Pre-Budget Briefing: What is PSNFL? And will more government borrowing for investment increase mortgage costs?

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Overview

- The Chancellor Rachel Reeves announced on Thursday that she will change the UK's fiscal rules to allow for more public investment.
- Details of the new rules will be announced at next week's Budget, but it has been widely reported that the government will stop targeting falling Public Sector Net Debt (PSND) and instead target falling Public Sector Net Financial Liabilities (PSNFL).
- This briefing outlines the case for reforming the UK's anti-investment fiscal rules and explains what a shift to PSNFL would involve.
- It also sets out why claims that increased government borrowing for public investment would increase inflation and mortgage costs are based on unsound assumptions.

The case for fiscal rule reform

Many of the UK's most esteemed policy institutions - such as the Institute for Government and the National Institute for Economic and Social Research - as well as leading economists such as Lord Gus O'Donnell and Lord Jim O'Neill have argued that the government's fiscal rules create incentives to cut public investment and are in need of substantial reform.

The Labour government has already committed to only borrow to invest, balancing taxation with day to day spending: the 'golden rule'. However, a different fiscal rule inherited from the Conservatives - the 'debt rule' - would still constrain public investment. This rule requires that Public Sector Net Debt (PSND) as a % of GDP must be falling between the fourth and fifth year of a forecast by the OBR. The debt rule drives an anti-investment bias in government spending plans, because the OBR assesses the stock of debt as a % of GDP before most of the positive impacts of public investment on economic growth have been realised. This assessment is also made on a pass/fail basis, without judging how the flows of debt and GDP will change over time. This effectively rewards the government for cutting investment, even when this spending could increase productivity, growth, tax receipts and thus the sustainability of public debt over the longer term.

What is Public Sector Net Financial Liabilities (PSNFL)

PSNFL is a more holistic account of the government's financial position as it includes the value of financial assets held by the government (such as student loans, guarantees to businesses, equity holdings by public sector banks, and assets held by public sector pension schemes), as well as its liabilities.

This approach therefore better reflects the benefits of borrowing to invest by capturing the value of the financial assets created through the investment as well as the debt taken on to fund it. The Institute for Public Policy Research (IPPR) calculated that targeting falling PSNFL instead of falling PSND in the fiscal rules could open up around £52bn of additional fiscal space which could be used for public investment, compared to the current debt rule.

Alternative pro-investment fiscal rule changes

It was reported in 2023 that Labour were planning to adopt a target for Public Sector Net Worth (PSNW) as part of their fiscal rules. PSNW is an internationally recognised accounting metric and is already calculated by the Office for National Statistics (ONS).

PSNW is another option for removing anti-investment biases within the fiscal framework. It is an even more comprehensive account of the government's balance sheet as it includes not just the value of financial assets and liabilities, but also the value of non-financial assets such as the value of the transport network, hospital buildings and other infrastructure.

Other potential pro-investment fiscal rule changes include the following changes which could be used in combination with a broader debt metric.

1. **Excluding the Bank of England's losses from the Asset Purchase Facility from the calculation of public debt.** This is a move supported by the vast majority of economists as it would remove distortions caused by the interaction of fiscal and monetary policy.

2. **Extending the time horizon of fiscal rules beyond five years** to allow more time for public investments to demonstrate growth benefits. This is something that has been called for by economists in order to enable the government to take a longer term view of the impact of public investment decisions. Targeting a PSNW or PSNFL measure would reduce the need for this intervention, but the government would still face the challenge of reduced incentives to undertake investment projects where the benefits accrue mainly beyond the five year time horizon.

Pros and cons of PSNFL

More holistic definitions of the government's balance sheet such as PSNFL have substantial benefits over debt-based fiscal rules. These include:

- **Better reflecting the benefits of borrowing to invest** by capturing the value of the financial assets created through the investment as well as the debt taken on to fund it. PSNFL therefore gives a more accurate and more holistic view of the government fiscal position.

