A Progressive Guide to Fiscal Sustainability

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1. Introduction

It is widely understood that the UK's fiscal framework is unfit for purpose. As Gemma Tetlow, writing for the Institute for Government, puts it: "The UK's fiscal framework, including a flawed set of rules, is incentivising bad policy decisions shaped by short-termism and fictional spending plans – and does little to promote fiscal sustainability".[1] Criticism of the framework has emerged from think tanks including the Institute for Fiscal Studies (IFS), the National Institute for Economic and Social Research (NIESR), the Institute for Public Policy Research (IPPR), the Fabian Society and the Resolution Foundation, among others.[2]

Fiscal policy – decisions about government spending and taxation – should be implemented on a long-term basis, reflecting the strategic aims of the government. Instead, policy is increasingly driven by judgements made by the Office for Budget Responsibility (OBR) on the basis of uncertain and volatile forecasts. Small changes in forecasts for growth and interest rates cause large shifts in so-called 'headroom' and therefore in judgements about whether fiscal rules have been met. Repeatedly, we have seen Chancellors scrambling to find tax increases or spending cuts in response to such shifts. This short-term focus results in inadequate public investment. This, in turn, is an important cause of the UK's persistent weaknesses in productivity and wage growth.

Disquiet has reached the backbenches of the Labour Party: Anneliese Dodds has said, "we must be prepared to reassess shibboleths, whether on the fiscal rules … or on taxation, especially when the very best-off are seeing so little impact on their wellbeing from the economic headwinds". Louise Haigh has been particularly outspoken, arguing for "a decisive break with the fiscal rules and institutional constraints that hold back renewal."[3]

1 https://www.instituteforgovernment.org.uk/publication/strengthening-uk-fiscal-framework

2 See, e.g., See, e.g., https://ifs.org.uk/publications/fiscal-rules-fiscal-traffic-lights-rethinking-uk-fiscal-framework; https://niesr.ac.uk/publications/consideration-fiscal-targetry?type=topical-briefing; https://www.ippr.org/media-office/budget-should-take-first-step-to-more-rigorous-fiscal-rules-that-also-promote-growth-ippr-urges; https://fabians.org.uk/high-stakes/; https://www.resolutionfoundation.org/publications/back-for-more/

3 https://www.politics.co.uk/week-in-review/2025/04/05/week-in-review-anneliese-dodds-gives-shape-to-soft-left-unease-in-labour/; https://www.newstatesman.com/politics/uk-politics/2025/09/the-fiscal-straitjacket-facing-labour-must-be-broken

Opposition to the current framework extends beyond the Labour Party. The leader of the Green Party, Zack Polanski has said that fiscal rules should be replaced with "fiscal referees", a policy also supported by the New Economics Foundation, and that we should "look again at the OBR". At the opposite end of the political spectrum, former Prime Minister Liz Truss has called for the OBR to be abolished. Reform leader Nigel Farage said that he was giving "very serious thought" to scrapping the OBR if Reform were elected, before back-tracking on the suggestion.[4]

In this paper, we hope to bring clarity to these debates by taking a step back to consider the fundamental principles underlying the British government's fiscal problems. These are:

1. The economic reality faced by policymakers is complex and unpredictable.

2. The ultimate fiscal risk faced by the British government is a political risk.

These principles are upstream of the more technical issues around which most debates revolve: definitions of appropriate targets, the assignment of targets to instruments and the construction of procedures to ensure that targets are met.[5]

Principle 1 reflects the fact that governments can regularly expect to face novel crises for which they are unprepared. It seems unlikely that this problem will soon recede. Principle 2 means that there is no 'simple' solution – no set of rules to follow – that can solve the problems of fiscal policymaking. Taken together, these principles imply that open, transparent institutional structures that permit flexibility and coordination between different arms of the public sector are key to improving fiscal policymaking in the United Kingdom.

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4 See https://greenparty.org.uk/2026/03/18/zack-polanski-lays-out-plans-to-back-the-caring-majority-in-major-speech/; https://finance.yahoo.com/news/liz-truss-calls-obr-abolished-060000562.html; https://www.gbnews.com/politics/nigel-farage-scrapping-obr-reform-uk-fiscal-rulebook; https://www.newstatesman.com/politics/uk-politics/2026/02/dont-abolish-the-obr

5 See, for example: https://renewal.org.uk/articles/a-new-fiscal-framework-to-renew-britain/; https://ifs.org.uk/publications/fiscal-rules-fiscal-traffic-lights-rethinking-uk-fiscal-framework; https://neweconomics.org/2024/09/calling-time-on-fiscal-rules

To make this argument, we first outline the approach to macroeconomic policy that has existed in the UK over the last thirty years, and the place of fiscal policy within it. In short, this 'consensus' approach to macroeconomics implies that monetary policy is the optimal tool for managing the level of demand in the economy, and should be free to do so. As a result, monetary policy should not be set with an eye to managing the public debt. Sustainable public finances should, instead, be secured by the conduct of fiscal policy.

This approach to macroeconomic policymaking has merit, but – as with all simplified policy prescriptions – governments often have to deal with events that require flexibility. In section 2, we explain how the simple 'assignment' of roles between independent monetary and fiscal policies first came under pressure during the 2008 financial crisis, and then visibly broke down during the Covid-19 pandemic.

Section 3 then outlines the nature of fiscal risk. In other words, why at least some part of government policy has to adjust to ensure that the public finances are sustainable, and how fiscal policy is meant to achieve this under the consensus approach. This risk, at least for a country like the United Kingdom, is ultimately a political risk. It arises from the difficulty of maintaining tax rates high enough to finance interest payments on the public debt, given the consequent redistribution of income from taxpayers to bondholders. The problem is compounded by the fact that the average taxpayer is much closer to the average voter than the average bondholder.

These distributional problems have long-term consequences, and were themselves exacerbated by the short-term liquidity problems faced by the government during the 2008 financial crisis and Covid-19 pandemic, and the increases in debt that occurred during these crises. Distributional issues were central to the fiscal response in the aftermath of the invasion of Ukraine, and they will be central to any domestic policy response to the current conflict in the Middle East.

A variety of policy conclusions follow, of which we emphasise two:

1. The institutional architecture of macroeconomic policymaking needs to be sufficiently flexible to permit continuous, effective coordination

of monetary and fiscal policy. The existing consensus is, in other words, well beyond its useful lifespan.

2. The institutional architecture of fiscal policymaking should clearly separate those institutions that do, and do not, face political risk. In particular, public investment projects that do not require subsidisation from general taxation should be excluded from both the general government balance sheet and any fiscal rules.

We outline a specific institutional form that satisfies our first conclusion. We also discuss some specific implications that follow from our second conclusion, including the ability to rapidly increase public investment to 'green' the economy, either by direct nationalisation or the establishment of a national investment bank.

