Fiscal Councils: The UK Office for Budget Responsibility

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Introduction

One of the most recent fiscal councils to be formed is the Office for Budget Responsibility (OBR) in the UK. It is distinctive in two respects. First, it provides the macroeconomic and budgetary forecasts on which government fiscal decisions are based. Second, it is not allowed to consider anything other than current government policy. To understand why the OBR has this specialised remit, we begin by examining the circumstances that led to its creation. After outlining its tasks in more detail, we then consider issues related to forecasting, policy analysis and independence.

Background

An Office for Budget Responsibility was first proposed by the then opposition Conservative Party in September 2008. The Labour government had been in power since 1997, and fiscal policy over most of that period was set in the context of two fiscal rules. These rules stated that, over the economic cycle, the government would only borrow to invest and that the ratio of net government debt to (annual) GDP would not exceed 40 percent. Both rules were set in relation to an economic cycle. This form of correction meant that checking that the rules were being observed required a forecast of when and how the current cycle would end, and how spending and revenues would develop over this period. Every year, the Treasury (the UK finance ministry) would publish budget forecasts that did this, as well as long-term (50 year) fiscal projections.

From 2002, the Labour government embarked on a substantial expansion in government spending. Tax revenues at the time were buoyant, in part due to the continuing expansion of the financial services sector, and the Treasury predicted that the two fiscal rules would be met. However, independent forecasters had already begun to argue that the Treasury's forecasts were too optimistic. The financial crisis of 2007–8 and the subsequent recession led to large budget deficits. The Labour government abandoned its fiscal rules, and argued that to combat the recession expansionary fiscal policy should be used. Partly as a result, government net debt rose above 50 percent of GDP, and was expected to reach a peak of around 75 percent of GDP.

Although there had previously been occasional proposals for some form of UK fiscal council (e.g., Wren-Lewis 1996), calls for institutional reform increased as the fiscal crisis developed. While the Conservative Party proposal in 2008 drew on both international experience and specific proposals for the UK (e.g., Kirsanova et al. 2007), it naturally emphasised the culpability of the Labour government for the expansion in government debt, with the suggestion that it had pressurised civil servants to make over-optimistic projections. As a result, it was proposed that an independent body should undertake budget forecasts.

Besides proposing the establishment of the OBR, the Conservative Party opposed the government's attempts to use fiscal policy to stimulate the economy, arguing that subsequent plans to bring the public finances under control were too slow. In the election of May 2010 the timing and speed of fiscal consolidation became a central issue.[1]

The election resulted in the Conservative Party forming a governing coalition with the Liberal Democrats. The establishment of an interim OBR was one of the first acts of the new government. A three-person interim Budget Responsibility Committee was set up, chaired by the former Treasury chief economic adviser Sir Alan Budd, and aided by a small secretariat of

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I am grateful for helpful discussions with Alan Budd, Lars Calmfors, George Kopits, and particularly Robert Chote, but I am responsible for the views expressed here.

[1] In contrast, the establishment of the OBR was not. Although the Labour government had chosen not to establish such a body, neither side made this a topic of debate during the election.

Treasury officials. They produced a forecast for the public finances shortly before the June Budget, followed by a second forecast on Budget day itself that incorporated the impact of the newly announced measures.

The permanent OBR was established by Act of Parliament in April 2011.[2] The Budget Responsibility Committee now consists of Robert Chote, former director of the independent Institute for Fiscal Studies, Steve Nickell, an Oxford academic, and Graham Parker, an experienced former Treasury and Inland Revenue forecaster. There is a staff of 15 and an annual budget of GBP 1.75 million.

Remit

Legislation defines the duty of the OBR as being "to examine and report on the sustainability of the public finances". This involves three main tasks.

1) Forecasting. The OBR produces the official five-year forecasts for the economy and the public finances twice a year. Previously these forecasts were prepared by the Treasury. The UK government has therefore "contracted out" the job of producing its fiscal forecasts. The Treasury still produces estimates of the fiscal costs of individual tax and spending measures announced in the Budget, but as these are part of the OBR's forecast, the OBR has to decide whether to accept these estimates.
2) Rule achievement. The OBR uses these forecasts to assess whether the government has a better than 50 percent chance of achieving the fiscal targets that the government has set itself. There are currently two such targets. The first, and more important, is the "fiscal mandate", that requires the government to set policy so as to achieve balance or surplus in the structural (cyclically adjusted) current budget five years ahead. This is the same principle as the previous government's "golden rule", but judged over a rolling, forward-looking five-year horizon rather than between the estimated start and end points of a particular economic cycle. The second "supplementary target" requires the ratio of debt to GDP to be falling in 2015–16.
3) Long term sustainability. The OBR is required to analyse the long-term sustainability of the public finances, looking at 40–50 year projections of tax and spending flows, as well as the health of the public sector balance sheet.

