

Launch of *Fiscal risks report 2019*

Robert Chote, Chairman, Office for Budget Responsibility

Good morning everyone. My name is Robert Chote, chairman of the OBR, and I would like to welcome you to the launch of this our 2019 *Fiscal risks report*.

[SLIDE] As you may know, the impetus for this report came from the IMF's 2016 report on fiscal transparency in the UK. It had lots of nice things to say, but noted that "summary reporting of specific fiscal risks is a weakness".

In response, the Government amended the Charter for Budget Responsibility to require us to produce a fiscal risks report every two years as well as committing itself to respond to each such report within a year. We produced our first FRR in July 2017 and the Treasury responded last year with its publication *Managing fiscal risks*. Today is the next stage in that dialogue.

It should be said that the UK is not alone in producing a fiscal risks report, but in most other countries it is written by the finance ministry or the equivalent of the cabinet office rather than by an independent watchdog.

[SLIDE] When considering fiscal risks, we focus on two different time horizons. Over the medium term, we identify the risks to our latest forecast, which came out in March. And over the long term, we identify risks to fiscal sustainability more broadly, not just the risks to our latest long-term projections, which already assume that accommodating demographic and other spending pressures would leave the public finances on an unsustainable path.

We are interested in the probability of different risks crystallising and their potential impact if they do – and at how either may have changed over the past two years. We look at how the risk landscape has been affected by government policy and at how the government responded to the issues we raised in 2017 in its MFR publication. That was a substantive response and we hope that the response to this report will be even more so.

It is important to emphasise at the outset that when a government takes on a fiscal risk that is not necessarily a bad thing. After all, the whole purpose of much government activity is to pool and manage different risks that society faces when the political process determines that this is best done collectively rather than leaving it to individuals to bear the risk or insure against it.

[SLIDE] This slide lists the various chapters of the report and highlights some of the themes that we have focused on this year. As you can see it is a long list – and it is a long report – so I am going to have to be selective in my remarks.

[SLIDE] To start with the big picture, most of the fiscal risks that we identified back in 2017 remain – which isn't a huge surprise – and for many of them the probability of crystallisation probably has not moved a great deal.

But the Government has taken some important steps to improve the monitoring and management of fiscal risks, including better management of new contingent liabilities, more transparent reporting on the balance sheet and (thanks to the ONS) plans to address the fiscal illusions created by the current accounting treatment of student loans. As for the public finances themselves, the Government has further reduced the budget deficit, has begun to reduce public debt as a share of GDP and started to lessen its exposure to inflation surprises by reducing its reliance on issuing index-linked gilts.

But policy risks are significant over the medium term and greater than they looked two years ago. The current Chancellor has all-but-abandoned the Government's legislated target to balance the budget in the mid 2020s and last year's announcement of £27 billion extra for the NHS – unfunded and outside the normal timetable – raises some doubts about Treasury control of public spending. Looking ahead, the Conservative leadership contenders have made a series of uncosted proposals for tax cuts and spending increases that could add tens of billions of pounds to borrowing if fully implemented. But we cannot look at these in detail unless and until they become Government policy.

While de-emphasising the importance of a balanced budget, Mr Hammond has written to the candidates urging them at the very least to keep debt falling as a share of GDP. As we show in the report, all else equal this would allow additional borrowing approaching £25 billion a year in the medium term.

All this of course takes place against the backdrop of continuing uncertainty about the precise form that Brexit will take. As I will explain in a few minutes, our fiscal stress test in this report assesses the implications of one of the 'no deal' Brexit economic scenarios published by the IMF earlier this year. It is more benign than some other scenarios, but it would still increase the budget deficit by around £30 billion a year relative to our March forecast.

These are all issues for the medium term. Over the longer term, rising healthcare costs and the ageing of the population remain the most significant

upward pressures on public spending and the budget deficit. If the triple lock on state pensions uprating were retained for the long term, that would ratchet up spending as a share of GDP too. And the outlook for productivity and potential output remains the key economic uncertainty.

