

## **Fiscal sustainability report 2013: speaking notes**

Good morning everyone.

My name is Robert Chote, Chairman of the OBR. And I would like to welcome you to the launch of our third *Fiscal sustainability report* – our annual publication looking at the health of the public sector balance sheet and the long-term sustainability of the public finances.

[SLIDE] As you know, the OBR was created in 2010 to provide independent and authoritative analysis of the UK's public finances. The conclusions in this report are the collective view of the Budget Responsibility Committee, helped by the OBR's full time staff, officials in many government departments, plus this year the Personal Social Services Research Unit at the LSE. Our thanks to them all.

We presented a draft of our conclusions to the Chancellor on July 3rd, so he could decide whether there were any additional policy decisions he wished us to take account of – and there were not. We provided him the final report 24 hours in advance of publication. I am pleased to report that we have come under no pressure to change any of our conclusions.

So how do we assess fiscal sustainability in this report?

[SLIDE] Our approach is twofold:

- First, we look at the impact of past government activity, as reflected in the assets and liabilities on the public sector's balance sheet. In doing so, we look at the familiar National Accounts measures and also at the Whole of Government Accounts, which consolidate the accounts of over 1000 public sector bodies and present them in the same format as private sector accounts.
- Second, we look at the potential impact of future government activity, by making illustrative 50-year projections of public spending, revenues and significant financial transactions. These can then be used to make a 50-year projection for public sector net debt. We can then judge the sustainability of the public

finances and quantify any future tax increases or spending cuts that might be needed to make them sustainable.

[SLIDE] Before turning to the numbers, there are four points I should make at the outset:

- First, the uncertainties surrounding any projections of spending and revenues over this long a time horizon are considerable. These are projections, not precise forecasts, and we show how sensitive they are to some of the judgements we make.
- Second, our goal is to judge whether the public finances are sustainable under current tax and spending policies. But in most cases these policies are not defined for the long-term, so we have to decide and explain what a sensible definition would be.
- Third, we assume that spending and revenues evolve in line with the medium-term forecasts we published at Budget time over the first five years. So we have nothing new to say today about the short to medium term outlook for the economy or the public finances. We do though illustrate how sensitive the long-term projections are to the end point of the medium term forecast.
- Fourth, when we come to quantify any additional fiscal tightening that might be necessary to achieve sustainability, we are talking about potential changes implemented after the five-year consolidation plans that are already in the pipeline. Nothing we have to say today should be construed as a call for a bigger fiscal tightening over the medium term than is already planned.

Those points made, let me now turn to what we can learn from the public sector balance sheet.

[SLIDE] The most familiar summary measure of the balance sheet is public sector net debt, the difference between liabilities and liquid financial assets and the orange line in this chart. Both this and the previous government have set medium-term targets for this measure, which was roughly £1,180 billion, 75 percent of GDP or £44,800 per household at the end of the last fiscal year. We forecast in March that

net debt would rise by about another 10 per cent of GDP by 2016-17 before falling back.

For some years the ONS has also published a wider balance sheet measure called public sector net worth (in yellow). This has the opposite sign (it is assets minus liabilities) and includes physical and illiquid financial assets. At the end of 2011 this was around minus 13 per cent of GDP and we forecast in March that it would fall to minus 27 per cent of GDP in 2016-17, reflecting the fact that the budget deficits over the next couple of years will be used primarily to finance current spending rather than to invest in new public sector assets.

[SLIDE] This chart shows that the outlook for both net debt and net worth has deteriorated since last year. This is because we expect higher cash deficits and lower nominal GDP than we did last year.

[SLIDE] So how do we compare with other countries? Comparable public sector data are not available, but if we look at the IMF's latest forecasts for general government net debt in 2017 we are between a quarter to a third of the way down the advanced country league table. [SLIDE] And, if we look at how the IMF's forecasts have changed over the past year, you can see that the UK has also seen one of the biggest deteriorations.

Commentators often criticise the use of net debt (and, implicitly, net worth) as an indicator of fiscal health, because it excludes payments that we know the government will have to make in the future as a result of actions it has taken in the past. But we can use the balance sheet information in the Whole of Government Accounts to shed more light.

