

Office for
**Budget
Responsibility**

Fiscal risks report 2019

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Chairman

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Background

- The IMF said in 2016 that “summary reporting of specific risks is a weakness that should be addressed”
- The Government then legislated for us to produce an *FRR* every two years, to which it is obliged to respond
- We published our first *FRR* in July 2017 and the Treasury responded with *Managing fiscal risks* in July 2018
- Several other countries produce risk reports, but usually by 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 2019) forecast over the medium term
 - To fiscal sustainability over the longer term
- We are interested in
 - Probability and potential impact: any change over last two years?
 - What the government is doing: response in *MFR* and policy
- But taking on fiscal risk not necessarily a bad thing

Chapters and special themes

- **Macroeconomic risks:** output gap mismeasurement
- **Financial sector risks:** shadow banking
- **Revenue risks:** tax relief and digital economy
- **Primary spending risks:** NHS & free TV licences for over 75s
- **Balance sheet risks:** fiscal illusions & intangible assets
- **Debt interest risks:** 'R-G' and debt dynamics
- **Fiscal policy risks:** looser fiscal rule?
- **Climate change:** introduction to future work
- **A fiscal stress test:** IMF no-deal Brexit scenario

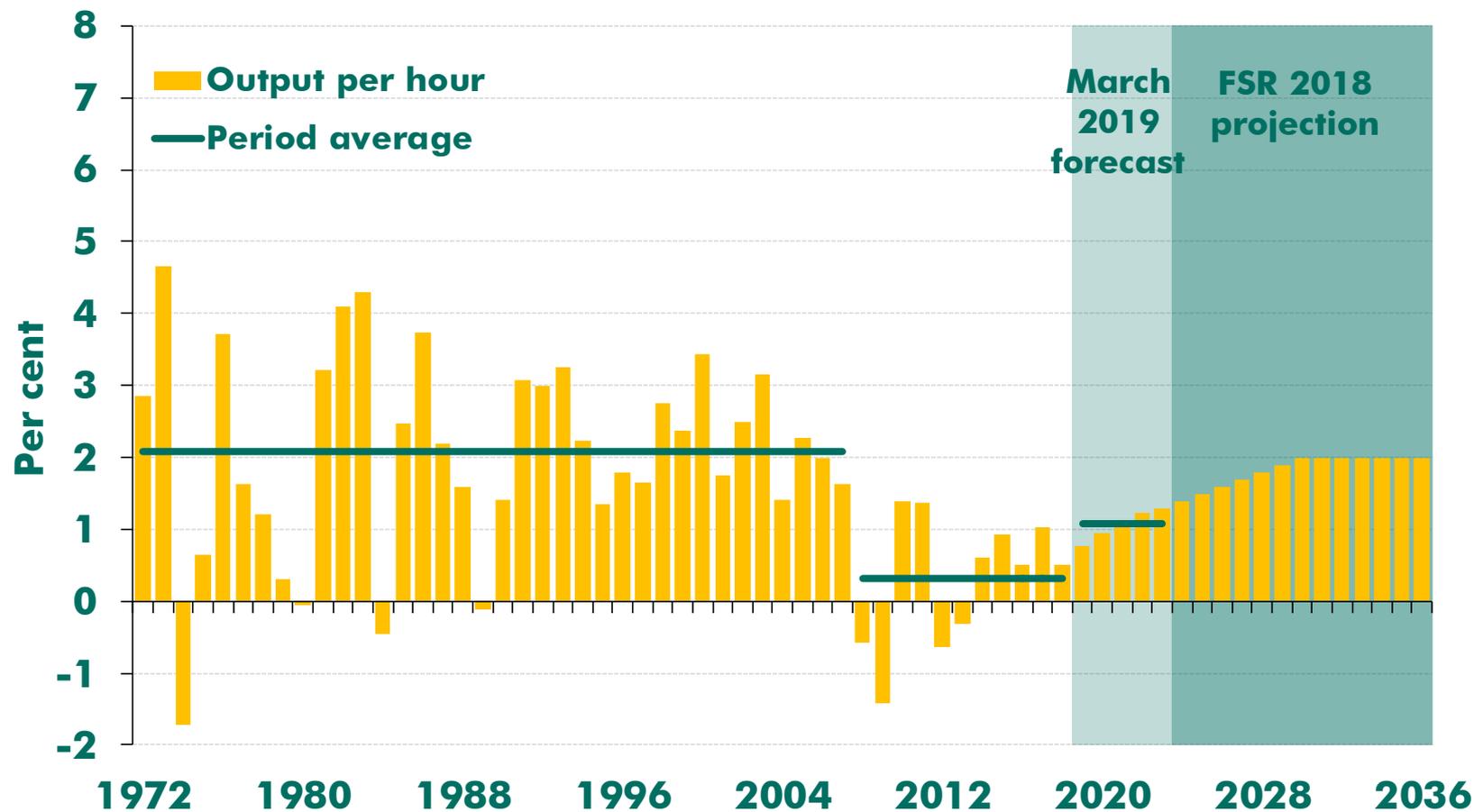
Big picture

- Most fiscal risks we identified in 2017 remain
- Some significant government action
 - Monitoring, management and transparency
 - Deficit lower and debt starting to fall as %GDP
- But significant medium-term policy risks
 - ‘Balanced budget’ objective being downplayed
 - Big spending increases off-timetable (NHS)
 - Potential PMs have big shopping lists
 - Possibility of disruptive no-deal Brexit
- Health costs and ageing remain big long-term risks

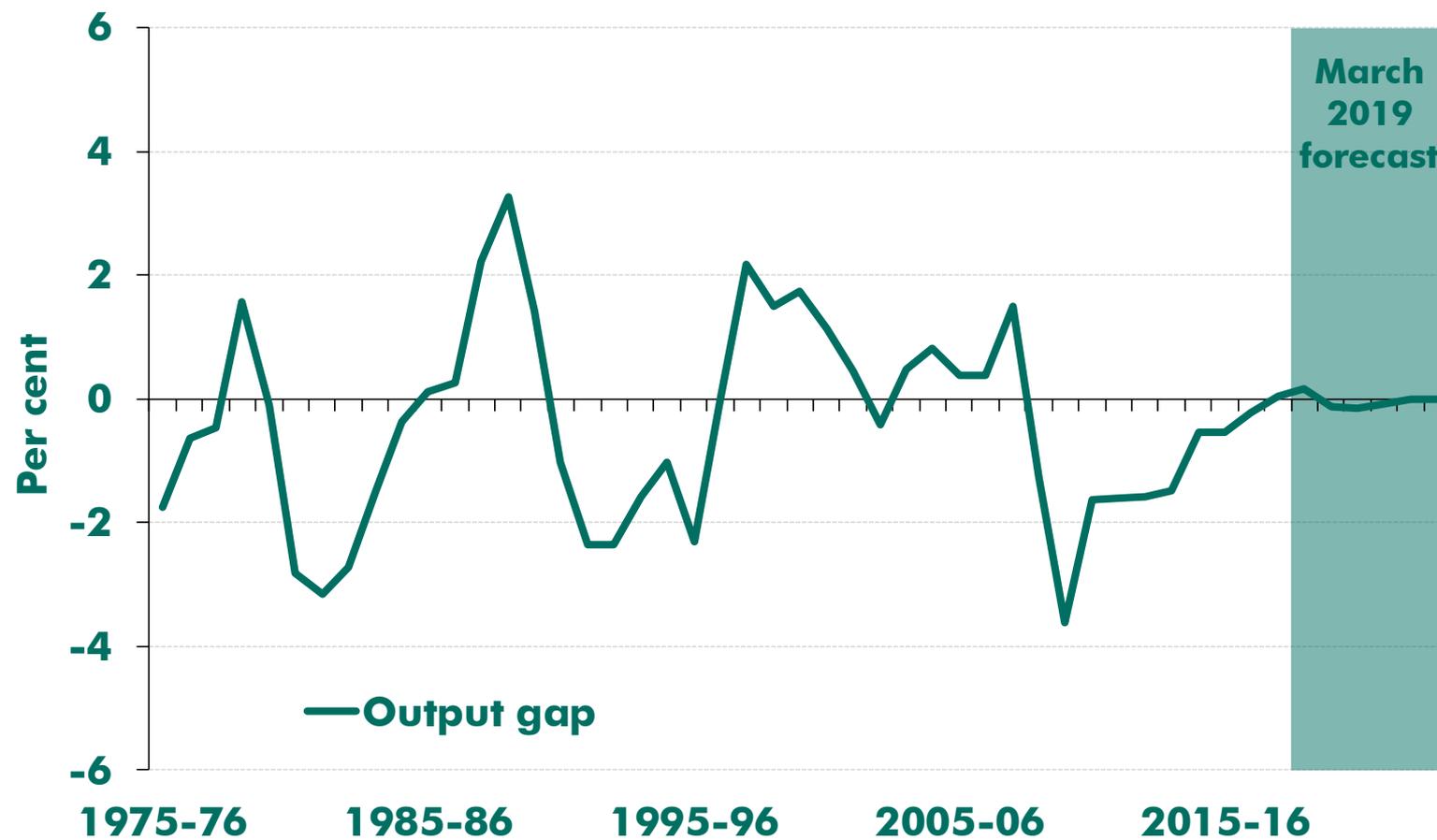
Macroeconomic risks

- Risks to potential output growth
- Risks of a cyclical downturn
- Sectoral balances
- GDP composition risks

