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Investing for Britain: Modernising the Sustainable Investment Rule

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Introduction

This paper sets out the case for modernising the Government's framework of rules governing its fiscal policy. In particular, it considers the case for reforming the sustainable investment rule. The evidence in this note on public borrowing, debt levels and debt interest payments all point clearly to the government's current fiscal rules having improved the management of the public finances. We strongly support the principles underlying the Chancellor's fiscal framework. Thus our proposals involve a modernisation of the existing system of fiscal rules rather than a radical change. The Government's fiscal rules distinguish between current and capital spending, which we view as a very important aspect of these rules. Current spending generally only benefits today's taxpayers and thus its costs should be met via taxes and not be passed on to future taxpayers via borrowing. In contrast, capital spending generates benefits for future generations and borrowing to finance it spreads the costs of such investment more fairly across the generations. We also believe that the Government should consider amending its fiscal framework to distinguish between public capital spending that supports economic growth and generates revenue flow backs, and which should ultimately be self financing, and capital spending that does not have these impacts.

Our proposals focus on the sustainable investment rule because we believe rigid adherence to its current precise formulation could prevent or delay the Government from investing in capital projects needed to address long term policy challenges. The 2006 Budget announced plans for a national debate on the priorities for public spending and public services to inform the Comprehensive Spending Review (CSR). These priorities will clearly be influenced by the need to respond to the five long-term challenges also identified in Budget 2006:

- Demographic and socio-economic change.
- The intensification of cross-border economic competition.
- The acceleration in the pace of innovation and technological diffusion.
- Continued global uncertainty and poverty.
- Increasing pressures on our natural resources and global climate.

As Budget 2006 states, 'These long-term challenges have fundamental and far-reaching implications for public services that require…. sustained investment in key areas.' The importance of continued public investment also emerges from the July 2006 Treasury document[1]. It again refers to the five long term challenges noted above and recognises that, 'Future infrastructure investment will need to adjust to support the needs of the UK economy in a more globally competitive environment and reflect these demographic changes'. Thus the Government's continued ability to invest is a key requirement of the CSR.

[1] HM Treasury, 'Releasing the resources to meet the challenges ahead: value for money in the 2007 Comprehensive Spending Review, July 2006.

Executive summary/Key points

The Government has established a framework of rules governing fiscal policy, which has significantly improved the management of the public finances.

Thus we strongly support the current fiscal framework and our reform proposals for the sustainable investment rule are a modernisation of this existing framework, which we believe are necessary if the Government is to meet the long term challenges it has identified.

The Government's fiscal rules distinguish between current and capital spending. Current spending generally only benefits today's taxpayers and thus its costs should be met via taxes and not be passed on to future taxpayers via borrowing. In contrast, capital spending generates benefits for future generations and borrowing to finance it spreads the costs of such investment more fairly across the generations.

We believe that the Government should also consider distinguishing between public investments that support economic growth and generate revenues and which are (if worthwhile) thus ultimately self-financing and those whose benefits are non-financial and thus not self-financing. Such an approach would require an assessment of whether investments really were revenue generating and thus eligible to be temporarily outside the scope of the sustainable investment rule. The establishment of an infrastructure fund governed by an Investment Board might be one way of achieving this.

Maintaining the sustainable investment rule's 40 per cent ceiling on the ratio of public sector net debt to GDP could prevent or delay the Government from investing in worthwhile major infrastructure projects, that would otherwise help stimulate economic growth and thus be of benefit to the UK.

Commonly expressed fears about the risks of higher public debt levels are not a strong argument against raising the 40 per cent ceiling as they are pertinent only for very high ratios of debt to GDP.

An increase in the ceiling to somewhere between 45 and 50 per cent of GDP would be reasonable. An increase of this magnitude would be a sensible pragmatic modernisation of the sustainable investment rule to allow the Government to invest in worthwhile major infrastructure projects in support of economic growth, and take advantage of the current historically low interest rates available on long dated government bonds. It would not be, and should not be seen as, an abandonment of fiscal discipline on the part of the Government.

The Government's fiscal rules

The Government has established two rules to govern its fiscal policy:

- the **golden rule**: over the economic cycle, the Government will borrow only to invest and not to fund current spending.
- the **sustainable investment rule**: over the economic cycle, public debt as a proportion of GDP will be held at a stable and prudent level.

Golden rule

The cost of government borrowing today is met by both current and future taxpayers. In general terms current spending now only benefits today's taxpayers. The golden rule is designed to ensure that future taxpayers only repay debt that has financed capital spending which can be expected to have future long run benefits. Thus future taxpayers benefit from public capital spending, and borrowing to fund such investment allows the costs and benefits of public spending to be more fairly matched. In contrast the costs of current spending benefiting only today's taxpayers should be met via taxes and not be passed on to future taxpayers via borrowing.

Borrowing only to invest over the whole of an economic cycle allows the 'automatic stabilisers' to operate. When economic activity is weak tax revenues are reduced and spending on welfare benefits are increased. This increases government borrowing and boosts total spending in the economy helping to support economic activity. The reverse is true in a boom. Tax receipts are higher and spending on welfare benefits is lower. This will help reduce inflationary pressures in the economy. In both cases allowing the automatic stabilisers to operate means that fiscal policy assists monetary policy in stabilising inflation and economic growth.

If the government could only borrow to invest each and every year then it would have to respond to an increased current budget deficit arising from a cyclical downturn by increasing taxes or cutting spending. This would only exacerbate such a downturn. Equally, responding to a current budget surplus resulting from a cyclical boom by cutting taxes or increasing spending would only add to inflationary pressures in the economy. Such a policy setting would place great strain on monetary policy's ability to stabilise the economy and generate large swings in interest rates as the Bank of England sought to counteract the destabilising effects of fiscal policy. Large swings in interest rates would increase the likelihood of boom and bust in the housing market which would in itself generate general macroeconomic instability. Thus the formulation of the golden rule as operating over an economic cycle has much to be said for it.

