HOUSE OF LORDS

Economics Affairs Committee

Corrected oral evidence: The Government's debt target

Tuesday 8 October 2024

3 pm

Watch the meeting

Members present: Lord Bridges of Headley (The Chair); Lord Blackwell; Lord Burns; Lord Davies of Brixton; Lord Griffiths of Fforestfach; Lord Lamont of Lerwick; Lord Layard; Baroness Liddell of Coatdyke; Lord Londesborough; Lord Razzall; Lord Rooker; Lord Turnbull; Baroness Wolf of Dulwich.

Evidence Session No. 1 | Heard in Public | Questions 1 – 26

Witnesses

I: Dr Isabel Stockton, Senior Research Economist, Institute for Fiscal Studies; Ben Zaranko, Senior Research Economist, Institute for Fiscal Studies; Thomas Pope, Deputy Chief Economist, Institute for Government.

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Examination of witnesses

Dr Isabel Stockton, Ben Zaranko and Thomas Pope.

Q1 **The Chair:** Welcome to this hearing of the Economic Affairs Committee, where we are discussing the debt target, a very live topic that seems to be getting a lot of attention, especially in the *Financial Times* and the *Guardian* today. I read in the *Guardian* that the Chancellor has to decide on the debt target measure within the next 24 hours, so it is good to welcome representatives from the Institute for Fiscal Studies. Would you like to introduce yourselves?

Dr Isabel Stockton: I am a senior research economist at the IFS.

Ben Zaranko: I am also a senior research economist at the IFS.

Thomas Pope: I am the deputy chief economist at the Institute for Government.

Q2 **The Chair:** There is a real danger that we will get lost in the detail in the discussion that we are about to have, so can I start by asking a very simple question? What is the motive for the Chancellor to change the current debt target, and the definition of debt?

Dr Isabel Stockton: There are many conceivable measures of debt, or the wider balance sheet, that one might target depending on what one is trying to achieve. We have heard from the Chancellor that she is keen to recognise the benefits of investment. That is one aspect in which we might think that the current measure could be improved upon.

There are pros and cons to all these different options, and there is an interesting theoretical debate, but in practical terms it also matters a lot because, with the rest of the framework as it is and with the debt rule in its current structure, it matters a great deal which of these measures we choose for how much measured "headroom" there appears to be for additional investment spending. There could be a huge impact on policy options in terms of topping up investment spending plans.

The Chair: You organisation has written: "It is … hard to escape the suspicion that the government is attracted not by any theoretical advantages of a change in the debt rule, but by the fact that it would allow for significantly more borrowing for investment".

The intent to enable the Government to borrow more for investment, rather than saying, "We need to have a debt rule that makes sure that debt is on a sustainable path", is what wins out.

Dr Isabel Stockton: We need to distinguish between two almost separate questions. There is a question about the case for more investment, and there is a question about how that investment should be funded. Certainly, we get the impression that there is currently an appetite to fund additional investment through additional borrowing rather than through tax rises or cuts to other spending. Of course, that

does not negate the other theoretical advantages of potentially targeting a different measure of the balance sheet.

Thomas Pope: I completely agree. What we should be trying to do in general in this discussion is distinguish the benefits of different measures of debt without getting too stuck in the weeds, so capturing different elements of fiscal sustainability—there is no one measure that perfectly captures that—the appropriate fiscal stance that the Government take, and indeed the appropriate design of the rule relating to any debt measure.

Many of the problems with the current rule do not just come from deficiencies with the measure of public sector net debt, but with the fact that the Government are targeting the change in that measure as a share of GDP between two years quite far in the future. That does nothing to restrain what the public sector does in the next three or four years, and it moves around quite a lot.

There is a problem with the way public sector net debt is interacting with quantitative tightening specifically, which we will come on to, and that is a theoretical reason why you might want to adjust the debt measure. The pace of quantitative tightening is not something that really has any bearing on fiscal sustainability, and it is not particularly helpful to have that interaction between Bank of England decisions about quantitative tightening, which are monetary policy decisions motivated by the Bank of England's objectives, and fiscal policy.

The Chair: Ben, do you want to add anything? You do not have to.

Ben Zaranko: The main points have been covered.

Q3 **The Chair:** Before we dive into PSND and all the others, Isabel, can you give the main definitions of debt that we will come on to for the sake of the record and anyone watching? Just map them out in case anyone wants to know this.

Dr Isabel Stockton: The first thing to keep in mind is that there is no exhaustive set or menu of options. There is nothing stopping the Government from coming up with their own custom-made measure of the balance sheet that includes and excludes different things because that makes the case that, "These are the things we should target. These are the incentives we would like to set for ourselves and for our successors. We think that's what matters". However, there are a number of measures which the OBR already forecasts and which there has been debate about in recent weeks. Of those, the most modest change in a way would be to revert to targeting headline public sector net debt as opposed to public sector net debt excluding the Bank of England, which is what the existing rule targets.

Excluding the Bank of England means excluding the balance sheet of the Bank of England. The main practical implication is, first, in relation to losses from the quantitative easing programme, which Tom already alluded to, and, secondly, in relation to the term funding scheme, which

is the programme, or a number of programmes, under which the Bank made loans to firms. Those are the two big components that account for the differences between those two measures.

We might go in a different direction and choose a measure of the balance sheet that is broader and includes a broader range of assets than public sector net debt. Public sector net debt is net, so it nets off some assets but only liquid short-term assets like currency and savings. You might think about a measure such as public sector net financial liabilities that nets off longer-term financial assets—things like the student loan book or equity that the public sector holds in banks, the equity we hold in the wake of the financial crisis. Those things get netted off. That would have implications for measured headroom, but theoretically it would not really account for the benefits of investment in that sense.

If we think further along those lines, we might get to something like public sector net worth, which is an attempt to capture a very broad range of assets that the public sector owns, including non-financial physical assets—roads, the NHS estate, the prisons estate, army barracks, energy pylons, whatever it happens to be. We might think that the incentives set by such a target would in some ways be better, not in all ways, but at the IFS we believe that there would be substantial practical difficulties with operationalising a debt rule of the type that we have at the moment, or even any kind of numerical fiscal rule in the tradition of fiscal rules here in the UK that targeted net worth directly. We think it would be very difficult to pull that off.

Q4 **The Chair:** Going straight in on PSND, do you think we should switch back to that as a target, and why, or why not?

Thomas Pope: There is a case for that. Again, it would be helpful to try to separate focusing on what measure of debts we want to target and exactly what the target looks like. We could have a separate debate about whether the Government gain more headroom in changing their debt measure and whether they should use that headroom, or indeed whether they should change how they target the path of a different measure. There is a pretty good case to move to PSND, mainly because of that interaction with quantitative tightening which I have already mentioned. Effectively, the more active gilt sales or gilt redemptions that there are in a given year, the more that public sector net debt, excluding the Bank of England’s, increases, so, focusing solely on that effect, the tighter the fiscal policy has to be.

There are a few issues with that. The first is the pace of quantitative tightening. I do not think that tells us very much about what the primary balance should be and how much we should be willing to invest in roads or anything else. Secondly, the Bank of England does not tell us what its planned path for quantitative tightening is beyond one year. The OBR is making reasonable estimates of what that might be in five years’ time, but it is extremely uncertain, and changes to that assumption make a very big difference to the headroom that we have. That is unhelpful.

We have introduced this interaction between decisions and the Monetary Policy Committee—I do not think it should be factoring in the balance sheet; it should be factoring in its primary mandates—with fiscal policies, but it is not altogether helpful.

Ben Zaranko: There is a principled case for it, which rests on this idea: the losses the Bank of England is making are lumpy and falling four or five years into the future when the fiscal rule happens to be biting, so we are running overly tight policy and having taxes too high or spending too low. It is not driven by fundamentals but by a quirk of what the Bank of England is doing.

If we were to take the opportunity to revisit the debt rule, it is probably worth zooming out another layer and asking whether we should be targeting the change in the stock of debt between two financial years. We are trying to forecast the size of a debt in five years, which is hard to do. We are trying to forecast GDP in five years, which is hard to do. We are dividing one by the other and then trying to target it precisely, and that is leading to policy flip-flops and forecasts going backwards and forwards. We tried it and it has not turned out well. It would be a good opportunity to revisit that at a deeper level than just tweaking the measure.

