***Fiscal sustainability report* and *Welfare trends report* 2015**

Good morning everyone.

My name is Robert Chote, Chairman of the OBR. And I would like to welcome you to the launch of our 2015 *Fiscal sustainability report* and *Welfare trends report*. We have produced these reports earlier in the year than we normally would – and in a slimmed-down form – so as to clear the decks ahead of the extra July Budget and the Spending Review that is expected to follow. Our work on the Budget forecast and on the scrutiny of potential policy measures is already under way, so you will have to forgive me for dodging any questions on those topics.

[SLIDE] The reports may be slimmer than usual, but they still cover a lot of territory between them and so my presentation will be slightly less comprehensive than usual. I will start by talking through the Fiscal sustainability report, focusing on our latest long-term projections, on the outlook for oil and gas receipts and on recent developments in the public sector balance sheet. I will then turn more briefly to the Welfare trends report, looking first at long term trends in welfare spending, then issues related to the medium term forecast and finally to some new work on international comparisons. As you are aware, Parliament has told us to look at trends in welfare spending and not at its impact on living standards, poverty or inequality – important though that is.

[SLIDE] So let me start with the fiscal outlook – and some preamble:

- The first point to make is the uncertainties surrounding the outlook for the public finances over a 50-year horizon are considerable and these are broad-brush projections and not precise forecasts. We are careful to show how sensitive they are to some of the judgements we have to make. But this uncertainty is no excuse for policymakers to ignore the potential long-term consequences of policy decisions that they take today.

- Second, our task is to judge whether the public finances are sustainable under current tax and spending policies. For the purposes of this report that means the policies set out by the Coalition in its final Budget – and not those set out by the

Conservatives in their election manifesto. But in many cases policies are not well defined for the very long-term in any event, and so we have to judge what a sensible definition would be.

- Third, and consistent with this, we assume that spending and revenues evolve in line with the medium-term forecasts that we made at the time of the March Budget over the first five years.

- 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.

The key message here is that these projections should be seen as a baseline against which the new Government can judge the potential impact of the measures that it announces in July and subsequently.

So let's turn to the details. [SLIDE] In assessing the fiscal outlook over a 50-year horizon, demographic trends are centre stage. Our analysis is based on population projections prepared every two years by the Office for National Statistics. This year – like last year – we use the ONS's latest 2012-based projections. However, as in our medium term forecast in March, we now use the ONS's principal population projections rather than its low migration variant. This change implies that net inward migration would fall towards a long-run rate of 165,000 a year rather than 105,000. With net inward migration now more than three times the Government's desired level, in the 'tens of thousands', this seemed a more realistic medium and long-term assumption. It does not mean that we see this level of migration as either desirable or undesirable. That is not a judgement for us to make.

The big demographic picture remains the same as last year: 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 projection shows the proportion of the population aged 65 and over rising from 12 per cent in 1961 to 18 per cent this year and to more than 26 per cent in 2065.

[SLIDE] The change in the migration assumption means that the population ages slightly less quickly than it did in last year's FSR. This is because inward migrants are more likely to be of working age than the native population. This chart shows that the move from the low migration to the principal projection increases the working age population by an extra 6.5 per cent by 2065, but increases the population 65 and over by a smaller 3.4 per cent.

[SLIDE] So why does an ageing population matter for the public finances? This chart shows how tax payments and the consumption of public spending vary 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 their middle years they pay more tax, but consume less health care and education. And in their 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 increasing pressure as more of the population clusters towards the right hand side of this chart.

[SLIDE] This chart shows the big fiscal 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 part. 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 1.9 per cent of GDP by 2064-65.

[SLIDE] On the spending side, non-interest spending rises by 4.2 per cent of GDP or £79 billion in today's money between the end of the medium-term forecast and 2064-65. 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 schemes.

We project that spending on the state pension will rise by 2.2 per cent of GDP over this period, in part because of the triple lock that sees it uprated by the highest of earnings growth, CPI inflation and 2.5 per cent each year. Based on recent outturns, we assume that the triple lock will

be more expensive than it looked last year. Thanks in part to the last government's decision to link the State Pension age to life expectancy, the rise in spending would be only 0.9 per cent of GDP if state pensions were indexed to earnings.

[SLIDE] This chart from the European Commission shows that age-related spending is expected to increase in most EU countries between 2020 and 2060 – and that the increase in the UK is slightly larger than average. The Commission projects a smaller increase than we do for the UK, because: they assume that the state pension will rise in line with wages rather than the triple lock; they do not incorporate the recent Dilnot reforms to long-term care funding and; they assume that healthy life expectancy will rise more quickly than overall life expectancy.

