Office for **Budget Responsibility**

July 2025 *Fiscal risks and sustainablity report*

Transcript of Presentation by:

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1. Opening Slide

- Thanks Laura, and good morning everyone.

- It's a pleasure to be here in Liverpool for the launch of our 2025 *Fiscal risks and sustainability report*.

- For those of you who are less familiar with these reports, and perhaps more familiar with our *Economic and fiscal outlooks;*

- The purpose of our *FRS* is to draw people's attention to the near-term risks and long-term pressures which are:

    - *not* in our medium-term forecasts for the economy and public finances;

    - but are still important for policymakers to understand and manage if they want to:

        - meet their fiscal targets with confidence in the medium term;

        - and ensure the public finances are on a sustainable path in the long term.

2. Context for this report

- Let me start by putting the contents of this year's *FRS* in the context of the current state of the UK's public finances.

- As you can see from the chart on the left, the UK's public finances have emerged from a series of global economic shocks in a relatively vulnerable position.

- At the end of 2024, the UK government's deficit stood at 5.7 per cent of GDP which is:

    - around 4 percentage points higher than the advanced-economy average;

    - and the third highest among 28 advanced European economies.

- Efforts to put the UK's public finances on a more sustainable footing have met with only limited and temporary success over the past 15 years.

- As you can see from the chart on the right:

    - while getting some measure of public debt falling as a share of GDP has featured in eight out of nine UK fiscal frameworks since 2010;

    - underlying debt has risen by 24 per cent of GDP over the past 15 years;

    - and by 60 per cent of GDP over the past 20.

- The rise in debt since 2010 is partly due to the pandemic and energy crisis, which hit the UK economy particularly hard.

- But borrowing remained elevated and debt has also continued to rise in their aftermath, because successive governments have:

    - reversed plans to consolidate the public finances;

    - and loosened the fiscal rules, which are now among the loosest we have ever had.

3. Context for this report

- At 95 per cent of GDP, public debt is now at its highest level since the early 1960s, and is projected to rise further over the medium term.

- And there are signs that the scale of public borrowing in the UK and other large, advanced economies is putting global sovereign debt markets under pressure.

- Government borrowing costs have risen across the world and are now higher in the UK than in any other major advanced economy.

- Volatility in the cost of the UK's growing stock of debt is just one of many potential claims on the narrow margin the Government has left itself against its fiscal targets of:

    - eliminating the current budget deficit;

    - and getting net financial liabilities falling;

- by the end of the decade.

4. Contents of this report

- Against this more challenging backdrop, the scale and array of risks to the UK fiscal outlook remains daunting.

- In this year's report we focus on three sources of fiscal risk in greater depth:

  - **Chapter 2** looks at the UK system of public and private **pensions**;

  - **Chapter 3** explores the composition of the public sector **balance sheet**;

  - **Chapter 4** updates our estimates of the fiscal risks from **climate change**; and

  - **Chapter 5** provide an update on the **other risks** in our fiscal risk register.

5. UK pensions system in context

- Starting with pensions, one notable feature of the UK system is that it's a mixed economy of public and private provision.

- Total income from pensions in the UK is around 10 per cent of GDP, split roughly evenly between public and private schemes.

- As you can see from this chart, most other European countries tend to have both more expensive and more state-dominated pensions systems.

6. Fiscal risks from the pensions system

- The UK's mixed system of pension provision means that the associated fiscal risks can come from several sources:

  - The most direct is the **state pension**, whose costs are projected to rise due to population ageing and the triple lock.

  - Risks can also come from gaps in **private pension saving**, which could give rise to both direct and indirect pressures on the public finances in future.

- Finally, private pension schemes have historically been important buyers of **government debt**, also known as gilts, and structural shifts in the pension sector are likely to have an effect on the demand for, and cost, of that debt.

