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SIMPLY RED

THE TRUE STATE OF THE PUBLIC FINANCES

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// SUMMARY

- According to the most recently published data, in September 2006 the UK's Public Sector Net Debt (PSND) is £486.7 billion (equivalent to 38% of GDP).
- However, this figure significantly understates the full costs of projects financed through the Private Finance Initiative (PFI) and the extent of public sector pension liabilities. Nor does it include debts incurred by Network Rail.
- If these liabilities are included, the real level of government debt would be £1,340 billion – or nearly three times greater than the official figures. This is equivalent to 103.5% of UK GDP.
- There are 24.2 million households in the United Kingdom. The real level of government debt is therefore the equivalent of more than £53,000 for every household in the country.
- These data are estimated on cautious assumptions. For example, they do not include any account of the risk of failure of PFI projects which have been commissioned by local government.
- The principle of greater transparency in the public finances has cross-party support. The public has a right to know the true extent of the liabilities which future generations of taxpayers will have to meet.
- In particular, action to control the debt that is being incurred for future generations cannot be taken without an honest assessment of its true extent.
- It is time for this Government to acknowledge the true state of the national debt.

UK PUBLIC SECTOR REAL GOVERNMENT DEBT (SEPTEMBER 2006)

	£bn	% of GDP
Net Debt	487	37.6%
Public pensions	720	55.6%
Local Government Pensions	90	7.0%
PFI	25	1.9%
Network Rail	18	1.4%
Total	**1,340**	**103.5%**

CHAPTER ONE
THE PRIVATE FINANCE INITIATIVE

THE MISLEADING ACCOUNTING OF CAPITAL EXPENDITURE

In recent years, critics have accused the Chancellor of using the PFI as a method of hiding, or simply deferring, a proportion of the capital costs associated with this Government's public sector investment. The Chancellor's response to this criticism has been to declare simply that: "We follow exactly the same rules as were followed by the previous Government, except for one thing – we tightened up the accounting standards."[1]

This is untrue. In principle, the 'Golden Rule' mandates "separate current and capital budgets."[2] But in practice PFI provides the potential to combine future service charges with the repayment of capital expenditure, and to keep most of the total figure off-balance sheet. The amalgamation of the capital and service costs of PFI projects into through-life 'unitary payments' has been confirmed in a Parliamentary answer.[3]

Unitary payments are used because they are supposedly simple and allow for easy comparison between contractors during the PFI bidding process. But as far as the public accounts are concerned, their effect is to shunt a vast amount of current capital expenditure to future revenue expenditure. In

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1 Hansard, 13 November 2003, col. 394.

2 HM Treasury, *Financial Statement and Budget Report*, 1999.

3 Hansard 14 Nov 2005 : Column 881W.

other words, the reality is that PFI is a type of disguised borrowing programme. There is no economic difference between PFI projects and straight government fund-raising from issues of government debt. The principal and the interest need to be repaid in both cases.

The use of unitary payments enables the government to shunt a vast amount of current capital expenditure to future revenue expenditure.

The use of unitary payments for PFI projects means that the official data give a seriously misleading picture of government commitments. If there is to be openness, honesty and transparency in government accounts, the obligation to repay principal under PFI projects should be accounted for as a government debt obligation. Unitary payments which contain a capital-equivalent component should therefore be accounted for in the same way as ordinary government debt. The lack of transparency and the use of off-balance sheet funding would not be acceptable in the private sector and these obligations should be placed on the country's balance sheet in the same way as gilt-edged securities. Indeed, the latest analysis by the Office of National Statistics (ONS) admits that: "HM Treasury has estimated that about half of all PFI assets (by capital value) are either on or will be on the public sector balance sheet."[4] This degree of uncertainty is unacceptable.

THE RISK OF FAILURE

The Treasury accepts that the accounting standard most applicable to PFI is the Accounting Standard Board's Financial Reporting Standard 5 – *Reporting the Substance of Transactions: Application Note F*.[5] The note concerns itself with the analysis required to determine whether the government has an 'asset of the property', that is, whether it bears the balance of risks and must therefore report the transaction on-balance sheet. The difficulty is in establishing these benefits and risks, and identifying which party bears the significant proportion.

When the then Shadow Chief Secretary to the Treasury first suggested the need to account for £100 billion of off-balance sheet government liabilities arising from PFI, the Chancellor replied:[6]

> He is trying to count every PFI commitment from now to 2030. What is more, most of the PFI commitments are in relation to maintenance and repair rather than construction programmes.

