

Fiscal sustainability report 2018 and Working paper No.12: student loans and fiscal illusions

Fiscal sustainability report

In our *Fiscal sustainability report (FSR)* we look beyond the medium-term forecast horizon of our twice-yearly *Economic and fiscal outlooks (EFOs)* and ask whether the UK's public finances are likely to be sustainable over the longer term.

Our projections are based on current stated Government policy, but in three key instances policy formation is ongoing:

- Our projections include the impact of the Government's as-yet unfunded June 2018 announcement of increased health spending over the medium term. The Government has indicated that measures to finance at least part of the additional spending will be announced at some point, but has given no firm details of their size or composition.
- Following the Government's December 2017 decision not to implement the Dilnot reforms to adult social care funding it planned for 2020, we have removed them from our projections, reducing projected spending. The Government says it will announce new policy proposals in due course, which could push projected spending up again.
- The Government's July 2017 State Pension age (SPA) review gave greater clarity on the probable timing of future increases to the SPA and we have included the consequences of this. The Government has also said that it will review the continued operation of triple-lock uprating of the state pension beyond this Parliament, potentially reducing projected spending. But in the absence of a firm decision to replace the triple lock we assume that it remains in place.

With or without these policy changes, our projections suggest that the public finances are likely to come under significant pressure over the longer term, due to an ageing population and further upward pressure on health spending from factors such as technological advances and the rising prevalence of chronic health conditions. Under our definition of unchanged policy, the Government would end up having to spend more as a share of national income on age-related items such as pensions and (in particular) health care, but the same demographic trends would leave government revenues roughly stable.

In the absence of offsetting tax rises or spending cuts, this would widen the government's budget deficit over time and put public sector net debt on an unsustainable upward trajectory. This fiscal challenge from an ageing population and from additional pressures on health spending is common to many developed nations.

The long-term outlook for the public finances is less favourable than at the time of our last *FSR* in January 2017. This is more than explained by the June health spending announcement, which – in the absence of accompanying offsetting tax or spending measures – increases spending by significantly more than the modest fiscal tightening implied by dropping the Dilnot reforms and accelerating rises in the State Pension age. If the higher health spending were to be fully financed by tax rises or cuts in other spending, the long-term outlook for the public finances would be little changed from our 2017 *FSR*. The latest population projections from the ONS weaken the long-term fiscal position, with prospective demographic trends slightly less favourable to the public finances.

Long-term projections such as these are highly uncertain and the results we present here should be seen as illustrative scenarios conditioned on particular ‘what if’ assumptions, not as precise forecasts. We quantify some of the uncertainties through sensitivity analyses, particularly relating to demography and health spending.

It is important to emphasise that we focus here on the additional fiscal tightening that might be necessary to achieve fiscal sustainability beyond our medium-term forecast horizon, which currently ends in 2022-23. Our March 2018 forecast incorporated the modest further fiscal tightening then planned by the Government over the medium term – primarily further cuts to departmental current spending as a share of GDP and cuts to working-age welfare spending. In the absence of offsetting tax or spending policies that have yet to be specified, the subsequent June health spending announcement leaves the deficit broadly flat over the medium term in the figures we use in the report, rather than narrowing.

While it is not for us to recommend the size or timing of any additional fiscal tightening measures, policymakers and would-be policymakers should certainly think carefully about the long-term consequences of any policies they introduce or propose in the short term, including at next year’s Spending Review. And they should give thought too to the policy choices that will confront them once the current planned consolidation is complete.

Student loans and fiscal illusions

A new working paper looks at alternative ways of accounting for the fiscal implications of student loans and whether alternative treatments can help us to analyse their impact on fiscal sustainability more effectively.

Currently, the ‘public sector net debt’ balance sheet measure ignores student loan assets entirely while the ‘public sector net financial liabilities’ measure records them at a significant premium to their true value. In borrowing, capitalised interest that is not expected to be repaid flatters the figures for decades, then large-scale write-offs far in the future recognise the subsidy cost of today’s lending decisions. And a quirk of the accounting treatment means that selling loans before write-offs have been recorded means the true cost of student loans is never recognised in borrowing, rather than being recognised very late. We have explored five alternative treatments to see if these can dispel any or all of these illusions and reveal the true impact of student loans on fiscal sustainability. None are perfect, but some do offer a better reflection of fiscal reality.

Notes

1. The OBR is the UK’s independent fiscal watchdog. We produce forecasts for the economy and the public finances, assess progress against the Government’s fiscal targets, and report on long-term fiscal sustainability.
2. Questions should be sent to OBRpress@obr.gsi.gov.uk or contact Mark Dembowicz on 0203 334 6348.