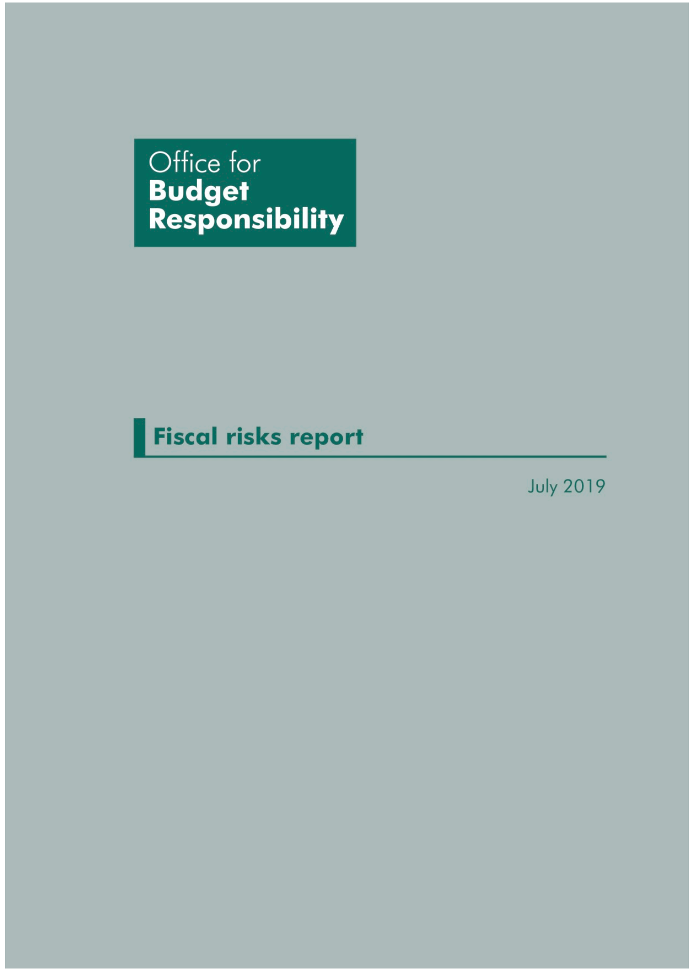
Fiscal risks report 2019

THE OFFICE FOR BUDGET RESPONSIBILITY REPORT ON RISKS TO THE UK PUBLIC FINANCES

Fiscal risks report 2019

- On 18 July 2019, the Office for Budget Responsibility published its second fiscal risks report.
- The report provides an analysis of the economic and policy risks facing the public finances, including a ‘fiscal stress test’, setting out how the fiscal numbers might react to a no-deal Brexit.
- The report analyses risks to the economy, the financial sector, revenue, spending, the balance sheet and debt interest, as well as policy risks. It is also considers the implications of climate change.



Fiscal risks report 2019

"The OBR highlights the continuing vulnerability of the UK public finances to economic headwinds and policy risks. Both revenue and spending are under increasing pressure as the population grows older and productivity stubbornly refuses to improve.

The report stresses the short-term risks to the public finances arising from Brexit or a potential global recession, with the 'mild' no-deal scenario presented by the OBR suggesting a significant hit to the public finances in the order of £30bn a year, before considering potential policy responses that could cost even more.

Perhaps more concerning is the OBR's observation that austerity fatigue is leading to a fiscal loosening and less ambitious objectives for the management of the public finances. With the public finances already on an unsustainable path in the longer-term, the temptation to defer necessary decisions even further into the future appears to be proving too difficult to resist."

Martin Wheatcroft FCA
Advisor to ICAEW on public finances

Overview

ICAEW

Similar risk profile to two years ago

- Most risks remain from first fiscal risks report
- The UK Government has improved monitoring, management and reporting of fiscal risks
- The fiscal deficit has reduced and the debt to GDP ratio has started to fall

But, policy risks are increasing

- Balanced budget objective appears to have been abandoned
- Unfunded commitment to increase NHS spending by £27bn a year
- Conservative leadership candidates uncosted proposals for tax cuts and spending increases
- All signs are for a fiscal loosening and less ambitious objectives for the management of the public finances
- There is no war chest

