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Fiscal sustainability report

Robert Chote
Chairman

12 July 2012

Preamble

- OBR set up in 2010 to provide independent and authoritative analysis of the UK public finances
- BRC responsible for the conclusions, drawing on full-time OBR staff, government departments and advisory panel
- Chancellor saw draft conclusions on 28 June and final report 24 hours prior to release
- No pressure to change conclusions from ministers or others

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Our approach in the 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 possible tightening

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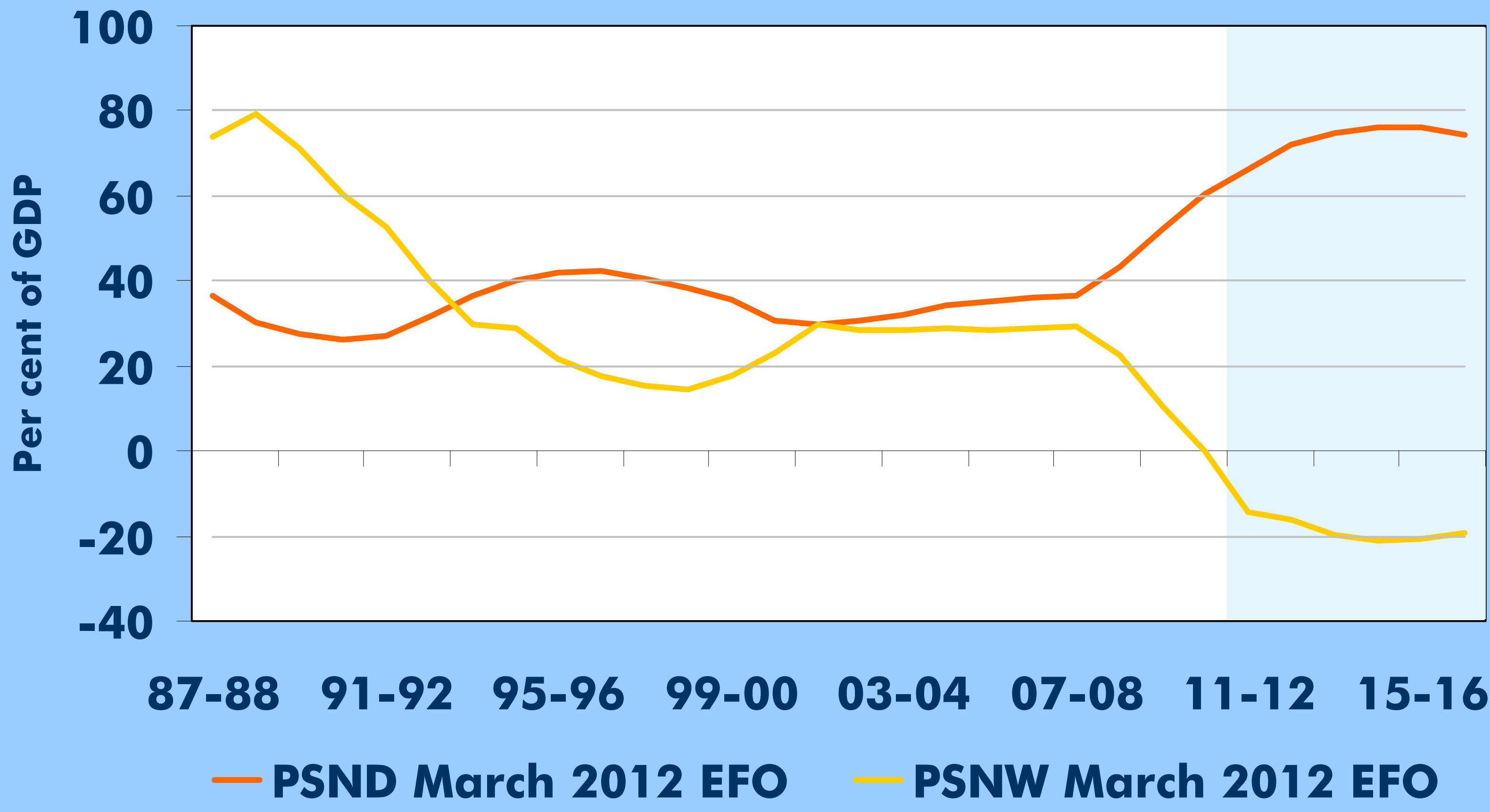
Some important things to remember

- 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

Public sector net debt and net worth



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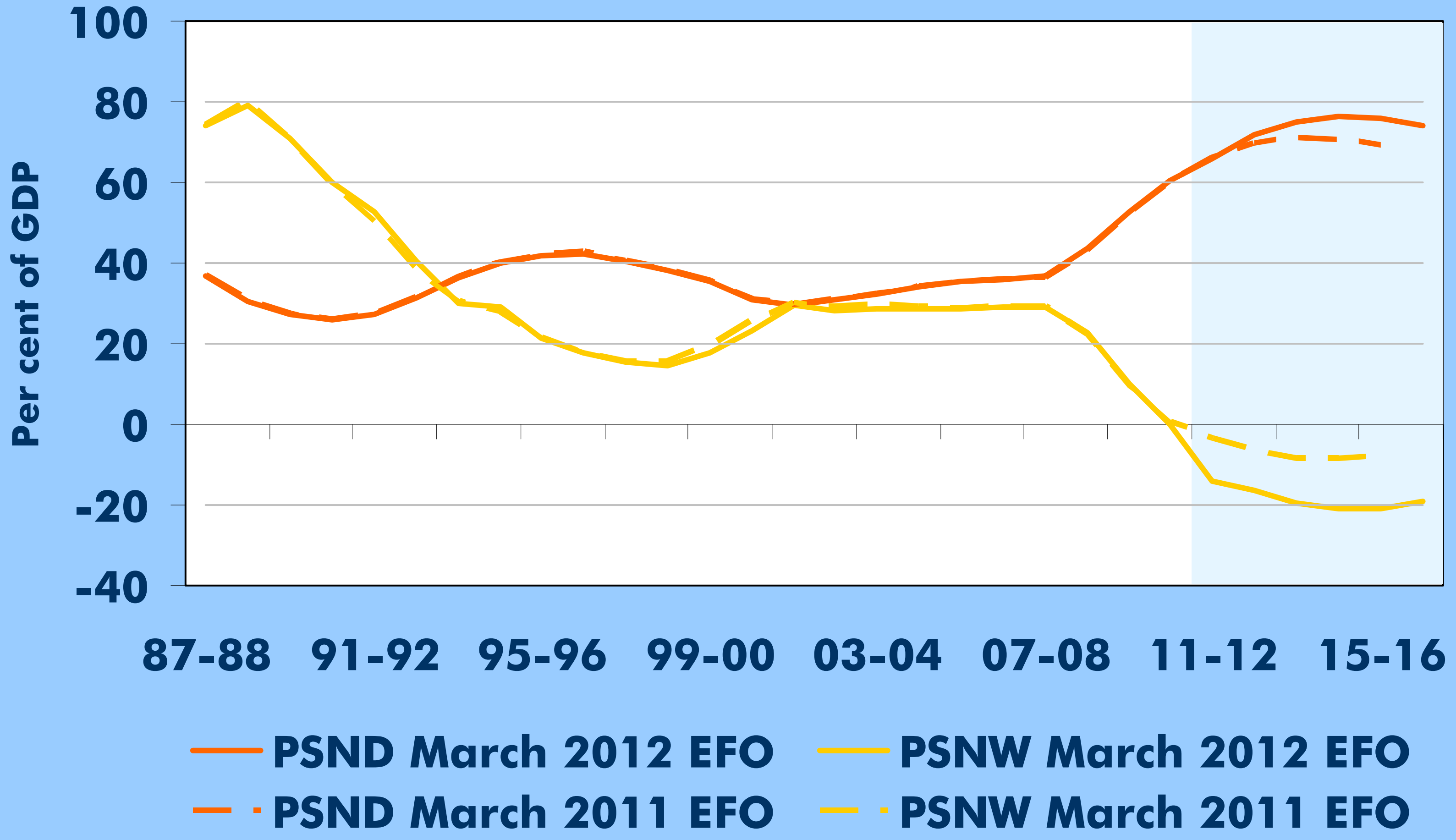

