HM Treasury, 1 Horse Guards Road, London, SW1A 2HQ

Lord Bridges of Headley
Chairman, Economic Affairs Committee
House of Lords
London
SW1A OPW

15 November 2024

Dear Lord Bridges,

I am writing to respond to the Committee's inquiry into the sustainability of the UK's national debt. I would like to thank the Committee for the work that has gone into this report.

The report highlights the challenges facing this and future governments in maintaining sustainable public finances, in common with many countries around the world. The government agrees with the Committee's conclusion that tough choices are required this Parliament to prevent the UK's national debt from being on an unsustainable path. That is why the government acted at the Autumn Budget on 30 October to fix the foundations, by addressing the £22 billion of in-year pressures identified against departmental budgets for 2024-25, setting realistic plans for public spending, boosting investment, and raising additional revenue to set the public finances on a sustainable path. These are essential foundations for long-run economic growth and stability.

The Committee's conclusions also underline the importance of growth and stability. To support economic stability and underpin the government's commitment to fiscal responsibility, at the Budget I announced a set of responsible reforms to the fiscal framework that improve certainty, transparency and accountability. This included the government's new fiscal rules, which the independent Office for Budget Responsibility (OBR) confirms the government is on track to meet.

The stability rule, which is the government's fiscal mandate, requires that the current budget must be in surplus in 2029-30, until 2029-30 becomes the third year of the forecast period. From that point, the current budget must then remain in balance or in surplus from the third year of the rolling forecast period. Balancing the current budget means that the government's day-to-day spending is met by revenues and so ensures that, over the medium term, borrowing is only for investment. This means future generations will not be burdened with the costs of public services today. The transition to targeting the third year of the forecast will provide a strong anchor for fiscal sustainability, while providing the necessary flexibility to respond to macroeconomic shocks.

The government's fiscal mandate is supplemented by a target to ensure debt, defined as public sector net financial liabilities (PSNFL, or net financial debt for short), is falling as a share of the economy by 2029-30, until 2029-30 becomes the third year of the forecast period. Debt should then fall by the third year of the rolling forecast period. Targeting net financial debt allows the government to deliver the step change needed in investment spending, while maintaining a strong fiscal anchor.

The rules are accompanied by a set of robust guardrails that will ensure investments are consistent with fiscal sustainability and decisions represent value for money. This includes a new Financial Transaction Control Framework.[1]

Wider improvements to the fiscal framework are set out in a new Charter for Budget Responsibility[2] and 'A strong fiscal framework'[3], including:

- Improvements to fiscal management by monitoring a wide range of metrics.
- A commitment to hold one major fiscal event per year to give families and businesses stability and certainty on upcoming tax and spending changes.
- Committing to hold a Spending Review every two years, setting departmental budgets for a minimum of three years. According to the IMF, this will "improve the credibility of the medium-term fiscal framework".[4]
- Confirming the details of the fiscal lock, as already legislated for, to ensure that no government can announce fiscally significant measures without being subject to an independent assessment by the OBR.[5]
- Accepting all 10 recommendations in the OBR's review of the March 2024 forecast for Departmental Expenditure Limits, including improving the transparency and consistency of the spending information the Treasury shares with the OBR.
- Requiring the OBR to report on the long-term economic impacts of capital investment and government policies in its forecast.
- Committing to publish an annual report on the government's contingent liabilities (such as guarantees, insurance contracts, and provisions).

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[1] Financial Transactions Control Framework, HM Treasury, October 2024.
[2] Draft Charter for Budget Responsibility: Autumn 2024, HM Treasury, October 2024.
[3] A strong fiscal framework: Explaining the government's new fiscal rules and framework, HM Treasury, October 2024.
[4] United Kingdom: 2024 Article IV Consultation, International Monetary Fund, July 2024.
[5] Budget Responsibility Act 2024, UK General Public Acts, September 2024.

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- An escape clause that provides a strengthened role for the OBR when the government assesses there is a need to temporarily suspend the fiscal rules due to economic shocks.

These reforms implement many of the recommendations of the Committee's report, including to overhaul the previous fiscal framework to make public debt more sustainable. The new fiscal framework will support the long-term growth needed to rebuild Britain by ensuring that the UK's debt is on a sustainable path, providing certainty to families and business, and prioritising sustainable public investment. The IMF welcomed these "Important reforms to strengthen the fiscal framework", including "shortening the horizon of fiscal rules, conducting regular spending reviews, moving to one fiscal event a year, and enhancing the role of the OBR".

The annex to this letter responds to the remaining recommendations detailed in the report, outlining the actions this government is taking to ensure the public finances remain on a sustainable path.