Economic headwinds and a potential recession

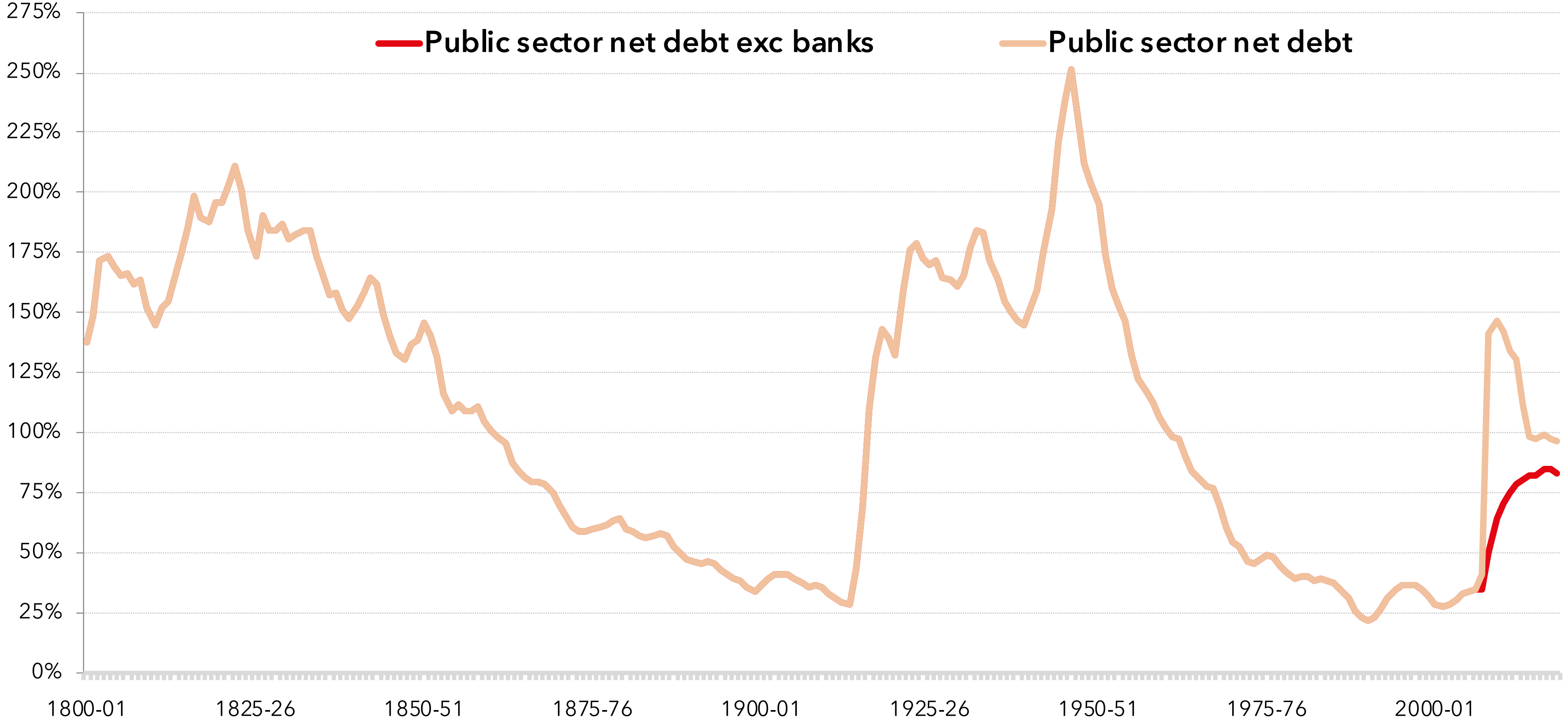
- Fiscal stress based on 'mild' no-deal Brexit would trigger a recession
  - Borrowing up by £30bn a year from 2020-21
  - Public sector net debt 12 per cent higher in 2023-24
  - Additional to the Brexit impact already in forecasts
  - Assumes no policy response such as tax cuts or more spending, which would involve more borrowing
  - A more disruptive Brexit would hit public finances harder
- Recessions occur roughly every decade
  - Policy responses can mitigate, but government accepts the need to reduce debt to provide capacity to absorb shocks

Public finances remain unsustainable in long-term

- Upward pressures on public spending
  - Ageing population and other cost pressures on health and social care budgets
  - Pensions triple-lock unaffordable in long-term term
- Climate change risks could be severe

Source: Office for Budget Responsibility, *Fiscal risks report,* 18 July 2019.

Public sector net debt at highest level for 50 years



 Source: Office for Budget Responsibility, *Fiscal risks report*, 18 July 2019.

Risks to the economy and the financial sector

Macroeconomic risks

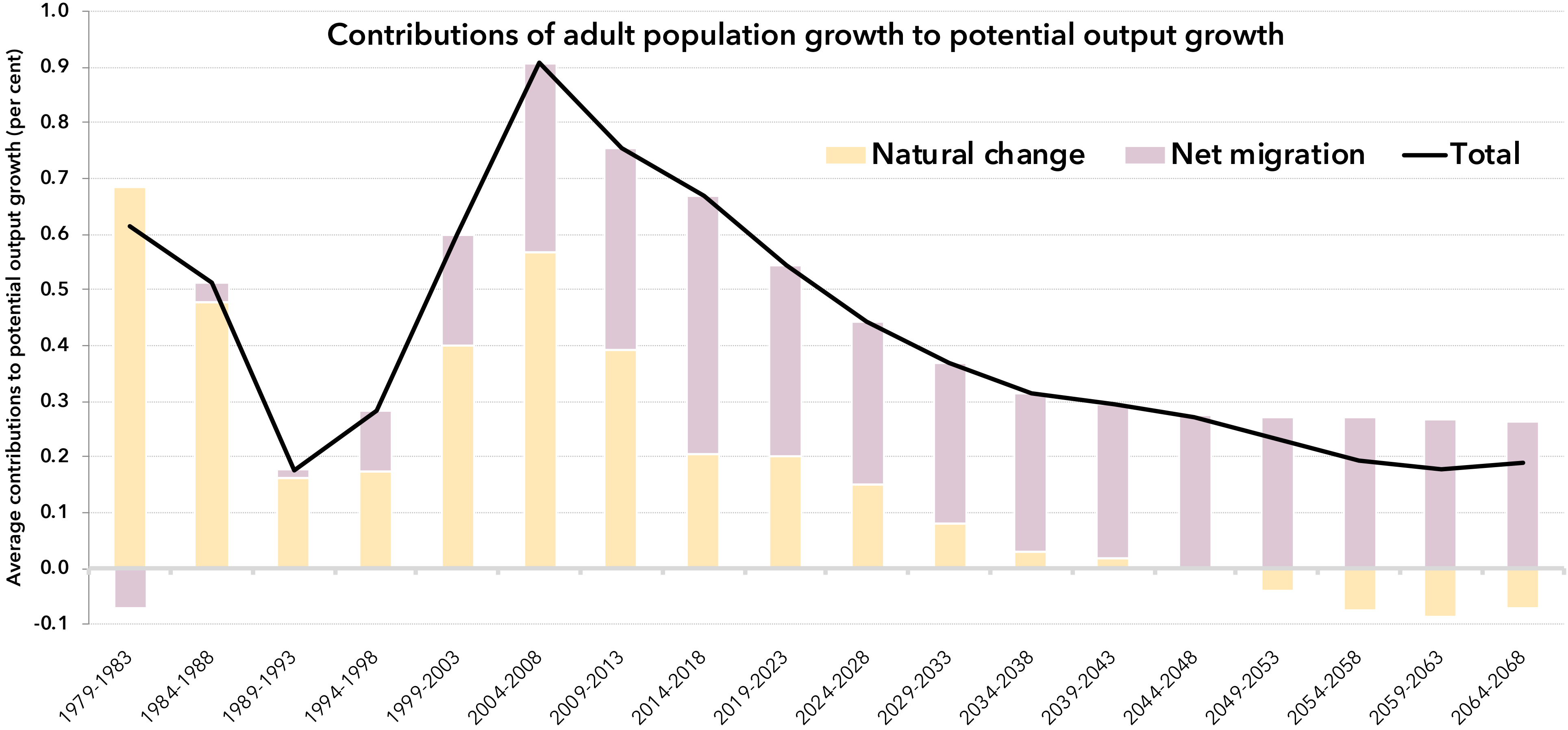
- Chance of recession around 50% in any 5 year period
- Significant fiscal risks from fluctuations in highly-taxed housing market and from workers changing employment status and paying less in taxes
- Government recognises the importance of long-run productivity growth and need for macroeconomic policy to play a supportive role in recessions
- OBR forecasts over last few years have reflected gloomier prognosis for productivity
- Short-term cyclical risks have risen this year
- Measuring output gap is difficult, and policy responses can be based on a misleading steer as to size of the structural deficit

