



Economic Affairs Committee

Corrected oral evidence: How sustainable is our national debt?

Tuesday 12 December 2023

3.05 pm

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Members present: Lord Bridges of Headley (The Chair); Lord Blackwell; Lord Davies of Brixton; Lord Griffiths of Fforestfach; Lord King of Lothbury; Lord Layard; Baroness Liddell of Coatdyke; Lord Londesborough; Baroness Noakes; Lord Turnbull.

Evidence Session No. 1

Heard in Public

Questions 1 - 24

Witnesses

I: Professor Jagjit Chadha, Director, National Institute of Economic and Social Research; Martin Slater, Emeritus Fellow in Economics, St Edmund Hall, University of Oxford.

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Examination of witnesses

Professor Jagjit Chadha and Martin Slater.

Q1 **The Chair:** Good afternoon and welcome to this first evidence session of the Economic Affairs Committee's inquiry into how sustainable our national debt is. Could our witnesses introduce themselves, please?

Martin Slater: For most of my life, I was economics fellow at St Edmund Hall in Oxford. I retired in 2013. Strangely, in my working life, I had nothing to do with the national debt—I was an industrial economist—but, when I retired, I got very interested in it. I ended up writing a book that was published in 2018, but I still consider myself as fairly retired.

Professor Jagjit Chadha: Thank you for inviting me. I am director of the National Institute of Economic and Social Research. You will know our work very well. It is particularly concerned with the UK's monetary fiscal programme, both in terms of reaching its own objectives but also in comparison to other advanced economies. As an institute, we have been involved in this work for many decades, but particularly since I became director in 2016.

The Chair: This is our first evidence session, so I will start off with a general scene-setter question before we go into the detail. I will ask you to make the three broadest points that you would like to make, just to help frame this discussion. We will cover a lot of issues, so if you could summarise very briefly your three key messages in response to our essay question, we can then go on. The question is, "How sustainable is our national debt?"

Martin Slater: When I wrote that book, which was about five or six years ago, my feeling at the time was that the national debt was relatively okay and that the hysteria of the time was somewhat overdone. Historically speaking, although the numbers were going in the wrong direction at the wrong time, they were still not large by historical comparisons. The UK national debt had a number of favourable characteristics that protected it against shocks. Clearly, some long-term decisions and some adjustments would have to be made, but there seemed to be ample time to do that.

Since then, we have had a rather rapid series of shocks, and some of those favourable circumstances have evaporated alarmingly quickly, so things look a little more worrying. Again, I still do not think that it is totally time for panic, but the timeframe for those decisions and adjustments is a lot more urgent.

Secondly, one thing that struck me recently is that there is an increasing proportion of foreign ownership of the national debt. One of the stabilising features of debt in the past was that most of it was domestically owned. One of the features of that is that this means that debt is not a net drain on the economy but mostly a redistribution within the economy. It is now more of a net drain on the economy.

The third thing that struck me originally is that the consequences of ageing and healthcare, which drive most of the dire long-term forecasts, are not really appropriate matters to be dealt with by the national debt. They are permanent and continuous problems, and you cannot fund those things continuously by the national debt. Some other method will have to be used to deal with those.

Professor Jagjit Chadha: The right way to think about national debt is that, ultimately, it is an instrument of economic management. The level of debt moves in response to economic shocks, as you just heard from Martin, and it rightly does so to limit the need for taxes to change immediately. One principle that we want the national debt to try to support is that of tax smoothing. We do not want to move taxes too quickly or too abruptly in response to shocks, so it is possible to let debt take the strain while we adjust the economy to those shocks and decide how, in the future, we will raise revenues.

It is also quite right to deploy debt as an instrument to deal with the build-up of the provision of public goods, and to think very hard about the level of public investment that we might need as a society in response to problems that we might face over time. Ultimately, if we manage these things properly, with due understanding of the constraints that we have to run—this is ultimately to fund the public debt through revenues and to understand very well that the holders of public debt will want security that their investments will repay over time—the Government must be in a position to have the public debt at such a level that, when shocks come along, they are able to act. In a sense, the ultimate instrument of economic policy is public debt in order to try to alleviate shocks and uncertainty when they come along.

The working definition with which I would like to think about sustainability is: a level of public debt such that, when a shock comes along, we are able to access financial markets and respond to the problems in a prompt manner to try to alleviate the impact on the economy that might otherwise obtain.

The Chair: That very nicely segues into the follow-up question that I was going to ask. Does the metric of debt as a percentage of GDP adequately capture sustainability?

Professor Jagjit Chadha: The issue is that sustainability is a long-run concept. It is something that we are thinking about over the very long run. In that sense, just looking at the way that debt to GDP evolves year to year does not give you much of a measure of whether it is sustainable. When we think about sustainability, we are really asking ourselves whether debt will grow without bound relative to national income. It inherently involves some judgment about the future path of expenditures and revenues over time, so that the debt does not grow in the manner I outlined.

Measuring debt to GDP is a useful start—it is our obligations in terms of debt relative to our tax base—but we need to know a lot of other things

before we can understand the constraints that government may face or, indeed, the space that it might have in response to those shocks. We may wish to know the level of debt service costs, how easily we can raise tax revenue performance and how much debt will be rolled over in any particular year, given that an equivalent level of debt that is more short term—as opposed to long run—is arguably riskier, because you have to roll over more of it every year and access financial markets.

The Chair: We might come back to that point.

Professor Jagjit Chadha: I am building up to a view that it is much more complicated than looking at just one ratio. There are a number of factors of public debt. The extent to which it is in conventional index-linked terms, or whether we might want to bring about other forms of debt linked in a particular way, will ultimately give us a sense of whether it is sustainable. As I said, the ultimate measure of its sustainability is whether, when a shock comes along, we can borrow what is needed to achieve the things that we want. That is not a very easy working definition for the purposes of this House, but that is what it boils down to.

Martin Slater: I would agree with most of that. The debt-to-GDP ratio does not guarantee sustainability of itself. The same debt ratio could be sustainable or unsustainable in different circumstances. It is part of a well-known formula of debt sustainability, which involves the debt ratio, the rate of interest, the growth of the economy and the Government's primary surplus, but it is not a good idea to try to interpret that equation too mechanistically. Sustainability is not black and white; it is largely a matter of the political difficulty and the political commitment to make it sustainable.

The Chair: Can I ask about your views on the use of it vis-à-vis what Reinhart and Rogoff argued in their 2010 paper, which is that the relationship between government debt and real GDP growth is weak for debt-to-GDP ratios below a threshold of 90% of GDP? Above 90%, their study found that "median growth rates fall by 1%, and average growth falls considerably more". I hear what you are saying, which I will not repeat, but surely it is a useful barometer from that point of view if you accept those findings.

Martin Slater: It is very useful information to have—there is no doubt about that—but I do not really like the Reinhart and Rogoff clear-cut, "There is a critical 90%", which was bandied around quite a lot at the time when I was writing the book. If you look back at British history, the British debt-to-GDP ratio was well above 200%, and that was followed by a century of the strongest economic growth that the British economy had. So these things are much more subtle than just one ratio can determine.

Professor Jagjit Chadha: Of course we worry about very high levels of national debt, which is, ultimately, a burden on future generations. It is right to think very seriously about how much of a burden we want to give to future generations. To the extent that the debt is responding to shocks, building up public capacity for the provision of public goods and

helping the economy get through shocks, that might be an appropriate level to have. But we cannot give you an exact number for the appropriate level.

To some extent, there is also some truth in the fact that too high a debt level signals to people in the economy that taxes will have to rise at some point in the future, and we may not be able to respond to shocks in the way that we have in the past. There is a concern about higher levels of debt, but you cannot boil it down to a number like 90%, 87.3% or, if we go back in time, the Maastricht criterion of 60%. It is just not as simple as that.

To some extent, the dialogue and the narrative that we have in the country is damaged by thinking about particular numbers in this case. There would be a case for a much richer analysis and explanation of why we are doing certain things to give a broader understanding.

Q2 Lord Davies of Brixton: I will pick up this point about a burden on future generations. Someone said that it was distributional, so how can a redistribution be a burden? Is it only the foreign debt that is a burden?

Martin Slater: Even if debt is purely redistributional, it still produces a burden on the economy, in that we have to levy taxes, which distort incentives in the economy, reducing GDP and growth. A purely redistributive debt is less of a drain than a debt that is owned by foreigners, who take the interest payments and the repayment away. That is a direct loss of GDP, whereas the distortionary effects are rather more indirect.