[SLIDE] So let me start with macroeconomic risks. As you can see, we focus in the report on five of them: risks to the underlying path of sustainable or potential GDP; risks of a cyclical downturn or recession; risks in patterns of sectoral lending; risks from particular parts of the economy (notably the housing market); and risks from the composition of GDP, because different types of income and spending are taxed at different rates.

[SLIDE] As you know, since the financial crisis we and many other forecasters have revised down our estimates of the economy's 'goldilocks' growth rate from roughly 2½ to roughly 1½ per cent per year, reflecting the remarkable historical weakness of productivity growth over the past decade – that is growth in output per hour worked. This has been true in many industrial countries and there are a number of potential explanations.

As you can see from this chart, we are expecting productivity growth to pick up over the medium term, as the labour market tightens and business investment picks up. And we continue to assume that over the long term productivity growth returns close to its pre-crisis average.

We see risks to both sides of the medium-term forecast and more to the downside over the longer-term. Weaker productivity growth means weaker GDP growth, a smaller economy and less tax revenue. If you assume that public spending grows roughly with the size of the economy, this need not show up as a rising budget deficit, but we would all be poorer in terms of the private and public goods we could consume.

[SLIDE] Turning to the ups and downs of the economic cycle, history suggests that the UK suffers a recession roughly once a decade and that this is one of the largest risks to the public finances and one of the most frequent to crystallise. This chart shows our current outturn estimates and forecasts for the output gap, the extent to which output moves above potential in upswings and below it in downswings. [SLIDE] This chart shows the latest estimates for quarterly and monthly GDP growth. It suggests that the economy may have flatlined or shrunk a little in the second quarter. But this does not yet suggest that a full-blown recession is under way, given that the weak performance of

the economy in the second quarter is likely in part to reflect the strength of Brexit-related stock building in the first quarter.

[SLIDE] This chart shows how swings in the economic cycle exacerbate swings in the budget deficit by imposing temporary cyclical deficits and surpluses on top of the underlying structural balance. As we discuss in the report, this may be how we interpret history now, but in real time it is hard to be confident about the size of the output gap and therefore how much of the budget deficit or surplus is cyclical or structural at any given moment. When a recession hits, economists typically lower their estimates of potential output made ahead of the downturn and conclude that there was more of a boom than appeared to be the case at the time – and therefore that more of the budget deficit was structural rather than cyclical. [SLIDE] This chart shows real-time estimates of the structural deficit and our current estimate. As you can see, the structural deficit now looks larger over the decade preceding the crisis than it did in real time.

[SLIDE] This difficulty of assessing whether and by how much the economy is running above potential is a headache for policymakers. As you would expect, this slide shows that fiscal policy is usually designed to be expansionary when the economy looks like it is running below potential. [SLIDE] But with the benefit of hindsight fiscal giveaways can often end up looking pro-cyclical, boosting demand when the economy was in fact already above potential.

[SLIDE] The next risks that we look at are those arising from the UK's unusually large and revenue-rich financial sector. Last time we focused on the cost of financial crises and the possibility the sector would shrink in relative size over the long-term. In *Managing fiscal risks*, the Treasury highlighted the regulatory reforms undertaken to make crises less likely and costly. Judging from the work of the Financial Policy Committee, the risk of a banking crisis in the medium-term is relatively small and little different from two years ago.

But one lesson of history is that when risks are suppressed in one part of the financial system, they often migrate to some less regulated area. So in this report we look at potential fiscal risks from shadow banking – institutions and chains of institutions that have the characteristics of banks without being regulated as such. Steps have been taken to increase oversight and regulation of them too, but some former policymakers have warned that this may not be sufficient. If problems surface here, the fiscal risks include potential calls on the public purse to bail out institutions and retail investors and damage to the

economy perhaps via contagion to the core banking system. [SLIDE] As this chart shows, shadow banking activities seem to have been increasing post-crisis.

