Zoltán Gálik

THE BRITISH LABOUR GOVERNMENT IN A FISCAL TRAP

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SUMMARY

- Labour and Keir Starmer's popularity had fallen sharply by autumn 2025, while voters' economic perceptions were increasingly shaped not only by macroeconomic indicators but also by the delivery of campaign promises and the government's communication strategy.

- The UK economy continues to bear the cumulative burden of successive crises over the past fifteen years (the sovereign debt crisis, Brexit, the war in Ukraine, and the energy shock); growth and productivity remain persistently weak, and both the deficit and the debt ratio have become entrenched at high levels.

- In the second half of 2025, inflation remains above target and growth is low and volatile, while the freeze of tax thresholds operates as a form of stealth taxation that compresses net incomes and intensifies cost-of-living pressures.

- Fiscal headroom is exceptionally tight, as debt and debt-interest costs are rising, the budgetary buffer has shrunk markedly, and it is difficult to prevent further deterioration in public services without meaningful revenue increases.

- The government's room for manoeuvre is fundamentally constrained by its pledge to keep "working people's taxes" unchanged, effectively removing the largest revenue-raising mass taxes from the consolidation toolkit. As a result, the political debate is shifting toward reforms affecting higher earners and accumulated wealth, the narrowing of reliefs and loopholes, and measures that imply a small additional burden for individual taxpayers but generate substantial revenue in aggregate—while lasting debt stabilisation also requires reforms that raise public-sector efficiency and strengthen the economy's supply-side growth capacity.

The public standing of the British Labour Party had deteriorated markedly by autumn 2025, barely more than a year after its historic general election victory. In parallel, the popularity of the Prime Minister, Keir Starmer, has fallen to a historic low (Opinium, 2025), while the advance of the populist Reform UK party has been striking across the country. The analysis below examines the economic – and within that, primarily fiscal – drivers of this loss of support, as well as the possible responses available to the government. The evolution of popularity is, of course, also shaped by other economic, political and social factors, but their detailed examination falls outside the scope of the present study.

Opinion polls consistently rank the rise in the cost of living among voters' most pressing concerns. On the question "which party would handle the economy better?", Labour's lead narrowed gradually over the course of the year, and surveys indicate that voters' assessment of the economic situation depends not only on the underlying macroeconomic data, but increasingly on the fulfilment of electoral promises and on government communication (YouGov; Ipsos Issues Index, October 2025).

In the 2026 budget debate, the possibility of tax increases may realistically arise. Such a move would be interpreted as a breach of electoral pledges and could trigger a major political storm.

The bleak outlook for the British economy

The past decade and a half has been an era of crises: the financial and sovereign debt crisis and its protracted fiscal consequences, Brexit, and subsequently the war in Ukraine and the energy crisis have all layered their effects upon one another, repeatedly preventing the British economy from shifting onto a path of sustained growth and macroeconomic balance. After the Conservative government took office in 2010, significant fiscal consolidation began rapidly; by the second half of the decade, hopes for restoring growth and balance had largely evaporated. During Liz Truss's short premiership, the radical tax-cutting experiment announced in September 2022 made the loss of market confidence tangible in the form of a mini financial crisis. This was the package that triggered a panic reaction on the markets, a sharp depreciation of sterling and a surge in yields, ultimately leading to the rapid fall of the prime minister. Although Rishi Sunak's government succeeded in stabilising the situation on financial markets and restoring at least the appearance of fiscal discipline, it failed to achieve any substantial improvement either in growth prospects or in the balance of the public finances. GDP growth remained subdued, productivity essentially stagnated, while the deficit and the debt ratio remained persistently high.

