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Fiscal sustainability report 2014

Robert Chote
Chairman

10 July 2014

Preamble

- OBR set up in 2010 to provide independent and authoritative analysis of the UK public finances
- BRC responsible for the conclusions, helped by full-time OBR staff and departments/agencies
- Chancellor saw draft conclusions on 26 June and final report 24 hours prior to release
- No pressure to change conclusions

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Two-fold approach in this 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 any need for tightening

Some 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

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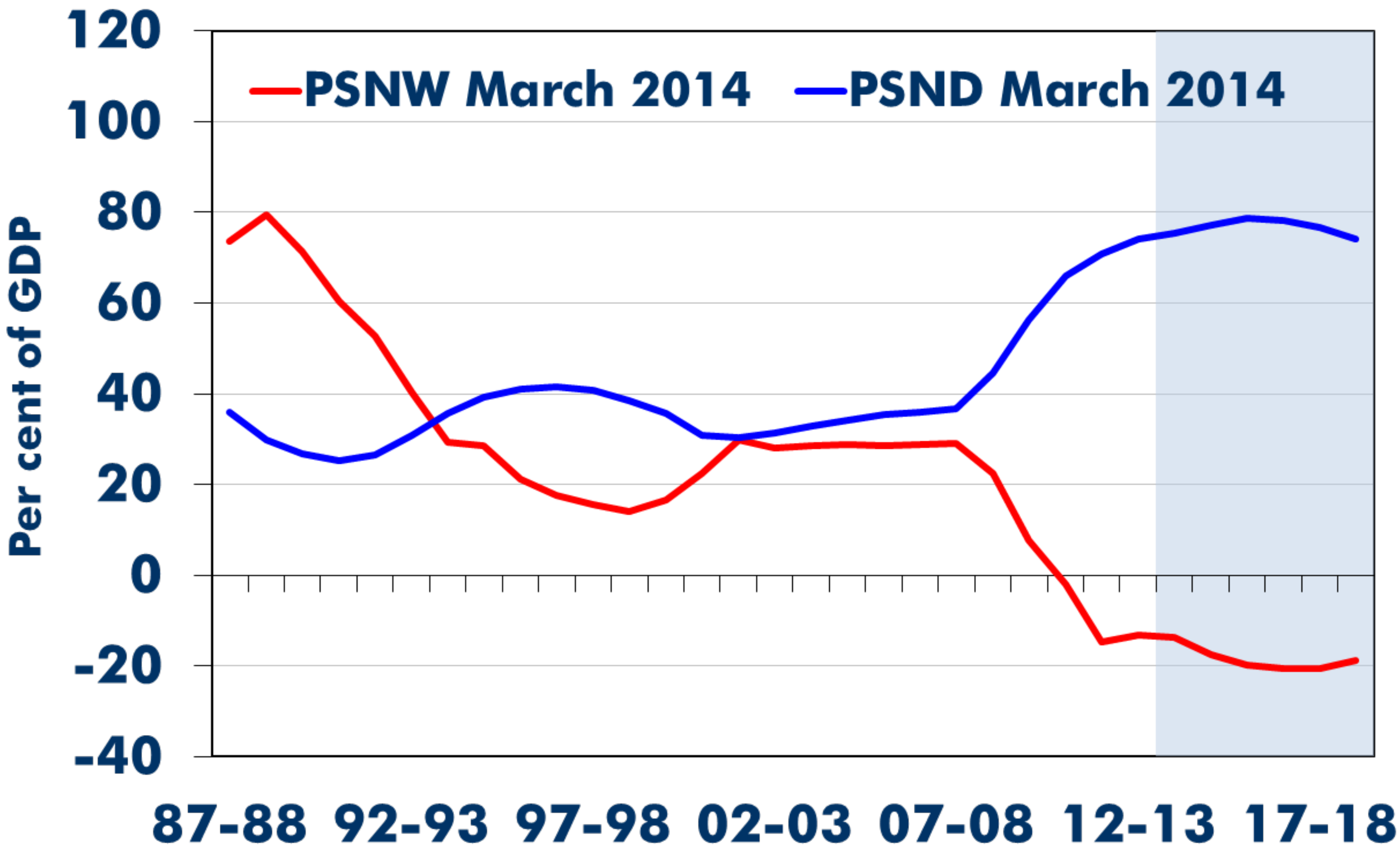
Public sector net debt and net worth



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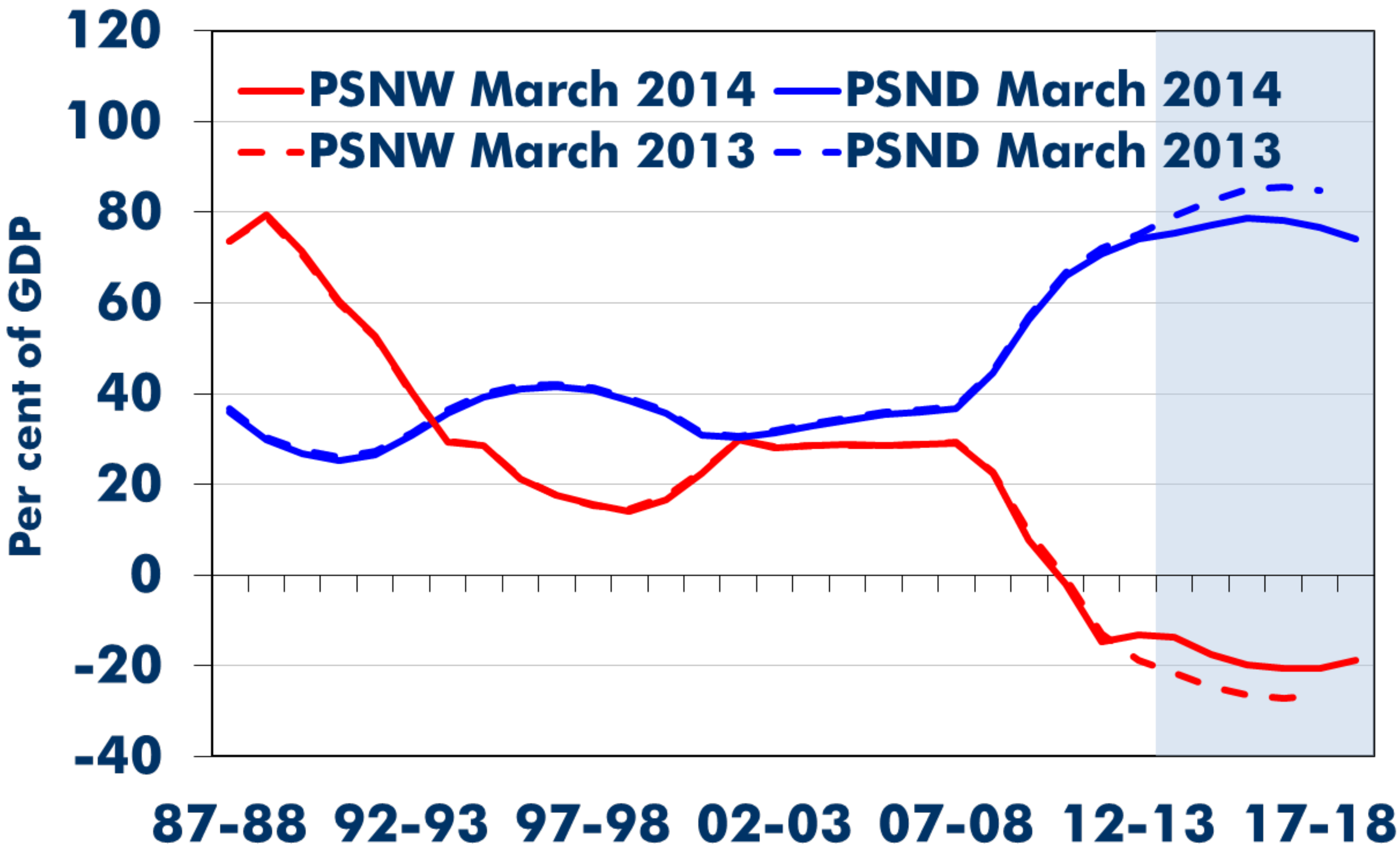