[SLIDE] Aside from those related to the economy and the financial sector, we discuss several risks related to different revenue streams. As we can see from this chart of revenue outturns and forecasts, there is always uncertainty around the path of receipts in both directions. As in 2017, we discuss risks from the concentration of tax receipts, trends in self-employment and incorporations, behaviour and technology, and non-payment.

Let me briefly mention three additional topics.

[SLIDE] The first is the tendency for Governments to cut taxes in high-profile ways for which the cost is relatively certain, but to raise revenues in ways that are less visible and inherently less certain – for example through anti-avoidance measures. The net tax increase since 2014 shown here is almost exactly equal to the forecast receipts from the anti-avoidance measures. We judge all these costings to be central but this is nonetheless a source of risk. These measures target people and firms that are already actively arranging their affairs to lower their tax liability, so it is naturally more challenging to predict how they might respond to measures designed to tackle that activity.

[SLIDE] Another issue we look at is the growth of tax reliefs and tax expenditures. These are part of every tax system and help define what is and is not to be taxed. Some are integral parts of the tax system, like the income tax personal allowance, while others are designed to change behaviour or achieve policy objectives, spanning everything from tax relief for pension saving to the exemption that ensures that pet cemeteries do not pay landfill tax.

Tax reliefs are not necessarily a bad thing, but in some instances they can be used as disguised and non-transparent alternatives to conventional public spending, which means that they get far less scrutiny as a result.

HMRC currently identifies 1,171 structural reliefs and expenditures. And it expects this number to rise as “Government and Parliament add more reliefs than they take away”. The estimated sum of all identified and costed reliefs is £441 billion or 21 per cent of GDP, although this is much larger than the sum you could raise by abolishing them all as many interact with each other. And, as I just noted, some are integral to the design of the tax system, while others

meet a public policy need that ministers might want to address in some other way if the tax system did not provide the desired incentives.

[SLIDE] So why might tax reliefs and expenditures pose a fiscal risk?

- First, the Government does not know the precise cost even of the reliefs that it can identify. The NAO says that “HMRC has an inconsistent approach to collecting, using and publishing data on tax reliefs”.
- Second, the cost of policy-motivated tax expenditures has risen significantly over the past decade to a [SLIDE] level large in absolute terms and by international standards at around 8 per cent of GDP. [SLIDE]
- Third, tax reliefs and expenditures get less frequent and detailed scrutiny than equivalently sized pots of public spending. The £4 billion cost of the little-discussed ‘tied oils scheme’ and the ‘rebated rate for gas oil’ is larger than HMRC’s entire annual budget.
- Fourth, there is a lack of transparency around reliefs and HMRC publishes almost no commentary on how their cost is evolving.
- Fifth, the Government does not have a systematic way of evaluating their effectiveness in meeting their objectives, and
- Sixth, they add complexity to the tax system that may encourage avoidance as taxpayers exploit new boundaries or challenge legal interpretations.

Building on these points, the chapter discusses six case studies of reliefs where costs have typically risen, evaluation has been rare or the rules have sometimes had to be tightened. These include entrepreneurs’ relief, the patent box, creative sector reliefs and R&D tax credits.

[SLIDE] A final topic that we address in the revenues chapter is the impact of digitalisation. The risks here go in both directions. On the one hand, digitalisation poses challenges in terms of what economic activity can be taxed and where. But on the other, the availability of more and better data could help improve tax administration. The downside risks look likely to dominate in the short term, while the upside ones could be realised over the longer term. Multilateral action looks the best way to limit some of the downside risks, but agreement as ever could be hard to reach.

[SLIDE] As with revenues, past Treasury and OBR forecasts show us that there are significant uncertainties around the path of public spending.

