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Fiscal sustainability report 2011

Robert Chote
Chairman

13 July 2011

Preamble

- OBR set up in 2010 to provide independent and authoritative analysis of the UK public finances
- FSR is our first assessment of the long-term health and sustainability of the public finances, complementing our medium-term forecasts
- BRC responsible for the conclusions, drawing on time and expertise of full-time OBR staff, government departments and advisory panel
- Chancellor received draft analysis on 30 June and final report on 12 July
- No pressure to change conclusions from ministers or apparatchiks
- All substantive contacts with ministers logged on website

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Our approach in the report

- Look at the impact of past government activity
  - Measures of assets and liabilities on the public sector balance sheet
  - Make use of new Whole of Government Accounts (WGA) data

- Look at the potential impact of future government activity
  - 50-year projections of spending, revenues and financial transactions
  - Make projections of budget deficits and public sector net debt
  - Judge sustainability and quantify possible need for fiscal tightening

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  - 50-year projections of spending, revenues and financial transactions
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- Four points:
  - 50-year projections inevitably have big uncertainties around them
  - ‘Unchanged policy’ not always straightforward to define
  - First 5 years of projections consistent with March EFO forecast
  - Focus on next Parliament and beyond, not current consolidation

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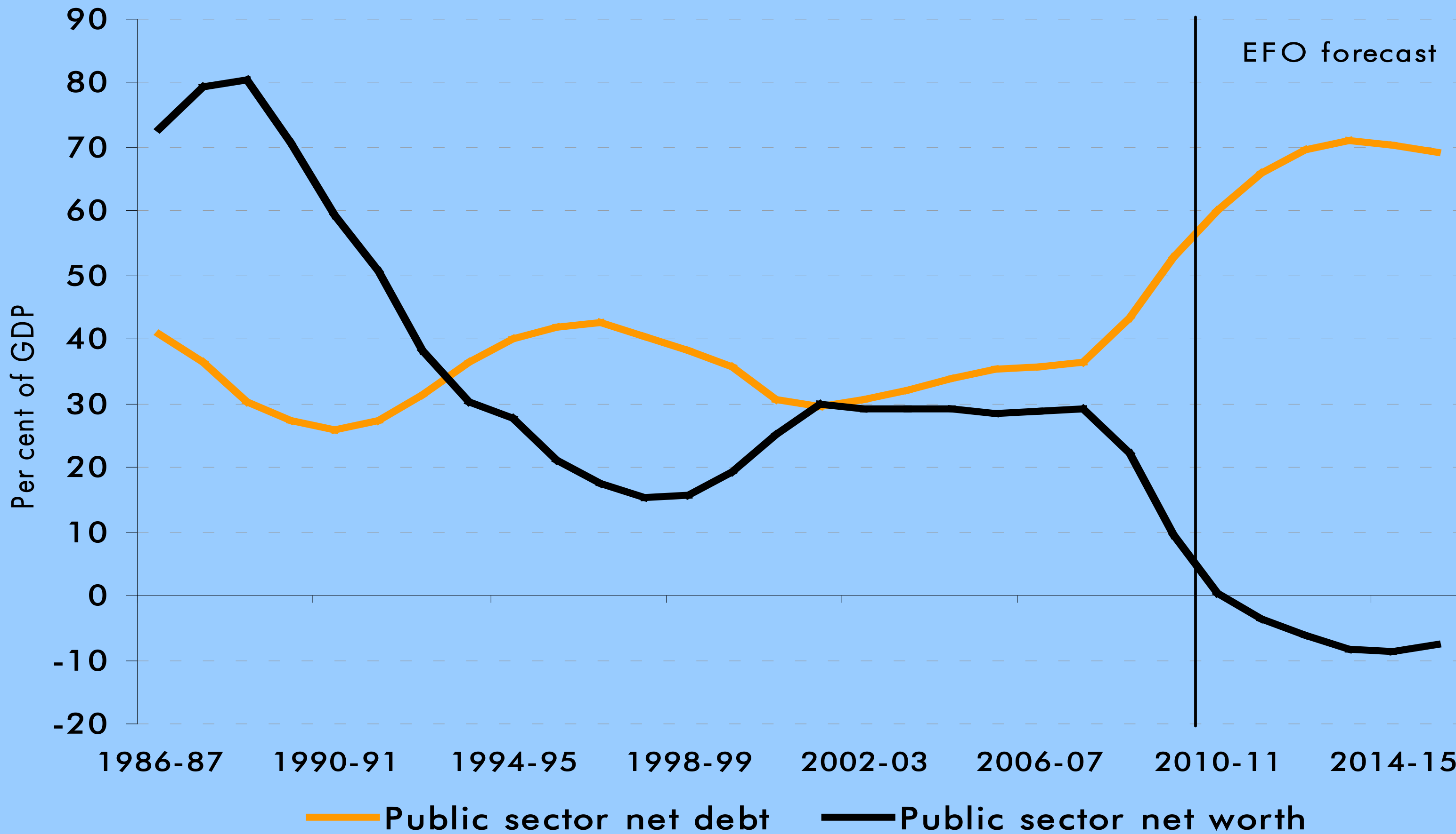
Public sector net debt and net worth



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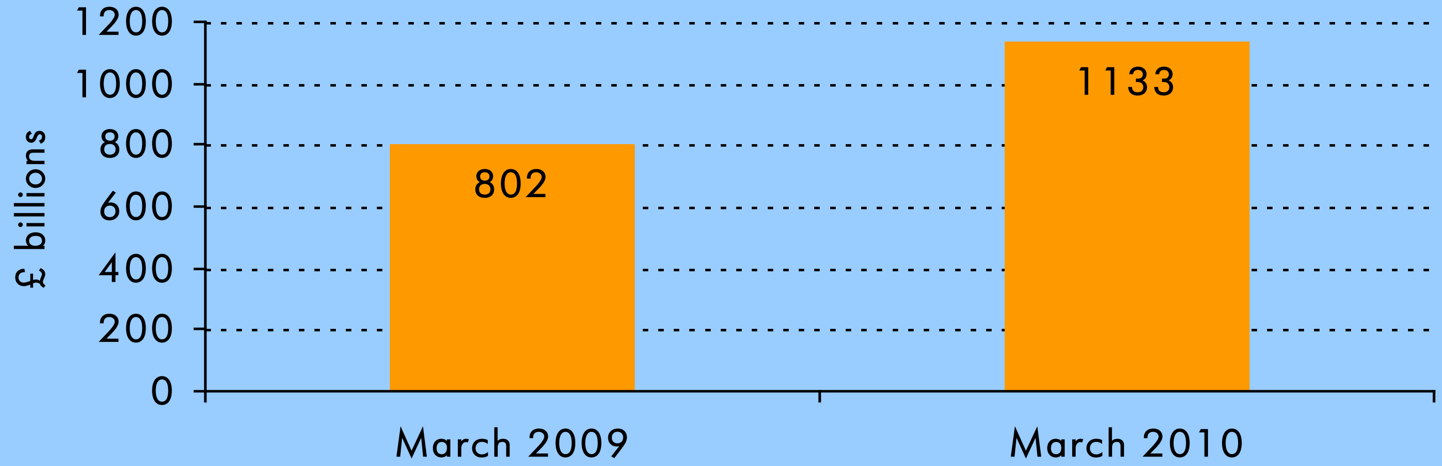
Public service pension liabilities in WGA



