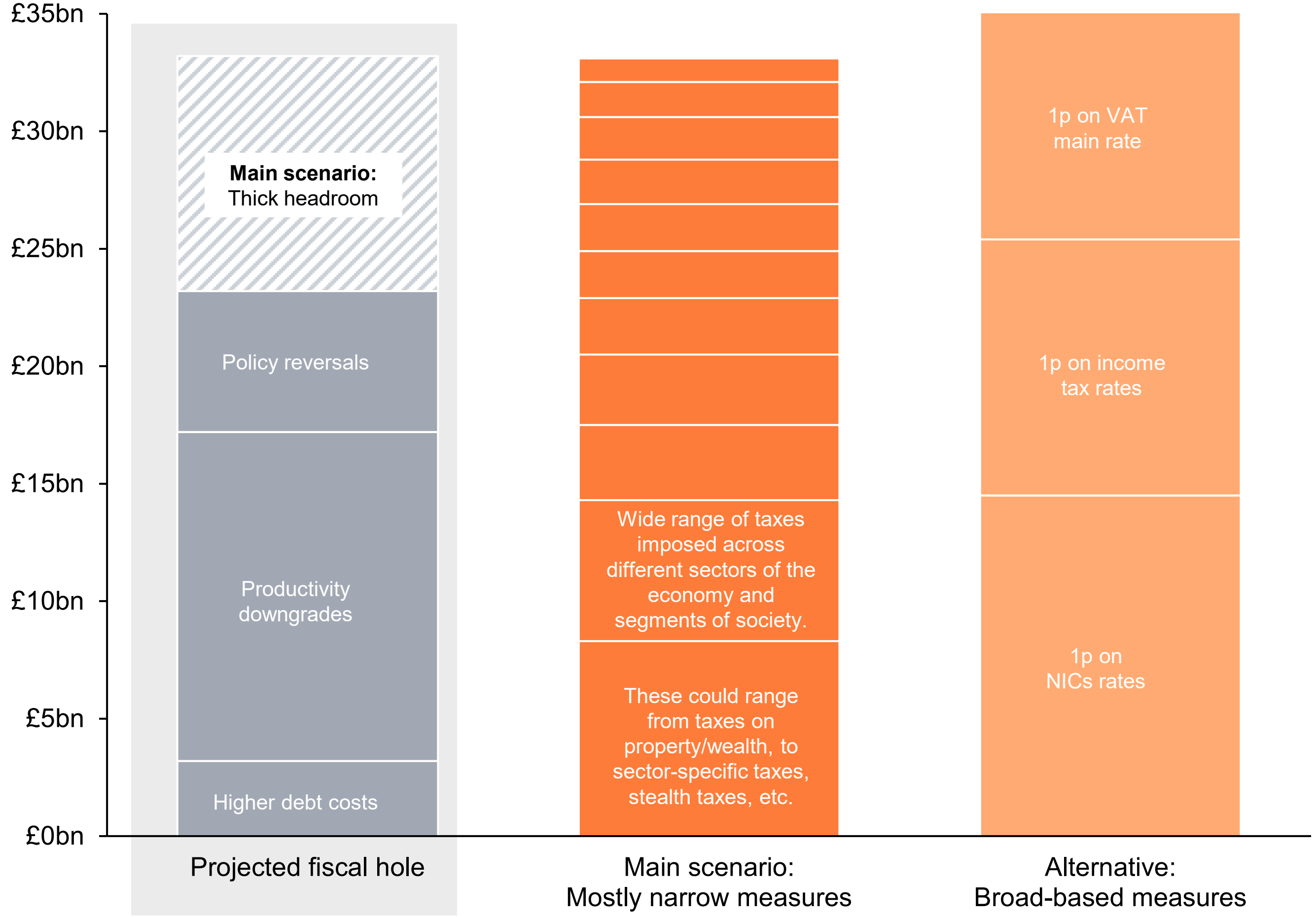
Alternative: Balanced consolidation

- The alternative is a more balanced mix of tax rises and spending cuts, which appears unlikely for the above reasons.
- There aren't many historical precedents. The Coalition's consolidation programme in the 2010s was dominated by spending cuts, and the most equally balanced consolidation, the 2022 Autumn Statement, was still weighted roughly 4:1 toward spending cuts.