[SLIDE] The WGA are prepared under commercial accounting rules and have broader coverage than PSND and PSNW. In this FSR we are looking at the 2011-12 WGA, which have been published by the Treasury today. This is the third year in which the WGA have been published, and the 2010-11 accounts have been restated so that they can be compared with this year's on the basis of the same accounting treatment.

So what do we learn?

[SLIDE] This table shows how you can move from the headline national accounts measure of net debt to its WGA equivalent: net liabilities.

As you can see, by far the biggest differences are that the WGA measure includes the present value of public service pension liabilities, but nets off the value of fixed assets like the road network. As you can see, net liabilities are somewhat larger than net debt [SLIDE] and the gap has widened in the latest year, mostly because of an increase in pension liabilities. So let's look at a few of these elements in a little more detail.

[SLIDE] Pensions first. Liabilities on the WGA balance sheet include the present value of all future public service pension payments arising from past employment, in other words up to the year of the accounts in question. These totalled £1,008 billion or 66 per cent of GDP at the end of March 2012. This is £47 billion or roughly 3 per cent of GDP up on last year. £35 billion of the increase reflects new liabilities for the latest year of employment. And £10 billion reflects a fall in the discount rate that the accountants use to convert the flow of future payments into a one-off upfront sum. There was a further fall in the discount rate during 2012-13, which could add around £40 billion to next year's figure.

This sensitivity to the discount rate is an important reason not to be mesmerised by these big present value liabilities. It is more helpful to look at the expected flow of future pension payments, which also includes payments arising as a consequence of expected future employment. And we will come to that in a few moments.

[SLIDE] A second difference between net debt and net liabilities is that the former only includes a small proportion of the liabilities arising from PFI contracts. In March 2012 net debt included £5 billion of liabilities for future PFI capital payments. At the same date just over £36 billion were on the WGA balance sheet, up from £32 billion a year earlier. The total capital liability on and off both balance sheets has also risen, but less sharply, to around £38 billion. If all these liabilities were put on the National Accounts balance sheet, public sector net debt would be about 2.1 per cent of GDP higher than it is now.

As you may be aware, the Government has announced a limit on total PFI spending of £70 billion between 2015-16 and 2019-20. By March 2012 expected PFI spending over this period had reached around £50 billion, although there were other deals in the pipeline. So we will need

to wait for more detail from the Treasury before we know how much headroom the Government has for further spending within that limit.

[SLIDE] The public sector's liabilities in WGA also include provisions - for future costs that are not certain to be incurred, but where the accountants think the probability is greater than 50 per cent. The biggest item here is nuclear decommissioning costs, which are hard to predict.

Provisions increased from £107 billion in 2010-11 to £113 billion in 2011-12. £3 billion of the increase was for nuclear decommissioning and £2 billion for potential clinical negligence payments. The accountants expect £13 billion of the provisions to be used during 2012-13.

[SLIDE] Contingent liabilities are costs that the public sector may incur, but where the accountants think the probability is less than 50 per cent – although not insignificant. These potential costs more than doubled to £101 billion in 2011-12, for two main reasons:

- First, there was seen to be a more significant possibility that the UK might be called upon to inject fresh capital into the European Investment Bank, which makes long-term infrastructure loans to EU countries. This contingent liability was considered 'remote' in the previous year's accounts and the change reflects decisions by a couple of credit rating agencies to put the EIB on 'negative watch' during the year.
- Second, there has been an increase in the estimated potential loss of tax revenue that could result from North Sea decommissioning costs, which oil companies can set off against tax bills. Note that these will no longer count as headline contingent liabilities next year, as they have now been judged 'unquantifiable'.

[SLIDE] A number of recent policy decisions could create new contingent liabilities in future vintages of the WGA – and the main ones are listed here. Our best guess is that most of these will be judged to have a probability near zero and will thus be designated 'remote'. But we should bear in mind that the probabilities of them crystallising are likely to be correlated; another serious economic and banking sector downturn would make most of them more likely – although in that event these particular liabilities may be the least of our problems.