7. State pension: Demography and triple lock

- Starting with the first of these, the state pension is the second-largest item in the government budget and annual spending on it has risen steadily:
  - from around 2 per cent of GDP in the mid-20th century;
  - to around 5 per cent of GDP, or around £140 billion, today.
- Part of this rise in the cost of the state pension has been due to a steady rise in life expectancy over this period.
- As you can see in the left-hand chart, in the *FRS* we explore the spending implications of alternative scenarios for life expectancy going forward:
  - our **central projection** assumes that life expectancy at 65 rises from 21 to 26 years by the early 2070s. These demographic changes explain just under 60 per cent of the projected 2.7 per cent of GDP increase in the cost of the state pension over the next 50 years;
  - in a **high life expectancy scenario** where life expectancy at 65 instead reaches 29 years, state pension spending is 0.7 per cent of GDP higher than in our central projection;
  - while in a **low life expectancy scenario** where life expectancy at 65 instead falls slightly to 20 years, spending is 0.8 per cent of GDP lower at the projection horizon.
- But as you can see in the chart on the right, uncertainty around the operation of the triple lock is an equally, if not more, important source of fiscal risk.
- Higher-than-expected volatility in inflation and earnings has meant that the triple lock has already cost around three times more than expected since its introduction in 2012, at around £15 billion by the end of this decade.
- So, in our report, we also explore the implications of different assumptions about the *future* behaviour in inflation and earnings for the cost of the triple lock:

- Our **central projection** for state pension spending is based on the pattern of inflation and earnings outturns between 1992 and the present, and sees state pension spending rise from around 5 to 7.7 per cent of GDP over the next 50 years.

- Were the future behaviour of inflation and earnings to look like the **more volatile** period from 2010 onwards, state pension spending would be 1.5 per cent of GDP higher by the early 2070s, or over £43 billion in today's money.

- By contrast, were inflation and earnings to look more like the **less volatile** two decades prior to the triple lock's introduction, spending would be 1.3 per cent of GDP *lower* by the early 2070s.

8. Private pension enrolment by sector

- Let me turn now to the potential fiscal risks coming from the private pensions sector.

- One positive development in recent years has been the success of auto-enrolment in increasing pension participation.

- As you can see from this chart, the proportion of employees saving in a pension has risen from under 50 to almost 80 per cent over the past decade.

- You can also see that *all* of that increase has come from a more than doubling in the number of employees enrolled in define *contribution* schemes – which has more than offset the steady *decline* in those enrolled in defined *benefit* schemes.

- However, as we highlight in the chapter, some groups including lower earners, renters, and the self-employed are still at risk of under-saving for retirement despite the auto-enrolment revolution.

9. Asset holdings of UK pension schemes

- This brings me to the final, important, source of fiscal risk coming from the pension sector which relates to the changing structure of pension schemes and its implications for the overall demand for UK government debt.

- As I mentioned earlier, the last 30 years have witnessed a shift in the weight of pension savings from DB to DC pension schemes.

- As you can see from this chart, this shift from DB to DC is likely to have a significant impact on overall demand for government debts as:

- DB schemes tend to hold much of their assets in gilts, especially long-term, index-linked gilts;

- while DC schemes tend to hold far fewer gilts and are more heavily invested in riskier assets such as equities in both in the UK and around the world.

10. Projected pension sector holdings of gilts

- The implications of this DB-to-DC shift for overall pension demand for gilts can be seen from this chart

- Pension scheme holdings of gilts are projected to more than halve as a share of GDP:

  - from just under 30 per cent today;

  - to just over 10 per cent by the middle of the century;

  - with slowly rising DC demand being nowhere near sufficient to make up for the steep fall in demand from DB schemes.

11. Gilt holdings by sector

- This poses a fiscal challenge for governments who, as you can see from the chart on the left, have historically relied upon pension schemes to purchase between one-third and two-thirds of their total debt issuance.

- And while the Bank of England has taken up a significant share of net issuance since the financial crisis, it is now also in the process of winding down its holdings of gilts.

- The need to entice more price-sensitive buyers into the market, such as overseas investors, could, we estimate, push up gilt yields by around 0.8 percentage points, some of which may already be reflected in market prices.

- And these overseas investors are, by their nature as comparison shoppers in the global debt market, likely to be more fickle and flighty than their domestic counterparts.

12. Different public balance sheet measures

- Let me now expand our horizons beyond just looking at the Government's principal liability, in the form of gilts, to take a broader view of the public balance sheet, which is the focus of the second chapter of our report.