Lord Turnbull: Another way of putting Lord Davies's point is that the burden is on the parts of the economy that pay tax—namely, working people and companies—and not on savers or the retired. It is a burden but not for everyone.

Martin Slater: It is a different kind of burden. The burden is not evenly distributed. That is one of its problems. From its very inception, the national debt divides the country into different groups and, historically, those divisions have sometimes been very severe.

Q3 Lord Blackwell: I declare that I am a trustee of charitable organisations that have investments in government bonds. I have also personally independently managed investments that have holdings of government bonds.

I will ask you about how the UK's national debt compares with other developed nations in terms of sustainability. Every major country has had growth in debt to GDP over the last few years. The UK is higher than the OECD average, but Japan is way out in front. You have both explained that sustainability depends on a number of national characteristics. When you look at the UK's debt level and trend compared to other countries', how should we think about our relative sustainability?

Professor Jagjit Chadha: You are right to say that the UK's debt relative to GDP has increased markedly this century. It was about 50% at

the turn of the century and is now around 100%. As you also said, that trend is common across advanced economies. You are quite right that we are above the OECD average, but we are at the bottom of the G7 pack in terms of debt to GDP. For advanced economies that have been at the forefront of incomes per head for a very long time, our debt does not look terribly high in comparison to those economies. Let us leave Japan, at 250%, on one side for the moment. Relative to the US, Italy and France, but not Germany, we are in a reasonable situation in simple comparison terms.

We might ask ourselves why it has ratcheted up so rapidly. Clearly, there were the financial costs associated with the financial crisis, as well as the support given to the economy during Covid and, subsequently, during what has been commonly called the cost of living crisis. All of these things have ratcheted up debt to the kind of level that we see.

One of the reasons that debt relative to GDP is higher than we might have anticipated a generation ago is that growth—the denominator—has been lower. Lots of people have tried to understand the extent to which our GDP is lower than what we anticipated 10 or 15 years ago, and a lot of numbers are bandied around, but it is something in the region of 10% to 15% lower than we anticipated. Had we had the level of GDP growth that we anticipated, debt to GDP would be considerably lower, at least in simple arithmetic terms.

Part of the call on the fiscal purse has been to sustain, to some degree, the level of public services that would have been consistent with the growth rate that we anticipated, which has tended to crank up the level of debt. When you add the shocks that I have talked about, that is the other reason that we have ended up with these higher levels of debt.

The situation is not at crisis point or desperate at the moment. Looking forward, our biggest concern is how that might evolve in the future. Having got to this level, will it ratchet up further? There are factors that we might want to come back to later, particularly now that financing or borrowing costs have come back to recognisable levels. Going forward, what will that do to the fiscal situation?

Where we currently sit does not seem too bad in terms of the maturity of our debt, if you put the quantitative easing programme to one side. The international demand for it, as well as that from domestic pension funds, seems to be good. If we put aside what we might call the fiscal experiment of last September and what that taught us about how to manage demand for public debt, it perhaps gives us a platform to think hard about how we will manage the risks of the public debt going forward and yet still meet the objectives for better economic policies than we have had.

Lord Blackwell: You mentioned that France, Italy, the US and Japan have higher levels. Are they in a better or worse position to sustain those debt levels?

Martin Slater: Going back to the earlier question about the status of the debt-to-GDP ratio on its own, one of the things that has happened in the last few years has disadvantaged the UK relative to those countries. France and the US have roughly the same debt-to-GDP ratio. In our case, the rate of interest on the national debt has, for peculiar reasons, gone up dramatically, and our growth rate has gone down. Those are two critical variables in the sustainability formula that I mentioned.

In the case of France and the US, things are much better. Although the debt-to-GDP ratios are rather similar, those economies are probably more sustainable than we are at the moment. Japan, which you mentioned, has had a debt-to-GDP ratio of well over 200% for decades. There are a lot of question marks about the Japanese economy, but no one questions the stability of the Japanese national debt.

Lord Blackwell: Has it been increasing at the same rate or has it been stable?

Martin Slater: I would not know about that. I have not been following that.

Professor Jagjit Chadha: On Japan, there are some issues as to whether they will be able to control inflation—there is a sense in which, given that large level of debt, it may be a cap. Something that is bandied about a lot is the idea of fiscal dominance and the extent to which the monetary policy authorities may find it hard to control inflation because of the way that that level of debt would interact with the government finances. I would not hold Japan up as an example for us to follow. We do not want to go anywhere near those kinds of levels.

There is, of course, a strong domestic demand in Japan for holding those bonds, which has helped support the supply of that quantity over this period, but I do not think that it is a world that we want to get into. Of course, to some extent, with France being in the euro area and the US having the world's reserve currency, there is an extra level of demand or stability for those bonds.

We might come to this later on, but it is so important that our fiscal and monetary institutions continue to be strong in the way that they have been over the last 15 years, leaving the period of September 2022 on one side. That provides overseas investors with comfort that things will be done in the appropriate way and that we will explain why we pick particular fiscal paths, which means that they will not substitute out of UK bonds for other bonds that they might otherwise want to hold. We saw that they can substitute very quickly for other bonds if they want to, if we do not do things appropriately and follow practices that are consistent with sound monetary practice.

Lord Blackwell: So far as the markets are concerned, it is not just the level of debt but their assumptions about future growth rates and debt levels.

Martin Slater: Yes.

Professor Jagjit Chadha: It is future growth rates, how taxes will evolve over time and the productivity of the economy. We might come to this a little later on, but it is not clear that, if we issue debt that is for capital expenditure, the markets will treat it in as bad a way as if we were issuing debt because we cannot raise enough tax revenues. It is a very different proposition for the markets.

Q4 **Lord Londesborough:** I am interested in your comments in relation to the global context of sovereign debt and how much comfort we should take that the UK does not look like one of the outliers within the G7. Japan is always the example that is used and appears to be at least two and a half times as indebted as us. Rather than looking just at the UK, what is your view of the sustainability of global sovereign debt? Can this go on expanding forever?

Martin Slater: I do not have any very firm views on that. I do not think that global debt has a limitless possibility either. The problem about the globe as a whole is that there are no unifying monetary and financial institutions that control it. To the extent that the US has been the dominant economy, we have all been heavily dependent on the control of the American authorities, but, if the Americans were to lose their dominance, life would be very turbulent indeed.

Lord Londesborough: Is it a false bit of comfort that we look and say, "Within the G7, we are positioned fifth and the problems are greater elsewhere", which raises less of a question around the sustainability of our debt?

Martin Slater: It is reasonably comforting. We would feel less comforted if we were at the top of those things along with Japan. It is not a cast iron guarantee that we will all right, but it certainly suggests that there is not something dreadfully wrong, idiosyncratically, with the UK economy.

Q5 **Lord King of Lothbury:** I will put two questions to you. First, it seems that the surprises that come along are of the kind where, every now and then, we may have a pandemic, need to raise military expenditure or need to subsidise energy prices, so there will be periods when the ratio of debt to national income jumps up. If that is the case and the shocks are like that, in a normal year, when you are not experiencing that phenomenon for the first time, would you not want the ratio of debt to national income to be gently declining, so that you are ready to allow it to jump up? Otherwise, you are in a position where there will be an underlying trend of higher and higher debt to national income.

Secondly, if you were commissioned by the Government to write a report on the factors that will determine the sustainability of the UK national debt over the next 25 years, which factors would you want to pinpoint and suggest to the Government that they should be the subject of a debate in Parliament?

Professor Jagjit Chadha: You are absolutely right. In response to shocks, there ought to be a temporary increase in debt and, once the shock has passed, we can look at the economy, see how it might have changed and think about ways of raising revenues to bring debt down. Also, growth will resume, which will act to bring down the level of debt to GDP.

The issue that we have when we describe the last 12 to 15 years is that we have had a number of large shocks that have followed each other, with relatively small periods between them to allow a natural adjustment to have occurred. You and I have looked in the past at the adjustment in the 18th century from a sequence of wars, in which debt to GDP came down very quickly afterwards. There were several years even between them, and we had, of course, long periods of adjustment after the Napoleonic wars as well to bring down debt to GDP.

In principle, it is absolutely right that, after discrete events, we should reconfigure the tax system to understand how we can best raise revenues, and the process of growth itself would affect debt to GDP. That has not happened yet, but that would certainly be and ought to be the aim of policy moving forward.

Martin Slater: You mention exactly what I thought. If you go back to the 18th century, you find a very similar problem of short, sharp shocks happening rapidly after one another. The whole thing ratchets up in a sawtooth. They never really get on top of it: they half pay off the debt from each war, and then the next one starts.

