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Fiscal sustainability report 2013

Robert Chote
Chairman

17 July 2013

Preamble

- OBR set up in 2010 to provide independent and authoritative analysis of the UK public finances
- BRC responsible for the conclusions, helped by full-time OBR staff and government departments
- Chancellor saw draft conclusions on 3 July and final report 24 hours prior to release
- No pressure to change conclusions

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Two-fold approach in this report

- **The fiscal impact of past government activity**
  - Assets and liabilities on the public sector balance sheet
  - National Accounts and Whole of Government Accounts (WGA)
- **The potential impact of future government activity**
  - 50-year projections of spending, revenues and financial transactions
  - Used to project budget deficits and public sector net debt
  - Judge sustainability and any need for tightening

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Some things to remember

- Broad brush projections, not precise forecasts
- 'Unchanged policy' not always easy to define
- First 5 years consistent with March EFO forecast
- Focus beyond the current fiscal consolidation

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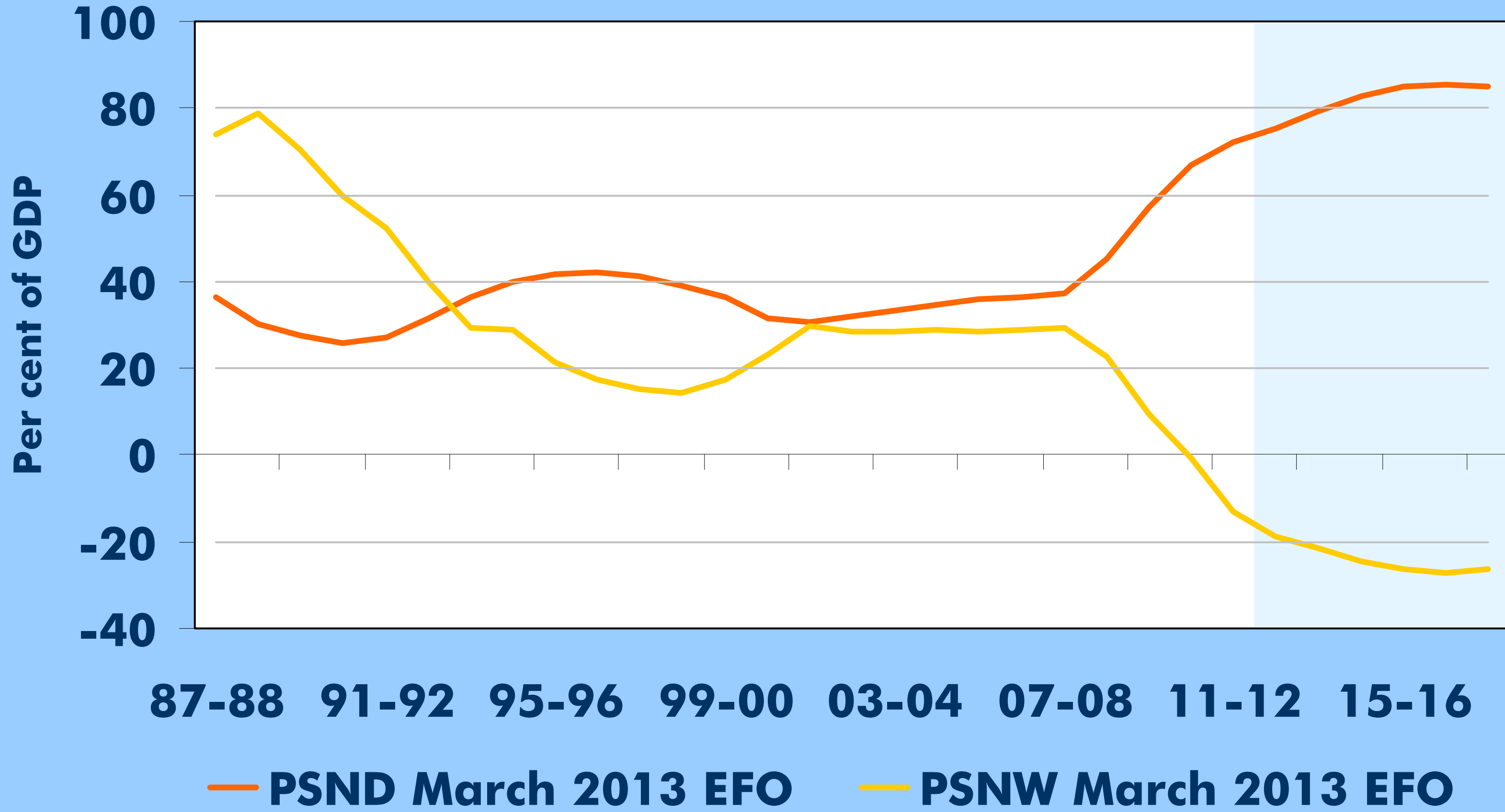
Public sector net debt and net worth



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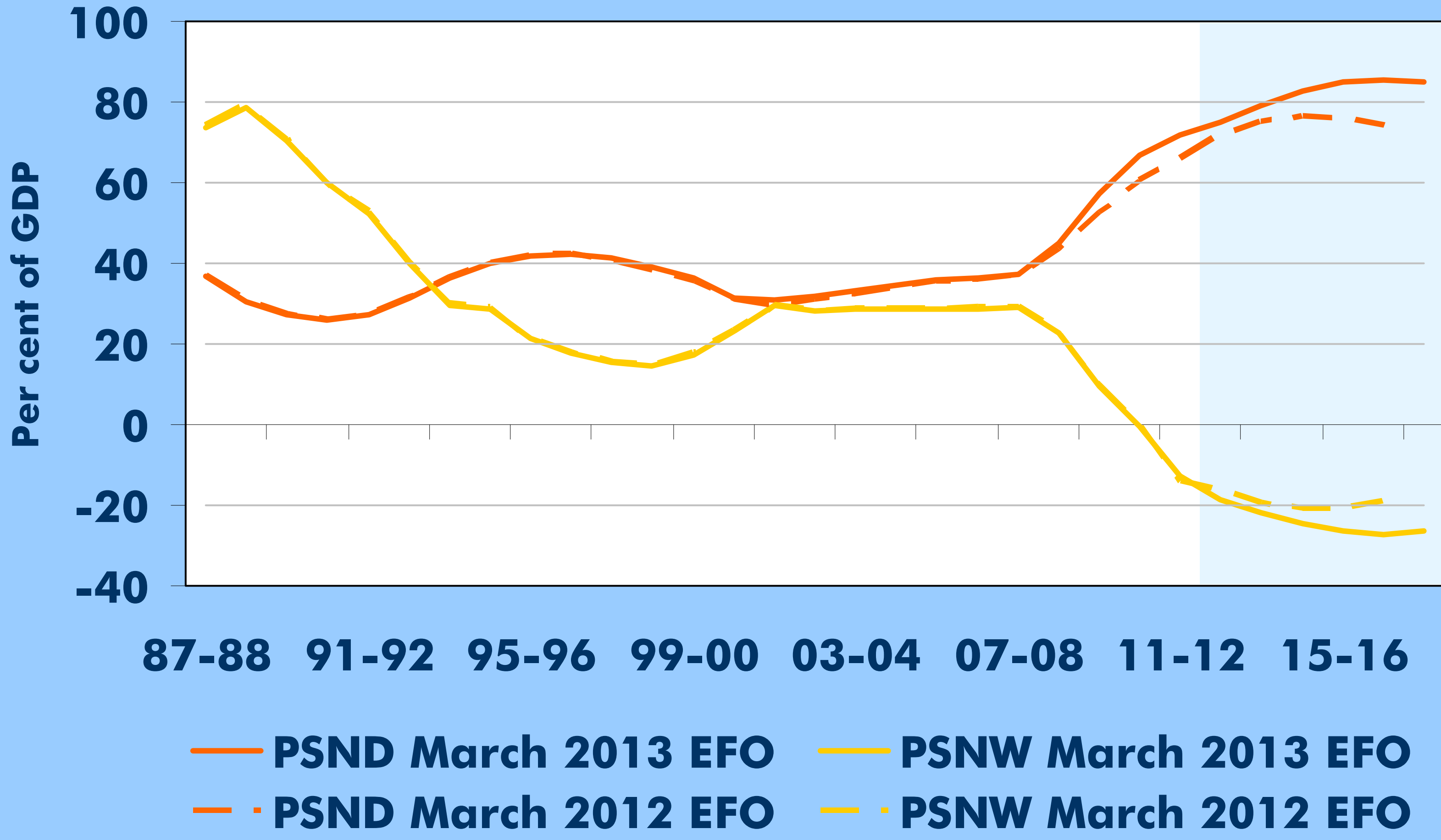