By the second half of 2025, the macroeconomic position of the British economy had severely constrained the government's room for manoeuvre in economic policy. The consumer price index stood at 3.8 per cent in September, still above the government's 2 per cent target, while quarterly growth indicators remained low and volatile: GDP expanded by 0.7 per cent in the first quarter of 2025 and by 0.3 per cent in the second. Economic developments have had a doubly negative impact on households: prices are falling only slowly, while the tax and contribution burden on wage growth – above all through the freezing of tax thresholds, which constitutes a hidden tax increase by pushing an ever-larger share of income into higher-rate bands – is eroding net incomes even though nominal tax rates have not changed (ONS, 2025a; ONS, 2025b). According to the OBR's March 2025 forecast, the tax-to-GDP ratio will approach a historic peak of 37.7 per cent in 2027/28 and is likely to remain at an elevated level thereafter. The rise begins with a jump in 2025/26, driven largely by the increase in employers' social contributions in place since April 2025 and by the restoration of tax burdens on capital income (OBR, 2025a, 1.16).

The government's budgetary room for manoeuvre is extremely limited. The fiscal deficit has remained persistently around 5 per cent of GDP; a substantial share of the crisis-related spending increases, originally intended to be temporary, has become embedded in the structure of the budget. The combination of a high deficit with a historically elevated level of public debt is exerting sustained upward pressure on expenditure via debt-servicing costs, the maintenance of the welfare system and defence spending, thereby narrowing the scope for future fiscal adjustment. Gross public debt, held predominantly by domestic investors, stands well above 100 per cent of GDP, while interest payments themselves constitute one of the fastest-growing items in the entire structure of public expenditure. Owing to persistently high interest rates, debt-servicing costs have become one of the most dynamic components of the budget. According to preliminary data, in September 2025 net public debt amounted to 95.3 per cent of GDP, whereas the broader indicator of net financial liabilities – the value of all government financial liabilities net of financial assets – reached 83.8 per cent of GDP (ONS, 2025c). Fiscal space – that is, the buffer represented by the gap between the deficit and debt paths permitted by the fiscal rules and the projected actual path – is small: expert analyses and press calculations suggest that it will shrink to around £10 billion by 2029/30, which, given forecast uncertainty, leaves very limited room for fiscal policy (OBR, 2025b, overview; FT, 2025). Under these conditions, fiscal policy must shift towards the revenue side if it wishes to avoid a significant deterioration in the performance of public services (the NHS, local government, the justice system) (OBR, 2025a; ONS, 2025c; FT, 2025).

To interpret the debt trajectory, it is useful to treat its constituent components separately. The debt-to-GDP ratio changes through three main channels: a) via the primary balance (tax revenues minus primary expenditure); b) via the difference between the interest rate and the growth rate, which determines whether the existing stock of debt "inflates itself" relative to the size of the economy; and c) through those discrepancies that mean public debt does not change exactly in line with the deficit (for example, asset revaluations, exchange rate effects, one-off items). The specific feature of the 2025 debt trajectory is that debt-servicing costs are structurally higher in an elevated yield environment, while medium-term growth prospects (potential growth) are modest, making the interest–growth differential unfavourable. To offset this, the fiscal rule – whose core requirement is that the net debt ratio should be falling by the final year of the forecast horizon – demands a sustained primary surplus and an expenditure and revenue structure that does not choke off growth (OBR, 2025a; ONS, 2025c). The government's room for manoeuvre is therefore simultaneously constrained by a high initial debt ratio, high interest rates and weak medium-term growth prospects. Any deterioration in one of these factors may push the debt trajectory upwards and necessitate further adjustment (OBR, 2025a; ONS, 2025c).

The economic component of the loss of popularity has been further amplified by interpretive disputes surrounding Labour's electoral pledges. In its 2024 election manifesto, Labour campaigned on the promise not to "raise taxes on working people", understood to cover the main rates of income tax, value added tax and national insurance. However, the category of "working people" has no precise legal definition, leaving the government with wide discretion as to which tax burdens it considers to fall within the scope of the pledge. This simultaneously provides an escape route for the government and an opening for accusations of broken promises, thereby deepening the communication crisis. If the pledge is interpreted to mean that broad-based tax increases on the majority who live off wages and salaries are excluded, then the most significant revenue sources are effectively ruled out from the fiscal adjustment toolkit, and deficit targets can be met primarily through cuts on the expenditure side – above all by reducing public investment. In such a situation, the most revenue-rich tax bases drop out of adjustment, leaving only "peripheral" instruments (for example targeted wealth and capital taxes) that, taken alone, do not generate sufficient revenue in the context of a deficit around 5 per cent of GDP and a high debt ratio. If we add that, for political reasons, it is scarcely feasible after the crisis years to compress further the budgets of the health service, schools, the police and local government services, a historically familiar pattern re-emerges: the government begins cutting the most deferrable and "least visible" item, public investment. While strictly maintaining fiscal discipline, several members of the cabinet – led by Chancellor Rachel Reeves – have therefore signalled that a literal interpretation of the pledge would force cuts in investment that would run counter to the objectives of growth and productivity enhancement (Reuters, 2025; IFS, 2025).

