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Who would want to be Rachel Reeves this autumn?

As borrowing costs soar and the pound falters, Chancellor Rachel Reeves faces mounting pressure to stabilise the UK's public finances. Difficulties include limited room for tax rises, sluggish growth and stubborn inflation. Iain Begg writes that the government must confront hard choices on debt, welfare and investment, before markets lose confidence.

Headlines about a sharp fall in the pound and rising borrowing costs will not be welcomed by the Chancellor of the Exchequer, Rachel Reeves. Comparisons are already being drawn with the short-lived premiership of Liz Truss when a spike in the cost of public borrowing so undermined the government that both the Chancellor and the Prime Minister were forced out of office within weeks of coming to power.

In the Truss episode, the blame lay with an ill-judged mini budget offering unfunded spending promises and unwise tax cuts for the very rich. The reaction of financial markets was swift and brutal, yet it is easily forgotten that the then new team of Jeremy Hunt as Chancellor and Rishi Sunak as PM managed quite rapidly to restore stability.

The problem now facing Rachel Reeves is much tougher and has several elements, all contributing to the growing concerns about the costs of servicing the national debt, some reflecting the state of the economy, others attributable to political and policy choices.

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Stagnant economy

First, after the economic rebound from the pandemic, the UK economy has essentially been flatlining. For all the hubristic rhetoric about having the fastest growth in the G7, the quarterly

increase in GDP since the start of 2022 has barely averaged 0.3 per cent.

Second, **public net debt** has increased markedly. In 2007, before the global financial crisis, it stood at 35 per cent of GDP, before doubling to 70 per cent four years later. Debt increased further during the 2010s and had reached over 80 per cent as the pandemic struck, then reached a new plateau of 95-96 per cent in the years that followed.

The third factor was a surge in inflation after 2021, obliging the Bank of England to jack up interest rates. Instead of being able to borrow at negligible interest rates, the cost of borrowing started to weigh much more heavily on the public accounts. In the fiscal year 2024/25, the **Office for Budget Responsibility** projected that debt service costs will be £107 billion, over four times the cost in fiscal year 2020/21 when the pandemic was at its height.

The figure represents some eight per cent of public spending and 3.7 per cent of GDP, the latter being substantially higher than defence spending or, indeed, of the ambition to raise defence spending to 3.5 per cent of GDP by 2035. It is expected to increase further in the current fiscal year and, if the current market rates do not ease, the cost will overshoot the OBR projections.

To reduce it, one of three things must happen: current government borrowing has to be reduced sufficiently to decrease the stock of debt, implying tax increases or expenditure cuts; the growth rate has to increase, such that the denominator of the debt to GDP ratio increases faster than the numerator; or the interest rate the government is obliged to offer has to fall.

Unfavourable prospects

Against this backdrop, the government's manifesto commitment not to raise any of the three main taxes on working people – VAT, income tax and employee's national insurance – leaves the Chancellor with little scope to increase government revenue substantially. As the débâcle over attempts earlier this year to prune the welfare budget showed, cutting public spending is hard. Moreover, the imperatives of spending more on defence, on net zero and, in the medium-term, on dealing with an ageing population all add to spending pressures. Consequently, a reduction in current government borrowing will not happen soon.

What about growth? The trouble is that governments do not possess magic wands that can be waved to increase it rapidly. Policies to boost productivity, to accelerate infrastructure investment and to loosen planning restrictions are appropriate, but the financial markets, which are driving up the UK's borrowing costs, look at developments today, not promises for tomorrow, let alone five years hence.

That leaves the general trend of interest rates. UK inflation is proving to be stubbornly high and could worsen if the pound falls in value, leading the Bank of England to be far more cautious than

its counterpart in Frankfurt about cutting rates. The trend is down a little and the Monetary Policy Committee may opt for another quarter point cut later this year, but not much more.

There has been talk of the UK having to seek a bailout loan from the IMF, but we are still a long way from such a scenario, which would, it should be recognised, come with tough conditions about curbing public spending. However, the direction of travel will have to change soon, evoking the old saying “I would not start from here”.

Three strategic responses

Rachel Reeves now must consider several strategic responses, none of which will be easy to adopt or offer quick solutions. First, she has tied herself to fiscal rules which **most commentators agree** are poorly conceived. Instead, she should focus on reducing public debt, both to ease the debt financing burden and to enhance debt sustainability. Financial markets will look much more favourably on governments that have a credible plan to reduce public debt.

Second, renewed efforts to curb welfare spending are essential, despite the evident political costs. The rise in the proportion of economically inactive working-age people needs to be reversed by designing more effective welfare-to-work policies and tough decisions will be needed on the rising costs of pensions, notably the “triple-lock”.

The third agenda is ostensibly at the heart of government policy: boosting economic growth. The trouble is that too many of the necessary initiatives are taking too long. Easing planning constraints, boosting infrastructure investment and enhancing skills are central to economic growth, but announcements will not suffice. These and other measures – innovation, new trade deals and so on – will have to be pursued with greater urgency.

The UK is not unique in facing fiscal headwinds and the Chancellor could even be allowed a little *schadenfreude* in observing developments in France, which has even higher public debt and is facing a period of severe political instability. But as a member of the Eurozone, France is able to borrow on much better terms than the UK, **despite its spread increasing** vis-à-vis the German bund, and can count on support from the European Central Bank. Few would want to be in Rachel Reeves’s shoes this autumn.

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