- **Discouraging the government from selling public assets to reduce short-term debt.** Previous Chancellors have often 'gamed' the debt rule by selling public assets for less than they were worth (such as the Student Loan book) to reduce debt within the forecast period. This has harmed longer term debt sustainability because such assets could have generated more returns for the government in the long run.

- **Giving investors in UK public debt a fuller picture of the public finances -** just as investors take a company's assets and growth strategy into account when valuing it, not just its borrowing. Lord Jim O'Neill, a former Treasury minister who was previously Chair of Goldman Sachs Asset Management, argues that "focusing on a more comprehensive debt metric" would "bring fiscal rules more in line with how financial markets think about fiscal sustainability"

- **Targeting PSNFL avoids some of the accounting challenges** associated with valuing less liquid, non-financial assets that would be included under a more comprehensive measure such as Public Sector Net Worth (PSNW). For example the challenge of valuing assets like public sector buildings, the transport network and other infrastructure. This would make it easier to implement a PSNFL target compared to PSNW, but it comes at the cost of being "less comprehensive and less reflective of the future benefits of public investment", in the words of IPPR.

However, a PSNFL target could still bring with it some problems. It could create incentives for the government to channel investment through financial mechanisms rather than directly building and owning infrastructure. PSNFL effectively makes public sector borrowing to invest in financial assets (for example loans made by the National Wealth Fund) fiscally neutral. Conversely, the value of investment in non-financial assets held by the public sector, such as hospital equipment, registers as a debt under PSNFL.

Barclays note this "raises the prospect of a change back to a "PFI-type" world of the early 2000s", which is why many experts have called for 'guardrails' to help guide additional public investment, including greater oversight and assessment by independent bodies. The Labour government has recently announced the creation of a new Office for Value for Money to scrutinise spending, alongside a new infrastructure oversight body. The National Audit Office's role will also be expanded.

There is no perfect set of fiscal rules, but it is important that any new rules create the right incentives for the long-term health of the economy, and properly measure the economic benefits of public investment.

The government moving to targeting PSNFL would be a significant step forward in this regard, but this would still only partially address the problems with the current rules, and concerted action to address the above risks would be needed.

Support for reforming anti-investment fiscal rules

Swapping the debt rule for more holistic accounting measures such as PSNFL is supported by a range of respected experts, such as Martin Wolf (Chief Economics Correspondent of the Financial Times), Mark Carney (the former Governor of the Bank of England), and Lord Gus O'Donnell (former Permanent Secretary of the Treasury and head of the Civil Service).

Polling commissioned by Invest in Britain has also shown strong support for more public investment:

- 70% of the public believed that UK public investment has been too low in recent decades. This rose to 84% among those who intended to vote Labour before the General Election.
- 72% of those who intended to vote Labour at the election believed that Labour would increase public investment, only 2% thought they would reduce it.
- The public were more than three times as likely to think that increasing government spending will be good for the economy (50%) than to think that cutting government spending will be good for the economy (15%).

Will more borrowing for public investment increase inflation and mortgage costs?

HM Treasury analysis commissioned by Jeremy Hunt in 2023 is being recycled to justify claims that any additional borrowing to fund public investment will be inflationary and risks increasing interest rates and mortgage costs. The analysis was written by civil servants under the direction of Conservative Ministers and Special Advisors, a practice which has been widely discredited.

Despite increasingly strong signals that the Chancellor will increase borrowing to invest, financial markets have not reacted in a way that Jeremy Hunt has been warning about. If Hunt's claims about inflationary impacts were well founded, this would already be reflected in government borrowing costs (to make up for higher inflation). However, the financial markets are relatively calm. See here, and also detailed analysis by Chris Giles.

Below we set out why these inflationary claims are not based on credible assumptions.