The sustainable investment rule

The sustainable investment rule requires that net public debt be kept 'at a stable and prudent level'. The Chancellor currently defines this as at or below 40 per cent of GDP. The Treasury has clarified that in order to meet this rule, 'at the end of every fiscal year of the current economic cycle, public sector net debt must be below 40 per cent of GDP'[2]. As discussed above there are good reasons for allowing the state to borrow to invest. The state is far from alone in this regard. Companies borrow from banks and issue corporate debt in order to finance their investments and most families borrow in the form of mortgages in order to purchase a particular type of capital asset –

[2] HM Treasury, 'Technical Note for HM Treasury Public Service Agreement (PSA) 2005-2008', July 2004.

residential property. If governments borrow then it will build up a stock of public debt. This raises the issue of how high should this stock of public debt be allowed to go? An increase in the debt to GDP ratio requires either increased taxes on future taxpayers, or reductions in public spending on items other than debt repayments, in order to fund the consequent increased debt interest repayments[3]. A limit on the debt to GDP ratio thus prevents today's government from imposing an excessive debt repayment burden on future taxpayers.

This can be justified on the grounds of fairness. Future taxpayers after all have no votes today and so no say in what today's government may decide to invest in. Any calculation of the benefits of public investment is inevitably a matter of judgement especially as many of these benefits are social rather than directly financial and tomorrow's taxpayers may see fewer benefits in a particular project than today's taxpayers do. Alternatively, a cap on the debt to GDP ratio can be justified on macroeconomic grounds if a high debt to GDP ratio has adverse economic consequences. For example, it has been argued that high public debt levels lead to high interest rates, which in turn crowds out productive private sector investment. The potential adverse economic effects of high levels of public debt are discussed in more detail below.

[3] This assumes interest rates at least stay constant. If interest rates rise in response to a rising debt to GDP ratio then this effect will be accentuated.

Fiscal rules in theory

The incentives that government face suggest that a system of fiscal rules might lead to better management of the public finances compared to purely discretionary fiscal policy. Governments fund public spending through a combination of taxes and, or borrowing. In the short run, borrowing has the politically attractive feature that it allows additional spending without the voters having to incur the pain of higher taxation. Thus governments focusing on the immediacy of popularity with the electorate may be tempted to borrow and spend now and ignore the longer run consequences of excessive borrowing. Over the longer term, this borrowing must be repaid and the interest on it must be serviced. This diverts resources that could otherwise be spent on future public services or returned to the pockets of taxpayers via tax reductions. As argued above, this may be fine if borrowing is funding worthwhile investment from which future taxpayers can be expected to benefit – hence the golden rule – but not if a government is trying to 'buy' electoral success with current spending financed by borrowing and leaving their successors to deal with the resulting debt burden.

If governments wish to demonstrate that they are committed not to pursue such a short run expedient fiscal policy then setting out a system of fiscal rules that it promises to stick by can demonstrate this to voters, the media and the financial markets. Simply stating that it is committed to fiscal responsibility but retaining a purely discretionary policy carries the risk that governments will renege on this commitment when short run political pressures come to bear.

A set of fiscal rules also aids transparency and so democratic accountability by making it easier for the electorate to judge the quality of a government's fiscal management. Gauging a government's management of fiscal policy can be difficult. Overall fiscal outcomes are shaped not just by a government's actions but also by factors over which any government has at best only limited influence, including the cyclical position of the economy, and shocks to the world economy. Thus it can be difficult to judge whether a government has managed the public finances well or simply been the victim or lucky recipient of events. A set of fiscal rules can help by focussing the debate on the government's performance against these rules.

Fiscal rules in practice

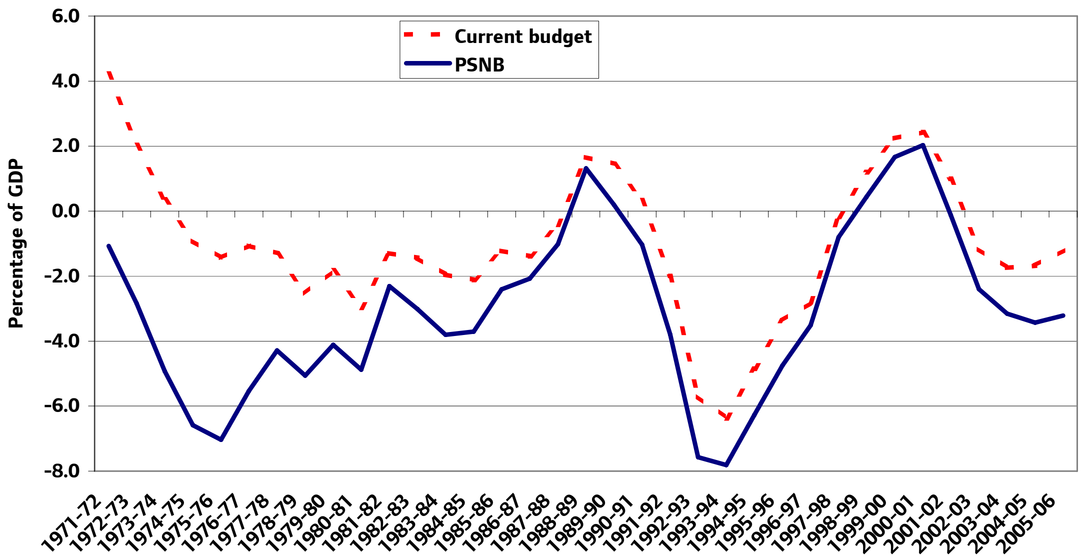
Fiscal rules in theory represent why we might expect a system of fiscal rules to lead to better fiscal management. However, what has been the actual experience of fiscal management under the golden and sustainable investment rules compared to previous periods without fiscal rules?