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[4] "Including Finance Lease Liabilities in public sector net debt: PFI and other" (ONS) 26 October 2006, paragraph 6.2 (sourced from HM Treasury estimates dated March 2006). See www.statistics.gov.uk/articles/nojournal/1638.pdf)

[5] HM Treasury, *PFI: Meeting the Investment Challenge*, July 2003 Annex B.18.

[6] Hansard, 13 November 2003, col. 395.

The advantage of PFI lies in offsetting the risk of project or service failure onto the private sector. That rationale is sound. However, the potential benefits must be weighed against the chance of default. Since the risk of default is spread over the full duration of the contract, every PFI contract for the next 25 years – and often beyond – should indeed be accounted for. (It should be noted that the Chancellor's statement also inadvertently confirmed the nebulous distinction between capital repayments and service costs.)

The Chancellor has inadvertently confirmed the nebulous distinction between capital repayments and service costs.

The Treasury has admitted the problem but has yet to provide an adequate solution:[7]

> It is impossible to predict with accuracy the percentage of PFI projects which may fail, but it is important to understand that in these extreme circumstances of failure… the Government will be prepared to terminate such contracts in accordance with its legal rights, even if at a loss to financial participants in the scheme. Where this happens, it will also act within its legal right to ensure that public services will be maintained.

In the event that a private company providing an essential public service goes into liquidation, or defaults, the government commits itself as ultimate guarantor. And many PFI projects involve essential public services which cannot be allowed to fail. As Professor Colin Talbot noted recently in evidence to the Treasury Select Committee:[8]

> There is no way, if there was a problem with GCHQ, that somebody will say, "We will just let that go."

One high-profile current example of the potential liability is the flagship PFI project for the construction of the Queen Elizabeth Hospital, Woolwich, which declared in December 2005 that it was technically bankrupt and would have a deficit of £100 million by 2008/09 unless its PFI debt was restructured.

This risk of failure is acknowledged. But no sum representing the cost to the taxpayer of potential default is included on-balance sheet. This figure must now be reassessed.

HOW MUCH IS THE RISK OF FAILURE?

As of July 2003, £20 billion of the capital value of PFI projects was included on the government balance sheet.[9] Estimated payments under PFI contracts for the 25 years from 2005-06 total £138 billion, leaving net payments of

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[7] HM Treasury, *PFI: Meeting the Investment Challenge*, July 2003.

[8] *Evidence to the Treasury Select Committee on the 2006Budget*, 27 March 2006, Q132.

[9] P Boateng, Parliamentary answer 11 October 2004, Hansard, col. 80W.

£118 billion unaccounted for. The liability is understated because many PFI projects have a duration of longer than 25 years – although the Government has not provided satisfactory answers to a Parliamentary Question intended to discover the full duration of all PFI projects.[10]

Capital Economics has calculated that an additional £25 billion should be added to the balance sheet, by including a risk-weighted percentage of total liabilities arising from PFI.[11] This would suggest that, including the £20 billion of liabilities that have already been admitted, a total of £45 billion should appear on the government balance sheet.

The £45 billion, however, relates only to PFI projects undertaken by the departments of central government. The majority of PFI projects are undertaken by local authorities. Yet neither the Government nor the NAO has made any attempt to carry out a "balance of risk" assessment for these projects. Indeed, Sir John Bourn has ruled out the consideration of local government PFI schemes from inclusion on-balance sheet on the grounds that there is no transfer of risk to central government.

Yet neither the Government nor the NAO has made any attempt to carry out a "balance of risk" assessment for PFI projects undertaken by local authorities.

This is questionable, given that local PFI projects are likely to concern the delivery of essential services such as the provision of schools. Two problems present themselves. The first is that if services are failing then extra finance will be required from central government in order to support or replace the PFI contractor. The second is that even where the contract is adequate, some long-term commitments will not be sufficiently flexible to cope with changing needs; meaning that PFI contractors may have to be bought out. In both these cases central government is acting as the backer of local PFI, or as the lender of last resort.

A 'balance of risks' test should therefore be applied to all local government PFI projects. Any PFI scheme for which the government is found to be the ultimate guarantor should be added to the balance sheet.

CONTINGENT LIABILITIES

There is also the further category of debt classed as 'contingent liabilities' by the ONS. A risk-weighted percentage of the debt belonging to Network Rail, and from similar projects, should be declared on the government balance sheet to ensure that the public accounts are consistent with the 'substance over form' principle of Fiscal Reporting Standard 5 which lays

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[10] Hansard, 14 November 2005, col. 881W.