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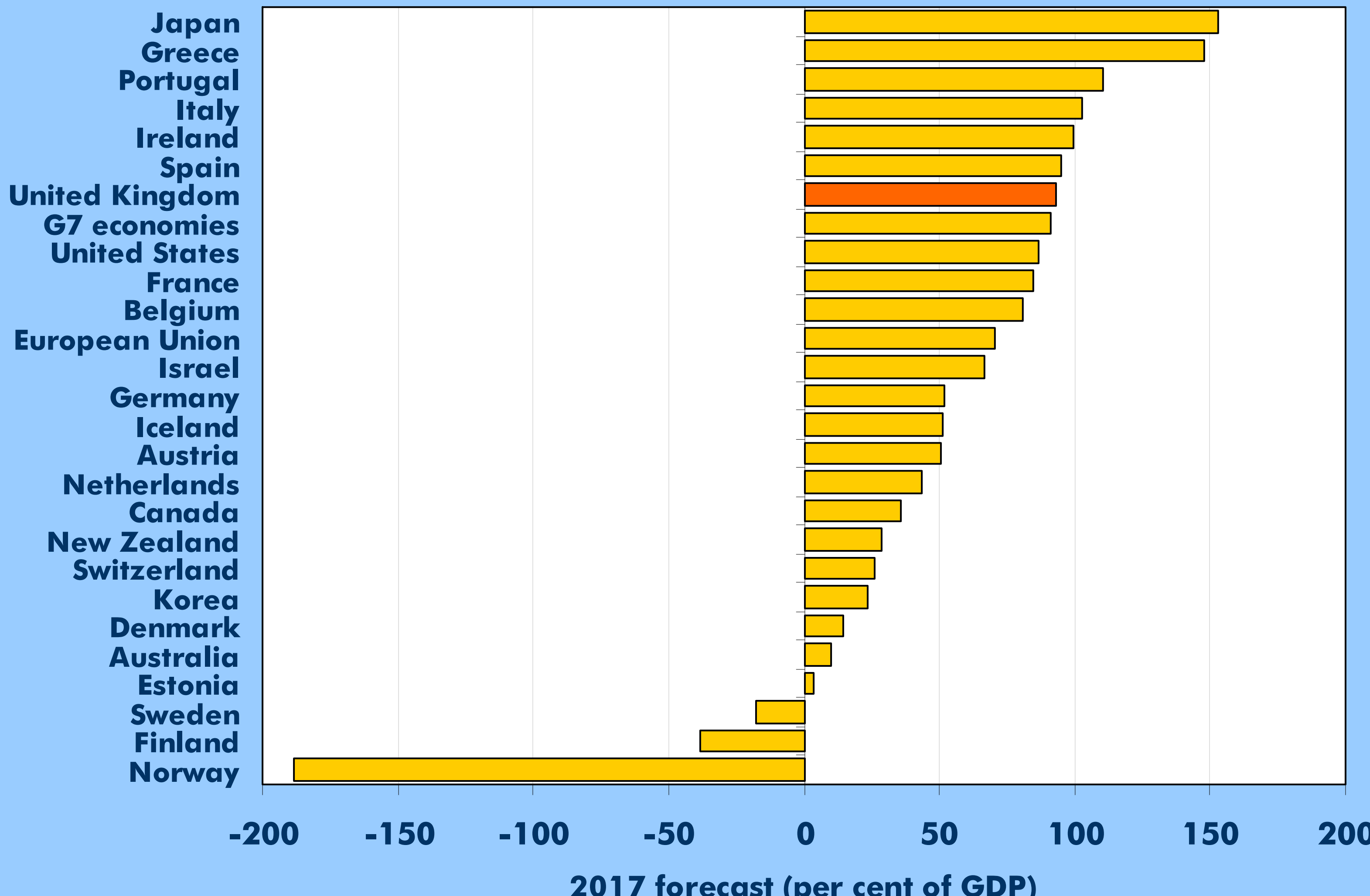
General government net debt (IMF)



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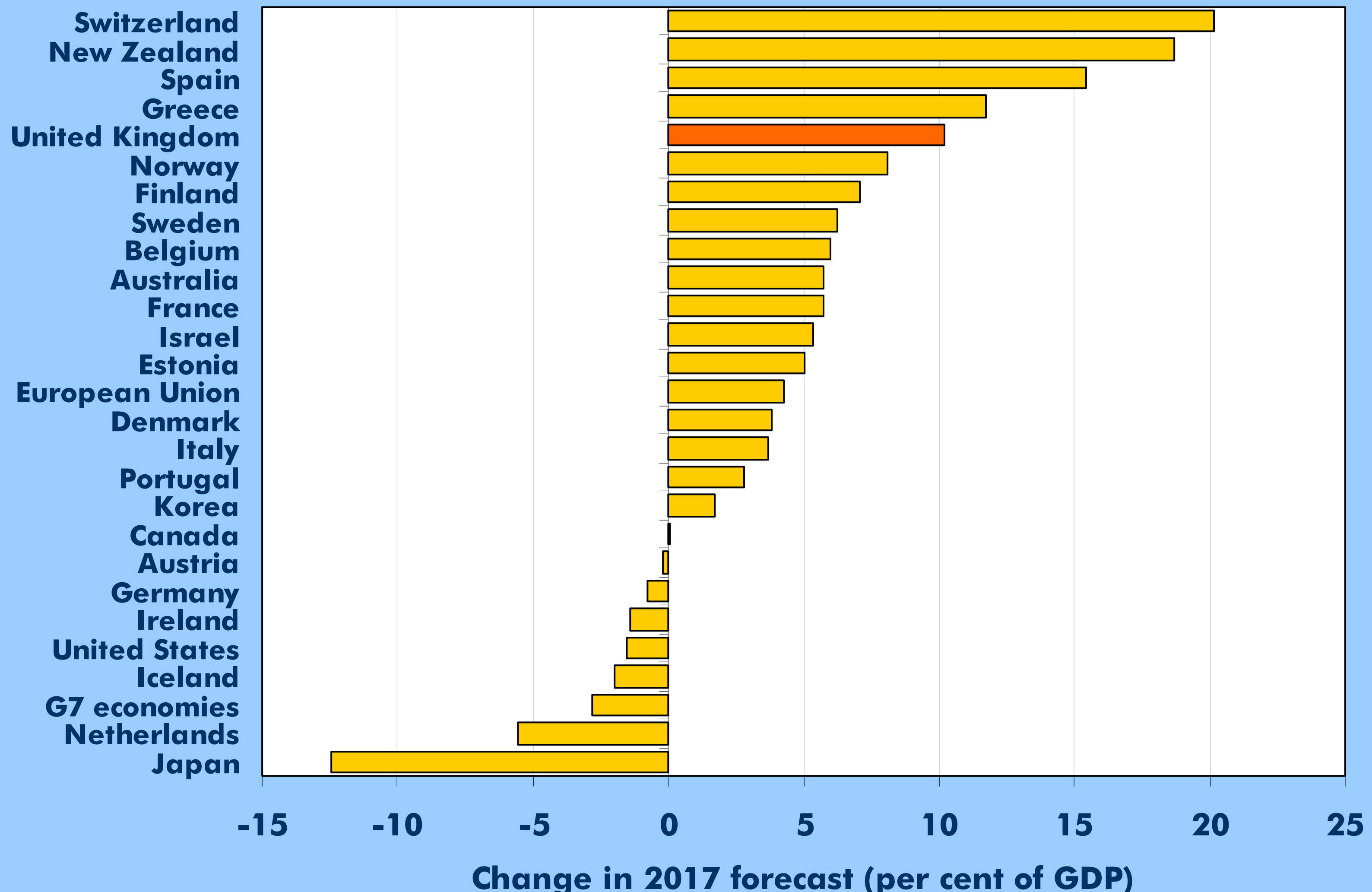

Whole of government accounts

- Prepared under commercial accounting rules
- Broader coverage than PSND/PSNW
  - Includes illiquid assets, public service pensions, PFI, provisions and (in notes) contingent liabilities
- 2011-12 WGA published today
- Published for third year
  - Limited methods and coverage changes
  - 2010-11 accounts restated for comparison

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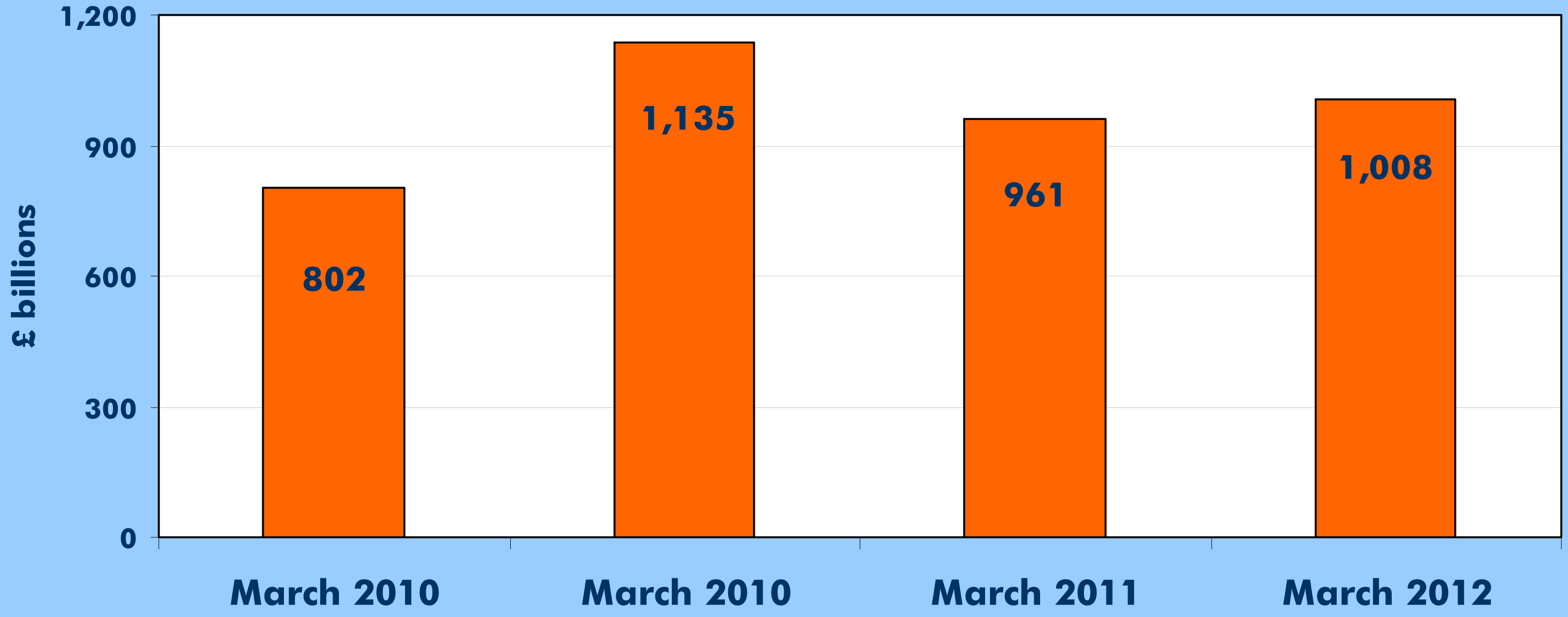
From net debt to WGA net liabilities

£ billion	2010-11	2011-12	*Change*
Public sector net debt		**1,106**	
Remove:			
B&B/NRAM		–83	
Add:			
Public service pension liabilities		+1,008	
Provisions		+113	
Capital liabilities for PFI		+30	
Fixed assets		–793	
Other		–34	
WGA net liabilities		**1,347**	