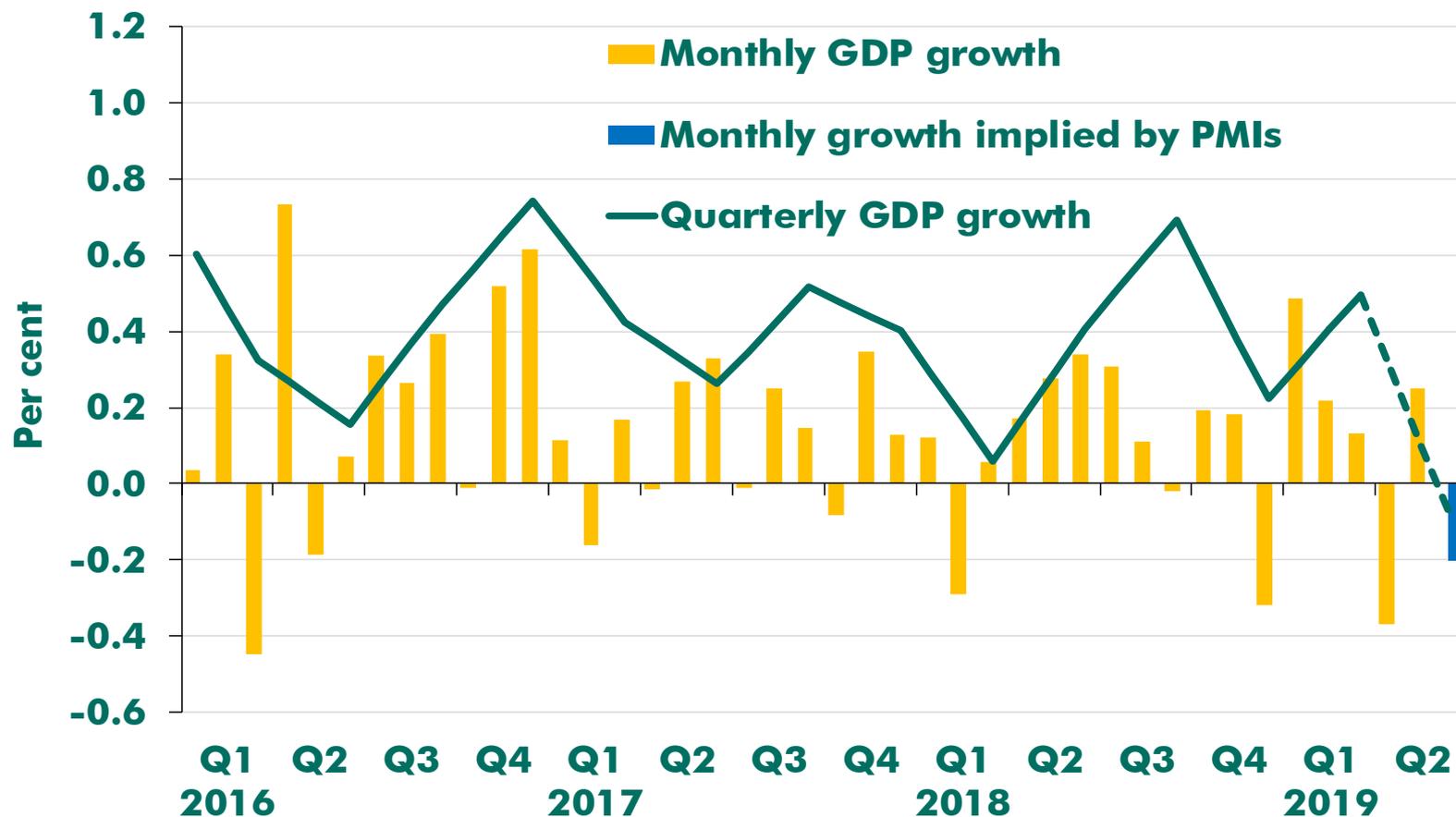
Productivity growth



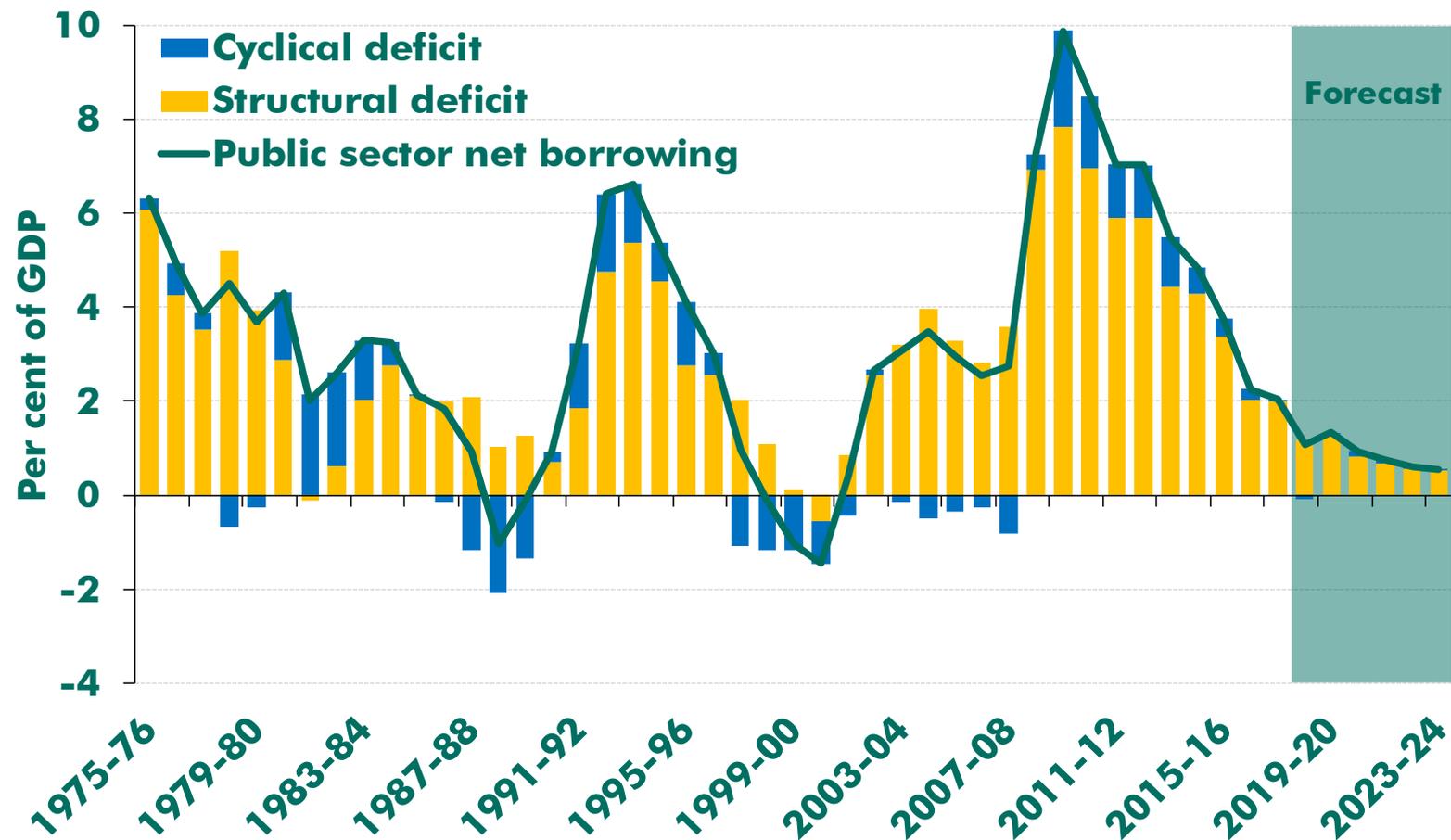
The economic cycle



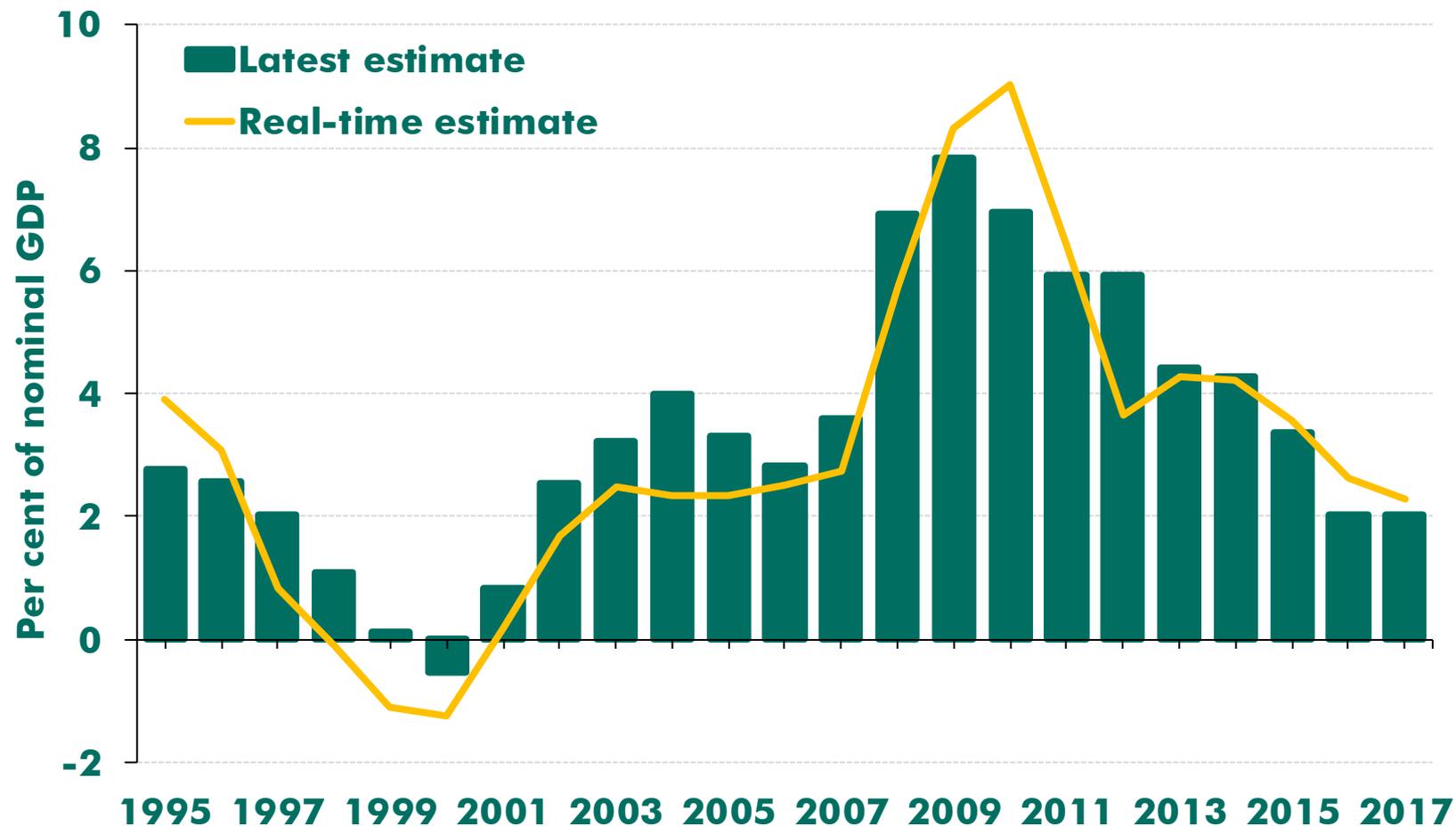
Monthly/quarterly GDP growth



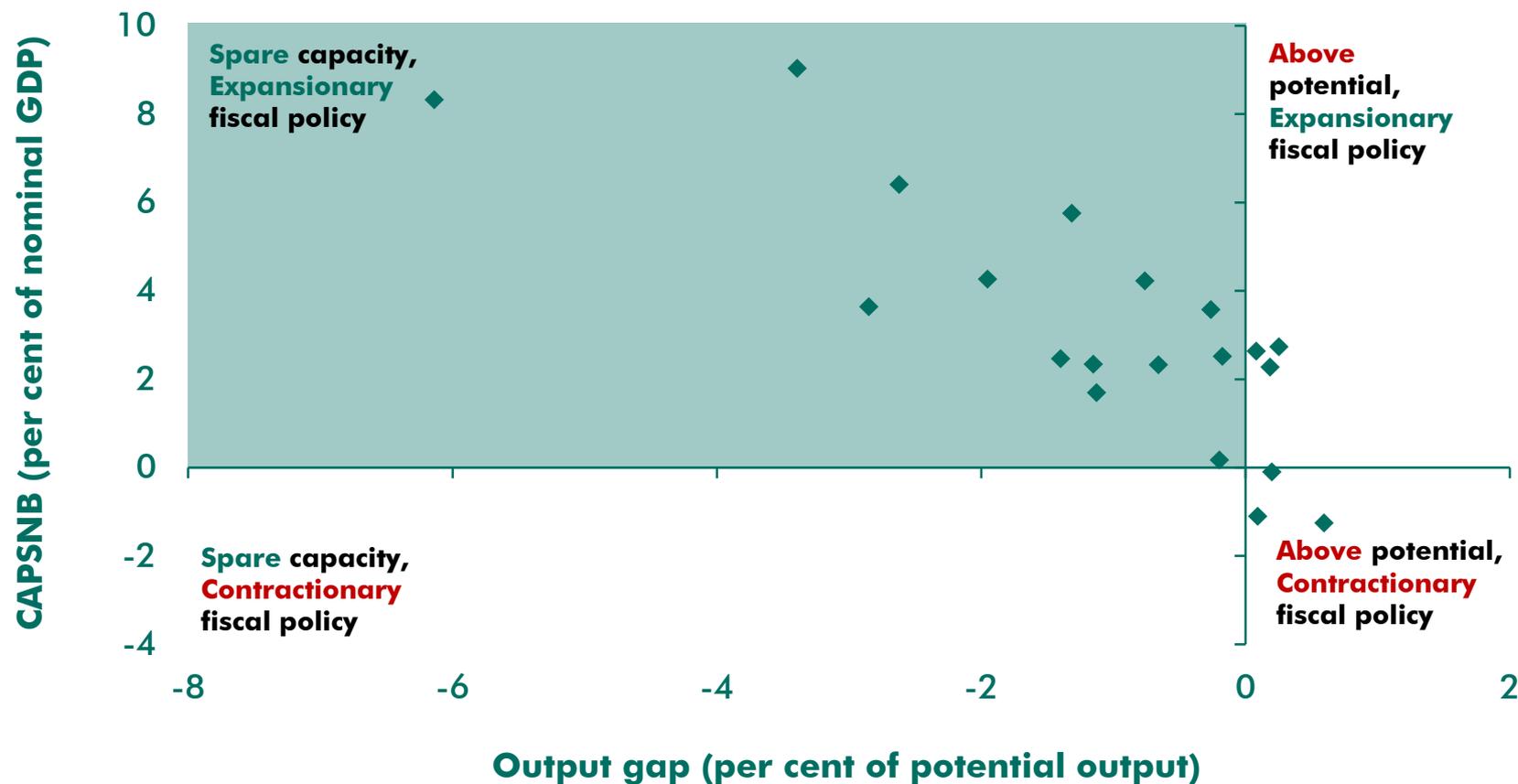
Structural and cyclical borrowing



