

Sir Humphrey's Legacy: An Update

UK Public Sector Unfunded Occupational Pensions

Neil Record

January 2008

27th IEA CURRENT CONTROVERSIES PAPER

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Summary

Five important events have occurred since the IEA published '*Sir Humphrey's Legacy*' in September 2006:

- The Government has not published total public sector occupational pension liabilities for two years running – breaking a well-established convention.
- The Government has reduced the real (after inflation) discount rate² it applies to value its unfunded pension liabilities from 2.8% p.a. to 1.8% p.a. from 31 March 2007.
- The Government has *not* increased the employer or employee contributions in 2007-08 to reflect the much higher current service cost³ that a 1.8% discount rate would require.
- The Government has explicitly chosen⁴ *not* to conform to the new International Employee Benefits accounting standards for the Public Sector (IPSAS 25).
- It has become clear that the Government uses two different discount rates in its pension calculations; one adheres to FRS17; the other is a fixed rate. This makes a material difference to the charging and recording of pensions costs.

¹ Neil Record is the author of the IEA monograph on unfunded public sector occupational pensions, *Sir Humphrey's Legacy (Sir Humphrey's Legacy - Facing Up to the Cost of Public Sector Pensions)*. Neil Record. IEA Hobart Paper 156, September 2006. ISBN-10: 0 255 36578 0, ISBN-13: 978 0 255 36578 9. Also available at <http://www.iea.org.uk/files/upld-book390pdf?.pdf>. He is a former Bank of England Economist, and Chairman and CEO of Record plc, a currency asset manager. This update expresses his personal views, not those of Record plc.

² I use 'discount rate' and 'interest rate' interchangeably in this paper.

³ "Current service cost" is the calculation of how much an employer should to pay each year to fully fund the pension obligations it takes on in that year. It is the same as the 'change in liability', since excluding employer's pensions payments and contributions, and excluding any return on assets and liabilities, the employer's pension obligations will increase by this amount.

⁴ Source: HM Treasury Paper FRAB (84) 11; 12 Feb 07, Para 14 (IPSAS Compliance). Paper available at http://www.hm-treasury.gov.uk/media/1/A/frab84_11_discout_rate_pension_liabilities.pdf

This update analyses the impact of this new information, and makes recommendations. I begin by outlining the recommendations.

Recommendations

1. The Government should publish the Public Sector unfunded occupational pension liabilities for March 2006 and March 2007 forthwith. A timetable should be established for the annual publication of this figure in the future. The public sector pension liabilities are a substantial debt burden that will have to be borne by future generations of taxpayers and their magnitude should be published.
2. The Government's actuaries should calculate the annual contributions required from employers and employees for 2007-08 under its SCAPE⁵ methodology on the basis of its newly-adopted real discount rate of 1.8% p.a. It has become clear that the Government is currently using a fixed 3.5% p.a. rate, and this *grossly understates the true annual cost* of providing pensions to key groups of public sector workers. The effect of this is fully quantified in the main text.
3. The Government should conform to IPSAS 25 (Employee Benefits) Accounting Standard in the choice of discount rate. This is an international standard for Government accounts. Conformity to IPSAS 25 would mean the real discount rate for 2008-09 and beyond would be the Index-linked gilt market rate for the appropriate maturity. The use of all artificial or differing discount rates should be ended.
4. Consideration should be given to changing the accounting definition of Government spending on its occupational pensions from a cash basis (i.e. only pensions in payment are recognised, as at the moment) to an accruals basis (i.e. pensions in payment should be excluded, but the cost of new pensions promises each year - the current service cost, and the interest cost on the liabilities - should be included). This change would bring the Government more in line with international accounting conventions for pensions as they apply to both the public and private sectors, but more importantly would give taxpayers and policymakers a much clearer idea of the cost of public sector pensions. This change would be highly material at the whole economy level (and hence would need to be introduced with care), and this scale is quantified in the main text. However, it is only by making these costs explicit that sensible negotiations can take place

