HM Treasury

# Managing fiscal risks:

## government response to the 2017 Fiscal risks report

Cm 9647

July 2018

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## government response to the 2017 Fiscal risks report

Presented to Parliament by
the Chief Secretary to the Treasury
by Command of Her Majesty

July 2018

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# Foreword

We are at a turning point for our public finances. We have made great progress repairing the damage of the financial crisis to put the public finances back on a sustainable footing. Thanks to the hard work of the British people, we have reduced government borrowing by three-quarters and, this year, debt is due to begin its first sustained fall in a generation. We can be proud of this achievement, but we must not be complacent, and we must reject the arguments of those who think that debt can rise again without consequences.

At £1.8 trillion, or over 85% of GDP, our national debt is still too high. High debt leaves us more vulnerable to economic shocks and less able to cushion their impact on households and businesses; it unfairly passes the burden to the next generation; and the resultant spending on debt interest, if it were a ministry, would be the third-largest government department after health and education.

So, it is vital that we lock in our hard-won progress and do not throw it away. Delivering on our commitment to deal with our country's debts and rebuild our economic resilience means we must acknowledge and address the fiscal challenges we face. That is why we commissioned the Office for Budget Responsibility to produce the 'Fiscal risks report' – the first ever survey of potential threats to the public finances, and the most comprehensive report of its kind in the world.

Our response, 'Managing fiscal risks', sets out how the government is tackling these risks as we continue to repair the public finances for the benefit of current and future generations – following our balanced approach of getting debt down, keeping taxes low, supporting our valuable public services, and investing in Britain's future so we can raise our productivity.

Boosting productivity is the key to a stronger economy, a more sustainable fiscal position and, crucially, a better quality of life for everyone. That is why we are building a globally competitive economy through our modern Industrial Strategy, increasing public investment to its highest sustained level in over 40 years through the £31 billion National Productivity Investment Fund, and equipping our workforce for the high-skilled, high-wage jobs of the future.

This report also highlights the specific steps the government is taking to mitigate key sources of fiscal risk, including strengthening regulation to reduce the likelihood and cost of financial crises, adapting the tax system to a rapidly changing global economy, ensuring the pensions system keeps pace with increasing longevity, tightening controls over the issuance of loans and guarantees, and managing the government's inflation exposure.

Managing fiscal risks is about responsible government. By shining a light on risks that may have been easier to ignore and setting out our clear strategy to manage them, we are building a stronger economy and delivering on our promise of a brighter future for the next generation.

Chancellor of the Exchequer

July 2018

# Executive summary

## Introduction

The government's balanced approach is repairing the public finances and reducing debt in order to secure the UK's economy against future shocks, ensure that taxpayers' money funds vital public services rather than debt interest payments, and avoid burdening the next generation. Commissioning the Office for Budget Responsibility's (OBR) 'Fiscal risks report' (FRR) and publishing this comprehensive response shows the government's commitment to thoroughly assessing and actively mitigating risks to the public finances.

In 2010, the government inherited a very difficult fiscal position. At 9.9% of GDP, the deficit was at its highest level since the second world war. The government has made good progress since then, having reduced borrowing by over three quarters to 1.9% of GDP last year. However, the UK's national debt remains too high at over 85% of GDP, which is equivalent to around £65,000 per household. This high level of debt means the government is required to spend around £50 billion a year on debt interest, which is more than spending on the police and armed forces combined. It also means the UK is less able to respond to macroeconomic shocks, as shown by the FRR's fiscal stress test and highlighted by the IMF, who warned advanced economies about the need to reduce their debt to more sustainable levels. Finally, it unfairly burdens the next generation with our debts.

That is why the government is committed to reducing the level of public debt in a balanced way, while also providing more money for public services like the NHS, keeping taxes low and investing in infrastructure to build an economy that is fit for the future. As a result, debt is forecast to begin its first sustained fall in a generation this year. This is an important turning point for the UK economy, but the government needs to ensure that it has world-class management of fiscal risks to keep the public finances moving in the right direction. This report, the first of its kind, sets out how the government will deliver this.

## Background

A comprehensive understanding and proactive management of fiscal risks is critical to ensuring that governments meet their fiscal objectives with confidence. A failure to appreciate and address these risks can leave governments vulnerable to fiscal shocks and obliged to take sudden and disruptive policy actions to restore credibility and long-term sustainability. Nowhere was this more evident than in the wake of the 2008 global financial crisis which saw government debt-to-GDP ratios double across advanced economies.

The UK is at the vanguard of fiscal risk disclosure and management internationally. The government commissioned the OBR – through the Charter for Budget Responsibility – to publish the UK's first biennial FRR in July 2017. The report was recognised by the IMF, OECD, and other international organisations as the most comprehensive report of its kind and the only one produced by an independent body.

The OBR's FRR surveyed the potential near-term shocks to and longer-term pressures on the public finances. It identified 57 different risks emanating from the macroeconomy, financial sector, and government revenue, spending and the balance sheet. It also included an innovative fiscal stress test which looked at the combined impact on the public finances of a range of macroeconomic and specific fiscal risks materialising at once.

'Managing fiscal risks' (MFR) provides a comprehensive account of the actions the government is taking to address the risks identified by the OBR. In doing so, this report provides a mechanism for Parliament and the public to assess the adequacy of the government's strategies for managing these risks and hold it to account for their implementation. With the publication of this report, the UK sets a new global standard not only for the disclosure of fiscal risks but also for their active management.

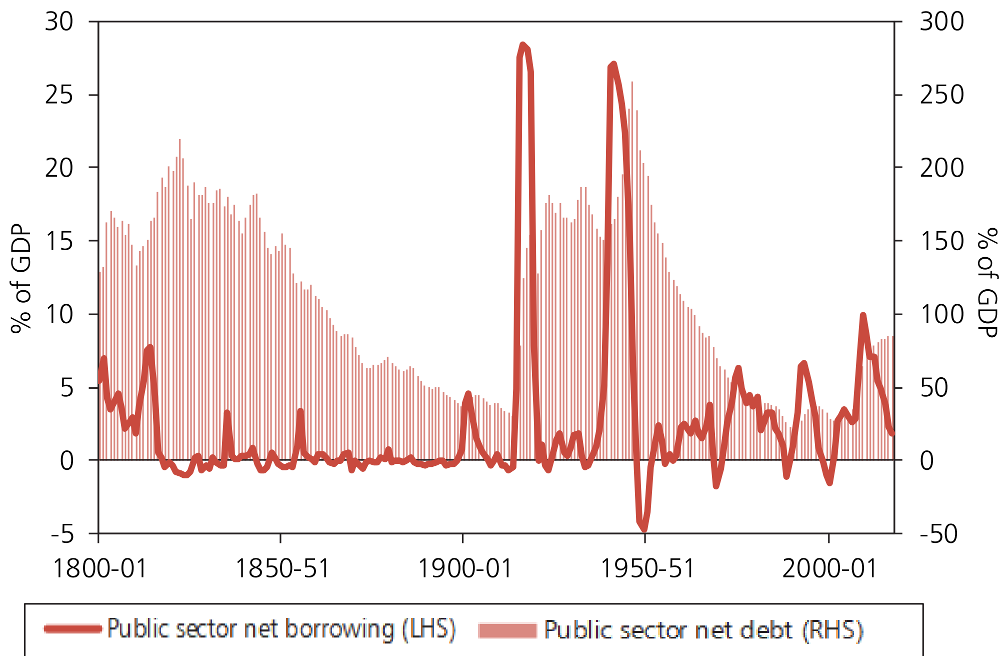
The report begins with a discussion of the government's overall strategy, institutions, and toolkit for managing fiscal risks (Chapter 1). Subsequent chapters describe the actions the government is taking to manage the fiscal risks arising from the macroeconomy (Chapter 2), financial sector (Chapter 3), government revenue (Chapter 4), public spending (Chapter 5), and the public sector balance sheet (Chapter 6). Annex A provides a complete register of where each of the 57 risks identified by the OBR are addressed in this report and the ministry or agency that is responsible for their management.

## Managing fiscal risks

Fiscal risks are factors that can cause a government's fiscal performance to deviate from what was forecast in the medium-term or pose a threat to sustainability over the long-term. These risks can originate from inside government (e.g. as a result of issuing a government guarantee) or from outside government (e.g. as a result of an economic downturn). Risks can materialise either as a result of a discrete event (e.g. a financial crisis) or the gradual accumulation of pressure (e.g. the ageing of the population).

As the size of government and scope of its responsibilities have grown over time, so has the range of risks to which it is exposed. Up until the mid-20th century, the single most important source of shocks to the UK public finances was wars which government borrowed to finance, while balanced budgets prevailed in peacetime (see Chart A). Since the 1950s, UK government borrowing has become both more volatile and more sensitive to changes in the macroeconomy, including by comparison with other advanced economies. Despite this exposure to fiscal risks, the UK has a relatively strong record in forecasting its fiscal position, especially since the establishment of the OBR in 2010.

Chart A: UK government deficit and debt since 1800




Source: ONS, Bank of England

In the medium-term, the largest potential risks originate from macroeconomic shocks in the form of recessions or financial crises, according to the FRR. Over the long-term, the most important risks come from structural economic and societal trends such as higher long-term interest rates, sluggish productivity growth, demographic change, and technological innovation which put sustained pressure on tax bases, financing costs, welfare systems, and public services. Over this time horizon, relatively infrequent events, such as recessions and financial crises, become factors that need to be anticipated when setting fiscal policy objectives.

The government's approach to managing risks follows a five-stage process, modelled on international best practice. This is to: (i) identify the source, scale and likelihood of the risk; (ii) disclose the risk to raise awareness and ensure accountability; (iii) mitigate the risk where cost-effective and consistent with broader policy objectives; (iv) provision for risks that cannot be mitigated but whose size and timing are relatively certain; and (v) accommodate residual risks when setting the overall fiscal policy stance.

HM Treasury has significantly enhanced its capacity to identify and manage fiscal risks through the establishment of the Fiscal Risks Group (FRG) in the mid 2000s, which meets monthly and reports to the Executive Management Board on a quarterly basis. In 2016, the Treasury established a new Balance Sheet Group, reporting to FRG, to bring greater focus on the management of the government's assets and liabilities. Active surveillance of fiscal risks is an obligation of all those responsible for the management of public resources. In the coming year, the government will be updating its Orange Book to reflect the latest best practice in operational risk management in both the public and private sector.

## Macroeconomy

Macroeconomic developments are, for most countries, the biggest source of fiscal risks over the medium-term. Countries are typically hit by a recession once every 12

years with an average fiscal cost of 9% of GDP. Macroeconomic shocks can originate from the rest of the world or as a result of the build-up of imbalances in one or more sectors of the domestic economy. Longer-term structural trends such as low productivity growth, persistently high or low inflation, rising interest rates, or shifts in the composition of GDP can also put the public finances under sustained pressure.

The government has reformed its monetary and fiscal policy frameworks in recent years to enable them to play a more active role in stabilising and supporting the economy. The 2013 Review of the Monetary Policy Framework provided the Bank of England with flexibility around its inflation target to respond to persistent shocks to output. In Autumn 2016, the government updated its fiscal rules, taking a balanced approach to fiscal policy and enabling it to tackle public debt, while keeping taxes low, supporting public services, and investing in economic infrastructure.

The Bank of England has significantly expanded its policy toolkit to enable it to support the economy and safeguard the stability of the financial system at a time when interest rates are close to zero. This enhanced toolkit has included purchases of financial assets including gilts and, more recently, corporate bonds, loans, and mortgages. These asset purchases, together with a structural increase in demand for central bank reserves since the crisis, have seen the Bank's balance sheet increase ten-fold since 2008.

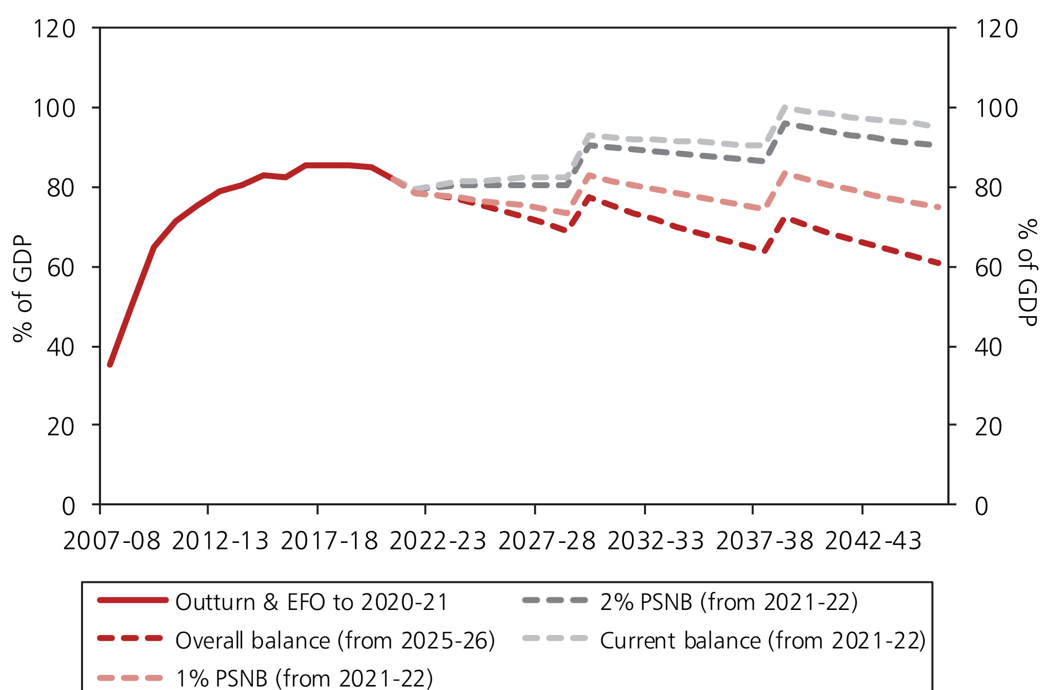
In recognition of the Bank's expanded remit and more extensive balance sheet, the Treasury and the Bank agreed a new capital and income framework in June 2018 which ensures that the Bank maintains a level of risk-bearing capital necessary to ensure its policy credibility even in the most stressed environment. As part of these arrangements, the taxpayer indemnity over the £127 billion Term Funding Scheme (TFS) was removed. Enhanced oversight arrangements have also been established to monitor the risks associated with the £435 billion stock of gilts held in the Bank's Asset Purchase Facility (APF), which continues to be indemnified by the Treasury.

The government has acted to reduce the large sectoral imbalances in the economy from their post-crisis peaks. To guard against an unsustainable build-up of mortgage debt, the Financial Policy Committee used its new macro-prudential tools in 2014 to limit bank lending to highly-indebted borrowers. The new Financial Conduct Authority has been given robust regulatory powers to protect borrowers and is consulting on new rules and guidance for assessing creditworthiness. The government has also acted to promote the stability of and manage its exposure to the housing market through its loan and guarantees schemes. Finally, the government is promoting British exports through the creation of the new Department for International Trade (DIT), the forthcoming publication of a new Export Strategy, and the negotiation of ambitious trade agreements with the EU and non-EU countries once the UK departs from the EU.

The government has made significant progress in reducing fiscal imbalances over the past eight years. The deficit has been cut by over three-quarters from its post-war peak of 9.9% of GDP in 2009-10 to 1.9% in 2017-18. The debt-to-GDP ratio is now forecast by the OBR to have peaked last year and to begin its first sustained fall in a generation from this year. However, as analysis by international experts and the OBR's own fiscal stress test has shown, governments with high levels of debt are more vulnerable to shocks and have less room to use fiscal policy to mitigate their impact on the economy. Moreover, leaving government debt at current levels would

see the burden of servicing that debt rise to levels not seen since the mid-1980s if interest rates normalise in the way assumed in the OBR's long-run projections. This would pass an unacceptable burden on to the next generation. The government is therefore committed to keeping debt falling until it returns to more sustainable levels. To do so, further reductions in the deficit will be needed which is why the government's objective for fiscal policy is to return the public finances to balance by the middle of the next decade. (Chart B).

## Chart B: Projections of public sector net debt with illustrative shocks




Source: ONS, OBR and HMT calculations

In the interim, the government has taken several steps to address the risks associated with its elevated level of debt. The government has maintained one of the longest average debt maturities among advanced economies at over 15 years, more than twice that of other G7 countries. This reduces the rate of transmission of possible interest rate shocks to the public finances. The government is also acting to mitigate its exposure to inflation risk by reducing the issuance of index-linked gilts in the latest financing remit and reviewing the appropriate balance between index-linked and conventional gilts going forward.

In the long run, boosting productivity growth would accelerate the return to fiscal sustainability and alleviate pressures on taxpayers, public services, and future generations. The government is taking forward a comprehensive strategy for boosting productivity based on supporting long-term investment in physical, human and intellectual capital and promoting a dynamic economy that encourages innovation and helps resources flow to their most productive use. The National Productivity Investment Fund will provide £31 billion of additional investment in areas critical to improving productivity and £1 billion in improving the UK's digital infrastructure. The government has also launched a modern Industrial Strategy, committed to increasing public and private investment in R&D to 2.4% of GDP by 2027, and is transforming technical education by investing in apprenticeships, including T-levels which will mean that all 16-18 olds have a choice of technical and

academic routes of equal status and quality. Overall, under this government, public investment is due to reach its highest sustained level in 40 years.

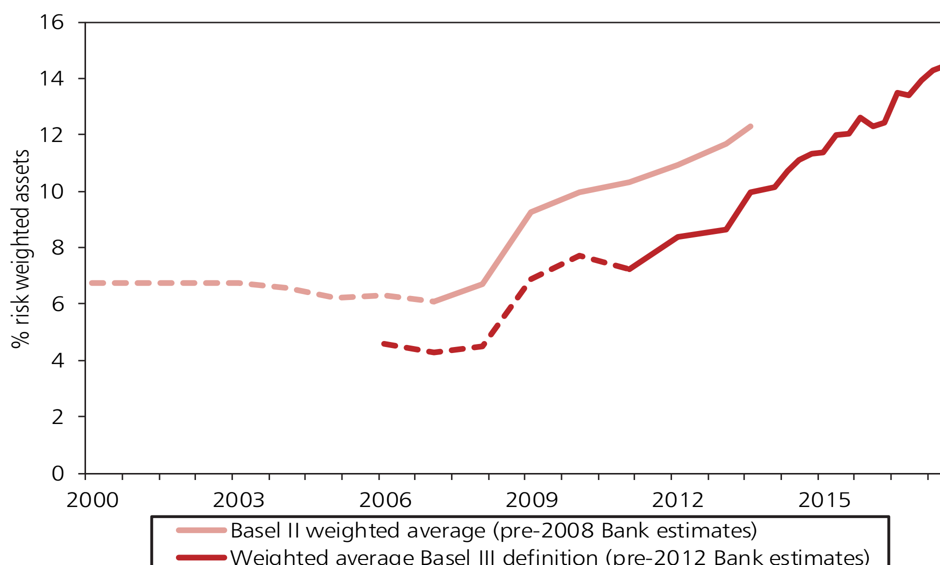
As the UK leaves the European Union (EU), the government is working to maximise future prosperity and minimise the potential disruption to trade between the UK and the EU, protecting jobs and livelihoods. The UK is seeking a deep and comprehensive economic partnership with the EU, broader in scope than any other that exists between the EU and a third country. The government seeks the establishment by the UK and the EU of a free trade area for goods and the phased introduction of a new Facilitated Customs Arrangement, alongside new arrangements for services and digital. On financial services, it is seeking new economic and regulatory arrangements that preserve the mutual benefits of integrated markets and protect financial stability, while respecting the right of the UK and the EU to control access to their own markets. In order to provide certainty while the UK negotiates the terms of its departure from the EU, the government has agreed the terms of a time-limited implementation period so that businesses can trade with the EU on the same terms as now up until the end of 2020. The government has agreed to protect the rights of EU citizens in the UK, and UK nationals in the EU under the Withdrawal Agreement. Finally, the government secured agreement on the UK's financial settlement with the EU equating to a central estimate of between £35 and £39 billion. The OBR's 2018 Spring Statement forecast is consistent with this estimate.

## Financial sector

Financial crises are typically the single largest source of shocks to the public finances, with an average cost of around 20% of GDP and an average frequency of one crisis every 20 years. The financial services sector is an important contributor to the UK economy and public finances, representing 7% of total output and 18% of corporate tax receipts. As seen during the global financial crisis, financial sector instability can affect the public finances both directly (through public rescues or takeovers of financial institutions) and indirectly (through its impact on the wider economy and government receipts).

The government has fundamentally reformed the system of financial regulation to reduce the likelihood, and cost to the taxpayer, of financial crises. It has put in place a legal framework which established the Prudential Regulation Authority (PRA), the Financial Conduct Authority (FCA), the Financial Policy Committee (FPC), and given the Bank of England primary responsibility for financial stability. The government has also expanded the array of tools available to regulators, including giving the FPC the power to set the countercyclical capital buffer which banks are required to hold against UK exposures. As a result, bank capital ratios have tripled since 2008 (Chart C). The Bank's 2017 stress tests of the largest UK banks and building societies showed that, for the first time since these tests were introduced in 2014, no bank needed to strengthen its capital position as a result of a scenario that was more severe than the global financial crisis. Finally, the government has acted to address misconduct and pay practices that favour short-term thinking within financial firms and is leading international efforts to harmonise banking standards, including full implementation of the Basel III reforms.

## Chart C: Aggregate increase in bank capital ratios




Source: Bank of England Financial Stability Report November 2017

The government has taken a range of actions to reduce taxpayer exposure to the financial sector in the event of financial instability. The Bank, PRA, FCA, and the Treasury have instituted a new comprehensive bank resolution regime which includes powers to 'bail in' shareholders and creditors of failed banks. It has required UK banks to ring-fence the provision of core retail services from other activities such as investment and international banking, in order to insulate individual and small business deposits from shocks originating elsewhere in the financial system. The government has also worked to diversify the sector and thereby reduce systemic risk through promotion of Open Banking, Fintech, and alternative funding sources. Finally, the government has changed the way banks are taxed, including through the introduction of an 8% Corporation Tax surcharge on banking profits, to incentivise banks to move away from riskier funding models, and ensure that the sector makes a fair contribution to the Exchequer that reflects the unique risks it poses to the UK economy.

The Treasury is working with other UK financial authorities and the National Cyber Security Centre to improve resilience across the financial sector to cyber attack. Over 30 major UK financial firms have now undergone a bespoke test simulating a cyber attack, and implemented a risk mitigation plan in response. The UK also works closely with the G7 and the Financial Stability Board to understand evolving cyber risks and coordinate action in response. The Treasury is also working with partners to mitigate cyber risks to the flow of public funds. Specifically, the Public Finance Business Continuity Group, which brings together all the institutions involved in managing public funds, has established an Information Security Sub-Group and is planning a cross-government cyber security exercise for later in 2018.

## Revenue

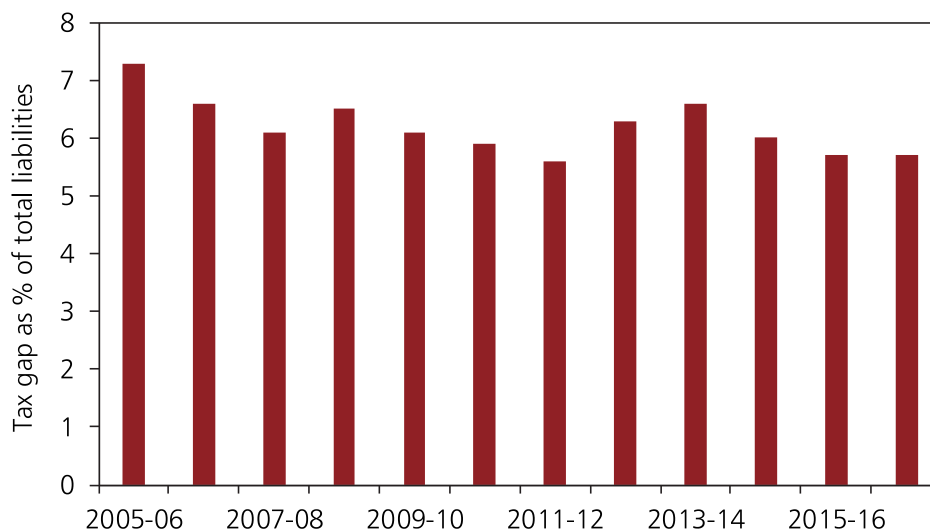
While the most significant risks to government revenues come from macroeconomic shocks, risks to government revenues also arise due to discretionary policy changes and economic, technological, and behavioural trends which can erode the tax base over the long term. The government is committed to a tax system which supports living standards and economic growth, ensures that everyone pays their fair share of

tax, and continues to raise the revenues to fund our public services. This requires the government to understand emerging risks to the tax system and take action to address them.

The government is taking steps to adapt the tax system to a changing economy. It is leading international efforts to ensure that multi-national and digital corporations are taxed where they create value and published a consultation paper on corporate tax and the digital economy alongside the Autumn Budget 2017. The government recognises the need to ensure that duties, including on smoking, encourage desirable changes in behaviour while also adapting to their consequences for government revenue. The government also continues to monitor the impact of different ways of working on revenues. Moving forwards, the government will ensure the tax system keeps pace with the rise of digital technologies and harnesses innovation to improve the administration of the tax system.

The government has a strong record of tackling tax avoidance, evasion and non-compliance so that everyone pays the tax that is owed. Between 2005-06 and 2016-17, the gap between taxes owed and taxes received has fallen from 7.3% to 5.7% (Chart D). The government has brought forward over 100 measures since 2010 to tackle tax avoidance, evasion, non-compliance and aggressive tax planning. Failure to take reasonable care and error are now large components of the tax gap, and so the government is also helping taxpayers understand the tax system and get their tax right the first time around, including through the introduction of Making Tax Digital. Businesses with turnover above the VAT threshold will be mandated to use the system to meet their VAT obligations from April 2019. Finally, the government is working with the Oil and Gas Authority and the industry to reduce the total costs of decommissioning oil and gas installations on the UK Continental shelf by at least 35%.

### Chart D: UK tax gap



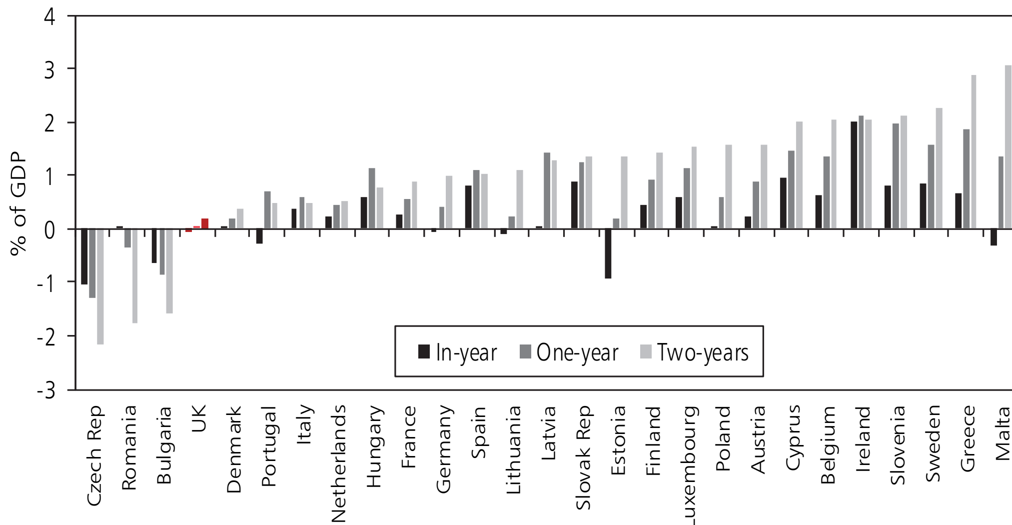

Source: Measuring Tax Gaps 2018 edition

## Spending

As part of its strategy for repairing the public finances in the wake of the financial crisis, the government has delivered a significant reduction in public expenditure as

a share of GDP from 44.9% in 2009-10 to 38.8% in 2016-17. However, the government recognises the need to be alert to emerging risks and long-term pressures on public expenditure, including an ageing population and rising costs of health and social care.

## Chart E: Average expenditure forecast error (2000-15)




Source: IMF Fiscal Transparency Evaluation 2016

The UK has a strong track record of planning and controlling spending which is underpinned by a world-leading system of expenditure management in which the Treasury, Parliament, National Audit Office (NAO) and others work with departments to ensure value for money. It is better than any European country in meeting its medium-term forecasts for government expenditure (Chart E). Nonetheless, the government is taking steps to enhance further its expenditure control framework, including by introducing a Welfare Cap for non-pensions benefit spending. The government is improving transparency and management incentives around the issuance of loans and other financial transactions by departments. The Green Book on project appraisal was updated in March 2018 to ensure adequate focus on financial and delivery risks. Finally, the government established the Infrastructure and Projects Authority (IPA) in 2016 to ensure that risks around infrastructure and major projects across government are identified, addressed, and monitored.

The government has improved the sustainability of the pensions system. In line with the recommendations of the independent State Pension Age review, the government confirmed its intention to increase the State Pension age to 68 in 2037-38. For future rises, the government will aim for ‘up to 32%’ as the right proportion of adult life to spend in receipt of State Pension. This means future generations of pensioners can expect to spend on average broadly the same proportion of their adult life with entitlement to the State Pension, as people reaching age 65 over the last 25 years were expected to spend above age 65. The government notes the OBR’s assessment of the cost of the Triple Lock, which causes the State Pension to continue to grow faster in value than the incomes of the working age population, but also recognises its contribution to reducing pensioner poverty to historically low levels, and is committed to keeping the Triple Lock in place for the rest of this Parliament.

The NHS is the government's number one spending priority. In June 2018, the Prime Minister announced that the NHS in England will receive an increase in funding over the next five years that equates to over £20 billion a year more in real terms by 2023-24 – an average annual growth rate in resources of 3.4% in real terms over five years. It has also set out five financial tests for the NHS to meet as it develops its new long-term plan. These will ensure that the NHS does its part in meeting the pressures that the OBR identified in the FRR and latest Fiscal Sustainability Report (FSR), including through improving its productivity, doing more to manage demand for NHS services, and tackling rising healthcare costs.

The government will fund this five-year commitment while continuing to meet its fiscal rules and reduce debt. As the Prime Minister has said, this will be partly funded by lower contributions due to the European Union. In addition, she has made clear that taxpayers will need to contribute a bit more in a fair and balanced way. This will also require prioritisation and further efficiencies within non-health expenditure to keep the growth in total spending on a sustainable long-run trajectory. The government will also be publishing a green paper looking at how we can further drive market innovation and foster new, more efficient and cost-effective models of social care, as well as considering how to put the system on a more sustainable financial footing. The government will confirm the full details of all health budgets and expenditure plans for all other government departments at the 2019 Spending Review.

The government has taken a number of steps to reduce the risks to the public finances from rising litigation costs. A cross-government strategy is being developed to address the rising costs of clinical negligence with a first report due in the autumn. The government has reduced tax litigation risks, including by introducing legislation to limit the Exchequer's exposure to losses and through HMRC undertaking a programme of work to more accurately forecast, predict and profile tax litigation risks. A number of positive judgements for HMRC in tax litigation cases with significant revenue risk have reduced HMRC's central estimate of likely tax litigation losses from £26.9 to £9.0 billion in the last year. Finally, DWP are taking steps to better understand and mitigate legal risks in the welfare system.

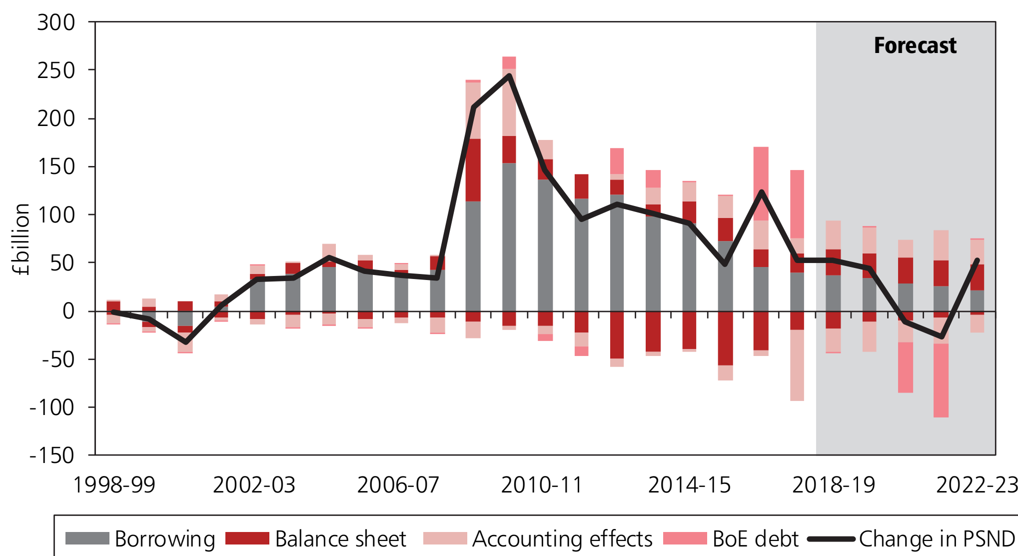
Action is also being taken to enhance financial oversight of local authorities and devolved administrations which manage a growing share of public revenue and spending. Local authorities have a legal duty to set a balanced budget in-year and a duty to ensure 'Best Value' in their decisions. In 2017, the government and the Chartered Institute of Public Finance and Accountancy updated the prudential borrowing framework for local authorities to improve transparency and support sound decision-making around borrowing decisions. The government will review the current approach to the collection and reporting of local government financial data to support fiscal monitoring and ensure that the data that is produced continues to meet the needs of the government, local authorities and other stakeholders. New fiscal frameworks for the Scottish and Welsh governments will underpin the funding arrangements for their respective tax, spend and borrowing powers.

## Balance sheet

While financial management in the public sector has typically focused on controlling government borrowing and debt, governments also have other fiscally significant liabilities and assets. Changes in the value of these assets and liabilities can have a

significant impact on the government's overall financial position and performance. In recent years, balance sheet transactions have been an important determinant of the year-on-year change in public sector net debt (Chart F). The government is therefore committed to strengthening its understanding and management of the public sector balance sheet and the risks around it.

## Chart F: Drivers of changes in PSND




Source: ONS and OBR

The government is taking a number of actions to enhance its understanding of the public sector balance sheet. Whole of Government Accounts, first published in 2011, provide a comprehensive picture of the evolution of the government's assets, liabilities, and net worth. More recently, the government has asked the OBR to forecast the value of its financial balance sheet and its component assets and liabilities. To further enhance the coverage and quality of fiscal statistics, the government is committed to complying with the IMF's Government Financial Statistics Manual (GFSM), the most comprehensive statistical reporting standard for governments which requires regular reporting of the government's entire balance sheet.

Building on this enhanced information base, the government is also taking action to improve the management of its assets and liabilities. It has recouped £114 billion of the £137 billion disbursed in the wake of the financial crisis to the private sector, and has sold other financial assets such as the first tranche of student loans in December 2017. At Autumn Budget 2017, the Treasury launched the Balance Sheet Review to identify opportunities to dispose of assets which no longer serve a public policy purpose, improve the returns on assets and reduce the cost of liabilities which remain on the government balance sheet, and reduce balance sheet risk. Finally, the government is strengthening transparency around financial asset sales to demonstrate value for money and take account of their impact on both sides of the government balance sheet.

The government has also strengthened its controls over balance sheet risks. In 2016, the Treasury introduced a new approval regime for guarantees and other contingent liabilities which has since been applied to over 60 new contingent liabilities with a total value of £158 billion (excluding contingent liabilities related to the TFS. The

Treasury is using the information collected from approved contingent liabilities to actively monitor and manage the associated risks. The ONS, after consulting the Treasury, have also announced a more transparent, forward-looking, and predictable framework for major statistical classification decisions related to the public sector finances.

# Chapter 1
# Managing fiscal risks

1.1 Fiscal risks are factors that can cause a government's fiscal performance to deviate from what was forecast in the medium-term or pose a threat to sustainability over the long-term. Fiscal risks can originate from outside government (e.g. because of exogenous events such as recessions or financial crises) or from inside government (e.g. as a consequence of operational or policy decisions such as the issuance of a guarantee). Risks can materialise as the result of a discrete event (e.g. a financial crisis) or the gradual accumulation of pressure (e.g. the ageing of the population).

1.2 A comprehensive understanding of the sources, scale, and likelihood of fiscal risks is critical to ensuring that governments meet their fiscal objectives with confidence and avoid disruptive policy changes along the way. Nowhere was this more evident than in the wake of the 2008 global financial crisis, during which a sharp and unexpected contraction in output and large-scale government interventions in the financial sector drove a doubling in debt-to-GDP ratios across advanced economies.[1]

1.3 Pro-active management of those risks is important to safeguarding public resources at all times, but has become increasingly important for the UK in recent years. While the government has cut the deficit by three-quarters since 2010 and the debt-to-GDP ratio is forecast to begin its first sustained fall in a generation, public debt remains at a 50-year high (see Chart 1.C). This compounds the pressure on public services from an ageing population and reduces the UK's ability to respond to any future shocks, as well as passing on an unacceptable burden to the next generation.

1.4 This chapter provides an overview of the government's approach to managing fiscal risks:

- Part I summarises the scale and sources of fiscal risks facing the UK
- Part II discusses the government's frameworks for managing fiscal risks
- Part III discusses the further actions the government is taking to strengthen fiscal risk management arrangements

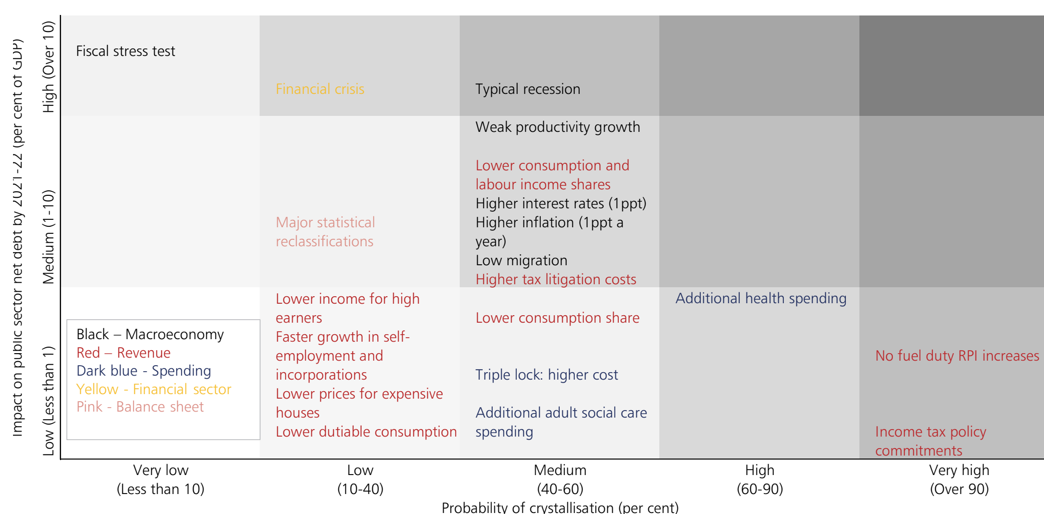
[1] 'OECD General Government Debt: 2008-2010' , OECD, 2018

# Part I: Scale and sources of fiscal risks

## Sources of fiscal risks

1.5 The Office for Budget Responsibility's (OBR) 2017 'Fiscal risks report'[2] (FRR) highlighted 57 potential sources of fiscal risk over the medium and long-term. The risks identified arose from a range of sources including the macroeconomy, financial sector, government revenue, spending, and the balance sheet. The FRR also highlighted the correlations and interdependencies between different risks by presenting the results of a novel fiscal stress test in which a number of significant risks crystallise simultaneously, including an economic recession; a spike in inflation, unemployment and interest rates; and a collapse of the housing sector. These events, in turn, trigger a number of contingent liabilities to government.

### Chart 1.A: OBR risk matrix: Sources of fiscal risk over the medium-term

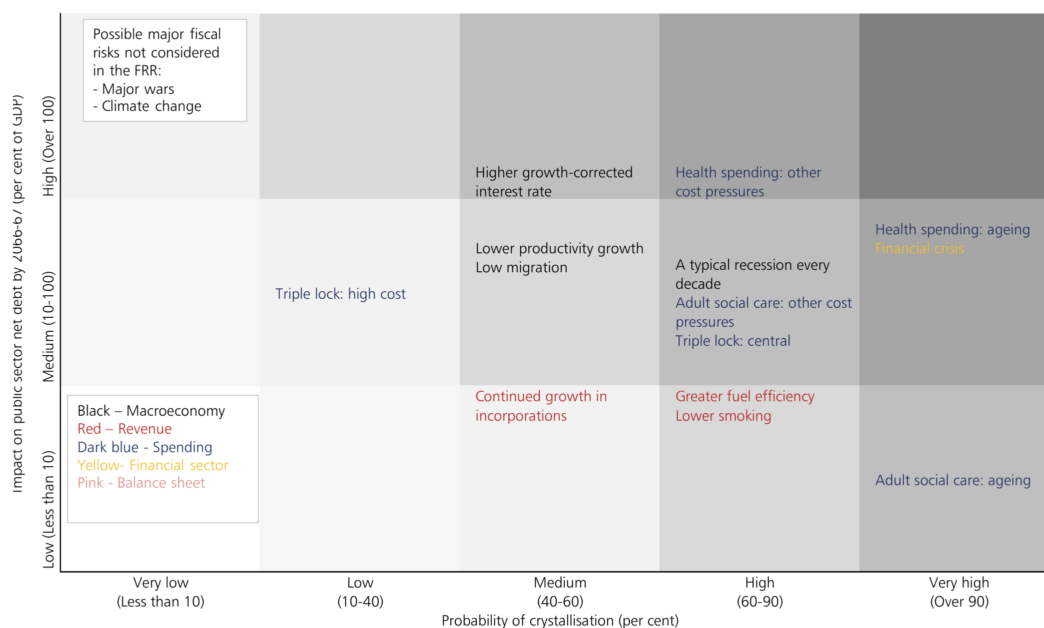



Source: OBR

1.6 In the medium-term (Chart 1.A), the largest potential risks identified by the OBR come from the macroeconomy and financial sector in the form of financial crises and major economic downturns. At the same time, these risks are less likely to materialise in any given 5-year forecast period than some other risks. The OBR judged that risks associated with government policy (such as not uprating fuel duty in line with inflation) or spending programs (such as the operation of the triple lock) tend to be smaller in magnitude over this horizon but also more likely to materialise.