The Chair: Are we arguing about the right thing? Should we actually be arguing that, if you want to put debt on a sustainable path, one key thing is to stop the rolling target and you have a fixed target in year five, and every year five after that? Is putting the debt on to a sustainable target what the Chancellor should be focusing on?

Dr Isabel Stockton: There are very big advantages to having forward-looking rolling targets in general. Having rigid targets that bite in the out-turn, or in the present or even within a single year, carries great dangers. It carries the danger that adjustments happen too fast, that they are more costly than they need to be and in a downturn the Government make things worse, or that there is too much fine-tuning and too many adjustments are made all the time rather than waiting for a longer-term trend to emerge.

I would certainly not argue for getting rid of forward-looking rules entirely. There is a case to be made that maybe the fifth year is too loose. The Government have recently argued, for example, for going back to targeting the third year rather than the fifth year and setting interaction with the spending review period and various other features. But I would certainly not want to target the out-turn.

The issues with the stock measure that Ben highlighted are a particular problem of targeting the change in that stock. The flip-flopping of the measures that we get with very small and economically insignificant changes in assumptions is an undesirable feature of targeting the change in debt. The supplementary fiscal rules—the old borrowing rule or the new current budget rule—are much more stable measures, and without actual material change in the forecast you are much less likely to get that kind of flip-flopping.

Q5 **Lord Blackwell:** There may well be reasons for considering other measures than we have been. It would make it credible to have a change in measure. In your view, would it be appropriate to use any calculated headroom that that creates to increase investment?

The basic point is that it is very difficult to define what is investment versus what is current spending. If you limit investment to physical assets, a lot of the investment we want in the economy is probably in software and other less tangible assets. However, if you go back to why we are interested in the debt levels, it is because, as the Chair says, we are interested in the affordability of the debt and its long-term sustainability. Whether you are using it for investment or otherwise, if the debt goes up you still have to service it in the future, you still have a greater cost, and as the debt goes up in the short term you are having to borrow in the market and therefore driving up interest rates and displacing private sector investment. So whether or not you choose to label it for investment, you cannot get away from the fact that you are choosing to have a higher level of debt.

If they want to invest, would it not be more straightforward to simply say, "We're going to change our target to allow for investment and have an honest discussion about it", rather than do it by changing the definitions?

Dr Isabel Stockton: I agree with your main point that the important thing is not whether the Government choose to make a particular technical tweak to the rule or not; it is that a coherent case is made as to why we should be borrowing more to fund investment, and that it is made clear that these are two separate propositions.

It is not enough to say that investment is good, or that the UK is historically a low-investment economy, and it is very likely that there are some profitable opportunities for investment out there if the Government were serious about identifying them and running those investment projects well. That may all be true, but there needs to be a separate case about why we think borrowing is the right way to fund that additional investment and do not think it could be done via tax rises or via user fees, or any other method of cutting down consumption now to increase investment, rather than borrowing and doing it in the future.

It is not that there is no possible case, but it would be really helpful to hear that case spelled out on the fundamentals, as it were. Who do we think should be paying for this rather than to pretend that it is possible for no one to pay for it?

Thomas Pope: I agree with everything that Isabel has said. You are, of course, completely right that we use investment as a proxy for something that will pay off more in the future than now, and there is no perfect division there.

Personally, I do not think that means that we should treat what we measure as current and what we measure as capital spending completely the same; the planned move to a current budget balance rule rather than

a net borrowing rule, for example, is a welcome and good one. There is sometimes a risk in the debate that we can move too far to a world where all investment is good. That can be tempting, but actually, if you look at the UK government record on this, not all investment is good and not all investment has been good value for money.

At the same time, there is a good case that the UK has underinvested in the private sector but also in the public sector. It is not inevitable that public sector investment will crowd out private sector investment; there are types of investment in the public sector that you can imagine would have a crowding-in effect rather than a crowding-out effect. If you look at the interventions that a national wealth fund might make in emerging technologies, for example, you can at least tell a story about how that might be a crowding-in effect rather than a crowding-out. So a positive case for investment can be made.

It should be accompanied by changes within government, certainly in the net spending review process, to provide additional confidence to the public, to markets and to people like us, that the additional investment is going to be well spent and that the projects that we invest in are going to be good.

There is just one other point I wanted to make. I know it is not the main point of your question, but you mentioned whether we should use all the additional headroom for investment. One problem the last Government had was that they got to a position where they only had a wafer-thin margin of headroom against their fiscal rule. That meant that very small, quite inconsequential changes in the economic forecast required them to make changes to their actual economic and fiscal policy.

If this Government are revisiting the debt rule, their asset rule, considering what that new rule should be and setting out a new path, I hope it would include having a lot more headroom against that rule. We want more stability in economic and fiscal policy, more stability in that fiscal framework. We do not want small changes in what we think growth is going to be in five years' time or, to take a recent example, how quickly we think the Bank of England is going to sell gilts to affect whether we can do full expensing on a temporary or permanent basis.

Ben Zaranko: Thomas brought up a nice, and important, point, which is that what we really care about is debt servicing. It is our ability to service future debt that matters, and the level of debt is clearly relevant for that, but it does not tell us everything that we need to know, because clearly it matters where interest rates are and what inflation is, and so on.

It also helps to think about the sort of investment that we might wish to be promoting, because if, in future, the UK absolutely needs to service its debt and we have invested in revamping the prisons estate, we cannot necessarily sell off those brand-new prisons in order to service our debt. They might be nice to have, but they are not that relevant for the question at hand, whereas an investment in boosting the transport

infrastructure in some great northern cities might produce growth benefits that make it easier to meet those future debt servicing costs.

That is why we should be distinguishing between different forms of investment and, where we can, pushing towards things that produce growth benefits as well as just assets.

Lord Blackwell: To summarise, if I have understood, you are all saying that there may be a case for better measures of debt, we can discuss and argue about those, and there may be a case for more public investment with appropriate controls, that case can be made, but the two should be considered independently; one should not follow from the other.

Ben Zaranko: That is fair.

Thomas Pope: That is probably right. I suppose I would go even further—this is a point the Institute for Government has made before—in saying that a big problem with how we have run fiscal policy in the last certainly five years and probably 10 or 15 years is that we have been driven by the rule first and we have not actually had a Chancellor set out a fiscal strategy and set of objectives that the rules and their approach to investment flows from and which then informs their path going forward. We have said, "Okay, what rule does the public like the sound of?", or, "What can we get away with in terms of a fiscal rule?", and our fiscal strategy is run from there.

A new Chancellor, a new Parliament, is a real opportunity to set out some broader fiscal objectives and a broader strategy, but you then set out some rules that are consistent with that, not just set out some rules.

The Chair: We now have four questions that are related to PSND versus PSND ex BoE. I suggest we take them pretty quickly so that we do not get into too much detail, because I sense from colleagues that we are very interested in the net worth and the investment definitions in debt.

Q6 **Baroness Liddell of Coatdyke:** Mine is a compare-and-contrast question. Is there a case for the UK mirroring the Federal Reserve's treatment of QE losses? Could you take into account, on reflection, whether the PSND ex BoE is an optimal arrangement, and whether it is fruitful?

Ben Zaranko: I would like to caveat the first question by saying that monetary policy operations are not my primary area of research. With that suitable caveat, my understanding is that one of the problems is that the Federal Reserve is effectively keeping the losses on its balance sheet and paying them off over time with profits from seigniorage: printing currency. The Federal Reserve prints a lot more currency than the Bank of England. The dollar is a global currency for which there is a phenomenal demand, and the Bank of England's ongoing profits are much smaller in scale, even relative to the size of their overall balance sheet, so the calculation here might well look quite different.

I wonder whether the point is that we do not think the Bank of England choices about precisely when and how to carry out monetary policy should have such big impacts on tax and spending choices. There might be ways to go about that without such a fundamental change to our monetary policy set-up that would require primary legislation and quite a big change to how these institutions operate with one another. There might be simpler ways to address that problem that are less dramatic, if that makes sense.

Thomas Pope: I would agree with that. Putting the losses on the balance sheet and not accounting for them does not mean that they are not there. They have to be paid at some point, and really this is just a question of timing and when the losses are recognised on the balance sheet, if they are reflected in what is happening.