[11] Capital Economics, *UK Economic Focus*, 20 February 2003.

down that financial reporting should follow the substance of the commercial effect of a transaction, not the form in which it is dressed up.

Encouragingly, the ONS is already moving in this direction. £1.25 billion of bonds issued by London and Continental Railway (LCR) – responsible for the Channel Tunnel Rail Link – were reclassified as government debt in August 2005, because the debt was ultimately guaranteed by the government and the bondholders not deemed at risk from default. On 20 February 2006 a further £5 billion of LCR debt was added to the government balance sheet by the ONS.[12] This reassessment is indicative of a change of thinking within the ONS in order to counteract the systematic understatement of public debt arising from PFI projects.

In a letter to *The Financial Times*, Len Cook, the Head of the ONS, had admitted that:[13]

> Imputing a fully reliable estimate of finance lease loans, the element of PFI debts that should be recorded within Public Sector Debt, is an extremely complex and difficult matter.

Nevertheless, the ONS announced on the 20 July 2006 that its revisions to public sector net debt to take account of PFI projects would be included in the Public Sector Finances release on 20 September.

The subsequent ONS reclassification increased the amount of PFI debt appearing on-balance sheet, by £4.95 billion to the end of March 2006, pushing the Chancellor ever closer to a breach of his Sustainable Investment Rule.[14] The piecemeal addition to the government balance sheet by the ONS, while a welcome step in the right direction, is an inadequate solution to the Government's lax accounting standards.

The announcement of a Statistics and Registration Services Bill in the 2006 Queen's Speech on 15 November is an opportunity to end the sense of uncertainty surrounding this Government's accounting. But, perhaps more importantly, truly independent statistics should remove the accounting benefit of using PFI as a method of procurement.

THE CASE OF NETWORK RAIL

One example of how government debt figures have been manipulated is the case of Network Rail's debt. Network Rail's level of debt stood at £18.2

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[12] H Shanks and M Kellaway, *National Accounts Classifications London & Continental Railways Ltd*, ONS, February 2006.

[13] *Financial Times*, 20 May 2005.

[14] HM Treasury's Sustainable Investment Rule states that: "public sector net debt as a proportion of GDP will be held over the economic cycle at a stable and prudent level." See hm-treasury.gov.uk/documents/uk_economy/fiscal_policy/ukecon_fisc_index.cfm

billion in July 2006.[15] Network Rail has confirmed that its government-guaranteed debt is expected to peak at £21.2 billion, although it has expressed a hope that debt beyond the £21.2 billion will not be guaranteed by the government.[16]

The issue of Network Rail's debt was considered by the Treasury Select Committee[17] which addressed the difference of opinion between the ONS and Sir John Bourn, the Comptroller and Auditor General, about whether to classify Network Rail's debt as being in the public or private sector.

The ONS only reclassified the debt as off-balance sheet after management restructuring had been accomplished to ensure that Network Rail was under the control of its "members" and claimed it was independent of the Government. Indeed, an adjustment to management structure was made in order to accommodate accounting objectives. On 17 February 2005, the ONS justified its view, stating that:

> The Office for National Statistics… considered the National Accounts classification of government support for Network Rail's borrowing. ONS received advice from the Department for Transport that this support is a contingent liability of government, later verified by the National Audit Office, and classified it as such in the National Accounts.

However, the fact remains that the Government has guaranteed the debt, the debt's risk regulatory risk weighting is nil and its credit rating is AAA. In other words, it is effectively government debt. It should therefore be on the government's balance sheet.

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

16 Network Rail press release, ibid.

17 Treasury Select Committee, *National Statistics: The Classification of Network Rail*, 20 January 2003.

CHAPTER TWO
PUBLIC SECTOR PENSIONS

The Chancellor has stated, as the justification for his 'Golden Rule', that:[18]

> The Government does not pass on the costs of services consumed today to the taxpayers of the future – each generation is expected to meet the current cost of the public services from which they benefit.

The Chancellor's principle of 'generational fairness' is laudable. The problem is that it has been discredited by the increasing burden of unfunded public sector pensions.

The principle of 'generational fairness' is laudable. The problem is that it has been discredited by the increasing burden of unfunded public sector pensions. Unfunded pensions liabilities mean that tomorrow's taxpayers will fund today's deficits. Alternatively, those who have made their pension contributions in good faith will see their entitlements crumble.[19]

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[18] HM Treasury, *Financial Statement and Budget Report 1999*, 1999. The Golden Rule states that: "over the economic cycle, the Government will borrow only to invest and not to fund current spending."