[2] 'Fiscal risks report 2017', OBR, 2017

## Chart 1.B: OBR risk matrix: Sources of risk over the long-term



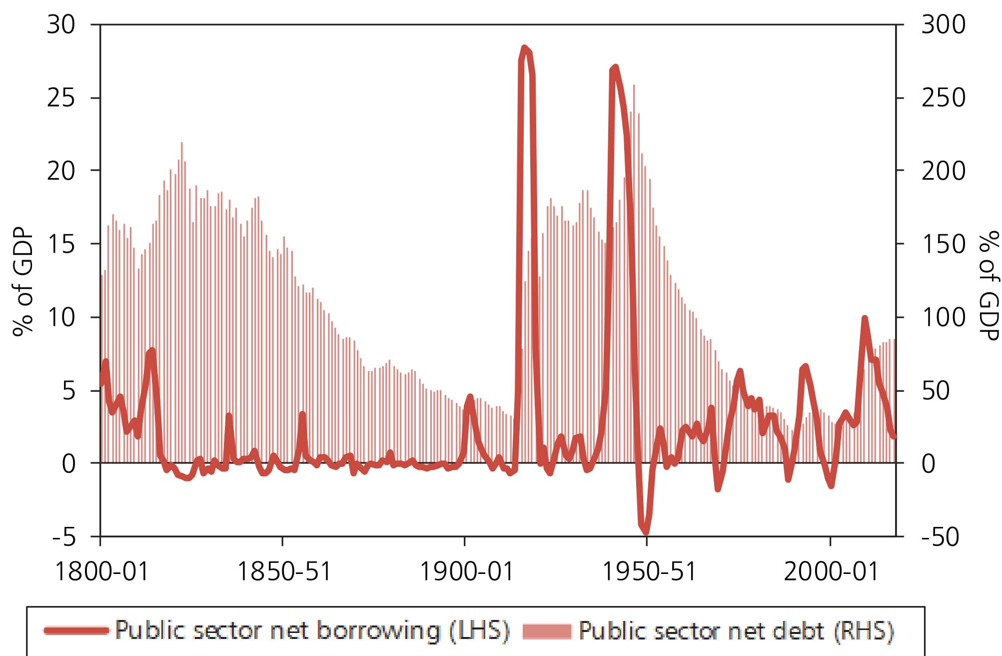

Source: OBR

1.7 In the long-term (Chart 1.B), the most significant risks identified by the OBR come from structural economic and societal trends such as lower productivity growth, higher interest rates, changes in consumption and working patterns, demographic pressures, and technological change. These factors are likely to put sustained pressure on tax bases, financing costs, welfare systems and public services. The OBR also note that over the longer term, relatively infrequent events, such as financial crises, become factors that also need to be anticipated when setting fiscal policy objectives.

# Part II: Scale of fiscal risks

1.8 As the size of the state and scope of government responsibilities has grown over time, so has the range of risks to which its finances are exposed. This can be seen from Chart 1.C which shows the path of the UK government's deficit and debt over the last two centuries. Up until the mid-20th century, the single most important source of shocks to the UK government finances were wars, which governments financed through borrowing. In peacetime, governments generally ran balanced budgets – in keeping with the so-called "Gladstone Doctrine."

## Chart 1.C: UK government deficit and debt since 1800

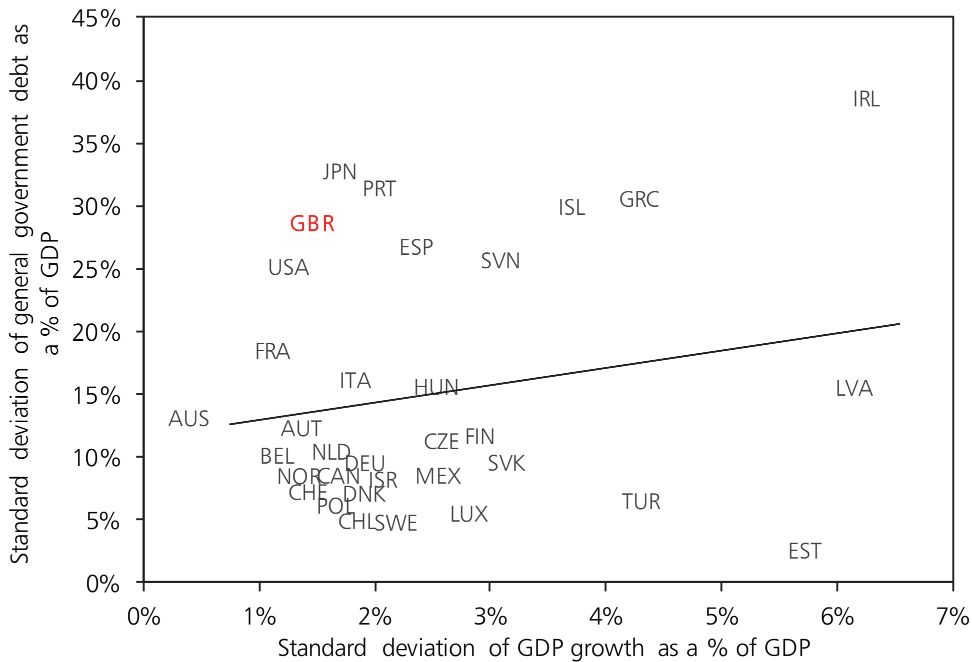



Source: ONS, Bank of England

1.9 However, since the 1950s, government borrowing has become both more volatile and more sensitive to changes in the macroeconomy. This reflects an expansion of state activity, greater sensitivity of progressive tax and welfare systems to economic fluctuations, and more active use of fiscal policy to smooth the fluctuations in economic activity.

1.10 The UK public finances are relatively more sensitive to shocks than most other advanced economies. This can be seen from Chart 1.D which compares the average year-on-year volatility in GDP growth with the volatility in government debt. Despite experiencing relatively stable economic growth compared with other OECD countries since the turn of the millennium, the UK government's debt has been relatively volatile. This likely reflects both the relative progressivity of the UK tax system and the contingent liabilities associated with having a large financial services sector.

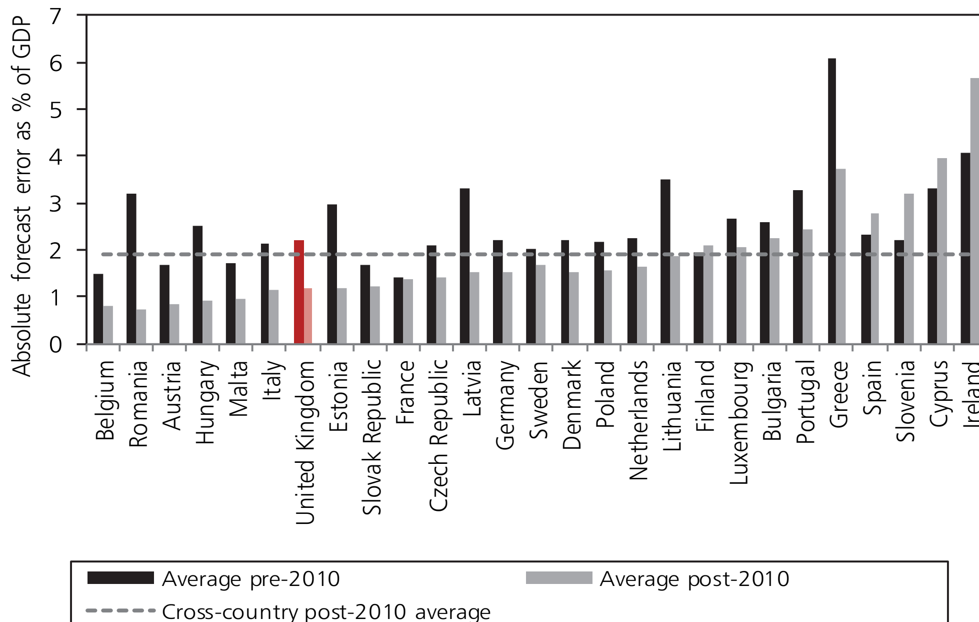
## Chart 1.D: Volatility in government debt vs. GDP growth (2000-16)




Source: OECD

1.11 Despite this heightened exposure to fiscal risks, the UK has a relatively strong record in forecasting its fiscal position. This is especially true since the establishment of the Office for Budget Responsibility in 2010. Chart 1.E shows the absolute forecast error for government borrowing one year after the forecast. It shows that the average error has been reduced by over a third since the establishment of the OBR, and is well below the average forecast error seen in other European countries.

## Chart 1.E: Year-ahead forecast errors for government borrowing: 2000-2015*

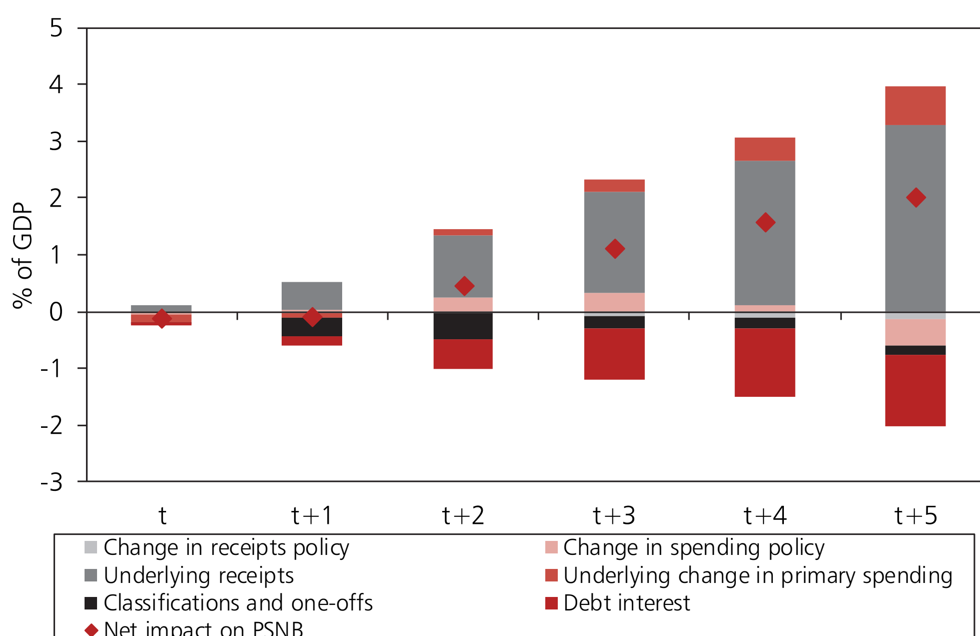



*absolute error

Source: IMF Forecast Evaluation Database

1.12 In the UK, most medium-term fiscal risks manifest themselves on the receipts side of the public finances. As shown in Chart 1.F, the OBR has tended to under-forecast public sector net borrowing five years ahead by around 1.5% of GDP since 2010. This forecast error for borrowing is more than explained by lower than expected receipts, which have been overestimated by around 2.7% of GDP due largely to forecast increases in productivity that never materialised. However, the tendency for debt interest spending to be around 1% of GDP below forecast has made up for some of the shortfall. As discussed in Chapter 5, the government has a strong track record in controlling the medium-term path of primary (non-interest) expenditure which makes only a small contribution to the overall forecast error in borrowing.

### Chart 1.F: Breakdown of average PSNB forecast error (2010-18)




Source: OBR and HM Treasury calculations
*t = year of the forecast

## Part III: Government's risk management framework

1.13 The government's objective is not necessarily to eliminate fiscal risks. Some risks, such as periodic economic recessions, are unavoidable in the long-term. Others, such as export credit guarantees, are the consequence of deliberate policy choices. Some, such as the decline in tax revenues due to the declining incidence of smoking, are desirable as they satisfy other policy goals. Moreover, governments are natural bearers of some risks, either due to incomplete markets (as in the area of terrorism reinsurance) or because leaving individuals to bear all risks would have unacceptable distributional consequences (as in the case of longevity risk).

1.14 The government's strategy for managing fiscal risks is to be aware of the risks it is facing, to reduce risks where this can be done in a cost-effective way and without detracting from its wider policy objectives, and to ensure the overall position of the public finances is resilient to risks that remain. In doing so the government seeks to set clear expectations regarding the limits

of the state's responsibility if and when risks materialise. However, it also recognises that actively taking on risk at certain times can minimise overall costs in the future.

## 5-stages of fiscal risk management

1.15 The government follows a 5-stage approach for managing fiscal risks, modelled on international best practice.[3] The stages are to:

- Identify the source of risk, the scale of fiscal exposure, and the likelihood of crystallisation. For example, all departments are obliged to identify any contingent liabilities, their size, and probability of realisation in their annual accounts
- Disclose the fiscal risk to Parliament and the public to raise awareness and ensure accountability for management of potential threats to public funds. In this regard, the 2017 FRR represents the most comprehensive statement of its kind in the world
- Mitigate fiscal risks where this can be done cost-effectively and without detracting from wider policy objectives. Risk mitigation tools can include discouraging risky behaviour (e.g. through financial regulation), encouraging actors to pool risk (e.g. through institutions like the Pension Protection Fund), or placing limits on the extent of government exposure (e.g. through limits on the issuance of export guarantees)
- Provision for risks that cannot be mitigated but whose size and timing is relatively certain. For example, as discussed in Box 1.A, the Nuclear Liabilities Fund was set up to finance the future cost of decommissioning the second generation of nuclear power stations once they have reached the end of their operating lives
- Accommodate those risks whose size or timing is too uncertain to explicitly provision for in advance. For example, the 2018 Spring Statement fiscal forecast showed that the government retained significant headroom against its 2020-21 deficit and debt targets in recognition of unknown pressures that it may face over the next three years

1.16 The government uses a range of tools to manage risks at different stages of the process. Box 1.A describes how this approach has been applied to manage the costs of decommissioning of old and new nuclear sites.

[3] 'Analyzing and Managing Fiscal Risks – Best Practices', IMF 2016

## Box 1.A: Managing the costs of nuclear decommissioning

The FRR highlighted the government's existing exposure to clean-up costs for old nuclear sites and potential risks associated with decommissioning new nuclear stations. The government is responsible for the cost of decommissioning Sellafield and 16 of the UK's earliest nuclear sites. The Nuclear Decommissioning Authority (NDA) is the government agency responsible for the management of these costs which extend well into the next century, as shown in Chart 1.G. The NDAs approach to managing this risk illustrates the 5-stage process outlined in this chapter:

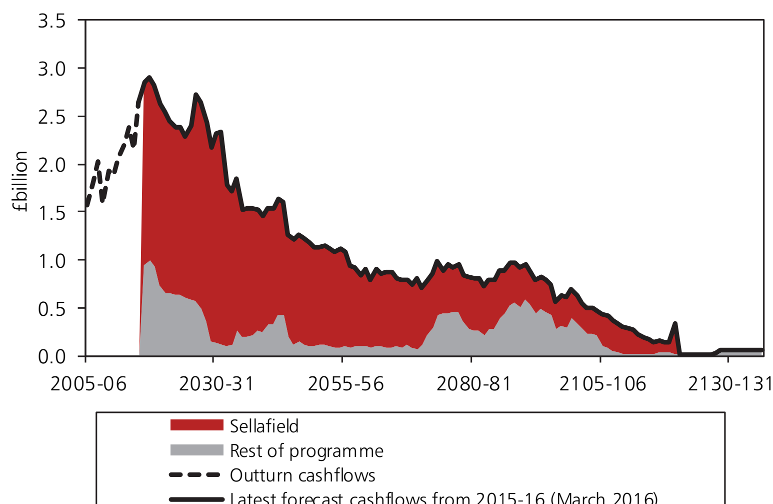
Identify/Disclose: The NDA publishes its best estimate of the discounted future costs of nuclear decommissioning on its estate in its annual accounts and explains any year-to-year changes. In 2016-17, this amounted to £164 billion over 100 years.[4]

Mitigate: For new nuclear stations, the Energy Act 2008 requires operators to have secure financing arrangements to meet the full costs of decommissioning and their share of waste management and disposal costs, through a Funded Decommissioning Programme (FDP). For new nuclear stations, the taxpayer's exposure to these costs is therefore remote. Hinkley Point C is the first station to be approved under this regulation. The NDA are also taking action to reduce the cost of decommissioning of existing sites by encouraging sharing of best practice and setting challenging targets across its estate.

Provision: In addition to the accounting provision included in the NDA's financial statements, around £9 billion has been set aside in the Nuclear Liabilities Fund (NLF), an independent segregated trust, to meet the future costs of decommissioning the second generation of nuclear power stations.

Accommodate: In the event that the NLF's assets are insufficient to meet its liabilities, outstanding liabilities will fall to government.

### Chart 1.G: Estimates of total future decommissioning spending




Source: NDA, OBR

## Managing fiscal risk across government

1.17 HM Treasury's 'Orange Book'[5] provides a basic introduction to risk management in central government organisations. It outlines principles for identifying, assessing, addressing and reviewing and reporting on risks. This includes key processes that support the maintenance of risk registers, regular reporting to governance forums, and regular discussion of the organisation's mitigation strategies. It notes that some risk is unavoidable and that it may not be within the ability of an organisation to manage it to a tolerable level; in these cases, organisations need to make contingency plans. The 'Orange Book' will be updated in the coming year, leveraging appropriate professional and technical guidance and other good practice principles, frameworks and processes.

1.18 The 'Orange Book' should be read and used in conjunction with HM Treasury's recently updated 'Green Book',[6] which provides guidance on project appraisal, including how to approach uncertainty, optimism bias and risk. It states that risks should be considered before, during and after implementation. Project risks should also be quantified and costed in a proportionate way and displayed in a risk register outlining the owner of the risk, the likelihood of crystallisation, and an estimate of the impact on project outcomes.

## HM Treasury's arrangements for managing fiscal risk

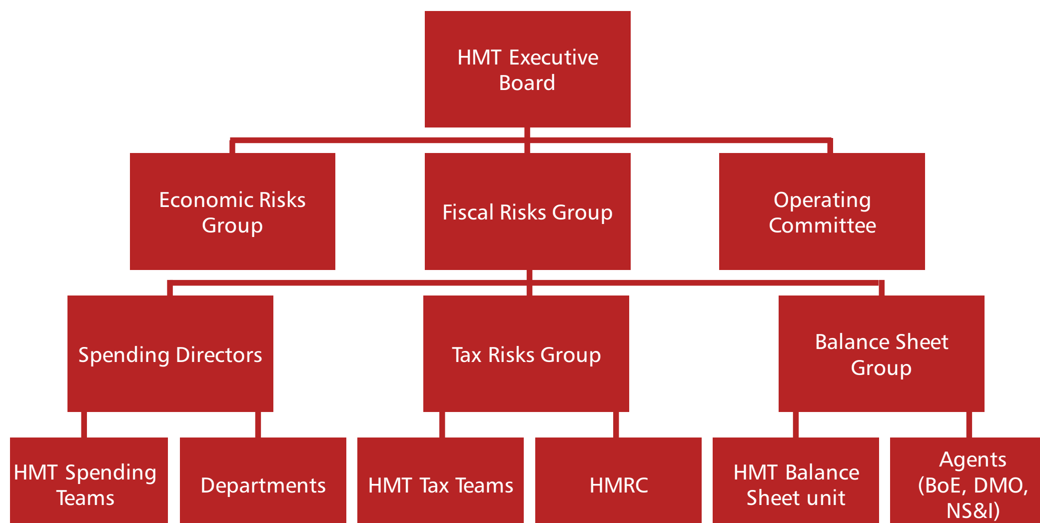
1.19 HM Treasury has significantly enhanced the surveillance and management of fiscal risks at the centre of government in recent years. In the mid-2000s, the Treasury established the Fiscal Risks Group (FRG) which meets on a monthly basis to survey the most important risks to the fiscal position. As shown in Chart 1.H, FRG is supported by groups responsible for the oversight and management of risks to the Economy, Tax, and Spending. In 2017, a new Balance Sheet Group was established to report to FRG on the risks to the government's holding of assets and liabilities. FRG reports on a quarterly basis to HMT's Executive Management Board on the most important risks to the fiscal position and actions being taken to manage them. Chapter 2 of the FRR outlines the Treasury's risk groups and reporting in greater detail.

4 'Nuclear Decommissioning Authority: Annual Report and Accounts 2016 to 2017', Nuclear Decommissioning Authority, 2017

5 'The Orange Book: management of risk - principles and concepts', HM Treasury October 2004

6 'The Green Book: appraisal and evaluation in central government', HM Treasury, updated March 2018

## Chart 1.H: HM Treasury risk group structure




Source: HM Treasury

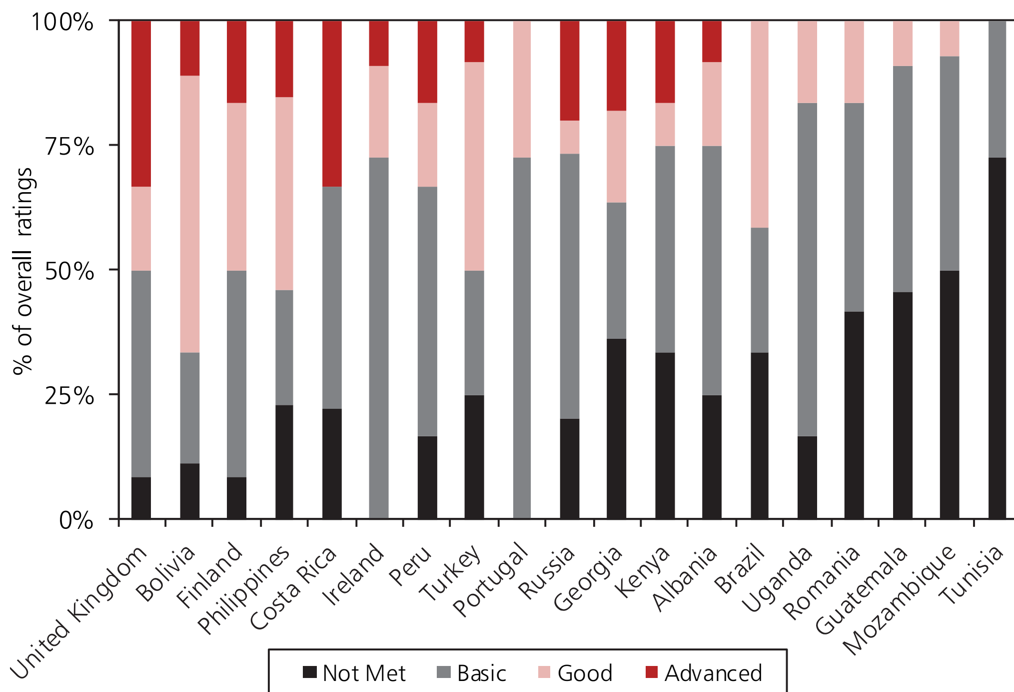
# Fiscal risk management in an international context

1.20 The UK is a world leader in fiscal risk disclosure and management. In 2016 the government asked the International Monetary Fund (IMF) to assess its arrangements for fiscal risk disclosure and management as part of the IMF's Fiscal Transparency Evaluation (FTE) programme.[7] Among the other 19 countries that had undergone FTEs at the time, the UK received the highest overall rating for fiscal risk management with practices in four areas rated 'Advanced,' two areas rated 'Good,' five areas rates 'Basic', and only one area rated 'Not Met' (Chart 1.I). The IMF's 2017 Article IV surveillance report noted that "The UK continues to set international standards with respect to fiscal transparency."[8]

[7] 'United Kingdom Fiscal Transparency Evaluation', IMF, November 2016

[8] '2017 Article IV Consultation' – Press Release, IMF, 2018

## Chart 1.I: IMF FTE scores for fiscal risk management




Source: IMF Fiscal Transparency Evaluations

# Part IV: Strengthening fiscal risk management

1.21 The government nonetheless remains committed to strengthening further its institutional arrangements for analysing and managing fiscal risks. Addressing the recommendation of the Treasury's Review of the Office for Budget Responsibility in 2015, the government amended the Charter for Budget Responsibility to ask the OBR to publish a biennial Fiscal Risks Report covering "the main risks to the public finances including macroeconomic risks and specific fiscal risks."[9] The UK is one of the few countries to publish a standalone report on fiscal risks and the FRR is the only such report to be published by an independent agency rather than the government itself. The FRR is also the most comprehensive report of its kind and was described by the IMF as "raising the bar on the assessment and quantification of fiscal risk to a new level that other countries should look to meet."[10]

1.22 The UK is determined to set the global standard not only for the disclosure of fiscal risks but also for the active management of those risks. The government therefore committed to responding to the FRR within a year. This report, 'Managing fiscal risks', honours that commitment and provides a comprehensive account of how the government is addressing the range of risks highlighted by the OBR in the FRR. This report also provides a mechanism for Parliament and the public to assess the adequacy of the government's strategies for managing these risks and hold it to account for their implementation. The OBR's next 'Fiscal risks report', to be published in 2019, will further strengthen the cycle of accountability by assessing the impact of the actions described in this document on the risks identified in

[9] 'Charter for Budget Responsibility: autumn 2015 update', HM Treasury, 2015

[10] 'Stressing the Public Finances - the UK Raises the Bar', Public Financial Management Blog, IMF, 2017

their 2017 report. The government will then publish a further edition of 'Managing fiscal risks' in 2020.

# Chapter 2
# Macroeconomy

2.1 Macroeconomic developments are, for most countries, the largest and most frequent sources of fiscal risk. IMF analysis shows that countries typically suffer a recession every 12 years, with an average fiscal cost of 9% of GDP.[1] Macroeconomic shocks can originate from the rest of the world or from the build-up of imbalances in one or more sectors of the domestic economy. Structural trends such as low productivity growth, persistently high or low inflation, or shifts in the composition of GDP can also put the public finances under sustained pressure.

2.2 Governments themselves can be a source of macroeconomic risk if they pursue monetary or fiscal policies which are either procyclical in the near term or unsustainable in the long term. However, governments can also mitigate macroeconomic risks by designing legal and institutional frameworks that allow monetary and fiscal policy to reduce the ups and downs of the economic cycle in the near term while ensuring sustainability over the long term. Microeconomic and macroeconomic policies can also mitigate the build-up of sectoral imbalances and strengthen the long-run drivers of economic growth.

2.3 The government's macroeconomic policy framework focuses on promoting strong, sustainable and balanced growth. Within the framework, the government's economic strategy has been framed by the need to tackle the public sector deficit, support the economy, and manage both internal and external imbalances. Accordingly, deficit reduction has been supported by monetary activism which has enabled the government to make significant progress in restoring the public finances to health, while promoting the government's broader macroeconomic objectives. Furthermore, deficit reduction and a flexible exchange rate are helping to address the high current account deficit.

2.4 This chapter describes the actions the government is taking to mitigate macroeconomic risks to the public finances and thereby addresses the issues raised in the FRR:

- Part I discusses the reforms to the fiscal and monetary policy frameworks aimed at ensuring macroeconomic stability
- Part II sets out the government's actions for addressing macroeconomic imbalances

[1] 'Analyzing and managing fiscal risks – best practices', IMF, June 2016

- Part III describes the government's strategy for restoring fiscal sustainability
- Part IV sets out the steps the government is taking to boost long-run productivity

## Part I: Ensuring macroeconomic stability

2.5 The FRR highlights the near-inevitability of future recessions – and the risk of persistent effects from them – as one of the most significant fiscal risks facing the UK and most other advanced economies. The FRR states that 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% of GDP. It also discusses the potential for economic disruption associated with the UK's exit from the European Union.

2.6 The government has introduced a number of reforms to the macroeconomic policy framework over time to enable monetary and fiscal policy to play a more supportive role in macroeconomic stabilisation. This section discusses the actions the government has taken to:

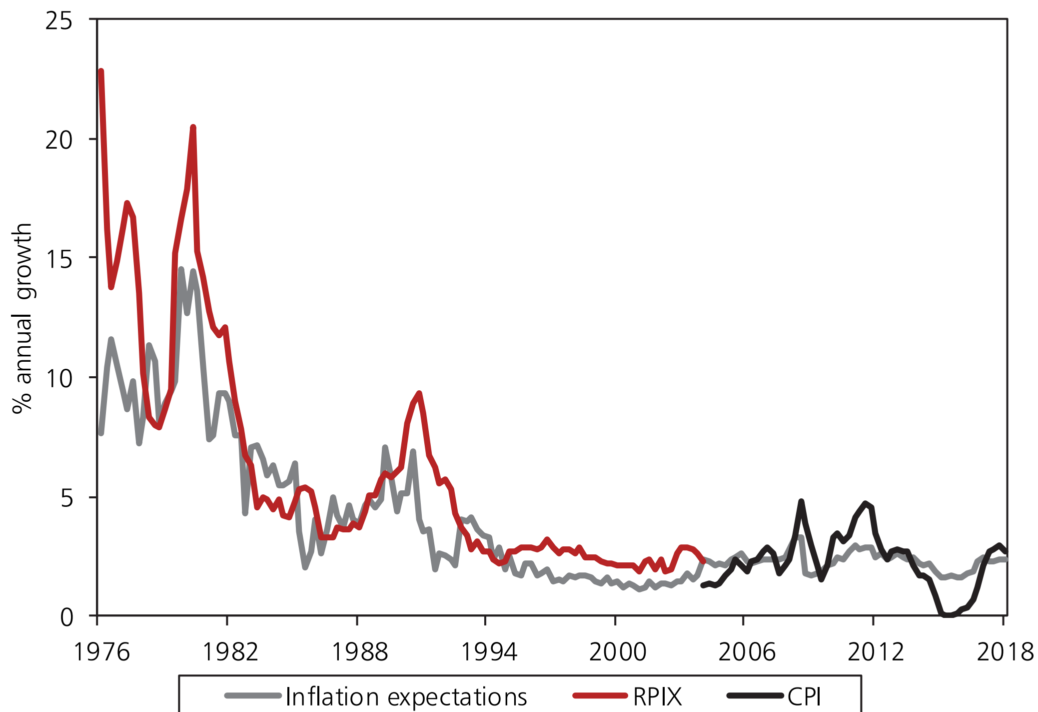
- enhance the effectiveness of monetary policy in maintaining price stability, while supporting growth and employment
- repair the public finances and enable fiscal policy to play a more supportive role in stabilising output
- ensure a smooth transition to a new and advantageous economic relationship with the EU

### Enhancing monetary policy effectiveness

2.7 Monetary policy is the responsibility of the independent Monetary Policy Committee (MPC) of the Bank of England (the Bank), which has the primary objective of maintaining price stability as set out in the monetary policy remit (the remit). Inflation targeting and the operational independence of the MPC have led to low and stable inflation and anchored inflation expectations to the 2% target, as shown in Chart 2.A. In the 20 years prior to Bank independence, inflation averaged over 6% and fluctuated from 1% to 22%, while over the past two decades inflation has averaged 2% and never risen above 5.2%.

2.8 Stable inflation has removed a significant source of risk to the public finances. Many of the government's tax and benefit rates, allowances, and thresholds are indexed to inflation. Also, as discussed in Part III of this chapter, a growing proportion of the government's debt is in the form of index-linked gilts whose principal and coupons are indexed to the Retail Price Index (RPI). Anchoring inflation expectations to the government's inflation target therefore mitigates a significant source of potential macroeconomic risk to the public finances.

## Chart 2.A: Inflation and inflation expectations




Source: ONS and Bank of England

# The monetary policy remit and expanded toolkit

2.9 Low and stable inflation over the medium term is a pre-requisite for robust economic growth. However actual inflation may depart from its target due to shocks and disturbances, sometimes for extended periods, and attempts to keep inflation at target under these circumstances may cause undesirable volatility in output. Recognising this, the 2013 Review of the Monetary Policy Framework[2] updated the remit to require the MPC to form, communicate, and promote understanding of the trade-offs between the speed at which it aims to bring inflation back to target and the variability of output. This allows for a balanced approach to the objectives set out in the remit, while retaining the primacy of price stability and the inflation target.

2.10 The MPC's response to developments in the wake of the June 2016 vote to leave the EU provides an example of balancing such trade-offs. The MPC judged that "Brexit-related uncertainties were weighing on domestic activity" while the over 10% fall in sterling immediately following the referendum temporarily pushed up Consumer Price (CPI) inflation (to a peak of 3.1% in November 2017).[3] Balancing the period of weaker growth with temporarily higher inflation, the MPC judged that "it was appropriate to set policy so that inflation returned to its target over a longer period than two years in order to support jobs and activity at a time when uncertainty was elevated and the economy was slowing".[4] In response, the MPC reduced Bank Rate by 25 basis points, announced an additional £70 billion of asset purchases, and

2 'Review of the monetary policy framework', HM Treasury, March 2013

3 'UK Consumer Price Inflation', ONS, May 2018

4 'Lambda', Speech given by Mark Carney, Governor of the Bank of England at the London School of Economics, January 2017

launched the Term Funding Scheme (TFS) to ensure banks passed on lower interest rates to end borrowers. Inflation expectations remained firmly anchored throughout, and inflation has fallen to 2.4% in April 2018.[5]

2.11 The Bank has made active use of a range of unconventional monetary policy measures to support aggregate demand when interest rates have been at or close to their effective lower bound. Bank purchases of gilts and corporate bonds, as part of its quantitative easing (QE) programme, have helped reduce yields and borrowing costs, supporting demand and helping the Bank meet its inflation target. Similarly, the TFS has reinforced monetary policy transmission by providing funding to participants at rates close to Bank Rate. In doing so, the TFS has encouraged commercial lenders to pass on the cut in Bank Rate to firms and households and helped support lending volumes.[6]

2.12 The Bank's vehicle for delivering this QE programme is the Asset Purchase Facility (APF). The facility currently holds £572 billion worth of assets including £435 billion of gilts, £10 billion of corporate bonds and £127 billion of TFS loans (Chart 2.B).[7] The facility is fully indemnified by the Treasury which means that the Exchequer receives any financial gains and would also cover any potential losses made by the APF over the lifetime of its operations. Box 2.A provides further details on the APF and the risk oversight arrangements in place between the Treasury and the Bank.

5 'UK Consumer price inflation', ONS, May 2018

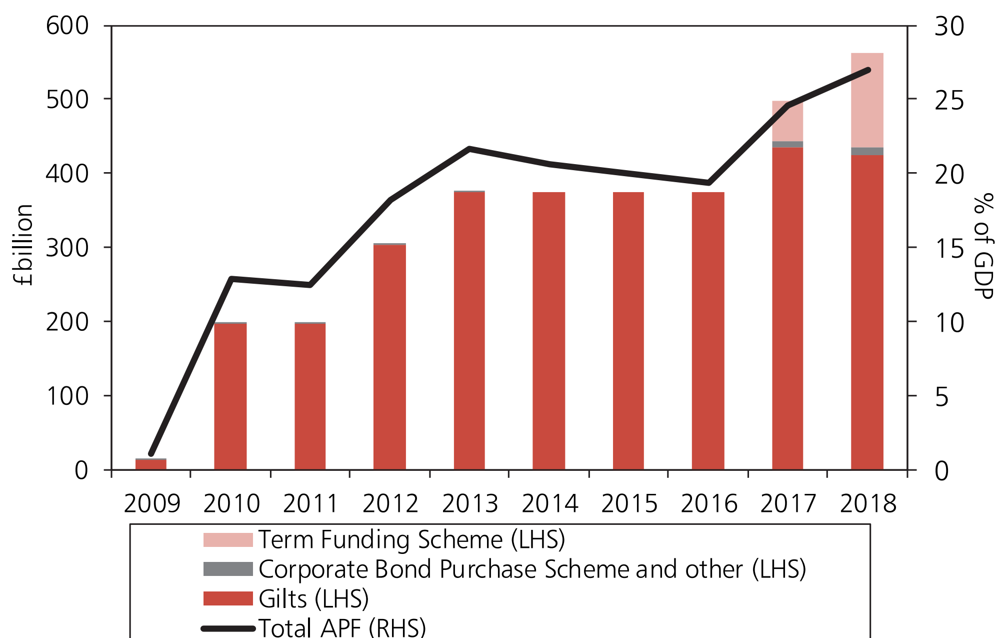
6 The latest TFS lending data is available on the Bank of England's website

7 The latest APF data is available on the Bank of England's website

## Box 2.A: The Asset Purchase Facility: risk oversight arrangements

Quantitative easing, through the operation of the Asset Purchase Facility (APF), has played a critical role in supporting the economy since the financial crisis. However, as noted in the FRR, the APF constitutes a risk to the public finances through potential losses on APF holdings and heightened sensitivity of the public finances to short-term interest rate changes.

### Chart 2.B: Composition of APF holdings




Source: Bank of England

To mitigate these risks, the Treasury and the Bank have put in place active oversight and governance arrangements for the APF including:

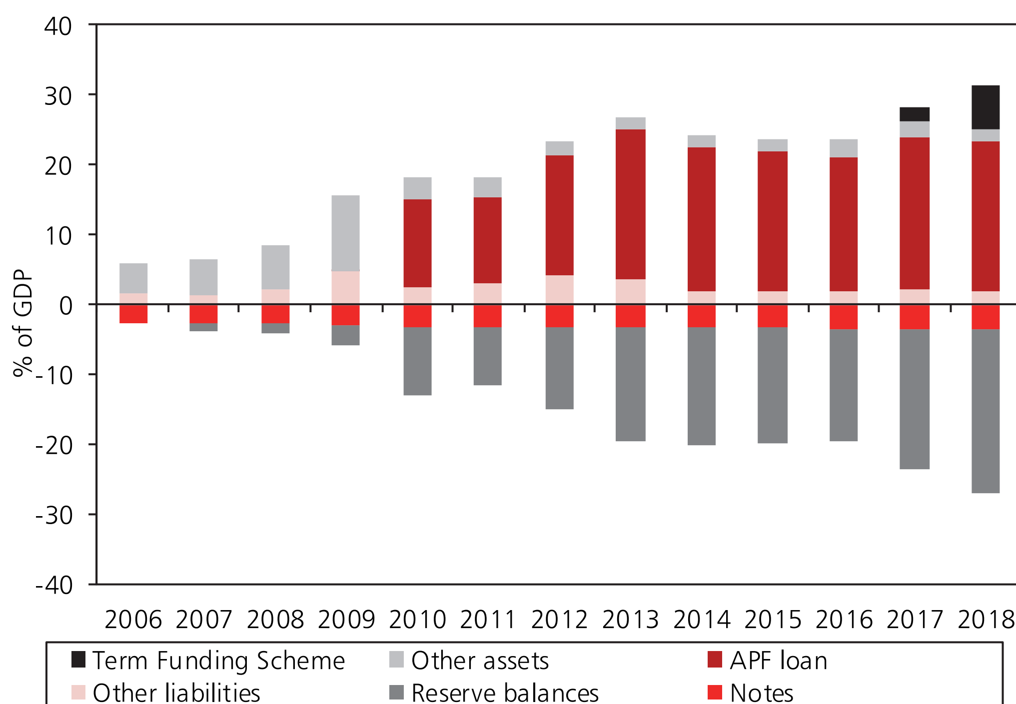
- a risk management framework setting the operational parameters of the APF schemes
- routine information-sharing to enable officials on both sides to monitor the performance of the APF
- regular risk oversight meetings between senior Bank and Treasury officials to discuss risks in the APF scheme

Any modifications to the APF schemes are discussed by the Treasury and the Bank. In line with the MPC remit any requests for changes to the size and composition of the APF are agreed through an exchange of letters between the Chancellor and the Governor.

It is for the independent MPC to make decisions on monetary policy, including decisions to unwind the APF, based on its own judgment of the balance of risks to inflation in the medium-term. However, if and when the MPC decides to unwind the facility, any sales of APF assets would be coordinated with the Treasury and the Debt Management Office (DMO) to manage the impact on the gilt market.

2.13 As a result of the expansion in its remit, the asset purchases associated with QE, and a structural increase in demand for liquidity in the wake of the global financial crisis, the Bank's balance sheet has expanded considerably since 2008. The Bank's assets have increased from just under £50 billion in 2008, to almost £600 billion today (Chart 2.C).[8] In response, the Bank introduced enhancements to its financial risk management arrangements, with separate departments responsible for first-line risk management and second-line activities including risk challenge, reporting to a senior Executive Risk Committee and through that Committee to the Bank's Court of Directors.

## Chart 2.C: Bank of England balance sheet




Source: Bank of England

2.14 To ensure that the Bank continues to have the loss-absorbing capital needed to manage the risks associated with its expanded remit, the Treasury is providing an additional £1.2 billion in capital to the Bank to bring its total risk-bearing capital up to £3.5 billion.[9] This capital injection is part of a new capital and income framework for the Bank, described in Box 2.B and set out in a Memorandum of Understanding (MoU)[10] between the Bank and the Treasury. The new framework reflects the Bank's expanded remit and ways in which the Bank provides liquidity and ensures the Bank's independence, resilience, and policy credibility even in the most stressed environments. This capital injection will allow the Bank to take the £127 billion TFS on to its balance sheet and allow the removal of the Treasury indemnity from this portion of the APF.

[8] The latest balance sheet data is available in the 'Bank of England's annual report', Bank of England, June 2018

[9] Letter from the Chancellor of the Exchequer to the Governor of the Bank of England – 'The Financial Relationship between HM Treasury and the Bank of England', HM Treasury, June 2018

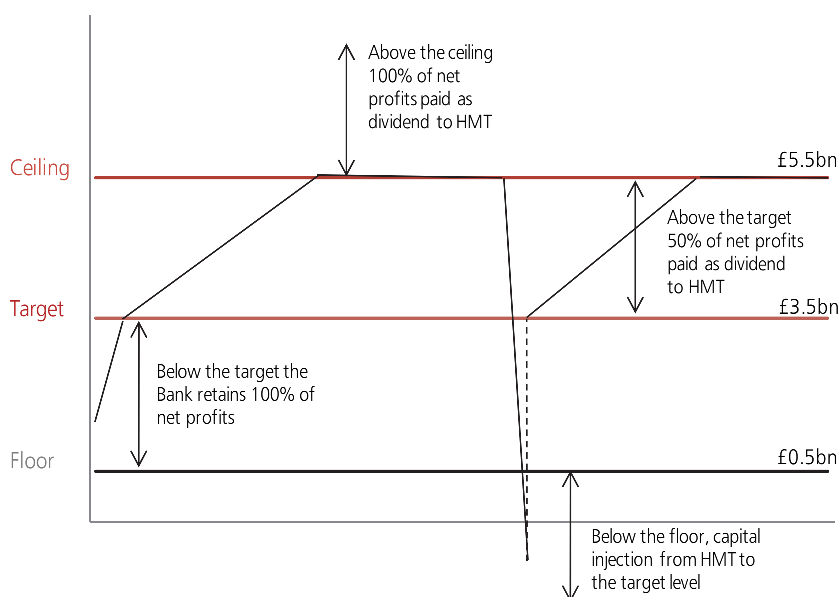
[10] 'The financial relationship between HM Treasury and the Bank of England', HM Treasury, June 2018

## Box 2.B: New Bank of England capital and income framework

To reflect the Bank of England's enhanced policy remit and expanded balance sheet since the crisis, the Treasury and the Bank have agreed a new capital and income framework which reinforces the Bank's independence, resilience, and policy credibility. The framework includes a capital target, ceiling and floor, alongside a flexible income-sharing arrangement which ensures that the Bank maintains an adequate level of loss-absorbing capital while returning any surplus income to the Exchequer.

