Pointmaker

THE HIDDEN DEBT BOMBSHELL

BROOKS NEWMARK MP

SUMMARY

- At the end of September 2009, the UK's Public Sector Net Debt (including financial interventions) was £825 billion. This is equivalent to £32,100 for every home in the country, or 59% of GDP.
- However, the official figures do not take into account the full cost of projects financed through the PFI, nor unfunded public sector pension liabilities, nor contingent liabilities such as Network Rail nor the cost of recent interventions in the financial sector. These hidden liabilities total £1,395 billion (100% of GDP).
- The true public debt is therefore £2,220 billion (159% of GDP or £86,390 per household). This is an increase of £366 billion since last year, when the true level of debt was £1,850 billion (127% of GDP).
- These data are based on cautious assumptions. For example, they estimate the cost of the bank bail-outs to be £130 billion, whereas total liabilities are in the region of £3.84 trillion or 274% of GDP.
- The Government has failed to provide transparency in its accounts. It is time for an independent audit of the Government's books.

TABLE 1: TRUE UK GOVERNMENT DEBT (2009)

	£ billion (2009)	% of GDP	Debt per household	£ billion (2008)
Official net debt	825	59.0%	£32,098	633
Public pensions	1,104	79.0%	£42,960	1,071
PFI	139	9.9%	£5,410	100
Network Rail	22	1.6%	£860	20
Bank bail-outs	130	9.3%	£5,060	30
Total	**2,220**	**158.8%**	**£86,388**	**1,854**

INTRODUCTION

Facing the current economic crisis, the Prime Minister claimed that:[1]

> *"Britain is in fact better positioned to deal with these problems because we have low national debt."*

However, the truth is that the national debt is far higher than the Prime Minister is willing to acknowledge. To continue to ignore this is both economically irresponsible and economic with the truth.

The Government has long persisted in hiding liabilities off its balance sheet. In the past, this helped it to meet Gordon Brown's 'Golden Rules'.[2] However, in late 2008, in the face of surging debt, the Government was forced to concede that its 40% rule had been exceeded. The Rules have now been 'temporarily suspended'.

Official statistics show that Public Sector Net Debt (PSND) has risen by £129.6 billion since September 2008. The Government now predicts debt to rise to 79% of GDP in 2013-2014.[3] Both the IMF and the OECD have warned the UK government that it needs to bring spending under control. Markets and international institutions also need confidence that the Government both understands the state of its public finances and is prepared to make the necessary reforms. As Richard Lambert, CBI Director-General, has remarked:[4]

> *"The Government is running too much of a risk with the willingness of investors to finance UK debt."*

Concerns abound that the UK's credit rating will be downgraded; and if the gilt market were to lose its appetite for UK Government debt, the cost of financing that debt could climb to perilous levels.

As the official debt burden increases, so does the cost of servicing it. This is forecast to double, from £25.6 billion this fiscal year, to £50.7 billion in 2013/14 due to a combination of both higher interest rates and the growing debt burden.[5] The annual rise is expected by the OECD to amount to £10 billion or 0.7% of GDP – the equivalent to the Millennium Development Goal.[6]

The Chancellor has called for greater transparency from the banks and corporations:[7]

> *"I agree with… the need for far greater transparency. There also needs to be stricter rules in relation to off-balance sheet activity, which has enabled some banks to get round their other regulatory responsibilities. That is clearly not a satisfactory position."*

It is time that he applied the same principles to the national finances and end the 'do as I say, not do as I do' culture of this Government.

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1 Speech of 28 October 2008.

2 The Golden Rule mandates that, measured over the economic cycle, the Government will borrow only to invest and not to fund current spending. The Sustainable Investment Rule requires that 'net public debt as a proportion of GDP will be held over the economic cycle at a stable and prudent level.' All else being equal, net debt will this be maintained below 40% of GDP over the economic cycle. HM Treasury, *The Economic and Fiscal Strategy Report*, 1998.

3 Note that projections for the current budget deficit in each and every year until the end of the forecast period (2013-14) have increased by at least £50 billion from those made at the time of PBR 2008.

4 'Full CBI reaction to chancellor's budget 2009 speech', CBI press release, 22 April 2009.

5 Simon Kirby and Ray Barrell, 'Prospects for the UK Economy', *National Institute Economic Review* 2009.

6 See OECD, *Economic Outlook*, June 2009, Table 31. www.oecd.org/dataoecd/5/51/2483816.xls.

7 Hansard, 21 April 2008, Column 1058.

THE PRIVATE FINANCE INITIATIVE

Private Finance Initiative (PFI) projects and straightforward government fundraising are identical in terms of their contribution to public sector debt: the principal and the interest requires repayment in both cases. However, for PFI projects, neither the construction costs nor the long-term obligation to pay future service charges appear on the Government's balance sheet.

