

UK Economic Outlook



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September 2025

- A strong start to the year is expected to make way for a slower pace of growth for the rest of the year, with GDP growth of 1.2% in 2025 and 1.1% in 2026.
- Elevated global uncertainty combined with a rising domestic tax burden could see a more modest increase in business investment, with public sector investment helping drive investment growth as a whole to 1.4%.
- Inflation is expected to rise to 4% over the coming months and remain around this level for the rest of 2025, gradually falling through 2026 to reach the Bank of England's 2% target in the middle part of next year.
- Another interest rate cut is likely before the end of the year, taking the base interest rate to 3.75% by the end of 2025. A slower pace of cuts from 2026 onwards could bring rates to 3.25% in the medium term.
- A strong UK-US trade exports performance in the early part of 2025 is likely to represent frontloading efforts, indicating weaker activity for the rest of the year. US tariffs are slowing UK-US trade, with exports potentially remaining subdued for the remainder of the year and into 2026.
- The UK Chancellor faces a difficult balancing act to meet growing spending pressures, which may require a steady pace of tax rises into the future.
- Recent weak productivity growth has been associated with a weakening of intellectual property investment. Such trend could make technology adoption more difficult and have longer term impact on productivity.

Table 1: KPMG forecasts

	2024	2025	2026
GDP	1.1	1.2	1.1
Consumer spending	0.6	0.9	0.9
Investment	1.5	1.9	1.4
Unemployment rate	4.3	4.7	4.9
Inflation	2.5	3.5	2.4
Base interest rate	4.75	3.75	3.25

Source: ONS, KPMG forecasts.

GDP, consumer spending and investment are all measured in real terms. Average % change on previous calendar year except for unemployment rate, which is average annual rate, while interest rate represents level at the end of calendar year. Investment represents Gross Fixed Capital Formation, inflation measure used is the CPI and the unemployment measure is LFS.

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UK economy – mixed short term outlook

After an unexpectedly strong start to the year, which was driven by transient factors, we expect upcoming data to show a more muted pace of growth in the second half of 2025. Weaker growth is expected to persist into the early part of 2026, resulting in an overall GDP growth rate of 1.2% in 2025 and 1.1% in 2026. Internal and external headwinds continue to dominate the outlook, with modest tailwinds arising from lower interest rates and increased public spending in the UK and Europe on defence and infrastructure.

Elevated levels of global uncertainty, together with the impact of tax rises both in the 2024 Autumn Budget and those expected in the 2025 Autumn Budget, could result in relatively modest increases in business investment despite falling interest rates. Business surveys continue to show worries over potential tax increases, with more than 13% of respondents of an ONS survey citing tax as a key concern in August 2025 (see [Chart 1](#)). Nevertheless, the strong expansion early in 2025 could see investment growth of 1.9% for the whole of this year.

Lower interest rates may also encourage more consumption spending, although we expect consumers to remain cautious. Recent data shows that despite rising real incomes, consumption growth has remained subdued because a significant portion of household income has been directed into savings. As lower interest rates reduce the incentives to save, we expect a modest acceleration to take place in consumption spending, with growth of 0.9% in both this year and next compared to 0.6% in 2024. This may support growth across consumer-facing sectors, specifically in retail and hospitality.

Headwinds generated by the new US tariffs announcements are expected to lead to a slowdown in UK-US trade, with exports remaining subdued for the remainder of the year as well as into 2026. Any strong exports performance in the early part of 2025 is likely to represent frontloading efforts, which may lead to even weaker activity for the remaining of the year. UK goods exports to the US were 23% higher in March of this year compared to the average monthly values in 2024. However, they have since fallen to a level 21% below the 2024 average level by June (see [Chart 2](#)).

The UK-US trade deal may provide an opportunity to UK exporters due to a lower tariff rate into the US across a number of goods categories compared to many other trading partners, however continuing high levels of uncertainty may limit the ability of businesses to capitalise on this opportunity in the short term.

The treatment of pharmaceuticals remains a key unknown, as the US has indicated significant tariffs to be imposed at a later date, with the rate applied to UK exports remaining unclear. Furthermore, the UK-US trade deal contains requirements for supply chain security – the practical implications of which also remain unclear. If these provisions lead to a requirement for a deeper realignment to existing production networks, then the impact of lower US trade barriers may be commensurately lower.

This may be offset somewhat by potential redirection of trade flows from other US trade partners to the UK. This could lead to lower imported prices for some goods but also intensify competitive pressures on those businesses competing directly with those imports.