- Public service pension liabilities rose £331 billion in 2009-10
- But almost £260 billion of the increase reflected a fall in the discount rate from 3.2% to 1.8%, not higher expected payments
- The discount rate will rise again to 2.9% in 2010-11

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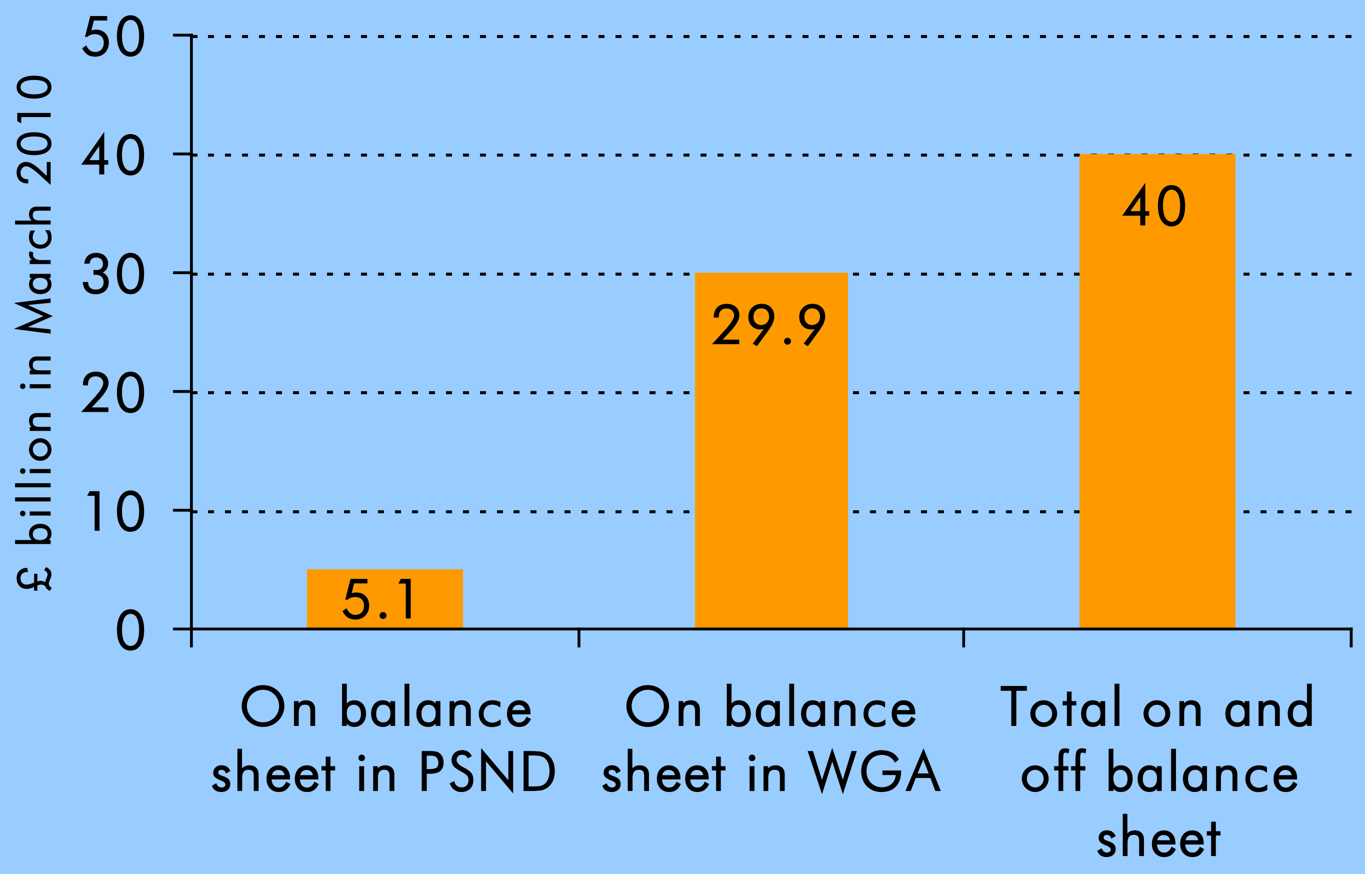
Private finance initiative capital liabilities



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Provisions and contingent liabilities

- WGA liabilities include £107bn (7% of GDP) of **provisions**
  - Costs where probability of incurring less than 100% but more than 50%
  - Main items: nuclear decommissioning and clinical negligence
- WGA also notes £207bn (14.4% of GDP) of **contingent liabilities**
  - Costs where probability of incurring is less than 50% but more than 0%
  - Main items: £175bn of financial sector guarantees and undertakings

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Stocks and flows

- WGA are a welcome boost to transparency with wider coverage
- They will become increasingly useful as time series builds up
- But balance sheets alone of limited value in judging sustainability
- They omit future flows arising 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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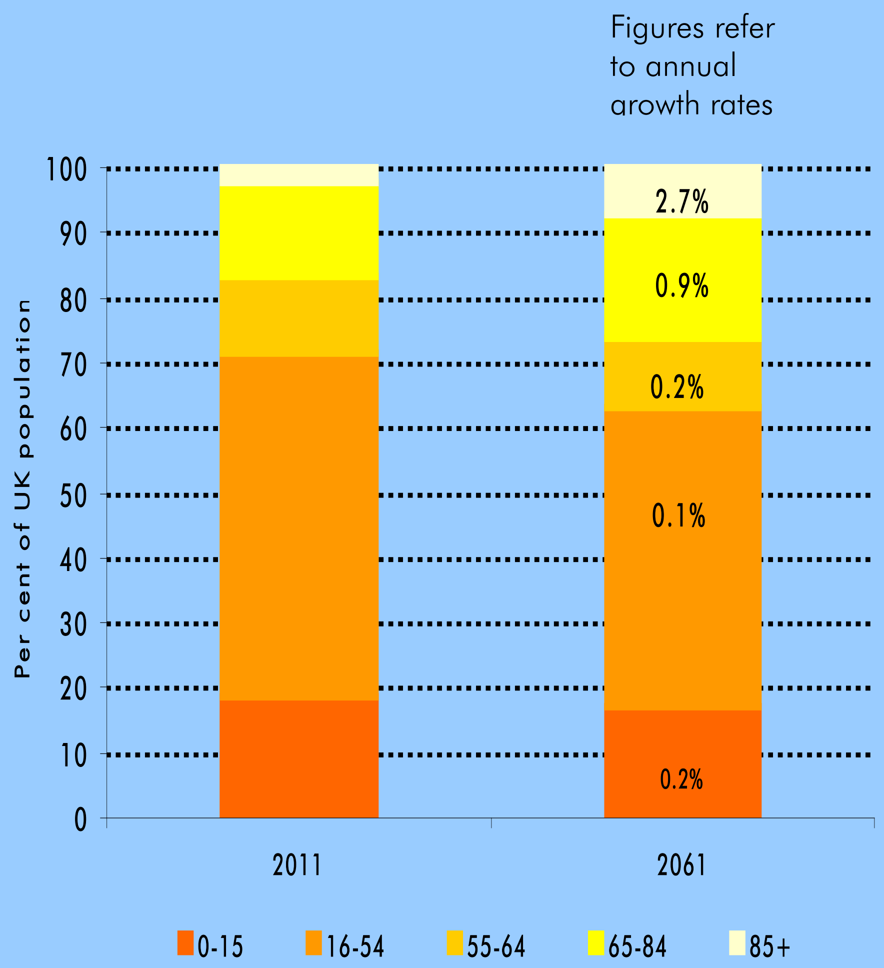
Assumptions: demography



