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BEYOND HEADROOM

**WHY WE NEED A BETTER FISCAL
FRAMEWORK TO FIX THE UK'S
LONG-TERM PROBLEMS**

**William Ellis and
Carsten Jung**

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SUMMARY

THERE HAS BEEN LONG-STANDING DEBATE ABOUT THE UK'S FISCAL RULES AND FISCAL FRAMEWORK

Fiscal rules exist to assure markets of responsible budgeting and fiscal sustainability, and hold government to account. But over the years, UK rules have been chopped and changed multiple times, somewhat weakening markets' reliance on them. Moreover, current fiscal rules have focussed the minds of the public, politicians and markets on narrow concepts of what it means to be fiscally sustainable, usually looking at 'headroom' against whichever rule is currently in place. In this report, we go back to first principles and ask: what actually is fiscal sustainability? How should citizens and markets assess it? And what are the principles that governments should follow to achieve it?

In this report, we review a wide body of fiscal sustainability research and historic case studies. Building on these, it is clear that to achieve fiscal sustainability, governments need to look at more than just one or two medium-term indicators. Instead, policy needs to work across different time horizons – especially long-term risks and opportunities that are currently completely absent from the UK's fiscal framework. Financial markets too often take a narrow view of government's fiscal strategies. They look at only a small set of indicators (such as the deficit trajectory) which neither capture most fiscal risks nor provide enough 'signal' to distinguish between good and bad fiscal policymaking. Debt servicing costs, and long-term structural reforms – both crucial – are often not considered. Looking only at headroom against a medium-term indicator does not allow for nuanced decisions and misses trade-offs that are important for keeping public finances afloat in the long term.

THE UK IS FISCALLY UNSUSTAINABLE IN THE LONG TERM, BUT THE STATE IS NOT POWERLESS TO ADDRESS THIS

Consideration of the long-term fiscal trajectory is largely absent from the discussion of the UK's fiscal sustainability (with the exception of the Office for Budget Responsibility's fiscal risk reports). We model a number of quantitative scenarios to fill this gap.

- We find that, if unaddressed, the UK's fiscal position could deteriorate over time as long-term factors like the cost of an ageing society and climate change damages put pressure on public finances. A 'generic' investment package would not materially change this conclusion.
- But we also model a reform and investment package designed specifically to tackle these long-term pressures. Investment targeted at long-term challenges could improve fiscal sustainability as it brings additional benefits – by enduringly increasing productivity and the tax base, as well as reducing fiscal impacts of long-run pressures like climate change and health costs.
- Our modelling also suggests that whether investing for fiscal sustainability works depends more on the quality and return of the investment, than just the interest rate at which it is financed. High returns, and the 'double dividend' of higher growth and lower future costs are crucial. If there are investments that have high future returns, it is worth pursuing them in the present rather than waiting for better economic times.

A comprehensive fiscal framework should allow for such a long-term strategy and encourage governments to credibly communicate it. This, together with a limited long-term fiscal consolidation strategy, could bring the UK's finances from an unsustainable to a sustainable path.

BUT A MORE COMPREHENSIVE FRAMEWORK SHOULD ALSO COVER NEAR-TERM MARKET PRESSURES

While we argue for a more long-term approach to fiscal strategy, the current short-term market dynamics cannot be ignored. With elevated inflation, and a reduced international market for UK government debt, borrowing costs are volatile. But the level of borrowing costs is only part of the short-term picture. A more comprehensive fiscal framework would also highlight annual financing needs and the wider fickleness of the UK bond market.

In this environment, big changes in borrowing to invest could thus have adverse effects on the gilt markets, if they are not part of a clear plan with clear economic returns. We show that borrowing to invest can be key for long-term sustainability, but only when well-targeted at sources of fiscal pressure (like productivity, health or climate change), and in areas with high economic returns like R&D or industrial policy for frontier clusters. So any significant change in the borrowing pathway would need a detailed plan that demonstrates the returns to investment. And we need a fiscal framework that allows the government to communicate those benefits to markets.

This does not mean the government could not slightly increase its borrowing pathway at all. The market is still functioning, and there is a world of difference between narrow, consistent and fully costed borrowing (eg the part of the defence plan that is unfunded) and a perceived chunky, unbounded commitment to borrow more. In current conditions, the former is unlikely to move confidence or gilt yields. The latter could risk a strong market reaction.

THE GOVERNMENT SHOULD STICK TO ITS FISCAL RULES, BUT SHOULD BEGIN TO MOVE TO A MORE COMPREHENSIVE FISCAL FRAMEWORK

We thus recommend that the government sticks to its existing fiscal rules and the implied borrowing pathway. But we think it can take first steps towards a more comprehensive approach to fiscal sustainability. It should consult on this, involving leading experts, and financial market participants. The ultimate goal should be both to hold the government to account and encourage it to fix the UK's long term fiscal challenges.

We set out five recommendations for framework reform:

- 1. Establish the debt servicing ratio as a medium-term 'backstop indicator', which gets stress-tested by the Office for Budget Responsibility (OBR).** A medium-term indicator is crucial for holding governments to account and giving citizens an intuitive read of the state of public finances. Rather than the debt and deficit targets, the government should use the debt servicing ratio (DSR) – the share of government revenue spent on interest payments – as its headline backstop metric. The OBR should report stress-test scenarios for how this metric evolves. We propose an 'adjustment zone' and a 'danger zone' which should prompt action.
- 2. Alongside this, publish a dashboard of 'early warning indicators',** including existing indicators like the deficit pathway, gross financing needs, Public Sector Net Worth (PSNW), and currently neglected ones such as the impact of the fiscal strategy on growth and future costs. These metrics all matter via their ultimate influence on debt servicing costs, and no single metric tells the full

story. The debt servicing ratio should be read alongside the indicators that feed into it, while PSNW crucially captures whether the state is building or running down its asset base.

3. **Crucially, add a long-term sustainability assessment alongside it, highlighting trade-offs.** The current framework only emphasises the medium term, leaving the trade-offs involved in managing long-term sustainability opaque. A formal long-term assessment would ensure policy decisions are evaluated against their structural implications, not just their five-year cost.
4. **This should include a more thorough assessment of fiscal sustainability under uncertainty.** Fiscal plans should be stress-tested transparently against adverse and favourable scenarios as a formal part of the Budget process. A broad set of scenarios and traffic lights should be what gets discussed in the public debate around the government's fiscal strategy. The dashboard and debate around it should urge the government to outline its fiscal strategy, and the way it seeks to address risks in the short, medium and long term. Currently, such debate is stifled by a narrow focus on 'headroom' in the medium term.
5. **Governments should outline a strategy and concrete actions for how they aim to change these indicators over time.** This should range from how they will change debt structure and deficit pathways, all the way to what the focus of public investment will be. The OBR should then create scenarios for how the dashboard of risks will change over time. This information will allow financial markets and citizens to see a comprehensive picture of the difference a government is making to fiscal sustainability.

1. WHAT IS FISCAL SUSTAINABILITY – AND WHY DOES IT MATTER?

1.1 DEFINING FISCAL SUSTAINABILITY

Fiscal sustainability is the cornerstone of a stable economy, economic growth and rising living standards. The objective of sound public finances is to ensure they do not destabilise the broader economy, now or in the future.

Building on the IMF's (2016) definition, we formally define fiscal sustainability as the ability of a country – both economically and politically – to fund future spending commitments without significant disruption. This definition encompasses both solvency (can future primary surpluses cover debt payments) and liquidity (can the government roll over maturing debt without losing market access). In both cases, fiscal unsustainability can involve very painful impacts for households and businesses (Corsetti et al 2012; Guajardo, Leigh and Pescatori 2014).¹

Crucially, it asks if sustainability can be achieved with politically and economically feasible policies. Fiscal sustainability is not met if it requires economically or politically infeasible actions (such as large reductions in public service spending or extremely high productivity growth). This means the public finances need to be robust to feasible but adverse circumstances – plans are not sustainable if they are blown off-course by lower net migration or productivity. This calls for independent scrutiny of fiscal plans – as carried out by the OBR – informed by economic and political evidence and tested against a range of scenarios to determine feasibility.

Finances are also not sustainable if managed while ignoring future spending pressures: for instance, the drain on public resources from an ageing population. Leaving these challenges unaddressed could put debt interest spending on an unsustainable path, whereas borrowing to address these risks can in fact improve fiscal sustainability.

1.2 SUSTAINABILITY CAN FAIL THROUGH ACUTE CRISIS OR SLOW DECLINE

Historical evidence suggests that fiscal unsustainability manifests either in a fast, acute crisis or a slow decline (Corsetti and Maeng 2020; IMF 2024). While the former captures headlines with spiralling yields and bailouts, the latter is equally pernicious – a trap where a state remains solvent only by destroying the long-term growth required to service its debt.

¹ Academic definitions of fiscal sustainability are related. Blanchard's (2019) definition asks whether a government can stabilise debt without primary surpluses that are unreasonably large. Bohn's (1998) solvency-based definition asks whether future primary surpluses can cover today's debt. In practice, both point to the same issue: a fiscal path can look 'solvent' on paper yet still be unsustainable if it relies on politically or economically infeasible surpluses at very high debt levels.

An acute crisis is characterised by a sudden unravelling of market confidence, often as the credibility of institutions surrounding debt is eroded

Greece serves as the archetypal warning. Greece's debt servicing ratio surged dramatically during its fiscal crisis in 2009, crowding out public spending and translating directly into hardship for ordinary people. While its debt was high upon Eurozone entry, the crisis was deepened by a failure in credibility. The initially projected deficit of 3.7 per cent in 2009 (Hellenic Republic Ministry of Economy and Finance 2007) was eventually revised to 15.4 per cent of GDP (BBC 2010) – largely due to the global financial crisis but exacerbated by revisions to borrowing statistics and creative accounting. Fiscal credibility was shattered and borrowing costs spiked, and the lack of a domestic central bank to act as a lender of last resort forced a 'sudden stop' in financing. The subsequent attempt to regain solvency through crushing austerity created a 'doom loop' and deepened the crisis it was intended to solve. The prescribed consolidation was unrealistic (IMF 2016), and growth-hampering adjustment deepened the recession (Thomsen 2019). Real GDP per capita fell by nearly a quarter and debt ratios rose to more than 180 per cent of GDP despite massive spending cuts (Gourinchas, Philippon and Vayanos 2016).

The consequences for households and businesses were devastating. Unemployment rocketed from around 10 per cent in 2009 to around 25 per cent by 2012, with youth unemployment reaching 49.8 per cent (Stylianidis et al 2019; Eurostat 2017). Extreme poverty surged from 2.2 per cent of the population in 2009 to 17.1 per cent by 2013, while household incomes fell by roughly one-third (Borgen Project 2018; Hellenic Statistical Authority 2015).

The level of debt can exacerbate crisis but is often a poor predictor on its own. Argentina's acute collapse in 2001 occurred with a debt-to-GDP ratio of just 48 per cent (IMF 2025) – a level many advanced economies would envy, and far below Greece's above 100 per cent on Eurozone entry (Arghyrou and Tsoukalas 2010). Fragility lay in the composition of that debt. Overly optimistic growth forecasts created complacency about rising debt, and again creative accounting through off-budget expenditures masked the extent of fiscal liabilities (IMF 2003). Since debt was denominated in US dollars, currency movements saw the debt ratio triple to 147 per cent almost overnight (IMF 2025c). Fiscal sustainability is determined as much by the structure of debt – currency denomination, maturity and ownership – as by its size.

Slow decline describes a state where high debt servicing costs force a government into painful fiscal consolidation that suppresses growth.