Financial sector risks

- Financial sector is important to the public finances as financial institutions and their staff pay a lot of tax
- Government has taken action to reduce financial stability risks and reduce taxpayer exposure to failing institutions
- Risk of financial crisis low, but not negligible; should be expected every 20 years
- Experience is that risks in one part of the financial system tend to migrate to less regulated areas
  - Rapid growth in shadow banking is a concern despite more attention from policy makers
  - Could be calls on public purse to bail out institutions and retail investors
  - Contagion to core banking system a possibility

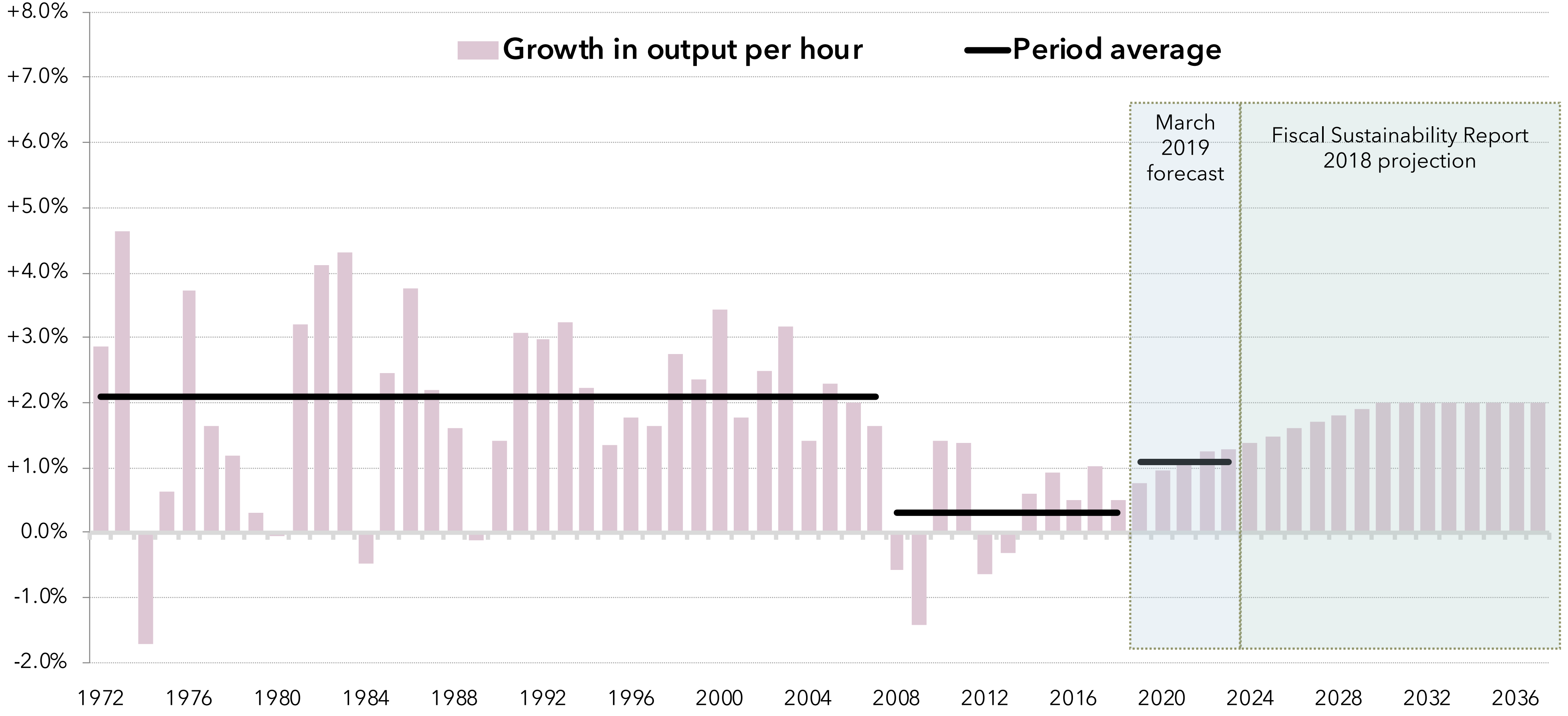
Source: Office for Budget Responsibility, *Fiscal risks report*, 18 July 2019.

Net migration a key driver of economic growth



 Source: Office for Budget Responsibility, *Fiscal risks report*, 18 July 2019 (Chart 2.1).

OBR assumes productivity growth will recover



 Source: Office for Budget Responsibility, *Fiscal risks report*, 18 July 2019 (Chart 2.3).

