

Fiscal Responsibility in the UK

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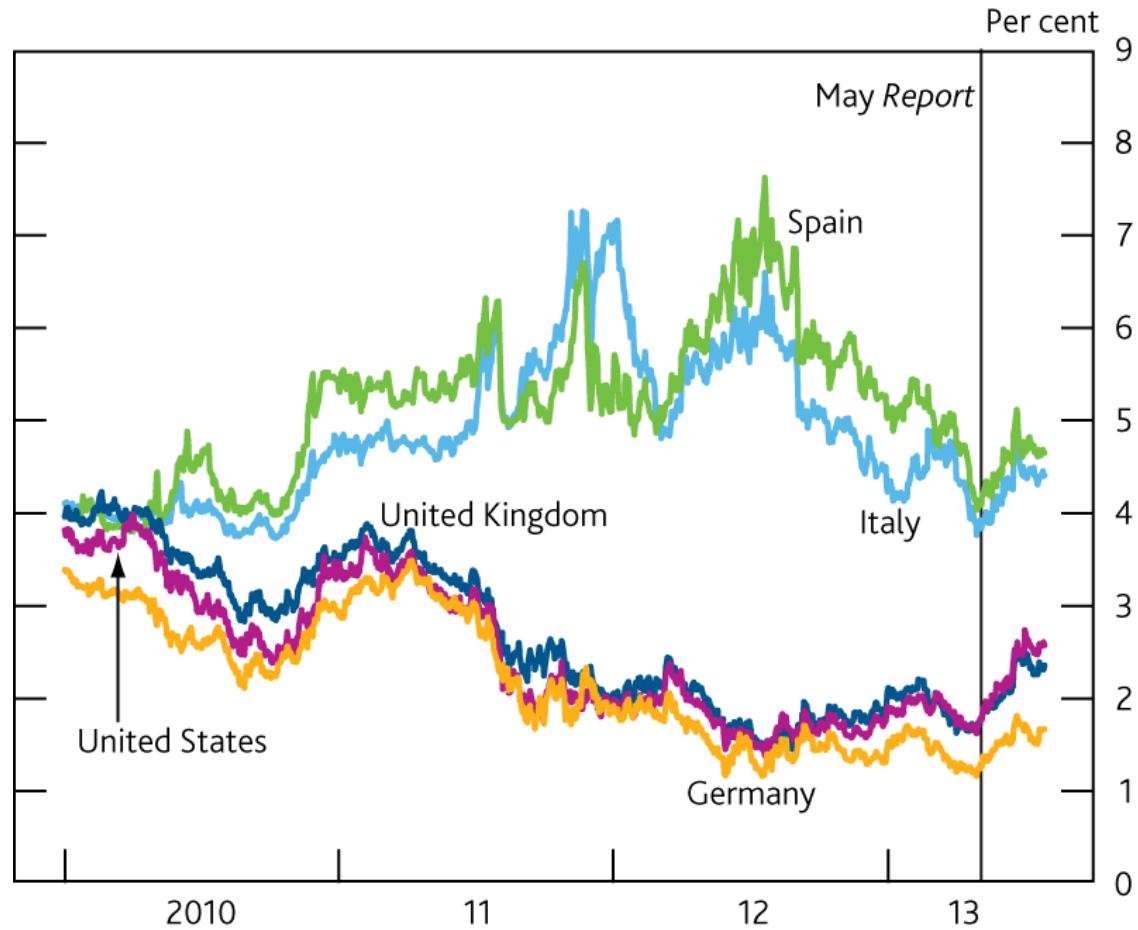
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Credibility

- If the credibility of a government's fiscal plans is weak, interest rates on newly issued debt will tend to rise. This, of itself, will tend to weaken economic prospects.
- The recent history of bond yields in different European countries makes the point clearly.

Selected ten-year government bond yields^(a)



Source: Bloomberg.

(a) Yields to maturity on ten-year benchmark government bonds.

