making business sense

Public sector liabilities – improving transparency

Working Study Paper

July 2010

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1 Executive summary

Introduction

1. This report attempts to improve understanding of the liabilities that do not appear as part of main measures of public sector net debt.

2. The public should be in no doubt that the UK government is exposed to liabilities that far exceed those represented by the Office of National Statistics (ONS) Public Sector Net Debt figure. While this is not a revelation, this report provides fresh comparative analysis on the scale of that liability. Our central estimate is that the UK public purse is exposed, at least, to an additional £1.13 trillion of liabilities beyond the Public Sector Net Debt estimate (excluding financial sector intervention) for 2010/11 of £932bn.

3. However, this is not to say that the ONS estimates are, by any means, incorrect. Indeed, this report analyses the ONS Public Sector Net Debt standard alongside alternative standards for measuring public debt and sets out the different bases, purposes and principles that they are prepared for. In addition to different assessments of UK public debt, the treatment of 'off-balance sheet' liabilities – including Public Private Finance/Private Finance Initiatives, provisions and contingent liabilities – is exceptionally complicated.

4. In an era of transparency about public finances, there is a public demand for complete information about the broader liabilities facing the UK, in addition to the liabilities covered by the Public Sector Net Debt figure. This information is not available in the public domain and can only be pieced together, incompletely, from component official sources and economic estimates. As a result, policy makers and the public do not have the required information to make any comprehensive assessment about the public liabilities as a whole. This frustrates both the incentive and the capacity to achieve sustainable public finances in the long-term and, at a more basic level, fairness from one generation to another.

5. The Whole of Government Accounts (WGA) project, though likely to be qualified in their first years, promise to drastically improve the accessibility and transparency of financial information. WGA will provide value by bringing information in statutory accounts together for the first time on an auditable basis.

6. Against this context, there is a powerful opportunity for the Office of Budget Responsibility to lead public inquiry into the full extent of public liabilities. This is particularly the case for contingent liabilities where financial commitment is led by public or market expectations rather than explicit contract. Greater transparency and understanding about these liabilities will encourage greater confidence in our requirement to respond to and manage those liabilities and will help provide the means to achieve fiscal sustainability.

Summary findings

7. The central estimate is that there are an additional £1.13 trillion of liabilities over and above the headline public sector net debt published by the Office for National Statistics, equivalent to 76% of nominal GDP. However, this figure reflects a conservative assessment of the liability to contingent liabilities.

8. However, as the Office of Budget Responsibility points out, these figures must be understood in context and interpreted carefully. ONS Public Sector Net Debt figures have been the main measure of public sector debt in the UK since the 1960s. This measure is prepared in line with the European System of Accounts (ESA 95) standard which is an interpretation of the internationally agreed National System of Accounts (NSA) standard, as set by the UN. PFI and PPP liabilities as a whole are not currently recognised on the NSA standard, though there is a process in development to revise the standard. Pensions provisions are not part of public sector net debt, but exist as commitments by the government to pay public sector employees income streams over the years ahead. Pay-as-you-go pensions are considered as part of current annually managed expenditure and hence impact projected estimates of public borrowing and net debt, a far smaller figure than the total pensions liability. Contingent liabilities, i.e. liabilities - such as the cost of specific financial sector interventions - that arise through implicit or political guarantees rather than through contractual obligations, are a hugely complex topic. Much more research and public debate is required to better understand and quantify the extent of UK exposure to contingent liabilities as there remains considerable uncertainty about this. As a result, upside risk to the upper bound of the estimate is shown in figure A.

Figure A: Range of recent estimates public liabilities that are not included in the ONS Public Sector Net Debt Figure, 2010/11 £ billion and % nominal GDP

	Estimate of the public liability (£ billion)			Estimate of the public liability (% nominal GDP)		
	Lower bound	**Central**	**Upper bound**	**Lower bound**	**Central**	**Upper bound**
PFI / PPP	0	43	58	0%	3%	4%
Unfunded public sector pensions	886	1032	1177	60%	70%	80%
Local government pension scheme	27	49	70	2%	3%	5%
Contingent liabilities	0	2	34+	0%	0%	2%+
Total	913	1,125	1,305	62%	76%	89%

Source: cebr (for pensions, the most recent GAD estimate is for 2008 so lower bound is based on the BNAC estimate of what the GAD estimate would be in 2009; some PFI / PPP liabilities do already appear in public sector net debt[1])

9. Figure B below illustrates a summary of the different measures of national debt. Estimates of net debt for the United Kingdom published by the Office for National Statistics are net of liquid assets – whereas the Maastricht and OECD measures are based on gross government liabilities. The data shows that the addition of pension and PFI related liabilities is non-trivial relative to GDP.

[1] See Office for National Statistics (2006) 'Including Finance Lease Liabilities in Public Sector Net Debt: PFI & Other'. Available here: http://www.hm-treasury.gov.uk/d/financeleasesarticle_200906.pdf

Figure B Estimates of public sector debt in the United Kingdom, £ billion and share of GDP, percentage, financial year 2010/11

	Debt for 2010/11 unless stated			
	ONS PSND ex financial	**Maastricht debt**	**OECD (2009 data)**	**Additional liabilities***
Public debt (£ billion)	932	1162	1098	1125
Public debt (% GDP)	62%	79%	75%	76%
Financial sector intervention	No	Yes	Yes	Yes
International comparison	No	Yes	Yes	No

Source: cebr *not strictly comparable with all other measures as adjustment needed where parts of financial sector liabilities are included.

Private Finance Initiative and Public Private Partnership liabilities

10. The capital value of committed PFI contracts is £56 billion while over £14 billion PFI projects are in the process of being commissioned. Some £43 billion of the existing PFI liabilities are considered off-balance sheet.2 After an ONS review, as of 2006, some £5 billion of PFI lease liabilities were included in the public sector net debt figures; but the more recent figures show around 78% of PFIs are not recorded on-balance sheet and included in public sector debt figures. To reflect their significant scale, payments associated with PFI can be quantified by assessing unitary charges payable each year. The net present value of these payments was estimated to lie between £131 billion and £146 billion – the central estimate of this range is equivalent 9% of GDP. As a flow, each year the unitary charges are equivalent to 0.5% of GDP.

11. However, this report explains some of the complexities around the treatment of PFI and PPP liabilities. While information is available in a piecemeal fashion, an accessible and transparent analysis of the liabilities associated with PPP and PFI projects is not available. However, the introduction of IFRS across public sector bodies will help address this for government accounting purposes. It will be important for this information to be made available and accessible alongside other items of major public liability so that comprehensive assessments of the UK's fiscal sustainability can be made.

12. There is an absence of official internationally comparable data on the value of liabilities associated with public private partnerships. The data show that PPPs have spread across Europe over the last 15 years, while World Bank data shows they have been widely used in developing countries. However, the data (for end 2006) show that the United Kingdom has had by far the largest share of PPP projects in Europe by value (58%) and volume (76%) in 2007. As such, if PPPs (or PFI) were to be included in international approaches to measuring national debt the effect on United Kingdom debt would be disproportionately large relative to other countries whose PPP commitments are far smaller.

Unfunded public sector pension liabilities

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[2] OBR pre-Budget forecast (2010), p. 58

13. On the issue of unfunded public sector pension liabilities, again there is an array of information publicly available. The most recent government estimate of total unfunded public pension liabilities was £770 billion as at 31 March 2008. The report finds considerable debate in the literature over the discount rate to use when estimating the present value of the pension liabilities while the National Audit Office has expressed concerns over the assumption that public sector workforce growth would be zero. These assumptions shape different pictures over the total pension liabilities. Differences between estimates made against the government estimate vary from 14% higher to 33% for the most recent year, while one older study found public pension liabilities to be 93% higher than the government estimate. For 2009, pension liabilities are found to range between £886 billion and £1,177 billion, although there has been no official analysis on this since 2008.

14. Again, public sector pension liabilities are not part of public sector net debt but exist as commitments by the government to pay public sector employees income streams over the years ahead. On the face of it, there are broad similarities between these commitments and the governments' commitment to pay bondholders. However, pension liabilities are included in estimates of debt in the years ahead in so far as net spending on pay-as-you-go pensions is part of current annually managed expenditure and hence impacts projected estimates of public borrowing and net debt. For example, the Office for Budget Responsibility projected annual net expenditure on unfunded pensions would rise from £3.1 billion in 2009-10 to £9.4 billion in 2014-15.

15. In addition to the unfunded public service pension liabilities, there is also a deficit on the Local Government Pension scheme which, in practical terms is underwritten by the taxpayer. The most recent government estimate was £27 billion but this was published in 2007; more recent private sector studies estimate that the liability could be closer to £70 billion. Figure A illustrates a range of estimates for this but there is clear need for greater transparency on this issue.

16. As pension liabilities are included as part of national accounts, there is a lack of cross-country information on public sector pension liabilities. However, data from the OECD on public expenditure on pensions and European Union data on current and projected spending on public pensions show that several large European countries face much larger annual flows of spending as a share of national income than the United Kingdom. As such, including public pension liabilities would not lead us to believe the United Kingdom's debt position is materially far worse compared to European countries than already thought. However, unfunded public pension liabilities as a share of GDP are far higher in the United Kingdom than in the United States or Canada. A welcome development will be the introduction of the new European System of Accounts in 2014, incorporating liability figures for state retirement and state second pensions in the UK, increasing transparency on this issue – but this is four years away.

Contingent liabilities

17. Finally, the paper also assesses other contingent liabilities such as the impact of financial sector interventions, though not all such interventions, and a guarantee of Network Rail's

debt. Contingent liabilities, i.e. liabilities that arise through implicit or political guarantees rather than through contractual obligations, are a hugely complex topic. The evidence on the effects of the financial sector interventions variously implemented from 2007 through to 2009 (with most still in place) was considered. The National Audit Office and Treasury have undertaken detailed analysis in this area; with an original estimate of the additional liability in the range £20 - £50 billion. However, the 2009 Pre-Budget Report reduced this to £8 billion on improved market conditions and changes to the Asset Protection Scheme. Even more recently, the June 2010 Budget estimated a lower cost of just £2 billion. There remains a chance of the estimate being still lower, but a safe range for the net liability would be £0 billion to £10 billion.

18. With regards to Network Rail, it is officially classified as a private sector organisation and this paper does not seek to dispute this official ruling. However, Network Rail does have £24 billion in debt on the latest data. It would be useful for further research to study what would happen if the infrastructure company failed and where the debt liability would lie.

19. Much more research and public debate is required to better understand and quantify the extent of UK exposure to contingent liabilities.

Policy recommendations

- Greater transparency and clarity of public sector liabilities beyond those included in public sector net debt estimates is urgently required.

- The Office of Budget Responsibility (OBR) has a key role to play, working with bodies like the ICAEW, in advising and informing public and parliamentary debate around the meaning and context of public financial information, especially public debt and those liabilities that are not part of the national accounts.

- The OBR should lead public inquiry into quantifying the extent of contingent liabilities exposure, i.e. liabilities that the government is exposed to through public expectation rather than through contract. Financial sector intervention, Network Rail debt and potential default, and other public body implicit guarantees all could be considered as part of this inquiry.

- Alongside the publication of ONS Public Sector Net Debt, the government should examine the viability of publishing figures for total liabilities for privately financed public sector procurement as a separate item.

- The UK Government should work with the European Commission to ensure that the development of the 2008 System of National Accounts standard is developed in a manner that provides the greatest possible transparency of PFI and PPP liabilities. The UK should be particularly active in these discussions as the UK has the highest exposure to such liabilities relative to other Member states.

- All UK political parties should support the timely completion of the 'Clear Line of Sight' project for all public bodies to report to IFRS and the Whole of Government Accounts project which will bring pensions and PFI/PP liabilities 'on-balance sheet' and will bring statutory accounts across the public sector together in one place for the first time on an auditable basis.

2 Introduction

2.1 About cebr

2.1.1 The Centre for Economics and Business Research (cebr) was established in 1993. It is a specialist economics consultancy with expertise in macroeconomic forecasting, local and regional forecasting and economic development, transport forecasting and economic impact analysis.

2.2 Background

2.2.1 While the United Kingdom's measures of public sector debt follow international standards, questions have consistently been raised over ambiguous areas such as the status of the contingent liabilities associated with Public Private Partnerships. Questions have frequently arisen in international contexts due to the ambiguity over the treatment of provisions and contingent liabilities. Moreover, as concerns mount over the debt crisis in Greece and the eurozone build and credit rating agencies carefully scrutinise government finances across the globe which have been severely strained, particularly among the advanced economies, by the extraordinary financial crisis and deep accompanying recession, never has the importance of transparency on the public sector finances been more important

2.2.2 The Institute of Chartered Accountants England and Wales has campaigned for transparency, accountability and good governance in the public sector in order to support effective delivery of public services and value for taxpayers' money.[3] Furthermore, the International Monetary Fund's latest Code of Good Practices on Fiscal Transparency states: 'the public should be provided with comprehensive information on past, current, and projected fiscal activity and on major fiscal risks.[4]'

2.2.3 The government has announced welcome moves towards greater openness on the public finances with the publication of the COINS database and the steps towards producing Whole of Government Accounts. Moreover, the creation of the Office for Budget Responsibility has been a positive step towards more credible, transparent management of the public finances. The OBR's first publication touches on some of the key issues of contingent liabilities but leaves many

[3] See for example: ICAEW (2009) 'Going for growth: a manifesto for good government and sustainable economic recovery' Available at: http://www.icaew.com/index.cfm/route/167828/icaew_ga/en/Home/Press_and_policy/Public_policy/Going_for_growth_an_ICAEW_manifesto

[4] IMF (2007) 'International Monetary Fund - Code of Good Practices on Fiscal Transparency' Available at: http://www.imf.org/external/np/pp/2007/eng/051507c.pdf

questions unanswered. This study aims to contribute to the debate that will arise from the OBR's publication on 14 June.