Chart 1: Taxation has remained a key business concern since 2024

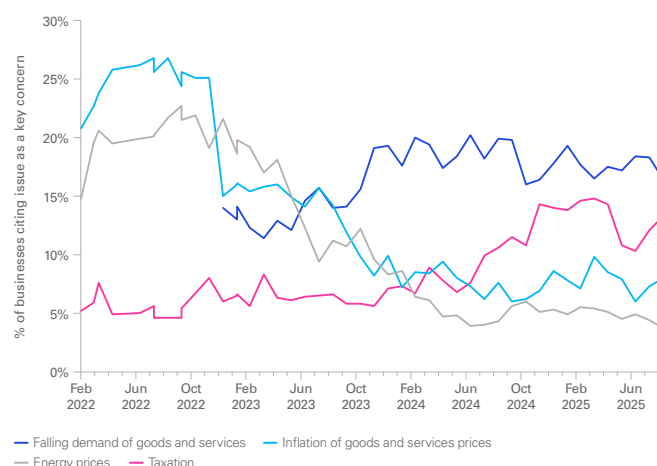
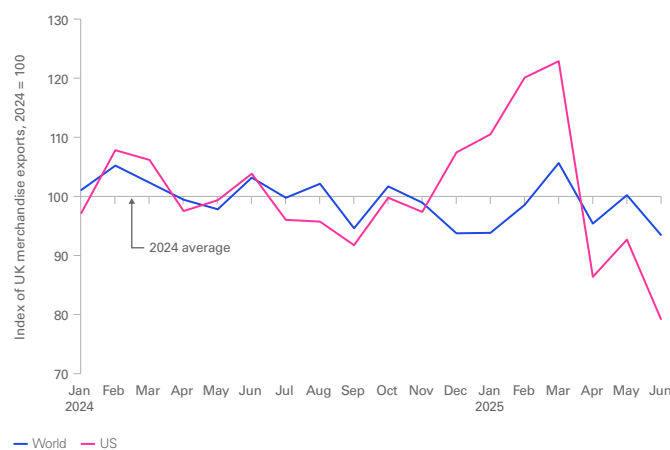


Chart 2: After a surge in Q1, goods exports to US have fallen significantly



Domestic pressures are set to see inflation peak at 4% this year

Inflation is expected to rise further over the coming months and remain above target until the latter part of 2026. The recent rise in inflation has largely been driven by domestic factors, which are set to persist in the near term. The hike in employer's National Insurance Contributions (NICs), which came into effect in April, has seen payroll costs rise for businesses. The rise in costs has seen businesses partially pass the increases onto consumers, leading to more persistence in services inflation, a key gauge of domestically generated price pressures.

Headline inflation has also trended upwards, driven by a sharp increase in food prices since the start of the year. Part of the increase in food prices has been driven by global factors, as warmer weather has seen crops fail, impacting global food supply. The UN Food and Agriculture Organization's food price index showed prices increased by nearly 7% in August 2025, with food prices currently at their highest level since early 2023. However, domestic factors, including higher labour costs, are also contributing to the recent rise in food prices. Processed food prices, which are also sensitive to labour costs, increased by 6% in August, up from just 1.4% in August 2024. We expect the combined impact of these domestic and global factors to see food price inflation peak at 5.3% this autumn and remain above 4% until early 2026.

The upcoming Autumn Budget presents a two-sided risk to KPMG UK's inflation outlook and adds a degree of uncertainty. The impact of the last year's Autumn Budget was on balance inflationary. With taxes widely expected to rise further next month, similar tax hikes on businesses would likely see further upside pressure to domestic inflation. However, the Chancellor could opt to hike taxes on households affecting consumer spending more directly, such as raising income tax, employee NICs or freezing tax thresholds. The impact of these taxes would likely see household incomes fall but could be disinflationary on balance. While workers could potentially look to demand higher wages to compensate for the higher tax burden, workers bargaining power is limited at present given

the weak state of the labour market. As such, plugging the fiscal hole through a tax increase on households may have less inflationary risks in the short term.