The problem that emerges, looking at the last 20 years, is the one that you suggest: unlike the previous pattern, which is that of a spike and recovery, there is a slow upward creep with no obvious end in sight. As I mentioned right at the beginning, the national debt is very good at evening out problems of dealing with spikes, but it is totally inappropriate for running a long-term, continuous and permanent budget deficit.

Lord King of Lothbury: My second question was about your report to the Government.

Professor Jagjit Chadha: A factor determining the medium-term path of public debt will very much be the pattern of real interest rates globally. We can see, in the last quarter of a century, a secular decline in real rates. Going back to an earlier question, it looks as though some Governments around the world have allowed us to trace out the demand curve in having to issue even more public debt as interest rates have gone down over time. That has also been part of what has commonly been called the savings glut: savings in growing parts of the world have tended to push down real interest rates and provide debtor countries, or countries that want to expand their level of demand by issuing more amounts of debt. That is something that we have seen.

Clearly, thinking about debt dynamics, it would be incredibly important to think about where borrowing costs will go, but one extra point on

borrowing costs is often missed. It is not only the cost of the debt that we have issued. If we think of the whole of government balance sheet, there is also a question of the returns from the assets that we have. If we have, net of the costs of borrowing, positive returns from the assets that we have, the costs of servicing debt may be somewhat less than just looking at borrowing costs alone. I would certainly want the cost of servicing debt to be a big part of any report.

The second thing, of course, is the denominator. Where do we think growth is going? What are the factors determining growth in the economy? That is the tax base. Is that being helped or hindered by an ageing population? Are there things that we can do to manage growth in a better way in order to deliver a greater tax base to allow public debt to be more easily serviceable?

The third thing that I would want to think about is government expenditures. Are there any ways that we can curtail some of the risks inherent in those? Can we automatically uprate retirement age with life expectancy? Are there things that we should do with the triple lock on pensions, which will cost 1% more of GDP over the next four or five years than we might have anticipated? Are there things that we have committed to, in terms of expenditure, that we should move away from because they have a residual risk to the ultimate level of public finances in the economy? Those are the three things that I would have in that report.

Martin Slater: I agree with a lot of that. One thing that I would add, which sometimes gets overlooked and was very important historically, is the importance of maintaining an efficient and effective tax system. Historically, the success of the UK national debt was very largely down to the fact that it also developed a very efficient and well-reputed tax system. To the extent that your tax system begins to fray at the edges, that really undermines the national debt because, essentially, the whole security of the national debt depends on the Government's ability to command tax repayments.

Q6 Lord Davies of Brixton: There has been discussion recently about the Government's ability to get enough people to buy their debt in the short term, which is clearly an issue. Do you have any comments on the more general aspect of whether there is a limitation on the Government's ability to sell their debt? To put it another way, what do they have to do to ensure that they can sell all of their debt?

Martin Slater: I am probably not best placed to answer that, because I have never been a debt practitioner, and debt practitioners are much closer to the important information there. At the time when I was writing my book, despite the numbers not looking terribly good, the Government seemed to have very little difficulty in placing their national debt. They have experienced a little more recently, and the episode of last autumn showed that there clearly is a limit to the patience of the buyers of national debt, which we have not seen before in that way.

One of the things that I noticed recently in the OBR predictions is that there has been a decline in interest in the national debt from UK pension and insurance companies. In the past, the mainstay of the bond-holding public were pension and insurance companies that loved the national debt as their reserve assets. The demand for this sort of thing has begun to tail off, due partly to the running down of defined benefit pension schemes.

This has been, to some extent, replaced by buyers from abroad, which I know very much less about, I am afraid. There are two problems there. One is that buyers from abroad might be a lot more volatile than the domestic institutions have been in the past. The second, as I said at the beginning, is that buyers from abroad show that there is a net drain, essentially, on the balance of payments, which was not there before.

Professor Jagjit Chadha: Buyers from abroad have alternatives that they are prepared to hold. Sovereigns can decide to hold another country's debt if they wish to. That supports the case for the UK monetary and fiscal programme being as clear as it can be. It argues for not altering the target for price stability of around 2% for the Bank of England. We do not want to see bonds or the exchange rate depreciating at a faster rate than those of other countries. All of that becomes very important. In terms of fiscal policy, abrupt changes in taxes, revenue performance or expenditure may also pose some problems for foreign holders of debt.

In general, the way to ensure that there is strong demand for UK debt at the time we want to issue it is to try to maximise liquidity in the market, minimise the cost of issuance and ensure that we have a long maturity of debt, such that there is no lumpy issuance at any particular moment in time or any greater need to call the market on one day than on any other day at some point in the future.

That would mean also appealing to preferred habitats out there in the marketplace in order to ensure that we have sufficient supply of index-linked bonds to provide inflation protection for people who want to buy that, as well as ensuring that there is an appropriate supply of short and longer-term maturities for people who want those kinds of matching assets and liabilities in their portfolios. It is very much a case of that overall programme being well designed, so that, when we go to the market, people can access the asset that they need.

Lord Davies of Brixton: The interest rate has to be right as well.

Professor Jagjit Chadha: Yes. The interest rate is the price at which you are able to lend the debt, but you do not want that to be biased or affected by particular habitat-type behaviour along the yield curve because one part of it is short at one point in time.

Lord Davies of Brixton: There is some suggestion that the experiment that the Government undertook last year was not so much the amount of the debt that was in prospect but the uncertainty about whether the

Government knew what they were doing.

Professor Jagjit Chadha: There were two aspects. One was the sudden and increased call on markets for debt, and then a further announcement that there may be even more to come, at a time when where we would end up after all of that was not entirely certain. Uncertainty was part of it, but there was a sequence of announcements that suggested that there would be a large call on debt, as well as that perhaps not being underpinned with an appropriate fiscal programme to say exactly how it would be paid.

Even if the Government were prepared to say it, they were not then prepared to have their analysis marked by the Office for Budget Responsibility, which would say whether this was a credible statement. That, of course, left markets unsure about the direction in which policy would go and whether it was, ultimately, something that was unsustainable in the manner that we have talked about today.

Q7 **Baroness Liddell of Coatdyke:** You said very succinctly at the beginning that it is a very powerful instrument of economic management. As an extension of what Lord Davies asked, what implications do the structure of the UK's national debt have for short and longer-term funding? Can you give us an idea of the costs and benefits of the extent to which there is foreign ownership of the debt as part of an overall picture?

Professor Jagjit Chadha: Around 30% of the debt is owned overseas.

Martin Slater: It is 25% to 30%.

The Chair: Has it grown?

Martin Slater: It has grown.

Professor Jagjit Chadha: It has been like that for a long time.

Martin Slater: According to the OBR, around about the millennium, it was only about 11% to 12%, and it has now grown to 25%. That is quite a considerable percentage of GDP that is going abroad.

Professor Jagjit Chadha: I would not see it as a problem per se that overseas investors are holding government debt. In a sense, it acts as a further constraint and examination of our fiscal position. If overseas sovereigns want to hold sterling debt as part of the management of their own liabilities and assets, that is not a bad thing. Some 6% of global bonds are held in sterling terms, although much larger fractions, of course, are in euro and dollar terms. Some part of it is potentially a legacy of when sterling was the world's reserve currency. As a country that has international trade and financial ambitions, having overseas investors hold UK bonds is not a problem or an issue per se, as far as I am concerned.

The point reverts again to the question that both Lord Davies and you asked, which is whether, on the margin, that makes people focus on what we do more carefully than they would otherwise because they are holding our debt. The experience of last autumn says that that is the case, but I do not necessarily think that it is a bad thing to have that discipline in mind when we set monetary and fiscal policy. If it means that we end up being in a place that is less worrisome in terms of debt and GDP and we are managing it better, that is a good rather than a bad thing.

On the structure of debt, if we take QE out of the equation, the maturity of our debt is some 15 to 17 years. That makes us, in principle, less sensitive to changes in the costs of borrowing. It also means that, in any one year, you are not rolling over as much debt, so it makes the debt more sustainable. That is a good thing, not a bad thing. We should keep encouraging debt issuance along the maturity structure as far as we can in order to ensure, as I have said a number of times, that, in any one year, there is not too much of a rollover or a requirement for financial markets to fund us. It could very well be that, that year, we hit the kinds of shocks that we do not want to hit—so we have the ability to borrow at that time. It limits our year-to-year call on financial markets.

Martin Slater: It is desirable to sell bonds as long term as possible, although, if one takes the view that interest rates are currently temporarily high, that would possibly produce an argument for borrowing short-term for the next few years and waiting for interest rates to fall before committing yourself to a long-term issue. That is, again, something that the practitioners are well suited to deal with.

