

Fiscal risk analysis in the UK

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Path for the Public Finances, 2017: Fiscal Risks
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Background

- **The IMF's November fiscal transparency evaluation for the UK**

“Fiscal risk practices score well, when compared to other countries that have undertaken the assessment. Examples of advanced practice include the OBR's reporting of risks related to the macro-economy and the long-term sustainability of public finances and the Treasury's and the Bank of England's reporting of risks related to the financial sector. However, the absence of summary reporting of specific risks is a weakness that should be addressed.”

- **Treasury had considered publishing one, but ministers said no**
- **The Government has now decided the OBR should produce one every two years, with the Government required in legislation to respond**

Preliminary work

- In October 2016 we published



- Scoping paper drawing on IMF recommendations, international examples and discussion on UK history and current risk reporting
- First report due on 13 July

Existing OBR risk reporting

- **Qualitative list of economic and fiscal risks**
- **Quantify uncertainty around forecasts**
 - **Probability distributions, sensitivity tests, scenarios**
- **Analysis of past forecast errors**
- **Sensitivity analysis around long-term projections**
- **Commentary on WGA contingent liabilities**

How will we define ‘fiscal risks’?

- **IMF:** “the possibility of deviations of fiscal outcomes from what was expected at the time of the budget or other forecast”
- **We will focus on risks to the medium-term forecast and to long-term sustainability (rather than to our long-term projections)**
- **Focus more on the downside**
- **Cannot recommend or look at policy options**

Broad approach

- **Use debt dynamics equation to motivate**
 - Primary balance (non-interest spending and revenue)
 - $r-g$
 - Stock-flow adjustments
- **So an interest in**
 - Macroeconomic risks
 - Specific revenue and spending risks
 - Asset purchases and lending to private sector
- **Discrete/continuous, ex/endogenous useful**
- **Illustrative stress test (based on Bank of England?)**
- **First report broad, then more selective**

Macroeconomic risks

- **Start from baseline medium-term forecast and long-term assumptions**
- **Look at r and g permutations**
- **Look at impact of symmetric cycles**
- **Look at cycles with ratchet effects**
- **What is a 'bad recession'?**
 - **Falling NGDP, external inflation**

Specific spending risks

- **Loss of Treasury/LA spending control**
- **Long-term pressures**
 - Ageing
 - Non-demographic health pressures
- **Contingent liabilities**
 - Legal cases (tax, clinical negligence)
 - Guarantees
 - Implicit/explicit

Specific revenue risks

- **Tastes and technology**
 - Alcohol, tobacco, road fuel
- **Avoidance and labour market trends**
 - Incorporation
 - Self-employment
- **Narrowing of tax bases**
 - Rise in tax-free allowance
- **Policy challenge**

Stock-flow adjustments

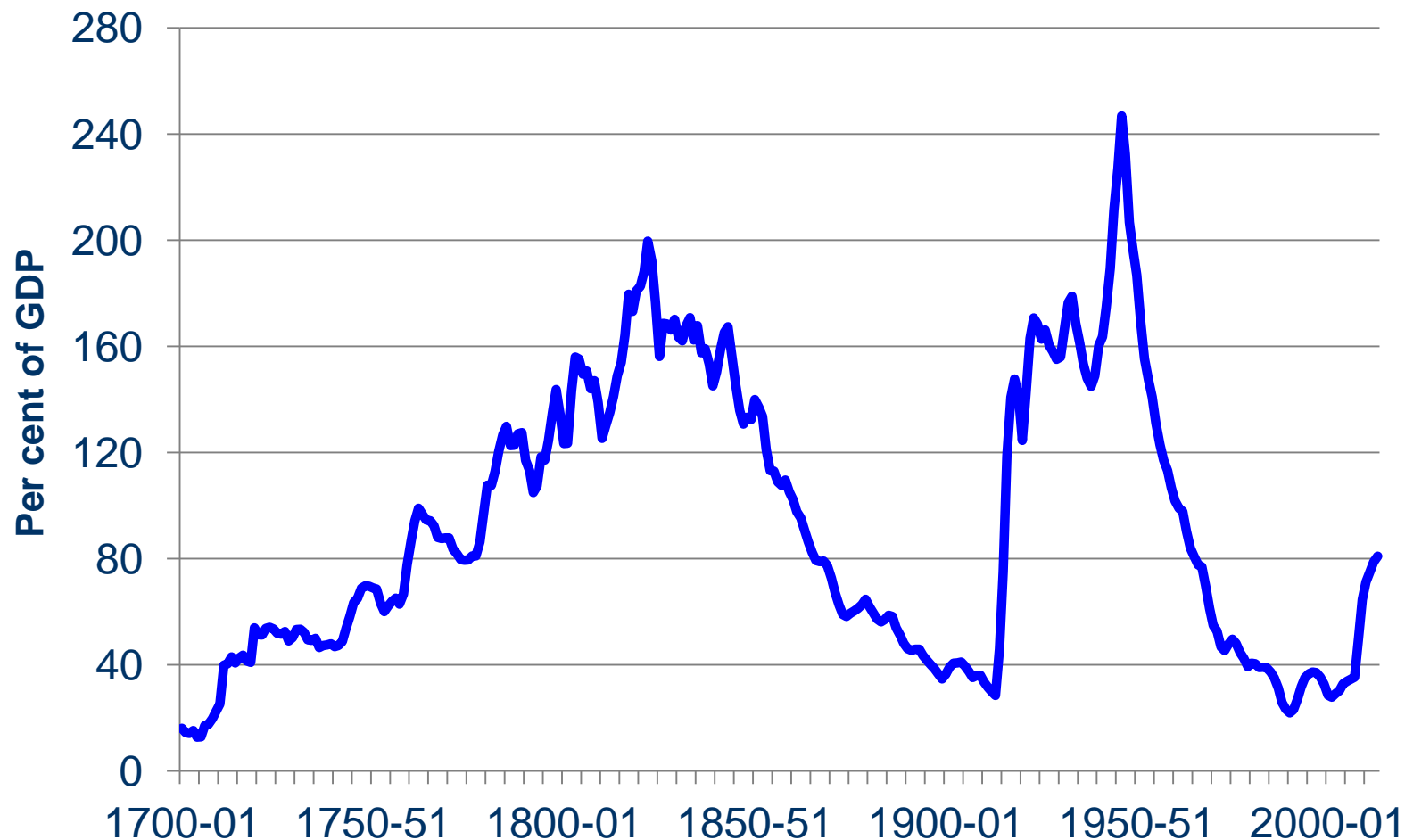
- **Political versus fiscal impact?**

- **Financial sector interventions**

Outlays	£137bn
Repayments/fees/interest	£88bn
Net cash shortfall	£49bn
Outstanding loans/shares	£56bn
Implied net gain	£7bn
Financing cost	£30bn
Overall balance	£23bn

- **Brexit divorce bill?**

UK public debt since 1700



Source: Bank of England, ONS

Engaging the Government

- A list of pointed questions
- Possibly building to a risk register
- Wary of undue emphasis on stress test or sophisticated quantitative techniques
 - Can allow government to quibble with detail
 - (Also beware discount rate sensitivity)

Risk management by Government

- **Choices reflect**
 - The risk appetite of the Government
 - The perceived benefits of taking on risk
 - The estimated cost of reducing risks
 - How it balances these factors
- **Responses include**
 - Tolerating (perhaps with provisioning)
 - Treating (e.g. controls, regulation or insurance)
 - Transferring
 - Terminating