[SLIDE] Contingent liabilities are useful risk indicators and they underline the fact that the WGA as a whole contributes significantly to the transparency of the public finances. But the public sector balance sheet alone cannot tell us all we need to know about fiscal sustainability.

If you were to take net debt, net worth or net liabilities at face value, you might conclude that the government was bust. But balance sheet measures look only at the impact of past government activity. They do not include the present value of spending that we know future governments will wish to undertake, for example maintaining health, education and welfare provision, which would actually make the position look even worse. But, more importantly, they also exclude the public sector's most valuable financial asset – its ability to levy future taxes. So, while stocks of assets and liabilities are interesting and helpful, if you are really interested in fiscal sustainability then go with the flows.

And so let me turn now to our flow analysis. To make long run projections of spending, revenues and financial transactions, we need to make assumptions about future demographic and economic trends, and about how we choose to define 'unchanged' policies.

[SLIDE] Demographic trends are critical over this time horizon. Our analysis is based on population projections prepared by the Office for National Statistics. This year's FSR uses 2010-based projections, unchanged since last year. The key features are that past increases in life expectancy and falls in fertility rates, combined with the demographic bulge created by the baby boom, imply an ageing population.

The population variant we use for our central projection has the proportion of the population aged 65 and over rising from 17 per cent this year to 26 per cent in 2062. It also has net inward migration averaging around 140,000 a year.

[SLIDE] For the economy, we assume that output per worker grows by 2.2 per cent a year in the long term, in line with historical trends. We assume that CPI inflation is in line with the Bank of England's target and that the GDP deflator grows by 2.2 per cent a year – down from the 2.5 per cent we assumed last year following data revisions. We also assume

that the interest rate on gilts will be higher than the growth rate of the economy over the long term, implying that a primary budget surplus (in other words a small budget surplus excluding spending on debt interest) would be needed to keep the ratio of net debt to GDP stable. And as we assume that there will still be significant slack in the economy at the end of our medium term forecast, we also include a three-year period of above trend growth through to 2020-21 to use it up.

[SLIDE] When defining 'unchanged policy', our key decision is what to assume about the uprating of tax allowances and working age benefits. Over the medium term the Treasury assumes that they rise in line with prices unless the government states otherwise. This may be defensible over a five-year horizon, but it is implausible over 50 years because earnings normally rise more quickly than prices. Allowances and benefit rates would fall steadily relative to average living standards. So people would find more and more of their incomes taxed at higher rates and the relative living standards of those on benefits would fall.

For this reason we assume that allowances and benefit rates rise with earnings rather than prices beyond 2017-18, which would keep revenues and benefit costs broadly constant as a share of GDP, other things being equal. Assuming price up-rating over the long term would increase revenues by 2.4% of GDP and reduce welfare costs by 1.4% of GDP by 2032-33, giving an unduly flattering impression of the fiscal outlook.

Turning to the value of the state pension, we assume that this rises in line with the Government's 'triple lock', in other words by the largest of earnings growth, CPI inflation or 2.5 per cent each year. Past history suggests this would average earnings growth plus 0.3 percentage points each year, slightly higher than we assumed last year.

For spending on public services and tax revenues, we assume in our central projection that these remain constant per capita as shares of GDP beyond the end of the medium-term forecast, adjusting only for the age composition of the population. This chart shows how consumption of public services and tax payments varies by age. When people are young they consume quite a bit of health care, then quite a bit of education, but they don't pay much tax. In the middle years they pay more tax but consume less health care and education. And in later years they pay less tax but consume more health care and long-term care. So

you can see why the public finances come under pressure as more of the population clusters in the right hand side of the chart.

As I will discuss later, there is a strong argument to say that upward pressure on health care spending will be greater than this simple view of unchanged policy suggests.

[SLIDE] Since last year's FSR, there have been a number of policy announcements that affect our long-term fiscal projections:

- First, the announcement that cuts in public spending will be extended by an additional year to 2017-18;
- Second, other more modest tax and spending measures in the Autumn Statement and the Budget;
- Third, the allocation of spending plans by department for 2015-16;
- Fourth, the cap on long-term care costs that followed the Dilnot Review;
- Fifth, the introduction of the Single Tier Pension from 2016-17, and;
- Sixth, the decision to transfer balances from the Bank of England's Asset Purchase Facility to the Treasury on an ongoing basis.

