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UNITED KINGDOM

Five ways the UK's Autumn Budget could shock us

From better fiscal headroom to surprise income tax hikes, this is how UK Chancellor John Healey's first budget could surprise investors



UK Chancellor John Healey

In a nutshell: What we expect

Higher debt interest costs look set to drive the level of 'fiscal headroom' from £24bn in March to £10bn. There's a growing sense that Chancellor John Healey would like to get this up to £15bn or higher. The government is set to modestly increase spending on the cost of living, though the total intervention is unlikely to meaningfully top £5bn and it's likely to be mostly billed as temporary to avoid counting against the main fiscal rule. We expect an increase in capital spending of roughly £10bn/year, bearing in mind this is exempt from the fiscal rule dictating that the current budget must be in surplus after five years. To rebuild headroom against that rule, we expect £5-6bn of tax hikes, likely via a higher Bank Surcharge and possibly broadening the National Insurance tax base.

In short, we don't expect the budget to deliver a material stimulus (or add materially to the already-planned fiscal consolidation). The impact on the Bank of England, which is

poised to hike rates in November, is likely to be fairly minimal.

But all chancellors like to keep a rabbit in their hat – and what follows are five ways it could surprise us.

1. Fiscal headroom goes up – not down

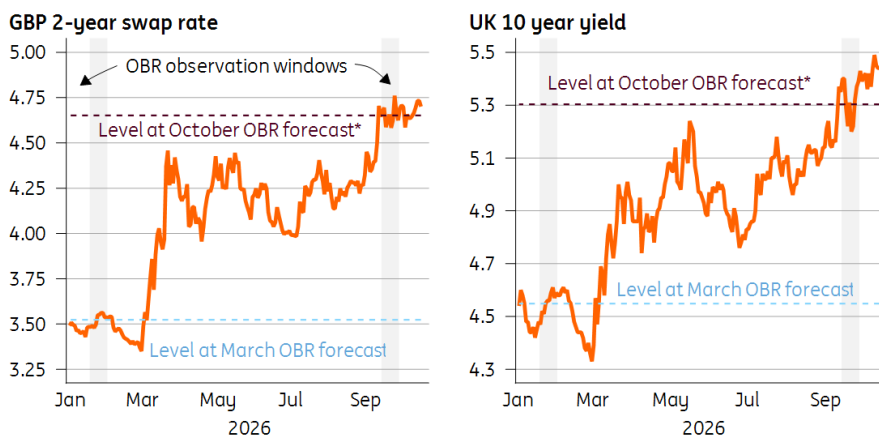
What if the UK's fiscal hole isn't nearly as bad as we think?

The widespread expectation going into the UK's Autumn Budget on 28 October is that the Chancellor is going to have to face up to higher debt interest costs with some modest tax hikes.

Bank of England rate expectations are almost a percentage point higher than they were at the time of the Office for Budget Responsibility's March assessment of Britain's public finances. 10-year bond yields are some 70 basis points higher, which, taken together, will push up debt interest spending by £11bn/year by 2029/30.

That points to a sizeable reduction in the amount of money the government has left under its main fiscal rule, which requires the current budget (day-to-day spending, including debt interest less revenue) to be in surplus within three years. Back in March, that surplus, or fiscal headroom, was projected at £24bn in 2029/30.

Debt interest costs are rising



Source: Macrobond, ING

*Based on the average rate in the 10 days up to 25 September, which likely represents the OBR's observation window for this budget

We think that headroom will have dropped to around £10bn before any corrective action. And the vibe from the Treasury suggests the Chancellor would prefer it to be above £15bn, to give

more breathing space in case of future adverse forecast revisions. That would point to some limited tax hikes.

But what if that's all wrong? The truth is, nobody really knows how the OBR will change its assessment of the UK economy. And as we saw last year, the Treasury is often inclined to talk up the doom and gloom to open up a positive surprise on the day. 12 months ago, the hit to headroom was considerably smaller than had been widely expected.