[19] The Government claims that unfunded public sector pension schemes are justified because they are supported by the government's wide tax-raising powers.

Pension payments are another clear example of deferred government expenditure. Put simply, they are a form of government borrowing.

Some of the UK's public sector pension schemes do use the Superannuation Contributions Adjusted for Past Experience (SCAPE) model to maintain a notional fund invested in index-linked gilts. However, the notional nature of this 'fund' has allowed the theoretical and real returns available to meet pension liabilities to diverge in an ever more noticeable fashion.

But this is only part of the problem. Private sector pension funds are now required to adhere to the FRS 17 accounting standard by valuing their pension liabilities using a discount rate equal to the yield on AA corporate bonds. The Government has claimed that its unfunded public pension liabilities were £460 billion as of 31 March 2004. But this is a considerable understatement as it relied on an unfeasibly high discount rate of 3.5% which the Government Actuary Department has now agreed to revise to 2.8% from 2005-06.

This adjustment still falls some way short of what is needed. The use of differing discount rates produces a wide variation of outcomes and, as the Government's treasury spokesman in the House of Lords admits: "The lower the discount rate, the higher the liability."[20] However, the new 2.8% discount rate is based on the AA corporate bond yield, whereas public sector pensions are backed by the government and there is no risk of default.

Net central public sector pension liabilities stand at £720 billion (other recent studies have estimated these higher – at £960 billion and £1,025 billion).

Other studies have estimated the government's pension liabilities to between £960 billion[21] and £1,025 billion.[22] In answer to Parliamentary Questions on this subject, the Chief Secretary to the Treasury confirmed the extent of unfunded public sector pension liabilities when calculated by using a lower discount rate:[23]

> Using a discount rate of 1.7% per annum net of price inflation, the yield published by the Debt Management Office for the index-linked gilt in issue on 31 March 2004 with duration to redemption closest to 25 years, the total liabilities of unfunded schemes would have been around £650 billion as at 31 March 2004.

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[20] Lords, Hansard, 9 March 2006, col 863.

[21] Watson Wyatt, Press Release, 7 March 2006.

[22] Neil Record,*Sir Humphrey's Legacy: Facing up to the Cost of Public Sector Pensions*, IEA, 22 September 2006

[23] Hansard, 11 November 2005, col 775W.

In addition, as of 31 March 2004 there was a deficit of £27 billion in local government pensions in England and Wales.[24] Applying the same methodology of a 1.7% discount rate to the funded Local Government Pension Scheme generates gross liabilities of £151 billion and a net liability of £71 billion.

But, since the government is not at risk of default, the appropriate discount rate should perhaps be the risk-free yield on index-linked government debt, which stood at 1.2% as of 1 December 2005. Using this discount rate, net central and local public sector pension liabilities stand at £720 billion and £90 billion respectively.

[24] Hansard 17 November 2005, col. 1442W.

CHAPTER THREE
CONCLUSION

In September 2006, the UK's Public Sector Net Debt was £486.7 billion (equivalent to 37.6% of GDP).[25] Yet the following tables suggest that the true figure could be three times higher. For if the true liabilities of public sector pensions and PFI are included, and if the real position with Network Rail acknowledged, then the PSND would have been over £1.3 trillion (or 103.5% of GDP) in September 2006. With 24.2 million households in the UK, this is equivalent to a real government debt of £53,470 per household.

UK PUBLIC SECTOR REAL GOVERNMENT DEBT (SEPTEMBER 2006)

	£bn	% of GDP
Net Debt	487	37.6%
Public pensions	720	55.6%
Local Government Pensions	90	7.0%
PFI	25	1.9%
Network Rail	18	1.4%
Total	**1,340**	**103.5%**

Notes: GDP is estimated at £1,294 bn from HM Treasury public sector finance databank figures

The principle of greater transparency in the public finances has cross-party support. The public has a right to know the true extent of the liabilities which future generations of taxpayers will have to meet.

In particular, action to control the debt that is being incurred for future generations cannot be taken without an honest assessment of its true extent and, in the Chancellor's words, by "ensuring that fiscal decisions are fully transparent and accountable."[26]

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[25] Public Sector Finance Databank 20 October 2006 (see www.hm-treasury.gov.uk/media/7A9/9F/pftdoct06a.xls)

[26] Hansard, 10 July 2003, col 1404.