



HOUSE OF LORDS

Economic Affairs Committee

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1st Report of Session 2024–25

# National debt: it's time for tough decisions

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Evidence is published online at <https://committees.parliament.uk/work/8090/how-sustainable-is-our-national-debt/> and available for inspection at the Parliamentary Archives (020 7219 3074).

Q in footnotes refers to a question in oral evidence.

## SUMMARY

The UK's national debt has risen fast in recent years and approached 100 per cent of GDP in September 2020 as government spending rose in response to the COVID-19 pandemic. Currently, it is provisionally estimated at 99.4 per cent of Gross Domestic Product (GDP).<sup>1</sup> According to the Office for Budget Responsibility's forecasts, debt is set to rise. Against this backdrop, our inquiry asked a simple question: how sustainable is the UK's debt?

A debt level risks becoming unsustainable if there is an insufficient buffer to absorb future economic shocks; or if a government's approach to fiscal policy creates a long-term trajectory of increasing debt service costs. We conclude that without an appropriate fiscal policy that addresses the challenges the UK faces, there is a risk of the debt becoming unsustainable. This is for the following reasons.

Since the 1950s, the management and reduction of the UK's debt was helped by a number of major trends: a baby boom, a gradual reduction in defence spending, and growth in world trade. Economic growth meant that governments could run a budget deficit—spending more than it received in revenue—without debt rising relative to GDP.

These trends have been thrown into reverse. The new Labour government now faces demands for higher spending to support an ageing population. It is committed to increase defence spending. On top of this, there is the need to invest in the green transition, our national infrastructure and public services. Interest rates and hence the cost of funding government debt are also likely to be higher than in recent years.

However, since the financial crisis, growth rates in many of the major economies have been anaemic. If real interest rates exceed the growth of national income, there must be a primary surplus. In other words, government expenditure net of interest payments must be less than government revenue to prevent the debt ratio rising.

Furthermore, while the UK is not an outlier in terms of its overall stock of debt, changes to the structure of the UK's debt have made it more vulnerable to economic shocks than was the case in the past. Successive rounds of quantitative easing have seen long-term debt exchanged for short-term debt, and a greater proportion of debt is index-linked and held by overseas investors. This has made the cost of servicing the UK's debt more sensitive to rises in interest rates and inflation as well as sudden changes in investor sentiment. Given today's geopolitical risks, the Government needs a larger fiscal buffer if it is to weather future economic shocks.

1 Public Sector Net Debt excluding public sector banks (PSND ex) is the measure for debt used by the Office for National Statistics in estimating the debt to GDP ratio. See PS: Net Debt (excluding public sector banks) as a % of GDP, Office for National Statistics, 'PS: Net Debt (excluding public sector banks) as a % of GDP: NSA' (21 August 2024): <https://www.ons.gov.uk/economy/governmentpublicsectorandtaxes/publicsectorfinance/timeseries/hf6x/pusf> [accessed 29 August 2024]. An alternative measure for debt that the previous government applied when targeting the main fiscal rule relating to debt is PSND excluding the contribution of the Bank of England's balance sheet—known as Public Sector Net Debt excluding the Bank of England (PSND ex BOE). This was estimated to be 91.9 per cent of GDP as of July 2024 or £2.54 trillion in cash terms; see Office for National Statistics, 'Public sector finances, UK July 2024' <https://www.ons.gov.uk/economy/governmentpublicsectorandtaxes/publicsectorfinance/bulletins/publicsectorfinances/july2024> [accessed 29 August 2024].

We support the new Government's ambition to reduce the debt ratio and to deliver higher growth and productivity. However, we await to see how the Government will increase productivity to deliver the level of growth required. Its approach to immigration will also be important. While high net migration has previously boosted GDP growth, it has made little impression on GDP per head: high net migration cannot be the solution to debt sustainability.

If we wish to maintain the level and quality of public services and benefits that we have come to expect, we face a choice: taxes will need to rise or the state will need to do less. Addressing this will demand clarity as to the responsibilities and the role of the individual versus that of the state. Muddling through is not an option. If this choice is ducked in this Parliament, the UK risks being on a path to unsustainable debt.

To help mitigate this risk, we need a new fiscal framework to ensure ministers are held accountable for reducing debt steadily as a proportion of GDP over time. As under the former government, the Labour government's proposed set of fiscal rules allows debt to rise for four years with success being claimed if it falls in year five—even if debt at the end of the five-year period is higher than in the first year. This is unwise: it gives a misleading impression as to the true state of the public finances and hides the need to take difficult decisions to secure debt sustainability in the medium-to-long term.

A new fiscal framework should set out credible tax and spending plans covering five years. Rather than have a continually moving target to reduce debt, the framework should set out how debt as a proportion of GDP will be lower on a given date in the fifth year, unless there are exceptional reasons. To provide accountability, the target for the fifth year should remain fixed until reached. A further year's target should be added at each yearly update and this new target should not normally be higher than the year preceding it. Furthermore, as the definition of which government spending should be classed as 'investment' is not clear cut, borrowing for investment should not be accounted for outside the Government's measure for meeting its debt target.

This new fiscal framework will help to build a fiscal buffer to build economic resilience; increase ministerial accountability; and put the UK's debt on a sustainable path.

# National debt: it's time for tough decisions

## CHAPTER 1: INTRODUCTION

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### The UK's national debt

1. Governments incur debt to fund a 'budget deficit', that is spending that is not met by its revenues. Typically, this debt is financed through the sale of bonds to domestic and international investors. In the UK those bonds are known as 'gilts'. The accumulation of debt over time, brought about by annual budget deficits, is often referred to as 'the national debt'.<sup>2</sup>
2. National debts have spiked sharply in times past as governments have sought to fund costly but temporary endeavours, such as war. Since 2020, sharp increases in expenditure on account of the COVID-19 pandemic have necessitated large increases in government borrowing across the globe—the International Monetary Fund (IMF) has said that in 2020, it “observed the largest one-year debt surge since World War II.”<sup>3</sup>
3. The headline measure of the UK's national debt is 'public sector net debt excluding public sector banks' (PSND ex), which the Office for Budget Responsibility (OBR) simply refers to as 'PSND'—a shorthand that will be adopted for the entirety of this report. At the end of July 2024, PSND was (provisionally) estimated at 99.4 per cent of the UK's Gross Domestic Product (GDP) or £2.74 trillion in cash terms.<sup>4</sup>
4. In the last Parliament, the Government adopted an alternative target for its main fiscal rule: PSND excluding the contribution of the Bank of England's balance sheet—known as Public Sector Net Debt excluding the Bank of England (PSND ex BOE).<sup>5</sup> This was estimated at 91.9 per cent of GDP as of July 2024 or £2.54 trillion in cash terms.<sup>6</sup>
5. Fiscal rules were first introduced in 1997 by the then Chancellor of the Exchequer, the Rt Hon Gordon Brown, in order to “ensure an historic break from the short-termism and expediency that have characterised the recent fiscal policies of our country”.<sup>7</sup> The rules stipulated that revenues should cover day-to-day spending over the economic cycle (the 'Golden rule'), during which time overall debt must average no more than 40 per cent of

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2 House of Commons Library, The budget deficit: a short guide, Research Briefing, [CBP-6167](#), January 2024

3 International Monetary Fund, 'Global Debt Reaches a Record \$226 Trillion' (December 2021): <https://www.imf.org/en/Blogs/Articles/2021/12/15/blog-global-debt-reaches-a-record-226-trillion> [accessed 28 May 2024]

4 Office for National Statistics, 'Public sector finances, UK: July 2024' (21 August 2024): <https://www.ons.gov.uk/economy/governmentpublicsectorandtaxes/publicsectorfinance/bulletins/publicsectorfinances/july2024> [accessed 29 August 2024]

5 For a time series of 'PSND (ex PS banks ex BOE)', see Office for National Statistics, 'Public Sector: PSND (ex PS banks ex BoE) as a % GDP: NSA' (21 August 2024): <https://www.ons.gov.uk/economy/governmentpublicsectorandtaxes/publicsectorfinance/timeseries/cpoa/pusf> [accessed 29 August 2024]

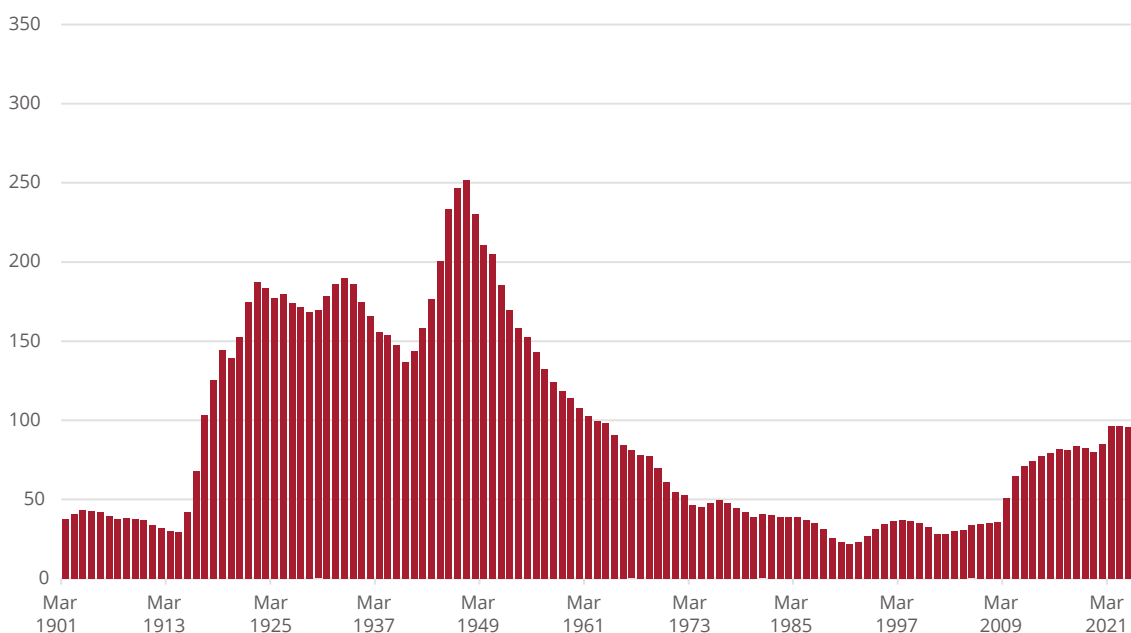
6 Office for National Statistics, 'Public sector finances, UK: July 2024' (21 August 2024) <https://www.ons.gov.uk/economy/governmentpublicsectorandtaxes/publicsectorfinance/bulletins/publicsectorfinances/july2024> [accessed 29 August 2024]

7 HC Deb, 2 July 1997, [col 303](#)

GDP (the ‘sustainable investment rule’).<sup>8</sup> In total, there have been nine sets of fiscal rules since their introduction. The former government’s main fiscal rule relating to debt was that PSND ex BOE as a percentage of GDP should be falling by the fifth year of the rolling forecast period.<sup>9</sup> We discuss the fiscal rule in more detail in Chapter 5.

6. In terms of debt’s trajectory over the years, PSND stood at just under 40 per cent of GDP at the start of the 20th century; but it had risen to more than 140 per cent by the end of the First World War. The debt ratio fell back only marginally before it then soared during the Second World War, reaching a peak of just over 250 per cent in its aftermath. By the start of the 1970s, it had fallen back to around 60 per cent of GDP; and as the 1990s got underway, it reached 20th century lows of just over 20 per cent. However, debt rose sharply in the aftermath of the 2008 global financial crisis and moved gradually higher over the course of the following decade, reaching highs of 83.5 per cent in 2017. As a result of increased public spending through the COVID-19 pandemic, however, the debt ratio rose further to just under 100 per cent of GDP in 2021 and as of July 2024, it stood at 99.4 per cent (see Figure 1).

**Figure 1: Public sector net debt excluding public sector banks (PSND), percentage of GDP, UK, financial years ending 1901 to July 2024**



Source: Office for National Statistics, ‘Public sector finances, UK: July 2024’ (August 2024), Figure 6: <https://www.ons.gov.uk/economy/governmentpublicsectorandtaxes/publicsectorfinance/bulletins/publicsectorfinances/july2024#borrowing-in-earlier-financial-years> [accessed 29 August 2024]

7. According to the Office for Budget Responsibility (OBR),<sup>10</sup> the increase in the UK’s national debt since the turn of this century reflects “the frequency

8 Institute for Government, ‘Fiscal rules in the UK since 1997’ (March 2022): <https://www.instituteforgovernment.org.uk/explainer/fiscal-rules-history> [accessed 16 March 2022]

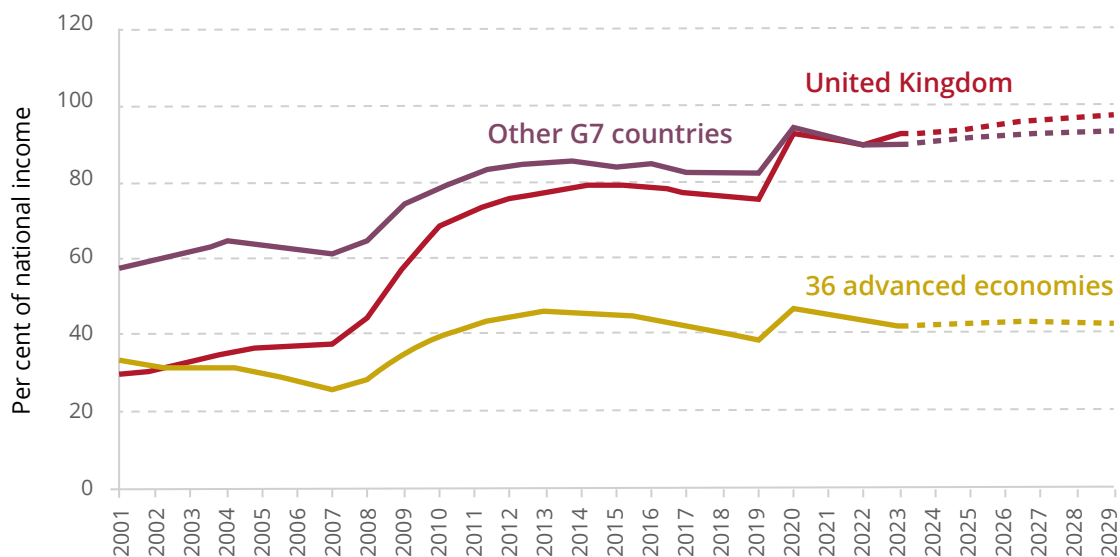
9 HM Treasury, *Charter for Budget Responsibility*, (January 2023), p 8: [https://assets.publishing.service.gov.uk/media/63d15c6cd3bf7f3c4900f11a/Charter\\_for\\_Budget\\_Responsibility\\_-\\_AS22\\_-\\_FINAL\\_as\\_published\\_in\\_draft.pdf](https://assets.publishing.service.gov.uk/media/63d15c6cd3bf7f3c4900f11a/Charter_for_Budget_Responsibility_-_AS22_-_FINAL_as_published_in_draft.pdf) [accessed 15 April 2024]

10 The Office for Budget Responsibility provides an “independent and authoritative analysis of the UK’s public finances”. See: Office for Budget Responsibility, ‘What we do’: <https://obr.uk/about-the-obr/what-we-do/> [accessed 8 May 2024].

and severity of the shocks the world has faced ... with three-quarters of the increase in the debt-to-GDP ratio since 2000 occurring in the six years immediately following the financial crisis, pandemic and energy crisis.”<sup>11</sup>

8. The Institute for Fiscal Studies (IFS) has highlighted that the UK’s debt ratio was 27 percentage points below the G7 average in 2001. The UK’s debt then grew comparatively faster than for other G7 countries during and after the 2008 global financial crisis, leaving it seven percentage points below the G7 average in 2019. The UK’s debt then surpassed the G7 average for the first time after the COVID-19 pandemic. Referring to IMF forecasts, the IFS points out that the UK’s debt ratio will continue to grow and reach five percentage points above the G7 average in 2029, or 55 percentage points above the average of 36 comparator countries (see Figure 2).<sup>12</sup>

**Figure 2: General government net debt**



Source: Institute for Fiscal Studies, ‘Spending as much as other countries but taxing less is unlikely to be sustainable’ (April 2024), Figure 3: <https://ifs.org.uk/articles/spending-much-other-countries-taxing-less-unlikely-be-sustainable> [accessed 8 May 2024]

### Wider economic context

9. As we noted in Paragraph 2, debt has tended to spike when governments have responded to economic shocks. In the years following the 2008 global financial crisis, the budget deficit rose sharply, exceeding 10 per cent of GDP in 2009/10<sup>13</sup> as public spending rose to around 43 per cent of GDP, up from pre-2008 crisis lows of under 35 per cent. Although spending fell to just under 40 per cent in 2018/19,<sup>14</sup> it subsequently rose to a post-war peak of

11 Office for Budget Responsibility, *Fiscal risks and sustainability*, CP 870, (July 2023): [https://obr.uk/docs/dlm\\_uploads/Fiscal\\_risks\\_and\\_sustainability\\_report\\_July\\_2023.pdf](https://obr.uk/docs/dlm_uploads/Fiscal_risks_and_sustainability_report_July_2023.pdf) [accessed 10 April 2024]

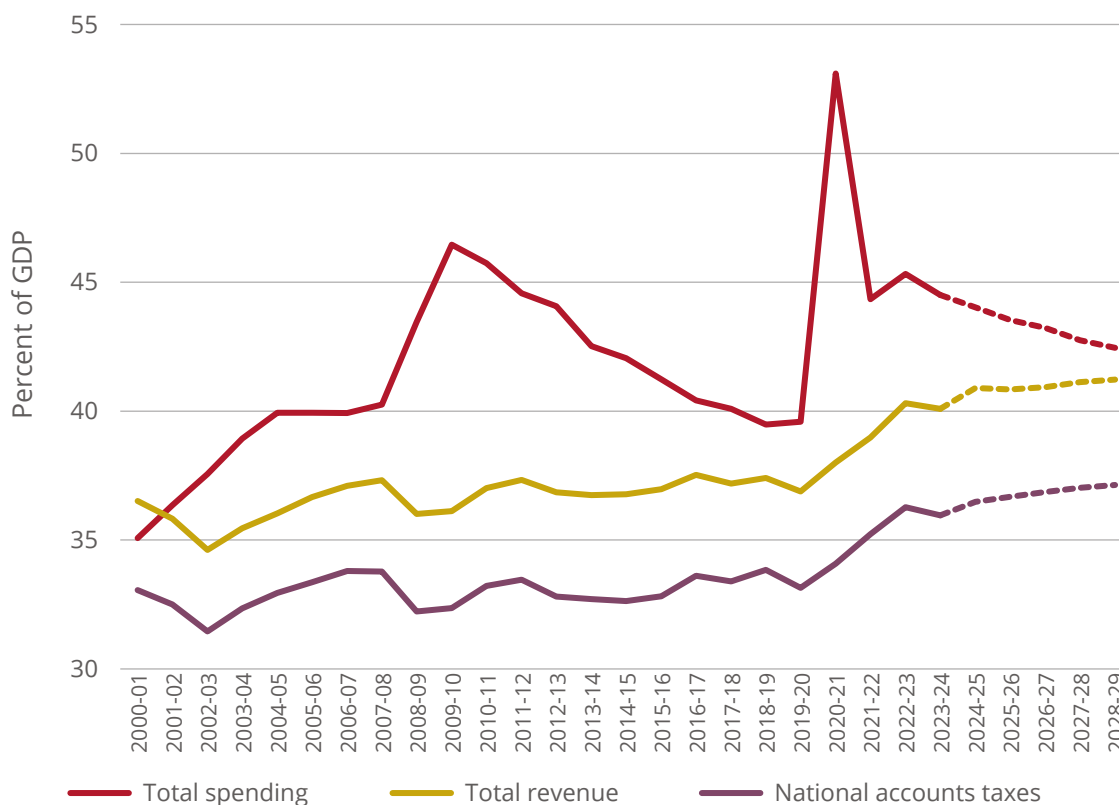
12 Institute for Fiscal Studies, ‘Spending as much as other countries but taxing less is unlikely to be sustainable’ (April 2024): <https://ifs.org.uk/articles/spending-much-other-countries-taxing-less-unlikely-be-sustainable> [accessed 8 May 2024]. The Institute for Fiscal Studies’ analysis of 36 countries includes the G7, the rest of the EU27, Iceland, Norway, Switzerland, Australia, New Zealand and South Korea.

13 House of Commons Library, *The budget deficit: a short guide*, Research Briefing, **CBP-6167**, January 2014

14 Office for Budget Responsibility, *Economic and fiscal outlook*, CP 1027 (March 2024), pp 93–95: [https://obr.uk/docs/dlm\\_uploads/E03057758\\_OBR\\_EFO-March-2024\\_Web-AccessibleFinal.pdf](https://obr.uk/docs/dlm_uploads/E03057758_OBR_EFO-March-2024_Web-AccessibleFinal.pdf) [accessed 8 May 2024]

53.1 per cent of GDP in the midst of the COVID-19 pandemic (2020/21).<sup>15</sup> Revenues were lower than spending throughout the decade to 2020, yielding an average deficit of 5.4 per cent of GDP per annum.<sup>16</sup>

**Figure 3: Government spending, revenues and the tax take**



Source: Office for Budget Responsibility, 'Data' (March/April): <https://obr.uk/data/> [accessed 28 May 2024]

**Table 1: Government borrowing and debt**

Government borrowing and debt				
Financial (year end)	Public sector net borrowing		Public sector net debt, % GDP	
	£ bn	% GDP	Total	Ex BoE
2013/14	104	5.8	79.2	77.0
2014/15	99	5.3	81.6	79.2
2015/16	82	4.3	81.3	78.9
2016/17	58	2.9	83.5	77.4
2017/18	61	2.9	82.3	73.7
2018/19	45	2.1	80.3	72.3
2019/20	61	2.7	85.2	77.1

<sup>15</sup> *Ibid.*, para 4.44

<sup>16</sup> Office for National Statistics, 'PS: Net Borrowing (exc PS Banks) as a % of GDP' (August 2024): <https://www.ons.gov.uk/economy/governmentpublicsectorandtaxes/publicsectorfinance/timeseries/j5ij/pusf> [accessed 30 August 2024]

Government borrowing and debt				
2020/21	315	15.1	96.5	86.5
2021/22	126	5.3	96.6	83.2
2022/23	128	5.0	95.7	84.9
2023/24	120	4.4	98.1	89.3

Source: House of Commons Library, *Public Finances: Key Economic Indicators, Research Briefing, The budget deficit: a short guide, Research Briefing, 02812, August 2024*. The briefing notes that the figures “for 2023/24 are not final and will be revised as provisional data are replaced with final audited data.”

10. Over the same period, although the tax take and other government revenues were fairly steady, they were persistently outpaced by spending. Although subsequently rising sharply higher in the wake of the COVID-19 pandemic,<sup>17</sup> the tax take averaged 32.5 per cent of GDP over the decade prior to 2020 compared with an average of 33.6 per cent for Organisation for Economic Co-operation and Development countries.<sup>18</sup> That successive governments ran budget deficits throughout this period partly reflected a secular slowdown in the UK’s economic growth rate. From 1950 to 2000, annual percentage growth rates averaged over each decade were 3.2, 3.4, 2.6, 2.7 and 2.3 respectively; but from 2000 to 2019, growth averaged just 1.8 per cent.<sup>19</sup>
11. In terms of existing pressures on public spending generally, the OBR pointed out in March 2024 that, assuming day-to-day real spending as a whole grows by one per cent on average, this leaves ‘unprotected’ spending needing to fall by 2.3 per cent a year in real terms from 2025/26 (if the Government at that time was to meet its fiscal rules).<sup>20</sup> As such, the OBR noted that if defence and Official Development Assistance spending increased in line with the then government’s ambitions, this would lead to unprotected spending needing to fall by an average of 3.6 per cent a year.<sup>21</sup>

### Debt and looking ahead

12. Based on the former government’s fiscal policies, the OBR forecast in March 2024 that PSND ex BOE will rise to a peak of 93.2 per cent of GDP in 2027/28, before falling to 92.9 per cent of GDP in 2028/29.<sup>22</sup> Therefore, the former Government had been on track to meet the main fiscal rule relating to debt: as stated above, PSND ex BOE as a percentage of GDP should be falling by the fifth year of the rolling forecast period (we cover this in more detail in Chapter 5). However, the OBR emphasised that these forecasts were

17 Office for Budget Responsibility, *Economic and fiscal outlook*, CP 804, (March 2023), Box 4.2: [https://obr.uk/docs/dlm\\_uploads/OBR-EFO-March-2023\\_Web\\_Accessible.pdf](https://obr.uk/docs/dlm_uploads/OBR-EFO-March-2023_Web_Accessible.pdf) [accessed 8 May 2024]

18 Institute for Fiscal Studies, ‘How do UK tax revenues compare internationally?’ (March 2024): <https://ifs.org.uk/taxlab/taxlab-key-questions/how-do-uk-tax-revenues-compare-internationally> [accessed 8 May 2024]

19 Office for National Statistics, ‘National Accounts at a glance’ (October 2020): <https://www.ons.gov.uk/economy/grossdomesticproductgdp/compendium/ukkingdomnationalaccounts/bluebook/2020/nationalaccountsataglance> [accessed 8 May 2024]

20 Office for Budget Responsibility, *Economic and fiscal outlook*, CP 1027 (March 2024), p 104: [https://obr.uk/docs/dlm\\_uploads/E03057758\\_OBR\\_EFO-March-2024\\_Web-AccessibleFinal.pdf](https://obr.uk/docs/dlm_uploads/E03057758_OBR_EFO-March-2024_Web-AccessibleFinal.pdf) [accessed 11 April 2024]. Note that ‘unprotected’ areas are all those not covered by an explicit commitment and include the courts, HMRC and local government.