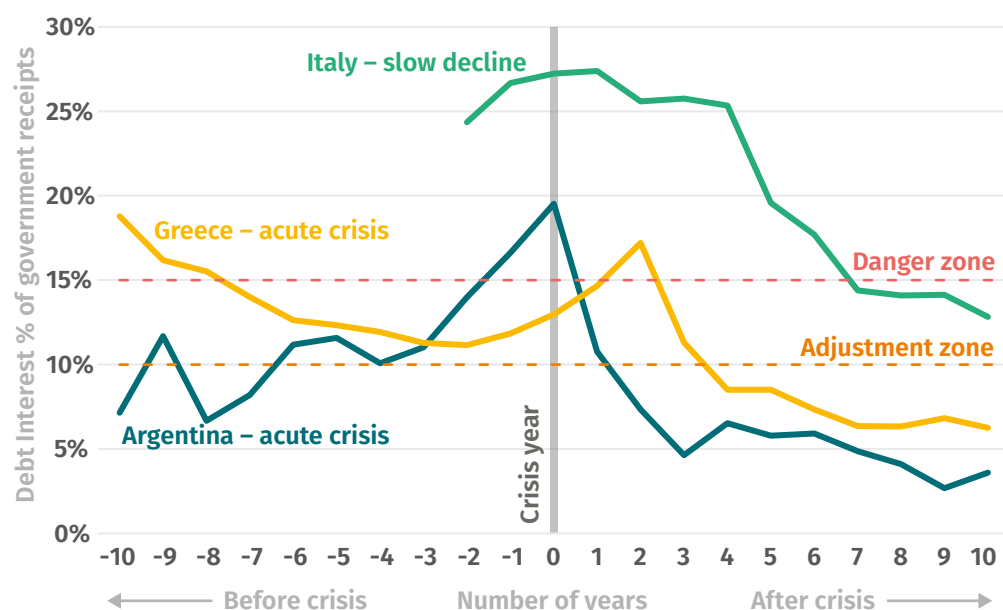
Post-1990 Italy epitomises the 'slow decline' scenario, where high debt servicing costs do not lead to a full-blown crisis, but crowd out growth, investment and public service spending and thus depress the economy. Italy's interest payments consumed a very large share of revenue through the 1990s – at its peak, more than 20 per cent of government receipts went to servicing debt (figure 1.1). This is well within what we call the 'danger zone' (more on this below).

Italy ran primary surpluses (revenues exceeding non-interest spending) almost every year since 1990 (IMF 2025c), yet the debt ratio remains stubbornly high at approximately 137 per cent of GDP (IMF 2025c). The cause is a long but vicious cycle: low growth and high debt servicing costs led to cuts in public investment and fiscal consolidation, which in turn has depressed productivity and growth (Balassone et al 2012). Italy's GDP has only grown by around 20 per cent since 1990 – the weakest performance in Europe – and is the only EU member state where wages fell between 1990 and 2020 (Secchi 2025).

Figure 1.1 below plots both Greece and Argentina's acute crises and Italy's slow decline. It demonstrates the prominence of the debt servicing ratio under each crisis – characterised by the government spending over 15 per cent of receipts on servicing debt.

FIGURE 1.1: THE DEBT SERVICING RATIO INCREASES SHARPLY IN BOTH TYPES OF CRISES, AND REMAINS ELEVATED DURING A SLOW DECLINE

Debt interest as a percentage of government revenue (left), ten years before and after fiscal crises in Italy, Greece and Argentina



Note: Italy crisis period=1992, Greece=2009, Argentina=2001

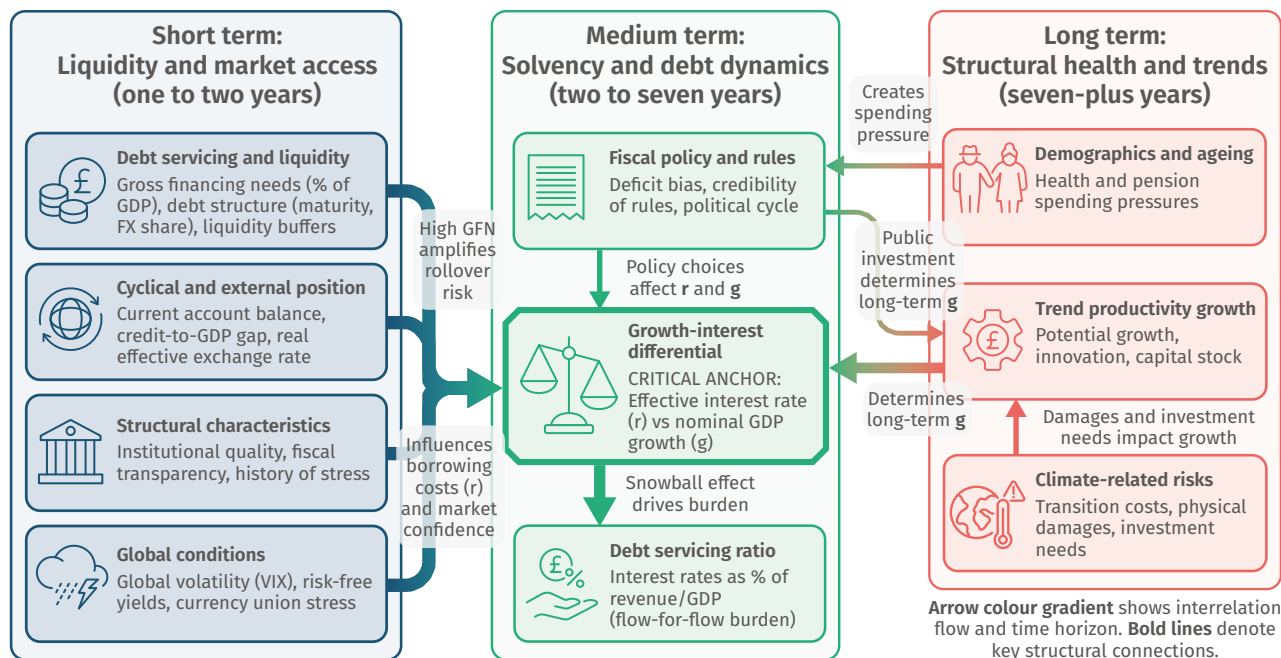
Source: IMF Fiscal Monitor Datamapper (IMF 2026b, 2026c)

1.3 TO GUARD AGAINST BOTH, A MULTI-HORIZON VIEW OF SUSTAINABILITY IS NEEDED

What matters for fiscal sustainability in a market wobble is different from what matters over a parliamentary term, and different again from what matters over decades. In line with the latest thinking from the IMF (2022), the European Commission's multi-horizon S0/S1/S2 framework (European Commission 2025), and the European Central Bank's (ECB) early-warning indicator work (ECB 2014), a complete assessment therefore needs to look across all three horizons. Figure 1.2 summarises the key indicators, interactions and pressures between short, medium and long-term risks.

FIGURE 1.2: DETERMINANTS OF FISCAL SUSTAINABILITY IN THE SHORT, MEDIUM AND LONG TERM ARE INTERRELATED BUT DISTINCT

Interrelated drivers across time horizons



Source: Author illustration

In the short term (one to two years), fiscal sustainability is about the ability to refinance debt and respond to shocks

The key risk is a ‘liquidity event’ – meaning the government struggles to access markets to cover its borrowing needs, for example because borrowing costs have spiked (or in an extreme case markets become unwilling to lend at all), forcing abrupt fiscal or monetary responses. Market confidence, quality of institutions and the share of debt that is short term or otherwise risky are most important. The 2022 gilt sell-off shows how quickly yields can jump when a credibility shock collides with fragile market structure, and how decisively effective institutions – like the Bank of England and Debt Management Office – must act in response.²

Empirical work underpinning the IMF’s Sovereign Risk and Debt Sustainability Framework (SRDSF) and post-crisis literature identifies three distinct sets of indicators that determine this risk (IMF 2022; De Grauwe and Ji 2013; ECB 2014).

1. Liquidity and short-term buffers

A government’s risk level depends heavily on its Gross Financing Needs (GFN) – the total amount it must borrow each year to cover both new spending and old debt. When this number is high, the government is more at the mercy of financial markets and vulnerable if investors become reluctant to lend (EC 2024).

The specific debt structure also matters; if a country owes money in foreign currencies, has very short repayment periods, or has debt linked to inflation, costs can spiral quickly if conditions change (Arghyrou and Tsoukalas 2010). On the other hand, governments that keep healthy liquidity buffers (cash reserves) can survive market panic without being forced into emergency spending cuts (IMF 2022; ESM 2024).

² The Bank of England is found to have acted decisively and to reduce market stress in this incident (Bank of England, IMF).

2. Exposure to global conditions and the economic cycle

Even the best domestic policies can be wrecked by external shocks or downturn. If global interest rates jump, countries that rely on international capital may face a ‘sudden stop’, where investors pull their money out overnight, leaving the government struggling to cover its obligations (Edwards 2007; Forbes and Warnock 2011). This risk is highest during a downward economic cycle, when tax revenues fall and welfare costs rise, or during a financial cycle where a banking crisis spills over into government debt.

Market volatility and sentiment also play a huge role; if investors get nervous, they may sell off the currency or demand higher interest rates. A country is generally safer if its external debt position is low – meaning debt is owned by local banks and pension funds rather than foreign investors – and if it avoids borrowing in foreign currencies, which can become much more expensive if the local exchange rate falls.

3. Institutional quality and credibility

The strength of a country’s laws and institutions determines whether markets stay calm during a crisis or react defensively. If a government provides transparent and reliable data, investors are more likely to trust the system; if statistics are unreliable, however, borrowing costs tend to rise. A country’s history of stress also matters, as those who have defaulted or needed bailouts in the past are often viewed as higher risk. Generally, high institutional quality gives a government the capacity to react quickly to fiscal pressure (IMF 2022).

Finally, specific institutional characteristics play a role; for example, membership in a currency union can be a double-edged sword. It offers stability but removes the exchange rate as a flexible shock absorber, which can leave countries vulnerable to contagion and forced spending cuts during a recession (Carney 2014).

Medium-term sustainability (two to seven years) is dictated by policy choices and the economic cycle

Here the question is how fiscal policy cumulates. A high degree of borrowing for two years over a crisis might not be a problem, but consistently high deficits and fast rising debt store up trouble for the future. This is where forecasts for the deficit, growth and the interest rate environment become crucial, as well as the spending decisions made by a government. Fiscal rules are often aimed at influencing such medium-term decisions, intended to avoid excess borrowing in ‘good times’ while allowing for Keynesian stimulus in bad times.³

The core dynamics: r vs g

The single most important determinant of debt dynamics is the differential between the effective interest rate on government debt (r) and nominal GDP growth (g).

- **When $r < g$ (the growth rate is bigger than debt interest rate):** Debt ratios can decline over time even with small deficits.
- **When $r > g$ (debt interest rate is bigger than growth):** Stabilising debt requires sustained primary surpluses (Blanchard 2019).

This dynamic is dangerous because of what economists call the ‘snowball effect.’ If the interest rate on a country’s debt is higher than its economic growth rate, then even if the government does not borrow another penny, the debt burden grows automatically – over decades this compounds, making the debt increasingly difficult to manage.

3 One prominent theory in political science suggests that governments can have an in-built ‘deficit bias’: the incentive to borrow and spend as much as possible to win votes. Conversely, in periods of crisis, governments can be forced to engage in excessive austerity – as the UK did in the 2010s – to the detriment of future growth and sustainability (Potrafke 2023; Mian, Straub and Sufi 2025).

In addition to the all-important $r-g$, there are three sets of measures that matter in the medium term.

1. **Stock balance sheet metrics.** Debt-to-GDP is the most used measure, but an incomplete one. There is no universal debt level that triggers a crisis – Japan sustains debt above 200 per cent of GDP while Argentina faced crises below 50 per cent. The total stock of debt matters because it directly affects the cost of servicing it, but on its own it does not tell us whether debt is affordable. Other key stock metrics include Public Sector Net Worth and Public Sector Net Financial Liabilities – both capture a wider set of assets and liabilities.
2. **Debt servicing ratio (interest as a share of revenue).** Arguably the most important medium-term indicator. It measures how much of the government's income goes to paying interest on its debt. Unlike debt-to-GDP, it directly captures whether debt is affordable by comparing spending on interest to the revenue available to pay it. If borrowing is cheap, this ratio stays manageable even as headline debt rises.
3. **Gross financing needs (GFN):** GFN is useful in the short term but less informative over longer periods, since a government can artificially lower medium-term GFN by issuing long-term debt, or spike it by issuing short-term debt (Damsinghe 2023). Therefore, without constant maturity assumptions, medium-term GFN is difficult to interpret compared to the debt servicing ratio.

Over the long term (more than seven years), fiscal sustainability is determined by structural characteristics and slow-moving pressures

Over future decades, sustainability hinges on slow-moving drivers such as ageing-related spending (health, pensions and long-term care), trend productivity growth, and the fiscal implications of climate change. Failure to act today can move debt from manageable to explosive in the long term.