- Ageing population – past rises in life expectancy and falls in fertility plus baby boom 'bulge'
- ONS population projections
- Our central projection assumes:
  - 65+ proportion rises from 17% in 2011 to 26% in 2061
  - Net inward migration averages roughly half recent levels
- We also show sensitivity to older and younger age structures and higher net migration

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Assumptions: economy

- Whole economy productivity growth averages 2% a year, in line with long-run historical experience
- Also show sensitivity to 1.5% and 2.5% productivity growth
- CPI inflation at 2%, consistent with Bank of England target
- GDP deflator rises 2.7% a year

Assumptions: 'unchanged policy'

- Income tax / NICs allowances rise by earnings post 2015-16
  - Price up-rating would push 3.9m extra people into higher rate tax and would increase receipts by 2.6% of GDP by 2030-31

- Most working age benefits rise by earnings post 2015-16
  - Price up-rating would reduce benefit generosity relative to average living standards and would cut costs by 1.6% of GDP by 2030-31

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- Assume public services spending rises with per capita GDP, but show scenario in which unchanged policy means raising health spending by 3% a year in real terms to offset weaker productivity growth

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Results: non-interest spending

	Per cent of GDP						
	Estimate		FSR Projection				
	2010-11	2015-16	2020-21	2030-31	2040-41	2050-51	2060-61
Health	8.2	7.4	7.7	8.5	9.1	9.5	9.8
Long-term care	1.3	1.2	1.3	1.5	1.8	1.9	2.0
Education	6.3	5.0	5.1	5.2	5.0	5.0	5.0
State pensions	5.7	5.5	5.2	6.1	6.8	6.9	7.9
Pensioner benefits	1.2	1.0	1.0	1.2	1.2	1.2	1.2
Public service pensions	2.0	2.0	1.9	1.8	1.6	1.5	1.4
Total age-related spending	**24.6**	**22.0**	**22.1**	**24.3**	**25.6**	**26.0**	**27.3**
Other social benefits	6.2	4.9	5.1	5.1	5.0	5.0	5.0
Other spending	13.3	9.4	9.4	9.4	9.4	9.4	9.4
Spending	**44.2**	**36.3**	**36.6**	**38.8**	**40.0**	**40.4**	**41.7**

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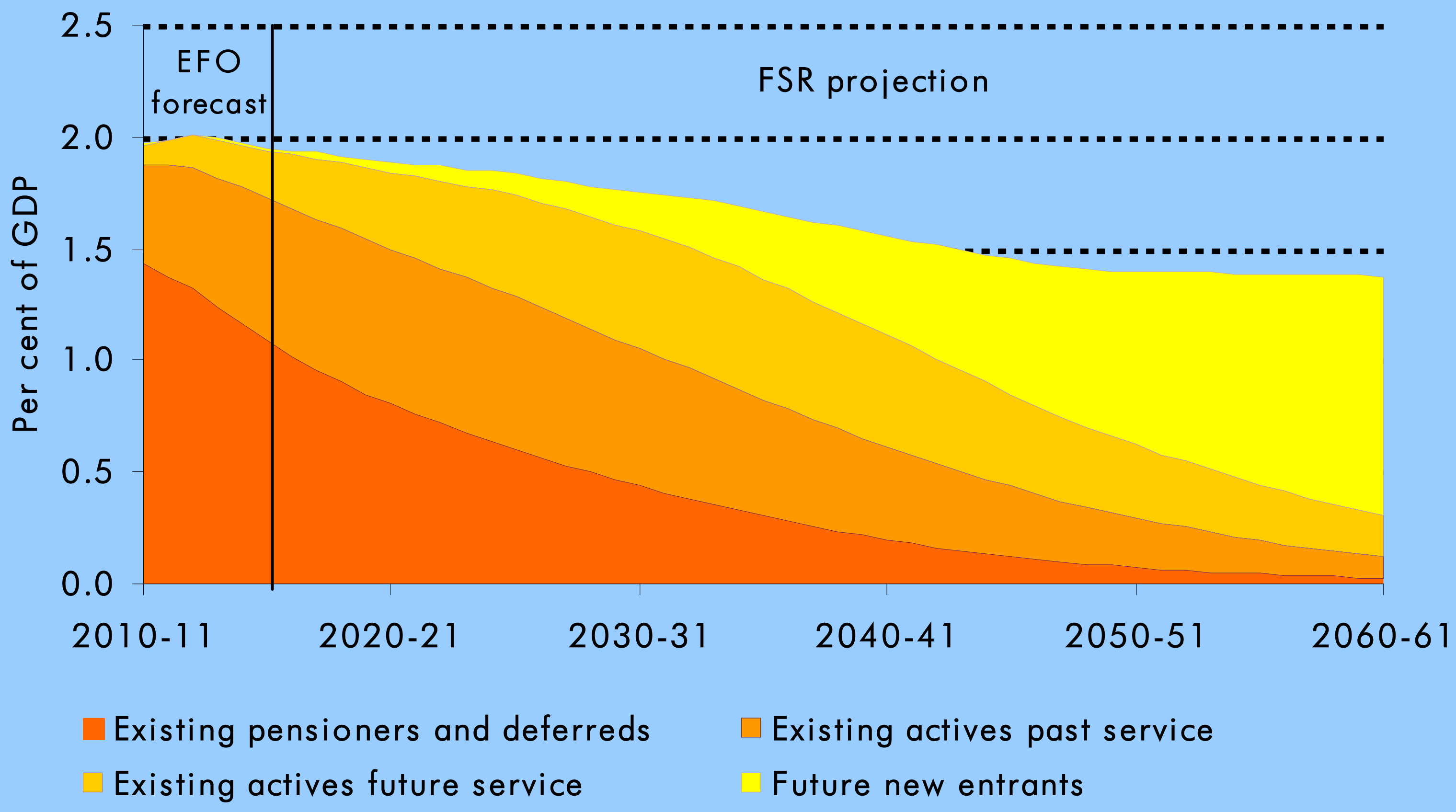
Gross public service pension payments



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Results: non-interest revenues

	Per cent of GDP						
	Estimate		FSR projection				
	2010-11	2015-16	2020-21	2030-31	2040-41	2050-51	2060-61
Income tax	10.3	10.7	10.8	10.8	10.9	10.8	10.9
NICs	6.5	6.6	6.6	6.5	6.5	6.4	6.4
Corporation tax	2.9	2.9	2.9	2.8	2.8	2.8	2.8
VAT	5.8	6.1	6.2	6.3	6.4	6.3	6.4
Capital taxes	1.0	1.2	1.3	1.4	1.5	1.6	1.7
Other taxes	10.4	10.1	10.2	10.3	10.4	10.4	10.4
Revenue	**37.0**	**37.6**	**37.9**	**38.2**	**38.4**	**38.2**	**38.5**

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Non-demographic influences on revenues

