



Institute for Fiscal Studies

The IFS Green Budget

October 2026

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In association with Barclays and funded by the Nuffield Foundation



The IFS Green Budget: October 2026

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Foreword from Barclays

It is both an honour and a pleasure for Barclays to partner again with the Institute for Fiscal Studies (IFS) on this Green Budget. At a moment of unusual economic and policy uncertainty, the value of rigorous, independent analysis is especially clear. By bringing together IFS's deep expertise in the public finances with Barclays' perspective as a global bank rooted in the UK, this report aims to provide a clear guide to the choices ahead.

The backdrop to this Budget is shaped by powerful global forces. Conflict in the Middle East is adding to inflationary pressures and uncertainty. The global interest-rate cycle has tightened financial conditions for households, businesses and governments. At the same time, a new global investment cycle – led by artificial intelligence and other technologies – is beginning to reshape the outlook for productivity, employment and competitiveness.

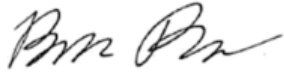
Barclays is well placed to help interpret these developments. We combine more than 300 years of experience in the UK with an international reach across markets, businesses and economies. Paired with the analytical strength and independence of IFS, that perspective offers a powerful basis for examining how global change is affecting the UK – and what it means for the decisions facing policymakers.

Those decisions now fall to a new set of faces, led by Prime Minister Burnham and Chancellor Healey. Markets, businesses and households will be looking not only at the direction they set, but also at how the detail of their plans compares with the high-level signals given so far. Their ambitions will need to be translated into deliverable policy, backed by transparent assumptions and a durable fiscal framework.

This Green Budget provides a careful assessment of that challenge. Our expert macroeconomists examine how the main global forces are likely to play out in the UK, pointing to slower growth in the near term but a more encouraging medium-term picture. Further analysis also shows that recent movements in financial markets should be understood in an international context, rather than viewed simply as a verdict on UK-specific risks.

With political and fiscal volatility evident across a number of advanced economies, there is value in a Budget that offers stability and as much certainty as possible. That does not mean avoiding difficult choices. It means confronting them clearly, setting credible priorities and creating the conditions in which households and firms can plan, invest and grow. We hope this report helps to illuminate those choices and contributes constructively to the debate around the Budget and the UK's longer-term economic prospects.

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 once again.

A handwritten signature in black ink, appearing to read 'Brad Rogoff', with a stylized, cursive script.

Brad Rogoff

Global Head of Research, Barclays

Foreword from the Nuffield Foundation

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

We are committed to helping 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 contributes to these aims through its forensic, independent and timely analysis of the UK's fiscal position and the major policy choices that will shape economic performance, public services and living standards. Over the years, the Green Budget has become a highly respected – and much anticipated – point of reference for assessing the key social and economic challenges facing successive governments. By supporting it, the Foundation helps strengthen evidence-informed decision-making and public debate.

In addition to analysis of the economy, the public finances and public spending, each year the Green Budget zooms in on selected topics of particular importance. These in-depth chapters will be of close interest to policymakers ahead of the forthcoming Budget while also strengthening the evidence base for future policy development.

This year, the topics chosen are all of great public interest. They focus on the impact of migration on the public finance forecast, options for reforming personal independence payments, the factors that determine the UK's electricity prices, and options for how tax-sharing might operate in a more devolved system of governance. All present difficult choices for policymakers. And all are highly relevant to our wider social, economic and fiscal future as well as to people's day-to-day lives.

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, thereby improving the quality of public debate.

As the government faces increasingly tough economic and fiscal challenges, and our governing institutions are put under greater pressure, the need for external scrutiny is perhaps more vital than ever. We are proud to continue supporting this vital work.



Gavin Kelly
CEO, Nuffield Foundation

Preface

Welcome to the IFS Green Budget 2026.

This year's edition previews John Healey's first Budget as Chancellor, which he delivers against a difficult backdrop.

Conflict in the Middle East has pushed up energy prices and inflation. While the economic shock to the UK has not yet been as large as some feared around the time of the Spring Forecast, it is unquestionably bad news for the economy.

The impact on the government's finances will depend on exactly how inflation feeds through to different parts of the economy. Higher gilt yields mean spending more to service government debt. Higher inflation also automatically increases government spending on some areas, particularly benefits. But higher inflation will also increase tax receipts, especially if it is reflected in higher wages. Exactly how these effects will balance out in the borrowing forecast the Office for Budget Responsibility hands the Chancellor is unclear. The OBR's forecast is likely to show that the Chancellor is still on track to meet his fiscal rules before any changes in policy. But even then the public finances will remain in poor health, with debt at historic highs – a very good reason to stick to the commitment to get borrowing down over the coming years.

The Chancellor's major challenge at this Budget will be setting plans for overall spending that are compatible with the government's ambitions for public services. John Healey inherits plans for public service spending that already looked tight, and higher inflation will make them even tighter. If he wants to increase defence spending to 3% of GDP by 2030 – his ambition in his former role as Defence Secretary – this will make living inside existing spending totals even harder. For his Budget to be credible, it will need to include spending plans that the Chancellor would be willing to live within.

While Budgets sometimes require a Chancellor to respond to changing forecasts, they also always provide an opportunity to improve the design of the tax and benefit system. In this year's Green Budget, we explore options for reforming the disability benefit system and for rationalising the UK's muddled system of energy taxation. In both cases, careful design is needed to ensure that the government's policies are well targeted and provide households with a sensible set of incentives. We also explore the issues and options for sharing tax revenues with England's regional mayors – an important part of the government's devolution agenda – in a chapter supported by the Chartered Institute of Public Finance and Accountancy (CIPFA). In another piece, we investigate how migration feeds into the OBR's forecast for the public finances, and examine ways this could be improved.

We are pleased to be collaborating with Barclays for a second year running. We thank them for their financial support for the Green Budget and for contributing chapters on the outlook for the UK economy, the bond market, and transfers between HM Treasury and the Bank of England stemming from the Bank's quantitative tightening programme. These contributions, drawing on Barclays's own research, provide excellent insights and key context for the rest of the Green Budget's analysis.

We are also grateful to the Nuffield Foundation for the ongoing funding it has provided to support the Green Budget, as well as for helpful engagement on the IFS-authored chapters. Our principal aims for the Green Budget are also central aims for the Nuffield Foundation: informing the public debate and influencing policy.

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, the Family Resources Survey and the Survey of Personal Incomes are available from the UK Data Service. Researchers can access the Labour Force Survey through the ONS Secure Research Service. 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. Some of this 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

About the Nuffield Foundation

The Nuffield Foundation is an independent charitable trust with a mission to advance social well-being. It funds and undertakes rigorous research, encourages innovation and supports the use of sound evidence to inform social and economic policy, and improve people's lives. The Nuffield Foundation is the founder and co-funder of the Nuffield Council on Bioethics, the Ada Lovelace Institute and the Nuffield Family Justice Observatory. This project has been funded by the Nuffield Foundation, but the views expressed are those of the authors and not necessarily the Foundation. Find out more at: www.nuffieldfoundation.org. Bluesky: @nuffieldfoundation.org, LinkedIn: Nuffield Foundation.

About Barclays Investment Bank

Barclays Investment Bank helps money managers, financial institutions, governments, supranational organisations and corporate clients manage their funding, investing, financing, and strategic and risk management needs. It is comprised of the Investment Banking, Global Markets and Research businesses.

As a leader in global finance, with comprehensive UK consumer, corporate and wealth and private banking franchises, a leading global investment bank and a strong, specialist US consumer bank, Barclays aims to provide a better financial future for our customers, clients and communities.

About CIPFA

CIPFA is a global professional body, operating at local, national and international level. As a global leader in public financial management and governance, our aim is to make a difference to the world we live in.

Our work enables people to prosper, protects the vulnerable and helps sustain the environment for future generations. We're committed to changing lives for the better. By setting standards, leading on policy debate and advising public bodies and governments we help ensure the money and resources used on behalf of citizens are raised and spent fairly, transparently, efficiently and free from fraud and corruption.

Our goal is to always make it count.

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1. Economic outlook: headwinds on the horizon

Jack Meaning (Barclays) and Cian Hennigan (Barclays)

The economic backdrop to this Budget is more difficult than was expected in the spring. The UK economy faces a number of headwinds, and the near-term outlook will be dominated by developments in the Middle East, which will drive a squeeze in the spending power of households.

Key findings

1. **The Middle East conflict has replaced the hoped-for soft landing with a renewed cost-of-living shock.** Oil has risen from around \$60 a barrel at the turn of the year to about \$100, while UK wholesale gas prices have more than doubled from roughly 70p to around 185p per therm. These increases will make the UK poorer by raising the cost of imported energy, squeezing household spending power and increasing costs for businesses and the public sector.
2. **Inflation is set to remain above target through 2027, but we do not expect it to become entrenched in our baseline.** We expect CPI inflation to average 3.1% in 2026 and 3.0% in 2027, before returning to 2% in 2028. Much of the near-term rise comes directly from energy, including an anticipated substantial increase in the Ofgem price cap in January. So far, broader price pressures, wage responses and longer-term inflation expectations remain relatively contained. In a scenario where energy prices stay at current levels through 2027, inflation would stay above 3% until the second quarter of 2028.
3. **The Bank of England faces a difficult trade-off, but we expect a smaller rate rise than market prices currently imply.** Bank Rate is already restrictive at 3.75%. We expect two quarter-point increases, taking it to 4.25% by February, before rates gradually settle at 3.25% in the medium term. Markets instead imply a rise to around 4.75%. In our view, a sharper tightening would do little to prevent the imminent energy-driven inflation peak but would weaken growth and employment. In a high energy price scenario, we expect Bank Rate rises to as high as 4.75% next year.

4. **Growth has been resilient in 2026, but households and the labour market are likely to feel the strain as we move into next year.** We forecast real GDP growth of 1.4% in 2026, slowing to 1.2% in 2027 as higher prices and interest rates bite; by the end of 2027, real GDP is around 0.8% lower than it would have been without the conflict. Real earnings fall in both 2026 and 2027, employment is broadly flat next year and unemployment rises to 5.7%. A key judgement for the Office for Budget Responsibility will be on how nominal earnings will respond to the energy price shock, with our baseline predicated on average annual nominal earnings growth of 2.5–3% over the next five years.
5. **Both fiscal and monetary policy are likely to weigh on demand.** Existing spending plans imply a prolonged fiscal consolidation, while higher inflation reduces the real value of cash departmental budgets. Higher nominal GDP may lift tax receipts, but elevated interest rates and gilt yields increase government borrowing costs. The challenge is to support growth and confidence without unsettling a bond market already wary of additional borrowing.
6. **Investment and productivity improvements offer a route to stronger medium-term growth, but the outcome is highly uncertain.** Recent strength in business investment, particularly in ICT and AI-related activity, is encouraging. In an upside scenario combining a sustained AI investment boom with wider productivity gains, real GDP could be 2.5% higher than in our baseline by the end of 2031. But if investment raises demand without broad productivity benefits, it would generate more inflation and higher interest rates, with a smaller lasting benefit to growth.

1.1 Introduction

At the time of the last Green Budget, the UK economy looked on the verge of turning a corner, having navigated a narrow path between risks. There were signs of private sector demand picking up and taking the baton from a public sector that was consolidating. Inflation was finally in touching distance of returning to the 2% target as the effects of the previous energy price shock faded. Monetary policy was on course to take the final steps towards a neutral interest rate.

Unfortunately, events, as they often do, have overtaken that outlook.

The breakout of conflict in the Middle East means that this Budget comes against a more difficult economic backdrop. The conflict has pushed inflation back up and it has now been

above the Bank of England's target for five years. Central banks have kept interest rates higher for longer than previously expected and this has pushed the cost of borrowing up for both the government and firms. The labour market is still subdued: unemployment remains heightened and vacancies have fallen to record lows. While growth has remained resilient thus far, the building pressure on the cost of living will squeeze households' resources and spending power. Similarly, with public sector budgets set in cash terms, higher inflation will erode real spending on key public services, although the same inflation will also push up tax receipts.

There are some positive signs for the economy. Private sector investment has grown recently, particularly in sectors associated with AI, and signs of a nascent improvement in the productivity outlook give hope for the medium term. However, there is a risk that tighter financial conditions and elevated uncertainty could choke off this potential growth before it has got started. This complicates the jobs of policymakers on both sides of the fiscal–monetary divide, with the Bank of England balancing dealing with a near-term inflation spike with not overly dampening the economy in the medium term, and the Chancellor looking to find ways to stimulate growth with constrained resources and a bond market that remains wary of additional borrowing. This chapter outlines the cyclical forces that are driving the near-term economic outlook, as well as the more structural longer-term course for the UK economy.

In Section 1.2, we describe the effects of the Iran war on the energy market. Section 1.3 considers the outlook for inflation and Section 1.4 the challenges facing the Bank in setting monetary policy. Section 1.5 examines how real economic activity might evolve, focusing in turn on households, firms and international trade, and on the impact of a planned fiscal consolidation on demand. Section 1.6 discusses productivity, before Section 1.7 analyses the outlook for the labour market and perhaps the most important judgement that will feed into the Office for Budget Responsibility's fiscal forecast – the extent to which higher inflation might feed through into higher nominal wages. Section 1.8 summarises our baseline scenario, before Section 1.9 looks at how the economy might fare in alternative scenarios – were the conflict in the Middle East to last for longer, or the UK to enjoy an AI investment boom. Section 1.10 concludes.

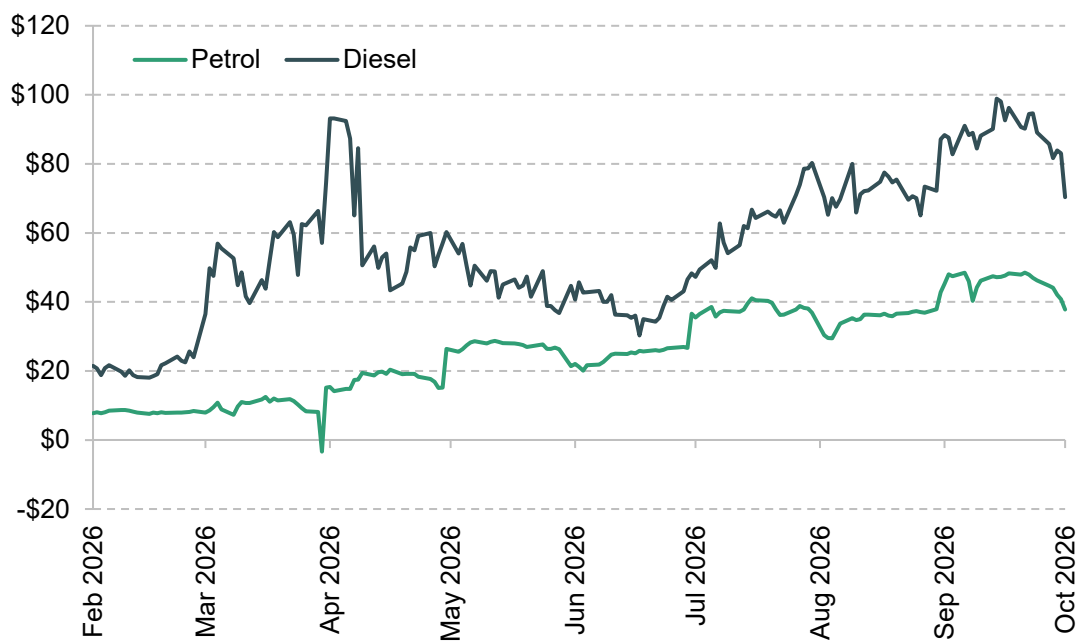
1.2 The UK and the Middle East shock

By far the most consequential global economic event since the last Green Budget is the conflict in the Middle East and the subsequent energy price shock that has reverberated around the world. As it runs through all aspects of the near-term outlook for the UK economy, we begin by outlining and contextualising what has actually happened.

Figure 1.1. Brent crude oil price (index)

Note: Price is indexed to price in August 2025. Start of the conflict refers to 24 February 2022 in the case of the Russia-Ukraine conflict and 28 February 2026 in the case of the Middle East conflict.

Source: Bloomberg; Barclays Research.

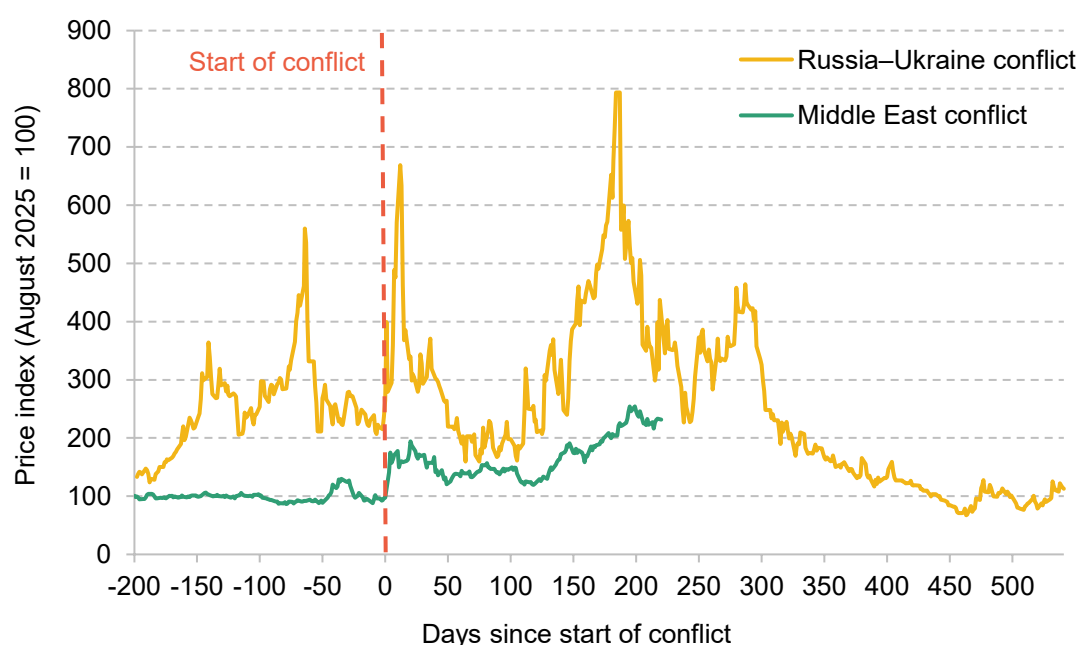
Figure 1.2. Crack spreads for European refined oil products (dollars per barrel)

Source: Bloomberg; Barclays Research.

The conflict in the Middle East has led to the partial closure of the Strait of Hormuz and more recently the Bab-al Mandeb Strait – two key channels for the oil trade.¹ As a result, the price of Brent crude oil has risen from around \$60 per barrel at the turn of the year, to around \$100 per barrel at the time of writing. As shown in Figure 1.1, the scale of this increase is akin to that seen around the time of the beginning of the Russia–Ukraine war in 2022.

Global petrol and diesel prices have risen due to the rising cost of crude oil as well as increases in the cost of refining oil. Figure 1.2 shows how ‘crack spreads’ for European petrol and diesel – a measure of the gap between the prices of these refined oil products and crude oil – have crept up over 2026. Both the Iran war and the Russia–Ukraine war have reduced available refining capacity and so pushed up the cost of refined products.

Figure 1.3. UK natural gas prices (one month forward)



Note: Price is indexed to price in August 2025. Start of the conflict refers to 24 February 2022 in the case of the Russia–Ukraine conflict and 28 February 2026 in the case of the Middle East conflict.

Source: Bloomberg; Barclays Research.

UK natural gas prices have also risen, from around 70 pence per therm before the conflict to around 185 pence now. As shown in Figure 1.3, the increase in wholesale natural gas prices has been much smaller than that seen around the 2022 Russia–Ukraine conflict. As highlighted by recent modelling, the gas price is disproportionately important for the outlook for UK inflation and growth, so the fact it has more than doubled this year is concerning (Barclays, 2026a).

¹ Exactly how partial this closure is remains a matter of debate, with imperfect data monitoring traffic in the conflict zone.

The future evolution of the situation in the Middle East will be very important for the UK economy in the near term. A rapid and lasting resolution to the conflict could bring with it falling inflation sooner than currently expected, which would in turn benefit growth and households, and falling bond yields which would reduce government debt servicing costs. On the other hand, as explored in Section 1.9, a more protracted conflict that kept energy prices elevated for longer could further hamper growth. Predicting how the geopolitics will play out is a near impossible task, introducing a genuine degree of uncertainty, in the radical sense of not being able to know, rather than just a quantifiable set of risks that may, with some rough probability, happen or not (Kay and King, 2020).

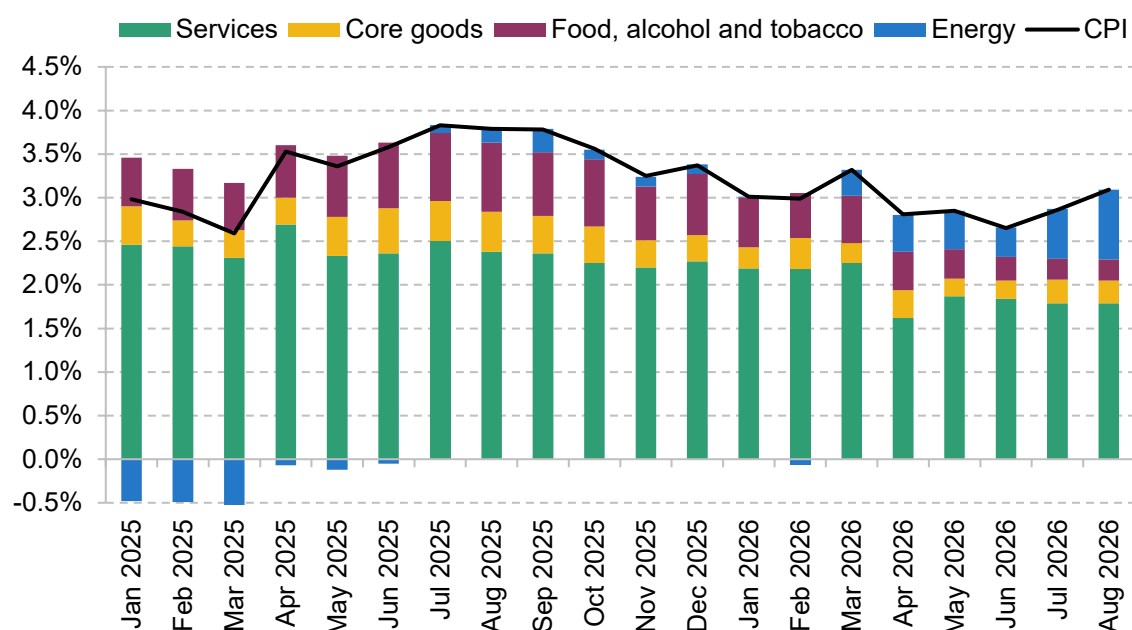
This is the backdrop to our baseline forecast and the scenarios presented below. This shock will both increase inflation and reduce the real size of the economy – the volume of goods and services actually produced. We first discuss the likely impacts on inflation and then discuss how it alters the outlook for the real economy.

1.3 Inflation will rise again. The key is for how long

The Iran war has already increased inflation and will likely continue to put upwards pressure on it in the rest of 2026 and into 2027. At the time of the last Green Budget, we had anticipated headline Consumer Prices Index (CPI) inflation being around 2% at this point, and broadly stable going forwards. As of August, CPI inflation was 3.1%. As shown in Figure 1.4, excluding the direct effect of energy prices (both household energy and petrol, shown together in blue), CPI inflation would have been only 2.3%.

The nature of the Ofgem energy price cap means elevated wholesale energy prices pass through to household energy prices with some delay. The cap increased by 4% this month, but market pricing of gas and electricity at the time of our forecast implies a much more substantial increase in the price cap of 20% in January, which will add considerably to UK inflation at the beginning of next year. The extent of volatility in energy prices in recent months means this judgement, while crucial, is highly uncertain. On top of this, forecasts of the cap require an assumption on what will happen to non-wholesale costs (other things Ofgem layers in on top of the raw energy cost). This means published estimates of the Ofgem cap in Q1 2027 have been swinging in a range of 10% to 25% in the last few weeks, depending on exactly when market prices were sampled and what is assumed on non-wholesale costs.

Figure 1.4. Decomposition of annual CPI inflation (% year on year)



Source: Office for National Statistics; Barclays Research.

One key question for the inflation outlook is how persistent this shock to energy prices is. The energy price curves we condition our baseline forecast on (see Appendix 1A) imply market participants expect gas and oil prices will begin to fall from Q1 2027 onwards, as the conflict subsides and the energy supply outlook recovers, suggesting the direct energy price shock might be relatively short-lived.

We also assume the gap between the prices of refined oil products and crude oil (the ‘crack spreads’ shown in Figure 1.2) will not grow from their current elevated levels, consistent with futures market pricing for refined oil products. There remain risks around refined oil products, with the supply of them seriously constrained by the Middle East conflict. Risks also remain that the conflict may not be resolved in coming months. We explore the potential consequences of a more prolonged period of elevated energy prices in Section 1.9.

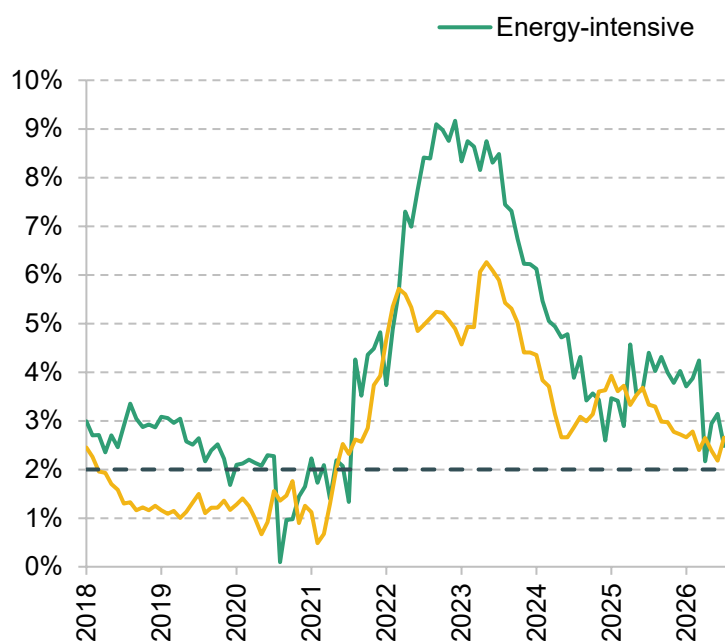
These increases in gas, electricity, petrol and diesel prices are the direct impact of the energy price shock. The second key question for the inflation outlook is whether rising energy prices will lead to broader increases in prices for other goods and services.

One potential channel for the energy price shock leading to broader inflation is through rising input costs for non-energy products. These are often termed indirect energy effects. However, so far we see little evidence of this. As shown in Figure 1.5, a measure of energy-intensive core inflation (which strips out direct energy bills, pump prices and also volatile food, alcohol and tobacco, but focuses on the goods and services where energy is a key input) remains around 2%.

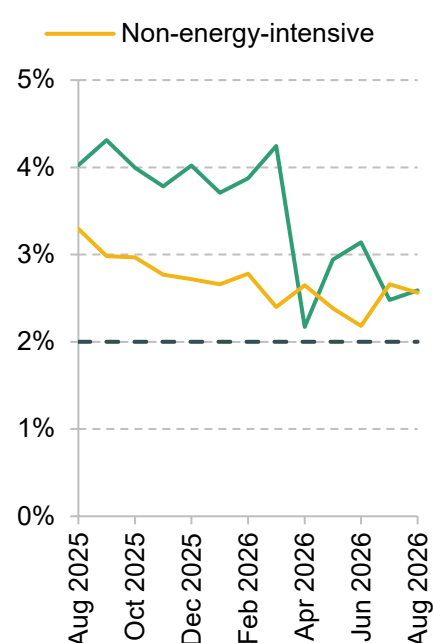
These are the goods and services where we would first expect to see any spillovers occurring from changes in direct energy costs. This effect is likely to build over time, and we expect a mild acceleration in the coming months but, eight months into the energy shock, we find it reassuring that there are still few signs of pressure in these groups.

Figure 1.5. Energy-intensive and non-energy-intensive core CPI inflation (% year on year)

Panel A. Since 2018



Panel B. Over the past 12 months



Note: Horizontal dashed line shows 2% inflation target. Scale of vertical axis differs between panels.

Source: Barclays Research.

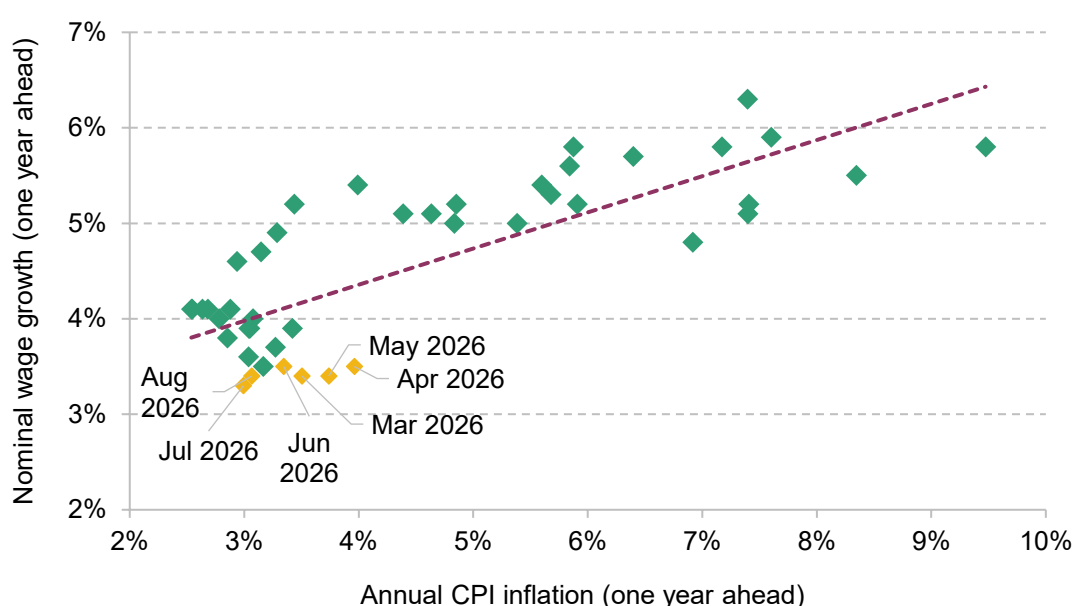
Another potential route from the energy price shock to broad inflation is through the labour market. Workers might respond to the increase in prices they face by demanding higher wages to compensate, and firms might finance these higher wages through raising their own prices. This mechanism – often termed second-round effects or, at the extreme, a ‘wage–price spiral’ – could transmit the energy price shock out into the broader economy. However, our view is that this is unlikely to happen in a meaningful way in this instance due to the relatively weak demand for labour in the economy currently, as we discuss in Section 1.7. This weak demand relative to the supply of workers looking for jobs means workers have less bargaining power in wage negotiations.

This point is illustrated by Figure 1.6, which shows the historical relationship between firms’ expectations of wages and of inflation, and how this has broken down since the conflict in the Middle East began. Since March, wage expectations have been insensitive, even as inflation

expectations have moved. Because of these conditions, in our baseline scenario we expect limited scope for pressures from the labour market to push up inflation more broadly.

Reassuringly, we do not see any evidence of the energy price shock passing on to non-energy-related goods and services yet. When we look at more granular data on prices in the UK, we can see little evidence of the energy shock spilling over more broadly. The Bank of England, for instance, has a measure of ‘sticky-central’ inflation that gives more prominence to parts of the consumer price basket that are associated with more persistent inflation. As with our own metric on energy-sensitive core inflation, this is currently at benign levels (Pill, 2026).

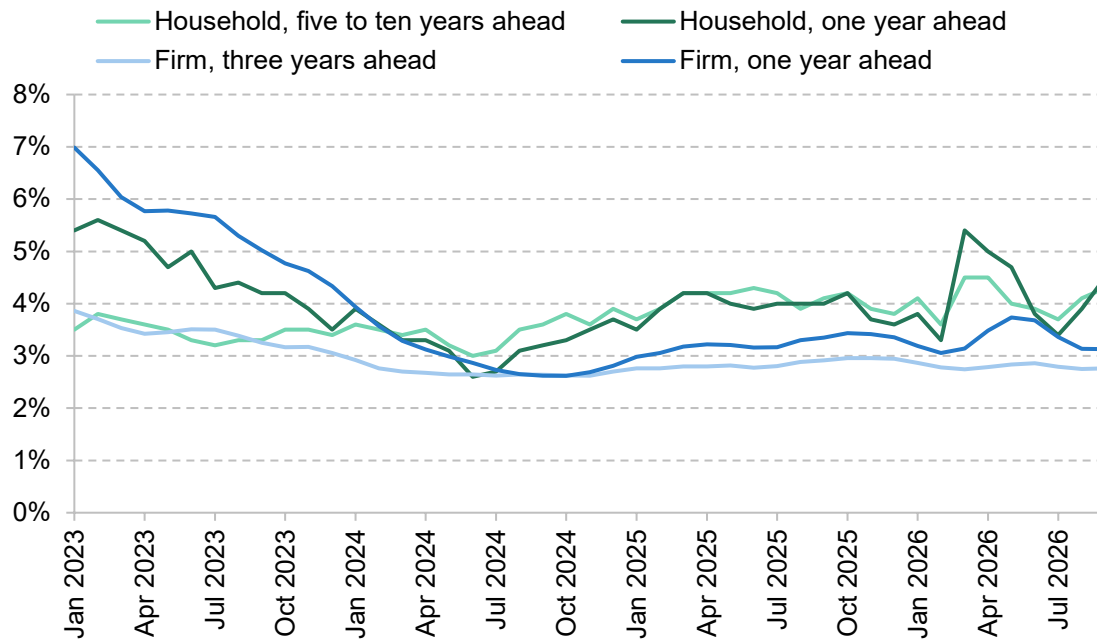
Figure 1.6. UK firms’ expectations of CPI inflation one year ahead and nominal wage growth



Note: Green markers show months from May 2025 to February 2026. Dashed line shows linear relationship over the whole period.

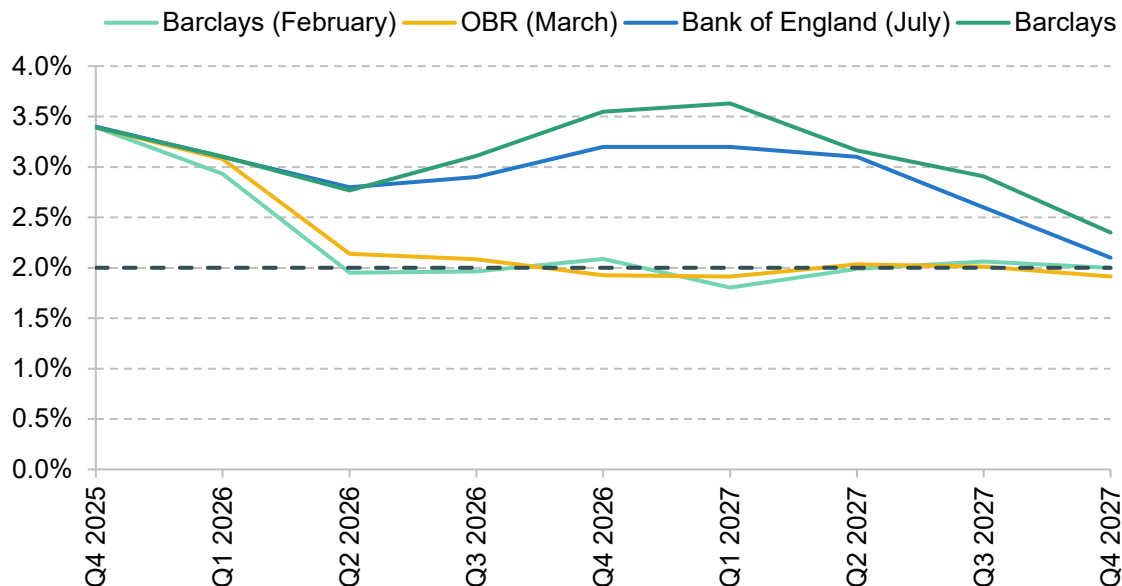
Source: Bank of England; Barclays Research.

Inflation expectations also look to be relatively contained so far. Figure 1.7 shows firm and household expectations of inflation over time. We have seen measures of household inflation expectations tick up, but short-term expectations (for inflation over the next 12 months) remain far below where they were in 2022. The increases in measures of firms’ expectations have been much more muted, and remain well anchored, especially over longer horizons. This provides further support for the view that the period of higher inflation resulting from the energy price shock is likely to be short-lived.

Figure 1.7. UK inflation expectations (% year on year)

Note: Household expectations are from Citi/YouGov data. Firm expectations are from DMP survey.

Source: Citi/YouGov; Bank of England Decision Maker Panel (DMP); Barclays Research.

Figure 1.8. Forecasts for annual CPI inflation (% year on year)

Note: Horizontal dashed line shows 2% inflation target.

Source: Office for Budget Responsibility's Economic and fiscal outlook March 2026; Bank of England's Monetary policy report July 2026; Barclays Research.

One further risk to the inflation outlook comes from food prices. These have been growing slowly in recent months, and many indicators of price pressures early in the supply chain remain benign. However, we expect there to be a pickup in the coming months as weak base effects that have been lowering the annual rate fall out of the growth rate calculation. This could be intensified by the erratic weather conditions already this year, which are likely to have affected coming harvests, and by the impact of the El Niño phenomenon – a natural climate pattern affecting large parts of the world – which is likely to cause further disruption over the next six months.

Monetary policy is also acting to reduce the persistence of the inflation shock. As we discuss in the next section, the current level of interest rates is restrictive, meaning it is weighing on the economy and reducing inflation. A further tightening of monetary policy in the coming months should act to slow inflation next year, though it will also push down on economic growth in the short term and increase the costs of government borrowing.

Taking all this together, we now expect headline CPI inflation to average 3.1% in 2026 and 3.0% in 2027, before normalising to 2% in 2028 as the spare capacity in the economy is absorbed and supply and demand become more balanced, stabilising price growth. Figure 1.8 compares our latest forecast for CPI with the Bank of England's latest forecast, made in July, the Office for Budget Responsibility's from March and our forecasts made in February before the Middle East conflict began. Our current forecast is in line with the Bank's latest forecast but is much higher in the near term than the OBR's forecast in March, when it expected CPI to average 2.3% in 2026 and 2.0% thereafter.

1.4 Monetary policy

This Budget comes at a crucial and difficult time for monetary policymakers at the Bank of England and around the world. Prior to the conflict in the Middle East, the Bank of England had been expected to cut its main interest rate by almost half a percentage point over the course of 2026. This was derailed by the conflict, which has increased inflation and put pressure on central banks around the world to tighten monetary policy.

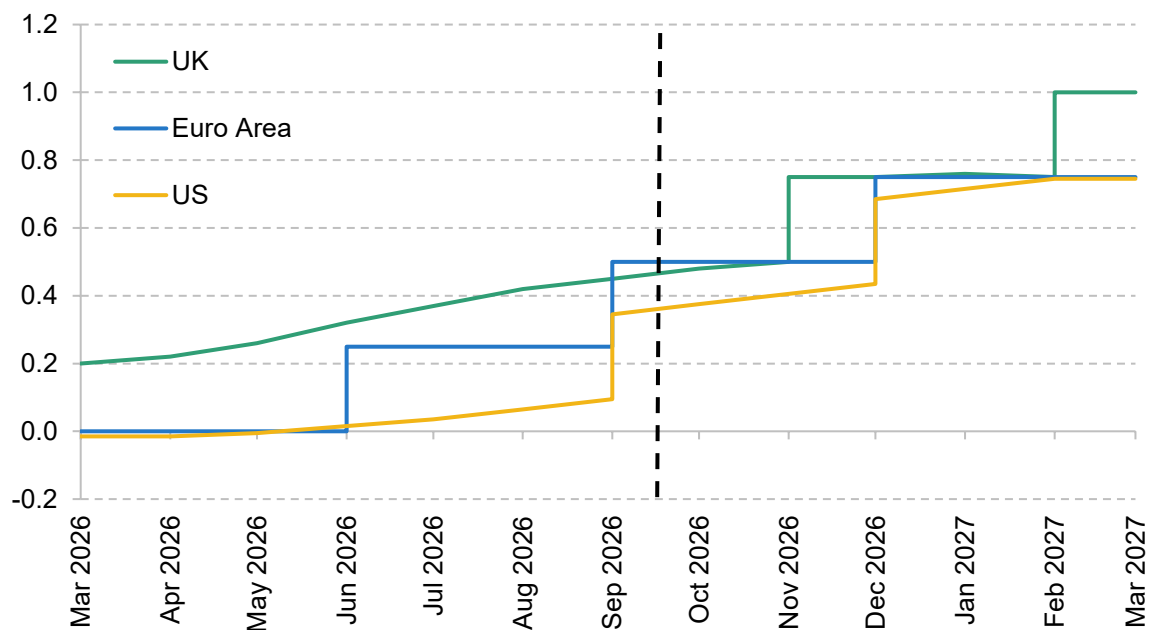
In response to this, the Bank of England has so far decided to keep Bank Rate at 3.75% – the same level at which it started the year. This represents a tightening of monetary policy relative to prior market expectations that the Bank would cut Bank Rate. Other central banks, most notably the Federal Reserve in the United States and the European Central Bank, have raised their policy rates, but they had different expected stances going into the shock, reflecting that their economies started from different positions. As shown in Figure 1.9, the amount that the Bank of England has changed course in response to the energy price shock is aligned with other central

banks' changes, which have also set policy rates that are currently around half a percentage point higher than was expected at the end of February.

We estimate the neutral interest rate – the Bank Rate that neither slows nor stimulates the economy – is between 3% and 3.5%. In our assessment, holding Bank Rate at 3.75% is therefore restrictive, weighing on demand in the economy and ultimately prices. This is another point of difference with, say, the European Central Bank, which entered the energy price shock with its policy rate at a broadly neutral setting. The question facing the Bank of England now is: 'Is this level of restriction enough, or should it increase Bank Rate from here?'.

We do expect the Monetary Policy Committee (MPC) at the Bank of England to raise Bank Rate to 4.25% by next February. Figure 1.10 shows our baseline forecast for interest rate changes compared with market expectations for interest rates taken at different times. Our baseline forecast includes two rises in the coming months, with the first increase likely to come as soon as November, just one week after the Budget.

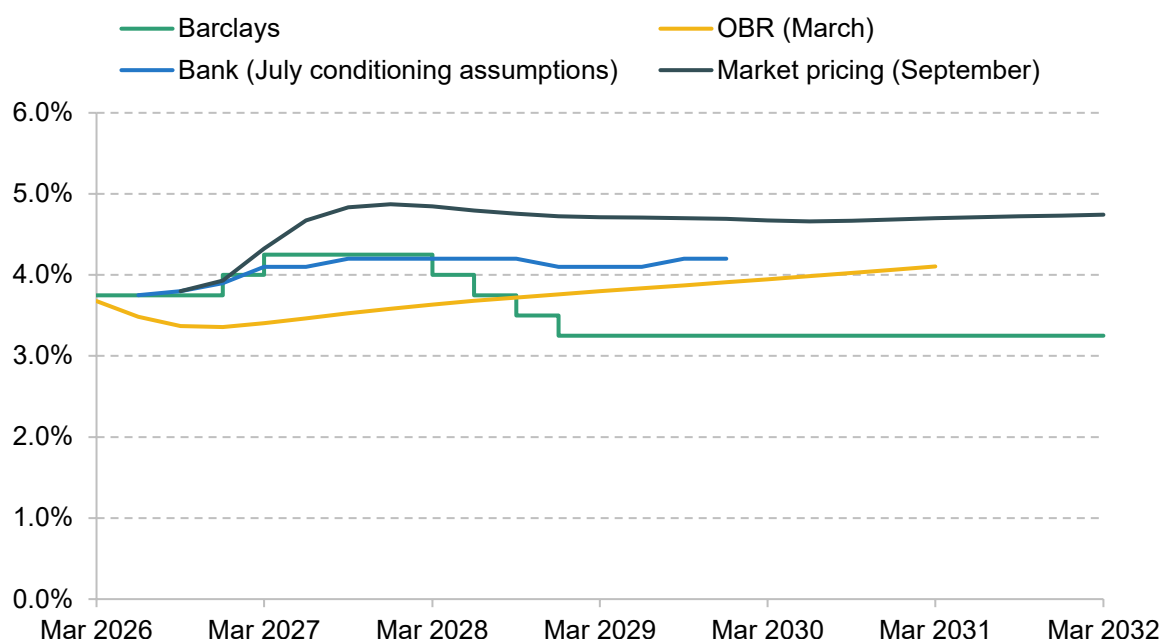
Figure 1.9. Changes in central bank policy rates compared with market expectations at the end of February (percentage points)



Note: Left of the dashed black line compares out-turns with expectations as of February 2026, and right of the dashed black line compares latest expectations as of September 2026 with expectations as of February 2026.

Source: Bloomberg; Barclays Research.

Figure 1.10. Expectations for path of Bank Rate



Source: Office for Budget Responsibility's Economic and fiscal outlook March 2026; Bank of England's Monetary policy report July 2026; Bloomberg; Barclays Research.

This is a more muted cycle of interest rate increases than financial markets are seemingly expecting, with market contracts pricing that the Bank will increase Bank Rate more materially, by 1 percentage point over the next 12 months. This matters, as it is the market's expectation for the path of Bank Rate that will be reflected in the OBR's forecast. At the time of the last OBR forecast, markets had expected the Bank of England to cut Bank Rate to around 3.25% by the end of 2026 and to keep it there, so the new OBR forecast is likely to reflect an expected swing of 1.5 percentage points.

So, why might our views differ? As we discuss in the next section, we assess there is slack in the economy – meaning the economy is smaller than the size it could sustain without generating excessive inflation. The MPC will be balancing this against the risk that the near-term inflation spike becomes embedded in expectations and spills over into more persistent inflation. As we discuss in Section 1.3, we think the evidence of such spillover so far is limited. The fact that expectations for future inflation remain reasonably well anchored at the 2% target makes the Bank of England's job easier. It will make the Bank more able to look through a temporary, near-term spike in inflation, without fearing that it will translate into a loss of credibility or more persistent inflation. This would mean it does not need to raise interest rates as much as it otherwise might in order to bring inflation back to its 2% target.

Of course, the longer the conflict in the Middle East continues, the larger the risk becomes that households' and businesses' inflation expectations are de-anchored from the 2% target and the larger the risk that the direct energy shock bleeds more widely into persistent prices.

While a number of members of the Bank of England's MPC believe these risks are enough to motivate them to increase policy rates, we do not judge that the energy price shock – at least, one of the scale and duration currently expected by energy markets – will warrant a more material increase in Bank Rate than these two quarter-point hikes.² As shown by stylised and simplified rules that mimic how policymakers think about setting interest rates in response to the economy, a policymaker who is forward-looking would not respond with higher Bank Rate if they were certain that the energy shock followed the price embedded in markets and that there would be limited second-round effects. Monetary policy can do little to influence price increases in the next three to six months, especially when they are driven by global supply-side shocks; by the time we get to the first half of 2028, inflation in our baseline scenario is projected to be just 0.2 percentage points above the Bank of England's 2% target. If we were to instead assume that there was a more severe tightening of monetary policy from the Bank, it would do little to reduce the inflation peak in Q1 2027, but it would slow growth and raise the unemployment rate.

Beyond the near term, we expect the MPC to bring rates back to a neutral setting over the course of 2028, settling at 3.25% in the medium term. This compares with an expectation in market pricing that Bank Rate will stay above 4% over the OBR's entire forecast horizon.

The MPC has also made a judgement about its quantitative tightening programme and the steady-state treatment of government bonds on its balance sheet. We expand on this in Chapter 3 of this Green Budget as, although it has limited direct implications for growth, it will impact the public finances.

1.5 GDP and activity

As well as leading to an inflation spike, and to revised expectations of Bank Rate, the Iran war has worsened the outlook for economic growth. We now turn to that.

Real GDP growth has been resilient so far this year ...

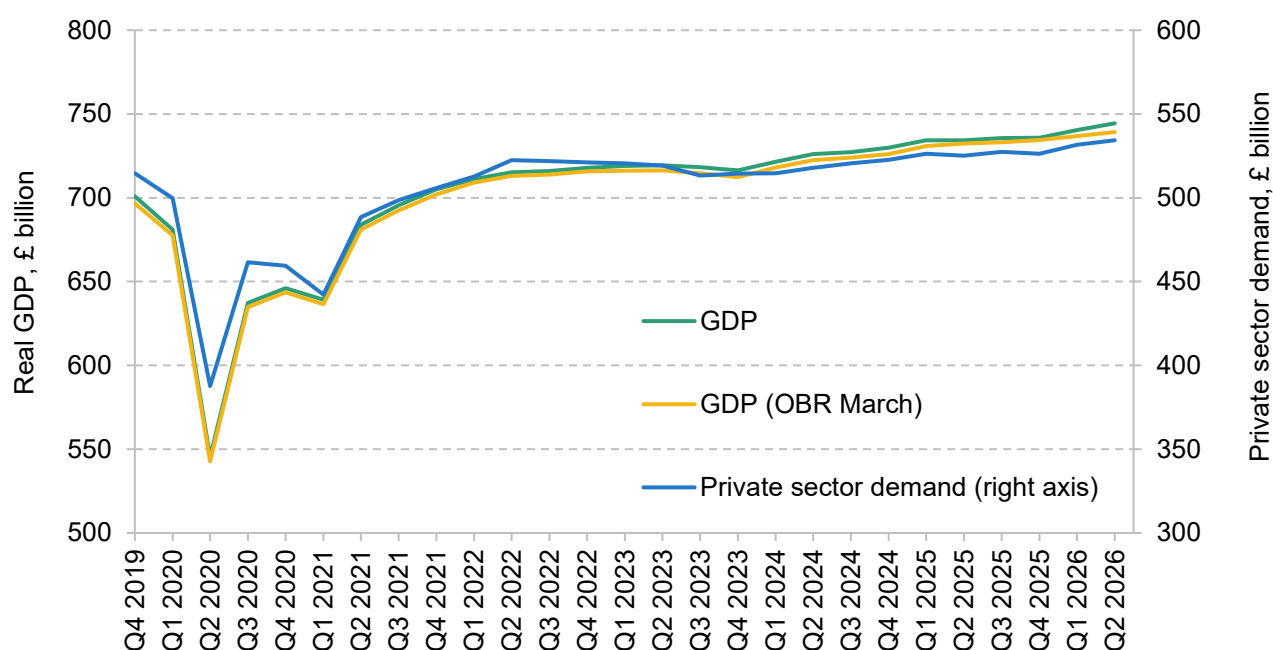
The UK economy has grown in real terms by 1.2% in the first half of 2026, and an additional 0.4% in July alone, according to current ONS data. This is higher than the 0.7% that was expected by the OBR at the time of its March forecast and, when coupled with revisions to the

² See Appendix 1A for details of our conditioning assumptions on energy prices.

historical data, means that the economy is both 0.7% bigger than had been expected and carrying more momentum into the second half of the year.

In further positive news, the required handover from public-sector- to private-sector-led growth, which we had emphasised as fundamental in last year's Green Budget in light of the planned fiscal consolidation, has occurred. Overall, private domestic demand (from household consumption and business investment) has increased by 1.5% in the first half of the year, showing a resilient picture so far, while public demand has grown by 0.5%.

Figure 1.11. Forecasts for real GDP and real private sector demand since Q4 2023



Source: Office for Budget Responsibility's Economic and fiscal outlook March 2026; Office for National Statistics; Barclays Research.

Growth has been driven by strong private consumption in the first quarter of the year, which expanded by 0.6% quarter on quarter. Although this slowed to 0.3% in the second quarter of the year, business investment grew 1.8%, helping to offset the slowing of private consumption. The increase in business investment was attributed in particular to hardware in information and communication sectors, likely linked to increased investment in AI-related infrastructure. Sectorally, services continue to be the main driver of economic activity in the UK, expanding 1.3% in the first half of the year, while industrial production contracted 0.3%.

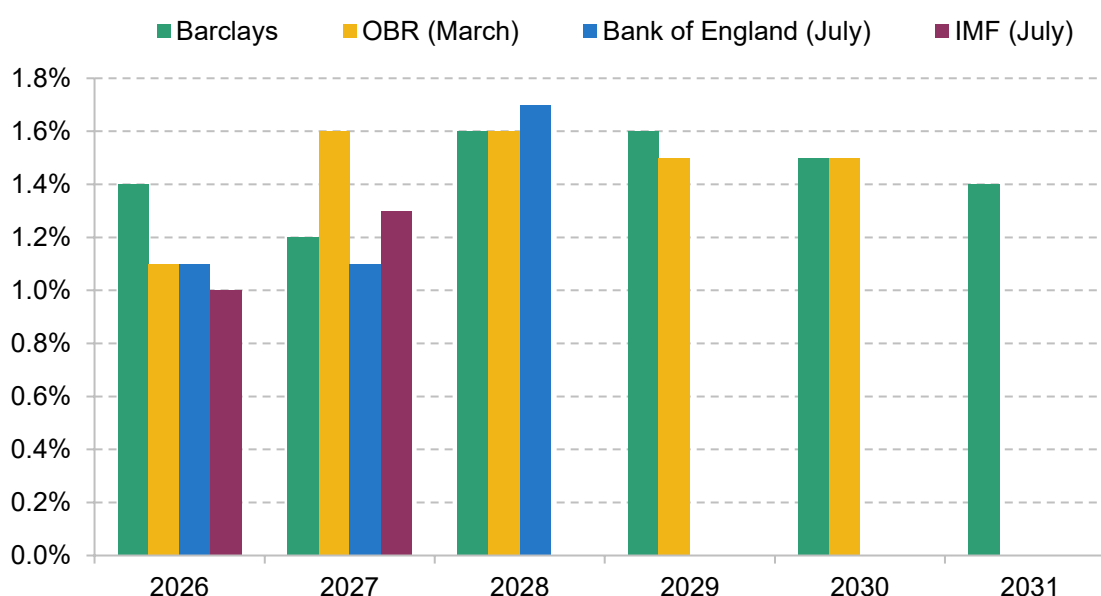
One concern is that some of the apparent strength in growth in the first half of the year may reflect measurement issues rather than genuine improvements in economic conditions. There has been a predictable pattern in recent years of stronger measured growth in the first half of the year that then fades in the second half. We judge that this effect has been lessening with time as the

Office for National Statistics updates its estimates, and so more of the growth we have seen has been reflective of a genuine expansion than in previous years.

... but likely to slow in coming quarters

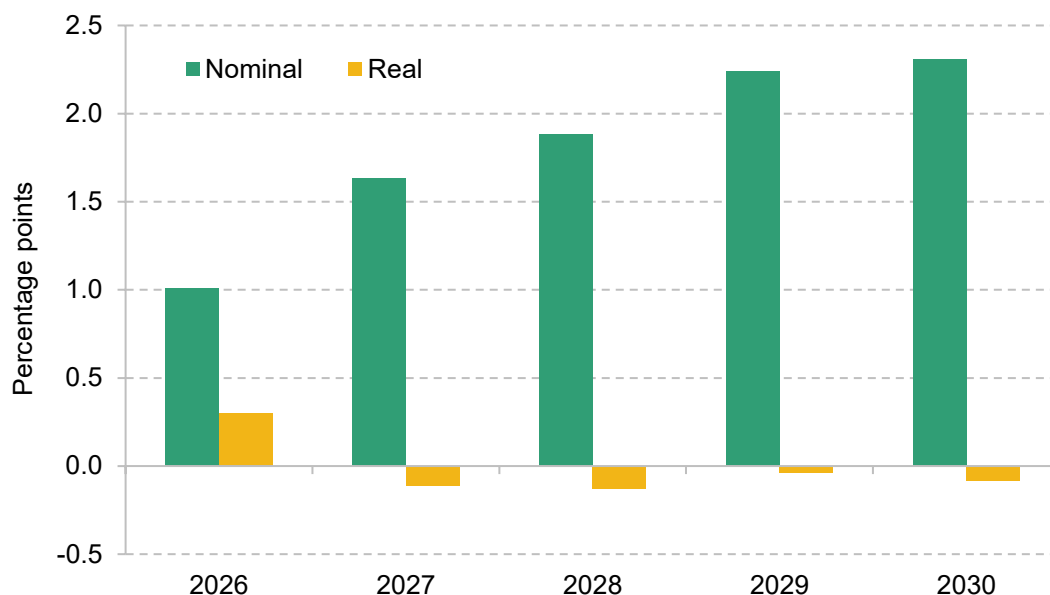
Looking ahead, growth is likely to slow in 2027. We expect real-terms annual growth in GDP to fall from 1.4% in 2026 to 1.2% in 2027 (Figure 1.12). The terms-of-trade shock emanating from the Middle East – where higher energy prices make countries that are reliant on energy imports, such as the UK, poorer – has not yet manifested in a meaningful way. Price rises, and their associated negative impacts, are only just starting to feed through, but next year we expect higher prices and the higher interest rates that have come alongside them to slow economic growth.

Figure 1.12. Forecasts for annual growth in real GDP (% year on year)



Source: Office for Budget Responsibility's Economic and fiscal outlook March 2026; Bank of England's Monetary policy report July 2026; International Monetary Fund's World economic outlook update July 2026; Barclays Research.

Our modelling suggests that, under our baseline assumptions for energy prices, the level of real GDP in the UK will be around 0.8% lower at the end of 2027 than it would have been in the absence of the conflict. In the medium term, growth will pick up to 1.5% annually in 2030 and 1.4% in 2031. Partly due to the Iran war shock, we expect real GDP to grow by 0.1 percentage points less between 2025 and 2030 than the OBR forecast in March (Figure 1.13).

Figure 1.13. Difference in forecast levels of GDP between Barclays baseline and OBR March 2026

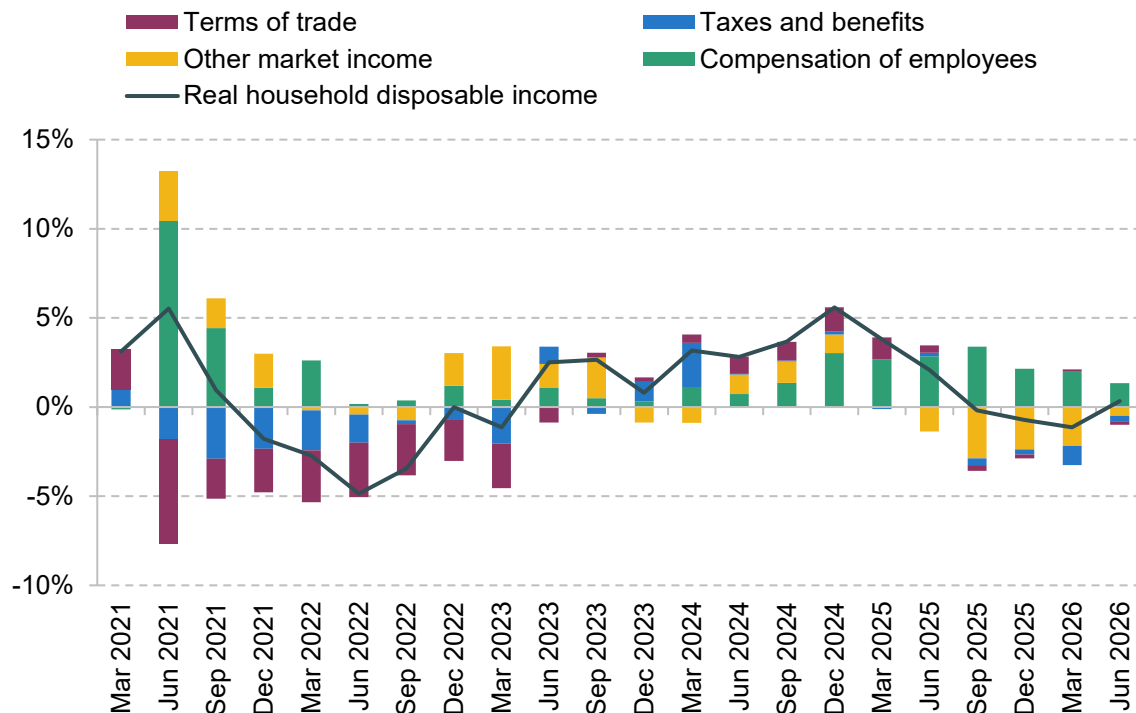
Source: Barclays Research.

Despite our forecasts implying slower real-terms growth in GDP than the OBR's forecast in March, we forecast higher levels of cash-terms GDP growth due to higher inflation. We expect nominal GDP to grow by 2.3 percentage points more between 2025 and 2030 than the OBR projected in March (Figure 1.13).

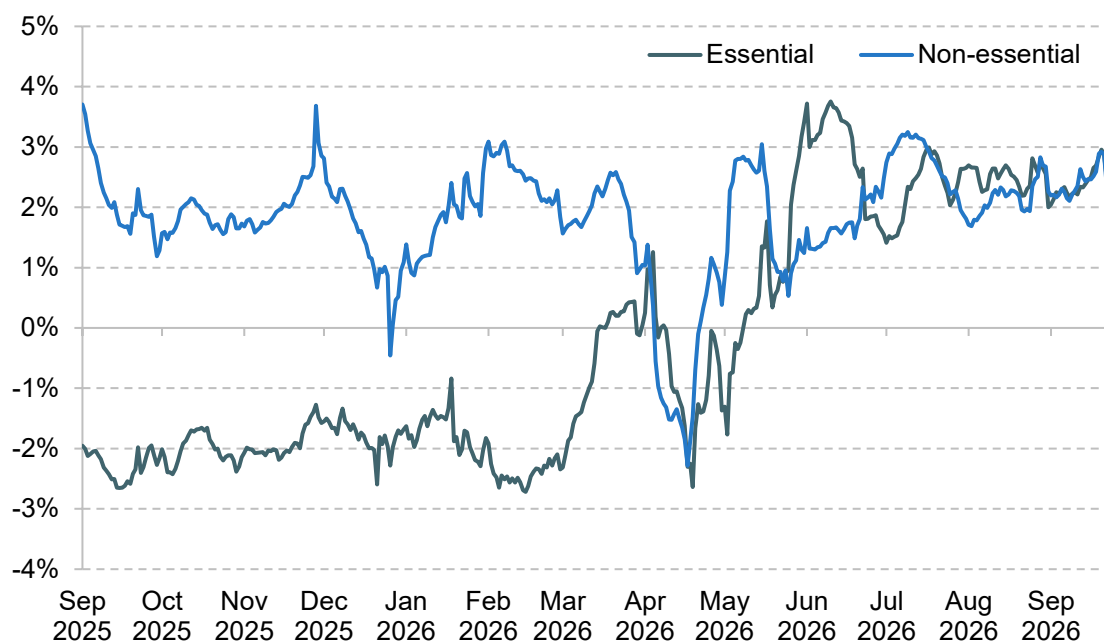
This is crucial for the fiscal outlook, as most taxes are levied on nominal quantities, such as prices and profits. As discussed in Chapter 4, higher inflation can therefore feed through into greater tax revenues.

Households to face a real income squeeze

Real disposable incomes of UK households fell on an annual basis in the second half of 2025 and only just began to stabilise in Q2 2026. Figure 1.14 shows how different income sources have contributed to the real household disposable income growth over time. The biggest shift, a negative contribution from other market income, has been the result of: falling rates on deposits and savings unwinding part of the windfall that savers had enjoyed during the period of high rates, reducing net interest income; and weaker dividend and property income growth. While incomes were growing in real terms from 2022 to the middle of 2025, higher inflation has led to falls in real disposable income since then. Figure 1.14 also highlights how the current terms-of-trade shock has not yet taken effect, but is likely to build, following the pattern of 2022 but to a lesser extent.

Figure 1.14. Changes in real household disposable income each quarter (% year on year)

Source: Office for National Statistics; Barclays Research.

Figure 1.15. Changes in essential and non-essential consumer card spending, from Barclays SpendTrends (% year on year)

Note: Essential spending includes spending on childcare, healthcare, insurance, grocery, fuel and public transport. Based on Barclays debit card and Barclaycard credit card transactions in the UK.

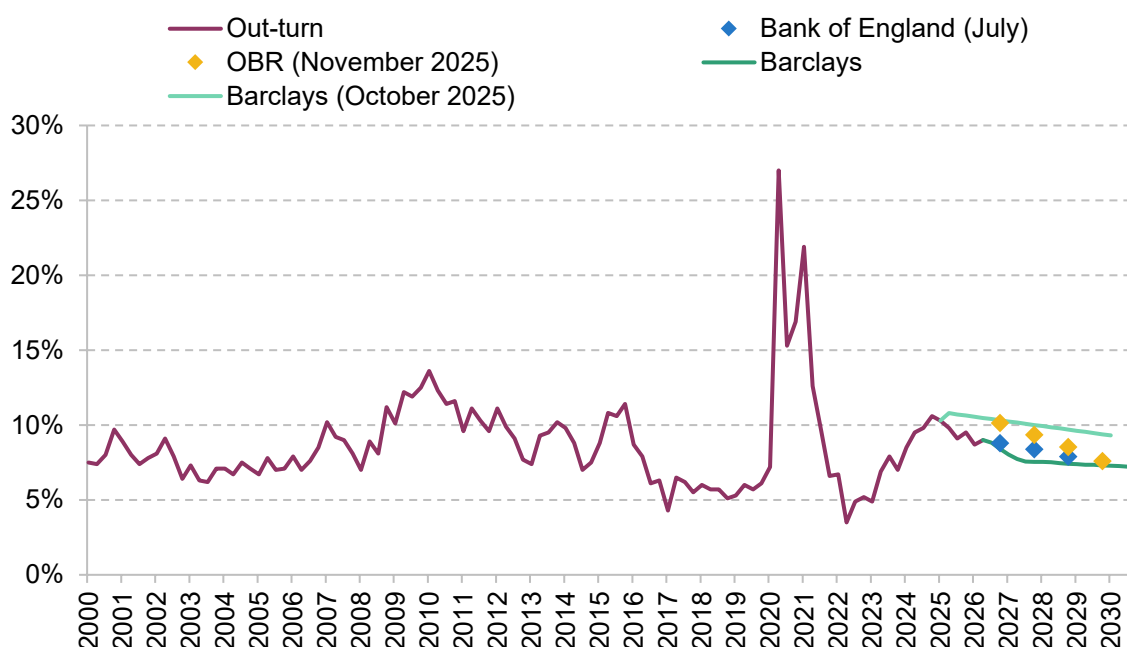
Source: Barclays SpendTrends data.

Whereas in the last Green Budget we had expected a normalisation of inflation and a pickup in economic growth to buoy household spending power, we now expect the inflationary shock from the Middle East to weigh on them further, keeping it falling in 2027.

Despite this, we expect households to continue to spend, and private consumption to grow by 0.4% in real terms in the second half of 2026. Consumer confidence metrics have remained resilient since the Middle East conflict began and Barclays SpendTrends data, which analyse information from roughly 40% of card spending in the UK, suggest UK consumers continue to prioritise spending on sectors they see as important, while looking to economise overall (Figure 1.15).

The corollary of consumption growth alongside falling real incomes is that we expect to see a larger fall in the saving rate than we had previously forecast. The saving rate is the share of annual income that households do not consume. So far in 2026, we have seen the household saving rate fall from 9.5% to 9.0% (as shown in Figure 1.16). This is faster than we had expected at the time of the last Green Budget, and faster than had been expected by the OBR in its March forecast. We explored what such a scenario would mean for economic growth this time last year (Meaning, 2025), although in the event, rather than boosting growth, the savings drawdown is being used to offset a negative shock and allow households to try to smooth through the pending real income squeeze.

Figure 1.16. Household saving rate: out-turn and forecasts



Note: Markers show annual forecasts. Barclays (October 2025) forecasts are from Meaning (2025).

Source: Office for Budget Responsibility's Economic and fiscal outlook November 2025; Bank of England's Monetary policy report July 2026; Barclays Research.

We saw a similar pattern in 2022 and 2023 when the Russia–Ukraine war started and inflicted a (larger) terms-of-trade shock on the UK. The main difference now compared with then is the extent of excess savings held by UK households. After the pandemic, households had built up significant savings balances they were able to run down. Now, having already used savings to absorb the last cost-of-living shock, aggregate savings are below what various metrics would imply would be the equilibrium level sought by households, and so the scope to run these down further is reduced. Households’ net financial wealth to income ratio has stabilised in recent quarters, at 8.6, having fallen from 15 in late 2020 to 8.5 in early 2025. However, it remains low compared with historical averages and will also limit the scope for households to unwind savings on a more prolonged basis as they try to repair this imbalance and restore previous levels of financial wealth.

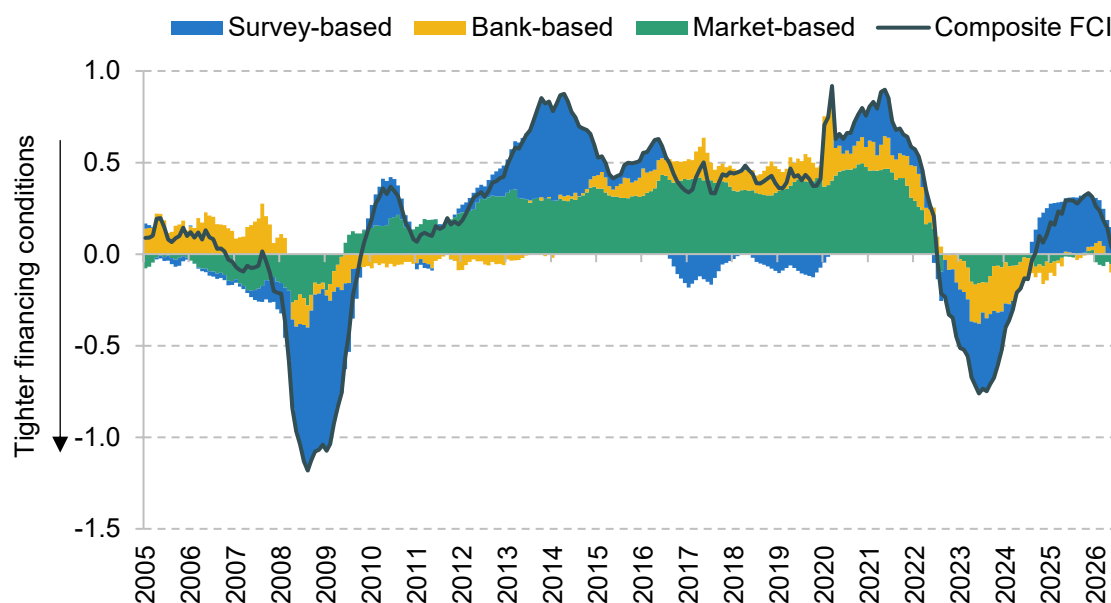
In the medium term, our forecast reflects an expectation that the saving rate reaches 7.5% in 2028 and then stabilises. From 2028 onwards, consumption is driven by real disposable income growth of 0.6% per year as inflation comes back to the 2% target, outstripped by nominal earnings growth stabilising.

There have been positive signs for business investment

Following a weak performance in 2025, business investment accelerated in 2026, expanding 3.0% in the first quarter and 1.8% in the second. Within this, there has been particular strength in investment in ICT and other sectors associated with the global AI boom. This is a trend that, although nascent in the UK, we have seen play out at scale in the United States, where AI-adjacent investment has added more than 4% to the level of GDP over the last 18 months. Were it to continue, this pattern could make a material contribution to UK growth in the coming years (something we explore in Section 1.9), raising the level of real GDP by more than 2% by 2030 compared with our baseline forecast.

However, we think in practice there remain headwinds that will weigh against this. The first is tighter financial conditions partly due to higher central bank policy rates. As shown in Figure 1.17, financing conditions for firms are now back to the levels of tightness last seen in mid 2024, raising the hurdle rate for investment – the minimum rate of return required to make an investment viable. The second factor is elevated levels of economic and policy uncertainty globally and domestically. UK firms responding to the Barclays Prosperity Index survey asked for more certainty, particularly in the policy outlook. That said, the same survey suggests 56% of businesses plan to increase investment in the next 12 months. How the Chancellor handles the Budget will be a crucial piece in the puzzle unlocking this investment. Respondents to the latest Barclays survey, released last week, say eight out of ten firms plan to increase their investment *if* the Budget delivers increased certainty.

Figure 1.17. Barclays UK financing conditions index (FCI)



Source: Barclays Research.

In the medium term, we see investment (gross fixed capital formation) rising from 20% of GDP to closer to 22% of GDP. This goes some way to improving the UK's capital to output ratio, lifting it from 2.01 to 2.04. It would still leave the UK behind many of its international peers, with the US and Germany holding capital around 2.5 times their GDP, France around 3 times GDP and Japan around 3.5 times GDP. Some of these differences will be due to the different industrial composition of the UK's economy relative to comparator countries, as discussed in Chapter 2.

The global economy and current account

Alongside household consumption and business investment, net exports – the difference between the UK's exports and imports – are another contributor to demand in the economy.

Global growth has remained resilient so far in 2026, especially considering that we are still experiencing the drag from higher global tariffs and absorbing the new shock from the Middle East. Despite these significant headwinds, we expect the global economy to expand by 3.3% in real terms in 2026, just 0.2 percentage point less than it did in 2025. We expect to see regional differences, with growth in the US remaining strong in the near term, spurred by a continuing AI investment cycle, Europe slowing and seeing significant divergence among members, and Chinese growth slowing, albeit from higher rates.

Global trade uncertainty has reduced significantly since last year, but remains elevated compared with a longer view of history, and while we have seen global supply chain pressures re-emerge,

they are still far short of the levels seen in 2022. This resilient global backdrop is expected to support UK exports. Having widened in the final quarter of 2025, the UK's current account deficit – the difference between what we earn from the rest of the world and what we pay abroad – has narrowed so far in 2026, to £19.9 billion, or 2.5% of GDP. We expect it to stay stable around these levels over the next year or so before falling back to around 2% of GDP in the medium term, helped by positive trade balances (exports exceeding imports) and reduced government borrowing. Key for the outlook will be the extent to which government policies are able to incentivise foreign direct investment, which has remained muted since 2016.

Fiscal policy

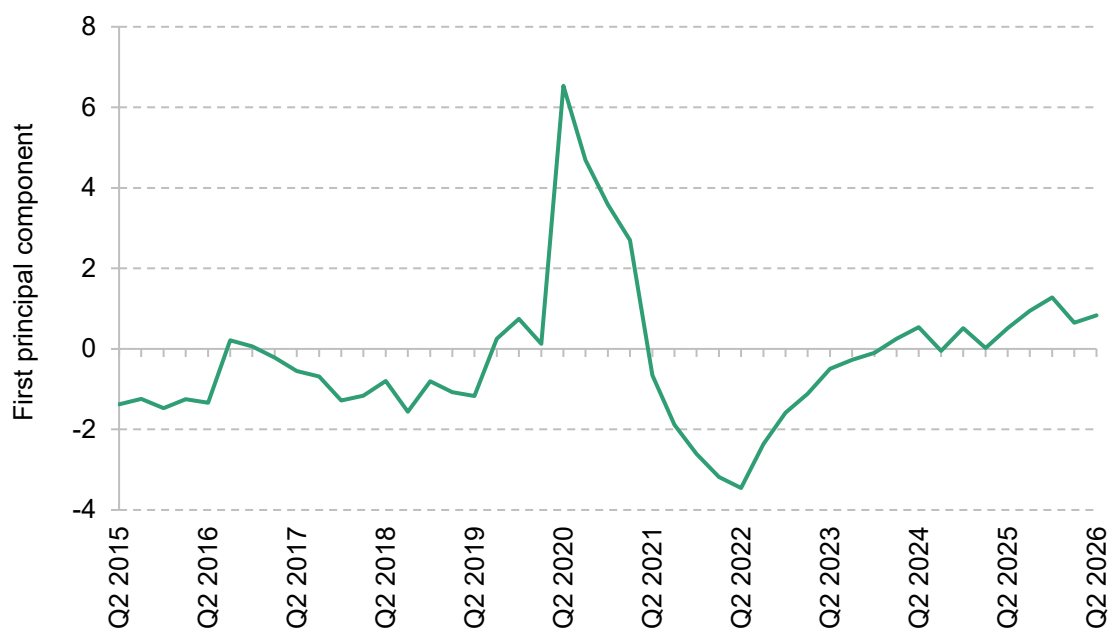
Government spending is an important component of demand in the economy. We expect to see reduced growth in total demand coming from this channel in the coming years, if the Chancellor sticks to plans to consolidate the public finances and reduce borrowing.

Our baseline forecast includes already-announced policies, rather than assumptions about what will be announced in the Budget. For the variant that underpins the fiscal estimates made in Chapter 2, we also strip out policies announced since the last fiscal event – such as the cost-of-living measures announced over the summer – to more cleanly approximate the process undertaken by the OBR in producing its pre-measures forecast.

The latest in-year data show that government has borrowed £77.3 billion so far this financial year (from April to August 2026), roughly £8 billion above the OBR's expectation in its March forecast for borrowing up to this point (Office for National Statistics, 2026c). The current budget deficit – the difference between day-to-day spending and revenues — was £51.9 billion over the same period, and £4.8 billion larger than the OBR had forecast. These misses are small in the scheme of large fiscal numbers though and do not change the overall fiscal narrative from March.

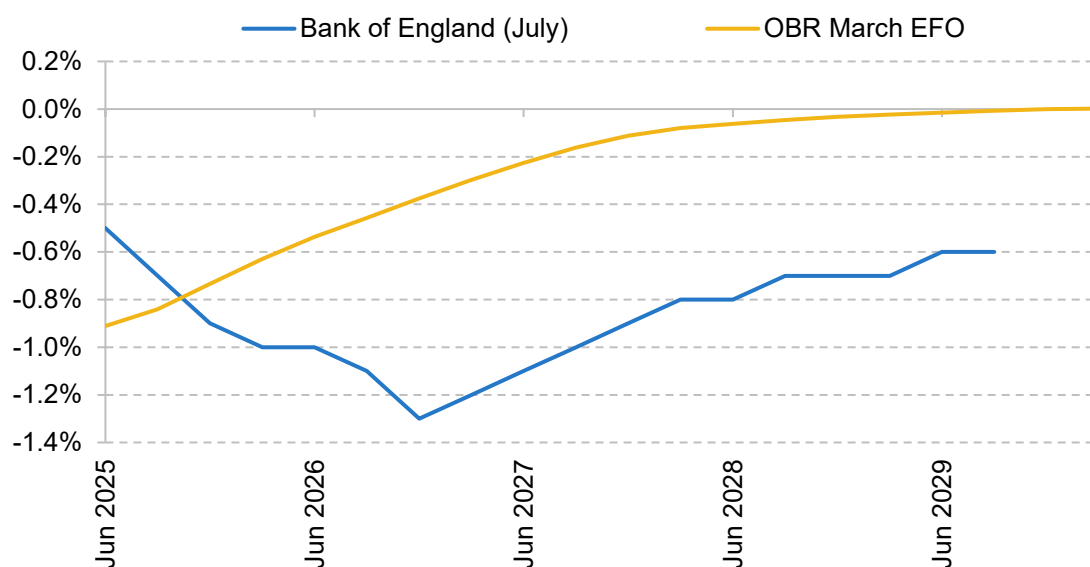
Based on the spending plans as laid out at the Spending Review last year, we expect a fiscal consolidation, with the cyclically adjusted primary balance – a measure of the fiscal stance – falling every year of this forecast, from a deficit of 1.1% of GDP in 2025–26, to a surplus by 2028–29, and a surplus of 0.1% in 2030–31. This means fiscal policy will be acting as a drag on aggregate demand and hence economic growth throughout the forecast horizon. Chapter 2 provides a detailed discussion of how changing economic conditions might impact the public finances.

A key element of our baseline forecast is that we have not assumed an increase in nominal departmental spending plans in line with the upwards revision to inflation. This means that the same spending profiles imply slower real-terms growth in departmental spending, a point investigated more in Chapter 6.

Figure 1.18. Measures of capacity utilisation and the output gap**Panel A. Capacity utilisation measure**

Note: We take the first principal component of the following survey measures of capacity utilisation: CBI industrial trends, BCC services/manufacturing, S&P PMI manufacturing, BoE Agents.

Source: Confederation of British Industry; British Chamber of Commerce; S&P Global; Bank of England; Barclays Research.

Panel B. Forecast output gap (% of GDP)

Source: Office for Budget Responsibility's Economic and fiscal outlook March 2026; Bank of England's Monetary policy report July 2026; Barclays Research.

Given the above, both fiscal and monetary policy are acting as headwinds to economic growth for much of this parliament, highlighting the difficult balancing act of navigating an inflationary supply-side shock when fiscal policy is constrained.

The output gap

We currently assess that there is slack in the UK economy, with the level of real GDP as of the second quarter of 2026 around 1–1.5% below potential output. This means that the UK is producing less than it could stably produce whilst maintaining inflation steady at the Bank’s target rate of 2%. This is consistent with a range of metrics of capacity utilisation (shown in Figure 1.18) and the Bank of England’s assessment, which put spare capacity at 1.1% of potential GDP in the third quarter of 2026 in its July monetary policy report.

We expect real economic growth in the second half of the year and first half of 2027 to be below trend, but only sufficiently so as to widen slack by a few tenths of a percentage point. As cyclical growth rebounds from 2028 onwards, we expect the output gap to narrow, but to not fully close by the end of our forecast horizon. This is because of the fiscal consolidation implied by current spending plans, which acts as a persistent drag on demand, and because we forecast the Bank of England will keep Bank Rate high, which also pushes demand in the economy down.

1.6 Potential output and productivity

Potential output is the amount of real output that the UK economy could produce while keeping the unemployment rate stable and inflation at the Bank of England’s 2% target over the medium term. While cyclical changes in output matter in the short term, in the medium term the path for potential output is the key determinant of real economic growth.

Potential output growth can be broken down into growth driven by increases in the labour force – the number of people available to work – and changes in real output per worker (productivity). Over the forecast, we expect potential output growth to increase from 1.2% per year in 2026 to 1.5% per year in 2031. This increase is driven by an anticipated increase in productivity growth which more than offsets slowing growth in the labour force. We now discuss our forecasts for those two components.

Changes in the size of the labour force

There are two reasons we expect labour force growth to slow over the forecast period.

Population. Recent evidence suggests that there is likely to be slower population growth between now and 2030 than previous forecasts suggested. In our baseline forecast of potential

output, we follow the latest ONS population projections (produced in April 2026), which imply the 16+ population grows on average by 0.6% per year. Much of this slowdown is driven by expectations of lower net migration. ONS population projections now project medium- and long-run net migration to be 230,000 a year, compared with 340,000 per year in its previous projections. Recent visa data suggest that immigration could fall even faster than forecast (Home Office, 2026). The OBR already started to downgrade its net migration forecast in March, assuming around 290,000 a year by 2030, but is likely to go further at the Budget. A lower population projection reduces the number of people available to work and so the potential output of the UK economy in the medium term. For more detail on how changing patterns of migration affect the public finances – and how the OBR forecasts this – see Chapter 5.

Labour force participation rate. We expect the labour force participation rate – the share of the 16+ population who are working or looking for work – to fall over time as the population ages. Older adults tend to be less likely to be available for work either because they have retired or because they have health conditions that limit their ability to work. As the population gets older, we expect the participation rate to fall from around 63.8% now to 63.5% at the end of the forecast period. This pushes downwards on potential output over the forecast period. The same dynamics, in our view, will drive a reduction in average hours worked by each worker, and further reduce the labour input to potential output.

Productivity growth

Offsetting declining labour force growth, we expect productivity – output per worker – growth to increase through the forecast from 0.6% per year in 2026 to 1.1% per year in 2031.³ There are two reasons output per worker is growing in our forecast. First, we expect investments in capital (e.g. buildings and equipment) to increase the stock of capital available to workers – ‘capital deepening’. This makes each worker more productive as each worker can do more if they have more equipment available to them. We expect this effect to be a steady upward force throughout our forecast period.

Second, we expect output per worker to increase as the technologies for translating a given set of capital and labour into output increase. In the near term, we expect cyclical influences that have weighed on productivity, such as labour hoarding post-pandemic and supply-side shocks, to subside and bolster productivity growth. We expect investments in new technologies such as artificial intelligence (AI) to pay off and improve the economy’s ability to translate inputs into

³ A recent ONS release (Office for National Statistics, 2026d) has revised down estimates of the number of hours worked in the economy, leading to higher estimates of growth in output per hour over the 10 years before the pandemic (up from 0.7% increases per year to 1.3% increases per year). We have revised our forecasts to account for this change in the historical data. We now forecast faster growth in output per hour and slower growth in hours worked. These two changes offset each other and our forecast for output per worker is broadly unchanged.

outputs going forward and for this technological growth to increase over time – from 0.1% per year in 2026 to 0.5% in 2031.

Productivity growth is highly uncertain and different forecasters will take different views. The OBR has historically been optimistic on productivity growth (Emmerson, Ridpath and Stockton, 2025) but revised down its medium-run productivity growth assumptions in March to 1.0% annual growth in output per worker. This is slightly below our medium-run projection for output per worker growth. An important potential upside risk on productivity growth is the development of AI. We discuss a scenario where the boom in investment in AI continues, and the potential consequences of this for productivity, in Section 1.9. How productivity growth turns out will be incredibly important for both the health of the public finances and labour market outcomes which we turn to next.

1.7 The labour market

We now turn to the likely trajectories for unemployment, employment and wages.

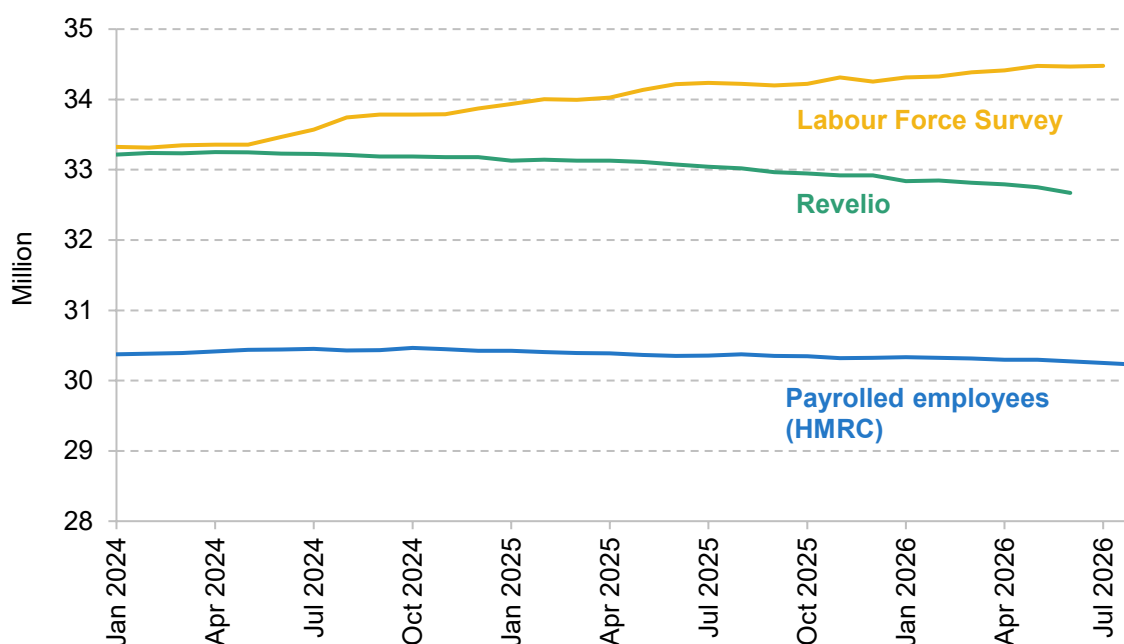
The labour market continues to show signs of weakness

Official data based on the Labour Force Survey (LFS) suggest the unemployment rate remains heightened but has fallen slightly in 2026. It rose from 4.3% in the first quarter of 2024 to 5.2% in the final quarter of 2025, before falling back slightly to 4.9% in the second quarter of 2026. The same Labour Force Survey would also paint a positive picture of strong employment growth. In fact, the figures for employment for Q2 2026 were around 260,000 more people in work than the OBR expected in its March forecast.

However, there are well-documented issues with the LFS post-pandemic, which make it hard to draw strong conclusions from recent LFS data alone (Office for National Statistics, 2026a and 2026b). Other indicators shown in Figure 1.19 suggest a weaker picture for labour demand. In contrast to the official LFS measures, other measures show employment falling during 2026. Our shadow employment indicator, based on web-scraped data from LinkedIn provided by Revelio, suggests the economy has lost 250,000 jobs since the start of the year. Tax data from HM Revenue and Customs (HMRC) on the number of payrolled employees also show a reduction in employment in the last two years.

Another measure of the demand for labour is the number of vacancies. Vacancies have continued to fall, hitting 702,000 from June to August 2026. There are now only 0.4 vacancies for each unemployed jobseeker, the lowest rate since the economy reopened in 2021 after the COVID-19 pandemic.

Figure 1.19. Estimates of UK employment since January 2024 (millions)



Note: Vertical axis is truncated.

Source: ONS labour market statistics time series (number of people in employment); ONS PAYE Real Time Information (number of payrolled employees); Revelio.

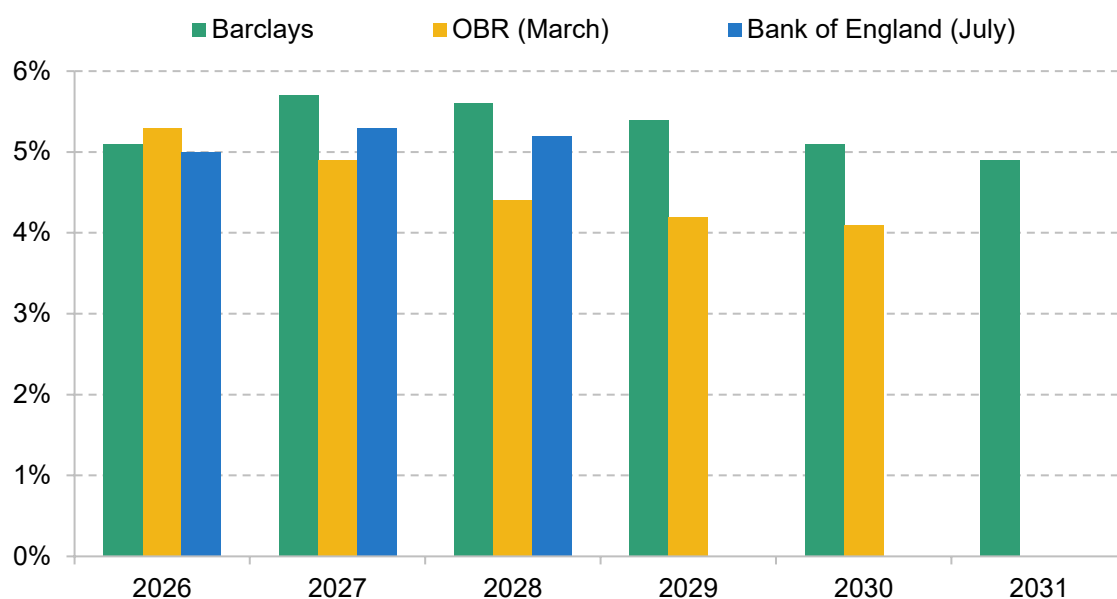
Taken together, this evidence suggests that faster-than-expected economic growth so far this year has not been associated with an increase in demand for labour.

Unemployment likely to rise in 2027, but fall back from 2028

We expect this pattern of weak employment growth and heightened unemployment to continue through 2027. We project that the level of employment will not grow at all in 2027 and the unemployment rate will rise to 5.7%. This is based on our forecast for weak real economic growth in 2027, due to the Iran war shock and because we expect a large proportion of growth in 2027 to be driven by investment and a rebalancing towards capital rather than labour. In its March forecast, the OBR expected the unemployment rate would peak in 2026 and be on a downward trajectory thereafter. As it incorporates the Middle East shock into its forecast this time round, we would expect to see a profile closer to our own, and that of the Bank of England, with a later and more persistent peak as shown in Figure 1.20.

After 2027, we expect overall real economic growth to increase and for this to pass through into higher demand for workers. This will lead the unemployment rate to gradually fall back towards a level consistent with stable economic growth and inflation at 2%. However, we expect this adjustment to be slow, given restrictive monetary and fiscal policy, and we do not expect the unemployment rate to fall below the rate expected in 2026 (5.1%) until as late as mid 2030.

Figure 1.20. Forecasts for unemployment rate each calendar year (%)



Source: Office for Budget Responsibility's Economic and fiscal outlook March 2026; Bank of England's Monetary policy report July 2026; Barclays Research.

We expect falling unemployment to translate into employment rises from 2027 onwards. In our baseline scenario, we expect the employment rate for adults aged 16 and over to increase from 59.6% in 2027 to 59.9% in 2031. This is predominantly driven by falling unemployment, which more than offsets the falling participation rate we discussed above. Rising employment during this period will help boost tax revenues, as discussed in Chapter 2.

Overall, we expect economic growth to be less jobs-rich in our forecast than it has been previously. In our forecast, the employment elasticity of GDP growth is around 0.3, meaning every 1% of additional real GDP generates around a 0.3% increase in employment. This sits around the lower end of the historical range; in the period since 2008, on average the elasticity has been closer to 0.5. This is consistent with our view that rising investment and improvements in labour productivity will be the main drivers of future growth.

Wage growth remains weak, but a key judgement in the medium term

Earnings growth has slowed in the UK so far in 2026 and we expect pay growth to remain low in 2027. Average weekly earnings grew by 4.2% from Q2 2025 to Q2 2026, relative to 4.7% in the previous year, and in the private sector specifically – which is often deemed more reflective of the balance of supply and demand in the labour market – average earnings slowed from 4.8% to 2.9%. Forward-looking surveys of employers suggest earnings growth will stabilise, if not slow further over the coming year as the slack in the labour market gives little bargaining power to workers, even in light of the pickup in inflation.

The implicit consequence, consistent with our view on households and consumers in Section 1.5, is that much of the burden of the terms-of-trade shock from the Middle East will be borne by workers. We expect private sector wages to grow by 2.8% in 2026 and 3.0% in 2027 in nominal terms. This increase is largely an artefact of base effects that have brought down wage growth in the middle of 2026 unwinding in 2027, rather than additional pressure from the labour market. Adjusting for inflation, we expect wages to fall by 0.4% in 2026 and 0.1% in 2027.

Looking beyond 2027, we expect real wage growth to increase. We expect nominal earnings growth to slow slightly to 2.6% on average from 2028 onwards, but because we expect inflation to fall by more, this is equivalent to a 0.6% increase in real-terms wages each year on average. The key driver for this is increased productivity growth, discussed in Section 1.6. We assume that workers accrue just over half of the gains from this productivity growth through higher earnings growth, in line with historical averages of UK labour share, with the rest of the gains going to firm and capital owners. Given the investment and capital-intensive nature of the productivity improvements we are expecting, there are risks this may overstate the pass-through in the near term as investors and capital owners recoup their initial costs. This would act to lower earnings growth relative to our baseline forecast.

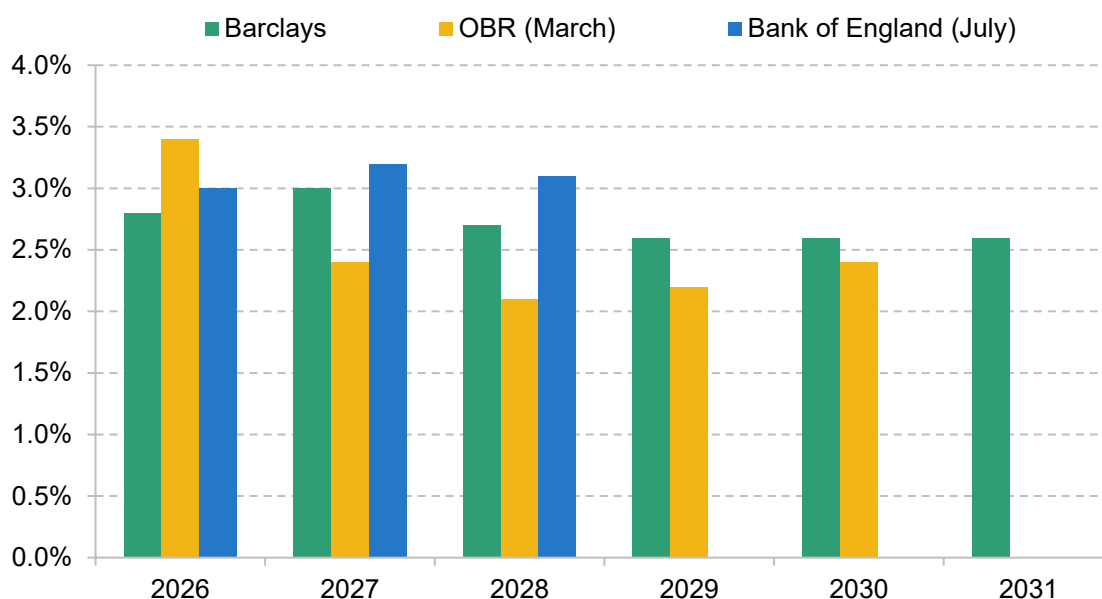
We do not expect workers to be able to bargain for higher wage growth in later years to compensate for the real-terms wage cuts in 2026 and 2027. This is because we expect the unemployment rate to remain elevated through 2028 onwards and this gives workers limited power to bargain up wages. A simulation of future wages and inflation based on a model often cited by the Bank of England suggests that an inflation spike of the nature we expect in our baseline does not have a persistent effect on wages, if the spike occurs during a period where there is a loose labour market, as we currently assess to be the case. This is therefore likely to be the case for the recent Iran-war-related inflation shock.

However, there is considerable uncertainty over the path for wage growth and different forecasters will take different views. As shown in Figure 1.21, the OBR's March projections had a lower path for nominal earnings growth, which dropped to 2.1% year-on-year growth in 2028 and averaged a little over 2% in the medium term. It is likely that the OBR will increase its forecast for wage growth later this month to reflect higher-than-expected inflation, but to what extent is uncertain.

In contrast, the Bank of England has consistently forecast higher wage growth than the OBR in the medium term. In its latest forecasts, the Bank forecasts wage growth of 3.1% on average each year from 2026 to 2028 relative to 2.8% in our forecasts. These differences in forecast nominal wage growth are due to a combination of different views on different factors including: the path for inflation; the extent to which an inflation shock passes through to wages; medium-run productivity growth; and the share of future productivity gains that workers receive. For

instance, the Bank of England estimates assume firms' profit margins do not add to inflation in the medium term, leaving more space for wages to expand without pushing up inflation. While this may be true in the medium term, we think in the near term the rebuilding of margins against a backdrop of weak demand is likely to weigh against wage growth. Given the importance of nominal wage growth for tax receipts (see Chapter 2) and public sector pay pressures (see Chapter 6), forecasts for nominal earnings growth will be a crucial judgement for the OBR.

Figure 1.21. Forecasts for nominal average weekly earnings (% year on year)



Note: The OBR uses a national accounts method to calculate nominal average weekly earnings, whereas our forecast is drawn from the ONS labour market data, and is for private sector earnings excluding bonus pay. Historically, the growth rates vary little.

Source: Office for Budget Responsibility's Economic and fiscal outlook March 2026; Bank of England's Monetary policy report July 2026; Barclays Research.

1.8 Summary of baseline scenario

In our baseline scenario, we assume there is some resolution to the Iran war in the next few months, so that global oil prices jump in 2026 but then gradually decline from 2027 to 2030. Rising energy prices have already pushed up inflation to 3.1% and we expect it to increase further until the first quarter of 2027. We do not expect the energy price rise to feed through into more generalised inflation and so we expect inflation to ease back towards the Bank of England's 2% target as global oil prices fall.

The Iran war shock will also make us poorer as a country. We expect real (inflation-adjusted) GDP to grow by only 1.2% in 2027. Following the easing of the shock, we expect GDP growth

to speed up to 1.6% in 2028, 1.6% in 2029 and 1.5% in 2030. We expect the unemployment rate to also rise in 2027 due to the Iran war shock before gradually falling back through our forecast.

We expect nominal earnings growth to increase slightly in 2027 and to reduce slightly before growing steadily in the later years of the forecast. However, we do not expect nominal earnings growth to increase sufficiently to offset the inflation jump, and so we expect real earnings to fall in 2026 and 2027 before growing by on average 0.6% each year from 2028 to 2030.

Table 1.1 summarises the key economic outcomes in our baseline scenario.

Table 1.1. Values of key economic indicators each year in Barclays baseline scenario

	2026	2027	2028	2029	2030	2031
CPI inflation (% year on year)	3.1	3.0	2.0	2.0	2.0	2.0
Real GDP growth (% year on year)	1.4	1.2	1.6	1.6	1.5	1.4
Unemployment rate (%)	5.1	5.7	5.6	5.4	5.1	4.9
Employment ('000s)	34,430	34,438	34,696	34,982	35,236	35,478
Nominal earnings growth (% year on year)	2.8	3.0	2.7	2.6	2.6	2.6
Real earnings growth (% year on year)	-0.4	-0.1	0.7	0.6	0.6	0.6

Source: Barclays Research.

1.9 Alternative economic scenarios

The above forecasts reflect a baseline scenario, which we consider a reasonable central forecast given the set of information we have at this time. However, it is predicated on a necessary set of assumptions about key areas which may or may not come to pass. To see what impact different choices about these assumptions might have, we look at scenarios in which we vary them and model the alternative path for the economy.

Scenario 1. The economic consequences of delayed peace

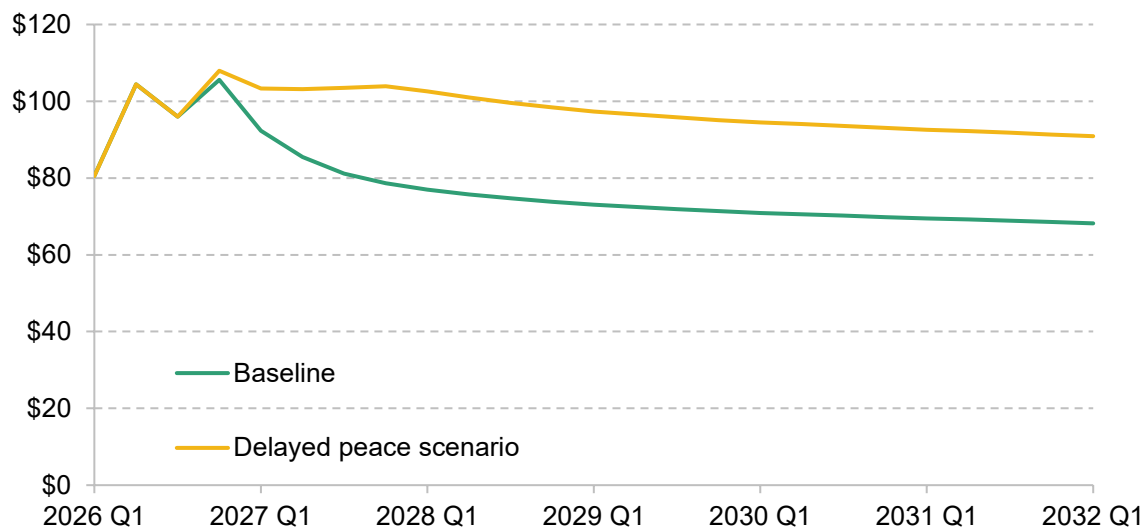
In our baseline projections, there is an implicit assumption that a resolution is found for the conflict in the Middle East in the coming months, or at least that it eases enough that energy prices fall through 2027, slowing inflation. However, there is no clear end in sight, and many financial market participants are nervous that downward-sloping gas and oil futures curves –

capturing that buyers are currently willing to pay more for near-dated contracts than for energy delivered further in the future – may be giving a false signal about the ultimate trajectory of prices. Here, we consider the potential impact of energy prices remaining higher for longer.

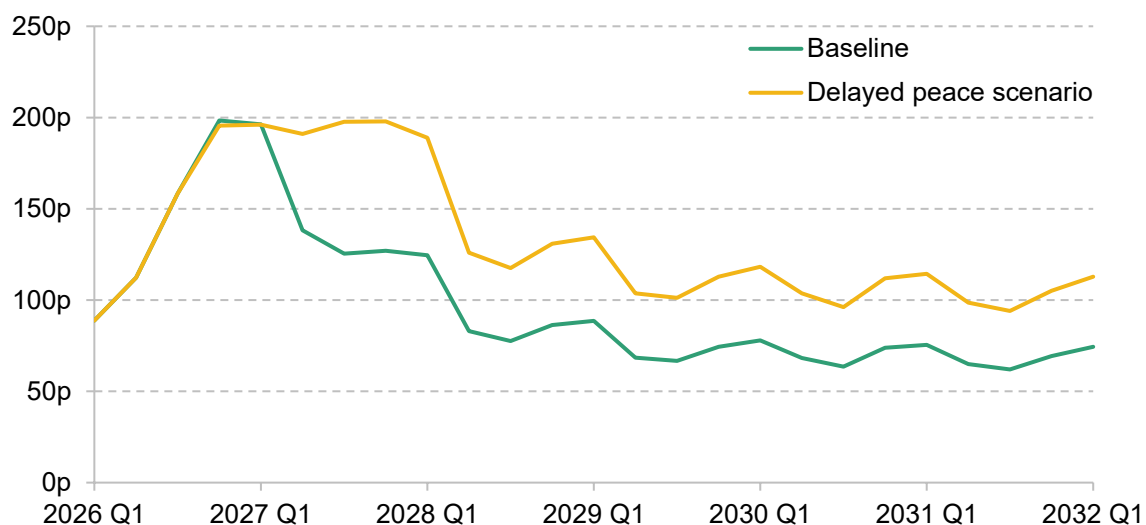
In particular, we analyse what it would mean if gas and oil prices were to stay at their current levels through 2027 before falling broadly in line with the slope of the existing curves thereafter. In specific terms, this would amount to gas prices that were roughly 33% higher in 2027 than in our baseline projections (Figure 1.22). We focus on the direct economic effects of higher energy prices, rather than the additional global uncertainty that might also follow from a prolonged conflict.

Figure 1.22. Energy prices under Barclays baseline scenario and alternative scenario with delayed peace

Panel A. Brent crude oil (dollars per barrel)



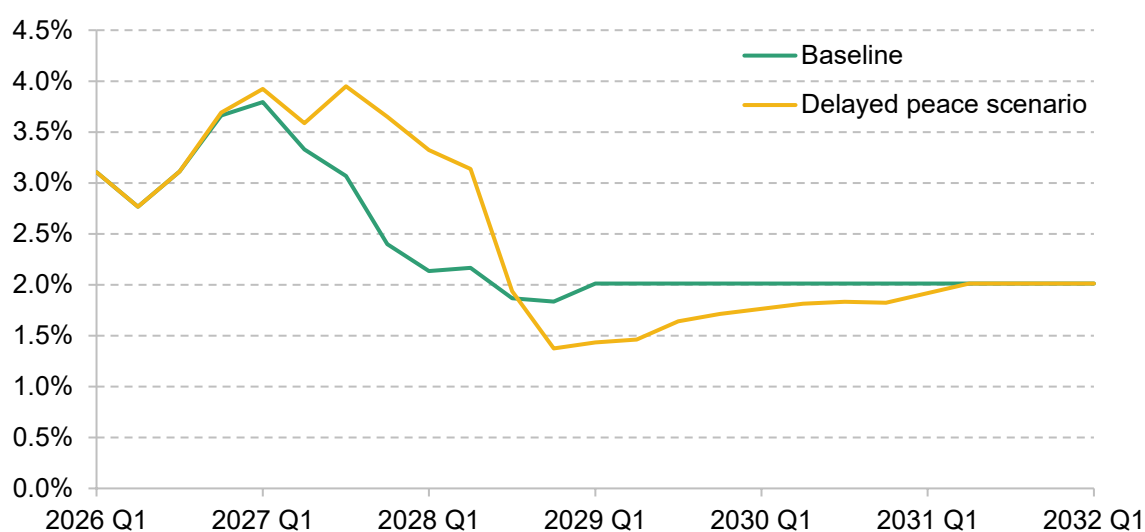
Panel B. UK natural gas (pence per therm)



Source: Bloomberg; Barclays Research.

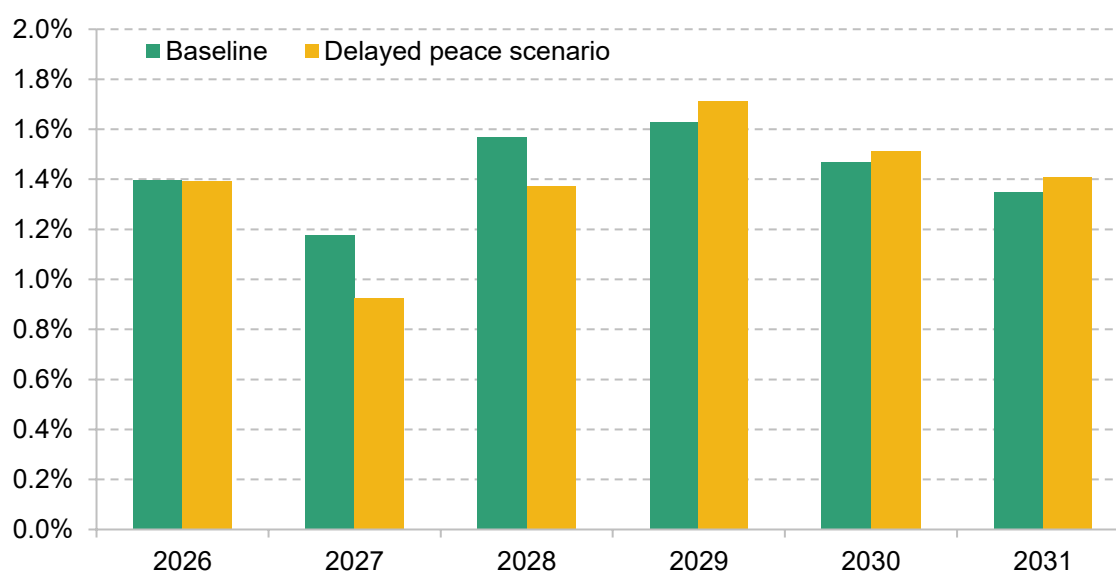
Our modelling suggests this would raise inflation by 1.25 percentage points (ppts) compared with the baseline in Q4 2027, keeping headline CPI above 3.5% for the entirety of next year. However, a longer energy price spike implies a larger drag on inflation when the shock begins to unwind. By mid 2028, year-on-year inflation would actually be lower than in our baseline, temporarily falling to as low as 1.4% in Q4 2028 and staying below 2% in 2029 and 2030, as shown in Figure 1.23.

Figure 1.23. Annual CPI inflation in Barclays baseline scenario and alternative scenario with delayed peace



Source: Barclays Research.

Figure 1.24. Forecasts for annual growth in real GDP (% year on year)



Source: Barclays Research.

The additional near-term inflation would likely cause a more aggressive response from the Bank of England. However, if the Bank was confident that persistent inflation would not become embedded in expectations – and, crucially, if it knew with a reasonable degree of confidence that elevated energy prices would last only for another year – we might still expect a relatively muted increase in Bank Rate in 2027. We assume it would peak 0.5 ppts higher at 4.75%, before falling back to the same rate as in our baseline scenario by the end of 2028.

Even with a reasonably muted response from the Bank, the larger terms-of-trade shock from higher energy prices and slightly tighter financial conditions would lead to lower real GDP growth: 0.3 ppts lower growth in 2027 than in our baseline scenario and 0.2 ppts lower in 2028 (Figure 1.24). It would also shift up the unemployment rate profile by roughly 0.2 ppts, implying around 70,000 more people unemployed at the end of 2028.

Scenario 2. How much could the UK benefit from an AI investment boom?

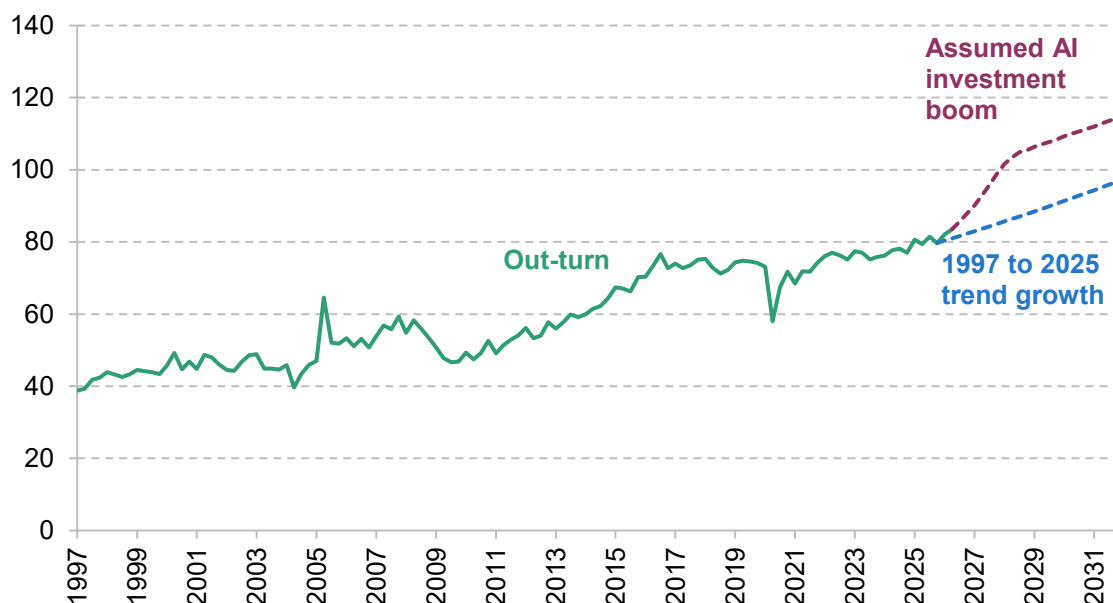
Recent growth has been driven by investment and activity in ICT and AI-related industries. Output in computer programming, consultancy and related activities grew by 9.3% in the first half of the year, while in the second quarter (April–June), business investment in ICT was 8.3% higher than in the previous quarter. This sector alone contributed roughly 65% of the total business investment growth in Q2, and incorporates investment in software, hardware, data centres and infrastructure. This is, on a smaller scale, akin to what has been seen in the US in recent years.

Our baseline forecast assumes this investment continues, but at a less aggressive pace. However, here we ask: ‘How would the outlook differ if the UK could continue to grow AI-related activity and investment?’.

In particular, we consider the impact of a period of sustained strong AI-related investment in the UK, where business investment grows at a pace of 2.5–3.5% quarter on quarter over the next two years, driven by ICT equipment, before returning to growth consistent with our baseline forecast for investment, as shown in Figure 1.25. This is aligned with AI investment adding 0.8 ppts to annual US GDP growth in 2025. As a reference point, UK business investment growth averaged 0.6% quarter on quarter from 2015 to 2025, while in the first two quarters of 2026, the average was 2.4% quarter on quarter.

We then consider two possible scenarios for the way that an AI boom could play out: one in which this investment constitutes a capital deepening, but has no other beneficial supply-side effects; and another where AI leads to wider improvements in productivity, increasing total factor productivity (TFP) – the rate at which a given level of labour input and capital input is transformed into output. While both raise the level of real GDP, only the latter changes the long-term growth rates the economy can reach and sustainably maintain.

Figure 1.25. Business investment out-turn since 1997 and trend growth up until 2025, and AI investment boom (£ billion, 2024 prices)



Note: Solid lines show out-turn and dashed lines are forecasts.

Source: Barclays Research.

Narrow capital deepening

In the first scenario, there would be a near-term growth boost from investment that adds to the capital stock. If the beneficial supply-side effects of the investments were fairly small, this additional demand would reduce spare capacity in the economy and increase inflation (Ambrosino, Chan and Tenreyro, 2026).

Limited supply-side effects could be plausible because the increase in the capital stock associated with the investment described would actually be relatively small, for three reasons. Investment in the ICT sector comprises a small share of business investment (about 15%). Investment as a flow is relatively small compared with the stock of capital. And we also expect the speed of capital depreciation to increase, as AI-related investments generally tend to be replaced quite quickly when compared with other types of investment (Barclays, 2026b).

This means that in the near term, an AI boom that was not associated with widespread improvements in TFP would represent a positive demand shock to the economy.

AI will likely change the demand for skills from employers, which may have negative impacts on hiring in sectors most exposed to AI, particularly for junior positions (Klein Teeselink, 2025). However, job losses in certain sectors may be offset by higher demand for labour in others, where AI increases demand (Barclays, 2026c). There are also large parts of the workforce that are relatively unexposed to AI, such as hospitality services. General-purpose technologies, such

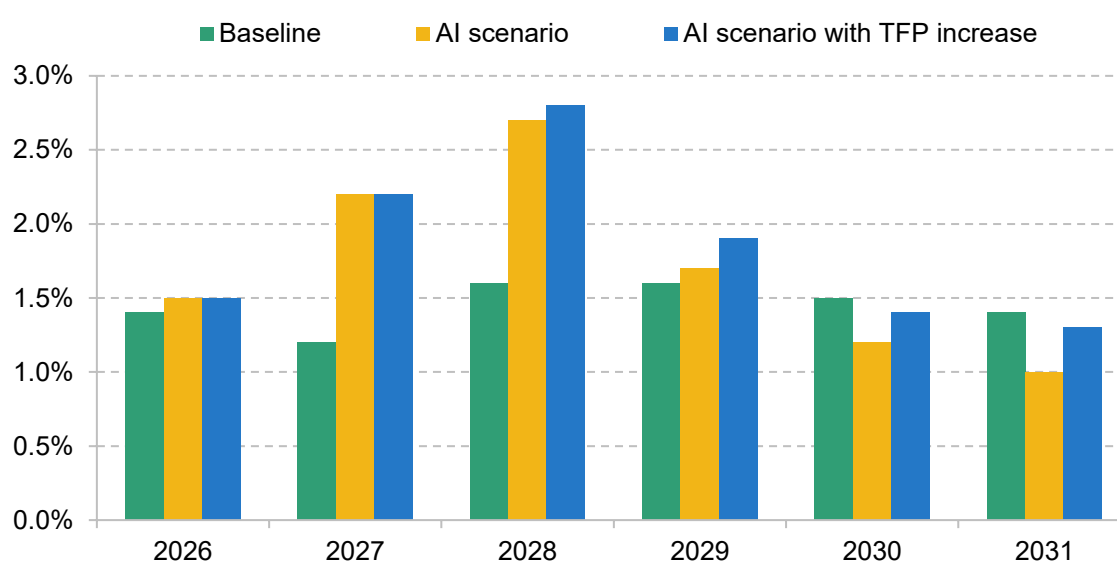
as the internet, have not thus far led to a decrease in employment, which may well hold once more for AI. As such, even if AI affects which sectors people are employed in, and potentially affects employment differentially across age groups, the aggregate impact may not be in a significant increase in overall unemployment.

If increased AI investment had no spillovers to TFP, we assume that firms' demand for labour would increase to meet the increase in aggregate demand, but to a lesser extent than the historical relationship between labour demand and real GDP growth would imply, given the rebalancing of capital and labour in the economy to a higher capital ratio.

In this case, we would expect the output gap to be reduced, and for inflation to rise. This in turn would likely lead to a higher path for the Bank Rate, weighing on growth and reducing the extent to which CPI would overshoot its 2% target in the medium term. For wages, we assume that around two-thirds of the increase in labour productivity feeds into stronger wage growth, which raises average weekly earnings growth, but the size of this impact would be minimal as the increase in productivity is only coming from capital deepening in this scenario.

We estimate that real GDP growth would average 2.7% year on year in 2028, 1.1 ppts higher than in our baseline scenario (Figure 1.26). However, we would expect annual growth at the end of our forecast horizon to be lower than in our baseline, as the AI investment cycle unwinds, and restrictive monetary policy would weigh on activity to curb the additional demand-induced inflation. This would leave the level of real GDP around 1.6% higher at the end of our forecast horizon than in our baseline scenario.

Figure 1.26. Forecasts for annual real-terms GDP growth in baseline scenario and two AI scenarios (% year on year)



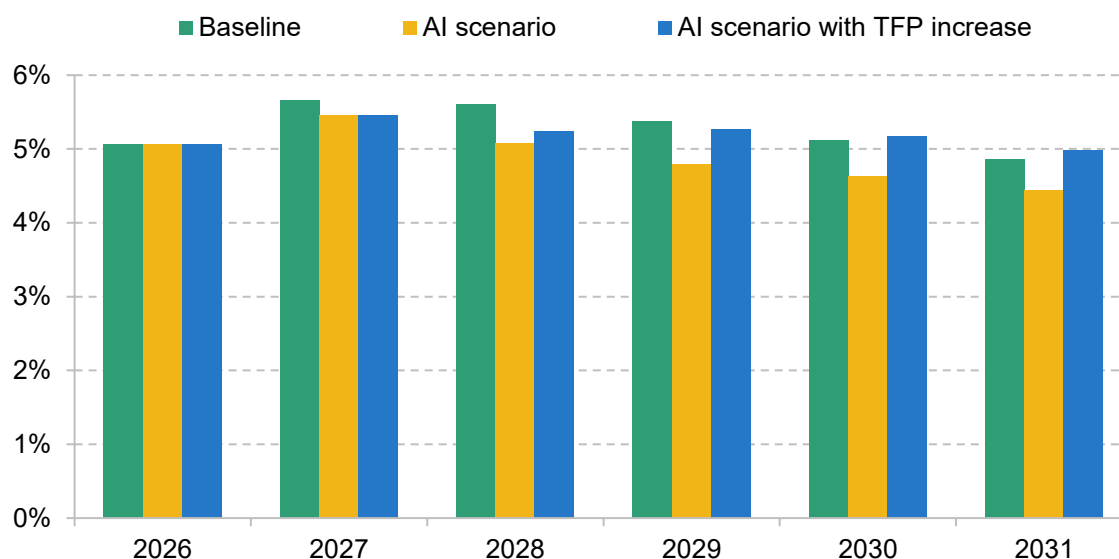
Source: Barclays Research.

Increases in total factor productivity

A key part of the positive narrative around developments in AI is that, as a general-purpose technology, it can lead to improvements in productivity beyond narrow capital deepening. In this scenario, we assume TFP growth increases by between 0.1 ppt and 0.5 ppts more per year than in our baseline, reaching 1% annually by 2030. This adds a further 0.5% to the level of GDP by 2030 and, importantly, as it is supply-side driven, would not add further to inflation. There are a wide range of estimates for the impact of AI on TFP growth, with our assumption falling more towards the upper end of the range, although it brings TFP growth in line with the OBR's baseline assumption (Cerutti et al., 2025).

If AI investment was to spill over to increase TFP growth, this would lead to higher potential growth, which increases the growth rate in the latter part of the forecast horizon. Annual real GDP growth is on average 0.2 ppts higher after 2029 in this scenario than in our scenario with no spillovers to TFP growth, and would accelerate past our baseline growth profile beyond 2031. As shown in Figure 1.27, the unemployment rate path is higher than in the scenario with only a capital deepening, due to an assumed increase in the non-accelerating inflation rate of unemployment (NAIRU) as firms substitute away from labour. However, while the rise in the NAIRU dominates in the latter stages of the forecast horizon, there would still be a boost in labour demand in the near term. Overall, we would expect the level of real GDP to be 2.5% higher than our baseline forecast by the end of 2031.