21 *Ibid.*

22 Office for Budget Responsibility, *Economic and fiscal outlook*, CP 1027, (March 2024), p 121: [https://obr.uk/docs/dlm\\_uploads/E03057758\\_OBR\\_EFO-March-2024\\_Web-AccessibleFinal.pdf](https://obr.uk/docs/dlm_uploads/E03057758_OBR_EFO-March-2024_Web-AccessibleFinal.pdf) [accessed 11 April 2024]

conditioned on the tax-to-GDP ratio increasing by a further 1.1 percentage points from its current level to close to a post-war high of 37.1 per cent of GDP by 2028/29.<sup>23</sup>

13. The OBR has acknowledged that pressures on public finances have been part of a global phenomenon. It has said that the average debt-to-GDP ratio among 33 advanced economies rose from 52 per cent of GDP in 2000 to 81 per cent of GDP in 2021.<sup>24</sup> Across G7 countries alone, the average rose from 76 per cent to 131 per cent of GDP.<sup>25</sup>
14. The IMF has described the mounting pressures on governments generally as a “policy trilemma” associated with strong spending pressures on national budgets, political resistance to taxation and the need to contain debt and deficits to deliver fiscal sustainability and financial stability.<sup>26</sup> Pierre-Olivier Gourinchas, Director of Research at the IMF, recently wrote: “With higher debt, slower growth, and larger deficits, it would not take much for debt trajectories to become much less comfortable in many places, especially if markets send government bond spreads higher, with risks for financial stability.”<sup>27</sup>
15. The OBR expects debt to pass 100 per cent of GDP by the mid-2040s.<sup>28</sup> However, the OBR routinely emphasises the degree of uncertainty around its own central forecasts by using probabilistic ranges (‘fan charts’), alternative scenarios, and sensitivity analysis.<sup>29</sup>

### Our inquiry

16. Against this backdrop, we launched our inquiry on 8 December 2023 with a call for evidence on the sustainability of the UK’s national debt. We sought evidence on whether the UK’s national debt is on a sustainable path. If not, what steps are required, and whether the Government’s fiscal rule relating to debt is meaningful. As this inquiry largely took place in the previous Parliament, this report is based on evidence taken before Parliament was dissolved on 30 May 2024 for the General Election on 4 July 2024. Much of the evidence we received was based on, or reflected the findings of analysis conducted by the OBR, including the OBR’s July 2023 Fiscal Risks and Sustainability report (FRS). The OBR will publish an updated FRS in September 2024.
17. Chapter 2 of our report considers how debt sustainability might be defined and measured. Chapter 3 looks at present vulnerabilities of our public finances related to rising costs and the financing of our debt. This is both in terms of international pressures and its structure. Chapter 4 assesses

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23 *Ibid.*, p 16

24 Office for Budget Responsibility, *Fiscal risks and sustainability*, CP 870, (July 2023), para 4.8: [https://obr.uk/docs/dlm\\_uploads/Fiscal\\_risks\\_and\\_sustainability\\_report\\_July\\_2023.pdf](https://obr.uk/docs/dlm_uploads/Fiscal_risks_and_sustainability_report_July_2023.pdf) [accessed 10 April 2024]

25 *Ibid.*, para 4.1

26 International Monetary Fund, ‘Fiscal Policy in the Great Election Year’ (April 2024): <https://www.imf.org/en/Publications/FM/Issues/2024/04/17/fiscal-monitor-april-2024> [accessed 8 May 2024]

27 International Monetary Fund, ‘Global Growth Steady Amid Slowing Disinflation and Rising Policy Uncertainty’ (July 2024): <https://content.govdelivery.com/accounts/USIMF/bulletins/3a8f004> [accessed 17 July 2024]

28 Office for Budget Responsibility, *Fiscal risks and sustainability*, CP 870 (July 2023), 4.47: [https://obr.uk/docs/dlm\\_uploads/Fiscal\\_risks\\_and\\_sustainability\\_report\\_July\\_2023.pdf](https://obr.uk/docs/dlm_uploads/Fiscal_risks_and_sustainability_report_July_2023.pdf) [accessed 10 April 2024]

29 Office for Budget Responsibility, Foreword, ‘Fiscal risks and sustainability: July 2023’ (July 2023): <https://obr.uk/frs/fiscal-risks-and-sustainability-july-2023/> [accessed 8 May 2024]

challenges to get debt falling and the pressure they will place on the public finances. It also considers the choices confronting the new government in looking to address these challenges. Finally, Chapter 5 considers the UK's fiscal framework with a focus on the efficacy of the main fiscal rule relating to debt.

18. We are grateful to all our witnesses for their evidence, and to our Specialist Adviser, Dr Isabel Stockton.

## CHAPTER 2: DEBT SUSTAINABILITY

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### Does debt matter?

19. Many witnesses were of the view that a government's ability to finance spending by borrowing is not without limit or consequence. Charles Goodhart, Emeritus Professor of Banking and Finance at the London School of Economics, observed that "[debt] has to be repaid with interest."<sup>30</sup> Joseph Stiglitz, University Professor at Columbia University, considered that debt matters "both economically, and, perhaps even more, politically."<sup>31</sup> Stephen D King, Senior Economic Adviser at HSBC, said that debt "has all sorts of implications depending on how quickly it is rising, who is indebted, what the returns are on the money that is raised."<sup>32</sup>
20. Some witnesses endorsed Modern Monetary Theory (MMT).<sup>33</sup> It posits that governments with their own sovereign currency are not fiscally constrained as they can print money to finance expenditure. History tells us that public spending unconstrained by a fiscal framework is very likely to be inflationary.
21. Sir Dieter Helm, Professor of Economic Policy at the University of Oxford, gave a nuanced view. He said that debt "certainly" matters but is "not a serious problem" if it has created "genuinely enhanced new assets".<sup>34</sup> However, he pointed out that debt is increasingly accrued to pay for current consumption, which is a problem in itself: the interest has to be paid and it constrains other public choices.<sup>35</sup>
22. Ultimately, a government's failure to manage its debt appropriately may have direct implications for economic stability and social welfare. As the World Bank has highlighted: "Overindebted governments are unable to pay for public goods such as education and public health care, thereby risking poorer human development outcomes and abrupt increases in inequality."<sup>36</sup> It also stated: "Countries in debt distress also have limited capacity to cope with future shocks and may be unable to serve as the lender of last resort to private sector companies in need of public assistance."<sup>37</sup>
23. In 2021, the Cato Institute conducted a study of literature produced between 2010 and 2020 on the relationship between public debt and growth. It found that for "the 40 studies reviewed, 36 studies identify a statistically significant (linear or nonlinear) negative effect of public debt on growth. Of the four remaining studies, two studies find that the negative effects of public debt on growth can be largely alleviated by good quality institutions and good policy, while two studies find only weak evidence for the existence of a negative debt-growth relationship."<sup>38</sup>

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30 [Q 149](#) (Charles Goodhart) and [Q 179](#) (Erich Arispe and Stephen D King)

31 [Q 196](#) (Joseph Stiglitz)

32 [Q 179](#) (Stephen D King)

33 See for example, written evidence from Professor Richard Murphy ([SND0016](#)) and written evidence from Gower Initiative ([SND0019](#)).

34 [Q 149](#) (Sir Dieter Helm)

35 *Ibid.*

36 The World Bank, 'World Development Report "Chapter 5. Managing sovereign debt"' (2022): <https://www.worldbank.org/en/publication/wdr2022/brief/chapter-5-managing-sovereign-debt> [accessed 22 April 2024]

37 *Ibid.*

38 CATO Institute, 'The Impact of Public Debt on Economic Growth' (2021): <https://www.cato.org/cato-journal/fall-2021/impact-public-debt-economic-growth> [accessed 8 May 2024]

24. Ultimately, poor debt management could leave a government unable to secure requisite levels of funding. As the IMF has noted: “Defaults can cause borrowing countries to lose market access and suffer higher borrowing costs, in addition to harming growth and investment.”<sup>39</sup> A government at growing risk of falling into a ‘debt trap’ or defaulting on its payments will see its fiscal choices severely restrained, and potentially see it resort to financial repression. We discuss this in more detail from Paragraph 37.

### What is meant by ‘sustainability’?

25. Witnesses were clear that there is more to the notion of debt sustainability than governments avoiding default on debt repayments. Peder Beck-Friis, Senior Vice President and Economist at PIMCO (one of the world’s largest investment managers), told us that “for a country such as the UK that has access to its own central bank, the risk seems to be higher inflation as opposed to an outright default.”<sup>40</sup> In view of a government’s ability to print more money, Julian Jessop, Economics Fellow at the Institute of Economic Affairs, pointed out that we should not expect a correlation between debt levels and default.<sup>41</sup>
26. Several witnesses also dismissed the idea that there is a fixed threshold beyond which debt becomes unsustainable.<sup>42</sup> James Smith, Research Director at the Resolution Foundation, explained: “There is no one level of debt that is too much, but the higher your debt is, the greater the risk of losing fiscal space and the ability to use fiscal policy.”<sup>43</sup> Carl Emmerson, Deputy Director at the IFS, similarly stated that “a combination of high debt, interest rates that are not ultralow and low productivity growth makes all of the economic challenges we face more difficult. If you want to make reforms in difficult areas, it is always easier to do so if you have money to spare.”<sup>44</sup> Moreover, reduced fiscal space may have broader implications. Sonja Gibbs, Head of Sustainable Finance at the Institute of International Finance, told us that higher debt “is going to bring more risks, including financial stability risks and challenges.”<sup>45</sup>
27. When considering whether the financial markets can be relied upon to give early warning signs of an unsustainable debt, Dr Mohamed A. El-Erian, Chief Economic Adviser at Allianz, said that “tipping points are really hard to predict, because they are a function not just of your initial conditions but of how markets receive your intentions, what is happening around you, and what is happening [across the global economy].”<sup>46</sup> Alluding to the gilt market turbulence of autumn 2022, he added: “It came as a shock to us all that the

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39 International Monetary Fund, ‘What is debt sustainability?’ (September 2020): <https://www.imf.org/en/Publications/fandd/issues/2020/09/what-is-debt-sustainability-basics> [accessed 22 April 2024]

40 Q 124 (Peder Beck-Friis). Further to this point, Mr Beck-Friis subsequently told the FT (on 18 July 2024) that “the fiscal outlook understandably raises concerns, but it shouldn’t raise alarm. In most developed countries, government debt levels are still too low to pose any immediate threat to fiscal credibility.” See: ‘There is no need for investors to panic over government debt’, *Financial Times*, (18 July 2024): <https://www.ft.com/content/3f40c12f-b0d9-43c8-af02-851914ce3ea2> [accessed 5 September 2024]

41 Q 103 (Julian Jessop)

42 See for example Q 104 (Julian Jessop) or Q 31 (Richard Hughes).

43 Q 95 (James Smith)

44 Q 124 (Carl Emmerson)

45 Q 124 (Sonja Gibbs)

46 Q 68 (Dr Mohamed El-Erian)

markets could lose confidence so quickly and that the pension system could be threatened.”<sup>47</sup>

28. Some witnesses preferred a particularly broad take on the notion of sustainability. Professor Jagjit Chadha, Director at the National Institute of Economic and Social Research, used a “working definition” of sustainability, namely “a level of public debt such that, when a shock comes along, we are able to access financial markets and respond to the problems in a prompt manner.”<sup>48</sup> Similarly, the Institute for Government said that a sustainable national debt is one where the “government [ensures] that in future the country will be able to meet its debt service requirements without compromising the ability of future governments also to provide essential public services and invest in long-term growth.”<sup>49</sup>

### Measuring debt sustainability

29. The public debt-to-GDP ratio is the most familiar and widely used metric to gauge a country’s indebtedness.<sup>50</sup> However, witnesses were generally of the view that while the ratio might be considered a useful proxy—with the “very great advantage of being comparable internationally”—it says very little about debt sustainability.<sup>51</sup> Richard Hughes, Chair of the OBR, told us that “one reason why [OBR] reports are so long, is because we think that there is more to sustainability than the debt-to-GDP ratio.”<sup>52</sup>
30. According to Dr El-Erian, both the numerator and the denominator of the debt-to-GDP ratio can be misleading. He said that ‘debt’ tells you little about the debt’s maturity profile,<sup>53</sup> for example, while “GDP has all sorts of issues”.<sup>54</sup> Accordingly, Martin Slater, Emeritus Fellow in Economics at St Edmund Hall, emphasised that context is important. He said: “The same debt ratio could be sustainable or unsustainable in different circumstances.”<sup>55</sup>
31. When considering the implications of high debt-to-GDP ratios, witnesses also raised questions about causality. Julian Jessop pointed out that a country might have a high level of debt if its economy is weak, not because the debt itself is causing the weakness. This reinforced his doubts that “there is a particular magic level of debt that you can identify as being a problem level.”<sup>56</sup> Carl Emmerson also questioned any discernible relationship between debt and growth. He said: “Countries that cannot have big debt are often poorer countries that have more scope for growth than bigger, richer economies. I suspect there are quite a lot of other factors causing those correlations that we can see in the data.”<sup>57</sup>

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47 *Ibid.*

48 [Q 1](#) (Prof Jagjit Chadha)

49 Written evidence from the Institute for Government ([SND0033](#))

50 See for example International Monetary Fund, *Global debt monitor 2023* (September 2023): <https://www.imf.org/-/media/Files/Conferences/2023/2023-09-2023-global-debt-monitor.ashx> [accessed 10 April 2024]

51 See [Q 131](#) (Richard Hughes), [Q 103](#) (Danisha Kazi), [Q 136](#) (Carl Emmerson, Peder Beck-Friis and Sonja Gibbs).

52 [Q 31](#) (Richard Hughes)

53 Maturity profile refers to the duration until a debt instrument reaches maturity and becomes due for repayment.

54 [Q 77](#) (Dr Mohamed El-Erian)

55 [Q 1](#) (Martin Slater)

56 [Q 103](#) (Julian Jessop)

57 [Q 137](#) (Carl Emmerson)

32. Therefore, witnesses were generally of the view that in order to provide the requisite context with which to gauge debt sustainability, a number of different economic and financial criteria must be assessed.<sup>58</sup> Dr El-Erian used the analogy of a cockpit, stating: “Some instruments are more important than others, but you need to look at all the instruments.”<sup>59</sup> One of the most important criterion in gauging debt sustainability is the difference between the rates of interest on debt instruments and GDP growth, or ‘r-g’ (with both measured in either real or nominal terms).<sup>60</sup>

### Box 1: ‘r-g’

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| <ol style="list-style-type: none"> <li>1. If <math>r</math> (the interest rate on government debt)<sup>61</sup> exceeds <math>g</math> (the GDP growth rate), the debt-to-GDP ratio is likely to rise in the absence of a government primary surplus (that is, the Government raises more in revenues than it spends on anything but debt interest).</li> <li>2. Equally, if <math>r</math> is smaller than <math>g</math>, the debt-to-GDP ratio is likely to fall in the absence of a primary deficit.</li> <li>3. In all these comparisons of <math>r</math> and <math>g</math>, they must both be measured in the same way—either in nominal terms or both in real terms (net of inflation).</li> </ol> |
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33. There are a number of factors that can influence the ‘r-g’ relationship, including inflation, macroeconomic and political stability (reflected in lower risk premia on public debt); the correlation of risk and interest rates (with ‘safe haven’ countries enjoying a fall in interest rates during a crisis); reserve currency status (which can push rates lower for reasons other than return) and trend growth.
34. Given the importance of whether debt is rising or falling (as opposed to its level), witnesses emphasised the significance of the expected trajectory of debt and associated variables in the sustainability ‘equation’. Julian Jessop remarked: “I do not think it really matters whether that debt level is 100% of national income or 120%, but I am concerned about the trends.”<sup>62</sup> Elaborating on this point, Professor Chadha told us: “When we think about sustainability, we are really asking ourselves whether debt will grow without bound relative to national income. It inherently involves some judgment about the future path of expenditures and revenues over time”.<sup>63</sup> However, Professor Goodhart argued that the level of debt matters as well as the trajectory, saying that “it would be a lot easier if we were starting from a debt ratio of 40% rather than a debt ratio of around 95%.”<sup>64</sup>
35. Aside from considering a government’s ability to pay its debt in ‘cash flow’ terms, several witnesses suggested that the concept of sustainability should also consider a country’s stock of assets and liabilities (its ‘balance

58 See for example [Q 103](#) (Danisha Kazi), [Q 1](#) (Prof Jagjit Chadha) and [Q 31](#) (Richard Hughes).

59 [Q 80](#) (Dr Mohamed El-Erian)

60 It has been argued that Olivier Blanchard is behind the renewed popularity of the framework in recent years, stemming from his presentation at the American Economic Association in April 2019. See: Olivier Blanchard, ‘Public Debt and Low Interest Rates’, *American Economic Review*, vol 109 (April 2019), pp 1197–1229: <https://www.aeaweb.org/articles?id=10.1257/aer.109.4.1197> [accessed 10 April 2024]

61 10-year bond yields are often used as a simple gauge of sustainability in the r-g dynamic but a more accurate analysis requires weighted averages of the various maturities of outstanding debt.

62 [Q 93](#) (Julian Jessop)

63 [Q 1](#) (Prof Jagjit Chadha)

64 [Q 150](#) (Charles Goodhart)

sheet’) and what debt has been issued against it (the implication being that borrowing might feasibly ‘pay for itself’ if it has funded investment).<sup>65</sup> James Smith stated: “Every private company in the world is valuing its assets and liabilities ... It is very odd that we suddenly drop any sort of sophistication in accounting when we are looking at the [UK’s] public finances.”<sup>66</sup> Sir Dieter Helm envisaged a Budget Day when the Chancellor would present accounts and on the balance sheet “would be the assets and the liabilities, and that is what the debt against the assets would be for.”<sup>67</sup>

36. Sam Beckett, Chief Economic Adviser to His Majesty’s (HM) Treasury, highlighted to us that alongside the fiscal rules, “the Charter for Budget Responsibility<sup>68</sup> includes a commitment to consider ‘wider data, analysis and evidence on the affordability of public debt and the strength of the public sector balance sheet’”.<sup>69</sup> As such, Ms Beckett noted that the Government pays particular attention to Public Sector Net Worth (PSNW) and Public Sector Net Financial Liabilities (PSNFL).<sup>70</sup>

### The ‘debt trap’

37. Dr Gerard Lyons, Chief Economic Strategist at Netwealth Investments, highlighted that the pre-2008 global financial crisis trend rate of growth (circa 2.25 per cent) meant that the economy doubled in size, in real terms, every 32 years. However, Dr Lyons noted that not only is trend growth now far lower, but “expectations on public spending do not appear to have adjusted accordingly.”<sup>71</sup> As such, he argued that “there is a serious danger that [the UK] will fall into a debt trap before the end of this decade.”<sup>72</sup> According to Dr Lyons, a debt trap occurs when a country’s debt-to-GDP ratio exceeds 100 per cent and GDP growth falls below the rate of interest paid on debt [i.e.  $r > g$ ]. He said that “in such a situation the ratio of debt keeps rising.”<sup>73</sup> Paul Johnson, Director of the IFS, has commented that “wishful thinking will not keep us out of a debt-interest-fuelled doom loop. Only hard choices will do that. We need either a serious re-evaluation of our welfare state or we

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65 See for example [Q 106](#) (Danisha Kazi).

66 [Q 108](#) (James Smith)

67 [Q 160](#) (Sir Dieter Helm)

68 The Charter for Budget Responsibility “presents the government’s approach to operating fiscal policy and managing sustainable public finances in the long-term interests of the UK” See: HM Treasury, *Charter for Budget Responsibility: autumn 2021 update*, (January 2022): [https://assets.publishing.service.gov.uk/media/61d55fedd3bf7f1f7036fb82/Charter\\_for\\_Budget\\_Responsibility\\_FINAL.pdf](https://assets.publishing.service.gov.uk/media/61d55fedd3bf7f1f7036fb82/Charter_for_Budget_Responsibility_FINAL.pdf) [accessed 8 May 2024]

69 Letter from Sam Beckett, Chief Economic Adviser, Second Permanent Secretary and Head of the Government Economic Service, to Lord Bridges of Headley, Chair of the Economic Affairs Committee (8 April 2024): <https://committees.parliament.uk/publications/44411/documents/220749/default/>

70 Letter from Sam Beckett, Chief Economic Adviser, Second Permanent Secretary and Head of the Government Economic Service, to Lord Bridges of Headley, Chair of the Economic Affairs Committee (8 April 2024): <https://committees.parliament.uk/publications/44411/documents/220749/default/> [accessed 28 May 2024]. PSNW is a statistical aggregate summarising the total value of the public sector’s assets and its liabilities. PSNFL is broader than PSND and includes all public sector financial assets and liabilities that are recognised in the national accounts. See Office for National Statistics, ‘Wider measures of the public sector balance sheet: public sector net worth’ (June 2021): <https://www.ons.gov.uk/economy/governmentpublicsectorandtaxes/publicsectorfinance/methodologies/widermeasuresofthepublicsectorbalancesheetpublicsectornetworth> [accessed 8 May 2024]

71 Written evidence from Dr Gerard Lyons ([SND0034](#))

72 *Ibid.*

73 *Ibid.*

need to contemplate getting used to taxes remaining higher than they have been at any point in the past 70 years. Or possibly rising further still.”<sup>74</sup>

38. Related to this latter point, Professor David Miles, member of the Budget Responsibility Committee at the OBR, commented: “The funding of the existing stock of UK government debt has already become a substantially greater burden.”<sup>75</sup> With reference to ‘r-g’, he noted that just “a few years ago” the real interest rates at which the Government could raise new debt “was around -1.5 per cent”.<sup>76</sup> This meant that GDP growth of 1.5 per cent could sustain a fiscal deficit of 3 per cent without upward pressure on the debt-to-GDP ratio. However, Professor Miles then highlighted that as of January 2024, comparable yields pointed to a real rate of more than 1 per cent with another 1 per cent upward adjustment required “because growth in the prices of UK output (the GDP deflator) is likely to be below inflation [as measured by the Retail Price Index] on which indexed linked real yields are based.”<sup>77</sup>
39. Therefore, Professor Miles noted that “the likely rate of r-g today is now positive and perhaps around +1% rather than the -3% of a few years ago” which if sustained means that “a primary surplus of around 1% of GDP—nearly £30 billion at today’s prices—would be needed to prevent debt rising further.”<sup>78</sup> Peder Beck-Friis highlighted that “Italy has barely grown for 20 years and has a trend growth of barely zero ... It has a much higher debt to GDP stock than the UK, but the markets seem fairly sanguine because it has a long history of being able to run primary surpluses.”<sup>79</sup>
40. Any government looking to pre-empt a looming ‘debt trap’ can see it resort to ‘financial repression’, in which it circumvents market forces in order to secure adequate levels of affordable funding. The IMF defines financial repression as “legal restrictions on interest rates, credit allocation, capital movements, and other financial operations”.<sup>80</sup> Julian Jessop delineated between “some soft forms of financial repression we have already had over the last few years and decades”. He said this included “a long period in which ... financial institutions in the private sector were encouraged to buy government debt through prudential regulations”; and “something more sinister, more the sort of thing that might happen in an emerging economy where private sector institutions are forced to lend to the Government”.<sup>81</sup> The latter, Mr Jessop noted, was “very unlikely in an advanced economy” but, he added that “there will clearly be more pressure on central banks to keep interest

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74 Institute for Fiscal Studies, ‘Talk of a ‘doom loop’ in the public finances is for very good reasons’ (December 2023): <https://ifs.org.uk/articles/talk-doom-loop-public-finances-very-good-reasons> [accessed 8 May 2024]