- Outside our central projection, we look at several revenue streams:
  - income tax: revenues would increase if income growth is skewed toward the top of the income distribution
  - transport taxes: better fuel efficiency could reduce revenue
  - North sea revenues: projected to decline as production falls
  - climate change levy / EU ETS: revenues look likely to rise
  - tobacco duty: revenues fall if consumption continues falling
- Net effect: revenues could fall by up to 2% of GDP by 2030-31

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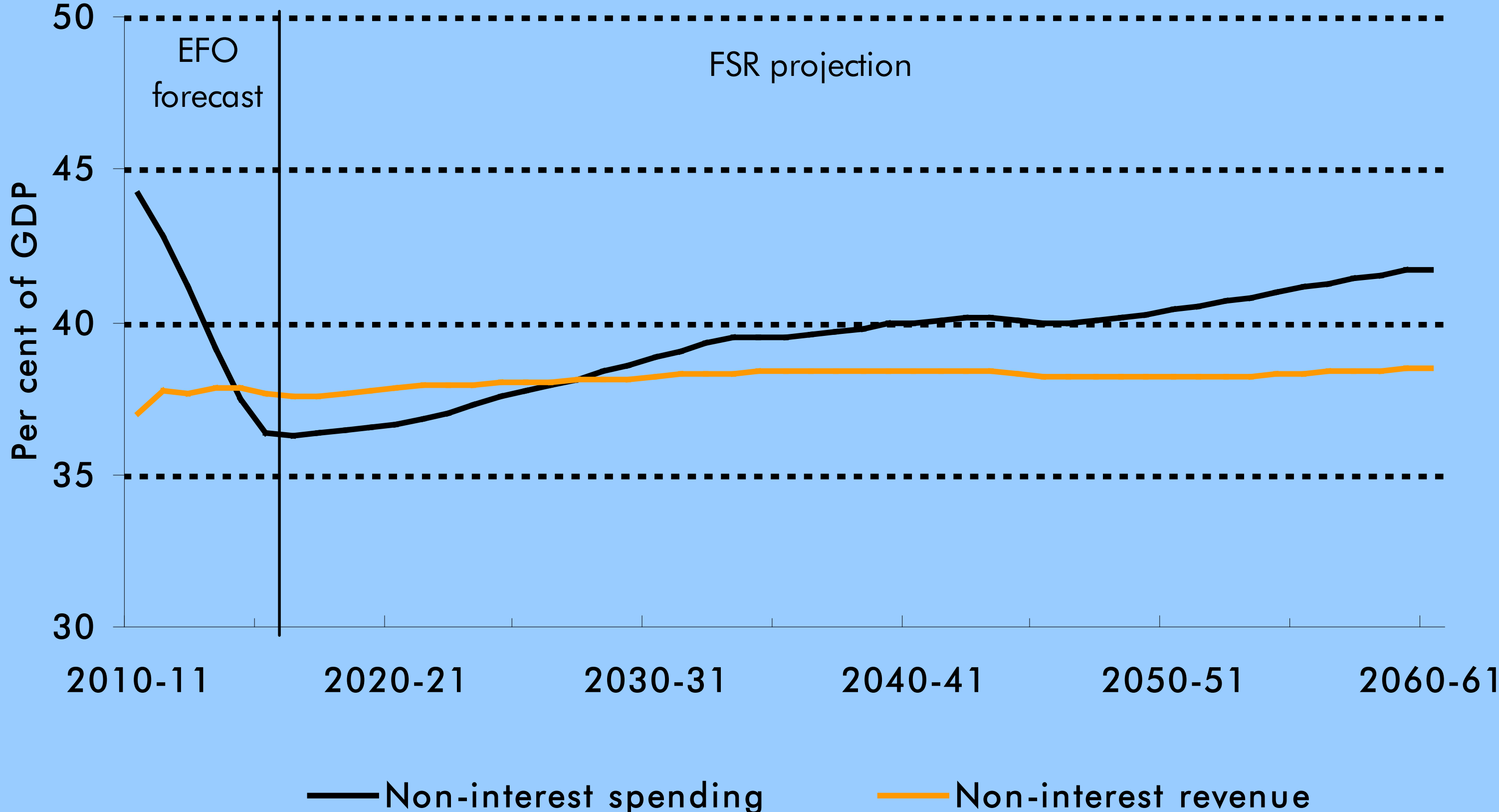
Long term revenue and spending projections



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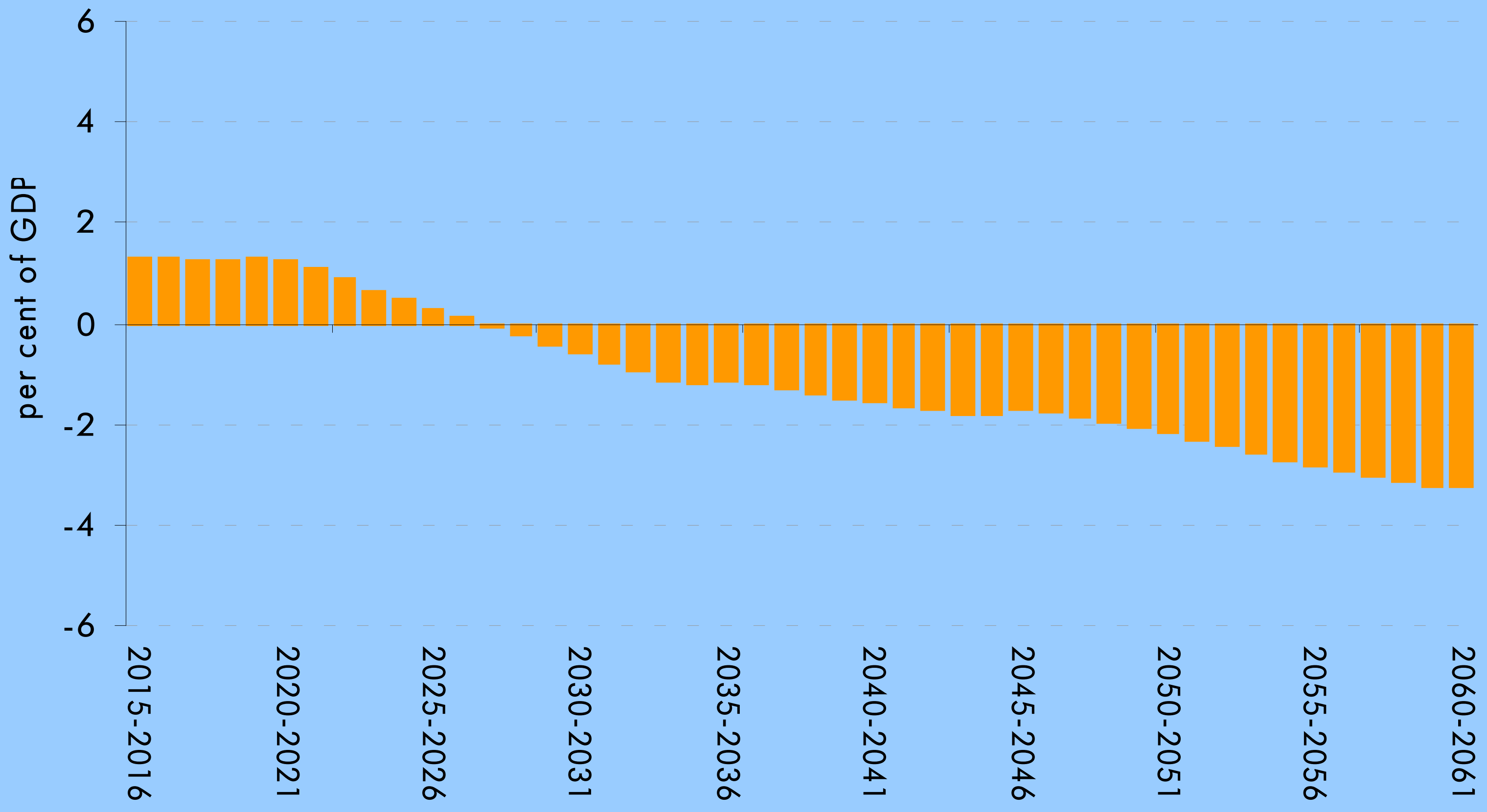
Primary budget balance



