

Office for  
**Budget  
Responsibility**

## **Our inaugural *Fiscal risks report***

---

**Robert Chote**  
Chairman

13 July 2017

# Background

- The IMF's 2016 *UK Fiscal Transparency Evaluation* said that
  - “In many cases, the government’s control of risks falls short of the Code’s standards of good or advanced practice”
  - “The absence of summary reporting of specific risks is a weakness that should be addressed”
- The Government has legislated for us to produce an FRR every two years, to which it is obliged to respond
- Several countries already produce risk reports, but usually from their finance ministries or cabinet offices

# Our approach

- 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”
- In this report we focus on risks
  - To our latest (March 2017) forecast over the medium term
  - To fiscal sustainability over the longer term
  - With greater attention to downside risks in both cases
- We are interested in
  - Their probability and potential impact
  - Whether they are correlated with other risks
  - What the government is doing about them

# Types of fiscal risk

- Increases in spending (one-off or persistent)
- Losses of revenue (one-off or persistent)
- 'Stock-flow adjustments'
  - Balance sheet transactions
  - Balance sheet transfers (real-world or statistical)
  - Balance sheet valuation changes

# Structure of the report

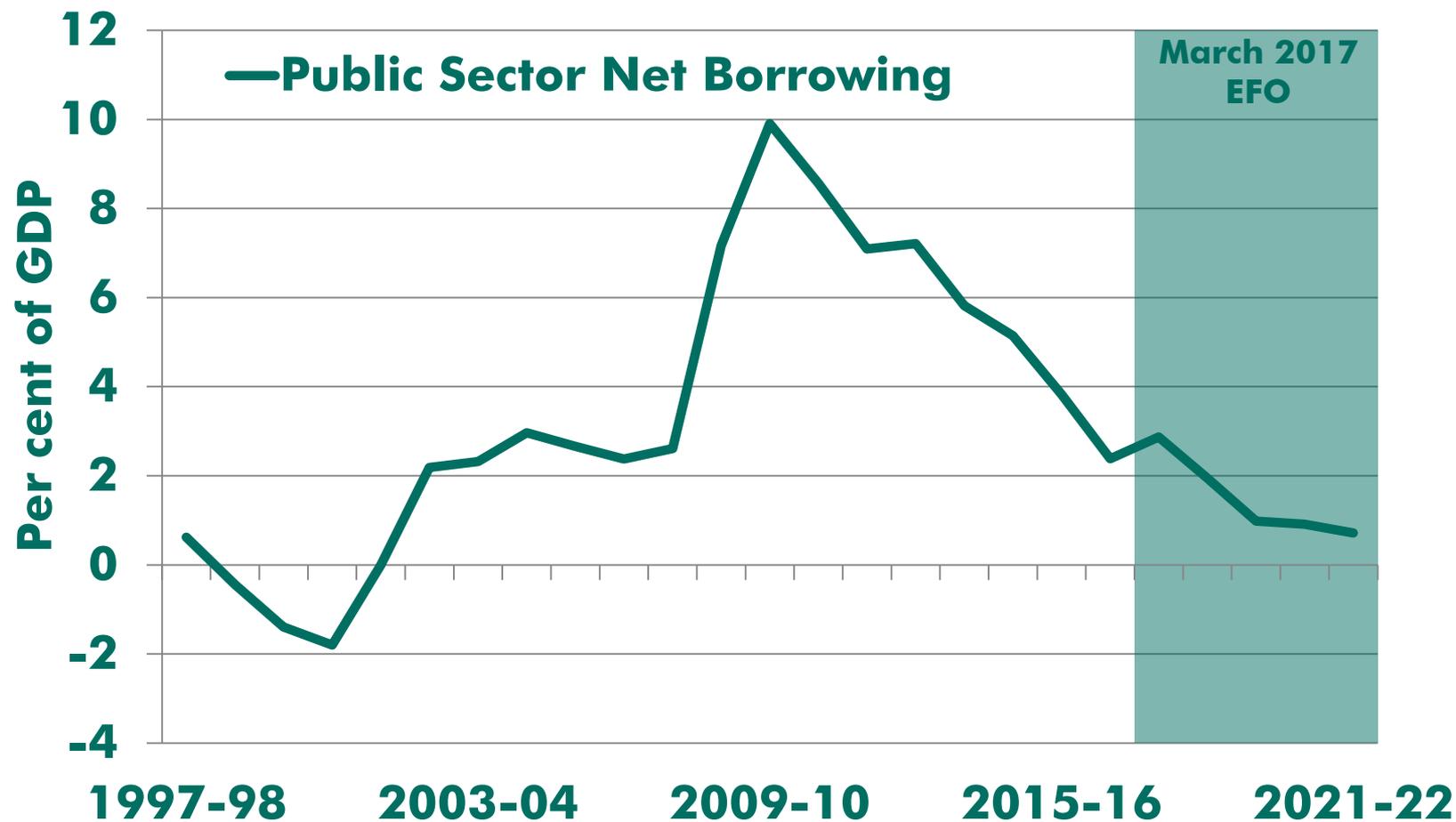
- Introduction: analytical framework
- Macroeconomic risks
- Financial sector risks
- Revenue risks
- Primary spending risks
- Balance sheet risks
- Debt interest risks
- A fiscal stress test
- Conclusions

# Structure of the report

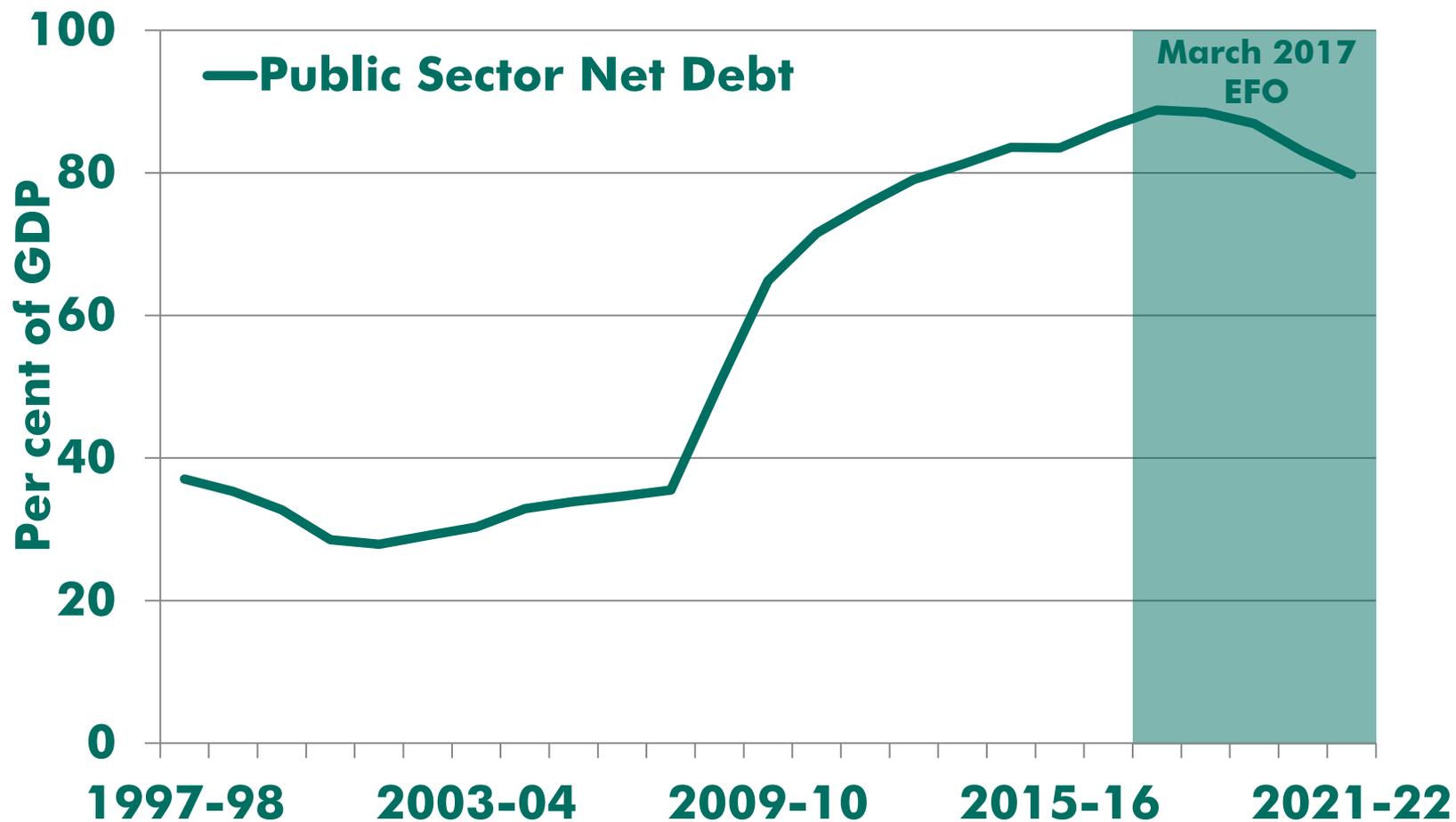
- Introduction: analytical framework
- Macroeconomic risks
- Financial sector risks
- Revenue risks
- Primary spending risks
- Balance sheet risks
- Debt interest risks
- A fiscal stress test
- Conclusions

Including 57 issues that the Government might wish to consider in its response

# Public finances



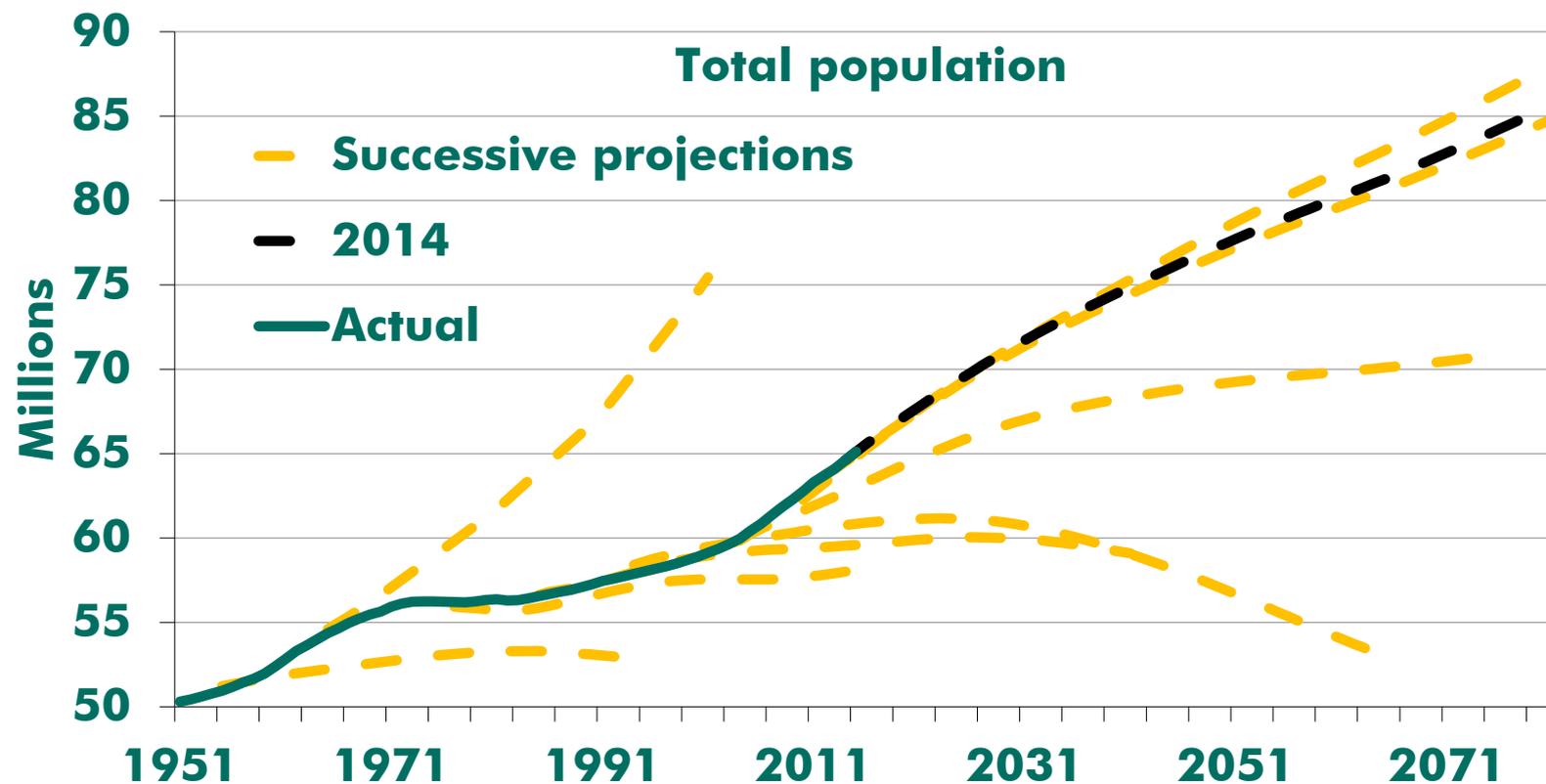
# Public finances



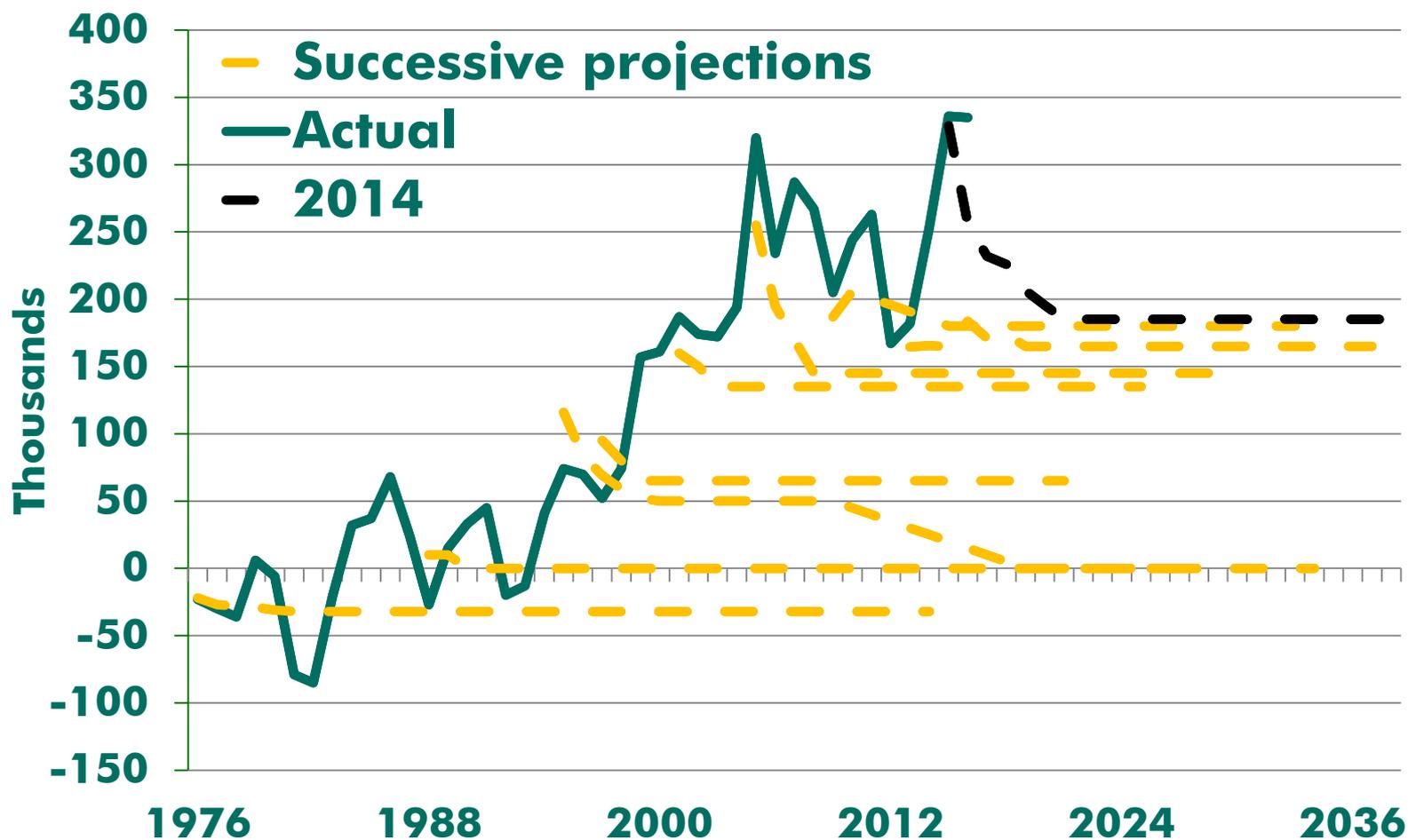
# Macroeconomic risks

- Risks to potential output growth
  - Including population and potential productivity growth
- Risks of a cyclical downturn
- Sectoral risks (especially housing)
- GDP composition risks
- Brexit-related economy risks