75 Written evidence from Prof David Miles (SND0012)

76 Prof David Miles refers to yields on index linked bonds of 10 years to 20 years maturity.

77 Written evidence from Prof David Miles (SND0012)

78 *Ibid.*

79 Q 142 (Peder Beck-Friis)

80 International Monetary Fund, ‘Working Papers, Financial Repression is Knocking at the Door, Again’ (September 2019): <https://www.imf.org/en/Publications/WP/Issues/2019/09/30/Financial-Repression-is-Knocking-at-the-Door-Again-48641> [accessed 10 April 2024]. However, there are many alternative definitions: see for example, Federal Reserve Bank of Minneapolis, ‘Financial Repression: Evidence and Theory’ (March 2016): <https://www.minneapolisfed.org/article/2016/financial-repression-evidence-and-theory> [accessed 10 April 2024] and Toby Nangle, ‘Britain’s trillion pound shortcut to financial repression’ *Financial Times* (October 2023): <https://www.ft.com/content/2f5c35ef-a332-4532-95b0-4366d0321862> [accessed 10 April 2024]

81 Q 96 (Julian Jessop)

rates lower for longer than they would otherwise have done, because of the need to finance a massive public debt.”<sup>82</sup>

41. Dr El-Erian pointed out that there are negative, longer-term consequences to bear in mind when using financial repression.<sup>83</sup> He told us that it “distorts financial relationships. It distorts the allocation of resources. When finally you get back to reality, to interest rates that are not artificially repressed, you have to deal with the stock of debt that was financed at artificially low interest rates and cannot be sustained that easily at high interest rates.”<sup>84</sup>
42. Bim Afolami, former Economic Secretary to the Treasury, was asked whether he felt confident that the Government at the time had a solution to the challenge of ensuring debt sustainability. He told us that:
 

“[All] we can do is focus on the two core things: the first is growing our economy as fast as we can, and I think we need to continue to do more on that ... The second is making sure that the demand for public services and the outputs more generally in how the service is run are done as effectively as possible.”<sup>85</sup>
43. **The sustainability of public debt depends on tax and spending policies which credibly align with expectations for economic growth and the cost of borrowing. Credibility is all important: it is the ‘glue’ between these parameters. Without credible policies, the Government runs the risk of serious financial and economic instability.**
44. **Since 2008, the UK’s debt has risen sharply. Such a sustained increase in debt has only happened in the past during wartime. The recent increase reflects global crises of a different kind: the global financial crisis, the COVID-19 pandemic and the energy crisis following Russia’s invasion of Ukraine. Each event has led to a large, one-off increase in government spending. However, it is the trajectory, rather than the level of debt and the ability of a nation to service it, which should be the principal consideration when assessing debt sustainability. A debt level risks becoming unsustainable if there is an insufficient buffer to absorb future economic shocks; or if a government’s approach to fiscal policy creates a long-term trajectory of increasing debt service costs. Although financial markets may appear content to fund a nation’s debt at a given moment, this does not indicate that its debt is on a sustainable path. Underlying problems could prove to be asymptomatic, leaving a government’s finances vulnerable to unforeseen shocks.**

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82 *Ibid.*

83 [Q 78](#) (Dr Mohamed El-Erian)

84 *Ibid.*

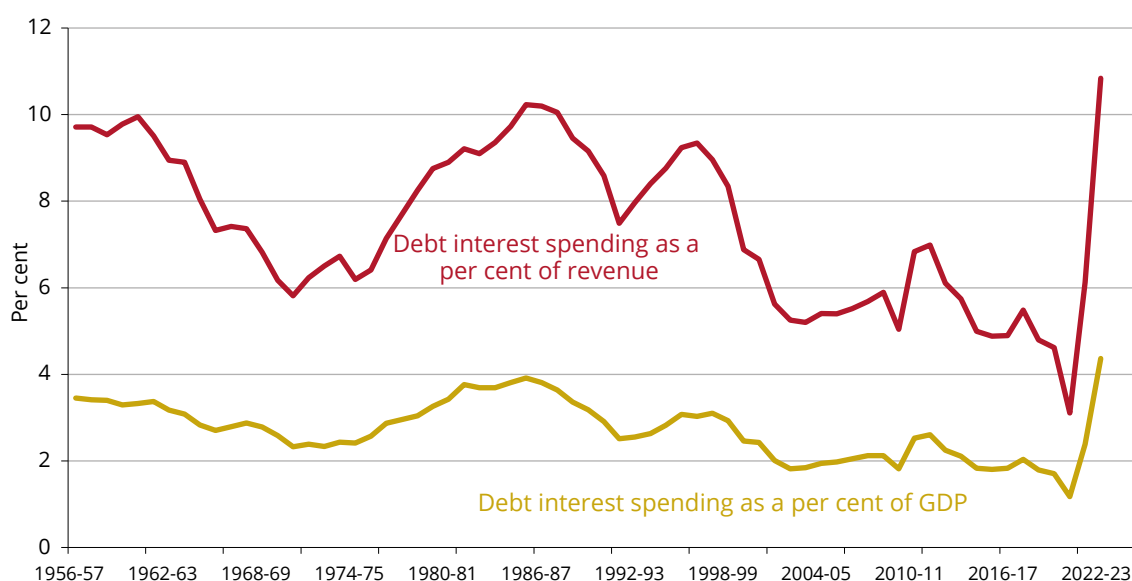
85 [Q 218](#) (Bim Afolami)

## CHAPTER 3: THE PRESENT VULNERABILITIES OF UK DEBT

### Rising costs

45. Danisha Kazi, Head of Economics at Positive Money UK, considered that “levels of public debt are not as important as the management and structure of debt, and the debt servicing costs.”<sup>86</sup> In the decade prior to the pandemic, UK debt interest costs were “remarkably stable” at around £40 billion per year according to the OBR. However, compounded by the accumulation of debt through repeated budget deficits over this period, “the rapid rise in global interest rates over the last two years means that interest costs have soared ... [reaching] a post-war record of 10.8 per cent of government revenue [in excess of £100 billion].”<sup>87</sup>
46. The UK is by no means alone in experiencing a marked increase in debt-servicing costs given that interest rates rose from ultra-low levels to combat inflation.<sup>88</sup> Moreover, the UK, like many other countries, is more likely to see interest rates remain at a level higher than they were before the pandemic. Dr El-Erian described a world which has transitioned from an era in which “you could flood the system with fiscal and monetary stimulus and not pay the cost in terms of inflation” to “a world of insufficiently flexible supply.”<sup>89</sup>

**Figure 4: Debt interest spending relative to GDP and revenues**



Source: Office for Budget Responsibility, *Economic and Fiscal Outlook*, CP 1027, (March 2024), Chart 4.12: [https://obr.uk/docs/dlm\\_uploads/E03057758\\_OBR\\_EFO-March-2024\\_Web-AccessibleFinal.pdf](https://obr.uk/docs/dlm_uploads/E03057758_OBR_EFO-March-2024_Web-AccessibleFinal.pdf) [accessed 17 July 2024]

86 Q 93 (Danisha Kazi)

87 Office for Budget Responsibility, *Economic and Fiscal Outlook*, CP 1027, (March 2024) Box 4.3: [https://obr.uk/docs/dlm\\_uploads/E03057758\\_OBR\\_EFO-March-2024\\_Web-AccessibleFinal.pdf](https://obr.uk/docs/dlm_uploads/E03057758_OBR_EFO-March-2024_Web-AccessibleFinal.pdf) [accessed 11 April 2024]

88 See for example, Policy paper from World Bank, which discusses the increased costs of debt accumulation following the COVID-19 pandemic. World Bank, *A Mountain of Debt: Navigating the Legacy of the Pandemic*, (October 2021): <https://documents1.worldbank.org/curated/en/258761633705709997/pdf/A-Mountain-of-Debt-Navigating-the-Legacy-of-the-Pandemic.pdf> [accessed 4 September 2024]

89 Q 87 (Dr Mohamed El-Erian). Specifically, Dr El-Erian highlighted the energy transition, geopolitics, corporate restructuring and skill mismatches.

47. Alongside rising interest rates, the ultimate cost of the Bank of England's quantitative easing (QE) programme has also been highlighted as a necessary consideration when assessing the UK's debt. Michael Saunders, former member of the Bank of England's Monetary Policy Committee, commented that the Bank of England's losses were likely to be comparatively larger than for other central banks because the Bank had bought longer-dated bonds than overseas counterparts.<sup>90</sup> When interest rates were at record lows, the scheme generated profits; but when interest rates rose, the Bank started to pay a much higher rate on reserves than it received for its gilt holdings.<sup>91</sup>
48. Sir Robert Stheeman, former Chief Executive Officer at the DMO, was asked if he was surprised that no apparent weight had been given to the cost of QE. He responded that "it is monetary policy which has been and is most likely, in my opinion, to continue to be the single biggest determinant of cost."<sup>92</sup> Although it is important to emphasise that forecasts are subject to significant volatility,<sup>93</sup> the OBR's March 2024 estimate of the likely lifetime losses incurred by the Bank of England's Asset Purchase Facility is £104.2 billion, which will be added to the UK's national debt.<sup>94</sup>
49. Before turning to the vulnerabilities of its debt structure, it should be emphasised that the UK is currently not an international outlier in terms of its present debt burden. As of 2022, the UK's debt-to-GDP ratio was the second lowest in the G7.<sup>95</sup> Sir Robert Stheeman also assured us that the market's current appetite for debt is "very good" and that over the past five years—during which time the DMO has raised £1.3 trillion—securing funds "has been a very smooth process".<sup>96</sup> He added: "The fact yields have not risen in an uncontrollable fashion over the past couple of years tells you it's not just me that isn't worried—the market isn't particularly worried either ... I am confident enough in the resilience and good function of the gilt market not to have a worry."<sup>97</sup>
50. Nevertheless, although the DMO has been successful in securing substantial levels of funding in recent years, an increased dependence on foreign investors exposes the UK's ability to finance its debt to a greater degree of geopolitical risk. We discuss this below.

### The structure of UK debt

51. Alongside the pressures on government spending, it is the structure of the UK's national debt (the combination of a greater share of debt being index-

90 Delphine Strauss, 'Bank of England losses on QE greater than other central banks, says ex-rate setter', *Financial Times* (21 December 2023): <https://www.ft.com/content/a411ebdf-1086-4537-af15-c6c5878353aa> [accessed 11 April 2024]

91 *Ibid.*

92 Q 239 (Sir Robert Stheeman)

93 As the OBR points out, the latest estimate of the likely APF lifetime loss of £104.2 bn is £21.9 bn less than it estimated in November 2023. See Office for Budget Responsibility, *Economic and fiscal outlook*, CP 1027, (March 2024) Box 4.4: [https://obr.uk/docs/dlm\\_uploads/E03057758\\_OBR\\_EFO-March-2024\\_Web-AccessibleFinal.pdf](https://obr.uk/docs/dlm_uploads/E03057758_OBR_EFO-March-2024_Web-AccessibleFinal.pdf) [accessed 28 May 2024]

94 Office for Budget Responsibility, *Economic and fiscal outlook*, CP 1027, (March 2024), Box 4.4: [https://obr.uk/docs/dlm\\_uploads/E03057758\\_OBR\\_EFO-March-2024\\_Web-AccessibleFinal.pdf](https://obr.uk/docs/dlm_uploads/E03057758_OBR_EFO-March-2024_Web-AccessibleFinal.pdf) [accessed 8 May 2024]

95 Office for Budget Responsibility, *Fiscal risks and sustainability*, CP 870, (July 2023), p 103: [https://obr.uk/docs/dlm\\_uploads/Fiscal\\_risks\\_and\\_sustainability\\_report\\_July\\_2023.pdf](https://obr.uk/docs/dlm_uploads/Fiscal_risks_and_sustainability_report_July_2023.pdf) [accessed 11 April 2024]

96 Q 238 (Sir Robert Stheeman)

97 'UK debt chief warns excessive borrowing risks investor backlash' *Financial Times* (4 January 2024): <https://www.ft.com/content/fb8974e4-355e-4276-be1f-7edb73273f75> [accessed 8 May 2024]

linked and foreign-held along with its shortened maturities) which underpins the OBR's analysis that "while other governments face rising interest rate costs on debts close to or in excess of 100 per cent of GDP", the UK's public debt position "is more vulnerable to some shocks, and more vulnerable than in the past."<sup>98</sup> This is the case despite some mitigating factors. Eric Arispe, Senior Director at Fitch Ratings' sovereigns group, explained that these factors included: an absence of foreign currency debt ("which represents an important asset to have in periods when exchange rates could be volatile") deep financial markets ("which supports the financing flexibility of the sovereign") and reserve currency status.<sup>99</sup>

### *Index-linked gilts*

52. Index-linked gilts are bonds that adjust their nominal coupon payments and final settlement repayment to meet accrued inflation, as measured by the Retail Price Index, thereby offering a guaranteed real return.<sup>100</sup> Inflation linked bonds typically offer real returns that are substantially lower than the nominal yields available on conventional bonds. This means that during periods of low inflation—and particularly during periods of deflation—they can prove to be cost effective for the issuer. However, the reverse is true during periods of high inflation given that coupon and principal are increased accordingly.
53. Tom Josephs, member of the Budget Responsibility Committee at the OBR, considered that they have been for the most part, "good value" for HM Treasury since their inception.<sup>101</sup> Bim Afolami also told us:
- "We are £158 billion better off since we started issuing index-linked debt [in the 1980s] ... If you look at the maturity and at the index-linked compared to the fixed, I think we have done the right things, broadly speaking, although we should always keep these things under review and assess them as time goes by."<sup>102</sup>
54. Nonetheless, as the OBR notes, their growing share of total debt (from about 10 per cent of total debt in the late 1980s to around 25 per cent in 2022), in conjunction with above-target inflation since 2021, has served to significantly raise debt servicing costs and nominal debt levels (and far more so than in other countries).<sup>103</sup> The OBR points out that at 25 per cent of the total, the UK's 'exposure' to inflation-linked gilts is more than twice as much as the second largest advanced-economy issuer, Italy, at 12 per cent.<sup>104</sup> Moreover, Carl Emmerson said that index-linked gilts and inflation generated by

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98 Office for Budget Responsibility, *Fiscal risks and sustainability*, CP 870, (July 2023), p 13: [https://obr.uk/docs/dlm\\_uploads/Fiscal\\_risks\\_and\\_sustainability\\_report\\_July\\_2023.pdf](https://obr.uk/docs/dlm_uploads/Fiscal_risks_and_sustainability_report_July_2023.pdf) [accessed 11 April 2024]

99 [Q 187](#) (Eric Arispe)

100 See IG, 'UK index-linked gilts: inflation-linked bonds explained': <https://www.ig.com/uk/trading-strategies/uk-index-linked-gilts--inflation-linked-bonds-explained-220425> [accessed 11 April 2024]; NB in 2020, the Government announced that from 2030, the CPIH will replace the RPI in making adjustment to inflation linked bonds. See: 'UK to stop using RPI inflation measure in 2030', *Financial Times* (28 May 2024): <https://www.ft.com/content/413286de-9903-4791-9d5e-72349ead6f1d> [accessed 28 May 2024]

101 [Q 36](#) (Tom Josephs)

102 [Q 231](#) (Bim Afolami)

103 See Office for Budget Responsibility, *Fiscal risks and sustainability*, CP 870, (July 2023), p 14: [https://obr.uk/docs/dlm\\_uploads/Fiscal\\_risks\\_and\\_sustainability\\_report\\_July\\_2023.pdf](https://obr.uk/docs/dlm_uploads/Fiscal_risks_and_sustainability_report_July_2023.pdf) [accessed 10 April 2024].

104 *Ibid.*

imports (as has been the case recently in the UK) is a poor combination because “you do not get the extra income tax, tax on profits or VAT, so you do not get the revenues to help cover that debt interest spending.”<sup>105</sup>

55. The National Audit Office (NAO) has pointed out that in 2018 “following OBR analysis”, the Treasury decided to reduce the proportion of new index-linked gilts issued in a “measured fashion over the medium term”. However, in 2022, it decided that the proportion was “appropriate”.<sup>106</sup> The NAO further noted Debt Management Office (DMO) analysis prior to the Spring Budget in March 2023 which showed that index-linked gilts were forecast to be more cost-effective than conventional gilts at maturities greater than or equal to 20 years, if inflation (RPI) does not exceed an average of three per cent over the gilts’ life.

*Foreign ownership of debt—and international pressures*

56. The second vulnerability specified by the OBR pertains to foreign ownership of UK debt. To capture this trend, the OBR uses an IMF series which collates data sourced from national central banks/statistical agencies. According to this series, which covers the period from Q1 2004 to Q4 2023, the share of UK government debt in foreign hands has roughly doubled from 15 per cent to 29 per cent.<sup>107</sup> Explaining the vulnerability this presents, the OBR’s 2023 FRS described how “overseas holders of gilts are less likely to have a such a structural desire for sterling assets [as domestic holders] ... As a result, smaller changes in the relative attractiveness of gilts can mean foreign investors quickly switch to other assets in potentially large volumes.”<sup>108</sup>
57. The OBR’s 2023 FRS based its analysis and conclusions upon private, non-bank foreign holdings of UK debt. However, since its publication, there have been substantial changes to the composition of holdings. It has been found that official holdings (i.e. debt held by central banks, government and associated agencies) now comprise a majority of the total. However, in written correspondence, Richard Hughes told us: “These revisions do not fundamentally alter the conclusion we drew in the 2023 FRS ... While the revised IMF data suggest that more of that debt is held by official rather than private investors, the same concerns about their lack of ‘home bias’ and susceptibility to shifts in global investor sentiment applies.”<sup>109</sup>
58. Professor Chadha felt that foreign ownership might act “as a further constraint and examination of our fiscal position”<sup>110</sup> while Sir Robert Stheeman commented that the UK has “a healthily diverse investor base.”<sup>111</sup> However, Richard Hughes has said that the UK’s “fickle and flighty” foreign

105 [Q 131](#) (Carl Emmerson)

106 National Audit Office, *Managing government borrowing*, HC 1658 Session 2022–23 (July 2023): <https://www.nao.org.uk/wp-content/uploads/2023/07/managing-government-borrowing.pdf> [accessed 8 May 2024]

107 International Monetary Fund, ‘Foreign Holdings’, See Table 2: <https://www.imf.org/-/media/Websites/IMF/imported-datasets/external/pubs/ft/wp/2012/Data/wp12284.ashx> [accessed 29 August 2024]

108 See Office for Budget Responsibility, *Fiscal risks and sustainability*, CP 870, (July 2023), Box 4.2: [https://obr.uk/docs/dlm\\_uploads/Fiscal\\_risks\\_and\\_sustainability\\_report\\_July\\_2023.pdf](https://obr.uk/docs/dlm_uploads/Fiscal_risks_and_sustainability_report_July_2023.pdf) [accessed 28 August 2024].

109 Letter from Richard Hughes, Chair of the Office for Budget Responsibility, to Lord Bridges of Headley, Chair of the Economic Affairs Committee (21 August 2024): [committees.parliament.uk/publications/45292/documents/224365/default/](https://committees.parliament.uk/publications/45292/documents/224365/default/)

110 [Q 7](#) (Prof Jagjit Chadha)

111 [Q 238](#) (Sir Robert Stheeman)

buyers of its government debt presents a growing risk to the stability of the gilt market.<sup>112</sup> Asked if foreign financing of the UK's debt was really a problem, Julian Jessop told us: "I think it is ... it is relatively easy for foreigners to decide not to invest in the UK."<sup>113</sup>

59. Elaborating on this point, Dr El-Erian equated foreign holders of debt to tourists, noting: "The minute something goes wrong ... We head to the airport and get out ... That is what tends to happen during shocks. Investors tend to be subject to home bias."<sup>114</sup> Dr El-Erian suggested that a number of factors contribute to and amplify 'home bias' such as structural aspects of investment management, for example. Hence, he emphasised that relying on foreign investors "as the UK does" entails a risk that funding will be withdrawn and that it "can be for shocks that have nothing to do with you at all."<sup>115</sup>
60. Some witnesses pointed to the reversal of global trends which have supported growth.<sup>116</sup> As Professor Chadha noted: "Global growth seems to be falling, as China and other newly advanced economies are reaching the productivity frontier."<sup>117</sup> Witnesses also talked about disruptions to supply chains from recent events in the Middle East and elsewhere, which have increased shipping costs for example.<sup>118</sup> Dr El-Erian saw these disruptions as part of a "secular" trend which he called "global fragmentation".<sup>119</sup> This, he argued, meant that countries were looking for greater "resilience" than in the past which would be particularly problematic for China (as a major exporter) with direct implications for its ability to remain a "meaningful engine of growth for the global economy".<sup>120</sup>
61. Encapsulating these points, Erich Arispe said: "Overall, at least in the near term ... the stars are not aligned on the external environment, from both the geopolitical and economic perspective."<sup>121</sup> Witnesses also alluded to the potential risks of funding pressures on account of the large number of G7 governments managing high levels of debt, which Mr Arispe noted, "represents a source of pressure on [credit] ratings."<sup>122</sup> In particular, the US Congressional Budget Office has warned that the "United States faces a challenging fiscal outlook".<sup>123</sup>
62. The IMF stated in its April 2024 *Fiscal Monitor* that "global debt is projected to increase to close to 100 percent of GDP by 2029" led by some large economies "which critically need to take policy action to address fundamental

112 Delphine Strauss, 'UK reliance on 'fickle' foreign investors a risk to gilts, says OBR chief', *Financial Times* (7 December 2023): <https://www.ft.com/content/7e0319a9-6f42-444a-9392-4b65f1cd60a7> [accessed 5 September 2024]

113 Q 118 (Julian Jessop)

114 Q 87 (Dr Mohamed El-Erian)

115 Q 87 (Dr Mohamed El-Erian). Volatility in UK debt markets can also be the source of global financial market 'contagion' - see for example Reuters, 'Britain's market rout stokes contagion fears around the globe' (September 2022): <https://www.reuters.com/markets/europe/global-markets-britain-contagion-pix-graphic-2022-09-28/> [accessed 29 August 2024]

116 See Q 67 (Dr Mohamed El-Erian) and Q 181 (Erich Arispe).

117 Q 22 (Prof Jagjit Chadha)

118 See Q 121 (Julian Jessop).

119 Q 73 (Dr Mohamed El-Erian)

120 *Ibid.*

121 Q 186 (Erich Arispe)

122 Q 181 (Erich Arispe)

123 Congressional Budget Office, 'The 2023 Long-Term Budget Outlook' (June 2023): <https://www.cbo.gov/publication/59331> [accessed 22 April 2024]

imbalances between spending and revenues.”<sup>124</sup> Robert Tipp, head of global bonds at PGIM Fixed Income, also told the *Financial Times* (FT):

“We are truly in an unmoored environment for government debt compared with previous centuries ... Everyone is getting a pass right now, whether you are in the US or Italy, but there have been some signs recently that investors and rating agencies are starting to think about this again.”<sup>125</sup>

63. Witnesses also depicted potential risks stemming from other specific countries or blocs. Julian Jessop noted that in recent decades, Japanese debt has offered near zero yields which have been unattractive to foreign investors and “if that changes, that is another challenge to the UK”.<sup>126</sup> Peder Beck-Friis also stated that G7 debt dynamics would look “much worse than they did pre-pandemic” should the emerging market “savings glut” dry-up given that it has allowed governments to run deficits and high debt levels.<sup>127</sup>
64. Commenting on the international aspect of the UK’s debt, and the question of whether there is “too much reliance on the kindness of strangers”, Bim Afolami told us: “Japan issues much more debt to what we would describe as retail investors ... than we do. Some people see that we should try to increase the amount of retail participation in our debt. At the Budget, the Chancellor set out what we called the British Savings Bond to encourage more retail investment in debt”.<sup>128</sup>

#### *Maturities—and the impact of quantitative easing*

65. The third vulnerability of UK debt highlighted by the OBR relates to maturities, or the period in time over which a debt instrument becomes due and must be paid back in full.<sup>129</sup> The issuance of debt with longer term maturities can help to promote stability by reducing the sensitivity of debt interest to changes in interest rates, since the bonds would not need to be re-financed or ‘rolled over’ as frequently.<sup>130</sup> While future governments may therefore look to maintain high average maturity rates in the gilt stock, it should be noted that structural changes underway in the pensions industry could serve as a constraint. In particular, the industry’s demand for gilts has eased in recent years in part because most defined benefit pension schemes<sup>131</sup>

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124 International Monetary Fund, ‘Fiscal policy in the great election year’ (April 2024): <https://www.imf.org/en/Publications/FM/Issues/2024/04/17/fiscal-monitor-april-2024> [accessed 8 May 2024]

125 ‘Investors warn governments about high levels of public debt’, *Financial Times*, (8 January 2024): <https://www.ft.com/content/33f85fd6-55ec-45a1-a1b6-69a845726d58> [accessed 8 May 2024]

126 [Q 121](#) (Julian Jessop)

127 [Q 146](#) (Peder Beck-Friis)

128 [Q 231](#) (Bim Afolami)

129 Short term bonds typically mature in one to three years, medium term mature in 10 or more years and long-term bonds mature in up to 30 years. See Investopedia, ‘What Is a Maturity Date? Definition and Classifications’ (September 2023): <https://www.investopedia.com/terms/m/maturitydate.asp> [accessed 11 April 2024]

130 When a sovereign (or corporate) bond (or other debt obligation) is about to mature and needs to be converted, or “rolled over”, into new debt, interest rates may have risen in the meantime, thereby leading to more costly financing. This is commonly referred to as “rollover risk”.