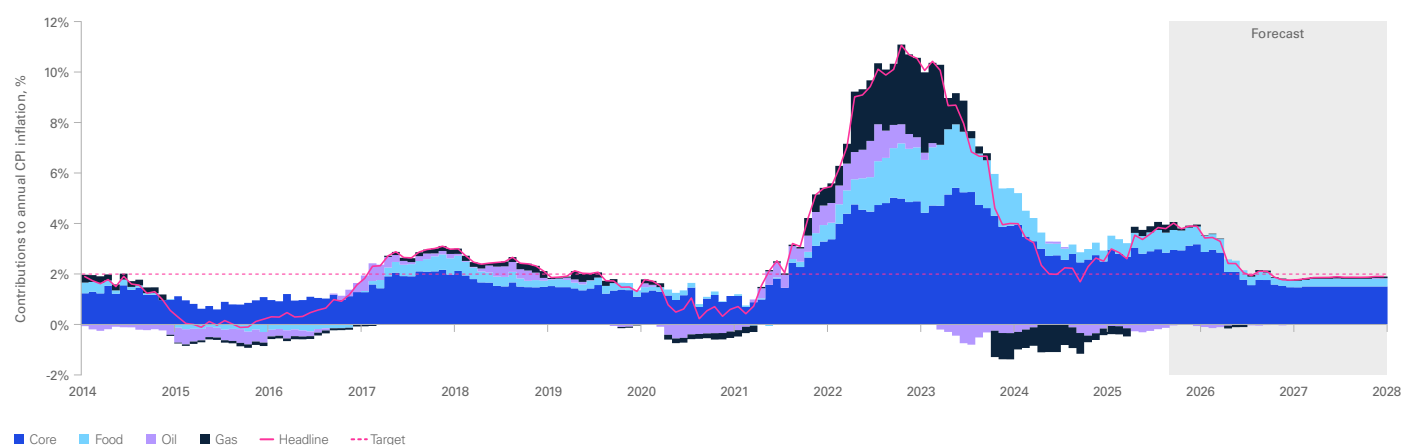
External developments are expected to be more favourable for the inflation outlook. The pound has performed strongly this year, up by 9% since the start of the year against the dollar, although, it has fallen back from its peak in the summer as global fiscal and inflation concerns have prompted investors to seek safe haven assets including gold and the dollar. However, market pricing points to the continued strength of the pound against the dollar over the coming year, driven by the expectation of more interest rate cuts in the US. We expect this to help keep import costs down in the UK.

The impact of global trade frictions could also see weaker import prices. The increase in US tariffs has made it more difficult for exporters worldwide to sell to the US market. This could lead to excess stock being rerouted to the UK and sold at lower prices. While evidence so far is limited, such practices could lower goods inflation further and offset the recent persistence seen in services inflation, with a faster return to the inflation target.

The rise in the pound has also been accompanied by a fall in oil prices, which are down by 13% since the start of the year. Concerns around weaker global demand coupled with OPEC production hikes are set to keep oil prices significantly below their 2024 levels. Lower oil prices have translated into cheaper fuel at the pump for motorists. The recent improvement in global sentiment is set to see oil prices remain around their current level over the coming year. This will mean oil prices could become less of a drag on headline inflation as more favourable prices fall out of the year-on-year comparison.

Overall, we expect headline inflation to peak at 4% in the autumn and remain around this level for the remainder of 2025. Inflation could then gradually fall from early 2026, returning to the Bank of England's 2% target in the middle part of next year (see [Chart 3](#)).

Chart 3: Inflation is expected to rise further over the coming months



Source: ONS, KPMG projections.

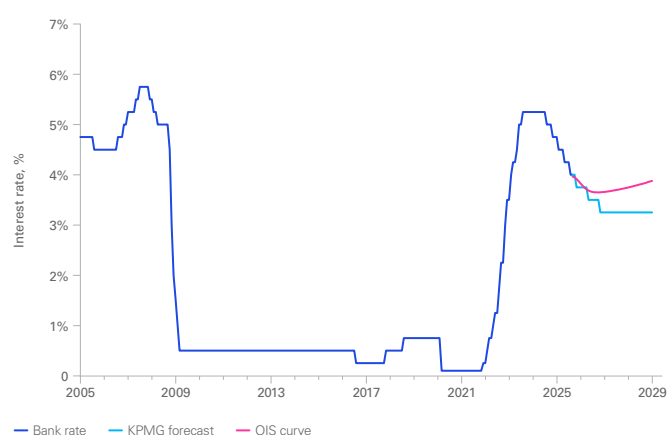
Higher inflation unlikely to derail another interest rate cut this year

The Bank of England kept interest rates unchanged in its September meeting, maintaining its pattern of holding rates steady at alternate meetings. The balance of risks to the inflation outlook have shifted towards the upside in recent months. This has seen Monetary Policy Committee (MPC) members on balance become slightly more hawkish overall, cautioning against moving too quickly with interest rate cuts.

Investors have also pared back their expectations of future rate cuts, with markets now anticipating no further easing of rates in 2025. However, while the recent shift has been driven by the combination of an elevated inflationary backdrop and uncertainty, we think there is scope for one more interest rate cut by the Bank this year. One off factors, which have pushed inflation up, are likely to unwind from early 2026 onwards. Additionally, a potential tightening of fiscal policy in the autumn could present a downside risk for domestic demand and inflation depending on the composition of any tax increases.

