Good morning everyone. My name is Robert Chote, Chairman of the OBR, and I would like to welcome you to the launch of this, our first *Fiscal risks report*. I am going to take you through the key points and then we will be happy to answer your questions.

[SLIDE] Some background to begin with. The origins of this report lie in the Government’s belief that it can improve the monitoring and management of risks to the public finances. This was underlined last year when the IMF reviewed the UK against its Fiscal Transparency Code. It had lots of complimentary things to say, but also concluded that:

“In many cases the Government’s control of risks falls short of the Code’s standards of good or advanced practice” and that “the absence of summary reporting of specific risks is a weakness that needs to be addressed”.

Reflecting these concerns, the Treasury has stepped up its internal risk management as well as legislating for us to produce a report on fiscal risks every two years, to which it will respond. The UK is not unique in having a report on fiscal risks, but they are published by the Treasury or the Cabinet Office in most other countries that have one.

[SLIDE] So what approach have we taken to the task?

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”. We have tweaked this a little, reflecting the fact that different risks matter over different time horizons. We focus on risks to our most recent March forecast over the medium term and to fiscal sustainability over the longer term. In both cases we focus more on downside than upside risks, as these pose bigger challenges to the Government and history suggests they are more likely to crystallise.

In discussing particular risks, we are interested in their likelihood and possible impact, whether they are likely to crystallise at the same time as other risks, and what the government is doing about them.
Fiscal risks come in three main varieties.

- One-off or persistent increases in spending;
- One-off or persistent losses of revenue; and
- Direct hits to the balance sheet. These are known as ‘Stock-flow adjustments’ because they affect the stock of debt without affecting the flow of borrowing.

These include:

- Balance sheet transactions, when the government issues debt to buy assets (such as bank shares) or to lend to people;
- Balance sheet transfers, when the government takes a private sector entity fully onto its balance sheet; and
- Changes in the value of existing assets and liabilities.

So this is how we have structured the report.

We begin with an introduction and analytical framework.

We then discuss risks related to the economy and financial sector. These are amongst the biggest and most likely to crystallise over the long term and they combine revenue, spending and balance sheet elements.

We then look at specific revenue, spending and balance sheet risks that could crystallise in any state of the economy, before turning to debt interest spending and debt dynamics. These are important in their own right and in determining whether the other risks pose a threat to fiscal sustainability. The nightmare scenario is one where the debt stock and debt interest payments get onto a trajectory where they would rise relentlessly as a share of GDP, ending in a full-blown fiscal crisis.

Building on our discussion of individual risks, we then illustrate what might happen if several of them crystallise at once, by running a ‘fiscal stress test’. This is an alternative scenario for the public finances based
on the stress test that the Bank of England will apply to commercial banks later this year, plus some additional fiscal pressures. We gain interesting insights by comparing the results to what happened during and after the last crisis and recession.

Finally, we draw some conclusions. Confronted by a vulnerable fiscal position and a challenging political environment, it would be wise for the government to review the fiscal risks that it has exposed itself to for policy reasons, to prepare for the cost of unexpected shocks and to address some of the long-term pressures on receipts and spending. These lessons would hold for any government, but this one also has to manage the uncertainties posed by Brexit, which could influence the likelihood and impact of several of the other risks we talk about.

[SLIDE] At the end of each chapter, we list a series of issues that the Government is likely to wish to look at when managing its risks and which it may wish to address in its response to this report. Like the ketchup king Henry Heinz, we have come up with 57 varieties.

As you can see, we are covering a lot of territory in this report and I will only be able to dip into the issues we cover this morning. The range of topics has required us to draw on the time and expertise of a wide variety of departments, agencies and outside experts over recent months and we are very grateful to them all for their help.

[SLIDE] Before I talk about the risks, let me remind you briefly what our central forecast for the public finances looks like over the next five years. On the eve of the financial crisis, the Government was running a budget deficit between 2 and 3 per cent of GDP. That ballooned to 10 per cent in 2009-10, but has since fallen back to broadly its pre-crisis level – thanks to the recovery in the economy and seven years of fiscal consolidation. Over the next five years, we expect the deficit to narrow further to 0.7 per cent of GDP, still some way from the Government’s target of a balanced budget by 2025. [SLIDE] Meanwhile public sector net debt has risen from 35½ per cent of GDP in 2007-08 to 89 per cent this year and is expected only to fall to 80 per cent by 2021-22.