131 Or ‘final salary pension’ schemes. Under these schemes employee members are entitled to a particular level of benefit depending on their length of service and the level of their salary when they retire. See: Gov.uk, *Defined benefit pension schemes: questions and answers* (May 2013): [https://assets.publishing.service.gov.uk/media/5a7cfc96e5274a33be6483d7/Defined\\_benefit\\_pension\\_schemes\\_questions\\_and\\_answers.pdf](https://assets.publishing.service.gov.uk/media/5a7cfc96e5274a33be6483d7/Defined_benefit_pension_schemes_questions_and_answers.pdf) [accessed 8 May 2024]

are closed to new members.<sup>132</sup> However, Sir Robert Stheeman assured us that “it takes an awfully long time for these [structural] shifts to feed through” and that it could take “many years” for the average maturity to decline to levels akin to those of other G7 nations.<sup>133</sup>

66. The average maturity of UK government bonds has for some time been longer than the average maturity of government debt in most other advanced economies.<sup>134</sup> However, the average maturity of the consolidated liabilities of the public sector as a whole (including the Bank of England’s balance sheet) has drastically shortened since 2008, from seven years to just two as of July 2023, largely on account of the Bank’s QE program. From 2008, the Bank purchased one-third of all conventional gilts with an average residual maturity of 15 years in exchange for its own central bank reserves, which are, in effect, of an overnight maturity.<sup>135</sup>
67. Hence, although initially introducing a net saving (given, at the time, the far lower interest payable on reserves than gilts), QE has shortened the median maturity<sup>136</sup> of public debt, thereby leaving the UK’s overall debt “much more sensitive to changes in conventional interest rates.”<sup>137</sup> The OBR has noted that the shortening of UK debt maturities has meant that rising interest rates have fed “six times more quickly into our debt servicing costs than in the past and faster than in other G7 countries.”<sup>138</sup>
68. In its EFO for March 2024 the OBR pointed out that since its 2023 FRS, the steady unwinding of the Bank’s gilt holdings via quantitative tightening (QT) has begun to reverse some of this sensitivity, with median maturities of the UK’s consolidated public liabilities rising from one year in 2021 to three years as of the end 2023.<sup>139</sup> However, although the OBR noted that even if its assumption bears out that 71 per cent of gilts will have been returned to the market by 2028—resulting in a pre-QE median maturity of seven years—it warned that “both the UK’s higher debt stock and the potential for continued volatility in interest rates are likely to continue to drive large changes in debt servicing costs from one forecast to the next.”<sup>140</sup>
69. Professor Chadha was asked whether the debate on debt should focus on overall public sector liabilities given that QE purchases were a large proportion of the overall stock of debt. He replied that including reserves

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132 See: Mary McDougall, ‘UK told to issue more short-dated debt as pension fund demand wanes’, *Financial Times* (30 January 2024): <https://www.ft.com/content/369ba1d8-43e9-49eb-a31d-12936bc66313> [accessed 11 April 2024]

133 Q 241 (Sir Robert Stheeman)

134 Office for Budget Responsibility, ‘Debt maturity, quantitative easing and interest rate sensitivity’ (March 2021): <https://obr.uk/box/debt-maturity-quantitative-easing-and-interest-rate-sensitivity/> [accessed 11 April 2024]

135 Office for Budget Responsibility, *Fiscal risks and sustainability*, CP 870, (July 2023), p 106: [https://obr.uk/docs/dlm\\_uploads/Fiscal\\_risks\\_and\\_sustainability\\_report\\_July\\_2023.pdf](https://obr.uk/docs/dlm_uploads/Fiscal_risks_and_sustainability_report_July_2023.pdf) [accessed 11 April 2024]

136 Median maturity is the time taken for half the stock to respond to interest rate changes - see Office for Budget Responsibility, *Fiscal risks and sustainability*, CP 870, (July 2023), p 106: [https://obr.uk/docs/dlm\\_uploads/Fiscal\\_risks\\_and\\_sustainability\\_report\\_July\\_2023.pdf](https://obr.uk/docs/dlm_uploads/Fiscal_risks_and_sustainability_report_July_2023.pdf) [accessed 11 April 2024]

137 Office for Budget Responsibility, *Fiscal risks and sustainability*, CP 870, 4.16 (July 2023), p 107: [https://obr.uk/docs/dlm\\_uploads/Fiscal\\_risks\\_and\\_sustainability\\_report\\_July\\_2023.pdf](https://obr.uk/docs/dlm_uploads/Fiscal_risks_and_sustainability_report_July_2023.pdf) [accessed 11 April 2024].

138 *Ibid.*, p 15

139 Office for Budget Responsibility, *Economic and Fiscal Outlook*, CP 870, (March 2024), p 112: [https://obr.uk/docs/dlm\\_uploads/E03057758\\_OBR\\_EFO-March-2024\\_Web-AccessibleFinal.pdf](https://obr.uk/docs/dlm_uploads/E03057758_OBR_EFO-March-2024_Web-AccessibleFinal.pdf) [accessed 11 April 2024]

140 *Ibid.*

as part of the total, means that “the cost of debt service issue is going to be something like 5% to 6%. It would not have been anything like that had we not had the stock of QE that we have.”<sup>141</sup>

70. Explaining the Bank of England’s balance sheet reduction strategy, Andrew Bailey, Governor of the Bank, told us that unlike the US Federal Reserve, the UK’s debt stock has a fairly long average maturity and that if it relied on passive run-off (holding debt to maturity) “it would be 50 or 60 years before we saw it all go off [the balance sheet].”<sup>142</sup> Mr Bailey also argued that “I hear it said sometimes that if only the Bank of England would hold these assets, the losses or the cash flow would go away, but that is not the case.”<sup>143</sup>
71. The Rt Hon Jeremy Hunt MP, former Chancellor of the Exchequer, told us that QE and QT “really are decisions that are made by the Bank of England ... There is no secret ‘What would you like to do, Chancellor?’ discussion.”<sup>144</sup> Sam Beckett commented that “there is a huge degree of transparency on how QE, and now QT, are impacting public finances. We have it in our Treasury annual report and accounts. The OBR put it in its EFO, and the Bank has a quarterly report on it all.”<sup>145</sup>
72. **Compared with other similar economies, the UK is currently not an outlier in terms of its overall stock of public debt. However, the servicing of UK debt has become more vulnerable to inflation and interest rates, along with changes in investor sentiment, any or all of which can increase its cost. This increased vulnerability results from successive rounds of quantitative easing (QE), and a greater proportion of debt being index-linked and held by overseas investors. Taken together, they point to the need for the Government to build fiscal resilience so that it can respond, if necessary, to future domestic or external crises.**
73. **While we understand the reasons for its adoption as an instrument of monetary policy, multiple bouts of QE were implemented without sufficient consideration of its impact on the maturity of the UK’s overall debt stock. By drastically shortening effective maturities, QE has served to increase the sensitivity of government borrowing costs to short-term movements in interest rates. Although the unwinding of QE will gradually mitigate this vulnerability to a degree, it is likely that it will crystallise significant losses which the taxpayer will ultimately bear. Decisions around the quantum of QE and the strategy around quantitative tightening seem to have been taken without consideration of potential fiscal risks. As a result, these decisions have blurred the boundary between monetary and fiscal policy.**
74. **At a time when many other nations are issuing high levels of debt, the extent of the UK’s reliance on debt purchases by overseas investors could heighten the UK’s vulnerability to financial shocks. This is of particular concern given the current heightened level of geopolitical**

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141 [Q 8](#) (Prof Jagjit Chadha)

142 Oral evidence taken before the Economic Affairs Committee, Governor of the Bank of England - Annual Scrutiny Session, 14 February 2024 (Session 2023–24), [Q 14](#) (Andrew Bailey)

143 *Ibid.*

144 Oral evidence taken before the Economic Affairs Committee, Chancellor of the Exchequer - Annual Scrutiny Session, 19 March 2024 (Session 2023–24), [Q 10](#) (Rt Hon Jeremy Hunt MP)

145 [Q 10](#) and [Q 12](#) (Sam Beckett)

**risk. The risks to the UK would increase further if it became an outlier relative to other developed countries in terms of its debt.**

## CHAPTER 4: CHALLENGES TO DEBT SUSTAINABILITY

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### The context

75. In its March 2024 EFO, the OBR stated that in order “just to stabilise debt in the medium term”, the Government needs to run a primary surplus of around 1.3 per cent of GDP. In Chapter 2, we cited Professor David Miles, member of the Budget Responsibility Committee at the OBR, forecasting that a primary surplus of “around” one per cent of GDP would be required. This compares with the 2010s when a primary *deficit* of 2.1 per cent of GDP was sufficient to stabilise debt.<sup>146</sup> Dr Gerard Lyons also highlighted the additional challenges of maintaining debt stability posed by the UK having ‘twin’ deficits—a current account deficit and a budget deficit. He said: “Japan, for instance, has a large ratio of debt to GDP, but its current account surplus echoes its high domestic savings and its ability to fund itself. The UK, in contrast, has low savings, a current account deficit and a need to fund itself not only at home from long-term domestic savers but also from overseas.”<sup>147</sup> (See Appendix 4 for a case study of Japan’s debt).
76. Some witnesses emphasised that the various challenges the UK faces in maintaining debt sustainability have been made more difficult by past shortcomings in UK economic policy. Sir Dieter Helm argued that since the 1980s, investment in the economy’s core infrastructures has been financed by borrowing. This, he noted, compares with the prior, post-World War II period, when such outlays were financed by ‘current’ customers’ bills and tax.<sup>148</sup> Sir Dieter argued that borrowing for “everything” including “maintenance” for infrastructure is “really quite damaging to the future prospects of the economy.”<sup>149</sup> Against this backdrop of an economy in urgent need of spending on capital maintenance, Sir Dieter urged us to think of the UK’s stock of assets and the public balance sheet as integral elements of any debt sustainability strategy.<sup>150</sup>
77. In addition to these challenges, the UK is currently experiencing significant pressures on public spending. As Sir Dieter Helm highlighted:
- “[At] some stage the economy will have to deal with the state of its infrastructure. It will have to fix the leaks in pipes. It will have to fix the sewers. It will have to fix the state of the transmission system. It will have to fix the roads. It will have to fix the railways. It will have to fix the state of schools and hospitals.”<sup>151</sup>

Generally, the IFS has said that government spending is expected to settle at a much higher level than before the COVID-19 pandemic, despite cuts to levels of spending from their “pandemic peak”.<sup>152</sup> When asked whether the UK could withstand a continuation of public spending at the rate expected

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146 Office for Budget Responsibility, *Economic and fiscal outlook*, CP 1027 (March 2024): [https://obr.uk/docs/dlm\\_uploads/E03057758\\_OBR\\_EFO-March-2024\\_Web-AccessibleFinal.pdf](https://obr.uk/docs/dlm_uploads/E03057758_OBR_EFO-March-2024_Web-AccessibleFinal.pdf) [accessed 8 May 2024]

147 Written evidence from Dr Gerard Lyons (SND0034)

148 Q 150 (Sir Dieter Helm)

149 *Ibid.*

150 *Ibid.*

151 *Ibid.*

152 Institute for Fiscal Studies, ‘Spending as much as other countries but taxing less is unlikely to be sustainable’ (April 2024): <https://ifs.org.uk/articles/spending-much-other-countries-taxing-less-unlikely-be-sustainable> [accessed 8 May 2024]

by the OBR, Richard Hughes replied: “Not if you do not want to see the debt-to-GDP ratio spiral in the way it does.”<sup>153</sup> On the question of whether the public sector is living beyond its means, Professor Goodhart said that it “almost certainly [is] yes, quite severely and increasingly [dangerously].”<sup>154</sup>

78. Despite these pressures, in 2022/23, government revenues (taxes and other sources) already stood at around 40 per cent of GDP—the highest level since the early 1980s.<sup>155</sup> The OBR forecast in March 2024 that tax as a share of GDP is set to rise.<sup>156</sup>
79. The Trades Union Congress told us that the “present macro policy approach is not delivering sustainable national debt”.<sup>157</sup> As the IFS argued at the start of 2024: “This will be a thorny inheritance for whoever is in office after this year’s general election.”<sup>158</sup> It added: “Both Labour and the Conservatives have promised to reduce debt as a fraction of national income ... [but] on one measure, it will be more difficult to reduce the debt-to-GDP ratio over the next parliament than in any other parliament since the 1950s.”<sup>159</sup>
80. Pointing to the OBR’s forecasts for “lower-than-average” nominal GDP growth and “higher-than-average” debt interest spending over the next five years, the IFS said: “These are not propitious circumstances in which to be aiming for a falling debt-to-GDP ratio.”<sup>160</sup> Looking at the period 1951 to present, the IFS added that “all parliaments with slower rates of growth than what is forecast for the next parliament had below-average debt interest spending; all parliaments with higher debt interest spending had above-average growth.” It concluded: “For a Chancellor with a goal of reducing debt as a fraction of national income, things have arguably never been so bad.”<sup>161</sup> In its report *Managing government borrowing*, published in July 2023, the NAO was similarly downbeat, stating that the “environment for borrowing and debt management has become more challenging since our last report in 2017.”<sup>162</sup>
81. Finally, the OBR has said: “Fiscal tailwinds from a post-World War II baby boom, global economic integration, and easing Cold War tensions have switched to headwinds in the first part of this century. Public finances are now under growing pressure from ageing populations, disappointing economic growth, a warming planet, and rising geopolitical tensions.”<sup>163</sup> Focusing specifically on debt interest spending, it added: “For most of this century, the fiscal burden of the Government’s elevated debt stock was offset

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153 Q 34 (Richard Hughes)

154 Charles Goodhart (SND0042)

155 House of Commons Library, Tax statistics: an overview, Research Briefing, CPB-8513, March 2024

156 Office for Budget Responsibility, *Economic and fiscal outlook*, CP 1027 (March 2024) pp 154 and 16: [https://obr.uk/docs/dlm\\_uploads/E03057758\\_OBR\\_EFO-March-2024\\_Web-AccessibleFinal.pdf](https://obr.uk/docs/dlm_uploads/E03057758_OBR_EFO-March-2024_Web-AccessibleFinal.pdf) [accessed 28 May 2024]

157 Written evidence from the Trades Union Congress (SND0036)

158 Institute for Fiscal Studies, *Constraints and trade-offs for the next government* (January 2024): <https://ifs.org.uk/sites/default/files/2024-01/Constraints-and-trade-offs-for-the-next-government-IFS-Report-R295.pdf> [accessed 8 May 2024]

159 *Ibid.*

160 *Ibid.*

161 *Ibid.*

162 National Audit Office, *Managing government borrowing*, (July 2023): <https://www.nao.org.uk/wp-content/uploads/2023/07/managing-government-borrowing.pdf> [accessed 8 May 2024]

163 Office for Budget Responsibility, *Fiscal risks and sustainability*, CP 870, (July 2023), p 99: [https://obr.uk/docs/dlm\\_uploads/Fiscal\\_risks\\_and\\_sustainability\\_report\\_July\\_2023.pdf](https://obr.uk/docs/dlm_uploads/Fiscal_risks_and_sustainability_report_July_2023.pdf) [accessed 10 April 2024]

by falling interest rates and low inflation, which kept central government interest payments ... at around 2 per cent of GDP. But both trends have suddenly reversed over the past year.”<sup>164</sup> We examine these points below.

### Demography

82. The OBR has said that “the size, age and composition of the population is one of the main drivers of the long-term fiscal outlook, affecting health care, welfare and pensioner spending.”<sup>165</sup> It has pointed out that the decline in public debt (from just over 250 per cent of GDP in 1946 to 28 per cent at the turn of this century) was facilitated, in part, by relatively favourable demographic trends (principally the ‘baby booms’, which led to improved dependency ratios.)<sup>166</sup> However, these demographic ‘tailwinds’ turned to ‘headwinds’ in the early part of this century in part due to the first ‘baby boom’ generation retiring and growth in the unit costs of age-related spending (healthcare, social care, and the state pension) outstripping growth in the wider economy.<sup>167</sup>
83. According to its July 2022 long-term forecasts (based on the 2021 Census), the OBR expects the UK population to be broadly flat over the next three decades before declining gently but steadily, with migration levels insufficient to compensate for a declining birth rate (see Figure 5).<sup>168</sup> Citing the latest UN population projections compiled in 2019, the OBR also noted that the UK’s old-age dependency ratio (which the UN defines as people aged 65 and over as a proportion of people aged 15 to 64), is projected to rise 18 percentage points by 2070.<sup>169</sup> Richard Hughes told us: “The underlying demographics remain pretty stark ... in the 1970s, we had about two people in work for every one person in retirement ... By the time we get out to 2070, we have only one person in work for every one person in retirement.”<sup>170</sup>

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164 *Ibid.*

165 *Ibid.*, p 123

166 *Ibid.*, p 12

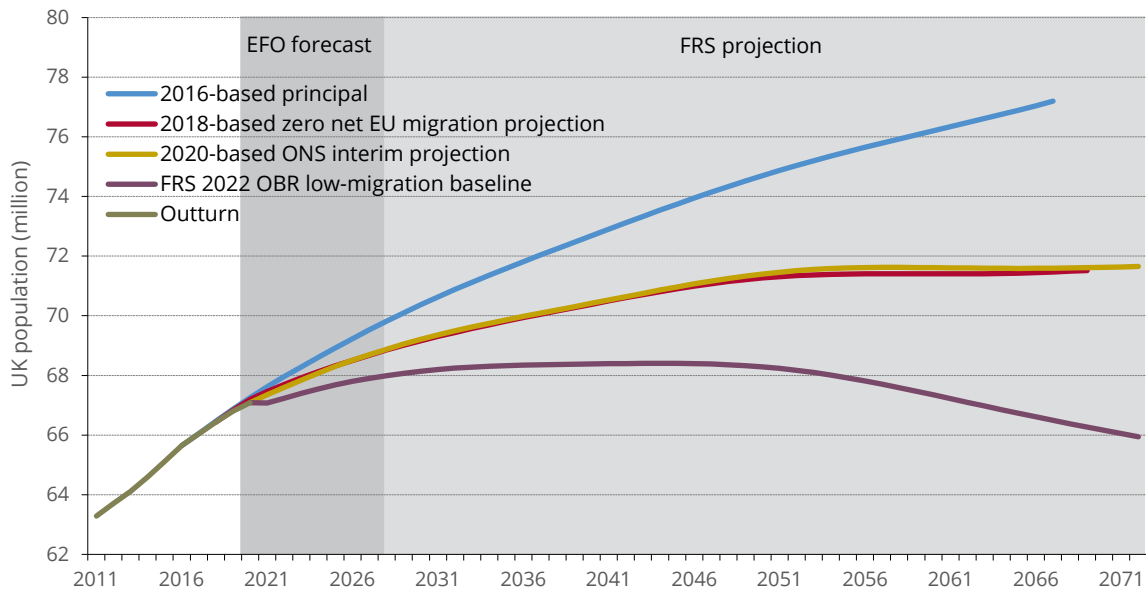
167 *Ibid.*, p 101

168 Office for Budget Responsibility, *Fiscal risks and sustainability*, CP 702, (July 2022), p 127: [https://obr.uk/docs/dlm\\_uploads/Fiscal\\_risks\\_and\\_sustainability\\_2022-1.pdf](https://obr.uk/docs/dlm_uploads/Fiscal_risks_and_sustainability_2022-1.pdf) [accessed 8 May 2024]

169 Office for Budget Responsibility, *Fiscal risks and sustainability*, CP 702, (July 2022), p 124: [https://obr.uk/docs/dlm\\_uploads/Fiscal\\_risks\\_and\\_sustainability\\_2022-1.pdf](https://obr.uk/docs/dlm_uploads/Fiscal_risks_and_sustainability_2022-1.pdf) [accessed 8 May 2024]

170 [Q 48](#) (Richard Hughes)

**Figure 5: UK population and successive outturns and successive projections**



Source: Office for Budget Responsibility, *Fiscal risks and sustainability*, CP 702, (July 2022), p 127: [https://obr.uk/docs/dlm\\_uploads/Fiscal\\_risks\\_and\\_sustainability\\_2022-1.pdf](https://obr.uk/docs/dlm_uploads/Fiscal_risks_and_sustainability_2022-1.pdf) [accessed 8 May 2024]

84. In its March 2024 EFO, the OBR updated its short-to-medium term projections to reflect fresh ONS population estimates, released on 30 January 2024. The OBR now expects the total UK adult population to be 1 million higher by 2028/29 than it expected in November 2023.<sup>171</sup> As part of these fresh forecasts, the OBR updated its assumptions for medium-term annual net migration to 315,000 from 245,000, and published estimates for debt and growth under divergent net-migration assumptions. It noted that annual net migration around 200,000 higher or lower than the ONS projection of 315,000 in the medium term would raise or lower GDP by around 1.5 per cent in 2028/29, and lower or raise debt as a proportion of GDP by 3.1 percentage points respectively.<sup>172</sup> However, the OBR emphasised that “the impact on GDP per person is much smaller and its direction unclear.”<sup>173</sup>
85. In modelling these trends over the next five years, the OBR assumed that migrants would have a slightly higher average participation rate than the adult UK resident population, reflecting the probability that they are more likely to be of working age (16-64).<sup>174</sup> The OBR also noted that the longer migrants stay, the more likely they are to participate although this “tends to reverse after 10 years.”<sup>175</sup>

171 Office for Budget Responsibility, *Economic and fiscal outlook*, CP 1027, (March 2024), p 6: [https://obr.uk/docs/dlm\\_uploads/E03057758\\_OBR\\_EFO-March-2024\\_Web-AccessibleFinal.pdf](https://obr.uk/docs/dlm_uploads/E03057758_OBR_EFO-March-2024_Web-AccessibleFinal.pdf) [accessed 11 April 2024]

172 Office for Budget Responsibility, *Economic and fiscal outlook*, CP 1027, (March 2024), p 15: [https://obr.uk/docs/dlm\\_uploads/E03057758\\_OBR\\_EFO-March-2024\\_Web-AccessibleFinal.pdf](https://obr.uk/docs/dlm_uploads/E03057758_OBR_EFO-March-2024_Web-AccessibleFinal.pdf) [accessed 11 April 2024]

173 *Ibid.*

174 Office for Budget Responsibility, *Economic and fiscal outlook*, CP 1027, (March 2024) p 30: [https://obr.uk/docs/dlm\\_uploads/E03057758\\_OBR\\_EFO-March-2024\\_Web-AccessibleFinal.pdf](https://obr.uk/docs/dlm_uploads/E03057758_OBR_EFO-March-2024_Web-AccessibleFinal.pdf) [accessed 11 April 2024]

175 *Ibid.*

86. Richard Hughes told us that assessing the changing demographic profile of migrants and its impact on economic and fiscal outcomes has become more difficult. He said: “Most of our migrants are now not coming from the EU but from other countries. We see in the data that a lot are coming in as students, but a lot are coming to work and they are bringing dependants.”<sup>176</sup> The difficulties in profiling, Mr Hughes said, meant that at present “the assumption we have made about their demographic profile is that they broadly look like the rest of the UK population.”<sup>177</sup>
87. Professor David Miles similarly cast doubt on whether sustained levels of migration, as a means to boost the labour force, could generate sustained fiscal improvements. He said: “New immigrants, particularly if they come on work visas, may generate a favourable balance of extra tax revenue relative to extra public spending for some years. But immigrants who stay grow older and have children so the favourable tax to spending balance does not persist.”<sup>178</sup> Moreover, he added that even “when the favourable fiscal effects persist, they may do so largely because government spending on public services (particularly on health and education) falls in per capita terms and the quality of those services is eroded as population rises.”<sup>179</sup>
88. Demographic challenges are not unique to the UK. The projected rise in the UK’s old-age dependency ratio is close to the average across advanced economies and its projected increase (as above, 18 percentage points) is smaller than most other advanced economies which, on average, see a 26-percentage point rise.<sup>180</sup> This, the OBR has noted, would leave the UK with one of the least aged populations among the advanced economies in the 2070s—in common with the Scandinavian countries, as well as the United States, Australia and Ireland.<sup>181</sup> The reason for this is that the UK population is expected to age more slowly due to “higher birth rates and higher net migration rates.”<sup>182</sup>
89. In terms of demographic pressures on public finances, Carl Emmerson identified two key areas: the triple lock (whereby the state pension increases each April in line with whichever of the following is the highest: CPI inflation, average wage inflation or 2.5 per cent) and the retirement age.<sup>183</sup> The new Labour government has pledged to keep the triple lock and has also announced that it will conduct a “review of the pensions landscape”<sup>184</sup> (the state pension age is currently scheduled to rise from 66 to 67 between 2026 and 2028 and to 68 in 2046). However, earlier this year, Professor Les Mayhew, author of the report *State Pension Age and Demographic Change* said: “[if] we define the UK’s working adult populations as 20 to 64 years, to account for time spent in full time education, the state pension age might

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176 [Q 48](#) (Richard Hughes)

177 *Ibid.*

178 Written evidence from Prof David Miles ([SND0012](#))

179 *Ibid.* Also see London School of Economics, ‘The link between growth and immigration: unpicking the confusion’ (October 2022): <https://blogs.lse.ac.uk/politicsandpolicy/the-link-between-growth-and-immigration-unpicking-the-confusion/> [accessed 11 April 2024]

180 Office for Budget Responsibility, *Fiscal risks and sustainability*, CP 702, (July 2022), p 124: [https://obr.uk/docs/dlm\\_uploads/Fiscal\\_risks\\_and\\_sustainability\\_2022-1.pdf](https://obr.uk/docs/dlm_uploads/Fiscal_risks_and_sustainability_2022-1.pdf) [accessed 8 May 2024]

181 *Ibid.*

182 *Ibid.*

183 [Q 135](#) (Carl Emerson)

184 Labour Party, ‘Labour Party pensions policy: We will keep the pension triple lock and give pensioners security in retirement’, (9 June 2024): <https://labour.org.uk/updates/stories/labour-party-pensions-policy-we-will-keep-the-pension-triple-lock-and-give-pensioners-security-in-retirement/> [accessed 29 August 2024]

need to hit age 70+ as early as 2040 to maintain the current dependency ratio”. He added that the recent stalling in life expectancy “has temporarily eased the pressure for increases in state pension age beyond 67 after 2027 but longer-term the pressure will be on to increase it to 68 or 69 before that”.<sup>185</sup> Demographic factors may also influence the path of UK interest rates, which we discuss below from Paragraph 105.

