

Press Release

Keeping official fiscal forecasts honest

Creating a new independent body to forecast the public finances could help keep the interest rates at which the government is able to borrow low, Robert Chote, the Director of the Institute for Fiscal Studies, will argue in the Scottish Economic Society / Royal Bank of Scotland Annual Lecture in Edinburgh this evening. But such a body would need to be willing and able to resist political pressure at a time when fiscal policy is likely to be unusually controversial and fiscal forecasting unusually difficult.

There are a number of ways in which the fiscal forecasting process could be made more independent. The Conservatives have proposed an Office of Budget Responsibility (OBR) and the Government is likely to move at least some way in this direction in its promised Fiscal Responsibility Act. The most likely model for the OBR may be the creation of a new independent body to forecast the public finances in parallel with the Treasury. A cheaper, but perhaps less convincing, option would be to make civil servants rather than the Chancellor responsible for Treasury forecasts, as in New Zealand.

The primary responsibility of an OBR should be to keep government fiscal reporting and forecasting honest, although it would also give advice on the fiscal policy decisions in Budgets and PBRs. Desirable features would include:

- A well-focussed and relatively narrow mandate set out in statute;
- Guaranteed access to the same information as Treasury forecasters;
- A focus on fiscal forecasting rather than macroeconomic forecasting;
- An approach that addresses uncertainty explicitly and avoids bias;
- Offering advice based on the probabilities of meeting fiscal goals;
- Eschewing advice on the choice between tax and spending changes;
- A small Board seeking consensus, rather than holding formal votes;
- Appointments and operating budgets longer than a parliament.

Interesting design questions include:

- Whether the OBR should make its own best forecast or whether it should explicitly 'audit' the most recent Treasury forecast?
- Whether the OBR should be willing to tell the Chancellor how it would respond to a Budget forecast before he finalises it?
- Whether the OBR should confine itself to forecasting different tax and spending streams, or also the impact of specific policy measures?
- Whether the OBR should look only at the Government's plans, or also at Opposition party plans (especially before general elections)?

If an OBR had been in existence over recent years it might have discouraged Gordon Brown from persevering with fiscal forecasts that most independent analysts thought over-optimistic from 2002 onwards. If he had taken steps to strengthen the public finances earlier, the UK would have confronted the financial crisis with somewhat lower government borrowing and debt, and perhaps with the public and investors seeing fiscal promises as more credible.

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But this would not have avoided the need for a big fiscal tightening over the next few years. As in the early 1990s, the need for a tightening does not just reflect the puncturing of politically inflated revenue forecasts, but a judgment that the economy is going to be permanently and significantly smaller in future than previously expected. An OBR is unlikely to have avoided this.

An independent budget watchdog might help take the politics out of fiscal policy in the same way that the independence of the Bank of England took the politics out of monetary policy. But it would likely have a rougher ride in its early years. The Bank had the advantage that it was made independent at a time when inflation was near its target and was to turn out much more stable than anyone expected. An OBR would come into being when the pace of fiscal tightening is highly controversial and when fiscal forecasting is likely to be unusually difficult, thanks to the very uncertain outlook for the economy and the prospect of significant tax and spending changes with uncertain effects.

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Notes to Editors:

1. Robert Chote will be speaking at the Royal Bank of Scotland's headquarters in Gogarburn, Edinburgh, at 6pm on 12 November 2009. He will discuss the outlook for the public finances (drawing on previous IFS analysis: <http://www.ifs.org.uk/bns/bn87.pdf>) plus the issues raised by Conservative proposals for an Office of Budget Responsibility and Government plans for a Fiscal Responsibility Act.¹ The full text of this section follows:

Independence in official fiscal forecasting

As we have argued in recent editions of our annual *Green Budget* publication, there is a strong case for introducing greater independence into the official fiscal forecasting process. This could help reassure voters and investors that official forecasts represent sound judgement, based on the best available evidence, rather than politically motivated wishful thinking. This might help reduce the probability of a disruptive increase in the interest rates at which potential buyers of government debt are willing to lend to the government, although in current market conditions it would be hard to argue that such a move would reliably be expected to reduce borrowing rates significantly from their current levels.

