Response to the House of Lords' Economic Affairs Committee inquiry into the sustainability of the UK national debt

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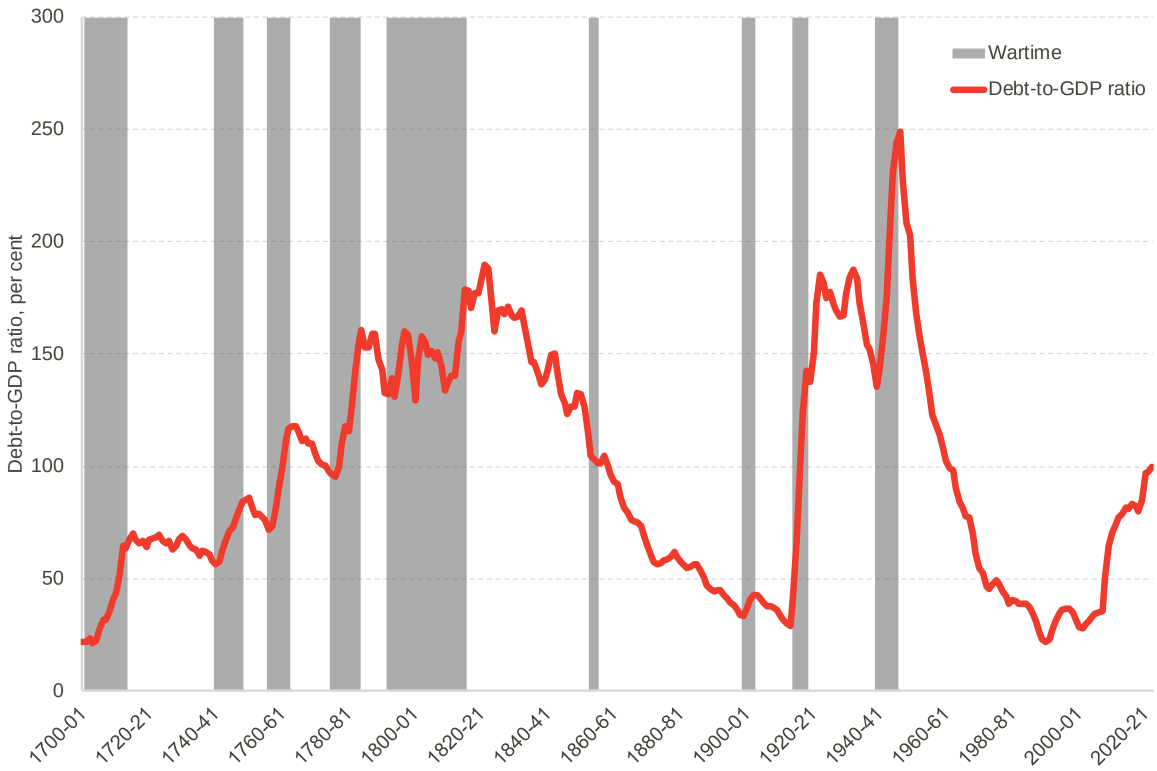
What is meant by a "sustainable" national debt? Does the metric of debt as a percentage of GDP adequately capture sustainability?

1. There is much debate in both academic and policy circles about what constitutes debt sustainability. It would be possible to define it the broadest academic terms, in that government debt should not be on an exploding path in perpetuity, and indeed that is a condition imposed on most academic models that are used for economic analysis – e.g. New Keynesian models.

2. Clearly that is not an operable rule – what constitutes an exploding path in practice? How can we tell if debt is growing too fast? Historical analysis of UK debt and of comparator countries shows no definitive threshold of the debt-to-GDP ratio – take chart 1 (UK debt) as an example. Debt has been much higher than it is today or than it was in 2022, when one of the big crisis of confidence in UK debt happened – and not, say, during spikes in debt during large-scale wars, or during the Covid-19 pandemic.

Chart 1: UK national debt since 1700-01 (source: OBR)



3. This points to the fact that fiscal space and debt sustainability in practice are elastic and context-dependent concepts.[1] National governments had no trouble issuing debt during the pandemic, for example, when the purpose of additional borrowing was clear and investors were happy to default to 'safe haven' assets such as UK gilts.

[1] OBR. 2021. "Fiscal risks report.", box 1.1.

4. The assessment of sustainability at any given point in time is a forward-facing one, and so it is not just the present level of debt that matters, but also expectations regarding future behaviour, and those expectations are moulded by past behaviour (both long-term and in the recent past) and by projections of what might happen.