An initial capital injection of £1.2 billion will bring the Bank's capital to the new target level of £3.5 billion with a ceiling of £5.5 billion and floor of £0.5 billion (Chart 2.D). This target level for the Bank's loss-absorbing capital was chosen based on a range of severe but plausible scenarios discussed between the Treasury and the Bank. The share of income retained by the Bank varies in response to its level of loss-absorbing capital, as shown in Chart 2.D. The parameters of the capital framework will be revised every 5 years, or sooner if there is a fundamental change in the risk environment, such that the Bank remains adequately capitalised to fulfil its remit now and in future.

### Chart 2.D: The Bank capital and income framework, illustration




Source: HM Treasury

The framework is supported by new governance and coordination processes, codified in a MoU between the Treasury and the Bank, which include enhanced information-sharing in respect of the Bank's finances and risk exposure. This will allow for greater transparency concerning the risks to the Bank while respecting the operational independence of the Bank's Court of Directors.

## Enabling fiscal policy to stabilise output

2.15 The government has also reformed its fiscal framework to enable fiscal policy to more actively support the economy. At Autumn Statement 2016,[11] the government announced a new set of fiscal rules described in Box 2.C. The near-term target for reducing the deficit below 2% of GDP by 2020-21 is expressed in cyclically-adjusted terms to allow the automatic stabilisers to operate in the event of a downturn. A long-term objective of returning the public finances to balance in the mid-2020s ensures that the government continues to make progress in restoring debt to more sustainable levels, as discussed in the next section.

### Box 2.C: The government's fiscal rules

The government's fiscal rules are stated in the Charter for Budget Responsibility.[12] The most recent Charter was approved by Parliament in January 2017. In light of changes to the parliamentary timetable, the government restated these rules at the Autumn Budget 2017. The rules include:

- a long-term objective to return the public finances to balance by the middle of the next decade
- a near-term target to reduce cyclically-adjusted public sector net borrowing to below 2% of GDP by 2020-21
- a supplementary near-term target for public sector net debt as a percentage of GDP to be falling in 2020-21
- a welfare cap to limit the amount that the government will spend on certain benefits and tax credits

In the event of a significant negative shock to the UK economy, the Treasury will review the appropriateness of the fiscal mandate and supplementary targets as a means of returning the public finances to balance by the middle of the next decade.

2.16 The government has used the flexibility provided by the revised Charter to take a balanced approach to the public finances by reducing debt, keeping taxes low, supporting public services, and investing in the UK's future to boost growth and productivity. As shown in Chart 2.E, over the six years between 2009-10 and 2015-16, the deficit was reduced by an average of 1.0 percentage points per year, driven primarily by reductions in spending as a share of GDP. By contrast, during the seven years between 2015-16 and 2022-23 deficit reduction is forecast to be 0.4 percentage points per year on average. Spending on gross investment is forecast to increase by 0.4% of GDP between 2015-16 and 2022-23, compared with a reduction of 1.6% of GDP in the preceding six years. This will bring spending on net investment to the highest sustained level in 40 years.[13] [14]

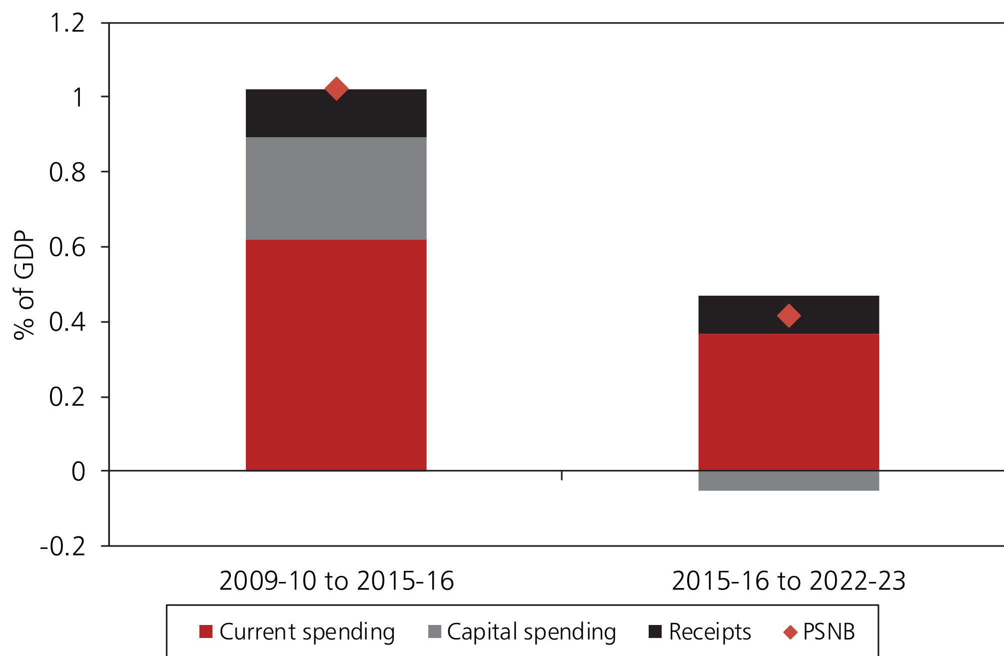
11 'Autumn Statement 2016', HM Treasury, November 2016

12 'Charter for Budget Responsibility', HM Treasury, January 2017

13 Excluding the financial crisis period

14 'Public finances databank', OBR, July 2018

## Chart 2.E: Average annualised deficit reduction




Source: ONS, OBR and HMT calculations

### Box 2.D: The UK's future economic partnership with the EU

The FRR highlighted the main macroeconomic risks associated with the UK's exit from the EU to be lower business investment due to near-term Brexit-related uncertainty; lower exports and imports depending on the UK's future trading regime with the EU and rest of the world; reduced labour supply associated with potential restrictions on EU migration; and relocation of financial firms and activities out of the UK.

As set out in its White Paper published on 12 July 2018, the government is seeking a deep and comprehensive economic partnership with the EU, broader in scope than any other that exists between the EU and a third country. This partnership will protect jobs and support growth while respecting the UK's sovereignty, preserving the constitutional and economic integrity of the UK's own Union, and respecting the EU's autonomy and the integrity of the Single Market.

The government seeks the establishment by the UK and the EU of a free trade area for goods, the phased introduction of a new Facilitated Customs Arrangement, and to maintain a common rulebook for goods, including agri-food, covering only those rules necessary to provide for frictionless trade at the border. For services and digital, the UK is proposing new arrangements that would provide regulatory flexibility.

The government's vision includes new economic and regulatory arrangements for financial services that preserve the mutual benefits of integrated markets and protect financial stability, while respecting the right of the UK and the EU to control access to their own markets. Box 3.B sets out in more detail the government's actions to address financial services risks in relation to Brexit.

It is important that certainty for individuals and businesses is maximised as the UK leaves the EU. Having agreed the terms of a time-limited implementation period, businesses will be able to trade on the same terms as now up until the end of 2020. This gives businesses and citizens certainty and will allow the government to deliver a smooth and successful Brexit. The government has also agreed to protect the rights of EU citizens in the UK and UK nationals in the EU under the Withdrawal Agreement.

Any future mobility arrangements will be consistent with the ending of free movement, respecting the UK's control of its borders and the government's objective to control and reduce net migration. The UK will make a sovereign choice in a defined number of areas to seek reciprocal mobility arrangements with the EU, building on current World Trade Organization (WTO) General Agreement on Trade in Services (GATS) commitments.

To support effective preparations for a range of exit scenarios, including no deal, and unlock the opportunities of leaving the EU, HM Treasury has allocated £3 billion of funding across 2018-19 and 2019-20.

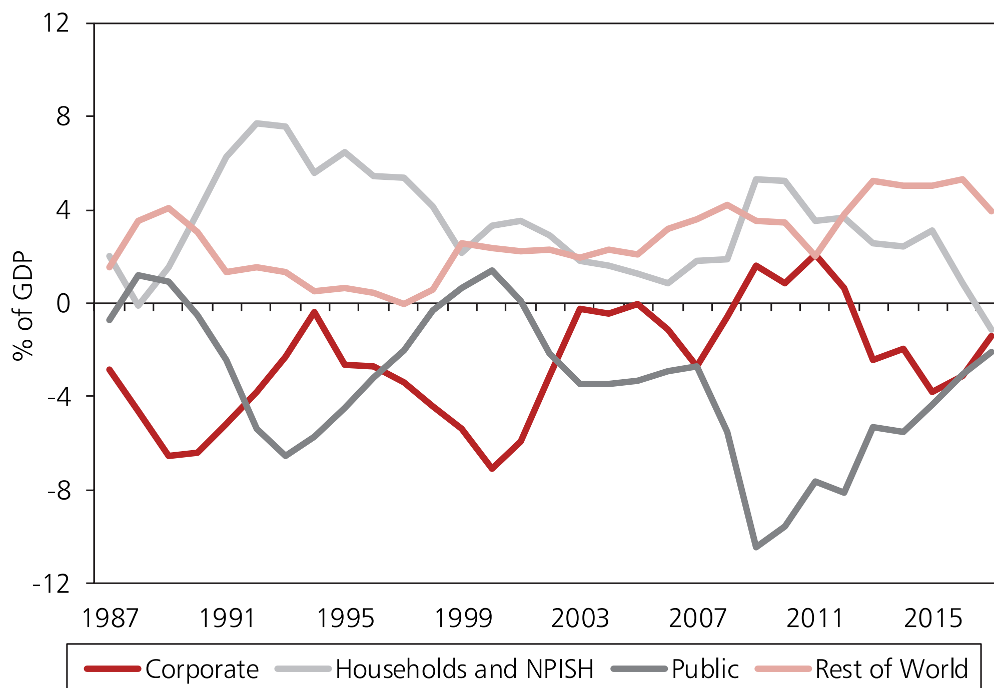
# Part II: Addressing macroeconomic imbalances

2.17 The OBR's FRR highlighted the potential fiscal risks that can arise due to the build-up of imbalances in one or more sectors of the economy. The report highlighted in particular:

- persistent household financial deficits
- housing sector volatility
- large current account deficits

2.18 As shown in Chart 2.F, the large domestic imbalances run by different sectors of the UK domestic economy have significantly reduced since their peaks in the wake of the global financial crisis. The UK's large current account deficit has also begun to narrow in the last year. This section discusses the actions that the government has taken to address imbalances and risks in the household sector, the housing market, and the current account.

## Chart 2.F: UK sectoral net lending




Source: ONS

## Households

2.19 As noted in the FRR, persistent household deficits can lead to the accumulation of unsustainable levels of household debts. Even before any risk of default arises, the consumption behaviour of households with high levels of debt is likely to be more sensitive to changes in earnings, employment, or interest rates – with consequences for economic activity and the public finances.

2.20 Household debt as a proportion of income is below its pre-crisis peak of 157% in Q1 2008, at 140% in Q1 2018.[15] At 8.5% in May 2018, consumer credit growth remains below its pre-crisis average of 13% over 1997-2007. The stock of consumer credit is also only around 10% of total household debt,[16] with 72% of total household debt comprised of mortgages of which over 60% are at fixed rates.[17] The latest OBR forecast shows the debt-to-income ratio remains below the pre-crisis peak. Overall households' financial positions have improved since the financial crisis, with debt interest as a proportion of income at a record low and household net financial wealth to income close to its record high in Q1 2018.

2.21 Steps have been taken to deliver a well-functioning credit market that supports sustainable growth while mitigating financial stability risks. In 2014 the Financial Policy Committee (FPC) acted to guard against risks associated with a build-up in mortgage debt and to limit a rise in the number of highly indebted borrowers. Mortgage lenders are now required to limit the amount of lending at high loan to income multiples and to test that new borrowers can still afford repayments if interest rates were to rise.

2.22 The government also fundamentally reformed consumer credit regulation in 2014, giving the Financial Conduct Authority (FCA) robust regulatory powers to protect consumers. The FCA's rules are based on the principle that money should only be lent to a consumer if they can afford to repay it. In July 2017, the FCA consulted on new rules and guidance for creditworthiness assessments. The FCA's proposals aim to clarify what is expected from firms, and to make sure that firms assess affordability as well as credit risk. The FCA will publish a policy statement with final rules and guidance in summer 2018.

2.23 The government has also taken action to help borrowers get the information and support they need when taking on and managing their debts. This includes establishing a new Single Financial Guidance Body to make it easier for people to get help with money matters. The government is also implementing a breathing space scheme to support those in problem debt, and the resources of the government-commissioned Money Advice Service (MAS) have increased, enabling it to provide debt advice sessions to over 500,000 people per year.[18]

## The housing sector

2.24 As highlighted in the FRR, the government's finances are both indirectly and directly exposed to the housing market. The government's indirect exposure derives from the fact that, for many households, their house is the largest item on their balance sheet. Accordingly, volatility in the housing market can lead to macroeconomic instability as homeowners adjust to the wealth effects of changes in the value of their houses. The government's direct financial exposure to housing comes through the significant revenues it collects from the sector in the form of Stamp Duty Land Tax (SDLT) as well as

[15] 'UK Economic Accounts: Sector – households and non-profit institutions serving households', ONS, June 2018

[16] 'Money and Credit', Bank of England, June 2018

[17] 'Mortgage Lenders and Administrators Statistics', Bank of England, June 2018

[18] '2018-19 Business Plan', Money Advice Service, March 2018

the range of government-backed savings products, loans, and guarantees designed to support housing supply and affordability. Chapters 5 and 6 contain further detail on how the government manages the approval of new loans and guarantees respectively.

2.25 Since the last downturn, the major housing developers are better capitalised and therefore less exposed to macroeconomic shocks. However, their business models remain unchanged, so they remain sensitive to house price falls. Mortgage market reforms have also changed lending practices to ensure banks are better capitalised and lending is more responsible. This is reflected in the decreasing trend in repossessions – in 2017 there were 7,300 properties taken into possession, the lowest since 1982.[19]

2.26 The latest data from the Royal Institute of Chartered Surveyors (RICS) points to a broadly stable housing market, with more surveyors reporting a rise than a fall in new buyers enquiries and instructions in May.[20] Planning permissions are up on the last year,[21] although housing starts were broadly flat during 2017 and slowed in 2018 Q1 as snow and other weather-related disruption hampered construction activity.[22]

2.27 The government's direct exposures to the housing market are projected to increase over the period to 2021. This is driven by the rollout of a range of Ministry for Housing, Communities and Local Government (MHCLG) loan and guarantee schemes (Chart 2.G) including:

- the Help to Buy Equity Loan, which is expected to increase from £8.4 billion in 2017-18 to over £22 billion in 2021, is the single largest source of direct financial exposure (1% of GDP in 2021), as shown in Chart 2.G. The scheme provides government loans of up to 20% of the cost of a new build home, enabling individuals to buy a home with a 5% deposit
- the Home Building Fund (HBF) is providing £2.5 billion in development finance by 2022-23 to support small and medium-sized enterprise (SME) builders and purpose-built private rented housing projects, as well as £2 billion for infrastructure on large sites
- the Affordable Homes Programme guarantee which was set up to improve Housing Association access to capital and lower their borrowing costs. The scheme, which closed to applications in 2016, guaranteed £3.25 billion in loans to 66 Housing Associations, supporting the development of 34,000 affordable homes[23]
- the Private Rental Sector Guarantee Scheme which was introduced to create a market for long-term debt to support the long-term ownership of private rented homes built at scale. The scheme remains open to new

19 'Table AP4 (Mortgage Possessions)', Industry Data Tables, UK Finance, August 2017

20 'May 2018: UK Residential Market Survey', Royal Institute for Chartered Surveyors, June 2018

21 'Planning Applications in England: January to March 2018', MHCLG, June 2018

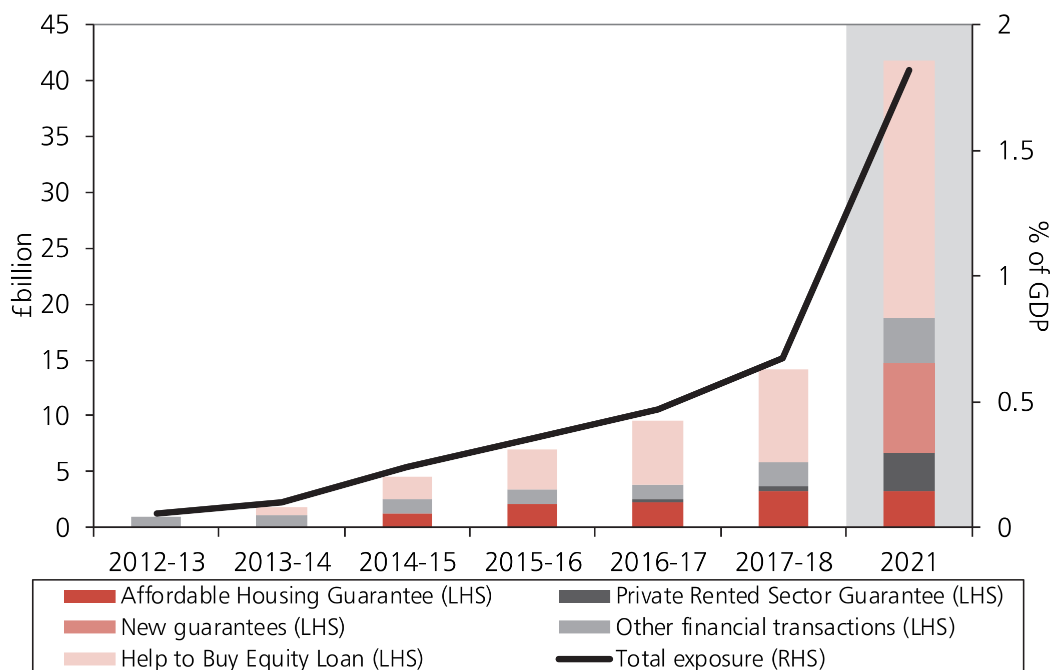
22 'Table 222 House building: permanent dwellings started and completed, by tenure, England (quarterly seasonally adjusted)', MHCLG, 2018

23 Infrastructure (Financial Assistance) Act 2012: annual report for year ending 31 March 2018, HMT Treasury, 2018

applicants until the end of 2018 and will provide up to £3.5 billion of guarantees

- at Autumn Budget 2017, the government announced that it would explore options with industry to create £8 billion worth of new guarantees to support housebuilding, including SME builders and purpose built rented housing

### Chart 2.G: MHCLG exposures to the housing sector




Source: MHCLG and HM Treasury calculations

2.28 MHCLG has put in place a framework to manage the risks associated with its portfolio of financial instruments, in particular the credit risk arising from its loan, guarantee and equity loan products. This includes procedures for identifying, measuring and monitoring key risks for both new products as they are developed, and live products which have been approved for delivery. A risk appetite statement is in place to control the department's exposure to any single counterparty group based on their assigned credit rating, with procedures for escalating where there are specific circumstances which warrant exceeding set limits. Programme-specific investment parameters are also developed and implemented as a further control.

2.29 Delivery of the investment products is managed by Homes England as the department's delivery partner for housing objectives. A robust risk management process has been implemented based on a three lines of defence model to effectively manage individual transactions and the portfolios developed under each product. Homes England operate within specified risk appetite, and determine an appropriate credit rating for individual borrowers, as well as ensuring robust security structures are in place. The transaction process includes origination, credit analysis, due diligence and ongoing portfolio management. Structures are also in place to identify and appropriately manage any investments which are becoming distressed. The portfolio is subject to ongoing monitoring and reporting, and

processes are in place to carry out annual stress testing and contingency planning.

### Box 2.E: The Private Rented Sector Guarantee Scheme

The £3.5 billion Private Rented Sector Guarantee Scheme (PRSGS)[24] provides sovereign guarantees of finance raised from the capital markets for large-scale managers of housing projects developed for market rent.

Operating under licence from MHCLG, PRS Operations Ltd appraises applications for guarantees. Besides looking at the capabilities of the sponsors and the details of the property, analysis is undertaken of the cash flows from the project, including downside sensitivity analysis. Key metrics considered are the interest cover ratio (i.e. the ability to meet interest payments from cash flows) and loan to value (i.e. the proportion of the property value that would be needed to pay off the loan). This analysis informs the credit score assigned to the project and also the level of fee that is charged to cover the risk of losses. The analysis is also used as the basis for financial ratios which the borrower must continue to meet over time in order to be able to release excess cash from the project and to avoid defaulting under the loan.

Once reviewed by PRS Operations' own credit committee, the recommendation for an application is reviewed by Homes England's credit team and credit committee before approval is given by MHCLG. Final due diligence is conducted before the guarantee is issued. MHCLG's guarantee covers principal and interest both under the bond that is issued in the capital markets by PRS Finance PLC and the onward loan to the project.

The loans require regular reporting by borrowers, with detailed annual updates. PRS Operations monitors the portfolio and reports to MHCLG on the portfolio on a quarterly basis. Any concerns raised can result in a borrower being placed on a watch list, with enhanced monitoring under certain circumstances.

In the event that a project were to default on its obligations, then a liquidity reserve is available to cover off up to 12 months of interest payments, permitting time for the security to be enforced (if necessary) and the proceeds of selling off the property to pay off the loan. The risk fees paid by the borrower also serve as a buffer against losses.

MHCLG monitors the guarantees portfolio, as part of its overall risk management processes. Stress testing is undertaken on an annual basis to review vulnerability to downside shocks.

A sister scheme to the PRSGS is in place for affordable housing operated by Housing Associations. Risks are managed through broadly similar processes.

24 'Private Rented Sector Housing Guarantee Scheme', MHCLG, March 2018

## Current account

2.30 As outlined in the FRR, the UK economy has had a current account deficit since the late 1990s. It reached a record high of 5.2% in 2016 but narrowed significantly to 3.9% of GDP in 2017.[25] The presence of a large current account deficit or surplus alone does not necessarily signify vulnerability within an economy. When assessing the riskiness of the current account it is important to consider not only its size but also how it is being financed. This is because certain sources of finance, such as foreign direct investment (FDI), are less prone to sudden reversals and capital flight.

2.31 As an open economy with significant trade and financial links to the rest of the world, the UK has historically performed well when it comes to attracting FDI. Since 2000, the UK has attracted the second-highest cumulative FDI inflows in the G7, second only to the US.[26] Over this period FDI has accounted for 26% of total capital inflows to the UK.[27] The UK is currently ranked as the 7th best place in the world to do business[28] and the 8th most competitive country in the world.[29]

2.32 The government has taken several actions which directly and indirectly address the risk posed by the current account balance. By providing a favourable business and tax environment, the government's macroeconomic policy framework contributes to the sustainability of the current account deficit by making the UK an attractive and competitive destination for foreign investment. The government also supports UK trade and exports through UK Export Finance and the Department for International Trade (DIT) which is tasked with promoting UK trade and investment across the world and will be publishing its Export Strategy soon.

2.33 The government's aim to maintain the greatest possible tariff and barrier free trade in goods and services, including financial services, once it departs from the EU will also contribute to stability in the current account. Finally, from a national savings-investment perspective, all else being equal, a gradual reduction of the public deficit, combined with accommodative monetary policy should contribute to reducing the current account deficit over the medium term.

# Part III: Ensuring fiscal sustainability

2.34 While the government has made significant progress in repairing the public finances, the financial crisis and its aftermath increased public sector net debt to a 50 year high of 85.4% of GDP, or £1.8 trillion in 2017-18.[30] This is equivalent to around £65,000 per household.[31] As a result of this high level of debt the government spends approximately £50 billion per year on gross

25 'Balance of Payments time series', ONS, June 2018

26 'OECD.stat', OECD, July 2018

27 'Balance of Payments time series', ONS, June 2018

28 'Ease of Doing Business Ranking, 'Doing Business Report', World Bank, October 2017

29 'Global Competitiveness Report 2017-2018', World Economic Forum, September 2017

30 'Public sector finances', UK: May 2018', ONS, June 2018

31 'Families and households', ONS, November 2017

debt interest,[32] which is more than the police and armed forces combined. If it were a ministry, it would have the third largest departmental spending after health and education.[33] If the government chose not to tackle this debt it would leave a significant burden on the next generation.

2.35 As highlighted in the FRR, there are a number of risks associated with elevated levels of public sector debt including the:

- more vulnerable starting position from which the government would approach the near-inevitable future economic and other shocks
- potential constraints on the government's ability to use fiscal policy to respond to those shocks when they occur
- heightened sensitivity of the public finances to changes in interest rates, including their eventual normalisation
- growing stock of index-linked debt and sensitivity of debt interest spending to inflation

2.36 This section discusses the actions the government is taking to address these risks and restore fiscal sustainability by:

- continuing to make progress in tackling the deficit
- returning debt to sustainable levels
- maintaining a long average debt maturity
- reviewing index-linked debt issuance

## Repairing the public finances

2.37 The government has reduced the historic deficit it inherited and is determined to live within its means. The global financial crisis saw the deficit rise from 2.8% of GDP in 2007-08 to a post-war high of 9.9% of GDP in 2009-10. Since 2010, the government has reduced the deficit by over three-quarters to 1.9% of GDP in 2017-18.[34] The government's actions have meant that the debt-to-GDP ratio is now forecast by the OBR to have peaked last year and will begin its first sustained fall in a generation from this year.[35]

2.38 However, as highlighted by the FRR, a persistently high level of debt exposes the public finances to a number of risks. Governments with high levels of debt are more vulnerable to economic shocks and have less room for counter-cyclical fiscal policies to mitigate their impact on households and business, with consequences for the length and depth of the resulting recessions. The FRR's fiscal stress test showed that, given current levels of debt, a severe but plausible macroeconomic shock could see the UK's debt-to-GDP ratio rise to 114%.

32 'Public sector finances', UK: May 2018', ONS, June 2018

33 'Autumn Budget 2017', HM Treasury, November 2017

34 'Public sector finances, UK: May 2018', ONS, June 2018

35 'Economic and fiscal outlook', OBR, March 2018

2.39 The only means of permanently restoring the UK's fiscal resilience is to reduce the debt-to-GDP ratio. As summarised in Box 2.F there is no consensus on what constitutes a 'safe' level of debt. However, analysis by academics, international financial institutions, and the OBR's own fiscal stress test suggests that the UK's current debt-to-GDP ratio of 85.4% of GDP leaves the public finances vulnerable to shocks. While the UK's debt-to-GDP ratio remains a significant distance from estimates of its 'debt limit', it is above estimates of 'debt thresholds' which risks undermining economic activity and constraining government's ability to stabilise the economy in the event of a shock.

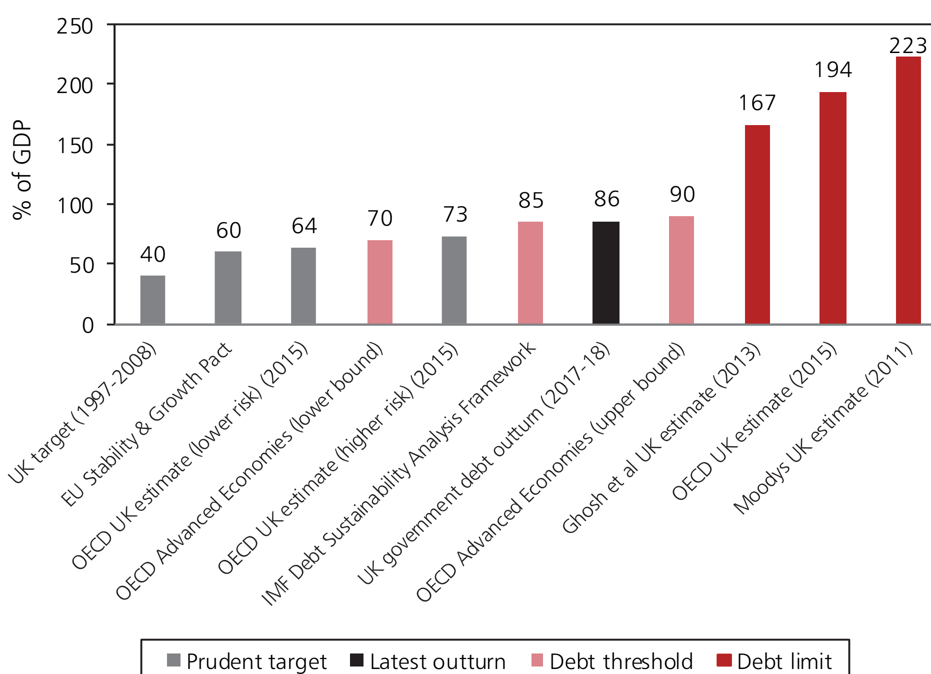
## Box 2.F: Prudent debt levels: international evidence

There is no consensus about a level of debt that is appropriate for all countries at all times. This is because what constitutes a 'safe' level depends on several factors including interest rates, economic growth, financial depth, exposure to shocks, and how governments to respond to them. The trajectory as well as the level of debt matters for sustainability: some studies find that governments can manage relatively high levels of debt if debt dynamics are favourable and debt is forecast to fall over the medium-term.[36]

The OECD has developed a framework to help identify prudent debt levels using three interrelated concepts:[37]

- **Debt limits** are where a government risks losing market access. Countries should maintain a substantial buffer to their debt limit, due to the severe consequences of default and the speed at which it can be reached if there is a sudden loss of market confidence or change in economic conditions
- **Debt thresholds** are where debt begins to have adverse effects on economic activity, constrains a government's ability to stabilise the economy, and puts long-term debt sustainability at risk. For high-income countries, the OECD estimate a debt threshold range of 70-90% of GDP, which is consistent with the 85% threshold in the IMF's Debt Sustainability Analysis framework
- **Debt targets** are the level of debt which would avoid an overshooting of the debt threshold in the event of a plausible range of economic shocks. OECD analysis suggests prudent debt targets of 15ppts of GDP below the debt threshold, on average, for high-income countries

### Chart 2.H: Estimates of government debt limits, thresholds, and targets



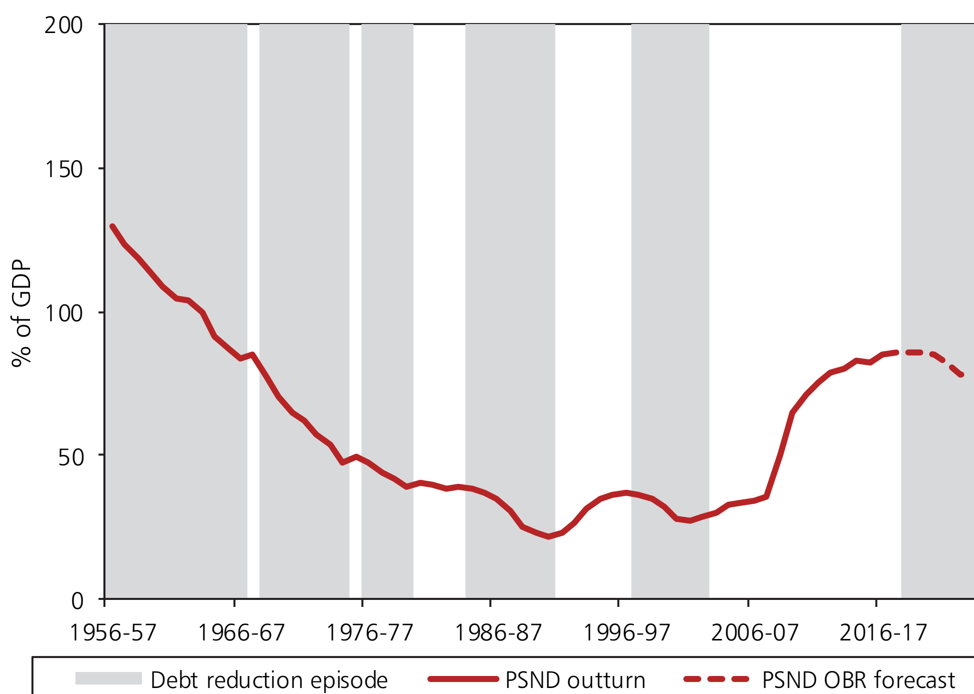

36 'Is there a debt-threshold effect on output growth?', Chudik et al, March 2017

37 'Prudent debt targets and fiscal frameworks', Fall et al, 2015

## Returning debt to sustainable levels

2.40 Chart 2.I shows that, since 1956-57, the UK has experienced several episodes of sustained debt reduction, and is forecast to be at the start of another sustained reduction.[38] Previous episodes have been supported by a combination of favourable macroeconomic tailwinds for debt reduction (high inflation, strong real GDP growth and low real interest rates) and fiscal effort by government in the form of sustained primary surpluses. The current macroeconomic conjuncture is less favourable for debt reduction relative to previous episodes. While interest rates are more favourable, both real GDP growth and inflation are forecast to be significantly less so over the next five years. This suggests that fiscal policy must continue to play an active role in delivering sustained reductions in debt.

### Chart 2.I: Periods of historic debt reduction




Source: ONS, OBR and HMT calculations

38 A sustained debt reduction episode is defined as such if the debt-to-GDP ratio falls for at least 4 years

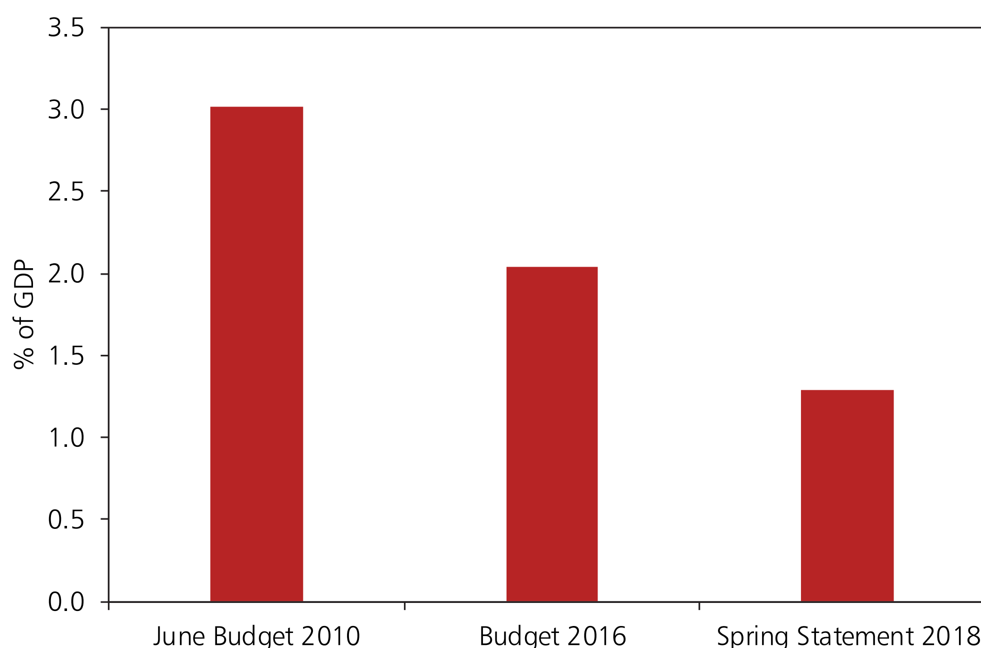
### Table 2.A: Economic conditions during periods of historic debt reduction

| Macroeconomic variable (annual average) | 1956-67 | 1968-75 | 1976-80 | 1984-91 | 1997-02 | 2018-23 |
|---|---|---|---|---|---|---|
| Reduction in debt (% of GDP) | 5.0 | 5.3 | 2.6 | 2.4 | 1.8 | 1.5 |
| Primary balance (% of GDP) | 1.6 | 1.5 | -0.7 | 1.8 | 2.3 | 0.2 |
| Real growth (%) | 3.0 | 2.9 | 3.4 | 3.3 | 3.4 | 1.4 |
| Inflation (%) | 3.6 | 9.5 | 14.0 | 6.2 | 1.1 | 1.7 |
| Interest rate (%) | 5.3 | 8.0 | 10.8 | 11.5 | 6.0 | 1.2 |

Source: ONS, OBR and HMT calculations

2.41 Reflecting these more challenging macroeconomic circumstances, the level of the deficit required to stabilise the debt-to-GDP ratio has fallen to 1.2% of GDP, down from 3% as recently as 2010-11 (Chart 2.J). The fall in recent years is as a result of a lower trend productivity growth assumption in the OBR's forecast and an increase in financial transactions.

### Chart 2.J: Debt-stabilising PSNB in the final year of the forecast



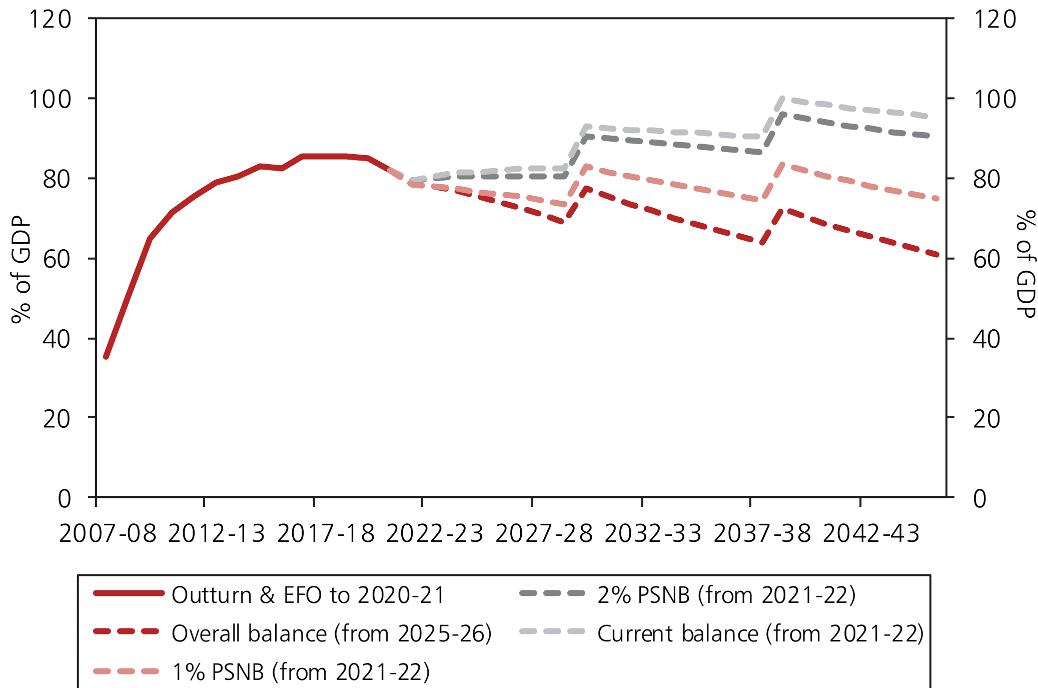

Source: OBR and HMT calculations

2.42 Further reductions in the deficit will therefore be necessary to return debt to a more sustainable level. As shown in Chart 2.K leaving the deficit at around its current level of 2% of GDP would mean that the debt-to-GDP ratio would stabilise at around 80% in the medium-term, in the absence of economic shocks.

2.43 Over a longer time period it is important to take into account the likelihood of future economic shocks. Chart 2.K shows that, under an illustrative scenario in which the economy is hit by a shock that increases debt by 10%

of GDP[39], every 9 years[40], public sector net debt would rise to over 90% of GDP if the deficit was maintained at 2% of GDP. Were the government to adopt an even looser fiscal policy of balancing the current budget and borrowing to invest, the debt-to-GDP ratio would reach around 100% of GDP once typical economic shocks are taken into account.

## Chart 2.K: Projections of public sector net debt with illustrative shocks




Source: ONS, OBR and HMT calculations

2.44 Reducing the deficit is also critical to insulating the public finances from rising debt interest costs. While the government's stock of debt is currently at a 50-year high, interest rates on that debt remain close to historic lows.[41] This has kept interest payments as a proportion of GDP at or close to historic lows in recent years. Chart 2.L shows projected debt interest spending, assuming the economy is hit by shocks, as set out in the paragraph above, and debt interest rates normalise in the way assumed in the OBR's long-run projections. This shows that further reductions in the deficit are necessary to keep debt interest from rising above the highs seen in the early 1980s.

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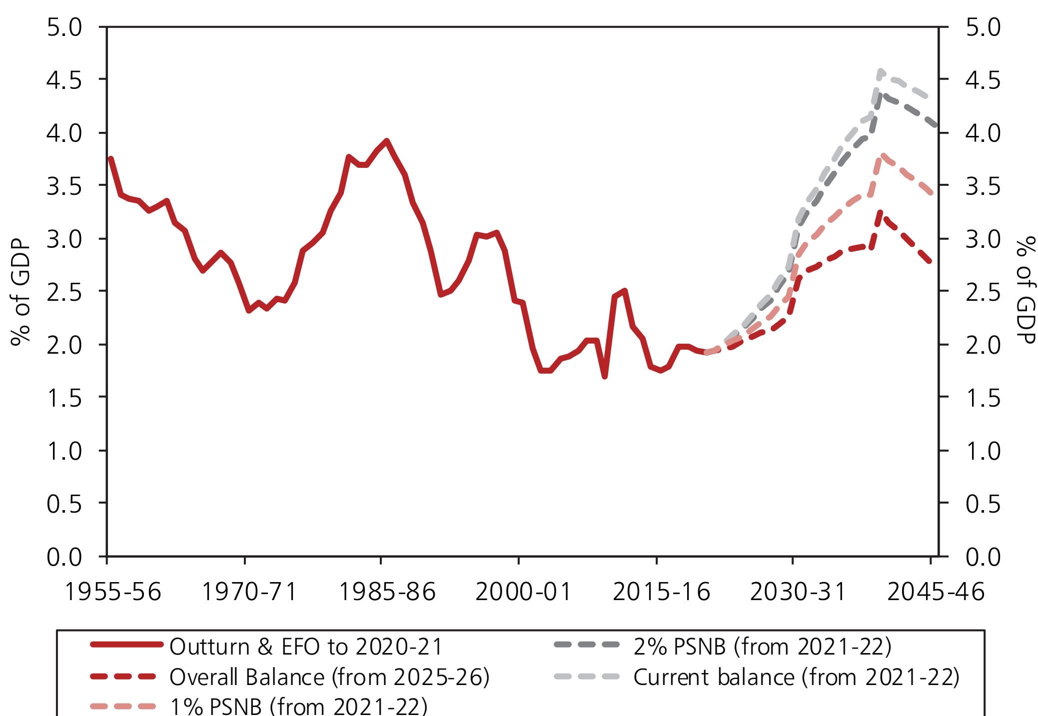
39 International evidence and analysis of previous UK recessions suggests that a typical recession could add at least 10% of GDP to the debt ratio. The IMF analysed shocks to government debt in 80 countries from 1990 to 2014. They found that macroeconomic shocks in the form of sharp declines in nominal GDP growth typically cause an average fiscal cost of 9% of GDP. Recessions in the UK have had a range of impacts on the public finances, reflecting differences in the nature and severity of the shocks. The early-90s recession, the most recent recession not to feature a significant financial crisis, increased the debt-to-GDP ratio by 13 percentage points.