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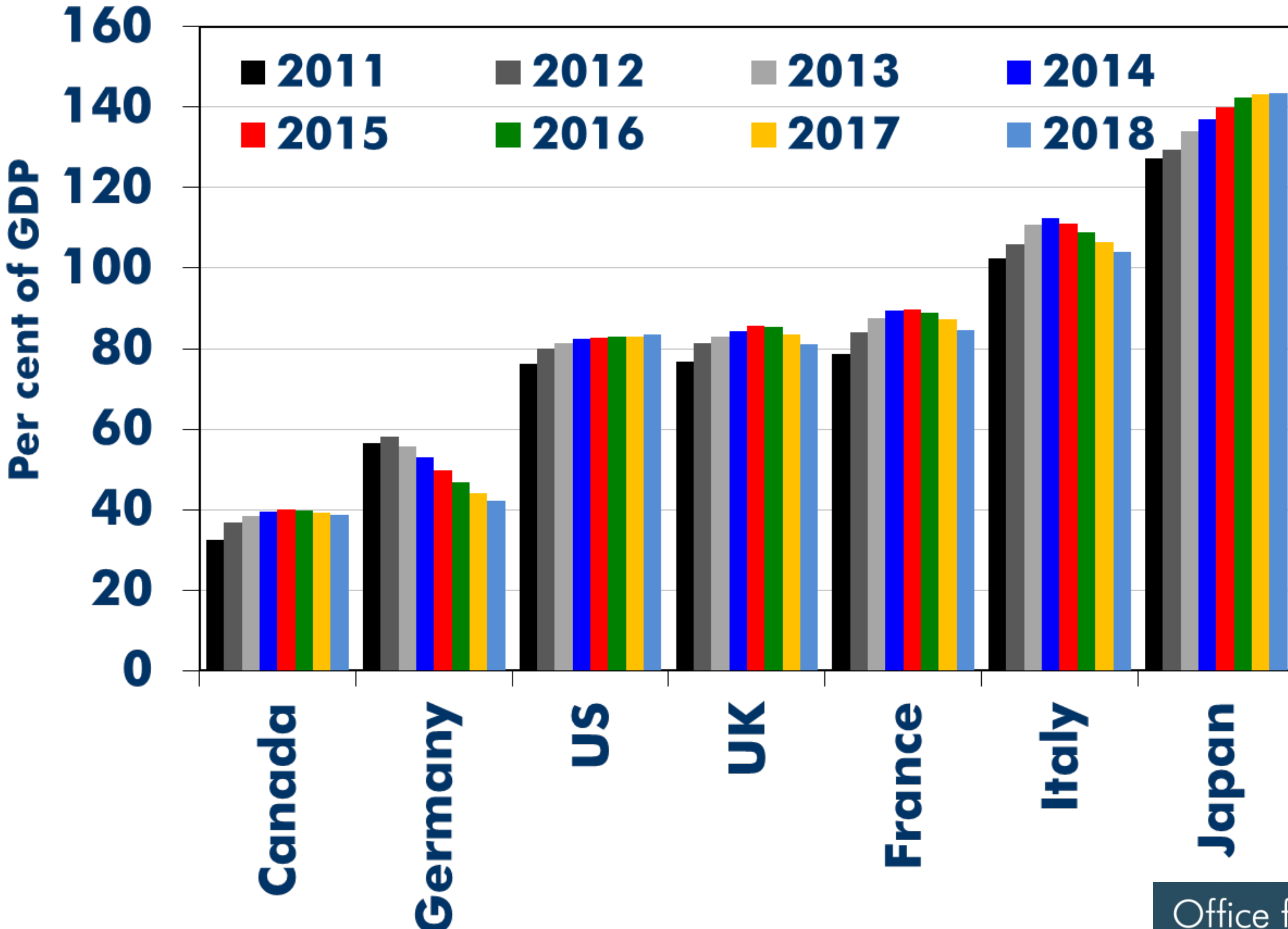
General government net debt (IMF)



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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
- Latest version for 2012-13
- Published for four years

From net debt to WGA net liabilities

£ billion	2011-12	2012-13	*Change*
Public sector net debt		**1,185**	
Remove:			
B&B/NRAM		-74	
Add:			
Public service pension liabilities		+1,172	
Provisions		+131	
Capital liabilities for PFI		+32	
Fixed assets		-794	
Other:		-21	
WGA net liabilities		**1,630**	

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From net debt to WGA net liabilities

£ billion	2011-12	2012-13	*Change*
Public sector net debt	**1,106**	**1,185**	***+79***
Remove:			
B&B/NRAM	-83	-74	*+9*
Add:			
Public service pension liabilities	+1,006	+1,172	*+166*
Provisions	+113	+131	*+18*
Capital liabilities for PFI	+31	+32	*0*
Fixed assets	-793	-794	*-1*
Other:	-33	-21	*+12*
WGA net liabilities	**1,347**	**1,630**	**+282**

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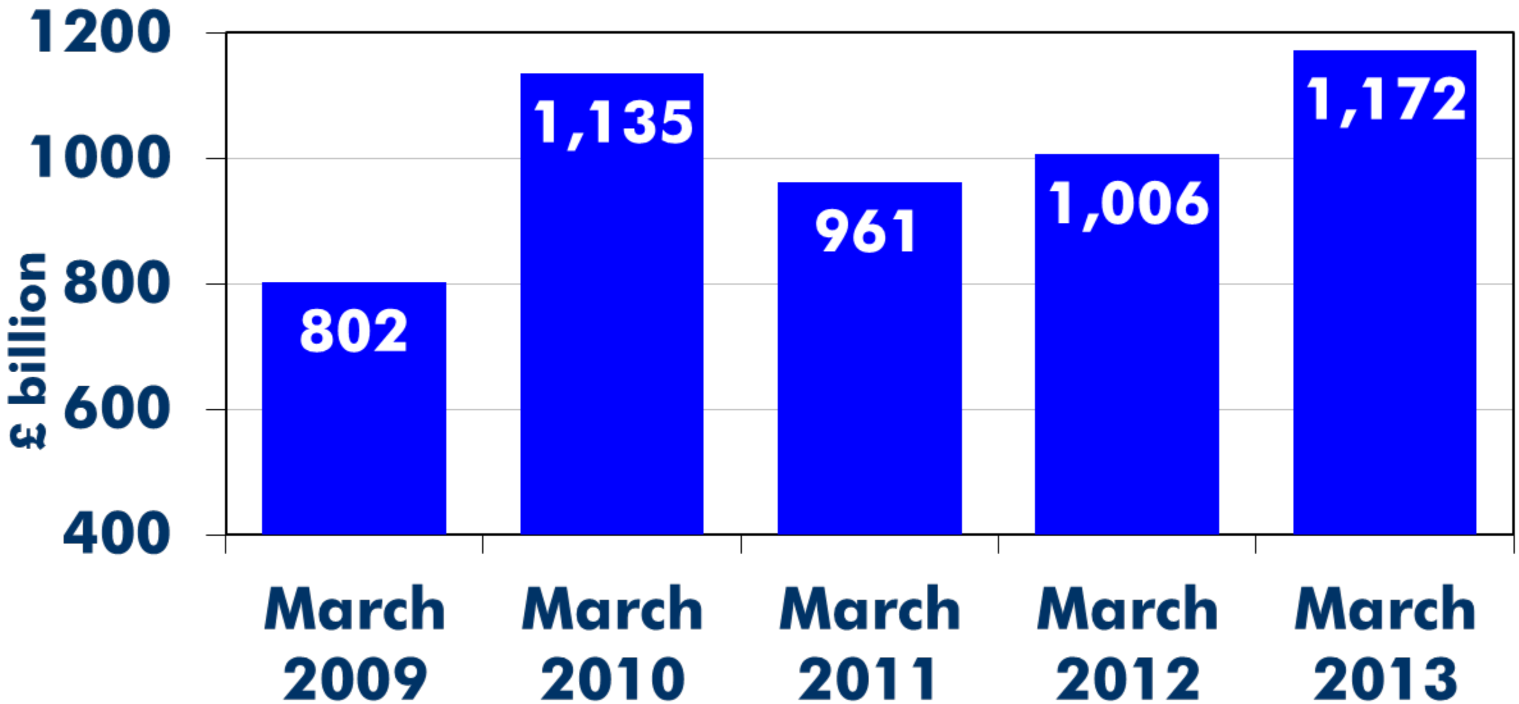
Public service pension liabilities in WGA



- Public service pension liabilities rose by £166bn in 2012-13

- Includes:
  - £57bn from lower discount rate
  - £40bn from adjusting assumptions to outturns
  - £28bn from Royal Mail transfer

