Some Observations on Debt Audit

The starting point for any discussion of a debt audit must be the principle that in a democratic polity *all* public sector and government income and expenditure, as well as debt, must be audited. Governments and politicians must be held accountable for all their financial as well as political transactions. So too must supposedly independent arms of the government.

Pooling and hypothecation

The monitoring of government financial transactions is complicated by the consolidation of government revenues and debts. Typically, government revenues are pooled and then allocated to particular expenditures, including capital expenditures that involve buying assets (such as schools, hospitals, roads, ministry buildings). Any deficit between total revenues and total expenditures consists of debts or, if some part of the debt is monetised, claims of the government bank on the government. There is therefore no particular debt issue, or revenue stream, that may be identified as having financed a particular expenditure. Any corrupt or illegitimate expenditure cannot usually be traced back to an identifiable tax or debt issue that may have financed it. The normal practice for dealing with corrupt or illegitimate expenditure is to require repayment from the beneficiary of the expenditure (for example a private contractor who overcharges for materials) rather than repudiation of, or default on, some portion of a debt that will have financed government expenditure in general.

The only exception to such pooling of revenues and debt may be where government income, expenditure, and debt are 'hypothecated', that is taxes are allocated to particular activities, and debts are then issued by the agency responsible for those activities. For example, car owners in the UK pay a car tax that is in theory allocated to the building and maintenance of roads. If the road building agency were able to issue debt then it might be possible to track debt to particular expenditures. However, because a debt backed by government revenue in general, which can be raised by the introduction of new taxes, is more secure than a debt backed by revenues from a specific tax, governments usually consolidate debts to reduce financing costs. Nevertheless various legal constraints on government debt, such as the Maastricht Treaty and constitutional debt ceilings in the United States and elsewhere, are encouraging hypothecation, through supposedly independent agencies, as a way of transferring government debt from the government balance sheet. This increases the cost of the debt, since the 'non-government' agency usually has to pay a higher rate of interest than the government, unless it issues debt under government guarantee. If those guarantees are not reported in the government's debt statement then the government is falsely reporting government obligations. But if those obligations are fully reported then the financial purpose of hypothecation, to get government debt off its balance sheet, has been subverted.

Stabilising financial operations

The auditing of government income, expenditure and debt must also take into account the necessary financial operations that governments need to perform to maintain an effective market in government bonds and a stable financial system. Such financial operations alter the profile of government debts. Auditors of government debt need therefore to be aware of them.

I have elsewhere argued that two kinds of financial operations are necessary in Europe to stabilise the financial system, as a precondition for a revival of economic activity. The first is a need for more active open market operations in government debt to maintain the stability of

government debt markets. This means more frequent buying and selling of government paper than happens at present. The present, very public buying in an effort to arouse 'shock and awe' in the secondary markets for government bonds, combined with declarations of 'this time, but not again' in order to discourage so-called 'moral hazard', or government reliance on central bank buying of the bonds, are clearly inadequate. Routine, repeated, open market operations are necessary to maintain a liquid market in government bonds, in order to encourage the use of these bonds as risk-free means of payment in the financial markets. It is such liquidity of government paper, rather than any debt ceiling, that is a precondition for financial stability.

The other financial operation that is necessary to stabilise the financial system is a tax on financial intermediation, in the form of a tax on holdings of financial assets, whether by financial institutions or by non-financial corporations, which hold increasingly large financial portfolios. The proceeds of such a tax would be used to buy back government bonds at their repayment price. Such a balance sheet tax would assist in maintaining a liquid market in government bonds, with high prices and therefore lower costs of government finance. The tax would be the contribution of financial intermediaries to the maintenance of stability and liquidity in markets in which they operate and has the fiscal advantage that it would not affect expenditure in the economy.

Balance sheet implications of financial operations

Such financial operations have two consequences for the balance sheet of the government. First of all they imply operations along the yield curve. This is the curve that shows the relationship between the yield (or interest cost of financing) and the term to maturity of government bonds (or the period of time before a given bond has to be repaid). A yield curve is usually upward-sloping, indicating that yields, or costs of financing, on short-term borrowing (say up to a year) are lower than those on long-term bonds that have ten or more years before they are due to be repaid. It is in a government's financial interest to keep long-term yields as low as possible because this then stabilises the cost of government borrowing at a low level over this longer period of time to maturity.

One way to reduce the long-term yield is for the government, or its central bank, to borrow money in the inter-bank market by selling short-term Treasury bills, with a maturity of say three months. The money borrowed is then used to buy in long-term government bonds at a higher yield. This operation is known among central bankers as a 'Twist'. When a government buys back its own bonds these bonds are in effect cancelled. So the operation does not change the amount of a government's debt. It merely changes its maturity profile, i.e., how long before the outstanding debt has to be repaid. However, by creating an artificial shortage of long-term government bonds, it may allow the government then to finance the repayment of the short-term bills by an issue of long-term bonds at a lower financing cost. It may even be worthwhile to refinance long-term debt by an issue of new debt at a lower rate of interest.

The other consequence of financial operations undertaken to stabilise the financial markets is that a government may find it necessary to 'over-fund', i.e., to issue more debt than is strictly necessary to finance the government's current deficit between its revenues and expenditure. Overfunding may occur if, for example, the government or its central bank issues long-term bonds in order to reduce the liquidity in the financial markets, because it wishes to reduce the money supply, or, more recently, to 'sterilise' a capital inflow. Overfunding reduces

commercial bank reserves in the same way that, most recently, quantitative easing, or the buying of bonds, has been used to increase commercial bank reserves. Such overfunding or underfunding is used to stabilise the financial system.

Conclusion: Democratic oversight of central bank balance sheet

Financial operations to stabilise and manage the financial markets have important implications for what a government's balance sheet, or its current outstanding debt, may say about that government's previous income and expenditure. With such financial operations, a significant, if not a major part of outstanding government debt, comes to consists of loans or bonds undertaken to repay other loans or bonds, or bonds issued to manage commercial bank liquidity. With quantitative easing, bonds that may been issued at a particular time to finance current expenditure, have been 'monetised' and are held by the central bank as claims on the government against reserves of commercial banks. The total debt outstanding at any one time comes to have only a tenuous link with past government expenditure and tax revenue. Indeed, original debt issued to finance a particular undertaking may have disappeared and been replaced by consolidated debt due to financial operations,

The disappearance of 'original' debt through the financial operations necessary to keep financial markets liquid and government financing costs low point to an important extension of debt audit demands. Independent central banks now argue that their cheap money policies of low interest rates, and quantitative easing to keep commercial banks liquid, are sufficient to stem the deflation that is depressing economic activity in the major capitalist countries. But cheap money and liquid banks cannot by themselves reflate economies that need much more active and stimulating fiscal and industrial policies. The debt audit should be extended to include a demand for greater accountability of central banks for their open market operations and for how those operations are supporting government financing and promoting more effective policies for economic recovery.

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