

Fiscal sustainability report 2014: 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 fourth *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 and officials in various departments and agencies. Our thanks to them all.

We presented a draft of our conclusions to the Chancellor on June 26th, so that he could decide whether there were any additional policy decisions he wished us to take account of – and there were not. We gave 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. We look at the familiar National Accounts measures and also at the Whole of Government Accounts, which consolidate the accounts of well over 1000 public sector bodies and present them in the same format as private sector company 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.

To cut straight to the chase, the conclusion will be that the picture looks slightly less unsustainable than it did a year ago. Our medium-term forecast and the latest population projections are less favourable for the public finances than a year ago. But this is more than offset by the Government's decisions to extend public spending cuts for an extra year to 2018-19 and to link the State Pension age to rising life expectancy.

[SLIDE] Before turning to the numbers in detail, 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 made 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.
- 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 - the blue line in this chart. Both this and the previous government have set medium-term targets for this measure, which was roughly £1,270 billion, 76 percent of GDP or £48,000 per household at the end of the last fiscal year. We forecast in March that net debt would rise to 79 per cent of GDP by 2015-16 before falling back.

For some years the ONS has also published a wider balance sheet measure called public sector net worth (here in red). This has the opposite sign (it is assets minus liabilities) and it also includes physical and illiquid financial assets. At the end of 2012 this was around minus 13 per cent of GDP and we forecast in March that it would fall to about minus 21 per cent of GDP in 2017-18.

Net worth has deteriorated by more than net debt in recent years, because much of the additional borrowing undertaken by the government has been used to finance day-to-day, rather than capital, spending. Indeed, of the £1½ trillion of debt that we expect to be outstanding in 2018-19, almost £830 billion will have been incurred financing deficits since 2009-10 – and of that more than £520 billion will have financed current spending rather than capital investment.

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

[SLIDE] If we look at broadly comparable data from the IMF, the UK is in the middle of G7 league table, alongside the US and France. Germany and Canada have smaller debts; Italy and Japan have bigger debts.

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 things that it has done 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 2012-13 WGA, which are the fourth set to be published.

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] First pensions. 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 £1,172 billion or 73 per cent of GDP at the end of March 2013. This is £166 billion or roughly 10 per cent of GDP up on last year. Some of this reflects the transfer of the Royal Mail's historic pension assets and liabilities into the public sector. And almost £60 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.

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 2013 net debt included £5 billion of liabilities for future PFI capital payments. At the same date just under £37 billion were on the WGA balance sheet. The total capital liability on and off both balance sheets is probably a fraction higher at around £38 billion. If all these liabilities were put on the National Accounts balance sheet, net debt would be about 2 per cent of GDP higher than it is now.

The Government has announced a limit on total PFI spending of £70 billion between 2015-16 and 2019-20. By March 2013 expected PFI spending over this period had reached around £51 billion, based on

deals signed up to that point. So there still appears to be significant headroom.

[SLIDE] The public sector's liabilities in WGA also include provisions – estimates of 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.

Provisions increased from £113 billion in 2011-12 to £131 billion in 2012-13. £6 billion of the increase was for nuclear decommissioning and £5 billion for potential clinical negligence payments. The accountants expect £13 billion of the provisions to be used during 2013-14.

[SLIDE] Contingent liabilities are costs that the public sector may incur, but where the accountants think the probability is less than 50 per cent – but not trivial. These potential costs dropped from £101 billion in 2011-12 to £88 billion in 2012-13. The main change is the removal of a £20 billion contingent liability for the potential loss of tax revenue that could result from North Sea oil field decommissioning costs, which companies can set off against tax bills. £4bn of this has now been taken as a provision, while any additional potential losses have been deemed unquantifiable.

[SLIDE] A number of recent policy decisions could create new contingent liabilities in future vintages of the WGA, including a variety of guarantee schemes designed to support the recovery. Our best guess is that most of these will be judged to have a probability of crystallising 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 to do so.

More broadly it is interesting to look at the changing pattern of risks and pressures on the public finances from recent changes in provisions and contingent liabilities. The potential impact of the crisis-related financial interventions is receding, while pressures from the likes of nuclear decommissioning and clinical negligence are increasing.

[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 – although these would actually make the position look even worse. 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, if you are really interested in fiscal sustainability then you should 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. In this year's FSR, we have moved from using the ONS's 2010-based projections to its new 2012-based ones. The big picture remains the same: 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.

As you can see here, the ONS population variant that we use for our central projection has the proportion of the population aged 65 and over rising from over 17 per cent this year to around 27 per cent in 2064. (It was closer to 12 per cent in 1961.) It also has net inward migration averaging 105,000 a year.

