UK public sector net debt: Out of control?

Financeable at present, but the worm may turn

By Nigel Hawkins

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Executive summary

- Since the late 17th century, when the National Debt – effectively today's public sector net debt (PSND) – was virtually nil, it has fluctuated widely, with financing various wars being the key factor. PSND soared on the back of the Napoleonic Wars, before falling during much of the 19th century. But the onset of World War 1 (WWI) in 1914, and especially of World War 2 (WWII) in 1939, saw PSND reach record levels.

- PSND first passed the £1tr mark as recently as 2011. Quite remarkably, over the intervening decade, this figure has more than doubled. In short, it took over three centuries for PSND to reach £1tr and less than the last decade for it to double.

- Inevitably, this surge in PSND raises the basic question as to whether the UK's public finances are spiralling out of control. Furthermore, there is currently minimal public debate as to how UK PSND should be cut. Indeed, there is a tacit acceptance among many commentators that reducing it conventionally – without excessive dependence on the printing press – is not feasible.

- Of course, the two great crises of recent years – the financially-driven recession of 2008/09 and COVID-19 – have had a devastating impact on PSND levels. And the transfer of Network Rail's net debt (£54.6bn at March 2020) onto the public sector balance sheet in 2014 did not facilitate matters.

- During the COVID-19 period, public expenditure – much of it health-related – has continued to soar. Moreover, tax receipts, especially from Income Tax and Corporation Tax, have fallen noticeably. The net result is a projected Public Sector Borrowing Requirement (PSBR), for 2020/21, of £355bn – almost £1bn per day.

- The sheer scale of the UK's PSND is a serious worry, especially if interest rates rise – the US 10-year Treasury Bond yield is the key driver. Reassuringly, though, the UK's gilt book has an average 13-year life – well above that of most other G7 countries.

- The last published Whole Government Accounts (WGA), covering 2018/19, also make sober reading. They show an unfunded net public sector pension liability of £1,894bn – an enormous figure, which is outside PSND accounting criteria. Even so, as with leading UK plcs, such as BT, BAE Systems and IAG, these pension liabilities have a quasi-debt status.

Background

National Debt dates back to 1694

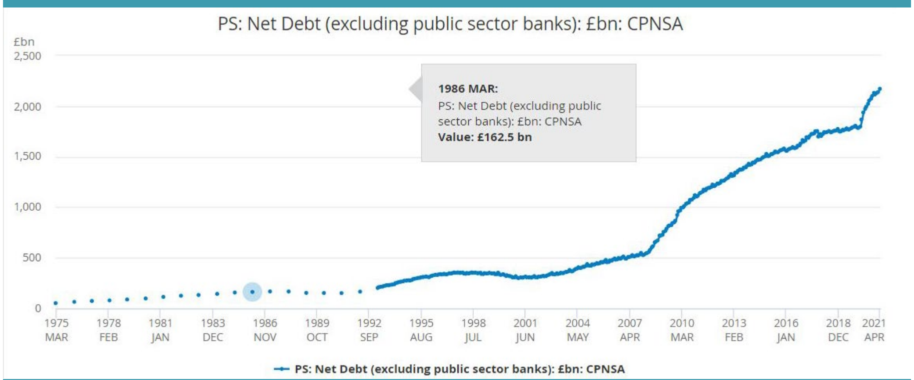
The UK's National Debt, now effectively PSND (and referred to as such throughout this document), was launched in 1694. Until the Napoleonic Wars, which culminated in the French defeat at Waterloo in 1815, debt levels had been modest. Having experienced a war-driven surge in the early 19th century, PSND levels fell back during much of the subsequent century, until the outbreak of WWI in 1914. As with the advent of WWII in 1939, there was very heavy military expenditure and massive borrowing.

Despite major concerns about debt levels in the 1970s, which led to an infamous International Monetary Fund (IMF) loan, the economic prosperity of the period between the early 1980s and the onset of the financial crisis in 2008/09 enabled growth in PSND to be restrained, certainly in terms of its percentage of GDP.