Notes: We reverse the Treasury scorecard convention in the case of spending, so that both tax rises and spending increases are shown as positive values. | Sources: PwC analysis, OBR

The Chancellor is expected to fill the fiscal gap with a patchwork of measures, leaning heavily on narrow tax tweaks to do most of the heavy lifting. Crucially, this means that the Government would avoid breaking its manifesto pledges.

Illustrative tax policy options for closing projected fiscal hole



Main scenario: Mostly narrow measures

- Though UK tax revenues are set to reach a record high, there is still scope for the Chancellor to find new sources of revenue, given that many of the UK's European peers still have much higher taxes relative to the size of their economies.
- The main challenge is that the three largest sources of tax revenue (income tax, NICs and VAT) have been ruled out in the manifesto. Similar political or practical constraints apply to the next four largest taxes (corporation tax, council tax, business rates and fuel duties).
- A patchwork of smaller, narrower measures, combined with the speculated freeze on income tax and NICs thresholds, would appear more likely. This approach could raise significant sums in aggregate (see chart) but could potentially run the risk of alienating some interest groups. It may also have the unintended consequences of making existing taxes more complicated (and thus more economically distortive).

Alternative: Broad-based measures

- The obvious alternative is using broad-based measures, such as adding 1p to each of the three largest taxes (see chart).
- This is the most straightforward way to raise large sums but could carry a political cost given their manifesto commitments. It is also not cost-free from an economics perspective. For instance, a VAT rise could risk reigniting inflation pressures.

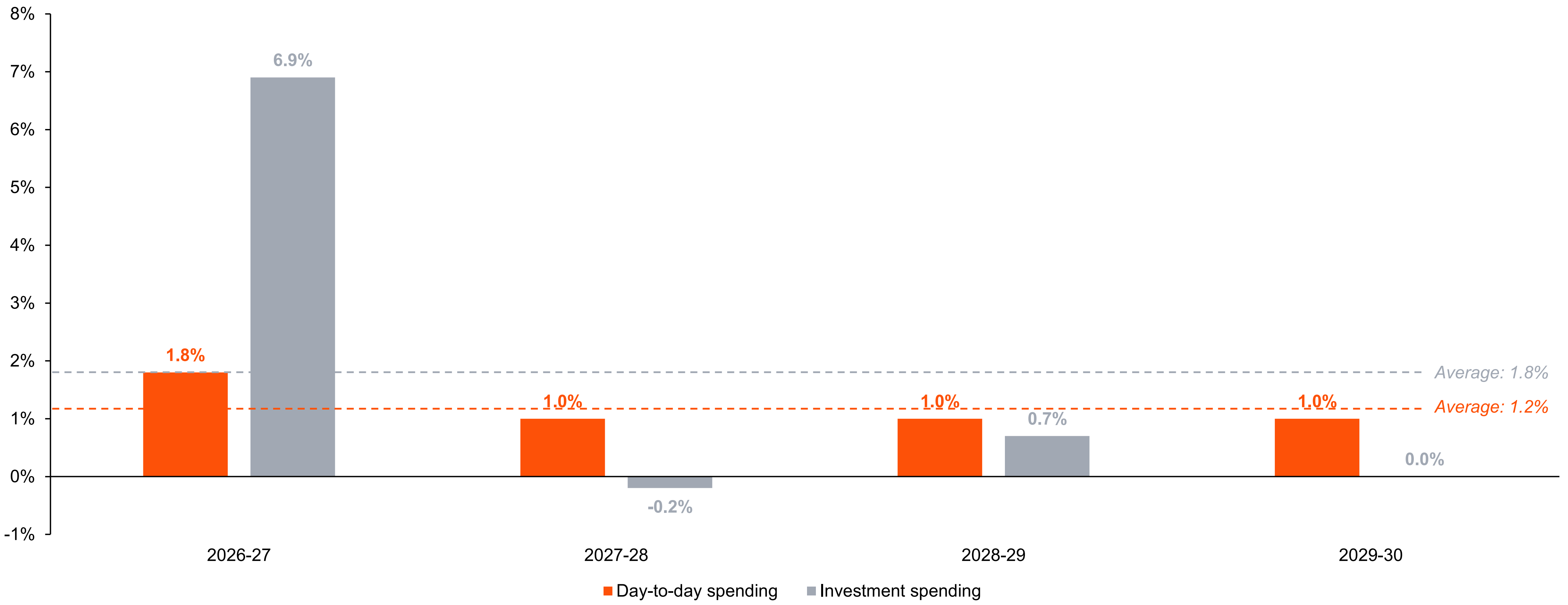
Notes: This is not a prediction of the exact tax measures the government will take; figures are illustrative and official OBR costings will differ in practice. NICs refers to National Insurance contributions. | Sources: PwC analysis, OBR, The Guardian, The Telegraph, Tax Policy Associates, IFS

3

What does this mean for the **long-term**?