40 The FRR found that the UK had experienced 7 recessions in the previous 61 years, or one every 8.7 years on average.

41 'Public finances databank', OBR, July 2018

## Chart 2.L: Projections of debt interest payments with illustrative shocks




Source: ONS, OBR and HMT calculations

2.45 Raising the trend rate of GDP growth would significantly improve public debt dynamics and alleviate pressures on the public finances. With employment at record levels and an ageing population, productivity growth will be the key driver in determining the trend rate of economic growth in future. If the trend rate of productivity growth was 2.5%, by running an overall balance from 2025-26, the government could reduce debt below 60% of GDP by the mid-2040s, even after accounting for shocks. Furthermore, the government would have an additional 4% of GDP to invest in public services as a result of a larger economy, relative to a scenario where productivity growth remains at the trend level projected by the OBR (2.0%). Part IV sets out the actions the government has taken to increase productivity growth.

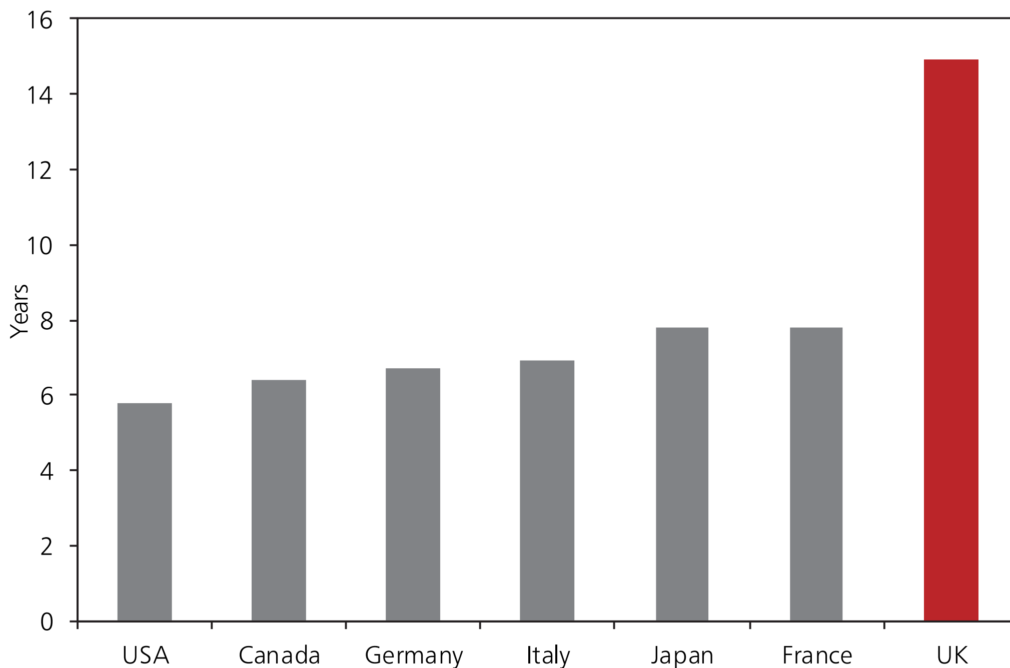
## Maintaining a long average debt maturity

2.46 In the interim, the government is taking a number of steps to address the risks associated with its elevated level of debt. Over recent years, the government has extended the average maturity of the stock of total gilts from 12.7 years in 2005-06 to 15.8 years in 2017-18.[42] This is underpinned by the decision the government took to issue 50-year and 55-year maturity conventional gilts in 2005 and 2013 respectively. Further, at a recent syndication, the maturity of the conventional gilt curve has been extended from 2068 to 2071.[43] The average debt maturity in the UK is around twice the average of maturity of other G7 governments, as shown in Chart 2.M.

42 'Historical statistics on the debt portfolio', UK Debt Management Office, 2018

43 'Press Notice- Syndicated launch of £6.0 billion nominal of 1 5/8 % Treasury Gilt 2071: Result', UK Debt Management Office, May 2018

## Chart 2.M: Average maturity of the debt stock by country




Source: Bloomberg

2.47 A long average maturity of debt significantly reduces the UK government's exposure to refinancing risks. On average since 2010, the UK government has refinanced debt equivalent to 6.9% of GDP each year.[44] This is the lowest across the G7, with the comparable figure at 7.0% in Germany, 17.6% in the US, 20.8% in Italy, and 46.1% in Japan. The UK's relatively long average debt maturity also slows the transmission of interest rate shocks to the public finances. With an average maturity of almost 16 years,[45] excluding APF holdings, on average it would take more than a decade and a half for rising interests rates to feed through higher debt servicing costs on half of the government's outstanding stock of gilts.[46]

## Reviewing index-linked debt issuance

2.48 The FRR highlighted how the elevated stock of index-linked gilts increased the government's sensitivity to inflation shocks. The OBR estimated that, holding the primary balance unchanged, a 1 percentage point increase in RPI inflation would raise the debt-to-GDP ratio by 1.2 percentage points over a five-year period. The OBR also considered a stress test scenario where simultaneous increases in borrowing, inflation, and interest rates led debt servicing costs to rise from 1.9% of GDP in 2017-18 to 5.1% of GDP in 2021-22, illustrating how debt interest spending has become increasingly sensitive to shocks.

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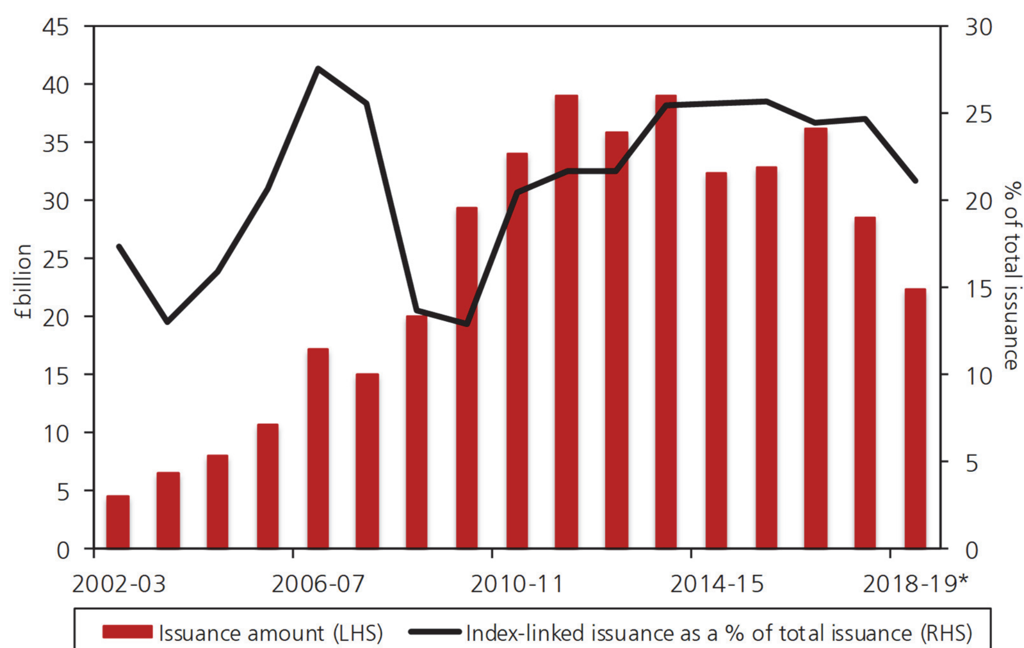
[44] 'IMF Fiscal Monitor', IMF, 2010-2018

[45] 'Historical statistics on the debt portfolio', UK Debt Management Office, 2018

[46] This time period will be shorter when Treasury Bills, NS&I products and gilts held by the APF are taken into account. The OBR estimated that, for end-March 2017, the weighted average maturity of the debt stock decreased from 16 years to around 11 years once these other instruments were taken into account.

2.49 Defined benefit pension schemes offering inflation protection to their members have historically provided a strong demand base for RPI-linked assets. Defined benefit pension funds currently invest more than half of their assets in bonds, of which 45% is invested in index-linked bonds.[47] High and persistent demand for index-linked gilts has made them a cost-effective financing source for government, and the share of index-linked debt in the total debt stock has increased from around 10% in the late 1980s[48] to over 20% in the current decade in nominal terms. Over the past five years, around 25% of the government's annual debt issuance has been through index-linked gilts (Chart 2.N).[49]

## Chart 2.N: Annual index-linked gilt issuance




Source: DMO and HMT

*Planned issuance set out in April 2018 revision to the DMO's financing remit 2018-19, subject to change as the unallocated pot is distributed over the year.

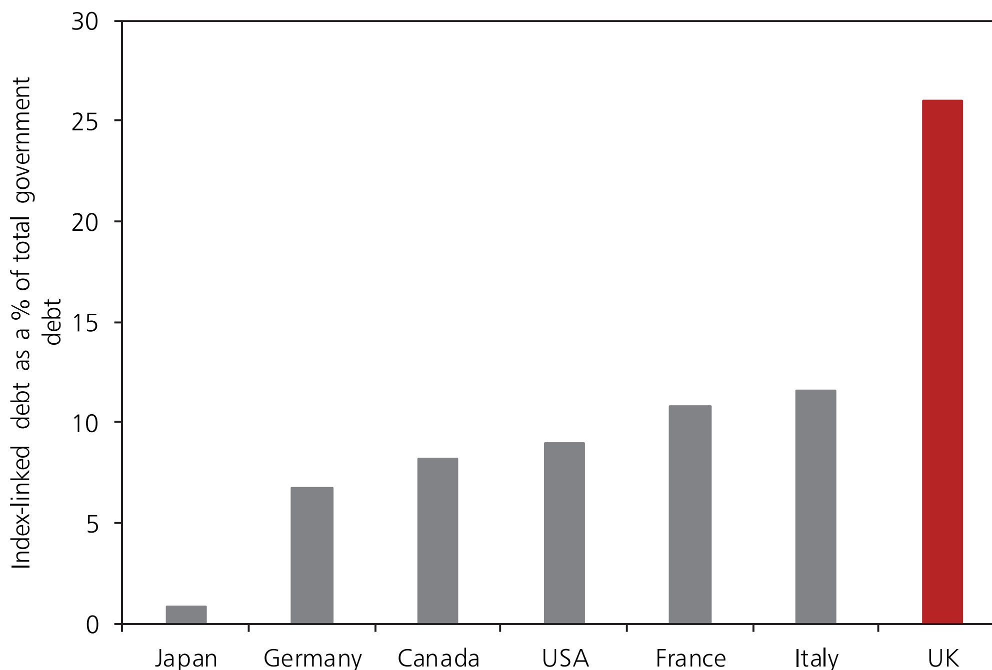
2.50 On a nominal uplifted basis, the UK has the highest proportion of index-linked debt in its total sovereign debt portfolio of any major economy. This is more than twice the share of index-linked instruments as Italy (12%), the G7 country with the second highest proportion of index-linked debt (Chart 2.O). This partly reflects the prevalence of inflation-protected defined benefit pension schemes in the UK relative to other advanced economies.

47 'The Pension Protection Fund', 'The Purple Book', December 2017

48 'The size of the gilt portfolio since 1987', UK Debt Management Office, 2018

49 'Cash sales of gilts by type and maturity', UK Debt Management Office, 2018

## Chart 2.O: Index-linked government debt: international comparisons




Source: OECD

2.51 However, the number of UK private sector defined benefit pension schemes remaining open is falling. Active members contributing to these schemes fell from 2.4 million in 2010 to 1.3 million in 2017.[50] As schemes mature and move from accumulating contributions and investing in new assets to paying out pensions, current expectations suggest that this could drive a reduction in the level and maturity of demand for index-linked gilts in future years.

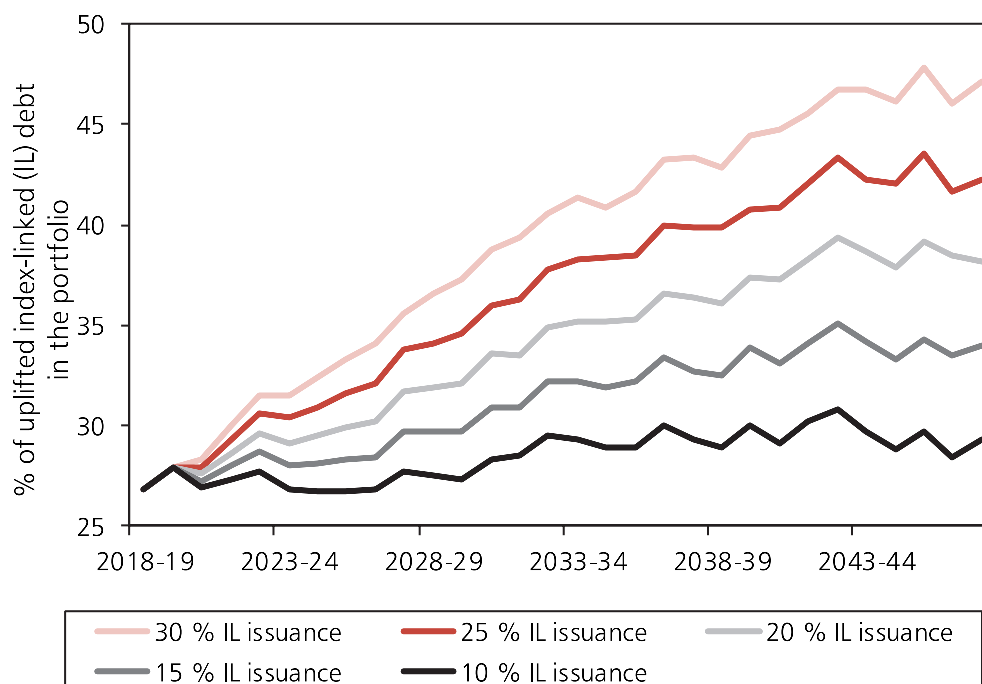
2.52 The government has therefore been considering the appropriate balance between index-linked and conventional gilts, taking account of the level of structural demand, the diversity of the investor base, and the government's desired inflation exposure. The government's current view on the balance between these considerations was reflected in the 2018-19 financing remit, which reduced index-linked gilt issuance by 2 percentage points compared to that planned at the start of the previous financial year (2017-18), from 23.1% to 21.1%.[51] Chart 2.P illustrates the future evolution of the stock of index-linked debt under different issuance assumptions.[52] Whilst the government's future inflation exposure is primarily dependent on the relative amount of index-linked gilt issuance each year, it also depends on the average maturity of that issuance relative to conventional gilts. The government will keep under review the appropriate balance of index-linked and conventional gilts in future annual financing remits.

50 'The DB landscape', The Pensions Regulator, March 2018

51 'Debt management report 2018-19', HM Treasury, March 2018

52 These assumptions, which are subject to uncertainty, include: future government financing requirements, overall levels of investor demand and maintaining the relative average maturity of conventional and index-linked gilts based on current investor preferences, market-derived rates and inflation.

## Chart 2.P: Future index-linked debt stock under different issuance assumptions




Source: DMO calculations

2.53 While all index-linked debt is currently indexed to the RPI, the government keeps issuance of potential new debt instruments under review. In 2013, RPI lost its status as a National Statistic, and its use is no longer encouraged by the ONS.[53] The ONS now counts the Consumer Prices Index including owner occupiers' housing costs (CPIH) as its preferred measure of inflation.[54] Responses to the 2011 consultation on issuing CPI-linked gilts indicated that uncertainty around the potential inclusion of owner occupiers' housing costs in the CPI was a key concern among gilt market investors. The government decided to keep the issuance of CPI-linked gilts under review.[55] As with all prospective new instruments, the government will need to be satisfied that demand is sufficiently strong and sustainable and that issuance will be cost-effective before deciding to issue. The government would expect to consult market participants at the appropriate time, and will announce any potential future decisions in a transparent and predictable manner, to allow sufficient lead time to allow the market to prepare.

# Part IV: Boosting long-run productivity

2.54 The FRR highlighted that productivity growth has slowed significantly across advanced economies since the financial crisis. In the UK, the annual productivity growth rate has averaged just 0.2% since 2008, compared with an average of 2.1% pre-crisis.[56] One of the key risks to the fiscal outlook is

53 'The Retail Prices Index', ONS, March 2013

54 'Statement on future of consumer price inflation statistics in the UK', ONS, November 2016

55 'CPI-linked Gilts: Response to Consultation', UK Debt Management Office, November 2011

56 'Labour productivity', ONS, July 2018

that hourly productivity growth fails to return to the 1.2% by 2022 assumed in the OBR's 2018 Spring Statement forecast.

2.55 The government is determined to boost productivity growth, and has put a plan in place to increase the UK's productivity, working across all of the main economic drivers. The government's strategy is based around two pillars:

- supporting long-term investment in physical, human and intellectual capital
- promoting a dynamic economy that encourages innovation and helps resources flow to their most productive use

## Supporting long-term investment

2.56 Driving productivity growth requires investment in different forms of capital including physical capital such as plant and equipment, human capital through education and training, and infrastructure capital such as roads and bridges. In advanced economies, productivity growth is also increasingly driven by intangible capital. This can include both business assets such as software, training or business processes, as well as new scientific innovations and technology.[57] These investments play a significant role in generating productivity growth.

2.57 To strengthen the foundations of productivity, the government launched the Industrial Strategy, which focussed on ideas, business, place, people, and infrastructure.[58] In addition it announced four Grand Challenges: Artificial Intelligence and the Data Economy, Clean Growth, Heathy Ageing and the Future of Mobility. These will help put the UK at the forefront of emerging technologies.

2.58 Supporting the vision set out in the Industrial Strategy, the government is increasing investment in key productivity-boosting infrastructure. Since 2010, the government has invested over half a trillion pounds in capital projects,[59] and transport investment will increase by 50% from 2015 to 2020, funding significant improvements in the rail and road networks. In 2016, the government established the National Productivity Investment Fund to provide £31 billion of additional investment in areas critical to improving productivity, including infrastructure. The government is also investing over £1 billion in improving the UK's digital infrastructure, to help stimulate private sector investment in the next generation of mobile and broadband infrastructure. Spending on net investment is set to increase to its highest sustained level in 40 years.[60] [61]

2.59 The government is also committed to making sure that Britain is the world's most attractive location for private investment. Corporation Tax, which acts

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57 'Intangibles and industry productivity growth: Evidence from the EU', Corrado, Carol, et al, 2014

58 'Industrial Strategy: building a Britain fit for the future', BEIS, November 2017

59 Calculated as the summation of Public Sector Gross Investment (PSGI) £ billion between 2010-11 and 2017-18, 'Public finances databank', OBR, July 2018

60 Excluding the financial crisis period

61 'Public finances databank', OBR, July 2018

as a tax on investment,[62] has been cut to 19%, the lowest rate in the G20. The rate is planned to fall further to 17% by 2020. The government also supports businesses through the Annual Investment Allowance, and via capital allowances. The Annual Investment Allowance has been set at £200,000, its highest ever permanent level, which means 99% of firms have their capital expenditure covered.

2.60 Building human capital through strengthening education and training is a priority for the government. To help guide policy decisions, HM Treasury is currently working with the ONS to develop the evidence base so the government can better understand its investment in people. The government is also taking action to transform technical education, helping to prepare people for the high-skilled jobs of the future. It is investing in apprenticeships through the introduction of the Apprenticeship Levy, introducing a National Retraining Scheme to help people train for new careers, and introducing T-levels. T-levels will provide all 16-18 year olds with a choice of technical and academic routes of equal status and quality; and will be backed by over £500 million a year of additional funding when fully rolled out.

## Promoting a dynamic economy

2.61 While investment in new economic resources is vital for productivity growth, it is just as important to ensure that these resources are properly allocated so they can generate the most value. Poor allocation of resources can have significant aggregate effects on productivity.[63] Improvements in allocation can take the form of more productive firms growing and less productive firms shrinking or closing. Alternatively, reallocation might mean workers and capital flowing from one industry to another, or into a new industry entirely. Research suggests the contribution of reallocation can be significant: one study estimated that approximately one half of productivity growth in the pre-crisis period was the result of re-allocation across firms.[64]

2.62 Reallocation depends on competitive, dynamic markets which push firms to make the best use of resources. The UK benefits from a flexible labour market and a strong competition system. The independent Competition and Markets Authority ensures that UK markets are competitive, and the UK performs strongly on international indicators of competition.[65] The UK labour market is regarded as one of the most flexible in the world.[66]

2.63 To support greater innovation, the government has increased public support for R&D to its highest levels in 30 years. This includes increasing the total government spending on R&D from £10.4 billion in 2015-16 to £12.5 billion by 2021-22[67] and increasing the main rate of the R&D Expenditure Credit from 11% to 12%. Ensuring that innovative firms can access the finance

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62 'How do Taxes Affect Investment and Productivity? An industry level analysis of OECD countries', Laura Varita OECD, 2008

63 'The Future of Productivity', Adalet McGowan, M., Andrews, D., Criscuolo, C. and C Nicoletti, G. OECD, 2015

64 'The productivity puzzle: a firm-level investigation into employment behaviour and resource allocation over the crisis', Barnett, A., Chiu, A., Franklin, J. and Sebastia-Barriel, M. Bank of England Working Paper 495, 2014

65 '2013 update of the OECD's database on product market regulation', Koske, I., Wanner I., Bitetti R., Barbiero O. OECD, 2015

66 'Global Competitiveness Report', Shwab, K. World Economic Forum 2015-16

67 'Autumn Budget 2017', HM Treasury, November 2017

required to scale up is essential if the economy is to reach its full potential. The government has developed a 10-year action plan to unlock over £20 billion of investment in innovative firms. Measures include setting up a £2.5 billion patient capital investment fund, expanding the world-leading Enterprise Investment Scheme and supporting long-term investment by pension funds and other investors. These measures will build on existing British Business Bank programmes which support more than £4 billion of finance to over 65,000 smaller businesses.[68]

2.64 The government is determined to ensure our regulatory system is fit for the challenge of new technologies. The emergence of new high productivity firms and the adoption of new technologies also depends on an open and flexible economy which enables experimentation and change. This in turn relies on smart, effective and proportionate regulation to enable the diffusion of new technologies while protecting consumers. The government has therefore asked the Law Commission to draw up rules for driverless cars, and has established a new Centre for Data Ethics and Innovation to promote safe, ethical innovation in artificial intelligence.

68 'British Business Bank agrees facility with 1pm to provide £35m of additional funding to smaller UK businesses', British Business Bank, March 2018

# Chapter 3
# Financial sector

3.1 The financial services sector is an important part of the UK economy. It represents around 7%[1] of total UK economic output, while the sector also provides employment for over one million people (3.2% of total employment), two thirds of whom are outside London.[2]

3.2 The FRR highlights the economic importance of the financial services sector to the UK, but also the fiscal risks it can pose. Financial sector instability can affect the public finances both directly (through public rescues or takeovers of financial institutions) and indirectly (through its impact on the wider economy and government receipts). The IMF estimates that financial crises are the single largest source of shocks to the public finances among its member countries, with an average cost of around 20% of GDP and an average frequency of one crisis every 20 years.[3]

3.3 This chapter provides an overview of the government's actions to reduce fiscal risks from the financial sector in three main areas:

- Part I discusses actions taken to reduce the likelihood of financial crises
- Part II discusses measures taken to reduce taxpayer exposure to the financial sector
- Part III describes efforts to tackle cyber security risks

## Part I: Reducing the likelihood of financial crises

3.4 The FRR highlights several features of the UK financial system which pose a risk to the public finances. These include:

- the frequency of financial crises in the UK
- the significant cost that these crises impose on the wider economy
- the tendency for loosening of financial regulation as economies recover from crises

3.5 Since the financial crisis, the government has fundamentally reformed the system of financial regulation to ensure greater resilience to any future shocks. This includes:

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1 UK GDP(O) low level aggregates, ONS, June 2018

2 JOBS05: Workforce jobs by region and industry, ONS, June 2018

3 Fiscal Risk Report, OBR, July 2017

- establishing a new legal and institutional framework for financial regulation
- making additional tools available to regulators across a wide range of policy areas including prudential, macroprudential, conduct, and resolution planning
- addressing financial misconduct and tackling pay practices that favour short-term thinking
- leading international efforts to promote financial stability

## New legal and institutional framework

3.6 The Financial Services Act 2012[4] introduced a new regulatory framework for financial services, providing the Bank of England with primary responsibility for assessing and responding to risks to financial stability. Key institutional reforms included the:

- introduction of the Prudential Regulation Authority (PRA) to regulate the safety and soundness of firms, through ensuring firms are properly managing their capital and liquidity positions
- establishment of the Financial Policy Committee (FPC) as the UK's macroprudential authority with the primary objective of identifying, monitoring and addressing systemic risks to financial stability
- creation of the Financial Conduct Authority (FCA) to regulate conduct across financial services and markets, to prevent inappropriate behaviour, enhance market integrity, promote competition and protect consumers

3.7 In 2016, the Bank of England and Financial Services Act[5] strengthened the governance and accountability of the Bank of England, by ending the subsidiary status of the PRA and allowing the National Audit Office to undertake value for money reviews of the Bank for the first time.

## Regulatory reform and expanded array of tools

3.8 Robust international prudential standards are critical to UK financial stability. The PRA is the host supervisor of approximately 170 international banks, including every foreign global systemically important bank and international banks whose UK banking sector assets amount to more than double the UK's annual GDP.[6]

3.9 The government continues to support the Basel framework[7], which is comprised of common regulatory and supervisory standards agreed by the Basel Committee on Banking Supervision, an organisation of international prudential authorities. These standards ensure financial stability at home, while providing certainty and predictability for international banks wishing to do business in the UK. While significant elements of the Basel III framework of microprudential regulatory measures already apply in the UK through the

[4] Financial Services Act 2012

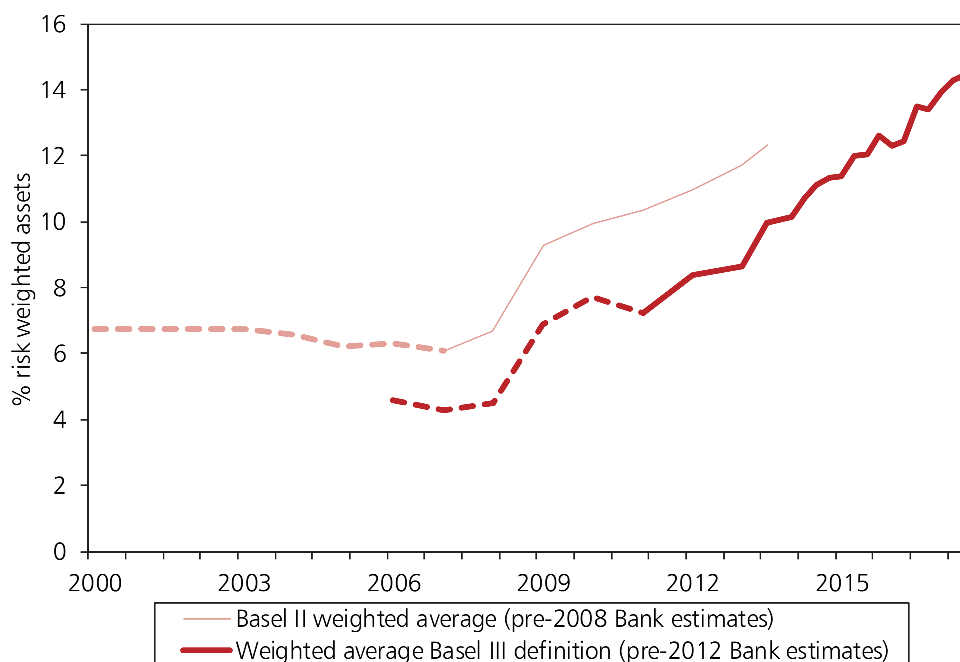
[5] Bank of England and Financial Services Act 2016

[6] 'Geofinance', Sam Woods, Bank of England, October 2017

[7] Basel III: International regulatory framework for banks, Basel Committee on Banking Supervision

domestic implementation of the EU Capital Requirements Directive IV, the government continues to support the full and timely implementation of the remaining elements of the package including the significant and final elements agreed in December 2017.

## Chart 3.A: Aggregate increase in bank capital ratios




Source: Bank of England Financial Stability Report November 2017

3.10 These reforms will continue to support financial stability by enhancing requirements for the quality and quantity of capital, as well as enshrining new liquidity and leverage requirements, for individual PRA-supervised institutions. Enhanced capital requirements increase banks' resilience to negative shocks by giving them a larger cushion with which to absorb losses. In the decade since the global financial crisis UK banks' Common Equity Tier 1 (CET1) capital ratios, a measure of how much high quality capital banks hold against potential losses, have tripled (Chart 3.A.). The new leverage standards, which include revisions to the measure of the leverage ratio and the addition of a leverage ratio buffer for UK global systemically important banks and domestic systemically important banks and building societies, will reinforce these enhanced capital standards. The new liquidity standards will increase banks' resilience to funding stresses and ensure banks are financing themselves with more stable forms of funding.

3.11 While the PRA regulates the safety and soundness of individual firms, the FPC has responsibility for identifying, monitoring, and mitigating risks to the financial system as a whole. The FPC's principal macroprudential tool is setting the size of the countercylical capital buffer (CCyB) which banks are required to hold against UK exposures. By increasing the CCyB when risks are judged to be building up, banks have an additional cushion of capital with which to absorb losses, thus enhancing their resilience. When threats to stability recede, the CCyB can be reduced to help mitigate a contraction in the supply of lending to the real economy.

3.12 Since 2015, the FPC has also had powers to set leverage ratio requirements. Alongside the risk-weighted CET1 ratio requirements for banks, the leverage ratio limits firms' incentives to respond to increases in capital requirements. It does so by reducing estimates of risk weights or shifting asset composition, rather than additional capital.

3.13 The FPC also has powers over other key macroprudential tools for UK banks. These include powers to set debt-to-income and loan-to-value ratio limits for residential mortgages, and loan-to-value limits and interest-coverage ratios for buy-to-let mortgages. These tools can be used to help mitigate emerging risks in the housing market. The FPC can also set sectoral capital requirements, if specific sectors of the economy are judged to pose a risk to the financial system as a whole. The FPC also has powers to make Recommendations; these can be made to anybody, although the FPC has a special power to make Recommendations on a comply or explain basis to the PRA and FCA. The FPC can also make Recommendations to HM Treasury, including on the need for additional macroprudential tools and on the regulatory perimeter.

3.14 These powers and tools will allow the FPC to tackle emerging financial stability risks and ensure the resilience of the UK's financial system. The FPC has judged that robust prudential standards require the currently planned level of resilience in the UK to at least be maintained. This level of resilience already exceeds required international baseline standards, in part reflecting the scale of the UK financial system, which is, by asset size, around ten times the size of GDP.[8]

## Stress tests

3.15 The Bank of England runs an annual stress test of the largest UK banks and building societies. These stress tests examine the potential impact of hypothetical adverse scenarios on the health of the banking system and individual institutions. In doing so, stress tests allow policy makers to assess banks' resilience to a range of adverse shocks and ensure they are adequately capitalised, not just to withstand these shocks, but also to support the real economy if a stress does materialise.

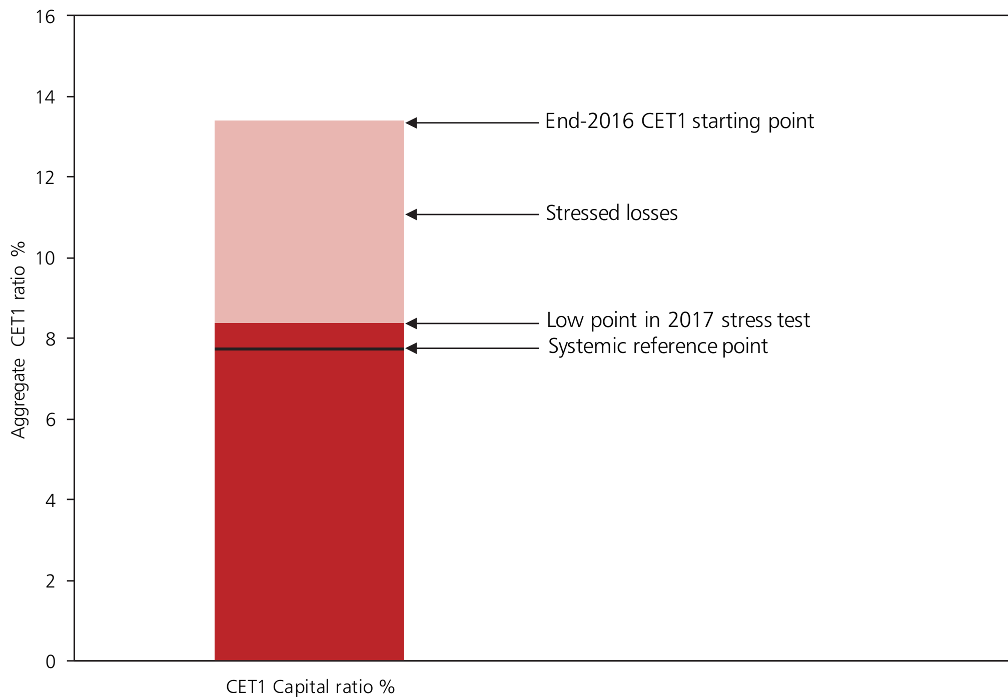
3.16 The 2017 stress tests explored a cyclical scenario more severe than the global financial crisis, and showed that for the first time since they were introduced in 2014, no bank needed to strengthen its capital position as a result of the stress test. Chart 3.B shows banks' aggregate capital positions before the 2017 stress test, the stressed losses they incurred in the stress test, and the CET1 capital low point in the stress test. As the chart demonstrates, the low point in the stress test exceeds the systemic reference point, which is the point used to judge whether banks need to take action to improve their capital positions. The systemic reference point is made up of banks' minimum capital requirements, plus a buffer to reflect individual banks' systemic importance.

3.17 The Bank of England's approach to stress testing will continue to evolve to ensure the banking system maintains its resilience to severe shocks. For

[8] Record of the Financial Policy Committee Meeting, March 2017

example, the 2018 stress test will hold banks of greater systemic importance to higher standards, and incorporate buffers to capture both the domestic and global systemic importance of individual banks.

## Chart 3.B: UK banks' resilience to the 2017 stress test




Source: Bank of England Financial Stability Report November 2017

## Tackling misconduct and unacceptable pay practices

3.18 As part of the work to reduce the likelihood of a financial crisis occurring, the government has acted to improve conduct and behaviour in the financial sector, establishing the FCA as a dedicated conduct regulator. The government has also enacted other reforms such as the Senior Managers and Certification Regime (SMCR). The SMCR is aimed at changing behaviours and culture within firms by ensuring individual accountability for misconduct, with enforcement powers acting as a deterrent. It places a duty on all senior managers to take reasonable steps to prevent misconduct in their areas of responsibility, and hold them to account for any misconduct that occurs on their watch. It also sets rules of conduct that apply to all individuals working in the financial sector at any level. The SMCR has applied to all banks, building societies, credit unions and dual-regulated (FCA and PRA regulated) investment firms since 2016, and is being extended to all other financial services firms.

3.19 The Parliamentary Commission on Banking Standards[9] highlighted inappropriate incentives, including pay, as having played a role which contributed to the financial crisis. Since the crisis, the UK has been at the forefront of global efforts to tackle unacceptable pay practices in the banking sector. This has included putting in place a framework that has led to a restructuring of pay, including a significant reduction in cash bonuses, and a better alignment of risk and reward in the financial sector. Firms are

[9] Parliamentary Commission on Banking Standards, parliament.uk

required to put in place policies to defer, reduce, cancel or clawback bonuses in the event that poor performance or misconduct comes to light and the government expects firms to be proactive in their application of these policies.

3.20 The government continues to oppose binding caps on bankers' bonuses, which undermine responsibility and financial stability in the banking system. This is because caps on variable remuneration can push up fixed salaries and make it harder for regulators to make use of their supervisory toolkit, such as clawing back bonuses in the event of misconduct or other failings.

## Leading international cooperation

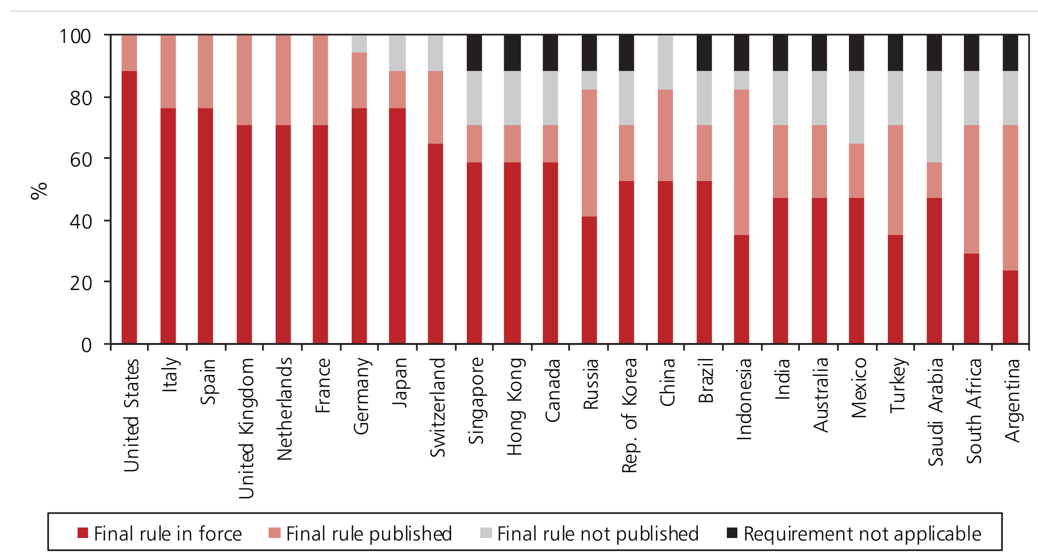
3.21 Alongside implementing comprehensive regulatory reforms domestically, the UK is a recognised global leader in the development of post-crisis reforms to financial regulation.[10] Through organisations such as the G20, Financial Stability Board (FSB), and the Basel Committee on Banking Supervision, the UK has led the way in a number of key reform areas, including on resolution regimes for systemic banks, building societies and central counterparties (CCPs). The UK has also shown leadership through the Fair and Efficient Markets Review and the Senior Managers regime on market conduct, influencing a new approach to codes of conduct that is being rolled out internationally.

3.22 The government remains committed to the full, timely and consistent implementation of reforms agreed among G20 countries, which has been varied across jurisdictions (Chart 3.C). Harmonised international standards are key to supporting financial stability and promoting an open and resilient global financial system. Most recently, the UK played a key role in the completion of the Basel III package of reforms, a cornerstone of post-crisis microprudential policy which includes measures to improve the stability and comparability of internationally-active banks and mitigate systemic risks.

3.23 As the UK prepares to leave the EU, it remains committed to the full, timely and consistent implementation of the Basel III package. The government will continue to support the work of the Bank of England at Basel and will continue to work with colleagues at the G20 to implement the reforms in a way that is proportionate and does not hinder competition.

[10] United Kingdom Financial Stability Assessment Program – Financial Stability Assessment, IMF, June 2016

## Chart 3.C: Implementation of key G20 financial sector reforms by FSB members




Source: Financial Stability Board Implementation of the G20 Financial Regulatory Reforms: Third Annual Report July 2017

3.24 The IMF's assessment of the UK's financial sector in 2016, as part of its Financial Sector Assessment Program (FSAP), found that the UK financial system is stronger, more resilient, and better able to serve the real economy since the previous FSAP in 2011.[11] The IMF highlight additional steps taken to enhance the governance and conduct of firms, including the government's decision to ringfence retail banking. As both home to a systemically important financial sector, and as a member of the FSB, the UK maintains its commitment to undergoing a stability assessment under the IMF's FSAP every five years. The UK will continue to support international surveillance by organisations such as the FSB and IMF, and their work to monitor and address new and emerging risks to the financial sector.

# Part II: Reducing taxpayer exposure

3.25 The UK's sizeable financial services industry brings great benefits to the UK economy and public finances. The sector represents a significant share of government tax receipts, with 18% of corporate tax revenues in 2016-17.[12]

3.26 While there are many advantages associated with the UK's financial sector, the FRR highlighted several risks relating to the taxpayer's exposure to the financial services sector, including the:

- scale of the UK banking sector as a share of the economy
- concentration of activity in a small number of large institutions
- government's reliance on the sector for tax revenue

3.27 Since the financial crisis, the government has taken a range of actions to mitigate taxpayer exposure to the financial sector. These actions are discussed further in this section and include:

[11] ibid

[12] HM Revenue & Customs, Corporation Tax Statistics 2017, HMRC, August 2017

- a resolution framework which ensures that firms' shareholders and creditors rather than taxpayers bear the costs of a firm failing
- a new ring-fencing regime to protect taxpayers from failing firms
- work to diversify the sector through promoting competition in banking and Fintech
- changes to bank taxation to incentivise banks to move away from riskier funding models, and to ensure the sector makes an additional contribution to reflect the unique risks it poses to the UK economy

## Managing the failure of financial sector firms

3.28 During the financial crisis, a number of governments bailed out failing financial firms to prevent excessive disruption to the critical functions that these institutions provide and to the wider financial system. The UK intervened in several institutions and is still recovering the costs (see Box 3.A).

3.29 Following the crisis, the government and UK authorities have implemented a comprehensive bank resolution regime which provides the Bank of England, PRA, FCA, and the Treasury with tools to manage the failure of financial sector firms. This includes powers for the Bank of England to 'bail in' shareholders and creditors of banks that have failed and to recapitalise the firm using the firm's own resources. This means that shareholders and creditors, rather than taxpayers, bear the costs of a firm failing. UK banks are issuing substantial amounts of loss-absorbing debt instruments suitable for this purpose to meet the Bank of England's minimum requirement for own funds and eligible liabilities (MREL).

## Separation of retail and investment banking

3.30 Following the global financial crisis, the government established the Independent Commission on Banking. The Commission's central recommendation led to the development of legislation in the Financial Services (Banking Reform) Act 2013 that required UK banks to separate the provision of core retail services from other activities within their groups, such as investment and international banking. These requirements are known as structural reform or ring-fencing and are a vital piece of the post-crisis reform architecture.

3.31 The ring-fencing regime applies to UK banks with retail deposits totalling more than £25 billion.[13] Deposits from UK individuals and small business must be inside the ring-fence, while most exposures to financial institutions and trading activities should be outside. Other activities, notably corporate banking, may sit on either side.