Possible directions for fiscal policy

Given the limited scope for economic policy, the key question is through which taxes meaningful additional revenue can be generated. The pledge made to “working people” severely restricts recourse to the broad-based mass taxes – above all the income tax and social contributions on labour income and the main rate of value added tax – while the government is also cautious in corporate taxation so as not to undermine the country’s competitive position. Political debate has therefore become concentrated on the reform of those taxes that primarily affect high earners and accumulated wealth (taxes on capital income, wealth and inheritance, reductions in reliefs, exemptions and loopholes), and which technically amount to tax increases but can be framed politically as a “fairer sharing of the burden”.

One particularly tempting option is the so-called “1 penny” income tax rise, which may appear negligible for the individual taxpayer but can generate substantial additional revenue when applied to the entire tax base. In British practice, the phrase “1 penny in the pound” denotes a 1 percentage point increase in the tax rate within a band – for example, within certain bands of personal income tax. “1 penny” therefore does not mean that each taxpayer pays “one penny more” per pound on their tax bill, but that the rate applied in the relevant band rises by 1 percentage point. The budgetary impact then depends on the income distribution and on which bands are affected: Treasury estimates regularly suggest additional annual revenues of several billion pounds for a 1 percentage point increase, although the exact figure depends on the specific features of the tax year and taxpayers’ behavioural responses (HMRC, 2025). By contrast, freezing thresholds – that is, fixing the boundaries of tax bands in nominal terms without indexation to inflation – increases tax burdens almost “invisibly”: as wages rise, more and more taxpayers drift into higher-rate bands even though the tax rates themselves remain unchanged. This “stealth tax increase” is a particularly sensitive area politically (HMRC, 2025; OBR, 2025a) and may contribute to further losses in popularity.

Fiscal adjustment can therefore be conceived as having three layers. In the short term, fine-tuning on the revenue side – extending the freeze on thresholds, broadening the tax base in relation to dividends, capital gains, pensions and employer-provided benefits, and implementing modest rate changes between bands – promises moderate but relatively reliable yields, at the cost of reinforcing the perception of “hidden increases in the burden”. In the medium term, the government cannot avoid improving the efficiency and capacity of the public service system by transforming the operation of public institutions, expanding digitalisation (for example through the planned digital enhancement of the NHS), and reforming public procurement and human resource management. If these reforms are not implemented, compliance with stricter fiscal rules may come at the expense of service quality. In the longer term, sustained economic growth depends on supply-side reform. Parliamentary background papers and independent research institute analyses alike highlight the consolidation of the fragmented system of tax reliefs, the need for performance-based management of public services, and the development of infrastructure for the energy transition, transport and the green transition more broadly (Lords Library, 2025; IFS, 2025). These are structural interventions that can durably reduce the debt ratio.

In sum, the collapse in Labour’s economic popularity is not the consequence of a single decision, but rather of the cumulative effect of political trade-offs forced by a high initial debt ratio, a persistently high interest rate environment, low potential growth and limited fiscal space.

To restore confidence, the British government would need, in the short term, to deliver tangible, targeted relief in the tax burden and visibly improved public services, while in the medium-term implementing tax base broadening and strengthening the supply side of the economy. If this dual objective is met, the primary budget surplus required to bend the debt trajectory downwards could become sustainable without significantly curtailing economic growth. If not, the persistence of the perception of “high taxes and poor services” may further erode the standing of the government and of the Labour Party (OBR, 2025a; YouGov, 2025; Ipsos, 2025).

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