The government's spending plans are heavily front-loaded. The Treasury likely hoped a stronger economic outlook would allow them to top them up in this Budget. The fiscal reality described earlier in this presentation makes clear that won't be possible.

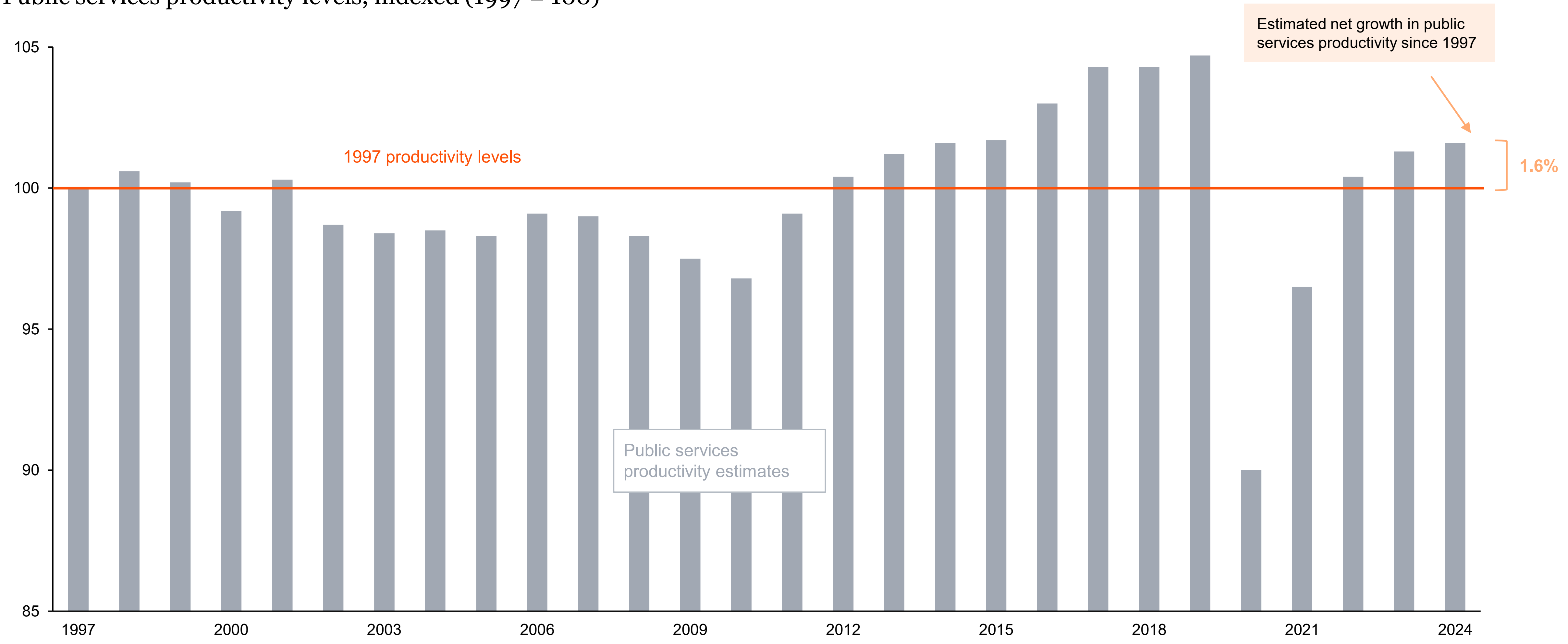
Planned annual growth rates in real departmental spending, 2026-27 to 2029-30



Sources: PwC analysis, IFS

This means that productivity gains will have to carry the load if the government wants to achieve its goals. However, that will be a tall order, given that public services productivity has stalled in the 21st century.