The Fed's situation—again, I am not a monetary policy operations expert—is that the US Government are not going to get the flow of profits for the next however many years that would have arisen from the Fed's, because they are instead paying off the losses accrued through QE. What we are doing is compensating the Bank of England at the point when those losses emerge, rather than waiting for their profits to outweigh that loss on the balance sheet. That is just a question of timing. Economically, the same thing is going on and, for fiscal policy, it should not matter which of those ways we choose to account for it.

Baroness Liddell of Coatdyke: The issue is about optimality: is it an optimal position for the UK to be in, vis-à-vis the US?

Dr Isabel Stockton: You put it quite nicely when you asked whether it is fruitful, because, in interaction with all the other imperfectly designed bits of fiscal framework that we have, one of the fruits is possibly tighter fiscal policy than we need. Many people have been arguing from the position that, "Fiscal policy should have been looser at point X in our history. That rule was constraining, so we should have had a different accounting treatment that would have then spit out the answer that I think was right all along from that fiscal rule". But that is different from saying, "I think on principled economic grounds that this is the right or the most honest way to account for those losses".

I recognise that sometimes there is a balance to be struck between these two things—the pure argument and the argument about what it produces in a particular policy context—but it is useful to keep the two a little separate.

Q7 **Lord Lamont of Lerwick:** You just talked about whether we could do the same as the United States, but is it not the Bank of England that is the outlier here? Is there another bank in the world that has the same system of indemnity? Is what the ECB does very similar to what the Fed does? It may not be correct, but I have read that there is not another bank in the world that does what the Bank of England does. It has always seemed rather shrouded in mystery to me when we cannot even see what this indemnity says.

Ben Zaranko: The Bank of England is an outlier, but I am instinctively cautious about changing the rules half way through the game. What I would say is that we should think about lessons we might learn for future rounds of quantitative easing, if that is going to be part of the toolkit on an ongoing basis, rather than the Treasury having banked all the profits when QE was making a profit and then, as soon as it starts making a loss, deciding to change the rules on, one suspects, not a principled basis. There might be a much stronger argument for whether we should consider a different institutional structure next time.

Q8 **Lord Burns:** You have mentioned that one of the issues in the choice between PSND and PSND ex-Bank of England is to ensure separation between fiscal policy and the Bank of England's monetary policy. I can see that an erratic valuation change is not helpful, but surely this is not a big issue. It happens to be striking us now but, looking at this as a longer-term prospect, the idea of deciding to change the rule because of this particular factor does not seem to be an issue of substance to me.

Thomas Pope: That is it. We are talking about a difference in measures of about £20 billion a year in terms of the change over a short period. In the grand scheme of things, it is not a big deal. We adopted the measure of public sector net debt excluding the Bank of England's when they introduced the term funding scheme, which is a set of loans to banks they were expecting to be repaid that led to quite large cash flow changes over a short period of time. £20 billion becomes a much bigger deal when the Government are only running about £9 billion of headroom against their rule. So I would come back to that as the reason why there is probably quite so much focus on this.

Q9 **Lord Burns:** Carrying on from Baroness Liddell's point, if one is looking at this in the longer term to do with QE and QT, is it not better to take valuation changes sooner rather than later? If one had a mark-to-market basis on looking at these flows, much of this would now be behind us and we would already be on a downward path as far as they are concerned. The more we put them off, the more we get this kind of erratic movement.

Thomas Pope: There is definitely an interaction between the fiscal rule and changes in QT, which is arising because we have this forward-looking rule; the losses are set to crystallise in the future, and we recognise them on that measure of debt. A mark-to-market would risk being pretty erratic from year to year based on the market value of gilts, which you might also not think is entirely optimal.

How things operate in PSND is that it is effectively a revaluation to redemption value. As it has turned out, because the APF bought gilts at a much higher price than they are now—by the way, that was entirely anticipated and sort of the point—they have done that kind of mark down to redemption initially, and that de facto means that we have recognised a bunch of the loss already. It is more in the past, so PSND is on that much more declining path.

Dr Isabel Stockton: You make a really important broader point. The danger with opportunistic tweaks to the fiscal rule because of a particular set of circumstances that we find ourselves in at a particular moment in time is that, in a year or two, these headroom measures against different measures of the balance sheet may well all relate to each other quite differently.

If we now, for example, say, "Let's target net financial liabilities because it's falling by a lot in that particular year, and that fall is driven by the treatment of student loans", when actually our motivation has nothing to do with how we fund universities, the danger is that we will need to change our mind again very frequently. That then starts to erode one of the key roles for having fiscal rules in the first place, which is to credibly signal a fiscal strategy. It comes back to what Tom was saying. If the fiscal rules do not flow from a coherent strategy and are changed opportunistically and very frequently, that is a danger.

The new Government have a real opportunity at the moment, because they are a new Government and everyone will be happy to see a change. There is nothing strange about a new government bringing in a new set of rules, but they should be able to credibly commit to that new set of rules for an extended period of time, and not need to come back next year and say, "Actually, now we want this different measure".

Q10 **Lord Burns:** Is the lesson from this that too much precision in these rules and having rules that are so precise, like for years four and five, will lead one into problems of finding that in these particular circumstances they do not quite work? If one was looking at a variety of measures and monitoring them, and taking a longer view of where we were trying to get to, one would not run up against this issue of essentially trying to manipulate definitions to suit the circumstances of this particular year.

Dr Isabel Stockton: That is one of the core trade-offs when it comes to designing fiscal rules. We like fiscal rules to be simple, but we also like them to be nuanced, comprehensive and constraining. One issue with a holistic measure is that there will always be a temptation that it is a bit more open to interpretation, maybe to spin of some kind. Of course, you can very well make a case that we have moved too far in the direction of simplicity and that we need to move away because we are sacrificing too much for that simplicity.

Q11 **Lord Blackwell:** On this issue of QE losses, is the real problem the pretence that QE conducted by the Bank of England can be regarded as completely independent of fiscal policy? In practice, here is an arm of government borrowing in order to boost consumption, and whether it is the Bank of England borrowing and boosting money supply or the Treasury borrowing and cutting taxes, they are both in effect forms of fiscal policy, or they are both borrowing to stimulate demand. The idea that the two are completely independent is really nonsense, is it not?

Ben Zaranko: It clearly changes some political economy dynamics. There are clearly incentives for fiscal policymakers to potentially rely

more on the Bank doing the heavy lifting when it comes to future crises and the need for stimulus. They may start to build possible impacts of QE into their decision making on their future fiscal policy or fiscal stance.

Those are complicated dynamics that I do not feel qualified to offer comprehensive judgment on, but I would say that the Bank of England would insist very strongly that all decisions are made independently.

Lord Blackwell: I am sure it would.

Lord Burns: We have been asking for some time whether it is really possible that you can take monetary policy decisions that can end up in large surpluses or in large deficits without any consideration of the consequences of that for fiscal policy. I keep asking where the decision point is in making these decisions, and so far we have not really had an answer. But I remain very puzzled about this: that somehow or other no one should be held responsible for, as we now know, quite large cumulative losses that cannot be without fiscal consequences. Somehow or other, we are brushing it aside.

Ben Zaranko: I would make two points. First, we should not treat the accounting loss on the QE programme as the entirety of its impact, because we do not know how much smaller the economy might have been or how much tax revenue the Government would have had without QE. It is part of the story, but it is not the whole story.

Secondly, we commissioned Sir Paul Tucker to write on this in 2022, which was an eventful year. His argument was that we should change the Bank of England’s mandate such that where the MPC is otherwise between different approaches for implementing its desired policy, it should take into account the impact on government debt and government debt structure. A tweak like that could be considered if you wanted to try to force this more into the thinking of the Bank.

Q12 **Lord Davies of Brixton:** Most of what was contained in my question has been answered, but just to be clear, as long as everyone knows what the Bank of England is doing with all its funds and accounts, how it is particularly written out does not really matter, because an informed observer would take everything into account. You are all nodding.

Thomas Pope: Yes, that is right. The accounting treatment is accounting. It is how we look at the numbers, it is not the economic treatment. The true loss at the end of the programme is the same whether you recognise that loss at the end or you address it at intervals throughout the programme.