[SLIDE] Compared to last year, [SLIDE] the latest population projections suggest that there will be fewer people of working age, more people in their 80s and 90s and roughly the same number of children. So the ratio of workers to non-workers is lower, which increases fiscal pressures.

[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. 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.

[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 is implausible over 50 years because earnings normally rise more quickly than prices. Allowances and benefit rates would fall steadily relative to living standards. 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 2018-19, which would keep revenues and benefit costs broadly constant as a share of GDP, other things being equal.

Turning to 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.

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 and gender composition of the population.

[SLIDE] This chart shows how consumption of public spending 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, as well as receiving larger welfare payments, mainly the state pension. 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.

[SLIDE] Since last year's FSR, there have two main policy announcements that affect our long-term fiscal projections:

- First, the announcement in last year's Autumn Statement that cuts in public spending will be extended by an additional year to 2018-19. This reduces spending by about 1 per cent of GDP, which persists through the projections, and;
- Second, the Government has announced that the State Pension age will be linked to life expectancy, based on the principle that people should expect to spend a third of adult life in receipt of the state pension, with changes announced in advance and phased in.

[SLIDE] On our central projection this implies that that the SPA would reach 70 by the early 2060s, compared to the increase to 68 in 2046 that is currently legislated for. Under the ONS's old age population projections, the SPA would rise to 75 by the early 2060s – by which time the number of people in the country aged 100 or more would be over a million.

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 are broadly flat while spending increases – reflecting the ageing of the population. The primary balance moves from surplus back into deficit, reaching 1.7 per cent of GDP by 2063-64.

[SLIDE] On the spending side, non-interest spending rises by almost 5 per cent of GDP or roughly £80 billion in today's money between the end of the medium-term forecast and 2063-64. 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 falls 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 about half a percent of GDP bigger than last year. This reflects: first, the fact that spending is no longer pulled down at the start of the projection as the output gap closes, and; second, that the new population projections imply a bigger increase in age-related spending. The policy decisions partially offset this.

[SLIDE] Focusing on the state pension, you can see that we project that this will cost 8 per cent of GDP in 2063-64, down from 8.5 per cent last year. The new population projections increase spending by 0.3 per cent of GDP, but this is more than offset by linking the SPA to life expectancy – which saves 0.9 per cent of GDP or £14 billion in today's terms.

[SLIDE] As we saw in the chart a second ago, the ageing of the population has relatively little impact on receipts – which are broadly flat as a share of GDP over the projection horizon. One category of receipts that we expect to fall over the long term is oil and gas receipts, as the North Sea basin matures. We discuss the outlook for these receipts in Chapter 4, but – given the interest in the issue because of the upcoming referendum - I have also summarised our latest medium and long-term projections in a letter to the Finance Committee of the Scottish Parliament, which we are also publishing today.

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

[SLIDE] Our central projection assumes that oil production falls by 5 per cent a year beyond the medium term forecast, significantly slower than the 7.8 per cent a year decline we have seen on average since 1999. Oil prices are assumed to rise with whole economy inflation.

On these assumptions, we project that oil and gas receipts will total just under £40 billion between 2019-10 and 2040-41, down £12½ billion since last year. This downward revision reflects unexpectedly weak production in 2013, lower sterling oil prices, more companies with losses

to set off against tax, and new information on field ownership, slightly offset by a lower projection for tax deductible expenditure.

Bolting the long-term projections onto our latest medium term forecast, we have reduced our estimate of receipts between 2013-14 and 2040-41 by roughly a quarter - from just over £80 billion to just over £60 billion.

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 for receipts is to some alternative price and production scenarios that we explain in the report. Even these probably understate the degree of uncertainty, since we do not attempt to model the effect of swings in oil prices on the wider economy, which can, of course, be significant.

[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 – to about 1.7 per cent of GDP in 2063-64. In effect, demographic factors gradually unwind about half 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. The average tuition fee loan per borrower was around £7,500 last year, higher than we assumed a year ago. We assume that fees and maintenance loans rise with earnings over the long term.

Under this scenario the addition to net debt peaks at almost 10 per cent of GDP in the mid-2030s, up from our estimate last year of 6.7 per cent of GDP in the early 2030s. The upward revision across the projection reflects the Government's decision to lift the cap on student numbers, an increase in the expected size of the average loan, and a reduction in the proportion of the loans that is expected to be repaid.

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 forecast 2018-19 level of 1.7 per cent of GDP, then net debt would be eliminated by the late 2040s.