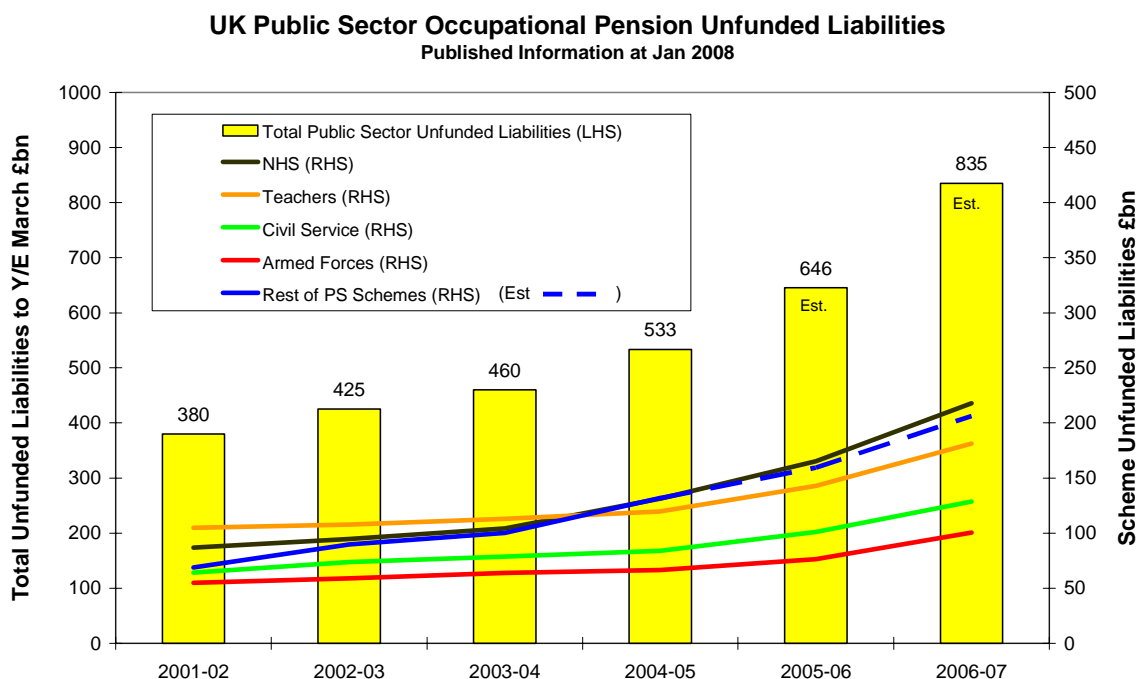
⁵ Superannuation Contributions Adjusted for Past Experience. See *Sir Humphrey's Legacy* for a description of this (perfectly sensible) method.

between public sector employees and employers about the nature of their benefits packages.

Public Sector Pension Liabilities

Since the publication of *Sir Humphrey's Legacy* in September 2006, there have been two years'-worth of Resource Accounts published for the four main UK Public Sector schemes (NHS; Teachers; Civil Service; Armed Forces). The years in question are year ending 31st March 2006 and year ending 31st March 2007. However, as mentioned in the Summary above, the Government has chosen not to report the Public Sector total liabilities, even though it clearly has this information available, and indeed we can estimate it reasonably accurately from these Resource Accounts and other disparate sources. Graph 1 shows the four main schemes with the updated numbers for 2005-06 & 2006-07, *as calculated using the Government's basis*.

Graph 1



Note that under “Rest of PS Schemes” are Police and Fire (which fall under Local Authority control, and so are disaggregated in reporting terms), NHS Scotland & Northern Ireland, Teachers Scotland & Northern Ireland, and miscellaneous schemes (including Northern Ireland).

There are several notable features:

- The NHS scheme’s liabilities are rising much faster than the other three main schemes. The average annual compound growth rate over the last five years in the NHS scheme has been 20.2%. This appears to be a ‘perfect

storm' combination of high salary growth rates, especially amongst the higher-paid employees (GPs; Consultants etc.); high staff-number growth rates; upward revisions of longevity (actuarial) assumptions, and lowered discount rates. There is an important lesson here. When the Government adds to NHS spending by, for example, increasing salaries, there is a current cost that is revealed and charged to current taxpayers (the higher salary). However, when an employee's salary in the NHS increases, the whole of the employee's past accrued pension rights (resulting from earlier years of employment) increase in value too. This cost is excluded from published figures for current Government spending despite the fact that it arises as a result of a decision taken at the current time. In the economic sense it is no different from a decision by the Government to take on an additional debt burden.