2. Macroeconomic Policy

2.1 The tools and targets of macroeconomic policy

Economists distinguish between the demand side (how much is spent) and the supply side (the production of goods and services). It is usually assumed that production adjusts to meet demand, at least in the short run. With higher spending, more goods and services are produced for sale. Increased production requires more hours of work so that, as spending increases, employment also increases.

This leads to a fundamental trade-off in macroeconomic policy: as unemployment falls, the bargaining position of workers improves, and their capacity to achieve pay rises increases. Higher pay reduces profits for employers, so firms respond by raising prices. As demand increases and unemployment falls, the chances of inflation increase.

The desire to avoid both inflation and unemployment creates a difficult balancing act for policymakers, and a key area of contention in economic policy. Economists disagree about how low unemployment can go before inflation becomes uncontrolled, and about the stability of the relationship

between the two variables. At its most basic level, macroeconomic policy involves pulling policy levers to affect spending in order to find an acceptable balance between unemployment and inflation.

The main tools of macroeconomic policy – the levers that can be pulled – are divided into two categories: monetary policy and fiscal policy. Monetary policy refers to actions taken by the central bank. The most important central bank policy tool is the power to set and influence interest rates. Since 2008 a wider array of 'instruments' have been used including the (widely misunderstood) policy of quantitative easing. Fiscal policy, on the other hand, refers to choices made by the Treasury about levels of taxation and government spending. At the aggregate level, the balance between tax and spending exerts a strong influence on overall demand.

In the case of monetary policy, reductions in the Bank of England's interest rate quickly affect most other interest rates, including the rates at which businesses and households borrow. Lower interest rates stimulate spending, raising output and employment. The opposite is the case for higher rates.

Fiscal policy can raise spending either indirectly by cutting taxes (and thus raising disposable incomes), or directly through increased government spending. In either case, the gap between spending and taxation increases, and the government must borrow to cover the difference between income and expenditure. This introduces another target for policy-making: a configuration of public debt and interest payments which is financially and – as we will argue – politically sustainable.

We therefore have three immediate targets for economic policy: low unemployment, controlled inflation, and sustainable public finances. Over the long run we can add another target: steadily increasing living standards. This is usually proxied, imperfectly, by economic growth.

These targets are neither independent nor separable. Lower unemployment often comes at the cost of higher inflation. Higher growth, while a target in itself, also eases pressure on public finances. Nor do these targets coincide: the level of unemployment which is politically acceptable may not be the level which achieves the Bank of England's inflation target. The size of the deficit needed to achieve a given unemployment rate may not be regarded as

acceptable from the point of view of the public finances. The choice of interest rate impinges on all of these trade-offs, as well as several others.

2.2 The consensus approach to macroeconomic policy

In order to impose order on these complex and disorderly problems of social welfare optimisation and political expediency, most rich nations, including the UK, the US and much of Europe, have converged on a similar approach to assigning policy tools to targets. This 'consensus assignment' makes monetary policy the primary tool of demand management: low and stable inflation is to be achieved by adjustments to the central bank's policy rate. Fiscal policy is subordinated to monetary policy: rather than being used to influence demand, taxation and spending policy must be set so as to achieve sustainable public finances.[6]

The organisational counterpart to this assignment of tools to targets is complete independence between the institutions responsible for setting monetary and fiscal policy. Central bank independence from elected government is regarded as essential to avoid politically-driven boom-bust cycles: the temptation to cut interest rates in the run-up to elections must be taken out of politicians' hands. At the same time, the issuance of debt to finance government borrowing should be independent of the central bank, and should be conducted in such a way that it does not affect monetary conditions.

While the virtues of independent central banks are widely proclaimed, the mechanism by which interest rate adjustment works to stabilise inflation receives less attention. The Bank of England's explainer notes that "higher interest rates will work because they will mean that less money will be spent … when overall spending in the economy falls, price rises slow down."[7] This does not, however, explain *why* lower spending leads to lower prices.

In the first step, higher interest rates lead to lower spending because borrowing costs increase: households face higher mortgage payments so that

6 For a fairly accessible yet rigorous 'orthodox' discussion of the consensus assignment in macroeconomic policy, see Kirsanova, T., Leith, C., & Wren-Lewis, S. (2009). Monetary and fiscal policy interaction: the current consensus assignment in the light of recent developments. The Economic Journal, 119(541), F482-F496.

7 https://www.bankofengland.co.uk/explainers/how-do-higher-interest-rates-help-to-lower-inflation

disposable income is reduced. Business borrowing costs likewise increase, squeezing profit margins.

Why does this lead to lower prices? The intuitive – and incorrect – answer is that the quantity of goods and services produced is constant, so that a reduction in spending leads to price reductions to ensure that everything is sold. This is not how central banks understand the mechanism. Instead, in response to lower spending, *production* falls relative to what it would otherwise have been. Lower production requires fewer hours of work, so unemployment increases. At higher levels of unemployment, workers are less likely to bargain for higher wages. Interest rate increases lead to lower inflation by raising unemployment and restraining wage claims.

There are, of course, other factors at play alongside this simplified account. As well as wage demands, firms' price-setting behaviour is affected by spending levels. Expectations of inflation tend to be self-fulfilling: if workers expect high inflation, they will bargain for stronger wage increases at any level of unemployment. But, at its core, a contemporary inflation-targeting framework works via the labour market: if inflation is too high, interest rates are raised with the intention of constraining wage claims – by putting people out of work if necessary.[8]

In this way, the consensus approach to macroeconomic policy assigns the management of demand, employment and inflation to independent central banks. This leaves the sustainability of the public finances, which is to be ensured by adjustments to fiscal policy, to the Treasury. It is this assignment that gave rise to the current framework of fiscal rules and OBR judgements.

The reader might have noticed that, despite discussing the role of fiscal policy in ensuring sustainable public finances, we have yet to provide a precise definition of 'sustainability' in this context. Before we do so, we consider objections to the consensus assignment, and how it began to break down following the 2008 financial crisis.

8 As an illustration, during the period of post-pandemic inflation, in comments to the BBC, Bank of England Governor Andrew Bailey said that in the interests of bringing inflation down workers should not ask for a pay rise: 'Don't ask for a big pay rise, warns Bank of England boss': https://www.bbc.co.uk/news/business-60206564.