The 'temporarily suspended' Golden Rule mandated 'separate current and capital budgets'. However, the PFI ignores this rule by unifying future service charges with the repayment of capital expenditure. The principle of 'unitary payments' may be useful, particularly for comparing competing bids from contractors. Yet it also has the effect of shunting a large amount of current capital expenditure to future revenue expenditure. As has been recognised across the political spectrum, this means that:[8]

> *"PFI has often been used by the government to keep the capital cost of buildings off its balance sheet, and thus make the public finances look better than they really are."*

The most accurate way of assessing the Government's obligations is to look at future payments under PFI contracts. According to HM Treasury, the capital value of PFI projects is now £64 billion, with an additional £181 billion of unitary charge payments due until 2047. If the total of £245 billion is discounted to present value (using a 2% growth rate), this is equivalent to £139 billion worth of liabilities that are not included on the balance sheet.[9]

It had been hoped that the International Financial Reporting Standards (IFRS) would bring balance sheet transparency for PFI projects. IFRS was due to be adopted from 2009-10. However, alarmed that any "such movement (of PFI) on to the balance sheet would put the country in a position in which it could not meet the sustainable investment rule and thus could not invest further in public services and our infrastructure",[10] the Government has fudged the implementation of IFRS.

So, while the Treasury has accepted that PFI schemes must be accounted for on departmental accounts, it has arbitrarily announced that a different accounting standard will be used for its own budgeting purposes. This will ensure that PFI projects do not reach the Government's balance sheet.

The Risk of PFI Failure

A major attraction of PFI is that, in theory, it transfers the risk of failure of a project from the Government to the private sector. However, unitary payments mean that, in reality, the Government carries most of the risk. If a private company providing an essential public service (such as a hospital, school or transport project) defaults, it is the Government that is committed as the ultimate guarantor.

Given the risk of default extends throughout the duration of the PFI contract, the Government balance sheet should therefore include the liabilities of all PFI contracts for the next 25 to 30 years.

Attention is often only focused on PFI projects undertaken by the departments of central government, yet the majority of PFI projects are undertaken by local authorities. However,

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[8] UNISON, *Reclaiming the Initiative – putting the public back into PFI*, 17 June 2009.

[9] Data taken from http://www.hm-treasury.gov.uk/d/pfi_signed_projects_list.xls.

[10] Chief Secretary to the Treasury, Hansard, 30 March 2006, Column 1031.

neither the Government nor the National Audit Office (NAO) has made any attempt to carry out a "balance of risks" assessment for these projects.

This approach is questionable, for two reasons. First, if a service (such as a school or fire station) is failing then extra finance will be required from central government in order to support or replace the PFI contractor. Secondly, even where the contract is adequate, some long-term commitments will not be sufficiently flexible to cope with changing needs: some PFI contractors may have to be bought out. In both of these cases, central government is acting as the backer of local PFI, as the lender of last resort.

Projects financed through the PFI have previously run into trouble, such as the failed Metronet PPP which cost the taxpayer £410 million. The Treasury estimates that it might have to lend £1 billion to £2 billion over the next 18 months, while others suggest this figure could be as high as £4 billion.[11]

PFI: £139 billion

In calculating the true level of Government debt, the figure of £139 billion has been used in Table 1. This is a cautious figure as it does not include local PFI projects, some of which may fail.

NETWORK RAIL

Network Rail is defined by the ONS as a private company. Hence its net debt is omitted from the public sector's balance sheet.[12] However, this is inaccurate – the Government has guaranteed to repay its debt if Network Rail were to collapse. Even if Network Rail were to simply appear at risk, the Government would likely assume greater control, thus forcing its reclassification by the ONS as part of the public debt (like Northern Rock and Bradford & Bingley) and compelling the Chancellor to finally add it to the national debt.

The substantial and high-profile debts of Network Rail should therefore be included on the Government's balance sheet. This would ensure that the public accounts are consistent with the 'substance over form' principle Financial Reporting Standard 5 that financial reporting should follow the substance of the commercial effect of a transaction, not the form in which it is presented.

Despite Network Rail's hope that debt would peak at £21.2 billion,[13] this figure has grown. It now stands at £22.3 billion.[14] In unstable times, contingent liabilities can easily solidify into actual liabilities and, for this reason, must be disclosed. Such liabilities should be included on the Government's balance sheet, either in the total debt figure, or at least as an additional statistic including *all* such contingent liabilities.

Network Rail: £22 billion

In calculating the true level of Government debt, the figure of £22 billion has been used in Table 1. This is derived from the company's latest Accounts.