PSND surge since 2008/09

The graph below, published by the Office for National Statistics (ONS), shows the surge in PSND from 2008/09 onwards and the impact of the financial crisis – notorious for the £45.5bn taxpayer support for the stricken Royal Bank of Scotland (RBS) – on PSND levels.

UK PSND, 1975-2021



Source: Office for National Statistics

£1tr breached in 2011 and £2tr breached – quite remarkably – in 2021

Having breached the threshold of £1tr in 2011, PSND had reached £2.1tr by April 2021 – this is equivalent to ca.97% of GDP, excluding the Bank of England's investments, such as its 62% stake in RBS (subsequently renamed NatWest Group). This ca.97% figure compares with the sub-40% recorded as recently as 2007/08.

Key factors for the ever-upward PSND trend

This massive increase in PSND can be explained by several factors, the most important of which are:

- Low interest rates, which have encouraged public expenditure – the very controversial and financially unjustifiable £100bn+ HS2 rail scheme being a case in point.
- A chronic inability by politicians to rein in public expenditure.
- The more general economic impact of COVID-19, and especially its impact on GDP – its 9.9% fall in the 2020 calendar year being an obvious example.
- The pronounced fall in tax receipts, especially since the onset of COVID-19.
- A political disinclination to ascribe priority to cutting excess debt levels.
- The impact of inflation on nominal figures.

Public expenditure

Over the last 50 years, UK public expenditure levels have risen very sharply, admittedly on the back of an expanding economy. In terms of the percentage of GDP, the last decade has seen a pronounced rise (expected to exceed 54% in 2020/21); the percentage figure was as low as 38% in 2000/01.

Soaring TME since COVID-19 erupted – epitomised by Test and Trace

The projected figure for this financial year is ca.46%. This figure and the ca.54% for 2020/21 were driven by COVID-19-related expenditure, such as the much-criticised and desperately expensive (estimated at ca.£37bn over a two-year period) Test and Trace scheme. For 2022/23, when the financial impact of COVID-19 should be far lower, the Treasury's projected figure reverts to below 42%.

The table below, which focuses on the first full financial year of each decade, provides a timeline for Total Managed Expenditure (TME) data.

TME and as a percentage of GDP

	£bn	% of GDP
1970/01	206	42.7
1980/81	272	47.3
1990/91	300	40.0
2000/01	365	38.3
2010/11	688	46.5
2020/21	1,141	54.4

Source: Treasury, Hardman & Co Research

In terms of departmental budgets, the table below shows the Treasury's expenditure projections for the current financial year. Not surprisingly, social protection – much of which covers pension payments – and the NHS are the largest components.

Departmental expenditure projections, 2021/22

	£bn
Social protection	302
Health	230
Education	124
Industry, agriculture, employment	70
Defence	60
Others (including EU transactions)	57
Transport	51
Debt interest	45
Public order and safety	41
Personal social services	40
Housing and environment	33
Total	**1,053**

Source: Budget 2021

Tax receipts

COVID-19 impact on tax receipts

In terms of tax receipts, COVID-19 has had a major impact, especially on Income Tax and Corporation Tax payments. In the last full year, prior to COVID-19, these receipts were projected to be £208bn and £58bn, respectively.

The projected 2021/22 tax receipts in the table below show rather lower tax receipt expectations.

Tax receipt projections, 2021/22

	£bn
Income tax	198
VAT	151
National insurance contributions	147
Other non-taxes	88
Other taxes	84
Excise duties	48
Corporation tax	40
Council tax	40
Business rates	24
Total	**820**

Source: Budget 2021

Rising taxation – pension funding a likely target?

Looking forward, tax receipts are set to recover, as the economy rebounds. In the case of Corporation Tax, the basic rate is being increased, and is due to reach 25% by 2023. Other tax increases, including of Income Tax, are likely, along with less generous treatment of contributions into private pension schemes.

PSBR and net debt projections

Projections are tentative

Clearly, given the profound uncertainties about COVID-19 and the economic rebound, these Treasury projections are necessarily tentative.