Lord Davies of Brixton: The more general issue is that that obviously applies across the field to all these different figures. In effect, all those things are control variables; they are not the output. The output is what the country does and what people spend and what industry invests. Looking at these intermediate figures is clearly important, but choosing one as the absolute truth and disregarding all the others just does not make sense. Any rational observer would look at all these things. The

argument against that, as someone said, is that you need a signal that you are behaving responsibly or markets will panic. Is that right?

Dr Isabel Stockton: That is a bit strong.

Lord Davies of Brixton: We are only doing it as a show. We are not actually looking at these control variables because they are intrinsically important in themselves, but because it tells a story and stories matter.

Thomas Pope: The last Government's charter for budget responsibility—there will be an update soon—already says that, alongside its primary target, it makes fiscal policy with regard to a series of other measures that include net financial liabilities, net worth, debt interest costs and so on. I cannot remember the full gamut; there are five or so. That is clearly a sensible way to be making fiscal policy. At the point when you are butting up against the one rule that you have very firmly committed to, those other things start to become a bit less important, and you tend to focus much more on that.

I suppose there is a question in all this that I know you considered in your report, which is whether we should have fiscal rules at all. Isabel has already referred to the trade-off there between simplicity and comprehensiveness. We view it as sensible to have a rule. The Government should also be setting out some overall fiscal objectives, so one thing we advocate for is that, as well as setting out an overall rule, the OBR should be able to judge whether it is meeting its rule in a way that is consistent with those overall objectives or whether it is effectively gaming them. An extreme example would be that, to get debt falling in the fifth year, the Government pre-announced a large sale of a particular asset in that year that would make that measure looking like it was moving down but would do nothing for underlying fiscal sustainability.

There are other issues to do with pencilling in unrealistic spending plans in the future. The OBR has said quite a lot about that in its boxes and its EFOs; it is restricted in how much it can put into its underlying forecast. If it had an opportunity to at least set out some risks around the Government's fiscal rule and ask whether they were really meeting the spirit of this rule as well as the letter, that would help to increase the focus on the broader sets of liabilities and broader measures, while also focusing on the realistic path, or otherwise, of government policy that underlies the forecast.

Q13 **Lord Davies of Brixton:** Yes, all those problems are clear. It has become a cliché, but we should mention Goodhart's law, which is true of any control variable, and the point that these figures are always going to be open to being massaged by the Government. Is the problem of having one single variable that, by implication, you have implicit unannounced policies on everything else? By focusing on one variable there is an assumption built into that about what all the other factors that go into controlling economic life are doing.

Ben Zaranko: I sympathise a lot with the line of questioning. We should worry about Goodhart's Law, we should worry about anything that places too much weight on one measure to the exclusion of others, and we should worry about trying to precisely target them. That is particularly acute for what you call stock measures: things like debt, net worth, net financial liabilities.

It is less acute for things like borrowing stats or aiming to run a current budget balance. Those things are less sensitive. But the overfocus on just one measure of debt does create perverse incentives to sell off the student loan book for less than it would be worth, or to try to reclassify things in and out of the public sector in a way that we might not have if we took a broader view of a broader set of indicators. I cannot remember whether it was Isabel or Tom who mentioned that it is already in the official charter for budget responsibility. It is really a question of emphasis and government choice about what they want to put front and centre.

Finally, there is another purpose of fiscal rules that is not talked about as often but is very real, which is that it is a useful way for the Treasury to say no to things. Having an actual line in the sand that is precise and numerical and is not a holistic view of five different indicators can strengthen the Treasury's hand in spending negotiations, and we should recognise that is one purpose, for better or worse.

Lord Burns: Announcing that you have a £50 billion allowance from changing the measures is not exactly constraining advice for the Treasury.

Q14 **Lord Londesborough:** Returning to the debate between headline PSND and underlying PSND, is it fair to say that this is something of a distraction from the fact that, whichever measure you take, they are both suboptimal targets? It strikes me that this is a discussion about headroom tactics rather than true fiscal strategy, particularly given that these two measures, as I understand it, are predicted by the OBR to converge in financial year 2028. So there is a bit of a windfall as to when you jump on the graph and when you come off it. Is that a fair comment?

Thomas Pope: Any one measure is imperfect. There are particular deficiencies with both measures of PSND, which we have talked a bit about and will probably talk more about. The deficiencies with the rule are as much, if not more, that we are targeting the change between year four and five and the sensitivity that creates, combined with having only very little headroom against that, which drives quite a lot of the suboptimality of how we are conceiving the rule. If we are going to change the measure of debt, it would be very disappointing if, very far in the future, we are still targeting the change in it between two years.

Dr Isabel Stockton: Among other things, when we only target the change between year four and five, we get a bigger difference when they are converging. We get the same answer when they stay parallel and fall

at the same rate, but we get very different answers in the year that they are converging, because one is falling by a lot more than the other.

Ben Zaranko: I agree that it is largely a distraction. The debate we should be having, if the Government want to borrow for invest, is about the case for doing so. What sort of investment should it be? Why borrow and not tax fund or fund in some other way? That is where the debate should be. We would be in a much healthier place if the Government just said, "We think that, given the state of large parts of the public realm and some the challenges associated with climate change, we're going to borrow this much for these reasons, and here's the case for it", rather than us all being buried in the minutiae. It is my job, but I recognise that these are really quite boring.

Q15 **Lord Turnbull:** One thing that troubles me is what we are basing all these figures on. The OBR has to take the Government's projections for the first five years. This produces a figure in 2027-28 that is nonsense. Grossly, it overestimates revenue in all sorts of ways, particularly the fact that it is going to index fuel duty but has never done so for the past 11 years, and the fact that it is unrealistic to expect that unprotected programmes will be cut by the amount necessary to keep the total growing by only 1%. If you do that, you get to 2028, where things do not look too bad, and the deterioration comes from there. Is the first thing to do to purge these figures that have been presented and actually give us some genuine, credible figures for the next five years?

Thomas Pope: That is a really big issue with the forecast, particularly given how much weight we put in year five, the set of underlying assumptions, many of which you outlined very well. It is for that reason that we have advocated having a fiscal target that binds sooner and one that does so in a year when the Government already have firm spending plans set out at a spending review.

In the last year or so we have been in the worst possible world where we have had only one year of spending plans, or less than a year, set out firmly, and, I would argue, a pretty unrealistic assumption for spending beyond that, applying for four whole years before the fiscal target binds, which allows that four years of assumption to do quite a lot of work.

We suggested that the Government could set out spending reviews every three years that set plans for five years. The Government have announced that they are going to have spending reviews every two years, setting out plans for three. That means we should have targets that bind in that third year. That would not deal with all the issues, we would probably still have the rigmarole over fuel duties every budget, but the spending assumption is doing a lot more of the heavy lifting to make the fiscal position look quite so rosy rather than the fuel duty assumption.

It is quite hard to decide what is a credible number for spending and force the Government to do that without there having been a spending review that allocates firm budgets to departments, which is why we

favour that rather than the OBR deciding what government spending should be.

Lord Turnbull: Do you know what they are going to do on spending and when it is going to be reviewed and over what time horizon?

Thomas Pope: Budgets for 2025-26, so for next year, will be set at the Budget in October. Then, in the spring, they will set at least a further two years of budgets covering 2026-27 and 2027-28, and every two years they will do a three-year spending review. They have committed to a spending review covering at least three years, so that we are never in the situation where we are five or six months before the start of the next fiscal year and no department or public body has any idea what its budget will be next year.

Lord Turnbull: Is there a trade-off here, where the Government have to decide whether they want to create credibility by having some tough figures, or get more credibility by having figures that look more generous but are actually more realistic?

Thomas Pope: Credibility with whom, I suppose, is your question. They are not very credible with us. They perhaps care less about what we think and more about what market players think. Hopefully, they are reading our work and so take a similar view to us. I do not think that people are looking at the OBR forecast in five years' time and treating it as gospel. They tend to have a more nuanced view of the situation, so I am not sure that the Government gain that much from pretending that the fiscal position is much better than it is.

Lord Turnbull: The penalty of coming clean is not that great.