- The 'Rest of PS Schemes' have also grown very fast, but this category is difficult to fully analyse because it is the residual of the 'big four' and the total liabilities as reported by Government.
- Most (69.8%) of the liability rise in the last two years has been the effect of the Government lowering the real discount rate from 3.5% p.a. to 2.8% p.a. (on 1st April 2005, affecting the 2005-06 liability), and from 2.8% p.a. to 1.8% p.a. (on 31st March 2007, affecting the 2006-07 liability). On the Government's own figures⁶, these two effects have caused an increase in liability of £158.4bn in the four main schemes, compared with the total rise of £227bn in the four main schemes over the last two years. £50.3bn of this increase in the liabilities is from the 1st April 05 change in the discount rate and £108.1bn of the change is from the 31st March 07 change in the discount rate.
- In Table 9 in *Sir Humphrey's Legacy*, I calculated the elasticity of liabilities with respect to interest rate changes (or 'Duration'⁷) from the 1st Apr 2005 discount rate change, based on the Government's own figures in the respective Resource Accounts. Table 1 below shows the same analysis, conducted on the 31st March 2007 discount rate change. Those interested in the technicalities might note that the duration (elasticity) has risen from an average of 18.0 years in 2005 to an average of 20.8 years now⁸. The only Scheme not to illustrate this effect is the Armed Forces – and this may reflect a shrinking workforce and therefore a maturing scheme. These

⁶ Sources: The Resource Accounts 2001-02 to 2006-07 of the four main pension schemes.

⁷ See *Sir Humphrey's Legacy* for a definition of Duration. In this example, the NHS calculation is $22.9\% / (2.8\% - 1.8\%) = 22.9$

⁸ This is not surprising, as it conforms to the lengthening effect on duration of lowering discount rates (known as 'convexity' in bond financial maths).

estimates of the elasticities allow the liabilities to be estimated at different interest rates – in effect, the elasticity measures how sensitive the estimate of the liabilities is to changes in the discount rate assumption. Thus we can use the elasticities to estimate the value of public sector pension liabilities at rates of interest different from the inappropriate rates that are used by the Government.

- Using the elasticities above (and even excluding convexity), we can calculate the total liabilities at 31st March 2007 based on market (Index-linked gilt) real interest rates, but otherwise on the Government's own figures. Market interest rates of 20.8 years' duration at 31st March 2007 were 1.19% p.a. real. This would mean that if 'Other Public sector schemes' have the same duration as the average of the main schemes, then the total public sector liability at 31st March 2007 was £835bn x (1 + (20.8 x (1.8% - 1.19%))) = £940bn based on the Government's own actuarial and other assumptions. If we include my other adjustments to Government assumptions from *Sir Humphrey's Legacy*⁹, which totalled a further uplift of 13.9%, then my current estimate of the 31st March 2007 liabilities estimate is £940bn x (1.139) = £1,071bn.

Table 1

Official estimates of Public Sector Pension liabilities' interest rate elasticity at March 2007				
	31 March 07 Liability post- interest-rate change £bn	31 March 07 Liability pre- interest-rate change £bn	% Change	Duration over this range (yrs)
NHS	218.0	177.4	22.9%	22.9
Teachers	181.3	153.0	18.5%	18.5
Civil Service	128.8	106.8	20.6%	20.6
Armed Forces	100.5	83.3	20.6%	20.6
Total	628.6	520.5	20.8%	20.8

Sources: 2006-07 Scheme Resource Accounts

⁹ I used 2% p.a. annual real salary growth, whereas the Government uses 1.5% - this added 5.9% to my liability estimate. I also used lower mortality figures than the Government, which added 7.6%. The geometric sum of these uplifts is (1.059x1.076)-1 = 13.9%. See Table 11 in *Sir Humphrey's Legacy* for details.