A full assessment of a country's fiscal sustainability – and its strategy to fix it – should thus cover:

- **The cost of ageing:** Ageing populations put pressure on pension, health and long-term care spending, deteriorating fiscal balances across advanced economies (OECD 2025; OBR 2025). Often summarised by the dependency ratio, representing the number of individuals aged 65 or older (who are a net fiscal drain) per 100 people of working age (who are a net fiscal positive). This is in turn driven by projections on the fertility rate and net migration – but individual characteristics like the extent of public healthcare provision, typical profile of migrants and nature of public pensions contribute significantly to the actual cost of this pressure.
- **Health and long-term inactivity:** The UK is currently grappling with health-related economic inactivity that structurally degrades the tax base and means less income tax is raised. Working-age inactivity remains persistently above pre-pandemic levels driven almost entirely by long-term sickness (OBR 2025), and the disability caseload has risen sharply. Without intervention, health spending is likely to increase from 8.3 per cent to 13.5 per cent of GDP by the mid-2070s (OBR 2026b).
- **Trend productivity growth:** Structurally low productivity suppresses growth relative to interest rates. The OBR estimates that a 1 per cent drop in productivity growth could add approximately 350 per cent of GDP to debt by 2073 (OBR 2025).
- **Climate change mitigation and its environmental damages:** Fiscal risks arise from both the physical damage of climate change (such as through flood damage) and the significant investment requirements for the net zero transition (EC 2024). The extent of these risks also depends on the global climate warming scenario into the future – and these costs should be projected with a range of scenarios to reflect this.

2. TOWARDS A NEW FRAMEWORK FOR FISCAL SUSTAINABILITY

2.1 FISCAL SUSTAINABILITY SHOULD BE CAPTURED BY A WIDE RANGE OF METRICS BUT ENFORCED THROUGH A BINDING BACKSTOP

Particularly since the introduction of fiscal rules, there has been a desire among academics and policymakers to identify a single metric that captures fiscal sustainability – or at the very least, single metrics have ended up dominating the public debate.

No single metric can predict or determine fiscal sustainability. Instead, countries should closely monitor and manage a basket of metrics across different time horizons. This conclusion is supported by both the IMF and the Institute for Fiscal Studies (Zaranko 2026), who arrive at similar positions through independent analysis. The IMF has moved on from past work that mainly focussed on the debt ratio, towards a much more multi-indicator framework, not dissimilar to the one we are recommending. Its country-specific reports include qualitative analysis alongside quantitative metrics, which we summarise in the next chapter.

Alongside a basket of metrics there needs to be a backstop metric which gives an intuitive sense of where fiscal sustainability is right now, and where it could go under a stress scenario. The debt level does not do this, as the examples above (like Japan) show.

We recommend using the debt servicing ratio (as a share of tax revenues) as this backstop. It is shaped by short, medium and long-term early warning indicators on the dashboard discussed below. Market conditions, policy choices, interest rates, growth and structural factors all feed into how much of government revenue is consumed by interest payments.

The debt servicing ratio should thus be seen as the key outcome variable. When fiscal sustainability fails, put bluntly, it is high interest payments that force a crisis. Debt servicing costs are also an intuitive metric for the public to understand, indicating how much of their tax payment is paid as interest to investors and is thus not used for productive or socially useful purposes (Jung 2024).

BOX 2.1: DEFINITION – DEBT SERVICING RATIO (DSR)

The most useful metric to capture fiscal sustainability across horizons is **government interest payments as a percentage of government receipts in each period.**

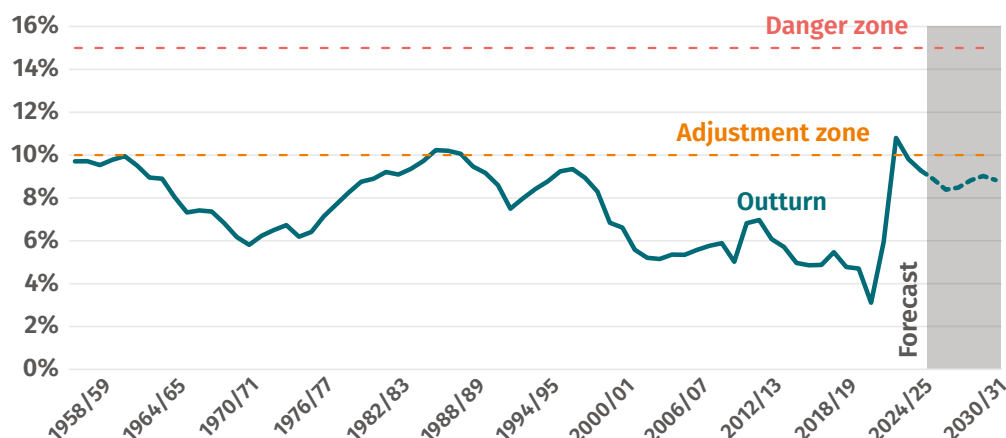
We define two sustainability thresholds for the debt servicing ratio (Jung 2024). These are not hard rules, but they reflect one economic reality: the higher the debt servicing ratio, the less resources the state has to operate. Based on historical experiences, we define the risk of this value going too high via two thresholds:

- The **adjustment zone** (debt servicing ratio above 10 per cent) follows Hughes et al (Resolution Foundation 2019), who note that a ratio at or above this level is considered ‘towards the weaker end’ of S&P’s sovereign creditworthiness scale. A DSR persistently above this level is typically associated with ratings downgrades and consolidation pressure, though not a hard trigger for crisis. It should thus spark concern and lead to policy adjustment that over time brings this metric down.
- The **danger zone** (debt servicing ratio above 15 per cent) represents a further escalation where debt service crowds out a material share of spending and sharp fiscal adjustment becomes increasingly unavoidable absent a significant improvement in economic conditions. The USA is currently in such a position (figure 3.1).

The debt servicing ratio backstop should not be a rigid rule in the traditional sense. It is intended to ensure sustainability under a range of plausible scenarios, not just one central projection. The UK’s long average debt maturity (about 14 years) means that poor fiscal decisions can take years to feed through to the debt servicing ratio – which is precisely why monitoring the deficit, gross financing needs, and the $r-g$ differential alongside it is essential. For example, a practical enforcement mechanism could require that no Budget brings the projected date of ‘danger zone’ entry forwards, even under adverse scenarios. This preserves enforceability within a parliamentary term while anchoring decisions to the long-term sustainability outlook. The precise calibration of such mechanisms is a task for subsequent work; this paper establishes the analytical case for the approach.

FIGURE 2.1: THE UK'S DEBT SERVICING RATIO CURRENTLY SITS AT AROUND 9 PER CENT, HAVING RARELY ENTERED THE ADJUSTMENT ZONE OVER THE PAST 70 YEARS

Debt interest in the UK as a percentage of government revenue (left), 1956/57–2030/31



Source: OBR 2026

Figure 2.1 shows the UK's debt servicing ratio currently sits at around 8.9 per cent of government receipts, and the OBR projects it will peak at approximately 9 per cent in 2029/30 before easing slightly (OBR 2026). This is still a very different position from the crisis countries examined in figure 1.1 – with a DSR surging past 15–20 per cent. The UK is not in that territory and is unlikely to be in the medium term.

2.2 HOW THIS FRAMEWORK COULD OPERATE IN PRACTICE

The most important indicators for sustainability depend on the economic context, source of pressure and an individual country's characteristics. While the debt servicing ratio represents the ultimate constraint on spending, responsible policymaking still needs to consider how risks can lead to high debt servicing costs.

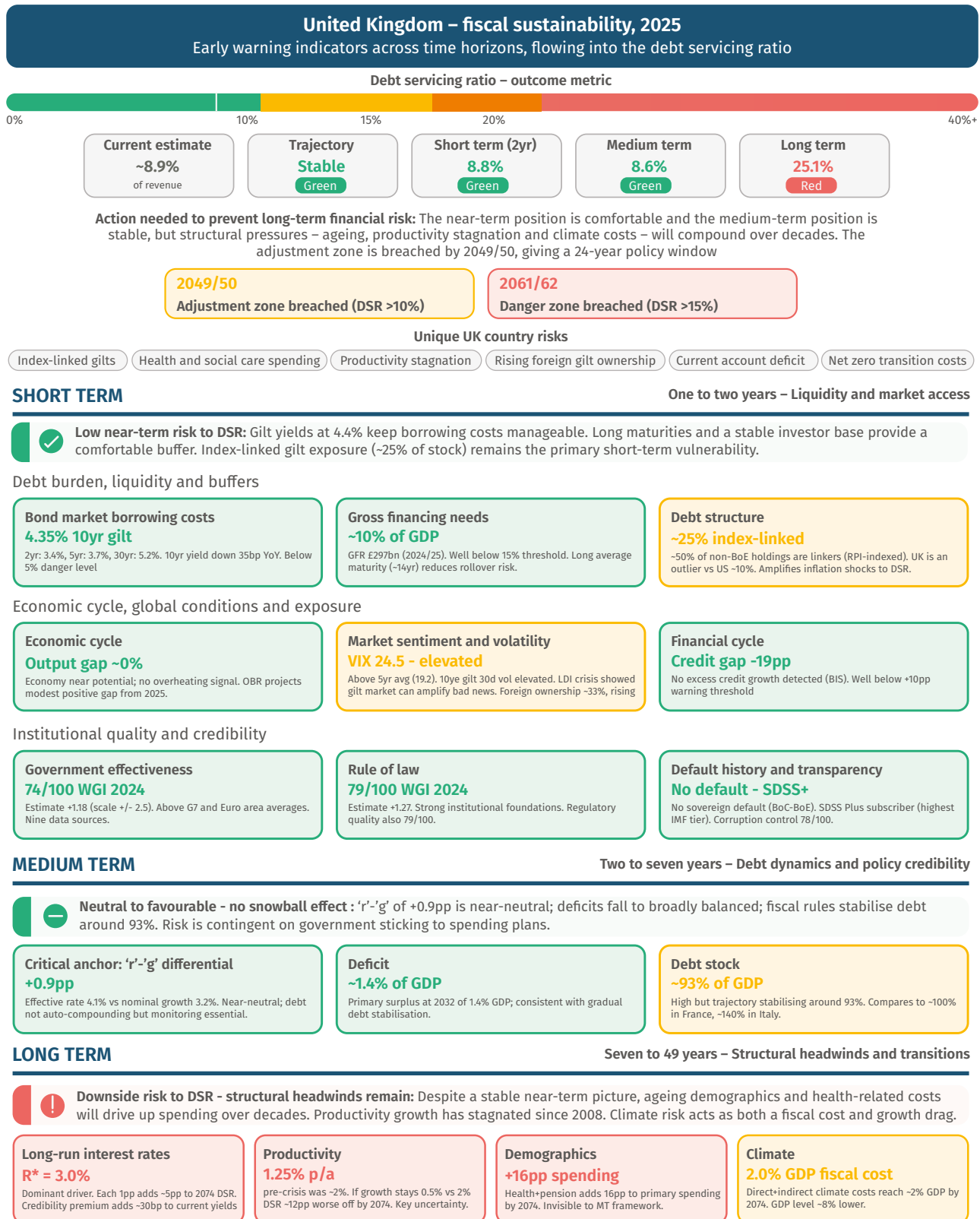
A framework that watches only the DSR would be watching an outcome without monitoring the drivers. Conversely, a framework that watches only individual risk indicators – bond spreads, the deficit, demographic projections – would track pieces of the puzzle without an overarching measure of whether they are adding up to a problem. The approach we recommend is to both monitor the upstream early warning indicators set out in this section and use the debt servicing ratio as a summary 'backstop' that tells you whether the underlying pressures are, taken together, on a sustainable path.

Figure 2.2 shows a mock-up of what such a dashboard could look like for the UK. The dashboard splits indicators into the short-term (one to two years, capturing liquidity and market access), medium-term (two to seven years, capturing debt dynamics and policy credibility), and long-term (seven to 49 years, capturing structural headwinds and transitions). Each indicator is assigned a traffic-light signal based on its contribution to fiscal risk. At the top, the DSR itself is shown as the outcome metric, with its trajectory under each scenario and the projected year at which the 'adjustment zone' (DSR above 10 per cent) and 'danger zone' (DSR above 15 per cent) are breached.

These dashboards are illustrative and should not be treated as precise forecasts. The purpose here is to demonstrate how such a framework could work in practice, not to produce a definitive risk assessment. The final calibration of indicators, thresholds and risk classifications is a task for subsequent work and should be informed by careful cross-country and historical analysis.