From net debt to WGA net liabilities

£ billion	**2010-11**	**2011-12**	***Change***
Public sector net debt	**1,005**	**1,106**	***+101***
Remove:			
B&B/NRAM	–94	–83	*+11*
Add:			
Public service pension liabilities	+961	+1,008	*+47*
Provisions	+108	+113	*+5*
Capital liabilities for PFI	+27	+30	*+3*
Fixed assets	–761	–793	*–32*
Other	–60	–34	*+26*
WGA net liabilities	**1,186**	**1,347**	***+161***

Public service pension liabilities in WGA



- Public service pension liabilities rose by £47bn in 2011-12
- Mostly new liabilities from latest year's employment
- Lower discount rate adds £10bn – could add around £40bn next year

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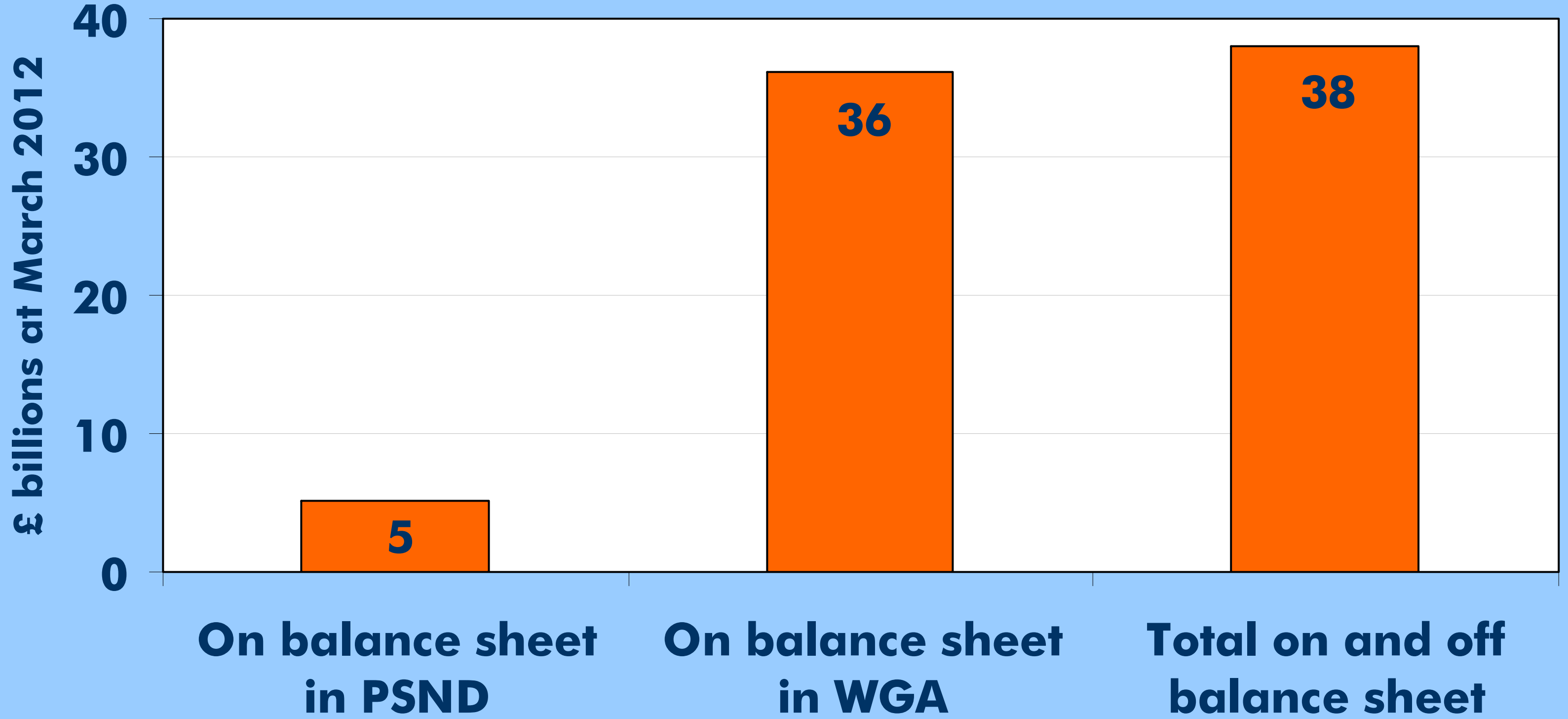
PFI capital liabilities



- If all PFI had been financed through conventional debt finance PSND would be 2.1% of GDP higher.

- Government setting PFI total spending limit of £70bn from 15-16 to 19-20: £50bn as of March 2012

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Provisions

- Provisions are made for costs that the public sector is not certain to incur, but where the probability is greater than 50%

- These totalled £107bn (7.1% of GDP) in 2010-11

- During the following year £21bn were added, £12bn used (much as expected a year ago) and £5bn removed

- So provisions rose £6bn on the year to £113bn (7.4% of GDP)
  - Nuclear decommissioning up £3bn to £64bn
  - Clinical negligence up £2bn to £19bn

- £13bn expected to be used in 2012-13

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Contingent liabilities in WGA

- Contingent liabilities capture costs that the public sector may incur in the future, but where the probability is less than 50%. Guide to risk.

- Doubled from £50bn to £101bn in 2011-12

  – £30bn increase as UK could possibly have to subscribe new capital to the European Investment Bank

  – £15bn increase from higher potential loss of revenue from oil field decommissioning costs – but these potential losses will be deemed ‘unquantifiable’ next year

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New contingent liabilities?

- Various policy measures may create WGA contingent liabilities and guarantees in the future
  - New Buy Guarantee
  - National Loan Guarantee Scheme
  - Export Refinancing Facility
  - UK Infrastructure Guarantee Scheme
  - Lending to PPPs
  - Rented Sector Guarantees
  - Help to Buy Mortgage Guarantee Scheme
- Many are likely to be 'remote contingent liabilities'
- But new downturn would increase probabilities

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From stocks to flows

- Provisions and contingent liabilities are useful risk indicators and cross-checks
- NA and WGA might suggest government is bust
- But they omit future flows from future activity:
  - Future spending on public services and transfers
  - Future tax revenues
- So look at 50 year flow projections to judge sustainability

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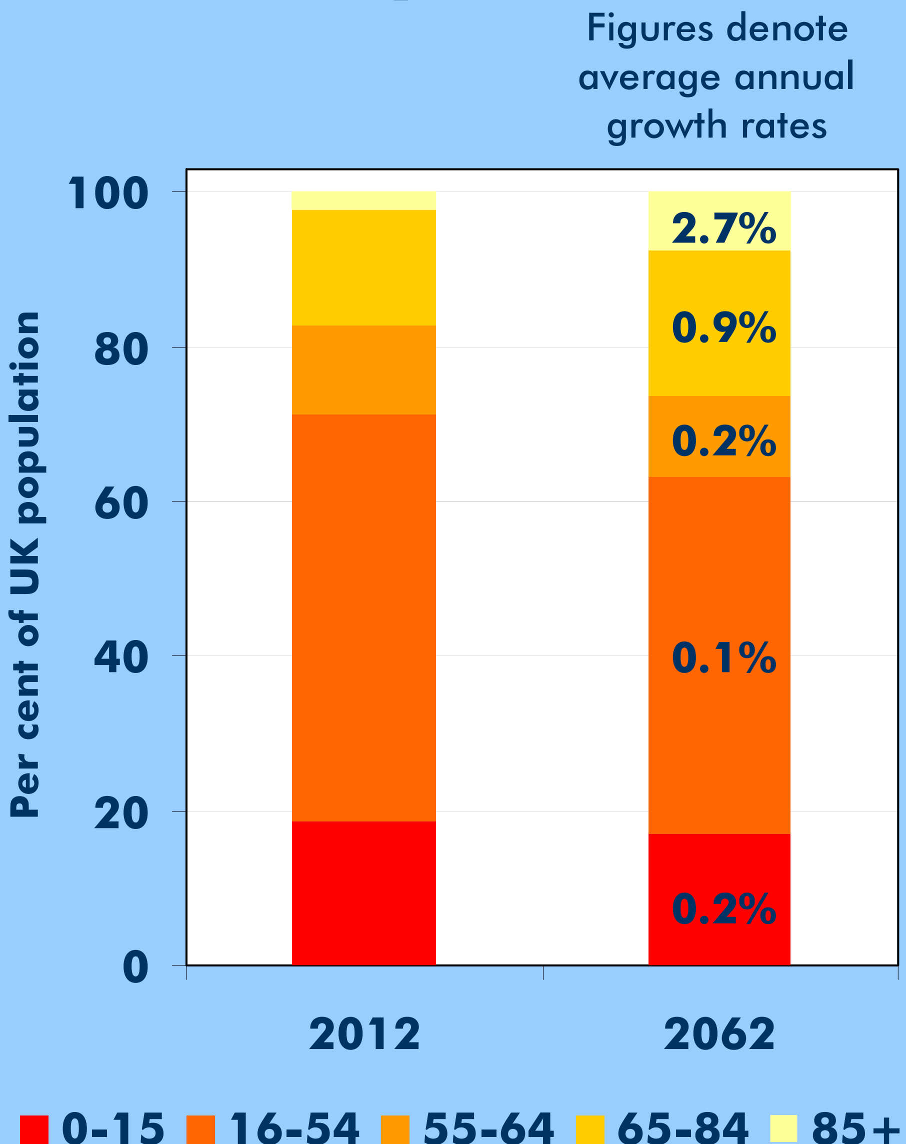
Assumptions: demography



- Demographic change is a key influence on our long-term projections
- Ageing population – past rises in life expectancy and falls in fertility plus baby boom 'bulge'
- Our central projection assumes:
  - 65+ proportion rises from 17% in 2012 to 26% in 2062
  - Net inward migration averages 140,000 a year

Assumptions: economy

- Whole economy productivity growth averages 2.2% a year, in line with long-run experience
- CPI inflation at 2%, consistent with Bank of England target
- GDP deflator rises 2.2% a year (down from 2.5% in last year's FSR)
- Interest rate on gilts slightly higher than GDP growth rate in long term – so small primary surplus needed to stabilise debt-to-GDP ratio
- Three years of above trend growth post 2017-18 to absorb remaining spare capacity

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Assumptions: 'unchanged policy'

