FORECASTING INDEPENDENCE

Taking the politics out of fiscal projections

Ian Mulheirn and James Lloyd

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EXECUTIVE SUMMARY

The UK public finances are in their worst condition since the Second World War and the country confronts a painful decade of public spending cuts and tax rises. Unsurprisingly, these events have thrown a spotlight on to arrangements for UK fiscal policymaking and the framework that governs the way in which decisions around taxation and public spending are made.

Arrangements for fiscal policymaking ultimately come down to a set of choices around: who should take fiscal decisions and how? Who should carry out the projections of revenue and spending on which those decisions are based? These choices are subject to competing objectives, such as the extent to which fiscal policymaking should be political and accountable versus independent and technocratic; and the extent to which decision-makers should be free to act with discretion, or should be constrained by pre-ordained rules or principles.

In the UK, fiscal policymaking has traditionally been highly centralised and discretionary, with all fiscal projections and decisions emanating from HM Treasury. The self-imposed fiscal rules of the 1997 Labour government represented an important experiment in the evolution of fiscal policy institutions. The rules sought to articulate formal standards by which fiscal policymaking could be judged thereby increasing political accountability, even if the rules themselves amounted to nothing more than statements of intent. However, the current fiscal crisis confronting the UK shows that even if the government's fiscal framework was an improvement on what went before, it clearly wasn't good enough.

The Government is right to argue that the global financial crisis of 2007-9 was an unforeseen external shock that caused the public finances to deteriorate. But it is also clear that excessively loose fiscal policy in the years preceding the crash has left the UK in a more difficult fiscal position than it might have been, and threatened the creditworthiness of the government. Labour's experiment with a framework of fiscal rules failed to prevent this situation from developing. In retrospect it is clear that excessively optimistic projections of economic growth and taxation revenue were used as the basis for fiscal policy for much of the last decade.

The experiences of the past decade, both in fiscal policy and other areas of government, have demonstrated the power of institutional arrangements to improve public policymaking. This has been achieved by separating different functions according to the need for analytical independence, political accountability. Good examples of this include the granting of operational independence to the Bank of England, the establishment of an independent UK

Statistics Authority and the setting up of an independent Low Pay Commission to advise on the level of the minimum wage. By learning the lessons from these experiences, the UK has the tools to improve fiscal policymaking for the future.

Many alternative arrangements for fiscal policymaking can be conceived, for example, the imposition of formal spending rules, or the transfer of responsibility for fiscal decisions from the Chancellor to an elected committee of MPs. The Conservative Party has said that, if elected, they will create a statutory Office for Budget Responsibility. This body would be charged with providing independent scrutiny of fiscal projections from HM Treasury, assessing the medium and long-term sustainability of the public finances, and producing formal estimates of how much fiscal loosening or tightening would be required for the government to meet its target for public borrowing.

Although an Office of Budget Responsibility would improve the oversight of ministerial decisions, the political risks to the government of the day embodied by such an institution mean that it is difficult to see how such a body could survive as a viable or independent entity. In addition, at different points in the economic cycle, there is a clear danger that HM Treasury would be able to claim the necessary legitimacy to 'move the goalposts' of fiscal policy by redrawing projections of the economic cycle, and aggregate public spending and taxation, claiming that an Office of Budget Responsibility lacked political legitimacy. Finally, and most importantly, government would be able to dismiss such a body's fiscal projections and conclusions, just as previous governments have dismissed the fiscal commentary of respected and independent economic forecasters.

Instead, this paper argues that the most appropriate reform to the institutions of fiscal policymaking would be the creation of an independent Office for Fiscal Analysis (OFA), separated from fiscal decision-makers in government, that would undertake all official fiscal projections. The OFA's independence, which would reflect the independence of the UK Statistics Authority, would ensure that it was entirely free from the risk or perception of organisational bias. Its modelling assumptions and inputs would, as far as possible, be open to public scrutiny and its outputs would be freely available to external bodies, in particular, the opposition parties. These reforms would increase the accountability of government both from the perspective of the markets and the electorate, thus lowering the cost of borrowing and ensuring the pursuit of sustainable fiscal policy in the medium-term.

PART 1: INTRODUCTION

When Labour was elected in 1997, it promised a prudent and responsible approach to public spending and fiscal policy. This was demonstrated, first, by a commitment to keep within the spending plans of the previous government for the first two years, and second, by the development of a clear 'fiscal framework' that would guide fiscal policymaking. No longer content to leave the enforcement of fiscal discipline to the market for government bonds, the government sought to ground fiscal policy by putting in place clear rules against which its management of the public finances could be judged by voters. These fiscal rules were:

- *Sustainable Investment Rule*
  - Maintain debt below 40% of national income in every year.
- *'Golden Rule'*
  - Borrow only to invest over the economic cycle, and not to fund current spending.