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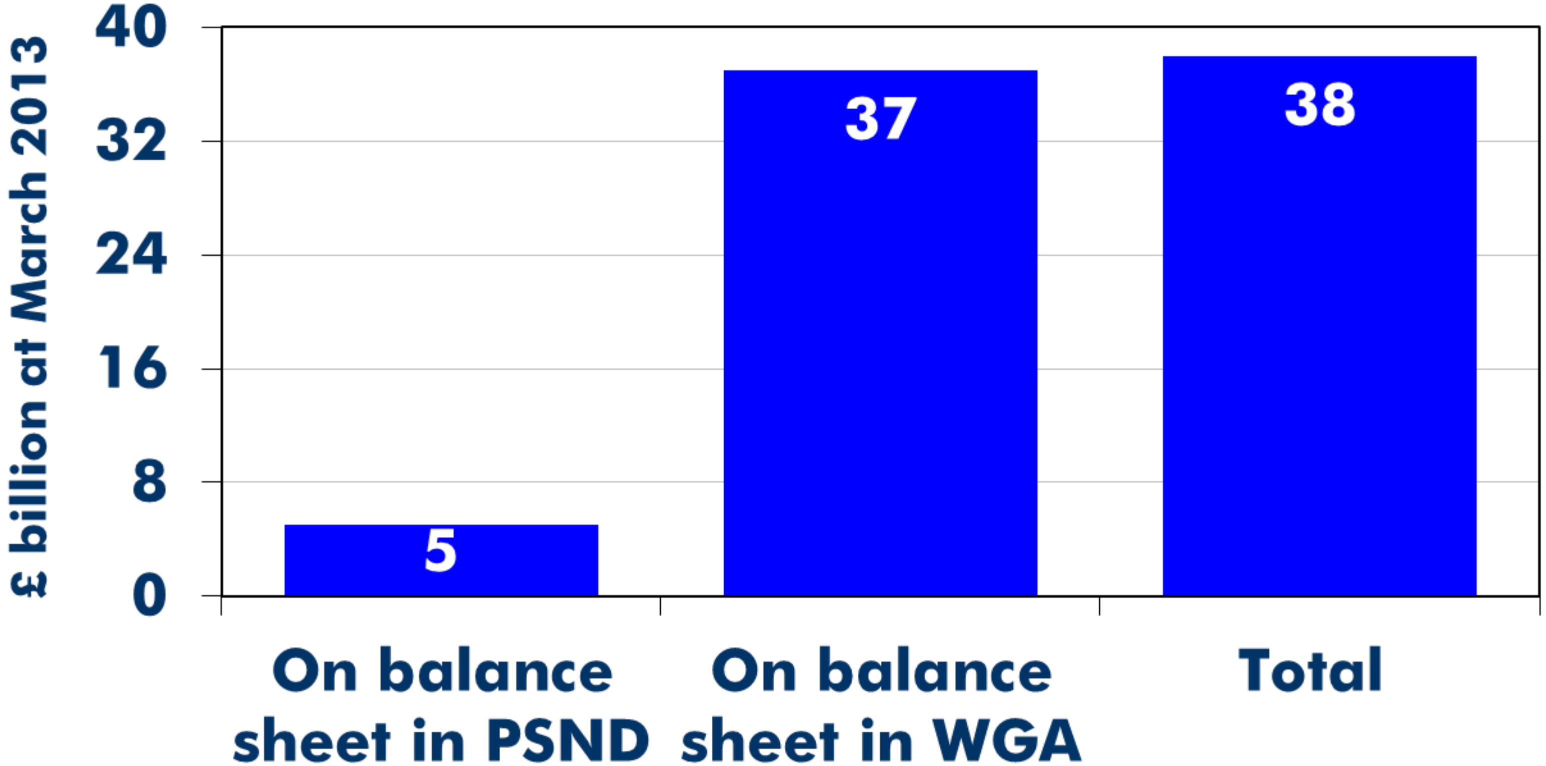
PFI capital liabilities



- If all PFI had been financed through conventional debt finance PSND could be 2% of GDP higher.

- Government setting PFI total spending limit of £70bn from 15-16 to 19-20: £51bn as of March 2013

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Provisions

- For costs that the public sector is not certain to incur, but where the probability is greater than 50%
- These totalled £113bn in 2011-12
- During the following year £33bn were added (plus £4bn notional borrowing costs), £13bn used (much as expected) and £6bn removed
- So provisions rose £18bn on the year to £131bn
  - Nuclear decommissioning up £6bn to £70bn
  - Clinical negligence up £5bn to £24bn
  - Using lower discount rates adds £5bn in total
- £13bn expected to be used in 2013-14

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Contingent liabilities in WGA

- Contingent liabilities capture costs that the public sector may incur in the future, but where the probability is less than 50%. Guide to risk.

- Down from £101bn to £88bn at end 2012-13

- £20bn contingent liability from oil and gas field decommissioning removed

  – now £4bn provision and remainder deemed unquantifiable

New contingent liabilities and risks

- Various policy measures may create WGA contingent liabilities and guarantees in the future
  - Including various guarantee schemes
- Many are likely to be ‘remote contingent liabilities’
- But chances of crystallising correlated, especially if housing and financial sector downturn
- Change in risk/pressure profile: away from financial interventions towards nuclear decommissioning and clinical negligence

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From stocks to flows

- Provisions and contingent liabilities are useful risk indicators and cross-checks
- NA and WGA might suggest government is bust
- But they omit future flows from future activity:
  - Future spending on public services and transfers
  - Future tax revenues
- So look at 50 year flow projections to judge sustainability

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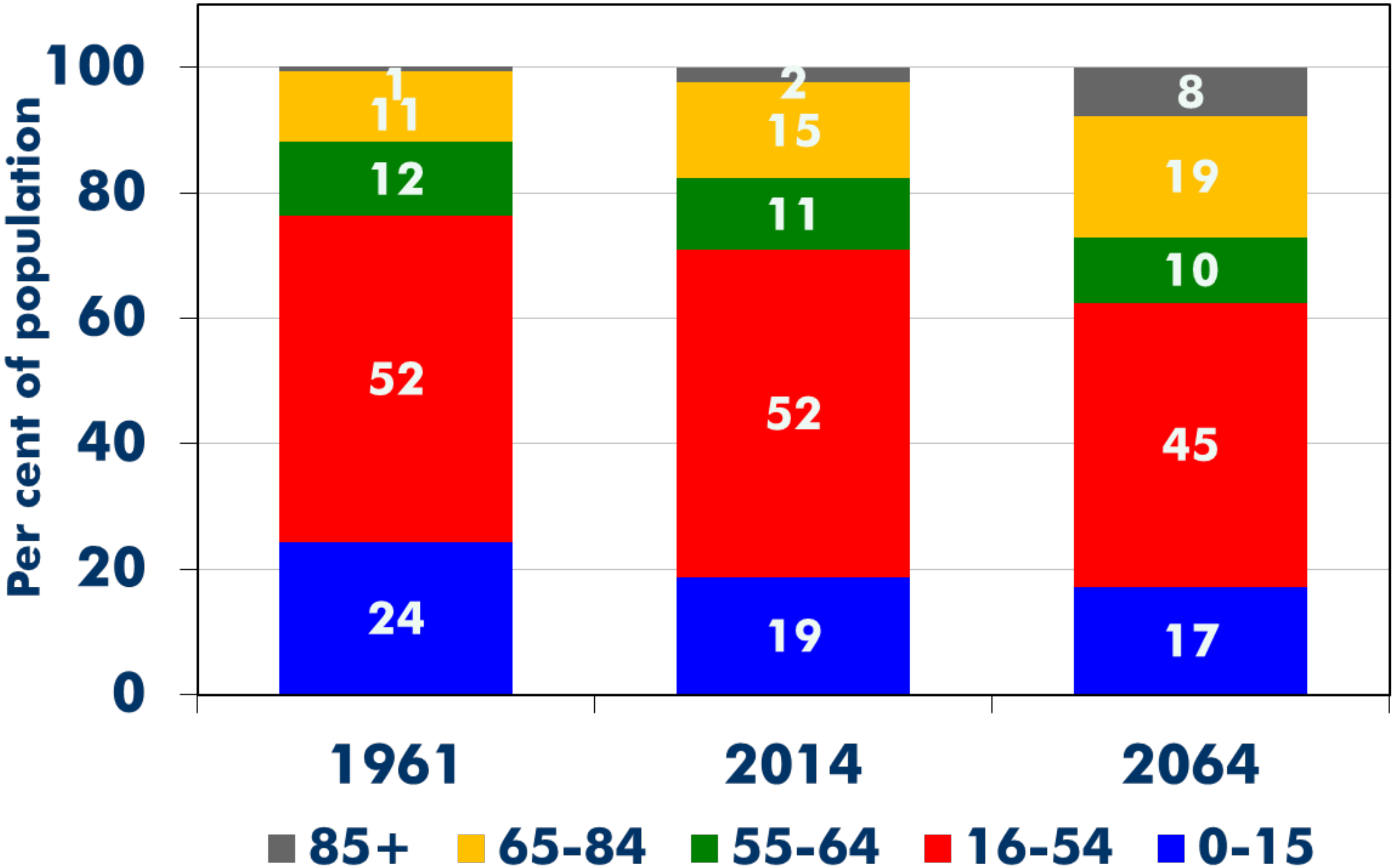
Assumptions: demography