- Income tax / NICs allowances rise by earnings post 2017-18
  - Price up-rating would increase receipts 2.4% of GDP by 2032-33
- Most working age benefits rise by earnings post 2017-18
  - Price up-rating would cut costs by 1.4% of GDP by 2032-33
- State pension subject to 'triple guarantee'
  - Rises by minimum of CPI, earnings or 2.5%
  - Assume average increase = earnings+0.3% a year
  - Costs 0.9% of GDP relative to earnings indexation in 2062-63
- Assume public services spending rises with per capita GDP, adjusted for age composition of the population

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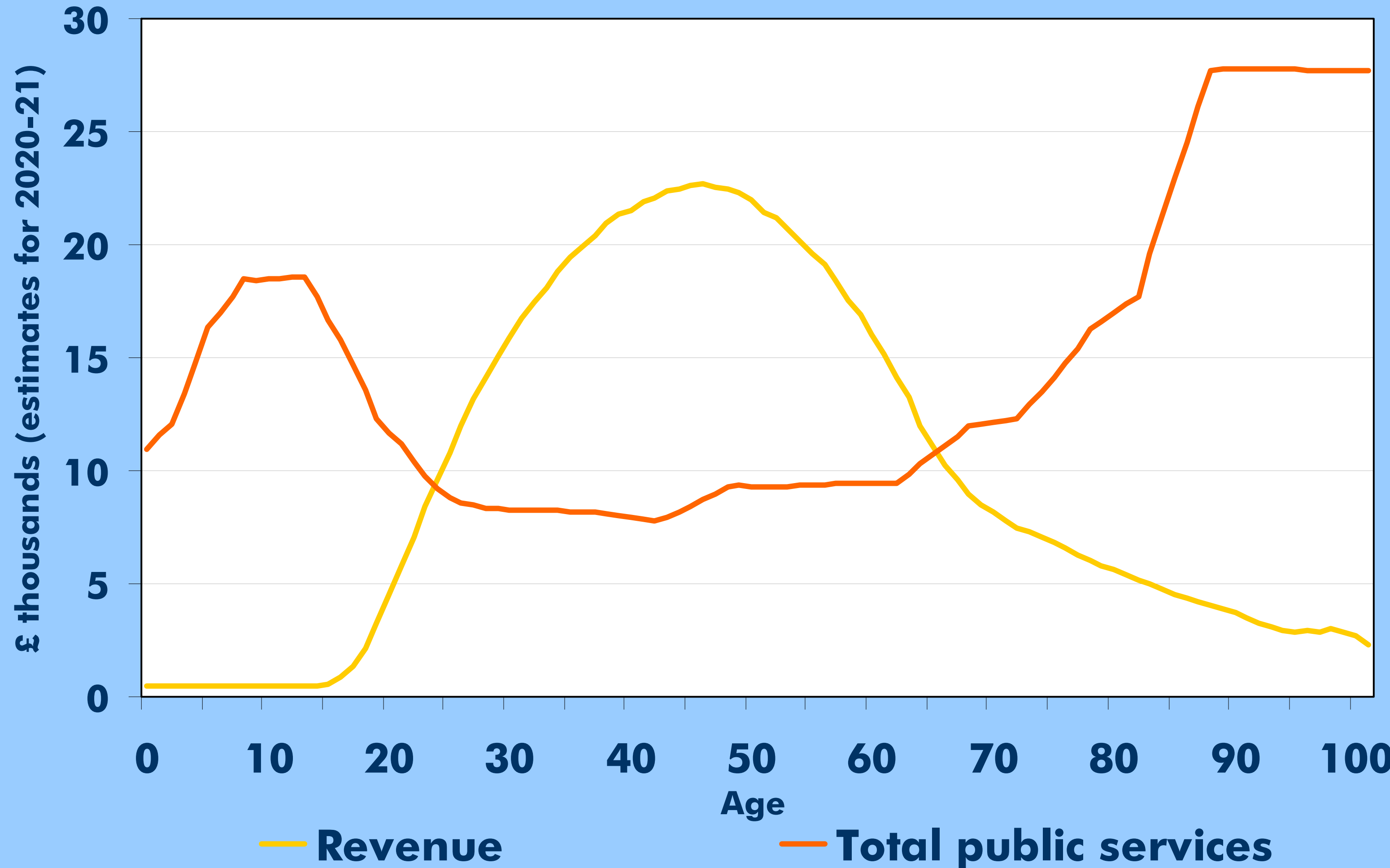
Revenues and public spending by age



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Policy changes since last year

- Additional year of spending cuts in 2017-18
- Other modest Budget and Autumn measures
- Allocation of spending by department in 2015-16
- Cap on long-term care costs (following Dilnot Review)
- Introduction of Single Tier Pension from 2016-17
- Balance transfers between APF and Treasury

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Potential policy changes not included

- Privatisation of Royal Mail
  - Timing and size of stake to be sold not clear
- Mansion House announcements on RBS and Lloyds
  - Good bank / bad bank being reviewed: no decision yet
- Linking state pension age to life expectancy
  - PM has said 1/3 of adult life in retirement reasonable
  - But no firm announcement or definition

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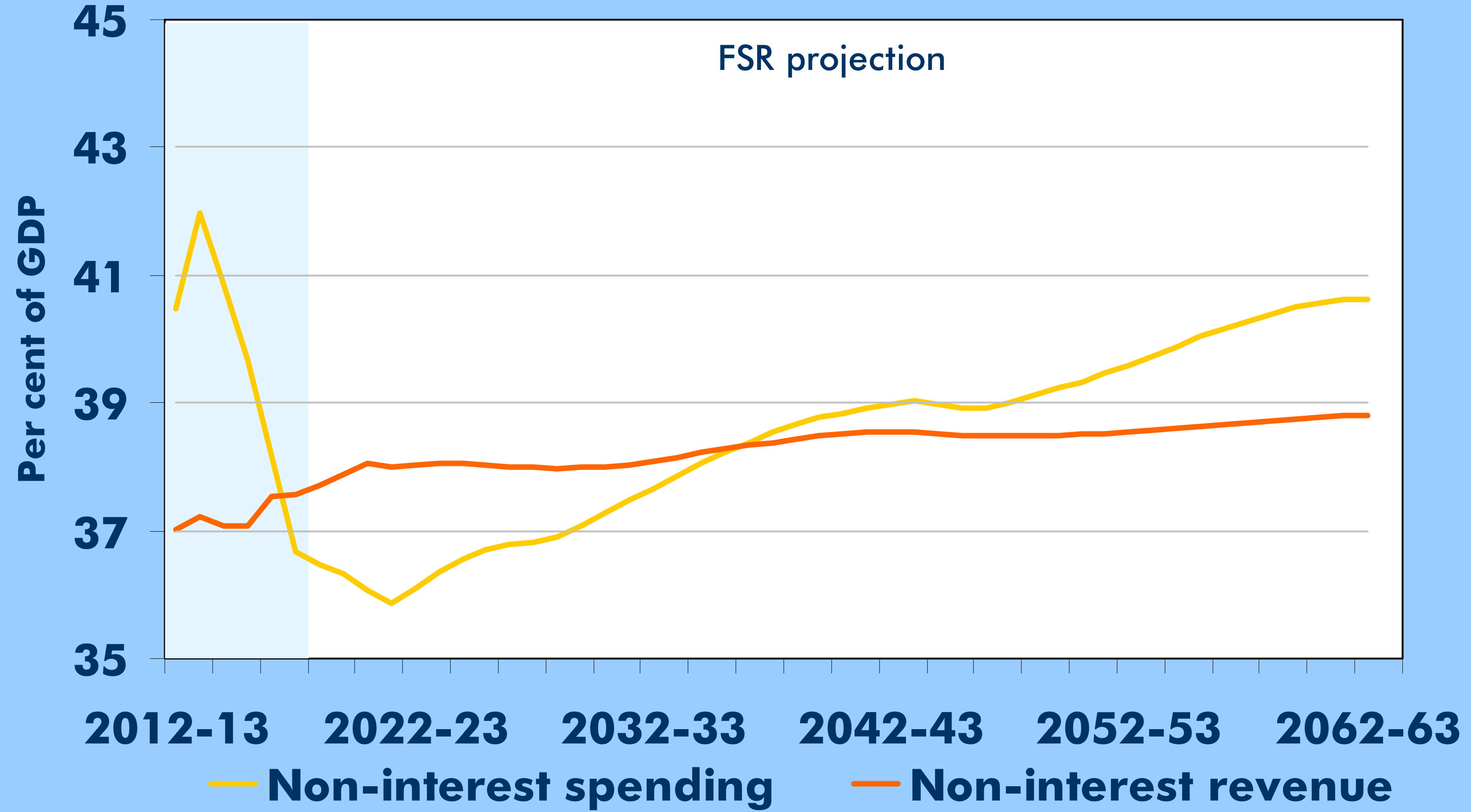
Revenue and spending projections



Spending

- Non-interest spending rises 4.0% of GDP (£61bn) between end of medium-term forecast and 2062-63
- Main drivers: health, state pensions and long-term care, all as a result of the ageing population
- Main offset: falling cost of public service pensions, thanks to falling public employment and reforms
- Increase smaller than last year's 5.2% of GDP
  - Policy savings from Single Tier Pension more than offset extra cost of long-term care. Bigger output gap in 2017-18.

