Public Pivot

How a growing state will shape the living standards outlook for 2025

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2025 will be a year with a bigger role for the state. Jeremy Hunt cut taxes in his last two Budgets and planned to pay for them with real-terms cuts to public spending in many areas. Rachel Reeves's October Budget reversed these plans, pivoting to increasing spending on public services as a share of the economy next year, and then keeping it above current levels for the rest of the decade. In this New Year Outlook, we consider what this means for the UK economy and living standards in 2025.

Higher spending on public services means more people working for them: the public sector share of employment will rise to 18.3 per cent in 2029-30, close to levels last seen in 2011-12, and up from a recent low of 16 per cent. This will mean that public sector pay – and the forthcoming pay settlements – will matter more for household incomes than it used to. It also means the private sector will face more competition for workers. But given the recent weakness in jobs data, rising public employment could act as a welcome shock-absorber.

Tax rises on top of lacklustre economic growth make for a gloomy living standards outlook in 2025. But the flip side of higher taxes will, in part, be higher spending on public services. To account for its benefits, we present a measure of 'broad living standards' that includes both disposable income and household benefits-in-kind gained from using public services like healthcare and education. We estimate that, on average, non-pensioners in the bottom half of the income distribution will see an improvement in 'broad living standards' of 0.2 per cent between 2024-25 and 2025-26, while those in the top half of the income distribution will see a fall of 0.4 per cent. But these rises will rely on higher public spending translating into better public services – disposable income itself is likely to fall across the income distribution. Furthermore, the poorest households, for whom the investment in public services does not compensate for the very weak outlook on disposable income, will see broad living standards fall unless the Government reverses benefits cuts planned for April 2025.

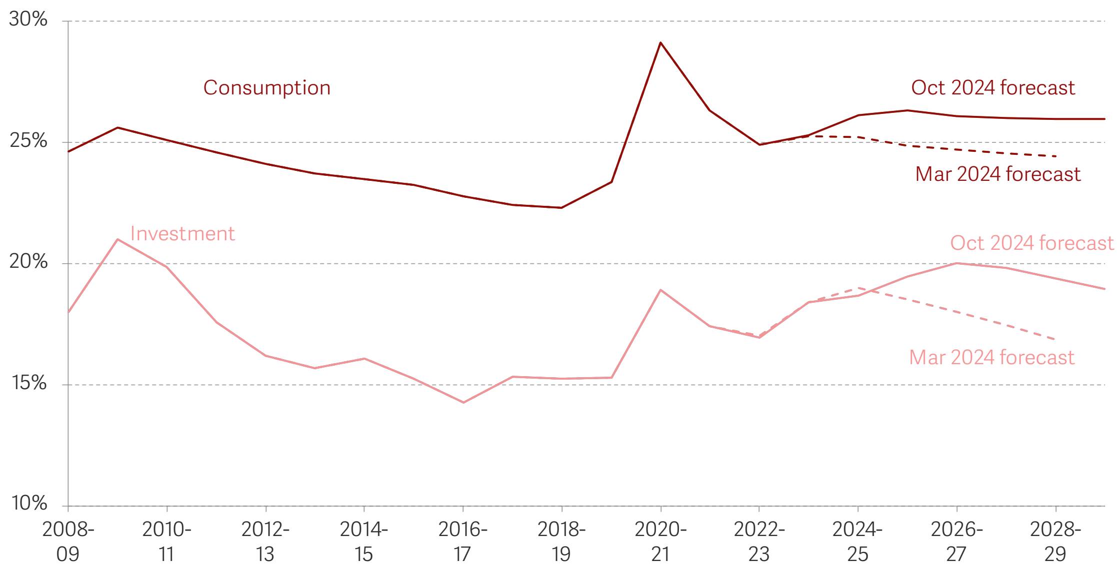
If 2024 was the year that Parliament took centre-stage (with a record 335 new MPs elected this summer), then 2025 looks set to be the year where government has its moment in the spotlight. The Autumn Budget marked a big pivot towards the public sector for the first time (outside of an economic or public health crisis) in the past quarter century. This pivot will begin in 2025, so in this New Year Outlook, we consider its impact on living standards over the coming year.