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[11] For the Treasury estimate, see http://www.hm-treasury.gov.uk/press_20_09.htm, for the £4 billion estimate, see "PFI 'may need government funds' " BBC Website, 15 February 2009 http://news.bbc.co.uk/1/hi/uk_politics/7891475.stm

[12] Network Rail Infrastructure Limited, *Annual Report and Accounts*, 2009.

[13] Network Rail press release, "Network Rail confirms plans to raise finance without Government guarantee", 31 July 2006.

[14] Network Rail press release, "Record train punctuality and record investment are delivered as network rail announces its annual results", 3 June 2009.

PUBLIC SECTOR PENSIONS

Estimating public sector pension liabilities is notoriously difficult. Calculations are affected by assumptions on individuals' pension tenure, their final salaries, the method of indexing pension benefits and the longevity of public sector workers. However, liabilities are undoubtedly high, and given that any pension schemes which are unfunded *will* be paid directly from the Treasury, "pension debt can and should be included in any reasonable definition of government debt".[15]

Today's opaque pensions system also ignores the principle of intergenerational fairness. Either tomorrow's taxpayers will have to fund today's deficits, or those who have diligently made their pension contributions in good faith will watch their entitlements crumble.

Government figures on unfunded public sector pension liabilities are inadequate. The Government Actuary's Department (GAD) last published estimate was of £650 billion of liabilities as of 31 March 2006. However, this figure is significantly out of date. Despite the large sums involved, no further official statistics have since been forthcoming.[16]

One way to calculate current pension liabilities is to estimate how much the £650 billion would have risen on the basis of the increase in public sector pay.[17] In March 2006, public sector pay on the ONS Average Earnings Index ("AEI") was 128.6. In March 2009, the AEI had risen to 142.3, an increase of 10.6%. If pension liabilities had increased by the same amount, this would suggest a current figure of £719 billion.

The Government's failure to acknowledge its public sector pension liabilities is striking for two reasons. First, according to both the International Accounting Standard 19 (IAS19) for the private sector, and the International Public Sector Accounting Standard 25 (IPSAS25) for the public sector, occupational public sector pension liabilities *should* be included on the balance sheet. Companies have to include pension liabilities as a debt in their accounts. The Government should be held to similar standards. Indeed, even the Treasury agrees that "financial reporting by central government bodies should be based on generally accepted accounting practice (GAAP) adapted where appropriate to take account of the public sector context".[18]

Secondly, the Treasury has moved the goalposts in deciding which discount rate to apply to pension calculations. Before 2001, the point at which actual market yields began to fall, the discount rate was market-based. However, after 2001, the Treasury stuck to a fixed rate of 3.5%, thereby superficially slashing the cost of pension liabilities. Using the correct market sovereign (or risk-free) rates, as specified by the International Public Sector Accounting Standards Board (IPSAB), public sector pension liabilities are estimated to be £1,104 billion or 79% of GDP.[19]

Public sector pensions: £1,104 billion

In calculating the true level of government debt, the figure of £1,104 billion has been used

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15 Nick Silver, *A Bankruptcy Foretold: The UK's Implicit Pension Debt*, IEA, 26 November 2008.

16 However, the Chief Secretary to the Treasury has promised a new long-term public finance report will be released later this year with an updated figure for pension costs.

17 This is valid as most public sector pensions are currently calculated by reference to final salary.

18 11th Report of the Financial Reporting Advisory Board.

19 Neil Record and James Mackenzie Smith, *Public Sector Pensions – The UK's Second National Debt*, Policy Exchange, June 2009.

for unfunded public sector pensions in Table 1. This is derived from the latest study by Neil Record. This is a cautious figure as it only includes the largest state pension funds. In addition, it includes neither the impact of greater longevity nor the baby boom bubble. However, the precise size of the liability is, to some extent, theoretical, even nebulous, not least because of the dramatic impact of interest rate changes on the figures.[20]

FINANCIAL SECTOR INTERVENTIONS

The eventual cost of Government support for the UK economy and banking sector remains uncertain. However, there are clearly substantial costs involved. As the IFS has noted:[21]

> *"Collapsing tax revenues and the cost of bailing out the banking sector have done breathtaking long-term damage to the public finances.*

The ONS currently estimates the Government's support for the financial sector at £142 billion. It has recently announced that the Royal Bank of Scotland (RBS) and Lloyds Banking Group will also be classified as public corporations from October 2008. As such, they must be accounted for in the public finances. However, their inclusion has been delayed because of the size and complexity of the two banks.