2.3 The Office for Budget Responsibility approach

2.3.1 As part of the terms of reference for the Office for Budget Responsibility published on 8 June 2010, the newly formed independent body assessed the public sector balance sheet as well as providing updated growth and borrowing forecasts for the United Kingdom economy. The OBR's terms of reference stated:

- 'The interim OBR has a role in beginning an independent assessment of the public sector balance sheet and fiscal sustainability, including assessing the impact of ageing, public service pensions and PFI contracts.

- 'The interim OBR will provide an initial discussion of public sector liabilities and their implications for the public finances alongside the first forecast.'

2.3.2 On Monday 14 June, the Office for Budget Responsibility published its first growth and public finance forecasts. Importantly, their report also included detail on additional public sector liabilities that have previously largely been left out of the debate on the health of the public finances.

2.3.3 The OBR remarked that given the variety of conceptual approaches to debt sustainability, a key principle for good government should be transparency. They highlighted that this applies particularly with respect to liabilities which are currently off-balance sheet.

2.3.4 The OBR report acknowledged the following relevant liabilities and fiscal pressures:[5]

- An ageing population, with demographic trends putting upward pressure on health care and pension spending. The annual impact of demographic change on the public finances is projected to amount to almost 4 per cent of GDP by 2049-50;
- Private Finance Initiative (PFI) contracts, representing a high profile example of a pre-commitment of future expenditure. The total estimated unitary charges payable under PFI for 2010-11 are £7.8 billion. As of the end of 2009-10, the capital cost of signed PFI projects was approximately £56 billion, of which approximately £43 billion was off-balance sheet;
- Unfunded public service pension liabilities, in terms of accounting are by far the largest example of an obligation arising from events now and in the past.

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[5] See Office for Budget Responsibility 'Pre-budget forecast: June 2010'. Accessed here: http://budgetresponsibility.independent.gov.uk/d/pre_budget_forecast_140610.pdf, p.58

The last Government Actuary's Department estimate of this liability, published in December 2009, was £770 billion. In addition to these liabilities, there is a long-term overall deficit in the funded Local Government Pension Scheme which is effectively a liability underwritten by taxpayers; and

- Contingent liabilities, examples of which include nuclear decommissioning and guarantees provided to the banking sector.

2.3.5 The OBR identified the following important areas for future work:[6]

- promoting the **transparent and coherent provision of information on public sector liabilities and longer-term fiscal pressures**, including drawing on the work of government departments and other bodies to highlight any gaps in information;
- providing a **comprehensive and periodic analysis of the implications of these liabilities for fiscal sustainability**, to promote understanding of fiscal pressures and allow the Government to take these into account when setting policy.

[6] See Office for Budget Responsibility 'Pre-budget forecast: June 2010'. Accessed here: http://budgetresponsibility.independent.gov.uk/d/pre_budget_forecast_140610.pdf, p.63 (emphasis added)

2.4 Objectives and outline

2.4.1 This document provides a brief update on the size of the United Kingdom's public sector debt considers the different ways of measuring public sector debt in both a domestic and internationally comparable context.

2.4.2 Second, the paper explores some of the more ambiguous areas in relation to public sector debt. The analysis aims to build on the OBR's identification of key public sector liabilities and fiscal pressures highlighted above and previous attempts to address the issue, such as the Centre for Policy Studies October 2009 'Hidden Debt Bombshell' paper.[7] The paper aims to offer a summary and update of the evidence on public sector liabilities that are currently considered to be off-balance sheet in some key areas, listed below.

1. Public Private Partnerships / Private Finance Initiative

2. Public sector pensions

3. Other contingent liabilities (including Network Rail and financial sector interventions)

2.4.3 A range of estimates are provided of the liabilities in each area and the impact on total national debt considered.

2.4.4 The study aims to explain and illustrate the differences between approaches to measuring debt and assess any comparative international evidence on the areas discussed.

[7] Newmark, B. (2009) 'The Hidden Debt Bombshell' Centre for Policy Studies Pointmaker

3 Approaches to measuring public sector debt

3.1 Introduction

3.1.1 Public debt is a key indicator of the health of public finances but there are several ways of measuring it. The main measures of debt published in the United Kingdom are described in the sections below.[8]

3.2 Public sector net debt

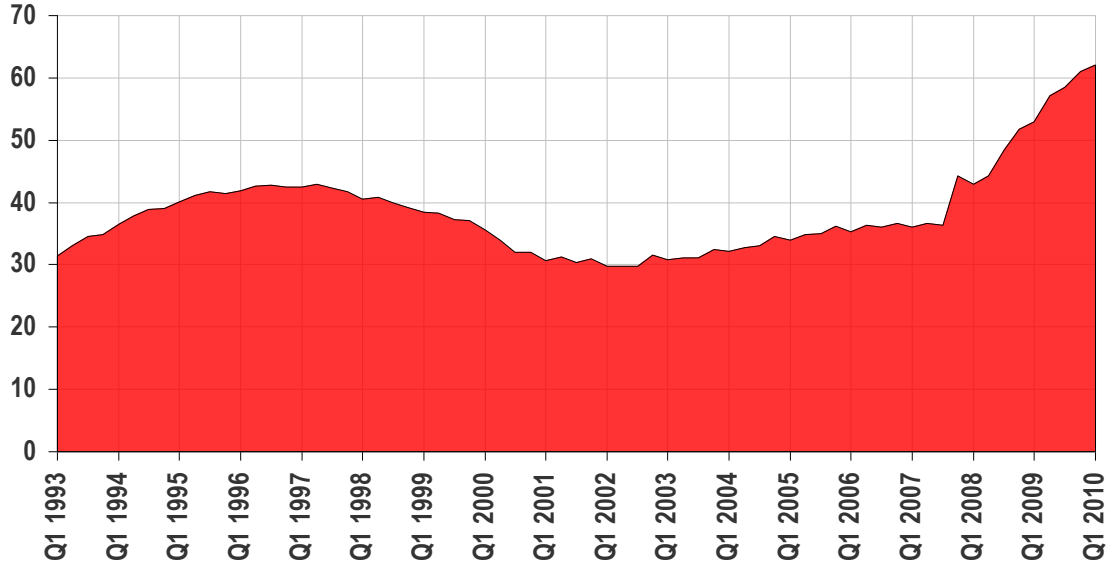
3.2.1 Public sector net debt is published monthly by the Office for National Statistics, measured at nominal values and reflecting the value of financial liabilities less liquid financial assets. The majority of debt financing is through central government issues of government securities (gilts) and treasury bills. This has been in use in the United Kingdom since the mid-1960s and has been a key reference statistic for assessing the previous Labour administration's fiscal rules. This measure of debt includes the liabilities taken on as a consequence of government intervention with financial institutions and as such has risen sharply since 2007 as a consequence of the credit crunch and recession. For example, by December 2008, classifying Northern Rock and Bradford & Bingley as public sector had added about £130 billion to net debt.[9]

3.2.2 Figure 1 shows public sector net debt as a share of gross domestic product since quarterly records began in 1993. Debt rose above the 40% of GDP mark following the recession in the early 1990s but then fell back beneath 30% in 2002. A series of budget deficits through the second and third Labour government saw public sector debt on an upward trajectory in the lead up to the credit crunch. As the early stages of the financial crisis hit the global economy, Northern Rock collapsed in September 2007 – ultimately becoming a public sector institution. This contributes the sharp spike in public sector net debt in Q4 2007. Adding this to the intervention with Bradford and Bingley causes a around a nine percentage point increase in the national debt share of GDP. By May 2010, public sector net debt stood at 62.2% of GDP or £903 billion in current prices. As a proportion of GDP, this is the highest level since comparable ONS records began in 1975.

[8] Classification based on O'Donoghue (2009) 'The public sector balance sheet' Economic & Labour Market Review, vol. 3, no. , July 2009

[9] O'Donoghue (2009) 'The public sector balance sheet' Economic & Labour Market Review, vol. 3, no. , July 2009, p. 42

Figure 1 United Kingdom public sector net debt, percentage of GDP



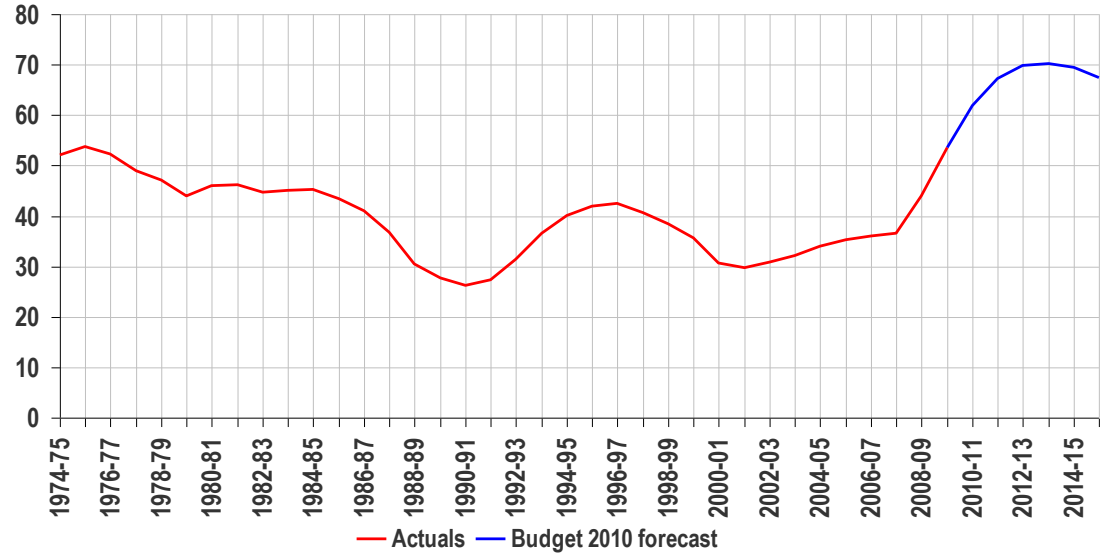
Source: Office for National Statistics

3.3 Public sector net debt excluding thee effect of financial sector interventions

3.3.1 Public sector net debt excluding financial sector interventions is published quarterly by the Office for National Statistics; this is essentially the same as public sector net debt but excludes the temporary effects of financial interventions while covering the net permanent costs that have already been realised. This figure is used by HM Treasury in its main Budget and pre-Budget report financial statements.

3.3.2 Figure 2 illustrates the change public sector net debt as a share of GDP on this measure since a comparable historical series begins in financial year 1974-75. On this measure, public sector net debt stood at 53.5% of GDP in the 2009-10 financial year, and £772 billion in current prices; roughly £120 billion less than the public sector net debt measure in 1) above. In the June 2010 Budget, the government announced that they expected net debt to rise to £1.235 trillion in financial year 2014-15 or 70.3% of GDP.

Figure 2 United Kingdom public sector net debt excluding financial sector interventions, percentage of GDP

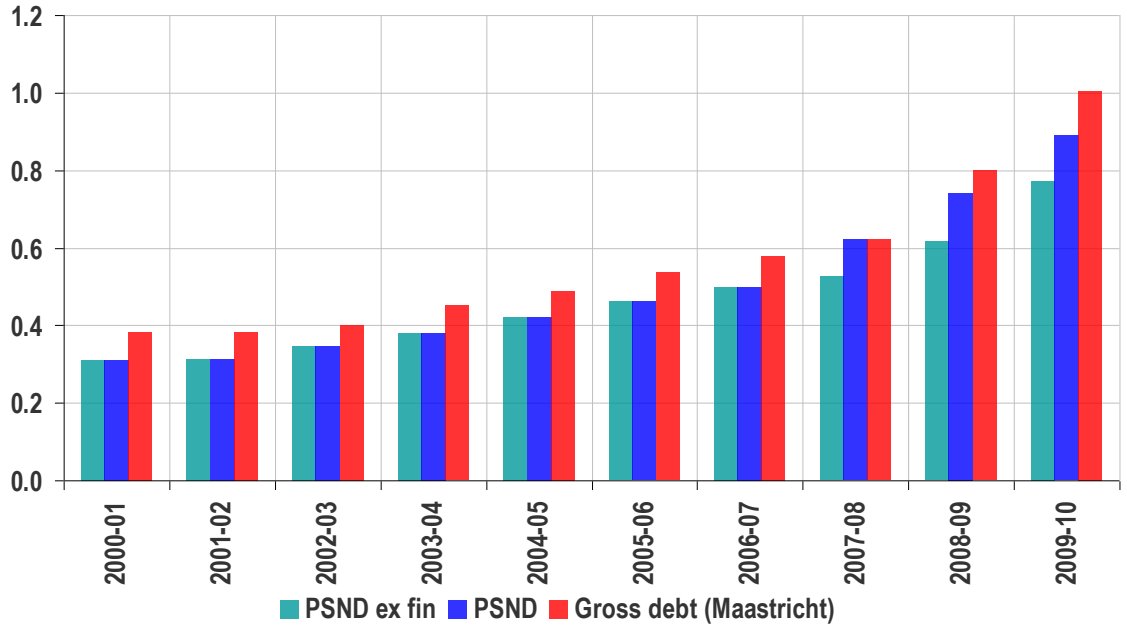


Source: HM Treasury, public finances databank

3.4 General government consolidated gross debt (Maastricht basis)

3.4.1 This is calculated for the purposes of the Maastricht Treaty's Excessive Debt Procedure, this is measured at nominal values for the general government sector. This is the best guide to governments' financial obligations but does not net off the value of liquid assets as in the net debt calculation, so is always a higher reading than in 1 or 2 above. Figure 3 below illustrates the difference between the Maastricht measure and the public sector net debt measures above.