While there are several measurements covering the PSBR, the Treasury figure, excluding the Bank of England's holdings, probably provides the best measurement of future trends. For 2021/22, the Treasury is forecasting a decline in the PSBR, from an estimated £355bn in 2020/21 to £234bn – still an enormous figure. By 2025/26, a figure of ca.£74bn has been inked in.

Not surprisingly, the surge in the PSBR during recent years has had a marked impact on PSND. The table below sets out the consequential PSND projections from 2019/20 until 2024/25, which may look – on first inspection – to be quite flat. However, on a longer-term perspective – as a percentage of GDP – it is probable that PSND (excluding the Bank of England's holdings) will have more than tripled between 2004/05 and 2024/25.

PSND as percentage of GDP

PSND/GDP	2019/20	2020/21	2021/22	2022/23	2023/24	2024/25
	88.8%	93.8%	96.0%	97.1%	97.0%	96.8%

Source: Budget 2021

Eightfold PSND rise in 20 years

In short, PSND is projected to have risen by more than eightfold between 2001/02 and 2021/22 – a phenomenal increase, irrespective of the COVID-19 impact and the 2008/09 financial crisis, over a relatively short period. It is very debatable whether there is the political will currently to tackle such a massive rise in PSND – until, as will assuredly happen one day, the markets will decide otherwise.

Quinquennial rises

The table below shows how PSND has risen very sharply in each of the quinquennial periods since 2001/02. Unquestionably, these are very steep increases and raise inevitable questions about long-term financeability.

PSND – historical data

£bn	
2001/02	311
2006/07	500
2011/12	1,039
2016/17	1,727
2021/22 (F)	2,503

Source: Budget 2021

Financing

Nonchalance prevails

In recent years, there has been a certain nonchalance about funding the excessive PSND, driven – in part – by the very low interest rates that have prevailed since the 2008/09 financial crisis. Despite minimal yields, investment levels in gilts have remained high, albeit distorted by the impact of Quantitative Easing (QE) and certain provisions imposing investment obligations upon pension funds.

There is, of course, no guarantee that very strong support for gilts will endure. At the international level, the key factor is the yield on 10-year US Treasury Bonds. If, for whatever reason, including heavy disinvestment by China, the yield on US Treasury Bonds were to rise sharply, there would be wide-ranging implications for debt-based economies, including all G7 members.

Markets do turn

The Treasury argues that "the current levels of government borrowing are affordable in the short term". It cites both "a well-diversified investor base" and the comforting fact that "Debt Management Office (DMO) auctions since the beginning of the (COVID-19) crisis have performed well". This may be so – but markets do turn.

More specifically, the Treasury has confirmed that the impact of a 1ppt increase in the relevant gilt variables, including inflation-linked debt, would amount to a £27.8bn higher debt interest bill in 2025/26.

1%+ interest rises – think Black Wednesday fiasco in 1992

In addition, there is, of course, no guarantee that any interest rate increase would be limited to just 1%. As demonstrated in the 1970s and 1980s, and by the infamous financial gyrations of Black Wednesday on 16 September 1992 – which led to the UK's exit from the Exchange Rate Mechanism (ERM) – interest rates can move to far higher levels than has been the case over the last decade, especially if inflation rises sharply.

Whole Government Accounts

The Whole Government Accounts (WGA) are published periodically; the figures for 2019/20 are still outstanding, having been delayed by COVID-19.

Unfunded pension liabilities are key

The WGA show figures drawn up on a similar basis to those of a quoted plc. Hence, all liabilities, including those relating to pension fund payments, are itemised alongside public assets.

The table below, which has rounded the figures to the nearest £bn, shows the financial position at the end of March 2019 – the latest official data. On a WGA basis, net liabilities exceed £2.45tr.