Performance on public borrowing

Figure 1 shows both the current balance budget and public sector net borrowing (PSNB) as a percentage of GDP. The current budget balance is the difference between tax receipts and current public spending. It is thus the variable against which the golden rule is judged. Since over an economic cycle the government will borrow only to invest, the golden rule requires that the current budget be in balance or in surplus with more collected from taxation than is spent on current or non-capital uses. PSNB is a measure of overall borrowing being the difference between total public spending, current and capital, and tax receipts. In Figure 1 an excess of spending over tax receipts i.e. borrowing is shown in negative terms to put it on the same basis as the current budget.

It is clear from Figure 1 that smaller public sector deficits have been run since the introduction of the current government's fiscal framework. Indeed both the mid-1970s and the early to mid-1990s saw large overall deficits of six to eight per cent of GDP which were much larger than anything that has been seen in recent years. With regard to the current budget it is clear that this was in deficit from the mid-1970s through to 1997 with the exception of a brief period in the late 1980s, and indeed substantial deficits of around five to six per cent of GDP were run in the early to mid-1990s.

Figure 1: Current budget balance and public sector net borrowing (PSNB)



Source: Public Finances Databank, September 2006, HM Treasury

As Table 1 shows the golden rule was clearly not met in previous economic cycles. So far in the current economic cycle the golden rule is being met and the Treasury expects it will be met over the whole of the current economic cycle, which they project will end in 2008-09. Some commentators project that the golden rule might just be missed.

However even if this turns out to be the case it would mean a much smaller average deficit on the current budget than was seen in previous economic cycles and thus much improved fiscal management. Over the same periods, total borrowing as measured by PSNB has also been dramatically lower since the introduction of the Government's fiscal rules compared to previous economic cycles.

Table 1: Average annual current budget balance and PSNB as a percentage of GDP

Economic cycle	Current budget	PSNB
72-73 to 77-78	-0.4	-5.2
78-79 to 86-87	-1.9	-3.5
87-88 to 96-97	-2.2	-3.4
97-98 to 08-09 (projected)	0.1	-1.0
97-98 to 05-06 (so far)	0.1	-1.0

Notes: This uses the economic cycles as identified by HM Treasury.

Source: GLA Economics calculations based on figures from the September 2006 HM Treasury Public Finances Databank

The picture that emerges from considering data on the current budget balance and PSNB over the last 30 to 35 years points clearly to improved fiscal management since the introduction of the current Government's fiscal rules.

As we have noted, the outcome for fiscal aggregates such as the current balance budget and PSNB depends not just on governments' fiscal management but also the state of the economy. Thus a government may end up borrowing substantial amounts not because of poor fiscal management but because of a downturn in the business cycle. Given this we should also consider cyclically adjusted measures of the current balance and PSNB in making judgements about fiscal management[4]. When we do this, the picture that emerges is that the cyclically adjusted current budget balance and PSNB have been in better shape since the introduction of the current fiscal rules.

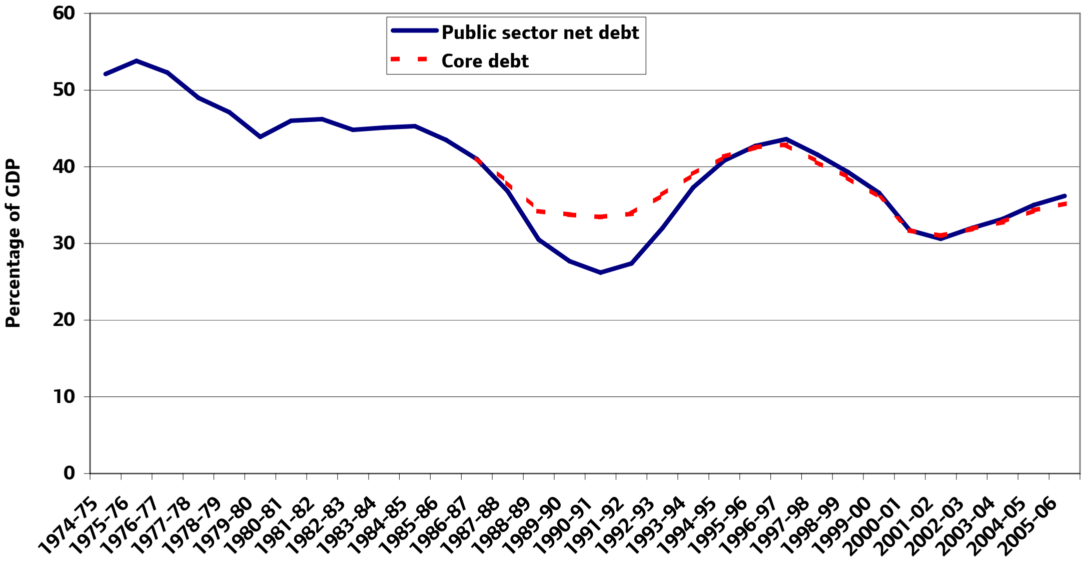
Performance on levels of public debt

Figure 2 shows the path of public sector net debt and core debt over the last 30 years. The measure of core debt strips out the impact of the economic cycle on debt levels. Weak economic activity leads to increased borrowing which adds to the stock of public debt. Data on core debt is only available back to 1986-87. The ratio of public sector net debt to GDP generally fell in the period up to the early 1990s. Between 1990-91 and 1996-97 it rose strongly from 26.2 per cent to 43.6 per cent reflecting the large public sector deficits of the period.