This 'fiscal framework' saw the Government retain complete control over fiscal policymaking, but for the first time provided a clear statement of objectives for fiscal policy by the government, against which it could be judged over the course of the economic cycle.

After the 2008 Budget many commentators judged that the government was close to breaking the golden rule of borrowing only to invest over the cycle. Meanwhile, revisions by HM Treasury of the official dates of the previous cycle had stretched the credibility of the rules to breaking point. Nevertheless, the political pain this caused the government was the clearest demonstration that the accountability mechanisms it had put in place were doing their job as well as could be expected.

Six months later, the global financial meltdown and collapsing asset prices, which threw economic growth into reverse, took their toll on tax revenues in a way that nobody, least of all the Government, had anticipated. The 2009 Budget was a watershed moment. With the Chancellor of the Exchequer projecting the highest level of public borrowing since the Second World War, it became clear that the rules had not prevented the development of the largest peacetime hole in the public finances in the UK's history.

The dire state of public finances inevitably raises questions, both about the fiscal policy choices made by the Government and the entire way in which fiscal policy is made. While even the Government's staunchest opponents might struggle to blame them for the global financial crisis, a more sustainable charge is that better management of the public finances in the good times might have made the UK less vulnerable to the ensuing crisis. Beyond questions of how to promote better financial stability, therefore, the lesson of the events of 2008-9 is that what is needed is a stronger fiscal policymaking process to bind politicians into more prudent public spending decisions in future.

Or is it? Could it be that Labour's 'fiscal framework' went as far as possible in constraining a democratically-elected government in its fiscal policy decision-making? Would stronger independent institutions set up to guide tax and spending decisions, and so limit the temptation for politicians to spend too much public money, carry sufficient democratic legitimacy to be effective or tenable?

Over the next few years, some new approach to guide fiscal policymaking is likely to emerge from the wreckage of the old approach. What could it look like and what are the pros and cons of different approaches?

This paper, which is aimed at both a general and specialist readership, seeks to contribute to this debate. The paper sets out the core 'building blocks' of fiscal policymaking and explores the different ways in which they can be arranged to tackle some of the perceived shortcomings of the current system. Having set out in abstract the different choices involved in designing fiscal policymaking, the paper then examines the experience of the UK and sets out some possible options for reform.

In Part 2, the core building blocks of fiscal policymaking are described. Part 3 considers the institutional framework within which fiscal policy choices are made, for example: who takes decisions and how much freedom should they be allowed?

In Part 4, the paper analyses fiscal policymaking in the UK, looking at the current institutional set-up and measuring it against the options outlined in the previous section.

Part 5 draws on the analysis of the earlier sections to identify possible alternative institutional arrangements for fiscal policymaking in the UK, which may address some concerns about the effectiveness of current arrangements that have emerged from the 2009 fiscal crisis. These alternatives are briefly evaluated and, in Part 6, recommendations for reform are proposed.

PART 2: THE BUILDING BLOCKS OF FISCAL POLICYMAKING

Whatever fiscal policy a government pursues, there are several core functions to fiscal policymaking. Most obviously governments have two decisions to make:

1) a taxation decision, i.e. a choice about how much aggregate revenue to raise through taxation; and
2) a public-spending decision, i.e. a choice about how much the state will spend in aggregate.

Achieving budgetary balance - for taxation and spending to equal one another – is no trivial task. Both revenue from taxation and public spending rise and fall at different stages of the economic cycle. This reflects the varying tax 'base' associated with different levels of economic growth, and the fact that some public spending automatically changes in line with the economic cycle, such as expenditure on unemployment related benefits.

This variation in the tax base over the cycle therefore introduces a high level of uncertainty into the management of the public finances. This makes the accuracy of *projections* of revenue and spending of critical importance in fiscal policy making, and these do in fact comprise two further 'building blocks' of fiscal policymaking:

3) Revenue projection, i.e. projecting how much revenue will be raised in aggregate through taxation, via different taxes, both now and in the future.
4) Public-spending projection, i.e. projecting how much the state will spend in aggregate, both now and in the future, whether on discretionary or ongoing policies, or costs that will vary with the economic cycle, such as unemployment benefit.