Risks to revenue and spending

Revenue risks

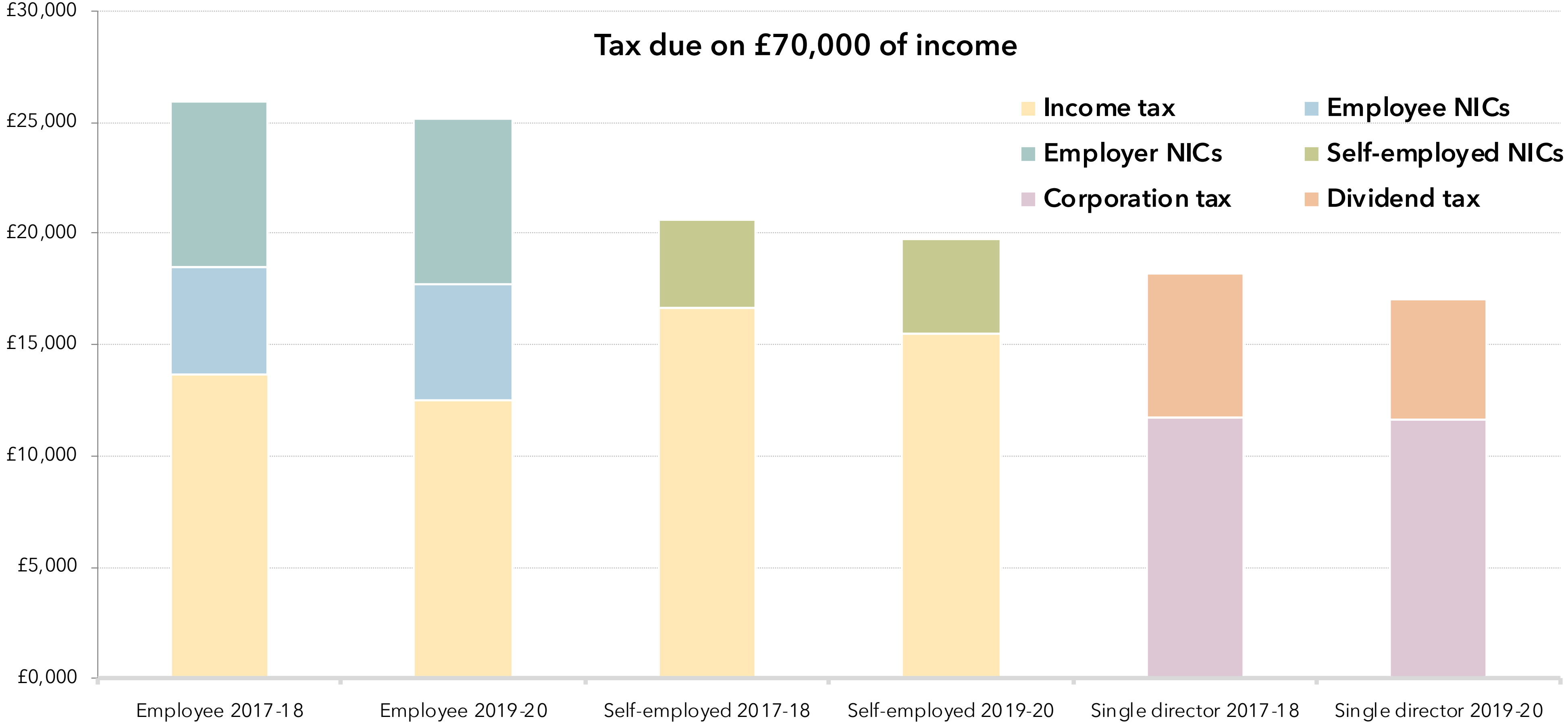
- Risks to the tax base remain from trends in smoking, drinking and driving, the depletion of North Sea oil and gas reserves, and the differential taxing of employment, self-employment and personal service companies
- Tax policy risks, including aspirations not factored into forecasts, failure to implement policies and uncertain yields from measures to tackle avoidance & evasion
- Concentration of receipts from small number of taxpayers
- Tax reliefs cost around 8% of GDP and are rising
- Risks posed by digitalisation are balanced, with lower rates of tax offset by potential for growth

Spending risks

- A reaction to austerity fatigue seems to be a fiscal loosening and more spending promises. Spending control framework under pressure
- NHS settlement crystallises largest medium-term risk previously identified, but was not accompanied by a plan. Social care funding remains unresolved and there are rising costs of clinical negligence
- Government committed to pensions triple lock for this Parliament
- Local authorities borrowing for commercial purposes is a risk; this is under review by Treasury
- BBC decision to means-test free licenses for over-75s could lead to more take-up of pensions credit, potentially offsetting the saving
- National living wage increases after 2020 and more restrictive immigration system could cause additional costs in the health and social care system
- HMRC victory in Littlewoods VAT repayment interest case removes one major risk