In the period since the introduction of the current government's fiscal framework the debt ratio initially fell to 30.6 per cent in 2001-02 before rising to 36.2 per cent by 2005-06. Despite this rise the debt to GDP ratio remains significantly below the average for the 1974-75 to 1996-97 period of 41.5 per cent.

[4] Of course it is also possible that a government's poor macroeconomic policy may unnecessarily worsen an economic downturn. It is however beyond the scope of this paper to consider the performance of macroeconomic policy over the last 35 years.

Figure 2: Public sector debt

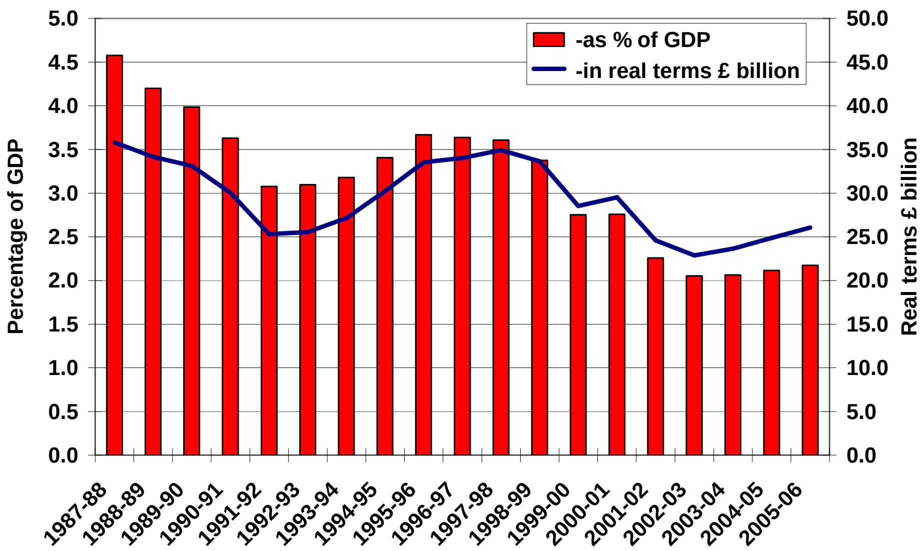


Source: Public Finances Databank, September 2006, HM Treasury

Performance on debt interest payments

Figure 3 shows public sector debt interest payments both as a percentage of GDP and in real terms.

Figure 3: Public sector debt interest payments



Source: Public Expenditure Statistical Analysis (PESA) 2006, HM Treasury

On both bases it is clear that debt interest payments have been lower since the introduction of the current fiscal rules than they were previously. Despite the increase in public borrowing and the debt-GDP ratio in recent years the percentage of GDP taken by debt interest payments has risen only marginally from 2.1 per cent in 2002-03 to 2.2 per cent in 2005-06. In contrast, on average between 1987-88 and 1996-97 debt interest payments averaged 3.6 per cent of GDP.

Conclusion on recent management of the public finances

The evidence on public borrowing, public sector debt levels and the burden of public debt interest payments in this section produces a clear conclusion. In accordance with our expectation on the basis of economic theory the management of the public finances has been improved by the existence of the Government's two fiscal rules. We thus strongly support the continuation of the basic fiscal framework that the Government has put in place. Our case is thus for a modernisation of the rules within the existing framework rather than radical change and certainly not for their abolition.

Modernising the sustainable investment rule

Why are we focussing our reform proposals on the sustainable investment rule rather than the golden rule? Various reforms to the golden rule have been suggested. Some of these suggestions are not without their merit but our proposals focus on the sustainable investment rule for purely pragmatic reasons. It might be possible to improve the workings of the golden rule but it is the sustainable investment rule that is our priority as it is about to constrain necessary and worthwhile major public investment of benefit to UK economic performance. The Government's fiscal rules distinguish between current and capital spending. We believe that the Government should also consider distinguishing between public investments that support economic growth and generate revenues and which are (if worthwhile) thus ultimately self-financing and those whose benefits are non-financial and thus not self-financing. In addition, regardless of the coverage of the sustainable investment rule there are a number of arguments that suggest the rule's current 40 per cent ceiling for the ratio of public sector net debt to GDP should be raised.

Growth/revenue generating investments

The Government should consider drawing a distinction between public investments that increase economic growth, generate revenues and those that do not. For example, investments in transport infrastructure should generate additional fares revenue. Hence the revenues from such investments can at least help with the financing of the initial investment. Good transport links are also important for a successful economy, providing access to jobs and services, facilitating the movement of goods and attracting investment. Thus investments in improved transport infrastructure should promote economic growth – increasing the size of the tax base that can be used to fund increased public services or reductions in tax rates.

In contrast, much public investment does not generate financial returns. For example, public investment in a new hospital may well be justified on the basis of the benefits it generates in terms of improved health outcomes but with NHS services provided free at the point of delivery it will not generate any revenues, and given the stage of development that the UK has reached, improvements in public health are unlikely to have any material impact on economic growth.

Some temporary increase in the level of public debt should be acceptable if the projects it finances provide sufficient economic benefit and consequent increase in tax revenue. The debt associated with borrowing for such projects should therefore be exempt from the sustainable investment rule's ceiling on the debt to GDP ratio. This would be in the spirit of the assessment of general government debt for the European Union's stability and growth pact. The definition of public debt used is one established by Eurostat. Under these rules a public corporation that receives more than 50 per cent of its income from sales is not considered to be a part of the general government sector and therefore any debt in these organisations does not count towards Eurostat's definition of government debt. Under these criteria, debt associated with London Underground past and prospectively future investments for example would not count as government debt since London Underground receives a majority of its income from fare revenues.