[SLIDE] The largest medium-term risks we identified two years ago were 'austerity fatigue' in general and the shortfall in planned health spending relative to growth rates that prevailed in previous years. We also noted the falling share of spending subject to departmental limits and the risk of local authorities running down their reserves or seeing commercial investments under-perform. We saw risks to welfare spending from the uncertain progress of reforms and from legal challenges.

Over the long-term, spending is the biggest risk to fiscal sustainability, thanks to non-demographic cost pressures in health and social care, and the impact of an ageing population on both them and pension spending. The long-term cost of the pension triple-lock is large too and would be larger still as a share of GDP if productivity and earnings growth turn out weaker than we currently assume so that the 2½ per cent floor comes into play more frequently.

The Prime Minister's announcement of an eventual £27 billion-a-year package for the NHS crystallised the medium-term risk that we identified last time and can be seen as a down-payment against the long-run cost pressures. The Treasury says this is a final deal, but past experience and outside analysis of health spending needs suggest that further top-ups cannot be ruled out.

It would have been good to be able to provide a substantive update on the fiscal risks posed by adult social care provision here, but, with the Dilnot reforms now shelved and the long-promised green paper on what will replace them still shackled somewhere in Whitehall, there is unfortunately little to say.

[SLIDE] We do use the spending chapter to highlight some less costly risks, including one that illustrates the danger of unintended consequences when Governments come up with clever ways to save money.

In the July 2015 Budget, the Government decided no longer to compensate the BBC for the cost of providing free TV licences to households containing someone over 75 and – in addition – to give the BBC responsibility for deciding whether and how to continue offering such concessions in future. It is, to put it mildly, unusual for a Government to delegate decisions over the scope and generosity of welfare benefits to a broadcasting company in this way.

A report prepared for the BBC by Frontier Economics estimated that it would cost the corporation £745 million in 2021-22 to continue providing free licences as before – and in our forecasts we assumed that they would, and that

this would reduce BBC spending and the budget deficit by roughly that amount.

Instead the BBC Board has decided to confine free TV licences to households containing someone aged 75 or over receiving pension credit. Frontier estimated that means-testing free licences in this way would reduce the cost to the BBC to £209 million, including some administration and compliance costs. But the BBC board estimated that the eventual cost would be closer to £250 million as it sensibly concluded that more people would now be encouraged to claim pension credit. Indeed, the BBC plans to raise the visibility of pension credit on the airwaves and by writing to all those affected.

If this £40 million difference was entirely the result of higher take-up, it would imply roughly an extra 250,000 claimants at a cost of around £850 million – more than wiping out the original saving. This could also trigger more claims for attendance allowance and housing benefit. There is of course considerable uncertainty around the impact on take-up. DWP's own efforts to increase it have met with mixed success, but in this case people may respond more because they are being confronted with a loss rather than being urged to claim money they do not currently receive. These are questions we will return to for our next forecast when we will need to put our own numbers on them all.

Government policy towards the licence fee in recent years highlights some of the policy risks and fiscal illusions to which hypothecated taxes or charges of this sort are prone. In principle the licence fee is a charge that people choose to pay for the right to receive broadcast services. But the link between what people pay and what the BBC can spend providing its share of those services has been weakened first by requiring it to pay for part of foreign policy – the World Service from 2014 – and now part of welfare policy.

[SLIDE] Some fiscal risks affect the balance sheet directly, without affecting flows of receipts and spending. The Government's response to our last report showed more progress in balance sheet management than in many other areas. It outlined plans to improve measures of the balance sheet (almost all of which have since been delivered), steps to increase transparency around asset sales and a new approval regime for guarantees and contingent liabilities. In addition, the Treasury's 'Balance Sheet Review' aims to improve information on assets and liabilities held across government and to identify opportunities to dispose of assets, improve the return on retained assets and reduce risk.