Government is taking centre-stage in 2025 when it comes to consumption and investment

The government shares of both consumption and investment are set to increase in 2025, and remain above current levels for the rest of the decade, as shown in Figure 1. This is a meaningful change, but it is important to put it into context. First, the baseline bequeathed to the current Chancellor by her predecessor indicated cuts to government consumption and investment without a plan for how this could be managed in the face of an ageing population, public dissatisfaction with public services, increased levels of inactivity due to long-term sickness, and high interest rates. Second, when we look at the government share of consumption, it wasn't long ago that we saw a big increase: the government share of national consumption reached a high of 29 per cent during the Covid-19 pandemic period (2020-21).

Figure 1 **The Autumn Budget pivoted toward the public sector for the first time, outside a crisis, in over two decades**

Government share of consumption and investment: UK



Source: RF analysis of OBR, Economic and Fiscal Outlook, various.
Notes: Government consumption share is general government consumption as a share of the sum of private and government consumption; government investment share is general government fixed capital formation as a share of total fixed capital formation. Both are shares in current prices.

Still, the trajectory for the rest of the decade is certainly not what the UK has become accustomed to in normal economic times. By 2028-29, the government share of consumption is set to be 26 per cent – compared to the 24 per cent forecast in March 2024. This takes the share up from its recent low of 22 per cent in 2018-19, to levels not seen since the post-financial crisis recession in 2009-10. 2025 also marks a turning point for investment, with the government share set to rise from a low of 14 per cent in 2016-17 up to 20 per cent in 2026-27. Under Jeremy Hunt's plans from Spring 2024, the government share of investment would have instead fallen for the rest of the decade.

General government fixed investment is set to increase from £77.7bn in 2024-25 to £79.4bn in 2025-26 (in real terms), and then again to £83.4bn in 2026-27.[ii] This increase in investment has been planned with two aims in mind. First, improved public infrastructure (such as better roads and railways) should help firms connect with workers and customers, boosting private sector productivity. Second, higher investment in capital for health, education and other public services will help to boost their supply, giving the extra public sector workers structures to work in and equipment to use. A greater output of public services will add to GDP directly, and more tangibly could help eventually create a healthier, better-educated workforce.

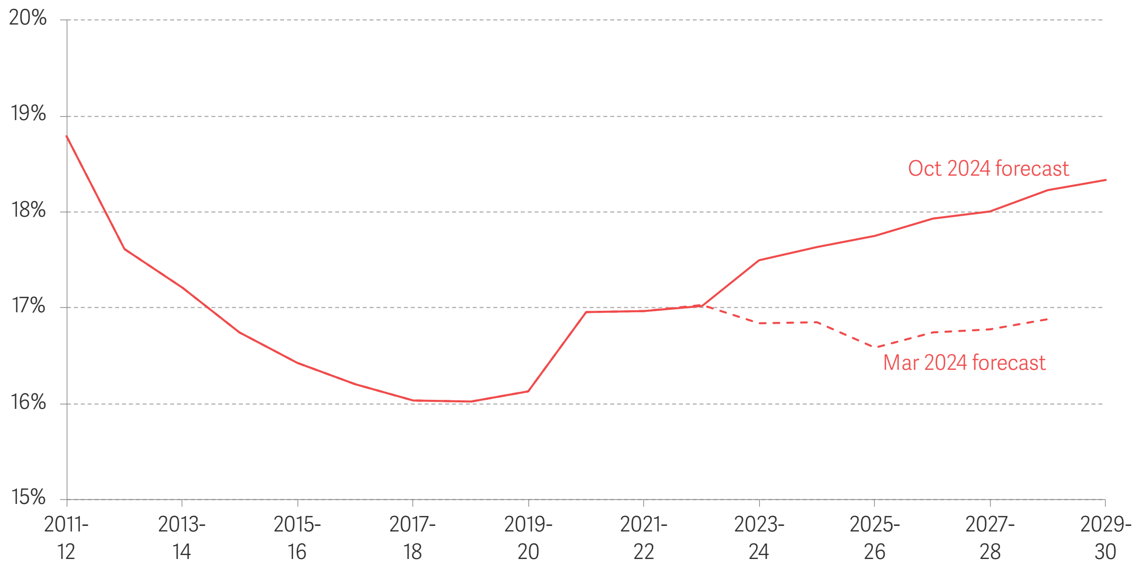
But a key unknown is whether extra public spending crowds business investment *out*, as the OBR expects, by taking resources away from the private sector – or whether it crowds investment *in*, with businesses expanding to take advantage of better infrastructure and a healthier, better-educated workforce. The OBR's judgement is on the gloomy end, with crowding out cancelling out all of the boost from higher public investment on the level of real GDP for the rest of this decade (reflecting that it thinks that the economy is operating very close to full capacity at the moment), although the OBR does note that the full benefit of public investment will not materialise until after their five-year projection period.[iii]