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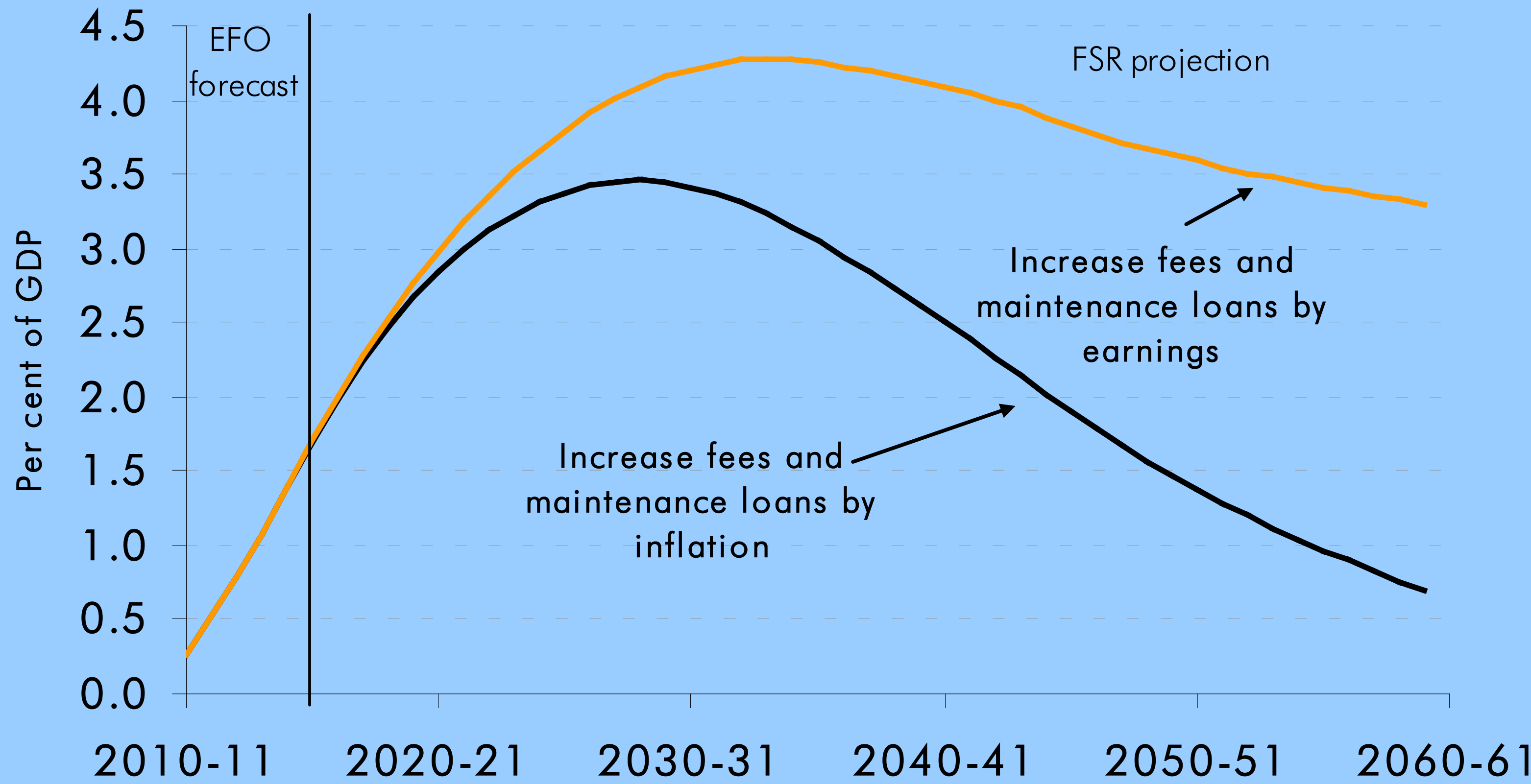
Impact of student loans on PSND



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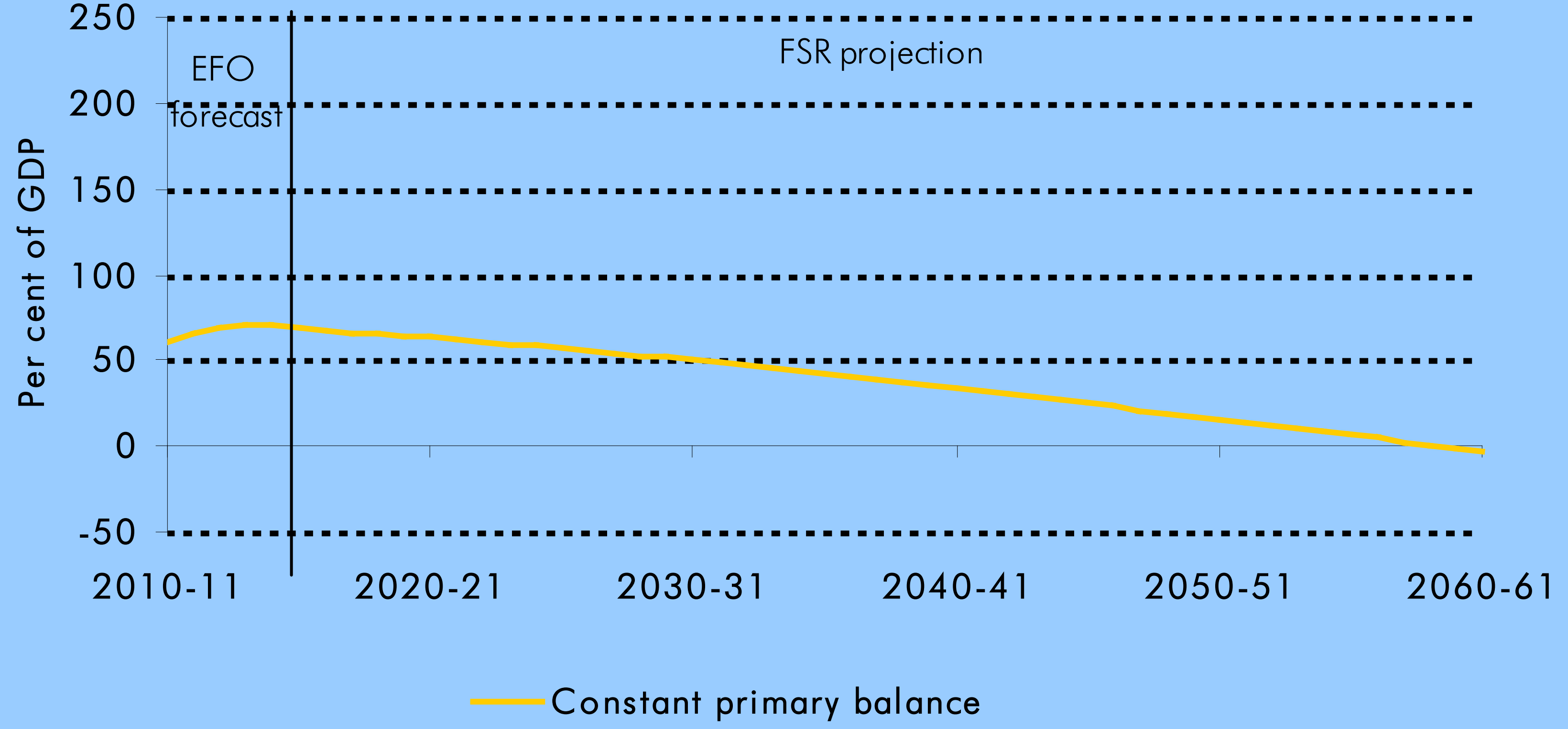
Public sector net debt