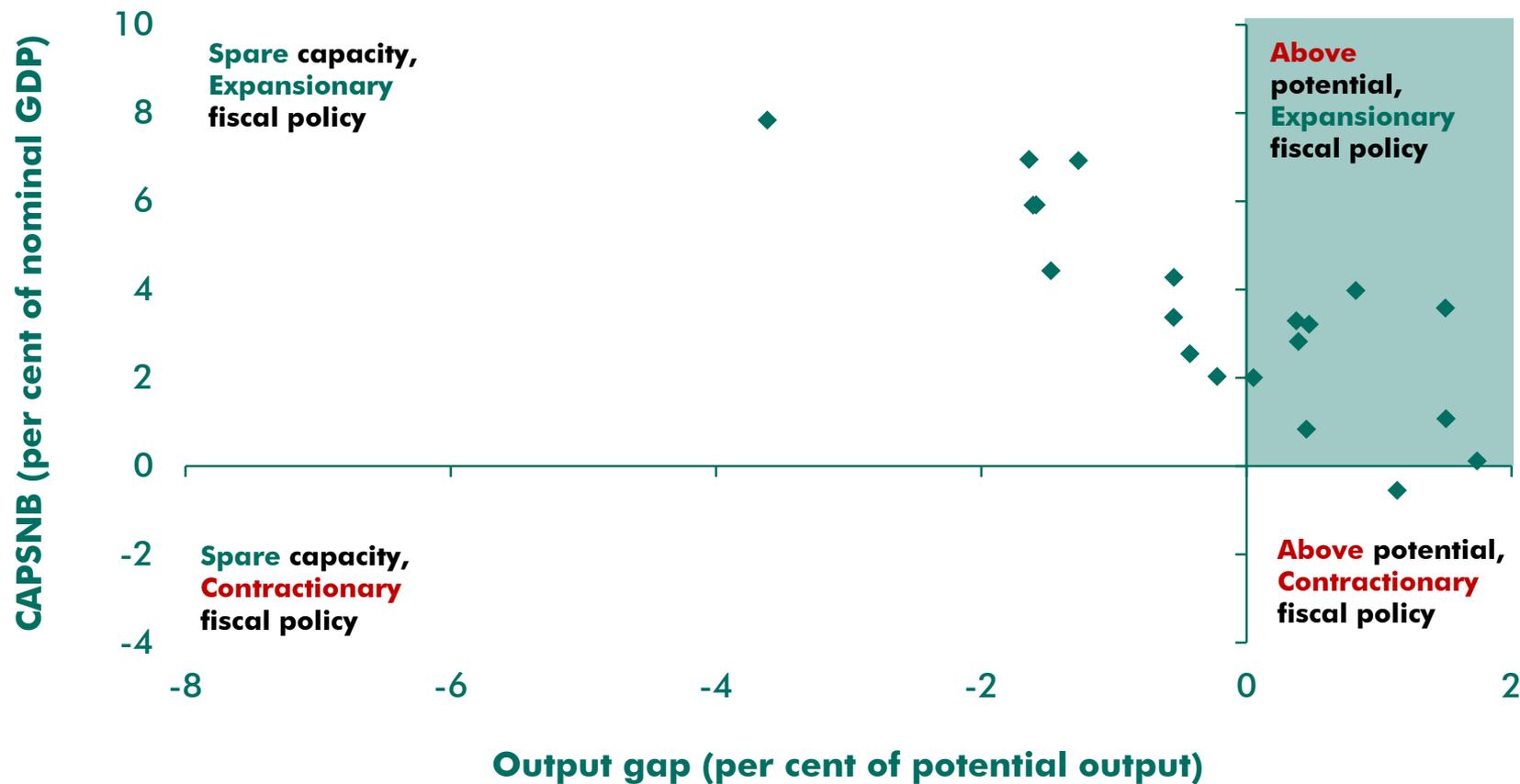
Structural deficit: original and now



Fiscal policy and spare capacity



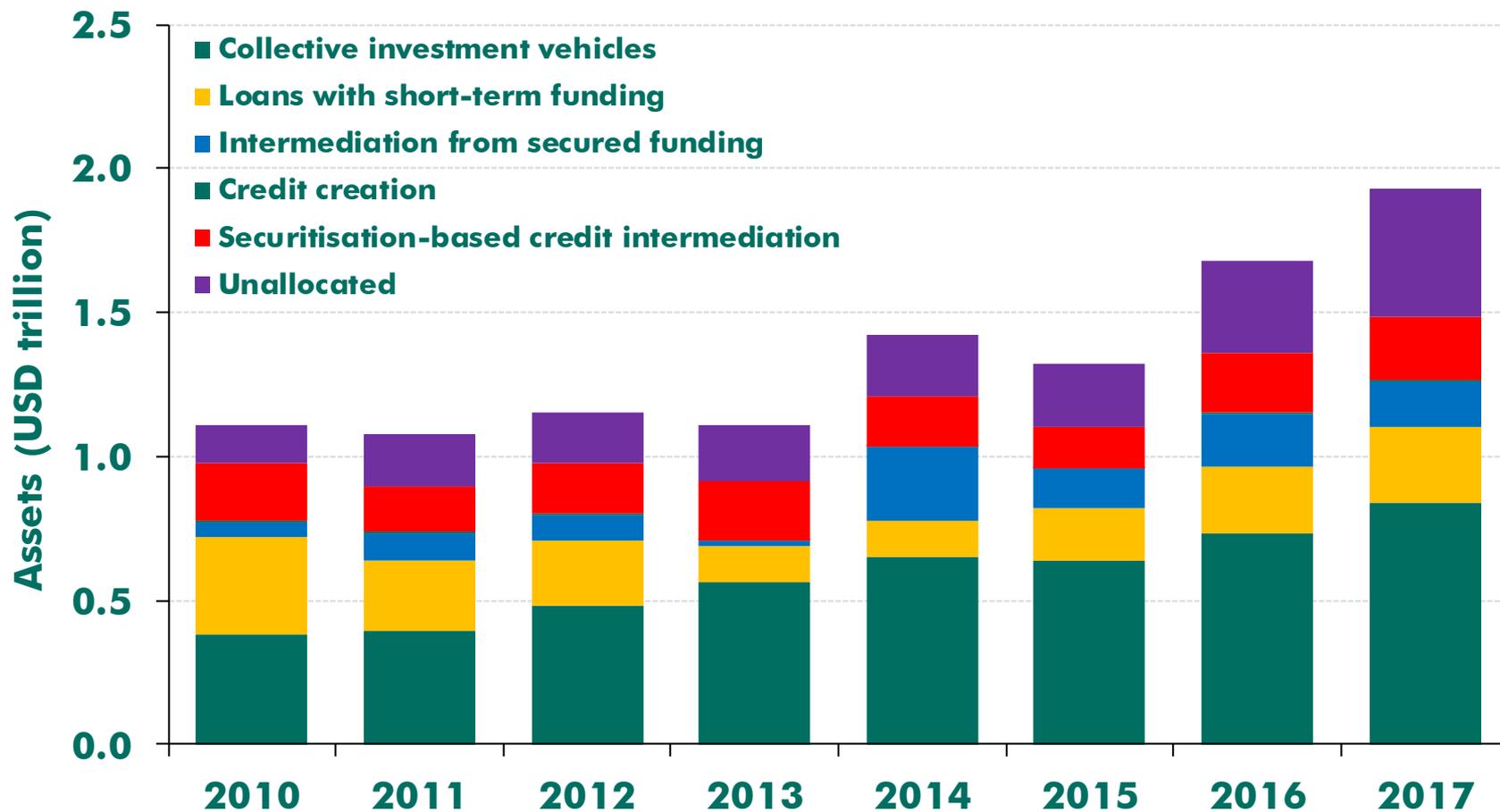
Fiscal policy and spare capacity



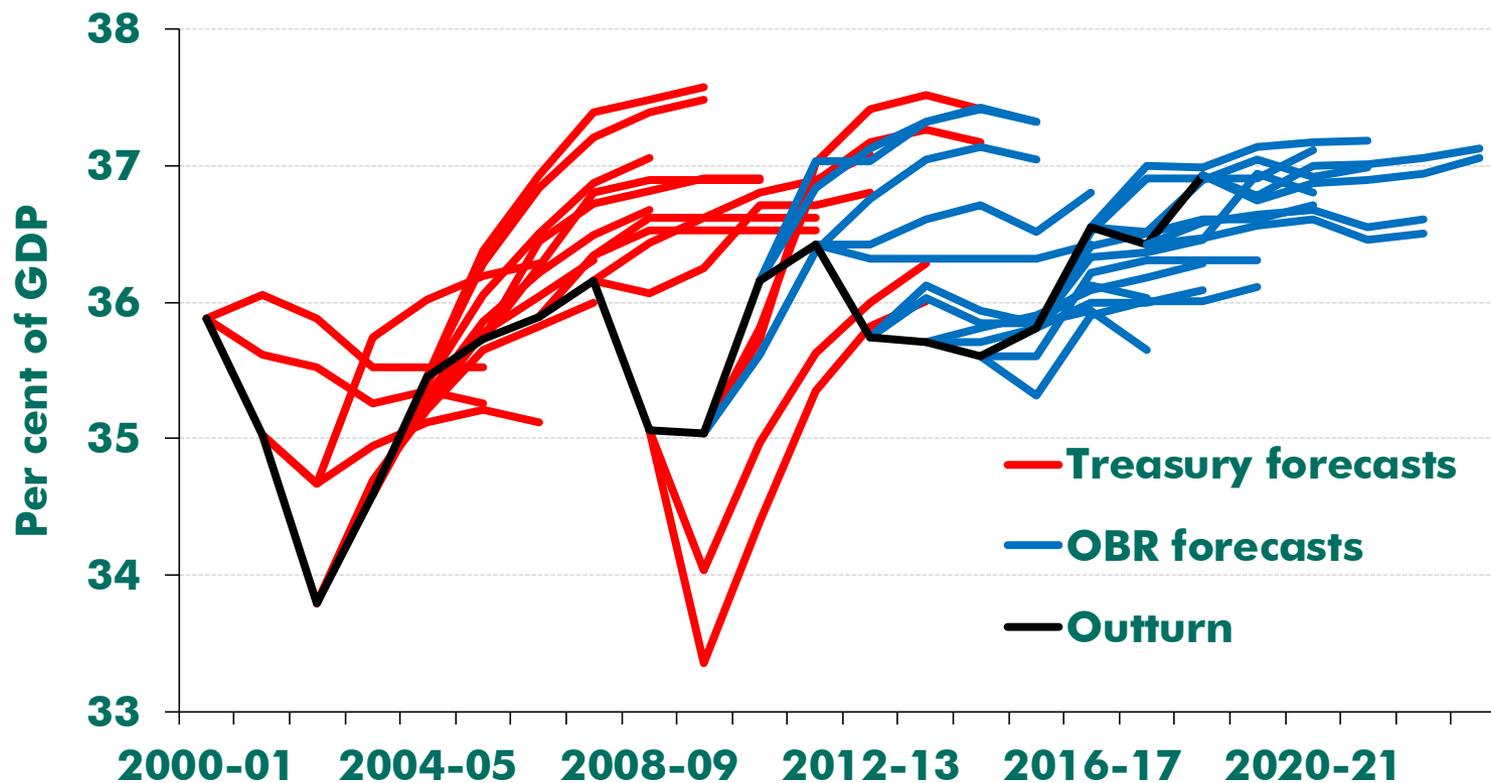
Financial sector risks

- Last time: financial crises and long-term trends
- HMT: better regulation of the banking sector has made crises less likely and potentially costly
- But what if risks are simply pushed elsewhere?
- More oversight and regulation of 'shadow banks', but is this sufficient?
- Potential bail-out costs and possible contagion

