GOWER INITIATIVE FOR MODERN MONEY STUDIES – WRITTEN EVIDENCE SND0019 - SUSTAINABILITY OF THE UK'S NATIONAL DEBT INQUIRY

1. Introduction

1.1 The national debt has been a recurring topic in Parliament since 1690[1]. Despite numerous attempts to eradicate the debt, all efforts have fallen short. Much has been written about the debt, often ill-informed. Unfortunately, the evidence presented to the committee so far lacks grounding in institutional reality. We would like to rectify that by arguing the following points:

1.2 Government spending and taxation involve issuing and collecting sterling; the government (or, more strictly, Parliament) is monetarily independent. The government does not need to and, as a matter of practice, does not collect money created and issued by other entities, such as commercial banks or foreign governments.

1.3 Governments invariably spend more into the economy than they receive in taxation whenever the private sector seeks to net save or net import. Either or both of these conditions have typically been satisfied in the UK over the last century, which explains why the government has had a financial deficit in the vast majority of fiscal periods. Particularly noteworthy is that government deficits arise from choices made within the non-government sector and are only very weakly related to discretionary government policy[2].

1.4 The national debt represents the cumulative net quantity of sterling issued by the Bank of England due to government fiscal operations, which both domestic and foreign entities have saved over time. This 'net money supply' constitutes a financial asset on the balance sheets of the non-government sector. It is recorded as a liability on the government's balance sheet merely as a balancing item to that asset.

1.5 Regarding structure, the national debt comprises National Savings, Treasury bills, gilts, and the government's Ways and Means account held at the Bank of England. Non-government sector counterparties hold the first three instruments because of their unsurpassable creditworthiness. They are employed as a store of value by businesses, individuals and financial institutions and as a medium of exchange in wholesale financial markets, including those in which monetary policy operates. These instruments are not typically considered money, but they have money-like characteristics and are material components of the monetary system. Considering them a threat to

1 House of Commons, 'House of Commons Journal Volume 10: 25 November 1690'.
2"Given the level of activity, the quantity of private wealth and the rate at which it accumulates are determined entirely by the propensities of the private sector, which the government cannot change. But this is to imply (again given the level of activity) that government deficits and debts (being identically equal to, respectively, private savings and wealth) are endogenous variables which cannot be controlled by governments" Godley and Lavoie, *Monetary Economics*, 97.

fiscal sustainability and, therefore, needing elimination is at best incoherent, and at worst highly damaging.

1.6 Gilts and Treasury bills are the most conspicuous of these components. They are issued not to provide funding for government spending but as an anachronism related to interest-rate targeting monetary policy. The existence and magnitude of interest on these instruments is a direct function of the Bank of England’s discretionary policy interest rate and not related to market sentiments regarding the government's creditworthiness.

1.7 Repayment of principal and interest associated with the national debt is guaranteed by the legislation and mechanisms that underpin the government’s financial activities[3]. There is no risk of default. In that sense, the fiscal sustainability of the national debt is beyond doubt. Interest paid does, however, represent a regressive flow of income to the more wealthy parts of the non-government sector and should be considered a questionable policy on these grounds.

2. The UK Fiscal Process

2.1 Government Banking Arrangements

2.1.1 Parliament holds ultimate authority over government spending: individual departments can only spend with parliamentary authorisation. Once Parliament has passed legislation, HM Treasury makes funds available to government departments according to the provisions of the Exchequer and Audit Departments Act 1866.

2.1.2 The first step (‘Monthly Treasury Requisition’) involves HM Treasury obtaining approval from the Comptroller and Auditor General[4]. Once approved, the Comptroller grants HM Treasury a credit on the Consolidated Fund Account at the Bank of England. An amount equal to the value of the credit is transferred[5] from the Consolidated Fund’s Account at the Government Banking Service to the accounts of each government department that has requested funds.

2.1.3 During the next step (‘Daily Cash Drawdown’), HM Treasury orders the Bank of England to make a transfer from the Consolidated Fund Account at the Bank of England to the Government Banking Service settlement account at the Bank of England. The amount transferred is the expected spending of government departments during that day. This transfer is statutorily mandated[6]; the Bank of England has no discretion. Once the deposit is in place, the Government Banking Service can settle departmental payments into the banking sector.

