Government Response to the 2022 Fiscal Risks and Sustainability Report
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Introduction

1.1 The Office for Budget Responsibility’s (OBR) Fiscal Risks and Sustainability Report (FRS) is the first of its kind, bringing together the previously separate risks and sustainability reports, which have made major contributions to the monitoring of risks and the long-term sustainability of the public finances respectively. The UK is at the forefront of best practice in managing fiscal risks (factors which may cause the public finances to deviate from forecast): the International Monetary Fund (IMF) commented that the OBR’s risks reports raised “the bar on the assessment and quantification of fiscal risks to a new level that other countries should look to meet”. Bringing these reports together enables the consideration of short- to medium-term fiscal risks alongside long-term trends that affect fiscal sustainability, providing a comprehensive examination of the public finances.

1.2 In the report, the OBR found that “it is hard to escape the conclusion that the world is becoming a riskier place”. The past year has seen heightened global challenges, with the ongoing Russian invasion of Ukraine, persistent inflation, and energy supply challenges demonstrating this high level of risk. Awareness of risk and careful management of the public finances in the face of inevitable shocks and slow-building pressures is more important than ever.

1.3 The government has taken action to respond to and mitigate risks faced by businesses and households, including those raised in the FRS. There has been tangible progress in responding to, for example, heightened energy prices and the transition to net zero. The Energy Price Guarantee (EPG) and Energy Bills Discount Scheme (EBDS) have provided significant support to households and non-domestic customers respectively through the temporary spike in prices. The government is also investing in the future to ensure that the UK has sustainable and reliable energy provision in the longer term, and has recently invested £700 million in Sizewell C.

1.4 The Prime Minister’s three priorities for the economy – halving inflation, growing the economy, and getting debt falling – underpin the government’s fiscal strategy and will help to build fiscal space. This is an important buffer for future shocks as fiscal space is needed so that the government can provide support to households and businesses when times are tough, as it did during the pandemic.

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1 Stressing the Public Finances – the UK Raises the Bar, International Monetary Fund, July 2017.
2 Fiscal Risks and Sustainability Report, Office for Budget Responsibility, July 2022.
3 UK government takes major steps forward to secure Britain’s energy independence, Department for Business, Energy & Industrial Strategy, November 2022.
Sustainable fiscal strategy

1.5 The action taken over the decade following the financial crisis to bring the public finances under control by stabilising borrowing and debt, meant that the government was able to respond comprehensively to the COVID-19 pandemic. Over this period, public sector net borrowing was reduced from a peak of 10.2% of Gross Domestic Product (GDP) in 2009-10, after the financial crisis, to 2.0% of GDP in 2018-19.\(^4\) Thanks to this responsible management of the public finances, when needed the government was able to borrow to provide direct support for households and businesses, including the Coronavirus Job Retention Scheme.

1.6 Estimates from the IMF showed that the UK’s discretionary fiscal expansion in response to the pandemic was one of the largest and most comprehensive fiscal support packages globally.\(^5\) The government’s response was delivered in a fiscally responsible way; support was temporary, targeted, and timely, and the government successfully unwound support as the UK emerged from the pandemic.

1.7 As a result, the government borrowed over £300 billion more than had been forecast in March 2020 through the two peak years of the pandemic (2020-21 and 2021-22).\(^6\) This increase in borrowing means that debt is now historically high. The OBR forecast that public sector net debt (PSND)\(^7\) will reach 100.6% of GDP in 2022-23, which would be its highest level since the 1960s.\(^8\)

1.8 In the current context, high debt is also expensive – higher inflation and rising borrowing costs have increased the amount government is spending to service debt. While debt servicing costs are lower than in the autumn, the OBR has forecast that spending on debt interest will reach £114.7 billion this year. This is the highest since World War II as a share of GDP, in large part due to the impact of high inflation on index-linked gilt stock.\(^9\) Although debt interest spending falls in 2023-24, over time higher interest rates applied to new issuance (both

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\(^5\) Fiscal Monitor, October 2021: Strengthening the Credibility of Public Finances, International Monetary Fund, October 2021.

