Office for
Budget
Responsibility

PRESS NOTICE

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Fiscal sustainability and Welfare trends reports – June 2015

Ageing population to put pressure on public finances

Our fifth* Fiscal sustainability report *shows that further tax increases or spending cuts are likely to be needed after the current fiscal consolidation to help meet the costs of an ageing population.

Once a year, we produce an analysis of the sustainability of the UK's public finances. Our approach to this issue is twofold:

- first, we look at the fiscal impact of *past* public sector activity, as reflected in the assets and liabilities that it has accumulated on its balance sheet; and

- second, we look at the potential impact of *future* public sector activity, by projecting how spending and revenues may evolve over the next 50 years – and the impact this would have on public sector net debt.

At the end of 2014-15, PSND was £1,484 billion, equivalent to 80.4 per cent of GDP or £55,600 per household. National Accounts balance sheet measures do not include liabilities arising from the future consequences of past government activities, for example the pension rights that have been accrued by public sector workers.

Liabilities included in the WGA but not within the National Accounts also include £142 billion (8.0 per cent of GDP) in provisions for future costs that are expected (but not certain) to arise. Total provisions have increased by £11 billion since last year's WGA. As in last year's WGA, the two largest sources of provisions – for future nuclear decommissioning costs and clinical negligence claims – increased significantly, by £7.6 billion and £3.0 billion respectively. Repeated and substantial increases in these provisions suggest they could become significant future pressures on public spending.

The overall net liability in the WGA was £1,852 billion or 104.4 per cent of GDP at the end of March 2014, up £224 billion on the previous year's restated results. This compares with PSND of £1,402 billion or 79.1 per cent of GDP at the same date.

One theme in this year's report is that the direct effects of the late-2000s financial crisis on the public sector balance sheet are now declining. Lloyds Banking Group has been reclassified back to the private sector. WGA contingent liabilities that the Government classifies as associated with financial sector interventions have fallen to £0.3 billion from £9.9 billion a year earlier. The Government is selling assets that it holds as a result of interventions made during the financial crisis. But the indirect effect on the balance sheet via the recession that accompanied the financial crisis and, more importantly, the large and persistent hit to the economy's potential to produce national income continues.

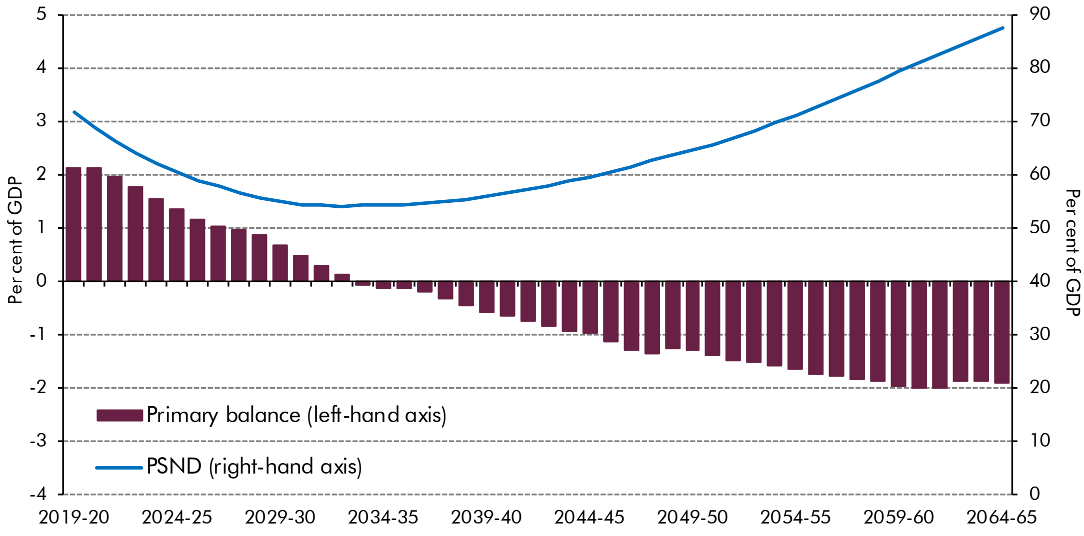
As in previous years, our central projections show that population ageing will put upward pressure on public spending. Spending will increase as a share of national income beyond the medium-term forecast horizon, gradually rising towards and then exceeding receipts. Spending excluding debt interest is projected to rise from 33.6 per cent of GDP in 2019-20 to 37.8 per cent of GDP by 2064-65, whilst receipts remain relatively flat (at round 36 per cent of GDP) over the same period.

As a result, the primary budget balance (the difference between non-interest revenues and spending that is the key to the public sector's debt dynamics) is projected to move from a surplus of 2.1 per cent of GDP in 2019-20 to rough balance in the mid-2030s and then to a deficit of 1.9 per cent of GDP in 2064-65 – an overall deterioration of 4.0 per cent of GDP, equivalent to £76 billion in today's terms.

Taking this and our projection of financial transactions into account, PSND is projected to fall from its medium-term peak of just over 80 per cent of GDP in 2014-15 to 54 per cent of GDP in the early 2030s, before rising to 87 per cent of GDP in 2064-65. Beyond this point, debt would remain on a rising path.