5. It is in that sense that one can interpret the mini-budget debacle of 2022. The announcement of a large loosening of fiscal policy in perpetuity without considering the principles of countercyclical policymaking led to a large-scale re-pricing of assets – that is, investors changed their long-term view of the certainty of returns on government debt, and a large number decided to sell them. It was an example too of the fact that what the market can bear is one of the ultimate indicators of whether a given trajectory of debt is sustainable or not, as current and prospective holders of UK debt decide at what level of interest rate they are prepared to hold gilts.

6. But though it is an indicator of sustainability, it is an unsatisfactory one for providing early warning. Debt crises usually come fast and without warning, or at least without unequivocal warning signs.[2] It is easy to identify crises after they happen, but much harder to forecast them – if they were forecastable, they would mostly be avoided.

7. That is why bodies such as the OBR focus on broader suites of indicators, such as the dashboard of balance sheet and fiscal affordability indicators published as part of chapter 5 of the *Economic and fiscal outlook*. The issue is that this kind of wide-ranging metrics yield a lot of 'false positives'. The OBR's latest dashboard is flashing red in almost all its indicators of levels, and year-on-year changes are concerning.

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[2] Hindmoor, A.; McConnell, A. 2013. "Why didn't they See it Coming? Warning Signs, Acceptable Risks and the Global Financial Crisis." *Political Studies*, volume 61, issue 3, pages 543-560.

Table 1: Reproduced dashboard of balance sheet and fiscal affordability indicators (source: OBR)

	Pre-2007 median	2023-24	2024-25	2025-26	2026-27	2027-28	2028-29
		Level (per cent of GDP, unless otherwise stated)					
Balance sheet metrics							
PSND	36.3	97.9	98.6	96.3	95.5	95.0	94.1
PSND ex BoE	36.6	89.0	91.6	92.7	93.2	93.2	92.8
PSNFL	31.6	83.1	83.3	82.9	81.8	80.2	78.2
PSNW (inverted)	-12.5	70.0	69.2	67.7	65.5	62.9	60.0
Cost of debt metrics							
Net interest costs	2.8	3.5	3.0	2.9	3.1	3.2	3.2
Net interest costs (per cent of revenue)	7.9	8.7	7.2	7.0	7.5	7.7	7.8
		Year-on-year change (percentage point of GDP)					
Balance sheet metrics							
PSND	-1.4	2.1	0.8	-2.3	-0.8	-0.5	-0.9
PSND ex BoE	-1.4	4.1	2.6	1.1	0.5	0.0	-0.4
PSNFL	-0.5	1.6	0.2	-0.4	-1.0	-1.6	-2.0
PSNW (inverted)	0.5	0.2	-0.8	-1.5	-2.2	-2.6	-2.9
Cost of debt metrics							
Net interest costs	-0.1	-0.4	-0.5	-0.1	0.2	0.1	0.1
Net interest costs (per cent of revenue)	-0.2	-1.0	-1.5	-0.2	0.5	0.1	0.1

Note: Pre-2007 median is from 1967-68 to 2006-07. For year-on-year changes, medians are from 1968-69. Values are coloured depending on the pre-crisis decile they lie in. PSNW has been inverted to facilitate comparisons with the other three metrics.

8. Given this, one could reasonably expect turmoil in the financial markets. Or at least looking back to the Autumn of 2022, one might expect these to have been very different then. But they almost certainly would not have been, and therefore it is not fully clear how informative this set of indicators is as a predictor of future crises.

9. This is not meant as a criticism of the OBR's particular choice of indicators, nor its use of the dashboard. Rather, it is a reflection of how difficult this kind of assessment is, and how doing so in a more holistic way would need to rely on the kind of judgement-based approach that we might think is too far for a neutral institution such as the OBR.

10. Ultimately, the judgement of what might be possible to achieve in terms of future fiscal policy includes a judgement on the deliverability of public sector spending and tax policy. The market judgement is aggregated across thousands if not millions of agents – which is not meant to imply that it cannot be wrong. But it would be rather unfair to expect a public body which has to retain its hard-won independence to make judgements such as this one that might be highly politicised or at least might have to rely on judgements based on political realities.

11. The other consideration is not only of government finances over the medium term, but also how they might evolve over the long run. The OBR has a section of its annual *Fiscal risks and sustainability report (FRS)* dedicated to such long-term projections, which are based on policy by the end of the medium-term forecast, long-term projections of productivity and demographic pressures, as well as other pressures that might correlate with those. On that basis, debt would be on an explosive path – thereby violating the principle mentioned in the opening paragraph, and so likely unsustainable. But there are a lot of assumptions going into those projections that make them less certain than they may appear – although the projections themselves may have some value regardless of the uncertainty.

