

A broader picture of the public sector balance sheet: State pension and other other pension obligations - An update at April 2012

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Abstract

Earlier ONS articles have discussed the broader public sector 'balance sheet' - including public sector assets, liabilities and obligations which are not normally included within core Public Sector Finances statistics. These previous ONS articles have included indicative quantifications of these assets, obligations and net worth, making use of currently available published figures. Since the last ONS article was published on this subject in December 2011, further indications of the size of Government pension obligations have become available as a result of work by ONS. These pension obligations estimates are published today in a separate ONS article. This article summarises the new pension obligations estimates and discusses their implications for assessing the broader 'public sector debt'. It clarifies that, while such new estimates provide very useful extra information for assessing the state of the UK economy, they do not add to public sector debt in either the general or accounting sense.

1. Introduction and background

Earlier ONS articles (Hobbs (2010a¹), Hobbs (2010b²), Hobbs (2011³)) have discussed the public sector assets, liabilities and obligations that fall outside the existing Public Sector Finances statistics, including the official fiscal measures, and have produced indicative quantifications of such assets and obligations. Hobbs (2010a) included published estimates of Government pension obligations, from both official and unofficial sources available at that time.

Since that time, the international methodological framework for statistics has moved on. The international framework – the *System of National Accounts* (SNA) has been revised. The new edition, published in 2010 (but referred to as 'SNA2008') includes a general requirement that National Accounts should be accompanied by a supplementary table on pensions, providing a range of estimates including those for Government pension obligations. Such obligations include those relating to state pensions.

While SNA2008 is the generally accepted international framework, the UK is legally obliged to comply with the European derivative of the SNA – the *European System of Accounts* (ESA). The current ESA – ESA95 - is in the final stages of revision and the new edition ('ESA2010') is due to be finalised and published shortly with an expected implementation date of 2014. Like SNA2008, ESA2010 includes the requirement for a supplementary table on pensions.

The first publication of the UK's audited *Whole of Government Accounts* (WGA)⁴ – a set of consolidated accounts for the UK public sector - occurred on 29 November 2011 and provided a wide range of valuable information useful for the purpose of analysing the state of the UK public sector's finances. A previous, unaudited, summary had been published in July 2011. The WGA include a range of figures relating to Government pensions liabilities but these do not include an estimate of any obligations arising from the state pension schemes. The first published WGA (for the year 2009-10) explained, in its Note 1.18 "*Pension costs and public service pension liability*":

"State retirement pensions are outside the scope of the IAS 19 'Employee Benefits pension liability', as they are paid to the general public, and are not employee benefits for public sector staff. State pensions are contributory benefits paid in accordance with government policy and are expensed as incurred (Note 6). Contributory benefits are funded from National Insurance Contributions, and are administered by the Department of Work and Pensions on behalf of the National Insurance Fund. Future state pension benefits are not recognised as a liability as they are only entitled to be paid as they fall due".

In a similar vein, the Office for Budget Responsibility's (OBR) *Fiscal Sustainability Report, July 2011*⁵ (FSR) commented (paragraph 2.35) on the nature of the state pension obligation and its degree of certainty as compared with public service pensions liabilities:

"The WGA includes net public service pensions liabilities, but excludes the present value of future state pension payments to the population in general. The rationale for this is that the public service pensions are a contractual obligation, while state pensions are a liability that arises according to the circumstances and legislation prevailing at the time of the claim, which makes any estimate of future payments too uncertain. But this distinction is less clear in practice, as the government can alter – and has altered – the generosity of public service pension payments. In June 2012, the Coalition Government announced that public service pensions would be uprated in line with consumer prices index (CPI) inflation rather than the generally higher rate of retail prices index (RPI) inflation from April 2011. This will reduce public service pension payments from 2011-12 onwards and will therefore also reduce the WGA net pension liability when this is revalued for the 2010-11 WGA".