More dovish MPC members are likely to look through the inflation overshoot and put more weight on emerging downside risks. While the bar for another rate cut has certainly moved higher on balance, we think there is enough evidence to support another rate cut by a small majority of MPC members before the end of the year. As a result, we see interest rates falling to 3.75% by the end of 2025. Next year will likely see fewer rate cuts as the Bank moves closer to the neutral rate, we expect two further cuts in 2026, leaving rates at 3.25% in the medium term (See [Chart 4](#)).

Chart 4: Interest rates to fall gradually over the next two years



Source: Bank of England, KPMG projections. OIS curve shows market expectations for bank rate.

Labour market set to weaken further as higher costs and weaker demand bite

The labour market has weakened significantly, with the recent rise in payroll costs adversely impacting hiring intentions. The latest data from the ONS show vacancies have fallen significantly over the past 18 months, down 44% from their post-covid peak in 2022. We expect labour market activity to remain subdued in the near term as weaker demand and higher costs look set to persist.

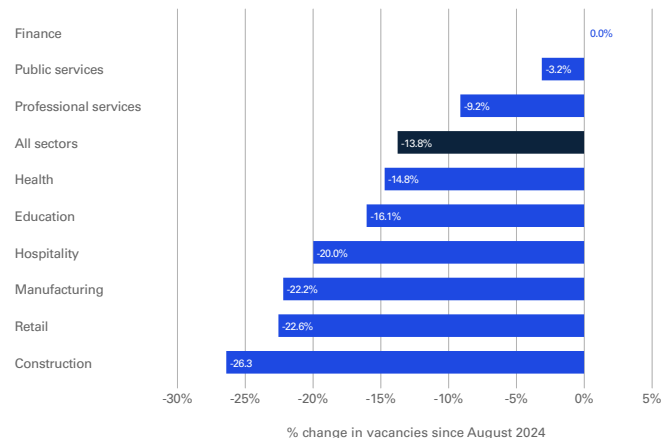
While demand for workers has declined across the labour market, some sectors have seen a more pronounced decline in activity. Since August 2024, vacancies in all sectors have fallen by 14%, however, during the same period, vacancies in the hospitality and retail sectors have fallen by 20% and 23% respectively, with only the construction sector faring worse than the latter, posting a decline of 26% (See [Chart 5](#)).

This suggests the fall in demand for workers has been more pronounced in labour intensive sectors which were impacted by both the increase in employers NICs and the rise in the National Living Wage. Additionally, the increase in US tariffs may have had the most significant impact on employment in the manufacturing sector, where vacancies have fallen by 22%. Hiring activity in the construction sector has also decreased sharply over the past year, with most subsectors experiencing a prolonged period of weakness with project delays and cancellations reducing demand for workers.

Forward looking survey evidence suggests the labour market is unlikely to see a reversal in fortune in the near term. We expect economic growth to slow in the second half of the year, which may see vacancies decline further over the coming months. Additionally, uncertainty in the run up to the Autumn Budget in November is set to keep hiring activity muted, with firms likely to postpone recruitment decisions until there is greater clarity on potential cost increases. As a result, we expect unemployment to gradually rise further over the coming year, increasing from 4.7% in July and peaking at 4.9% in 2026 (See [Chart 6](#)).

Pay growth is expected to gradually ease over the coming year, as the impact of weaker labour market activity continues to feed through. Wage growth fell to 4.8% in July, down from 5.8% at the start of the year. Nonetheless, pay growth remains significantly above levels consistent with the medium-term inflation target, estimated to be around 3%. Elevated pay pressures are being driven by a recent rise in public sector pay, following last year's annual pay settlement increase of 5.5%. This has seen public sector pay increase to 5.6% in July, up from 4.2% in November 2024. In contrast, pay in the private sector has slowed to 4.7%, down from nearly 6% since the start of the year.

Chart 5: Vacancies have fallen sharply in labour intensive sectors



Source: ONS, KPMG analysis.

Chart 6: Unemployment is expected to rise further in the near term



Source: ONS, KPMG forecast.

We expect pay in both the private and public sector to ease over the coming year. The government is unlikely to offer a pay settlement on par with last summer given current fiscal pressures; this will likely see pay pressures ease in the public sector. However, upside risks remain in some parts of the public sector. For example, recent strikes by transport workers and ongoing negotiations between the government and health workers on next year's pay settlement.