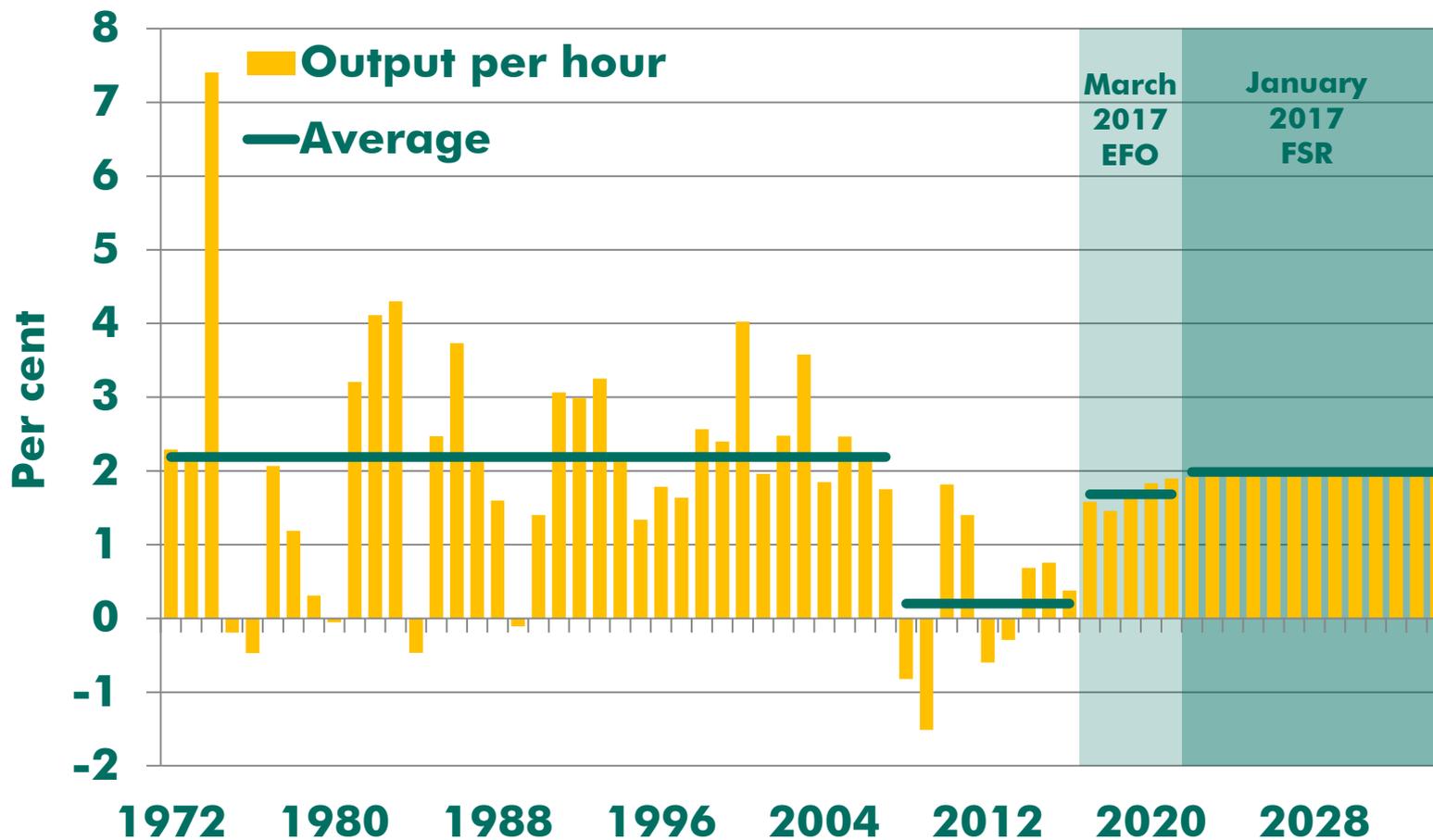
# Population projections



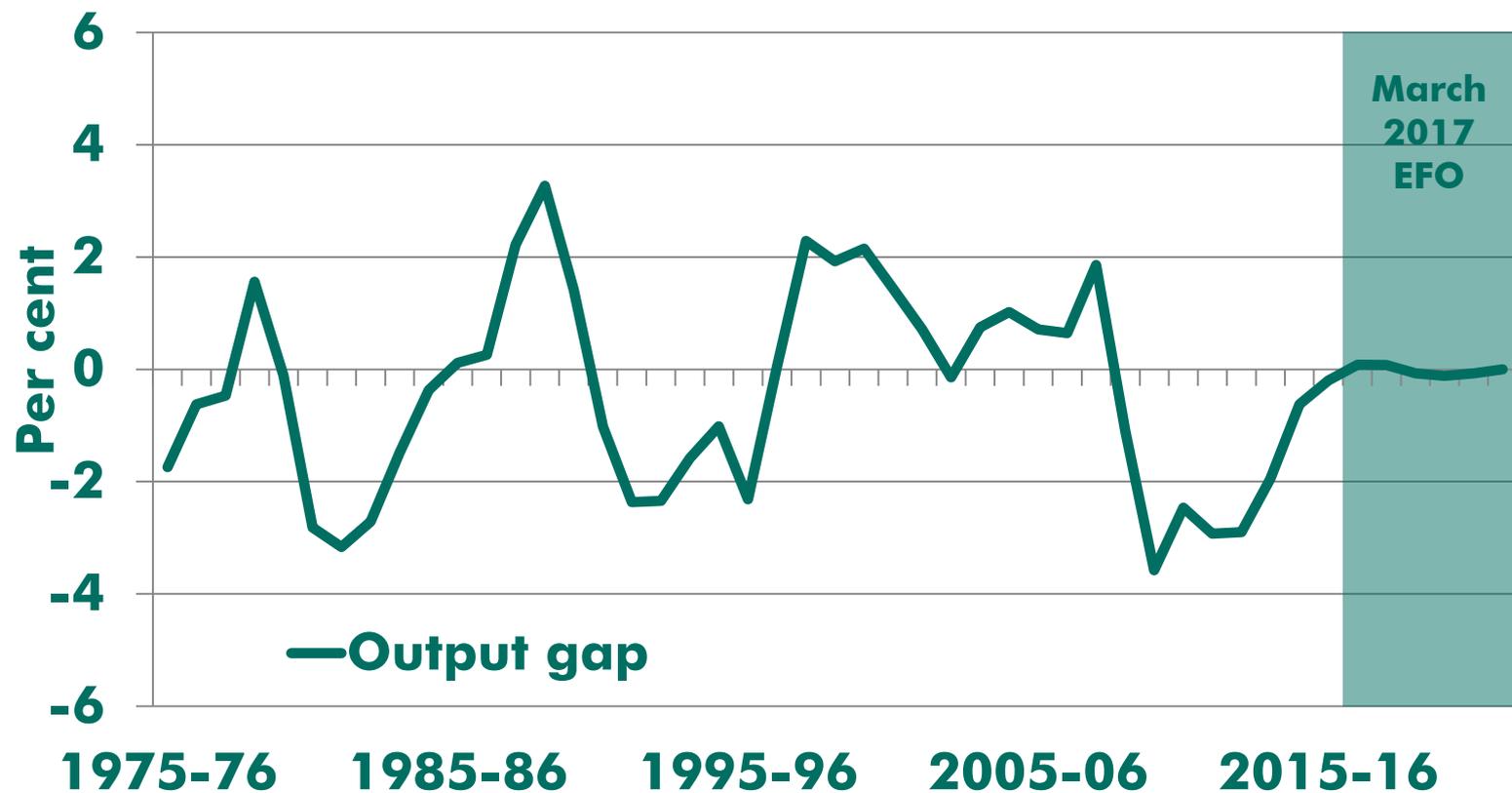
# Net migration projections



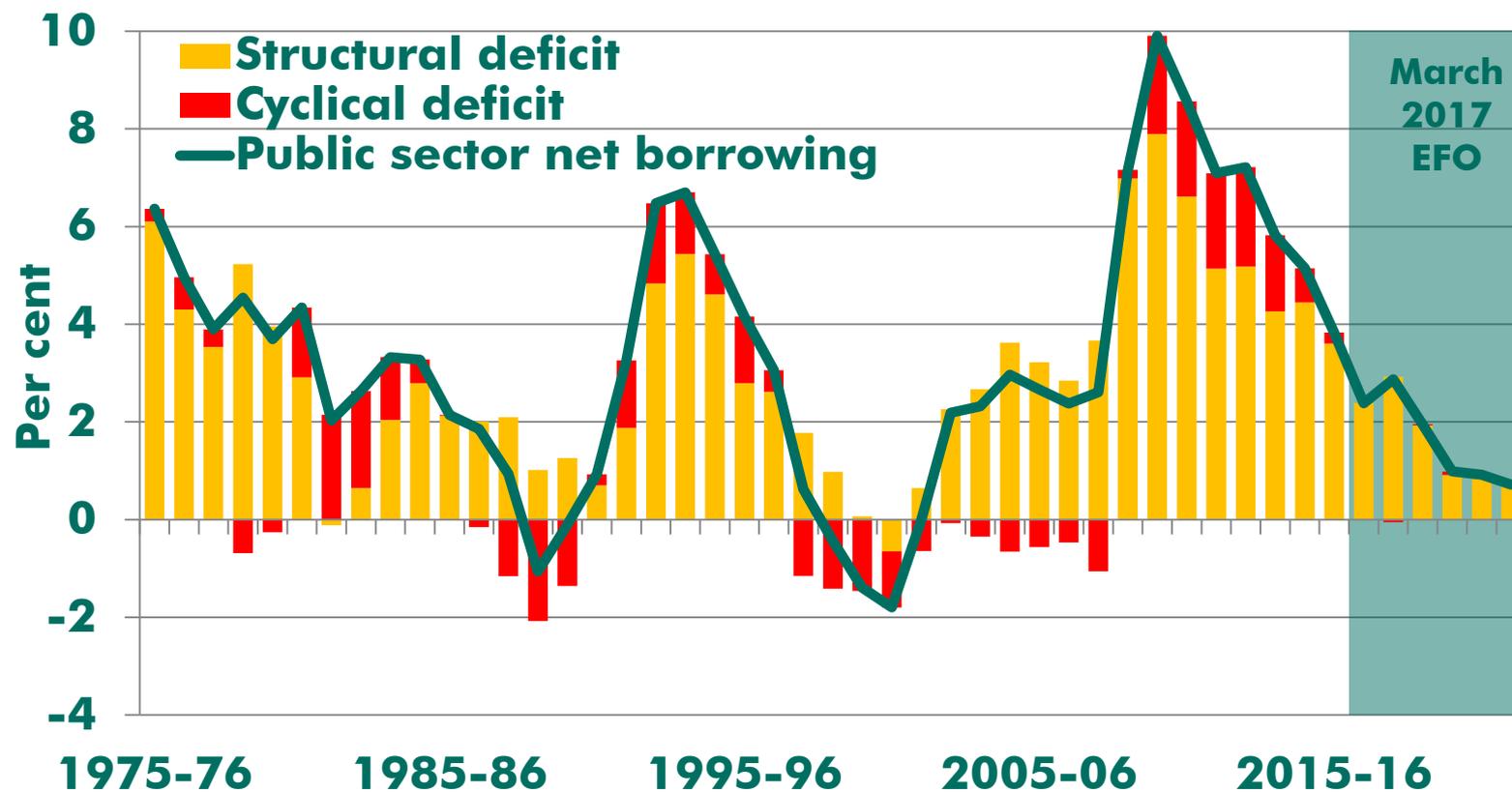
# Productivity growth



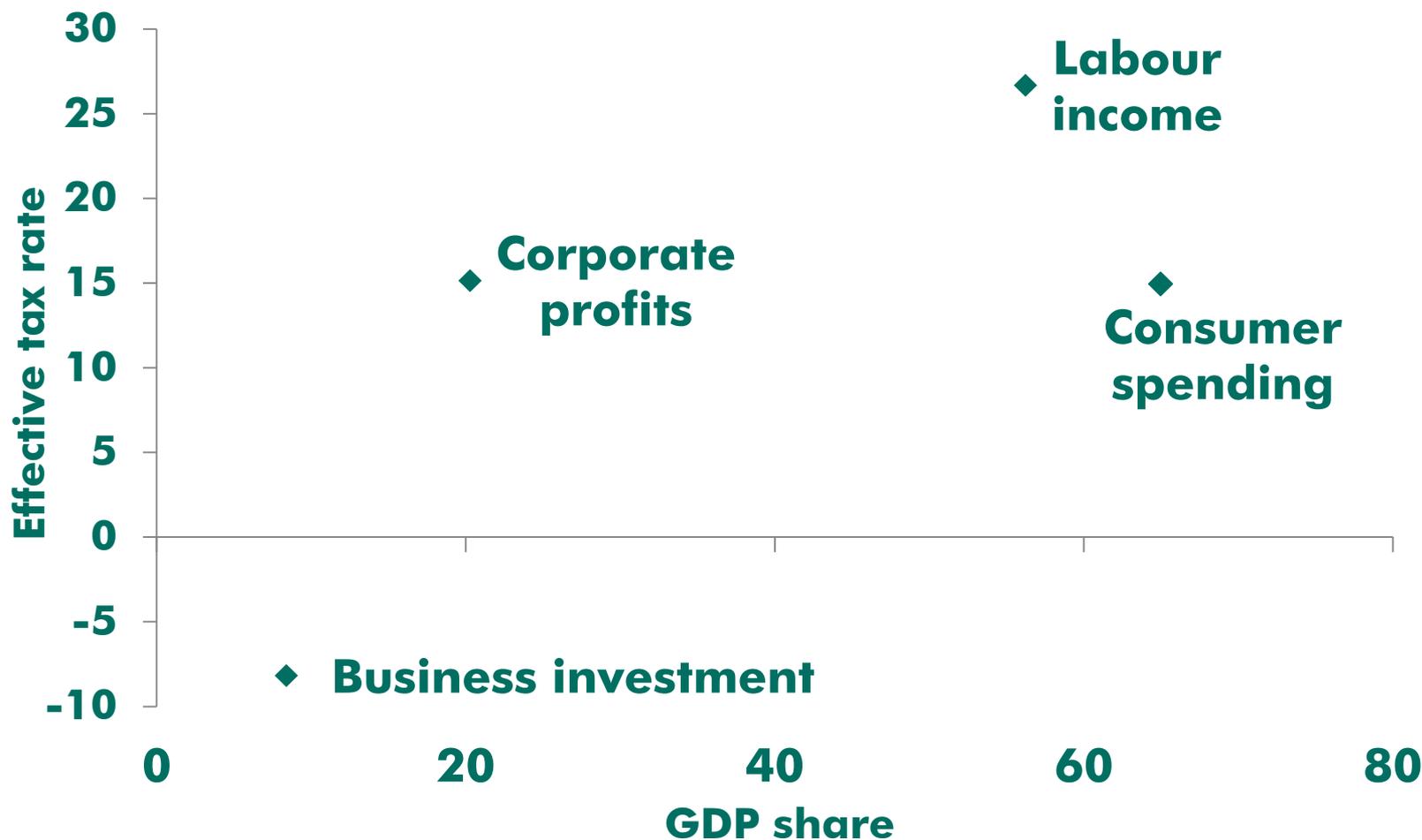
# The cycle and the public finances



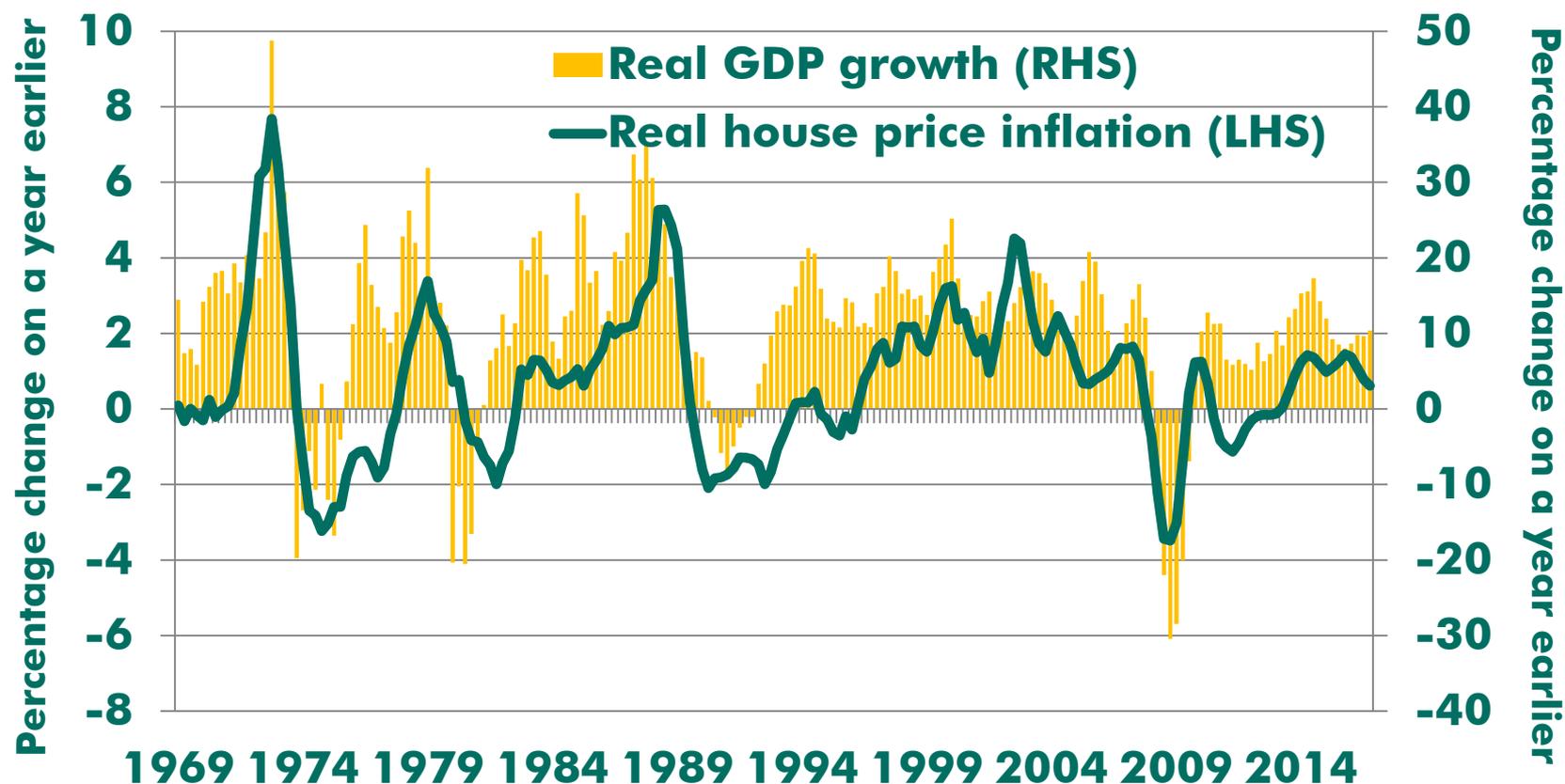
# The cycle and the public finances



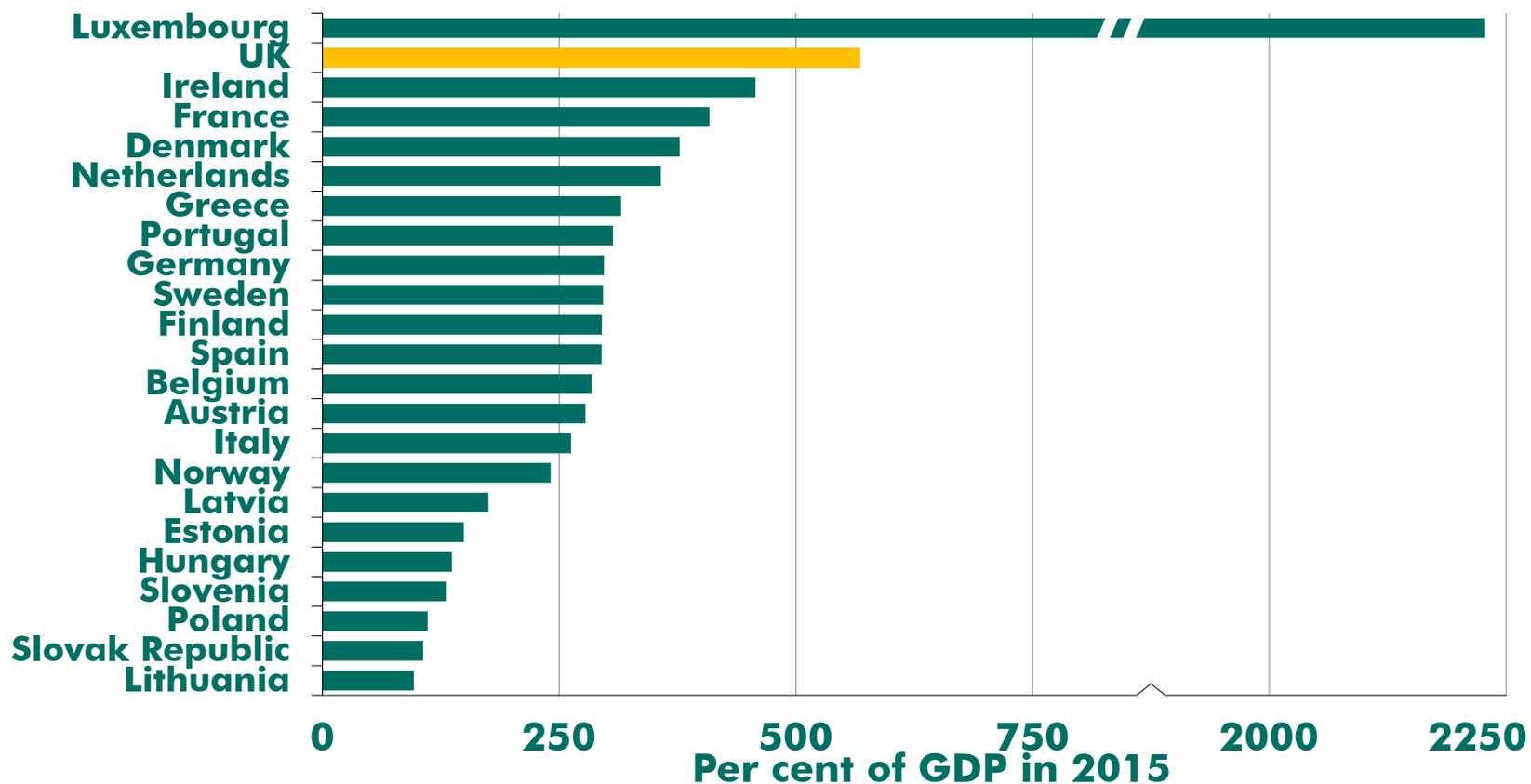
# Tax rates on components of GDP



# The housing sector



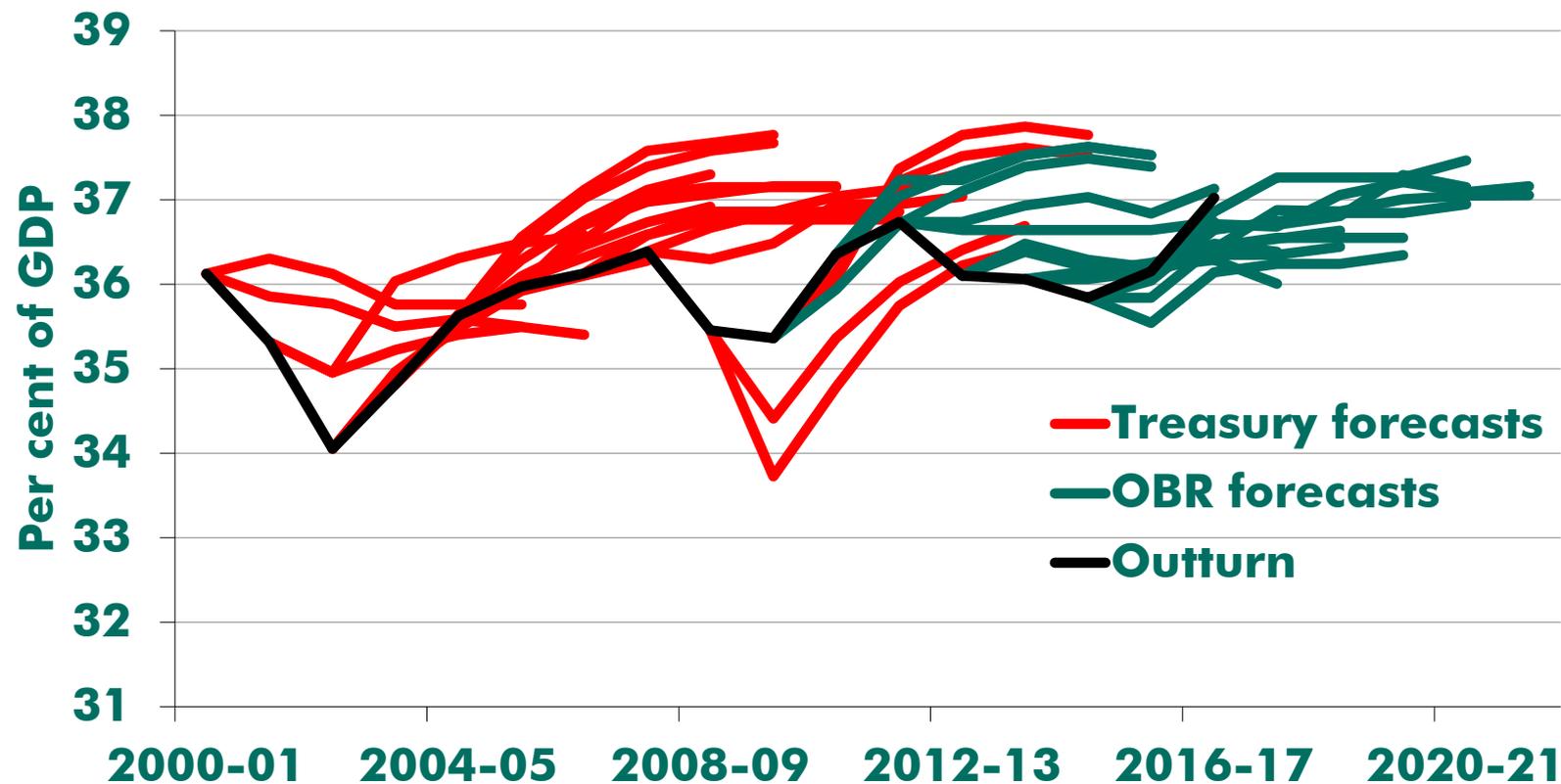
# Bank balance sheets



# Costs of the financial crisis

- Direct – bailouts and nationalisations
