

Debt reckoning

The chancellor faces a tricky decision about a crucial fiscal rule

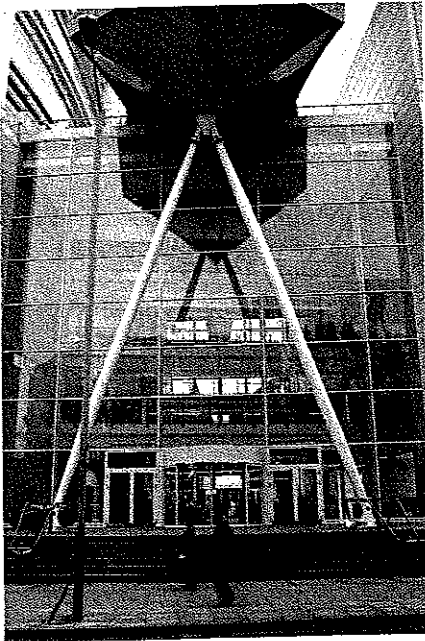
AS ALISTAIR DARLING has been preparing his first budget, due on March 12th, troubles have crowded in on him. Despite the chancellor's unstinting efforts to escape the inevitable, he eventually had to nationalise Northern Rock. Businesses remain vexed about botched tax proposals. Above all, the public finances are running a big deficit, which will swell as the economy slows over the next year or so.

Budget-watchers will pay especially close attention to what Mr Darling has to say about debt. Until now the government has stipulated that public debt (net of liquid assets such as foreign-exchange reserves) should be held below 40% of GDP. The most recent figures show that it has been meeting the rule. However, the bailout of Northern Rock will smash through the ceiling by adding liabilities of around £90 billion—6% of GDP—to existing debt of £512 billion—36% of GDP.

Mr Darling can quite reasonably argue that the mortgage lender's debt should be

disregarded for the purposes of the fiscal rule. The easiest way to do this would be to publish the debt figures with and without Northern Rock, as the Institute for Fiscal Studies (IFS), a think-tank, has suggested. But this would in effect provide a running update on the bank's balance-sheet, something the government may prefer to avoid.

As he labours with this thorny issue, Mr Darling has been grappling with another. Over the past decade, the Treasury has increasingly turned to the private sector not just to build and operate but also to finance new public investment through the "private-finance initiative". Under a PFI deal, a private consortium raises money to fund the capital expense of, say, a new hospital. The government then pays a regular charge, typically for 25-30 years, that bundles together debt repayment with interest and operating expenses. The Treasury insists the policy is all about getting better value for money. It also pushes debt off the public books, however. ▶▶



A new hospital with a long bill attached

► At the end of last year, 620 PFI deals involving a total capital commitment of £57 billion had been agreed. In some of the deals, the investment has been made; in others, especially three contracts to renovate the London Underground, years of capital spending lie ahead. Under current government accounting rules, only 13% of the deals and 42% of the total value—most of it arising from the Underground deals—were recorded as public liabilities.

This unsatisfactory position, which has allowed some deals to be off both public and private balance-sheets, was due to change soon. In his last budget a year ago Gordon Brown said that the public sector would adopt international accounting rules from April 2008. This would be likely to bring most of the PFI deals on to the government's balance-sheet, says Ken Wild, a member of the Financial Reporting Advisory Board, which offers independent guidance to the government.

It now looks as if Mr Darling will delay adopting the new rules for a year, but that merely postpones the agony. Quite how sharp the pain will be hinges on the response of the Office for National Statistics (ONS), which applies different concepts and procedures to measure the figure for public debt used for the fiscal rule.

The ONS took a first step towards including PFI liabilities in public debt in September 2006, when it came up with a surprisingly low figure of £5 billion for them. But the deals that gave rise to this estimate—those already recorded on the public books—were skewed by the big Tube contracts, much of the spending on which has still to be done. Excluding these, deals worth £7 billion resulted in some £3 billion of PFI debt being included in the fiscal numbers. If this pattern is repeated when

the remaining deals, worth over £30 billion, are properly accounted for, around £15 billion—1% of GDP—might be added to the statisticians' figure for debt.

That may seem a relatively small amount but, as the public finances deteriorate, it could be enough to push debt through the 40% ceiling even if Northern Rock is excluded. The accounting changes will also remove the present incentive for

public-sector bodies to go down the PFI route, says David Heald of Aberdeen University. That will further exacerbate the strains on the public finances.

The simplest way out would be to raise the ceiling, even though that would dent the government's already battered fiscal credibility. Whatever he does, Mr Darling is likely to face "presentational difficulties", says Carl Emmerson of the IFS. ■