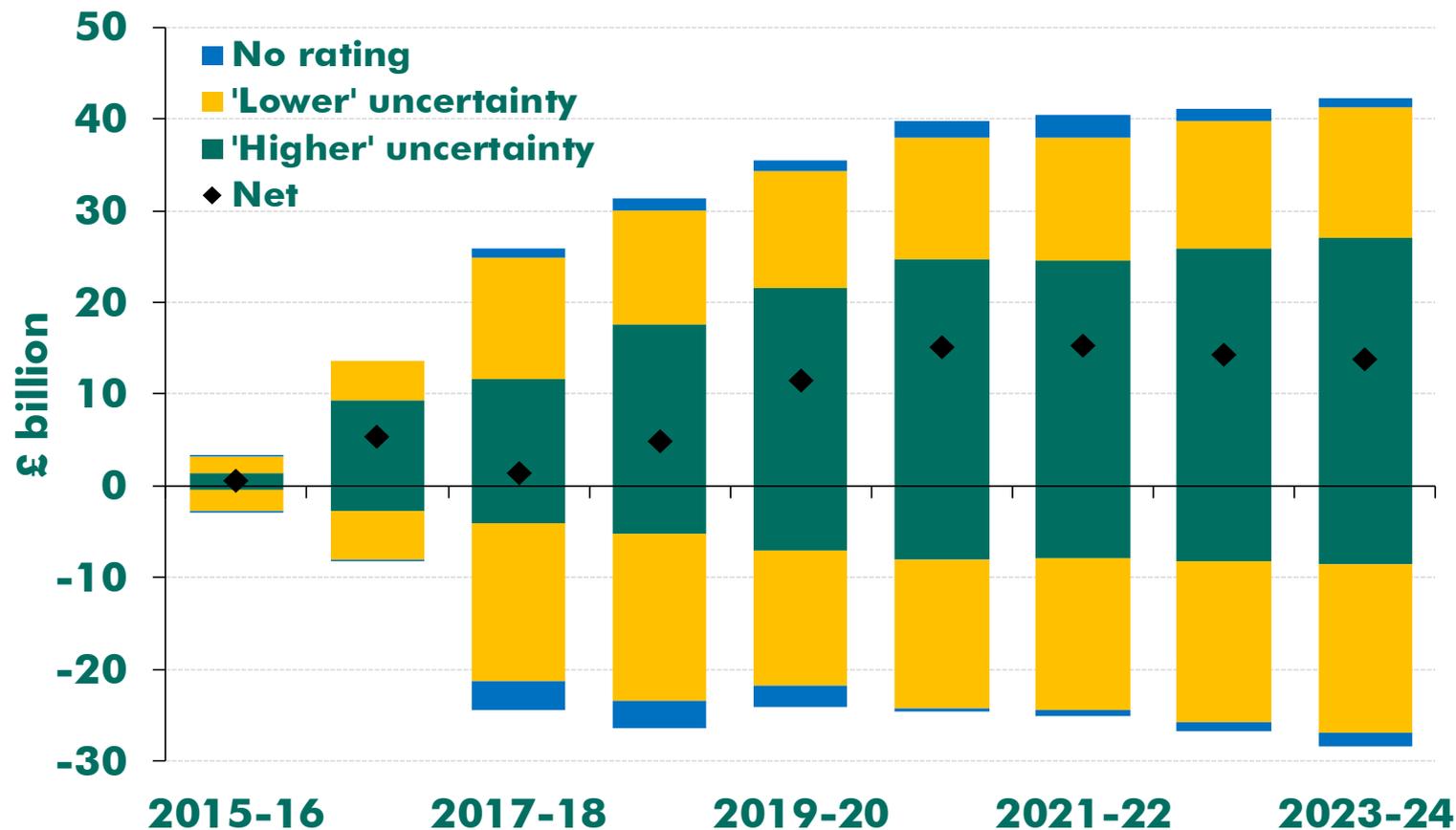
Shadow banking in the UK



Revenue risks: forecasts



Tax rises less certain than tax cuts



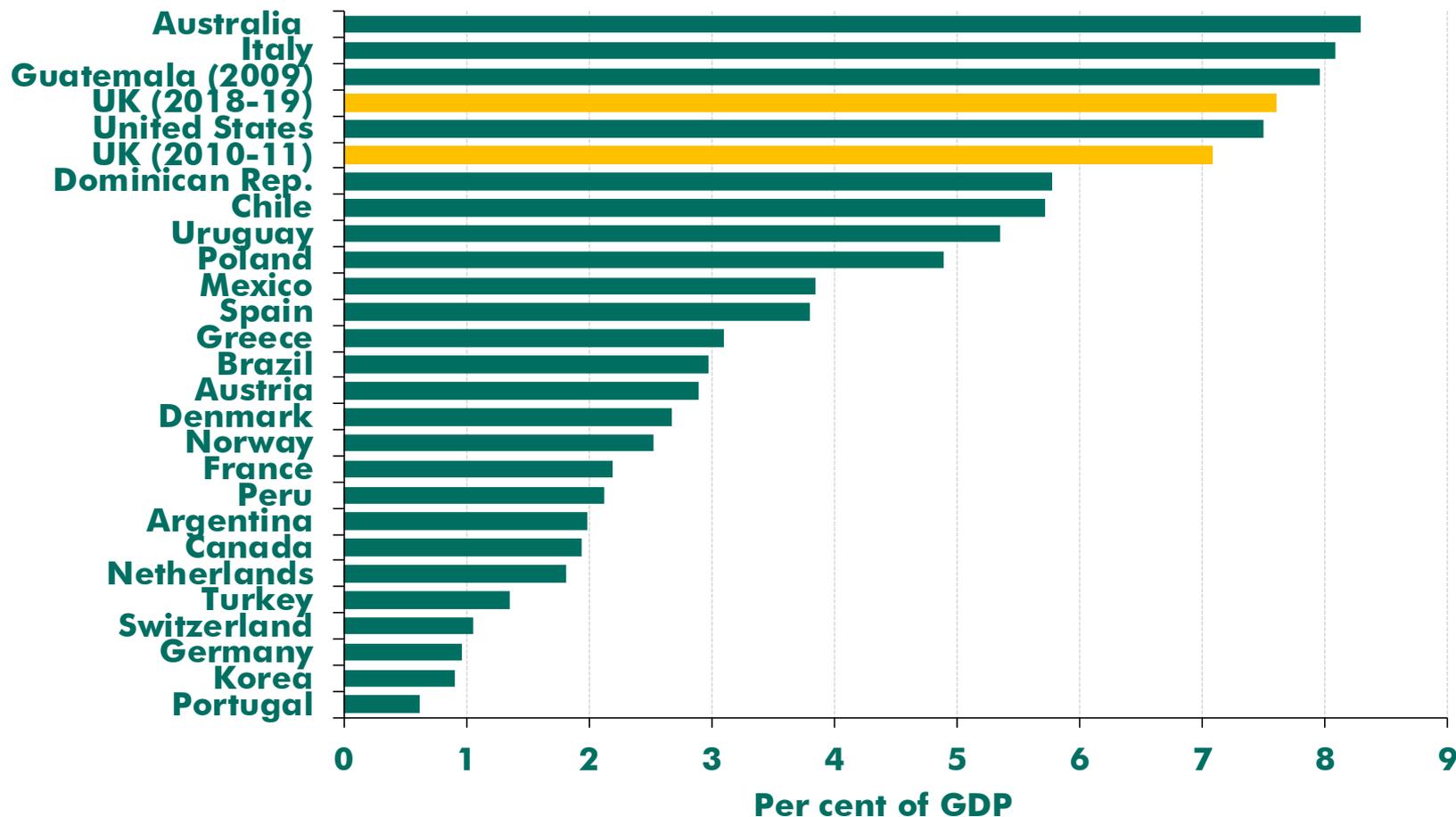
Tax reliefs

- Tax reliefs and expenditures help define the tax base
- Some are structural and some policy-motivated
- HMRC has identified 1,171
- Sum of reliefs estimated at 21% of GDP, but this reflects interactions. Not the gain from abolition

Why might tax reliefs pose a risk?

- Overall cost not clear and data poor
- Cost of policy-motivated reliefs high and rising
- Less effective scrutiny than equivalent pots of spending
- Lack of transparency and HMRC commentary
- No systematic evaluation of effectiveness
- Add to complexity and encourages avoidance

Tax reliefs



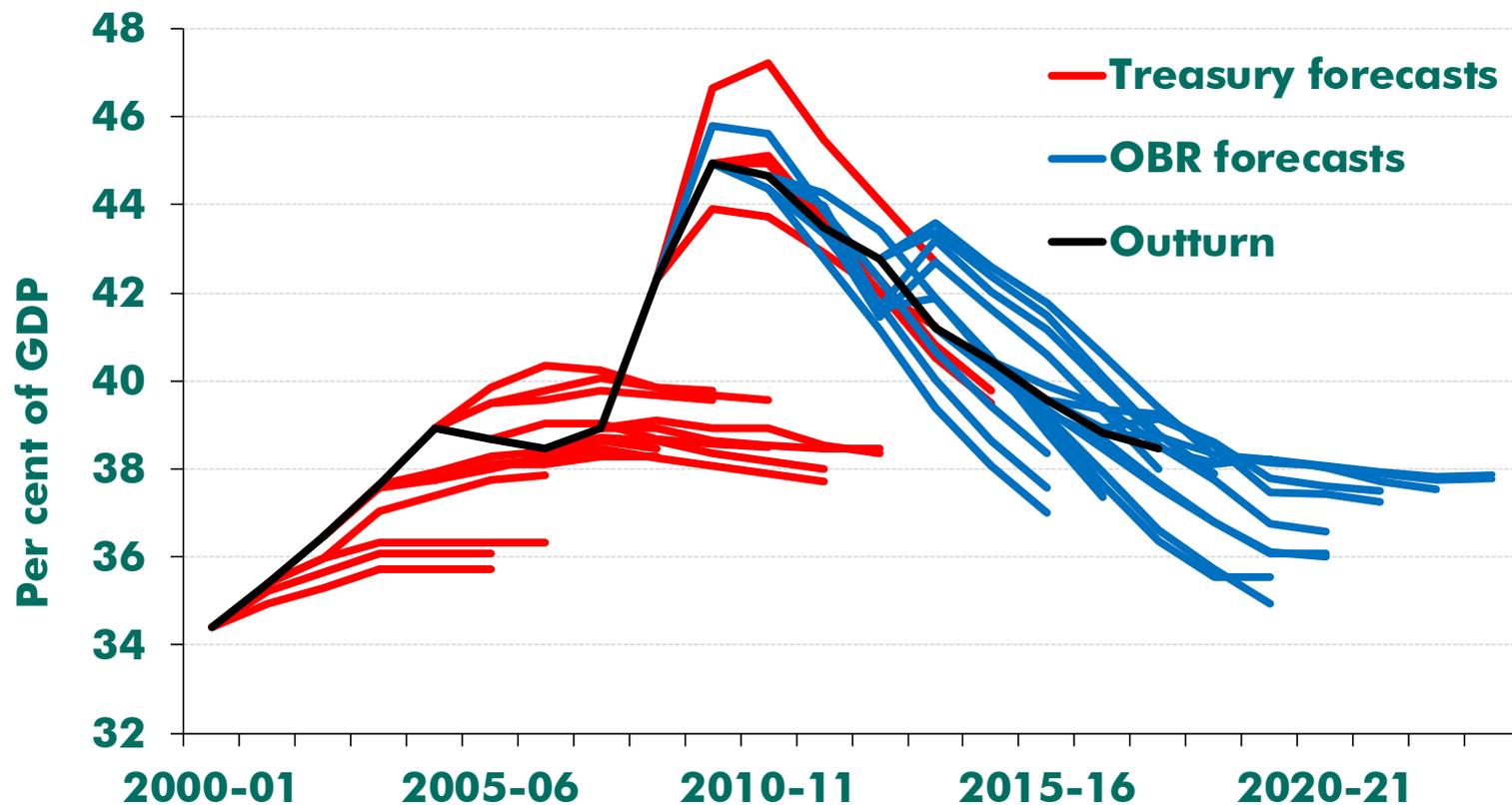
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Digitalisation

- Risks in both directions
- Poses challenges in terms of what economic activity can be taxed and where
- More and better data could aid administration
- Multilateral action to address downside risks?