There are several potential approaches, among them:

1. **Keeping fiscal forecasting within the Treasury, but making officials rather than ministers responsible for the forecasts:** This would be the least expensive option and has been adopted with apparent success in New Zealand: the Permanent Secretary there states that the official fiscal forecasts have been prepared on the Treasury's "best professional judgement", with the Minister of Finance promising that he has advised officials of "all Government decisions and other circumstances of which I was aware and that had material economic or fiscal implications".² Such an approach would

¹ My thanks to a number of current and former Treasury and Bank of England officials for sharing their views on this topic and for very helpful comments on an earlier draft.

² <http://www.treasury.govt.nz/budget/forecasts/befu2009/001.htm>

change the relationship between ministers and civil servants in a way that could have implications far beyond the Treasury. One concern is that it could weaken ministers' trust in their officials, giving extra impetus to the use of political special advisers rather than getting the best out of civil servants. It would also make senior officials more high-profile figures in their own right, raising the question of whether voters and investors would see the existing incumbents as genuinely independent from ministers.

2. **Taking fiscal forecasting out of the Treasury altogether and handing the task and associated resources to an official independent body:** By avoiding a significant duplication of roles, this option would also be relatively inexpensive (although presumably somewhat more expensive than Option 1). Like Option 1, it has been considered within the Treasury in the past, but has been ruled out as impractical. This looks a potentially self-serving conclusion, but the main and genuine concern is that disentangling the Treasury's fiscal forecasting and policy development roles would be far from straightforward and could well weaken the Treasury's analytical capabilities in areas such as the design and maintenance of the tax and welfare systems. Critics point to an undesirable weakening of the Treasury's analytical capacity in monetary and financial policy following the move to central bank independence and the creation of the Financial Services Authority in 1997.
3. **Contracting one or more existing independent organisations to carry out fiscal forecasts in parallel with the Treasury:** Funding one or more organisations to second-guess the Treasury's fiscal forecasts would not be cheap if they were to be given resources adequate to the job. Handing the task to existing bodies with an established reputation could help establish credibility relatively rapidly, but it is not clear that a comprehensive fiscal forecasting role would be particularly attractive to such organisations. It might also be hard to give unofficial bodies the access to information and official expertise that would allow them to forecast on a "level playing field" with the Treasury. Without such access it is not clear that the Government would feel more inclined to take the advice of such bodies in the future than it has in the past.
4. **Creating a new official independent body to undertake fiscal forecasting in parallel with the Treasury:** Official status and larger resources might make the advice and analysis of a specially created new body harder to ignore than those of unofficial organisations, especially if it was accompanied by access to the same information from within government that Treasury forecasters enjoy. It would be important to ensure that such a body was set up and run in such a way that it would be seen as genuinely independent rather than as a semi-detached arm of government vulnerable to ministerial pressure. And, as we have seen recently with the Advisory Council on the Misuse of Drugs, the relationship between strong-minded advisers and strong-minded ministers is not always harmonious.

Notwithstanding its expense, this fourth option looks the most promising model for the Office of Budget Responsibility that has been proposed by the Conservatives – although Option 1 probably deserves more serious consideration than it is likely to get. The current Government meanwhile has promised a Fiscal Responsibility Act, of which we are likely to hear more details in the Pre-Budget Report on 9 December. This would enshrine a set of fiscal targets in law, but it is far from clear why investors and voters should be any more impressed by this than they were by the Code for Fiscal Stability, which was enshrined in statute with much fanfare in 1998. As we have seen, this committed the government to set down its fiscal objectives clearly and to assess progress against them regularly. Yet by early 2007 – well before the current crisis – the *Financial Times*' annual survey of City and academic economists found that “almost none use the Chancellor's fiscal rules any more as an indication of the health of the public finances”. If the Fiscal Responsibility Act is to be any sort of an advance, it too is going to have to include moves towards greater independence in the production or scrutiny of official fiscal forecasts.