Best wishes,

RT HON RACHEL REEVES MP
Chancellor of the Exchequer

Credibility (Conclusion 1)

The government agrees with the Committee that sustainable public finances must be based on credible policies. In July, the audit of public spending set out £22 billion of in-year pressures against departmental budgets for 2024-25.[6] The government has published the full breakdown of the £22 billion pressure in the 'Government Response to the OBR Review of DEL Forecasting'.[7] The effect of these pressures is apparent in published public sector finances data, where current spending for the first half of the year is £11.8 billion higher than predicted in the OBR's March 2024 forecast profile.[8]

That is why the government acted at the Budget to fix the foundations, by setting realistic plans for public spending, boosting investment, and raising additional revenue to set the public finances on a sustainable path. Supporting economic and fiscal stability are essential foundations for long-run economic growth.

The Budget confirmed a set of reforms to the fiscal framework to support stability by creating a predictable fiscal policy-making environment and increasing transparency. They include:

- A commitment to hold one major fiscal event per year, which will give families and businesses stability and certainty on upcoming tax and spending changes.
- Confirming the details of the fiscal lock, as already legislated for in the Budget Responsibility Act, ensuring any major future fiscal announcements will be subject to an independent assessment by the OBR.
- Confirming that Spending Reviews will take place every two years setting departmental budget for a minimum of three years. According to the IMF, this will "improve the credibility of the medium-term fiscal framework".
- Accepting all 10 recommendations in the OBR's review of the March 2024 forecast for Departmental Expenditure Limits, including improving the transparency and consistency of the spending information the Treasury shares with the OBR.

The government is strengthening the UK's independent institutions, including through its reforms to the fiscal framework and by maintaining the Monetary Policy Committee's target of two per cent inflation (as measured by the 12-month increase in the CPI).

This approach strengthens certainty, transparency and accountability, supporting economic and fiscal stability.

Economic shocks (Conclusion 2)

The Lords Economic Affairs Committee (LEAC) Report sets out that economic shocks have been a significant driver of rising debt in recent years and the government agrees with the Committee on the importance of building resilience to future shocks. The UK

[6] Fixing the Foundations: public spending audit 2024-25, HM Treasury, August 2024.
[7] Government Response to the OBR Review of DEL Forecasting, HM Treasury, October 2024.
[8] Public Sector Finances, Office for National Statistics, October 2024.

economy has faced unprecedented shocks, including the pandemic and Russia's illegal invasion of Ukraine, which contributed to the largest increase in inflation in almost 50 years. The policy response shaped the economic effect of these shocks. External shocks have been exacerbated by UK-specific factors, resulting in elevated levels of domestic policy uncertainty that have far outstripped global trends. This is why the government took action at the Budget to restore stability, to protect working people and create the necessary conditions for investment and growth.

Public investment is a crucial driver of the long-term economic growth required to build economic resilience. Under the government's new spending plans, public sector net investment will average 2.6% of GDP over the next five years, and includes over £100 billion additional capital investment. The OBR judges that if sustained beyond the forecast horizon, the combination of higher capital investment and crowding in increases potential output by 1.4% in the long run.

The new fiscal framework and the government's commitment to get net financial debt falling provides flexibility to respond to future shocks. The transition to targeting the third year of the forecast under the fiscal rules, rather than the fifth year, will provide a strong anchor for fiscal sustainability, while providing the necessary flexibility to respond to macroeconomic shocks.

Sensitivity of debt to inflation and interest rates (Conclusion 3)

The LEAC Report notes the UK's relatively high share of index-linked gilts. The government makes decisions about how to borrow the money it needs in line with its debt management objective. This long-term objective is to minimise, over the long term, the costs of meeting the government's financing needs, taking into account risk, while ensuring that debt management policy is consistent with the aims of monetary policy.

As government borrowing is a long-term exercise, the cost-effectiveness of the borrowing programme should be assessed by looking over a long-term horizon. As the LEAC Report notes, analysis by the Debt Management Office (DMO) shows that, for gilts that matured since their introduction in 1981 but prior to August 2023, the government generated direct savings of £158 billion in 2023 terms. Issuing index-linked gilts also underlines the government's stated commitment to low and stable inflation, reducing investors' perception of inflation risk and hence the yields they seek on nominal gilts.

Nonetheless, it is right that the government keeps the proportion of index-linked gilts under review in order to balance the benefits and risks. The government takes decisions on the overall structure of the financing programme annually and will continue to consider refinancing risk alongside other cost and risk factors when taking those decisions.