Figure 1.27. Forecasts for annual unemployment rate under baseline scenario and two AI scenarios (%)



Source: Barclays Research.

1.10 Conclusion

The UK economy faces a number of headwinds at a time when policy, both fiscal and monetary, is likely to have to remain restrictive and unable to support demand growth in a meaningful way. The near-term outlook will be dominated by developments in the Middle East, which will drive a squeeze in the spending power of households and reduce the incentives for firms to invest. Without a relatively quick resolution that allows energy prices to begin to fall in coming months, this drag could be even more material. Weighing against that, though, there is a nascent trend emerging for rising investment in technology and improving productivity that could raise growth and standards of living. It is against this uncertain and conflicting backdrop that the Chancellor will deliver his first Budget on 28 October.

Appendix 1A. Conditioning assumptions

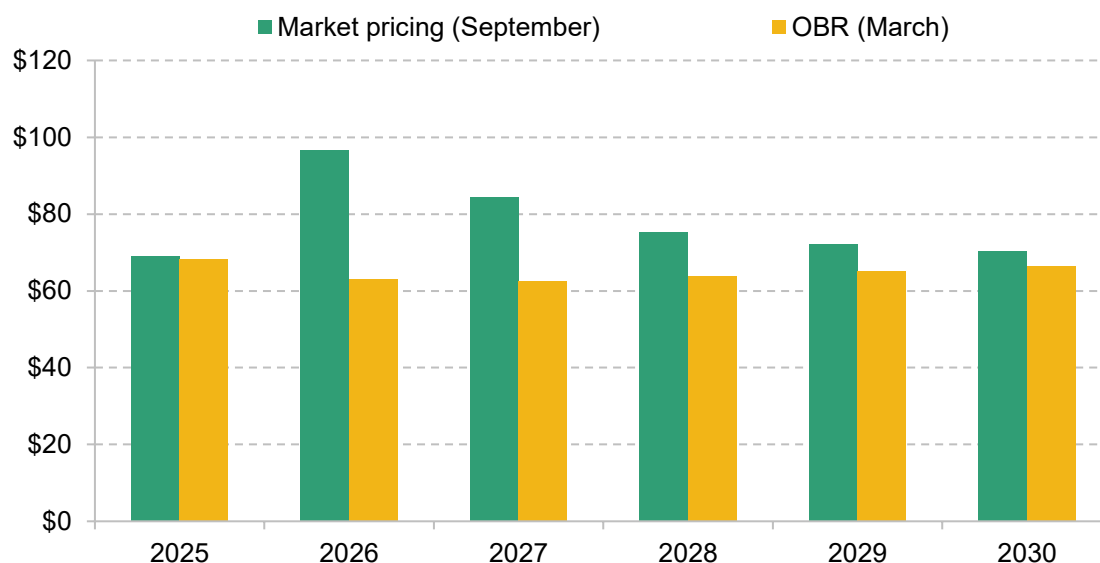
The OBR in March based its conditioning assumptions – market-implied expectations of the likely path of several components of its economy forecast – on the 10-day average up until 22 January, with a later cut-off date for interest rates expectations (30 January). This was around five weeks before the Spring Forecast (3 March). We will not know precisely which 10-day window the OBR will use for its upcoming forecast until it is published. But following a similar schedule in relation to the date of the upcoming Budget would suggest a conditioning period in the 10 days up until mid to late September.

Energy prices. The outlook for energy prices has shifted considerably since the OBR's last forecast. During the March forecast's conditioning period, the Brent crude oil price averaged \$65 per barrel, but the spot price now stands at around \$100 per barrel, a roughly 50% increase. A similar picture can be seen for gas, with the spot price of UK natural gas averaging 89 pence per therm in the March conditioning window, and now sitting at around 185 pence per therm (more than double). Gas prices on futures markets have also risen, adding to price pressures over a more protracted period.

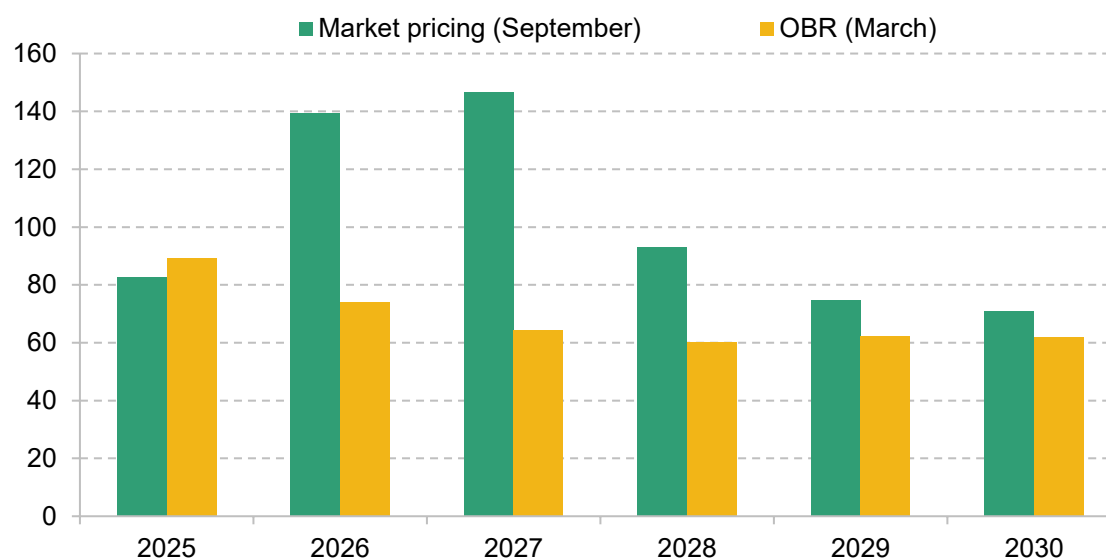
Interest rates. The Middle East conflict has also impacted the outlook for UK interest rates and bond yields since March. As discussed in Section 1.4, the conditioning path of the March forecast assumed Bank Rate would fall, whereas the new forecast in October will assume a rise from current levels of around 1 percentage point. In government debt markets, the 10-year nominal yield is now 0.9 ppt higher than in March at 5.4%, while the 20-year yield has risen around 0.6 ppt to 5.8%. The upwards shift in yields has been primarily driven by an upwards shift in the expected path for central bank policy rates, as the inflation outlook has worsened. At the time of the last OBR forecast, markets had expected the Bank of England to cut Bank Rate to around 3.25% by the end of 2026 and keep it there. The new OBR forecast is likely to be conditioned on an outlook that expects 1 ppt of hikes over the next 12 months (to 4.75%), a swing of 1.5 ppts.

Figure 1A.1. Out-turn and forecast energy prices

Panel A. Brent crude oil (dollars per barrel)



Panel B. UK natural gas (pence per therm)

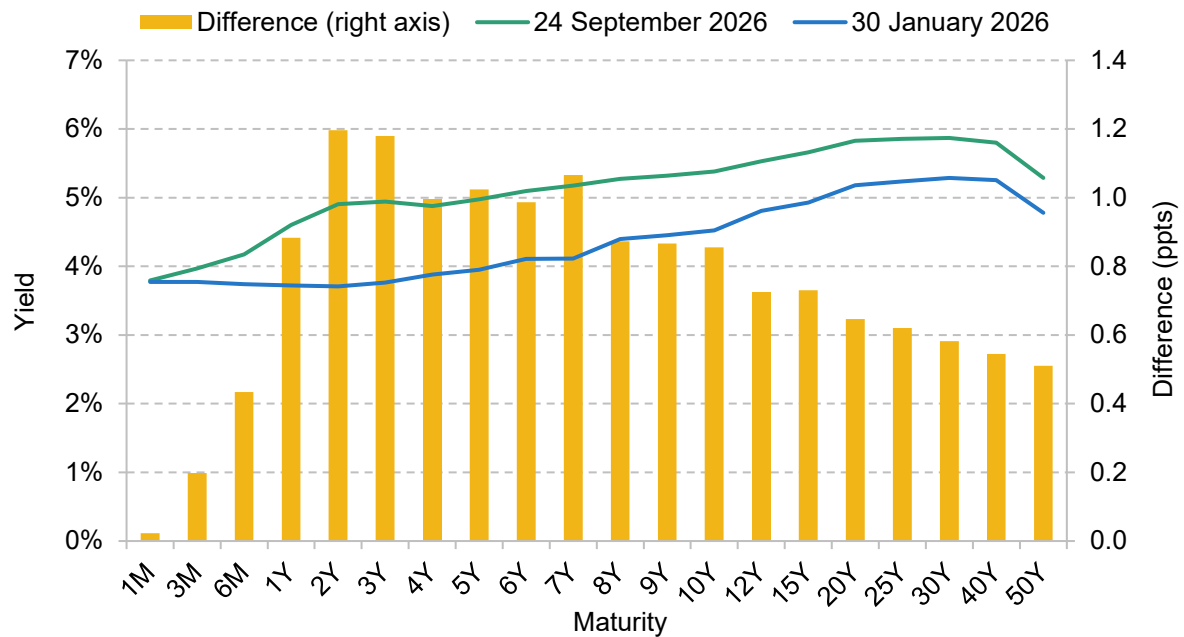


Note: Market pricing is as of 24 September 2026.

Source: Barclays Research.

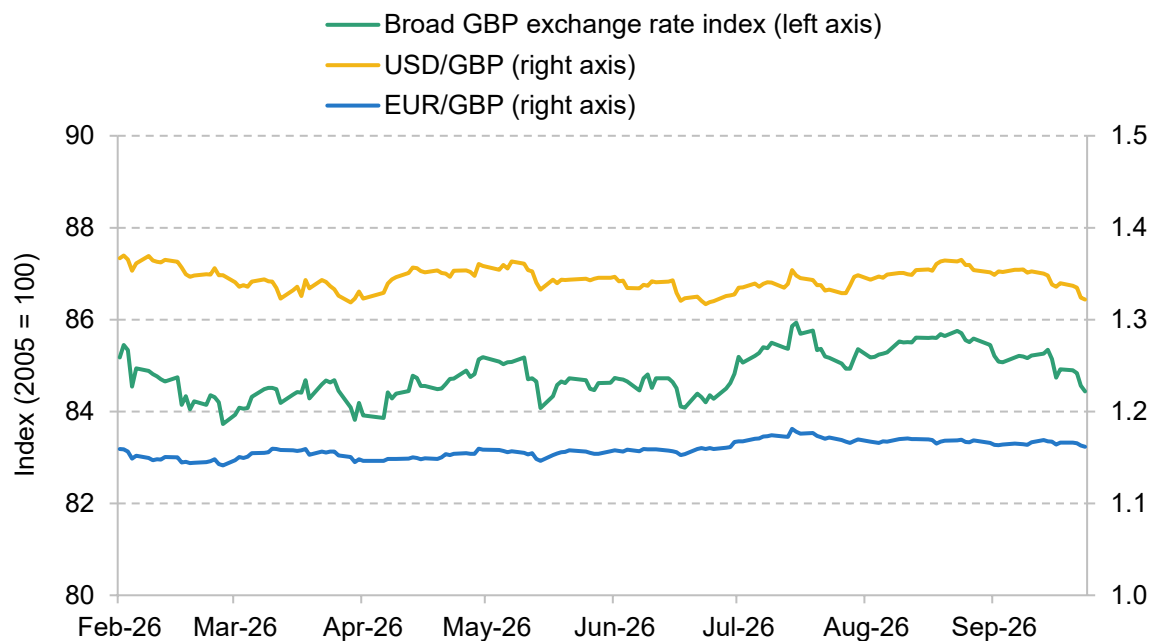
The Bank of England recently announced that it would modify its existing quantitative tightening programme to stop selling gilts with a maturity date later than 2049 (in 23 years' time) to the market. This helped to lower long-term gilt yields on the day, but the continued worsening of the energy inflation outlook has seen yields continue to increase since. For more on the detail and fiscal implications of this, see Chapter 3. Market prices continue to suggest yields will be higher still at the end of our forecast horizon, with the 10-year yield rising to 6.2% by 2032.

Figure 1A.2. UK gilt yield curve



Source: Bloomberg; Barclays Research.

Figure 1A.3. Sterling exchange rates since February 2026



Source: Bank of England; Bloomberg; Barclays Research.

Exchange rates. Although the outlook for inflation and gilt yields has shifted, the outlook for sterling has been less volatile, due to the global nature of the inflation shock. On a trade-weighted basis, sterling has been remarkably stable, staying in a range of 84 to 86 since March, as the dollar (USD) has strengthened but sterling has appreciated relative to the euro (EUR).

Fiscal policy is a more pertinent risk to sterling at the moment, as any sign of a loosening of the fiscal stance would likely put pressure on the pound. Were we to see a more significant swing in sterling in the coming months, this would drive a different path for our inflation and demand outlook, with lower sterling (stronger US dollar or euro) increasing inflationary pressures but making UK goods and services more internationally competitive.

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2. The outlook for the public finances

Nick Ridpath (IFS), João Sousa (IFS) and Isabel Stockton (IFS)

The most significant news for the fiscal outlook since the spring is higher inflation following increased conflict in the Middle East. Central bank interest rates are now expected to be higher for longer, while the outlook for economic activity has weakened. There is substantial uncertainty about the likely trajectory of prices, interest rates, earnings and economic growth. This chapter examines how the changing economic outlook, alongside a range of spending pressures and new ambitions, could affect the outlook for the public finances. It explores the key decisions that the Chancellor will have to make at the Budget.

Key findings

1. Following the closure of the Strait of Hormuz, government borrowing costs have risen around the world. Interest rates on a 10-year UK government bond were around 0.5 percentage points higher in September than in March. **Higher debt interest spending is now expected to push up borrowing across the parliament.** This might reduce the margin by which the government meets its fiscal rules – often termed ‘headroom’ – by about £11 billion in 2029–30. While significant, this change is modest relative to the more-than-doubling of debt interest spending as a share of national income since 2019–20, a £65 billion rise in today’s terms.
2. Higher inflation pushes up tax revenues because most taxes are levied on cash quantities. Spending on inflation-indexed debt and benefits also rises. At this forecast, **revenues are likely to rise by more than the increase in inflation-linked spending.** However, the Office for Budget Responsibility’s judgement of how nominal earnings are likely to grow in coming years will be crucial for determining the forecast for revenues from income taxes and therefore the extent to which the direct effects of higher inflation reduce borrowing.
3. The OBR has, in recent years, taken a more pessimistic view of the likely course of nominal earnings than other forecasters. It seems plausible that the OBR will revise up

its forecast for nominal earnings in light of recent inflation, but continue to expect lower earnings growth going forward than other forecasters. **In an illustrative scenario in which nominal earnings rise more quickly for two years before returning to the OBR's previously forecast growth rate, and before any changes in policy, borrowing would be slightly higher across the forecast period than expected in March; 'headroom' would be around £20 billion** after accounting for higher borrowing costs (of around £12 billion) and higher other spending (of around £10 billion), largely offset by higher revenue (of around £19 billion). This would be a small change compared with the £24 billion of headroom implied by the OBR's March forecast.

4. Uncertainty around the forecast for tax revenues – and therefore around the whole forecast – is particularly high. **Shifts in the forecast for earnings can, on their own, lead forecast income tax revenues (and therefore headroom) to be £10 billion higher or lower than in our illustrative scenario.** How inflation is judged to feed through to other revenues also makes a substantial difference, as do judgements about employment, migration, disability benefits and other factors. But it is worth remembering that the borrowing rule targets the difference between two very large numbers: in March, forecast revenue was around £1,490 billion in 2029–30 and forecast day-to-day spending around £1,470 billion. In that context, a difference in headroom estimates of, say, £5 billion is small.
5. Changes in headroom should not distract from challenges elsewhere. **Higher inflation reduces the spending power of government departments' cash budgets.** Maintaining the real-terms generosity of day-to-day spending plans at its March level could require a £12 billion top-up in 2029–30, with £3 billion more needed to maintain the generosity of capital spending plans. Departments are already seeing budgets squeezed by more generous pay settlements and need to make ambitious productivity improvements to meet service delivery plans. **It is spending pressures, including the ambition to increase defence spending and the cuts that might need to be made at next year's Spending Review, rather than the borrowing forecast, that will present the main challenge at the Budget.**
6. Government investment is currently at its highest sustained level in 50 years. Raising investment further – as the government has indicated it would like to do – could deliver economic returns and support other government priorities. Investments in financial assets – such as those made by the National Wealth Fund – could be made without raising public sector net financial liabilities and therefore would not be constrained by the fiscal rules. But this would not make them costless: **funding any investment through increasing debt would raise the cost of debt servicing.** Investment

decisions should be made based on whether the benefits outweigh the costs, and never based purely on how they are treated by a particular fiscal rule.

7. The point of having significant headroom is to ensure that the public finances can withstand small, run-of-the-mill changes in forecasts without the government needing to immediately change policy for fear of breaking its fiscal rules. **The Chancellor could choose to accommodate a small forecast downgrade through lower headroom; maintaining £24 billion of headroom should not be seen as a target.** But lower headroom reduces the scope to absorb future shocks and forecast changes. The Chancellor should not use up existing headroom to fund new policy commitments.
8. **If the Chancellor wants to top up departmental budgets in the face of pressures, to fund new spending priorities or to cut borrowing (e.g. to restore headroom), he will need to consider raising taxes or cutting benefit spending.** The options here are as familiar as they are difficult. All come with trade-offs. Rachel Reeves's two Budgets have already made this the biggest tax-raising parliament on record. Further tax rises should be expected to drag on growth but, importantly, some tax rises would do more damage than others – the design of any tax-raising measures would be key.
9. The broader fiscal context should be front of mind as the Chancellor makes his choices. Debt is high – it exceeds 90% of national income, has roughly tripled since the financial crisis and is still rising. The debt interest bill is high – it has more than doubled as a share of national income since 2019–20 and is now £1 in every £13 of government spending. **Even if borrowing is cut substantially and tax revenues made to balance with day-to-day spending by 2029–30, debt will remain high and expensive.** Future governments will need to manage this while also tackling the challenges of an ageing population, cost and demand pressures in healthcare, and any net-zero transition, alongside any future shocks.
10. Recent governments have a poor track record of cutting borrowing. Since the OBR's establishment in 2010, Chancellors have, on average, aimed to borrow 1.1% of GDP in the fifth year of the forecast. When that year arrived, however, the average out-turn for borrowing has been 4.8% of GDP (or 3.8% if excluding the first year of the pandemic). **What will ultimately matter for the public finances is not whether John Healey meets the fiscal rules by pencilling in a fall in borrowing, but whether he actually goes on to deliver it.**

2.1 Introduction

The new Prime Minister and Chancellor, Andy Burnham and John Healey, have come to office at a time when the economic outlook has worsened. War in the Middle East and the closure of the Strait of Hormuz have driven up inflation, leading central banks to keep interest rates higher for longer and weakening the outlook for growth.

This will undoubtedly make the Chancellor's job more challenging. Government borrowing costs are substantially higher than they were expected to be in the OBR's March forecast and will increase borrowing to the tune of £11 billion in 2029–30. But inflation will also increase the nominal size of the economy and therefore push up tax revenues. It is likely that revenues will rise by more than inflation-linked spending. In that event, the direct effects of inflation on the government's inherited borrowing plans would be relatively muted. However, the path of revenues is highly uncertain: it will depend on exactly how the energy price shock feeds through to earnings, consumption and profits. Either way, inflation also has another effect: it erodes the value of budgets for government departments.

A new squeeze from higher inflation will come at a difficult time for government departments. As we detail in Chapter 6, a range of other pressures are already putting pressure on budgets and making it harder to deliver the planned quality and quantity of public services. This is also a government with new spending priorities, ranging from policies to help people with the cost of living which have so far been temporary and relatively small, through to large expansions in some parts of the state, particularly defence. Next year's Spending Review has long looked difficult, and will be a key focus for the Chancellor in 2027.

John Healey has already said that he will navigate these challenges while sticking to the two fiscal rules set out by his predecessor, Rachel Reeves.¹ These require the current budget – the difference between revenue and day-to-day spending – to be forecast to be at least in balance in the third year of the forecast, which is currently 2029–30. Public sector net financial liabilities (PSNFL) – a measure of debt – is required to be falling as a share of national income in the third year of the forecast.

The Chancellor is unlikely to need to change policy simply to stay within the fiscal rules. We expect the OBR's 'pre-measures' forecast – before taking account of any new policy decisions

¹ The fiscal rules are set out in the Charter for Budget Responsibility (HM Treasury, 2026a), and must be met at every Budget. After changes implemented by Rachel Reeves at the 2025 Budget, the fiscal rules are no longer assessed by the OBR at every forecast, but only at Budgets, which Rachel Reeves moved to holding once per year. A third fiscal rule, the welfare cap, remains in place but tends to be ignored – it has been continually redefined when it is set to be breached, and therefore has no constraining effect on the government.

since March – to show the fiscal rules still being met with a buffer. But that does not imply that the Budget will be easy.

John Healey will need to make big decisions at this Budget about how to address the spending challenges. The Chancellor does not have to increase public spending. He could choose to live within the plans he inherited and accept a lower quality and/or quantity of public services than previously planned. He could pare back his ambition for defence spending or cut other departments' budgets to make room for it. He could even cut planned overall public spending, which is what Rachel Reeves did at the last Budget.

However, it should be noted that living within current spending plans would almost certainly imply large cuts to some departments, especially if defence spending is to be raised to 3% of GDP. The Chancellor does not need to decide how much to allocate to each department in the final years of the parliament – that decision can be left to next year's Spending Review. But he must lay out a set of plans for overall government spending across the rest of the parliament that he would be willing to live within. If he already knows that he would not be willing to negotiate the next Spending Review without a higher spending 'envelope', it is crucial that he sets out – and funds – higher overall spending at this Budget. If the Budget contains public service spending plans that the government would not be willing to live within, the public finances outlook will be flattered and the consolidation needed to meet the fiscal rules will not be credible.

Recent years have demonstrated that fiscal forecasts can very quickly be changed by events in the world. The Chancellor should look not just at the central forecasts that he is handed by the OBR but at the uncertainty and risks around them. The risks are not all to the downside. As we illustrate below, investment in AI could improve productivity and, with it, the outlook for the public finances. But when making plans, the Chancellor should remember that things can get worse as well as better. He should also not lose sight of the broader fiscal picture. Under current plans, government debt is likely to stay at historically high levels over the rest of the parliament, while UK borrowing costs remain higher than those of other G7 governments.

The rest of this chapter is organised as follows. Section 2.2 summarises the most important fiscal changes since the COVID-19 pandemic and how Rachel Reeves's decisions have shaped the new government's inheritance. Section 2.3 discusses the key economic developments since March and how they impact the fiscal outlook. Section 2.4 outlines some of the policy pressures facing the government, while Section 2.5 discusses some of its emerging policy ambitions. Section 2.6 concludes with a broad view of the choices facing the Chancellor at the Budget.

2.2 The state of the public finances

We start by stepping back and describing the big shifts in the fiscal landscape since the COVID-19 pandemic. We then discuss the choices of the Labour government so far, before providing a broad overview of the fiscal outlook as it stood the last time the Office for Budget Responsibility (OBR) presented a forecast, in March of this year.

Three changes following the pandemic

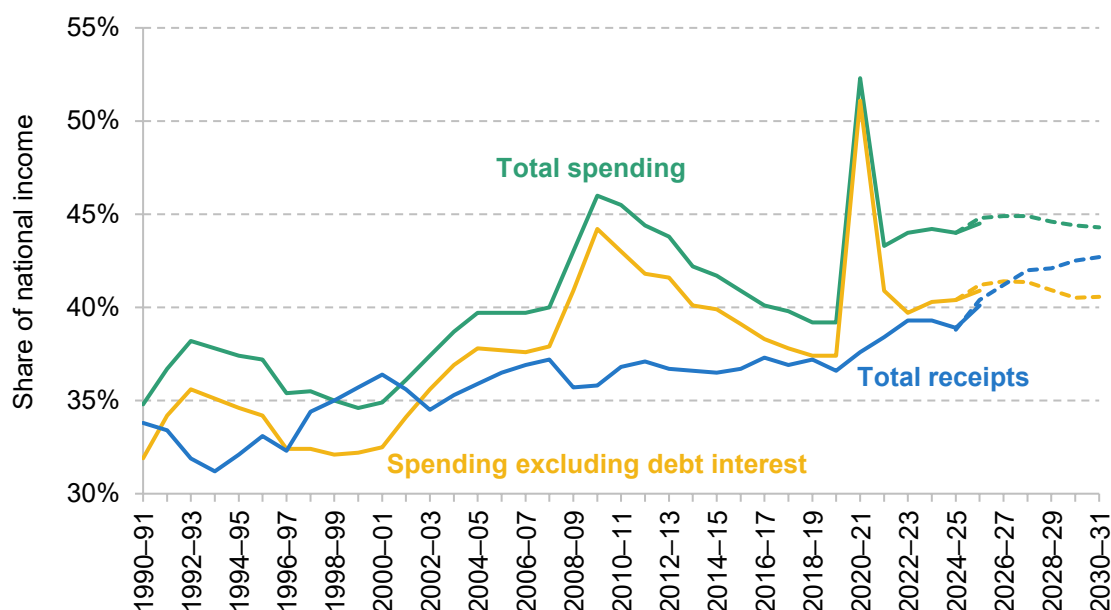
Since the onset of the COVID-19 pandemic, the size of the state, government debt and the cost of servicing that debt have all grown significantly. This is a difficult backdrop for a Chancellor intending to bring debt down.

Figure 2.1 illustrates the shift towards a larger state, showing how spending and receipts have changed over time, and their expected trajectory based on the OBR's March forecast (discussed in the next section). Total public spending was 44% of national income in 2025–26, around 5 percentage points higher than just before the pandemic. This is 4 percentage points higher than under the New Labour government on the eve of the financial crisis. The last time public spending was sustained at this level was during the Second World War. Part of this represents increases in debt interest costs, which we discuss in more detail below. But public spending excluding debt interest has also grown significantly, and is now over 3 percentage points higher than pre-pandemic levels.

Receipts have been on a steady upward trend since the pandemic. The last time revenues were this high on a sustained basis was during the Attlee government in the early 1950s. But their growth has not been enough to match the increase in spending. This leaves borrowing – the gap between spending and receipts – higher as a share of national income than pre-pandemic.

Spending and borrowing rose sharply during the Global Financial Crisis and the pandemic, leading to higher levels of debt, which successive governments have not managed to decisively reduce. This is true for whichever measure of debt is used; Figure 2.2 shows two common measures. The green line shows public sector net debt – the value of government debt after the value of liquid financial assets, such as foreign exchange reserves, is netted off. The yellow line shows public sector net financial liabilities. This is the measure of debt used in the fiscal rules, and includes a wider range of financial assets and liabilities than the net debt measure. Each measure was growing gradually before 2008, jumped up sharply between 2008 and 2010, increased steadily over most of the 2010s and then jumped up again during the COVID pandemic. Since the pandemic, debt has increased further, though by different amounts depending on the measure. Whichever measure we consider, debt is now at the highest level for half a century.

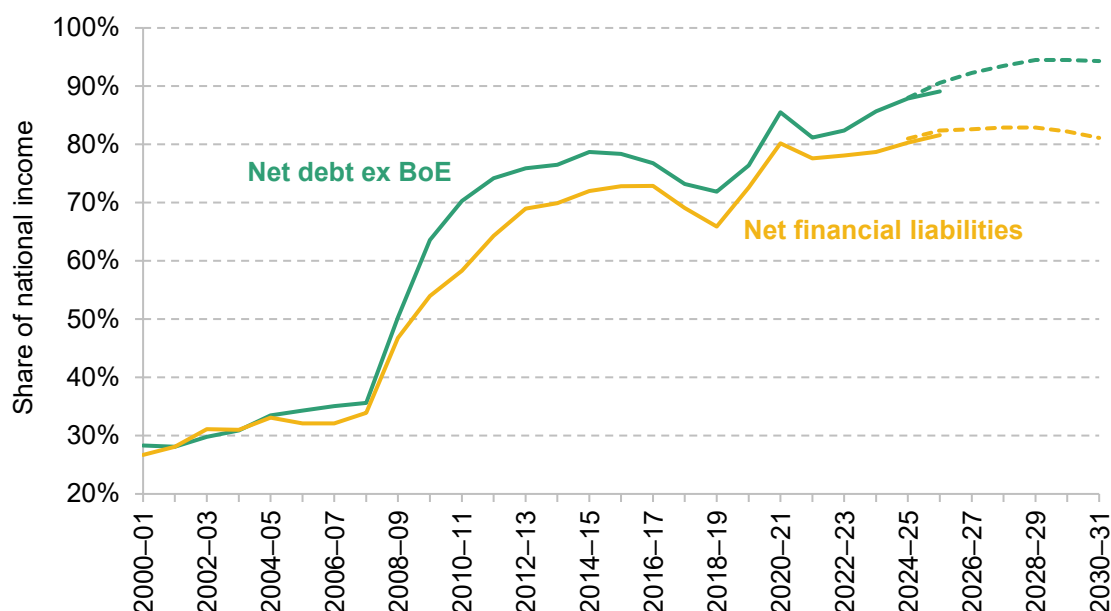
Figure 2.1. Total spending, non-debt-interest spending and total receipts: out-turn and March 2026 forecast



Note: Non-debt-interest spending is total managed expenditure (ONS code KX5Q) minus central government debt interest spending (ONS series NMFx) net of transfers to and from the Asset Purchase Facility (ONS series MU74). Figures from 2026–27 onwards represent the OBR's March 2026 forecast.

Source: Office for Budget Responsibility's Public finances databank September 2026.

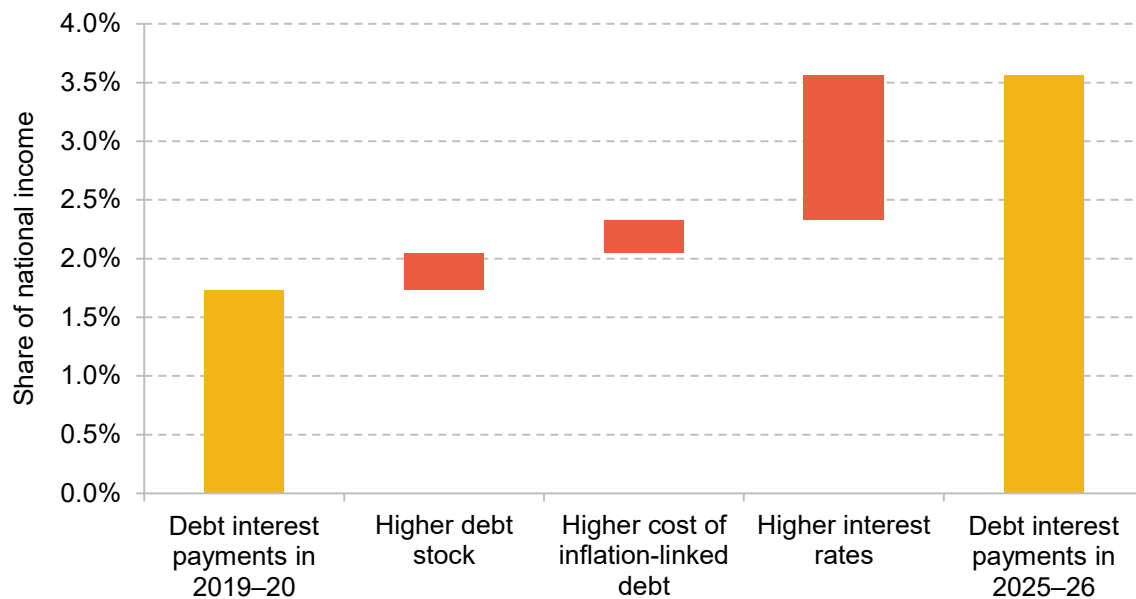
Figure 2.2. Public sector net debt excluding the Bank of England and net financial liabilities: out-turn and March 2026 forecast



Note: Figures from 2026–27 onwards represent the OBR's March 2026 forecast.

Source: Office for Budget Responsibility's Public finances databank September 2026.

Figure 2.3. Change in debt interest payments as a share of national income between 2019–20 and 2025–26



Note: Decomposition splits the interaction between interest rates and the debt stock equally (the Bennet decomposition). 'Interest rates' are effective interest rates, calculated by dividing debt interest payments by outstanding debt. Debt interest is defined as central government debt interest spending (ONS series NMF_X), net of transfers to and from the Asset Purchase Facility (APF, ONS series MU74), which reflect transfers of surpluses and losses of the quantitative easing programme between the Treasury and the Bank of England. 'Debt' is public sector net debt excluding the Bank of England (ONS series CPPH). See Chapter 4 of this Green Budget for a detailed discussion of the effect of the APF on the public finances.

Source: Authors' calculations based on Office for National Statistics, Public sector finances borrowing by sub-sector: Appendix R, July 2026.

The third shift in the fiscal landscape is much higher debt servicing costs. Debt interest spending has more than doubled as a share of national income since 2019–20, from 1.7% on the eve of the pandemic to 3.6% of GDP in 2025–26, its highest level since 1988.² Money spent on debt interest is unavailable for other government priorities such as hospitals, schools, tax cuts or, indeed, reducing the deficit. This is one of the reasons why, despite a much larger state than pre-pandemic, spending choices are tightly constrained.

Figure 2.3 breaks down the 1.8% of national income (£70 billion) increase in debt interest spending between 2019–20 and 2025–26 into three different components. The increase in the stock of debt mechanically pushes up debt servicing costs, which explains 0.3 percentage points of the increase. Around a quarter of the UK's stock of debt is inflation-linked, which means interest payments change in line with inflation measured by the Retail Prices Index. Higher inflation has therefore contributed another 0.3 percentage points to the increase. But the main

² This is central government debt interest spending net of transfers to or from the Bank of England's Asset Purchase Facility.

factor driving the increase is that the government is paying a much higher interest rate on newly issued non-inflation-linked debt. This has pushed up debt interest payments by 1.2% of GDP – £38 billion in 2025–26, or around two-thirds of the total increase in debt interest costs. A substantial share of government debt was issued before the recent increases in government borrowing costs, and so is still at lower interest rates. But as time passes, that debt will mature and be replaced by new debt at higher rates. Given this, without a substantial downward shift in interest rates, debt interest spending is likely to remain high, or even rise further, for the foreseeable future.

What has Labour done so far?

In 2024, Jeremy Hunt pencilled in plans for spending to fall substantially as a share of national income across the following five years, combined with a small tax rise. As we argued at the time, these spending plans looked challenging to deliver: once specific commitments for the NHS and schools were accounted for, other departments would have faced very steep cuts over time (Emmerson, Johnson and Zaranko, 2024). Under these plans, borrowing was set to fall from over 4% of national income in 2023–24 to 1.2% over the following five years, bringing the current budget into a small surplus.

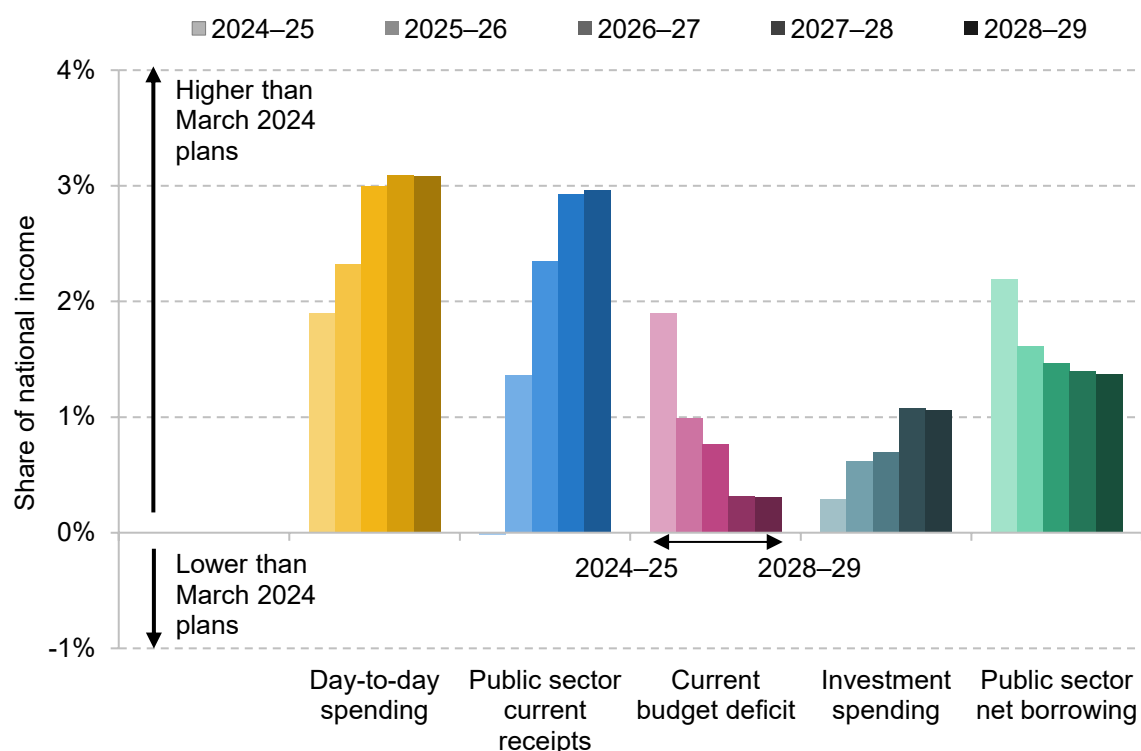
Rachel Reeves set out her own plans to bring borrowing down, but they took a very different shape from her predecessor's. Three key differences between Jeremy Hunt's plans and those of Rachel Reeves can be seen in Figure 2.4.

First, Rachel Reeves chose to substantially increase day-to-day spending (the yellow bars) – by the end of the parliament, it is due to be 3% of national income (£104 billion) higher than in the plans she inherited. The spending plans were front-loaded; growth was fastest in the first two years of the parliament.

Second, Rachel Reeves chose to fund the higher spending with additional borrowing in the short run and higher taxes in later years. This has meant that borrowing is higher in every year of the forecast and the consolidation – the reduction in the current budget deficit (the pink bars) – has been more back-loaded.

Finally, Rachel Reeves chose to keep public investment spending as a share of national income roughly flat at around 2.6% over the parliament (the grey bars), rather than let it fall, as Jeremy Hunt had planned. This is a level not sustained since the 1970s. Higher investment was paid for by higher borrowing (green bars) – even by 2028–29, when the gap between current plans and previous Conservative plans for the current budget deficit is narrowing, overall borrowing is set to be 1.4% of national income (£46 billion) higher. Debt is forecast to be higher as a result of these choices.

Figure 2.4. Increase in spending, receipts and borrowing in out-turns and March 2026 forecast compared with Conservative government's plans as of March 2024



Note: Differences between the March 2024 OBR forecast and the latest out-turn or forecast available. Investment spending measured as public sector net investment. Restated GDP is used for March 2024 values, based on out-turn GDP growth rates instead of forecast GDP growth rates in March 2024, to account for revisions to 2024–25 GDP.

Source: Office for Budget Responsibility's Economic and fiscal outlook March 2024 and Public finance databank July 2026.

The increase in borrowing was made easier by a change Rachel Reeves made to the debt rule. She chose to use public sector net financial liabilities (PSNFL) as the measure of debt that the government aims to get on a falling path as a share of national income. PSNFL captures a wider range of financial assets and liabilities than public sector net debt (excluding the Bank of England), the measure targeted by the previous government's debt rule. In recent years, PSNFL has risen more slowly, and this is expected to continue – as shown in Figure 2.2 – making it easier for the government to meet its falling debt rule while still borrowing more overall.³ This has made a meaningful difference, given the government would have been closest to breaking the debt rule – and in some cases would have broken it, on the plans it announced – at every forecast since Rachel Reeves took office, had she not changed the measure of debt. She also

³ PSNFL is on a less steep upward trajectory than public sector net debt (PSND) because the government's net financial assets – which are netted off PSNFL but not PSND – are forecast to increase in value over time, reducing the rate at which PSNFL increases (or increasing the rate at which it decreases).

chose to target the current budget deficit with the borrowing rule rather than the overall deficit. This means that investment spending decisions are not directly constrained by this rule at all, only by the debt rule.⁴

Despite this higher borrowing compared with the 2024 Conservative government plans, Rachel Reeves's plans still imply a significant fall in borrowing over the course of the parliament. In the OBR's March forecast, borrowing is set to fall from 4.3% of national income in 2025–26 to 3.6% in 2026–27, around a quarter of the fiscal consolidation of 2.6% of national income planned over the course of this parliament. We discuss the preliminary fiscal out-turn data for 2026–27 available so far in Box 2.1.

Box 2.1. Public sector finance data so far this year

The Office for National Statistics (ONS) publishes monthly data on the public finances, covering revenues, expenditure and borrowing, which can be compared with the OBR's monthly projections. Initial data out-turns are prone to significant later revisions. Part of the data for the most recent months is based on assumptions and forecasts, which are only gradually replaced with out-turns. All of this means that it would be unwise to over-interpret the data released in the first five months of the financial year.

That said, the OBR forecast in March that public sector net borrowing in the first five months of 2026–27 would be £69 billion. Provisional out-turns for the first five months of 2026–27 show that it has been £77 billion – £8 billion higher than forecast. The difference comprises:

- higher spending on debt interest by around £2 billion;
- higher spending by central government on other areas by around £5 billion; and
- higher tax receipts by around £1 billion.

The provisional out-turn also shows a £2 billion smaller-than-expected surplus run by public corporations, although the data on these are described by the ONS as 'highly provisional' and therefore even more susceptible to future revisions. Even though inflation has exceeded the forecast, cash revenues from VAT so far have been very close to forecast. These effects may unwind as the year goes on, but we discuss the possibility of higher-than-expected inflation not being associated with higher-than-expected revenues going forward in Section 2.3. Net benefit spending in the five months to August was running 1.8% above the March forecast. This effect, too, may not persist throughout the full year, much less over the forecast horizon, but we discuss the risk that it might in the same section.

⁴ Higher borrowing and higher debt lead to higher debt interest spending, which does affect the current budget rule, but only indirectly and in smaller magnitudes. The 2024 Conservative government aimed to keep all borrowing – regardless of its purpose – under 3% of national income. The practical effect of this change was limited, as the previous borrowing rule was very loose: with investment within the typical range, it was very unlikely to put significant constraints on planned borrowing.

In addition to her tax and spending plans, Rachel Reeves also leaves some welcome improvements to the fiscal policymaking process for John Healey. The horizon of the fiscal rules was shortened from five years to three, and aligned with the length of a Spending Review period. One effect of this is to place greater limits on borrowing: borrowing tends to be lower in the fifth year of the OBR's forecast than the third. Another effect is to increase the credibility of the government's plans. With a shorter horizon, it is more likely that a government – or Chancellor – will still be in place when in the horizon year, and so harder to make plans that they do not intend to stick to. And by aligning with the horizon of Spending Reviews, it is harder for a government to pencil in plans for spending cuts to boost its performance against the fiscal rules without specifying where they will come from.

Another change is increased 'headroom' against the current budget rule,⁵ which was £24 billion, or 0.7% of national income, in the March 2026 OBR forecast. This is higher than had been the case throughout Jeremy Hunt's chancellorship and in Rachel Reeves's first two forecasts. Operating with very small levels of headroom left them overly beholden to small, run-of-the-mill movements in the OBR's forecast and thus generated an overly volatile policy environment (Emmerson, Miller and Zaranko, 2025). Nevertheless, the present level of headroom is still low by the standards of the 2010s. Similarly, whilst previous governments have often made commitments to limit themselves to one fiscal event a year, Ms Reeves is one of the few who actually honoured it, with the March 2026 Spring Forecast a genuine non-event. John Healey would do well to continue the practice.

A broader view of medium-term fiscal sustainability

So far, we have focused on plans for debt and borrowing. This subsection summarises the broader state of the public finances, as measured at the time of the OBR's March 2026 forecast, using 'fiscal traffic lights' (Figure 2.5). The figure sets out forecasts of a range of fiscal indicators in 2025–26 and into the medium term, building on Zaranko (2026). The colours reflect our judgements on when the value of a particular indicator is more or less concerning; dark green indicates the least concerning position while red indicates the most concerning position.⁶ No single indicator can fully encompass all aspects of fiscal sustainability; looking across a range of indicators paints a fuller picture.

⁵ The current budget rule was the one of the two rules that was closest to being broken, and therefore throughout this chapter we use the level of the forecast current budget surplus in 2029–30 to refer to the level of 'headroom' in March 2026, even though the OBR did not formally assess compliance with the fiscal rules at the Spring Forecast.

⁶ The thresholds that determine the colours have been chosen in light of historical and international comparisons, but also inevitably require judgement. A full list of the thresholds used and the rationale for the choices can be found in a forthcoming appendix to this chapter. Various intergovernmental bodies, such as the European Commission, already use similar traffic-light-style tools for monitoring purposes (European Commission, 2025). The OBR also uses a similar tool as part of its assessment of the fiscal context, risks and sustainability – see, for example, table 6.1 of the March 2026 Economic and Fiscal Outlook.

Figure 2.5. Fiscal traffic lights for the March 2026 OBR forecast



Note and source: See the next page.

Note and source for Figure 2.5

Note: A forthcoming appendix to this chapter sets out the methodology in detail, particularly the colour thresholds.

Source: Office for Budget Responsibility's Economic and fiscal outlook March 2026; Debt Management Office; Federal Reserve Economic Data.

We start from a concerning place. In 2025–26 – the financial year in which this forecast was made – all measures of borrowing were high; debt was high as a share of GDP and rising in all measures. The amount spent on debt interest, the share of debt owned by non-UK residents (an indicator of the government's exposure to sudden changes in global market conditions) and the UK's higher debt interest costs relative to other G7 countries (indicated by the '10-year bond spread'⁷ row) all looked very concerning.

The overall picture was expected to improve in coming years. As discussed above, Rachel Reeves had set out a plan to reduce borrowing in every year going forward and deliver a current budget surplus by 2028–29. If achieved, this would have put borrowing in a more sustainable position and started to get all measures of debt falling slightly as a share of national income – hence the move towards green on those measures.

However, this plan follows a common pattern: since the OBR was created, successive forecasts have shown a relatively concerning picture in the short run that improved by the end of the forecast. But it is easier for Chancellors to make plans to improve the state of the public finances over the coming five years than to actually deliver them.⁸ In every single one of the 33 forecasts the OBR has produced, debt was projected to fall by the end of the five-year forecast; instead, it has risen by an average of 15% of national income over that same period. In part, this reflects adverse shocks that have hit the UK, but planned fiscal consolidations have also been abandoned or pushed back. If the government does not deliver the fall in borrowing in its current plans, the borrowing picture will remain concerning. We discuss some of the challenges that could make delivering the planned consolidation politically difficult in Sections 2.4 and 2.5.

But even if these, or an alternative set of, plans were used to deliver a fall in borrowing, the overall stock of debt is slow-moving and would remain concerningly high. It is important that the government has a credible plan to stop the rise in debt. Clearly, a future crisis (whatever its particular nature and exact timing) may require a sharp, temporary increase in borrowing before too long. Given this, there is a strong case that debt should be stabilised and brought down gently outside these moments of crisis. This could also help ease borrowing costs relative to peer

⁷ Bond spreads measure the difference between interest rates on government debt in different countries in hundredths of a percentage point (known as basis points, or bps), so a value of 0 would indicate that interest rates on government bonds in the UK are the same as the average of G7 countries, and a value of 100 that interest rates in the UK are 1 percentage point higher.

⁸ See the forthcoming appendix to this chapter for more details on these patterns across forecasts.

economies, which have become of one of the main areas of concern, as has the high ongoing cost of servicing debt.

2.3 Changes to the fiscal outlook since March

The main development since March has been increased conflict in the Middle East. This has driven up inflation around the world, which in turn has fed through to higher central bank interest rates – in expectation and in practice.

One resulting impact on the public finances has been well publicised: the cost of government borrowing has risen sharply, and this will reduce the amount of ‘headroom’ the Chancellor has against his fiscal rules in 2029–30. Another likely change in the state of the public finances has received relatively little attention: higher inflation can be expected to increase tax receipts. Any extra revenue from inflation is likely to be larger than the automatic increase in public spending, because of the way spending on public services is controlled. This, all else equal, means higher inflation will increase headroom.

In this section, we discuss how changes to a range of economic factors will likely feed through to the fiscal outlook facing the Chancellor at the Budget. Our analysis draws heavily on the Barclays ‘baseline forecast’ for the UK economy, discussed in Chapter 1 of this year’s Green Budget, but also considers other forecasters’ views, including those of the Bank of England. A theme throughout is that the level of uncertainty is high. At this moment, it is not possible to know how long the Strait of Hormuz will be closed or exactly how the supply shock will feed through to prices, economic activity or wages. Independent forecasters take a range of views on how various factors are likely to play out. How they actually play out will matter enormously for the health of the public finances over the coming years.

The level of uncertainty is high, but the Office for Budget Responsibility (OBR) will have to make specific judgements about how it expects the energy price shock to feed through to the wider economy and, in turn, how those effects will change tax revenues and benefit spending. A particularly important judgement will be how the OBR expects nominal – that is, in cash terms and not adjusted for inflation – earnings to grow in coming years, since this is key for forecasting receipts from income taxes. We discuss how different factors and assumptions will likely affect the OBR’s ‘pre-measures’ fiscal forecast – including the performance against the fiscal rules – that John Healey faces when making policy decisions at the Budget.

Given the level of uncertainty, the Chancellor would be well advised to not over-focus on the particular ‘headroom’ number the OBR delivers. The broader picture of the public finances is

key; we discuss that broader picture at the end of this section. We also set out that there are both downside and upside risks to the public finances going forward, illustrating this with the economic scenarios produced by Barclays and discussed in Chapter 1.

Key determinants of the fiscal outlook

Interest rates on government debt

Government borrowing costs have risen sharply since the spring, not just in the UK but in many countries. In large part, this has been driven by war in the Middle East, which pushed up global energy prices and increased expectations for inflation. Markets now expect central banks across the world – including the Bank of England – to raise interest rates to try to control inflation. Expectations of higher central bank interest rates tend to increase interest rates (or yields) on government debt.

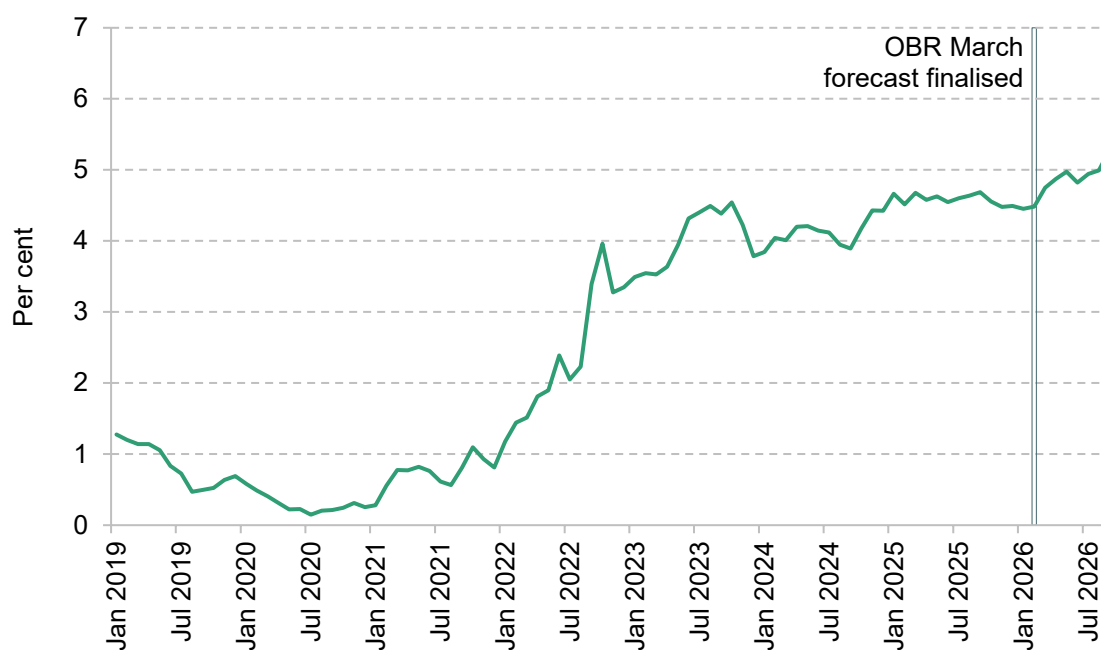
Government bond yields have also been pushed up by longer-term developments: governments are issuing large quantities of debt, while demand from some traditional buyers of long-term government bonds has weakened. Investors require higher interest rates to buy this debt (Chapter 3 of this Green Budget discusses this in more detail). Higher yields push up government spending on debt interest: a sustained, 1 percentage point increase across short- and longer-term borrowing costs might be expected to increase debt interest spending in 2029–30 by £14 billion.⁹

To construct its forecast, the OBR uses market expectations for both Bank Rate (set by the Bank of England and relevant for overnight or very short-term borrowing) and long-term government interest rates. Both have risen since March. Market expectations are for the Bank of England to increase Bank Rate above 4.75% – a more than 1 percentage point increase – by 2028.¹⁰ Figure 2.6 shows that the interest rates that the government faced for new 10-year debt in September were around 0.8 percentage points higher than before the Iran war. Market participants in the week commencing 14 September – roughly the time when the OBR is likely to measure expectations – expected higher interest rates on government debt to persist for the next five years.

⁹ Throughout this section, calculations of how certain economic indicators will translate to the OBR forecast are based on the OBR's March 2025 Ready Reckoner (Office for Budget Responsibility, 2025), updated by authors for comparison with the OBR's March 2026 forecast. All forecast data from Barclays in this section are based on their forecast as of 24 September 2026, with the effects of any recent or anticipated fiscal policy changes stripped out. This explains any small discrepancies with Barclays analysis in Chapter 1, which is based on their most up-to-date forecast, which includes effects of any recent or anticipated fiscal policy changes.

¹⁰ In Chapter 1, Barclays authors set out a forecast of Bank Rate that is different from market expectations. In this chapter, we use market expectations, which is what the OBR will use.

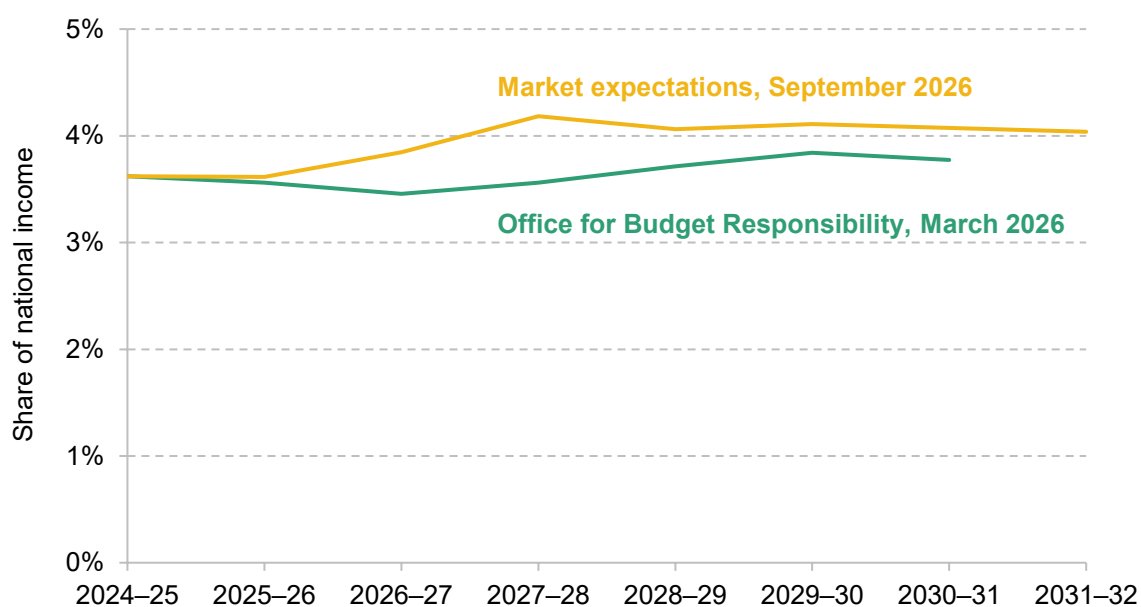
Figure 2.6. Interest rates on 10-year government debt



Note: The figure shows monthly average interest rate, on a government bond (an agreement by the government to pay back borrowed money) that needs to be repaid (potentially being replaced by another bond) after 10 years.

Source: Debt Management Office, Historical average daily conventional gilt yields.

Figure 2.7. Debt interest spending: different forecasts



Note: Based on market expectations for Bank Rate and 20-year gilt rate.

Source: Market expectations from Bank of England and Barclays; debt interest spending estimates based on authors' calculations.

Combined, these increases in interest rates would be expected to add around £8 billion to debt interest costs by the end of the forecast period (see Figure 2.7). In addition, because around a quarter of the UK's debt is index-linked, the cost of servicing the stock of debt rises automatically with inflation. Higher inflation therefore mechanically pushes up debt interest spending in addition to the rise in interest rates. In the Barclays scenario, this effect would add a further £2 billion to debt interest spending in 2029–30. Effects of the Bank of England's decision in September to slow the rate of quantitative tightening are expected to add around £1 billion more.

The OBR has a set process for incorporating interest rate expectations into its forecast. This means that there is essentially no uncertainty about the impact of higher interest rates on the forecast the OBR will present at the Budget. However, there is, of course, a lot of uncertainty about the actual path for interest rates going forward. One way to illustrate this is to consider past changes to interest rates. The increase that the OBR will score at this forecast – around £11 billion – is substantial and we would expect it to materially impact on the Chancellor's choices at the Budget. But it is modest compared with the overall change in debt interest costs we have seen since the pandemic. In November 2020, the OBR forecast debt interest spending in 2025–26 to be just £29 billion; out-turn spending was £109 billion, mostly due to higher-than-expected interest rates.

Inflation and its effects on the public finances

Since March, UK imports have become more expensive relative to exports. This largely reflects higher prices for imported goods, especially oil and gas. This has pushed up consumer prices, although the speed of adjustment varies by product. For example, petrol and diesel prices adjust quickly, while household gas and electricity prices are capped every quarter and so adjust around three months in arrears.

In March, the OBR expected consumer price inflation to fall rapidly over the first half of 2026, then remain around the Bank of England's 2% target. Instead, inflation in August – the most recent available data at the time of writing – stood at just over 3%. Barclays now expect that inflation will peak at 3.4% at the start of 2027 and will not return close to the 2% target until early 2028, almost two years later than the OBR had forecast in March. Both the Bank of England and most other forecasters polled by HM Treasury are in agreement that inflation is going to remain higher than the OBR's March forecast this year and, to a lesser extent, next year.¹¹

¹¹ There are, as ever, some divergent views: one forecaster in the September survey (HM Treasury, 2026b) expects inflation at the end of 2027 to be below target at 1.6%, while another expects it to remain at 3.3%. But 12 out of the 16 forecasters who submitted a forecast in September expect inflation at the end of 2027 to be between 2.1% and 2.5%, as does the Barclays scenario from Chapter 1.

Inflation increases both government spending and revenues. Over the forecast period, we expect the increase in revenues will be bigger than the automatic increase in the parts of spending that are mechanically linked to inflation, and so the overall effect will be to reduce borrowing.

In addition to its direct effect on debt interest for inflation-linked debt, inflation automatically pushes up spending on many benefits such as universal credit and disability benefits, which are uprated annually in line with inflation.¹² **Using the Barclays inflation forecast, spending on benefits would increase by £6 billion a year from 2028–29 onwards because of higher inflation.**

Higher prices also put pressure on public service spending – inflation erodes the spending power of departments’ budgets. **Because departmental budgets are set in cash terms, there is no automatic mechanism to compensate departments for higher-than-expected inflation.** Instead, the government faces a choice as to whether to top up departmental spending or allow the real-terms generosity of spending allocations to decline (see Chapter 6 for an in-depth discussion).

On the revenue side, taxes are typically levied on cash quantities such as wages, prices and profits. This means that when inflation pushes up cash values, revenues increase, even if underlying economic activity is no stronger, or even weaker, than before. The Barclays forecast assumes that economic activity will grow more slowly as a result of the higher prices and reduced supply of oil and gas through the Strait of Hormuz. In that scenario, cumulative growth from 2025–26 to 2031–32 in real GDP is 0.5 percentage points lower than under the OBR’s March forecast. But in cash terms, the economy will be grow cumulatively by 2 percentage points more over the same period, due to higher inflation more than offsetting the slower growth in economic activity. This will push up revenues from a range of taxes. Below we provide estimates of how overall tax revenue could change. Here we discuss the uncertainties around what higher inflation could mean for VAT and corporation tax and how it may feed through into labour income taxes.

Taking the Barclays forecast, we might expect higher prices and profits to push up revenues from VAT and corporation taxes by some £5 billion in 2029–30. However, the effects are uncertain and depend not only on how high inflation turns out to be and how long-lasting it is, but also on how ‘tax-rich’ it is.

¹² Inflation also feeds into the triple lock which determines the uprating of the state pension. In the Barclays scenario, inflation would always be lower than at least one of earnings growth and 2.5% in every forecast year, and therefore has no impact on the state pension.

Starting with VAT, an important uncertainty comes from the fact that higher-than-expected inflation driven by energy prices might shift spending towards goods and services taxed at lower rates of VAT, reducing the increase in revenues. Energy is a necessity, and so people may not reduce their energy consumption by very much even if it becomes more expensive. Higher energy prices could therefore leave households with less cash to spend on other, less essential goods and services. Energy is taxed at a lower rate of VAT – 5%, reduced to zero for the second half of 2026–27, rather than the standard 20% – which could mean that consumer spending as a whole becomes less tax-rich, and does not translate into as much revenue as a broader increase in prices would. A similar argument could be made about spending on food, which is mostly zero-rated; food prices have not increased significantly in recent months, but could do so in response to higher transport costs. Chapter 1 also highlights potential risks to food prices from weather and climate conditions.

A shift in spending towards goods taxed at lower rates might temper the increase in VAT revenues, but by how much is uncertain. As we discussed in Box 2.1, it is too early in the year to gauge information about revenues for the whole of 2026–27 from recent out-turn data on government revenues. And because the most acute pressure on household budgets will be felt in winter, when energy needs are highest, it will be some time until we have a full picture of how expenditure is translating into VAT revenues in out-turn. There is also some uncertainty as to how the OBR might incorporate some of these effects into its forecast. If the OBR judges that they are significant, it might include a lower standard-rated share of consumption expenditure in its forecast, which might mean a more muted boost to revenues.

We also expect corporation tax revenues to increase with higher inflation as businesses make higher profits in cash terms. But energy is an input into nearly all production processes, meaning that profits do not rise as much as in the case of more generalised inflation. And how much profits rise is also related to how inflation feeds through into earnings, which we discuss in detail next. The more earnings rise, the more will be raised from income tax and National Insurance contributions but the lower will be some of the additional revenues from corporation tax as inflation feeds through to earnings rather than profits.

How will higher prices feed through to earnings?

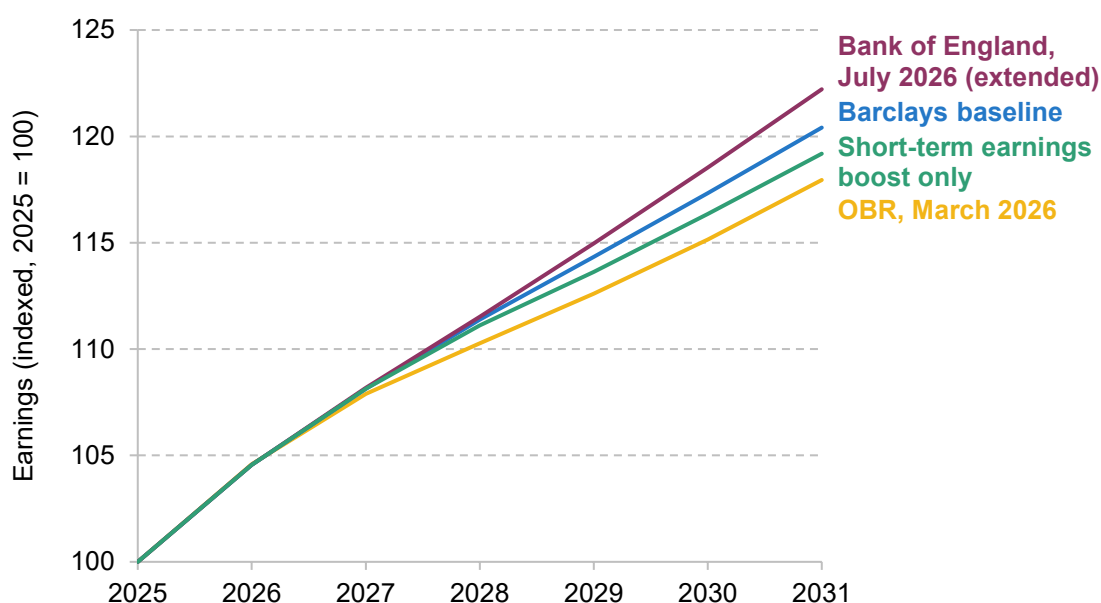
How earnings will evolve over the next five years is perhaps the most important judgement that the OBR will have to make in its upcoming forecast. Almost half of tax receipts come from the two main taxes on income – income tax and National Insurance contributions – and taxes on income are levied at a higher rate than on most other parts of the economy.

The path of nominal earnings is therefore very important for the fiscal outlook, but is subject to significant uncertainty. Figure 2.8 shows a range of different scenarios for nominal earnings over time. In March, the OBR forecast that nominal earnings would grow by around 3.2% in 2027,

and then by just around 2.2% per year for the rest of the decade. This meant that earnings were forecast to be 15% higher in 2030 than in 2025.

The blue and purple lines show the latest forecasts from Barclays and the Bank of England respectively. In line with most forecasters, both expect that nominal earnings will remain in line with the OBR's March forecast this year (2026). However, both Barclays and the Bank of England expect higher growth from 2027 onwards. Relative to the OBR's March forecast, this leaves nominal earnings 1.9% higher in 2030 in the Barclays forecast and 3.0% higher in the Bank of England's forecast. Such differences can have large impacts on the public finances: we would expect a 1 percentage point higher cumulative earnings growth over this period to increase tax revenues by roughly £8 billion in 2029–30.

Figure 2.8. Nominal earnings forecasts: different scenarios



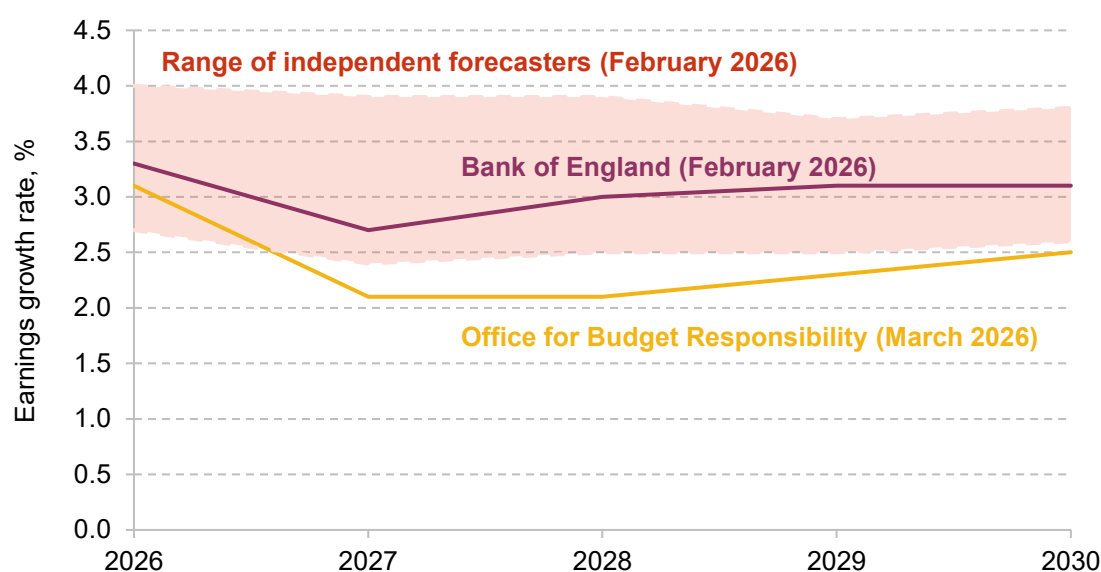
Note: Bank of England forecast is only published up to 2028, but assumes a constant growth rate of 3.1% in the final two years of its forecast. We assume that this continues until 2031, in line with the Bank's estimate of target-consistent wage growth (Bank of England's Monetary policy report February 2026).

Source: Authors' calculations using economic scenarios from Chapter 1, Office for Budget Responsibility's Economic and fiscal outlook March 2026 and Bank of England's Monetary policy report July 2026.

There are two main reasons that forecasters have different paths for nominal earnings. The first is that the OBR has, in recent years, forecast lower wage growth than other forecasters, including the Bank. One key reason for this is that, since 2023, the OBR has taken the view that a falling share of the economy would go towards wages, as firms recoup profits lost during the 2022 inflation spike and, more recently, pass on the cost of higher employer National Insurance contributions. As shown in Figure 2.9, other forecasters took different views of likely nominal

earnings growth even before the outbreak of war in Iran.¹³ In every year but 2026, the OBR's forecast is below all independent forecasts surveyed by the Treasury, and well below the Bank of England's, which was in the middle of the range of independent forecasters. The Barclays forecast in Chapter 1 is also towards the pessimistic end, close to the bottom of the range. However, the gap between the Barclays forecast and the OBR's – which existed before the March forecast – is enough to cause a large part of the divergence in the medium term seen in Figure 2.8.

Figure 2.9. Nominal earnings growth forecasts before the start of the war in Iran



Note: Bank of England forecast is only published up to 2028, but assumes a constant growth rate of 3.1% in the final two years of its forecast. We assume that this continues until 2030, in line with the Bank's estimate of target-consistent wage growth (Bank of England's Monetary policy report February 2026).

Source: Authors' calculations using Office for Budget Responsibility's Economic and fiscal outlook March 2026, Bank of England's Monetary policy report February 2026 and HM Treasury's Independent forecasts February 2026.

The second reason for different paths relates to how the conflict in the Middle East could affect wages, through its impact both on inflation and on economic activity. A key judgement for forecasters is how well workers will be able to bargain for higher wages to compensate for higher prices. All independent forecasters (that were surveyed by the Treasury both before and after the start of the conflict) have increased their nominal wage forecasts since the closure of the Strait of Hormuz – thereby assuming that workers will be able to command at least some degree

¹³ One reason for the difference in medium-term earnings forecasts between the OBR and the Bank of England is a difference in method. The Bank of England calculates what earnings growth would be consistent with its 2% inflation target, and assumes that earnings will grow at that level once the target is reached. The OBR (and Barclays) use a more bottom-up approach, which assumes that some share of labour productivity growth will feed through to earnings, and the rest will feed through to profits. The OBR then assumes separately that inflation will reach its 2% forecast. Other forecasters use different methods from either of these, such as time-series modelling.

of compensation for inflation. But the extent to which forecasters have revised their expectations over nominal wages varies a lot – some have increased their forecast for earnings in 2030 by as much as 2%, while the Bank of England has only made a very small change.

The OBR could decide that conflict in the Middle East will have little impact on nominal wages – i.e. that workers will not be able to command higher wages, such that real wages decline. In this case, it may stick with a forecast close to the March 2026 forecast. It could instead decide that nominal wage growth will be substantially higher, and move more in line with the Barclays or Bank of England forecasts – this would imply both that the OBR thinks that nominal wages will grow following the recent rise in inflation and that, more generally, it has become less pessimistic relative to its March forecast. The green line in Figure 2.8 shows an illustrative middle option: the OBR could revise up its forecast nominal earnings growth in the short term (in 2027 and 2028) but leave subsequent growth the same as in its March forecast. In this illustrative scenario, nominal earnings would be 1% higher in 2030 than its March forecast. In our view, it is reasonable to expect that the OBR will forecast a path for earnings that is higher than its March forecast, but lower than the Barclays forecast. This could follow a similar pattern to the ‘short-terms earnings boost only’ scenario, but many other scenarios are possible; there is considerable uncertainty around this judgement. We discuss how these assumptions could feed through into tax revenues, and therefore the ‘headroom’ against the Chancellor’s fiscal rules, in the next section.

So far, we have focused on nominal earnings, as these are what is most important for the public finances. But real earnings – i.e. earnings after accounting for inflation – are more important for household living standards. All forecasters expect real earnings to grow more slowly this year than the OBR did in March. But there are then differences in the expected levels of real earnings in future years, with forecasters having both different expectations about long-run real earnings growth, and different expectations over whether conflict in the Middle East will leave real earnings permanently lower or whether there will be some level of ‘catch-up’ growth in real earnings to compensate for falls this year.

While the OBR’s assumptions over earnings growth will be very important for the Budget, the health of the public finances will ultimately be determined by what actually happens to earnings in the coming years. Alongside the scenarios discussed above, in which nominal earnings might fall below Barclays’ primary forecast, there are other scenarios, which the OBR is less likely to forecast at the Budget, but which could see even higher earnings growth over the medium term.

One such scenario – discussed in Chapter 1 – revolves around an increase in investment in artificial intelligence (AI). Recent preliminary growth out-turns have suggested an uptick in investment in AI-intensive industries in the UK. If this were to continue, and we saw levels of investment similar to those seen in the United States in recent years, we might expect a small

increase in nominal earnings relative to the Barclays baseline forecast, of around 0.3% by 2032, driven by the increase in investment increasing overall capital stock and demand in the economy. In an alternative scenario, if this investment fed through to higher economy-wide productivity growth, Barclays forecasts that this could lead to a 1.3% increase in nominal earnings compared with the same baseline by 2032. This shift in earnings would increase receipts by £10 billion, though there would also be other effects on receipts via higher investment and a small fall in employment.

Employment and migration

The outlook for employment can also have a significant impact on the public finances: as a rule of thumb, every additional 100,000 workers would be expected to add around £1.5 billion to revenues from taxes on income per year.

There have been two substantial but countervailing changes to the employment picture since March. The first is that recent data suggest that employment this year is around 180,000 higher than the OBR thought back in March.¹⁴ This would add between £2 and £3 billion to this year's tax revenues. However, employment is likely to fall back towards the OBR's March forecast in the medium term. The primary reason for this is migration: recent projections from the Office for National Statistics expect net migration in the medium term to be 230,000 per year, substantially lower than previous projections. The OBR pre-empted some of this downward shift in its March forecast, but this still means that net migration is expected to settle at 60,000 fewer people per year compared with the OBR's March forecast.¹⁵ This is likely to slow employment growth over the next several years, and so employment by the end of the forecast may be similar to the level expected by the OBR in March. If this were the case, shifts in employment would have only a very small effect on the overall outlook for the public finances.

However, there remains significant uncertainty over the path of employment. Recent visa data suggest net migration could have fallen by 130,000 this year, while the OBR's most recent forecast did not expect any fall this year. This could cause the OBR to push its net migration forecast down further, which would in turn lead to lower revenues. More broadly, net migration has been very volatile in recent years, rising by 800,000 in two years at the start of the decade, before falling back down almost as quickly. Against that backdrop, it seems plausible that net migration will not settle at its current level, and instead may continue to move around sharply, with substantial implications for the public finances. For any given level of net migration, the

¹⁴ This shift in the employment rate stems from measures in the Labour Force Survey, from which it can be hard to draw strong conclusions. However, as the OBR's employment measures rely on Labour Force Survey data, the OBR could reflect a similar shift in its forecast.

¹⁵ For a more detailed discussion of the OBR's approach to forecasting net migration and how it could be improved, see Chapter 5.

composition of migration flows (e.g. by route, as discussed in Chapter 5) further adds to the uncertainty around the employment forecast.

The trajectory of the unemployment rate is also uncertain. In recent years, the unemployment rate has crept up, and the Barclays forecast now expects it to be higher than previously expected by the OBR, reaching 5.7% by 2027. This pushes down the employment forecast, and also pushes up expectations for benefit spending. This higher unemployment rate is expected to add £3 billion to spending on universal credit by 2029–30 relative to the OBR’s forecast in March. The judgement the OBR makes on the unemployment rate will therefore also have consequences for the overall employment forecast.

Health- and disability-related benefits

Sharply rising caseloads since the pandemic have driven up spending on benefits to support children and working-age adults with disabilities and health conditions.¹⁶ Between 2019–20 and 2024–25, spending on these benefits increased from 1.3% of national income to 1.9% of national income – equivalent to an £18 billion rise in today’s terms. The OBR projects spending on these benefits to continue growing but to slow. It expects spending to hit 2.2% of GDP by 2029–30, a further increase equivalent to 0.3% of national income or £9 billion. Rising health-related benefit spending is a pressure on the public finances, but existing forecasts are already baked into current plans.

However, if the OBR increased its forecast of health-related benefit spending further, this would pose an additional pressure on the government’s fiscal position. In-year data on benefit spending is running 1.8% ahead of the OBR’s March forecast (see Box 2.1 earlier). We should be cautious of putting too much weight on these monthly snapshots, which are prone to significant revision as more data become available, but it is possible that this will prove an early indicator of faster spending growth going forward.

The OBR may decide to increase its forecast for health-related benefit spending because of higher-than-expected inflation, which could increase health-related spending through two channels. First, benefits are uprated in line with inflation, so higher inflation mechanically leads to higher spending, which is accounted for in the scenarios discussed above. Second, cuts to real incomes from higher inflation could increase the number of people claiming health-related benefits – and there is some evidence that previous cuts to real incomes have increased health-related benefit claims (Cribb et al., 2025). It is therefore plausible that the OBR could respond to

¹⁶ This includes spending on incapacity benefits (primarily employment & support allowance and people on the health element of universal credit) and disability benefits (personal independence payment and disability living allowance) for working-age adults and children. It does not include spending on disability benefits in Scotland, which was devolved in 2020, and it does not include spending on carers’ benefits.

the higher-than-expected inflation by increasing its forecast for the number of health-related benefit claimants. This would place another pressure on the public finances above and beyond the mechanical effect of benefits rising with inflation.

Health-related benefits are also an area where the government may look to make reforms at the budget. We discuss options for reforming disability benefits in Chapter 7.

Where does this leave the Chancellor?

The 'headroom' picture

The combination of these economic shifts could have a significant impact on the Chancellor's 'headroom' against his more constraining fiscal rule – running a current budget surplus in 2029–30. In March, the OBR forecast a current budget surplus of £24 billion in 2029–30. As discussed, economic changes since March will feed through to revenues, debt interest spending and spending on benefits. **It bears repeating that the exact shape and size of these effects are very uncertain, and any forecast – the OBR's included – will be a matter of judgement.** We now discuss the different judgements that are likely to be most important, using illustrative adjustments to the Barclays baseline. We focus on the impact of different judgements on the 'pre-measures' – that is, before the impact of new policies – headroom forecast.¹⁷

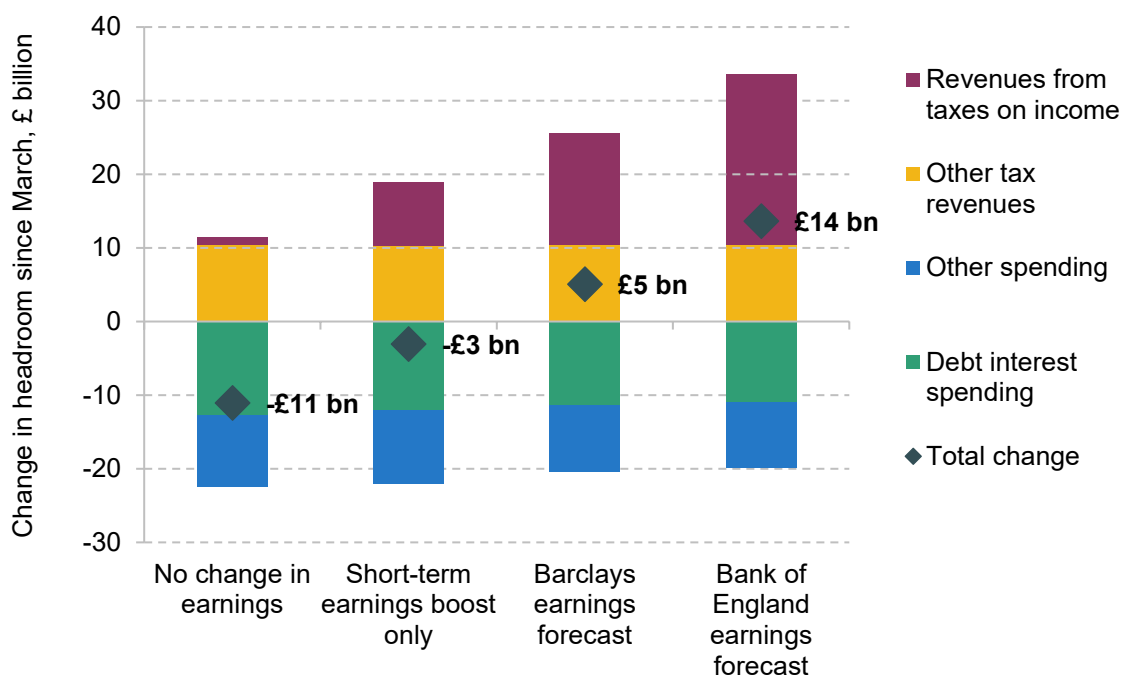
A shift in debt interest costs has taken centre stage of the fiscal debate in recent weeks. As discussed in the previous subsection, we can be fairly certain about the impacts of this on the OBR's headroom forecast. Specifically, we expect higher interest rates and inflation will push up forecast net debt interest costs by around £11 billion by 2029–30. On its own, this would almost halve the Chancellor's headroom against the borrowing rule.

The government also looks set to spend around £9 billion more than forecast in March on non-debt-interest spending, mostly benefit spending. This comes mostly from higher CPI inflation, which means higher benefit uprating, but also from a higher unemployment forecast.

However, the impact of inflation on tax revenues – which pushes in the other direction – is more uncertain. We would expect the extra tax revenues from higher inflation to be greater than automatic increases in (non-debt-interest) spending, reducing forecast borrowing overall – but there is a high degree of uncertainty about the extent of that reduction.

¹⁷ There have been several small policy changes announced since March, though all of them are unlikely to significantly affect the forecast current budget surplus in 2029–30. The Defence Investment Plan left around £1 billion per year of spending to be found at the Budget, though this will only affect the current budget surplus if the spending is on day-to-day costs. Other changes, such as the energy VAT cut and the pause in the removal of the 5p cut in fuel duty, are scheduled to be temporary and so will not appear in the OBR's forecast for 2029–30. We discuss the risks of these temporary policies in Section 2.4.

Figure 2.10. Changes in headroom relative to March OBR forecast: different illustrative scenarios for the OBR earnings forecast



Note: The figure shows changes to the forecast current budget surplus in 2029–30 ('headroom' against the borrowing rule) relative to the March 2026 OBR forecast of £24 billion. Debt interest effect and non-income tax revenues effect in all scenarios based on market expectations for Bank Rate and longer-term interest rate expectations in the week commencing 14 September, the Barclays inflation forecast from Chapter 1, and recent Bank of England announcements on quantitative tightening.

Source: Office for Budget Responsibility's Economic and fiscal outlook March 2026, Barclays earnings forecast from Chapter 1, Bank of England's Monetary policy report July 2026 and authors' calculations.

The most consequential component of the judgement on inflation will be the path for nominal wages, which is crucial for determining how inflation feeds through into higher income tax and National Insurance revenues.

Figure 2.10 shows the change in headroom under four illustrative scenarios, each of which makes a different assumption about the earnings forecast (as discussed above).¹⁸ In each case, the overall change since the OBR's March forecast (the diamond) is broken down into the change coming from higher debt interest spending, higher 'other spending' (mostly on benefits) and higher tax revenues.

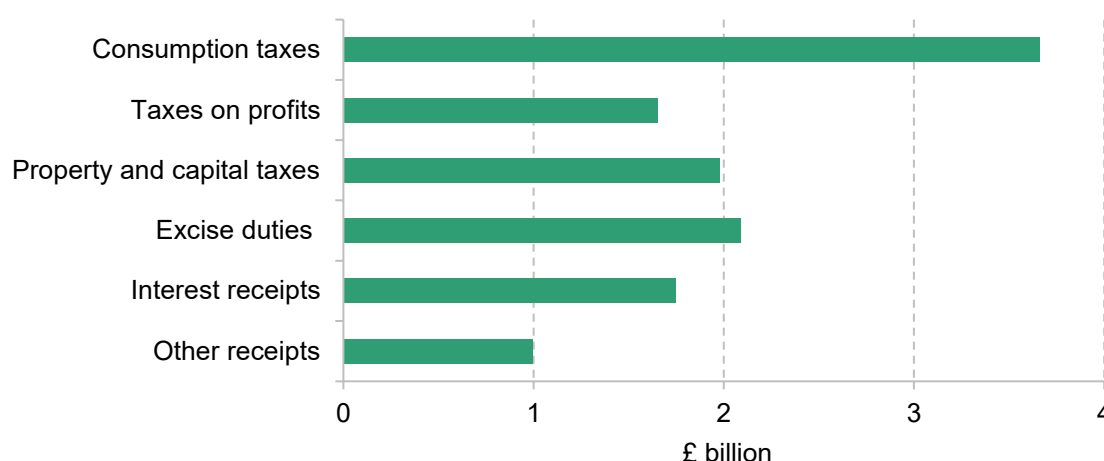
These highlight that changes to the assumed path of nominal earnings make a huge difference to 'headroom', with a spectrum of estimates from £13 billion (an £11 billion decrease relative to

¹⁸ Changes in debt interest spending are different in each scenario, and different from the £11 billion impact of higher interest rates. This is because different scenarios have different implications for borrowing, which affects the stock of debt that the government has to pay interest on. Different earnings trajectories also affect welfare spending, by reducing in-work benefit spending and by increasing the indexation of the triple lock. These effects roughly offset.

March) if the OBR assumed that earnings do not rise at all to compensate for higher inflation, to £37 billion (a £14 billion increase) if the OBR were to adopt the Bank's much more optimistic view of earnings growth.

Whilst very consequential, this is by no means the only source of uncertainty for the OBR forecast. There is also uncertainty over how higher inflation will feed into other tax receipts beyond income tax and National Insurance contributions. In the Barclays forecast, and relative to the March OBR forecast, higher inflation leads to a £25 billion increase in tax revenues (as shown in the yellow and purple bars in Figure 2.10), approximately £10 billion of which comes from an increase in non-labour-income tax revenues. Figure 2.11 decomposes how this additional £10 billion is split across different taxes. As we discussed above, actual revenue effects may turn out smaller (or larger) than these estimates, depending on how the energy price shock feeds through to profits and consumer spending.

Figure 2.11. Illustrative increase in revenues from tax bases other than income in Barclays scenario, 2029–30



Note: Consumption taxes include VAT, insurance premium tax and customs duties. Taxes on profits include corporation taxes and energy profits levy. Property and capital taxes include capital gains tax, inheritance tax, stamp taxes and business rates. Excise duties include fuel, alcohol, tobacco, betting and gaming, air passenger and vehicle excise duties, and the climate change levy. Other receipts include the licence fee.

Source: Authors' calculations using Office for Budget Responsibility's Ready reckoner March 2025.

Other judgements will also affect the fiscal forecast. For example, with housebuilding lagging behind forecasts, the OBR may choose to revisit the impact of planning reform it scored in 2025. However, this would likely only have a very modest effect. The original forecast was that reforms would lead to a 0.2% boost to national income by 2029–30 (box 3.3 of the OBR's Economic and fiscal outlook March 2025). If this were cut in half, as a pessimistic scenario at the time suggested, we might expect a decrease in forecast revenues of £1–2 billion.

In summary, a set of OBR judgements will be key to determining how much headroom John Healey faces. These include: how nominal earnings will evolve in coming years; whether the revenue increase that results from higher inflation will be more muted than we would usually expect; and whether spending on health-related benefits will be higher than previously forecast. It seems unlikely that the OBR would either make no revisions to its nominal earnings forecast or move it in line with the Barclays forecast. If the OBR took some form of middle path – for example, an increase in nominal earnings in the short run but without an increase in the longer-term path (as shown in the ‘short-term earnings boost only’ scenario above) – the headroom would be around £20 billion. But there is substantial uncertainty, and not just about the path of earnings. To highlight just one of the many examples where the OBR’s judgements could make a significant difference: if the OBR decided not to revise up employment estimates on the basis that there are concerns about the quality of the LFS data, that judgement alone could lower headroom by around £2 billion. More broadly, while we judge that there are good reasons to expect headroom to be higher than £13 billion (which would be the headroom if only the effects of higher debt interest are accounted for), it would be no surprise if the OBR forecast headroom lower than £20 billion. The OBR could also make a set of judgements that would leave headroom higher than it was in March. It is also always worth bearing in mind that, in the context of overall levels of government revenues and spending, a swing of £5 billion one way or the other is a relatively inconsequential change.

If the Chancellor is facing an increase in borrowing (and therefore a fall in headroom against the main fiscal rule) in the pre-measures forecast, he will have to decide whether to pursue a fiscal consolidation to increase headroom and, if so, on what scale.

There are good reasons to not meet the fiscal rules exactly, but to leave some headroom against them. The OBR forecast is necessarily uncertain – adequate headroom can absorb the inevitable fluctuations from one forecast to the next and avoid Chancellors being forced into overly frequent policy changes in response. This should limit damaging policy volatility and free up capacity for higher-quality policymaking with a longer-term view (Zaranko, 2026).

If the Chancellor is faced with a small change in forecast borrowing – and especially if he judges that the forecasts may improve in future – he could choose to absorb the forecast downgrade (i.e. accept lower headroom), rather than responding with a compensating tax rise or spending cut. There is nothing special about £24 billion and no reason to see it as a target for headroom.

However, if the downgrade were large – and especially if the Chancellor judges that the effect is likely to prove persistent – there would be a greater case to rebuild headroom. Allowing headroom to remain at a lower level for an extended period would permanently increase borrowing. Accommodating higher borrowing would mean higher debt and higher spending on servicing it going forward. Operating with low headroom would also raise concerns that plans

were less likely to be deliverable, and could lead to damaging policy volatility should a future run-of-the-mill forecast downgrade push the government the wrong side of its fiscal rules.

An important piece of context is that past Chancellors have responded asymmetrically to changes in the forecasts handed to them by the OBR, absorbing the cost of forecast deteriorations but spending the proceeds of forecast improvements (Emmerson et al., 2023). This leads to a ratchet effect on debt over time and means that the forecast is no longer central once typical policy responses are taken into account. Since this effect is well known, a Chancellor looking to strengthen the credibility of their stated plans may wish to demonstrate that they are as willing to raise taxes or cut spending in response to bad fiscal news as they are to do the opposite in response to good news. For all these reasons and more, John Healey may wish to add to his headroom, or rebuild it in case of a downgrade.

If the Chancellor were to find himself with higher headroom than in March (before any policy decisions), he should consider very carefully whether to ‘spend’ the extra headroom, or instead operate with a larger headroom – more in line with levels in the 2010s – and use it to reduce borrowing more quickly.

It is also important to remember that, to the extent that higher revenues are pushing down on borrowing and up on headroom, that effect is coming through inflation which is simultaneously putting pressure on departmental budgets. Were that pressure to be offset through top-ups to departmental budgets, the (post-measures) headroom would go down. Whether the increase in revenues would partially, fully or more than offset spending impacts of inflation depends on exactly how higher inflation feeds through into tax revenues, including the path of earnings.

A view of the broader public finances

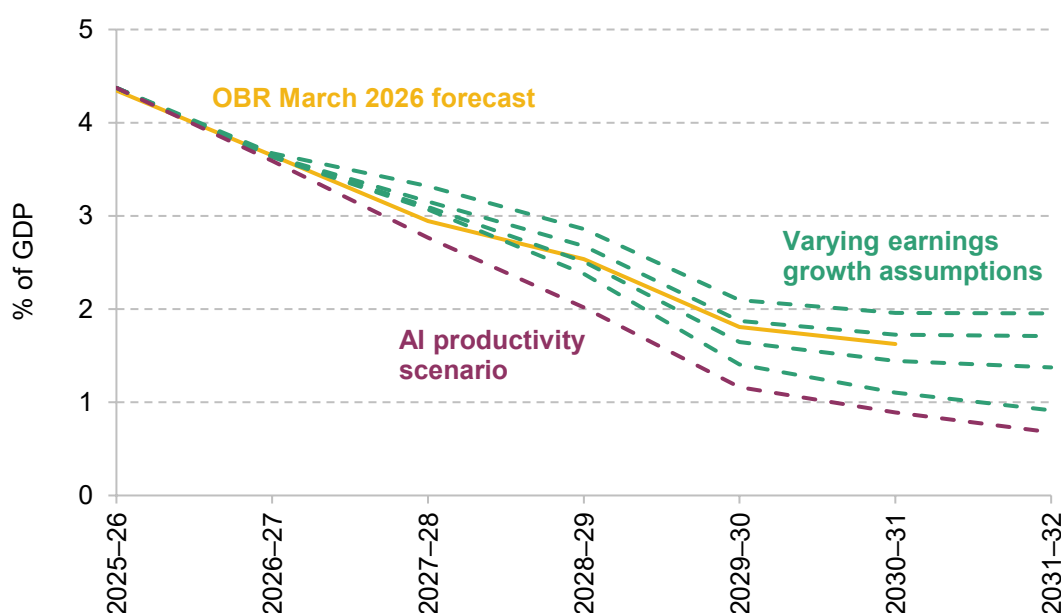
Ultimately, the wider outlook for the public finances – across different indicators and across time – and the uncertainty inherent in it are what matter for fiscal sustainability. These, rather than a single, spuriously precise ‘headroom’ number – should be the focus of fiscal debates. We now present a few headline indicators in a range of different scenarios, and examine how they compare with the OBR’s expectations back in March. We continue to focus on economic uncertainties. Of course, the trajectory of borrowing and debt will also crucially depend on policy choices of this and future governments – we will turn to their potential fiscal impacts in Section 2.5.

Figure 2.12 shows the expected course of overall borrowing (public sector net borrowing, PSNB) as a share of national income. Unlike the current budget, which is the target of the borrowing rule, this measure includes borrowing for investment spending. By the end of the forecast, different nominal wage growth assumptions could lead to a borrowing forecast that is essentially the same as, lower than or higher than the OBR’s in March, as a share of national

income. However, in all these scenarios, we would expect an increase in the borrowing forecast for this year and next, as the high cost of servicing inflation-linked debt outpaces other effects.

We also show the trajectory of borrowing under an optimistic scenario where higher investment in AI boosts productivity growth, much closer to the levels seen before the Global Financial Crisis. This is unlikely to be something the OBR would forecast at this point, but it shows that there are possible upside, as well as downside, scenarios that could materialise in coming years. Higher investment and productivity in this scenario boost real GDP growth to 1.9% per year over the next five years, leaving the level of economic activity over 2% higher by 2031–32 than in the central scenario. Under this scenario, overall borrowing would fall to 0.7% of national income in 2031–32, which would be the lowest level since 2001–02.¹⁹

Figure 2.12. Public sector net borrowing as a share of national income: OBR March 2026 forecast and Barclays/IFS scenarios



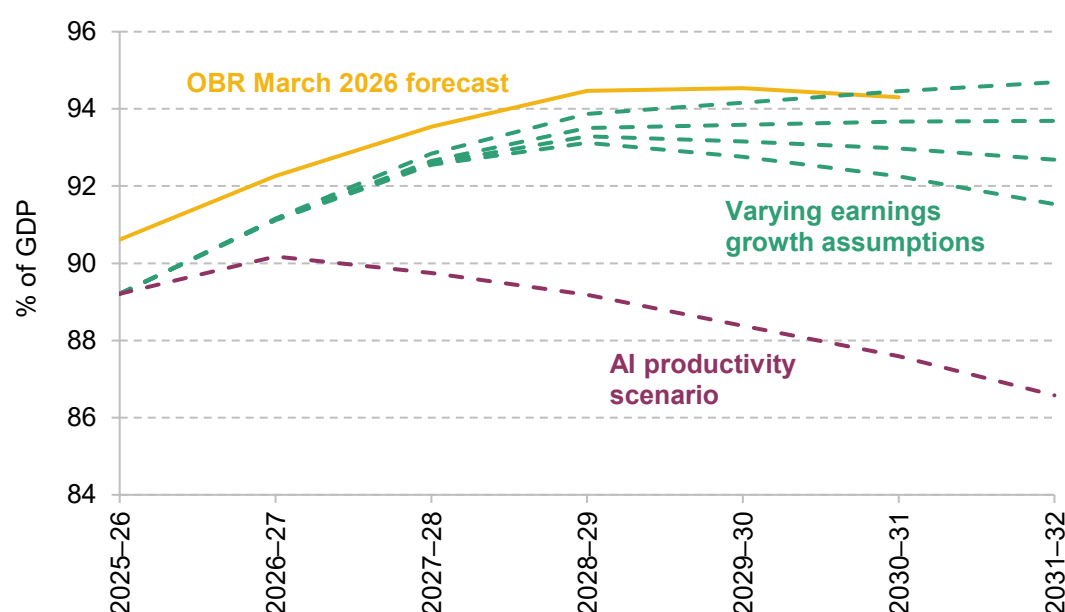
Note: Debt interest effect and non-income-tax revenues effect in earnings growth scenarios (dashed green) based on market expectations for Bank Rate and longer-term interest rate expectations in the week commencing 14 September and the Barclays inflation forecast from Chapter 1.

Source: Office for Budget Responsibility's Economic and fiscal outlook March 2026. Barclays economic forecast, using authors' calculations based on Office for Budget Responsibility's Ready reckoner March 2025.

¹⁹ In Chapter 1, Barclays authors consider a negative scenario where the Strait of Hormuz remains closed for longer, keeping energy prices higher for longer. While the associated higher inflation would be negative economically, we estimate it could increase tax revenues by a small amount more than it automatically increases spending, leading to a reduction in borrowing relative to the Barclays baseline forecast.

Figure 2.13 shows what each of these scenarios would mean for the total stock of government debt, as measured by public sector net debt excluding the Bank of England (PSND ex BoE). In March, the OBR forecast PSND ex BoE to fall very slightly as a share of national income at the end of the forecast period. All the scenarios we have set out have debt lower as a share of GDP in the next few years, as higher-than-expected growth out-turn data in the first half of 2026 and a larger expected economy in cash terms reduce debt's share of it. The range of assumptions for earnings growth makes the difference between debt rising or falling as a share of national income towards the end of the forecast horizon. However, the differences across scenarios are relatively modest: only in the most optimistic earnings growth scenario does debt get on a meaningfully falling path as a share of national income, though that is only enough to bring it back to its current level by the end of the forecast period.

Figure 2.13. Public sector net debt (excluding the Bank of England) as a share of national income: OBR March 2026 forecast and Barclays/IFS scenarios



Note: Forecast trajectories start from a different level from the OBR March 2026 forecast due to higher-than-expected nominal growth towards the end of 2025–26, which pushes up the denominator and brings down the level as a share of GDP.

Source: Office for Budget Responsibility's Economic and fiscal outlook March 2026. Barclays economic forecast, using authors' calculations based on Office for Budget Responsibility's Ready reckoner March 2025.

In the more optimistic scenario for productivity, we do see more of an improvement: debt as a share of national income ends up 5 percentage points lower than even in the most optimistic earnings growth scenario. This is a result of meaningfully higher real growth in this scenario, highlighting how important economic growth is for the sustainability of the public finances. However, even in this very optimistic case, debt is only falling by 1% of national income per year: it would take 14 years of that trajectory to get debt back to the level seen just before the pandemic.

Of course, one lesson from the recent past is that unexpected crises do happen, and can ratchet debt up sharply. Moreover, all this discussion has centred on what the forecast might look like before the effects of any policies announced at the Budget. The situation may look very different when John Healey sits down again after announcing his policy decisions in his speech. These decisions could be driven by the challenges he has inherited or by the new government's fresh ambitions. We briefly discuss both of these in the next two sections.

2.4 Inherited pressures

John Healey has inherited a substantial set of pressures on the public finances from his predecessors. Above, we focused on economic developments that trigger an automatic change in the fiscal outlook – higher interest rates lead to more debt interest spending, more consumption in cash terms brings in additional revenue, and so on. In contrast, we now focus on areas where the government will face pressure to change its currently stated policy, but has a choice over whether to and to what extent it responds. Chapter 6 analyses public service spending pressures in much more detail; here, we briefly outline the range of uncertainty for the public finances as a whole from pressures on departmental spending plans from inflation, ambitious productivity assumptions and a difficult looming Spending Review, as well as from a potential set of temporary measures, including a freeze to fuel duties.

Departmental spending plans

Departmental spending makes up around half of total public spending and is mostly spent on delivering public services, including the NHS, schools, defence and the justice system. Under the framework set by Rachel Reeves, the upcoming Budget would be the last clear opportunity to make changes to the total amount of planned departmental spending for 2028–29 to 2030–31, which are the years for which departments are due to be allocated budgets at the Spending Review next year. 2029–30, the year the fiscal rules currently target, is part of that period. This is no accident but a helpful consequence of 2024 reforms to avoid over-optimistic spending plans artificially flattering reported performance against the fiscal rules. The government must also set spending totals for 2031–32, the new fifth year of the forecast, and will set capital budgets for departments for that year at the upcoming Spending Review too.

John Healey could choose to stick to the inherited totals, or even cut them back. If he wants to increase them, and stick within the existing framework, spending increases would have to be made at this Budget. Alternatively, he could depart from the spending framework set by Rachel Reeves, but doing so would mean either conducting the Spending Review within the current spending plans, holding a second fiscal event next year or conducting the Spending Review alongside the Autumn Budget. There are good reasons for the government not to settle every detail about departmental spending this autumn, especially given the change in Prime Minister

and Chancellor. Importantly, however, the spending totals published at this Budget should be ones that the Chancellor could credibly stick to in the Spending Review. But if he already expects to increase spending at the Spending Review, postponing the announcement of this increase until next year would understate future spending and flatter the outlook for the public finances at the Budget.

On current plans, real-terms growth in day-to-day departmental spending in 2029–30 is set to be very modest, at 0.5%, followed by 1.3% in 2030–31.²⁰ Chapter 6 considers a scenario where the government decides to grow health spending at 2.7% per year in real terms, the same as planned at the 2025 Spending Review, and maintains defence spending at 2.7% of GDP between 2027–28 and 2030–31. These decisions would imply average real-terms cuts of 0.9% per year for other departments over this period under the current spending totals.

Current plans look tight in part because of plans set out for ambitious efficiency savings between 2025–26 and 2029–30. Departments were asked to set out how they will use automation, improve procurement, and reallocate funding between programmes to reduce overall costs. If the hoped-for efficiency savings cannot be found, the government may be left looking at a choice of finding extra funding or lower quality of public services. If only half of the planned efficiencies were delivered, for example, and the government wanted to maintain its intended quality of public services, this could require an £11 billion top-up to total day-to-day spending in 2029–30.

This picture is made more challenging by the persistently high inflation coming from the closure of the Strait of Hormuz, which is likely to reduce the real-terms generosity of existing spending plans. If the government wanted to just keep its current pencilled-in plans for 2029–30 unchanged in real terms since the spring, that might require £15 billion of additional funding under the Barclays inflation forecast. £12 billion would be for day-to-day spending, and so would affect performance against the borrowing rule, while £3 billion would be for capital spending.

There are signs that this higher inflation may already be feeding through in the form of higher public sector pay settlements. Public sector pay deals this year mean that average pay growth will be approximately 3.9% in 2026–27, compared with the OBR’s forecast for public sector pay growth of 2.2% when budgets were first set and 3.0% this spring. Higher pay this year will on its own have persistent effects: relative to the OBR’s expectations when budgets were set (its March 2025 forecast), pay could be £4 billion higher in 2029–30. There is also a risk that pay growth will be higher in future years too: Barclays forecasts that wages will begin to grow faster than the OBR was previously expecting over the medium term, which could continue to push up public sector pay and further squeeze departmental budgets.

²⁰ This uses the OBR’s March GDP deflator forecast to calculate real-terms increases.

Temporary giveaways

Given the large rise in energy prices, the government may decide to announce a temporary giveaway to help households with ‘cost of living’ pressures. All else equal, this would push up on borrowing this year.

It would not be a surprise either to see fuel duties frozen again. Fuel duties are statutorily set to increase in line with inflation, but have instead been frozen in cash terms in a series of ‘temporary’ policies since 2011–12. A similarly ‘temporary’ 5p cut has been in place since 2022. A gradual unwinding of these cuts was planned to begin last month, but in May the cut was once again extended, this time to the end of 2026. This four-month delay is expected to have a one-off cost of around £200 million. Shortly after the Prime Minister took office, the government also announced a cut to VAT on household electricity bills from 5% to 0%, initially for a period of six months, which the Treasury estimated would cost around £850 million.

The cost of these temporary measures in themselves is not particularly large in the context of the public finances, and the OBR’s forecast at the Budget will be predicated on these freezes and temporary cuts being unwound, since this is stated government policy. But history clearly suggests that the fuel duty freeze is likely to be extended, and there may be pressure to do the same for the recent VAT cut. Making the 5p cut permanent and freezing fuel duties for an extra year would cost £2.7 billion, while if the freeze were extended until 2029–30 the cost would reach £4 billion a year by then under the OBR’s March forecast for inflation. But higher inflation would push the cost higher: under the Barclays inflation forecast, those figures would be £3.2 billion and £4.5 billion respectively. Making the cut in VAT on household electricity bills permanent would have an annual cost of around £1.5 billion, although the exact cost would depend on future household electricity spending. Of course, if the government does announce a further ‘temporary’ extension to some of these policies, this will increase borrowing or require other tax rises or spending cuts to offset. Importantly, these temporary policies also make the forecast for future years less transparent and more uncertain because it no longer represents a central expectation of what is likely to happen. Ultimately, this can erode the credibility of the forecast.

2.5 Policy ambitions

The new government has stated ambitions to increase defence spending and public investment. We discuss the potential implications of new spending commitments in these areas. We do not consider recent announcements on the pensions triple lock (discussed in Cribb, Karjalainen and Miller (2026)) or social care, since these are plans that would come into force after the next election and are therefore unlikely to have major impacts on spending in the final years of the forecast.

Defence spending

In June 2025, NATO members including the UK committed to spending 3.5% of national income on defence by 2035. Under current plans, spending will rise from 2.1% in 2023–24 to 2.7% next year. This includes top-ups announced in the Defence Investment Plan at the end of June, funding for around a third of which – an average of around £1 billion per year – still needs to be set out at the Budget.

In his resignation letter as Defence Secretary, John Healey called for the government to go further and spend 3% of national income on defence by 2030. If he were to follow through with this in his new role as Chancellor, this would mean spending £11 billion more on defence in 2030–31, relative to keeping defence spending at 2.7% of national income. If he decided to increase defence spending on a steady path from 2026–27 onwards to reach 3% in 2030–31, this would mean an increase in defence spending of £7 billion by 2029–30. This is the year in which the fiscal rules apply, though it is worth noting that a large share of any increase in defence spending is likely to be extra capital spending, which will not impact the current budget deficit.

In the longer term, the government has an ambition to spend 3.5% of GDP on defence in 2035. This is equivalent to a £25 billion increase in spending in today's terms – more than the increase in spending implemented by the Labour government so far. Chapter 6 provides more detail on the spending implications of different policy options for the defence budget and how these interact with decisions on the timing of the Spending Review.

Investment spending

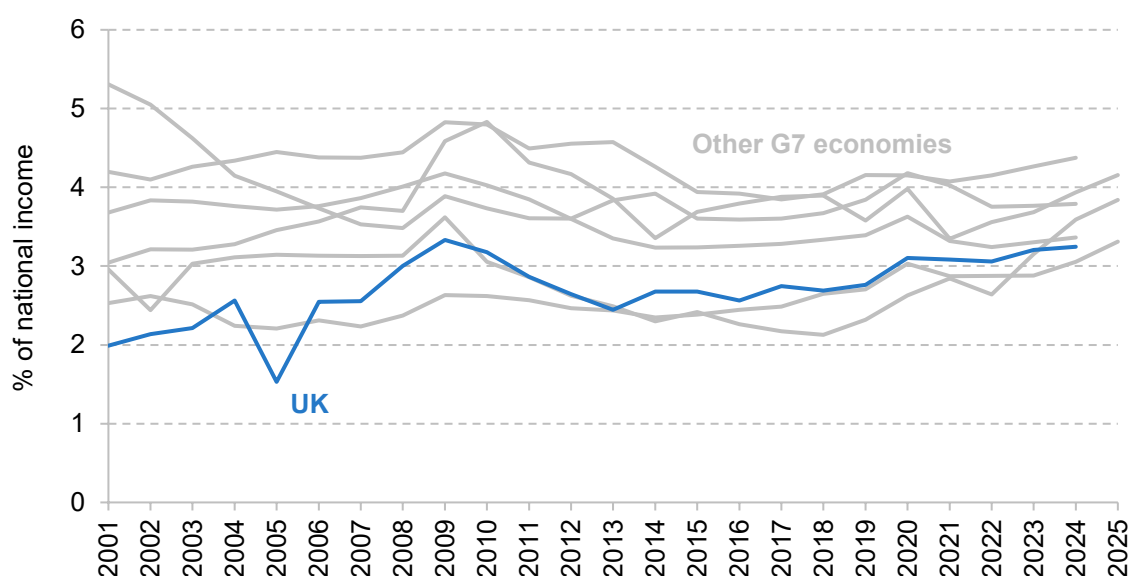
New Chancellor John Healey told the press in August 2026 that he saw ‘scope for more and more rapid investment’. The Prime Minister has suggested he would like to significantly increase council housebuilding, which could come from new investment spending or cutting back other, already planned investments. It is hard to predict the exact scale of any additional investment: one proposal from the Resolution Foundation suggested increasing investment by £9 billion per year, in order to match the amount invested in the UK by the European Investment Bank prior to Brexit (Christensen et al., 2026). As described in Section 2.2 above, after a significant top-up of inherited investment spending plans at the 2024 Autumn Budget, investment spending is already set to reach its highest sustained level since the 1970s. This is not necessarily in conflict with the Chancellor's statement, but does underline its ambition.

One oft-cited argument in favour of higher public investment – and one made, for example, by now First Secretary of State Louise Haigh in May 2026 – is that UK public investment is low by international standards. Figure 2.14 shows that UK governments have indeed invested less than most G7 peers since the turn of the century relative to the size of their respective economies. In 2024, the last year for which comparable data are available for all countries, only the German

government was investing less than the UK government, and government investment in Canada, France, Germany and Italy was on a sharp upward trajectory.

The same argument could be made for overall investment in the economy: on standard measures, economy-wide investment (public and private) is lower in the UK than in other G7 countries, and has been for most of this century. It is not obvious, however, that every country should dedicate the same share of national income to either public or private sector investment. For example, the UK economy has a large service sector, which relies less on capital investments than manufacturing does.²¹

Figure 2.14. Government investment spending as a share of national income in the UK and other G7 countries



Note: Government investment is defined as general government gross fixed capital formation.

Source: OECD National Accounts at a Glance (NAAG), chapter 3: expenditure, dataset DSD_NAAG@DF_NAAG_III.

If the government would like higher economy-wide investment, it could choose to directly target some of the factors that hinder private sector investment, which might include policy uncertainty, regulatory costs, poor tax design or insufficient competition. Of course, the government can also increase public investment – ideally without replacing private sector investment or even while encouraging (‘crowding in’) additional investment by firms.

²¹ On a broader measure of investment that includes management practices, brand values and other ‘intangible’ investments, the UK’s level of overall investment looks less atypical in comparison with other G7 economies (Competition and Markets Authority, 2025, figure 7.2). This may explain differences in private sector investment. It is less clear that it would drive significant differences in government investment, which is much more heavily skewed towards infrastructure and physical capital goods to support the delivery of public services.

Investment spending, like any other kind of government spending, can be funded through cuts to other areas of spending, tax rises or borrowing. There is a principled case that borrowing for investment is more justifiable than borrowing for day-to-day spending: if done well, investments should create a return that future generations benefit from, which may reconcile them to the additional debt servicing cost they will have to pay. If the investment generates economic growth, the additional tax revenue may help offset, and in some cases could outweigh, the cost of servicing the additional debt. This approach is not risk-free, however, and does not justify unlimited borrowing for investment. The hoped-for return on investment might not materialise, and investments precommit spending for future generations: given the option, a future generation may choose to spend money on something other than the benefit created by a past investment, if that benefit does not come in the form of additional tax revenues. Moreover, even though some investments can have large payoffs, this will not necessarily be true for all investment – the details of what a government invests in matter. There are also reasons to place constraints on government borrowing and to prevent debt from being on an ever-rising path, such that, even if more investment is deemed desirable, it does not automatically mean that it should be funded through more borrowing.

The current borrowing rule reflects the idea discussed above – that borrowing for investment is preferable to borrowing for day-to-day spending – by aiming to balance the current budget: in other words, to raise enough revenue to pay for day-to-day spending, but potentially still borrow to invest. The debt rule – which requires public sector net financial liabilities as a share of GDP to be falling by the third year of the forecast – can constrain borrowing, whether for day-to-day spending or investment. However, the degree to which this rule constrains borrowing for investment depends on the type of investment. As outlined in Box 2.2, investment spending that involves acquiring a financial asset, such as a loan to be repaid or an equity stake in a private company, does not necessarily affect performance against the debt rule.

Of course, while investments in financial assets can leave PSNFL unchanged, any additional borrowing used to fund this type of financial transaction would still increase public sector net debt and, consequently, debt interest spending (which also affects performance against both fiscal rules). As such, although there can be a good economic rationale to invest through public financial institutions (PuFins) – especially where a public investor can provide coordination and attract additional private investment (King and Jameson, 2024) – it is not costless. The Treasury’s framework for financial transactions provides some guard rails against these transactions being used excessively as a replacement for regular government spending. If the government follows the spirit of the guidelines, and aims to construct a portfolio of investments that align with government priorities and generate a profit, the cases where investment can occur through PuFins may turn out to be relatively limited. The government should avoid trying to use investments by PuFins as a way to mask the impact of subsidies or other spending on the fiscal rules.

Box 2.2. The effect of different types of investment on public sector net financial liabilities

After changes made to the fiscal rules in 2024, the measure of debt targeted by the government is public sector net financial liabilities (PSNFL) instead of public sector net debt excluding the Bank of England (PSND ex BoE). When the rule targeted PSND ex BoE, additional borrowing for investment would simply add to the measure of debt. For PSNFL, this is still the case for most forms of borrowing for investment – for example, direct investment by government departments in infrastructure. However, when the government invests through a financial transaction that creates a financial asset, the value of this financial asset is netted off PSNFL. Assets netted off this measure include loans to and equity stakes in companies, such as those held by the National Wealth Fund and other public sector financial institutions (so-called PuFins). If these assets are of equivalent value to the borrowing that was used to finance the investment, these types of investments do not increase PSNFL and are therefore not constrained by the fiscal rules, except in their indirect effects via additional debt interest spending.^a There would only be an effect on PSNFL if there were future changes in the value of these assets.

Alongside shifting the debt rule to target PSNFL, the Treasury also instituted a framework governing the use of financial transactions. This requires them to be used only in pursuit of clear policy objectives and places an emphasis on additionality – using public investment to enable activity that would not otherwise occur, while avoiding unnecessary displacement of private sector investment. Public financial institutions are generally expected to target a return – across all their investments – at least equal to the government's cost of borrowing. The framework also permits investments that are expected to earn less than this where there is a policy justification and provided that the resulting subsidy or expected cost is transparently recognised. For example, subsidised loans – such as student loans – are treated as a combination of spending (for the portion of the loan that the government expects to eventually write off) and an asset included in the measure of PSNFL (for the portion it expects to receive back).

^a These types of investments also do not increase public sector net borrowing: provided a financial asset is acquired at fair value, its acquisition is recorded separately from PSNB.

In summary, if the government decides to increase investment, the types of additional investment that it chooses to use will determine how that interacts with the fiscal rules. Some types of investment could be straightforwardly accommodated within the fiscal rules. Others would push up PSNFL. In either case, higher borrowing would push up public sector debt and government should have a clear rationale for why that would be justified – in both of these respects, borrowing for investment is no different from any other kind of borrowing.

2.6 Choices for the Chancellor

John Healey inherits the same fiscal challenges faced by his predecessors. Debt levels, spending on debt interest and borrowing are high. These challenges must be tackled at a time when tax revenues are already historically high and in the face of large spending pressures.

War in the Middle East has added to the scale of the challenge. Compared with the OBR's March forecast, interest rates on government debt are higher, inflation is higher, and real growth is expected to be slower in the short term. The net effect on borrowing, and therefore on the much watched 'headroom' against running a balanced current budget in 2029–30, is uncertain. Higher interest rates will undoubtedly push up debt interest spending and therefore borrowing. But higher inflation will raise the nominal size of the economy, increase revenues and thereby reduce borrowing. Under a plausible set of assumptions about the effects of inflation, the headroom forecast handed to the Chancellor by the Office for Budget Responsibility could be around £20 billion. But it would be no surprise to see the OBR forecast lower or higher headroom: differences in judgements around the path of earnings can, on their own, leave headroom £10 billion higher or lower. It is worth noting that in the context of forecasting around £1,470 billion of spending and £1,490 billion of tax receipts, a difference between the two numbers of, say, £10 billion is very small. It is also important to remember that the same inflation that is pushing up on tax revenues is also reducing the spending power of departments' budgets, adding to the already significant pressure on public spending.

Whatever the exact OBR 'pre-measures' forecast, the Chancellor will need to answer a set of interrelated questions. His choices will determine the path of the public finances.

If headroom is forecast to be lower, should it be rebuilt? The £24 billion of headroom forecast in March should not be seen as a target. Headroom can – and sometimes should – be used to absorb shocks and avoid fine-tuning tax or spending policy in response to small changes in forecasts. However, £24 billion was a relatively low level of headroom to start with, and a further fall would reduce the scope to absorb future shocks, and could thereby reduce the credibility of the planned consolidation and lead to damaging speculation in advance of future fiscal events. It is also worth emphasising that operating with lower headroom would mean more borrowing; with very high levels of debt and debt servicing costs, there would be clear risks to adding further to this.

How quickly should borrowing for day-to-day spending be brought down? Sticking to the fiscal rules requires the forecast current budget to at least be in balance in 2029–30. In principle, this could be achieved while allowing higher borrowing in the short run than was previously planned. This could, for example, be used to fund a package of cost-of-living support or to top up public spending. But there would be costs in terms of higher debt and debt servicing costs. It

would also weaken credibility if a more back-loaded consolidation was deemed less likely to be delivered.

Should the government borrow more to fund investment and should any additional investment be in financial assets? Investments in financial assets could be made without increasing public sector net financial liabilities and therefore without being constrained by the fiscal rules. But the nature of the fiscal rules should not drive the type of investments the government makes. The key question should always be whether the government thinks there are investment opportunities that would drive growth or achieve some other policy goal and not be undertaken by the private sector while achieving value for money. Even if such opportunities are found that do not count against the fiscal rules, there should be no illusion that higher borrowing is costless. Sticking to the fiscal rules would not prevent higher debt and debt servicing costs. Fiscal rules can only ever be one part of a government's broader strategy to ensure the sustainability of the public finances and signal fiscal credibility. Ultimately, it is important for both that borrowing is not simply forecast to fall in coming years but actually falls.

Should public service spending be topped up in the face of pressures and/or to accommodate new ambitions? Inherited plans for departmental spending already looked challenging when first set out by Rachel Reeves, as we warned at the time. They were based on historically ambitious growth in public sector productivity and, under reasonable assumptions about growth in the NHS budget, almost certainly implied cuts for some departments. Higher inflation is now expected to significantly reduce departments' spending power. On top of this, meeting the ambition for defence that the new Chancellor stated when he resigned as Defence Secretary would imply spending an additional £11 billion on defence by 2030. Growing the NHS and defence budgets within current spending plans would imply large cuts to other departments. Without top-ups, we should expect the quality and/or quantity of some public services to decline relative to previous plans. This is a choice the government could make, and one that inflation may make politically easier – previous governments responded to inflation after the 2022 energy crisis with relatively small top-ups – but it would nevertheless be a choice. The Chancellor should not attempt to avoid this choice by producing spending plans that he has no intention of delivering when the time comes. To do so would unduly flatter the outlook for the public finances, making the Budget and the fiscal rules less credible.

Should plans for taxes and benefit spending be changed? If the Chancellor wants to cut borrowing (by more than expected in the pre-measures forecast) and/or significantly increase public service spending, he will have to consider raising taxes or cutting benefit spending. The options here are as familiar as they are difficult. The commitments in the 2024 Labour manifesto severely restrict the options for using the simplest, most reliable levers to raise tax – income tax, National Insurance and VAT. The remaining tax-raising options – which are discussed in Adam, Delestre and Miller (2025) – are also narrower following two Budgets in which Rachel Reeves

made this the biggest tax-raising parliament on record. If the Chancellor chooses further tax rises, they should be expected to drag on growth but, importantly, some tax rises would do more damage than others – the design of any tax-raising measures would be key. Similarly, the design of any reforms to the benefit system will be key – we discuss options for reforming disability benefits in particular in Chapter 7.

In making all of these choices, the Chancellor will, understandably, be focused on the next few years – the years in the run-up to the next general election and those covered by the OBR’s fiscal forecast. He should also cast his view further ahead. Even if a current budget surplus is reached by the end of the parliament – which would be an achievement – warning lights will still be flashing on the fiscal sustainability dashboard. Debt and the cost of servicing it will still be high. An ageing population, cost and demand pressures in healthcare, and any net zero transition will still confront fiscal policymakers with difficult choices. The Budget should not be judged merely on whether the fiscal rules are met. That is a necessary but far from sufficient condition for more sustainable public finances.

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3. Chancellor Healey meets the bond market: ‘let sleeping dogs lie’

Moyeen Islam (Barclays)

UK government borrowing costs are near multi-decade highs and have risen sharply since March, making the upcoming Budget much more challenging. The UK is not an outlier since this most recent rise has been in line with that seen across similar countries, as inflation has risen and central banks have increased policy rates. The attention of the bond market is currently elsewhere, and John Healey should be trying to keep it that way.

Key findings

1. **UK government borrowing costs have risen further since last year’s Autumn Budget.** Yields on 30-year gilts – long seen as an indicator of bond market sentiment – have risen from around 5.2% on the eve of the Spring Forecast to reach 5.9% (2 October). Over the same period, yields on 10-year gilts rose from 4.4% to 5.4%. This further increase in the cost of borrowing is an important contributor to the difficult outlook for the public finances.
2. **The rise in yields on UK sovereign debt over the last year have been in line with – or even slightly smaller than – the increases seen across other major economies.** Whereas 30-year gilt yields have increased by around 0.6 percentage points, this compares with 0.7–1 percentage points for other comparable sovereign bonds.
3. **Global rises in yields mostly reflect expectations of both inflation and central bank policy rates rising and staying higher for longer, in light of the price shock from conflict in the Middle East.** Market pricing implies that annual UK CPI inflation is expected to increase from just over 3% currently to 4.5% in early 2027. Inflation is expected to stay higher for longer in the UK than in the US or the Eurozone, and is not expected to return to the Bank of England’s 2% target in the near term. Market pricing

also implies that central bank policy rates are expected to increase – by at least 0.75–1 percentage point over the next 12 months in the UK, the US and the Eurozone.