Q16 **Lord Lamont of Lerwick:** The main motive when you strip everything away seems to be the headroom argument rather than separating fiscal and monetary policy, as Isabel said, to get the benefits of investment. When you go to some of the more extreme variants of altering it, illiquid assets being involved in financial liabilities, you get some extreme figures coming up, talking about an increase in investment of something like £60 billion. If we were to go down that road, do you think there ought to be an alteration in the way that public sector investment is appraised? Would you envisage a bigger role for the OBR, or is that completely unrealistic? I find it a bit difficult to imagine that it could really know better than anyone else ex ante what the benefits of investment are. The benefits of investment are not 100% guaranteed, and yet you are taking a very big step. Do you see a need for a change in procedure in evaluating public sector investment?

Dr Isabel Stockton: You touch on a set of related and really important issues. One comes back to something we talked about previously, which is the importance of setting out a credible strategy. At the moment, motives for investment are often a little muddled in the discourse. For one thing, it would be important to distinguish between investment that we feel needs to happen because of any policy priority you choose to

name—I include in that things like modernising the prisons estate because it is in a terrible state or subsidising the construction of net zero infrastructure—because we think that only the public sector will do it. Those may all well be very important things to do, but they are not going to realistically add to growth.

Anything to do with net zero is largely, to a first approximation, about us producing the same amount of things, just in a less polluting way. It is not going to help us produce more. It is helpful to keep that separate, not necessarily by starting to fiddle with the definition of investment, but by conceptually keeping it separate from investment where the argument is: in a fiscal sense, this is going to pay for itself, as in it is going to raise future tax revenue because the economy is going to be better.

The question of who scrutinises that case, or who passes a judgment on whether it is credible or sound or not, is one step further. We are not at a point where anyone is even arguing the case credibly. So, I think that is the first step, and then we can worry about whether we have enough of a process in place to prod that case and make sure it stands up.

When it comes to thinking about those things, there is always a bit of a danger—Ben has written about this before—especially for people like us who work in the roles that we do, of always calling for a technocratic solution, or a solution where we delegate to the OBR or to some expert body. Sometimes that can be a good thing. I do not think we should undersell ourselves. The OBR is a great institution, and its forecast is much more credible than many fiscal forecasts around the world, where there are many bigger problems than the fuel duty escalator in how people can fiddle tax numbers. So, it may be a good thing in some cases. But at the end of the day, policymakers doing the right thing and making decisions around priorities can never be delegated; that is just the nature of the matter. I also think we should be cautious about that instinct to say, "Oh well, the OBR could then ask, has this been achieved, or is this a credible case that investment will boost growth?" That is another dimension where we need to keep the trade-off in mind.

The Chair: I want to bring in Lord Layard, who caught my eye, before I go to you, Lord Griffiths.

Q17 **Lord Layard:** I want to ask a couple of unrelated questions. Following on from this discussion, surely we should be having an equally serious scrutiny of current expenditure as of capital expenditure, not only because that is obviously necessary, but also because a lot of current expenditure is more of an investment than capital expenditure and pays for itself more quickly, such as mental health expenditures and so on. Would you not agree that in this spending round there should be a requirement for the cases to be supported by estimated benefit/cost ratios, whether they are capital or current?

The second question relates to my little tutorial which I had before this, which relates to the briefing. We have not so far mentioned these loans to SMEs which are going to be repaid over the course of this Parliament

to the tune of something like £144 billion, which will reduce the PSND by that amount. People have been asking you what you think about the validity of taking into account the losses on the asset purchase facility. Would you like to comment on how we should think about that bit of the time trend in the PSND?

Thomas Pope: I will start on current and capital spending and the spending review. I agree with the point Isabel made that politicians are able to make decisions, and this is not all about technocratic decision-making. We have done quite a lot of work looking at how the next spending review can be as effective as possible, and one of the things we have highlighted is the importance of getting the appraisal process right. We focus quite a lot on capital, but you are right, Lord Layard, that current spending is also very important. There are systemic issues in investment projects, particularly in terms of forecasting both how long they are going to take and how much they are going to cost, so a tendency for optimism bias. There is a case for more ex-ante review. That probably should happen principally within Government, through the Treasury or possibly with an additional role for the new NISTA, which is going to be a merger of the National Infrastructure Commission and the Major Projects Authority. So, there could be a greater role to ensure that those business cases are reasonable.

We also think that for large projects there is a strong case that business cases should be published so they can be scrutinised publicly. That mainly is a job for the Treasury. Also, the Government can clearly set out at the start what they are trying to achieve and what their priorities are, which would go a step beyond what they have set out in terms of their missions, it will be easier in the Green Book process to focus not just on the economic case and the cost-benefit analysis, which is very important, but equally on the strategic case, which factors in those broader priorities. Does one of you want to take the Term Funding Scheme?

Ben Zaranko: I can take that. One quick point before I do is that if you think about the institutional setup here, it is worth reflecting on why the OBR has been generally, not universally, judged to have been a success. Its integration into the budget process has made it not impossible but quite difficult to ignore in a way that maybe the National Infrastructure Commission has not been, and so maybe it is worth thinking about whether bringing whatever setup we land with into the budget process might make it more high-profile and more likely to lend itself to supporting good decision-making.

The reason why there is much less focus on the Term Funding Scheme is because most of the loans are expected to be repaid over the next two or three years, and the debate, for better or worse, has been around the fiscal rules which bite in four and five years. So, the Term Funding Scheme is a big part of why the two measures are converging, but it is less relevant for this question of how much headroom the Chancellor has to do more borrowing for investment. That is why it has been less prominent in the debate.

I would say that the original decision to use the measure stripping out the Term Funding Scheme was reasonable because, as we have found in a lot of our debate, there is no good reason to think that the timing of repayments from firms should be a key consideration in what fiscal policy stance we take, given that the lifetime effect on the public finances is, by the by, the same; it is just a timing question.

Q18 **Lord Layard:** Can I just ask a question about strategy? It seems extraordinary to me that strategy is not meant to be subject to the value of the strategy. If we are serious as an economic community that we are trying to produce benefits from this expenditure, how can strategy not have to be based on the benefits of the expenditure that the strategy is advocating?

Ben Zaranko: To give one example, sometimes it can be very hard to estimate the benefits of a transformative infrastructure project that is meant to bring a genuine game-changing new railway to an area, particularly based on past evidence. There should be a role, though not an unlimited one, for politicians to be able to take a punt on certain things, even where there is not an enormous convincing evidence base to rely upon. If you only do things for which there is fantastic pre-existing evidence, you do not do anything that has never been done before. So, there has to be some willingness to accept that governments can take punts.

The Chair: I am going to move on to Lord Griffiths and then to Lord Razzall.

Q19 **Lord Griffiths of Fforestfach:** My reading of the current situation is that the Government feel there is a strong case for public not private sector investment, that the public sector will not crowd out private sector investment for the reason Tom gave us, and that this investment will lead to a change in productivity which will lead to a change in growth. The OBR have produced a paper on this subject, so what we are really doing is accepting the bet that the OBR is taking—because clearly it is not black and white—that in 10 years' time we are going to see an increase of 1.8% or something like that. What is your view of that bet?

Dr Isabel Stockton: I would not necessarily think of the OBR's exercise as capturing a bet. In heuristic terms, if we increase investment spending, and the additional spending is average or typical, and if we then make a really big change, what might we expect to happen? Now, that is slightly different from the kind of scenario where we take a punt, or even where I am as a policymaker picking a particular project, because any particular project is not going to be average, and that average, in a sense, encompasses all these different types of scenarios that we have been painting.

So, it is fair to say that the number they came up with has a modest effect. That is not to say that it would not be great to have. Of course, we would all take an extra tenth of a percentage point on average growth over the next five years. That would be great, but it would not make all

our problems go away. It would not obviate the need for tough choices. Of course, one can argue with the particular methods of estimating that effect, but most methods would come up with a similar answer in that there is a distribution of possible and probable returns. Some projects are likely to have a bigger return; some projects are likely to have no return, maybe because they failed or because they were never expected or intended to have a growth return at all. But, while those are all really important questions, we cannot use them as an excuse to get out of other difficult decisions around tax and spend in the current budget. So, always pointing to investment and growth and saying, "Oh, but it is defeatist to question us on our spending and tax plans" is a bit of a false excuse. It does not quite work like that. It is not going to be a get out of jail free card.

The Chair: Lord Griffiths, do you have anything else you want to say?

Lord Griffiths of Fforestfach: No, but it is the size, the new scale of the investment that you want to focus on.