WGA – statement of financial position, 31/03/2019	
£bn	2018/19
Non-current assets	
Property, plant and equipment	1,268
Investment property	23
Intangible assets	37
Trade and other receivables	18
Other financial assets	321
	1,667
Current assets	
Inventories	10
Trade and other receivables	172
Other financial assets	194
Cash and cash equivalents	44
Gold holdings	10
Assets held for sale	1
	432
Total assets	**2,099**
Current liabilities	
Trade and other payables	-133
Government borrowings	-307
Other financial liabilities	-652
Provisions	-18
	-1,110
Non-current liabilities	
Trade and other payables	-59
Government borrowings	-1,100
Other financial liabilities	-98
Provisions	-294
Net public sector pension liability	-1,894
	-3,444
Total liabilities	**-4,555**
Net liabilities	**-2,456**
Financed by taxpayers' equity	
General reserve	-3,019
Revaluation reserve	559
Other reserves	4
Total liabilities to be funded by future revenues	**-2,456**

Source: HM Treasury/ONS

Unfunded £1,894bn public pension liability

In the table above, the £1,894bn public pension liability is, undoubtedly, the key figure. Most public sector pensions are unfunded – hence, the vast "pay-as-you-go" liability.

Of the £1,894bn total, £620bn arises from NHS pension liabilities, while the education equivalent is £411bn; the Civil Service component is a lower – although far from insubstantial – £261bn.

Quoted UK plcs' pension accounting treatment is somewhat different

If a quoted plc were involved, these pension liability figures would effectively be regarded as part of its net debt, in the same way in which BT, BAE Systems and IAG account for their formidable pension deficits. As such, it could be argued that these liabilities should form part of PSND; under present accounting rules, this is not the case.

Publicly-owned infrastructure valuations

The WGA also disclosed some relevant valuations on publicly-owned infrastructure assets, including those owned directly by Network Rail and indirectly by the government. These figures, which will be updated once the 2019/20 WGA are finally published, have implications on the valuation front.

Planned WGA re-visiting

A future edition of the Hardman & Co Monthly will address this issue, once the 2019/20 WGA data are available.

Conclusion

The fund(ing)amental issue

Despite sparse analysis of the UK's PSND, a figure of £2.171tr, which has more than doubled in a decade, along with a near £1.9tr unfunded public pension liability, raises real questions about the UK's ability to finance such formidable debt levels.

Moreover, given the widespread disinterest in addressing the issue of a burgeoning PSND, along with the unfunded public sector pension issue, there is likely to be a time when it is thrust suddenly into the front line of UK politics, most obviously if inflation and interest rates pick up sharply.

Turning worms

The worm may then turn – with a vengeance.

About the author

Nigel Hawkins

Nigel Hawkins is the Infrastructure and Renewables Specialist at Hardman & Co.

Nigel specialises in the energy sector, with a particular focus on the expanding renewable generation market, both in the UK and overseas, about which he has written several reports assessing the sector's finances. He has been involved in analysing the utilities sector since the 1980s. He covered the privatisation of the water and electricity companies for Hoare Govett between 1989 and 1995. Subsequently, he researched the UK and EU telecoms sector for Williams de Broe. He has also written many feature articles for Utility Week magazine since the mid-1990s. Between 1984 and 1987, Nigel was the Political Correspondence Secretary to Lady Thatcher at 10 Downing Street. Nigel joined Hardman & Co in February 2016. He holds a BA (Hons) in Law, Economics and Politics from the University of Buckingham and is a senior fellow of the Adam Smith Institute.

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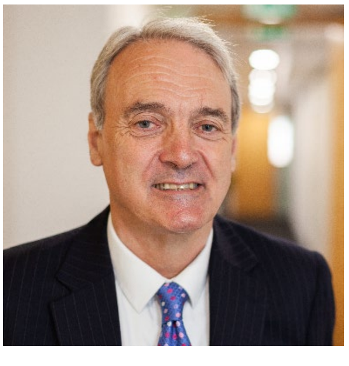

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research@hardmanandco.com

1 Frederick's Place
London
EC2R 8AE

+44(0)20 3693 7075

www.hardmanandco.com