4. **The UK is no longer the focus of global bond markets, with attention now mostly on other governments, notably the US and France.** The UK's term premium – the compensation required by investors for the additional uncertainty associated with holding a longer-term bond – is elevated, but has not materially increased in the last year. This suggests that the increases in long-term UK government borrowing costs over the last year have been mainly driven by moves in central bank policy rate expectations, rather than by changes in views of the riskiness of holding UK government debt specifically.
5. **Expectations of UK fiscal policy have remained relatively unchanged over the last 12 months.** Survey evidence suggests that market participants expect a government deficit of around 3.3% of GDP in 2027 and 2.9% in 2028, which is broadly in line with the OBR's March forecast for borrowing.
6. **The UK bond market is not risk-free, but the risk of a domestic catalyst for a gilt crisis has fallen.** The bond market still views the UK partly through the lens of the 2022 gilt crisis, which followed the mini-Budget. Rebuilding fiscal credibility takes time, but UK policymakers have learned lessons from 2022 and taken significant steps to improve monitoring of system-wide financial risks and leverage. The main immediate risks in the bond market are more likely to come from international markets, which could be the genesis of a crisis and are a source of uncertainty and volatility to the UK market.
7. From a bond market management perspective, it would be best for the Chancellor to deliver a Budget that reaffirms the fiscal rules and has no discussion of flexibility or indications of creative fiscal accounting. **For now, the focus of the bond market is on other countries, which is to the UK's advantage. The government should try to keep it that way.**

3.1 Introduction

John Healey will be delivering his first Budget against a backdrop of persistent inflation and rising bond yields across the world. The UK government faces much higher borrowing costs than many similar nations. UK government debt stands at around 90% of national income and the share of national income needed to service that debt (nearly 4%) is now twice as high as it

was in the 10 years preceding the COVID-19 pandemic. The upcoming OBR forecast will revise up the debt interest bill, which, in the March forecast, was already due to reach £137 billion in 2030–31. Given these factors, maintaining the confidence of a wary bond market will be a key consideration for the Chancellor in a few weeks' time. An adverse market reaction to the Budget would once again draw attention to the UK's ongoing fiscal vulnerability and could overshadow the more substantive debate of policy measures in the Budget. This chapter explores the current state of the gilt market and highlights how, out of the spotlight, the gilt market is stabilising at a new equilibrium.

Section 3.2 examines market expectations for the path of inflation and central bank policy rates. Section 3.3 shows how global bond yields have changed over time, and the extent to which UK yields have moved in tandem with those of other countries. Section 3.4 examines differences in the yields of gilts of differing maturities and market expectations about government borrowing. Section 3.5 discusses the risk of bond crises, and particularly a repeat of the 2022 bond crisis, before Section 3.6 concludes.

3.2 'This time it's different' – maybe not for government bonds

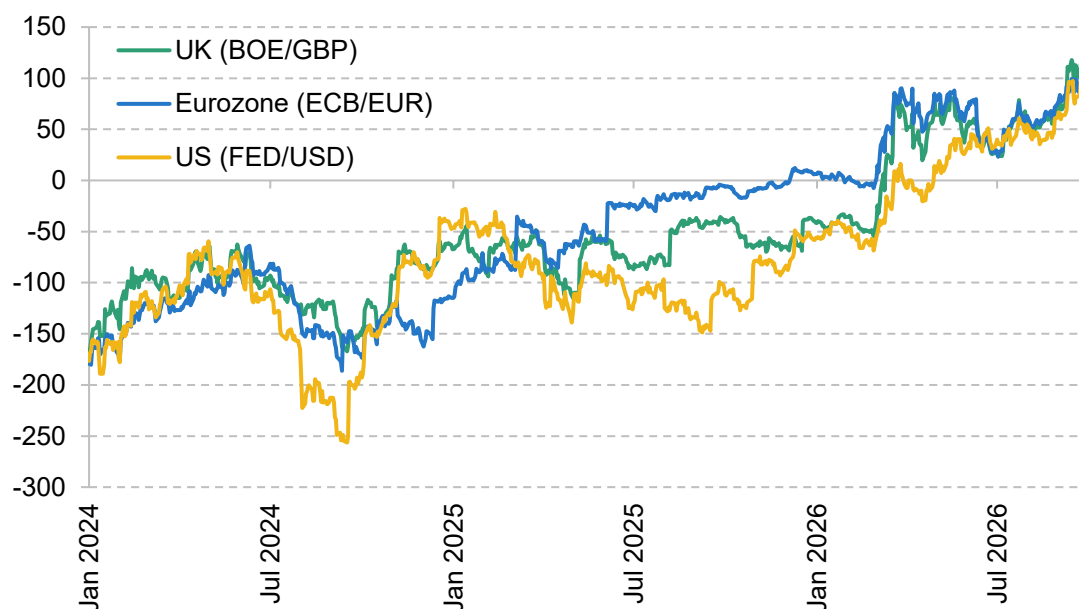
'This time it's different' is perhaps the most seductive but loaded phrase in the financial lexicon. Time and time again across all types of financial assets, investors assure themselves (and are assured) that history will not repeat itself. But while equity and corporate bond markets grapple with the new challenge of valuing AI-related assets, global sovereign bond markets are assessing an altogether more familiar combination of factors. As Chapter 1 describes, the conflict in the Middle East has seen oil prices and, more importantly for the UK, natural gas prices rise significantly. Across the world, high and rising inflation is underpinning a turn in the central bank cycle, and all against a backdrop of high government indebtedness.

Figure 3.1 shows the spread between central banks' key policy rates and three-month swap rates, one year ahead. These rates are a good indicator of market expectations for policy rates, to which they are closely linked. The figure shows that for the US Federal Reserve (FED), the European Central Bank (ECB) and the Bank of England (BOE), market rates imply the expectation of between 0.75 and 1 percentage point of increases in policy rates over the next 12 months.

Both the ECB and Federal Reserve have already responded to higher inflation by tightening monetary policy, raising their key policy rates and promising more increases should they be required. In contrast, the Bank of England has yet to raise its policy rate, but now seems likely to do so at its November meeting. The emerging view from the most recent speeches from members of the Bank's Monetary Policy Committee (MPC) has been that the longer the conflict

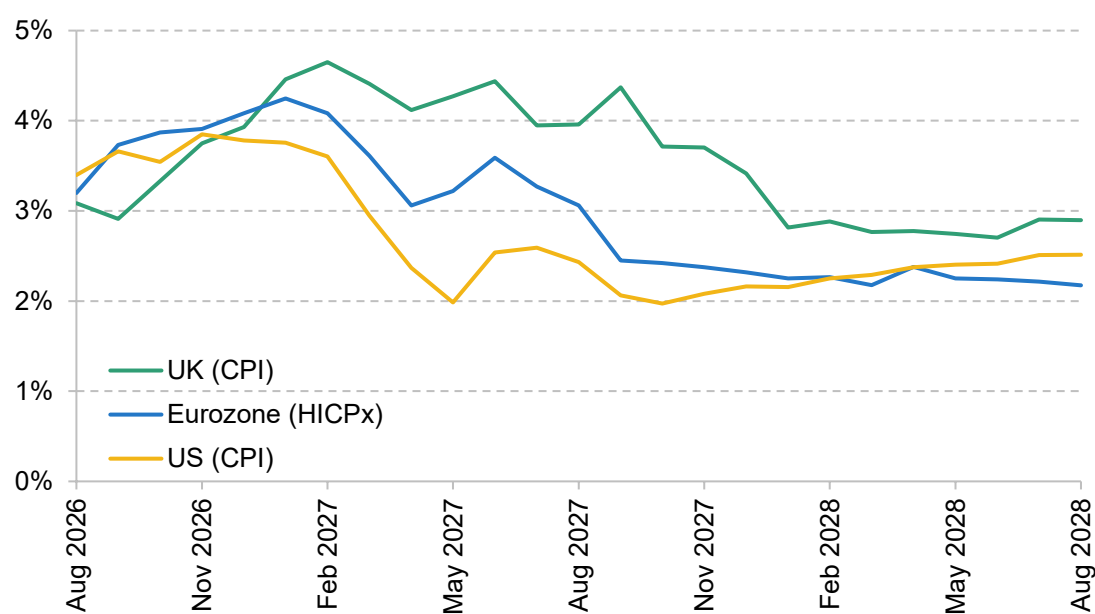
in the Middle East lasts, the greater the risk that second-round effects begin to show up in the wider economy. This increases the likelihood that the committee will deliver higher rates (discussed in more detail in Chapter 1).

Figure 3.1. Spread between central banks' key policy rate and three-month swap rates, one year ahead, in selected countries (basis points)



Source: Bloomberg and Barclays Research.

Figure 3.2. Market-implied path of headline inflation measure in selected countries (% year on year)



Source: Barclays Research.

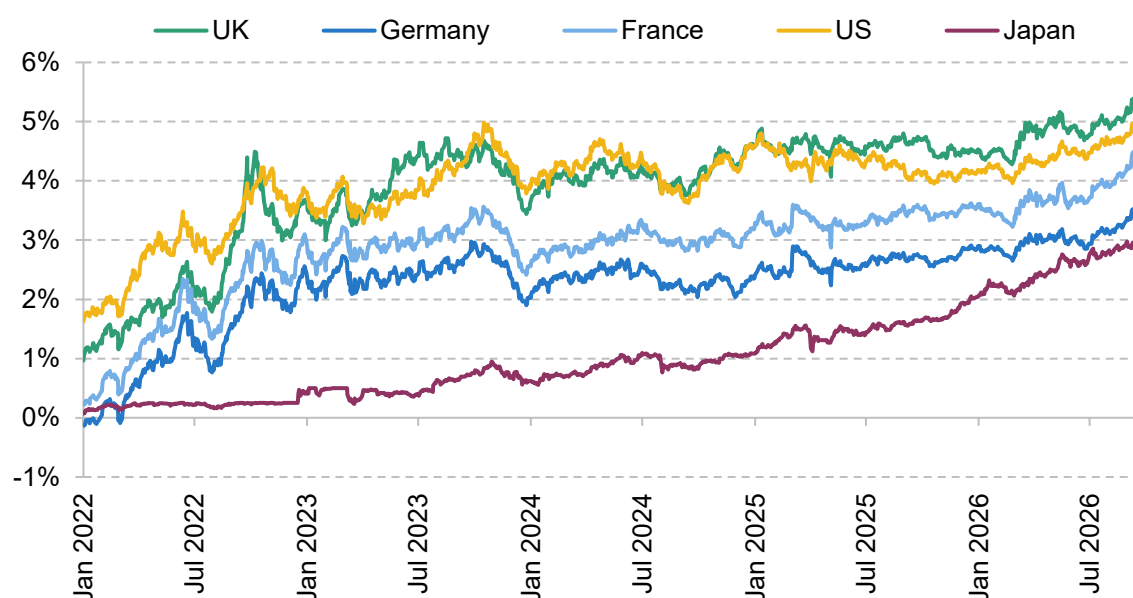
Market participants also expect inflation to keep rising.¹ Figure 3.2 shows the market-implied path of annual inflation over the next two years, derived from inflation market pricing. UK CPI inflation is expected to reach 4.5% in early 2027, and is not expected to return to levels consistent with the Bank of England's 2% target in the near term. It is notable that UK CPI inflation is expected to stay higher for longer than analogous measures of inflation in the US or Eurozone.

3.3 Hiding in plain sight

A year ago, there was intense international scrutiny of the UK fiscal position as the then Chancellor Rachel Reeves prepared to present the government's Budget to parliament, the UK and wider financial markets. In the last IFS Green Budget, we outlined some of the drivers and historical reasons for the UK facing such intense scrutiny, as well as explanations for why the UK term premium – the part of the gap between short-term and long-term yields that can be thought of as reflecting the extra risk of holding debt for longer – appeared to be so elevated.

A year on, the new Chancellor John Healey is preparing his first Budget. As shown in Figure 3.3, UK government borrowing costs remain much higher than those facing other governments, with yields for 10-year bonds at 5.4%. These are up from 4.45% in November 2025, and are more than twice as high as the government faced before the 2022 gilt/LDI crisis (discussed in Section 3.5).

Figure 3.3. Yields on 10-year government bonds issued by different countries

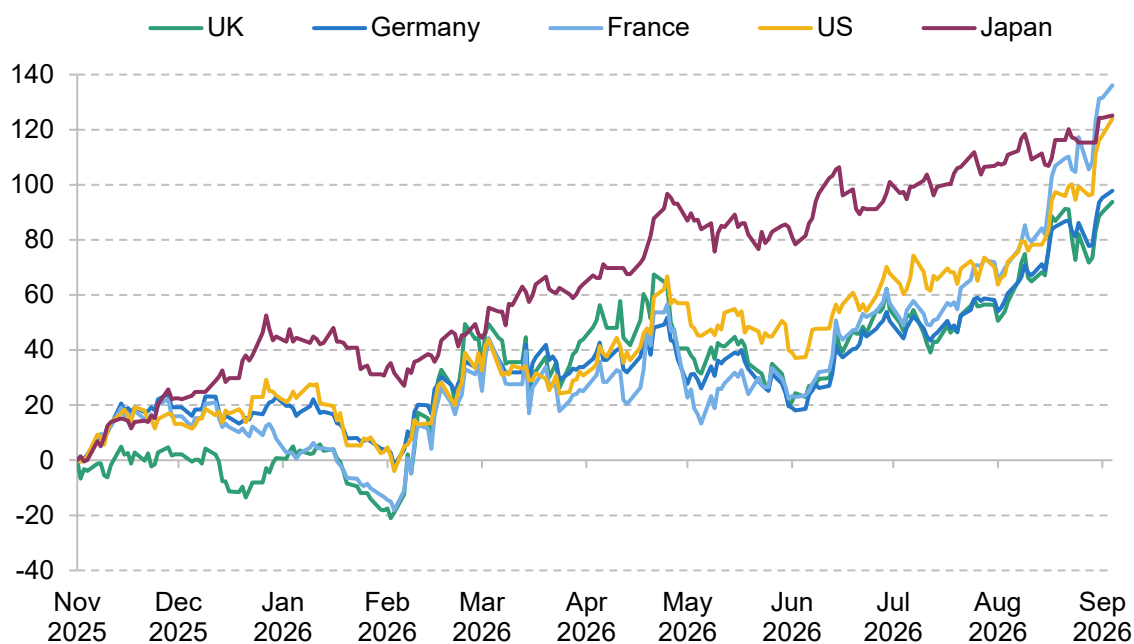


Source: Barclays Research.

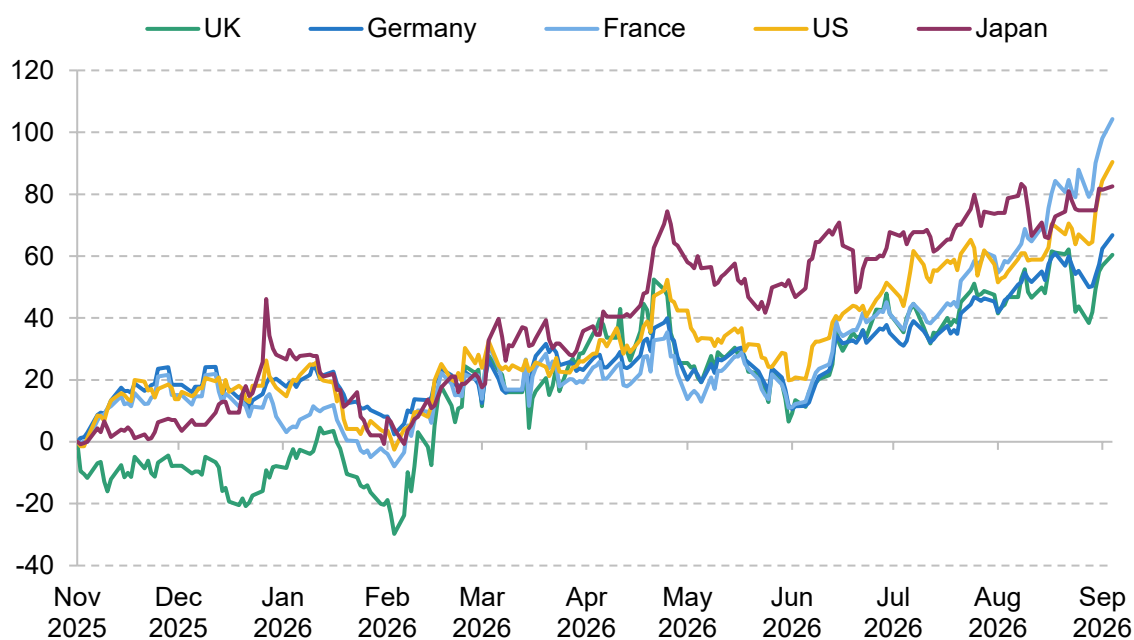
¹ Market pricing of inflation differs from the Barclays forecast of inflation, which is set out in Chapter 1.

Figure 3.4. Cumulative change in yields on government bonds of selected countries (basis points)

Panel A. 10-year government bonds



Panel B. 30-year government bonds



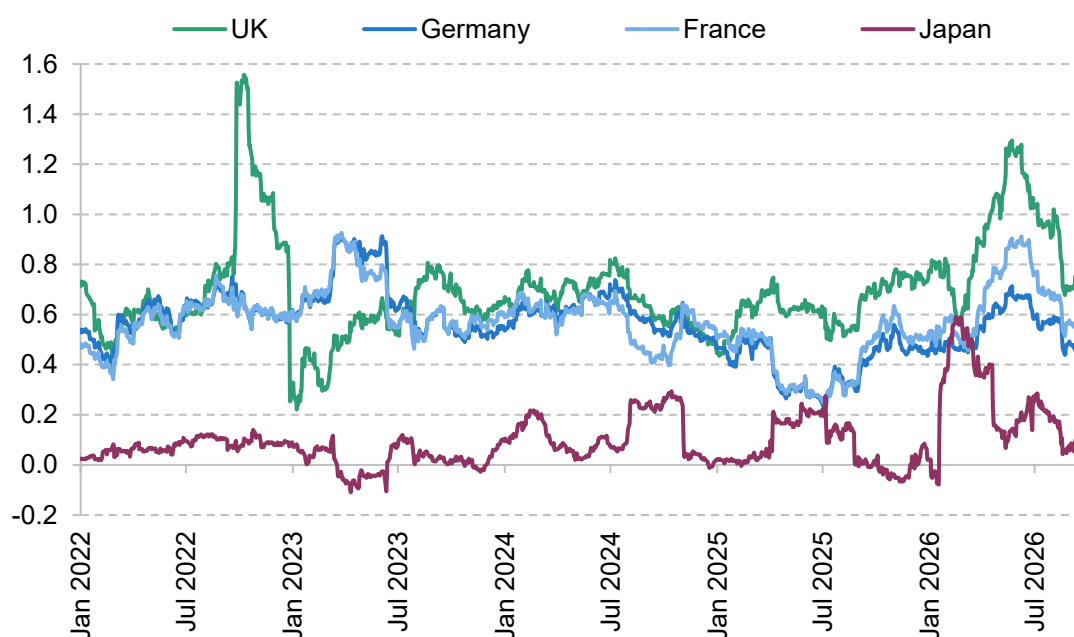
Note: Cumulative change since 25 November 2025, up to 28 September 2026. The Autumn Budget 2025 was delivered on 26 November 2025.

Source: Barclays Research.

Since the last Budget was delivered, yields on long-dated UK sovereign debt have risen by around 1 and 0.6 percentage points on 10-year and 30-year gilts respectively. But the UK has not been alone in its moves. This increase has been seen globally and has been driven by the combination of higher inflation and, in response, higher central bank policy rates. Panel A of Figure 3.4 shows the path of yields for global 10-year government bonds, while Panel B shows the same for 30-year government bonds.

If anything, gilts have performed more strongly than the bonds of other governments, with 10-year yields rising by around 0.9 percentage points compared with 1.0–1.4 percentage points for other markets since the last Budget. Similarly 30-year gilt yields, for so long seen as the lightning conductor for negative bond market sentiment, have increased by around 0.6 percentage points compared with 0.7–1 percentage point increases for other sovereign markets. Rather than headlines telling us that ‘gilt yields are at their highest levels since <insert year>’, headlines are now dominated by moves in other markets – most notably the US and France. The French Government bond market has come under extreme pressure recently, with developments there drawing comparisons with the Eurozone crisis of 2011–12.

Figure 3.5. Rolling 66-day average of beta between selected countries and 30-year US Treasuries



Source: Barclays Research.

One way to empirically assess whether UK gilt yields are experiencing greater pressure than the bonds of other governments is to examine how closely they move with respect to moves in other major bond markets. The relationship between the yields on a specific UK bond (e.g. a 30-year gilt) and a bond in another market (e.g. a 30-year US Treasury) is commonly referred to as a

'beta'. This measure guides market participants as to how much they should expect gilt yields to move given a move in other core markets. A beta greater than +1 means that gilt yields have tended to move by more than yields in the comparator market. This would imply, for example, that in a sell-off, gilt yields move higher by a greater amount and thereby underperform in the sell-off.

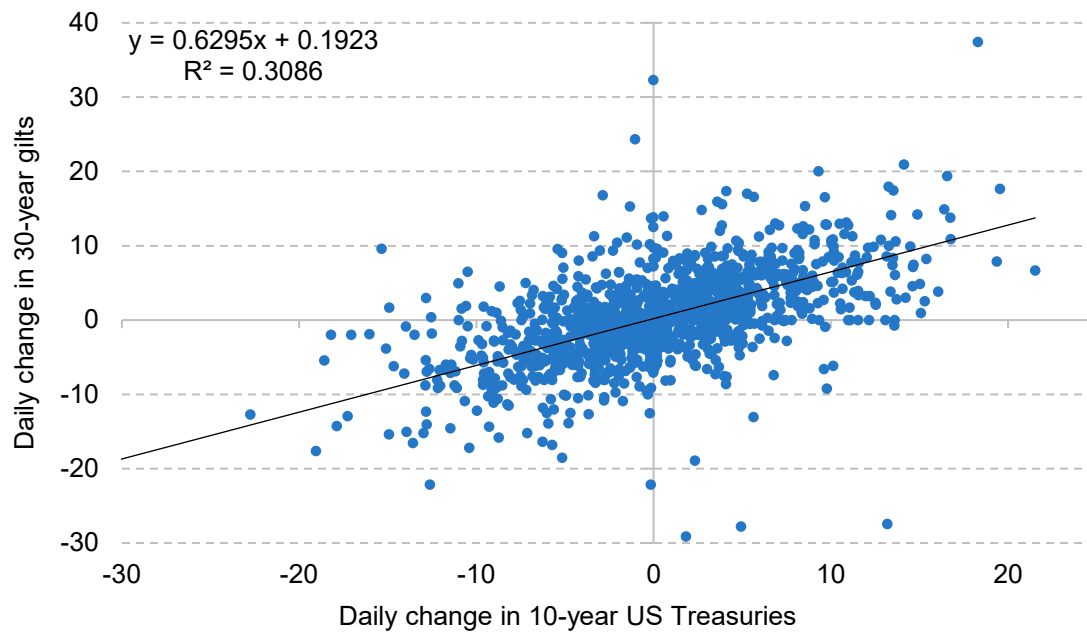
Over the last 12 months, and as shown in Figure 3.5, the betas against a range of comparators have fallen, suggesting that the UK is not coming under the pressure that we had seen in previous episodes of global fixed income discontent. Indeed, the rolling three-month beta has fallen below +1, suggesting that gilts, while retaining their directionality to broader market moves, have sold off by less than other markets. Interestingly from an investor perspective, bonds with falling betas provide a degree of 'portfolio insurance' as they would be outperforming other bonds in sell-offs.

Another way to assess whether gilts are coming under pressure is to consider the relationship between daily changes in 10-year US Treasury rates and 30-year gilt rates. This is shown in Panel A of Figure 3.6 for the period since the start of 2022. The 10-year US Treasury rate can be thought of as the benchmark rate in global bond markets. The long-run beta is around 0.6 – in other words, for a 0.1 percentage point increase in 10-year US Treasury rates, we would expect that 30-year gilt rates would increase by 0.06 percentage points. The measure is similar if we instead compare 30-year gilt rates with 30-year US Treasury rates, as shown by Panel B.

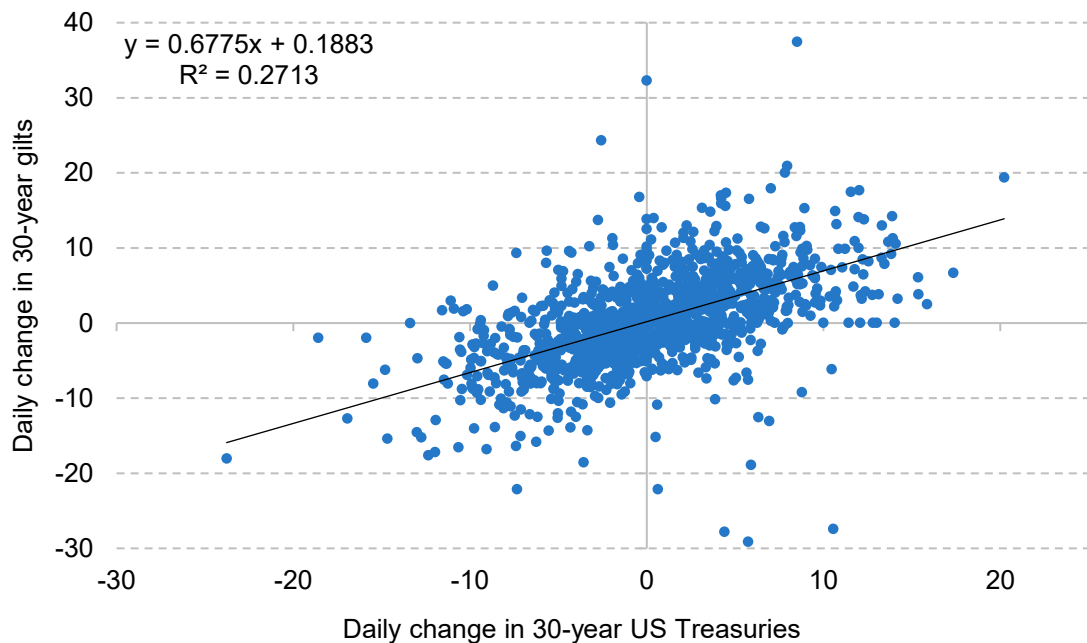
The similarity between the beta to 10- and 30-year US Treasuries is significant. It suggests that the most recent decline in the beta is bringing it back into line with its long-run value – its average over the past five years – and that most recent movements in long-dated gilt yields have largely reflected broader moves in global bond markets, rather than unusually strong upward pressure on the long end of the UK yield curve. If the beta between UK gilts and 30-year US Treasury bonds was as high and rising as it had been during the early part of 2026 (around 1.25 compared with around 1.1 for 10-year rates), this would be indicative of a rising and potentially unstable term premium at the 30-year point. In other words, the government would be facing higher and potentially more volatile longer-term borrowing costs. This in turn would suggest that markets were demanding higher compensation for the risk of lending to the UK government over longer maturities by demanding higher yields, underpinned by a rising term premium (discussed in Section 3.4). It is therefore good news that the betas associated with long-term gilts have been stable. There have recently been more substantive and volatile moves in yields at shorter maturities, but these have been due to the turn in the central bank interest rate cycle and the moves in energy prices.

Figure 3.6. Daily changes in yields on 30-year gilts and ...

Panel A. ... 10-year US Treasuries (basis points)



Panel B. ... 30-year US Treasuries (basis points)



Note: Points show daily changes between 3 January 2022 and 2 October 2026 in basis points. Line shows the average linear relationship between changes in these yields over this entire period. The slope of the line represents the 'beta' measure.

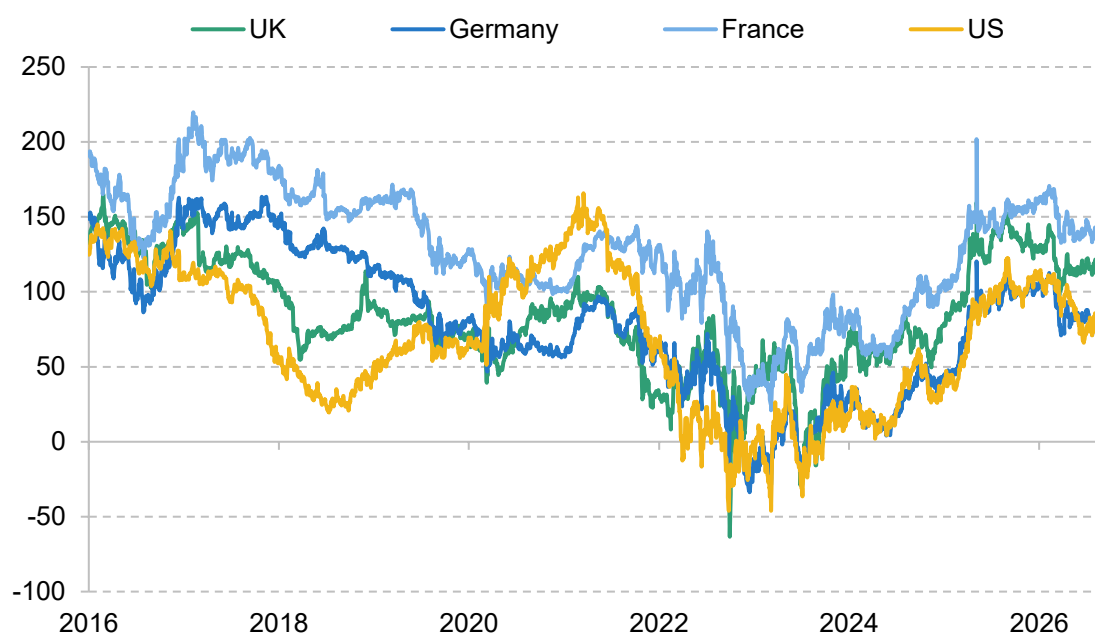
Source: Barclays Research.

3.4 The UK government is no longer the cause of global bond market volatility (for now)

A yield curve maps out the interest rates the government pays to borrow for different lengths of time – for example 5, 10 and 30 years. It illustrates how government borrowing costs vary depending on the maturity of the bonds issued and reflects both current and future expected borrowing costs. Yield curves typically slope upwards, reflecting higher borrowing costs at longer maturities. If we compare the shape of the UK yield curve with other markets, it appears steep – yields are higher on longer- than shorter-maturity gilts – but not unduly so.

The steepness of the yield curve can be measured by the spread (the difference in yields in basis points) between 5- and 30-year bond yields. Figure 3.7 shows how these spreads have evolved over the past decade for the UK, Germany, France and the US. The spread between yields on 5-year and 30-year bonds is currently higher for the UK than for the US and Germany, but lower than for France. But it is notable that recent changes have not been out of line with moves in these other markets. A stable curve is indicative of a contained term premium (discussed in more detail below) and, implicitly, a lower expectation for underlying volatility in yields for longer-dated gilts.

Figure 3.7. Spread between 5- and 30-year bonds for selected countries (basis points)



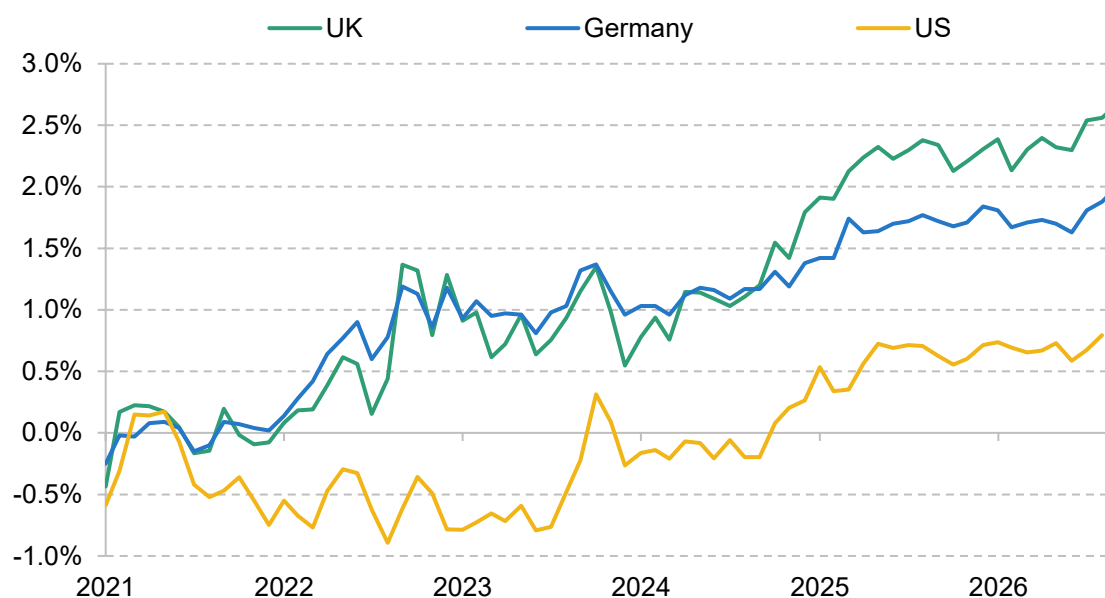
Source: Barclays Research.

The combination of a more stable term premium and declining beta implies that gilts, rather than being a cause of volatility in the global market for government bonds, are instead mostly on the receiving end of moves in other markets. For different reasons, yields in the US and France in particular have come under bearish pressure – the US due to pressure from both higher Fed rates and the unprecedented levels of corporate borrowing to fund AI-related capital expenditure, and France due to concerns over the fiscal outlook and the upcoming presidential elections in April 2027.

The yield curve spread described above can be directly measured: it is simply the difference between yields on long- and short-term bonds. But a steeper curve can be indicative of a higher (or unstable) term premium and this must be estimated. Specifically, the term premium is an inferred measure of how much of the long-term yield reflects compensation for bearing the additional uncertainty associated with holding a longer-term bond (instead of a series of short-term bonds). Typically, the term premium is interpreted as a bigger driver of moves in longer-maturity issues (10 years and longer) than moves in shorter-maturity issues, where changing policy rate expectations are likely more important.

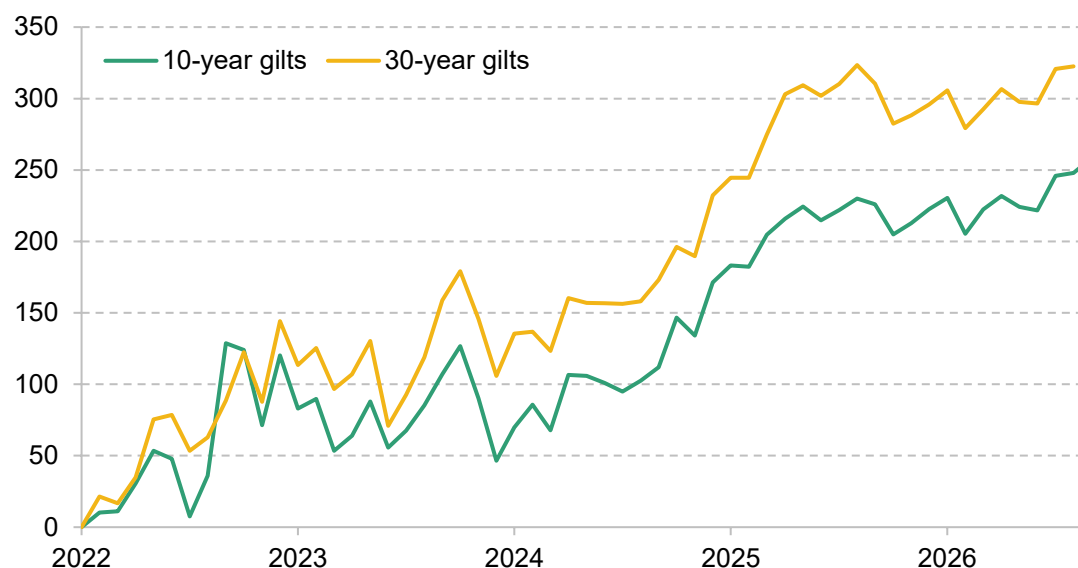
Figure 3.8 shows the model-estimated 10-year term premium for the US, Germany and UK. The UK term premium – while elevated – has not materially increased in the last year. This suggests the move in yields on long-term gilts over the last year was mainly driven by evolving central bank policy rate expectations, rather than by moves in the term premium component of yields.

Figure 3.8. Term premium on 10-year government bonds, selected countries



Note: US Treasuries term premium is from FRBNY ACM model.

Source: NY Fed and Barclays Research.

Figure 3.9. Cumulative change in term premium on 10- and 30-year UK gilts since January 2022 (basis points)

Source: Barclays Research.

Figure 3.9 shows both the 10-year and 30-year term premium for the UK. It is notable that over 2026 so far, the move in the implied 10-year term premium has been greater than the move in the implied 30-year term premium (around +35bp versus +12bp respectively). This is consistent with the relative increase in the supply of 10-year gilts and the relative lack of 30-year gilt supply from the UK's Debt Management Office (DMO) – the government agency that manages issuing UK gilts to the bond market. For more discussion, see last year's Green Budget chapter on bond markets.

Expectations for fiscal policy have remained relatively unchanged over the last 12 months, as captured in the Bloomberg monthly survey of economists' forecasts for the government deficit. Expectations are that this will be around 3.3% of GDP for 2027 and 2.9% for 2028, and both of these have been at this level for much of 2026.² They are very broadly in line with the OBR's March forecast for borrowing. In other words, a material worsening in the UK fiscal position is not expected by survey respondents.

The UK bond market is not free of fiscal risk, but the perception of risk of a domestic catalyst for a gilt crisis has probably fallen. It is now the international market which could be the genesis of a bond crisis and which is a source of uncertainty and volatility for the UK market.

² September survey published at end of month but may not reflect policy discussions around the Labour Party Conference (27–30 September).

3.5 2026 is not a rerun of 2022

The most recent bout of bond market turbulence has inevitably resurrected the market's collective memories of the events of the 2022 gilt/LDI crisis.

LDI – liability-driven investments – are strategies that UK pension funds used to structure their investments in order to efficiently hedge liabilities. They are meant to ensure that the value of their assets and future pension entitlements move in step. However, the use of leverage and repo exposed pension funds to risk if gilts moved sharply. In the mini-Budget in September 2022, Chancellor Kwasi Kwarteng announced large unfunded tax cuts that implied much higher government borrowing. Gilt yields rose sharply. Pension funds had to find cash to cover the fall in the value of gilt collateral against which they had borrowed. In order to meet margin calls, they were forced to sell gilts and this triggered a doom loop of falling values and forced selling. The Bank of England had to step in to break the spiral as it judged that the moves posed a significant financial stability risk.³

It is understandable that the shadow of the LDI crisis still looms over the gilt market and, as we are frequently reminded, ‘those who cannot remember the past are condemned to repeat it’. But it would not be correct to think that UK institutions and policymakers have ignored the lessons from that experience – in fact, quite the opposite. The amount of leverage in the pension fund sector has fallen, the Bank of England has taken steps to improve market resilience by requiring pension schemes to hold larger liquidity buffers, and contingent liquidity facilities now exist that the Bank can activate if necessary.

There is no simple definition of a bond crisis. US Supreme Court Justice Potter Stewart's famous turn of phrase with regards to a threshold test for obscenity (‘I know it when I see it’) could easily be applied to bond market crises. A 21st century bond crisis is not necessarily characterised by uncovered auctions (auctions with insufficient demand at acceptable prices to the issuer), spiralling yields and a triumph of the ‘bond vigilantes’. Rather, if the experience of the UK in 2022 is anything to go by, it can be a more technically complex story about credibility, leverage and market structure. Crises frequently start slowly until a trigger acts as an accelerant on a transmission mechanism, requiring rapid corrective policy interventions. That trigger can be a loss of confidence in fiscal policymaking and institutional processes, or simply a liquidity event that begins a chain reaction, with leverage acting as a financial accelerant. In 2022, a key problem was the degree of hidden leverage embedded in UK LDI strategies. This leverage was the transmission mechanism, which turned a sharp sell-off following Chancellor Kwarteng's mini-Budget into a much wider crisis.

³ A comprehensive assessment of the episode has been published by the International Monetary Fund: <https://www.imf.org/-/media/files/publications/selected-issues-papers/2023/english/sipea2023049.pdf>.

This distinction is important because it suggests fiscal slippage (a worsening fiscal out-turn compared with forecasts or expectations) alone can be viewed as a necessary but not sufficient condition for a bond market crisis. Rather, the credibility shock of weakening or unsustainable fiscal policy becomes dangerous when it interacts with existing financial system vulnerabilities.

If we frame the LDI crisis in this way, the September 2022 gilt crisis appears to have been an idiosyncratic UK event driven by a combination of fiscal policy errors and structural vulnerabilities in the UK pension system. For policymakers, the key lesson is not that bond vigilantes are perennially poised to punish fiscally profligate governments, but that institutional credibility, hidden leverage and financial sector vulnerabilities matter enormously.

It would be a reach to think that the episode in 2022 triggered a lasting rejection of UK government debt. Discretionary appetite for gilts has remained solid. But it did give rise to an impression of fiscal vulnerability that has proven nigh on impossible to shake off. Perhaps the most important lesson is that once fiscal authorities lose the confidence of the market, regaining it is difficult and often forces policymakers into more cautious behaviour later. It means that fiscal policy becomes risk-averse, leading to possible suboptimal outcomes as choices are more driven by the need to minimise risk than by what is deemed economically optimal. Boring is good in fiscal space, but the UK could become the story again quickly.

All of this points to a backdrop in which the gilt market has been a bystander rather than shaper of moves over the last year. Conversations and market narratives are centred on the US Federal Reserve, the AI investment cycle, whether the Bank of Japan can match the Federal Reserve's rate-hiking cycle, the outlook for French politics and fiscal policy, and other non-UK topics. UK bond yields are increasing due to expectations of higher neutral rates, a more price-sensitive buyer base for UK gilts and, to a lesser degree, the ongoing deterioration in and the myriad of risks to the health of public finances across advanced economies.

However, despite yields having been more stable over the last year, the UK still has little room for complacency. The underlying fiscal settlement remains extremely tight and, given the current fiscal rules, the new Chancellor and Prime Minister have little scope or appetite to dramatically increase borrowing or materially cut spending.

But the lack of headroom could be used as something of a 'get out of jail free' card by the Chancellor. He can quite reasonably point towards the lack of fiscal space as one of the key reasons to not pursue a fiscal programme that might entail large rises in government borrowing. In concert with risks around market volatility, the lack of headroom allows the government to make the argument that this is not the time for fiscal ambition but rather for fiscal discretion.

The UK could become the central character in a bond market story quickly. The market has been quick to react to what it perceives as indications of fiscal indiscipline. As an example, PM Burnham's comments about the available 'fiscal flexibility' on 20 July led to immediate market moves: 30-year gilts rose 10bp to 5.75% on a day when yields on other long-dated bonds globally rose by 1–3bp. That was the market reacting to the new PM's remarks, interpreting them as a signal that government borrowing would rise. This jump was eventually reversed, but it tells you that investors' reflexes on UK fiscal issues are still scarred by the Truss/Kwarteng era and market sentiment can deteriorate quickly.

The UK already carries the highest borrowing costs of any G10 nation.⁴ That is a statement about the UK's relative risk and reflects a combination of higher neutral rates, structurally higher inflation than its peers and the MPC's inability since 2022 to deliver low inflation. But it does also reflect ongoing uncertainty about the direction and execution of fiscal policy and the slow rebuilding of credibility in the post-LDI-crisis era. It is easy for critics to claim that the market is 'hostile' to the government and it is impossible to disprove that. But it would be fair to say that the market remains concerned about the UK's fiscal outlook. The bond market is not punishing Burnham and Healey, but it has not forgiven the events of 2022 either.

3.6 Fiscal discretion remains the better part of valour (for now)

For a new Chancellor facing an uncertain backdrop, delivering a boring Budget might well turn out to be the best outcome from a bond market management perspective. What would be 'boring'? Reaffirming the fiscal rules and no discussion of flexibility or perception of creative fiscal accounting such as using investment through 'PuFins' purely as a means to circumvent the fiscal rules.⁵ Chancellor Healey should not give the global market a UK-specific narrative to latch onto when its focus is on Washington, Paris and Tokyo. The UK's advantage right now is that it is being ignored and, arguably, it is the Chancellor's job to keep it that way. The worst outcome would be a speech that was interpreted as requiring more borrowing at a moment when global yields are at multi-decade highs and the cross-market spreads are already near post-mini-Budget levels. 'Boldness' of this type would differentiate the UK from the global pack in the wrong direction.

⁴ This is a group of 11 countries that cooperate on international financial matters. It consists of Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the UK and the US.

⁵ PuFins are public sector financial institutions. See Chapter 2 for a discussion of how different types of investment affect public sector net financial liabilities (PSNFL), the measure of debt targeted by the government's fiscal rules.

4. The direct fiscal effects of quantitative easing and tightening

Jack Meaning (Barclays) and Cian Hennigan (Barclays)

HM Treasury is currently making annual payments to cover the Asset Purchase Facility's losses as the Bank of England's programme of quantitative easing is unwound. This chapter summarises how the APF works and how flows between the APF and HM Treasury impact the public finances.

Key findings

1. Since 2009, the Bank of England has bought significant quantities of government bonds, and some corporate bonds, through its quantitative easing (QE) programme. These are held in the Asset Purchase Facility (APF), a legally separate entity which is indemnified by HM Treasury. **Between 2009 and 2022, the APF was making profits and a policy choice was made to send these immediately to HM Treasury.** These had amounted to £124 billion in total by Q3 2022.
2. Since then, the APF has been reducing its holdings (quantitative tightening, QT) and has begun making losses. We estimate that **payments from HM Treasury to cover APF losses in 2026–27 will be £19 billion.** This is roughly equivalent to total spending on police services in England and Wales. By early next year, the government is expected to have roughly broken even on the QE/QT programme in a narrow accounting sense, but with further losses to come.
3. Economic changes since March have increased the APF's projected losses over the next five years. A higher expectation for Bank Rate increases the cost of financing the loans that initially funded the APF's bond purchases, and higher yields on government debt decrease the value of the government bonds that the APF decides to sell. The Bank of England also announced changes to the QT programme last month: slowing the pace of bond sales, and concentrating sales on bonds that are set to mature

between 2035 and 2049. **Together, we estimate that changes since March mean that total APF losses will be around £5 billion higher in each of 2026–27 and 2027–28.** Largely as a result of the changes announced by the Bank, total losses are expected to fall to £13 billion in 2030–31 – £6 billion less than we expected in March.

4. Only a portion of these losses affect the fiscal aggregates that are targeted by the government's fiscal rules. **We estimate the changes since March are likely to reduce the current budget surplus – revenues net of day-to-day spending – by £3.4 billion.** In contrast, we expect them to leave the government's preferred measure of debt (PSNFL) roughly unchanged in the same year. Importantly, under current arrangements, the whole of any losses results in a cash transfer from HM Treasury to the APF. This can be funded through higher government borrowing, higher taxes or reduced government spending on other things.
5. **Other ways of managing these losses are possible, and have international precedents.** Changing arrangements between HM Treasury and the Bank would not be a free lunch: all options would amount to reallocating losses either through time or between different groups in the economy. However, given the extent of the costs in the near term, now is the time for an open and informed discussion of these arrangements.

4.1 Introduction

In response to the financial crisis of 2008 and subsequent shocks, the Bank of England, along with other global central banks, bought significant quantities of government bonds, in a policy known as quantitative easing (QE). More recently, it has been reversing this through quantitative tightening (QT), allowing its holdings of these bonds to mature without replacing them and actively selling some back to investors on financial markets.

Over the course of this policy, the Bank has made gains and losses, which have resulted in payments to and from HM Treasury. The technical arrangements surrounding this are complex, but they are important, because the exact arrangement affects the government's fiscal position.

In this chapter, we explain how the QE/QT programme is operating and describe the recent changes announced by the Bank. We discuss how gains and losses currently feed through into transfers to and from HM Treasury and impact the public finances, and how the scale of these transfers is set to change in the coming years. Finally, we discuss whether there are changes the government could make to its arrangements with the Bank which would impact the fiscal arithmetic in the coming months and years.

Box 4.1. How do bonds work?

One way that companies or governments can borrow is by issuing bonds. Effectively this involves selling IOUs for future payments. When issuing a bond, the issuer sets a term (e.g. five years) and can then include commitments to two different types of future payment:^a

- **a coupon:** an amount paid at regular intervals (e.g. every six months) over the life of the bond;
- **a redemption value:** an amount paid at the end of the bond's term (at maturity).

For example, a government or company could issue a bond that lasts ten years and promises to provide £5 each year for those years, and a further £100 when it reaches maturity.

When government issues (sells) a bond to a lender, it receives an up-front payment – the price. The price of bonds reflects the balance of demand and supply for that specific type of bond. If lots of investors want to buy a particular type of bond, it might have a high price; if there are low levels of demand relative to supply, it might sell for a low price. The demand and supply for a given bond will depend both on economic conditions, such as central bank policy rates and inflation, and on the specific characteristics of the bond issuer.

The higher the price of a given bond, the lower the effective interest rate – the yield – on that bond. Take a simple example of a bond that only lasts one year, offers no coupons and has a redemption value of £100 after that year. If it is sold for £90, the lender gives up £90 immediately for a promise of £100 a year later. They receive interest of £10, so the effective interest rate is 11% (£10 divided by £90). If instead the same bond sold for £95, the lender would only receive £5 of interest after a year, so the effective interest rate would be 5.3% (£5/£95).

As well as a primary market for bonds – in which lenders buy bonds directly from bond issuers (in this case, government) – there is also a secondary market for bonds. A lender who has already bought a bond can sell it on. In doing so, the original lender receives cash immediately in return for giving up any remaining coupon payments on the bond and the future redemption value.

^a In most cases, the coupon and redemption value of a bond are fixed cash amounts. There are also inflation-linked bonds where the value of the coupon payment and the redemption value are automatically updated with inflation.

4.2 A brief history of quantitative easing and quantitative tightening

Quantitative easing (QE) was rolled out in 2009 during the financial crisis to help stimulate the economy out of recession and bring inflation up to the Bank of England's 2% target. It was an

untested tool and there was limited precedent to inform its design. In order to let the Bank of England focus on its aim of stabilising the economy, rather than concerns of the potential profit and loss inherent in holding a large portfolio, the Bank and the government agreed that the bonds purchased would be held in a legally separate entity rather than directly on the balance sheet of the Bank of England. This entity was termed the Asset Purchase Facility (APF). The government then guaranteed, or indemnified, the financial position of this facility, meaning HM Treasury would make good on any losses that were incurred.

The APF then purchased predominantly government bonds, as well as some corporate bonds, from the market. It funded these purchases with a loan from the Bank of England, on which it is required to pay the Bank of England's base rate – like a tracker mortgage. The Bank of England in turn financed these loans by creating new money, in the form of reserves held by commercial banks, on which it pays interest at the Bank of England's base rate.

When QE was initiated, the UK was in recession and inflation was below the Bank's target, so the Bank wanted to stimulate additional demand in the economy. By buying government and corporate bonds, the APF aimed to reduce interest rates across the economy, reducing the cost of borrowing for both households and firms, with the aim of stimulating additional investment and consumption.

QE was used to support the economy after the 2008 global financial crisis, following the 2016 Brexit shock and in response to the 2020 pandemic-induced slowdown. The APF's bond holdings peaked in 2021 when it owned £875 billion in gilts (around a third of total government debt) and a further £20 billion in UK corporate bonds (Ramsden, 2023).

QE was always intended to be a temporary intervention. Since 2022, the Bank of England has been 'unwinding' it, reducing the stock of bonds it holds in the APF. This has become known as quantitative tightening (QT).

The Bank has carried out QT in two ways. First, it has let some bonds reach maturity. When this happens, the APF receives the redemption value from the bond issuer and pays back the initial loan it took out from the Bank of England. This is termed passive unwind. Second, the Bank has sold some bonds on the market. The APF then receives the going market price for the bond and pays back the initial loan it took out from the Bank of England, which in turn reduces the reserve balance of commercial banks, all else equal. These are called active sales, or active unwind.

4.3 How do QE and QT lead to financial flows between HM Treasury and the Asset Purchase Facility?

There are three direct ways that the QE/QT programme affects the public finances. All of these involve cash flows between HM Treasury and the Bank of England, but they have different effects on the fiscal aggregates (such as measures of government spending and debt).

First, there is the **interest rate loss or gain**. This is the coupon payments the APF receives for the bonds it owns, minus the interest it pays to the Bank on the loan it used to finance the purchases (on which it is charged Bank Rate). For a long time, the APF was making a profit as the coupon payments it received from its bond holdings averaged 3–4% of their purchase cost and Bank Rate was at rock-bottom levels of 0.5% or less. From 2012 onwards, this interest rate gain was sent each quarter to HM Treasury. The decision to send these profits immediately to HM Treasury was a policy choice; the government and the Bank could instead have agreed to keep those profits within the APF's portfolio to cover potential future losses.

More recently, this interest rate channel has turned negative. Bank Rate has risen (and is expected to rise further) while the coupon payments on the bonds have remained unchanged. Each quarter, the government sends payments to the APF to cover this loss and these are counted as current or day-to-day spending.

Second, there are **maturity losses or gains**. These occur when a bond is held until redemption (passive unwind). At this point, the APF receives the redemption value of the bond from the bond issuer (in most cases, the government). This redemption value is often different from the price the APF paid for the bond initially – the initial proceeds amount – and the difference between these two is the maturity loss/gain.

At the point when the APF initially buys the bond, the government can anticipate the future maturity loss (or gain), and so for all bonds purchased the difference between the purchase value and the redemption value is recognised on the government's balance sheet up front through an adjustment in the level of public sector debt (PSND). This means that when the loss is actually realised when the bond matures, there is no additional shift in PSND or public sector net financial liabilities (PSNFL), an alternative measure of debt.

Third, there are the **sales losses or gains**. These occur when the APF sells a bond to the market (active unwind) and reflect the difference between the price paid for the bond originally – the initial proceeds amount – and the price at which the bond is sold. Conceptually, this is because the APF receives the current price of the bond from the market, but must pay back a portion of

the loan it owes the Bank equal to what it borrowed to buy the bond in the first place. As with maturity losses, this loss does not affect day-to-day government spending in the current budget, but it does add to public sector debt. A key difference is the timing. As the eventual sale price is not known when the APF first buys the bond, the sales gain or loss only adds to PSND and PSNFL in the year the bond is sold.

Where there are losses, the cash transfer to the APF – the sum of these three losses – does have to be funded. It adds, all else equal, to the government's net cash requirement.

As well as the direct fiscal implications of transfers relating to the QE/QT programme, there are also indirect consequences for the government's finances. The QE programme increased demand for government bonds and so reduced yields and government borrowing costs, although this was not the primary aim of the policy. The QE programme did aim to stimulate growth, at a time when the UK economy was in recession. Higher growth would also have been positive for the government's finances. Viewed narrowly, QT acts in reverse on both these same channels. However, the difference for QT is that, with interest rates still a long way from the low levels of the 2010s, the Bank can, and does, look to offset this drag by setting Bank Rate lower than it might otherwise have done, meaning the macroeconomic costs of QT through this channel are likely to be less than the benefits of QE. Any broader evaluation of the fiscal consequences of the programme should take these indirect channels into account.

4.4 How big are these financial flows, and what has changed recently?

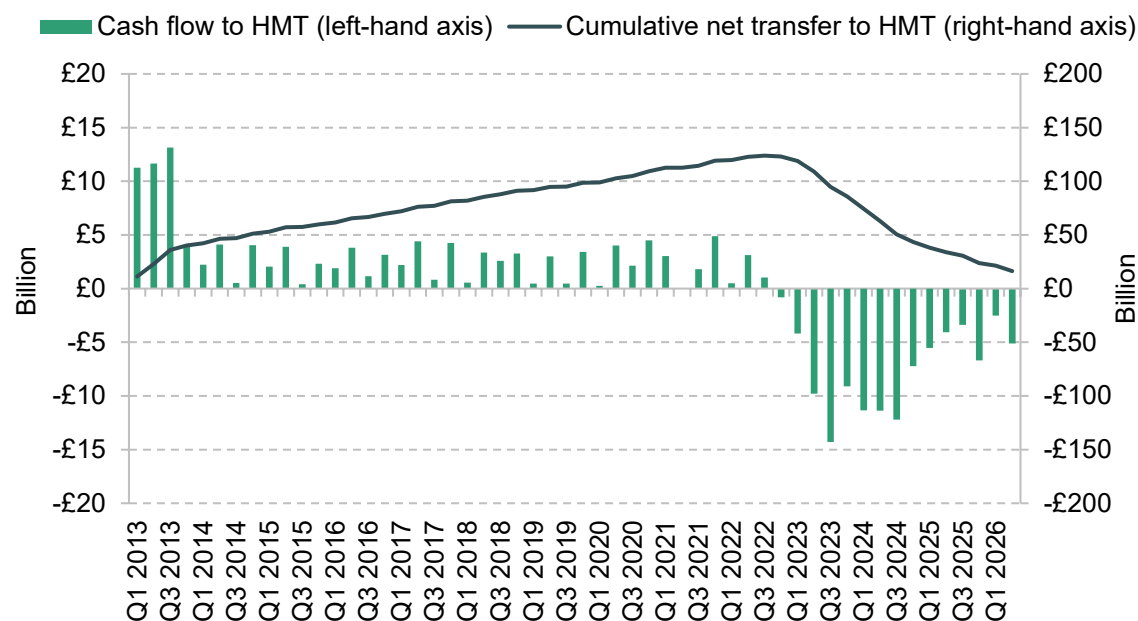
Scale of financial flows

Between 2009 and 2022, the APF was making a profit and the cumulative cash flows to HM Treasury peaked at £123.9 billion in Q3 2022.¹ Since then, money has flowed back the other way at an average pace of around £30 billion per year. By the end of Q2 2026, the net cumulative flows to the Treasury remained positive, but just, at £16.2 billion: HM Treasury has roughly broken even on the QE/QT programme so far. Continuing losses mean this is likely to turn to a cumulative loss by early next year.

Estimates of the scale of these projected flows in future years are very sensitive to what one assumes about bond yields, Bank Rate, and both the pace and maturity profile of the Bank's QT programme.

¹ For more, see Bank of England (2026).

Figure 4.1. Quarterly cash flows from APF to HM Treasury and cumulative value of total transfers from APF to HM Treasury



Source: Barclays Research.

In March, the Office for Budget Responsibility (OBR) assumed that the Bank of England would unwind the APF by actively selling £32 billion of bonds each year, on top of whatever naturally reached maturity.² On this basis, it projected that losses – and so flows from HM Treasury to the Bank – would average around £19 billion per year over the next five years. This is roughly equivalent to the entire budget for policing in England and Wales.

Recent Bank of England announcements on QT programme

Helpfully, at its annual review of the QT programme in September, the Bank of England resolved much of the uncertainty around this path, publishing a multi-year outline of what it plans to do.³ This gives us greater certainty and allows us to model more confidently what the fiscal flows will be.

The Bank of England explicitly stated it plans to actively sell £20 billion of government bonds each year for the next eight years, £12 billion a year less than the OBR had assumed in March.

² The amount sold is measured in proceeds terms, which means it is based on the average amount the Bank has paid for that particular bond when it has bought it in the past. This enables the value of the portfolio, measured in proceeds terms, to match the size of the loan that was taken out to fund the purchases.

³ For more detail, see Ramsden (2026).

Furthermore, it announced that it would not sell any bonds that are set to mature *after* 2049. Instead, these long-dated bonds will be held and used as a long-term asset to back up the Bank of England's bank note liability. This matters particularly for the public finances as it is these long-dated bonds which tend to incur the largest losses when sold. It will also refrain from selling any bonds that are set to mature *before* 2035. These will be held until they naturally mature and passively unwind. This means that all of the sales will be concentrated in bonds that would otherwise mature between 2035 and 2049, as opposed to the previous policy of selling across the entirety of the portfolio.

An important further detail is that, within this 2035–49 bucket, the Bank plans to sell bonds in reverse order of maturity, starting with those with the longest maturity and cascading down. Previously, it had offered all bonds with a maturity of three years left to the market, in buckets of short-dated, medium-dated and long-dated bonds. The precise allocation actually sold then depended on what was demanded by the market.

The final twist in the new phase of QT is that, whereas previously the Bank of England sold bonds to the market, it will now sell them to the Debt Management Office (DMO) – a UK government agency that is responsible for debt and cash management. These sales will still happen at market prices, which means this innovation does little to affect the profit and loss dynamics. But it has the advantage that, by financing these purchases through its normal gilt issuance programme, the DMO can shift the maturity profile of issuance to more closely match market demand.

How have expected flows changed since March?

Figure 4.2 compares our estimates for the expected path of flows between HM Treasury and the APF based on the information available in March with our latest estimates of these cash flows.⁴ Since March, three factors have changed the expected path of flows between HM Treasury and the APF.

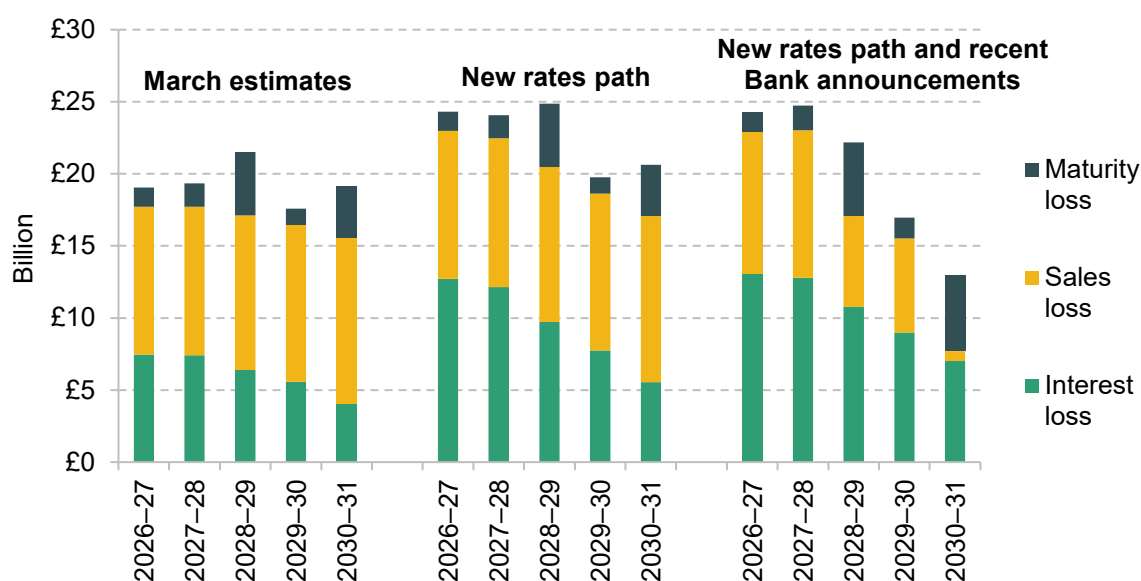
- 1 Expectations for Bank Rate are now significantly higher, as are government bond yields (as we discuss in Chapter 3). Both of these increase the scale of interest rate losses and worsen sales losses. Higher rates increase the spread between Bank Rate and coupons, while higher yields imply lower prices and therefore bigger losses on bonds that are sold. If we model this change in isolation, we estimate it would add £5 billion to losses in 2026–27 and a similar

⁴ These figures all use Barclays estimates for forecasted APF flows from March rather than OBR estimates so that consistent modelling assumptions are used across the different scenarios. In March, the OBR estimates and Barclays estimates both averaged £19 billion in total annual losses over the next five years although the distribution of losses across different types of flows does differ between the two estimates.

amount in 2027–28, falling to around £1 billion extra in 2030–31. The effect of these changes alone is shown in the second set of bars in Figure 4.2.⁵

- 2 The new slower pace of unwind of the portfolio, from £32 billion to £20 billion of active sales each year, reduces sales losses in the short term, as fewer bonds are sold and fewer losses crystallised. This is partially offset in future years as slower unwind means interest losses are made on a larger stock of bonds remaining in the APF in future years. Still, the net effect of slower active tightening is to reduce APF losses over the next few years by £3–4 billion per year.
- 3 The Bank of England’s decision to focus sales in the middle segment of its portfolio (to sell only bonds maturing between 2035 and 2049) further reduces the cost of the programme over the life of this parliament as it avoids the APF selling and realising losses on the costliest long-term bonds. However, the decision to sell bonds within this bucket in reverse maturity order adds some of this back in, relative to a scenario in which sales were distributed evenly across maturities in the portfolio. The net of these two adds to APF losses by £3–4 billion over the next two years before falling to be broadly neutral in 2028–29 and 2029–30.

Figure 4.2. Estimated APF losses between 2026–27 and 2030–31 under different assumptions



Note: Figures are not adjusted for inflation. March estimates reflect Barclays estimates rather than OBR forecasts.

Source: Barclays Research.

⁵ Analysis conditions on the market-implied path for Bank Rate as of 24 September 2026.

All taken together, our modelling suggests that total cash flows from the government to the APF in each of 2026–27 and 2027–28 are likely to be higher than expected in March. The impact in 2028–29 and 2029–30 is more neutral, with overall flows estimated to be around £6 billion *lower* in 2030–31 than expected in March.

4.5 How does this affect the public finances?

As mentioned above, the three different types of losses affect various fiscal aggregates differently. This means they have different implications for the government’s compliance with its two main fiscal rules:

Borrowing rule. This rule requires the government to achieve a forecast current budget surplus – with government revenues exceeding day-to-day spending – in the third year of the forecast, currently 2029–30. Of the three cash flows discussed above, only the interest losses count as day-to-day spending so only this one directly affects the government’s compliance with the borrowing rule. We estimate that interest losses will be £9.0 billion in 2029–30 – £3.4 billion higher in 2029–30 than our March-based estimates, reducing the government’s headroom against this rule – all else equal – by £3.4 billion. Of this, we estimate £2.2 billion results from the change in Bank Rate expectations and £1.2 billion from the Bank’s new approach to quantitative tightening.

Debt rule. This rule is a commitment to have the government’s preferred measure of debt, public sector net financial liabilities (PSNFL), falling by 2029–30. This rule is affected both by sales losses – which increase PSNFL in the year they are realised – and interest losses. We estimate that in 2029–30, the sum of the interest and sales losses will be £15.5 billion, £0.9 billion lower than our March estimates.⁶

Whatever the precise implications for compliance with the fiscal rules on any particular time frame, it is still the case that under current arrangements, the totality of interest, maturity and sales losses needs to be made good and the transfer from HM Treasury to the APF needs to be funded. All else equal, these transfers add to the government’s net cash requirement, increasing the amount of debt the government issues to the market. If government chose to adjust borrowing (rather than taxes or spending on other things), the government would have to borrow an estimated £5.2 billion more from the market in 2026–27 and £5.4 billion more in 2027–28 as a result of changes in forecast APF losses. This is against a backdrop of expected borrowing of

⁶ While changes in expected interest and sales losses in earlier years will affect the level of PSNFL in 2029–30, only changes to the flows in 2029–30 affect the trajectory of PSNFL between 2028–29 and 2029–30, and hence the government’s compliance with its borrowing rule.

around £300 billion per year.⁷ The impact thereafter is broadly neutral in 2028–29 and 2029–30, and changes since March would actually *lower* borrowing in 2030–31 by around £6 billion.

4.6 Does the timing of APF losses matter?

Several commentators, including the Governor of the Bank of England, have stated that the precise timing of losses, and how they are accounted for on the combined public sector balance sheet (which brings together the Bank and the government) are simply a matter of accounting and not economically important. On one level, this is true. HM Treasury will ultimately bear the costs of the QE/QT programme. Whether losses are crystallised now through sales or later through maturing bonds should, in the long run, lead to a similar eventual loss, when discounted through time. And given HM Treasury's commitment to indemnify those losses, whether transfers to the APF are made now or in some future year only moves resources through time.

However, to draw on the often-used sentiment from Keynes, in the long run we are all dead, and if economics is anything, it is the study of how to best allocate our resources not just across people and places, but also across time. Keeping the current arrangements is a choice to spend £20 billion per year on a transfer to the Bank of England now, rather than to do that at some other time. This is a similar choice the government faces when it is deciding whether to bear the costs of public spending now through taxation or to borrow now and finance them through taxation in future. Both choices involve choosing how to distribute costs between current taxpayers and future taxpayers, or between different groups of taxpayers at a given point in time.

4.7 Alternative ways of managing and accounting for the costs of QT going forward

Given the importance of how these flows are distributed across people and time, a number of alternative arrangements have been discussed that would result in a different set of allocations.

One often discussed proposal aims to **reduce the near-term costs of the policy by slowing the unwind of the gilt holdings in the APF**. As highlighted by the analysis above, this reduces or even removes the sales losses, but elongates both the interest rate losses and maturity losses. In fact, if the entire gilt portfolio were held to maturity, with only passive unwind, HM Treasury would still be covering losses as far into the future as 2071. This problem is particularly acute in

⁷ On a gross financing requirement basis.

the UK compared with its peers as the average maturity of government borrowing in the UK is much longer. This proposal amounts to a shift of the cost burden through time, pushing more of it into the future.

The essence of this proposal has largely been enacted by the Bank of England as part of its September announcement. Although it stopped short of reducing active sales to zero, it reduced the pace of sales and decided to hold a significant fraction of the debt to maturity. One important element of the September decision was that it was led by the Bank of England and motivated through monetary policy and balance sheet management considerations. If the same process had seemed to be dictated by HM Treasury in order to make fiscal savings, this could have been perceived as fiscal policy stepping into the independent decisions of the Bank of England.

A second possible way to reduce the fiscal burden of the APF in coming years would be to **reduce the compensation offered on central bank reserves**. This is the cost part of the profit and loss equation. If the Bank no longer paid interest on reserves held by commercial banks then there would be scope for the APF to stop paying interest on its loan from the Bank, removing interest losses. Other economies have tried this at a limited scale, reducing the interest they pay on a fraction of the balances held with them in reserves. This change would do nothing to reduce sales or maturity losses, which amount to around half of the overall fiscal burden. This would also effectively shift the loss from government onto commercial banks, who would no longer receive interest income and might pass at least some of the loss on to depositors and borrowers (Islam, Khan and Meaning, 2024). Another risk with this approach would be that it would complicate the implementation of the more traditional tool of monetary policy – the Bank of England being able to set the interest rate on reserves to influence market rates more broadly.⁸

A third option, put forward previously by one of the authors and others, is that **the bonds in the APF could be moved onto the Bank of England's own balance sheet, removing the government indemnity** (Islam, Khan and Meaning, 2024). This is much more in line with how similar programmes have been managed by the Bank of England's peers in other countries, such as the Federal Reserve. Losses would then have to be borne by the Bank of England, rather than HM Treasury. To deal with this, the Federal Reserve employs a form of accounting known as a deferred asset that allows it to offset current losses with future income streams from the interest on its holdings (seigniorage income).⁹ Using this internationally established framework would require allowing the Bank to keep its seigniorage income. The framework would allow the Bank of England to smooth out the losses over a longer period. Rather than £20 billion per year over

⁸ For more discussion of the potential effects of a tiered-reserves approach, including on economic efficiency, credit conditions and the resilience of the banking system, see Tucker (2022).

⁹ The face value of currency and reserves the Bank issues is, on average, higher than the cost of producing it. The difference generates an asset for the Bank, and the interest on this asset is termed 'seigniorage income'.

the next few years, the fiscal cost would be more like £1–2 billion per year of lost seigniorage income,¹⁰ but these losses would persist over a longer period of time.

4.8 Conclusion

Accounting arrangements between the Bank of England and HM Treasury may seem obscure and complex, but they matter directly for fiscal policy and the decisions that will face the Chancellor, at this Budget and beyond. After years of profiting from the Bank of England's quantitative easing programme, since 2022 the government has been financing losses. In 2026, this is set to cost £13 billion in interest costs (which represent day-to-day spending for the government) and a further £11 billion in costs relating to the reduction in bond holdings.

Recent innovations from the Bank of England go some way to ameliorate this cost in coming years, but our modelling suggests the OBR will still revise up its projections for these costs in its October forecast. Different countries have chosen different ways of accounting for similar losses and, given the scale of the transfers involved, there should be an open debate about the different options here. This could perhaps be facilitated by the current Treasury Select Committee inquiry into the independence framework of the Bank.

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¹⁰ Figure estimated by Barclays Research.

5. Migration and the public finance forecast

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The government's performance against its fiscal rules, and hence many decisions taken by the Chancellor at the Budget, hinge on the Office for Budget Responsibility (OBR)'s five-year ('medium-term') forecast for the public finances. An important component of this forecast is migration, which is a key driver of changes in the size and composition of the UK population. But migration is hard to measure, and even harder to forecast. Migration will also have different impacts on government revenues and spending depending on its composition: between immigrants and emigrants, and between immigrants arriving on different visa routes. In this chapter, we outline the challenges the OBR faces in accurately reflecting the impacts of migration in its medium-term public finance forecast and suggest ways to improve the current approach.

Key findings

1. Immigration into the UK was relatively stable in the 2010s and is estimated to have averaged 750,000 per year between 2012 and 2019. Emigration out of the UK was rising and is estimated to have averaged around 500,000 per year. Net migration (i.e. the difference between immigration and emigration) therefore averaged around 250,000 per year across the 2010s. **Immigration rose sharply in the 2020s, with an estimated peak of 1.4 million per year in 2022 and 2023.** Emigration also rose, but by less, so net migration exceeded 800,000 in 2022 and 2023. **Since 2023, net migration has fallen sharply, driven by a slowdown in immigration and higher emigration of recent immigrants. The latest estimates suggest net migration in 2025 was around 171,000.**
2. **The composition of migration has changed substantially over time.** In 2025, around three-quarters of new immigrants were from non-EU countries, compared with around a third between 2012 and 2020. Relative to 2019, the composition of non-EU migrants has also changed. A much greater share of non-EU immigrants in 2025 were students and their dependants (47% in 2025 versus 33% in 2019) or on asylum or

humanitarian routes (20% versus 13%). A much smaller share were on a family route (mostly spouses of existing residents, 7% versus 21%) or workers and their dependants (23% versus 27%).

3. **Forecasting the future level of net migration is very hard: between 2015 and 2025, net migration turned out on average 170,000 a year higher than the Office for National Statistics (ONS) had projected five years earlier.** Even estimating the current level of net migration is challenging, and past estimates are frequently subject to large revisions: estimates of net migration in 2022 have been revised up by nearly 300,000, while estimates for 2024 have been revised down by 100,000.
4. **Policymakers should not make decisions about migration policy based primarily on the impacts it will have on the OBR's fiscal forecast.** The fiscal forecast – by construction – only captures impacts over five years. As the OBR has documented, the longer-term fiscal impacts of migration could well be different, as migrants who remain in the UK gain more access to the benefits system over time, and use different public services as they age, for instance. Migration also has broader societal impacts which are outside the scope of the OBR's forecast. Just as for other areas of policy, these wider impacts should also be considered when policy is made.
5. **Migration policy can have very large impacts on the economy and the public finances.** For example, the Home Office projected that three big policy changes since the pandemic – the visa route for Hong Kongers in 2020, restrictions on international students switching routes and bringing dependants in 2023 and restrictions on Skilled Worker visas in 2025 – would each change migration by at least an average of 40,000 per year over five years. **We estimate that these policies could have had larger impacts on the size of the economy than any of the high-profile 'supply-side' policies announced since 2023,** including planning reform, tax changes and childcare subsidies. For this reason, migration is an important component of the OBR's economic and fiscal forecasts.
6. The OBR's medium-term migration forecast is closely linked to long-run ONS migration projections. These ONS projections are not intended to account for all policy announcements and are released much less frequently than OBR forecasts; by construction, they do not respond to recent policy changes. While the OBR can, in principle, deviate from the ONS projections, in practice it almost never has in the later years of its forecast. There is a strong case that, **considering the period since late 2020 as a whole, the OBR migration forecasts did not fully account for policy changes. This in turn has likely reduced the accuracy of fiscal forecasts in recent years.**

7. The OBR has recently separated its short-term migration forecast from the ONS projections, allowing it to explicitly account for trends in visa numbers and stay rates of recent emigrants. **We recommend that the OBR builds on these improvements and fully detaches its medium-term forecast from the ONS projections, with a view to better capturing policy going forward.** There would be a case for the OBR to also more explicitly distinguish between policy-driven and other changes to its net migration forecast, and how these feed through to the fiscal forecast. This would aid transparency and external scrutiny of policy choices.
8. **When considering the impacts of net migration on the public finances, the OBR is required to take government spending plans as given and therefore has to assume there are no related changes in public service spending in its medium-term forecast.** Higher net migration could increase the pressure on public services; similarly, lower migration could free up resources. However, government departments are set cash budgets which the OBR is required to take as given: it is up to the government whether it changes spending or allows performance to change in response to changes in migration. The OBR was granted new powers in 2024 to adjust its spending forecasts where the government may be forced to spend more or less than it previously thought, and has previously used these to account for pressures on asylum spending. Were future migration to increase, the OBR should use these powers to forecast migration-related overspends where they seem likely.
9. The impact of higher net migration on borrowing over a five-year period will depend heavily on how tax revenues change and how government spending on public services responds. As an illustration of the potential scale: in a scenario published in March 2024, the OBR estimated that an increase in net migration of 200,000 per year for five years could reduce borrowing by about £20 billion per year by the end of the forecast horizon. If the government chose to increase spending in order to keep public service quality unchanged, borrowing could instead fall by about £13 billion per year by the end of the forecast horizon. Similarly, **a reduction in net migration would likely worsen the fiscal forecast, even if a government responded by reducing planned spending on public services.** For any specific change in net migration, the precise composition of migrants would determine the fiscal impacts.
10. The ONS has recently reduced its long-run projection for net migration by 110,000 per year. If the OBR continues to tether its net migration projection to the ONS's long-run projection, this could result in a reduction in its own migration forecast at the Budget. Depending precisely on how the OBR adjusts each year of its forecast in response, **this could lead to an increase in forecast borrowing of around £1–5 billion in 2031–32** (taking existing spending plans as given). Such a change in the forecast

should not normally drive fiscal policy changes, but can matter when Chancellors choose to leave minimal headroom against their fiscal rules.

11. Different types of migrants can have very different effects on the public finances.

For some migrants, employment is a visa requirement, such that they are much more likely to be employed than people born in the UK, while other groups have lower employment rates or are prevented from working. This affects the taxes they are likely to pay. Some immigrants have immediate access to the benefits system, while many others do not. Not all changes in composition will be material, but some changes could make a meaningful difference to the fiscal forecast. In the past, the OBR has sometimes adjusted its forecast to capture changes in the characteristics of migrants beyond their age. **There are ways that the OBR could more systematically adjust for differences across different migration routes in its forecast, which could improve transparency.**

5.1 Introduction

Migration has wide-ranging effects on the UK economy and society. Migration changes the size and composition of the UK population, and can therefore impact both the overall size of the economy and its per-person size, with potential impacts on both labour markets and productivity (Dustmann, Frattini and Preston, 2013; Ottaviano, Peri and Wright, 2018). Patterns of migration feed through to fiscal impacts, including the impact on tax revenues and public spending (Dustmann and Frattini, 2014; Vargas-Silva, Sumption and Brindle, 2026). There is also a whole suite of non-economic impacts of migration policy, including on the well-being of migrants, humanitarian goals and social cohesion (e.g. Letki, 2008; Bell, Fasani and Machin, 2013). All these impacts can differ substantially across different parts of the UK, across different time horizons and for different groups of migrants.

Migration is not the only factor to affect the size and make-up of the UK population, but it typically changes much more from year to year than either fertility or mortality (Billari, 2022). It is also much more responsive to policy, with the government having more control over the number and mix of arrivals to the UK than it does over numbers of births or deaths.

In this chapter, we focus on just one aspect that policymakers may consider when making decisions about migration policy: the impact of migration on the outlook for the UK's public finances. We focus in particular on the Office for Budget Responsibility (OBR)'s medium-term public finance forecast which considers tax revenues, public spending, borrowing and debt over a five-year horizon. This forecast is very important for fiscal policy decisions, as the UK's

current fiscal rules are forward looking and whether they are being met is based on these OBR forecasts. As with other policy areas, this forecast should not be the only – or indeed even the primary – driver of migration policy: the wider economic and social impacts of net migration, as well as the longer-term fiscal impacts, should be the core part of the policymaking process (Johnson, 2023; Emmerson, Ridpath and Stockton, 2025).

Nevertheless, the link between migration and the OBR's forecast is very consequential, for two main reasons. First, substantial changes to migration – whether driven by policy or other factors – can have large effects on the path of tax revenues, public spending and overall borrowing. The forecast of these impacts feeds through to the margin by which the fiscal rules are being met, and thereby can have a significant impact on tax and spending choices across government. For example, at the 2026 Spring Forecast, the OBR accounted for the Office for National Statistics (ONS)'s upward revision to estimates of recent British emigration by 50,000 per year, which in turn led it to raise its forecast of future British emigration and consequently lower its forecast of net migration (Office for Budget Responsibility, 2026). We estimate that this reduction in projected net migration reduced the OBR's forecast of tax revenues in 2030 by around £5 billion (Ridpath, 2026). At the Autumn Budget, the Chancellor is likely to face a further downgrade to the OBR's net migration forecast, after the ONS lowered its long-run net migration projection from 340,000 to 230,000 per year (Office for National Statistics, 2026c). It is important for broader fiscal policy decisions that the OBR's forecast adequately captures the effects of these changes in migration. This is especially relevant when the government leaves little room against its fiscal rules, so that even small changes in the OBR's fiscal forecast can force the government to make tax and spending changes to continue meeting the rules.

Second, the impact of policy reforms on the public finances, and more narrowly on compliance with the fiscal rules, can be – for right or wrong – a key factor in the government's decision-making process. Given this, it is important that the forecast captures the expected effects of policy reforms, including any to migration policy, accurately. If it does not, this could lead to policymakers making decisions on migration policy based on the impacts that possible reforms might have on the forecast rather than based on their actual expected public finance impacts.

In this chapter, we argue that the way migration policy feeds into the OBR forecast is unclear and broadly inconsistent with how other areas of policy are treated. There is a strong case that the impacts of past policy changes have not been fully captured in recent fiscal forecasts and that, without a change of methodology, the impact of future policy would not be fully or transparently reflected. This matters both for the accuracy of the fiscal forecast and for how policymakers and broader audiences understand the impact of migration policy on the economic and fiscal outlook. We therefore recommend that the OBR moves to more explicitly accounting for policy when producing its migration forecast.

There are other issues that warrant discussion too: while the OBR's forecast automatically accounts for differences in the age of migrants, it has used ad hoc adjustments for other characteristics. There is a case that the forecast should account for the differences between different types of migrants in a more systematic way. Additionally, the OBR's forecast could overstate the benefits of immigration because it is required to mostly assume that there are no related changes to public service budgets. That is not the fault of the forecast – there are good reasons that, under the current fiscal framework, the OBR mostly takes the government's public service spending plans as given – but it is one of several reasons that the forecast should not be used as the only way to make or judge migration policy.

Our focus in this chapter is on the impacts of migration over a five-year horizon, rather than any longer-run impacts. This is a key time frame given the current fiscal framework, and it is also a meaningful time period for considering migration in its own right: many immigrants, often a majority, leave the UK within five years of arriving (Home Office, 2024, 2025a and 2026a).¹ But the longer-run effects of migration for the group who stay in the UK (or remain out of the UK) for longer are also important, and should also be considered by policymakers. Box 5.1 examines why the medium- and long-run impacts of migration may differ, and some of the existing evidence on the public finance impacts of migration.

The rest of this chapter is organised as follows. Section 5.2 presents some basic facts about migration to, and from, the UK. Section 5.3 discusses the challenges of measuring and forecasting levels of net migration. Sections 5.4 and 5.5 examine the challenges in forecasting the impacts of migration on government revenues and on government spending, respectively. Section 5.6 concludes.

Box 5.1. The long-run impacts of migration on the public finances

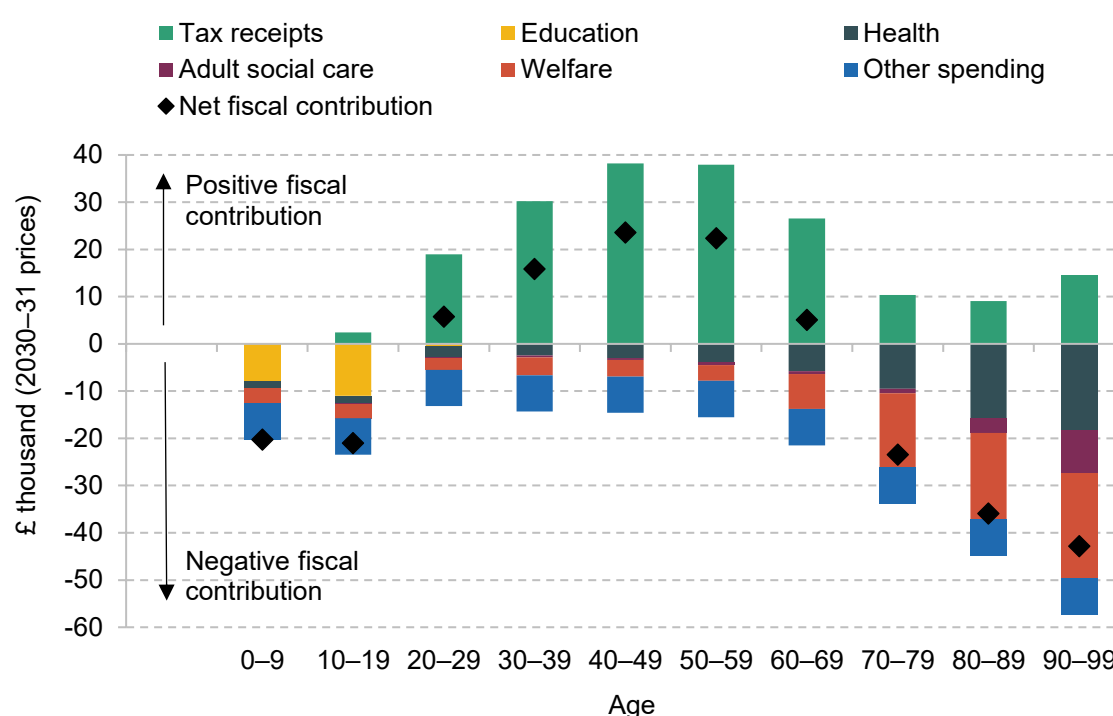
In this chapter, we focus on the impacts of migration over a five-year period, the length of the OBR forecast horizon. Many immigrants leave within five years and so will have minimal longer-run impact on the public finances. For example, of the migrants who were granted a visa or claimed asylum in 2019, 57% had no entitlement to still be in the UK five years later (Home Office, 2025a).^a Similarly, some emigrants may return to the UK within five years of leaving, and so their decision to emigrate will also have minimal longer-run impact on the public finances.

Nonetheless, many immigrants will remain in the UK for longer than five years and many emigrants will leave the UK for longer than five years. In general, the impacts on the public finances in the

¹ For much of the period we consider, the fiscal rules focused on the fifth year of the forecast. In recent years, they have moved to focus on the fourth and now third year of the forecast. Throughout, we focus on the five-year fiscal forecast as a whole, rather than the specific year in which the fiscal rules bind.

longer run are likely to differ from the short-run impacts. For example, most immigrants gain access to more parts of the benefit system when they receive Indefinite Leave to Remain (discussed more in Section 5.5) and no longer have to pay visa fees. As immigrants and emigrants age, there will also be changes to tax revenues coming from them and spending on areas such as health, social care and the state pension – Figure 5.1 shows how tax receipts and public spending differ for the average UK resident by age. Long-term immigrants may also have children in the UK and may have different fertility rates from the existing population, which will feed into longer-run demographic changes in the UK. These differences between the short-run and long-run impacts of migration on the public finances are something the OBR has also discussed, including in recent Fiscal Risks and Sustainability reports (e.g. Office for Budget Responsibility, 2024b).

Figure 5.1. Age profile for public spending and tax receipts for an average UK resident



Note: See the introduction and annex C of the OBR's 2026 Fiscal Risks and Sustainability report for more details on how these are constructed.

Source: Office for Budget Responsibility, 2026b.

When estimating the long-run fiscal impacts of migration, there is much more uncertainty than over the five-year horizon. This uncertainty stems from the behaviour of immigrants, including how long they stay in the UK, as well as the general equilibrium effects that migrants will have on the wider economy, labour markets and productivity. The long-run impacts of migration are also very dependent on how costs and benefits in different years are valued. The government typically discounts future costs and benefits, meaning that it places less weight on impacts occurring further in the future than on those occurring sooner. This can be justified in several ways: society may place greater value on more immediate impacts – for instance, if it expects future generations to be better off – while reductions in

government borrowing today are more valuable than future reductions in borrowing as there is less accrued interest, so that immediate savings are worth more than the same cash amount received in the future.

The Migration Advisory Committee (MAC) has estimated the long-run fiscal effects of some groups of immigrants, specifically Skilled Worker visa holders and their dependants (Migration Advisory Committee, 2025). To do this, it has estimated a net present value of the sum of all the future annual fiscal contributions (or costs), discounted using a 3% real discount rate. This is similar to the approach taken by the Treasury.

For those on Skilled Worker visas, the MAC estimates a mean net present value of £689,000. This is even higher (£931,000) for skilled workers who do not leave the UK. It estimates that health and care workers have much smaller impacts, but they are still on average positive, with an average net present value of £54,000. It estimates that adult dependants of those on worker visas have lower fiscal benefits in the long run – dependants of skilled workers have very small positive effects (£3,000) and dependants of health and care workers have a negative fiscal impact (–£67,000).

It is worth noting that the mean UK resident has a net negative fiscal contribution, though this can be explained by much of the negative fiscal impact coming during childhood: when the MAC adjusts the fiscal impact of UK residents to start from the same distribution of ages as observed across immigrants on arrival, the mean UK resident has a positive fiscal contribution.

^a Among those who were granted a visa or claimed asylum in 2020, the latest year for which we have data but also likely an exceptional year for migration, 45% had no entitlement to still be in the UK five years later (Home Office, 2026b).

5.2 Recent trends in migration

In this section, we present some basic facts about international migration to and from the UK. We describe historical trends in immigration and emigration, the main immigration routes, and the age profile of immigrants and emigrants.

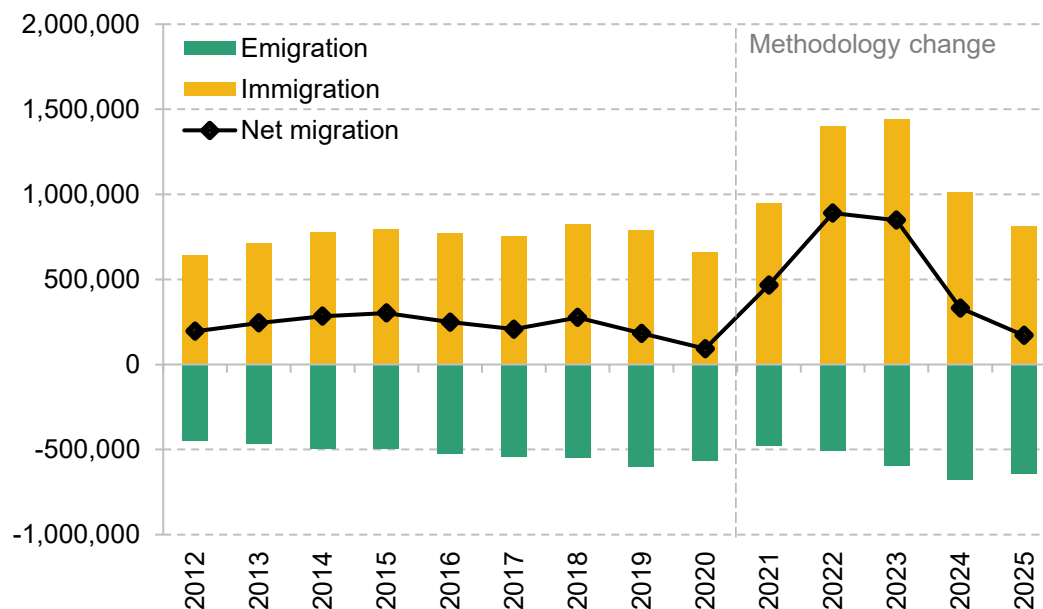
Figure 5.2 shows the Office for National Statistics (ONS) estimates of international immigration, emigration and net migration (the difference between the two) since 2012. In the chart, and throughout the chapter, we use the ONS's definition of long-term migration, defined as the number of people moving to the UK for at least 12 months (immigrants) or leaving the UK for at least 12 months (emigrants).² It is important to note that these figures are estimates. As we

² Of course, migrants who are in the UK for less than 12 months, or leave the UK for less than 12 months, could still have an impact on the public finances.

discuss in more detail in Box 5.2, all forms of migration are difficult to measure directly, and some – such as the migration of British nationals – particularly so. This means that the ONS must rely on estimates of different migration flows, and these are often subsequently revised.

Net migration was generally stable through the 2010s, ranging between 200,000 and 300,000 a year. This reflected annual immigration of between 600,000 and 800,000 people, partly offset by emigration of around 500,000 people. After a sharp dip during the COVID-19 pandemic, immigration rose sharply from 2021 onwards, reaching historically high levels in 2022 and 2023 at 1.4 million per year. As a result, net migration rose to around 500,000 in 2021 and almost 900,000 per year in 2022 and 2023. Since then, immigration has fallen steeply from its peak, while emigration has remained relatively high, bringing net migration below its pre-pandemic level in 2025.

Figure 5.2. Immigration, emigration and net migration



Note: Figures are rounded to the nearest thousand. The chart reflects estimates for each year ending December (i.e. between January and December). Migration is dated by the migration event, i.e. the date of arriving in or leaving the UK, but estimates include only long-term migrants who move to the UK or leave the UK for at least 12 months. Includes ONS revisions to its own estimates between 2012 and 2021 to improve consistency with new approach introduced in 2021 (discussed in Box 5.2). A significant methodological break remains for British nationals around 2021 as estimates before and after this point are produced using different methods.

Source: Office for National Statistics, 2026b.

Box 5.2. Challenges measuring net migration

There are several difficulties in estimating recent levels of net migration. The first is in estimating immigration. This stems from the fact that the definition of long-term migrant only counts those who live in the UK for at least a year. While most movement into the UK can be measured through visa and border data, it is harder to measure how many of those arrivals went on to leave within a year.

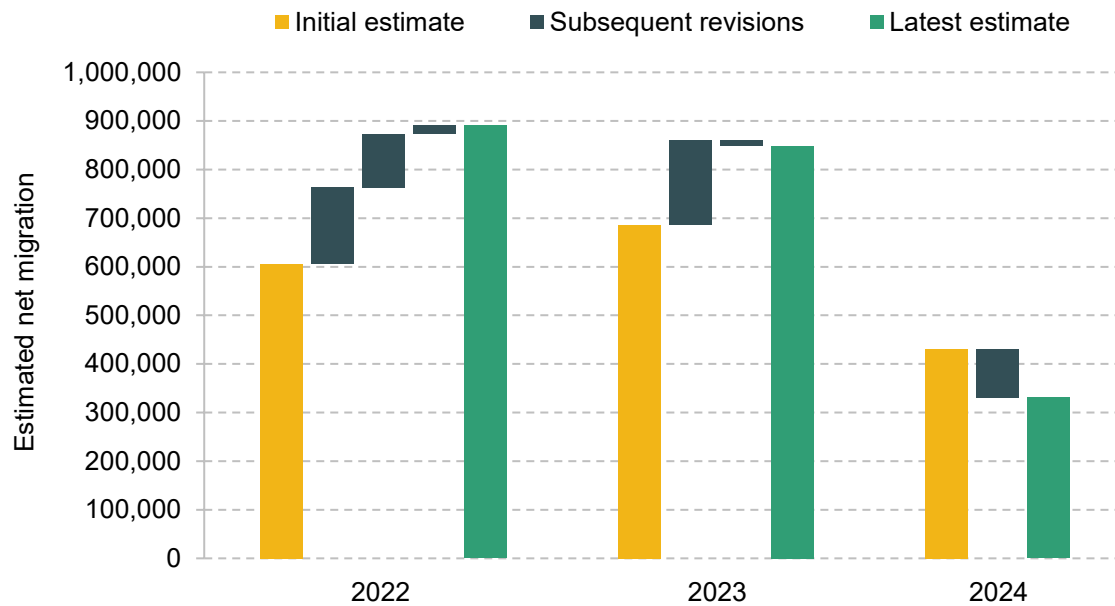
The lack of detailed reporting of reasons for departure from the UK is an even bigger challenge for estimating emigration. Neither departure data nor visa expiration data perfectly capture levels of emigration. Those who leave the country are not required to report that they are leaving permanently, and departure data do not in themselves reveal whether someone is leaving for a short trip or leaving permanently. Visa expiry data do not capture permanent emigration, as individuals may have left before their visa expired or may overstay their visa.

This poses a substantial challenge for the ONS, and in recent years it has changed its method for measuring emigration. Until 2020, it used the International Passenger Survey (IPS), which asked travellers at points of exit from the UK more details about their reasons for travel. However, due to issues with the survey, the ONS has now moved to the use of administrative data, including tax and benefit data from HM Revenue and Customs (HMRC) and the Department for Work and Pensions (DWP) and data on international students from the Department for Education (DfE).

The move to administrative data should improve measurement by providing much broader coverage than the IPS, but it does not eliminate uncertainty, as moves lasting at least 12 months take time to become apparent in the data, and not everyone ceasing to appear in administrative data will have emigrated. Following this methodological change in 2021, the ONS revised past estimates back to 2012 to improve consistency with the new approach. The historical series was harmonised with the new methodology mainly for non-British migration; for British nationals, revisions were also made, but estimates before and after 2021 remain based on different methods.

Given these challenges, revisions to the net migration estimates are common. Figure 5.3 shows how estimates have been revised over time. These mismeasurements can be very large: the initial net migration estimate for 2022 (produced in 2022) was 610,000, while the most recent estimate (produced in 2025) is 890,000, almost 50% higher. Estimates of net migration for 2024 have been revised down from 430,000 to 330,000 in just a year. Against this backdrop, estimates of the public finance impacts of recent migration are inherently uncertain. Forecasting future migration is also more challenging when estimates about the recent past are uncertain.

Figure 5.3. Revisions to net migration estimates



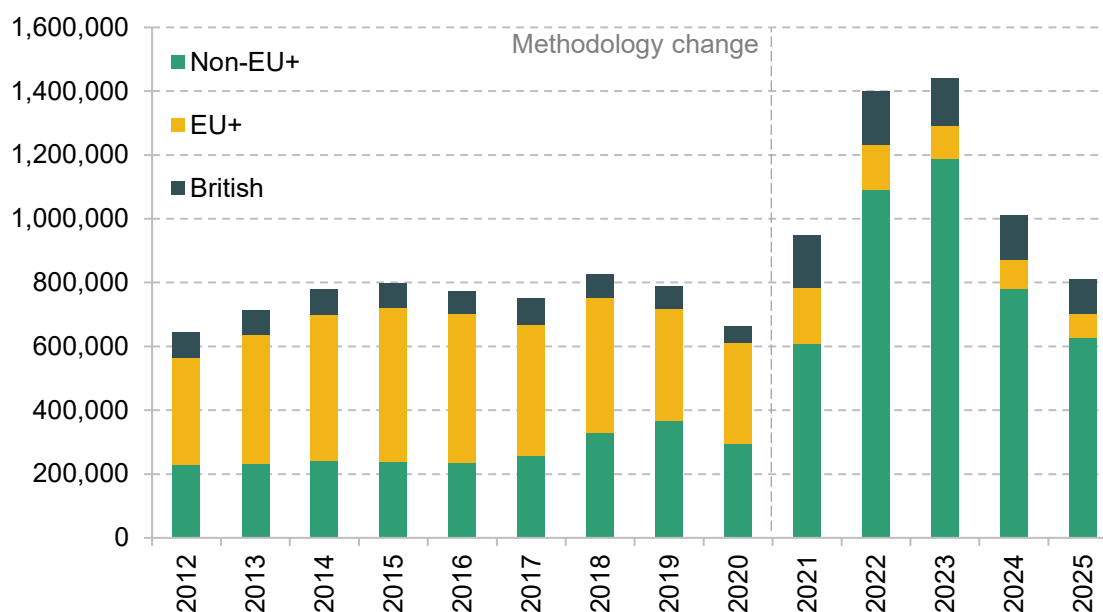
Note: Latest estimate is as of 2025 in all cases. Estimates by date of arriving in or leaving the UK for each year ending December (i.e. between January and December).

Source: Office for National Statistics, 2026d.

Indeed, the ONS estimates are not the only estimates of UK net migration. Aristotelous, Smith and Bijak (2023) estimate that net migration to the UK in the 2010s may have been much higher than the ONS has estimated. In 2019, for example, their median estimate is net migration of 430,000 (with a 25th percentile estimate of 350,000 and a 75th percentile estimate of 530,000), compared with the ONS's estimate of 183,000.

Figure 5.4 shows estimates of immigration broken down by nationality, grouping countries into European countries that had free movement pre-Brexit (EU+) and all other countries (non-EU+).³ Recent fluctuations in immigration have been driven mainly by non-EU+ nationals. Immigration from EU+ countries has declined steadily since the vote to leave the European Union in 2016 and now accounts for a much smaller share of total immigration than in the past. British nationals returning to the UK now slightly outnumber European nationals moving to the UK.

³ EU+ includes all 27 EU member nations, as well as members of the European Free Trade Association (Iceland, Liechtenstein, Norway and Switzerland).

Figure 5.4. Immigration to the UK by nationality

Note: Figures are rounded to the nearest thousand. The chart uses estimates for each year ending December (i.e. between January and December). Immigration is dated by the migration event, i.e. the date of arriving in the UK, but estimates include only long-term migrants who remain in the UK for at least 12 months. Includes ONS revisions to its own estimates between 2012 and 2021 to improve consistency with new approach introduced in 2021 (discussed in Box 5.2). A significant methodological break remains for British nationals around 2021 as estimates before and after this point are produced using different methods.

Source: Office for National Statistics, 2026d.

Immigration to the UK can be for different reasons, which we refer to as migration routes. These include work, study, family reasons, asylum and other humanitarian reasons. Most non-European immigrants come to the UK on visas tied to a particular purpose for being in the UK, which means it is possible to break down their immigration by route, as shown by Figure 5.5.⁴

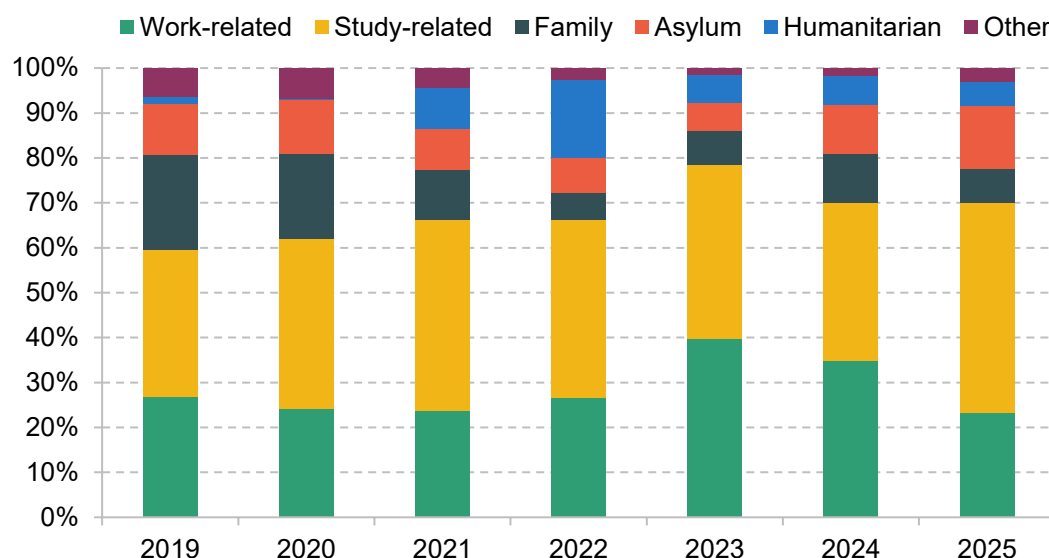
Work and study are the most common routes into the UK for non-EU+ nationals, and constituted 70% of new immigrants in 2025.⁵ The share of immigrants arriving for family reasons, who mostly join either a British citizen or a settled migrant, has fallen since 2019 and 2020. Humanitarian migration became a more significant share of total immigration from 2021, following the opening of the Hong Kong BNO route in 2021 and the Ukraine schemes in 2022.

⁴ This decomposition by route is only available from 2019 onwards. Moreover, we cannot produce a comparable route breakdown for EU+ nationals. Before 2021, they could generally move under free movement, and those with EU Settlement Scheme status and Irish nationals still do not require visas. The ONS therefore distinguishes only between visa holders, EU Settlement Scheme status holders and Irish nationals.

⁵ Work- and study-related reasons include main applicants and dependants. This is broadly also the case for asylum and humanitarian migration.

Asylum seekers, including those arriving on small boats, have, in recent years, accounted for between 5% and 15% of total non-EU+ immigration inflows.⁶

Figure 5.5. Non-EU+ immigration to the UK by route



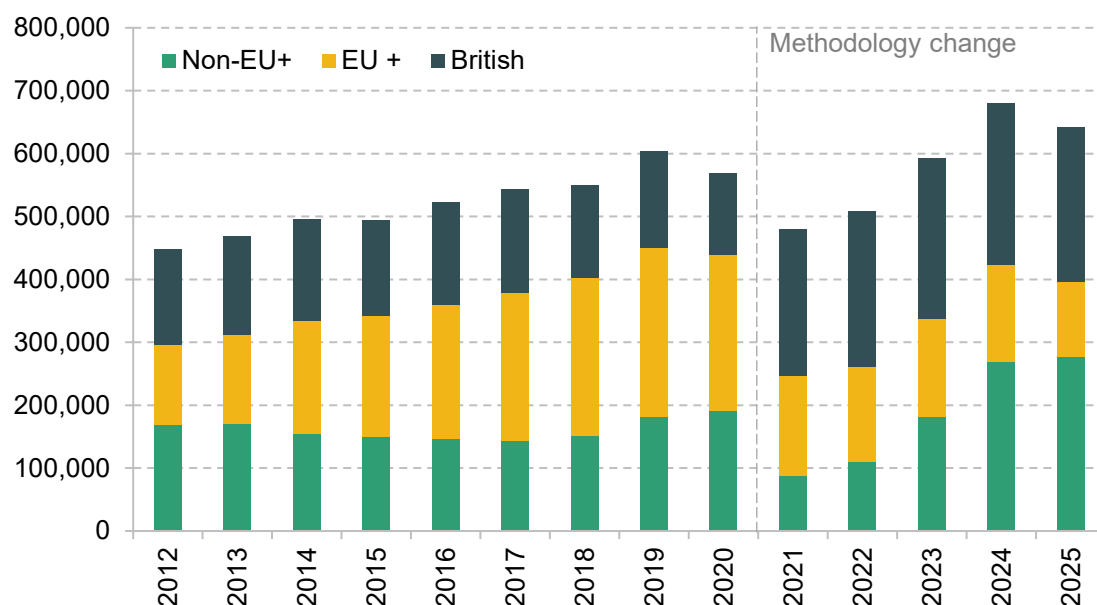
Note: The chart uses estimates for each year ending December (i.e. between January and December).

Source: Office for National Statistics, 2026d.

Figure 5.6 shows estimates of emigration by nationality. Emigration is more evenly split between non-EU+, EU+ and British nationals than immigration. Trends in emigration among non-British nationals depend strongly on earlier immigration patterns, as many immigrants leave the UK within a few years of arrival (see Box 5.1). Accordingly, the surge in non-EU+ immigration from 2021 is now being reflected in higher emigration of non-EU+ nationals from 2023 onwards, the majority of whom are those who initially moved to the UK to study. Conversely, lower inflows of EU+ nationals are now translating into fewer EU+ nationals leaving the UK. Emigration among British nationals is now estimated to be higher than in the past, largely because of a methodological change in the production of these estimates from 2021 onwards (discussed in Box 5.2).⁷

⁶ Immigration for asylum reasons includes both people who enter through regular routes before claiming asylum and those using irregular routes, such as small boats. The precise share of people counted as long-term immigrants for asylum reasons who entered through irregular routes is not published. Irregular arrivals enter ONS migration estimates when they appear in Home Office administrative data, usually through an asylum claim. Home Office data show that around 41,000 people claiming asylum in 2025 had entered by small boat, suggesting that they accounted for somewhat less than half of the 88,000 asylum-related long-term immigrants estimated by the ONS (Home Office, 2026c). The comparison is approximate for two reasons. First, not all small-boat arrivals who claim asylum will necessarily be counted as long-term migrants, as the ONS uses returns data to identify applicants who leave within a year of applying. Second, the ONS also removes asylum applicants who were already counted as long-term migrants through a previous visa, which may disproportionately affect those who initially entered through regular routes.

⁷ While this methodological break has a sizeable effect on the series for British emigration, its effect is more muted on overall net migration.

Figure 5.6. Emigration from the UK by nationality

Note: Figures are rounded to the nearest thousand. The chart uses estimates for each year ending December (i.e. between January and December). Includes ONS revisions to its own estimates between 2012 and 2021 to improve consistency with new approach introduced in 2021 (discussed in Box 5.2). A significant methodological break remains for British nationals around 2021 as estimates before and after this point are produced using different methods.

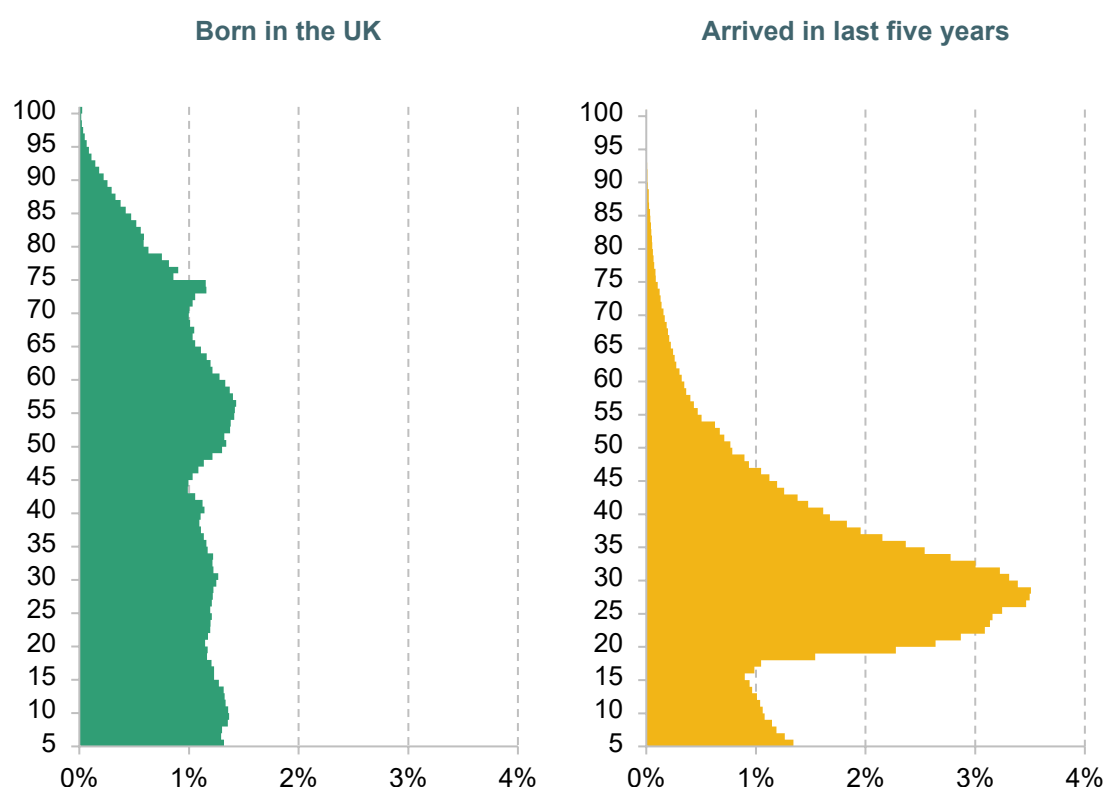
Source: Office for National Statistics, 2026d.

An important distinguishing feature of migrants, both those moving to and those moving from the UK, is their age. Both immigrants and emigrants tend to be younger than long-term UK residents. We can use the latest Census to examine the full age profile of immigrants. Foreign-born individuals who arrived in the UK recently are overwhelmingly of working age, with a particularly strong concentration between ages 16 and 40, as well as a visible peak among very young children (Figure 5.7).⁸ This is a very different profile from that of the UK-born population.⁹ For emigrants, we cannot observe age with the same level of detail as in the Census, but ONS estimates suggest that most migrants leaving the UK for at least 12 months are aged between 16 and 64, among both British and non-British nationals (Office for National Statistics, 2026b). The age distribution of migrants is important as it has consequences for their fiscal impact. As shown by Figure 5.1, on average, working-age adults pay more in taxes than they receive in public services or benefits, whereas the reverse is true for children and older adults. We discuss these impacts in more detail in Sections 5.4 and 5.5.

⁸ Note that relying on the Census, which was carried out in March 2021, means these recent arrivals will not include those who arrived during the peak of immigration since 2021. Furthermore, as we focus on immigrants who arrived within the last five years, we trim both distributions at 5 years old to avoid a mechanical drop in density.

⁹ Considering all foreign-born individuals in the 2021 Census, and not only those who arrived in the UK in the five years prior to the Census, the difference in age distribution relative to the UK-born population is less pronounced, although these people remain more likely to be of working age.

Figure 5.7. Age distribution of recent immigrants and UK-born population



Note: We trim both distributions at 5 years old to avoid a mechanical drop in density among immigrants who arrived within the last five years.

Source: Authors' analysis of 2021 Census.

5.3 Forecasting net migration

The Office for Budget Responsibility (OBR) needs to forecast the level of net migration; this is an important input into the overall economy and fiscal forecasts. Future migration patterns are difficult to predict because they depend on factors such as how many people in the UK and in other countries want to migrate, the relative attractiveness of the UK compared with other destination countries, and UK government policy.

The OBR's net migration forecast is closely linked to the ONS population projections. In this section, we first examine the ONS approach to projecting net migration. We then describe the OBR's current approach to forecasting migration and discuss its shortcomings, particularly in accounting for the impacts of policy announcements.

ONS migration projections

Every two years, the ONS produces projections for the population over the next 50 years, which include a long-run projection of migration. These are the UK's principal population projections,

used across government and beyond. The ONS migration projection is made up of two components: a long-run annual level of net migration, which is usually assumed to be constant from around the sixth year of the projection onwards, and a short-run path that connects the latest out-turn data with this long-run level.¹⁰ We focus here on the long-run projection, as it is most relevant for the OBR's approach.

The ONS combines two approaches to get a single principal projection for long-run net migration. It consults a panel of experts, who provide their view on the expected level of net migration in the long run. It also calculates an average of past levels of migration. The ONS provides limited details as to how either of these approaches is operationalised, or as to how these different estimates are combined. In its latest population projections, produced in April 2026, it assumed that net migration would be 230,000 per year in the long run. This was the average level of net migration between 2013 and 2025, excluding the peak years from 2022 to 2024. Its expert panel had provided a mean central estimate of 186,000 in 2030 and 244,000 in 2050 (Office for National Statistics, 2026e).

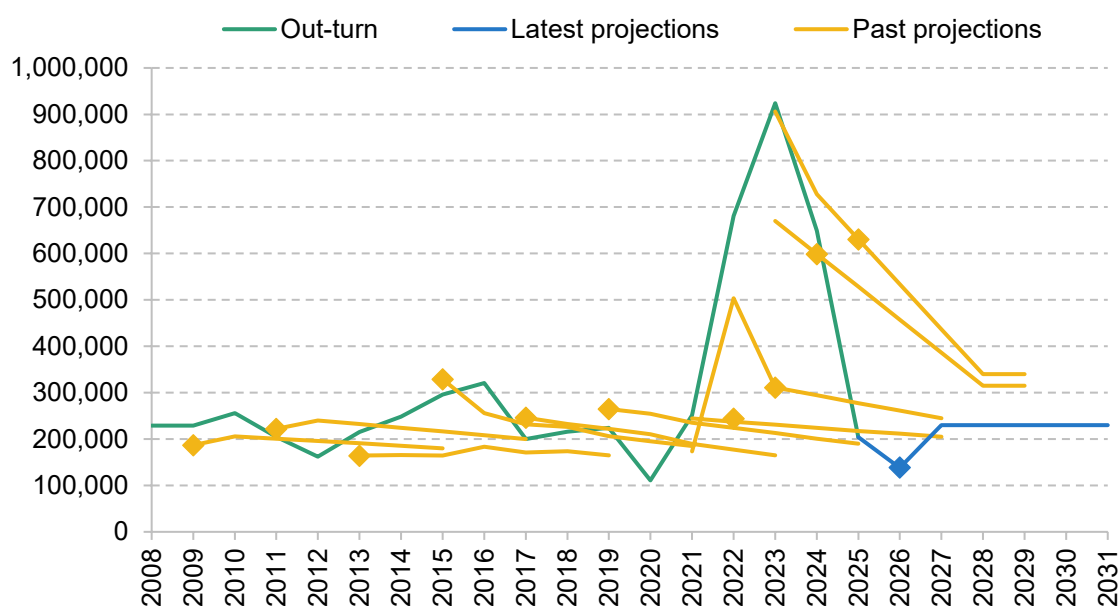
Forecasting migration is challenging as future levels of migration are dependent on the future behaviour of possible immigrants and emigrants, which can be very hard to predict (Czaika, Bijak and Prike, 2021). Given this inherent uncertainty, out-turn net migration has often differed from the ONS projections.

Figure 5.8 compares successive ONS population projections with the out-turn since 2009. Throughout the 2010s, in which net migration stayed relatively flat, the ONS tended to underestimate net migration by projecting a fall in migration in its principal projections. This may have reflected the fact that net migration in the 2010s was above levels seen in previous decades, so any projection based on historical averages would have projected some fall back to earlier levels.¹¹ The substantial spike in net migration from 2022 to 2024 was not anticipated by the ONS, which meant that pre-spike projections heavily underestimated net migration in this period. However, since then, projections have expected the spike to last for longer than it has, leading to an overestimate of net migration in recent years.

Revisions to out-turn measures of net migration can also create errors in migration forecasts. As discussed in Box 5.2, recent net migration out-turns are frequently subject to large revisions. Since the most recent out-turns serve as a baseline from which expected trends in net migration stem, this can also impact the accuracy of the forecast going forward.

¹⁰ In general, the ONS has treated its single 'long-run' level of net migration as kicking in after six years. However, in the most recent projections, released in April 2026, its projection was that the long-run level of migration would be reached in two years, and stabilise after that. The ONS also produces different variants of its projections, with a single principal projection, which we focus on here.

¹¹ This is a well-known phenomenon in demography, usually called 'assumption drag' (Shaw, 2007).

Figure 5.8. Performance of ONS net migration projections

Note: 'Latest projections' are 2024-based from the latest available provisional out-turn. The diamond markers show the year each forecast was published. Both out-turns and projections are mid-year estimates (July to June).

Source: Office for National Statistics, 2025a and 2026c.

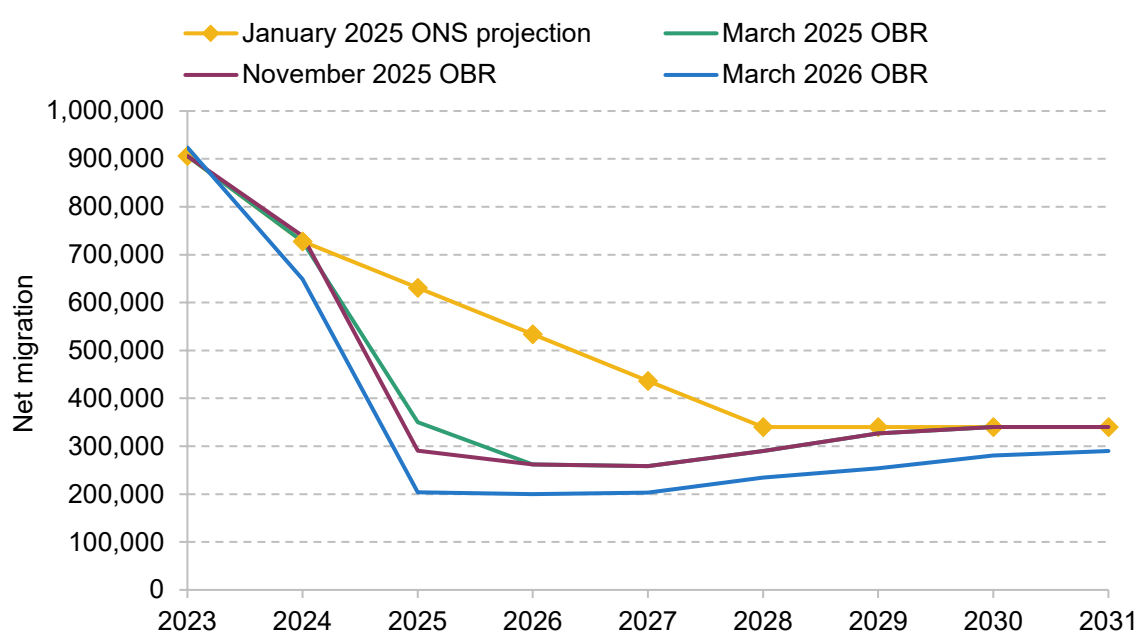
OBR migration forecasts

The OBR forecasts migration for the next five years to feed into its medium-term public finance forecast. The OBR has always closely linked its forecast to the ONS projections. In every fiscal forecast between 2015 and 2019, the OBR simply used the latest ONS principal projection for its own forecast.

In more recent years, the final year(s) of the OBR's net migration forecast has continued to be tethered to the ONS projection. Specifically, to make its medium-run forecast, the OBR starts with the ONS projection and then considers – including by consulting external experts – whether to deviate from it. In some Economic and Fiscal Outlook reports, the OBR has discussed how different factors could affect the forecast relative to ONS projections (discussed in more detail in the next subsection). However, this process has almost never led the OBR to judge that its forecast should deviate from the ONS projections in the later years of the forecast. In all but one of the last eight fiscal forecasts, the OBR's net migration forecast five years out has been identical to the ONS's long-run projection; this has often also been true for the third and fourth years. The exception, at the March 2026 Spring Forecast, reflected that the ONS had adjusted its method for estimating the emigration of British nationals but had not yet produced updated long-run population projections incorporating this change. The OBR scaled down its estimates for net migration by 50,000, seemingly pre-empting the change that would come the following month in the April 2026 set of ONS population projections.

For the intermediate period between the most recent out-turn and the fifth year of the forecast, the OBR has sometimes deviated from the ONS projections in recent years. It has started using a more sophisticated approach to forecasting short-term net migration, known as the stay-rate method (Office for Budget Responsibility, 2024a, box 2.3), which is a very welcome development. This method involves a forecast for short-term immigration trends based on recent visa flows, and a more detailed forecast for the emigration of previous immigrants using past immigration flows and probabilities of leaving the UK (Hall, Manning and Sumption, 2023). The OBR has recently published more detail on this approach (Office for Budget Responsibility, 2026c).

Figure 5.9. Net migration forecasts in recent years from the Office for National Statistics and the Office for Budget Responsibility



Note: Mid-year estimates (July to June). OBR estimates for 2023 and 2024 are revised estimates of the out-turn rather than projections.