So while balance sheet risks overall are largely unchanged from two years ago, they are now better monitored. But fiscal illusions – where published data fail to paint a true picture of the health of the public finances – remain a risk. The Government’s successful efforts to lighten the regulation of housing associations just sufficiently for the ONS to take them off balance sheet again makes the debt and deficit numbers look better, but with no real change to the Government’s underlying exposure. But the new accounting treatment for student loans is an improvement. Again nothing significant has changed in the real world, but the budget deficit will no longer be materially under-measured by ignoring the fact that much student loan debt and accrued interest is never repaid – and that that is a deliberate feature of the system, not a bug.

[SLIDE] Turning to the outlook for debt interest and debt dynamics, this chart shows how low government borrowing costs have kept debt interest spending relatively low as a share of GDP since the financial crisis, even though the stock of debt has more than doubled as a share of GDP and only just started falling.

In this area, one of the most interesting academic contributions to fiscal risk analysis since our last report has come from Olivier Blanchard, the former chief economist at the IMF, in his presidential lecture to the American Economic Association in January. He argued that increases in public sector debt are now less risky and less costly than policymakers typically claim because the interest rates at which most governments can borrow are likely to remain below the growth rates of their economies for some time. To use the economists’ shorthand, ‘ R minus G ’ is negative. [SLIDE] Indeed, the IMF expects this to be true for most advanced countries over the next 5 years.

Having R below G makes explosive debt dynamics less likely, as the economy grows more quickly than the cash stock of debt (other things equal). It may also imply that the crowding out of private sector investment is less costly.

In the report we look at some of the analysis that Blanchard carried out for the US and assess to what extent it can be applied to the UK. [SLIDE] This chart shows the nominal interest rate, the nominal growth rate and ‘ R minus G ’ back to 1900. On average the interest rate is very slightly lower than the growth rate, although the opposite is true if you exclude the war years.

[SLIDE] But while the averages are very close to zero, the range of outcomes is very wide – as this chart shows. So the future path is necessarily highly uncertain. The pattern of past outcomes suggests that while ‘ R minus G ’ has

put downward pressure on the debt ratio overall, there have also been extended periods when it has pushed it higher. All this suggests that the current favourable relationship is no excuse for complacency over the future.

It is also important to remember that Blanchard is talking primarily about the risks from a step increase in debt. His analysis does not imply that you could run a significant and increasing primary budget deficit over an extended period. So a continued favourable relationship between R and G will not avoid the need for tax increases if future governments wish to spend a significantly higher share of GDP over time on health, social care and pensions.

[SLIDE] One issue that we noted in 2017, but did not discuss in detail, was the fiscal risks created by climate change. In this report we have an introductory chapter, hopefully as a precursor to more work in future editions.

We note that the scale of the risks will depend hugely on the extent to which global temperatures rise. If the most ambitious of the goals agreed in Paris in 2015 are met, risks might resemble those we are currently seeing, though on a greater scale. But if global mitigation efforts fail and temperatures rise more significantly, the risks could be much greater and more difficult to assess, with mass international migration and induced periods of conflict more likely.

As in the discussion of risks throughout the report, we can distinguish between those that arise from sudden shocks and long-term pressures. The former include extreme weather events, which can be expensive to respond to but not yet on the scale of recessions or financial crises. And the latter include spending on adaptation measures (such as flood defences) and mitigation measures designed to discourage particular CO₂ emitting activities or to encourage the adoption of green technologies. These too could be expensive, but perhaps not on the scale of the long-term pressures from health costs and ageing. That said, we should be wary of complacency, given that climate-related risks to the economy and then to the public finances are not particularly well-modelled or well-understood. We hope to do more quantitative work in this area in future, drawing on work currently being undertaken by central banks on the implications of climate change for the financial system – where many of the same channels are relevant.

