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1. Summary

- 1.1 **There is no magic number when it comes to debt sustainability.** The sustainability of public debt depends on what the government is investing in. In other words, how debt is being used is more important than the level of debt.
- 1.2 Contrary to the discredited argument of economists Carmen Reinhart and Kenneth Rogoff, which linked government debt to weaker economic growth and promoted austerity policies, it is critical to understand that **government spending can take the form of investments in the long-range drivers of productivity and growth.** These drivers include, for example, education and training, research and development, and wider factors that are critical to building an innovative, resilient, sustainable and inclusive economy. **Investment-led sustainable and inclusive economic growth can expand the productive capacity of the economy, which can in turn contribute to a fall in the debt-to-GDP ratio.**
- 1.3 How this investment is structured is also important. **Mission-oriented policies can turn big challenges like climate change into market opportunities, catalyzing cross-sectoral innovation and investment oriented around tackling these challenges, leading to spillovers** (Mazzucato, 2021). This can in turn generate a multiplier effect (i.e., where the growth enhancing impacts of government investments are greater than the increase in debt) (Deleidi et al., 2019).
- 1.4 In considering the sustainability of debt, it is therefore important to look at long run rather than short run effects, and to consider a **dashboard of metrics** for tracking progress, rather than relying only on reductive macroeconomic indicators such as debt and GDP.

2. What is meant by a “sustainable” national debt? Does the metric of debt as a percentage of GDP adequately capture sustainability?

- 2.1 A “sustainable” level of debt is easily understood when applied to a household. If the level of debt expenditure, e.g. on monthly repayment of principal and interest payments, is rising at a faster rate than the level of the household’s income plus other necessary expenditures, there is clearly a risk of default. The ‘state is like a household’ analogy is commonly used by politicians to justify reductions in borrowing. This analogy is inappropriate and highly misleading for several reasons.
- 2.2 Firstly, since sovereign currency-issuing nations like the UK create their own unit of account (£sterling), they cannot be forced in to default on debts denominated in their own currency. Indeed, the institutional reality is that public expenditure is always initially financed through sterling money creation by the Bank of England rather than taxation or debt issuance (see Berkeley et al 2022 for a detailed explanation). Due to the existence of a voluntarily imposed ‘full-funding’ rule, the government chooses to off-set the impacts of this money creation via either taxation or borrowing on financial markets – but this always

occurs after the initial spending authorised by Parliament. Default on national debt repayments can only occur with an express or implied repeal by Parliament of the relevant legislation.

- 2.3 Relatedly, there are no limits on the ability of the Bank of England to buy UK denominated debt in secondary markets by creating new sterling reserves and deposits in the UK banking system, after which the state effectively owes the debt to itself (interest payments to the Bank of England by HM Treasury are routinely transferred back to HMT). The multiple episodes of Quantitative Easing after the global financial crisis (GFC) of 2008-09 and during the Covid-pandemic demonstrated the ability of the Bank to control the interest rate on UK denominated debt by reducing its availability in financial markets, and thus increasing demand for these assets.
- 2.4 The state thus does not face solvency, liquidity or market risks in the way a household (or indeed a firm) does. Rather, the main constraint on UK government spending is inflation and relatedly the sterling exchange rate, as the UK is dependent on purchasing significant non-sterling denominated goods and services from overseas.
- 2.5 Large increases in government borrowing could be perceived as inflationary by investors and lead them to sell sterling denominated assets which will fall in relative value. This could then result in a fall in sterling's value, resulting in imported inflation in a self-fulfilling cycle. This dynamic is reinforced by the fact that the main tool for addressing inflation in the UK's macroeconomic framework are increases in interest rates and/or the sale of government bonds (so called 'Quantitative Tightening'), which will also reduce the relative value of government bonds.
- 2.6 To be clear, however, it is the fear of future inflation and higher interest rates rather than concerns about the government's ability to re-finance such bonds, that would drive such sales. As mentioned in section 1.3, the Bank of England can purchase unlimited quantities of UK debt to reverse these dynamics.
- 2.7 Inflation has multiple causes on both the demand- and supply-side. One of them is the productive capacity of the economy to absorb new government spending or other sources of new money creation. Rather than focussing on the size of the national debt relative to GDP or the size of the budget deficit as a guide to available 'fiscal space', the focus of fiscal policy should be on analysing the inflationary and dis-inflationary potential of different fiscal policies and relatedly, how fiscal policy can expand the economy's productive capacity to enable absorption of needed increases in spending. Relatedly, consideration should be given to whether raising interest rates is always the best response to supply-side price shocks such as those recently experienced following the Covid-pandemic and Russian-Ukraine war.
- 2.8 It should also be noted that due to the centrality of fixed-term government debt securities as collateral in the modern financial sector, they may carry interest rate risk for private financial institutions holding them. Volatility in the value of these instruments – due to, for example, rapid increases in inflation and or interest rates (or expectations of future increases) – can then lead to financial stability risks as was seen at the beginning of 2023 in the US and during the Liz Truss premiership in the UK