Source: 2022-based population projections (Office for National Statistics, 2025c); Economic and Fiscal Outlook, March and November 2025 and March 2026 (Office for Budget Responsibility, 2025b, 2025c and 2026a).

Figure 5.9 shows the ONS population projections that were published in January 2025, the latest projections available for the three most recent OBR forecasts, which are also shown. There are now substantial deviations from the ONS projections in the early years of the OBR forecast, up to a difference in net migration of about 450,000 in 2025. However, the fifth year of the OBR's forecast has remained anchored to the ONS long-run projection, with the only deviation coming in March 2026 in anticipation of changes in ONS measurement practice (discussed above). It is unclear exactly how the OBR aligns its short-term and medium-term approaches: it is possible that the short-term forecast is adjusted to reach the ONS projection along a reasonable path. For

example, Figure 5.9 shows the forecast trending towards the ONS long-run projection gradually over the last three or four years of the forecast.

In its most recent projections, released in April 2026, the ONS downgraded its long-term net migration assumption from 340,000 to 230,000. If the OBR continues its practice of aligning the fifth year of the forecast with the ONS projection, this will bring down its net migration forecast in that year (2031) by a further 60,000, in addition to the 50,000 reduction already made in the OBR's March 2026 forecast. It will then face a choice about whether to reduce its forecast for net migration in all earlier years (perhaps by a similar 60,000) or only to change its forecast for later years.

The close alignment with the ONS forecast poses several challenges. The first is that the ONS projections are normally only produced every two years, while the OBR is required to produce a migration forecast twice a year. This means that the ONS's projections can be relatively out of date by the last time the OBR uses them: in practice, the OBR has tended to use the exact same ONS projection for several fiscal forecasts in a row. The second problem is that the ONS projection is designed to be a long-run estimate of the average level of migration (typically over a 45-year period), rather than a specific estimate for the year that happens to be the fifth (or earlier) year of the OBR forecast horizon.

The third problem is that the ONS projections may capture some of the impacts of government policy, but to an unknowable degree and in a very different way from how the OBR is required to account for policy. The ONS has explicitly stated that its projections 'do not directly account for recent and future policy or economic changes' (Office for National Statistics, 2025b). In practice, the ONS projection may capture some impacts of recent policy to the extent that they are reflected in recent out-turn data or in the predictions of the expert panel. The projection may also capture some impacts of new policy to the extent that policy was anticipated by the expert panel. But, importantly, predictions will also include judgements about the effectiveness of policy and potential future changes in policy, including those long beyond the five-year forecast horizon, whereas the OBR mandate requires that it only account for current stated government policy. Even where policy is captured (to an unknown extent) by the predictions of the expert panel, these predictions will not necessarily change the central ONS projection (which is sometimes based on an average of past data) and, if they do change the projection, this will only feed through into OBR forecasts when the ONS updates its projections.

We now discuss in more detail how the OBR adjusts the ONS projections for policy.

The OBR's approach to accounting for migration policy

According to the Charter for Budget Responsibility (HM Treasury, 2026), the OBR has an obligation to take the government's planned policy as given, and make forecasts based on 'all

government decisions and all other circumstances that may have a material impact on the fiscal outlook'. In general, the OBR produces 'pre-measures' forecasts that capture the outlook as it would have been without the expected impact of any policy announcements made since the last fiscal event. In other areas, such as benefit spending or tax policies, the OBR forecasts the expected additional savings or costs from new policies that either are announced at the fiscal event or have been announced in the period since the last fiscal event, and includes those in its 'post-measures' forecast. It is this post-measures forecast that the fiscal rules are assessed against.

The OBR very rarely takes this approach for migration policy. The OBR has only produced a post-measures migration forecast once since its inception in 2010, which came when it incorporated the expected impacts of the UK's departure from the EU on net migration as a post-measures impact in March 2020. At the time, it estimated that the new points-based immigration system would reduce net migration by 61,000 in the fifth year of the forecast, reducing real GDP by 0.3% (Office for Budget Responsibility, 2020). In the 2010s, the OBR sometimes adjusted its pre-measures forecast in response to the government's broad policy agenda, including by adopting a variant of the ONS's migration projections with a lower net migration assumption when the government had expressed a stated agenda to reduce levels of net migration.

However, since late 2020, it is not clear to what extent the OBR has accounted for migration policy in its net migration forecast, despite there having been several large migration policy changes in that time. From late 2020 to early 2022, the government introduced reforms to Hong Kong BNO visas, graduate route visas, the Health and Social Care Worker visa, and humanitarian visas for Ukrainians impacted by the war between Russia and Ukraine; most of these policies were assessed by the Home Office as being expected to significantly increase immigration. A range of policies intended to reduce immigration, including restrictions on dependants of those on student visas, and changes to skilled worker and graduate routes, were introduced in the following years.

Throughout this period of major policy change, the OBR's *short-term* migration forecast has sometimes been adjusted to account for policy changes, though it is unclear how often this has happened, and the OBR has not historically specified the magnitude of any policy changes it has accounted for.¹² In contrast, the OBR continued to anchor its *five-year* forecast to the ONS's long-run migration projection. As discussed in the previous subsection, while the ONS's population projection may capture some impacts of policy, the nature of the projections is that they do not, and cannot, fully account for policy announcements since the last fiscal event –

¹² Even where adjustments are made for policy, any link to the ONS projections to ensure a smooth path towards the projection may still mean policy is not fully captured in earlier years.

most often there is no new projection and, even when there is, the ONS methodology will not account for policy in the way that the OBR would typically do for other areas.

For each fiscal forecast, the OBR may consider whether to deviate from the latest ONS population projection, because of policy or other changes to migration. In some Economic and Fiscal Outlooks (EFOs), it has discussed how policy changes have affected its judgement over the net migration forecast; it did this in the November 2025 EFO in relation to Immigration White Paper measures, including restrictions to Skilled Worker visas and the closing of the care visa route. However, each time the OBR has considered the impact of a policy, it has judged that the effect on net migration has been balanced out or superseded by a different development in the opposite direction. As such, it has judged that the ONS's long-run projections continue to be the appropriate basis for the five-year forecast.

To see why this might be surprising, consider the example of changes to the student route, announced in May 2023, which restricted the ability of international students to switch between visa routes and to bring dependants to the UK. There was no subsequent update to the ONS's long-run projections in 2023 and the OBR did not forecast any change in net migration for 2026, 2027 or 2028 between its March 2023 forecast (before the announcement) and its November 2023 forecast (after the announcement). This was despite the Home Office impact assessment, published in July 2023, forecasting that the policy would reduce net migration by an average of 100,000 in 2024–25 and 2025–26 and an average of 28,000 per year between 2026–27 and 2028–29, the latter more than 10% of the OBR's forecast level (Home Office, 2023). At the time, the OBR argued that the impact of immigration policy had been considered, but offset by recent changes in out-turn data (and its forecast for net migration in 2024 and 2025 increased between the March and November 2023 forecasts to account for the changes in out-turn data).

More broadly, and as shown in Figure 5.8 earlier, the ONS projections (and therefore the OBR five-year forecast) did not anticipate the spike in net migration from 2022 to 2024, nor the subsequent sharp reduction in net migration. But these changes were preceded by large policy changes and accompanied by Home Office impact assessments predicting effects on the direction of the out-turn change in migration.

Forecasting is difficult and it is necessarily the role of the OBR to make judgement calls. It is not possible to formally assess, *ex post* and from outside the OBR, whether each individual judgement to keep the five-year forecast exactly in line with the ONS projection was right. This was clearly a period when there was a large degree of uncertainty in both the levels of net migration and the migration policy environment. Nonetheless, given the series of large policy changes across the period since late 2020, we would have expected the later years of the OBR's forecast to have deviated from the ONS projections at some point in the past five years. We

conclude that there is a strong case that, across this period as a whole, the OBR migration forecasts did not fully account for policy changes.

The OBR could have instead used a method that always and explicitly adjusted its net migration forecast for the impacts of policies when they were announced, rather than treating the much-slower-moving ONS projections as a default that might be moved away from in extreme circumstances. If it had done this, it seems very plausible that the forecast might have captured more of the increase and subsequent decrease in net migration since 2020.

A better migration forecast in turn might have substantially changed the OBR's forecast for tax revenues and overall borrowing. For example, each of the OBR's forecasts for net migration in the EFOs from November 2023 to March 2025 overestimated levels of net migration in 2025 by over 100,000. These differences are not just significant for the accuracy of the migration forecast itself: all of these figures are large enough to have a substantial impact on the OBR's growth, tax revenues and borrowing forecasts. In practice, it is difficult to estimate exactly how much a more accurate migration forecast could have affected the OBR's fiscal forecasts over this period, precisely because it is not possible to establish how much the ONS's migration forecast accounts for migration policy in the way the OBR would account for it. But, as we show shortly, the effect of migration policy since 2020 was large enough that even not accounting for part of it could have made a meaningful difference.

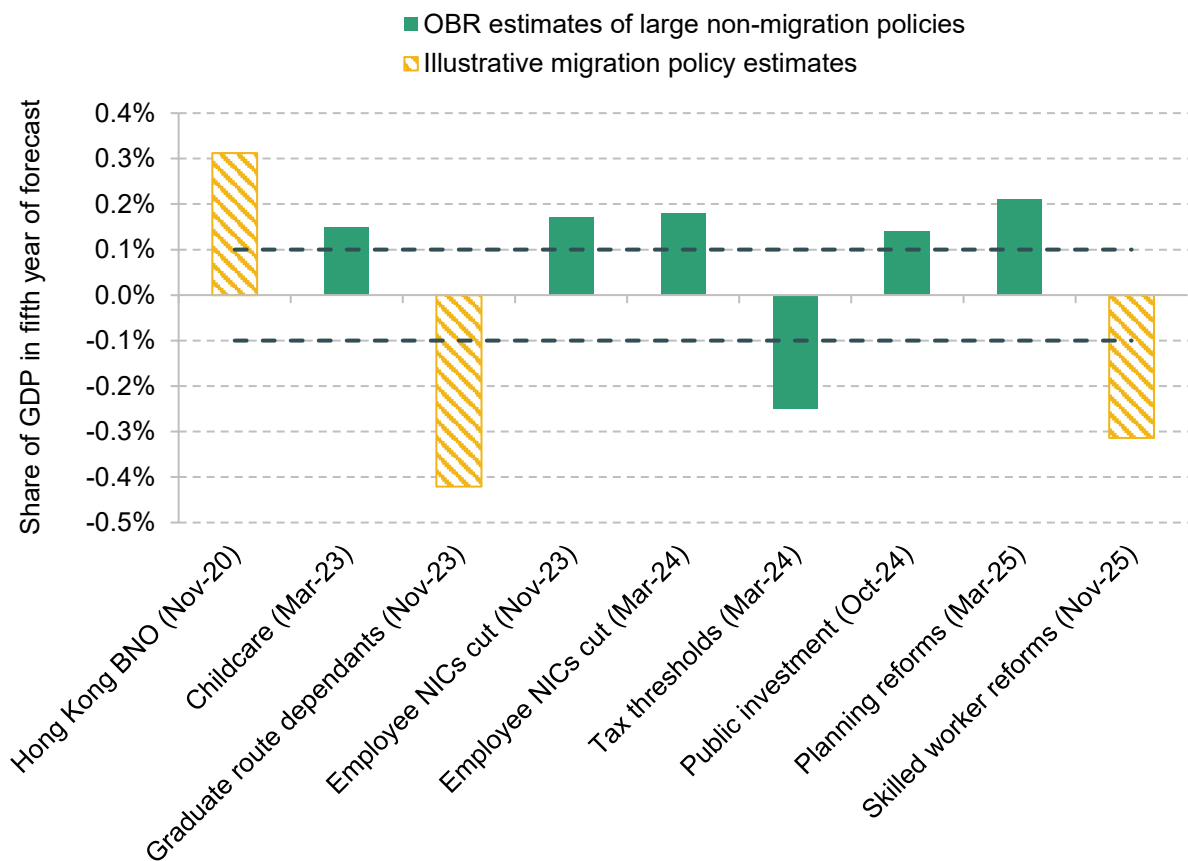
Accounting for policy does not just matter for the accuracy of the forecast. Regardless of whether the OBR has always made the best migration forecast it could, there would also be considerable value in the OBR more explicitly documenting how migration policy has changed its forecast. The OBR's role in scoring the impact of policies provides useful information for policymakers, and provides an indication for a broader audience of how the government's decisions have both affected its performance against the fiscal rules and affected the fiscal forecast more generally.

A natural way to think about migration policy is as a supply-side policy that affects the productive potential of the economy, primarily through changing the size and composition of the labour force. This then has downstream impacts on tax revenue and public spending for the fiscal forecast (discussed in Sections 5.4 and 5.5). Since March 2023, the OBR has taken a more transparent approach to including the supply-side impacts of policies on its economic forecast. This has included scoring the economic effects of free childcare, tax changes, public investments, and residential planning reforms. Following a review of how it scores these policies, a new criterion for the OBR to incorporate the estimated supply-side effects of a policy is its significance test, which requires that the policy must be expected to change potential output by at least 0.1% by the fifth year of the forecast (Office for Budget Responsibility, 2025a).

Box 5.3. Supply-side effects of migration policy: illustrative examples

The Home Office publishes impact assessments laying out the expected effects of recent migration policies on net migration levels over five years. To get a sense of the potential magnitude of the associated supply-side impacts of those policies, we use a scenario published by the OBR in March 2024. This scenario involved net migration increasing by 200,000 per year (i.e. a cumulative 1 million increase over the five-year forecast horizon). The OBR estimated that this could increase GDP in the fifth year of the forecast by 1.5%.^a We scale this figure to get an estimate of the supply-side impact of three different recent migration policies. These estimates, alongside the supply-side effect of the largest policy changes scored by the OBR in recent years, are shown in Figure 5.10.

Figure 5.10. Possible supply-side impacts of migration and non-migration policies



Note: The impact assessment for the Hong Kong BNO change only included estimates for immigration rather than net migration. Building on available survey evidence (<https://www.gov.uk/government/publications/survey-of-hong-kong-british-national-overseas-visa-holders-2021/hong-kong-bno-survey-results-accessible-version#table-10---bno-visa-holders-intended-length-of-stay-in-the-uk>) and <https://migrationobservatory.ox.ac.uk/resources/briefings/hong-kong-bnos-living-in-the-uk/>), we assume that 90% stay over the five-year horizon. The dashed line shows the 0.1% of GDP significance threshold. This was not in place until late 2025, and the OBR scored many policies that were under the threshold before this.

Source: Office for Budget Responsibility (2025a) and authors' calculations using various Home Office impact assessments and Office for Budget Responsibility (2024a).

The chart shows that recent migration policies could have had large supply-side effects, well above the OBR's new significance threshold. Moreover, all three of the policies we consider here could have had supply-side effects larger than the impact of every other supply-side policy the OBR has scored in recent years. It is important to note that these figures are rough estimates and are unlikely to capture the true effect of any of these migration policies on potential output. As we discuss in Section 5.4, the impacts of migration policy changes will vary substantially depending on the people who are induced to immigrate (or not immigrate), which is not accounted for here. But this analysis still illustrates the potential magnitude of migration policy changes for the OBR's economic forecast.

Importantly, we are not arguing that the OBR's economic forecast was always incorrect by the magnitudes shown in Figure 5.10. As we have discussed throughout this section, it is possible that some anticipated impacts of policy announcements have in practice fed into the OBR's migration forecast and therefore into the GDP forecast. But it is far from clear that policy announcements have always been fully accounted for. The magnitude of these supply-side effects is large enough that even missing part of the effect could have a meaningful impact on the economic and fiscal forecast.

^a The exact impacts depend on the assumptions made: this estimated impact assumed there was no change in average UK productivity per hour worked from this change in migration. But the OBR also considered two other scenarios: if the UK's capital stock remained constant, this would reduce productivity per hour, and the increase in GDP would only be 1.0%; if migrants instead had a much higher participation rate than the adult UK population, the increase would be 2.2%. In both of these two alternative scenarios, the policies we consider here would still have met the threshold for scoring supply-side policies.

Box 5.3 shows that, in recent years, there have been several migration policy reforms that we would expect to have passed this significance test. Indeed, we would expect them to have had larger supply-side impacts than any other supply-side policy the OBR has scored in recent years. It is therefore very notable that no migration policy change has been scored as a supply-side policy change since late 2020.

Options for improvements to forecasting net migration

Measuring and forecasting net migration is very difficult: ONS projections and OBR forecasts have often been proven wrong. This is an inherent challenge, without an easy solution (Bijak, 2010). The OBR already does well to emphasise the inherent uncertainty in net migration forecasts, and scenarios that consider alternative paths, such as those included in the March 2024 EFO, are very welcome. As we have argued previously, uncertainty over the economic forecast, including from migration, is an important reason why the government should not design policy to meet its fiscal rules by a very small margin (Emmerson, Ridpath and Stockton, 2025).

The bigger concern with the OBR's net migration forecast is how it responds to changes in policy: under the current approach, it is unclear to what extent policy has been accounted for in the fiscal forecast. This is in large part because the OBR's forecast is anchored to the ONS's

projections, which may capture some of the impact of policy announcements, but to an unknowable extent.

The OBR has improved its forecasting methodology for net migration in the short term, and this is a welcome development. There would be value in the OBR going further and fully detaching its forecast from that of the ONS. This would allow the OBR to incorporate the impact of new policy into its migration forecast, and thus its forecast for growth and borrowing. To do this, the OBR could simply extend its existing short-term forecast, which includes relatively detailed analysis of stay rates of recent immigrants, to estimate levels of emigration and to incorporate several more years. The short-term forecast already accounts for different migration routes, so it would be relatively straightforward to account for route-specific policies.¹³ Alternatively, the OBR could lean more heavily on forecasts of future migration flows from departments such as the Home Office and scrutinise and adjust these, analogously to how it bases much of its forecast for welfare spending on forecasts from the Department for Work and Pensions. Another alternative would be to ask the ONS and its expert panel to produce a net migration forecast that explicitly does not take into account policy developments announced since the last fiscal event or any expectations of future policy.

Ideally, any method should result in a pre-measures baseline and a post-measures forecast that added the expected impact of policy announcements since the previous fiscal event. This would provide two benefits. First, it could help to improve the accuracy of the forecast going forward, given the potential importance of policy in driving changes in net migration. Second, it would ensure that the forecast clearly distinguished the role of policy changes from the role of other factors. This would give policymakers better information when designing policy changes in future, and would ensure that the impact of the government's decisions on the economic and fiscal forecast could be better understood by broader audiences.

In other areas in which the OBR forecasts and estimates the impact of government policies, it usually bases its assessments on estimates produced by government departments, which it scrutinises and adjusts, rather than starting from scratch (Office for Budget Responsibility, 2023a). This might be harder with migration policy because it is not typically produced as part of the fiscal event cycle. But this is not insurmountable: the OBR has already incorporated other policy changes not made on this cycle, such as changes to planning regulations. In the case of migration, the Home Office already produces impact assessments of the effects of different policies on levels of net migration, so the OBR would be able to take a similar approach to generate a post-measures forecast. This would likely require the OBR to build a more established working relationship with the Home Office, as it has with the Department for Work and Pensions.

¹³ This option would now be easier than in past years, as the OBR is now less reliant on the ONS projections by age, which previously formed an important part of its wider forecast (Office for Budget Responsibility, 2026a).

5.4 Forecasting the impact of net migration on revenues

Net migration can affect revenues from many taxes by changing the size and composition of the tax base, including through impacts on employment, earnings and taxable income. In this section, we examine how these effects are reflected in the OBR's medium-term forecast. We argue that it does not always adequately capture important differences between new net migrants and the rest of the UK population, nor between different types of migrants. This is particularly important because revenues are the main channel through which migration affects borrowing and debt in the OBR's forecast, with much of public spending assumed to remain unchanged, as discussed in Section 5.5.

The OBR's current approach

The main route by which migration affects overall government revenues is through changes in tax revenues (a smaller impact runs through revenues from visa fees, discussed in Box 5.5 later).

The scenarios from the OBR's March 2024 Economic and Fiscal Outlook report that we discussed in Section 5.3 illustrate how large the impact of migration on revenues can be: 200,000 higher net migration per year over five years can raise tax revenues by £17.5 billion in the final year of the forecast (in 2028–29 prices).¹⁴ Using these estimates, if the OBR continues to anchor its year-5 net migration forecast to the ONS's long-term projection, the recent downgrade to the ONS long-run migration assumption could reduce forecast tax revenues by £1–5 billion in 2031–32, depending on how the OBR adjusts its net migration forecast over years 1 to 4 of the forecast.¹⁵

In general, including in the OBR's illustrative scenario, the OBR models migrants as affecting tax revenues similarly to the average UK resident. For its labour market forecast, which feeds into revenue forecasts for income tax and National Insurance, the OBR assumes that migrants pay the same amount of tax as the average UK resident of the same age and sex (Rawlings, 2025).

The OBR has made additional adjustments in some of its forecasts. In March 2025, it accounted for new migrants' slightly lower participation rates at any given age than the existing UK population (Rawlings, 2025). In March 2026, following ONS revisions that raised estimates of British emigration, the OBR adjusted its forecast to reflect that these additional emigrants were

¹⁴ In the scenario, the reduction in borrowing is slightly higher than the increase in tax revenues, because of £0.5 billion more revenue from visa fees and £1.9 billion lower debt interest spending from a lower stock of debt.

¹⁵ If the reduction applied only in year 5, the implied revenue effect would be around £1 billion in 2031–32. If it instead applied in every year of the forecast, the effect of the cumulative change in immigration would be around £5 billion in 2031–32.

disproportionately young, had relatively high employment rates and earned less than the average UK adult (Office for Budget Responsibility, 2026a). More broadly, when discussing the potential impacts of migration on the public finances, the OBR has highlighted the importance of the composition and characteristics of migrants beyond age (e.g. Office for Budget Responsibility, 2024a).

However, there has not been a consistent and systematic adjustment to revenue estimates for the composition of new migrants. In the rest of this section, we discuss the importance of differences between different types of migrants, before setting out the case for the OBR changing the approach it takes for its labour market and tax forecasts.

Employment and earnings of different migrant groups

Migrants often differ from the UK-born population, even after accounting for age and sex, and may have different employment rates and earnings from otherwise comparable UK-born individuals. Part of the difference between immigrants and people born in the UK relates directly to the route they are on. Notably, employment is built into the work route through job-offer and salary requirements. By contrast, international students are limited to 20 hours of work a week during term time, while asylum seekers are generally not permitted to work while their claims are being considered.

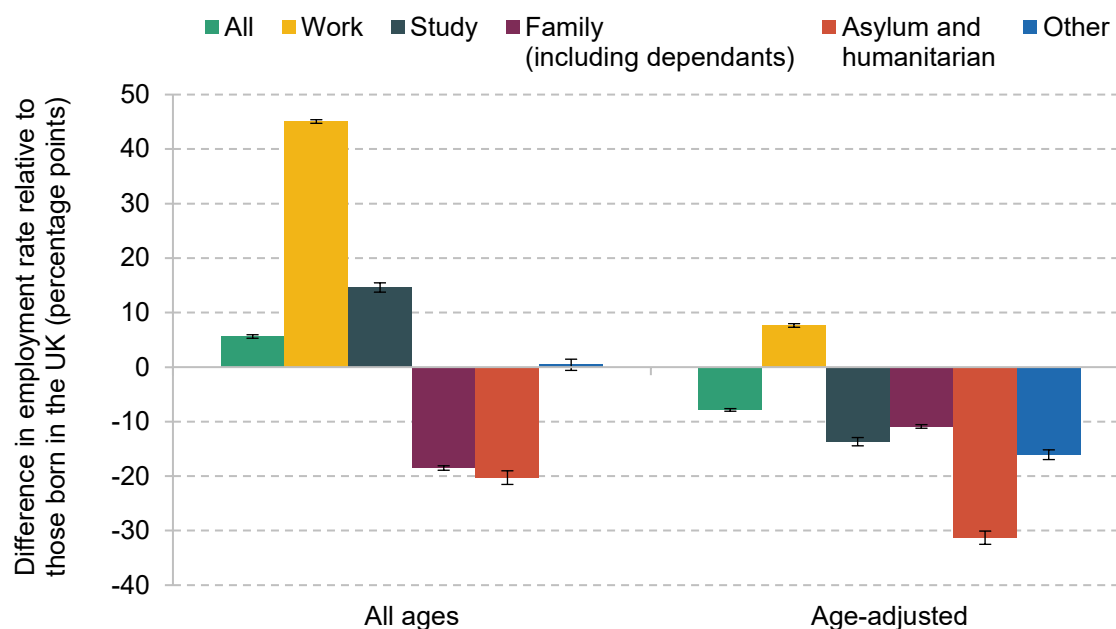
In Figure 5.11, we illustrate the magnitude of differences in employment rates and earnings, which would translate into first-order effects on tax revenues. The chart shows estimates of differences in labour market outcomes for recent non-UK-born immigrants, split by their self-reported reason for coming to the UK, compared with those born in the UK. This analysis uses data from the Labour Force Survey (LFS). These are the best data available to us for measuring heterogeneity by reason for coming to the UK, but have a number of important limitations, particularly since the COVID-19 pandemic. These are discussed in more detail in Box 5.4.

Panel A of Figure 5.11 shows differences in employment rates (including self-employment) while Panel B shows differences in weekly earnings for those who are employees. Recent immigrants to the UK are more likely to be employed than the UK-born population, but this in large part reflects that migrants are more likely to be of working age (Figure 5.7). Once we adjust for differences in age and gender, recent immigrants are slightly less likely to be employed. Conditional on being employed, recent immigrants have slightly higher earnings than the UK-born population, while the relationship flips when we adjust for age and gender.¹⁶

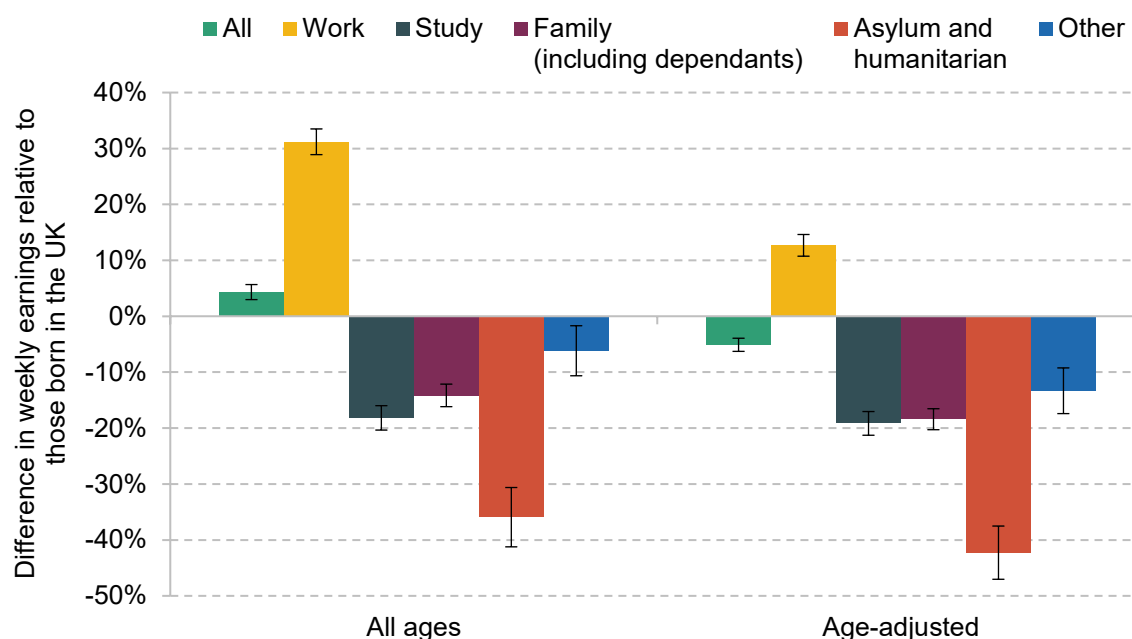
¹⁶ The unadjusted differences between all recent immigrants and UK-born individuals are affected by the composition of recent immigrants observed in the LFS and are not reweighted by reason for migration. This composition may differ from that of the overall immigrant population, including because migrants arriving through different routes have different probabilities of remaining in the UK over time.

Figure 5.11. Labour market outcomes for recent non-UK-born immigrants relative to people born in the UK, 2021–25

Panel A. Employment rates (including self-employment)



Panel B. Weekly earnings conditional on working as an employee



Note: We define recent immigrants as those not born in the UK who arrived within five years of responding to the Labour Force Survey. Figures are averages for respondents over 2021–25. The groups of migrants (work, study, family, asylum/humanitarian, other) are based on self-reported reasons for initially coming to the UK rather than visa routes. We obtained the age-adjusted differences by regressing employment on routes, controlling for age-by-sex of the respondent fixed effects. Error bars show standard errors for the differences between means. See Box 5.4 for discussion of the challenges with the Labour Force Survey.

Source: Authors' analysis of the Labour Force Survey.

Box 5.4. Caveats on using the Labour Force Survey

The Labour Force Survey (LFS) is the main UK household survey for measuring labour market outcomes, and is one of the few data sources that allows us to distinguish individuals by country of birth, time since arrival and reason for coming to the UK. This makes it useful for examining differences in employment, earnings and other characteristics across migrant groups. However, it is a survey rather than an administrative data source, and two caveats are particularly important for our purposes.

First, the quality of the LFS has been affected in recent years by lower response rates and changes in survey collection. These concerns became more acute during and after the COVID-19 pandemic, and were particularly prominent in 2023, when the ONS highlighted these issues. It may be that immigrants are particularly affected by these challenges, or that for other reasons the LFS is less representative for immigrants (e.g. if more immigrants – whether students or asylum seekers – live in communal accommodation). Analysis by the ONS suggests that non-UK-born residents are slightly under-represented in the LFS relative to the Census, but the gaps are not large (Office for National Statistics, 2026a). Second, the LFS does not directly observe immigration route or visa status in the same way as administrative Home Office data do. We use reported reason for coming to the UK as a proxy for route, but this is not identical to visa category and may be measured with error.

These caveats mean that the LFS is not the most appropriate source to produce precise fiscal estimates by route: new administrative data that link Home Office visa data to HMRC tax records is much better suited to this (Home Office, 2025b). The value of the LFS in this chapter is instead to illustrate the broad scale of heterogeneity in labour market outcomes across migrant groups. In the limited cases where it is possible to compare our LFS results with results from administrative data, though, we do find similar patterns by route.

But there are large differences by route: migrants who came to the UK for work are much more likely to be employed and have higher weekly average earnings than the UK-born population, while dependants and those seeking asylum or on other routes are all less likely to be employed and have lower average earnings than those born in the UK, even compared with those of the same age and sex.¹⁷ Students are more likely to work than the average UK-born individual, but this is mostly because they are young: once we account for age, they are substantially less likely to be employed.

¹⁷ Note that dependants in the LFS are not directly comparable with family-related immigrants in Figure 5.11. In the ONS statistics, dependants of work- and study-related migrants are classified under the route of the main applicant rather than as family-related migrants, while in the LFS we think they are likely to report having moved to the UK as dependants.

In this analysis, we have focused on the mean differences between groups of recent immigrants and the UK-born population. But there are also likely to be large differences within some groups of migrants. For example, Advani et al. (2025) have estimated that immigrants are over-represented at the top of the income distribution, though their analysis includes both recent and non-recent immigrants. They estimate that around 25% of those in the top 1% of incomes were immigrants in 2018, as were 40% of those in the top 0.01%. Any policy that attracted significantly more of these very-high-income migrants would therefore be likely to have an outsized positive effect on the public finances per person.¹⁸

Box 5.5. Immigration-related fees

The government also raises immigration-related revenues, from visa application fees, the immigration health surcharge (fees paid by migrants to use the NHS) and charges paid by employers sponsoring workers. Although these revenues are much smaller than general tax revenues, immigration-related fees are an important area of migration policy.

In 2025–26, the Home Office raised £6.9 billion from visa and passport fees, the immigration health surcharge and sponsor-related charges. This exceeded the £2.0 billion cost of processing visa and passport applications, leading to net revenue of £4.9 billion.^a Because such fees are explicitly route-specific, this is one of the clearest cases where the revenue effect of migration depends directly on immigration route.

The OBR produces forecasts for visa fee income, the health surcharge and the immigration skills charge.^b Unlike changes in the levels of net migration, the OBR has recently scored government policies that affect these revenues using the government's costings. For example, in the 2025 Autumn Budget it accounted for the increase in the immigration skills charge (raising around £800 million over five years), and at the 2023 Autumn Statement it accounted for changes in visa fees and the health surcharge (raising around £6.5 billion over five years).

^a Source: Home Office Supplementary Estimates 2025–26 Tables A and B, available at <https://committees.parliament.uk/committee/83/home-affairs-committee/publications/10/estimate-memoranda/>.

^b The OBR treats visa fees as government revenue. This is different from HM Treasury, which treats visa fees as part of departmental spending plans, and so will give the Home Office a lower budget than it expects to spend, with the gap covered by the forecast visa fees. This means that changes in visa fees could affect government public spending decisions in ways that are reported differently by HM Treasury and the OBR.

¹⁸ For earners in the top 1%, a larger share of income comes from non-labour sources. Their contribution to the public finances is therefore still substantial but extends beyond the channel of labour income taxation.

Given the large differences in (age-adjusted) employment and earnings of migrants by visa route, an OBR forecast that captures migration mainly through population size and age–sex structure may miss important compositional effects. Age is important, because migrants are more likely than the resident population to be of working age. But route composition is also relevant to consider for income tax revenues. A shift from migrants on work-related routes to student or humanitarian routes, for example, could therefore reduce expected income tax receipts even if overall net migration were unchanged. Conversely, a shift towards migrants on work-related routes could raise receipts by more than implied by a forecast based mainly on age and sex.

An example illustrates the potential magnitude of such effects. Consider a scenario where changes in policy or applicant behaviour increased the share of non-British immigrants coming to the UK specifically to work by 10 percentage points and reduced the share coming to study by 10 percentage points in a year. Given current levels of immigration, our LFS estimates suggest that this change could increase total employment by around 20,000, despite there being no changes in the aggregate level of net migration. For comparison, the OBR has previously scored policy changes that it judges to have smaller impacts on labour supply, such as reforms to the Work Capability Assessments (increasing employment by 10,000), expansion of talking therapies (also 10,000) and the Restart work support scheme (5,000) (Office for Budget Responsibility, 2023b). It is worth noting, though, that this hypothetical change in immigrant composition would now be under the 0.1% of GDP threshold for scoring supply-side policies (discussed in Section 5.3). This change in immigration composition would likely increase average and total earnings of new immigrants substantially, increasing income tax revenues.

Options for improving the OBR's forecasting approach

The OBR could continue to make ad hoc adjustments for forecast revenue effects when there are material changes in the composition of migration. As the example above shows, some changes in composition may not be large enough for it to be worth the OBR making an adjustment every time. But this is not without risks: that an important compositional change is missed; that it is more work to consider and make ad hoc adjustments each time; or that it increases the scope for government to lobby (or not lobby) about changes to composition.

An alternative approach would be to build a more systematic adjustment into the forecasting process. The simplest of these would come from more explicitly distinguishing between immigration and emigration. Given the large differences between immigrants depending on their reasons for moving to the UK, there is a clear case for also distinguishing between different visa routes in the forecast. One simple implementation of this might entail a split between those immigrating for work, for study, as family or dependants, for asylum or for other reasons.

This would require producing forecasts of migration levels by broad route. This could build on the existing work the OBR has done producing a stay-rate model for short-term migration flows, as this already requires distinguishing between different routes. The OBR could then account for differences by route in employment and other factors in its economy and revenue forecasts. New data linkages between visa information and HMRC tax records would enable past differences in employment rates and earnings to be more precisely estimated and then incorporated into the forecast than can be done in the Labour Force Survey (Home Office, 2025b). Moreover, other parts of government have already tried to account for differences in migrants' effects on tax revenues and the public finances, particularly in Home Office impact assessments, which the OBR could build on.

5.5 Forecasting the impact of net migration on spending

Net migration has significant implications for public spending. Higher net migration means a higher population, which we would expect to increase demand on public services. Many immigrants also work for public services, and there are also some areas of spending that are specifically linked to immigration, such as asylum services. Net migration may also affect benefit spending (including the state pension),¹⁹ as some immigrants are eligible to receive benefits in the short run and most emigrants are eligible before their departure. In this section, we examine how the OBR accounts for the impacts of migration on public spending.

Public services

Changes in net migration will likely impact the delivery of public services. On the demand side, many immigrants will use services such as education and the NHS. Many emigrants would have used these services before they left the UK, and cease doing so after they leave the country. Demand for other activities of the public sector, such as the work of the civil service, may be less responsive to the size of the population and therefore changes in migration. On the supply side, many immigrants work for public services and many emigrants would have previously worked for public services. This could affect the cost of providing public services. For example, international recruitment to health and social care may help the government to fill vacancies without having to increase wages by as much. As with tax revenues, there are likely to be large differences between different types of migrants: differences in the age and health of migrants will matter, while some immigration routes have an outsized impact on specific sectors, such as international students or those on health and social care visas.

¹⁹ Throughout, we use benefit spending to refer to spending on cash payments including means-tested benefits and the state pension.

The government sets fixed *cash* budgets both for total government departmental spending and for specific government departments – i.e. budgets that do not vary with the inflation rate or with the number of people using services. Departmental budgets cover spending on public services such as health, education and defence, as well as specific areas of spending linked to immigration, particularly asylum services. These budgets are typically set for several years in advance at Spending Reviews and will take into account factors such as population forecasts. There is also a cross-government Reserve, intended for use if unexpected spending pressures arise.

Because departmental budgets are fixed in advance, the impacts of changes in net migration (relative to expectations of net migration when budgets were originally set) depend on how policymakers respond.²⁰ For example, higher net migration could increase the pressure on public services, and the default (with unchanged departmental budgets) is that service quality will be allowed to fall. Alternatively, the government may decide to increase budgets to hold service quality constant.²¹

Given that the government has set out departmental budgets, and that the OBR is required to produce forecasts based on stated government policy, the OBR has historically always taken the size of these budgets as given. That means changes in net migration, or any other changes in the size and mix of the population, will typically have no direct effect on the OBR's forecasts for spending on public services. In other words, the OBR is required to make an assumption about how the government will respond to changes in net migration: it will allow service quality to change rather than budgets to change. This is also true for other factors, such as changes in inflation that would change the real-terms generosity of spending plans relative to what was originally planned. This is something the OBR has itself frequently discussed the consequences of in Economic and Fiscal Outlook reports.

There are very good reasons for the OBR to take departmental budgets as fixed, and we do not propose that it deviates from this assumption in general. However, it is notable that the government itself sometimes makes a different assumption: in Home Office impact assessments

²⁰ One growing exception to this is that the government has decided that some areas of spending should be linked to GDP, including defence spending, aid spending and more recently spending in the NHS on new medicines, which collectively currently account for 3.3% of GDP or around 15% of public service spending. If net migration increases GDP, this will require the government to increase spending in these areas if it is to maintain these spending commitments. The government would then have to decide whether to increase overall spending plans, or to fund higher spending on these areas from cuts to the budgets of other departments. To give a sense of scale, the OBR scenario discussed in Section 5.3 suggests that an increase in net migration of 200,000 per year could increase real GDP in the medium term by 1.0–2.2% in different scenarios. This could increase spending on these areas by £1–2 billion in the fifth year of the forecast. This is not a particularly large impact, equivalent to £1,000–2,000 of additional public spending per new immigrant

²¹ If the required budget top-ups are relatively small, these could be met from the Treasury Reserve – contingency funding for unexpected spending pressures – rather than requiring top-ups to total public service spending plans (though there are typically many other demands on Reserve funding too).

of migration changes, changes in public service spending are often included in the estimated net present social value, even for years already covered by Spending Review plans.²²

If the government did decide to increase public service spending in response to higher net migration, this would mean the OBR's forecast overstates how much higher net migration might be expected to reduce borrowing in the medium term. The OBR highlighted this in the March 2024 scenario that we discussed in Section 5.3. It estimated that an increase in net migration of 200,000 per year (so a 1 million increase in total population over five years) would increase day-to-day public service spending by around £6 billion in the fifth year of the forecast if the government instead maintained the age-adjusted per-person generosity of public service budgets (in 2028–29 terms) rather than holding them fixed. That is equivalent to £6,000 of additional departmental spending per new immigrant per year. This would reduce the estimated fiscal benefits of higher net migration, though they would still be positive in this scenario, as this is only a third of the £18 billion positive impact on tax revenues discussed in Section 5.4. It is worth noting though that this scenario only captures the direct effect of higher migration on demand for public services, assuming that immigrants put the same spending pressure on public services as British-born people of the same age, and does not take into account any of the potential effects of immigrants working for public services.

Since 2024, the OBR has had more power to scrutinise the feasibility of departmental spending plans (HM Treasury, 2024). The OBR has historically forecast that the government will slightly underspend relative to its spending plans, but it can now say whether it expects the government to need to deviate from the spending plans it has set out – for example, because the government has in recent years persistently overspent its budgets in a given area. The OBR can therefore now adjust the assumption in its fiscal forecast for how much actual spending may be above or below stated plans. In November 2025, the OBR substantially reduced the amount it expected the government to underspend on plans between 2026–27 and 2028–29 (Office for Budget Responsibility, 2025c). One of the reasons it listed for this change in expected spending was a risk that spending on asylum accommodation may not fall as fast as the government had planned, given recent data on rising numbers of small-boat arrivals and asylum seekers.

If there were a large increase in migration or expectations for future migration relative to the level assumed when spending plans were set, such as that we saw after the 2021 Spending Review, it would not be unreasonable for the OBR to use these new powers to forecast that the government could overspend by more, or underspend by less, than total allocated levels of departmental spending. This is similar to how the OBR has in the past considered the pressures from large changes in inflation relative to when spending plans were made.

²² The OBR also assumes that spending changes in response to changes in net migration in the longer run when it produces its long-run fiscal projections for its Fiscal Risks and Sustainability reports.

We have previously recommended that the government should state clearly the assumptions it uses when setting multi-year spending plans (Boileau, Warner and Zaranko, 2024). This could include the demographic assumptions that spending plans are based on, which could help the OBR decide whether an adjustment is needed. Alternatively, the government could be more explicit about how it plans to change public service spending in response to changes in migration policy, which the OBR could then account for.

Benefit spending

Most new immigrants will initially have no access to the benefits system. Most of them only have temporary permission to live in the UK – i.e. those on a time-limited visa, rather than those with Indefinite Leave to Remain – and most people with this status have no recourse to public funds (NRPF). This means that they are ineligible to claim most benefits, including universal credit, disability benefits, housing benefit and child benefit (Home Office, 2025d). It typically requires at least five years in the UK to be eligible for Indefinite Leave to Remain, and so for most new immigrants there will be no impact on benefit spending over the OBR's medium-term forecast horizon. This is an area where the longer-term impacts of migration could be very different as and when immigrants gain Indefinite Leave to Remain.

However, that does not mean there will be no impact of migration on benefit spending over a five-year horizon. Some groups of immigrants do gain access to the benefits system earlier, either immediately on arrival or after a shorter time. This includes those who have been granted asylum and those who already have EU settled status, as well as Irish and British nationals moving to the UK. Those with EU settled status and Irish and British nationals together made up around 20% of all immigrants in 2025. Asylum seekers made up another 6%, though a large share of these will not go on to be granted asylum and so will not gain access to the benefits system. Together, a non-negligible share of immigrants are therefore still eligible for benefits immediately or shortly after arriving in the UK.²³

A much higher proportion of emigrants are likely to have had access to the benefits system than the proportion of immigrants who arrive. This is because all British emigrants (around 40% of total emigration in recent years), as well as many non-British emigrants who had been granted Indefinite Leave to Remain or had EU settled status, would not have been affected by NRPF when they left. This means an increase in net migration coming from higher immigration might be expected to increase benefit receipt by less than the same increase if it came from lower emigration.

²³ Ukrainians moving to the UK through the Ukraine scheme also have immediate access to benefits. However, we cannot isolate their share within the humanitarian category, and their numbers have fallen substantially since the scheme was introduced in 2022.

Even among immigrants and emigrants who can potentially access the benefits system, we would expect different groups to have different likelihoods of actually claiming benefits compared with British nationals. For example, as Figure 5.11 shows, those who moved to the UK for work are more likely to be employed than natives, while those who moved with family are much less likely to be employed, which might spill over to higher benefit claims among dependants. Similarly, emigrants may vary a lot in their propensity to claim benefits, though data on emigrants is not good enough to easily estimate this.

Spending on benefits is planned differently from public service spending: total spending depends on how many people are eligible and apply for benefits rather than on fixed budgets. The OBR therefore produces forecasts for total benefit spending, building on forecasts by the Department for Work and Pensions. These are based on factors from the OBR's economy forecast, including population, earnings and unemployment (Office for Budget Responsibility, 2026a). Given the complex link between migration and welfare spending over the medium term, the extent to which net migration will feed through into the OBR's forecast of welfare spending depends heavily on the OBR's treatment of different groups that make up the change in net migration.²⁴ The extent to which the OBR currently adjusts its forecast of benefit spending depending on the make-up of a change to net migration is unclear.

The OBR says that it accounts for NRPF in its benefit spending forecasts to some degree, and that it adjusts its forecast of who will have NRPF according to forecast levels of net migration and for the number of past immigrants who will gain eligibility for benefits in future.

However, given that a reasonable share of immigrants (and an even larger share of emigrants) do have recourse to public funds, there may be value in the OBR differentiating between different components of net migration and their different impacts on benefit spending. As with heterogeneity by tax revenues, this could build on forecasts of net migration across routes that already exist across government departments. Using this split would enable the OBR to capture more readily the effects of net migration on benefit spending, though as with tax revenues, such changes may only be material in some cases.

5.6 Conclusion

Recent changes in levels of net migration, and large changes in immigration policy, have highlighted the importance of migration for the public finances, the economy and society more broadly. In this chapter, we have focused on how the OBR accounts for migration and migration

²⁴ Another complexity is how past cohorts gaining access to the welfare system over time is modelled. This will be particularly important if the government decides to change the requirements for Indefinite Leave to Remain.

policy in its medium-term fiscal forecast. Despite this focus, it should be emphasised that, as in other areas of policy, the effect of any policy change on the government's performance against the fiscal rules should not be the main lens through which a policy is viewed. Even when focusing more narrowly on fiscal impacts, there are things the OBR forecast will not, and should not be expected to, capture. This includes not just the long-run fiscal impacts, but some of the impacts on public spending, where the impact of migration may be to increase strain on public services rather than to increase spending.

However, as it stands, there is a strong case that the effects of changes to migration policy are not fully and transparently captured in the OBR's forecast. This is problematic for two separate reasons.

First, it could damage accuracy of the fiscal forecast: recent years have seen net migration tick sharply upwards and then sharply downwards again, with much of that shift resulting from policy changes. The ability to capture this is particularly important when governments decide to operate with just a fine margin against their fiscal rules, meaning that even small changes to the OBR's forecast can influence wider tax and spending decisions.

Second, there is value – for both public and policymaker understanding – in clearly distinguishing the impacts of policy decisions from the impacts of other changes to migration, as is done in other areas of policy. We therefore recommend that the OBR continues the improvements it has made in recent years and moves to producing its net migration forecast entirely separately from the ONS long-run population projections. It should ideally then make pre- and post-measures forecasts that explicitly account for policy announcements since the last fiscal event. Migration policy is one of the most important levers the government has to influence the supply side of the economy, and it is important that the OBR fully accounts for this, as it does for other levers.

The OBR's forecast also tends to treat different types of migrants as having very similar impacts on the public finances. This may not always make a material difference to the forecast, but there is a case to be more systematic in the approach. We recommend that the OBR considers producing forecasts for migration by broad route, and then makes some broad adjustments for these different groups in its fiscal forecasts – such as accounting for differences in employment rates and access to the benefits system. This would ensure that changes in policy or other factors that dramatically change the composition of migration would be automatically reflected in the forecast. Whether the OBR should make such changes depends in part on the administrative costs of doing so, though much of the required data and modelling already exist elsewhere in government. While we only focused on migration in this chapter, there may well be other aspects of the OBR's forecast that should be a higher priority for improvements first.

Regardless of whether these recommendations are taken up, migration will continue to be an important part of the fiscal forecast. The ONS has recently downgraded its estimate of long-run net migration from 340,000 to 230,000 per year. If the OBR continues to anchor its net migration forecast to the ONS projection, this could result in a 60,000 per year reduction in net migration in its forecast at the Autumn Budget (following the 50,000 per year downgrade at the Spring Forecast). Under the OBR's current approach, the Chancellor could be facing an increase in forecast borrowing of £1–5 billion in the fifth year of the forecast from this change, with the total effect depending on whether and how the OBR adjusts its forecast in the earlier years. This could make a big difference for the Chancellor's margin against the fiscal rules, and play a role in shaping the government's fiscal strategy.

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6. Public service spending: plans and pressures

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The Autumn Budget will be the new government's first opportunity to formally revisit inherited departmental spending plans. The Chancellor faces two linked choices: whether to change budgets already allocated to departments over the next few years, and how much to spend on departments as a whole in later years. Overall departmental spending grew relatively quickly over the last two years and continues to do so this year, but under the inherited spending plans it will grow much more slowly over the remainder of the parliament. Pay, productivity and demand pressures are making existing plans harder to deliver, and the government has signalled new spending ambitions in areas such as defence and adult social care.

Decisions about total departmental spending will matter for both the performance of public services and the public finances. This chapter examines pressures against inherited plans, the government's new spending ambitions, and the choices facing the Chancellor at the Autumn Budget.

Key findings

1. **The previous Labour government increased departmental spending considerably relative to plans inherited from the Conservatives. But the increase was heavily front-loaded: planned spending growth slows sharply in coming years.** The size of the state has grown over this parliament so far, but spending as a share of national income is projected to fall after 2027–28. Day-to-day departmental spending is set to grow by 2.4% in real terms this year, but by an annual average of just 1.0% over 2028–29 to 2030–31. Capital spending is even more front-loaded.
2. **Over the years for which departmental budgets are already set, 2025–26 to 2028–29, spending increases are heavily concentrated in a few large areas.** Planned growth in health and defence spending takes up the bulk of all real-terms growth in spending between 2025–26 and 2028–29; a number of other departments face real-terms cuts. There were therefore already squeezes on some services, before

considering a range of pressures that could increase the cost of delivering existing plans beyond what was assumed when budgets were set.

3. **Public sector pay is running above the path departments appear to have budgeted for, and higher inflation is reducing the real value of non-pay budgets.** Staff costs account for roughly half of day-to-day departmental spending, so even relatively small differences in pay growth can have large effects on departments' costs. Higher public sector pay growth in 2026–27 than was assumed when budgets were initially set could impose pressure of £3 billion against budgets in 2028–29. This is equivalent to around an eighth of the planned real increase in departments' budgets between 2025–26 and 2028–29. If future pay awards follow recent forecasts for average earnings growth, this pressure could be £7–9 billion. Higher inflation than was forecast when budgets were originally set could reduce the real value of departments' non-pay day-to-day budgets by £4–8 billion in 2028–29 and capital budgets by £2–4 billion.
4. **Inherited spending plans also depend on making historically ambitious improvements to public sector productivity.** Last year's Spending Review was accompanied by a detailed set of plans for productivity improvements across public services. The previous government made these plans more ambitious both at the last Autumn Budget and in the recent Defence Investment Plan. Current plans imply around 1.2% annual productivity growth, compared with around 0.2% historically. Achieving only half of planned gains would mean £9 billion of pressure against plans in 2028–29.
5. **Some services face particular spending risks because costs are particularly uncertain and difficult to control.** Spending on special educational needs and disabilities (SEND) has grown rapidly in recent years. Current plans rely on that growth slowing as reforms take effect; if instead recent trends continued, spending could be around £3 billion higher than funding in 2028–29. Asylum spending currently looks on track to fall broadly as planned at last year's Spending Review, but there remains a risk that it will overshoot expectations.
6. **The consequences of some of these pressures could persist well beyond 2028–29, the last year for which detailed departmental budgets have been set.** Higher-than-expected pay settlements increase the paybill in future years, while failing to achieve planned public sector productivity gains means more resources are needed to deliver the same services in future. These pressures, if realised, would therefore also affect what departments could deliver within the spending totals allocated at the next Spending Review.

7. **Over the next Spending Review period (2028–29 to 2030–31), existing departmental spending totals imply likely real-terms cuts across a range of services.** As an illustrative scenario: if health spending grew by 2.7% a year in real terms between 2027–28 and 2030–31, matching the rate planned at the last Spending Review, and defence spending was held constant at 2.7% of GDP from 2027–28 onwards, the combined budgets of all other departments would be cut in real terms by 0.9% per year. In this scenario, keeping non-health and non-defence spending constant in real terms would require a top-up to total departmental spending of £9 billion in 2030–31. This is before allowing for pay, public sector productivity and other pressures described above.
8. **On top of delivering existing plans, the government may have ambitions to spend more in some areas. Defence is the clearest example.** If the government decided to increase defence spending to 3% of GDP in 2030–31, this could require around £11 billion more spending in that year than if it stayed at 2.7% of GDP. If this increase were delivered within existing spending totals, and health spending grew at 2.7% a year in real terms, total spending outside health and defence would be cut by an annual real average of 2.0% between 2027–28 and 2030–31. Cuts of this scale would imply a sharp reduction in what other departments can deliver.
9. **Neither spending pressures nor new ambitions translate mechanically into a required top-up to total spending.** Absorbing a pressure or funding a new ambition while staying within existing spending totals is possible, but would require the government to pursue some combination of improving public sector productivity beyond its already-ambitious plans, accepting worse public service performance than planned in some areas, and deciding to stop providing some services. The government could also decide to reduce overall departmental spending at the Budget, which would sharpen these trade-offs. In either case, the government should be clear about how it will reconcile its plans and ambitions for public services with the spending totals it sets.
10. **If the government wanted to increase overall departmental spending to accommodate pressures or ambitions, the price tag could be large.** For example, funding a path to 3% of GDP on defence in 2030–31, increasing health budgets in real terms by 2.7% each year and avoiding real-terms cuts to other areas over the next Spending Review period could require a top-up of £20 billion in 2030–31. Additionally compensating departments for plausible pay and productivity pressures against existing budgets could bring this illustrative total to £35 billion.

6.1 Introduction

The new Chancellor, John Healey, faces two linked decisions about departmental spending at the Autumn Budget: how far to revise existing departmental budgets and how much to spend in later years. Departmental spending is around half of total government spending and funds public services such as the NHS, schools, defence and courts. Choices here therefore matter both for the overall public finances and for everyone's lives.

This government inherits detailed departmental budgets between 2026–27 and 2028–29 for day-to-day spending and up to 2029–30 for capital spending. It also inherits aggregate spending totals ('envelopes'), which have not yet been allocated to individual departments, up to 2030–31. At the Budget, Healey could reopen departmental settlements and change as-yet-unallocated envelopes in later years. He will also have to set an initial spending total for 2031–32, the new fifth year of the Office for Budget Responsibility (OBR)'s forecast.

Existing plans for public services are likely to be harder to deliver over the next couple of years than anticipated when they were first set. Some risks are cross-cutting: public sector pay is rising faster than departments appear to have budgeted for; inflation is higher than anticipated when budgets were set; spending plans rely on ever more ambitious improvements in public sector productivity. There are also risks from areas where costs are particularly uncertain and hard to control; we examine spending on special educational needs and disabilities (SEND) and asylum as two important examples.

Inherited spending envelopes for 2029–30 and 2030–31 look relatively tight, even before accounting for the emerging pressures discussed above. While total departmental spending is set to grow in real terms in each of the next four years, this growth is set to slow sharply, and departmental spending to begin falling as a share of national income after 2026–27. How to allocate this slowing growth to individual departments in these future years will be the central challenge of next year's Spending Review – keeping to current totals almost certainly implies real-terms cuts to a set of departmental budgets.

The government may also decide to spend more in some areas. Defence is the clearest example: there is substantial pressure to go further and faster with increases in defence spending, as John Healey himself argued for when he resigned as Defence Secretary earlier this year. The government also plans to introduce significant adult social care reform in the next parliament. This could affect spending settlements from 2029–30, although we do not expect to have details confirmed at this Budget.

None of these spending pressures or ambitions automatically requires higher levels of overall departmental spending. Departments can absorb higher costs, through reducing public service

performance or potentially finding efficiencies. Ministers can also reprioritise between programmes. Indeed, the government could also decide to cut back total spending plans at the Budget, as Rachel Reeves did at the Budget last year. But these responses are not cost-free, and will be particularly challenging given existing plans for slowing spending growth. When past governments have been faced with allocating slowing spending growth to departments, they have often instead decided to top up budgets (Boileau, Warner and Zaranko, 2024). But the outlook for the public finances – discussed in Chapter 2 of this Green Budget – will place constraints on the Chancellor’s room to accommodate higher levels of departmental spending.

Under the framework set by Rachel Reeves, this Budget would be the last clear opportunity to make changes to the total amount of planned departmental spending between 2028–29 and 2030–31, which is due to be allocated to departments at the Spending Review next year. John Healey could depart from this framework and instead revise plans for total departmental spending next year, either at a second fiscal event or by conducting the Spending Review alongside the Autumn Budget.

There are good reasons for the government not to settle every detail about departmental spending this autumn – not least that a new Chancellor and Prime Minister may still be deciding their precise priorities for public services. But the totals published at this Budget should be ones within which the Chancellor could credibly conduct the Spending Review. If he already expects to allocate budgets at the Spending Review that would exceed existing totals, postponing the increase in spending plans until next year would flatter the outlook for the public finances at the Budget. Of course, he could also choose to keep inherited totals, or even cut them back, if he is prepared to make the resulting choices between services.

This chapter evaluates pressures on and ambitions for departmental spending plans over the next few years and sets out the Chancellor’s options at the Budget. Section 6.2 sets out the departmental spending plans the government has inherited. Section 6.3 examines sources of pressure against those plans: cross-cutting pay, inflation and public sector productivity risks, and risks for specific services that are particularly exposed to uncertain levels of demand. Section 6.4 considers new ambitions the government has which may require additional spending, while Section 6.5 considers the resulting trade-offs and decisions that must be made at the Budget and next year’s Spending Review. Section 6.6 concludes.

6.2 Inherited spending plans

The departmental spending framework

The UK government is set to spend £1.4 trillion in 2026–27: approximately 45% of national income. Around half of this spending is managed through departmental budgets – which cover

most spending on public services, including the NHS, schools, defence and the justice system – and classified as departmental expenditure limits (DEL) spending. Departments are set fixed annual DEL budgets, generally over multi-year periods at Spending Reviews. The other half of government spending is classified as annually managed expenditure (AME spending). This covers areas where spending is argued to be harder to control, volatile or demand-led, making it challenging to set fixed multi-year budgets – for example, all benefit spending (including the state pension) and debt interest spending.¹ Our focus in this chapter is DEL spending.

Both DEL and AME spending are divided into day-to-day and capital spending. Day-to-day, or resource, spending covers recurring expenses – for example, on staff (RDEL spending) or on benefits (RAME spending).² Capital, or investment, spending covers things expected to produce an enduring asset – for example, central government spending on new buildings (CDEL spending) or councils' locally financed spending on council housing (CAME spending). Day-to-day spending is by far the larger of these components, set to represent around 89% of total government spending in 2026–27.

At Spending Reviews, aggregate resource and capital DEL totals – ‘envelopes’ – are allocated to individual departments, generally over a multi-year period. These departmental budgets are specified as annual cash limits, and are not automatically adjusted if inflation or other cost pressures turn out differently from forecast. While Spending Reviews sometimes coincide with Budgets (as was the case for the 2021 and 2024 Spending Reviews), more often aggregate RDEL and CDEL envelopes are fixed at Budgets before being allocated to departments at a subsequent Spending Review. This top-down approach is intended to impose a hard budget constraint on HM Treasury negotiations with departments (Crawford, Johnson and Zaranko, 2018).

Once Spending Review settlements are set, departments have some flexibility to move money between programmes within their resource and capital budgets in each year. They cannot as easily move money between years, or between the two budgets; moves from CDEL to RDEL are particularly discouraged. Both types of changes, though, have often occurred in practice. A cross-government ‘Reserve’ for both resource and capital spending is usually set for each year, within overall DEL totals and alongside departmental allocations. This is an unallocated pot of money to cover unforeseen and unavoidable pressures that departments may face in each year.

On coming into office, following a review of inherited spending plans and pressures, Rachel Reeves made some adjustments to the spending control system. She returned to a system of

¹ As Section 6.3 explores, this distinction is not completely firm; parts of DEL spending are very demand-led and challenging to manage within fixed multi-year budgets.

² Note that throughout this chapter when discussing RDEL spending, we use the Treasury control total of RDEL excluding depreciation.

overlapping Spending Reviews, whereby a Spending Review would be held every two years, and set spending over three years. The last Spending Review took place in June 2025, and set resource budgets between 2025–26 and 2028–29, with an additional year set for capital budgets. Currently, 2028–29 is the overlapping year for day-to-day spending (with 2029–30 also overlapping for capital spending). If the government retains this framework and the commitment to hold only one fiscal event each year, the upcoming Autumn Budget would be the moment to set the aggregate spending envelopes within which the 2027 Spending Review will be conducted.

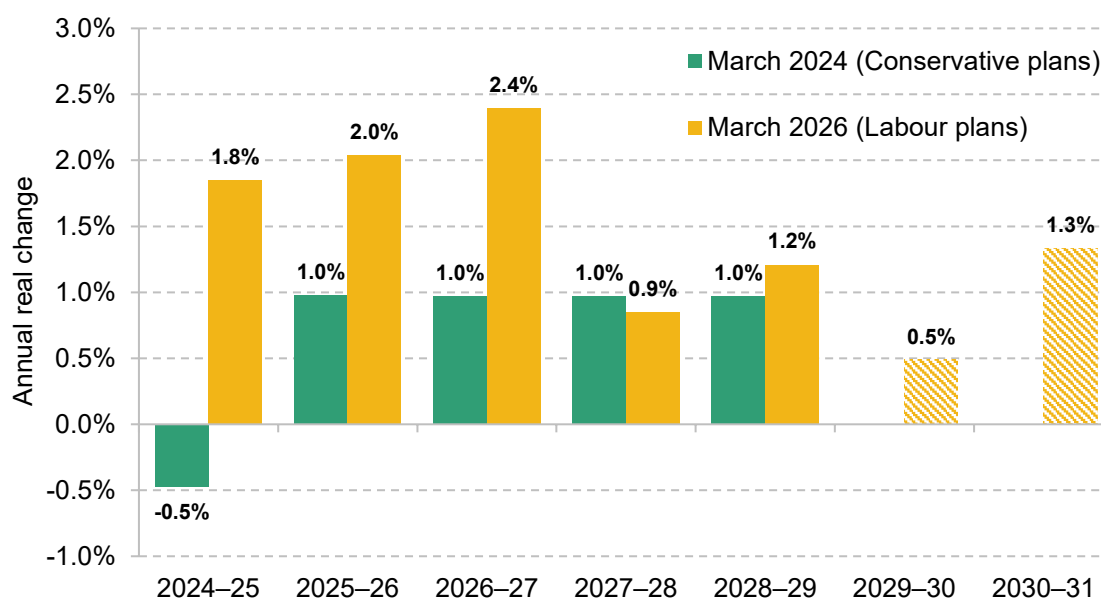
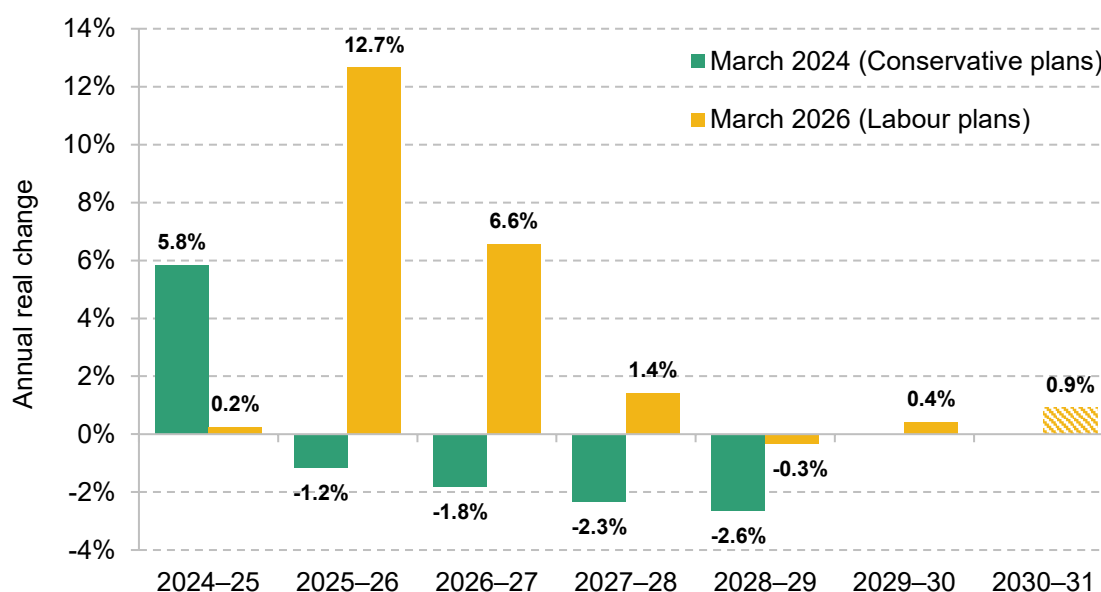
Departmental spending envelopes

The new government inherits overall departmental spending envelopes going to 2030–31, with detailed departmental budgets to 2028–29 for day-to-day spending and to 2029–30 for capital spending. These plans have changed substantially over the past few years:

- **Spring Budget 2024.** The Sunak government set provisional totals for departmental spending for 2026–27 to 2028–29 but did not specify how these would be allocated between departments. These plans implied sharp real-terms cuts to some areas of day-to-day spending and falls in overall capital spending (Emmerson, Johnson and Zaranko, 2024).
- **Autumn Budget 2024.** Chancellor Rachel Reeves substantially raised both day-to-day and capital spending, increasing day-to-day spending totals by £50 billion and capital spending totals by £26 billion in 2028–29.
- **Spending Review 2025.** The government allocated these higher spending totals to departments, setting day-to-day budgets through 2028–29 and capital budgets through 2029–30.
- **Autumn Budget 2025 and Spring Forecast 2026.** There were small revisions to spending plans at subsequent fiscal events. At the Autumn Budget, the government reduced planned departmental spending from 2028–29 onwards, describing these reductions as a set of departmental efficiencies. At the Spring Forecast, the government topped up Department for Education (DfE) budgets in 2028–29 (and increased envelopes thereafter), reflecting a package of SEND reforms.

The Spring Forecast provides the latest complete set of spending plans used in this chapter.³

³ Some additional spending changes were confirmed alongside the publication of the Defence Investment Plan in June. It remains unclear exactly how elements of this will be funded, and we await further detail at the Autumn Budget. Whether elements are funded through other departmental spending cuts or through non-departmental spending cuts, tax rises or higher borrowing will affect how the overall departmental spending envelope changes.

Figure 6.1. Planned annual real-terms spending growth, March 2024 and Spring Forecast 2026**Panel A. Day-to-day spending (RDEL)****Panel B. Capital spending (CDEL)**

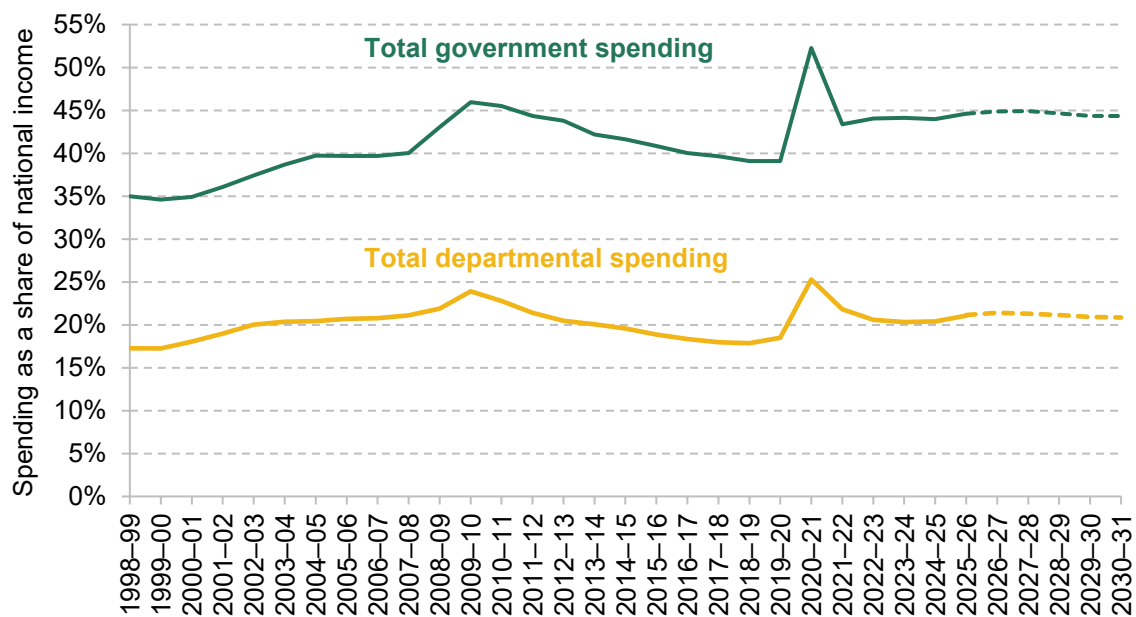
Note: 2024-25 RDEL growth rate is adjusted for the impact of SCAPE (superannuation contributions adjusted for past experience) changes and employer NICs (National Insurance contributions) compensation. 2025-26 RDEL growth rate is adjusted for the impact of employer NICs. Figures in 2024-25 and 2025-26 are based on out-turn spending; figures in 2026-27 onwards are based on plans. CDEL growth rates are adjusted for the 2026-27 reclassification of Sizewell C from DEL to AME. Numbers do not account for any changes implied by the Defence Investment Plan. Real-terms growth is calculated using the GDP deflator when plans were set. Dashed bars are those for which spending has not yet been allocated to departments.

Source: Authors' calculations using HM Treasury's Spring Budget 2024 and Spending Review June 2025, and Office for Budget Responsibility's Economic and fiscal outlook March 2026.

Figure 6.1 shows what these changes have meant for growth in departmental spending. The March 2026 plans are expressed using the OBR's inflation forecast from March 2026; we discuss in Section 6.3 how changes to inflation expectations since then could impact the real-terms generosity of existing spending plans. Spending is substantially higher than was envisaged in March 2024, but fast spending growth is confined to earlier years, with much slower growth pencilled in for later years. Real-terms day-to-day spending is set to grow by 2.4% this year, falling to 0.9% next year, then 1.2% in 2028–29, the final year for which we have detailed department-level allocations. Real-terms capital spending growth will slow from 6.6% this year to 1.4% next year, before essentially staying flat for the following two years.

Slower growth in departmental spending is also currently set to continue in the years where the government has only set overall envelopes, shown by the dashed bars. Real-terms day-to-day spending is set to grow by just 0.5% in 2029–30 and 1.3% in 2030–31, while capital spending is set to grow by 0.9% in 2030–31. This front-loaded profile means that, while the size of the state will stay high relative to historical levels, departmental spending is forecast to peak as a share of national income in 2026–27, and slightly fall thereafter, as Figure 6.2 shows. The path of total government spending looks very similar, peaking in 2027–28.

Figure 6.2. Total government spending and total departmental spending as a share of national income, 1998–99 to 2030–31



Note: Datapoints after 2025–26 are forecasts.

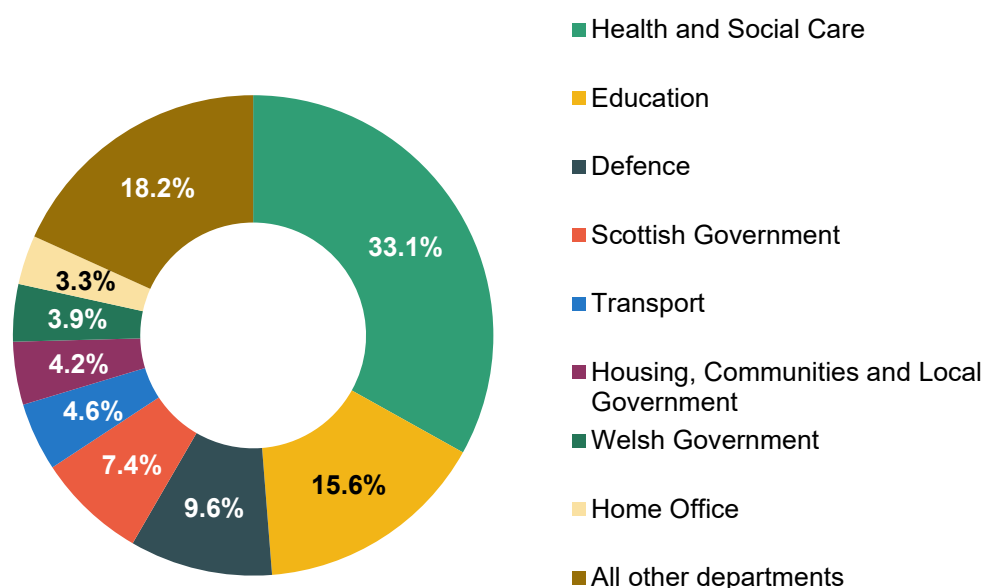
Source: Authors' calculations using the Office for Budget Responsibility's Public finances databank and Economic and fiscal outlook March 2026.

There can be good reasons for larger spending increases to come earlier in a time period. Faster increases earlier on can help services address backlogs or meet the up-front costs of reforms. But moving from relatively rapid increases to much slower growth can also be challenging, particularly where earlier growth has supported recurrent commitments or where costs and demands continue to rise. Relatively low growth at the end of the parliament leaves limited room to substantially increase spending in priority areas without making cuts elsewhere; we return to these trade-offs in Section 6.5.

Departmental budgets

Departments – and areas of spending – differ substantially in size: Figure 6.3 shows the planned split of total DEL (TDEL) between different departments in 2026–27. The Department of Health and Social Care (DHSC) alone accounts for a third of departmental spending; DHSC and the Department for Education together represent around half. Spending by the Ministry of Defence is another 10%.

Figure 6.3. Planned components of total departmental expenditure limits (TDEL) in 2026–27



Note: Scottish and Welsh Government figures refer to the portion of devolved governments' funding that comes directly from Westminster (so does not include, for example, devolved and retained tax revenues). Welsh Government figure is adjusted to add back tax block grant adjustments. Housing, Communities and Local Government funding includes the bulk of central grants to local government but does not include local tax revenues (e.g. business rates, council tax). This decomposition does not account for small changes to departmental budgets made alongside the Defence Investment Plan, or for Machinery of Government changes introduced by the new Prime Minister on taking office.

Source: Authors' calculations using the Office for Budget Responsibility's Economic and fiscal outlook March 2026.

Not all of the spending shown in Figure 6.3 maps straightforwardly onto services delivered by UK government departments. A substantial share of DEL is transferred to the devolved governments through block grants: funding for the Scottish, Welsh and Northern Irish Governments accounts for around 14% of the TDEL shown. These block grants are only one source of devolved government funding, alongside revenues from devolved taxes and other sources. Analysis in this chapter largely focuses on budgets controlled directly by UK government departments ('non-devolved spending'), since these are the allocations over which the Chancellor makes the most direct choices.⁴ These cover UK-wide public services (e.g. defence) and the provision in England of devolved public services (e.g. the NHS and schools in England).

Box 6.1. Local government funding and spending

Local government is somewhat different from most of the central government departments shown in Figures 6.3 and 6.4. Spending Reviews determine most of the central government grants to councils, but this central funding is only one part of what determines councils' finances. Revenues from local taxes – in particular, council tax and retained business rates – are another important source of funding for English councils, and are expected to account for around 45% of councils' overall resource funding in 2026–27.^a Spending funded through local revenues does not appear in MHCLG DEL totals (it is instead part of AME).

The outlook for councils' finances therefore depends heavily on what happens to council tax. Across England, councils' core spending power is set to increase by around 2.9% a year on average in real terms between 2025–26 and 2028–29 if council tax rises in each year by the maximum amount permitted, compared with 1.2% if council tax instead rises with inflation (Phillips, 2026). This is likely to differ significantly across different councils.

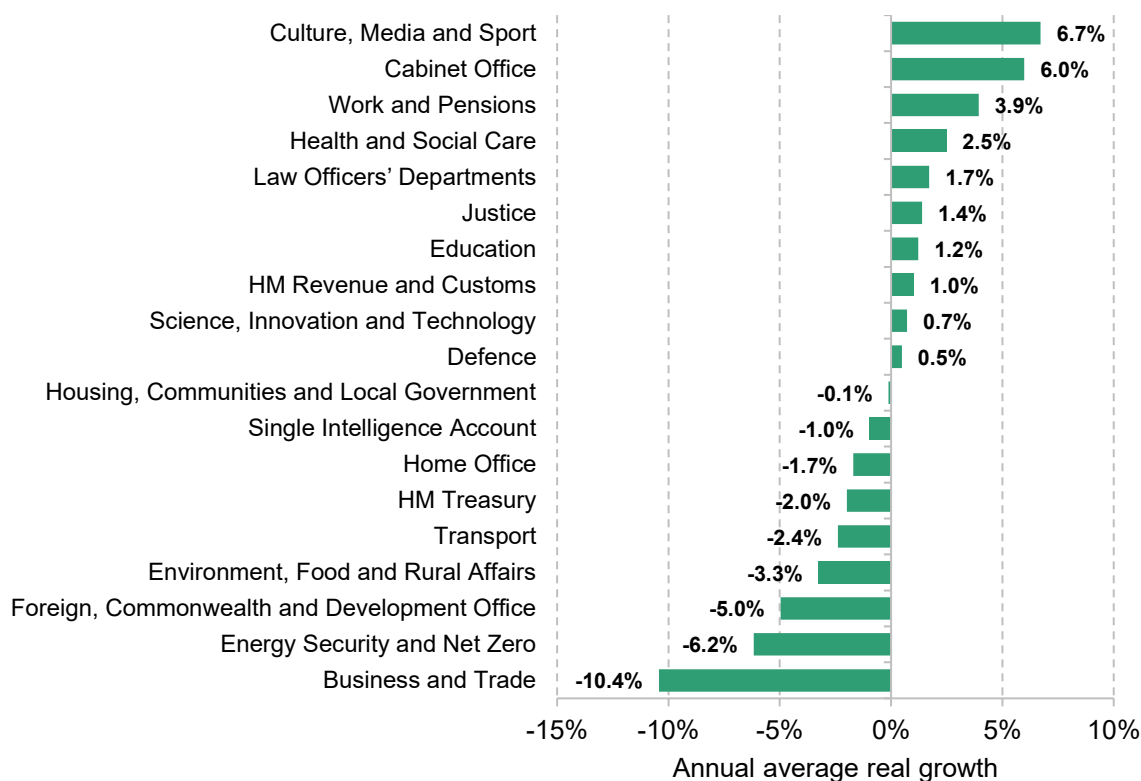
The boundary between central and local government finances may also change over time – for instance, as responsibilities are moved between different tiers of government. Alongside the Autumn Budget, the government plans to replace more of local authorities' grants with retained business rates revenues. In addition, it will publish more details of plans to assign a share of income tax revenues to strategic authorities (see Chapter 9 of this Green Budget). While it intends these reforms to be fiscally neutral overall, they could change the balance of spending managed through departments and as locally financed annually managed expenditure.

^a See Appendix 9A of Chapter 9 for details of how councils' overall resource funding has been estimated based on budget/forecast data published by MHCLG.

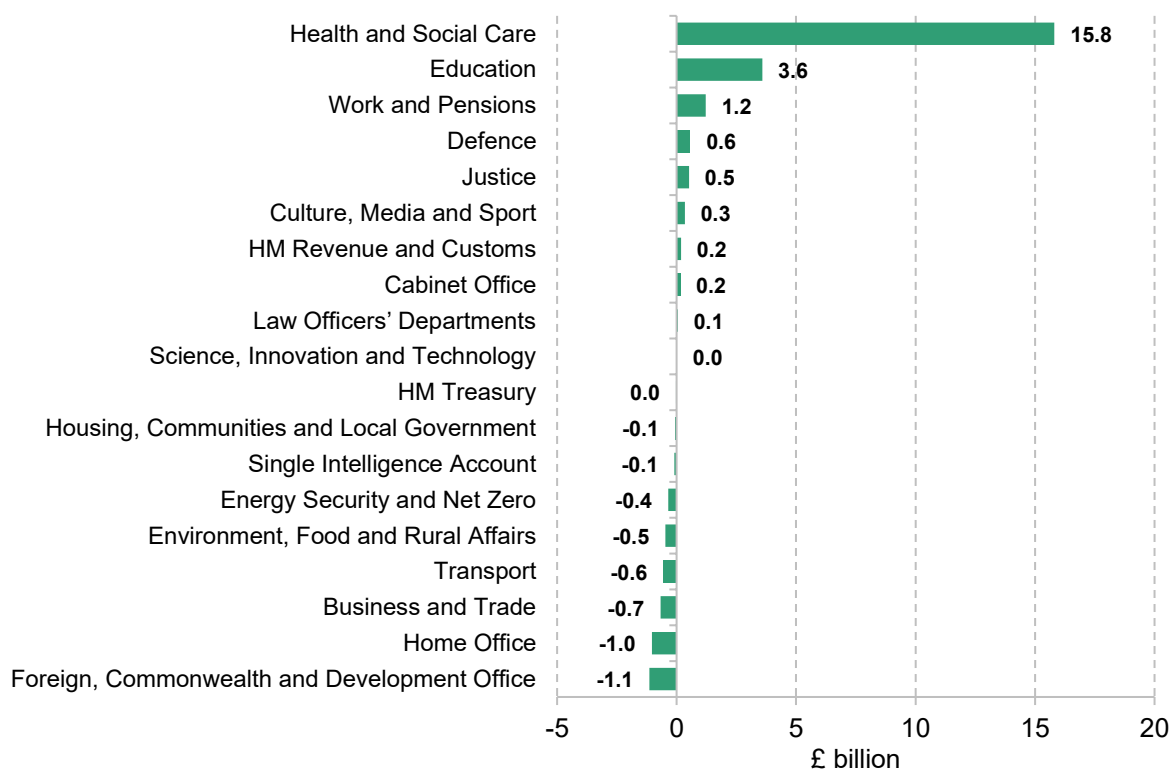
⁴ Changes to non-devolved spending have automatic consequences for block grants to devolved government, determined by the Barnett formula. When we discuss options for increasing non-devolved spending in Section 6.5, we always account for these Barnett 'consequentials' to the devolved governments. Devolved governments themselves face spending pressures, which can lead to requests for additional UK government funding. In September 2026, for example, the UK government offered the Northern Ireland Executive a package of additional funding over the next three years (Northern Ireland Office, 2026).

Figure 6.4. Day-to-day spending growth over the Spending Review period, 2025–26 to 2028–29

Panel A. Annual average real growth rate by department



Panel B. Real-terms change (£ billion) in departmental budgets, 2025–26 to 2028–29



Note and source: See next page.

Note and source for Figure 6.4

Note: This does not account for spending changes made alongside the Defence Investment Plan, or for Machinery of Government changes introduced by the new Prime Minister on taking office. Block grant allocations are not shown. Health and Social Care and Home Office budgets are adjusted for a budget control transfer in 2025–26.

Source: Authors' calculations using the Office for Budget Responsibility's Economic and fiscal outlook March 2026.

The same qualification applies to local government. The Ministry of Housing, Communities and Local Government (MHCLG) budget, which includes the bulk of central grants to councils, accounts for a further 4% of TDEL. As with devolved governments, these grants make up only part of councils' funding; Box 6.1 describes local government funding in more detail.

Planned growth in departmental spending also differs considerably between departments. Panel A of Figure 6.4 shows annual average real-terms growth in day-to-day spending across different departments. Some relatively small departments are set to see very fast real-terms increases in their day-to-day budgets over this period: for example, day-to-day spending by the Department for Culture, Media and Sport and the Cabinet Office is set to grow particularly quickly between 2025–26 and 2028–29. At the other end, a number of departments face real-terms cuts, including the Department for Energy Security and Net Zero and the Department for Business and Trade.

But these budgets are vastly different in size, as Figure 6.3 shows, so growth rates in spending alone do not give the full impression of where additional resources are going. Health is the clearest example: day-to-day DHSC spending is set to grow by a real-terms average of 2.5% each year between 2025–26 and 2028–29, but accounts for the vast majority of total real-terms spending growth. Panel B of Figure 6.4 shows that the DHSC budget is set to be £16 billion higher in real terms in 2028–29 than in 2025–26. In contrast, spending on the fastest-growing department – Culture, Media and Sport – will only be £0.3 billion higher, because its initial budget is much smaller.

The allocation of capital spending increases is even more concentrated. Figure 6.5 shows annual average real-terms growth in capital spending (Panel A) and total changes in capital budgets (Panel B) by department. Defence capital spending is set to grow by around 7.4% a year in real terms between 2025–26 and 2029–30, considerably faster than other large capital budgets, even before accounting for top-ups to defence spending made alongside the Defence Investment Plan (DIP) earlier this year (which would bring its growth to around 8.4% a year).

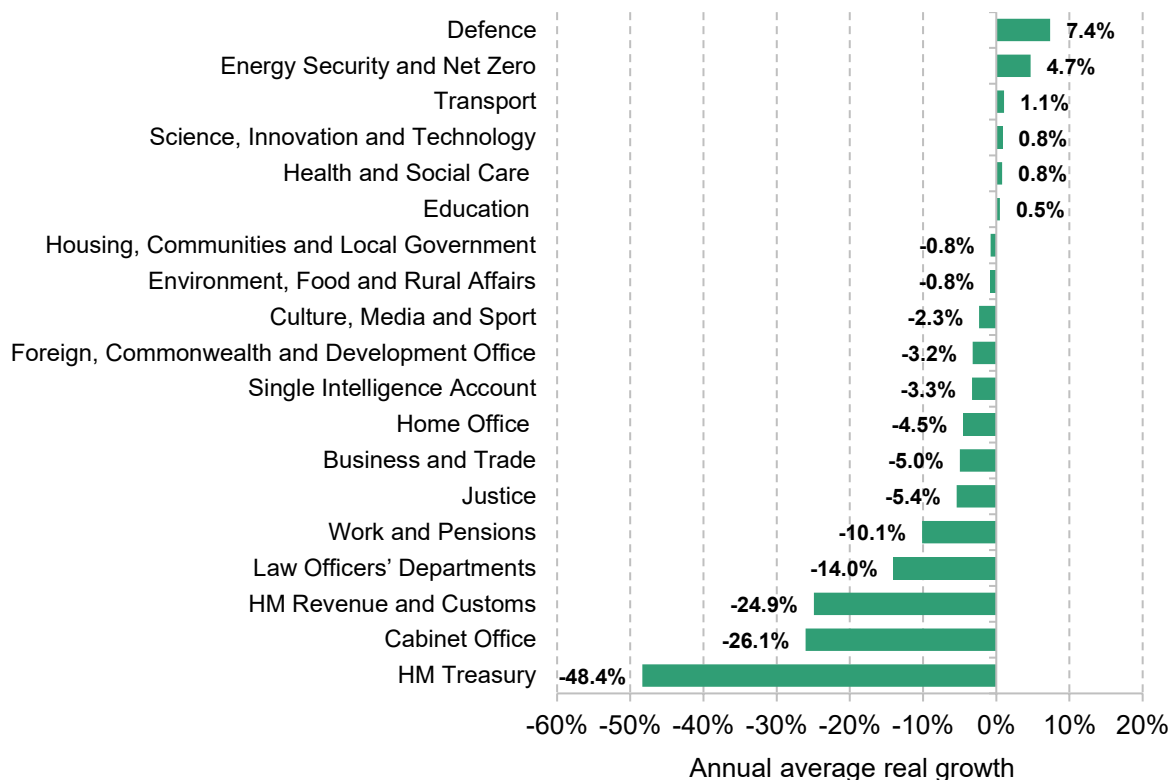
Note and source for Figure 6.5

Note: This does not account for spending changes made alongside the Defence Investment Plan, or for Machinery of Government changes introduced by the new Prime Minister on taking office. Energy Security and Net Zero growth is adjusted for the reclassification of Sizewell C in 2026–27.

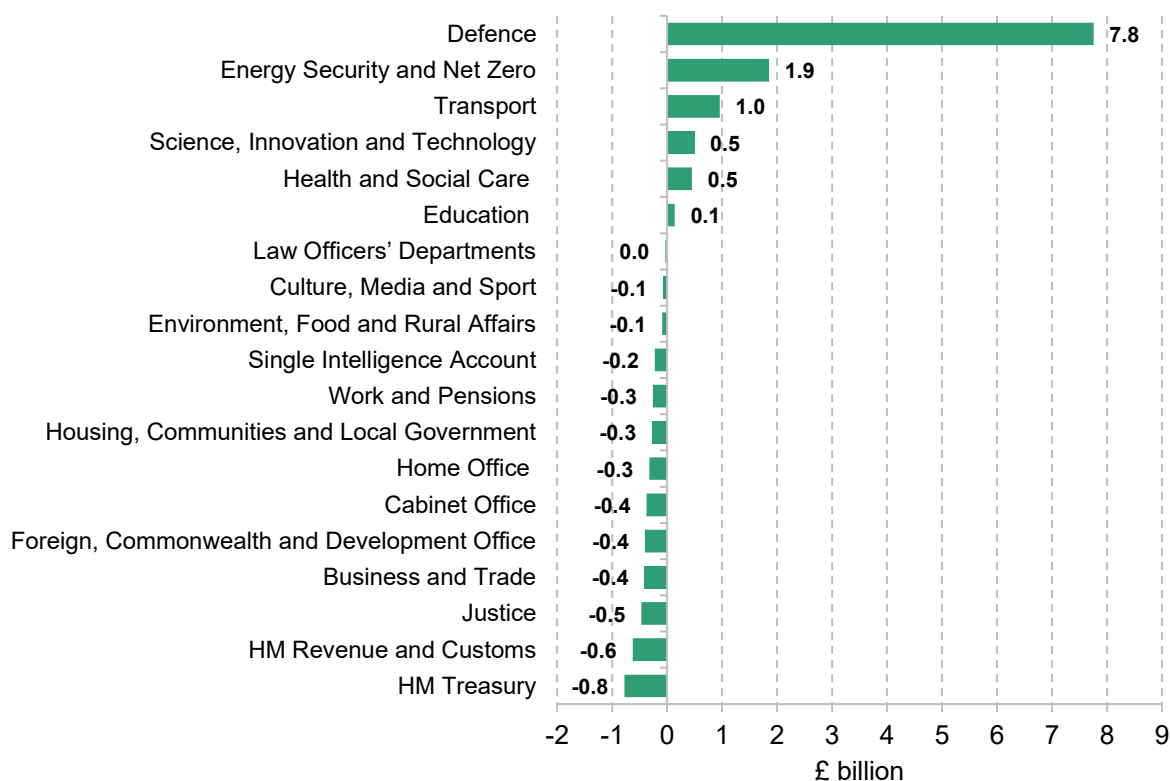
Source: Authors' calculations using the Office for Budget Responsibility's Economic and fiscal outlook March 2026.

Figure 6.5. Capital spending growth over the Spending Review period, 2025–26 to 2029–30

Panel A. Annual average real growth rate by department



Panel B. Real-terms change (£ billion) in departmental budgets, 2025–26 to 2029–30



Note and source: See previous page.

Unlike day-to-day spending, the departments for which capital spending is growing fastest tend also to be the largest departments. As the Ministry of Defence (MoD) has the largest capital budget, this translates into an even more concentrated picture when considering real-terms changes. The MoD budget is set to be £7.8 billion higher in real terms in 2029–30 than in 2025–26 (£9.0 billion after accounting for top-ups made alongside the DIP). This is most of the real-terms increase in the overall capital budget, and most other departments are seeing real-terms cuts to their capital budgets over this period.

Both day-to-day and capital spending increases are therefore concentrated in some large and important areas – health, education and defence – while other areas of spending are set to see slower growth and, in some cases, real-terms cuts. Decisions over these three areas of spending are therefore by far the most important for total departmental spending. And despite current plans, even these areas do not look entirely insulated from further pressure, as will be described in the next section.

6.3 Pressures against existing spending plans

The existing departmental budgets for the next few years could come under pressure in various different ways; we consider these in this section. First, there are cross-cutting challenges affecting public services. Public sector pay appears likely to rise faster than departments have budgeted for and inflation is higher than was expected when budgets were set, while existing plans assume very ambitious improvements in public sector productivity. Second, there are service-specific risks to areas where spending may be particularly difficult to control within fixed budgets. We focus here on spending on special educational needs and disabilities (SEND) and asylum support. While this is clearly not an exhaustive list of public service pressures – other services, such as prisons, tribunals and childcare, face important pressures of their own – they illustrate important mechanisms and risks affecting existing budgets.⁵

We do not attempt to assess whether budgets set at the last Spending Review were sufficient to achieve the government's wider ambitions for public service performance. Instead, and as an illustration of the scale of the pressures, we use existing budgets as our baseline, and ask how much more it would cost to implement the plans implied by these budgets if assumptions about pay, productivity or demand turned out differently from what was assumed when plans were first set.⁶

⁵ See Cattan et al. (2026) for analysis of pressures on prisons and tribunals, and Farquharson (2025) for analysis of pressures on childcare spending.

⁶ Our figures in this section are costs to UK government departments. If departmental budgets were topped up, this would add Barnett consequential for devolved governments, approximately increasing numbers by 10–20%. Numbers for how much it would cost to top up budgets after accounting for this are given in Table 6.2.

The government faces a choice in how to respond to pressures against spending plans. It could choose to top up funding to maintain planned public service performance, or alternatively to leave funding unchanged and accept a deterioration in public service performance (or reduce what services the government offers). We come back to this choice in Section 6.5.

Cross-cutting challenges

Higher-than-anticipated public sector pay

Public sector pay makes up roughly half of day-to-day departmental spending, so even relatively small changes in pay settlements for public sector workers can have large effects on departments' overall budgets. Departmental budgets are set in cash terms over a multi-year period, while public sector pay awards are generally determined annually through the Pay Review Body (PRB) process. Pay awards will be driven by a number of factors, including what departments say they can afford, inflation and private sector earnings growth. If awards turn out higher than expected when budgets were initially set, the effect is likely to persist: a higher pay award in one year will raise the level of pay, and so the cost of employing the same workforce, in every subsequent year.

Departments' assumptions about how public sector pay will grow were not made public when budgets were agreed at the last Spending Review.⁷ As our best publicly available proxy, we use the path for general government pay per head provided to the OBR by the Treasury in March 2025, shortly before the Spending Review. This path implied that pay per worker was expected to grow by 2.2% in 2026–27.

Pay now looks likely to grow substantially faster this year. Headline pay awards in the public sector have averaged around 3.4% in 2026–27.⁸ Headline awards are not quite the same as growth in average pay per worker, which also tends to rise because of progression and other compositional changes within the workforce. Adding an additional assumption on this 'pay drift' gives an estimate of around 3.9% growth in average pay per worker in 2026–27.⁹ If pay per head grew at this rate in 2026–27, and then grew with the OBR's March 2026 assumptions for general government pay in future years, holding employment growth unchanged, this could mean the

⁷ There are clear political economy reasons to keep these assumptions from being public – for example, the risk they would then serve as a lower bound in annual public sector pay negotiations.

⁸ Pay awards for most large public sector workforces have been between 3.3% and 3.6% in 2026–27. They were 3.5% for most workforces covered by the Pay Review Bodies (around 45% of the public sector workforce): for doctors, police, prison officers and teachers. They were 3.3% for most NHS workers and 3.6% for those in the armed forces. Outside workforces covered by the PRBs, the settlement for local government employees was 3.3%, and junior civil servants will receive pay awards of up to 3.5% (<https://www.slcc.co.uk/lga-announces-2026-local-government-pay-settlement/> and <https://www.gov.uk/government/publications/civil-service-pay-remit-guidance-2026-to-2027/civil-service-pay-remit-guidance-2026-to-2027>).

⁹ This approach is in line with analysis elsewhere – for example, as done by the Treasury in its evidence to the Pay Review Bodies (HM Treasury, 2025) to capture progression and changes in workforce composition.

paybill across non-devolved areas of spending rising by around £3 billion more than our illustrative baseline by 2028–29.

There are signs that pay awards in future years may also turn out higher than was expected in March 2026. We do not have forecasts specifically for public sector pay growth beyond 2026–27, so we use forecasts for overall economy wage growth as a guide to the likely trajectory of public sector pay growth. A range of evidence from independent forecasters implies that average earnings growth across the economy is now expected to be much higher over the next few years than the OBR expected in March (HM Treasury, 2026). Independent forecasts collated by the Treasury in August were for average annual earnings growth of around 2.8–3.3% in 2027 to 2029, compared with an average of 2.2% in the OBR’s March forecast.

If public sector pay grew with our estimate of public sector pay growth in 2026–27, then grew in line with the most recent forecasts for economy-wide pay growth from 2027–28 to 2028–29, the paybill across non-devolved areas could rise by £7–9 billion more than our baseline in 2028–29.¹⁰

Higher-than-anticipated non-pay inflation

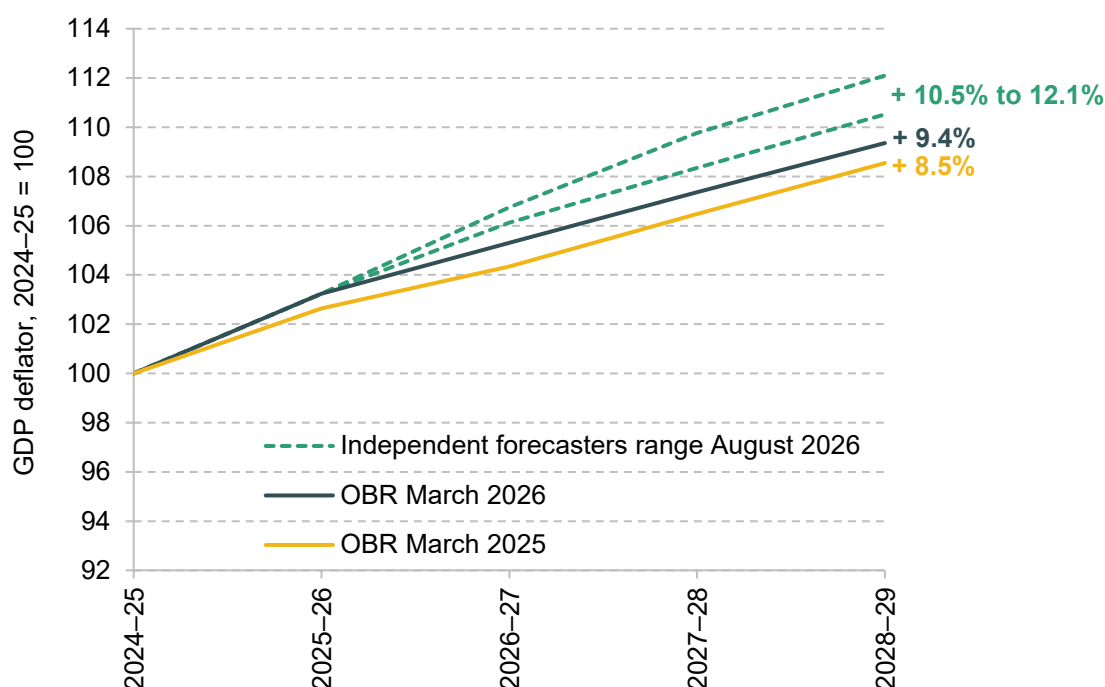
Higher-than-expected non-pay costs can also put pressure on departmental budgets. Departments spend much of the remainder of their budgets on purchasing goods and services. Since budgets are fixed in cash terms, higher-than-expected prices affect how much departments can purchase. There are signs that the GDP deflator – the standard measure of inflation used to assess departmental budgets’ real value – may turn out higher than was expected at last year’s Spending Review. This will, of course, affect tax revenues too, as discussed in Chapter 2 of this Green Budget.

In March 2025, the OBR expected the GDP deflator to cumulatively increase by 8.5% between 2024–25 and 2028–29 (Figure 6.6). By March 2026, this was 9.4%, largely reflecting higher-than-expected inflation in 2025–26. More recent independent forecasts imply cumulative growth of around 10.5% to 12.1% over the same period. This is a relatively substantial rise in inflation, and in inflation expectations, although over the 2021 Spending Review period there was a much

¹⁰ One potential offsetting factor is that the government has increased the discount rate with which public sector pension liabilities are valued (the superannuation contributions adjusted for past experience – SCAPE – rate). This is likely to mean that the employer pension contributions that must be paid by departments and public services will fall. When these have risen in the past, the government has provided extra funding to departments (as discussed further in O’Brien and Zaranko (2023)). If it takes away the equivalent funding this time, as the Department for Education recently announced it would with schools, this will leave departmental spending power and overall public spending unchanged. If the government does not change departmental budgets in response, departmental spending power will be increased, as will total public spending (as the difference between public sector pension income and expenditure – which is included in RAME – will narrow).

larger rise in inflation relative to what was expected when budgets were set (Boileau, Warner and Zaranko, 2024).

Figure 6.6. Successive forecasts for cumulative GDP deflator growth between 2024–25 and 2028–29



Note: Range from independent forecasters based on second-highest and second-lowest forecast in the database for each financial year.

Source: Authors' calculations using HM Treasury's independent forecasts August 2026 and the Office for Budget Responsibility's Economic and fiscal outlooks March 2025 and March 2026.

Settlements in 2025–26 were therefore less generous in real terms than originally planned and, based on current forecasts, future settlements will also be less generous than originally planned.

To distinguish pressures from higher inflation on non-pay elements of departmental budgets from the pay pressures discussed above, we apply these alternative inflation paths to non-pay day-to-day spending in non-devolved areas and to total capital spending in non-devolved areas. Table 6.1 shows our estimates of the implied non-pay pressures.¹¹ The increase in inflation between the March 2025 and March 2026 OBR forecasts implies that non-pay day-to-day budgets would be worth around £2 billion less in real terms in 2028–29. Under the scenarios constructed from the August 2026 independent forecasts, the reduction compared with the March 2025 OBR forecast would be between £4 and £8 billion. Higher inflation also erodes

¹¹ In this section, we distinguish between pay and non-pay inflationary pressures. We can instead consider the effect of higher inflation on *total* (non-devolved) budgets. The August 2026 independent forecasts imply a reduction in their real-terms value of £7–16 billion in 2028–29 compared with March 2026 forecasts, and £11–20 billion compared with March 2025 forecasts.

capital budgets. Relative to the March 2025 forecast, the August 2026 forecasts imply a reduction in their real-terms value of around £2 to £4 billion by 2028–29.

Table 6.1. Estimates of non-pay pressures from higher-than-expected inflation in 2028–29

	Non-pay, non-devolved day-to-day spending	Non-devolved capital spending
OBR March 2026 versus OBR March 2025	£2 billion	£1 billion
Independent forecasters range August 2026 versus OBR March 2026	£3–6 billion	£1–3 billion
Combined	£4–8 billion	£2–4 billion

Note: Top-ups to offset these pressures would have to be slightly larger because of Barnett consequentials to devolved governments – this is discussed in Section 6.5. Figures are expressed in cash terms, and may not sum due to rounding.

Source: Authors' calculations using HM Treasury's independent forecasts August 2026 and the Office for Budget Responsibility's Economic and fiscal outlooks March 2025 and March 2026.

Ambitious plans for departmental efficiencies

At the 2025 Spending Review, the government set out a wide-ranging set of plans to improve the productivity of public services. Departments published detailed breakdowns of how they intended to make 'efficiency savings' over the course of the parliament, including by procuring inputs more cheaply, investing in digitising and automating processes, and reallocating funding towards more effective programmes. Cuts to central administration budgets were also set out. For more on these plans and their implications, see Harvey-Rich and Warner (2025).

These were large, ambitious plans. Achieving them would mean delivering an average of 1.0% productivity growth in each year of this parliament, compared with a historical average of 0.2% between 1997 and 2019.¹² Disappointing productivity growth would make it more expensive than was anticipated at the Spending Review to deliver the same performance from public services, placing pressure on departmental budgets.

Since then, the government has set out two additional sets of savings from further productivity growth. First, at the 2025 Autumn Budget, plans to 'go further on efficiencies' included further savings of £2.8 billion in 2028–29 (around 0.5% of departmental budgets), as well as the first set

¹² These figures – and those in the rest of this subsection – are a measure of input productivity, the relationship between inputs to public services (staff, buildings, equipment, etc.) and outputs. It does not take account of changes to prices for inputs. For more on the relationship between different measures of public sector productivity, see Harvey-Rich and Warner (2025).

of intended savings for 2029–30 and 2030–31. Second, the recent Defence Investment Plan (Ministry of Defence, 2026) increased the level of savings intended to be made from the MoD's budget over this parliament. In 2028–29, the department now intends to make £2.1 billion of efficiency savings from its day-to-day budget of £43.7 billion, compared with a £0.9 billion saving for the same year set out at the 2025 Spending Review.

Taken together, changes since the Spending Review have increased the level of annual public sector productivity growth implicit in spending plans from 1.0% to 1.2%. Savings from defence have also become a more significant component of the overall total (although starting from a relatively low base, partly in acknowledgement of further announcements to come).¹³ Departmental spending plans were already reliant on productivity growth being significantly above the historical average, and now assume even stronger growth.

There are some reasons to be optimistic about the deliverability of these plans. Productivity growth has recently been fairly strong in the English NHS (NHS England, 2026; Office for National Statistics, 2026),¹⁴ where a large share of the overall efficiency gains are intended to be made. If this trend continues, productivity growth could meet – or even exceed – the rates that current spending plans rely on.

Yet a number of important risks remain. Potential productivity growth is very uncertain in other departments, and has frequently been negative in the past. For example, more than three-quarters of the efficiency savings for the MoD confirmed in the Defence Investment Plan for 2028–29 are classed as 'low maturity', implying that they are not on the verge of being delivered, and that there is substantial risk attached to their successful delivery (Public Accounts Committee, 2026).

Further efficiency plans announced since the Spending Review also came with almost no operational detail on how they are intended to be delivered, in stark contrast to those published at the Spending Review. It is striking that departments were asked to find further savings at the 2025 Autumn Budget less than six months after agreeing detailed three-year plans for productivity improvements. It seems plausible that some of the new planned efficiency gains were a way to rationalise cuts to budgets, rather than assessments of what productivity improvements could realistically be made. If, for whatever reason, these productivity

¹³ Official measures of public sector productivity produced by the Office for National Statistics do not measure defence productivity growth, as it is very difficult to measure the quantity or quality of services produced by the Ministry of Defence. The historical average productivity growth of 0.2% assumes that defence productivity was unchanged over this period. Regardless of measurement issues, these plans imply that the MoD is assumed to significantly improve the value it gets from its budgets.

¹⁴ There are a number of ways to measure healthcare productivity growth. The Office for National Statistics and NHS England produce two measures that differ in the services in scope and the geography, as well as some methodological differences. Both estimate relatively strong productivity growth in 2025.

improvements are not made, the government will need to either reduce its level of ambition for public service delivery or increase budgets.

We consider two scenarios. First, if the government delivers only half of its intended savings – which would still mean strong productivity growth by historical standards – current plans for public services would be around £9 billion more expensive to deliver than previously anticipated in 2028–29. If instead, in an even more adverse scenario, public sector productivity grows at its historical rate over this parliament, the corresponding pressure would be around £25 billion. Public sector productivity could also exceed current expectations (such as in a scenario where artificial intelligence can be applied widely and adopted rapidly in the public sector), which would reduce pressure on budgets. But given the level of ambition in existing productivity plans, the risks are mostly on the downside.

Volatile and uncertain areas of spending

SEND demand and implementation risks

Policy – and spending – relating to young people with special educational needs and disabilities (SEND) is one of the areas where the government’s plans have changed most since the Spending Review.

Under the current system, there is a disconnect between the funding local councils receive for SEND and their spending on SEND. Councils receive pre-set funding for SEND provision as part of their annual schools grant and then allocate this funding to schools in order to meet pupils’ needs. Their spending, however, is largely determined by statutory entitlements, rather than the value of the funding received. Many pupils with special educational needs have Education, Health and Care Plans (EHCPs), which give them legal entitlements to specific forms of support.¹⁵ Providing this support can require councils to spend more than the funding they receive.

In 2026–27, spending on SEND provision is set to be over £16 billion, a real-terms doubling from its 2015–16 level; the number of young people with EHCPs has grown even faster over the same period. Funding for SEND costs has not kept pace, leading councils to accumulate substantial deficits between SEND spending and funding received¹⁶ (see Latimer, Sibieta and Snape (2025) for more detail). The government has committed to cover 90% of deficits

¹⁵ In this subsection, we focus on identified SEND spending, which includes funding allocated as part of the Experts at Hand and Inclusive Mainstream Fund grants, and spending from the high needs block of the Dedicated Schools Grant (e.g. high needs top-up funding for pupils in mainstream schools, and funding for pupils in special schools).

¹⁶ Deficits in the high needs budget have been artificially taken off councils’ main balance sheets since 2020 under an accounting treatment known as the ‘statutory override’, which is set to end in March 2028, at which point remaining deficits will have to be met from councils’ own resources.

accumulated up to March 2026, but arrangements for deficits arising in 2026–27 and 2027–28 – expected to total around £10 billion over these two years – have not yet been confirmed.

From 2028–29, responsibility for meeting all SEND costs will move from councils to the Department for Education (DfE). Ahead of this, around £4 billion of DfE’s existing budget is being reallocated to improve mainstream schools’ baseline SEND provision (e.g. teacher training on SEND). Importantly, this funding is not intended to go towards the costs of delivering support outlined in EHCPs; the intention is to better meet pupils’ needs without them requiring an EHCP. In 2028–29, when SEND costs become DfE’s responsibility, there will be a £3.5 billion top-up to DfE’s day-to-day budget, which we assume will fully go towards meeting the costs of EHCP provision. From 2029–30, a planned set of statutory reforms to EHCPs, with the aim of tightening eligibility and reducing costs, will begin to kick in.

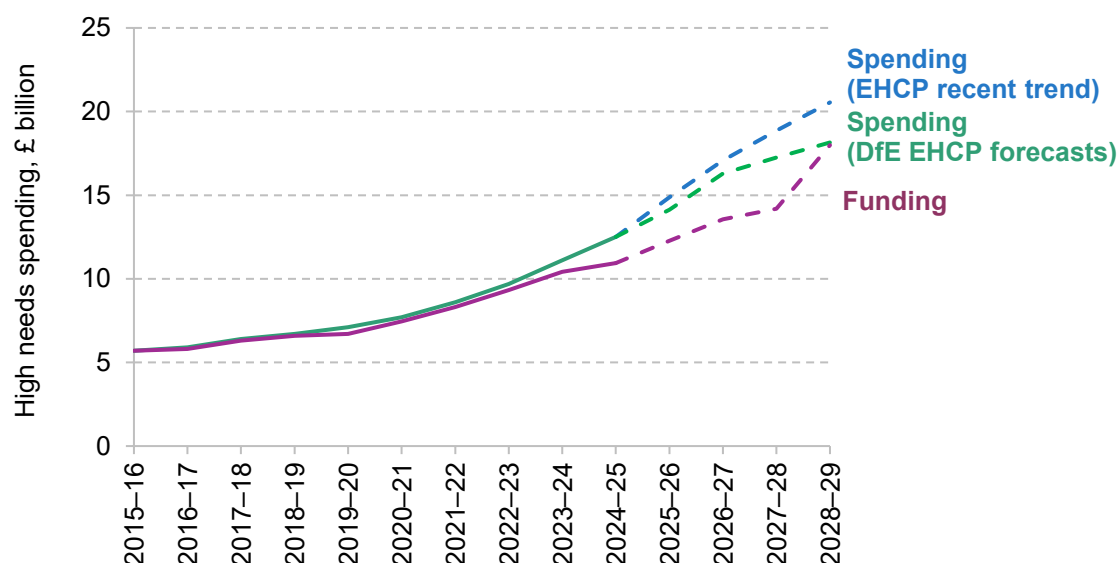
An important question is therefore whether the combined impact of additional mainstream support and the extra £3.5 billion in funding will be sufficient to meet the costs of SEND support in 2028–29, before the main statutory reforms take effect.

One key uncertainty is how the share of pupils with an EHCP will evolve until 2028–29. DfE projects that investment in mainstream schools’ SEND provision will slow down the rise in the share of pupils with EHCPs as more pupils have their needs met by mainstream support. It forecasts that the share of pupils with EHCPs will reach 7.3% in 2028–29 and 7.7% in 2029–30, before falling thereafter (Department for Education, 2026b). We estimate that, if EHCP numbers grow in line with these projections, SEND spending growth will slow between now and 2028–29 (the green line in Figure 6.7).

There are some reasons to think that growth in pupils with EHCPs will not necessarily slow over the next few years. First, more people may rush to secure an EHCP before changes to eligibility are made – there is some early evidence that this may be the case (Adams, 2026). Second, councils have slightly weaker incentives to control SEND spending over the next two years as it is likely that they will not have to bear the costs of SEND deficits (see Farquharson et al. (2025) for more discussion). If EHCP rates were instead to increase at their average pace since 2019, we would expect roughly 8.3% of pupils to have an EHCP in 2028–29. Assuming per-EHCP spending follows its recent trend, the costs of EHCP provision in 2028–29 would be around £20.5 billion in this case (the blue line in Figure 6.7).¹⁷

¹⁷ The level of spending per EHCP is another key uncertainty. The government is aiming for per-EHCP costs to fall, and has pledged to create 60,000 specialist places to better meet demand for these placements (Department for Education, 2026a). If these new places prevented further growth in independent specialist placements – which have very high unit costs – then this could significantly reduce the average cost per EHCP, bringing down overall spending on SEND. If instead the new places were largely used by pupils who would otherwise be in mainstream settings, then this could increase per-EHCP costs and therefore overall SEND spending.

Figure 6.7. SEND funding and spending, actual and forecast



Note: Spending projections are authors' calculations. The green line combines DfE projections for the share of pupils with an EHCP with our projections of pupil numbers. The blue line instead projects EHCP rates using age-specific cohort trends since 2019 (based on Latimer, Sibieta and Snape (2025)). Both scenarios assume that per-EHCP spending continues to decline slightly in line with recent trends.

Source: Baseline funding is taken from the funding amounts implied by OBR forecasts of SEND spending and deficits, from the Office for Budget Responsibility's Economic and fiscal outlook – March 2026 for 2015–16 to 2027–28 and November 2025 for 2028–29 – along with an additional £3.5 billion in funding for 2028–29 and the allocated amounts from the Inclusive Mainstream Fund and Experts at Hand grant announced in the SEND White Paper (Department for Education, 2026a).

School funding allocations have not yet been set past 2026–27, but if baseline high needs funding¹⁸ were to stay flat in real terms, as in the OBR's projections, then in 2028–29 total high needs funding would come to around £18 billion, shown by the purple line in Figure 6.7. This would be enough to meet forecast spending under DfE's EHCP projections in 2028–29 (green line). But if EHCP rates grew at their recent pace (blue line), spending could exceed this level of funding by around £3 billion in 2028–29.

Uncertainties over asylum costs falling

Another area of DEL spending where it is difficult to predict and control costs is asylum. The number of people claiming asylum in the UK has risen steeply in recent years, from 45,000 in 2019–20 to 96,000 in 2025–26. Home Office spending on asylum support rose from £0.7 billion in 2019–20 to £4.7 billion in 2023–24 and is budgeted to fall back to £3.6 billion for 2025–26. Spending Review plans assume a further substantial fall in spending to £2.5 billion by 2028–29.

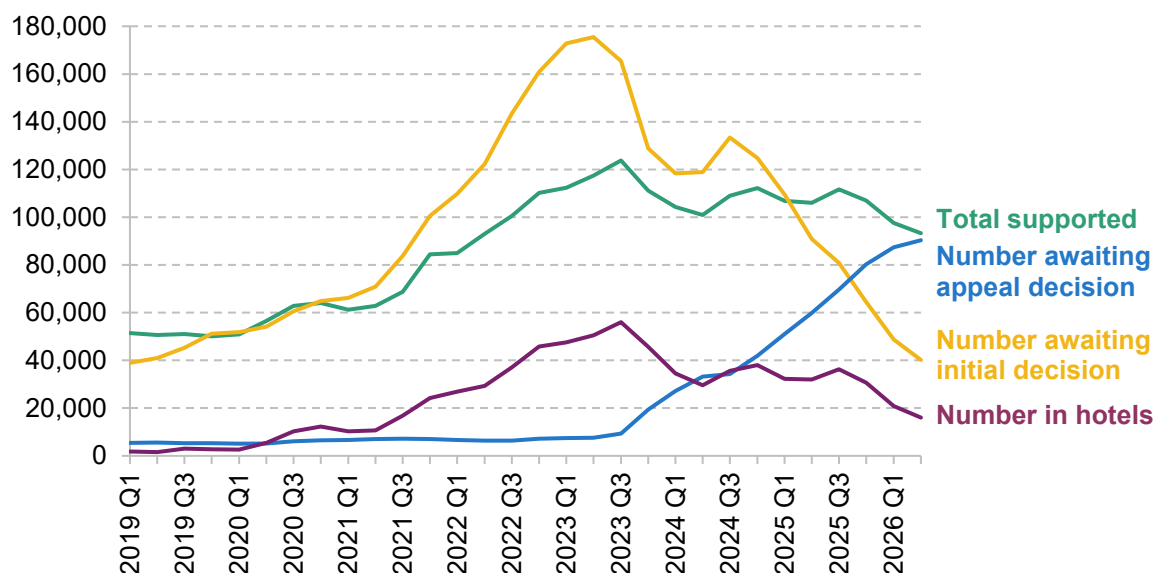
¹⁸ We use 'baseline funding' to refer to high needs funding excluding the additional amounts announced as part of the SEND White Paper. Baseline high needs funding allocations have not been set past 2026–27 and are likely to exceed OBR funding forecasts, as discussed in Section 6.5.

This is a particularly difficult area on which to cut spending since the government has relatively few levers to control asylum costs: it can be difficult to control the number of people claiming asylum, and the Home Office has statutory duties towards people seeking asylum in the UK.

Whether plans to substantially decrease asylum spending in the coming years are delivered depends on two key factors: the number of people who have to be supported and the cost of supporting each asylum seeker.

The number of asylum seekers who have to be supported. Figure 6.8 shows how the number of asylum seekers receiving support from the Home Office or awaiting claim decisions has changed over time. The total number of asylum seekers the Home Office is responsible for supporting has fallen from its late 2023 peak, but remains much higher than levels pre-2022. Many of those the Home Office supports are waiting for the results of their asylum claim. Investment in processing capacity has reduced the backlog of claims awaiting an initial decision from the Home Office to less than a quarter of its peak (see yellow line in Figure 6.8). But because many whose claims are initially refused subsequently appeal that decision, pressure has been shifted into the appeals system, with the number awaiting an appeal decision rising sharply (blue line in Figure 6.8). Consequently, the overall number of people supported has been slow to fall and backlogs in the tribunal system have grown (Rizzotti and Tomlinson, 2026).

Figure 6.8. Number of asylum seekers by claim status and accommodation type



Note: 'Hotel accommodation' before 2022 Q4 refers to section 98 accommodation. The Home Office only has a duty to support asylum seekers who would otherwise be destitute, and as such the number supported will be lower than the total number of asylum seekers in the system.

Source: <https://www.gov.uk/government/statistical-data-sets/immigration-system-statistics-data-tables#asylum>. Tribunal statistics are taken from Asylum and Protection cases in the First-Tier Immigration and Asylum tribunal: <https://www.gov.uk/government/statistics/tribunals-statistics-quarterly-april-to-june-2026>.

As the Home Office has now largely worked through the backlog of initial decisions that built up in 2022, the number of new appeals is likely to fall over coming quarters, and as a result the tribunals backlog is likely to grow more slowly. Even without an expansion of tribunal capacity, we would therefore expect the total number of asylum seekers requiring support to grow relatively slowly over the next few years, reaching around 95,000 in 2028–29 if arrivals and other features of the asylum system remain at current levels.

The cost of supporting each asylum seeker. Asylum accommodation in hotels, used when the Home Office’s traditional accommodation reaches capacity, is particularly expensive. In 2025, it cost £144 per night to house an asylum seeker in a hotel, compared with around £23 in standard asylum accommodation. Accordingly, in 2024–25, the Home Office spent £2.1 billion on hotels compared with £600 million on other forms of accommodation (National Audit Office, 2025), despite hotels housing only around a third of supported asylum seekers. A central assumption behind the Spending Review settlement was that hotel use will end by 2029.

There has been consistent progress in recent years on both expanding non-hotel accommodation and increasing the number of asylum tribunal decisions. The Home Office has already been able to achieve substantial spending reductions by reducing the use of hotels (see purple line in Figure 6.8). The average number of asylum seekers housed in hotels in 2025–26 was around 30,000, down from 47,000 in 2023–24, due to a combination of fewer people requiring support and more spaces in non-hotel accommodation. The asylum support budget in 2026–27 is also broadly in line with – indeed, slightly below – Spending Review plans.¹⁹ If tribunal and non-hotel accommodation capacity were to continue growing at their recent pace, we project that all asylum seekers requiring accommodation could be housed in non-hotel accommodation by 2028–29. There is therefore little evidence so far of significant pressure against the asylum support budget set at the Spending Review.²⁰

There nevertheless remain clear risks. In particular, the number of people who claim asylum remains difficult for the government to control, while tribunal and non-hotel accommodation capacity take time to expand. Housing an additional 10,000 people for a full year would cost around £85 million if in standard accommodation, compared with around £530 million if in hotel accommodation. A sudden increase in arrivals would likely increase the numbers of people housed in hotels, pushing spending up rapidly and creating pressures that would take time to unwind. In addition, faster processing does not necessarily eliminate pressures on spending altogether: some people leaving Home Office accommodation may instead require

¹⁹ While over the 2021 Spending Review period final spending systematically turned out much higher than initial budgets (Warner and Zaranko, 2024), in recent years initial budgets have been far closer to final out-turns.

²⁰ At the Autumn Budget last year, the OBR warned that asylum spending could overshoot Spending Review plans. We interpret our differences from the OBR’s assessment as largely driven by having more recent out-turn asylum data, rather than differences in judgements.

accommodation support from local authorities, shifting rather than eliminating some costs. Migration also has implications for public spending beyond the asylum system, as discussed in Chapter 5 of this Green Budget.

6.4 Additional spending ambitions

Beyond the pressures against existing budgets and plans for public services, the government may decide to increase some areas of departmental spending or responsibilities beyond what was envisaged at the last Spending Review. In this section, we discuss two important examples: defence and adult social care. Chapter 2 also considers public investment ambitions.

In both these cases, the government has signalled that final decisions about the path of spending are unlikely to be made at the Budget. The Prime Minister has said that the government will determine and announce a path for defence spending to reach 3% of GDP at next year's Spending Review, and has said that adult social care reform will be introduced in the next parliament, with detail awaiting the Casey Review's report next summer. While the government need not settle all the details of its public service plans at this Budget – particularly for adult social care – it should set spending totals within which it could credibly conduct the next Spending Review.