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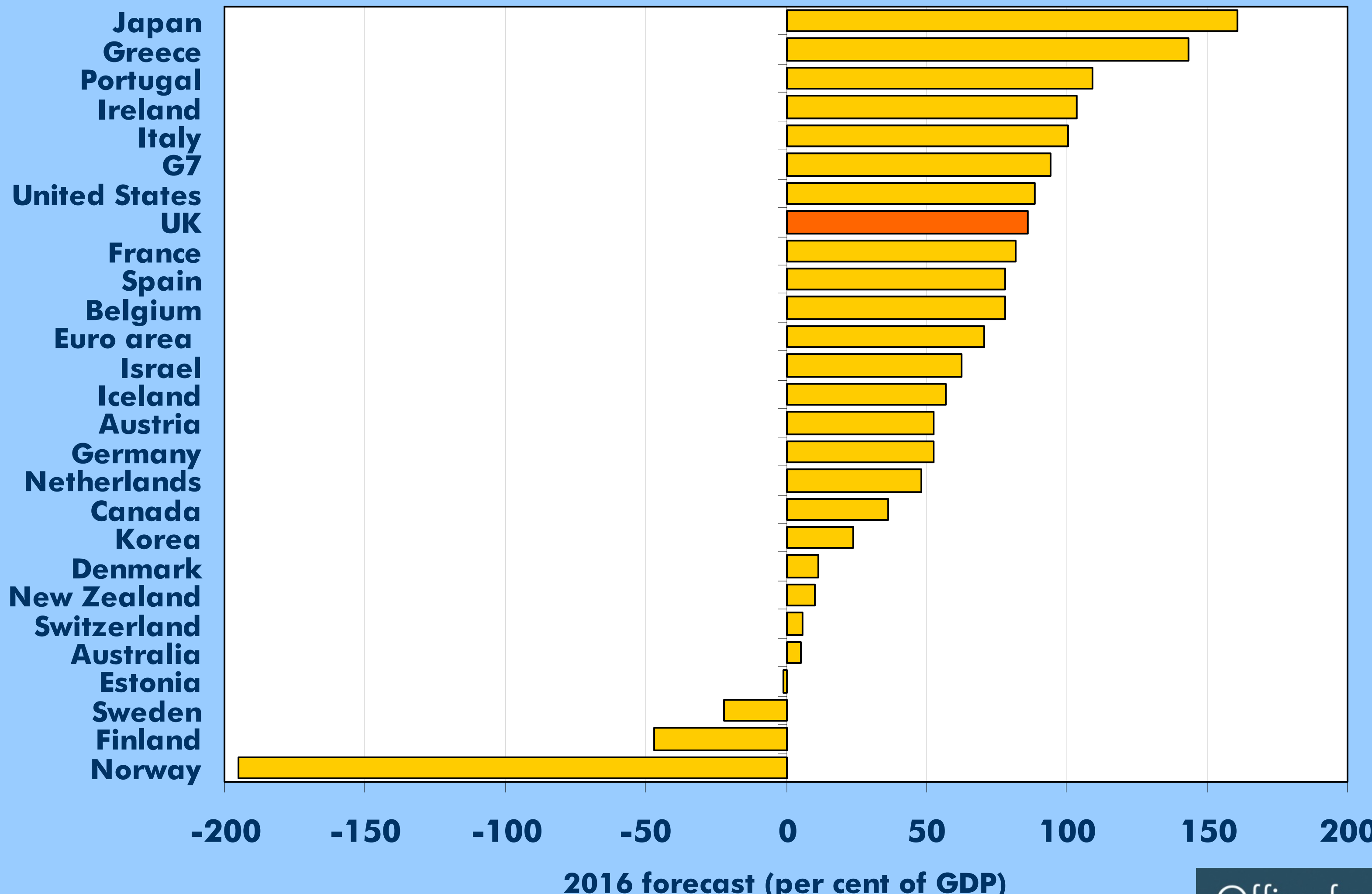
General government net debt (IMF)



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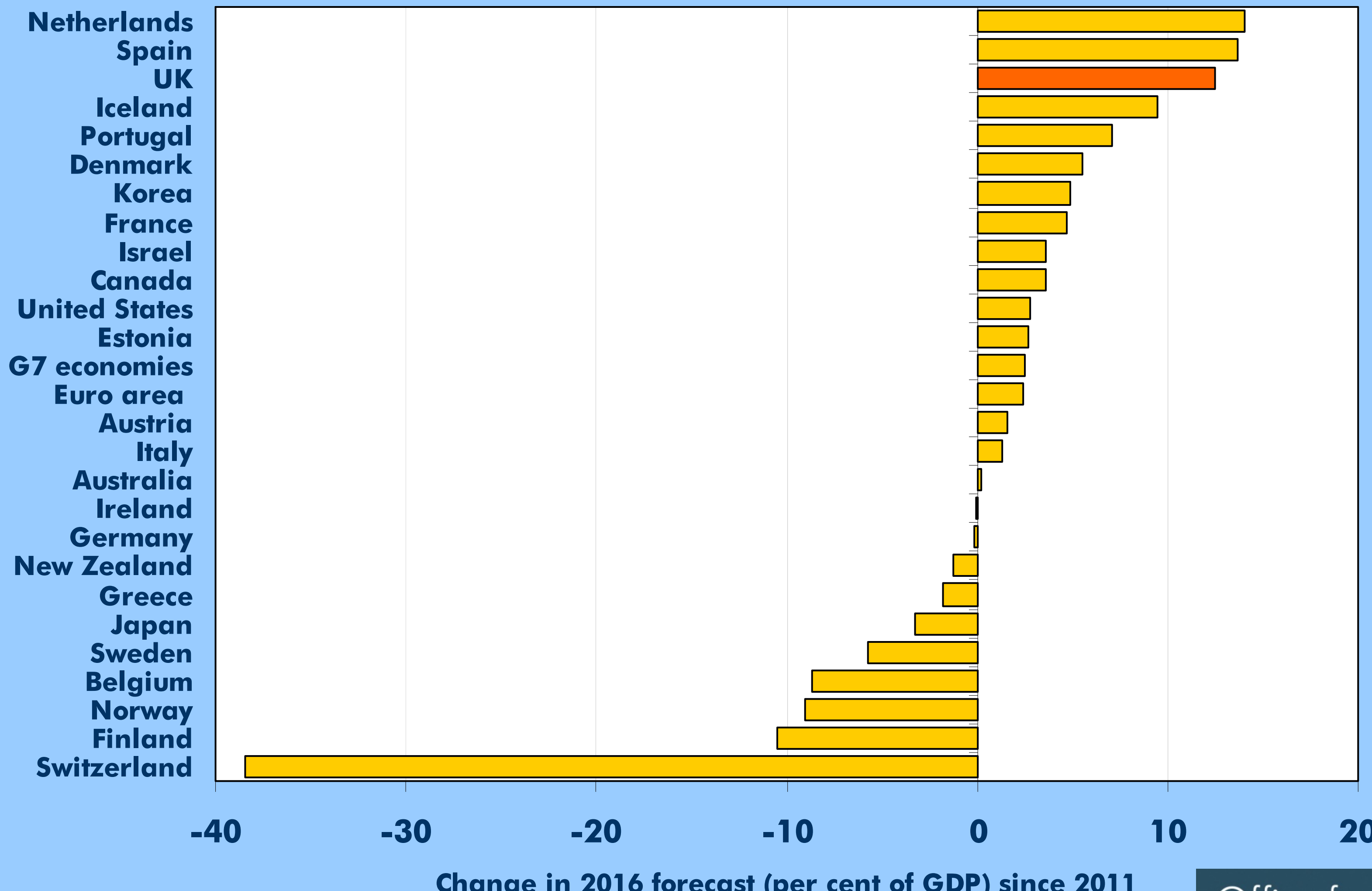
General government net debt (IMF)



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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
- For financial year 2010-11
- Published for second year
  - Broader boundary than last year
  - Bank of England and L&C Railways included
  - But 2009-10 accounts restated for comparison