3.32 Ring-fencing supports financial stability and protects the taxpayer by:

- insulating retail and small business deposits and payments services (known as 'core services', whose continuous provision is essential to the economy) from shocks originating elsewhere in the global financial system

[13] Structural Reform, Bank of England, www.bankofengland.co.uk

- making banks that provide those essential services simpler and more resolvable, so core services can keep running even if a non-ring-fenced bank or the group fails

3.33 The restructuring process was an extensive undertaking. The largest firms used a court approved ring-fencing transfer scheme to move their assets and liabilities around their banking groups or to new entities authorised by the PRA. Banks have mostly implemented, and are due to complete by the summer of 2018, the movement of customers from one part of the bank to another in advance of the legislation coming into force. Firms made changes to over a million sort codes and joined both UK and international payment systems to facilitate operational separation. They also completed large technology migrations as part of the changes to their internal processes.

## Box 3.A: Recovering the cost of taxpayer bailouts

In 2008-09 the government undertook a number of interventions in the financial sector to protect the financial stability of the UK economy, disbursing £137 billion in cash. The government has received principal repayments of £92 billion and collected a further £21 billion through fees and dividends (Chart 6.I). The government remains committed to returning the financial sector assets acquired to private ownership, when it represents value for money to do so and when market conditions allow. The proceeds of these disposals are used to pay down the national debt.

As the OBR have set out in their 'Economic and fiscal outlook' (EFO), although the costs of these interventions were substantial, the economic and fiscal costs of not intervening, although difficult to quantify, would almost certainly have been greater.[14]

UK Asset Resolution (UKAR) was formed in 2010 to manage the closed loan books of Bradford & Bingley (B&B) and NRAM (formerly part of Northern Rock). Since 2010, UKAR has sold over £30 billion[15] of assets and reduced its balance sheet by 87%, from £116 billion to £14.5 billion in May 2018[16]. The government announced at Autumn Budget 2017 that it expects to divest its remaining B&B and NRAM assets by March 2021.

Following a first sale in September 2013, the government returned its stake in Lloyds Banking Group to full private ownership in May 2017. This recouped £21.2 billion for the taxpayer, including sales and dividends, representing almost £900 million more than the original intervention.[17]

In August 2015, the government undertook a first sale of Royal Bank of Scotland (RBS) shares, raising £2.1 billion for the taxpayer.[18] At Autumn Budget 2017, the government announced the intention to recommence the privatisation of RBS before the end of 2018-19, and to carry out a programme of sales expected to dispose of around £15 billion worth of shares by 2022-23. On 5 June 2018, the government concluded a second sale of its shareholding in RBS, restarting the phased return of the bank to full private ownership. The government sold approximately 7.7% of the bank, raising just over £2.5 billion for the taxpayer. This reduced the government shareholding to 62.4%, from 70.1% pre-sale.[19]

The impact on the government's balance sheet of these interventions is considered in Chapter 6 of this document.

14 'Economic and fiscal outlook – March 2018', OBR, 13 March 2018: paragraph 4.24.

15 HMT calculations, gov.uk

16 Press release, UKAR, 26 April 2018

17 'The return of Lloyds Banking Group to private ownership', NAO, June 2018

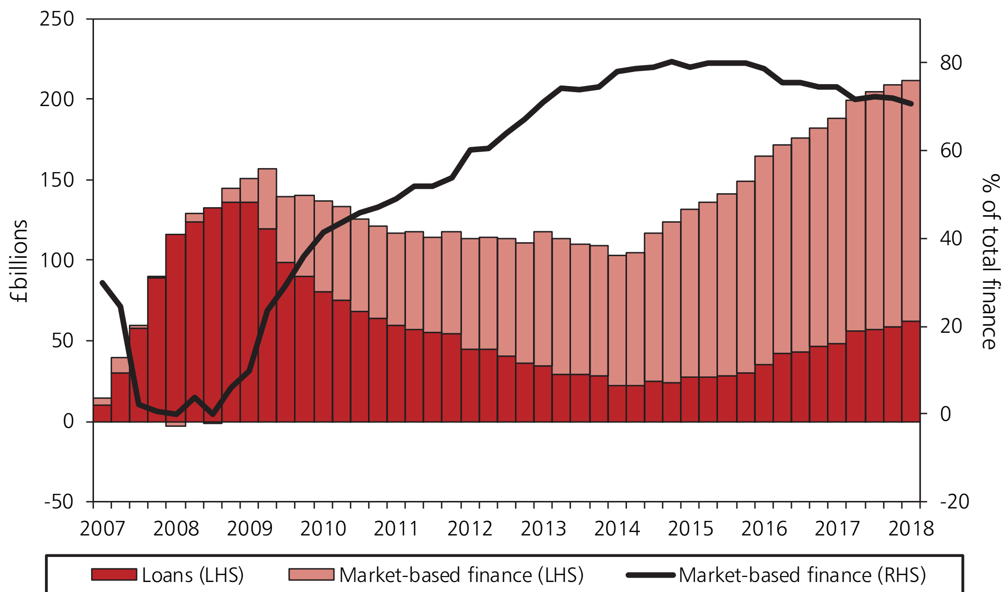
18 'Government begins sale of its shares in the Royal Bank of Scotland', gov.uk, August 2015

19 'RBS share sale returns £2.5 billion to UK taxpayers', gov.uk, June 2018

## Financial sector diversification

3.34 The UK's status as a global financial centre means that the sector is large compared with those of many other countries. The FRR highlighted the financial stability risks stemming from a concentrated banking sector. However, in the years since the financial crisis, the sector has diversified. This includes more market-based finance, a wider range of funding sources, and a reduced reliance on the UK banking system. As shown in Chart 3.D, over 70% of net finance raised by UK non-financial corporations since 2007 has been in the form of market-based finance, including bonds, equities, and commercial paper, rather than bank loans. Furthermore, the composition of the UK's financial system is relatively diverse compared to other countries with large financial sectors (see Chart 3.E). The FPC continues to monitor risks from the structure of the financial system, as highlighted in the most recent Financial Stability Report.[20]

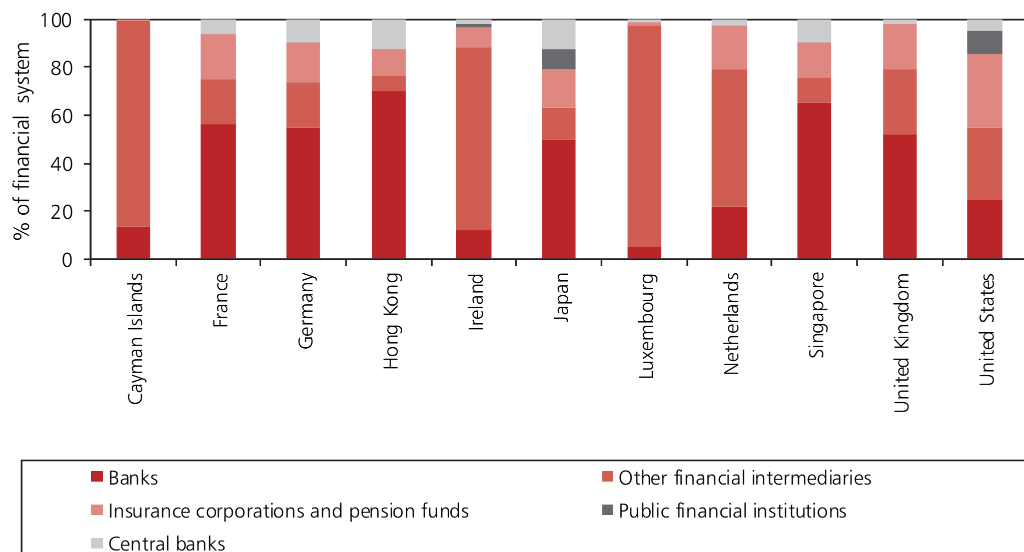
### Chart 3.D: Cumulative net finance raised by UK private non-financial corporations




Source: Bank of England, Capital Issuance Statistics, April 2018

20 'Financial Stability Report', Bank of England, June 2018

## Chart 3.E: Composition of the financial system among selected countries




Source: Financial Stability Board, Global Shadow Banking Monitoring Report 2018

3.35 The government has acted to promote greater competition in financial services, to promote innovation, reduce financial concentration, and enhance market resilience. The government has embedded competition objectives in the FCA and PRA, who set up the New Bank Start-up Unit to help prospective new banks enter the market and through the early days of authorisation. Since 2013, the PRA has authorised 16 new UK banks, increasing the competitive pressure on the UK's biggest banks. The government also created a dedicated economic regulator for payments – the Payment Systems Regulator (PSR) – the first of its kind worldwide. The PSR opened in 2015 with statutory objectives to promote competition, innovation, and the interests of end-users.

3.36 The government set up the Competition and Markets Authority (CMA) in 2013 as a single, stronger competition regulator. The government has welcomed the CMA's 2016 report on its retail banking market investigation as an important step towards the goal of a highly competitive banking system.

3.37 To further diversify the financial sector, the government has also taken direct action to stimulate competition in the SME lending market with two structural interventions. The Bank Referral Scheme gives SMEs who do not meet their bank's risk appetite the opportunity to be referred to 'finance platforms' who can match them with alternative providers. The Commercial Credit Data Sharing scheme allows alternative finance providers to access a wider range of SME credit information than previously.

3.38 FinTech – technology-driven innovation across financial services – has the potential to reduce the economy's reliance on the banking sector and diversify the financial sector, reducing concentration. In 2016 peer-to-peer

lending to businesses was the equivalent of 7% of all new loans by UK banks to small businesses.[21]

3.39 The government has taken a wide range of action to support the FinTech sector, including giving the FCA a strong competition objective, resulting in the Innovation Hub and Regulatory Sandbox to support firms. It also includes creating a new Payments Systems Regulator, taking action to level the playing field with incumbent financial services firms, and establishing international 'Fintech bridges' with countries such as China, South Korea and Singapore. The government is committed to ensuring that the UK remains the best place in the world for Fintech, and the new Fintech Sector Strategy, published in March, sets out how it intends to ensure that this remains the case.

3.40 Finally, the asset management industry also plays an important role in the efficient allocation of capital within the economy and supports the development of capital markets as the principal means of non-bank funding available to businesses. With the publication of the Investment Management Strategy II in December 2017[22], the government is playing an active role in supporting the industry to fulfil its role in the economy by strengthening the talent pipeline, working with industry to seek out international opportunities, and establishing the asset management taskforce.

## The taxation of financial services sector

3.41 The government recognises the significance of the financial services sector to the UK economy and public finances. However, given the risks financial services firms, especially those in the banking sector, pose to the UK economy, the government believes that they should make an additional contribution to public finances. As part of this, in 2011 the government introduced the Bank Levy on the balance sheet liabilities of banks and building societies. The Bank Levy was designed to create appropriate incentives to encourage banks to move away from riskier forms of funding by charging a bank's short term funding arrangements at the highest rates, and therefore encouraging funding from more sustainable long term sources.

3.42 In 2015 and 2016 the government announced a package of reforms to bank taxation which took account of recent international regulatory changes while continuing to secure the additional contribution from banks. These banking tax reforms shifted the tax incidence from bank liabilities towards banking profits and included an 8% Corporate Tax surcharge on banking profits over £25 million. This shift in taxation away from a bank's balance sheet towards taxing profits means that the recovery in banks' profitability will be reflected in the Exchequer's tax receipts (see Chart 3.F), while also ensuring a sustainable long term basis for raising revenues from the sector.

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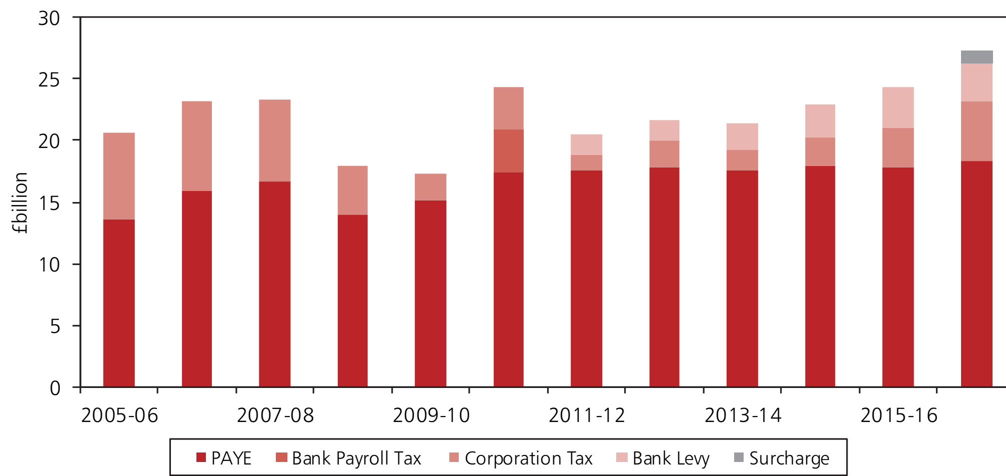
21 'Entrenching Innovation: The 4th UK Alternative Finance Industry Report', University of Cambridge, December 2017

22 'The UK Investment Management Strategy II', HM Treasury, December 2017

## Chart 3.F: Tax revenues from the banking sector




Source: HMRC Pay-As-You-Earn and Corporate Tax Receipts from the Banking Sector 2017

### Box 3.B: Brexit and financial services

The FRR highlighted a number of potential risks to the public finances related to the impact of EU exit on the UK financial sector. This includes the risk of financial services firms relocating activities and staff from the UK to the EU in order to maintain access to the European market, the economic and fiscal costs of the fragmentation of European financial market, and risks associated with disruption of cross-border banking and insurance flows at the point of exit.

To minimise the risks to the financial system around the point of the UK's departure from the EU, the government has:

- **reached agreement with the EU for an implementation period** which will allow financial services firms to plan on the basis that they can continue to operate as they do now through to the end of 2020
- **committed to bring forward legislation,** if necessary, to enable EEA financial services firms and funds that use a passport to obtain a 'temporary permission' from UK regulators to continue their activities in the UK for a limited period after exit day and ensure a functional legal framework is in place. The Treasury set out its approach to fixing EU legislation under the EU Withdrawal Act on 27 June
- **established a joint technical working group on risk management** with the European Central Bank and Bank of England in the period around 30 March 2019
- **set a clear vision** for our future relationship with the EU on financial services, which should prioritise financial stability, preserve cross-border economic integration, and be grounded in regulatory and supervisory cooperation
- **set out a plan** for capitalising on the UK's world-leading position in financial services post-Brexit, at the heart of which is a new approach to the UK's global engagement – 'Global Financial Partnerships' (GFPs) with key jurisdictions

## Part III: Enhancing cyber resilience

3.43 The FRR highlighted the growing risk to the financial sector from cyber attacks. They highlight that cyber attacks could lead to instability by disrupting the economy's key intermediary and payment functions. They also cite the potential for a cyber attack to negatively impact banks and their customers with implications for wider confidence in the financial sector.

3.44 HM Treasury works together with the other UK financial authorities, the Cabinet Office, the National Cyber Security Centre (NCSC) and the National Crime Agency to improve cyber resilience across the financial sector. These bodies continue to drive forward a capability-building work programme for the sector and the financial authorities, and to test and refine their incident response frameworks for when incidents do occur.

3.45 Over the past year, the financial sector has continued to make progress in improving its cyber resilience, reflecting firms' ongoing investment. Over 30 firms have undergone bespoke intelligence-led penetration testing known as CBEST and have acted to remediate the issues identified.[23] The financial authorities will continue to develop tools to deliver improved resilience, including by drawing on the expertise of NCSC.

3.46 Given the interconnectedness of global markets, HM Treasury, alongside the other UK financial authorities, also works closely with our international partners. The UK plays an active role in the G7 and FSB to understand the evolving risks to the global financial system and explore what cross-border collaboration may be possible to mitigate them.

3.47 Threats to the financial services infrastructure can also disrupt the flow of public funds which rely on these networks to collect revenue, make payments, and account for those transactions. Risks to the flow of public funds are managed by the Public Finances Business Continuity (PFBC) group. The group is chaired by HM Treasury and comprises representatives from the Bank of England, Government Banking Service, DMO, the NAO and HMRC. The group meets quarterly to discuss potential business continuity risks, learn lessons from recent incidents, and agree and monitor actions to strengthen collective resilience.

3.48 Within the PFBC cyber risk is regarded as a serious risk with resource coordinated across stakeholders to reduce the likelihood of crystallisation, and to minimise and manage any impacts. A sub-group, the Information Security Group, has been established with additional membership from NCSC to focus on current and emerging cyber threats that could disrupt the public finances. This informs the test strategy and response mechanisms of all members in order to improve the cyber resilience of public funds processes.

3.49 The PFBC plans to develop and deliver a cross-PFBC cyber security based exercise in Q4 2018. It will focus on operational resilience in the event of a critical banking infrastructure failure.

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23 'Financial Stability Report', Bank of England, June 2017

# Chapter 4
# Revenue

4.1 The government is committed to a tax system which supports living standards and economic growth, ensures that everyone pays their fair share of tax, and continues to raise the revenues to fund our public services. This requires the government to understand emerging risks to the tax system and take action to address them.

4.2 While the most significant risks to tax revenues are associated with macroeconomic shocks, discussed in Chapter 2, there are also pressures coming from economic, technological, and behavioural trends which may erode the tax base over the medium and long-term. These pressures include structural changes in the economy, improvements in vehicle technology, and tax avoidance, evasion and non-compliance. The government monitors the fiscal impact of these trends and aims to update the tax system where appropriate. Moving forwards, the government will ensure the tax system keeps pace with the rise of digital technologies and harnesses innovation to improve the administration of the tax system.

4.3 The government is also putting the policy-making framework in place to help ensure tax sustainability. Moving to a single annual fiscal event means that individuals and businesses face less frequent changes to the tax system, helping to promote certainty and stability. The new timetable ensures that legislation is announced well in advance of the start of the tax year, while allowing time for extensive policy consultation.

4.4 This chapter considers how the government is managing specific risks to tax receipts to ensure sustainability of funding for public services:

- Part I outlines how the government is adapting the tax system to structural changes in the economy
- Part II highlights the government's actions to ensure that everyone pays the taxes which are due while minimising the burden of compliance
- Part III addresses the government's strategy for working with industry to assess and reduce costs associated with oil and gas decommissioning

4.5 In June 2018, the government announced a new spending settlement for NHS England, outlined in Chapter 5, providing average growth of 3.4% a year in real terms over the next five years. The government will fund this five-year commitment while continuing to meet its fiscal rules and reduce debt. As the Prime Minister has said, this will be partly funded by lower contributions due to the European Union. In addition, she has made clear

that taxpayers will need to contribute a bit more in a fair and balanced way. The Chancellor will set out more details at future fiscal events.

## Part I: Adapting to a changing economy

4.6 In the FRR, the OBR identified a number of risks to tax receipts associated with structural changes in the UK economy including:

- narrowing of the personal tax base due to structural changes in the labour market and increases in the personal allowance
- wider changes to the composition of GDP, including between capital and labour
- pressures on alcohol, tobacco and fuel duty receipts such as behavioural and technological changes together with duty freezes

4.7 To address these risks, the government is ensuring that the tax system keeps pace with wider changes in the economy to provide sustainable funding for public services, including by:

- continuing to monitor the impact of different ways of working on revenues
- countering global avoidance and profit-shifting strategies as well as working towards reforms to ensure that profits are taxed where a company creates value
- using digital technology to improve tax data and collection

4.8 In some cases, it may be right to accept narrowing in the tax base to pursue other goals. For example, the government's efforts to reduce smoking have helped many enjoy better and longer lives, while increases in the personal allowance and freezes in fuel duty have supported living standards.

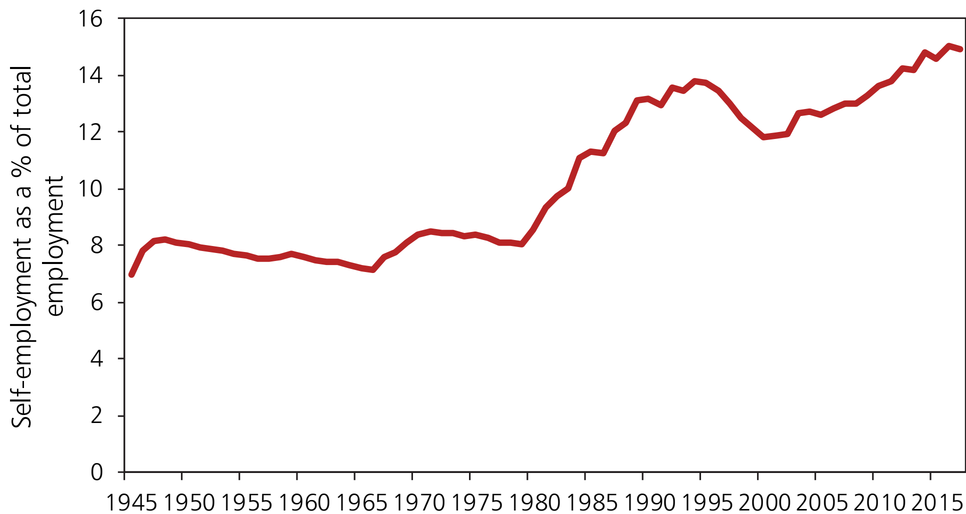
4.9 Technological and economic change will undoubtedly have further impacts on the tax system beyond those identified in the FRR, and whose scale and speed of diffusion are hard to predict. These may include, for example, the development of artificial intelligence and adoption of increasing automation within new sectors of the economy, or the wide applications of distributed ledger technologies. The government will seek to ensure that the tax system plays an appropriate role in supporting beneficial change, while continuing to provide sustainable funding for public services. It will also use innovation to improve the administration of the tax system as highlighted in Part II.

### Different ways of working

#### Trends in the labour market

4.10 While the overall share of labour income in the economy has remained broadly stable, the ways in which people are providing that labour are evolving. The past few decades have seen significant growth in self-employment. Since 1980, the proportion of the workforce who are self-employed has increased from 9% to 15%, as shown in Chart 4.A.

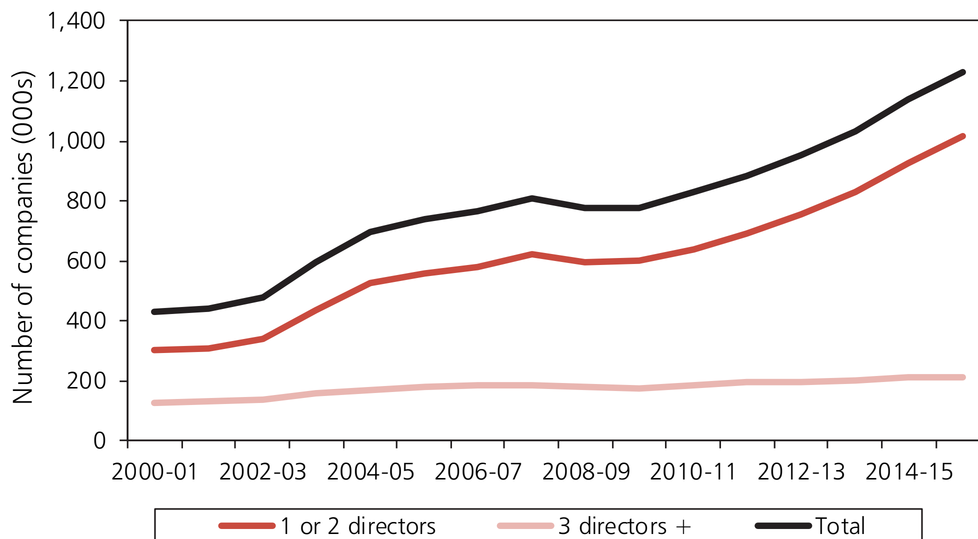
## Chart 4.A: Self-employment in the workforce[1]




Source: 'A Millennium of Data', R. Thomas and N. Dimsdale, Bank of England, 2017 and ONS.

4.11 The last twenty years have also seen a steady increase in the number of people working through small companies. Since the early 2000s, the number of companies with one or two directors has risen from less than 400,000 to over one million, as shown in Chart 4.B.

## Chart 4.B: Small companies in profit[2], by number of directors[3]




Source: HMRC

## Drivers and impacts of trends

4.12 These labour market trends are partly driven by changes in technology, in society, and in the economy. In some cases, changing labour market conditions can bring benefits to individuals, giving them greater choice over how they structure their work, or the opportunity to follow an ambition to

[1] Note: The self-employed here will include company owner-managers.

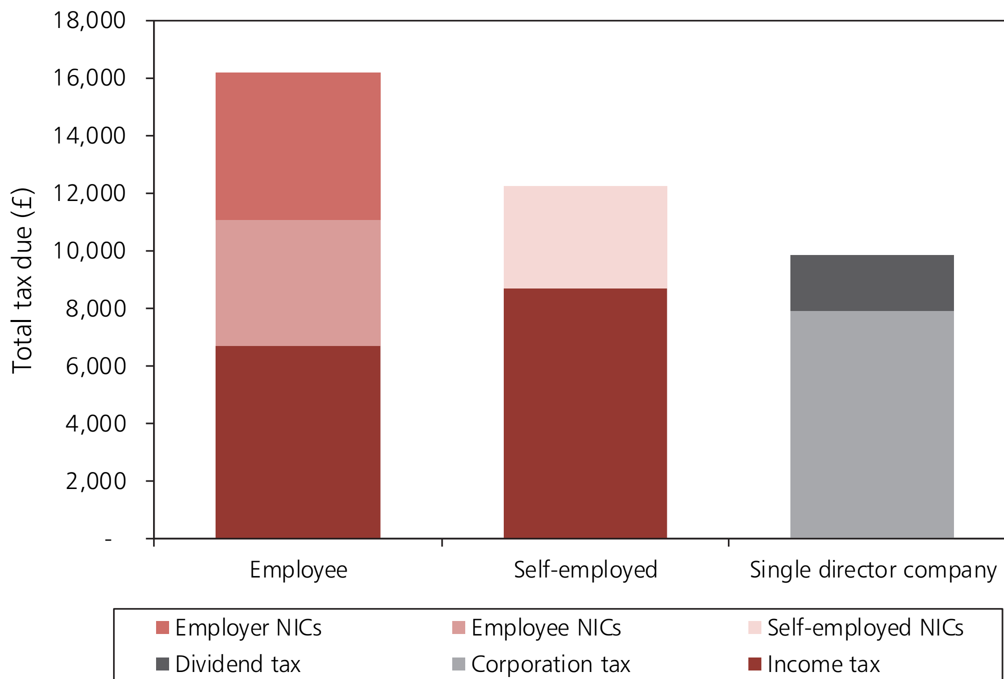
[2] This population is defined as companies with positive trading profits (after losses carried forward) of up to £500,000 (in 2014 prices).

[3] "Director" here includes any additional person appointed as company secretary

work for themselves. New businesses can emerge which may grow and develop – in turn – into employers themselves.

4.13 As the OBR has highlighted, the tax system also creates incentives for companies and individuals to work in a way that limits tax liability. For example, Chart 4.C shows the FRR's illustration of how much of a £50,000 income or salary cost is paid in tax or NICs, depending on whether the work is carried out by an employee of a medium-sized company, a self-employed individual, or a single-director company. The chart shows that the employee faces the largest tax burden, paying 32.3% of the £50,000 income in tax or NICs, compared to 24.5% for the self-employed individual and 19.7% for the sole director of his or her own company. As Chart 4.B shows, the growth in companies with 1 or 2 directors coincided with the introduction of a 0% rate of Corporation Tax in the early 2000s.[4]

## Chart 4.C: Tax due on £50,000 of income in 2017-18




Source: OBR Fiscal risk report

4.14 As the FRR highlights, these differences in tax treatment combined with labour market changes have a significant fiscal impact, especially if the increase in the share of workers running their own business is not associated with workers becoming more productive. The OBR also note the implications they have for individuals, who can pay very different amounts of tax while doing very similar work. The difference in tax and NICs treatment between the employed and self-employed is estimated to cost the Exchequer £4.1 billion annually.[5] The FRR also states that further increases in self-employment are expected to reduce receipts by £1 billion more a year by 2021-22. The cost to the public finances of those already working through a

[4] In 2000, the Corporation Tax rules were changed so that small companies with profits of less than £10,000 paid a reduced starting rate of Corporation Tax which fell to 0% between 2002 and 2006 before being withdrawn.

[5] 'Estimated costs of principal tax reliefs', HM Revenue & Customs, May 2018

company structure will be £6.6 billion in 2022-23.[6] The OBR has estimated that if current trends in the growth of incorporation continue, this cost will increase by a further £2.6 billion annually by 2022-23.[7]

## Updating the tax system

4.15 The tax differentials outlined above put pressure on the boundaries in the tax system between different forms of labour. The government is taking action to strengthen these boundaries.

4.16 In July 2017, a review headed by Matthew Taylor[8] highlighted that a lack of clarity in the current rules on employment status can lead to miscategorisation, impacting on the rights individuals receive and the taxes they pay. In response to the review, the government has consulted and is now considering how reform to the employment status rules could improve clarity, including to ensure those who ought to be employees are taxed in the correct way.

4.17 The government is also strengthening boundaries in the tax system by tackling disguised employment where an individual is operating through a company structure but would be classed as employed if they provided their services directly to their engager. Off-payroll working rules (commonly known as IR35) are designed to prevent individuals from sidestepping employment taxes by working through their own company. Without these rules, two individuals doing the same work but structured in different ways could end up paying very different taxes. The rules have been in place for 20 years, but non-compliance with these rules in the private sector is estimated to cost taxpayers £1.2 billion a year by 2022-23,[9] making up part of the estimated cost to the public finances from people working through a company structure.

4.18 In 2017, the government reformed the off-payroll working rules to address non-compliance in the public sector. Government analysis suggests these reforms have been successful in improving compliance.[10] In May 2018, the government launched a consultation on options to improve compliance in the private sector, including (but not limited to) extending the reforms made to the public sector.

4.19 As set out in the government's response to the Taylor Review, the government has no plans to revisit the difference in rates of NICs paid in respect of employees and the self-employed. However, the government has taken action to reduce the fiscal costs from increased incorporation. In April 2016, the government reformed the taxation of dividend income by increasing dividend tax rates by 7.5 percentage points alongside the

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[6] Source: HM Revenue & Customs. This cost estimate is the difference in estimated tax receipts from the population of companies owned by individuals that have a genuine choice over their legal employment status – namely, those with trading profits below £500,000 in 2014 prices – and the counterfactual of these individuals operating as unincorporated self-employed or as employees. The employee population of this counterfactual is the estimate of contractors who are non-compliant with the IR35 off-payroll working rules, all others are considered self-employed in this counterfactual.

[7] Source: HM Revenue & Customs. This cost is relative to if the company population grew in line with the employment population.

[8] 'Good Work: The Taylor Review of Modern Working Practices' an independent review of modern working practices by Matthew Taylor, May 2018

[9] 'Off-payroll working in the private sector', HM Treasury and HM Revenue & Customs, May 2018

[10] 'Off-payroll working in the private sector', HM Treasury and HM Revenue & Customs, May 2018

introduction of a tax-free dividend allowance. In April 2017, the government took a further step by reducing the dividend allowance from £5,000 to £2,000.

4.20 The government will continue to monitor changes in the labour market and their impact on tax receipts. Any future policy proposals will be guided by considerations of fairness, fiscal sustainability and promoting productivity and economic efficiency.

## Taxing corporations in a new global, digital economy

4.21 The government is working to ensure that multinational and digital companies are taxed fairly and sustainably as digitalisation and globalisation continue transforming the economy. This has involved action to counter global avoidance and profit-shifting strategies as well as working towards reforms to ensure that profits are taxed where a company creates value.

### Countering avoidance and profit shifting

4.22 The Diverted Profits Tax (DPT), which came into effect in 2015, counters aggressive tax planning by large multinational companies. The DPT targets contrived arrangements that erode the UK tax base. The DPT raised £281 million[11] in 2016-17, both directly and through increased corporation tax receipts from groups changing their behaviour.

4.23 This government has been at the forefront of the Base Erosion and Profit Shifting (BEPS) Project, looking at aggressive tax planning strategies that exploit tax rules to artificially shift profits to low or no tax jurisdictions where there is little or no economic activity. Following the conclusion of the BEPS Project, in 2015, the government introduced Corporate Interest Restriction (CIR) rules to limit the amount of interest expense that a corporate group can deduct against its taxable profits. The CIR rules will raise an estimated £1 billion per year from multinationals and other large companies.[12]

### Corporate tax and the digital economy

4.24 The government supports the principle underlying the BEPS project that company profits should be taxable in the location where a company creates value. This principle is especially important to how corporations are taxed in the digital economy. At Autumn Budget 2017, the government published a position paper, 'Corporate tax and the digital economy', [13] setting out how the current system fails to recognise the fact that the active participation of users creates value for certain digital business models. This means that the user jurisdiction does not have the right to tax companies' profits, even though significant value is created there. This poses risks to the fairness and sustainability of the corporate tax base given the growing economic significance of the digital economy. The government published an update on

[11] 'Transfer Pricing and Diverted Profits Tax Statistics', HM Revenue & Customs, September 2017

[12] 'Corporation Tax: tax deductibility of corporate interest expense', HM Revenue & Customs, December 2016

[13] 'Corporate tax and the digital economy: position paper, HM Treasury, November 2017

this position paper at Spring Statement 2018 setting out its views in more detail.[14]

4.25 The government is leading international efforts to tackle this issue. The UK is part of the OECD's Task Force on the Digital Economy, which published its interim report in March, discussing value creation in the digital economy and the principles that could guide short-term policy action. Member countries also reached agreement on the need to review important elements of the international tax system, with the aim of reaching a consensus-based solution by 2020. The UK also remains engaged at the European level, where possible measures are being considered. Ultimately, the best solution to this problem will be reform of the international tax rules, so that the contribution of users is recognised. The government has discussed in its position papers how this might be achieved through changes both to the definition of a permanent establishment and to transfer pricing rules which govern how profits are attributed to different entities within a multinational group for tax purposes.

4.26 However, the government recognises that this international reform may take time and is exploring interim measures such as a revenue-based tax. This would seek to compensate countries for the value created by user participation within their borders and address the fiscal risks posed by inaction. An interim tax will be most effective if implemented multilaterally, and the UK is cooperating with its international partners, including in Europe, to consider how such a measure could be designed.

4.27 This tax would be targeted at those business activities that depend most on the contribution of users, and so where there is the greatest scope for mismatch between value creation and the location of taxable profit. Any measure will need to be developed with important policy and legal considerations in mind. While both an interim measure or reform of the international tax rules will play an important part in ensuring the sustainability of the corporate tax system, neither is likely to substantially alter the tax mix in the short-term, and other forms of business taxation will remain important.

## Increasing the Personal Allowance

4.28 The FRR noted that the government's policy to increase the Personal Allowance (PA) has reduced the income tax base. Since 2010-11, the government has chosen to increase the PA faster than inflation in every year until 2018-19, and it has risen from £6,475 to £11,850. This has supported living standards, by giving 31 million people a tax cut and taking over a million of the lowest paid out of income tax altogether, compared to 2015-16[15], supporting working families to keep more of what they earn.

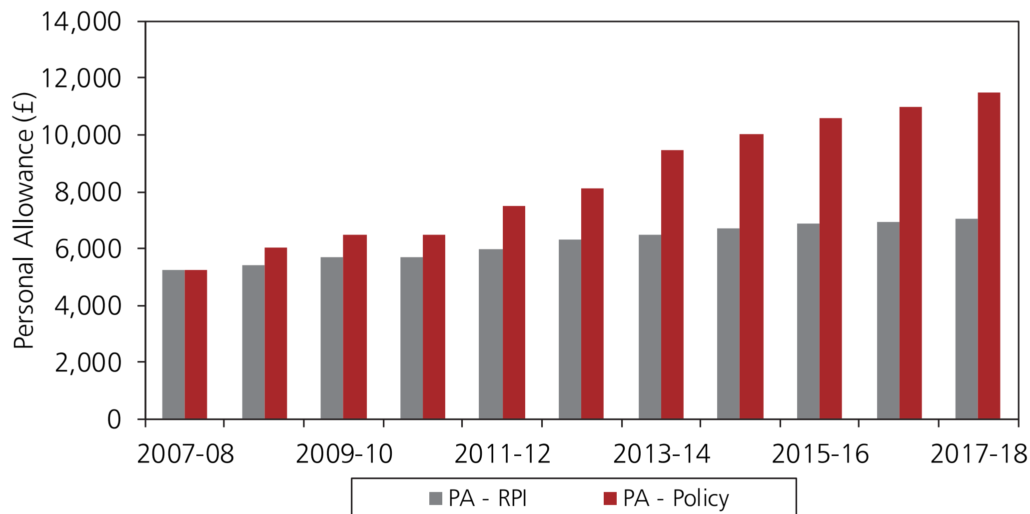
4.29 These above-inflation increases have supported living standards by taking the lowest paid out of income tax, and reducing the tax liability of lower and

[14] 'Corporate tax and the digital economy: position paper, HM Treasury, November 2017

[15] HM Revenue & Customs analysis, based on Survey of Personal Incomes (SPI) 2014-15 data, and Autumn Budget 2017 OBR forecasts. Compares actual tax liability and number of taxpayers in 2018-19 versus a scenario where the PA increased with CPI from 2015-16.

middle earners. As a result, in 2017-18, a typical basic rate taxpayer will have paid £1,255 less in income tax than in 2007-08.[16] The actual path of the PA, versus its path if it had increased with RPI since 2007-08, is shown in Chart 4.D.

## Chart 4.D: Personal Allowance: policy and RPI




Source: HMT analysis, based on ONS outturn RPI data

4.30 The government has also increased the Higher Rate Threshold above inflation in order to support individuals to move up the earnings scale and reduce the number of taxpayers who pay the higher rate of tax. Over 500,000 individuals will be taken out of the higher rate of tax in 2018-19, compared to 2015-16.[17]

4.31 The FRR points out that these changes have had an impact on the fiscal position, the number of income taxpayers and the progressivity of the tax system. In particular:

- the policy to increase the PA has had a significant impact on income tax receipts. It is estimated that PA policy decisions since 2010 and the government's plan to get the PA to £12,500 will have reduced income tax receipts by around £24 billion (1% of GDP) by 2020-21, compared to a 2010-11 inflation baseline[18]
- successive PA increases have meant that the proportion of adults paying income tax has fallen. The proportion of the working age population paying income tax has fallen from 66% in 2007-08 to 59% in 2017-18[19] and the absolute number of income taxpayers has fallen from 31.3 million

[16] HM Treasury analysis

[17] HMRC analysis, based on Survey of Personal Incomes (SPI) 2014-15 data, and Autumn Budget 2017 OBR forecasts. Compares actual number of higher rate taxpayers in 2018-19 versus how many there would have been if the Higher Rate Threshold increased with CPI from 2015-16.

[18] HMRC analysis based on SPI 2015-16 and OBR data, comparing a PA of £12,500 in 2020 with a baseline of RPI, which was the inflation policy in 2010-11. As announced at Budget 2011, the indexation of income tax thresholds was changed from RPI to CPI once the PA reached £10,000, starting from 2015-16. This is in line with the indexation of other direct tax thresholds.

[19] HMT analysis based on taxpayer numbers from Table 2.1 in HMRC's 'Income Tax statistics and distributions' publication, May 2018 and ONS population statistics.

in 2010-11 to 31 million in 2018-19,[20] despite the population growing during this period

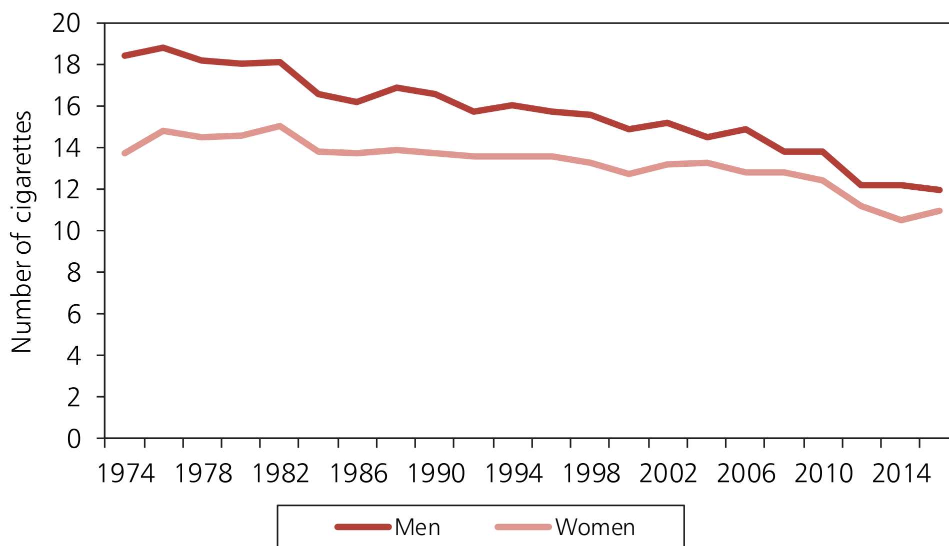
- there has also been a change in the distribution of income tax receipts, with a growing proportion of income tax receipts coming from higher earners. In 2007-08, the top 50% of income taxpayers paid 89.6% of all income tax and the top 1% paid 24.4%. In 2017-18 the top 50% is forecast to pay 90.4% and the top 1% forecast to pay 27.8%[21]

## Pressures on duties

### Tobacco duties and smoking

4.32 The FRR notes that tobacco clearances have been on a downwards trend for years, reflecting the decline in smoking prevalence, and the amount of tobacco people smoke. This has been a continuing trend, though the FRR acknowledges there is uncertainty around the effects of the factors that contribute, such as increased duty, regulatory change and attitudes to smoking.

**Chart 4.E: Average daily consumption of cigarettes among smokers**




Source: ONS data

4.33 Smoking among adults in England has fallen from 20% in 2010 to 16% in 2016 according to the latest ONS data.[22] As Chart 4.E, the average daily consumption has also fallen. This is influenced in part by new products (e.g. e-cigarettes) as well as tighter regulation and the impact of the tobacco duty escalator. The number of cigarettes released for consumption has declined by, on average, two billion each year between 2013-14 and 2017-18,[23] while the volume of hand rolling tobacco released has seen a more gradual

[20] Taxpayer numbers from Table 2.1 in HMRC's 'Income Tax statistics and distributions' publication, May 2018, population figures from the ONS (England and Wales), National Records of Scotland and Northern Ireland Statistics and Research Agency.

[21] Table 2.4, 'Income Tax statistics and distributions', HMRC, May 2018

[22] 'Adult smoking habits in the UK: 2016', ONS, June 2017

[23] 'HMRC Tax and Duty Bulletin: Tobacco', HMRC, April 2018

decline. This is in keeping with broader tobacco market trends of consumers swapping to cheaper products.