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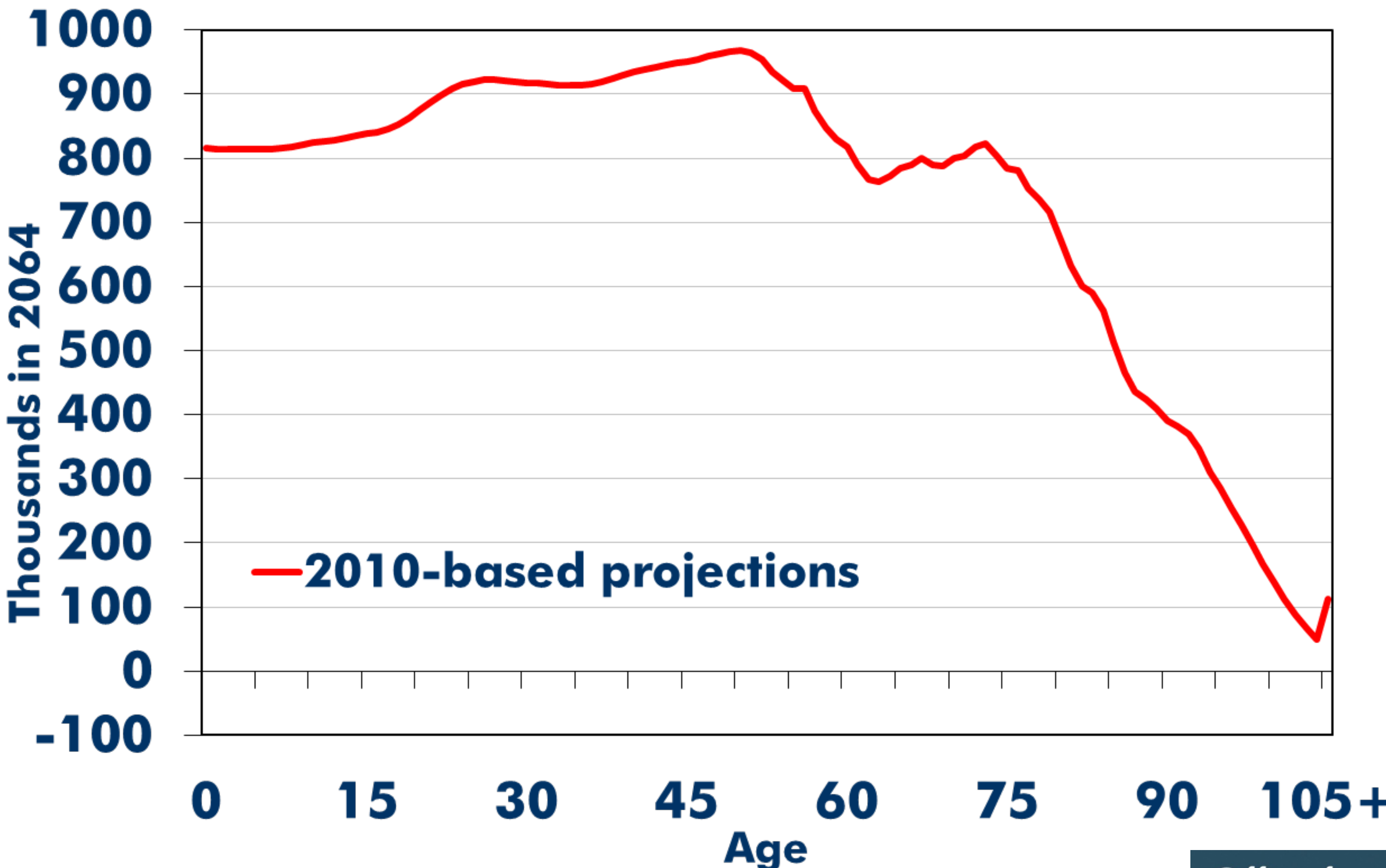

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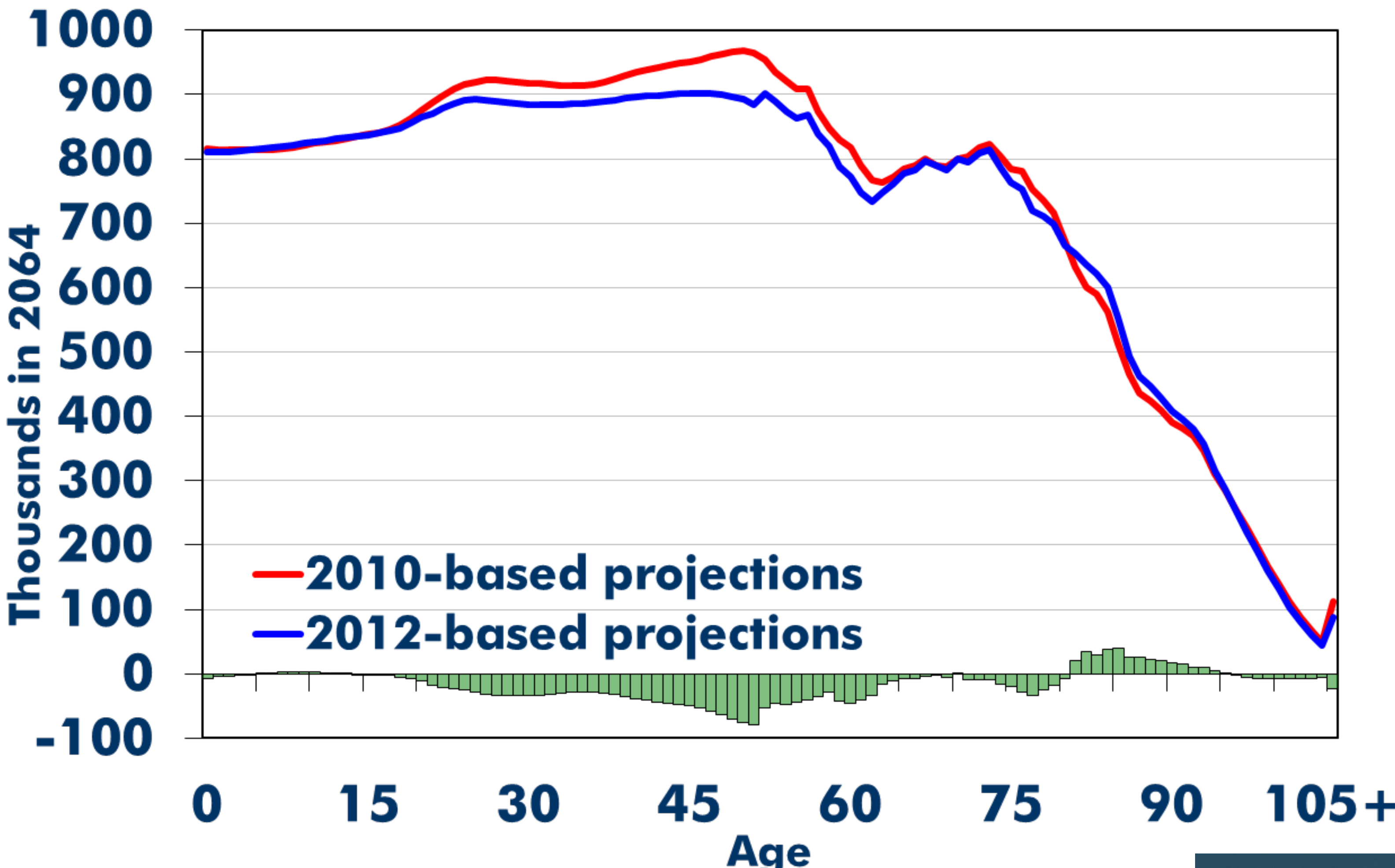

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Assumptions: economy

- Whole economy productivity growth averages 2.2% a year, in line with long-run experience
- CPI inflation at 2%, consistent with Bank of England target
- GDP deflator rises 2.2% a year
- Interest rate on gilts slightly higher than GDP growth rate in long term – so small primary surplus needed to stabilise debt-to-GDP ratio

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Assumptions: ‘unchanged policy’

- Income tax / NICs allowances rise by earnings post 2018-19
- Most working age benefits rise by earnings post 2018-19
- State pension subject to ‘triple lock’
- Public services spending rises with per capita GDP, adjusted for age composition of the population

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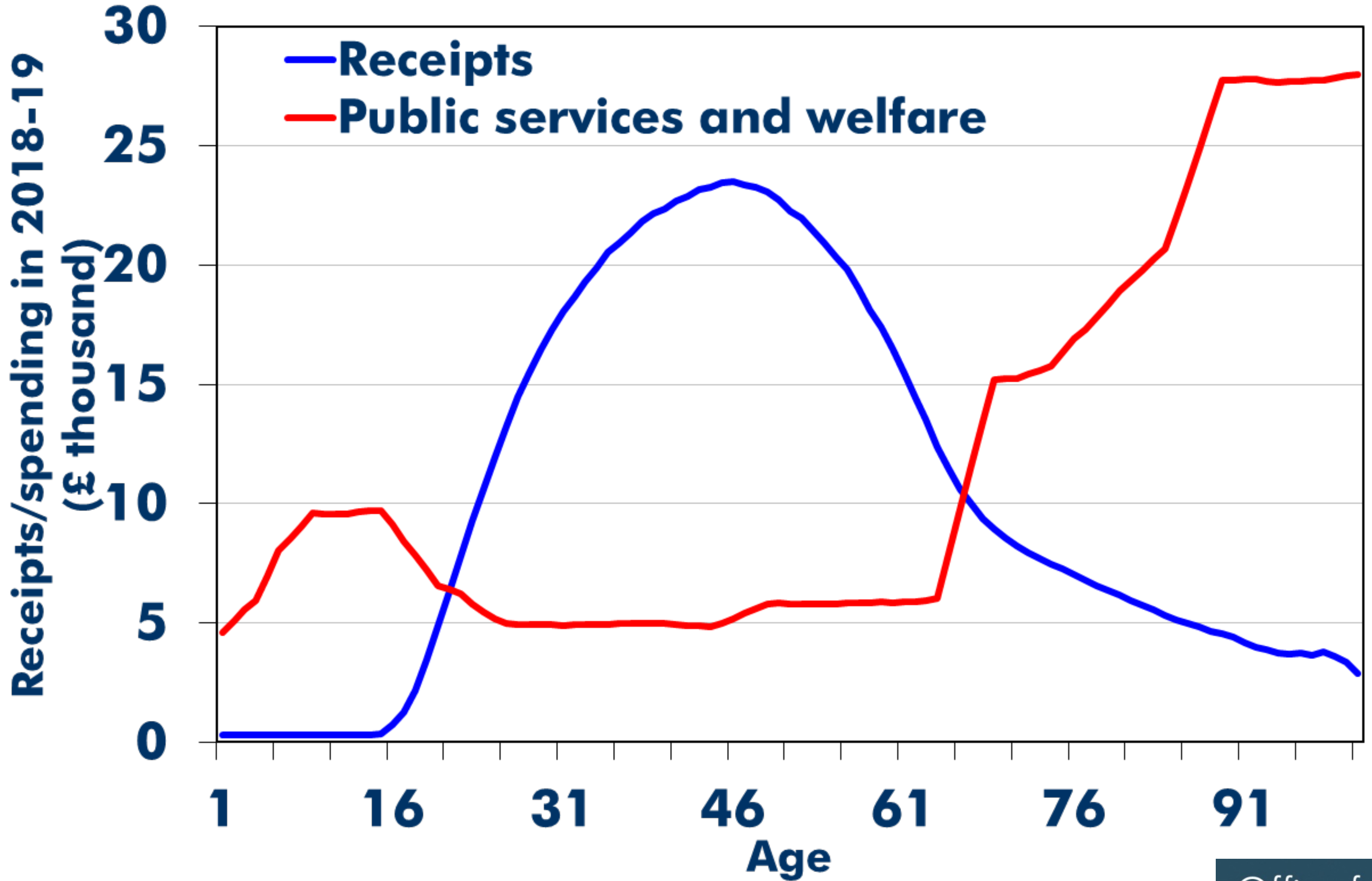
Revenues and public spending by age