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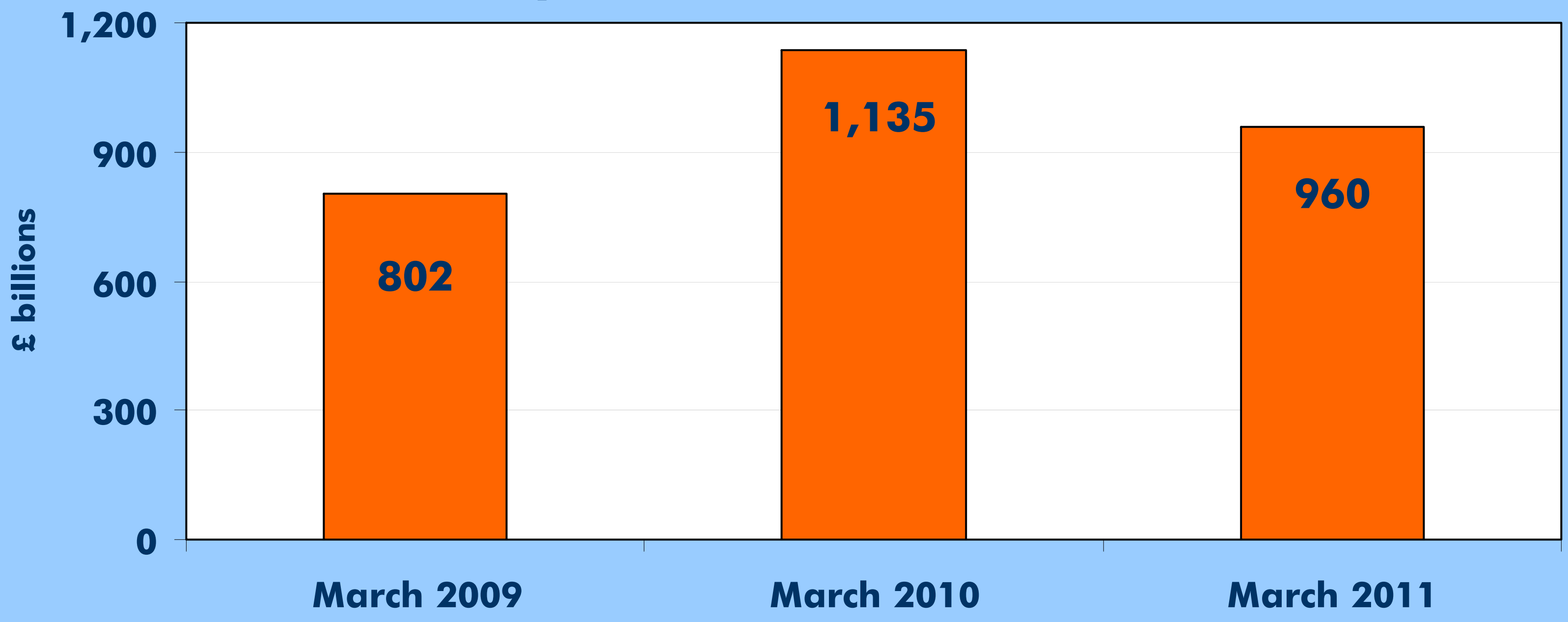
Public service pension liabilities in WGA



- Public service pension liabilities fell by £175bn in 2010-11

- Increase in real (RPI) discount rate cut liability by £69bn while move from RPI to CPI uprating of payments (and use of real (CPI) discount rate) cut liability by a further £126bn

- Very small fall in real discount rate in next year's WGA will increase liabilities by a few billion

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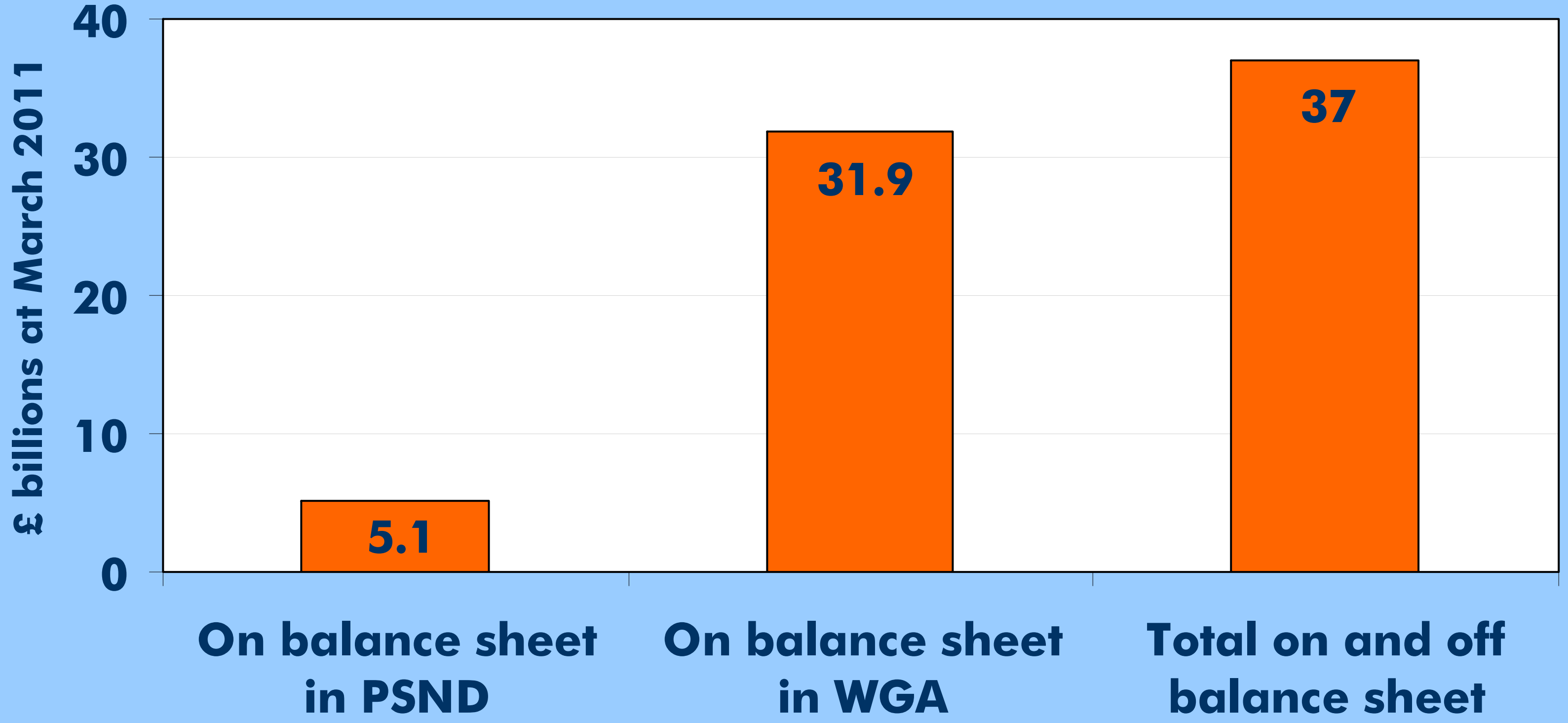
Private finance initiative capital liabilities



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

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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 £102.2bn (7% of GDP) in 2009-10

- During the following year £24bn were added, £12bn used (less than the £15bn expected) and £6bn removed

- So provisions rose £6bn on the year to £108.1bn (7% of GDP)
  - Nuclear decommissioning up £4bn
  - Clinical negligence up £2bn

- £12bn expected to be used in 2011-12

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Contingent liabilities

- Contingent liabilities capture costs that the public sector may incur in the future, but where the probability is less than 50%
- The 2009-10 estimate has been restated to remove HMT's £165bn guarantee for the Bank of England's Special Liquidity Scheme, now the Bank is within WGA. (SLS has closed anyway.)
- The restated liabilities have risen from £41.4bn to £49.7bn
- Half the increase comes from a rise in legal challenges to HMRC
- Various increases in contingent liabilities in the pipeline:
  - £15bn new potential losses on oil field decommissioning
  - £5bn more legal challenges to HMRC
  - £20bn in potential losses on credit easing
  - New announcements on government guarantees?

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Looking at stocks and flows

- WGA is a welcome contribution to transparency
- Provisions and contingent liabilities are useful risk indicators
- But balance sheets of limited value in judging sustainability
- PSND, PSNW and WGA might suggest government is bust
- But they omit future flows from future government activity:
  - Future spending on public services and transfers
  - Future tax revenues
- When in doubt, go with the flows