[SLIDE] So let me first say a bit about macroeconomic risks to the public finances, which are among the largest and most likely to crystallise.
The most important long-term economic risk is weaker-than-expected growth in potential output – the sustainable level of activity consistent with stable inflation. Small changes in potential output growth can build up over time to have big effects on the size of the economy and the pool of potential tax receipts from which to finance public spending.

Potential output growth has a number of determinants, among them population growth and potential productivity growth – growth in the amount of output that the economy can produce each hour a worker works. The latter is the ultimate driver of living standards.

[SLIDE] We assume in our forecasts and projections that the population evolves in line with the principal projection by the Office for National Statistics. But you need only look at the performance of past such projections to see that there are risks to both sides of these. [SLIDE] Among the most significant in the near term are those that arise from net migration, which has consistently surprised on the upside in recent years, but where Brexit may affect the outlook looking forward.

[SLIDE] Potential productivity growth is the most important and uncertain judgement that any economic forecaster has to make over the medium and long-term. You can see here that actual productivity growth has been far weaker on average since the crisis than before it, but that we assume it will return to historically more normal rates over the medium and long term. But if the recent past turns out to be the ‘new normal’ then that will pose a significant challenge.

If you assume that benefit levels and tax thresholds rise in line with average earnings – and that most public services spending remains broadly stable as a share of GDP – this would not show up primarily as a fiscal problem, but we would all be poorer in the private and public goods that we consume. Alternatively, if productivity and receipts grew just 0.1 percentage points more slowly than projected over the next 50 years, but spending growth was unchanged, debt would end up 50 per cent of GDP higher.

[SLIDE] Alongside trend growth in the economy, the other main macroeconomic risk comes from the upswings and downswings either side of that trend, shown in this chart. Since 1970, no decade has passed without a recession and all but one have pushed the budget deficit
above 6 per cent of GDP. Cycles matter for the public finances because, when the economy is weak, revenues are weak, welfare spending is higher and public services spending is higher as a share of GDP.

Viewed with enough hindsight the booms appear to offset the busts and the corresponding cyclical budget deficits offset the cyclical budget surpluses. But looking far enough forward recessions are still a high probability, high impact risk. Busts generally come as a bigger surprise than booms, and often come after the benefits of the boom have been spent in the belief that they were a structural improvement. History suggests there is an evens chance of a recession in any five years and a 15 per cent of GDP rise in net debt would be quite feasible for a ‘normal’ recession based on our scenario analysis.

[RSLIDES] Risks related to trend growth and the cycle both reflect uncertainty about the future size of the economy. But there are also risks arising from its composition. As this chart illustrates, different categories of income and spending face different effective tax rates. We tax wages and salaries and consumer spending more heavily than profits and investment. So a shift in composition can affect the amount of revenue the Government gets from each pound of GDP.

[RSLIDE] Some sectors of the economy also pose particular risks to the public finances. The housing market is a good example. It is relatively tax-rich, it helps drive welfare spending and in recent years it has spawned a number of policy initiatives that involve potentially costly guarantees and liabilities if the market were to take a serious downturn. As the chart shows, it is also relatively volatile, with large cyclical swings in prices and real terms falls around each of the last four recessions.

[RSLIDE] But it is the financial sector that poses the greatest risk to the public finances, both because it is an important generator of tax receipts and because of its importance to the smooth running of the economy. Financial crises are a risk in all countries, but especially in the UK where (as this chart shows) it remains unusually large relative to the economy.

[RSLIDE] When the financial sector gets into trouble, there are typically two sorts of fiscal cost: the direct cost of bailing out or nationalising failing institutions and the indirect costs from damage to the economy.
The upfront cost of bailing out banks is highly visible and often politically contentious, but the ultimate cost is often relatively small once the interventions have been unwound. The bail-outs and nationalisations in the last crisis had an upfront cost of £137 billion, but when we last estimated it in March the net cost to date was closer to £24 billion. There is still considerable uncertainty around this figure, depending in particular on the price at which the government sells its remaining stake in RBS. But the indirect costs were much, much bigger, reflecting the fact that financial crises inflict larger and longer lasting damage on economic activity and revenues than normal recessions do. The economy is about 15 per cent smaller today than it would have been on its pre-crisis trend – that is around £300 billion of lost GDP in a single year.