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Policy changes since last year

- Additional year of spending cuts in 2018-19
  - Cuts structural spending by 1.0 per cent of GDP
- Link State Pension Age to life expectancy
  - People should expect to spend on average a third of their adult life (beginning at age 20) in receipt of the state pension, with at least 10 years' notice provided and changes being phased in over two years

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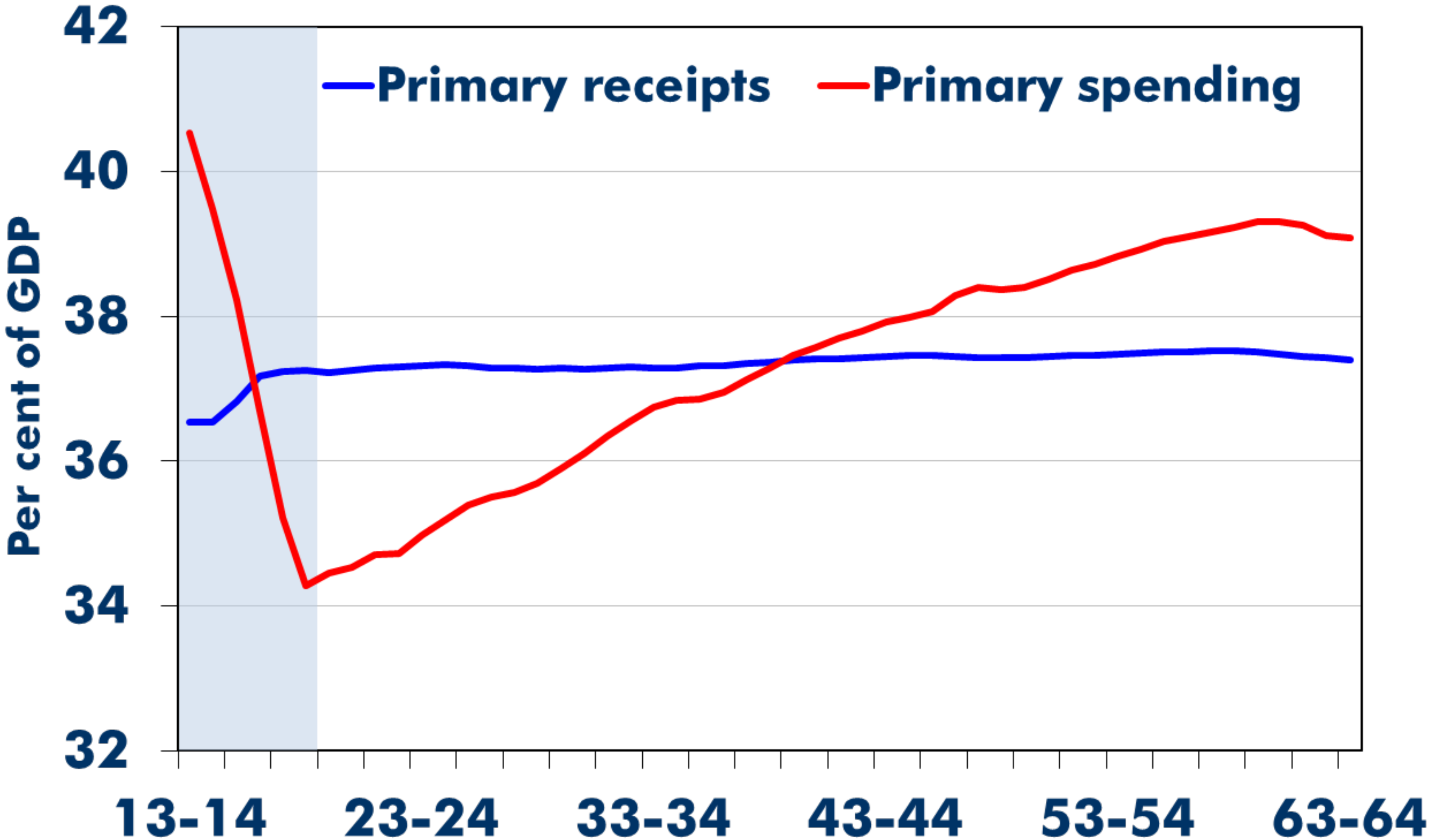
State Pension Age

	Year in which the rise is fully implemented			
	Legislated	**Young age**	**Central**	**Old age**
66	**2020**	**2020**	**2020**	**2020**
67	**2028**	**2028**	**2028**	**2028**
68	**2046**		**2036**	**2031**
69			**2049**	**2034**
70			**2063**	**2037**
71				**2040**
72				**2045**
73				**2051**
74				**2057**
75				**2064**
2063 pop (m)				
Aged 75+		*10.2*	*12.6*	*15.4*
Aged 100+		*0.1*	*0.5*	*1.1*

Revenue and spending projections



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Spending

- Non-interest spending rises 4.8% of GDP (£79bn) between end of medium-term forecast and 2063-64
- Main drivers: health, state pensions and long-term care, all as a result of the ageing population
- Main offset: falling cost of public service pensions, thanks to falling public employment and reforms
- Increase about 0.5% of GDP bigger than last year
  - Output gap closing no longer reduces spending
  - More age-related spending: more old and young people
  - Offset: 18-19 spending cut and SPA change

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State pension costs in 2063-64

	% GDP
FSR 2013	**8.5**
Modelling, including re-costing single tier	+0.0
New population projection	+0.3
Linking SPA to life expectancy	-0.9
FSR 2014	**8.0**

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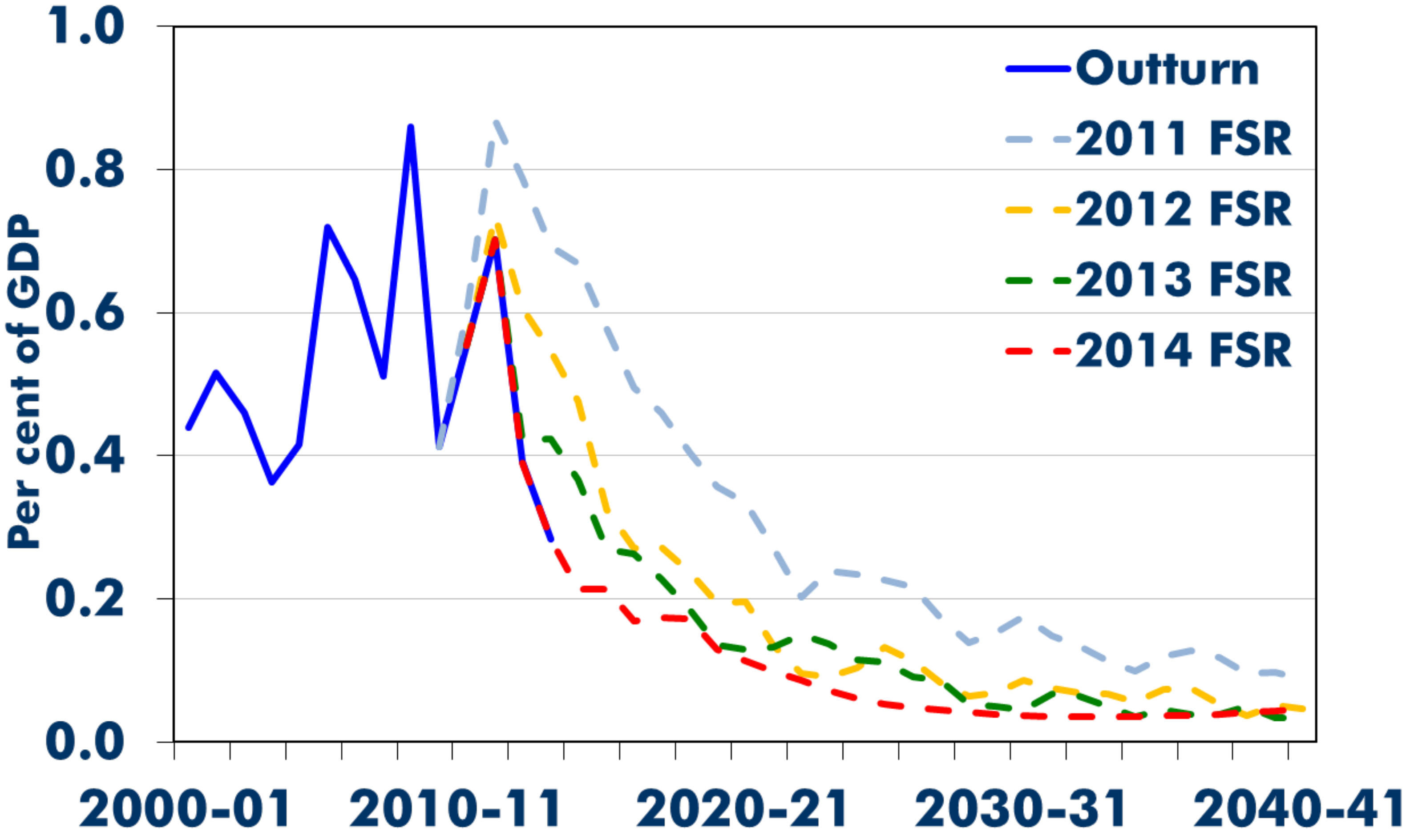
Receipts