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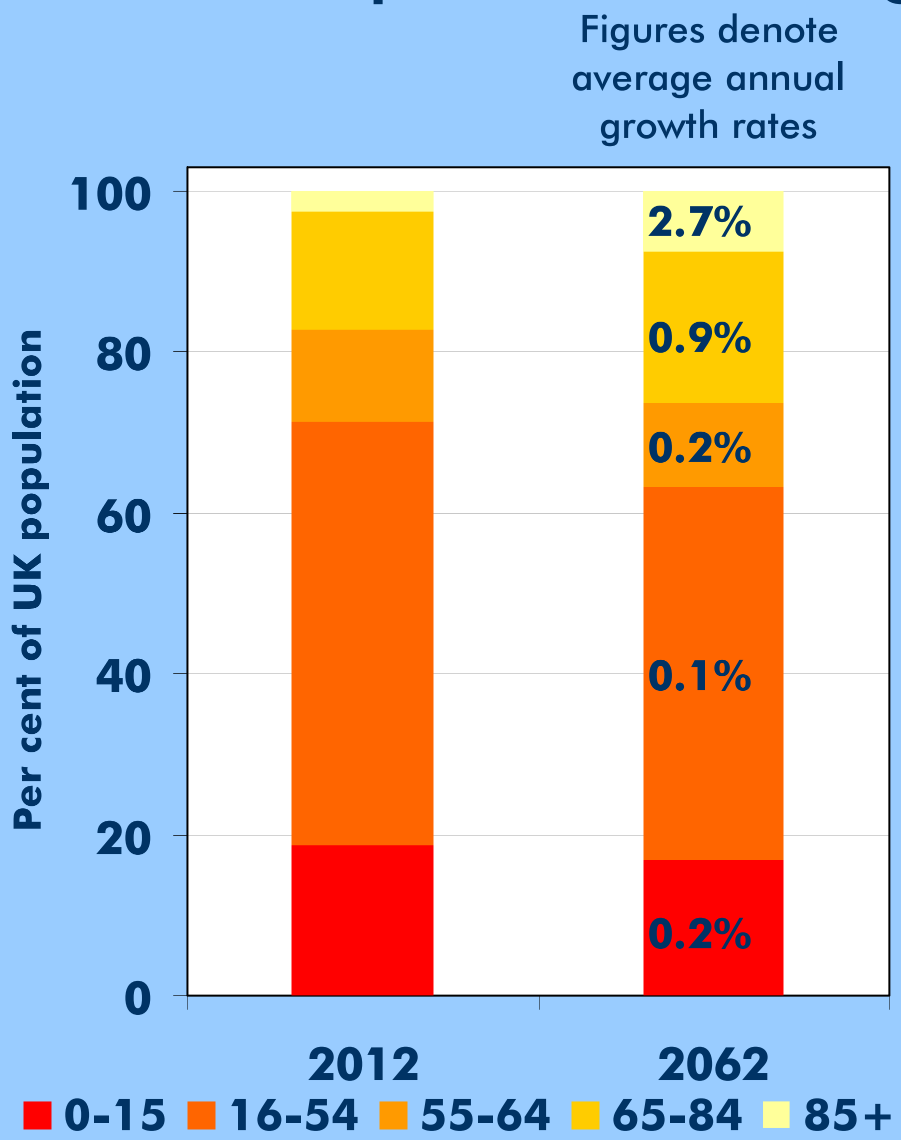
Assumptions: demography



- New ONS projections this year
  - More inward migration
  - Life expectancy lower for elderly and higher for future newborns
  - Leads to bigger population
- 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 2011 to 26% in 2061
  - Net inward migration averages roughly half recent levels

Assumptions: economy

- Whole economy productivity growth averages 2.2% a year, in line with long-run historical experience
- Also show sensitivity to 1.7% and 2.7% productivity growth
- CPI inflation at 2%, consistent with Bank of England target
- GDP deflator rises 2.5% a year
- Long term nominal GDP growth rate unchanged on last year

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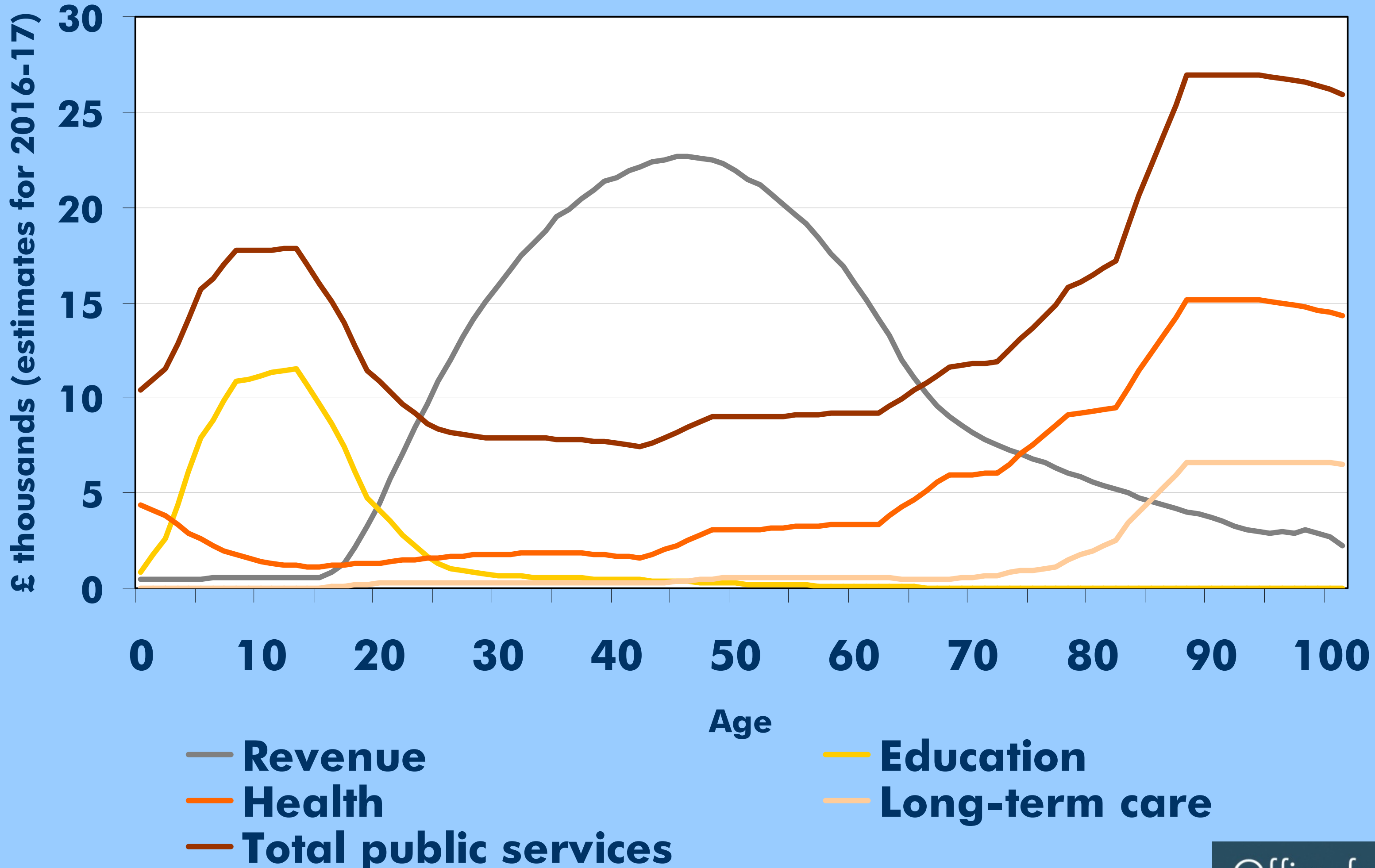
Assumptions: ‘unchanged policy’

- Income tax / NICs allowances rise by earnings post 2016-17
  - Price up-rating would increase receipts 2.6% of GDP by 2031-32
- Most working age benefits rise by earnings post 2016-17
  - Price up-rating would cut costs by 1.6% of GDP by 2031-32
- Basic state pension subject to ‘triple guarantee’
  - Rises by minimum of CPI, earnings or 2.5%
  - Assume average increase = earnings+0.26% a year
  - Costs 0.6% of GDP relative to earnings indexation in 2061-62
- Assume public services spending rises with per capita GDP, adjusted for age composition of the population

Revenues and public spending by age



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Results: non-interest spending

	Per cent of GDP							
	Estimate		FSR Projection					
	2011-12	2016-17	2021-22	2031-32	2041-42	2051-52	2060-61	2061-62
Health	8.1	6.8	7.1	7.7	8.3	8.7	9.0	9.1
Long-term care	1.3	1.1	1.2	1.5	1.7	1.9	2.0	2.0
Education	5.7	4.5	4.6	4.6	4.4	4.4	4.5	4.5
State pensions	5.7	5.6	5.3	6.1	7.0	7.3	8.2	8.3
Pensioner benefits	1.2	1.1	1.1	1.2	1.3	1.2	1.2	1.2
Public service pensions	2.1	2.2	2.0	1.7	1.5	1.3	1.3	1.3
Total age-related spending	**24.1**	**21.3**	**21.3**	**22.8**	**24.2**	**24.9**	**26.2**	**26.3**
Other social benefits	6.3	5.1	5.3	5.2	5.1	5.2	5.2	5.2
Other spending	12.2	9.2	9.2	9.2	9.2	9.3	9.3	9.3
Primary spending	**42.6**	**35.6**	**35.8**	**37.2**	**38.5**	**39.4**	**40.7**	**40.8**