The four building blocks of fiscal policymaking are therefore:

Taxation decision	Public-spending decision
Revenue projection	Public spending projection

When governments spend more than is raised through taxation, the result is public sector borrowing. The Government borrows from capital markets by issuing bonds – called 'gilts' – which are effectively loans from private investors and institutions. The perceived riskiness of government bonds – how likely investors think it is that a government will not be able to pay its debts – is reflected in the cost of borrowing for governments: the interest rate or 'coupon' they must pay on bonds. As the level of government debt increases, investors may perceive that their chances of being repaid are falling and hence that government bonds are more risky, making borrowing more expensive for the government and limiting its incentive to borrow more. Traditionally, it has been the bond market that has forced governments to limit their largesse with public spending and run a sustainable fiscal policy.

Like companies or individuals, a government can remain in debt in any given financial year even when it spends less than it raises in taxation. Why would a government choose to be in debt? While achieving a balanced budget is not easy, it is arguably not always desirable either. This might be because government wishes to boost spending to offset a fall in aggregate demand in the private sector (as in the current recession), or because it wants to pay down the national debt while the economy is in good health and tax revenues are strong. Consequently, a *sustainable* fiscal policy is often thought to be represented by a strategy that seeks to balance taxation and spending over the course of a complete economic cycle.

Arguably, market discipline is insufficient to enforce prudent fiscal management in the short-term. A government may choose to run a budget deficit for political considerations, for example, to reap the short-term benefits of an unsustainable fiscal policy at the ballot box. Governments may make excessively optimistic projections of revenue and spending to justify pre-election promises to voters. This raises the question of whether institutions – in addition to the market - are required to enforce fiscal discipline. In effect the fiscal framework set out by the Government in 1998 was an attempt to augment 'market discipline' by establishing very public metrics by which the Government's fiscal policy could be measured. Running an unsustainable fiscal policy would no longer just carry a higher price in terms of interest payments: it would also carry a political cost for the governing party.

Despite these innovations, the current dire state of the UK's public finances inevitably raises questions about the way in which fiscal policy is made. Might better management of the public finances in the good times have left the UK less vulnerable to the ensuing crisis? Would stronger institutions to govern fiscal policy have ensured greater fiscal sustainability? And is a different, more stringent approach to fiscal policymaking now needed to bind politicians into more prudent public spending decisions in future?

While the previous fiscal framework focused on promoting transparency to allow the electorate to scrutinise policy, it left the different building blocks of fiscal policymaking outlined above entirely at the discretion of the Government. A stronger institutional structure could involve a reorganisation of the building blocks of fiscal policymaking, potentially involving different agents, whether elected politicians, civil servants or independent statutory bodies. In fact, many different configurations of the elements of fiscal policymaking are possible.

Indeed, it is important to recognise that the way in which fiscal policymaking occurs in the UK effectively represents a choice to maintain an institutional legacy inherited by today's policymakers, rather than a necessarily constant or fixed arrangement. The rest of this paper considers the pros and cons of having fiscal policy determined by different actors and then considers the role that separation of the functions of policymaking can play in producing the optimal institutional structure to govern the fiscal position.

PART 3: THE PARAMETERS OF FISCAL POLICYMAKING

As described above, it can be argued that a different configuration of the building blocks of fiscal policymaking in the UK would have prevented the fiscal crisis exposed by the 2009 Budget. How else could fiscal policymaking be undertaken? How should these core functions be organised and carried out?

The parameters of fiscal policymaking ultimately boil down to a set of key questions around: who should take fiscal decisions and how? Who should carry out the projections of revenue and spending on which those decisions are based? To answer these questions, it is necessary to consider the extent to which fiscal policymaking should be political versus independent and technocratic. It is also important to consider the extent to which decision-makers should be free to act or constrained by rules in order to reduce the scope for poor decisions being made.

Who should take fiscal decisions? Legitimacy versus political independence

In the UK, it is generally assumed and expected that elected politicians, armed with a democratic mandate, must take fiscal decisions regarding both aggregate taxation and aggregate public spending. However, in theory, it is not just elected *ministers* that could be charged with taking fiscal decisions. Conceivably, other individuals with a democratic mandate could have this responsibility. In Parliament, committees within the House of Commons or House of Lords could be directly elected by Parliamentary colleagues or by the public to take fiscal decisions. Alternatively, external to Parliament, individuals could be elected to decision-making roles in fiscal policy, for example, by a group of academic peers.

Conversely, *appointed* individuals could also take decisions on fiscal policy. Such appointments could be made on the basis of merit and expertise, just as the UK government has ceded control of monetary policy to a committee of appointed officials comprising the Bank of England's Monetary Policy Committee (MPC).[1] A key parameter of fiscal policymaking is therefore whether fiscal decision-makers are elected or appointed to this responsibility.

