

11. Reforming UK fiscal institutions

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Summary

- Voters and investors need to be reassured that this or a future government will repair the damage to the public finances that has been created by the financial crisis. This creates a powerful case for institutional reform to increase people's confidence in official forecasts of the public finances.
- The Fiscal Responsibility Bill, which – once on the statute book – would place the government under a self-imposed legal obligation to deliver particular fiscal targets, is unlikely to achieve this. The government's existing Code for Fiscal Stability was enshrined in legislation in 1998, but this did not prevent the fiscal rules set out under it from losing their credibility once the then Chancellor Gordon Brown was widely thought to have 'moved the goalposts' to avoid a formal breach.
- The National Audit Office has a limited and inappropriate role in the current fiscal forecasting process, being required to audit a small number of assumptions chosen by the Treasury. The NAO could be given more power and an extended role, but it does not possess the expertise or resources to challenge the Treasury on a level playing field. It could be given those resources and expertise, but this would leave it with a combination of important responsibilities that would best be separated.
- Creating an independent Office for Budget Responsibility to produce or oversee official fiscal forecasts is a good idea, but such a body would require careful design. The key challenge is to provide independent and believable forecasts based on the information available, without losing the benefits of integrating fiscal forecasting and policy design. Taking fiscal forecasting out of the Treasury would threaten this synergy, while replicating the existing operation in the OBR would be expensive.
- The most promising route might be to have an independent Budget Responsibility Committee oversee, challenge and sign off forecasts by officials in the Treasury.

11.1 Introduction

This year, the UK is set to record its largest budget deficit since the Second World War and one of the largest in the industrial world. The financial crisis has significantly increased the structural budget deficit, which means that – in the absence of large spending cuts and tax increases – borrowing would remain high and public debt would rise to unsustainable levels (see Chapter 2). All three main UK political parties acknowledge that a big fiscal tightening is required over the coming years to bring the budget deficit back to appropriate levels, although they disagree about when it should start, how quickly it should be completed and what its composition should be.

Given the size and timescale of the necessary adjustment, the parties also accept that it is important to convince potential purchasers of government debt that the fiscal repair job will be carried through. Otherwise, those investors may charge the government more to

borrow from them and thereby make the fiscal problem even worse. The parties have proposed a variety of institutional reforms to try to offer this reassurance:

- The government has proposed, and is in the process of legislating for, a new Fiscal Responsibility Law that will make it a legal requirement for the government to set out and deliver a plan for sound public finances, with the plan initially having to be approved by Parliament. The government's first proposed plan (the Fiscal Consolidation Plan, FCP) sets three objectives in primary legislation:
 - reduce the budget deficit each year between now and 2015–16;
 - reduce the headline budget deficit by one-half by 2013–14 compared with its level in 2009–10;¹
 - have net debt falling as a proportion of GDP in 2015–16.The Act would also allow the government to impose further obligations relating to the period 2010–11 to 2015–16 by order. A draft *Fiscal Responsibility Order 2010* has been published, which includes the additional obligation to:
 - reduce the headline deficit to 5.5% of national income or less in 2013–14.²
- The Liberal Democrats have proposed giving the National Audit Office (NAO) greater responsibility, asking it to audit the Treasury's assumptions and forecast and the forecast's compliance with the fiscal rules.
- The Conservatives have promised to set up a new independent body called the Office for Budget Responsibility (OBR). This body would produce fiscal forecasts and advise how big a tightening or loosening would be necessary to give the government a better than 50% probability of:
 - having debt falling as a share of national income at the end of an as-yet unspecified forecasting horizon;³
 - balancing the current budget (revenues minus non-investment spending) at the end of the forecasting horizon, after adjusting for the estimated impact of the economic cycle.

In this chapter, we examine these various proposals for institutional reform. (We discuss the choice of fiscal targets for the next few years in Chapter 6.) We begin by asking why institutional reform may be needed at all in Section 11.2. We then move on to discuss the Fiscal Responsibility Bill proposed by the government in Section 11.3. In Section 11.4, we assess the proposals from the Liberal Democrats for greater levels of fiscal transparency and audit by the NAO. In Section 11.5, we examine the Conservative proposal for the creation of an independent fiscal agency, the OBR, and how such an agency should be designed to achieve its objectives. Section 11.6 concludes.

11.2 The rationale for institutional reform

Looking back over recent decades, more often than not governments have not raised sufficient tax revenue to pay for all of their spending, and have borrowed to make up the

¹ Borrowing in 2009–10 is forecast to be 12.6% of national income. If this proves correct, then it would need to be cut to 6.3% of national income, or lower, in 2013–14. However, the forecast for borrowing in 2013–14 from the December 2009 PBR (of 5.5%) shows that the government is currently aiming to over-achieve this target.