As we discuss in the report, the chances of another recession or financial crisis may be relatively low in the near term – in part because of recent regulatory changes – but over the long term one or more is almost inevitable. Governments do what they can to limit the probability and impact of recessions and financial crises, but they cannot eliminate the risk entirely. Hence the importance of managing the public finances prudently in normal times so you can bear the costs when they come.

[SLIDE] Now let me turn to specific fiscal risks related to government revenue, whatever the state of the economy. As you can see from this chart, comparing the latest outturns with successive Treasury and OBR forecasts, the outlook for revenue is always uncertain, even when measured as a share of GDP.

[SLIDE] In the report we look at six sets of revenue risks:

- The impact of behavioural and technological changes, such as the decline of smoking and improvements in fuel efficiency;
- The oil and gas sector, where revenues have all but disappeared, but uncertainty remains over the cost of decommissioning;
- Avoidance, evasion and non-compliance;
- Changing work patterns;
- Policy risks; and
The increased concentration of tax receipts among people with relatively high incomes and significant holdings of assets.

Let me touch briefly on some of these.

[SLIDE] The change in work patterns is a risk that has crystallised in our recent forecasts and which may well have further to run. As this chart shows, a growing share of the workforce are becoming self-employed or turning themselves into companies, rather than being employees.

In part this reflects underlying changes in the nature of work, but it also reflects the tax advantages of doing so. [SLIDE] This chart shows the tax paid on £50,000 of income, with the effective tax rate ranging from 32 per cent for an employee to 25 per cent for a self-employed person and less than 20 per cent for a company sole director. The differences reflect employers’ national insurance contributions and the relatively low rates of corporation and dividend tax. We assume that continued rises in the self-employment and incorporation shares will reduce receipts by around £4½ billion by 2021-22, but the figure could easily be bigger if these trends accelerate.

[SLIDE] Risks around avoidance and evasion reflect that fact that there is already a significant gap between the tax that people actually pay and what HMRC think they should pay. This was estimated at £36 billion in 2014-15, 6½ per cent of the receipts HMRC think should have been paid. As this chart shows, the gaps vary significantly from tax to tax – from 1 per cent for PAYE income tax to almost 20 per cent for self-assessed tax. The corporation tax gap is significantly larger for small businesses than large ones. The government hopes that its ‘making tax digital’ initiative will reduce this, but implementing this involves risks of its own.

[SLIDE] Risks from tax policy include the possibility – in some cases the probability – that current stated policy will not be implemented. As this slide shows, since fuel duty was cut in Budget 2011 the default policy – to raise it in line with inflation – has been delayed three times, cancelled six times and has never actually been implemented, at a cost of around £8½ billion by 2017-18. Alcohol duty is another less costly example.
The concentration of tax receipts among high earners and the asset rich is not so much a risk in its own right as something that makes the public finances more vulnerable to other risks that affect them.

This chart shows the growing concentration of income tax receipts. The proportion of pre-tax income received by the top 1 per cent of taxpayers has fallen from 13.4 to 12 per cent over the past decade, but the proportion of income tax they pay has risen from 24.4 to 27.7 per cent. This reflects increases in the tax-free personal allowance – narrowing the tax base by taking people out at the bottom – and increases in effective tax rates at the top, thanks to the new additional rate, the personal allowance taper and changes to pension tax relief. A 1 per cent fall in the top 10 per cent of incomes would now cost £1½ billion a year.

Stamp duty land tax is also highly concentrated, with just 9,250 residential transactions in Westminster, Kensington and Chelsea accounting for 14 per cent of receipts in 2015-16. The move to a slice system with more steeply rising marginal rates has increased concentration, with the proportion of receipts from properties over £1 million doubling since 2007-08.

Now let me turn to spending risks. Once again we can see from the latest outturns and past forecasts that there is a lot of uncertainty around the path of spending, with official forecasts more often under-predicting than over-predicting spending since 2000.

Let me start by mentioning two sets of risks that we have highlighted in past OBR reports.