This time, any positive surprise is most likely to come from wage growth. Will the rise in energy prices spill into higher pay, just as it did in 2022? We think it won't, not least because the jobs market is much weaker, an assessment we suspect the OBR will share.

But even relatively small upgrades to wage growth can make a big difference to the government's fortunes. Since 2010, the OBR has revised the level of earnings across its five-year forecast by an average of 1.3 percentage points in absolute terms. If it did that now, say by lifting wage growth over the next two years by 0.6ppt apiece, it would add £10bn to headroom, almost perfectly offsetting the hit from higher interest costs.

There are also reasons to think the impact of lower migration projections, which some reports suggest could wipe another £7bn off headroom via lower tax revenue forecasts, could be much less than feared. The starting point for employment looks a little higher than it did back in March. The rise in global equities this year should also be helpful for capital gains tax projections.

Why does this all matter? Because the higher the headroom, the less 'need' there is to hike taxes, and if it is significantly higher than expected, the more room there is to increase spending under the fiscal rules.

The simple message is this: don't judge the Autumn Budget by the level of headroom left over.

2 2. Spending splurge

The problem with 'headroom' is not only that it's highly sensitive to the OBR's economic outlook, but that the forward-looking nature of the fiscal rules opens the door to a lot of creative accounting.

The impact of higher inflation is a case in point. This helps the Treasury through higher receipts – both VAT and income tax. Yes, it also pushes up the cost of indexed benefits. But importantly, departmental budgets don't automatically increase to offset the impact of higher prices.

That opens up a classic trick from the Treasury, which is to leave spending plans virtually unchanged in nominal terms, setting up substantially smaller real-terms budget increases across the medium term.

Even before the Iran War, government plans pencilled in real-terms cuts to per capita departmental spending in FY2029. Given some functions, like health, are 'protected', that implies much deeper cuts to smaller departments.

Suffice to say, that is unrealistic. Higher inflation will push up the wage bill across government. It would cost £12bn to simply maintain those March departmental spending plans in real terms. That's before considering the cost of ending that austerity pencilled in for later this decade, or how the government will fund its defence or social care ambitions.

A top-up to government departments is inevitable – the question is when. It looks like the Treasury wants to kick the can on these tricky budget decisions until next autumn, when it plans to release its next Spending Review, a process of allocating money across departments. No doubt the hope is that debt interest costs will have fallen and the economic outlook brightened, such that there's more space under the fiscal rules to make bigger spending commitments.

That points to a very modest package of spending measures this month, mainly targeting the cost of living. On top of the already-announced cut to VAT on energy, we'd imagine the Treasury will replicate last year's budget and lower household bills by funding a greater share of 'policy costs' from general taxation. This has the added benefit of lowering headline inflation at a particularly sensitive moment for the Bank of England. Crucially though, the government is likely to bill these moves as temporary, so they don't count under that main fiscal rule.

But if the economic picture really is better than feared, don't rule out the government going further. A decision to fully fund the UK's 3% defence commitment would be a major wildcard, though this would likely come at the expense of capital plans in other areas of government.

Ultimately, the key thing to watch is the OBR's assessment of how all these policy changes affect GDP growth and borrowing over the next year. If there's a material stimulus effect, it could add to market bets on UK rate hikes.