Maturity of the UK's debt stock (Conclusion 4)

The LEAC Report highlights that quantitative easing (QE) has increased the sensitivity of government borrowing costs to short-term movements in interest rates. While this is true, as the report also notes, the average maturity of the total stock of gilts is significantly higher than other G7 countries. This remains true even after adjusting the UK figure for the impacts of QE and without applying any QE adjustment to other countries which will also face significant QE effects.[9]

The government has historically issued a high proportion of long-dated gilts. This has lowered annual refinancing needs, and reduced exposure to interest rates, all else equal. Changes to interest rates therefore impact refinancing costs and debt servicing costs more slowly in the UK than in any other G7 country.

As noted by the OBR in its March 2024 Economic and Fiscal Outlook, this effect on maturity is now unwinding as QE unwinds which will increase the UK's effective debt maturity, all else equal. The unwinding of 15% of the Bank's peak gilt holdings has extended the median maturity of the UK's consolidated public liabilities from 1 year in 2021 to 3 years by the end of 2023. By 2028, when the OBR assumes that 71% of gilts will have been returned to the market, the effective maturity will have reached 7 years. This is the same as its pre-QE level, reflecting the relatively long effective maturity of gilts, Treasury bills, and National Savings and Investment products whose combined maturity has remained relatively stable between 7 and 9 years since 2010.

As the OBR notes, this steady re-extension of maturities will help to re-insulate the public finances from future changes in borrowing costs.

Sensitivity of debt to investor sentiment (Conclusion 5)

The LEAC Report notes the UK's reliance on debt purchases by overseas investors. Overseas investors play an important role in maintaining the diversity of the gilt investor base, ensuring that underlying demand for UK debt remains strong and borrowing costs can be minimised. A diverse investor base ensures that the government is not overly reliant on any one type of investor.

Overseas investors include a range of different types of investors, who each have different incentives to buy and trade gilts. It is not the case that appetite for gilts from all overseas investors will be perfectly correlated or that they are all inherently riskier than domestic investors.

The reforms to the fiscal framework announced at the Budget will support investor sentiment by improving certainty, transparency and accountability. For example, the government's commitment to hold one major fiscal event per year will give stability and certainty on upcoming tax and spending changes.

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[9] Calculated on a nominal weighted basis, excluding inflation uplift, including Treasury Bills. To adjust the UK's weighted average maturity of government debt outstanding for the impact of the asset purchase facility (APF), gilts held in the APF are treated as having a maturity of zero. By financing the purchase of fixed rated government bonds using floating overnight rate central bank liabilities, quantitative easing shortens the effective maturity of government debt outstanding. This effect is present across all countries where central banks have engaged in quantitative easing, including all G7 countries, but is only shown in the chart for the UK.

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Demographics (Conclusions 6-7), migration (Conclusion 8) and productivity (Conclusion 12)

The LEAC Report highlights the pressures that demographics will place on the public finances. The OBR regularly assesses the long-term outlook for the public finances, including the impact of demographic changes, in its Fiscal Risks and Sustainability (FRS) report. In the latest report, published in September 2024, the OBR updated its demographic projection assumptions using the latest population projections from the Office for National Statistics (ONS), which were released in January 2024. In this updated projection, the UK's population rises from 68 million in 2022 to 82 million in 2074. This is 16 million higher than at the end of the FRS 2022 projection in 2072, which had the population slightly falling to 66 million. The old-age dependency ratio is lower in every year than in FRS 2022 which, all else equal, reduces spending on health, social care, and pensions as a share of GDP.

The government's focus on economic growth is an essential component of ensuring the public finances remain sustainable in the long term. The OBR estimates that every 0.1% increase in productivity growth reduces the rise in the debt-to-GDP ratio by 25 percentage points over the next 50 years, if it does not result in higher public spending. A full one percentage point increase in annual productivity growth to 2.5%, equivalent to a return to pre-financial crisis rates of productivity growth, could keep debt below 100% of GDP throughout the next 50 years.

This underlines the importance of tackling the UK's weak productivity performance through the government's growth mission. The government is making the reforms needed to deliver sustained growth in the long term. These include ambitious planning reforms to remove barriers to growth, the development of a 10-year infrastructure strategy to be published alongside Phase 2 of the Spending Review, the forthcoming publication of the Get Britain Working White Paper, and the establishment of Skills England to ensure we have the highly-trained workforce needed to deliver economic growth.

The government is also increasing investment in the economy to support growth, while ensuring debt is on a sustainable trajectory, as outlined in response to conclusion 2.

On migration, the government recognises and values the contribution that legal migration makes to our country, however, we are clear that that net migration must come down. The government will continue to strike a balance between ensuring that we have access to the skills that we need, whilst encouraging businesses to invest in the domestic workforce and reducing the level of net migration.