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Public service pensions

- Gross payments projected to fall as share of GDP
  - 2012 FSR: 2.2% in 2016-17 to 1.3% in 2061-62
  - 2011 FSR: 2.0% in 2015-16 to 1.5% in 2060-61
- Change since last year
  - Starting point: lower GDP forecast
  - End point: workforce cuts and post-Hutton reforms
- Impact of all Coalition reforms in 2061-62
  - Move from RPI to CPI uprating saves 0.4% of GDP
  - Post-Hutton reforms save 0.1% of GDP
  - Higher contributions save 0.1% GDP on *net* cost

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Results: non-interest revenues

	Per cent of GDP							
	Estimate		FSR Projection					
	2011-12	2016-17	2021-22	2031-32	2041-42	2051-52	2060-61	2061-62
Income tax	10.0	10.6	10.6	10.6	10.7	10.7	10.8	10.9
NICs	6.7	6.9	6.8	6.7	6.8	6.7	6.7	6.7
Corporation tax	2.9	2.5	2.5	2.5	2.5	2.5	2.5	2.5
VAT	6.4	6.3	6.3	6.4	6.4	6.4	6.5	6.5
Capital taxes	1.1	1.3	1.4	1.4	1.5	1.5	1.5	1.5
Other taxes	10.2	9.8	9.8	9.9	10.0	10.0	10.1	10.1
Primary revenue	**37.3**	**37.3**	**37.5**	**37.5**	**37.9**	**37.9**	**38.1**	**38.2**

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Non-demographic influences on revenues

- Expected receipts from North Sea oil and gas halved since last year, but small per cent of GDP
- Revenues from oil and gas, transport, tobacco and green taxes could fall up to 2% of GDP by 2030s
- Extended analysis this year:
  - Corporation tax revenues could be hit if lower rates elsewhere prompt profit-shifting or if UK follows them down
  - VAT faces modest hit if falling prices for imported manufactures leads to fall in consumption share taxed at standard rate

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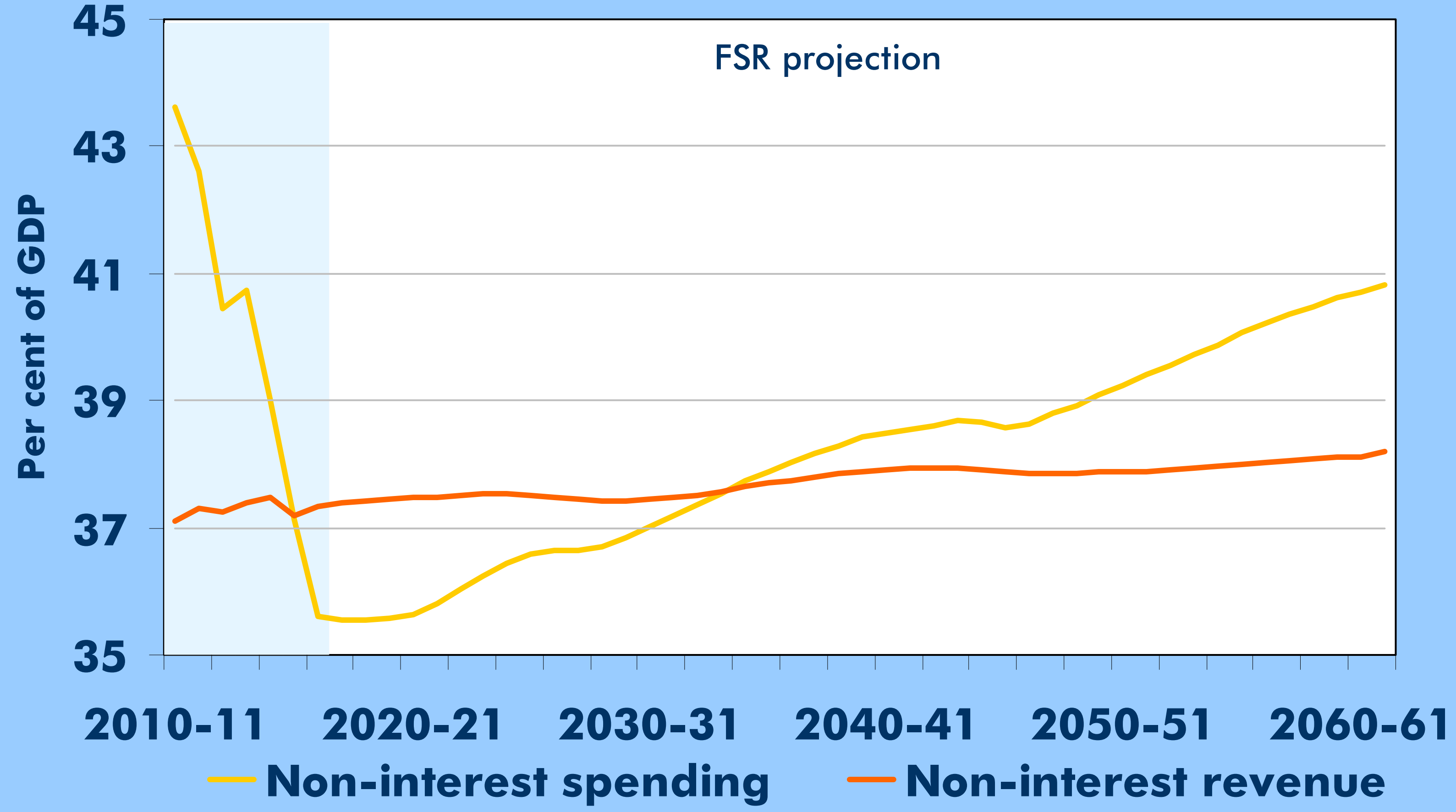
Revenue and spending projections



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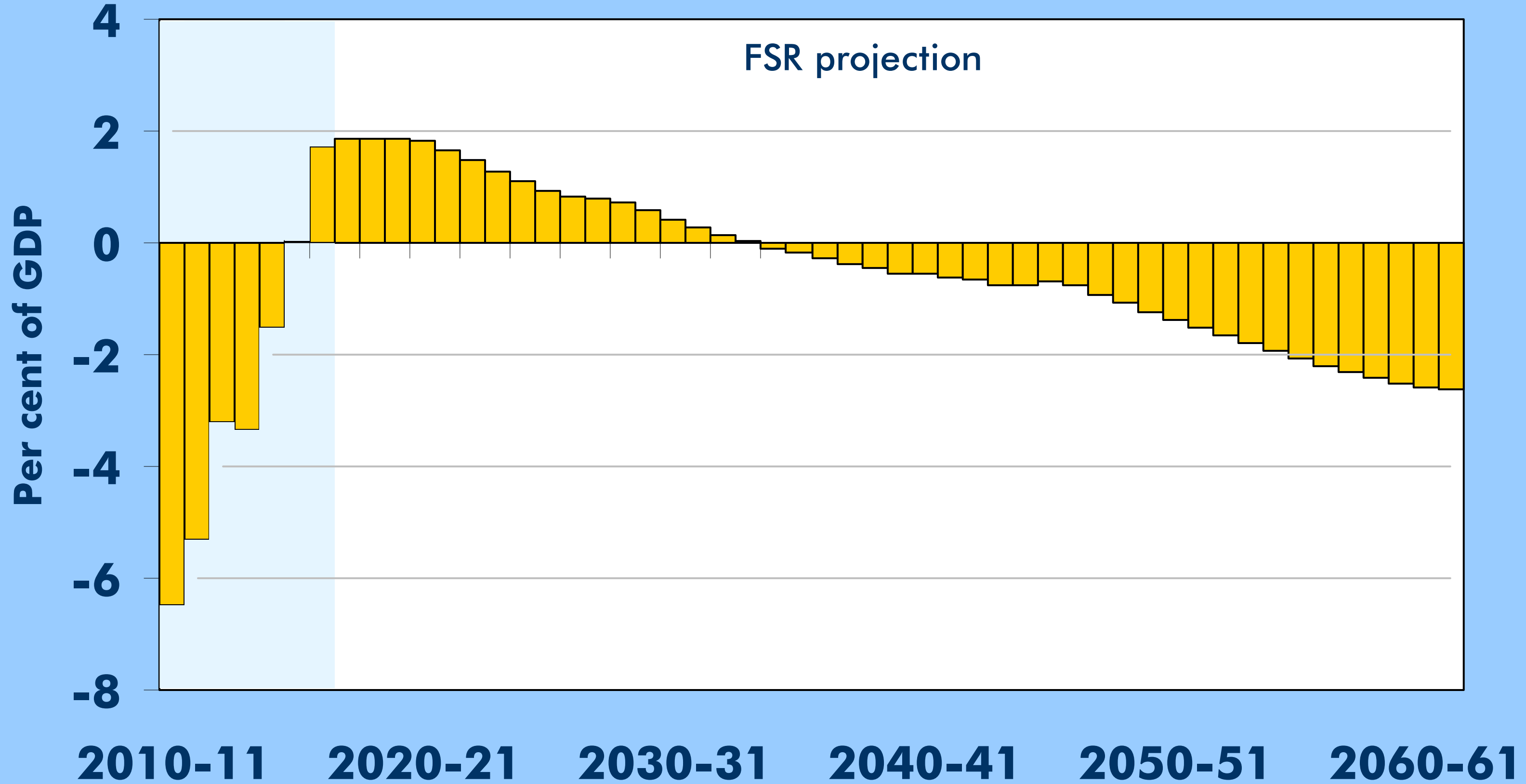
Primary budget balance