Defence ambitions and the path to 3% of GDP

Successive governments have increased defence spending considerably in the last few years: NATO-qualifying defence spending was around 2.1% of national income in 2023–24, and is set to be 2.6% this year.²¹ As part of the Defence Investment Plan published earlier this year, defence spending was topped up relative to Spending Review plans by an average of £3 billion each year, meaning that spending will reach 2.7% of national income from 2027–28 and stay there until 2029–30. Much of this increase was funded by cutting departmental capital spending elsewhere, but part of this increase (an average of £1 billion each year) is currently unfunded, representing money that the new Chancellor will have to find at the next Budget, whether from tax, borrowing or other spending, if he sticks to existing plans.

But there is evidently domestic and international political pressure to move further and faster on defence spending. John Healey, now Chancellor, resigned as Defence Secretary in June over disagreements with the top-ups to defence spending that would be made alongside the DIP, arguing that the amount of money committed to the defence budget was too small, and writing

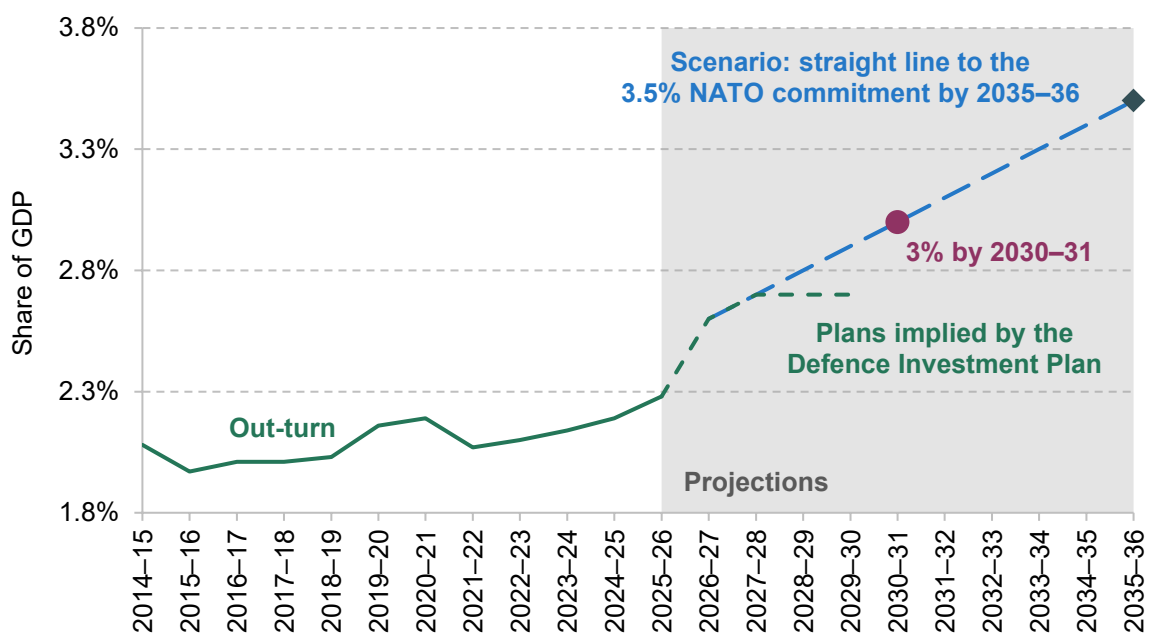
²¹ The NATO definition of defence spending is a broader measure of spending than just the Ministry of Defence budget (including items such as military pensions and intelligence spending). For more on defence spending definitions, see section 7.2 of Boileau and Warner (2025).

that ‘I am certain that a headmark date for 3% of GDP on defence in 2030 is what Britain must set’. While the UK has topped up defence spending substantially, other NATO members have recently increased spending as a share of national income more rapidly (Boileau and Warner, 2025).

The previous Labour government committed to spending 3.5% of national income on defence by 2035, alongside NATO allies. This would imply spending around an additional £25 billion each year in today’s terms relative to existing plans (Boileau and Warner, 2026). Since becoming Chancellor, John Healey has said that at next year’s Spending Review he will set out ‘a clear path about how we will meet that NATO commitment in 2035, of 3.5% of GDP. And as part of setting out that clear path, we will set that target date for 3%’ (Reuters, 2026).

The fact that defence spending is currently set to remain at around 2.7% of national income between 2027–28 and 2029–30 (as shown by the green line in Figure 6.9) means that, if the 3.5% commitment is to be reached by 2035 and if current plans are retained over this parliament, increases in defence spending in the next parliament would have to be much faster than in this parliament.

Figure 6.9. Defence spending out-turn, plans and scenarios



Note: Defence spending here refers to NATO-qualifying defence spending, a broader measure than Ministry of Defence funding alone. DIP plans are rounded to one decimal place, in line with the wording in the DIP funding plan document. Scenario shows a linear path of defence spending to 3% of national income by 2030–31 and to 3.5% of national income by 2035–36.

Source: Authors’ calculations using NATO figures, Defence Investment Plan funding explainer (<https://www.gov.uk/government/publications/the-defence-investment-plan/the-defence-investment-plan-funding-explainer>) and Office for Budget Responsibility’s Economic and fiscal outlook March 2026.

The government might instead decide to increase defence spending steadily from 2026–27 to 3% of national income by 2030–31; this potential path of spending is illustrated by the blue dashed line in Figure 6.9. This would be in line with the current Chancellor’s stated aims when he resigned as Defence Secretary. This rate of growth in spending as a share of national income would also be consistent with reaching 3.5% of national income spent on defence in 2035–36. This scenario would imply spending around £3 billion more than current plans in 2028–29, £7 billion more in 2029–30 and £11 billion more in 2030–31 than if spending had stayed at 2.7% of national income.

Adult social care reform

In July, one of the Prime Minister’s first announcements on taking office was to emphasise his commitment to improving the quality and accessibility of social care, and to announce that Baroness Casey’s review of the social care system would be brought forward by a year (Prime Minister’s Office, 2026). In his speech to the Labour Party Conference in September, he went further and announced plans to ‘start laying the ground now for the National Care Service’, to be introduced in the next parliament.

The details – and potential spending implications – of what this service could look like remain highly uncertain. Its design will be informed by the recommendations of the Casey Review, due in Summer 2027. Costs could vary significantly depending on the services in scope (such as whether residential as well as home-based care would be covered), the eligibility requirements, and any further bundled reforms (such as higher pay for care workers).

For a sense of scale, local authorities in England currently spend around £30 billion on publicly funded adult social care each year. Alderwick and Allen (2026) estimate that free provision of personal, home-based care (as is currently available in Scotland) to those aged 65 and older could cost around £7.5 billion per year. A broader ‘NHS-style’ system, under which the government covers all care and support costs, could cost closer to £18.5 billion. Such estimates are inherently uncertain, as they will depend in part on how take-up responds to changes in the price and quality of social care available, as well as how population health changes, but are a useful reference point for the potential costs of significant reforms to the adult social care system.

Given the Prime Minister’s stated timeline for the introduction of reforms, these costs provide only a limited guide to how much the government will choose to spend on social care over the next five years. If the government intends to begin introducing the service immediately in the next parliament, spending settlements from 2029–30 would be affected, with exact amounts dependent on what the government chooses to provide, when provision starts and expands, and how take-up responds. But much detail is yet to be worked out, and we should not expect this to take place at this year’s Budget.

6.5 Implications for the Autumn Budget and 2027 Spending Review

At the Autumn Budget, the Chancellor will have to decide whether to revisit detailed departmental budgets between 2026–27 and 2028–29. He could choose to do nothing, letting departments absorb all pressures that materialise; he could keep overall spending totals unchanged, but reopen settlements and move money between departments; or he could top up some or all departmental budgets, increasing total departmental spending.

The Budget would also be a natural time to consider spending envelopes that will be allocated for the first time at next year's Spending Review. While the Chancellor will not make detailed departmental allocations this autumn, the totals he sets should be consistent with a set of plans that he would be willing to allocate to departments next year and deliver.

Keep plans for total departmental spending unchanged

One option within an unchanged overall spending total is to keep individual departmental budgets the same as inherited plans, and require departments to absorb any pressures that materialise in the years up to 2028–29 within their existing budgets. The Treasury has explicitly indicated that it expects departments to fund pay awards from existing budgets, for example (HM Treasury, 2025). Departments can adjust to a pressure within budgets by reducing the quantity or quality of services they provide, or by finding productivity improvements (beyond the ambitious improvements already assumed in current plans) to allow them to provide the same services with fewer resources. One example of such adaptation is how the NHS in England slowed down growth in hospital activity to stay within budget in 2025–26 (Harvey-Rich and Warner, 2026).

For more demand-led spending where statutory responsibilities exist – on areas such as SEND and asylum – departments have less scope to reduce spending directly. Staying within the relevant budget (the Department for Education, after 2027–28, for SEND; the Home Office for asylum) in the face of growing costs would mean reallocating spending from other programmes within the department. Pupil numbers are expected to fall in the coming years, which could allow DfE to increase SEND funding while keeping per-pupil core schools funding flat in real terms (Sibieta, 2026). This is what has repeatedly occurred over the last decade (Farquharson et al., 2026) and what is likely to occur again when funding allocations are set for 2027–28 onwards. It could be harder for the Home Office to reprioritise within its budget given its other statutory duties – overspends in the early 2020s were mainly funded instead through the Treasury Reserve (Warner and Zaranko, 2024).

There is a strong rationale for requiring departments to manage some pressures that emerge within fixed budgets without top-ups. Doing so avoids reopening departmental spending settlements and the associated bargaining process, maintains the credibility of multi-year budgets, and preserves incentives for departments to control costs. But this does not make the underlying pressure disappear. Instead, public services in those departments hit by larger pressures bear more of the adjustment, rather than the government explicitly reconsidering exactly where any worsening of public service performance is to take place between departments.

The adjustment need not be left concentrated in the departments where pressures arise. Other options – while keeping unchanged the overall spending totals that were set for the years up to 2028–29 – are to reallocate money between departments, or increase individual departmental budgets using the Treasury Reserve. This would allow the government to choose more explicitly which services to protect, weighing reductions in other DfE activities (e.g. schools) to accommodate higher SEND costs, for example, against reductions elsewhere in government. That flexibility comes at the cost of some of the planning certainty and incentives provided by firm departmental budgets. Reallocation between departments could be more challenging for broad-based pay, inflation and public sector productivity pressures, which affect many departments simultaneously. The stated purpose of the Reserve – and its size – makes it inappropriate as a tool for meeting most of these pressures.

The nature of the problem changes after 2028–29. Detailed departmental allocations have not yet been set, so there are no existing departmental budgets to absorb a pressure. Instead, the government is yet to decide how to divide a fixed total between departments. Even before considering any of the pay, productivity or service-specific pressures discussed above, existing totals imply a squeeze for many public services.

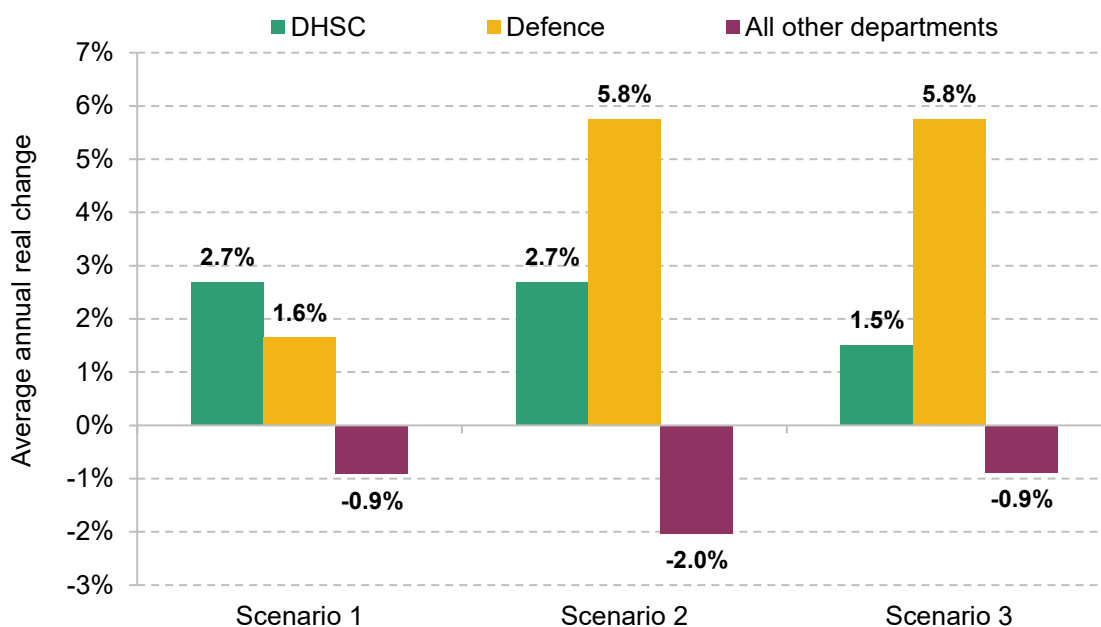
Growth in existing departmental envelopes is planned to slow in later years, with annual real-terms growth in total departmental spending between 2027–28 and 2030–31 set to average 0.9%. This relatively slow growth rate in spending will be challenging to allocate between different areas: health spending has tended to grow much more rapidly than this in recent history (Stoye, Warner and Zaranko, 2024); and as discussed in the previous section, there is clear pressure on defence spending in particular.

To illustrate the potential challenges posed by this relatively slow growth rate in overall departmental spending, we consider three broad spending scenarios. Figure 6.10 shows average annual real-terms growth rates between 2027–28 and 2030–31 in budgets for DHSC, defence

and other areas under these scenarios.²² In all cases, this is total departmental spending (both day-to-day and investment).

In Scenario 1, we assume that Department of Health and Social Care spending grows at 2.7% each year in real terms, in line with its settlement at the last Spending Review.²³ We also assume that spending on defence is held flat as a share of national income, consistent with plans in the Defence Investment Plan up to 2029–30 (implying average annual real-terms growth of 1.6%, in line with the OBR’s real GDP forecast). In this scenario, the combined budgets of other departments would need to be cut by an annual average of 0.9% in real terms. Some departments would likely still see budget increases, leading to even steeper real-terms cuts in other areas.

Figure 6.10. Scenarios for real-terms growth in departmental budgets between 2027–28 and 2030–31



Note: We here top up total Ministry of Defence spending by the amount implied in the Defence Investment Plan, and keep total departmental spending unchanged. ‘Defence’ refers to the Ministry of Defence and Single Intelligence Account (SIA) combined. Devolved spending through block grants is excluded from ‘All other departments’, as is the Reserve. Real-terms growth rates are calculated using the OBR’s GDP deflator forecast from March 2026.

Source: Authors’ calculations using the Office for Budget Responsibility’s Economic and fiscal outlook March 2026.

²² This uses expectations for the GDP deflator from the OBR’s March 2026 forecast – if inflation turns out higher, as discussed in Section 6.3, the implied real-terms cut to spending in all other departments would be greater.

²³ The growth rate planned at the Spending Review is higher than current expectations for growth in DHSC spending over this period, because of higher-than-expected inflation between the Spending Review and the OBR’s March 2026 forecast.

The squeeze on other areas would be greater if the government chose to increase defence spending faster. In Scenario 2, we assume that defence spending instead grows in line with the illustrative linear path discussed in Section 6.4, such that it reaches 3% of national income by 2030–31. This would mean annual average spending growth of 5.8% in real terms between 2027–28 and 2030–31.²⁴ If we continue to assume that real-terms health spending grows by 2.7% per year, the combined budgets of other departments face a much steeper average real-terms cut of 2.0% per year between 2027–28 and 2030–31.

Of course, the government could choose to slow health spending growth to help accommodate higher defence spending. Scenario 3 shows one way in which this could happen. In this scenario, the government increases health spending by only 1.5% per year in real terms between 2027–28 and 2030–31. This growth rate would be very low by recent historical standards, and would make the government's existing targets for NHS performance harder to achieve. Even with slower health spending growth, rising spending on defence would still leave other departments facing real-terms cuts on average from 2027–28 to 2030–31.²⁵

These scenarios illustrate the broader fiscal challenge entailed in increasing both health and defence spending simultaneously. For much of the post-war period, defence spending fell as a share of national income, a decline often referred to as a 'peace dividend' (Boileau and Warner, 2025). This fall allowed health spending to rise substantially over the same period without corresponding increases in the overall size of the state. If both health and defence spending are now to rise together, other areas are likely to be squeezed, or further upward pressure be placed on the size of the state.

Change planned total departmental spending

The Chancellor could instead choose to increase total departmental spending. This could be financed through lower spending elsewhere (e.g. cuts to benefits), higher taxes or additional borrowing. These choices are described further in Chapter 2 of this Green Budget. Top-ups could be motivated by various factors: in order to preserve public service performance as envisaged at last year's Spending Review in the face of cost or public sector productivity pressures; in order to fund new ambitions, such as for defence or social care; or in order to avoid the squeeze on public services towards the end of the parliament. Of course, the government could instead decide to cut departmental spending totals, as Rachel Reeves did at the Autumn

²⁴ We here assume a top-up comes against a baseline of all components of NATO-qualifying defence spending remaining constant as a share of GDP in 2029–30 and 2030–31. We assume the top-up is entirely to Ministry of Defence DEL (this is the way in which recent top-ups – for example, the top-up alongside the Defence Investment Plan – have happened).

²⁵ Because the defence path in Scenario 2 raises spending in earlier years, Scenario 3 also slows health spending growth in earlier years to keep totals unchanged.

Table 6.2. Illustrative top-ups to total departmental spending to compensate for emerging pressures or to fund new ambitions, 2028–29 to 2030–31

Scenario	2028–29 (£ billion)	2029–30 (£ billion)	2030–31 (£ billion)
High public sector pay: scenarios relative to March 2025 expectations			
2026–27 pay awards, then pay growth in line with independent earnings forecasts from August 2026	8–11	8–11	8–11
Inflation follows the OBR's March 2026 GDP deflator forecast	3	3	3
Inflation follows scenarios based on August 2026 independent forecasts	8–14	8–15	8–16
Other illustrative pressures and ambitions			
Meet SEND costs if recent trends in EHCP rates continue*	3	Not estimated	Not estimated
Raise defence spending from 2.7% to 3% of GDP by 2030–31	3	7	11
Fund top-ups to get defence spending to 2.7% of GDP, consistent with the Defence Investment Plan	1	1	1
its 2027–28 real level, with annual real average health growth of 2.7% and defence constant as a share of GDP (at 2.7%)	3	9	9

* SEND pressures are not estimated after 2028–29, as policy changes significantly at this point (see Section 6.3).

Note: 2028–29 figures are generally higher than the numbers quoted in earlier sections as Barnett consequential of top-ups are included. Illustrative totals cannot be derived from the table information alone, as some compensation for public sector pay and productivity pressures would go to defence budgets, and so reduce the additional funding required to reach the illustrative defence target. Inflation here refers to the GDP deflator. Productivity and public sector pay pressures are grown with RDEL growth to estimate figures in 2029–30 and 2030–31. Inflation pressures are calculated in each year using the OBR's March 2025 long-term economic determinants (available at <https://obr.uk/efo/economic-and-fiscal-outlook-march-2025/>). Social care reform is not included in the table as the precise design of reform is not yet known and has large implications for cost.

Source: Authors' calculations.

Budget last year. If it did this, the government should set out where it expects departments to do less, or how existing pressures can be mitigated through other means.

Table 6.2 brings together estimates of the additional departmental spending that could be required to compensate departments for the pressures discussed above or to fund new government ambitions. These are not forecasts of how much spending needs to increase, and the rows cannot simply be added together (as some are alternative scenarios and some overlap). Rather, they illustrate the scale of the choices facing the Chancellor at this Budget and at the next Spending Review. Some of these top-ups would fall on capital rather than day-to-day budgets – parts of the inflation and defence top-ups, in particular. They therefore would not translate one-for-one into a reduction in headroom against the government’s fiscal rule that it must be running a current budget surplus in 2029–30 (i.e. that revenues must exceed day-to-day spending).

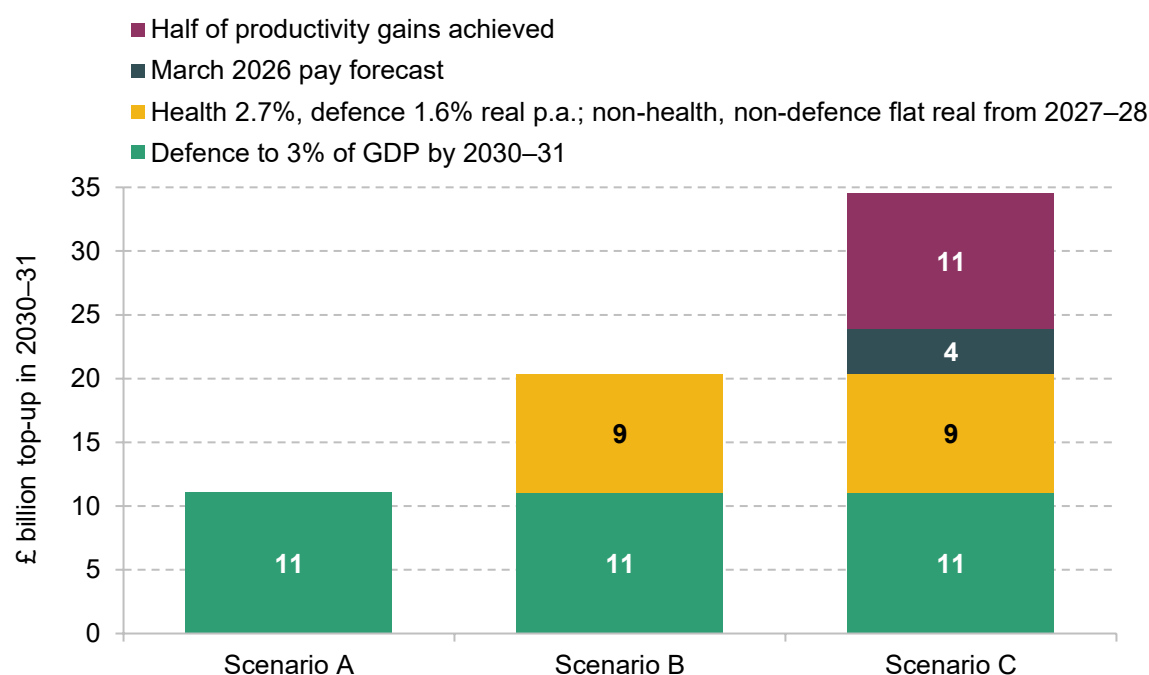
Potential top-ups could be sizeable in the final year for which detailed budgets are allocated, 2028–29. Compensating departments if only half of planned productivity improvements materialised could require around £11 billion. For non-pay inflation, compensation for the increase forecast by the OBR between March 2025 and March 2026 could require £3 billion; under more recent forecasts for inflation, this could rise to between £8 and £14 billion.²⁶ Higher-than-anticipated public sector pay growth in 2026–27 could require £4 billion in compensation if subsequent pay grew according to the OBR’s March 2026 forecast, or between £8 and £11 billion if it followed more recent forecasts for whole-economy earnings growth. Compensating DfE for faster growth in SEND spending than expected could add around £3 billion.

Many of these pressures would carry into 2029–30 and 2030–31. A higher level of public sector pay permanently raises the paybill; a failure to achieve planned productivity improvements leaves departments needing more inputs to deliver a given level of public services; a permanently higher price level reduces cash budgets’ purchasing power in future years. In later years, the Chancellor also faces the planned slowdown in departmental spending growth. If the government wanted to keep defence spending constant at 2.7% of GDP, increase health spending by 2.7% per year in real terms (in line with its settlement at the last Spending Review), and avoid real-terms cuts to other departments, it could need to top up overall departmental spending by £9 billion in 2030–31. Funding a rise in defence spending to 3% of GDP in 2030–31 could mean a further £11 billion of departmental spending in 2030–31.

²⁶ Keeping the real-terms value of *total* departmental budgets the same as implied by March 2026 forecasts would require top-ups of £8–18 billion in 2028–29, £8–20 billion in 2029–30 and £9–21 billion in 2030–31, based on August 2026 independent forecasts. Maintaining their value at the level implied by March 2025 forecasts would require top-ups of £13–23 billion in 2028–29, £13–25 billion in 2029–30 and £14–26 billion in 2030–31.

While these different pressures and ambitions cannot all straightforwardly be added together, illustrative combinations show how quickly the numbers can grow. Increasing defence spending to 3% of GDP in 2030–31 could require around £11 billion more defence spending in that year relative to holding spending constant as a share of national income (Scenario A in Figure 6.11). If health spending were additionally increased in real terms by 2.7% per year, holding the combined budgets of other departments flat in real terms over the next Spending Review period would require a further £9 billion. Together, these choices imply around £20 billion of additional spending in 2030–31 (Scenario B in Figure 6.11).

Figure 6.11. Scenarios for departmental top-ups in 2030–31



Note: As for Table 6.2. Pay and productivity numbers are slightly lower as they exclude parts of the top-up that would otherwise go to the Ministry of Defence or Single Intelligence Account budgets. The 1.6% average annual real growth for defence is consistent with spending on defence being held flat at 2.7% of national income.

Source: Authors' calculations.

That would still leave departments to absorb the pay, price and productivity pressures examined in Section 6.3. The government could also choose to compensate departments for higher-than-expected pay growth, which would imply an additional £4 billion in 2030–31 if pay were to grow by the 2026–27 pay awards, then as forecast by the OBR in March 2026. If departments only achieved half of planned productivity gains, the government would need to top spending up by an additional £11 billion in 2030–31 to keep service quality unchanged. Other combinations of pressures could justify top-ups of a similar order of magnitude to this £15 billion figure for pay and productivity: for example, compensating departments for a higher pay scenario combined with non-pay inflation changes between March 2025 and 2026, or just for the higher

end of August 2026 inflation forecasts alone. Additional top-ups of this size, on top of the defence and health scenarios above, would imply a total top-up of around £35 billion (Scenario C in Figure 6.11).

Topping up departmental budgets to compensate them for emerging pressures and new policy priorities could therefore amount to tens of billions of pounds by 2030–31. Even top-ups of this scale would not leave departmental spending growing particularly fast between 2025–26 and 2030–31 by historical standards. Topping up total departmental spending by £35 billion in 2030–31 would mean average annual real growth over this period of 2.3%, very close to average annual growth in total departmental spending between 1998–99 and 2025–26 of 2.4%.

6.6 Conclusion

The Chancellor faces difficult choices at the Autumn Budget. Emerging pressures against departmental budgets, the sharp slowdown in planned spending growth in later years, and the costs of new ambitions all make inherited plans harder to deliver. He must decide how far to revise existing departmental budgets in response, and what day-to-day and capital spending totals to set up to 2031–32. If the inherited spending framework is retained, this Budget will finalise the spending totals which next year's Spending Review will allocate to departments, making these choices particularly consequential.

The Chancellor need not settle every detail about departmental spending this autumn. But he should explain how the government's broad ambitions for public services can be delivered within the spending totals set. If inherited spending totals are not revised, he should signal where he intends the resulting squeeze to fall in the coming years. If he already expects to increase spending for next year's Spending Review, that increase should be reflected in the totals set at the Budget. Postponing the increase until next year would understate future spending and present an unduly favourable picture of the public finances. Plans for the public finances that rest on spending totals inconsistent with the government's own ambitions for public services are unlikely to be seen as credible.

The amounts at stake are potentially large. Under our illustrative scenarios, raising defence spending to 3% of national income by 2030–31, increasing health spending by 2.7% annually in real terms, and avoiding a real-terms squeeze on departments outside defence and health over the next Spending Review period could require a top-up of around £20 billion in 2030–31. The number rises to around £35 billion if departments were also compensated for plausible pay and productivity pressures. A top-up of this size is not inevitable: the government could instead ask departments to absorb pressures or reprioritise within services, or it could scale back ambitions for public services. But the underlying trade-offs cannot be avoided. The central choice, and one

that the Chancellor should make explicitly in the autumn, is where the adjustment should fall: within public services, elsewhere in government spending, or through higher taxes or borrowing.

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7. Options for reforming personal independence payment

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Personal independence payment (PIP) is the main working-age disability benefit in England and Wales. Eligibility is based only on whether someone has difficulty carrying out daily tasks – it is not means-tested on income or wealth, nor linked to work status. In this chapter, we use the term ‘disability benefits’ to refer to PIP and disability living allowance (DLA) – an equivalent benefit that PIP has gradually replaced for working-age adults since 2013.

The government has set up a review – the Timms Review – which is working with disabled people to make recommendations, due this autumn, on the design of the disability benefit system. The Timms Review has declared the current system ‘no longer fit for purpose’ and is exploring structural changes to how eligibility for the benefit is assessed and what type of support recipients receive. It has committed to only make recommendations that leave spending on disability benefits in line with or below the current forecasts for spending. The government may choose to implement some reforms to the disability benefit system at the Budget.

This chapter outlines what is known about the effectiveness of the current disability benefit system and the experiences of recipients and it explores potential options for reforming the structure of disability benefits. We focus on the question of how to structure the system rather than on how much to spend on the system. The structural reforms we study would either leave total spending unchanged or reduce spending if implemented in isolation. However, each reform could be combined with changes in the amount provided per claimant to achieve any level of total spending on the system. For example, a reform that reduced eligibility could be combined with an increase in award amounts to leave total spending unchanged.

Key findings

1. **The share of 16- to 64-year-olds claiming disability benefits increased from 5.5% in August 2019 to 8.2% in August 2025.** There have been large increases across all ages and health conditions, with the fastest proportional increases for claims relating to mental health, learning and neurodevelopmental conditions and claims from younger adults.
2. Rising numbers of people claiming disability benefits has pushed costs up. **Spending on working-age disability benefits has risen in real terms from £14 billion in 2019–20 to £25 billion in 2025–26.** This, combined with rising spending on other health-related benefits, is the main reason that total benefit spending on working-age adults and children rose from 4.3% of GDP in 2019–20 to 4.7% of GDP in 2025–26 (from £127 billion to £148 billion in today's prices). This puts total working-age benefit spending as a share of GDP around the level it was at in 2015–16. Disability benefits now make up a much greater share of total benefit spending on working-age adults and children – 21% now, up from 11% in 2015–16. Official forecasts suggest working-age disability benefit spending will rise further to £34 billion in 2030–31 (1.0% of GDP and 26% of non-pensioner benefit spending).
3. **PIP claimants are more likely to report struggling to afford essentials than both disabled people who do not claim PIP and non-disabled people.** 51% of PIP claimants are in 'material deprivation' (meaning they report being unable to afford five or more basic essentials out of a list of 21 items), higher than the share of people with disabilities who do not claim PIP (33%) and much higher than the same figure for people without disabilities (15%). Those who claim PIP tend to have lower household incomes than those without disabilities, which explains part of the difference, but substantial gaps remain even when comparing households with the same incomes. One reason for this could be that people with disabilities have higher living costs. These gaps in material deprivation provide one rationale for benefits that provide additional income to people with disabilities.
4. **PIP claimants are also more likely to report low life satisfaction than both disabled people who do not claim PIP and non-disabled people.** 26% of PIP claimants report low levels of life satisfaction, compared with 16% of disabled people not claiming PIP and 4% of people without disabilities. Again, gaps remain when comparing people with similar levels of income. This could be driven by disabled people having higher living costs, or because of other impacts of having a disability on

well-being. Another reason that governments may want to provide additional support to disabled people is to improve their well-being. If this is the government's priority, it should look to provide the most cost-effective support to improve well-being for disabled people. This could be providing cash in some instances, but it also may be providing in-kind support such as therapy, which has been shown to improve well-being for people with mental health issues.

5. **PIP currently gives the same amount of money to people with very different levels of assessed disability.** PIP assessments assign 'points' to applicants, based upon the number and severity of difficulties they have with daily living activities and with mobility. To get the highest daily living component of PIP (currently worth £5,960 per year), claimants need to score 12 or more points. 53% of claimants reach this threshold, and 26% of claimants get 16 points or more and 5% get at least 31 points – yet these claimants all receive the same benefit amount. There is a case for tying support more closely to the degree of disability. If done using the current PIP assessment, this would particularly benefit younger claimants and claimants with learning disabilities or cerebral palsy, who are particularly likely to score a very high number of points.
6. Currently, assessors award PIP based on an assessment of the applicant's difficulties doing certain tasks. One potential reform would be to also require specific medical diagnoses to qualify. This would introduce an extra, potentially more objective, check on the disability of the claimant. However, requiring *any* medical diagnosis would only have a modest impact on the number of people who are eligible because **85% of PIP claimants already report having a medical diagnosis and 69% report having multiple diagnoses for different conditions** – and these figures would likely rise if PIP receipt required a diagnosis. Alternatively, the government could restrict PIP eligibility to just a subset of medical diagnoses, which would deliver bigger savings, at the cost of more people losing access to PIP. Making PIP conditional on medical diagnoses could remove some of the subjectivity of the current assessment, although medical diagnoses also often require some subjective judgement. It would also put additional costs on both applicants and the health system and may push more people to seek private diagnoses for health conditions.
7. Another commonly discussed option is for PIP to treat mental and physical health conditions differently, perhaps substantially reducing entitlements for the former. Administrative data show that 45% of existing PIP claimants have, when assessed, a mental health condition or a learning or neurodevelopmental condition listed as their *main* disabling condition. One way of restricting access to PIP for those with mental health conditions would be to require that claimants have a physical health diagnosis.

This would significantly reduce the cost of PIP. However, these savings are both uncertain and likely far smaller than that 45% headline might suggest, for two reasons. First, **two-thirds of claimants with a diagnosis for a mental health, learning or neurodevelopmental condition** (irrespective of whether it is the ‘main’ condition) **also report a physical health diagnosis**. Second, **more claimants would likely obtain a physical diagnosis if it was a requirement for PIP receipt**. If the government wanted to make bigger savings, it could restrict access only to those with certain physical health diagnoses.

8. The government could reduce the generosity of the disability benefit system specifically for young people, perhaps if it considers any negative effects of receiving these benefits to be larger for those who have a whole working life ahead of them. **There are 689,000 people under 30 who claim PIP (20% of the total working-age PIP caseload), accounting for £5.5 billion per year in spending.** However, young PIP recipients are disproportionately likely to have the most severe disabilities; 12% of 16- to 19-year-old recipients receive at least 31 points in the PIP daily living assessment, compared with 5% among all PIP recipients. If policymakers wanted to keep providing PIP for young people with more severe disabilities (proxied as those who get the highest possible award) while removing it for others, the impact on the caseload and spending would fall to 327,000 and £2.2 billion respectively, before accounting for any behavioural responses.
9. One unusual feature of PIP relative to other benefits is that it is not means-tested, so high-income households can claim it. If the main goal of the benefit is to reduce inequalities arising from disability, there is a good case for keeping PIP as a non-means-tested benefit. Alternatively, if greater weight is placed on ensuring that disabled people can obtain a minimum standard of living, there is a stronger argument for means-testing PIP – something recently proposed by Reform UK, though the Timms Review has indicated it will recommend keeping PIP non-means-tested. **Means-testing PIP, by integrating it into universal credit, would deliver a saving of £8.2 billion (33% of PIP spending) if claimant behaviour did not respond to the change.** However, in reality, the saving will be somewhat smaller due to behavioural responses. In response to the change, more people would claim universal credit in order to keep their PIP, and fewer people would work as the reform would weaken work incentives.

7.1 Introduction

Since 2019, there has been a big increase in the number of people claiming personal independence payment (PIP) or equivalent legacy benefits. PIP is a cash payment with the stated purpose of providing additional income to cover extra living costs faced by disabled people. In August 2025, 8.2% of people aged 16–64 in England and Wales claimed disability benefits, up from 5.5% in August 2019.

More people claiming a disability benefit has led to increased spending on them. Spending on working-age adults increased from £14 billion in today's prices in 2019–20 (0.5% of GDP) to £25 billion in 2025–26 (0.8% of GDP). Spending is forecast to increase further to £34 billion by 2030–31 (Department for Work and Pensions, 2026c). Disability benefits now make up a much greater share of total benefit spending on working-age adults and children – 21% now compared with 11% in 2015–16. Rising spending on these benefits is one of several factors putting upward pressure on total public spending. Cuts to disability benefits would be one way the Chancellor could reduce the broader pressures on the public finances (see Chapter 2 of the Green Budget).

In response to these trends, the government announced its intention to reform PIP. It has commissioned the Timms Review of PIP, which is being co-produced with disabled people. In its interim report in July, the Timms Review declared that PIP was ‘no longer fit for purpose’, and it is due to make recommendations on the future disability benefit system in a final report in the autumn. The government has also commissioned a review into the employment and education outcomes of 16- to 24-year-olds (the Milburn Review), which is also due to report this autumn and could include recommendations about PIP for people aged under 25 in particular. The Chancellor may choose to propose reforms to PIP at the Budget.

The government faces a choice over both how much to spend on disability benefits in total and how to distribute that spending to different people. In this chapter, we discuss a range of potential options for changing the structure of the disability benefit system inspired by proposals made by commentators, political parties and systems in other countries. We focus primarily on the question of how to distribute a given level of spending, but we also briefly discuss options that could reduce total spending.

PIP has three key features that distinguish it from other health-related benefits. First, it is not means-tested: the amount you can claim does not vary based on your other income. Second, you can apply for it while in or out of work. Third, claims for it are assessed based on applicants' ability to do day-to-day activities such as washing themselves or preparing food, rather than on their ability to work. Disability living allowance (DLA), which PIP has gradually replaced since 2013, shares a similar structure. Throughout this chapter, we will refer to PIP and DLA jointly as

‘disability benefits’, and spending or caseload numbers will include claimants of either benefit unless otherwise stated.

Any reform to PIP should consider it in combination with the other types of support available to disabled people. There are other health-related benefits, most notably incapacity benefits, the biggest of which is the health element of universal credit. The rationale for incapacity benefits is to support people whose disability limits their ability to work. Accordingly, most incapacity benefits are means-tested, applicants need to be out of work (or working limited hours) to apply for them and they are awarded based on an assessment of how the applicant’s disability affects their ability to work. People can claim both incapacity and disability benefits, and around half of those who claim either type of benefit also claim the other. There has been a big increase in claims for and spending on incapacity benefits since the COVID-19 pandemic, but in this chapter we focus on options for disability benefits as they are the focus of the Timms Review.

Many disability benefit recipients also receive state support for their health conditions from the adult social care system or from the healthcare system. Young adults could also be getting support for their special educational needs through the education system. While considering how to reform the disability benefit system, the government needs to account for interactions across these different systems, look for ways of joining up support and consider whether it is providing the right balance of support for disabled people.

In this chapter, we focus on the disability benefit system in England and Wales. Since 2020, disability benefits have been devolved to Scotland and the Scottish Government has replaced PIP with the adult disability payment (ADP), which functions in a similar way but with a different assessment system.¹ Any reforms to disability benefits in England and Wales would not directly affect the disability benefit system in Scotland, but reforms that affected the amount spent on disability benefits could alter total funding for the Scottish Government.² Disability benefits are also devolved in Northern Ireland, but in practice the Northern Irish system matches the system in England and Wales almost exactly.

We also restrict our attention to working-age PIP claimants. Under-16s and pensioners are not eligible to apply for PIP and instead can apply for alternative disability benefits (child disability living allowance for under-16s, attendance allowance for pensioners). However, if someone is claiming PIP when they reach pension age, they can continue to receive PIP (instead of

¹ For details on how ADP differs from PIP and how it has affected claimants, see Judge and Murphy (2025) and Adam et al. (2026).

² Any reform that increased total spending on disability benefits in England and Wales would automatically increase funding for the Scottish Government, and vice versa for a reform that reduced total spending. The Scottish Government could then decide what it spent that money on or where it reduced spending, which could but does not have to include disability benefits in Scotland.

attendance allowance). In this report, the numbers we quote do not include pension-age PIP claimants, of which there are 697,000 currently.

The rest of the report is structured as follows: Section 7.2 explains how PIP currently works and highlights some issues with the way eligibility is currently assessed, Section 7.3 describes who claims PIP and documents recent trends in claimant numbers, Section 7.4 discusses what government might be trying to achieve with a disability benefit, Section 7.5 examines some options for policy changes to PIP and Section 7.6 concludes.

7.2 How does PIP currently work?

In this section, we summarise how PIP currently works and some of the challenges with the current system.

PIP has two components: a ‘daily living’ component and a ‘mobility’ component. The daily living component is assessed based on the applicant’s ability to do various day-to-day activities and the mobility element is assessed based on the applicant’s ability to get around.

How are new applications to PIP assessed?

To apply for PIP, an applicant needs to go through a multi-stage process. First, they phone the Department for Work and Pensions (DWP) to register their interest in applying.³ Second, they fill in a form, either online or on paper, which details how their condition(s) affects them, which they must provide evidence to support. For those with the most severe conditions, the government might judge this form to be sufficient evidence and then allocate them an award without further assessment.⁴ Otherwise, the applicant is invited to a face-to-face or virtual assessment where an assessor asks for more evidence to support the individual’s claim. The assessment process itself is costly: assessments currently cost on average £326 each (National Audit Office, 2023), or £0.2 billion per year in total (around 1% of spending on awards). The government then decides whether to award the applicant PIP and what level of PIP to award them.⁵

The government assesses PIP applicants based on their ability to do various activities. The daily living component is assessed based on 12 activities. For example, one activity is ‘preparing food’, where applicants are given scores depending on whether they can prepare and cook food

³ This first stage is available online in some trial areas.

⁴ These paper-based assessments make up around 16% of all assessments from July 2024 to September 2025. This includes both first-time assessments and reassessments.

⁵ After this decision, claimants have the option of pursuing a two-stage appeal process where applicants can first apply for their claims to be reassessed by the DWP and then take their case to tribunal.

(either unaided, with help or not at all, with the score increasing in how much assistance they need). The mobility component is scored on only two activities: applicants' ability to 'plan and follow journeys' and applicants' ability to 'move around'. These questions are thus not directly linked to whether the applicant has a given medical condition but instead seek to assess the functional impairment that an applicant has overall. Each of the activities requires subjective judgements on the part of the assessor and applicant as to their ability to do various activities and, as we discuss later, this leads to arbitrary variation in assessment scores across assessors.

How much money do PIP recipients get?

For either element, recipients can receive a standard or enhanced award, depending on their score on each part of the assessment; recipients can also receive both the daily living and the mobility component. Table 7.1 shows the distribution of awards amongst PIP claimants in November 2025. While the average amount received is £7,420 per year, 37% of claimants received both the enhanced daily living component and the enhanced mobility component, leading to a total award of £10,120 a year.

Table 7.1. Share of PIP claimants aged 16–64 receiving different awards and the annual amounts

		Mobility award (annual amount)		
		Nil (£0)	Standard (£1,580)	Enhanced (£4,160)
Daily living award (annual amount)	Nil (£0)	N/A	2% of claimants £1,580 total award	2% of claimants £4,160 total award
	Standard (£3,990)	16% of claimants £3,990 total award	15% of claimants £5,560 total award	12% of claimants £8,150 total award
	Enhanced (£5,960)	4% of claimants £5,960 total award	12% of claimants £7,530 total award	37% of claimants £10,120 total award

Note: England and Wales only. Includes a small number of disability living allowance claimants aged 16–64. Rounded to nearest £10. Totals may not sum due to rounding. Shares of claimants are as of November 2025, and award amounts are as of 2026–27.

Source: Authors' analysis of Department for Work and Pensions Stat-Xplore data for November 2025.

Applicants' experience of the assessment

Many applicants to PIP report concerns, worries or negative experiences relating to the assessment process. A common complaint is that the process requires a lot of work from the applicant to evidence their claim. One Timms Review respondent said: 'It is an extremely long-winded and unnecessarily complex process, which places additional stress on individuals who are already vulnerable'. In a survey of people considering applying to PIP, just over half

reported having worries about applying, and 11% worried that the application would be too difficult (Barry et al., 2018).

Another common complaint is that the assessment feels inquisitory rather than supportive. One respondent to the Timms Review said: ‘I felt like I was being cross-examined, not supported. Every answer I gave felt like it was being used against me’. In a survey of applicants going through an assessment, nearly a quarter of applicants reported that the assessor did not listen to them (Barry et al., 2018). All else equal, clearly the government should try to improve applicants’ experience of the assessment, though it will need to weigh this up against other objectives such as the accuracy of the assessment, clarity of the assessment criteria and costs of carrying the assessments out. The Timms Review’s ‘emerging recommendations’ in September 2026 suggest a number of reforms designed to improve the experience of applying for PIP, such as making the forms easier to complete and providing advocacy services for claimants who struggle to articulate the effects of their condition (Department for Work and Pensions, 2026d).

The design of the application process also affects who applies for PIP. The more time-consuming and difficult the application process is, the fewer people are likely to apply. This effect reduces the fiscal cost of the scheme, by reducing both the number of assessments, which are costly in themselves, and the number of actual awards.

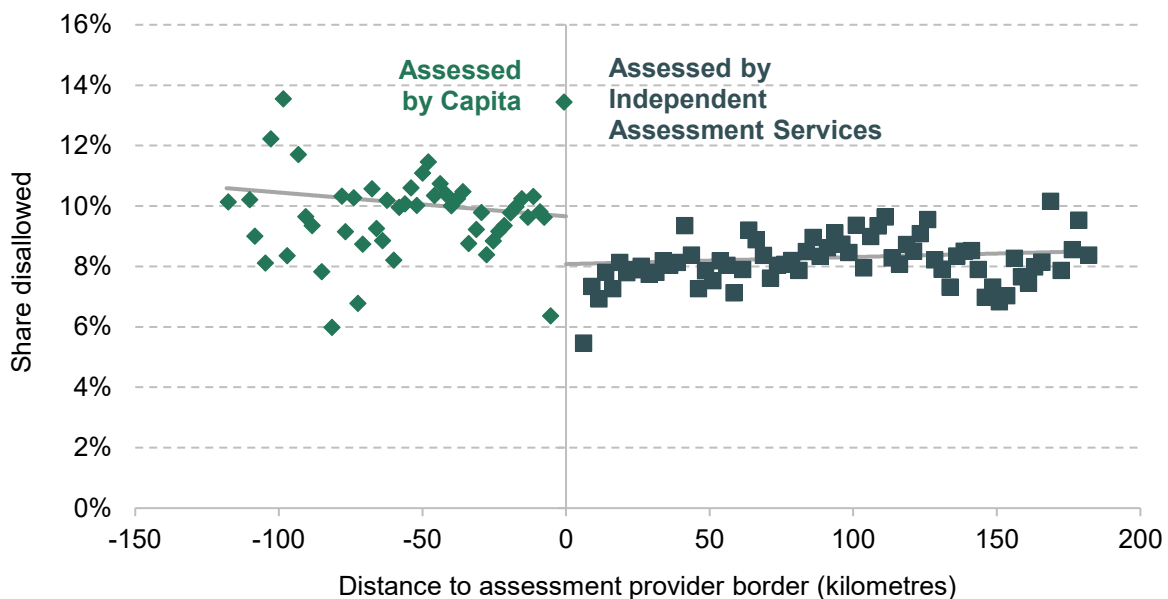
A crucial question is who gets ‘screened out’ from applying by these sorts of barriers, and how likely they would be to be accepted if they had applied. When the US Social Security Administration closed field offices in the US where claimants could get support to apply for disability insurance, fewer people applied and those dissuaded from applying were on average more disabled than the typical applicant (Deshpande and Li, 2019). In contrast, when the UK government trialled an online form for applying for PIP, applications increased by 27%, but these additional applications were much less likely to be accepted than the average applicant (Department for Work and Pensions, 2026b), suggesting that those screened out by the previous application process typically had lower levels of need than those who would have applied anyway. If it is considering reforming the assessment process, the government should therefore consider the effects of changes on who applies for PIP.

Inconsistency in assessment outcomes

Another key consideration in the design of the disability benefit system is the extent to which the test can consistently and correctly assess people. This matters both because the government presumably wants to treat people who are similarly impacted by their conditions similarly, and because targeting is worse if the system is noisy (some people who the government wants to get support may miss out, or people who the government does not want to get support may receive it).

Figure 7.1 shows an example of the noise in the PIP assessment by examining one source of this inconsistency: which of the two PIP assessment providers handles the application. Those who live in the Midlands, Wales and Northern Ireland are assessed by Capita, while those who live in the South or North of England or Scotland are assessed by Independent Assessment Services (IAS). We compare the experiences of those being assessed either side of the southern border between the two providers, between the Midlands and the South. Since differences in the application process between providers could alter who decides to apply in the first place, we include only reassessments of people who previously claimed DLA, the disability benefit that PIP replaced.⁶ All DLA claimants were automatically reassessed as part of the transition to PIP, and so should be comparable across the border. Instead, we find that those who lived just on the Capita side of the border had around a 9.7% chance of being rejected, whereas those who lived just on the IAS side had an 8.1% chance (a 1.6 percentage point difference or, in proportional terms, a 20% difference). This is evidence that there are different interpretations of the assessment process across the providers and this leads to arbitrary variation in treatment of applicants.

Figure 7.1. Border discontinuity in disallowance rates for DLA to PIP reassessments across two assessment providers for PIP



Note: Analysis of southern border between Capita and Independent Assessment Services. Includes all DLA to PIP reassessments carried out in 2013–25. Estimated difference is based on difference in fitted line either side of the border. Each point represents a Middle Layer Super Output Area, an area containing between 2,000 and 6,000 households.

Source: Authors' analysis of Department for Work and Pensions Stat-Xplore.

⁶ Assessments for DLA did not vary on either side of this southern border.

This is evidence of variation in treatment between assessment providers, but it is likely that there is also variation between the individual assessors employed by each provider. One piece of evidence for this is that unsuccessful applicants can apply to ask a second assessor to review their application.⁷ When this occurs, 15% of initially rejected applications are awarded PIP following review. While some of these overturned decisions occur because the applicant provides more evidence as part of their appeal, some of these decisions are likely overturned simply due to differences in interpretations across assessors. Evidence suggests there is considerable variation between assessors for disability-related benefits in the US, for example (Maestas, Mullen and Strand, 2013; French and Song, 2014).

This inconsistency in how claimants are assessed weakens the case for having a disability benefit system. Imagine an extreme case where the disability benefit assessment is purely random, and so someone with a severe disability and someone with no disability have the same probability of being accepted onto the benefit. In this case, there would clearly be little point in having a disability benefit system, since the government cannot target money to those with a disability. Conversely, if the disability benefit assessment can accurately differentiate between people with more or less severe disabilities, policymakers can target greater resources towards those with greater levels of disability.

There may be things the government could do to reduce the variability of assessments, and indeed the Timms Review's 'emerging recommendations' suggest several reforms along these lines. Some may be relatively low-cost – for instance, introducing a framework for assessments to improve consistency across assessment providers. However, others (not included in the 'emerging recommendations') – such as collecting more information from applicants and perhaps making the assessments longer – may lead government to incur greater direct costs. Such reforms may also make the assessment more intrusive or demanding for applicants. The government should weigh these costs against the benefits of more accurate assessments.

The degree of noise and variation in the PIP assessment may vary between people with different conditions and different levels of severity. For example, some types of conditions may receive more consistent assessment than other types of conditions, even in a functional assessment that asks the same questions of all applicants. All else equal, the government may want to offer higher payments to groups of applicants for whom the assessment is more reliable, as there will be less risk that they are receiving more support than the government intends. This is one reason to potentially treat mental and physical health conditions differently, something we examine in more detail in Section 7.5.

⁷ This is referred to as a 'Mandatory Reconsideration'.

How much can applicant behaviour change awards?

It is possible that applicant or assessor behaviour might change in response to changes in the assessment criteria. At its most extreme, this could be fraud, in which someone reports a health condition or functional disability that they do not actually have or exaggerates a condition to cross a threshold within the PIP assessment.⁸ More benignly, applicants will put more effort into providing evidence to meet the criteria of the assessment the more important it is. For instance, medical evidence that supports an applicant's account can strengthen a PIP application. Getting this evidence requires effort and, in some instances, financial cost on the applicant's part. The more important this evidence is for the result of the application, the more effort an applicant is likely to put into providing that evidence.

The scale of behavioural responses to assessment criteria is difficult to measure directly; we do not have a good measure of functional disability other than the one in the PIP assessment. However, during the transition from DLA to PIP, there was strong evidence of a behavioural response among those with lower levels of disability. The DLA daily living component had three levels.⁹ PIP retained only the middle and upper levels. Modelling conducted by the government prior to the transition projected that it would reduce spending by 27% and the working-age caseload by 28%, mostly driven by people with the lowest daily living award under DLA receiving nothing under PIP (Office for Budget Responsibility, 2019). This initial modelling was based on trial assessments, which were carried out without any stakes for the applicants – they did not determine award amounts – and so did not account for incentive effects on claimant behaviour. If anything, the reform increased spending (Office for Budget Responsibility estimates suggest by 15–21%), likely in part because applicants responded to the reforms by better tailoring their applications to the PIP criteria than the initial modelling suggested they would. This example suggests that claimant behavioural response to changes in assessments can be significant.

Basing the assessment on more verifiable information would limit the scope for claimant behaviour to affect awards, but this would have to be traded off against the risk of denying support to people who have severe but difficult-to-verify limitations.

⁸ There is little evidence about the scale of fraud in disability benefit claims. The government does carry out random audits of existing claimants, which record low levels of fraud (1.4% of spending audited in 2025–26 was found to be fraudulent). However, these audits only test whether claimants have failed to report changes in their circumstances rather than whether they initially misrepresented their condition at assessment. Fraud, by its very nature, is difficult to measure.

⁹ This was in fact known as the 'care' component under DLA, but it was similar in spirit to PIP's daily living component.

When are PIP claimants reassessed?

Most claimants for PIP are periodically reassessed (formally, ‘reviewed’).¹⁰ When that reassessment takes place depends on the outcome of their initial assessment. Those assessed to have a more changeable health condition can be reassessed as soon as three years after their initial assessment, whereas those with severe conditions that the government judges unlikely to change are given only a light-touch review after ten years. For claimants who get a full review, the government sends them another form to detail how their condition(s) affects their ability to do day-to-day activities and then can ask them to attend another in-person or virtual assessment.

The government faces a difficult decision in setting the frequency of reassessments. 18% of planned reassessments end in claimants losing access to PIP, and for another 25% the amount they receive changes (either increasing or decreasing). Each reassessment comes at an administrative cost for the government and requires effort on the part of claimants, who often describe the process as unpleasant. There are also operational limits to the number of reassessments that providers can currently carry out. Indeed, the default review period was recently increased from two years to three to reduce operational pressures on the assessors. The other side of the trade-off is that more frequent reassessments mean that support is more closely linked to claimants’ existing conditions.

Lessons from the current system for any proposed reforms

A potential pitfall for policymakers when considering reforming PIP is to consider the question ‘Who do we want to target resources towards?’ and not ask two other important questions: ‘How well can any assessment process identify those we want to target resources towards?’ and ‘How does the assessment process itself affect the well-being of applicants?’. The evidence from this section shows that there are three key issues with the PIP assessment: some applicants find it difficult or stressful; there is arbitrary variation in the treatment of similar claimants; and the assessment criteria are to some degree subjective, leading to the risk that applicants’ behaviour can affect the outcomes of their assessment. While it is unlikely any of these issues can be entirely avoided, any proposal for reform should consider how the new system compares on these issues relative to the current system.

¹⁰ In this section, we use reassessments to refer to award reviews of ongoing PIP reviews. This does not include reassessments from DLA to PIP.

7.3 Trends in disability benefit claims

In this section, we document who claims disability benefits, look at how this has changed over time and review what is known about potential causes of recent changes.

Who are PIP claimants?

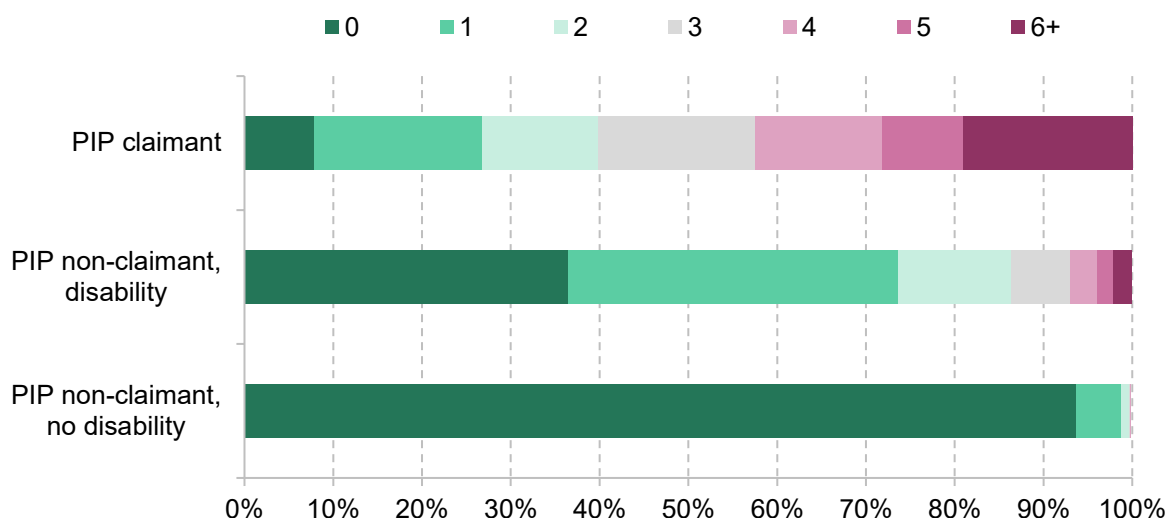
Severity of disability

There are many different definitions of disability. The most commonly used one is the Equality Act definition that to have a disability someone must have a condition that lasts or is expected to last 12 months or longer that limits their day-to-day activities. In 2024, 22% of working-age adults in England and Wales reported a disability based on this definition.¹¹ The share of people reporting a disability in the UK has risen to record highs according to most data sources, though there are differences across sources, and some even suggest that there has not been an increase (Latimer, Ray-Chaudhuri and Waters, 2025).

Although 22% of working-age adults reported a disability in 2024, only 7.5% of working-age adults claimed PIP (or an equivalent benefit). This suggests that a majority of those who report having a disability are not claiming disability benefits. Someone who reports a disability might not claim disability benefits for two reasons. First, their disability may not be sufficiently severe or not limit their day-to-day activities in the kinds of ways the PIP assessment tests for, meaning they are ineligible for PIP. Second, they might not apply for PIP despite being eligible, because they choose not to or because they are not aware of the benefit or that they would be eligible for it.

In order to assess the severity of disability among PIP claimants and compare it with other disabled people and the broader population, we use Understanding Society, a representative survey of UK households. As a proxy for the severity of disability, we use a set of questions asking whether respondents experience difficulties in a range of different areas (mobility, manual dexterity, personal care, etc.) and count the number of areas in which they have a difficulty. This list is similar to, but not the same as, the questions asked in the PIP assessment, so it is possible that some differences reflect this distinction. Answers to these questions, as well as benefit receipt itself, are self-reported in the survey. Some PIP recipients may not mention when surveyed that they receive the benefit, creating some measurement error. Readers should therefore focus on the broad relationships rather than the specific figures in this analysis.

¹¹ The figure for the percentage of people reporting a disability is from the Family Resources Survey. The questions used in the survey do not exactly match the Equality Act definition of disability, though they are a good approximation of it. We will use the Equality Act definition of disability throughout this chapter. The figure for the percentage of people claiming disability benefits is based on DWP caseload and expenditure tables.

Figure 7.2. Number of day-to-day activities where respondents report difficulties, by PIP status

Note: The 'PIP claimant' group includes a small share (7%) of PIP claimants who do not report a disability. The sample is restricted to working-age people in England or Wales.

Source: Authors' analysis of Understanding Society, 2023–24.

Figure 7.2 plots the number of day-to-day activities that PIP claimants and non-claimants say they find difficult due to health conditions. It shows that PIP claimants are more likely to report multiple difficulties with day-to-day activities than PIP non-claimants, including PIP non-claimants with disabilities. The median person who has a disability but does not claim PIP reports difficulties with one activity, while the median PIP claimant reports difficulties with three activities. This is what we would expect given that PIP eligibility is specifically assessed on applicants' ability to do various day-to-day activities.

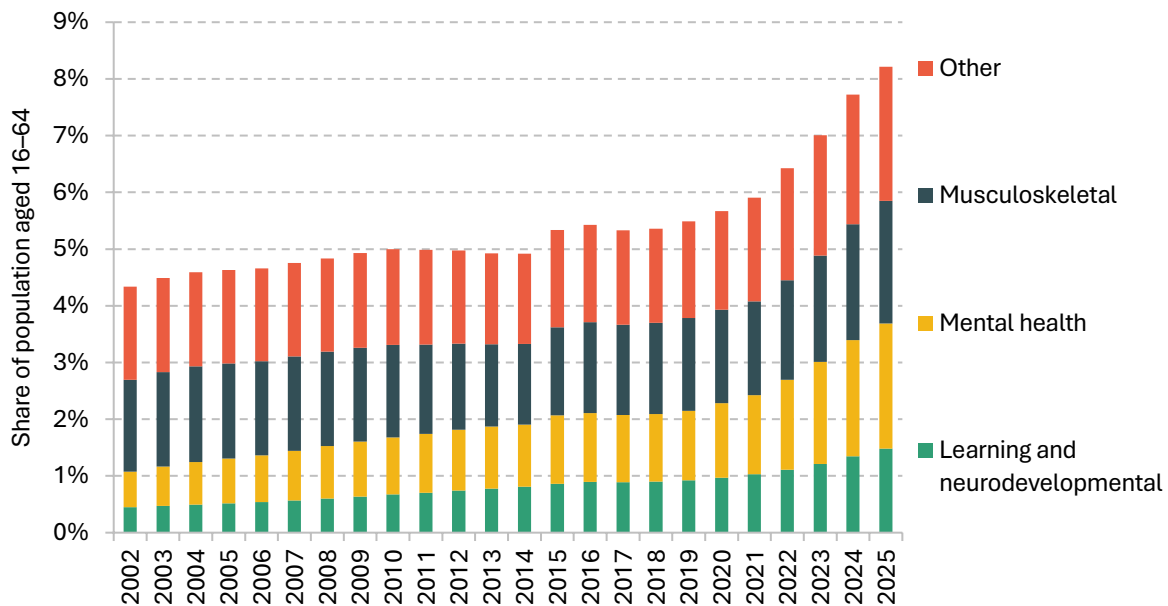
Figure 7.2 also shows that there is considerable variation in the number of day-to-day activities that PIP claimants have difficulties with: 19% of PIP claimants report difficulty with six or more day-to-day activities, while 27% of PIP claimants report difficulties with one or fewer. This variation across PIP claimants raises an important question for policymakers around the extent to which they want to target awards towards those with the highest needs or to provide broad support for everyone above a certain level of need. We discuss this further in Section 7.5.

Nature of disability

Figure 7.3 shows the share of working-age people who claimed disability benefits over time, broken down by their main health condition, as recorded in the assessment. Two points are worth drawing out. First, the share of the working-age population claiming disability benefits grew gradually from 4% in 2002 to 5% in 2019 before increasing much faster, reaching 8% in 2025. Second, the types of conditions for which people claim disability benefits have changed over time. In 2002, 25% of disability benefit recipients claimed primarily for a mental health

condition or a learning or neurodevelopmental condition;¹² by 2025, this had risen to 45%. The shift towards these types of primary conditions has occurred steadily over the last 20 years. Of the increase in claims since 2019, about half is in mental health, neurodevelopmental or learning conditions – so while rising demand for support related to mental health is a big part of the recent rises in claimant numbers, it is not the whole story.

Figure 7.3. Disability benefit claims as a percentage of 16–64 population by condition over time



Note: All data relate to August of the year shown.

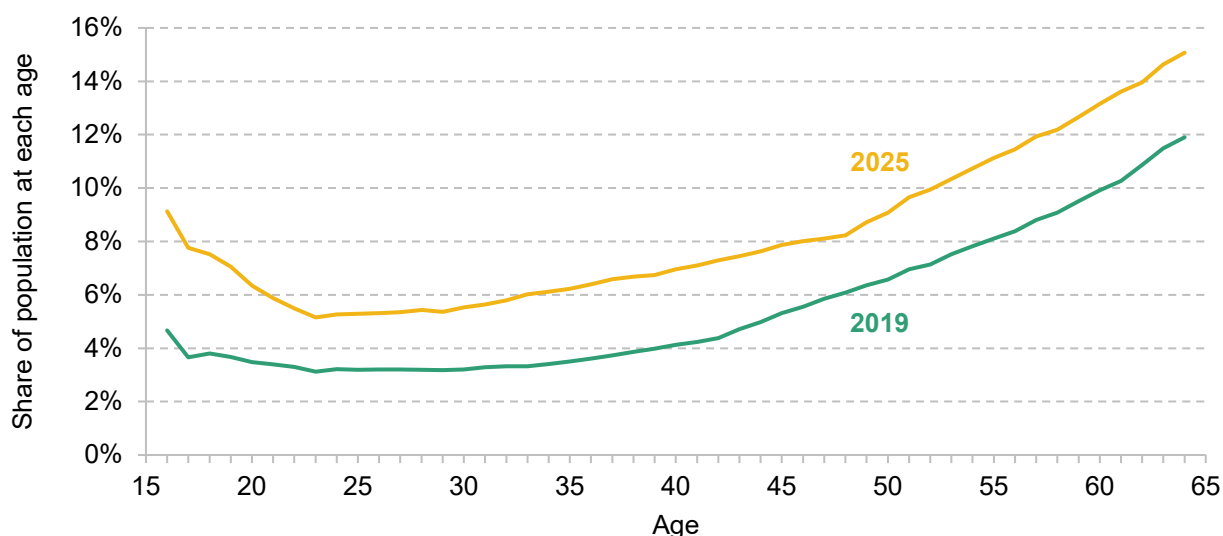
Source: Authors' analysis of Department for Work and Pensions Stat-Xplore.

Age

Figure 7.4 shows, by age, the shares of the population that claimed disability benefits in 2019 and in 2025. It reveals two key points about the disability benefit system. First, older adults are in general more likely to claim disability benefits than younger adults.¹³ Around 5% of 25-year-olds claim a disability benefit, but this rises to 11% among 55-year-olds. This echoes patterns in reported disability and is likely due to older adults picking up additional health conditions as they age.

¹² We use learning and neurodevelopmental condition here to refer to conditions labelled in the data as learning disabilities, learning difficulties, behavioural conditions, autism spectrum disorders and attention deficit disorders.

¹³ One exception to this is for the transition from teenagers to young adults. There are two reasons that claim rates are particularly high for 16-year-olds. First, claimants of child disability benefits (child disability living allowance, CDLA) are invited to apply for PIP around their 16th birthday but will usually not be reassessed for some months after, so there are some 16-year-olds who still claim CDLA who are included in this chart. Almost everyone is reassessed by age 18, so this is one reason for the decline in claim rates between ages 16 and 18. Second, many young adults experience improvements in their ability to manage their conditions as they age. Because of this, many people who are initially awarded PIP before age 18 are then reassessed and lose PIP in their 20s.

Figure 7.4. Share of people of each single year of age claiming disability benefits in 2019 and 2025

Note: Data as of August each year.

Source: Authors' analysis of Department for Work and Pensions Stat-Xplore and ONS population data.

Second, Figure 7.4 shows that the increase in disability benefit claims since 2019 occurred across all ages. The share of the population claiming disability benefits increased fairly uniformly – by between 2 and 3 percentage points – among most age groups. This implies slightly faster growth in *proportional* terms for younger claimants, but still fast growth for people in their 50s and 60s. Growth has been even faster amongst teenagers. The share of 16-year-olds claiming a disability benefit increased from 5% to 9%. This is related to the growth in claims for child DLA, which have grown even faster than claims for PIP. (See Latimer, Sibieta and Snape (2025) for a detailed discussion of child DLA trends.) Some of these 16-year-olds are still claiming child DLA while they are waiting for their PIP application to be processed, and others will have started their PIP claims. In other work, we have also shown the increase has occurred relatively evenly (in proportional terms) across different parts of England and Wales (Latimer, Pflanz and Waters, 2024).

Why has the number of people claiming disability benefits risen since 2019?

Despite much research, it is still unclear what drove the large increase in disability benefit claims since the start of the pandemic. We know that at least two-thirds of the increase is due to more people starting new claims for PIP, with the rest relating to fewer people ending their PIP claims (Latimer, Pflanz and Waters, 2024). But it is not known exactly why there has been such a big increase in new applications for PIP.

One theory is that it is due to worsening health following the pandemic. As Figure 7.3 shows, the growth in disability benefit claims started increasing dramatically from 2021 onwards. Latimer, Ray-Chaudhuri and Waters (2025) show there is mixed evidence across sources about what has happened to the overall prevalence of long-term health conditions, but all sources show that adults have gradually become more likely to report mental health conditions through the 2010s, and this has continued into the 2020s. There is no consensus on the cause of this increase. There does not seem to have been a sudden surge in reported health conditions post-pandemic that mirrors the growth in disability benefit claims. Changes in population health are likely to be part of the story, although they are unlikely to be the whole story.

Another theory is that the increase in claims is related to the rising cost of living. People with varying levels of disability may have responded to the rising cost of living in 2022 by looking for additional sources of income and therefore applied for PIP if they were not already claiming it. One supporting piece of evidence for this is that Citizens Advice received a large increase in the number of requests for advice on financial issues such as rising energy costs in 2022–23 and it also provided about a quarter of clients who it advised on these issues with advice on PIP (Department for Work and Pensions, 2026a, annex b). We have also found evidence that cuts to non-disability-related benefits led to more people claiming disability benefits (Cribb et al., 2025). While these cuts occurred too early to explain the post-pandemic rise in disability benefits, they provide some supporting evidence that some people respond to falls in their income by applying for disability benefits.

Finally, there is a set of explanations that suggest the increase in claims relates specifically to the design of the UK's benefit system. One explanation could be that the move from in-person assessments to remote assessments (either video calls or phone calls) may have induced more people to apply, possibly because some potential applicants find face-to-face assessments stressful or expect more scrutiny of their claim in such assessments. There is no evidence currently available that isolates the impact of this change. An alternative story is that fixed features of PIP which have not changed since the pandemic (such as the assessment criteria or the ability to apply in or out of work) make PIP particularly responsive to the rising cost of living and the rise in reported mental health conditions that have occurred since the pandemic. This might explain why the kinds of rises seen for PIP have not been repeated in other countries (Latimer, Pflanz and Waters, 2024).

Naturally, the lack of a clear understanding of what has driven the rise makes designing policy more challenging.

7.4 What is the purpose of the disability benefit system?

Before considering options for reforming PIP, it is helpful to zoom out and consider what the government might be trying to achieve with a disability benefit, and how PIP relates to those goals.

We begin by discussing *what outcome arising from disability* the benefit is supposed to target. We consider two possible options: the additional costs of disability; and reductions in well-being or life satisfaction arising from disability. Then, we move on to *the distributional goals* policymakers might have with the benefit: reducing incidence of particularly poor outcomes for disabled people, or reducing inequalities between disabled and non-disabled people. Finally, we briefly discuss *what form* the benefit could take, such as cash or benefits in kind, and how this relates to what the government wants the benefit to achieve.

What outcome arising from disability should disability benefits target?

The additional costs of disability

Policymakers may want a disability benefit to address the additional costs faced by individuals as a result of their disability. This is the government's stated rationale for PIP. Intuitively, this rationale is straightforward: it is easy to think of examples of specific additional costs for people with certain disabilities. For instance, someone with mobility needs may need to take taxis more often or someone who requires a ventilator needs to pay to charge it and maintain it.

Whatever form the support takes, putting this 'additional costs' rationale into practice requires a definition of 'the additional costs of disability'. We understand additional costs here to mean the extra costs one would incur in order to do a particular set of activities. The additional cost a disabled person faces (compared with a non-disabled person) to visit the local shops might be minor; the additional cost for them to travel across the world might be much larger. Policymakers must therefore consider which of these activities PIP should cover the additional costs of.

The Timms Review Steering Group has attempted to tackle this issue, stating that the purpose of PIP should be to 'reduce the inequalities they [D/deaf people and people with disabilities] face in participating in everyday life through a contribution towards the extra costs of disability'. 'Participating in everyday life' implies the government wants PIP to cover costs associated with a given set of activities. However, what these activities are is not obvious. A minimal definition might, in principle, include only the basic functions of human life such as eating, sleeping and bathing, while a broader definition might also include being able to participate in social, leisure

and civic activities. PIP currently assesses people both on their ability to undertake basic functions such as ‘preparing food’ or ‘washing themselves’ and on social activity such as ‘engaging with others face-to-face’. The more activities included in the definition, the more additional costs arising from disability the benefit would need to cover.

Whatever the set of activities the policymaker has in mind, they need to determine the additional costs disabled people face in doing those activities. We consider here how a policymaker can estimate average additional costs to inform the appropriate level of PIP awards, potentially conditional on a range of characteristics, rather than how they could estimate the additional costs facing a specific individual.¹⁴

One approach is to estimate costs ‘directly’ by surveying people on the goods and services they would need to pay for, and hence the costs they would face, if they were to do the set of activities the government wishes to target.¹⁵ The survey could ask this of those with and those without disabilities, compare the two, and attribute the difference to additional costs arising from disability. For example, if one activity in scope was having a clean home, a person with arthritis might explain that they would need a cleaner, and the cost for that would be included in the measure of the additional costs they face. Inevitably, some sort of averaging across disabled people (and conditions) would be required to produce an estimate of the additional costs of disability. The Timms Review is in the process of carrying out a survey of additional costs along these sorts of lines. However, this approach has drawbacks. The person being surveyed might not know what items they would need to pay for in order to do a listed activity, especially if it is not something they do at the moment. There is also an ambiguity in the goods and services one *needs* to do a particular activity: for example, a person may be able to do an activity without support, but not without significant effort or even pain.

These challenges with directly measuring disability-related costs have led researchers to explore alternatives. One alternative is to try to infer the additional costs of disability based on observed differences in living standards between people with disabilities and without (Zaidi and Burchardt, 2005; Scope, 2025; Banks et al., 2026). Ideally, this would involve comparing a measure of living standards that captured the specific set of activities that the government wanted to estimate the costs of (such as activities required to ‘participate in everyday life’, as discussed above). In the absence of that, a commonly used measure of living standards is material deprivation. Households are asked whether they are able to afford a number of essential

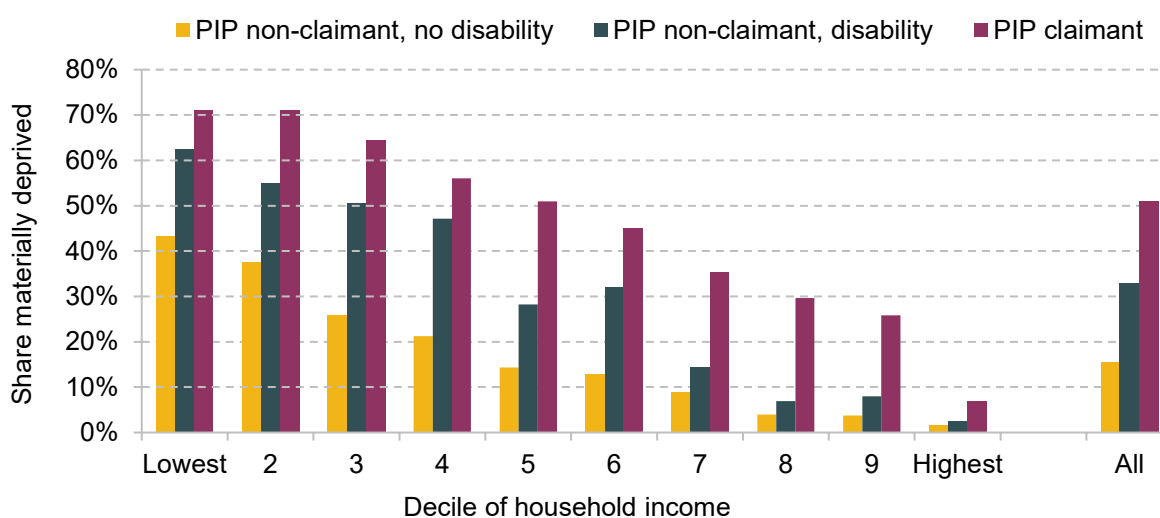
¹⁴ It is not possible to observe these average additional costs by looking at the actual spending of disabled people, since observed spending patterns are not informative about what particular activities required the costs incurred. In addition, some activities the government wants disabled people to be able to do may entail costs which a given disabled person did not incur – for example, because they could not afford them.

¹⁵ Banks et al. (2026) review the evidence on disability-related costs and how it differs across different estimation methods. They refer to this approach as the ‘goods and services required’ approach.

goods and services (e.g. fresh fruit and vegetables or the ability to heat the home adequately). In line with standard practice, we use the term ‘materially deprived’ to refer to anyone who cannot afford five or more essentials.

Figure 7.5 shows the share of different groups that are materially deprived, separately by decile of household income.¹⁶ PIP claimants with low incomes are the most likely group to be materially deprived – 62% of PIP claimants on below-average income are in material deprivation. Even among those who have the same level of income, people with disabilities are much more likely to be materially deprived than other adults, and PIP claimants are more likely again. These gaps remain even for relatively well-off PIP claimants – 34% of PIP claimants who have above-median incomes are materially deprived compared with only 5% of people above median income without a disability. Put another way, claiming PIP is associated with as large an increase in material deprivation as having a much lower income: non-disabled people in the second income decile are about as likely to be materially deprived as PIP recipients in the seventh decile, whose incomes are 135% higher.¹⁷

Figure 7.5. Percentage of group in material deprivation for working-age PIP claimants and for other working-age people with and without disabilities, by decile of household income



Note: Household income is equivalised and is after housing costs. Disability is self-reported. Someone is classified as materially deprived if they report they are unable to afford five or more essentials. The full list of material deprivation questions is provided in Appendix 7A.

Source: Authors' calculations using Family Resources Survey, 2024–25.

¹⁶ Income is equivalised to account for household size, and is after deducting housing costs. We deduct housing costs because they vary dramatically by housing tenure, and as a result are not always a good guide to the quality or quantity of housing a household actually receives. See Cribb, Wernham and Xu (2023) for more details.

¹⁷ The same relationships we describe here hold if you rank households based on their incomes excluding PIP, as we do in Figure 7A.1 in Appendix 7A.

The gaps in material deprivation between those who have the same income provide some evidence of the additional costs of disability. Disabled people may find some of the list of essentials in the material deprivation measure more expensive. For instance, one of the listed essentials is heating; some disabled people might require their home to be kept at a higher temperature as a result of their health condition and so might be more likely to report not being able to afford to heat their home adequately. Furthermore, disabled people may face additional costs for activities that are not included in the list of essentials, but paying for those additional costs may leave them with insufficient funds to afford the essentials that are on the list.

While this analysis is certainly suggestive of the existence of considerable additional costs, it is imperfect as a means to quantify them precisely. First, there may be other differences between people with and without disabilities, unrelated to additional costs, which cause these differences. For instance, disabled people may have lower levels of savings, for a given level of income, which might make it harder for them to afford essentials. Second, higher-income disabled people may face additional costs but still be able to afford the list of essentials. In that case, a small measured gap in material deprivation (such as the one we see in the top decile) would not necessarily imply that those costs were small, only that they were insufficient to push high-income individuals into material deprivation.

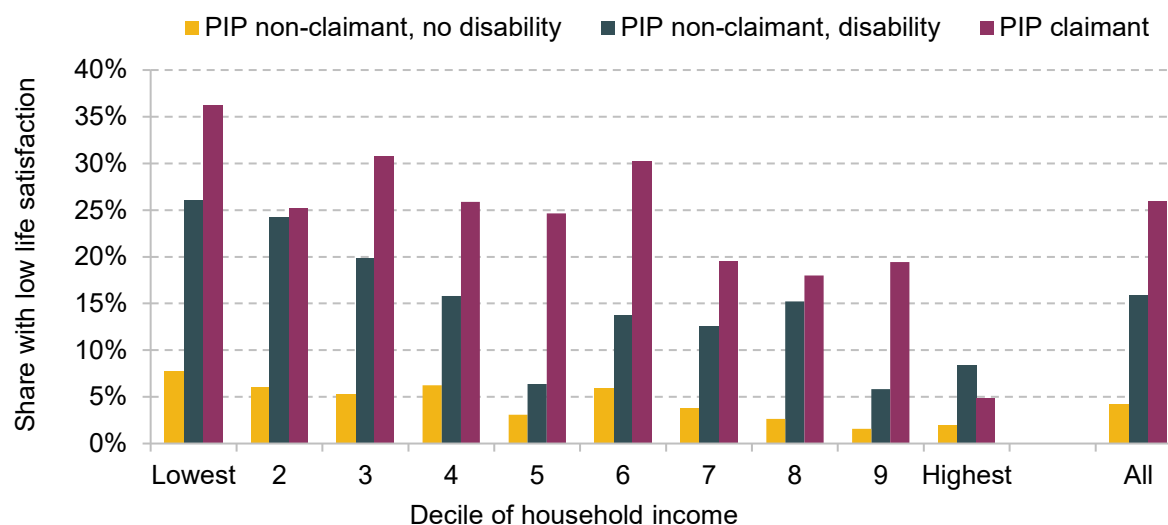
Reductions in well-being or life satisfaction arising from disability

As well as potentially increasing living costs, having a disability in itself is likely to reduce well-being or life satisfaction. This is an alternative outcome arising from disability that policymakers may want to address. Extra income is a means of achieving this in so far as it improves life satisfaction (and, as we show below, the two are correlated).

Figure 7.6 shows the share of people reporting low levels of life satisfaction (defined as reporting a score of 4 or below on a 10-point life satisfaction scale) by income and disability status. Similar to the picture for material deprivation, disabled people are more likely to report low life satisfaction than the general population and this relationship holds within income groups. Even PIP recipients in the top half of incomes report having lower levels of life satisfaction than those who are not disabled in the bottom income decile. This suggests that there is a significant life satisfaction ‘penalty’ associated with disability which policymakers may want to try to offset – though, as with the material deprivation comparison above, there may be differences *other than disability* between people with and without disabilities which contribute to these life satisfaction gaps.¹⁸

¹⁸ The same relationships we describe here hold if you rank households based on their incomes excluding PIP, as we do in Figure 7A.2 in Appendix 7A.

Figure 7.6. Percentage of group reporting low life satisfaction for working-age PIP claimants and for other working-age people with and without disabilities, by household income



Note: Household income is equivalised and is after housing costs. Disability is self-reported. Low life satisfaction is defined as answering the question ‘Overall, how satisfied are you with your life nowadays?’ with a 4 or below on a 10-point scale.

Source: Authors’ calculations using Family Resources Survey, 2024–25.

What distributional goals might policymakers want to achieve with disability benefits?

After deciding what outcome arising from disability is the target of the benefit, policymakers need to decide what distributional goals they want to achieve with it.

One option is to attempt to reduce the incidence of very poor outcomes among disabled people. For example, policymakers may be concerned about the additional costs of disability for low-income disabled people specifically, because they want to ensure that the standard of living of disabled people does not drop below a certain threshold. Figures 7.5 and 7.6 show that people on low incomes and with a disability are the most likely to report not being able to afford essentials and to report low levels of satisfaction with their lives. On either of these measures, the government would most efficiently target those with the worst outcomes by means-testing disability benefits so that all of the support goes to those with both disabilities and low incomes. We explore the option of means-testing in detail in Section 7.5.

Another option is to try to reduce inequalities between disabled and non-disabled people, irrespective of their income. If this is the aim, then the case for keeping PIP non-means-tested is stronger. Disability-related costs, or life satisfaction penalties, may be large even among those on higher incomes – indeed, Figures 7.5 and 7.6 show that, apart from in the top income decile, there are substantial gaps in material deprivation and life satisfaction between people with and without disabilities across the income distribution. These inequalities could justify keeping PIP

as a non-means-tested benefit, that is available to disabled people even on fairly high incomes given they may still be worse off than similarly high-income non-disabled people.¹⁹

Of course, the government may want to achieve both of these goals to some extent – it need not choose only one of the two objectives. However, given limited resources, it would then need to balance the amounts spent on achieving each objective. It could potentially do this by providing a mixture of means-tested and non-means-tested support.

What form should disability support take?

The government could choose to provide support to disabled people in many ways. For example, rather than providing a cash benefit, it could provide in-kind support (such as subsidised social care or healthcare) or vouchers (which we discuss in Section 7.5). Cash support, such as PIP, may be a particularly attractive option if the government's aim is to address the additional costs of disability and resulting low material living standards, since these are fundamentally financial problems. A particular advantage of cash is that it enables claimants to choose how to spend the benefit (and they could, for example, spend it on social care or healthcare). If there are large differences among claimants in the specific goods or services needed to address the impact of their disability, providing cash rather than in-kind support could be especially advantageous to claimants and imply a lower administrative burden than in-kind support.

It is less obvious that cash is the right form of support if the goal is to address reductions in well-being arising from disability. If cash was very effective at improving well-being, we would expect PIP recipients with high incomes to be much less likely to report low life satisfaction than PIP recipients with low incomes. In fact, Figure 7.6 shows that while PIP recipients with high incomes are less likely to report low life satisfaction than those with low incomes, these differences in life satisfaction across income deciles are small relative to the differences between PIP claimants and people without disabilities. Research also tends to find that additional income can increase well-being but that the effects of this are relatively small and can be short-lived (Thomson et al., 2022; Miller et al., 2024). All this suggests that even fairly high PIP awards may not fully close well-being gaps that are associated with disability.²⁰

Alternative forms of support might have a bigger positive effect on well-being for a given level of spending. For instance, one alternative could be increased investment in mental health

¹⁹ It might be thought that giving PIP to someone on a high income is inequality-increasing overall, increasing income gaps between low-income PIP non-claimants and high-income PIP claimants. But PIP is not the only way the government can reduce inequalities between people: for example, it can reduce inequalities between rich and poor through the tax and (non-disability) benefit system. Means-testing PIP cannot therefore be motivated just by wanting to redistribute more to low-income households at the expense of high-income households: there are many other levers in the tax and benefit system that already do this and could do it more.

²⁰ This evidence is only suggestive as it is based on the correlation between well-being and income, which might not reflect a causal relationship.

treatment, which has been shown to be effective at improving well-being for those with mental health conditions (Cuijpers et al., 2013; Oparina, Krekel and Srisuma, 2024). If the government wants to improve well-being for disabled people, it should evaluate the cost-effectiveness of different forms of support rather than necessarily defaulting to cash.

7.5 Potential reforms

Finally, we present a range of options for reforming PIP. The government faces choices around the structure of disability benefits such as how should eligibility be assessed, should the benefit be cash or in-kind support and how much should awards vary between claimants? For any given structure, the government can also decide how much it wants to spend overall. It may decide it wants to spend more or less on PIP than it does currently – £25 billion a year on working-age claimants, an amount that is due to rise to £34 billion by 2030–31.

The simplest way to change spending on PIP would be to change all award levels proportionally. A reform that increased or reduced award amounts by 10% for all claimants would increase or reduce spending on working-age adults by £2.5 billion before accounting for any behavioural responses. On average, each claimant would receive £740 a year more or less in income. The government could also change the thresholds required to qualify for each level of PIP or alter the number of points that questions (or levels within a question) are associated with. Increasing the threshold to qualify or reducing the points scored on each question would result in fewer claimants qualifying, reducing spending.

The government has asked the Timms Review to look at options for changing the structure of PIP rather than immediately increasing or decreasing spending, and so, in the rest of this section, we focus on options for structural reform. We discuss seven options that illustrate the range of different types of changes the government could make to the disability benefit system. For each reform, we provide relevant context, model how it might change the caseload where possible, and discuss the advantages and disadvantages of the change.

The seven reforms we consider are:

1. Changing the distribution of awards while maintaining a functional assessment
2. Requiring a medical diagnosis
3. Treating mental and physical illness differently
4. Age-dependent disability benefits
5. Issuing vouchers in place of cash for some or all awards
6. Providing services in place of cash for some or all awards
7. Means-testing PIP

Each of these reforms could be combined with changes in award amounts to achieve different levels of total spending on the system. For instance, restricting access to PIP for younger claimants would reduce spending if it was not combined with any other reforms. We illustrate the possible scale of some cost reductions that could be made, if desired. We note, however, that the government could choose to recycle any savings from a particular change into higher awards for remaining PIP claimants, leaving total PIP spending unchanged, or into other forms of support for disabled people, such as the direct provision of health or social care support.

Changing the distribution of awards while maintaining a functional assessment

One option is to continue to assess eligibility for PIP based on measures of functional disability but to change how awards are allocated. This could involve changing the severity of disability required to qualify for each level of award, changing the number of levels or the value of award they attract, or some combination of these. These choices determine how many people receive at least some PIP, and the share of overall PIP spending that is received by those with the most severe disabilities.

Although each of the two components of PIP – daily living and mobility – is currently available at only two levels (standard and enhanced), the PIP assessment involves a more granular numeric points system. Individuals are given scores on a range of individual activities, with the score for each corresponding to a level of difficulty the individual has with the activity in question.

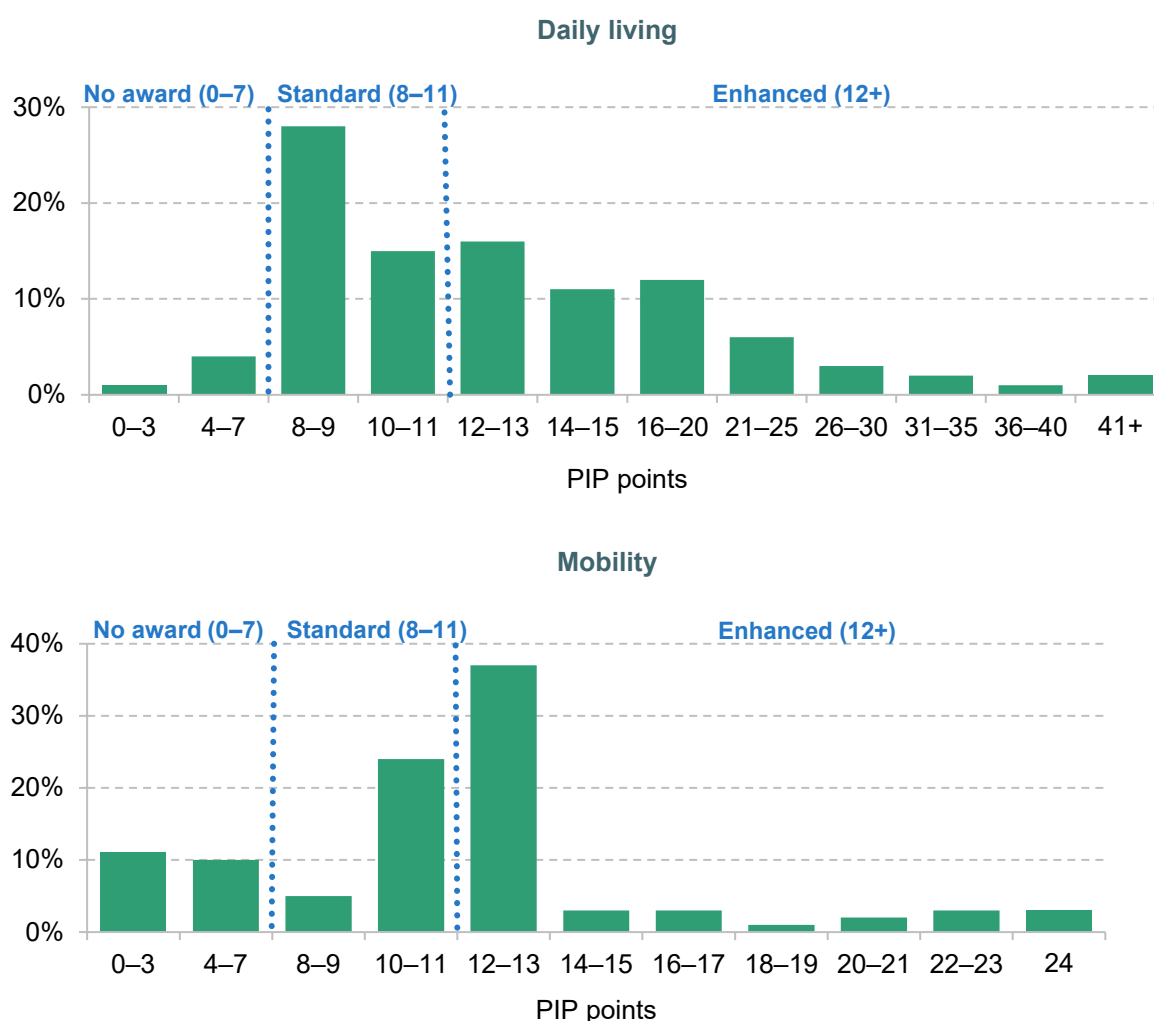
Figure 7.7 shows the share of successful applicants who receive each number of points in total. Because the charts are among PIP claimants only, there are few people who score below the eight-point threshold – the only individuals in this category are people who qualify only for the PIP component that is not the one shown on the chart (either mobility or daily living).

Even among people granted enhanced awards (and, to a lesser extent, standard awards), there is significant variation in scores. Indeed, many PIP claimants receive many more points than are needed to qualify for the enhanced level of support. For example, for the daily living component, among those who receive the enhanced level (scoring at least 12 points), around half receive at least 16 points and 9% (5% of all PIP claimants) receive at least 31. There are fewer questions for the mobility component, resulting in a smaller variation in scores, though still among enhanced mobility recipients there are 6% who receive the maximum 24 points.

It seems very likely that someone who scores 12 in the assessment for the daily living component, and thus just qualifies for the enhanced award, will have different needs and costs from someone who scores over 30. For instance, someone who cannot wash and bathe themselves and needs assistance to dress or undress their upper body would receive 12 points on

the daily living assessment and only just qualify for the enhanced level. Someone who cannot wash and bathe themselves, cannot dress or undress at all, cannot express or understand verbal information at all even with communication support, and needs prompting to be able to read or understand basic written information would receive 32 points. But both would currently be awarded the same level of the daily living component of PIP, worth £5,960 per year.²¹

Figure 7.7. Distribution of PIP points, by PIP component



Note: Award distribution is among successful applicants for at least one component of PIP, and relates to claimants as of January 2024.

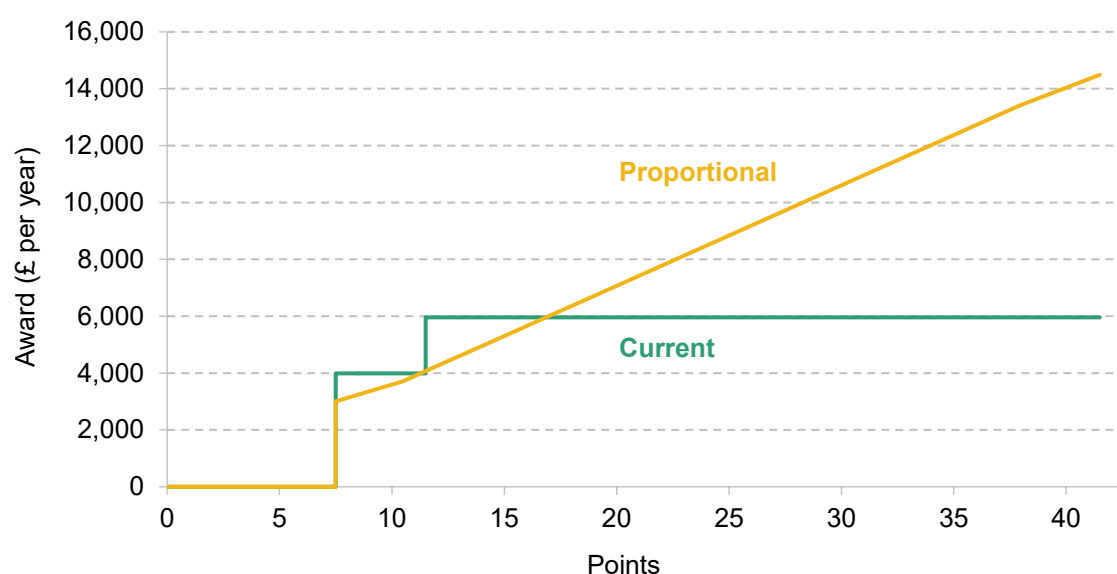
Source: Authors' analysis of Department for Work and Pensions Pathways to Work Evidence Pack 2024.

²¹ Of course, they may well receive different amounts of other kinds of government support, such as social care provided by their local authority or healthcare through the NHS.

If needs do vary substantially between people with different scores, there would be a case for (for a given budget) awarding greater support to those with very high scores, and lower awards for people who only just cross one of the existing thresholds. Such a change would make those with a lower level of disability worse off but would target the existing budget to those with higher needs.

There are many ways to make the system more sensitive to the level of assessed disability. For example, PIP could have more than two levels of award for each component. A simple illustrative alternative, which we model here, is a £-per-point system in which claimants receive an award that is proportional to the number of points they receive in the PIP assessment. We maintain the restriction that no award is made for the first seven points scored on either the daily living or mobility component. Figure 7.8 shows the award given for each number of points under such a proportional system, compared with the current system. We set the award for each point at a level to keep overall spending on each component the same as it is currently (before accounting for any behavioural changes). This would mean that a person scoring 12 points in the daily living assessment would get £4,240 per year (£1,720 less than now), while a person scoring 32 points would get £11,310 (£5,350 more than now).

Figure 7.8. PIP daily living award by points under current and proportional systems



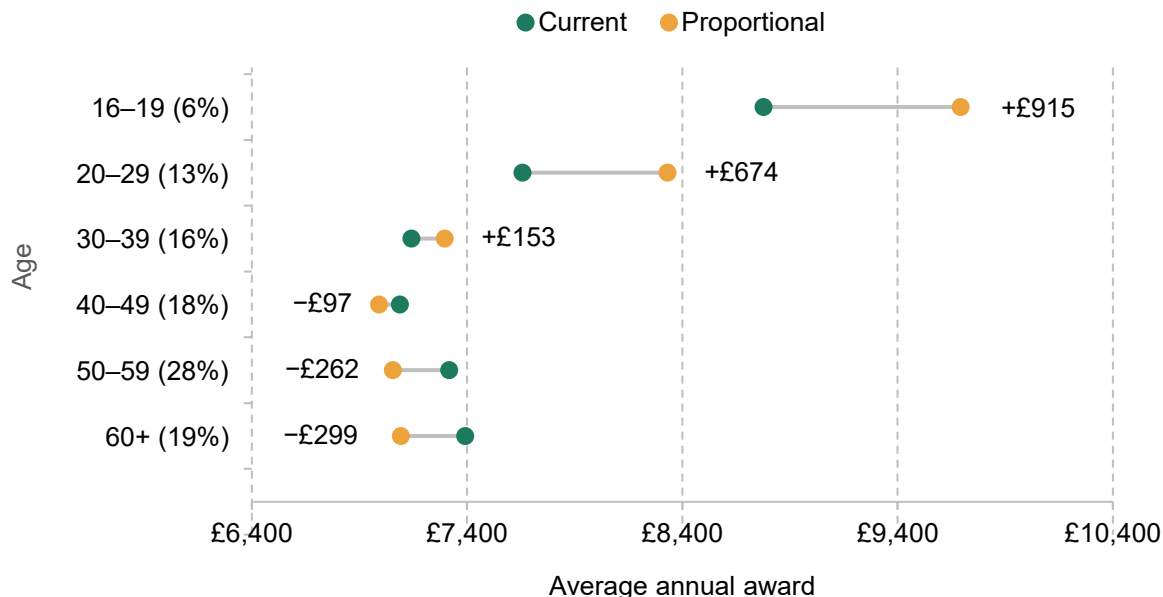
Note: Award levels under the proportional system have been set to be revenue-neutral given the distribution of PIP points among successful claimants as of January 2024 and assuming no behavioural response. The points distribution is available in bands, so we have rounded scores to the centre of each band. For those in the 41+ category, we have assigned 43 points.

Source: Authors' analysis of Department for Work and Pensions Pathways to Work Evidence Pack 2024.

Importantly, we model the results of this reform assuming that nobody changes their behaviour, and hence that the distribution of PIP points is the same as the distribution among current claimants. This helps us illustrate the likely effects of the reform. However, in reality, it is likely that there would be some behavioural response to such a reform. The incentive to move from 8–11 to 12 points would be weakened as this would no longer lead to a sharp rise in support, while the incentive to increase points within the 8–11 or 12+ ranges would be strengthened. Claimants are likely to respond to this incentive and take action (such as providing more evidence for their applications or being more likely to challenge their award). Since the incentives push in both directions, the overall effect on spending is ambiguous.

Roughly a quarter of claimants would receive an increase in their daily living component due to the reform, of whom around 15% would gain more than £1,000 per year. Around 70%, meanwhile, would receive a lower daily living award, with 55% of current claimants losing more than £500 per year. Around a third of claimants would receive an increase in their mobility component of more than £1,000 per year, while nearly half would lose out, almost all of whom would lose more than £500 per year. The fact that there would be fewer (big) winners than (smaller) losers under this alternative reflects the fact that a minority of claimants have a very large number of points.

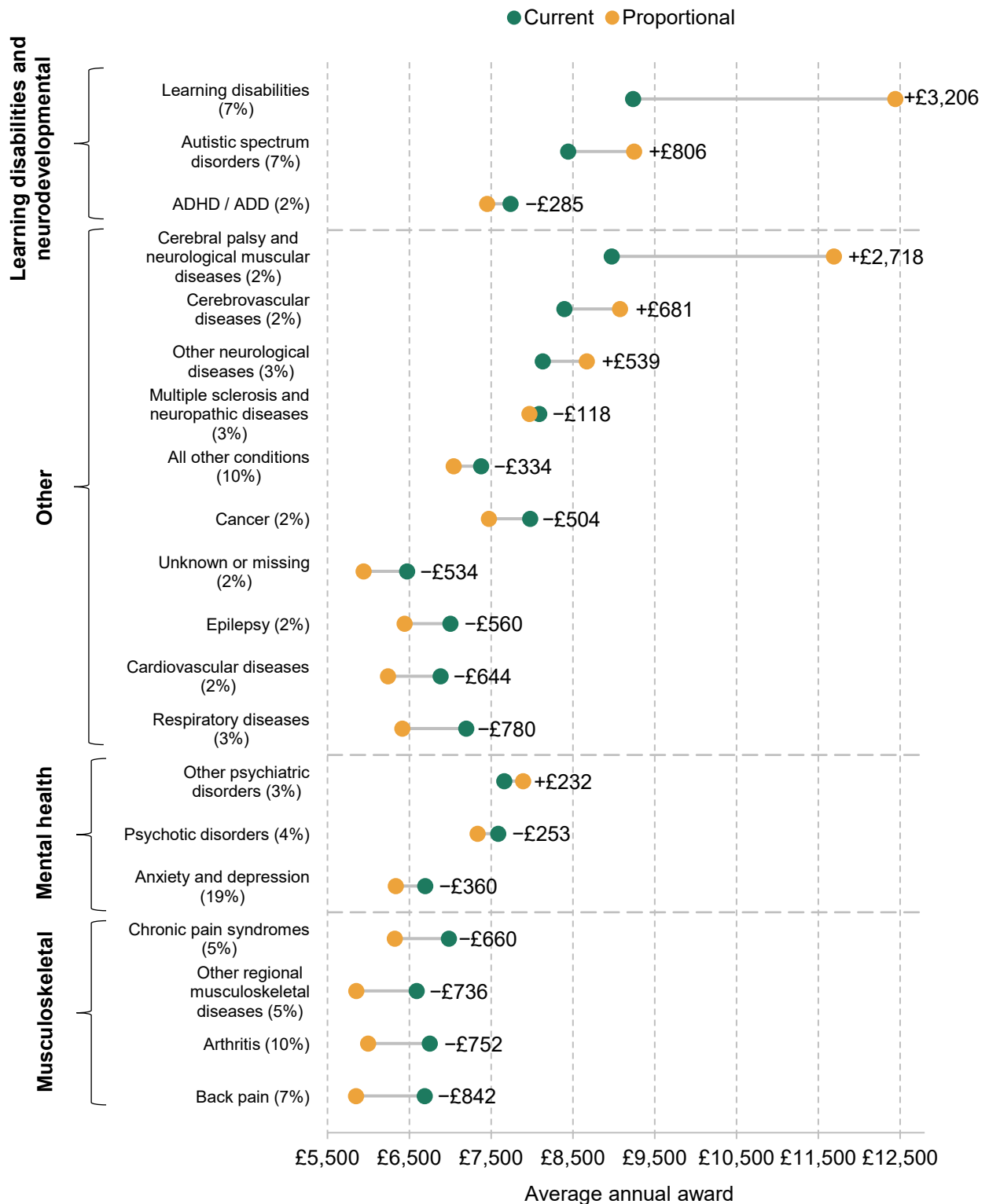
Figure 7.9. Average PIP award under current system and proportional reform, by age



Note: %s on the vertical axis show the shares of overall claimants. The horizontal axis does not start at 0.

Source: Authors' analysis of Department for Work and Pensions Pathways to Work Evidence Pack 2024.

Figure 7.10. Average PIP award under current system and proportional reform, by condition



Note: Conditions shown are main conditions as recorded in the PIP assessment. As a result, they are averages which will partly reflect co-morbidities of different main conditions. %s on the vertical axis show the shares of overall claimants. The horizontal axis does not start at 0.

Source: Authors' analysis of Department for Work and Pensions Pathways to Work Evidence Pack 2024.

Figures 7.9 and 7.10 show the average amount different groups' awards would change by if the existing system were replaced with a proportional system (again assuming no behavioural response), broken down by age and condition respectively. The biggest winners would be those whose main condition is a learning disability or a condition such as cerebral palsy, who tend to have very high PIP assessment scores. Claimants whose main condition is musculoskeletal would lose the most, since they do not tend to score very highly on the PIP assessment. The reform would also benefit younger claimants (on average), since a higher share of young claimants receive very high point scores.

The simple £-per-point system modelled here would make the most sense if the costs associated with disability rose linearly with levels of need assessed by the current assessment (e.g. if someone with twice as many points over 7 on the assessment also faced costs associated with their disability that were twice as high). In reality, it may be that costs increase less than proportionally with the number of points – for example, getting assistance at home could help with a range of limitations (cooking, cleaning, getting dressed), meaning that someone who has several of them may only have modestly higher costs than someone who has one. In addition, there are other elements of state support (such as social care) which may be more likely to be received by those with very high PIP scores, and may be more appropriate than cash for people with very substantial needs.

On the other hand, limitations could interact with each other, making the costs to those who suffer from many conditions higher than the sum of the costs of each condition on their own. Either way, given the large differences in the severity of disability among those with the same level of award under the current system, it would be worth considering whether there should be increased gradation between those with the very highest needs relative to those with more moderate needs. While we have shown a simple £-per-point system here for illustrative purposes, it is worth reiterating that the same kind of effect could be achieved by having more award levels. Furthermore, if it added more tiers, the government may want to alter the PIP assessment itself. The current PIP assessment was designed knowing that, over certain ranges, the specific number of points an individual scored would not affect their award level. If this relationship between points and award were strengthened, government may wish to alter the way points are allocated to people with different levels of need.

Requiring a medical diagnosis

There are some international examples of disability insurance programmes which require applicants to have specific medical diagnoses (such as the United States). At present, medical evidence can be used in the PIP assessment, but a specific diagnosis is not required. Applicants can provide additional medical evidence to support their claim and assessors can also request additional evidence from medical professionals such as the applicant's GP. The government could choose to make a medical diagnosis a more formal part of the PIP assessment.

One option would be to scrap the functional assessment and only allocate PIP based on diagnoses. Most people with some medical diagnosis do not claim PIP, so the government would have to specify a small number of specific diagnoses if it wanted to avoid greatly increasing the PIP caseload. An advantage of this kind of approach is that in some cases it would offer a more objective criterion by which to determine PIP eligibility, since one can sometimes definitively say whether an individual has a particular condition. For other conditions, subjective symptoms are also important in diagnosis – for example, where and how much pain a patient experiences. These are no easier to observe or verify than a functional assessment’s attempt to measure individuals’ ability to perform specific activities. Moreover, even for objectively verifiable conditions, medical diagnoses may not map well onto additional costs from disability, since a single diagnosis can impair people to different degrees.

Another less radical option would be to make PIP entitlement dependent upon both passing the existing functional assessment and having a medical diagnosis. Adding this additional requirement to the PIP assessment would exclude some claimants altogether, enabling higher awards or a lower threshold in the functional assessment for remaining claimants for any given amount of spending.

Currently, 85% of working-age PIP claimants report having at least one diagnosis, and 69% report several.²² This is likely due to a combination of the fact that scoring enough points in the PIP assessment to receive an award is highly correlated with having a diagnosis, and that the current assessment does use medical evidence (and it may be quite important for the assessment). If the government required a diagnosis for entitlement to PIP, claimants may respond to this incentive by seeking a diagnosis (and, as discussed below, doctors are unlikely to have much incentive to reject such requests). As a result, requiring claimants to have any medical diagnosis in addition to the functional assessment is unlikely to result in a major shift in who receives PIP. The government could instead decide to restrict to only a subset of medical diagnoses, which could have a much larger effect on who receives PIP, but this would depend entirely on which diagnoses were chosen.

There are several risks associated with adding a medical diagnosis to the PIP eligibility criteria. Increasing the incentive to seek a medical diagnosis would likely raise demand for NHS services. In addition, it would raise the administrative burden for those applying for PIP, potentially reducing applications. One particular risk is that this requirement might disproportionately deter low-income people from applying. They may be less likely to seek a diagnosis through the private medical sector and so be more impacted by NHS waiting lists and

²² To investigate the effects of such a reform, we use a series of Understanding Society questions about what medical diagnoses respondents have. The survey asks about a range of conditions and an ‘other diagnosis’ category. It is possible that respondents may miss conditions that are not explicitly listed and, since answers are self-reported, respondents may not answer accurately.

delays and, even in the NHS, doctors can charge for providing some forms of evidence (albeit an amount that is very low when compared with a PIP award). In principle, the government could waive NHS charges for providing the relevant forms of evidence, and could increase spending on NHS services to reduce waits for diagnoses, although this would come at additional fiscal cost.

Given there is some subjectivity in medical diagnoses, the impact of the reform on diagnoses and PIP claims would also depend on doctors' behaviour. Currently, doctors would have little incentive to reject requests from patients for diagnoses needed for PIP assessments, and so requiring a diagnosis may only have limited effects on PIP eligibility in practice. If instead doctors were incentivised to reject some requests, the relationship between doctors and patients could become more adversarial.

Treating mental and physical illness differently

Another potential reform is to restrict eligibility to PIP among people with mental health conditions. This idea has received some attention recently, with both the Conservative Party and Reform UK making proposals along these lines (BBC News, 2025 and 2026), following the large rise in disability benefit claims for mental health problems (as shown in Figure 7.3).

There are two main potential justifications for treating mental health conditions differently. First, policymakers may be concerned that mental health conditions, and their impact on claimants' lives, are particularly hard to verify and hence more open to fraudulent or exaggerated claims – motivating a different assessment process, or restricting eligibility only to those who have particularly serious mental health issues. Consistent with this, a survey of GPs in Norway who assess disability insurance claimants found that they considered mental health conditions to be among the least verifiable (Overland et al., 2008). A second potential justification is that mental health conditions may be easier to treat and recover from or more variable – motivating more regular reassessment, or in-kind treatment instead of cash benefits.²³

Of course, a condition affecting mental rather than physical health is at best a proxy for its verifiability and treatability. Many physical health conditions are also difficult to verify; in fact, that same Norwegian survey found that the two least verifiable conditions were *physical* (joint/muscle pain and back pain).²⁴ Likewise, some mental health conditions are lifelong. So, if the government does want to distinguish between conditions on these grounds, it may make

²³ The current system does already reassess claimants whose condition is likely to change more frequently than other claimants and this leads to more frequent reassessments for mental health claims. 85% of new awards for mental health conditions in 2025–26 were due to be reassessed within two years compared with 71% of other new awards.

²⁴ Specifically, 'unspecified rheumatism/myalgia' and 'dorsopathies'.

more sense to do so on the basis of verifiability and treatability specifically, rather than simply by whether a condition is mental or physical.

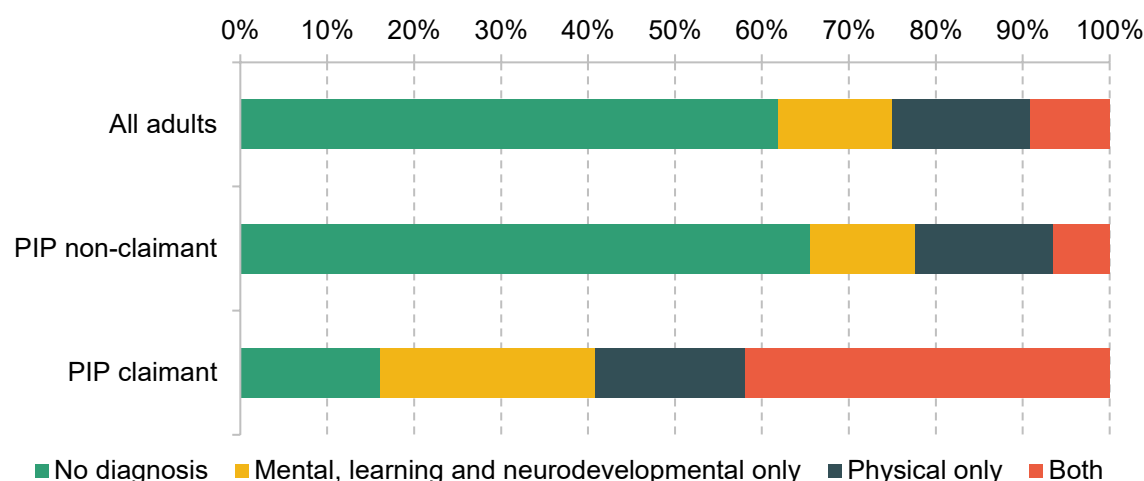
If the government did want to limit PIP eligibility for mental health conditions, it would need to move away from the existing assessment framework. As discussed earlier, at present the PIP assessment does not seek to assess the *cause* of any functional disability: it only asks whether an applicant is able to do a given activity. Indeed, given that people often have multiple health problems, it is not conceptually clear how a functional assessment could distinguish between causes in this way: if someone is unable to carry out a given daily living activity (e.g. if they need prompting to be able to ‘take nutrition’), it is not obvious that an assessor could attribute this objectively to one specific condition rather than another.

Rather than trying to determine whether a given functional limitation is caused by one condition or another, we consider two potential reforms, both of which would make it more difficult for people with mental health conditions to qualify for PIP.

The first, more straightforward approach would be to only allow people to take the PIP assessment if they have a physical condition (or possibly a severe mental health condition), perhaps requiring a medical diagnosis as evidence. Having met this requirement, people could still be assessed for PIP based on their functional limitations, whether these were caused by mental or physical health conditions.

Administrative data show that 45% of existing PIP claimants have, when assessed, a mental health condition or a learning or neurodevelopmental condition listed as their *main* disabling condition. However, requiring applicants to have a physical condition would certainly not exclude nearly that many people. This is because many PIP claimants report having both mental and physical health conditions. Figure 7.11 shows the share of PIP claimants and non-claimants who reported in a survey that they had different combinations of physical and mental health diagnoses. PIP claimants are more likely to have either mental health or physical health diagnoses than PIP non-claimants, but they are particularly likely to have both. Indeed, of PIP claimants with a mental, learning and neurodevelopmental health diagnosis, about two-thirds *also* have a physical health diagnosis (and so would remain eligible for PIP under this reform). And, once again, requiring claimants to have a physical health diagnosis would likely increase the number of people seeking such a diagnosis, further reducing the number of people who would lose eligibility.

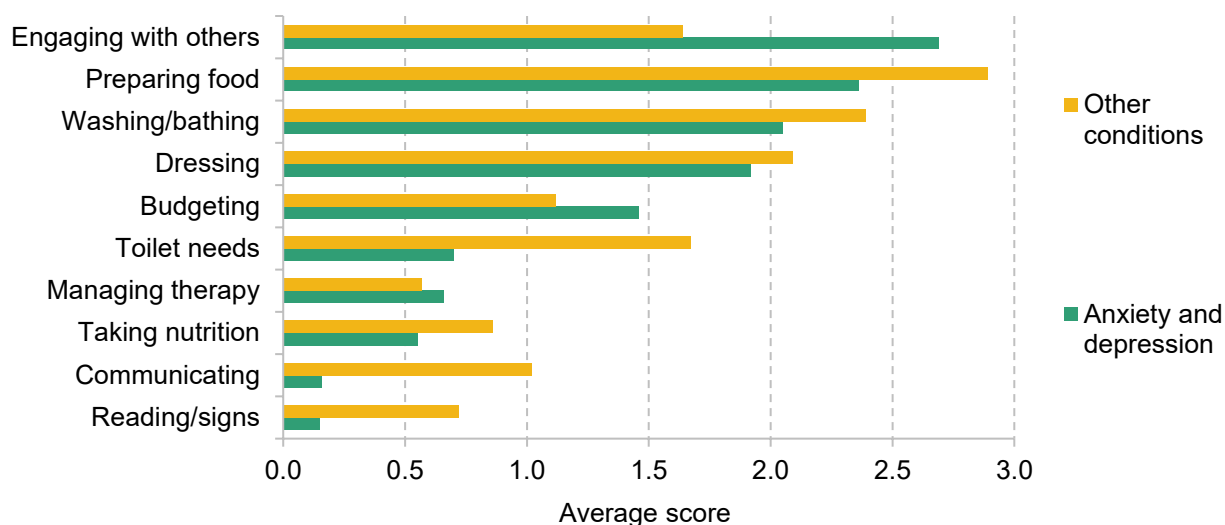
Figure 7.11. Share reporting mental and physical health diagnoses



Note: Understanding Society does not ask about every condition (though it does have a miscellaneous 'other condition' category). As a result, some conditions may be missed from this breakdown. See Appendix 7A for details of which conditions we have categorised as mental, learning and neurodevelopmental, and which as physical.

Source: Authors' analysis of Understanding Society, 2023–24.

Figure 7.12. Daily living score by question for different main conditions



Source: Department for Work and Pensions Pathways to Work Evidence Pack, table 2.28.

A second approach that could reduce the number of people receiving PIP for mental health reasons would be to change the points given to different assessment questions. Figure 7.12 shows the average points scored by PIP recipients by whether their main disabling condition is anxiety and depression, or another condition (mental, learning and neurodevelopmental, or

otherwise).²⁵ Claimants whose main condition is anxiety and depression are particularly likely to score highly on the part of the assessment that determines difficulties with ‘engaging with others face-to-face’. Reducing the points available for this question (or excluding it entirely) would reduce the share of people who would qualify due to these particular difficulties. This would change the relative generosity of the system towards people with different types of difficulties – and effectively towards people with different types of conditions – while retaining the functional assessment structure.

Age-dependent disability benefits

Another option is to change the design of the disability benefit system specifically for a certain age group. It is already the case that substantially different systems operate for children under 16, people aged 16–66, and pensioners. Age variation among working-age people in benefit entitlements is not unprecedented – the standard allowance for universal credit is lower for those aged under 25, and the same is true of maximum support for privately rented housing for single people aged under 35, for example. Here we focus on options that treat younger disability benefit claimants differently from other claimants.

There are several reasons why, in principle, the government may want a different disability benefit system for people of different ages.

First, the government may believe that the costs of disability, or the well-being impact of being disabled, are different for people of different ages, even for a given level of functional disability. For example, an inability to travel may have a different impact on people of different ages.

Second, younger people may change their behaviour more in response to receiving PIP or the changes they make may be more important. In general, we would expect increasing the benefits someone receives to reduce their likelihood of working, albeit modestly. These effects might be bigger for younger people, since they may have less income from other sources (such as partners) than older people, such that PIP represents a larger fraction of their total income. In addition, the government may be more worried about the knock-on consequences of employment effects for young people than for older claimants. For example, there could be ‘scarring’ effects to being out of work, meaning that any negative employment effects may be particularly damaging for the future earnings of young people, who have their entire working life ahead of them. However, on both counts, since claimants can receive PIP both in and out of

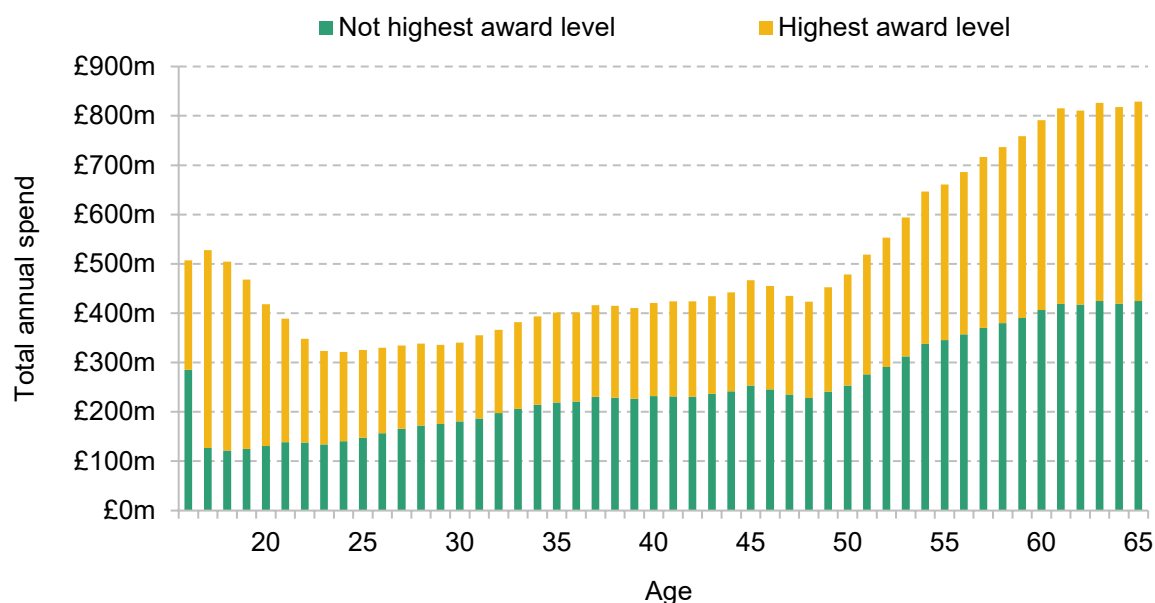
²⁵ We include this breakdown partly due to data availability: we could not split out all mental health conditions from others. Figure 7A.3 in Appendix 7A shows the same figure, but with autistic spectrum disorders also separated from ‘other conditions’. This shows that there is enormous variation among mental, learning and neurodevelopmental disorders. For example, the average score on the communication question is just 0.2 for people with anxiety and depression (meaning most receive a score of 0), while it is 2.1 for those with autistic spectrum disorders and 0.9 for those with other conditions.

work, any negative employment effects are likely to be small. Such an argument would be stronger for the universal credit health element as – unlike PIP – that *does* generally require claimants to be out of work.

Finally, conditions (or the difficulties they cause) may be more likely to change over time for certain age groups than for others. There is some evidence that younger claimants are more likely to see changes in their condition. 26% of reassessments for claimants aged under 30 end in the claimant losing access to PIP, compared with 17% for claimants aged 30 and over.²⁶ On average, younger people are already more likely to be reassessed; however, this is likely due to their conditions (not age itself). It is plausible that even for the same condition (and the same assessed functional disability), younger claimants could have a higher chance of recovery than older ones. Therefore, the government could go further and have explicitly different policies on the frequency and nature of reviews by age.