While in the private sector we see risks skewed more to the downside for pay, with worker bargaining power curtailed by a combination of weaker hiring activity as well as an improvement in the availability of workers. Forward looking survey evidence also points to a further decline in pay growth. The latest Bank of England's Decision Maker Panel survey showed business expectations for pay settlements falling to 3.6% over the coming year. This is consistent with our forecast which sees pay growth falling to 3.8% by the end of the year, and down to 3.1% by the end of 2026 (See [Chart 7](#)).

Chart 7: Weaker labour market could see pay pressures moderate



Source: ONS, KPMG projections.

Prospects for UK fiscal policy: more and higher taxes

The UK Chancellor faces the challenge of juggling competing priorities against a backdrop of mounting spending pressures and the urgent need for public investment to revive the pace of productivity growth. The high level of public debt and high cost of debt interest payments make that task harder still as the room for manoeuvre is limited.

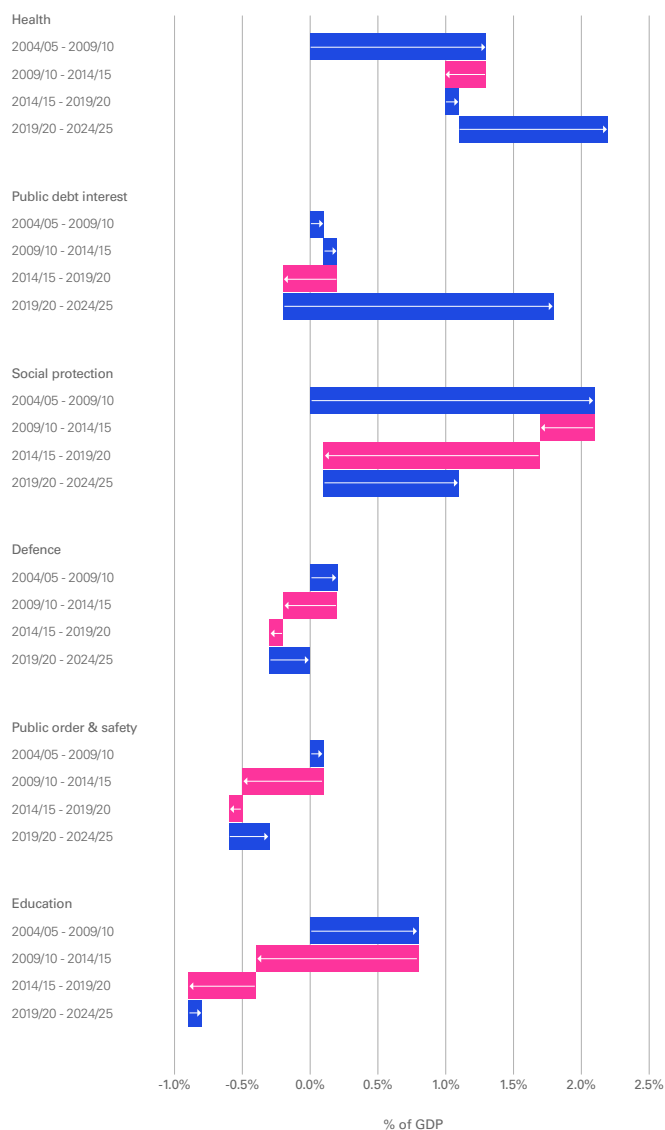
Looking ahead to the 2025 Autumn Budget, most forecasters predict that the target to balance the current deficit would be missed, compared to a £10bn headroom that the OBR estimated in March of this year.

This in part reflects the relatively optimistic assumptions for GDP growth the OBR made at the time of the Spring Statement and policy changes such as the reversal of planned welfare cuts and changes to planned cuts to winter fuel payments. We estimate that the impact of these could see the Chancellor needing to cover a shortfall of around £16bn to meet her target to balance the current deficit as well as needing to raise around £10bn extra to maintain a level of headroom as in the previous Budget.

The challenge for the Chancellor is likely to continue beyond the next Autumn Budget, as pressures to increase spending will probably rise, driven by growing demands for health spending and a continued ramping up of defence spend. **Chart 8** shows that health spending increased by 1.1 % of GDP between 2019/20 and 2024/25. The OBR projects that health spending will rise by an additional 6.6% of GDP by the 2070s at a rate of approximately 1% every decade. This trend reflects advances in medical science and a general ageing of the population.

What makes the coming decades unusual is that unlike previously, there are fewer areas where spending could fall to even partially compensate for increases in age-related spending. In the 1990s, the so-called “peace dividend” saw the share of UK defence spending fall from 4% of GDP to 2.4%. In the 2010s, the sustained period of low interest rates meant that the cost of borrowing fell from 2.6% of GDP in 2010/11 to 1.7% in 2019/20, and further to 1.2% in 2020/2. This decrease occurred even as debt caused by pandemic-related spending surged. Interest costs have now risen to 3.6% of GDP in 2024/25 and are expected to rise to 3.8% of GDP by 2029/30. Defence spending is also rising to meet the NATO goal of 3.5% of GDP.