Some financial transactions also have long-term effects on the public finances. We project that the direct flows related to student loans will add 5.5 per cent of GDP to net debt in 2019-20, rising to 8.8 per cent of GDP by the late-2030s, and then falling to 8.0 per cent of GDP in 2064-65.

Chart: Central projection of the primary balance and public sector net debt



Source: OBR

Needless to say, there are huge uncertainties around these projections. We therefore test these sensitivities using a number of different scenarios. The eventual increase in PSND would be greater than in our central projection if long-term interest rates turned out to be higher relative to economic growth, if the age structure of the population was older, or if net inward migration (which is concentrated among people of working age) was lower than in our central projection.

Non-demographic factors are also likely to affect tax revenues. Our long-term projections of North Sea revenues again show that they are likely to fall to below 0.1 per cent of GDP over the coming decades. Our central projection suggests around £2 billion will be raised in North Sea revenues in total between 2020-21 and 2040-41, down from around £37 billion in last year's report. The combined effect of lower oil and gas prices and production since last year, which are offset by lower expenditure, leave implied pre-tax profits relatively low. Accumulated losses and future decommissioning costs also weigh on potential future revenues. We stress again that oil and gas revenues are particularly difficult to forecast, and these results are subject to considerable uncertainty.

Our analysis of longer-term pressures on revenue streams suggests that governments will, over time, need to find new sources of revenue to maintain the overall ratio of revenue to national income, let alone to meet the spending pressures from an ageing population.

In our central projections, and most of the variants we calculate, on current policy we would expect the budget deficit to widen sufficiently over the long term to put public sector net debt on a continuously rising trajectory as a share of national income. This would be unsustainable.

Summary indicators of sustainability can be used to quantify the tax increases and/or spending cuts necessary to return the public finances to sustainability. We focus on the 'fiscal gap' measure that asks how big a permanent spending cut or tax increase would be necessary to move public sector net debt to a particular desired level at a particular chosen date. The current Government does not have a long-term target for the debt to GDP ratio. So, for illustration, we calculate the additional fiscal tightening necessary from 2020-21 to return PSND to 20, 40 or 60 per cent of GDP in 2064-65.

Under our central projections, a once-and-for-all policy tightening of 1.1 per cent of GDP in 2020-21 (£21 billion in today's terms) would see the debt ratio reach 40 per cent of GDP in 2064-65. But this is less than the 1.9 per cent of GDP required to stabilise debt over the longer term and so the debt ratio would continue rising beyond the target date. Tightening policy by 0.4 per cent of GDP a decade would see the debt ratio fall more slowly to begin with, but the overall tightening would be large enough to stabilise the debt ratio at around the target level and prevent it from taking off again. Targeting debt ratios of 20 and 60 per cent of GDP would require larger and smaller adjustments respectively.

Welfare trends report

This year's *Welfare trends report* looks back at our most recent welfare spending forecasts in the light of the conclusions we drew from last year's report. We describe how the analysis contained in last year's report prompted us to revise up spending on disability and incapacity benefits, to assume a further delay in the delivery of universal credit, but also to revise down spending on jobseeker's allowance substantially. The main economy risk we highlighted last year – inflation – came in much lower than forecast a year ago, leading to substantial downward revisions to our medium-term forecast of welfare spending.

We also draw on international data to compare total spending allocated to social expenditure in the UK to that in other countries.

The comparisons presented in the report show that spending on social protection in the UK:

- is broadly in line with the average of advanced economies covered in this chapter in terms of public spending;

- is above average when private spending (particularly on pensions) and the net effects of the tax system are taken into account. This is despite the international data not being available to reflect the cost of tax relief for pension contributions, which is also estimated to be relatively high in the UK;

- is relatively unusual in relying quite heavily on private provision for pensions, but relatively close to average in terms of the overall resources devoted to pensions given the demographic structure of the population;

- spends a similar share of national income on support for sick and disabled people, with a high share of that support in the form of cash benefits rather than benefits-in kind. It has been suggested that disability living allowance in the UK is unusual in its 'extra costs' model, which aims to contribute towards the costs of certain goods and services associated with differing severity of disability, rather than providing those goods and services as benefits-in-kind;

- spends much less than average on unemployment benefits, mainly because the generosity of jobseeker's allowance (as measured by the ratio of benefits to previous earnings from employment) is relatively low. But that partly reflects the use of housing benefit to deliver support for housing costs among those out of work and renting;

- spends more than other OECD countries on family benefits, defined as financial support exclusively for families and children. In large part, that reflects child tax credits, which our previous report showed had increased in cost in the mid-2000s (when they became the main tool for trying to reduce child poverty) and since the late 2000s recession (when they were subject to generous uprating); and

- spends much more than average on support for housing costs, but that is likely to be largely because that support is not wrapped up in the level of other benefits, such as unemployment or incapacity benefits.

Notes

1. The Office for Budget Responsibility is the UK's independent fiscal watchdog – responsible for producing forecasts for the economy and the public finances, assessing progress against the Government's fiscal targets, and reporting on long-term fiscal sustainability.
2. All of the documents published by the OBR today are available on our website at: http://budgetresponsibility.org.uk/
3. Questions about the *Fiscal sustainability report* or the *Welfare trends report* should be sent to OBRpress@obr.gsi.gov.uk.