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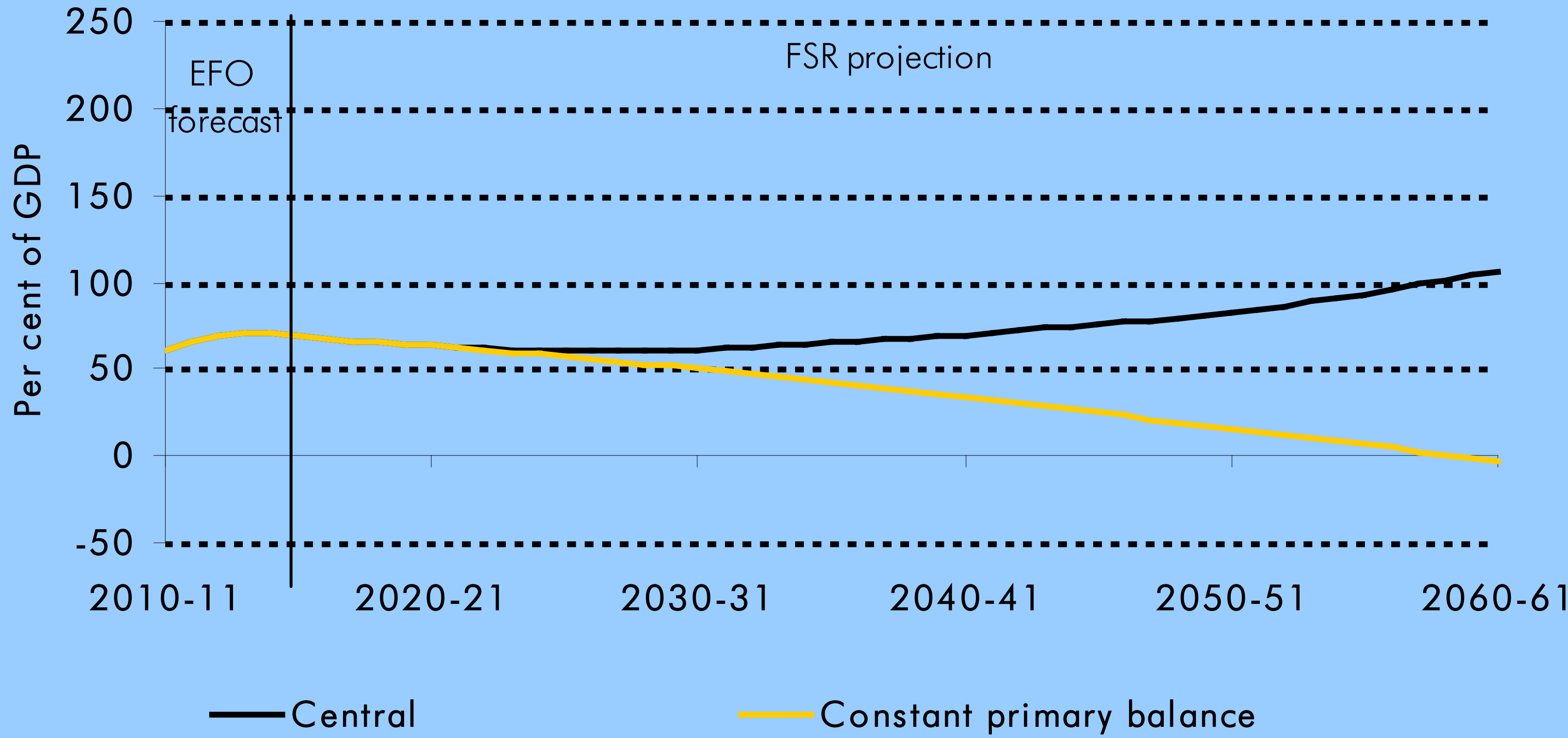

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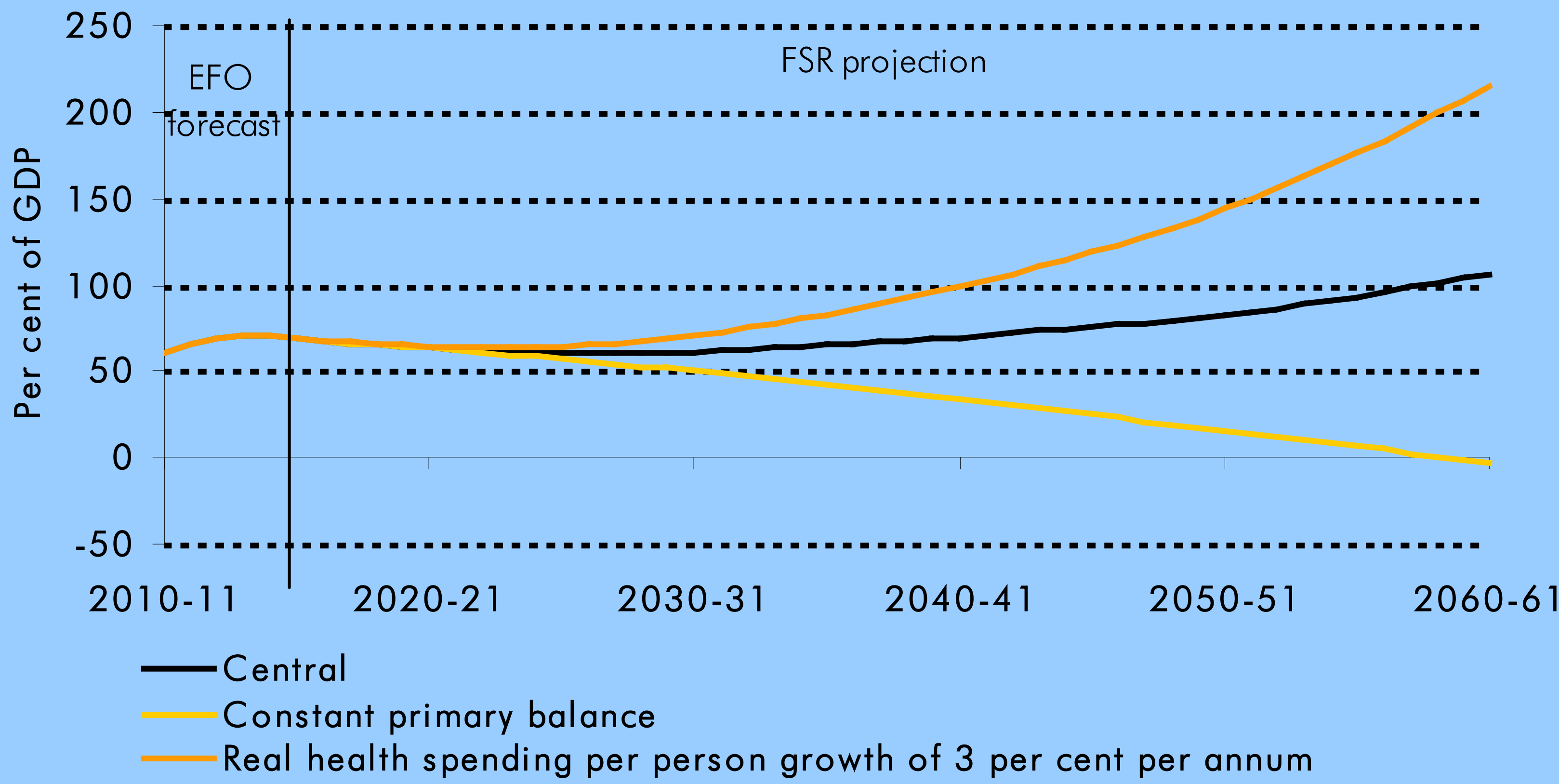