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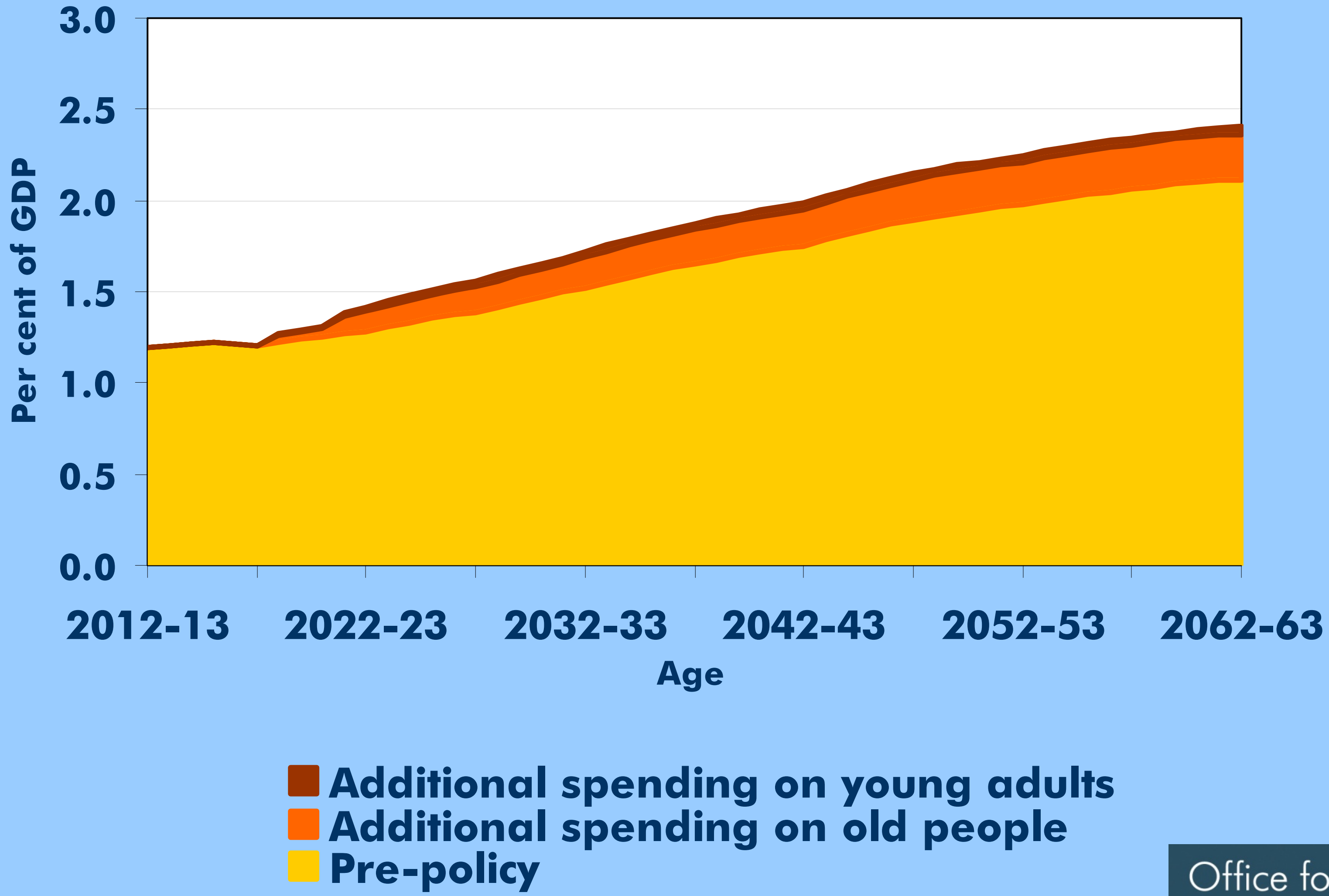
State pension costs in 2062-63

	% GDP
FSR 2012	**8.4**
Modelling changes	+0.7
Introduction of Single Tier Pension	–0.7
FSR 2013	**8.4**
Earnings uprating, not triple lock	*–0.9*

Long-term care costs



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Receipts

- Non-interest receipts rise by 1.2% of GDP (£19bn) between end of medium-term forecast and 2062-63
- Partly reflects pick-up in capital taxes as above-trend growth uses up spare capacity
- Ageing has much less impact on receipts
- Oil and gas receipts in long term decline

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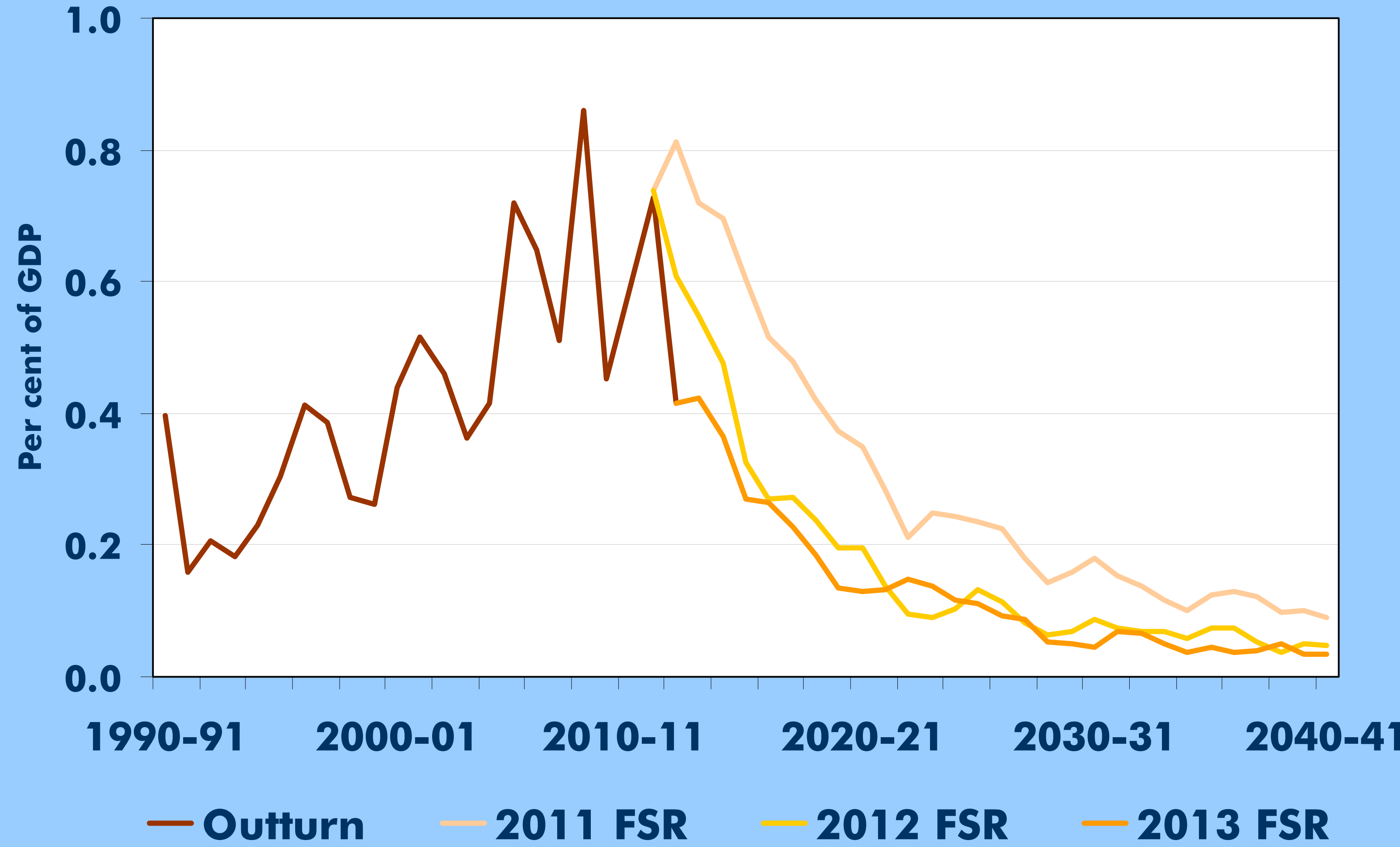
Oil and gas receipts I



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Oil and gas receipts II

- Central projection assumptions
  - Oil prices in line with futures over medium term forecast, then rise with whole economy inflation
  - Production falls 5% a year (7.8% since 1999)
  - Operating and capital expenditure falls with production

- Central projection results
  - Receipts fall from 0.4% GDP last year to 0.03% by 2040-41
  - Receipts total £56bn from end medium term to 2040-41
  - Down from £67bn last year thanks to lower starting point
  - But receipts very volatile in short term and pace of long-term decline similarly uncertain

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Oil and gas receipts III

	Average, % GDP (18-19 to 40-41)	Total £ billion
Central projection	0.08	56
Low prices	0.07	43
High prices	0.11	82
Low production	0.06	40
High production	0.11	73

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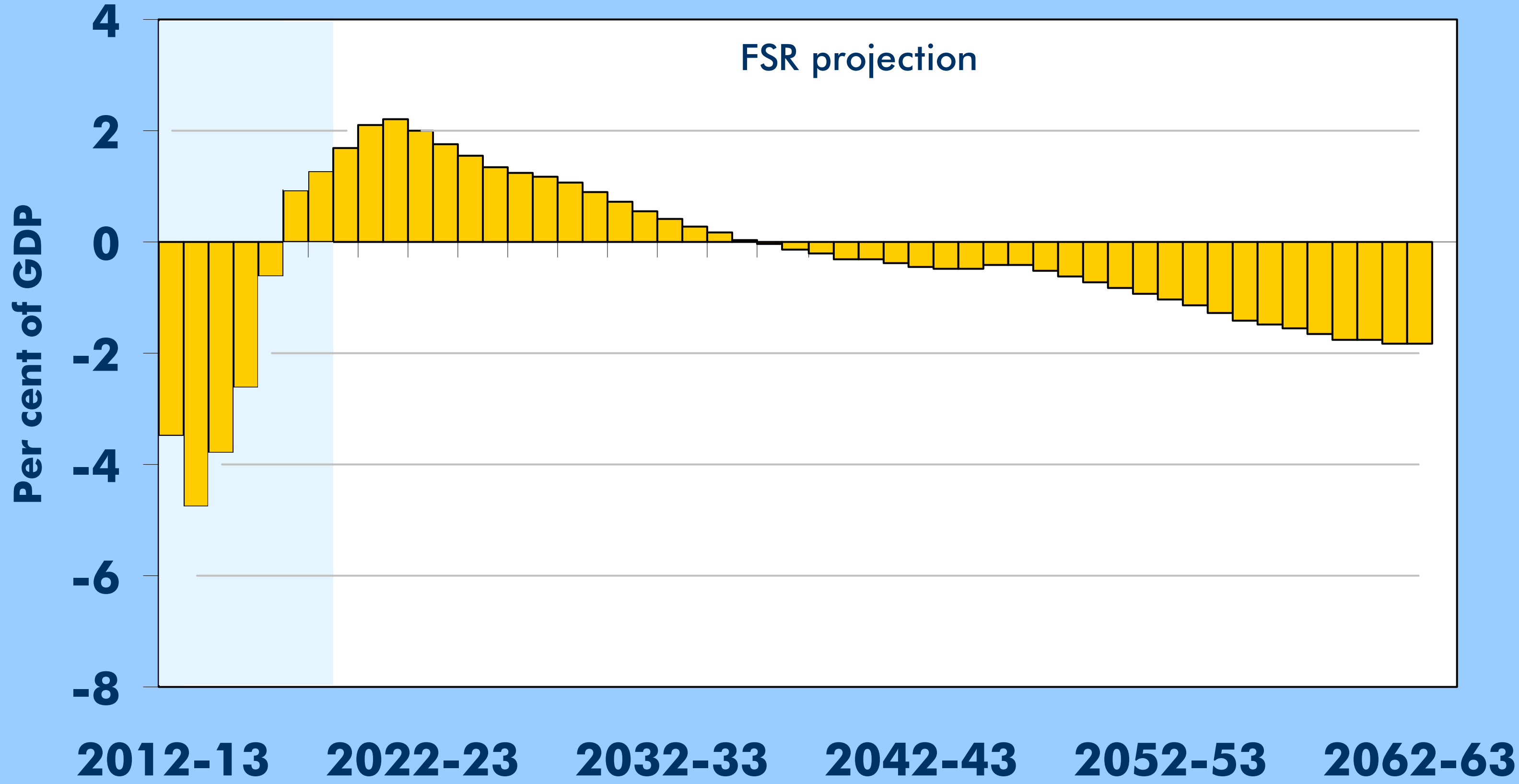
Primary budget balance