[SLIDE] As we saw in the chart a second ago, and in contrast to spending, receipts are broadly flat as a share of GDP over the projection horizon. The ageing population pushes them up a little because the retired continue to pay tax while contributing relatively little to measured GDP.

I will have a little more to say about the outlook for oil and gas receipts in a minute.

[SLIDE] So, to return to the big picture, the paths of non-interest 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 – by about 1.9 per cent of GDP in 2064-65. In effect, demographic factors gradually unwind about two-fifths of the fiscal tightening that got under away after the financial crisis.

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 to exceed new loans. The peak addition to net debt is 8.8 per cent of GDP in the late 2030s, falling to 8 per cent of GDP by the mid-2060s.

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 2019-20 level of 2.1 per cent of GDP, then net debt would be eliminated by the early 2050s.

[SLIDE] Under our central scenario the primary balance moves back into deficit and – after dipping to a trough of 54 per cent of GDP in the early 2030s – net debt climbs to 87 per cent of GDP in 2064-65 (£1.6 trillion in today's terms) and is still rising.

[SLIDE] So what has changed since last year's report? As you can see here, the primary budget deficit and net debt are both projected to be slightly larger in the early 2060s than we thought last year. A good portion of the deterioration reflects the fact that receipts are weaker and departmental spending on public services, administration and capital spending is higher at the end of the medium term forecast than it was a year ago. This is because lower debt interest costs have loosened the squeeze on departments within the overall spending envelope and because last December the Chancellor in effect asked us to assume a rise in departmental spending as a share of GDP in 2019-20.This weakens the primary balance and this is pushed through the long-term projections.

Alongside some other changes, this would have pushed net debt around 20 per cent of GDP higher in 2064-65 than last year. But most of the impact is offset by our decision to assume higher net inward migration. This slows the ageing of the population and increases revenues more than spending, thereby improving the primary balance and lowering the path of net debt – at least over the next 50 years.

The assumption that higher net inward migration improves the fiscal position is common to many studies, including those carried out for the US by the Congressional Budget Office. But this does not mean that policymakers have to accept higher levels of immigration to achieve (or to avoid) particular outcomes for the public finances. They may have other reasons to frame their immigration policies and they could choose to offset their direct fiscal impact through tax and spending measures.

[SLIDE] As I said at the outset, there are significant uncertainties around all our projections. 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 2019-20 – thereby letting them rise in line with short-term ageing pressures – rather than cutting them in line with other public services spending – as we assume in our central projection. This is because the share of public spending subject to demographic pressures beyond the medium term, notably health, would be bigger.

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. Assume for the sake of argument that we mean returning net debt to 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 an additional permanent tax increase or spending cut of 1.1 percent of GDP (£20 billion in today's terms) starting in 2020-21 to do this – on top of the current consolidation. This rises to 3.3 per cent of GDP if health spending was to be raised by 3.3 per cent a year in real terms to compensate for slower productivity growth. The necessary adjustment is slightly bigger than last year, reflecting the slight deterioration in the debt profile.

[SLIDE] This chart shows the path for net debt that would result. The 1.1 per cent of GDP tightening would be sufficient to achieve a 40 per cent of GDP ratio in 2064-65, but would not be sufficient to stop it rising thereafter. That would require a tightening of 1.9 per cent of GDP.

[SLIDE] One way to achieve this would be to implement an additional tightening of 0.4 per cent of GDP each decade, starting in 2020-21. This would stabilise debt at around 40 per cent of GDP over the longer term, although it would not drop significantly below that level beforehand.

When making long-term projections for receipts, we focus on the relatively modest impact of the ageing population. But this year's FSR also contains a more detailed look at prospects for oil and gas revenues, which are of particular interest because of recent moves in oil prices.

Let me briefly summarise that work.

[SLIDE] As you can see from this chart, oil and gas receipts are highly volatile from year to year – about nine times as volatile as income tax receipts. Consequently they are very difficult to forecast. Our medium-term forecasts to date have tended to be over-optimistic, initially reflecting an over-optimistic view of production and more recently the sharp decline in the oil price from $110 a barrel to around $60.

Our current medium term forecast is for oil receipts to total £3.4 billion over the next five years, down from £16.7 billion a year ago. This reflects the direct effects of lower prices, the consequent scaling back of production and the cost of tax measures to help the industry, partly offset by lower tax-deductible spending on investment and exploration.