  - Upfront cost of £137 billion, but net cost estimated at £24 billion in March
- Indirect costs – via the hit to the economy
  - Economy around 15 per cent smaller today than on pre-crisis trend. Around £300 billion of GDP lost in a single year

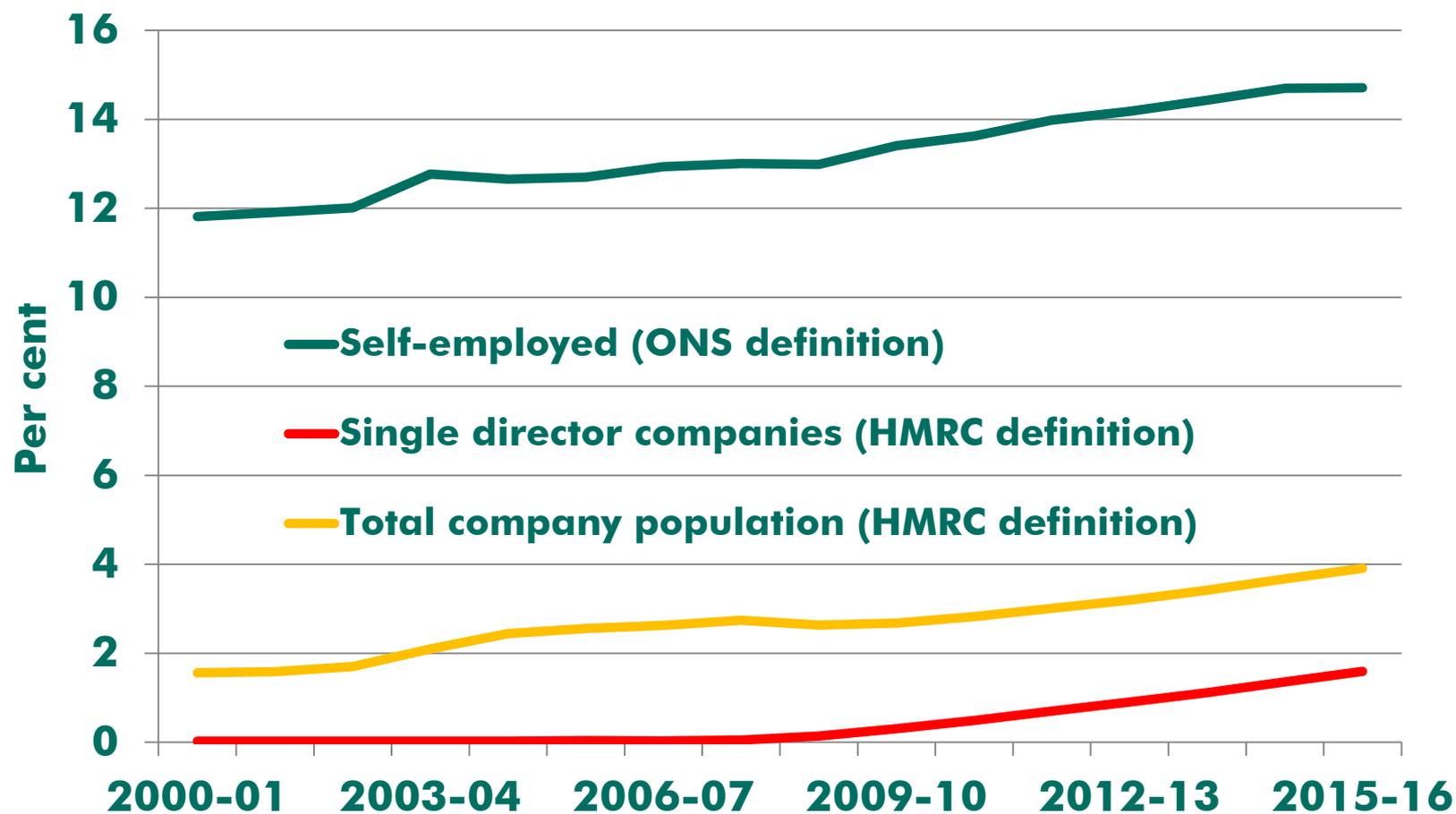
# Revenue forecasts



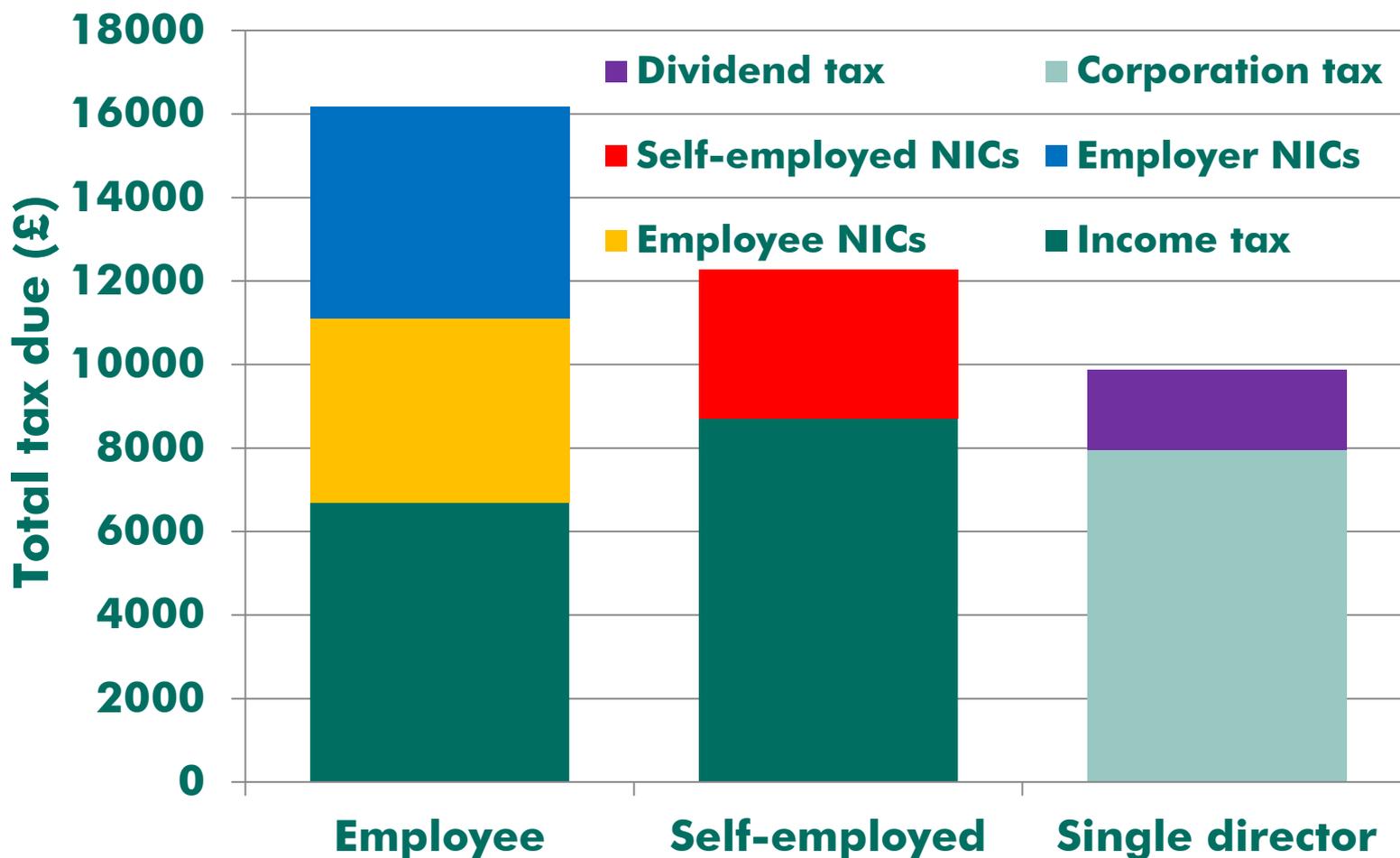
# Revenue risks

- Behavioural and technological change
- Oil and gas
- Avoidance, evasion and other non-compliance
- Changing work patterns
- Policy risks
- Concentration of tax receipts