Figure 7.13 shows total PIP spending by age, to illustrate the potential savings from restricting PIP to certain ages. As an extreme example, the government could simply exclude anyone under 30 from the benefit. This would reduce the caseload by 689,000 people (20% of the total working-age PIP caseload) and reduce spending by £5.5 billion.

Figure 7.13. Total spending on PIP by single year of age



Note: Estimates are not adjusted for the age distribution of the population, so differences in cost are driven by different probabilities of receiving awards by age, different average award size by age and different numbers of people at each age. Estimates are for November 2025.

Source: Department for Work and Pensions Stat-Xplore.

²⁶ Authors' calculations using DWP StatXplore data. Reassessments refer to all PIP award reviews since 2016.

However, young people are disproportionately likely to have the most severe disabilities. On Figure 7.13, we also split spending by age into that which goes on claimants who receive the highest possible PIP award (the enhanced component of *both* the mobility and the daily living element) and that which goes on all other claimants. Approximately half of under-30s qualify for the highest possible PIP award relative to only 34% of claimants over 30. If policymakers wanted to remove PIP from most claimants under 30 but protect those with the most severe disabilities (modelled as continuing to provide awards for young people who currently get the highest possible award), the impact on the caseload would halve to 327,000 (10% of the working-age caseload), and the impact on spending would fall to £2.2 billion, before accounting for any behavioural responses. Any savings from these sorts of reforms could, for example, be used to increase PIP awards for older claimants or to provide alternative support for under-30s.

Issuing vouchers instead of cash

Another avenue for reform would be to link benefits to actual disability-related spending, rather than allow claimants to spend PIP on anything. There are various ways this could be attempted. For example, one option is to pay disability benefits on the basis of receipts for items within an approved catalogue, which is the approach taken in New Zealand²⁷ and is similar to the structure of the UK's disabled students' allowance, a benefit for disabled students in higher education to pay for additional costs related to their course. An option considered by the previous Conservative government was to provide some disability-related support in the form of vouchers that can only be redeemed for certain disability-related products, instead of cash. The underlying economics of these options are quite similar. Here we focus on a voucher-based approach.

There are a number of possible advantages of a voucher-based approach. First, if the key rationale for PIP is to cover disability-related costs, a voucher or receipts-based system would more closely link spending to specific costs judged by the government to be disability-related. Second, the government might want disabled people to spend money on certain types of disability-related items, perhaps because it takes the view that they are particularly effective at helping people manage their conditions or improve their well-being, even if that is not how people would choose to spend the money themselves. Vouchers achieve this. This argument is particularly strong if the key objective for government is to improve claimant well-being rather than to cover disability-related costs. Third, restricting claimants to spending their benefits in this way may also reduce the incentive for people with low disability-related costs to apply. Of course, if the PIP assessment worked perfectly, they would be rejected anyway. But as discussed in Section 7.2, there is imprecision in the assessment.

²⁷ <https://www.workandincome.govt.nz/products/a-z-benefits/disability-allowance.html>.

Such an approach would also have disadvantages. First, and perhaps most fundamentally, a key advantage of cash is that it allows disabled people to decide how to spend their money, and they may know best what spending would be most valuable to them. If vouchers are redeemable for purchases that a disabled person would have made anyway, they will have no effect on the goods and services the person ends up consuming compared with providing a cash benefit of the same value. If vouchers are only redeemable for purchases that a disabled person would not have made anyway, they would change spending to something that is less appealing from the claimant's perspective.

Second, the government would have to determine what products claimants are allowed to spend the vouchers on. As discussed in Section 7.4, distinguishing between disability-related and non-disability-related spending is often not straightforward: while a wheelchair clearly falls in the former category, things such as taxis and cleaners may be a necessity for one claimant and a luxury for another. If vouchers were restricted to only certain items which were clearly disability-related (such as wheelchairs), recipients would not be able to use them to cover other genuine disability-related costs (such as taxis). Were vouchers issued only to certain providers, there could be an increase in the price of goods for which they were redeemable. On the other hand, if vouchers could be redeemed on a wide range of goods and services, they would be little different from cash.

Third, using vouchers may attract stigma that cash payments do not. The US food stamp programme is a useful comparator here. Food stamps are distributed to low-income households, can only be used on certain items, and require using a recognisable form of pre-paid card. In a survey of food stamp recipients, 56% reported behaviour or experiences consistent with stigma, such as hiding their use of food stamps (Hatton et al., 2024). This argument does not so clearly apply to a receipts-based, rather than a voucher-based, system.

Finally, a reform of this kind would add to administrative costs, since the government would need to build and maintain a list of allowable products. If it used a voucher-based system, it would also have to monitor the use of the vouchers and arrange for suppliers of the relevant products to accept the vouchers. This would impose an administrative burden on private sector firms too, relative to providing cash.

Providing services instead of cash

An option related to issuing vouchers is for the government to provide disability-related services (such as therapy) in-kind directly to PIP claimants, replacing some or all of the cash provided by PIP. While the Timms Review's 'emerging recommendations' include cash remaining the 'foundation of the award', they also suggest that some awards could include services and other non-cash support too (Department for Work and Pensions, 2026d). Economically, this kind of reform is similar to vouchers in that the government chooses what types of support can be

funded by PIP (or its replacement). This means it has the same main advantages and disadvantages of moving to a voucher-based system.

One potential advantage of public provision of services over issuing vouchers is that, because of its scale, the government might be able to provide certain types of support at lower cost than the private market. For instance, local authorities tend to get a cheaper price for social care services than private payers because they buy care services in bulk and so have more bargaining power (Jarrett, 2018). A disadvantage of public provision relative to vouchers is that – if disabled people were unable to choose an alternative provider – there would be less competitive pressure on the provider to supply a high-quality service.

The government could also take advantage of potential cost savings from public provision while still giving claimants choices over how to spend their award, by keeping PIP as a cash benefit but giving claimants the option of purchasing services at an attractive price (which would be less than the market rate for them).²⁸ Any move to integrate provision of services within PIP should make sure that it is joined up with other forms of support already available through the NHS and the social care system.

Means-testing PIP

Finally, we consider the option of imposing a means test for PIP. This was recently proposed by Reform UK, though the Timms Review has indicated it will recommend keeping PIP non-means-tested. Means-testing PIP would mean that claimants with significant income themselves, a high-income partner or significant savings would lose eligibility to PIP. By reducing eligibility, a means test would reduce costs. The government could choose either to reduce the amount it spends on PIP, or to increase average awards among those unaffected by the means test.

Section 7.4 sets out the case for and against targeting PIP at those on low incomes in principle. Here we ask how such a means test could be implemented in practice, and what other effects this might have.

The simplest way the government could means-test PIP would be to integrate it into universal credit (UC), the main means-tested benefit in the UK.²⁹ There would be two key advantages to

²⁸ This would be conceptually similar to the Motability scheme, in which claimants of the enhanced component of the mobility element of PIP can forgo their PIP in exchange for the lease of a car, which is offered on attractive terms.

²⁹ The health element of universal credit is assessed by the work capability assessment (WCA), which assesses ability to work. In the ‘Pathways to Work’ Green Paper published in March 2025 (Department for Work and Pensions, 2025), the government stated that it intended to scrap the WCA and move to assess UC health with the PIP assessment too. If this reform was enacted, means-testing PIP would entail simply increasing the health element of UC and scrapping PIP as a separate benefit.

implementing a means test through UC. First, it would be simple for claimants as they would only have to apply for UC rather than UC and a separate means-tested version of PIP. Second, UC is designed to ensure that no claimant has very weak work incentives (Ray-Chaudhuri and Waters, 2024).

At present, 67% of working-age PIP claimants receive universal credit,³⁰ reflecting the fact that, even though PIP is not currently means-tested, most PIP claimants are on low incomes. Consequently, at least this share of PIP claimants would continue to receive their full PIP award under means-testing. If there was no change in behaviour among the other 33%, such a reform would save at most £8.2 billion per year (which equates to 33% of current PIP spending³¹).

However, in reality, some share of PIP claimants who are not currently receiving UC would still receive at least some of their PIP award and the reform would save less. First, the integration of PIP into UC might encourage some PIP claimants who are eligible for UC but who do not receive it to apply (which would *increase* their income, compared with the status quo). Second, the structure of UC means that adding PIP to UC would mean some families who currently have earnings too high to qualify for UC would gain eligibility.³² There would likely still be a large saving from incorporating PIP into UC, although it would be less than £8.2 billion per year as a result of these two effects.

Any means-tested benefit involves a trade-off between the degree of targeting at low-income households and discouraging people from earning. Means-testing PIP is no different and would weaken work incentives for some PIP claimants. UC is withdrawn at a rate of 55 pence for every £1 earned after tax (above, for some claimants, a small ‘work allowance’). This is known as the UC ‘taper’. For existing UC claimants, adding PIP to UC would increase the level of earnings at which UC is tapered to zero. This means that, for some claimants, it would reduce their incentive to take on additional hours of work (as there would be a wider range of hours over which they would be subject to the UC taper). In addition, anyone who applies for UC because of the reform (as discussed above) would face much weaker work incentives after applying, since they would now be on the taper. Those who are ineligible for UC because their income is too high, and so lose their PIP, would also have a greater incentive to reduce their hours after the reform in order

³⁰ Or the income-related employment and support allowance (ESA), which is a legacy benefit that will eventually be replaced by UC.

³¹ We calculated this using the actual average award for this group, which happens to be similar to the overall average award.

³² Each UC claimant will have an earnings level above which they will not qualify, which is determined based on the size of their out-of-work award and their taper rate (for most claimants for every £1 they earn, they receive 55 pence less in UC). Adding PIP to UC would increase out-of-work award amounts and so, assuming the government did not also change the taper rates applied to people, it would increase the amount that someone can earn before losing eligibility for UC.

to obtain UC and hence PIP.³³ Means-testing PIP would therefore improve targeting towards those who are worse off but would weaken work incentives.

Finally, any proposal to means-test PIP should consider how it interacts with existing means-tested support. There is already a health element of universal credit, which provides an additional £2,607 a year for those assessed to have limited capability for work or work-related activity due to their condition. Adding PIP to UC would mean two arms of health-related means-tested support, with two separate tests. If the government does want to means-test PIP, there may be a case for integrating the two elements of support and using the same assessment to assess eligibility for both. Both the Starmer government and the previous Conservative government have proposed linking eligibility for the UC health element to the PIP assessment. Ray-Chaudhuri and Waters (2024) provide a detailed discussion of the advantages and disadvantages of these reforms.

7.6 Conclusion

Personal independence payment was introduced 13 years ago. Since then, there have been big changes in the prevalence and nature of reported disability, as well as to the economy and to the rest of the benefit system. We can see the effects of these trends in the growing and changing caseload of PIP claimants. As spending and claimant numbers for PIP grow, making sure the system is well designed becomes increasingly important. This is a good time to review the system and decide whether reforms are needed.

When designing reforms to PIP, the government needs to decide what it is trying to achieve. What outcome arising from disability is the government attempting to address? Does it want to target resources towards those whose living standards are lower because they face the additional disability-related costs? If so, this would justify a benefit that provides financial support such as PIP. Alternatively, does it want to improve overall well-being? In which case, it is possible that it is more effective to subsidise *particular* goods and services, which could be achieved by providing vouchers or in-kind support. The government must also decide on the distributional outcomes it would like to achieve. Does it want to reduce inequalities caused by disability even if this means providing additional money to people on high incomes? If so, then this would justify the current non-means-tested structure of PIP. Alternatively, does it want to focus resources on those most likely to have poor outcomes? In that case, it should consider means-

³³ The work incentive effects we discuss here are ‘substitution’ effects: means-testing PIP would (in some cases) change the extra income claimants could keep if they increased their hours. The final group we discuss would also experience an ‘income’ effect: the loss of PIP income could encourage them to work *more* hours to make up for it. Income effects are generally thought to be smaller than substitution effects.

testing support, as those with disabilities and on low incomes are more likely to report not being able to afford essentials and more likely to report low life satisfaction.

Once the government has chosen the broad structure of the new disability benefit system, it then needs to think carefully about how best to design the benefit to reach that goal.

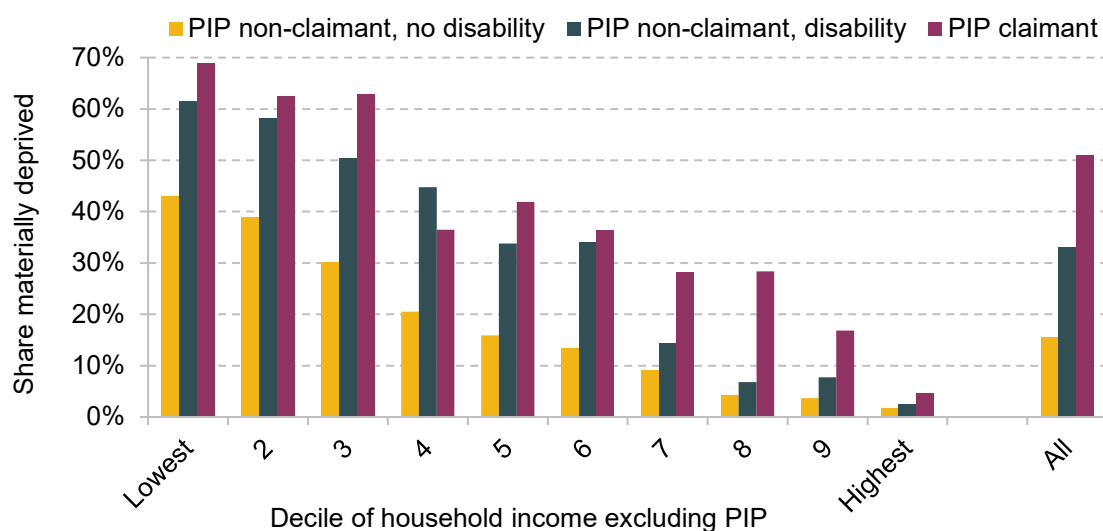
One dimension of potential reform is the assessment process itself. How a disability affects one's life is a private experience and so it is difficult for an assessor to understand or measure it precisely. Issues with the current PIP assessment reinforce this point. One's likelihood of being rejected from PIP differs somewhat depending upon which firm does the assessment, and there is some evidence to suggest that the assessment is sensitive to claimant behaviour. But this presents policymakers with a trade-off. Getting information is not costless – claimants often report that the current assessment is already an intrusive and unpleasant experience – and obtaining more information to improve accuracy would likely only make these experiences worse. Irrespective of whether the assessment process can be improved, it does seem that as things stand PIP targets a high-need group: its claimants are more likely to struggle with multiple day-to-day activities, be materially deprived, and report low well-being compared even with other disabled people and certainly with the broader population.

When designing the system and assessment process, the government faces a trade-off: making the eligibility criteria or assessment process stricter will reduce the number of people who receive support that it would rather did not, but at the risk of withdrawing support from people who it does want to help. The more narrowly support is targeted, the fewer people in the first category, but also the more in the second. One way of achieving such a narrowing would be to target support towards those with the most severe disabilities, whose conditions and their effects are easier to verify. More prosaically, there is also a case for targeting extra support towards those with the more severe disabilities as they are likely the most in need of it. A number of the options we consider would target more resources towards those with more severe or easier-to-verify needs – for example, by increasing the amount of support those with the greatest needs (as determined by the current system) receive relative to other claimants or by introducing vouchers that can be redeemed only for disability-related costs. However, the government should be cautious of trying to target those with the greatest need through blanket policies which, for example, treat all people with mental health conditions or all young people differently, as there are people with high needs in each of these groups.

There are no easy options for reform: all the options we discuss entail difficult trade-offs and will involve winners and losers. However, if PIP is not effectively achieving the rationales the government has for it, as the Timms Review has stated, this will only become an increasing problem if, as the official forecasts expect, the number of claimants continues to rise.

Appendix 7A

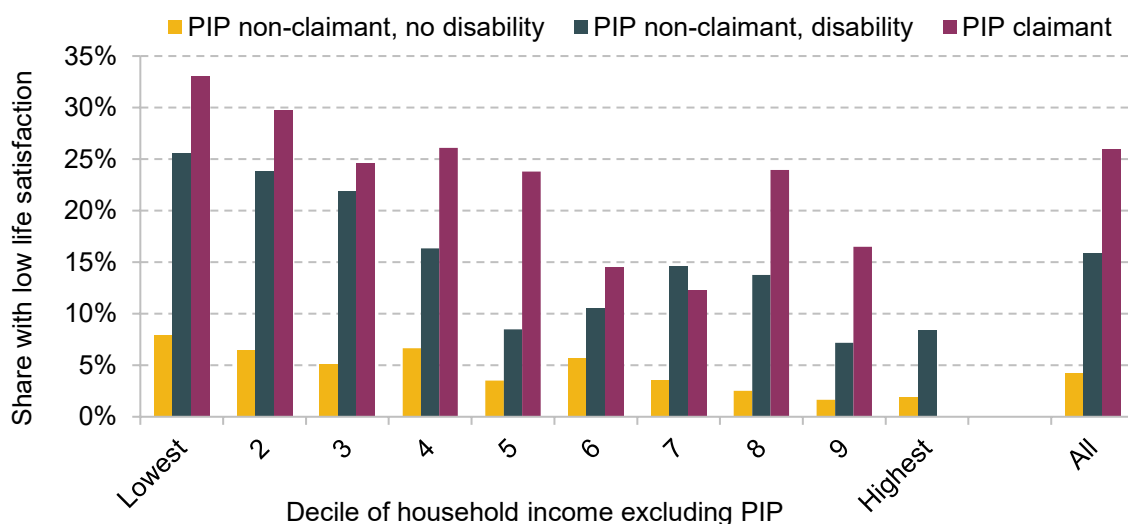
Figure 7A.1. Percentage of group in material deprivation for working-age PIP claimants and for other working-age people with and without disabilities, by decile of household income excluding income from PIP



Note: Household income is equivalised and is after housing costs. Disability is self-reported. Someone is classified as materially deprived if they report they are unable to afford five or more essentials. The full list of material deprivation questions is provided below.

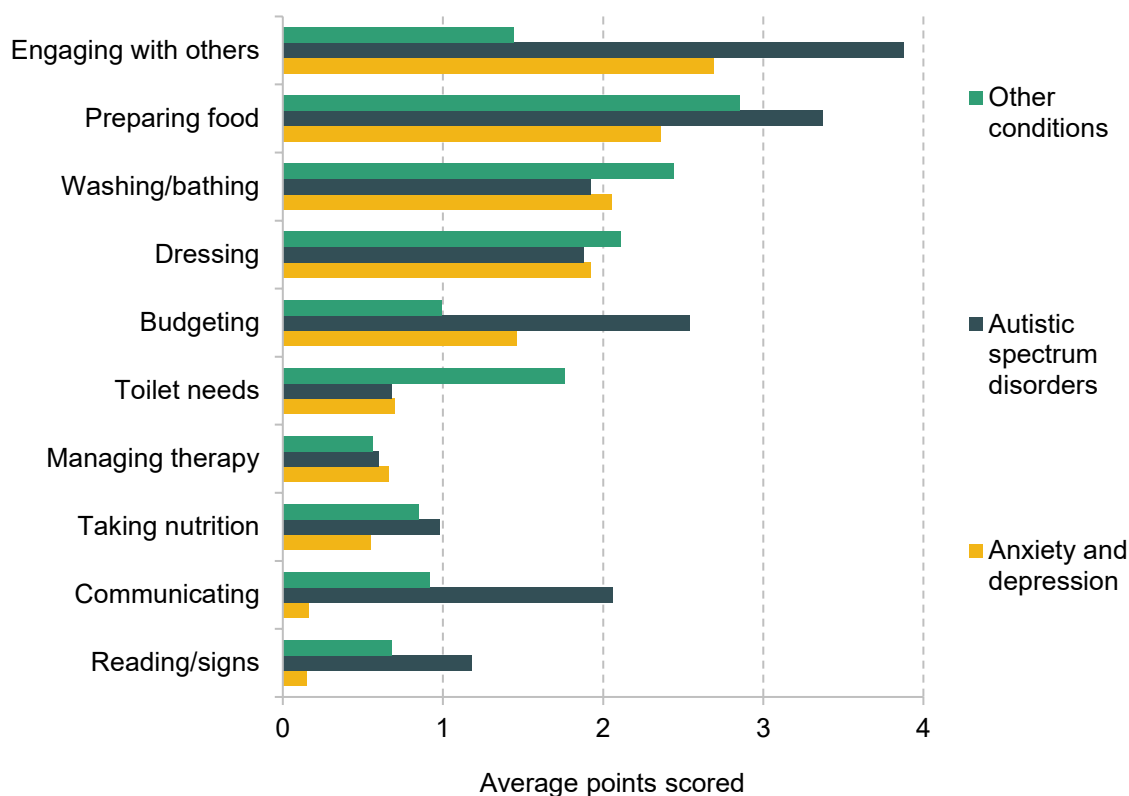
Source: Family Resources Survey, 2024–25.

Figure 7A.2. Percentage of group reporting low life satisfaction for working-age PIP claimants and for other working-age people with and without disabilities, by household income excluding income from PIP



Note: Household income is equivalised and is after housing costs. Disability is self-reported. Low life satisfaction is defined as answering the question 'Overall, how satisfied are you with your life nowadays?' with a 4 or below on a 10-point scale.

Source: Family Resources Survey, 2024–25.

Figure 7A.3. Daily living score by question for anxiety and depression, autism spectrum disorders and other conditions

Source: Department for Work and Pensions Pathways to Work Evidence Pack, table 2.28.

Categories of condition used in Figure 7.11

Mental, learning and neurodevelopmental conditions used in Figure 7.11

Depression, Psychosis or schizophrenia, Bipolar disorder, Eating disorder, Post-traumatic stress disorder (PTSD), Phobia, Panic attacks, Attention deficit hyperactivity disorder / attention deficit disorder (ADHD/ADD), Post-natal depression, Personality disorder, Obsessive–compulsive disorder (OCD), Seasonal affective disorder, Alcohol or drug dependence, Any other anxiety disorder, Any other emotional, nervous, psychiatric problem or condition, Generalised anxiety disorder, Learning disability.

Physical conditions used in Figure 7.11

Asthma, Congestive heart failure, Coronary heart disease, Angina, Heart attack or myocardial infarction, Stroke, Emphysema, Hypothyroidism or an under-active thyroid, Chronic bronchitis, Liver condition, Epilepsy, High blood pressure, Multiple sclerosis, Chronic obstructive pulmonary disease (COPD), Osteoarthritis, Rheumatoid arthritis, Other arthritis, Bowel or colorectal cancer, Lung cancer, Breast cancer, Prostate cancer, Liver cancer, Skin cancer or melanoma, Other cancer, Type 1 diabetes, Type 2 diabetes, Gestational diabetes, Other diabetes, Dementia (including Alzheimer's), Nervous breakdown, Cystic fibrosis, Blood or bone marrow

cancer (e.g. leukaemia), Chronic kidney disease, Parkinson's disease, Motor neurone disease, Cerebral palsy, Other brain or nerve condition, Spleen problems, Sickle cell disease, Very overweight.

Working-age material deprivation items

The Family Resources Survey asks the following questions of working-age people. Any individual who answers that they (or their household) cannot afford at least five of them is labelled as 'materially deprived'.

Asked once per family – one response applies to all working-age adults in that family

- Able to pay bills without cutting back on essentials
- Able to put money aside for unexpected expenses
- Cover cost of repair or to replace appliances
- Home in good state of decoration or repair
- Home adequately warm in cold weather
- Home damp free
- Reliable access to internet at home
- Access to computer or tablet
- Adequate access to reliable transport
- Heating, electrics and plumbing in good working order
- Home contents insurance

Asked separately of each working-age adult in the family

- Three meals a day
- Fresh fruit or vegetables every day
- Annual break away from home
- Without regular money worries
- Regular payments to workplace or private pension
- Appropriate clothes for work or job interview
- Regular dental appointments
- Go out socially at least monthly
- See friends and family at least monthly
- Small amount of money for oneself

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8. Electricity prices

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UK electricity prices are now among the highest in the developed world. Over the last 10 years, the UK has moved from being close to the average of advanced economies to having some of the highest electricity prices among comparable countries. High electricity prices are concerning because they exacerbate cost-of-living pressures, harm international competitiveness in energy-intensive industries, and frustrate wider efforts to electrify heating and transport.

Policymakers are understandably under pressure to bring these high prices down, and it is notable that one of the first policy announcements of the new Burnham administration was a temporary cut in the rate of VAT for households' electricity consumption. However, the temporary nature of this and other recent measures betrays an absence of a long-term plan for determining how electricity should be taxed and priced. Confusingly, politicians also seem to offer contradictory solutions, with some arguing that the answer to high prices is to continue investing in renewable power to get the UK off the 'fossil fuel rollercoaster', while others argue that we should instead slow the pace of greenhouse gas emissions reductions and accept a grid with more power generated by fossil-fuel-fired power plants.

This chapter takes a step back to survey the complex policies that currently determine the UK's electricity prices, and to ask how the structure of incentives for electricity consumers and generators could be altered, both to improve the efficiency of the electricity system and to meet any given greenhouse gas emissions target at lower cost.

Key findings

1. **Household electricity prices have risen by almost 150% since 2010, and business electricity prices by nearly 175%, with a particularly rapid rise in the last five years.** Two factors stand out as particularly important contributors to rising prices. First: since 2021, gas prices have risen rapidly, primarily due to geopolitical instability. Prices were 63% higher in real terms in the first quarter of 2026 than in the second quarter of 2021. The UK electricity system is particularly exposed to the gas price due to the mix of generation technologies used, although the growth of renewables is now reducing its exposure. Second: from around 2010, there has been

an increase in carbon taxes on fossil fuel generators, and in the scale of support for low-carbon generators and home retrofit schemes, the costs of which were passed on to electricity prices. Taxes and levies (excluding VAT) grew by 59% in real terms between 2017 and 2025, and made up 23% of an average household's electricity bill in 2025, though since then the government has taken significant steps to reduce these costs. This and higher wholesale prices meant that taxes and levies only made up 17% of an average household's bill in July–October 2026.

2. **Continuing to push for rapid decarbonisation does risk increasing costs, but the dramatic fall in the cost of renewables has made the effect of decarbonisation on long-run energy costs difficult to predict.** Renewable plants built today often require much lower subsidies than those built in the 2000s and 2010s. Forecasts from government bodies suggest that achieving net zero by 2050 would modestly increase the overall costs of the energy system by 2050 compared with making less ambitious emissions reductions. The forecast costs associated with decarbonising electricity are front-loaded, rising into the 2030s before lower day-to-day costs are realised through the 2040s. However, these projections are highly uncertain and depend on the future evolution of, among other things, fossil fuel prices, technological developments and interest rates.
3. **The costs of upgrading and operating the electricity grid are entering a 'crunch' period of steep increases.** Annual spending on grid upgrades is forecast to more than double in real terms by the end of the decade, largely in order to accommodate more renewables feeding into the grid. The costs of ensuring that supply is always equal to demand throughout the grid ('balancing costs') are also expected to more than double over the same period. Together these costs, which were £7 billion in 2024–25, are set to rise by around £12 billion a year by 2030–31, after which the annual costs are expected to ease, provided new grid upgrades are delivered on time.
4. **Consumer electricity prices are poorly aligned with the way the costs of supplying electricity actually vary over time and space, raising the overall cost of the electricity system.** Wholesale electricity prices vary substantially by hour and day, yet only around 10% of households and a minority of firms face time-varying prices, despite this now being technologically feasible. Encouraging more time-varying prices would incentivise consumers to change when they use electricity – moving away from peak times when it is expensive to produce towards times when it is cheaper, including times when there is so much renewable electricity being produced that the grid currently has to pay some generators to reduce their output. Ensuring electricity prices also reflect cost differences across locations could yield further savings. The government has ruled out allowing wholesale electricity prices to vary across the

country (i.e. 'zonal pricing') to avoid creating uncertainty for investors, but there are other options to introduce more locational price signals into existing markets and policies.

5. **The taxation of electricity needs simplification and reform.** There are some costs of supplying electricity that do not rise with day-to-day consumption, such as payments to existing low-carbon capacity, maintaining the grid and support for low-income households. That these are, at least in part, currently recovered through levies on the unit price of electricity excessively penalises electricity use. **Funding these fixed costs of the electricity system through standing charges or general taxation would be more efficient than recovering them through per-unit charges.** The issue of how these fixed costs are paid for will become more pressing as the expansion of renewables moves the UK from an electricity system with relatively low fixed costs but high costs of extra consumption (when an additional unit of electricity is produced using gas), to one with higher fixed costs but where the costs of extra consumption are very low (when electricity is produced using wind and solar).
6. While the per-unit taxes and levies that fund fixed costs inefficiently penalise the use of electricity, **the reduced 5% VAT rate on domestic energy (falling to 0% for electricity use from October 2026 until April 2027) inefficiently encourages households to consume more energy.** Discounted VAT rates on energy have greater benefits for lower-income households as a proportion of their income, but they are a blunt tool for redistribution relative to other instruments in the tax and benefit system. In cash terms, most of the benefits accrue to higher-income households. Fixing this will require careful attention to the distributional implications.
7. Looking across the energy system, incentives to reduce greenhouse gas emissions vary wildly across different energy sources and by end user. There are disproportionately strong incentives to reduce emissions arising from electricity generation, as well as supplemental targets for electricity to decarbonise faster than other sectors. Both make the path to net zero more expensive than it needs to be. **The government should make incentives to reduce carbon emissions more balanced across different sectors of the economy.**

8.1 Introduction

UK electricity prices are high and have risen rapidly in the past 15 years. The price of electricity for households has risen by 147% since 2010; in contrast, general prices – measured by the Consumer Prices Index (CPI) – increased by 63% over the same period. Electricity prices for businesses rose by 174% compared with an average input price increase – measured by the Producer Price Index (PPI) – of 76%.¹

While electricity prices have risen across the world, prices have risen faster in the UK than elsewhere, with the result that UK households and businesses today face some of the highest electricity prices among high-income countries. This is concerning for many of the government's goals, including increasing economic growth, increasing living standards and ambitions to 'electrify' UK transport and heating to achieve carbon emissions targets.

Two main factors have contributed to these trends. Over the last five years, the main factor driving up electricity prices has been much higher international gas prices since Summer 2021, with prices spiking in the run-up to, and following, the start of the Russia–Ukraine war. These particularly affected the UK because of the importance of gas-fired power in determining electricity prices. Higher wholesale gas prices were the primary reason for the 52% increase in household electricity prices and 85% increase in household gas prices from June 2021 to December 2023 – increases which would have been significantly larger were it not for massive government subsidies to keep energy bills down over this period.² While wholesale gas prices have come down since then, they remain elevated relative to pre-war levels, and recent price fluctuations following conflict in the Middle East are a reminder of the ongoing threat of additional shocks.

The second contributing factor is policy. The 2008 Climate Change Act enshrined in law a commitment to achieve significant reductions in territorial greenhouse gas (GHG) emissions by 2050, and this was later amended to require 'net zero' emissions by that date.³ To meet these targets, successive governments have incentivised renewable electricity generation while phasing out fossil fuels. As a result, the UK electricity market has been transformed over the last 15 years. In 2010, just 7% of the UK's electricity came from renewable sources while nearly 30% was generated by burning coal. By 2025, renewables accounted for just over half of the

¹ Authors' calculations based on ONS CPI series for electricity (D7DT), CPI all items (D7BT), PPI series for manufacturing inputs (GHIP) and electricity input costs including the climate change levy (EWM). Comparison period is January 2010 to July 2026.

² Authors' calculations based on ONS CPI series for electricity and gas (D7DT and D7DU).

³ Territorial emissions are emissions that occur on UK soil. This is how international climate change agreements have decided to allocate responsibility for emission reductions between countries.

UK's electricity supply, and coal-fired electricity had been phased out entirely.⁴ These changes would not have happened without significant government intervention, including support for renewables and taxes on carbon emissions associated with burning fossil fuels.

As anticipated, this transformation has led to higher electricity prices to date relative to a 'business-as-usual' case where the electricity system invested in the lowest-cost sources of power, irrespective of their GHG emissions. Significant subsidies were required to make renewable sources of power economically viable over this period, and these have been funded through taxes on electricity, pushing up prices.

The electricity sector also provides a striking example of industrial policy. Successive governments have decided to steer which technologies are developed and deployed, with policies designed to favour the use of technologies such as offshore wind or nuclear power, even where cheaper sources such as onshore wind and solar have been available.

As a stepping stone towards the 2050 net zero goal, the Starmer government set a 'clean power' target in 2024 that entails almost complete decarbonisation of Great Britain's electricity system by 2030. This brought forward a 2035 target set in 2021 by the prior Johnson government, requiring significant acceleration of investment in additional generation and storage capacity, as well as upgrades to the electricity grid.

Future government decisions about the electricity sector now occur in a radically different context from what was the case even a decade ago. Technological change and economies of scale have brought about massive reductions in the cost of renewable technologies and energy storage, making the deployment of renewables increasingly economically viable. This dramatic drop in the cost of renewables means there is now considerable uncertainty over how net zero policies will affect the cost of energy going forward.

In addition, the large expansion in renewables capacity has changed, and will continue to change, the cost structure of electricity supply. A largely fossil-fuel-based system has relatively low fixed costs compared with the high costs of producing an additional unit of electricity, as this requires burning expensive fuel. The continued growth of renewables is taking us towards a system with relatively high fixed costs, including the significant capital costs of installing capacity and ensuring the grid can distribute and store electricity as needed, compared with much lower day-to-day costs of producing electricity (indeed, near-free during sunny or windy periods).

⁴ Authors' calculations from table 5.6.C of Department for Energy Security and Net Zero (2026e).

The fact that electricity prices in Great Britain (GB) are currently so high reflects the fact that current consumers are paying the cost for historical renewables subsidies and ongoing network investment to upgrade the grid, but are not yet able to fully reap the benefits of renewables displacing gas-fired generation from the electricity supply mix. This is exacerbated when gas prices are at their current elevated levels.

These challenges are compounded by the design of the electricity market, which sets a single national price for electricity generation even when some local areas have excess cheap electricity. Moreover, most consumers do not face prices that vary throughout the day, limiting how much consumers can benefit from times when electricity is very cheap to produce or be encouraged to reduce their consumption when electricity is very expensive.

In the short term, the government has responded to the high price of electricity by temporarily funding some of the cost of renewables subsidies through general taxation rather than taxes on domestic electricity consumption. It has also shifted the costs of home retrofits into general government spending, implemented a temporary reduction in VAT charged on domestic electricity from 5% to 0%, expanded eligibility for the Warm Home Discount (a discount for lower-income households on their electricity bills) and extended relief from policy levies for energy-intensive businesses. The temporary nature of some of these measures, and the fact they often only affect the electricity price for households rather than businesses, are indicative of a lack of long-term thinking into how electricity should be priced and taxed in general. They also do not help to reduce the underlying costs of the electricity system, which is the fundamental driver of high prices.

In this chapter, we consider the fundamental principles of how electricity should be priced and taxed, unpack the causes of the high costs of the GB electricity system, and recommend several policy reforms.

Electricity generation and consumption are currently subject to a confusing array of charges and taxes, some affecting only businesses and some affecting households. Layered on top of this complexity is a reduced rate of VAT on households' domestic energy consumption, including electricity. This system needs to be rethought and simplified.

Our recommendations are guided by the principle that the price of electricity faced by consumers should be equal to the cost of producing an extra unit of electricity (including any social costs such as emissions) plus the standard rate of VAT for households.

However, many of the taxes and charges currently applied to households' and businesses' per-unit consumption of electricity are there to recover fixed costs of the electricity system, including the costs of funding low-carbon capacity, network infrastructure and schemes to help

low-income consumers. Since these costs do not change according to how much electricity users consume, funding them through per-unit charges excessively penalises additional electricity use. We recommend they should be removed from the unit price. Of course, these fixed costs still need to be paid for. We discuss several approaches that would cover these costs with less distortion of electricity prices and consumption decisions. Fixed costs are set to grow in the coming years, making these changes more important.

For households, the reduced 5% rate of VAT applied to household energy use currently offsets the impacts of some of these charges on the unit price. But this is more of a coincidence than a deliberate choice by policymakers, and discounted rates of VAT on gas and heating oil mean that households' energy consumption is still distorted towards using these more polluting fuels. Moreover, as the charges needed to recover fixed costs of the electricity system grow in future, the penalty on electricity relative to other forms of energy will grow. A more coherent and principled approach to taxing electricity and energy in general would help ensure domestic users face the right incentives now and in the future.

Finally, we argue that Britain's approach to taxing GHG emissions is inconsistent both across fuel types – such as electricity and gas – and across users – households and businesses. This makes achieving net zero more costly for the country as a whole than it needs to be, as does the priority placed on decarbonising the electricity sector faster than any other sector.

The remainder of the chapter is structured as follows. In Section 8.2, we discuss UK/GB electricity prices in their historical and international context. In Section 8.3, we present the different components that determine electricity prices and how they have changed over time. In Section 8.4, we set out our framework for thinking about what electricity prices would give different actors in the electricity system the right incentives. In Section 8.5, we discuss the goal of net zero and what decarbonisation has done and is likely to do to energy costs. In Section 8.6, we put forward policy options to bring down the system cost of producing electricity. In Section 8.7, we present options to reform the way electricity is taxed. Section 8.8 summarises our conclusions and recommendations.

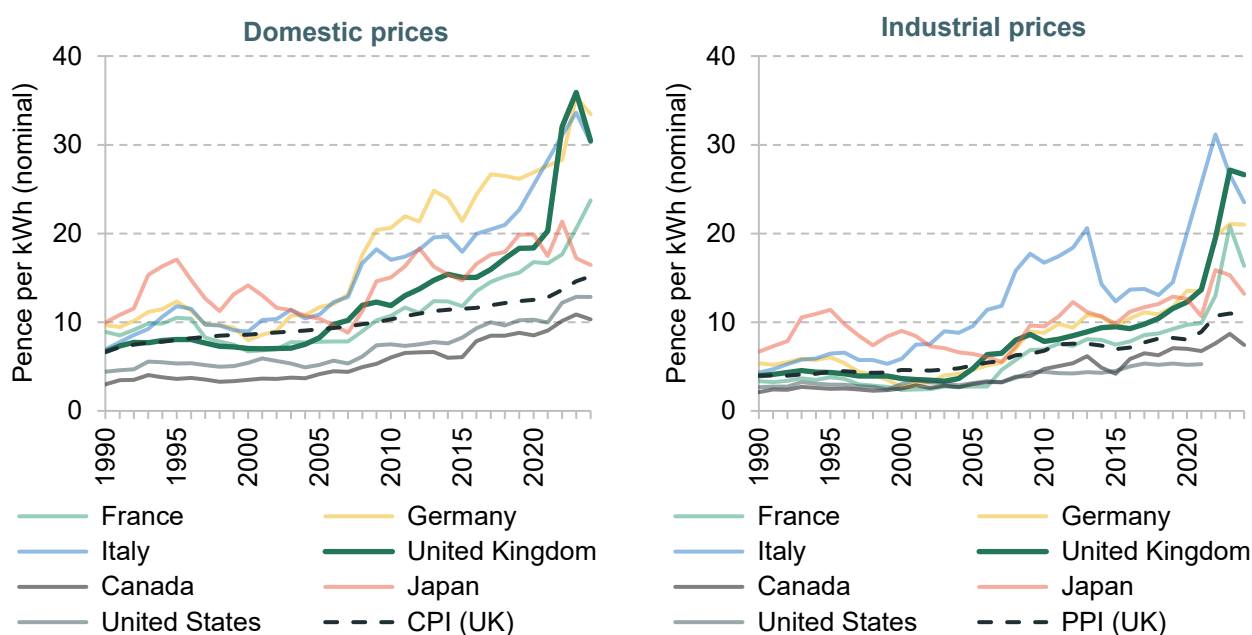
A word on terminology: Great Britain has a separate electricity system to Northern Ireland, which shares a single electricity market with the Republic of Ireland. This means that much of the discussion of markets and policies below pertain to Great Britain rather than the UK. However, some statistics on energy usage and prices are only published for the whole of the UK rather than Great Britain, and some policies – including the goal of achieving net zero GHG emissions – are UK-wide. Throughout the chapter, we have been careful to distinguish the two.

8.2 UK/GB electricity prices

Figure 8.1 shows the growth in the electricity prices faced by domestic and industrial consumers in the UK and other comparable countries. For much of the last two decades, UK electricity prices have risen steadily. For households, the increase has been faster than the increase in prices for most other consumer goods, as captured by the Consumer Prices Index, and industrial electricity prices likewise have risen faster than the prices of most other inputs to production. There was then a particularly sharp increase in UK prices from mid 2021 onwards as countries emerged from the COVID-19 pandemic and the war in Ukraine affected energy supplies.

Before 2020, UK electricity prices were broadly in the middle of the pack relative to other advanced economies. While prices in some countries have been consistently lower than in the UK over this period – most notably the US and Canada – others saw large price increases much earlier than the UK, including Germany and Italy. However, the UK stands out in having seen particularly big price increases since 2020. The consequence of this is that UK electricity prices are now among the highest in the G7, and among the highest across Europe.

Figure 8.1. Evolution of electricity prices in G7 countries and overall UK price inflation

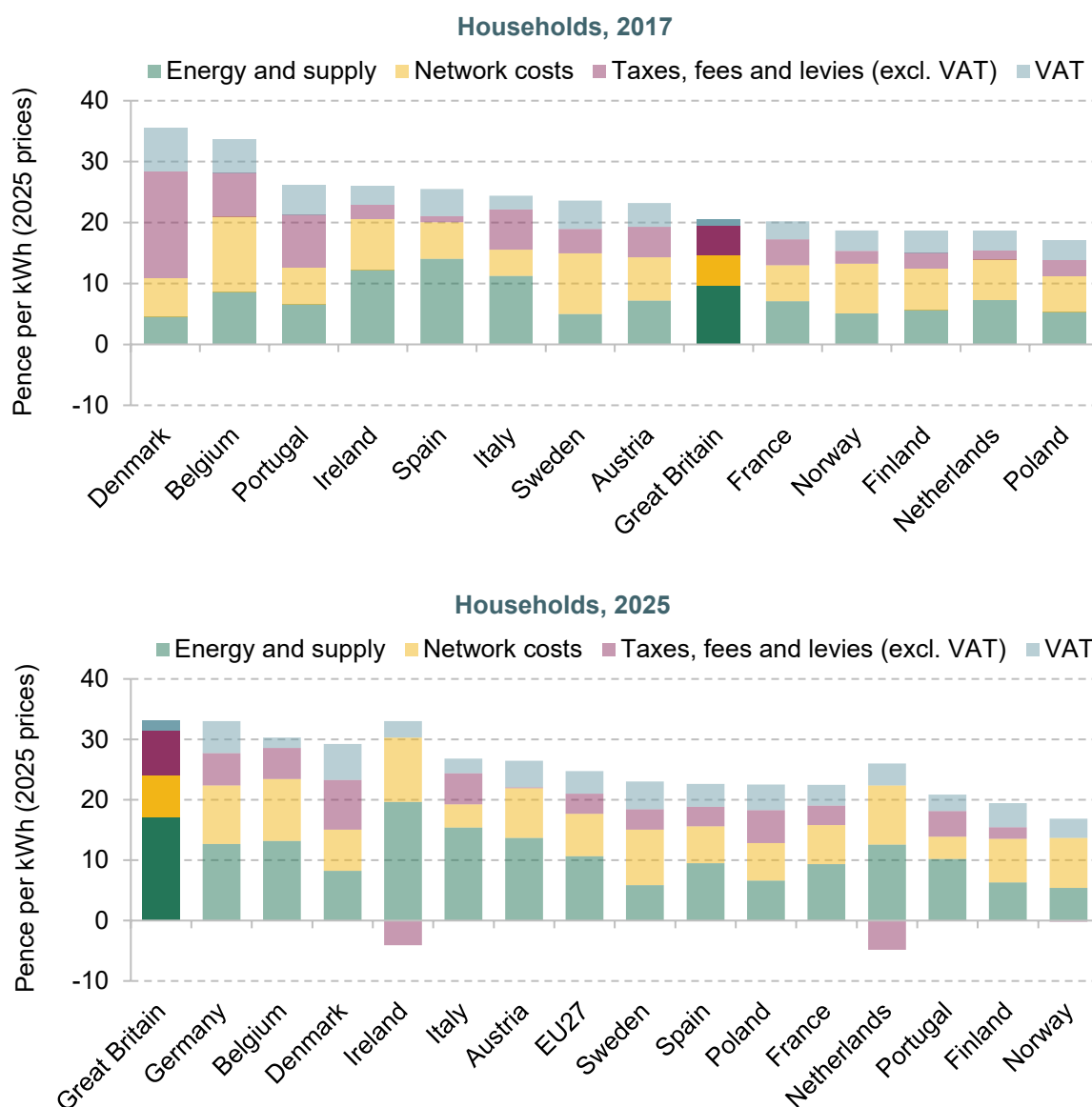


Note: Electricity prices are annual averages and include taxes. The dashed line in each chart represents how UK electricity prices would have evolved if they had followed the consumer price index excluding energy costs (CPI) or the producer price index (PPI) respectively since 1990. The PPI series includes energy inputs, and so is not fully independent of electricity prices.

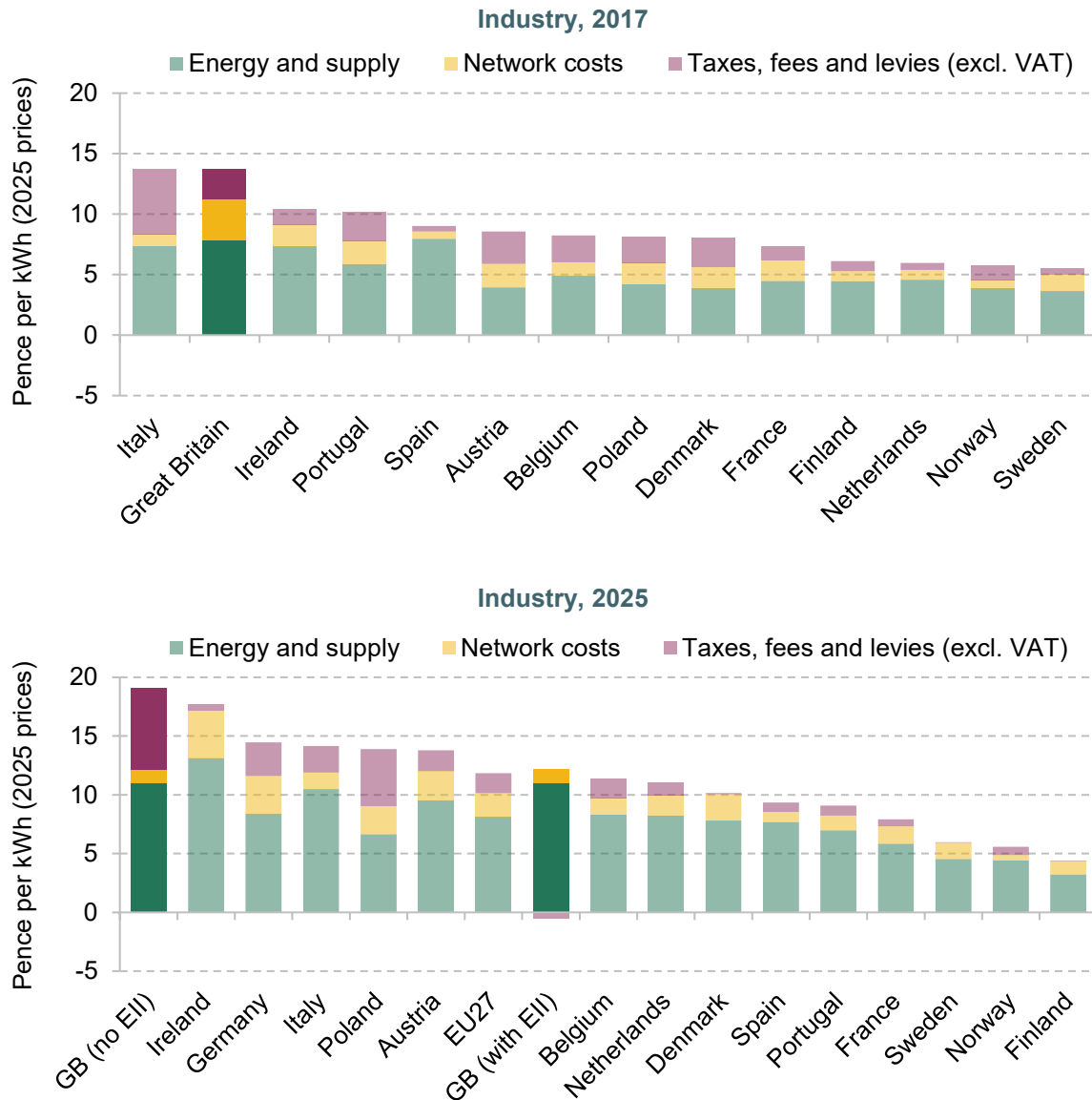
Source: Energy prices come from the Department for Energy Security and Net Zero (<https://www.gov.uk/government/statistical-data-sets/international-domestic-energy-prices> and <https://www.gov.uk/government/statistical-data-sets/international-non-domestic-energy-prices>) respectively. CPI comes from Office for National Statistics (<https://www.ons.gov.uk/economy/inflationandpriceindices/timeseries/dkc5>). PPI comes from Office for National Statistics (<https://www.ons.gov.uk/economy/inflationandpriceindices/timeseries/ghip/ppi>).

In most countries, the single largest cost component of electricity is the ‘energy and supply’ costs which include both the wholesale cost of generating electricity and the retail supplier costs. These costs have risen significantly throughout Europe, primarily driven by increases in the price of gas in the run-up to, and following, the start of the Russia–Ukraine war. Gas prices faced by firms in Great Britain were still 63% higher in real terms in the first quarter of 2026 than in the second quarter of 2021 (Department for Energy Security and Net Zero, 2026g).⁵

Figure 8.2. Electricity price breakdown across European countries



⁵ This figure is the average gas price for manufacturing industry, uprated using CPI excluding energy.



Note: 'Energy and supply' comprises the direct fuel component minus the Contracts for Difference allowance, balancing costs, operating costs, payments method adjustments, debt-related costs, earnings before interest and taxes for energy suppliers, and headroom allowance. 'Network costs' includes transmission and distribution network charges, smart meter network charges, and industry charges. 'Taxes, fees and levies' includes all policy costs, including Contracts for Difference, charges for the capacity market and levelisation fees. GB household figures for 2025 were taken from the Ofgem price cap methodology, averaging over each quarter in 2025. Non-GB figures are for a household with consumption between 2,500 kWh and 4,999 kWh and have been converted to GBP using annual average exchange rates. Industrial figures are for a firm with consumption of 20–70 MWh. We report two figures for industrial prices in Great Britain in 2025, one for an industrial firm eligible for the energy-intensive industry (EII) discounts under the British Industry Supercharger scheme, explained in Box 8.3 later, and one ineligible. Figures relate to Great Britain rather than the UK due to data availability constraints. We include all European Economic Area (EEA) countries with data available for both years and EU 27 average in 2025 for reference.

Source: See next page.

Source for Figure 8.2

Authors' calculations using Eurostat

(https://ec.europa.eu/eurostat/databrowser/view/nrg_pc_205_c/default/table?lang=EN) and Eurostat (https://ec.europa.eu/eurostat/databrowser/product/page/NRG_PC_204_C) for industrial and domestic prices respectively for EEA countries. Ofgem consumption-adjusted breakdown in 'Final levelised cap rates model (Annex 9): 1 July to 30 September 2026' at <https://www.ofgem.gov.uk/energy-regulation/domestic-and-non-domestic/energy-pricing-rules/energy-price-cap/energy-price-cap-default-tariff-levels> for GB 2025 household price breakdown. Data generously provided by Cornwall Insight for GB 2025 industrial price breakdown.

'Network costs' have also risen for most countries over this period, with Great Britain experiencing particularly large increases for households (though not industry). Lastly, 'taxes, fees and levies' which cover various policy costs, such as subsidies for renewables, have risen markedly, with Great Britain an outlier in terms of growth in these costs and the amount of them placed on non-energy-intensive industries.

Between 2017 and 2025, average electricity prices facing households in Great Britain increased by 13 pence per kilowatt-hour (in 2025 prices). Decomposing this, energy and supply costs increased by 7.5p; network costs by 1.8p; taxes, fees and levies by 2.8p; and VAT by 0.6p. For industrial consumers without an energy-intensive industry discount, energy and supply costs increased by 3.1p, network costs fell by 2.2p and taxes, fees and levies increased by 4.5p.

Policy developments in the last year have reduced the taxes and levies charged on domestic electricity in Great Britain, such as through temporarily funding three-quarters of the cost of domestic Renewables Obligation (RO) levies through general taxation and scrapping the Energy Company Obligation (ECO) scheme, reducing household prices by just over 3 pence per kilowatt-hour.⁶ From October 2026, the rate of VAT on domestic electricity will be cut from 5% to 0%. These changes are not reflected in Figure 8.2, nor are any changes in the energy policies of other countries introduced after 2025 (as this is the latest year for which we have data).

8.3 How are electricity prices determined?

To understand how we got here, we need to explain how electricity prices in Great Britain are determined. In this section, we set out in detail the constituent parts of the electricity prices faced by both households and businesses. These are: wholesale costs, balancing costs, network costs, supplier costs, and taxes and levies. These costs will be inclusive of both the underlying costs of generating and distributing electricity and any profit margin accruing to firms within the electricity supply chain. We end the section by explaining how retail suppliers set the prices that consumers pay in order to cover these various costs.

⁶ Authors' calculations using the 'Policy cost allowance methodology' annex in Ofgem (2026d).

In this section, we simply describe the way things work at present; we discuss the pros and cons of the current system in Sections 8.6 and 8.7, where we also examine potential policy reforms.

Wholesale costs

The electricity that households and businesses use is procured on their behalf by their energy supplier. Energy suppliers do this by buying power from electricity generators in the wholesale market. These wholesale costs made up 31% of the average household electricity bill in 2025–26 (£283 per household).⁷

As in most markets, wholesale electricity prices adjust to balance supply and demand. However, electricity has one particularly distinctive feature that shapes how this works: supply and demand must match exactly on a second-by-second basis because electricity cannot be stored cheaply at scale. Failing to maintain this delicate balance can lead to blackouts if there is a deficit or damage to grid infrastructure if there is a surplus.

The UK's wholesale electricity market operates in half-hour periods. Trading takes place ahead of each period to ensure the electricity needed to meet demand is effectively supplied by generators in order of cost, cheapest first – a sequence known as the ‘merit order’. The cheapest sources of generation are scheduled first, and progressively more expensive sources are brought online as needed, until enough power is scheduled to meet demand. This means that the market-clearing price for a given half hour is set by the cost of running the most expensive generator needed – the ‘marginal’ plant.⁸ This outcome can seem counterintuitive to some; we discuss its implications in Section 8.4.

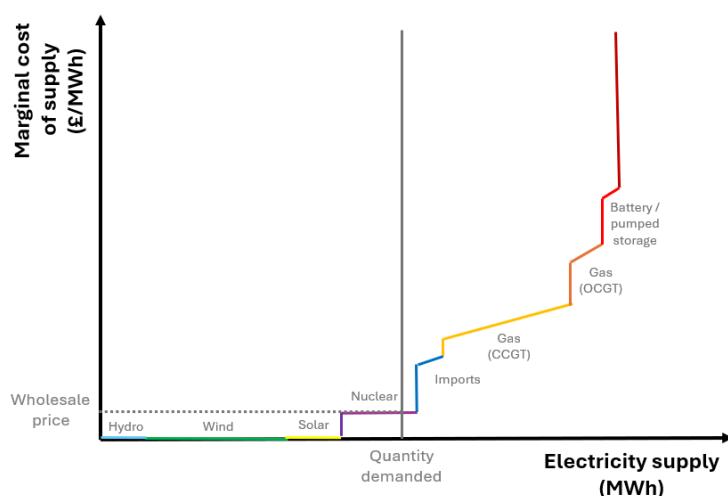
Because of the need to consistently balance supply and demand in real time and the role of the marginal plant in setting the price, wholesale prices vary significantly depending on which types of plant are needed at any given time, as illustrated in Figure 8.3. When demand is low and when it is particularly windy or sunny, renewables and nuclear alone are enough to meet demand. These sources have high up-front capital costs, but their marginal operating costs are very low. This means wholesale prices can be very low during these periods, as shown in Panel A.

⁷ Authors' calculations using Ofgem price cap methodology (Ofgem, 2026d).

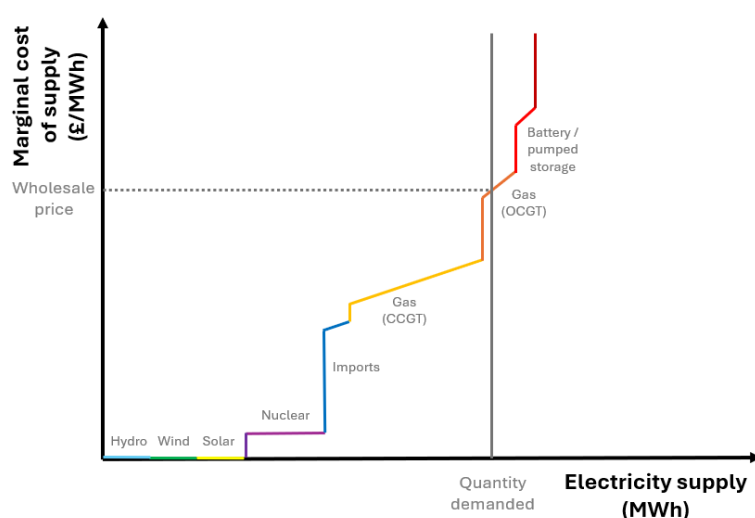
⁸ In practice, buying and selling power in the wholesale market is more complicated than this stylised description. For a given half-hour period, a generator may have actually struck contracts to sell power to suppliers anything from years to days in advance, or even in real time. These different timescales allow both generators and suppliers to hedge and manage risk. Some trading is bilateral or via exchanges where participants are paid-as-bid, while some trading involves uniform clearing-price auctions. Other generators receive a guaranteed strike price as set by a Contract for Difference (see Box 8.1) rather than a market-clearing price. In all cases though, the broad ‘merit order’ principle described here underpins the wholesale prices realised in each trading period.

Figure 8.3. Stylised illustration of the electricity dispatch curve

Panel A. Low-price scenario



Panel B. High-price scenario



Note: Charts are illustrative. Panel A shows a period where demand is low, wind output is high and gas prices are low. Here, gas plants are not needed and nuclear is the marginal supply source, so the wholesale price is low. Panel B shows a period where demand is high, wind output is low and gas prices are high. Here, an inefficient expensive (open-cycle gas turbine – OCGT) gas plant is the marginal supply source, so the wholesale price is high.

When demand is higher or conditions for renewables are less favourable, some generation is required from gas-fired power stations, pushing the price up to the level needed to make it worth their while to operate (Panel B). Gas plants have relatively low capital costs, but higher marginal operating costs due to the cost of purchasing fuel and greenhouse gas (GHG) emissions permits. Most of the UK's gas plants are efficient combined-cycle gas turbines (CCGTs), but there are

also some less efficient open-cycle ‘peaker’ plants (OCGTs). At times of peak demand, nearly all available capacity is running, including inefficient gas plants, batteries and pumped storage facilities, all of which are more expensive to run but can be turned on quickly.

Because gas power plants are often the marginal source needed to meet demand at any given point in time, the price of gas has an outsized effect on electricity prices in the UK. In 2021, gas-fired plants accounted for 40% of total generation (Department for Energy Security and Net Zero, 2026e), but were required to generate in an estimated 97% of half-hour periods to meet demand, meaning the wholesale price in those periods was set by the marginal cost of gas generation (Zakeri et al., 2023). The equivalent share in the same year was 82% in Italy, 65% in Spain, and 7% in France where nuclear power accounts for a much greater share of generation. This closer tie to gas prices helps explain why wholesale electricity prices in the UK have risen particularly sharply in recent years as gas has become more expensive.

As renewable and nuclear capacity expands, the share of periods in which gas generation is needed to meet demand is set to fall. This means gas will play a smaller role in setting the wholesale price, gradually loosening the link between gas prices and electricity bills. Government announcements indicate the share of time where gas sets the price of electricity will be ‘around 60%’ in 2026, compared with ‘around 90%’ in the early 2020s (Miliband, 2026). The National Energy System Operator (NESO) expects this share to fall to 15–47% in 2030 depending on the approach taken to reach the government’s clean power target (National Energy System Operator, 2024).

Box 8.1. Generator support schemes

In addition to receiving revenues from the wholesale market for the electricity they produce, most generators receive some form of additional payment, either to support low-carbon sources or to make sure there is sufficient capacity available to ensure supply security.

Renewables Obligation (RO)

For large-scale renewable projects built between 2002 and 2017, the government decided to provide a per-MWh subsidy under the RO scheme. While the scheme is now closed to new applicants, some currently eligible generators will still receive subsidies up until 2037.^a The RO operates by giving *Renewables Obligation certificates* to electricity generators for each MWh of renewable electricity they produce and requiring electricity suppliers to buy these certificates to cover a certain share of the megawatt-hours of electricity they supply to consumers. Renewable electricity generators therefore receive a subsidy by selling certificates to energy suppliers. Electricity supplied to energy-intensive industries is now completely exempt.^b The share of RO certificates suppliers needed to purchase per MWh initially ratcheted up over time but is now dependent on forecast supply from RO-accredited

generators (and so falls as generators exit the scheme). The size of the subsidy has varied by technology type since 2009 when the government began giving more certificates per MWh produced to technologies that it wished to support more generously (e.g. offshore wind). The cost of purchasing these certificates is then passed on to consumers through higher electricity prices. In 2024–25, the latest year for which we have data, the RO cost £7.8 billion with an average subsidy over-and-above the wholesale price of £104 per MWh – 123% of the original wholesale price in 2024–25 (Ofgem, 2026a).^c In the Autumn Budget 2025, the government decided to fund 75% of the cost of the RO certificates for households' electricity use out of general taxation from 2026–27 to 2028–29, which was forecast to cost around £2 billion per year.^d

Feed-in Tariff (FiT)

Smaller renewable generators built between 2009 and 2019 received support from the FiT scheme, which has also now closed to new applicants. These generators received fixed prices for all their electricity output for the 20-year duration of their FiT agreements. These price levels were administratively determined for each technology (e.g. onshore wind or solar) and were steadily reduced for new applicants over time as the costs of renewable technologies fell (Ofgem, 2026e). The FiT scheme was particularly important for supporting the roll-out of small-scale solar installations during the 2010s, especially residential rooftop solar. The ongoing costs of the scheme are recovered via a levy on consumer bills, adding around £20 to an average household's bill in 2025–26 (Ofgem, 2026d).

Contracts for Difference (CfD)

In 2014, the government started the CfD scheme whereby the government guarantees large-scale low-carbon electricity generators a set 'strike price' for the electricity they produce. These CfDs have generally had a 15-year duration, although this was extended to 20 years for new contracts starting this year. Over this period, the government commits to paying the generator the difference between the agreed strike price and the current wholesale market price for electricity. If the market price is above the strike price, the generator pays the difference to the government. The funding for any net costs of the CfDs is raised through a levy on most users' electricity (energy-intensive industries' use of electricity is exempt). This is now the main scheme through which the government supports large-scale low-carbon electricity generation.

Initially, CfDs were awarded based on the government's estimate of the cost of different low-carbon technologies. The largest such contract went to support the Hinkley Point C nuclear plant which is currently under construction. However, the scheme quickly moved to awarding CfDs through auctions in which the government invites developers to place bids for the strike price they would need to go ahead with their project. The government then selects an amount of capacity to procure based on a budget, and the projects with the cheapest bids are selected up to the budget cap, with the last project setting the per-MWh strike price for all successful projects. This gives prospective generators an

incentive to bid according to their actual expected costs. Many other countries now use similar auctions to encourage the development of renewable energy projects (e.g. Brazil, Germany, India and Spain).

Early CfDs in the UK had high strike prices as renewable generation was still expensive, meaning CfDs provided a significant net subsidy relative to the wholesale price. For example, in 2014, several offshore wind projects were awarded strike prices averaging around £200 per MWh, which when compared with observed wholesale prices over their operational lifetimes to date have resulted in net CfD payments of around £100 per MWh (Low Carbon Contracts Company, 2026a).

As the cost of renewables has fallen, newly agreed strike prices have also come down, as shown later in Figure 8.4. Recent auction rounds have increasingly seen strike prices near to or even below wholesale prices, indicating these contracts could entail low or even no net subsidies.^e Despite this, such contracts can still be attractive to developers because the guaranteed strike price helps reduce the risk to these investments, making it easier to raise the necessary capital.

In 2024–25, the CfD scheme cost £2.3 billion with an average subsidy over-and-above the wholesale price of £70 per MWh, lower than the equivalent subsidy under RO.^f Moreover, the most recent auction round for projects starting before 2030 secured strike prices of £91, £72 and £65 per MWh for offshore wind, onshore wind and solar respectively. For comparison, the average wholesale market price in 2025 was around £80 per MWh (Department for Energy Security and Net Zero, 2026a; Ofgem, 2026b), suggesting average net costs of CfDs per MWh are likely to fall further.

When wholesale electricity prices rose, as they did dramatically in 2021 and 2022, many low-carbon generators were able to earn large rents from elevated wholesale prices. However, those on CfDs did not because they continued to be paid their fixed strike price. In 2023, the government introduced the electricity generator levy, a windfall tax on low-carbon electricity generators without a CfD, which temporarily taxed revenues made on electricity sold above a benchmark price at a rate of 45%. In April 2026, the government increased the rate to 55% and extended the duration beyond 1 July 2028 in an attempt to get more renewable generators off the RO scheme and to sign new ‘voluntary’ CfDs instead.

The government is using CfDs not simply to support low-carbon electricity generation but also to choose which types of technologies should be added to the UK energy grid. It does this by specifying which types of technology are allowed to bid and by running separate auctions with different target capacities for offshore wind, onshore wind and solar. This and other aspects of CfDs, including potential reforms, are discussed in Section 8.6.

Capacity market (CM)

In 2014, the government introduced the CM to address concerns about ensuring reliable power supplies as traditional plants which can be turned on and off as needed (e.g. coal) were retired. CM payments provide

guaranteed, regular payments to qualifying generators for being available at times of peak demand. Capacity prices are determined in annual auctions where generators and developers submit bids, and the government sets a target amount of capacity to procure based on the forecast maximum demand it expects will need to be met. Bids are ranked and accepted in order of cost, with the capacity price for successful bidders set by the last bid required to meet the government's overall capacity target. Payments are intended to encourage efficient investment in both new and existing facilities to ensure there is sufficient capacity available to provide reliable power when the grid is under stress. CM revenues primarily go to gas-fired and nuclear plants, storage and interconnectors, as well as to some consumers that are able to reduce demand when instructed. Several other countries also have capacity markets that operate alongside their wholesale electricity market (e.g. France, Italy and much of the US).

^a Generators who were accredited on or before 25 June 2008 will stop receiving subsidies in April 2027. Those accredited after 25 June 2008 will stop receiving subsidies either 20 years after their accreditation date or on 31 March 2037, whichever date comes earlier.

^b This section draws on previous work from Adam et al. (2022).

^c Total generation from eligible generators was 74,800,000 MWh (Ofgem, 2026a). Dividing the total scheme cost of £7.8 billion (Office for Budget Responsibility, 2026a) by this gives the average cost per MWh.

^d The reason this is much lower than the total cost of the RO is because household electricity consumption is just over a third of the total (Department for Energy Security and Net Zero, 2026e).

^e While the contracts themselves may provide no net subsidies, renewable generators under CfDs still benefit from not having to pay some of the costs that their intermittent generation imposes on the wider electricity system.

^f Total generation from eligible generators under CfDs in 2024–25 was 32,800,000 MWh (Low Carbon Contracts Company, 2026a). Dividing the £2.3 billion cost (Office for Budget Responsibility, 2026a) by this gives us an average cost of £70 per MWh.

Balancing costs

The generation procured ahead of time in the wholesale market is not always exactly the right amount in the right part of the country. To ensure a stable electricity supply at every second of the day even if there is an unexpected surge in demand, or an outage from a key generator, the publicly owned National Energy System Operator makes payments to generators in order to 'balance' the grid. These balancing costs are recovered via charges on electricity bills and made up around 4% of the average household bill in 2025–26 (£40 per household) (Ofgem, 2026d).

A large part of balancing costs results from network constraints: occasions when there is enough electricity scheduled to meet demand overall, but the network cannot physically carry it to where it is needed. This is a growing problem in Great Britain, where wind capacity in the north has been built faster than the transmission capacity needed to carry its output south. During certain periods when there is excess wind generation, NESO has to pay wind farms in the north to reduce their output so as not to overload and damage the grid, and pay other generators in the south, usually gas-fired plants, to increase their output to match demand. The size of the payments to wind farms to curtail their production is also affected by the support schemes many renewable generators operate under, such as Contracts for Difference and the Renewables Obligation described in Box 8.1.

Transmission and distribution network costs

Generating electricity and ensuring a consistent balance between supply and demand is only part of the cost of getting power to consumers. Power also has to be physically transported – often over long distances – from where it is generated to where it is used, via the transmission and distribution networks. The transmission network carries electricity over long distances at high voltage; the distribution network then carries it at lower voltage to homes and businesses.

All this entails costs which are currently covered by network charges. These are controlled by regulation since the electricity network is a natural monopoly – it would be wasteful to build competing sets of pylons and cables to the same homes, making market competition both infeasible and undesirable. In practice, there are three transmission network companies and six distribution network companies, each of which has a regional monopoly in different parts of the country. The regulator Ofgem sets multi-year price controls that fix the revenue these network companies are allowed to recover from consumers. As part of this, Ofgem must determine which of their planned investments and operating costs are reasonable. Ofgem must also set the rate of return that network companies are allowed to earn to attract the necessary investment from private shareholders and lenders to fund network capital spending. The total network revenues are then collected through dedicated regulated charges on electricity bills.

Network charges can vary quite significantly by customer type and location. While most network charges for households and small businesses have a simple charging structure, with a fixed charge and a variable component based on their total electricity consumption, larger businesses face charges that vary according to the costs of supplying them. Larger commercial and industrial consumers generally face lower network costs as less infrastructure is required to serve them. The very largest industrial consumers, such as steel plants or data centres, can sometimes connect directly to the higher-voltage transmission grid, avoiding distribution network charges altogether.

Overall network costs made up 18% of the average household electricity bill in 2025–26 (£165 per household).⁹ In the coming years, these charges will rise to cover rising investment in networks, with annual transmission network charges on bills forecast to more than double in real terms, from £5.1 billion in 2025–26 to £12.3 billion in 2030–31 in 2025 prices (National Energy System Operator; 2025a and 2025b). This is driven largely by the need to build new transmission capacity to carry wind power from northern parts of the country, where it tends to be generated, further south where much of it is consumed.

⁹ Authors' calculations using Ofgem price-cap data for a single-rate metering tariff on Standard Credit (Ofgem, 2026d).

Importantly, network costs and balancing costs are closely related. As new transmission capacity is built to carry electricity from the north to the south, fewer balancing payments to curtail generation in the north will be needed, and less cheap, zero-carbon electricity will go to waste. But in the near term, both network and balancing costs are rising together as low-carbon capacity continues to be added to the grid: NESO expects balancing costs to more than double in real terms, from around £3 billion in 2024–25 to around £7 billion in 2030–31, before falling back once the transmission upgrades needed to relieve network constraints are completed.¹⁰ Consumers therefore face a ‘crunch’ period of rising costs on both fronts, with combined costs – which were £7 billion in 2024–25 – increasing by £12 billion a year by 2030–31, before the benefits of network investment start to show up as lower balancing costs later in the 2030s (Electricity System Operator, 2024). As the costs increase in size, the way these costs are funded becomes much more important. We return to how these system costs should be funded in Section 8.4.

Supplier costs

A final part of the costs of supplying electricity to consumers is the costs that retail energy suppliers themselves incur in serving customers. These made up around 18% of household bills in 2025–26 and include things such as the costs of billing, marketing, customer service and covering bad debt from customers who are unable to pay their bills (Ofgem, 2026d).

Taxes and policy costs

In addition to the costs of electricity supply (set out above), electricity bills for households and businesses also include a range of taxes and levies. Taxes and levies (excluding VAT) made up 23% of an average household’s electricity bill in 2025 and grew by 59% in real terms between 2017 and 2025, although recent changes to taxes combined with higher wholesale prices have meant that taxes and levies only made up 17% of an average household’s bill in July–October 2026 (Ofgem, 2026d). Some of the main taxes and levies are:

- **Generator support schemes.** Most government support for low-carbon sources of electricity and back-up capacity is funded via levies on consumer bills. This includes most of the Renewables Obligation (RO), Feed-in Tariff (FiT), Contracts for Difference (CfDs) and the capacity market (CM) (see Box 8.1 for a detailed description of these schemes). While the RO and FiT schemes are now closed, they will still have legacy costs into the 2030s. CfDs, which pay low-carbon generators a guaranteed ‘strike price’ for their output that is determined via competitive auctions, are still being signed. The cost of the CfD scheme is currently less than the cost of the RO, but is expected to rise as CfDs are used to procure

¹⁰ Costs taken from National Energy System Operator (2025e) and put in 2024–25 prices using table 1.7 of Office for Budget Responsibility (2026b).

further capacity (even if this is at a lower per-unit cost, as discussed in Box 8.1). Finally, the new Sizewell C nuclear plant is being financed under a new Regulated Asset Base (RAB) model, instead of a CfD. The cost of this is recovered via an additional dedicated levy.

- **Subsidies for vulnerable and low-income households.** The Warm Home Discount provides eligible low-income households a £150 lump-sum discount on their electricity bills each winter. This is funded via a levy on electricity bills.¹¹
- **Climate change levy.** Businesses pay a flat-rate tax on their use of energy, including their consumption of gas, electricity and other fuels. This was introduced in 2001 to encourage businesses to reduce their energy use. For electricity usage, it is currently set at a rate of 0.8p per kWh.
- **Subsidies for energy-intensive industrial consumers.** Firms in energy-intensive industries and that compete internationally, such as steel and chemicals producers, may be eligible for a discount through the Network Charging Compensation Scheme. This effectively exempts them from paying many levies and network charges paid by other consumers. As of February 2026, around 550 businesses qualified for these discounts, which are funded via levies placed on commercial and residential electricity bills (McDonald, 2026). The British Industrial Competitiveness Scheme (BICS) will soon provide similar discounts to approximately 10,000 businesses, starting in April 2027, funded in part by other consumers and in part via general taxation (Department for Business and Trade, 2026).
- **Value added tax.** VAT on households' electricity consumption is charged at a reduced rate of 5%, relative to the standard rate for most goods of 20%. This rate is set to fall to 0% at the beginning of October 2026 until April 2027.
- **Explicit carbon taxes.** Other taxes are levied on the greenhouse gas emissions of electricity at the point of generation. The UK Emissions Trading Scheme (UK ETS) and Carbon Price Support (CPS) are both paid directly by fossil fuel generators per tonne of carbon dioxide (CO₂) emitted. As such, these are embedded directly in the wholesale electricity price discussed earlier. The government is due to reduce a portion of these costs when it removes CPS in 2028. We argue that this is a welcome development in Section 8.7.

Several of these taxes and policy costs are set to grow in the coming years. This is largely due to the expansion of existing schemes, such as subsidies (via CfD support) as more capacity comes online and the Sizewell C RAB charge as construction at the plant advances. Other future schemes, such as government efforts to promote carbon capture and storage (CCS), are also mooted to be at least partly funded via electricity bills (Department for Energy Security and Net Zero, 2024). Conversely, where schemes are retired or policy costs moved off electricity bills,

¹¹ The Energy Companies Obligation (ECO) scheme also mandated that suppliers provide energy efficiency upgrades to eligible households. Again, the costs were recovered via a levy on electricity, although this scheme closed last year and was replaced by the Warm Homes Plan which is funded through general taxation.

such as the recent changes to the RO and ECO levies, this can reduce electricity prices. We return to this in our discussion of policy options later in the chapter.

How retail markets price electricity

Energy suppliers buy electricity from the wholesale market and then charge households and businesses a price to recover their costs and earn a profit.

Most household electricity tariffs set by retail suppliers comprise two main charges: a fixed daily ‘standing’ charge to be connected to the grid, and a unit price paid for each kilowatt-hour of electricity actually consumed. Both charges vary across providers, but in 2025 the average household in Great Britain had a standing charge of 53p per day and unit price of 26p per kWh (Department for Energy Security and Net Zero, 2026b). For an average household consuming 3,400 kWh per year, this means that 18% of their annual electricity bill is due to the standing charge, while the remaining 82% is based on their consumption.

Small businesses often face similar tariff structures to households, with a standing charge and a unit price. For larger businesses and industrial consumers, electricity can be subject to more complex tariffs that better reflect the network costs incurred in supplying them. Some industrial consumers may be sufficiently large that their unit price simply tracks the wholesale price, or they may even trade in the wholesale market directly.

Most suppliers offer tariffs that reflect the cost structure of serving their customer base, such that fixed costs (e.g. billing, customer service, or fees and levies funded on a per-customer basis) are covered by the standing charge, and then variable costs (e.g. the cost of procuring energy in the wholesale market, or fees and levies funded on a per-kWh basis) are covered by the unit price. However, suppliers can and do choose to deviate from this in an effort to compete and win new customers, such as by offering a zero standing charge tariff with a correspondingly higher unit price. Increasingly, suppliers offer more innovative tariffs, with features such as time-varying prices, automated electric vehicle charging, free electricity at particular low-cost times such as weekends, and even bundled provision of heat pumps, solar panels or batteries.

The main way that retail tariffs are directly regulated by the government is the energy price cap for households. The price cap is set by Ofgem every quarter based on its analysis of the underlying costs of supplying a residential household. The cap determines the maximum standing charge and unit rate that suppliers can charge on their standard tariffs (the tariffs that customers will be defaulted onto if they do not actively choose a different one). It was introduced in 2019 to protect households that do not switch or shop around from facing excessive price increases. No such cap exists for business electricity tariffs.

8.4 How should the price of electricity be determined?

The previous section described how electricity is currently priced in Great Britain. Here we think about how the price of electricity *should* be determined.

High prices are not necessarily a sign of a market that is not working well. Prices serve an important function in allocating resources: in situations of scarcity, higher prices give consumers an incentive to economise on use, and suppliers an incentive to enter the market and increase supply. But what's the 'right' price?

As we described above, electricity tariffs typically have a fixed component and a per-unit charge. This means that the average price of electricity per kWh consumed (as shown in Figure 8.2, for example) differs from the price of consuming an additional unit (the marginal price). The average price will include the fixed component, whereas the marginal price reflects only the per-unit charge.

Economists say that the marginal price of a good is 'efficient' if it implies that the cost of consuming an additional unit of a good (electricity in this case) is equal to the incremental social costs of producing it. The logic underpinning this definition is as follows. If the price were lower than this, consumers would have an incentive to consume electricity that is more costly for society to produce than the amount they are willing to pay for it. If the price were higher than this, consumers would miss out on electricity that they value more than it would cost to supply them. The fixed component of energy bills typically means that the average price consumers pay is greater than the marginal price, but in so far as this does not affect consumers' incentive to adjust the quantity of electricity they consume, it is not relevant for efficiency.

To illustrate what this means in practice, consider a household in Scotland on a windy day. In these circumstances, the electricity they consume may be entirely supplied by renewables and, as we discussed above, this might lead to a situation where electricity is basically free and the grid is even willing to incentivise consumers to increase their consumption to avoid having to pay generators to curtail their production. In these circumstances, it would be efficient for consumers to face a zero or even negative marginal price, as additional consumption *lowers* the costs of the electricity system. Now consider a household in the South East of England during the evening hours of peak consumption. In this case, an extra unit of consumption is likely to be costly for the grid as it would need to buy more electricity from gas power plants that charge high prices to cover their operating costs. In this case, it would be efficient for households to face a high marginal price to ensure they have the right incentives to cut back consumption and so reduce overall system costs, as we discuss in more detail in Section 8.6.

In practice, there are a number of reasons why markets, and the electricity market in particular, might not reach an efficient marginal price.

- The electricity system is characterised by high fixed costs, such as the maintenance of the electricity grid and the costs of subsidising low-carbon capacity that has already been built. These costs do not change as consumers increase or decrease usage on a day-to-day basis, and so they do not affect the efficient price in the short term. But when these costs are financed through levies or charges on the per-unit prices consumers pay, this leads to underconsumption. This could then be reflected in, for example, inefficiently low take-up of technologies such as electric-powered heat pumps or electric cars.
- The electricity market may not always be competitive. Lack of competition would allow firms to earn excess profits by charging prices above the true cost of production. We address the topic of excess profits in Section 8.6.
- Government raises revenue through charging VAT on the consumption of most goods and services, including electricity, although this will be temporarily removed from October. This creates distortions by potentially driving prices above an efficient level. However, because tax revenues fund government expenditure, the distortions that come from charging VAT on goods and services, such as electricity, must be weighed against distortions that would be created by raising revenue from other taxes (e.g. on income).
- Electricity generation is associated with a number of externalities. These are social costs that generators in a free market would avoid paying for, leading them to generate more than would be socially optimal. For example, burning fossil fuels leads to CO₂ emissions that contribute to global warming and can worsen local air quality. These costs will not be included in the price consumers pay for additional consumption unless there are corrective policy interventions (including taxes on consumption).

We set out this framework because it gives important guidelines when thinking about how to reduce costs across the electricity system, which we will rely on in the rest of the chapter. In particular:

- Marginal prices should ideally reflect differences in costs of supplying electricity over time and place.
- Firms should not earn excessive profits from anti-competitive practices.
- Fixed costs should not be recovered through per-unit charges.
- Externalities should be corrected through taxes targeted at the activity that generates the externality.

This broad framework also has important implications when thinking about proposals to ‘de-link’ electricity prices from the price of gas-fired power through structural reforms to the wholesale electricity market. To many policymakers, the fact that the wholesale electricity price is set by the most expensive form of generation can be deeply frustrating as it implies that, even

as the share of low-marginal-cost renewables grows in the *average energy mix*, it is not until they are able to more frequently displace gas as the marginal generator that they have the potential to lower wholesale prices. This has led to some calls for changes in how wholesale prices are set, although realising substantial benefits from such changes would be challenging in practice.¹²

Moreover, the role of the marginal generator in setting wholesale prices is by no means unique to electricity markets – the same logic underpins global and national markets for other commodities such as oil, copper and wheat. Similarly, virtually all wholesale electricity markets in advanced economies function on the same ‘merit order’ basis, and countries such as China and India are moving towards operating their electricity systems in the same manner (International Energy Agency, 2023 and 2025a; Akcura and Mutambatsere, 2024).

Following the logic set out above, there are advantages in the wholesale price for additional supply being set in this manner (so long as the bids of marginal suppliers accurately reflect their marginal costs). A price different from the marginal cost would send the wrong signal to the marginal generator on the benefits of increasing production, and to consumers regarding the benefits of cutting consumption.

8.5 Decarbonisation and electricity prices

The transformation of the UK’s electricity system was motivated by successive governments’ desire to reduce greenhouse gas (GHG) emissions produced by the energy sector. The UK has a goal – legislated through a 2019 amendment to the 2008 Climate Change Act – to achieve net zero GHG emissions by 2050. As a stepping stone towards complete decarbonisation of the UK economy by that date, the Starmer government set an intermediate ‘clean power’ target that electricity generated from renewable sources should account for 95% of Great Britain’s generation, and be equivalent to 100% of its consumption, in a typical weather year by 2030.¹³

¹² One temptation – motivated by differences in the marginal cost of supply across technologies as in Figure 8.3 – is to charge different generators different prices according to their individual costs (perhaps redistributing the gains to consumers without distorting their incentives at the margin). To an extent, this already happens through the Contracts for Difference scheme and by charging firms participating in the Renewables Obligation a windfall tax whose revenues then benefit consumers by financing public spending. The general challenge to doing this more broadly would be that cheap producers would be reluctant to reveal their true costs of supply as this would reduce their profits under such a system. Moreover, the gains to consumers would not be as large as implied in Figure 8.3, because firms must cover their average as well as their marginal costs (e.g. low-marginal-cost renewables often have high capital costs they need to recoup).

¹³ Consumption and generation can be different because electricity is traded across countries. Taken together, these two goals require either that the UK becomes a net exporter of electricity, or that all of its generation comes from low-carbon sources (excluding losses that occur during transportation). Gas power generation would still be used but only ‘when essential’ (Department for Energy Security and Net Zero, 2025b).

The net zero target has recently become the subject of increasing political disagreement. Reform UK and the Conservatives have both pledged to scrap the net zero target and repeal the Climate Change Act, with the aim of lowering energy costs. This raises an important question: ‘What are the costs of reaching net zero and what is likely to happen to these costs in the future?’. We address this question in the context of the energy system.

The roll-out of renewables over the last 15 years has almost certainly contributed to the rise in overall electricity prices, despite the rapid decline in the cost of wind and solar technologies over this period (see Box 8.2). This is because renewables capacity would not have been built at the same rate without both the subsidies available to low-carbon generators (see Box 8.1), which are funded by taxes on electricity use, and the taxes and charges that are applied on GHG emissions from fossil fuel plants discussed in Section 8.3. Both directly raise overall electricity prices. Indeed, the government expected price rises as it began increasing subsidies for wind and solar generation, and raising taxes to reflect the social costs of GHG emissions from burning fossil fuels.¹⁴

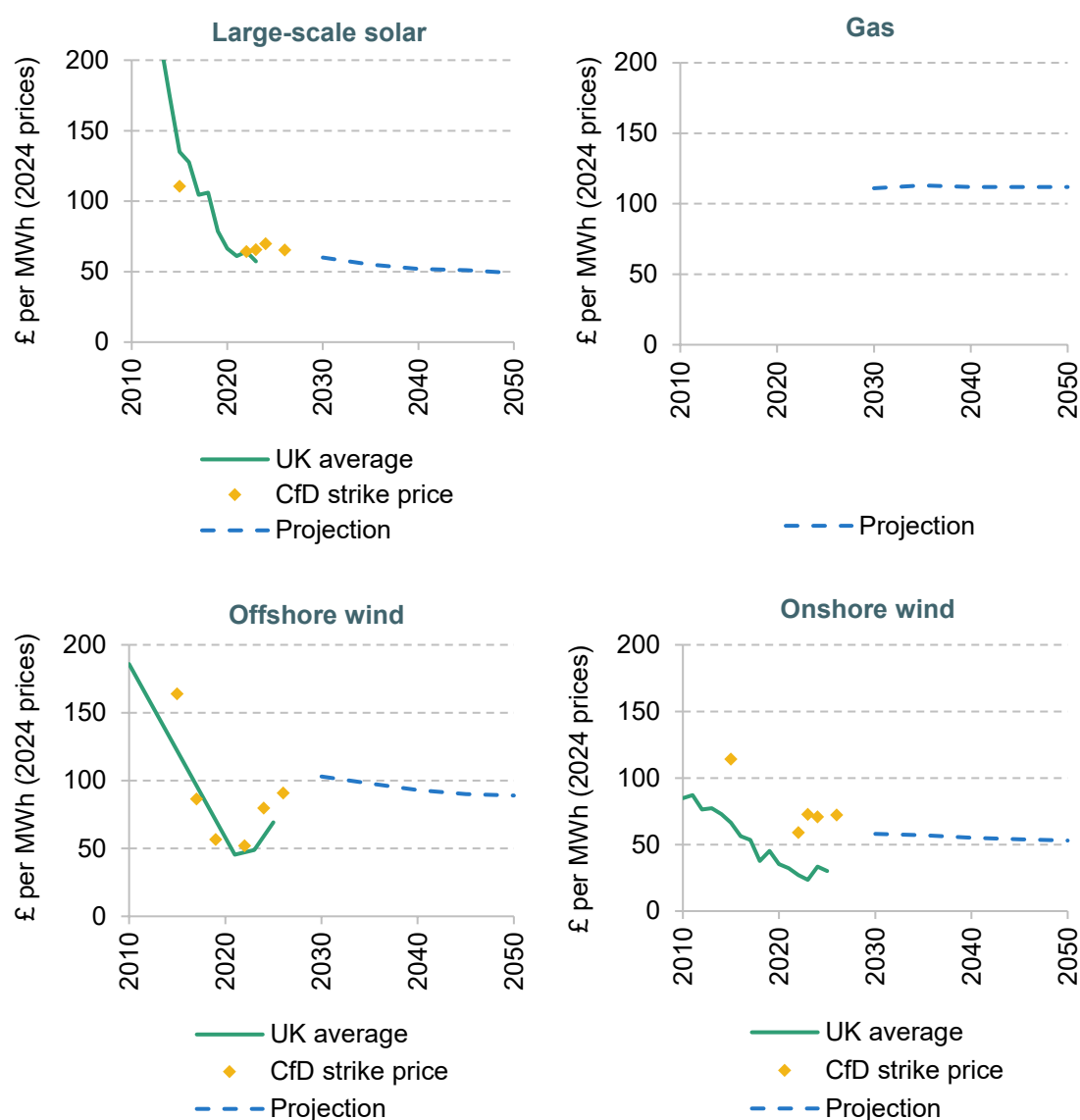
Box 8.2. How do the costs of different sources of electricity generation compare?

A key question – currently the subject of much debate – is how the relative costs of different electricity sources, such as renewables and gas, compare. As with most things in the electricity sector, this is a surprisingly complex question. Focusing just on the short-run marginal cost – i.e. the cost of producing an additional unit of electricity, which can be relevant for wholesale electricity prices, as set out earlier – low-carbon sources are highly competitive. Once built and connected to the grid, the cost of generating and delivering a unit of electricity from a solar, wind or nuclear plant is very low – the wind and sun are free, and nuclear fuel is relatively inexpensive. By contrast, to generate an additional unit of power with a fossil-fuel power plant requires paying the cost of acquiring and burning fuel, which is relatively expensive, and also paying charges associated with the resulting GHG emissions.

However, these short-run marginal costs do not reflect all the costs associated with electricity generation. In particular, they do not reflect the capital costs associated with building a plant, any ongoing operations and maintenance costs, or the costs that inflexible and intermittent generators impose on the wider electricity network. These additional costs mean that low-carbon generators would not have been rolled out at their current pace without additional support.

¹⁴ For example, table 1 in Department of Energy and Climate Change (2010) reports a forecast that energy and climate change policies, including renewables subsidies and home retrofit programmes, would increase domestic electricity prices by 33% in 2020 relative to a business-as-usual scenario. Table 2 in the same source reports a prediction that policies would raise electricity costs for non-domestic users by 43% by the same date.

Figure 8.4. Levelised cost of electricity by technology and commissioning year



Note: UK average prices are UK project average (weighted by capacity) prices from IRENA (International Renewable Energy Authority) renewable power generation costs, converted from real US dollars at base-year average market rates. We do not have comparable data on the average costs of gas-fired generation. CfD strike prices are capacity-weighted strike prices by allocation round.

Source: UK average prices come from IRENA (2017, 2018, 2022, 2024, 2025, 2026) 'Renewable power generation costs' for each respective year. CfD strike prices are from CfD allocation round results: [round 1 \(2015\)](#), published by the Department of Energy and Climate Change; rounds [2 \(2017\)](#), [3 \(2019\)](#) and [4 \(2022\)](#), published by the Department for Business, Energy and Industrial Strategy; and rounds [5 \(2023\)](#), [6 \(2024\)](#) and [7 and 7a \(2026\)](#), published by the Department for Energy Security and Net Zero. The 2014 offshore wind price is from the investment contracts (early CfDs) awarded under the Final Investment Decision (FID) Enabling for Renewables process (Department of Energy and Climate Change, 2014). Projections are from annex A of Department for Energy Security and Net Zero (2025a).

A more comprehensive, but still incomplete, way to capture the total cost of generating from different sources of electricity is to measure the average cost per unit of electricity produced over the lifetime of a generator. This will include the capital and maintenance costs. The so-called ‘levelised cost’ of electricity (LCOE) is a way of measuring how much it costs, on average, to generate one unit of electricity from a given technology expressed in pounds per megawatt-hour. It works by forecasting the total costs and electricity output over a plant’s lifetime, then discounting these to produce a single figure in today’s terms which is comparable across different technologies.

Figure 8.4 shows the levelised costs for four key technologies for projects commissioned in different years based on observed costs and forecasts by the Department for Energy Security and Net Zero. It also shows how the strike prices achieved in Contracts for Difference auctions compare with the observed and forecast UK average levelised costs. The government’s latest forecast LCOE of gas for projects commissioned in 2030 is £111 per MWh, which compares with £60 per MWh for large-scale solar, £58 per MWh for onshore wind and £103 per MWh for offshore wind. The UK government does not publish equivalent estimates for nuclear power, including for the two plants currently under construction and the new small modular reactors (SMRs) due to be built by Rolls-Royce. One indicator of the cost of the Hinkley Point C nuclear plant is its CfD strike price, which currently sits at £131 per MWh (Low Carbon Contracts Company, 2026b). Thus, on a simple levelised-cost basis, renewables are now significantly cheaper than gas or nuclear – by as much as 50% in the case of large-scale solar and onshore wind.

Furthermore, there has been a tendency for the LCOE of wind, solar and storage technologies to fall faster than original expectations over the past decade. For example, the LCOEs predicted in 2016 for large UK solar plants and wind plants commissioned in 2030 were around a third higher than the 2025 projections (Department for Business, Energy and Industrial Strategy, 2016). The opposite has been the case for nuclear power in Europe and the US, where projects have often been subject to delays and cost overruns. Some countries have achieved lower-cost deployment of nuclear power, notably when this was done at scale in France in the 1980s and more recently in China in the 2010s and 2020s, but the UK’s buildout of new nuclear thus far has yet to replicate this.

Critically, while LCOEs are a useful tool for comparing different technologies and are widely cited, they are only informative about the average costs of electricity produced from a particular plant over its lifetime. Importantly, this does not account for whole-system costs relating to the timing of generation. Renewables do not always produce power when it is needed: their supply is intermittent, with less (or no) power generated when the wind is not blowing or the sun not shining. The grid must supply sufficient electricity at all hours of the day, and be able to meet occasional unexpected surges in demand. The growth of renewables must therefore be accompanied by investments in additional grid upgrades and connections between regions, as well as a greater buffer of standby generation capacity from sources of power that can be turned on quickly, such as gas or storage. These factors all serve to

push up the system costs of the grid as the share of intermittent renewables increases, relative to what might be expected by focusing on technology-specific levelised cost measures alone.

There have been attempts to create ‘enhanced’ levelised cost measures that include these system costs in a single comparable cost per MWh for each technology (Department for Energy Security and Net Zero, 2020). These adjustments raise the estimated cost for renewables, for the reasons just given, and lower the estimated costs for gas because it can help the grid to meet peaks in demand.

However, these sorts of numbers need to be used with some care – it would be simplistic to use these comparisons to say, for example, that one technology is always cheaper than another. The system costs of adding, for instance, solar or gas capacity depend on the technologies already in place on the grid. For example, adding renewables to a grid with less flexible capacity or responsive demand implies higher system costs than adding them to a grid with plenty of flexible capacity. Similarly, it would not necessarily be correct to say, if enhanced levelised costs are currently higher for renewables, that it would be cheaper to meet rising electricity demand in the coming years entirely with gas, as at some point the grid may have enough flexible capacity to cheaply incorporate more renewable power.

For these reasons, when addressing the impact of achieving the government’s net zero goal on the costs of the energy system, we prefer to compare projections of the whole-system costs of different portfolios of technologies/scenarios. These are what we refer to in the main body of this section. Government forecasts of these costs imply that achieving net zero is indeed likely to involve higher electricity system costs from adding large amounts of renewables capacity, though these forecasts are subject to a lot of uncertainty. It is also true that the expansion of renewables up until now has pushed up system costs, as indeed the government anticipated as their roll-out started to accelerate in 2010 (Department for Energy Security and Net Zero, 2010).

That said, neither renewables subsidies nor carbon taxes are the main cause of the more recent rise in electricity prices that has occurred since 2021 (shown in Figure 8.1). These price rises coincided with steep increases in international gas prices caused by international conflicts, which fed through into the wholesale price of electricity, as discussed previously.

Looking ahead to the future of electricity generation, it is important to note the rapid declines in the costs associated with renewable technologies that have occurred over the previous decade (Box 8.2). These mean that it almost certainly makes economic sense for some types of renewables to play an increasing role in electricity generation going forward, both in the UK and globally, irrespective of environmental objectives. Policymakers concerned primarily with costs should therefore be thinking about the pace and extent to which the electricity sector adopts renewables rather than whether this should happen at all.

To provide some global context on this, the International Energy Agency (IEA), which is part of the Organisation for Economic Cooperation and Development (OECD) and is a key international source for energy information, makes projections of the costs, compositions and GHG emissions of future energy systems for countries around the world under a range of scenarios. Under the IEA's least ambitious scenario, where global emissions plateau at current levels by 2050 and temperatures rise almost three degrees by the end of the century, it still forecasts that the share of electricity generated by renewables globally would increase from 32% in 2024 to 60% in 2050 (International Energy Agency, 2025b). A scenario in which net zero were to be reached in 2050 is necessarily more aggressive, with the global renewables share hitting 89% by 2050. The IEA's estimates of the average electricity system costs under these two pathways are remarkably similar, both in Europe and globally. These forecasts are underpinned by a prediction that the cost of renewables will continue to fall substantially in coming years, while the cost of fossil-fuel generation will not.

One source of information for the costs of different approaches to decarbonisation for Great Britain's specific case is provided by NESO (National Energy System Operator, 2025c). It models the overall GB energy system, including the roles played by electricity, gas, oil and other fuels. To capture different potential pathways for decarbonisation, it accounts for the costs of adopting and using associated energy-using capital assets and durable goods, such as electric versus combustion engine vehicles, or heat pumps versus gas boilers. Its modelling indicates that total energy system costs (excluding carbon costs) were around £300 billion, or close to 10% of GDP, in 2025. By 2050, it estimates this will fall to around £220–250 billion (in today's prices), or 5–6% of GDP, across a range of scenarios, including those that meet net zero in 2050.¹⁵ This is driven in part by an expected fall over time in the average cost of electricity. However, costs in a net zero scenario do not fall quite as much as in an alternative scenario where less ambitious action is taken on decarbonisation.¹⁶ Averaged over the 2025–50 period, energy costs in the net zero scenario are about 0.4% of GDP higher in relative terms, and electricity costs about 1 pence per kWh higher in 2025 prices.¹⁷ To put this in context, prices in 2025 were 26 pence per kWh (Department for Energy Security and Net Zero, 2026c). These calculations ignore the benefit from lower GHG emissions.

¹⁵ Estimates expressed as a share of GDP are based on contemporaneous GDP and are based on UK government assumptions about GDP growth, which are the same across scenarios. That is, NESO does not model the impact of the different scenarios themselves on the path of GDP.

¹⁶ This 'Falling Behind' scenario still involves some decline in emissions but only to around half of today's levels by 2050 rather than to net zero, and this is partly because some projects to reduce GHG emissions are already underway and expected to yield emissions reductions in the coming years. Gas demand remains roughly flat at current levels out to 2050, compared with the roughly 80% reduction in gas demand seen in the main 'Holistic Transition' net zero scenario.

¹⁷ Similar analysis conducted by the Climate Change Committee also found a modest net energy system cost from meeting net zero by 2050, of 0.2% of GDP (Climate Change Committee, 2026).

All estimates of future energy system costs are, of course, highly uncertain and depend on long-run forecasts of fossil fuel prices, technological change and consumer behaviour. Both the IEA's and NESO's forecasts could easily either under- or over-estimate the costs of net zero relative to their more fossil-fuel-intensive scenarios. The relative costs of decarbonising the electricity sector will tend to be higher where clean infrastructure investments are more expensive than forecast (e.g. due to high interest rates, planning delays or slower technological advances).¹⁸ Conversely, relative costs will be lower where gas prices remain high (e.g. due to geopolitical tensions) or if there is unanticipated additional technological progress (e.g. as seen for solar and batteries in the last decade).

In addition, it is important to highlight that most of the costs associated with the decarbonisation of the electricity sector are front-loaded. Increased capital investment in renewables and grid upgrades is concentrated in the next decade, with lower day-to-day costs being realised through the 2040s as reliance on fossil fuels falls (National Energy System Operator, 2025d). As such, the costs of operating and investing in the electricity grid are likely to remain high or even rise in the next few years.

To sum up, decarbonisation of the electricity system has contributed to higher overall electricity prices to date in the UK. This is due to the cost of subsidising renewable plants that were built when they were relatively expensive, as well as the imposition of carbon taxes on fossil fuels. The best available evidence appears to suggest that, for a range of different scenarios, average electricity costs will rise in the next few years before falling in the long term. The scale and timing of these changes are highly uncertain, although more aggressive action on decarbonisation does run some risk of exacerbating near-term cost increases and delaying the point at which costs start to come down because of more up-front investments needed.

Whether any additional electricity costs arising from decarbonisation are worth it ultimately depends on whether these costs outweigh the potential benefits, and how these are valued. The aim of decarbonisation is, of course, to lower the UK's total GHG emissions. This matters for meeting international commitments the UK has made, and for efforts to mitigate climate change. How much the UK's actions actually lower global emissions also depends on the extent to which energy-intensive activities currently located in the UK are displaced elsewhere.¹⁹

¹⁸ The profitability of new low-carbon generation is especially sensitive to interest rates, because a large share of its costs are up-front, while revenues accrue across multiple years.

¹⁹ How much does this happen in practice? A partial answer can be obtained by comparing the paths of consumption-based GHG emissions (which include emissions 'embedded' in the UK's imports) and of territorial emissions that form the basis of the UK's energy target. The former have fallen since 2010 – suggesting that this displacement is not total – but at around half the rate of territorial emissions (Department for Environment, Food and Rural Affairs, 2026). To try to avoid this problem, the UK currently provides incentives for energy-intensive businesses not to relocate, including carve-outs from various taxes and 'use or lose it' allowances under the Emissions Trading Scheme. These are discussed in Section 8.7.

Besides reducing GHG emissions, there are other likely positive impacts from moving away from fossil fuels, such as improved local air quality, less price volatility and potentially greater security of energy supply. On air quality, the closure of the UK's coal power plants has contributed to significant reductions in air pollution over the last two decades, and a growing body of research has shown that air quality improvements can yield significant health and productivity benefits (Holland et al., 2020; Gadenne et al., 2024). On price volatility, coal plant closures have contributed to the UK's current reliance on expensive and price-volatile gas. Further decarbonisation through increased deployment of renewables and nuclear would mean the UK is less exposed to fossil fuel price fluctuations in the future. For example, the gas price spike in 2022 was a shock to UK energy costs equivalent to 1.8% of GDP. If this were repeated for a net zero energy system in 2050, NESO modelling indicates the shock would be just 0.3% of GDP, or about one-sixth as much (National Energy System Operator, 2025d). On the security of energy supply, the benefits of being less reliant on imported fossil fuels must be weighed against the challenges of relying on other countries for key inputs to low-carbon energy sources, such as critical minerals.

Ultimately, there are real trade-offs and uncertainties here. Claims that rapid decarbonisation efforts are completely costless appear wide of the mark – we should expect to pay more for our electricity if we want to reach net zero by 2050 and ensure that prices reflect the social costs of burning fossil fuels. But the same is true for claims that electricity generated from renewables is always more expensive than electricity generated from burning fossil fuels or nuclear – some additional low-carbon generation is now economically viable without subsidies and Great Britain's current reliance on gas and the buildout of new nuclear have proven expensive.

Whatever pace and extent of decarbonisation are pursued going forward, as we argue in the following sections, it is almost certainly the case that there are less costly ways to achieve given emissions targets than Great Britain's current approach. With that in mind, we now turn to policy options for reform.

8.6 Options for lowering the costs of the electricity system

This section outlines some options for reducing the costs of the electricity system. These are options that lower the overall cost of the electricity either through making more efficient use of

the electricity system or through achieving decarbonisation objectives in a less costly way. The policy options we discuss here are:²⁰

- supporting the take-up of time-varying electricity prices;
- introducing more locational signals in the electricity system;
- closely monitoring market competition, network costs and the potential for excess profits;
- reducing frictions to trading electricity internationally;
- reforming the design of Contracts for Difference.

We also discuss whether there is a role for more extraction from the North Sea.

In Section 8.7, we examine a range of additional policy options around how fixed costs of the electricity system can be efficiently recovered without discouraging electricity use.

Support the take-up of time-varying electricity prices

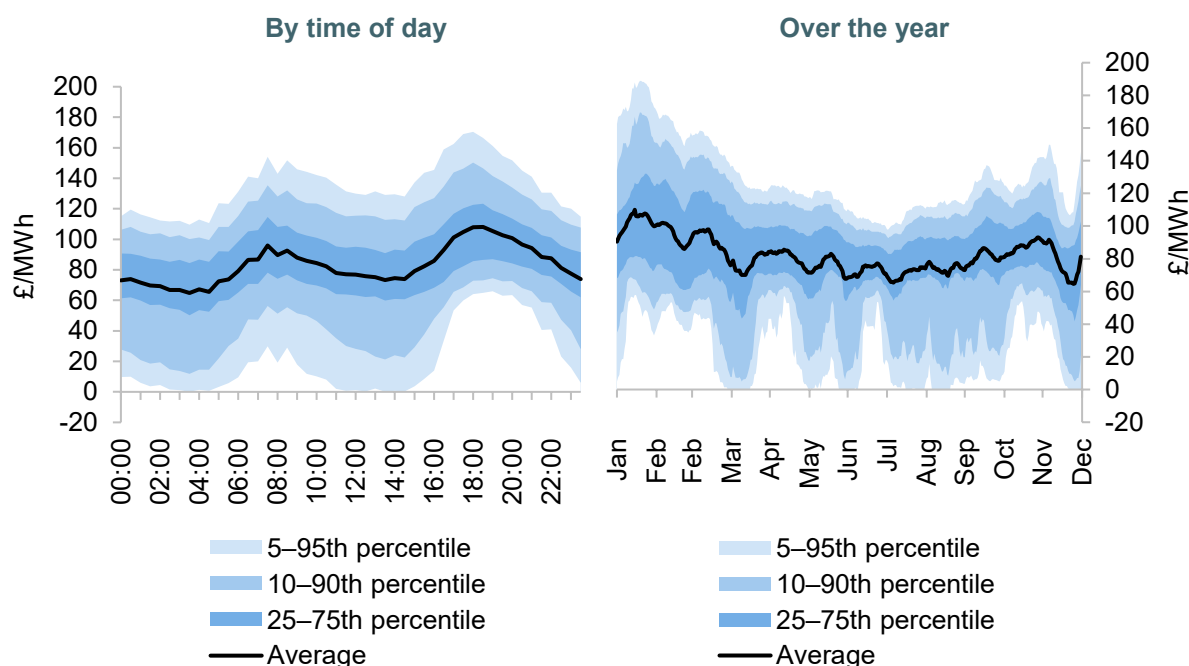
The cost of producing and supplying electricity varies dramatically from month to month, day to day and even hour to hour. This is due to variations in demand, in the availability of intermittent renewables and in fuel prices for non-renewable generators.

These fluctuations are reflected in the wholesale price of electricity (the price paid to generators). As shown in Figure 8.5, the average wholesale price ranges from around £65 per MWh overnight to a peak of £108 per MWh in the evening. Over the course of any given day, though, the price can vary by much more than this. For example, on 7 April 2026, the wholesale price reached a low of –£58 per MWh and a high of £122 per MWh (Elexon, 2026).²¹ The wholesale price also tends to be higher in January and February when demand peaks, solar output is lowest and gas fuel costs are higher. For example, between 2023 and 2026, wholesale prices were 45% higher in January than in August. Within a month, there is also a lot of day-to-day variation.

²⁰ The policy options we consider here are not exhaustive. For example, planning delays and grid connection bottlenecks are another source of costs for the electricity system that the government could potentially reduce. Recent steps have been taken to do so: the Planning and Infrastructure Act 2025 aims to streamline consenting for nationally significant infrastructure projects and limit the scope for repeated judicial reviews; since 2024, the government reversed the de facto ban on onshore wind in England and progressed several ministerial decisions to approve multiple large solar projects; and NESO has recently taken steps to reform the process for connecting new power generation projects to the grid. While these measures appear to target several key constraints on the timely and cost-effective delivery of major electricity infrastructure projects, it is too early to assess their effect on costs and so we do not address them in detail here.

²¹ The wholesale price can be negative for two reasons. First, there are costs of curtailing generation. This means a generator may continue generating electricity even if the price is zero, meaning a negative price is needed to clear the market. Wholesale prices can also be negative because, as described in Box 8.1, many renewable generators receive either a fixed price per kWh or a subsidy per kWh, and they need to be compensated for the value of the subsidy or strike price forgone to stop generating.

Figure 8.5. Variation in the wholesale price of electricity, 2023–26



Note: Wholesale price is a volume-weighted average of the wholesale price reported by EPEX and Nord Pool. We exclude settlement periods where the volume traded was zero. The figures are based on data from 1 January 2023 to 12 June 2026. The average is the mean price.

Source: Authors' calculations from Elexon market index prices data, 2026 (<https://bmrs.elexon.co.uk/market-index-prices>).

However, while prices paid to generators vary substantially over time, only around 10% of households and a minority of firms currently face prices that vary throughout the day, week or month (LCP Delta, 2025). Historically, this could be explained by the technical limitations of metering infrastructure which was not able to record when households were consuming with much granularity. But today, 72% of households and 67% of firms have smart meters capable of recording consumption on a minute-by-minute basis.²²

The mismatch between the cost of supplying electricity, as reflected in wholesale prices, and the price faced by consumers removes the incentive for consumers to consume less electricity when it costs more to produce, and more electricity when it costs less to produce. Lowering consumption during high-cost periods would reduce reliance on expensive sources of supply, lowering the average cost of electricity, and would reduce the need for costly investment in standby capacity to meet demand peaks. Conversely, the growth of renewables means there are frequently periods with an oversupply of cheap power, so much so that wholesale prices can even turn negative. Increasing consumption during these low-cost periods would make use of cheap power that would otherwise go to waste. Households and businesses altering or shifting

²² Authors' calculations using table 5 of Department for Energy Security and Net Zero (2026d).

their consumption in response to time-varying price signals could therefore lead to lower costs, and thus lower bills.

As a simple example, consider a household that faces a constant per-unit electricity price. Electricity consumed in the morning costs 8p per kWh to supply, while electricity consumed in the evening costs 12p per kWh to supply. The household consumes 10 kWh per day and initially consumes the same amount in both the morning and the evening, which costs the electricity system £1 per day to provide. If the household faced a time-varying price, and shifted 20% of its daily consumption from the evening into the morning in response, it would cost the electricity system 92p per day to provide the same amount of electricity, an 8% reduction in total costs.²³

Importantly, substantial growth in demand flexibility is assumed in the government's 'Clean Power 2030' plan. NESO estimates that the amount of time-varying consumption will need to triple between 2025 and 2030 to reach the government's clean power goals (National Energy System Operator, 2024).

The impact of time-varying prices in practice will depend on how responsive people are to the price they face. Evidence from reforms in other countries and time-varying tariffs in the UK suggests households do respond, but the size of the response depends on the technology available. For example, when Spain moved to a time-varying tariff for electricity in 2021, with peak prices double the normal prices, peak-hour consumption reduced by between 1% and 9% (Enrich et al., 2024). This is a relatively small response.

However, responses are much larger when paired with automated technology. Heat-pump owners in the UK on a time-varying tariff roughly halved their evening peak consumption in response to a 60% higher price and doubled it during off-peak periods when electricity was 40% cheaper, with annual bill savings of around £300 (Bernard et al., 2024). Post-study surveys indicate that much of this response was driven by automated appliances, namely smart thermostats that heat more when the price is lower. This is reinforced by experimentation in offering customers free electricity at times when the wholesale price is at or near zero. Households in the UK without electric vehicles had a limited response to an hour of free electricity, increasing consumption by 25%, whereas households with an electric vehicle increased electricity consumption by 108% (Lopez Garcia et al., 2026).

The potential bill savings for consumers are large and are possible precisely because wholesale prices vary so much: in 2025, the three highest-price trading periods had prices in excess of

²³ Of course, if many households shifted their demand in this way, the cost of electricity consumed in the evening would fall relative to the cost in the morning. This would in turn affect the efficient marginal prices in each period and hence the overall savings.

£1,200 per MWh and the three lowest-price trading periods had *negative* prices of almost –£100 per MWh.

The benefits from encouraging consumers onto time-varying tariffs must be weighed against the greater burden to consumers of monitoring their own usage. The government may also be concerned about vulnerable consumers who are inattentive or unable to adjust their consumption towards lower-cost periods paying considerably more. Caps on the peak prices consumers can face could offer protection against the most extreme spikes, but further efforts to improve awareness will also be important to ensure consumers are making informed choices.

Take-up of time-varying tariffs, such as those currently offered by electricity suppliers in Great Britain, is low when it is voluntary, but evidence suggests this could well reflect customers' inertia rather than a considered decision. In a large-scale trial with the Sacramento Municipal Utility District, Fowlie et al. (2021) found that defaulting households onto time-based pricing – with an easy opt-out – dramatically raised participation, and that the roughly 70% who would never have opted in nonetheless cut their peak consumption in response to higher prices.²⁴

There are steps the government could take to increase the take-up and intensity of time-varying tariffs, from making time-varying tariffs the default, as in Spain, to reforming the Ofgem price cap to allow for greater price variation.²⁵ Australia has also moved in this direction: from July 2026, energy retailers in New South Wales, South Australia and South East Queensland must offer households a tariff providing three hours of free electricity in the middle of the day, when solar generation is at its peak (Australian Energy Regulator, 2026). The benefits that would be realised from similar reforms in the UK, however, depend heavily on the roll-out of technologies, such as electric vehicles and heat pumps, that are able to respond automatically to price changes.

Introduce more locational signals in the electricity system

The cost of supplying electricity can also vary substantially across different locations. This is primarily due to where supply sources and demand centres are located, and the capacity of the grid connecting them. For example, there is lots of cheap wind generation in Scotland, lots of electricity consumption in the south of England and limited grid capacity running north to south. There are also greater costs of supplying electricity to sparsely populated areas because more grid infrastructure is required per person.

²⁴ It is also possible that electricity suppliers underprovide time-varying tariff plans, perhaps because they underestimate the potential demand.

²⁵ The current design of the Ofgem price cap precludes electricity suppliers from charging households on default tariffs a price above that level at any point in the three-month period it applies to, thereby putting a ceiling on how much the price can vary over time.

One option for addressing this directly is to move away from a single national wholesale price. Under *zonal* pricing, the country would be split into several price zones, each reflecting local conditions of supply and demand on an hour-by-hour basis. This kind of model is common in other markets such as Italy and Norway. In much of the US, wholesale markets operate on an even more granular *nodal* basis, with wholesale prices varying at hundreds of points across the network.

The government considered locational pricing reforms for the wholesale market at length as part of its Review of Electricity Market Arrangements (REMA) in 2022. Modelling conducted for Ofgem indicated that if we moved from national pricing to zonal pricing in 2025, regional average wholesale prices in Scotland would fall substantially, reflecting the surplus of low-cost wind generation there, while wholesale prices in much of England and Wales would rise slightly (FTI Consulting and Ofgem, 2023). Zonal pricing would have therefore meant average wholesale prices in Scotland around half the level of wholesale prices in England in 2025, making them some of the lowest in Europe.

This may initially suggest an overall increase in average costs for consumers, given that most GB households and businesses are located in England and Wales. However, any small increase in overall average wholesale costs would be more than offset by improving the efficiency with which the system operates, particularly through reductions in the balancing costs created by grid constraints (FTI Consulting and Ofgem, 2023). Accounting for the combination of these impacts means zonal pricing reforms were estimated to cut overall costs to consumers by approximately 5%. While some of the improved efficiency was forecast to come from long-run changes to demand and more cost-effective locations for new electricity generators, the majority was attributable to short-run gains from making better use of the generation and network capacity that already exists.²⁶ Importantly, the estimated efficiency gains were sufficient that all consumers could have seen net bill savings, but with some likely benefiting more than others (e.g. those living in areas such as Scotland where electricity is cheaper to produce).

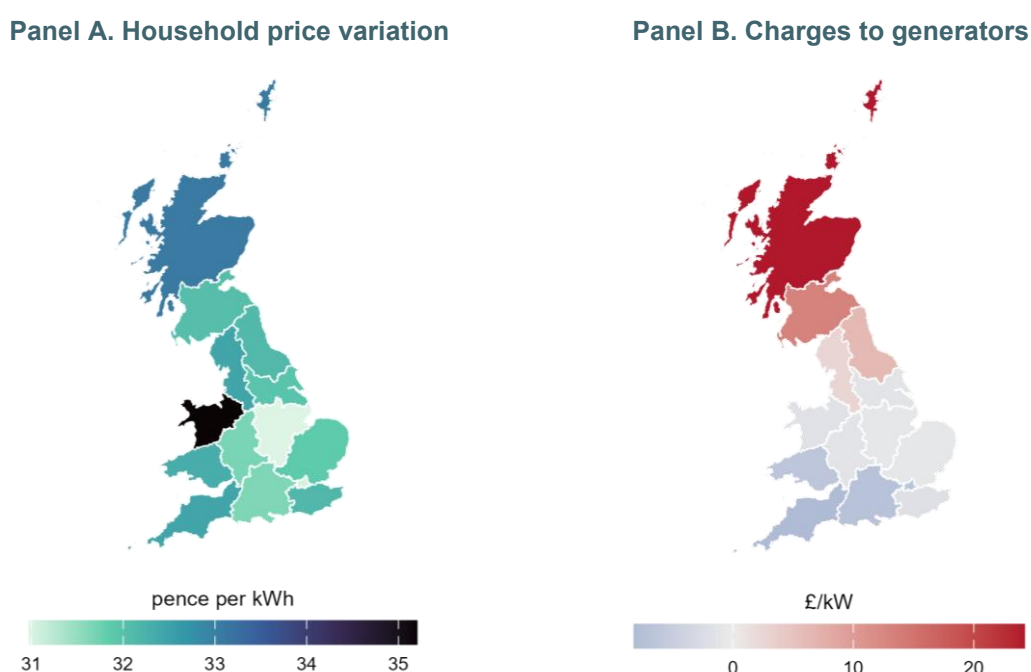
In reality, current regional prices are almost the opposite of what you would expect. This is because only some differences in cost are reflected in the price households pay and the fees generators face, as shown in Figure 8.6. A household in the East Midlands currently pays an average price around 4 pence per kilowatt-hour (or around 10–15%) less than a household in North Wales. This is mainly because transmission charges tend to be higher in the south of the country, while more remote or sparsely populated areas typically face higher distribution charges. Generators on average pay transmission charges of £12 per kW each year (National Energy System Operator, 2026). However, a wind farm in northern Scotland might pay £25 per

²⁶ This modelling mirrors findings in the academic literature that suggest operational savings of 1–4% when other markets have transitioned to more granular locational pricing (Wolak, 2011; Eicke and Schittekatte, 2022).

kW (reflecting its greater average distance from electricity consumers) while one in southern England could have negative charges of –£5 per kW, and one located offshore may incur an extra £60 per kW fee to cover additional grid upgrade costs.

These existing charges do not reflect most of the varying cost of supplying electricity to different locations. First, the variation in Panel A shows that electricity for households is generally cheaper in England, and more expensive in Scotland and North Wales. While this may reflect differences in distribution network costs across regions, it is the opposite of what we would expect under a zonal market discussed above.

Figure 8.6. Current spatial variation in electricity costs



Note: The residential price is the average price including standing charge for a household consuming 3,400 kWh a year, averaged over all payment methods in 2025. The charge to generators is the Transmission Network Use of Service (TNUoS) generation wider tariff only, in 2026–27, for a representative wind farm with a 45% load factor. The 27 generation zones have been mapped onto distribution network operator (DNO) area to the authors' best approximation.

Source: For Panel A, table 2.2.4 of Department for Energy Security and Net Zero (2026b). For Panel B, table 2 of National Energy System Operator (2026), wider tariff only (excludes residual).

Moreover, these network charges in Panels A and B only change from year to year, while regional imbalances in electricity supply and demand can vary from hour to hour. As discussed earlier, the wholesale electricity market has a single national price that does not vary by location. Instead, NESO takes actions to manage these regional imbalances in light of the physical constraints on the grid, paying generators in areas of excess supply to turn off, and others elsewhere to turn on. The costs of this balancing, discussed in Section 8.3, are substantial and

rising, and fall on consumers generally rather than being reflected in the price paid by those creating the costs in the first place.

Nevertheless, in July 2025, the government ruled out a move to zonal pricing, in part due to concerns that changes to market rules would introduce uncertainty for renewable developers, deterring investment at a time when the government is trying to ramp up new capacity. Instead, the government opted to retain the national price while pursuing more targeted reforms such as using the process for connecting new generation projects to the grid to prioritise projects closer to demand centres. This decision preserves the inefficiencies of the status quo. However, several targeted reforms could still improve locational signals within the existing national-price system, even if the current system is retained.

One option for reform would be making improvements to the balancing mechanism that is currently used to resolve network constraints. At present, batteries and interconnectors are significantly underutilised in the balancing mechanism relative to gas-fired plants. Resolving this would ensure that batteries in particular help resolve network constraints, rather than exacerbating them (Mann, Perkins and Schittekatte, 2024).²⁷ Reforms could also involve making more use of demand-side flexibility, with energy suppliers offering customers prices that vary not just by time but also by location. For instance, consumers in Scotland could be offered cheaper electricity at times when local wind generation exceeds what the network can carry south, encouraging them to use more of this electricity locally rather than NESO paying to have it curtailed. This would achieve some of the efficiency gains of full zonal pricing without exposing generators to the same degree of uncertainty.

A final set of options could be to introduce more location-based differentiation into existing government tax and subsidy programmes that affect electricity demand (e.g. in programmes supporting the roll-out of heat pumps, energy efficiency upgrades and EV charging infrastructure). Reforming the Contracts for Difference regime to better reflect different costs by location is another option, which we discuss below.

Closely monitor competition, network costs and the potential for excess profits

If companies are earning excess profits, due to either anti-competitive practices or lax regulatory oversight, this will result in higher prices for consumers than necessary. This could potentially occur at any stage of the electricity supply chain: among generators, network companies or retailers.

²⁷ There are specific inefficiencies in how batteries are used based on their location, with the current market structures incentivising ‘repetitive re-trading’ (Ofgem, 2026c). During periods when the grid is constrained, some battery storage operators are able to sell their electricity on the wholesale market, be paid by the grid not to generate the electricity because their local grid cannot cope with more electricity, resell the same electricity in the next half-hour and again be paid by the grid not to generate.

In the wholesale market, there have been several instances of generators securing excess returns from balancing activities. Since 2020, Ofgem has brought enforcement actions against generators for sending misleading availability signals to increase the size of balancing payments they could receive for supplying additional electricity at short notice (Ofgem, 2020) and for exploiting their market power to charge excessive prices to offer to curtail their supply at times when they faced limited competition in the balancing market (Ofgem, 2023b and 2023c). This is an area where Ofgem itself recognises that close focus is still needed to ensure that market rules are being adhered to, with quite recent incidents of generators being paid unusually large payments to supply extra electricity at short notice in the winter of 2024–25 (Ofgem, 2025).