² Borrowing forecasts from the December 2009 PBR show that the government is currently aiming to hit this target exactly.

³ The current government uses a five-year forecasting horizon in its Budgets and Pre-Budget Reports.

difference (primarily by issuing gilts, in effect government IOUs that pay interest). There are four main reasons why governments might wish to borrow to finance some spending:

1. **Intergenerational fairness.** The benefits of some forms of spending are spread across time, so it seems fair that the cost should also be spread over current and future generations. One obvious category is capital investment. Similar arguments could apply to the costs of wars (which historically have prompted the largest spikes in government borrowing and indebtedness) and investment in human capital – for example, the training of teachers or doctors. Firms and individuals often borrow for similar reasons – for example, when investing in a new factory or home or when undertaking education. In principle, one could also advocate borrowing to finance other spending on redistributive grounds – because future generations are likely to be richer than today's.
2. **Output stabilisation.** The public finances fluctuate with the strength of the economy: when economic activity is depressed, tax revenues fall, welfare costs rise and government borrowing increases (or budget surpluses decline). These 'automatic stabilisers' help smooth out fluctuations in national income. If the government responded to high borrowing during a recession by raising taxes or cutting spending to close the gap, this would withdraw spending power from the economy and, other things being equal, would make the downturn more severe. While the automatic stabilisers operate in the right direction, their strength reflects non-macroeconomic factors such as the size of the state and the progressivity of the tax and benefit system. So there is no reason to believe that the automatic stabilisers will be the 'right' size for the needs of the economy at any particular time. Governments may therefore choose to augment or offset them with discretionary measures. The case for using changes in government borrowing to help stabilise the economy is particularly powerful when monetary policy is constrained – for example, if nominal interest rates are close to zero or if the exchange rate is fixed and therefore unable to depreciate.
3. **Tax rate smoothing.** In the face of expected changes in government spending, governments may seek to smooth tax rates over time to avoid the welfare costs implied by continual changes in tax rates.⁴ For example, a government may smooth tax rates in the face of an expected increase in spending needs arising from an ageing population (examples of which include the 'pre-funding' strategies in Australia and New Zealand) or an expected fall in resources arising from the depletion of a country's oil reserves (for example, Norway). There is also considerable uncertainty in forecasting the public finances from year to year, reflecting the fact that the budget balance is the difference between two large numbers (revenues and spending) that are in themselves difficult to forecast. This means that it would be hard to balance the budget every year even if one tried. However, if forecasts are unbiased, then the errors should balance out over time.
4. **Political expediency.** Politicians face pressure to increase spending or to reduce taxes (or to avoid spending cuts or tax increases) in the short run in order to gain electoral support, increasing the deficit and debt levels. Even though politicians may

⁴ For the original formulation of the tax smoothing hypothesis, see R. Barro, 'On the determination of public debt', *Journal of Political Economy*, 1979, 87, 940–949.

recognise the need for long-run fiscal sustainability, the immediate benefits of staying in office may outweigh any future costs of excessive short-term borrowing. Such an effect is known as a 'deficit bias'.

Of course, in a world of perfect information, far-sighted voters and investors should punish governments that exhibit such a 'deficit bias', or that, in the present context, put off a necessary fiscal tightening for inappropriate reasons. However, in reality, they lack the necessary information to assess with confidence the outlook for the public finances and the need for future policy changes to maintain sustainability. Governments are far from able to assess this perfectly either, but they can exploit the fact they have more relevant information on revenue and spending developments than outsiders do. This creates a temptation to produce optimistic borrowing forecasts, and to blame unforeseen events should actual borrowing exceed what was previously forecast. For example, Chancellor Gordon Brown published consistently over-optimistic fiscal forecasts from 2002, brushing away the concerns expressed in successive Green Budgets, and in other independent forecasts, and only taking offsetting action after the May 2005 general election.

In the December 2009 Pre-Budget Report (PBR), the government published fiscal forecasts showing a gradual policy tightening that would eliminate the extra structural deficit that the Treasury believes the crisis has caused by 2017–18. This is forecast to prevent public sector debt rising above 80% of national income and would put it on course to return to pre-crisis levels by the early 2030s (see Chapter 2 for detailed discussion of the Treasury's forecasts for borrowing and Chapter 6 for the Green Budget forecasts for borrowing under different scenarios for the macroeconomy). But how can the current (or any would-be) government persuade voters and investors that this outcome can reasonably be expected to come about, given the serial over-optimism shown by Budget and PBR forecasts over recent years? The parties' institutional reform proposals try to do this by increasing the political cost of under-achieving these forecasts *ex post* and/or by attempting to insulate the forecasts from any suspicion of political wishful thinking *ex ante*.

We now turn to the reforms that the three main parties have put on the table.