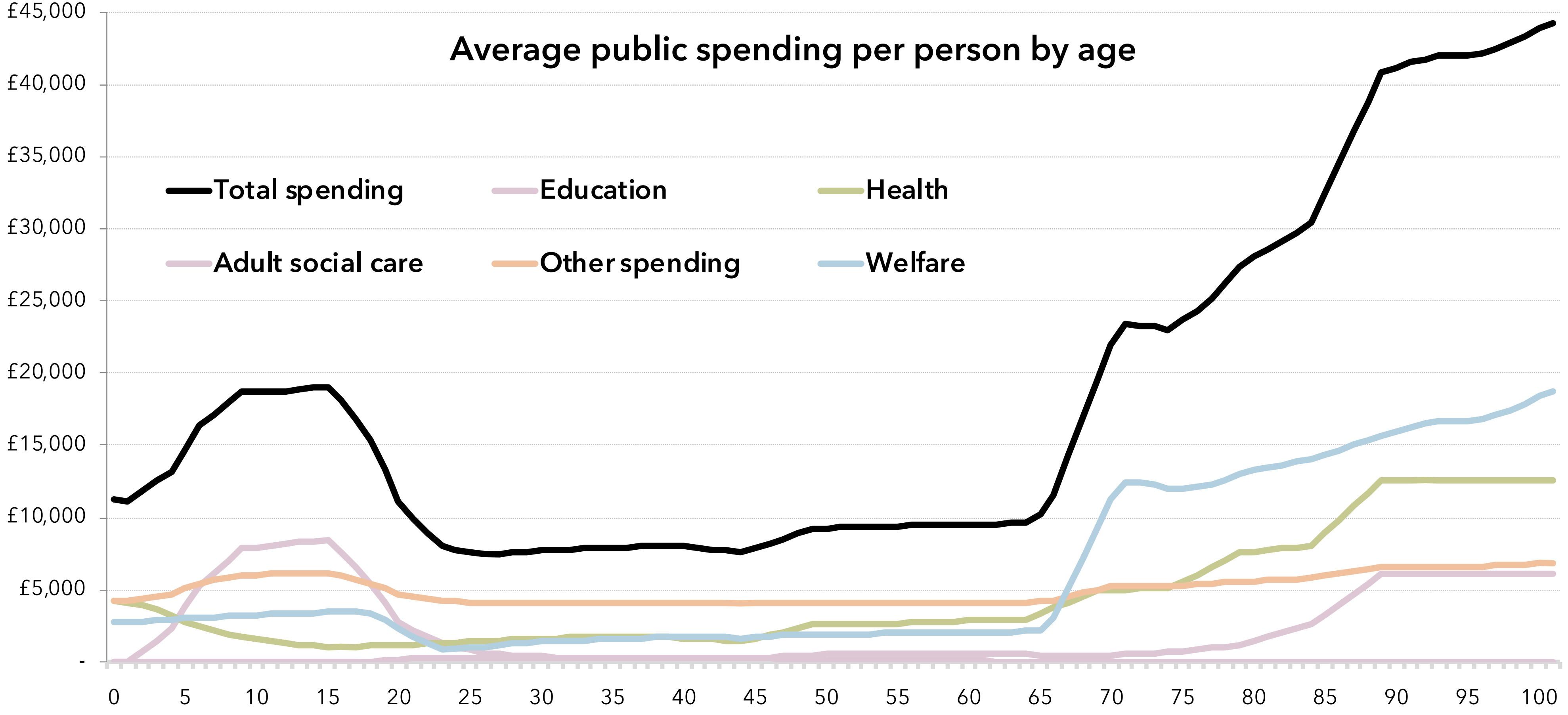
Source: Office for Budget Responsibility, *Fiscal risks report,* 18 July 2019.

Employment status affects tax take



 Source: Office for Budget Responsibility, *Fiscal risks report*, 18 July 2019 (Chart 4.6).

Ageing demographic drives spending increases



 Source: Office for Budget Responsibility, *Fiscal risks report*, 18 July 2019 (Chart 5.3).

Risks to the balance sheet and debt interest

Balance sheet risks

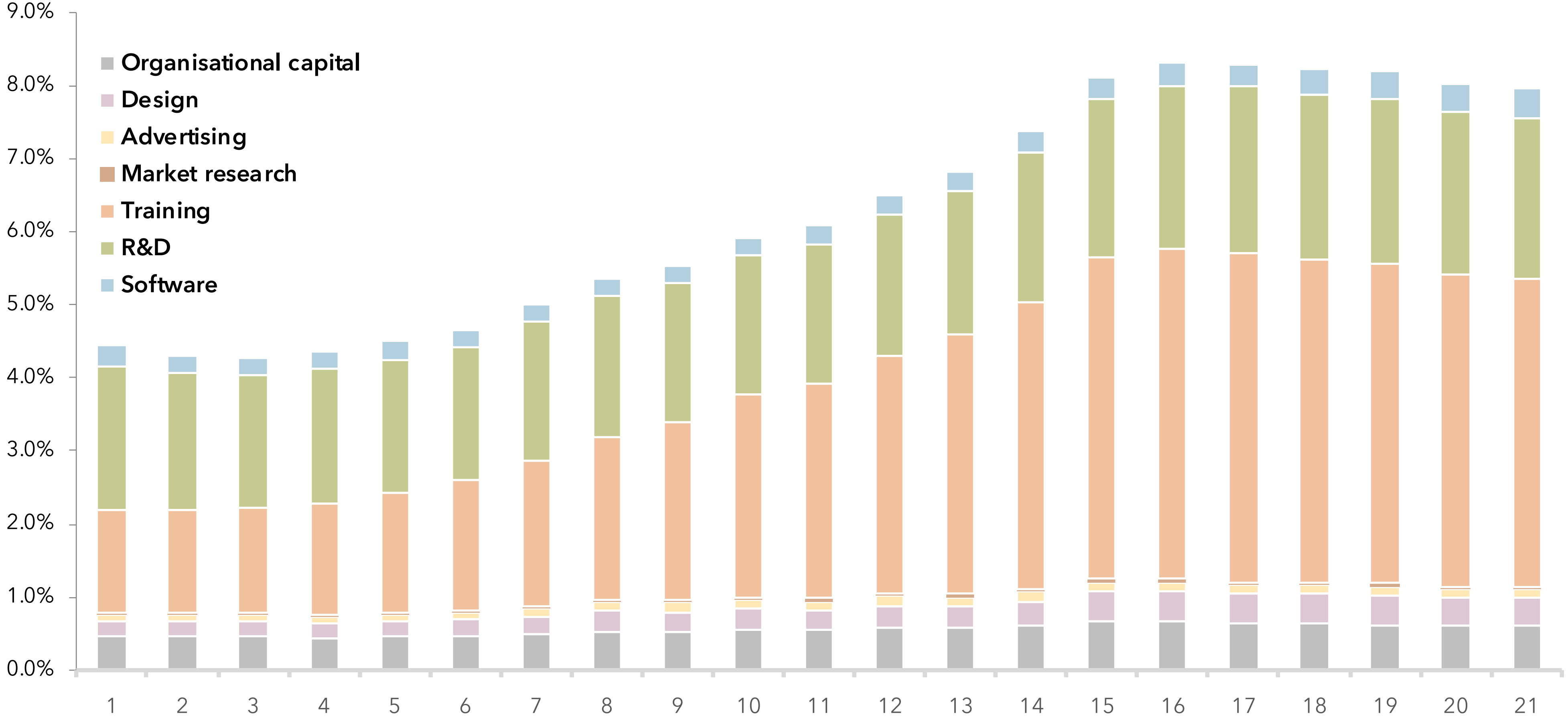
- There are a wide range of balance sheet risks associated with assets, liabilities and financial commitments
- Policy risks arise from an incomplete understanding of the balance sheet and ‘fiscal illusions’, such as off-balance sheet debt
- Government has made progress in balance sheet management, with improved measures, increased transparency around asset sales, and better management of guarantees and contingent liabilities. The Balance Sheet Review aims to improve information on assets and liabilities, identify opportunities to dispose of assets, and improve the return on retained assets
- OBR believes balance sheets are largely unchanged, but are better monitored
- The greatest risk remains the fiscal exposure from policy responses to a future event or crisis.
- Fiscal illusions remain with incentives to hide public sector activity off the balance sheet. The planned change in student loans accounting to record irrecoverable loans as an expense will remove one fiscal illusion, but the reclassification of housing associations to the private sector reinstates another