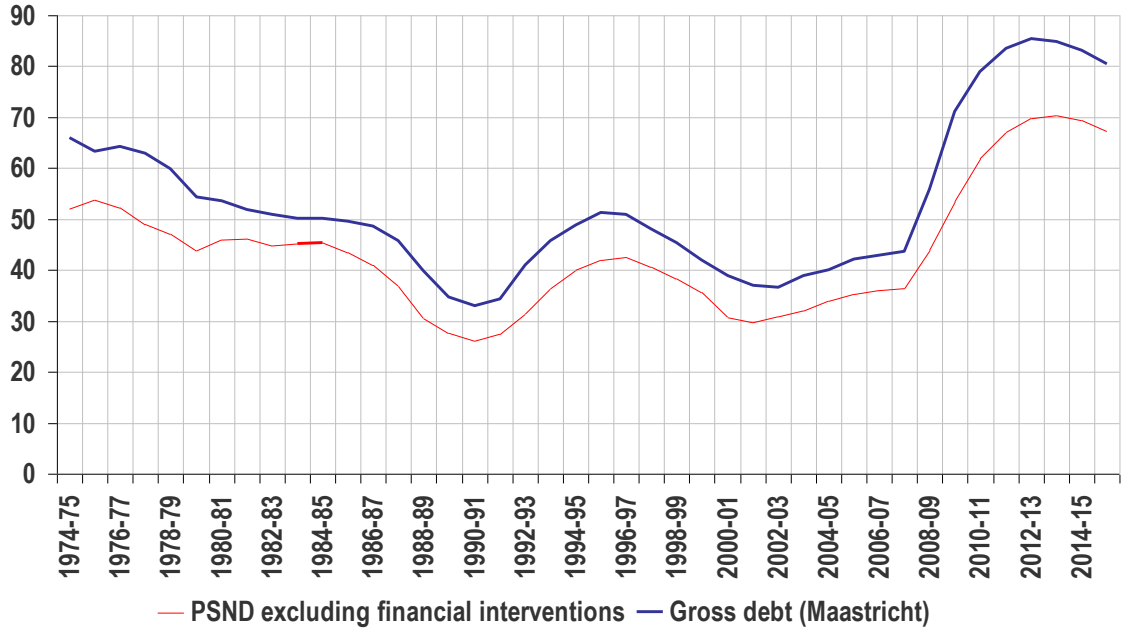
Figure 3 United Kingdom general government gross debt (Maastricht basis) and public sector net debt (including and excluding financial interventions) 2009/10, £ trillion



Source: ONS, HM Treasury

3.4.2 Looking relative to national income and over a longer timeframe, figure 4 shows public sector net debt excluding financial interventions and gross debt on a Maastricht basis. There is a consistent gap between the two measures on account of the Maastricht measure not subtracting liquid assets. However, the gap widens in 2008-9 as the effect of the financial sector interventions, which are not included in the Treasury's headline measure, are included in the Maastricht measure. In the internationally comparable measure, all temporary and permanent effects of financial sector interventions on general government gross debt are included.

Figure 4 United Kingdom general government gross debt (Maastricht basis) and public sector net debt excluding financial interventions, percentage of GDP

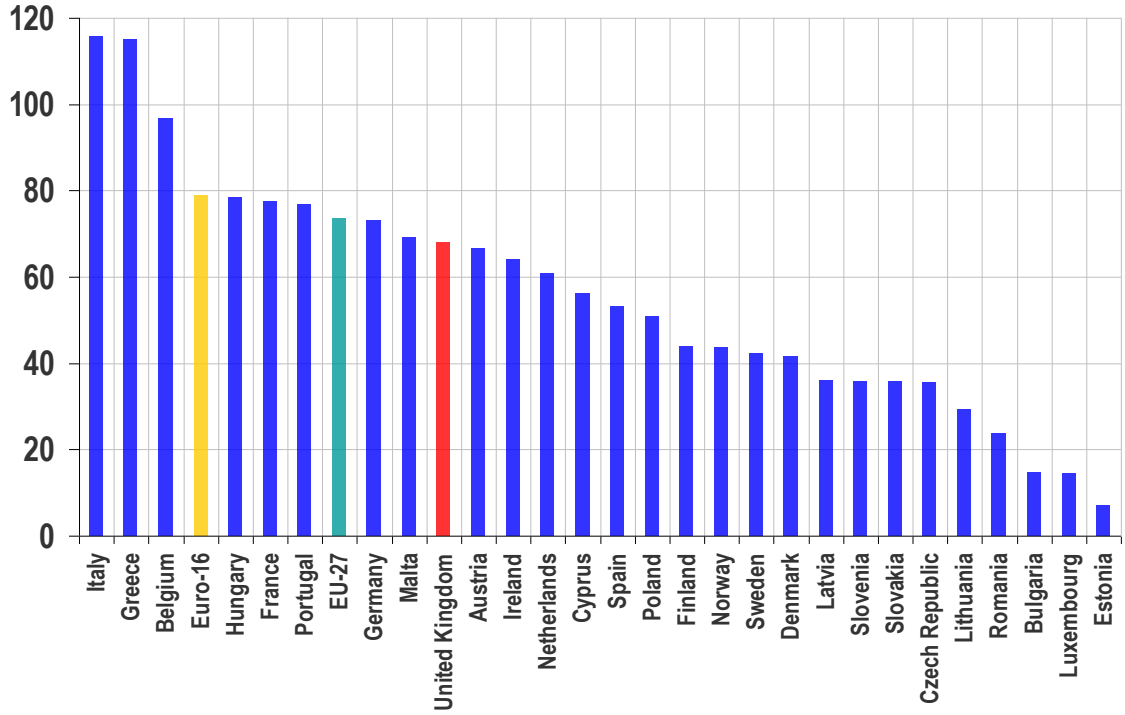


Source: ONS, HM Treasury

3.4.3 The Excessive Deficit Procedure Statistical Bulletin shows the gross general government debt measure in detail.[10] This measure is consistent with the European System of Accounts, which the United Kingdom national accounts have been based on since 1998. Data on this is submitted to Eurostat by European Union member countries (the Office for National Statistics compiles and sends debt on this measure to the European Commission biannually), so clear internationally comparable data exists on the relative debt position on this basis. Figure 5 shows gross debt on a Maastricht basis across European Union member states in 2009. At 68% the debt as a share of GDP in the United Kingdom is lower than both the eurozone (79%) and European Union (74%) average levels. Debt is also below levels in the largest European economies of France, Germany and Italy, which has the highest debt to GDP share among European countries, closely followed by Greece. Debt in the United Kingdom is higher than 19 of the 27 European Union countries.

[10] Office for National Statistics 2010, accessed here: http://www.statistics.gov.uk/pdfdir/maast0310.pdf

Figure 5 Gross general government debt (Maastricht basis) across Europe in 2009, percentage of GDP



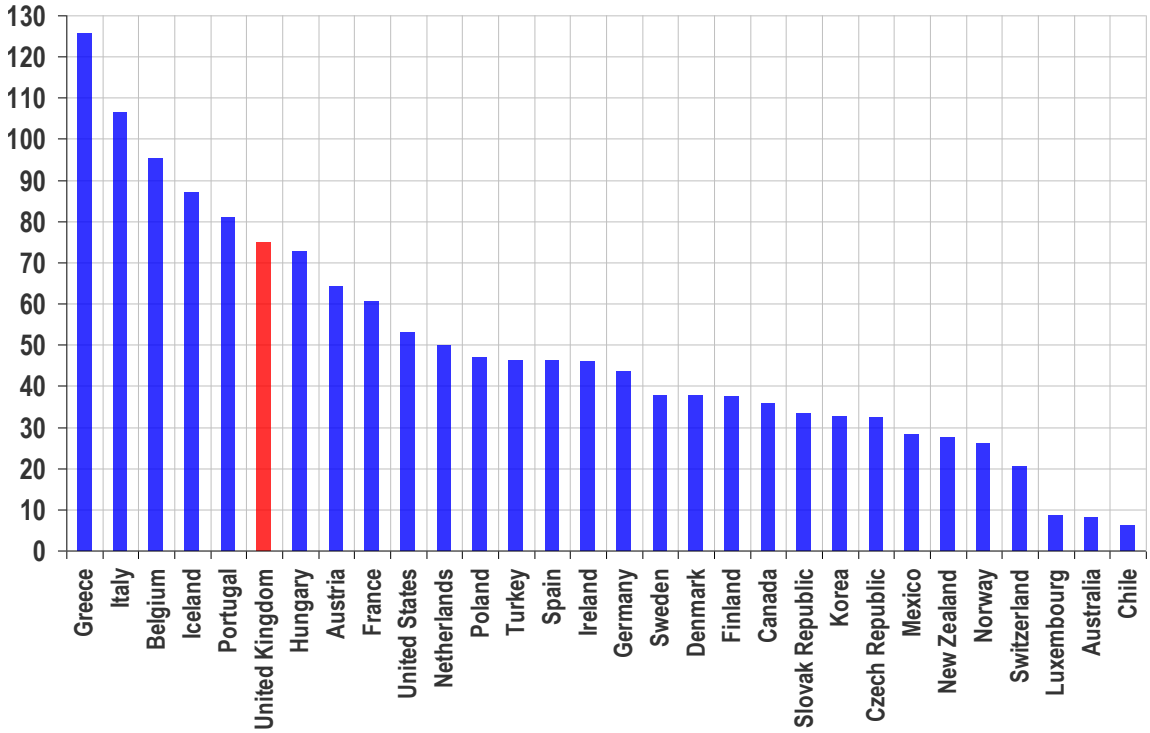
Source: Eurostat

3.5 General government unconsolidated gross liabilities at market values

3.5.1 This is calculated in the National Accounts and published quarterly in the UK Economic Accounts. As with the Maastricht debt, this is a gross measure that closely captures governments' financial obligations while being less of a guide to creditworthiness. The Organisation for Economic Cooperation and Development and International Monetary Fund use measures on this basis to construct internationally comparable measures of government debt.

3.5.2 Figure 6 shows central government debt as a share of GDP across the OECD member countries. In the United Kingdom, central government debt is equivalent to 75% of GDP and is higher than 24 of 30 OECD countries for which there are data. However, this measure shows some key differences with the Maastricht measure in Figure 5; for example debt to GDP is significantly higher in the United Kingdom than in France or Germany on the OECD measure. This is partly explained by the fact that large parts of public sector debt fall with local rather than central government in these countries; the OECD measure is of central rather than local government debt. As in the Maastricht measure, Italy, Greece and Portugal all have higher debt to GDP ratios than the United Kingdom, although Greece rather than Italy has the largest debt to GDP share on the OECD measure.

Figure 6 Central government debt as a percentage of GDP across OECD countries, 2009



Source: OECD

3.6 Discussion and comparison with financial accounting

3.6.1 The measures above reflect different features. While the main Office for National Statistics public sector net debt measure receives most publicity – and is usually the main measure used by HM Treasury – it is a United Kingdom measure and is not directly comparable with other countries. The Maastricht basis and IMF or OECD measures allow easy comparison of the United Kingdom's overall debt position – showing that public sector debt is below European Union and Eurozone averages.

3.6.2 However, these main measures of public debt all contain a common feature – they are generally built up from and approach key issues using national and government accounting standards. That is, they build on approaches reified by the United Nation's 1993 System of National Accounts[11] (interpreted by Eurostat in the European System of Accounts[12]) for national accounting purposes and the IMF's Government and Financial Statistics Manual[13] for government accounting. The latter encourages the publication of comparable public finance statistics. Crucially, these UN, Eurostat, OECD and IMF national and government accounting approaches do not follow the same standards as financial accounting approaches that predominate in the private sector.

3.6.3 The financial accounting standards from the International Accounting Standards (IAS) and the International Financial Reporting Standards (IFRS) are widely used in business. Indeed, all listed companies in the European Union have been required to use IFRS since 2005.[14] These standards are designed to provide the world's integrating capital markets with a common language for financial reporting with a single set of high quality global accounting standards.[15] In general, IFRS offers a more comprehensive approach to liabilities than the System of National Accounts. Indeed, liabilities are defined more narrowly in SNA 1993 than in other accounting standards.[16] The differences are abundantly clear when looking at the approach to contingent liabilities and provisions.

3.6.4 A **provision** is a liability uncertain in timing or amount, which is recognised in the main accounts since payment is probable and a reasonable estimate of the amount can be made.[17]

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[11] SNA 1993 accessed here: http://unstats.un.org/unsd/sna1993/introduction.asp

[12] ESA 1995 technical details accessed here http://circa.europa.eu/irc/dsis/nfaccount/info/data/esa95/en/een00000.htm

[13] IMF 2001 'International Monetary Fund – Government Finance Statistics Manual 2001'

[14] European Commission, accessed here: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:32008R1126:EN:NOT

[15] International Accounting Standards Board; accessed here http://www.iasb.org/Home.htm

[16] Maitland-Smith, F. (2009) 'Government financial liabilities beyond public sector net debt' p. 46

[17] Maitland-Smith, F. (2009). p. 44

3.6.5 A **contingent liability** is an obligation activated by a discrete event that may or may not occur. The event is determined ex-ante, but its occurrence and timing are uncertain. If it does occur, then the commitment becomes a direct liability for the government. Both the probability of its occurrence and the magnitude of the resulting outlays are often very complex to estimate. Contingent losses can be recognized by reducing the value of an asset (impairment) or increasing the value of a liability (creating a provision).[18]

3.6.6 The System of National Accounts does not record contingent liabilities (unless they are tradable) or provisions. The IMF's Finance Statistics Manual stipulates both should be disclosed as memorandum items or notes to the accounts – but they are not clearly treated as part of debt in the SNA system. This is where the clear contrast with the IAS/IFRS exists. Liabilities are described more loosely (or comprehensively) in the IAS/IFRS framework:

3.6.7 'Present obligations of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits or service potential.'