So how might an Office of Budget Responsibility or a similar body operate in practice? There are many tricky design issues to tackle, but let me offer a few tentative suggestions and raise a few questions, informed in part by a recent helpful seminar at the Institute for Government at which officials from similar bodies overseas shared their experiences:

1. The OBR should be given a clearly defined and relatively narrow statutory mandate, discouraging mission creep and aiding accountability. Its primary responsibility should be to help keep the government's fiscal reporting and forecasting honest. To that end it should produce:
 - a. Detailed short- and medium-term forecasts for spending, revenues, budget balances and debt (as produced for the Budget and PBR);
 - b. Illustrative long-term projections of the same fiscal variables (as produced for the Treasury's Long Term Public Finance Report), and;
 - c. Analysis of the public sector balance sheet, including an assessment of the importance of and changes in off-balance sheet and contingent liabilities.
2. To generate these forecasts and assessments, the OBR would need to be guaranteed (preferably by statute) access to the same sources of information on revenues and spending that Treasury forecasters currently enjoy. This would include access to data from official bodies, such as HM Revenue & Customs, the Department of Work & Pensions and the Debt Management Office. In an ideal world, this information would be made publicly available, creating a level playing field for all fiscal forecasters and helping the OBR to justify its conclusions.

3. The OBR should focus on fiscal forecasting rather than macroeconomic forecasting. To that end, it should use the best regarded independent macro forecasts as the basis for its assessment of the outlook for the public finances, perhaps drawing attention to the potential implications of different scenarios around those forecasts. One obvious candidate would be the forecasts underlying the Bank of England's Inflation Reports. This would have the virtue of helping to ensure that monetary and fiscal policy decisions were based on a consistent medium-term view of the economy. However, this would require the Monetary Policy Committee to agree and publish a rather more detailed breakdown of its macroeconomic forecasts than it currently provides, and to overcome its reluctance to say much in public about its estimates of the amount of spare capacity in the economy and what it sees as a sustainable medium-term growth rate for national income. An alternative would be to construct some average forecast from those provided by City and academic forecasters. But aggregating disparate forecasts in a coherent way is not straightforward, given differences in coverage, methodology and timescales.
4. The OBR should present its forecasts in a way that makes explicit the considerable uncertainty that surrounds all fiscal forecasts (in part because fiscal balances are the differences between two large numbers – spending and revenues – neither of which is easy to forecast in its own right). The fan charts in the Bank of England's Inflation Reports, the IFS Green Budget and National Institute's Economic Review show one potential approach. The OBR's forecasts should also represent its best assessment of the likely outcomes, and not – as the Treasury claims that its current forecasts do – a deliberately cautious one. Any desire for caution should be reflected in the policy goals that the government sets itself, not in the production of deliberately biased forecasts.
5. Given its forecasts and its assessment of the uncertainties surrounding them, the OBR should then estimate the probability on existing policies that the government will achieve whatever fiscal goals and targets it has set itself. It should then explain the extent to which tightening or loosening of fiscal policy (through changes in taxes or spending) would alter that probability. Whether this would translate into concrete advice on the tightening or loosening necessary or permissible in any particular Budget or PBR would depend on how tightly the rules or targets were specified. But, at the end of the day, given the uncertainties that surround any forecast, it is for the government to decide what it regards as an acceptable probability of achieving its goals. There is a strong argument for setting fiscal rules in a continuous forward-looking way, rather than over a fixed time period as until recently. But this could allow the Government always to say (with justification) that it is on course to achieve its target in a few years time, but without ever actually hitting it. This is a particular problem because the Treasury's Budget and PBR forecasts define "existing policy" as a

world in which key tax thresholds and allowances rise in line with prices rather than earnings, thereby delivering a rise in the average tax rate over time. The Treasury has conceded that this is not a sensible long-term definition of unchanged policy.