Thomas Pope: The important point is that the OBR has set out very transparently how it is going to think about the economic supply side impact of additional investments. That does not mean that the Government should just think, "Whatever investment we do, no matter how much we scale it up, is going to have that effect". Indeed, they should be looking for projects that are better than average and will get a better effect than 0.1%, even if the OBR is not going to score it. They certainly should not think, "Well, we have £15 billion of good projects, but we should also say we will do an additional £5 billion because we will get extra credit for those as well".

So, the question of what and how much investment we should do should also be driven by that internal process of asking where the good projects good evidence that we should expect these projects to crowd in private investment are. We certainly should not get into a situation where, because the public sector can, it starts doing the types of projects that the private sector would invest in anyway. I think that OBR paper is really helpful, and it has taken a very reasonable approach, but it does not take away the need for the Government to rigorously assess each investment decision they make.

The Chair: Can I pick up on this point that Lord Griffiths is getting at? It is a simple question, which may have an obvious answer. I was interested in the IFS paper which looks at the impact that extra spending could have on borrowing costs and interest rates. You write that, "Previous Treasury modelling suggested an increase in borrowing of 1% of GDP might increase interest rates by between 50 and 125 basis points, depending on economic conditions. An extra £50 billion of borrowing in 2028-29 (roughly the amount of extra 'headroom' provided by a switch to PSNFL) would amount to around 1.6% of GDP".

I am interested in what Lord Griffiths said about time lag. If you are investing, and you see the benefits of growth of 0.4% in five years' time,

how does that square off with the impact of this in terms of debt service costs in that interval? How risky therefore is this potential bet and what we are seeing—the *Financial Times* points this out today—in terms of how the market would respond to this? How risky in your mind is this PSNFL approach of £50 billion extra?

Dr Isabel Stockton: On interest rates, it is useful to distinguish two types of risk. There might be an almost mechanical effect that if the public sector, or indeed anyone else, borrows a lot more, by simple supply and demand that will probably drive up the price of credit, i.e. interest rates. There are different considerations around how big that risk is likely to be in different states of the economy or for different types of policy and so on, and they are all interesting, but those are fairly modest costs. While it is important to be aware of them, and while the Government should make a case of why they think these costs are worth it, they are different from the other type of risk in that, if we suddenly announce a large increase in investment spending, and it does not look like there is a credible strategy behind it, markets may get quote "spooked", there may be a sharp increase in interest rates, and we may be in the bigger kind of trouble we have recently experienced. So, those are two separate risks, and while neither of them should be ignored, they are on different scales and need a different attention.

Ben Zaranko: The OBR has a framework for thinking about this which is helpful. Basically, if you take a really long view, the OBR paper says if you spend 1% of GDP more on investment for ever, the economy is eventually 2.4% bigger for ever. Obviously, those gains are further into the future, but they boil this down to one single number, which is almost the hurdle rate as to how good the investment has to be to make it self-financing, which, in their framework, comes to about 2%. Tom, you have probably read this in more detail than I have.

Thomas Pope: I think it is 1.9%.

Ben Zaranko: I am going to take that as a victory. So, it is about 2%. That tells you, depending on where borrowing costs are, how good the investment is. That is a helpful way to think about it. When interest rates were close to zero and borrowing was more or less free—negative in real terms—there were lots of cases which might have eventually been self-financing. When interest rates are much higher, there will be fewer cases where that is true. That is a slightly different but helpful way to think about what OBR modelling tells us.

Thomas Pope: It is 2% real, or 1.9% real.

The Chair: I am going to turn to Lord Razzall, so we can go into a little more depth on public sector net worth, et cetera.

Q20 **Lord Razzall:** My question slightly pulls together issues that have been touched on in various answers. We have looked at four separate methods of government targeting: public sector net debt; public sector net debt ex-Bank of England; public sector net worth; and public sector net

financial liabilities. Could you give your pros and cons as to targeting public sector net worth or public sector net financial liabilities rather than PSND or PSND ex-Bank of England?

Ben Zaranko: I will take that; this is almost a hobby of mine. Public sector net worth is one of the most comprehensive measures of the government balance sheet we have, so by virtue of including a much broader range of assets and liabilities, it paints a more complete picture. We have seen that, in the not-too-distant past, one of the downsides of focusing narrowly on debt is that you can neglect the asset side of things, which can provide incentives to sell things off when they perhaps ought not to be sold off, and to reclassify things in and out of the public sector, and all the issues we mentioned earlier when we talked about Goodhart's law.

By taking a more complete view—in particular, proponents would argue by taking into account the assets that you acquire when you invest for the long term—you can encourage better long-term decision-making by encouraging governments to invest where returns are highest and to focus on better managing their assets. There is a fairly good theoretical case for this.

I worry primarily about how it would function in practice, and there are several reasons for that. One is that measuring non-financial assets, things like the value of the road network or NHS hospitals, is conceptually difficult.

Lord Razzall: Or a school.

Ben Zaranko: Or a school. The statistical manuals that inform these things generally say you should do it on what is called replacement cost. How much would it cost to replace that school? Let us say construction costs spike because of a global supply chain problem, and the price of all the land that we would build schools on goes up. The replacement cost of schools has gone up. The value of our schools and our net worth measure has shot up. Should the Government take that as a sign that they can afford to borrow more? It is not obvious to me that they can. It is also not obvious that it is telling us anything meaningful about the benefits of investment. If construction costs have gone up, I would argue the Government's position is weaker. It is now more expensive to refurbish our schools and to do infrastructure projects and so on. So, I think it can give you quite misleading signals.

The second big problem, which is related, is that movements in net worth do not necessarily tell you about what really matters, which is your ability to service debt and access capital markets. You cannot sell off a school in a financing crisis. Some people argue we should put the value of natural assets in there as well. I love bumblebees as much as the next person, but you cannot sell off a bumblebee in a fiscal crisis. Whatever you do, there is a good case for having some regard to debt servicing, perhaps debt itself, and on balance I am firmly of the opinion that the downsides

would exceed the benefits, but I note that other people disagree with that.

The Chair: In terms of who disagrees, I have in front of me, as you may have seen already, the IPPR paper that came out.

Ben Zaranko: I have read it.

The Chair: In terms of public sector net worth, they argue that using this would, "Bring fiscal rules more in line with how financial markets think about fiscal sustainability", which seems to be the complete reverse of what you just said. I would agree with you, but there seems to be a very wide gulf between the IPPR and you. Despite all the misgivings that you have—which I would share about the inability to suddenly sell, for example, our prisons, the NHS or the nuclear deterrent—somehow the markets and the IPPR think this is a good measure. That seems to be a very wide gulf.

Ben Zaranko: There is. To its credit, the IPPR paper engages with some of the criticisms. The assertion that this is what financial markets want to see would not be universally shared. It is true that any private sector company thinks about its assets as well as its liabilities.

The Chair: Just on this point about the market, surely it is about how the markets can see a government's ability to service its debts, is it not?

Ben Zaranko: Exactly.

The Chair: It is not clear to me that a government could service its debts by suddenly selling some of the assets that public sector net worth obviously takes into account.

Ben Zaranko: I am not a financial market participant, but if I were in the bond trade, I would be thinking about exactly how many bonds the Government is likely to have to issue in future. What is this likely to mean for things like inflation and interest rates? How likely is it that the Government will be able to service their debt in the future? Anything that means the economy is growing faster, and tax revenues are higher, might well mean future gilt issuance will be lower. But I am sceptical as to how much big investments in the government estate that are not well measured or well valued will really make a difference.

Thomas Pope: Just to engineer the mildest of disagreements, I think that investments in things like hospitals in particular are not irrelevant to economic growth, because public sector productivity is quite important as well. An investor could look at our dilapidated hospitals estate, or indeed our dilapidated prisons estate, and see a very large liability there in the future that the Government will need to finance. So, I do not think these assets are entirely irrelevant, and one advantage of more comprehensive measures is that they recognise that not all borrowing is exactly the same and might be treated differently.

That said, we cannot sell all our schools to finance our debts. I broadly agree with Ben. There is a bigger issue that, even if public sector net worth is fundamentally in an economic sense what we care about—Ben has laid out reasons why that might not even be the case—the valuation issues are such that I do not think we can be confident that our accounting measure of public sector net worth is the idea that economists might have in their mind of a genuine public sector net worth, insofar as that is a coherent concept at all.