Public sector employment is set to increase

This ramping up of government consumption and investment will mean a growing public sector workforce. As Figure 2 shows, the share of employment in government jobs is set to grow over the rest of the decade, from 17.6 per cent in 2024-25 to 18.3 per cent in 2029-30 – just below the 18.8 per cent last seen in 2011-12, after the Blair-Brown expansion and the financial crisis and before the Cameron-Osborne austerity.

Figure 2 **Public sector employment is set to rise to levels not seen since the start of the Osborne-Cameron years**

General government share of employment: UK



Source: RF analysis of OBR, Economic and Fiscal Outlook, October 2024.

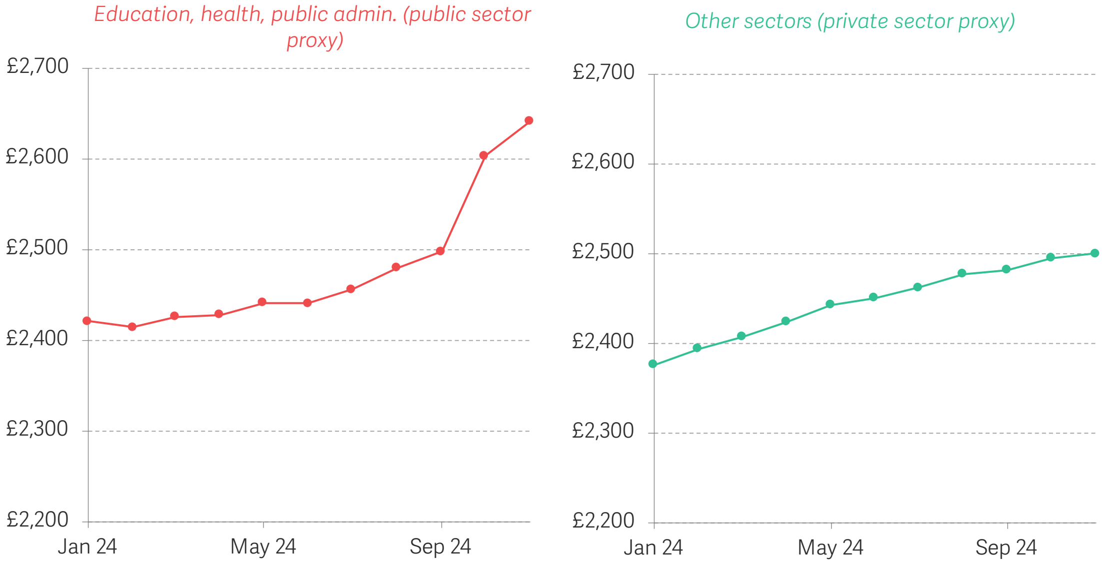
This is very different from Jeremy Hunt's plans, under which the government share of employment would have fallen to 16.9 per cent (although it is far from certain that this would have been achieved, given that the number of full-time equivalent Civil Service employees increased from 392,000 to 513,000 between 2015 and 2024, a rise of 31 per cent). In a cooling labour market, rising public employment could serve as a welcome shock-absorber.

However, the make-up of government employment will look quite different in 2029-30 to 2011-12. For example, in 2000, over half (54 per cent) of total general government employment was in local government; a decade ago in 2014 this was 44 per cent; and by 2024, this stood at just one-third (34 per cent). At the same time, we should expect a further increase in the proportion of public-sector employees working in the health and social work sector. This has risen from 29 per cent of all public sector employment in 2000 to 37 per cent in 2024.

With government employment rising, a key question for both households and the Bank of England is what this means for pay across the economy. As Figure 3 shows, while private sector pay has risen gradually over the past year, in the public sector, the real change happened in October, when NHS pay settlements took effect. As a result, average pay for public sector workers ended up 6 per cent higher than for private sector workers in the three months to November 2024, having started 2024 only 2 per cent higher. With a growing share of employees having their pay decided by the Government, its approach to these negotiations impacts a larger number of household budgets, as well as the cost of providing public services.