One particular element of structure, which I imagine weighs quite heavily on their minds at the moment, is the question of index-linked gilts. Since their inception, index-linked gilts have been quite a success and an economical way of raising money for the Government. But, in the last couple of years, they have bitten the hand in a bad way, so I cannot imagine that people will want to expand the stock of index-linked gilts until inflation is under control again, which the Bank of England suggests may not be very soon.

Q8 **Lord King of Lothbury:** Some of this discussion about the duration of debt cannot be separated from QE because the effective duration has been shortened considerably. QE is large relative to the amount of public debt. For a decade, Governments did not finance themselves at very low long-term interest rates, when they might have. It is a bit of a stretch to imagine that they will suddenly start doing more short term when they are worrying about the scale of QE already. Should we not be focusing much more, in the statistics and debate, on the amount of public debt held by the private sector—that is, excluding the debt held by the Bank of England? If you do that, the duration has shortened quite noticeably. Is that not a concern looking forward?

Martin Slater: It is.

Professor Jagjit Chadha: The QE programme is a concern in many areas, not least because the likely losses from the end of the programme are going to be in the range of £150 billion to £200 billion, which is a huge fiscal cost that the state will have to deal with. The shortening of the maturity, once we account for QE, takes it down to something under 10 years if we allow for that. If we count the reserves that are held as part of public debt, it has made the whole of the debt burden much more sensitive to interest rate changes than would otherwise have been the case, such that the cost of debt service issue is going to be something like 5% to 6%. It would not have been anything like that had we not had the stock of QE that we have.

There is potentially upward pressure on interest rates as the QT programme continues. I know that it is being designed in a manner to feed into liquid markets, so that the sale of bonds back to the financial sector does not lead to lower prices, but, in a world where interest rates are high, it seems to me likely that such a large stock of sales may put further upward pressure on interest rates and further increase the costs of financing.

As you know, I and many colleagues have concerns about the nature of the QE programme and how it has interacted with monetary policy, debt management and fiscal policy, and the whole of that ought to be subject to a further review at some point in the future.

Lord King of Lothbury: This will be in your report to the Government.

Professor Jagjit Chadha: It would be a big annex to that report.

Q9 **The Chair:** Sticking on this point for a moment, can you remind us how the analysis of our debt profile that you just gave compares with other comparable developed economies that also do QE?

Professor Jagjit Chadha: The effective debt profile has fallen across all economies that had QE. We have had a larger fall in the debt profile. I cannot be sure just now, although I can check and come back to you, whether our relative purchase of QE or bonds was larger than we saw in other economies relative to GDP, but, at well over 30%, it was very large indeed.

The Chair: When will those losses that you mentioned be crystalised? Flowing from that, when will this hangover from Covid and lots of QE dissipate out of the system?

Professor Jagjit Chadha: If we look at various scenarios for the stock of bonds held by the asset purchase facility of the Bank of England, we are at something like £750 billion now. At the end of the exercise, we were at £895 billion. We are likely to get to something like £200 billion to £250 billion by the end of this decade in terms of the stock of bonds held. The losses are working their way through. What the APF is paying for the reserves that it has borrowed is now more than the coupons that it is receiving from the bonds that it holds. It is also selling back bonds at a loss compared to the price at which it bought them.

The first couple of rounds of QE were undertaken when it was likely to be profitable, but, as time went on and bond prices were very high, we were buying bonds after 2016 at what might be called the top of the market. We are now selling them at a time when, given that interest rates have fallen, prices have fallen markedly, so there is this loss being affected by the QT programme, when bonds are being sold back.

If you work through those two elements of the calculation, you get to an overall loss at the end of the programme of something in the region of £150 billion to £200 billion. I cannot give you an exact answer on that, because it depends on the point at which we end the QT programme, how quickly we do it and what happens to interest rates in the interim. As ever with economics, there are a number of assumptions in order to get to that number, but the Bank has come up with an estimate of around £150 billion. I would go slightly north of that, but it gives you an idea of the scale of the losses.

Martin Slater: I do not want to add to that. He knows a lot more than I do.

The Chair: Just summing up your analysis so far of where we are, I am going to put words into both of your mouths: I am hearing that, although it is sustainable now, you have concerns about the structure of our debt, before we even come on to the pressures that we might face. Those do not seem to be of as great an order of magnitude as in other developed nations. Is that right? Should we be no more overly concerned than others, as things currently stand?

Martin Slater: I am not sure about comparisons. The concerning thing is something that is, in principle, a very desirable thing to have: the OBR. The OBR reports and projections in the long term are very disturbing indeed, but not in the short to medium term. Its projections are that, for five or 10 years, the debt-to-GDP ratio may dip a little bit, from 100% down to about 90%, but, after that, it is uphill all the way. Its most recent projection is something like 350% of GDP by 2070.

These are valiant attempts. They are not really forecasts—this is not going to happen—but they tell you what would happen if we are under unchanged policies. Something will have to give. It will not have to give in the next five to 10 years, and there is no possibility of a formal default. What there might be, of course, is a prospect of rather turbulent inflationary and interest rate conditions, which would be very uncomfortable, but, at some time, decisions have to be made about very long-term expenditure, and the timeframe has tightened a bit in the last few years.

The Chair: Before I turn to Lord Griffiths, who will ask about this, do you agree with that, Jagjit?

Professor Jagjit Chadha: I mostly agree. We are in the fortunate position that our national debt-to-GDP position is not disastrous or at a crisis point, but it is not comfortable. As Martin said, looking ahead, there

are a number of calls on our expenditures that we can be pretty sure about: the demographics, the green transition, the need to think about where we place the health service, and defence expenditures. In the absence of fiscal reform, those will place us in that uncomfortable and potentially crisis situation that I am talking about.

Q10 Lord Griffiths of Fforestfach: We talked about the 19th century and so on, but, if you look at the 19th century from, let us say, the 1820s to the First World War, one of the distinctive features was that we faced no war. In that sense, there was a period of really enormous stability. However, if you look at the 21st century, we have had the great financial crisis, Covid, Ukraine and now Hamas, and we are in a Knightian world of radical uncertainty. If you were asked to advise the Chancellor and he said to you, "I'm looking at five years in terms of what the OBR will tell me, and it will then look at a longer period", how cautious would you say a Chancellor who has to face an election within the next 12 months should be in thinking about the future?

Professor Jagjit Chadha: You have put your finger on one of the problems of fiscal policy. We have been talking mostly about long-run things, medium-term prospects and shocks that come along suddenly but take years to adjust to. It requires long-term planning and long-term statements of where we will raise the revenues from in order to meet the demands of the electorate, whether in terms of health, education or defence.

I am sorry to say this and it is not something that this House involves itself in, but it is not something that we ought to be thinking about in terms of the headlines that might be in tomorrow's newspapers, which is often how fiscal policy seems to be set, certainly from my perspective at the national institute around the corner. We have had a world, it seems to me, where fiscal policy has increasingly been designed to try to hit headlines in the newspapers the next day, rather than thinking about the issues that you have been talking about. I would very much argue for much more long-term thinking in the way we think about fiscal policy, not to allow the month-to-month or year-to-year changes in the economy to drive tax and spending decisions but to present a much more sophisticated view.

I will give one example. You could try to reach a given fiscal target at the end of the Parliament. Of course, the fiscal rule is now for a five-year rolling period, but that illustrates the point even further because, on the one hand, you can try to set a fiscal plan to hit a particular point in the future at the end of the Parliament, and you could do it by cutting expenditure on public investment and spending the money on, for example, marginal constituencies, which would not help the long-run prospects of the British economy. On the other hand, if you had a five-year rolling target that went beyond the parliamentary horizon, you could be told that you will hit your fiscal target, but all the necessary adjustment is put on the shoulders of the next Chancellor in the next Parliament. In a sense, it does not boil down to a very credible

statement. These are examples of short-termism. They are not helping us get into the fiscal position that we are talking about.

The discussion that we have had today is all about thinking about how we can stop ourselves being in a fiscal crisis in 2030 or 2040. That will require fundamental reform now in the way that we think about expenditure and taxes. One thing in particular is how we deal with capital investment in the fiscal position, because, at the moment, if we are thinking just about debts and deficits, they count exactly the same way in the fiscal position, but things that help the potential growth and the supply side of the economy, and can be demonstrated to do so, will ultimately relax the fiscal position rather than not. I do not think that there is enough discussion of these kinds of fiscal levers that might be used.