Debt interest risks

- In 2017, OBR identified increased risks from higher levels of debt
- Index-linked gilts and quantitative easing increase the exposure to RPI-inflation and short–term interest rates respectively
- Government has taken steps to reduce the proportion of index-linked gilts issued, but this will take time to feed through
- Interest rates have continued to fall, meaning debt interest likely to be lower than current forecast in the short- to medium-term
- The growth-corrected interest rate (‘R-G’) has been highly variable over the last 120 years, giving a highly uncertain outlook for debt interest costs in the longer run

 Source: Office for Budget Responsibility, *Fiscal risks report,* 18 July 2019.

Public sector intangible assets are significant



 Source: Office for Budget Responsibility, *Fiscal risks report*, 18 July 2019 (Chart 6.6).

Policy risks and climate change

Policy risks

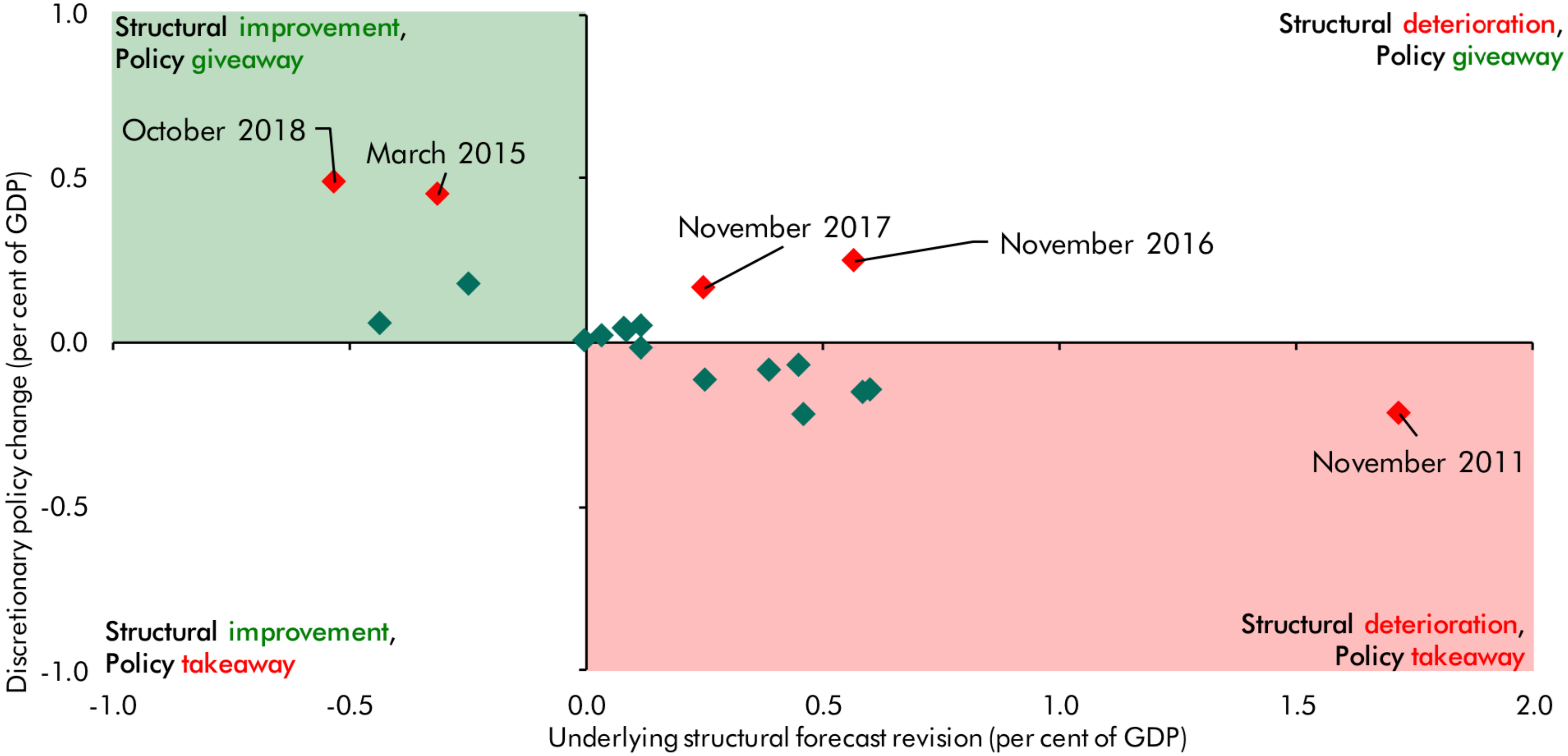
- Governments have often chosen to revise fiscal targets to accommodate changes in forecasts rather than policy being adjusted to meet them, leading to a higher profile of debt
- At the same time, governments have often been very focused on remarkably precise fine-tuning to meet specific targets, often by margins that were not fiscally or statistically significant - missing the bigger picture
- Spending is likely to rise with looser fiscal policy and less ambitious fiscal objectives
- Objective of balancing the budget appears to have been abandoned, while tax cuts and spending pledges could affect achievability of current fiscal mandate to reduce debt to GDP ratio every year