- 2.9 However, the fact there is volatility in the value of government debt instruments should not be confused with the sustainability of a country's debt. As was shown in the Truss premiership, the volatility in the long-term government debt market was temporary and quickly eased once the Bank of England stepped in with further Quantitative Easing purchases. The 'gilt crisis' can be attributed more to regulatory issues than the Truss government's budget, as it resulted from certain pension funds using risky hedging instruments that could strain liquidity when interest rate volatility rises (House of Commons, 2023). The Bank has now taken steps to provide a 'lender of last resort' function to non-banks to ensure this type of event does not happen again.
- 2.10 The household analogy also suffers from the 'fallacy of composition' problem. If I cut down my spending and pay off my debts, I may be better off and no-one else worse off in the economy. But if all households, or indeed an agent like the state which is the size of many millions of households, cuts spending, the result is likely to be a collapse in economic activity and a fall in growth rate at a much faster rate than the corresponding reduction in debt.
- 2.11 Moreover, since sovereign debt is the most secure, low-risk form of debt (since sovereigns do not default), it always carries a lower yield than other forms of debt. Given this, and all the above, during times of recession or stagnant growth and productivity, there is a strong macroeconomic case for public borrowing to finance growth, whatever the size of the deficit. During such times, the private sector is likely contracting its spending, banks are reducing their lending and government spending can be the only means via which demand can be created in the economy. This applies in particular in cases where there is a trade or balance of payments deficit as has been the case in the UK for many decades.
- 2.12 Relatedly, depending on how the spending is allocated and the rate of interest on government debt, deficit-financed fiscal expansion may well have growth enhancing impacts greater than the increase in debt (or fiscal multipliers of more than 1). The impact of public spending on growth and the size of fiscal multipliers remains subject to considerable debate and uncertainty, as do estimates of the 'output gap' that inform estimates of fiscal multipliers. It should be noted that high-income economies significantly underestimated the size of fiscal multipliers in the response to the Great Financial Crisis (Blanchard et al. 2013).
- 2.13 Strategic 'mission-oriented' fiscal policies aimed at addressing major societal challenges – such as the net-zero transition for example - can generate dynamic private sector investment by increasing the business sector's productive capacity and mobilising cross-sectoral economic activity and spill overs (Mazzucato 2013; Deleidi and Mazzucato 2019; Deleidi and Mazzucato 2021).
- 2.14 Indeed, public investment should focus on generating additionality: incentivising investment to happen that otherwise would not have (Mazzucato and Rodrik 202; UCL IIPP, 2020). Shifting from using a static multiplier to more dynamic evaluation methodologies can help governments capture the spillovers generated by and multiplicative effects of mission-oriented public investment (Mazzucato et al 2020).
- 2.15 In the UK context, the green transition has huge potential in regard to mission-oriented public sector investment. Green industries could be worth more than \$10 trillion globally by 2050, and ONS data shows that the UK's green industries

are already growing four times faster than the rest of the UK economy (Arup and Oxford Economics, 2023; Green Economy, 2022). When public investment is done strategically guided by a clear mission, it can create new markets, crowd in private sector investment, and increase long-term competitiveness (Mazzucato and Semieniuk, 2018).

2.16 Another way to create greater multipliers on public investment is to implement conditionalities on public sector investments. These can be used to (1) increase access to goods and services for consumers, (2) direct investment towards climate-friendly goals, (3) profit-share with a wider range of stakeholders including workers, and (4) reinvest in productive business activities, such as R&D and worker training, and (5) limit share buybacks and other forms of financialization (Mazzucato and Rodrik, 2023). For example, the US Department of Commerce has embedded clear conditionalities in the CHIPS Act focused on limiting share buybacks, ensuring worker training, and making water and energy use more efficient (Mazzucato and Rodrik, 2023).

3. The Government's target is for public sector net debt (excluding the Bank of England) to be falling, as a percentage of GDP, by the fifth year of the OBR's forecast. How meaningful is this target; and how does it inform an evaluation of the sustainability of our national debt?

3.1 For the reasons listed above, the 5-year rolling target to have net debt falling as a percentage of GDP by the 5th year of the OBR's forecast is arbitrary with little economic justification. Public investment may increase the deficit in the short run but if its effect is to ultimately increase the productive capacity of the economy in the longer run by, for example, improving the health and education of the population, improving transport infrastructure and sustainable and domestically sourced energy or food production, it will likely increase growth at a faster rate than future increases in debt (again, this is dependent on the interest rate on government debt which can be controlled by the central bank). Hence focussing on the long-run impact (e.g. 10 years or beyond) of spending makes more sense than 5 years.

3.2 Cuts to public investment due to short-run targets (including 5-years), can ironically cause the debt-to-GDP ratio to rise both because the denominator does not grow, but also because failing public services are likely to cause an increase in automatic stabilizer-related spending and thus borrowing in the social sphere (e.g. more spending on crime, more episodes of acute health emergencies and hospitalisation, worsening mental health, more expensive temporary housing policies and more benefits to be paid to the unemployed).