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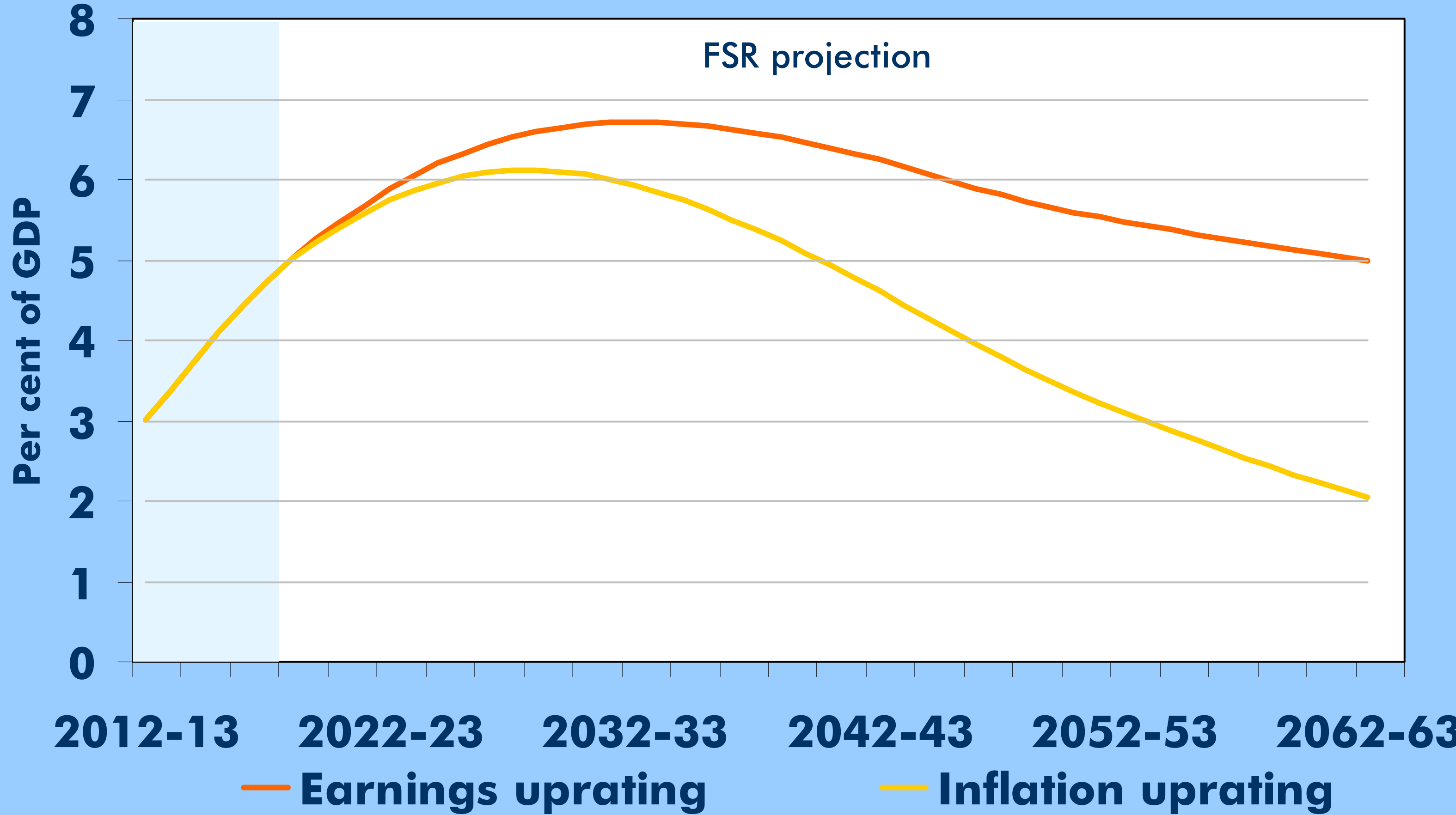
Impact of student loans on PSND



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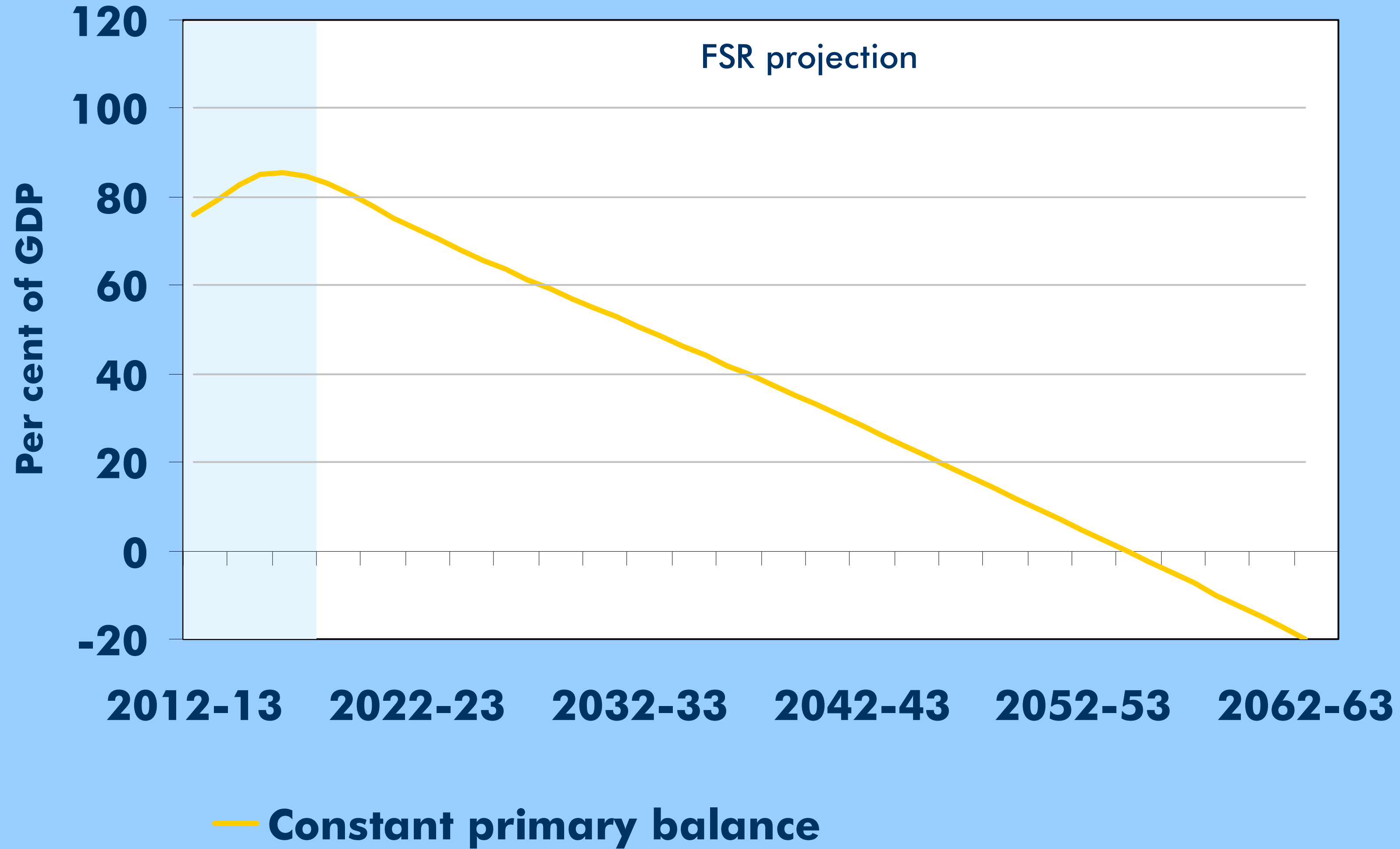
Public sector net debt