An Attempt to overcome this problem in the UK

- The role of the UK Office for Budget Responsibility.
- Why was it invented and how does it work?

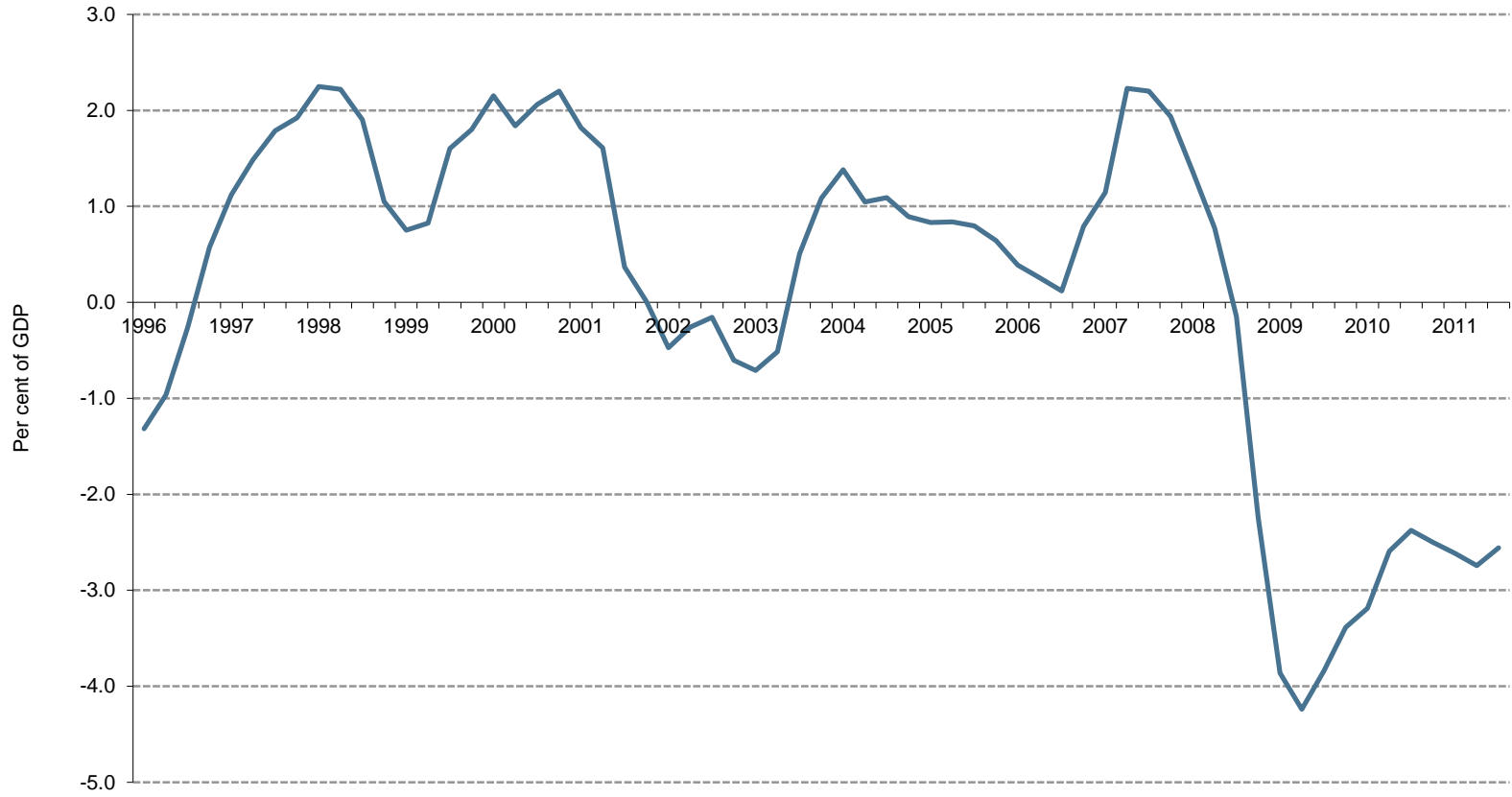
Some relevant history

- The old regime in the UK (1998-2008). Two fiscal rules:
 - (a) Over the economic cycle, the Government will borrow only to invest and not to fund current spending.
 - (b) Public sector net debt as a proportion of GDP will be held over the economic cycle at a stable and prudent level (in practice, 40% is the maximum).
- There was no independent entity to determine whether these rules were being followed. The Treasury was in charge.