2.3 Objections to the consensus approach

The assumptions underlying the consensus approach to macroeconomic policy were never particularly convincing, but they appeared plausible during the relatively serene period from the mid-1990s until the 2008 financial crisis. Growth was steady while inflation remained low. There were debates as to why this occurred, but a significant part of the economics profession attributed this 'great moderation' to the policy consensus we have just described, and in particular to the independence of central banks.[9]

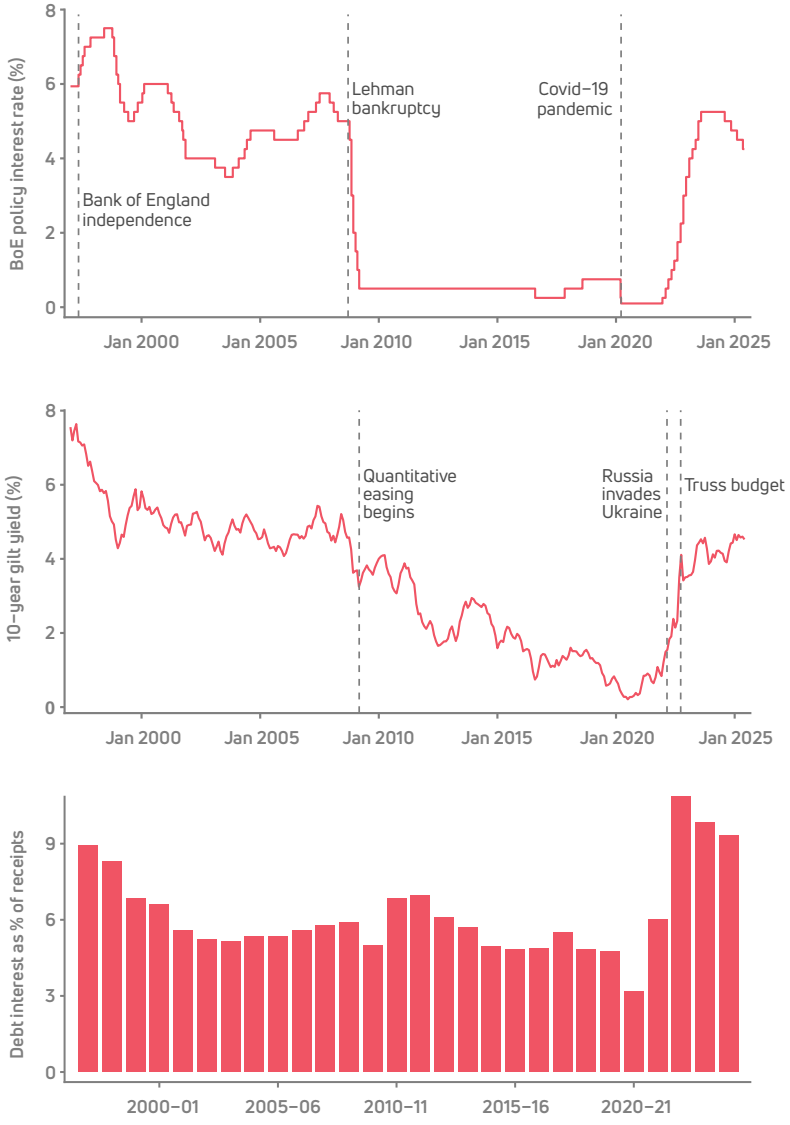
Aside from the inherent implausibility of the 'great moderation' being the result of policymaking, a number of objections can be raised to the relegation of fiscal policy in the consensus assignment. Monetary policy is a distributionally blunt tool: interest rate hikes redistribute income from debtors to creditors in an indiscriminate way. In contrast, the distributional outcomes of changes to fiscal policy can be targeted more directly. Further, in many instances, fiscal policy has more powerful demand effects than monetary policy. The relationship between interest rates and business investment, in particular, is far from mechanical. Conversely, it is widely accepted that fiscal policy has a 'multiplier' effect: for every additional pound in government spending, output will generally rise by more than a pound. With higher output and employment, tax revenues increase, so that the overall increase in borrowing will usually be less than a pound.

The multiplier effect becomes particularly important when interest rates are close to zero. In fact, this is the single scenario – when central banks cannot reduce their interest rates any further – in which the consensus approach permits fiscal policy to be used directly for stimulating demand. Once tax cuts or government spending increases have raised demand sufficiently, allowing the central bank to raise interest rates above zero, then fiscal policy should revert to its main role of ensuring sustainable public finances.

Reflecting this, in a speech to the London School of Economics in October 2008, George Osborne (then Shadow Chancellor of the Exchequer) argued that,

9 Craig Hakkio's 2013 discussion is a useful post-GFC account from the perspective of an American monetary policymaker: https://www.federalreservehistory.org/essays/great-moderation.

Figure 1: Bank of England policy interest rate (source: Bank of England), 10-year gilt yield (source: FRED), and central government debt interest as a percentage of receipts (source: OBR March 2026 EFO databank), 1997 to 2025.



> *. . . if we reach the point at which interest rates can go no lower, or if it becomes apparent that the monetary policy lever is not working as it should, then we would be in dangerous and uncharted territory for the UK economy in modern times. But with interest rates still at 4.5% in the UK, we are a long way from that point.*[10]

This assessment did not age well: within months, the Bank's policy rate had been cut to 0.5%. According to the consensus assignment – well established by that time – the government ought to have run an expansionary fiscal policy until interest rates could rise. But this is not what happened. Instead, as displayed in Figure 1, the Bank's policy rate stayed at 0.5% between 2009 and 2016, when it was lowered to 0.25% in the wake of the Brexit referendum. Over this entire period, Osborne pressed ahead with fiscal tightening in the form of his austerity programme.

Meanwhile, the Bank judged that demand was too weak to be compatible with its two percent inflation target, but could not cut rates any further. At this point, like central banks elsewhere, it resorted to 'unconventional monetary policy'.

2.4 The breakdown of the consensus

Quantitative easing is a widely misunderstood policy tool. The shorthand description of it as 'printing money' easily leads people astray. The reality is relatively mundane: the Bank of England buys government debt from private institutions such as pension funds. The bank accounts of pension funds are credited with the purchase price, and those banks' reserve accounts at the Bank of England are credited with an equivalent sum. At the time of implementation, when interest rates were close to zero, it was effectively a swap of one type of asset that yielded near-zero interest (government debt) for another that also yielded near-zero interest (bank balances).

10 This passage is from George Osborne's speech to the LSE on 31st October 2008, entitled 'Recovery through fiscal responsiblity': https://www.lse.ac.uk/assets/richmedia/channels/publicLecturesAndEvents/transcripts/20081031_Osborne_tr.pdf.

The intention was that pension funds and other institutions – which would not want to hold the additional bank balances – would buy up other financial instruments and, in doing so, would exert a downward influence on the longer-term rates of interest that influence business investment (and government financing costs).

What quantitative easing demonstrates is that it is entirely possible for the Bank of England to own the debt of the government in large quantities. Once the Bank becomes a substantial holder of gilts (debt instruments issued by the Treasury), the Bank's policy rate determines its cost of holding those gilts and thus the ultimate cost to the taxpayer of servicing the debt held by the Bank. Quantitative easing introduces a direct link between monetary policy decisions and public debt sustainability.

This introduces new risks: if the Bank ever needed to increase its interest rates to combat inflation, then quantitative easing would create a significant headache for the Treasury. While the government debt held by the Bank of England would continue to provide no return, the reserves – balances at the Bank of England held by other banks – which were issued by the Bank when buying that debt would pay the increased interest rate. This is exactly what has happened, with the cost to the public sector running at tens of billions of pounds per year.

