Office for
Budget
Responsibility

PRESS NOTICE

10 July 2014

Fiscal sustainability report – July 2014

Ageing population to put pressure on public finances

Our fourth* Fiscal sustainability report *shows that further tax increases or spending cuts are likely to be needed after the current fiscal consolidation to help meet the costs of an ageing population.

Once a year, we produce an analysis of the sustainability of the UK's public finances. Our approach to this issue is twofold:

- first, we look at the fiscal impact of *past* public sector activity, as reflected in the assets and liabilities that it has accumulated on its balance sheet; and

- second, we look at the potential impact of *future* public sector activity, by projecting how spending and revenues may evolve over the next 50 years – and the impact this would have on public sector net debt.

The National Accounts balance sheet measure shows that at the end of 2013-14 the UK's public sector net debt (PSND) has reached £1,273 billion – 76.1 per cent of GDP. The Whole of Government Accounts (WGA) balance sheet measure, produced on commercial accounting principles, shows net liabilities of £1,630 billion at end-March 2013 – 102 per cent of GDP – up £282 billion since end-March 2012.

The WGA measure of net debt rose more sharply than PSND in 2012-13. This was partly because the WGA liabilities include an estimate of the net present value of future public service pension payments arising from past employment, which increased by £166 billion. While some of that reflected an increase in the expected future flow of pension payments – due to an additional year of public employment – much reflected the fact that the projected flow has been converted into a one-off upfront net present value sum using a lower discount rate. The WGA also include PFI capital costs (little changed at £37 billion) and provisions (up by £18 billion due to higher expected costs of future nuclear decommissioning and clinical negligence settlements, and more likely costs of future oil and gas field decommissioning).

Our long-term projections show that population ageing will put upward pressure on public spending. Our central projection shows spending excluding debt interest rising from 34.3 per cent of GDP at the end of our medium-term forecast in 2018-19, to 39.3 percent of GDP by 2059-60, before falling slightly to 39.1 per cent of GDP in

2063-64. That would represent an overall increase of 4.8 per cent of GDP or £79 billion in today's terms. The main drivers are spending on health, state pensions and long-term care. Demographic factors will have less impact on revenues than on spending. Non-interest revenues are projected to be broadly flat across the projection period as a share of GDP.

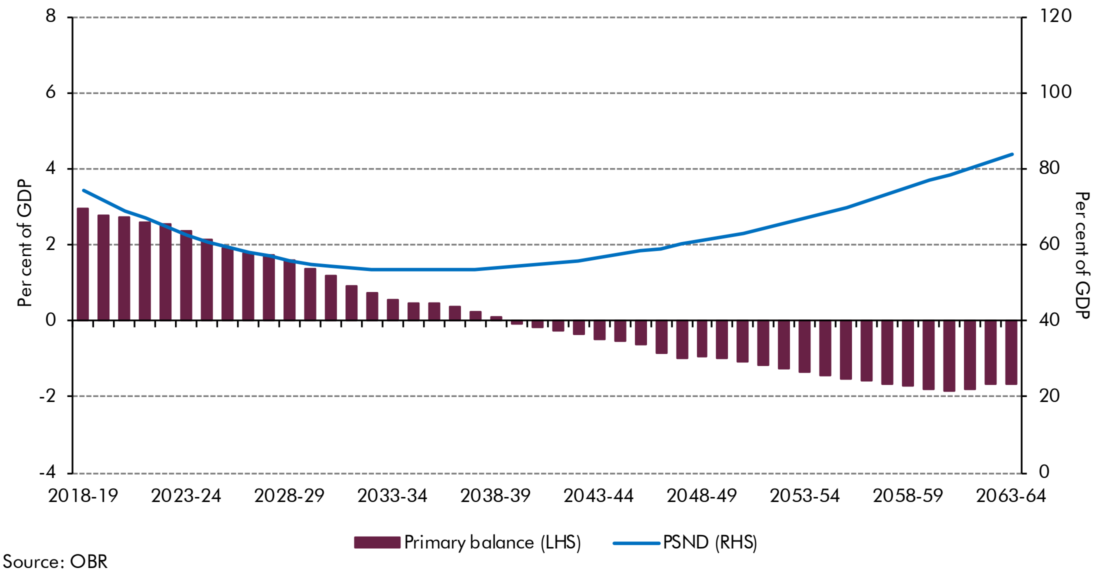
Our central projections show public spending increasing as a share of national income beyond the medium-term forecast horizon, gradually rising towards and then exceeding receipts. As a result, the primary budget balance (the difference between non-interest revenues and spending that is the key to the public sector's debt dynamics) is projected to move from a surplus of 3.0 per cent of GDP in 2018-19 to rough balance in the late-2030s and then to a deficit of 1.7 per cent of GDP in 2063-64 – an overall deterioration of 4.7 per cent of GDP, equivalent to £77 billion in today's terms.