Dr Isabel Stockton: I am also not a financial market participant, and it is not my main area of research, but it strikes me that we have better measures that we could target if we care about what investors think. We have price signals and interest rates which tell us something about investor confidence. That seems to me a more direct way of getting at that aspect of fiscal rule design rather than trying to guess what investors might care about and then emulating that.

Lord Razzall: Are you all basically PSND people then?

Ben Zaranko: Noting the concerns about the distinction between current and capital being an imperfect one, there are good reasons generally to think we should not be funding current spending out of borrowing on a sustained, structural basis. I am not sure that directly targeting any single stock measure like debt, like public sector net worth, is wise. That is why the much more sensible view would be to consider a range of them as a comprehensive set of indicators together rather than getting too bogged down on any single one and using the current budget as your guiding star, if you like.

Thomas Pope: Broadly, I would agree with that. In terms of direct targeting, I have more concerns about public sector net worth than net financial liabilities, although some the same issues exist to—

The Chair: We will come back to that in a second.

Thomas Pope: Considering a range of different measures is definitely important. Having your current budget rule is a really important discipline as well, and that in many ways could be the most important reform to the fiscal framework and set of fiscal rules that Rachel Reeves announces, which we are not focused on today because that is not up for debate.

Q21 **Lord Blackwell:** I want to come back briefly to your comments about the public sector net worth. It seems to me some of the advocates of this misunderstand the way the private sector companies think about debt sustainability. When you draw up a going concern statement for a private company, you look at cash flow and outgoings, the serviceability of the debt. You cannot, any more than you can in the public sector, take account of the fact that you can sell assets if they are not easily liquidatable. The other private sector measure of debt as a percentage of the total balance sheet is only relevant because, for the debt holders, you can wipe out the equity holders. You cannot wipe out the Government if they cannot service their debt. So, there are a lot of misleading analogies

with commercial companies that are not appropriate.

Ben Zaranko: There are plenty of things Government do that are not cash flow generating, which is a key point, and those assets are particularly difficult to value.

Q22 **Lord Rooker:** I want to see what confidence you have in the ability of the Treasury or the Government to explain change in some things we have been talking about this afternoon. Earlier this year, people in this room were horrified to hear Joseph Stiglitz tell us that investing in more nurses to cut waiting lists and get people back to work was really worthwhile. We were not able to follow that up, but in terms of change in the current circumstances—we can quote the *FT* and the *Guardian* until the cows come home—can it be explained in such a way that the population or opinion formers do not think, "Oh, it is a fiddle. If this is so good, why did the last lot not do it?" Is the capacity there to explain it in such a way that it does not become negative?

Dr Isabel Stockton: If I did not believe in the possibility of explaining policy in such a way as to make a difference then I would have to quit my job, so I would have to say, yes, it is possible.

Thomas Pope: We have been making the point that you can separate thinking about the measure itself and what you are trying to do with it from the fiscal position. It is much easier for the Government to land an explanation about a change on a principled basis—there are principled bases, as we have discussed—if they are not using that change immediately, using up all the extra headroom and taking all that on. They could also take the opportunity to go more slowly, to consult on different options for example and perhaps announce something next year that would move more slowly. If they are going to make a change and at the same time effectively use a large chunk of whatever extra headroom they have gained, they are not going to really get a hearing from the public.

Lord Rooker: Then it looks like a fiddle?

Thomas Pope: Then it looks like a fiddle because it looks opportunistic.

Lord Rooker: That is my language; I am not putting words in your mouth.

Thomas Pope: Yes.

Lord Rooker: Thank you.

The Chair: Can we end by asking you about the benefits or otherwise of public sector net financial liabilities versus PNSW? Thomas, you were about to talk about this.

Thomas Pope: My colleagues might be better placed to go first.

The Chair: It would be good to end with what the pros and cons are of that.

Ben Zaranko: One last thing about net worth, which is really helpful for this discussion, is that its main benefit is it gets us, imperfectly, to start measuring the benefits of investment, which is what Rachel Reeves said she wanted, i.e. the Treasury to recognise the benefits of investment as well as the costs. Public sector net financial liabilities would buy you a similar amount of extra headroom if you just plugged it into the existing rules, but it would not get you much recognition of the benefits of the investments. It would in some cases where you have, for example, a new National Wealth Fund taking an equity stake in a promising battery startup or whatever it happens to be. That would be recognised, but any investment in transport infrastructure, hospitals or physical assets, would not be. It does not suffer from as many of the problems as a net worth target, but it also does not have the theoretical attractions in terms of recognising benefits.

Clearly, it would be easier to sell off the student loan book in a crunch than it would be to sell off St Mary's Hospital, but it is not quite as good as having just liquid assets. So, it sits somewhere between the two, and I would be very keen to have that come with what we talked about earlier in terms of how we make sure investment is done well, how we appraise it properly, how we try to add credibility to any plan. As Tom said, it should be downstream of an overall fiscal strategy; it should not be driving policy decisions itself.

Thomas Pope: One risk of going as far as public sector net financial liabilities and not as far as public sector net worth is, in a way, these rules seem more attractive because we know how governments game public sector net debt. We have had rules based on them for 20 years. We have not yet thought about how they are going to game possible future rules, but you have an incentive to invest in such a way that creates a financial asset going forward rather than perhaps invest directly in a physical thing, even if that is the most effective way to do it because of how it is accounted for.

Ben Zaranko: The other thing to worry about is it creates incentives for departments to behave in a way that is more PSNFL-friendly. To take the example of student loans, if we instead had a graduate tax, there would be no financial assets sat on the Government's balance sheet, because it would all be future tax revenues, and we do not put those on. So, you might get wider incentives to finance more things through loans that make you look better on PSNFL. That is just one off the top of my head. I am sure there are many ways we would discover of gaming it, which brings us back to the downsides of targeting any single stock measure.

Dr Isabel Stockton: Of course, there can be different positions on how desirable it is to fund any public service through something like a student loan system versus a graduate tax. But one of the big-picture principled arguments as to why we care about borrowing biases and why we have fiscal rules at all is we do not want to pre-commit future policymakers or future voters too much. We want to leave them as many choices as possible, and it strikes me that organising a lot of things through loans is

not going in that direction in a very broad sense. I would worry if it turned out that it was the incentive set and that policymakers responded in that direction.

Q23 **Lord Burns:** I am struggling slightly with some of the differences this conversation is highlighting between capital and current spending. Fundamentally, the difference is that with capital spending you are buying a stream of services. That stream of services needs to be no different in terms of the impact it has on the economy than a flow of current spending in some areas; but one is lumpy and the other one is not. So the basic principle is that you can borrow in order to have the lumpy asset now that will provide you with a stream of services. What the market concerns itself with is if you can pay the interest on this during the period - if you can afford it, and if you can repay the capital at the end of the loan.

The issue of whether the rate of return on things that we call capital spending is higher than the rate of return on some of the things that we call current spending seems to me to take us off in a direction that we do not need because, very often, it underestimates investment in human capital as against physical capital. It fails to spot where many of the investments that could take place and be paid for out of current spending could improve productivity quite substantially. It is a frustration, and I worry how much of this debate has become an argument about whether capital spending is really better for the economy than well-targeted current spending. The issue of borrowing—for it surely is an issue—is can you afford it? And that comes down to issues of interest payments as a proportion of income.

In my private sector life, when I borrowed money from the markets, I was only interested in two things: first, can you pay the interest? Secondly, will you be able to repay the capital at the end of the period? Norman raised this at the beginning. We are not giving sufficient attention to that part of the affordability issue and where that might lead to, as we are to this rather vague issue as to whether or not buying a set of services that we call capital spending is more important for the economy than buying a set of current expenditure.

Thomas Pope: There are, potentially, a couple of separable issues here. One is thinking about how the OBR thinks, and how the Government think about what is good for the economy. You are absolutely right, we should not just be focusing on the potential benefits of investment and, indeed, current spending can have those benefits. In the last couple of years, the OBR has adjusted its supply side forecast to account for, say, the investment in childcare. It was current expenditure that was judged to increase participation in the economy and other things like that. So, we do not need to focus only on capital versus current spending. Then, there is the issue that you raise that capital is just buying a stream of future flows, and we are going to have a set of current future flows.