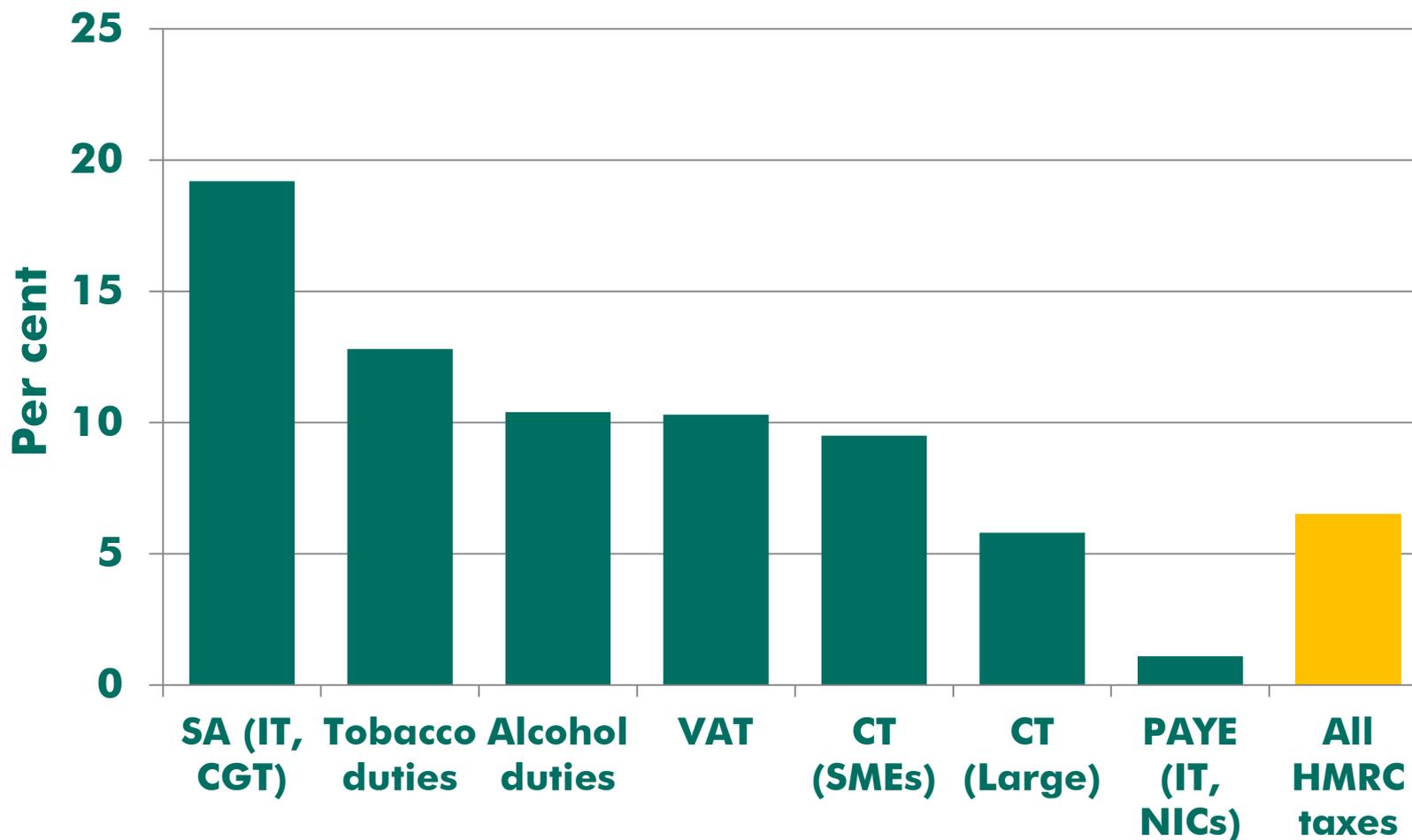
# Self-employment and incorporations



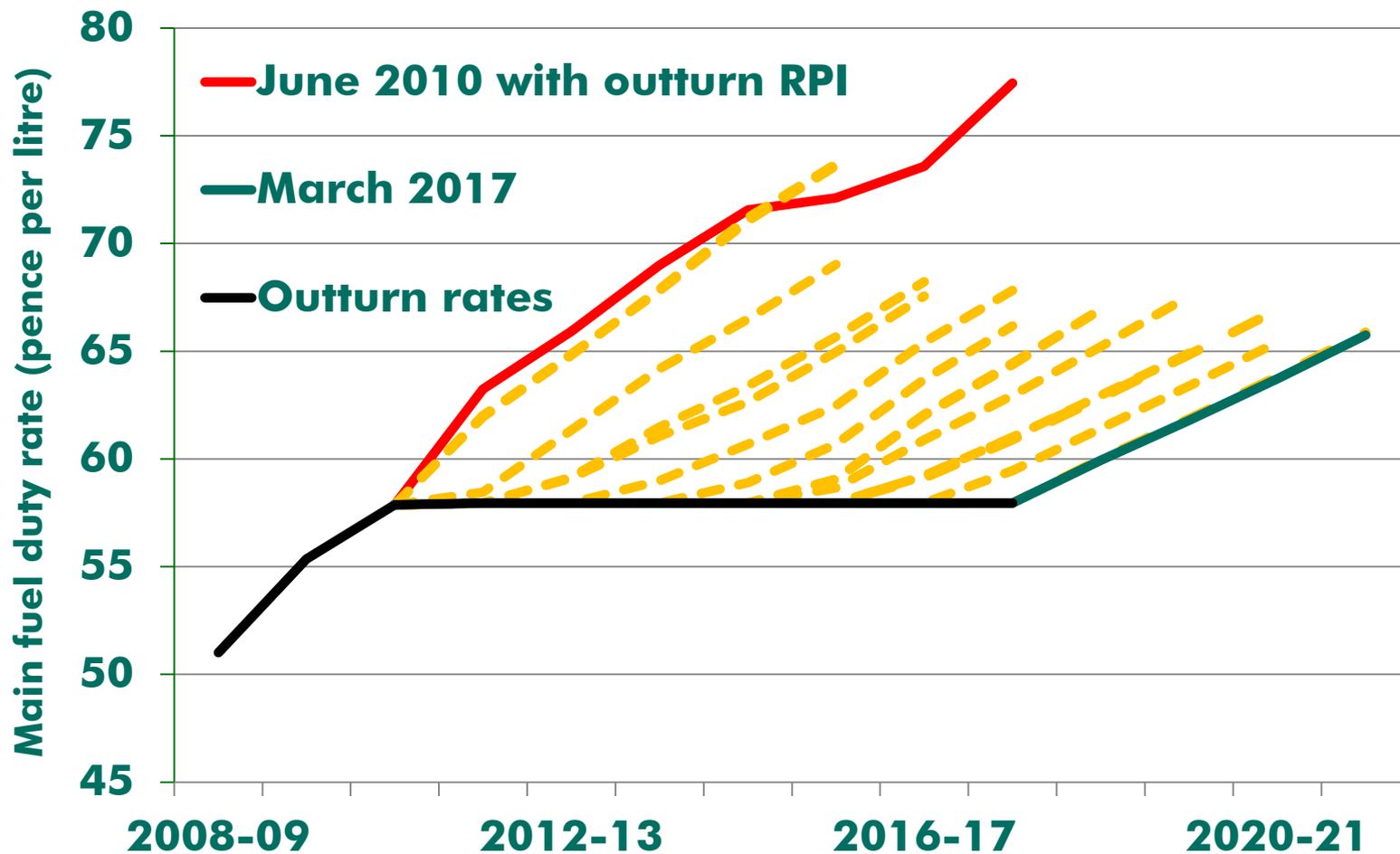
# Tax paid on £50,000 income



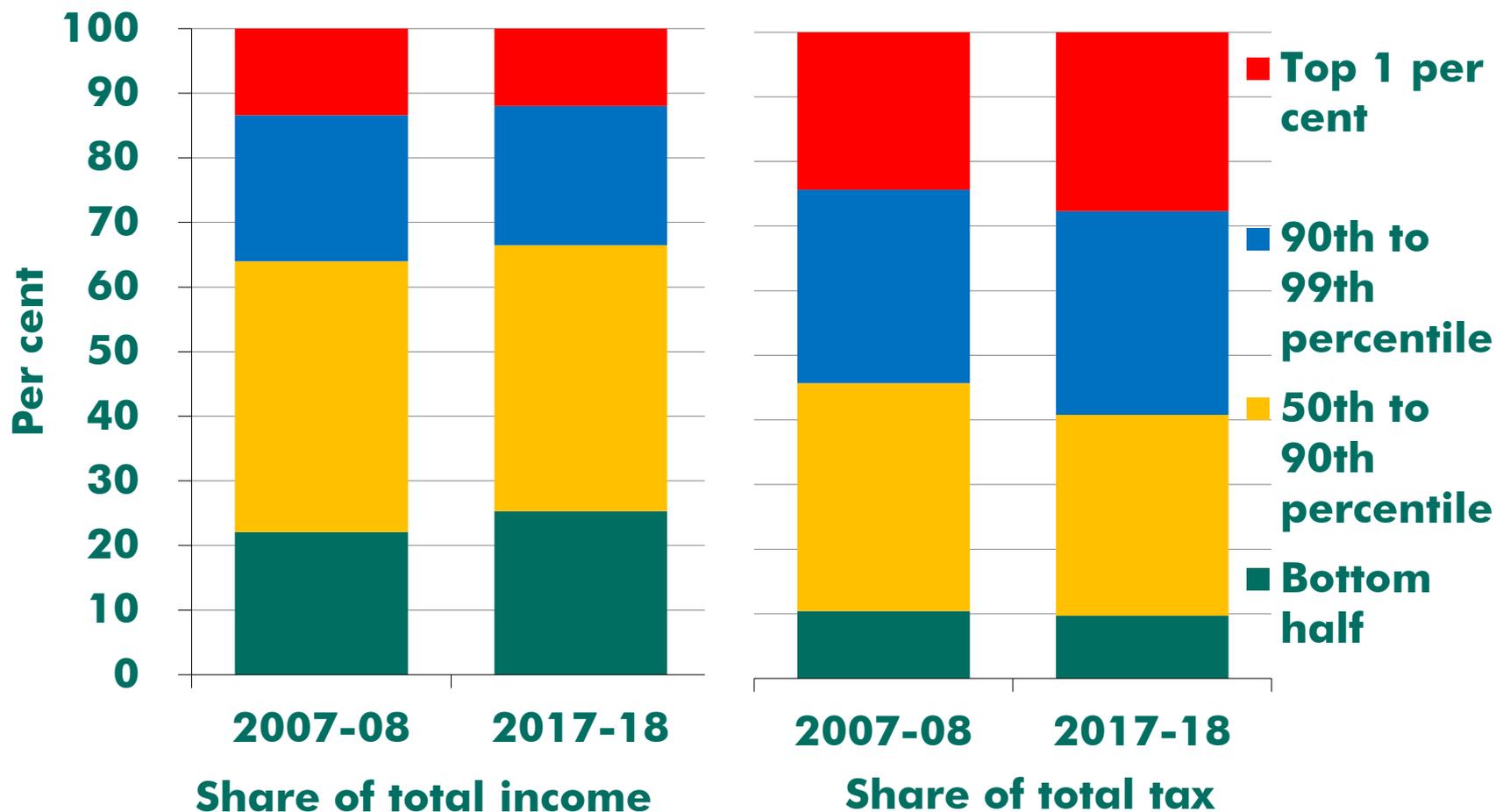
# The tax gap by type of tax



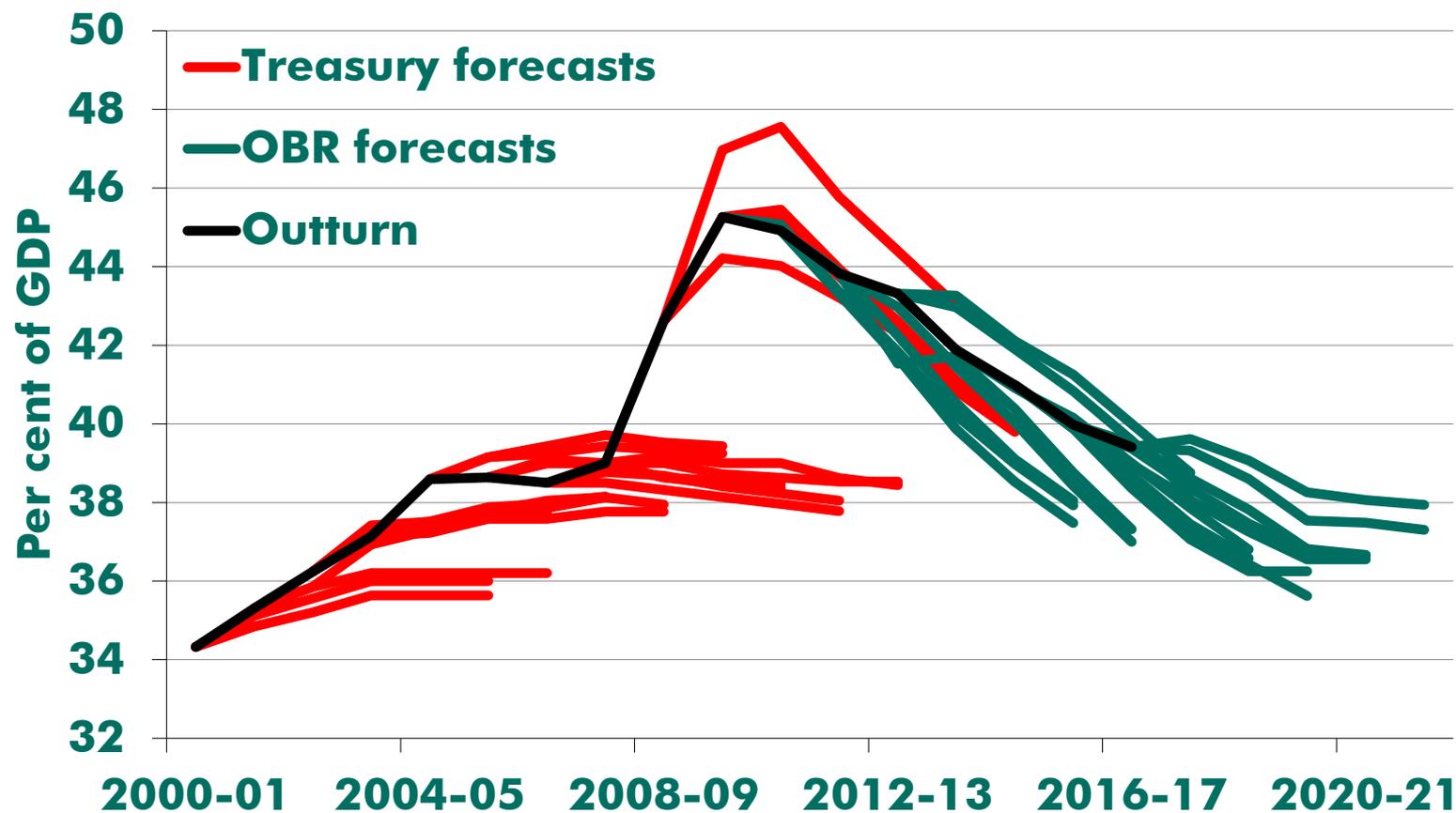
# Actual and default fuel duty rates



# Shares of income and income tax



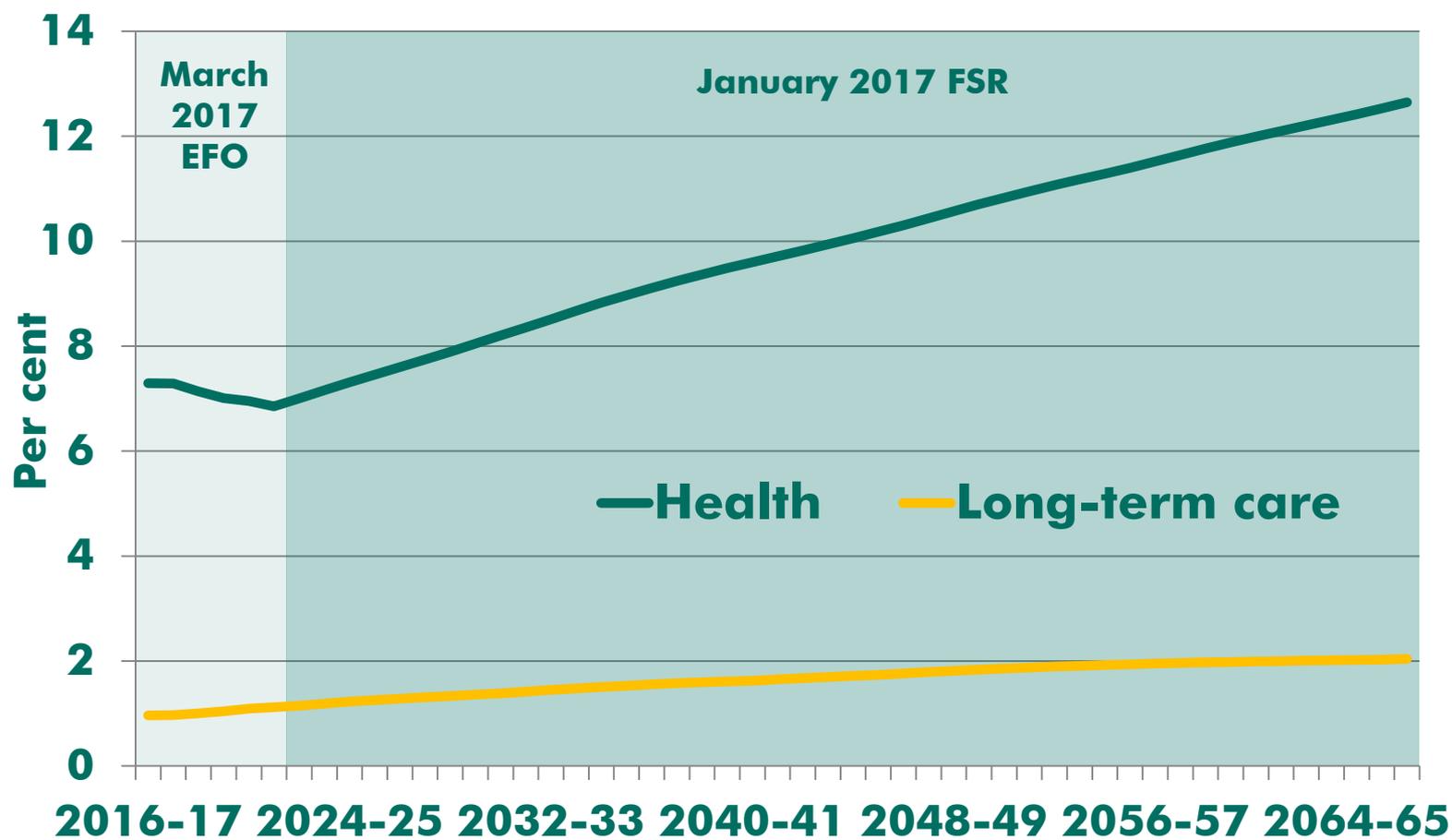
# Spending forecasts



# Spending risks

- Welfare
  - Long-term: ageing and triple lock on pensions