Interest rates (Conclusion 9)

The OBR's Fiscal Risks and Sustainability report also assesses the potential long-term impacts of changes in interest rates on the public finances.

The growth-corrected interest rate (the difference between the average yield on the stock of debt and the nominal growth rate of the economy or 'r-g') is important for fiscal sustainability. While some economic theory suggests that interest rates might change in line with productivity, the OBR's assumption in the FRS is that 'r' does not increase in the long run and that it is always 0.2 percentage points higher than 'g'.

The OBR has also considered what would happen to its long-run debt projections if interest rates changed in line with productivity, leaving r-g constant. In a higher productivity scenario, higher growth in receipts would be partially offset by higher debt interest spending, albeit on an increasingly smaller debt stock. In a lower productivity scenario, the impact from lower receipts growth would be partially offset by reduced spending on debt interest payments due to lower interest rates.

Net zero transition (Conclusion 10)

Early and ambitious climate action is vital for the UK's long-term economic growth, enabling a cost-effective transition to net zero. The government's Clean Energy Superpower Mission is based on the twin objectives of delivering clean power by 2030 and accelerating towards net zero, to boost energy independence, protect consumers, and support jobs across the country.

The LEAC Report recommends that the government produce and publish a fully-funded, coherent plan for meeting net zero targets. The government will publish a revised Carbon Budget Delivery Plan in spring 2025, detailing policies to achieve Carbon Budgets 4-6.

HM Treasury recognises the importance of ensuring fiscal decisions align with our net zero target and interim Carbon Budgets. At fiscal events, proposed measures and bids are therefore assessed according to their climate and environmental impacts, alongside their impact on wider government objectives.

Private finance is also crucial for meeting climate objectives. The government has launched Great British Energy, a publicly owned clean energy company capitalised with £8.3 billion of investment, to help stimulate private sector investment and turbocharge the growth of clean energy projects across the UK. The new National Wealth Fund will create a step change in our ability to mobilise private capital in the UK's world-leading clean energy and growth industries and support the delivery of our new Industrial Strategy.

Defence spending (Conclusion 11)

The government is committed to strengthening the Armed Forces and protecting national security during a period of geopolitical instability. The settlement announced at the Budget provided £2.9 billion of additional funding to the Ministry of Defence (MoD) in 2025-26 compared to 2024-25. The average annual real growth rate of the defence budget from 2023-24 to 2025-26 is 2.3%.

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This means the defence budget will grow in line with the economy in 2025-26, ensuring the UK comfortably exceeds the NATO spending target of 2% of GDP. The government will set a path to spending 2.5% of GDP on defence at a future fiscal event.

Beyond this settlement, the government has also commissioned a Strategic Defence Review which will determine the role, capabilities and reforms required of UK defence to meet the challenges, threats and opportunities of the twenty-first century. The review will ensure that defence is central to the security, economic growth and prosperity of the United Kingdom. The review will conclude in the first half of 2025.

Debt sustainability (Conclusions 13-15) and borrowing for investment (Conclusion 19)

The government is delivering its growth mission by prioritising stability, investment and reform to drive prosperity across the UK. The government agrees with the LEAC Report that difficult decisions are required to avoid the UK's debt being on an unsustainable path. The Budget took the necessary difficult decisions to put the public finances on a sustainable path – setting realistic plans for public spending while raising revenue – to create the conditions for growth.

This will be supported by the government's new fiscal rules. The stability rule requires the current budget to move into balance so day-to-day spending (e.g. on public services) is met by current revenues (e.g. tax). The current budget excludes spending on capital investment, measuring the difference between current receipts and all other expenditure. Balancing the current budget ensures that, over the medium term, borrowing is only for investment. This means that future generations will not be burdened with the costs of public services today.

The boundary between current and capital (investment) spending is based on international statistical principles and applied by the independent ONS, thus ensuring transparency and credibility.[10] Under alternative flow rules, such as public sector net borrowing (PSNB), capital spending could be cut to meet the rule. The stability rule removes this incentive, with cuts to capital spending no longer available as a means to meet the fiscal mandate.

The Institute for Fiscal Studies notes that "there are good reasons to target the current budget rather than overall borrowing, most obviously because we might think 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".[11]

The government's debt target is to reduce net financial debt (public sector net financial liabilities) as a proportion of GDP. This rule keeps debt on a sustainable path while allowing the step change needed in investment, by capturing not just the debt that government owes, but also financial assets that are expected to generate future returns.

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[10] European System of Accounts; The System of National Accounts.
[11] How do the parties' policy proposals fit in with their fiscal rules?, Institute for Fiscal Studies, June 2024.