Non-interest spending: forecasts



Spending risks

- **Medium term**
 - ‘Austerity fatigue’
 - Health spending (now crystallised)
 - Shrinking spending limit share
 - Local authority reserves and commercial activity
 - Welfare reform and legal challenges
- **Long term**
 - Non-demographic health and social care costs
 - Ageing population and triple-lock

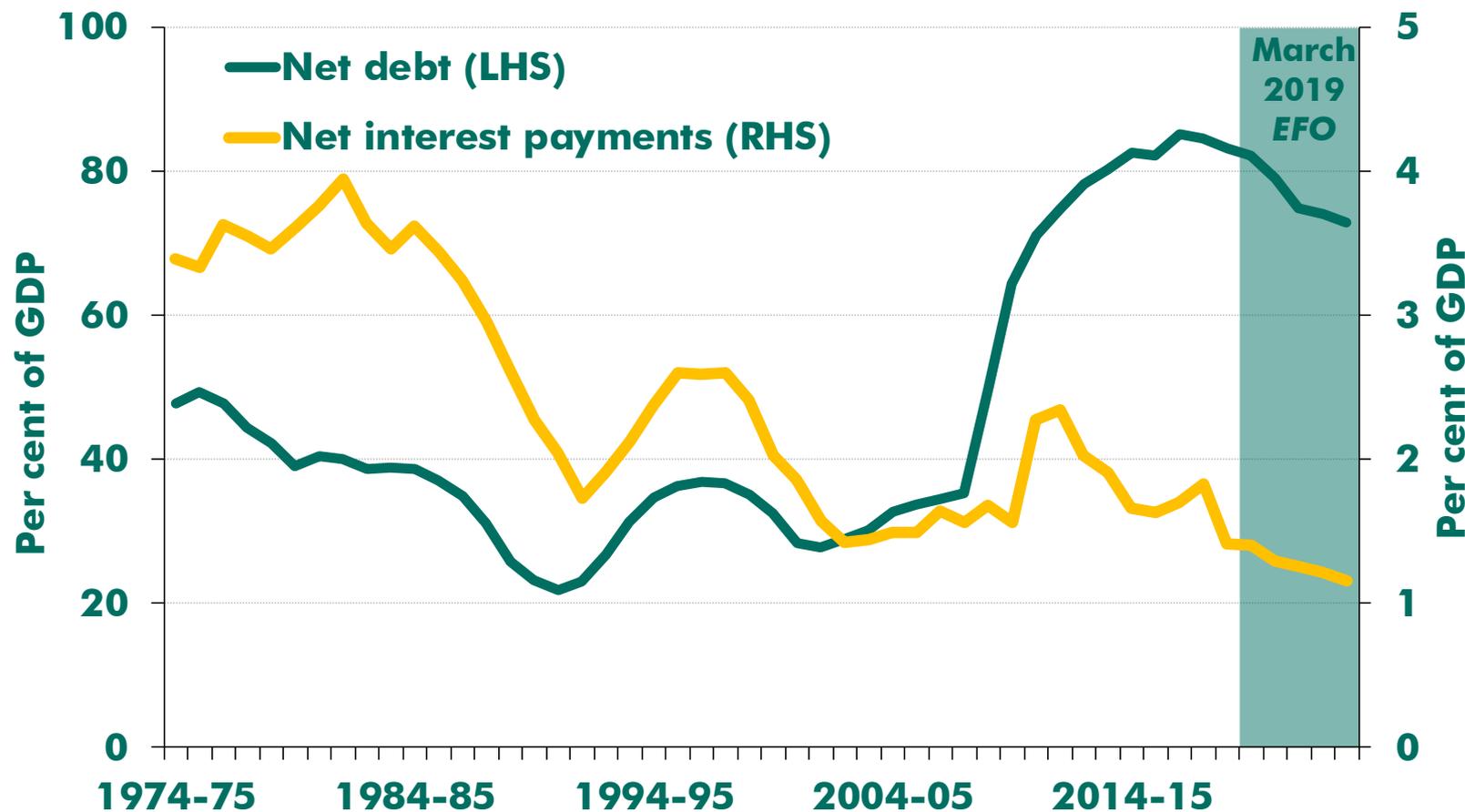
Free TV licences for over-75s

- July 2015 Budget: BBC loses compensation for lost revenue and given decision on future policy
- Maintaining status quo would cost BBC £745m, but confining to PC recipients reduces this to £250m
- But that implies 250k rise in take-up costing £850m
- Highlights risks from hypothecation
- Will consider fully in our next forecast

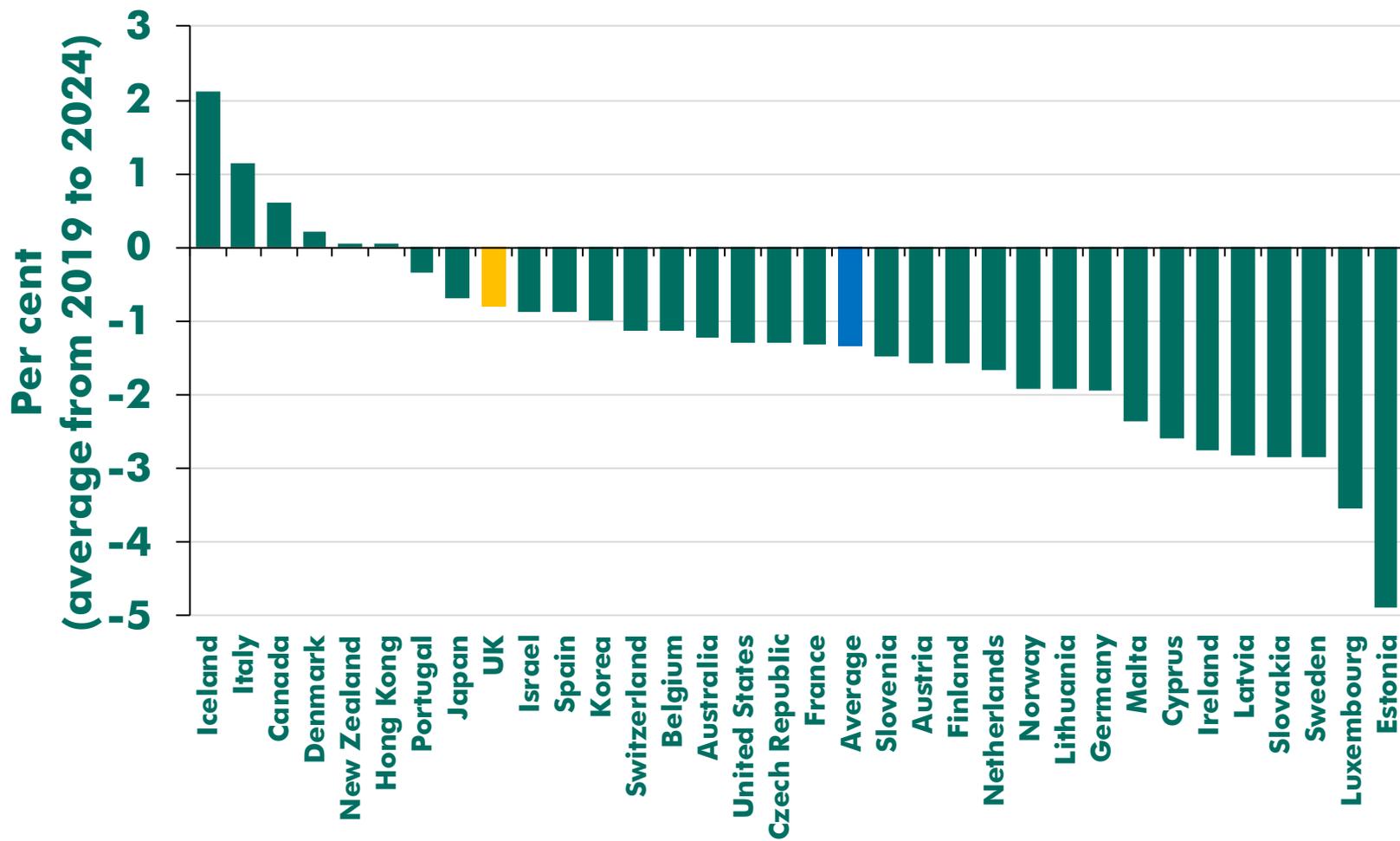
Balance sheet risks

- Balance sheet risks little changed
- But better monitoring and management
- Fiscal illusions remain an issue
- Housing associations off balance sheet
- But better treatment of student loans