The Discount Rate

One of my fundamental arguments with the Government's current methodology is the choice of discount rate.

In *Sir Humphrey's Legacy* I made the case that an unfunded scheme, such as we have here, cannot in logic assume a real discount rate other than that which applies to the borrowing and lending capacity of the sponsoring institution. The argument for a funded scheme invested in risky assets may be less clear-cut – but in an unfunded case, there is no logic which can justify any other rate.

International Public Sector Accounting Standards

The use of the risk-free discount rate, proposed in *Sir Humphrey's Legacy*, has now been recognised (November 2007) by the International Public Sector Accounting Standards Board (IPSASB) in a new public sector Employee Benefits International Accounting Standard - IPSAS 25. This is based on the international private sector Standard IAS19, which in turn has strong roots in FRS17, the equivalent UK standard for private sector entities. Interestingly, in IPSAS 25 there is no distinction between funded and unfunded schemes – public sector liabilities are all to be discounted at the risk-free (Sovereign) rate.

This new standard was preceded by Exposure Draft ED31, for which consultation is now closed. The relevant clause in this draft is as follows:

“The rate used to discount post-employment benefit obligations (both funded and unfunded) shall be a risk-free rate determined by reference to market yields at the reporting date on Government bonds, or, where there is no deep market in Government bonds, or where market yields at the reporting date on Government bonds do not reflect a risk-free rate, by reference to market yields on high quality corporate bonds. The currency and term of the Government bonds or corporate bonds shall be consistent with the currency and estimated term of the post-employment benefit obligations.”

I note that no representations on this matter were received from the UK Government in the consultation period, *although apparently there nearly were*. The extract from the minutes of the UK Government's Financial Reporting Advisory Board (FRAB)¹⁰ meeting of 12 Feb 2007, when the IPSAS Exposure Draft 31 was discussed¹¹, shows that HM Treasury had prepared a letter to go to the IPSASB, presumably justifying their opposition to the use of the risk-free rate, but that the

¹⁰ The FRAB is the body responsible for determining the discount rate used for discounting Public Sector liabilities.

¹¹ The minutes of this meeting are at http://www.hm-treasury.gov.uk/media/B/A/frab84_minutes_120207.pdf

meeting decided not to send the letter. The contents of the proposed letter have not been published.

Government Position on the Discount Rate

The Government's position on the discount rate to be applied to public pensions has been quite difficult to unravel. I reported in *Sir Humphrey's Legacy* the following statement from the 7th meeting of the FRAB:

"Section 2.10.... the Board noted that it had accepted that the discount rate for pension scheme liabilities promulgated by the Treasury on the advice of the Government Actuary's Department should remain at 3.5 per cent in real terms for accounting periods prior to 2005–06. This rate was based on a review of long term historical patterns of real rates of return on gilts. However, as also noted in the Board's sixth report, the Treasury accepted the Board's proposal that the discount rate ought to be set in line with the requirements of the FRS: the AA corporate bond rate. The Board agreed that, in order to achieve budgetary certainty, the rate would be reviewed for each Spending Review period.

Section 2.11. The Treasury reported to the Board at its March 2004 meeting that the Government Actuary's Department had concluded its review of the discount rate for provisions for pension scheme liabilities. Based on the yields of AA corporate bonds with maturity dates of more than 15 years, measured over a three month period, the Actuary has determined that the rate to be used, with effect from 2005–06, in discounting pension provisions is 2.8 per cent real. The impact of a reduction in the discount rate is an increase in the level of the provisions; the overall impact of the change will be accounted for in central Government

However, I have now seen a more recent document, published by the Treasury¹² in 2007, which adds a new dimension by making it clear that two quite different discount rates are being used simultaneously. I quote (extracts):

"...2. The discount rate for pension liabilities will change from 2.8 per cent real to 1.8 per cent real with effect from 31 March 2007.

3. This rate does not apply for investment appraisal purposes, for calculating employer pension contributions or for provisions other than for pension liabilities.