[SLIDE] Thanks primarily to ageing, under our central scenario the primary balance moves back into deficit and - after dipping to a trough of 53 per cent of GDP in the mid-2030s - net debt reaches 84 per cent of GDP (£1.4 trillion in today's terms) in 2063-64 and is still rising.

[SLIDE] So what has changed since last year's report? As you can see the primary budget deficit and net debt are both expected to be slightly smaller in the early 2060s than we thought last year.

[SLIDE] In the absence of any policy measures, things would have got worse, for two main reasons. First, the new population projections are less favourable – a smaller working population relative to the young and old. And second, the structural budget balance at the end of the medium term forecast would be slightly worse - in part because we expect to get less tax revenue per pound of economic activity than we did a year ago.

[SLIDE] This underlying deterioration is more than offset by two main policy changes. First, the decision to extend cuts in public services spending for an additional year to 2018-19, which is then locked in through the projection. And second, the decision to link the State Pension age to life expectancy, which implies that it would rise gradually to 70 within our projection horizon, rather than to 68 as currently legislated for. As you can see, both measures have a similar impact on the primary budget balance at the end of the horizon, but the spending cuts do more to reduce net debt because they apply from 2019 onwards rather than taking effect gradually as the State Pension age is increased.

[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 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.

The outlook would also be slightly worse if the Government chose to keep health and education spending broadly constant as a share of GDP through to 2018-19 – broadly in line with demographics – rather than cutting them in line with other public services spending beyond the current spending review - even if it made up the cuts in other departments. This is because the share of public spending subject to demographic pressures beyond the medium term, notably health, would be bigger.

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. But the impact may be less beneficial over a longer time horizon as more inward migrants retire.

[SLIDE] Our central projection assumes, as it did last year, that net inward migration moves in line with the ONS's low migration population variant, reflecting the international environment and government efforts to reduce inflows. The latest projections show that this corresponds to net inward migration of 105,000 a year, down from 140,000 in the previous projections. This weakens the fiscal position, although we cannot isolate the quantitative impact of this from the other changes in the population projections.

The latest population projections also suggest that a given flow of net inward migration will be less positive to the public finances than we assumed a year ago, because the ONS in effect projects that inward migrants will spend a smaller proportion of their working lives in the UK than it did previously.

In the report we show the impact of a number of alternative assumptions for migration flows. For example, if the government succeeded in reducing net inward migration to the 'high tens of

thousands' – 90,000, for the sake of argument – and kept it there then we estimate that this would increase the budget deficit by an extra 0.2 per cent of GDP at the end of the projection. Conversely, if net inward migration remained around 225,000 a year then the budget deficit would be about 1.2 per cent of GDP smaller than in the central projection. Needless to say the government could offset these effects if it wished to with changes to taxes and public spending.

There are of course lots of other factors to take into account in deciding migration policy. We are making no recommendations here – we are simply assessing the narrow fiscal impact of different scenarios.

So back to the big picture. 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 – and we look at a number of alternative definitions in the report. One of them is to ask what governments would need to do to ensure that debt was back at its pre-crisis level of 40 per cent of GDP at the end of our 50-year horizon. Under our central projection, you would need a permanent tax increase or spending cut of 0.9 per cent of GDP (£15 billion in today's terms) starting in 2019-20 to hit the 40 per cent target. This rises to 3.5 per cent of GDP if health spending was raised by 3.4 per cent a year in real terms to compensate for slower productivity growth.

[SLIDE] This chart shows the path for net debt that would result. The 0.9 per cent of GDP tightening would be sufficient to achieve a 40 per cent ratio in 2063-64, but would not be sufficient to stop it rising thereafter. That would require a tightening of 1.7 per cent of GDP.

[SLIDE] One way to achieve this would be to announce an additional tightening of a little over 0.3 per cent of GDP each decade, starting in 2019-20. This would be sufficient to stabilise debt at around 40 per cent of GDP over the longer term, although it would not drop significantly below that level beforehand.

[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.

The position looks slightly better than it did last year. The population projections and the medium term forecast are less favourable, but this is slightly more than offset by the decisions to announce an additional year of spending cuts and to link the State Pension age to life expectancy.

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

Before we take questions, let me just alert you to some other material we are putting out today, but which I haven't covered:

Within the FSR, we have some discussion of future prospects for transport taxes, the treatment of student loans and labour market developments. And in addition to the FSR, we have some relatively technical papers on methods of estimating the output gap and projecting house prices, which are of relevance to our economic forecasts. Please enjoy these at your leisure.

Now we would be happy to take your questions.