90. The Rt Hon Jeremy Hunt MP told us:

“Migration has definitely contributed significantly to our growth in GDP over many decades ... It is a much harder question to answer if you ask about GDP per head, which is a much more important metric because that is more closely linked to rises in living standards for ordinary families.”<sup>186</sup>

He added: “As I tried to outline in the Budget, as a country, I believe we should say we are going to move decisively towards a high-skill, high-wage economic model that does not depend on unlimited migration.”<sup>187</sup>

91. Bim Afolami considered that an ageing population “is one of the central challenges of our time.” He told us:

“It is not just the ageing per se, but how healthy people are in the latter period of their life and the costs that that imposes on the NHS ... broadly speaking, the direction of travel is to try to reduce demand for the NHS in all sorts of practical ways, but also to make sure that we are getting more bang for our buck, so to speak.”<sup>188</sup>

92. He considered that the UK was on track to “meet that challenge if we continue along the process of reducing demand in the NHS, investing more to get better productivity and growing our economy, which grows our revenues as well.”<sup>189</sup>

### Net zero

93. The OBR explored in depth the likely long-term costs of the net zero transition in its 2021 FRS. It considered any direct public spending on the cost of transition, receipts lost from existing emissions-related taxes (especially fuel duty), receipts gained from taxing carbon more heavily, and indirect effects of different paths for the economy on the public finances.<sup>190</sup> It then constructed different scenarios produced by the Climate Change Committee (for whole economy costs and savings from decarbonisation) and the Bank of England (for the price of carbon necessary to achieve net zero and its economic implications).<sup>191</sup>

185 Professor Les Mayhew, ‘The UK and other ageing populations will have to increase their state pension age to 71 by 2050 to maintain the number of workers per retiree’, International Longevity Centre UK (5 February 2024): <https://ilcuk.org.uk/ageing-populations-forced-to-increase-state-pension-age-to-71-by-2050-to-maintain-dependency-ratio/> [accessed 5 September]

186 Oral evidence taken before the Economic Affairs Committee, Chancellor of the Exchequer - Annual Scrutiny Session, 19 March 2024 (Session 2023–24), [Q 7](#) (Rt Hon Jeremy Hunt MP)

187 *Ibid.*

188 [Q 221](#) (Bim Afolami)

189 *Ibid.*

190 Office for Budget Responsibility, ‘*Fiscal risks report*’ (July 2021) p10: <https://obr.uk/frs/fiscal-risks-report-july-2021/> [accessed 11 April 2024]

191 *Ibid.*

94. The OBR stated that the fiscal impact of achieving net zero in an ‘early action’<sup>192</sup> scenario would “add 21 per cent of GDP” to PSND by 2050/51 (£469 billion in 2021 terms).<sup>193</sup> It detailed that one clear benefit of ‘early action’ would be the avoidance of even higher debt interest spending (which, the OBR expects, would already reach 0.7 per cent of GDP by 2050/51 in the early action scenario). However, even assuming that the Government will bear 25 per cent of the £1.4 trillion cumulative investment up until 2050, when combined with savings from more energy-efficient buildings and vehicles, the OBR estimated the net cost to the state would be £344 billion in real terms, or an average of 0.4 per cent of GDP per year spread across three decades.<sup>194</sup> As the OBR then pointed out in its July 2023 FRS, this “unfunded policy ambition” must be considered alongside its baseline projection for debt-to-GDP (which foresees the ratio accelerating to 310 per cent by the mid-2070s) which, the OBR noted, is “alarming in itself.”<sup>195</sup>
95. Sir Dieter Helm has previously commented: “If energy policy is to be effective, the Government needs to revisit its net zero objective, define it properly and admit that the costs will be a lot higher than it currently claims.”<sup>196</sup> By way of explanation, Sir Dieter told us that existing cost calculations do “not properly incorporate the cost of intermittency or the fact that they are low-density energy, or the fact that they are distributed geographically very widely.”<sup>197</sup>
96. Erich Arispe emphasised that uncertainty surrounding the former Government’s specific plans for net zero constituted a risk from a ratings perspective, albeit one that is not unique to the UK.<sup>198</sup> Carl Emmerson noted that “the UK has made some pretty good progress [towards net zero] in recent decades”<sup>199</sup> but this is in part because “we have taken the low-hanging fruit, such as big improvements in electricity generation.”<sup>200</sup> He added: “The cost will come if we muddle through rather than take a strategic approach ... If we take earlier action and come up with a plan and get it right, it will not be as costly.”<sup>201</sup>
97. Despite the potential costs of the transition, witnesses were of the view that failure to facilitate it would result in worse outcomes. As Dr El-Erian said: “The alternative [to funding net zero] is much worse. If we were not to facilitate a green transition, the bill would be absolutely astronomical

192 Early action means that carbon taxes and other policies would be intensified “relatively gradually”. See BBC, ‘Bank tested on climate crisis risks’ (June 2021): <https://www.bbc.co.uk/news/business-57402955> [accessed 11 April 2024]. Under the Bank of England’s “late action” scenario, for example, action would be delayed until 2031. This could see climate policies achieve the same goals by 2050 (as early action) but because emissions are reduced over a shorter timescale, this would mean greater economic disruption.

193 Office for Budget Responsibility, ‘*Fiscal risks report*’ (July 2021): <https://obr.uk/frs/fiscal-risks-report-july-2021/> [accessed 11 April 2024]

194 *Ibid.* The OBR states that the rising take-up of electric vehicles is expected to cost £13 bn a year in foregone fuel duty by 2030. See Office for Budget Responsibility, *Fiscal risks and sustainability*, CP 870, (July 2023): [https://obr.uk/docs/dlm\\_uploads/Fiscal\\_risks\\_and\\_sustainability\\_report\\_July\\_2023.pdf](https://obr.uk/docs/dlm_uploads/Fiscal_risks_and_sustainability_report_July_2023.pdf) [accessed 11 April 2024]. Richard Hughes also noted that decarbonising the building stock – via the replacement of gas boilers – is the single largest element of net zero costs: see [Q 57](#) (Richard Hughes).

195 Office for Budget Responsibility, *Fiscal risks and sustainability*, CP 870, (July 2023) p 16: [https://obr.uk/docs/dlm\\_uploads/Fiscal\\_risks\\_and\\_sustainability\\_report\\_July\\_2023.pdf](https://obr.uk/docs/dlm_uploads/Fiscal_risks_and_sustainability_report_July_2023.pdf) [accessed 11 April 2024]

196 ‘Energy expert slams UK’s net zero strategy as ‘hopelessly unrealistic’, *Financial Times* (1 April 2022): <https://www.ft.com/content/18ed12e9-30c5-49ce-8543-549930a552c3> [accessed 5 September 2024]

197 [Q 153](#) (Sir Dieter Helm)

198 [Q 195](#) (Erich Arispe)

199 [Q 145](#) (Carl Emmerson)

200 *Ibid.*

201 *Ibid.*

in terms of the consequences.”<sup>202</sup> Danisha Kazi sought to emphasise the cost-saving aspects of green investment, noting that “dealing with up-front costs now will avert higher costs later”.<sup>203</sup> Green Alliance similarly argued: “Investing in net zero and nature pays off in the long term and protects us from the risks associated with climate change, so our management of fiscal policy needs to change to incentivise more green investment.”<sup>204</sup>

98. Ruth Curtice, Director for the Fiscal Group at HM Treasury, told us: “The OBR has characterised [the investment costs of net zero] as significant but not exceptional. In the Treasury we would agree with that ... the OBR estimated that it might need to be about £10 billion a year and that it might be absorbable within the existing public sector investment assumption that it makes over the long term. Obviously, that will be a choice for a future Government.”<sup>205</sup>
99. The new Labour government committed in its manifesto to introducing an ‘Energy Independence Act’, to enable the UK to become a “clean energy superpower.” The manifesto also committed to establishing Great British Energy (GBE), a publicly-owned “clean power” company, which would receive £8.3 billion of capital investment across the new Parliament. It would be part funded by a time-limited windfall tax on oil and gas companies. The remainder would be funded by government borrowing.<sup>206</sup>
100. The Rt Hon Jeremy Hunt MP rejected the idea that the former government had not looked “properly” at the costs of net zero. He said: “I do not agree but I accept there are uncertainties ... we have actually succeeded in decarbonising more than anywhere else ... We have also met our carbon budgets to date.”<sup>207</sup>

## Defence

101. The OBR has pointed out that post-World War II demobilisation followed by a cooling of Cold War tensions permitted a steady reduction in defence spending from 10 per cent of GDP at the end of the Korean war in the early 1950s to 2 per cent of GDP following the end of the Cold War in the early 1990s.<sup>208</sup> This, the OBR added, “created fiscal space for an expansion of the welfare state which grew by a similar proportion over the same period.”<sup>209</sup>
102. In keeping with this point, we heard that one of the areas from which successive governments have sought costs savings in order to meet other spending commitments has been the defence budget.<sup>210</sup> It was suggested, however, that there is limited scope for this to continue: Sir Dieter Helm noted that once Trident nuclear missiles and pensions are subtracted from the budget “we do not spend very much [on defence].”<sup>211</sup>

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202 [Q 90](#) (Dr Mohamed El-Erian)

203 [Q 94](#) (Danisha Kazi)

204 Written evidence from Green Alliance ([SND0017](#))

205 [Q 225](#) (Ruth Curtice)

206 House of Lords Library, ‘Kings Speech 2024: Energy security, net zero, environment and agriculture’, Research Briefing, [LLN-2024-0034](#), July 2024

207 Oral evidence taken before the Economic Affairs Committee, Chancellor of the Exchequer - Annual Scrutiny Session, 19 March 2024 (Session 2023–24), [Q 9](#) (Rt Hon Jeremy Hunt MP)

208 Office for Budget Responsibility, *Fiscal risks and sustainability*, CP 870, (July 2023), p 101: [https://obr.uk/docs/dlm\\_uploads/Fiscal\\_risks\\_and\\_sustainability\\_report\\_July\\_2023.pdf](https://obr.uk/docs/dlm_uploads/Fiscal_risks_and_sustainability_report_July_2023.pdf) [accessed 28 May 2024]

209 *Ibid.*

210 [Q 126](#) (Carl Emmerson)

211 [Q 174](#) (Sir Dieter Helm)

103. The latest North Atlantic Treaty Organization's (NATO) figures show that the UK spent an estimated 2.3 per cent of GDP on defence in 2023.<sup>212</sup> In its manifesto, the new Labour government committed to spending 2.5 per cent of GDP on defence “as soon as we can”<sup>213</sup>—above NATO's minimum requirements.<sup>214</sup> As we noted above, if defence (and Official Development Assistance) spending increased in line with the Government's ambitions, this would lead to unprotected spending needing to fall by an average of 3.6 per cent a year.<sup>215</sup>
104. The Dreadnought programme—commonly referred to as the ‘renewal’ or ‘replacement’ of Trident—is also expected to cost £31 billion, with annual in-service costs of around six per cent of the defence budget.<sup>216</sup> The Rt Hon Grant Shapps, former Secretary of State for Defence, has said: “Our nuclear deterrent is as important now as it has ever been.” However, the FT recently reported that one senior defence official said that although it is essential, “it keeps on eating up the budget headroom we create for it.”<sup>217</sup>

### The long-run outlook for interest rates

105. As discussed in Chapter 2, the relationship between expected rates of (real and nominal) interest on government bonds and GDP growth is a key determinant of debt sustainability. However, there is general disagreement about the likely path of long-term equilibrium rates of interest (the ‘natural’ / ‘neutral’ rate, or  $r^*$ ). In 2017, the Bank for International Settlements (BIS) conducted a study looking into long term interest rates across 19 countries over the years 1870 to 2016. It concluded: “No single factor or combination of such factors can consistently explain the long-term evolution of real interest rates ... The link between real interest rates and saving-investment determinants appears tenuous.”<sup>218</sup>
106. Nonetheless, many economists are of the view that the low interest rates that have characterised the Millennium thus far may have come to an end.<sup>219</sup> Professor Goodhart has written extensively on the issue and has argued that

212 NATO, *Defence expenditure of NATO countries (2014–2023)*, (March 2024), p 8: [https://www.nato.int/nato\\_static\\_fl2014/assets/pdf/2024/3/pdf/240314-def-exp-2023-en.pdf](https://www.nato.int/nato_static_fl2014/assets/pdf/2024/3/pdf/240314-def-exp-2023-en.pdf) [accessed 29 August 2024]

213 Labour Party, ‘Labour defence policy: How we will provide strong national defence for Britain’: <https://www.gov.uk/government/news/pm-announces-turning-point-in-european-security-as-uk-set-to-increase-defence-spending-to-25-by-2030> [accessed 29 August 2024]

214 The Vilnius Summit Communiqué of July 2023 reaffirmed NATO's “enduring commitment [for members] to invest at least 2% of our GDP annually on defence.” See North Atlantic Treaty Organisation, ‘Vilnius Summit Communiqué’ (July 2023): [https://www.nato.int/cps/en/natohq/official\\_texts\\_217320.htm](https://www.nato.int/cps/en/natohq/official_texts_217320.htm) [accessed 12 April 2024]. See also: HM Government, ‘PM announces ‘turning point’ in European security as UK set to increase defence spending to 2.5% by 2030’, (April 2024): <https://www.gov.uk/government/news/pm-announces-turning-point-in-european-security-as-uk-set-to-increase-defence-spending-to-25-by-2030> [accessed 29 August 2024]

215 Office for Budget Responsibility, *Economic and Fiscal Outlook*, CP 1027 (March 2024), p 104: [https://obr.uk/docs/dlm\\_uploads/E03057758\\_OBR\\_EFO-March-2024\\_Web-AccessibleFinal.pdf](https://obr.uk/docs/dlm_uploads/E03057758_OBR_EFO-March-2024_Web-AccessibleFinal.pdf) [accessed 11 April 2024]

216 House of Commons Library, Replacing the UK's strategic nuclear deterrent: Progress of the Dreadnought class, Research Note, **Number 8010**, May 2023, p 6

217 John Paul Rathbone, ‘UK faces difficult and expensive choice over ‘essential’ nuclear deterrent’, *Financial Times* (26 March 2024): <https://www.ft.com/content/b28ae2f3-9f03-4246-9dd6-fe6ffa011cc3> [accessed 22 April 2024]

218 Bank for International Settlements, *Why so low for so long? A long-term view of real interest rates* (December 2017): <https://www.bis.org/publ/work685.pdf> [accessed 12 April 2024]

219 For example, political economist, William Davies, ‘The era of low interest rates is ending - its legacy is inequality and toxic politics’, *The Guardian*, (21 April 2022): <https://www.theguardian.com/commentisfree/2022/sep/21/era-low-interest-rates-legacy-inequality-toxic-politics> [accessed 5 September 2024]

demographics will “reverse three multi-decade global trends”.<sup>220</sup> He argued in his book, *The Great Demographic Reversal*, published in 2020: “The old, at their late stage in the life cycle, don’t save, but spend, so savings ‘gluts’ of the kind thought to have paved the way for today’s low interest rates will vanish as populations age. Nominal interest rates will rise and so will inflation.”<sup>221</sup> Accordingly, Professor Goodhart told us: “No one can foretell crises, but the possibility of a significant increase in long rates relative to short, at some stage in the next five years, is more likely than not.”<sup>222</sup>

107. However, Stephen D King suggested a stipulation to Professor Goodhart’s views about demography and interest rates. He told us that the likely impact of an ageing population on the economy rather depends on what form their savings take. Mr King said that if savings were mostly in the form of real and financial assets, they would be sold to younger and smaller generations, risking a loss of value and in turn, potentially leading to deleveraging, weak growth, low inflation and low interest rates.<sup>223</sup> Alternatively, Mr King said that if these savings were entirely in the form of cash, they would “simply be spent” and the velocity of circulation of money would go up and “other things being equal, that will be inflationary and you have to set interest rates nominally at higher levels than was the case previously.”<sup>224</sup>
108. Andrew Bailey, Governor of the Bank of England, has suggested that interest rates could prove to be lower than many economists expect. In a March 2023 speech, he discussed ‘equilibrium’ interest rates and long-term trends. He said: “As  $R^*$  has fallen, monetary policy has moved with it ... The low level of interest rates over the past few decades reflects deep underlying factors on the supply side of the economy. As these underlying factors—trends in technology and demographics—only move slowly, it is not unreasonable to expect that  $R^*$  will remain low.”<sup>225</sup>
109. Peder Beck-Friis told us: “If I think about these structural factors that have been pushing down interest rates over the last 20 or 30 years, they very much remain intact. As a baseline, we at PIMCO think that real rates will remain fairly low going forward, which helps with the debt dynamics.”<sup>226</sup> However, Isabel Schnabel, executive member of the European Central Bank, told the FT earlier this year that there “are good reasons to believe that the global  $R$ -star [neutral rate] is going to move up relative to the post-financial crisis period.”<sup>227</sup> Moreover, the IMF has argued that “even if  $r^*$  remains low, the real borrowing cost of government, household, and corporate sectors could be higher in the future ... because they tend to borrow ... longer term, and

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220 See Charles Goodhart (c-authored), *Demographics will reverse three multi-decade global trends* (August 2017): <https://www.bis.org/publ/work656.pdf> [accessed 12 April 2024]

221 ‘Why economics needs to wake up to ageing populations’, *Financial Times* (2 December 2020): <https://www.ft.com/content/fcbccad8-491e-4f5b-a859-6622bc368e5c> [accessed 5 September 2024]

222 [Q 162](#) (Charles Goodhart)

223 [Q 185](#) (Stephen D King). Mr King pointed out that this description characterised the Japanese experience over the past thirty years.

224 [Q 185](#) (Stephen D King)

225 Bank of England, ‘Supply matters - speech by Andrew Bailey’ (March 2024): <https://www.bankofengland.co.uk/speech/2023/march/andrew-bailey-speech-at-london-school-of-economics> [accessed 12 April 2024]

226 [Q 124](#) (Peder Beck-Friis)

227 Isabel Schnabel, ‘The last mile of disinflation may be the most difficult one’, *Financial Times* (7 February 2024): <https://www.ft.com/content/50fca952-f218-4168-acf7-c393c4dbb0> [accessed 5 September 2024]

the associated long-term interest rates incorporate a risk premium ... that compensates lenders for providing funds for an extended period of time.”<sup>228</sup>

110. Moreover, Mr Bailey told us that notwithstanding the forces that will determine the long-term equilibrium rate, “there is now a second and possibly more important element: what we tend to call the shorter-term cyclical equilibrium rate. There are good reasons to think that that has gone up a bit.”<sup>229</sup> He “deduced” from restrictive monetary policy, falling inflation and stable unemployment that “the shorter-term equilibrium rate has gone up. I cannot give you a number .... [but] in the medium term, I doubt that we are going back to zero.”<sup>230</sup>
111. Witnesses suggested that in view of the uncertainty surrounding the outlook for interest rates, it should not be assumed that ‘r-g’ will be “zero or slightly negative” in the future.<sup>231</sup> Olivier Blanchard, Senior Fellow at the Peterson Institute for International Economics, said: “I think that is likely, but it is not sure. So you may have to plan to get not just to a balance but to a surplus, maybe 1% or even 2% of GDP. You can wait and see how it goes, but you have to be ready. There must [be] a contingency plan.”<sup>232</sup>
112. In its 2023 FRS, the OBR highlighted that, over the prior year, movements in 10-year gilt yields had pushed marginal ‘r-g’ into positive territory taking the effective ‘r-g’ towards zero. At the start of Chapter 4 we discussed expectations of the requisite budget balance for the purposes of debt stability in the medium term.<sup>233</sup> The OBR said that “such a high positive marginal R-G [with both measured in real terms], if persistent, would be unusual in the UK, with only the early 1990s persistently at this level since the Second World War.”<sup>234</sup> It noted therefore that some (including the IMF) have argued that such “unusually high rates will return towards pre-pandemic levels.” However, the OBR noted that “while global R-G may turn negative this does not mean that all countries will benefit. While over the ten-year period preceding the pandemic the UK had negative R-G in almost all years, this was not true of 12 out of 32 advanced economies.”<sup>235</sup>

### The need for growth

113. Dr El-Erian was emphatic that the “good way” to reduce debt “is to achieve the sort of economic growth that allows you to maintain and improve living standards while also lowering your debt burden over time.”<sup>236</sup> Elaborating on this point, he noted that there are three alternatives to growth when

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228 International Monetary Fund, ‘The Fiscal and Financial Risks of a High-Debt, Slow-Growth World’, (March 2024): <https://www.imf.org/en/Blogs/Articles/2024/03/28/the-fiscal-and-financial-risks-of-a-high-debt-slow-growth-world> [accessed 22 April 2024]

229 Oral evidence taken before the Economic Affairs Committee on 14 February 2024 (Session 2023–24), [Q 8](#) (Andrew Bailey)

230 *Ibid.*

231 [Q 150](#) (Oliver Blanchard)

232 *Ibid.*

233 Office for Budget Responsibility, *Fiscal risks and sustainability*, CP 870 (July 2023), para 4.34: [https://obr.uk/docs/dlm\\_uploads/Fiscal\\_risks\\_and\\_sustainability\\_report\\_July\\_2023.pdf](https://obr.uk/docs/dlm_uploads/Fiscal_risks_and_sustainability_report_July_2023.pdf) [accessed 8 May 2024]. ‘Effective’ R-G is calculated using net interest payments divided by the stock of debt. When interest rates change suddenly this effective rate may significantly lag the ‘marginal’ R-G which is calculated using the market rate of interest which feeds through to the stock of debt as each instrument matures and rolls over onto the new market rate.