5.The lower discount rate will also result in a lower charge for the unwinding of the discount (interest charge) in the existing pension liability provision and a higher current service cost....

....8. From 2005-06, the accounts of the public sector pension schemes within central Government prepared under the requirements of Financial Reporting

¹² "Guidance on managing the change in discount rates for pension liabilities", PES (2007) 02, 1 Feb 07, HM Treasury. Available at: http://www.hm-treasury.gov.uk/media/B/4/pes_2007_02.pdf

Standard (FRS) 17 have been using a real discount rate of 2.8 per cent reflecting GAD's advice on the appropriate AA corporate bond rate. GAD has advised that the AA corporate bond rate as at 31 January 2007 is 1.8 per cent....

*...12. Various arrangements are in place for setting employer contributions in unfunded schemes that also require a discount rate. Most of these arrangements are based on the SCAPE methodology that uses a fixed real discount rate. These arrangements are unaffected by the discount rate used for FRS17 purposes. Schemes and their actuaries should continue to use existing arrangements: in particular, **under SCAPE, the real rate of return of 3.5 per cent should continue to be used.**" (my bold)*

I had previously been led to believe that there was one real discount rate that applied across all public sector pension liability and current cost calculations, but it appears from my highlighted bold wording in this statement from HM Treasury that this belief may have been misplaced. This is important because SCAPE is the principal means by which the Government calculates the contributions payable by public sector employees and employers to HM Treasury. The statement above implies that the Government has chosen to continue to use an artificially high discount rate to keep down the apparent cost of pensions (and therefore, most importantly the contributions actually paid by employees and employers). The practical effect of this is to hide from taxpayers a significant part of the true cost of employing public sector workers – with this additional, hidden cost effectively being passed on as unrecorded Government debt to future generations. Furthermore, the effect of this practice is to hide from *employees* the true value of their pension arrangements which, given a free choice and a knowledge of their value, they may be willing to trade for higher pay. I have seen no justification for either the continuing use of two discount rates, or the choice of 3.5% p.a. for the higher one.

This use of two rates would explain why in 2007-08, the planned current service cost of public sector pensions (based on a discount rate of 1.8% p.a. real) is much higher than contributions to be billed from employers and employees. I will deal with this point more fully in the next section.

I want to turn now to the basis on which the Government defends its decision to retain the FRS17/IAS19 standard for the determination of (one of!) its discount rates, and I will largely use the Government's own words.

Minutes of the 84th FRAB Meeting 12th February 2007, HM Treasury¹³:

"51. The Board previously considered the issue of an appropriate discount rate for pension liabilities in March 2003. At that meeting, the Board agreed that a rate based on the AA corporate bond rate should be used to calculate the discount rate.

¹³ Source: see footnote 11

At its meeting in June 2006 the Board agreed that the rate should be calculated annually from 2005-06. The Treasury reported that, as a result of the 2006-07 review of the discount rate, a PES paper was issued at the start of February 2007, which changed the discount rate for pensions' liabilities to 1.8%, a reduction from the previous rate of 2.8%.

52. The Treasury also presented a draft response to IPSASB from the FRAB related to the Exposure Draft (ED) 31 Employee Benefits, particularly related to the proposal to use gilts for discounting pension liabilities.

53. The Board agreed with the Treasury's proposal to continue to use the corporate bond rate, as it was an established market. The Board felt that it was unnecessary for it to respond to the ED."

The following extract from the Treasury's FRAB Paper on IPSAS ED 31 (FRAB (84) 11; 12th February 2007)¹⁴ shows in more detail the thinking behind this peremptory report:

"8. FRS 17 specifies the AA bond rate that is intended to reflect the ability of employers as a whole to finance their liability (i.e. the AA bond rate is a reflection of the average borrowing cost of corporate sponsors of pension schemes). FRS 17 ensures consistency in disclosure between employers and does not seek to require an assessment of the liability that is specific to the employer's financial circumstances.