[SLIDE] Looking over the subsequent two decades, 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 2000. Oil prices are assumed to rise with whole economy inflation.

On these assumptions, we project that oil and gas receipts will total just £2.1 billion between 2020-21 and 2040-41, down from £36.6 billion billion last year. We expect receipts to be negative in a number of years as companies receive repayments of past tax to reflect current losses.

[SLIDE] As you can see from this chart, negative tax receipts are consistent with companies wishing to stay in the industry as both pre- and post- tax profits are expected to remain positive, especially if you exclude what are now unavoidable decommissioning costs.

Bolting the long-term projections onto our latest medium term forecast, we have reduced our estimate of receipts between 2014-15 and 2040-41 from £57 billion to £8 billion.

[SLIDE] The decline is even more dramatic when you compare our latest revenue projections to those we made in our first FSR in 2011. For the period between 2020-21 and 2040-41 this has fallen from £132 billion to £2 billion. [SLIDE] As you can see here, lower prices are the biggest factor, with lower production, changes in tax-deductible expenditure and cost of tax cuts all contributing too.

It is important to emphasise that while we can be confident that North Sea receipts are on a downward path from recent highs, the pace of that decline is highly uncertain. In the report we show how sensitive our central projection is to alternative price and production scenarios.

[SLIDE] Now let me turn from flows of tax receipts and spending to some brief observations on the public sector's balance sheet.

The most familiar summary measure of the balance sheet is public sector net debt, the difference between its liabilities and liquid financial assets – and we discuss recent movements in this and other national accounts measures in report. But we also draw on information from the Whole of Government Accounts, which are prepared under commercial accounting rules and have broader coverage than net debt. In this FSR we are looking at the 2013-14 WGA, the fifth to be published.

Let me just pick up on two issues.

[SLIDE] First, it is striking from both approaches that the direct impact of the financial crisis on the public sector balance sheet is diminishing.

This shows up in three ways:

- First, the gap between the measures of net debt that include and exclude the public sector banks has narrowed from £1.5 trillion at its peak to 'just' £0.3 trillion today. This reflects the shrinking of the banks' balance sheets and the reclassification of Lloyds as a private sector bank as the Government has reduced its stake.

- Second, the stock of contingent liabilities directly related to the crisis – that is say potential liabilities for which the probability of them crystallizing is non-trivial but less than 50 per cent – has fallen from £9.9 billion in 2012-13 to £0.3 billion in 2013-14. This

follows the removal of the contingent capital facility offered to RBS. At their peak, interventions like the Special Liquidity Scheme and Credit Guarantee Scheme represented contingent liabilities that ran into hundreds of billions, though the risks of having to pay out in support of some of them was deemed remote.

- Third, the Government announced in the Budget that it would sell £20 billion of crisis-related assets during the current fiscal year – notably mortgage assets held by NRAM and much of its remaining stake in Lloyds. This will help reduce measured net debt this year, but it does not do much to strengthen the balance sheet in an underlying sense as it simply swaps one asset for another.

[SLIDE] The second issue that I want to highlight from the balance sheet is the information it provides on future spending pressures. The WGA balance sheet includes provisions, which are an estimate of potential future liabilities where the probability of them crystallizing is greater than 50 per cent but where there is still uncertainty about their likelihood, size and timing. The latest WGA show provisions rising from £131 billion in 2012-13 to £142 billion in 2013-14. The two biggest items are nuclear decommissioning costs and pay-outs for clinical negligence:

- The provision for nuclear decommissioning has risen by £7½ billion since last year to more than £77 billion. This is mostly down to Sellafield, where the clean-up is expected to be longer and more expensive than previously thought. The bill is expected to increase further as the Nuclear Decommissioning Authority completes its scrutiny of the decommissioning plan.

- The provision for clinical negligence payments has increased by £2.9 billion to £26.6 billion. The WGA report an unprecedented number of new claims, coming in at more than a thousand a month for much of the year. This surge coincided with new legislation on the funding of civil litigation, which is expected to reduce claimants' lawyers' fees. Legal costs absorb about a third of the money paid out.

[SLIDE] Looking at provisions in aggregate, it is striking that successive vintages of the WGA have judged that the amount of provisions that are expected to be spent in the coming year has been relatively stable at

around £10 to £15 billion. But the amount that is expected to be spent from provisions over the coming five years and beyond has risen quite steadily and significantly. Once again, nuclear decommissioning and clinical negligence are the main contributors – underlining the pressure that they are likely to exert on future departmental spending plans.