[2] The Budget Responsibility and National Audit Act.

All of these tasks were previously undertaken by the Treasury. The key change is therefore that these tasks are now completed by an independent body. Legislation gives the OBR "complete discretion in the performance of [its] duty", as long as it is performed "objectively, transparently and impartially" and as long as it takes into account current government policies but not alternative policies. The OBR "should not provide normative commentary on the particular merits of government policies". Independence includes complete discretion to decide on forecasting methodology and judgements, on the content of publications and the work programme of any additional research and analysis.

With only a small staff, the OBR relies on civil servants in various departments to provide detailed forecasts of individual tax or spending programmes. The legislation gives the OBR "right of access (at any reasonable time) to all Government information which it may reasonably require for the performance of its duty". The OBR is "entitled to require from any person holding or accountable for any government information any assistance or explanation which the Office reasonably thinks necessary for that purpose". The extent to which this reliance on civil servants allows true independence is discussed below.

Eleven fiscal councils, including the OBR, are surveyed in Calmfors and Wren-Lewis (2011). All are advisory: for example in the case of the UK, the government is not required to take action to ensure that the OBR believes its fiscal mandate will be met. The OBR has a relatively narrow remit: it does not comment on non-fiscal issues (the Danish, Dutch, Swedish and German councils analyse employment, growth and other structural policies) or conduct analysis of individual projects (as the CBO in the US and the PBO in Canada do). Calmfors and Wren-Lewis (2011) argue that the OBR is "the most extreme case of positive analysis", because it cannot look at the impact of different policy options, but has to restrict itself to analysis of the current government's existing policies.

While the OBR's remit is narrow, it is nevertheless central to the fiscal policy process. The pre-budget and post-budget forecasts which the OBR now produces form the basis on which aggregate fiscal decisions are based. In this respect, the OBR is perhaps closest to the Central Planning Bureau (CPB) in the Netherlands. However the CPB also formally assesses the economic and fiscal consequences of opposition political parties' manifestoes ahead of their general elections, while the OBR does not.

Forecasting, policy analysis and independence

The specific remit of the OBR raises interesting issues involving the interrelationship between forecasting, policy analysis and independence. Does it make sense to separate fiscal forecasting from policy analysis? Can a fiscal council that relies on the civil service to produce detailed forecasts be truly independent?

Policy analysis

The central role of forecasting for the OBR can be easily understood given the historic and political circumstances of its creation. The Conservative Party in opposition blamed excess optimism by the government for "deficit bias", which it argued lay behind the unsustainable debt position following the recession. If this was the main source of deficit bias, then contracting out this function to an organisation that would not be over-optimistic would be a logical response. Similar contingent factors help explain why the OBR is restricted to only consider current government policy. In the 2010 election the speed of fiscal consolidation was a central issue between parties. When elected, the new government would not have wanted its own creation (the OBR) to produce analysis which showed that more rapid fiscal consolidation would reduce output and raise unemployment.

While the decision to prevent the OBR from doing any policy analysis may be politically explicable, it makes less sense in economic terms. Looking at the impact of alternative tax or spending plans involves using much of the same tools as the production of forecasts, so it seems odd that the expertise established in the OBR should not be used for both tasks. It is important here to distinguish between policy analysis and policy advocacy. As fiscal councils such as the CBO in the US have shown, it is quite possible to analyse the implications of alternative policies without then advocating the adoption of one of those policies. Instead the pros and cons of each policy can be set out, allowing a well informed choice to be made by others. It is also worth noting the Dutch experience that regular, formal independent analysis of competing policy platforms and measures can be helpful in facilitating post-election coalition formation and preventing parties from attempting to "bribe the electorate".

One danger of restricting the function of a fiscal council to forecasting based on current policies is that it focuses on just one source of deficit bias. While over-optimistic forecasting may well have contributed to deficit bias in the past, both in the UK and elsewhere (see, i.e., Jonung and Larch 2006), there are many other potential sources of deficit bias (for a detailed discussion, see Calmfors and Wren-Lewis 2011). For example, when fiscal programmes are not sustainable in the long term, governments may put off taking corrective action. While sometimes such delays may be justified – to help recovery from a recession, for example, as Wren-Lewis (2011) advocates – on other occasions it can simply reflect a desire to avoid political costs. The underlying problem is that the public is not informed of the costs of delay. In this context, a fiscal council that is able to analyse the costs and benefits of delaying fiscal consolidation can help avoid deficit bias.

