Office for
Budget Responsibility

PRESS NOTICE
Fiscal risks and sustainability – July 2022

Riskier world and ageing population ultimately leave the public finances on unsustainable path

It is hard to escape the conclusion that the world is becoming a riskier place. The past two decades have seen a global financial crisis, a global health crisis, and a global energy crisis triggered by Russia's invasion of Ukraine. These global shocks add to ageing and other domestic cost pressures to place public debt on an unsustainable path and projected to surpass 250 per cent of GDP over the long term. This all adds up to a challenging outlook for this and future governments as they steer the UK economy and public finances in the years ahead.

1.1 In little more than two years, the UK economy and public finances have felt the consequences of a global health crisis caused by Covid-19, a global security crisis sparked by Russia's invasion of Ukraine, and a global energy crisis brought about by both. In a little over a decade, we have also felt the economic and fiscal consequences of a global financial crisis and the uncertainty created by the UK's decision to leave the EU and the ensuing negotiations on how to go about it. And in the decades ahead, governments in the UK and around the world face perhaps the still greater economic and fiscal challenges of addressing climate change, dealing with the fiscal costs of ageing, and managing all these pressures and risks against a backdrop of potentially weaker productivity growth, higher levels of public debt, and rising interest rates.

1.2 It is hard to escape the conclusion that the world is becoming a riskier place. And for fiscal policy makers, the costs associated with those risks seem to be rising too. Discretionary fiscal support for households, firms, and public services during the pandemic was unprecedented in scale, reaching 10.4 per cent of GDP at its peak in the UK, and may have raised expectations regarding the role of government in future crises. The UK Government has so far spent as much this year (1¼ per cent of GDP) to help households to cope with the sharp rise in the cost of living as it did supporting the economy through the financial crisis. It is largely as a consequence of successive shocks, and the Government's response to them, that, at over 90 per cent of GDP, public debt is now more than triple its level at the start of the century and more than double the around 40 per cent of GDP projected by the Treasury in the UK's first pioneering Long-term public finance report published two decades ago.

1.3 It is to provide a more comprehensive understanding of the interplay between the near-term threats to the fiscal outlook and the long-term health of the public finances that we are publishing this inaugural Fiscal risks and sustainability report (FRS). The FRS brings together the analysis previously found in our biennial Fiscal risks reports (FRRs) and Fiscal sustainability reports (FSRs) into a single annual report. In addition to surveying the universe of smaller fiscal risks, previous FRRs have looked in depth at a number of potentially major shocks to the economic and fiscal outlook including a severe recession, a 'no deal' Brexit, Covid, climate change, and rises in the cost of debt. Previous FSRs have provided regular 50-year fiscal projections and assessed the long-run sustainability of the public finances based on the latest demographic, economic, and fiscal policy developments.

1.4 In this first combined FRS, we focus on three more significant threats to the public finances:

- Rising geopolitical tensions (Chapter 2). The Russian invasion of Ukraine has prompted many to reassess the risks from both conventional and cyber security threats and the sustainability of current historically low levels of defence spending across Western countries. Rising geopolitical tensions have also manifested themselves in the economic sphere with the breakdown of multilateral trade negotiations, the US-China tariff war, and a slowdown, and partial reversal, in international trade and investment flows potentially auguring a retreat from the global economic integration that has brought significant economic gains over the past 70 years.

- Higher energy prices (Chapter 3). The recent more than doubling of gas and oil prices and the rise in inflation to rates not seen since the energy crises of the 1970s have underscored the economic and fiscal risks associated with the UK's continued dependence on fossil fuel imports. It has also brought into sharper focus the fiscal choices and trade-offs involved in shifting the UK's energy mix to one that is compatible with getting to net zero emissions by 2050.

- Long-term fiscal pressures (Chapter 4). The pandemic has had remarkably little impact on the medium-term fiscal position (with debt marginally higher but the primary balance slightly stronger), thanks in part to the substantial tax rises announced in its wake. Since our 2018 FSR, demographic pressures have eased somewhat in the near-term thanks to a lower birth rate and slower improvements in life expectancy, reducing age-related spending as a share of GDP, while lower migration levels bring some fiscal offsets. But in the long run the pressures of an aging population on spending and the loss of existing motoring taxes in a decarbonising economy leaves public debt on an unsustainable path in the long term.

1.5 Given the experience of the past two decades, this slightly more benign baseline fiscal projection for the coming two decades needs to be seen in the context of the risks discussed in this report. And these emergent geopolitical and energy challenges add to, rather than replace, the risks we studied in previous FRRs. Many threats remain, with rising inflation potentially tipping the economy into recession, continued uncertainty about our future trading relationship with the EU, a resurgence in Covid cases, a changing global climate, and rising interest rates all continuing to hang over the fiscal outlook.