[SLIDE] So now let me turn from the Fiscal sustainability report to the Welfare trends report, which we introduced last year following the Government's announcement of its welfare cap. We focus on trends in social security and tax credit payments, in other words cash transfers rather than benefits in kind such as health care and education. But we cast the net a little wider when we talk about international comparisons.

Spending on benefits and tax credits totalled just under £215 billion or 12 per cent of national income in 2014-15. This was very close to the figure that we forecast a year ago. The welfare cap covers almost £120 billion of that spending, as it excludes the state pension and those benefits that move most closely with the ups and downs of the economic cycle.

[SLIDE] Looking back over the last 30 years you can see that welfare spending has been rising in cash terms, real terms and in terms of real spending per capita. Under our March budget forecast, which does not include the as yet unidentified £12 billion in welfare cuts promised in the Conservative manifesto, spending continues to rise in cash terms, stabilises in real terms and falls in real terms per capita.

[SLIDE] Viewed as a share of national income, there has been no obvious trend upward or downward in welfare spending over the past 30 years, although this ratio fluctuates with the ups and downs of the economic cycle. Over the medium term we expect welfare spending to return to roughly the level it had maintained in the decade prior to the financial crisis. If the Government announces additional welfare cuts in the Budget or the Spending Review, then this decline would steepen.

[SLIDE] Looking at the medium term forecast in more detail, spending is expected to rise by about 10 per cent in cash terms over the next five years, significantly less than the 22½ per cent rise in nominal GDP that we expect over the same period. This would be sufficient to reduce welfare spending by 1.3 per cent of GDP.

We have revised our forecasts for welfare spending down since last year, despite taking a more pessimistic view of the savings that are likely to arise in the near term from reforms of incapacity and disability benefits.

This has been offset by a number of factors, including the unexpectedly rapid fall in claimant count unemployment, which reduces the cost of jobseeker's allowance and associated payments of housing benefit. The prospective cost of housing benefit has also been reduced by a downward revision in expected growth in the number of households.

Most important, the fall in the oil price has led us to reduce our forecasts for CPI inflation. This means that most benefits are uprated by less than we had assumed last year. By the end of the forecast, we have revised down our estimate of welfare spending by a total of £7 billion since last year to just over £229 billion.

[SLIDE] So where is the 1.3 per cent of GDP fall in welfare spending that we forecast over the next five years coming from?

Spending inside the welfare cap is forecast to fall by 0.9 per cent of GDP. The biggest contributors are tax credits – thanks to a cap on uprating and measures to tackle debt, error and fraud – and disability benefits – thanks to tighter eligibility rules as people move from Disability Living Allowance to the Personal Independence Payment. Savings across most welfare cap benefits reflect average awards rising less quickly than earnings and GDP, rather than expected falls in caseloads.

Spending outside the welfare cap is expected to fall by 0.4 per cent of GDP. Half of this comes from state pensions, as the increase in the state pension age offsets the ageing of the population. Spending on the unemployed falls as the claimant count drops a little further and as average awards rise less quickly than earnings.

[SLIDE] Based on these forecasts, we predicted in March that spending would come in below the welfare cap from 2016-17 onwards, by about £1 to £3 billion each year. Spending is forecast to exceed the cap this year, but within the 2 per cent margin for forecasting changes.

[SLIDE] Risks to the cap include trends in housing tenure and rents, further disappointments in the reform of incapacity and disability benefits and the possibility of higher inflation. To date good news on inflation has created space to pay for bad news on reform delivery.

Looking ahead, the Conservatives have promised further savings from the welfare budget. We will presumably learn in the Budget if that will be reflected in the level of the cap. But is important to remember that, even with the best will in the world, policy measures do not necessarily raise or cost the amount expected once they are implemented.

[SLIDE] In the report we look back at a number of policy measures announced by the last Government and compare the latest estimates of their cost and yield to those made by the Government at the time and which we endorsed as central and reasonable.

Unexpected movements in inflation and earnings mean that the triple lock has been much more expensive than expected, while the switch from RPI and ROSSI uprating of most benefits and tax credits to CPI has saved less than expected. The withdrawal of child benefit from high earners is expected to save less than originally estimated, because fewer families than forecast are likely to be affected by it. Meanwhile, delivery problems and lower initial levels of fraud and error than anticipated have reduced the savings from operational changes to tax credits.