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Economic feedbacks

- Budget deficits provide helpful boost to the economy when private spending unusually depressed
- But higher debt and deficits over the long term may reduce national saving, increase interest rates and 'crowd out' investment
- This could reduce GDP and worsen fiscal position
- Historical correlations suggest central projection deficit path would reduce GDP, but only modestly
- But not necessarily good guide to the future

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Sensitivity analysis

- Considerable uncertainty around any 50 year projections

- Outlook for debt would be worse if:
  – 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 will erode as immigrants reach old age

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Achieving sustainability

- Satisfy ‘inter-temporal budget constraint’
  - Permanent tightening of 3% of GDP from 2016-17

- Fiscal gap: achieve PSND of 40% of GDP in 2060-61
  - Permanent tightening of 1.5% of GDP from 2016-17
  - Permanent tightening of 3.9% of GDP from 2016-17 if per capital health spending rises 3% a year in real terms
  - If structural budget position 1% of GDP better or worse in 2015-16 than we forecast in March, necessary fiscal tightening less or greater by the same amount
  - Could tighten 0.5% of GDP per decade rather than 1.5% one-off

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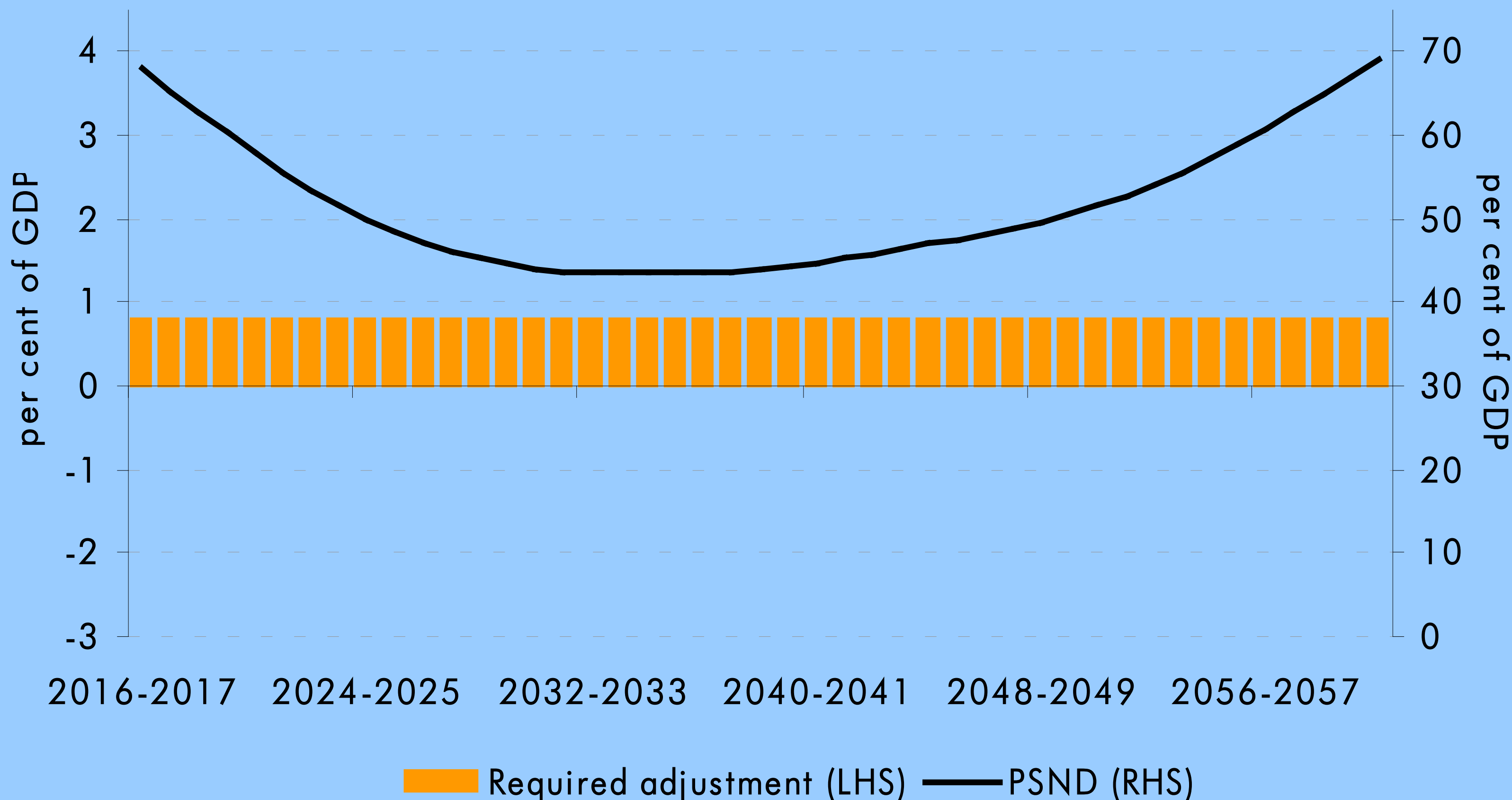
Timing the response: one-off