234 Office for Budget Responsibility, *Fiscal risks and sustainability*, CP 870, (July 2023), p 119: [https://obr.uk/docs/dlm\\_uploads/Fiscal\\_risks\\_and\\_sustainability\\_report\\_July\\_2023.pdf](https://obr.uk/docs/dlm_uploads/Fiscal_risks_and_sustainability_report_July_2023.pdf) [accessed 28 May 2024]

235 *Ibid.*

236 [Q 68](#) (Dr Mohamed El-Erian)

looking to reduce debt: austerity—for which “there is a limit” given that it is potentially “counterproductive because it undermines future growth”; financial repression (see Chapter 2); and restructuring debt (changes to existing payment terms).<sup>237</sup>

114. However, Dr El-Erian concluded: “When you look at the alternatives to growth, they are not very appealing.”<sup>238</sup> In the absence of growth, then there is a likely need for governments to run primary budget surpluses (per ‘r-g’); and as the IMF has pointed out: “[In] the absence of economic growth, even sound public finances will be eventually undermined.”<sup>239</sup>
115. Conditions for debt reduction were particularly favourable in the four decades after the Second World War. The OBR has said that over this period, “relatively rapid growth in productivity coupled with high rates of inflation and comparatively low rates of interest ... created a negative ‘growth-corrected interest rate’ (‘R-G’) that averaged minus 4.9 percentage points.”<sup>240</sup>
116. A number of witnesses were pessimistic about the UK economic outlook, thereby suggesting another ‘tailwind’ has turned into a ‘headwind’. Referring to ‘r-g’ (see Chapter 2), Professor Goodhart said: “The tendency is still to believe that we will go back to a world in which ... g will be significantly greater than r. That is hopelessly optimistic for a series of reasons.”<sup>241</sup> Similarly, Stephen D King suggested that forecasts for GDP per capita (a preferable measure of living-standards to GDP)<sup>242</sup> may be somewhat optimistic, stating the OBR “is still assuming that long-term growth will pick up to maybe an average of 1.5% or so per capita per year, which is about double what it has been over the last 20 years or so.”<sup>243</sup> He said that the problem both major political parties face is that it is “quite difficult to admit to the public ... the scale of the problem that currently exists. It is easier to pretend that economic growth will simply rebound to something faster over the next two or three decades.”<sup>244</sup>
117. Observations about growth were invariably linked to the need for higher rates of productivity, which, Professor David Miles suggested “is the almost pain free route to fiscal sustainability.”<sup>245</sup> In its March 2024 EFO, the OBR stated that productivity growth is central to the economic projections that underpin its fiscal forecast. It pointed out that although it expects higher productivity growth over its five-year forecast period (an average of 0.9 per cent per annum, and therefore above the post-2008 average of 0.5 per

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237 *Ibid.*

238 *Ibid.*

239 IMF, ‘Fiscal Monitor’ (April 2024): <https://www.imf.org/en/Publications/FM/Issues/2024/04/17/fiscal-monitor-april-2024> [accessed 28 May 2024]

240 Office for Budget Responsibility, *Fiscal risks and sustainability*, CP 870, (July 2023), p 101: [https://obr.uk/docs/dlm/uploads/Fiscal\\_risks\\_and\\_sustainability\\_report\\_July\\_2023.pdf](https://obr.uk/docs/dlm/uploads/Fiscal_risks_and_sustainability_report_July_2023.pdf) [accessed 28 May 2024]

241 Q 162 (Charles Goodhart)

242 Widely used, but not a comprehensive measure. See: International Monetary Fund, ‘Gross Domestic Product: an economy’s all’: <https://www.imf.org/en/Publications/fandd/issues/Series/Back-to-Basics/gross-domestic-product%20GDP> [accessed 20 April 2024]

243 Q 181 (Stephen D King); Mr King noted that UK GDP per capita grew by just 5 per cent between 2003 and 2013 and by 8 per cent between 2013 and 2023, which compares to 26 per cent between 1983 and 1993, and 31 per cent between 1993 and 2003.

244 Q 181 (Stephen D King)

245 Written evidence from Prof David Miles (SND0012)

cent), “it is still below the pre-crisis trend of 2 per cent.”<sup>246</sup> Furthermore, it noted: “Scenario analysis in our November 2023 EFO estimated that if productivity was 0.5 percentage points above or below our central forecast, it would reduce borrowing by an estimated £46.0 billion or increase it by £42.2 billion, respectively, by the end of our forecast.”<sup>247</sup>

118. In correspondence, Richard Hughes told us that there “is no simple answer to the question of how much productivity growth is needed to stabilise the public finances.”<sup>248</sup> He added that “changes to productivity growth in the whole economy will have consequences for the costs of providing public services which are not straightforward to analyse.”<sup>249</sup> Professor Miles argued that if “productivity growth over the next five years were to be 1% higher than the OBR central forecast—and so close to pre financial crisis levels—the stock of debt relative to GDP could be £150 billion lower and the debt to GDP ratio over 5% lower and falling steadily.”<sup>250</sup> Conversely, he added that “if productivity growth is barely positive over the next five years debt would [be] around £200 billion higher, some 7% of GDP, than the OBR central forecast of November 2023.”<sup>251</sup>
119. Julian Jessop noted that “since the [2008] global financial crisis, it is noticeable that some of the biggest slowdowns were in two sectors: financial services and the energy sector. Both have seen quite big increases in regulation for various reasons. Simply reversing that could make a big difference to productivity.”<sup>252</sup> However, witnesses tended to be of the view that successfully promoting higher productivity, and hence growth, is far from straightforward.<sup>253</sup> Moreover, Professor Miles considered it a “risky strategy” to rely on productivity growth to prevent ever increasing debt to GDP ratios. He said: “Past evidence suggests that government policies to bring it about cannot be relied upon to transform the fiscal outlook. In their absence the balance between taxation and spending does not look as if it can continue as is.”<sup>254</sup>
120. Bim Afolami told us that “there are over 120 [growth measures] in the last six months from both the Autumn Statement and the Budget”.<sup>255</sup> Mr Afolami also said that the work the former Government had been doing to improve the productivity of public services is quite fundamentally different to measures taken in the past. He said: “Although efficiency drives have their place, what is transformational about this productivity plan is that it actually requires investment. We are investing to improve outputs in public services.”<sup>256</sup>

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246 Office for Budget Responsibility, *Economic and fiscal outlook*, CP 1027, (March 2024), p 124: [https://obr.uk/docs/dlm\\_uploads/E03057758\\_OBR\\_EFO-March-2024\\_Web-AccessibleFinal.pdf](https://obr.uk/docs/dlm_uploads/E03057758_OBR_EFO-March-2024_Web-AccessibleFinal.pdf) [accessed 28 May 2024]

247 *Ibid.*

248 Letter from Richard Hughes, Office for Budget Responsibility, to Lord Bridges of Headley, Chair of the Economic Affairs Committee (9 April 2024): <https://committees.parliament.uk/publications/44413/documents/223641/default/>

249 *Ibid.*

250 Written evidence from Prof David Miles ([SND0012](#))

251 *Ibid.*

252 [Q 116](#) (Julian Jessop)

253 [Q 150](#) (Charles Goodhart) and written evidence from Prof David Miles ([SND0012](#))

254 Written evidence from Prof David Miles ([SND0012](#))

255 [Q 215](#) (Bim Afolami)

256 *Ibid.*

121. On 17 July 2024, King Charles III outlined the new Labour government's plans for the new Parliament. In the "King's speech", the Government assured that "securing economic growth will be a fundamental mission" and that it "will seek a new partnership with both business and working people ... by prioritising wealth creation for all communities."<sup>257</sup> The Government also announced plans to focus on stimulating investment, in order to "get Britain building" (via a Planning and Infrastructure Bill) and "pursue sustainable growth by encouraging investment in industry, skills and new technologies".<sup>258</sup> The Government will also implement a National Wealth Fund Bill which, it says, "will play a central role in the Government's industrial strategy and growth and clean energy superpower missions."
122. During the 2024 General Election campaign, Paul Johnson, Director of the IFS, published his initial thoughts on Labour's economic plans as detailed in the Party's election manifesto. Mr Johnson noted that Labour's "focus on economic growth and stability" incorporating "planning reform, an effective industrial strategy, promises of regulatory reform [and] some education reform" were to be welcomed.<sup>259</sup> However, he added that "details remain thin" amid a "dizzying number of reviews and strategies". Mr Johnson conceded that this "is better than a shopping list of half-baked policy announcements" but concluded that "delivering genuine change will almost certainly also require putting actual resources on the table. And Labour's manifesto offers no indication that there is a plan for where the money would come from to finance this." He stated:

"Like the Conservatives and the Liberal Democrats, Labour continues in a conspiracy of silence on the difficulties they would face. These challenges are already perfectly clear. The books are open. A post-election routine of shock-and-horror at the state of the public finances will not cut it."

### The choices ahead

123. When asked whether action needs to be taken in the next parliament in order to keep debt-to-GDP below 100 per cent, Richard Hughes told us that there "is a window of opportunity over the next five to 10 years to take action in these areas to deal with the demographic challenges, and there is obviously a need to take action early to deal with the climate challenges".<sup>260</sup> Dr El-Erian said that action is necessary in the next parliament to secure debt sustainability "because it gets harder and harder to turn the ship around the further in you go in the next few years."<sup>261</sup>
124. Sir Dieter Helm told us that "since the Second World War, there has been an incremental addition of government functions, one upon the other."<sup>262</sup> Accordingly, he suggested that we need to ask: "Where is the balance between the take of tax ... and the functions that we want government to have? What you cannot do—it is what democracies tend to do—is keep expanding the

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257 Prime Minister's Office, *The King's Speech 2024*: <https://www.gov.uk/government/speeches/the-kings-speech-2024> [accessed 29 August 2024]

258 *Ibid.*

259 Institute for Fiscal Studies, 'Election 2024: Labour Party manifesto: an initial response' (June 2024): <https://ifs.org.uk/articles/labour-party-manifesto-initial-response> [accessed 29 August 2024]

260 [Q 27](#) (Richard Hughes)

261 [Q 68](#) (Dr Mohamed El-Erian)

262 [Q 174](#) (Sir Dieter Helm)

functions then not provide the money to do them.”<sup>263</sup> In relation to the overall level of public spending, Julian Jessop considered that the “number could probably be a lot lower than some other people might think ... I find it difficult to understand why the Government need to spend more than about 40% of national income—or certainly more than 50%, as is the case in many European countries.”<sup>264</sup> Professor Chadha similarly questioned whether there were any ways for government expenditures to be curtailed:

“Can we automatically uprate retirement age with life expectancy? Are there things that we should do with the triple lock on pensions, which will cost 1% more of GDP over the next four or five years than we might have anticipated? Are there things that we have committed to ... that we should move away from because they are a residual risk to the ultimate level of public finances in the economy?”<sup>265</sup>

125. As for levels of taxation, Carl Emmerson observed that the current tax take (of 36.3 per cent) is “not that high by western European or Scandinavian standards”.<sup>266</sup> However, Dr Gerrard Lyons pointed out that there “is a need to change the UK’s terms of reference. European countries with high tax rates are often cited as reasons to justify ... an upward drift of taxes [but] ... in less than twenty-five years [western Europe’s] share of global GDP will be less than 10% and smaller than India.”<sup>267</sup> Professor David Miles made a similar point. He said: “Being in the same boat as others does not help you if it is sitting low in the water as the waves ahead are becoming larger.”<sup>268</sup> Although it was suggested that there is unlikely to be a specific threshold beyond which the tax take necessarily impacts growth,<sup>269</sup> some witnesses said that there is a point beyond which the overall tax take introduces disincentives.<sup>270</sup> Dr El-Erian stated that “at a certain level, [tax] certainly has a detrimental impact. It has negative incentive effects. It can crowd out investment. It can do all sorts of things.”<sup>271</sup>
126. During the 2024 General Election campaign, Paul Johnson, Director of the IFS, said: “Now more than ever, as a country, we face some big decisions and trade-offs over what we want the state to do and how we’re going to pay for it. Those looking to form the next government should be honest about these trade-offs.”<sup>272</sup> This echoed evidence the Committee received before the General Election was called.
127. It was suggested that if debt stability is to be maintained, then governments might need to make difficult choices about taxes and spending.<sup>273</sup> Stephen D King said: “We aspire to European levels of public spending and public benefits, and we aspire to US levels of taxation. I am afraid the two do not sit

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263 *Ibid.*

264 [Q 113](#) (Julian Jessop)

265 [Q 5](#) (Prof Jagjit Chadha)

266 [Q 125](#) (Carl Emmerson)

267 Written evidence from Dr Gerard Lyons ([SND0034](#))

268 Written evidence from Prof David Miles ([SND0012](#))

269 [Q142](#) (Carl Emmerson)

270 See [Q 89](#) (Dr Mohamed El-Erian) and [Q 23](#) (Martin Slater).

271 [Q 89](#) (Dr Mohamed El-Erian)

272 ‘Labour and Tories need to be honest about economic trade-offs, says IFS’, *The Guardian* (25 January 2024): <https://www.theguardian.com/politics/2024/jan/25/labour-and-tories-need-to-be-honest-about-economic-trade-offs-says-ifs> [accessed 5 September 2024]

273 See [Q 184](#) (Stephen D King), [Q 22](#) (Prof Jagjit Chadha), [Q 79](#) (Dr Mohamed El-Erian) and [Q 126](#) (Carl Emmerson).

together very easily.”<sup>274</sup> Professor Goodhart noted that as it will be necessary for spending on defence (and climate change) to go up, “the only alternative is for taxes to go up, too, in order to bring the primary deficit down to zero.”<sup>275</sup> Sir Dieter Helm implicitly agreed with the suggestion that the UK has been living beyond its means for the past 25 years and that the ‘real’ challenge, as opposed to ensuring debt sustainability *per se*, is that the population “needs to be confronted, to come back to living within our means.” He said: “A fundamental question is whether the economy is sustainable, because then the debt follows from that, and the economy is not sustainable in its current form.”<sup>276</sup>

128. When asked whether more debate was needed about what the state does, Bim Afolami said: “We definitely do ... because of what the Government had to do to step in and support individuals and households during the pandemic, we spent over £400 billion. That led to a significant expansion of what the Government were doing.” He added: “I think the focus now will be much more on growth and making sure that the state does manageable things. We just lived through a very unusual time in that regard.”<sup>277</sup>
129. On the UK’s approach to taxation, Mr Afolami stated that he shared the former Chancellor’s view that lower-taxed economies “tend to grow faster.” He also told us he was glad his government cut the higher rate of capital gains tax from 28 per cent to 24 per cent. He said: “That is a very good example of where cutting a tax can increase the amount for the Exchequer and increase economic growth. We should be looking for those all the time.”<sup>278</sup>
130. **From the end of World War II to the 1990s, the level of debt fell rapidly as a proportion of national income, as governments were aided by ‘tailwinds’, or a variety of helpful factors. These included a growing working age population, the growth of national income outpacing the rate of interest on government debt, a decline in defence spending and strong investment demand for government debt from defined-benefit pension schemes. These ‘tailwinds’ are now becoming ‘headwinds’.**
131. **While the UK’s demographic projections are far from certain, the UK’s population will age and its dependency ratio will rise. Both will increase demands on the UK’s public finances in terms of the funding of public services, including health and social care, and the funding of state pensions.**
132. **While high net migration has previously boosted GDP growth, it has made little impression on GDP per head: high net migration cannot be the solution to debt sustainability.**
133. **An ageing population and shrinking proportion of those in work might see savings fall and wage inflation rise. There is a view that this could put upward pressure on interest rates, leading to an increased cost of servicing debt and further pressure on public services.**

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274 [Q 184](#) (Stephen D King)

275 [Q 150](#) (Charles Goodhart)

276 [Q 176](#) (Sir Dieter Helm). Sir Dieter Helm also suggested that the *actual* tax take “is [probably] higher, because we have had 30 to 40 years of shifting things from government accounts on to customer bills.”

277 [Q 235](#) (Bim Afolami)

278 [Q 230](#) (Bim Afolami)

134. **The cost of the transition to net zero will increase pressure on public finances. It highlights the need for the Government to produce and publish a fully-funded, coherent plan for meeting net zero targets.**
135. **The Government is committed to raise defence spending to 2.5 per cent of GDP as soon as it can. This will increase fiscal pressure still further, especially as we received evidence that previous governments have sought cost savings from the defence budget to finance expenditure elsewhere: this option will be no longer available.**
136. **We await to see the details of the new Government's plans to improve productivity, especially in the public sector. However, we are not convinced that productivity alone will contain the projected rise in government expenditure. Nor are we persuaded that governments can rely on significantly higher economic growth rates to avoid the pressures on public finances. These pressures will increase further if interest rates exceed the growth rate of national income, as this would mean that the Government would have to generate a primary surplus to keep the debt ratio from rising. As a result of these factors, the Government will face painful choices on spending, tax and borrowing.**
137. **Without an appropriate fiscal policy, there is a risk of debt becoming unsustainable. This is thanks to a combination of factors: the vulnerabilities and pressures outlined in Chapter 3; the prospect of low productivity and growth, with interest rates remaining at a level not seen for a decade; an ageing population and a shrinking workforce. Moreover, although public spending is still at a higher level than before the COVID-19 pandemic, there are already numerous demands for the Government to spend more on public services.**
138. **To ensure debt is on a sustainable path, we face a choice. If we wish to improve the level and quality of services, and continue the current provision of benefits, taxes will need to rise. The alternative is that the state does less. Addressing this will demand clarity as to the responsibilities and role of the individual versus that of the state.**
139. **If this choice is ducked during this Parliament, the UK risks being on a path to unsustainable debt. Muddling through is not an option.**

## CHAPTER 5: A NEW FISCAL FRAMEWORK

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### Meeting the current debt rule

140. The UK's fiscal framework establishes how the Government manages the public finances and is set out in the Charter for Budget Responsibility, a document required under Section 1(1) of the Budget Responsibility and National Audit Act 2011.<sup>279</sup> The Act requires the Charter to set out the incumbent government's 'fiscal rules'. For the previous government, the rules embodied the 'fiscal mandate' or a main fiscal rule which was "to have public sector net debt (excluding the Bank of England) falling as a percentage of GDP by the fifth year of the rolling forecast period."<sup>280</sup> This debt rule was supplemented by:
- "a target to ensure public sector net borrowing does not exceed 3 percent of GDP by the fifth year of the rolling forecast period" and;
  - a target to ensure that expenditure on welfare is contained within a predetermined cap and margin set by the Treasury."<sup>281</sup>
141. The debt rule was proposed by the Rt Hon Jeremy Hunt MP in the Autumn Statement 2022 and subsequently came into force in February 2023.<sup>282</sup> As we mentioned in Chapter 1, fiscal rules have been in existence since 1997 and, under the previous government, were in their ninth iteration.<sup>283</sup> Dr Gerard Lyons told us that when the first rules were introduced, they "remained unchanged until 2008. Then, like subsequent ones, they were discarded once they were not met and replaced with new ones." He added: "You wonder why anyone takes them seriously."<sup>284</sup> The new Labour government has announced that it will change aspects of the previous government's fiscal rules, but debt must still fall as a share of the economy by the fifth year of the forecast: see paragraph 165 below.<sup>285</sup>

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279 HM Treasury, *Charter for Budget Responsibility*, (January 2023), p 8: [https://assets.publishing.service.gov.uk/media/63d15c6cd3bf7f3c4900f11a/Charter\\_for\\_Budget\\_Responsibility\\_-\\_AS22\\_-\\_FINAL\\_as\\_published\\_in\\_draft.pdf](https://assets.publishing.service.gov.uk/media/63d15c6cd3bf7f3c4900f11a/Charter_for_Budget_Responsibility_-_AS22_-_FINAL_as_published_in_draft.pdf) [accessed 15 April 2024]

280 *Ibid.*

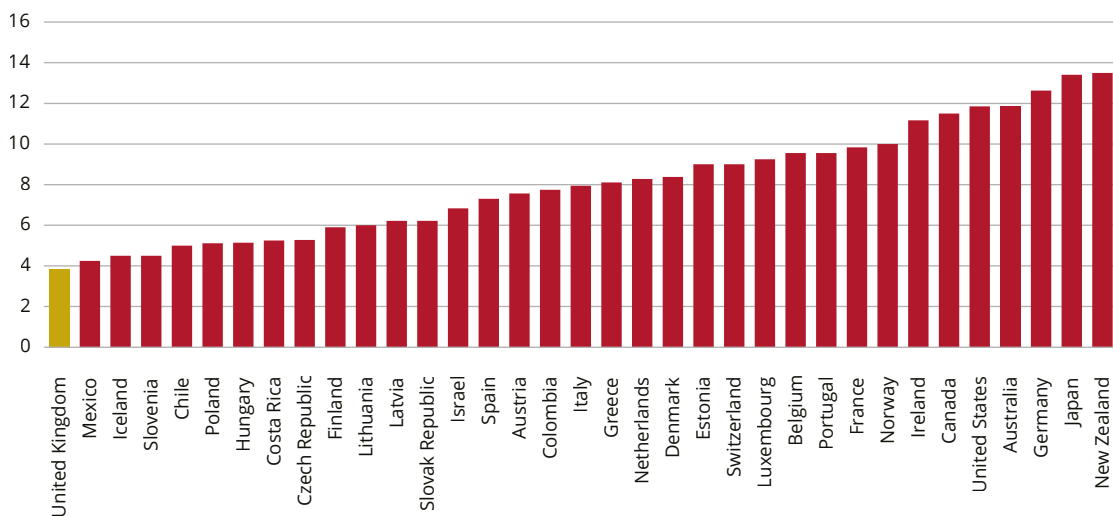
281 *Ibid.*

282 House of Commons Library, The UK's fiscal targets, [CPB 9329](#), March 2024

283 Institute for Government, 'Fiscal rules in the UK since 1997', (March 2022): <https://www.instituteforgovernment.org.uk/explainer/fiscal-rules-history> [accessed 15 April 2024]

284 Dr Gerard Lyons written evidence ([SND0034](#))

285 Labour Party, 'Labour's fiscal plan', <https://labour.org.uk/change/labours-fiscal-plan/> [accessed 3 September 2024]

**Figure 6: Average lifespan of fiscal rules in different countries (years)**

Source: Institute for Government, ‘Strengthening the UK’s fiscal framework’ (February 2024), Figure 1: <https://www.instituteforgovernment.org.uk/sites/default/files/2024-02/strengthening-uk-fiscal-framework.pdf> [accessed 8 May 2024]

142. As part of the Charter for Budget Responsibility, the OBR is charged with examining and reporting on the sustainability of the public finances and publishes “forecasts of the economy and public finances consistent with the forecast horizon set by the Chancellor of the Exchequer.”<sup>286</sup> The OBR also produces assessments “of the extent to which fiscal policy has delivered, or is likely to deliver, the fiscal mandate.”<sup>287</sup>
143. Richard Hughes told us that having fiscal rules has been a good development for policy-making and that citizens “have a right to know what the financial objectives of the Government are.”<sup>288</sup> This was supported by Tom Josephs who said that it is “really important to have a transparent and clear fiscal objective and fiscal strategy, and to have the political commitment and credibility to deliver that.”<sup>289</sup> Dr El-Erian considered that the rules forced “a certain amount of thinking” and that “finding out how much headroom exists relative to whatever target is binding first and giving that as a parameter, plays a really important function. It is an anchor.”<sup>290</sup>
144. James Smith referred to the gilt market turbulence of September 2022 as an example of what can happen when “fiscal anchors [and] fiscal expectations, get lost” and that having “clearly set out fiscal rules helps to avoid that situation.”<sup>291</sup> Professor Chadha similarly noted that the current fiscal rules were introduced when debt “had increased rapidly, and we were even worried about default in the UK.” He said that “having some kind of rule, alongside the OBR, looked sensible to tie the hands of fiscal policy-makers so that the markets would continue to want to hold debt and buy rollover debt at a time when it had increased rapidly.”<sup>292</sup>

286 HM Treasury, *Charter for Budget Responsibility, Autumn 2022 update (January 2023)*: [https://assets.publishing.service.gov.uk/media/63d15c6cd3bf7f3c4900f11a/Charter\\_for\\_Budget\\_Responsibility\\_-\\_AS22\\_-\\_FINAL\\_as\\_published\\_in\\_draft.pdf](https://assets.publishing.service.gov.uk/media/63d15c6cd3bf7f3c4900f11a/Charter_for_Budget_Responsibility_-_AS22_-_FINAL_as_published_in_draft.pdf) [accessed 15 April 2024]

287 *Ibid.*

288 Q 40 (Richard Hughes)

289 Q 40 (Tom Josephs)

290 Q 83 (Dr Mohamed El-Erian)

291 Q 110 (James Smith)

292 Q 20 (Prof Jagjit Chadha)

### Is the main debt rule fit for purpose?

145. Despite their support for the principles and objectives underpinning the last government's fiscal rules, witnesses had concerns about the form of the debt rule. The Institute for Government highlighted that as the rule only requires debt to be falling relative to GDP between the fourth and fifth years of a rolling forecast, this means that the target only "needs to be met in forecasts and does not necessitate actual debt reduction."<sup>293</sup> Other witnesses also noted that the debt rule does not address the actual path of debt over the forecast horizon and that it "does not necessarily get debt falling in [the] outturn."<sup>294</sup> (As an aside, in its Green Budget 2024, the IFS discussed the merits of the PSND target as opposed to the existing PSND ex BOE target. It noted: "However the government chooses to measure debt in its fiscal rules, a fiscal loosening is a fiscal loosening, and additional borrowing is additional borrowing." It added that "it is very difficult to see a principled case for targeting headline PSND rather than the existing measure of 'underlying' debt".)<sup>295</sup>
146. The Institute for Government further stated that in looking to meet the target set by the debt rule, "successive governments have systematically tended to deliver policy-giveaways in the short-term, while announcing unrealistic never-to-be delivered tax rises or spending cuts in the longer term." Therefore, "even if a government is 'on course' to have debt fall, that need never be achieved in reality." It referred to this as "fiscal fiction".<sup>296</sup>
147. Richard Hughes elaborated on this point in relation to the policy assumptions the OBR is required to factor-in when producing its forecasts. This includes fuel duty being indexed to inflation every year when in fact it has been frozen every year since 2011. In relation to spending on public services and how they will be delivered, Mr Hughes emphasised that beyond the then government's departmental spending review for the year until 31 March 2025, no further detail had been provided.<sup>297</sup> Mr Hughes said of the two numbers the Government provides the OBR (total current spending and total capital spending):

"Some people have referred to that as a work of fiction. That is probably generous, given that someone has bothered to write a work of fiction, whereas the Government have not even bothered to write down their departmental spending plans underpinning their plans for public services."<sup>298</sup>

Speaking to us before the July 2024 General Election, Julian Jessop said that "the big problem for the next Parliament, whoever wins, is that they will

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293 Written evidence from the Institute for Government ([SND0033](#))

294 See for example written evidence from the Fraser of Allander Institute at the University of Strathclyde ([SND0023](#)), [Q 138](#) (Carl Emmerson) and [Q 40](#) (Richard Hughes).