[SLIDE] Let me conclude with a brief summary of a special chapter in the report on international comparisons of welfare spending. For reasons of data comparability, we are looking here at spending on social protection – as defined by the OECD and the European Commission – which includes benefits in kind as well as cash transfer payments. In the chapter we compare spending in the UK – which is mostly financed by direct taxation – with spending in 'Bismarckian' continental European countries – who make more use of social contributions than we do – and Nordic countries, who use direct taxation, but spend more than we do.

[SLIDE] The first and most obvious comparison is of total public spending on social protection, where the UK is in the middle of the pack and very close to the OECD average. [SLIDE] But the picture looks somewhat different when we also take into account private spending on social protection. The UK ranks higher here because of our extensive private

provision of pension benefits, while the US looks higher because of private spending on both pensions and healthcare. France ranks highest in the OECD for both public spending and total spending. This chart also shows that the Nordic countries recoup more social protection spending by taxing it or the consumption that it finances.

[SLIDE] Looking at different categories of spending, we note four features of the UK system in international context:

- First, the UK is notable for its reliance on private pension provision. But once this is taken into account our total spending – including on public sector pensions - is not out of line with other countries that have similar demographic characteristics.

- Second, our spending on help for the sick and disabled is near the OECD average, but the UK is notable for providing most of it through direct cash payments rather than benefits in kind.

- Third, we appear to spend much less that the OECD average on the unemployed, but that may be because we are unusual in having a separate housing benefit to subsidise rental costs rather than reflecting those costs in unemployment benefits.

- Finally, the UK spends more than any other OECD country on family support. This reflects the last Labour government's use of tax credits to target child poverty under Tony Blair and Gordon Brown, and more recently the decision to uprate child tax credits often by more than inflation during a period in which earnings growth and nominal GDP growth have been unusually weak following the financial crisis.

Let me conclude with a brief comment on the Chancellor's announcements on fiscal rules and asset sales in yesterday's Mansion House speech.

First, on fiscal rules, the Chancellor said that – and I quote: "in normal times, governments should run a budget surplus to bear down on debt and prepare for an uncertain future". Once this has been turned into a concrete rule, we would then have to check that the government is on course to meet it, as we do with the current fiscal rules.

It is not our place to comment on whether this objective is a good idea or not. It is certainly a more ambitious goal than governments have in practice achieved over recent decades. The public sector has run a budget surplus in only five of the last forty years - and in at least three of those years that was only because economic activity was running above its sustainable level (at least with the benefit of hindsight).

In turning the objective into a concrete rule, much of course depends on how you define 'normal times'. Judging from some of the coverage of the speech, I think there is some confusion about whose job that will be. The Chancellor was clear in his Royal Economic Society speech earlier this year that the Government would define what it means by normal times – probably with reference to the amount of spare capacity in the economy and/or the pace of economic growth – and we can then see if the economic conditions at any given time and our forecasts for the future are consistent with that definition.

That is the right allocation of responsibility – it should not be for us to decide under what circumstances it is appropriate to run a deficit. That is for the elected government to do and we can then hold them to account for their performance against that objective.

It should be said that defining normal times is not straightforward, especially following the size and sort of recession that we have just been through. No-one can know with confidence how much spare capacity there is in the economy or what the sustainable growth rate of the economy will be looking forward. Any rule needs to be defined in the knowledge that our estimates of these things may change over time. Second, on the announced plans to sell bank shares, it is perhaps worth reminding you how this affects the public finance numbers. Shares owned by the government are treated as illiquid assets and so when the sale proceeds come in this reduces the headline measure of public sector net debt – either because the government has a new liquid asset in the form of cash or because it uses the proceeds to reduce gilt issuance. But the government will also be foregoing the future flow of dividends that would have come from owning those shares which means higher deficits in the future. Put simply, if the government sells a financial asset for roughly what it is worth the health of the overall balance sheet is little affected.

In the Economic and fiscal outlooks that we publish alongside each Budget and Autumn Statement, we estimate the aggregate profit or loss to the taxpayer from the financial interventions if all assets were sold and loan payments made at prevailing market prices. In March we said that on this basis the Government would realise a cash surplus of £9 billion, a figure that the Treasury and Rothschilds yesterday updated to £14 billion.

But we also noted in March that these figures exclude the cost to the Treasury of borrowing the money to finance these interventions. We noted in March that that additional debt interest costs to date – net of interest and dividend receipts on the assets – were around £17 billion. This figure, of course, rises year by year until all the interventions have been unwound.

[SLIDE] Well thank you for listening that that rather diverse range of topics. We would be happy now to take your questions.