As discussed earlier, the costs of network companies are directly regulated by Ofgem through multi-year price controls, and a key regulatory function is ensuring the costs being incurred are necessary and reasonable, with any improvements/upgrades being delivered as affordably as possible. There are long-standing challenges for any natural monopoly regulator in striking the right balance here (Dunkle Werner and Jarvis, 2026). However, there are some signs this balance may have tipped too far in companies' favour. For example, unexpectedly high inflation in recent years has resulted in windfall earnings for the network companies that are materially more than was intended under the current system for regulating network charges. While Ofgem has acknowledged this particular issue, it did not pursue any remedy to correct for or recover the excess profits (Ofgem, 2023a). Even if there are good reasons for this, there remain questions about whether the existing price control process is doing enough to bear down on the network costs being passed on to consumers.

In the retail market, there have been long-standing concerns about the level of competition. An investigation by the Competition and Markets Authority in 2016 into the retail energy market (including electricity) estimated that households were paying almost £2 billion more in 2015 due to excessive pricing from the largest six energy suppliers (Competition and Markets Authority, 2016). A crude measure of market power – the domestic market share of the largest six electricity suppliers – fell after 2016 from 85% to 76% in 2018 as new suppliers entered the market, but this has since rebounded to 91% in 2025 (Ofgem, 2026f).²⁸ This is an area that needs continued monitoring to ensure households do not overpay.

Reduce frictions to trading electricity internationally

Cross-border interconnectors that enable power to be imported from or exported to neighbouring countries are an increasingly important part of the UK power grid. In 2019, 8% of electricity consumed in the UK was imported and 1% of UK-produced electricity was exported

²⁸ This was calculated as the sum of the top six electricity providers' average market share over the four quarters of the respective year.

(Department for Energy Security and Net Zero, 2026e). These shares increased substantially to 16% and 5% respectively by 2025, and currently approved projects to increase interconnector capacity could increase them further by the early 2030s.

Despite this rapid expansion of new infrastructure, the Brexit-related departure of the UK from the EU's integrated cross-border trading system has made the interconnectors operate much less efficiently since the start of 2021. Traders struggle to coordinate across the various markets in which electricity is bought and sold in Great Britain and its neighbours (Energy UK, 2023). This means there are periods when it would be cheaper to import electricity than to generate it domestically, but due to these market coordination frictions, electricity is not imported and a more expensive UK generator is used instead. The same is true for periods when the UK has surplus low-cost wind it could export, but is instead incurring expensive curtailment costs. The annual cost in terms of increased wholesale costs for UK consumers was estimated to be £130–370 million in 2022, around £8 per household per year (Energy UK, 2023). As the physical capacity for trade of electricity increases (as interconnector capacity increases), and with it the potential benefits, the cost of these trade frictions increases.²⁹

Proposals for the UK rejoining the EU electricity trading arrangements are active areas of UK–EU discussion (Cabinet Office, 2025). There are certainly important trade-offs to be made in these negotiations, but removing trade barriers with our only trading partners for electricity would deliver economic benefits that could help lower bills.

Reform the design of Contracts for Difference

Contracts for Difference are an increasingly important part of the electricity system. In 2025, 12% of electricity generated in the UK came from a generator with a CfD, with more capacity procured and yet to start generation (Low Carbon Contracts Company, 2026a; Department for Energy Security and Net Zero, 2026e). CfDs are now the government's primary means of bringing forward new investment in low-carbon generation. The design of these contracts, which is described in Box 8.1, is thus of increasing importance.

Historically, strike prices were high, meaning top-up payments were common and contracts provided a clear net subsidy to renewable generation projects over their lifetime. As renewable costs have fallen, so have strike prices. As explained in Box 8.1, recent contracts are less likely to provide a net subsidy over their lifetime. Even where they provide no net subsidy, CfDs still play an important role in reducing the risk to developers in funding large capital-intensive

²⁹ A further challenge is posed by the introduction of the EU Carbon Border Adjustment Mechanism (CBAM). Due to limitations in the EU CBAM's ability to capture real-time emissions intensity of electricity, traded electricity could pay substantial surcharges during low-price, windy periods, when gains from trade are largest, introducing further frictions.

investments in new wind and solar capacity. The growing role of CfDs means the way these contracts are designed and allocated to generators is of increasing importance to the total cost of the electricity system.

Currently, CfD prices are determined in auctions, with the eighth auction round scheduled for later this year. All successful projects in the auction within the same group of technologies receive contracts with the same fixed strike price, conditional on the price being below a predetermined cap that varies by technology and delivery year (the year when generation begins). In many ways, the move from the previous Renewables Obligation scheme to CfDs has been a success. Unlike under the previous scheme, CfD auctions provide a valuable means of price discovery that prevents generators from earning windfall gains. In addition, CfD auctions have succeeded in procuring significant volumes of new renewables capacity.

However, the current design of the CfD process may not be optimal.

First, CfD strike prices do not generally differ based on the location of a project. This means that two wind farms in different parts of the country could come online in 2030 and then receive the same CfD strike price for their generation until 2050. As discussed earlier in this section, the value of a kilowatt-hour to the grid depends a lot on when and where it is produced. Failing to account for this means that projects of greater value may be overlooked in favour of less valuable ones. The most recent CfD auction round did introduce different prices for offshore wind projects in Scotland and the rest of Great Britain. This is a step in the right direction, but more could be done to prevent CfDs from exacerbating future balancing and grid costs by allowing the strike price to vary by location.³⁰

Second, there is a question of whether CfDs should be focused on procuring low-carbon capacity as cheaply as possible or supporting specific nascent technologies with more generous strike prices. Providing more generous support to new technologies can be beneficial where it spurs innovation and lowers costs for future developments. Arguably, this is exactly what CfDs achieved for offshore wind projects over the last decade. But the UK government should weigh carefully whether it needs to extend further generous support to unproven technologies via CfDs or other similar contract structures. New long-term agreements for nascent technologies, such as carbon capture and storage, tidal and wave power, or even floating offshore wind, run the risk of locking in sizeable costs for consumers that will persist for decades.³¹ Where there is a high

³⁰ Another question is whether CfDs should pay out when wholesale electricity prices are negative. Generators awarded contracts from the 2021–22 auction round onwards are no longer paid for electricity supplied when the electricity price is negative (Department for Business, Energy and Industrial Strategy, 2020). This likely raises the strike prices renewable generators are willing to accept and bid for, but also gives them a greater incentive to find ways to store energy when demand is low.

³¹ Floating offshore wind is a more expensive and less developed technology than conventional, fixed-bottom offshore wind.

probability of decarbonisation objectives being achievable at lower cost with existing proven technologies, providing large, differentiated subsidies to nascent technologies becomes harder to justify.³²

Is there a role for more extraction from the North Sea?

One aspect of UK energy policy that has received a lot of attention recently is issuing new licences for extraction of oil and gas from the North Sea. This chapter is focused on the electricity market so we will focus our discussion here on the potential effect of more North Sea extraction on the electricity market.

As discussed in Section 8.2, a key reason for the increase in UK electricity prices has been the recent increase in gas prices combined with the exposure of the UK's electricity system to the gas price. The amount of time that gas sets the price of electricity in Great Britain is falling and this will bring down the wholesale price of electricity. Another way to bring down the wholesale price would be to bring down the price of gas.

Gas is a globally traded commodity and UK production currently accounts for 0.8% of global production (Offshore Technology, 2024). Any changes in policy toward offshore North Sea licences would need to meaningfully increase the *global* supply of gas to bring down the price of gas and thus electricity.³³ This would require a substantial increase from current levels of North Sea production. This is made more difficult by the fact that the most accessible gas has already been extracted (Department for Energy Security and Net Zero, 2025d).

8.7 Options to reform the taxation of electricity

As discussed in Section 8.2, taxes are an increasingly large part of the total electricity bill and have been an area of rapid policy change in recent years. Unfortunately, many of these changes have been short-term patchwork solutions, leaving the structural problems underlying the taxation of electricity, and energy more widely, unaddressed.

³² One further option for reform would be to move from contracts that provide per-kWh payments to some form of capacity-based contract, whereby renewable projects receive a fixed amount annually based on how much they are expected to generate. A benefit of such a change is reducing what is referred to as 'volume risk' for generators. Wind and solar generators are, generally speaking, not in control of how much they generate, with production dependent on external weather conditions. Varying the payments from CfDs by something largely beyond the control of the generator introduces risk with limited benefits, pushing up the strike price required. A reform of this kind in Spain led to modest cost savings (Petersen, Reguant and Segura, 2024).

³³ There are transport costs involved in the international trading of gas, which create differences in price by region. Increased domestic production could cause the UK price of gas to fall to the European price minus the cost of transporting it to Europe. This already happens in the summer months when the UK exports gas to Europe.

This section will discuss three key aspects of the taxation of electricity: covering the fixed costs of the electricity system, avoiding creating distortions to what people consume, and incentivising greenhouse gas emissions reductions. In each of these areas, we identify reforms that allow the government to achieve its goals in a less harmful way. The reforms we propose are to:

- take all fixed costs off the unit price;
- remove VAT discounts for domestic electricity and other energy use;
- spread the cost of decarbonisation across the entire economy through a more consistent approach to the taxation of GHG emissions.

Some of these reforms could bring the price of electricity down, such as taking fixed costs off the unit price, while others – particularly removing VAT discounts for household energy use – will likely increase the price of electricity for some consumers (namely, households). Together, these reforms would simplify the complex array of taxes currently levied on electricity and address key distortions that have been created through the plethora of policies introduced across the last two decades.

However, these reforms would also have important distributional implications. In what follows, we discuss the potential distributional effects of each proposal and how to address them.

A note on terminology: this section refers to a range of taxes, charges and levies, some of which are not formal taxes but rather tax-like charges on electricity suppliers over which the government has significant control. We refer to these all as ‘taxes’.

Take all fixed costs off the unit price

As discussed in Section 8.4, the price of an extra kilowatt-hour of electricity should reflect the incremental social cost of producing and supplying that electricity to the consumer. The main incremental costs of electricity are the direct wholesale costs of generating the power, the losses incurred in the transmission and distribution network, and the social cost of any local air pollution or GHG emissions created in the process.³⁴

Other costs are essentially fixed in the sense that they do not change when a household or business consumes an extra unit of electricity. These fixed costs currently comprise:

³⁴ In the long run, part of the cost of network infrastructure and standby capacity is also marginal. Higher demand increases the amount of capacity that must be built, especially when that demand occurs at peak times. Efficient marginal-cost pricing should therefore, in principle, include the costs of adding capacity alongside the wholesale price. Critically, however, any charges to reflect this would ideally be time-varying, applying mainly at peak periods, rather than being added uniformly to every unit of consumption.

- the costs of maintaining the infrastructure to transmit and distribute electricity to households and businesses;
- the costs of paying for standby generation through the capacity market;
- the costs of paying subsidies for low-carbon capacity, whether the legacy costs of generators built under the Renewables Obligation or the costs of capacity already procured through Contracts for Difference;
- the costs of paying for the Warm Home Discount.

This subsection considers the choices of how to fund these fixed costs.

The fixed costs of the electricity grid are currently funded in three ways: through the unit price of electricity, through the electricity standing charge and through general government spending. Here we discuss the advantages and disadvantages of each of these.

We argue that, absent a strong government desire for those consuming more electricity to pay more towards these costs, they should not be funded through the unit price, and should instead be covered either by the standing charge or general government spending.

Recover fixed costs through the unit price

The unit price that consumers pay for electricity very rarely aligns with the marginal cost – the incremental cost of supplying an additional unit of electricity. This is for a range of reasons. In Section 8.6, we highlighted how retail electricity prices generally do not vary over time and by location, while the costs of supplying electricity do. But even putting that to one side (along with the discounted rate of VAT for households, which we return to later), the unit price consumers pay for electricity in the UK is not equal to the average incremental cost of electricity supply. This is in large part because many fixed costs are recovered through the unit price of electricity, rather than through the standing charge or general government spending.

For example, the RO and Feed-in Tariff are legacy renewable subsidy schemes whose costs do not depend on how much electricity consumers use at any given moment, yet they are funded through per-unit charges. The same is true for the ongoing discounts to energy-intensive industries' network charges, discussed in Section 8.3, the nuclear RAB levy and the Warm Home Discount (a lump-sum payment to low-income households). Network costs are also largely fixed, yet half of the network costs paid by the average household are recovered based on their actual consumption.³⁵ Funding these fixed costs through the unit cost disincentivises the

³⁵ Authors' calculations based on Network Cost Allowance – Electricity for single-rate metering arrangement (Ofgem, 2026d).

consumption of electricity, deterring people and businesses from using more electricity when it would otherwise be the best choice for them and for society.

Disincentivising consumption of a good can be desirable. Indeed, this is exactly what taxes on negative externalities, such as carbon taxes, aim to do. As discussed in the section on carbon taxes below, the problem with the taxes used to fund fixed costs is that they do not target an externality such as pollution, but apply to all electricity, polluting and clean alike. Because these taxes, when they are applied to low-carbon electricity, are not internalising any external cost to society of consuming additional electricity, they end up disincentivising socially desirable electricity use.

Recovering fixed costs through unit taxes means that those who consume more electricity pay a larger share of the fixed costs of the electricity system. In the rest of this subsection, we discuss the distributional effects of instead recovering fixed costs through the standing charge, or moving these costs into general government spending.

Recover fixed costs through the standing charge

An alternative approach to recovering the fixed costs of the electricity system without distorting consumption would be to put them on the standing charge rather than the unit price. This would be more efficient: it removes the unjustified distortion to consumption while raising the same revenue.

A common concern with shifting more costs onto the standing charge instead of the unit price is that it would be regressive. Lower-income households tend to consume less electricity on average, and so lowering unit prices and raising standing charges would typically increase their electricity bills relative to the status quo, and reduce the bills of higher-income households.

However, the relationship between income and electricity consumption is not as strong as it may at first seem. In fact, many high-income households have low electricity use (e.g. those in modern, energy-efficient properties, or households of young professionals who are often not at home) and plenty of low-income households have high electricity use (e.g. families in social housing with electric heating, or households with elderly or disabled people who are often at home) (Ofgem, 2024). As such, which consumers would gain or lose from shifting the balance between standing charges and unit prices depends on far more than just their incomes. It is also important to note that reforms to the structure of underlying charges and levies do not preclude energy suppliers from competing to offer low or zero standing charge tariffs if there was sufficient demand for these from consumers.

More broadly, electricity prices are an imperfect mechanism for tackling concerns about regressivity, and doing social policy via energy bills comes with real downsides, as highlighted

above. Ultimately, it is not the progressivity of individual policies or the prices of specific goods and services that matter for household welfare, but the overall effect of taxes, benefits and regulations on the distribution of incomes and spending. If the government is concerned with low-income households being made disproportionately worse off compared with higher-income households by moving costs from the unit price to the standing charge, it could, for example, offer a discount to standing charges for low-income households. Indeed, in effect, it already does this with the Warm Home Discount, an annual lump-sum transfer of £150 to low-income households.

Box 8.3. Support schemes for energy-intensive firms

Changes to bring charges off per-unit costs and onto standing charges would reduce distortions to how much electricity consumers use. But high standing charges could distort decisions over where businesses choose to locate their operations. Large, internationally mobile businesses might be deterred from operating in Great Britain if they were required to contribute significant amounts to the fixed costs of the electricity system, and instead choose to locate in countries with lower charges. This concern threatens the efficiency case for raising funds through standing charges, which rests on the fact that they do not distort behaviour.

A response to this concern is to provide exemptions to fixed costs for energy-intensive firms.

The government already exempts energy-intensive industries from several fixed costs of the electricity system. The British Industry Supercharger scheme, introduced in 2024 and expanded in 2026, gives around 600 firms in this group complete exemption from renewable subsidy and capacity market costs, plus exemption from most network charges. The British Industrial Competitiveness Scheme (BICS) will extend similar discounts to around 10,000 firms from 2027. These exemptions are funded by increasing the charges on other businesses' and households' electricity bills.

Other tax exemptions serve a similar purpose for different sets of industries, all aimed at protecting the competitiveness of Great Britain as a location for investment by energy-intensive firms. Climate change agreements, for example, provide large discounts on climate change levy rates for firms in eligible sectors. Firms in sectors on a 'carbon leakage list' can also receive some carbon permits free of charge under the UK Emissions Trading Scheme – equivalent to a cash transfer – to address the risk of energy-intensive firms relocating production to countries with lower carbon taxes.

These schemes all address the same underlying problem, yet each applies different criteria to define which businesses are at risk of relocating. Given that the schemes share a common justification, these inconsistencies are hard to rationalise. A more joined-up approach would be simpler and more transparent, and also make it easier to ensure support is well targeted at firms genuinely at risk of relocating.

Moving costs from unit prices to standing charges is generally not something government directly controls. As discussed in Section 8.3, suppliers set prices and standing charges. However, government can change the charges and levies suppliers face, such as moving from a per-kWh charge to a per-customer charge. For instance, Ofgem made a number of changes in 2022 following its Targeted Charging Review that resulted in a larger share of transmission and distribution costs being paid through fixed charges. This change – which affected the cost structure facing suppliers – was partly passed on; the share of network costs paid by households via fixed charges (rather than per-unit charges) went from around 10% in 2021–22 to around 50% today.³⁶ Changes were also made to the Warm Home Discount earlier this year, although unfortunately these went in the other direction by moving away from the previous fixed fee per customer towards a per-kWh charge. Still, both examples highlight that government can and does already alter the way different electricity supply costs are incurred. Suppliers will generally adjust their tariff structure to mirror the costs they incur supplying customers.

A key advantage of raising funds through the standing charge is that there are limited ways people can change their behaviour in response to higher standing charges, making it an efficient way of raising money. However, this is less true for internationally mobile firms which may relocate in response to higher standing charges.³⁷ There are carve-outs already in place for these firms, discussed in Box 8.3.

Move fixed costs into general government spending

For much of the last decade, the government has chosen to fund new fixed costs of the electricity system through taxes, levies and charges on energy bills. The government could take steps in the other direction, moving these fixed costs into general government spending. It could then choose to fund this higher spending with some combination of general taxes, cuts to other spending and borrowing. Such changes would interact with the government's fiscal rules, but this should not be the primary factor considered when choosing between alternative reforms.³⁸

³⁶ Calculations based on network costs methodology at <https://www.ofgem.gov.uk/energy-regulation/domestic-and-non-domestic/energy-pricing-rules/energy-price-cap/energy-price-cap-default-tariff-levels>.

³⁷ A related risk is that high standing charges might distort whether firms connect to the grid at all. Large electricity users might, for example, prefer on-site generation to a grid connection with all the costs that entails.

³⁸ Moving fixed costs into general government spending will interact with the fiscal rules in complex ways depending on the type of spending and whether the government receives financial assets in return. The government has two fiscal rules. The borrowing rule requires the government to balance the current budget (i.e. the difference between receipts and day-to-day spending) by the third forecast year. Day-to-day fixed costs of the electricity grid would affect this rule (such as day-to-day balancing, transmission and network running costs, or the change to the RO discussed in the next paragraph), while investments in electricity infrastructure would not. The debt rule calls for debt to be falling as a share of national income by the third forecast year. This uses a measure of debt (public sector net financial liabilities, PSNFL) that also accounts for the financial assets the government holds. Investment spending on the electricity system would affect this rule, but this could be offset in some cases by any financial assets the government gets in doing so (such as taking an equity stake in a project, or providing a loan to fund a project that will be subsequently repaid). The current Treasury framework requires that these investments only be made through the acquiring of financial assets where the investment is expected to generate a return higher than the government cost of borrowing.

This has already happened for some costs. In the Autumn 2025 Budget, the government announced that 75% of the RO levy on households' electricity would move to being funded out of general government spending. There is a case for going further and, importantly, doing so not just for fixed-cost charges on households' electricity use but also for businesses'.

The government could also consider bringing a portion of network costs onto the government balance sheet too. The large-scale upgrades being made to the grid over the next decade could reasonably be described as a national programme of public investment with benefits for the whole country.³⁹ The government could therefore decide it is warranted in providing more direct funding to cover a portion of these costs, just as it already does for rail infrastructure (Benson, 2025).

Compared with recovering fixed costs through electricity bills, paying for them out of general government spending gives the government more control over how these funds are raised, both in terms of which groups pay more today and in terms of the balance between how much more is paid by people today versus people in the future through borrowing. Moreover, as with moving these costs onto the standing charge, removing fixed costs from the unit price would remove distortions to the price of electricity.

A further benefit could arise if the government is able to borrow at a lower interest rate than private network operators who currently fund these network investments. Where government can borrow at lower cost than the private sector, it is possible the cost of borrowing for new infrastructure investment could be reduced.

Any such reforms would obviously have significant implications for the government budget and could require substantial increases of potentially tens of billions of pounds in taxes, spending cuts or borrowing.

If the additional government spending were financed from increased taxes, the distributional effects would, of course, depend on how any additional tax revenue is raised. However, it seems likely that the main losers would be higher-income households with low electricity consumption, who would see a smaller fall in their electricity bills while paying relatively more in tax.⁴⁰ The main winners would likely be lower-income households with high electricity consumption who would see a larger fall in their electricity bills while facing a relatively small increase in their tax burden.

³⁹ Indeed, a large section of the government's 10-year infrastructure strategy was devoted to the electricity grid upgrades (HM Treasury, 2026).

⁴⁰ Households not currently connected to the grid would also be losing out from this reform, as they would start contributing to the costs of the electricity grid. The government does not currently collect information on how many households are not connected to the grid, and no reliable estimates exist.

Alternatively, the additional spending could be financed with cuts in spending in other areas or increased borrowing. Again, the distributional effects of spending cuts would depend on what spending is cut. If the additional spending were funded through increased borrowing, that would impose more of the burden on future taxpayers.

Remove VAT discounts for domestic electricity and other energy use

While the previous subsection identified taxes and charges that incentivised consumers to use *less* electricity, there are also VAT exemptions that encourage households, but not businesses, to use *more* electricity (as well as more gas and heating oil).

Unlike most goods and services, households' energy use does not incur the standard 20% rate of VAT. Instead, it is charged at a reduced rate of 5%, with the rate on electricity set to fall to 0% at the beginning of October 2026 until April 2027. This creates an incentive for households to consume more electricity and gas relative to goods on which the standard rate is charged.⁴¹

This distortion would be removed if domestic energy use, both gas and electricity, were charged the standard VAT rate. This is not uncommon internationally. For example, as of January 2021 (the latest year available), 21 of the 27 EU member states charged their standard rates of VAT on domestic electricity and gas use (European Commission, 2021).

The standard justification for the reduced rate is distributional: energy takes up a larger share of poorer households' budgets, so taxing it lightly is a way of protecting them. As discussed earlier in this section, if the goal is to provide support to low-income households, this is a poorly targeted instrument. The vast majority of the revenue forgone accrues to better-off households, who consume the most energy in absolute terms.

However, increasing the VAT rate on domestic energy would create winners and losers. It is likely that those who consume a lot of energy, some of whom are on low incomes, would not be fully compensated by adjusting existing benefits, and those who consume little energy could end up better off. Introducing an offsetting benefit that provides support to low-income households who consume a lot of energy would reintroduce incentives to consume more energy.

⁴¹ Small businesses not registered for VAT face the same 5% rate on electricity and gas, and thus the same distortion, if they consume less than their respective de minimis threshold. These thresholds are three to four times the average household's consumption of the respective fuel (HM Revenue and Customs, 2026).

The overall effect of taking all policy costs out of the unit price and increasing VAT to 20% would leave electricity prices for households relatively unchanged.^{42,43} However, it would be a significant improvement to the taxation of domestic energy as it ensures that households face the right incentives, regardless of the size of policy costs which do not relate to the cost of producing more electricity.⁴⁴

Energy is only one example of a wider problem. The UK's array of VAT zero rates, reduced rates and exemptions creates a needlessly complex system that distorts choices between goods and makes raising tax revenue more harmful to the economy than it needs to be (Adam, Delestre and Miller, 2025).

Move to a more coherent approach to taxing GHG emissions

As discussed in Section 8.5, the UK government has a legal commitment to reach net zero territorial GHG emissions by 2050. This is a significant commitment that likely requires changes across all sectors of the economy. Attention is increasingly focused on minimising the costs of net zero. This subsection discusses the lowest-cost way to decrease emissions and how far the UK's current strategy is from this cost-minimising approach.

As shown in Figure 8.7, the UK has seen substantial decarbonisation of electricity over the last 25 years, as well as across industry, but much less progress in bringing down emissions from buildings, transport or agriculture. This could reflect cheaper abatement options in the electricity sector. However, the incentives to reduce emissions in this period were much stronger in the electricity sector than in other sectors which have seen much less decarbonisation.

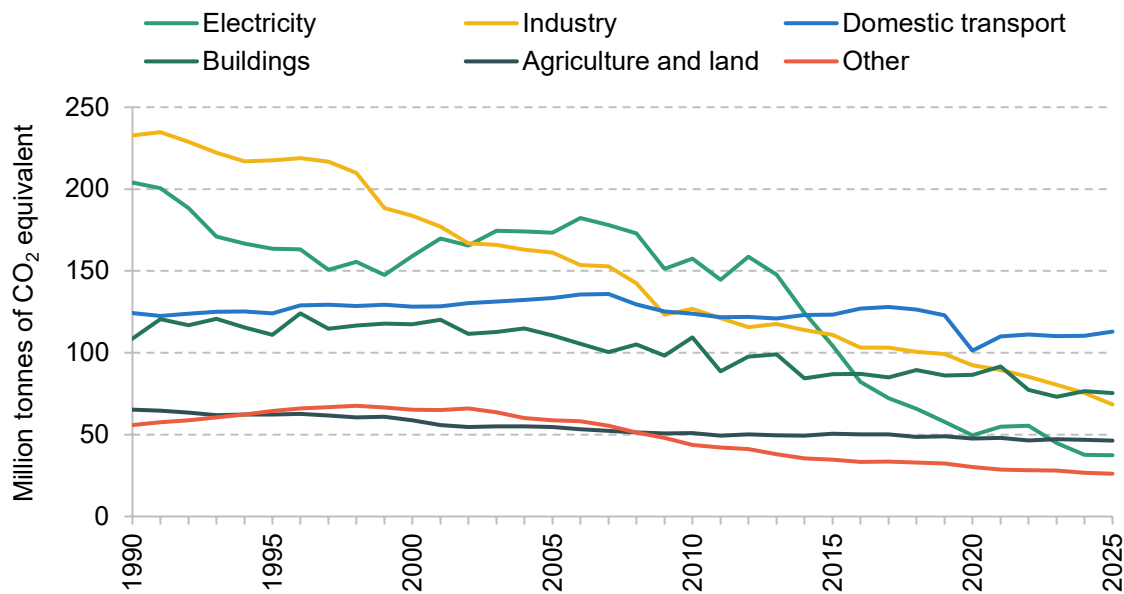
The lowest-cost way to reach net zero would be to use a uniform economy-wide carbon tax, as this would ensure that decarbonisation took place at the lowest possible cost. A uniform carbon tax of, for example, £100 per tonne of CO₂ would ensure that all emissions that could be avoided for less than £100 would be. This would mean that the cheapest decarbonisation options across the entire economy were prioritised and the UK reduced its emissions at the lowest overall possible cost.

⁴² The policy costs currently levied on the unit cost of electricity, plus 5% of VAT were equal to 19% of the pre-VAT unit price in the July–September 2026 price cap (authors' calculations using 'Policy cost allowance methodology' annex in Ofgem (2026d)). With the temporary 0% VAT rate, this would fall to 14%, but once the temporary discount on RO expires, it will be around 20%.

⁴³ Such reforms would also increase the price of domestic gas and heating oil for households, as use of these fuels incurs fewer policy costs. For illustration, policy costs plus 5% of VAT for a unit of gas are 8% of the pre-VAT price in the July–September 2026 price cap (authors' calculations using 'Policy cost allowance methodology' annex in Ofgem (2026d)). Moving to 20% VAT on gas and heating oil while removing policy costs from the unit price would be an 11% unit-price increase.

⁴⁴ This alone would not align the implicit carbon tax rates across emissions from electricity and gas discussed in the following subsection. One example of a policy that maintains this misalignment is the UK Emissions Trading Scheme. All emissions from electricity production in the UK are included under the UK ETS, whereas emissions from households' and most businesses' use of gas are not included.

Figure 8.7. UK territorial GHG emissions by sector



Note: 'Other' includes greenhouse gas emissions from product use and waste. 'Industry' includes emissions from fuel supply. Emission figures for 2025 are provisional.

Source: Department for Energy Security and Net Zero (2026f).

However, the UK is far from having the ideal of a uniform carbon tax: it imposes wildly different implicit carbon taxes on emissions across and within sectors and across fuel types and end users, without good reason (Adam et al., 2022). Moreover, there are supplemental net zero targets that push some sectors of the economy to decarbonise faster than others. Both these factors affect the UK's electricity sector, pushing it to decarbonise much faster than other parts of the economy. In this subsection, we examine why this is, why it is problematic and what the government could do about it.

Implicit taxes on GHG emissions vary dramatically based on who is consuming the energy, and the fuel that they use. For a full discussion, see Gadenne and Upton (2025), but the key points are:

- Tax rates on emissions from businesses' electricity use are almost five times higher than for emissions from gas, and around double the rate for emissions from households' electricity use.⁴⁵ This is due, in part, to the climate change levy as well as to a series of discounts for households that do not apply to businesses, such as the recent temporary 75% discount on RO and the 5% rate of VAT.

⁴⁵ These are businesses that are not eligible for any energy-intensive industry support discussed in Box 8.3.

- Every consumer (including businesses) faces a higher carbon tax rate on emissions from their electricity use than on emissions from their gas use.
- Households face an effective *subsidy* on emissions from gas use due to the discounted VAT on domestic energy, and a much higher carbon tax rate on emissions from electricity use.

This creates the remarkable situation whereby emissions from gas are taxed at a much higher rate if the gas is burned in a power plant versus in a home. This means that more costly emission reduction choices are incentivised to take place in the electricity sector despite cheaper options that would reduce emissions by the same amount being available in other sectors. Ultimately, this imposes disproportionate decarbonisation costs on the electricity sector and makes reaching net zero more costly than it has to be.

Many taxes levied on emitting activities are not explicit carbon taxes, but serve the same role (often less precisely targeting the externality of emissions). The taxes and levies imposed on electricity to fund renewables subsidies and social programmes, and the climate change levy on businesses' energy use, fall into this category. In so far as these taxes and levies are charged on all electricity, clean and dirty alike, they are poorly targeted at reducing emissions.

Removing these taxes from the unit price, as discussed above, improves the relationship between the price of consuming more electricity and the cost of producing more electricity. If the government wants to set higher carbon tax rates on emissions, it should decide the rate and apply it to all GHG emissions, rather than relying on poorly targeted, sector-specific taxes such as those listed above. Any additional revenue raised from this uniform carbon tax could then be used to fund the above policies, but the rate of carbon tax charged does not need to be linked to the size of social programmes and legacy renewable subsidies the government wants to fund.

The UK Emissions Trading Scheme (UK ETS) puts a price on carbon but only covers around a quarter of the UK's emissions (Department for Energy Security and Net Zero, 2025c). A uniform carbon price could be achieved by expanding the UK ETS to include the entire economy, setting it at a rate consistent with the UK's objectives, and scrapping the complex patchwork of other taxes incentivising decarbonisation such as the climate change levy.

Recent policy choices by the Starmer government, such as scrapping Carbon Price Support – a carbon tax levied exclusively on emissions from electricity generators – have brought the implicit carbon tax rate on emissions from electricity closer to that on emissions from gas and, importantly, have simplified the way emissions are taxed (Adam et al., 2026). This is the right direction of travel if the government wants to achieve the lowest-cost transition to net zero.

Beyond the overall net zero commitment, the UK government has further clean power targets for decarbonisation of electricity by 2030, discussed in Section 8.5. This adds further pressure on the electricity sector to decarbonise quickly.

Most modelled scenarios for achieving net zero rely heavily on electrifying energy use in other sectors, such as by switching to heat pumps for heating buildings and electric vehicles for road transport, and on ensuring that the electricity consumed comes from clean sources. A net zero economy requires a low-carbon electricity system sooner or later. The question is whether the government wants to prioritise completely decarbonising the electricity system by 2030, when there may be cheaper ways of bringing down emissions in other sectors.

The government's interim 2030 targets do pose a risk of exacerbating certain cost pressures by compressing the timeline for procuring new renewables capacity. For example, the results from the last two CfD auction rounds saw record amounts of capacity procured but at a higher-than-expected cost, most notably for offshore wind. Some of the increase in strike prices has been driven by higher borrowing costs for developers – unrelated to the government's clean power goals. Even so, recent strike prices are still above government expectations from just a few years ago and noticeably higher than the levels assumed in the NESO modelling discussed above (Department for Energy Security and Net Zero, 2023 and 2026e). Because CfD contracts lock in prices for renewable electricity for 20 years, contracts agreed today will affect costs well into the future. Taking a less aggressive approach to low-carbon capacity procurement in future auction rounds could boost competition between developers and help bring down costs while remaining consistent with net zero by 2050.⁴⁶ Moreover, rapidly expanding renewables when the grid is already struggling to integrate existing capacity does risk exacerbating near-term cost increases, especially when there are already concerns about the timely delivery of existing grid upgrades (National Audit Office, 2026).

8.8 Summary and policy recommendations

Energy prices in many countries have been rising since around the early 2010s and have risen rapidly in recent years, with the UK seeing a particularly dramatic increase from 2021. The Russia–Ukraine war and ongoing geopolitical instability in the Middle East have pushed up the price of gas, with particularly strong knock-on implications for the price of electricity in the UK. At the same time, subsidies that make the continued rate of expansion of renewables capacity viable, accompanying network upgrades, and the increased payments to generators to balance the grid have all had to be paid for and, to a large degree, have been paid for through higher electricity prices. So far, the large investments made in renewable generation capacity have had only a modest effect in terms of shielding UK electricity prices from dramatic increases in fossil

⁴⁶ Beyond meeting the target of net zero emissions by 2050, the government may also be concerned about the total stock of emissions that are released before net zero is reached, as these translate into higher global temperatures and greater cost to society. However, the government could maintain the same path of emissions, and still lower overall costs, by simultaneously increasing decarbonisation incentives on other activities that currently have lower incentives to reduce their emissions.

fuel prices due to gas's continued role as the price-setting marginal supplier. This unfortunate combination – bearing the up-front costs of decarbonisation while gas remains the marginal supplier and gas prices are high – has led to a surge in electricity prices for both households and businesses in the last few years, with significant consequences for living standards and growth.

In the search for solutions to the current situation, there have been numerous calls for the government to take steps to 'de-link' domestic electricity prices from the high marginal costs of gas-fired power. There remains a lack of clarity on precisely how this would be achieved as long as gas remains so important in the UK generation mix. As we have argued, the fact that electricity prices rise to reflect the cost of gas-fired generation when gas is needed to meet consumer demand is not a bug but a feature of the electricity market. It ensures enough power is produced to keep the lights on at the lowest possible cost, and that consumers face the right incentives of when and how much electricity to use. Indeed, creating a *stronger* link between consumer prices and the marginal costs of electricity generation – as could be achieved through some of the recommendations we summarise below – is a key way to start bringing down the total costs of the electricity system. Ensuring prices reflect the underlying marginal cost of supplying electricity helps avoid costly spending on extra capacity during peak periods, while also ensuring that cheap surplus renewables electricity does not go to waste. Fortunately, the government has so far aimed to decouple electricity prices from gas through continued expansion of renewables rather than trying to change the role of marginal suppliers in setting the price.

Our main recommendations for what the government should do are as follows.

To bring down the costs of the electricity system, the government should:

1. **Improve incentives to use more electricity when the cost of supplying it is low, less when the cost is high, and incentivise generators to locate where demand is.** The cost of supplying electricity varies significantly across time and space but the incentives to use it do not. This weakens incentives to invest in energy storage technologies and increases the need to use gas-fired power that has high marginal costs. It also weakens incentives for generators to locate in places where the grid is able to transport their generation to consumers more cost-effectively. The government has so far rejected proposals to move to paying generators different prices according to location through zonal or nodal pricing, preserving an inefficient system of price incentives. Even without these changes, there are still ways to improve incentives in this area. For example, consumers could be encouraged to adopt tariffs that offer time-varying prices. The government could also tailor incentives to adopt electric heat pumps and solar panels for households and firms by geography, and put more importance on the location of potential generators in the Contracts for Difference auction process.

2. **Adopt a more flexible path to achieving emissions reductions.** There is a risk that near-term efforts to accelerate the move towards a fully clean electricity grid by 2030 lead to costs that are higher than necessary. Where these raise the price of electricity further, this actually frustrates efforts to decarbonise other sectors due to the central role that electrification plays in efforts to reduce greenhouse gas emissions from buildings and transport. In short, a slower pathway to a low- or zero-carbon grid need not come at the expense of the UK's current, broader goal of achieving net zero GHG emissions. A more coherent and consistent approach to taxing energy use would, of course, be a helpful step in this direction, which would be achieved with our next set of recommendations.

To improve the tax treatment of electricity, the government should move towards a system where:

3. **The fixed costs of the electricity system that are currently financed by per-unit levies on electricity should be funded in another way.** One approach to achieving this would be to change the structure of levies and charges facing suppliers, using per-customer standing charges rather than per-unit levies to recover fixed costs. This would need to be done carefully to address equity concerns, as we discuss below. The government could also fund more of these costs through general taxation, though this would of course mean other taxes or borrowing going up, or public spending coming down.
4. **Incentives to reduce greenhouse gas emissions are made more consistent across activities.** There is no uniform carbon tax in the UK. Schemes such as the UK Emissions Trading Scheme put a price on carbon but this only covers around a quarter of the UK's emissions (Department for Energy Security and Net Zero, 2025c). This means incentives to reduce emissions vary significantly across activities and by who is undertaking the activity (households, non-industrial or industrial businesses). A better approach would be to decide what cost of carbon is consistent with the government's emissions objectives and to set it in a much more consistent way across emissions regardless of their source.

Moving to more consistent taxation of GHG emissions could be achieved by, for example, extending the existing UK ETS to cover the entire economy and abolishing all other taxes and charges designed to encourage decarbonisation such as the climate change levy.

5. **Household electricity and other energy use is charged the standard rate of VAT.** VAT discounts currently distort households' decisions on how much electricity, and energy more widely, to use. Moreover, most of the cash benefits of these discounts accrue to better-off households. More targeted support to low-income households would be a better tool to address redistributive concerns.

Our goal in this chapter has been to lay out what a coherent, principled approach to the taxation of energy looks like. Implementing the second set of changes (3, 4 and 5) would bring us to this point, but would not be without significant political challenges. They would undoubtedly create losers as well as winners, and so raise important distributional concerns. While removing fixed costs from the unit price of electricity would offset the impact of a VAT rise for electricity users, domestic users of gas and heating oil would lose out more unless steps were taken to help them. It is noteworthy that a 1994 attempt to impose the standard rate of VAT on domestic energy ended in failure (Weston, 2023). Similarly, if some fixed costs were moved onto standing charges, this could leave low-use electricity users significantly worse off relative to the status quo.

Any such reforms would therefore likely need to be paired with targeted compensation (e.g. through changes to the tax and benefit system), and perhaps measures to help households improve their energy efficiency and to support them to shift away from gas boilers and oil-based heating systems. One way to provide support to lower-income households hit by higher standing charges would be to simultaneously expand eligibility for the Warm Home Discount and increase its generosity.

Importantly, to move towards a more coherent system of taxation for energy, the government needs to correct multiple distortions – some of which encourage energy use while others discourage it. Fixing one distortion while others remain in place therefore risks making things worse. This makes it difficult to welcome individual measures, even if they are consistent with some of what we are recommending, while other issues remain unaddressed. This includes the decision to take 75% of the costs of funding the Renewables Obligation off per-unit electricity taxes and to fund them – and future home retrofit programmes – through general taxation instead.

Judged by the costs of the measures it has announced, the majority of the government's focus has been on the prices that households pay for their electricity. The price businesses pay has, by contrast, received notably less attention – particularly non-energy-intensive businesses that do not benefit from tax exemptions. Our recommendations would be most likely to result in lower electricity prices for these businesses. This would benefit households indirectly, as these businesses' customers, employees and shareholders.

Many other areas of UK government policy also potentially affect electricity prices, such as regulatory action to avoid excess profits and anti-competitive behaviour in the electricity supply chain, or international agreements affecting the import and export of electricity with the UK's trading partners. Planning delays and grid-connection bottlenecks are another area where there have been long-running concerns in the electricity sector, with evidence these have increased the costs of the UK's deployment of renewable energy to date (Jarvis, 2025). Each of these areas

involves complex trade-offs and is the subject of ongoing policy efforts. While we do not make firm recommendations here, all are important to future electricity costs and remain key areas for further scrutiny and possible reforms.

The importance of electricity prices for the UK's economy is set to grow substantially in the coming years. Swift action in the context of a long-term plan could yield significant benefits. The government should not pass up the opportunity in the coming Budget.

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9. Issues and options for sharing tax revenues with England's regional mayors

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Devolution has recently risen to the top of the political agenda, forming a key plank of the new Prime Minister Andy Burnham's plans for boosting growth, improving public services, and changing how politics and policymaking are conducted in the UK, and England in particular. But perhaps the single biggest change currently in train was started by the last Chancellor Rachel Reeves in March: allocating a share of business rates and income tax revenues to English mayoral strategic authorities (MSAs), based on revenues collected from their areas. Mr Burnham has confirmed that a 'roadmap' setting out more detail on plans for such a system of 'revenue assignment' will be published alongside the Budget. This chapter considers the rationales for revenue assignment, and discusses the issues and options facing the government in designing the new system. Will it help boost growth and tackle regional inequality? Are income tax and business rates appropriate for assignment? What arrangements for redistribution and insurance should the government consider? And are MSAs the right tier of government to assign revenues to?

Key findings

1. All of England is covered by local authorities with responsibility for a range of services including social care, public health and some schools. In addition, **England now has 20 strategic authorities that sit above local authorities. These currently cover 65% of the population, with an ambition of reaching 100% by the end of 2028.** Their precise powers and responsibilities vary substantially, but generally include elements of economic development, transport, housing, strategic planning, skills and employment support policy, with some, such as the Greater London Authority, also responsible for police and fire services. **The subset of strategic authorities that are led by elected mayors (MSAs) have more powers and responsibilities than those without** – with the most powers granted to mayoral authorities that the government deems have a track record of successful delivery and good governance arrangements (termed 'established' MSAs).

2. **A majority of the funding available to strategic authorities is provided by central government grants: a forecast £15.7 billion in total this year, or £457 per person on average.** Grant funding varies from £38 per person for Cumbria Combined Authority to £832 per person for Greater London, mostly reflecting differences in their responsibilities. Strategic authorities also generate income from investment activity and can borrow for capital investment purposes. MSAs can also levy supplements to both council tax and business rates – although only a few make use of these powers. These other sources of funding amount to a forecast £10.2 billion this year, or £296 per person on average – albeit again with huge variation across authorities.
3. **Fewer revenues are devolved or assigned to subnational government in England than in most other high-income countries.** English local and strategic authorities are also more reliant on grant funding than subnational governments in other countries: approximately 60% of English local and strategic authority spending is funded by central government grants, compared with 20–30% in Canada, France, Germany and the US. Canada, France, Germany and Japan all make greater use of revenue assignment specifically as a means of funding subnational governments.
4. **Assigning a share of tax revenues to MSAs will not give mayors more direct control over their funding – tax rates will still be set nationally. But it will bring a range of opportunities.** First, by linking their funding more closely to the performance of local tax revenues, assignment could provide MSAs with stronger financial incentives to facilitate economic growth. Second, if MSAs can retain some of the additional revenues generated by their investments, this could be used to help finance the borrowing to pay for those investments in the first place – so-called tax-increment financing. And third, while tax revenues are subject to some uncertainty, the permanent assignment of tax revenues may provide MSAs with greater long-term clarity over funding than their current reliance on mostly short-term grant funding.
5. **Revenue assignment also brings risks, including both short-term revenue volatility and longer-term divergences in revenues relative to different MSAs' spending needs – often due to factors outside mayoral control.** There is also the potential for excess competition between MSAs for private sector investments or for high earners to locate in their areas.
6. International evidence suggests impacts on both economic growth and financial sustainability will depend crucially on the design of the revenue assignment system and on local capacity and governance quality.

7. Local authorities and some MSAs already share in local growth in business rates revenues via the business rates retention scheme (BRRS). **Assigning MSAs a bigger share of business rates would provide stronger incentives for them to support the development of new and improved non-domestic property** – which they potentially could do through their powers over strategic planning, economic development and transport. Given the BRRS already exists, this change would be fairly straightforward to administer. But, as with the existing BRRS, it will be important to take account of the big differences in how much is raised from business rates in different MSA areas: revenues per person this year are forecast to be around three times higher in Greater London (£1,214) than in the North East MSA area (£400).
8. **Assigning a share of income tax revenues based on where people live (rather than where they work) would provide a different, arguably complementary set of incentives to business rates retention.** It would incentivise authorities to increase the taxable incomes of their residents, including through commuting to high-paid jobs in neighbouring areas or remote working. The partial devolution of income tax to Scotland and Wales shows that residence-based income tax assignment would be administratively possible, although it would entail somewhat higher set-up and running costs than (increased) business rates assignment. As for business rates, **there are large differences in income tax revenues across MSAs: in 2023–24, we estimate income tax revenues per person were over three-and-a-half times higher in Greater London (£8,587 in today's prices) than in the Tees Valley MSA area (£2,389).**
9. **There are different ways that income tax revenues could be assigned to MSAs. The simplest option would be a flat percentage (e.g. 10%) of all income tax revenues.** Income tax is progressive, meaning higher earners face a higher marginal tax rate. As a result, a given increase in income for a higher- or top-rate taxpayer would generate two or more times as much funding for their MSA as an equivalent-sized increase in income for a basic-rate taxpayer. Under this approach, MSAs would therefore have a stronger financial incentive to boost the incomes of high-income taxpayers than low- and middle-income taxpayers. **Another approach would be to assign MSAs revenues from a fixed number of percentage points of the tax rates for these different tax bands (e.g. 3ppt).** This would mean MSAs would benefit equally from boosting the incomes of low-, middle- and high-income taxpayers. Conversely, they would benefit less financially if, over time, more of their taxpayers become higher- or top-rate taxpayers – including from fiscal drag.

10. Given the very significant variation in both the underlying tax revenues collected in each area and MSAs' existing grant funding – particularly between Greater London and the Northern and Midlands MSAs – we recommend that a formal system of equalisation should be used to offset these differences. As part of this, **the government will need to decide *how much* business rates and income tax revenue to assign, and *how much* to equalise (how much funding to redistribute) for the large differences in revenues and existing grants across MSAs.** This is mostly a political question: how willing are the government and mayors to see variation in an MSA's funding based on how tax revenues perform locally? But decisions should also reflect views on what the main rationale for revenue assignment is: if it is to directly incentivise growth and enable tax-increment financing, then a higher rate of assignment and/or less ongoing equalisation for changes in revenues would provide stronger incentives; conversely, if the aim is longer-term clarity over funding, then a lower rate of assignment and/or more ongoing equalisation for changes in revenues would protect MSAs more from revenue volatility and uncertainty.
11. Trade-offs between incentives, funding certainty and redistribution cannot be fully avoided when designing a revenue assignment system, but they can be ameliorated. **Initial equalisation payments could be set so that no MSA immediately gains or loses from revenue assignment, without this adversely affecting incentives for future revenue growth. There is a strong case for uprating these initial equalisation payments each year in line with average growth in assigned tax revenues;** MSAs would still gain from faster growth in their areas, preserving their incentives, but this would ensure equalisation payments do not fall relative to overall assigned revenues, which they likely would if held fixed in cash or even real terms. The government will also need to decide whether to include 'floors', 'ceilings' or 'tapers' in the system to limit the biggest decreases and increases in assigned revenues, and whether and how to eventually 'reset' the system, updating equalisation payments to reflect changes in MSAs' revenues and spending needs, to avoid divergences between MSAs growing indefinitely. **The government should consider whether different arrangements are required for Greater London, given its much higher tax revenues per person than other MSAs'.**
12. **We model a series of scenarios for future revenues and show that these choices around system design will have significant effects on the funding and financial risks facing different MSAs.** For instance, we consider a scenario where 10% of income tax revenues are assigned to all MSAs in lieu of the portion of grants they currently receive as integrated settlements, and all areas see the same growth in their underlying income tax revenues. If equalisation payments were inflation-linked, Greater

London's post-equalisation income could outpace that of other MSAs to the tune of billions of pounds a year within 10 years. Revenue-indexing equalisation payments would avoid this and mean the Greater London Authority (and other MSAs) would only see their net revenues outpace others if their underlying income tax revenues did too.

13. While the government has said it plans to increase the share of business rates assigned to local authorities, as well as to MSAs, it does not currently plan to assign a share of income tax to them. This is a reasonable decision. **Assignment would create stronger, broader financial incentives for local authorities to support growth too, as well as a long-term funding source, but the challenges and risks would also be greater for local authorities.** Revenues are even more unequal at local authority level than at MSA level, and likely subject to greater volatility and risk too. And most local authorities' spending goes on the provision of services (such as social care) for vulnerable residents, where one may place a greater weight on ensuring funding aligns with need.

9.1 Introduction

Recent years have seen a new middle tier of government sitting between central government and local authorities spread across large parts of England, including its largest cities. Now termed 'strategic authorities', these new institutions have been given varying powers over elements of economic development, transport, housing, spatial planning, skills and employment support policies, with the aim of better tailoring and joining up efforts to boost local economic growth and improve residents' well-being. The main source of funding for these authorities is currently central government grant funding. This is mostly provided through a combination of ring-fenced grants for specific responsibilities and – in seven of the longest-established authorities led by elected mayors – an 'integrated settlement' offering authorities a little more flexibility on how money is allocated between different responsibilities.

The new Prime Minister Andy Burnham was, until June, the Mayor of Greater Manchester and head of that city-region's strategic authority. In his first major speech after announcing his intention to stand for the leadership of the Labour Party (Burnham, 2026), he drew upon his experience as mayor to strongly criticise the current system of governing England as too centralised and siloed, and to advocate for deeper devolution across England as a whole (as well as within Scotland, Wales and Northern Ireland). Since he became Prime Minister, his Cabinet has confirmed that a new devolution White Paper will be published alongside the Budget on 28 October, giving strategic authorities in England more powers over 16–19 education, rail

transport, and housing and planning, and potentially a greater say in other services such as the NHS (Cabinet Office, 2026).

But perhaps the biggest change that is currently in train was initially signalled by the last Chancellor Rachel Reeves in her Mais Lecture in March, and confirmed by Mr Burnham in July. This is the development of a 'roadmap' for fiscal devolution, also to be published alongside the Autumn Budget. The heart of this will be a plan for sharing a portion of the revenues raised from income tax and business rates with mayoral strategic authorities (MSAs), based on the performance of revenues from their areas – a policy termed 'revenue assignment'. Alongside new powers to levy taxes on overnight visitor accommodation (a 'tourism tax'), this will complement existing and planned administrative and spending devolution with greater revenue devolution.

The introduction of revenue assignment will not lead to big overnight changes in funding. The aim is for the revenue assignment system to be revenue-neutral at the point of introduction, with newly assigned revenues replacing existing grant funding, rather than providing an immediate boost to mayors' overall funding. And mayors would not be able to vary tax rates: they will still be set nationally.

However, MSAs and their residents would have a stronger financial stake in improving local economic performance, as strong economic growth would boost the funding available for mayors to spend. For example, the new Mayor of Greater Manchester Bev Craig would, over time, gain if the assigned income tax and business rates revenues from Greater Manchester performed well, and lose if they performed poorly. The permanent assignment of a share of tax revenues to MSAs could also give them greater long-term clarity over their future funding than relying on grants from central government that are confirmed for a few years ahead, at best. But it would expose them to the year-to-year volatility of tax revenues and the risk of long-term falls in revenues due to factors potentially outside of their control.

The details of the systems for assigning business rates and income tax revenues will matter for their effects on: the financial incentives facing MSAs; the level and certainty of their funding; their financial sustainability and resilience; and wider economic and social outcomes. Key choices include precisely which business rates and income tax revenues to assign, the specifics of any system of equalisation and insurance to limit divergence and volatility in funding, and whether income tax revenue assignment should extend to local authorities. Answers to these design choices will be needed for the roadmap being published alongside the Budget and the options available are the core focus of this chapter, which proceeds as follows.

Section 9.2 describes England's system of strategic and local authorities, including how they are currently funded. It briefly compares this with how subnational governments in other high-

income countries are funded, distinguishing revenue assignment from true revenue devolution, where subnational governments have some control over tax rates and/or bases.

Section 9.3 discusses the potential advantages and disadvantages of revenue assignment in general, relative to funding authorities either through grant funding or true revenue devolution. It also briefly discusses the (limited) evidence on the effect of revenue assignment on economic outcomes.

Section 9.4 explains the government's plans and objectives for assigning business rates and income tax revenues. It provides a set of criteria for assessing the suitability of different taxes for assignment and applies these to business rates and income tax.

Section 9.5 discusses three key decisions the government will need to make to implement revenue assignment. First is whether to roll out assignment to all MSAs in one go or to trial it for a subset of MSAs first. Second is the form of income tax revenue assignment to pursue, which need not be based on a flat share of all income tax revenues. And third is how much revenue to assign and which grants should be replaced with assigned revenues.

Section 9.6 looks in detail at the options for the design of an equalisation and insurance system for assigned revenues, with a particular focus on how they affect the incentives and risks that would be faced by MSAs, and the potential for funding divergences between different parts of England. It argues that a trade-off between financial incentives and the risk of funding divergences can be ameliorated, although not eliminated, through appropriate mechanism design.

Section 9.7 uses quantitative modelling to show how big the financial effects of different assignment, equalisation and insurance mechanisms for income tax could be for different MSAs in different scenarios. Appendix 9A provides information on the data and assumptions used in this modelling.

Section 9.8 examines the case for and challenges associated with assigning further revenues to local authorities – which cover smaller and more differentiated areas than strategic authorities.

Finally, Section 9.9 draws our analysis together, emphasising the key decisions about the new revenue assignment system that the new Prime Minister and Chancellor will have to take in conjunction with stakeholders as they develop their fiscal devolution roadmap, and how these should be guided by their wider vision and objectives for devolution.

9.2 English strategic and local authority funding in an international context

What are English strategic and local authorities responsible for?

The whole of England is covered by local authorities (or ‘councils’) responsible for the provision of a range of public services including:

- adults’ and children’s social care services;
- public health services;
- local roads and support for buses;
- refuse collection and disposal, and other local environmental services;
- licensing and local regulatory services;
- housing regulation and homelessness prevention;
- planning and building control;
- local economic development and regeneration;
- leisure centres and libraries;
- some schools (although some are directly funded by central government) and childcare;
- in some instances, fire services.

In large parts of the country, including most large urban areas, these core local public services are provided by a single ‘unitary’ authority: variously called unitary authorities, London boroughs (in the capital) or metropolitan districts (in the largest urban areas outside the capital). In other parts of the country, these responsibilities are currently split between lower-tier district councils and upper-tier county councils which each cover several districts. The government had planned to move these two-tier areas to a unitary structure by April 2028, with the aim of reducing costs and improving local services (Ministry of Housing, Communities and Local Government, 2024). However, a review of these plans was announced last month and their status is currently uncertain (Ministry of Housing, Communities and Local Government, 2026a).

As discussed above, recent years have also seen a new middle tier of government emerge in large parts of England – now termed ‘strategic authorities’.¹ The first of these was the Greater London Authority (GLA), set up in 2000, led by an elected mayor and accountable to an elected assembly. Then, from 2011 onwards, new strategic authorities have been set up in many of the

¹ A previous middle tier of government covering Greater London and metropolitan areas of the North and Midlands (Greater Manchester, Merseyside, South Yorkshire, Tyne & Wear, West Midlands and West Yorkshire) existed between 1965 and 1986, and 1974 and 1986, respectively. The stated reason for their abolition was to reduce governance and administration costs (Department of the Environment, 1983), and after this, their responsibilities (which differed somewhat from the post-2000 strategic authorities’) were either devolved to local authorities or transferred to other public bodies or corporations.

other most urbanised areas of England, such as Greater Manchester, Merseyside, South Yorkshire and the West Midlands, as well as a growing number of county areas too, such as Cheshire, the East Midlands – covering Derbyshire and Nottinghamshire – and Hampshire & the Isle of Wight.

There are now 20 strategic authorities in England, which collectively cover around two-thirds of England's population (38.2 million people). The powers and responsibilities of the different strategic authorities differ, in part reflecting the use of negotiated 'devolution deals' for the development of the strategic authorities created between 2011 and 2025. However, the Labour government's English Devolution and Community Empowerment Act 2026 aims to make powers and responsibilities more consistent based on the governance arrangements, institutional capacity and maturity of strategic authorities, categorised into the following three groups:

- non-mayoral 'foundation' strategic authorities (FSAs) where authority lies with boards made up of the leaders of the local authorities that sit under the strategic authority, and which have the fewest powers;
- mayoral strategic authorities (MSAs) which have (or are soon to have) elected mayors, who can decide certain matters directly and who need the agreement from a majority or supermajority of the boards for other decisions;²
- 'established' mayoral strategic authorities (E-MSAs), assessed by central government to have high capacity and mature governance arrangements, which are being provided with the most powers (and the ability to request additional powers).

As shown in Table 9.1, there are currently two FSAs, seven MSAs and eleven E-MSAs (four of which were awarded this status in July 2026). Just under two-thirds of the population (65%, 38.2 million) live in areas that currently have a strategic authority, while just under half (47%, 27.8 million) live in areas covered by E-MSAs. As illustrated in Figure 9.1 though, while all of the North of England is covered by strategic authorities, large parts of the South and Midlands remain uncovered. The government's aim is for all areas to be covered by strategic authorities by the end of 2028, but it does not have the power to compel local areas to set up a strategic authority. At the time of writing, plans are confirmed for two further MSAs covering Greater Essex (Essex, Southend-on-Sea and Thurrock) and Norfolk & Suffolk (Ministry of Housing, Communities and Local Government, 2025a), with negotiations between local authorities and the government ongoing for the remaining areas of the country.

² A full list of the powers that mayors exercise sole authority over and those requiring a majority of board members (or specific local authority approval) can be found at <https://www.gov.uk/government/publications/english-devolution-and-community-empowerment-bill-devolution-framework-explainers>.

Table 9.1. List of strategic authorities in England

	Type	Formed	Population in 2025
Greater London	E-MSA	2000	9,122,909
West Midlands	E-MSA	2016	3,027,190
Greater Manchester	E-MSA	2011	3,017,590
West Yorkshire	E-MSA	2014	2,424,324
East Midlands	E-MSA [#]	2024	2,290,652
Hampshire & the Solent	MSA	2026	2,063,185
North East	E-MSA	2024 [*]	2,050,194
Sussex & Brighton	MSA	2026	1,767,265
Lancashire	FSA	2025	1,615,860
Liverpool City Region	E-MSA	2014	1,610,919
South Yorkshire	E-MSA	2014	1,434,478
Greater Lincolnshire	MSA	2025	1,125,531
Cheshire & Warrington	MSA [†]	2026	1,014,835
West of England	E-MSA [#]	2017	1,004,945
Devon & Torbay	FSA	2025	985,027
Cambridgeshire & Peterborough	E-MSA [#]	2017	941,740
York & North Yorkshire	E-MSA [#]	2023	848,251
Tees Valley	MSA	2016	712,552
Hull & East Yorkshire	MSA	2025	633,591
Cumbria	MSA [†]	2026	513,650
Total across strategic authorities			38,204,688
England			58,834,812

* An original North East authority was in place between 2014 and 2018. However, between 2018 and 2024, the region was covered by two strategic authorities: the non-mayoral County Durham, Gateshead, South Tyneside and Sunderland authority (covering said local authorities) and the mayoral North of Tyne authority (covering Newcastle-upon-Tyne, Northumberland and North Tyneside). These re-merged in 2024 as a single mayoral authority.

† Cheshire & Warrington and Cumbria will hold their first mayoral elections in May 2027.

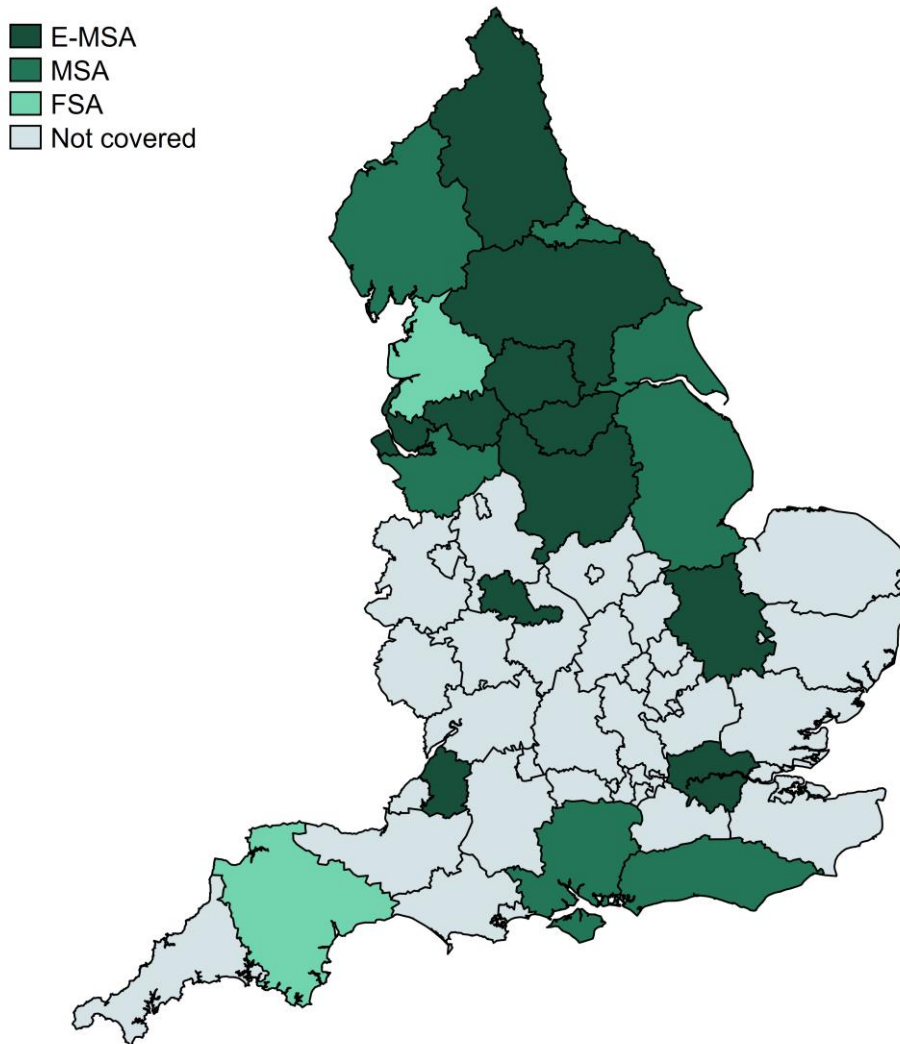
These four mayoral strategic authorities gained E-MSA status in July 2026. The other seven E-MSAs receive much of their funding through an 'integrated settlement'.

Note: Mid-2025 resident population in the geographic areas covered by current strategic authorities.

Authority type is as of September 2026.

Source: Authors' calculations based on ONS mid-year population estimates (Office for National Statistics, 2025).

Figure 9.1. Map of strategic authorities in England (as of July 2026)



Note: Upper-tier local authority boundaries are shown in areas not covered by strategic authorities as of July 2026.

Bearing in mind these differences, and the aforementioned plans for further devolution of spending set out by the Burnham administration, the responsibilities and powers of strategic authorities currently fall under the following categories:³

- **Economic development and regeneration.** All MSAs are required to produce local growth plans to be implemented in partnership with the UK government and local authorities, while FSAs are required to set out a less formal ‘vision for growth’. After notifying the government, MSAs can borrow for investment related to redevelopment (such as site

³ A full list of the statutory functions and powers of the different types of strategic authorities can be found at <https://www.gov.uk/government/publications/english-devolution-and-community-empowerment-bill-devolution-framework-explainers>.

development and land remediation), as well as for other capital purposes. All strategic authorities can pay grants to constituent local authorities and, subject to the UK's subsidy control regime, provide grants and loans to local businesses.

- **Transport and local infrastructure.** All strategic authorities have the responsibility for preparing a local transport plan and a bus strategy plan, as well as managing concessionary bus fare schemes for their areas, for which they can charge levies to their constituent authorities. They can also franchise local bus services.⁴ MSAs must also define and manage key roads in their area, while FSAs can do so in agreement with constituent local authorities. Established MSAs can also request a statutory role in planning and developing local rail services, including the devolution of responsibility for certain services and stations (Greater London and Liverpool City Region already have such powers).
- **Housing and strategic planning.** All strategic authorities are required to produce a spatial development plan setting out long-term plans for the amount and location of new housing and commercial property, as well as enabling infrastructure. They can also acquire and dispose of land for housing purposes and provide financial assistance to enable housing development. In addition, MSAs can 'call in' strategic planning applications if they think local authorities have made the wrong decision, establish mayoral development corporations to coordinate the development of specific strategic sites, and set an infrastructure levy payable by developers. They also have a greater role alongside Homes England in planning investment in social housing, with Greater London controlling its own social housing investment budget.
- **Skills and employment support.** All strategic authorities have funding and responsibility for non-apprenticeship adult education budgets. MSAs and especially established MSAs have an increasing role in the co-design and delivery of employment support programmes outside of Jobcentre Plus, with a particular focus on young adults and those with disabilities or health conditions, as well as integrating employment support with skills provision and local growth plans.
- **Environment and climate change.** All strategic authorities have the responsibility for coordinating which areas should be subject to requirements for district heating systems. More generally, they may coordinate and fund initiatives related to decarbonisation and energy efficiency, and environmental and biodiversity protection.
- **Health, well-being and public service reform.** All strategic authorities have a duty to consider how they can improve health and reduce health inequalities. They can develop regional health and well-being strategies, and support coordination between different public

⁴ Under a franchised bus service, the strategic authority (or other local transport authority where a strategic authority does not exist) awards exclusive contracts to private operators to provide bus services in a specific area or on specific routes, with operators bidding for these contracts. This allows the authority to control branding and timetables and to use fees paid by operators to operate profitable routes to cross-subsidise unprofitable routes deemed socially desirable.

bodies. In a trial in Greater Manchester and South Yorkshire, chairs of the local NHS integrated care board will report to mayors as well as to NHS England.

- **Public safety.** All strategic authorities can help fund and coordinate community safety projects. MSAs can, where geographies align, become responsible for police and/or fire services, as is already the case in Greater London and several other MSAs.⁵

How are English strategic and local authorities funded?

Both English strategic authorities and local authorities are funded via a mix of central government grant funding, local tax revenues, fee and commercial income, and capital borrowing.

Overall strategic authority funding

The government does not collate comprehensive figures on strategic authorities' funding. However, based on figures reported in their resource and capital budget returns for 2026–27,⁶ we estimate that funding and borrowing for the 18 strategic authorities that were in place when these returns were submitted amount to approximately £25.9 billion this year, or an average of £753 per person in the areas they cover. This estimate excludes income from fees and charges for the services they provide (including public transport), which is netted off the reported budget figures.

Council tax. MSAs, but not FSAs, can set a surcharge (or 'precept') on council tax bills, although only five do so currently. The vast majority of the revenue raised by these precepts is for police services, and just three MSAs (Greater London, Greater Manchester and Liverpool City Region) set a precept to help pay for their other more economy-focused responsibilities. This year, MSAs' council tax revenues are forecast to amount to £2.5 billion, with the majority (£1.7 billion) being for Greater London.

Business rates. Five MSAs (Greater London, Greater Manchester, West of England, West Midlands and York & North Yorkshire) are formally allocated a share of business rates revenues raised in their areas under the so-called business rates retention scheme (BRRS) – a revenue assignment scheme, which is discussed in more detail in Box 9.1, later in this section. Several others (such as Tees Valley) retain business rates revenues from specific Freeport and

⁵ Greater London, Greater Manchester and York & North Yorkshire strategic authorities have responsibility for policing and fire services. South Yorkshire and West Yorkshire strategic authorities have responsibility for policing only.

⁶ Respectively, these cover day-to-day funding and spending (resource, or in local government terminology 'revenue', items), and funding for and spending on buying, constructing or improving of physical assets, such as buildings or vehicles (capital items). See Appendix A for full details on our calculations. Note that our approach aims to avoid double counting of funding that can be reflected in both resource and capital accounts and has been checked with officials from the Ministry of Housing, Communities and Local Government. However, the design of the forms means some relatively small expenditures may unavoidably be double counted.

Investment Zone sites. E-MSAs also have the power to levy business rates supplements to pay for local infrastructure, although only Greater London Authority currently does so, to help fund Crossrail. MSAs received £3.4 billion in retained business rates revenues this year, almost all of which went to the Greater London Authority (just under £3.4 billion).⁷

Central government grants are a bigger and more widely used source of funding, with resource grants accounting for an estimated £7.6 billion and capital grants £8.1 billion of funding this year, or approximately 60% of overall strategic authority funding. For most strategic authorities, while part of their grant funding is in the form of a long-term (30-year) 'investment fund' that is not ring-fenced, most is provided through a series of ring-fenced grants for particular services, for anything from one to several years, each with its own reporting and outcome framework.

Integrated settlements. Seven of the established MSAs now receive part of their previously ring-fenced grant funding in the form of an 'integrated settlement', which provides somewhat more flexibility over how funding is used.⁸ In particular, rather than separate ring-fenced grants for specific services, integrated settlement funding is split into six themes aligned with MSAs' broad responsibilities.⁹ These integrated settlements amount to £3.4 billion this year, with £1.6 billion for day-to-day ('resource') purposes and £1.8 billion for investment ('capital') purposes – roughly a quarter of the total resource and capital grant funding these MSAs expect to receive this year. Established MSAs can spend money as they see fit within a theme, transfer up to 10% of funding between themes, and transfer up to 10% of capital funding into resource funding. However, the integrated settlements remain far less flexible than strategic authorities' small investment funds, and retain detailed reporting and outcome frameworks, which the National Audit Office (2026) suggests should be simplified in future. The settlements are also only confirmed until the end of the Spending Review period – currently 2028–29 for resource funding and 2029–30 for capital funding.

Other sources. In addition to local taxes and government grants, strategic authorities receive funding from a range of other sources including commercial and investment income, developer contributions and mayoral infrastructure levies, land and property sales, levies charged to constituent authorities for the provision of certain services, and the use of capital borrowing and

⁷ Note that these figures include funding for police services in South Yorkshire and West Yorkshire that is reported separately in financial returns but which is now also the responsibility of the MSAs in practice.

⁸ These are Greater London, Greater Manchester, Liverpool City Region, North East, South Yorkshire, West Midlands and West Yorkshire. The four MSAs granted 'established' status in July (Cambridgeshire & Peterborough, East Midlands, West of England and York & North Yorkshire) still receive equivalent funding as a series of separate ring-fenced grants, but are eligible for integrated settlements in future.

⁹ These are: economic development and regeneration; transport and local infrastructure; skills and employment support; housing and strategic planning; environment and climate change; and health, well-being and public service reform.

reserves. Taken together, these amount to a forecast £4.3 billion in 2026–27, with capital borrowing (under the CIPFA prudential regime)¹⁰ accounting for £1.7 billion of this.

Most of the funding provided to or raised by strategic authorities is for responsibilities that would otherwise (and previously did) sit with central government or other public bodies (such as stand-alone police authorities or transport authorities), and which continue to sit with such bodies in areas without strategic authorities. Some funding and associated spending is clearly additional: it would not have been there if the MSA did not exist. This includes the ‘investment pot’ grants and the council tax raised by strategic authorities for their non-police non-fire functions. But it is impossible to know exactly how much of the funding provided to strategic authorities is additional, because we do not know what would now be being spent on transport and economic development projects, for example, in the strategic authority areas if the authorities had not been created.

Variation in funding between strategic authorities

Figure 9.2 shows estimated funding per person by these different sources, for the 18 strategic authorities for which budget data are available. It shows there is significant variation in both overall funding and the contribution of different funding sources across strategic authorities – mostly reflecting their different responsibilities, but also the evolving grant funding allocation processes (from the initial ‘devolution deals’ to recent more formula-based approaches). Sources of resource funding are shown in green and capital funding in blue.

Overall, funding per person is by far the highest for the Greater London Authority (£1,580 per person), reflecting its costly policing and transport responsibilities. Its resource grant (£424 per person) and capital grant (£408 per person) funding together account for 53% of its overall funding, with council tax revenues (£183 per person) and business rates revenues (£369 per person) accounting for 35%. The Greater Manchester Combined Authority has the second-highest level of funding per person (£1,113) – again driven partly by its policing responsibilities, as well as by it having the highest level of planned capital borrowing (£187 per resident).

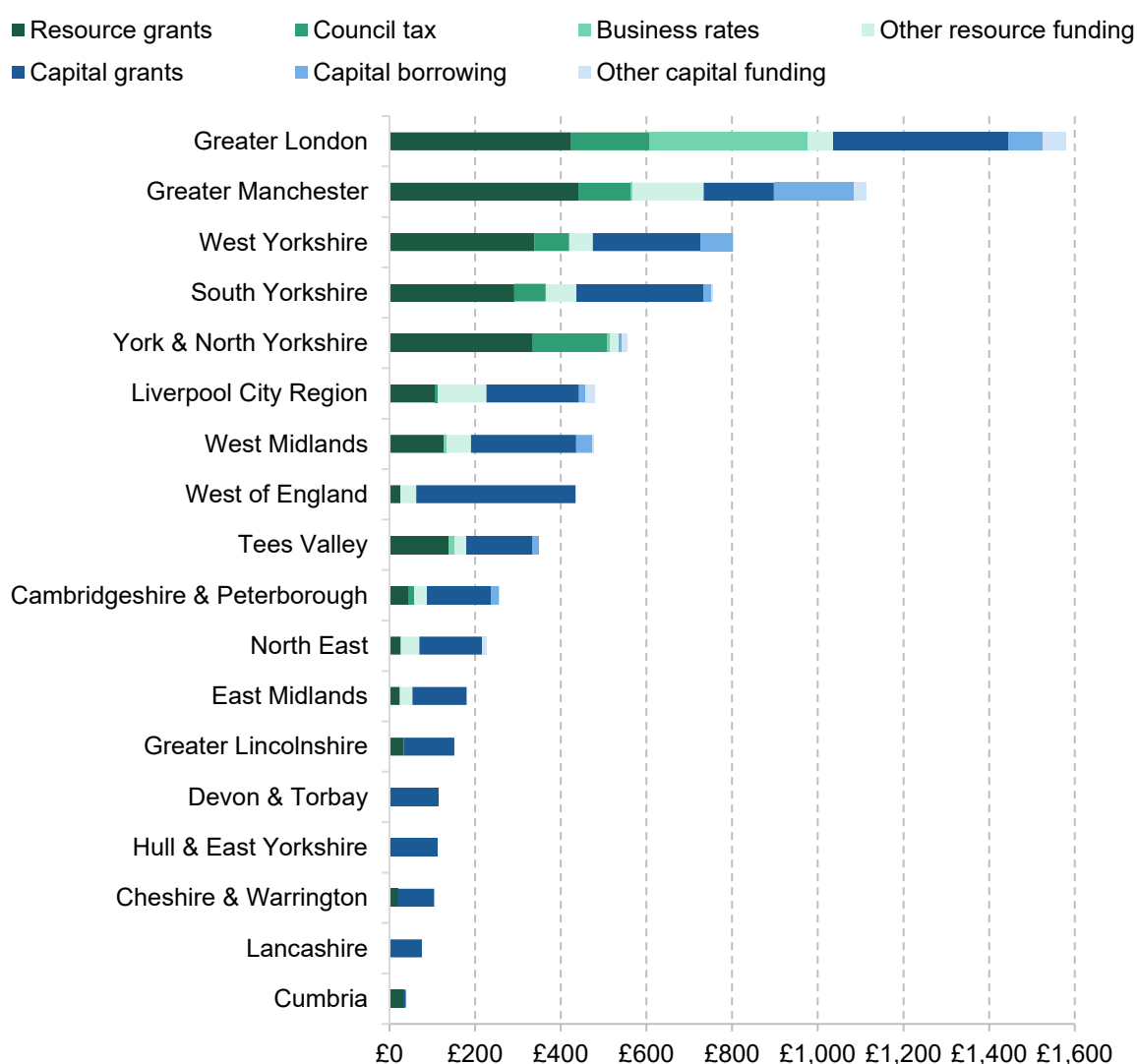
Levels of funding per person are much lower for the other strategic authorities – and particularly the newer ones, where the vast majority of the funding is in the form of grants from central government.

These estimates of overall funding include funding received by seven E-MSAs through their integrated settlements. As we discuss in Section 9.5, this subset of grant funding may be the

¹⁰ The prudential regime allows MSAs and local authorities to set borrowing limits based on assessments of the sustainability and affordability of associated debt interest and repayment costs. It is important to note that the government also sets caps on accrued MSA (but not local authority) debt.

most appropriate to form the core of the new revenue assignment system. Table 9.2 looks specifically at the integrated settlement components of grant funding for recipient authorities for both this year and 2028–29 (the year that income tax assignment is due to start). Differences again reflect differences in the grants and associated responsibilities that have been rolled into the integrated settlements for the different authorities, as well as differences in the amounts received per person under the various agreements and formulas used to allocate funding across places.

Figure 9.2. Estimated strategic authority funding per person, by source, 2026–27



Note: Per-person estimates assume the population of each area grows in line with the projected average across England between mid 2025 and mid 2026. Excludes Hampshire & the Solent and Sussex & Brighton, for which budget data were not available. Excludes income from fees and charges for the non-commercial services that MSAs provide. See Appendix 9A for the specific budget lines included.

Source: Authors' calculations using Revenue account (RA) and Specific and special revenue grants (SG) budget data from Ministry of Housing, Communities and Local Government (2026b and 2026c) and Office for National Statistics (2024 and 2025).

Table 9.2. Integrated settlement funding, 2026–27 and 2028–29 (2026–27 prices)

	2026–27			2028–29	
	Total	Per person	% of total funding	Total	Per person
Liverpool City Region	£352m	£218	46%	£423m	£258
West Midlands	£660m	£217	46%	£716m	£233
Greater Manchester	£641m	£212	19%	£732m	£239
North East	£419m	£204	90%	£529m	£254
South Yorkshire	£279m	£194	26%	£378m	£259
West Yorkshire	£468m	£193	24%	£578m	£235
Greater London	£581m	£64	4%	£545m	£59
All E-MSAs with an integrated settlement	£3,400m	£150	14%	£3,902m	£169

Note: Estimated total funding as shown in Figure 9.2. Real-terms figures in 2028–29 reflect latest OBR forecast for the GDP deflator.

Source: Authors' calculations using Office for National Statistics (2024 and 2025), Ministry of Housing, Communities and Local Government (2025b) and Office for Budget Responsibility (2026a).

Bearing this in mind, the biggest differences are between Greater London and the other MSAs: integrated settlement funding for Greater London this year amounts to £64 per person, compared with between £193 and £218 per person for other E-MSAs with an integrated settlement. This is despite Greater London's much higher levels of overall grant funding, and reflects the composition of Greater London's grant funding – with large shares ring-fenced for police services, social housing investment and Transport for London – and existing retained business rates revenues.

Across all seven of these E-MSAs, the integrated settlements amount to £3.4 billion, or £150 per person. On average, this makes up 14% of their overall budgeted funding – although this varies dramatically across E-MSAs, from 4% in Greater London to 90% in the North East.

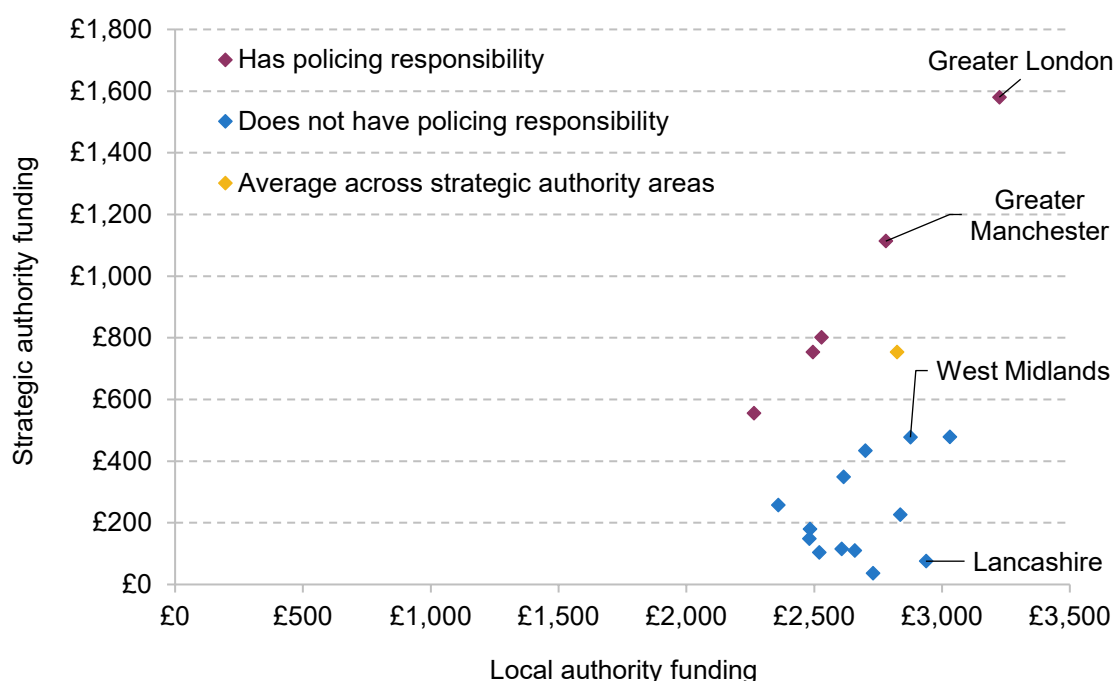
Total integrated settlement funding for these E-MSAs is set to increase by £0.5 billion (14%) in real terms over the next two years to £3.9 billion, which is equivalent to £169 per person (an additional £20) in today's prices. But trends also differ over time: funding is set to fall by 7% in real terms for Greater London, but increase by 34% in real terms for South Yorkshire, reflecting big increases in the amount earmarked for capital spending on transport schemes in the latter.

Comparison with local authority funding

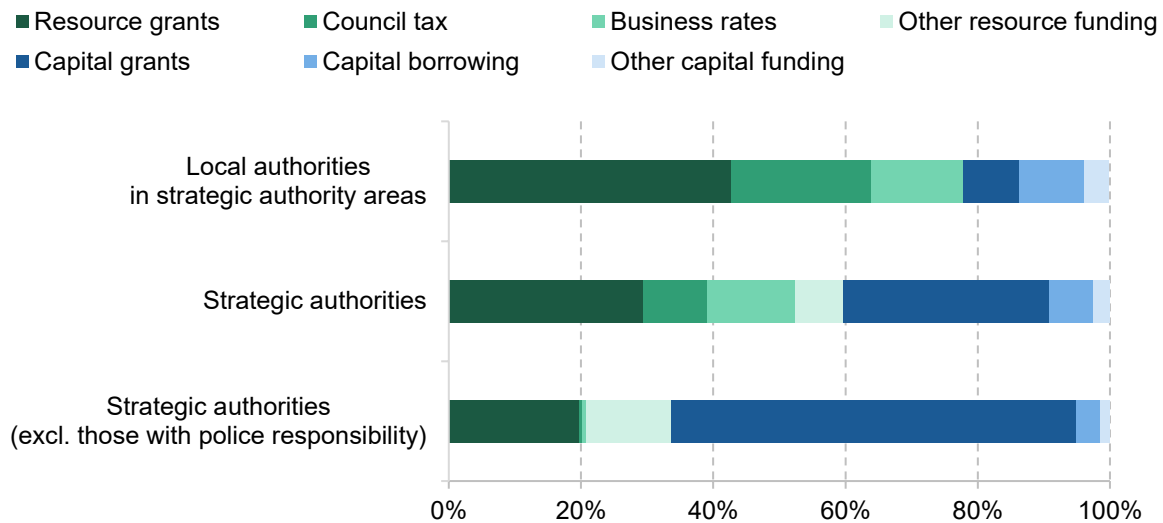
Local authority funding is substantially higher than strategic authority funding, and differs in its composition. Calculated on the same basis as for strategic authorities, English local authorities' funding for resource and capital purposes (again after netting off fees and charges for the services they provide) is forecast to amount to £158 billion, or £2,680 per person across England as a whole this year.

Figure 9.3 compares the amount of funding per person available to strategic authorities this year with the amount available to local authorities in their areas. Even in Greater London, where strategic authority funding is highest, local authority funding is twice as much on average (£3,224 versus £1,580). Overall, local authority funding in all parts of England covered by strategic authorities is just under four times higher than strategic authority funding, on average (£2,824 versus £753). And in most cases, particularly the newer strategic authority areas, the difference is much greater: around sixfold in the West Midlands (£2,876 versus £477); ninefold in Cambridgeshire & Peterborough (£2,360 versus £257); and over twentyfold in Cheshire & Warrington, Cumbria, Devon & Torbay, Hull & East Yorkshire and Lancashire. This pattern reflects the differing and often limited responsibilities of strategic authorities but the common and costly responsibilities of local authorities, including social care services and much of the schools and childcare budget.

Figure 9.3. Estimated strategic and local authority funding per person, by area, 2026–27



Note: Local authority funding estimates are population-weighted averages across local authority areas that were covered by strategic authorities in 2026, and exclude a small number of unitary authorities for which budget data were not available. In addition, see note and source to Figure 9.2.

Figure 9.4. Estimated strategic and local authority funding per person, by source, 2026–27

Note: 'Strategic authorities (excl. those with police responsibility)' excludes Greater London, Greater Manchester, York & North Yorkshire, South Yorkshire and West Yorkshire. Also see note and source to Figure 9.2.

Figure 9.4 compares the sources of funding for local authorities in areas with strategic authorities with the strategic authorities themselves. Several big differences stand out. First is that a much larger share of local authority funding is for resource spending (the green bars): 78%, compared with 60% across all strategic authorities and just 34% across those strategic authorities without police responsibilities. Second is that local authorities raise more of their funding through local taxes – council tax and business rates – than strategic authorities. Council tax and business rates together account for 35% of all funding, compared with 23% across all strategic authorities and 1% for strategic authorities without police responsibilities. All local authorities charge council tax and all receive a proportion of business rates revenues through the BRRS, discussed in Box 9.1.

Compared with local authorities, strategic authorities therefore have more capital-intensive and grant-dependent funding. The former reflects strategic authorities' economy- and investment-related functions, in contrast to local authorities' responsibility for delivering core public services such as social care. The latter reflects the fact that many of the responsibilities of strategic authorities have only relatively recently been devolved to them, so the government has devolved associated funding in the form of grants, rather than devolving or assigning tax revenues.

Box 9.1. The business rates retention scheme (BRRS)

Since April 2013, business rates revenues have been partially assigned to local authorities and some strategic authorities under the business rates retention scheme (BRRS), in lieu of the grant funding they previously received. However, as we illustrate in Section 9.4, business rates revenues vary substantially between local authority areas. Assigning the same share of overall business rates revenues to local and strategic authorities in every part of England would therefore have led to some areas gaining substantial funding and others losing substantial funding compared with the previous grant funding. To address this, the BRRS incorporates a system to redistribute business rates revenues across the country, as follows:

- First, at the point the BRRS was introduced, authorities covering each part of England were initially allocated 50% of business rates revenues in their areas.^a This was their business rates baseline (BRB).
- Second, the amount of grant funding to be forgone and hence the business rates revenue ‘need’ of each authority was calculated. This was their baseline funding level (BFL).
- Third, the difference between each authority’s BRB and BFL was calculated. An authority whose BRB exceeded its BFL (i.e. with high revenues relative to assessed revenue needs) was required to pay a tariff equal to the difference between the BRB and BFL. In turn, these tariffs paid for revenue top-ups for authorities whose BRB was less than their BFL (i.e. with low revenues relative to assessed revenue needs).
- Then, in subsequent years, the tariffs and top-ups were indexed in line with CPI inflation, maintaining their value relative to business rates bills (which, by default, are also increased in line with CPI inflation each year).

This set-up means that local and strategic authorities in each area ultimately retain a different proportion of the overall *stock* of business rates raised in their area: those areas where authorities pay tariffs receive less than 50% of the overall business rates revenues raised in their areas, once tariffs are subtracted; while those areas where authorities receive top-ups ultimately receive the equivalent of over 50% (and possibly over 100%) of the overall business rates revenues raised in their area, once top-ups are added on. But the fact that tariffs and top-ups are indexed in line with inflation means that most parts of England bear up to 50% of the real-terms *change* in local business rates revenues.

It is ‘up to’ 50%, because of two further features of the BRRS designed to limit both downwards and upwards divergences in local authorities’ retained revenues:

- a safety net, which tops up revenues if retained revenues fall below a certain point;
- a levy, which tapers retained growth in areas subject to tariffs from 50% down to a minimum of 25%, depending on how much their BRB exceeds their BFL.

The aim of this system is to provide incentives for local authorities to support the development of commercial and other non-domestic property, while maintaining (in real terms) the redistribution of the initial stock of business rates revenues across the country. We further discuss the rationale for assigning business rates in this way in Section 9.4, and redistribution systems in Sections 9.5 to 9.7.

It is worth noting that local and strategic authorities in some parts of England now operate enhanced business rates retention, with up to 100% of business rates revenues assigned locally, in return for forgoing further grant funding. These include the areas covered by the Greater London, Greater Manchester, Liverpool City Region, West of England and West Midlands strategic authorities.

^a In areas with multiple tiers of local government, district councils were allocated 40%, county councils 9% and fire authorities 1%. This 50% assignment (and 40/9/1 split) remains the standard BRRS.

How do revenues compare with those of subnational governments elsewhere?

England's local authorities and especially its strategic authorities have access to fewer devolved and assigned revenue streams than subnational governments in most other high-income countries, and rely more on grant funding.

When confirming its revenue assignment plans, the UK government highlighted the low share of overall government revenues retained at a subnational level in England (Cabinet Office, 2026). Figure 9.5 illustrates this using OECD estimates of the share of overall tax revenues that are devolved or assigned to subnational governments in the UK and other G7 countries as of 2023.¹¹

Measured on a consistent basis across countries, the OECD classifies just 5% of all government revenues as devolved or assigned to subnational government in the UK – less than half the level of the next-lowest country, Italy (11%). OECD statistics exclude business rates retained under the BRRS from these figures, but even accounting for these revenues, the total assigned or devolved would be less than 7%.¹² And the share of overall tax revenues assigned (less than 2% even accounting for retained business rates) is lower than in Japan (4%), Canada (6%), France (7%) and Germany (26%). OECD statistics also show much higher shares of revenues are

¹¹ The OECD defines the governments of Northern Ireland, Scotland and Wales as part of central government based on international national accounts standards. This means from the perspective of the devolved nations, OECD statistics significantly underestimate the degree of revenue and spending devolution. However, OECD statistics do count both tiers of subnational government in England (local authorities and strategic authorities) within the local government sector, so they are more suitable for assessing the degree of devolution in England – the focus here.

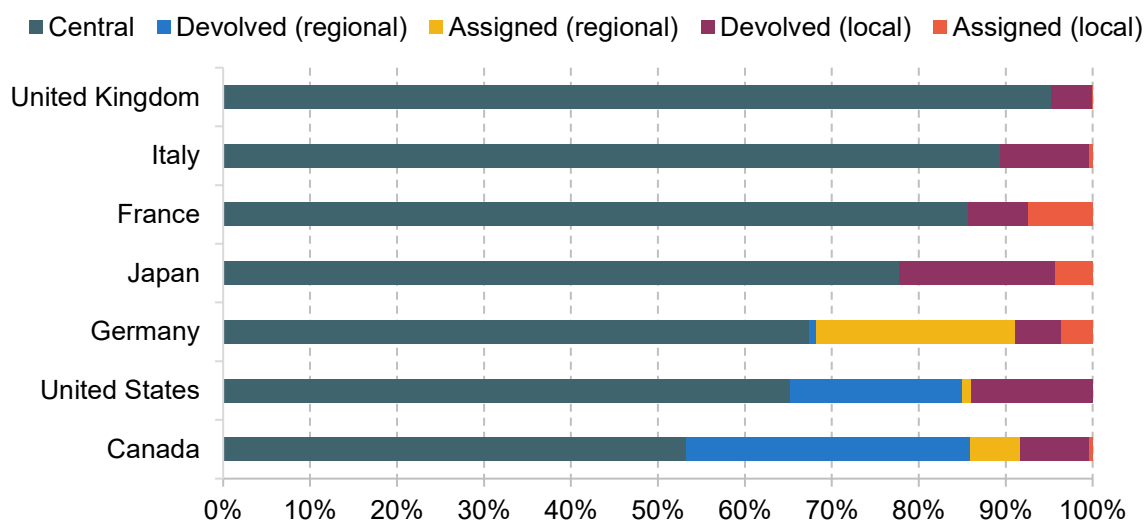
¹² The OECD does not count retained business rates as assigned revenues because the rules of the BRRS are fully determined by the UK government, rather than co-determined with subnational governments as with the assigned revenues in other countries reported in Figure 9.5.

devolved or assigned to local and/or regional governments in much smaller countries than the UK, including Belgium (15%), Denmark (27%), Sweden (36%) and Switzerland (41%).

To some extent, these differences will reflect differences in the extent to which spending responsibilities are devolved to subnational government. However, OECD statistics suggest that local and regional governments in the UK rely much more on grant funding and less on devolved or assigned tax revenues than most other high-income countries, even relative to their spending: based on these statistics, Selby and Breach (2026) estimate that grant funding from central government accounted for 62% of local and regional government spending in the UK, compared with between 20% and 30% in France, Germany, the US and Canada, 45% in Japan and 56% in Italy.

England's subnational tax powers are currently restricted to recurrent property taxes (council tax and, to some extent, business rates). However, as illustrated in Table 9.3, subnational governments in other countries often have devolved powers over or assigned revenues from a much wider range of taxes. This includes income tax, where there are several examples of both locally and regionally assigned and devolved taxes.

Figure 9.5. Share of overall tax revenues that are devolved or assigned to subnational governments, 2023



Note: For the UK, the Scottish, Welsh and Northern Irish governments are defined as central government and English strategic authorities as part of local government. More generally, with the exception of Colombia and Spain (not included in this figure), in non-federal countries, the OECD classifies regional governments either as part of central government or as part of local government, rather than as a separate regional tier.

Source: OECD, 2025.

Table 9.3. Examples of subnational taxation in other countries

	Devolved	Assigned
Income tax	Flat taxes levied in Denmark (local), Finland (local), Sweden (regional and local) Progressive taxes levied in Canada (regional), Spain (regional), United States (regional and local)	Germany (regional and local), Poland (regional and local)
Corporation tax	Canada (regional), Italy (regional), Germany (local), Portugal (local), United States (regional)	Denmark (local), Finland (local), Germany (regional), Poland (regional and local)
VAT / sales tax	Canada (regional), United States (regional and local)	Italy (regional), Spain (regional)
Tourism tax	France (local), Germany (local), Italy (local), Netherlands (local), Spain (regional), United States (local)	
Inheritance tax	Poland (local), Spain (regional)	Germany (regional)
Vehicle taxes	Belgium (regional), Spain (regional)	

Note: This table provides examples of where different taxes are devolved or assigned to subnational government but it is not exhaustive in its coverage. Not all US states charge income tax, and not all of those that do charge it progressively. Taxes are defined as assigned only where the assigned revenues are based, at least in part, on estimates of revenues raised in particular local or regional authority areas. This excludes examples where subnational governments receive a share of national revenues based on a needs (rather than revenue-based) formula.

Source: European Commission, 2012; Nicol, 2014; Convention of Scottish Local Authorities, 2018; PWC, 2019.

9.3 The case for tax revenue assignment

The rationales for and potential risks of revenue assignment

The fact that other countries make greater use of revenue assignment does not in itself provide a rationale for assigning tax revenues to English mayoral strategic authorities. However, the academic and policy literature has identified several potential rationales for and risks of tax revenue assignment (Martínez-Vázquez, 2008; Boadway and Shah, 2009; Boadway and Eyraud, 2018).

A first rationale is that, by linking funding more closely to the performance of local tax revenues, revenue assignment could provide MSAs – and their residents – with stronger financial incentives to facilitate local economic growth, and hence growth in tax revenues. This will require MSAs to gain or lose at the margin from changes in revenues raised locally, rather than just being assigned a fixed share of national revenues, which would be much less responsive to local economic performance. Stronger financial incentives for MSAs would, of course, mean somewhat weaker financial incentives for central government to grow tax bases – if MSAs in future bear part of the marginal change in revenues, central government will conversely bear less.¹³ But as it stands, while some of the costs and policy levers to help deliver growth are the responsibility of MSAs, marginal changes in revenues and hence financial incentives lie almost entirely with central government. Revenue assignment could address this imbalance, better aligning costs, powers and incentives.

Second, if MSAs' revenues increase if their policies and/or investments boost growth, this could help finance mayoral investments. In particular, mayors could borrow against the expected future growth in revenues as a result of an investment to help pay for its up-front cost and then use the resulting revenues to repay the borrowing: so-called tax-increment financing. This is most feasible for investments where the impact on subsequent revenues is forecastable with a high degree of accuracy.

Third, as discussed above, MSAs currently rely overwhelmingly on grant funding, with the amount they can expect to receive mostly confirmed for just a few years in advance at best. Thus, while tax revenues are subject to uncertainty and volatility, assigning them to MSAs – if this is itself credibly permanent – may provide greater long-term clarity about funding availability, enabling longer-term spending and investment decisions even if revenues do not perform particularly strongly. Note that assigning a fixed share of national revenues, rather than a share of local revenues, would likely provide greater long-term clarity over funding: national revenues are subject to less uncertainty and volatility than local revenues. This illustrates how the appropriate design of a revenue assignment systems depends on one's view of the relative importance of the different ways in which it could facilitate growth-enhancing policies and investment.

Revenue assignment also brings risks both for individual MSAs and for the country more generally.

¹³ Stronger financial incentives for spending on investments and services that generate additional tax revenues also reduce the relative attractiveness of investments that do not generate such revenues but which may have social benefits.

First, while efforts by MSAs to grow tax bases – including by competing for activity with other parts of the country – will often be beneficial for the country as a whole, that may not always be the case. If they compete for the same types of activity (particularly large-scale, mobile investments), MSAs may overinvest in certain types of infrastructure or skills, or bid up subsidies and other support to investors, relative to a nationally coordinated system (Slattery and Zidar, 2020).

Second, as we show in Section 9.4, there are large differences in the amounts raised per person from most taxes – including income tax and business rates – between different parts of the country. These may be very different from the government’s assessments of local spending needs. Simply assigning the same share of revenues to each MSA would therefore risk exacerbating regional inequalities by increasing funding for already-affluent areas relative to disadvantaged areas.

Third, in addition to potentially being influenceable by MSAs’ policy and investments, tax bases and hence assigned revenues will be affected by many factors outside of strategic authorities’ control – including national and international economic cycles and trends, and policy decisions by the UK and other governments. As well as providing incentives, revenue assignment also transfers potentially significant financial risk to MSAs. Relatedly, tax bases can be subject to both short-term volatility and long-term divergences – both of which are subject to significant uncertainty.

Fourth, the spending needs of MSAs are also likely to change over time, and these changes may differ from the changes in their assigned revenues. There may be negative correlation between some types of spending needs and assigned revenues – for example, for services that are used predominantly by unemployed or low-income people, such as employment support programmes. And as discussed above, over half of the integrated settlements – the grants which seem most likely to be replaced with assigned revenues – are for capital spending, the need for which may vary more significantly over time than the need for resource spending. In part this is because capital spending is lumpy – once a tram system has been built, for example, the ongoing capital spending to maintain it is much lower. But it also reflects the fact that capital spending needs are often driven by *changes in* local circumstances – such as changes in demographics and economic structure – rather than existing local circumstances. If MSAs’ existing integrated settlements partly reflect temporary variations in their capital spending needs, anchoring long-term assigned revenues on them may lead to future mismatches between funding and spending needs even if each MSA’s assigned revenues were to grow at similar rates.

Fifth, and related to this, as well as mismatches between funding and spending needs across MSAs, revenue assignment could lead to mismatches between funding and spending needs for specific *services* and types of investments. This is because it bears some relationship to tax

hypothecation: assigning a portion of national tax revenues to MSAs means those revenues have to be spent on the function of those MSAs rather than on other functions. This would be of most concern if MSAs had very narrow responsibilities – such as the transport and police authorities some have subsumed. As discussed in Section 9.2, MSAs can spend money on a wide range of economy- and well-being-related functions, and can provide grants to local authorities – which in turn have a wide set of responsibilities for local services – reducing this risk in practice. Government should still be mindful of this when deciding how much revenue to assign to MSAs overall.

As already mentioned, and will be discussed in Sections 9.5 and 9.6, the precise revenues that are assigned and systems of equalisation and insurance can help address revenue inequalities and risks, as well as changes in spending needs – albeit by reducing the potential rewards from good revenue performance, and hence the incentivisation effects of revenue assignment. The balance between incentivisation on the one hand, and redistribution and insurance on the other, is therefore one of the key trade-offs in the design of a revenue assignment system.

How do these rationales and risks compare with tax devolution?

It is important to note that the rationales and risks for assignment differ somewhat from those associated with tax devolution – where MSAs would have powers to directly vary the tax rates or bases of certain taxes, like they already do to some extent with council tax and business rates.

The most obvious difference is that unlike tax devolution, revenue assignment will not enable MSAs to directly increase or decrease their funding, or change the taxes paid by their resident households or businesses.¹⁴ Thus, given that the government intends that revenue assignment will be revenue-neutral at the outset (with assigned revenues replacing equivalent grant funding), it does not provide a new, immediate source of funding for mayoral spending. The lack of revenue-varying powers also removes one of the self-insurance mechanisms that tax devolution includes for areas facing significant revenue shortfalls (or indeed increases): the ability to offset this through higher (lower) tax rates.

The lack of revenue-varying powers has two further important implications:

¹⁴ Some mayors have criticised the plans for not allowing them to cut taxes or rebate taxes to local taxpayers. Note, however, that while MSAs will not have the power to reduce tax rates, they do potentially have the power to make cash payments to taxpayers under their 'general power of competence'. They would need to demonstrate that the payments did not contravene other legislation or regulations (including state aid rules and any funding ring fences) and were related to their statutory functions and areas of competence (such as economic development, health and well-being, and skills and employment support). This may prevent rebates for households that are exactly based on the amount of assigned taxes they pay, but would allow targeted payments to households that would, in effect, partially offset their assigned tax payments.

- First, it poses fewer concerns about potentially damaging competition between areas. In particular, MSAs will not be able to reduce tax rates on all or a subset of income tax payers to compete for the underlying tax base. It also avoids the less commonly appreciated upwards pressure to tax rates that can also accompany tax devolution.¹⁵
- Second, the administration and compliance costs associated with revenue assignment can be lower than for tax devolution. Devolution would require identifying the exact taxpayers and tax base for each MSA so that any local changes in tax policy can be applied to the correct taxpayers and their liabilities calculated accurately. However, while such accuracy is preferable for revenue assignment too, assignment could be implemented just using proxies for the underlying tax base (including sample-based estimates), provided the proxies are sufficiently strongly linked to the types of activities revenue assignment is designed to encourage (e.g. policies and investments that are conducive to growth).

Thus, while revenue assignment will not provide MSAs with the direct revenue-varying lever that tax devolution would, it also poses fewer issues for tax policy and administration. And, as discussed above, like tax devolution, it can still provide stronger incentives for tax base growth and longer-term clarity over funding than a series of short-term grants. It is therefore a meaningful reform to funding arrangements for MSAs, and a legitimate choice for a government balancing the different opportunities and risks associated with different degrees of fiscal devolution.

What is the evidence on the effects of revenue assignment on economic performance and other outcomes?

Empirical evidence on the effects of revenue assignment is limited, in part because it is difficult to isolate its effects from those of wider fiscal devolution and differences in local institutions. The available evidence is suggestive of positive impacts on economic growth, but is far from definitive.

The most direct evidence on revenue assignment comes from China, where research finds that greater retention of increases in tax revenues is associated with more infrastructure investment

¹⁵ The potential for damaging tax competition comes from so-called *horizontal* fiscal externalities between subnational jurisdictions: when cutting tax rates in an effort to attract taxpayers to migrate to its area and boost its tax base, an MSA would not account for any reductions in the tax bases of other MSAs. This mechanism leads to tax rates being set lower than if they were set nationally. However, tax devolution also entails *vertical* fiscal externalities between the central and subnational governments. In particular, when setting their tax rates, while MSAs would account for the effect of any tax-induced changes in the size of tax bases on their own revenues, they would not account for the impacts on the central government's revenue. While internal migration effects would net out for the central government, international migration effects and other changes in behaviour (such as labour supply, some forms of tax avoidance, and tax evasion) would not. Thus, MSAs could set tax rates higher than if they were set nationally, because they do not account for the full impact of any reduction in the size of tax bases when making their tax rate decisions. Whether tax devolution leads to lower or higher taxes than under a centralised system depends on the importance of internal and international migration and other forms of behavioural responses to overall tax-induced changes in tax bases.

and faster economic growth (Jin, Qian and Weingast, 2005; Han and Kung, 2015; Chen, Lyu and Ma, 2024). Evidence from Europe points in a similar direction. Studies of reforms in Germany find that allowing municipalities to retain more of the revenues generated by increases in their tax bases leads them to allocate more spending to infrastructure and other growth-related activities (Hauptmeier, 2007 and 2009; Egger, Köthenbürger and Smart, 2010).

The broader literature on fiscal devolution also provides some suggestive evidence of positive economic effects. But results vary substantially across studies and countries, making causal interpretation difficult. Importantly, impacts appear to depend on institutional capacity and governance quality (Rodríguez-Pose and Ezcurra, 2010; Dougherty and Akgun, 2018; Jong et al., 2021). The main lesson for England is therefore that revenue assignment may support growth, but its effects are uncertain and likely to depend heavily on system design and the capacity of the MSAs receiving it. This includes having sufficiently well-resourced finance and strategy teams, as well as suitable arrangements for political decision-making and scrutiny, to ensure risks and opportunities are identified and responded to.

9.4 Are business rates and income tax suitable for assignment?

What we know about the government's plans

As discussed in Section 9.1, the government's plan to assign a share of tax revenues to MSAs was first announced in a speech by then Chancellor Rachel Reeves in March. Reeves said that the plans would see 'the proceeds of growth benefiting the places that generated that growth', but would require 'managing volatile receipts' and would be 'fiscally neutral' (HM Treasury, 2026a). They would be developed in conjunction with stakeholders, and set out in detail in a fiscal devolution 'roadmap' alongside this autumn's Budget.

The principles for reform were fleshed out in the Starmer administration's Northern Growth Strategy published several days later (HM Treasury, 2026b). These principles were:

- **Empowerment.** Mayors should benefit from the proceeds of growth, and have both the certainty and flexibility over funding to undertake long-term investments.
- **Accountability.** Transparent outcomes and a robust assurance process would need to be agreed, so that mayors could be held to account for results.
- **Sustainability.** Reforms would need to balance rewards for growth with protections for both risks of volatility and poor revenue performance. Reforms would also be designed in a way so as to avoid adding pressure to national public finance challenges.

- **Fairness.** Confirming that this was a plan for revenue assignment rather than higher or new taxes, and that a system of equalisation would be built in, if necessary, to redistribute from high-revenue to low-revenue areas.

These principles reflect several of the rationales and risks of tax assignment that were discussed above. For example, the ‘empowerment’ principle relates to both the financial incentivisation (‘proceeds of growth’) and certainty of funding rationales. And the ‘fairness’ and ‘sustainability’ principles relate to managing risks associated with differences in revenues between MSAs, and year-to-year volatility in revenues. So far, the government has not indicated how it will make the necessary trade-offs between its principles (and so between incentivisation, equalisation and insurance) when designing its revenue assignment system.

The Burnham administration confirmed it would go ahead with revenue assignment on 31 July 2026 (Prime Minister’s Office, 2026). In doing so, it also confirmed the taxes that would be assigned to MSAs. Starting in April 2027, MSAs as well as local authorities will receive a bigger share of the business rates revenues raised in their areas as part of the business rates retention scheme. Then, from April 2028, MSAs will start receiving a share of the income tax revenues raised in their areas. Again, the government emphasised that the plans were aimed at rewarding growth and enabling investment:

This means when places create jobs and grow their economies, they will now keep more of the rewards – giving local leaders new powers to invest in what matters most locally.

Prime Minister’s Office, 2026

Turning this high-level plan into implementable policy will require not only trade-offs between the government’s different principles, but also answers to a number of specific policy design questions, which we discuss in Sections 9.5 and 9.6. First though, are business rates and income tax suitable taxes for revenue assignment, in principle?

How should we assess whether particular taxes are suitable for assignment?

To answer whether business rates and income tax are suitable for revenue assignment, it is first worth highlighting a set of criteria that can be used to assess the suitability of a tax for assignment. Based in part on the rationales for and risks of tax revenue assignment in general, these are:

- **Incentivisation and influenceability.** The size of the assigned tax base should be positively linked to stronger economic performance and/or other desirable outcomes that revenue assignment is aimed at providing financial incentives for. In addition, MSAs should be able to influence the size of the tax base in ways that improve targeted outcomes – otherwise assignment is just a source of financial risk rather than actionable incentives. The time it takes for mayoral decisions to influence tax bases is also relevant, as political considerations mean that impacts on tax bases that take many years to develop may have less influence on MSA behaviour than impacts that are felt during an electoral cycle.
- **Risk, volatility and uncertainty.** Tax bases that are subject to significant changes that are outside of the control of MSAs – due, for example, to economic cycles or structural economic changes – mean assignment entails greater financial risk. This is particularly true if the impact of such factors is uncertain and highly volatile from year to year, which could make it harder for MSAs to plan their spending and investment, and require the holding of bigger reserves to ensure financial resilience.
- **Inequality and divergence.** Assigning tax bases that are highly unequally distributed would, all else equal, lead to lower funding for economically disadvantaged areas than for successful areas, potentially exacerbating (rather than reducing) geographical economic inequalities. As discussed in Section 9.5, while initial differences in the size of tax bases can be equalised without affecting incentives to grow tax bases subsequently, further divergence cannot be fully offset without destroying these financial incentives. Given that the potential for future divergence is likely greater when tax bases already significantly differ between places, this means that tax bases that are highly unequal and/or expected to diverge over time are generally less suitable for assignment.
- **Buoyancy.** Given that the aim is for the assigned revenue to be a long-term replacement for grant funding, if possible the revenues should keep pace with changes in the spending needs of MSAs over time. Taxes where revenues automatically grow as prices and economic activity increase – so-called ‘buoyant’ taxes – are more likely to satisfy this than taxes where tax rates need to be frequently manually adjusted to keep pace with inflation and economic growth. However, certain spending needs – such as those related to deprivation and unemployment – may be expected to increase when the local economy *shrinks*, so buoyancy is no guarantee that revenues will keep pace with spending needs.
- **Administrative feasibility.** While revenue assignment does not necessarily require identifying the specific taxpayers and tax liabilities for each MSA (it would be possible to use proxies instead), different taxes still entail different administration costs and issues. In particular, if taxes are already collected locally, or taxpayers can be assigned to a specific geographic location, it is generally easier to administer an assignment scheme than for taxes collected nationally from taxpayers operating across multiple geographic areas.

Concerns about political accountability where a tax is paid by non-residents (and non-voters) are less acute for assigned taxes, given the lack of tax-varying powers, than for devolved taxes.

However, voters are likely to be more concerned to ensure the revenue generated by assigned taxes is used effectively where these taxes have been paid predominantly by local voters.

There are both synergies and trade-offs between these criteria. For example, a tax that is buoyant is also more likely to provide financial incentives to support growth than a tax that needs to be manually increased to keep pace with increases in prices and economic activity over time. However, such a tax is also likely to be subject to greater uncertainty, volatility and divergence over time as economic performance varies for reasons outside MSAs' control.

Which criteria to prioritise should depend on the main channel through which the UK government expects assignment to change MSA behaviour and improve outcomes. If it is through financial incentivisation, then greater weight should be placed on the incentives created by assigning different taxes. On the other hand, if it is through the provision of a longer-term funding stream than existing grants, then greater emphasis should be placed on the risk, uncertainty and volatility associated with different taxes – as risky, uncertain, volatile revenue streams are less likely to support long-term decision-making. The government should also consider its longer-term plan for devolution: if revenue assignment is a stepping stone to fiscal devolution, it should also consider suitability for devolution when choosing the taxes to initially assign.¹⁶

How suitable are business rates for assignment?

Business rates score highly on two of these criteria:

- **Administrative feasibility.** Business rates are collected by local authorities (and so can easily be summed at the MSA level) and, as discussed earlier, some MSAs already receive a share of business rates under the BRRS. Administratively, it should therefore be straightforward to assign a (bigger) share to all rather than some MSAs. One issue that will need to be addressed is what to do in areas where the combination of local authorities, fire authorities and MSAs already retains 100% of business rates revenues (see the last two columns of Table 9.4 later). Increasing the share of business rates revenues assigned to MSAs in these areas would require reductions in the share assigned to local authorities. Local authorities could be compensated for the initial impact of this change through higher grant funding, paid for by the reductions in MSAs' grant funding when they start receiving a higher share of business rates instead. But local authorities would no longer benefit from (or lose from) any subsequent real-terms changes in that reassigned share of business rates – which would instead flow to MSAs.

¹⁶ Amin-Smith, Harris and Phillips (2019) and the Fiscal Commission for Northern Ireland (2022) provide criteria and an assessment of the suitability of different taxes for devolution (rather than assignment).

- **Incentivisation and influenceability.** The business rates tax base – the value of non-domestic property in an area – is both linked to economic activity and potentially influenceable by MSAs through their powers over strategic planning, economic development and transport. For example, new or improved commercial or industrial space could support economic growth, and be facilitated by mayoral investments in land remediation and transport – and by wider efforts to make an area attractive for business and investment, including adult skills and business support programmes. Currently, authorities receiving a share of business rates revenues under the BRRS gain (and lose) as a result of changes in the *quantity* of non-domestic property – for example, through construction, renovation and demolition – but not changes in the estimated value of properties when they are revalued every three years.¹⁷ In its current guise, therefore, the BRRS incentivises local and strategic authorities to support the development and physical improvement of non-domestic properties rather than activities to increase the value of existing properties.

On the other criteria, business rates revenues are not particularly **buoyant**: tax rates (the ‘multiplier’) need to be manually increased and legislation caps increases at the rate of inflation. This is true even when properties are revalued every three years: individual properties see their bill increase or decrease in real terms if their rateable values increased or fell relative to the average since the previous revaluation, but the tax rate is adjusted so that the change in the average business rates bill is still linked to inflation. And political pressure has led the government to increase the tax rates by less than inflation in several recent years.

Business rates revenues are also **highly unequally** distributed around the country. This is illustrated in the first two columns of Table 9.4, which shows forecast business rates revenues in 2026–27 for the different English MSAs.¹⁸ It shows that forecast revenues per person in Greater London (£1,214) are just over three times higher than in the North East MSA (£400), reflecting both the concentration of commercial office space, and higher property values and rents in the capital. Outside London, revenues per person are around 1.5 times higher in Cambridgeshire & Peterborough (£669) than in most of the Northern and Midlands MSAs. Allowing all MSAs to retain the same share of business rates revenues would, all else equal, therefore lead to significant differences in their funding. But as we discussed in Box 9.1 in Section 9.2, the current BRRS includes a system of ‘tariffs’ and ‘top-ups’ to redistribute revenues across England based on assessments of local and strategic authorities’ spending needs and initial revenues when the BRRS was first set up. It would be natural to extend this to any additional

¹⁷ The effect of changes in revenues as a result of revaluation is stripped out by updating the BRRS’s tariffs and top-ups to avoid large overnight changes in local and strategic authorities’ funding at the point of revaluation.

¹⁸ The revenue figures include funding from the government via so-called section 31 grants to compensate local and strategic authorities for the cost of mandatory reductions in tax bills (called ‘reliefs’).

assigned business rates for MSAs, although assessing their spending needs may not be straightforward.

Table 9.4. Forecast business rates revenues per person by mayoral strategic authority, 2026–27

	Total revenue	Total revenue per person	Currently assigned share	
			Overall	MSA
Greater London	£11,098m	£1,214	67%	37%
Cambridgeshire & Peterborough	£631m	£669	50%	0%
West of England	£573m	£569	100%	5%
Cheshire & Warrington	£552m	£543	50%	0%
Sussex & Brighton	£935m	£528	50%	0%
Cumbria	£271m	£527	50%	0%
Greater Manchester	£1,575m	£521	100%	1%
Hampshire & the Solent	£1,062m	£514	50%	0%
York & North Yorkshire	£426m	£502	50%	1%
West Yorkshire	£1,132m	£466	50%	0%
West Midlands	£1,400m	£461	100%	0%
Liverpool City Region	£714m	£443	100%	0%
Greater Lincolnshire	£481m	£427	50%	0%
Hull & East Yorkshire	£270m	£425	50%	0%
South Yorkshire	£607m	£423	50%	0%
East Midlands	£944m	£411	50%	0%
Tees Valley	£292m	£409	50%	0%
North East	£822m	£400	50%	0%
Total across MSAs	£23,786m	£667		
England	£35,796m	£607		

Note: Total forecast non-domestic rating income collected in 2026–27 by billing authorities in areas covered by mayoral strategic authorities (E-MSAs and MSAs) as of July 2026. The foundation strategic authorities (Devon & Torbay and Lancashire) are excluded.

Source: Authors' calculations using Office for National Statistics (2024 and 2025) and Ministry of Housing, Communities and Local Government (2026d).

Business rates revenues are also potentially **risky and volatile** at a local level due to reliance on a relatively small number of high-value properties for a large share of overall revenues. For example, a third of overall estimated rateable value of non-domestic property in England is accounted for by the 1% of properties with an estimated rateable value of more than £500,000. If several of the most valuable properties in an area – such as major shopping centres – were demolished, this could lead to a meaningful reduction in the revenues assigned to some MSAs. However, the BRRS's 'safety net' system, also discussed in Box 9.1, caps declines in revenues, ameliorating this concern somewhat.

The design of the BRRS also protects local authorities from another risk: the risk that UK government business rates policy directly reduces their retained business rates revenues. In particular, the government compensates local authorities for revenue-reducing policies through so-called section 31 grants, where the amount of grant received equals estimates of the lost revenues. Again it would be natural to extend both the 'safety net' and compensatory section 31 grants to MSAs' (higher) assigned share of business rates.

How suitable is income tax for assignment?

Assigning income tax also looks administratively feasible, and would provide a different (arguably complementary) set of financial incentives to MSAs from business rates assignment. Income tax is a more **buoyant** tax than business rates, but it is also subject to significant geographical inequalities, and risk and uncertainty over time.

- **Administrative feasibility.** As income tax is collected nationally, a system would need to be set up to calculate each MSA's assigned revenues. This would be easiest if assignment was on the basis of taxpayers' primary residence: this is how income tax is already partially devolved to Scotland and Wales, and extending this approach would be easier than trying to assign revenues on the basis of where people work. First, whereas income tax records generally include taxpayers' primary residential address, they do not include the address of their place of work, only their employer (which might operate from multiple sites). Second, whereas everyone has a primary residence, not everyone has a fixed place of work – for example, self-employed tradespeople and non-workers such as pensioners. In fact, HMRC already estimates income tax revenues on a residence basis for each local authority based on a sample of tax records, which could be summed at MSA level. Sample-based estimates are subject to statistical margins of error, which could increase the volatility and uncertainty of assigned revenues, but may be easier to implement quickly than a system requiring the primary residence of *all* taxpayers to be identified and verified.
- **Incentivisation and influenceability.** The income tax base is also linked to economic performance. Residence-based income tax assignment would provide MSAs with a financial incentive to increase the taxable income of people with primary residences in their area. This

Table 9.5. Estimated income tax revenue per person by mayoral strategic authority, 2023–24 (2026–27 prices)

	Estimated income tax revenue per person
Greater London	£8,587
Cambridgeshire & Peterborough	£5,098
Cheshire & Warrington	£4,873
Sussex & Brighton	£4,604
Hampshire & the Solent	£4,434
York & North Yorkshire	£4,121
West of England	£4,101
Cumbria	£3,125
East Midlands	£3,024
Greater Manchester	£2,919
Greater Lincolnshire	£2,789
West Yorkshire	£2,754
Hull & East Yorkshire	£2,657
Liverpool City Region	£2,642
North East	£2,599
South Yorkshire	£2,445
West Midlands	£2,401
Tees Valley	£2,389
Average across MSAs	£4,611
Average across England	£4,576

Note: The foundation strategic authorities (Devon & Torbay and Lancashire) are excluded.

Source: Authors' calculations using Office for National Statistics (2025), HM Revenue and Customs (2026) and Office for Budget Responsibility (2026a).

could encourage a greater focus on policies, services and investments that might attract higher-income residents to live in an area, and that might improve the skills, employment and progression prospects of existing residents – including in jobs involving remote working or commuting to neighbouring areas. Residence-based income tax assignment could therefore provide a useful complement to greater business rates assignment which will provide financial incentives to support the construction and improvement of non-domestic

property in an area.¹⁹ The link between MSAs' behaviour and increases in residents' incomes may be less direct than for property construction and redevelopment, but increases in incomes are more closely linked to improvements in local living standards – one of the key 'end goals' of economic growth.

However, as with business rates, income tax revenues per person are **highly unequally distributed** across MSAs, as shown in Table 9.5.