Even the Chancellor now recognises that the bank bail-outs will give the taxpayer material losses. However, the estimate he made in the 2009 Budget – that the losses would equal 3.5% of GDP – are over-optimistic. The IMF, for example, believes the costs of financial sector interventions to be significantly greater, at 9.3% of GDP, nearly three times what the Government is willing to admit, and equivalent to £130 billion.[22]

However, if the liabilities of the four nationalised banking institutions were included, without accounting for assets, the national debt would increase by £2.44 trillion.[23]

The Government is also committed to providing £526.5 billion of asset insurance, £250 billion to guarantee bank lending, Government loans to the Bank of England of £185 billion to finance special liquidity programmes for banks, and the central bank purchasing £150 billion of assets through its quantitative easing programme. It also has to pay some smaller amounts through direct investment in UK lenders, assistance for the customers of Icelandic banks, and the bailout of Dunfermline Building Society – these total £288.5 billion. Coupling these commitments with the £2.44 trillion of potential bank liabilities, the taxpayer could theoretically be liable for as much as an extra £3.84 trillion.

Nevertheless, it is difficult to be sure of any figure. Such is the uncertainty pervading the financial sector, the Government's exposure to losses at the nationalised banks could either decrease, or increase yet further. For example, the banks have not yet taken sizeable write-downs on commercial real estate. Although the figure of £3.84 trillion does already include the Asset Protection Scheme, further declines in UK house prices would leave billions of pounds more in negative equity, with these mortgages

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[20] See Michael Johnson, *Don't let this crisis go to waste: a simple and affordable way of increasing retirement income,* CPS, 2009.

[21] Robert Chote, IFS, April 2009.

[22] IMF Companion Paper, *The State of Public Finances: Outlook and Medium-Term Policies after the 2008 Crisis,* 6 March 2009.

[23] This is comprised of liabilities of £89 billion at Northern Rock and £55 billion at Bradford & Bingley (less the £118 billion already accounted for by the ONS), plus £1,028 billion at Lloyds and £1,386 billion at RBS. Data from company websites.

not covered by the government insurance programme. Yet, for the nationalised banks, given the Government is ultimately liable for their debts, this could add yet more to the national debt.

Bank bail-outs: £130 billion

In calculating the true level of Government debt, the figure of £130 billion has been used in Table 1 for bank bail-outs. This is derived from the IMF data. This is a cautious figure as it does not include the total liabilities of the banks which have been rescued, nor the full cost of all the measures (such as the special liquidity programme or quantitative easing) that have been used in the crisis.

CONCLUSIONS

The Governor of the Bank of England now acknowledges that "we came into this crisis with fiscal policy along a path that was not itself sustainable".[24]

The lax control of public money over the last decade has created a catastrophic level of debt, now equivalent to £2.22 trillion – or 159% of GDP. This is an increase of £366 billion since last year, when the true level of Government debt was £1.85 trillion (or 126.9% of GDP).[25]

Acknowledgement of this level of debt – and its rate of growth – should force the Government to behave with prudence. Yet the Prime Minister continues to announce more and more unfunded spending commitments.[26]

This refusal has five consequences. First, the disregard for transparency in the public finances undermines the already fragile trust the public has in the political process.

Secondly, this level of debt puts serious constraints on the options a government can pursue for economic recovery. To build out of the recession and put this country on a sustainable economic trajectory, we need a new fiscal framework and a government that is prepared to recognise this.

Thirdly, it is time for the Government to recognise the inadequacy of its own fiscal framework. It should admit that the Golden Rules were misconceived. Gordon Brown must recognise that, as the OECD recommends, 'reformulated rules should be forward-looking, ensure medium-term spending discipline and account more explicitly for off balance sheet public liabilities.'[27] We need a new and forward-thinking fiscal framework.

Fourthly, it is time to be honest about the true level of debt associated with PFI. All PFI liabilities *must* be acknowledged on the Government balance sheet. In addition, a 'balance of risks' assessment is needed which should be applied to all local government PFI projects. Any PFI scheme for which the Government is found to be the ultimate guarantor should also be included on the balance sheet.

Finally, the persistent refusal to accept the true level of national debt reflects the urgent need for an Office for Budget Responsibility to conduct an independent audit of the Government's books. Only when we know the true scale of the public debt can realistic debt targets be made and a substantive policy debate emerge on this country's economic future.

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[24] Mervyn King, Treasury Select Committee, Minutes of Evidence, 24 June 2009.

[25] For estimates of last year's true level of debt, see by the author, *The Price of Irresponsibility*, CPS, 2008.

[26] See for example, his speech to the Labour Party Conference, 29 September 2009.

[27] OECD, *Economic Survey of the United Kingdom 2009*, June 2009.

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