The upshot of all of this is that an unexpected event – the 2008 financial crisis – exposed the fiction that monetary policy and fiscal policy are independent. Yet our policy institutions are still organised in line with this fiction.

If the macroeconomic consensus began to break down after the financial crisis, it was conclusively shattered by the Covid-19 pandemic. Faced with a crisis that it was completely unprepared for, the government was forced to subsidise the forced shutdown of swathes of the economy. This led to the largest issuance of government debt in peacetime.[11]

Meanwhile, the Bank of England expanded quantitative easing, with the amount of government debt purchased close to the quantity of public

11 https://commonslibrary.parliament.uk/government-borrowing-peacetime-record-confirmed/

borrowing in the early period of the pandemic. Many bond investors believed that the motivation for these purchases was not inflation targeting, but the need to ensure that the Treasury could issue the debt needed to finance its support schemes. Given the requirement to maintain at least the appearance that the consensus assignment remained in place, these suggestions were refuted by the Bank's governor Andrew Bailey who insisted that "We do not … set a level of quantitative easing and asset purchases in any way related to what the government is going to borrow."[12]

Interactions between the Bank and the Treasury took centre stage during the short-lived premiership of Liz Truss: following the mini-budget of autumn 2022, movements in bond markets become disorderly, amplified by the actions of pension funds. With financial stability at risk, the Bank of England offered to buy government debt directly from pension funds. As pension funds hesitated, put off by the low prices offered by the Bank, Bailey announced an ultimatum, giving the pension funds days to come to the table. By announcing that support for government debt markets was time-limited, Bailey also made clear that the Bank would not support the Treasury in its attempt to raise borrowing and cut taxes. Within days, Truss had sacked her Chancellor, backtracked on the budget and would be out of office herself within weeks.[13]

The price inflation which followed the pandemic highlighted the limits of the consensus assignment in another way: sharp increases in imported food and energy prices translate into a fall in living standards for the whole country. Raising interest rates does nothing to alleviate the immediate problem of higher prices, which are set globally. Higher rates instead reduce the disposable incomes of many households, particularly those with mortgages, just as their finances are also being squeezed by higher prices. Monetary policy is not the appropriate tool to respond to this type of inflation. Instead, fiscal policy is needed to support those on low incomes and ensure that those who can afford it carry the bulk of the costs.

12 The Financial Times reported that a "survey of the 18 biggest players in the market for UK government bonds found the overwhelming majority believe that QE in its current incarnation works by buying enough bonds to mop up the amount the government issues and keep interest rates low". https://www.ft.com/content/f92b6c67-15ef-460f-8655-e458f2fe2487

13 'Lessons from the downfall of Truss for macroeconomic governance': https://ukandeu.ac.uk/lessons-from-the-downfall-of-truss-for-macroeconomic-governance/.

These events illustrate our first principle of economic policy: economic reality is inherently complex. Governments can expect to regularly face genuinely novel crises which require novel policy responses. The crises that *have* occurred over the last twenty years teach us a simple lesson: monetary and fiscal policy are not independent, and cannot be neatly assigned to independent policy targets. Any institutional architecture that forces them to act as though they are independent is sub-optimal.

3. Fiscal sustainability

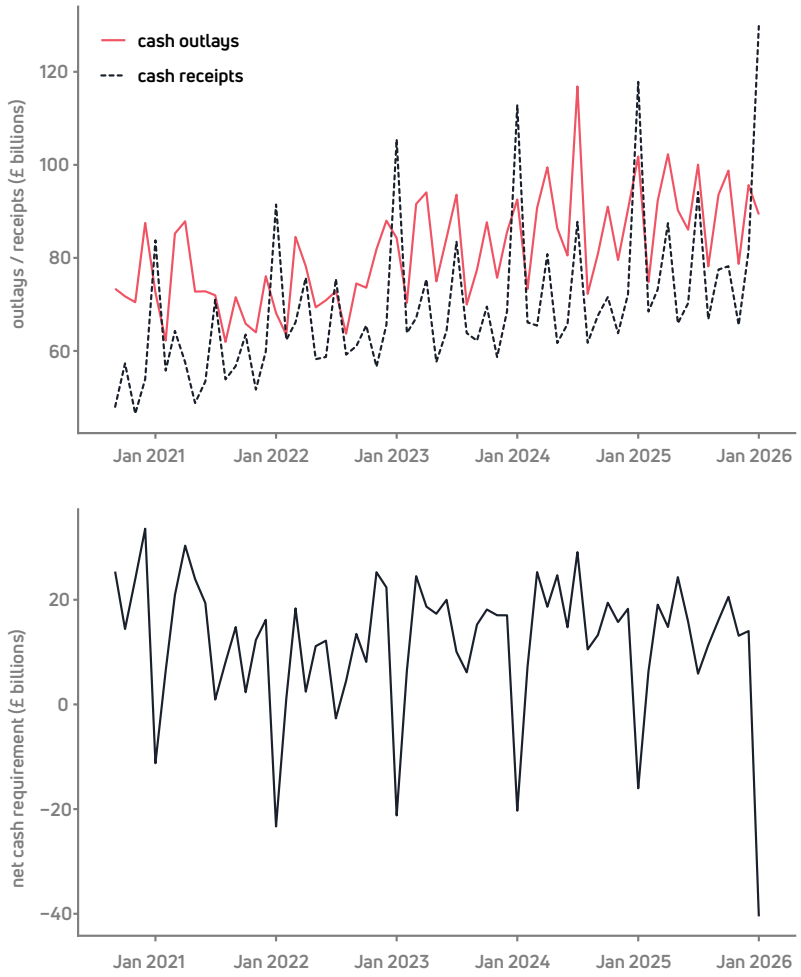
3.1 How does the government finance its spending?

In section 2 we outlined the nature of the existing policy consensus, the ways in which it has come under pressure in recent years, and the resulting dissolution of the boundaries between monetary and fiscal policy.

One important area of intersection between the two relates to the financing of government spending and borrowing. The difference between taxation and spending is usually covered by issuing debt instruments. Longer term instruments – bonds – are the usual method of financing most government borrowing. The government also issues shorter term instruments, known as bills. Finally, the government can draw on overdraft facilities at the Bank of England in order to spend without requiring either taxation or debt issuance. And, as illustrated by quantitative easing, the Bank of England can buy and hold the debt issued by the Treasury.