295 Institute for Fiscal Studies, 'Definitions of debt and the new government's fiscal rules' (August 2024): <https://ifs.org.uk/articles/definitions-debt-and-new-governments-fiscal-rules> [accessed 29 August 2024]. As the IFS explains, the fiscal 'headroom' to be gained (currently) from swapping to a PSND target reflects both discrepancies in the timing of valuation losses on gilt holdings and the technical (accounting) aspects of the BOE's lending schemes. The IFS therefore dismisses the suggestion that changing targets increases the Government's scope for permanent increases in spending or cuts in taxation.

296 Written evidence from the Institute for Government ([SND0033](#))

297 [Q 28](#) (Richard Hughes)

298 *Ibid.*

be looking at a set of fiscal forecasts based on an implausible set of public expenditure assumptions.”<sup>299</sup>

148. Witnesses also argued that the debt rule serves to undermine sensible policy<sup>300</sup> and a long-term fiscal approach.<sup>301</sup> Dr Gerard Lyons referred to policy announcements in the Spring Budget of 2023 as an example of this playing out, with one stipulating that certain investment allowances would only last three years. While this allowed the then Chancellor to meet the debt rule, Dr Lyons noted that this “had the adverse impact of that measure being seen as temporary, and thus it did not have the immediate full positive economic impact intended.”<sup>302</sup> Joseph Stiglitz criticised this “rigid” aspect of the debt rule as being “unhelpful”, stating that any rule should “pay attention to how the money is spent and the circumstances of the country at that particular juncture.”<sup>303</sup>
149. Dr Robert Calvert Jump, Senior Lecturer in Quantitative Methods at the University of Greenwich, and Professor Jo Michell, Professor of Economics at UWE Bristol, said that the debt rule has resulted in “fiscal headroom ... taking a central and unhelpful role in fiscal policy-making.” They highlighted how, in cases of negative headroom, the former government had responded with cuts to spending. In cases of positive headroom, it had implemented tax cuts that were “widely regarded as unsustainable.” In their view, the debt rule had acted to “introduce a ratchet mechanism pushing us towards lower government spending, and a share of tax in GDP which is unsustainably low given the projected costs of government services, an ageing population and other challenges.”<sup>304</sup> Professor Mariana Mazzucato, Professor in the Economics of Innovation and Public Purpose at UCL, and Dr Josh Ryan-Collins, Associate Professor of Economics and Finance at UCL, argued:

“Cuts to public investment due to short-run targets (including 5-years), can ironically cause the debt-to-GDP ratio to rise because the denominator does not grow, but also because failing public services are likely to cause an increase in automatic stabiliser-related spending and thus borrowing in the social sphere.”<sup>305</sup>

### **An alternative fiscal framework**

150. A number of witnesses argued that an alternative fiscal framework should prioritise a longer-term approach for managing debt.<sup>306</sup> Professor Chadha told us:

“We have had a world, it seems to me, where fiscal policy has increasingly been designed to try and hit headlines in the newspapers the next day... I would very much argue for much more long-term thinking in the way we think about fiscal policy, not to allow the month-to-month or year-to-year changes in the economy to drive tax and spending decisions but to present a much more sophisticated view.”<sup>307</sup>

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299 [Q 95](#) (Julian Jessop)

300 Written evidence from Dr Gerard Lyons ([SND0034](#))

301 See for example written evidence from Prof Mariana Mazzucato and Dr Josh Ryan-Collins ([SND0043](#)) and written evidence from New Economics Foundation ([SND0015](#))

302 Written evidence from Dr Gerard Lyons ([SND0034](#))

303 [Q 201](#) (Joseph Stiglitz)

304 Written evidence from Dr Robert Calvert Jump and Prof Jo Michell ([SND0025](#))

305 Written evidence from Prof Mariana Mazzucato and Dr Josh Ryan-Collins ([SND0043](#))

306 See for example [Q 10](#) (Prof Jagjit Chadha), [Q 103](#) (Danisha Kazi) and [Q 20](#) (Martin Slater).

307 [Q 10](#) (Prof Jagjit Chadha)

151. Danisha Kazi emphasised that rules should be focused on “long-term investment in our public services and our economy in order to make us resilient for the next set of economic shocks that are potentially around the corner.” She highlighted the example of Germany not including its state investment banks in its public debt, and that the UK should look at what other countries are doing to support investments in their public infrastructure, services and economy.<sup>308</sup>
152. In Chapter 2, we noted that some witnesses had suggested that a country’s ‘balance sheet’ should form part of any assessment of debt sustainability. While Sam Beckett had highlighted that the Government does pay attention to Public Sector Net Worth (PSNW) and Public Sector Net Financial Liabilities (PSNFL), there have been some calls for a formalised role for these two measures in the Government’s fiscal rules. In its paper *Seeking public value*, published in 2019, the Resolution Foundation argued that incorporating one of these measures into the next set of fiscal rules would “help bridge the current gulf between policymakers’ stated fiscal aims and measured fiscal reality”.<sup>309</sup> This, it argued, would enhance “the political salience of fiscal rules, expand the information base for fiscal decision-making, and reinforce public accountability for fiscal performance.”<sup>310</sup>
153. Nevertheless, while some witnesses were open to some form of debt-management approach incorporating a more direct role for the public sector balance sheet, they struggled to envisage its practical implementation.<sup>311</sup> Julian Jessop pointed out that a school, for example, delivers important economic and social benefits, “but it does not pay for itself. It is not necessarily something that the markets would look at and say, “This makes it easier for us to justify buying government debt””.<sup>312</sup> Moreover, Mr Jessop alluded to the problems of defining investment, noting that “if you are doing a lot of current spending on healthcare or education, to what extent is that also an investment in the future? ... It is a good example of where we sort of agree on the principles, but whether it would be an improvement in practice is debatable.”<sup>313</sup>
154. The Institute for Government set out its proposals for an alternative approach to fiscal policy, which were also included in its report *Strengthening the UK’s fiscal framework*, published in February 2024.<sup>314</sup> It advocated amending the wider fiscal framework so that the Chancellor is first required to set out a comprehensive fiscal strategy, arguing: “Debt and deficits are not ends in themselves; they are the means by which governments make trade-offs between outcomes and across time.” This strategy, it argued, would see the Government follow a set of rules which:
- Treat investment spending differently to current spending;
  - Specify targets as ranges rather than point targets; and

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308 [Q 110](#) (Danisha Kazi)

309 Resolution Foundation, *Seeking public value* (September 2019): <https://www.resolutionfoundation.org/app/uploads/2019/09/Seeking-public-value.pdf> [accessed 28 May 2024]

310 *Ibid.*

311 See [Q 104](#) (Julian Jessop and James Smith).

312 [Q 104](#) (Julian Jessop)

313 [Q 107](#) (Julian Jessop)

314 See written evidence from the Institute for Government ([SND0033](#)).

- Bind in the third year of the forecast, rather than the fifth year.<sup>315</sup>
155. The Institute for Government also proposed that the Chancellor should commit to holding “only one fiscal event per year and commit to a new cycle of regular overlapping spending reviews to allow fiscal policy-making to be slower and more strategic, and to provide public bodies with greater certainty about their future spending plans.”<sup>316</sup>
156. Witnesses also discussed alternative approaches to fiscal management, often with a focus on the ‘debt brake’ policies of Germany and Switzerland. According to the Swiss Federal Department of Finance, the ‘debt brake’ is designed to “at least stabilise” the level of debt. It points out:
- “In the medium term, i.e. over an economic cycle, the federal budget is balanced with the debt brake: surpluses must be generated during a boom to offset the deficits of the structural recession. Ordinary expenditure is limited to the level of structural i.e. cyclically adjusted receipts.”<sup>317</sup>
- This, it states, allows for a “steady expenditure trend” and mitigates against a “stop-and-go” policy. The German ‘debt brake’ requires that the Federal and Länder (state) budgets must be balanced without revenue from loans.<sup>318</sup>
157. Nevertheless, referring to the German ‘debt brake’, Dr El-Erian considered it “a perfect example of when some rules can be counterproductive.” He said: “[The German] Government had to find savings to compensate for what was deemed to be excessive debt. It did that at a time when Germany was going into recession and major investment was needed for the drivers of tomorrow’s growth.”<sup>319</sup> Carl Emmerson agreed that such requirements can be “too binding, in that they have very firm limits, which you then get up against and you decide ... that it is more appropriate or easier to break them rather than adhere to them.”<sup>320</sup> While there have been recent calls in Germany to reform the ‘debt brake’,<sup>321</sup> in Switzerland the policy has been considered a success, in large part due to the fact that the country’s debt ratio has fallen to around 30 per cent of GDP.<sup>322</sup>
158. A number of witnesses emphasised the need for “fiscal buffers” so governments are able to respond to economic shocks. Carl Emmerson advocated reducing

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315 According to the Institute for Government, a five-year horizon provides an unnecessary degree of flexibility for dealing with economic shocks and “too much scope for fiscal fiction [see Paragraph 146] ... A three-year horizon would allow the government to respond to minor shocks (with an impact of three years of less) while staying within the rules and, when combined with our recommendations for regular overlapping spending reviews, reducing the potential for gaming through pencilling in implausible spending plans.” See Institute for *Government, Strengthening the UK’s fiscal framework* (February 2024): <https://www.instituteforgovernment.org.uk/sites/default/files/2024-03/strengthening-uk-fiscal-framework.pdf> [accessed 15 April 2024].

316 See written evidence from the Institute for Government ([SND0033](#))

317 Federal Department of Finance, *The debt brake*: <https://www.newsd.admin.ch/newsd/message/attachments/82378.pdf> [accessed 25 July 2024]

318 Federal Ministry of Finance, *Germany’s Federal Debt Rule (Debt Brake)* (February 2022): [https://www.bundesfinanzministerium.de/Content/EN/Downloads/Public-Finances/germanys-federal-debt-rule.pdf?\\_\\_blob=publicationFile&v=5](https://www.bundesfinanzministerium.de/Content/EN/Downloads/Public-Finances/germanys-federal-debt-rule.pdf?__blob=publicationFile&v=5) [accessed 15 April 2024]

319 [Q 84](#) (Dr Mohamed El-Erian)

320 [Q 138](#) (Carl Emmerson)

321 Reuters, ‘German advisory council floats debt brake reform after budget mess’ (January 2024): <https://www.reuters.com/world/europe/german-advisory-council-floats-debt-brake-reform-after-budget-mess-2024-01-30/> [accessed 15 April 2024]

322 Federal Department of Finance, *The debt brake*: <https://www.newsd.admin.ch/newsd/message/attachments/82378.pdf> [accessed 25 July 2024]

debt down over the medium term, noting “we cannot have debt not going down in the okay and good years, and yet going up every time a bad shock hits. We need to aim to get it down.”<sup>323</sup> Similarly, Joseph Stiglitz agreed that lower debt-to-income ratios are essential “if we live in a world with high levels of deep and radical uncertainty, we have to have more buffers, and we have to be able to respond.”<sup>324</sup>

159. Higher debt levels might also restrict fiscal choices. Stephen D King said that the higher a country’s debt level at the start of a shock or downturn, “the more quickly public finances will deteriorate, because the starting point gives you a higher debt service cost, which in turn implies that your primary surplus has to be bigger to offset the size of that debt service cost.”<sup>325</sup> Dr El-Erian suggested that governments, generally, have not been attentive to the need to pay down debt in ‘good’ years. He told us: “In example after example in the developing world in the last 40 years, we have seen the problem that countries never fully exit from debt sustainability red zones.”<sup>326</sup>
160. Dr Jump and Professor Michell emphasised the importance of accountability and transparency as part of a government’s fiscal approach. They highlighted that “Chancellors of the Exchequer have set many targets for themselves over the past decade, failed to meet them, then set new ones.” They proposed that instead of this setting and breaking of “arbitrary fiscal targets”, fiscal risks should be evaluated by a fiscal policy committee potentially based within the OBR or acting as a separate advisory agency. It would evaluate fiscal risks in accordance with principles outlined in the Orange Book,<sup>327</sup> and would also recommend future trajectories for primary surpluses, and also evaluate the benefits of borrowing.<sup>328</sup>
161. The Fraser of Allander Institute at the University of Strathclyde suggested that the National Audit Office should conduct “after-the-fact analysis” as to whether the Government’s debt rule was met “in actuality”. It argued that this would mitigate against the risks relating to the rolling nature of the debt rule, and the fact that there “is never an assessment of whether the fiscal rule at each budget or fiscal statement was in fact met” due to the assessments being forward looking.<sup>329</sup>
162. The Rt Hon Jeremy Hunt MP acknowledged that fiscal rules are “very difficult to get right in practice” but act as “guardrails that give people confidence that Chancellors are taking decisions with the long-term interests of the economy in mind.” Mr Hunt also said that the fiscal rules “were a product of the time” but that it is “really dangerous for Chancellors to change the fiscal rules at every fiscal event.” He added:

“The criticisms levelled at the fiscal rules are that some people say they are too loose and there is no path to bringing down debt sustainability, and other people say they are too tight and are not allowing enough investment for growth. Both criticisms can be managed by sensible

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323 [Q 126](#) (Carl Emmerson)

324 [Q 199](#) (Joseph Stiglitz)

325 [Q 189](#) (Stephen D King)

326 [Q 77](#) (Dr Mohamed El-Erian)

327 UK Government, *The Orange Book: Management of Risk - Principles and Concepts*: [https://assets.publishing.service.gov.uk/media/6453acadc33b460012f5e6b8/HMT\\_Orange\\_Book\\_May\\_2023.pdf](https://assets.publishing.service.gov.uk/media/6453acadc33b460012f5e6b8/HMT_Orange_Book_May_2023.pdf) [accessed 15 April 2024]

328 Written evidence from Dr Robert Calvert Jump and Prof Jo Michell ([SND0025](#))

329 Written evidence from the Fraser of Allander Institute at the University of Strathclyde ([SND0023](#))

Budget decisions within the fiscal rules we have ... the £3.5 billion we are investing in NHS productivity is an additional investment in our productive capacity, and it is very important we are able to do that within the current fiscal rules. We are also bringing down debt by the fifth year; that is really the balance.”<sup>330</sup>

163. Mr Hunt also said that when the former government’s fiscal rules were introduced in the autumn of 2022, a five-year horizon was chosen instead of the former three years “because we did not want to have a debt rule that forced an even bigger consolidation that ended up putting the economy in a spiral of decline because it affected growth so badly.” As such, Mr Hunt noted that a five-year horizon had enabled the last government to avoid a serious recession. He added that five years has facilitated “much more dynamic forecasting” from the OBR and that it “has never been able to model the impact of things like tax cuts or full expensing, which was the business tax cut in the autumn [of 2023].” Mr Hunt said that this has encouraged long-term decision-making because “one of the first questions I ask when I am thinking about what to do is, ‘What will be the GDP impact be in five years’ time?’” Ultimately, he considered that there are no perfect fiscal rules but the current ones “are sensible on balance.”<sup>331</sup>
164. In response to criticisms of “fiscal fiction” (see paragraph 146), Mr Hunt said he did not accept this. He said that the freezing of fuel duty is a decision taken at each Budget and that he hoped that any future decision with regards to fuel duty would be made “on the basis of public finances at the time and whether I can afford to do it; it is not pre-decided”.<sup>332</sup>

### The new government’s fiscal approach

165. According to the Labour Party election manifesto, the new government’s fiscal rules are as follows:
- The current budget must move into balance, so that day-to-day costs are met by revenues. There will be no borrowing for day-to-day spending.
  - Debt must be falling as a share of the economy by the fifth year of the forecast.<sup>333</sup>
166. Writing in the FT in June 2024, the Rt Hon Rachel Reeves MP elaborated (as shadow Chancellor) on the specifics of her proposals. She stated that the rules differ:
- “in an important respect from the Conservative government’s fiscal rules, which include a borrowing rule that does not distinguish between day-to-day-spending and investment. This acts as an incentive to cut the investment needed to leverage private sector capital. I reject that

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330 Oral evidence taken before the Economic Affairs Committee, Chancellor of the Exchequer - Annual Scrutiny Session, 19 March 2024 (Session 2023–24), [Q 3](#) (Rt Hon Jeremy Hunt MP)

331 *Ibid.*

332 Oral evidence taken before the Economic Affairs Committee, Chancellor of the Exchequer - Annual Scrutiny Session, 19 March 2024 (Session 2023–24), [Q 2](#) (Rt Hon Jeremy Hunt MP)

333 Labour Party, ‘Labour’s fiscal plan’: <https://labour.org.uk/change/labours-fiscal-plan/> [accessed 29 August 2024]

approach, and that is why our borrowing rule targets day-to-day spending within a framework that will see debt falling”.<sup>334</sup>

167. Writing in the FT in December 2023, Ms Reeves said: “We will guarantee in law that any government making significant, permanent tax and spending changes will be subject to an independent forecast of its impact from the OBR.”<sup>335</sup> This “fiscal lock” will be introduced via the Budget Responsibility Bill as announced in the King’s speech.<sup>336</sup> Ms Reeves has also stated that a Labour government would commit to holding a single Autumn budget every year by the end of November.<sup>337</sup>
168. As the FT commented on 19 March 2024, Ms Reeves’ pledge to borrow only to invest echoes the fiscal rules of former Labour chancellor Gordon Brown.<sup>338</sup> Of such a rule—which excludes investment spending—the IFS has said that “it is reasonable that the costs of financing investment spending are shared with future generations who, if the investments are done well, are likely to benefit from them.”<sup>339</sup> However, the IFS pointed out that as long as public investment is below 3 per cent of national income (it is forecast to average 1.9 per cent over the next four years), Labour’s current budget target would be more constraining than the Conservatives’ rule for overall borrowing to remain below 3 per cent of national income.<sup>340</sup> Moreover, Paul Johnson has highlighted that having signed up to the fiscal rule, Labour has “no room” for more spending than planned by the previous government—plans which “involve[d] cuts both to investment spending and to spending on unprotected public services.”<sup>341</sup>
169. In its 2024/25 public spending audit *Fixing the foundations*<sup>342</sup> published on 29 July 2024, the Government argued that the failure to hold regular spending reviews has been one significant underlying cause of current spending pressures. As such, the Government pledged to hold spending reviews every two calendar years, and with a minimum duration of three years of the five-year forecast period. Moreover, the Government outlined plans to change the Charter for Budget Responsibility to require the Treasury to share with the OBR its assessment of pressures against departmental expenditure limits for the current and following financial year. The OBR would be empowered

334 Rachel Reeves, ‘Wealth creation will be the defining mission of the Labour government’, *Financial Times*, (June 2024): <https://www.ft.com/content/4c50b962-a249-4ca3-9e15-5a1f8e404557> [accessed 5 September 2024]

335 Rachel Reeves, ‘From the OBR to new fiscal rules, we will bring back stability’, *Financial Times*, (21 September 2023): <https://www.ft.com/content/9c1eea5b-4fcc-4828-bd8a-f6e63cfc5b5b> [accessed 5 September 2024]

336 Prime Minister’s Office, ‘King’s Speech 2024: background briefing notes’, (July 2024): <https://www.gov.uk/government/publications/kings-speech-2024-background-briefing-notes> [accessed 29 August 2024]

337 Rachel Reeves, ‘From the OBR to new fiscal rules, we will bring back stability’, *Financial Times*, (21 September 2023): <https://www.ft.com/content/9c1eea5b-4fcc-4828-bd8a-f6e63cfc5b5b> [accessed 5 September 2024]

338 ‘Rachel Reeves pledges to borrow only to invest under Labour fiscal rules’, *Financial Times*, (19 March 2024): <https://www.ft.com/content/9191853c-6844-419d-b729-9051f88cc0c3> [accessed 5 September 2024]

339 IFS, ‘How do the parties’ policy proposals fit in with their fiscal rules?’ (June 2024): <https://ifs.org.uk/articles/how-do-parties-policy-proposals-fit-their-fiscal-rules> [accessed 3 September 2024]

340 *Ibid.*

341 IFS, ‘Labour Party manifesto: an initial response’ (June 2024): <https://ifs.org.uk/articles/labour-party-manifesto-initial-response> [accessed 3 September 2024]

342 HM Treasury, ‘Fixing the foundations: public spending audit 2024–25’ (August 2024): <https://www.gov.uk/government/publications/fixing-the-foundations-public-spending-audit-2024-25> [accessed 3 September 2024]

to interrogate this assessment and request further information required to make an assessment of whether the Government is likely to underspend or overspend against those departmental limits in aggregate.<sup>343</sup>

170. **The former government's main fiscal rule related to debt was that debt should be falling as a percentage of GDP by the fifth year of the rolling forecast period; and the new government has planned to adopt a similar rule. The previous government's experience was that the rule was widely regarded as lacking credibility. A rolling target means that this rule is easily gamed and incentivises the wrong behaviours. It allows the possibility of debt rising for four years, with success being claimed if it falls in year five—even if debt at the end of the five-year period is higher than in the first year. This is unwise: it gives a misleading impression as to the true state of the public finances and hides the need to take difficult decisions now to secure debt sustainability in the medium-to-long term.**
171. **The Government must overhaul the existing fiscal framework to make public debt more sustainable and resilient to external shocks. While a government has to contend with the economic cycle, its long-term fiscal ambition should be to reduce debt steadily as a proportion of GDP over time. A new fiscal framework should set out credible tax and spending plans covering five years. Rather than have a continually moving target to reduce debt, the framework should set out how debt as a proportion of GDP will be lower on a given date in the fifth year, unless there are exceptional reasons. To provide accountability, the target for the fifth year should remain fixed until reached. A further year's target should be added at each yearly update and this new target should not normally be higher than the year preceding it.**
172. **The OBR should publish annual progress reports which set out how the Government is meeting its fiscal targets and the reasons for any deviation from the plan.**
173. **As the definition of which government spending should be classed as 'investment' is not clear cut, borrowing for investment should not be accounted for outside the Government's measure for meeting its debt target.**
174. **This framework would show whether the UK has a sufficient fiscal buffer to withstand an economic shock. It would also enable the House of Commons to hold Ministers to account for the Government's fiscal plans. Above all, it would help ensure that the UK's debt is sustainable.**

## SUMMARY OF CONCLUSIONS AND RECOMMENDATIONS

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1. The sustainability of public debt depends on tax and spending policies which credibly align with expectations for economic growth and the cost of borrowing. Credibility is all important: it is the 'glue' between these parameters. Without credible policies, the Government runs the risk of serious financial and economic instability. (Paragraph 43)
2. Since 2008, the UK's debt has risen sharply. Such a sustained increase in debt has only happened in the past during wartime. The recent increase reflects global crises of a different kind: the global financial crisis, the COVID-19 pandemic and the energy crisis following Russia's invasion of Ukraine. Each event has led to a large, one-off increase in government spending. However, it is the trajectory, rather than the level of debt and the ability of a nation to service it, which should be the principal consideration when assessing debt sustainability. A debt level risks becoming unsustainable if there is an insufficient buffer to absorb future economic shocks; or if a government's approach to fiscal policy creates a long-term trajectory of increasing debt service costs. Although financial markets may appear content to fund a nation's debt at a given moment, this does not indicate that its debt is on a sustainable path. Underlying problems could prove to be asymptomatic, leaving a government's finances vulnerable to unforeseen shocks. (Paragraph 44)
3. Compared with other similar economies, the UK is currently not an outlier in terms of its overall stock of public debt. However, the servicing of UK debt has become more vulnerable to inflation and interest rates, along with changes in investor sentiment, any or all of which can increase its cost. This increased vulnerability results from successive rounds of quantitative easing (QE), and a greater proportion of debt being index-linked and held by overseas investors. Taken together, they point to the need for the Government to build fiscal resilience so that it can respond, if necessary, to future domestic or external crises. (Paragraph 72)
4. While we understand the reasons for its adoption as an instrument of monetary policy, multiple bouts of QE were implemented without sufficient consideration of its impact on the maturity of the UK's overall debt stock. By drastically shortening effective maturities, QE has served to increase the sensitivity of government borrowing costs to short-term movements in interest rates. Although the unwinding of QE will gradually mitigate this vulnerability to a degree, it is likely that it will crystallise significant losses which the taxpayer will ultimately bear. Decisions around the quantum of QE and the strategy around quantitative tightening seem to have been taken without consideration of potential fiscal risks. As a result, these decisions have blurred the boundary between monetary and fiscal policy. (Paragraph 73)
5. At a time when many other nations are issuing high levels of debt, the extent of the UK's reliance on debt purchases by overseas investors could heighten the UK's vulnerability to financial shocks. This is of particular concern given the current heightened level of geopolitical risk. The risks to the UK would increase further if it became an outlier relative to other developed countries in terms of its debt. (Paragraph 74)
6. From the end of World War II to the 1990s, the level of debt fell rapidly as a proportion of national income, as governments were aided by 'tailwinds', or a

variety of helpful factors. These included a growing working age population, the growth of national income outpacing the rate of interest on government debt, a decline in defence spending and strong investment demand for government debt from defined-benefit pension schemes. These 'tailwinds' are now becoming 'headwinds'. (Paragraph 130)