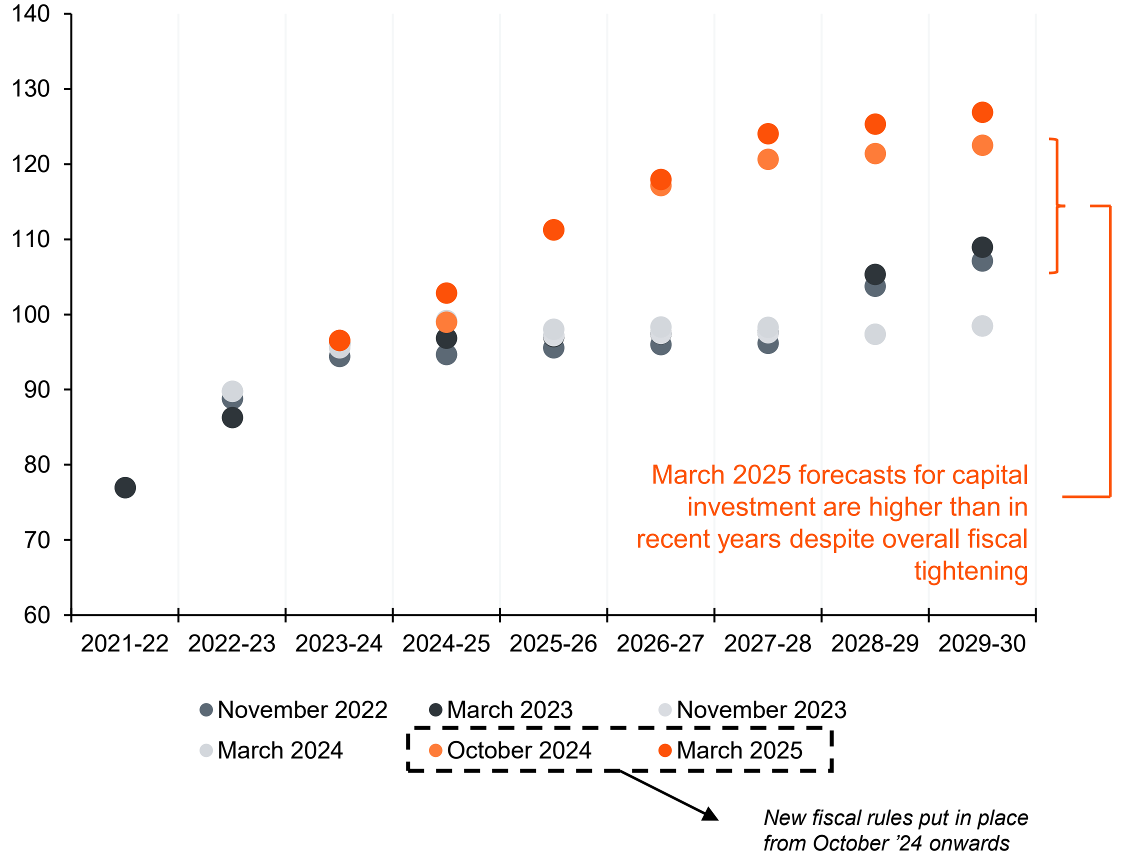
Public services productivity levels, indexed (1997 = 100)