  - Medium-term: reforms and legal challenges
- Health
  - Long-term: ageing and technology
  - Medium-term: pressures and 'topping up'

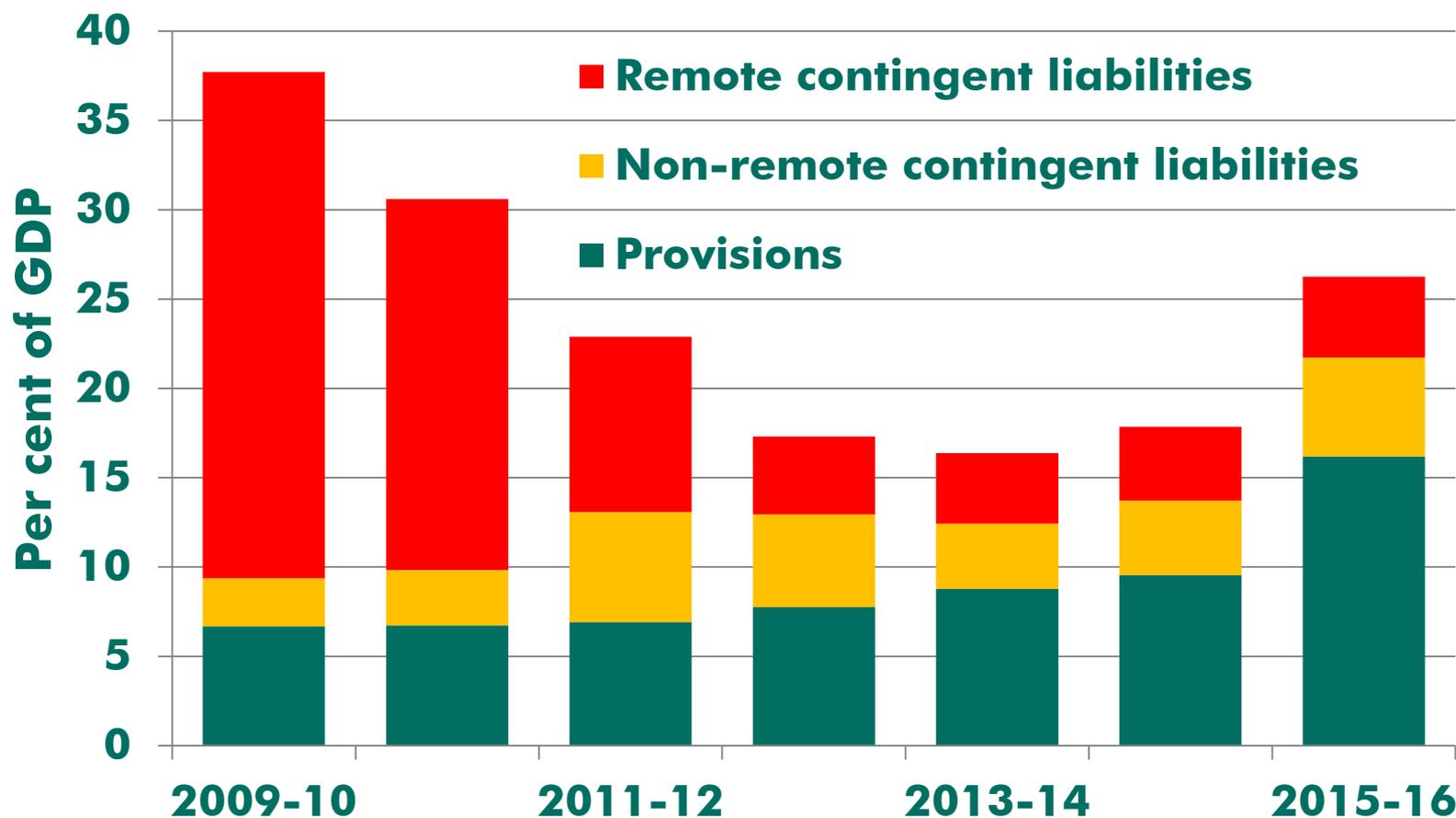
# Projected health and care costs



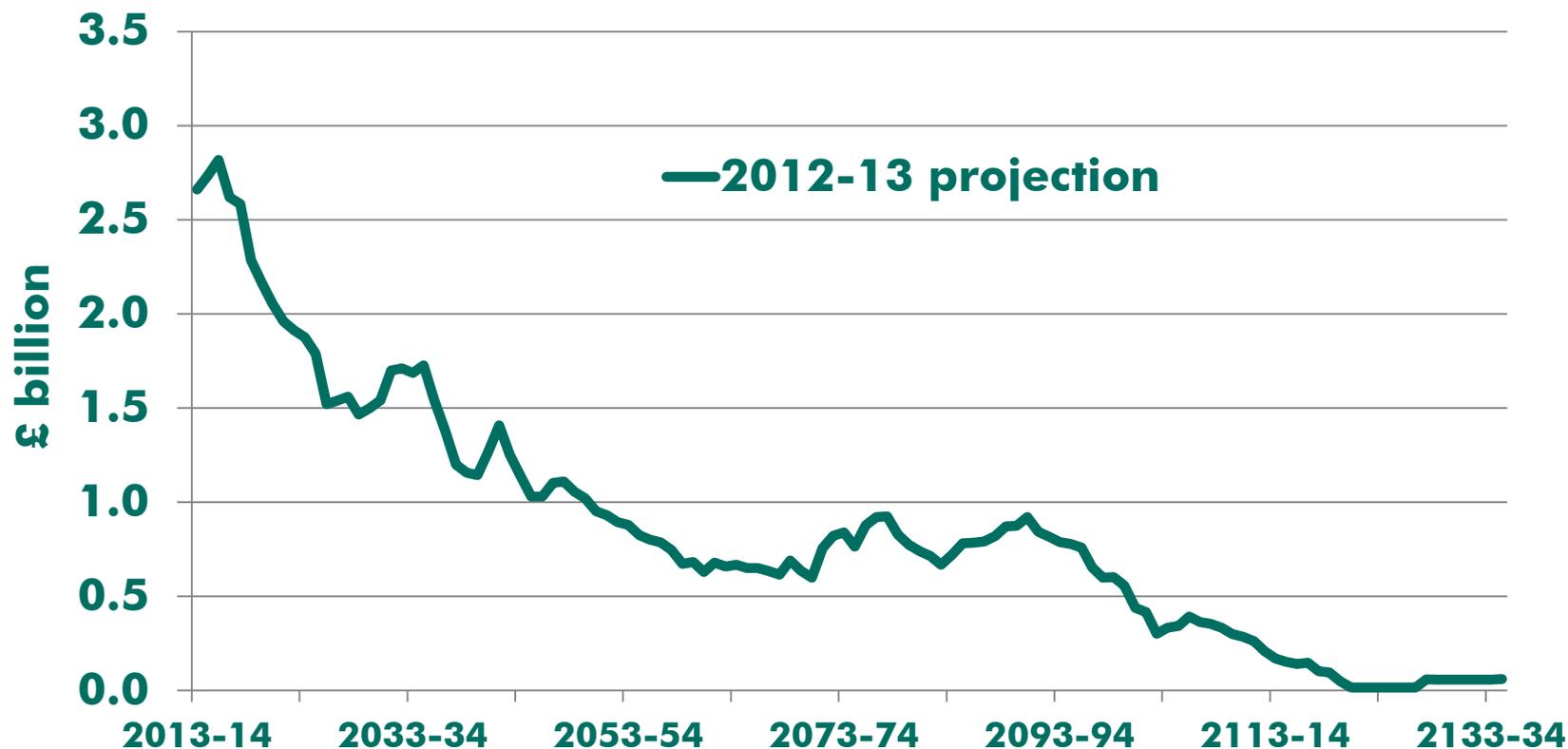
# Spending risks

- Welfare
  - Long-term: ageing and triple lock on pensions
  - Medium-term: reforms and legal challenges
- Health
  - Long-term: ageing and technology
  - Medium-term: pressures and 'topping up'