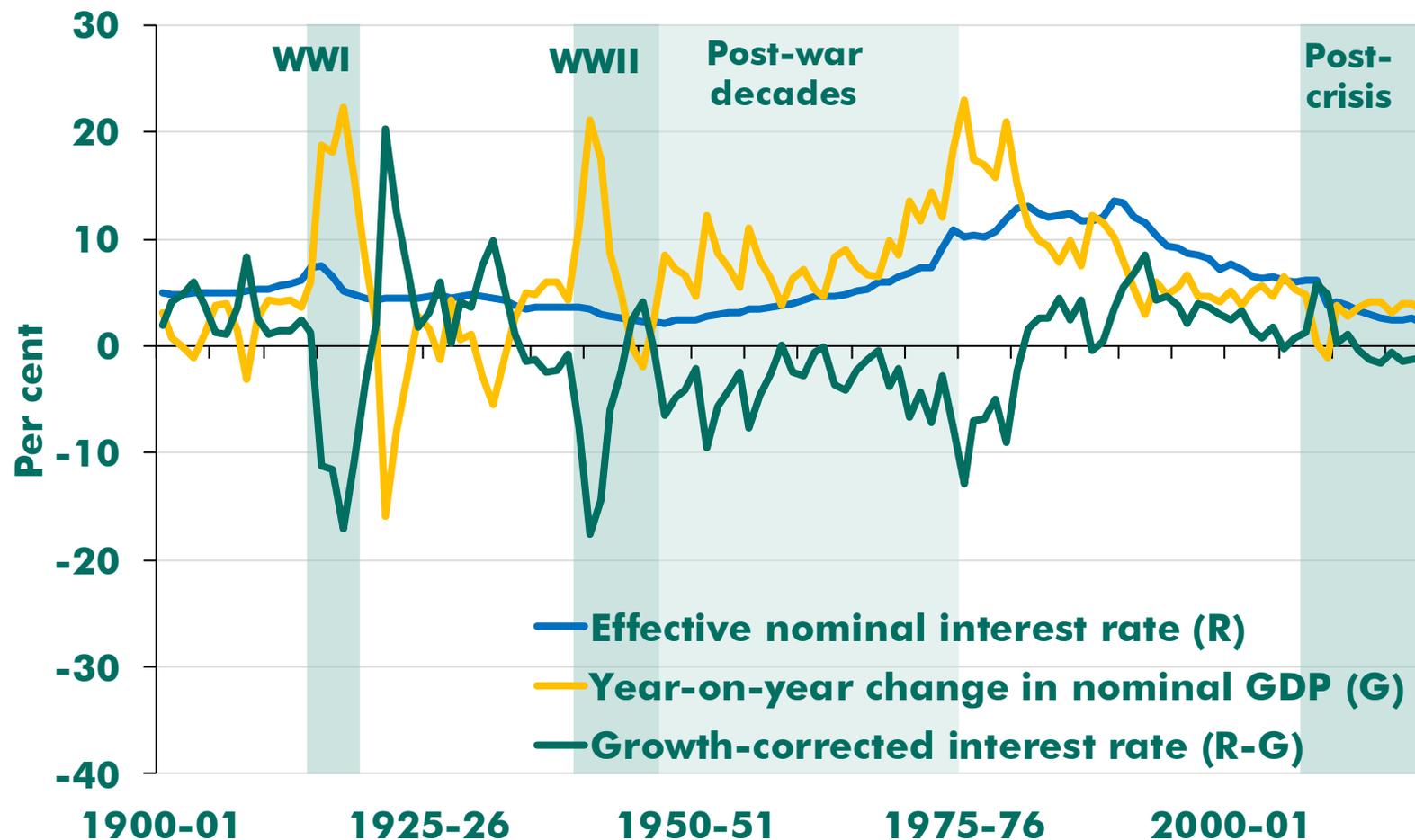
Debt interest and debt stock



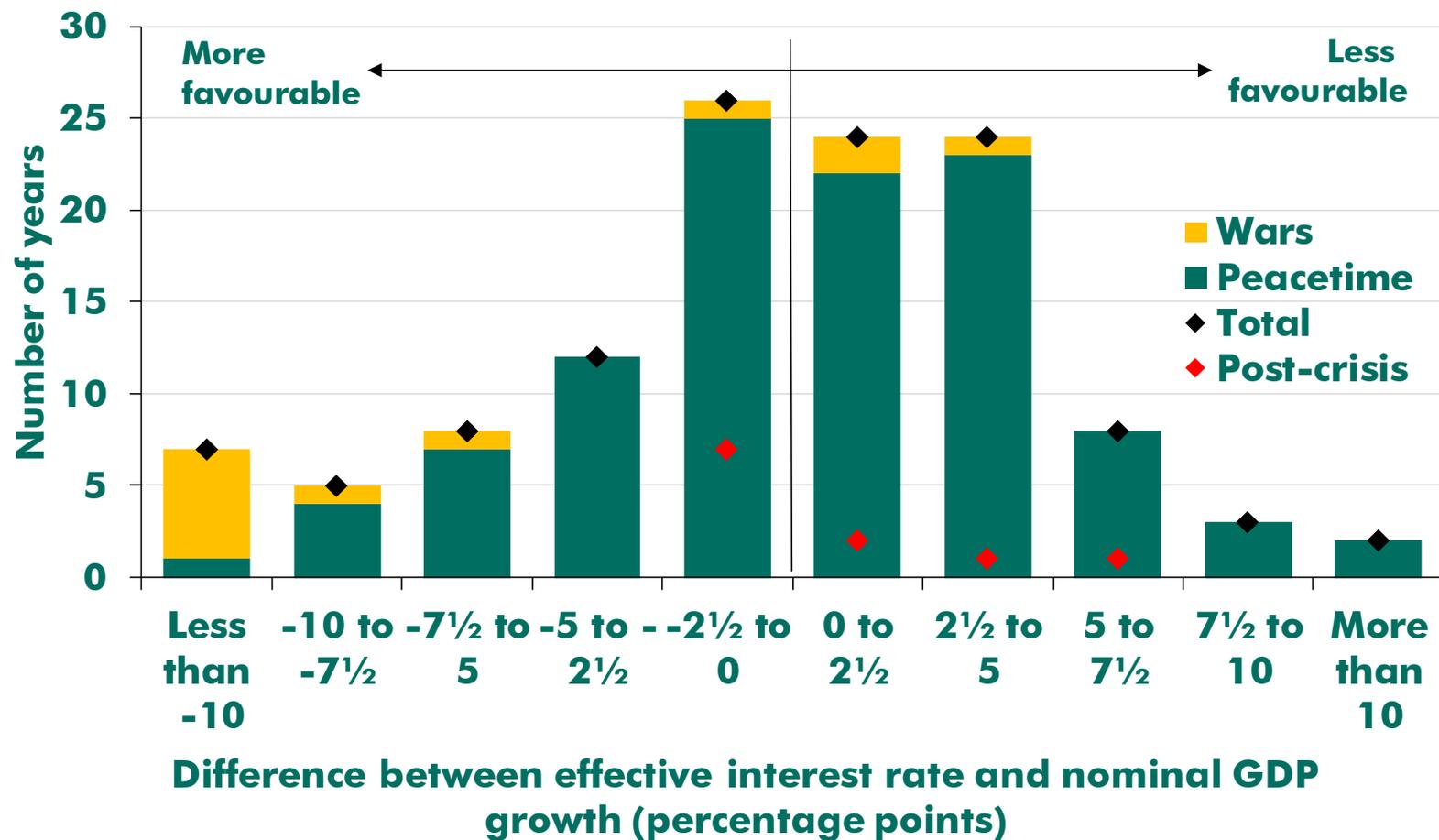
'R-G' favourable in most countries



Nominal growth and interest rates



The distribution of 'R-G' since 1900



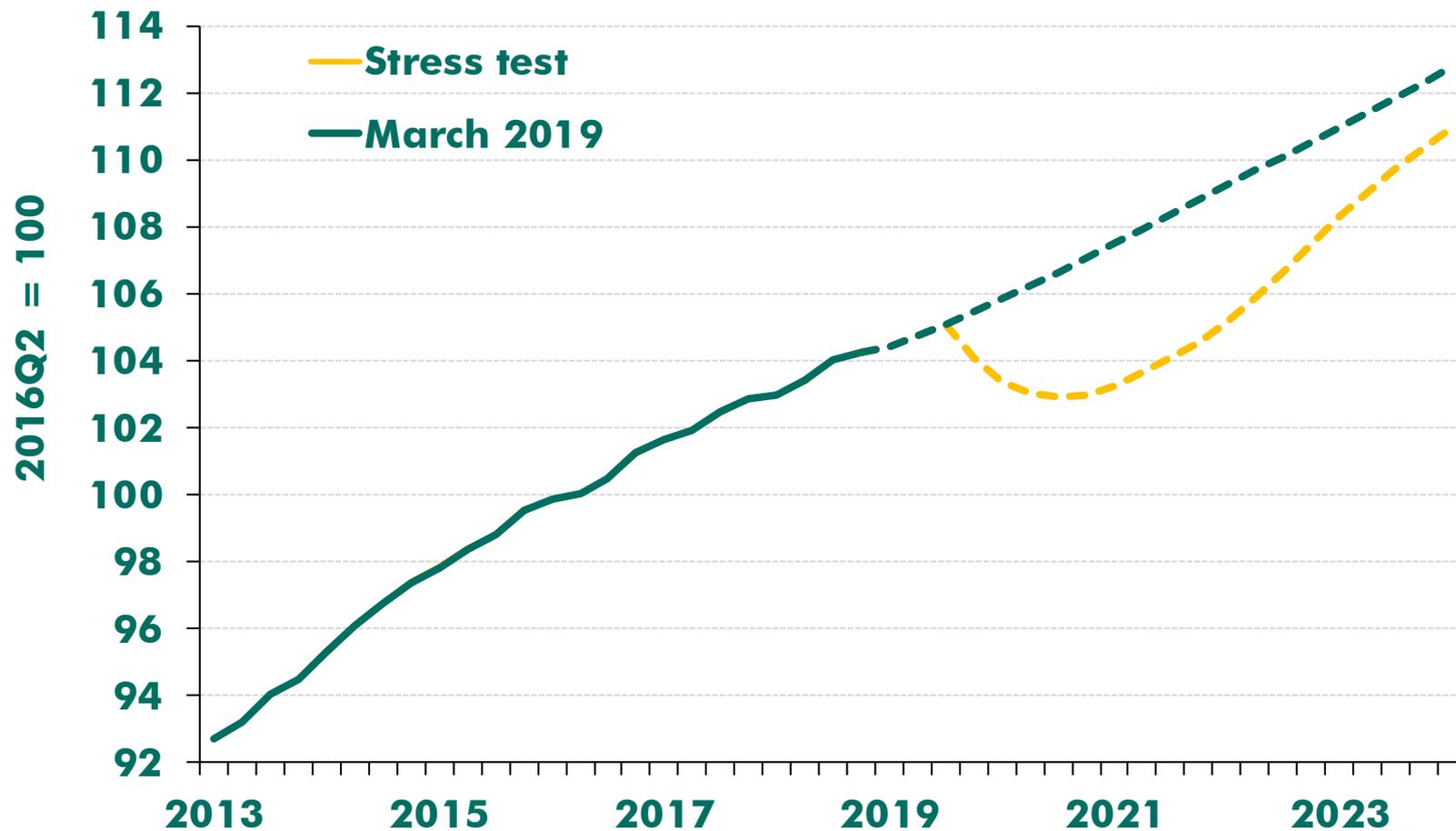
Climate change

- Scale of fiscal risk depends on temperature change
- Risks from sudden shocks (extreme weather events) and long-term pressures (adaptation and mitigation)
- If Paris targets broadly met, less costly than recessions / financial crises and healthcare cost pressures / ageing?
- But climate-related risks not well modelled or understood
- Hope to do more quantitative analysis in future, drawing on central bank analysis of financial sector risks