FIGURE 2.2: A MORE COMPLETE FISCAL DASHBOARD WOULD ALLOW FOR BETTER DECISION MAKING

Illustrative mock-up of a fiscal sustainability dashboard for the UK



Source: Author illustration

This would allow for better fiscal decision-making. Consider a government wants to address the rising cost of health and social care driven by ageing. Under the current framework, investment in preventive health or social care infrastructure worsens the headline debt metric in the short term, even if it reduces spending pressures over the following decades. The result is a bias against precisely the kinds of forward-looking policy that the UK's long-term fiscal position demands.

Under a dashboard framework, the same decision could be assessed differently. The short-term indicators would register the additional borrowing – gross financing needs would rise, and the deficit would widen modestly. But the long-term indicators would also reflect the reduced trajectory of age-related spending, a slower path towards the adjustment and danger zones, and potentially an improved DSR at the 2074 horizon. Crucially, the government could present this as a deliberate trade-off – accepting a small, transparent cost today in exchange for a measurably better long-term fiscal position – rather than as a breach of a rigid rule.

The dashboard makes the full picture visible, reducing the risk that governments face disorderly market reactions to fiscally sound policies that move a single headline number unfavourably. Bond markets, credit rating agencies and fiscal commentators would have access to the same assessment, making it harder for any one metric to be taken out of context.

This is not a licence for fiscal profligacy. The DSR backstop remains in place as the ultimate constraint: no Budget should bring the projected date of 'danger zone' entry forwards, even under adverse scenarios. The early warning indicators should incentivise near-term discipline and highlight trade-offs across time horizons. A government borrowing to invest in climate resilience, for example, would see the short-term indicators flash amber while the long-term climate and DSR indicators improved – a coherent and defensible policy position. A government borrowing simply to fund current consumption would see short-term indicators deteriorate with no offsetting improvement anywhere else on the dashboard – an incoherent position that would be immediately visible.

BOX 2.2: BOND MARKETS ARE IMPORTANT, BUT CURRENTLY TOO FOCUSED ON NARROW MEDIUM-TERM METRICS

Bond markets matter because they determine the rate at which governments borrow. When investors are confident, borrowing costs stay low, and vice versa. Sustainability can be maintained without persistent surpluses where the interest rate paid on debt remains below the economy's growth rate, ie where ' r ' is lower than ' g ' (Blanchard 2019).

But market pricing is an imperfect guide to fiscal health because markets' focus is often narrow. Government bond yields reflect more than solvency risk: they are also shaped by central-bank purchases, regulation, global risk appetite, and structural demand from pension funds and insurers seeking long-duration assets (Krishnamurthy and Vissing-Jorgensen 2012; Greenwood and Vayanos 2014; IMF 2022). Markets can therefore under-price risk for long periods and then overshoot abruptly in periods of stress.

Recent history shows both problems. Before the euro-area crisis, Greek and German bonds traded at similar yields despite very different fiscal positions. In Japan, decades of financial repression and large-scale sovereign bond purchases have kept yields compressed despite very high debt (Hall and Sargent 2022; Chien et al 2025).

The UK and other advanced economies illustrate the same tension. The OBR projects that, on unchanged policies, public debt could rise well above 200 per cent of GDP by the 2070s, yet investors still buy 50-year gilts at yields that do not fully reflect that path. The most likely explanation is that markets expect future governments to adjust policy through tax rises, spending restraint or fiscal drag, rather than that they are validating the sustainability of the current fiscal stance.

Governments should therefore not treat benign bond market pricing as proof that the long-term fiscal position is sound. Neither should a short-term bond market wobble be seen as a judgement on long-term sustainability. A comprehensive fiscal framework, combined with a credible fiscal strategy, are a safer guide to sustainability than the moods of the market.

3.

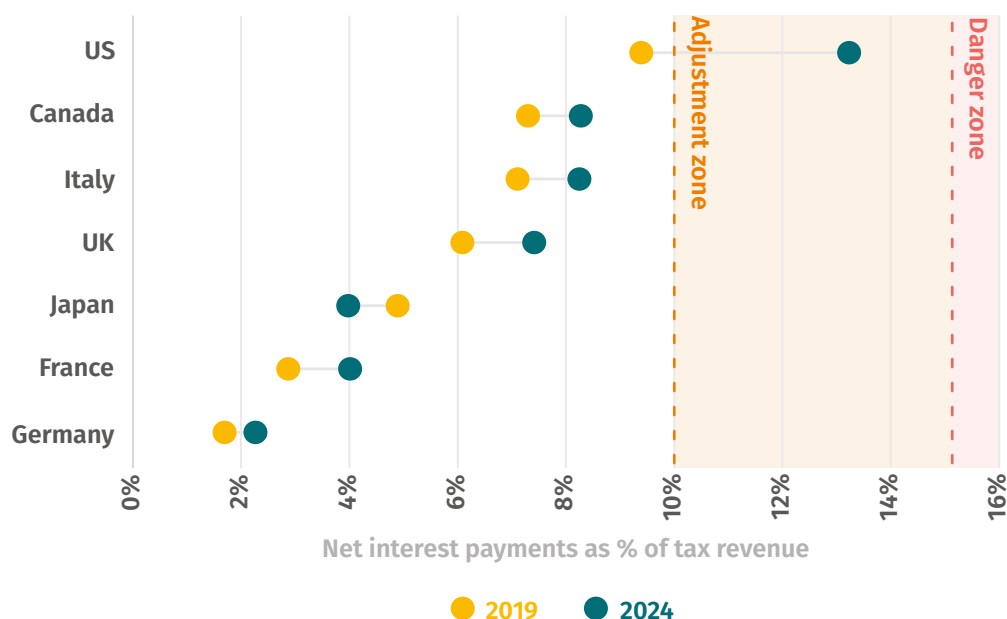
COMPARING THE UK TO OTHER COUNTRIES

The previous section set out how fiscal sustainability can be assessed across different time horizons, drawing on a wide range of indicators. In this section, we apply that framework to the UK and seven comparator economies – France, Germany, the United States, Japan, Canada, Italy and China – using the IMF’s most recent Article IV consultations as our primary evidence base. The aim is to move towards a multi-horizon view of relative fiscal positions, as introduced in the previous section.

3.1 AN OVERVIEW OF FISCAL SUSTAINABILITY ACROSS ADVANCED ECONOMIES

FIGURE 3.1: DEBT SERVICING RATIOS ACROSS THE G7 FOR THE LARGE PART REMAIN BELOW THE ADJUSTMENT ZONE – AND THE UK IS MIDDLE-OF-THE-PACK

Debt interest in the G7 as a percentage of government revenue 2019–2024



Source: IMF Fiscal Monitor Datamapper (IMF 2026b, 2026c)

Figure 3.1 compares G7 debt servicing ratios (DSRs) from 2019 to 2024. Every country apart from the US currently sits below the adjustment zone. Japan also stands out as the only country that has actually reduced its DSR – now the second lowest in the G7 – despite having the most debt. Japan is able to maintain this due to exceptionally cheap borrowing following from artificially low interest rates. But this is only a snapshot of fiscal sustainability. A country’s future DSR depends heavily on its growth and deficits in the short-medium and long-term, represented by the full range of indicators presented in the previous section.

In table 3.1, we draw on the IMF's latest Article IV assessment to review how countries' debt servicing ratios might change over time – improving or worsening sustainability. This builds on the set of indicators described in section 2 to give a more complete view of the risks to fiscal sustainability for each country across the short, medium and long term. The cell colour indicates the level of risk, and accompanying notes explain this level of risk at each horizon.

TABLE 3.1: FISCAL SUSTAINABILITY RISK ACROSS TIME HORIZONS (CONTENT AND RISK COLOUR CODING IS DIRECTLY BASED ON IMF ARTICLE IV CONSULTATIONS)

Country	Short-term (1–2 years)	Medium-term (2–7 years)	Long-term (7+ years)
UK	UK has strong market access, but gilt-market intermediation and rollover resilience need watching under stress	Medium-term sustainability depends on spending plans being delivered. Headroom is tight, and these plans are sensitive to shocks	Larger ageing and health pressures compared to others, needing structural reform
France	Market access is solid under the ECB, but short-term refinancing needs are very large	Vulnerable due to very high debt and refinancing needs. Important to keep consolidation credible	Significant ageing, health and pensions pressures that may need structural reform
Germany	Germany has lower debt and stronger funding position compared to peers.	Hinges on policy mix and fiscal rules; quality of investment matters	Ageing, defence and green transition needs; productivity constraints
US	Reserve currency status of the dollar allows the US to absorb very large financing needs. Political brinkmanship over budget is largest concern	A credible adjustment is needed to stop rising debt path pushing up the interest bill and increasing rollover risk	Entitlements (social security) and healthcare (Medicare, Medicaid) are key long-term drivers, and worsen without reform
Japan	Near-term stress is low. Japan has a stable domestic investor base and debt is issued at long maturity	Japan has extremely high debt and is sensitive to changes in rates. A consolidation plan is needed as monetary policy normalises	Japan has a rapidly aging society, with long-term care and a rising interest bill pushing debt up
Canada	Canada has high credibility and large financial assets, that support its short-term market access	Manageable, IMF encourage Canada to have a better fiscal rule/anchor, and steady consolidation plan	Ageing and labour-supply pressures are material over decades, but containable
Italy	Large refinancing needs leave it exposed to swings in sentiment	High debt demands sustained primary surpluses; sensitive to r–g dynamics	Ageing and weak productivity make debt reduction a slow grind
China (augmented)	Short-term financing is supported domestically, but pressure point is local government financing rollover (LGFV)	Augmented debt keeps rising without consolidation; needs LGFV restructuring and framework reform	Ageing, growth slowing from rapid levels, and high contingent liabilities (off balance-sheet)

Note: Cell colour indicates assessed risk level. These are direct reflections of the IMF risk rating.

Low risk	Low-moderate risk	Moderate risk	High risk
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Source: Author assessment drawing on IMF Article IV consultations (2024–2025) and supporting literature

3.2 HOW THE UK COMPARES IN THE SHORT, MEDIUM AND LONG TERM

Short-term refinancing risks are generally manageable across the G7, but specific pressures differ by country. Some countries, like France and Italy, suffer because they have a large stock of debt making them sensitive to a shift in market sentiment – the interest payment is larger on a higher amount of debt, and so changes in that interest rate matter more. The US benefits from strong demand and steady for its debt, since the dollar retains a unique reserve currency status. However, issuance is vast, and the recurring political standoffs over the debt ceiling creates instability that other countries don't have to contend with. Germany, Japan and Canada have the least to worry about in the near term. Germany has low debt, Canada has enough credibility and fiscal room, and Japan benefits from very unique circumstances (box 3.4).

BOX 3.1: THE UK'S SHORT-TERM POSITION

The UK occupies a middle position in the short term. The IMF's main concern is regarding potential bond market risks. The IMF flags that a combination of factors could cause UK borrowing costs to spike and, over some time, send the UK's debt servicing ratio soaring. The market disruption in 2022 demonstrated that the gilt market can amplify bad economic news. If these are short-lived it should not have a significant impact. But if high refinancing costs last for, say two years, this can become a lasting problem.

However, currency risk is low because almost all debt is in pounds (sterling), avoiding exchange rate shocks that often hit emerging markets. While foreign ownership of UK debt has risen to about one third – up from 28 per cent in 2019 – making the UK more sensitive to global investor moods, this is still much lower than the levels that typically trigger a crisis (DMO 2025). The UK's strong institutions score higher than the G7 and Euro Area averages, and a clean record of never defaulting provides a vital layer of market trust (IMF 2025).

Average borrowing needs (GFN) are at 10.6 per cent of GDP in 2030/31 – significant, but a lower level than seen in France or Italy. The UK takes a long time to pay back its debt on average, so there is less immediate pressure to 'roll over' or refinance loans (IMF 2025b; HMT 2025). A quarter of UK debt is index-linked (linked to inflation), which means the UK is more sensitive to price spikes than most other countries.

In the medium term, the picture separates. Germany and Canada are comfortable, with low debt in the former, and strong financial assets owned by the latter which provides insurance. Apart from the UK, all other countries in the G7 are rated high-risk. The US has issues with a climbing debt and interest bill without a strong reduction plan, whereas France and Italy need large consolidations to refinance debt and keep it table in the medium term. China has specific issues with lending from local government financing vehicles (LGFVs), which is set to rise sharply without structural reform.

BOX 3.2: THE UK'S MEDIUM-TERM POSITION

The UK's medium-term position is not critical but is constrained. The UK's risk is classed as moderate by the IMF, with little margin for error. Debt only stays table if spending plans are delivered as planned, and those plans are particularly sensitive to changes in data. Lower growth than expected, or sharp interest rate shocks have the ability to eliminate the UK's headroom and put pressure on spending plans.