3 National Loans Act, s12(4); Exchequer and Audit Departments Act, s15(3).
4 Exchequer and Audit Departments Act, s15(2).
5 ‘Transfer’ in this document means an accounting journal that debits the first account and credits the other account(s). The journal is applied regardless of the current balance position of either account.
6 Exchequer and Audit Departments Act, s15(3).

2.1.4 Taxpayers make tax payments by instructing their bank to transfer funds to tax-specific HMRC accounts held within the Government Banking Service. The taxpayer's bank makes a transfer from its settlement account at the Bank of England to the settlement account of the Government Banking Service service provider[7]. Throughout the day, HMRC transfers amounts from particular tax accounts at the Government Banking Service to HMRC's general account at the Bank of England.

2.1.5 At the end of each day, all accounts held by government entities at the Bank of England are consolidated into a single balance known as the 'Net Exchequer Position'. As part of this 'Exchequer sweep', HM Treasury transfers any balance of HMRC's general account - the tax revenues collected during the day - to the Consolidated Fund Account. Subsequently, the balance (positive or negative) of the Consolidated Fund Account is transferred to the National Loans Fund Account, leaving the Consolidated Fund Account with a zero balance for the following day.

2.2 Cash Management and Monetary Policy

2.2.1 The banking sector holds an equal and opposite financial position to the end-of-day balance in the National Loans Fund Account: on days during which the government has net spent, the banking sector has additional money; on days of net taxation, the banking sector has less money. This balance is referred to historically as 'book debt'[8].

2.2.2 The current policy, known as the 'full funding rule'[9], is designed to discharge the Bank of England's intra-day advance to the government by the end of each day, the aim being to neutralise any change in the quantity of central bank money held in the banking system due to the government's activities. This results in the private sector holding government liabilities (such as gilts and Treasury bills) instead of liabilities of the Bank (central bank money). The point at which the public purchases government securities does not signify the point at which the government incurs a debt. Instead, these trading activities represent refinancing an existing debt (to the Bank of England), consistent with monetary policy. The government typically refinances again when it sells longer-term gilts, via auctions and other methods, to financial institutions through the Debt Management Office. These activities are generally called "government borrowing".

2.2.3 The full funding rule is not motivated by fiscal policy but by monetary policy. However, since the Bank of England introduced interest on reserves in 2006, controlling the amount of central bank money in the system is no longer necessary to achieve the target interest rate. Yet, the full funding rule remains, anachronistically, in place. In some cases, it can work against

7 It's unclear whether this is Barclays' settlement account at the Bank of England or the Government Banking Service's settlement account at the Bank. HMRC refuse to release the information under FoI (HMRC to Berkeley, 'Reply to Freedom of Information Act 2000 Request, Ref: FOI2020/02512', 2 December 2020.)
8 Select Committee on Public Monies, 'Report with Proceedings: 279-Sess. 2'.
9 Debt Management Office, 'Debt Management Report 2023-24', 10.

monetary policy, such as during Quantitative Easing, when the Bank of England bought back many of the securities sold by the government.

2.3 Summary

2.3.1 The Consolidated Fund Account starts each day with a zero balance and only receives a transfer of tax collected at the close of business. As such, all spending initiated by HM Treasury during the day operates via the issuance of new money by the Bank of England intra-day credit system, much like any other member of the 'Sterling Monetary Framework'. This process accommodates all spending authorised by Parliament, including all the permanently authorised principal and interest payments on debt securities[10]. None of these payments can be prevented by any other entity in the system.

2.3.2 It's important to understand that although the government can control how much it spends, the amount of tax collected depends on the number of taxable transactions happening in the economy, as tax is generally a percentage of the transaction amount. Therefore, the total amount of tax collected in any given period is primarily determined by the spending and saving decisions of the non-government sector and not by government policy. If the non-government sector decides to increase its net savings or import even more than it exports, only a portion of the money spent by the government will recirculate within the domestic economy. The tax collected will be less, and the budget deficit will increase. Net saving and net importing are typical behaviours of the UK domestic private sector, which is why the government has a deficit financial position in most years.