3.3 The fiscal conservatism pursued by UK governments for the past 15 years as a means to reduce the budget deficit has therefore been self-defeating in terms of reducing the debt-to-gdp ratio (Calvert Jump et al., 2023).

3.4 Even if we accept the existence of a debt-to-gdp rule of some kind, the 5-year debt-to-gdp target is relatively easily played by governments because it allows very significant increases in debt within the five-year forecast horizon, without breaching the government's 'falling debt' target. Regardless of its near-term plans, the government can always achieve the target by pencilling in implausible numbers for tax and spending at a rolling five-year horizon.

- 3.5 The five-year target has resulted in “fiscal headroom” - the difference between the forecast debt to GDP ratio and the threshold at which it will neither rise nor fall – playing a central role in media and policy discussion. But given enormous uncertainties about future growth rates, inflation and the economies’ productive capacity and interest rates and the ability of governments to play the five year rule, this is focus has not been helpful.
- 3.6 In reality, the target has been achieved in a damaging and asymmetric fashion by the conservative government: in cases of negative “headroom”, the government has responded with cuts to spending. In contrast, positive “headroom” has been used to implement tax cuts which are widely regarded as unsustainable. The rule has effectively pushed the UK towards lower government spending and lower tax rates which would appear unsustainable given the projected costs of government services, an ageing population and other productive capacity challenges.

4. If we are to ensure our national debt is sustainable, what might this mean for fiscal policy?

- 4.1 Fiscal policy should be focused on achieving desired public purpose outcomes - e.g. full employment, stable prices, or missions, e.g. the net-zero transition— unconstrained by considerations over the relative size of the government deficit (Lerner 1943). The latter should instead be viewed as an indicator of where in the economy demand is coming from. This will fluctuate depending on the confidence of the private sector and the business and financial cycle.
- 4.2 As mentioned above, rather than focussing on the size of the national debt relative to GDP as a guide to available ‘fiscal space’, the focus of fiscal policy should be on analysing the inflationary and dis-inflationary potential of different needed fiscal policies are and relatedly, how fiscal policy can expand the economy’s productive capacity to enable absorption of needed increases in spending.
- 4.3 The UK economy requires structural change: the shift to a net-zero carbon economy. This will require patient, long-term high-risk finance that can crowd in other forms of finance (see points 1.12-1.15), creating transformational change at different stages of the technological and business cycle. Such funds can come from a variety of direct and indirect sources: loans, grants, guarantees, and debt- and equity-based instruments. In the case of renewable energy technologies, governments and public financial actors tend to lead on early stage, high-risk, and capital-intensive projects, acting as investors of first resort and playing a critical role in creating and shaping new green markets to crowd in private capital. (Mazzucato and Semieniuk, 2018).
- 4.4 Relatedly, more attention also needs to be given to the emergence of environment- related capacity and resources constraints and shocks to the economy as drivers of inflation, including constraints on energy and food production and precious metals. These can only be addressed in the long-run by a successful green transition which will require major capital investment. Given capacity constraints, the increase in spending required may mean that other forms of less important consumption in the economy (e.g. luxury consumption or environmentally damaging activities) need to be restrained via regulation and the imposition of higher levels of tax (Michell 2024).

4.5 Increased capital investment to support such a transition needs to be supported by the Bank of England through a more flexible approach to inflation targeting which recognises that supply-side inflation shocks cannot be addressed through rising interest rates and that some control over interest rates on government debt will be required to maintain financial stability under such conditions. In general, greater coordination between monetary, fiscal and industrial policy will be required going forward to enable the net-zero transition (Ryan-Collins et al 2023).

5. Should the definition of the national debt differentiate between debt incurred for investments (which generate revenue for the Government), and other areas of spending?

5.1 Public sector accounting in the UK is currently too focused on debt and short-term cash measures, and largely neglects public sector assets. A better approach for public sector accounting would be to focus on net worth (assets less liabilities) as the most comprehensive fiscal measure using accrual-based accounting. This takes into account both sides of the balance sheet and, when linked to the budget, would incentivise public sector investments and reduce the incentive to generate short-term increases in income from privatisations of public sector assets with potentially valuable long-term returns (in particular publicly owned land and utilities).

5.2 Relatedly, there is a need to reform the UK's outdated public accounting rules. Currently, loans extended by state investment banks are counted as part of the overall public debt, failing to consider the assets they generate for the state. This accounting quirk artificially inflates public debt figures (Macfarlane, 2018). Aligning these rules with global standards would enable the UK to leverage its public banks, like the UK Infrastructure Bank, more effectively (Mazzucato, 2023). This change could potentially unlock billions of pounds 'off balance sheet', channelling them through these institutions for a more efficient and impactful response to the climate crisis.

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