Background

- The IMF’s 2016 *UK Fiscal Transparency Evaluation* said that
  - “In many cases, the government’s control of risks falls short of the Code’s standards of good or advanced practice”
  - “The absence of summary reporting of specific risks is a weakness that should be addressed”

- The Government has legislated for us to produce an FRR every two years, to which it is obliged to respond

- Several countries already produce risk reports, but usually from their finance ministries or cabinet offices
Our approach

• The IMF defines fiscal risks as
  – “the possibility of deviations of fiscal outcomes from what was expected at the time of the Budget or other forecast”

• In this report we focus on risks
  – To our latest (March 2017) forecast over the medium term
  – To fiscal sustainability over the longer term
  – With greater attention to downside risks in both cases

• We are interested in
  – Their probability and potential impact
  – Whether they are correlated with other risks
  – What the government is doing about them
Types of fiscal risk

• Increases in spending (one-off or persistent)

• Losses of revenue (one-off or persistent)

• ‘Stock-flow adjustments’
  – Balance sheet transactions
  – Balance sheet transfers (real-world or statistical)
  – Balance sheet valuation changes
Structure of the report

- Introduction: analytical framework
- Macroeconomic risks
- Financial sector risks
- Revenue risks
- Primary spending risks
- Balance sheet risks
- Debt interest risks
- A fiscal stress test
- Conclusions
Structure of the report

- Introduction: analytical framework
- Macroeconomic risks
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Including 57 issues that the Government might wish to consider in its response
Public finances

- Public Sector Net Borrowing

Per cent of GDP


March 2017
EFO
Macroeconomic risks

• Risks to potential output growth
  – Including population and potential productivity growth

• Risks of a cyclical downturn

• Sectoral risks (especially housing)

• GDP composition risks

• Brexit-related economy risks
Population projections

Total population

- Successive projections
- 2014
- Actual

Millions

1951 1971 1991 2011 2031 2051 2071
Net migration projections
Productivity growth

- Output per hour
- Average

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The cycle and the public finances

Output gap

Per cent


March 2017 EFO
The cycle and the public finances

<table>
<thead>
<tr>
<th>Year</th>
<th>Structural deficit</th>
<th>Cyclical deficit</th>
<th>Public sector net borrowing</th>
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<td>1975-76</td>
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<td>1985-86</td>
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March 2017 EFO
Tax rates on components of GDP

- Consumer spending
- Business investment
- Labour income
- Corporate profits
- Consumer spending

Effective tax rate vs. GDP share

- 0
- 20
- 40
- 60
- 80

- 0
- 5
- 10
- 15
- 20
- 25
- 30

- -5
- -10
The housing sector

- Real GDP growth (RHS)
- Real house price inflation (LHS)
Bank balance sheets

Per cent of GDP in 2015
Costs of the financial crisis

• Direct – bailouts and nationalisations
  – Upfront cost of £137 billion, but net cost estimated at £24 billion in March

• Indirect costs – via the hit to the economy
  – Economy around 15 per cent smaller today than on pre-crisis trend. Around £300 billion of GDP lost in a single year
Revenue forecasts

Per cent of GDP

- Treasury forecasts
- OBR forecasts
- Outturn
Revenue risks

- Behavioural and technological change
- Oil and gas
- Avoidance, evasion and other non-compliance
- Changing work patterns
- Policy risks
- Concentration of tax receipts
Self-employment and incorporations

- Self-employed (ONS definition)
- Single director companies (HMRC definition)
- Total company population (HMRC definition)
Tax paid on £50,000 income
The tax gap by type of tax

- SA (IT, CGT)
- Tobacco duties
- Alcohol duties
- VAT
- CT (SMEs)
- CT (Large)
- PAYE (IT, NICs)
- All HMRC taxes
Actual and default fuel duty rates

- June 2010 with outturn RPI
- March 2017
- Outturn rates

Main fuel duty rate (pence per litre)

- 2008-09
- 2012-13
- 2016-17
- 2020-21
Shares of income and income tax

Share of total income

2007-08
2017-18

Top 1 per cent
90th to 99th percentile
50th to 90th percentile
Bottom half

Share of total tax

2007-08
2017-18
Spending forecasts

- Treasury forecasts
- OBR forecasts
- Outturn

Per cent of GDP

Spending risks

• Welfare
  – Long-term: ageing and triple lock on pensions
  – Medium-term: reforms and legal challenges

• Health
  – Long-term: ageing and technology
  – Medium-term: pressures and ‘topping up’
Projected health and care costs

Per cent

March 2017 EFO

January 2017 FSR

Health

Long-term care

2016-17 2024-25 2032-33 2040-41 2048-49 2056-57 2064-65
Spending risks

• Welfare
  – Long-term: ageing and triple lock on pensions
  – Medium-term: reforms and legal challenges