As explained in earlier ONS articles, for example Hobbs (2010a), UK Government pension obligations include those relating to:

- liabilities of unfunded, pay-as-you-go (PAYG) public employee schemes including those for teachers, NHS employees, civil servants, members of the armed forces, the police and fire-fighters
- liabilities of funded public sector schemes, the largest being the Local Government Pension Scheme (LGPS) for local authority employees
- obligations relating to the state pension schemes

The new, experimental, supplementary table on pensions, to accompany the core National Accounts from 2014, includes a range of information on pension scheme obligations for both the public and private sectors. It provides estimates of the actuarial obligations of all pension schemes for which government is the pension 'manager'. These are mainly public sector schemes and include public employee schemes, both funded and unfunded, and the state pension schemes.

The estimates in the new table cover the estimated gross liabilities, at end of December 2010, of pension schemes included in 'social insurance', as defined by the SNA – that is workplace pension schemes and state pensions accrued through National Insurance contributions. It does not include individual personal pensions as they are not considered part of social insurance; nor does it include social assistance (for example Pension Credit), or health, long-term care insurance or individual insurance policies.

The methodology and data sources utilised in developing the pension statistics for the new supplementary table were described in recent ONS articles (see Levy (2011a)⁶ and Levy (2011b)⁷). These drew attention to the difficulties involved in providing a single figure estimate for Government pension obligations, including obtaining suitable data, the necessary assumptions about mortality, earnings growth etc, and the choice of suitable discount rates. They also explained the differences between the approach taken for the purposes of the supplementary table and that used within the Whole of Government Accounts.

2. Previous estimates of Government pension obligations

2.1 Unfunded state pension obligations

Levy (2012) explains that the last official figure for the state pension schemes' obligations was produced by the Government Actuary's Department (GAD), as at 31 March 2005, at £1.347 trillion, for Great Britain, based on the legislation in force at that date. The GAD estimate comprised liabilities of £1.02 trillion relating to accrued rights to the basic state pension and £0.33 trillion relating to accrued rights to additional pension, net of amounts given up as a result of contracting out. HM Revenue and Customs published a UK-equivalent figure, as at the same date, of £1.354 trillion.

The state pension scheme (providing the basic and additional state pensions) is classified as a social security scheme, and the pensions it pays are classified as social benefits, in the National Accounts, the benefits being paid on a pay-as-you-go (PAYG) basis from the National Insurance Fund. As explained above, these obligations do not constitute a 'liability' in the financial reporting sense and so are not included as a liability within the WGA. Consequently, the estimates of state pension obligations that the new ONS supplementary table on pensions presents are the first official estimates of such obligations since 2005.

2.2 Unfunded public service pensions (i.e. unfunded public employee schemes)

Hobbs (2010a) discussed a range of estimates, both official and unofficial that had been made of public service pension obligations at that time – ranging from £770 billion (the ONS’s estimate as at 31 March 2008, published in *Pension Trends*⁸, and based on published accounts of pension schemes and departmental resource accounts) to an estimate, at end of March 2010, of around £1.2 trillion according to a March 2010 report by the actuarial consultants Towers Watson. The range of such estimates is explained by the range of different assumptions, including those about discount rates, that are made in deriving such estimates.

Hobbs (2011) updated these official estimates using data published in *Pension Trends* and the 2009-10 WGA (the latter prepared under the International Financial Reporting Standards (IFRS) principles enshrined in the accounting manual for government entities – the *Financial Reporting Manual*⁹). Hobbs (2011) indicated that, at the end of March 2010, unfunded public service pension liabilities stood at £1.02 trillion. As explained in *Pensions Trends* and in the FSR, much of the rise in these liabilities is explained by the degree of variability in the market-based interest rates that are used in producing these accounting-based estimates.

2.3 Funded public service pensions

Hobbs (2011) explained that the largest funded public service pension scheme is the Local Government Pensions Scheme (LGPS). *Pensions Trends* Chapter 14 (April 2011, page 14-7) stated that the latest available figures indicated that the LGPS had, at 31 March 2007, assets of £132 billion and liabilities of £159 billion (i.e. a net liability of £27 billion).