Figure 3 **Average pay has increased more for public sector than private sector workers**

Median monthly pay (nominal terms), by sector: UK

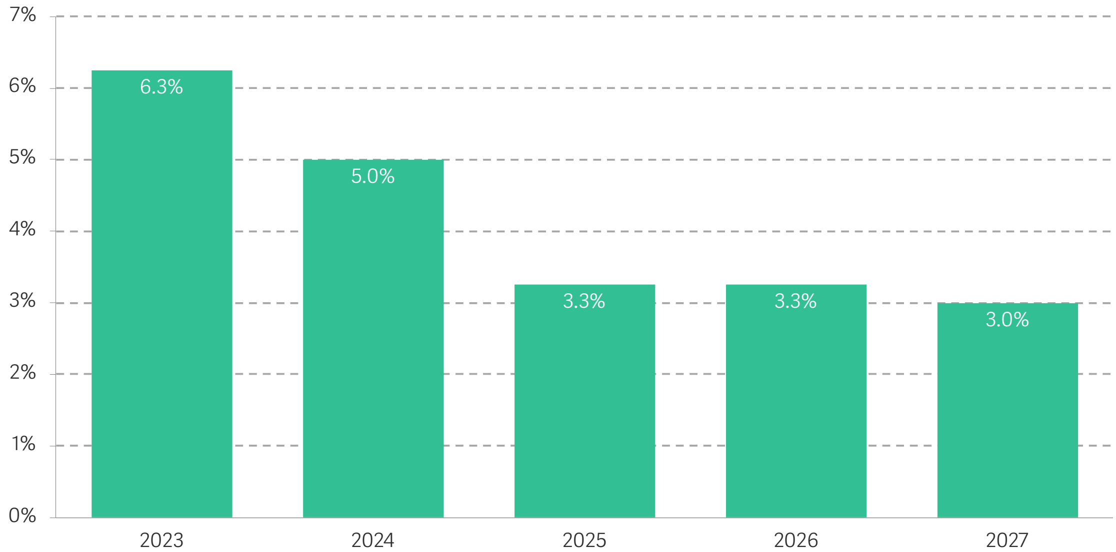


Notes: Growth is year-on-year change in three-month average. Series is seasonally adjusted. Last data point is November 2024.
Source: RF analysis of ONS/HMRC, Pay As You Earn Real Time Information.

So far, the Government has recommended a 2.8 per cent pay rise next year, marginally above the predicted average rate of inflation (2.6 per cent), but lower than in the private sector. The Bank of England expects private sector pay growth to average 5 per cent across 2024, only slightly below the bumper pay growth of 6.3 per cent we saw in 2023 (see Figure 4).

Figure 4 **Private sector wage growth is set to slow sharply from next year**

Private sector regular average weekly earnings (AWE) projections



Notes: Private sector average weekly earnings excluding bonuses and arrears of pay.
Source: RF analysis of Bank of England, Monetary Policy Report, November 2024.

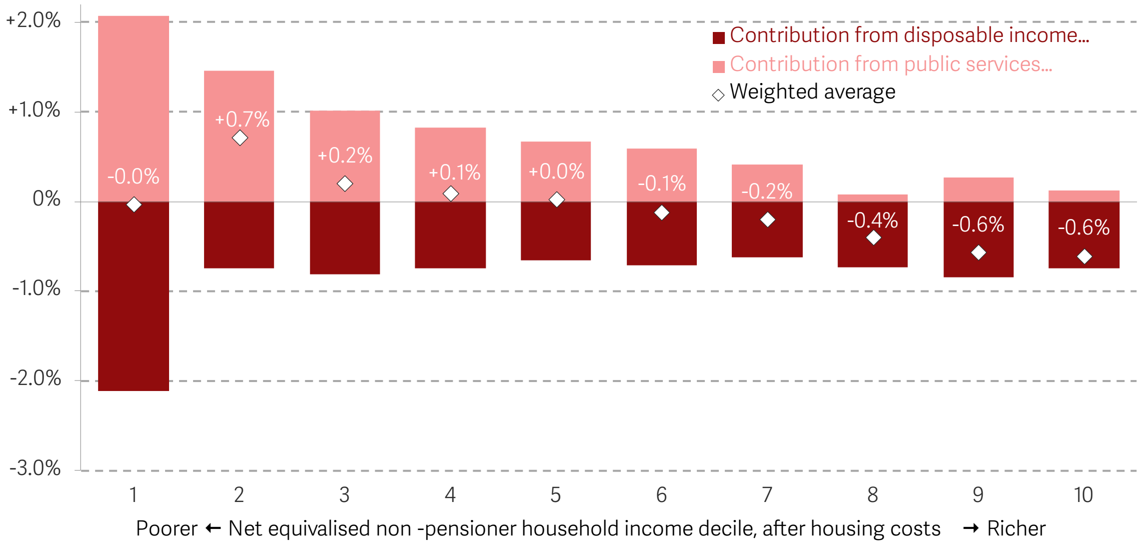
However, the Bank expects private sector wage inflation to slow sharply in 2025 – back down to a more familiar (low) rate of 3.3 per cent.