What happened?

- During the period 1997 to 2007, the estimates of both the starting point and the finishing point of the cycle were changed several times.
- Assuming the cycle started in 1996 and finished in 2006, the fiscal rules were met. This was achieved by having surpluses in the period 1997 to 2001 offset by deficits in 2001 to 2006.

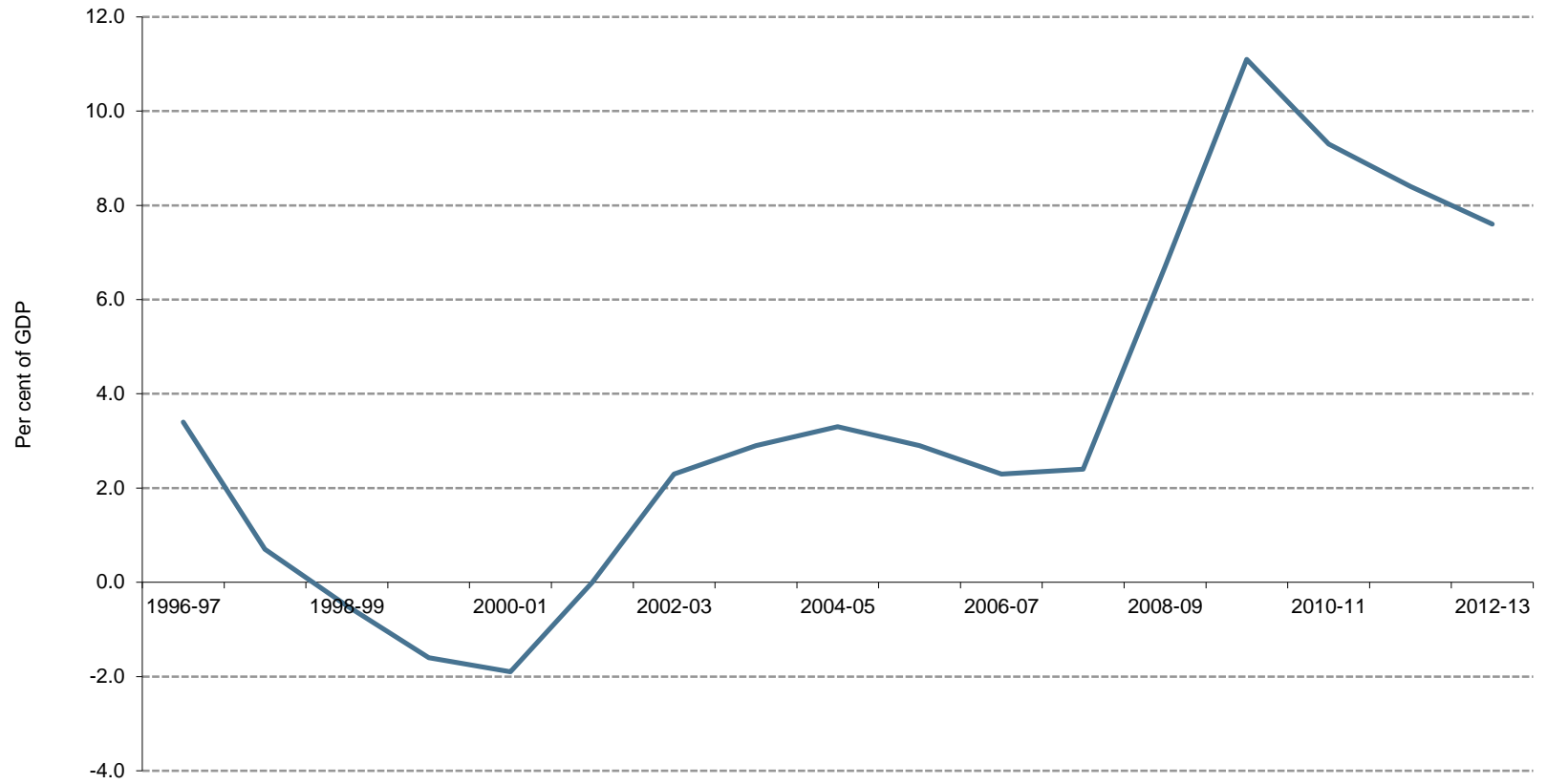
Output Gap



Source: ONS, OBR

— Output Gap

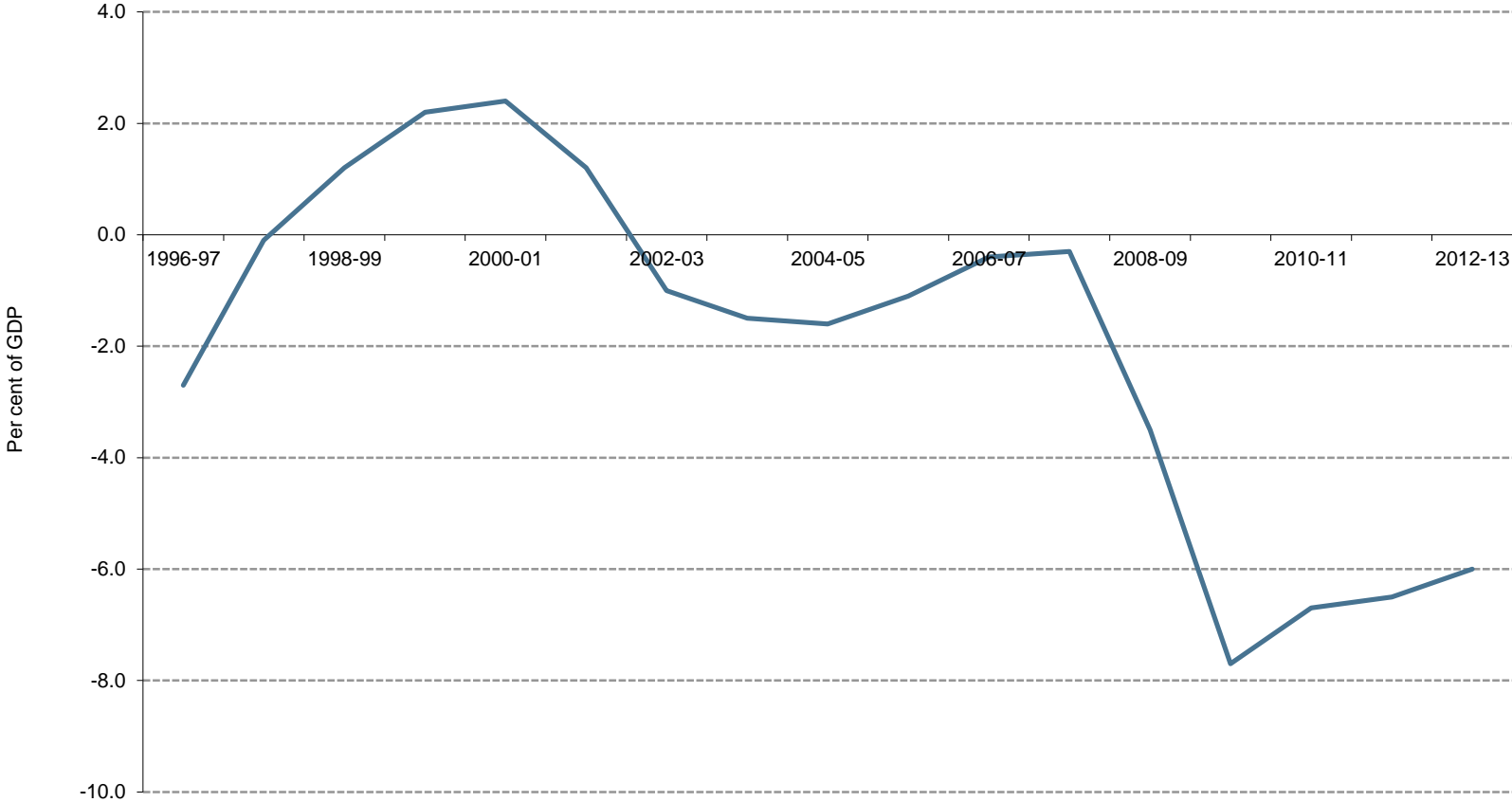
Public Sector Net Borrowing



Source: ONS, OBR

Public Sector Net Borrowing

Current Budget



Source: ONS, OBR

— Current Budget

Problems prior to the crisis

- From 2000 to 2007/8, growth was close to its long run trend (the Great Moderation). From 2000 to 2006, HMT economic forecasts were reasonably good. However, projected tax receipts in every Budget from 2001 to 2006 significantly over-predicted outcomes. Average over-prediction was 0.9% of GDP for 1 year projections and 1.5% of GDP for 2 year projections. So, over this period, deficits were systematically under-predicted.
- From 2003-4 to 2007-8, Public Sector Net Borrowing (PSNB) averaged 2.8% of GDP. Growth was very close to trend. Despite the fiscal rules being met because of earlier surpluses, this was bound to cause problems in the next cycle, even were it to be “normal”. Thus, when the crisis hit, and PSNB rose, it was rising from an already high level.

Consequences