While the UK has challenges from lower growth and higher interest rates, debt is expected to fall from its comparatively elevated level. Interest rates are expected to stay roughly 0.8 per cent above growth by 2029 ($r-g$), putting the UK in a tougher spot than Germany or Canada, but in better shape than Italy. Debt interest is set to peak at 9 per cent of revenue in 2029/30 before slightly easing (OBR 2026). While UK debt levels remain historically high, both gross and net debt are projected to fall after 2028/29. This contrasts with the US and France, where debt continues to climb, and Italy, which must maintain much higher budget surpluses than the UK to keep its debt stable.

All G7 countries face long-term fiscal risks, driven almost entirely by ageing populations. Whilst this is a common problem for advanced economies, the severity varies depending on how the economy is geared to support an aging population. The UK, US, France, Italy, Japan and China all carry a 'high' long-term risk rating, due to the rising cost of pensions, health care and social care as their societies age. This spending will require reform.

BOX 3.3: THE UK'S LONG-TERM POSITION

The UK stands out in the IMF's analysis for having an unusually large projected rise in spending-to-GDP by 2050 relative to peer advanced European economies, driven by health and pension costs. Germany and Canada face more moderate long-term pressures, though both confront ageing alongside other structural spending needs – defence and the green transition in Germany's case, and labour supply constraints for Canada.

The UK's old age problem is not unique, but the pension and health costs of that problem are outsized. The UK's old age dependency ratio is expected to increase, though not by as much as in Japan or Italy, partly due to higher net migration and birth rates (OBR 2019). However, health spending is projected to rise to 13.5 per cent of GDP by the mid-2070s, driven not only by demographics but also by rising chronic disease and health technology costs (OBR 2026b). Climate change adds materially for the UK as with other countries – under a below-3°C warming scenario, UK GDP would be approximately 8 per cent lower by the 2070s, and the fiscal cost of unmitigated climate damage is roughly six times greater than the cost of the transition (OBR 2025; Carbon Brief 2025).

BOX 3.4: JAPAN SHOWS THAT THE DEBT RATIO ALONE SAYS LITTLE ABOUT FISCAL SUSTAINABILITY

Japan's experience cannot be replicated – and highlights shortcomings with headline debt-to-GDP ratios and the conditionality of sustainability.

Japan's gross public debt at 230 per cent of GDP (IMF 2026) would suggest near-certain crisis under conventional frameworks (OECD 2013). Yet borrowing costs remain low, and Japan's overall risk is assessed as merely 'moderate' (IMF 2024). Commentators often point to Japan as an example of a country that can service high levels of debt while remaining sustainable.

However, this experience cannot be replicated in the UK or elsewhere, as the Japanese fiscal authority benefits from three factors:

1. Japan has a remarkably stable investor base. Approximately 88 per cent of Japanese government bonds (JGBs) are held domestically (BoJ 2024). In contrast, overseas investors hold roughly one third of UK gilts.
2. Japan has a stronger net asset position – and invests internationally. Japan is a net lender to the rest of the world and runs a persistent current account surplus. Once assets are consolidated, Japan's net public liabilities are roughly 78 per cent of GDP (St Louis Fed 2025) rather than 230 per cent. The UK, conversely, runs a current account deficit.
3. Japan has experienced near-zero inflation for most of the past 30 years and accordingly very low interest rates (Chien et al 2025). This has led to some of the lowest debt servicing costs in the G7 (figure 3.1). However, the high debt level leaves Japan highly exposed in case interest rates rise. The recent rise in inflation means that this indeed could happen.

Japan's fiscal sustainability has been conditional on economic and structural factors – which may be ending. The Bank of Japan is raising interest rates with the return of inflation. Japan's large stock of debt means that even small rises in interest rates cause a large increase in costs. Debt will also need to attract more demand from other domestic institutions and, potentially, foreign investors – eroding one of Japan's key structural advantages (IMF 2025, Fitch 2026).

4. LONG-TERM FISCAL SUSTAINABILITY SCENARIOS IN THE UK

In the previous sections we identified that a holistic, multi-horizon view of fiscal sustainability should look across a wide range of indicators – and that the UK is largely resilient in the short term due to strong institutions and the right trajectory for fiscal plans. In this section, we consider scenarios for the most under-studied aspect of fiscal sustainability: the long run. In the long term the UK is much more at risk to be fiscally unsustainable, but we show that actions taken today can prevent this risk.

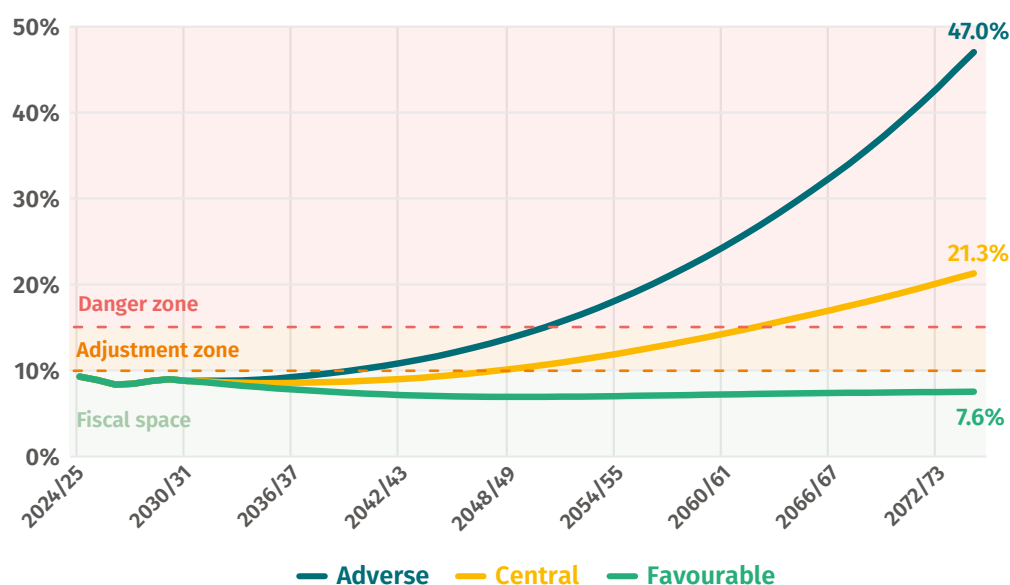
Throughout, as we set out in section 2.1, the debt servicing ratio is our preferred outcome metric. It is the measure where underlying fiscal pressures ultimately show up – which is why we advocate it as the headline backstop for governments, and why we focus our scenario analysis on it here. In this section, we apply scenario analysis to show actions that could be taken today to improve long-term resilience and highlight the trade-offs between sustainability at different horizons.

4.1 OUR APPROACH AND HEADLINE FINDINGS

We build a scenario model that extends the OBR's existing fiscal projections across five key drivers of long-term fiscal sustainability. By varying assumptions across these drivers, we generate a range of plausible futures for the UK's public finances.

FIGURE 4.1: THE UK COULD BE SPENDING ANYWHERE FROM 8–47 PER CENT OF RECEIPTS ON DEBT INTEREST BY 2074/75

Debt interest in the UK as a percentage of government revenue (left) 2026/27–2074/75



Source: IPPR analysis based on OBR (2024a, 2024b, 2025a, 2025b, 2025c, 2026a, 2026b), ONS (2024b, 2025b, 2026)

The UK is likely sustainable in the short and medium term even under an adverse scenario – but there is a large difference in the long run between different scenarios, depending on the path of four key drivers:

- **Long-run nominal interest rates** make up 50 per cent of the difference between the adverse and favourable scenarios⁴: this determines the effective rate the government pays on its debt, both new debt and existing debt that's rolled over. Higher interest rates mean higher debt servicing costs and potentially adverse debt dynamics if the interest rate exceeds the growth rate ($r > g$). Fiscal credibility, if maintained, can reduce this burden by reducing the interest rate premium.
- **Trend productivity growth** makes up 22 per cent of the difference between the adverse and favourable scenarios⁴: assumptions on productivity feed directly into real GDP growth in the long run. Higher GDP means a larger tax base. Productivity growth settling at pre-financial crisis levels (~2 per cent) versus post-financial crisis levels (~0.6 per cent) makes a significant difference. Although uncertain, AI has the potential to bring significant upside to productivity growth (Goldman Sachs 2025b) and so we select a favourable scenario that benefits from this uplift, in line with recent US productivity growth data (BLS 2026).
- **Demographics/net migration** makes up 17 per cent of the difference between the adverse and favourable scenarios: the age profile of the population determines pension costs, healthcare costs, social care costs, and the size of the working-age tax base. This is primarily influenced by fertility and mortality rates and net migration. The UK's ageing population is placing increasing pressure on public finances, a fiscal strain mitigated by young migrants who are typically net positive for the fiscal position – and the primary driver of population growth as deaths are projected to outnumber births from the mid 2020s onwards (ONS 2026). We only vary net migration in this paper as it's a key area of uncertainty moving forwards.
- **Climate change** makes up 10 per cent of the difference between the adverse and favourable scenarios: climate change will bring significant costs to public finances globally through direct damage, mitigation costs and adaptation costs – for instance, rebuilding after floods, transitioning away from fossil fuels, and building disaster-resilient infrastructure (OBR 2025). This both lowers the tax base and increases borrowing needs.

Our scenarios combine reasonable, indicative sensitivities by changing these key drivers to examine the relative importance of each on fiscal sustainability. Table 4.1 below details the assumptions underpinning the central, adverse and favourable scenarios.⁵ The impact of each of these channels is further broken down in appendix 2.

4 The interaction and ordering of changes make a difference on the final outcome – for instance, increasing net migration alongside productivity gives a bigger boost since the new migrants have higher output. As such, per cent of difference is the average marginal impact (Shapley contribution) of each factor, as a share of the total difference between adverse and favourable scenarios.

5 Long-run productivity growth is a seven-year ramp from the OBR's value in 2030 to the long-run assumption by 2037; Effective interest rates converge linearly from 2030 to 2074 to match the long-term nature of the neutral rate; Climate change below 3°C and 2°C scenarios are given directly by the OBR. The high damage scenario is added by the author at 1.5x below 3°C; Net migration assumptions are given by the OBR's current central estimate (+230k), with adverse and favourable based on the lower (+105k) and higher (+455k) migration variants of the ONS population projection.

TABLE 4.1: ASSUMPTIONS UNDERPINNING THE FISCAL SUSTAINABILITY SCENARIOS IN THE UK

Parameter	Adverse	Central	Favourable
Long-run productivity growth	0.6%	1.25%	2.3%
Long-run interest rate	4.0%	3.0%	2.0%
Climate damages	High damage	Below 3°C	Below 2°C
Demographics/net migration	+105k	+230k	+455k

Source: Assumptions informed by authors' analysis

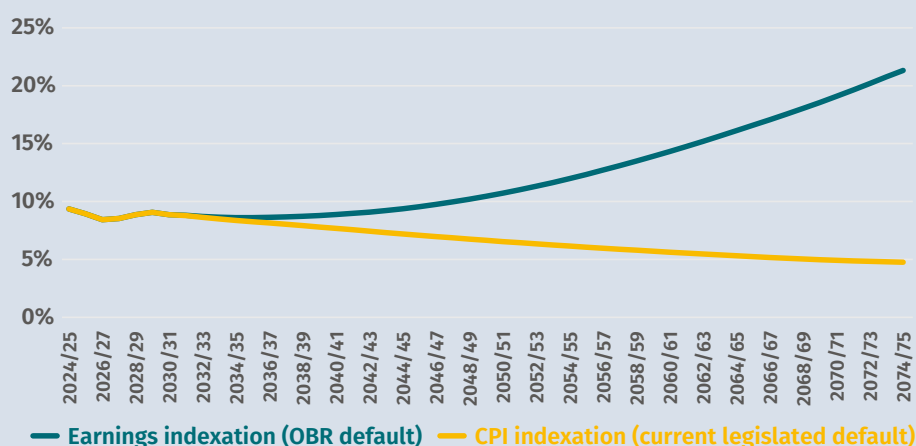
BOX 4.2: FISCAL DRAG MATTERS MORE THAN ANY OTHER VARIABLE

The UK has frozen tax thresholds since 2022/23, now extended to 2030/31. After the freeze ends, thresholds will rise with consumer prices rather than wages. Because wages typically grow faster than prices, more income gets pulled into higher tax brackets each year – a process known as fiscal drag.