3.6.8 Consequently, this shapes a different definition of government debt under IFRS which goes beyond the SNA definition:

3.6.9 'Governments have significant liabilities beyond debt, which may have important implications for fiscal sustainability. The disclosure of information about the potential cost of unfunded public pension funds, and government guarantees and other contractual obligations (such as commitments under Public Private Partnerships), is an important element of fiscal transparency.'

3.6.10 So, the System of National Accounts definition of debt does not include unfunded pensions schemes, government guarantees and payment streams for Public-Private Partnerships on the government balance sheet, but an IFRS approach would. Given this, schemes such as Public-Private Partnerships have been open to accusations of 'fiscal gimmickry' since they initially reduce the general government deficit and debt for a given level of investment in publicly-used infrastructure.[19] Indeed, in this sense the SNA approach – although endorsed internationally and used by key multinational bodies such as the OECD, IMF, Eurostat and UN – may be seen as less transparent and comprehensive than the IFRS approach.

3.6.11 In the introduction, the IMF's fiscal policy code was highlighted: the public should be provided with comprehensive information on past, current, and projected fiscal

[18] ibid

[19] See Koen, V. and van den Noord, P. (2005) Fiscal Gimmickry in Europe: One-Off Measures and Creative Accounting", OECD Economics Department Working Papers, No. 417,

activity and on major fiscal risks. In the light of this and concerns raised among economists and policymakers, there has been a movement towards increased transparency. The governments of Australia and New Zealand have led the way in introducing IFRS to their government accounts and the United Kingdom is moving this direction.

3.6.12 A central pillar of the UK government's approach to this issue is the introduction of The Whole of Government Accounts.[20] This programme will provide an annual IFRS-based consolidated statement of accounts for the public sector and its sub-sectors. This will consolidate the accounts of around 1300 public sector bodies and bring public sector accounting to a comparable basis with the private sector – the set of accounts produced will be comparable with those of a public limited company. This will mean all provisions and contingent liabilities are shown, introducing greater transparency. However, the IFRS approach on Whole of Government Accounts, as things stand, will not lead to any changes in measures of public sector net debt. Although the implementation of IFRS will bring, for example, Private Finance Initiative assets onto the balance sheets of government departments, the public sector net debt is derived from the National Accounts framework.

3.6.13 So, despite the introduction of the IFRS standard, the national accounting statistical framework still adopts a different approach. Ultimately, measures of net debt are reliant on the System of National Accounts (SNA), which have excluded contingent liabilities from the accounting framework. However, a considerable literature has developed highlighting the flaws of the current SNA's approach. For example, in relation to public private partnerships:

3.6.14 There is not a comprehensive fiscal accounting and reporting standard specifically for PPPs. The absence of such a standard makes it difficult to close loopholes that enable PPPs to be used to bypass expenditure controls, to move public investment off budget and debt off the government balance sheet, or to hide the potentially high costs of using guarantees to secure private financing.[21]

3.6.15 An internationally accepted accounting and reporting standard could promote transparency about the fiscal consequences of PPPs, and in the process ensure that increased efficiency, rather than a desire to meet fiscal targets, is their main motivation. In any event, as PPPs become more commonplace, market analysts and rating agencies are developing the expertise to assess the fiscal risks involved and, in particular, the implications for debt sustainability of future commitments under PPPs and contingent liabilities.

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[20] More information on the Whole of Government Accounts can be accessed here

[21] Public-private partnerships, government guarantees, and fiscal risk / prepared by a staff team led by Richard Hemming — Washington D.C.: International Monetary Fund, 2006.

3.6.16 Indeed, the head of OECD National Accounts, Francois Lequiller, has proposed for the SNA to recognise the provisions and impairments of assets that are recognised by business accounting standards.[22] And this was endorsed by the Task Force on Harmonization of Public Sector Accounting, which was chaired by the IMF, with an OECD-led secretariat. As part of this, the Advisory Expert Group agreed at their January/February 2006 meeting, that Public Private Partnerships are sufficiently important to be described in the revised SNA.[23] So, there is movement among multinational agencies to reconsider the approach to the treatment of contingent liabilities and provisions such as PPPs.[24]

3.6.17 In this context, the rest of this paper aims to assess the evidence on some of the contentious areas in relation to public liabilities that have typically arisen and, ultimately aims to quantify the different picture that might emerge among different approaches to measuring public sector net debt. Where possible, an assessment is made on the internationally comparable position of the United Kingdom in the contentious areas.

[22] Lequiller, F. (2004) 'The treatment of provisions in the national accounts: elements for the review of the SNA http://www.oecd.org/dataoecd/53/49/33740137.pdf Working Party on National Accounts

[23] Kaufman, B.; Lynch, R.; Maier, C. & Pitzer, J. (2006) 'Public-private partnerships'. Update of the 1993 SNA – Issue No. 24; Fourth meeting of the Advisory Expert Group on National Accounts; 30 January – 8 February 2006, Frankfurt

[24] See the Advisory Expert Group on National Accounts' conclusions in the appendix

4 Private Finance Initiative

4.1 Introduction to private finance in public sector procurement

4.1.1 Private Finance Projects are contractual arrangements between the public and private sectors which use private finance to realise public programmes – first introduced under the name public-private partnerships (PPPs) and latterly seen in the private finance initiative (PFIs).[25] They are well established, with some 800 existing in the United Kingdom with a capital value of £64 billion. PPPs or PFIs (used interchangeably hereafter) have enjoyed a generally good reputation for delivering projects on time and on budget but there have been notable failures amid the successes and a key controversy remains over the treatment of PFI liabilities in public accounts.

4.2 Treatment in national accounts

4.2.1 A House of Lords review found that in many cases there was an institutional bias towards PFIs because PFI liabilities were kept off public authorities' balance sheets.[26] The National Audit Office found that public authorities often feel pressured to use private finance because of its treatment in financial accounts makes it seem more affordable.[27] Moreover, an influential OECD paper included public private partnerships in their list of tools of fiscal gimmickry that governments can use in the sense that PFIs can initially reduce the general government deficit and debt for a given level of investment in publicly-used infrastructure.[28]

4.2.2 In addition, the IMF has highlighted the lack of a comprehensive fiscal accounting and reporting standard specifically for PPPs and the problems this creates: 'While the accounting profession is taking steps to develop an internationally accepted standard, the eventual features of such a standard are not yet clear. In the meantime, the current lack of such a standard makes it difficult to close loopholes that enable PPPs to be used to bypass expenditure controls.[29]' Furthermore, the IMF has acknowledged that the 'government guarantees provided in connection with PPPs are a major source of fiscal risk.'[30]

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[25] House of Lords Select Committee on Economic Affairs (2010) 'Private Finance Projects and off-balance sheet debt' Volume I: Report. Accessed here: http://www.publications.parliament.uk/pa/ld200910/ldselect/ldeconaf/63/63i.pdf

[26] Ibid, p. 17

[27] House of Lords Select Committee on Economic Affairs (2010) 'Private Finance Projects and off-balance sheet debt' Volume II: Evidence; NAO p.95. Accessed here: http://www.publications.parliament.uk/pa/ld200910/ldselect/ldeconaf/63/63ii.pdf

[28] Koen, V. van den Noord, P. (2005) Fiscal Gimmickry in Europe: One-Off Measures and Creative Accounting

[29] IMF (2004) 'Public Private Partnerships' http://www.imf.org/external/np/fad/2004/pifp/eng/031204.pdf (p. 22)

[30] Ibid pp. 43-44

4.2.3 According to the National Audit Office, around 78% (£22 billion) of operational PFIs in England by capital value are not recorded on the balance sheet of public sector financial accounts and are excluded from the Public Sector Net Debt statistics part of the National Accounts.[31]

4.2.4 As the government moves the public sector to International Financial Reporting Standards, assets which are controlled by the public sector, including most PFIs, will be brought onto departments' resource accounts However, as ESA 95 and the System of National Accounts will remain the basis upon which public sector net debt statistics are produced, the majority of PFIs will not be included in the net debt figure.[32] Given this, in its March 2010 report, the House of Lords Economic Affairs committee concludes (emphasis added):

4.2.5 ***'There should be greater clarity about financial liabilities arising from PFIs.*** The Treasury's requirement that departments should run two sets of accounts, though an understandable response to the use of one accounting system within departments and another nationally, is far from ideal. Furthermore, national accounts solely on a UK GAAP basis give a misleading picture of overall liabilities by excluding most PFIs from figures of Public Sector Net Debt. ***We recommend that the Government should publish figures for total liabilities for privately financed public sector procurement as a separate item alongside figures for Public Sector Net Debt.*** Brief statistical information should also be supplied as to the distribution of these liabilities across a series of separate categories that reflects differences in the extent of risk transfer away from the public sector.'

4.2.6 'Inclusion of PFI liabilities in Departmental balance sheets, as now required, together with publication of aggregate figures of national PFI liabilities, as we now recommend, should provide a clearer picture of their economic significance. The motive widely imputed by witnesses to the Treasury for its perceived bias in favour of PFIs— their low profile in accounts—would also fall away.'

4.2.7 'We recommend that, subject to the need to maintain control of public spending, the Government should take measures to remove institutional bias in favour of private financing of public procurement, so that public authorities can select it, or another procurement method, on a case-by-case basis according to value for money.'[33]

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[31] House of Lords Select Committee on Economic Affairs (2010) 'Private Finance Projects and off-balance sheet debt' Volume II: Evidence; NAO p.95

[32] House of Lords Select Committee on Economic Affairs (2010) 'Private Finance Projects and off-balance sheet debt' Volume I: Report, p. 17

[33] House of Lords (2010, I), p.18

4.2.8 In the government response to this, HM Treasury stated that a number of steps have already been taken in these areas to improve the availability of data on PFI projects:

4.2.9 'Departments will publish their resource accounts on an IFRS basis in summer 2010, and these will reflect the PFI accounted for under IFRS. Whole of Government Accounts (WGA) will be published around Spring 2011 and will also reflect PFI on an IFRS basis. A reconciliation between National Accounts debt measures and WGA on an IFRS basis will be provided.'[34]

4.2.10 There is no doubt that the government is taking positive strides forward with the introduction of IFRS across the public sector and the development of the Whole of Government Accounts projects, however, there are still question marks about the wider issue of how contingent liabilities such as public-private partnerships should be treated in the national accounts. This remains a key issue internationally; academics, the IMF and OECD have acknowledged the flaws in the existing of System of National Accounts in treating PPPs worldwide. For example in a wide ranging review of public-private partnerships by IMF staff concludes:

4.2.11 'While practices and standards continue to evolve the paper emphasizes the need for strengthening disclosure requirements for all PPPs, in particular their underlying risks and contingent liabilities, which are in line with best fiscal transparency practices.'[35]

4.3 International context

4.3.1 The movement towards greater transparency when details of PFI liabilities by department are published will be a positive step, but a clear understanding of the impact on public sector net debt would be a further step in the right direction. But this will be useful when international agreement is reached on approaching public-private partnerships. This is important since there has been a 6-fold increase in the use of PPPs across Europe from the early 1990s to 2005-6 and a 7-fold increase in developing countries in 2006-8 compared with 1990-2.[36]

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[34] House of Lords (2010) 'Government response to report on private finance projects and off-balance sheet debt', p.7 accessed here: http://www.publications.parliament.uk/pa/ld200910/ldselect/ldeconaf/114/114.pdf

[35] Cangiano, Hemming & Ter-Minassian (2004) 'Public-private partnerships: implications for public finances'; Public Debt, bancaditalia.it. Access here:

http://www.bancaditalia.it/studiricerche/convegni/atti/publ_debt/session3/553-574_cangiano_hemming_and_ter-minassian.pdf

[36] Fischer, R. (2010) 'PPP: Conceptual issues and pitfalls' Prepared for: The Economics of Infrastructure in a Globalised World: Issues, Lessons and Future Challenges, 17 March 2010. Accessed here:

http://cama.anu.edu.au/Events/Infrastructure%20Conference/PPP%20Conceptual%20issues%20and%20pitfalls.pdf

4.3.2 No European database on public-private partnerships exists, although some national databases are published.[37] In addition, the World Bank runs a database for the many PPP projects in the developing economies. However, as key player in the financing of PPP projects, the European Investment Bank has gathered data on the volume, value and sector mix of PPPs in Europe. The data shows that PPPs have gradually spread from the United Kingdom to the rest of Europe, with over 1000 PPP projects with a capital value of almost €200 billion in Europe over the fifteen years to 2007. [38] With 812 PPP projects closed by end-2006, the UK accounts for some three-quarters of all European PPPs by number and almost three-fifths by value, as shown in figure 7 below. [39] Researchers at the European Investment Bank conclude:

4.3.3 '[T]he UK is in its own league in terms of the maturity of the PPP market is evidenced also by the widespread use of PPP procurement in a large number of sectors and by all levels of Government for major projects. In continental Europe, in contrast, the transport sector, especially roads, continue to dominate the PPP market. While PPPs are spreading into other sectors as well, the relative importance of investment through PPPs remains small.'[40]

4.3.4 To sum up, the evidence across Europe suggests that public-private partnerships are, by some way, most abundant in the United Kingdom. As such, if there was an update to the System of National Accounts determining that PPP projects should be brought onto balance sheet and included in public sector liabilities, the effect on debt would be disproportionately large for the United Kingdom relative to other European countries.