• Health
  – Long-term: ageing and technology
  – Medium-term: pressures and ‘topping up’
Provisions and contingent liabilities

Per cent of GDP

- Remote contingent liabilities
- Non-remote contingent liabilities
- Provisions

Year 2009-10: 37.5%

Year 2011-12: 25.0%

Year 2013-14: 16.5%

Year 2015-16: 22.0%
Nuclear decommissioning costs
Nuclear decommissioning costs

2013-14 projection

£ billion

Nuclear decommissioning costs

2014-15 projection

£ billion

2015-16 2035-36 2055-56 2075-76 2095-96 2115-16 2135-36
Nuclear decommissioning costs

- 2015-16 projection
Annual clinical negligence costs

- Existing Liabilities and Ex-Regional Health Authorities Scheme
- Department of Health Clinical Liabilities Scheme
- Clinical Negligence Scheme for Trusts

£ billion

Spending control

• Departmental expenditure limits (DELs) a strength
  – But declining share of spending covered
  – And cash limits on welfare not very successful
  – DEL limits rarely overspent, but often adjusted

• Local government
  – Reserves being drawn down
  – Some risky commercial investment for revenue
Balance sheet risks

• Recent balance sheet shocks
  – Financial interventions and reclassifications

• Transaction risks
  – Student loans, financial asset sales, monetary policy and housing schemes

• Transfer risks
  – Housing associations and ‘near government’ bodies

• Fiscal illusions
  – Asset sales, grant-to-loan, guarantees, off balance sheet
Debt interest spending

- Other public corporations
- Local authorities
- Central government net of the APF

Per cent of GDP

March 2017 EFO

Debt stock and debt interest

- Stock: £ trillion
- Debt interest: £ billion

**Effective interest rate (per cent):**
- 1.6
- 1.5
- 0.5
- 3.4
- 2.6
- 0.4

**Other debt**
- NS&I products
- Treasury bills
- Index-linked gilts
- Conventional gilts (APF holdings)
- Conventional gilts (net of APF holdings)
Maturity of the debt stock

- Central government gilts
- Plus Treasury bills and NS&I products
- Plus central bank reserves to finance APF purchases

£ trillion

- Over 10 years
- Up to 10 years
- Up to 5 years
- <1 year
Stress test: real GDP

Years from base

2008Q1 = 100, 2017Q1 = 100

Stress test
Late 2000s
Stress test: average earnings

- Percentage change on a year earlier
- Years from base

Graph: Stress test compared to Late 2000s
Stress test: Bank Rate

Years from base vs. Per cent

- Stress test
- Late 2000s
Stress test: CPI inflation

- **Percentage change on a year earlier**
- **Years from base**

Lines on the graph:
- **Stress test**
- **Late 2000s**
Stress test: net borrowing

Per cent of GDP

- Stress test
- March 2017

Years:
- 2003-04
- 2009-10
- 2015-16
- 2021-22
Stress test: net debt

Per cent of GDP

2003-04  2009-10  2015-16  2021-22
### Stress test damage in 2021-22

<table>
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<tr>
<th>£ billion</th>
<th>Stress Test</th>
<th>March 2017 EFO</th>
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Conclusions: main risks

• Main medium-term risks
  – Economy: recession, weak productivity
  – Spending: debt interest, health, DELs
  – Policy: further fuel duty cancellation

• Main long-term risks
  – Economy: recessions and financial crisis
  – Spending: Ageing and health costs
  – Revenues: fuel, tobacco and work patterns
Giveaways today, takeaways tomorrow

Year 1 Year 2 Year 3 Year 4 Year 5

Per cent of GDP

Spending Review 2010 to Budget 2015
Summer Budget 2015 to Spring Budget 2017
All fiscal events since Spending Review 2010
Impact of policy measures in 2017-18

- Individual fiscal events
- Net giveaways
- Cumulative effect

Per cent of GDP

Dec 12, Mar 13, Dec 13, Mar 14, Dec 14, Mar 15, Jul 15, Nov 15, Mar 16, Nov 16, Mar 17
Conclusions: main risks

• **Main medium-term risks**
  – Economy: recession, weak productivity
  – Spending: debt interest, health, DELs
  – Policy: further fuel duty cancellation

• **Main long-term risks**
  – Economy: recessions and financial crisis
  – Spending: Ageing and health costs
  – Revenues: fuel, tobacco and work patterns
Conclusions: Brexit specific

• Economy related
  – Trade, productivity, investment, migration and financial sector

• Spending related
  – Divorce bill, EU schemes, UK regulators, negotiations/implementation, sector interventions

• Receipts related
  – Financial sector
Conclusions: lessons for policy

• Keep the risks that the Government has chosen to expose itself to under review

• Prepare for nasty surprises

• Take action on long-term pressures