This works on both sides of the budget. Tax revenues rise as earnings outpace thresholds. At the same time, most working-age benefits – which are also uprated with prices, not wages – slowly shrink relative to living standards. Only the state pension, protected by the triple lock, is unaffected. Our model captures both effects, drawing on estimates from the Fraser of Allander Institute (2026) and OBR publications.

FIGURE 4.2: FISCAL DRAG HAS A MASSIVE IMPACT ON FISCAL SUSTAINABILITY IN THE UK

Debt interest in the UK as a percentage of government revenue (left) 2026/27–2074/75, broken down indexation policy



Source: Author calculations based on (FAI 2026), OBR (2024a, 2024b, 2025a, 2025b, 2025c, 2026a, 2026b), ONS (2024b, 2025, 2026)

- **The combined effect of fiscal drag would make the UK fiscally sustainable on its own.** CPI indexation reduces the long-term debt servicing ratio from around 21 per cent to under 5 per cent by 2074/75 – the single largest lever in the model, dwarfing productivity, interest rates or climate change.
- **But this path is likely not politically straightforward.** Over 50 years, the average worker's income would cross into the highest tax band, pushing their marginal rate from 20 per cent to 45 per cent – a big tax policy change. And unemployment benefits have already dramatically lost their value relative to wages. While benefits replaced nearly a third of average earnings in the mid-1960s (Resolution Foundation 2021), today someone losing their job typically retains just 12 per cent of their previous income (IFS 2025). With benefits indexed to CPI rather than earnings, this already-low OECD replacement rate is guaranteed to shrink even further. Governments would almost certainly intervene before either extreme was reached.

We therefore present the rest of this analysis with fiscal drag switched off, so that the effects of other variables can be seen clearly. But policymakers should recognise that threshold policy is a powerful fiscal tool, and the realistic path lies somewhere between the two extremes modelled here.

4.2 THE IMPACT OF BORROWING TO INVEST

The fiscal outlook is heavily shaped by productivity and growth. Sustained public investment has the potential to raise both, but borrowing to invest also adds to the debt stock and to debt servicing costs. Investment can make the fiscal picture more sustainable depending on the economic environment and critically on how investment is directed.

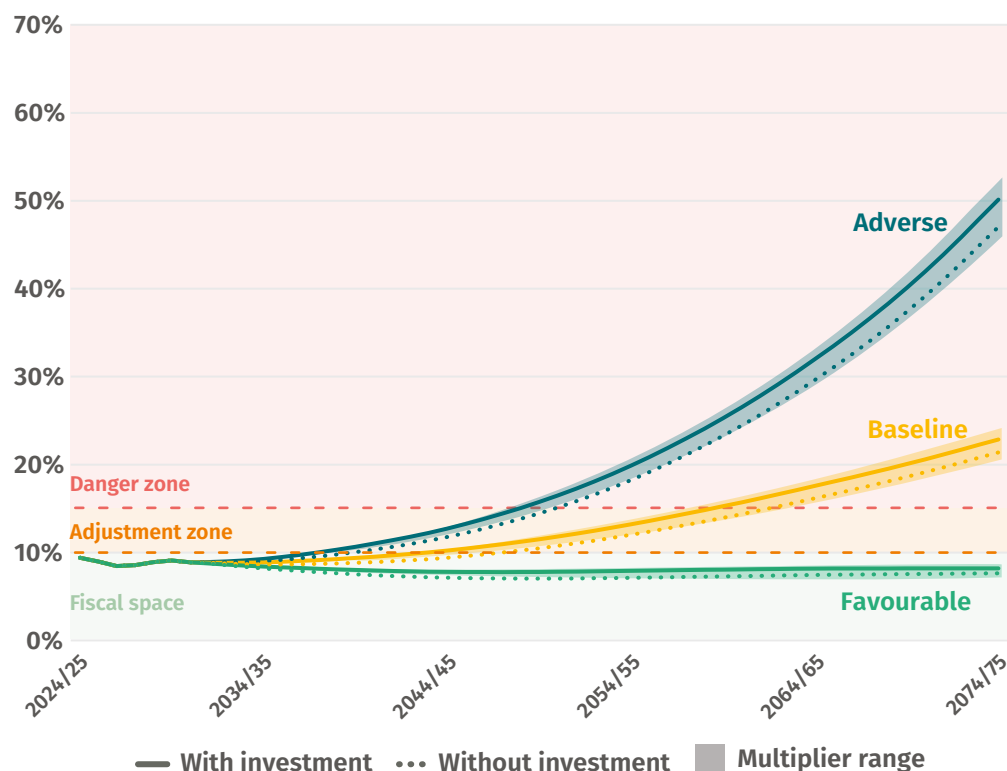
The impact on fiscal sustainability of a 1 per cent 'generic' investment boost is outweighed by the overall economic backdrop

In figure 4.3, we model a 1 per cent 'generic' ongoing investment stimulus. It lifts output and productivity but does not act to relieve long-term pressures on climate change, health or demographics. Two findings stand out:

- First, as the shaded area around the lines shows, **the investment stimulus itself is outweighed by the economic backdrop** – meaning it does not fundamentally alter whether the UK sustainable or not.
- **Second, under a high returns to investment scenario** (building on OBR work) the investment pays for itself by 2054/55 – shown by the shaded area reaching below the dotted line (which is the no-extra-investment scenario).

FIGURE 4.3: THE IMPACT OF A GENERIC SUSTAINED INVESTMENT BOOST IS OUTWEIGHED BY THE ECONOMIC BACKDROP

Debt interest in the UK as a percentage of government revenue (left) 2026/27–2074/75, under different economic backdrops (lines) and fiscal multipliers (shaded area)



Source: IPPR analysis based on OBR (2024a, 2024b, 2025a, 2025b, 2025c, 2026a, 2026b), ONS (2024b, 2025, 2026)

This is consistent with external evidence that debt-financed public investment pays for itself only over longer time horizons and if it has reasonably high returns. As we argue in a forthcoming piece, clearly directed industrial strategy spending could fulfil these criteria (Jung, forthcoming). A temporary investment push typically causes a rise in debt to GDP and the debt servicing ratio because the immediate budgetary cost outweighs the growth effect. Medium-term fiscal costs can also be much lower – and debt dynamics can even improve – in two exceptional cases: if the long-run interest–growth differential is strongly negative (so debt can be ‘outgrown’), with some sort of fiscal drag where spending is held flat, or doesn’t increase as fast as receipts (see box 4.2 above) (Motyovszki, Pfeiffer and in ’t Veld 2024).

Investment and reform that target future spending pressures are more likely to be sustainable

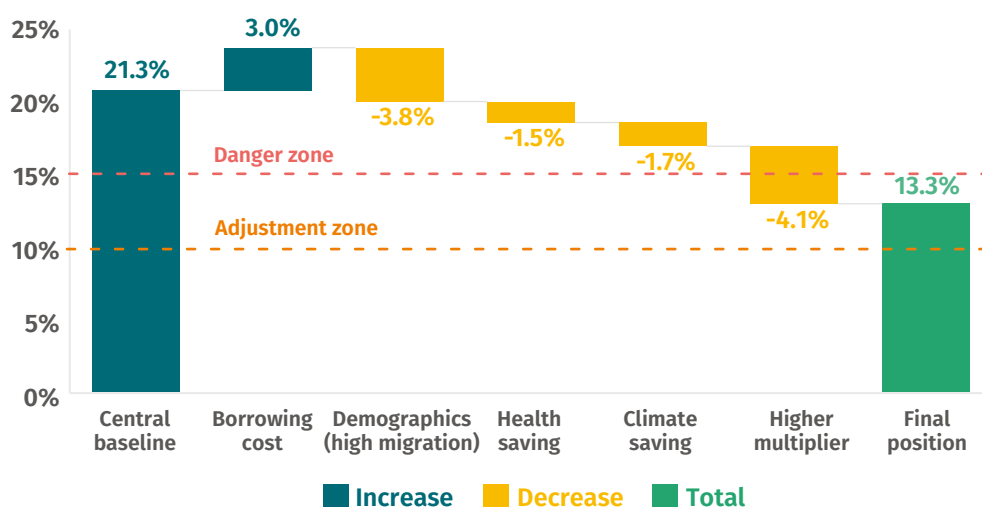
When investment and policy are directed at the root sources of long-term fiscal pressure, the picture improves dramatically. The UK faces large, predictable drivers of rising expenditure and narrowing tax bases: an ageing demographic profile, rising health demand, and climate-related GDP damages.

A comprehensive policy package that addresses these structural pressures delivers multiple dividends. To illustrate this, we test a combined reform and investment package under central economic conditions – with 2 per cent of GDP borrowed to invest in both climate and health, and a new high immigration policy. **This illustrative package combines the following.**

- **Demographic shift:** A move from the OBR's baseline (~230k/yr) to a high net migration scenario (~455k/yr), expanding the working-age tax base and reducing old-age dependency ratios.
- **Climate-mitigating investment:** Sustained capital investment equal to 1 per cent of GDP that halves the GDP damage from climate change in the UK, as part of a broader multilateral effort.
- **Health-improving investment:** Sustained investment, equal to 1 per cent of GDP in preventative health that reduces future demographic health demand by 25 per cent. Policies that could achieve this include expanded early-years and childhood health programmes, greater investment in mental health services, and preventative public health investments targeting obesity, smoking, loneliness and physical inactivity.⁶
- **Making sure that this investment is delivered as part of strategic industrial policy, which focusses on and grows frontier ecosystems.** This – our scenario assumes – would ensure that this investment has high multipliers consistent with the OBR's optimistic scenario for investment returns.

FIGURE 4.4: A PACKAGE OF REFORM AND WELL-TARGETED INVESTMENT COULD IMPROVE THE UK'S LONG-RUN FISCAL SUSTAINABILITY

Debt interest in the UK as a percentage of government revenue (left) 2074/75, showing fiscal the impact a 2 per cent of GDP debt-financed investment and reform package by channel



Source: IPPR analysis based on OBR (2024a, 2024b, 2025a, 2025b, 2025c, 2026a, 2026b), ONS (2024b, 2025, 2026)

This approach would significantly improve the long-run debt trajectory. Compared to a baseline debt servicing ratio of 21.3 per cent in 2074/75: the borrowing cost of the package adds 3.0 percentage points; but shifting to high migration reduces the DSR by 3.8 percentage points; targeted health savings reduce it by a further 1.5 percentage points; climate savings by 1.7 percentage points; and if this investment is well directed with high returns, this reduces the burden by 4.1 percentage points (the 'higher multiplier' introduced at the start of 4.3). The net result is a DSR of around 13.3 per cent – a reduction of approximately 8 percentage points.

⁶ This for instance, could be significant investment in community health hubs and preventative health, which could hugely increase population health and reduce the cost of ageing, as IPPR has argued.

Bringing the DSR the final stretch into the adjustment zone (below the red line in figure 4.4 above) could realistically be delivered via fiscal consolidation. In other words, a well-targeted investment stimulus together with some fiscal consolidation could bring the UK towards long-term fiscal sustainability, everything else being equal.

This demonstrates exactly why the UK's fiscal framework needs to evolve.

A framework solely focussed on a rolling five-year horizon might reject this package due to the upfront debt incurred. Yet over the long term, enacting policies that directly target the structural drivers of fiscal pressure is the most reliable path to genuine fiscal sustainability.

We see this in action, with regular cancellations to meet medium-term fiscal rules despite the UK's poor international standing on public investment. Former chancellor Jeremy Hunt cancelled the northern leg of HS2 'apparently motivated in part by a desire to help meet fiscal rules' (IFS 2023) – representing genuine loss in £2.1 billion write-offs. In 2024, the incoming Labour chancellor Rachel Reeves similarly cancelled investment in road infrastructure, railway restoration and computing infrastructure – citing the £22 billion budget deficit (Reeves 2024).

5.

IMPLICATIONS FOR FISCAL FRAMEWORK REFORM

5.1 THERE IS A MISMATCH BETWEEN THE UK'S FISCAL CHALLENGES AND THE FRAMEWORK DESIGNED TO MANAGE THEM

The most consequential threats to fiscal sustainability – demographic pressures, lagging productivity and climate damages – compound over decades and are largely invisible to a framework that targets a rolling five-year horizon. Meanwhile, the framework's treatment of all borrowing as equivalent creates perverse incentives to cut the very investment that could bend the long-term expenditure curve.