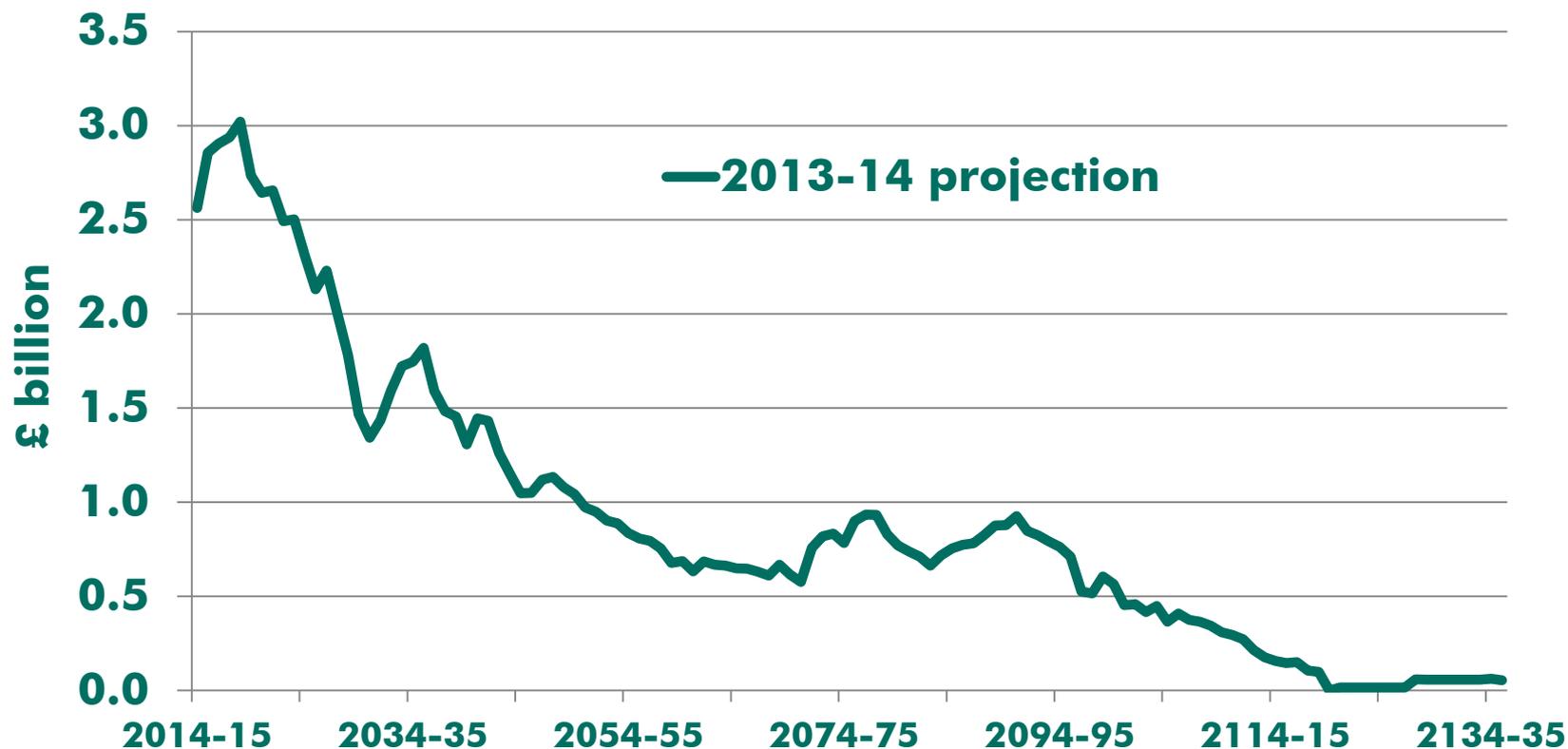
# Provisions and contingent liabilities



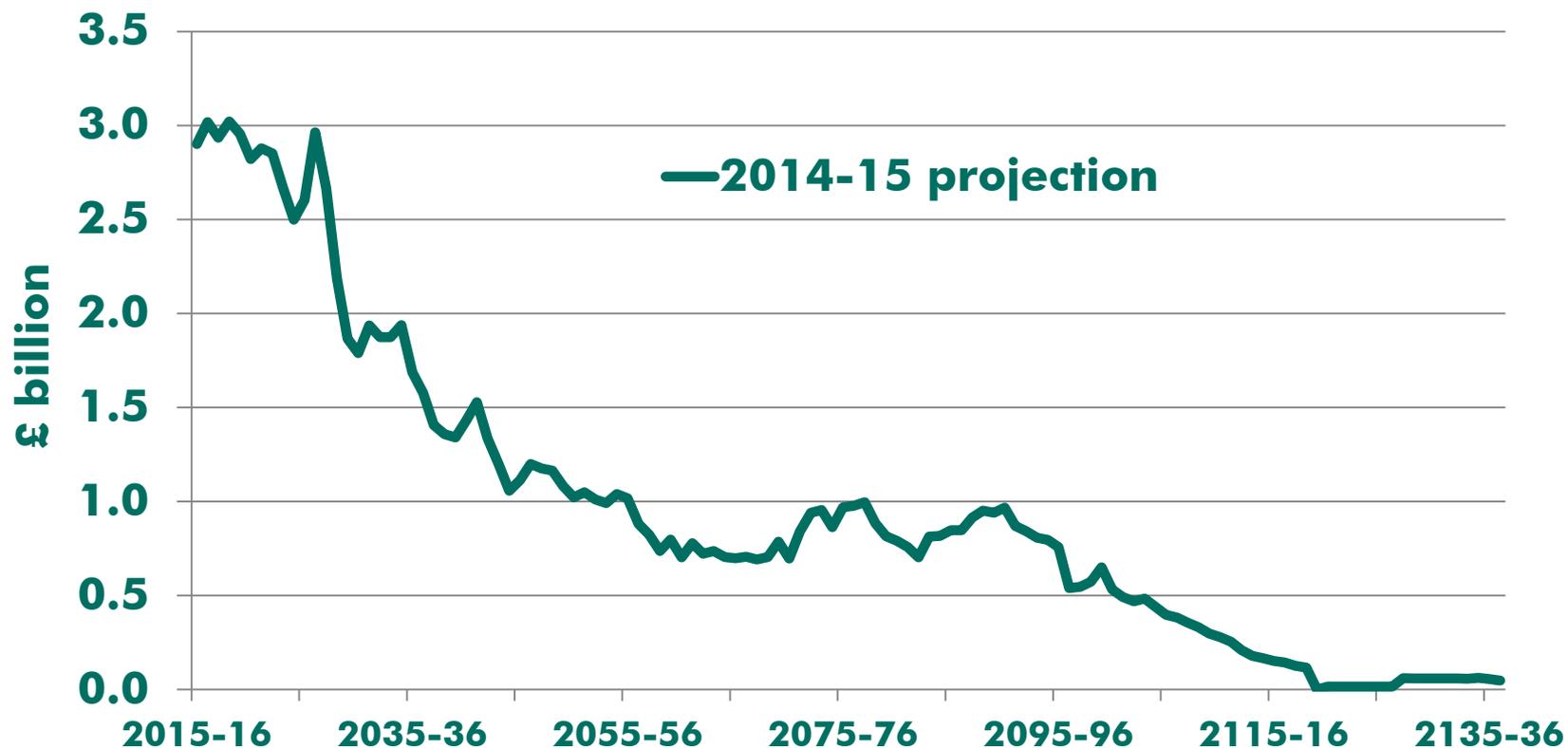
# Nuclear decommissioning costs



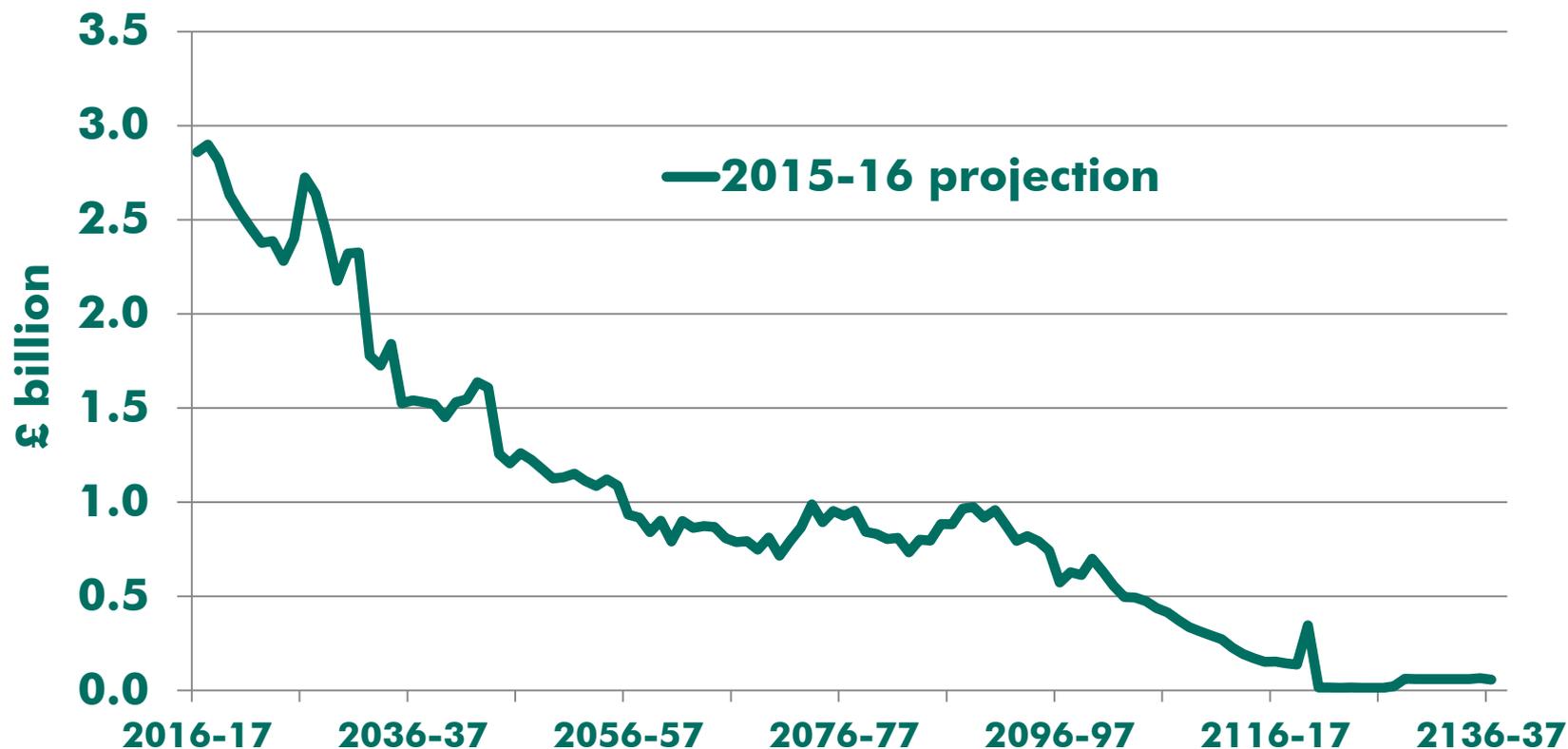
# Nuclear decommissioning costs



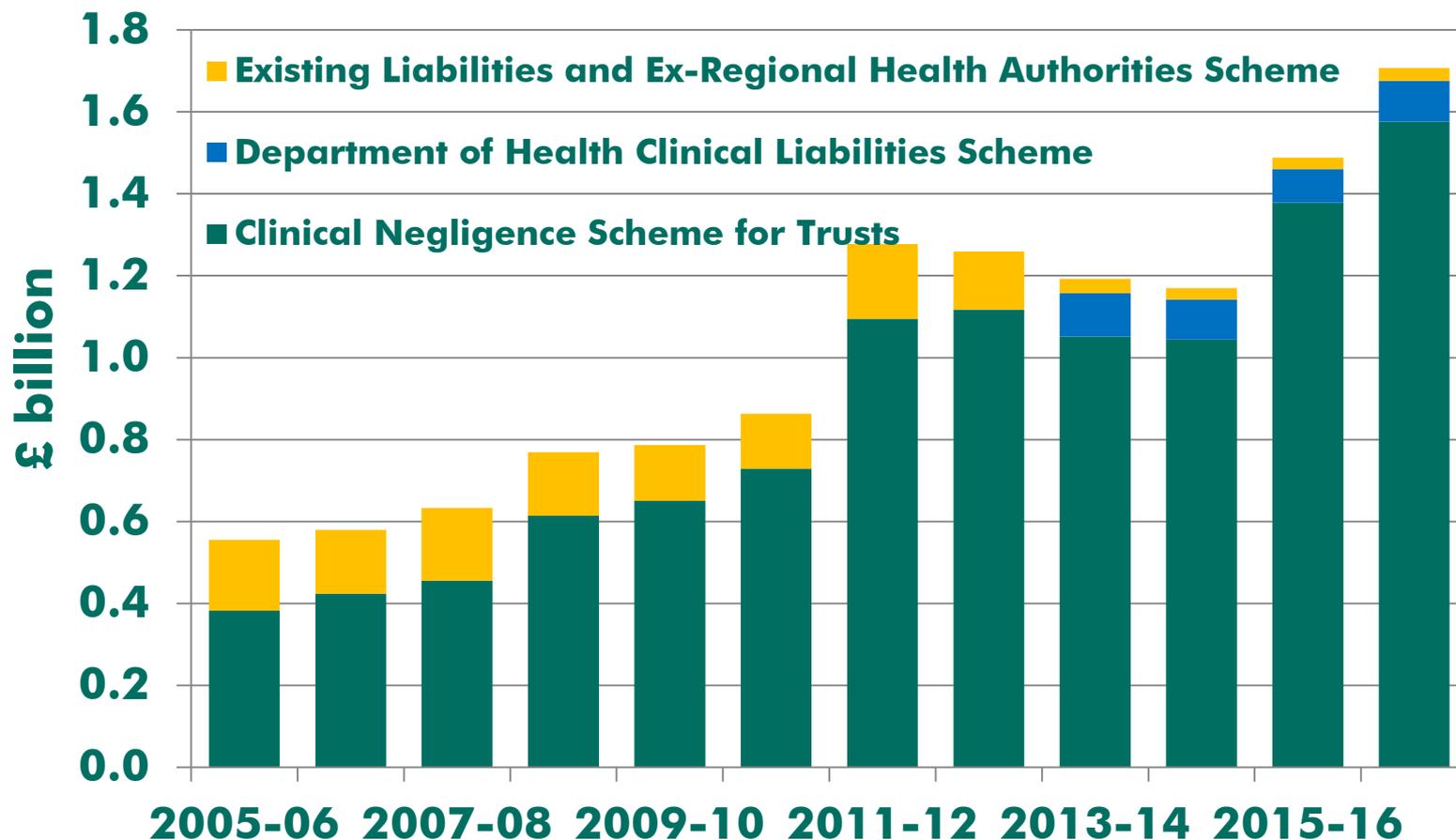
# Nuclear decommissioning costs



# Nuclear decommissioning costs



# Annual clinical negligence costs



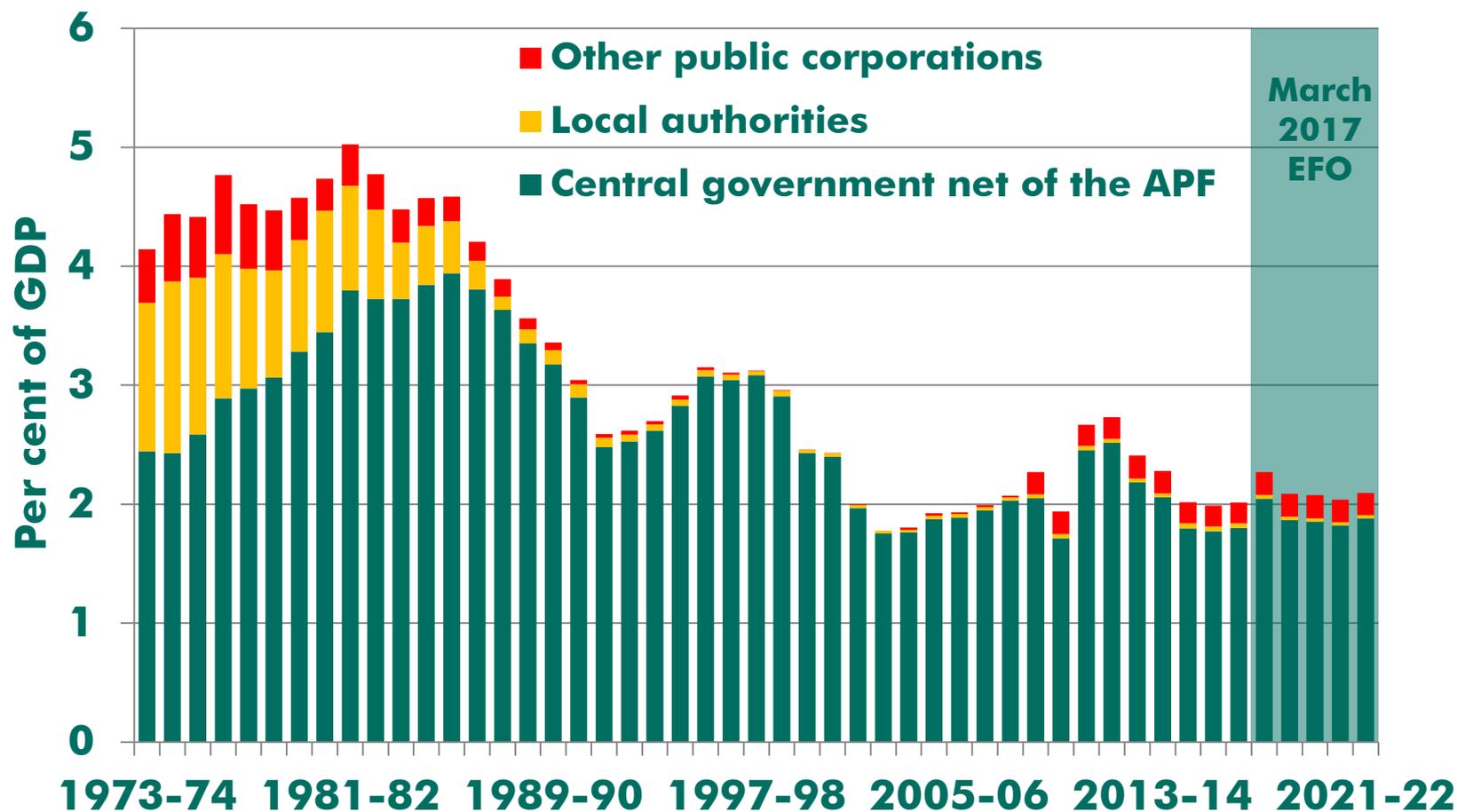
# Spending control

- Departmental expenditure limits (DELs) a strength
  - But declining share of spending covered
  - And cash limits on welfare not very successful
  - DEL limits rarely overspent, but often adjusted
- Local government
  - Reserves being drawn down
  - Some risky commercial investment for revenue

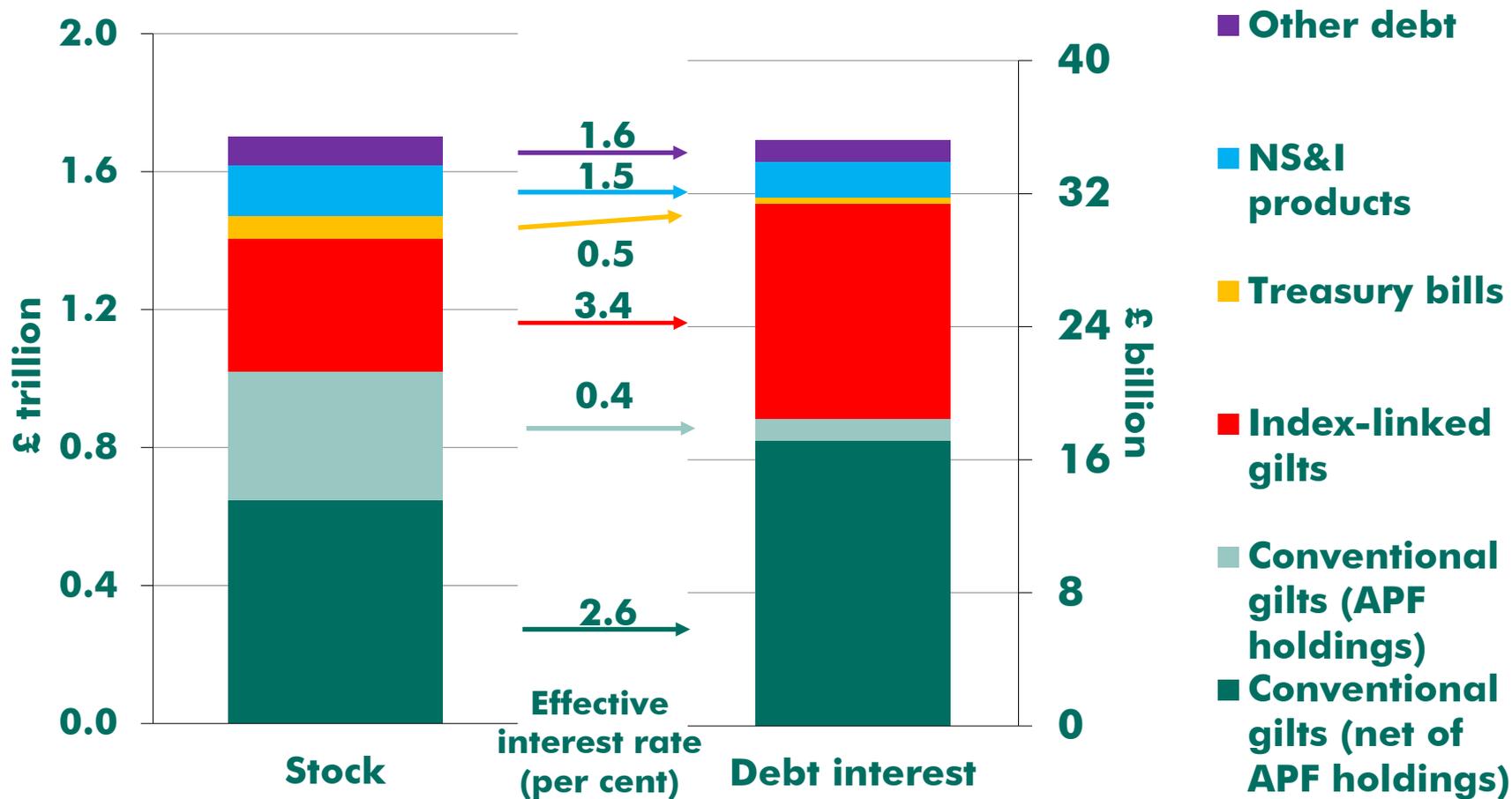
# Balance sheet risks

- Recent balance sheet shocks
  - Financial interventions and reclassifications
- Transaction risks
  - Student loans, financial asset sales, monetary policy and housing schemes
- Transfer risks
  - Housing associations and 'near government' bodies
- Fiscal illusions
  - Asset sales, grant-to-loan, guarantees, off balance sheet