9. In contrast, the use of a gilt-based discount rate would set Government apart from other entities subject to FRS 17 (and IAS 19). It would seek to reflect in some sense the Government's own circumstances when there is no clear consensus on what those circumstances are. (my bold)

10. When the FRAB took its decision in 2003 it chose to replace a previous set of measures based on long-term gilt yields in favour of maintaining close consistency with FRS 17. FRS 17 remains materially unchanged since that decision was taken and the arguments used at that time remain valid."

The bold highlighted statement is curious, to say the least. The AA bond or equivalent rate is recommended for use by the private sector (not the public sector) because, according to FRS17¹⁵:

"32. Defined benefit scheme liabilities should be discounted at a rate that reflects the time value of money and the characteristics of the liability. Such a rate should be assumed to be the current rate of return on a high quality corporate bond of equivalent currency and term to the scheme liabilities

¹⁴ Source: see footnote 4

¹⁵ Source: Accounting Standards Board, FRS17, Nov 2000.

33. *For this purpose, a high quality corporate bond means a bond that has been rated at the level of AA or equivalent status. The rate of return for such a bond reflects the time value of money and a small premium for risk. That premium is taken to reflect the options that the employer has to reduce the assumed scheme liabilities, including in extremis the option of closing down the scheme....*” (my bold).

In the statement in the Treasury’s FRAB paper¹⁶, the Government is saying that it would not want to be “set apart from other entities subject to FRS17”. *So it seems that the Government wishes to retain the option to “reduce scheme liabilities, including, in extremis, the option of closing down the scheme”*. If this is the reason for the choice of discount rate, then I think the public, and Parliament needs to know this. We should be very clear here precisely what this risk relates to. All employees know that there is a risk that the terms for future pension accrual will change. There have already been limited reforms of public sector schemes in the last two years. However, when it comes to accrued liabilities, by rejecting IPSAS 25 the Government is apparently saying that there is some risk attached to the *already accrued* pensions of public sector workers. If the Government does not intend to reduce *already accrued* pensions, then it should demonstrate this commitment by adopting IPSAS 25.

Finally, under IPSAS 25, no case can reasonably be made on grounds of market depth that UK Index-linked gilts should not be used as the reference interest rates. At 4th January 2008 there were £136.4bn of UK Index-linked gilts outstanding, including the inflation uplift. The Index-linked gilt market is highly liquid. There are few corporate index-linked bonds outstanding, and they are illiquid.

Contributions and Current Service Cost

The Government has made the argument in the past that the discount rate is not important because the future pension cash flows do not change with respect to the discount rate. This is true, but it misses the key point that the taxpayer expects to be clearly informed of *today’s* cost of future pension promises in the form of the current service cost of the pension schemes, and the contributions paid by employers and employees for their pensions. Today’s cost of a pension is crucially determined by the discount rate applied, and the Government’s position fundamentally misses this point.

Current Service Cost at a Discount Rate of 1.8%

It has until fairly recently been a tenet (at least in theory) of Government policy that public sector employees and employers are charged by HM Treasury (by way of

¹⁶ HM Treasury, FRAB (84) 11, *Op cit*

“contributions”) roughly the current service cost of the pensions. As we have seen in *Sir Humphrey’s Legacy*, and also in this update, the reported current service cost has been understating the true current service cost, but I will deal with that point in a moment.

The Government has designed an actuarial process called SCAPE, in which each public sector employer’s Scheme Actuary calculates the annual contribution required from employers and employees to fully fund a ‘notional’ Index-linked gilt fund. If the discount rate used to calculate contributions required under SCAPE is the same as that used to calculate the current service cost, then the resulting contributions under SCAPE should be the same as the current service cost.

However, it appears from the Government documents in the discount rate section above, that the current service cost is being calculated at a 1.8% p.a. real rate, and the contributions under SCAPE are being calculated at 3.5% p.a.

What is the effect of this inconsistent use of discount rates? The Government itself provides the answer¹⁷ in the revealing Public Expenditure Statistical Analyses (PESA) document that HM Treasury publishes annually.

