Office for
Budget
Responsibility

PRESS NOTICE

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Fiscal sustainability report 2017: Rising health care costs put pressure on public finances

Rising health care costs could make it harder for the Chancellor to balance the budget in the next Parliament and put the public finances on an unsustainable path over the longer term in the absence of further tax increases or cuts in other public spending, according to the latest *Fiscal sustainability report (FSR)*[i] from the independent Office for Budget Responsibility.

Evidence from the UK and other countries suggests that health spending will grow faster than the economy over time, thanks in part to the ageing population, but more importantly to non-demographic factors, such as technological advances and relatively low productivity growth. Even apparently cost-saving developments – such as the use of stents as an alternative to heart surgery – can put upward pressure on spending if they mean that more patients are treated.

The OBR has assumed in previous *FSRs* that governments will increase health spending as a share of GDP to reflect population ageing, with the proportion of the population aged 65 and over set to rise from 18.0 per cent today to 26.1 per cent in 2066-67 in the Office for National Statistics' principal population projections. But we now assume for the first time that they will also raise spending to reflect non-demographic pressures. This is consistent with their behaviour in recent decades, with real health spending rising by an average of 3.8 per cent a year since 1978-79 while the economy has grown by an average of 2.2 per cent a year. Population ageing alone cannot account for this.

Initially we assume that health spending rises to accommodate non-demographic cost increases of 2.7 per cent a year in primary care and 1.2 per cent a year in secondary care, in line with NHS England's estimates for 2015-16. We then assume that both decline in a straight line to 1 per cent a year from 2036-37 onwards, the steady-state cost growth assumption used by the Congressional Budget Office in the United States. This is sufficient on its own to increase health spending by 4.5 per cent of GDP (£88 billion a year in today's terms) between the end of our latest medium term forecast in 2021-22 and 2066-67. Population ageing adds a further 1.3 per cent of GDP to give a total increase in health spending from 6.9 per cent of GDP in 2021-22 to 12.6 per cent of GDP in 2066-67.

In our central projection, the ageing of the population also sees the cost of long-term care rising from 1.1 per cent of GDP in 2021-22 to 2 per cent in 2066-67. The cost of state pensions and pensioner benefits rises from 5.8 to 8 per cent of GDP, with upward pressure from ageing and the 'triple lock' guarantee more than offsetting savings from prospective rises in the state pension age. In contrast, the cost of public service pensions drops from 2.1 to 1.3 per cent of GDP, largely reflecting reforms since 2010 and cuts in the public sector workforce.

With tax and other revenues projected to remain broadly flat as a share of GDP, these trends would see a steady and unsustainable deterioration in the public finances without a policy response. Public sector net borrowing would rise from 0.7 per cent of GDP in 2021-22 to 16.6 per cent of GDP by 2066-67, lifting public sector net debt from 82 to 234 per cent of GDP. Getting debt back to 40 per of GDP by then would require additional tax increases and/or spending cuts of 1.5 per cent of GDP (£30 billion a year in today's terms) in the early 2020s and in each successive decade.

The fiscal challenge from rising health care costs – assuming that future governments spend more to accommodate them – is substantial over the longer term, but they would also make the current Chancellor's nearer-term goal of balancing the budget in the next Parliament harder to achieve.

Our long-term projections imply that, rather than moving into surplus, the budget deficit would rise from 0.7 per cent of GDP in 2021-22 to 1.8 per cent by the end of the next Parliament in 2025-26. Health spending is assumed to rise by 0.6 per cent of GDP, with population ageing contributing one third of the increase and other cost pressures the remaining two-thirds. State pension spending is assumed to rise by 0.3 per cent of GDP, with the number of people receiving the state pension set to rise by 9.1 per cent in the next Parliament after falling by 2.6 per cent in this one. And long-term care costs would rise by 0.1 per cent of GDP, thanks to population ageing.

These projections are based on a definition of unchanged current policy that would be broadly fiscally neutral over the long term, for example raising tax allowances and benefit payments in line with earnings. The potential increase in the deficit would be offset if we used an alternative definition more in line with our medium-term forecast, including raising tax allowances and benefits payments in line with CPI inflation. But this would still not be sufficient to restore a surplus.

The report assumes that the public finances evolve over the next years in line with the medium term forecast published in our November 2016 *Economic and fiscal outlook*. It contains no new analysis of the impact of Brexit, beyond that published in the November *EFO*.

Notes

1. The OBR is the UK's independent fiscal watchdog. We produce forecasts for the economy and the public finances, assess progress against the Government's fiscal targets, and report on long-term fiscal sustainability.
2. Questions should be sent to OBRpress@obr.gsi.gov.uk or contact Mark Dembowicz on 0203 334 6348.

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[i] http://budgetresponsibility.org.uk/fsr/fiscal-sustainability-report-january-2017/