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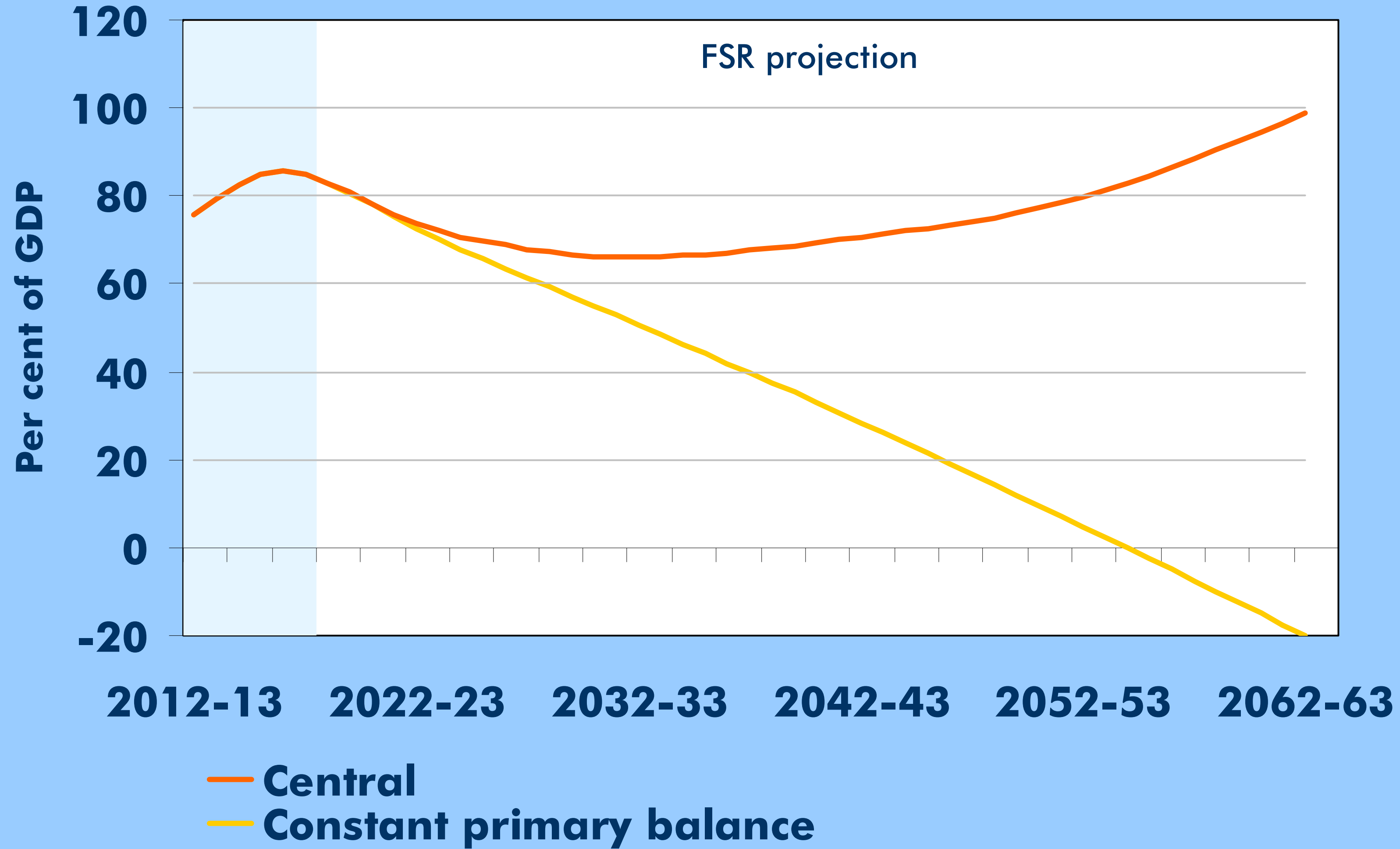

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Sensitivity analysis

- Considerable uncertainty around 50 year projections

- Outlook for debt would be worse if:
  - Primary surplus at end of EFO forecast smaller
  - Population structure older
  - Productivity growth slower
  - Long run interest rates higher relative to long run growth rates
  - Health spending had to rise to offset weak productivity growth

- Higher net migration would improve outlook as immigrants more likely to be of working age

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Migration variants

Impact relative to central projection (+140k) in 2062-63	**Non-interest Spending**	**Non-interest revenue**	**Primary balance**	***Net debt***
High net inward migration (+260k)	–0.8	–0.2	+0.6	*-25*
Zero net inward migration	+2.6	+0.5	-2.1	*+46*
Zero net and gross inward migration	+3.7	+0.6	-3.1	*+82*

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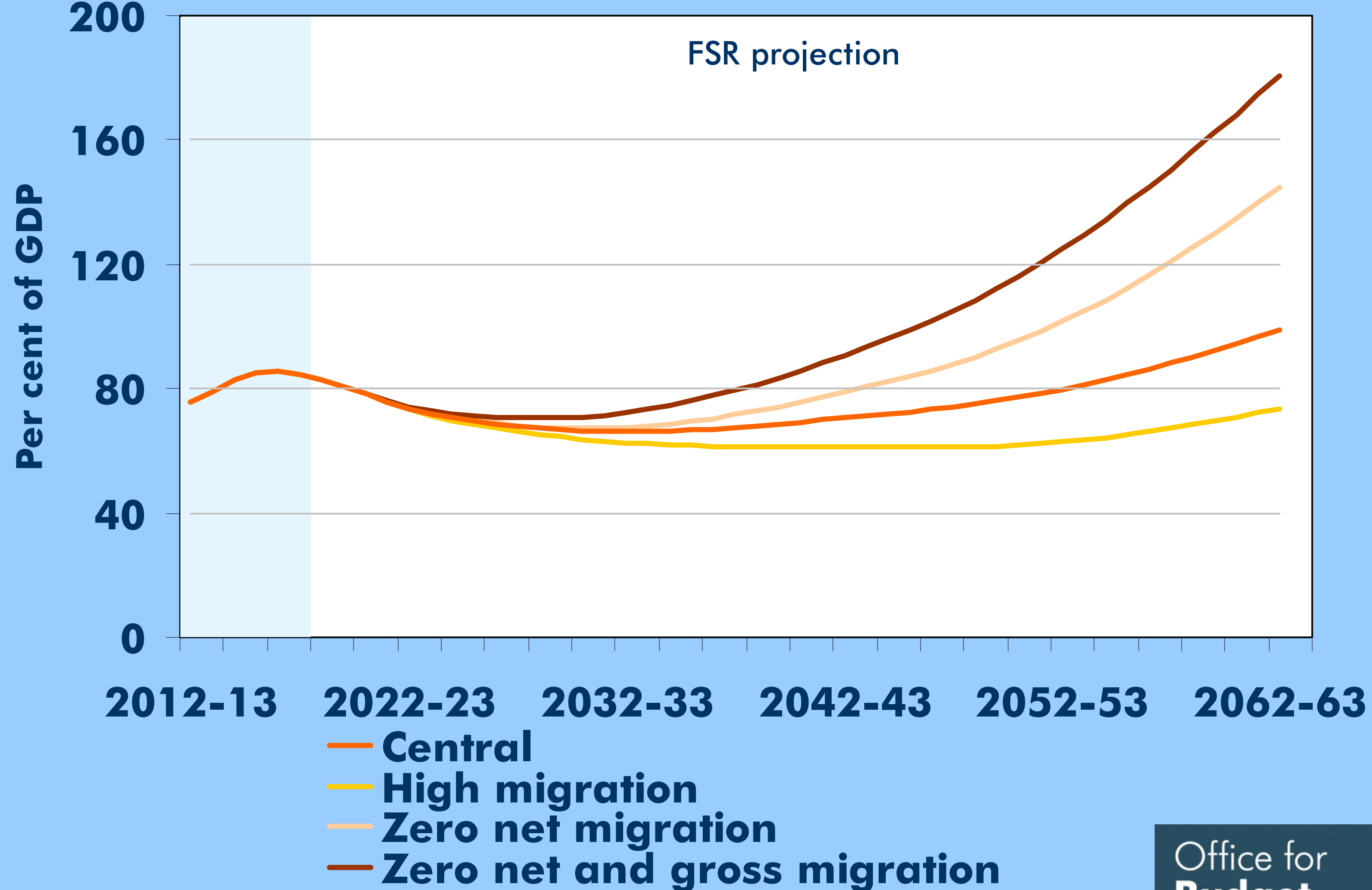
Migration variants and net debt



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What has changed since last year?

% GDP in 2062-63	**Primary balance**	**Net debt**
FSR 2012	**–2.7**	**91**
Pre measures	***–0.5***	***+59***
2017-18 debt-to-GDP	*0.0*	*+13*
2017-18 structural balance	*–0.6*	*+27*
Other	*+0.1*	*+19*
Measures	***+1.4***	***–51***
Long-term care reform	*–0.3*	*+4*
2017-18 spending cuts	*+1.0*	*-48*
Single Tier pension	*+0.7*	*–7*
FSR 2013	**–1.8**	**99**

Achieving sustainability

- Satisfy 'inter-temporal budget constraint'
  - Permanent tightening of 1.9% of GDP from 2018-19
  - Down from 2.6% last year, mostly thanks to 17-18 cuts

- Fiscal gap: PSND of 40% of GDP in 2061-62

  - Permanent tightening of 1.2% of GDP from 2018-19 or 0.5% of GDP each decade in central scenario (fractionally more than last year)

  - Permanent tightening of 3.6% of GDP from 2018-19 if per capita health spending rises 3.4% a year in real terms