I suppose the principled argument for why people often say, “Let’s borrow for capital and not for current”, is that investment in capital now

is going to accrue in future years and will pay for those in debt interest in future years, whereas that future flow of current spending should be paid for by current tax revenues in each of those years. But there is another issue, which is that there are elements of current spending that actually look quite a lot like capital spending in that the returns come some way down in the future.

You mentioned the classic example of investment in skills, human capital and so on. My view is that our segmentation of investments and capital investment is not perfect. Those other things clearly matter. The evidence of the last 15 years suggests that investment in physical infrastructure is something that does seem particularly prone to being very sharply cut in times of downturn. Having a fiscal framework that protects around that seems quite expedient, even if there is not the principal case to distinguish that from other current spending. Defining human capital investment and so on gets a lot messier than physical capital investment. For those reasons, I am relatively relaxed about having a fiscal framework that distinguishes between those two things, even though there is not a perfectly principled reason that gets you to that point.

Q24 **Baroness Wolf of Dulwich:** Much of what I was going to raise has already been covered, because it is on a similar point. It seems to me that one reason why everybody is agonising about this is because of an underlying worry that we can go for years and years, spending less and less on capital, and nothing brings that to the surface. So, you get people going, "I will borrow only for investment". Honestly, almost anything a government spends on can be characterised as investment.

It seems to me that what you have all been saying, particularly in terms of whether it is possible to look at public sector net worth, is that there is no simple way within fiscal rules or definitions that you can bring that major question up to the surface. Am I interpreting you correctly that fiscal rules are not the way you do that? But can I push you a little further on fiscal frameworks? First, do you agree that one of the reasons that this keeps bubbling along is because of this worry that there is nothing that, over a period of years, really makes you go, "Hmm, it's going in the wrong direction"?

Secondly, what can you actually do? You mentioned, for example, the fact that the OBR is very involved in the whole process of working one's way through the annual budgets. Is the answer partly to make the major infrastructure organisations more involved, or is it something where you just basically have to keep banging away and hope the politicians take some notice?

Thomas Pope: You are right that there is no simple rule that can align all the incentives in the right way. We are demanding too much of our fiscal rule if we want our politicians to look at the rule, see how they meet it, and out pops a perfect set of policies. The fiscal rules are part of the fiscal framework. As we have already said, they should be derived from a strategy and, actually, if a Chancellor is really committed to not

just meeting the rules, but to investing optimally in all these other ways then, in a sense, the fiscal rule is a useful check out there to make sure they are continuing to do that. But actually, it is not the fiscal rule that should be driving their decisions; it is the evidence that is presented to them by their officials on what types of investment or other kinds of spending are likely to drive which kind of change.

There is a natural bias; we call it a deficit bias. It is a bias toward politicians wanting to see returns quickly because they have a political shelf life. There is no reason why a politician could not decide to prioritise what is going to have the most difference on growth in 15 years' time. Ultimately, we should not be relying on a set of institutions to force them to do that. You need a Chancellor who is willing to stand up and say, "This is what I am trying to do", and design a fiscal framework that would not prevent that, but your fiscal framework is not going to drive every decision in the right direction.

Q25 **Lord Layard:** I wanted to say something very similar to what Terry said, but I will say it in a slightly different way because it is so important. This discussion of public assets is really a discussion about what is cashable or should be a discussion about what is cashable and, of course, the thing that is cashable is the GNP. It is the GNP that produces the taxes, and that is the central asset that the Government have is the GNP that it can tax. If you then ask yourself what produces the GNP, it is about 60% human capital, 30% physical capital, and 10% indirect taxes, something like that. If you ask what produces a change in the GNP, looking back over recent history, it is something like half and half physical and human capital. It is kind of weird that physical capital is in this category.

I am also not persuaded that there is a bias against physical capital. There is a huge bias in favour of what you can touch versus what you cannot touch. Recently, the road programme has been sailing along with a very low rate of return. Public services are in a state of frightful disarray. They cannot be seen, but the roads can be seen. There is, actually, quite a bias in the political system the other way. I do not really think we should assume it is all one way.

This is not in terms of fiscal rules, but one must be pushed back to thinking of the budget as a limited resource and how to maximise population well-being subject to the limited resource. Then, you look at every policy, physical or current, in terms of what benefits it produces relative to the net cost, which includes the cost of the flowback from that investment being deducted from it. That is how you get a typical situation—if you do the kind of exercises we have been doing—where you get many much better benefit cost ratios from human capital than from physical capital. Is that point of view acceptable to the witnesses?

Ben Zaranko: There are a couple of things to say. One is that there is a bias against capital investment in the budgeting process. Perhaps that is the reason why the capital/current distinction was introduced in 1998, because there was a generally agreed perception that when the going gets tough it is much easier to cancel a road project that has not yet

started than it is to lay off staff from the NHS or local government or whatever. Every time a big fiscal tightening has been announced, it is always bigger cuts to investment than it is to current spending. It is much more volatile and, if you look at where the UK is unusual internationally, it is not really in how much it spends on education and skills; the UK is unusual in its relatively low levels of gross fixed capital formation, physical investment. So, there is a degree to which the UK does less of that than it might.

It is, of course, true that things like human capital investments could yield better returns. The theoretical ideal you describe is attractive but, at the present moment, we are not capable of doing that across all different items of spending. We are moving a little closer towards that now that the OBR is scoring growth benefits of childcare spending or, potentially, interventions to try to get young people with mental health problems back into work. Those sorts of policies are now being recognised as potentially growth-relevant, which at least gets us a step further in the direction of not just thinking capital good, current bad.

Fundamentally, the distinction is an accounting one, and we should not let accounting treatment guide policy as a general rule, but I worry about the Pandora's box you would open where if the Government came up with a new definition of growth-enhancing spending, you would have every Department and every spending line argued to be doing that. Is prison rehabilitation an investment in human capital? Is the NHS in its entirety an investment in human capital? Are we borrowing for all that? I just worry about where you draw the line, and if you have to draw the line somewhere, doing it on clearly agreed international accounting guidelines is not, in my view, too bad an option.

Dr Isabel Stockton: The other point you raise is that, of course, we have been talking about net worth as the maximum, the most comprehensive measure, but it still omits the biggest asset that the state has, which is the ability to tax in future. But, with the measures that attempt to account for that, you then get to the World Bank debt sustainability analysis-type models, so what international institutions run when a country is in a debt crisis to figure out what is feasible and what is not. While those have their place, they are not an appropriate tool for us to target in our internal process when we are in the fortunate position that we believe we have scope to make future policy. We believe that if the Government decided to raise taxes, they could raise taxes. There is nothing fundamental in the capacity of the economy that stops us from making these adjustments in future and that becomes really important. If you run these kinds of models that tell you whether, if we are on that same trajectory forever more, we end up in trouble or not.

Q26 **The Chair:** Can I ask you each a very flippant final question? We have discussed a lot about the pros and the cons of what might happen. What do you actually think Rachel Reeves will do, because she is making up her mind tonight: is it going to be PSND, public sector net worth, or public sector net financial liabilities she will move to? Or will she just stick

with what we have?

Ben Zaranko: It would be surprising, if she gives interviews saying, "Invest, invest, invest; growth is the challenge and investment is the solution", that she would not to be planning some increase in investment spending. I do not know if it is a guess or a hope, but two options would not be surprising. One would be if she went for public sector net debt, but she strips out things like the new National Wealth Fund and the policy banks as being a distinctive new government thing. Or if she went for some measure of something like net financial liabilities, but with accompanying measures to not get the full £60 billion and to tighten up the current budget target, maybe go for year three rather than five, something like that.

Dr Isabel Stockton: Those seem not surprising but, maybe because of the period I have spent working on UK public finances, there are not a lot of things that would seem all that surprising.

Thomas Pope: Ben stole my answer. It was stripping out the policy banks and the National Wealth Fund and treating those differently, which is some of the way to PSNFL but not all the way, hopefully accompanied by a strategic review of what we are looking for the policy banks to achieve and how they are going to be run and how accountability will work; that would be my answer.

Chair: Excellent. Thank you very much. With two minutes to spare, that has been a very good session indeed. Thank you very much all three of you for coming.