11.3 The Fiscal Responsibility Act

Alongside the December 2009 PBR, the government released details of a Fiscal Responsibility Bill, which has since been passed by the House of Commons and is due to have its second reading in the House of Lords on 10 February 2010.⁵ Once legislated, the resulting Act will impose a statutory duty on the Treasury to set and meet specific targets for reducing government borrowing and debt. The government believes that this will demonstrate its commitment to ensuring the sustainability of the public finances.

Clause 1 of the Bill requires the Treasury to ensure that:

- public sector net borrowing as a percentage of national income in each financial year 2010–11 to 2015–16 is lower than the previous year;

⁵ For more details, see House of Commons Library, *Fiscal Responsibility Bill*, Research Paper 09/96, 22 December 2009, <http://www.parliament.uk/commons/lib/research/rp2009/rp09-096.pdf>. Details of the Bill's passage through Parliament can be found at <http://services.parliament.uk/bills/2009-10/fiscalresponsibility.html>.

- public sector net borrowing as a percentage of national income in 2013–14 is no more than half its 2009–10 level;
- public sector net debt as a percentage of national income in 2015–16 (at year end) is lower than its level in 2014–15 (at year end).

The Act would also allow the government to impose further obligations relating to the period 2010–11 to 2015–16 by order. A draft Fiscal Responsibility Order 2010 has been published, which includes the additional obligation that:

- public sector net borrowing should be 5.5% of national income or less in 2013–14.

Given the December 2009 PBR forecast for the budget deficit in 2009–10, this is a more ambitious goal than that set out in the second requirement of Clause 1 above (which, if the PBR forecast for borrowing in 2009–10 of 12.6% of national income is correct, would require the deficit to be reduced only to 6.3% of national income in 2015–16). The Treasury has presumably put the tougher target in secondary rather than primary legislation to make it less onerous to drop or amend than the other targets.

The Act will require the Treasury to make orders to secure sound public finances for the period after 2015–16, thereby requiring it always to have a fiscal duty laid down by legislation. It also requires the Treasury to report on progress towards, and compliance with, its targets in Budgets and PBRs. The government must provide an explanation where they have not been complied with. It will be held accountable for meeting the obligations through these reports, which must be laid before Parliament. But there is no legal sanction for failure other than the requirement to report to Parliament – the Act will be essentially declaratory or a high-profile public statement of intent.

The Act will also give Parliament a greater role in fiscal policy than it currently enjoys, by giving it the power to vote on the government's medium-term fiscal plans. Parliament currently approves public spending and taxation separately, through the Supply Estimates and the Finance Bill respectively. The Bill gives Parliament the power to vote on targets for government borrowing and debt directly. Furthermore, the Bill allows Parliament to vote on medium-term fiscal plans. This contrasts with the current Supply Estimates process and Finance Bills, which are generally of a more short-term nature.

The Fiscal Responsibility Bill is one of a number of pieces of recent legislation that seek to enshrine policy targets in law. Other examples include:⁶

- the Child Poverty Bill, which enshrines the 2020 child poverty target in legislation;
- the Climate Change Act 2008, which sets legally binding targets for carbon dioxide emissions in 2020 and 2050;
- the proposed International Development Spending Bill, whose purpose is to enshrine in law the commitment to spend 0.7% of gross national income on Official Development Assistance from 2013.

It is worth noting that all these pieces of legislation set down targets that cannot be judged hit or missed during the current Parliament. With the Labour Party behind in the opinion polls at the time the legislation was announced, there is a natural suspicion that

⁶ For more details of each of these see, respectively, <http://services.parliament.uk/bills/2009-10/childpoverty.html>, <http://services.parliament.uk/bills/2007-08/climatechange.html> and <http://www.commonleader.gov.uk/output/page2931.asp>.

these Bills are designed less to convince people of the current Labour government's commitment than to inconvenience a future Conservative one.

As regards the Fiscal Responsibility Act, it is not immediately obvious why breaching the targets set out within it (or moving the goalposts so as to avoid a formal breach) should involve a greater political or reputational cost than breaching or finessing the fiscal rules set out under the Code for Fiscal Stability, which was enshrined in legislation in 1998. Independent economic observers had lost confidence in the fiscal rules as a meaningful constraint on government tax and spending decisions well before the recent crisis. In its 2007 New Year survey of the views of independent economists, the *Financial Times* concluded that 'Almost none use the chancellor's fiscal rules any more as an indication of the health of the public finances'.⁷

The credibility of the Fiscal Responsibility Act targets may also be undermined by the fact that they make no allowance for any potential deterioration in the fiscal outlook that might arise from a double-dip recession or another negative shock to the economy. In this event, the requirement to see the budget deficit fall year after year might well no longer be sensible – and no one would expect the government to implement a fiscal tightening under those circumstances simply because of the Act. Conversely, if the economy and/or the underlying health of the public finances were to improve much more rapidly than the Treasury expects, the goals set out in the Act might be thought too modest.