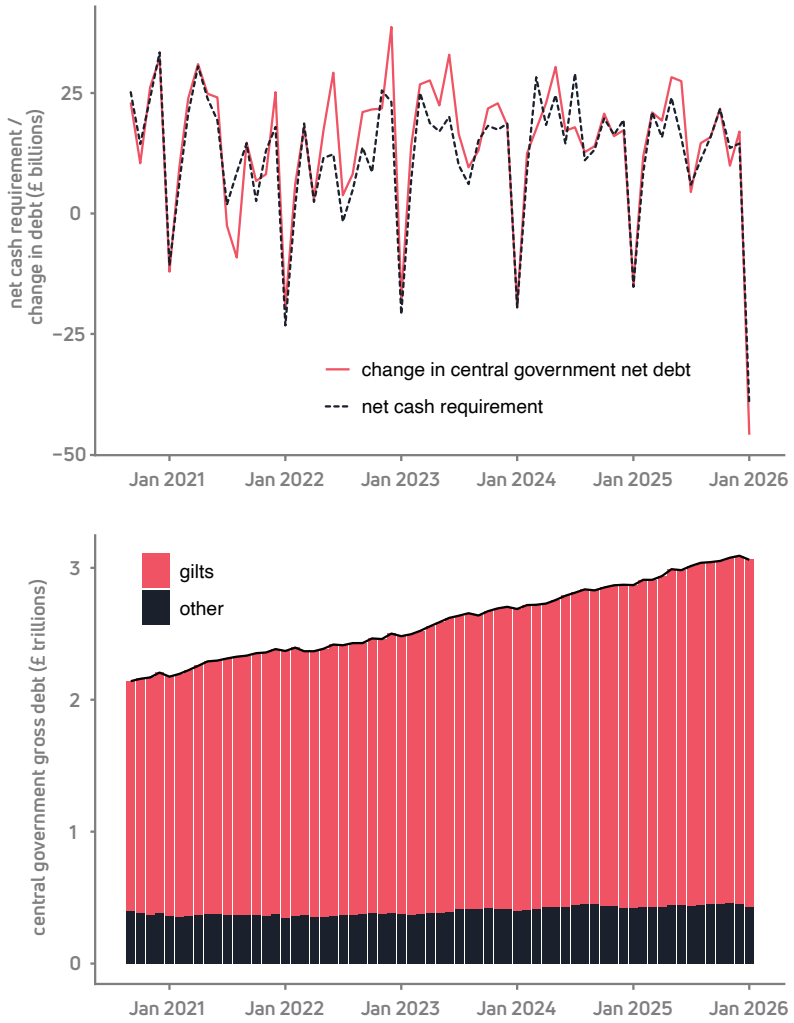
Under quantitative easing, the Bank was not allowed to buy gilts directly from the Treasury but instead had to make purchases in the 'secondary market' – to buy gilts from existing holders. The current consensus strongly discourages direct purchases, as well as even more direct routes such as the Treasury drawing on overdraft facilities at the Bank of England. The consensus view is that Bank of England financing of Treasury spending must be avoided and that bond issuance should therefore be used for the great majority of government financing needs. Why is this the case?

Figure 2: Central government cash outlays (source: ONS series RUUQ), cash receipts (source ONS series: RUUN) and net cash requirement (source: ONS series M98S) between 2020 and 2026.



The short answer is that under a system of inflation targeting by an independent Bank of England – the institutional counterpart to the consensus assignment – there is no alternative. This is because the Bank of England would lose control of the short-run interest rates it targets in its monetary policy operations if the government were to routinely rely on overdraft spending. Under the consensus assignment, as well as targeting sustainable

Figure 3: Change in central government net debt, central government net cash requirement, and the components of central government gross debt (source: ONS Appendix A data tables to Public Sector Finances, January 2026), 2020 to 2026.



public finances, fiscal policy should be conducted in a way that minimises its impact on the Bank's monetary policy operations.

To understand how this is achieved, consider the monthly series of central government cash outlays and receipts illustrated in Figure 2. Outlays have fluctuated around an average of about £80 billion per month in recent years, while

receipts have fluctuated around a slightly lower average. And while outlays do not show a pronounced seasonal pattern, receipts are much higher in January, when a large part of tax revenues are paid, than in other months.

The government's cash flows are therefore uneven – tax receipts and spending do not arrive and leave in a smooth, predictable pattern. To manage this, the government holds a set of accounts at the Bank of England, and uses the balances in these accounts to settle payments whenever a government department needs to spend. Over the course of each day, the difference between total cash outlays and receipts determines the government's 'net cash requirement' for that day.

This daily cash requirement is managed by the Debt Management Office (DMO). Using cash flow forecasts, the DMO deals with money and debt markets to keep the government's balances at the Bank stable. It borrows from money markets or sells bills when more cash is needed, and lends in money markets or buys back bills when there is a surplus. Over time, the DMO also sells longer-term bonds (gilts) according to an annual Financing Remit set by the Treasury, so as to avoid an excessive build-up of short-term instruments. As shown in Figure 3, gilt issuance closely tracks the net cash requirement. This is all done to avoid fluctuations in government borrowing leading to changes in cash balances in the banking system, so that government deficits do not interfere with the Bank of England's ability to set short-term interest rates.[14]

It is important to recognise, however, that this is a policy choice rather than an operational necessity. The government could borrow directly from the Bank of England – which remains part of the public sector and is owned by the government – and indeed did so fairly regularly in the twentieth century.[15] A direct overdraft facility, the 'Ways and Means' account, still exists for this purpose. Because the government currently avoids using it, central government net debt closely tracks the net cash requirement and consists

14 Much of the details are contained in official cash management handbooks, HM Treasury's 'Managing Public Money' documents, and National Audit Office explainers. A very useful account with a lot of institutional detail, which takes a somewhat different perspective to our own, can be found in: Berkeley, A., Ryan-Collins, J., Tye, R., Voldsgaard, A., & Wilson, N. (2025). The self-financing state: an institutional analysis of government expenditure, revenue collection and debt issuance operations in the United Kingdom. Journal of Economic Issues, 59(3), 852-880.

15 See, e.g., https://positivemoney.org/uk/archive/historical-examples-of-sovereign-money-creation/

predominantly of gilts, Treasury Bills, and National Savings & Investments liabilities – but the option to draw on the Bank of England remains available, and it is important to bear this in mind in what follows.

3.2 Bond villains

The fact that the government relies so heavily on the financial markets to finance its cash requirement necessarily poses risks. As we shall see, these risks could – in certain circumstances – become significant, but most of the time are immaterial. Despite this, they tend to be dramatically overblown by politicians and the media.

Consider, for example, George Osborne's speech to the British Chambers of Commerce in 2011, after the first year of austerity:

> *If you hear the stories about the cuts and still wonder why our country needs to take these difficult decisions, then look at what is happening around us. First Greece, then Ireland, today Portugal. All of them countries that did not convince the world they could pay their debts . . . Today of all days we can see the risks that would face Britain, if we were not dealing with our debts and paying off our national credit card.*[16]

This passage is a prime example of a politician exaggerating fiscal risk as a cover for policy choices, and is astonishingly misleading. It compares Britain, a country that sells debt in its own currency, to Greece, Ireland and Portugal, which do not: these countries are part of the Eurozone, and did not have unrestricted access to liquidity from the European Central Bank. It was entirely possible that the European Central Bank would let one or more of those countries default on their debts in 2011, and so market participants holding Greek, Irish or Portuguese bonds faced a very real default risk. Indeed, Greece was forced to restructure its debt more than once during the Eurozone crisis, and defaulted on loans from the International Monetary Fund. The fiscal crisis that

16 https://www.gov.uk/government/speeches/speech-by-the-chancellor-of-the-exchequer-rt-hon-george-osborne-mp-at-the-british-chambers-of-commerce-annual-conference-in-london

shook the Eurozone in the early 2010s was only halted when Mario Draghi, the head of the European Central Bank, declared his intention to intervene with 'whatever it takes'.