Lord Griffiths of Fforestfach: Just to follow up on that, you talked about the need for some profound change in the structure of our democracy. For example, about 15 years ago, Switzerland found that its ratio of debt to GDP was rising uncomfortably high. In the end, they voted on a change in the constitution and put into it a brake on the ratio of debt to income. It was something like 60%. We do not have a constitution in the UK. I very much agree with your point about the Treasury and politicians, in quite a solid democracy, wanting to think long term, not just short term. What institutional changes would you suggest we should be thinking about to make this possible?

Martin Slater: This goes back to the Office for Budget Responsibility, which is one of the best innovations in fiscal policy for many decades. The reason for that is that, as you are saying, fiscal policy has been thought of in a very short-term way—"Shall we balance the budget this year or not?" But balancing the budget in one year is totally irrelevant if your long-term position is unsustainable. This is one of the questions that it has been suggested might come up later.

The whole business of fiscal policy ought to be seen in a long-run view, and that is what the OBR has supplied in the last few years. It has been able to monitor government decisions and say, "You will be all right this year, but where are we going with this?" One of the things that was most damaging about last autumn's affair was the apparent sidelining of the OBR. Without the guarantee of some kind of long-run sustainability, your short-run policies are just floundering.

On debt ceilings, you mentioned the Swiss case. I am not a great fan of debt ceilings, partly because of the American example. You can see that ceilings are as destabilising as they are stabilising. Again, the OBR has a much more nuanced view, saying, "Let us review the evidence. Look at the facts, chaps. This is not going in a good direction, is it?" Those pressures would be very good for the politicians to have to reflect on.

Q11 **Baroness Noakes:** On that point, do you think that sufficient attention is paid to the OBR's long-term sustainability exercise? It produces its forecasts at the time of the fiscal events, where it does get quite a lot of

publicity, but the longer-term look, which raises quite significant issues, does not seem to get the same degree of attention and certainly is not linked into the political process of fiscal planning.

Professor Jagjit Chadha: That is exactly right. It is good that we are on the same page in this area. There are two points that I would make. First, I had a look at some OECD countries that have lower levels of debt to GDP. New Zealand is quite an interesting example, at something like 35%. It has a specific fiscal programme. It is not a ceiling, but people have talked about principles there and have said that, because there are very high levels of private debt to GDP, they have taken the view that, since where they sit in the world in a geological sense is risky, they will have the shocks that we were talking about earlier on, which will require rebuilding, with alarming frequency. They have committed to trying to keep debt to GDP low, so that they are able to respond when these shocks come along.

That is an interesting example of longer-term thinking to commit to that fiscal programme. In that sense, you are absolutely right. The fiscal risks report, which comes out every other year in July, when, let us say, many politicians are not around—I am sure you all are in this House—does not necessarily lead to a response from the Government or the Treasury on how they will mitigate the risks that they have identified. There is a form of reply, but it does not particularly tie hands.

That feeds back to a point that we have been talking about in the institute for a while, which is for the Chancellor or the Treasury to make an annual state of the economy address, to understand the risks that the economy is facing and to explain how they will be mitigated. These are not the risks in the next month or so but factors that we can identify in the 10-to-15-year horizon that we are looking at, whether it is demographics, the green transition or shortages that we might have in our education, health or defence services. They would plot a path to explain how we will deal with those risks over the next 10 to 15 years.

Because those risks may not materialise, and the policies may not have an impact in the immediate or short-term period, the next year's report would be able to outline progress towards that objective. That kind of serious analysis would allow us to move policy into that medium or long-term space that has been lacking for a long time.

Q12 **Lord King of Lothbury:** Can I press you a little on how you would generate a debate of this kind? You have argued, persuasively, that we should look much more at the long term. In the US, Larry Kotlikoff in particular tried to initiate an examination of intergenerational impacts—basically, trying to identify the answer to Martin's question—and, under current policies, what would happen to national debt in the long run.

It did not get a great deal of traction, and part of the reason for that was that small changes in the assumptions that you have to make in order to predict where you will be 50 or 100 years from now—for example, the underlying growth rate of productivity, or demographics, which we have

never been very good at forecasting in the past—make an enormous difference to the outcome.

How do you manage to reconcile the debate with the uncertainty about these numbers? Budget speeches at present are littered with point forecasts—meaningless numbers, most of them—but Chancellors go on using them. Do you have any ideas for how you can manage to turn this into an intelligent debate about the long run, recognising the amount of uncertainty that there is about any particular path for the future?

Professor Jagjit Chadha: Put that way, it is an incredibly interesting problem, but it would require an explanation for the broader public about how we find the resources at some level to build a better economy as well as to meet the requirements of an advanced economy into the 21st century. We need to nest it in that way. The numbers are there in the background, but, going back to the discussions that we had in the past, that narrative must be alongside that.

If we want a particular form of health service, if we want a particular set of schools or if we want to be able to get to Manchester or Leeds, from Manchester to Newcastle or from Newcastle to Scotland by train in a certain amount of time, and we think that that will help flatten the income distribution—when we look at the shocks in the last three or four years, they seem to have caused particular problems for people in the bottom three or four deciles—and if we can improve access to better, more convenient, more stable and higher-paid jobs as a result, that is how you would start that narrative, so that people could understand why this was important.

As you say, if we get bogged down in long-run forecasts, which we know will be wrong—but we know that the factors that are driving them are probably the right factors and that we will probably have to respond in some way—we can start a debate along those lines. I am being optimistic here, as ever.

Lord King of Lothbury: Do you sign up to the narrative approach?

Martin Slater: Yes. It rings a bell. When I was trying to interest publishers in my book, I remember one who replied, “This is a very interesting topic, but, frankly, after two pages, my eyes glazed over”. That, of course, is the problem, but how do you get around that? You get around it in a way that Parliament has got around it, more or less. You have a reviewing Chamber. You have committees or councils that have a slightly longer-term view. All that they can do is produce reports. They can warn. They cannot control matters, but the more information you can put out there, and the more accessible that information is, the better the chance you will have.

Lord King of Lothbury: The House of Lords lives on.

Martin Slater: The House of Lords lives on. It is designed for that purpose.

Lord Turnbull: As an observation, there is much in favour of this idea of a state of the nation report that gives greater prominence to the OBR's long-term work. You then suggested that next year's report would review progress, but, of course, we do precisely the opposite: we have automatic rebasing, because we are always looking at this thing five years ahead. The fact that we have gone way off course between year 0 and year 1 is all swept away and we are looking just at this number over here. Do we not need to make sure that we have some mechanism to stop this drift year by year?

The Chair: Baroness Noakes will come to this question.

Professor Jagjit Chadha: You are absolutely right. We need to make sure that we do not end up on a random walk and that it is pinned down by something that we wanted to achieve at some point in the future.

- Q13 **Lord Blackwell:** A lot of this discussion comes down to the fact that it is not the level of debt that is necessarily the issue for sustainability but the future trajectory, which is ultimately the difference between public spending and taxation. We could have a much higher level of public spending in these projections than the OBR does, if it also assumes that taxation was going to rise. We are really coming down to the decision about what level of taxation is sustainable in the economy against the projections on public spending. It makes me wonder whether, as opposed to having a rule about the level of debt to GDP, sustainability would be better expressed as a judgment about what level of public expenditure versus GDP was sustainable against a viable tax base.

Martin Slater: They are, to some extent, counterparts of each other. They are inextricably linked. It is an aphorism in economics that debt is simply deferred taxation. What you are talking about in terms of the future profile of the national debt is the future profile of taxation, which comes back to my point about health. The problems of health and ageing will require a lot of expenditure. It will be not a spike in expenditure but continuous and permanent expenditure. There is only one answer to that, which is, if the Government will still involve themselves with those issues, taxation.

Lord Blackwell: Alternatively, it is higher growth.

Martin Slater: Higher growth has always been the answer in the past, but that is because the normal problem with the national debt is that you are trying to pay off a nasty spike in expenditure from the past. The point about ageing and healthcare is that they will grow with the growth of the economy. As we get richer, people will demand better healthcare, so both sides of the balance grow at the same rate, which has not been noticed very much so far but is important.

- Q14 **The Chair:** Jagjit, you mentioned a few moments ago that we really need to make these decisions now. I am thinking here particularly about the demographics and how we pay for an ageing population and the healthcare-related costs. Is it the case that, if we do not make a

fundamental decision on, or reappraisal of, how we pay for that in, say, the next five years, we will be on a path to unsustainable debt, or can you not think of it like that? I am trying to get a sense of the urgency of this decision.