\(^6\) Public Sector Finances, UK: January 2023, Office for National Statistics, February 2023 & Economic and Fiscal Outlook, Office for Budget Responsibility, March 2020.

\(^7\) Public Sector Net Debt excluding Public Sector Banks.

\(^8\) Economic and Fiscal Outlook, Office for Budget Responsibility, March 2023 & Public Sector Finances, UK, January 2023, Office for National Statistics, February 2023.

\(^9\) Economic and Fiscal Outlook, Office for Budget Responsibility, March 2023.
on new borrowing and re-financing redemptions) means that debt interest spending trends back up over the remainder of the forecast. As a result, the debt interest to revenue ratio is expected to remain 1.3 percentage points above the historical average by 2027-28, the end of the forecast period, as shown in Chart 1.

If debt interest spending were a government department, its departmental budget for 2022-23 would be second only to the Department for Health and Social Care (including all NHS spending). By getting debt down, the government can reduce the money spent on servicing debt and instead use it to invest in public services or lower taxes.

Reducing the debt burden is central to making sure that the public finances are on a sustainable footing for future generations. In its report, the OBR’s projections showed that in the long term and absent further policy action debt is on an unsustainable path, reaching 267% of GDP in 50 years. This is driven by slow-building pressure from an ageing population and the erosion of the tax base from the transition to net zero.

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In the midst of profound global challenges and high levels of debt, the government has prioritised setting a clear direction for the public finances and taking the necessary decisions to achieve it, getting debt falling while growing the economy and halving inflation. Growing the economy also supports the government’s debt falling objective. Over the longer term, the UK’s strong fundamentals and the government’s plan - built around the four pillars of enterprise, education, employment and everywhere - will further support growth. All four elements aim to grow the capacity of the economy while limiting inflationary pressure and therefore supporting fiscal sustainability. As part of this, the UK is leading the way in growth industries which are anticipated to become increasingly important including life sciences, advanced manufacturing and technology.

The government’s fiscal policy decisions will be guided by the fiscal rules, as announced at Autumn Statement 2022 (AS22). The rules require public sector net debt (excluding the Bank of England) to be falling as a percentage of GDP and public sector net borrowing to be below 3% of GDP by the fifth year of the rolling forecast. The debt rule ensures that future policy decisions maintain the sustainable path achieved at AS22 and maintained at Spring Budget 2023. Alongside this, limiting borrowing will ensure debt reduction is delivered sustainably through tax and spend policy. Targeting the fifth year of the forecast provides additional space to allow the economy to recover from the global energy price shock. Policy decisions taken at Spring Budget balance the current budget by the end of the forecast period, ensuring that the government’s day-to-day spending is met with revenues.\textsuperscript{11}

\textsuperscript{11} Economic and Fiscal Outlook, Office for Budget Responsibility, March 2023.
The Charter for Budget Responsibility sets out how the government manages the public finances through the fiscal framework. This framework helps to ensure the stability and long-term sustainability of the public finances by codifying fiscal rules, setting an objective for managing debt, and outlining the relationship between the government and the OBR – including the OBR’s role in producing independent forecasts which support transparency, accountability and credibility. An updated Charter, which reflects recent changes to the fiscal rules, was approved by Parliament in February 2023.

The government’s approach to managing those risks which do arise is modelled on international best practice. The five stages through which the government manages fiscal risks are summarised in Figure 1.

**Figure 1: Five Stages of Fiscal Risk Management**

1. **Identify**
   - the source of the risk, scale of fiscal exposure and likelihood of crystallisation.

2. **Disclose**
   - the fiscal risk to Parliament and the public to raise awareness and ensure accountability for managing the risk.

3. **Mitigate**
   - the risk where it can be done cost-effectively and without detracting from other policy objectives.

4. **Provision**
   - for risks which cannot be mitigated but whose size and timing is relatively certain.

5. **Accommodate**
   - risks whose size or timing is too uncertain to explicitly provide for in advance.

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1.15 This framework underpins the government’s management of and response to fiscal risks. The principles of provision and accommodation work towards protecting the sustainability of the public finances, ensuring that there is sufficient headroom to cushion against future shocks. This is in line with the OBR’s conclusion in its 2021 Fiscal Risks Report that “fiscal space may be the single most valuable risk management tool”.

