

UK debt and the Scotland independence referendum

The transfer of debt

1.1 In the event of Scottish independence from the United Kingdom (UK), the continuing UK Government would in all circumstances honour the contractual terms of the debt issued by the UK Government. An independent Scottish state would become responsible for a fair and proportionate share of the UK's current liabilities, but a share of the outstanding stock of debt instruments that have been issued by the UK would not be transferred to Scotland. For example, there would be no change in counterparty for holders of UK gilts. Instead, an independent Scotland would need to raise funds in order to reimburse the continuing UK for this share.

1.2 An entirely separate contract between the continuing UK Government and an independent Scottish state's Government would need to be established. The respective shares of debt and the terms of repayment would be subject to negotiation.

1.3 In the event of independence, the full spectrum of assets and liabilities – past, future and contingent – would need to be considered in negotiations between the continuing UK and Scottish Governments, on a case-by-case basis. This means that the negotiations would need to cover the arrangements for all forms of debt covered in this note, not just gilts and Treasury bills.

Aggregate measures of UK debt

1.4 There are several measures of UK debt used in the public accounts which vary in scope, categorisation and therefore size. The most obvious one to start with is 'Public Sector¹ Gross Debt ex^{2,3}', as this a more comprehensive measure of UK liabilities. The note also considers two further measures commonly used and referred to: 'Public Sector Net Debt ex' (PSNDex) and 'General Government Gross Debt' (GGGD). The components of these measures are given below:

Public Sector Gross Debt ex: PSGDex = central government gross debt + local government gross debt + public corporations gross debt – cross holdings of debt

General Government Gross Debt: GGGD = PSGDex – public corporations gross debt

Public Sector Net Debt ex: PSNDex = PSGDex – liquid financial assets – cross holdings of debt

¹ There are some differences in the scope of the public sector between Scotland and the rest of the UK. For example, Scottish Water is a public corporation in Scotland whereas the corresponding services are provided by the private sector elsewhere in the UK.

² "ex" refers to "excluding the temporary effects of financial sector interventions". The financial interventions were made during the crisis to support the financial system.

³ Whilst this note uses current ONS definitions for debt it should be noted that in December 2013 the ONS announced its intention to reclassify Network Rail into the public sector and launched a consultation which includes proposals to redefine the "ex" measures. See following link for details: <http://www.ons.gov.uk/ons/guide-method/method-quality/specific/economy/public-sector-finances/developments-to-public-sector-finances-statistics.pdf>

Table 1.A: Debt levels in 2012-13 under different measures of debt

Measure	Debt level in 2012-13 (£ million)
Public Sector Gross Debt ex	£1,388,273
General Government Gross Debt	£1,386,681
Public Sector Net Debt ex	£1,185,181

Source: November 2013 Public Sector Finance release, Office for National Statistics

Public Sector Gross Debt ex (PSGDex)

1.5 According to the Office for National Statistics (ONS), by the end of 2012-13 UK PSGDex stood at £1,388 billion, or around 87 per cent of GDP.^{4,5}

1.6 UK public sector debt only includes liabilities from the issuance of debt instruments. It does not therefore include liabilities due to other types of instruments (for example derivatives or accounts payable). It only covers the financial liabilities accrued as a result of past government activity. That is, it does not capture expected future liabilities from past government action, such as public sector pension obligations, or nuclear decommissioning costs. Nor does it consider contingent liabilities of the UK Government, such as guarantees the UK government provides.

General Government Gross Debt (GGGD)

1.7 A commonly used measure of debt by international institutions and credit rating agencies is General Government Gross Debt (GGGD). For example, the EU Stability and Growth Pact states that general government gross debt of EU states must not exceed 60 per cent of GDP. GGGD is narrower in scope than PSNDex (described below) in that it excludes debt issued by public corporations. However, since liquid financial assets are not netted off in GGGD it is currently larger than PSNDex. Since privately held debt of non-financial public corporations amounts to less than 0.1 per cent of GDP there is currently little difference between PSGDex, which includes public corporations' debt, and GGGD.

1.8 By the end of 2012-13 UK GGGD stood at £1,387 billion, or around 87 per cent of GDP. The Office for Budget Responsibility (OBR) forecast in December 2013 that UK GGGD will be 94 per cent of GDP in 2016-17.⁶

Public Sector Net Debt ex (PSNDex)

1.9 The headline measure of debt used by the UK Government is "public sector net debt excluding the temporary effects of financial sector interventions" (PSNDex). The UK Government has a fiscal rule which uses this measure of debt.⁷ PSNDex includes all debt issued by the public sector (and held by the private sector) net of liquid financial assets held by the public sector. These assets are largely holdings of cash and deposits such as the official reserves.

1.10 By the end of 2012-13 UK PSNDex stood at £1,185 billion, or around 74 per cent of GDP. The OBR forecast in December 2013 that UK PSNDex will be 80 per cent of GDP in 2016-17.

Impact of financial sector interventions

1.11 Excluded from "ex" measures of debt are the temporary effects of the financial sector interventions made during the crisis. These include the debt on the balance sheets of the public

⁴ This measure does not include the gross liabilities of the Bank of England.

⁵ November 2013 Public Sector Finance release, Office for National Statistics – available at www.ons.gov.uk

⁶ Economic and fiscal outlook – December 2013, Office for Budget Responsibility

⁷ The supplementary target requires PSNDex as a percentage of GDP to be falling at a fixed date of 2015-16.

sector banks currently under UK government control, including the Royal Bank of Scotland and Lloyds Banking Group. Since these banks will eventually be returned to the private sector their impact on debt is distortive and is therefore excluded from headline measures of debt.