The outlook for public services – and public investment – matters for living standards

The big story of the autumn Budget was the rise in employer National Insurance, which offset some of the two rounds of cuts to National Insurance under the previous government. This, combined with other tax rises (in total, the Chancellor announced £24 billion of tax rises for 2025-26, lie behind the fall in disposable incomes expected next year (Figure 5). The judgement from the Chancellor was that, while people may be made worse off in terms of their household finances, the resulting improvement in public services will be worth it. To illustrate how this trade-off might play out in 2025, we have created a measure of 'broad living standards' that includes disposable income (the sum of post-tax wages, investment income and social security benefits, deducting housing costs) and household benefits-in-kind (from using public services e.g. education or healthcare), similar to what the ONS and the Treasury produce when looking the effects of taxes and benefits on household income.[iv]

Figure 5 **Rises in broad living standards (for some poorer households) will be driven by improvements to public services, but disposable income is set to fall across the income distribution**

Estimated change in weighted average of disposable income and benefits-in-kind from public services among non-pensioners, by household income decile: UK, 2024-25 to 2025-26



Notes: The growth rate of broad living standards is a weighted average of the growth rates of real per capita household income after housing costs and real government RDEL in education, health and social care, transport and MHCLG. Household income is deflated by the CPI excluding housing costs. Government expenditure is deflated by the GDP deflator. The weights are the shares of each of the two components in the sum, in nominal terms in 2023-4.
Source: RF analysis of DWP, Households Below Average Income; ONS, The Effects of Taxes and Benefits on Household Income; HM Treasury, Budget and Spending Review documents, various; and RF projection including use of the IPPR Tax Benefit Model. For more details on the RF projection, see: A Clegg & A Corlett, The Living Standards Outlook 2024, Resolution Foundation, August 2024.

Low-to-middle income families use more public services, and they represent a bigger share of their 'real living standards', so they tend to benefit most from improvements to public services. Consistent with this, non-pensioners in the bottom half of the income distribution will see their broad living standards rise very slightly – by 0.2 per cent between 2024-25 and 2025-26 – while those in the top half will see their broad living standards fall, by 0.4 per cent. These changes to broad living standards are equivalent to an annual gain of £28 for individuals in the bottom half of the distribution – with the largest gain of £100 for those in the second-lowest income decile – and a loss of £140 for those in the top half.

Two other things stand out in Figure 5. First, higher-income households face a gloomy outlook. These households benefit less from better public services (since they use them less); will not benefit as much as poorer households from the bottom-heavy wage growth fuelled by minimum wage rises announced in the Autumn Budget; and will see their income from savings follow interest rates down. The 0.6 per cent broad living standards fall for the richest tenth of households is equivalent to a cash hit of £356 per person next year. The blame for richer households' living standards hit is likely to fall squarely on the Chancellor, and the tax rises she announced last Autumn (though the tax rises announced by her predecessor are also having an effect). But it's worth noting that the squeeze at the top is much about decisions made at the Bank as at the Treasury – rapid interest rates in recent years are continuing to feed through into higher mortgage costs, while expected interest rate falls this year will feed through into lower savings income.

Second, at the other end of the income distribution, the investment in public services does not quite do enough to compensate for the dire outlook for disposable income for the very poorest households: these households are hit hard by rising housing costs, as well as tax rises (including Council Tax, which is set to rise by up to 5 per cent).This will be compounded for some by introduction of new welfare cuts and retention of existing benefit caps, which we turn to next.