First, whether increased borrowing to fund higher public investment is inflationary depends on how close the economy is to its total productive capacity:

- Back in 2023, when the Treasury analysis was commissioned, inflation was 4% and the labour market was tight, i.e. demand for labour was high and unemployment was relatively low. This means there was minimal 'slack' in the economy, i.e. minimal spare productive capacity[1]. This led the authors to double their assumptions about how sensitive inflation was to any injections of demand in the economy from higher government borrowing.

- The authors noted that their estimates of the inflationary potential of higher borrowing "would be expected to return to more normal levels [i.e. half] as inflation returns to target and slack emerges in the economy". This is the stated view of the IMF (who they cite): that economies are only at higher risk of inflation when inflation is already abnormally high (as it was in 2023 when the Treasury produced their report). However, right now inflation is back to target and inflation expectations are anchored. So the assumption of doubling the economy's sensitivity to inflation is far removed from accepted standard models.

Second, whether increased borrowing to fund higher public investment is inflationary also depends on what the borrowing is used for:

- Their analysis assumes an "unexpected" spending increase of 1% of GDP and models the Bank of England's Monetary Policy Committee (MPC) reaction vis-a-vis interest rates in a "highly stylised way". Their analysis "does not consider potential supply-side benefits of certain fiscal policies", e.g. the potential public investment enabled by the borrowing. And the authors note that, in reality, "the MPC will make interest rate decisions based on the full range of specific factors".

- Growth-enhancing public investment directly increases the supply-side (productive capacity) of the economy. For instance, investment in NHS capacity reduces the amount of people on long term sick leave, and investment in childcare allows more parents to return to work; both therefore increase productivity and the number of people able to work. Similarly, investment in energy efficiency and renewables makes the economy more resilient to the kind of supply-side energy price shocks that have been the main driver of the record bouts of inflation seen since the pandemic.

- This means that productivity-enhancing public investment can reduce inflationary pressures in the long run, and lower the future path of interest rates. This key factor is not captured by the analysis. Increased global insecurity caused by external shocks like climate change or rising geopolitical tensions is leading to greater risk of

[1] The amount of spare productive capacity (or 'output gap') in the economy is contested. Both the Office for Budget Responsibility and Bank of England admit the difficulties in estimating this and the former's methodology has been criticised by NIESR.

inflation. In this context there is a *stronger* – not weaker – case for higher public investment to make the UK economy more secure.

In summary:

- Increasing public investment is unlikely to be inflationary if there is spare productive capacity in the economy.
- On the contrary, productivity-enhancing public investment can be disinflationary and make the economy more resilient to supply side shocks.
- The Treasury's analysis doesn't take account of these factors, because it was focused on a very specific scenario.
- The claims that any increase in borrowing will stoke inflation and provoke the Bank of England to increase interest rates and, consequently, mortgage costs, are therefore based on unsound assumptions and neglect basic economic facts.

Conclusion

- **The UK's anti-investment fiscal rules have held back growth and damaged the economy, so it is welcome that the government is revising them.**

- **A new fiscal framework must unlock ambitious public investment, properly measure the economic benefits created, and drop the arbitrary short-term timescales that bias governments against long-term thinking.**

- **The government moving to targeting Public Sector Net Financial Liabilities (PSNFL) would be a significant step forward, but would still only partially address the problems with the current rules.**

- **Claims that increased government borrowing for public investment would increase inflation and mortgage costs are based on unsound assumptions.**

About Invest in Britain

Invest in Britain is calling on politicians to start focusing on the long-term interests of the country. This means shifting the UK towards a sustainably higher level of public investment, so we can build a clean, modern economy which supports families, businesses and communities to prosper and thrive.

And we are calling on the media to start holding politicians properly to account for public investment decisions and their consequences, and to fairly represent the economics of investment to the public.

Invest in Britain is a project of the Economic Change Unit (ECU), a non-profit organisation that campaigns to change the way the economy works so everyone has the freedom and security to live a good life.

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