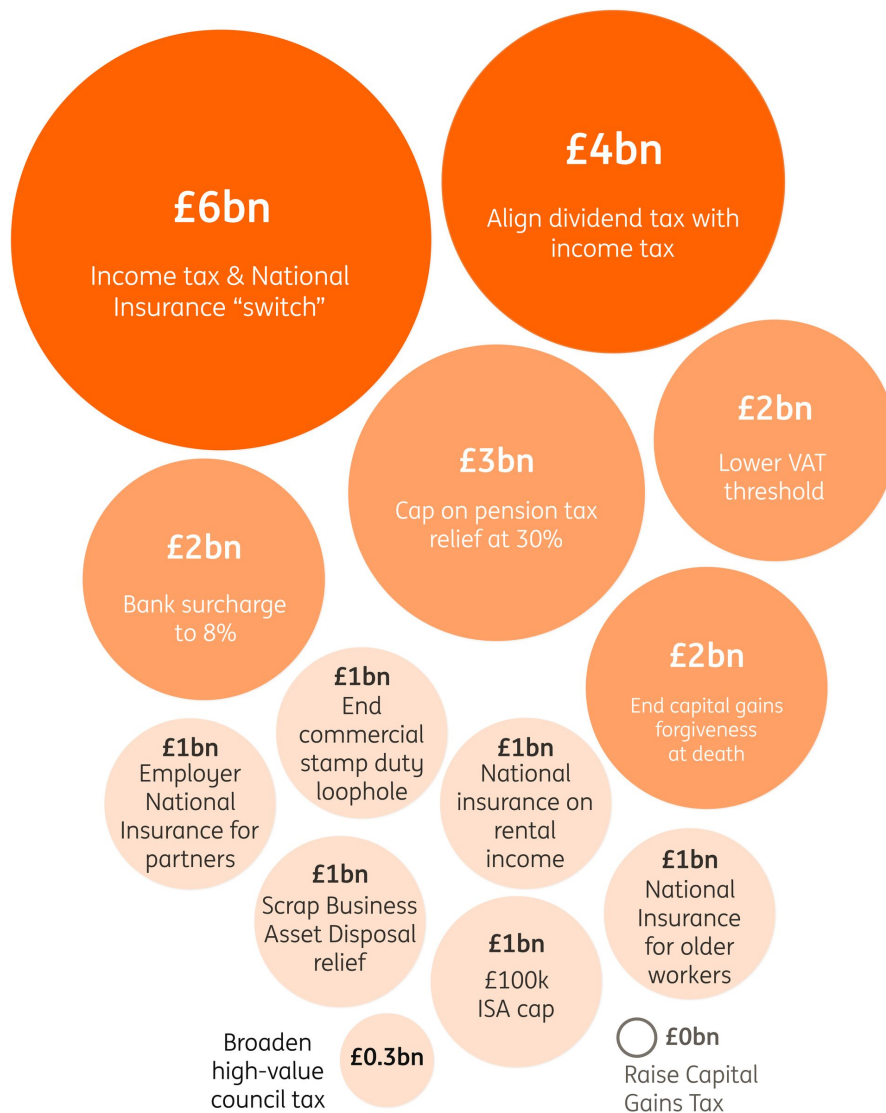
3. A manifesto break on income tax

Tax hikes are likely at the Autumn Budget, but should be very small. We're probably looking at a package of circa £5bn (0.2% of GDP). Part of the problem is that the list of viable options looks perilously small – without breaking the Labour manifesto pledge not to raise the major taxes, which together account for around 70% of total revenue.

Our best guess is that the budget will include a hike in the Bank Surcharge (raising £2bn if increased from 3% to 8%), together with a broadening of the tax base for National Insurance to landlords and partners in LLCs (together yielding around £2bn/year). Other options, like ending a loophole on stamp duty for commercial property or lowering the VAT threshold for businesses, have also been on the table.

The problem with many of these measures is that they require massive changes to stand any chance of raising material sums, risking big behavioural reactions while offering uncertain revenue potential. There's a reason why former chancellor Rachel Reeves shied away from many of the measures we outline in the chart below.

How the Chancellor could raise taxes



Source: ING calculations, Institute for Fiscal Studies, HMRC, Office for Budget Responsibility, Resolution Foundation

Is there scope for a surprise? We think there are two main ways on tax – one good, one bad.

The good? A surprise announcement of a so-called 'tax switch', a novel proposal from Resolution Foundation which would see the government simultaneously raise basic income tax and cut employee National Insurance by 2ppt. The impact on workers would be neutral, but

because income tax has a broader base (including pensions), this would raise £6bn/year.