Chart 8: Public spending changes for selected categories



Source: PESA 2025, KPMG analysis.

The current UK fiscal framework requires the government to balance planned current spending with revenues three years into the future as well as ensuring that the net financial liabilities of the public sector are on a downward trajectory. While incoming Chancellors may in future wish to alter the fiscal rules they use to guide government spending, they are likely to stick with the principle that outside of recessions day-to-day spendings are in line with tax receipts.

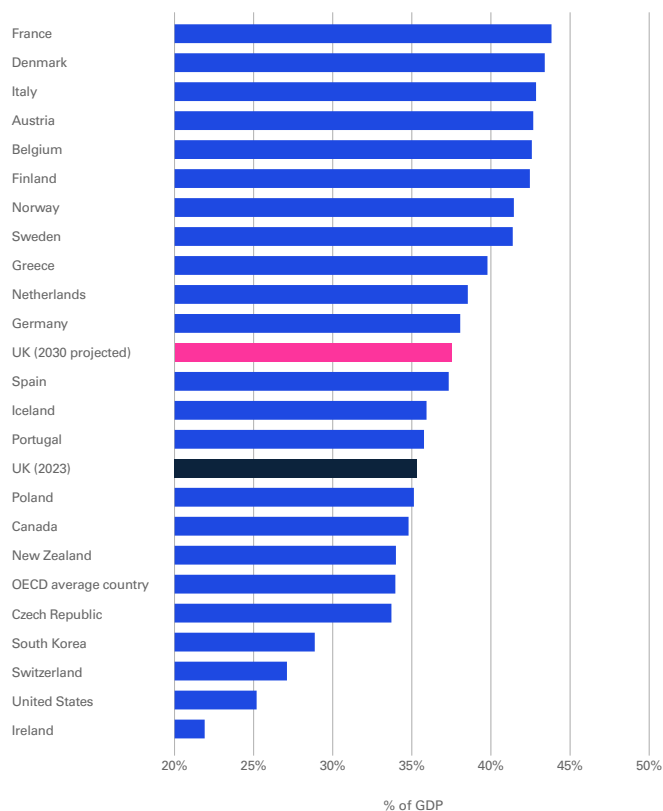
We expect higher spending pressures to be largely met through tax increases, rather than cutbacks in public service spending. Public opinion shows a large, albeit declining, preference for higher taxes over cuts to public service provision¹. Moreover, the level of UK tax revenues remains below some European countries, even once the recent tax increases are considered, although the level of public service provisions also varies. UK tax revenues as a share of GDP would remain below that in Germany, Italy and France in 2029/30 based on current stated plans (see **Chart 9**).

This could lead to a gradual ratcheting up of tax revenues over the next decade, as mounting spending pressures and weaker than expected growth may require a series of tax increases to match the higher levels of day-to-day spending. As an approximate estimate, we may see tax increases of up to 1% of GDP over the course of each five-year parliament after 2030.

To combat these spending pressures, the government needs to urgently address productivity in the public sector, with health the most promising area for productivity gains. According to ONS data, as of 2024, productivity in the health service remains 8.8% below its 2019 levels. This points to lingering pressures on the health service in the aftermath of the pandemic, which saw a significant uplift in the resources available, with overall inputs up by almost a quarter over this period. Using resources more efficiently could partially offset the pace of spending increases required to maintain a given level of service provision.

Improved productivity in the health sector could also help unlock potential growth by reducing the higher level of inactivity observed since the pandemic. This inactivity has been associated with long NHS waiting lists. Recent data shows some progress made on reducing the waiting list for treatments, which nevertheless stands at over 7 million. More progress here could help alleviate the shortfall in UK labour participation by allowing more people to return to work. This in turn could help fuel economic growth and ease the challenging public finance arithmetic in the UK.

Chart 9: UK tax burden compared with other western economies



Source: OECD, OBR, KPMG analysis.

Note: chart shows total government tax revenues as a percentage of GDP for 2023. Data for UK also shows the latest OBR projected level of UK taxes as a share of GDP for 2029/30 (see pink bar) for comparison.

¹ National Centre for Social Research; Shifting public attitudes to taxation and spending; March 2025.

Box 1: The tax options available to the Chancellor

The government's election manifesto pledged not to increase the rates of National Insurance, Income Tax or VAT. These three taxes raise a combined 60% of overall tax revenues.