- Non-interest receipts broadly flat as % GDP between end of medium-term forecast and 2063-64
- Ageing has much less impact on receipts
- Bigger increase last year thanks to pick-up in taxes as above-trend growth uses up spare capacity
- Oil and gas receipts in long term decline

Oil and gas receipts I



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Oil and gas receipts II

- Central projection assumptions (beyond 5 years)
  - Production falls 5% a year (7.8% average since 1999)
  - Oil prices rise with whole economy inflation
  - Operating and capital expenditure falls with production

- Central projection results
  - Receipts total £39.3bn from end medium term to 2040-41
  - Down £12.6bn since last year, of which
    - £9bn lower production
    - £1bn lower sterling oil prices (more than offsets higher gas prices)
    - £6bn new data on field ownership; RFES; more losses
    - Partly offset by £4bn from lower expenditure
  - From 2013-14 to 2040-41 receipts down £20.6bn to £61.6bn

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Oil and gas receipts III

	Average, % GDP (19-20 to 40-41)	Total £ billion
Central projection	0.06	39.3
EIA low prices	0.02	16.3
EIA high prices	0.16	111.1
Low production	0.04	26.4
High production	0.07	54.3

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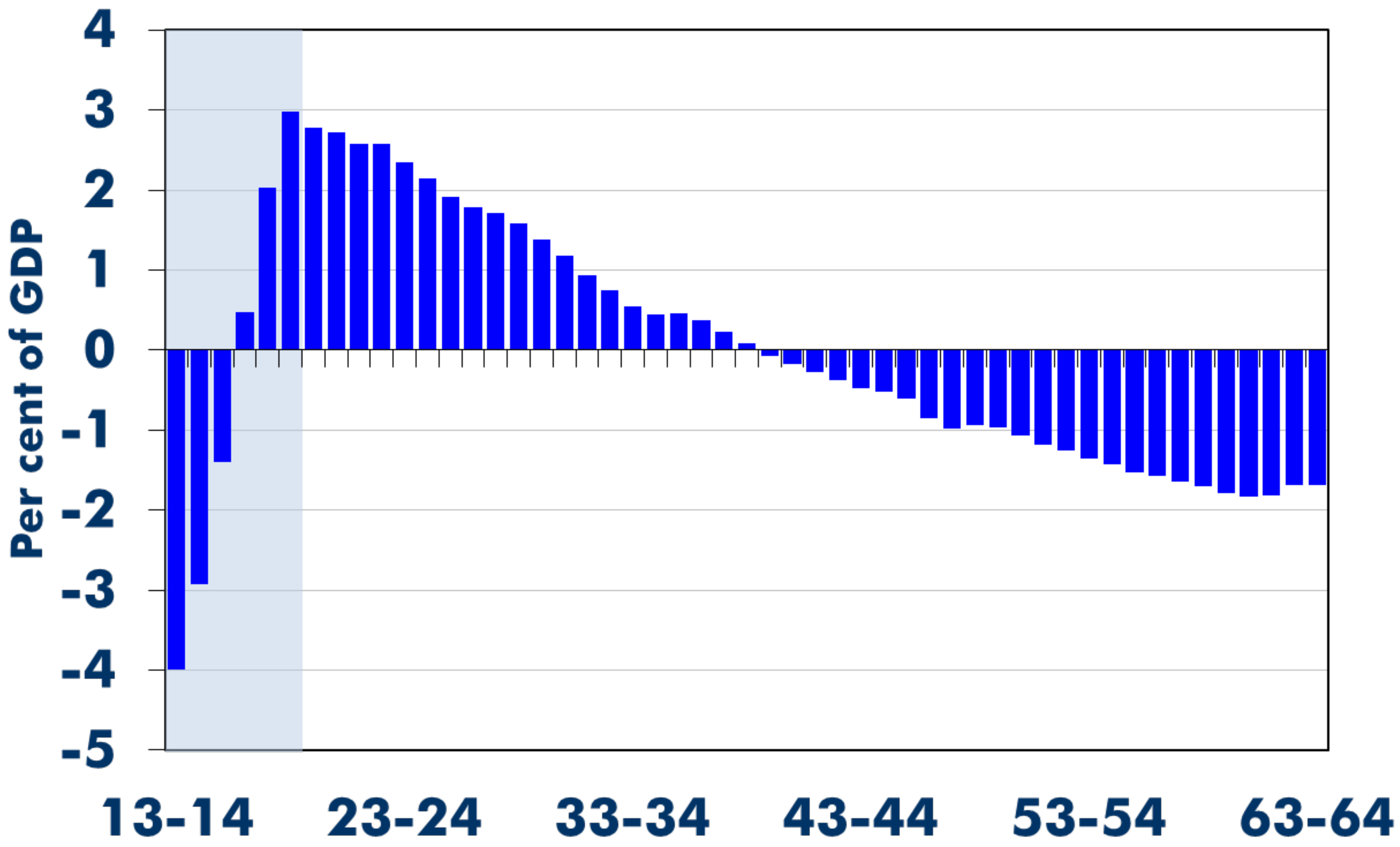
Primary budget balance



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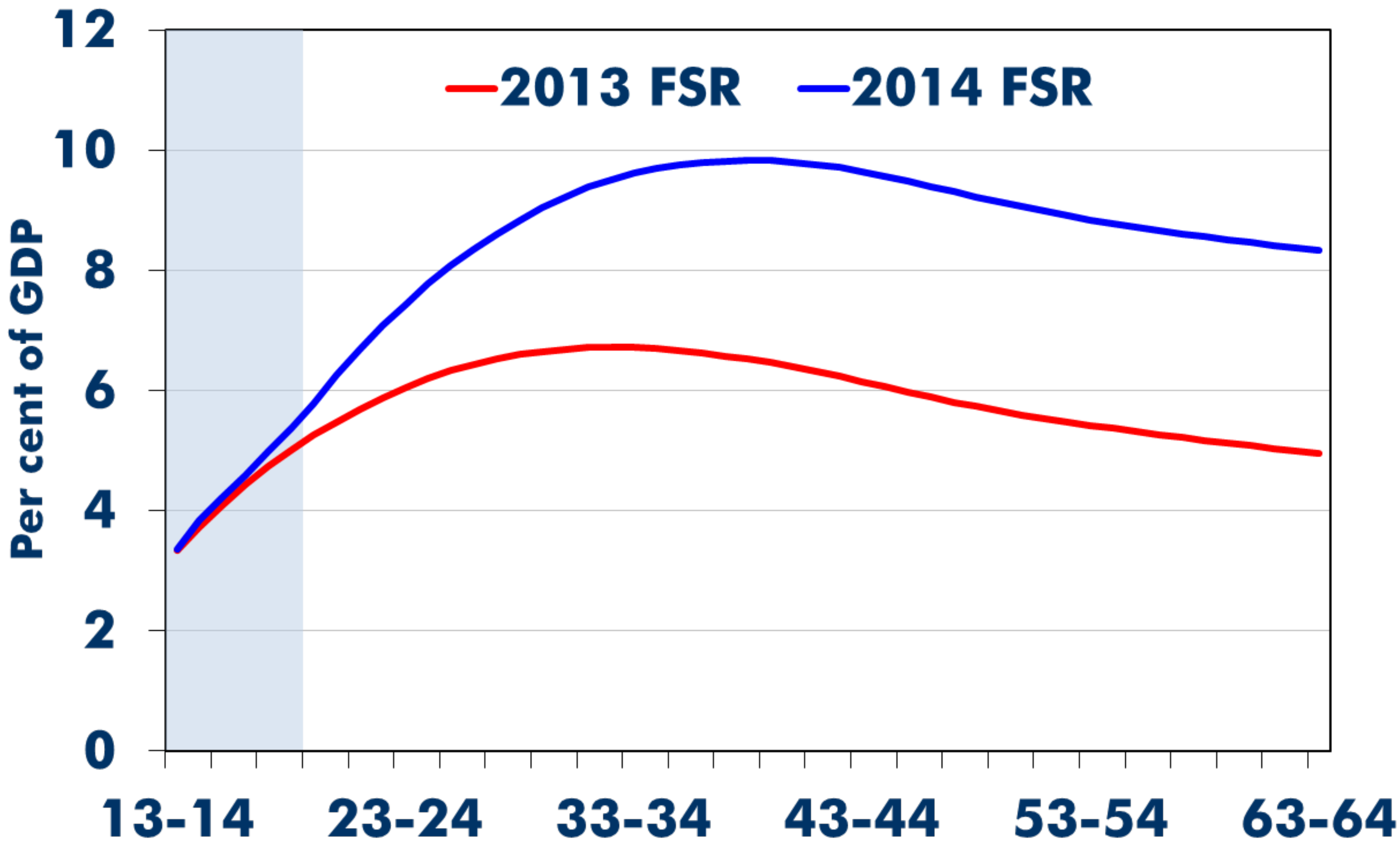
Impact of student loans on net debt