7. While the UK's demographic projections are far from certain, the UK's population will age and its dependency ratio will rise. Both will increase demands on the UK's public finances in terms of the funding of public services, including health and social care, and the funding of state pensions. (Paragraph 131)
8. While high net migration has previously boosted GDP growth, it has made little impression on GDP per head: high net migration cannot be the solution to debt sustainability. (Paragraph 132)
9. An ageing population and shrinking proportion of those in work might see savings fall and wage inflation rise. There is a view that this could put upward pressure on interest rates, leading to an increased cost of servicing debt and further pressure on public services. (Paragraph 133)
10. The cost of the transition to net zero will increase pressure on public finances. It highlights the need for the Government to produce and publish a fully-funded, coherent plan for meeting net zero targets. (Paragraph 134)
11. The Government is committed to raise defence spending to 2.5 per cent of GDP as soon as it can. This will increase fiscal pressure still further, especially as we received evidence that previous governments have sought cost savings from the defence budget to finance expenditure elsewhere: this option will be no longer available. (Paragraph 135)
12. We await to see the details of the new government's plans to improve productivity, especially in the public sector. However, we are not convinced that productivity alone will contain the projected rise in government expenditure. Nor are we persuaded that governments can rely on significantly higher economic growth rates to avoid the pressures on public finances. These pressures will increase further if interest rates exceed the growth rate of national income, as this would mean that the Government would have to generate a primary surplus to keep the debt ratio from rising. As a result of these factors, the Government will face painful choices on spending, tax and borrowing. (Paragraph 136)
13. Without an appropriate fiscal policy, there is a risk of debt becoming unsustainable. This is thanks to a combination of factors: the vulnerabilities and pressures outlined in Chapter 3; the prospect of low productivity and growth, with interest rates remaining at a level not seen for a decade; an ageing population and a shrinking workforce. Moreover, although public spending is still at a higher level than before the COVID-19 pandemic, there are already numerous demands for the Government to spend more on public services. (Paragraph 137)
14. To ensure debt is on a sustainable path, we face a choice. If we wish to improve the level and quality of services, and continue the current provision of benefits, taxes will need to rise. The alternative is that the state does less. Addressing this will demand clarity as to the responsibilities and role of the individual versus that of the state. (Paragraph 138)

15. If this choice is ducked during this Parliament, the UK risks being on a path to unsustainable debt. Muddling through is not an option. (Paragraph 139)
16. The former government's main fiscal rule related to debt was that debt should be falling as a percentage of GDP by the fifth year of the rolling forecast period; and the new government has planned to adopt a similar rule. The previous government's experience was that the rule was widely regarded as lacking credibility. A rolling target means that this rule is easily gamed and incentivises the wrong behaviours. It allows the possibility of debt rising for four years, with success being claimed if it falls in year five—even if debt at the end of the five-year period is higher than in the first year. This is unwise: it gives a misleading impression as to the true state of the public finances and hides the need to take difficult decisions now to secure debt sustainability in the medium-to-long term. (Paragraph 170)
17. The Government must overhaul the existing fiscal framework to make public debt more sustainable and resilient to external shocks. While a government has to contend with the economic cycle, its long-term fiscal ambition should be to reduce debt steadily as a proportion of GDP over time. A new fiscal framework should set out credible tax and spending plans covering five years. Rather than have a continually moving target to reduce debt, the framework should set out how debt as a proportion of GDP will be lower on a given date in the fifth year, unless there are exceptional reasons. To provide accountability, the target for the fifth year should remain fixed until reached. A further year's target should be added at each yearly update and this new target should not normally be higher than the year preceding it. (Paragraph 171)
18. The OBR should publish annual progress reports which set out how the Government is meeting its fiscal targets and the reasons for any deviation from the plan. (Paragraph 172)
19. As the definition of which government spending should be classed as 'investment' is not clear cut, borrowing for investment should not be accounted for outside the Government's measure for meeting its debt target. (Paragraph 173)
20. This framework would show whether the UK has a sufficient fiscal buffer to withstand an economic shock. It would also enable the House of Commons to hold Ministers to account for the Government's fiscal plans. Above all, it would help ensure that the UK's debt is sustainable. (Paragraph 174)

## APPENDIX 1: LIST OF MEMBERS AND DECLARATIONS OF INTEREST

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### Members

Lord Burns  
 Lord Blackwell  
 Lord Bridges of Headley (Chair)  
 Lord Davies of Brixton  
 Lord Griffiths of Fforestfach  
 Lord Lamont of Lerwick  
 Lord Layard  
 Baroness Liddell of Coatdyke  
 Lord Londesborough  
 Lord Razzall  
 Lord Rooker  
 Lord Turnbull  
 Lord Verjee  
 Baroness Wolf of Dulwich

### Declarations of interest

Lord Burns  
*Adviser to the Bank of Santander*

Lord Blackwell  
*Trustee of the Royal Academy of music and Yehudi Menuhin School, both of which hold government bonds in their investments*  
*Personal investment in OEICs, investment*

Lord Bridges of Headley (Chair)  
*Senior Adviser, Banco Santander S.A. Madrid, Spain*

Lord Davies of Brixton  
*No relevant interests to declare*

Lord Griffiths of Fforestfach  
*No relevant interests to declare*

Lord Lamont of Lerwick  
*Director European Opportunities Investment Trust PLC*  
*Advisor to OMFIF (Official Monetary and Financial Institutions Forum)*

Lord Layard  
*No relevant interests to declare*

Baroness Liddell of Coatdyke  
*No relevant interests to declare*

Lord Londesborough  
*No relevant interests to declare*

Lord Razzall  
*No relevant interests to declare*

Lord Rooker  
*No relevant interests to declare*

Lord Turnbull  
*No relevant interests to declare*

Lord Verjee  
*No relevant interests to declare*

Baroness Wolf of Dulwich  
*No relevant interests to declare*

A full list of Members' interests can be found in the Register of Lords' interests:  
<https://members.parliament.uk/members/lords/interests/register-of-lords-interests>

**Specialist Adviser**

Dr Isabel Stockton

*No relevant interests to declare*

## APPENDIX 2: LIST OF WITNESSES

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Evidence is published online at <https://committees.parliament.uk/work/8090/how-sustainable-is-our-national-debt/publications/> and available for inspection at the Parliamentary Archives (020 7219 3074). Evidence received by the Committee is listed below in chronological order of oral evidence session and in alphabetical order. Those witnesses marked with \*\* gave both oral and written evidence. Those marked with \* gave oral evidence and did not submit any written evidence. All other witnesses submitted written evidence only.

### Oral evidence in chronological order

*	Professor Jagjit Chadha, Director at the National Institute of Economic and Social Research	<a href="#">QQ 1–24</a>
*	Martin Slater, Emeritus Fellow in Economics at St Edmund Hall, University of Oxford	<a href="#">QQ 1–24</a>
*	Richard Hughes, Chair of the Office for Budget Responsibility	<a href="#">QQ 25–65</a>
*	Tom Josephs, Member of the Budget Responsibility Committee at the Office for Budget Responsibility	<a href="#">QQ 25–65</a>
*	Dr Mohamed A. El-Erian, Chief Economic Adviser at Allianz	<a href="#">QQ 66–91</a>
*	Julian Jessop, Economics Fellow at the Institute of Economic Affairs	<a href="#">QQ 92–123</a>
*	James Smith, Research Director at the Resolution Foundation	<a href="#">QQ 92–123</a>
*	Danisha Kazi, Head of Economics at Positive Money UK	<a href="#">QQ 92–123</a>
*	Carl Emmerson, Deputy Director at the Institute for Fiscal Studies	<a href="#">QQ 124–147</a>
*	Peder Beck-Friis, Senior Vice President and Economist at PIMCO	<a href="#">QQ 124–147</a>
*	Sonja Gibbs, Head of Sustainable Finance at the Institute of International Finance	<a href="#">QQ 124–147</a>
**	Charles Goodhart, Emeritus Professor of Banking and Finance at the London School of Economics	<a href="#">QQ 148–177</a>
*	Sir Dieter Helm, Professor of Economic Policy at the Oxford University	<a href="#">QQ 148–177</a>
**	Olivier Blanchard, Senior Fellow at the Peterson Institute for International Economics	<a href="#">QQ 148–177</a>
*	Erich Arispe, Senior Director, Sovereigns Group at Fitch Ratings	<a href="#">QQ 178–195</a>
*	Stephen D King, Senior Economic Adviser at HSBC	<a href="#">QQ 178–195</a>
*	Joseph Stiglitz, University Professor at Columbia University	<a href="#">QQ 196–211</a>

- \* Bim Afolami, Former Economic Secretary at HM Treasury [QQ 212–236](#)
- \* Ruth Curtice, Director for the Fiscal Group at HM Treasury [QQ 212–236](#)
- \* Sir Robert Stheeman, Former Chief Executive Officer at the Debt Management Office [QQ 237–249](#)

### Alphabetic list of all witnesses

- \* Bim Afolami, Former Economic Secretary at HM Treasury ([QQ 212–236](#))
- \* Erich Arispe, Senior Director, Sovereigns Group at Fitch Ratings ([QQ 178–195](#))
- \* Peder Beck-Friis, Senior Vice President and Economist at PIMCO ([QQ 124–147](#))
- \*\* Olivier Blanchard, Senior Fellow at the Peterson Institute for International Economics ([QQ 148–177](#)) [SND0041](#)
- Mr Boxall [SND0018](#)
- The Business Services Association [SND0024](#)
- Mr Jon Camden (retired teacher) [SND0005](#)
- \* Professor Jagjit Chadha, Director at the National Institute of Economic and Social Research ([QQ 1–24](#))
- Common Weal [SND0026](#)
- Mr Christopher Counsell, former Managing Director at The Tintometer Ltd [SND0002](#)
- \* Ruth Curtice, Director for the Fiscal Group at HM Treasury ([QQ 212–236](#))
- Dirk Helmer Ehnts, Adjunct lecturer at Torrens University, Adelaide, Australia and Steinbeis University, Berlin, Germany [SND0038](#)
- \* Dr Mohamed A. El-Erian, Chief Economic Adviser at Allianz ([QQ 66–91](#))
- \* Carl Emmerson, Deputy Director at the Institute for Fiscal Studies ([QQ 124–147](#))
- Nick Foster, Lecturer in Actuarial Science at University of Leicester [SND0009](#)
- Fraser of Allander Institute at the University of Strathclyde [SND0023](#)
- \* Sonja Gibbs, Head of Sustainable Finance at the Institute of International Finance ([QQ 124–147](#))
- \*\* Charles Goodhart, Emeritus Professor of Banking and Finance at the London School of Economics ([QQ 148–177](#)) [SND0042](#)
- The Gower Initiative for Modern Money Studies [SND0019](#)

	Green Alliance	<a href="#">SND0017</a>
*	Sir Dieter Helm, Professor of Economic Policy at the Oxford University ( <a href="#">QQ 148–177</a> )	
	Mr Bill Hughes (Retired Careers Adviser)	<a href="#">SND0027</a>
*	Richard Hughes, Chair of the Office for Budget Responsibility ( <a href="#">QQ 25–65</a> )	
	Dr Graham Hunter	<a href="#">SND0014</a>
	Institute for Government	<a href="#">SND0033</a>
*	Julian Jessop, Economics Fellow at the Institute of Economic Affairs ( <a href="#">QQ 92–123</a> )	
*	Tom Josephs, Member of the Budget Responsibility Committee at the Office for Budget Responsibility ( <a href="#">QQ 25–65</a> )	
*	Danisha Kazi, Head of Economics at Positive Money UK ( <a href="#">QQ 92–123</a> )	
	Bill Kerr-Smith	<a href="#">SND0007</a>
*	Stephen D King, Senior Economic Adviser at HSBC ( <a href="#">QQ 178–195</a> )	
	Stephen Laughton	<a href="#">SND0040</a>
	Warwick Lightfoot	<a href="#">SND0021</a>
	Dr Gerard Lyons	<a href="#">SND0034</a>
	Peter May	<a href="#">SND0013</a>
	Professor Mariana Mazzucato, Professor in the Economics of Innovation and Public Purpose at UCL, and Dr Josh Ryan-Collins, Associate Professor of Economics and Finance at UCL	<a href="#">SND0043</a>
	Andrew McLauchlin	<a href="#">SND0020</a>
	Professor Jo Michell, Professor of Economics at UWE Bristol, and Dr Robert Calvert Jump, Senior Lecturer in Quantitative Methods at University of Greenwich	<a href="#">SND0025</a>
	Professor David Miles, Member of the Budget Responsibility Committee at the OBR	<a href="#">SND0012</a>
	Professor Denis Mollison, Emeritus Professor of Applied Probability at Heriot-Watt University	<a href="#">SND0039</a>
	Peter James Rhys Morgan, Macroeconomist at Morganist Economics	<a href="#">SND0001</a>
	David C Murray, Gardener at The Whole Shebag Ltd	<a href="#">SND0031</a>
	New Economics Foundation	<a href="#">SND0015</a>
	George Savvides	<a href="#">SND0032</a>
*	Martin Slater, Emeritus Fellow in Economics at St Edmund Hall, University of Oxford ( <a href="#">QQ 1–24</a> )	

- \* James Smith, Research Director at the Resolution Foundation ([QQ 92–123](#))

Julian Smith, retired Secondary Principal Teacher at West Lothian Council [SND0037](#)
- \* Sir Robert Stheeman, Former Chief Executive Officer at the Debt Management Office ([QQ 237–249](#))
- \* Joseph Stiglitz, University Professor at Columbia University ([QQ 196–211](#))

Mark E Thomas and Vincent Gomez of the 99% Organisation [SND0029](#)

Trades Union Congress [SND0036](#)

Robin Trow [SND0011](#)

Dr Dawid Trzeciakiewicz, Lecturer in Economics at Loughborough University, Professor Gulcin Ozkan, Professor of Finance at King's College London, and Dr Richard McManus, Director of Research Development at Christ Church Business School [SND0010](#)

R Wain [SND0004](#)

### APPENDIX 3: CALL FOR EVIDENCE

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UK public sector net debt, often referred to as ‘national debt’, currently stands at just under 100 per cent of GDP.<sup>344</sup> The UK’s growth outlook remains weak; quantitative easing has significantly increased the sensitivity of the UK’s debt to changes in short-term interest rates; and it is unclear whether the Government’s fiscal rule, as it relates to the national debt, is fit for purpose.

In July 2023, the Office for Budget Responsibility’s (OBR) Fiscal Risks and Sustainability report stated that “the 2020s are turning out to be a very risky era for the public finances”. It observed that “governments face growing costs from an ageing society, a warming planet, and rising geopolitical tensions—challenges that no longer loom in the distance in our 50-year projections but pose significant fiscal risks in this decade”.<sup>345</sup>

The Economic Affairs Committee is launching an inquiry to investigate whether the UK’s national debt is on a sustainable path; if not, what steps are required; and whether the Government’s fiscal rule regarding the national debt is meaningful.

The Committee seeks evidence on the following questions. Respondents are not obliged to address all of them.

- What is meant by a “sustainable” national debt? Does the metric of debt as a percentage of GDP adequately capture sustainability?
- The Government’s target is for public sector net debt (excluding the Bank of England) to be falling, as a percentage of GDP, by the fifth year of the OBR’s forecast. How meaningful is this target; and how does it inform an evaluation of the sustainability of our national debt?
- How robust are the assumptions used by the Office for Budget Responsibility when forecasting our national debt?
- What implications does the structure of the UK’s national debt have for its short and longer-term funding?
- What are the market risks created by high levels of public debt; and what factors will influence the market’s appetite for this debt?
- What levels of productivity and growth are required to ensure our national debt is sustainable?
- If we are to ensure our national debt is sustainable, what might this mean for fiscal policy?
- Should the definition of the national debt differentiate between debt incurred for investments (which generate revenue for the Government), and other areas of spending?

This is a public call for written evidence to be submitted to the Committee. The deadline for submissions is 9 February 2024.

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344 Office for National Statistics, ‘PS: Net Debt (excluding public sector banks) as a % of GDP: NSA’ (November 2023): <https://www.ons.gov.uk/economy/governmentpublicsectorandtaxes/publicsectorfinance/timeseries/hf6x/pusf> [accessed 3 September 2024]

345 Office for Budget Responsibility, ‘Fiscal risks and sustainability’ (July 2023): <https://obr.uk/frs/fiscal-risks-and-sustainability-july-2023/> [accessed 3 September 2024]

## APPENDIX 4: JAPAN—A BRIEF CASE STUDY IN DEBT

1. As of the fourth quarter of 2023, Japan's debt-to-GDP ratio stood at 252.4 per cent—by far the highest ratio in the G7.<sup>346</sup> This reflects the accretion of large fiscal deficits resulting from attempts by successive governments to 'pump prime' growth during a prolonged era of economic stagnation following the collapse of the country's asset price bubble in 1990.<sup>347</sup> From 1990 to the global financial crisis of 2008/2009, successive governments introduced a total of fifteen fiscal stimulus packages which were concentrated in public works projects (in the 2000 financial year, such spending reached 14.2 per cent of GDP);<sup>348</sup> but since 1990, annual GDP growth has nonetheless averaged just under one per cent.<sup>349</sup>
2. Inextricably linked to this debt profile is the country's grey and shrinking population. Japan's population is the oldest in the world and ageing quickly—by 2036, people aged 65 and over are forecast to represent a third of the population.<sup>350</sup> Unsurprisingly, this is expected to bring with it a growing burden from social welfare expenses, which are forecast to reach 25 per cent of GDP by 2040.<sup>351</sup> Moreover, some startling estimates suggest that by 2065, Japan's population could have fallen to 88 million from 126 million at present.<sup>352</sup> In view of these challenges—many economists have long predicted a debt crisis in Japan.<sup>353</sup>
3. Japanese governments have nonetheless been able to attract the requisite levels of funding over an extended period of time thanks to a number of factors. These include, *inter alia*, a comparatively healthy overall balance sheet and a prolonged era of low interest rates. Japan has substantial assets which include, for example, a social security fund valued at around 55 per cent of GDP. As such, as of Q3 2022, assets totalling 134 per cent of GDP help to yield a somewhat smaller net debt figure of 119 per cent.<sup>354</sup> Moreover, unlike the UK, Japan is also a large net lender internationally and has a

346 Office for National Statistics, 'UK government debt and deficit: December 2023', (April 2024), Figure 3: <https://www.ons.gov.uk/economy/governmentpublicsectorandtaxes/publicspending/bulletins/uk-governmentdebtanddeficitforeurostatmaast/december2023> [accessed 3 September 2024]

347 See Bank for International Settlements, *The asset price bubble in Japan in the 1980s: lessons for financial and macroeconomic stability*: <https://www.bis.org/publ/bppdf/bispap21e.pdf> [accessed 3 September 2024]. NB this prolonged period is often referred to as Japan's "lost decades" - see for example 'The unseen casualties of Japan's lost decades suffer in silence', *Financial Times*, (9 March 2015): <https://www.ft.com/content/042a592e-c283-11e4-ad89-00144feab7de> [accessed 5 September 2024]

348 IMF eLibrary, 'Public Investment as a Fiscal Stimulus: Evidence from Japan's Regional Spending During the 1990s' (April 2010): <https://www.elibrary.imf.org/view/journals/001/2010/110/article-A001-en.xml> [accessed 3 September 2024]

349 1990 to 2022 – see The World Bank, 'GDP growth (annual %) – Japan': <https://data.worldbank.org/indicator/NY.GDP.MKTP.KD.ZG?end=2022&locations=JP&start=1990&view=chart> [accessed 3 September 2024]. Annual percentage growth rate of GDP at market prices based on constant local currency. Aggregates are based on constant 2015 prices, expressed in U.S. dollars.

350 See European Parliament, *Japan's ageing society* (December 2020): [https://www.europarl.europa.eu/RegData/etudes/BRIE/2020/659419/EPRS\\_BRI\(2020\)659419\\_EN.pdf](https://www.europarl.europa.eu/RegData/etudes/BRIE/2020/659419/EPRS_BRI(2020)659419_EN.pdf) [accessed 3 September 2024].

351 See Nikkei Asia, 'Japan's growing debt mountain: Crisis, what crisis?' (August 2023): <https://asia.nikkei.com/Spotlight/Asia-Insight/Japan-s-growing-debt-mountain-Crisis-what-crisis> [accessed 3 September 2024].

352 European Parliament, *Japan's ageing society* (December 2020): [https://www.europarl.europa.eu/RegData/etudes/BRIE/2020/659419/EPRS\\_BRI\(2020\)659419\\_EN.pdf](https://www.europarl.europa.eu/RegData/etudes/BRIE/2020/659419/EPRS_BRI(2020)659419_EN.pdf) [accessed 3 September 2024]

353 Federal Reserve Bank of St Louis, 'What Lessons Can Be Drawn from Japan's High Debt-to-GDP Ratio?', (November 2023): <https://www.stlouisfed.org/on-the-economy/2023/nov/what-lessons-drawn-japans-high-debt-gdp-ratio> [accessed 3 September 2024]

354 *Ibid.*

structural current account surplus.<sup>355</sup> Japanese government bonds also have a relatively long average maturity and are mostly held domestically (85.5 per cent as of December 2023) which facilitates debt roll-over.<sup>356</sup>

4. The country's low interest rates have also meant that roll-over funding costs have for some time been close to zero. In fact, on 19 March 2024, the Bank of Japan ended an eight-year period of negative interest rates with the first increase in its benchmark rate for 17 years.<sup>357</sup> The willingness of Japanese households to lend to government via banks at comparatively low rates is in part based on the need for higher precautionary savings due to (comparatively) low outlays for social security and an undeveloped private pension system.<sup>358</sup> However, despite these favourable circumstances, in 2022, Japan spent 22 per cent of its annual budget on debt redemption and interest payments—more than the 15 per cent spent on public works, education and defence combined.<sup>359</sup> With the potential for further increases in inflation and interest rates leaving debt stability contingent on sustained growth (per 'r-g'), Japan's ability to continue to finance its debt in an orderly fashion may become more challenging.<sup>360</sup> Christian de Guzman, senior vice president at Moody's Investors Service, has said that Japan is facing a "very risky time" managing debt, adding: "We are looking to see how [the Bank of Japan] manages [growing pressures]. It is an unprecedented situation."<sup>361</sup>

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355 Bank of Japan, *Japan's Balance of Payments Statistics and International Investment Position for 2022* (July 2023): [https://www.boj.or.jp/en/statistics/br/bop\\_06/exdata/data/bop2022a.pdf](https://www.boj.or.jp/en/statistics/br/bop_06/exdata/data/bop2022a.pdf) [accessed 3 September 2024]

356 See Asia Nikkei, 'Foreigners hold more JGBs than Japan banks for first time' (November 2023): <https://asia.nikkei.com/Business/Markets/Bonds/Foreigners-hold-more-JGBs-than-Japan-banks-for-first-time> [accessed 3 September 2024].

357 Bank of Japan, *Minutes of the Monetary Policy Meeting: March 18/19 2024* (May 2024): [https://www.boj.or.jp/en/mopo/mpmsche\\_minu/minu\\_2024/g240319.pdf](https://www.boj.or.jp/en/mopo/mpmsche_minu/minu_2024/g240319.pdf) [accessed 3 September 2024]

358 See for example, 'Letter: Why Japanese savings have been so high, for so long', *Financial Times*, (17 April 2023), <https://www.ft.com/content/3b8b02b5-1a2e-4bea-8f44-8b67f7dd23a4> [accessed 5 September 2024].

359 Reuters, 'Japan's debt time bomb to complicate BOJ exit path' (February 2023): <https://www.reuters.com/markets/japans-debt-time-bomb-complicate-boj-exit-path-2023-02-10/> [accessed 3 September 2024]

360 See Nikkei Asia, 'Japan's growing debt mountain: Crisis, what crisis?' (August 2023): <https://asia.nikkei.com/Spotlight/Asia-Insight/Japan-s-growing-debt-mountain-Crisis-what-crisis> [accessed 3 September 2024].

361 Reuters, 'Japan's debt time bomb to complicate BOJ exit path' (February 2023): <https://www.reuters.com/markets/asia/japans-debt-time-bomb-complicate-boj-exit-path-2023-02-10/> [accessed 3 September 2024]