[SLIDE] There have also been a number of announcements that are not sufficiently firm or detailed for us to include:

- First, the privatisation of Royal Mail, where the date and the size of the stake to be sold have not yet been decided;
- Second, the announcements on RBS and Lloyds in the Mansion House Speech. Most significantly, the Chancellor announced a review of whether to split RBS into a 'good' and 'bad' bank. If the Government went ahead with this, then the experience with Northern Rock suggests that the bad bank would likely be classified as part of central government. This would push public sector net debt significantly higher, with the impact then being



reversed over time as its balance sheet shrank. It is important to understand that this would not represent a genuine deterioration in the state of the public finances, but rather the recognition of an underlying reality. Indeed, in the view of some observers, it would offer the best way to maximise value for the taxpayer as well as to get the banking system functioning more normally again.

- Third, the suggestion in the Pensions Bill that the State Pension Age should be linked explicitly to life expectancy. Addressing the nation on ITV's *Daybreak*, the Prime Minister said earlier this year that it would be reasonable for people to spend a third of adult life in retirement. But this is not yet a formal policy and leaves open the precise definition of 'adult life'.

So, having made all these assumptions and defined current policy, what are our results?

[SLIDE] This chart shows the big picture. We start today with a large primary budget deficit, as non-interest spending far exceeds non-interest receipts. The primary budget then moves into surplus as the fiscal consolidation shrinks the structural part of the deficit and as the recovery in economic activity shrinks the cyclical deficit. Then, from the early 2020s, revenues increase slightly as a share of GDP while spending increases much more rapidly – reflecting the ageing of the population. The primary balance moves from surplus back into deficit, reaching 1.8 per cent of GDP by 2062-63.

[SLIDE] On the spending side, non-interest spending rises by around 4 per cent of GDP or roughly £60 billion in today's money between the end of the medium term forecast and 2062-63. The upward pressure comes primarily from health, state pensions and long-term care, all of which reflect the ageing of the population. The main offset is the cost of public service pensions, which fall as a share of GDP reflecting cuts in employment and wage restraint in the public sector, plus recent reforms to the generosity of public sector pension schemes.

The total rise in spending is slightly smaller than last year, partly reflecting the fact that the introduction of the Single Tier Pension saves more money than the reforms to long-term care cost. There is also more

spare capacity at the end of the medium term forecast, allowing a little more above-trend growth.

[SLIDE] Focusing on the state pension, you can see that we project that this will cost 8.4 per cent of GDP in 2062-63, unchanged from last year. The Single Tier Pension saves an eventual 0.7 per cent of GDP, essentially because people can no longer build up entitlement to a second state pension. This offsets other upward pressures – such as a lower path for nominal GDP and our judgement that the triple lock is likely to be more expensive. The legislation underpinning the Single Tier Pension says that it will rise at least as fast as earnings – if we were to assume that the Basic State Pension and the Single Tier pension rose with earnings then this would save another 0.9 per cent of GDP by the 2060s. All this of course depends on the future behaviour of earnings and inflation on a year by year basis, which is impossible to predict.

[SLIDE] Turning to long-term care, where we have been helped in our modelling by the PSSRU, this chart shows that the ageing population will increase the cost of long-term care over time and that the decision to cap long-term care costs for most people following the Dilnot Review is estimated to cost an additional 0.3 per cent of GDP by the 2060s, almost all reflecting care costs for the elderly. In the report we note that bigger increases in life expectancy or people spending a longer period of time in care would both put modest upward pressure on this figure.

[SLIDE] Turning now to receipts, non-interest receipts are projected to rise by 1.2 per cent of GDP between the end of the medium term forecast and 2062-63. This in part reflects a pick up in capital taxes later this decade, as above-trend growth eliminates the spare capacity in the economy. Over the longer term population ageing has much less impact on receipts than it does on spending.

One category of receipts that we expect to fall over the long term is oil and gas receipts, as the North Sea basin matures. In Chapter 4 we revisit our long-term projections for oil and gas receipts and look at how sensitive they are to alternative assumptions for production and prices.