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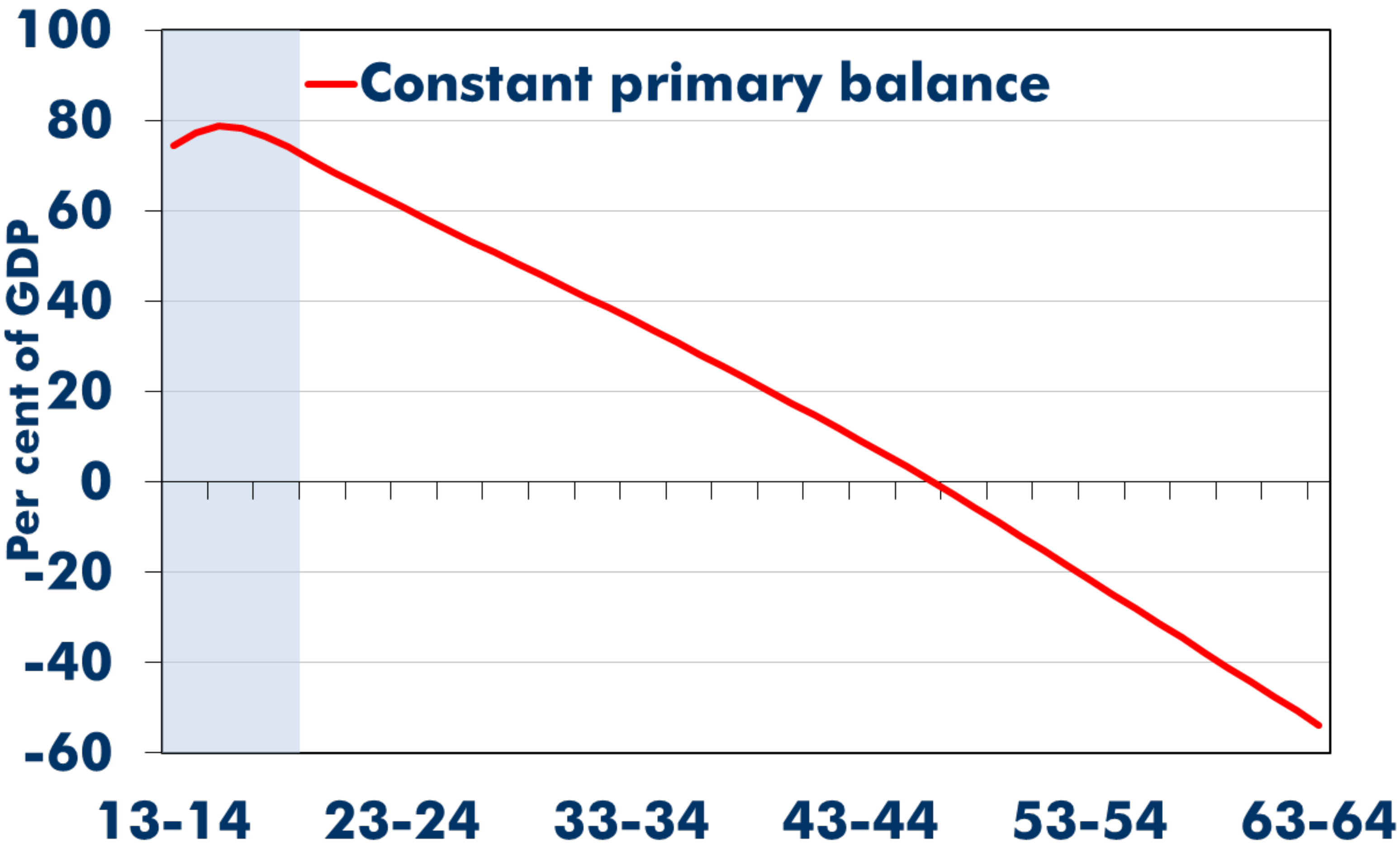
Public sector net debt



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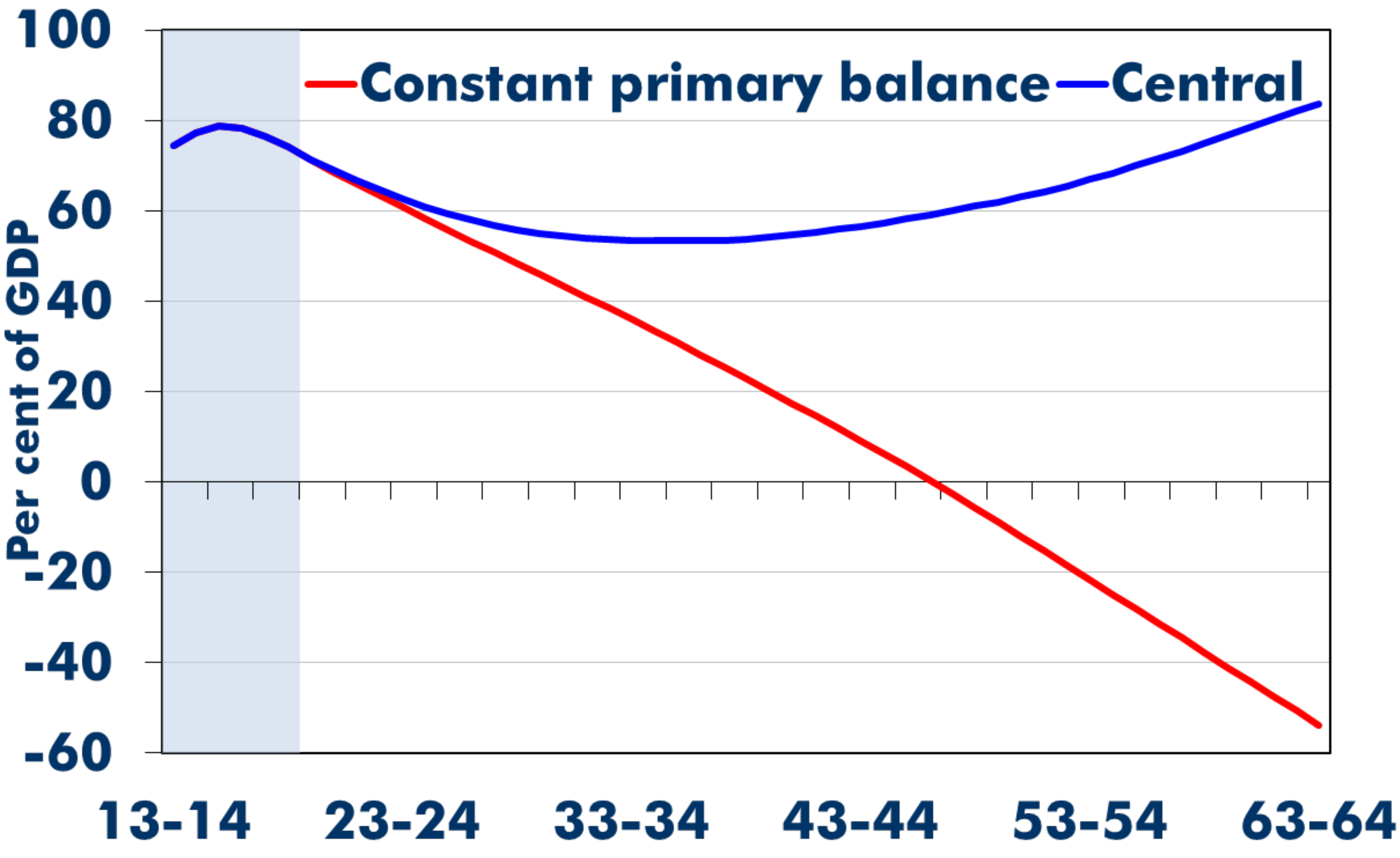

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What has changed since last year?

% GDP in 2063-64	**Primary balance**	**Net debt**
FSR 2013	**-1.9**	**101**
Pre measures		
Demographics		
Medium term structural deficit		
Measures		
Spending cuts in 18-19 etc		
SPA link to life expectancy		
FSR 2014	**-1.7**	**84**

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What has changed since last year?

% GDP in 2063-64	**Primary balance**	**Net debt**
FSR 2013	**-1.9**	**101**
Pre measures	***-1.8***	***49***
Demographics	*-1.4*	*44*
Medium term structural deficit	*-0.4*	*5*
Measures		
Spending cuts in 18-19 etc		
SPA link to life expectancy		
FSR 2014	**-1.7**	**84**

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What has changed since last year?