Public Sector Pension Cost versus Employer and Employee Contributions			
Source: PESA 2007 Table D.1			
	2006-07 Estimate £bn	2007-08 Planned £bn	% Change
Current Service Cost (change in liability)	21.5	28.9	+34.4%
Contributions	18.0	19.3	+7.2%

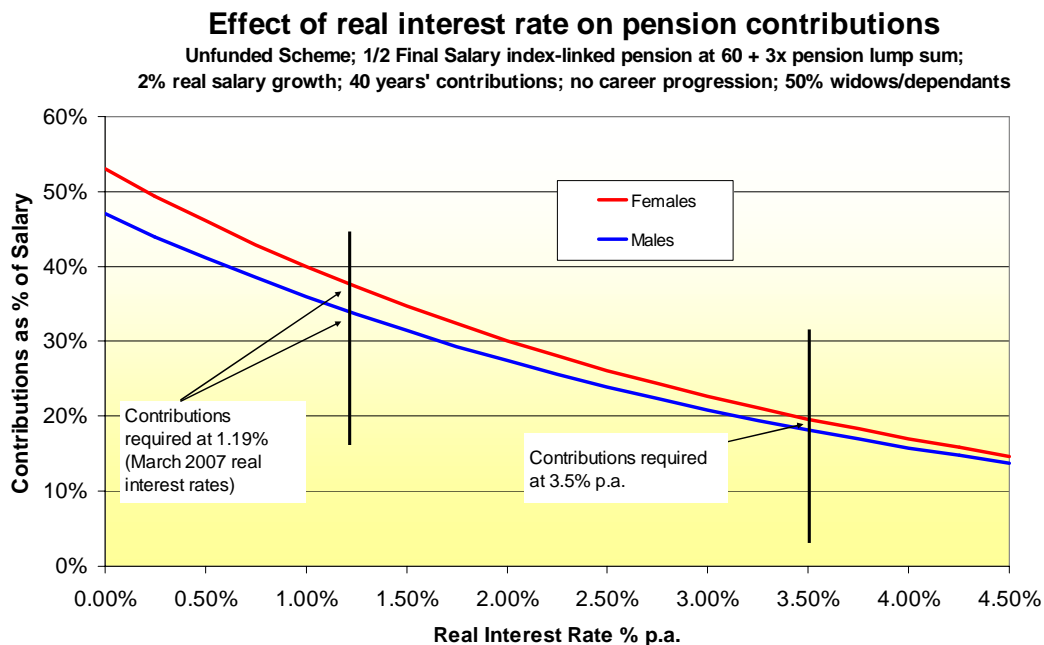
So what appears to have happened is that the Government’s reduction in the discount rate to 1.8% p.a. in 2007-08 from 2.8% has increased the current service cost by 34.4% to £28.9bn. But it has failed to reflect this in the contributions HM Treasury is charging the public sector employees and employers; their contributions, already £2.5bn less than the current service cost in 2006-07, have only risen to £19.3bn, some £9.6bn less than the annual current cost of pensions on the Government’s own figures. This £9.6bn is an annual subsidy from the taxpayer to public sector employees (i.e. future pensioners) of which it appears that neither employers, employees, unions nor the taxpayer have any knowledge. This subsidy is calculated using the Government’s own approach to calculating the liabilities and current service cost.

¹⁷ Source: HM Treasury PESA 2007, April 2007, planned 2007-08 expenditure, Table D.1. PESA 2007 is available at: http://www.hm-treasury.gov.uk/media/E/B/pesa07_complete.pdf

Current Service Cost at a Risk-Free Rate of Interest

Turning to the general effect of discount rates on the current service cost, Graph 2 shows the effect of changes in the real discount rate on a stylised Public Sector scheme's current service cost. We can use this to show what would happen if the Government used the International Public Sector Accounting Standard IPSAS 25 and applied a risk-free discount rate. It is based on the NHS and Teacher's accrual rates of 1/80th of final salary per annum plus a lump sum equal to three times the level of pensions with 50% spouse/dependants' pension (and some other minor benefits), but excludes career progression. It produces a percentage current service cost at 3.5% that looks very similar to the current contribution rates in these schemes.

Graph 2



Graph 2 has been checked for accuracy against Scheme Resource Accounts' current service cost reported sensitivity to interest rates, and it matches well.