- In October 2024, the Government adopted a new fiscal rule targeting public sector net financial liabilities, or PSNFL.

- This represented a break with past fiscal frameworks, which have traditionally focused on the narrower concept of public sector net debt, or PSND.

- As you can see from the second column on this diagram, while PSND captures all debt liabilities of the public sector, it only nets off its holdings of *liquid* financial assets (principally foreign exchange reserves and cash deposits).

- Relative to PSND, PSNFL captures, as you can see from the third column:

    - a wider range of financial liabilities, notably those of funded pension schemes;

    - and a wider range of financial assets, notably *illiquid* assets such as loans and equity investments.

- But, as you can see from the right-hand column, PSNFL is still narrower in coverage than the most comprehensive measure, public sector net worth, which:

    - captures *all* liabilities, including those of *unfunded* pension schemes;

    - and *all* assets including *physical* assets, such as land, buildings, military equipment, infrastructure, and intangible assets.

13. Composition and evolution of PSNFL

- Over the past two decades, the size and complexity of the government's financial balance sheet has expanded considerably.

- Since 2004, net financial liabilities have more than doubled from 33 to 83 per cent of GDP. Within this:

    - Financial liabilities have more than doubled from 57 to 132 per cent of GDP, due to an increase in gilt issuance and to finance quantitative easing and other Bank of England activities since 2008.

    - And financial *assets* have also nearly doubled from 26 to 50 per cent of GDP, reflecting growth in funded pension schemes, student loans, and loans to businesses.

14. Sources of risk to PSNFL

- The wider balance sheet coverage of PSNFL means that it is exposed to a wider array of risks than the narrower debt measure.

- In the chapter, we explore three potential sources of risk to the outlook for PSNFL:

    - There are risks that arise from new financial **transactions** which involve a subsidy element, such as concessional loans which would increase net financial liabilities.

    - In addition, the value of PSNFL is exposed to changes in the **valuation** of assets and liabilities that are already on the balance sheet.

    - Finally, PSNFL is exposed to changes in the **classification** of institutions into and out of the public sector.

15. Sensitivity of PSNFL to valuation shocks

- To illustrate the second of these risks, we explore three kinds of valuation shocks:

    - a 1 percentage point reduction in the discount rate used to value public pension liabilities;

    - a 10 per cent fall in the market value of the equity assets on the balance sheet;

    - and a 30 per cent decrease in the value of the government's loan book.

- As you can from this chart, these shocks would raise the level of PSNFL by between 1 and 2½ per cent of GDP in the year of the shock.

- But because the Government's fiscal target is to have PSNFL falling as share of GDP in the later years of the forecast, the rule is still met in all cases.

16. PSNFL impact of water reclassification

- A final set of risks to the outlook for PSNFL come from the potential reclassification, by the ONS, of 'near public sector' bodies which are currently classified to the private sector but provide essential services or serve an important policy purpose.

- To illustrate the potential scale of these risks, this chart looks at the impact of a potential reclassification of private water companies into the public sector.

- Moving from left to right, water companies:

    - only have around £12 billion in financial assets, shown in the first two purple bars, which would be recognised in PSNFL;

    - but they have £91 billion in debt and other financial liabilities, shown in the second two bars in green, which would also be recognised in PSNFL;

    - this means that the net impact of their reclassification into the public sector would be an increase in PSFNL of around £78 billion, or just under 3 per cent of GDP, shown in the large black bar;

    - and while water companies also have £94 billion in *non-financial* assets, mainly the water network shown in purple, these physical assets would *not* count toward PSNFL, which only counts financial assets.

17. Emissions, temperatures, and damage

- Let me know turn to the last of the main chapters of the report which looks at the fiscal risks from climate change.

- As you can see from the chart on the left, the world is on course to exceed, by the end of the decade, the Paris Agreement goal of limiting the rise in global temperatures to 1.5°C above pre-industrial levels.

- As you can see from the chart on the right, the costs of a hotter and more volatile climate are also rising, with economic and insured losses from extreme weather up by 29 and 38 per cent respectively on the previous decade.