% GDP in 2063-64	Primary balance	Net debt
FSR 2013	**-1.9**	**101**
Pre measures	***-1.8***	***49***
Demographics	*-1.4*	*44*
Medium term structural deficit	*-0.4*	*5*
Measures	***2.0***	***-66***
Spending cuts in 18-19 etc	*1.1*	*-49*
SPA link to life expectancy	*0.9*	*-17*
FSR 2014	**-1.7**	**84**

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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
  - Long run interest rates higher relative to long run growth rates
  - Health spending had to rise to offset weak productivity growth
  - Health & education spending move with demographics from 2015-16 onwards

- Higher net migration would improve outlook as immigrants more likely to be of working age

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Migration: changes since last year

- Our central projections uses ONS ‘low migration’ variant
  - ONS revised down from 140k to 105k : weakens fiscal position
- Any given amount of net inward migration less fiscally beneficial this year, as latest projections suggest immigrants spend less of their working lives in UK
- Reducing inward migration to 90K would increase structural deficit by 0.2% GDP in 2063-64
- Keeping inward migration around 225k would reduce budget deficit by c. 1.2% GDP in 2063-64

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Achieving sustainability

- Fiscal gap: PSND of 40% of GDP in 2063-64
  - Permanent tightening of 0.9% of GDP from 2019-20 or 0.3% of GDP each decade in central scenario (slightly less than last year)
  - Permanent tightening of 1.2% of GDP from 2019-20 if health and education spending assumed to move with per capita GDP age-adjusted from 2015-16 to 2018-19
  - Permanent tightening of 3.5% of GDP from 2018-19 if per capita health spending rises 3.4% a year in real terms to compensate to likely weakness of productivity growth

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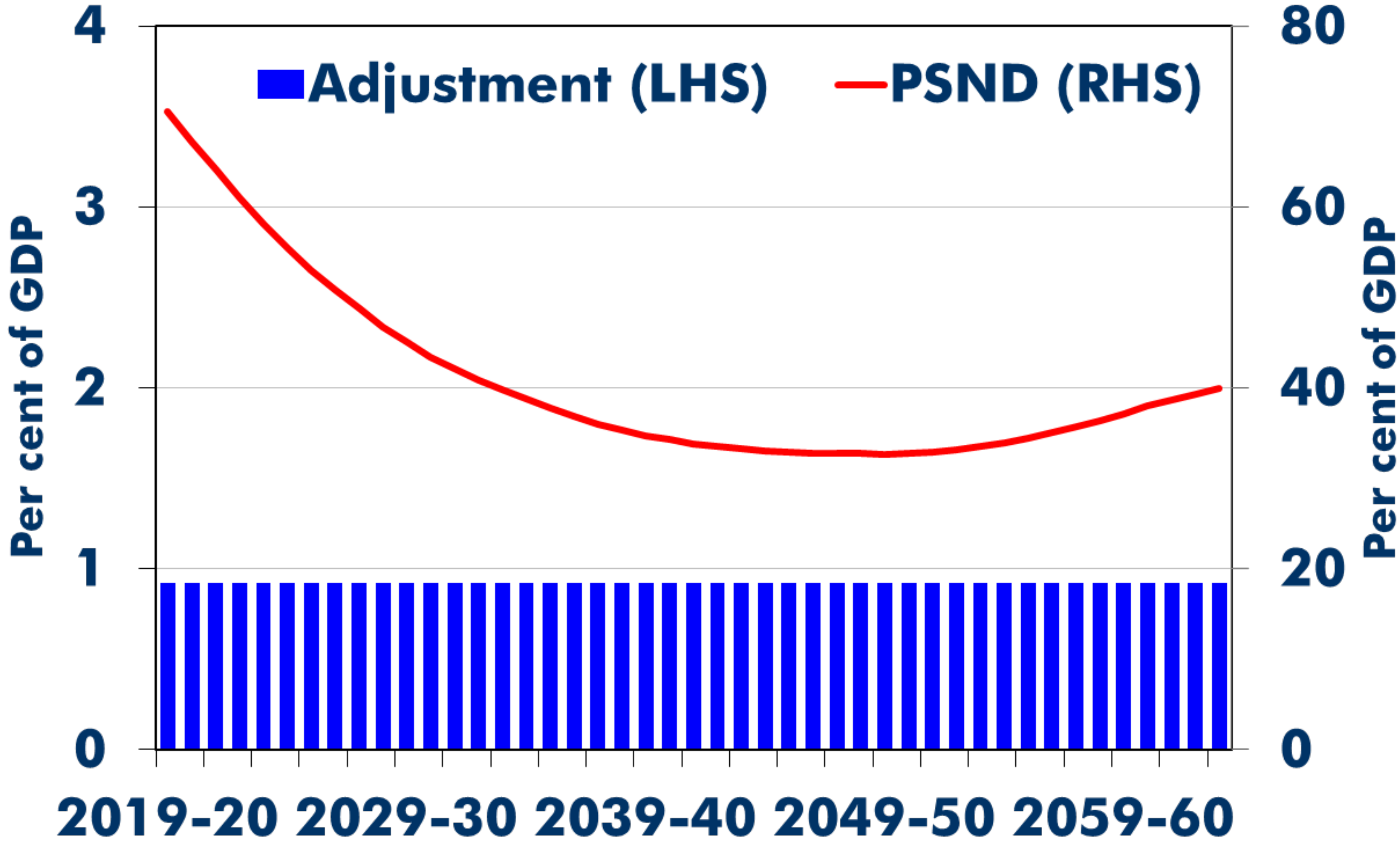
Timing the response: one-off



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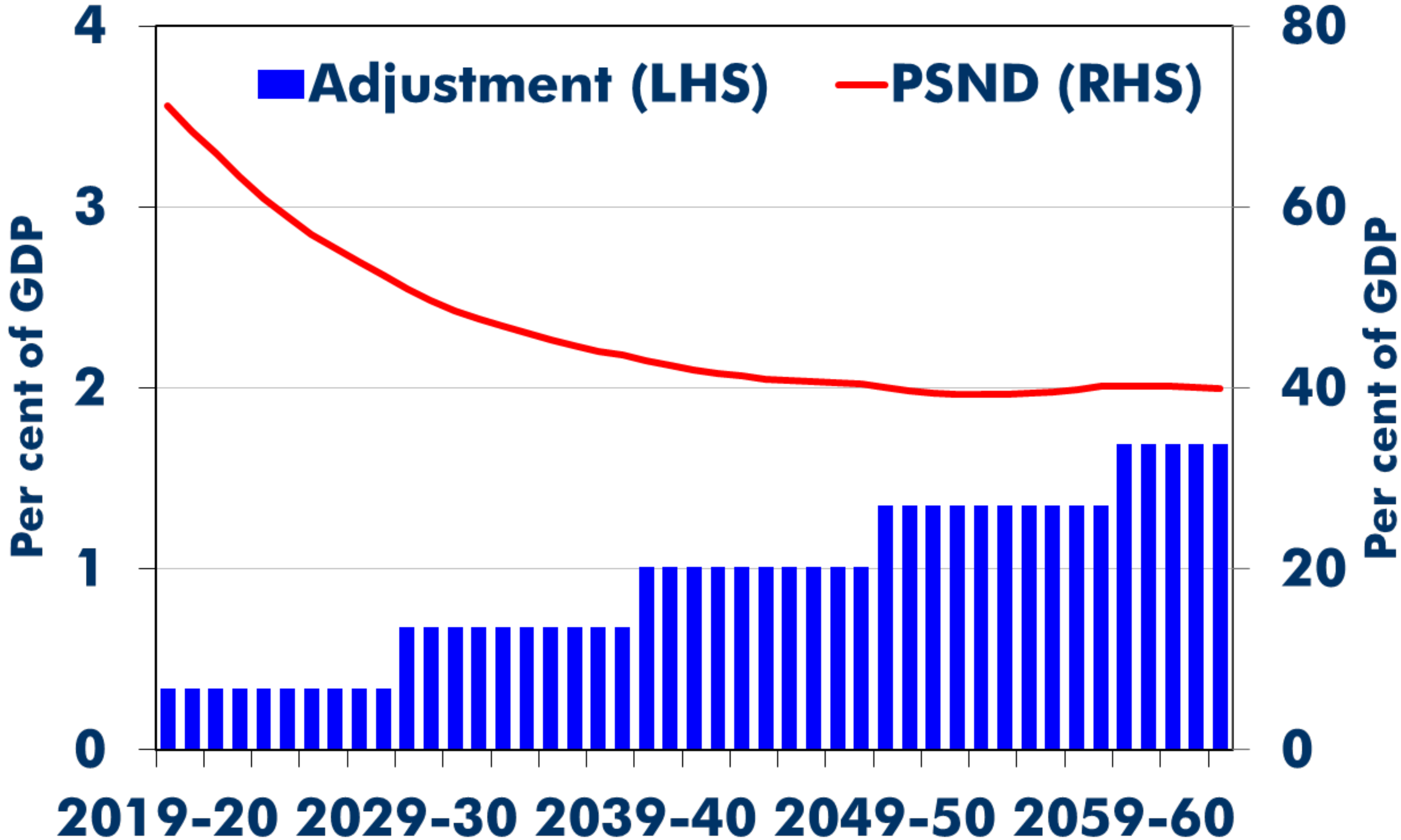
Timing the response: decade by decade



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Conclusions

- Ageing puts pressure on public finances
- Some additional tightening likely to be needed after current consolidation
- Position slightly better than last year
  - Population projections and medium term less favourable
  - But offset by extra spending cuts and extra SPA increases
- Huge uncertainty and UK by no means unique

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