- Rules based on balancing the budget over the cycle are tricky because pinning down the cycle in real time is impossible. So need something more forward looking.
- If there are rules, there has to be an independent body to determine if they are met. If the rules are forward looking, then there must be independent forecasts.
- What emerged was grounded in this history.

The UK Office for Budget Responsibility

- Founded in interim form following the May 2010 election.
- Three person interim Budget Responsibility Committee (BRC) appointed, aided by a small team of mostly ex-Treasury economists.
- The existing BRC was appointed in Autumn 2010. The selection of Chote (full time Chair), Parker and Nickell (part-time) was subject to veto by the Treasury Select Committee.
- In March 2011, the Budget Responsibility and National Audit Act passed Parliament and, on April 4, the Office for Budget Responsibility (OBR) became a statutory body run by the BRC with a dedicated staff of 16 and an annual budget, set for five years, of £1.75m.

Remit and Governance I

- The Act defines the duty of the OBR as being “to examine and report on the sustainability of the public finances”.
- Annual Tasks:
 - i) To produce two five year forecasts for the economy and public finances;
 - ii) Judge progress towards the Government’s fiscal targets;¹
 - iii) Scrutinise Treasury costing of new tax/spending measures;
 - iv) Assess the long term sustainability of the public finances.

¹ The current “fiscal mandate” requires to government to set policy to achieve balance or surplus in the cyclically adjusted current budget (excluding investment spending) five years ahead.

There was a supplementary target requiring the ratio of debt to GDP to be falling in 2015-16.

Remit and Governance II

- BRC decides on methodology, judgements, work programme; has right of access to all necessary information from government departments; should not provide normative commentary on the merits of policy.
- OBR is a non-departmental public body, accountable to Parliament via the Treasury Select Committee which has a veto on the membership of the BRC.

Process I

- In November or December the Chancellor delivers the Autumn Statement and in March, the Budget. Each of these typically contains policy changes.
- Several weeks before, the OBR sends a preliminary economic and fiscal forecast to the Treasury including an assessment as to whether the fiscal mandate has at least a 50% chance of being met under current policies. The Chancellor decides on policy proposals in the light of this.
- The OBR also sends a preliminary economic forecast to various Government Departments so that they can produce estimates of tax revenues and certain expenditures conditioned on the forecast. These estimates are comprehensively challenged in a lengthy series of meetings.