Professor Jagjit Chadha: If we look at what the pressure on public expenditure over the next 15 years will be, there are a number of studies out there saying that the increase in public expenditure to meet the things that we are talking about gives us 70% of GDP. Only if the economy grew at 3.5% a year would that then not lead to an increase in debt to GDP. We have never done 3.5% regularly, apart from a few years in the post-war period. Our growth rate for the last few years has been, on average, about 1%, which means that debt will climb unless we think about limiting these expenditures or about the forms of taxation that we might have to introduce to limit the increase in debt that would otherwise occur.

The Chair: Can I press you on that? You say “thinking”; I am thinking about deciding.

Professor Jagjit Chadha: I am trying not to force you into decisions. I am using “thinking” in an abstract sense here. You would have to decide.

The Chair: In what timeframe, though, will this become unmanageable when you look at the developing trends?

Professor Jagjit Chadha: If debt went up another 50 percentage points, given current growth rates and demands for public expenditure, we could easily find ourselves at 150% of GDP by 2040. If I am still around, my alarm bells would be ringing very loudly by then. If that is the case, we absolutely need to think about acting now and, over the course of the next Parliament, decisively to address these issues.

The Chair: Martin, do you agree with that?

Martin Slater: Yes, I roughly agree. It is very difficult to put a hard and fast endpoint to this. Again, in the early days of the national debt, everyone was totally appalled at the beginning of the 18th century about the prospects of the national debt going up. Each war roughly doubled the national debt and, each time, all the politicians and the economists said, “This is absolutely unsustainable. This is totally unbelievable. It cannot go on”, but it did. It went on for a whole century and eventually got sorted out only after 1815.

Professor Jagjit Chadha: Yes, but it did come down, and that is the point. It came down as a result of growth and a large sequence of primary surpluses that, essentially, paid for the interest on debt.

The Chair: Comparisons with that period, when there was no welfare state and no ageing population that had demands on it, are interesting but have their limits.

Martin Slater: They have their limits. My point, really, is that debt is a very elastic concept. One reason that it is convenient for politicians is that it can stretch.

- Q15 **Lord Blackwell:** I am very struck by your comment, Professor Chadha, that 3.5% growth would be needed. Put another way, you are suggesting that there are no believable levels of growth that will avoid the forecast levels of expenditure becoming unsustainable.

Professor Jagjit Chadha: That is right.

Lord Blackwell: That is very stark.

The Chair: It would be very good if you could possibly furnish us with those studies that you mentioned.

Professor Jagjit Chadha: I would be very happy to provide a supplementary note.

The Chair: Thank you very much. That would be fantastic.

- Q16 **Lord Layard:** I wanted to ask you about the assets as well as the debts of the public sector and whether we should take more of a balance sheet approach, where we weigh the assets against the liabilities. Of course, the same issue arises when we talk about the change in the debt. Do we distinguish between capital expenditure and current expenditure?

There are several sub-issues there. One is whether the return on the capital or the asset is cashable in some sense. I would be interested in your comments on that. Secondly, of course, there is a huge problem, which you perhaps referred to, in that what we know as current expenditure is, in fact, investment, be it in health, education or whatever. How cashable is that?

How should all of this be introduced into a more intelligent debate? One of the problems that many of us have had is the spend to save issue when we are talking about health or education. This OBR report was the first to treat many things that had never been allowed to include a saving element set against their cost. Can you give some general reflections on where you stand on that and whether that, in some sense, means that the simple number of the debt-to-GDP ratio is really not the right thing to get fixated on?

Martin Slater: There is an exercise, which still goes on, known as the whole of government accounts, where the statisticians have, essentially, said, "Can we look at the Government as accountants would look at a plc?" We will have assets and liabilities, and the liabilities will include not just the official national debt but liabilities of any kind. Indeed, a lot of people were very exercised about, for instance, public sector pension liabilities, which do not figure in the national debt. They are almost as big as the national debt, but, on the other hand, when you look at it in this way, they are counteracted by quite a lot of assets. Strangely, the biggest asset is the land holdings of Network Rail.

This process has been going on experimentally for 10 or 12 years now. It is not terribly precise, and the Comptroller and Auditor-General does not like to sign off these accounts. One of the problems is that it is hellishly difficult to value public assets. Year to year, the asset figure used to change dramatically, largely because they would change the way that they valued Network Rail. Every year, the accountants would choose a different formulation.

The problem with public assets is that, unlike the official national debt, which is very liquid, most public assets are not liquid at all, so it is not really the kind of exercise where you can say, "We could easily pay off our national debt by liquidating our assets". It certainly asks some interesting questions, such as, "What other assets might we identify? What about the human assets of the country?" Nobody talks about that, but healthcare is all about improving the human assets of the population, which has no accountability in the traditional accounts.

Professor Jagjit Chadha: It is of interest to note that the position of government net worth has been declining. It went negative around the time of the financial crisis and has continued downward since then. Even though it is interesting and helpful to try to build a picture of the whole of government accounts to get a sense of the asset and the liability balance sheet, it is interesting to reflect on the extent to which that decline of the government net worth has been a result of underinvestment in capital projects in the UK, and the extent to which, had we made a different set of fiscal choices over the last 12 to 15 years and developed public investment, there would not have been such a large decline in government net worth.

Ultimately, a question for economists to do more work on, as it always is, is whether that would have helped the supply side of the economy, helped productivity and led to a larger economy as a result. In the end, we can do this kind of analysis, but the government debt is a financial obligation that we have to pay, so we need revenues from somewhere in order to pay it.

To the extent that the assets that we hold may give us a return that reduces the cost of servicing the bonds, that is useful—I mentioned that earlier—but the fact is that it is a financial obligation that we have to find the resources to meet. That means either revenues from taxation or returns from assets that the Government hold, and I certainly encourage us to try to financialise those returns if we can, although, for reasons already given, it is not terribly easy.

There are two points. It is worth monitoring what happens to government net worth and seeing the extent to which it has been a consequence of underinvestment in public capital, and then also trying to understand the extent to which it might alleviate the costs of financing government debt through other returns from government assets.

Q17 **Lord Layard:** There is a slight problem in making that the criterion, is there not? If you were choosing to invest in roads or railways, or in

health or education, you would not want to ask, "How does this affect the conventionally or otherwise measured balance sheet?" You would really want to ask, "What is the benefit-cost ratio of each of these types of expenditures?" without bothering to say whether they are capital or current. Would you agree with that as the ultimate test of the composition of expenditure?

Professor Jagjit Chadha: In terms of its social and economic return, it would be very valuable to know that. It could be that our current way of measuring the returns from investment is not in the right space either. It has difficulty dealing with the latent employment that might be created by public investment, and it tends to give a much higher return to places that are already well off, highly populated and with high levels of employment. There may be a need to rethink how we assess public investment, perhaps in the way that you said. That would be a good thing to do.

Lord Layard: There is also the investment aspect of what is called current expenditure, which is a huge chunk of the return on previous outlays.

Professor Jagjit Chadha: Yes, I very much agree.

Lord Layard: My understanding—and I have been trying to find out about this—is that there is very little systematic comparison of benefit-cost ratios for different elements of the Budget. In the spending review, there is an omnium gatherum of benefit-cost ratios for physical capital, but it would be nice to know whether you agree that this should be extended more widely to include current as well.

Professor Jagjit Chadha: Current expenditure has benefits and we ought to assess it as well as we can. It seems very sensible to do that.

Q18 **Lord King of Lothbury:** But you would accept that any benefit-cost calculation would have to include the cost of raising taxes in order to service the debt if the investment did not generate revenue to the Government. For a toll motorway, you might get money from it, but, for so-called investment in other projects that do not generate revenue to the Government, you have to raise taxes, and there is an economic cost to that that has to go into the calculation.

Professor Jagjit Chadha: Yes, absolutely, but what may be missing from that calculation is the extent to which building that road might generate jobs at the destination of that road, which would lead to taxes being raised from the people in employment there, ultimately helping to fund the building of it. This is the argument often put, and we can decide whether we believe it.

Lord King of Lothbury: We are always being told that certain projects, investments or ideas will increase the number of jobs, et cetera, but there is a limit. You cannot go on indefinitely claiming that projects will increase jobs.

Professor Jagjit Chadha: Yes, absolutely, but having some idea of what the estimates say, examining them and deciding whether we believe them would be an important part of the analysis. There may be elements of double counting in all of this as well, because some jobs may be displaced from one place to another, so you are not adding jobs in total.