If such investments were outside of the scope of the sustainable investment rule some other mechanism may well be required to ensure that such projects really are worthwhile and that they will deliver sufficient revenue flow backs to ensure that the costs of the initial investment and associated borrowing are met. Otherwise there is a substantial risk that such a change to the sustainable investment rule will be and/or will be seen to be a mechanism for merely avoiding the disciplines of the existing fiscal rules for short-run political advantage at the expense of long-term economic policy.

Investment Board and Infrastructure Fund

London First,[5] in their submission to the Eddington Transport Study examining the long-term links between transport and the economy, has suggested the establishment of a Transport Investment Board. Under their proposal, access to borrowing exempt from the sustainable investment rule's ceiling would have to come via a ring-fenced infrastructure fund, managed by a Transport Investment Board. Access to this fund, and exemption from the sustainable investment rule, would depend on the Board's assessment that such investments were truly capable of generating revenues sufficient to repay the costs of financing the investment so that any increase in public debt associated with this project was only temporary. The corollary of this is that such investments would only be exempt from the sustainable investment rule for a certain period of time – the period over which the Board determined the costs of the investment should be paid back. This would ensure that if, despite the due diligence exercised by the Board in their initial appraisal, a project failed to generate sufficient revenues to payback within this period then the outstanding debt associated with the project would become covered by the sustainable investment rule's ceiling thus ensuring continued prudent management of the public finances.

It would be for the Board to ensure that the projects it managed could be financed within the infrastructure fund's budget. As well as vetting projects to ensure they would produce an adequate return, the Board would need to be satisfied about their governance structure and project management capability and would monitor progress against budget and timetable. The Board would bring together members with a successful track record in running relevant businesses and provide a centre of expertise in management and delivery of big projects.

The coverage of such a board could be widened to include not just transport infrastructure but also all sorts of public investment with the potential to generate future revenues and thus be ultimately self-financing. The details of how such a body might operate clearly need to be developed in greater detail. But the idea is worthy of further consideration by government as a way of allowing revenue and growth generating public investments to go ahead outside of the scope of the sustainable investment rule but without undermining prudent and responsible management of the public finances.

Sustainable investment rule's 40 per cent ceiling

In addition, to the above argument there are a number of arguments that suggest the rule's current 40 per cent ceiling for the ratio of public sector net debt to GDP should be raised.

Fiscal projections

The Treasury projects that the debt to GDP ratio will rise and then stabilise at 38.4 per cent by 2010-11. In contrast, GLA Economics' latest projections show the debt to GDP ratio reaching 39.5 per cent by 2010-11 – just below the sustainable investment rule's 40 per cent ceiling. A very similar view is taken by the Institute for Fiscal Studies (IFS)

[5] London First is a business membership group supported by 300 of the capital's leading businesses

whose January 2006 Green Budget projections indicated that public sector net debt was expected to reach 39.6 per cent of GDP by 2010-11. Thus by 2010-11 the sustainable investment rule's ceiling of 40 per cent is likely to be all but hit. Also the basis of these projections does not include the financing costs of any major infrastructure projects that might be recommended by the Eddington Transport Study which is currently examining the long-term links between transport and the economy.

Treasury investment plans

The 40 per cent ceiling is also unlikely to be able to accommodate the Treasury's existing indicative plans for public investment. On the assumption that the current budget is in balance i.e. the golden rule is just met, then with public sector net debt at 40 per cent of GDP, inflation (GDP deflator) at 2½ per cent per annum and economic growth of 2½ per cent, then the government can sustain borrowing and so public net investment of two per cent of GDP per year (40 per cent of the five per cent growth in money GDP) whilst keeping public sector net debt at 40 per cent of national income. Higher investment will take the debt GDP ratio above 40 per cent. Lower investment will allow the debt GDP to decline from 40 per cent. The Treasury's latest projections as set out in Budget 2006 through to 2010-11 envisage net public investment at 2.3 per cent per annum. In order to achieve this on a sustainable basis and assuming five per cent growth in money GDP one would require an increase in the debt to GDP ratio to 46 per cent of GDP. Thus keeping public net investment to just two per cent of GDP would potentially sacrifice worthwhile public investment. This argues for an increase in the sustainable investment rule's 40 per cent ceiling on the debt GDP ratio.

Redefinition of public sector net debt: The impact of the Private Finance Initiative (PFI) and Public Private Partnerships (PPP) related debt

On 20 September 2006, the Office for National Statistics (ONS) announced the results of changes to the treatment of the debt associated with the PFI and PPP that increase the official measure of public sector net debt (PSND). PSND now includes debt associated with projects undertaken by the private sector under PFI/PPP, where government accountants and their independent auditors judge that the public sector has taken on the risks of owning the asset concerned, such as the obligation to undertake repairs, and where that new asset or improvement to an existing asset is operational. The effect of this change is to increase PSND by £4.95 billion in March 2006. By itself, this change would have increased the debt to GDP ratio by 0.4 per cent. However, because of recent upward revisions to estimates of GDP, the overall change added just 0.1 per cent to the debt to GDP ratio. In the future, there will be further additions to PSND by the outstanding value of projects that become operational. On the other hand, PSND will also be reduced by payments made by the public sector to the private sector that cover part of the liabilities which are already included in PSND. Thus it is not easy to judge the longer-term impact of this methodological change on the level of PSND.

It should be emphasised that this change in the definition of public sector net debt leads to an upward revision to the public debt-GDP ratio for purely methodological reasons (nothing in the real world has changed). Thus as the IFS have commented, 'it could be argued that a significant change in the definition of net debt should be accompanied by an equivalent change in the ceiling under the sustainable investment rule.'[6]

Is there a rationale for the precise ceiling on the debt to GDP ratio of 40 per cent?