4.34 The government is committed to reducing smoking prevalence through its control plan, 'Towards a smoke-free generation'. [24] The government has also committed to continuing the tobacco duty escalator (RPI + 2%) until the end of this Parliament and duty rates are reviewed at each Budget to ensure they continue to meet revenue and public health objectives.

4.35 At the same time, the government is prepared to adapt the tax system to new technologies in smoking. In July 2018, the government published draft legislation, committing to creating a new category for heated tobacco products within the duty regime.[25] The government's aim is to ensure the integrity of the duty system as the market for these products develops and the government will continue to monitor the sector to consider such innovations.

## Developments in vehicle technology

4.36 The FRR highlights that, in the long-term, revenues from fuel duty will decline as vehicles switch from liquid fuels to electric power and become more efficient. At the time, the OBR forecast that fuel clearances per mile driven will fall by 2.5% a year on average in the next five years. This is not solely because of the uptake in Ultra Low Emission Vehicles (ULEVs), but also a result of improvements in internal combustion engines and a shift to lighter vehicles, aided by government policies such as the plug-in grant scheme and the ambition to meet UK carbon budgets. The government recognises that these changes may impact tax revenues, but it believes fuel duty will continue to have an important role in the tax system.

## Uprating of duties

4.37 The OBR have highlighted that duty freezes have real fiscal costs, compared to the counterfactual of keeping pace with inflation. With each freeze the government forgoes tax revenues, and this can have direct trade-offs when it comes to public spending decisions on services we value. Any gaps in funding for essential services then have to be financed from elsewhere and, as demand for public services increases, so do these funding pressures.

4.38 To support families and businesses, since 2011 the government has taken the decision at each annual Budget to freeze fuel duty rates, saving the average car driver a cumulative £850 by April 2019 compared to what they would have paid under the pre-2010 escalator.[26] The announced freezes to fuel duty have meant the Exchequer has not collected around £46 billion in revenues through 2018-19, and a further £38 billion of revenues will be foregone over the forecast period as a result of these previously announced freezes. The freeze at Autumn Budget 2017 cost £4.25 billion across the OBR forecast period.[27]

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24 'Towards a smoke free generation: tobacco control plan for England', Departmental of Health and Social Care, July 2017

25 Tobacco Duty on heated tobacco, HMRC, July 2018

26 HM Treasury calculations

27 HM Treasury analysis

4.39 The government has also supported the alcohol industry and local pubs by freezing alcohol duty at Autumn Budget 2017 and reducing duty on beer, spirits and most cider in 2015.

4.40 The government's stated policy, which the OBR uses for its forecasts, is that all duties continue to be uprated (along with several tax and duty rates) in line with inflation. As always, final decisions on tax rates are taken at fiscal events.

# Part II: Improving compliance and simplifying tax

4.41 In the FRR, the OBR also discusses the risks to tax revenues associated with the gap between taxes owed and actual receipts. In particular, the FRR highlights the:

- large tax gap for self-assessed income tax
- relatively uncertain impact of anti-avoidance and evasion measures
- growing volume and apparent complexity of tax legislation

4.42 The government recognises the need to continue to make progress in reducing the tax gap and simplifying the tax system. This section discusses the action it is taking to tackle taxing avoidance, evasion and other non-compliance as well as to simplify the tax system. While it is true that forecast revenues from these measures will be relatively uncertain, given the nature of some of the underlying behaviours, the OBR continues to view these estimates as appropriate and its analysis has not found any systematic bias.

## Tackling avoidance, evasion and non-compliance

### The tax gap

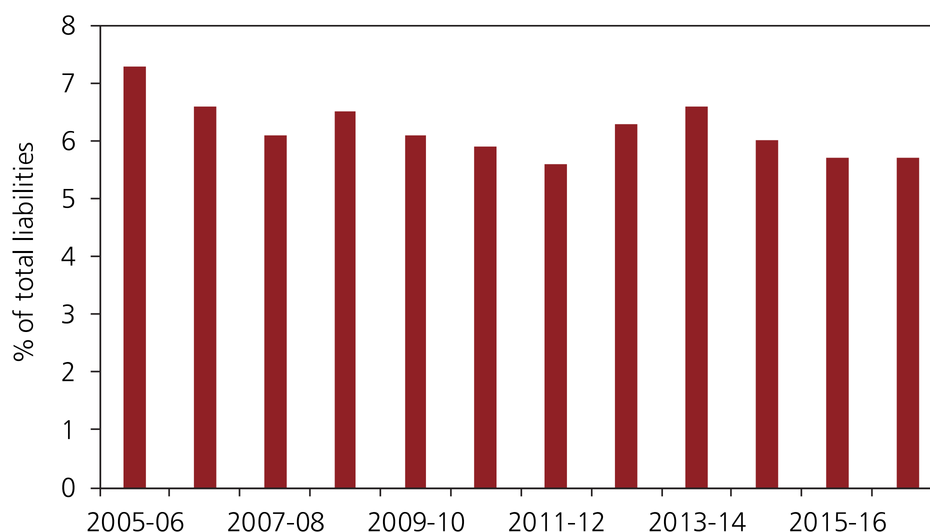
4.43 The government has a strong record of action to tackle tax avoidance and evasion. Over the past decade, the UK tax gap has fallen from 7.3% of total theoretical tax revenue in 2005-06 to 5.7% in 2016-17.[28] This success has been supported by HMRC's sustained efforts to help taxpayers get their tax right first time and their continuous activity to tackle non-compliance. Since 2010, HMRC have secured and protected over £175 billion of tax that would have gone unpaid.[29] This includes £900 million from the wealthiest individuals and £8 billion from the largest and most complex businesses operating in the UK in 2016-17 alone.[30]

28 'Measuring Tax Gaps 2018 Edition' Tax Gap Estimates for 2016-17, p4, HMRC, July 2018

29 HMRC calculations using HMRC Annual Reports 2010-11 – 2016-17 and HMRC quarterly performance updates for 2017-18 up to end of December 2017 (the latest quarter published)

30 'HMRC Annual Report and Accounts 2016-17', p28 & p52, HMRC, July 2017

## Chart 4.F: UK tax gap




Source: Measuring Tax Gaps 2018 edition

4.44 The government has brought forward over 100 measures since 2010 to tackle tax avoidance, evasion, non-compliance and aggressive tax planning.[31] These include increasing the penalties and consequences for those who devise, enable, or use tax avoidance schemes, removing the economic benefit from avoidance and ensuring that those enabling tax avoidance cannot keep a single pound of what they make by helping others to avoid tax. Other actions the government has taken include the introduction of the UK's first General Anti-Abuse Rule (GAAR) and successively strengthening and expanding the Disclosure of Tax Avoidance Schemes (DOTAS) regime. The government is also addressing online sales fraud by non-compliant overseas traders by enabling HMRC to hold an online marketplace jointly and severally liable for the unpaid VAT of an overseas business that sells goods in the UK via the online marketplace's website.

4.45 In the 2017 Autumn Budget, the government took further action to tackle avoidance and evasion, and announced a package of compliance measures forecast to raise £4.7 billion by 2022-23. In tackling non-compliance the government also needs to consider the burdens placed on individuals and businesses and ensure that any proposed changes are deliverable, proportionate and effective.

4.46 HMRC's estimates of the tax gap are of course subject to uncertainty. However, the degree of uncertainty varies across different tax gaps depending on the data available and the methodology used for estimating each gap. The government notes that HMRC's VAT tax gap statistics are integral to the OBR's economic and fiscal outlook forecast, and that tax gap estimates are also the basis of some OBR certified policy costings. For estimates such as self-assessment and PAYE, HMRC uses a robust random sampling method to arrive at population representative statistics. Other

[31] 'Government Action to Tackle Tax Avoidance, Evasion, Non-Compliance and Aggressive Tax Planning', HM Treasury, November 2017

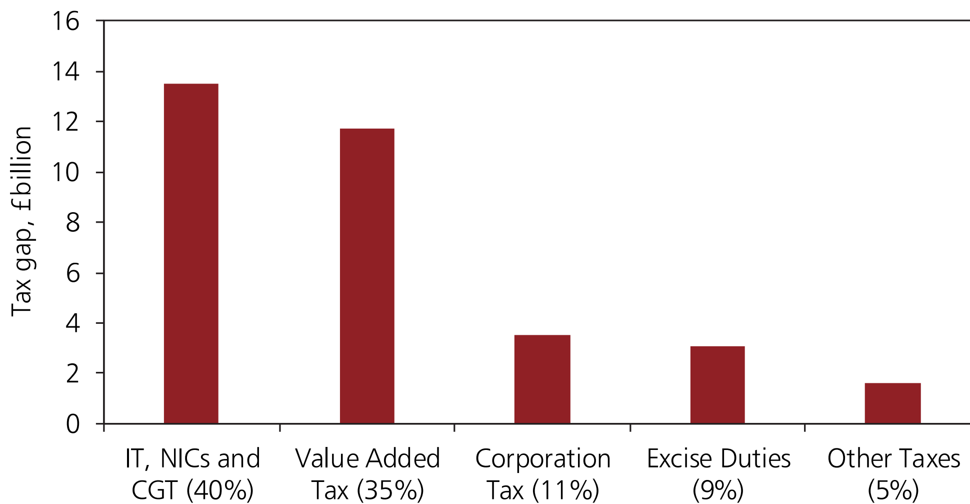
estimates rely on administrative information where there is comprehensive data available, for example with estimates of unpaid debt owed.

4.47 HMRC continues to improve methodology across the tax gap, including for the most challenging estimates. For example, commissioning a survey of more than 9,000 individuals provided valuable new information on the prevalence of, and income generated by, hidden economy activities. This enabled HMRC to provide tax gap estimates of much greater certainty than in earlier years.

4.48 The government is committed to helping taxpayers get their tax right and reducing the level of error. The Making Tax Digital (MTD) programme is an innovative and ambitious approach to address the part of the tax gap that arises from error and failure to take reasonable care across a number of taxes. The first group that will be required to use the new system will be businesses with turnover above the VAT threshold. They will initially use the system to meet only their VAT requirements. The MTD system is currently available on a voluntary basis for businesses and individuals to meet their income tax self-assessment liabilities as well.

## The self-assessment tax gap

### Chart 4.G: Tax gap – value and share of tax gap, 2016-17




Source: Measuring Tax Gaps 2018 edition

4.49 As highlighted in the FRR, and shown in Chart 4.G, the size of the tax gap varies across taxes. The report draws attention to the difference between the tax gaps for the two main methods of collecting income tax, Pay as You Earn (PAYE) and self-assessment. The tax gap for self-assessment, which covers income tax and NICs paid by the self-employed and all CGT, remains one of the highest proportions of any component of the tax gap, at 16.4% of liabilities in 2016-17.[32] Given that the individuals and businesses who use self-assessment are reporting their own income, and can have more complex tax affairs and potentially higher liabilities than those whose employers operate PAYE on their behalf, there is greater scope for error and therefore a

32 'Measuring Tax Gaps 2018 Edition': Tax Gap Estimates for 2016-17, p17, HMRC, July 2018

higher tax gap. In cases where tax is withheld, such as for PAYE for employees, or where HMRC has a significant amount of information on the individual or business's tax affairs, such as through Customer Compliance Managers for large businesses, tax gaps are lower because there is less chance of income being inaccurately reported. The report highlights that there are growing revenue risks from the concentration of self-assessment receipts in a relatively small number of taxpayers and the shift in the economy from employee status to self-employment.

4.50 The government is taking a range of steps to address the self-assessment tax gap including extending HMRC's bulk data powers to help identify businesses operating in the hidden economy, consulting on cash and digital payments, including how the government could use behavioural insights to address cash related tax evasion and the hidden economy, and consulting on introducing tax registration based conditionality for some public sector licenses.

4.51 In the longer term, HMRC's ambition is to become one of the most digitally advanced tax administrations in the world, preventing error and making it easier for everyone to get their tax right. As was highlighted above, HMRC has designed the MTD system to address the part of the tax gap that relates to error and failure to take reasonable care. As the use of MTD grows this will help to address the self-assessment tax gap. £5.9 billion of the £33 billion UK tax gap (2016-17) is attributed to taxpayer failure to take reasonable care making this the largest behaviour contributing to the tax gap and £3.2 billion is attributed to error.[33]

## Operational measures to tackle non-compliance

4.52 Another source of risk to OBR forecasts noted in the FRR was the relatively uncertain costings of HMRC operational measures to tackle non-compliance. The OBR certifies all government forecasts and policy costings as a central estimate, providing the government with external challenge to ensure our costings are the best estimate they can be from the information available. The OBR also assigns certified costings with an uncertainty rating. As summarised above, the government has introduced a large number of measures to tackle non-compliance in recent years. The OBR notes that these types of measures typically attract the OBR's highest uncertainty ratings.

4.53 The government recognises that the costings for operational measures can often be more uncertain, since they target a subset of taxpayers who are actively changing their behaviour to lower their tax liabilities. Additionally, many of these measures target activities which are not disclosed to HMRC, and therefore estimating the size of those activities creates a number of challenges. Given the more limited information available, there can be a higher level of uncertainty. However, as recognised in the FRR and the OBR's analysis, the government's revenue estimates appear central.

4.54 At every fiscal event, HMRC re-estimate the revenue of previously announced policies using the latest available data in conjunction with the OBR. While

[33] 'Measuring Tax Gaps 2018 Edition': Tax Gap Estimates for 2016-17, p11, HMRC, July 2018

some forecasts are revised downwards, some of the forecasts are revised upwards.

## Simplifying the tax system

4.55 The FRR claims that increases in the length of Finance Bills and the number of tax reliefs may create opportunities for taxpayers to challenge legal interpretations or exploit boundaries. The government agrees on the need for simplification of the tax system, but the length of tax legislation and the number of tax reliefs are not necessarily good measures of complexity.

4.56 The government is committed to striking a balance between a tax system that is simple to understand and easy to comply with, but which also allows it to tackle avoidance and evasion, and ensures fairness in the system – objectives which can increase pages of legislation. The government established the Office of Tax Simplification (OTS) in 2010 to provide independent advice on simplification of the tax system and put it on a permanent, statutory basis through Finance Act 2016. Its strengthened status allows it to play a greater role in the public debate, to respond to requests from the Chancellor, such as the recent review of VAT including the registration threshold, to develop new thinking in additional areas and to tackle particular complexities in the tax system such as its recent review of Inheritance Tax.

4.57 Recommendations from the OTS have led to several improvements in the tax system, including:

- introducing several reforms to employee benefits and expenses, reducing administrative burdens by around £25 million per annum
- introducing the cash basis for micro-businesses, benefitting over 1.1 million trading and property businesses

## The role of tax reliefs

4.58 Tax reliefs often serve an important role in the tax system, acting as simplifications, reducing administrative burdens for businesses and individuals, and allowing HMRC to focus resources appropriately.

4.59 Tax reliefs can also ensure that the tax system operates fairly, help the UK to remain internationally competitive, and encourage certain behaviours. For example, research and development tax credits encourage businesses to invest in innovation and new technology which can boost UK productivity, and pensions tax relief encourages people to save for their future.

4.60 The government recognises the need to monitor and evaluate existing tax reliefs, and to ensure that any new reliefs introduced are justified and appropriately targeted. HMRC has a well-established risk-based approach to managing compliance across all aspects of the tax system. This is continually reviewed and updated to reflect best practice. The department publishes annual figures on the cost of tax reliefs, and changes to HMRC's internal processes to improve management of tax reliefs have been shared with the National Audit Office, who have confirmed that they satisfy recommendations arising from their recent work in this area.

4.61 While tax reliefs are an important facet of a functioning tax system, they need to be fiscally sustainable and represent value for money for the taxpayer. The government will continue to monitor their use and act where appropriate – for example through the changes made as part of the recent Patient Capital Review.

# Part III: Oil and gas decommissioning costs

4.62 The FRR highlighted that, over the long term, the UK's receipts from the taxation of profits from oil and gas production will continue to fall as a percentage of GDP. This is a natural consequence of the maturity of the UK's oil and gas resources: reserves will gradually be depleted and economically-recoverable resources will decline.

4.63 The FRR also presented the cost of oil and gas field decommissioning as a downside risk. Estimates of the scale and timing of decommissioning costs have historically been uncertain and subject to revision. This poses a risk to forecasts of net tax receipts from the sector over the life of the basin.

## Trends in oil and gas revenues and costs

4.64 Since the start of the 1970s, the oil and gas industry is estimated to have paid £191 billion (in nominal terms) in direct upstream taxes and royalties[34]. The sector continues to support hundreds of thousands of jobs across the UK. Net tax revenues[35] have declined over the last few years from £10.9 billion in 2011-12 to £1.2 billion in 2017-18.[36] The fall reflects lower oil prices and the significant fiscal reforms over this period to support new investment and mitigate some of the downside risks from declining production. Oil and gas producers are legally required to decommission fields and associated assets once they reach the end of their productive lives. Decommissioning offshore assets is expensive and can be technically-challenging. The UK's tax system recognises this by allowing an extended carry-back of decommissioning costs against historic profits.

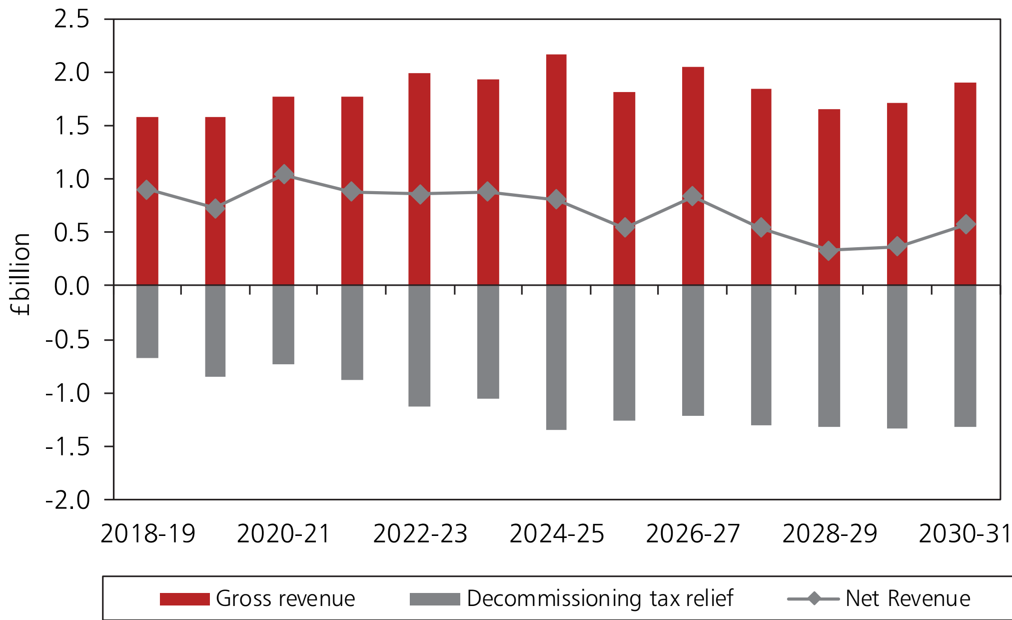
4.65 Chart 4.H extends the forecast of oil & gas tax revenues beyond the period covered by the most recent Economic and Fiscal Outlook. It breaks it down into the gross tax revenue paid by oil and gas companies on their ring-fence profits, repayments made in respect of decommissioning costs carried back ("decommissioning tax relief") and the resulting net tax revenues. It shows that decommissioning tax relief is forecast to offset a significant portion of gross tax revenues in the coming years. This is a longstanding feature of the tax system, but the effect is likely to become more pronounced over the coming decades as production gradually declines and decommissioning activity increases.

[34] 'Statistics of Government Revenue from UK Oil and Gas Production', HM Revenue & Customs, June 2018

[35] Tax revenues on profits from oil and gas minus any tax repayments

[36] 'Statistics of Government Revenue from UK Oil and Gas Production', HM Revenue & Customs, June 2018

## Chart 4.H: Oil and gas tax revenues and repayments




Source: HMRC data

## Managing the uncertainty around oil and gas decommissioning costs

4.66 There are inherent uncertainties in the timing and quantum of decommissioning costs, given the scale and complexity of work involved, and external factors such as the volatility of the oil price. However, all parties - the government, oil and gas producers and the independent regulator, the Oil and Gas Authority (OGA) - have a shared interest in cost-effective decommissioning.

4.67 The government is working with industry and the Oil and Gas Authority (OGA) to manage the uncertainty around the costs of decommissioning. The OGA's Decommissioning Strategy[37] recognised the need for greater cost certainty and cost reduction. The OGA now publishes probabilistic estimate of UK Continental Shelf (UKCS) decommissioning costs, incorporating data provided by operators and taking account of the wide range of uncertainties embedded in industry's cost estimates. These figures are updated annually.

4.68 The OGA's current central estimate for total UKCS decommissioning costs to 2062 is £58.3 billion (in 2017 prices).[38] Based on this estimate, HMRC forecast that £24 billion will be met either through repayments of previously paid tax or a reduction in future receipts.[39] At the same time, the OGA has set a target of a minimum 35% cost reduction. If achieved, this would take total decommissioning costs to below £39 billion (in 2016 prices). [40] Reducing the total aggregate cost across industry would reduce the level of

37 'Decommissioning Strategy', Oil & Gas Authority, June 2016

38 'UKCS Decommissioning 2018 Cost Estimate Report', Oil & Gas Authority, June 2018

39 'Statistics of Government revenues from UK Oil and Gas Production', HM Revenue & Customs, June 2018

40 'UKCS Decommissioning 2018 Cost Estimate Report', Oil & Gas Authority, June 2018

tax repayments government is required to make. The government is working closely with the OGA to monitor progress.

4.69 The OGA has committed to:

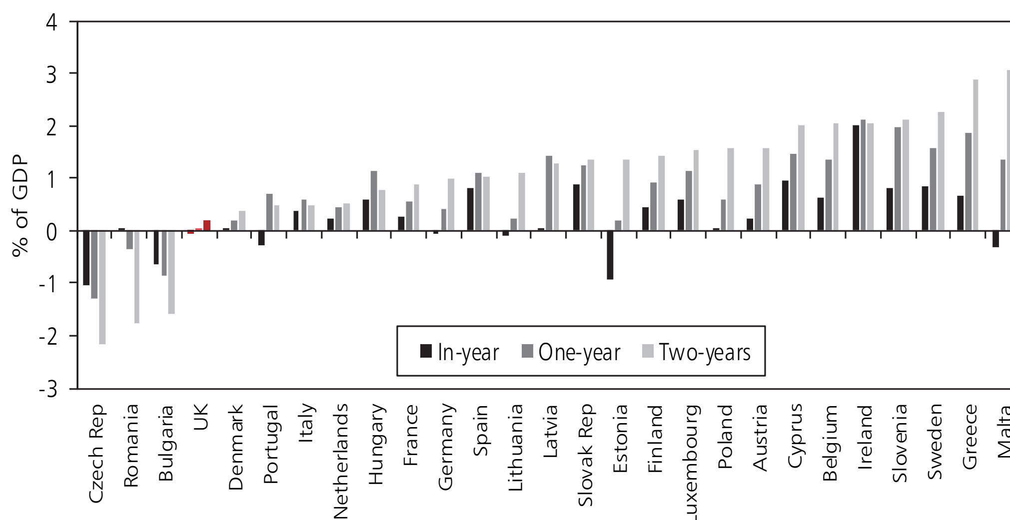
- publishing an annual progress update report
- working with operators and the wider industry to share lessons learned and develop innovative approaches to contracting strategy
- promoting innovative collaboration, for example the multi-operator well plugging and abandonment campaign

4.70 HM Treasury has also established a UKCS Decommissioning Costs Board to embed expertise and accountability for supporting the OGA's target across government.

# Chapter 5
# Spending

5.1 As part of its strategy to repair the public finances, the government has delivered a significant reduction in public expenditure as a share of GDP in the wake of the financial crisis from a 30-year high of 44.9% in 2009-10 to 38.8% in 2016-17, close to its post-war average.[1] The UK's record of controlling spending is underpinned by a world-leading system of expenditure management in which the Treasury, Parliament, the National Audit Office and others work with departments to ensure value for money. As shown in Chart 5.A, the UK has the best record of any EU country in meeting its medium-term spending forecasts over the last 15 years.

## Chart 5.A: Average expenditure forecast error (2000-15)




Source: IMF Fiscal Forecast Database

5.2 However, the government recognises the need for vigilance in the face of emerging risks and long-term pressures on public expenditure, including from an ageing population and rising costs of health and social care. This chapter sets out how the government is managing spending risks across five areas:

- Part I sets out the government's action to strengthen the spending control framework
- Part II discusses the government's strategy for responding to pressures on health and social care

[1] 'Public Finances databank', OBR, June 2018

- Part III outlines the government's approach to managing pensions spending
- Part IV highlights the government's actions to reduce the costs of litigation; and
- Part V addresses other spending risks including those associated with the UK's Exit from EU, local authorities and devolved administrations

## Part I: Spending control framework

5.3 The FRR discusses three potential risks to the government's framework for managing public spending:

- the declining proportion of total spending subject to Departmental Expenditure Limit controls
- growing reliance on loans and other financial transactions rather than conventional expenditure to fund new policies
- cost or time overruns for major projects such as HS2 and Universal Credit

5.4 The government has strengthened its frameworks for controlling spending and managing major projects by:

- strengthening controls over Annually Managed Expenditure
- enhancing transparency and management incentives around the use of the issuance of loans and other financial transactions
- updating the 'Green Book' in 2018 to reflect important advances in appraisal and evaluation of major projects
- establishing the Infrastructure and Projects Authority (IPA) in 2016 to improve the way infrastructure and major projects are delivered

### Expenditure control

5.5 The Treasury manages Total Managed Expenditure (TME) as part of either Annually Managed Expenditure (AME) or Departmental Expenditure Limits (DEL). DEL is expenditure which is allocated to government departments in the form of multi-year nominal spending limits which are fixed at spending reviews every 3 to 4 years. DEL covers most spending on frontline public services including health, education, policing, transport and defence. AME is expenditure which is too volatile or demand-led to manage within fixed nominal limits. It is therefore reforecast at each fiscal event and includes spending on welfare, public sector pensions, and debt interest.

5.6 The FRR highlights the increasing proportion of TME in AME as a risk given that these are more difficult to control than spending in DEL. AME has increased from 49% of TME in 2010-11 to 54% in 2017-18 This partly reflects the Treasury's success in controlling DEL spending since 2010 as part of its strategy for repairing the public finances. It also reflects the government's commitment to supporting pensioner incomes through the

Triple Lock which contributed to welfare spending on pensioners growing by 9.7% in real terms over this period.[2]

5.7 HM Treasury keeps the classification of spending between AME and DEL under constant review. HM Treasury is currently in discussion with Network Rail, the Department for Transport (DfT) and the Office of Rail and Road (ORR) to move Network Rail from AME into DEL at the start of Control Period 6 (April 2019). In preparation, Network Rail are 'shadow-running' a DEL regime in 2018-19, as there is a fixed AME loan limit available for the final year of Control Period 5. This would move around £7 billion of spending from AME to DEL.[3]

5.8 The government has introduced additional levers to control AME while retaining its flexibility. The welfare cap was introduced in 2014 to control certain welfare spending in AME, and total spending covered by the cap accounted for 15% of TME spending at Autumn Budget 2017. The OBR makes a formal assessment of the welfare cap at the first fiscal event of each new Parliament and the Secretary of State for Work and Pensions is accountable to Parliament for any breaches of the cap. DWP have put in place governance structures to manage welfare AME within the cap, including a regular senior board on which HM Treasury officials sit. At Autumn Budget 2017, the OBR judged that the terms of the welfare cap, which at the time applied in 2021-22, were being met. The cap was then reset and will apply in 2022-23.

## Management of financial transactions

5.9 The FRR highlighted an increase in the size of financial transactions after the financial crisis as a growing source of fiscal risk. These financial transactions include loans made by government including to help students meet the costs of higher education and homebuyers to get a foot on the housing ladder. The government continues to keep the value for money of these transactions under review and, as described in Chapter 2, actively monitors the risks associated with its outstanding loan portfolio.

5.10 To enhance transparency and improve management incentives for both current and future financial transactions, the government will issue updated guidance to departments ahead of the next financial year. This will focus on ensuring that departments are accurately forecasting the level of income and write-offs expected from their loan schemes and are appropriately incentivised to manage these in line with the policy design.

## Project appraisal

5.11 The 'Green Book'[4] is the government's manual for appraisal of new projects and policies. All centrally-funded public spending proposals, including those subject only to departmental approval, are required to use the Green Book's guidance in submitting their business case. This includes demonstrating value for money and proper consideration of potential risks and overruns.

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2 'Department for Work and Pension's Benefit expenditure and caseload tables, outturn and forecast', DWP, March 2018

3 'Economic and Fiscal Outlook', OBR, March 2018

4 'Green Book', HM Treasury, March 2018

Supplementary guidance provides more information on the treatment of uncertainty and risk when valuing major projects, including how to adjust for the optimism bias in the planning of large and complex infrastructure projects.

5.12 In March 2018, the 'Green Book' was updated to reflect important advances in appraisal and evaluation that government departments and agencies have made since 2003. The updated edition places particular emphasis on the need to address optimism bias, evaluate risk, and conduct sensitivity analysis as an integral part of project appraisal. This guidance is supplemented by a detailed appendix and technical guidance on recognising uncertainty, optimism bias, and risk in the appraisal of projects.

## Reducing risks in major projects

5.13 The Infrastructure and Projects Authority (IPA) was established in 2016, bringing together Infrastructure UK (IUK) and the Major Projects Authority (MPA). As the government's centre of expertise for infrastructure and major projects, the IPA works across government and with industry to ensure infrastructure and major projects are delivered efficiently and effectively, and to improve performance over time. The IPA assure, support and report on the Government Major Projects Portfolio (GMPP), which covers 133 major projects with a total whole life cost of around £423 billion.[5]

5.14 Since its establishment, the IPA has worked with the managers of major projects to develop their skills and improve delivery. In October 2017, the IPA published its guidance on improving benefits realisation when planning and delivering government projects.

5.15 In December 2017, the IPA launched Transforming Infrastructure Performance (TIP), the government's long-term plan to improve the delivery and performance of infrastructure.[6] TIP examines how the government and industry can work together to benchmark performance (including cost and schedule) and select the right projects; improve integrated planning across sectors; support effective commercial relationships; and increase uptake of technologies and innovations, both for new and existing infrastructure.

5.16 In March 2018, a review of the IPA assurance model found that independent assurance remained an important part of successful project delivery and made a number of recommendations that were accepted. The recommendations look to enhance the work of the IPA and its project assurance to better meet the evolving needs and priorities of government by, for example, ensuring the IPA is engaged early in project development and is focused on the highest-risk areas. Moving forwards, the IPA will be focusing on supporting projects in its 'early development pool' to ensure they are set up for success.  This means supporting departments to tackle early the most common causes of failure such as the lack of clear objectives, insufficient resources, and over-ambitious cost and schedule amongst others.

5 'Annual Report on Major Projects 2017-8', Infrastructure and Projects Authority, July 2018

6 'Transforming Infrastructure Performance', Infrastructure and Projects Authority, December 2017

5.17 Individual departments are also improving their project management capability. To address uncertainty for Network Rail projects, the Department for Transport (DfT) has released guidance on the Rail Network Enhancements Pipeline.[7] The guidance makes clear that government will not fully commit to new rail projects until a full business case, and therefore more certainty on costs, has been agreed.

5.18 Network Rail have undertaken a review of their 'Infrastructure Projects' function, to address optimism bias in the costing of projects which concluded in April 2018. DfT is implementing recommendations via a joint steering group, with changes to be in place by April 2019. Implementation will bring about a more effective operating model and improved performance of enhancements delivery for future rail projects. The move of Network Rail from AME to DEL should reinforce better costing practices.

5.19 The FRR identifies risks relating to the forecasting of Universal Credit (UC), in particular the forecast's sensitivity to assumptions underpinning the modelling; the rollout timetable; and the complexity of the caseload as rollout progresses.

5.20 While there are considerable uncertainties around the UC forecast and the marginal cost of UC relative to the legacy benefit system, the OBR has assessed the assumptions behind their Spring Statement 2018 forecast as central. The increased pace of roll-out during 2018 offers opportunities to strengthen the forecast by using UC outturn data to test, inform and update key assumptions. HMT and the OBR will meet DWP on a monthly basis to provide further assurance of this work and review outturn data as it becomes available. This will help to ensure that the forecast spend continues to represent a central estimate and is based on the best available evidence.

5.21 The FRR also identifies risk associated with implementation of the new State Pension, which was successfully implemented on 6 April 2016. No risks associated with its implementation have materialised. DWP continue to monitor and evaluate the operation of the new system. The UC Programme has made significant progress on rollout since the FRR. Over 920,000 claimants are now in receipt of UC, and it has now been rolled out to nearly 360 jobcentres - over half the total number. The Programme continues to deliver to its revised plan announced as part of Autumn Budget 2017 and is on course to roll out to every jobcentre by December 2018.

## Part II: Health and social care

5.22 The FRR identifies three sources of risk to health and social care spending:

- long-term upward cost and demand pressures on health spending given past topping-up of health spending settlements
- the potential impact of the National Living Wage (NLW) and migration reform on health and social care costs
- potential pressure to bail out a private social care provider

[7] 'Rail Network Enhancements Pipeline: A New Approach for Rail Enhancements', Department for Transport, March 2018

5.23 The government is taking a number of steps to address these risks including:

- announcing a new multi-year funding settlement for the NHS amounting to an average annual increase of 3.4% in real terms between 2019-20 and 2023-24, in return for the NHS agreeing a new long-term plan with the government[8]
- developing a new ten-year plan to enhance NHS productivity, efficiency, and performance, and putting the service on a sustainable long-term footing
- publishing a green paper for care and support for older people later in 2018

## Health

5.24 The FRR identified pressures on health spending as one of the most important long-term risks to the public finances. This finding is reinforced in the OBR's 2018 'Fiscal sustainability report' which finds that, left unaddressed, long-term pressures on the health service would see spending rise from 7.6% of GDP in 2022-23 to 13.9% of GDP in 2067-68. The majority of the OBR's projected increase in spending is attributable to non-demographic cost pressures. Non-demographic pressures are caused by the low productivity of the labour-intensive health sector relative to the rest of the economy (looking at long-term historic trends); increases in chronic conditions; and improvements in technology and medical research leading to the provision of new drugs and treatments.

5.25 The government recognises that health spending will need additional resources to help meet these pressures – alongside action being taken to tackle these cost-drivers over the long-term – and has made the NHS its number one spending priority for the next Spending Review period. In June 2018, the Prime Minister announced that the NHS in England will receive an increase in funding over the next five years that equates to over £20 billion a year more in real terms by 2023-24 – an average annual growth rate in resources of 3.4% in real terms over the five years.[9]

5.26 The final settlement will be confirmed at a future fiscal event, subject to an NHS 10-year plan that delivers the efficiency, productivity, and performance improvements necessary to address the long-term cost pressures highlighted by the OBR. The government has set the NHS five financial tests for the plan, to show how the NHS will fulfil its part in putting the service onto a more sustainable financial footing by:

- improving productivity and efficiency
- eliminating provider deficits
- reducing unwarranted variation in the system so people get the consistently high standards of care wherever they live

[8] Speech on the NHS at the Royal Free Hospital, Prime Minister, June 2018

[9] Speech on the NHS at the Royal Free Hospital, Prime Minister, June 2018

- getting much better at managing demand effectively
- making better use of capital investment

5.27 The NHS has begun to take steps to address these issues. In its 2017 'Next Steps on the Five Year Forward View',[10] the NHS outlined a ten-point efficiency plan. The 2017 Naylor review of NHS property and estates[11] and the government's response earlier this year set out how the NHS can combine better management of NHS assets with targeted use of public capital and private finances to drive service reconfiguration and performance improvements across the NHS. To support this transformation, the government provided an additional allocation of £3.6 billion over the next five years provided to the NHS at the 2017 Autumn Budget.[12]

5.28 The government will fund this five-year commitment while continuing to meet its fiscal rules and reduce debt. As the Prime Minister has said, this will be partly funded by lower contributions due to the European Union. In addition, she has made clear that taxpayers will need to contribute a bit more in a fair and balanced way. This will also require prioritisation and further efficiencies within non-health expenditure to keep the growth in total spending on a sustainable long-run trajectory. The government will confirm the full details of all health budgets and expenditure plans for all other government departments at the 2019 Spending Review.

## Adult social care

5.29 Adult social care services provide vital support to the lives and independence of older and disabled people. As highlighted by the OBR's FRR and latest FSR, the rising cost of that support is also a source of long-term risk to the public finances. The 2018 FSR projects that, under the current system of funding, the cost of social care would rise from 1.3% of GDP in 2022/23 to 1.9% of GDP in 2067-68. Similar to health spending, non-demographic pressures, including relatively low productivity, account for a significant part of the spending increase.

5.30 The government recognises that the need to improve sustainability of the current system for the funding of social care. It has already acted to secure additional financing for the social care sector at the Spending Review 2015, including the expected costs of the National Living Wage.[13] This included the creation of a social care precept to give local authorities who are responsible for social care the ability to raise new funding to spend exclusively on adult social care, and the introduction of the improved Better Care Fund.

5.31 The Care Act 2014[14] gave the Care Quality Commission (CQC) statutory responsibility for monitoring and assessing the financial sustainability of difficult-to-replace care providers in England. This provides local authorities with greater support in fulfilling their responsibility to ensure continuity of care if a provider is at risk of failing.

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10 'NHS England Five-Year Forward View', NHS England, March 2017

11 'NHS property and estates: Naylor review', March 2017

12 'Autumn Budget 2017', HM Treasury, November 2017

13 'Spending Review and Autumn Statement 2015', HM Treasury, November 2015

14 'Care Act 2014', UK Government, May 2014

5.32 Looking ahead, the government will be publishing a green paper on care and support for older people in Autumn 2018. The government is committed to ensuring that everyone has access to the care and support they need, but the government is also clear that there should continue to be a principle of shared responsibility, and that people should continue to expect to contribute to their care costs when preparing for later life.

5.33 Improving care sector productivity will be important to ensuring sustainability while maintaining the quality of care provision, and the government is looking at how to drive market innovation and foster new, more efficient and cost-effective models of care. The Industrial Strategy through the Ageing Grand Challenge is also looking at how to support people to remain independent for longer. Later this year the government will also publish an NHS and social care 10-year workforce strategy, which will consider the future workforce needs of both sectors together. The NHS plan, also published later this year, will include plans for closer and better integration of health and social care to ensure greater efficiency and sustainability is delivered in both systems.

## Part III: Pensions

5.34 In addition to putting pressure on public services such as health and social care, the ageing of the population has its most direct impact on the public finances through the pension system. The FRR identifies pressures on pension spending over the longer-term. The government has taken a number of steps to address this risk including:

- legislating for rises to the State Pension age to improve the sustainability of the State Pension system and fairness between generations; and
- supporting individuals to plan and prepare for retirement through private savings and measures to support fuller working lives

### State Pension age

5.35 In 1948, when the modern State Pension was introduced, a 65-year-old could expect to live for a further 13.5 years.[15] Due to the success of medical advances, today this has increased to 21.8 years, and by 2066, it is projected to be 26.6 years.[16] The number of people claiming the State Pension is projected to increase from 13 million in 2016-17 to almost 17 million in 2067-68.[17]

5.36 The Old Age Dependency Ratio (OADR), defined as the number of people of pensionable age for every 1,000 people of working age, is projected to rise from 296 to 360 over the next 20 years if the State Pension age (SPa) were to increase according to the currently legislated timetable (Chart 5.B). This means that a smaller working population will need to support a significantly larger number of State Pension claims. Increases in life expectancy are to be celebrated. Increasing longevity does however present a challenge for the

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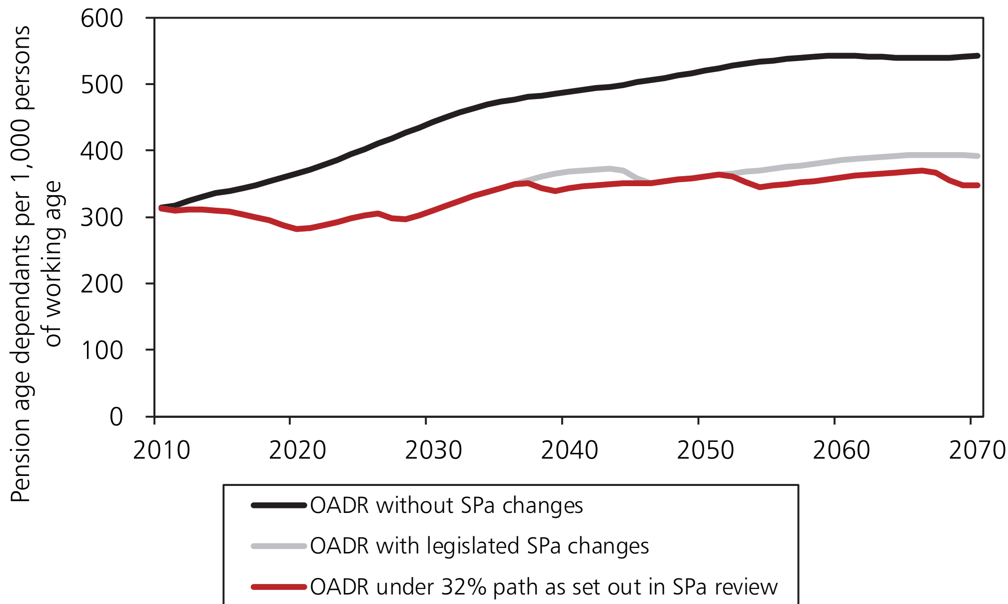
15 '2016 based England and Wales cohort mortality rates and life expectancies, 1945 to 2016', ONS, March 2018. Average of male and female life expectancy.

16 'Expectation of life, principal projection, UK', ONS, December 2017. Average of male and female life expectancy.

17 'Fiscal sustainability report', OBR, July 2018

public finances, and there is a balance to be struck between securing the State Pension for years to come and ensuring fairness for future generations of taxpayers. The 2018 FSR forecasts that State Pension spending will have increased from 5.0% of GDP in 2022-23 to 6.9% of GDP in 2067-68.[18] These increases are driven by both demographic trends and individual entitlements.

## Chart 5.B: Old Age Dependency Ratio (OADR)




Source: ONS publication on Population estimates, mid-2017

5.37 In July 2017, the government published its first State Pension age review, supported by two independent reports from John Cridland CBE[19] and the Government Actuary's Department.[20] The report announced the government's proposal to increase State Pension age to age 68 between 2037 and 2039, in line with John Cridland's recommendations. For future rises, the review said that "… the government is minded to commit up to 32% as the right proportion of adult life to spend in receipt of the State Pension."[21] The government will carry out a further review before legislating, to enable consideration of the latest life expectancy projections and to allow an evaluation of the current rises in State Pension age.