Nevertheless **Sharon Baynham**, Tax Policy Director at KPMG UK, and **Tim Sarson**, Head of Tax Policy at KPMG, believe households will bear most of the burden of Budget tax rises.

They think that with rates frozen the government may still seek to increase revenue from the three main taxes by changing the tax base. For example, personal tax thresholds could be frozen for a further two years, which could raise c£10bn in 2029/30. Alternatively, we could see the reintroduction of a tax such as the Health and Social Care Levy, which was expected to raise around £12bn annually but was repealed before it came into effect.

The government could consider restricting some of the higher cost tax reliefs. Private residence relief costs in excess of £30 billion per annum and giving higher rate relief to pension contributions costs c.£15 billion per annum. However, both actions would have negative consequences; limiting private residence relief risks stalling the housing market, and restricting pension tax relief would be fiendishly complicated to implement, especially for defined benefit schemes they advise.

In their opinion, supporters of a wealth tax may forget that the UK already taxes wealth in the form of inheritance tax and capital gains tax. Very few countries have implemented effective wealth taxes. In 1990, twelve OECD countries had a net wealth tax. In 2024, this had reduced to three countries, with the main reasons cited for repeal being efficiency, complexity of administration and lower than expected revenues. Despite its public popularity they therefore believe that it is unlikely to happen.

At the same time, increases to capital gains tax announced in 2024 have largely used up the capacity for further tax revenue, with HMRC's own estimates showing further significant rises being revenue negative.

Unwilling to break manifesto commitments and faced with no easy options it is likely that the Chancellor will need to raise niche taxes to fill the gap according to Sharon and Tim, who expect a raft of small measures perhaps in 'sin' taxes (alcohol, gambling, cigarette and air passenger duties) and tweaks but not wholesale reform to more mainstream areas, which runs the risk of adding complexity to the tax system.

With the short-term focus on fixing fiscal deficits, there remains no real tax policy to encourage investment and growth and thus allowing tax revenues to grow organically.

Internationally, there has been a paradigm shift in investment location decisions since the US passed its reconciliation bill alongside the OECD G7 agreement to effectively exempt US businesses from the global minimum tax rules. As a result, activity and profit are moving across the Atlantic at the expense of the UK and other countries. Tim Sarson and Sharon Baynham believe that rearguard action could include widening UK incentives, especially in the area of technology and AI.

There has been a lot of coverage in the media on proposals for changes to property taxes. There is certainly a case for reforming property taxes, especially if combined with the removal of Stamp Duty Land Tax, if it could encourage activity in the housing and construction sector.

More could also be done to remove cliff edges in the tax system that disincentivise work such as removing the tax-free allowance and free childcare when income reaches £100,000 or reforming the VAT threshold.

Increasing tax incentives in the current environment would be a brave policy move, but this may be the last opportunity for the Chancellor to make reforms that reap rewards before the next election.

UK productivity growth: falling behind

Recent UK productivity performance has been poor, even compared to the weak growth seen in the decade following the Great Recession of 2008/09. Productivity growth is the key driving force behind long-term economic growth outside of cyclical factors such as recessions and recoveries, which means any slowdown could have severe implications for the economic outlook over the coming decade.

As **Chart 10** highlights, the performance of productivity varied significantly between the UK and the US. While both economies experienced an uplift in the level of measured productivity during 2020, US productivity growth accelerated from an annual average rate of 1.0% between 2010 and 2019 to 1.2% from 2021 onwards. In contrast, UK productivity growth fell from 0.5% to -0.2% over the same period. The decline in UK productivity since the pandemic has been sufficient to fully unwind the uplift that took place over the pandemic period.

This slowdown in UK productivity growth and decline in the level of productivity may have been related to an inflexion point in intellectual property investment. This includes investment in software and data, research and development as well as rights to intellectual products such as artistic and literary works. This represents the measured component of a wider set of intangible assets that also include design, branding, organizational know-how and skilled talent and which have become an increasingly important factor in production.

Unlike other more volatile components of investment, investment in intellectual property had seen a steady pace of growth prior to the pandemic, becoming the largest component of overall investment in 2004. But around the end of the pandemic, real volume of investment in intellectual property entered a period of decline (see **Chart 11**). Recent data for investment in intellectual property for Q1 2025 shows a 6% fall compared to Q1 2020. This stands in stark contrast to the US economy, where a large part of the recent GDP growth is being driven by investments in AI infrastructure, and has been associated with higher investment in intellectual property.

With increases across all other components of UK business investment, this means that the composition of business investment has shifted away from intellectual property and in favour of tangible forms of capital. As a share of total business investment, intellectual property has fallen from 43% in Q1 2020 to 35% in Q1 2025.