Even if the economy follows the path expected by the Treasury, revenues could still, of course, disappoint or spending come in higher than projected. In the November 1998 PBR, the Treasury estimated that the average absolute error forecasting borrowing one year in advance had been 1.2% of national income (£17 billion in 2009–10 terms) and that, even once the effect of errors in forecasting GDP were taken into account, the average error had been 1.0% of national income (£14 billion). Looking four years ahead, the figures were 4.1% of national income (£58 billion) and 2.4% of national income (£34 billion) respectively.⁸

The fact that the public finance outcomes have often been very different from those forecast by the Treasury – and others⁹ – means that even a government genuinely aiming to comply with any fiscal target *ex ante* may find that *ex post* they have missed it. Let us assume that the current Treasury forecasts are a fair expectation of the likely strength of the public finances going forwards, and that they prove as accurate as the Treasury forecasts have been over the longer term up to, but not including, the large errors that have arisen due to the financial crisis. This would suggest that there is a four-in-ten chance that, without policy action, borrowing will be more than half its 2009–10 level in 2013–14 and the Fiscal Responsibility Act therefore broken. Even if the forecasts are accurate to 2012–13, there would still be a one-in-four chance of borrowing exceeding 6.3% of national income and the Fiscal Responsibility Act being broken – and in this case there would be only limited time to implement tax rises or spending cuts to avoid a breach of the new law. The additional obligation that borrowing is at most 5.5% of

⁷ 'Cut spending to reduce borrowing', *Financial Times*, 2 January 2007, <http://www.ft.com/cms/s/683400d2-9a05-11db-8b6d-0000779e2340.html>.

⁸ Figures for forecast errors as a share of national income from paragraph B23 of HM Treasury, *Pre-Budget Report*, November 1998, http://www.hm-treasury.gov.uk/prebud_pbr98_repannexp.htm.

⁹ For a comparison of the forecasts of different bodies, see C. Giles and J. Hall, 'Forecasting the PSBR outside government: the IFS perspective', *Fiscal Studies*, 1998, 19, 83–100, <http://www.ifs.org.uk/publications/2250>, and R. Barrell, S. Kirby and R. Metz, 'Forecast comparisons', *National Institute Economic Review*, 2005, no. 193, 70–74 (DOI: 10.1177/0027950105058557).

national income in 2013–14, which is the level of borrowing that the Treasury is currently forecasting, only has a 50:50 chance of success without a further fiscal tightening, given the assumption that the Treasury's forecast is as likely to be pessimistic as it is to be optimistic. The fact the Fiscal Responsibility Act would also be broken if borrowing were not reduced as a share of national income in every year to 2015–16, or if public sector net debt as a share of national income were not falling in 2015–16, increases still further the likelihood that this new law will end up being broken.

Like the current government's original fiscal rules, the Fiscal Responsibility Act fails to take explicit account of the uncertainty that lies around all fiscal forecasts. This uncertainty means that the government must, in effect, decide what probability of a breach it is willing to accept when setting out a policy path. Ducking this fact may encourage a return to the 'conviction forecasting' of the past – the government constantly insisting that it will meet its targets until it leaves itself too little time to make corrective policy action and thereby finds itself under pressure to finesse the targets to avoid an embarrassing breach.

11.4 An enhanced role for the National Audit Office

One reason that voters find it difficult directly to punish governments that borrow excessively in the short run is, as mentioned in Section 11.2, that they have access to less information on fiscal developments than the Treasury does. The government can then sideline the concerns of independent commentators about the accuracy of fiscal forecasts by asserting that it has superior information (which is true) that justifies the published forecasts (which may or may not be true). Voters and investors have good reason to be suspicious of such tactics in the light of the history of the last few years, so the opposition parties have both proposed ways to convince people that published official forecasts for the public finances are based on best professional judgement rather than politically-motivated wishful thinking.

As we noted in the introduction, and as we shall discuss in more detail in Section 11.5, the Conservatives propose to create an Office for Budget Responsibility that would undertake official but independent fiscal forecasts. But speaking in the Commons on 26 November 2009, Vince Cable, the Liberal Democrat Deputy Leader and Shadow Chancellor, said:

There is a role for legislation to strengthen the fiscal framework. I am probably not too far from the Conservative spokesman in his belief that we need an additional independent element in fiscal policy, as we have in monetary policy with the Bank of England. However, my party's approach would be more modest. There is probably an argument for giving the National Audit Office a stronger role in auditing what the Government have done – not just their forecasts as at present. The NAO could make an assessment about whether the Government have delivered on their targets. We have already had some strengthening of the legislation regarding the independence of the statistics office. That was a step forward and there is an argument for an independent audit role – an Ofsted – on fiscal policy. I agree with that, although I should not create quite such an elaborate institution as the Conservative spokesman

proposes. None the less, there is a role for strengthening the institutional backbone of fiscal policy.¹⁰