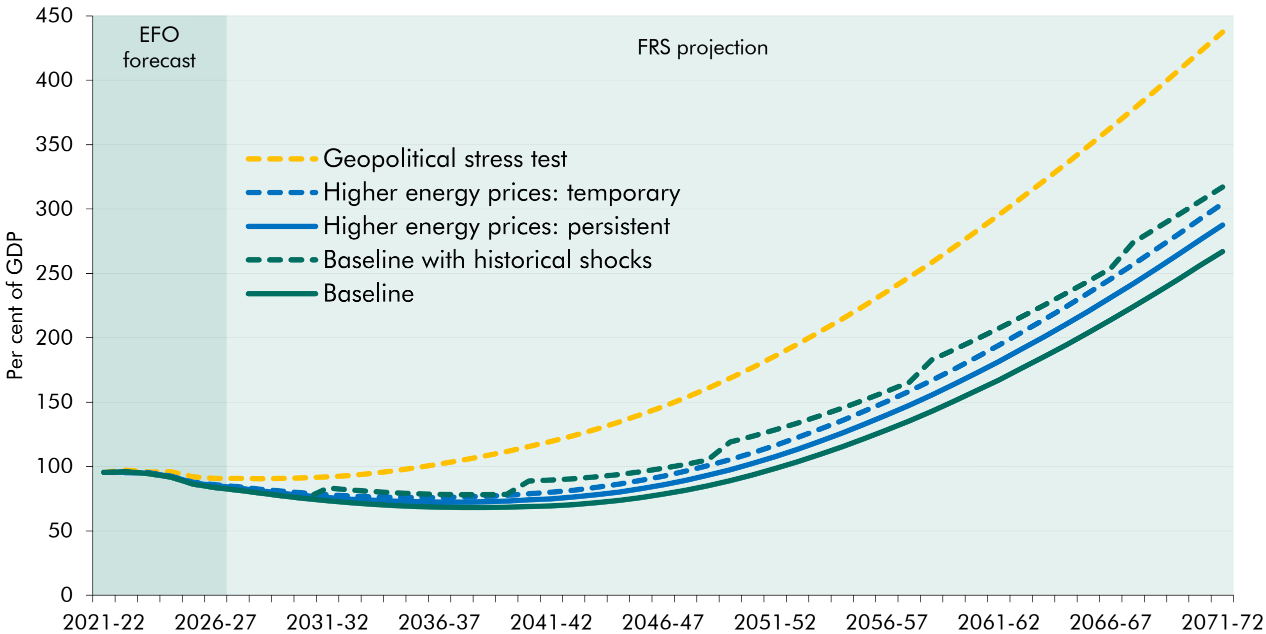
1.6 Taken together, they add up to a challenging outlook for this and future governments as they steer the public finances through inevitable future shocks, while managing multiple slow-building pressures. Our long-term projections show debt rising to over 100 per cent of GDP by 2052-53 and reaching 267 per cent of GDP in 50 years if upward pressures on health, pensions and social care spending, and the loss of motoring taxes, are accommodated (Chart 1). Bringing debt back to 75 per cent of GDP – the level at which it stabilised in the Government's pre-pandemic March 2020 Budget – would need taxes to rise, spending to fall, or a combination of both, amounting to a 1.5 per cent of GDP additional tightening (£37 billion a year in today's terms) at the beginning of each decade over the next 50 years.

1.7 Factoring in a stylised estimate of the asymmetric costs associated with inevitable periodic shocks would push debt up to 100 per cent of GDP by 2047-48 and nearly 320 per cent of GDP in 50 years. These figures are based on a simple reading of post-war UK fiscal history. This FRS also explores the potential fiscal costs associated with two specific risks:

1.8 Geopolitical stress test. If geopolitical tensions continue to rise, with threats to both security and economic integration crystallising, the fiscal outlook could be materially weaker – as illustrated in this year's 'fiscal stress test'. It includes: a future Government increasing defence spending from just over 2 to 3 per cent of GDP, at a cost of £24 billion in today's terms; a major cyber-attack that delivers a short, sharp recession in 2024 that pushes public debt higher, but leaves no lasting scars; and a global trade war that escalates over time and eventually subtracts 5 per cent from UK GDP. This simultaneous crystallisation of several risks adds 28 per cent of GDP to public debt in 2036-37 and leaves debt at over 430 per cent of GDP in 2071-72.

1.9 Near- and medium-term energy price shocks. What if energy prices were to spike even higher or to persist at current high levels? In our 'temporary spike scenario' gas prices more than double next year and oil prices spike too, keeping inflation in double digits. The associated recession leaves public debt higher in the medium term, and it reaches over 300 per cent of GDP in 2071-72. In our 'persistent shock scenario', high gas and oil prices weigh on the economy's productive potential. The fiscal impact of this also raises public debt in the medium term and leaves it at under 290 per cent of GDP in 2071-72. Asymmetries in the welfare system explain the temporary price shock being fiscally more costly than the persistent one. Additional fiscal support for households of the type seen this year would dampen the short-term hit to household incomes, but only at the expense of passing a higher public debt burden onto future households.

Chart 1: Public debt: baseline projection with historical and specific shocks



Source: OBR

Notes

1. The OBR is the UK's independent fiscal watchdog. We produce forecasts for the economy and the public finances, assess progress against the Government's fiscal targets, and report on long-term fiscal sustainability and fiscal risks.
2. All the documents and supporting material published today is available on our website: http://obr.uk/
3. All questions about the *Fiscal risks and sustainability* report should be sent to OBR.Press@obr.uk.