The first is welfare spending, where over the long term the ageing population and the triple lock on uprating are both expected to raise state pension spending as a share of GDP. Over the medium term there are also risks around the delivery of incapacity and disability benefit reforms, the introduction of universal credit and various legal challenges that could extend eligibility to particular benefits. These are reported less transparently than legal challenges to the tax system.

The second is health spending, which we identified earlier this year as the biggest long-term threat to fiscal sustainability. The Government has succeeded in reducing health spending slightly as a
share of GDP in recent years, but our latest long-term projections show it rising from 7 to 12½ per cent of GDP in 50 years’ time, reflecting demand pressures from the ageing population and cost pressures from new technology. [SLIDE] There are also signs of pressure in the medium term – higher demand, longer waiting times, knock-on pressures from social care and emerging budget overspends. The Government has already responded by topping up health budgets from the Treasury’s reserve, from new issue-specific funds and by allowing capital budgets to be spent on current needs. Further such top-ups cannot be ruled out.

[SLIDE] Spending risks can also be found in the Treasury’s Whole of Government Accounts, which report provisions and contingent liabilities notified by government departments. These are categories of uncertain future spending for which the probability of crystallisation is greater than 50 per cent for provisions, less than 50 per cent for contingent liabilities and much lower than 50 per cent for remote contingent liabilities. As this chart shows, provisions and contingent liabilities have been growing in size in recent years while remote contingent liabilities (mostly a legacy of the financial crisis) have been shrinking.

The biggest provisions in the WGA are for the costs of nuclear decommissioning. These are dominated by the on-going clean-up of Sellafield where, as the Nuclear Decommissioning Authority puts it, “in a heady atmosphere of scientific discovery, plans for future dismantling were barely considered”. Figures quoted in the WGA are sensitive to the discount rate used to convert the expected future flow of spending into a one-off sum, but the underlying cash figures show the uncertainty.

[SLIDE] This chart shows the annual payments projected over the next 120 years in 2012-13, [SLIDE] 2013-14, [SLIDE] 2014-15 and finally [SLIDE] 2015-16 – quite a bit of variation year by year. The total cost over this period is currently projected at £117 billion, but the NDA says it could be anywhere between £95 billion and £218 billion – although annual spending would still peak at around £3 billion a year near-term.

The government is less exposed to decommissioning costs for the second and new generations of nuclear power stations, but it still faces risks if future cost pressures cannot be met by the private sector.
Clinical negligence costs are the second largest set of provisions and contingent liabilities in the WGA. These have been rising steadily in recent years, with annual spending now around £1.7 billion a year.

Rising life expectancy and costly medical advances have pushed up the average size of claims. Most importantly, the average claim for brain damage at birth has risen from £4.1 to £8.3 million since 2010. The Government’s decision to reduce the ‘personal injury discount rate’, which increases the size of one-off pay-outs, could see this double again, although ministers are now revisiting the decision. The Treasury has already put another £1.2 billion a year into its reserve to address this.

The Treasury manages public spending through two control totals. ‘Departmental Expenditure Limits’ or DELs, cover most spending on public services, administration, capital investment and grants, all of which can be planned over a number of years. ‘Annually Managed Expenditure’ is more demand-led and dominated by welfare spending, debt interest and local authorities’ self-financed spending.

The control of departmental spending has long been a strength of fiscal management in the UK, although a declining share of total spending is subject to DELs and attempts to put cash limits on welfare spending have not been a great success. Departments almost always underspend their final DEL limits, although the Department of Health overspent theirs in 2015-16. But the limits themselves are often adjusted many times, so pressures may still lead to higher spending than originally planned. Given current ‘austerity fatigue’ and the extra spending already announced for Northern Ireland since the election, further increases in current departmental plans seem a significant risk.

As for local government, budgets have faced sharp cuts in recent years and there are now signs that local authorities are beginning to draw down their reserves to maintain spending in the face of reduced income. Some local authorities also appear to be undertaking relatively risky investments in commercial property to boost their revenues.

Now let me turn from revenues and spending to risks that affect the balance sheet directly. We have seen a variety of balance sheet shocks in recent years, including the nationalisation and recapitalisation
of banks during the financial crisis and the reclassification of Network Rail and housing associations into the public sector.