The Treasury currently asks the National Audit Office to audit a number of economic assumptions used in its public finance forecasts – for example, the outlook for equity prices, oil prices and unemployment. But the NAO can only audit the assumptions that the Treasury asks it to. In evidence to the Treasury Select Committee, David Heald, Professor of Accountancy at Aberdeen University, argued that: ‘This arrangement (“look only at what we ask you to look at”) breaches the fundamental postulate of auditing, that there must be independence to investigate as well as independence to report. In my view, the NAO has allowed itself to be misused’.¹¹ What is more, the NAO is not asked to say whether these assumptions are the best available, but only whether they are ‘reasonable’. For many of the assumptions concerned, this is not a particularly demanding yardstick and the difference between an assumption that was only just ‘reasonable’ and one that was the ‘best available’ could be considerable.

Even if the NAO was allowed to choose which assumptions to audit, this is not the same as auditing the forecast as a whole – a frequent misapprehension that Treasury ministers and advisers rarely seek to correct. Using the NAO to reassure people that the forecasts represent best professional judgement would require it to be given this broader role. But the organisation does not currently possess the expertise to undertake it. The NAO could, in principle, be given the expertise and resources to fill this role, but this would be a high-profile and important task very different from its core functions. For reasons of focus and public accountability, it is probably best that they are in separate institutions.

11.5 An Office for Budget Responsibility

The Conservatives propose to set up an independent OBR to prepare fiscal forecasts and to offer advice on the management of the public finances. As of early January 2010, their proposals were as follows¹²:

- The OBR will consist of a three-person Budget Responsibility Committee, plus a Secretariat. Appointments to the Committee will be made by the Chancellor, using the same procedure as appointments to the Monetary Policy Committee (MPC) of the Bank of England. They would serve single non-renewable terms (in contrast to the MPC, where terms can be renewed). Members will appear before the Treasury Select Committee.
- The OBR will publish medium-term fiscal forecasts twice a year, before Budgets and PBRs. These forecasts will take uncertainty explicitly into account, as the Bank of England’s fan charts for inflation and economic growth do. The Treasury, the Department for Work and Pensions, HM Revenue & Customs and the Office for National Statistics will have a duty to cooperate with the OBR and provide it with internal data and forecasts. Once a year, the OBR will also produce an assessment of all government financial liabilities, including public sector pensions and PFI liabilities, and the long-term sustainability of the public finances.

¹⁰ <http://www.publications.parliament.uk/pa/cm200910/cmhansrd/cm091126/debtext/91126-0012.htm>.

¹¹ <http://www.publications.parliament.uk/pa/cm200910/cmselect/cmtreasy/180/180.pdf>, Ev 51, paragraph 6.

¹² <http://www.publications.parliament.uk/pa/cm200910/cmbills/013/amend/psc013200110a.392-396.html>, plus briefing to journalists.

- Based on its forecasts, the OBR will recommend how big a fiscal tightening or loosening it thinks is necessary to have a better than 50% chance of meeting a mandate for the public finances set out by the Chancellor – but it will not recommend how any tightening or loosening should be split between tax and spending measures.
- The Conservatives have said that the mandate will be:
 - to have debt falling as a share of national income at the end of an (as-yet unspecified, but currently five-year) forecasting horizon;
 - to balance the current budget (revenues minus non-investment spending) at the end of the forecasting horizon, after adjusting for the estimated impact of the economic cycle.

As an OBR would not be up and running in time for the Budget that the Conservatives plan to hold within 50 days of taking office, should they win the general election, they plan to appoint an interim committee of independent figures to oversee the production of fiscal forecasts within the Treasury for publication with the Budget. Sir Alan Budd, former chief economic adviser of the Treasury and current chairman of the IFS Tax Law Review Committee, has been appointed to oversee this process.

The idea of injecting greater independence into the fiscal forecasting process is one that we have argued for in a number of recent Green Budgets.¹³ The proposal for an OBR certainly seems an improvement on current practice in that light. The devil, of course, is in the detail, and we now discuss a few of the design issues that arise in thinking about how it might work. We end by discussing what such a body could realistically be expected to achieve in practice.¹⁴

The mandate of the OBR

Unlike monetary policy (where achieving low and stable inflation is a generally agreed target for policy), fiscal policy aims to achieve a variety of goals. Many are matters of political as much as economic judgement. While we may be able to outline some widely shared broad principles for good fiscal management, there is no consensus on what levels of borrowing or public sector indebtedness would be desirable or sustainable. Given that the MPC does not have responsibility for setting its own targets, it certainly seems sensible to leave the setting of fiscal targets to the government, rather than delegating them to an independent body. This is a feature common to all three parties' proposals, although Labour is going further than current practice as its Fiscal Responsibility Act will give Parliament the power to vote on targets for government borrowing and debt directly.