12. Another aspect of importance when dealing with the sustainability of debt is whether such holders are domestic or foreign, particularly if they are private foreign creditors. As the OBR note[3], there is evidence that in the event of shocks or sudden changes of perception of relative risk of a country's official debt, investors can suddenly cause quick spikes in government bond yields, which can render a seemingly stable debt trajectory unsustainable. This is a vulnerability that is exacerbated by the UK's large stock of foreign private holdings of its debt.

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?

13. The target is widely accepted by economists as being meaningless. If one views fiscal rules as a signal to the polity and the market about the government's commitment to sustainability, a credible signal requires it to be costly, binding and verifiable. That means that there is a trade-off between discretion (which political actors value inherently) and commitment (which is valued by market actors). The reason to have a fiscal rule is that commitment allows one to access better borrowing conditions, but only if the signal it sends out is credible.

14. That means that a good fiscal rule has to tie the government's hands to some extent, otherwise the information it conveys is meaningless. But the debt-falling rule is poor at that, and in many ways worse than the ones that came before it. For one, it does not actually tell us anything about the path of debt over the forecast horizon. Take the latest OBR forecast as an example: debt as share of GDP (excluding the Bank of England) is forecast to rise by 7.9 per cent of GDP between 2022-23 and 2028-29, yet because it is forecast to (just about) fall between 2027-28 and 2028-29, the government claims that debt is falling. It is therefore unsurprising that the chair of the UK Statistics Authority reprimanded the Prime Minister for claiming just that – especially in a financial year in which it is forecast to increase by 4.1 per cent of GDP.

15. The rolling nature of the target also makes it meaningless. The assessment is always forward-looking, and therefore there is never an assessment of whether the fiscal rule at each budget or fiscal statement was in fact met. The OBR does look at forecast performance, but it is constrained in saying whether something a previous rule was met in actuality or not. One solution would be to ask a body such as the National Audit Office to conduct after-the-fact analysis as to whether it actually did, and why/why not. There may be very good reasons for not having met it – but it serves no one other than the government to not have that discussion in the open.

16. Finally, the five-year horizon for a fiscal rule is an example of what is known as 'Augustinian' fiscal policy, promising fiscal discipline but not yet. It encourages loose fiscal policy in the short run, which has little bearing on the movements in debt between years 4 and 5 of the forecast, while encouraging the pencilling in of non-credible assumptions on both the tax (e.g. fuel duty) and spending (e.g. departmental expenditure limits (DEL) post-Spending Review) sides of the ledger.

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[3] OBR. 2021. "Fiscal risks report.", box 1.1.
OBR. 2023. "Fiscal risks and sustainability", paragraphs 4.17 to 4.20 and box 4.2.

The following questions are all discussed in the section below:

(a) How robust are the assumptions used by the Office for Budget Responsibility when forecasting our national debt?

(b) What levels of productivity and growth are required to ensure our national debt is sustainable?

(c) If we are to ensure our national debt is sustainable, what might this mean for fiscal policy?

17. The OBR has a difficult job in hand, and some of the constraints it faces mean that some of the assumptions it uses are not the most robust. As the official forecaster, the OBR relies on spending plans as set out by the Treasury, and even if those are not credible, there is little the OBR can do (in the current institutional framework) other than use them and highlight how they compare historically. DEL settlements account for over 40 per cent of all spending, and are the most directly discretionary way for the government to spend money – and are therefore critical to the direction of fiscal policy, and consequently the changes in the projection for debt.

18. There are other questionable assumptions in the forecast, such as the increase in fuel duty that is included in the forecasts – yet no increases in cash terms have happened since 2011. It is reasonable to think that if they have not happened for 12 years, the default should be that they will not happen in future. The House of Commons' Treasury Committee has done some good work in highlighting this, and it is helpful that the OBR now publish an additional line of the fiscal rule without fuel duty uprating.

19. But no fuel duty uprating should be the default, and the OBR should feel empowered to make that decision. The government might argue that it does intend to increase fuel duty in future, not only is that not credible until different behaviour is demonstrated, but the OBR already treats some future policy intentions as not defined enough to include in the forecast, and instead list them as policy risks. The OBR has considerable discretion to change the default assumption it uses to uprate different tax rates in the absence of credible government policy, and it should use it to end the fiction of fuel duty uprating.

20. As it pertains to long-term debt projections, the OBR is in a difficult position. The FRS projections are meant to be based on constant policy, but as the OBR points out in its publication, knowing what constitutes a neutral assumption is very hard over the long run.[4]

21. The OBR's analysis is based partly on representative spending profiles, but also on how they evolve relative to GDP growth. The analysis richer on the spending side than on the tax side, the latter seeing very little movement apart from adjustments for net zero (mostly in the from of fuel duty eventually disappearing) and from a smaller share of the population being of working age and therefore liable for NICs.