Climate change

- The scale of risks associated with climate change will depend hugely on the extent to which temperatures rise
- If Paris targets are met then physical risks may be manageable, with scale and frequency of cilimate-related events increasing, but perhaps not significantly
- If global mitigation efforts fail, it will be difficult to predict the consequences. More extreme weather events, mass international migration and induced periods of conflict would be costly
- Transition risks relating to a shift to a low-carbon economy are also uncertain. Diverting investment could impinge on investment on productive capital, with risks of being locked into outdated infrastructure
- Direct fiscal implications can arise from public funding of repairs to damaged assets as well as costs of investing in preventative measures such as flood and coastal erosion defences risk. These direct effects appear relatively modest if global warming proceeds as envisaged by the Paris targets

 Source: Office for Budget Responsibility, *Fiscal risks report,* 18 July 2019.

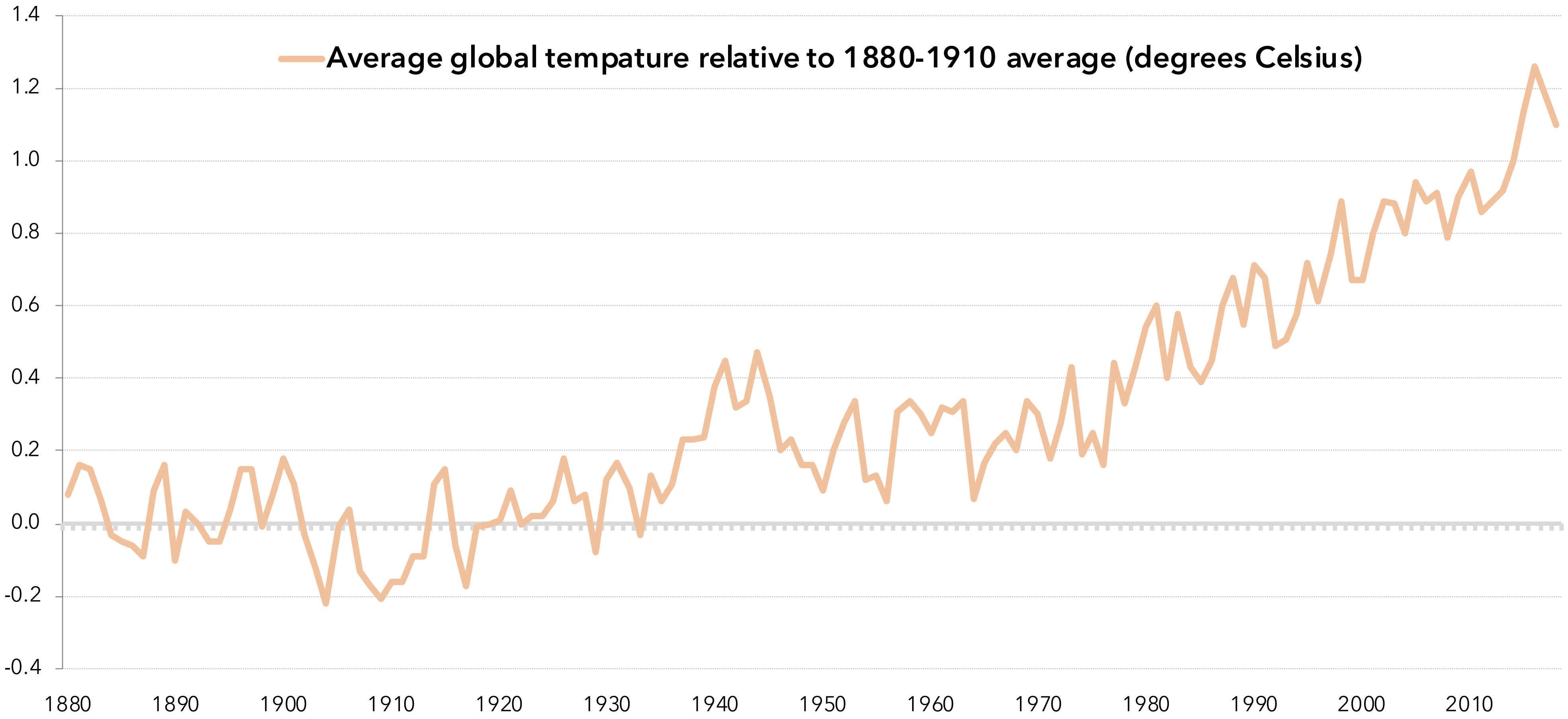
Policy responses biased towards giveaways



Note: Reflects the cash revision over the last 5 years of the forecast, rebased to each historic nominal GDP forecast.

 Source: Office for Budget Responsibility, *Fiscal risks report*, 18 July 2019 (Chart 8.4).

Climate change: temperatures are increasing



 Source: Office for Budget Responsibility, *Fiscal risks report*, 18 July 2019 (Chart 9.1).