Lord King of Lothbury: None of this changes the dynamics of looking at what is happening to national debt. You have to have revenue to service the debt. Whether you invest in other projects is not really the issue here. The issue for the national debt is how you service it.

Professor Jagjit Chadha: In the steady state, which is long run, you need revenues to equal expenditures. The point of policy is to decide the rate at which you approach that steady state and what changes you make to revenues and expenditures as you move towards it. That is really what we are talking about today.

- Q19 **Lord Davies of Brixton:** I am increasingly coming to feel that the balance sheet is not a very good way of looking at a system, and we need to look much more at of a flow-of-funds approach. We had balance sheets because we did not have the computing power that enabled us to understand the flow of funds. Now that we have the computing part, the balance sheet is of interest only if you are winding up, and I hope that we are not winding up the UK economy.

Professor Jagjit Chadha: No, not yet.

Lord Davies of Brixton: That was a point rather than a question. I will leave it there.

- Q20 **Baroness Noakes:** Can I start with a digression on the balance sheet? The whole of government accounts have been around for a lot longer than 10 to 12 years. I gave a speech on this about 25 years ago, when I was president of the Institute of Chartered Accountants in England and Wales, and I predicted that they would never be used in a decision-useful way, because they are a static point-in-time view of the world and cannot cope with the complexities of decision-making. The head of the government accounting service was so appalled at my speech that he never spoke to me again, but I digress.

I want to come on to the Government's fiscal rules, which we touched on earlier. We now have the latest incarnation of them, where we have a rolling five-year view of whether debt is coming down and whether the annual deficit is not exceeding 3% of GDP. In the context of what we are doing now, which is fiscal sustainability, I want to explore the relevance of this particular rule, or any rule that is based on a budget time horizon.

Martin Slater: I do not think that this particular rule is of very much help for the things that I am worried about. Like a lot of these rules, they are more a political commitment than an economically meaningful concept. The Government want to be in a position to say that they have begun to get the national debt down. That is a vague aspiration. They will only just about do it, if they are successful in doing it, and it does not tell

you anything about what will happen from then. As I said, the OBR projections are fairly merciless about what will happen from then, so, in that sense, it is a bit misleading.

Baroness Noakes: Should we have a different fiscal rule?

Martin Slater: Yes, I suppose so. My preference would be for something that feeds into a very long-term projection. The problem with very long-term projections is that the longer-term they are, the more the assumptions become much less reliable, as we heard. However, if you are involved, as you are, in a very long-term economic process, leaving off at some arbitrary point in the future is just as bad, is it not?

It seems to me that you have to grasp the nettle and try to improve increasingly the sophistication of our projections in the long term and to get more and more consensus and less and less arbitrariness in them. That will begin to command some respectability, whereas the trouble with fiscal rules of the type we have is that they can come and go.

Baroness Noakes: They do.

Professor Jagjit Chadha: You have to remember the situation we were in when the formal fiscal rules were brought in, along with the OBR. Debt had increased rapidly, and we were even worried about default in the UK. There were questions about the extent to which CDS spreads had risen. At the time, having some kind of rule, alongside the OBR, looked sensible to tie the hands of fiscal policy-makers so that markets would continue to want to hold debt and buy rollover debt at a time when it had increased rapidly.

We quickly learned that politicians could not adhere to these rules. There were too many shocks coming along for them to manage. The one benefit that they had was in encouraging government departments to become more efficient than they otherwise would have been. It provided some element of efficiency in public expenditure over that period. We have done some work in that area.

It probably helped us in the situation we are in now. We have lower debt than many of our G7 colleagues, so we are in a better position. But it could also be argued that, as a result of these fiscal rules, we had too tight a constraint on public investment over the same period in order to hit those fiscal rules, which in the end we did not hit.

We now have a fiscal rule that is not really a rule. Following any shock, as we have discussed several times today, we would expect debt to GDP to fall over a meaningful time horizon. This will almost automatically happen, barring future shocks. As we return to a normal state of the world, debt to GDP ought to fall.

We might want to focus attention on, as we have been talking about today, asking the Government, "How will you manage the risks that we can see over the medium and long run? What policies are you putting in place to ensure that debt to GDP does not escalate in a worrying manner

over the next 20 to 30 years?" That is the kind of mechanism and discussion we need here, on the assumption that any Government will seek to reduce debt to GDP following any particular shock within the period of their Parliament.

Baroness Noakes: Yes, but the background to this is the risks that have been identified by the OBR, for example, which show an exponential increase in debt when you get past about 2040.

Professor Jagjit Chadha: We have talked about this. There is a long sequence of primary deficits in the OBR's analysis. In a way, it is using those forecasts to try to bring attention to the fact that these things need to be addressed.

Baroness Noakes: So we have a rule that does not help us appraise fiscal sustainability. Is there a more meaningful way of doing it?

Professor Jagjit Chadha: It would be moving away from the idea of a rule that you are breaking or not breaking and moving into a fiscal programme—something that a Government will work through to decide how they will deal with the risks they have identified, how they will change the way they raise tax and how they will limit unconditional expenditures so they do not rise with the age of the population. I mentioned one earlier on. You might want to increase the retirement age alongside life expectancy, for example. There are others that we could think about. All these things will be mechanisms by which we limit fiscal risk.

There are potentially other types of instruments that might be issued. Income-linked debt may be one way of reducing the costs we face fiscally. There are instruments that could be issued along those lines as well. I have gone slightly off beam there, but ultimately it is about having a fiscal programme rather than a rule, in this case.

Baroness Noakes: One of the advantages of the fiscal rules, as they were conceived and as you explained, was to give a sense of shaping the future that a Government could be held to account against. In fact, things turned out differently and they never really were. Is there anything of a similar ilk that is not a programme but a set of measurements or yardsticks by which Governments could be judged?

Professor Jagjit Chadha: One of the problems I have here is that fiscal policy is so complex. We have talked about so many things: the issue of debt management and the different instruments that might be issued; the panoply of taxes that might be raised; and the various demands on expenditure.

I would prefer, if we can, to get to a world in which we have more sophisticated discussions about these things rather than imagining that we can boil down all of fiscal policy to one ratio that may or may not be achieved in a couple of years' time. I am sorry—that is maybe not the

answer you want, but I would prefer a much more sophisticated discussion on these issues.

Martin Slater: This is the standard problem with targets in any area: they tend to distort. If you give someone a target and say, "You will be rigorously held to account to meet this target", the probability is that they will meet it at the expense of all the other things you have not specified, which are also beneficial.

A simple target in what is, as Jagjit said, a very complex situation is potentially dangerous, as we see in the health service. Targets in the health service proliferate, and the consequences are not always what people expect.

Q21 The Chair: Picking up on this point from Baroness Noakes, you said you were not in favour of ceilings. Is there any nation anywhere that has the right approach to this? It might be a rule or anything else. Is your suggestion, Jagjit, something that nations should adopt more broadly?

Professor Jagjit Chadha: We have talked a little about New Zealand and Switzerland. When Norway discovered oil, it decided to have its own sovereign wealth fund, which has acted to hold back its level of debt in an important way. The key thing here is to work through what is appropriate for the country. Norway was brave enough to do that. There were arguments here at the time suggesting that it would have been equivalent to reduce debt instead of having a sovereign wealth fund, but that did not deal with the fact that such a fund would grow at a much faster rate because of the increases in equity returns over that period.

It might be a case of thinking through what is appropriate for us. We are a post-industrialised economy that is heavily concentrated on services and that has an exceptionally good financial sector. We may have to think about the things that suit us.

The Chair: I am sorry—I do not want to labour the point too much, but is the rule damaging as it currently exists because it gives us the false hope that debt is falling? Even though it is falling in the forecast, the Government have a track record of failing to do things such as raise fuel duty, and they want to increase defence spending. It is stopping a debate on all the issues we have been discussing.

Professor Jagjit Chadha: That is exactly right. We have fiscal events where the centrepiece is, "We are going to hit the target", or, "The OBR has given us a tick", but all these other risks are not exposed. That is where we have to push the debate, if we possibly can. We have to recognise that, as Martin said, we are hitting one target, but we are not really dealing with the fundamental problems that the economy faces. If we can get fiscal episodes to confront the fundamental problems that the economy faces, we will all be in a better position.

Q22 Lord Londesborough: I will come back to this huge question around growth and productivity. Putting our debt in context, arguably it is the lack of GDP growth that we have suffered over the last 15 years or so

that has put us in what Martin called an “uncomfortable” position in relation to debt, if not one of crisis. If we had maintained the growth rate post financial crisis, we might have been looking at more like 50% of GDP, rather than nearer 100%, for our debt.