[SLIDE] As you can see from this chart, oil and gas receipts are highly volatile from year to year and this has a significant impact on the jumping-off point for the long-term projections.

[SLIDE] Our central projection assumes that oil prices move first in line with futures prices and then with whole economy inflation. Production falls 5 per cent a year, somewhat more slowly than in the recent past, with operating and capital expenditure falling in parallel. These assumptions imply that receipts would fall from 0.4 per cent of GDP this year to 0.03 per cent in 2040-41, giving total receipts of £56 billion from the end of the medium-term forecast to 2040-41. This is down from £67 billion last year, reflecting the recent weakness in production.

It is important to emphasise that while we can be confident that North Sea receipts are on a downward path, the pace of that decline is highly uncertain. [SLIDE] This table shows how sensitive the central projection is to some alternative price and production scenarios that we explain in the report. One additional uncertainty, of course, is the implication of shale gas and fracking. We don't have enough information about the scope and tax treatment of this activity to quantify it yet, but it clearly represents an upward risk to the central projection.

[SLIDE] So, to return to the big picture, the paths of spending and receipts that I showed you a moment ago imply this path for the primary budget balance – moving from deficit to surplus and then back to deficit again. In effect, demographic factors gradually unwind about two-fifths of the fiscal tightening that the Government is currently embarked upon.

In order to move from a projection of the primary balance to a projection for public sector net debt, we also need to include financial transactions that affect debt directly, notably student loans.

[SLIDE] This chart shows the increase in public sector net debt that results as the stock of student loans increases and then repayments start flowing in. We continue to assume that the average fee loan per student is £7,000 and that fees and maintenance loans rise with earnings over the long term. Under this scenario the addition to net debt peaks at 6.7 per cent of GDP in the early 2030s, falling back to 5 per cent by 2062-63. This is slightly up on last year because of lower nominal GDP.

So now, if we bring together revenues, spending and financial transactions, we can look at the outlook for public sector net debt.

[SLIDE] If the cyclically adjusted primary surplus remained constant at its 2017-18 level of 2.5 per cent of GDP, then net debt would be eliminated in the mid 2050s.

[SLIDE] Thanks primarily to ageing, under our central scenario the primary balance moves back into deficit and net debt reaches 99 per cent of GDP (£1.5 trillion in today's terms) in 2062-63 and is still rising.

[SLIDE] As I said at the outset, given the time horizon involved, there are significant uncertainties around all our projections. So we present a number of alternative projections based on different assumptions.

Broadly speaking, the outlook would be worse:

- If the primary surplus at the end of the medium term forecast was smaller;
- If the population structure was to age more quickly;
- If productivity growth was to be slower;
- If long-run interest rates were higher relative to long run economic growth rates, or;
- If governments felt they had to increase per capita health spending more quickly to compensate for slower productivity growth in that sector than in the rest of the economy.

If net inward migration was higher than in our central projection, the fiscal outlook over our 50 year horizon would improve. This is because inward migrants are more likely to be of working age than the rest of the population. So we avoid the cost of educating them and some will leave before we have to finance them in old age.

[SLIDE] In the report we show the implications for the public finances if net inward migration was to be stronger than in the central projection, or to fall to zero, and what would happen if the gross flows were also reduced to zero. For example, with zero net migration we might expect the primary budget balance to be 2 per cent of GDP weaker in the early 2060s with the net debt about 45 per cent of GDP higher than in the central projection. [SLIDE]

All these migration scenarios rely on simplifying assumptions about the characteristics of inward migrants relative to the native population, for example their productivity and fertility. We discuss some of the evidence on this in the report. We note that there is a lack of consensus on a number of these issues, but overall the evidence suggests that our central conclusion - that higher net migration probably improves the public finances over this timescale - is not an unreasonable one.

[SLIDE] Returning to the central projection, let me briefly recap and summarise what has changed since last year's report. First, the underlying long-term outlook for the public finances is somewhat worse than it looked last year, reflecting a gloomier view of the potential of the economy and the structural health of the public finances. This manifests itself in a higher ratio of debt to GDP and a bigger structural primary budget deficit at the end of the medium term horizon than last year.