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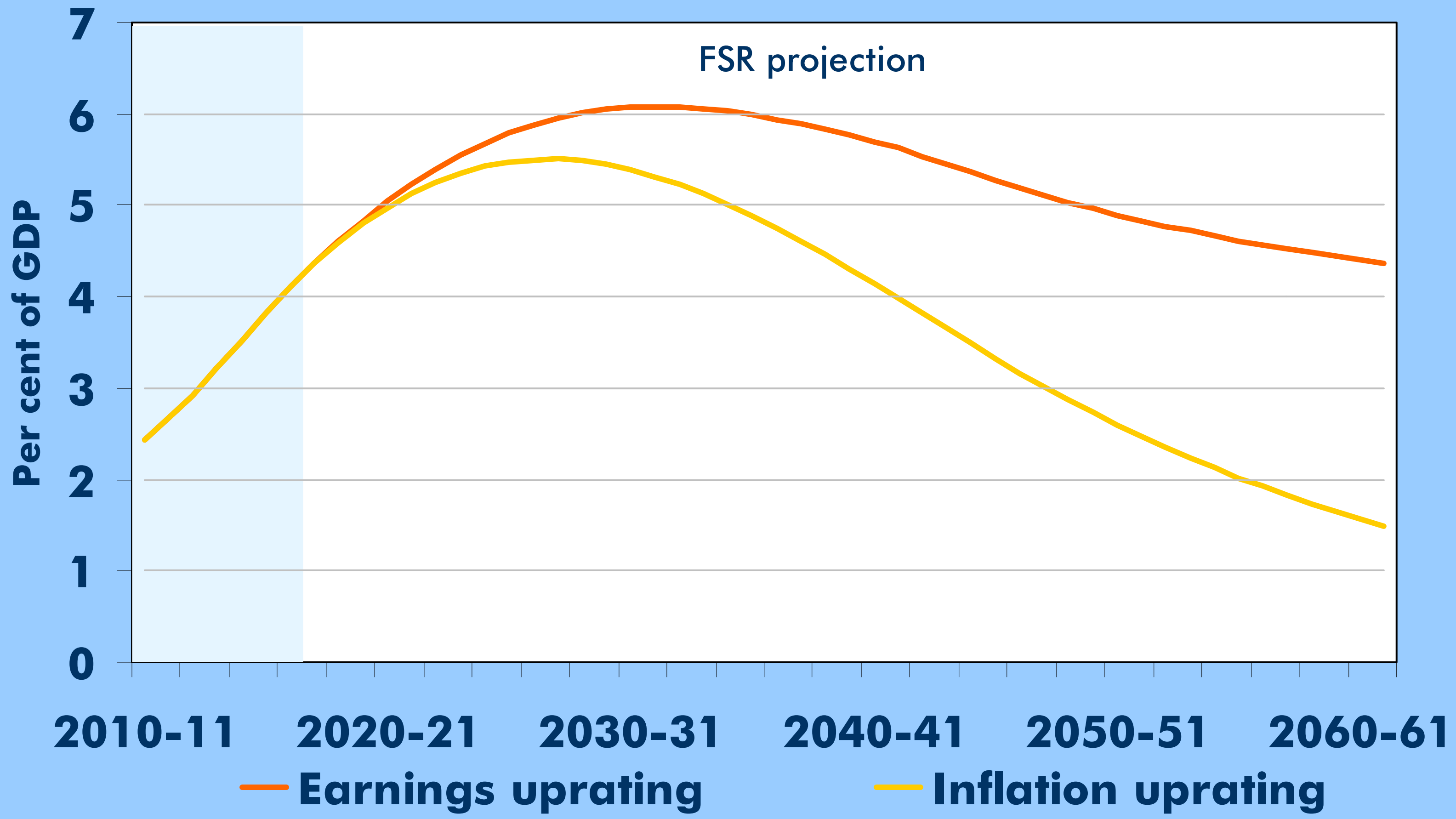
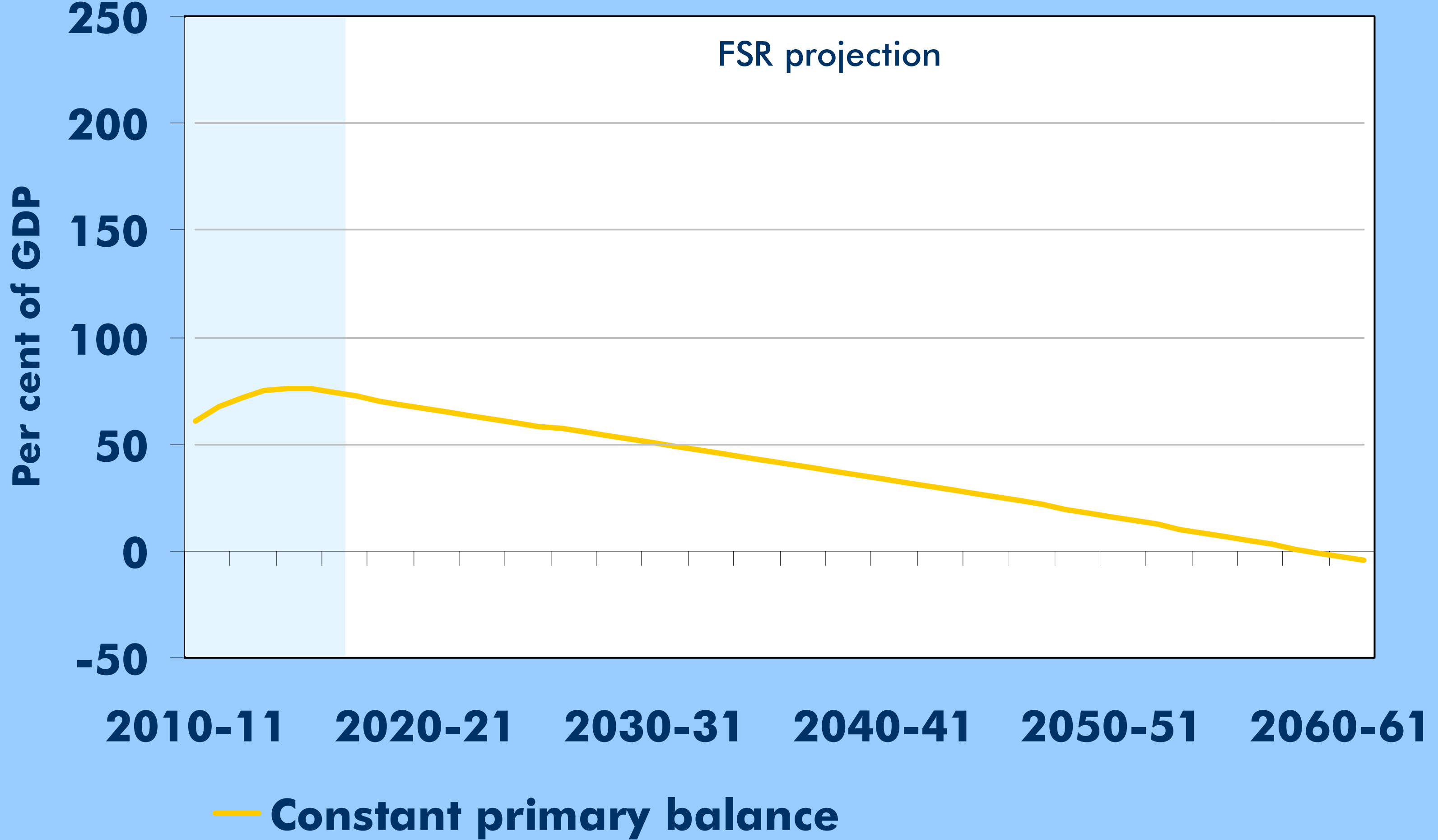
Impact of student loans on PSND