I have two questions. First, what are your views on the minimum levels of growth and productivity that are required to ensure debt sustainability in the UK? Secondly, what is your reaction to the assumptions in the OBR outlook on growth and productivity?

Martin Slater: Again, it is difficult to be black and white on this, but, historically, in the periods when the debt-to-GDP ratio did sustainably fall over many decades, the growth of the UK economy was about 2%. In the post-war period it was about 2%—sometimes it was a bit better than that. Most recently, it has fallen a lot short of that, and that has hit us suddenly.

This also depends a bit on the rate of interest. The crucial thing in the sustainability formula is the difference between the growth rate and the rate of interest. Your ideal circumstances would be where you have a relatively high growth rate and a very low interest rate. At the moment, we have the reverse. That is the problem. If rates of interest fell, we could begin to repay even with growth rates of only 1%, but the long term seems to suggest that 2% is more comfortable.

Professor Jagjit Chadha: I am in a very similar space. If we could get to growth of 2% to 3%, that would allow us to relax in terms of a lot of this discussion. It just seems unlikely we will—

Lord Londesborough: Over how many years would it have to be 2% to 3%?

Professor Jagjit Chadha: It would have to be sustainable, so over 10 to 15 years and beyond. That would allow us to meet what seem to be the increasing pressure on the public purse in a way that would not then lead to a large increase in debt to GDP and over time would cause it to fall.

The safe assumption is that we will not get to 2% to 3%. Global growth seems to be falling, as China and other newly advanced economies are reaching the productivity frontier. That is driving down global growth to something like 3% to 4%. The advanced economies look as though they are stuck at about 1% or so. We can hope we get to 3%, but that is not a good way of planning.

We will probably have to assume, for planning purposes, that we are around 1%, which will then be problematic for debt to GDP. It leads to some very difficult choices in terms of our priorities for expenditure and how we respond to future shocks. It is a very difficult situation.

Lord Londesborough: The OBR forecast is for average productivity growth of 1% over the next five years. That sounds quite modest, but, if you compare that to our 2.3% productivity growth before the financial crisis, which in recent years has dropped to 0.5%, it actually requires an

improvement. The OBR has not explained how that will happen, but there is a little note in the report that, if our productivity remains at a 0.5% growth rate, that will add £40 billion to our annual national borrowing requirements by 2028. Is that alarming to you?

Martin Slater: Yes. I go back to the word: it is certainly uncomfortable.

Lord Londesborough: Margins are pretty thin. It is a pretty delicate balance, is it not?

Martin Slater: It shows the sensitivity of these things to small changes in growth.

Professor Jagjit Chadha: Looking ahead, it looks like we are in a low-growth world in the UK. It does not look as though there is a great prospect for economic growth in GDP per head for the rest of this decade. The debt problem has to be couched in that sense. That has to make us much more cautious about taking on more debt, and we will have to make some very hard choices about priorities.

If your question is about whether the OBR's assumptions are reasonable, I think they are. They are very much in line with our views and those of many colleagues working in this area. Trend growth has fallen. At least for the medium term, it has fallen markedly in the UK as a result of some of the economic choices we have made in the last five or seven years, which have further restricted our supply capacity. That may come back over time, but, as an assumption underpinning debt dynamics, it is an appropriate position to take.

We have to think very carefully about where we think real interest rates are going. They have moved up in the last couple of years. We are not sure whether they will come back down again, but my sense is that they have gone up relative to the period after the financial crisis. That also makes us more concerned about debt dynamics than we have been in the past.

All this does not mean that the crisis is coming in the next day or two. It is a slow burn. We can see what is happening. The crisis will increasingly become obvious over the next 10 to 15 years, which is why we have to think about how to respond to it over the next Parliament.

Q23 **Lord Turnbull:** We had a discussion about whole of government accounts and the asset approach. The reason I am sceptical is because the biggest asset is not railway land but the fact that the Government own the tax franchise. In a sense, there is a valuation put on that, which is put on it by the markets.

First, are there reasons to think the tax franchise is fraying? Will the buoyancy of revenues to GDP be less than it has been in the past? We know that road fuel duty is clearly one issue. It could be something to do with who has the spending power. If there is a group of people who spend more on less highly taxed goods, this buoyancy will decline. There may be reasons why we do not enjoy the buoyancy we have had in the

past.

The other feature is that it is dependent on the subjective valuation of the markets, which is very fragile. A year ago, the markets suddenly decided that they had lost confidence, in effect, in the value of this franchise. We have a false comfort. While things are fine they are fine, but by the time they are not it is too late to do anything about it. There is a reason for always holding something in reserve. We cannot count on—what was Carney’s phrase?—the kindness of strangers. It can be withdrawn very quickly.

Is that another reason to look again particularly at not just the amount of tax but the way in which we will need to collect it? We seem to be trying to get more tax out of employment income and turning a blind eye to the fastest-growing source of tax, which is probably the wealth in property. That has been deemed to be off limits for taxation.

Similarly, there are things on the expenditure side, such as the triple lock and the fact that the pension age has gone up but the age at which you get free prescriptions has not. All sorts of privileges are being given to most of the people in this room. Do we have to rethink quite a lot of those things so we can look at increasing the natural buoyancy of taxes and reducing the natural buoyancy of expenditure?

Martin Slater: Yes, you are quite right. The problem is that the tax base is fraying. Taxpayers are savvier, more flexible and more mobile now. This goes back to one of the earliest debates on the national debt. David Ricardo, the famous economist, said there are limits to the price people will be willing to pay to live in their own country. If you map out a future for the economy that is a very high-tax one, a lot of mobile taxpayers will take the lesson from that.

Tax systems need reform every now and again, and they are very difficult because there are immense vested interests in them. One of the great saviours of the British national debt in the early 19th century was the invention of income tax, which was ferociously resisted by all the vested interests of the time. After 20 or 30 years, it began to be viewed as one of the British economy’s greatest and proudest inventions.

We need something of a thorough investigation, as you say, into the ways in which we are collecting tax. The way in which politicians have trapped themselves in a corner on taxation is one of our problems. Very few politicians are willing to countenance raising taxes. If you then have a situation in which expenditure is bound to go up, hey presto, you have a national debt problem—of course you do. The nettle has to be grasped somewhere: taxes have to be restructured in some way.

Professor Jagjit Chadha: This comes back to the conversation we had some moments ago. If we start a discussion or dialogue about what the Government need to do in order to meet the requirements of a modern post-industrialised economy—we go back to the issues of health, education, infrastructure and defence—people will begin to understand that, alongside that, there needs to be a redesign of the tax system.

From some calculations that I and others have done, it is clear that a reform of land taxes would help tremendously, given the wealth that is incorporated in land. There may be some need to think about the VAT regime and its incidence as well.

On the other side, we have had a fall in participation in the workforce since the Covid crisis. Anything we can do to increase the participation of older people, with a demographic that is ageing, will ultimately also help the tax base. A number of interventions could be designed to increase the buoyancy of tax revenues, which is due to the number of people working as well the taxes that we apply to them.

That would be difficult—I know people do not want to pay taxes—but, if the narrative is contained within this discussion of how we will make our way in the world over the next part of the century, it is something that might ultimately be effective.

Q24 Lord Blackwell: I want to reference the fact that, over the last 50 years, the tax take has never risen above about 38% of GDP. It may be possible to extract more tax out of the population, but it does not change the fact that public expenditure to afford healthcare and ageing demographics is growing at more than 1% and our GDP growth rate is only 1%. If that were to be funded, it would imply that expenditure on everything else—namely, people’s living standards and everything else—would be falling in real terms. If one bit is growing more than GDP, the rest has to contract.

Professor Jagjit Chadha: It has to contract at least in the long run. In the short run, there can be some deviation.

Lord Blackwell: This comes back to the political challenge of facing up to those consequences.

Lord Davies of Brixton: That is based on the presumption that GDP is a good measure of people’s living standards. It is the one we have, and it is the one we will use, but there is a lot more to life than what you get out of GDP. I am not coming up with an easy answer to that, but we must never fall into the trap of feeling that GDP, which is a questionable statistic anyway, is a good measure.

Professor Jagjit Chadha: That is absolutely right. Of course, Lord Layard’s work in this area is very well known. In the end, this is a financial issue. If the tax base is approximated by GDP, that will be what we look to raise revenues from to meet our obligations. If we start taxing happiness, it might go away. I do not know.

The Chair: Thank you both very much indeed. We have covered a great deal of ground in our first session. We have a lot of food for thought. Thank you both very much for coming in.