2.3.3 For a fuller exposition of the government's fiscal structures and processes, please see the referenced works[11].

3. The National Debt

3.1 The Sustainability of the National Debt

3.1.1 For sterling-denominated government liabilities, default risk is an impossibility. Parliament has permanently authorised the repayment of principal and interest, and payment proceeds in every case under the provisions of the Exchequer and Audit Departments Act. From both an institutional and operational standpoint, servicing the national debt presents no obstacle. The statutory provisions are such that a UK court would order HM Treasury to make the payments even if a government tried to default voluntarily.

3.1.2 Regarding interest rate and refinancing risk, there are two ways in aggregate for corporations to hold the National Loans Fund liabilities that constitute the

10 National Loans Act, s12(4).
11 Berkeley et al., 'The Self-Financing State: An Institutional Analysis of Government Expenditure, Revenue Collection and Debt Issuance Operations in the United Kingdom'; Berkeley, Tye, and Wilson, 'How Does the Government Spend? A Functional Model of the UK Exchequer'; Berkeley et al., 'The Self-Financing State'; Berkeley, Tye, and Wilson, *An Accounting Model of the UK Exchequer*.

national debt. One is buying gilts and Treasury bills directly, while the other is through Bank of England deposits[12]. The market value of gilts and Treasury Bills is determined relative to the expected market value of the alternative instrument, Bank of England deposits, with the interest paid on these deposits being fixed directly by the Bank. Hence, the government determines the interest rate path on the national debt when it sets the monetary policy targets.

3.1.3 Is market hostility an impediment to the successful auctioning of government securities, as is often claimed? As explained by the Bank of England five decades ago[13], since the government injects money into the banking system in the first instance when it spends, the banking system already holds excess funds to purchase the securities the government wishes to sell. When the securities are traded, their value will match this additional money.

3.1.4 The government is not obligated to sell securities, and any perceived execution risk exists solely because of the current political choice to follow the full funding rule. Due to the statutory provisions, liquidity risk cannot exist in sterling, even under the full funding rule. As the Debt Management Office explains in its annual reviews[14], 'Automatic transfers from the government Ways and Means (II) account at the Bank of England would offset any negative end-of-day balances'. Indeed, the government demonstrated in April 2020[15] that merely threatening to use the Ways and Means account was enough to force market prices for Treasury bills back into line.

3.1.5 In the first instance, sterling is a tax credit not backed by any tangible asset. The government has no more money at its disposal when the budget is in surplus than when it is in deficit. Therefore, using a metric like the debt-to-GDP ratio to assess the government's solvency is not meaningful. The government is always solvent in its denomination, and any interest it pays is a policy decision. Fiscal sustainability does not concern finance but is directly related to how labour resources are utilised in the economy. Hence, the priority should be to generate genuine full employment by eliminating all involuntary unemployment.

3.2 Conclusion

3.2.1 Ultimately, the existence of the national debt and the rate of interest that the government pays are political questions that centre entirely on distributional issues. Historically, policymakers have responded to these questions in various ways, such as creating index-linked gilts to defray the government-imposed accounting requirements of final salary pension schemes.

12 The balancing asset held by the Bank ends up as a charge against the National Loans Fund via several paths.
13 Bank of England, 'The Treasury Bill'.
14 Debt Management Office, 'DMO Annual Review 2022-23', 32.
15 HM Treasury, 'HM Treasury and Bank of England Announce Temporary Extension of the Ways and Means Facility'.

3.2.2 To that end, the government should explore transforming gilts, Treasury bills, and other negotiable government securities into deposit accounts at National Savings. Extending the remit of National Savings to cover certain corporations would allow these accounts to sit alongside Premium and Capital Bonds, with the same guaranteed payment of interest and principal. The true nature of these instruments would become evident to all - safe savings for the non-government sectors.

3.2.3 Once such a facility is in place, there would no longer be any need to issue gilts and Treasury bills, no need for a Debt Management Office and no need for a market in gilts. Gilt market participants would move to other areas of the economy where their skills could be better utilised. The remaining gilts would run off over time. HM Treasury could offer the option to purchase any priced below par at the current market rate.

3.2.4 Cash management policy should shift to utilising the Ways and Means account, which would receive the balance of government fiscal operations as it did during the 20th century. Negotiability would still exist, but it would be provided by money funds in the private market discounting their deposits with the state.