6. The OBR should not be tempted to offer advice on broader economic policy issues, as some of its overseas counterparts do. Neither should it recommend the composition of any fiscal tightening or loosening – for example, whether spending cuts are preferable to tax increases (this is at least as much a political judgement as an economic one). But, if and when the government changes its fiscal rules or targets, the OBR should assess whether it believes these are consistent with the ultimate objective of long-term fiscal sustainability.
7. The OBR needs a robust, but not unduly burdensome, governance structure. One option would be a Chair and a small board, including recognised experts in economics, and public sector accounting and statistics. (They will need to be respected not only for their expertise, but also for their willingness and ability to defend the OBR's independence.) Drawing on the work of the OBR's in-house staff, and external advice where necessary, they should aim wherever possible to reach an agreed view on their forecasts and policy advice. Given the nature of the issues in the OBR's remit, and the fact that it would be an advisory rather than a decision-making body, it does not seem necessary to replicate the Bank of England model of a large committee with formal votes on policy conclusions.
8. The OBR needs to be demonstrably independent of political pressure. This suggests that in the context of the governance structure described above:
 - a. The Chair and board should be appointed through standard procedures for senior public appointments and subject to confirmation hearings by the Treasury Select Committee;
 - b. The Chair and board members should be offered terms of office longer than a parliament, although they would of course be able to step down early (a model that would ideally have been applied to membership of the MPC);
 - c. The OBR's budget should be sufficient to match the resources devoted to fiscal forecasting and analysis in the Treasury and guaranteed over a period longer than a parliament. (Setting an exact budget would not be easy in the first instance as it is only when the OBR is up and running that its resource needs would be fully apparent.);
 - d. Less clear is whether the OBR should be formally accountable to the Chancellor or to Parliament. The latter might seem the obvious choice at first glance, but, in the eyes of many, Parliament has not proved a particularly effective steward of the National Audit Office in recent years. While remaining accountable, in practice the OBR will need to demonstrate its independence from political influence from both ministers and backbenchers.

9. The OBR should place a high priority on the effective communication of its analysis. One possible modus operandi would be to publish two “Fiscal Sustainability Reports” a year, prior to the Budget and Pre-Budget Report, and based on the macroeconomic forecasts in the Bank of England’s February and August Inflation Reports. (The Pre-Budget Report has become a second annual Budget in all but name, and should be treated as such as long as it remains so.) In addition to the forecasts and analysis described above, these Reports could include special articles on relevant issues by staff or externally commissioned experts. One choice is whether to produce the best independent forecast the OBR can make at the time, or whether instead to ‘audit’ the Treasury’s most recent forecast on the basis of the information that the Treasury had available then. Another choice is whether to confine its assessments to these reports or whether to comment on trends in the public finances as they unfold through the year with the publication of the official public finance statistics.
10. Careful thought needs to be given to the appropriate degree of interaction between the OBR and Treasury officials during their respective forecasting processes – and in particular whether the OBR should be willing to tell the Chancellor how it would respond to a particular Budget or PBR forecast before he finalises it. On the one hand, communication and regular exchange of views might be expected to improve the quality of both institutions’ forecasts. On the other hand, such exchanges might be construed as an opportunity for collusion in avoiding presentationally awkward differences of opinion – people may suspect that both institutions would be happier to be wrong together than to risk being seen as wrong on their own. But reasonable people will differ in their fiscal forecasts and at a minimum the OBR and the Treasury should present their analysis in such a way that they can identify and explain the reasons for any such differences in an agreed way – for example, whether they reflect different assumptions about the composition of growth, or about tax revenue elasticities.
11. It will necessary to decide whether the OBR should confine itself to forecasting different tax and spending streams in aggregate, or whether it should also comment specifically on the Treasury’s estimates of the costs or revenues raised either from the whole set of measures announced in a particular Budget or PBR, or from particular policy measures, even if they have a relatively modest impact on the overall fiscal picture. The controversial introduction of the 50p income tax rate on high incomes is an obvious example. The latter might be a useful discipline on ministers, but would require more resources and a widening of focus.
12. The OBR could confine its analysis to the government of the day, but it could also comment on the implications of policy proposals put forward by the other big political parties – particularly in the run-up to elections. Arguably, with the Conservatives well ahead in the