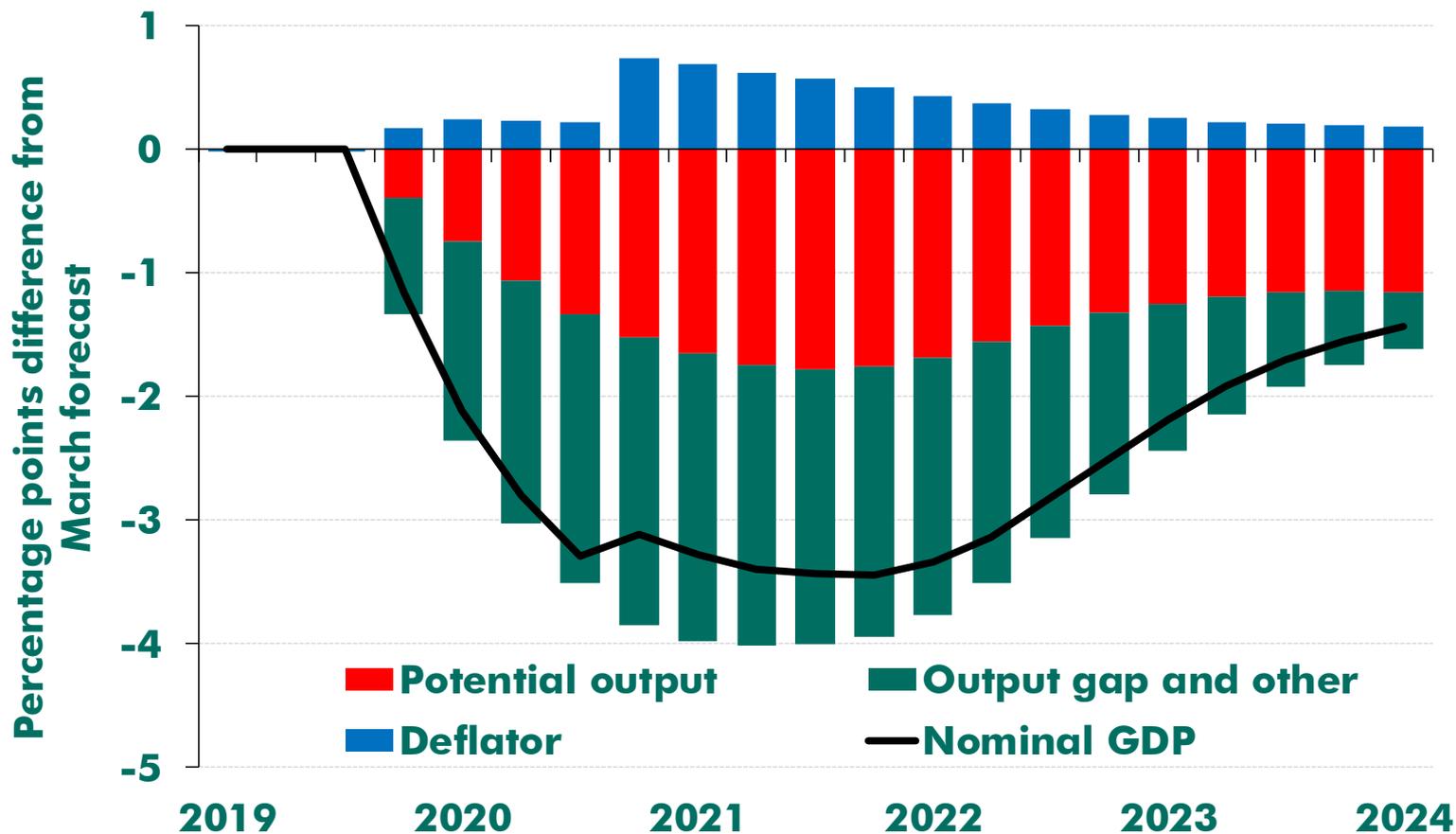
A no-deal Brexit stress text

- Based on the IMF's 'no deal, no transition' scenario A in the April World Economic Outlook
- Not necessarily the most likely – scenario not a forecast
- Less severe than some and than our 2017 stress test
- But useful to illustrate potential channels

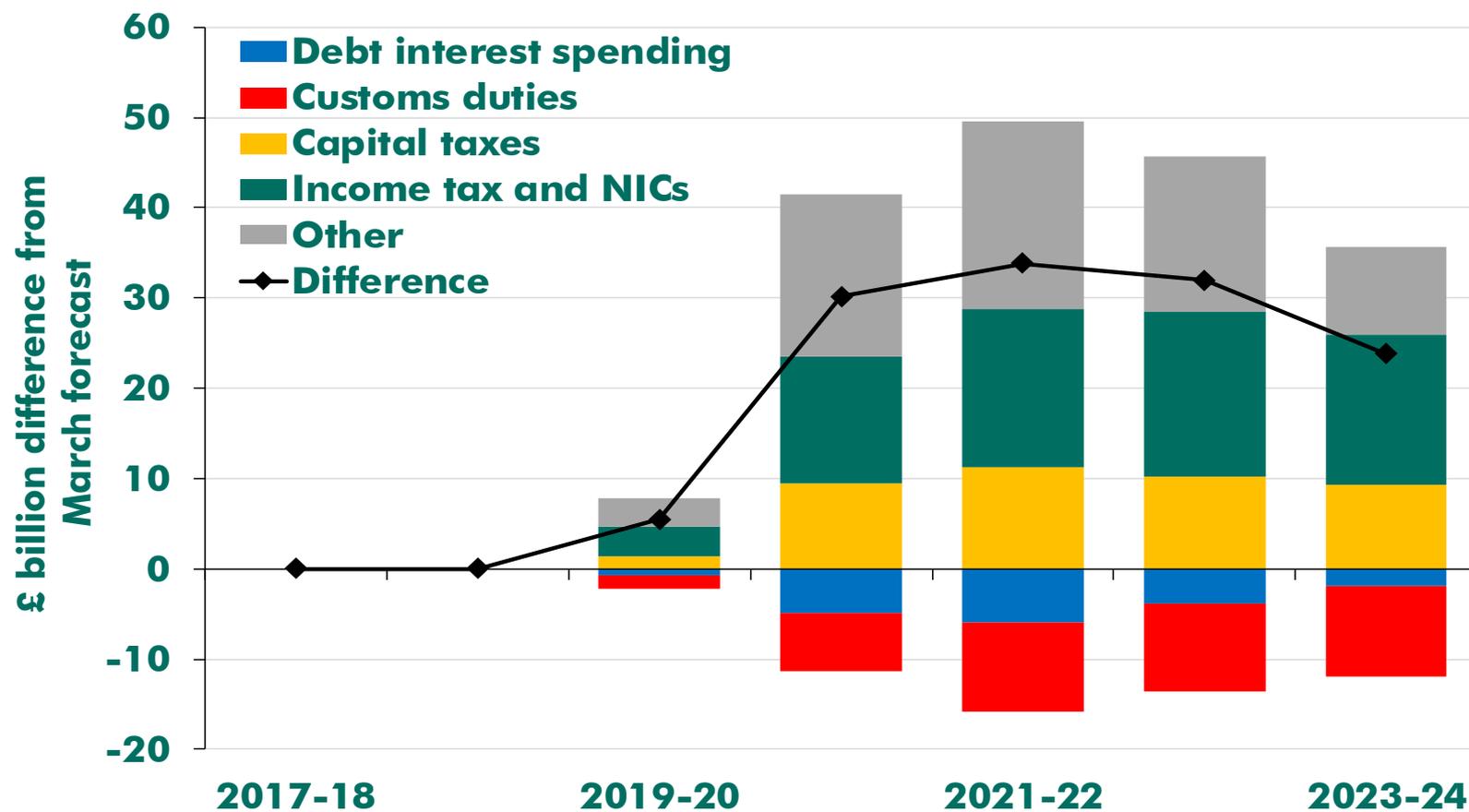
Stress test: real GDP



Stress test: nominal GDP



Stress test: borrowing



Conclusion

- Many potential shocks, pressures and risks taken on by choice are much as they were two years ago
- But 'no deal' Brexit risks more prominent
- 'Austerity fatigue' risk partly crystallised
- But still apparent in leadership shopping lists and open discussion of looser fiscal objective