As regards balance sheet transactions, risks looking forward include the uncertainties that lie around our student loans forecasts, the possibility that planned sales of financial assets could be delayed, the possibility of further monetary policy interventions and potential calls on various housing schemes and guarantees. The risk from the last of these will depend in part on take-up of the Help to Buy scheme, which could easily exceed the numbers assumed in our forecasts.

Risks from balance sheet transfers include the possibility that housing associations could be moved back into the private sector thanks to recent deregulation. But, while this would lower measured net debt, it is unlikely to reduce the risk of the government having to intervene if one got into serious trouble. There are a number of “near government” entities where the public sector might be thought to stand behind a private sector body and where they could be reclassified. Universities are one example, where their credit ratings are already explicitly boosted by the assumption of public sector support.

The balance sheet deserves closer scrutiny than it gets in analysis of the public finances, in part because it is prone to what the IMF calls ‘fiscal illusions’ – where changes in fiscal aggregates all too often do not reflect changes in the underlying health of the public finances. Examples include the treatment of asset sales, the conversion of grants to loans, use of guarantees and off balance sheet financing.

[SLIDE] So far we have looked at risks that could raise future budget deficits, or the debt stock directly, both of which would increase debt interest spending. But increases in the cost of new borrowing are an important additional risk, not just because they would increase debt servicing costs, but because they could push the debt-to-GDP ratio towards an unsustainable trajectory.

This chart shows that debt interest is low by historical standards and expected to stay so in our central forecast. But this is an area where the government is now much more vulnerable than it was pre-crisis to unexpected increases in interest rates or retail price inflation. This reflects both the rise in the debt stock and changes to its composition.
This chart shows the composition of the central government’s £1.7 trillion gross debt at the end of 2016-17 and of the £35 billion of interest that it paid on it. A couple of things are striking: first, quantitative easing is currently saving the government about £10 billion a year; and second, higher retail price inflation raised the accrued interest cost of index-linked gilts last year. As regards the former, the Bank of England holds conventional gilts with a face value of £371 billion, a third of the stock. Because these purchases were financed by the creation of new central bank reserves that only pay Bank Rate, the government has in effect refinanced relatively expensive fixed rate debt at a lower floating rate set by the Monetary Policy Committee. This saves money now, but leaves it more exposed when Bank Rate rises.

The UK has traditionally been insulated from interest rate shocks by the relatively long average maturity of the debt stock – 15 years at the end of March, at least twice the level in other G7 countries. This chart shows that only 6 per cent of gilts held by the private sector are set to mature within a year, but that rises to 18 per cent when Treasury bills and National savings products are added and to 42 per cent when the holdings of the Bank’s Asset Purchase Facility are as well.

The government is more exposed to inflation shocks too, thanks to the increase in the stock of index-linked gilts to nearly 20 per cent of GDP. A one-off 1 percentage point rise in RPI inflation would increase debt interest by £4 billion within a year and more than £6½ billion within five.

If interest rates and inflation pick up because the economy is growing more strongly, higher revenues would offset the increase in debt interest payments. So the most threatening shocks, especially over the longer term, are those that would raise interest rates relative to GDP growth, adding more to public spending than to GDP or receipts. This would require the government to run a stronger primary budget balance to keep the debt-to-GDP ratio from rising relentlessly. The relationship between market interest rates and GDP growth is favourable at the moment, so even a return some way to historical norms would be costly.

This vulnerability of the public finances to interest rate and inflation shocks is illustrated by the fiscal stress test set out in chapter nine. As I mentioned earlier, we have based this on the ‘annual cyclical
scenario’ published by the Bank of England in March. In some ways it resembles the late 2000s: a deep recession, with asset prices and the pound falling sharply and lasting effects on potential output. But in others it is different: SLIDE earnings growth holds up to begin with and SLIDE the Bank raises interest rates to 4 per cent to combat domestic inflation. SLIDE In addition to the pure economic effects, we assume that the Government spends almost £100 billion on bail-outs and other private sector interventions and that it is hit by a £25 billion tax litigation bill. But beyond this, we do not assume any fiscal policy response.