This section sets out a practical roadmap for reform. It does not propose abandoning fiscal discipline – the evidence that credible rules reduce deficit bias and borrowing costs is robust (Potrafke 2023). Rather, the framework should be extended to match the time horizon of the UK's challenges, and the metrics underpinning the rules should also better reflect the distinction between borrowing that builds productive capacity and tackles these problems and borrowing that simply raises liabilities. Importantly, this section sets out what a reformed framework should consider and the principles it should embody – it does not prescribe the exact framework specification. That detailed institutional design, including the calibration of thresholds, enforcement protocols, and testing against established evaluation criteria, is the natural next step from the evidence and arguments presented in this paper.

5.2 THE CURRENT FRAMEWORK HAS BLIND SPOTS

The UK's fiscal rules have been revised more than 10 times since 1997 (IfG 2024), yet their fundamental architecture has remained consistent: a debt target assessed at a rolling medium-term horizon, supplemented by a current budget balance rule. The current framework targets Public Sector Net Financial Liabilities (PSNFL) falling as a percentage of GDP and the current budget (day-to-day spending) in surplus by 2029/30 – unless the targets are less than three years out, in which case it becomes a rolling three-year target (HM Treasury 2026).

This design has three consequential limitations:

- 1. First, it is structurally blind to long-term risk.** Our modelling shows that the total gap between adverse and favourable scenarios is just 1.8 percentage points at the 2037–38 horizon but widens to 39 percentage points by 2074/75. Policy choices about productivity-enhancing investment, climate mitigation and health – the levers that matter most for long-term sustainability – register as rounding errors in a medium-term assessment. A framework that only sees the next 3–5 years cannot distinguish a fiscal stance that is building long-term resilience and one that is storing up problems and runs the risk of a slow decline to unsustainability.
- 2. Second, it treats all borrowing identically.** If the government borrows £1 billion to pay wages, PSNFL rises. If it borrows £1 billion to build infrastructure – creating an asset that raises productivity and future tax receipts – PSNFL also rises by the same amount (ONS 2024a). The fiscal rule is indifferent to whether borrowing creates future value. The predictable consequence is that when headroom

is tight, capital spending is the easiest item to cut – and the UK has cut it repeatedly, from HS2’s northern leg to hospital building programmes to transport infrastructure (see box 4.2). Cumulatively, this has left the UK with around a third less capital per hour worked than peers (Allas and Zenghelis 2025), feeding the productivity gap that is itself the largest long-term threat to fiscal sustainability.

3. **Third, it manages to a single point estimate of headroom.** The OBR’s central forecast is one path through a wide fan of possible outcomes. Our scenario analysis shows that the range of plausible long-term debt servicing ratios spans from 7.6 per cent to 47.0 per cent by 2074/75. Managing to a single central projection – and the thin band of headroom it implies – leaves the framework unable to communicate the asymmetric risks that fiscal policy should be managing against.

We set out five principles for reform to address these blind spots:

1. **Keep the medium-term anchor but change what it targets.** The evidence is clear that well-designed and enforced rules generally reduce borrowing costs and improve fiscal outcomes (Potrafke 2023). Without a target that’s binding within a typical term (less than five years), governments have too strong of an incentive to splurge today without having to do the hard work consolidating later. They do this already – consolidation is almost always pencilled in for the end of the forecast, and almost always not met (IFS 2026). The government should focus on the **debt servicing ratio** (interest as a share of revenues) **as a primary anchor**: it’s a flow-for-flow measure that captures the actual budgetary burden, reflects the interaction of borrowing costs and growth, and tells you directly whether the state can afford its commitments.
2. **Governments should outline a strategy and concrete actions for how they aim to change these indicators over time.** This should range from how they will change debt structure and deficit pathways all the way to what the focus of public investment will be. The OBR should then make predictions for how dashboard assessments will change over time. This broader information will give financial markets and citizens a comprehensive picture of the difference a government is making to fiscal sustainability.
3. **Assess fiscal sustainability more thoroughly under uncertainty.** The OBR does report the probability of meeting a fiscal rule, but subject to past forecast error and not alternative economic conditions. Fiscal plans should be stress-tested against adverse and favourable scenarios as a formal part of the budget process. **The OBR should present scenarios of how the debt servicing metric could evolve under different shock scenarios** including, say, a crisis or an interest rate shock scenario.
4. **Introduce a multi-indicator dashboard to predict risks to fiscal sustainability.** Such a broader set of indicators should include Public Sector Net Worth and short-term liquidity metrics. This will incentivise the government to improve more aspects of fiscal sustainability. No single metric tells the full story. PSNW is not a panacea, but it crucially captures whether the state is building or running down its asset base – and better incentivises investment. The IMF has argued PSNW would be more conducive to investment and growth (IMF 2024), and recent improvements in this metric make it viable for the first time in the UK (Hughes et al 2019) – and is already in use in New Zealand and Australia. Measurement challenges around valuing non-financial assets are real (OBR 2021), but the appropriate response is for the OBR to forecast PSNW with explicit uncertainty bands – not to ignore the information entirely. A framework informed by PSNW alongside the debt servicing ratio gives a richer picture across time horizons.
5. **Add a more binding long-term sustainability assessment alongside it, highlighting public investment trade-offs.** A formal assessment would ensure that policy decisions are evaluated against their structural implications, not just

their five-year cost. The gap in sustainability between adverse and favourable scenarios is minimal in the medium term, but snowballs in the long term. The trade-offs behind long-term decisions should be communicated – we show that increasing borrowing in the short to medium term may be preferable in certain contexts. The OBR's Fiscal Risks and Sustainability Report already perform elements of this function; the reform would be to give its long-term findings formal weight in fiscal decision-making. Any such mechanism should be accompanied by a strengthened investment appraisal process, potentially including an independent public investment watchdog within the OBR, to ensure that the distinction between productive investment and relabelled current spending is rigorously maintained.

The UK can continue to manage public finances solely through a medium-term lens, cutting investment when headroom narrows and hoping that long-term pressures resolve themselves. Or it can adopt a framework that takes the long view – encouraging genuinely productive investment, building resilience against climate and demographic pressures, and treating fiscal sustainability as a multi-horizon challenge.

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APPENDIX 1:

KEY EARLY WARNING INDICATORS

This appendix provides detailed technical descriptions of the key early warning indicators referenced in the main text.

SHORT-TERM INDICATORS

Gross financing needs (GFN): This measures the total amount a government needs to borrow each year, comprising both the budget deficit (new borrowing) and the principal on existing debt that matures and must be repaid or refinanced. Expressed as a percentage of GDP, high GFN means the government must constantly return to financial markets to raise large sums, leaving it vulnerable if those markets become less willing to lend. GFN has strong predictive power for short-term fiscal risks (EC 2024).

Debt structure: The composition of the debt stock matters as much as its size. If a large share of debt is denominated in foreign currencies, linked to inflation, or has short maturities (meaning it must be refinanced frequently), then shocks – such as a currency depreciation or a spike in market interest rates – can rapidly increase the government's borrowing costs. Crises in emerging markets demonstrate how these structural vulnerabilities amplify shocks (Arghyrou and Tsoukalas 2010).

Liquidity buffers: Governments that hold high levels of liquid assets – such as cash balances held at the central bank or international reserves – relative to their short-term refinancing needs are better able to weather periods of market volatility without being forced into emergency spending cuts or fire-sale borrowing.

CYCLICAL/GLOBAL CONDITIONS AND EXPOSURE

Volatility and market sentiment: Heightened global volatility, typically measured by the VIX index (tracking turbulence in financial markets), and disruption in the bond market can cause borrowing costs to rise and reduce demand for a country's debt (Comelli 2012; Rey 2015).

Exchange rates: Changes in the Real Effective Exchange Rate (REER), which adjusts exchange rates for differences in inflation across countries, can signal a structural loss of competitiveness that markets price in through higher borrowing costs for government debt (Jahjah et al 2012).

Economic cycle: If an economy operates below potential – with a negative output gap – the tax base shrinks and expenditure increases as automatic stabilisers kick in (such as higher welfare payments). A sharp drop in real GDP has been found to be a significant predictor of sovereign stress (Manasse and Roubini 2005).

Financial cycle: The credit-to-GDP gap measures how far lending in an economy has deviated from its long-run trend, signalling when the financial system is overheating. When banks lend far more than normal relative to the size of the economy, financial crisis can follow and rapidly spill over into a debt crisis. This measure is considered the single best early warning indicator for systemic banking crises (Borio and Lowe 2002; BCBS 2010). Sharp swings in asset prices, such as a

surge in house prices, are also among the most reliable precursors of banking crises (Reinhart and Rogoff 2009).

External debt position: Debt costs are less volatile and borrowing cheaper for governments if debt is held by actors within the country – including domestic banks, pension funds and households. If a high proportion of a state's debt is owned by foreign entities, this relies on the willingness of foreign investors to roll over maturing loans and makes borrowing sensitive to changes in global sentiment (Fang and Hardy 2021).

Share of debt in foreign currency: This is less of an issue for advanced economies with their own currency and deep financial markets like the UK, but developing economies often lack a savings pool large enough to fund public investment domestically. This is known as the 'original sin' in fiscal policy (Eichengreen, Hausmann and Panizza 2003) – leaving a country highly vulnerable to a currency move that can inflate debt (in foreign currency) relative to ability to pay (in domestic currency).

STRUCTURAL CHARACTERISTICS

Transparency and data reliability: Financial markets rely heavily on official statistics when assessing a country's fiscal position. Large revisions to data or concerns about reliability correlate with higher borrowing costs (Bernoth and Wolff 2008).

History of stress: A country's past fiscal history shapes investor expectations. A history of default, restructuring or exceptional IMF access acts as a red flag, as investors perceive a higher risk of recurring policy reversals (Reinhart et al 2003). This can increase borrowing costs.

Institutional quality: Ineffective or low-quality institutions make it more difficult to respond in a timely or effective fashion to periods of stress, reducing the capacity for policy adjustment when it is most needed. Investors may also demand a higher level of compensation for lending to states with weaker governance.

MEDIUM-TERM METRICS

Debt-to-GDP Ratio: The headline metric in most frameworks (the Maastricht Criteria, for instance). While comparable and simple, it is structurally flawed: it compares a stock (total debt) to a flow (one year's GDP). There is no universal threshold that triggers a crisis; Japan sustains 235 per cent while Argentina faced crises at 48 per cent. Thus, while an important signal, it is an incomplete measure of sustainability (Goldman Sachs 2025; IMF 2024). The total stock of debt is, however, an important risk indicator as it directly determines the cost of servicing debt.

Debt Servicing Ratio: Arguably the most vital medium-term indicator (Furman and Summers 2020). Unlike debt-to-GDP, this compares flow-for-flow: it captures the interaction of borrowing and interest rates, accurately reflecting the budgetary burden. If growth is financed at low rates, this metric remains stable even if headline debt rises.

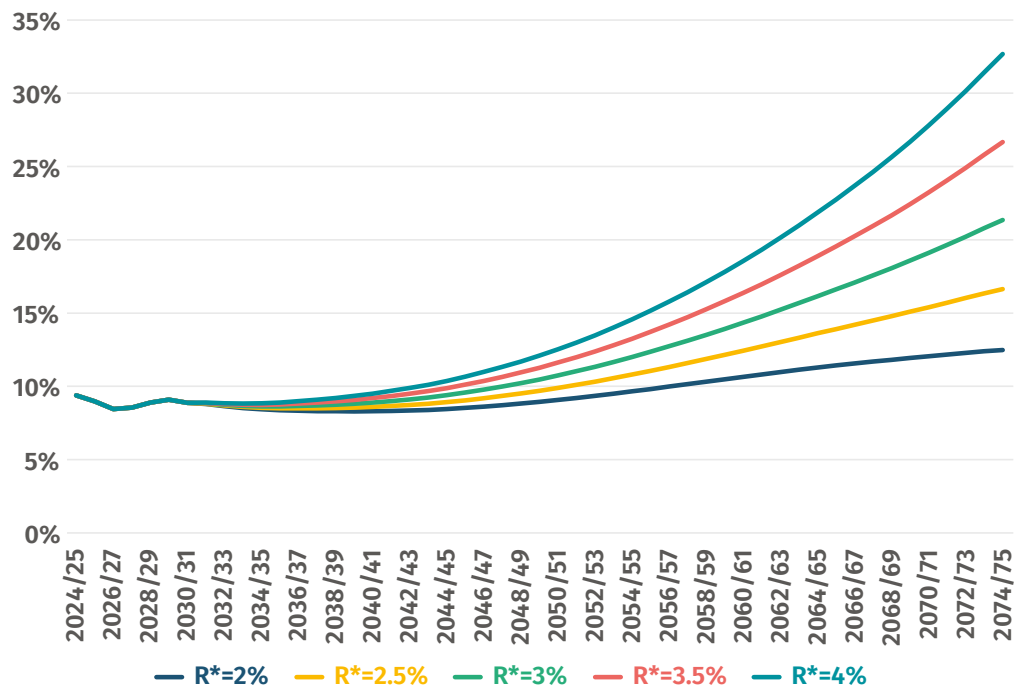
APPENDIX 2: IMPACT OF KEY LONG-RUN FACTORS

LONG-RUN NEUTRAL RATE OF INTEREST

Interest rates have a material impact at all horizons – with a direct impact in the short run, and a snowballing impact in the long run. A higher rate of interest immediately means the government pays more to service its debt, both new debt and existing debt that’s rolled over. A higher long-run neutral rate of interest can also lead to deteriorating debt dynamics if the interest rate exceeds the growth rate, causing the debt burden to compound automatically over time.