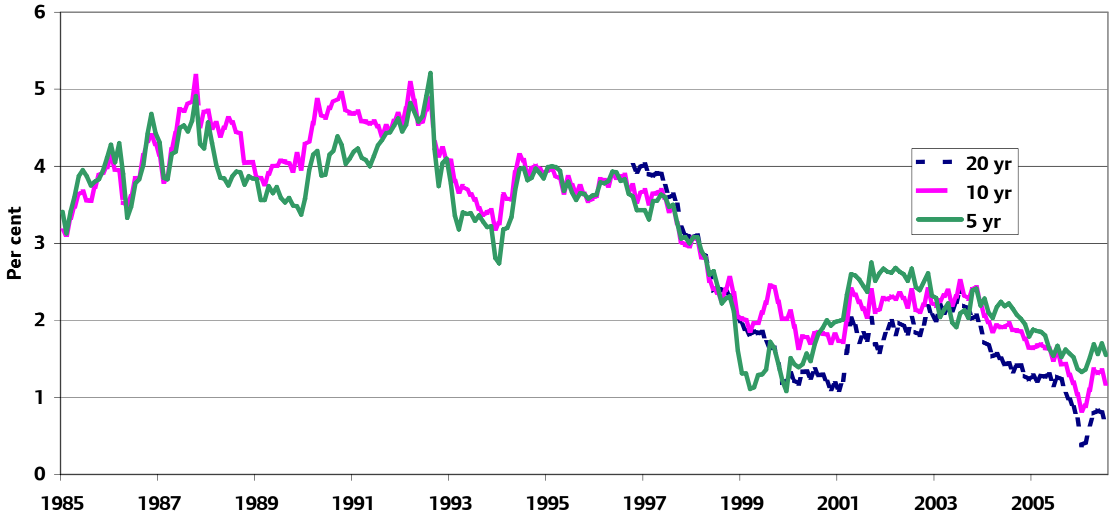
While we have argued above that some ceiling on the public debt-GDP ratio is sensible to prevent today's taxpayers passing an excessive debt burden to future taxpayers this does not make the case for the current particular limit of 40 per cent. It is hard to make a logical economic case that the current ceiling is better in some sense than say 30 per cent or 50 per cent. The Treasury has reviewed attempts to deduce an optimal debt ratio from comparisons with the debt equity ratios prevailing in the private sector and from theoretical and/or empirical studies of the links between investment, interest rates and economic growth[7]. However the Treasury concluded that 'the range of results obtained illustrate the difficulty encountered in arriving at a precise answer', and the IFS's similar conclusion on this approach was 'none has given a particularly precise or robust result'[8]. It is thus very difficult to argue that the Government would be diverging from an optimal policy stance were they to decide to raise the 40 per cent ceiling in the sustainable investment rule.

Long run interest rates and the cost of borrowing

Currently the cost to the Government of borrowing via long dated government bonds is at low levels by historic standards. Figure 4 shows the path of real interest rates over the last 20 or so years. The longest 20-year forward rate is especially low suggesting that the Government could in particular finance its borrowing at low costs with long dated 20-year bonds. Furthermore research by Morgan Stanley Research has suggested that the level of real interest rates on long dated UK government bonds is now close to 300 year lows[9] - see Figure 5[10].

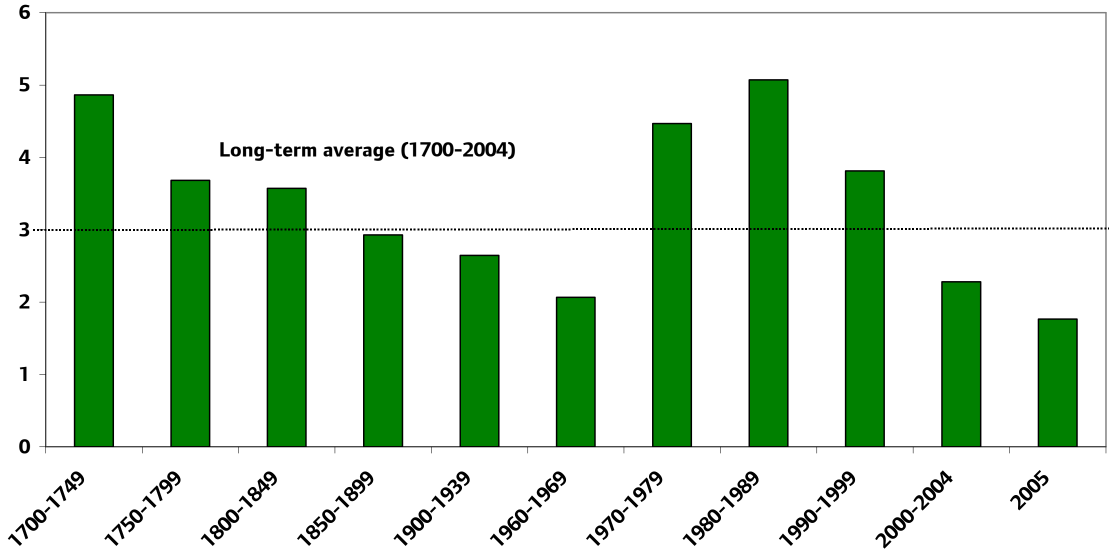
[6] Institute for Fiscal Studies, 'IFS analysis of today's public finance figures', 20 September 2006. Available at www.ifs.org.uk/pr/pubfin_sept06.pdf
[7] See pages 174-5 of Balls and O'Donnell (eds), 'Reforming Britain's Economic and Financial Policy: Towards Greater Economic Stability', HM Treasury, 2001.
[8] See Chote, Emmerson and Frayne, 'The fiscal policy framework', Chapter 2 of the Institute for Fiscal Studies Green Budget, January 2006.
[9] Miles and Anderson, 'Funding issues and debt management', Chapter 6 in the Institute for Fiscal Studies Green Budget, January 2006, Morgan Stanley Research.
[10] We are grateful to Professor Miles and his colleagues at Morgan Stanley Research for making this interest rate data available to us.