[37] For UK see Partnerships UK website at http://www.partnershipsuk.org.uk; for Italy see Osservatorio Nazionale del Partenariato Pubblico Privato website at http://infopieffe.it and for Ireland see http://www.ppp.gov.ie/projects/

[38] Blanc-Brude, F., Goldsmith, H. & Valila, T. (2007) 'Public Private Partnerships in Europe: an update' European Investment Bank; p. 7 Accessed here: http://www.eib.org/attachments/efs/efr_2007_v03_en.pdf

[39] Ibid.

[40] Blanc-Brude, F., Goldsmith, H. & Valila, T. (2007)

Figure 7 European public-private partnership projects by country, percentage share of total

	% of No. of signed projects	% of value of signed projects
Austria	0.2	0.6
Belgium	0.7	1.1
Cyprus	0.3	0.4
Czech Rep.	0.2	0.4
Denmark	0.0	0.0
Finland	0.2	0.2
France	2.8	3.9
Germany	2.4	2.9
Greece	0.6	3.9
Hungary	0.8	2.7
Ireland	0.7	0.7
Italy	2.1	3.7
Latvia	0.1	0.0
Malta	0.1	0.1
Netherlands	1.0	1.7
Poland	0.4	0.9
Portugal	2.3	5.8
Romania	0.3	0.1
Slovak rep.	0.1	0.0
Slovenia	0.1	0.0
Spain	8.6	12.8
Sweden	0.1	0.2
UK	76.2	57.7
Total	100.0	100.0

Source: European Investment Bank

4.4 Discussion and estimated range of PFI liabilities

4.4.1 The latest HM Treasury data for February 2010 shows PFI projects underway have a capital value of £56 billion. Of these projects, some £43 billion are currently considered as off-balance sheet, or around four-fifths of all PFIs. However more recently the capital value has been estimated at £64 billion, of which £25 billion are on-balance sheet; so only three fifths are considered on-balance sheet.[41]

4.4.2 In 2006, the Office for National Statistics reviewed the treatment of some of the PFIs, including estimates of imputed finance lease liabilities associated with PFI for projects classified as on-balance sheet. These totalled £4.92 billion in March 2005; and £4.95 billion in March 2006, increasing public sector net debt by the equivalent of 0.4% of GDP.[42] So, there has been some movement to acknowledge

[41] House of Lords (2010, II), pp. 45-6

[42] ONS (2006) 'Including Finance Lease Liabilities in Public Sector Net Debt: PFI & Other'. Available here:

and incorporate PFI liabilities in public sector net debt, but a significant proportion of PFIs remain off-balance sheet.

4.4.3 Further to the capital values discussed above, HM Treasury data show that some 114 projects are in procurement, with a capital value of over £14 billion.[43] Hence, based on HM Treasury figures, the maximum total capital value of PFI projects committed and in procurement is £71 billion on the latest evidence if the strongest assumption that all projects are considered on-balance sheet. On that basis, Figure 8 summarises the potential liabilities associated with PFI projects. However, underlining the complexity of the treatment of PFI/PPP projects, it is important to note that the capital value of aggregated PFI will not equate with the liability, as some projects are not yet live, and for those that have been in progress for a number of years the liability will be less than the original value.

Figure 8 Total United Kingdom PFI liabilities, £billion

	Estimated total capital value (£bn)
Signed projects	56
Off-balance sheet	43
Already included in net debt	5
Projects in procurement	14
Maximum liability	71

Source: HM Treasury, ONS and cebr calculations (Maximum does not sum due to rounding)

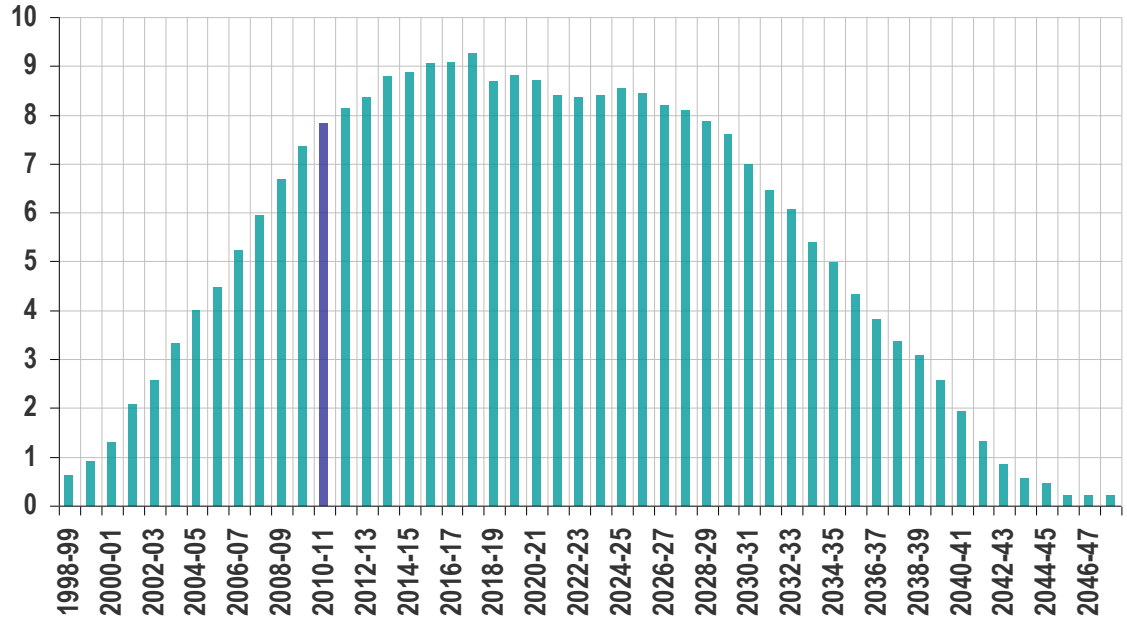
4.4.4 Another way of looking at PFI projects is annual payments by the public sector as part of the project. The payment schedule for the over 600 projects is illustrated in figure 9 below.[44]

http://www.hm-treasury.gov.uk/d/financeleasesarticle_200906.pdf

[43] HM Treasury (2010) PFI projects in procurement, accessed here:
http://www.hm-treasury.gov.uk/ppp_pfi_stats.htm

[44] HM Treasury (2010) Public private partnerships signed projects list, accessed here:
http://www.hm-treasury.gov.uk/ppp_pfi_stats.htm

Figure 9 Total annual government payments on PFI projects, £ billion



Source: HM Treasury

4.4.5 The net present value of all future payments due is dependent upon the discount rate used. Figure 10 shows estimates of the net present value of the total payments linked with the PFI contracts using HM Treasury data on unitary charge payments and cebr analysis of a range of specified discount rates that closely relate to the current prevailing long term interest rates that the government pays on its borrowings. The graph shows the annual payments by government from financial year 1998-9 through to 2047-8.

Figure 10 Total net present value of United Kingdom PFI payments under different discount rates, £billion

Discount rate	**Total PFI payments (£bn 2010 prices)**
2.0%	222
3.5%	146
4.0%	138
4.5%	131
10.0%	79

Source: HM Treasury and cebr analysis

4.4.6 In the Centre for Policy Studies study, Brooks Newmark MP ultimately arrives at an estimate of PFI related liabilities at £139 billion. This is based on HM Treasury data showing the capital value of PFI projects is £64 billion and an additional £181

billion of unitary charge payments due until 2047. This gross figure of £245 billion is discounted using a 2% rate to give the £139 billion estimate of liabilities.[45]

4.4.7 Figure 10 shows that depending on the discount rate used, the net value of total future payments by the public sector in private sector deals is between £131 billion and £146 billion on rate related to government borrowing costs. These figures reflect the value of the discounted future revenue streams in today's prices. Applying a higher discount rate such as 10% lowers the net present value to £79 billion while a lower rate such as that used in the CPS study raises the net present value to £222 billion. It does not make sense to add together the capital value of the project and the stream of future payments as is done in the CPS study, while it does not make sense to use as low a discount rate as low as 2%.

4.4.8 As the graph of future PFI payments in figure 8 showed, the annual payments related to PFIs do not rise above £10 billion per year in current prices – and if future payment obligations are deflated into real terms they only just surpass £8 billion in 2010 prices.[46] Hence, the payments are equivalent to just 0.5% of GDP per year. Rolling up the PFI payments over the next 37 years and applying discount rates based on government borrowing costs means the discounted value of all payments associated with PFI is equivalent to 9% of nominal GDP.

4.4.9 As explained in this section, the treatment of PFI and PPP liabilities is a hugely complex topic. While information is available in a piecemeal fashion, an accessible and transparent analysis of the liabilities associated with PPP and PFI projects is not available. However, the introduction of IFRS across public sector bodies will help address this for government accounting purposes. It will be important for this information to be made available and accessible alongside other items of major public liability so that comprehensive assessments of the UK's fiscal sustainability can be made.

[45] CPS (2009) p.3

[46] Estimated using HM Treasury forecast of GDP deflator and cebr calculations. Deflators available here: http://www.hm-treasury.gov.uk/data_gdp_fig.htm

5 Public sector pensions

5.1 Introduction

5.1.1 The issue of unfunded public sector pension liabilities has attracted considerable media attention and was addressed in the Office for Budget Responsibility's first report.[47] The potentially large costs to the taxpayer that could result from meeting public sector occupational pension commitments have been covered in studies from the Institute for Economic Affairs, the Confederation of British Industry, Policy Exchange and the National Audit Office.

5.1.2 Unfunded public sector pension liabilities are not included in net debt figures for the United Kingdom but they are reported by departments and will be included in the Whole of Government Accounts. These liabilities are estimates of the rights that have been built up during service already provided by employees and not projections of rights likely to be accrued in the future.[48] As such, they are payments that the government is committed to make in the years ahead, just as it must repay holders of United Kingdom government bonds, and must be carefully considered when analysing the United Kingdom's long term fiscal sustainability

5.1.3 This chapter begins by introducing public sector pensions further through the latest estimates from the Office for Budget Responsibility and HM Treasury. Following this, a brief review of the literature on public sector pension liabilities is undertaken before the key discussion points are raised and a plausible range of estimates of public sector pension liabilities derived.

5.2 Office for Budget Responsibility analysis

5.2.1 The Office for Budget Responsibility's first report highlights how the government runs most UK public service pension schemes with no fund on a pay-as-you-go basis. As such, the government must ultimately supply the monies needed to finance cashflows to pensioners.[49] Net annual expenditure on the PAYG public pension scheme is equivalent to the amount spent on paying cash benefits less contributions made by public sector employees. As and when contributions received fall below the cost of making pension payments, the government must finance this shortfall through current expenditure.

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[47] See, for example, "Cost of public-sector pensions equal to 85% of GDP, think tank warns"; the Guardian, "Public sector pension bill dwarfs defence budget", Daily Mail, 20 June 2009; Macer Hall, "£700 bill for each home in Britain: New Public sector bombshell', Daily Express, 18 December 2009; 'Public sector pensions will cost £1 trillion', Sunday Times, 2 November 2008

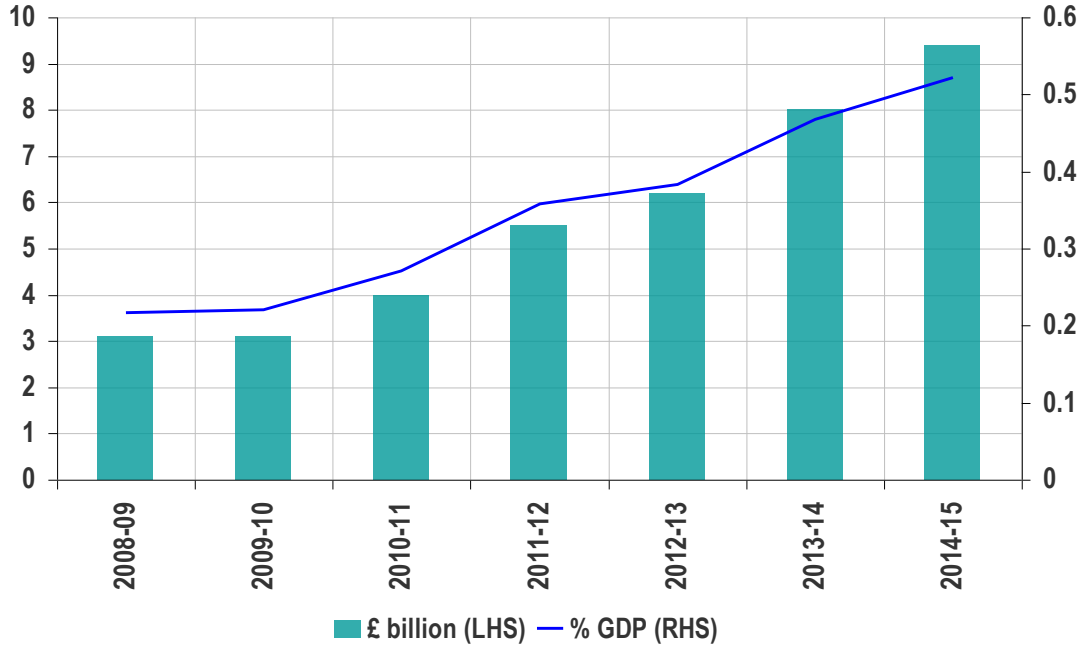
[48] Maitland-Smith (2009), p. 49

[49] Office for Budget Responsibility (2010) 'Pre-Budget forecast: June 2010' Available here: http://www.hm-treasury.gov.uk/data_obr_index.htm; p. 61

5.2.2 In the short to medium term, the OBR has estimated the annual cost of funding public sector pensions out to 2014-15. Expenditure forecasts are shown in figure 11 below; expenditure is expected to reach £9.4 billion in 2014-15 up from £3.1 billion in 2009-10.[50] As a share of nominal GDP, this amounts to a rise from 0.2% to 0.5%.