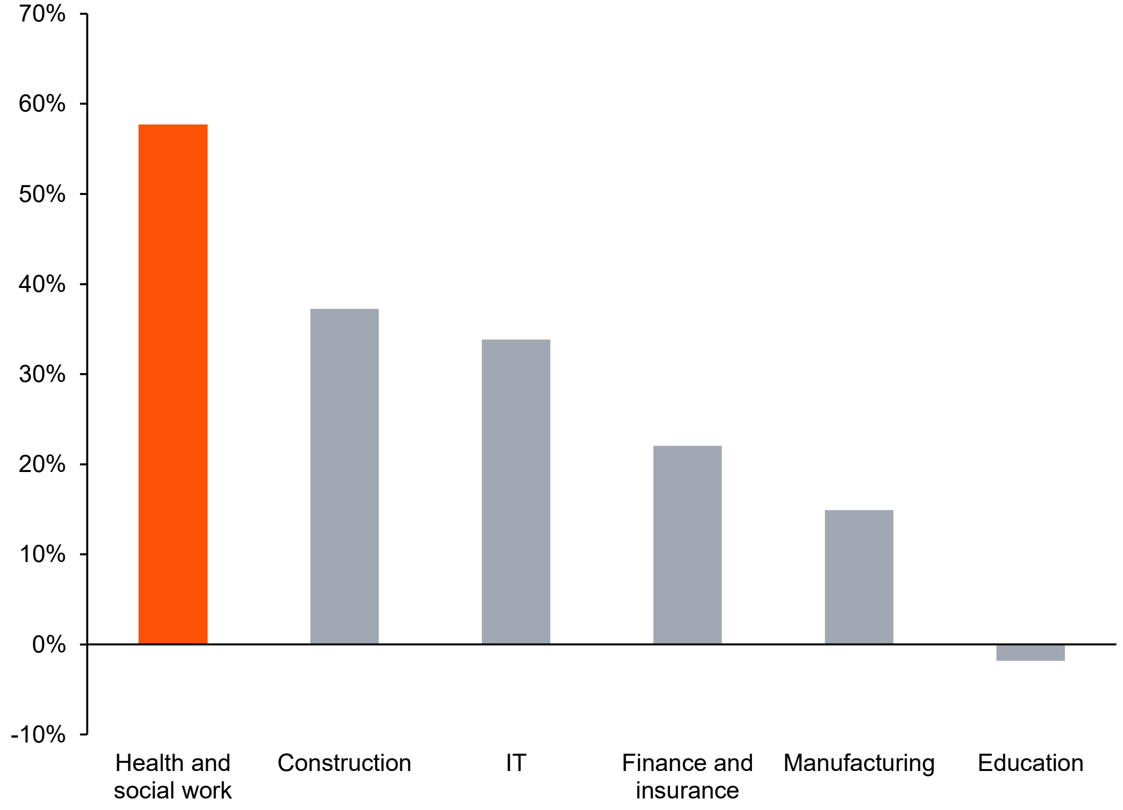
Sources: PwC analysis, ONS

The good news is that, unlike in previous fiscal tightening cycles, the Chancellor's fiscal rules mean that public investment is protected. And there are early signs that AI is being picked up by the largest public sector dominated industry, which could presage future productivity gains.

Capital Departmental Expenditure Limit (CDEL) forecasts, consecutive fiscal events. Current prices, £bn



Annual growth in the share of jobs requiring AI skills, from 2023 to 2024



Notes: Beyond OBR forecast period, 2028-30 values estimated based on historic growth rate. | Sources: PwC analysis, OBR

The Chancellor’s main objective on Budget day should be to make future Budgets boring again. Doing so will free up resources to deal with the country’s long-standing challenges.

Non-exhaustive

Area	Challenge	Policy considerations	Economic impact
Infrastructure	Planning reform to build more homes	Streamline the planning and permitting process to encourage significantly higher and sustained levels of housebuilding. This would be a significant tailwind to consumer finances, encourage labour mobility and improve productivity levels. The UK currently has one of the oldest, coldest, smallest and most expensive housing stock in Western Europe.	H
	Planning and other reforms to upgrade and build more infrastructure	Combine planning reform, public-private partnership models, regulatory clarity to close UK’s infrastructure gap (energy, transport, digital). Improved infrastructure raises productivity via agglomeration, reliability, connectivity.	H
Productivity	Public-sector productivity	Raise public sector productivity via process re-engineering, digitisations, outcome-based funding, better measurement of outputs, automation and workforce upskilling.	H
	Skills agenda	Develop lifelong learning, high-quality apprenticeships, management training. Align FE/HE curricula to industry demand. Improve digital and AI skills. Enable labour mobility between sectors/regions (also links to the residential planning reforms). Invest more time and resources on the cohort of the population with non-tertiary education. Encourage higher participation rates for older workers	H
	AI adoption	Encourage AI adoption across sectors by improving data access/infrastructure; supporting smaller firms update, aligning regulation and stands’ training workforce and embedding AI in business models.	M
Economic governance	Closer and more predictable relations with large trading partners	Reduce non-tariff and regulatory barriers between the UK and our large trading partners. Improve data-flow agreements, services mobility/recognition of professional qualifications an actively encourage long-term cooperation and co-ordination. This lowers trade costs, reduces investment uncertainty, improves FDI and export potential.	M
	Decentralisation	Give sub-national levels real powers over planning, infrastructure, skills, budgets. Link local growth-plans to devolved fiscal-tools. Encourage tailored regional investment rather than one-size-fits-all central model.	M
	Tax reform	Reform the tax mix by reducing distortionary taxes and increasing less distorting ones. Make tax rules more predictable to encourage investment decisions and ensure compatibility of tax system with the government’s growth plan and priorities and to ensure intergenerational fairness.	M

Source: PwC analysis

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