The Conservatives sensibly aim to give the OBR a tightly defined remit, limited to forecasting fiscal aggregates and assessing whether the government has complied or is on course to comply with pre-defined fiscal targets. However, even though the setting of fiscal targets is ultimately a political judgement, it would seem appropriate (and helpful for external credibility) if an OBR were to assess publicly whether it believes any changes to the rules it is tasked with policing are consistent with the ultimate objective of long-term sustainability. An OBR should not be tempted to offer advice on broader economic

¹³ See, in particular, R. Chote and C. Emmerson, 'Fiscal policy framework', in R. Chote, C. Emmerson, D. Miles and Z. Oldfield, *The IFS Green Budget 2005*, January 2005, <http://www.ifs.org.uk/publications/3250>.

¹⁴ Much of the discussion that follows is drawn from Robert Chote's Scottish Economic Society Annual Lecture, delivered on 12 November 2009: http://www.ifs.org.uk/pr/obr_press_release.pdf.

policy issues, as some of its overseas counterparts do (for example, in Sweden). The cost of commenting on broader economic policy could be getting drawn unnecessarily into conflict with other parts of the policymaking process and thereby reducing the credibility of the OBR on its key function – the production of high-quality independent fiscal forecasts.

Forecasting

One problem with fiscal rules on their own is that ministers have an incentive to produce unduly optimistic forecasts, which show them meeting their targets, while external observers find it hard to challenge them as everyone knows they have inferior information. Creating an independent body to carry out forecasting with the same resources and information that are currently available to Treasury forecasters would sharply change the incentives that ministers face. Provided that there was a cross-party consensus in favour of keeping such a body in a particular form, an OBR would have no obvious stake in the incumbent government keeping office and thus would have no incentive to produce politically motivated forecasts.

The Conservatives clearly want to go further than having independent experts ‘kick the tyres’ of a ministerial forecast produced as now. One option would simply be to remove the existing fiscal forecasting function from the Treasury into the new organisation. However, former Treasury officials say that this has been considered before and ruled out as impractical. The main 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 have pointed, for example, 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.

An alternative would be to have an OBR in a position to produce the ‘official’ forecast, but with the Treasury retaining the capacity to carry out its own forecasts for ministers. But it is not clear then where the critical mass of expertise and resources would lie. It would certainly be odd if the primary official fiscal forecasting function in the OBR were less well resourced and less plugged in to the policymaking machine than the secondary one. The Conservatives need to avoid the trap of replacing the current well-resourced and well-organised fiscal forecasting operation in the Treasury (albeit one whose outputs have been undermined by unhelpful political pressure in the past¹⁵) with two less well-resourced and less well-organised operations in the Treasury and the OBR.

One option that would avoid this danger, as well as the cost of simply duplicating the Treasury’s existing forecasting function, would be to have the forecasts carried out by the same officials who undertake them now, interacting with the rest of the Treasury as they do now, but with the process overseen and the end product signed off by the equivalent of the Conservatives’ Budget Responsibility Committee, i.e. independent and publicly accountable figures from outside the civil service. (This would be a more arm’s-length and visibly independent version of the system in New Zealand, where the Permanent Secretary of the Treasury states that the official fiscal forecasts have been prepared on

¹⁵ We should, though, remember that Budget and PBR forecasts are formally those of ministers, rather than officials, so under the current system they are within their rights to tell the officials what to forecast.

the Treasury's 'best professional judgement', with the Minister of Finance promising that he has advised officials of 'all Government decisions and other circumstances as at [date] of which I was aware and that had material economic or fiscal implications'.¹⁶) But such an approach might change the relationship between ministers and civil servants in an unhelpful way: if the fiscal forecasters were seen to owe their primary loyalty to the Budget Responsibility Committee, rather than to ministers, then this could give extra impetus to the use of political special advisers rather than the official machine.

Access to data and information

The Conservatives rightly point out that for the forecasts of an independent OBR to be credible, the body would need guaranteed access to the same information from HM Revenue & Customs, the Department for Work and Pensions and the Office for National Statistics that Treasury forecasters enjoy today. Indeed, this access should be guaranteed in legislation (and should probably also include the Debt Management Office and the Government Actuary's Department, since their data would be useful in projecting, respectively, net debt interest and public-service pension spending).

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. However, there may be some confidentiality issues that would prevent all such information being shared with non-official bodies. But it would be useful if the OBR were, by default, to make all of its data and models publicly available apart from in cases where it considered that confidentiality issues prevented it from doing so.