1.16 The government has broader shoulders than individuals, and it is right that it takes responsibility to protect households, businesses, and individuals in the context of acute external shocks such as the pandemic and energy crisis. In addition, the government ensures that expected structural changes, such as demographic change and climate change, are prepared for well in advance – as set out in the final section of this response.

1.17 Continuing this focus on balance sheet management, the government committed in AS22 to periodically assess public sector assets and liabilities and publish a report on how they are being managed. This report will set out the government’s objectives across the balance sheet, continuing the work of the Balance Sheet Review report which was published in 2020. The government will look to publish the first report by the end of 2024. This reflects on the experience of recent years when the government has used the public sector balance sheet, through guarantees, indemnities and loans, to help absorb the impact of economic shocks, including the COVID-19 pandemic and energy crisis.

1.18 Contingent liabilities are an increasingly important policy tool, used to support growth and safeguard the economy in times of stress. These are liabilities, including guarantees and indemnities, that are uncertain but might lead to future expenditure if specific conditions are met or specific events happen. Since 2017, the government has introduced the “Contingent Liability Approval Framework” and set up the Contingent Liability Central Capability to understand the risks it is exposed to, improve compensation for the taxpayer where appropriate, reduce the probability of risk materialising and reduce the cost when it does. The UK is one of the first countries to establish an organisation focused exclusively on the management of this source of fiscal risk. In AS22, the government committed to publishing an annual report covering its portfolio of contingent liabilities by the end of 2023. These changes show the government is committed to the holistic management of contingent liabilities and their associated fiscal risk.

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Through creating new institutions, committing to transparency, and building expertise, the government will ensure it has the systems in place to deliver value for money while managing risk.

1.19 The OBR’s continued independent work on quantifying and reporting on fiscal risks and sustainability contributes to rigorous risk monitoring. The government’s agreement to respond at a subsequent fiscal event establishes a feedback loop which demonstrates the government’s commitment to thoroughly assessing and actively mitigating fiscal risks, and to fiscal transparency.
Rising geopolitical tensions

1.20 This is a time of significant challenge for the global economy and for global stability, particularly in the form of high inflation, high and rising interest rates, and economic slowdown. Putin’s illegal war in Ukraine has contributed to a surge in energy and food prices, partly driving high inflation across the world, which has particularly affected Europe, including the UK. Central banks have responded by raising interest rates to return inflation to target. High inflation and interest rates, alongside the high level of uncertainty, has depressed demand. Growth is slowing and the IMF expects about 90% of advanced economies will see a decline in growth in 2023.

1.21 There are welcome emerging signs, however, that global headline inflation has peaked and is likely to moderate over the course of the year, in the absence of further shocks. Global headline inflation is projected by the IMF to fall from 8.8% in 2022 to 6.6% in 2023 and 4.3% in 2024, reflecting the cooling effects of monetary policy tightening and declining international energy and non-energy commodity prices. The Bank of England noted in February that disruption stemming from the latest COVID-19 outbreak in China could temporarily slow the easing of world export price inflation. However, further ahead, the removal of many public health restrictions by the Chinese authorities reduces the likelihood of repeated lockdowns and associated supply chain disruption.

1.22 In the FRS, the OBR highlighted that periods of heightened geopolitical tension have also affected the UK’s economic and fiscal outcomes indirectly. This includes risks arising from escalating trade tensions and rising global protectionism which could reduce global trade volumes.

1.23 The government recently announced the Windsor Framework, which will restore the free-flow of trade within the UK internal market and provides a stable framework for the future, with the EU agreeing to work together if further issues arise in the future. In the OBR’s view, the Windsor Framework “should help support the effective functioning of the Trade and Cooperation Agreement” and reduce some of the downside risks facing UK trade. The credit rating agency Moody’s

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14 World Economic Outlook, International Monetary Fund, January 2023.
15 World Economic Outlook, International Monetary Fund, January 2023.
17 Economic and Fiscal Outlook, Office for Budget Responsibility, March 2023.
recently assessed the Windsor Framework to be “credit positive” for the UK.\(^\text{18}\)

1.24 However, the overall balance of risks to the global outlook remains tilted to the downside, with the risk that inflation remains higher than target levels for longer than expected and the possibility of further shocks in commodity markets. February 2023 marked a year since Russia’s illegal invasion of Ukraine, with Ukrainians entering their second year resisting relentless Russian aggression.