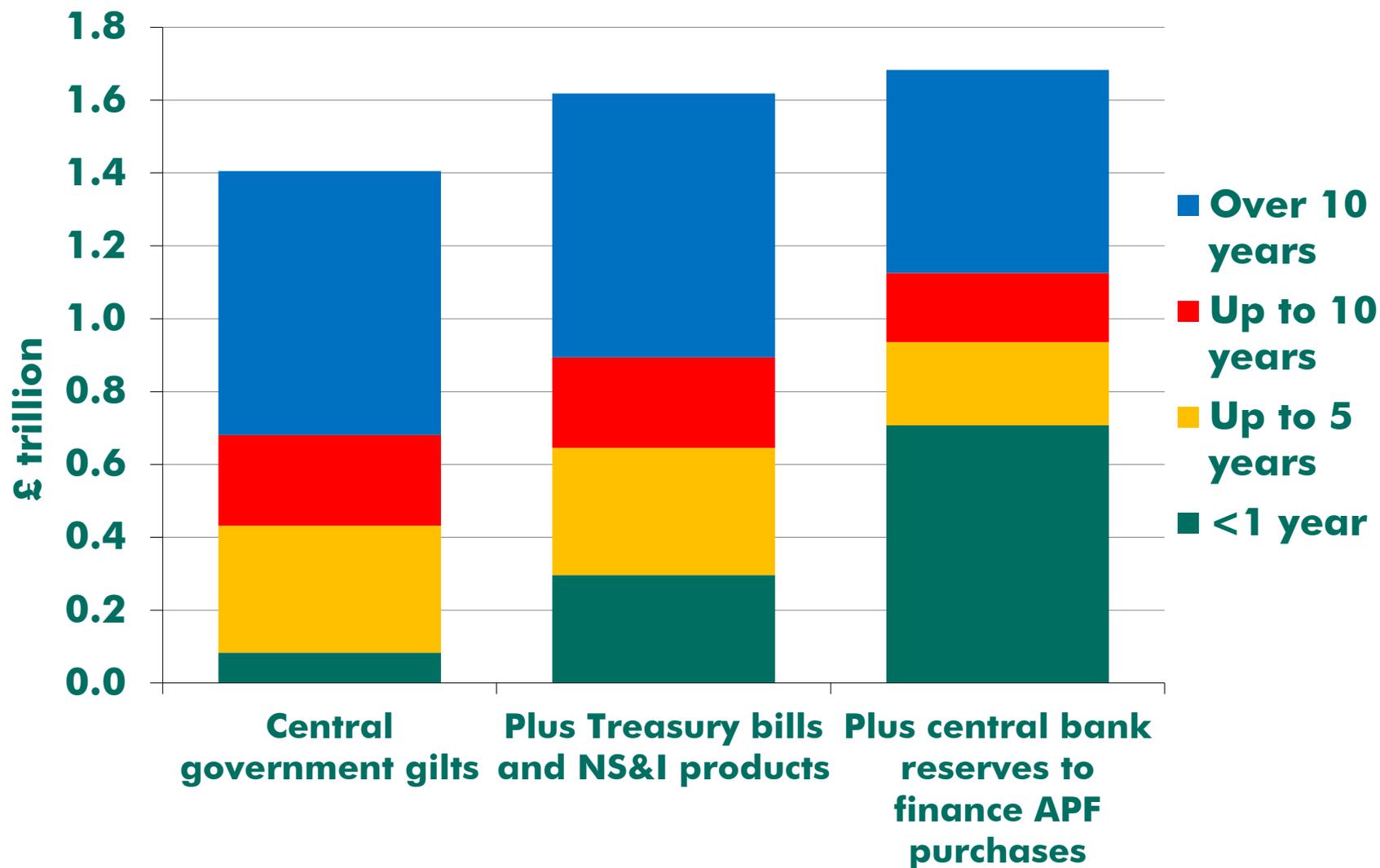
# Debt interest spending



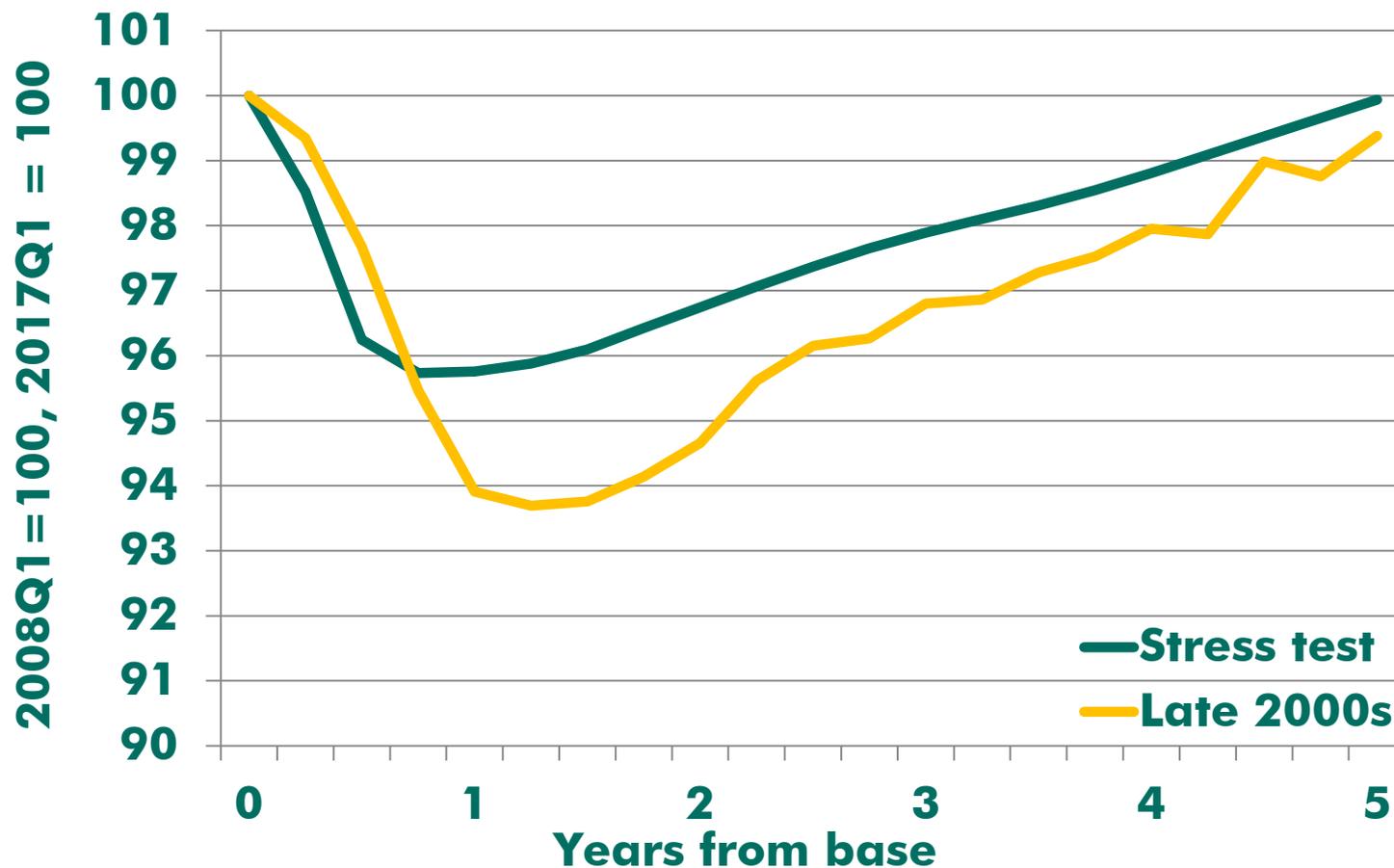
# Debt stock and debt interest



# Maturity of the debt stock



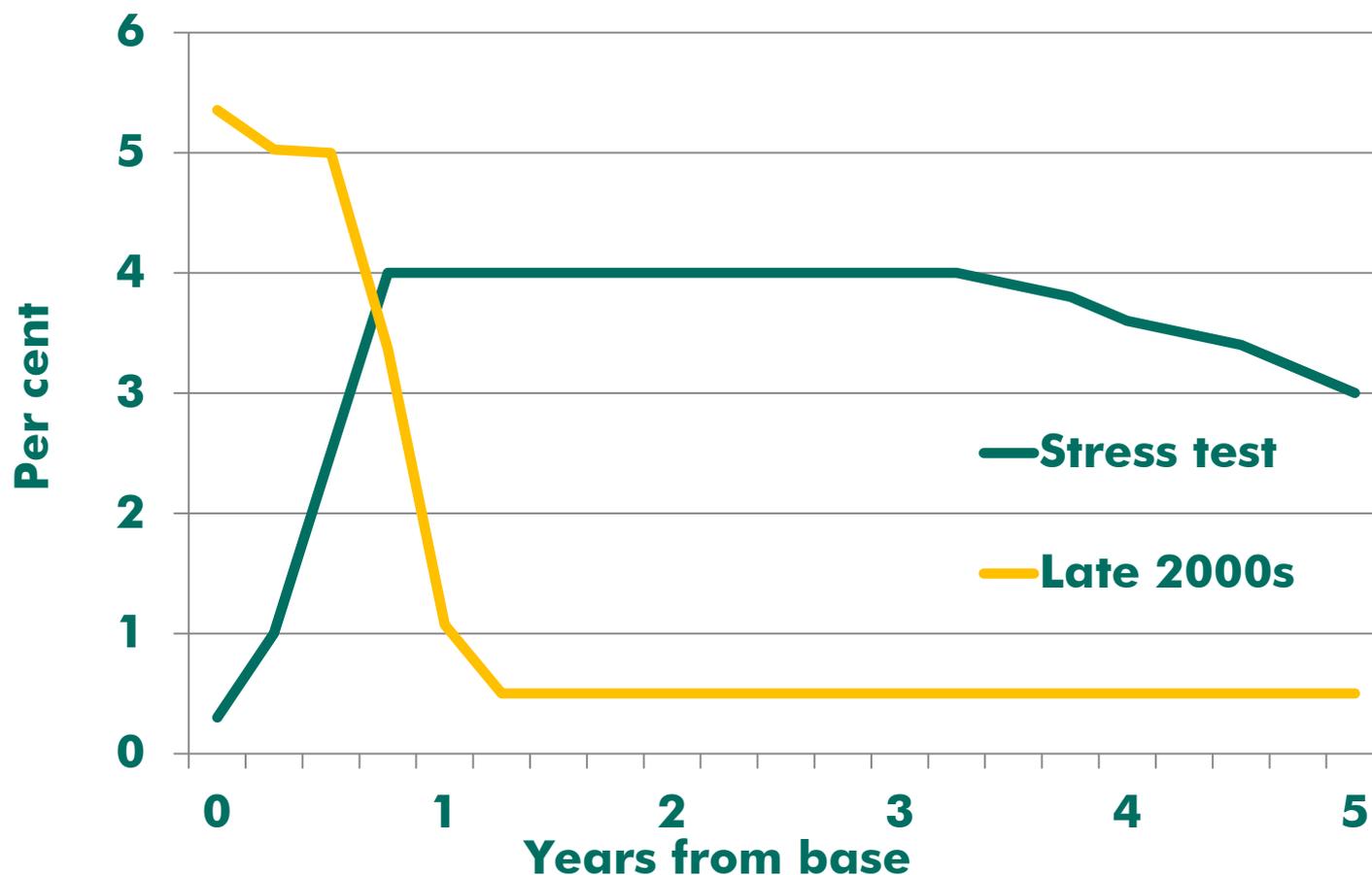
## Stress test: real GDP



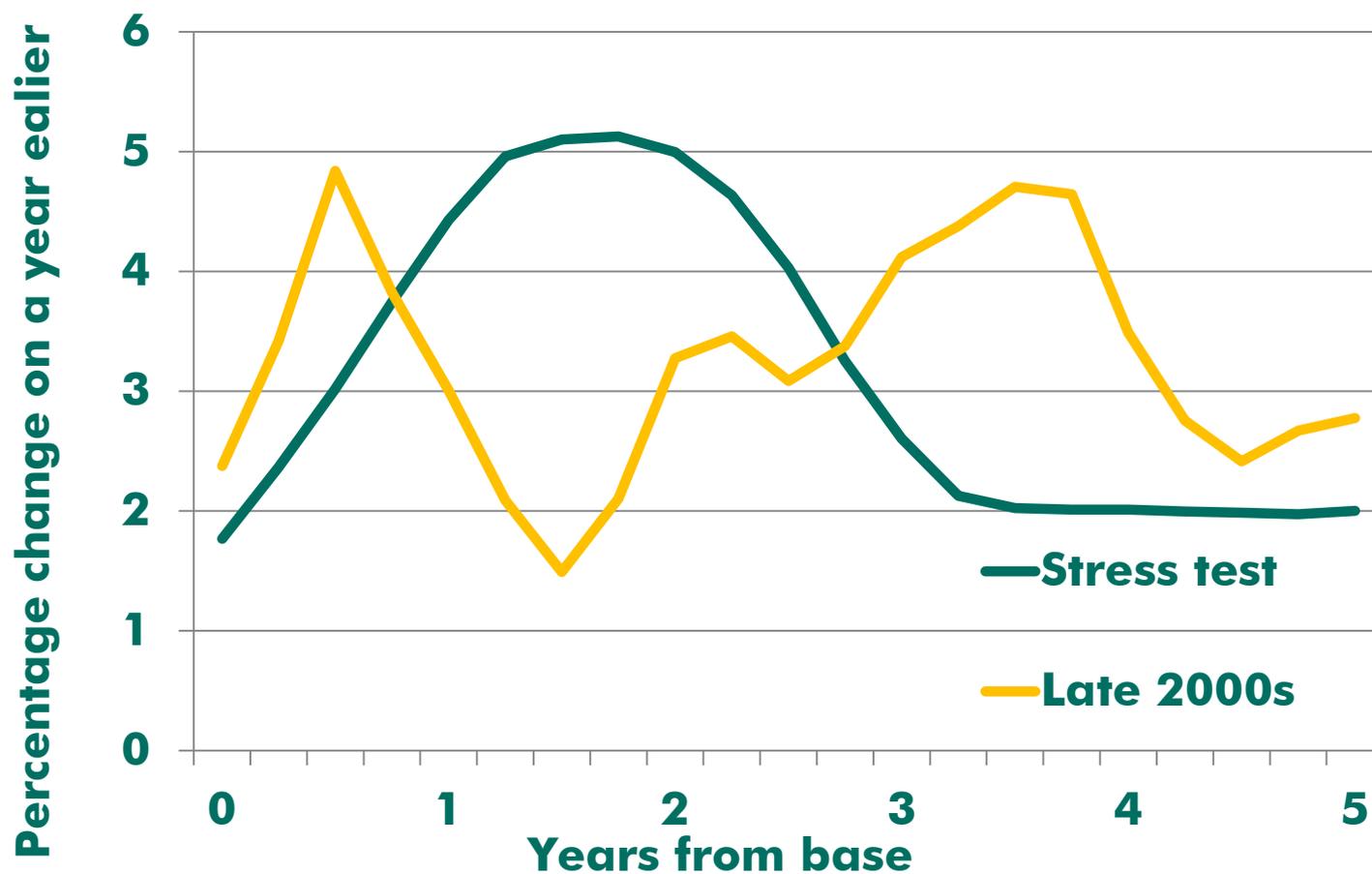
# Stress test: average earnings



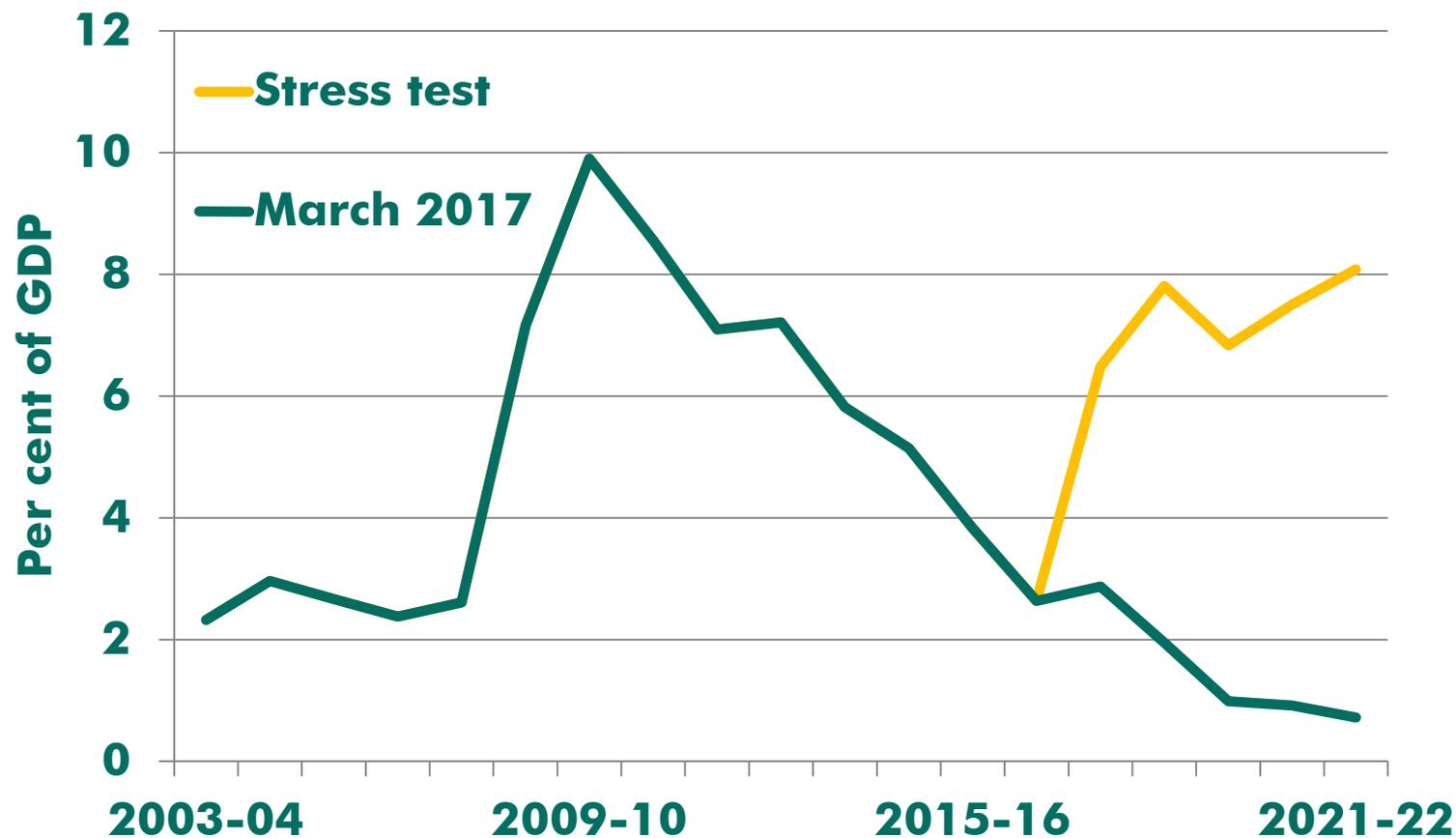
## Stress test: Bank Rate



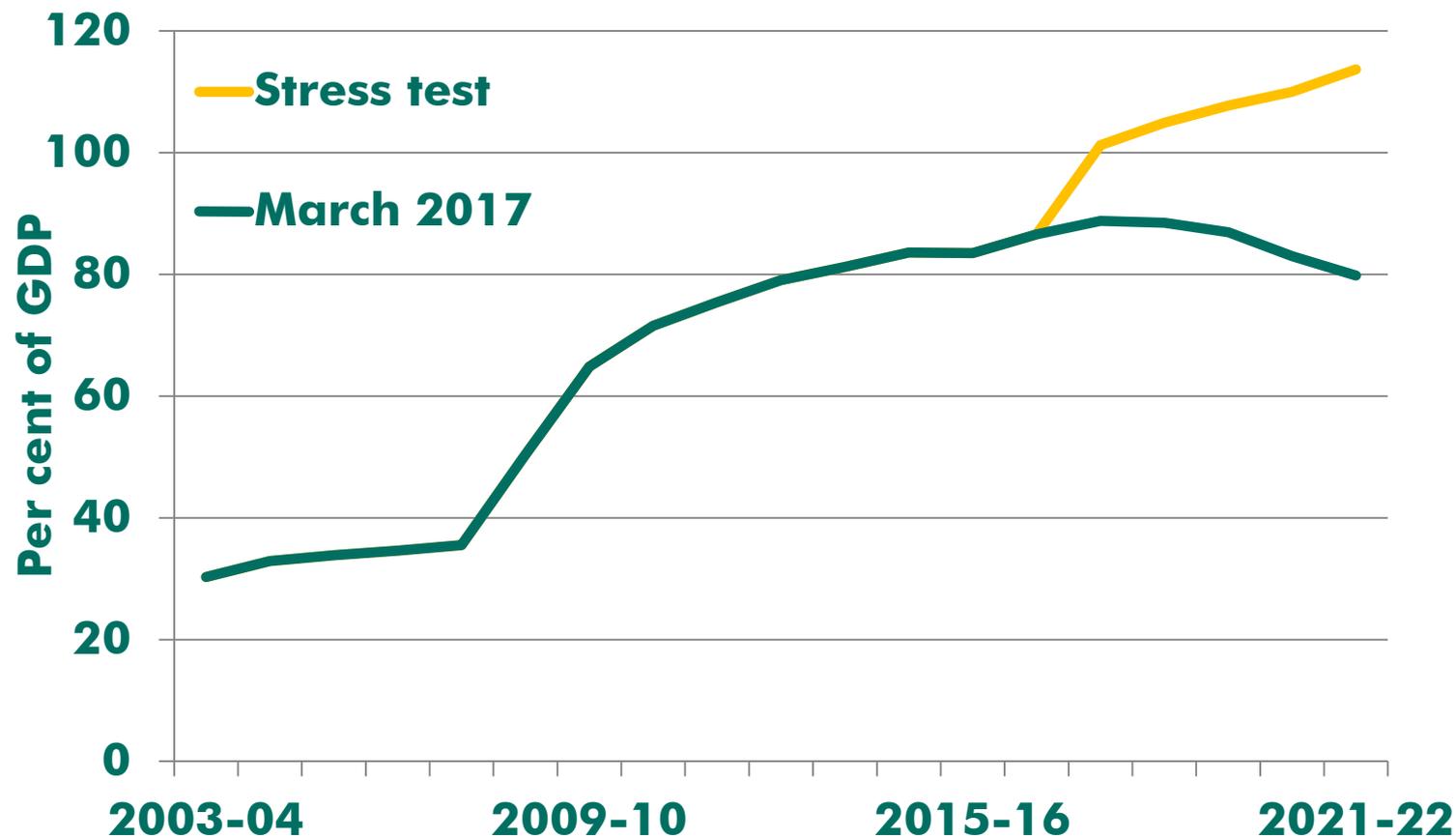
## Stress test: CPI inflation



# Stress test: net borrowing



## Stress test: net debt



# Stress test damage in 2021-22

£ billion	Stress Test	March 2017 EFO	Difference
<b>Public sector net borrowing:</b>	<b>175</b>	<b>17</b>	<b>158</b>
<i>of which:</i>			
<b>Spending</b>	<b>976</b>	<b>886</b>	<b>90</b>
Debt interest	110	44	66
Welfare	255	240	15
Other	611	602	9
<b>Receipts</b>	<b>801</b>	<b>870</b>	<b>-69</b>
Capital and property taxes	53	77	-24
Income tax and NICs	335	364	-28
Other	412	429	-17

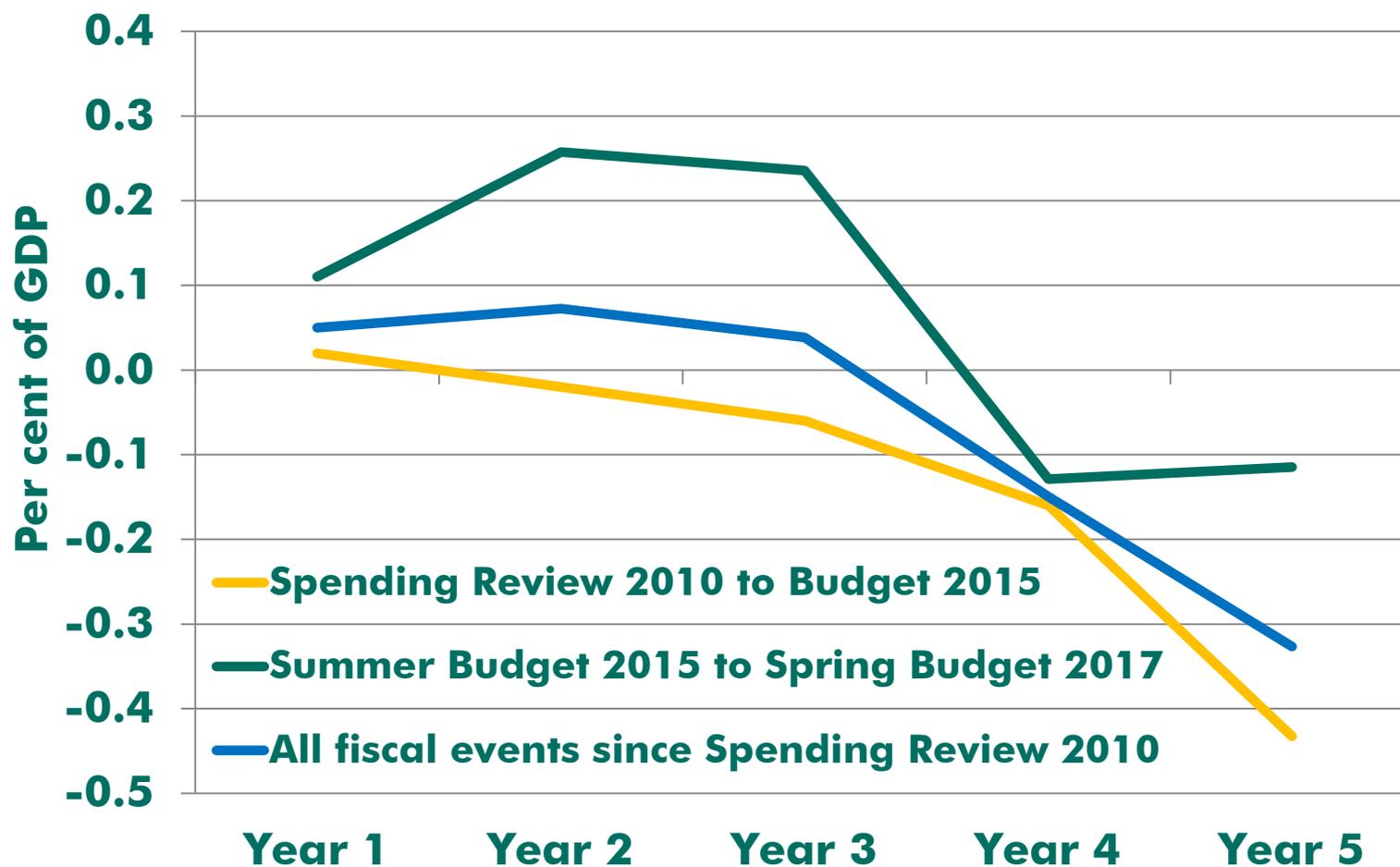
# Stress test damage in 2021-22

£ billion	Stress Test	March 2017 EFO	Difference
<b>Public sector net borrowing:</b>	<b>175</b>	<b>17</b>	<b>158</b>
<i>of which:</i>			
<b>Spending</b>	<b>976</b>	<b>886</b>	<b>90</b>
Debt interest	110	44	66
Welfare	255	240	15
Other	611	602	9
<b>Receipts</b>	<b>801</b>	<b>870</b>	<b>-69</b>