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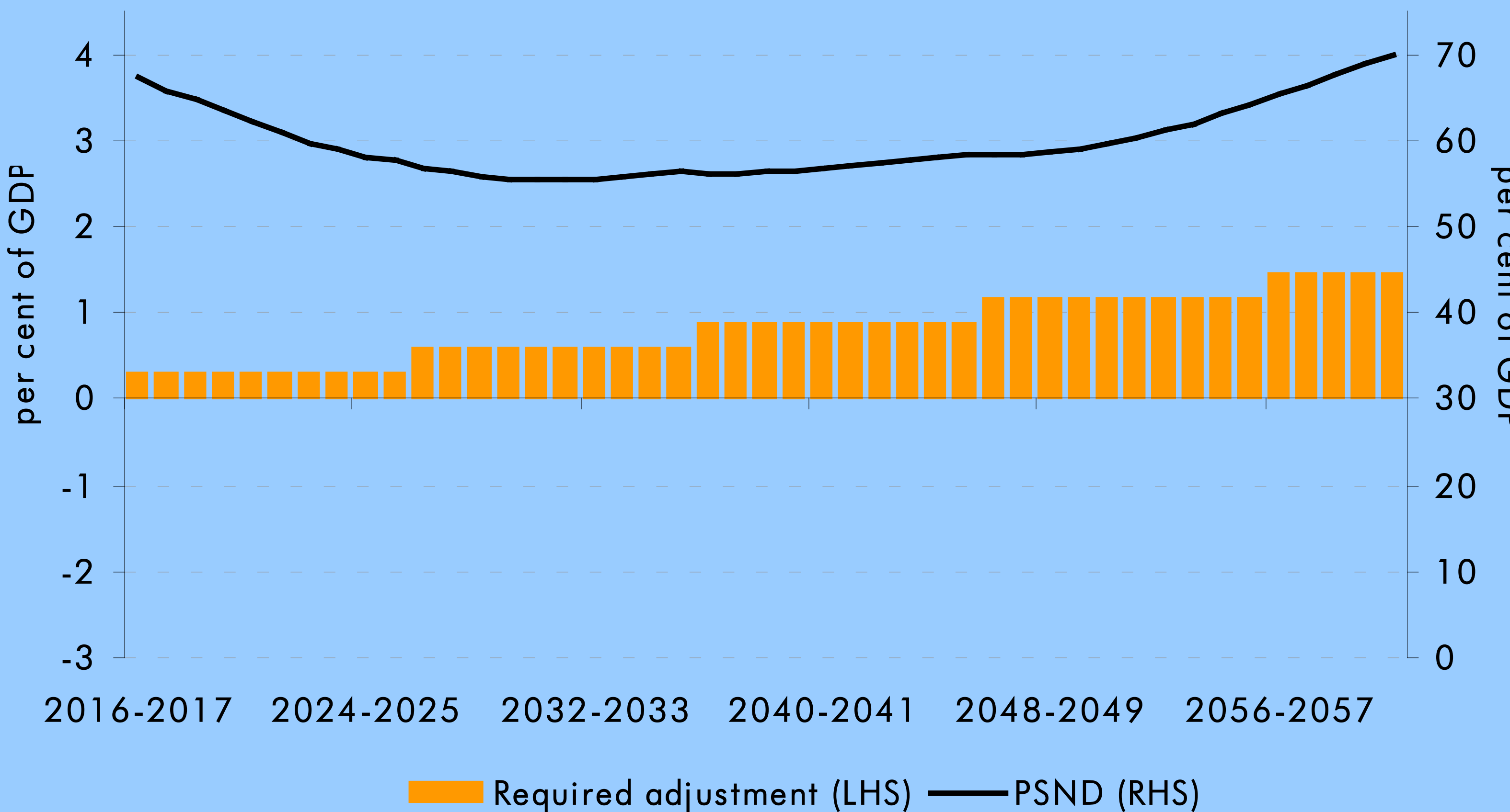
Timing the response: decade by decade



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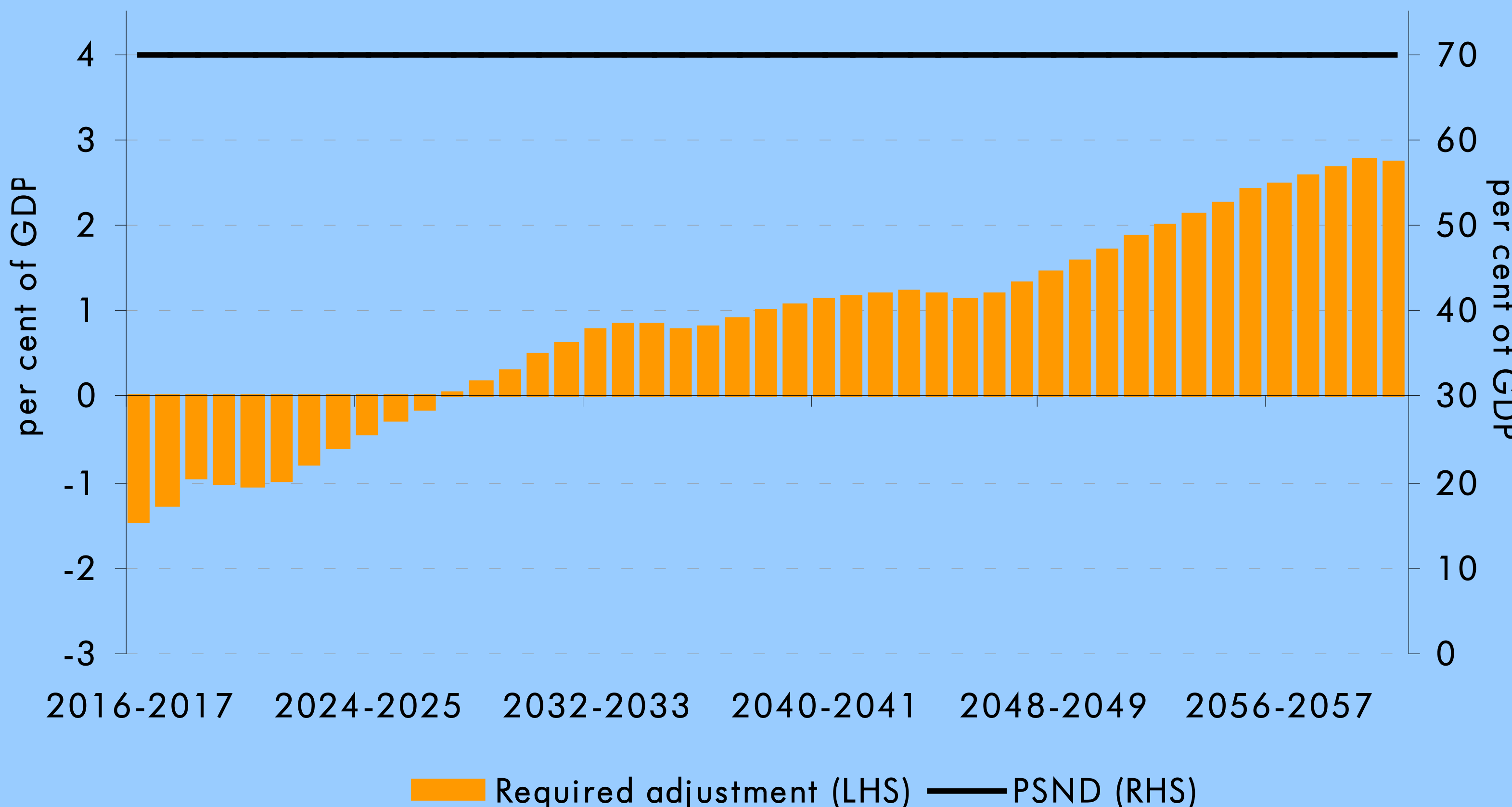
Timing the response: holding debt flat



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Conclusions

- WGA bring a welcome increase in transparency
- Balance sheets limited as a guide to sustainability
- Ageing population increases fiscal costs, here and abroad
- More tightening likely to be needed post-consolidation
- Long term projections uncertain, but should not be ignored

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