22. It is questionable whether some of these assumptions really are as neutral as they seem at first glance, as they would require not only active policy decisions but also run counter to policy as has been implemented. For example, the assumption that tax thresholds start to be updated with earnings from the end of the forecast period, avoiding what the OBR describes as implausibly high tax rates. But the system and policy as they stand are geared towards generating these increasingly high effective rates, and it is worth questioning whether ignoring this effect really serves that purpose.

[4] See the OBR's 2022 FRS, paragraph 4.30 and table 4.5.

23. On the spending side, there are a number of areas where there is richer analysis, which is welcome. An example of this is education, which is obviously to a large extent demographically driven. The same is true of the state pension and other welfare benefits, although again it is worth questioning whether the assumption on uprating with average earnings across the board (rather than only for the state pension, which government policy specifically links to average earnings through the triple lock) is as neutral as claimed. Again, the OBR states that such an assumption avoids unrealistically low benefit replacement rates – but arguably that an attribute of the system as it was designed, and it is unclear that attempting to see through those implications is beneficial to the public discourse.

24. Where some larger issues appear is on health spending, which is by far the largest driver of the OBR's results, and which is highly sensitive to assumptions about non-demographic cost increases. The assumption that underpins the OBR's calculations is based on its 2016 analysis, which uses historical data on estimated cost pressures to calibrate an increase in the cost of providing healthcare over time, and one which the government is assumed to choose to accommodate based on past behaviour.

25. The OBR originally assumed these cost pressures to start at 2.7 per cent a year in primary care and 1.2 per cent a year in secondary care, converging to 1 per cent in the long run after 15 years beyond the end of the medium-term forecast, which at the time of introduction into the projections would have meant convergence to the long-term trend by 2036-37.

26. However, four main issues arise from the way these are implemented. The first is the sheer old vintage of data which is being used. The NHS England exercise used in 2015-16 has not been updated since, and so the projections rely on very outdated data points by now.

27. The second issue is the fact that the OBR has retained the 15-year convergence assumption from the end of the forecast, meaning that it continues to be rolled forward – convergence is now assumed to be 2043-44, and will continue to compound every time the projections are rolled forward.

28. The third issue is the sheer sensitivity of the projections to this assumption. The 2016 analysis shows[5] that including these assumptions near-enough doubles health spending as a share of GDP by the projection horizon, which has huge implications for the conclusions on debt sustainability. These are not well understood assumptions, and the sensitivity of the results further casts doubt on their robustness.

29. Finally, it is not clear that assuming accommodation, especially to the extent it is assumed, is the most compelling way of understanding how the government might act in the face of the pressures materialising. This might not even be the intended purpose of the OBR's assumption, which appears more focussed on the level of risks to future spending than in determining what is a reasonable expectation of government behaviour, but there might be a perception problem in that it almost becomes the default path for government spending.

30. A final point is worth making, which is an underlying assumption to many of the spending areas that the OBR projects going forward (that is, other than those modelled separately such as health and education, and which are more directly related to demographics or

[5] See table 3.2 of the OBR's *Fiscal sustainability analytical paper* on "Fiscal sustainability and public spending on health".

additional cost pressures directly). The assumption used is that, save for small changes, these remain constant as a share of GDP, and therefore the level of public services adjusts to the size of the economy.

31. This means that long-term changes in productivity growth have little to no effect on the OBR's projections, which feels unsatisfactory. Partly this is because the tax modelling on a per person basis assumes perfect alignment with productivity growth, as discussed above.

32. Part of the reason for this is that the framework for long-term sustainability reports is an old one which has not been reviewed wholesale since the Treasury's initial long-term sustainability analysis in 2002. It seems clear that a richer picture of how tax and spending might evolve across time would be helpful to understand long-run debt dynamics.

33. To be clear, it seems undeniable that coming pressures on the public finances will require a degree of fiscal tightening, be that through levying higher taxes, not fully accommodating cost pressures in the health service or restricting spending on other areas – or most likely, a combination of the three. The OBR's contribution to the debate as a whole has been very helpful in bringing sustainability concerns to the forefront, and its use of the level of fiscal tightening on a decade-by-decade basis has been helpful in explaining this in a way that is understandable and does not rely on obscure metrics like the intertemporal government budget constraint, which is meaningless for policymakers. The suggestions in this paper attempt to enrich the analysis, which might enhance the public debate even more.

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