SLIDE The fiscal consequences are severe. The budget deficit rises to 8 per cent of GDP and SLIDE net debt to 114 per cent of GDP. The size of the hit is of course somewhat arbitrary – the worse the scenario, the nastier the results, but it is clearly more troubling to increase net debt by 34 per cent of GDP when you start at 80 rather than 40.

However, it is the composition of the damage that is most interesting.

SLIDE Compared to the late 2000s, less comes from weaker receipts and more from higher public spending. Because of the scenario the Bank has chosen, income tax holds up better than in the crisis, but capital and property taxes are hit harder. On the spending side, welfare bills rise less sharply than in the crisis, despite a bigger jump in unemployment, partly because the four-year freeze in working age benefits transfers the pain of higher inflation onto benefit recipients rather than the Exchequer.

But debt interest is the main area where the stress test inflicts more damage than the crisis. It rises by 2.8 per cent of GDP in the stress test – £66 billion in 2021-22 – as you can see in this table, having fallen by 0.3 per cent in the crisis. That reflects four factors:

- Interest rates rise sharply, having fallen in the crisis;
- The initial stock of debt is much higher;
- The Bank is assumed to sell gilts rather than to buy them, while the gap between Bank Rate and gilt rates is less favourable; and
- The peak in RPI inflation is higher and more sustained.
This increase in sensitivity to inflation and interest rates is one of the key conclusions we highlight in the concluding chapter. We also summarise the possible impact and likelihood of the main medium term and long term risks in the grids on pages 298 and 303.

Over the medium term the biggest economic risks are probably a recession and continued weak productivity growth. The biggest specific risks are probably higher debt interest costs, health spending or pressures on departmental spending more broadly. Cancellation of future fuel duty rises would have a smaller, but still material, impact.

In the current political environment, the government may be under pressure to announce giveaways on either the tax or spending side come the Budget. As this chart shows, in recent fiscal events governments have tended to announce giveaways today with the promise that they will be funded by takeaways tomorrow – but the risk is that tomorrow never comes. You can see that in the impact of past policy measures in 2017-18 – every fiscal event from December 2012 to December 2014 announced net takeaways; every subsequent one announced net giveaways. We can come back to these charts in the autumn to see whether the autumn Budget follows this pattern or not.

Over the longer term, recessions and another financial crisis seem almost inevitable. The ageing population and cost pressures are likely to push up spending on the state pension, health and social care. And revenues are likely to be depressed by further improvements in fuel efficiency, declines in smoking and changes in work patterns.

Alongside these are the risks from Brexit. We set out the main economic risks on page 68 and the main spending risks on page 208. We have no basis for predicting the outcome of the negotiations, but we assume that most would reduce net inward migration and weaken potential productivity growth. But these effects could be bigger or smaller than we currently assume. As regards spending, much attention focuses on the potential ‘divorce bill’, with sums as high as €75 billion being mooted. This would be 3 per cent of GDP in 2019-20. But – while highly visible and politically controversial – as a one-off hit this would not be a serious threat to fiscal sustainability. More important is whether the deals we negotiate with the EU and other trading partners are good for the long-term growth potential of the economy or not.
From the report as a whole, we draw three main lessons for policymakers:

- First is the need to keep those risks that the Government has chosen to expose itself to for policy reasons – or where their probability and potential impact depends on government behaviour – under careful review. Do the benefits outweigh the costs? Is there scope to mitigate them to improve that balance?

- Second is the need to prepare for nasty surprises. Further recessions and financial crises are almost inevitable – the risks can be reduced but not eliminated. Other unanticipated developments with spending implications may also come along: military action, natural disasters or terrorist attacks.

- Third is the need to deal with the many sources of slow-building pressure on the public finances. The costs of ageing, technological progress in health, weak productivity growth and the erosion of tax receipts would mount slowly over the years. That gives time to respond, but with a less obvious trigger to take action.

This has been a fascinating report to produce and we hope that it provides food for thought for the government and outside observers. This is certainly a good time to be thinking about fiscal risks. The budget deficit has only just returned to pre-crisis levels and the debt stock is not yet falling. The fiscal position is more vulnerable than before the crisis, thanks to the size and composition of the debt stock and the narrowing and concentration of tax bases. And the political backdrop is, to say the least, challenging. With that, we are happy to take your questions.