Net financial debt is an official statistic published by the ONS and has been forecast by the OBR since 2016, based on international statistical guidance.[12]

There are three significant advantages to targeting net financial debt as a fiscal rule:

- Strengthening fiscal management – it provides a fuller account of what the government owes and owns, improving incentives to manage a broader set of liabilities and drive asset performance.
- Recognising the value of financial assets – net financial debt recognises that financial investments, such as loans, have a positive value and where they make a return above the government's cost of borrowing, they reduce (not increase) the debt burden.
- Supporting growth enhancing investments – financial investments, such as those made by the National Wealth Fund, are expected to help grow the economy while yielding a positive return for the taxpayer. Using a debt metric that does not recognise financial assets could create an incentive for the government to forgo profitable and growth enhancing investments.

To support the move to the new investment rule, the government is introducing robust guardrails to ensure investments are consistent with fiscal sustainability and decisions represent good value for money. This includes the Financial Transaction Control Framework published alongside the Budget, which introduces new controls: that financial investments should by default target a return for the Exchequer that at least covers their cost of financing, that all largescale financial transactions will be managed by expert bodies like the National Wealth Fund, and that the government will publish an annual report on the performance and value of its financial assets.

Fiscal rules and the fiscal framework (Conclusions 16-17)

The Committee recommends an overhaul to the fiscal framework to make public debt more sustainable and resilient to external shocks. The government has confirmed a set of responsible reforms to the fiscal framework that improve certainty, transparency and accountability. The full detail of these reforms can be found in the new Charter for Budget Responsibility and 'A strong fiscal framework'.[13,14]

The LEAC Report recommends that debt as a proportion of GDP should be lower on a given date in the fifth year of the forecast, unless there are exceptional reasons. The new fiscal rules, set out earlier in this response, begin with targeting the fifth year of the OBR forecast and move to target the third year. This represents a phased approach and balances the initial need to manage the £22 billion of in-year spending pressures identified in the government's audit of public spending, with enhancing fiscal discipline

[12] Definitions follow the National Accounts, set out in the 'System of National Accounts, 2008' and 'Eurostat'. Details can be found here: Autumn Statement: Supplementary fiscal aggregates, Office for National Statistics, November 2016.
[13] Draft Charter for Budget Responsibility: Autumn 2024, HM Treasury, October 2024.
[14] A strong fiscal framework: Explaining the government's new fiscal rules and framework, HM Treasury, October 2024.

by setting rules that bind sooner. This binds near-term decisions while still providing space for macroeconomic adjustment and the operation of the automatic stabilisers in the first two years of the forecast.

The rationale for moving to a rolling rule (targeting a year in the forecast, i.e. the third year, that continuously moves forward) rather than a fixed rule as recommended by the Committee (targeting a specific financial year, e.g. 2029-30, that gets closer each year), is that it avoids the need to make sharp policy adjustments in response to small changes in the forecast or economic shocks. With a fixed rule, as the target grows nearer, adjustments like in-year savings or tax rises become more challenging and economically damaging. A rolling target instead provides a medium-term anchor to support stability and sustainable public finances.

In addition to its fiscal rules, the government has committed to consider a wide range of metrics to inform a full assessment of the sustainability of the public finances, and will seek to improve sustainability over time.

OBR reporting against fiscal targets (Conclusion 18)

The Committee recommends that 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. The Treasury is required by the Budget Responsibility and National Audit Act 2011 to set out the means by which its objectives in relation to fiscal policy will be attained ("the fiscal mandate"). This act also requires the OBR to assess the government's performance against the fiscal mandate.

The OBR's public finances forecast must include projections of the key fiscal aggregates that are required to judge progress or achievement against the government's mandate for fiscal policy. Alongside its Budget forecast, the OBR makes a formal judgement on whether the fiscal policy set at that Budget is consistent with a greater than 50% chance of achieving or exceeding the fiscal mandate.

The OBR is also required to produce analysis of past forecasting performance and its latest Forecast Evaluation Report was published in October.

Fiscal buffers (Conclusion 20)

The Committee recommends that the framework shows whether the UK has a sufficient fiscal buffer to withstand an economic shock. The OBR has confirmed that the government is on track to meet its stability and investment rules, with both rules being met early. The current budget is in surplus by £9.9 billion in the target year, 2029-30, and the rule is met two years early. Net financial debt falls in the final year of the forecast with a £15.7 billion buffer and is also met two years early in 2027-28. Net financial debt is slightly lower at the end of the OBR's forecast (2029-30) than at the start (2024-25), at 83.4% and 83.5% of GDP respectively, showing the path of debt is stabilised.