1.25 The Integrated Review of Security, Defence, Development and Foreign Policy, published in March 2021, noted that China’s increasing power and international assertiveness is likely to be the most significant geopolitical factor of the 2020s, and identified Russia as the most acute threat to the UK’s security.

1.26 In March 2023, the government published a refresh of the Integrated Review to reflect the rapid pace of geopolitical change since publication of the Integrated Review in 2021 - including Russia’s illegal invasion of Ukraine and the intensifying systemic challenge from China.

1.27 Recognising the growing security threat and deteriorating geopolitical picture, the government has at Spring Budget, announced that it is providing an extra £4.9 billion for defence over the next two years to improve the resilience and readiness of the UK’s conventional and nuclear forces, by bolstering our conventional stockpiles and enabling the early investment for the AUKUS submarine alliance. As set out in the Integrated Review Refresh, the government’s aspiration over the longer term is to invest 2.5% of GDP on defence as the fiscal and economic circumstances allow. This additional defence spending will be delivered in a fiscally sustainable way, ensuring that debt still falls by the end of the forecast.

1.28 Cyber-attacks have increased in frequency in recent years. Though there is a risk of attacks linked to nation states, the majority of attacks are conducted by criminal groups. The UK continues its work with global partners to detect and disrupt shared threats, and in 2022 the government launched a new National Cyber Strategy, outlining how it will build resilience for the public sector, people and business over the next decade.

\(^\text{18}\) More constructive relationship with the EU will ease Brexit implementation, a credit positive, Moody’s, February 2023.
Higher energy prices

1.29 Over 2022, both Putin’s illegal invasion of Ukraine and global supply chain pressures pushed UK inflation, as measured by the Consumer Prices Index (CPI), to 40-year highs as energy prices rose to record levels. As a net energy importer with a high dependence on gas and oil, the rise in energy prices has made the UK worse off. In the UK, household energy remains the largest single contributor to headline CPI. However, more recently, while global price pressures appear to be easing, tightening in the labour market means that domestic factors are playing a bigger role.

1.30 Achieving a sustained reduction in inflation towards target levels is therefore critical for the economy and halving inflation is one of the Prime Minister’s three economic priorities. The government has affirmed the remit of the Monetary Policy Committee (MPC) of the Bank of England, which is taking action to get inflation under control and back to the 2% target. At its meeting ending on 1st February 2023, the MPC voted to increase Bank Rate to 4%, its 10th consecutive increase. The OBR forecasts that CPI inflation will fall from its peak of 10.7% in Q4 2022 to 2.9% in Q4 2023, a fall of over half. The OBR then expects inflation to fall further over 2024 and to fall below the 2% target in Q1 2024.

1.31 These exceptionally high energy prices have put pressure on households and businesses. The government has taken steps to make sure this burden is distributed fairly while not exacerbating inflationary pressures. To support households through this price shock, the EPG has lowered household energy bills so that the average household pays £2,500 per year. As announced at Spring Budget, the EPG will remain at £2,500 until July 2023. Alongside the Energy Bills Support Scheme (EBSS), this will have saved the average household £1,500 since October 2022. In addition to this, the government is providing extra targeted support to millions of the most vulnerable households over 2023-24. This includes a £900 Cost of Living Payment for those on means-tested benefits, plus an additional £300 for pensioner households and £150 for individuals on disability benefits. This is in addition to the support already provided in 2022-23, including up to £650 in Cost of Living Payments for those on means-tested benefits, with additional support of £300 for pensioners and £150 for individuals claiming disability benefits.

1.32 The government has also provided support to businesses to limit their costs. The EBDS, which replaced the Energy Bill Relief Scheme (EBRS), caps costs to the taxpayer whilst providing businesses with a discount on high energy bills, with a higher level of support for businesses in sectors with particularly high levels of energy use and trade intensity. In addition, at least part of the fiscal cost of energy
support schemes will be offset by taxes levied on oil and gas producers and energy generators.