3. The new ONS estimates

The new supplementary table published by ONS in Levy (2012)¹⁰ includes the following headline figures for Government pension obligations as at end December 2010:

- Social security pension schemes (i.e. unfunded state pension scheme obligations): **£3.843 trillion**, being **263 per cent of gross domestic product (GDP)** (£3.497 trillion at end of December 2009)
- Centrally – administered unfunded pension schemes for public sector employees (i.e. unfunded public service pension scheme obligations): **£852 billion**, being **58 per cent of GDP** (£915 billion at end of December 2009)
- Funded DB pension schemes for which government is responsible: **£313 billion**, being **21 per cent of GDP** (£332 billion at end of December 2009).

In summary, the estimates in the new supplementary table indicate a total Government pension obligation, at the end of December 2010, of **£5.01 trillion**, or **342 per cent of GDP**, of which around £4.7 trillion relates to unfunded obligations.

Levy (2012) clarifies that the new supplementary table applies an EU-required standard, stable, discount rate of 3 per cent (real) or 5 per cent (nominal) for purposes of comparability. This compares with the variable discount rates used in previous official estimates; for example, the 2009-10 WGA reports – Note 27.6 – that the discount rate used for central government schemes went from 3.2 per cent in 2008-09 to 1.8 per cent in 2009-10 and was largely responsible for the sudden increase in central government funded and unfunded schemes' liabilities over that period.

It is therefore unsurprising that the new ONS estimates of Government pension liabilities and obligations, as provided in the new supplementary table, are considerably different from previous estimates. Levy (2012) provides a commentary on the significance of discount rate assumptions for estimates of pension liabilities and obligations and provides indicative sensitivity analysis for the estimates within the new supplementary table.

4. Relevance of the new ONS Government pension obligation estimates

As discussed above, the new ONS supplementary table provides a relatively comprehensive set of estimates of Government pension obligations. These updated estimates differ from previous estimates reported by ONS for a number of reasons, including that they relate to a different time (end December 2010), use different methodologies and make different assumptions, including those relating to discount rates.

The new ONS estimates provide useful and interesting additional information on Government pension obligations. In terms of their scale, it is interesting to compare the new estimates of unfunded Government pension obligations at the end of December 2010, at around £4.7 trillion, with the level of Public Sector Net Debt (PSND) at that time.

As explained in earlier ONS articles, for example O' Donoghue (2010)¹¹, PSND is published on two bases – that including the impacts of the financial sector interventions (PSND) and that excluding the interventions ('PSND ex'). At the end of December 2010 – see the latest published estimates in *Public Sector Finances: Statistical Bulletin, March 2012*¹² - PSND ex stood at around £883 billion (59.4% of GDP) and PSND at £2,257 billion (151.8% of GDP).

The latest published figures, as at the end of March 2012, were PSND ex of £1,023 billion (66.0% of GDP) and PSND of £2,181 billion (140.8% of GDP).

However, as explained in the ONS, OBR and WGA reports described above, Government pension obligations, because of their more contingent nature, and the extent to which they are extremely sensitive to discount rate assumptions, should not be simply added to public sector debt.

5. Conclusion

As discussed in Hobbs (2010a) and Hobbs (2011), public sector obligations fall into a spectrum ranging from clearly measurable and time-bound liabilities through to remote and unquantifiable contingent obligations. The former will generally be included within balance sheets; the latter rarely. Where a specific obligation falls on this spectrum is often strongly debated and views change over time.

As cautioned in previous articles, care should be taken when aggregating or comparing such different data sources and the data provided by this article should be viewed in this context. Consequently, the new estimates of Government pension obligations presented in Levy (2012) should be used carefully.

The purpose of this article is not to provide a 'single figure' for the public sector's indebtedness but, rather, to promote transparency by drawing attention to the broader range of information that is available on the obligations of the UK public sector.

Background notes

1. Details of the policy governing the release of new data are available by visiting www.statisticsauthority.gov.uk/assessment/code-of-practice/index.html or from the Media Relations Office email: media.relations@ons.gsi.gov.uk

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This document is also available on our website at www.ons.gov.uk.

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