Public sector net debt



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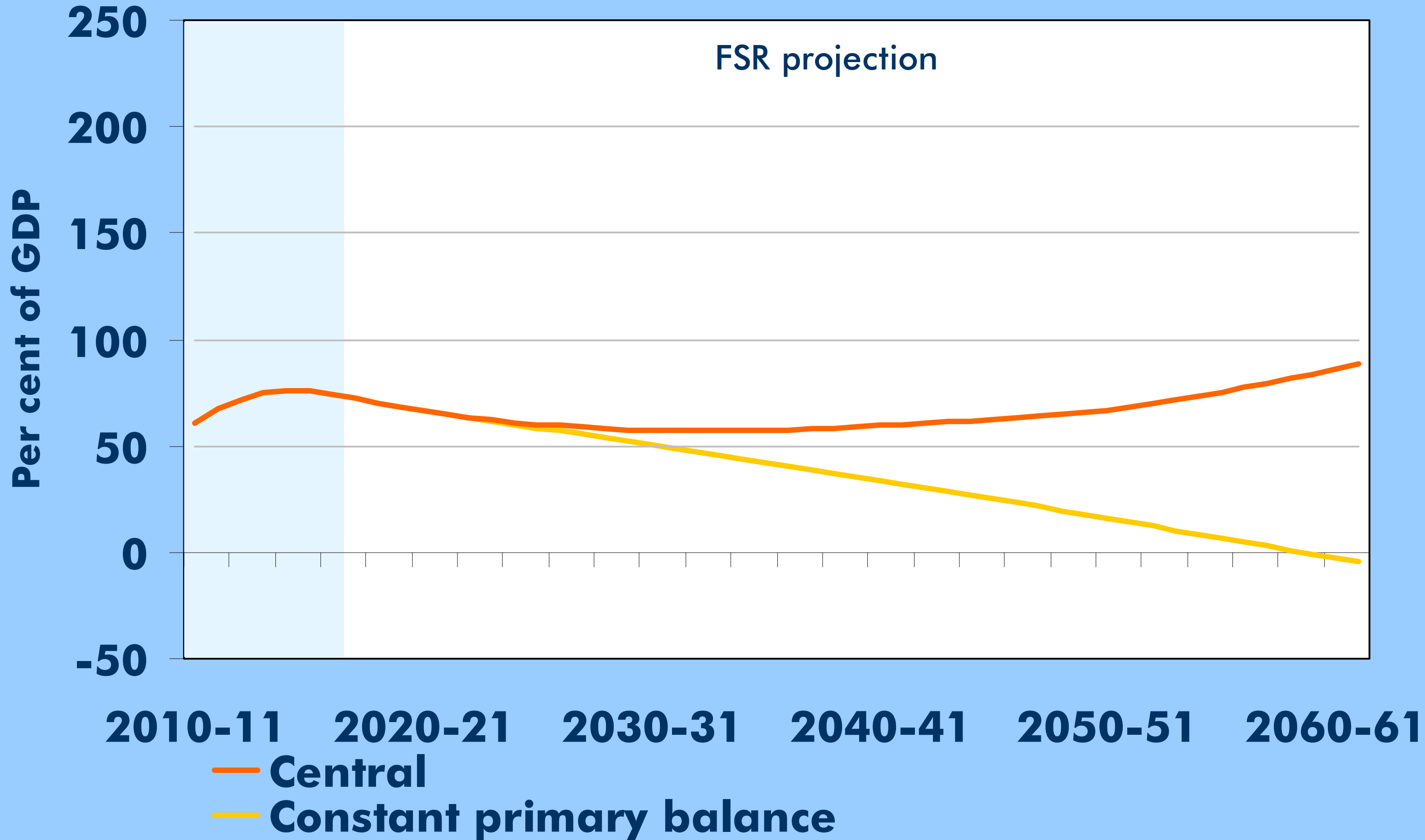

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Health care spending

- Central assumption is for per capita health spending to rise with GDP, adjusted for population changes

- But output of health care will only rise in line with the output of the rest of the economy if productivity growth is the same (we assume 2.2% a year)

- But productivity growth in health care c.0.8% a year since 1979. If it stays that way, health spending would need to rise 3.6% a year in real terms for health care output growth to match rest of economy

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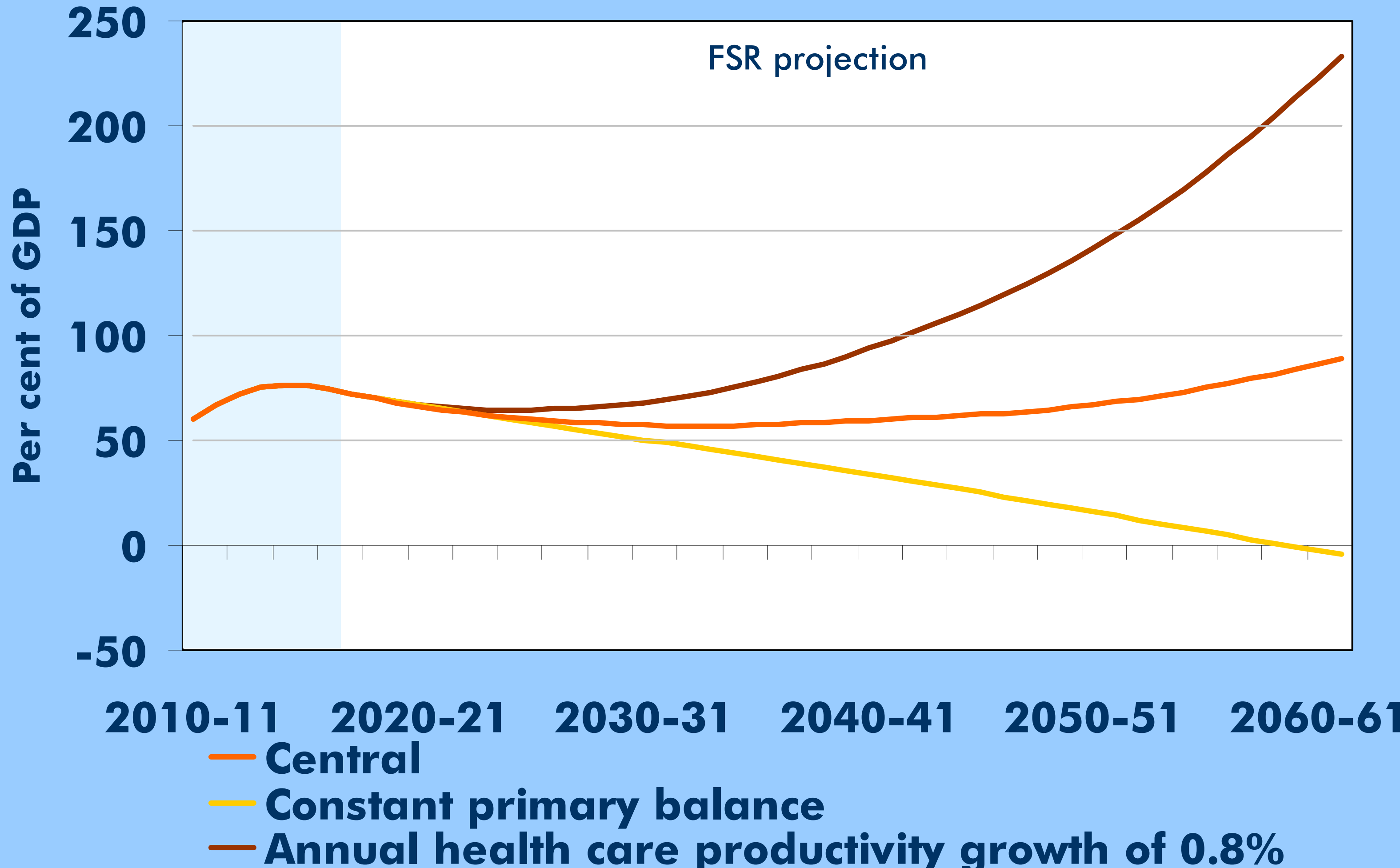

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What has changed since last year?