1.33 Monitoring and forecasting the fiscal impacts of energy support schemes is challenging, given the volatility of energy prices and shifts in consumer behaviour. For example, cash payments for the scheme were around 5% lower than expected in October-December 2022, partly due to a warmer than average quarter and partly due to higher energy saving by households.\textsuperscript{19} HM Treasury is working closely with the Department for Energy Security and Net Zero to monitor the cost of the scheme regularly.

1.34 Since AS22, energy prices have fallen by 50% which has reduced the forecast cost of the EPG in 2023-24 from £12.8 billion to around £1 billion, although this is partially reversed by the EPG extension which costs an additional £3 billion approximately. This has also more than halved the forecast costs of the EBRs, which has reduced based on current prices from £18.4 billion to £7.3 billion, and means that the expected cost of the EBDS is well below the £5.5 billion cap that was announced in January 2023. The design of the schemes – linking support to the price of energy with a price floor – means that as energy prices have fallen, reducing the need for support, the cost of such support has also fallen, avoiding overpayments. Furthermore, the OBR shows that higher borrowing under a high energy price scenario would be partially “offset by higher... revenues from taxes on the North Sea and electricity generators”.\textsuperscript{20}

1.35 The government is also investing in the future to ensure that the UK has sustainable and reliable energy provision and can deliver the transition to net zero. The government has recently invested £700 million in Sizewell C, and launched Great British Nuclear at Spring Budget, a new state-backed nuclear delivery body that will support the development of future projects.\textsuperscript{21} The government will also provide up to £20 billion funding for early deployment of Carbon Capture, Usage and Storage (CCUS), to help meet the government's climate commitments and provide a source of reliable low carbon power. A shortlist of projects for the first phase of CCUS deployment will be announced later this month. Further capture projects will be able to enter a selection process for Track 1 expansion to be launched this year, and two additional clusters will be selected through a Track 2 process, with details announced shortly. This is a landmark commitment that will support decarbonisation of heavy industry and provide a source of reliable, low carbon power generation for when the wind isn’t blowing and the sun isn’t shining.

\textsuperscript{19} Economic and Fiscal Outlook, Office for Budget Responsibility, March 2023.
\textsuperscript{20} Economic and Fiscal Outlook, Office for Budget Responsibility, March 2023.
\textsuperscript{21} UK government takes major steps forward to secure Britain’s energy independence, Department for Business, Energy & Industrial Strategy, November 2022.
Long-term fiscal pressures

1.36 Over the coming decades, structural changes caused by an ageing population, climate change and the transition to net zero will create significant pressures to public spending and pose risks to the tax base. While we can’t know exactly how structural changes like these will play out over time, we can use projections to prepare for them.

1.37 As the OBR highlights, an ageing population puts upward pressure on health, adult social care, and pension related spending. Taken together, this is expected to grow by around 11 percentage points as a share of GDP from 2026-27 to the end of the long-run horizon in the early 2070s.

1.38 Labour market inactivity has risen since the pandemic, driven primarily by increasing numbers of older workers and increasing numbers of people inactive with a long-term health condition.22 Addressing labour market inactivity and boosting labour supply will deliver fiscal benefits and help to manage the fiscal pressures from an ageing population. An increase in the UK's labour force will increase the tax base, creating higher receipts and more savings. Increases in labour market activity will support UK businesses and help the economy grow, which will provide fiscal benefits through, for example, higher business profits and increased consumer spending. To address labour market inactivity, the government will ensure people are equipped with the right support, training and skills to get the job that they want, as well as removing barriers to work including those relating to health issues or caring responsibilities.

1.39 There is currently a Review of the State Pension age being carried out which is considering whether the existing timetable remains appropriate. The Secretary of State for Work and Pensions will publish the government’s Review of the State Pension age in early 2023. The Review will need to carefully balance important factors, including fiscal sustainability, the economic context, the latest life expectancy data and fairness both to pensioners and taxpayers.