5.2.3 Looking into the longer term, the HM Treasury report on long-term public finances published in December 2009 provides estimates of the projected costs of pension expenditures through to 2060.[51] This finds that the cost is projected to be low and stable share of GDP at around or below 2% through to 2059-60.[52] This projection models the effect of an increased quantity of pensioners over the period and assumes the schemes remain as now; between 2009 and 2059 the number of those aged 68 and above is projected to increase by 9m.[53]

Figure 11 Annual net public service pension expenditure, financial years, £ billion (LHS) and share of nominal GDP, percentage (RHS)



Source: Office for Budget Responsibility Pre-Budget forecast

5.2.4 The annual flow of payments via the Pay-as-you-go scheme can also be considered as a total public service pension liability, representing the net present value of all future payments to pensioners by the government. In line with this, the Government Actuary's Department (GAD) estimated the liability at £770 billion on 31 March 2008. Figure 12 shows GAD's estimates of the unfunded public pension

[50] OBR (2010) p. 48

[51] HM Treasury (2009) 'long-term public finance report: an analysis of fiscal sustainability' December 2009

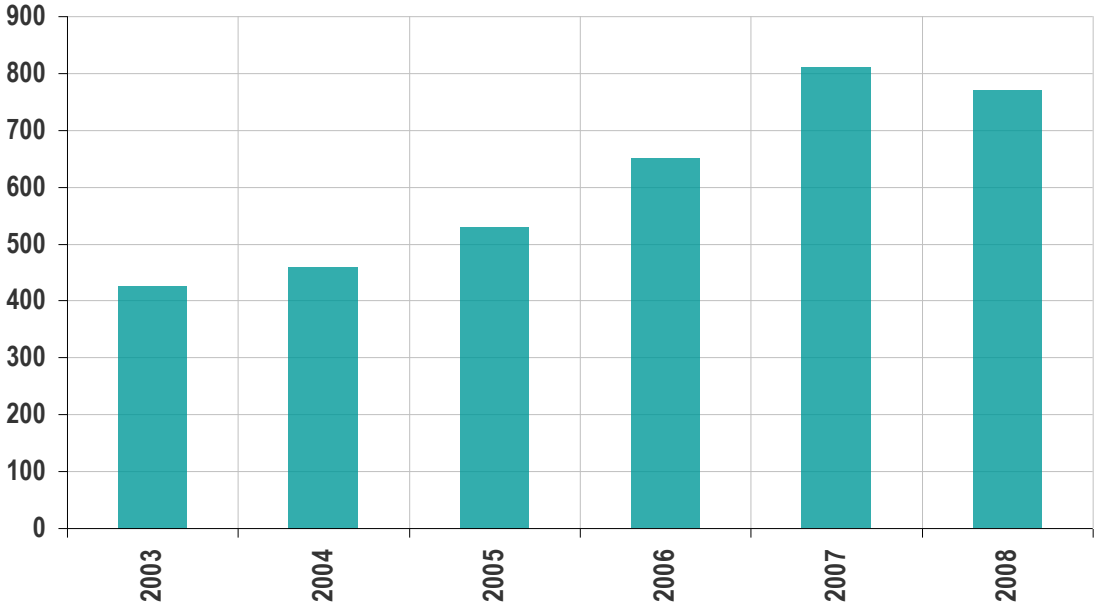
[52] Ibid p. 48, see chart 6.E

[53] Ibid. p.49, from ONS 2008-based Population Projections, Office for National Statistics 2009

liability in recent years. The size of this figure depends on a variety of factors including crucially:

- Mortality rate of current and future pensioners within the schemes
- The discount rate used to express future cash flows as a single figure

Figure 12 Total liability of unfunded public service occupational pension schemes (£million)



Source: HM Treasury

5.2.5 Indeed, the estimated size of the liability is extremely sensitive to assumptions made about the discount rate.[54] In terms of the annual accruing liability to the public pension schemes the OBR states that: 'the most appropriate measure is probably the current service cost. Current service cost represents the amount that discounted pension scheme liabilities will increase over the year by reason of the additional year's service of active members of the pension scheme. The current service cost for all PAYG public service pension schemes was around £26 billion for the year ending 31 March 2008.'

5.2.6 Notably, the OBR highlights some of the risks related to the unfunded, PAYG system: 'the lack of a fund to back liabilities imparts a level of fiscal inflexibility regarding future shocks to revenue. For example, a negative GDP growth shock could mean that the cost of paying current pension obligations displaces other expenditure and thereby causes distortions.'[55] This suggests that careful consideration of the size of public sector pension liabilities is vital in assessing their contribution to overall fiscal sustainability.

5.3 IEA: Facing Up to the Cost of Public Sector Pensions

5.3.1 In 2006, economist Neil Record undertook a detailed study of the United Kingdom's unfunded public sector pension liabilities, published by the Institute of Economic Affairs (IEA).[56] The first main flow of the arguments presented, was that official estimates of public sector pension liabilities do not use sound accounting or actuarial methodology and, as such, they underestimate the true liability that taxpayers owe to public sector workers in the form of future pensions. The study explains the key factors that drive pension costs; namely discount rates, mortality rate and salary rises. The paper questions the assumed discount rate used by the government to assess the value of future pension payment obligations that the government owes.[57]

5.3.2 The IEA paper describes how private sector pension schemes have to disclose their pension liabilities transparently, because shareholders increasingly understand the costs of final salary and defined-benefit pension schemes. Record argues that In the public sector, the costs are still hidden and the incentives for action to be taken to reduce costs are limited.

5.3.3 At the time of publication, the official government estimate of public sector pension liabilities was £530 billion. However, Record estimates using what he

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[54] Maitland-Smith (2009) p.49

[55] Office for Budget Responsibility (2010) 'Pre-Budget forecast: June 2010' p. 61

[56] Record, N. (2006) 'Sir Humphrey's Legacy Facing Up to the Cost of Public Sector Pensions', Institute of Economic Affairs. Available here: http://www.iea.org.uk/record.jsp?type=book&ID=390

[57] See ibid p. 35-58 for detailed explanation

supposes to be more realistic assumptions that the figure would be £1,025 billion.[58] For 2006, this sum was over 80 per cent of GDP and over twice the size of the official national debt. Record argues further that since these commitments must be honoured by government, pension liabilities should be regarded in the same way as the official national debt.

5.3.4 Neil Record, the author of the IEA study, published an updated estimate of the United Kingdom's pension liabilities in June 2009 through the British-North American Committee. Total public sector pension liabilities were found to have reached £1,177 billion in 2009 – equivalent to 85% of GDP. [59] The BNAC report highlights the difference between this estimate the government's figures derived using different assumptions over interest rates, with total pension liabilities at £886 billion. Hence, the BNAC estimate of the total pension liabilities stands some 32% higher than the government estimate.

5.4 CBI – 'getting a grip'

5.4.1 A December 2008 Confederation for British Industry (CBI) briefing note found that unfunded pension liabilities amounted to at least £900 billion.[60] The estimate for pension liabilities was based on using discount rates derived from corporate bonds, in line with what would be used in the private sector.

5.4.2 Furthermore, the study pinpoints the differences between the private and public sector responses to the provision of pensions. The CBI states that: 'private sector organisations have responded to pressures on funding by increasing their contributions into final salary schemes and taken steps to contain future costs.' The CBI explains that longer life expectancy and lower returns have sharply increased the cost of defined benefit pension provision. The CBI argues that the government must make greater effort to establish transparency, using the same principles for disclosing pension costs as the private sector, in line with UK and international accounting and actuarial standards.[61] The CBI highlights that:

- There is a lack of transparency over the costs and liabilities of public sector pensions;
- Steps already taken in the public sector do not go far enough; and

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[58] Ibid, pp. 72-3

[59] British-North American Committee (2009) 'UK public sector pension liabilities now 85% of GDP, hugely exceeding those of US and Canada' Published 29 June 2009; accessed here: http://www.bnac.org/files/BNAC%20Release%20on%20public%20sector%20pension.pdf

[60] CBI (2008) 'Clearing the fog: Achieving transparency on public sector pension costs'. Accessed here: http://www.cbi.org.uk/ndbs/press.nsf/0363c1f07c6ca12a8025671c00381cc7/0261a45505173d0c8025751c00363ed7/$FILE/CBI%20Public%20Sector%20Pensions%20Brief%20Dec%2008.pdf

[61] Similar arguments to those introduced in chapter 3 – section 3.6 on the comparison between IFRS and national and government accounting methods.

- The private sector has taken action to ensure affordability – the lessons should be applied to reforming public sector provision.

5.4.3 A recent update to the CBI briefing published in April 2010 quantifies the total pension liability at over £1 trillion; 'total liabilities in the unfunded public sector schemes – using realistic pricing in line with private sector practice – is now £1.01 trillion, up from £915 billion in 2008.'[62] This estimate is 24% higher than the government estimate.

5.5 Policy Exchange: 'the UK's second national debt'

5.5.1 The Policy Exchange study published in 2009 is relatively similar to the IEA study three years before. Again, key to this report is the argument that the government's promises to public sector workers of defined benefit pensions, 'often worth two thirds of final salary, index-linked for life' creates major challenges for the public finances because the way the government is calculating the total cost is unrealistic.[63] The report states that on the Government's own figures 'which are based on artificial assumptions', the accumulated liability is estimated to be greater than the national debt.[64]

5.5.2 Applying a different (which the authors refer to as the 'proper') method to calculating the accumulated liability of the public sector pension schemes, the study finds it is equivalent to 78% of GDP or £1.1 trillion in financial year 2007-8.[65] The argument goes: 'in order to work out what the value of its promises to pay out money in the future are worth today, [the government] applies an interest rate to those promises that allows the final figure to be expressed in today's money. The prevailing market interest rate would be the most natural one to use, but the government has decided to adopt a rate that exceeds it. This has the effect of making the liabilities look smaller than they are.'[66] Ultimately, for the most recent year, the authors estimate that unfunded pension liabilities are 39% higher than the government's estimate.

5.5.3 The third chapter of the paper offers a detailed treatment of the government and the authors' approach to the discount rate for unfunded pension liabilities. The Government uses a rate chosen by the Financial Reporting Advisory Board.[67] Until 2005 a 3.5% fixed real discount rate was used, based on long-tern historical

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[62] CBI (2010) 'Getting a grip: the route to reform of public sector pensions' Accessed here: http://www.cbi.org.uk/pdf/20100406-cbi-getting-a-grip-a-route-to-reform-of-public-sector-pensions.pdf

[63] Record, N. Mackenzie-Smith, J. & Kay, L. (2009) 'Public sector pensions – the UK's second national debt' Policy Exchange. Accessed here: http://www.policyexchange.org.uk/publications/publication.cgi?id=122, p. 5

[64] ibid

[65] ibid

[66] ibid p. 6

[67] More information on FRAB is available here: http://www.hm-treasury.gov.uk/psr_frab_index.htm

patterns of real rates of return on gilts. From the financial year 2005-06, the FRAB adopted a discount rate based on yields of AA-rated corporate bonds of more than 15 years' maturity, in line with the requirement of the FRS17 and IAS19 private sector accounting standards for funded schemes.[68] The effect of using these different rates has a material effect on the valuation of public sector pensions, as reflected in the Policy Exchange's headline figures on public sector liabilities discussed above.

5.6 NAO: the cost of public service pensions

5.6.1 In its March 2010 report, the National Audit Office aimed to bring greater transparency to, and understanding of, the costs of public service pensions.[69] The report assesses pension payments made over the last ten years and projected payments over the next 50 years. The analysis of past payments covers the four largest schemes, which represent over three quarters of all UK public service pay-as-you-go pension payments, while the analysis of projected payments covers all UK public service pay-as-you-go pension schemes.

5.6.2 The report finds that total payments to the 2.13 million pensioners in the four largest UK public service 6 pay-as-you-go pension schemes were £19.3 billion in 2008-09, which is a real-terms increase of 38 per cent since 1999-2000. Most of the increase was due to a 23 per cent rise in the volume pensions in payment over the period. This is driven by more employees retiring each year, which is a substantially more significant factor than longer lifespans. The total cost to the taxpayer of the four largest UK public service pay-as-you-go pension schemes in 2008-09 was £14.9 billion, net of income from employee contributions, a real-terms increase of 33 per cent since 1999-2000. It was met through a combination of £12.5 billion in employer contributions generally paid by taxpayer funded organisations, such as NHS Trusts and government departments, as part of the normal cost of employing staff, and £2.5 billion directly from the Treasury (the two elements not adding exactly because of rounding).

5.6.3 Expressed in terms of 2008-09 prices, the Government Actuary's Department projects payments rising to £79.1 billion by 2059-60 from an estimated £25.4 billion in 2009-10. Expressed in terms of 2008-09 earnings, projected payments reach a peak of £29.4 billion between 2031-32 and 2033-34 before falling to £28.8 billion by 2059-60. This is based on the Treasury's assumption of 2.0 per cent real-terms annual earnings growth across the economy as a whole.