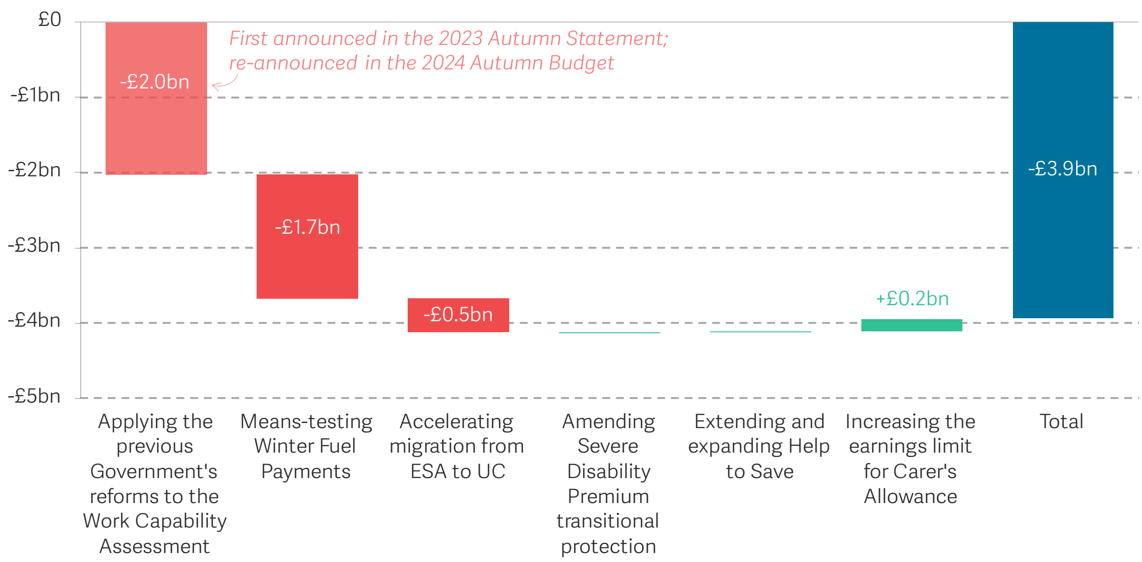
The Government is proceeding with inherited benefits cuts, with additional cuts in the Budget

One area where the current Government is, so far, trying to reduce the size of the state is in the social security system. 2024 saw cuts to social security that will be worth £3.9 billion by 2029-30, largely by restricting Winter Fuel Payments and implementing cuts to health-related benefits first promised by the previous Government. This is shown in Figure 6.

Resolution Foundation

Figure 6 **Government is not increasing investment in social security, which will see considerable spending cuts by the end of the decade**

Benefit changes announced in the 2024 Autumn Budget: UK, 2029-30



Notes: Excludes measures focused on fraud and error; these amount to a £3.5 billion reduction in spending in 2029-30. Excludes spending on enhancing Pension Credit take-up for new Housing Benefit claimants and extending the Universal Credit surplus earnings threshold for one year, since these policies do not impact spending in 2029-30. Changes shown in 2029-30 prices.
Source: RF analysis of HMT,Table 5.1 Autumn Budget 2024 Policy Decisions; HMT, Table 5.2 Measures announced at Spring Budget 2024 or earlier that will take effect from October 2024 or later.