1.40 The transition to net zero also has important implications for the public finances. The government estimate of the overall additional capital expenditure requirements for achieving net zero peaks at over £60 billion by the mid-2030s.23 The exact size and profile of the investment required is uncertain, but most of it will come from the

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private sector. If action were delayed, the OBR estimates this could see debt reaching levels in 2050-51 that are 47% of GDP higher than its early action scenario. If the world fails to bring global warming under control, the OBR estimates debt could rise to 289% of GDP by the end of the century, 199 percentage points higher than a baseline which assumes a stable level of borrowing over the long-run. This is a decisive decade for mobilising private sector investment and managing the risks of climate change. Other major economies such as the US and EU are investing to build their net zero capabilities and drive growth. In AS22, the Chancellor identified green industries as a key growth area for the UK. The commitments at Spring Budget to Carbon Capture, Usage and Storage, nuclear, and the announcement of a call for evidence on green investment incentives will help drive investment into crucial green technologies.

1.41 The Skidmore Review on net zero, which was published in January 2023, highlights the opportunities net zero presents for both individuals and the UK economy. The report makes a number of recommendations for a pro-growth and pro-business green transition, including that the government should accelerate renewables and expedite the set-up of Great British Nuclear in 2023. The government is currently reviewing the recommendations made in the Review and will respond to them later in the year.

1.42 Tax revenues are also affected by the transition to net zero. The shift from internal combustion (ICE) to electric vehicles (EVs) means fuel duty revenues will decline. While this shift is central in achieving net zero, it means fuel duty revenue that in 2019-20 amounted to around £28 billion a year will trend to zero by 2050. As such the government has previously committed to motoring tax revenue keeping pace with the transition to electric vehicles to ensure the government can continue to fund essential public services, while remaining affordable for consumers. With the EV transition accelerating, AS22 announced that from April 2025 EVs will be liable to pay Vehicle Excise Duty in the same way as their ICE counterparts, meaning that all drivers will start to make a fair tax contribution. The government continues to keep tax policy under review.

1.43 The outlook for interest rates and growth are both important for fiscal sustainability. Higher interest rates increase the cost of borrowing and the amount governments spend on servicing its debt, which could otherwise be spent on public services.

1.44 Economic growth is important in ensuring the public finances are on a sustainable path and debt as a share of the economy falls. As set out above, the government’s plan, which is built around the four

26 Economic and Fiscal Outlook, Office for Budget Responsibility, March 2021.
pillars of enterprise, education, employment and everywhere, aims to grow the capacity of the economy and support growth.

1.45 As Chart 2 shows, over the long term, the OBR’s projections show borrowing rises due to growing structural fiscal pressures. Without action, these long-term pressures compound as increased levels of debt will lead to significantly higher spending on debt interest. The actions the government is taking to addressing structural pressures and put the public finances on a sustainable path in the medium term are imperative to avoid these debt interest costs and limit the burden of high debt on future generations.

Chart 2: Change in long-term structural pressures relative to 2026-27

Source: Office for Budget Responsibility and HM Treasury calculations
Conclusion

1.46 The turbulent events of the past year, with heightened global inflation and war in Europe, show the importance of managing risks and fiscal sustainability more than ever. As the OBR highlighted in its report, the “succession of shocks that have buffeted the global and UK economies in recent years have highlighted the challenges of separating consideration of medium-term fiscal risks from the analysis of long-term fiscal sustainability”. The OBR’s report demonstrated the importance of considering sustainability and risks in tandem to ensure both near- and long-term implications are accounted for when setting fiscal strategy.

1.47 As set out in this response, the government is committed to doing just that, with careful management of the public finances including monitoring of risk. The government has taken decisive action to boost growth, halve inflation, and to support households across the UK through cost of living challenges ahead, while making sure to do so in a fiscally responsible way.

1.48 The fiscal rules set out a clear path for the public finances. The OBR’s forecast shows that the rule to have debt falling is met in 2027-28 with a margin of £6.5 billion and the rule to have borrowing under 3% of GDP is met early in 2025-26, and with a headroom of £39.2 billion in the target year, 2027-28.27

27 Economic and Fiscal Outlook, Office for Budget Responsibility, March 2023.
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