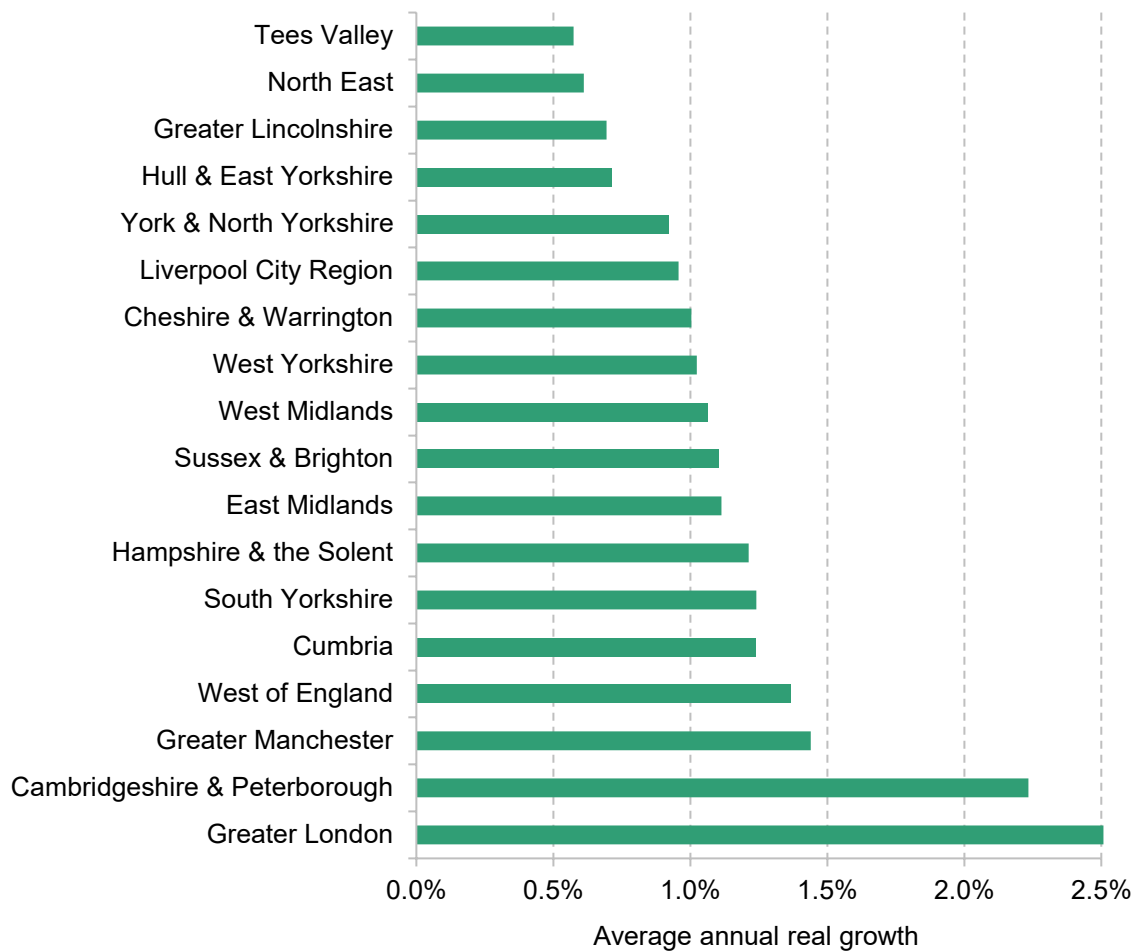
The combination of higher income levels and the UK's progressive income tax schedule, with higher rates of tax applied to higher incomes, means that in 2023–24 (the latest year for which estimates are available), estimated revenues per person were approximately 3.6 times higher in Greater London (£8,587) and over two times higher in Cambridgeshire & Peterborough (£5,098) than in the West Midlands (£2,401) and the Tees Valley (£2,389). As with business rates, assigning the same share of income tax revenues to all MSAs would, all else equal, lead to big differences in the funding they would receive.

Figure 9.6 shows that over the period between 2011–12 and 2023–24, there was also significant divergence in revenue *growth* between MSAs, with estimated revenues per person growing by an average of 2.5% per year in real terms in Greater London and 2.2% in Cambridgeshire & Peterborough, compared with 0.6% in the North East and the Tees Valley. Such annual differences rapidly accumulate: over the 12-year period analysed, estimated revenues per person increased by 35% in real terms in Greater London, compared with 7% in real terms in the Tees Valley.

Part of these historical differences in revenue growth rates may reflect differences in the growth of underlying taxable incomes by MSA: for example, Greater London's employment rate for all adults increased from around 1 percentage point above the all-England average in 2011–12 to around 5 percentage points above by 2023–24 (Office for National Statistics, 2026), although it is worth noting that average pay among those in employment grew less quickly in the capital. But likely more important is the effect of UK government income tax policy. In particular, the 2010s saw substantial above-inflation increases in the tax-free personal allowance – in today's prices from around £11,300 in 2011–12 to around £16,400 by 2019–20 – but a real-terms reduction in the higher- and top-rate tax thresholds. These policy changes acted to reduce income tax revenues in areas where average taxable incomes are relatively low (such as Northern and Midlands MSAs) but increase them in areas where average taxable incomes are relatively high (such as Greater London and Cambridgeshire & Peterborough).

¹⁹ Workplace-based income tax revenue assignment would incentivise MSAs to boost the taxable income of people working in their areas – including in-commuters. This is more similar to the incentives provided by business rates assignment, leading to a narrower overall set of financial incentives than with residence-based income tax assignment.

Figure 9.6. Growth in real-terms income tax revenue per person by mayoral strategic authority, 2011–12 to 2023–24



Source: Authors' calculations using Office for National Statistics (2025), HM Revenue and Customs (2026) and Office for Budget Responsibility (2026a).

This is therefore a stark illustration that revenue assignment could potentially expose MSAs to significant risk and uncertainty related to central government tax policy changes – and that impacts for a given policy change could differ significantly between MSAs, potentially exacerbating inequalities in revenues.

More generally, income tax revenues are subject to **uncertainty, risk and volatility** – potentially exacerbated if assignment were on the basis of existing sample-based estimates of MSA-level revenues (which is subject to sampling variation). At a national level, during the 2010s, revenues in a given year were typically 2–5% different from forecasts made the prior autumn – although this increased to around 10% in the early 2020s as a stronger-than-expected recovery from the COVID-19 pandemic and then inflation pushed up revenues more than

expected.²⁰ Sample-based estimates of MSA revenues also exhibit year-to-year volatility: the average absolute change in the year-on-year growth rates of estimated MSA revenues between 2011–12 and 2019–20 was around 4–9 percentage points. Following the COVID-19 pandemic, it was generally higher, ranging from 6 to 11 percentage points from 2020–21 to 2023–24.

As with business rates, an income tax revenue assignment system could partially mitigate both policy and wider revenue risks. For example, the UK government could directly compensate MSAs for the direct revenue effects of income tax policy changes that reduce (or increase) their revenues. A ‘safety net’ system could be used to protect MSAs from the biggest falls in assigned revenues. And, as we discuss in the next section, there are ways to assign income tax revenues that would reduce MSAs’ exposure to both policy and wider revenue risks in the first place.

9.5 The key decisions to be made on revenue assignment

The assignment of (more) business rates revenues and a share of income tax revenues is therefore administratively feasible and would provide complementary incentives to support economic development. But to turn a high-level idea into actionable policy, the government’s fiscal devolution roadmap will need to address several important questions – including in relation to the management of revenue inequalities, risks and volatility. The key issues to address include:

- how rapidly to roll out revenue assignment to different mayoral strategic authorities, and what to do in areas not governed by MSAs;
- the form of income tax revenue assignment to pursue;
- how much tax revenue to assign and which grants to replace;
- the design of equalisation arrangements and, in particular, how such arrangements are updated over time.

We discuss the first three in this section, before looking in depth at the last issue in Section 9.6.

Rolling out revenue assignment

One option would be to roll out revenue assignment to all MSAs at the same time, so that all start retaining (more) business rates in April 2027 and all start receiving a share of income tax revenues in April 2028. Alternatively, the government could begin revenue assignment to a subset of MSAs initially, before rolling it out more widely at a later date. Chancellor John

²⁰ Authors’ analysis of the Office for Budget Responsibility’s economic and fiscal outlook (various editions).

Healey said last month that ‘every Mayoral Strategic Authority beginning in 2028’ will be assigned a share of income tax revenues (HM Treasury, 2026c). This could be read in a way that is consistent with either approach: with revenue assignment beginning for every mayor in 2028, or a process beginning in 2028 that will eventually reach every mayor. There are pros and cons of both approaches, which the government will need to weigh up.

There is a reasonable case to roll out revenue assignment to more established MSAs first. It may be easier to replace grant funding with an assigned share of business rates and income tax revenues for MSAs where a significant fraction of grant funding has already been rolled into the somewhat more flexible ‘integrated settlements’ than for MSAs still receiving funding via a range of ring-fenced specific grants. MSAs’ ability to manage the risks and take advantage of the opportunities brought by revenue assignment may also vary based on their institutional capacity and governance arrangements and, as discussed in Section 9.3, international evidence suggests such factors can be an important determinant of the effects of fiscal devolution. Relatedly, starting first with the more institutionally mature MSAs may enable and encourage improvements in the capacity and governance of other MSAs too.

However, if revenue assignment proves to be successful and leads to changes in MSAs’ behaviour and associated economic outcomes, a phased roll-out based on existing capacity could end up exacerbating inequalities in MSA capacity and local economic outcomes. In addition, while there may be scope for lesson-learning on the operation of the assignment system from a staggered roll-out (e.g. how large tax revenue forecast errors are, and the implications for budget management), the scope to learn much about the financial and economic effects of revenue assignment would likely be limited: significant funding divergences and economic effects are likely to take at least several years to develop, and it is unlikely a roll-out or ‘pilot’ phase would last this long. And having long-term differences in how strategic authorities are funded would run counter to the effort put into rationalising their spending powers and responsibilities in the English Devolution and Community Empowerment Act.

The government will also need to consider the implications of revenue assignment for areas of England that do not have mayors, including the foundation strategic authorities of Lancashire and Devon & Torbay, as well as the areas that currently have no form of strategic authority.

Starting first with FSAs, the government has justified devolving more spending and revenue powers to MSAs than to FSAs on the basis that directly elected mayors provide greater accountability to both local residents and central government than the boards of local authority representatives that lead FSAs – because mayors are accountable solely for MSA performance, whereas local authority representatives are primarily responsible for local authority performance. While this may justify differences in how much is devolved and *how* spending in areas without

mayors is funded relative to MSAs, it does not in itself justify differences in *how much* is spent in such areas relative to MSAs (which revenue assignment may affect).

Around a third of the population of England live in areas that do not currently have any strategic authority – their new middle tier of government does not yet exist. This is still likely to be the case when the roll-out of revenue assignment for other areas begins: the government intends for all of England to be covered by strategic authorities only by the end of 2028, and does not have the power to compel areas to set up strategic authorities.

When considering the design of the revenue assignment and associated equalisation systems, the government should therefore consider effects not only on funding levels and risks for MSAs but also on spending in other parts of the country (which will continue to be undertaken directly by central government or funded via grants). And if, over time, evidence suggests that revenue assignment is associated with higher funding and/or better outcomes, the government should consider how to prevent areas without mayors from falling permanently behind – whether through mandating mayoralities, strengthening the accountability arrangements of FSAs, or assigning revenues directly to local authorities in areas without mayors. We discuss the possibility of extending income tax revenue assignment to local authorities – which exist in all parts of England – in Section 9.8.

The form of income tax assignment to pursue

The government will also need to decide which form of income tax revenue assignment to pursue. As discussed in Section 9.4, while in principle there is a choice between assignment on the basis of primary residence and assignment on the basis of place of work, the latter approach would be substantially more difficult to implement. We therefore assume in the rest of this chapter that the government will assign based on primary residence.

Instead, the more relevant choice is how to assign the revenues from each income tax rate.

The simplest option would be to assign MSAs a flat percentage (e.g. 10%) of revenues raised in their areas from all tax rates. Such an approach would mean that, like central government's, MSAs' revenues would be particularly dependent on the incomes of high-income taxpayers. This is because income tax is progressive, so higher-income taxpayers pay a greater proportion of their incomes than lower-income taxpayers. For example, 10% of all income tax revenues is equivalent to 2% of taxable income in the basic-rate tax band (10% of the 20% basic rate of tax) plus 4% of all income in the higher-rate tax band (10% of 40%) and 4.5% of income in the top-rate tax band (10% of 45%). An increase in income subject to the higher and top rates would therefore generate two or more times as much funding for the MSAs as an equivalent-sized increase in income subject to only the basic rate.

An alternative approach would be to allocate the revenues from a fixed number of percentage points of the tax rates for these different tax bands – for example, 3 percentage points for each tax band, or for just the basic-rate band as suggested by the think tank Re:State (Walker, Ganesharatnam and Kaye, 2026). The former would assign revenues equivalent to the same 3% of taxable income for income in each tax band, while the latter would assign revenues equivalent to 3% of taxable income in the basic-rate band and 0% for income in the other tax bands.

Which approach the government chooses will have several important implications. In particular, it will affect:

- **The financial incentives MSAs have to support increases in the incomes of different taxpayers.** This is because different approaches mean MSAs would benefit to different extents from growth in different taxpayers' incomes.²¹
 - Assigning a flat 10% of income tax revenues, for example, would provide stronger financial incentives for MSAs to boost incomes in the top-rate band than in the basic-rate band. Such an approach would make most sense if the government aims to incentivise MSAs to implement policies and investments that support growth in overall income tax revenue.
 - Assigning 3 percentage points of the tax rate in each band would provide the same financial incentive to increase income in all tax bands. This approach would therefore make most sense if the government wishes to incentivise MSAs to boost overall local economic growth, and support growth in taxable incomes across the income distribution.
 - Assigning 3 percentage points of the tax rate in just the basic-rate band would focus financial incentives on increasing incomes in that band.²² This would make sense if the government wants MSAs to focus specifically on increasing employment and the incomes of their low- to middle-income residents – for example, to reduce poverty and inequality.
- **The scale of (pre-equalisation) revenue inequalities between MSAs.** Geographical inequalities in incomes are concentrated towards the top of the income distribution (Agrawal and Phillips, 2020), and so geographical inequalities in income tax revenues are driven to a large extent by differences in revenues from the higher- and top-rate tax bands. This is illustrated in Table 9.6, which compares estimates of how much revenue per person each MSA would receive relative to the average if revenue assignment was based on (1) 10% of revenues, (2) 3 percentage points of each tax rate and (3) 3 percentage points of just the

²¹ It is worth noting that, as incomes below the personal allowance (£12,570) are not subject to income tax, none of these three approaches would provide incentives for MSAs to increase the incomes of people earning below the personal allowance, unless policies could move their incomes above that allowance.

²² This would be equivalent to assigning 3% of income tax revenues collected from the portion of incomes subject to the basic rate, or 15% of all taxable income that is taxed at the basic rate.

basic rate. The estimates are for the latest year of available data, 2023–24, prior to any equalisation that might subsequently be applied to address revenue inequalities. The (weighted) average across all MSAs is normalised to 100 for each option.

Table 9.6. Income tax revenue per person by mayoral strategic authority relative to the MSA average, 2023–24

	(1) 10% of all revenues (index)	(2) 3ppt of each rate (index)	(3) 3ppt of basic rate (index)
London	186	163	121
Cambridgeshire & Peterborough	111	110	110
Cheshire & Warrington	106	107	109
Sussex & Brighton	100	104	110
Hampshire & the Solent	96	102	111
York & North Yorkshire	89	94	102
West of England	89	96	108
Cumbria	68	82	107
East Midlands	66	75	93
Greater Manchester	63	72	86
Greater Lincolnshire	60	72	94
West Yorkshire	60	69	86
Hull & East Yorkshire	58	67	84
Liverpool City Region	57	68	89
North East	56	66	84
South Yorkshire	53	63	82
West Midlands	52	61	77
Tees Valley	52	60	76
MSA average	100	100	100

Note: Indexed to the MSA average income tax revenue per person, a population-weighted average across the 18 mayoral strategic authorities only, rather than to the average across all of England. Weighting uses ONS mid-year population estimates for 2023. See Appendix 9A for details of how estimates are constructed.

Source: Authors' calculations using Office for National Statistics (2023 and 2025) and HM Revenue and Customs (2025 and 2026).

The table shows that whereas Greater London would have received 186% of the average revenue per person from 10% of all income tax revenues, it would have received an estimated 163% of the average from 3 percentage points for each tax band and an estimated 121% of the average from 3 percentage points for the basic-rate band. Conversely, the Tees Valley would have received 52% of the average revenue per person from 10% of all income tax revenues, but 60% from 3 percentage points for each tax band and 76% from 3 percentage points for the basic-rate band. By-band approaches – especially if focused on revenue from the basic rate of income tax – could therefore reduce the scale of inequality in pre-equalisation revenues between MSAs, thereby reducing the amount of equalisation that the government would subsequently want to undertake.

- **Cyclical revenue risks and volatility faced by MSAs.** It is incomes subject to the higher and top rates of tax that are typically most uncertain and volatile – due, for example, to variation in bonus payments and dividend receipts. In contrast, revenues from basic-rate taxpayers tend to be more predictable and stable from year to year. By reducing exposure to changes in incomes in the higher- and top-rate bands relative to a flat-percentage-of-revenue approach to assignment, by-band approaches can therefore reduce revenue risk and volatility for MSAs.
- **How UK government income tax policy decisions affect MSAs' revenues.** Assigning a flat percentage of income tax revenues would mean that if the UK government changed income tax rates or thresholds, reducing or increasing overall income tax revenues, this would affect the revenues assigned to MSAs. While, as discussed in Section 9.4, in principle it would be possible for the UK government to compensate MSAs for such effects, calculating the amount of compensation due to (or from) MSAs would require HMRC to calculate tax payments under two systems: the actual one and the counterfactual 'no reform' system. This could become increasingly complicated as the actual and counterfactual systems diverge over time.

Assigning a fixed number of percentage points of all tax rates instead would mean that the revenues assigned to MSAs would not be directly affected by changes in either tax rates or the higher- or top-rate band thresholds – 3 percentage points of all tax rates would still be 3 percentage points of all tax rates, irrespective of whether overall tax rates had increased or decreased.²³ A by-band approach to revenue assignment could therefore reduce the revenue uncertainty and risk associated with UK government decisions on tax rates and thresholds – although changes in the tax-free personal allowance would still affect assigned revenues.

²³ Note that MSAs' assigned revenues could still be affected by behavioural responses to UK government income tax policy changes. But that would also be true under a flat-percentage-of-revenue approach to assignment.

- **How easy it is to move from revenue assignment to true revenue devolution in future.**

While the current government's plan is for income tax revenue assignment, future governments may want to partially devolve income tax to MSAs to enable them to directly increase or reduce their funding. The most straightforward way to do this would be to reduce the tax rates set by the UK government and allow MSAs to set rates on top of these, as is the case with Wales, where the UK government reduces each tax rate by 10 percentage points and the Welsh Government sets its tax rates on top. A by-band approach to revenue assignment would be a more natural stepping stone to this than a flat-percentage-of-revenue approach.

By-band approaches to income tax assignment would therefore reduce the revenue inequalities and risks that subsequent revenue equalisation and insurance systems would need to address. But in deciding which approach to revenue assignment to pursue – a flat percentage of revenues or a by-band approach – the government's long-term vision for fiscal devolution and the precise incentives it wants to provide MSAs with are also important.

How much revenue to assign and which grants to replace

As well as deciding *how* to assign income tax revenues, the government will also need to decide *how much* revenue to assign, and which grants that assigned revenue should replace.

In making these decisions, it is important to distinguish between the *stock* of revenues assigned to MSAs and the amount of any subsequent *change* in revenues that MSAs bear once the assignment system is in place. These do not need to be the same. But first, we discuss the factors the government should account for when deciding which grants that assigned revenue should replace.

Which grants the assigned revenues should replace

As discussed in Section 9.2, MSAs receive a range of different grants, with different strings attached. Many are subject to strict ring fences, mandating their use for particular services. The integrated settlements received by seven of the E-MSAs provide some flexibility to move funding between broader 'thematic pots'. And the investment funds provide flexible grant funding that MSAs are able to spend as they see fit, as long as it relates to one of their responsibilities.

Assigned tax revenues could replace any or all of this grant funding. But the suitability of these different types of grants for assignment differs. In principle, revenue assignment is most suitable as a replacement for grants that MSAs have significant flexibility over, rather than those subject to ring-fencing. This is for two interrelated reasons. First, replacing a single ring-fenced grant with assigned revenues would mean future spending on the service for which the grant is ring-fenced may need to rise and fall as assigned revenues rise and fall, irrespective of changes in

needs for said service: a potentially problematic case of tax hypothecation. Second, replacing several ring-fenced grants together could help address this concern, provided that MSAs have some flexibility to allocate spending between services following assignment (e.g. to insulate a service seeing a particular increase in spending needs from a fall in assigned revenues). But presumably there is a reason why the government has strictly ring-fenced funding in the first place: it wants to guarantee certain funding it provides goes to particular services – such as policing, for example.

Replacing MSAs' investment funds with assigned revenues would avoid such concerns. However, these are generally a very small proportion of overall grant funding, especially in E-MSAs (e.g. £30 million a year for Greater Manchester, equivalent to less than 0.3% of projected income tax revenues from this area in 2028–29)²⁴ – and the Greater London Authority does not receive an investment fund grant at all. In addition, it is unclear whether MSAs would want to replace guaranteed 30-year investment funds with assigned revenues that are subject to at least some uncertainty; it is their other grant funding which some have argued is too short-term.

This suggests the 'integrated settlements' may be the most appropriate grants to form the core of the new revenue assignment system. They are substantially larger than the investment funds (e.g. a planned £732 million for Greater Manchester in 2028–29, equivalent to 6.8% of projected income tax revenues). They are currently only confirmed for a few years at a time, so MSAs may welcome greater long-term clarity via a revenue assignment system. And the government has already relaxed ring-fencing requirements, suggesting it is more comfortable with MSAs moving funding between the services the integrated settlements fund – easing concerns about the risks of revenue hypothecation.

As discussed in Section 9.2 though, the fact that a large proportion of the existing integrated settlements are capital funding – the need for which is particularly hard to assess and is potentially lumpy – may increase the likelihood of significant mismatches between spending needs and assigned revenues opening up over time, even if the amount of revenue initially assigned matched the integrated settlement for that year. The government should therefore consider either excluding from assignment the elements of the integrated settlements that are likely to be most lumpy (e.g. one-off funding for transport schemes the MSAs inherited from the Department for Transport) or undertaking an assessment of the average need for such capital spending over a long time horizon, matching initial assigned revenues to this level, and then allowing MSAs to borrow or save to reallocate this funding over time to fund lumpy investments.

²⁴ The investment funds for the original strategic authorities were negotiated, whereas those for more recent authorities have been based on population.

As only some authorities receive 'integrated settlement' funding – seven currently, with a further four E-MSAs eligible to in future – restricting the new revenue assignment system to replacing this component of funding could also limit the set of authorities to which assignment could be rolled out, at least initially, unless the government can identify the equivalent ring-fenced grants received by other MSAs.

In addition, while the integrated settlements of the Northern and Midlands MSAs that receive them are of broadly similar scale (between a planned £233 and £259 per person in 2028–29), they are less than a quarter as large (£59 per person) for Greater London. As we see below, when combined with Greater London's high income tax revenues per person, this poses some challenges for the design of a revenue assignment system.

How much of the *stock* of revenues to assign to MSAs

As already highlighted, the government's plan is for revenue assignment to be revenue-neutral at the point of introduction. This means that at a national level, the *stock* of revenues initially assigned to MSAs must equal the amount of grant funding that they will forgo. This would ensure that revenue assignment does not cause an immediate worsening of the UK government's difficult fiscal situation.

Table 9.7. Comparison of integrated settlements with projected income tax revenues, 2028–29 (2026–27 prices)

	Integrated settlement	Share of all income tax revenues	Percentage points of each rate equivalent	Percentage points of basic rate equivalent
South Yorkshire	£378m	8.7%	2.1	2.5
North East	£529m	8.0%	1.9	2.4
Liverpool City Region	£423m	8.0%	1.9	2.3
West Midlands	£716m	8.0%	1.9	2.3
West Yorkshire	£578m	7.0%	1.7	2.1
Greater Manchester	£732m	6.8%	1.7	2.2
Greater London	£545m	0.6%	0.2	0.4
All E-MSAs with an integrated settlement	£3,902m	2.8%	0.8	1.3

Note: See Appendix 9A for details of how estimates are constructed.

Source: Authors' calculations using Office for National Statistics (2023 and 2025), Ministry of Housing, Communities and Local Government (2025b) and HM Revenue and Customs (2025 and 2026).

However, there is significant variation in both MSAs' existing grant funding per person and their business rates and income tax revenues per person – particularly between Greater London and the Northern and Midlands MSAs. This is illustrated in Table 9.7, which compares the planned integrated settlements for 2028–29 for the seven E-MSAs that currently receive them with projected income tax revenues for the same year. It shows that the integrated settlements vary between 6.8% and 8.7% of projected income tax revenues (equivalent to the revenue from between 1.7 percentage points and 2.1 percentage points for all tax bands) for the Northern and Midlands MSAs, but just 0.6% (and 0.2 percentage points for all tax bands) for Greater London.

On its own, replacing the same set of existing grants – for example, the integrated settlements – with the same assigned portions of business rates and income tax revenues would therefore lead to some MSAs seeing an overall increase in funding and others an overall decrease, even if the shift from grant funding to revenue assignment was revenue-neutral for England as a whole. These windfall gains and losses could, reasonably, be seen as unfair.

To avoid this, three options would be possible.

First, the same share of revenues could be assigned to each MSA but the amount of grant funding that they would forgo could be varied to match the initial amount of revenues assigned to them – with MSAs with higher revenues forgoing more grants (or more of each grant). For example, assigned revenues could replace more grants in Greater London than in the Northern and Midlands MSAs.

Second, MSAs could forgo the same grants but the share of revenues assigned to each MSA could be calibrated to match the value of those grants – with MSAs with higher revenues having a lower share of those revenues assigned to them. For example, a lower share of tax revenues could be assigned in Greater London than in Greater Manchester than in South Yorkshire.

Both of these options come with drawbacks though. Varying the grants (or share of each grant) that are replaced and/or the share of revenues assigned to each MSA in this way would be complex. As discussed above, different grants are more or less suitable to be replaced by assigned revenues. Varying the rate of revenue assignment between MSAs would also vary the financial incentives and risks associated with marginal *changes* in revenues – those with higher (lower) assignment would bear a larger (smaller) fraction of the gains or losses associated with increases or decreases in the revenues from the taxes assigned to them. There may be a case for some variation across MSAs in this way – giving stronger financial incentives to those MSAs in traditionally poorer-performing regions, to give an extra boost to growth, and/or more incentives to those MSAs with the most spending responsibilities and powers, and so the greatest ability to influence the local economy. But it is unlikely to be the case that the optimal level of incentives

and risk for each MSA to bear will be perfectly correlated with how its initial revenues and grant funding compare.

A third, and in our view better, option would be a formal system of equalisation to offset differences between assigned revenues and the grants due to be replaced. We discuss the options for the detailed design of such a system in Section 9.6. But one way such a system could work is as follows:

- Any MSAs for which the initial revenues that will be assigned are lower than the grants they will forgo would receive a transfer from central government to offset the difference.
- Any MSAs for which the initial revenues that will be assigned are higher than the grants they will forgo would pay a transfer to central government to offset the difference.

After accounting for these equalisation payments, the *stock* of revenues initially assigned would equal the grants being replaced not only nationally but also for each MSA. This would ensure that MSAs do not face immediate windfall gains or losses simply as a result of the introduction of the revenue assignment system, which would be consistent with the ‘no detriment’ principle that has guided tax devolution for both Scotland and Wales (Smith Commission, 2014).

Appendix 9B illustrates graphically how equalisation payments can be used to deliver revenue neutrality for individual MSAs and fiscal neutrality overall, whatever grants government chooses to replace with assigned revenues and whatever *stock* of those revenues it wants to assign initially.

How much of the *change* in revenues to assign to MSAs

By offsetting any differences between initial assigned revenues and the grant funding to be replaced, these equalisation payments would therefore allow the government to assign the same pre-equalisation portion of revenues and replace the same grants for each MSA – avoiding the need to vary assignment and grant decisions on a case-by-case basis to ensure ‘no detriment’.

Assigning the same pre-equalisation portion of local revenues to each MSA would mean that they would have the same financial incentives to grow local tax bases – because they would each bear the same portion of any subsequent *change* in revenues once the assignment system is in place – for example, the same X% of the increase in the resulting business rates revenues, or the extra revenues from the same Y percentage points for each income tax band. The choice of what portion of revenues (X and Y) should be assigned, prior to any equalisation, should depend on how the government, MSAs and other stakeholders trade off incentives to grow local tax bases, with the uncertainty, risk and volatility that greater exposure to changes in local tax bases entails:

- If incentives are highly prioritised, the government should assign a relatively high pre-equalisation share of local revenues, so that MSAs bear a relatively large share of any changes in local tax bases – even though this means more risk too. In this case, it is possible that all MSAs would receive more in the way of pre-equalisation revenues than the grants that will be replaced – meaning that all would pay equalisation transfers back to the government, albeit of different sizes.
- If, on the other hand, the government prioritises protection against tax revenue uncertainty, it should assign a relatively low pre-equalisation share of local revenues, so that MSAs bear a relatively small share of any changes in local tax bases – even though this means weaker incentives too. In this case, it is possible that all MSAs would receive less in the way of pre-equalisation revenues than the grants that will be replaced – meaning that all would receive equalisation transfers from the government, albeit again of different sizes.

As we have highlighted already, this incentives–insurance trade-off is inherent to any tax revenue assignment and equalisation system. But as we now discuss, certain design choices can ameliorate this trade-off somewhat – keeping equalisation transfers more ‘up to date’ and providing more insurance against certain types of revenue risks, without undermining the financial incentives MSAs would have to enact policies that help grow local tax bases.

9.6 The options for equalisation and insurance arrangements

In designing equalisation and insurance arrangements to accompany mayoral strategic authorities’ newly assigned revenues, the government can learn from two approaches already used as part of existing revenue assignment and devolution policies in the UK:

- 1 the redistributive tariffs and top-ups that are used to equalise the business rates revenues already assigned to local and some strategic authorities as part of the business rates retention scheme, discussed in Box 9.1 in Section 9.2;
- 2 the block grant adjustments (BGAs) used as part of the devolution of a range of tax revenues and powers, including income tax, to the Scottish and Welsh Governments.

The government also needs to decide how to update any initial equalisation payments over time. This includes any regular annual indexation of the payments, as well as any more general ‘resets’ of the system to account for changes in different MSAs’ pre-equalisation assigned revenues and spending needs. The government may also want to include mechanisms to insure MSAs against particularly large changes in their revenues. And it needs to consider what arrangements may be needed to help MSAs address uncertainty in revenues – including

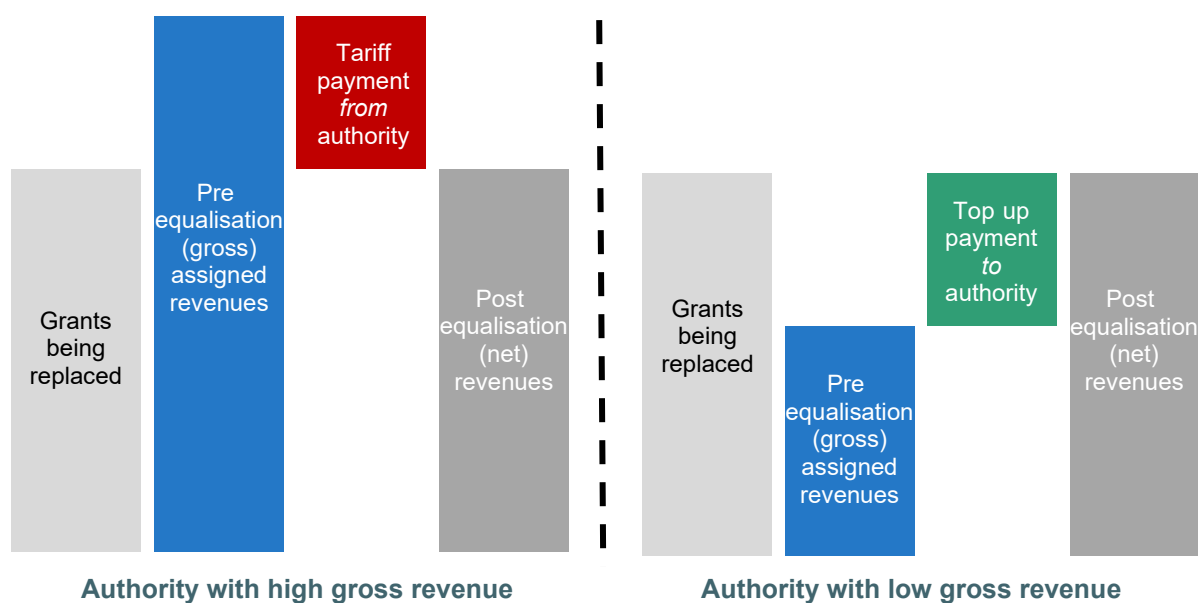
differences between forecasts for revenues when they set their budgets, and actual revenue collections. We discuss each of these options in turn.

Option 1. Tariffs and top-ups

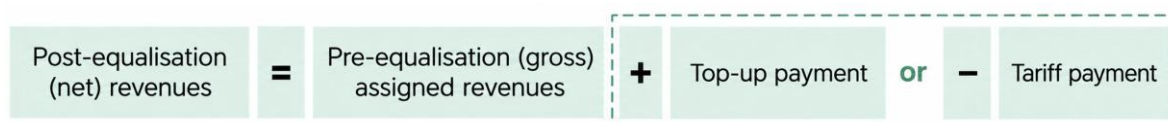
'Tariffs' and 'top-ups' are the terms used in the BRRS for the equalisation payments to offset initial differences in authorities' pre-equalisation (gross) assigned revenues and the grants those revenues are replacing. As discussed in Box 9.1, tariffs are payments *from* authorities whose initial business rates revenues exceeded the grant funding being replaced, while top-ups are payments *to* authorities whose initial business rates revenues were lower than the grant funding being replaced. Panel A of Figure 9.7 illustrates how this could work for authorities that were initially in each of these positions, equalising their post-equalisation (net) revenues; Panel B expresses this in the form of an equation.

Figure 9.7.

Panel A. Illustration of the operation of tariffs and top-ups for equalisation, for an authority with (i) high gross revenue and (ii) low gross revenue



Panel B. A tariffs and top-ups approach to equalisation



It would be natural to use the existing BRRS and its system of tariffs and top-ups to undertake equalisation for MSAs' increased share of business rates revenues. It is a scheme that local authorities, strategic authorities and central government are used to, and its continued operation has already been confirmed as part of recent reforms to the local government finance system.

Using a different system for authorities' additional shares of business rates revenues from the one used for their existing shares would be complex administratively, and likely to make it harder for local policymakers to understand the incentives and risks they face.

A tariff and top-up system could be utilised to equalise assigned income tax revenues too. However, rather than simply replicate how they operate in the BRRS, the government should consider changing how initial tariffs and top-ups are indexed over time – a key factor in how redistributive they are in the years following the start of revenue assignment.

The choice of indexation approach

As set out in Box 9.1, under the BRRS, tariffs and top-ups are indexed in line with CPI inflation each year – specifically the rate of CPI inflation from the prior September, which is also used to index taxpayers' business rates bills. Indexing tariffs and top-ups in this way means that the amount of redistribution they do is maintained in real (CPI-adjusted) terms. This reduces the risk of authorities heavily reliant on top-ups seeing real-terms reductions in their funding.

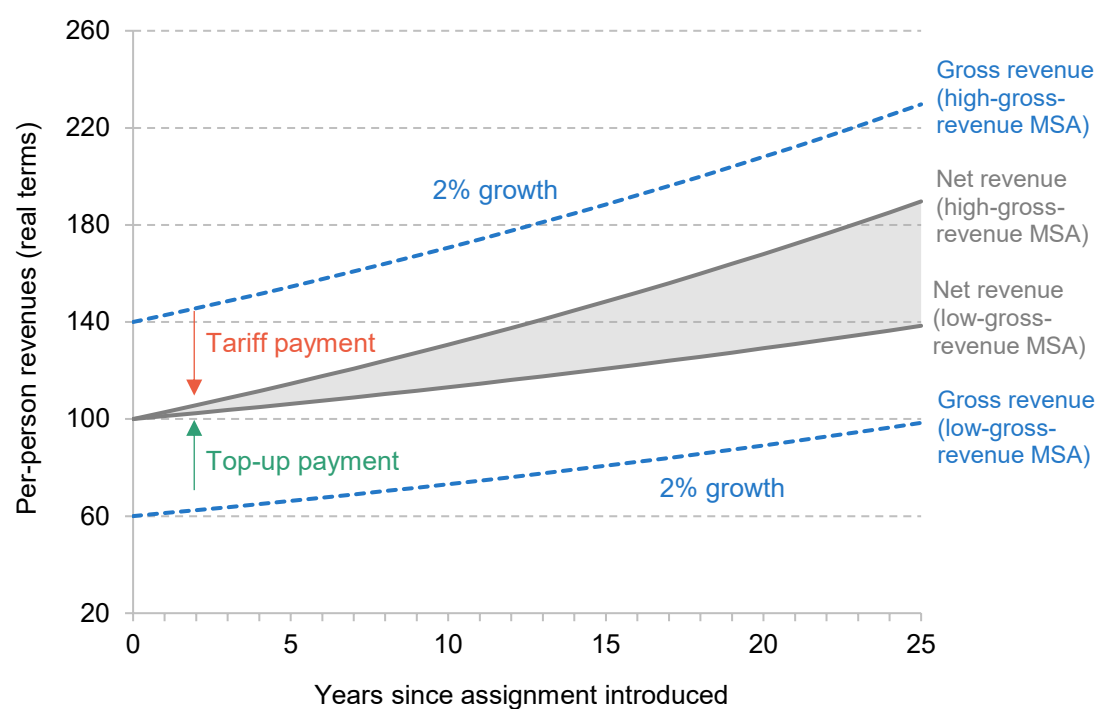
However, if overall revenues increase at a rate faster than inflation – as is the norm for income tax – the amount of redistribution undertaken by the inflation-linked tariffs and top-ups would *fall* relative to these faster-growing revenues. Over time, authorities receiving top-ups would see their overall (net) funding fall relative to authorities paying tariffs, even if their pre-equalisation (gross) revenues grew at the same rate – because a falling share of those gross revenues would be redistributed via the tariffs and top-ups.

This is illustrated in Panel A of Figure 9.8, which shows the evolution of post-equalisation (net) revenues (in grey) for two hypothetical MSAs that start with different levels of pre-equalisation (gross) revenues (in blue). Their underlying gross revenues are assumed to grow at the same 2% real-terms rate each year, while their tariffs and top-ups are indexed in line with inflation and so are fixed in real terms. The tariffs and top-ups are initially set to fully equalise for differences in these MSAs' gross revenues (as in Figure 9.7 earlier). But over time, their net revenues diverge. This is because the inflation-linked tariff offsets less of the high-gross-revenue MSA's growing revenues, while the inflation-linked top-up provides a proportionally smaller boost to the low-gross-revenue MSA over time.

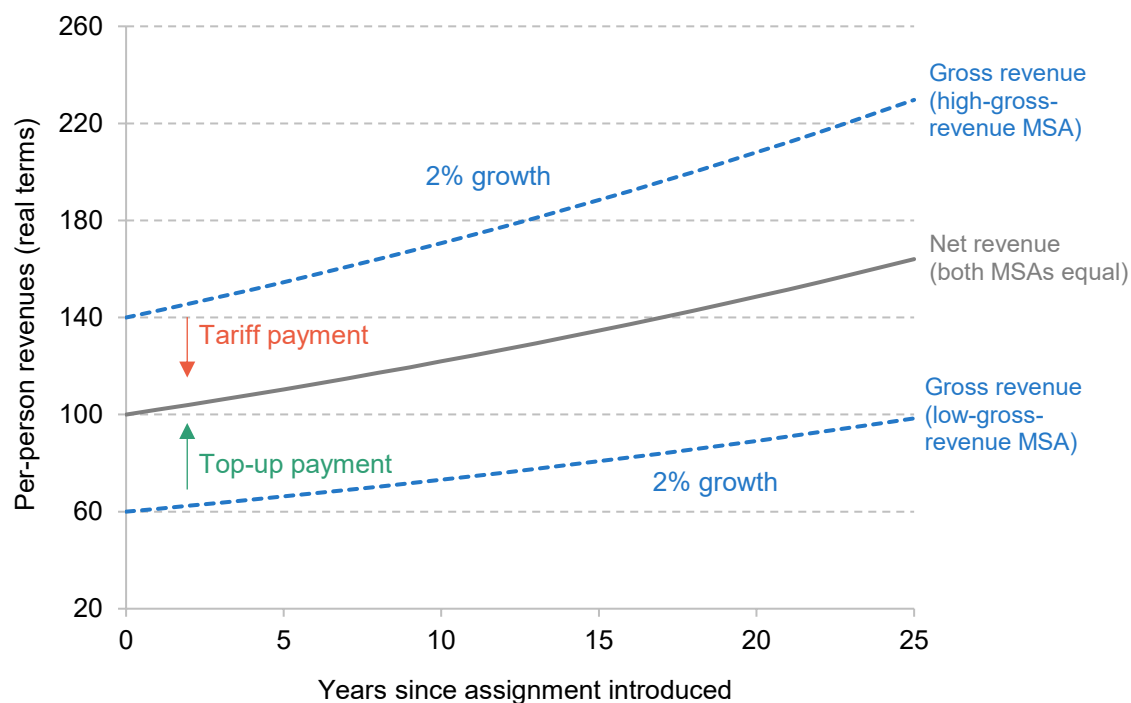
Such divergence in net revenues would take place even if all MSAs paid tariffs or all received top-ups. For example, with gross revenues growing at the same rate, the net revenues of MSAs with bigger tariffs would pull ahead of those with smaller tariffs – because bigger tariffs mean that how they are indexed has a bigger effect on growth in net revenues. The patterns would reverse if gross revenues were to fall in real terms: the inflation-linked tariffs and top-ups would *increase* relative to the falling gross revenues, such that the net revenues of high-gross-revenue MSAs would fall behind those of MSAs with low gross revenues.

Figure 9.8. Illustration of indexation systems for tariffs and top-ups

Panel A. Inflation-linked tariffs and top-ups



Panel B. Revenue-indexed tariffs and top-ups



Note: This figure is based on two hypothetical MSAs that have different gross revenues, with initial tariffs and top-ups designed to fully equalise their net revenues at year 0. Gross revenues grow by 2% in real terms for each MSA and tariffs and top-ups are either fixed in real terms (Panel A) or increased in line with the average 2% real-terms growth in gross revenues (Panel B).

However, the amount of redistribution could be maintained relative to revenues by indexing tariffs and top-ups in line with national growth in the assigned tax revenues rather than inflation. If revenues nationally were growing in real terms, this would ensure that the areas reliant on top-ups benefit more fully from the growth and that areas paying tariffs would not see their net revenues pull ahead (unless their gross revenues were growing more quickly than the national average). This is illustrated in Panel B of Figure 9.8.

Indexation based on national revenue growth would also still maintain MSAs' financial incentives to grow their own assigned income tax revenues – because they would still gain or lose from marginal changes in their own revenues.²⁵ Revenue-based indexation could therefore ameliorate (although not eliminate) the trade-off between incentivisation and equalisation, compared with inflation-based indexation.

Option 2. Block grant adjustments

Tariffs and top-ups, whether inflation- or revenue-linked, would provide relatively little insurance against one significant source of revenue uncertainty and volatility, particularly for income tax – the national economic cycle. And automatic falls and rises in MSA funding when the UK economy shrinks and booms and assigned tax revenues fall and rise could risk exacerbating the economic cycle. Insurance against this risk could be provided by another approach to equalisation: a system of revenue-indexed block grant adjustments (BGAs) as used alongside Scottish and Welsh tax devolution.²⁶

This approach is illustrated in Figure 9.9. The first thing to note with a BGA-based system is that even after tax revenue assignment commences, the UK government would continue to calculate and allocate the underlying grant funding it wants to provide to MSAs. But this grant funding would be adjusted to account for the revenues assigned to each MSA. In particular, at the point the revenues are assigned, a BGA equal to the amount of gross revenue being assigned would be subtracted from the block grant. This means that at the point of introducing the assignment scheme, MSAs' net revenues would exactly equal their block grant funding – thereby achieving both revenue neutrality at a national level and no detriment to any MSAs.

²⁵ For Greater London, whose revenues make up a relatively large share of national revenues, changes in local revenues would have a meaningful effect on the change in national revenues too. Thus, changes in Greater London's revenues would lead to meaningful changes in the tariffs and top-ups too. If, as seems likely, Greater London's revenues would be subject to a tariff, this change in tariff would offset some of the change in Greater London's gross revenues – somewhat dampening its financial incentives to grow those revenues. The fact that other MSAs' revenues make up a much smaller share of national revenues means any effects of their revenue growth on tariffs and top-ups under a revenue-indexation approach will be much smaller – and so too would any effects on incentives.

²⁶ A full discussion of how these BGAs work for Scotland and Wales can be found at <https://ifs.org.uk/articles/block-grant-adjustments>.

Figure 9.9. A block grant approach to equalisation

Post-equalisation (net) revenues	=	Pre-equalisation (gross) assigned revenues	+	Block grant	-	BGA
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In subsequent years, the BGAs would be increased in line with national growth in the assigned tax revenues, maintaining their value relative to national revenues. This means that an MSA would neither gain nor lose from tax revenue assignment if its assigned (gross) revenues grew in line with the national average. But it would gain if its assigned revenues grew at a faster rate than the national average and would lose if its assigned revenues grew at a slower rate than the national average. This would maintain MSAs' incentives to grow their own assigned revenues – as they would still benefit from the marginal growth in local revenue.²⁷

Indexing BGAs in this way would also provide protection against revenue risks and volatility affecting the whole of the country – unlike the tariff and top-up system described above. To see this, consider a recession that reduces tax revenues nationwide. This would reduce the MSAs' gross assigned revenues. But the fall in national tax revenues would mean that the BGAs would also fall, offsetting the falls in the MSAs' gross revenues. The BGA-based approach therefore means that the UK government rather than the MSAs would bear the revenue risk and volatility associated with the national economic cycle – through lower or higher BGAs.

Revenue-indexed BGAs would also offer some protection against UK government policies that affect revenues nationally. Consider an increase in the nationwide tax-free personal allowance. This would reduce the MSAs' gross assigned revenues, but because it would also reduce revenues nationally, it would also reduce the BGAs too. These lower BGAs would then offset the reductions in gross revenues – insulating MSAs' net revenues from the change in the tax-free personal allowance.

The offset would not be exact though. As discussed in Section 9.4, differences in MSAs' income distributions mean that the same policy can have somewhat different effects on their revenues. For example, lower-than-average incomes in the Northern and Midlands MSA areas mean that an increase in the personal allowance would reduce their gross revenues by proportionately more than the national average. This would mean that the fall in these MSAs' gross revenues would be larger than the fall in the BGAs: their net funding would still fall somewhat as a result of the UK government's decision to increase the tax-free personal allowance. Further refinement of the BGA approach – such as separate BGAs for revenues from the different income tax bands, as in

²⁷ Again, however, Greater London's large share of revenues and hence meaningful impact on changes in national revenues means that its incentives to grow local revenues would be somewhat weaker – because higher local revenues would be partially offset by a higher BGA.

Wales – could provide some insurance against economic shocks or UK government policies affecting different parts of the income distribution and hence different MSAs differently.²⁸

But the continued existence of underlying grant funding in a BGA system does introduce one element of risk for MSAs that would not exist in a tariff and top-up system: the UK government’s decision about the levels of those underlying grants. Indeed, the Scottish and Welsh Governments highlight the uncertainty associated with block grant funding which can be changed multiple times during the course of a year (e.g. House of Commons Scottish Affairs Committee, 2025).

The uncertainty associated with grant funding for MSAs is perhaps not as extreme as for the Scottish and Welsh Governments, for which the Barnett formula means that every change in spending in England leads to a change in grant funding: most MSAs’ grants are set out for a period of one to a few years. But if one of the objectives of revenue assignment is to provide MSAs with not only greater financial incentives but also longer-term clarity over future funding than currently, a BGA approach and continued reliance on short-term underlying grants would not achieve this.

However, the insurance against nationwide tax revenue shocks and tax policy changes provided by the BGA approach to equalisation means this approach would be worth considering if either:

- The UK government could provide longer-term grant funding spanning multiple Spending Review periods, on a much larger scale than the long-term ‘investment funds’ it already guarantees for 30 years. Whether this is feasible is not just a political question: setting MSAs’ grant funding a decade or more in advance may increase the risk to the UK government’s finances given uncertainty about the overall long-term fiscal outlook and so the affordability of any long-term grant commitments.²⁹
- Or the government and MSAs decide that it is worth continued uncertainty about grant funding in order for MSAs to be insured against nationwide tax revenue shocks.

Floors, tapers, resets and other insurance mechanisms

A key feature of both the tariff and top-up approach and the BGA-based approach to equalisation described above is that they equalise only for initial differences in revenues and spending needs – albeit indexed in some way over time. This is what provides the financial incentive to support economic and tax base growth: as discussed above, MSAs would benefit

²⁸ This by-band BGA approach is utilised in Wales precisely because its lower-than-average incomes mean much more of its revenues come from the basic rate of tax and much less from the higher and top rates of tax than in England as a whole.

²⁹ One way to reduce this risk would be to allow grants to be changed in specific circumstances – for example, if there were particularly large changes in the economic and public finance outlook.

from the marginal growth in their assigned tax revenues, because the equalisation they benefit from or contribute to does not get updated if they fall further behind or pull further ahead of the national average.

Over time, though, this could lead to very large divergences in funding opening up, potentially due to factors largely outside of MSAs' control. MSAs struggling economically would see their funding fall behind MSAs in economically thriving areas, reducing their capacity for investment and spending to support growth, and so potentially exacerbating differences in their economic fortunes.

If the government wants to provide financial incentives for growth, some divergence is inevitable. But, especially if factors outside MSAs' control are a big driver of differential revenue performance – as seems likely to be the case – the government might still want to prevent divergence growing too large or persisting indefinitely. Here we discuss a number of methods it could use to do this.

Floors, ceilings and tapers

One option is a mechanism to limit the largest relative falls and increases in revenues. For example, as highlighted in Box 9.1, the BRRS includes a 'safety net': payments that top areas' retained business rates revenues up to a minimum floor level if they would otherwise be below that level. These are funded by 'levies' on revenue growth in areas that started with relatively high initial revenues, which reduce the marginal retention of changes in business rates revenues down to a minimum of 25% (from the standard 50%).³⁰ Similar floors and/or tapers exist in equalisation systems in several other countries, including Australia, Canada, Denmark, Germany, Sweden and Switzerland.³¹

A feature of both the BRRS and many systems elsewhere is that they are asymmetric: equalisation is stronger for areas whose tax base either falls significantly or is low than it is for areas whose tax base either rises significantly or is high. Contrast, for example, the hard floor

³⁰ The cost of safety-net payments typically does not exactly match the yield from levy payments. The government pays for any unfunded safety-net payments, but redistributes any excess levy payments to local authorities.

³¹ For example, in Germany's system, a horizontal tapering system equalises for 63% of the differences in tax bases for a basket of assigned and devolved tax revenues – meaning that Länder bear up to 37% of the difference and changes in the tax bases assigned or devolved to them. Then, a system of transfers from the federal government (thereby funded by all Länder in proportion to their contribution to national tax revenues) to Länder with below-average tax capacities compensates for a further 80% of the remaining difference between their (post-taper) tax bases and 99.75% of the average. Taking the horizontal taper and the vertical grants together, a Land with an underlying tax base of 80% of the national average has its post-equalisation tax base made up to 98.32% of the national average. If its underlying tax base fell to 75% of the national average, equalisation would make it up to 97.95%. This means it would bear 7.4% of the reduction in its tax base. If its underlying tax base rose to 85% of the national average, equalisation would make it up to 98.69%, such that it benefits from 7.4% of the increase in its underlying tax base. Conversely, Länder with above-average tax bases bear 37% of the upside and downside changes in their underlying tax bases.

provided by the BRRS's safety net with the partial tapering of its levies. Hard floors (and ceilings) significantly reduce the financial incentives that areas subject to them have to boost their revenues – for example, authorities on the BRRS's safety net do not gain from underlying revenue growth at all until they get back above the safety-net threshold. In contrast, tapers preserve some financial incentives, but do less to offset big falls or increases in revenues.

An asymmetric system such as that used in the BRRS makes sense if it is funding levels that are of paramount importance for authorities whose revenues have fallen substantially – for example, to fund a core set of services and investments – and the government still wants to provide at least some financial incentive for successful areas to support further growth. But a system could be symmetric or asymmetric in the other direction – using a tapered system to limit falls in revenues but a hard cap to limit increases.

The appropriate choice of floors, ceilings and tapers depends on how the government trades off funding levels and financial incentives for the affected MSAs. For example, if it wanted those MSAs whose gross revenues have fallen significantly to still have at least some incentive to increase them, a taper rather than a hard floor would make sense – although that would do somewhat less to protect them from the fall in their revenues.

Resets

Another option to prevent divergences between MSAs growing indefinitely is some form of update or reset to the tariffs and top-ups or BGAs. This would allow MSAs to retain the benefits (and bear the costs) of good (and poor) performance of their assigned gross revenues for some period of time, before fully or partially updating the equalisation system to reflect the new revenues (and potentially spending needs) of different MSAs. For example, after retaining above-inflation increases in business rates revenues from 2013–14 to 2025–26, authorities' funding is now being updated on the basis of new assessments of business rates revenues and spending needs between 2026–27 and 2028–29. Authorities will again gain or lose from real-terms changes in business rates until a further periodic reset is made (the date of which has not yet been confirmed).

There are several considerations when designing such a reset.

First is the design. The periodic reset used in the BRRS has the benefit of being relatively straightforward conceptually: an area will bear the marginal changes in its assigned revenues up until a given year T, when the system is reset again. However, this fixed cut-off year T can, in principle, distort incentives. In the immediate run-up to a reset, it would be more financially beneficial to an MSA if activity that boosts revenue could be delayed until just after the reset – the revenue increase would then be retained for several years, rather than being redistributed away as part of an imminent reset. Conversely, if actions that reduce revenues could be brought

forward, the revenue loss could be compensated for as part of the reset. Whether such incentives would affect MSA behaviour in practice is unclear – although it seems like more of a risk for business rates than for income tax. This is because MSAs may have more direct influence over the timing of business rates revenues, given the role they play in both facilitating and authorising property development.

A rolling or phased reset is one way to avoid this distortion to incentives. Rather than a reset applying to all assigned gross revenue in a given year T , a rolling reset allows changes in gross revenues from any given year to be kept for up to T years. For example, for $T=10$, changes in revenues in 2026–27 would be retained until 2035–36, while changes in revenues in 2027–28 would be retained until 2036–37. MSAs would know that any changes in revenue in a given year would be retained for the full 10 years, whichever year they occur in – with no incentive to artificially delay or bring forward activities. The drawback of this approach, though, is greater complexity: each year, assigned revenues need to be portioned out into growth and declines associated with each previous year, so that the appropriate portion can be reset. This complication means it is probably only worthwhile if the distortions created by periodic resets in fixed years are likely to have a meaningful impact on MSAs' behaviour.

A second issue is how often any resets should take place – and whether they should be full or partial. Less frequent and partial resets would mean stronger financial incentives for increasing the tax base and economic growth – because the revenue gains resulting from growth (or reductions from poor economic performance) would be borne by the MSA for longer. Conversely, more frequent and fuller resets would provide greater insurance against large divergences in funding opening up, likely due in many cases to factors largely outside of MSA control.

Forecasts and reconciliations

Tax revenues are not just volatile, divergent and uncertain in the longer term; they are also subject to uncertainty in-year. It is unclear in advance exactly how much taxable activity there will be during the year, and some taxes – including self-assessed income tax bills – are paid once the tax year is over. This means the government cannot assign MSAs their actual revenues in a given year, because it does not know what they will be.

Existing approaches used in the BRRS and tax devolution to the Scottish and Welsh Governments provide examples of how this can be addressed. The key thing is that in both cases, the amount of revenue retained in respect to a given year is initially based on forecasts. Any differences between forecasts and actual revenues are then reconciled in subsequent years – with authorities and the devolved governments receiving a reconciliation payment if actual revenues exceed forecasts and making a reconciliation payment if actual revenues are lower than

forecasts.³² Using a similar approach for MSAs' assigned income tax revenues would give them time to plan how to respond if revenues under- or over-shoot forecasts.

The Scottish and Welsh Governments are also able to borrow to smooth the cost of paying reconciliation payments back to the UK government when initial forecasts for revenues are overly optimistic. Currently, MSAs – like local authorities – cannot borrow for day-to-day (resource) expenditure, only capital expenditure. There is therefore a question as to whether MSAs should be given the flexibility to borrow to address forecast errors, or whether their existing reserves and re-timing of capital borrowing would be sufficient to address this risk. If borrowing powers are deemed necessary, these should probably be accompanied by independent forecasting for the assigned revenues of MSAs (as the Office for Budget Responsibility does for Wales and as the Scottish Fiscal Commission does for Scotland). This would avoid the risk of MSAs purposefully over-forecasting revenues and delaying the financial consequences through the use of the resource borrowing powers.

9.7 Modelling different assignment and equalisation options for income tax

We now illustrate how big an effect different assignment and equalisation options for income tax could have on the future funding of different mayoral strategic authorities using a number of scenarios for revenue and income growth. It is important to note that these are not forecasts of how different MSAs will actually fare; they are instead projections based on a range of reasonable alternative paths for revenues. The scenarios illustrate how the design of the new assignment system will impact the post-equalisation (net) funding received by different MSAs.

All monetary amounts presented are in 2026–27 prices using the GDP deflator. Further information on our data and modelling assumptions can be found in the methodological appendix to this chapter. Our scenarios start in 2028–29, the year in which the government plans income tax revenue assignment to begin. MSA-level revenues in that year are projected forward from the estimates for 2023–24 set out in Table 9.5, under the assumption that they increase in line with the Office for Budget Responsibility (OBR)'s March 2026 forecasts for national income tax revenue growth. We assume from that point onwards that assigned income tax revenues will replace the integrated settlement grants received by each MSA. For that reason,

³² Under the BRRS, reconciliations take place in two phases: differences between initial forecasts and updated in-year forecasts for a given year T are accounted for by reconciliation payments in year T+1. Then, when actual revenue data become available, differences between these revenue out-turns and the updated in-year forecasts are reconciled in year T+2. For Scotland's and Wales's devolved income taxes, differences between initial forecasts for revenues (and the associated BGAs) and the actual out-turn figures are reconciled in full in year T+3. This longer time lag reflects the time it takes for self-assessment taxpayers to pay their income tax bills.

our analysis focuses on the MSAs that already receive integrated settlements: Greater London, Greater Manchester, Liverpool City Region, North East, South Yorkshire, West Midlands and West Yorkshire. As shown in Table 9.7 above, integrated settlements account for approximately 7–9% of projected income tax revenues for the Northern and Midlands E-MSAs, but less than 1% for Greater London.

Our baseline assumption is that the government assigns each MSA 10% of income tax revenues. While this exceeds the integrated settlement for all of the authorities currently receiving them, meaning they would all be subject to tariffs (albeit of different sizes) under a tariff and top-up equalisation system, we choose this as it represents an easy-to-communicate round number. In reality, the government could choose to assign more or less revenue and replace more or less grant funding than the integrated settlements. Appendix 9B illustrates how a formal equalisation system could operate with different stocks of grant funding replaced and different rates of assignment, by offsetting these with tariffs or top-ups for each MSA. A higher rate of assignment would mean stronger financial incentives but also greater financial risk, while a lower rate of assignment would mean weaker financial incentives but also lower financial risk.

We set up the different equalisation systems so that, post-equalisation, the net revenue retained by each MSA is equal to its confirmed integrated settlement in 2028–29, satisfying the ‘revenue neutrality’ and ‘no detriment’ principles. Again, the government could choose a different approach in practice. For example, as discussed earlier, existing grant allocations are based in part on previous negotiations, the investment priorities as of past Spending Reviews, and differences in assessed spending needs. The government may choose to anchor a longer-term revenue assignment and equalisation system on updated funding allocations for each MSA: for example, the same funding per resident for a given set of responsibilities; or an updated estimate of spending needs. If the government does make such changes, we will analyse them in due course, but we do not model the (infinite) range of potential changes to existing integrated settlements here.

Our scenarios for revenue growth are used to illustrate the quantitative importance of the following key points already discussed qualitatively:

- 1 Revenue-based indexation of equalisation would better maintain equalisation.
- 2 A lower assignment share for London would reduce the risk of funding divergence between the capital and other MSAs.
- 3 By-band assignment would reduce scope for funding divergence under inflation-linked tariffs but not necessarily under revenue-indexed tariffs.
- 4 A BGA-based approach would provide meaningful protection against common revenue shocks.

Our analysis focuses on growth and volatility of net revenues measured relative to the integrated settlements that revenue assignment is assumed to replace. The figures below therefore illustrate the growth in net funding or the volatility in net funding relative to existing funding for the range of services and investments covered by integrated settlements. However, as illustrated in Table 9.2 above, the integrated settlements represent only part of MSAs' overall funding: around 90% for the North East, just under half for Liverpool City Region and the West Midlands, around a fifth to a quarter in Greater Manchester, South Yorkshire and West Yorkshire (where large police budgets are the responsibility of the MSAs), and 4% in Greater London (where large police budgets, social housing budgets and transport budgets are the responsibility of the mayor). While large parts of MSAs' overall funding – notably funding for police services – is ring-fenced, and so could not be cut back if assigned tax revenues disappointed, *increases* in assigned revenues could be spread across services funded by other parts of MSAs' funding (remaining grants, council tax, existing assigned business rates revenues). We therefore also report changes in net revenues and volatility in net revenues measured as a share of MSAs' overall funding to show implications of assignment for MSAs' overall spending power.

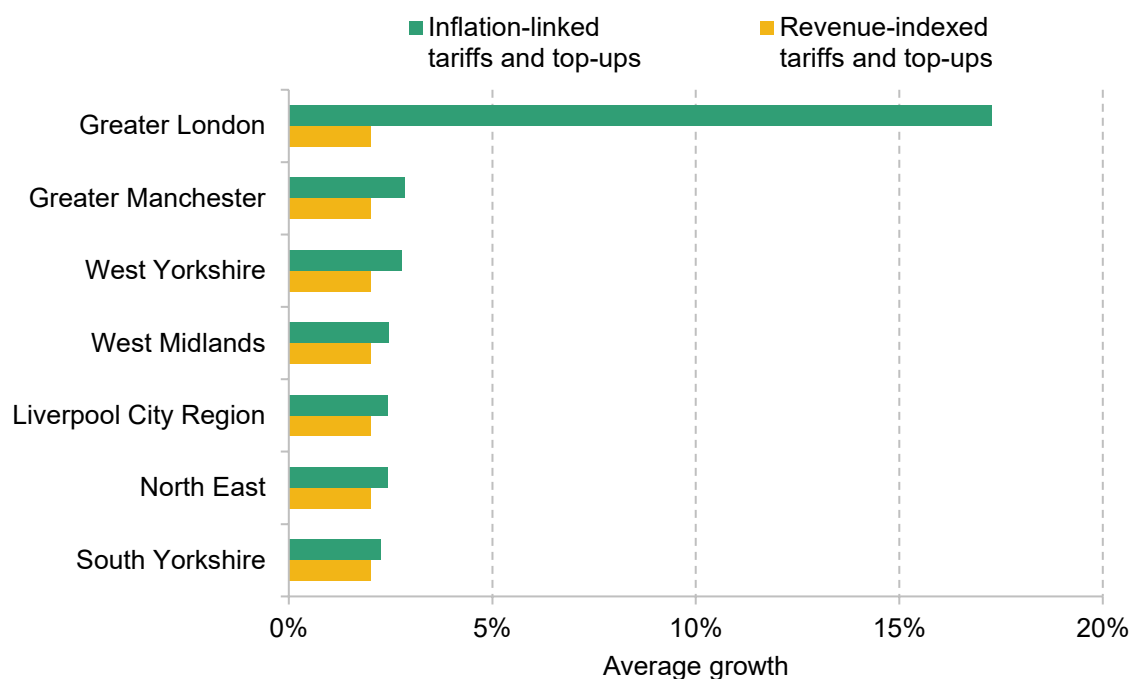
Scenario 1. Revenue-based indexation would better maintain equalisation

Our first scenario illustrates that the choice of indexation for tariffs and top-ups would have significant effects on the scale of net revenue growth that will be seen by different MSAs – even if underlying income tax revenues in all areas grow by the same rate.

With 10% of revenue assigned, the tariffs required so that the initial post-equalisation revenues equal the integrated settlement grants to be forgone in 2028–29 would vary from £54 million in today's prices (£37 per person) for South Yorkshire to £9.2 billion (£994 per person) for Greater London – reflecting both Greater London's relatively much higher income tax revenues and its much lower integrated settlement. Importantly, this means the tariffs would account for a much smaller share of assigned income tax revenues in South Yorkshire (13%) than in London (94%). In other words, while South Yorkshire's initial post-tariff revenues would be 87% of its initial assigned income tax revenues, Greater London's would be just 6%.

For future years, we assume that inflation is 2% (in line with the OBR's long-term assumptions for CPI inflation) and that every MSA's assigned (gross) revenue grows by 2% above inflation. Figure 9.10 shows how post-tariff (net) revenues would evolve under this scenario if tariffs were indexed in line with prices (in green) or in line with national income tax revenues (in yellow).

Figure 9.10. Revenue divergence under different tariff and top-up indexation schemes if 2% real-terms growth in income tax revenues in all areas



Source: Authors' calculations using Office for National Statistics (2025) and HM Revenue and Customs (2026).

As discussed above, with gross revenues increasing faster than inflation, inflation-linking would see the tariffs become progressively smaller compared with growing income tax revenues over time. In turn, this would mean post-tariff (net) revenues would grow faster than pre-tariff (gross) revenues. But differences in the size of the tariffs mean that just how much faster would vary across MSAs. In particular, the bigger the initial tariffs, the more important is the gap between the inflation-linked tariffs and the growth in underlying gross revenues – meaning faster growth in net revenues.

Greater London illustrates this most clearly: its very high tariff means it would benefit most when tariffs increase less quickly than revenues. Indeed, even with 2% real-terms growth in pre-tariff (gross) revenue, its post-tariff (net) revenue would increase by 17% in real terms a year on average, compared with between 2% and 3% in the other MSAs. This is a huge difference: after 10 years, an average of 17% real-terms growth would amount to an additional £2.0 billion in funding (£170 per person) for Greater London compared with 2.5% real growth, for example. The difference between Greater Manchester (2.8%) and South Yorkshire (2.3%) would amount to an extra £54 million a year in funding for the former after ten years – although this is only equivalent to £14 per person. The decline in equalisation, particularly between Greater London and the other MSAs, if tariffs are indexed in line with prices would therefore be economically meaningful.

Indexing tariffs in line with average revenue growth would instead mean that if all MSAs' pre-equalisation (gross) revenues grew in line with that national average, so would their post-equalisation (net) revenues, as illustrated by the yellow bars in Figure 9.10. In other words, equalisation between MSAs would be better maintained over time.

Under our scenario, *all* MSAs would see slower growth in their net revenues if tariffs were linked to average revenue growth (yellow bars) rather than inflation (green). This is because all would be paying a tariff and – if gross revenues are growing in real terms – these tariff payments grow faster if linked to revenue growth than if linked to inflation. Again the amounts involved are not insubstantial: after 10 years, even for South Yorkshire, where the effect would be smallest, tariffs would be £12 million higher in today's prices, and the strategic authority's funding £12 million lower.

But it is not necessarily the case that all MSAs would have lower incomes under revenue indexation: income tax revenues could grow less quickly than prices, meaning revenue-indexed tariffs would grow less quickly; or if either a lower share of revenues were assigned or more grant funding replaced than just the integrated settlements, some MSAs would receive top-ups, and so benefit from revenue-indexed top-ups if gross revenue growth outpaced inflation.

In addition, revenue indexation is arguably more consistent with the government's 'revenue neutrality' principle. It ensures that if MSAs' pre-equalisation (gross) revenues were to grow in line with the national average, so would their net revenues. In contrast, if gross revenues grow in real terms, inflation-linking would see authorities' net revenues outpace their gross revenues. This would increase the share of overall income tax revenues flowing to MSAs and reduce the share flowing to the UK government for allocation across the country as a whole.

Changes in net revenues measured as a share of overall MSA funding

Figure 9.10 shows changes in net revenues measured relative to the integrated settlements that we assume revenue assignment would replace. If we instead measure changes in net revenues relative to MSAs' overall funding, the picture looks rather different.

While under inflation-linked tariffs, growth in net revenues for Greater London would be very high (17% a year in real terms) measured relative to the integrated settlement being replaced, it would be much slower (1.4% a year in real terms) relative to the capital's large overall budget (including for police, social housing and transport). This would be more comparable to the situation in other MSAs, where measured as a share of MSAs' overall funding, growth in net revenues would be between 0.7% a year (in Greater Manchester) and 2.3% a year (in the North East) in real terms. Under revenue indexation, net revenue growth for Greater London would equate to an average of 0.1% a year in real terms relative to the mayor's overall budget, and range from 0.5% to 1.9% a year in real terms relative to overall budgets for the other MSAs.

This is because if only integrated settlements are replaced with assigned revenues, Greater London's small integrated settlement and large overall budget mean any growth in assigned revenues, while large relative to the integrated settlement, would be only small relative to the capital's overall funding. If the government wanted Greater London to be exposed to bigger changes in its overall funding as a result of revenue assignment, it should therefore replace more of its grant funding beyond just the integrated settlement. Inflation- rather than revenue-linking tariffs would be a poor substitute for this.

Scenario 2. A lower assignment share for London would reduce the risk of funding divergence between the capital and other MSAs

Scenario 1 illustrated the effects of different tariff and top-up indexation methods under the assumption that revenues grew at the national average in all MSAs – an unlikely scenario. Our second scenario illustrates that even if tariffs were revenue-indexed, Greater London's high revenues mean it could still see its net income pull far ahead (or indeed fall behind) the other MSAs.

To show this, we assume that income tax revenues in Greater London grow by 4% per year above inflation each, compared with 2% elsewhere.³³ The first two bars in Figure 9.11 show that under this scenario, if Greater London were assigned the same 10% share of revenues as the other MSAs, its net revenues would increase by an average of 25% a year in real terms with inflation-linked tariffs and by 16% under revenue indexation – far outstripping the 4% growth in its underlying gross revenues.³⁴ This compares with growth of just 2.6% and 1.7%, respectively, for the other MSAs, as illustrated in the last two bars in the figure.

The middle two bars show that reducing Greater London's share of assigned revenues to 2% would substantially reduce the divergence in net revenues: Greater London's net revenues would grow by an average of 11% a year in real terms with inflation-linked tariffs and 7% with revenue-indexed tariffs.

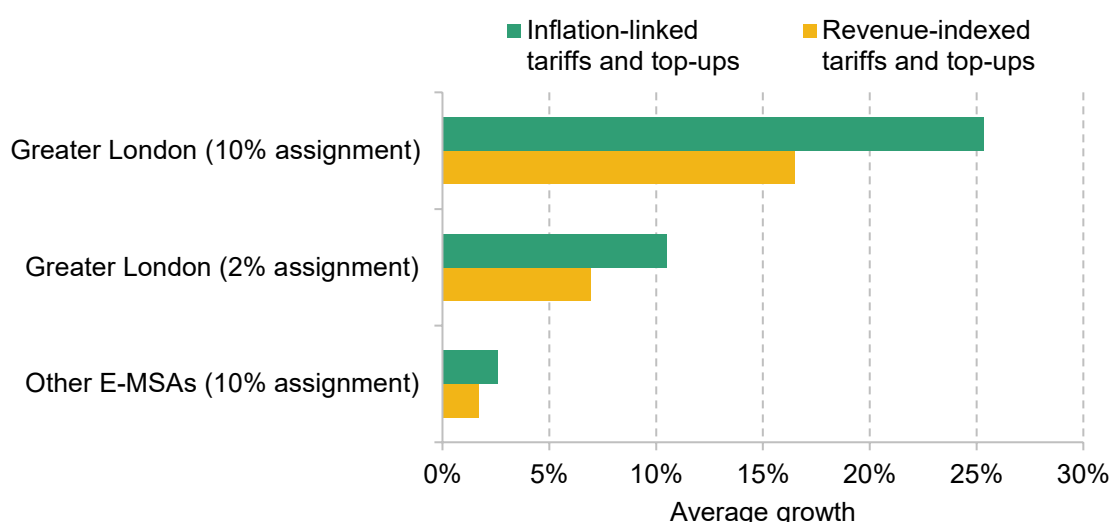
Again, the amounts of funding involved could be substantial: real-terms growth of 7% a year rather than 11% would mean £219 million a year less in funding for Greater London on average, over 10 years – and £1.1 billion less in the tenth year – and an equivalent amount extra for the UK government to distribute across the country. And while our scenario illustrates the effects of different assignment rates for Greater London if revenues in the capital outpace those in the rest

³³ This is a relatively large gap but not unprecedented: between 2011–12 and 2023–24, tax revenues grew 2 percentage points faster in Greater London (2.5% a year in real terms) than in the Tees Valley and the North East (0.6% a year in real terms).

³⁴ Again, this reflects Greater London's high tariff, which means the gap between growth in its gross revenues and its tariff is particularly consequential for percentage changes in post-tariff (net) revenues.

of the country, they could also lag: a lower assigned share of revenues would mean Greater London's exposure to this risk is less outsized than it would be if the same share of revenues was assigned as nationally. Of course, as well as reducing the upside and downside risk to Greater London's net revenues, a lower revenue assignment share would also significantly reduce the financial incentives it faces to grow its income tax base: the usual insurance–incentive trade-off.

Figure 9.11. Revenue divergence under different assignment shares for London if 4% real growth in income tax revenues in London and 2% elsewhere



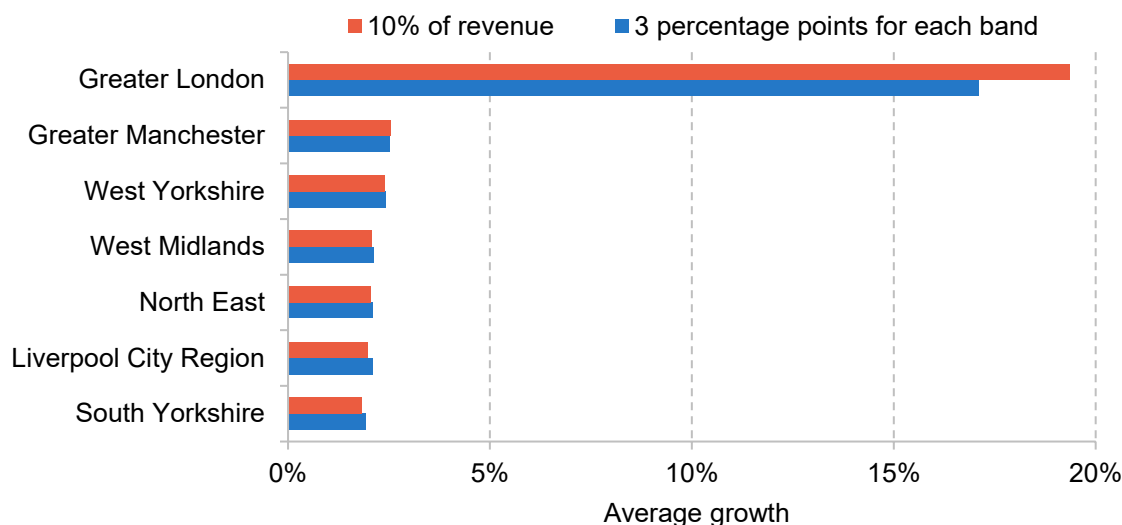
Source: Authors' calculations using Office for National Statistics (2025) and HM Revenue and Customs (2026).

Again, if we examine changes in net revenue measured as a percentage of MSAs' overall funding, the picture looks somewhat different. For example, with 10% of revenues assigned to Greater London, its net revenue growth would equate to an increase in overall funding of 2.9% a year in real terms under inflation-linked tariffs and 1.3% under revenue-indexed tariffs. And with 2% of revenues assigned, Greater London's growth in net revenues would equate to increases in overall funding of 0.6% and 0.4% a year, respectively, under inflation-linking and revenue indexation. Again this illustrates that the potential for Greater London's net revenues to pull away or fall behind other MSAs' is significant relative to the integrated settlement that seems almost certainly set to be replaced – but much smaller relative to Greater London's overall budget.

Scenario 3. By-band assignment would reduce scope for funding divergence under inflation-linked tariffs but not necessarily under revenue-indexed tariffs

Differences in revenue growth between MSAs can sometimes reflect differences in revenue growth from different parts of the income distribution – whether due to underlying economic trends or policy changes (such as the changes in income tax thresholds seen during the 2010s).

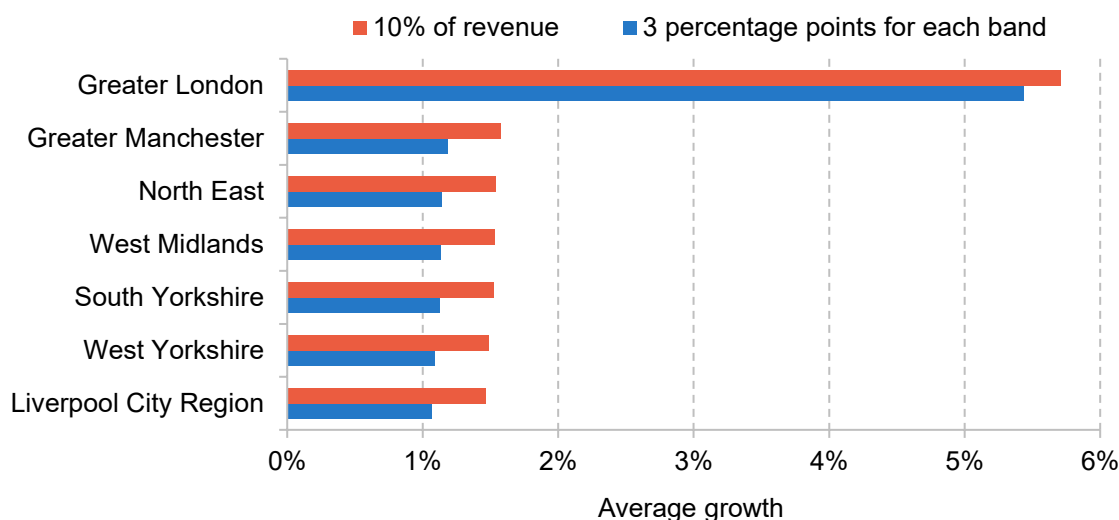
Figure 9.12. Revenue divergence with inflation-linked tariffs and top-ups, and different portions of income tax assigned, if differential growth in revenues by band



Note: Both assignment options modelled using inflation-linked tariffs for equalisation, and assume income tax revenues from the basic-rate band grow by 1% a year in real terms in every area, and revenues from the higher- and additional-rate bands grow by 3% a year in real terms. See Appendix 9A for details of how estimates of income tax revenues by band have been constructed.

Source: Authors' calculations using Office for National Statistics (2023 and 2025) and HM Revenue and Customs (2025 and 2026).

Figure 9.13. Revenue divergence with revenue-indexed tariffs and top-ups, and different portions of income tax assigned, if differential growth in revenues by band



Note: Both assignment options modelled using revenue-indexed tariffs for equalisation, and assume income tax revenues from the basic-rate band grow by 1% a year in real terms in every area, and revenues from the higher- and additional-rate bands grow by 3% a year in real terms. See Appendix 9A for details of how estimates of income tax revenues by band have been constructed.

Source: Authors' calculations using Office for National Statistics (2023 and 2025) and HM Revenue and Customs (2025 and 2026).

Figures 9.12 and 9.13 show how post-equalisation (net) revenues for the different MSAs would evolve under the two approaches to assigning income tax revenues discussed in Section 9.5 – a flat percentage of revenues and the by-band approach – under such a scenario. In particular, we assume that income in the basic-rate band grows by 1% a year in real terms, while income in the higher- and additional-rate bands grows more quickly, at 3% a year in real terms. The red bars in the charts show the average annual real-terms change in net revenues for each MSA if 10% of overall income tax revenues were assigned, and the blue bars if 3 percentage points for each tax band were assigned. We illustrate this separately with inflation-linked tariffs and top-ups in Figure 9.12 and revenue-indexed tariffs and top-ups in Figure 9.13.

The combination of real-terms growth in income tax revenues and the concentration of that growth in the higher- and top-rate tax bands means that Greater London's post-equalisation (net) income would significantly outpace that of the other MSAs: growing by almost 20% a year in real terms over 10 years with inflation-linked tariffs and top-ups, compared with between 1.8% and 2.6% for the other MSAs under the flat-percentage-of-revenue model. With revenue-indexed tariffs and top-ups, Greater London's funding would grow by 5.7%, compared with 1.5–1.6% in the other MSAs.

Under the by-band approach, growth in Greater London's net revenues would still be very high, but would be reduced somewhat: with inflation-linked tariffs and top-ups, it would be reduced from 19.4% to 17.1%; with revenue-indexed tariffs and top-ups, it would be reduced from 5.7% to 5.4% a year in real terms over 10 years. This would entail £555 million less funding a year for Greater London by the tenth year with inflation-linking and £24 million less with revenue indexation.

With inflation-linking, there would be modest *increases* of about 0.1 percentage point a year in the growth of net revenues under the by-band approach for the other MSAs (other than Greater Manchester) – which total £23 million a year *extra* in the tenth year. In contrast, there would be reductions of 0.4 percentage points a year under revenue-indexed tariffs and top-ups – a total reduction of £120 million a year in the tenth year for the same five MSAs.

These results reflect three different impacts of the by-band approach relative to the flat-percentage-of-revenue approach:

- **Less exposure to increases in income tax revenues from the higher- and additional-rate tax bands.** This reduces the growth in net revenues across all MSAs under the by-band approach relative to the flat 10% of revenue approach. It is particularly pronounced for Greater London given a larger fraction of its tax base is in the higher- and top-rate tax bands.
- **Effects on the amount of revenue initially assigned and hence the size of tariffs and top-ups.** For Greater London, 3 percentage points for each band represents less than 10% of all

revenues. This means assigning 3 percentage points for each band would require a smaller tariff for Greater London – and so, for a given increase in gross revenue, the increase in post-tariff (net) revenue would be smaller. Conversely, for the other MSAs, 3 percentage points for each band represents more than 10% of all revenues. This means assigning 3 percentage points for each band would require bigger tariffs for the other MSAs – and so, for a given increase in gross revenue, the increase in post-tariff (net) revenue would be larger. This is why under inflation-linked tariffs, the other MSAs see faster growth in net revenue under the by-band approach than under the flat 10% of all income tax revenues approach.

- **Effects on the indexation of tariffs and top-ups.** Under revenue-indexed tariffs and top-ups, the slower average growth rate for gross revenues from 3 percentage points for each band than from 10% of all revenues under our scenario means that tariffs would increase by less. This slower increase in tariffs particularly benefits Greater London with its still very high tariff. This is why with revenue-indexed tariffs and top-ups, the by-band approach does not narrow the gap in the growth in net revenues between Greater London and the other MSAs as one might initially expect it to.

These complicated interactions between assignment approach, size of tariffs and top-ups, and indexation of tariffs and top-ups illustrate the importance of the government considering the design of the revenue assignment and equalisation system in the round. A by-band approach, by reducing differences in income tax revenues per person between Greater London and the other MSAs, would reduce the likelihood and scale of divergences arising from different rates of revenue growth from different tax bands if tariffs and top-ups are linked to inflation. But if tariffs and top-ups are linked to average growth in assigned (gross) revenues, and if Greater London is subject to a large tariff, it is possible that by-band approaches could even increase divergences in the funding received by Greater London and other MSAs.

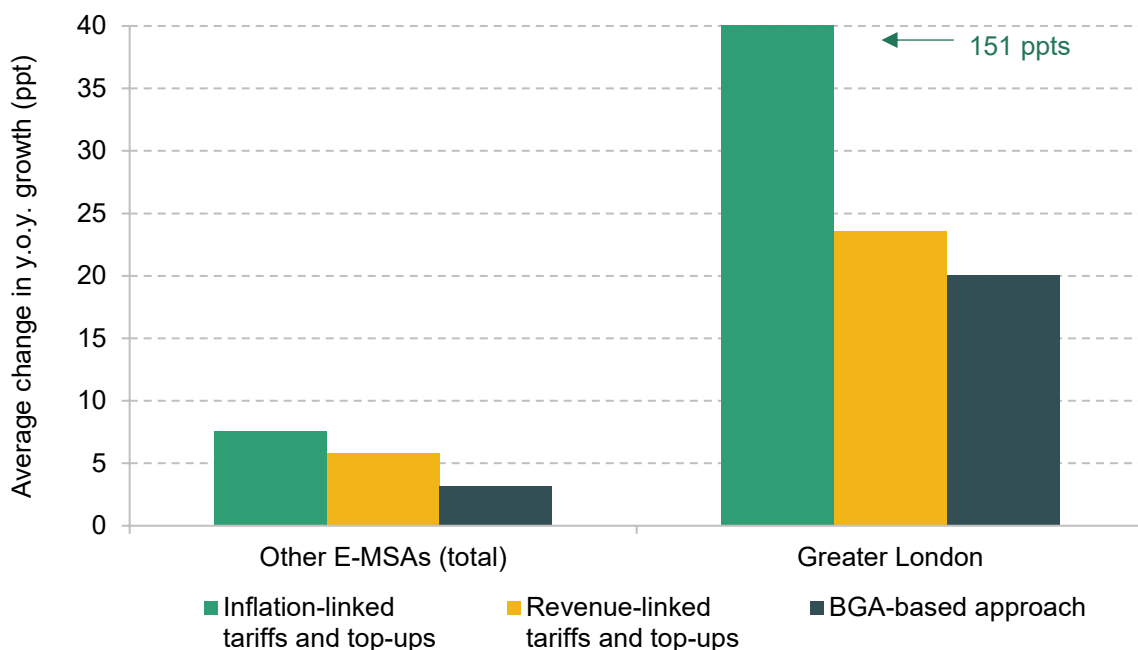
Scenario 4. A BGA-based approach would provide meaningful protection against common revenue shocks

Our final scenario illustrates the potential for a BGA-based approach to meaningfully reduce the volatility of net revenues for MSAs – provided that the UK government can set the accompanying block grant funding on a long-term basis. In particular, we assume that each MSA's pre-equalisation (gross) revenues grow by 2% a year in real terms, on average, but that year-on-year growth rates are volatile and correlated across MSAs (with a correlation coefficient of 0.75), so that each MSA's revenues usually (but not always) follow the same national cycle. The volatile part of the growth rate is calibrated to have a standard deviation of 5.9 percentage points to match the degree of volatility observed for non-London MSAs from 2011–12 to 2019–20. We then compare the volatility of net revenues for the tariff and top-up approaches and the BGA-based approaches, assuming that the block grant that would be required alongside the BGA-based approach is increased at a steady 2% a year in real terms. Our measure of volatility is the average year-on-year difference in the growth rate of net revenues, measured in percentage

points. To ensure our results reflect the most likely effect of these systems, we run 1,000 simulations (for each MSA for 10 years) and report the median degree of volatility in net revenue across all simulations (to avoid extreme values affecting the measure disproportionately).

Figure 9.14 shows the resulting estimates of volatility: the green bars if equalisation was undertaken by inflation-linked tariffs, the purple if it was undertaken by revenue-indexed tariffs and top-ups, and the yellow bars if it was undertaken by BGAs. The figure shows that for the Northern and Midlands MSAs, the average difference in year-on-year growth rates in net revenues would be 7.5 percentage points under inflation-linked tariffs, 5.8 percentage points for revenue-indexed tariffs and 3.2 percentage points under the BGA-based system. In other words, revenue-driven volatility would be around half as high under the BGA-based approach as under the tariff-based approaches.

Figure 9.14. Volatility in growth of net revenues under block grant adjustment (BGA) approach and tariffs and top-ups, if underlying income tax revenues grow by around 2% a year in real terms in each area but are subject to shocks

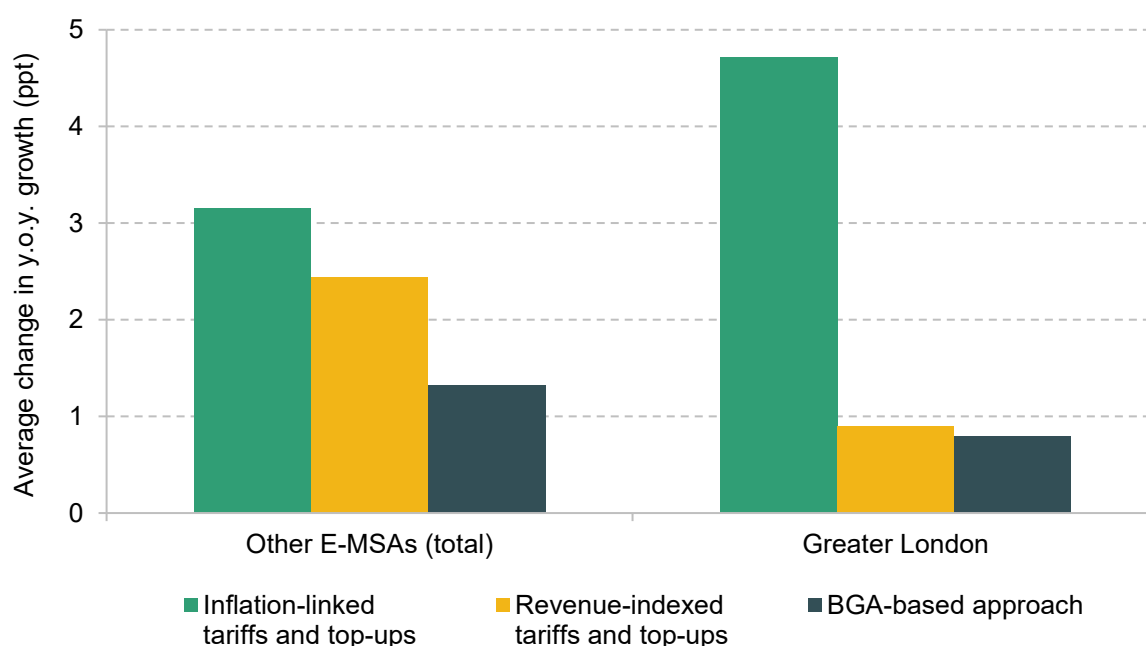


Note: Vertical axis for Greater London is truncated at 40 percentage points. Median volatility for Greater London with inflation-linked tariffs and top-ups was 151 percentage points across 1,000 simulations. Reflects volatility in post-equalisation (net) revenues under same assumptions as Scenario 1, but with year-to-year volatility in growth in underlying income tax revenues (around the same 2% trend real-terms growth rate).

Source: Authors' calculations using Office for National Statistics (2025) and HM Revenue and Customs (2026).

For Greater London, volatility would be extremely high under inflation-linked tariffs: the average difference in year-on-year growth rates in net revenues would be 151 percentage points. This reflects the fact that Greater London's large tariffs (initially 94% of gross revenues given a 10% assignment share) would mean even modest volatility in pre-equalisation (gross) revenues would translate into very high volatility in net revenues. Indexing the tariffs in line with average revenues would address most of this excess volatility: the average difference in year-on-year growth rates in Greater London's net revenues would be 24 percentage points. This is because with Greater London's tariff being so large and revenue shocks correlated across the country, varying the tariff up and down with national revenue growth would insulate Greater London from most of the volatility in its own assigned income tax revenues. The BGA-based approach would further reduce the average difference in year-on-year growth rates in net revenues to 20 percentage points – a smaller proportionate fall than for the Northern and Midlands MSAs.

Figure 9.15. Volatility in growth of overall funding under block grant adjustment (BGA) approach and tariffs and top-ups, if underlying income tax revenues grow by around 2% a year in real terms in each area but are subject to shocks



Note: Reflects volatility in MSAs' overall funding, assuming the portion of each MSA's total funding in 2026–27 (Figure 9.2) which is not from their integrated settlement is fixed in real-terms every year. Scale of y axis differs from that in Figure 9.14.

Source: Authors' calculations using Office for National Statistics (2025) and HM Revenue and Customs (2026).

Once again, if we were to examine volatility in net revenues relative to overall funding, this would make a very substantial difference for Greater London in particular. In fact, as shown in Figure 9.15, volatility in overall funding in the capital would be similar to that in other MSAs with inflation-linked tariffs (4.7 percentage points compared with 3.2 percentage points); with

other approaches, it would be *less* volatile from year to year than the average across other MSAs. This reflects that London's integrated settlement funding – which we assume in these scenarios will be replaced by revenue assignment – represents a much smaller share of its overall funding (4%) than the average across other MSAs (around 31%). How difficult managing volatility in assigned revenues is in practice for MSAs will depend on the extent to which other parts of their overall funding is ring-fenced – a large share of Greater London's funding is ring-fenced for police services and social housing investment, for example – as well as on their existing reserves and capital borrowing powers.

Summary

Taken together, these scenarios therefore illustrate that choices over the precise revenues to assign to (different) MSAs and the design of equalisation arrangements will have very important implications for both the funding levels and risks faced by different MSAs. Increasing initial tariffs (and top-ups) in line with average revenue growth rather than inflation could prevent Greater London's net income pulling ahead to the tune of billions of pounds a year even if its pre-equalisation (gross) revenues grew in line with the rest of the country – and mean more for the UK government to redistribute around the rest of the country (Scenario 1). A lower assignment share for London would also limit the risk of Greater London pulling ahead or falling behind, albeit by reducing its financial incentives for growth (Scenario 2). And the amount of insurance against cyclical volatility that a BGA-based system could provide relative to a tariff and top-up system would be meaningful – provided that underlying block grants could be set out on a long-term basis (Scenario 4). Finally, comparisons of net revenue growth under assignment on a by-band approach and on a flat-percentage-of-revenue approach illustrate how different aspects of the assignment and equalisation system – how much revenue is assigned, what form assignment takes, and the indexation of tariffs and top-ups – interact (Scenario 3). The UK government should account for this in its modelling and decision-making.

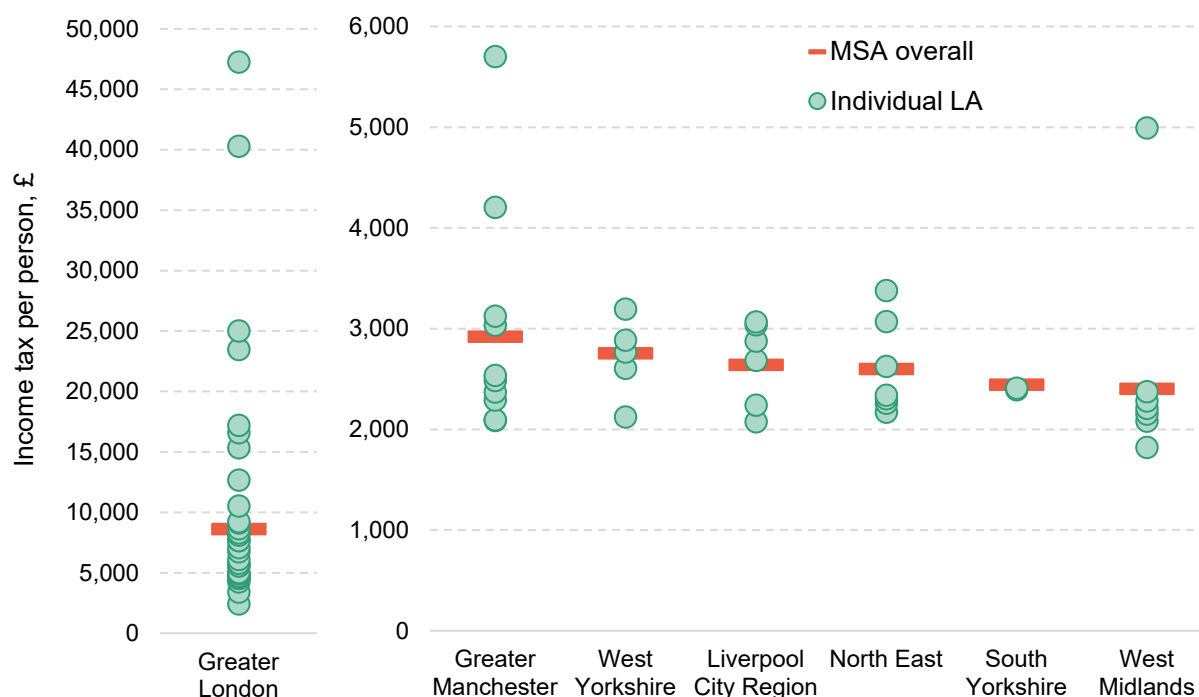
9.8 Should income tax revenue assignment extend to local authorities too?

While the government has confirmed that most local authorities as well as mayoral strategic authorities will from April 2027 see part of their grant funding replaced with an increased share of business rates revenues, local authorities are not currently set to receive an assigned share of income tax.

There are a number of reasonable arguments in favour of focusing on MSAs rather than local authorities for income tax assignment in the first instance. First is the function of strategic authorities, with both their powers and spending relating to economy-related services and

investments. In contrast, local authorities spend the largest share of their budgets on demand-led services for vulnerable residents, such as social care services – and the government may be less willing for funding for such services to vary based on local income tax revenue performance (particularly given local authority funding already varies due to the pre-existing business rates retention scheme).³⁵

Figure 9.16. Comparison of income tax revenues per person for selected MSAs and their constituent local authorities, 2023–24 (2026–27 prices)



Note: Shows the seven E-MSAs that received an integrated settlement in 2026–27. A separate vertical axis has been used for Greater London.

Source: Authors' calculations using Office for National Statistics (2025), HM Revenue and Customs (2026) and Office for Budget Responsibility (2026a).

Second is the geography of strategic authorities, which are closer to covering functional economic areas, including the more affluent and more deprived parts of city regions (such as Trafford and Rochdale in Greater Manchester, or Kensington & Chelsea and Barking & Dagenham in Greater London). In contrast, local authorities cover much smaller areas, and there is even greater variation in revenue levels and trends, and volatility, than at strategic authority level. This is illustrated in Figure 9.16, which compares differences in revenues per person as of 2023–24 for selected MSAs and their constituent local authorities (in today's prices). For

³⁵ Of course, there is also the potential for business rates revenues to diverge from the need for such demand-led services at a local level too. But local authorities still make most planning decisions, and these can directly influence local business rates revenues.

example, while at an MSA level revenues per person varied by a factor of just over 3.5-fold between the highest (Greater London, £8,590) and the lowest (West Midlands, £2,400), at a local authority level they varied by a factor of over 25 (City of London, £47,260, versus Sandwell, £1,820).³⁶ Indeed, nine local authorities in Greater London had revenues over £10,000 per person, while all bar one of those in the West Midlands (Solihull) had revenues below the West Midlands MSA average.

There have, though, been multiple calls for greater devolution of revenues to local authorities as well as strategic authorities, including by the Local Government Association (2020, 2022 and 2024), the County Councils Network (2025) and the All Party Parliamentary Group on Local Government (2026). These mostly emphasise the potential for devolved tax and revenue-raising powers to enable councils to have more ways to directly raise funding than solely council tax.

Assigning local authorities a share of income tax would not provide them with such direct revenue-raising powers. But, as with strategic authorities, it could provide a stronger financial reward and incentive for supporting economic growth, as well as a long-term buoyant source of revenue stretching beyond annual or three-yearly local government finance settlements. However, the nature of the services provided by local authorities would suggest more focus on equalisation, insurance and long-term stability of funding (and less on incentivisation) than at the strategic authority level, if a share of income tax or other tax revenues were to be assigned in future.

Assignment for local authorities could be operated in several ways. The government could directly assign revenues to them in place of part of their grant funding (as with MSAs), enabling it to implement a standardised equalisation system for all local authorities. Alternatively, it could assign further revenues to MSAs, and require them and their constituent local authorities to agree how revenues should be shared within their areas. However, if MSAs wanted to insulate local authorities from revenue divergences, volatility and uncertainty, that would mean the MSAs bearing the associated risks instead.

If in future, rather than assigning income tax revenues, the government decides to allow subnational variation in tax rates, there would perhaps be a stronger case for granting such rate-varying power to local authorities as well as strategic authorities. In particular, local authorities are responsible for a set of services – most notably, adult social care services – for which spending needs are expected to increase substantially over time (Office for Budget Responsibility, 2026b). Currently, local authorities can raise revenues directly only via council tax, otherwise relying on (uncertain) growth in retained business rates and central government

³⁶ These estimates relate only to those lower-tier local authorities within the selected MSA areas shown in Figure 9.16.

grant funding. The power to raise revenues through a major tax such as income tax would provide an important additional way for local authorities to vary their budget (up or down) to better reflect local preferences and to support financial sustainability. More local revenue-raising powers could reduce the pressure on the UK government to raise revenues to pay for the increasing demand for (and costs of) local as well as national public services. Greater reliance on local revenue-raising powers need not imply less redistribution across the country: as it now once again does for council tax, the UK government could continue to redistribute between local authorities on the basis of how much they would raise if they set the average local income tax rate.

Amin-Smith, Harris and Phillips (2019) discuss the options for the design of a local income tax. They argue that a flat-rate local income tax (such as in Scandinavia) would have several advantages over a progressive one, including less inequality in revenues, less uncertainty and volatility over revenues, and less scope for either upwards or downwards pressure on the tax rates charged on the highest incomes. However, the design of a local income tax is a potential issue for a future Budget, rather than the upcoming Budget and fiscal devolution roadmap.

9.9 Concluding remarks: the key decisions

The UK government has confirmed its intention to assign a (bigger) share of business rates revenues and a share of income tax revenues to England's mayors in lieu of part of their current grant funding. This chapter has shown there are several important decisions on how this will work in practice that need to be made.

First and foremost is the main objective of revenue assignment. This should then guide decisions about how much revenue to assign and how much ongoing equalisation of revenues to undertake. The government has made clear it wants the system to balance rewards for growth with fairness between places with different spending needs; but where should the balance lie?

If the government decides that it is the provision of financial rewards for growth (and the ability to borrow against and re-invest these rewards) that is the most important way in which the policy could improve outcomes, then assigning a larger share of revenues and equalising less of the subsequent changes in revenues would make sense: mayoral strategic authorities need sufficient skin in the game to make it worth playing.

On the other hand, if the government decides that the biggest potential benefit is longer-term clarity over funding and hence greater scope for longer-term planning and investment by mayors that is the main benefit of revenue assignment, then it would make sense to equalise more: funding will be more predictable if MSAs are insulated from more of the volatility and potential divergences in local revenues over time.

The government may decide both rationales for revenue assignment (‘rewards’ and ‘funding clarity’) are important, but it will still need to decide which is more important. Answers to several related questions should help with this question, and guide how much revenue to assign and how much to equalise for post-assignment changes in the revenues of different MSAs:

- **How much influence the government, MSAs and other stakeholders believe mayors have over local business rates and income tax bases.** As we have discussed, there are clear links between MSAs’ powers and responsibilities and these tax bases, but how important MSA policy and investment are for local revenue growth relative to other factors is uncertain. The bigger the potential influence of MSA behaviour, the more scope there is for financial incentives to improve outcomes. Conversely, if the major drivers of local assigned revenue performance are believed to be outside MSA control, then more of the changes in revenue represent ‘luck’ (or a lack thereof) rather than ‘reward’ (or ‘punishment’) for local policies. In that case, more ongoing equalisation of revenues would make sense to insulate MSAs from this financial risk.
- **How changes in the spending needs of MSAs relate to changes in assigned revenues.** Greater divergences between spending needs and underlying trends in business rates and income tax revenues would imply more ongoing equalisation – to limit the scope for divergence. As we have discussed, given a large share of the grants that are likely to be replaced by assigned revenues relate to capital spending, and capital spending tends to be ‘lumpier’ than resource spending, the potential for divergences between MSAs’ assigned revenues and spending needs may be relatively high.
- **How willing the government, MSAs and other stakeholders are to see divergences in revenue performance lead to divergences in funding for mayors’ economy-related functions and investment.** In part, this should reflect views on how important MSA spending and investment are for local economic development and well-being. But fundamentally it is a political question about where we, as a society, think the balance between local and national responsibility for funding the type of services and investments MSAs are responsible for lies.

Our analysis has also shown that while the trade-off between incentives for revenue growth and equalisation according to needs cannot be avoided, it can be ameliorated. Assigning income tax revenue on a by-band basis, increasing initial equalisation payments (such as ‘tariffs’ and ‘top-ups’) over time in line with average growth in assigned tax revenues, and assigning a lower share of revenues to London than to the other MSAs could all reduce the scope for divergences in funding over time, and should be seriously considered by the government. But as our scenario analysis has shown, the impacts of these different choices do interact – by-band approaches do not *always* reduce the scope for divergence, depending on other design choices – and these approaches come with trade-offs that need to be considered:

- Assigning revenues from a fixed number of percentage points of each tax band (e.g. 3ppt) would mean MSAs gain just as much from boosting the income of basic-rate taxpayers as of higher- and top-rate taxpayers – rather than less, as is the case if a flat share (e.g. 10%) of all revenues is assigned. It would also insulate MSAs from the revenue effects of some central government decisions, such as changes in tax rates and in the higher- and top-rate thresholds. But such a system would also mean MSAs would not benefit as much from ‘fiscal drag’ – the boost to revenues from people moving up over tax thresholds as incomes outpace tax thresholds. Thus, while such a system *may* reduce divergences in revenue trends between MSAs, it will also likely mean lower average growth in assigned revenues too – with more of the growth instead continuing to flow to the UK government to allocate across the country as a whole.
- Increasing initial equalisation payments in line with average revenue growth would keep redistribution between individual MSAs and between MSAs and the UK government more up to date without weakening incentives for growth – but would be a little more complex to operate. It would also tend to favour different areas from the inflation-linked equalisation payments that mayors may already be familiar with from the business rates retention scheme (BRRS).
- Assigning a lower share of local tax revenues to the Greater London Authority than to other MSAs would reduce the scope for Greater London’s net revenues to diverge (upwards or downwards), but would also weaken the financial incentives of policymakers in the capital to boost local growth.

Decisions will need to be taken on a range of other issues. The existing BRRS and systems in other countries suggest floors, ceilings and/or tapers to insulate MSAs’ funding from the biggest decreases or increases in assigned revenues could be sensible – especially if big changes are more likely to be due to factors outside mayors’ control. A system of revenue forecasting and reconciliation to out-turns will also be needed – which the BRRS and devolved tax arrangements for Scotland and Wales can provide templates for. Consideration needs to be given to whether such a process, when combined with MSAs’ existing reserves and capital borrowing powers, will provide sufficient flexibility to address remaining volatility in assigned revenues, or whether further borrowing powers may be required, again as in Scotland and Wales.

The fiscal devolution roadmap will also need to confirm the pace of change: although the government has confirmed that income tax assignment will apply to all MSAs and begin in April 2028, it is not fully clear whether this marks the start of a roll-out or the date all MSAs will swap grants for assigned revenues. With international evidence suggesting institutional capacity and governance quality are important elements of successful fiscal devolution, a phased roll-out, starting with the most mature E-MSAs, may be less risky. This would enable investment in the finance and strategy teams of other MSAs, as well as provide time for improvements to political decision-making. However, if revenue assignment does prove successful, too long a delay in

rolling it out to the rest of England may risk entrenching inequalities in strategic authority performance – and hence local economic outcomes.

It is unclear how long-term the roadmap will be. Increased business rates assignment will start next April, with income tax assignment beginning from April 2028. But given the Burnham administration's clear belief in devolution as a way to improve services, support growth and rebuild engagement between government and the public, the government will need to decide whether to set a longer-term destination for reform. This could include powers for mayors to introduce new taxes beyond their planned tourism tax powers and/or to move from income tax *assignment* to partial *devolution* in the future. Such a move towards greater fiscal devolution would bring additional administration and compliance costs, as well as the potential for tax rate differences to distort the location of economic activity. But it would also give MSAs a more direct lever to vary both their funding and the post-tax incomes of their residents. And it may increase the benefits of extending arrangements to local authorities too, given their currently limited options to raise revenues to cover the rising costs of the core public services they provide – although the government would need to think carefully about the balance between local and national responsibility for raising these revenues.

With devolution at the heart of the government's agenda, evidenced and justified decisions on these different issues will be important not only for the upcoming roadmap and Budget – but for the government's broader direction and legacy.

Appendix 9A. Methodology

Estimating strategic and local authority funding in 2026–27

To estimate funding on a consistent basis across strategic and local authorities (Figures 9.2, 9.3 and 9.4), we use budget/forecast data published by MHCLG for 2026–27, from three sources: Revenue account (RA) data and Specific and special revenue grants (SG) budget data, both from Ministry of Housing, Communities and Local Government (2026b) and Local authority capital expenditure and receipts (CER) from Ministry of Housing, Communities and Local Government (2026c). Components of funding are calculated as follows:

- **Resource grants** = Revenue Support Grant (RA line 951) + Police Grant (RA line 956) + Total Revenue Grants within AEF (SG line 699)
- **Council tax** = Council tax requirement (RA line 990) + Collection fund surpluses and deficits for Council Tax (RA line 980)
- **Business rates** = Retained income from Rate Retention scheme (RA line 970) + Business Rates Supplement (GLA only) (RA line 893)
- **Other resource funding** = Appropriations to/from other earmarked financial reserves (RA line 915) + Appropriations to/from unallocated financial reserves (RA line 916) +

Community Infrastructure Levy (RA line 894) + Interest and investment income: external receipts and dividends (RA line 886) – Capital Expenditure charged to the GF Revenue Account (RA line 865) + External Trading Accounts net surplus/deficit (RA line 831) + Integrated Transport Authority levy (RA line 822) + Waste Disposal Authority levy (RA line 824) + London Pensions Fund Authority levy (RA line 827) + Other levies (RA line 828)

- **Capital grant funding** = Grants from central government departments (CER) + Grants from non-departmental public bodies (CER) + Grants from other local authorities (CER) + Grants from GLA bodies (CER)
- **Capital borrowing** = Total prudential borrowing (CER)
- **Other capital funding** = Total capital receipts used to finance capital expenditure (CER) + General Fund Revenue Account (CER) + Grants from private developers & leaseholders (CER)

For South Yorkshire and West Yorkshire strategic authorities, we add in funding for the South Yorkshire and West Yorkshire Police and Crime Commissioners respectively, to reflect that the mayors of these authorities have responsibility for police services in their areas.

Note that our approach aims to avoid double counting of funding that can be reflected in both resource and capital accounts and has been checked with officials from the Ministry of Housing, Communities and Local Government. However, the design of the forms means some relatively small expenditures may unavoidably be double counted.

For forecast business rates revenues in each area (Table 9.4), we use line 12 from part 1 of published NNDR1s for 2026–27 (Ministry of Housing, Communities and Local Government, 2026d). These reflect the total forecast non-domestic rating income collected by billing authorities in areas currently covered by mayoral strategic authorities, whether or not they are retained locally. This includes rates actually collectable from rate payers, as well as section 31 grants which are paid to compensate authorities for the cost of changes to the business rates system.

Modelling income distributions and tax revenue by local authority

Estimates of actual revenue from income tax, by MSA (Table 9.5 and Figure 9.6) and local authority (Figure 9.16), are taken from HMRC estimates (HM Revenue and Customs, 2026). Revenues from a 10% share of overall income tax revenues can be directly calculated from these.

To estimate the revenues that would be obtained from a given number of percentage points of each tax band, we combine three data sources:

- For the bottom 90% of the earnings distribution, we use the Annual Survey of Hours and Earnings (ASHE), which provides earnings at each percentile for local authorities within the relevant MSAs (Office for National Statistics, 2023).
- We then use the Survey of Personal Incomes (SPI) to derive region-specific ratios between earnings and taxable income at each percentile and apply these ratios to scale ASHE earnings up to an estimate of taxable income for the same 90% of the distribution (HM Revenue and Customs, 2025).

Table 9A.1. Estimates of income tax revenues from each tax band by mayoral strategic authority, 2023–24

	Basic rate	Additional rate	Higher rate
Greater London	30.0%	26.9%	43.1%
Cambridgeshire & Peterborough	45.7%	27.5%	26.8%
Cheshire & Warrington	47.5%	28.4%	24.0%
Sussex & Brighton	50.6%	28.8%	20.6%
York & North Yorkshire	52.5%	27.6%	19.9%
Hampshire & the Solent	53.2%	30.2%	16.6%
West of England	56.0%	30.2%	13.8%
Greater Manchester	62.8%	25.5%	11.6%
Hull & East Yorkshire	67.3%	22.7%	10.0%
East Midlands	65.4%	25.1%	9.5%
Tees Valley	67.3%	23.8%	8.9%
West Midlands	68.3%	23.3%	8.5%
West Yorkshire	66.4%	25.2%	8.4%
North East	68.4%	24.0%	7.6%
South Yorkshire	71.2%	22.5%	6.3%
Liverpool City Region	71.1%	23.6%	5.3%
Greater Lincolnshire	71.4%	23.4%	5.2%
Cumbria	72.7%	23.3%	4.0%
Total across MSA areas	46.0%	26.5%	27.5%

Source: Authors' calculations using Office for National Statistics (2023) and HM Revenue and Customs (2025 and 2026).

- For the top 10% of the distribution, we fit a Pareto distribution to each local authority's taxable income distribution, choosing the shape parameter so that simulated income tax receipts – calculated by applying the historical tax schedule to the combined distribution – match HMRC's published receipts for that local authority as closely as possible (HM Revenue and Customs, 2026).

Combining the bottom 90% and the fitted top 10% gives a full estimated income distribution for each local authority in each year, from which we calculate revenue raised from each income tax band. These are then aggregated to MSA level. The proportion of total income tax revenues in each MSA area that we estimate were raised from each tax band are shown in Table 9A.1. Note that these are estimates only.

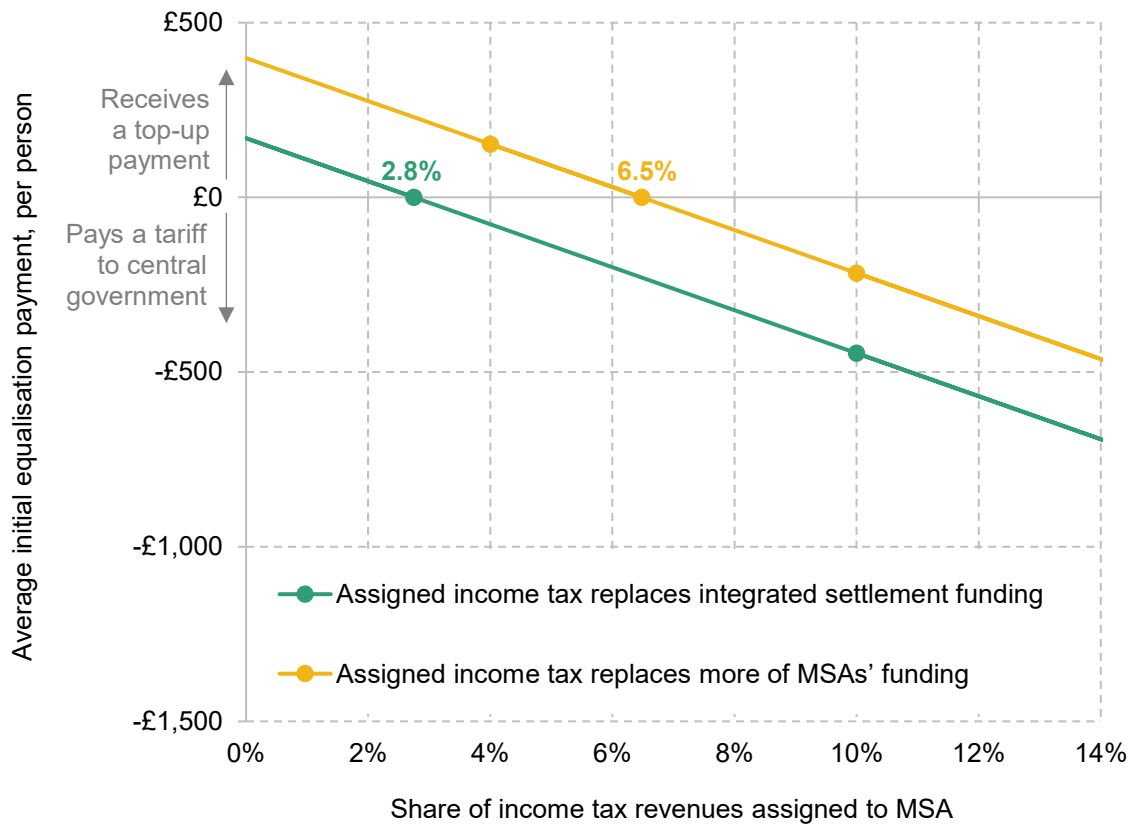
The forward-looking scenarios in the analysis in Section 9.7 start from 2028–29 estimates of income tax revenue, overall and by band, for each MSA. These figures are derived by projecting 2023–24 out-turns forward in line with projected UK-wide income tax growth to 2028–29. These are used as the starting point for all scenario modelling.

Appendix 9B. Illustration of how equalisation payments could operate

A formal system of equalisation payments to/from MSAs could allow government to achieve overall fiscal neutrality in the first year that revenue assignment is introduced, as well as revenue neutrality for each MSA. This is true whatever initial stock of income tax revenues government wants to assign to MSAs, and whatever grant funding it wants these assigned revenues to replace. If an MSA's assigned revenues exceed the grants it forgoes, it pays a tariff equal to the difference, reducing its net revenues to the same level as if revenue assignment had not been introduced. If an MSA's assigned revenues are lower than the grants forgone, it receives a top-up payment from central government equal to the difference, increasing its net revenues to the same level.

The green line on Figure 9B.1 shows the options open to government if it decided to replace integrated settlement funding for the seven MSAs that receive it in 2028–29 and wanted to achieve overall fiscal neutrality. The share of overall income tax revenues assigned would then imply different equalisation payments to or from MSAs on average. Total planned integrated settlement funding in 2028–29 is equivalent to 2.8% of total projected income tax revenues collected from these MSA areas in the same year; if this share of revenues were assigned, equalisation payments could average zero (although individual MSAs would need to pay tariffs or receive top-up payments). Assigning these areas a 10% share of income tax revenues would be consistent with MSAs paying a tariff to central government of £446 per person on average.

Figure 9B.1. Combinations of share of income tax revenues assigned and average equalisation payments that deliver overall fiscal neutrality



Note: Real-terms (2026–27 prices) assuming assigned income tax revenues replace funding in 2028–29 for the seven MSAs that receive integrated settlements. Income tax revenues in each MSA area are projected based on 2023–24 receipts by local authority and the OBR's March 2026 estimates for UK-wide increases in nominal income tax receipts.

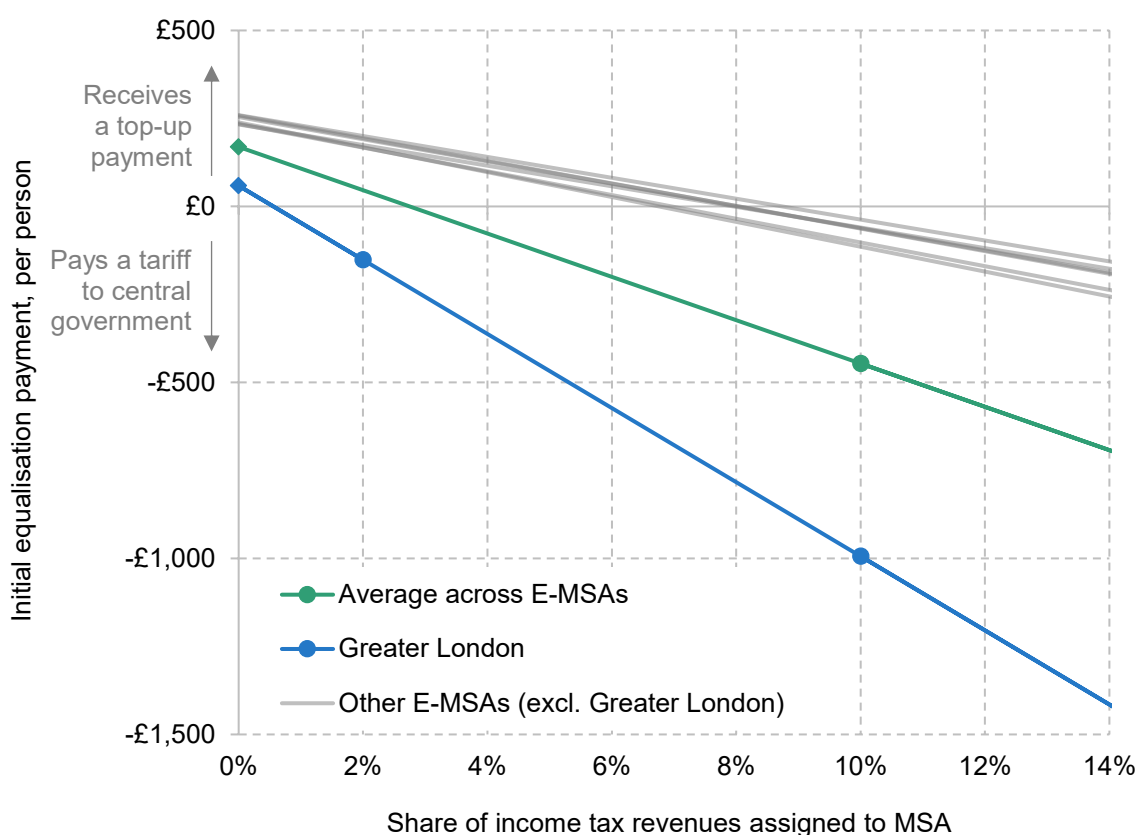
Source: Authors' calculations using Office for National Statistics (2024 and 2025), HM Revenue and Customs (2026) and Office for Budget Responsibility (2026a).

Government could choose any other set of existing grant funding to replace with assigned income tax revenues. As an illustrative example, it could choose to replace funding equal to 6.5% of income tax revenues in these areas. This would be approximately the same as replacing all of the resource and capital grants and council tax revenues they budgeted to receive in 2026–27, less the amount they expected to spend on police services. The yellow line shows the combinations of shares of income tax assigned and average tariff or top-up payments that would be consistent with overall fiscal neutrality in that case. If government assigned MSAs 10% of income tax revenues, they would need to pay a tariff of £217 per person on average to deliver fiscal neutrality. If it assigned only 4% of income tax revenues, MSAs would need to receive a top-up payment of £153 per person on average.

Figure 9B.2 shows the options open to government if it decided to replace integrated settlement funding for the seven MSAs that receive it in 2028–29 and wanted to deliver revenue neutrality

for each MSA – leaving them no better or worse off in 2028–29 than if revenue assignment has not been introduced. The intercept of the line for an MSA (the diamond marker) reflects its per-person integrated settlement funding; the slope reflects estimated income tax revenues per person in its area. Higher income tax revenues result in a steeper line, as any given percentage point increase in the share of income tax revenues assigned to an MSA yields more gross revenue per person, and must be offset by a larger tariff payment if the MSA is not to see an immediate boost to its overall funding.

Figure 9B.2. Combinations of share of income tax revenues assigned and equalisation payments that deliver revenue neutrality for individual MSAs when assigned revenues replace integrated settlement funding



Note: Real-terms (2026–27 prices) assuming assigned income tax revenues replace funding in 2028–29 for the seven MSAs that receive integrated settlements. Income tax revenues in each MSA area are projected based on 2023–24 receipts by local authority and the OBR's March 2026 estimates for UK-wide increases in nominal income tax receipts. Lines represent combinations such that each MSA would be no better or worse off if assigned income tax revenues replaced their integrated settlement funding in 2028–29.

Source: Authors' calculations using Office for National Statistics (2024 and 2025), HM Revenue and Customs (2026) and Office for Budget Responsibility (2026a).

The blue line shows the combinations that would deliver revenue neutrality for Greater London, and the grey lines for the other six MSAs. The intercept of Greater London's line (the blue diamond) is lower as it receives less integrated settlement funding (£59 per person) than the other MSAs. The blue line slopes more steeply downward, reflecting that income tax revenues

per person are higher in the capital. The combination of these two factors explains why our scenarios in Section 9.7 involved Greater London paying a much higher per-person tariff than other MSAs. If government rolled in integrated settlement funding and assigned London 10% of income tax revenues, we estimate it would need to pay a tariff of £994 per person to be made no better off in 2028–29. With a smaller assignment share (e.g. 2% of overall revenues), the required tariff would be much smaller (£152 per person). The other six MSAs that receive integrated settlements would need to receive a top-up payment if they were assigned less than 7–9% of income tax revenues, and to pay a tariff if they were assigned a greater share.

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