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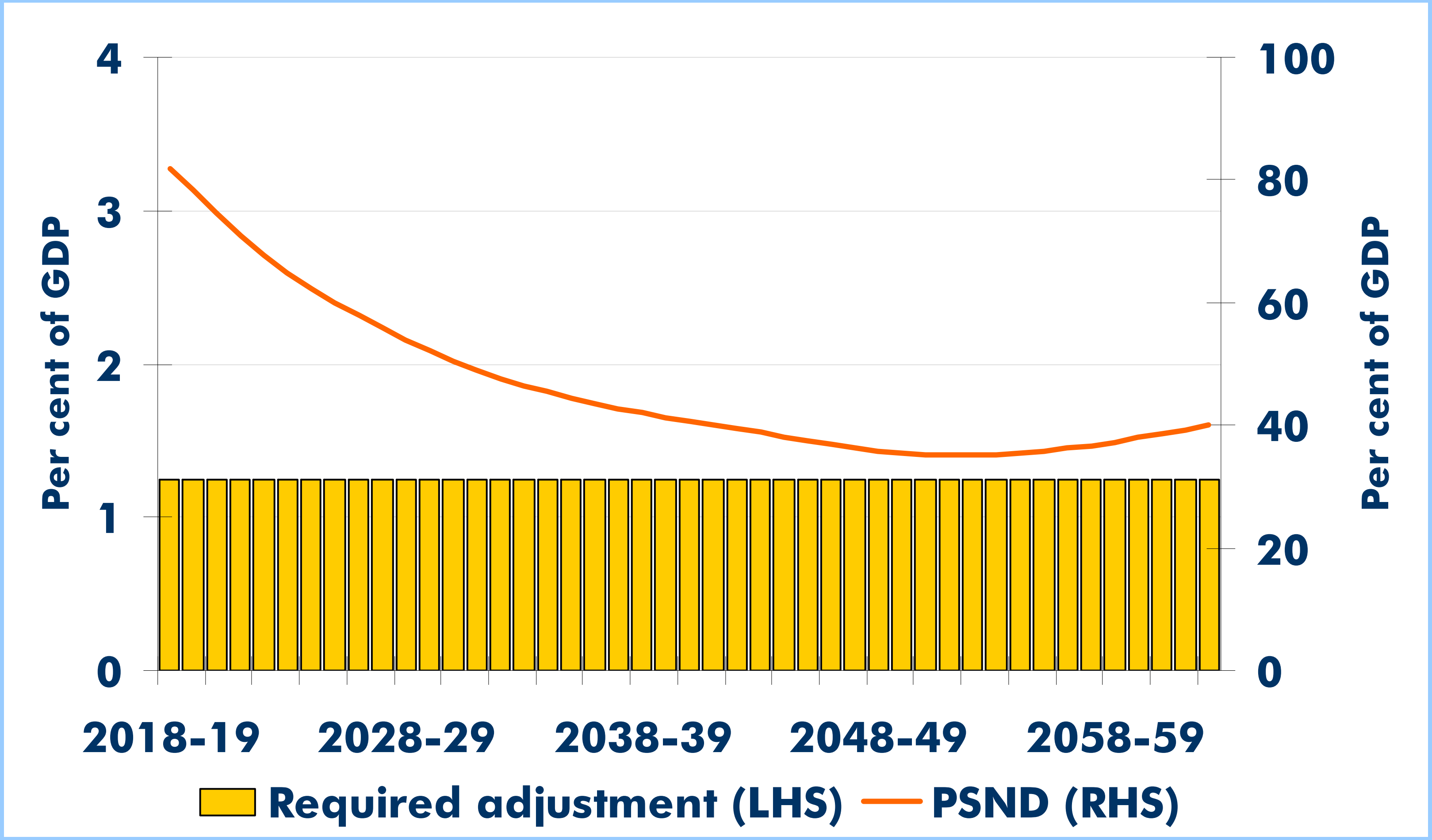
Timing the response: one-off



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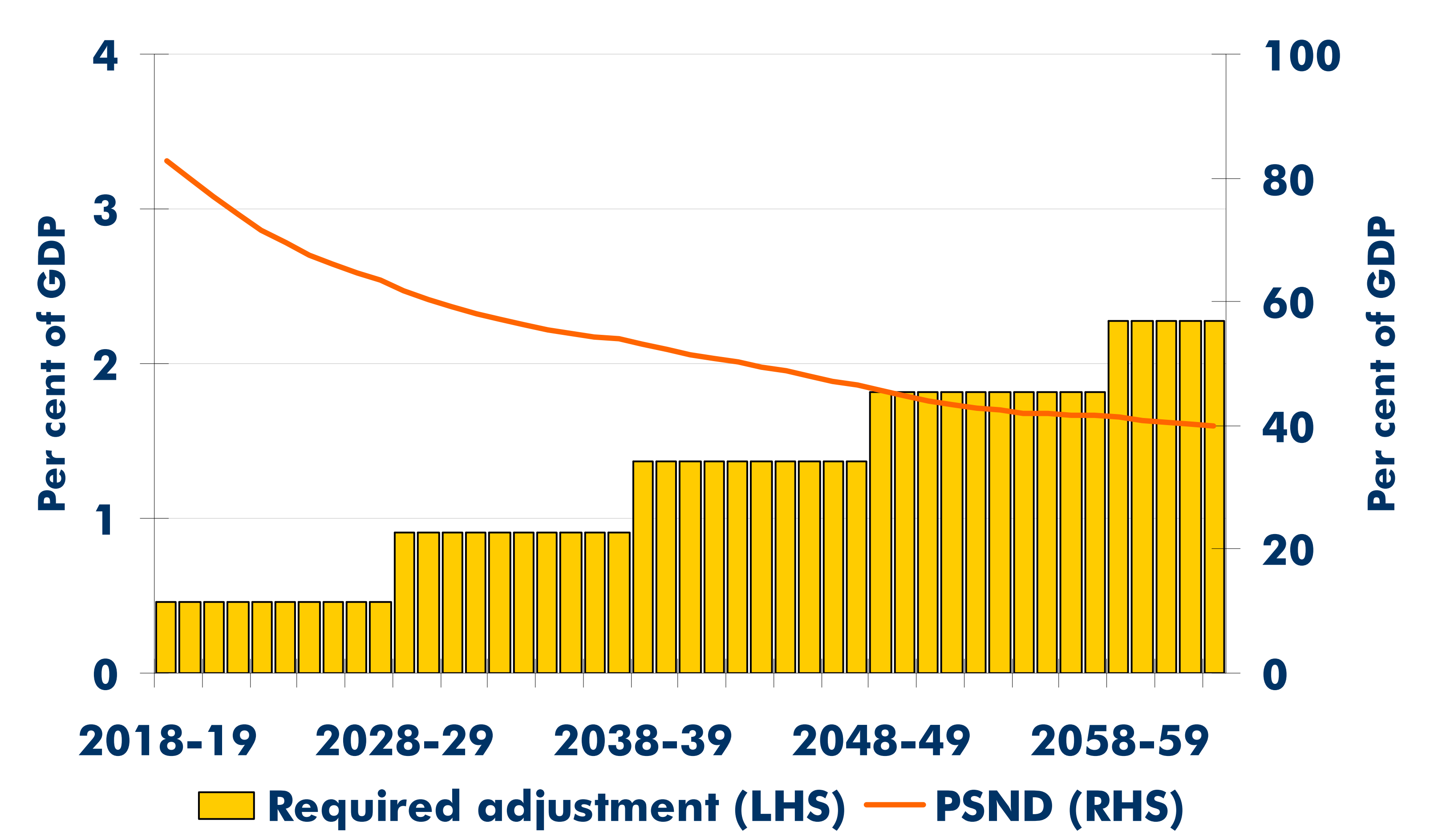
Timing the response: decade by decade



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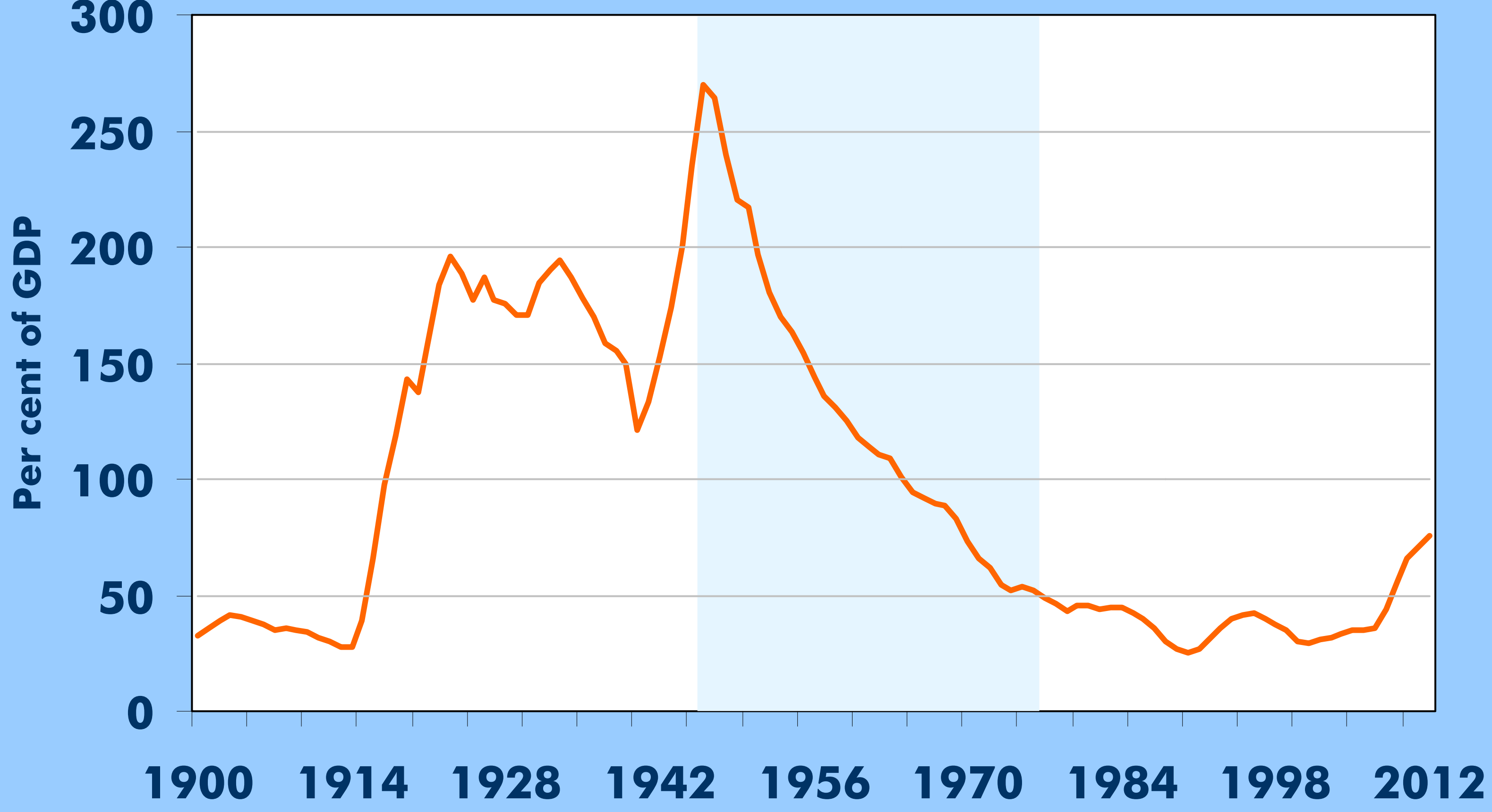
Reducing debt after WW2



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Conclusions

- Ageing puts pressure on public finances
- Some additional tightening likely to be needed after current consolidation
- Since last year:
  - Underlying deficit and debt path less favourable
  - Plus additional costs of long term care reform
  - Broadly offset by 17-18 spending cuts and Single Tier Pension
- Huge uncertainty and UK by no means unique
- Need to keep an eye on contingent liabilities