But this underlying deterioration in the structural budget balance is more than offset by policy changes announced since last year – the additional spending cuts in 2017-18 and the savings from the Single Tier Pension offset the structural deterioration as well as the costs of the long-term care reforms. So the primary budget deficit is down to 1.8 per cent of GDP by the early 2060s compared to 2.7 per cent last year.

However, spending on debt interest is higher as a share of GDP over the projection than it was last year. So even though the primary balance looks better by the end, the stock of debt actually looks a little worse – with net debt reaching 99 per cent of GDP by the early 2060s compared to 91 per cent last year. But, as the report shows, this difference is modest compared to a number of the uncertainties that lie around the central projection.

So, if future governments were to be confronted by the pressures set out in our central projection, what might they need to do to return the public finances to a sustainable position?

[SLIDE] This depends on what we mean by a sustainable position. Most formal definitions are based on the idea of solvency, the ability of the government to meet its formal obligations. The so-called 'inter-temporal budget constraint' requires governments to raise enough revenue to pay for all their non-interest spending and to service and eventually pay off all their debts over an infinite time horizon. We estimate that the

government could expect to satisfy this constraint if it announced a one-off and permanent tax increase or spending cut of 1.9 per cent of GDP (£29 billion in today's terms) from 2018-19 onwards. This is lower than last year, mostly because of the additional spending cuts in 2017-18

This approach may be theoretically rigorous, but the infinite time horizon limits its practical relevance. More realistically, people judge sustainability by asking what needs to be done to achieve a particular debt-to-GDP ratio at a particular date – the so-called 'fiscal gap'.

So, for example, we can ask what would be needed to ensure that debt is back at its pre-crisis level of 40 per cent of GDP at the end of our 50-year horizon. (The government does not have a long-term target for the debt-to-GDP ratio and so we use this purely for illustration.)

Under our central projection, you would need a permanent tightening of 1.2 per cent of GDP (£19 billion in today's terms) starting in 2018-19 to hit the 40 per cent target. This is little changed since last year. This figure rises to 3.6 per cent of GDP if health spending was raised by 3.4 per cent a year in real terms to compensate for weak productivity growth.

[SLIDE] This chart shows the path of net debt that would result, with the ratio falling below 40 per cent of GDP for a while but then rising over the longer term.

Of course governments need not – and probably would not – make the whole adjustment in one go. [SLIDE] For example, you could hit the 40 per cent target by raising taxes or cutting spending by a little under 0.5 per cent of GDP in 2018-19 and each subsequent decade rather than by 1.2 per cent once and for all. This chart shows that debt would fall more slowly under this scenario, but as the eventual tightening would be larger the debt ratio would continue falling beyond 2062.

[SLIDE] In thinking about how the debt ratio might fall from the heights that it has reached as a result of the financial crisis, it is interesting to look back and think about the post war period in which the national debt fell from 270 per cent of GDP to around 50 per cent of GDP in the 30 years following the Second World War. This was a period in which the cash value of the debt more than doubled, but the cash value of the economy increased 13 times. Nominal GDP rose by almost 9 per cent a year, thanks to both real growth and whole economy inflation. Nominal

interest rates were also lower than the nominal growth rate, thanks in part to quantity and price controls on domestic bank lending and exchange rate controls. This meant that the debt ratio would have fallen even if the government had run a primary budget deficit – whereas in fact on average it ran a modest primary budget surplus.

[SLIDE] So let me finish with some brief summary conclusions:

The ageing of the population is likely to put pressure on the public finances, primarily as a result of upward pressure on public spending.

As a result, some additional fiscal tightening is likely to be needed after the current crisis-related consolidation has been implemented.

Since last year, the underlying deficit and debt path look less favourable. But this and the costs of long-term care reform are likely to be offset by the Government's announcement of additional spending cuts in 2017-18 and savings from the Single Tier pension.

That said, there are huge uncertainties around the scale of the challenge and the UK is certainly not alone in confronting it.

Finally, we also need to keep an eye on the risks to our projections, which include the growth of contingent liabilities.