- Central projection looks less alarming in 2060-61
  - Primary deficit 0.6% of GDP smaller at –2.6% of GDP
  - Debt ratio 20% of GDP lower at 89% of GDP (but rising)

- Why?
  - Underlying health of public finances weaker over medium term, largely reflecting weaker outlook for potential output
  - But more than offset by Government policy: November public spending cuts and another year of fiscal drag
  - So primary surplus at end of EFO forecast 0.4% of GDP higher now than last year at 1.7% of GDP vs 1.3% of GDP
  - New population projections also mean deterioration over next 45 years roughly 0.2% of GDP smaller than last year

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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

- Higher net migration would improve outlook as immigrants more likely to be of working age
  - But effect would erode as immigrants reach old age

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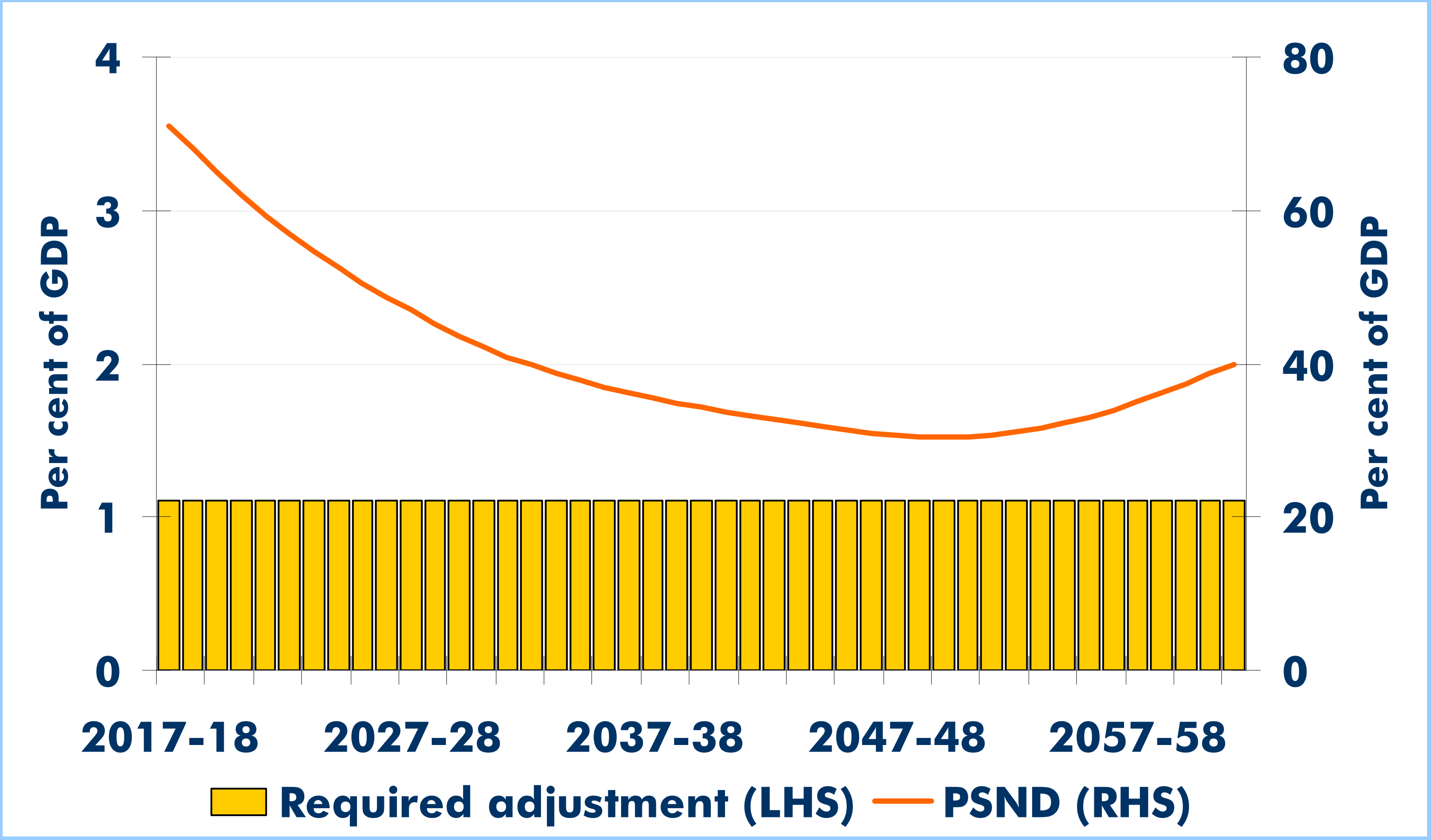
Achieving sustainability

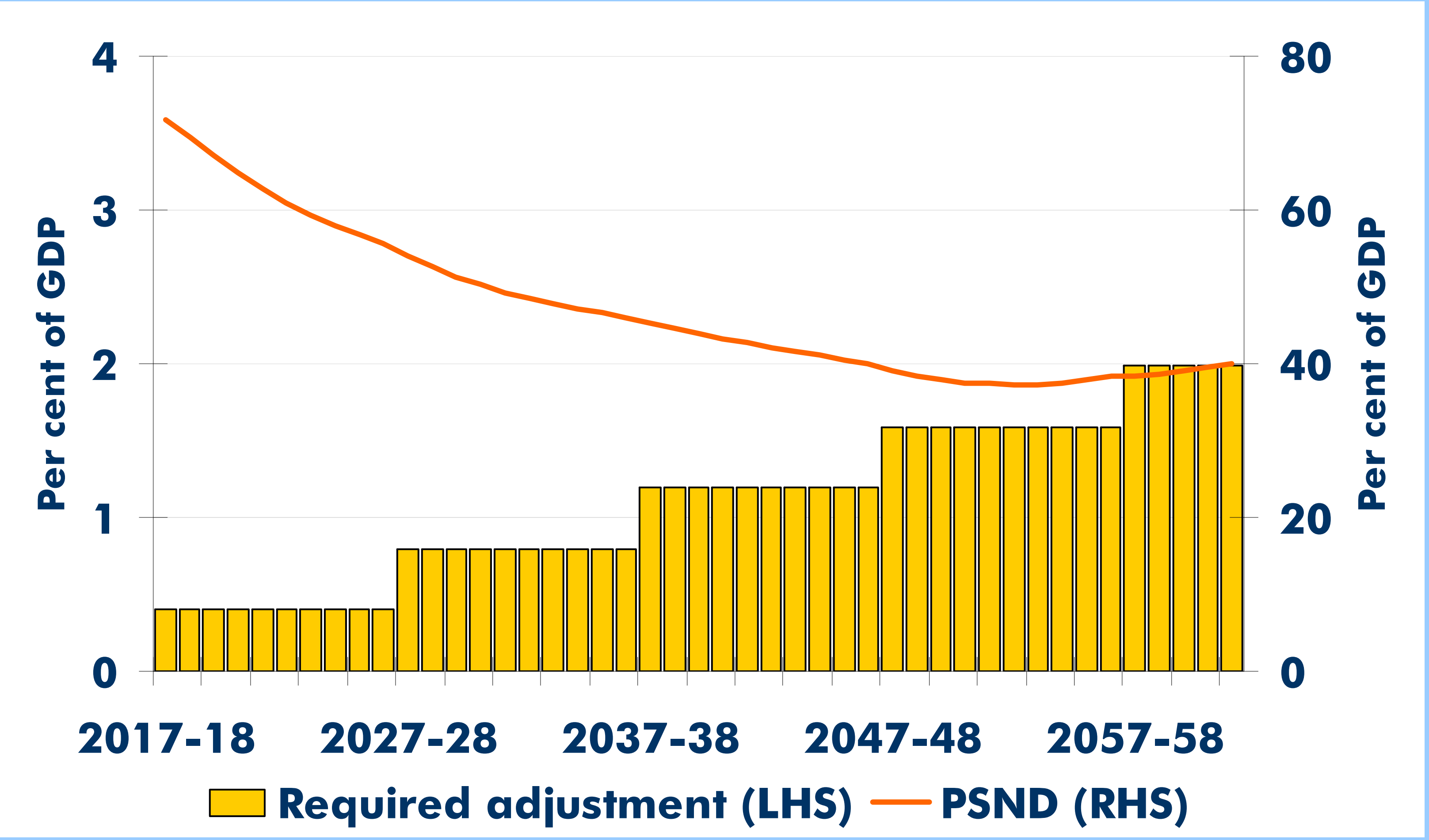
- Satisfy 'inter-temporal budget constraint'
  - Permanent tightening of 2.6% of GDP from 2017-18
  - Down from 3.1% last year

- Fiscal gap: PSND of 40% of GDP in 2061-62
  - Permanent tightening of 1.1% of GDP from 2017-18 or 0.4% of GDP each decade in central scenario
  - Permanent tightening of 4.4% of GDP from 2017-18 or 1.4% of GDP each decade if per capita health spending rises 3.6% a year in real terms

Timing the response: one-off



Timing the response: decade by decade



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Conclusions

- Ageing population puts pressure on public finances
- Also non-demographic pressures on health spending and some tax receipts
- Huge uncertainty and UK by no means unique in this
- Policy action and new population projections have somewhat eased pressures relative to last year
- Need to keep an eye on growth of contingent liabilities

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