Some financial transactions also have long-term effects on the public finances. We project that the direct flows related to student loans will add 5.4 per cent of GDP to net debt in 2018-19, rising to 9.8 per cent of GDP by the mid-2030s, and then falling to 8.3 per cent of GDP in 2063-64.

Taking our projections for spending, revenues and financial transactions into account, PSND is projected to fall from its medium-term peak of around 79 per cent of GDP in 2015-16 to just over 53 per cent of GDP in the mid-2030s, before rising to 84 per cent of GDP in 2063-64. Beyond this point, debt would remain on a rising path.

Needless to say, there are huge uncertainties around these projections. We therefore test these sensitivities using a number of different scenarios. The eventual increase in PSND would be greater than in our central projection if long-term interest rates turned out to be higher relative to economic growth, if the age structure of the population was older, or if net inward migration (which is concentrated among people of working age) was lower than in our central projection.

Chart: Central projection of the primary balance and public sector net debt



Source: OBR

Non-demographic factors are also likely to affect tax revenues. Our long-term projections of North Sea revenues again show that they are likely to fall to below 0.1 per cent of GDP over the coming decades. Our central projection suggests around £40 billion will be raised in North Sea revenues in total between 2019-20 and 2040-41, down by around a quarter relative to last year's report. The majority of this change is explained by lower production in our latest medium-term forecast, which knocks through to our long-term projection. Our projections of transport tax revenues – from fuel duty and vehicle excise duty – show that improvements in vehicle fuel efficiency are likely to put downward pressure on revenues over time.

Our analysis of longer-term pressures on revenue streams suggests that governments will, over time, need to find new sources of revenue to maintain the overall ratio of revenue to national income, let alone to meet the spending pressures from an ageing population.

In our central projections, and most of the variants we calculate, on current policy we would expect the budget deficit to widen sufficiently over the long term to put public sector net debt on a continuously rising trajectory as a share of national income. This would be unsustainable.

Summary indicators of sustainability can be used to quantify the tax increases and/or spending cuts necessary to return the public finances to sustainability. We focus on the 'fiscal gap' measure that asks how big a permanent spending cut or tax increase would be necessary to move public sector net debt to a particular desired level at a particular chosen date. The current Government does not have a long-term target for the debt to GDP ratio. So, for illustration, we calculate the additional fiscal tightening necessary from 2019-20 to return PSND to 20, 40 or 60 per cent of GDP at the end of our projection horizon in 2063-64.

Under our central projections, a once-and-for-all policy tightening of 0.9 per cent of GDP in 2019-20 (£15 billion in today's terms) would see the debt ratio reach 40 per cent of GDP in 2063-64. But this is less than the 1.7 per cent of GDP required to stabilise debt over the longer term and so the debt ratio would continue rising beyond the target date. Tightening policy by 0.3 per cent of GDP a decade would see the debt ratio fall more slowly to begin with, but the overall tightening would be large enough to stabilise the debt ratio at around the target level and prevent it from taking off again. These fiscal gap estimates are slightly lower than in last year's report, reflecting the slightly smaller primary deficit and lower PSND at the end of the projection period. Targeting debt ratios of 20 and 60 per cent of GDP would require larger and smaller adjustments respectively.

Alongside the *FSR*, we have published two working papers that look in detail at aspects of our economy forecast.

- *Working paper No.5 – Output gap measurement: judgement and uncertainty* considers the definitions of the output gap and the uncertainties to which output gap estimates are subject. A range of estimation methods are presented. Revisions owing to the arrival of new data are on average of the same magnitude as the output gap itself. Uncertainty arising from data revisions is found to make a smaller contribution. Since no single estimation method is likely to be reliable at all times, it is suggested that a wide range of evidence should be considered when reaching a judgement about spare capacity and the cyclically adjusted fiscal position; and

- *Working paper No.6 – Forecasting house prices* presents the technical detail behind the house price model we adopted in our December 2013 forecast and the broader approach we take to forecasting house prices. The model results suggest that, absent policy effects, distributional issues or income constraints, both house prices and household debt are likely to rise faster than income for some time yet. As the model alone is unlikely to capture short-term price dynamics fully, particularly when house price inflation is changing rapidly, it is used in conjunction with near-term indicators and is ultimately subject to the judgement of the Budget Responsibility Committee.

Notes

1. The Office for Budget Responsibility is the UK's independent fiscal watchdog – responsible for producing forecasts for the economy and the public finances, assessing progress against the Government's fiscal targets, and reporting on long-term fiscal sustainability.
2. All of the documents published by the OBR today are available on our website at: http://budgetresponsibility.org.uk/
3. Questions about the *Fiscal sustainability report*, or the Working Papers that are being published at the same time, should be sent to OBRpress@obr.gsi.gov.uk.