Capital and property taxes	53	77	-24
Income tax and NICs	335	364	-28
Other	412	429	-17

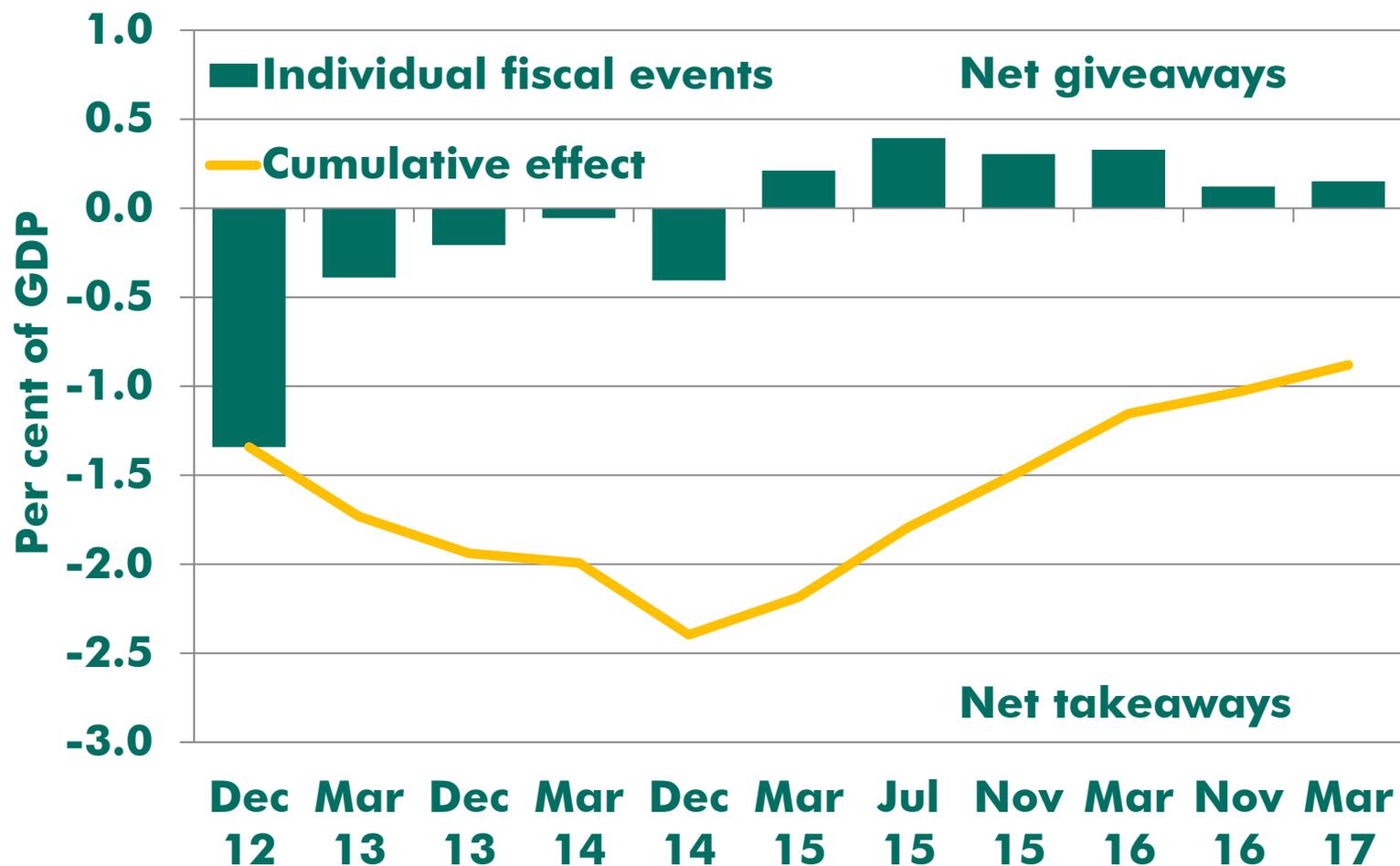
# Conclusions: main risks

- Main medium-term risks
  - Economy: recession, weak productivity
  - Spending: debt interest, health, DELs
  - Policy: further fuel duty cancellation
- Main long-term risks
  - Economy: recessions and financial crisis
  - Spending: Ageing and health costs
  - Revenues: fuel, tobacco and work patterns

# Giveaways today, takeaways tomorrow



# Impact of policy measures in 2017-18



# Conclusions: main risks

- Main medium-term risks
  - Economy: recession, weak productivity
  - Spending: debt interest, health, DELs
  - Policy: further fuel duty cancellation
- Main long-term risks
  - Economy: recessions and financial crisis
  - Spending: Ageing and health costs
  - Revenues: fuel, tobacco and work patterns

# Conclusions: Brexit specific

- Economy related
  - Trade, productivity, investment, migration and financial sector
- Spending related
  - Divorce bill, EU schemes, UK regulators, negotiations/implementation, sector interventions
- Receipts related
  - Financial sector

# Conclusions: lessons for policy

- Keep the risks that the Government has chosen to expose itself to under review
- Prepare for nasty surprises
- Take action on long-term pressures