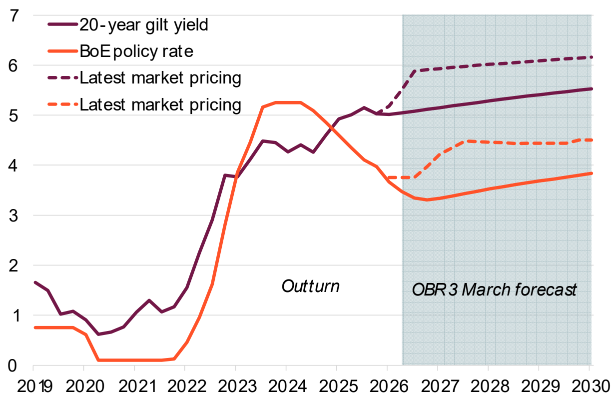
Economics

7 September 2026

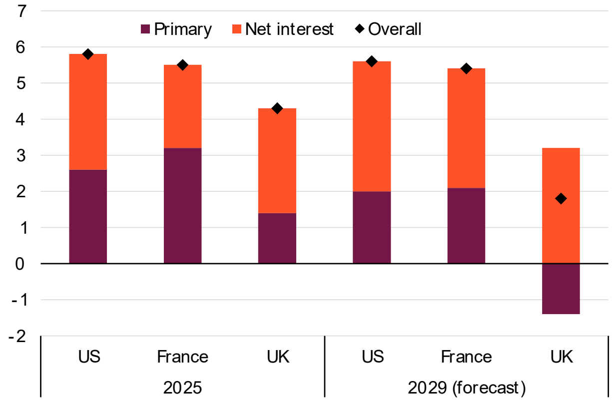
UK: best of a bad fiscal bunch

Chart 1: Higher interest rates = higher debt servicing costs



%. Sources: OBR, Bloomberg

Chart 2: Spot the worst offenders



In % of GDP. Sources: The UK Office for Budget Responsibility (UK), Congressional Budget Office (US) and the European Commission (France)

- **Hands tied:** Newish UK Chancellor John Healey's pledge to meet the fiscal rule set by his predecessor, Rachel Reeves, will limit his room for manoeuvre in his first budget on 28 October. Whereas the US and France have no plan to reduce their fiscal deficits, left on autopilot UK policy would result in a drop in government borrowing from 4.2% of GDP in fiscal year 2025-26 to c2% of GDP in 2029-30. This fiscal consolidation is not only necessary to avoid a nasty reckoning with the bond market, but also the path to faster growth. The Bank of England has ample scope to offset the hit to aggregate demand by lowering interest rates to stimulate private sector growth.
- **A recap of the UK fiscal ecosystem:** Chancellor Healey has kept his predecessor's self-imposed rules: to meet all day-to-day expenditure with tax revenue by 2029-30 and reduce one measure of public sector debt as a share of GDP at the same point. Chancellors set their own rules, but an independent quango – the Office for Budget Responsibility (OBR) – judges whether they will meet them. The OBR publishes economic and public finances forecasts alongside each budget that show whether policy is on track. Political pressure to raise spending and cut tax incentivises the chancellor to meet their target by the finest of margins. After several experiences of small changes in the economic outlook blowing wafer-thin margins for error out of the water, Rachel Reeves left a slightly wider £22bn (0.6% of GDP) margin for error in the spring.
- **Mind your head:** The sharp increase in market interest rate expectations and bond yields since the OBR produced its last set of projections will raise debt interest expenditure by about £12bn in 2029-30 under the new forecast – see Chart 1. This increase will eat up just over half of the government's "headroom". Less predictable are downgrades to the immigration projection (which would lower tax receipts) and upgrades to the inflation forecast (which would raise the inflation-linked interest and welfare bill). There will be little scope to pay for higher spending or tax cuts with more borrowing. Higher taxes would be necessary to achieve that.
- **Tax risk:** The government's existing plan narrows the budget deficit by raising taxes from 35% of GDP to 38%, a post-WWII high. The risk is that the government implements new tax hikes that hurt the supply capacity of the economy by damaging the incentives to employ, work and invest. Past chancellors have calculated how much revenue to raise based on seemingly immovable spending commitments. Encouragingly, Prime Minister Andy Burnham appears to have accepted that expensive renationalisation of water companies and a big additional step-up in spending will have to wait. Small tax hikes are likely, but we do not anticipate another major increase in the size of the state in this budget.
- **Consolidation on course:** It is fashionable to claim that the US, France and the UK are the three economies with the most alarming public finances. However, the US and France are far worse offenders, in our view – see Chart 2. Whereas neither has any plan to cut the deficit, the 2025 payroll tax hikes and frozen personal tax thresholds are working in the UK. The deficit narrowed from 5.2% of GDP in 2024-25 to 4.2% in 2025-26 and is on track to hit 3.5% of GDP this year. Even if the government uses up all the "headroom" on 28 October, unless it also raises its plan for public investment, the OBR will forecast that the deficit will fall to 2.6% of GDP in 2029-30.
- **Fiscal consolidation is a growth policy:** International investors are nervous about lending to the UK because of its recent struggles with inflation and, since Liz Truss's "mini" budget, fears that policymakers are not serious. The bond market would eventually reward the UK for fiscal consolidation. Deleveraging since the financial crisis has cut private sector debt to a 27-year low as a share of GDP. Tighter fiscal policy and disinflation in the labour market can clear the way for a reduction in interest rates that stimulates private sector activity. Burnham should turn to former US President Bill Clinton for inspiration. By prioritising deficit reduction over campaign promises to cut taxes for the middle classes and raise public investment, Clinton ushered in a decline in Treasury yields and faster growth that got him re-elected.

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