[SLIDE] Finally, let me take you through the main findings from our fiscal stress test. As I mentioned earlier, with both remaining candidates for Number 10 explicitly countenancing the possibility of a 'no-deal' Brexit on October 31st,

we have decided to look at the fiscal implications of the less severe of the two 'no-deal, no-transition' scenarios set out by the International Monetary Fund in its April *World economic outlook*. This scenario is not necessarily the most likely outcome and it is relatively benign compared to some (for example, assuming no major short-term border disruptions). A more disruptive outcome, closer to the Bank of England scenario we used for our stress test two years ago, would have more severe consequences. Nonetheless it is useful for thinking about some of the channels through which a no deal Brexit might affect the public finances – and to illustrate the extent to which even a relatively benign 'no deal' scenario might knock the public finances off course.

[SLIDE] This chart shows the path of real GDP under the Brexit stress test, compared to that in our March EFO forecast. This path is based directly on the IMF scenario, with the start date of Brexit pushed back to the fourth quarter. But the Fund publishes only a limited amount of information on the composition of the downturn and associated economic and market developments, so we have had to fill in some blanks ourselves as we detail in the report. So the Fund should not be held responsible for our conclusions.

The big picture is that heightened uncertainty and declining confidence deter investment. Higher trade barriers with the EU weigh on domestic and foreign demand, while the pound and other asset prices fall sharply. These factors combine to push the economy into recession. The economy and asset prices then recover somewhat over time.

[SLIDE] This chart decomposes the hit to nominal GDP from the stress test into lower potential GDP, a wider output gap and higher whole economy inflation. (Because nominal GDP is more important than real GDP in determining the path of the public finances.) Higher trade barriers lower potential productivity and lower inward migration reduces labour force growth. As a result, potential GDP is lower and accounts for most of the loss of nominal GDP at the five year horizon. The imposition of tariffs and the fall in sterling push inflation higher, but the MPC is assumed to look through this and cut Bank Rate to support demand and eventually bring output back towards potential.

[SLIDE] The consequences for the public finances are that borrowing is around £30 billion a year greater under the stress test than in our March forecast and net debt is about 12 per cent of GDP higher at the five year horizon – and it rises rather than falls relative to GDP over the next three years. The main contributing factors are as follows:

- Income tax and national insurance are hit by the cyclical downturn, raising borrowing by about £16½ billion a year from 2020-21.
- Capital tax receipts fall sharply, thanks to lower house prices, equity prices and property transactions. This raises borrowing by around £10 billion.
- Conversely debt interest spending benefits more from lower interest rates and RPI inflation than it suffers from higher borrowing, so it lowers the deficit by £6 billion in 2021-22 but by less thereafter.
- Customs duties raise more than in March and now count as UK tax receipts, lowering borrowing by around £10 billion a year from 2021-22.
- We assume, as we do in our baseline forecast, that reduced budget contributions to the EU are recycled into domestic spending. Subsumed within this is the cost of the divorce settlement, whatever form that might take in a 'no deal' scenario.

Needless to say there is huge uncertainty around estimates of this sort and the impact of a 'no deal' Brexit will depend on the behaviour of governments, businesses and consumers abroad as well as here. As we discuss at the end of Chapter 10, there are a number of economic risks and other risks to tax receipts that could lead to a more adverse outcome than in the stress test.

It is important to remember that this scenario is relative to our March forecast. Economic and fiscal developments over the past three years already incorporate some impact of the referendum vote, although you cannot isolate that easily from other surprises we have seen relative to our pre-referendum forecasts. And the impact of Brexit would also continue to make itself felt well beyond the five-year horizon, according to the IMF's and most other studies. So these numbers should not be taken as the total fiscal impact of Brexit.

[SLIDE] So what does this all add up to in terms of our assessment of the risks around the public finances and how they have changed since 2017?

The perennial issues of shocks, pressures, and risks taken on by choice are largely as they were two years ago. But Brexit risks feel more prominent than they did two years ago, with 'no deal' being countenanced at the highest levels amid considerable uncertainty around what that would mean in practice. Meanwhile, the risks from austerity fatigue have partly crystallised in terms of higher health spending, while others are forming in the leadership election

shopping lists and in open discussion of how the government's legislated objective of a balanced budget may be replaced by something looser.