Process II

- In the light of the Chancellor's policy proposals, Departmental estimates of tax revenues and the latest information, the economic and fiscal forecasts are revised by the OBR.
- The cycle is then repeated two or three times.
- A final economic and fiscal forecast is produced which incorporates all the new policies which the Chancellor announces in Parliament in the Autumn Statement or the Budget.
- The OBR publishes this forecast in the *Economic and Fiscal Outlook* which is released when the Chancellor finishes his speech. The BRC then holds a press conference.
- One week later, the BRC appears in front of the Treasury Select Committee in a public hearing.

Independence I

- This whole activity is pointless unless the OBR is independent and is believed to be independent.
- How can independence be demonstrated?
 - i) The OBR has rights and responsibilities set out by Act of Parliament. The BRC is accountable to Parliament via public hearings of the Treasury Select Committee, which has a veto over BRC appointments and dismissals.
 - ii) The OBR has a public, multi-year budget. It also has independent non-executive directors (Terry Burns, Chair and Kate Barker).

Independence II

- iii) OBR methods and processes are published. The OBR responds to all requests for information on methodology within reason.
- iv) All meetings with the Treasury and other Government Departments are logged and made public.
- v) The politics of this are crucial. For some, none of the above is enough. For sceptics, more persuasive evidence might be provided if the process described generates an economic policy shift which is politically difficult.

Independence III

- In the process leading up to the Autumn Statement of November 2011, the OBR told the Government that in the absence of additional policy measures, the Government would have had a less than 50 per cent chance of meeting its fiscal mandate.
- In the Autumn Statement, the Government put itself back on course to meet its targets by announcing new expenditure cuts in 2015-16 and 2016-17 of £8b. and £15b. respectively.
- There is some evidence that these events increased the perception of OBR independence.

Independence IV

- In the process leading up to the Autumn Statement of December 2012, the OBR told the Government that in the absence of additional policy measures, the Government would have had a less than 50 per cent chance of meeting its supplementary target (debt to GDP ratio falling in 2015-16).
- The Government chose not to act on this and it is now generally accepted that this supplementary target will not be met.
- Again this appears to have further advanced the perception of OBR independence.

Independence V

- Following the Autumn Statement of November 2011, the three members of the Budget Responsibility Committee appeared before the House of Commons Treasury Committee in a public hearing on December 6th.
- We were criticised for producing a more pessimistic forecast than we had produced at the time of the 2011 Budget in March. The questions Q132-142 and the answers in the transcript give a good flavour of the event.
- Few people understand that forecasts are random variables whose distributions may change over time as more information becomes available. Most people want certainty about the future and expect “experts” to provide it!
- Indeed some would put forward the argument, “why bother with the OBR if their forecasts are always wrong?”

International Perspective

- Like all other “fiscal councils”, the OBR is an advisory body. However, it does pronounce on whether the Government will meet its fiscal target. If it does not, then while the Government does not have to act, it has a very strong incentive to do so.
- OBR has a narrow remit and is forbidden from analysing alternative policies.
- By contrast, most Fiscal Councils provide commentary on the wisdom of fiscal and other Government economic policies.
- OBR is unusual in that the Government has contracted to it the task of producing official economic and public finance forecasts and it has direct access to Government Departments.
- Given OBR transparency, others can use the information we provide to analyse alternative policies. The UK has a number of organisations with high levels of public credibility which are well equipped to do this (eg. IFS, NIESR).

Conclusions

- The history of fiscal rules in the decade prior to 2009 illustrates the problems associated with “balancing the budget over the cycle”.
- It is helpful to have an independent body to assess whether the fiscal rules are being followed.
- It is helpful to have an independent body producing the official public finance forecasts.
- Having an official independent body to analyse economic policies in areas such as labour markets, pensions, education, climate change etc. might be helpful. In the UK, we are lucky to have credible privately funded bodies who perform this task (eg. IFS, NIESR).