Though not a substantial sum, it would signal to investors that Prime Minister Andy Burnham isn't afraid to go near the thorny issue of raising taxes. But in light of recent pension changes, including to the infamous 'triple lock', this feels like too much of a political gamble at this stage.

The negative surprise would be if the Treasury decided to raise the basic tax allowance. Burnham flirted with this on his first day in office; it would not only be expensive (potentially £10bn), but it would also signal that the UK's commitment to the threshold freeze – which is doing the lion's share of the planned fiscal consolidation – is waning.

4 A big rise in the National Living Wage

The minimum wage increase in April 2027, which will be announced alongside the budget, is perhaps the most important variable for the Bank of England.

This is based on a recommendation from the Low Pay Commission, which earlier this year provisionally estimated the increase at 3.7%. That's a smaller increase than over the past two years and, crucially, is not a million miles above the level the Bank considers consistent with a 2% medium-term inflation target (3.25%).

But the LPC has some flexibility in its recommendation, and one criterion is the cost of living. Higher inflation means we could see a final proposal between 4% and 4.5%. Anything above that would, we suspect, be problematic for the Bank of England and would bolster the case for higher rates.

The government is no doubt well aware of this. And there appears to be growing recognition among Labour figures, including on the left of the party, that the big minimum wage increases, coupled with previous payroll tax increases, have had a big impact on business – particularly in consumer services.

But if the LPC were to recommend minimum wage growth of close to 5%, could the government resist it? In theory, yes. But politically, we suspect not.

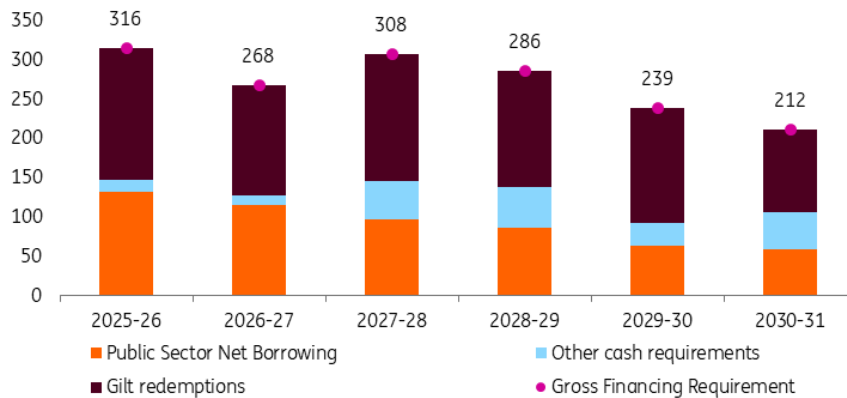
5 A surge in bond issuance

We already know that bond issuance is set to increase again in 2027, though for reasons unrelated to the UK's fiscal trajectory.

The chart below shows that in April, the Debt Management Office projected a gross financing need of £308bn, similar to the big number in FY2025. We suspect that when we get the updated DMO remit following the budget, next year's issuance could be closer to £325bn – though a greater chunk of that will likely get funded using bills, meaning the actual pick-up in

gilt sales relative to those previous plans is likely to be more modest.

How debt issuance plans broke down as of March/April



Source: Office for Budget Responsibility, Debt Management Office, ING

Other cash requirements includes financial transactions, excludes local authorities and public corporations and Network Rail net cash requirements, plus DMO financing adjustments

Still, the point is that, beneath these numbers, public sector net borrowing is still likely to be projected to keep falling through the rest of the decade. The major risk – related to some of the things discussed earlier, like larger near-term spending or surprise increases in tax allowances – would jeopardise this fundamental improvement in bond issuance in the medium term. Something investors wouldn't take kindly to.

Author

James Smith

Developed Markets Economist, UK

james.smith@ing.com

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THINK Economic and financial analysis

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