In theory, fiscal rules are designed to prevent deficit bias. The OBR, as with most fiscal councils, operate alongside fiscal rules established by government. Does this imply that, as long as the fiscal council ensures that the fiscal rule is met, deficit bias will be avoided? It should be the case that having an independent body established by government monitor fiscal rules makes it more difficult for governments to break or fiddle those rules. However, as Kirsanova et al. (2007) argue, fiscal rules are likely to be a poor approximation to optimal policy. Macroeconomic theory suggests that government debt should act as a buffer for macroeconomic and fiscal shocks, and any debt correction should be slow. As a result, any targets for debt should be heavily state contingent and achieved over decades rather than years. In these circumstances, there may well be circumstances in which fiscal rules should be broken in the short term. As Calmfors and Wren-Lewis (2011) argue, a fiscal council can play a useful role in suggesting when rules should be ignored as well as when they should be met. (The Swedish Fiscal Council argued for additional fiscal expansion after the recent recession on these grounds.) However, the OBR, because it cannot examine alternative policies, cannot fulfil this role.

Independence

Some commentators have argued that the OBR's interaction with ministers, Treasury officials and officials from other government departments in the budget policy and forecasting process makes it impossible for it to be truly independent (see, for example, Calmfors 2010). Although these interactions allow the OBR to potentially add value to the work already being done by other institutions (like the IFS or National Institute), if this additional information is not objective it may have dubious worth.

Independence of a fiscal council could be compromised if it was being fed false information that suited the government's agenda. In terms of the forecast, it could be fooled or persuaded to take an overly optimistic view of tax receipts, for example. The OBR is well aware of these dangers. It is transparent about the dates of meetings it has with government ministers and officials. When decisions are taken too late for it to properly analyse, it has said so publically. However, such transparency cannot in itself dispel suspicion that it is being manipulated by government.

In practice two factors may mitigate this problem. The first, discussed in Chote (2011), is that it is a mistake to see government as a single entity. Detailed discussions over tax forecasts, for example, may allow individual civil servants to express their own objective views to the OBR, bypassing any attempt to spin the facts to suit a government position. Second, as long as the OBR is staffed by economists with some experience of fiscal forecasting, then they should be able to spot crude attempts at manipulation. There is a difficult line to be drawn here, as economists who are too familiar with forecasting within government may also be subject to regulatory capture.

A more serious risk to independence may come from threats to the fiscal council's budget, employment of its directors or its very existence. Calmfors and Wren-Lewis (2011) describe how the Canadian Parliamentary Budget Office (PBO) had its budget reduced in 2009–10 after it released controversial reports on the costs of Canada's engagement in Afghanistan and the economic and fiscal outlook. After just two years in existence the Hungarian Fiscal Council was stripped of its secretariat and transformed into a toothless body after criticising the government's budget for overoptimistic assumptions and lack of transparency.

The OBR's budget is part of the Treasury's (albeit separately identified within it) and so the OBR could be subjected to a financial squeeze. The main protection here is transparency. The OBR has been given a multi-year budget which is made public, so any squeeze would thus be plain for all to see. The Canadian and Hungarian episodes demonstrate that making a fiscal watchdog formally responsible to parliament rather than to the government does not necessarily protect it from political pressure via its budget. Most other fiscal watchdogs report to governments rather than parliaments. The OBR is something of a halfway house. It is a non-departmental public body under the aegis of the Treasury, but is accountable to parliament via hearings before the Treasury Select Committee (TSC) of Parliament, and the TSC also has a veto over appointments to and dismissals from the Budget Responsibility Committee.

In the UK context this role for the TSC is important. Although the chair and the majority of TSC members are from the governing parties, in the past select committees (including the TSC) have not been afraid to openly challenge government. The appointment of members of the Budget Responsibility Committee has to go through a confirmation hearing with the TSC, and any appointment that was only approved through voting on party lines would severely (perhaps fatally) compromise the public's perception of OBR independence. Additional independence safeguards can be provided by the two non-executive directors of the OBR.

There may be an interesting link between policy analysis and independence. In the longer term, being able to conduct policy analysis may help establish a reputation for independence. Even if a fiscal council does not advocate particular positions, its analysis will on some occasions be used as a means to contest government policy. However, in the short term exactly this fact may tempt governments to threaten the budgets of fiscal councils. Perhaps in the case of the UK the restrictions on policy analysis may give the OBR time to build up its reputation, but once this has been done and the long term position of the council is more secure, these restrictions on policy analysis can be lifted, as Chote (2011) suggests.

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