5.6.4 Expressed in terms of Gross Domestic Product (GDP), the presentation the Treasury uses in its Long-term public finance reports, projected payments reach a peak of 1.9 per cent of GDP between 2018-19 and 2033-34 then fall to 1.7 per cent

[68] Paragraph adapted from Record et al (2009) pp.31-33

[69] National Audit Office (2010) 'The cost of public service pensions'

by 2059-60. This compares to a rise from around 1.5 per cent to 1.7 per cent over the last ten years. The projection is based on Treasury assumptions of 2.0 per cent annual productivity growth in the economy as a whole and 20 per cent growth over 50 years in the working population.

5.6.5 Higher life expectancy, equal for example to around two extra years for a man reaching 65 in 2015 and three extra years for a man reaching 65 in 2025, would add around 0.05 percentage points to the cost of public service pensions as a proportion of GDP by 2059-60. A 0.25 per cent lower annual productivity growth rate, affecting earnings and GDP, would add 0.1 percentage points to the cost of public service pensions as a proportion of GDP by 2059-60.

5.6.6 Higher life expectancy and lower productivity growth would increase the cost of public sector pensions as a proportion of GDP. Conversely, lower life expectancy and higher productivity growth would reduce costs as a proportion of GDP. The Treasury has not undertaken any systematic analysis of the impact of changing the assumption about zero public service workforce growth, although it did consider doing so. In our view, such an analysis is needed to understand the potential impact on public service pension costs of plausible alternative outcomes.

5.7 Discussion, range of estimates and international comparison

5.7.1 In assessing the total public pension liabilities, there are key contentions over the discount rate that should be applied, public service workforce growth and assumptions about life expectancy.

5.7.2 The most recent official estimate of the unfunded pension liabilities is £770 billion, taken from the GAD analysis for the year ending 31 March 2008. However, other organisations have published higher estimates as illustrated in figure 14. As such, the upper bound for the estimated unfunded pension liabilities is £1,100 billion.

Figure 14 Estimates of unfunded public sector pension liabilities, £ billion

	GAD	IEA, BNAC	CBI	Policy Exchange
2005	530	1025		
2006	650			
2007	810			1100
2008	770		915	
2009	886*	1177	1010	

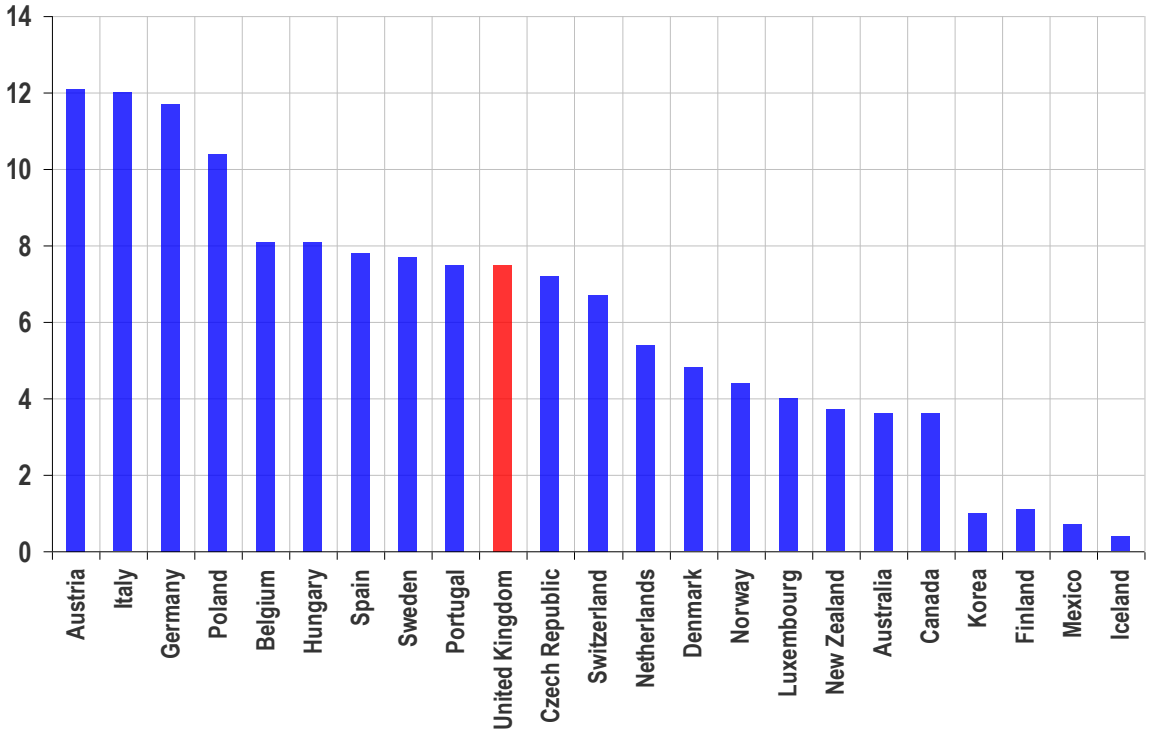
*BNAC estimate

Source: GAD, IEA, CBI, Policy Exchange, BNAC

5.7.3 While the figures for the unfunded pension liabilities are large, it is worth putting into an international context. The latest OECD data shows that public sector pension expenditure in the United Kingdom is lower than for many other European countries, including: Italy, Germany and Spain. This is shown in figure

15 below. In addition, HM Treasury's long term public finance projections show pension expenditure as a share of GDP is lower than the eurozone and European Union averages both in 2007 and by 2060.[70]

Figure 15 Public sector pension expenditures across OECD countries in 2006, percentage of GDP



Source: OECD Factbook 2009; Population and Migration

5.7.4 So, while many studies have helped to consider the risks around public sector pension liabilities, looking in an international context, the evidence does not show that the United Kingdom is a 'basket case' with respect to this as some studies have implied. But the analysis above does show that the unfunded pension liabilities are large relative to GDP and there are risks ahead. As such, greater transparency and assessment of the risks related to unfunded pensions will be needed. The new European System of Accounts, coming in from 2014 will provide liability figures for state retirement and state second pensions in the UK, and not only for government occupational pensions.

[70] See HM Treasury (2009) 'Long term public finance report', Chart 6G, page 51 – taken from EU Economic Policy Committee study: European Commission (2009) '2009 Ageing Report: Economic and budgetary projections for the EU-27Member States (2008-2060)' EUROPEAN ECONOMY 2|2009; available here: http://ec.europa.eu/economy_finance/publications/publication14992_en.pdf

5.8 Local Government Pensions Scheme

5.8.1 In addition to the unfunded public service pension liabilities, there is also a deficit on the Local Government Pension scheme which is in practical terms underwritten by the taxpayer.[71] Again, there is uncertainty over the exact magnitude of this liability and a lack of timely and transparent data of the deficit. The most recent official estimate of the deficit was £27 billion in 2007. However, a recent estimate from actuary consultants Punter Southall predicts a £70 billion deficit in the scheme:[72]'Although the results of the forthcoming LGPS valuation will not become known until some time after the valuation date of 31 March 2010, our analysis indicates that at the end of 2009 the LGPS might have had assets of only 60% of the estimated amount required to meet its liabilities to current members.'

5.8.2 It is difficult to know precisely what the liabilities associated with the LGPS are – further research and greater transparency would only help to clarify the impact on total UK liabilities and national debt.

[71] OBR (2010) p. 58

[72] Punter Southall press release; available here: http://www.puntersouthall.com/news-archive?n=218

6 Contingent liabilities

6.1 Financial crisis interventions

6.1.1 The financial sector interventions through the credit crunch added to the stock of public sector net debt through the official reclassification of Northern Rock and Bradford & Bingley as shown in chapter 3. However, assessing the long-run effect on national debt is far from straightforward; the public purchase of financial institutions was intended to be a temporary measure and future privatisation of the publicly owned financial institutions is highly likely; the government holds assets which will go some way to offset the liabilities. This is a point that the CPS study fails to recognise in deriving its estimate of £130 billion for the cost of the bank bail-outs. The section that follows assesses National Audit Office and HM Treasury work in this area.

6.2 Network Rail

6.2.1 Following the failure of Railtrack, the government created Network Rail as a company limited by guarantee. The Office for National Statistics classified Network Rail as a private sector organisation:

6.2.2 Network Rail is classified to the private sector by the Office for National Statistics (ONS) for National Accounts. ONS applied the definitions of the European System of Accounts 1995 (ESA95) in making their decision. The government compiles its fiscal measures using National Accounts definitions. As such, Network Rail's activity will not be included in the public sector current surplus and net borrowing, nor will its liabilities be included in public sector net debt. But subsidies and investment grants paid by Government to the rail industry will continue to count in those public sector balances. [73]

6.2.3 This classification was also reached by the National Audit Office in a joint statement with the ONS:

6.2.4 'Sir John Bourn (head of the NAO at the time) has concluded that, under UK Generally Accepted Accounting Practice (GAAP), Network Rail should be accounted for as a subsidiary of the Strategic Rail Authority (SRA). Len Cook (National Statistician at the time, ONS) has decided that, under the international rules for the compilation of economic statistics, Network Rail should be classified

[73] Office for National Statistics (2002) 'Network Rail: NAO ONS joint statement'

as a private, nonfinancial corporation in the National Accounts from the time that a vote of its members approved its board of directors.[74]

6.2.5 'In classifying Network Rail as a private non-financial corporation in the National Accounts, Len Cook concluded that, once the members voted to approve the board of directors, control of ongoing corporate policy at Network Rail does not rest with the Government - the SRA's director being one out of twelve on the board - but with the members and the board of directors. He also concluded that, until this vote, the government exercised control, and that Network Rail was in the public sector. Further, it would be reclassified as part of the public sector if the SRA were to use its powers to gain control in the event of Network Rail's financial failure. SRA's powers to take control are conditional on financial failure, and are therefore detached from ongoing corporate policy decisions.[75]

6.2.6 However, questions have been raised about the implications for public finances of the rising debt accumulated by Network Rail. In an analysis of Network Rail operations since its inception, Robert Jupe argues that increased infrastructure expenditure has been financed partly through increased subsidies but partly through a large increase in debt, as expenditure has exceeded income.[76] Hence, Network Rail's increasing debt has led to a large rise in the interest payments it has to pay.[77] Debt rose further in the latest financial year – with preliminary results showing net debt at £23.8 billion in the financial year ended 31 March 2010. [78] Net debt stood at £9.7 billion on 31 March 2003, so over seven years, debt has increased by almost 150% in nominal terms.

6.2.7 In a recent paper, accounting academic Jupe argues that Network Rail's status as a private sector company with private sector debt seems increasingly anomalous, when considering that: 'all of the key regulatory changes introduced by the Labour government following the 2004 rail white paper have led to an increase in public control over the company.'[79] While the SRA no longer exists, the government has taken powers, from the ORR, to determine the company's future funding, which would bring into question the classification as a private sector company. Indeed, the government face the dilemma that "it cannot be seen to

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[74] Office for National Statistics (2002) 'Network Rail: NAO ONS joint statement'

[75] ibid

[76] Jupe, R. (2009) 'New Labour, Network Rail and the third way' Accounting, Auditing & Accountability Journal Volume: 22 Issue: 5 Page: 723

[77] Jupe, R. (2009) 'New Labour, Network Rail and the third way' Accounting, Auditing & Accountability Journal Volume: 22 Issue: 5 Page: 724

[78] Network Rail (2010) 'Financial Highlights for the year ended 31 March 2010' Accessed here: http://www.networkrail.co.uk/browse%20documents/preliminary%20financial%20results/a.%202009-10/network%20rail%20limited%20-%20preliminary%20financial%20results%202009-2010.pdf

[79] Jupe, R. (2009) p. 730

exercise too much direct control over Network Rail at the risk of reclassification" of it debt from private to public.[80] Jupe concludes (emphasis added):[81]

6.2.8 '...railway infrastructure costs are "camouflaged" and Network Rail's debt "appears in the UK national accounts as private sector borrowing"[82] *Should Network Rail fail, however, it is clear that responsibility for its debts will lie with the government*. Its borrowing could therefore be seen as "imputed debt" falling within the public sector net debt calculation, similar to the finance lease liabilities associated with Private Finance Initiative projects which were recently reclassified by the ONS from private to public.[83]'

6.2.9 In line with this, the Centre for Policy Studies concluded that Network Rail's liabilities of £22 billion should be considered as part of the public sector balance sheet, or 'at least as an additional statistic including all contingent liabilities'.[84]

6.2.10 The discussion above has demonstrated that Network Rail officially is a private sector non-financial corporation; however, the argument can be made that if Network Rail fails, responsibility for its debts would lie with government. As such, Network Rail's debts could be considered a contingent liability for which provisions could be made. However, in the current system of national accounts this would not be classified as part of public sector net debt. Further research and clarification on the procedures in the event of Network Rail failure would be welcome.

6.3 Evidence from the NAO and HM Treasury

6.3.1 The National Audit Office's detailed report on the government's interventions in the financial sector states that: 'It is not possible to estimate with any certainty the net cost of the Government's support of the UK's financial system.'[85] Nonetheless, the NAO pulls together the relevant information to provide as comprehensive picture as possible. Figure 16 below shows that the Treasury's gross outlay to support the banking system was £131 billion by the end of 2009. However, by the end of 2009, the Treasury was expected to have recovered nearly £14 billion in

[80] Wolmar, C. (2006), "CTRL: an outrageous saga of arrogance and incompetence", Rail, 15-28 March, pp. 28-9.

