Office for
Budget
Responsibility

PRESS NOTICE

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Fiscal risks report – July 2017

Our first Fiscal risks report is a comprehensive review of risks from the economy and financial system, to tax revenues, public spending and the balance sheet, and includes a fiscal stress test. Confronted by a vulnerable fiscal position and a challenging political environment, the Government will need to review the fiscal risks that it has exposed itself to for policy reasons, to prepare for the cost of unexpected shocks and to address some long-term pressures on receipts and spending. And to do so while managing the uncertainties posed by Brexit, which could influence the likelihood and impact of several other risks.

The Office for Budget Responsibility has produced regular medium-term forecasts and long-term projections for the UK public finances since 2010. We have always emphasised the uncertainty that lies around them and have quantified it in various ways. Parliament has now asked us to build on this work by producing a regular report on 'fiscal risks'. In doing so, we seek to identify specific shocks or pressures that could push the public finances away from our latest medium-term forecast or threaten fiscal sustainability over the longer term.

We produce this report at a sensitive time. A decade after the outbreak of the financial crisis and recession, net borrowing is well down from its peak. But the budget is still in deficit by 2 to 3 per cent of GDP – as it was on the eve of the crisis – and net debt is more than double its pre-crisis share of GDP and not yet falling. As a result, the public finances are much more sensitive to interest rate and inflation surprises than they were. In terms of the political backdrop, the previous Government had to abandon a number of measures to increase taxes and cut welfare spending, the new Government has just agreed a 'confidence and supply' arrangement that increases public spending significantly in Northern Ireland and the Chancellor of the Exchequer notes of austerity that "people are weary of the long slog".

Nonetheless, the Government says it remains committed to balancing the budget by 2025. Our March forecast showed it on course to reduce the deficit to 0.7 per cent of GDP by 2021-22, but predicated on plans for a further significant cut in real public services spending per person. In making judgements on tax and spending in its first Autumn Budget this year – and in those that follow – the Government will need to bear in mind not just our central forecasts, but also the many risks that surround both them and the longer-term outlook.

In this report we have taken a broad view of those risks, not all of which are negative. They range from the economy-wide costs of financial crises and recessions to the specific challenges of taxing modern work practices and cleaning up nuclear reactors. But the main message is clear: governments should expect nasty fiscal surprises from time to time – because policy can only reduce risks, not eliminate them – and plan accordingly. And they have to do so in the context of ongoing pressures that are likely to weigh on receipts and drive up spending and a variety of risks that governments choose to expose themselves to for policy reasons. This is true for any government, but this one also has to manage the uncertainties posed by Brexit, which could influence the likelihood or impact of other risks.

History tells us that the biggest peacetime fiscal risks over the medium term relate to the economy. The chance of a recession in any five-year period is around one in two, and in three of the last four the budget deficit topped 6 per cent of GDP. Recessions associated with financial crises are typically the most costly, especially when their economic effects persist. These long-term costs are generally much more significant, if less immediately visible, than any money spent bailing out banks. The chance of a financial crisis in any five-year period is around one in four, but thankfully not all are as big or as costly as the most recent one.

With recessions and financial crises almost inevitable over a 50-year horizon, governments need to recognise the very high probability that they will have to deal with their costs at some point in the future. Policy can reduce the likelihood of these risks crystallising and their fiscal impact when they do, but the underlying risks cannot be eliminated. So the public finances need to be managed prudently during more favourable times to ensure that when these shocks do crystallise they do not put the public finances onto an unsustainable path. This is all the more important given the rise in the stock of debt in recent years, and the greater sensitivity of future debt interest costs to changes in interest rates and retail price inflation.

The economy could also be a source of slow-building fiscal pressures. Most importantly, our productivity growth assumptions, which underpin current fiscal plans and forecasts, assume that the weakness of recent years will dissipate over the next five years and historical norms will re-assert themselves. But if the past few years prove to be the 'new normal', even the current challenging spending plans would require either higher taxes or higher borrowing. By way of illustration, if trend productivity and GDP growth were just 0.3 percentage points a year lower than we assume, half the £26 billion of headroom the Government has against its structural deficit target for 2020-21 would be lost. The remaining £13 billion would disappear if just some of the other risks discussed in this report were to crystallise.

Surveying specific risks to receipts and spending points to a wide range of ongoing pressures that governments must deal with, while also preparing for inevitable future shocks:

The tax system is designed in a way that should increase the tax-to-GDP ratio over time, for example by linking thresholds to inflation so that real earnings growth drags more income into higher tax brackets. But in practice that ratio has fluctuated within a fairly narrow range, partly because of pressures on tax bases and effective tax rates that work in the opposite direction. Some taxpayers will always seek to reduce their liability through legal or illegal means. Some heavily taxed activities are in relative decline (fuel consumption, smoking, North Sea oil production). Some activities become harder to tax (changes in the way people work are weighing on receipts). And policy is a source of risk, for example repeated decisions not to implement fuel duty increases.

Pressures on public spending abound. By far the biggest relate to health, where an ageing population is raising demand while technological advances raise costs. Ageing also creates pressures on adult social care and the state pension – which each face policy-driven cost pressures in the form of the National Living Wage and the triple lock respectively. To these can be added ongoing pressures from the uncertain costs of cleaning up nuclear power stations, compensating victims of clinical negligence and reimbursing tax that the courts determine should not have been collected. In the near term the Government may also need to finance an extensive programme of fire safety measures in the wake of the Grenfell Tower tragedy. All these have to be considered in the context of medium-term spending plans that imply significant real terms cuts in spending per person over the next three years, on top of those implemented since 2010. Lifting current limits on public sector pay increases would pose a fiscal challenge to the extent that departments had their budgets increased to pay for it, rather than simply giving them greater flexibility over how they manage their pay bills.

The new Government must also manage the risks posed by Brexit. These do not supplant the possible shocks and likely pressures that we have already discussed, but they could affect the likelihood and impact of many of them. A lot of attention focuses on the possible 'divorce bill', but, while some numbers mooted for it are very large, a one-off hit of this sort would not pose a big threat to fiscal sustainability. More important are the implications of whatever agreements are reached with the EU and other trading partners for the long-term growth of the UK economy, which we do not attempt to predict here. If GDP and receipts grew just 0.1 percentage points more slowly than projected over the next 50 years, but spending growth was unchanged, the debt-to-GDP would end up around 50 percentage points higher.

None of this should be taken as a recommendation to refrain from particular spending increases or tax cuts, or to avoid particular fiscal risks – that would lie beyond our remit. And there are those who believe fiscal policy is still too tight, given the pace of economic growth and the looseness of monetary policy. But new unfunded 'giveaways' would take the Government further away from its medium-term fiscal objective and would only add to the longer-term challenges. In many recent fiscal events, giveaways today have been financed by the promise of takeaways tomorrow. The risk there, of course, is that tomorrow never comes.

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 and fiscal risks.
2. All the documents and supporting material published today is available on our website: http://budgetresponsibility.org.uk/
3. Questions about the *Fiscal risks report* should be sent to OBR.Press@obr.gsi.gov.uk.
4. Any requests for additional information will be subject to our release policy, which can be found on our website at: http://budgetresponsibility.org.uk/topics/requests-for-information/