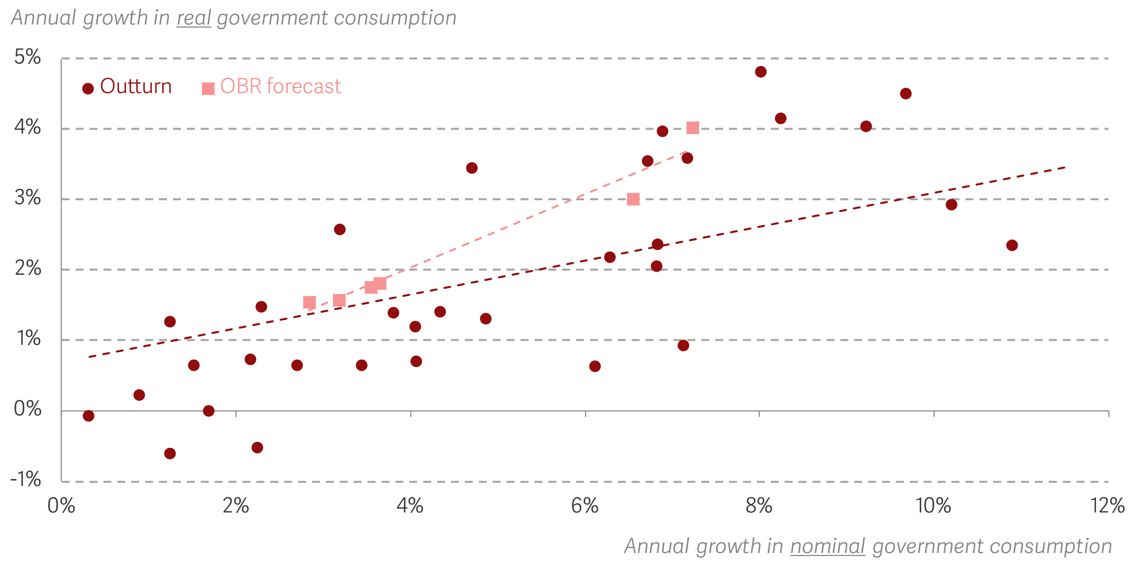
But also significant was the lack of action to mitigate poverty-inducing policies such as the two-child limit, benefit cap and Local Housing Allowance (LHA) freeze. These policies will bite more and more over coming years, as more children are born beyond the 2017 cut-off for the two-child limit, and as rents continue to increase. These choices have big implications for living standards: scrapping the two-child limit, the benefit cap and unfreezing the LHA in April 2025 would immediately lift around 1 million people, including 600,000 children, out of relative poverty. Looking ahead, the upcoming Child Poverty Strategy, provides the Government an opportunity to change course and avert further increases in poverty.

So a great deal rests on improvements in public sevices

So, despite the Government's new targets for living standards in its Plan for Change, the living standards outlook for 2025 is not a cause for celebration: disposable income is likely to fall, and if households are to feel better off, it will only be if they see and value the benefits from spending more on public services.

The OBR appears to be relatively optimistic about this, forecasting that higher spending will feed through into better services. The dark red line in Figure 7 shows that, on average over the past, this has been the case – higher growth in cash spending has fed through into higher real government consumption. But the line is relatively flat, suggesting that, while extra spending is easy, turning it into better services is hard: about half of any increase in cash spending growth is eaten up by increased costs. The pink dots in Figure 7 show that the OBR expects the Government to get more than an average public services bang for its public spending buck. If this turns out to be true, then it's good news for the Government – and for all of us – as its these outputs that matter for broad living standards.

Figure 7 **In the past, increases in public spending have fed through roughly equally into improved public services and higher public-sector inflation**
Annual growth in real government consumption and annual growth in nominal government consumption, outturn and forecast: UK, 1990-2029



Source: RF analysis of ONS, GDP data; OBR, Economic and Fiscal Outlook, October 2024.

Stepping back, we can trace the coming years' stagnation in living standards and need for tax increases back to the UK's poor overall economic performance since 2009. The outlook for living standards in 2025 and beyond can only be substantially improved with sustained growth in GDP per person, which fell again in Q3 2024, and by the Government spending its increased share of taxpayers' money well. However, even this will not be enough to help those facing upcoming benefit cuts. Expect the Government to return to this issue over the coming year.

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[i] The authors would like to thank Mike Brewer and Emily Fry for their contributions and comments.

[ii] These figures are for to general government fixed investment, measured in chain-linked volumes, seasonally adjusted.

[iii] See Figure 2 in: C Aref-Adib et al., More, more, more: Putting the Autumn Budget 2024 decisions on tax, spending and borrowing into context, Resolution Foundation, October 2024.

[iv] To estimate the distributional impact of changes in benefits-in-kind, we combine data from the Treasury on Resource Departmental Expenditure Limits (RDEL) excluding depreciation (in both 2024-25 and 2025-26) with the ONS's latest estimates for the effects of taxes and benefits on household incomes across the distribution (in 2022-23). We estimate the impact of changes in spending on benefits-in-kind across four departments: Education (including childcare and school meals), Health and Social Care, Transport, and Communities, Housing and Local Government. For each department, we take the real-terms increase in its RDEL between 2024-25 and 2025-26 and allocate it to each decile of the income distribution based on the proportion of relevant benefits-in-kind that went to that decile in 2022-23. We also account for Barnett consequentials.