Chart 10: Trends in UK and US productivity growth pre- and post-pandemic

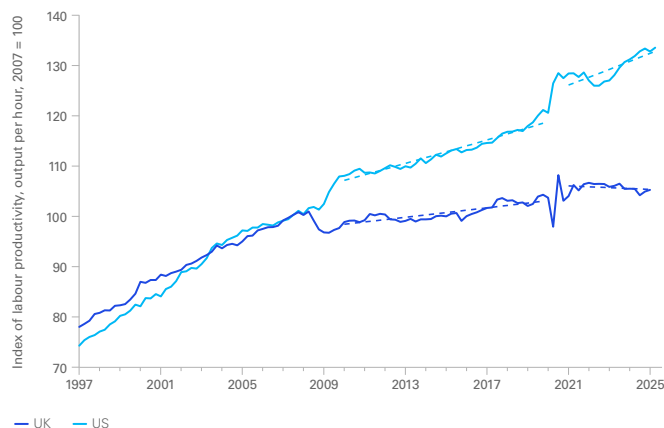
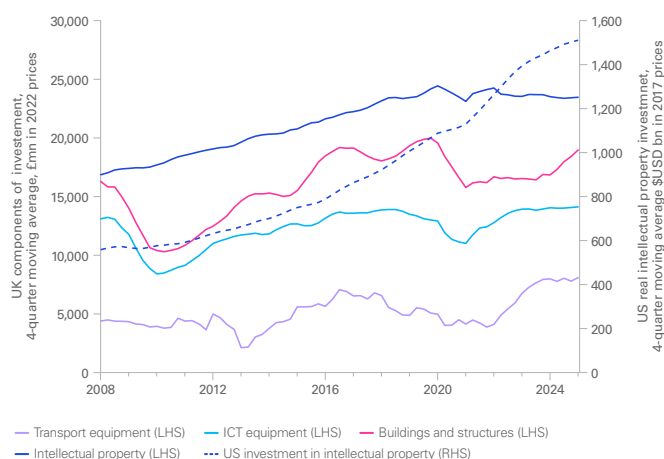


Chart 11: UK intellectual property investment has entered a period of decline



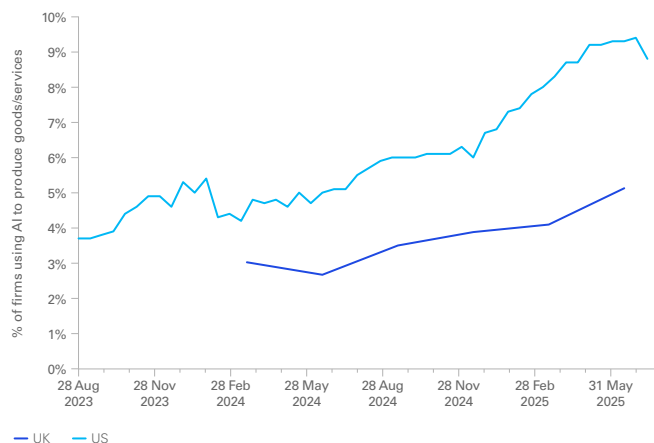
The reason for the slowdown in intellectual property investment is unclear and could plausibly be driven by a range of factors, such as changes in technology, sectoral relocations following the disruption of the pandemic, the UK's exit from the European Union, or measurement issues which underestimate the extent of investment. Some of these could be only temporary and would not represent a major new concern.

Another potential explanation could be related to the impact of tax policies, such as the capital investment super deduction and the full expensing policy that replaced it. These policies were put in place to stimulate business investment, allowing UK firms to claim accelerated tax relief on the value of plant and machinery investment. Since some forms of intellectual property investments are excluded, the policies may have encouraged some firms to prioritise investments that qualified for the relief in the short term.

Slowing intellectual property investment could lead to a slower pace of AI adoption in the UK compared with the US. The latest data show 5.2% of UK firms are using AI in production in some capacity compared to 8.8% in the US (see [Chart 12](#)). If AI technologies become an important driver of future productivity growth, the UK may be missing out on some of the benefits of this new technology as a result of ongoing underinvestment.

Weaker productivity could ultimately have wider ranging implications, including on wages and living standards, pension provisions, public services, as well as UK businesses' international competitiveness. The ongoing underperformance in UK productivity growth suggests that the adoption of new technology adoption may be an important focus of government policy aimed at boosting UK growth prospects.

Chart 12: UK lags behind the US in using AI to produce goods/services



Source: ONS BICS, Census Bureau, KPMG analysis.

Note: UK estimates are derived as the product of estimates for the share of businesses using AI and the share using AI to produce goods and services.

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