Moving from a 2 per cent to a 4 per cent long-term interest rate⁷ increases the debt servicing ratio from 12 per cent to 33 per cent by 2074/75. It also determines when fiscal distress begins: the danger zone is reached in 2055/56 under high interest rates but is not reached at all if rates are close to the zero lower bound.

FIGURE A2.1: IMPACT OF CHANGES IN THE NEUTRAL RATE ASSUMPTION ON THE DEBT SERVICING RATIO



Source: IPPR analysis based on OBR (2024a, 2024b, 2025a, 2025b, 2025c, 2026a, 2026b), ONS (2024b, 2025, 2026)

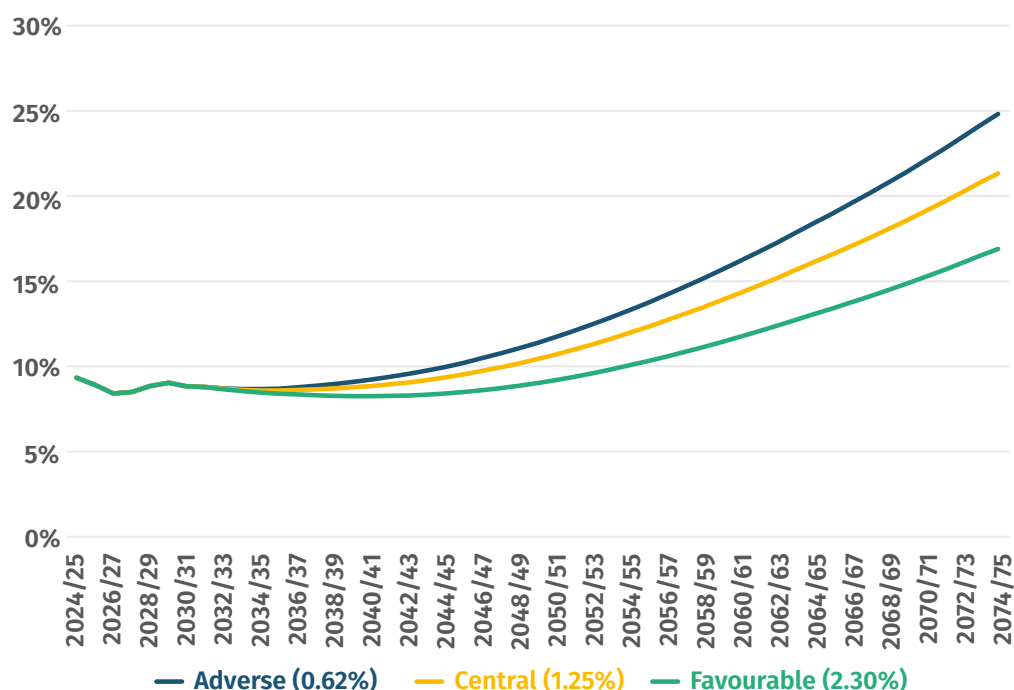
⁷ There is considerable uncertainty around this final rate of interest. Historically, the neutral rate has fallen over time, and this might be expected to continue (Bank of England 2015), and recent analysis expected a negative $r-g$ in the UK over the next 20 years (Heylen et al 2024). Currently, effective rates are high at around 4.2 per cent. This does follow a unique period of persistent above-target inflation, and as such all our scenarios expect a declining interest rate from 2 per cent (zero lower bound) in the most favourable scenario, to a slight decline to 4 per cent.

Fiscal credibility can directly reduce the interest rate burden. Previous IPPR analysis (Ellis and Jung 2025) shows that UK borrowing costs were elevated by around 30 basis points in late 2025, due to fiscal uncertainty and credibility concerns. Closing this gap alone, over the long term, would lower the DSR by around 2.9 percentage points in 2074. Otherwise, it is difficult for government policy to directly lower interest rates – examples include increasing incentives to save, lowering debt issuance (reducing the deficit) and as has been frequently argued, reducing inequality (Rachel and Summers 2019).

TREND PRODUCTIVITY GROWTH

Whether the UK returns to its pre-financial crisis productivity growth rate (~2 per cent), continues to plateau (~0.6 per cent), or potentially gets a boost from AI or technological advancements (~2.3 per cent) is a key question for long-run sustainability – directly influencing debt dynamics through $r-g$. In the medium term, the difference between 2.3 per cent and 0.6 per cent long-run productivity growth gives a DSR difference of just 0.5 percentage points. But this snowballs to 7.9 percentage points by 2074/75, and the UK hits the danger zone 12 years earlier.

FIGURE A2.2: IMPACT OF CHANGES IN TREND PRODUCTIVITY ASSUMPTION ON THE DEBT SERVICING RATIO



Source: IPPR analysis based on OBR (2024a, 2024b, 2025a, 2025b, 2025c, 2026a, 2026b), ONS (2024b, 2025, 2026)

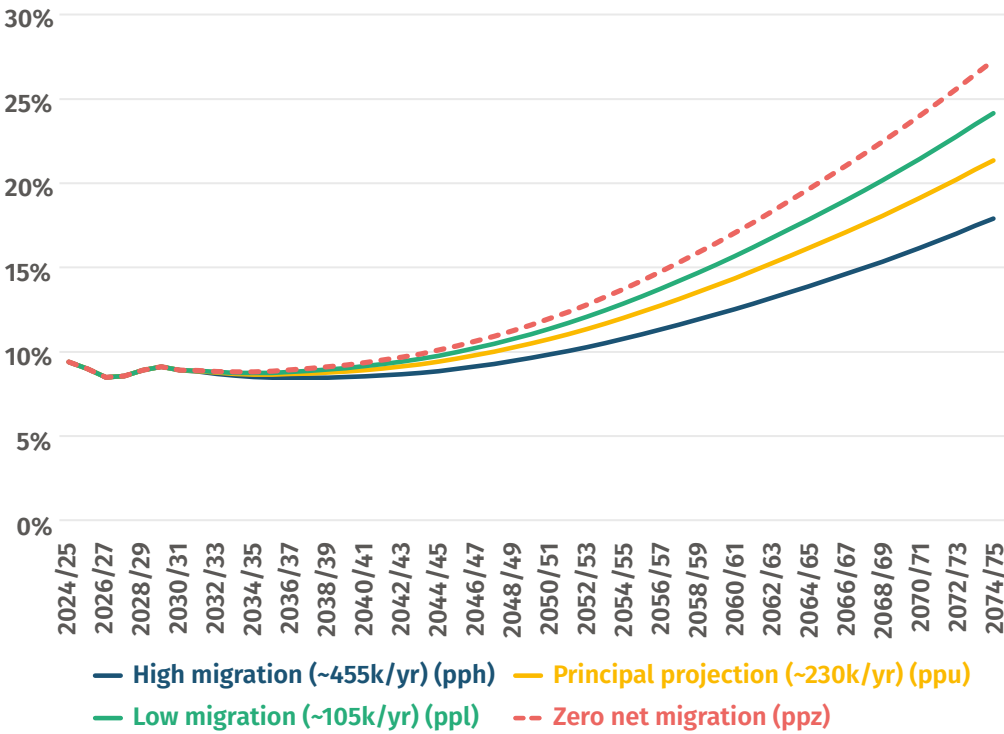
DEMOGRAPHICS AND NET MIGRATION

An ageing population is bad for public finances – and the fiscal outlook is particularly sensitive to net migration assumptions. In the UK, an ageing population typically means more public spending on healthcare and social care, less taxable income from work, more spent on pensions (which are protected by the ‘triple lock’), and more spent on other age-related benefits. Given the UK’s declining fertility rate, the age of the population is supported by migrants – who

are typically young and net positive for the UK’s fiscal position (Migration Advisory Committee 2025; OBR 2024a).

Net migration has a significant impact – from 18 per cent of receipts being used to service debt in 2074/75 under high migration, to 24 per cent under low migration. If the UK had zero net migration, this would increase even further to 27 per cent.

FIGURE A2.3: IMPACT OF CHANGES IN DEMOGRAPHIC ASSUMPTIONS ON THE DEBT SERVICING RATIO



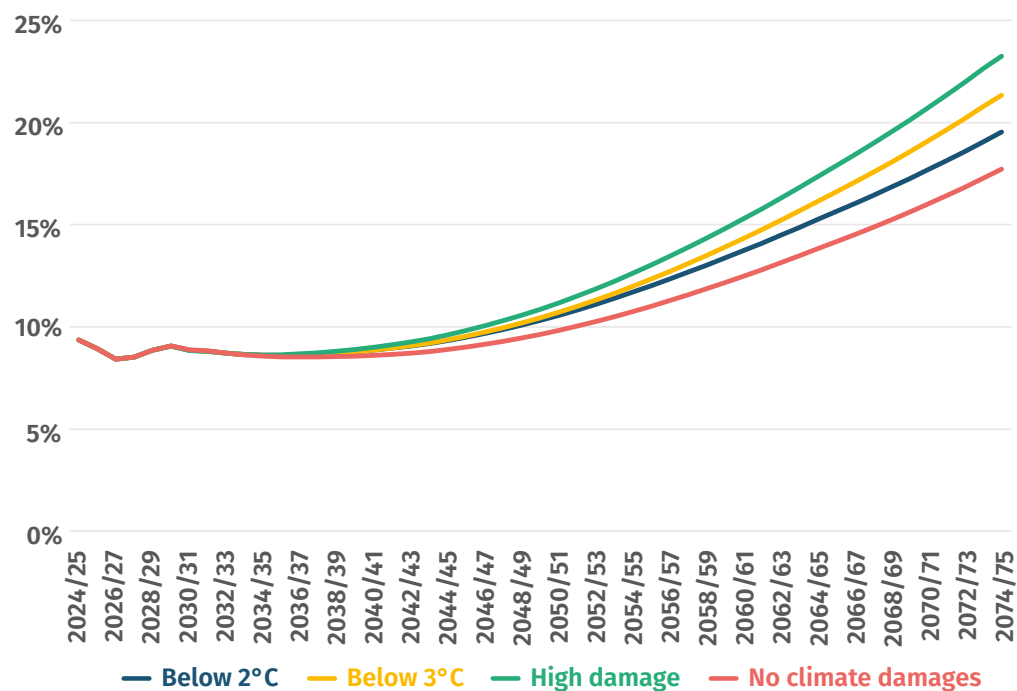
Source: IPPR analysis based on OBR (2024a, 2024b, 2025a, 2025b, 2025c, 2026a, 2026b), ONS (2024b, 2025, 2026)

CLIMATE CHANGE

Mitigation costs and adaptation costs will bring damage globally – for instance, rebuilding after floods, transitioning away from fossil fuels, and building disaster-resilient infrastructure (OBR 2025a). The difference between below 2°C damages and high damages⁸ is negligible in the medium term (less than 0.1 percentage points) but increases to 3.7 percentage points by 2074/75.

8 We base our scenarios on OBR’s damage calculations for below 2° and 3°C global temperature warming scenarios, adding an illustrative ‘high damage scenario’ (1.5x the damage in the 3°C scenarios) to reflect the increasing costs of climate change and potential for even more disruption (OBR 2025), and recognising the need for symmetry around the below 3°C warming scenario that we take as baseline.

FIGURE A2.4: IMPACT OF CHANGES IN CLIMATE CHANGE ASSUMPTIONS ON THE DEBT SERVICING RATIO



Source: IPPR analysis based on OBR (2024a, 2024b, 2025a, 2025b, 2025c, 2026a, 2026b), ONS (2024b, 2025, 2026)

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