Pointmaker

THE PRICE OF IRRESPONSIBILITY

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SUMMARY

- According to the most recently published data, in September 2008, the UK's Public Sector Net Debt (including Northern Rock) is £632.7 billion. This is equivalent to 43.3% of GDP.

- This is a significant underestimate of the true scale of government debt. It fails to account for the full cost of projects financed through the PFI, the extent of unfunded public sector pension liabilities, the debt incurred by Network Rail and the recent nationalisation of Bradford and Bingley.

- If these liabilities are included, the real level of government debt is £1,854 billion – three times greater than the official figures. This is equivalent to 126.9% of GDP, or just under £76,000 for every household in the UK.

- If the cost of the recent bail-out of the UK banking sector were included, this could add up to £500 billion to the debt figure. This would imply a total debt of £2,354 billion – the equivalent of 161.1% of GDP or over £96,475 per household.

UK PUBLIC SECTOR REAL GOVERNMENT DEBT (2008, EXCLUDING RECENT BANK BAIL-OUTS)

	£ billion	% of GDP	Debt per household
Net debt	633	43.3%	£25,943
Public pensions	1,071	73.3%	£43,893
PFI	100	6.8%	£4,098
Network Rail	20	1.4%	£820
Bradford & Bingley	30	2.1%	£1,230
Total	**1,854**	**126.9%**	**£75,984**

- These data are based on cautious assumptions. They do not, for example, include the risk of failure of PFI projects which have been commissioned by local government; nor do the unfunded public pension liabilities include the future cost of state employees in smaller schemes.

- The IFS has estimated that the current financial and economic problems are likely to increase government borrowing by £65 billion.[1]

- The extraordinary level of public debt is pushing the costs of current spending onto future generations of taxpayers.

- The Government has failed to provide transparency in its accounts. It has only reluctantly acknowledged that some PFI spending should be included in the debt figures; and it is still claiming that the £87 billion of Northern Rock debt should not be included.

- Hiding these substantial liabilities has enabled the Government to circumvent the 'golden rule' and the 'sustainable investment rule' for political purposes at the expense of the country's economic future.

- The Government must acknowledge the true scale of the national debt.

- This continued refusal to accept transparency reflects the urgent need for the establishment of an Office for Budget Responsibility to conduct an independent audit of the government books.

[1] See Carl Emmerson, *The Times,* 12 October 2008.

INTRODUCTION

The Government has often congratulated itself on its efforts to keep public finances on a stable footing. In the midst of the current crisis, for example, the Prime Minister announced:[2]

"I have to say to you that we face this situation as a country with relatively low national debt because of the steps we have taken since 1997 where we wiped off perhaps more than around £100 billion of debt by reducing the proportion of debt in our national income."

The true figures revealed here show that the national debt is far higher than the Prime Minister is prepared to recognise. The Prime Minister's golden rule and the sustainable investment rule have clearly been broken.[3] It is now time for the Government to recognise the true extent of the problem; to accept the failure of its fiscal rules; and to create an entirely new and forward-thinking fiscal framework.

Official statistics show that Public Sector Net Debt (PSND) has increased from 36.4% of GDP in August 2007 to 37.3% one year later (this figure excludes the £87 billion takeover of Northern Rock). At the time of the Budget, the Chancellor forecasted that debt will rise by the end of March 2009 to £581 billion or 38.5% of GDP, increasing further to a projected 39.8% of GDP by 2010/11,[4] conveniently remaining just beneath the 40% limit.

[2] Prime Minster's Press Conference, 13 October 2008.

[3] 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.' Other things being equal, net debt will thus be maintained below 40% of GDP over the economic cycle. HM Treasury, *The Economic and Fiscal Strategy Report*, 1998.

[4] HM Treasury, *2008 Budget Report*, 12 March 2008.

This is not only a problem of a level of debt that is both too high and expanding but it is also a problem of transparency. The Government has shrouded the public finances in opaque off-balance sheet measures which obscure the true debt position. And yet, without any apparent sense of irony, it is the Chancellor of the Exchequer who has called for greater transparency amid the current banking crisis:[5]

"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."

THE PRIVATE FINANCE INITIATIVE

Private Finance Initiative (PFI) arrangements have proliferated under this Government. This is not necessarily a problem. It is their use to keep public debt off the balance sheet by stealth that is the real travesty.

While PFI projects and simple government fundraising are essentially identical in terms of their contribution to public sector debt, with the principal and the interest requiring repayment in both cases, the PFI can be manipulated. It now represents little more than a disguised borrowing programme for the Government.

The Golden Rule mandates "separate current and capital budgets". However, the PFI presents the opportunity to unify future service charges with the repayment of capital expenditure. While the principle of 'unitary payments' is theoretically useful for simplicity in comparing competing bids from contractors, it also shunts a large amount of current capital expenditure to future revenue expenditure. Thus neither the building nor the long-term obligation to pay future service charges appears on the Government's balance sheet.