Forecast coverage

Fiscal forecasting has two elements. First, you need a macroeconomic forecast – that is, a forecast for how the UK economy will perform and, in particular, how key variables such as employment levels, earnings and corporate profitability will evolve. Second, given the macroeconomic outlook, you need to forecast how government revenues and spending (and consequently the budget balance and debt) will evolve. (The Treasury currently produces forecasts on what it describes as deliberately cautious assumptions – for example, regarding the trend growth rate of the economy. It would be better, and more transparent, for an OBR to publish forecasts that are its best assessment and leave the government to decide how cautious it wishes to be in deciding its policy settings.)

Providing a credible challenge to the government's fiscal forecasts does not, however, necessarily require an independent body to produce its own macroeconomic forecasts (for which the Treasury enjoys no obvious informational advantage). Indeed, it might be more sensible for an independent fiscal agency to focus its resources on fiscal forecasting, while simply using the best-regarded independent macro forecasts as the basis for its assessment. It could then provide some analysis of the sensitivity of its results to the macroeconomic assumptions used.

One obvious candidate would be the macroeconomic forecast underlying the Bank of England's *Inflation Reports*. This would have the virtue of ensuring that monetary policy decisions and the OBR's advice on fiscal policy were based on a consistent medium-term view of the economy. However, this would require the MPC to agree and to publish a rather more detailed breakdown of its macroeconomic forecasts than it currently provides. It would also require it to overcome its reluctance to say much in public about

¹⁶ <http://www.treasury.govt.nz/budget/forecasts/befu2009/001.htm>.

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. This is the approach currently used by the Canadian Parliamentary Budget Office. However, aggregating disparate forecasts in a coherent way is not straightforward, given differences in coverage, methodology and timescales. Compiling an average forecast for different components of the economy is also likely to lead to a projection that is intrinsically inconsistent, although while this is not desirable it does not necessarily mean that a fiscal forecast using such a compiled average macroeconomic scenario would not be a reasonable one.

In addition to producing a fiscal forecast based either on its own macroeconomic forecast or on another independently produced forecast (such as one from the Bank of England or one compiled from the average of independent forecasters), it would also be sensible for an OBR to produce a fiscal forecast based on the latest Treasury macroeconomic forecast (perhaps immediately after each Budget and PBR). This would help to communicate clearly the extent to which differences in the forecast strength of the public finances were due to differences in the assumed path of the economy or other differences between the forecasts, such as differences in tax revenue elasticities.

Alternatively, under the lower-cost option of a Budget Responsibility Committee overseeing the Treasury forecasting team and signing off the Treasury forecast, there would be only one body producing public finance forecasts. Even in this arrangement, it would be sensible for sensitivity analysis around the central fiscal forecast to be published – for example, the impact on the forecasts for borrowing and debt from using different macroeconomic scenarios could be set out in a similar way to the Green Budget projections in Chapter 6.

Long-term forecasts

The Conservatives have also proposed that the OBR should regularly analyse the public sector balance sheet, including an assessment of the importance of and changes in off-balance-sheet and contingent liabilities. This could reduce any incentive for the government to structure its policies in a suboptimal way simply in order to avoid increasing the probability of breaching its rules – for example, by accumulating off-balance-sheet liabilities to avoid increases in the headline public sector debt measure. There was, for example, a suspicion that while the Labour government's sustainable investment rule was in operation, there was an inclination for the government to carry out investment projects using the Private Finance Initiative rather than conventional debt financing because the former had a smaller impact on headline measures of debt (at least in the short term). Similarly, going forwards, there may be a concern that the need to reduce the headline measure of public sector net borrowing leads to too much emphasis on cutting public sector wages rather than cutting public sector pensions (see Chapter 9).

Communication between the Treasury and the OBR

If a model is adopted in which both the OBR and the Treasury publish fiscal forecasts, one interesting question is the extent to which they should communicate with each other during the forecasting process. 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 might suspect that

both institutions would be happier to be wrong together than to risk being seen as wrong on their own. But reasonable people are bound to differ in their fiscal forecasts and, at a minimum, an OBR and the Treasury should present their analysis in such a way that they can identify and explain the reasons for any differences in an agreed way – for example, whether they reflect different assumptions about the composition of growth or about tax revenue elasticities.

Costing individual policies

An OBR would need to forecast aggregate spending and revenue figures, but it is less clear-cut whether it should also comment specifically on the Treasury's estimates of the costs or revenues raised from individual (or even the combined set of) policies announced in each Budget and PBR. In recent times, the controversial introduction of the 50p income tax rate on high incomes is an obvious example where the Treasury costing of the measure has come under close external scrutiny. Were an independent office to assess each policy measure, this might provide useful discipline on ministers, but it would require significant additional resources and a widening of focus.