3.2.5 The government will need to change policy to make these options viable, primarily by cancelling the full funding rule. A relic of the time before interest on reserves and a consequence of the 'twin star' paradigm[16], the rule does little more than increase the risk premia on gilt sales by artificially creating systemic risks in execution that would not otherwise exist.

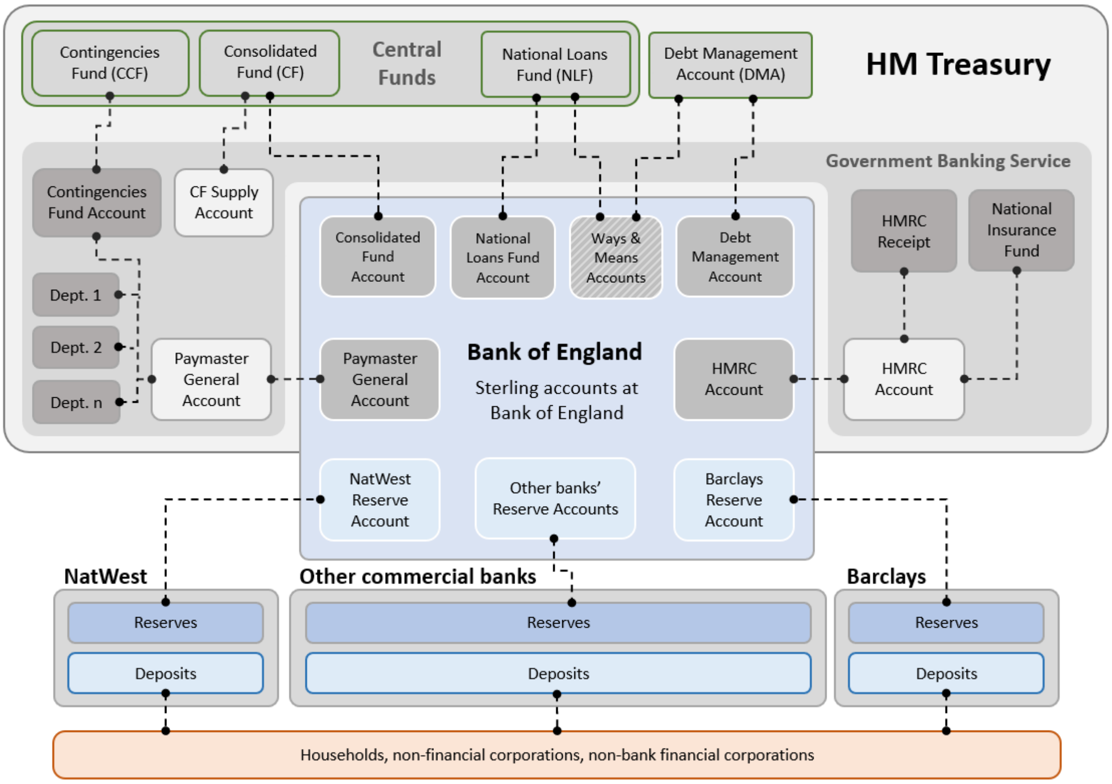
3.2.6 The debt-to-GDP metric should be abandoned. The government should budget in physical terms, not financial terms[17].

3.2.7 Currently, the UK invests only 18% of GDP - a level similar to that of Cameroon and Kenya and one of the lowest in the OECD. Significant increases in investment are needed to drive employment and productivity innovations across the nation. Investment in public infrastructure, education, and job creation with genuine full employment should be prioritised. By doing so, the government would ensure the long-term physical sustainability of the UK economy and all of its liabilities, public and private. Given that any national debt repayment can never be in doubt, there is no valid reason for inaction.

3.2.8 Political rhetoric that propounds the unsustainability of the national debt and the government's inability to finance its expenses[18] is misleading and anti-democratic. This rhetoric has led to a widespread political consensus that accepts degraded public infrastructure and services, unemployment, and poverty. Instead, the government should educate the public on its fiscal capabilities. This will develop political capital for national regeneration, leading to a more sustainable and equitable economy.

16 Powell, 'Speech by Chairman Powell on Monetary Policy in a Changing Economy'.
17 Beveridge, *Full Employment in a Free Society*, para. 182.
18 'Treasury Note'.

A 'system map' of the institutions, accounts, and banking infrastructure that support HM Treasury's financial activities



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