18. Fiscal risks for climate change

- Climate change creates risks to the public finances through three main channels:

    - First, there are the costs to government of climate change **mitigation** – that is the actions necessary to reduce our carbon emissions and limit our contribution to the rise in global temperatures. These were the focus of our 2021 *Fiscal risks report*.

    - Second, there are the economic and fiscal consequences of the physical **damage** caused by the climatic changes that still occur despite those mitigation efforts. These were the focus of last year's *FRS*.

- Third, there are the economic and fiscal implications of **adapting** to a hotter and more volatile climate. We'll be looking into these in a future *FRS*.

- Chapter 4 of this report focuses on updating and integrating our previous estimates of climate-related damage and mitigation, to get a more comprehensive estimate of the fiscal implications of climate change.

19. Climate damage (3˚C): Economic and fiscal costs

- Starting with climate-related *damage*, our latest estimates of the economic and fiscal costs of a 3 degree rise in global temperatures is significantly higher with:

  - real GDP being 8 per cent lower by the early 2070s, which is 3 percentage points more than in our previous estimate;

  - and the primary fiscal deficit is project to be 2 per cent of GDP higher by the early 2070s, which is 0.7 percentage points higher than our 2024 estimate.

- These increases in estimated costs are largely due to using a more comprehensive and up-to-date analysis of climate-related damage to the UK economy which takes account of not just higher temperatures but also higher precipitation and more extreme weather.

20. Climate mitigation: Fiscal costs

- Turning to the fiscal costs of *mitigating* climate change, our latest central estimate of the cost to government of reducing the UK's carbon emissions to net zero by 2050 is around £30 billion per year:

  - as you can see from the chart on the left, around two-thirds of this cost comes from lost tax receipts, mostly from fuel duty as petrol driven cars are replaced by electric vehicles;

  - the remining third is a central estimate of the state's share of the economy-wide investments needed to transition our energy, transport, heating systems from fossil fuels to renewable sources.

- The chart on the right shows that our latest central estimate of the cumulative fiscal costs of the net zero transition, at 21 per cent of GDP, is 9 percentage points lower than our previous estimate.

- This fall in fiscal costs is mainly driven by a reduction in the Climate Change Committee's estimates of the whole-economy investment cost of reaching net zero.

21. Climate change: Total fiscal costs scenarios

- For the first time in this report, we can also combine our estimates of the fiscal costs of climate damage and mitigation into an overall estimate of the fiscal risks from climate change.

- While it is tempting to want to infer some trade-off between investments in climate mitigation and reductions in climate damage, the reality for a relatively small emitter like the UK is that these costs are likely to be additive rather than substitutes.

- So, in our central 3°C scenario, the combined fiscal impact of climate change adds 74 per cent of GDP to government debt by the early 2070s, relative to our latest long-term projection.

- But as you can see from the other bars on this chart, this is only one of an array of possible scenarios for the fiscal costs of climate change which stretch from:

    - on the far left, a low fiscal cost scenario, costing just 34 per cent of GDP, in which government accepts a much lower share of the economy-wide investment costs of getting to net zero and finds a replacement for the lost revenue from motoring taxes;

    - and on the far right, a scenario is which the damage from climate change is twice our central estimate and debt is 137 per cent of GDP higher by the early 2070s.

22. Conclusions

- In conclusion, the UK's public finances have exited a series of global shocks in a relatively vulnerable position.

- At the end of last year, the UK government had the sixth-highest debt, fifth-highest deficit, and third-highest borrowing costs among 36 advanced economies.

- UK government debt is now at its highest level since the 1960s and set to continue rising over the next five years.

- The report we have published today explores only three of the many sources of risk to the public finances over the coming decades.

- The final chapter of the report and associated risk register considers a large array of other risks I have not mentioned including:

    - rising global tensions over trade policy;
    - upward pressures on defence spending in Europe;
    - and uncertainty around the medium-term outlook for the UK economy.

- Given the frequency and severity of the shocks that the UK economy and public finances have experienced in recent years, any appreciation of the fiscal outlook:
    - cannot be based solely on a central forecast of tax, spending, borrowing, and debt;
    - but also needs to take account of the inevitability of at least some of these risks materialising.