5.38 Increases in the State Pension age help to maintain fairness between generations and improve State Pension sustainability. The approach in the State Pension age review would ensure that a similar average proportion of adult life is spent above State Pension age as people who reached age 65 during the last 25 years were expected to spend above age 65. An increase to 68 in 2037-39 would save £74 billion by 2045-46 compared to the currently legislated State Pension age timetable. [22]

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18 'Fiscal sustainability report', OBR, July 2018

19 Independent review of the State Pension age: Smoothing the transition', State Pension age independent review, March 2017

20 Periodic review of rules about State Pension age', Government Actuary's Department, March 2017

21 'State Pension age review', DWP, July 2017

22 'State Pension age review', DWP, July 2017017. – Note figures have not been updated for the 2016-based population projections

## Supporting pensioner incomes

5.39 Over the last 20 years, pensioner living standards have improved, both in real terms and relative to the working age UK population on an after housing cost (AHC) basis.[23] Average AHC income amongst pensioners has increased by 71.5% in real terms over this period,[24] and the share of pensioners receiving incomes from private pensions has also increased.[25] Furthermore, relative AHC pensioner poverty has fallen from 29% in 1996-97 to 16% in 2016-17.[26] Private saving, greater labour market participation among older workers, and increases in state support for pensioner incomes have all contributed to this improvement in living standards.

23 Analysis of 'Households below average income: 1994/95 to 2016/17', DWP, March 2018. Median net equivalised disposable income, AHC in £ per week in 2016/17 prices. Data is on a GB basis prior to 2002-03.

24 Analysis of 'Households below average income: 1994/95 to 2016/17', DWP, March 2018. Median net equivalised disposable income, AHC in £ per week in 2016/17 prices Data is on a GB basis prior to 2002-03.

25 'Pensioners' incomes series: financial year 2016/17', DWP, March 2018

26 'Households below average income: 1994/95 to 2016/17 ', DWP, March 2018. Relative low income defined as percentage below 60% of contemporary median income on an after housing cost basis. Data is on a GB basis prior to 2002-03.

## Box 5.A: The UK's ageing population: economic and fiscal implications

Ageing populations are an issue affecting all advanced economies and some emerging markets, and are cited by the IMF as a major factor constraining medium-term global growth prospects.[27] They also place upward pressure on public spending: OECD countries with older populations have higher levels of government spending as a share of GDP.[28] In the UK, current projections show ageing pressures materialising in the medium term. The population aged 21-59, those with the highest economic participation rates, is projected to fall by 2.5% between 2020 and 2030,[29] putting downward pressure on economic growth and tax receipts over this period.

In the 2018 'Fiscal sustainability report' (FSR), the OBR project that demographic change will put upwards pressure on public spending over the medium and longer term, principally in health, social care, and state pensions. The OBR's latest projections suggest that the primary deficit will rise to 8.6% of GDP and public sector net debt to 282.8% of GDP by 2067-68,[30] assuming policy remains unchanged. These areas of public spending are also substantially impacted by non-demographic factors. As the OBR note, there is significant uncertainty around this long-term projection, and it does not account for the impact of any possible action to address projected cost pressures in future Parliaments. However, the OBR's underlying conclusion is clear: over the long-term, fiscal sustainability is likely to come under increasing pressure from an ageing population, alongside other factors.

### Table 5.A: OBR projections of spending as % GDP

| | 2017-18 | 2022-23 | 2027-28 | 2037-38 | 2047-48 | 2057-58 | 2067-68 |
|---|---|---|---|---|---|---|---|
| Health | 7.1 | 7.6 | 8.4 | 10.0 | 11.3 | 12.7 | 13.8 |
| Adult social care | 1.2 | 1.3 | 1.4 | 1.6 | 1.8 | 1.9 | 1.9 |
| Education | 4.3 | 4.1 | 4.0 | 3.8 | 3.8 | 3.9 | 3.8 |
| State Pensions[1] | 5.1 | 5.0 | 5.0 | 5.9 | 6.3 | 6.6 | 6.9 |
| Pensioner benefits | 0.8 | 0.8 | 0.9 | 1.1 | 1.3 | 1.3 | 1.3 |
| Public service pensions | 2.0 | 2.1 | 2.1 | 1.8 | 1.6 | 1.6 | 1.5 |
| **Age-related spending** | **20.5** | **20.9** | **21.8** | **24.3** | **26.0** | **27.9** | **29.3** |
| **Total spending[2]** | **36.7** | **36.4** | **37.1** | **39.4** | **41.4** | **43.3** | **44.6** |

Source: 'Fiscal sustainability report', OBR, July 2018'[31].

[27] 'World Economic Outlook', IMF, April 2018

[28] HM Treasury analysis of OECD data (General government spending and Elderly population)

[29] 'National Population Projections: 2016-based statistical bulletin', ONS, October 2017. Principal projection

[30] 'Fiscal sustainability report', OBR, July 2018

[31] 2017-18 and 2022-23 spending consistent with the March 2018 Economic and fiscal outlook. 1. Includes many items in addition to the basic state pension and single-tier pension, such as pension credit, winter fuel payments, and the Christmas bonus. 2. Excludes interest and dividends.

## Improving labour market participation among older workers

5.40 Extending working lives can help people to stay active, save more, and enjoy a more fulfilling retirement[32] as well as supporting fiscal sustainability. The employment rate of 50-64 year olds has increased by 6.9 percentage points since 2010, compared to a 5.4 percentage point increase across the working age population as a whole.[33] However, the employment rate amongst the 50-64 year old population (71.8%) is still lower than that of the working age population (75.6%).[34] A one percent increase in the number of people in work aged 50 – 64 could increase GDP by around £5.7 billion per year and have a positive impact on income tax and NICs liabilities of around £800 million per year.[35]

5.41 The government has taken action to encourage and support older people to remain in the work place:

- In 2016 the government appointed the Business in the Community Age at Work leadership team to spearhead its work to support employers to hire and retrain older workers by promoting the benefits of older workers to employers across England.
- In February 2017 the government published a new employer-led strategy "Fuller Working Lives: a partnership approach", which sets out the benefits of expanding working lives to employers and individuals and the action the government is taking to help older workers to remain in the labour market.[36]
- In February 2018, in response to Matthew Taylor's review of employment practices in the modern economy,[37] the government announced it would create a flexible working taskforce to bring together business groups and employers to encourage flexible working - a key requirement for many older people to stay in work.
- In March 2018 the £98 million Healthy Ageing Industrial Strategy Challenge Fund was announced to promote the innovation and development of new products, technologies and services that will help people live better for longer encompassing work, housing, health, finances and communities.

## Encouraging pension saving

5.42 The government is committed to enabling more people to save while they are working, so that they can enjoy greater security and independence when they retire. In order to incentivise long-term saving, the government provides tax incentives for both individuals and employers to save into pensions. These incentives – relief on income tax and National Insurance relief on

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32 'Work, health and disability green paper: improving lives,' DWP & DHSC, October 2016

33 'ONS: Employment, unemployment and economic inactivity by age group', June 2018 (data: Feb-Apr 2018)

34 'ONS: Employment, unemployment and economic inactivity by age group', June 2018 (data: Feb-Apr 2018)

35 HMT analysis based on ONS ASHE, LFS and mid-year population statistics. The analysis assumes that the additional people in work would have the same characteristics as 50 – 64 year olds currently in work. Further detail can be found in Data Sources.

36 'Fuller Working Lives: a partnership approach', DWP, February 2017

37 'Good Work: A response to the Taylor Review of Modern Working Practices', HM Treasury, February 2018

employer contributions – totalled £54.8 billion in 2016-17[38] or 2.8% of GDP,[39] although some of this tax will then be paid back in retirement as taxable payments are made from these pensions.

5.43 Alongside these tax incentives, the government has also rolled out automatic enrolment into workplace pensions since 2012. This has improved saving into workplace pensions and increased participation rates. Between 2012 and 2017 there was a 53 percentage point rise in participation in workplace pensions by eligible employees in the private sector aged 22 to 29.[40] By the end of May 2018, over 9.7 million jobholders had been automatically enrolled into a workplace pension.[41] Overall, 84% of eligible employees were participating in a workplace pension in 2017 and, for the first time, women are now participating in workplace pensions at broadly the same rate as men.[42]

5.44 In December 2017, DWP completed a review of automatic enrolment, which set out the government's ambitions for future development of the policy for the mid-2020s. These included expanding the population in scope by reducing the minimum age to 18 and simplifying the policy and increasing contributions by starting contributions from the first £1 of earnings for everyone enrolled.[43] The government's ambition is to implement these proposals in the mid-2020s, subject to consideration of the increases in statutory minimum contribution rates in April 2018 and April 2019, and to finding ways to make the change affordable, recognising there are cost consequences which need to be shared between individuals, businesses, and taxpayers.

## The Triple Lock

5.45 The government has also supported pensioner living standards through significant increases in the real value of the State Pension. From 1981-2001, the State Pension was increased in line with prices which caused pensioner incomes to fall behind economy-wide earnings. Price inflation uprating continued in legislation until 2011(for some years a 2.5% minimum increase was applied when price inflation fell below that level). Changes made to the legislation with effect from April 2011 ensured there would be an earnings rather than prices underpinning for pensions uprating.

5.46 The introduction of the Triple Lock in 2010, which requires that the State Pension is uprated each year by the highest of earnings, prices or 2.5%, has lifted the incomes of millions of older people and played a part in reducing pensioner poverty to historically low levels. Since the introduction of the Triple Lock in 2011-12, the average pensioner household has seen their income after housing costs increase by 8.7%[44] above the rate of inflation.

38 'Personal Pensions Statistics', HMRC, February 2018

39 'Public Finances databank', OBR, June 2018. Non-seasonally adjusted nominal GDP

40 'Workplace Pension Participation and Savings Trends of Eligible Savers Official Statistics: 2006 to 2016', DWP, June 2018

41 'Automatic enrolment: Declaration of compliance report', The Pensions Regulator, June 2018

42 'Workplace Pension Participation and Savings Trends of Eligible Savers Official Statistics: 2007 to 2017', DWP, June 2018

43 'Automatic enrolment review 2017: Maintaining the momentum', DWP, December 2017

44 Analysis of 'Households below average income: 1994/95 to 2016/17', DWP, March 2018. Median net equivalised disposable income, AHC in £ per week in 2016/17 prices

5.47 As the OBR highlights, the Triple Lock causes the State Pension to continue to grow faster in value than the incomes of the working age population who pay for it. The 2018 Fiscal Sustainability Report shows that if the Triple Lock were to continue, State Pension spending could increase from 5.0% of GDP in 2018-19 to 6.8% of GDP in 2069-70.

5.48 The government has committed to keep the Triple Lock in place for the rest of this Parliament.

## Part IV: Litigation risks

5.49 The FRR highlights a number of fiscal risks associated with the costs of litigation across a range of areas, including:

- higher clinical negligence pay-outs than currently provisioned for in the Department of Health's accounts
- possible further increases in tax litigation pay-outs
- limited reporting of the cost of potential legal challenges to the welfare system

5.50 The government is assessing and managing these risks including by:

- developing a cross-government strategy with the NHS to address the rising costs of clinical negligence to report in autumn 2018
- introducing a 45% withholding rate of corporation tax on the interest element of restitution awards from tax litigation cases and working to more accurately forecast, predict and profile tax litigation risks
- Improving Department for Work and Pensions (DWP) internal reporting and management of legal risks in the welfare system

### Clinical negligence

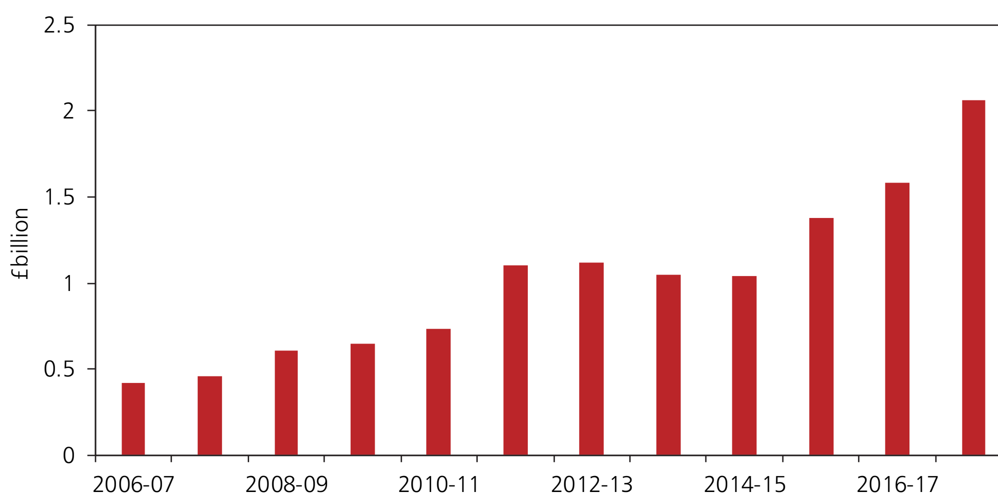
5.51 Clinical negligence is the breach of a legal duty of care to a patient by members of the healthcare professions or by others acting on their decisions or judgements, which directly caused harm to the patient. If clinical negligence has occurred, a patient or their representative may claim for damages against the clinicians or their employers. The NHS is legally liable for any clinical negligence by its employees.

5.52 From 2006–07 to 2017-18, the number of clinical negligence claims registered annually with NHS Resolution under the Clinical Negligence Scheme for Trusts doubled from 5,300 to 10,600.[45] Annual cash spending on the Scheme increased fivefold over this period, from £0.4 billion to £2.1 billion. The £2.1 billion includes £360 million of damages payments incurred as a result of the change in the personal injury discount rate (PIDR) in March 2017. The estimated cost of settling current and future claims stood at £71 billion in 2017-18.[46]

45 'Managing the costs of clinical negligence in trusts', NAO, September 2017

46 'NHS Resolution Annual Report and Accounts 2017-18', NHS Resolution, July 2018

## Chart 5.C: Clinical negligence cash payouts




Source: NHS Resolution expenditure under the Clinical Negligence Scheme for Trusts

5.53 Claims for certain injuries at birth, where clinical negligence is proven, are generally the highest value claims. Increases in damages awarded in these cases are one of the major drivers for the recent rise in the costs of claims. Other drivers are increases in the number of claims and to a rise in legal costs (mainly associated with claimant's legal costs for low- and medium-value claims up to £250,000).

5.54 The government is focused on actions to reduce patient harm, including to users of maternity services. In November 2017, the government announced plans for a refreshed Maternity Safety Strategy which brought forward from 2030 to 2025 the existing ambition to halve rates of stillbirths, neonatal and maternal deaths, and brain injuries occurring during or soon after birth. This included standardisation of investigating cases of stillbirth, early neonatal death, and severe brain injury so that the NHS learns as quickly as possible from what went wrong and shares the learning to prevent future tragedies.

5.55 Another factor driving the increase in costs, which contributed to an increased cash outlay in 2017-18, was the lowering of the PIDR reflecting changes in long-run interest rates - the rate applied to lump sum awards to personal injury claimants to allow for investment returns – from 2.5% to minus 0.75%. Following the change in the PIDR, the Ministry of Justice announced a review of the framework for setting the rate. After this review, including a consultation in 2017[47], the Civil Liability Bill including the PIDR reforms was introduced in March 2018. The current PIDR is determined in line with the principles set out in law, stating that claimants should neither be under or overcompensated. The bill proposes to update the basis for setting the rate to reflect more closely how claimants actually invest their money. The new framework would also ensure that the rate is reviewed regularly, and involve an expert panel in the reviews.

5.56 A third significant driver of the recent increase in clinical negligence costs has been the cost of litigation. Noting that legal fees accounted for 36% of the

47 'The Personal Injury Discount Rate: How it should be set in future', Ministry of Justice, March 2017

cost of clinical negligence claims against the NHS, in January 2017 DHSC consulted on a mandatory system of fixed recoverable costs for clinical negligence claims below £25,000.[48] For these claims the claimant's recoverable legal costs were, on average, 220% of damages awarded. As set out in DHSC's consultation response, government has now asked the Civil Justice Council (CJC) to devise a bespoke process and propose a grid of costs; CJC's working group is expected to report later in 2018.

5.57 The government will be publishing a coordinated cross-government strategy on managing the growth in the rising costs of clinical negligence in the autumn.[49]

## Tax litigation

5.58 Since the FRR was published in July 2017, the government has seen a significant reduction in its estimated losses from tax ligation. As a result of several positive judgements, HMRC's central estimate of tax litigation losses has fallen by 67% to from £27 billion to £9 billion.[50] The most notable of these judgments occurred in November 2017, when the Supreme Court ruled in favour of HMRC in a long-running litigation action on compound interest on VAT overpaid from 1973 to 2004. The claim was for £1.2 billion, in addition to £268 million statutory interest paid and £205 million VAT reimbursed, and HMRC would have been exposed to follower claims of over £17 billion.[51]

5.59 In recent years, the government has also undertaken a variety of actions to mitigate against this fiscal risk consistent with the key principles of HMRC's litigation and settlement strategy.[52] These include introducing accelerated payments in litigation cases involving tax avoidance and a 45% corporation tax on the compound interest paid in restitution claims. In addition, HMRC brought forward legislation to prevent them having to make interim payments in restitution claims, restricted the limitation period for 'mistake of law' claims to six years, and issued follower notices to apply favourable judgements to cases whose assessment has not been finalised.

5.60 HMRC built upon existing governance structures that manage tax litigation by introducing senior challenge panels to consider legal risk judgements and revenue estimates. HMRC are also undertaking a significant amount of work to more accurately forecast, predict and profile tax litigation risks. This includes:

- evaluating and centrally addressing systematic legal pessimism in assessing the likelihood of winning cases
- further differentiating between legally bound and non-legally bound follower cases

48 'Introducing Fixed Recoverable Costs in Lower Value Clinical Negligence Claims: consultation document', DHSC, January 2017

49 'Treasury Minutes, Government response to the Committee of Public Accounts on the Fourth to the Eleventh reports from Session 2017-9', HM Treasury, March 2018

50 'Internal HMRC analysis

51 'Littlewoods Limited and others (Appelants) v Commissioners for Her Majesty's Revenue and Customs (Respondent)', Supreme Court, November 2017

52 'Litigation and Settlement Strategy', HMRC, October 2017

- more accurately predicting the impact of time-lag on risks materialising

## Monitoring legal challenges to the welfare system

5.61 The FRR suggested the Department for Work & Pensions (DWP) could improve reporting of expected or potential costs of current or anticipated legal challenges in their departmental accounts.

5.62 DWP carefully monitor all existing legal challenges to the welfare system and disclose as required in their Annual Report and Accounts in line with relevant International Accounting Standards and HMT Financial Reporting Manual (FReM). Legal challenges are regularly monitored through senior internal monthly governance boards where contingency planning is put in place as required, and key risk areas are discussed with senior HM Treasury officials quarterly. Ministers are also regularly informed of changes to significant risks.

5.63 DWP continuously builds on its strategy for mitigating the fiscal impact of legal rulings, and ensuring that claimants receive accurate awards from the beginning. For instance:

- as part of ongoing efforts to improve the assessment process for determining eligibility for disability benefit payments, DWP will be piloting videoing the assessment with a view to then roll this out across Great Britain. This is aimed at further building trust among claimants, that they can be sure of a fair and reviewable outcome
- since the FRR, DWP have decided to no longer continue with a number of historical appeals relating to PIP. Work is now underway to implement these judgments, ensuring that claimants receive any backdated payments owed; and
- further to this, DWP have taken steps to better capture legal risks in the welfare forecast. For example, the disability benefits forecast now includes some provision for the expected costs of legal cases, as well as other medical or cultural changes that could increase caseload over time. This approach seeks to incorporate learning from the introduction of similar benefits in the past, and to ensure a central welfare forecast

# Part V: Other spending risks

5.64 The FRR also highlights potential fiscal risks associated with the devolution of fiscal responsibilities to local authorities and the devolved administrations and the UK's exit from the EU. These include risks of:

- local authorities facing growing pressure on core services, running down their reserves, becoming insolvent, or undertaking potentially risky commercial investments
- the devolved administrations making unexpected use of their borrowing powers
- uncertainty surrounding the UK's financial settlement with the EU at the point of exit

5.65 The government is mitigating these risks in a range of ways including:

- strengthening the financial support and oversight of local authorities
- implementing new fiscal frameworks with the Scottish and Welsh governments to underpin their respective tax and borrowing powers
- agree a settlement of the UK's financial obligations to the EU as discussed in Box 5.B

## Local authorities

5.66 The OBR notes that responsibility for public spending decisions increasingly sits with local authorities, rather than central government. They highlight four areas in which financial decisions by local authorities could give rise to fiscal risk:

- pressure for more funding if delivery of core services falling short of legally or politically acceptable levels could build
- greater-than-expected drawdown of reserves
- the unprecedented situation of a local authority becoming insolvent
- greater use of potentially risky means of generating local revenue

### Increased funding to local authorities

5.67 Councils in England have access to over £200 billion to deliver local services from 2015-16 to 2019-20.[53] In 2016-17 the government made available four-year funding allocations for the first time which was accepted by 97% of local authorities. [54] In February 2018, the 2018-19 Local Government Finance Settlement provided access to an additional £1 billion for local services over two years, enabling local government to increase its spending power in real terms over the next two years.

### Financial sustainability and oversight

5.68 Local authorities have a legal duty to set a balanced budget in-year and a duty to ensure 'Best Value' in their decisions. Every local authority is required by statute to appoint an appropriately qualified individual with personal responsibility for the proper management of its financial affairs (known as the section 151 officer). This includes borrowing. A local authority may only borrow if the section 151 officer is satisfied that the borrowing is and will continue to be affordable from revenues. Local authorities are not allowed to run budget deficits: borrowing is intended to be used to manage the cash requirements of capital plans that include large up-front costs.

5.69 As the OBR note in the FRR, no local authority has experienced bankruptcy since the balanced budget requirement was introduced in 1992, and no local authority has defaulted on their borrowing since the Prudential Code was introduced in 2004. If it appears to the section 151 officer that the council will spend more in any financial year than the resources it has available, they must issue a formal statement to this effect – known as a 'section 114 notice.' This notice prevents the local authority from entering

53 'Local government finance settlement 2018 to 2019', MHCLG, February 2018

54 'Annual Report and Accounts 2016-17', DCLG, June 2017

into any new arrangements that incur expenditure until full council meets to consider the notice. The full council must then meet within 21 days and agree an appropriate way forward. This is an important part of the framework for local accountability and spending control.

5.70 In January 2018, MHCLG commissioned a Best Value inspection to look into financial management in Northamptonshire County Council. In February 2018 Northamptonshire County Council issued a Section 114 Notice. As the inspector noted in his report, the failure for Northamptonshire to comply with its Best Value duty was not about government funding, but failings in the Council's financial management and budgetary control, and internal governance and scrutiny.

5.71 Going forward, the government will review the current approach to the collection and reporting of local government financial data. The aim of the review will be to ensure that the data that is produced and collected is proportionate; supports fiscal monitoring (including in light of the additional reporting commitments made in Chapter 6) and continues to meet the needs of the government, local authorities, and other stakeholders.

## Reserves drawdowns

5.72 Local authorities hold reserves for a variety of reasons, including: to meet unexpected calls on their resources, like the consequences of flooding or heavy snow; to act as a cushion against uneven cash flows; to avoid the need for temporary borrowing; and to build resources to cover certain or probable future liabilities. Unexpected drawdown of reserves poses a risk to the government's PSNB forecast which includes the revenue and expenditure of all public sector bodies, including local authorities.

5.73 Determining the level and use of reserves is a matter for local authorities, taking into account their local challenges and priorities. To ensure prudent financial management, some authorities will maintain revenue reserves at different levels to others. The OBR's assumed profile of reserves drawdowns from Spring Statement 2018 would leave local authorities in England with £20.2 billion of reserves at the end of 2020-21. This is £3.8 billion (23.5%) more than they held at the end of 2010-11.[55]

5.74 The government has taken action to improve the security over, return on, and visibility of local authority reserves. The Debt Management Office provides a flexible and secure facility, the Debt Management Account Deposit Facility (DMADF), to users (mainly local authorities) as part of its cash management operations and in the context of a wider series of measures designed to support local authorities' cash management. The key objective of the DMADF is to supplement the existing range of investment options open to local authorities, whilst saving interest costs for central government. Since April 2018, the DMADF has been updated to allow active provision of variable interest rates to DMADF counterparties based on deposit size and tenor. This has increased the volume and maturity of local authority deposits

55 'Department for Communities and Local Government: Local authority Revenue Expenditure and Financing: 2016-17 Final Outturn', England, DCLG, June 2017

with the DMADF which also aids central government's ability to monitor local authorities' use of their financial resources.

## Borrowing and investment

5.75 The decisions that local authorities make around borrowing, investment, and capital finance are subject to prudential guidance published by MHCLG and the Chartered Institute of Public Finance and Accountancy (CIPFA). Taken together, these documents form the prudential framework. It is a statutory requirement for local authorities to have regard for this guidance.

5.76 In 2017, this framework was updated to improve transparency and support sound decision-making by ensuring that key individuals have sufficient knowledge and expertise. These changes which came into force in April 2018:

- enhance transparency requirements
- require authorities to demonstrate how they have ensured those signing off commercial decisions understand the risks
- require local authorities to consider affordability of borrowing over a longer time period than the previous guidance
- make it clear that borrowing more than or in advance of need solely to generate a profit is not prudential
- require local authorities to demonstrate that the level of debt taken on and aggregate risk from investments is proportionate to the authorities' size
- update the guidance on calculating minimum revenue provision to make it clear that local authorities should not make imprudent assumptions to minimise their debt servicing costs

5.77 The enhanced local authority reporting requirements retain the need for an 'Investment Strategy' to be prepared at least annually, although local authorities have flexibility on the structure, and introduced some additional disclosures to improve transparency. The new disclosures provide additional information to enable members to understand their local authority's risk exposure to commercial decisions.

5.78 In February 2018, the government published a set of recommended quantitative indicators for local authorities to prepare and monitor when making investment decisions, covering the performance and risks of their assets and of the debt, commercial income, and other financing used to buy and maintain them.

5.79 The OBR noted in the March 2018 'Economic and fiscal outlook' that the revisions to the prudential codes 'are expected to curb commercial activity by authorities'. The government will monitor how local authorities respond to the revised guidance, and make take appropriate further action if this is necessary.

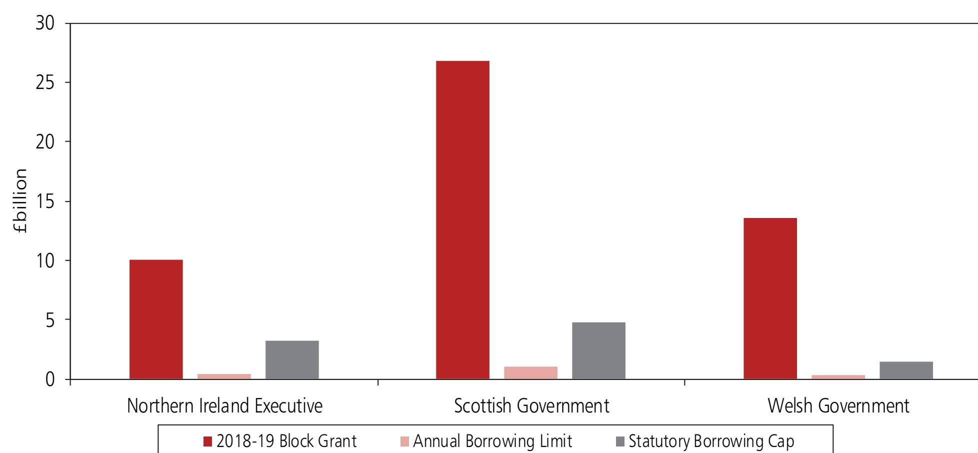
## Devolved administrations

5.80 The FRR highlighted that devolution of greater revenue-raising, expenditure, and borrowing powers to the devolved administrations could present a risk to the public finances if a devolved administration were to become unable to fund essential services while servicing their debts.

5.81 The Scotland Acts 2012[56] and 2016[57] devolved significant tax powers to the Scottish Parliament, including Stamp Duty Tax and Landfill Tax from April 2015; all rates and thresholds of income tax from April 2017; assigned VAT revenues from April 2020; and Air Passenger Duty and Aggregates Levy. In addition, the Scotland Act 2016 will devolve various welfare powers, including most disability benefits and those from the Regulated Social Fund, by 2021-22.

5.82 The Wales Acts 2014[58] and 2017[59] also devolved tax powers to the Welsh Assembly including Stamp Duty Land Tax and Landfill Tax from April 2018, and Welsh rates of income tax from April 2019.

### Chart 5.D: Devolved administration budgets and borrowing powers




Source: Scottish and Welsh Governments' Fiscal Frameworks, Stormont House Agreement, HMT's Block Grant Transparency Publication

5.83 The government's principal mechanisms for mitigating this risk are new fiscal frameworks agreed with the Scottish[60] and Welsh[61] governments which underpin the funding arrangements for their respective tax, spend and borrowing powers. These frameworks include limits on the total borrowing permitted by the devolved administrations as well as annual limits on such borrowing, as set out in Chart 5.D above.

5.84 The Scottish and Welsh governments' fiscal frameworks also include requirements for their governments to have independent forecasting arrangements for scrutiny of devolved taxes. The Scottish Fiscal Commission

56 'Scotland Act 2012', UK Government
57 'Scotland Act 2016', UK Government
58 'Wales Act 2014', UK Government
59 'Wales Act 2017', UK Government
60 'The agreement between the Scottish government and the United Kingdom government on the Scottish government's fiscal framework', HM Treasury and The Scottish Government, March 2016
61 'The agreement between the Welsh government and the United Kingdom government on the Scottish government's fiscal framework', HM Treasury and the Welsh Government, March 2016

produced its first statutory independent fiscal and economic forecasts for the Scottish government in December 2017[62]. The Welsh government is currently in the process of confirming forecasting arrangements for its own new taxes. The Scottish government has also published its medium-term financial strategy[63] which it will update annually and sets out its approach to using the financial powers provided through the Scotland Acts 2012 and 2016.

5.85 Tax devolution will add an extra element of volatility to the devolved administrations' budgets, as more of their funding will be determined by devolved tax revenues (rather than just the block grant provided by the UK government). However, the block grant adjustment mechanisms that we have agreed for tax devolution will mean the Scottish and Welsh governments' spending power is still largely protected from wider UK-wide economic risks. These risks will be limited instead to forecast error and slower growth in devolved tax receipts relative to the rest of the UK.

62 'Scotland's Economic and Fiscal Forecasts December 2017', Scottish Fiscal Commission

63 'Scotland's Fiscal Outlook: The Scottish Government's Five Year Financial Strategy', May 2018

### Box 5.B: EU exit financial settlement

The FRR noted uncertainty around the UK's financial settlement with the EU as a significant fiscal risk arising from EU exit negotiations. In December 2017, the UK and the EU published a Joint Report on the first phase of negotiations and, in March 2018, published a draft Withdrawal Agreement.[64] [65] These documents include details of the agreement concerning the settlement of the financial commitments made during membership and was secured on the basis of three key principles.

First, the UK would pay and receive funding on the same basis as other Member States. In other words, the UK share of budget contributions would be based on actual budget implementation, excluding those parts in which the UK has an opt-out. In relation to liabilities, contingent liabilities and assets, the UK would not pay for liabilities that do not materialise. The UK would also receive a share of funds that accrue to the EU budget.

Second, the financial settlement would reflect the financing share of the EU budget during its membership. 2019 and 2020 contributions would be based on what the UK would have paid had it remained a Member State for the remainder of the 2014-20 Multiannual Financial Framework (MFF). After that, it would be based on the UK's average share of EU budget contributions over the MFF.

Third, the UK would only be required to make payments as they fall due. This means that the UK cannot be required to incur expenditure any earlier than would have be the case had we remained a Member State, although the UK may choose to apply one of the early settlement mechanisms as set out in the draft withdrawal agreement, but these cannot be used without the UK's agreement.

These principles equate to a central estimate of the total settlement of between £35 billion and £39 billion. The £37.1 billion estimate for the EU financial settlement included in the OBR's 2018 Spring Statement forecast is close to the centre of this range. Because the UK cannot be required to pay more or earlier than if it had remained a Member State, the actual settlement payments will remain within or below the EU membership counterfactual on which the OBR's fiscal forecast is based, as illustrated in March 2018 EFO.[66] Future spending decisions on domestic replacements to EU programmes will be considered at the next Spending Review in 2019, which will also provide the context for discussions on future participation in EU programmes.

64 'Joint report from the negotiators of the European Union and the United Kingdom Government on progress during phase 1 of negotiations under Article 50 TEU on the United Kingdom's orderly withdrawal from the European Union', EU and UK, December 2017

65 'Draft Withdrawal Agreement', EU and UK, March 2018

66 'OBR Economic and Financial Outlook', May 2018

# Chapter 6
# Balance sheet

6.1 In the private sector, financial statements cover both flows (revenue and expenditure) and stocks (assets and liabilities). This ensures that financial decisions are informed by a comprehensive picture of the financial position and performance of the company and decision makers are held to account for the impact of their decisions on the company's long-run value.

6.2 By contrast, public sector financial reporting and forecasting has typically focused on government borrowing and the stock of government debt. However, as shown in Chart 6.A, in the UK, borrowing is only one of a range of determinants of the change in government debt which is also affected by transactions in other parts of the balance sheet – especially since the financial crisis of 2008-09. Moreover, the financial balance sheet is usually only a subset of the array of assets and liabilities typically held by governments, as shown in Chart 6.B. Taking a more comprehensive view of the government balance sheet can help to provide a more complete picture of the sustainability of the public finances and promote greater accountability for the management of public wealth.

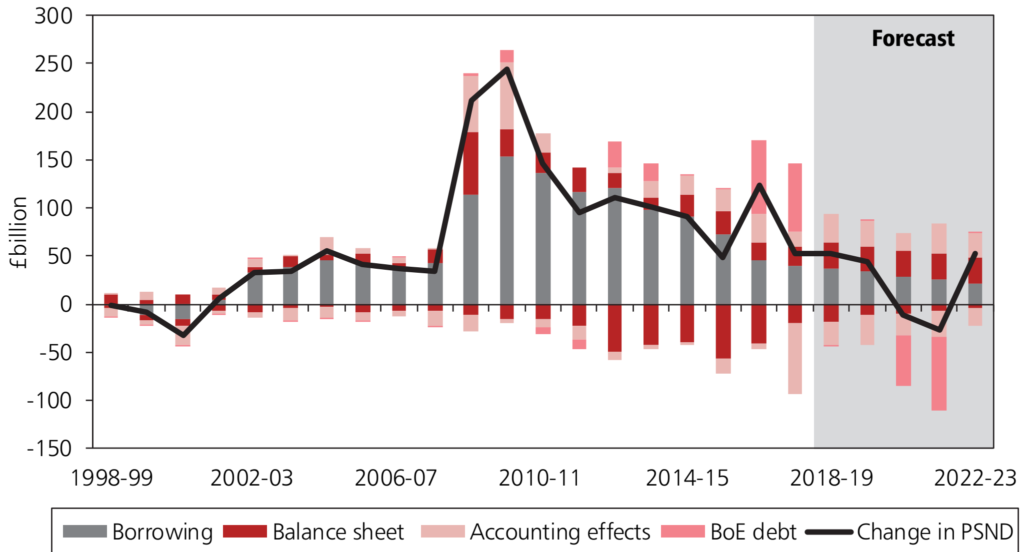
6.3 This chapter describes the actions the government is taking to strengthen the management of the public sector balance sheet and the risks around it. It addresses the issues raised in the FRR:

- Part I discusses the government's recent efforts to better understand the balance sheet
- Part II sets out the government's recent actions to encourage better management of assets and liabilities
- Part III presents the actions that the government has taken to strengthen controls over balance sheet risks

6.4 In doing so, the chapter also responds to the recommendations made by other expert bodies including the NAO, Public Accounts Committee (PAC), IMF, and Institute of Chartered Accountants in England and Wales (ICAEW) about the need to improve understanding of the public sector balance sheet

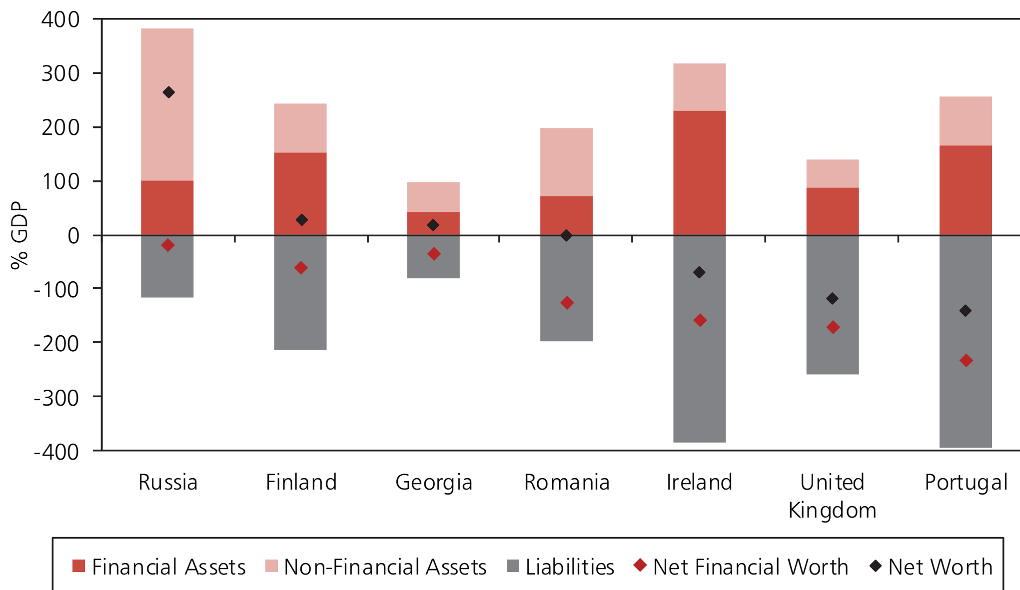
and strengthen the institutional arrangements for managing assets and liabilities.[1,2,3,4]

## Chart 6.A: Drivers of changes in public sector net debt




Source: ONS, OBR, Treasury Calculations
Note: (1) "Accounting effects" refers to accounting reconciliations in central government (such as the adjustment for interest on gilts) and changes from local government and public corporations. (2) "Balance sheet effects" refers to government transactions that contribute to debt without impacting the deficit. This mostly reflects asset sales and loans but also includes revaluations. (3) "BoE debt" reflects the operations of the Bank of England, including transactions in the Term Funding Scheme in 2016-22.

## Chart 6.B: Balance sheets of selected governments




Source: IMF
Note: Comparator countries are countries in Europe who have been through an IMF Fiscal Transparency Evaluation.

1 'Evaluating the government balance sheet', NAO, 30 June 2016

2 'The Government Balance Sheet', Committee of Public Accounts, Nineteenth Report of Session 2016-17

3 'Balance sheet analysis in fund surveillance', IMF, 25 June 2015

4 'Managing the Public Sector Balance Sheet', ICAEW Better Government Series, 2017

## Part I: Understanding the balance sheet

6.5 The FRR highlighted a number of risks associated with an incomplete understanding of the government balance sheet including the:

- deterioration in broad measures of public sector net worth since the crisis
- tendency for partial reporting of the government financial position to give rise to 'fiscal illusions

6.6 The government is taking a number of actions to address these risks including:

- developing more comprehensive, timely, and forward-looking indicators of balance sheet performance
- making better use of those indicators to inform financial decision making and risk management

### New measures of balance sheet performance

6.7 In recent years, the UK has been in the vanguard of international practice in the reporting of information on the public sector balance sheet. In 2011, the UK became the first country to produce Whole of Government Accounts (WGA) which provide a comprehensive picture of the public sector's total liabilities, assets and net worth, as well as a statement of revenue and expenditure. These accounts encompass the whole of the UK public sector, consolidating over 7,000 organisations, are based on the International Financial Reporting Standards (IFRS), and are independently audited.[5]

6.8 While the publication of WGA has transformed the government's understanding of its balance sheet, it has three limitations from the point of view of informing fiscal policymaking. First, WGA is currently published over a year after the balance date which means that the government does not have an up-to-date picture of its balance sheet position when deciding next year's budget. Second, WGA is a backward-looking report focusing on audited outturn figures for the previous year which means that it does not provide information about the future evolution of assets and liabilities. Third, WGA is based on private sector accounting standards (IFRS) as interpreted for the public sector. It therefore does not easily reconcile to government's supplementary debt rule which targets public sector net debt (see Box 2.C), which is a National Accounts measure prepared to the European System of National and Regional Accounts (ESA 2010) statistical framework. WGA does, however, include a reconciliation to the National Accounts. The components of public sector net debt, WGA and other fiscal aggregates published by the government are explained further in Box 6.A.

[5] WGA 2016-17: page 3

## Box 6.A: Headline balance sheet metrics

The government has developed and published a range of summary fiscal aggregates to aid understanding and decision making regarding the public sector balance sheet.

**Public Sector Net Debt (PSND)** is the chosen metric for the government's supplementary fiscal target to reduce debt as a share of GDP in 2020-21. PSND is a relatively narrow measure and includes only 'debt' liabilities (debt securities, loans, currency and deposits) and 'liquid' assets (mostly currency and deposits and additional currency assets that the government uses for cash management). It therefore provides an approximate stock equivalent of the cash deficit – the 'public sector net cash requirement'.

**PSND excluding the Bank of England (PSND ex BoE)** deducts from PSND the assets and liabilities held on the Bank of England's balance sheet. This metric was developed following the launch of the Bank's time-limited Term Funding Scheme (TFS) in August 2016 which adds significantly, but temporarily, to PSND in order to finance the assets purchased.

**Public Sector Net Financial Liabilities (PSNFL)** includes all financial assets (including loans and equity) and all financial liabilities (including derivatives and insurance) in the National Accounts, including those debt liabilities recognised in PSND. PSNFL therefore provides an indication of the performance of the government's financial balance sheet. It was first published in December 2016 as an experimental, but official, statistic.

**Public Sector Net Liabilities (PSNL)** (based on WGA) includes all assets (including non-financial assets such as property, plant and equipment) and all liabilities (such as pension entitlements of public sector employees, private finance initiative (PFI) liabilities and provisions). By incorporating government's fixed assets as well as long-term liabilities, PSNL provides the most comprehensive measure of the government's balance sheet position and long-term solvency.

