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Rachel Reeves Faces £40bn Budget Gap Pressure

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Chancellor Rachel Reeves is under increasing scrutiny as a leading economic think tank warns she faces a £40 billion shortfall in the public finances, an early test of Labour's economic credibility.

The National Institute of Economic and Social Research (NIESR) has cautioned that Reeves may be forced to raise taxes and reform council tax bands if she intends to meet her selfimposed fiscal targets. These include balancing day-to-day government spending with tax revenues by 2029-30 and reducing public debt as a share of GDP.

According to NIESR, the combination of weaker-than-expected growth, higher borrowing, and recent policy U-turns has left the Treasury with an estimated £41.2 billion gap. This leaves Reeves with limited options, particularly given Labour's campaign pledge not to increase taxes on "working people".

The institute described her position as an "impossible trilemma" trying to honour fiscal rules, fund Labour's spending promises, and avoid tax rises. NIESR called for a "moderate but sustained" rise in taxes, suggesting changes to England's outdated council tax bands, which are still based on 1991 property values. The possibility of replacing council tax altogether with a land value tax was also floated.

However, a government source told reporters that no plans are currently in place to reform council tax bands.

One likely course of action is to extend the freeze on income tax and national insurance threshold, a measure that quietly increases tax receipts by drawing more people into higher tax bands due to wage inflation. This method avoids directly raising rates and would technically uphold Labour's tax promise.

Professor Stephen Millard, NIESR's deputy director for macroeconomics, said: "With growth at only 1.3 per cent and inflation above target, things are not looking good for the Chancellor, who will need to either raise taxes or reduce spending or both in the October Budget if she is to meet her fiscal rules."

Additional pressure comes from Capital Economics, where deputy chief UK economist Ruth Gregory estimated Reeves may need to find between £15 billion and £25 billion in new taxes to maintain existing fiscal headroom. She said: "If the Chancellor is going to continue to meet her fiscal mandate, she will likely need to raise significant additional revenue."

Gregory suggested that if the requirement exceeds £20 billion, Reeves might be compelled to revisit larger taxes Labour previously ruled out, such as income tax, VAT or employee national insurance contributions. Freezing thresholds alone beyond 2027–28 could raise approximately £8 billion annually by the end of the decade.

Other options include introducing new levies, such as a health and social care tax or a defence surcharge, both effectively disguised income tax hikes. With businesses already carrying the weight of previous tax increases, Gregory concluded that "most of the burden this time will probably fall on households".

Dr Edward Thomas Jones, senior economics lecturer at Bangor University, expects Reeves to persist with the threshold freeze. He noted that discussions around wealth and inheritance taxes are gaining attention, particularly as baby boomers begin transferring assets. However, he added, "There is little international evidence that this will be effective."

Not all economists are convinced by NIESR's outlook. Julian Jessop, a senior economist, said: "Any attempt to forecast the public finances in five years is little more than guesswork." He pointed out that NIESR's previous forecast in May estimated an even larger shortfall of £57 billion.

Nevertheless, Jessop acknowledged that the Office for Budget Responsibility (OBR) is likely to echo concerns about missed fiscal targets. He blamed sluggish growth, stating the UK remains stuck in a "doom loop" where weak economic output undermines revenue, fuelling further borrowing and policy constraints.

NIESR projects the UK economy will grow by 1.3 per cent in 2025 and 1.2 per cent in 2026, modest figures that place Britain in the middle of the G7 pack. It also expects inflation to remain above the Bank of England's 2 per cent target, forecasting 3.5 per cent inflation in 2025 and 3 per cent in early 2026. This persistence, it said, stems from public spending decisions and high wage growth.

In a recent interview, Professor Adrian Pabst, NIESR's deputy director for public policy, noted that while the Chancellor's announcements on public investment were welcome, Labour's economic plans still lack coherence. "The Government needs a guiding narrative that can anchor an ambitious policy programme," he said.

Pabst stressed the need for better coordination across departments to implement pro-growth measures if Labour is to achieve its stated goal of delivering the fastest growth in the G7 and raising living standards across the country.

The Autumn Budget is shaping up to be a critical moment for Reeves and Labour. With little room to manoeuvre and high expectations, the Chancellor will soon be forced to show how she plans to reconcile her party's pledges with the hard realities of governing.