In comparison, the Bank of England is part of the British public sector, so the government could borrow directly from the Bank if it ever faced a liquidity crisis in the bond markets; it is difficult to imagine the Bank of England forcing a default on the British government. In fact, the government borrowed £20 billion from the 'Ways and Means' account for about six weeks during the 2008 financial crisis.[17]

This is the reason why threats of a 'gilt strike' are – usually – empty. For example, Jamie Dimon, the chairman and CEO of JP Morgan, suggested to Alastair Darling that his bank might stop buying British government debt in 2009. But Alastair Darling recognised that this was an empty threat, correctly pointing out that JP Morgan,

> *. . . bought our debt because it was a good business deal for them. [Dimon] went on to say they were thinking of building a new office in London but they had to reconsider that now.*[18]

Britain's public debt was a 'good business deal' in the sense that it remained a risk-free asset: it was denominated in sterling, and backed up (ultimately) by the Bank of England. Unsurprisingly, JP Morgan continued to buy gilts, and did build a new office.

3.3 Political risk

So, if the government can borrow from the Bank of England in response to crises, and is, as a result, relatively insulated from the threat of bond vigilantes, what is the nature of fiscal risk?

17 Weekly amounts outstanding of Bank of England Issue Department sterling ways and means advances to central government between 2006 and 2014 can be found in series RPWB54A in the Bank of England database: https://www.bankofengland.co.uk/boeapps/database/

18 'Faisal Islam: Mandelson, Darling and the conversation I can't forget': https://www.bbc.co.uk/news/articles/cx2kzmnr14lo

Instead of the risk that bond traders will suddenly lose confidence in the government's ability to 'pay its credit card', the fiscal risks faced by a government like that of the United Kingdom are more long-term. Essentially, they revolve around the risk that the government *chooses* to default on its debt, or – more pertinently – bond traders believe that the government *wants* to default on its debt. This is, at heart, a political risk arising from the difficulty of redistributing income.

In a liberal democracy, much of the art of politics lies in the control of who pays tax and who benefits from government spending. If a large enough number of voters feel that they are paying too much without getting enough back, then the government of the day is unlikely to be re-elected.

This does not pose much of a problem for most public goods, like education, healthcare, and defence, which the great majority of people benefit from (or, at least, expect to benefit from at some point in their lives). Things become more complicated, however, when a large part of government spending is comprised of interest payments on the public debt.

To understand how this works, divide public spending into spending on interest payments and spending on everything else. In this case, government borrowing can be written as,

Borrowing = Interest Payments + Other Spending - Taxation.

The government's 'primary balance' is defined as the difference between its tax revenues and its non-interest spending (its spending on everything *other* than interest payments). We then have:

Borrowing = Interest Payments - Primary Balance,

where a negative primary balance is referred to as a primary deficit, and a positive primary balance is referred to as a primary surplus.

Consider a situation in which borrowing is fixed. Clearly, the higher are interest payments, the higher the primary balance has to be, and if interest payments are very high then the government might have to run a very large primary surplus. And in order to run a primary surplus, taxation needs to be

greater than spending on things the public cares about: education, healthcare, local amenities, and so on.

This poses a potential problem when interest payments are very high: voters will feel that they are paying too much without getting enough back. High primary surpluses are, essentially, a redistribution of income away from a country's voters towards its creditors, and this does very little for a government's prospects of being re-elected.

3.4 Redistribution and credibility

The upshot of this is that if the public debt is high, or interest rates on that debt are high, then the primary surplus required to stop the public debt from growing any further might become politically infeasible.

Suppose, for example, that the public debt is 200% of annual GDP, and the interest rate on government bonds is 5%. Then the government would have to redistribute 10% of GDP from taxpayers to bondholders every year. If the government could not increase tax revenues past 40%, say, without suffering a general election defeat, then a full quarter of its tax revenues would be spent on interest payments each year if the government wanted to avoid any further borrowing.[19]

This might be just about feasible, particularly if a political consensus could be engineered between the major political parties. But if another crisis occurred which required even more borrowing, or if global interest rates suddenly increased, then the government's interest payments would increase beyond 10% of GDP.

At some point the government will become incapable of engineering the resulting distribution of income, and might resort to further borrowing to cover its interest payments. But this will only make matters worse, as more debt in the future implies an ever-increasing interest bill, quickly leading to

19 In this case the government could actually keep borrowing while maintaining a 200% debt-to-GDP ratio, because GDP also grows. This slightly complicates the argument without changing the basic logic; the interested reader can consult Escolano (2010) for an approachable guide to the algebra of debt dynamics: A Practical Guide to Public Debt Dynamics, Fiscal Sustainability, and Cyclical Adjustment of Budgetary Aggregates, IMF Technical Note, https://www.imf.org/external/pubs/ft/tnm/2010/tnm1002.pdf

a positive feedback loop of higher borrowing, higher interest payments, and higher debt.

The only ways out of this feedback loop, if the government has already concluded that redistributing more money from taxpayers to bondholders is politically impossible, are default or systematic reliance on the Bank of England to finance spending. In other words, the fiscal risk facing a government like that of the United Kingdom is the possibility that the primary surplus it requires to avoid a debt spiral is not politically feasible. If this were the case – or if bondholders *believe* it to be the case – then the government could indeed face a gilt strike, which would, at that point, be nothing other than a self-fulfilling prophecy.

Unsurprisingly, given all of this, gilt strikes are very rare events. In fact, the last event generally considered a 'gilt strike' in the UK occurred in 1976 during the IMF crisis of that year. There was a similar dynamic at play to the one we have described: bond traders in the City of London expected that the government would have to borrow money from the IMF, who in turn would force the government to raise interest rates. As a result, they refused to buy gilts until this occurred. The difference here is that the source of the crisis was the sterling exchange rate, not the public finances themselves.[20]

The usual course of events is more mundane: after an event like the Truss mini-budget, for example, a government's debt can start trading with a risk premium. In other words, bondholders demand a higher return on British government debt than, for example, German government debt. This is exactly what happened after that episode and, despite being less dramatic than a run on sterling, events like this can impose a significant cost on the public that can persist for many years.

3.5 Fiscal sustainability: A definition

We now, finally, have a definition of sustainable public finances: a configuration of public debt and borrowing that requires a primary surplus which is

20 See, for example, Burk, K., & Cairncross, A. (1992). Goodbye, Great Britain: The 1976 IMF Crisis. New Haven and London: Yale University Press.

sufficiently low that the government can credibly sustain the required redistribution of income from its taxpayers to its creditors. This is essentially the same as the government being able to credibly commit to an expected real interest rate on its debt, without 'cheating' via default or inflation.