An obvious area in which this issue might arise under a Conservative government is if the party implements its plan to introduce a new charge of £25,000 for UK residents not paying tax on any overseas income as a result of being domiciled outside the UK for tax purposes. The party has argued, on the basis of advice from private sector tax advisers, that at the time it was announced (in September 2007) it would raise £3.5 billion a year, and that this fell to £2.8 billion after the impact of the changes that the government chose to implement in the October 2007 PBR was taken into account. However, the government claims, using costing produced by the Treasury, that these figures are unrealistically high, with its latest estimate suggesting that the revenue raised in 2012–13 would be just £50 million.¹⁷ Given that HMRC has not in the past collected the information necessary to provide a firm estimate of the revenue that would be raised by this policy, an incoming Chancellor would have to decide on what basis to make a formal estimate and the OBR would doubtless be asked whether it thought that that estimate was the most appropriate one.

Costing opposition policies

In addition to forecasting the fiscal outlook under the policies of the government of the day, there might also be a case for allowing the OBR to forecast the outlook under the policies of the opposition parties (especially in the run-up to general elections). This would help inform public debate and act as a discipline on would-be governments. Arguably, with an incumbent party behind in the polls (as is currently the case in the UK), financial markets may be more concerned with whether the main opposition party's policies are consistent with long-term fiscal sustainability than whether those of the government are. One option might be to allow opposition parties to submit plans to the OBR for scrutiny if they wish. Bringing the OBR into the political arena in this way clearly poses dangers, but it would perhaps be preferable to the current situation in which Treasury officials produce private costings of opposition policies for ministers (although

¹⁷ The latest Treasury costing is that it would raise £350 million in 2009–10, falling to £50 million in 2012–13. This was provided in response to a parliamentary question by Lord Oakeshott. See *Hansard*, Col. WA101, 7 December 2009, <http://www.publications.parliament.uk/pa/ld200910/ldhansrd/text/91207w0004.htm#09120728000527>. For more details on the HMT costing done in 2007, see http://www.hm-treasury.gov.uk/foi_costing_2007.htm.

not for the opposition) and they subsequently become public through Freedom of Information requests. An alternative might be for the Treasury automatically to publish, on a regular basis, all of the costings that it has done on opposition policies.

What difference might an OBR have made in the past?

An OBR might have discouraged Gordon Brown and his advisers from ‘sniffing round the forecasters’ pockets’ from 2002 onwards, as some mandarins have quaintly described it. Assuming that the OBR had taken a similar view to that of IFS researchers 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. Perhaps more importantly, 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 (a mistake that was shared with many macroeconomic forecasters outside government; see Chapter 4). The proposed OBR would have been no better placed to foresee such an event than any other macroeconomic 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 would be unlikely to find its path as smooth in its early years as the Bank did.

For one thing, the Bank had the advantage that it became independent at a time when its 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 (and it was unlikely that this was because the Bank of England was made independent, as the same was true in almost all developed economies). 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 effects on individual behaviour and, potentially, knock-on effects on the wider economy). There is a

relatively high probability that good advice *ex ante* may appear 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.

11.6 Conclusion

At a time when it is necessary to reassure voters and investors that the significant damage to the public finances from the financial crisis will be repaired over an appropriate timescale, there is a powerful argument for institutional reforms to increase public confidence in official fiscal forecasts.

The Fiscal Responsibility Act is unlikely to achieve this. It is not clear why the government should be more deterred by the prospect of breaking this law than it was by the loss of credibility it suffered by publishing serially overoptimistic fiscal forecasts from 2002 onwards, by ‘moving the goalposts’ to reduce the chance of breaching its fiscal rules (that had been laid out under the legislated Code for Fiscal Stability) and by delaying corrective fiscal action until shortly after the 2005 general election.

Injecting greater independence and transparency into the fiscal forecasting process seems a more promising route. Expanding and intensifying the scrutiny function of the National Audit Office would help at the margin, but the NAO does not possess the expertise or the resources that would allow it in effect to forecast on a level playing field with the Treasury. It could be given those resources and expertise, but this would give the NAO a new and high-profile role that would sit oddly with its current core functions.

The Conservative proposal for an Office for Budget Responsibility has much to recommend it, but such a body would require careful design. The central challenge is to deliver truly and demonstrably independent forecasts, without losing the two-way flow of expertise and understanding between fiscal forecasting and policy development. Taking the fiscal forecasting function out of the Treasury would threaten this synergy, while fully replicating it would be expensive.

The most promising route might be to give the Conservatives’ proposed independent Budget Responsibility Committee the task of overseeing, challenging and publicly signing off fiscal forecasts undertaken within the Treasury, but based on externally produced macroeconomic forecasts as well as internal ones. In seeking to achieve laudable objectives, if elected the Conservatives must avoid replacing an effective, well-organised and well-resourced fiscal forecasting operation within the Treasury – albeit one that has had to accommodate the views of its political masters – with two less well-organised and less well-resourced operations in the Treasury and the OBR.