1.12 By the end of 2012-13 the net debt on balance sheets of the UK public sector banks stood at around £1,000 billion or around 63 per cent of GDP, which largely reflects net debt of the Royal Bank of Scotland and Lloyds Banking Group. This debt is classified within the debt of public corporations and is counted as part of PSND and PSGD but excluded from PSNDex or PSGDex. It is also not counted in GGD as public corporations are outside of the scope of general government.

The valuation of existing debt

1.13 Importantly, all measures of debt in the public accounts are not “marked to market”⁸. That is, they do not reflect the current market value of the debt should it be resold in the secondary market. Instead, they reflect the nominal value of the debt at maturity. For example, a conventional gilt issued by the Debt Management Office is accounted for in the public finances at its nominal redemption value – the amount, or ‘principal’, that the Government must repay the gilt-holder when the gilt matures/redeems. Inflation linked securities are recorded at their nominal value plus an accrued inflation uplift up to that date.

1.14 It should be noted that it is the market value of UK debt that represents the present value of the liability and includes the cost of future interest payments. At current interest rates the market value of most UK debt is greater than the nominal redemption value recorded in the public accounts.

The components of UK debt

1.15 UK public sector debt is the outstanding value of all debt instruments issued by the public sector. It is comprised of debt held by:

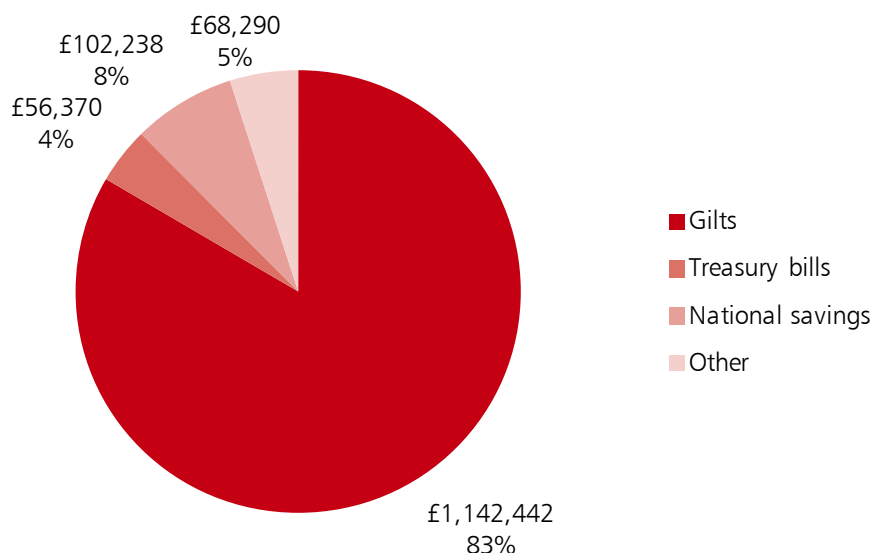
- 1 central government;
- 2 local government; and
- 3 public corporations.

Central government debt

1.16 UK central government gross debt totalled £1,369 billion in 2012-13, of which £1,142 billion was from the issuance of gilts and the remainder from Treasury bills, national savings debt, and other means. This breakdown of central government gross debt by debt instrument is shown below.

⁸ A notable exception is foreign currency holdings which are converted to sterling at the prevailing exchange rate.

Chart 1.A: Breakdown of 2012-13 central government gross debt by debt instrument, £ million



Source: November 2013 Public Sector Finance release, Office for National Statistics

1.17 The majority of UK debt is funded by the issuance of gilts but National Savings & Investments (NS&I) products currently constitute 8 per cent of existing UK debt. In Scotland there are 1.66 million customers who have a total of £5.65 billion saved in NS&I products.⁹ These products are not typically sold to non-UK residents. NS&I's products may only be purchased using a UK bank or building society account. Where customers nominate an account to receive payments, i.e. interest dividend payments and Premium Bond prizes, the nominated account must be a UK bank account. Currently payments are only made in pounds sterling. In addition, the Direct ISA and Direct Saver accounts are only available to UK residents. Whilst NS&I products can be purchased by those outside the UK, they are offered on the basis that the purchaser checks that local regulations allow them to purchase and hold.

Local government debt

1.18 UK local government gross debt totalled £85 billion in 2012-13, of which £67 billion is debt owed to central government. A large proportion of this is owed to the Public Works Loan Board (PWLB), a statutory body operating within the United Kingdom Debt Management Office, whose main function is to lend money to local authorities. Funds are advanced to the PWLB by the National Loans Fund (NLF) in order to make loans. Loan repayments are then surrendered back to the NLF as repayment of the PWLB advances. The remaining local government debt is directly raised from banks and financial markets and held by the local authorities.

1.19 Of the £85 billion UK local government gross debt in 2012-13 around £10 billion,¹⁰ or 12 per cent, is debt accruing to Scottish local authorities, of which £8.7 billion is owed to the Public Works Loan Board.

⁹ National Savings & Investments

¹⁰ *Scottish Local Government Financial Statistics 2011-12*, published by the Scottish Government, shows that in 2011-12 the precise figure was £12.13 billion.

Public corporations debt

1.20 Gross UK non-financial public corporations debt totalled £10 billion in 2012-13, of which £8.9 billion was debt owed to central government. Some corporations are 100 per cent located in a country, such as Scottish Water, which has borrowed around £3 billion of the £10 billion gross UK non-financial public corporations debt. However, others operate across the UK as a whole.