As noted in the introduction, the fundamentals of fiscal sustainability are not often discussed in the day-to-day debates on Britain's public finances, which tend to focus on more immediate technical questions, like the exact form that fiscal rules should take. But despite this, our account of fiscal risk is not particularly controversial. It underpins academic analyses of maximum sustainable debt ratios, for example. And, as observed by Xavier Debrun and co-authors at the International Monetary Fund,

> *. . . if we completely ignore the past, then virtually any government could be deemed solvent regardless of its existing debt level. All it takes is to consider as credible any public commitment to generate sufficiently high primary surpluses at some point in (and possibly very far into) the future. Hence, the final call on solvency is a mere judgement on a government's credibility.*[21]

A solvent government is a government that has both the political will and the capability to redistribute income from its taxpayers to its creditors.

4. Policy implications

In section 2 we provided an account of the consensus approach to macroeconomic policy, how it has shaped our policymaking institutions in the United Kingdom over the last thirty years, and how it began to break down after the 2008 financial crisis. In section 3 we discussed the manner in which fiscal policy is supposed to be conducted in this consensus, the reasons for this, and the nature of fiscal risk that underpins this.

21 For a discussion of maximum sustainable debt ratios, see Collard, F., Habib, M., and Rochet, J. C. 2015. Sovereign debt sustainability in advanced economies. Journal of the European Economic Association, 13(3), 381-420. The quote is from: Debrun, X., Ostry, J., Willems, T., and Wyplosz, C. 2018. Chapter 4: Public debt sustainability. IMF Online Conference Paper: https://www.imf.org/en/News/Seminars/Conferences/2018/05/24/sovereign-debt-a-guide-for-economists-and-practitioners

This discussion motivates two fundamental principles that underlie Britain's fiscal problems. These are:

1. The economic reality faced by policymakers is complex and unpredictable.

2. The ultimate fiscal risk faced by the British government is a political risk.

In other words, governments can regularly expect to face genuinely novel crises for which they are badly prepared, and for which there is no 'simple' solution – no set of rules covering every conceivable outcome – that can solve the problems of fiscal policymaking.

What are the implications for policy? Is a progressive fiscal policy – one that reverses fifteen years of austerity – even possible?

4.1 The reverse assignment

Some advocate a complete abandonment of the existing consensus as a solution to the problems outlined above. Drawing on ideas associated with economists in the US, they argue that the Bank of England should set interest rates at a fixed low level, or even zero. The Bank of England should then buy gilts, or provide overdraft facilities to the Treasury, at whatever scale is required to hold interest rates on government debt at a level that ensures sustainable finances.

Government spending could then increase to any level compatible with stable inflation, proponents claim, without concern for the public finances. In this way, the consensus assignment would be reversed: fiscal policy would target unemployment and inflation while monetary policy would ensure sustainable public finances. Proponents of the approach regard this as a way to substantially increase government spending and thus to end austerity.[22]

22 The most sophisticated recent account of this policy framework, in our view, is provided in Tankus (2022): https://publicmoneyaction.org/wp-content/uploads/2023/07/M3F000001.pdf. Also see Jayadev and Mason (2018): https://www.ineteconomics.org/perspectives/blog/mainstream-macroeconomics-and-modern-monetary-theory-what-really-divides-them.

We do not think this is a plausible policy framework: it is akin to using a hammer to crack a nut. It may be *possible* for a government to follow this approach, if it has the political will, but the potential pitfalls are substantial. And, as we argue below, it is unnecessary – austerity can be reversed without such radical changes.

What are these pitfalls? If interest rates on government debt were fixed at a low level, the gilt market would be effectively neutralised: rather than interest rates reflecting willingness to lend to the government, creditors would be offered a take-it-or-leave-it deal. While curtailing the influence of the bond vigilantes is desirable, such a dramatic change has potential destabilising effects: the government bond market provides the foundations on which much of the rest of the financial system rests.

Perhaps most importantly, with unrestricted cross-border financial flows and the UK's substantial import dependence, much of the adjustment would take place via the exchange rate: if the UK offered substantially lower interest rates than comparable economies, the international demand for British financial assets would fall. This would lead to sustained falls in the price of sterling relative to other currencies, which in turn would increase the prices of imported goods in the United Kingdom, generating inflation. In the limit – if interest rates in the UK were significantly lower than overseas rates for a sustained period of time, and a permanent depreciation of sterling were to be avoided – the only option would be to introduce strict controls on international transactions. The reverse assignment would thus entail substantial additional policy changes in the form of management of financial flows and the exchange rate. Ultimately, it is a policy which would require the UK to significantly reduce its degree of integration into the world economy.

A policy approach in which interest rates are free to vary does not have this problem. This does not mean that interest rate adjustments should be the *complete* response to the various shocks that the government may face, and it does not imply that the conduct of monetary policy should be entirely separated from other tools such as fiscal policy. But it does imply that pinning interest rates to zero to avoid government default is very difficult in a world of free financial flows.

In simply flipping the assignment of targets to instruments, the reverse assignment repeats many of the errors implicit in the consensus assignment: advocates of this approach often assume that 'full employment' and 'stable inflation' are equivalent, and that fixing government spending and taxation so as to achieve this combination is straightforward. While there are good reasons to be sceptical of interest rate adjustment as the *only* demand management tool, continual adjustment of government spending and taxation in response to inflation is unlikely to generate a coherent long run fiscal strategy – and it has the potential to reproduce the short-termism that characterises the current fiscal rules-driven approach.

4.2 A progressive approach

If the consensus assignment and conduct of fiscal policy are well beyond their useful lifespans, but a complete repudiation of the existing system is untenable, what is the alternative?

We propose two basic changes to the United Kingdom's policy institutions:

1. The institutional architecture of macroeconomic policymaking needs to be sufficiently flexible to permit continuous, effective coordination of monetary and fiscal policy.

2. The institutional architecture of fiscal policymaking should clearly separate those institutions that do, and do not, face political risk. In particular, public investment projects that do not require subsidisation from general taxation should be excluded from both the general government balance sheet and any fiscal rules.

Our first proposal follows from our first principle of macroeconomic policymaking, and the discussion in section 2 of this report. The crises that have occurred over the last twenty years – the 2008 financial crisis, the Covid-19 pandemic, and the cost of living crises since – teach us that governments will regularly face events for which they are unprepared, and which require monetary and fiscal policymakers to work together.