[81] Jupe, R. (2009) p. 731

[82] House of Commons (2004), "The future of the railway", Transport Committee, House of Commons paper 145-I, Vol. 1, Session 2003-04, The Stationery Office, London. Para. 16

[83] Chesson, A. and Maitland-Smith, F. (2006), Including Finance Lease Liabilities in Public Sector Net Debt: PFI & Other, ONS, London.

[84] CPS (2009), p. 4

[85] National Audit Office (2009) 'Maintaining financial stability across the United Kingdom's banking system'. Published 4 December 2009. Accessed here: http://www.nao.org.uk/publications/0910/uk_banking_system.aspx. P. 37

fees, loan repayments or other redemptions leaving a net outlay of around £117 billion.[86]

Figure 16 Gross HM Treasury outlays on financial sector support by end 2009

Support	Financial outlay (£bn)
Purchases of shares in RBS (recapitalisations announced in October 2008 and November 2009 – in addition, up to a further £8 billion of shares may be purchased if RBS's capital ratio falls below a set level)	46
Purchases of shares in Lloyds Banking Group (recapitalisations announced in October 2008 and November 2009)	23
Loan to, and capital injection in Northern Rock	20
Loans to the Financial Services Compensation Scheme, working capital facility for Bradford & Bingley and other debts	37
Interest on debt raised to fund the above support measures	5
Total	**131**

Source: National Audit Office[87]

[86] NAO (2009) p. 38

[87] Taken from NAO (2009), figure 17, page 38

6.3.2 Moreover, the government expects additional fee income and returns from selling their equity stakes in financial institutions. At the Budget 2009 the Government provisionally estimated that potential losses from the financial interventions would lie within a range of £20 billion to £50 billion. The estimate was set out as a range because of the significant uncertainty over potential outcomes from the interventions. The high end of this range was adopted for fiscal policy purposes as a cautious judgement. It was used to create a measure of PSND including unrealised losses from the financial interventions. This measure was not on a National Accounts basis and was not reported by the ONS. Exceptional financial market and economic uncertainty has receded since the Budget and, as set out in Chapter 3, significant changes to the APS policy agreement mean the risks to the taxpayer have reduced. Taking these changes into account, the eventual fiscal cost will be determined by a number of factors:[88]

- The eventual net profit or loss on the recapitalisations of RBS and Lloyds. This will depend on the eventual sale price achieved compared to the purchase price.

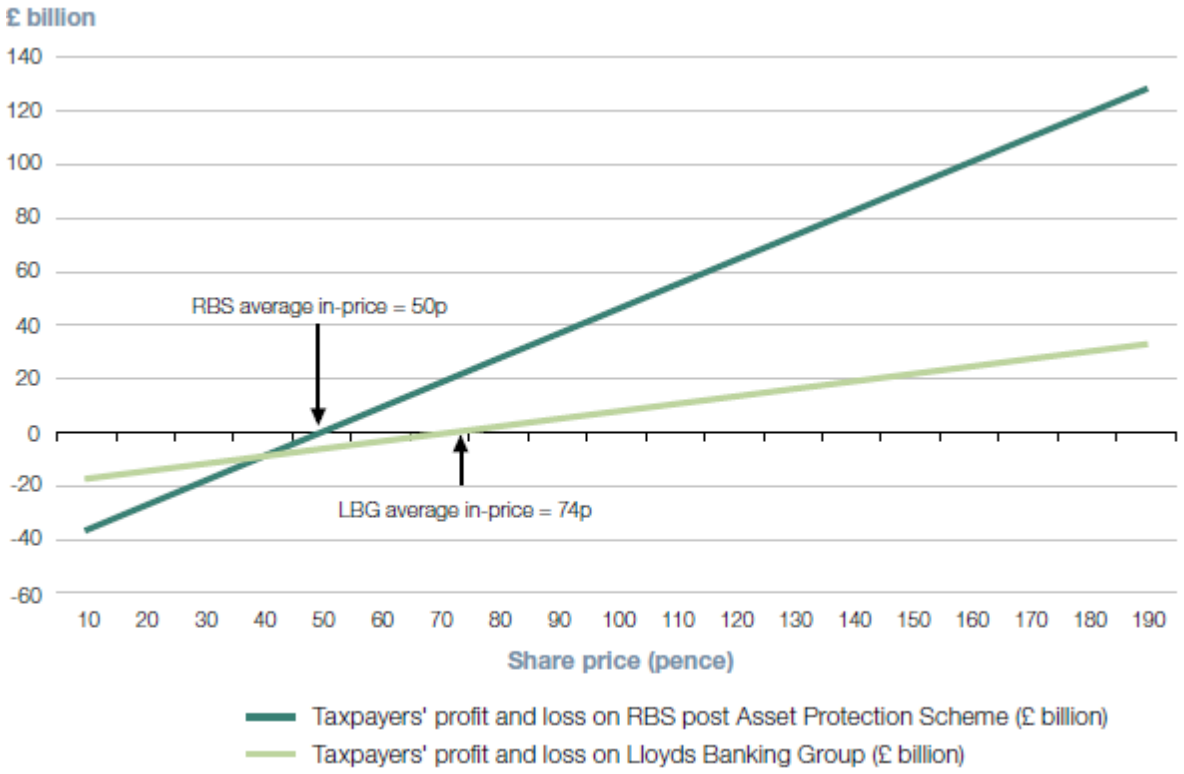
- Net payouts under the Asset Protection Scheme. Based on due diligence of APS assets and the outlook for asset prices and the economy, the central expectation is that net losses on the insured pool of assets will not exceed the revised £60 billion first loss that will fall to RBS. Under the APS the Government will receive fees of £2.5 billion from Lloyds and at least £2.5 billion from RBS; and

- The aggregate costs for all other interventions are expected to be close to zero overall once fees and other income are taken into account. They have been designed to minimise exposure and fair value fees are charged.

[88] Taken from 2009 Pre-Budget Report: Annex B: The Public Finances; Box B4: The net fiscal cost of financial interventions, page 199. Accessed here: http://webarchive.nationalarchives.gov.uk/20100407010852/http://www.hm-treasury.gov.uk/d/pbr09_annexb.pdf

6.3.3 At the time of the preparation of the 2009 pre-Budget Report current market prices implied the net cost of these components would total £8 billion.[89] The NAO illustrates the importance of the change in the Lloyds and RBS share price in determining the final net liability to the taxpayer from the government intervention. Figure 17 below reproduced from the NAO report, shows that for every 10 pence increase in the prices obtained for the shares, taxpayers would secure an additional £9 billion from the sale of shares in RBS, and an additional £3 billion from Lloyds Banking Group shares.

Figure 17 Potential profit or loss for the taxpayer at different share prices (£ billion)



Source: National Audit Office[90]

[89] 2009 Pre-Budget Report Box B4: The net fiscal cost of financial interventions, p. 199

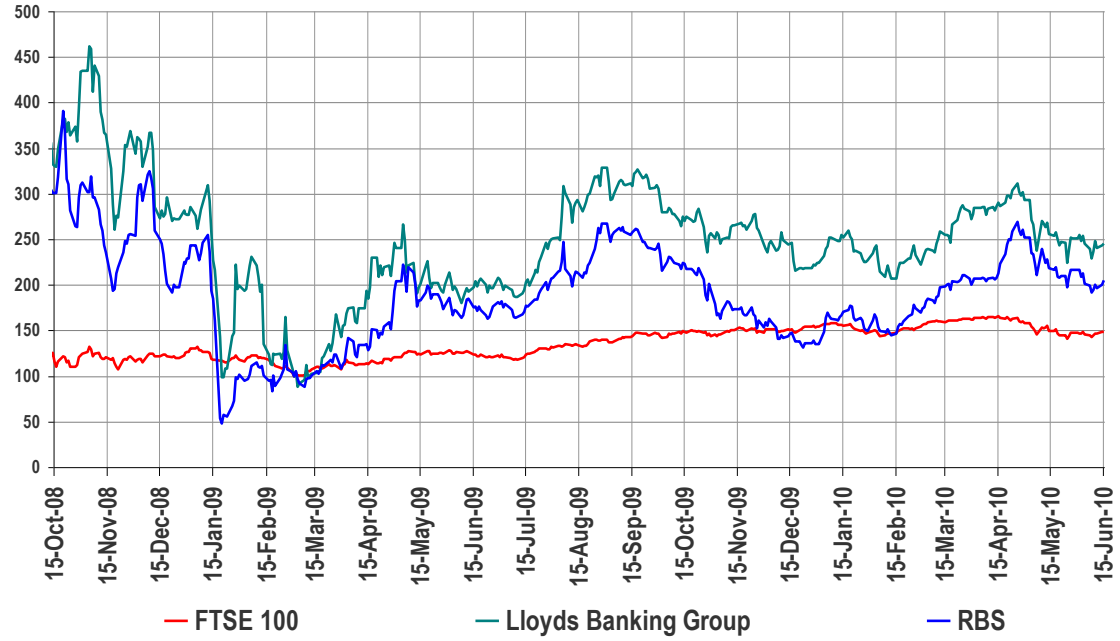
[90] Taken from NAO (2009), figure 19, page 40

6.3.4 In the 2009 Budget, the Treasury indicated that it had made a provision of £25 billion for expected losses from the Asset Protection Scheme. This estimate was based on a preliminary analysis of a sample of assets that RBS and Lloyds Banking Group proposed to include in the scheme. Economic and market conditions would clearly affect the timing and size of potential losses. Following Lloyds Banking Group's withdrawal from the scheme, and changes to the terms under which RBS will participate, the estimated loss is very likely to be lower than originally expected.

6.4 Discussion

6.4.1 Since the updated estimate of the net cost of the interventions in the December 2009 Pre-Budget Report, valuations of Lloyds Banking Group and RBS improved to a peak in late April before deteriorating since then, as shown in figure 18. Overall, at the time of writing, the FTSE is down by 1.9% from its average level across December 2009 while RBS is up by 43% and Lloyds is up by 6%. This implies that, the latest estimate of the net debt for the tax payer would be still lower than the revised £8 billion estimate in the 2009 Pre-Budget Report than the more cautious estimate.

Figure 18 Share prices of Lloyds Banking Group, RBS and the FTSE 100, index 3 March 2009=100, daily data



Source: DataStream, cebr analysis

6.4.2 Indeed, the June 2010 Budget sets out an updated estimate of the cost of the financial sector interventions. The HM Treasury estimate based on current market prices was that the final cost of the interventions would be £2 billion. This was

based on the current market value of the Government holdings of RBS and Lloyds Banking Group shares implying a cost of £7 billion and the expectation that the Asset Protection Scheme would result in a net benefit to the taxpayer of at least £5 billion. Finally, the estimate assumes that the aggregate costs of all other interventions will 'not be material after fees, other income and recoveries are taken into account.'[91]

6.4.3 Overall, with an improved outlook for the costs from the Asset Protection Scheme it is reasonable to suppose that the upper bound of the original cost estimate will be far lower than the £50 billion originally estimated. However, there are still uncertainties over the returns from the sale of the government stakes in the banks and the assumption that the aggregate costs of all other interventions will be neutral so caution is needed over when estimating the net public sector liability. As the NAO concluded: 'The major determinant will be the prices obtained for the taxpayers' current holdings in the various banks.'[92]

6.4.4 Given, this uncertainty, it would be prudent to include a upper bound estimate for the net liability for the tax payer of around £10 billion, accounting for the reduced liabilities from the asset protection scheme but leaving room for risks from changing market conditions. Accounting for the possibility of further improvements in market conditions over the coming months means a lower bound estimate would be a net cost of £0 billion; with the possibility that the slate of the government's assets actually generates a return for the taxpayer not implausible.

6.5 Other contingent liabilities not considered

6.5.1 Although not considered in detail here, other contingent liabilities are also likely to be important. In its pre-Budget forecast the OBR briefly discussed the contingent liabilities linked with nuclear decommissioning. Again, further research and greater transparency on the range of contingent liabilities that government departments could be exposed to would be welcome in the context of fiscal sustainability.

[91] HM Treasury Budget 2010; Box B1: Estimates of the costs of financial sector interventions, p. 74

[92] NAO 2009 'Maintaining financial stability across the United Kingdom's banking system: Executive Summary', p. 8. Accessed here: http://www.nao.org.uk/publications/0910/uk_banking_system.aspx

7 Appendix

7.1 UPDATE OF THE 1993 SNA - ISSUE No. 24

ISSUES PAPER FOR THE JANUARY 2006 AEG MEETING

PUBLIC-PRIVATE PARTNERSHIPS

Selected conclusions

7.1.1 Conclusion: Economic ownership of the assets referred to in a PPP contract is determined by assessing which units bear the risks, will receive the rewards, and are able to control the assets. The text of the SNA should discuss the principal types of control and/or risks and rewards relevant for PPPs. Given that the relative importance of each factor is likely to vary with each PPP, it is not possible to prescribe rules that will be applicable to every situation. A general description of the factors to consider is all that is feasible. Because statistical offices may not have the resources to evaluate each PPP contract, the decisions of government accountants and their auditors generally should be accepted as long as the methodologies used do not materially contradict the general principles of the SNA When the IASB guidelines for PPPs have been finalized, the ISWGNA should evaluate them for consistency with SNA principles.

7.1.2 Conclusion: The text of the SNA should state that the complexity and variety of PPP contracts precludes the enumeration of detailed rules governing the transactions to be recorded concerning the control and use of the assets. The appropriate accounting treatment needs to reflect a government's residual interest in assets economically owned by the private unit, the acquisition of operational assets taken into use by a government as economic owner, and the measurement of production.