This means that the official data gives a very misleading impression of government commitments. Future payments under PFI contracts are the most accurate measurement of the government's obligations. The Select Committee on Public Accounts estimates that the present value of future payments for PFI projects amount to £100 billion.[6]

Things will only get worse. The Government's preference for PFI looks set to continue, with £23.2 billion due to be signed in future PFI deals over the next five years.[7] The Government's overspending today is saddling future generations with a rapidly growing but obscured bill.

The maintenance and additional costs of covering PFI problems are also debilitating; for example, in February 2008, the Department for Transport provided £2 billion to Transport for London to take on Metronet's existing and prospective debts, along with some incidental costs.

While the Government has managed to postpone the inclusion of the PFI on its balance sheet, this will be thwarted when International Financial Reporting Standards (IFRS) are adopted from 2009-10. As the Institute for Fiscal Studies has remarked: 'Any significant classification change (of PFI projects currently not on the public sector balance sheet) that increased public sector

[5] Hansard, 21 April 2008, Column 1058.

[6] Select Committee on Public Accounts, *HM Treasury: Making changes in operational PFI projects*, September 2008.

[7] HM Treasury, *Infrastructure procurement: delivering long term value,* March 2008.

net debt could quite plausibly result in it being pushed above 40% of national income.'[8] The Government is losing more and more of its options for fiscal concealment. It is time to come clean.

THE RISK OF PFI FAILURE

One of the attractions of PFI is that, at least in theory, it transfers the risk of failure of a project from the government to the private sector. However, in reality, unitary payments mean that the government carries the risk of the PFI. If a private company providing an essential public service (such as a hospital or a school) defaults, it is the government that is committed as the ultimate guarantor. With so many PFI projects involving vital public services, this risk ought to be accounted for on the government balance sheet.

The risk of default extends throughout the duration of the contract. Thus the government balance sheet should include the liabilities of every PFI contract 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, neither the Government nor the National Audit Office (NAO) has made any attempt to carry out a "balance of risks" assessment for these projects.

Given that local PFI projects are likely to concern the delivery of essential services, this approach is questionable. Two problems arise. First, if services are 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, meaning PFI contractors may have to be bought out. In both of these scenarios, the central government is acting as the backer of local PFI, or as the lender of last resort.

Thus, a 'balance of risks' assessment should be applied to all local government PFI projects. Any PFI scheme for which the government is found to be the ultimate guarantor should be included on the balance sheet.

CONTINGENT LIABILITIES

Debt classified by the Office for National Statistics (ONS) as 'contingent liabilities' must be included on the government balance sheet; in particular the risk-weighted percentage of the substantial and high-profile debts of Network Rail, Northern Rock and Bradford and Bingley. This would ensure that the public accounts are consistent with the 'substance over form' principle[9] that financial reporting should follow the substance of the commercial effect of a transaction, not the form in which it is dressed up.

Network Rail is defined by the ONS as a private sector company and thus both it and its net debt of £20 billion in June 2008 is omitted from the public sector's balance sheet.[10] However, this is inaccurate – the government guarantees to repay its debt if Network Rail collapses. If Network Rail were to appear at risk, the Government would probably have to assume greater control, forcing it to be reclassified by the ONS as part of the public sector, and thus compelling the Chancellor to add it to the national debt. Network Rail's contribution to the public sector net debt is set

8 IFS, *Green Budget*, 2008.

9 Financial Reporting Standard 5.

10 Network Rail Infrastructure Limited, *Annual Report and Accounts*, 2008.

to rise even further as government-guaranteed debt is projected to increase to £22 billion in March 2009,[11] surpassing the hope reiterated less than one year prior that this debt would peak at £21.2 billion.[12]

The Northern Rock takeover adds further to the Government's debt problems, as the bank's nationalisation brought its liabilities and assets onto the public sector balance sheet. The recent decision by the ONS that Northern Rock will be included in public sector net debt is a welcome increase in transparency. Yet the Government is still seeking to evade responsibility. It claims that because the reclassification of Northern Rock to the public sector is only expected to be temporary, the Government will conveniently measure performance against the sustainable investment rule using figures excluding its impact.

While Ministers claim that it would be inaccurate to distort the figures by including this 'unusual circumstance', the recent nationalisation of Bradford and Bingley, which has added another estimated £30 billion to the balance sheet, shows this was not simply a one-off. To continue to exclude the Northern Rock debt (as well as that of Bradford and Bingley) from the balance sheet is unjustifiable.[13]

PUBLIC SECTOR PENSION LIABILITIES

Estimating public sector pension liabilities is a notoriously difficult task. Calculations are affected by assumptions which have to be made on individuals' pension tenure, their final salaries, the method of indexing pension benefits and the longevity of public sector workers. What is certain, however, is that liabilities are extraordinarily high.

Unfunded public sector pension payments ignore 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 shrouded in mystery. The Government Actuary's Department (GAD) has estimated these liabilities as £650 billion[14] as of 31 March 2006. However, breaking down a previous GAD estimate of liabilities of £530 billion in March 2005, this comprised £401 billion from the four biggest schemes,[15] and £132 billion from the rest of the unfunded schemes. The most recently known liabilities from the four large schemes, as of March 2007, are £629 billion.[16] Thus by adding the out-of-date figure of £132 billion from other schemes, using their own calculations, Government estimates of unfunded public sector pension liabilities will have to be, at the very least, £761 billion.