Figure 4: Real interest rates: Implied real forward rates at various points of the yield curve



Source: Bank of England; derived from British Government Securities, using VRP model

Figure 5: Long-term real interest rates on UK conventional debt



Source: Morgan Stanley Research

Given this it is perhaps not surprising that this same Morgan Stanley research concludes that the current very low levels of real interest rates is unlikely to persist. They assess a number of possible reasons why real interest rates could stay at current low levels and conclude:

> *We think real yields on bonds issued by the UK government are significantly more likely to be higher in the future than to stay at current low levels or fall further. Yields on long-dated index-linked bonds have fallen well under 1%. The UK government may look back in 10 years and regret that it issued anything other than long-dated index-linked bonds at yields under 1%. We believe that issuing long-dated inflation-proof debt represents a good deal for future taxpayers. …Locking in at today's low real yields by issuing long-dated indexed debt is therefore sensible.*

(David Miles and Niki Anderson, page 132 in Chapter 6, Funding issues and debt management in the IFS Green Budget, January2006)

In our opinion, the corollary of this argument is that now is also the time to undertake worthwhile long-term public investments when the Government can take advantage of the very low cost of borrowing that is unlikely to persist. Crossrail, which it is estimated would lead to an extra £31 billion of UK GDP over 30 years, is certainly one of those investments. Delaying investment to try and keep it within the current 40 per cent ceiling in the sustainable investment rule risks backfiring on the Government as the costs it ends up paying to finance such a major project may increase substantially with higher real interest rates in the future.

Consistency between microeconomic and macroeconomic policy

In its most comprehensive account of the Government's reformed framework for macroeconomic policy the Treasury stated that:

> *… judgements on the desirable public debt ratio for any one country are contingent on … the worthwhile investment opportunities that are available to the government.*
>
> (Balls and O'Donnell (eds), page 178 of 'Reforming Britain's Economic and Financial Policy: Towards Greater Economic Stability', HM Treasury, 2001.)

We agree. In short this is the argument we are making for an increase in the sustainable investment rule's 40 per cent ceiling on the debt to GDP ratio. Potential projects may have sound economic benefits and clearly pass the Treasury's microeconomic rules for investment as set out in the Green Book (2003)[11], but then there is a risk that they could be substantially delayed, because of the current formulation of the sustainable investment rule. This raises an important question for the government's investment strategy, which is whether, if there are potentially good investment projects or portfolios of investment projects, it is right that these should be constrained by the sustainable investment rule, or whether it is right that, if achievable, the sustainable investment rule should be modified to enable such beneficial projects to go ahead without jeopardising responsible management of the public finances.

Our contention as set out in this paper is that it is in our nation's interests to modify the sustainable investment rule to allow beneficial investment projects to proceed, whilst maintaining necessary and beneficial responsible management of the public finances.

[11] HM Treasury, 'Green Book, Appraisal and evaluation in central government', 2003.

Possible dangers of higher public debt

While we believe that there is a strong case for raising the sustainable investment rule's 40 per cent ceiling for the debt to GDP ratio, we do need to address the not unreasonable concerns that are raised about the potential dangers of higher levels of public debt. These are usually taken to be three inter-related dangers:

- Governments' future ability to find buyers for public debt is affected
- Leads to an increase in interest rates and increases the perceived risk of holding debt
- Implies a high level of debt servicing on future taxpayers

Suppose that a government is continuing to borrow and that the debt-GDP ratio is rising. At some point it will become very difficult for this ratio to rise further because investors are no longer willing to purchase further government debt. For example, at high levels of debt, investors may start to fear that the government will no longer be able to service its debt and thus will either default on it, attempt to reduce its real value by driving up inflation or renegotiate it, which reduces the value of the outstanding debt to investors. In such circumstances, the ability of government to boost weak economic activity in a cyclical downturn by increasing borrowing may be highly constrained because they will be unable to issue government debt to fund such borrowing. They may even be forced to raise taxes to keep borrowing in check adding to the forces pulling down economic activity. The effective choice may be between not increasing borrowing and seeing the economy move into recession or funding borrowing by printing money. The latter potentially leading to too much money chasing too few goods i.e. rising inflation.

Risks of debt repudiation

These problems are only pertinent where debt to GDP ratios have reached very high levels. An increase in the debt to GDP ratio from say 40 per cent to 50 per cent carries no risk that a government will seek to repudiate its debt. Debt repudiation is a costly option of last resort. A government reneging on its promises to pay debt will find it very difficult to borrow again for a long time into the future. Investors will remember what happened and be reluctant to lend again. Any funds such a government does manage to procure are likely to be on very costly terms, as investors demand a substantial risk premium against the possibility that the government might repeat its bad habits.

Seignorage

The chances of any UK government seeking to reduce its debt burden by allowing inflation to rise ('seignorage') are also very small. For seignorage to have a significant impact on a country's level of public debt requires a large increase in inflation over and above the rates prevailing in the economy. Such an approach would be next to impossible in the UK within the current framework for monetary policy. The independent Bank of England is required to keep inflation at two per cent. Thus any attempt by government to inflate away its debt burden would be counteracted by the Bank of England raising interest rates to keep inflation stable at two per cent. In order to generate higher inflation, the government would have to explicitly reject its own framework for monetary policy. This is inconceivable as there is a general recognition across the political spectrum of the benefits of low and stable inflation.