No-deal Brexit stress test

- The fiscal stress test quantifies the effect on the public finances of a particular no-deal no-transition Brexit scenario. (The OBR used the less disruptive of the two scenarios presented by the IMF in its April 2019 *World Economic Outlook*)
- Existing forecasts already reflect some adverse affect from Brexit, so this is not the full picture. It also does not assume any fiscal policy response, for example tax cuts or higher spending to stimulate the economy
- The scenario assumes that investment is deterred by uncertainty and declining confidence, while higher trade barriers with the EU weigh on exports. Together these could push the economy into recession in 2020, with falling asset prices and the pound falling sharply
- Real GDP falls by 2 per cent by the end of 2020 and 4 per cent below OBR's March 2019 forecast. Borrowing is around £30bn higher in 2020-21 and public sector net debt to GDP ratio is 12 per cent higher by 2023–24
- This is not the worse case scenario!

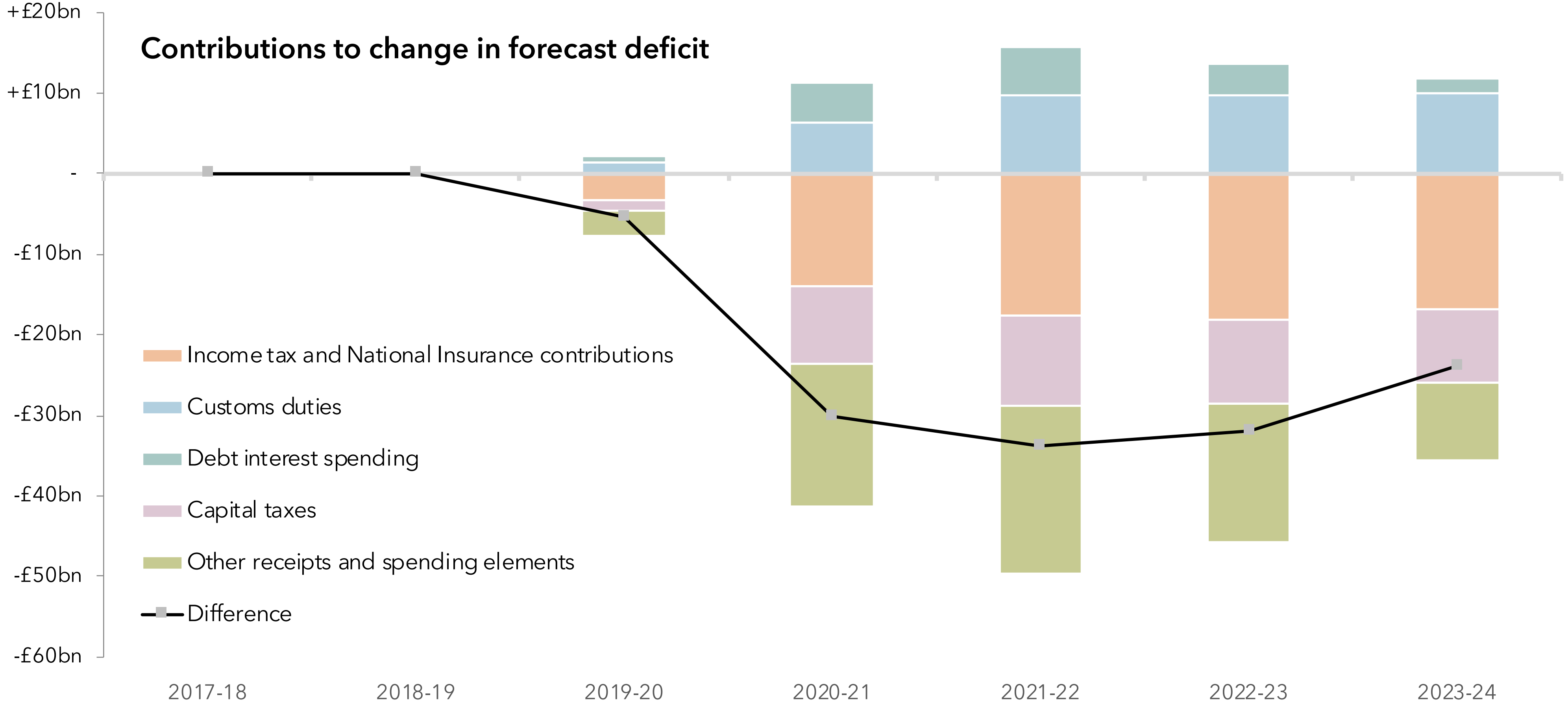
Five years to 2023-24	Stress test scenario	Change v March f'cast
Fiscal deficits	£221bn	£125bn
Public sector net debt	£2,150bn	£272bn
Debt to GDP ratio	85.1%	12.1%

Stress test changes:

- Higher deficits mainly driven by lower tax receipts, down £128bn
- Assumes no policy response, so expenditure unchanged apart from a £3bn reduction because of lower interest rates
- Reported debt also affected by extending the £121bn Term Funding Scheme, delaying £13bn in asset sales beyond March 2024 and £10bn from crystallisation of contingent liabilities

 Source: Office for Budget Responsibility, *Fiscal risks report*, 18 July 2019.

Stress test: Deficit £34bn worse in 2020-21



 Source: Office for Budget Responsibility, *Fiscal risks report*, 18 July 2019 (Chart 10.3).

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OBR conclusion

- Many potential shocks 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

ICAEW perspective

- The strength of the fiscal risks report is that it is produced by the OBR, a body independent of government
- Some minor fiscal risks have been addressed, but Brexit and policy risks have increased
- Important decisions on issues such as social care have been deferred; these will be more costly if not dealt with
- The UK needs a long-term fiscal strategy to address the serious financial challenges facing the public finances

 Source: Office for Budget Responsibility, *Fiscal risks report*, 18 July 2019.

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