Elected ⟷ Appointed

[1] Typically, if appointed individuals are to take decisions, it is generally seen as a preferable for committees of appointees rather than single individuals to exercise this power.

The question of whether fiscal decision-makers are elected or appointed reflects a set of judgements and choices around the basis of legitimacy for those deciding fiscal policy, their accountability, and their incentives.

Elected fiscal decision-makers, such as the Chancellor or Prime Minister, have a high degree of accountability to their electors, and a strong basis for their legitimacy to make decisions. The public finances are unlike those of a household: for example, it is sometimes optimal to run a budget deficit for years at a time to stabilise the macro-economy. Consequently, a level of judgement is involved on the part of those who make fiscal policy for which democratic accountability is arguably essential.

The corresponding disadvantage of elected politicians making fiscal decisions arises from the incentives for elected officials to use public spending for short-term electoral gain at the expense of medium-term fiscal sustainability. This issue reflects the disconnection between the political cycle – elections typically occur every four to five years – and the economic cycle, which may last 5-15 years.

Appointed fiscal policymakers, by contrast, freed from the need to run for election and win favour with electors, can be assumed to act in the long-term interests of the country. They can be directed to take decisions according to predetermined criteria (as discussed in more detail below), similar to the inflation-targeting framework that provides the terms and reference for the Bank of England's Monetary Policy Committee. For example, an independent council taking fiscal decisions could be responsible for ensuring public debt does not exceed 30% of national income. In addition, individuals appointed to set fiscal policy according to a set of rules or principles may find it easier to make unpopular fiscal decisions, such as to raise taxes or cut public spending, given they are removed from any expression of public anger at the ballot box.

However, such freedom from political incentives is also associated with a clear deficit in accountability. In running the fiscal deficits that are often deemed necessary, policymakers are essentially taking risks with taxpayers' money: it is therefore difficult to envisage a democratically unaccountable body being able to withstand public disquiet at the chosen level of taxation or budget deficit. Further, it may be impossible to achieve consensus in relation to something as politically sensitive as levels of taxation and spending, making it difficult for any appointed body to function. Practically, these objections to independent control of fiscal decision-making are borne out across the world: the taxation and spending elements of fiscal policy (at least) are regarded as key responsibilities to be discharged by accountable, elected politicians, and are a core characteristic of democratic political systems.

How are fiscal decisions taken?

A further key parameter in fiscal policymaking is how much discretion decision-makers have in setting fiscal policy. At one extreme, decision-makers might have total discretion and autonomy. Alternatively, they may have discretion to apply or meet certain *principles* for fiscal policy. At the other extreme, policy-makers may have very little discretion, with their autonomy constrained to following certain pre-ordained *rules* that must govern fiscal policy.

High discretion ⟷ Low discretion

Discretion *Principles* *Rules*

Rules-based fiscal decision-making may be relatively clear, predictable and transparent. For example, a fiscal rule might state that public spending cannot exceed tax revenue by more than a fixed proportion. However, the use of strict rules in fiscal policymaking creates complex challenges, which are a barrier to their application: Who defines the rules and with what legitimacy? Who evaluates if rules have been breached? What happens if rules are breached? Indeed, a secondary tier of oversight may be required to ensure that rules are enforced. Nevertheless, fiscal rules have been adopted in many jurisdictions: for example, the majority of state governments in the US and provincial governments in Canada are subject to balanced budget requirements or limits on debt, and the German Federal Government voted in 2009 to legally restrict the ability of the federal government to run deficits of more than 0.35% of GDP from 2016. However, rules-based fiscal decision-making does have drawbacks.

Fiscal rules may tie governments into policies that exacerbate the economic cycle, by cutting spending and raising taxes during a recession. Although more complex rules may be able to address such situations, complexity can create disagreement on interpretation and application, ultimately undermining the benefits of rules-based decision-making. Academic research has also noted that in many instances, politicians devise mechanisms to circumvent fiscal rules through the use of novel debt instruments, particularly when such rules are applied to devolved levels of government.[2] There is also a danger that rules can be ignored when they are deemed to carry insufficient democratic legitimacy. The EU's experience of the Stability and Growth Pact, adopted in 1997, but subsequently ignored by a number of EU states

[2] Von Hagen J (2002) "Fiscal Rules, Fiscal Institutions, and Fiscal Performance" in *The Economic and Social Review*, Vol. 33, No. 3, p263-284

participating in monetary union is a case in point, perhaps demonstrating the limits of strict rules, or at least the need for a body with the power to police them.