The Government uses the FRS 17 Accounting Standard, valuing its pension liabilities using a discount rate equal to the yield on AA corporate bonds. However, variations in the discount rate

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11 Network Rail press release, "Network Rail launches index-linked bond programme", 25 April 2007.

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

13 Data from Northern Rock are from ONS and HM Treasury, *Public Sector Finances First Release*, 18 September 2008; the figure for Bradford and Bingley is calculated on the basis of its estimated total finacial liabilities of £51 billion minus £22 billion of retail deposits sold to Santander.

14 HM Treasury, *Long Term Public Finance Report: An Analysis of Fiscal Sustainability*, March 2008.

15 National Health Service Pension Scheme, Teachers' Pensions Scheme, Principal Civil Service Pension Scheme, Armed Forces Pension Scheme.

16 Resource Accounts 2006-07.

produce widely varying outcomes, making the last published government figure from 31 March 2006 redundant.

It has been argued that unfunded public sector pension liabilities should be estimated using a different discount rate. Since the government is not at risk of default, the appropriate discount rate should be the risk-free yield on index-linked government debt. The most recent reliable estimates thus suggest the government's pension liabilities are £1,071 billion.[17]

THE BANK BAIL-OUT

Recent Government support for the UK banking sector in response to the global financial turmoil could have a dramatic additional effect on government debt.

Such is the uncertainty of the current economic climate that it is impossible to say exactly how much the Government's support for the UK banking sector will add to public sector debt. Including the whole Government package of a £50 billion Bank Recapitalisation Fund, the contingent liability of a £250 billion guarantee for inter-bank loans, and £200 billion available to banks under the Special Liquidity Scheme could increase public debt by £500 billion to reach £2,354 billion in total, or 161.1% of GDP. Including only the Bank Recapitalisation Fund and the contingent liability of a £250 billion guarantee for inter-bank loans would add £300 billion to public debt, increasing it to £2,154 billion, or 147.4% of GDP.

Alternatively, the public sector liability could be much lower, around £25 billion, increasing total debt to £1,879 billion, or 128.6% of GDP. This could result if the preference share capital provided for the banks is redeemed within 10 years, the securitised mortgage debt taken on the public balance sheet is held to maturity and the issuing institution is made liable for any shortfall in value at maturity. However, there is a risk that house price deflation creates large shortfalls that cannot be borne by the issuer without becoming insolvent.[18]

CONCLUSION

The true figures for government debt are the result of this Government's loose fiscal policies and excessive spending. Gordon Brown's decade of lax control of public money has led to a catastrophic deficit in the public finances of 126.9% of GDP (or 161.1% if the highest potential cost of the banking rescue is included).

The Government is unlikely to recognise the true level of public sector debt. This refusal will leave the next Government and future generations with the costs of servicing this debt.

This enormous deficit is adding to the woes of the taxpayer at a time they need it least. As households are already grappling with the effects of the credit crunch and the banking crisis, they now must bear more debt than ever previously realised.

This dire situation has been aggravated by further Government economic ineptitudes. For

[17] Neil Record, *Sir Humphrey's Legacy: An Update. UK Public Sector Unfunded Occupational Pensions*, IEA, January 2008. This estimate of public sector pension liabilities is the unfunded liabilities of the Teachers' Pensions Scheme (England and Wales), Principal Civil Service Pension Scheme, Armed Forces Pension Scheme, UKAEA Pension Schemes, DfID: Overseas Superannuation, Police Pension Schemes, Firefighters Pension Schemes and the National Health Service Pension Scheme. Since the liabilities of other, albeit relatively smaller, schemes are excluded, the total unfunded liabilities will be greater than this.

[18] Equity accounting would imply the debt figure could be as high as £4,574 billion after including the gross assets of £1,900 billion of RBS and £500 billion of Lloyds/HBOS.

example, the Chancellor's scrapping of the 10 pence income tax band will cost a further £2.7 billion as compensation. Suspending the inflation increase in fuel duties planned for October will cost another £0.6 billion, while suspending stamp duty on the purchases of residential properties worth between £125,000 and £175,000 will cost £0.3 billion this year.

At a time when many other Governments are trying to reduce their level of net debt, the Labour Government has done the reverse. In the current global economic situation it is imperative that the Government admits its true debt so that vital decisions and proposals to remedy the financial crisis are taken in the light of all the facts.

THE AUTHOR

Brooks Newmark was elected MP for Braintree in 2005. He is currently the Opposition Treasury Whip and has served as a Member of the Treasury Select Committee and the Science & Technology Select Committee. Before entering Parliament he was a Senior Partner at Apollo Management LP, a leading international Private Equity firm. He is, with Stephen Hammond MP, the author of *Simply Red: the true state of the public finances* (CPS, 2006).

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ISBN 978-1-905389-85-8

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