opinion polls, financial markets may be more influenced now by whether the Opposition's policies are consistent with long-term fiscal sustainability than those of the Government. One option would be for opposition parties to be invited to submit their plans to OBR for scrutiny if they wish.

Not all of these questions (and many others) need or should necessarily be resolved before the OBR is created. Some could be left for its Chair and Board to decide for themselves, in consultation with the Treasury, the Treasury Select Committee and other stakeholders.

So what difference might the existence of an OBR have made to recent fiscal history?

One can reasonably argue that such a body might have discouraged Gordon Brown and his advisers from “sniffing round the forecasters’ pockets” from 2002 onwards, as some mandarins quaintly put it. Assuming that the OBR had taken a similar view to that of the IFS and other independent forecasters over this period, Mr Brown might have felt constrained to make his forecasts more realistic and to take steps to restrain government borrowing more quickly than he did as revenues fell short of his forecasts. This would have meant that when the financial crisis hit, we would have had a somewhat smaller structural budget deficit and somewhat lower public debt. And voters and investors may have seen the Government's fiscal promises as more believable.

All that would have been welcome. But it would not have avoided the need for a severe fiscal tightening over the next few years. As in the early 1990s, the squeeze over the next few years is not simply a response to the puncturing of politically inflated tax revenue forecasts. In large part it reflects the Treasury's judgement that the economy and people's wealth are going to be significantly and permanently smaller for the foreseeable future than it had previously thought. The proposed OBR would have been no better placed to foresee such an event than any other macro-economic forecaster – indeed, if it had adopted an outside macro forecast as the baseline for its predictions, it would not necessarily even have tried to.

Whatever one might think of its actions either side of the financial crisis, the decision to make the Bank of England independent in 1997 is widely recognised as having taken the politics out of monetary policy in a way that the Government's Code for Fiscal Stability and fiscal rules failed to take the politics out of fiscal policy. An independent OBR could help rectify that, although its formal role would be more similar to that played by the Bank between 1993 and 1997 – providing independent advice to the Chancellor – rather than having policy instruments in its own hands. But it is unlikely to find its path as smooth to begin with as the Bank did.

For one thing, the Bank had the advantage that it became independent at a time when the task was to keep inflation broadly at its existing level, rather than to bring it down from a much higher one. What is more, inflation was more stable over subsequent years than almost anyone would have expected beforehand. This allowed the Bank to establish its credibility without coming under serious challenge for its forecasting record and without getting embroiled in debates over how quickly a significant deviation from the

inflation target should be tackled, with all the pain that that would have implied.

In contrast, the OBR would likely come into being at a time when there will be considerable controversy over the appropriate pace of fiscal tightening and at a time when fiscal forecasting is likely to be even more difficult than usual (because of uncertainty surrounding the medium-term outlook for the economy and because of the prospect of significant tax and spending policy changes with uncertain behavioural effects). There has to be relatively high probability that good advice ex ante could look like bad advice ex post, at least to the untutored eye. An opportunistic Chancellor might well be tempted to exploit such appearances if he wished to ignore subsequent advice.

To summarise, an independent budget watchdog along the lines I have described would likely make a useful contribution to the achievement of long-term fiscal sustainability. But its success and credibility (especially in its tender early years) would depend on many factors – its design, the rules it is instructed to police, and luck, among them.

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