Assuming that SCAPE will produce similar contribution rates as the current service cost, the two vertical lines marked on the graph show the effect on contributions (as a percentage of salary) of moving from a real discount rate of 3.5% p.a. (which the Government appears to be currently using) to the current market real discount rate (1.19% p.a.). If this rate is used, we see a rise of 89.7% in the required contribution rates for public sector pensions (i.e. from 18.6% of salary to 35.3% of salary) in the contributions that the Treasury would have to charge public sector employees and employers to fully pay for the pensions it offers.

If the reader is in any doubt that using the risk-free market rate would really make such an enormous change, then the Bank of England's Annual Report & Accounts

2007¹⁸ should dispel this. The Bank of England changed its discount rate to risk-free in 2005, and its pension fund now charges the Bank 41.3% of pay to cover the cost of its (very generous) Index-linked pension, despite the fact that it is a funded scheme.

The enormous change in contributions required to accurately reflect the real cost of public sector pensions would fundamentally undermine the current basis of budgeting and pay for the nation's main public services. This unpalatable fact is just that: the reality behind the gilt-edged public sector pensions.

Hidden Cost

The public sector pension liabilities we are dealing with are unfunded. The Government has created liabilities (debt) in the future against which it has not provided any assets, even though it has charged employers and employees an annual cost, albeit one which is far too low.

What happened to the pension contributions received by the Treasury? It has spent them. They have been spent as if they were current income, instead of a payment to cover a future liability. The effect of this 'hidden borrowing' is to hide not only a much larger Government deficit than is reported, but to also hide the interest cost of the borrowing.

The size of the 'hidden borrowing' each year is the current service cost at market interest rates plus the interest cost, less the pensions already in payment (which the Government does report as expenditure). The planned figures for 2007-08 are set out by the Government itself¹⁹ in Table D.1 of PESA 2007. We will begin by using the Government's own figures, based on the 1.8% p.a. real discount rate.

On the Government's own figures:

Pension current service cost (" <i>change in liability</i> ")	£28.9bn
plus Interest cost (" <i>Unwinding of discount rate</i> ")	£32.5 bn
less Pensions in payment	(£21.3) bn
Total (<i>Accounting adjustments (pensions)</i>)	£40.1bn

To reiterate, the £28.9bn is today's annual cost of the pension rights accruing to current Government employees; the £32.5bn is the accumulated interest cost of the series of past Government decisions not to fund the Government's own pension promises. The £28.9bn can be negotiated, at least in principle, to a lower

¹⁸ The report can be found at <http://www.bankofengland.co.uk/publications/annualreport/2007full.pdf>

¹⁹ Source: HM Treasury PESA 2007, April 2007, planned 2007-08 expenditure, Table D.1 – "Accounting Adjustments (Pensions) Section, 2007-08 column.

figure, if public sector pension plans are changed for future accrual of pension. The £32.5bn is a fixture, and is on an upward trend.

The scale of this hidden expenditure is enormous. It contrasts with the reported planned Government deficit of £34bn²⁰ for 2007-08. If the hidden expenditure were included in the Government's reported spending, the Public Sector deficit would be an eye-watering £74.1bn, or 5.4% of GDP.

If the current service cost were calculated at the risk-free rate of 1.19%, as it should be, then it would rise to about £34.5bn (calculated from Graph 2). This would raise the total cost to £45.7bn and the Public Sector deficit to 5.8% of GDP. We should be absolutely clear in this conclusion that this figure of 5.8% of GDP is the true underlying Government budget deficit after allowing for public sector pension costs: it is not an issue of semantics or an "accounting effect". If a Government employer promises a policeman (say) a pension of £15,000 per annum starting in 2020, this is just as much of a burden on future taxpayers as the issue of an Index-linked gilt of the same present value to fund welfare payments or the building of an arts centre and it should be treated as such.

If the reader needed just one illustration of just how important the issue of unfunded Public Sector Finances has become to the whole country's finances, this adjusted figure for public sector borrowing is that illustration.

²⁰ Source: HM Treasury: 2007 Budget Report; Chapter C, Table C4. March 2007.