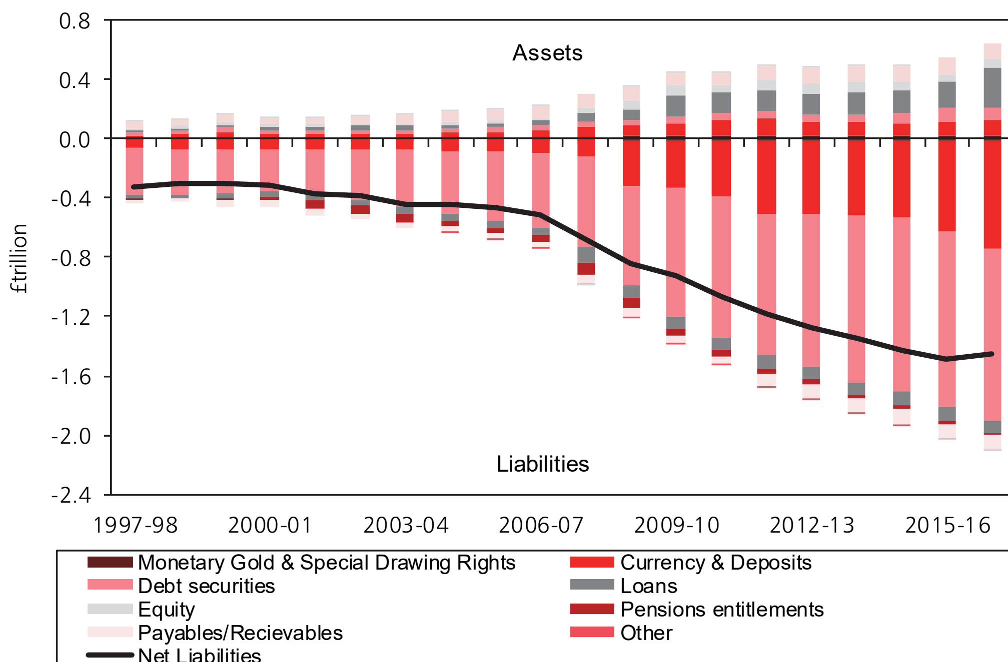
## Chart 6.C: Components of different balance sheet aggregates

| | National Accounts | | WGA |
|---|---|---|---|
| | Public Sector Net Debt (PSND) | Public Sector Net Financial Liabilities (PSNFL) | Public Sector Net Liabilities (PSNL) |
| | | | Non-financial assets |
| | | Illiquid financial assets | Illiquid financial assets |
| **Assets** | Liquid financial assets | Liquid financial assets | Liquid financial assets |
| **Liabilities** | Government borrowing | Government borrowing | Government borrowing |
| | Other liabilities | Other liabilities | Other liabilities |
| | | | Provisions |
| | | | Public sector pensions |
| | | | PFI liabilities |

Source: WGA, ONS.

6.9 To provide policymakers and the public with a more timely, forward-looking, and statistically-based measure of the balance sheet, the government asked the ONS to publish and the OBR to forecast public sector net financial liabilities (PSNFL) in November 2016.[6] PSNFL provides a summary of the government's financial balance sheet, is published monthly by the ONS, and projected 5-years ahead by the OBR in the Economic and Fiscal Outlook (EFO). Following improvements in data quality, PSNFL shed its experimental status in April 2018. To provide a more detailed picture of the evolution of the government's financial balance sheet, the government has asked the OBR to publish the main components of its PSNFL forecast in future EFOs.

## Chart 6.D: Changes in PSNFL components over time




Source: ONS

Note: 'Other' includes non-life insurance technical reserves; provisions for call under standardised guarantees and financial derivatives and employee stock options.

6.10 The government is committed to further improving the comprehensiveness, transparency, and timeliness of its fiscal statistics by reporting against the IMF's Government Finance Statistical Manual 2014 (GFSM) framework. GFSM is the most comprehensive international statistical standard for governments and requires publication of a full balance sheet (including fixed assets, public-private partnerships, and pension liabilities) as well as disaggregated presentation of the finances of local governments and public corporations. GFSM 2014-based fiscal statistics are based on the same concepts as the System of National Accounts 2008, which will complement the ESA 2010-based statistics upon which the fiscal rules continue to be based. The ONS have outlined in their article, published alongside this report, their plans to published GFSM-consistent tables in 2019.[7]

6.11 Both WGA and GFSM show a static balance sheet – a snapshot in time showing only past assets and obligations. There is growing international

6 'Autumn statement: Supplementary fiscal aggregates: 2016', ONS, 23 November 2016

7 'Looking ahead: developments in public sector finance statistics', ONS, July 2018.

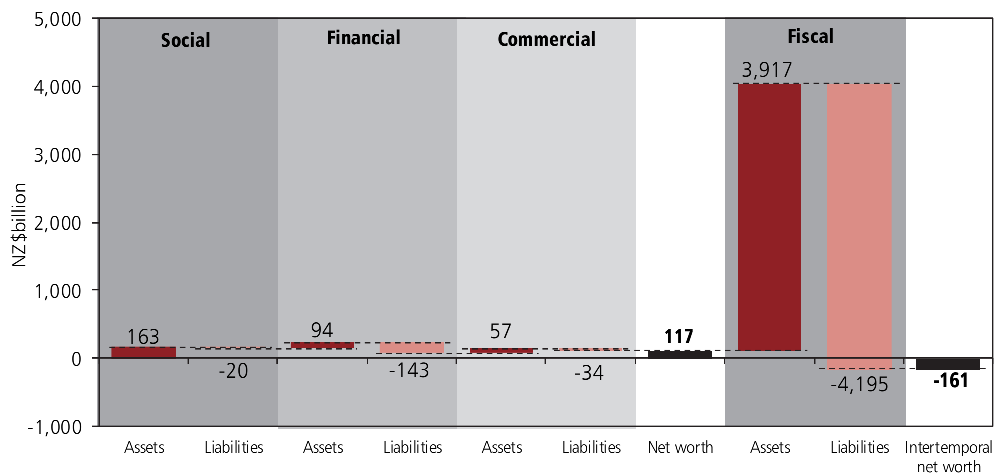
interest in dynamic measures of the balance sheet which take account of future revenue and expenditure (Box 6.B).

## Box 6.B: Measuring intertemporal net worth

The growth internationally in balance sheet reporting has highlighted the limitations of the typical, static balance sheet. These balance sheets are backward-looking, which limits their value in assessing fiscal solvency and responding to fiscal risks. Therefore, the IMF and leading-edge countries have focused on developing a forward-looking balance sheet (the 'intertemporal balance sheet') which provides a measure of net worth that captures the government's future asset and liability position ('intertemporal net worth').

The intertemporal balance sheet improves on the static balance sheet by incorporating the government's largest asset and liability: the right to raise taxes, and the obligation to meet future expenditures, respectively. The result is a comprehensive view of the fiscal position and a measure of intertemporal net worth.

### Chart 6.E: The New Zealand intertemporal balance sheet




Source: The New Zealand Treasury.

New Zealand publishes intertemporal net worth every four years as part of their Investment Statement (Chart 6.E).[8] It divides the government's balance sheet into social (held to provide public services), financial (that finance or prefund government expenditure), commercial (belonging to entities with commercial objectives), and fiscal (future expected spending and revenue). The 2018 Statement showed that the government's static net worth was positive at NZ$117 billion, but including the fiscal balance sheet (especially spending pressures associated with an ageing population), implied that intertemporal net worth was negative. A negative intertemporal net worth suggests a need for policy action to reduce the fiscal burden on future generations and support intergenerational fairness.

8 'He Puna Hao Pātiki: 2018 Investment Statement', New Zealand Treasury, 20 March 2018

## Using balance sheet information to inform decision making

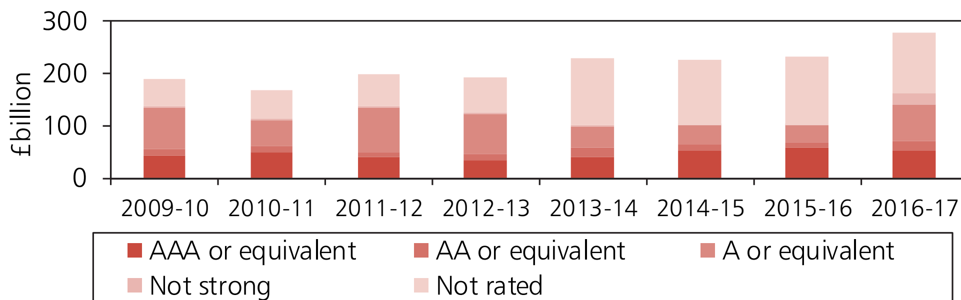
6.12 The government is using this more comprehensive data about its assets and liabilities to make more informed decisions about its balance sheet, as recommended by the PAC and NAO. In September 2016, HMT established the Balance Sheet Analysis Unit. The Unit sits within the Fiscal Group and acts as a hub of analysis in the Treasury to improve balance sheet decisions across the public sector. The Unit also acts as the secretariat to the Balance Sheet Group (BSG) discussed in Chapter 1 and in the next section of this chapter.

6.13 Over the past year, the Unit has developed an additional suite of balance sheet indicators for tracking the performance of the public sector balance, set out in Box 6.C. This work has helped to inform decisions about the management of contingent liabilities, exchange rate exposures, and the sale of financial assets. It has also helped to identify common risk factors across the range of government financial holdings.

## Box 6.C: Balance sheet indicators

The government monitors a range of indicators of the health of its balance sheet, supported by the information in WGA and the work of the new Balance Sheet Analysis Unit. Chart 6.F shows the evolution of the government's credit risk according to maximum exposure per the credit rating of its assets.

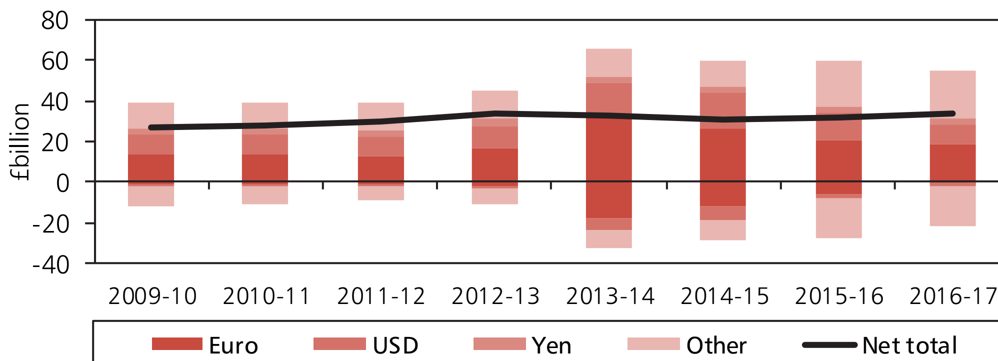
### Chart 6.F: Maximum exposure by investment grade




Source: WGA and HM Treasury

Chart 6.G depicts the composition of the government's foreign currency holdings. It shows that the government has positive net foreign assets.

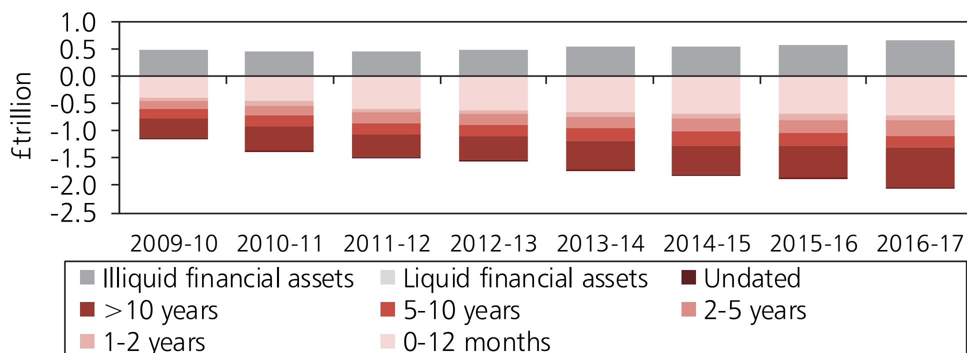
### Chart 6.G: Foreign exchange holdings by currency




Source: WGA, HM Treasury

Chart 6.H shows the maturity structure of the government's financial assets and liabilities. It shows that short-term liabilities have grown significantly since 2009-10, while assets are largely illiquid and have remained steady.

### Chart 6.H: Asset and liability maturity




Source: WGA, HM Treasury

## Part II: Better management of assets and liabilities

6.14 In the FRR, the OBR also identified a set of risks associated with how the government's assets and liabilities are managed, including from:

- asset sales that could be delayed or raise less than expected
- asset sales that have not been factored into current forecasts

6.15 In addition to taking steps to improve understanding of balance sheet developments, the government is also strengthening the institutions and procedures for managing the assets and liabilities it holds. This section details the measures the government is taking to:

- return the assets acquired during the 2008-09 financial crisis to the private sector
- conduct a comprehensive review of its wider asset and liability holdings
- further improve transparency around asset sales

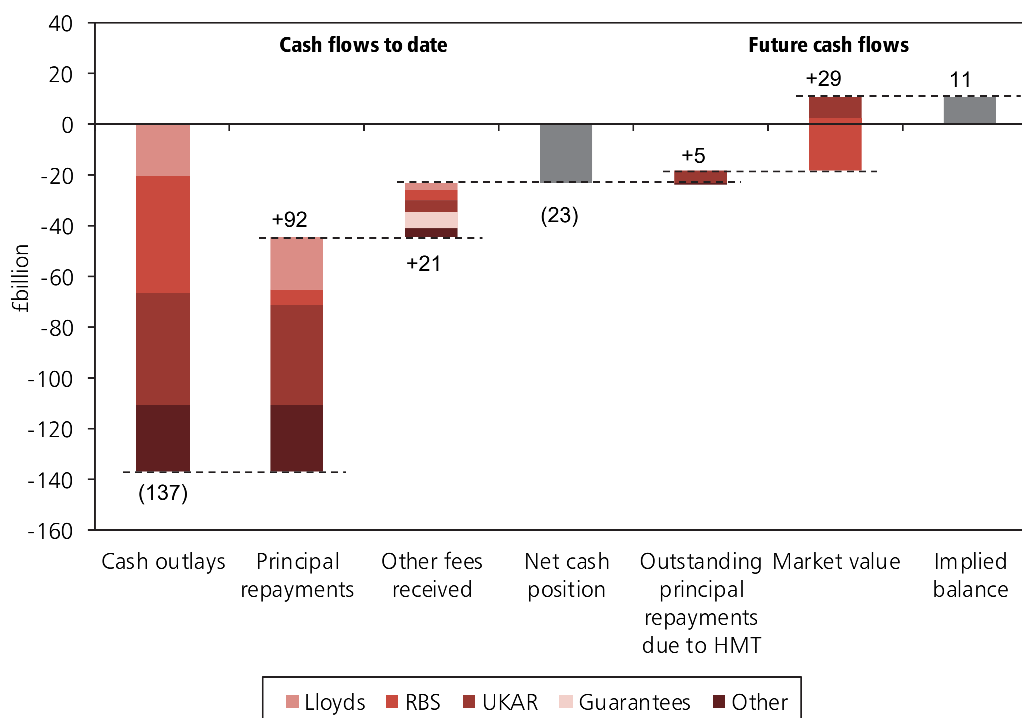
### Returning crisis-related assets to the private sector

6.16 The government has made significant progress in returning the financial assets acquired in the wake of the 2008-09 financial crisis to the private sector. As illustrated in Chart 6.I, the government disbursed £137 billion in cash as part of its financial sector interventions following the crisis. The government acquired these assets during the financial crisis to ensure financial stability and to protect the wider economy. Returning these assets to the private sector will reduce public debt and build a stronger and safer financial system. Since the financial crisis, the government has received principal repayments of £92 billion, including fully returning Lloyds to the private sector and completing two RBS shares, as explained further in Box 3.A. The government has collected a further £21 billion through fees and dividends through owning these assets.

6.17 A further £34 billion of crisis-related assets remain on the government's balance sheet.[9] If the government were to receive remaining loan repayments in full and sell its remaining financial assets, it would realise an overall cash surplus of around £11 billion, although this does not take account of borrowing costs associated with the funding the interventions. However, the aim of the government's interventions was to protect financial stability and the broader economy, not to make a profit.

[9] Including £4.7 billion of loans from HMT to UKAR, and £28.8 billion of equity in UKAR and RBS, as shown in Chart 6.I.

## Chart 6.I: Cash flows from assets acquired in the financial crisis




Source: OBR and HM Treasury

Note: As at 30 June 2018. RBS market value calculated using share price as at the latest RBS sale on 6 June. UKAR market value uses the net asset value of equity in HMT's 2017-18 financial statements.

6.18 The NAO's reports into sales of Lloyds and RBS shares, as well as UKAR's largest asset sale in 2016, highlighted the government's success in achieving value for money.[10] Moreover, the OBR noted in March 2018 that UKAR has historically met most of its sales plans.[11] Given the inherent limitations in forecasting asset sales, the Treasury uses its internal risk reporting processes to ensure that the appropriate level of reliance is placed on forecasts and that issues which will impact the timing and size of sales are fully understood and flagged early.

## Balance Sheet Review

6.19 With the bulk of the financial assets acquired during the financial crisis on course to be returned to the private sector, the government is shifting its focus to getting better value from the £1.9 trillion of assets and £4.3 trillion of liabilities that remain on its balance sheet.[12] In February 2017, the Treasury established the BSG to provide more effective cross-government leadership, coordination, and decision making in the management of assets and liabilities. Supported by the Balance Sheet Analysis Unit described above, the BSG meets quarterly and reports to the FRG on risks and opportunities related to the balance sheet.

6.20 At Autumn Budget 2017 the Treasury launched the Balance Sheet Review (BSR), a comprehensive review of the management of the government's

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[10] 'The £13 billion sale of former Northern Rock assets', NAO, 19 July 2016, 'The first sale of shares in Lloyds Banking Group', NAO, 18 December 2013, 'The first sale of shares in Royal Bank of Scotland', NAO, 14 July 2017.

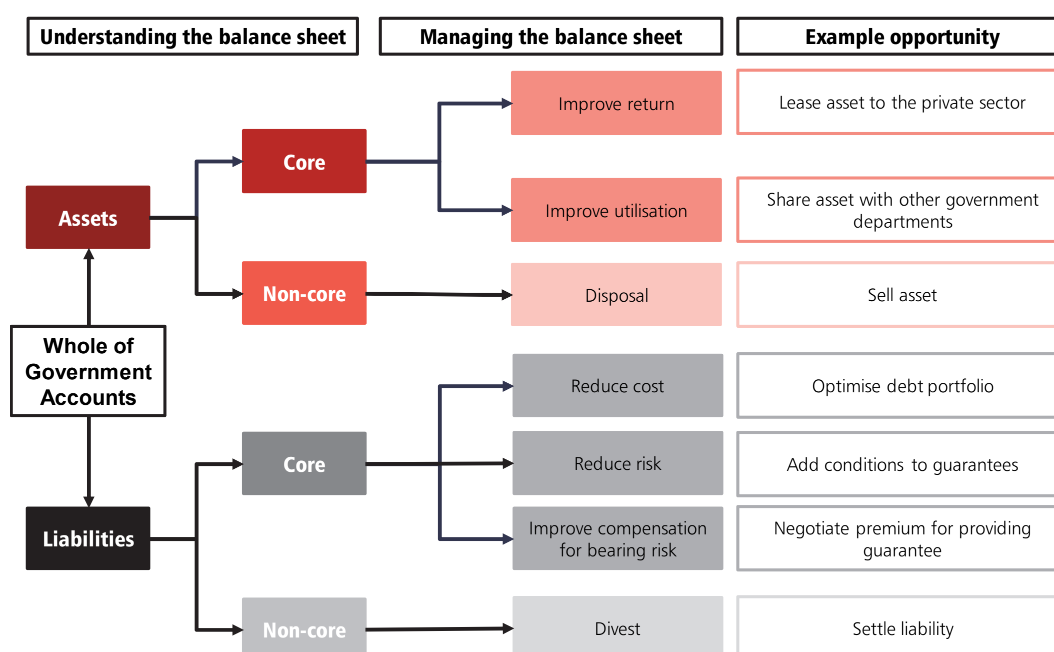
[11] 'Economic and fiscal outlook – March 2018', OBR, 13 March 2018: paragraph 4.168.

[12] WGA 2016-17.

wider assets and liabilities led by the BSG.[13] The BSR draws on the wealth of balance sheet information now available and seeks to learn from best practice in balance sheet management in both public and private sectors. As shown in Chart 6.J, the BSR is centred around a root and branch review of all government departments' balance sheets to identify opportunities to:

- dispose of assets which no longer serve a public policy purpose
- improve the return on assets retained for public service delivery
- reduce the cost of liabilities held by departments
- reduce the risks associated with their assets and liabilities and improve compensation for bearing those risks

## Chart 6.J: Framework for the Balance Sheet Review




6.21 The BSR has already identified a number of opportunities for getting better value from the assets and liabilities it holds. In particular, the BSR is looking at how to:

- increase the return on the intangible assets owned by government such as intellectual property, data, and software
- improve government management of its £420 billion estate,[14] building on the successful consolidation of Whitehall office space
- reduce the cost of liabilities such as provisions, including the cost of clinical negligence
- improve our management of PFI/PF2 projects
- improve the management of and compensation for contingent liabilities

13 'Autumn Budget 2017', HM Treasury, 22 November 2017: paragraph 6.24

14 WGA 2016-17, note 12

- strengthen balance sheet controls, such as the improved procedures for issuing loans and selling assets as described in Chapter 5 and this chapter

6.22 The BSR will provide an update on its findings in Autumn Budget 2018 and its recommendations will inform the 2019 Spending Review.

## Management of asset sales

6.23 In addition to returning the financial assets taken on in the financial crisis to the private sector, the government has also successfully sold other financial assets where there was no longer a policy reason to hold them and value for money could be achieved. On 20 April 2017, the government announced the sale of the UK Green Investment Bank plc (GIB) to Macquarie Group Limited, with a £2.3 billion deal which secured a profit on the government's investment in the bank, provided value for taxpayers and ensured GIB continues its green mission in the private sector.[15] The first sale of pre-2012 income-contingent student loans concluded in December 2017, raising £1.7 billion via a securitisation from loans. This is part of a programme of sales from the pre-2012 loan book, aiming to raise £12 billion. Borrowers are not affected by the sale, and the sold loans continue to be serviced by HMRC and the Student Loan Company. In announcing the sale, the government committed not to change the terms of pre-2012 loans.[16]

6.24 Decisions to sell financial assets are made based on market conditions and the ability to achieve value for money at the time. The government continues to draw on the expertise of UK Government Investments (UKGI) and experience gained from past sales when managing asset sales. While the PAC and NAO have generally been positive on the overall assessment that sales have proved to be value for money, they have called for increased transparency of the impact of asset sales to support long-term decision making.[17]

6.25 To demonstrate that the decisions arising from the BSR, and those on asset sales more broadly, represent value for money for the taxpayer, the government is also taking steps to further increase transparency. After each material asset sale, Departments will be required to publish, through a Written Ministerial Statement, the impact of that sale on a range of measures including PSNB, PSND, PSNFL, the accounting balance sheet, and, subject to any commercial sensitivities, whether the sale price was above, below, or within the hold valuation range.

# Part III: Strengthening control of balance sheet risks

6.26 In the FRR, the OBR also noted that the public sector balance sheet is affected by factors outside of the government's control. In particular, it highlighted the:

- risks to the balance sheet arising from the growing use of government guarantees, especially in infrastructure and housing

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15 'Sale of Green Investment Bank', GOV.UK, 20 April 2017.

16 'Government asset sale: Written statement – HCWS316', Parliament, 6 December 2017.

17 'Treasury Minutes: Government responses on the Fifteenth to the Twentieth reports from the Committee of Public Accounts: Session 2015-16', HM Treasury, March 2016: pages 5 and 11.

- possibility of reclassifications that expand the public sector balance sheet

6.27 This section describes the steps that the government is taking to enhance its controls over balance sheet risks through:

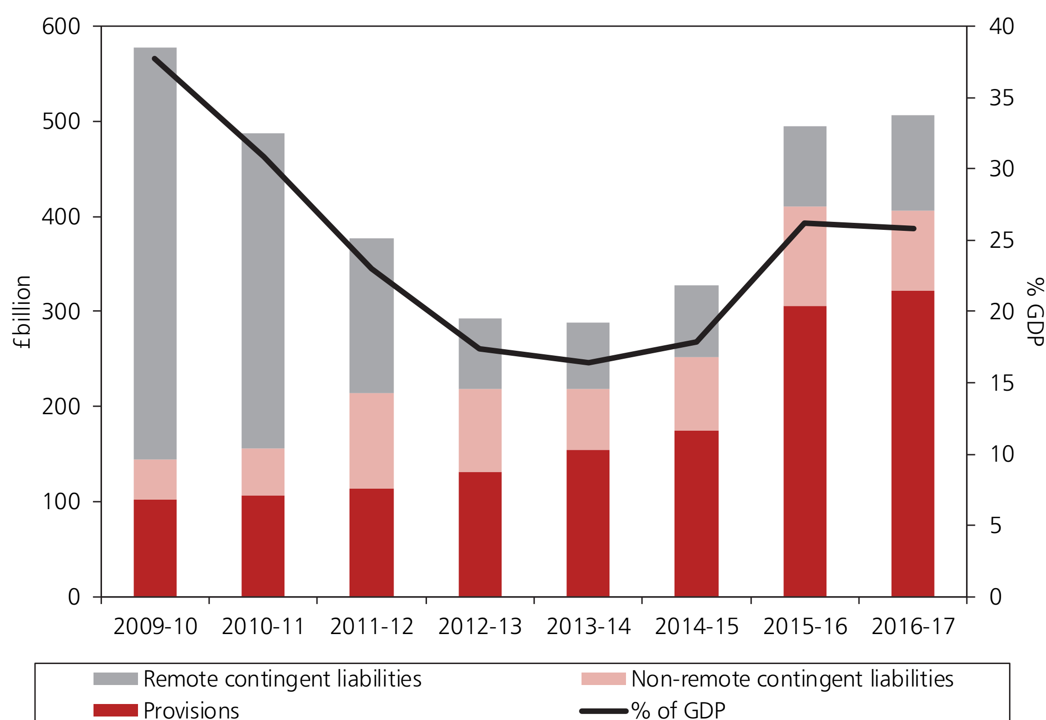
- a new approval regime for government guarantees and other contingent liabilities
- active monitoring of risks associated with its portfolio of housing, infrastructure, and other guarantees
- strengthening cooperation between HMT, ONS, and OBR in the implementation of statistical reclassifications

## New approval regime for contingent liabilities

6.28 Following a steep decline in the wake of the financial crisis, the value of financial exposures (in the form of provisions and contingent liabilities) on the government's balance sheet has been rising since 2013-14, as shown in Chart 6.K. This reflects the rapid unwinding of remote contingent liabilities due to the closure of financial stability schemes set up during the global financial crisis, which has been offset by a rapid increase in non-remote contingent liabilities and provisions. The recent increase in these more probable risks is largely due to changes to the long-term discount rate. This increased the value of provisions for nuclear decommissioning and clinical negligence liabilities (see Chapters 1 and 5) as well as the expansion of government guarantee schemes, including those related to the housing sector (see Chapter 2).[18]

18 WGA 2015-16, paragraph 1.16.

## Chart 6.K: Provisions and contingent liabilities in WGA




Source: WGA 2009-10 to 2016-17

6.29 The Treasury has established a new approval regime for contingent liabilities in the light of the growth in guarantees and other contingent liabilities since 2013-14 and in response to recommendations from expert bodies such as the IMF, NAO, and PAC. Building on the principles set out in 'Managing Public Money',[19] the new process is applied to all contingent liabilities that are novel, contentious, or repercussive with a maximum exposure of over £3 million. Contingent liability proposals are evaluated against five criteria summarised in Chart 6.L. Guidance on the new process was published in July 2017 to assist officials in the application of the new contingent liability controls.[20] The new approval process has been featured by both the IMF[21] and OECD[22] as an example of international best practice in the management of government guarantees.

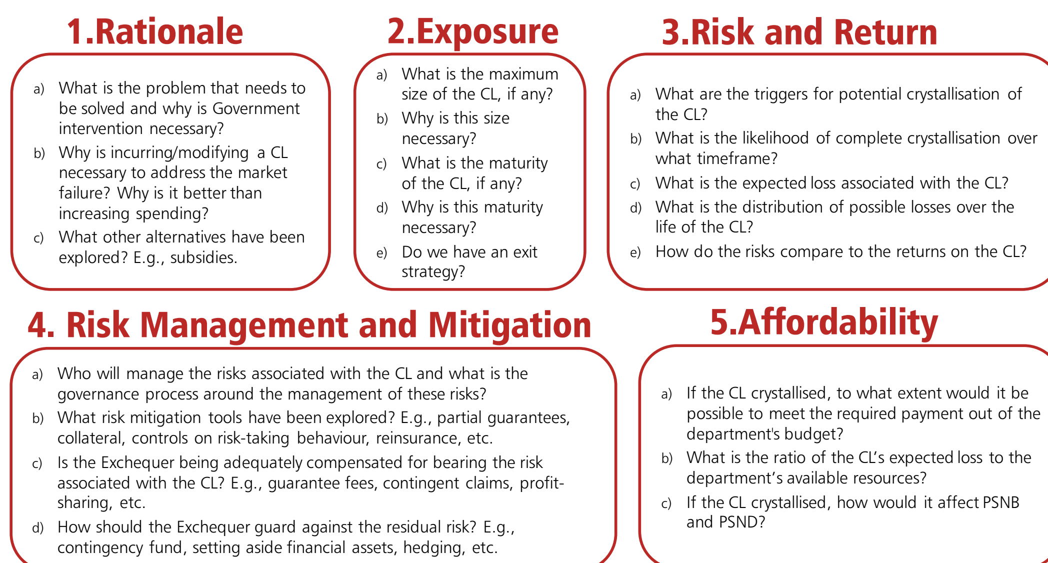
19 'Managing public money', HM Treasury, July 2013 with annexes revised as at March 2018.

20 'Contingent liability approval framework', HM Treasury, 13 July 2017.

21 'How to strengthen the management of government guarantees', IMF, 19 October 2017.

22 '18th Annual Meeting of OECD Senior Financial Management and Reporting Officials', OECD Paris, 1-2 March 2018.

## Chart 6.L: Contingent liability approval framework




Source: HM Treasury, Contingent liability approval framework.

## Active monitoring of guarantee exposure

6.30 The application of the new approval framework has also enabled the centralised collection and active monitoring of contingent liability exposures. Details of the new contingent liabilities recorded in the Treasury's new database are summarised in Box 6.D.[23] Since the adoption of the new approval regime in early 2017, over 60 new contingent liabilities with a total value of £158 billion (excluding contingent liabilities related to the TFS) have passed through the process. A number of contingent liabilities with a total exposure of over £1 billion were rejected outright. The vast majority were only approved after:

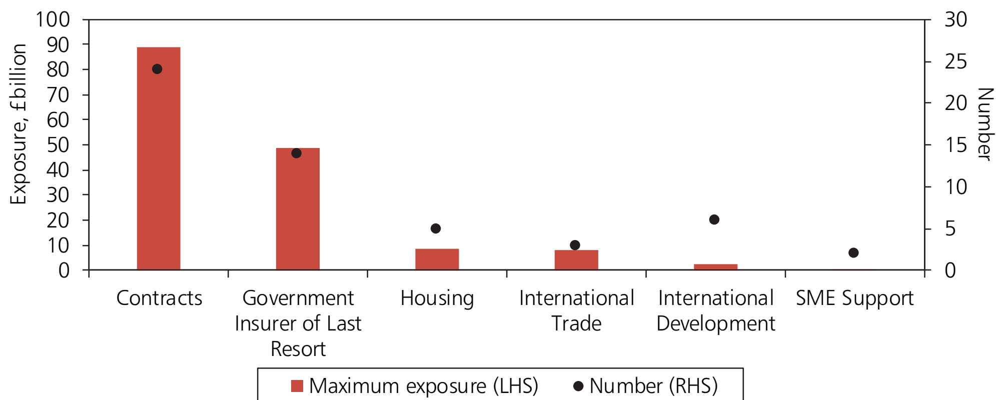
- more comprehensive information was provided to demonstrate that the fiscal risk was clearly understood
- substantive policy changes were made to ensure the fiscal risk was manageable within the initiating departments' budget
- the fees charged to the beneficiary were revised to ensure the taxpayer received adequate compensation for the risks they were taking on

[23] The Treasury's contingent liability database contains policy sensitive information and is not published.

## Box 6.D: Contingent liability database

The Treasury's new contingent liability database is based on those contingent liabilities that have been through the new process since early 2017 and is used by the Treasury to assess where fiscal risks may be concentrated or accumulating. As shown in the chart below, the largest categories relate to guarantees embedded in contracts, insurer of last resort policies, and housing guarantees. The database records common external triggers (such as interest rates and house prices) which allows for an assessment of potentially systemic risks.

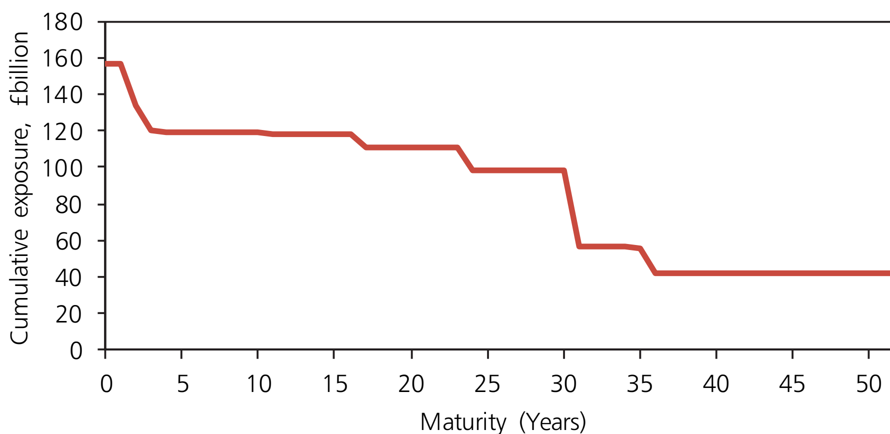
### Chart 6.M: Contingent liabilities: number and maximum exposure




Source: Treasury calculations

The database enables the Treasury to gauge the maturity profile of contingent liabilities, represented below, which can be used to inform internal stress tests and risk mitigation strategies.

### Chart 6.N: Contingent liabilities: maximum exposure over time




Source: Treasury calculations.

The database also allows the Treasury to monitor concentrations of fiscal risks in departments and ensure they retain adequate budgetary flexibility to cover the cost of contingent liabilities that might be triggered.

6.31 While the contingent liability approval process focuses on new contingent liabilities, there are also significant risks associated with the large stock of existing contingent liabilities. The Balance Sheet Review has a specific work stream, being led by the Government Actuary's Department, dedicated to collecting more detailed information about the stock of outstanding guarantees and other contingent liabilities, improving management of the risks surrounding these contingent liabilities, and looking for opportunities to increase the compensation for bearing that risk. As the Treasury builds up a more a detailed picture of its contingent liability exposures and their triggers, this database will provide an important analytical input into future stress tests of the public finances.

## Managing classification risks

6.32 As the FRR highlights, statistical reclassifications can present a significant risk (both positive and negative) to the government's performance against its fiscal targets. In line with international best practice, decisions about the statistical treatment of specific institutions or transactions are made by the independent ONS based on standards and guidance provided by international organisations. The independent OBR also has full autonomy to decide what fiscal aggregates to publish in its EFO and related documents, though it is required to report performance against the government's fiscal rules as defined in the Charter for Budget Responsibility.

6.33 Alongside this report, and after consultation with the Treasury, the ONS have published a strategy to improve the visibility of future classification and methods changes and the predictability of their implementation. To provide this greater transparency and predictability, the ONS will be:[24]

- publishing regular articles (the first of which is published today) outlining their medium-term plans for classification and methods changes and their potential impact on the main fiscal aggregates
- packaging together major classification and methods changes so that they are only implemented once a year
- providing more information on the impacts of major changes by publishing parallel time series which show their effects on the main fiscal aggregates for an extended period after implementation

[24] 'Looking ahead: developments in public sector finance statistics', ONS, July 2018.

# Annex A

# Fiscal risk register

## Table A.1: Fiscal risk register

| | Risk | Paragraph | Department. |
|---|---|---|---|
| I | Risk management | | |
| 1 | The need to review risks that governments choose to expose themselves to | 1.13-1.14 | HMT |
| 2 | Sources of fiscal risk that we have not analysed – major wars and climate change | 1.8 | HMT |
| 3 | The increase over time in the expected cost of cleaning up the Sellafield nuclear site | Box 1.A | BEIS |
| 4 | The government's potential exposure to clean-up costs for new nuclear stations | Box 1.A | BEIS |
| II | Macroeconomic risks | | |
| 5 | Continued weak post-crisis productivity growth | 2.54-2.64 | HMT |
| 6 | The near-inevitability of future recessions – and the risk of persistent effects from them | 2.5-2.16 | HMT |
| 7 | Persistent current account deficits | 2.30-2.33 | HMT |
| 8 | Interest rates returning to more normal levels relative to GDP growth | 2.44-2.45 | HMT/BoE |
| 9 | The economic risks associated with Brexit | Box 2.D | HMT/ DExEU[1] |
| 10 | Persistent household financial deficits | 2.19-2.23 | HMT |
| 11 | Exposure to potentially greater exchange rate volatility as a result of Brexit | Box 2.D | HMT/ DExEU |
| 12 | The increase in the debt stock | 2.34 | DMO |
| 13 | The increased sensitivity of debt interest spending to inflation and interest rate risk | 2.44 | HMT |
| 14 | The temporary impact of the APF in lowering the government's borrowing costs | Box 2.A | HMT |

[1] Department for Exiting the European Union

| | | | |
|---|---|---|---|
| 15 | The government's fiscal exposure to the housing sector | 2.24-2.29 | HMT |
| 16 | The growing use of guarantees in infrastructure and housing | 2.27, Box 2.E | MHCLG/HMT |
| 17 | Evidence of 'austerity fatigue' when planned spending cuts are still to be delivered | 2.15-2.16 | HMT |
| 18 | The need to prepare for near-inevitable future shocks | 2.5 | HMT |
| 19 | The need to deal with many slow-building pressures | 2.45 | HMT |
| 20 | The challenges of dealing with those needs while negotiating Brexit | Box 2.D | DExEU |
| 21 | The challenges of doing so in an environment of apparent 'austerity fatigue' | 2.15-2.16 | HMT |
| 22 | The more vulnerable starting fiscal position from which all of this is faced | 2.38-2.40 | HMT |
| III | Financial sector risks | | |
| 23 | The frequency of financial crises and their fiscal cost | 3.4-3.5 | HMT |
| 24 | The tendency for post-crisis tightening of regulation to be loosened over time | 3.4-3.5 | HMT/FCA |
| 25 | The comparatively large and highly concentrated UK banking system | 3.34 | HMT |
| 26 | Potential effects of Brexit on the financial sector and the tax receipts it generates | Box 3.B | HMT |
| 27 | The growing risk posed by threats to cyber security. | 3.43-3.49 | HMT |
| IV | Revenue risks | | |
| 28 | Pressure on tobacco and fuel duties from behavioural and technological change | 4.32-4.35 | HMT |
| 29 | Uncertainty around the projected cost of oil and gas infrastructure decommissioning | 4.62-4.70 | OGA |
| 30 | The growing volume and apparent complexity of tax legislation | 4.55-4.61 | HMRC |
| 31 | Loss of revenue as people move to more lightly taxed forms of employment status | 4.10-4.20 | HMT |
| 32 | Periodic policy reversals and persistent failure to implement some default tax rises | 4.37-4.40 | HMT |
| 33 | The different effective tax rates imposed on different components of GDP | 4.6-4.24 | HMT |
| 34 | The substantial 'tax gap' for self-assessed income tax and capital gains tax | 4.49-4.59 | HMRC |
| 35 | Reliance on anti-avoidance and evasion measures with relatively uncertain impact | 4.43-4.45 | HMRC |

| | | | |
|---|---|---|---|
| 36 | Narrowing of the income tax base, thanks to increases in the personal allowance | 4.28-4.31 | HMT |
| V | Spending risks | | |
| 37 | The declining proportion of total spending subject to relatively firm DEL controls | 5.5-5.8 | HMT |
| 38 | Possible further increases in tax litigation pay-outs, including large 'lead' cases | 5.58-5.60 | HMRC |
| 39 | The renewed commitment to the 'triple lock', which ratchets pension spending higher | 5.45–5.48 | DWP |
| 40 | Risks surrounding the implementation of the new state pension Universal Credit | 5.19-5.21 | DWP |
| 41 | Limited formal reporting of the cost of potential legal challenges to the welfare system | 5.61-5.63 | DWP |
| 42 | Significant long-term upward cost and demand pressures on health spending | 5.24-5.28 | DHSC |
| 43 | The precedent created by repeated topping-up of initial health spending settlements | 5.26-5.28 | DHSC |
| 44 | The potential impact of the NLW and migration reform on health and social care costs | 5.30 | DHSC |
| 45 | Potential pressure to bail out a private social care provider if in financial difficulty | 5.31 | DHSC |
| 46 | The likelihood of higher clinical negligence pay-outs than currently provisioned for | 5.51-5.57 | DHSC |
| 47 | The significant proportion of clinical negligence costs still accounted for by legal fees | 5.55 | DHSC |
| 48 | Initial signs that local authorities have started running down their reserves | 5.72-5.74 | MHCLG |
| 49 | Local authorities undertaking potentially risky commercial investments | 5.75-5.79 | MHCLG |
| 50 | Increased and as-yet untested borrowing powers for the devolved administrations | 5.80-5.85 | DAs |
| 51 | The possibility of cost overruns for major projects like HS2 and Universal Credit IT | 5.13-5.21 | DfT/DWP |
| 52 | The possibility that the UK will have to pay a large 'divorce bill' on leaving the EU | Box 5.B | DExEU/HMT |
| VI | Balance sheet risks | | |
| 53 | The deterioration in broad measures of public sector net worth since the crisis | 6.7-6.11 | HMT |
| 54 | Asset sales that could be delayed or raise less than expected | 6.16-6.17, Box 3.A | HMT |

| | | | |
|---|---|---|---|
| 55 | Asset sales that have not been factored into current forecasts | 6.18 | HMT |
| 56 | The possibility of reclassifications that expand the public sector balance sheet | 6.32-6.33 | HMT |
| 57 | The impact of 'fiscal illusions', where accounting rules drive policy decisions | 6.12-6.13, Box 6.C, 6.23-6.25, 6.28-6.31, 5.9-5.10 | HMT |
| *Source: OBR 'Fiscal risks report'* | | | |

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This document can be downloaded from www.gov.uk

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