Elsewhere, we have proposed the creation of an Economic Policy Coordination Committee as an institutional structure that could enable this

coordination.[23] The Treasury and the Bank of England would be senior members; other members could include the devolved governments and advisory bodies like the Climate Change Committee and the OBR. Each institution would retain primary responsibility for its own areas of economic policy, but the coordinating committee would provide each institution with a direct understanding of the analysis and perspective of the others, in order to inform the work of all.[24]

Instead of following simple rules such as a 'Taylor rule' – which states that the Bank should always raise interest rates in response to above-target inflation – the Bank would still retain its inflation mandate, but would form policy jointly in open, transparent and statutory consultation with the Treasury and other institutions. In an ideal world, this would have prevented the Bank from raising interest rates in response to the cost of living crisis in 2022, with fiscal policies taking most of the strain. In the context of the energy price shock caused by the US-Israeli war with Iran, Andrew Bailey acknowledged that monetary policy "cannot prevent higher global energy prices from affecting the UK economy and inflation."[25]

Such coordination would be equally desirable in situations of financial dislocation. A formal institution for coordination would permit the Bank to adjust interest rates and provide support to financial markets – including gilt markets – in conversation with the Treasury. And a statutory coordination body of this type would likely have prevented the Truss mini-budget from occurring, given that many of the problems surrounding that episode stemmed from the government bypassing existing institutional checks and balances.

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23 https://fabians.org.uk/publication/in-tandem/

24 Our policy proposals emphasise the importance of transparency, and the superiority of conversation and coordination over rules. In a general sense, the use of quantitative rules to guide any area of policy — not just fiscal — are highly exposed to Campbell's Law, i.e.,

The more any quantitative social indicator is used for social decision-making, the more subject it will be to corruption pressures and the more apt it will be to distort and corrupt the social processes it is intended to monitor.

Campbell, D. (1979). Assessing the impact of planned social change. Evaluation and Program Planning, 2(1), 67-90.

The spirit of this law runs through much of the recent criticism of the government's fiscal rules. For example, a former head of the OBR claims that public sector net debt targets have encouraged ever-greater private finance initiative (PFI) liabilities, as these were not included in the public sector net debt for much of the post-1997 period: "what gets excluded gets exploited". (Hughes et al. 2019) The move to targeting public sector net financial liabilities in 2024 suffers from similar problems, inasmuch as it encourages the government to take financial stakes in existing companies rather than increase public investment directly.

25 https://www.bankofengland.co.uk/-/media/boe/files/monetary-policy-report/2026/april/opening-remarks-april-2026

Of course, if the Bank of England does not have an explicit target of controlling public debt affordability, the government still has to set fiscal policy with an eye to fiscal sustainability. At the same time, public spending needs to increase significantly if the damage done by fifteen years of austerity is to be repaired.

Our second policy conclusion squares this circle. Simply put, there are some parts of public spending that do not suffer the type of political risk outlined in section 3. These are spending areas that either do or can generate returns from market activity, and therefore do not require cross-subsidisation from tax revenues.

Although part of government revenue is earned from income streams other than taxation,[26] there are relatively few examples of the British public sector earning income from the sale of goods and services. Some examples in recent years include the British Business Bank, the National Wealth Fund (previously the UK Infrastructure Bank), and Great British Energy. The BBC and Ordnance Survey are more established examples, while much of the country's utilities were publicly owned before they were privatised in the 1980s.

Inasmuch as these parts of the public sector do not require subsidisation by taxation, they face no fiscal risk. Instead, they face the same risks as any firm that operates in a market – often attenuated given a degree of monopoly power – and therefore can and should be run without regard to fiscal sustainability. It is important to realise that this is not currently the case: for the purposes of the public sector accounts, the British Business Bank and National Wealth Fund (UKIB) are classified as a part of central government.[27]

A corollary of this is that strategic nationalisation of privatised utilities is entirely possible without materially increasing fiscal risk. Aside from an appropriate estimate of the contingent liability associated with a potential bailout, there is no fiscal risk associated with nationalising a large part of the energy sector, for example, in order to permit the significant increases in investment

26 https://ifs.org.uk/taxlab/taxlab-key-questions/where-does-government-get-its-money

27 See https://www.ons.gov.uk/methodology/classificationsandstandards/economicstatisticsclassifications/introductiontoeconomicstatisticsclassifications. Great British Energy (Nuclear) is also classified as central government; GBE itself does not yet appear to be classified.

required to achieve our net zero targets. This could be achieved via a larger National Wealth Fund taking controlling equity stakes in energy firms, or the issuance of government debt to directly purchase the firms in question. Either way, inasmuch as those firms are profitable, they would not require subsidy from taxation, and would not increase the political risk faced by the government. In this sense, the operation would not affect fiscal sustainability.[28]

Equally importantly, our policy conclusions imply that public investment could be significantly increased, financed by an increase in borrowing, without any material increase in fiscal risk. This could be achieved via a significantly larger National Wealth Fund or Great British Energy, or a National Investment Bank of the form proposed in Labour Party manifestos prior to 2024. It could also be achieved via nationalisation of utilities that have under-invested in recent decades, or the creation of new public sector institutions. The important point is that, if the debt issued to finance these organisations creates cashflows that do not require subsidisation from taxation, then it should not enter the government's estimates of fiscal sustainability.

A further benefit of this 'institutional diversification' in the public sector is that it would start to decentralise the control of public spending in the United Kingdom, and particularly public investment spending. This is consistent with a growing appreciation that a significant problem of Britain's governance is its highly centralised nature. Sam Freedman makes a particularly comprehensive case for this in *Failed State*, but it is a widely shared observation across the political spectrum.[29]

Finally, our proposed institutional structures would make it transparent that the great majority of current spending, and a significant part of the government's existing capital spending, does suffer from fiscal risk. A large part of public spending will always be on public goods that markets will rarely provide, and other goods and services that markets tend to underprovide. The provision of these goods and services requires subsidisation by taxation, and this may

28 Note that the nationalisations after the Second World War involved the issuance of government bonds, but these were not gilts and instead were liabilities of the nationalised firms themselves. See, e.g., https://researchbriefings.files.parliament.uk/documents/CBP-8325/CBP-8325.pdf

29 Sam Freedman (2024). Failed State: Why Britain Doesn't Work And How We Fix It. London: Pan Macmillan.

well imply the continued reliance on some form of fiscal rule or standard.[30] Such rules, however, should been seen as heuristics providing an indication of sustainability (as defined here), not as hard and fast targets to be achieved in the short run at the expense other policy objectives. Further, given the political nature of fiscal risk, quantitative targets for stocks of debt, public sector net worth or other balance sheet measures are unhelpful in isolation, and should not become primary targets for policymaking.

But, fundamentally, increased spending on publicly subsidised goods and services in an environment of high interest payments requires increases in taxation. There is no avoiding this: fiscal policy is about the distribution of income and, ultimately, if we are to reverse austerity, taxes will need to rise.

30 See Blanchard et al. (2021) for the difference between rules and standards https://academic.oup.com/economicpolicy/article-abstract/36/106/195/6122701

Progressive Economy Forum

About PEF

The Progressive Economy Forum (PEF) was founded and launched in May 2018. It brings together a Council of distinguished economists and academics to develop a progressive and sustainable macroeconomic programme and to foster wider public engagement with economics. It opposes and seeks to replace the current dominant economic narrative based on austerity.

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