Risk of Higher Interest Rates

Clearly linked to the above danger is the potential risk of higher interest rates. In order to persuade investors to continue to purchase government debt in spite of the high levels of outstanding debt the government may have to offer higher returns on holding that debt i.e. raise interest rates. The perceived risk of holding debt would be higher and investors would thus demand a higher risk premium. Higher interest rates in turn are expected to lead to a crowding out of private sector investment to the detriment of long-term economic growth.

Again this risk is unlikely to be germane for an increase in the debt GDP ratio from 40 to say 45 or 50 per cent. Indeed two recent UK studies of the link between public borrowing, public debt and interest rates are not consistent with the conventional wisdom that higher public borrowing and debt leads to higher real interest rates. Research by Morgan Stanley[12] suggests that an increase in the debt ratio leads initially to a very small temporary increase in real interest rates but that the long run impact of higher debt levels is to *reduce* real interest rates by a very small amount. Research by PricewaterhouseCoopers[13] reaches similar conclusions, although their estimated impact on interest rates of a higher debt to GDP ratio is not statistically significant. Using these two pieces of research suggests that the long run impact of say an increase in the public sector debt from 40 per cent to 50 per cent of GDP would be to reduce interest rates by 0 to at most ¼ of a percent. For all intents and purposes the path of real interest rates appears independent of that for the debt-GDP ratio as long as this ratio is not at an excessive level. Such results are not unexplainable. With increasing integration of capital markets across the world, real interest rates will be determined increasingly by the global supply of savings and demand for investment rather than by national factors.

We do not deny that very high levels of public debt are likely to induce a risk premium on interest rates. The results of the above research will primarily reflect the relationship between debt levels and interest rates at the more frequently observed lower levels of the debt to GDP ratio, and are thus of relevance to the case where public debt might be increased from 40 per cent to 45 or 50 per cent of GDP.

The level of debt interest payments

An increase in debt levels implies a higher level of debt interest payments. This takes up part of public spending that would otherwise be available for spending on public services or money that could be returned to taxpayers in the form of tax cuts. On the basis of Treasury estimates an increase in the debt to GDP ratio from 40 per cent to say 50 per cent could consume resources equivalent to around 0.7 per cent of GDP each year[14]. With debt interest payments currently just under 2¼ per cent of GDP a year, this implies an increase to at most three per cent of GDP per annum– just below the average for the period 1987-88 to 2005-06 of 3.1 per cent of GDP per annum. Such a level of debt payments can hardly be seen as excessive. It remains, however, true that higher debt levels today imply lower spending on future public services or higher future taxes. These are the opportunity costs to future taxpayers of the benefits to them of long term investments made today. If these investments are worthwhile and so

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[12] Miles, Baker, and Pillonca, 'What should long-term interest rates be today? A 300-year view', Morgan Stanley, March 2005

[13] PricewaterhouseCoopers, 'Does higher public borrowing imply higher interest rates?', PricewaterhouseCoopers UK Economic Outlook July 2005

[14] Based on estimates quoted on page 174 of Balls and O'Donnell (eds), 'Reforming Britain's Economic and Financial Policy: Towards Greater Economic Stability', HM Treasury, 2001.

generate sufficient benefits for future taxpayers then this is not an unreasonable deal for tomorrow's taxpayers.

Conclusion on the potential dangers of higher debt to GDP ratios

The dangers of higher public debts that are commonly pointed to all require much higher levels of public debt than either 40 per cent of GDP or what debt levels might rise to with a reasonable increase in the sustainable investment rule's ceiling on the debt to GDP ratio to 45 or 50 per cent. They are not strong arguments against raising this ceiling.

Conclusion

The Government has established a framework of rules governing fiscal policy. There are a number of reasons why a system of rules might be expected to lead to more responsible management of the public finances than a purely discretionary fiscal policy. Our judgement is that the actual experience of fiscal management under the Government's two rules has indeed been superior to fiscal management in the 20 to 25 years before 1997. Hence we strongly support the current fiscal framework. Our reform proposals for the sustainable investment rule are thus a modernisation of the existing fiscal framework rather than a radical reform of the current system.

The Government's fiscal rules distinguish between current and capital spending. The Government should also consider distinguishing between on the one hand capital spending that supports economic growth, generates revenues and which are (if worthwhile) thus ultimately self-financing, and public investments whose benefits are non-financial and thus not self-financing. Such an approach would require an assessment of whether investments were genuinely revenue generating and thus eligible to be outside the scope of the sustainable investment rule. The establishment of an infrastructure fund governed by an Investment Board could be one way of achieving this.

The sustainable investment rule's 40 per cent ceiling on the ratio of public sector net debt to GDP will soon bite if it is left unreformed. Maintaining this ceiling at its current level may well prevent or delay the Government from investing in worthwhile capital projects that would otherwise be of benefit to the nation. Commonly expressed fears about the risks of higher public debt levels are not a strong argument against raising the ceiling. How high should the ceiling be raised? For the Treasury's projections for net public investment of 2.3 per cent of GDP to be achieved on a sustainable basis would require an increase in the ceiling to 46 per cent of GDP assuming money GDP grows on average by five per cent each year. Respected academic and City economist, Professor David Miles, Managing Director in Economic Research at Morgan Stanley, has advocated an increase in the ceiling to 50 per cent[15]. An increase in the ceiling to somewhere between 45 and 50 per cent of GDP would be reasonable. An increase of this magnitude would be a sensible pragmatic modernisation of the sustainable investment rule to allow the Government to invest in worthwhile major infrastructure projects in support of economic growth, and take advantage of the current historically low interest rates available on long dated government bonds. It would not be, and should not be seen as, an abandonment of fiscal discipline on the part of the Government.

[15] David Miles, 'Brown's debt rule risks stifling investment', Financial Times 2 June 2005

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