Principles-based decision-making affords fiscal decision-makers a higher degree of flexibility and discretion in setting policy, while also enabling open and predictable decision-making. As others have noted,[3] the use of principles and guidelines in fiscal policy may also help the electorate to evaluate a government's performance of fiscal management, requiring governments to make clear and persuasive arguments to justify any deviation from the guidelines, for example in the case of external economic shocks, thus increasing the level of democratic oversight.

Governments sometimes seek to formulate and articulate a '*fiscal framework*' in relation to fiscal policymaking. A fiscal framework is effectively a government's statement of its objectives for fiscal policy, and how it intends to achieve them over the course of the economic cycle. A fiscal framework could comprise rules or principles, or a mixture of both. The UK's recent fiscal framework, described in Part 4, is a medium-term strategy to ensure the sustainability of the public finances. This fiscal framework helps to hold the government accountable, and convince investors in government bonds (gilts) that public finances will ultimately remain sustainable, such that there will be no risk of the government defaulting on the bonds owned by investors.

However, a principles-based approach raises several questions: Who defines the principles and what is the basis of their legitimacy? Who evaluates if principles have been applied? What happens if it is judged that principles have not been applied? Again, a second tier of oversight may be required to ensure that principles are adhered to, whether in the form of 'scrutiny at the ballot box', or through an institutional process. Nevertheless, in some countries, such secondary-tier oversight exists, for example, Belgium's High Council of Finance.

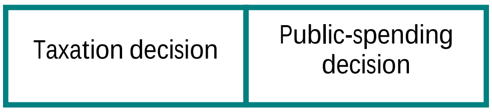
Discretion-based fiscal decision-making sees elected or appointed individuals have total, or near-total, discretion to decide fiscal policy. A high degree of discretion affords fiscal decision-makers a high-level of flexibility, enabling them to respond to events and changing objectives in a manner that even highly complex and contrived rules or principles would not be able to accommodate. In such a framework, the actions of market investors in government bonds provide the most powerful external constraint on fiscal policy-making. Nevertheless, high levels of discretion in fiscal decision-making by elected politicians may, as described above, result in imprudent decisions taken for political gain. Conversely, high-levels of discretion afforded to appointed, non-elected fiscal decision-makers would see substantial power transferred to individuals who lack any kind of democratic mandate of their own.

[3] Emmerson C et al. (2004) *Updating the UK's Code for Fiscal Stability*, Institute for Fiscal Studies

Ultimately there are strong parallels in the choices about fiscal policymaking between discretion/rules and elected/appointed decision-makers. In the deployment of rigorous fiscal rules or appointed technocrats, both reduce the vulnerability of fiscal policy to politicisation; but both forms also reduce the level of fiscal policy accountability to the taxpayer. Both extremes are therefore perceived to be problematic. For this reason, some commentators have explored a possible mixture of institutions and political control that can limit politicisation without making decisions unaccountable to the electorate. This institutional approach involves separating the different 'building blocks' of fiscal policymaking that the UK current centralises in HM Treasury. Indeed, as explored below, it is theoretically possible to separate these different components of the process and house them in different institutions in order to ensure sound decision-making.

Separating taxation and public-spending decisions

As described above, fiscal policy involves two core decisions about how much a government will tax in aggregate, and how much it will spend. A key parameter of fiscal policymaking is whether these decisions are taken separately or together. In the UK, it is generally assumed that the Chancellor of the Exchequer must take decisions about both aggregate taxation and public spending.



However, these functions within fiscal policymaking can be separated, and one or both could be undertaken by other bodies, whether a committee of the House of Commons, or an independent statutory body.

What would be the benefits of separation? The separation of fiscal decision-making may be one strategy to ensure fiscal policymaking is prudential and not steered by political incentives. For example:

- The Chancellor of the Exchequer could decide on aggregate taxation levels, with an independent statutory body, such as an 'Independent Fiscal Authority', or a committee within the House of Commons or House of Lords subsequently deciding overall aggregate public spending that would be allowed. Such an arrangement might prove particularly useful during an extended period requiring public spending cuts, given an independent authority or Parliamentary committee can take, or provide political cover for, difficult public spending decisions that could arouse significant public opposition.[4]
- Conversely, elected politicians could decide on levels of aggregate public-spending, with an independent statutory body, such as the Bank of England, then deciding overall aggregate levels of taxation to be imposed, given pre-defined criteria for levels of public debt. However, given the highly politicised nature of taxation, such an arrangement would be unlikely to withstand public hostility.

Separating the two elements of decision-making would therefore have the effect of limiting the scope for politicisation of fiscal policy. However, by leaving it with control of only one side of the equation, the power of democratically-mandated governments would be severely constrained.

Separating the fiscal projection and decision-making functions

Projections of revenue and expenditure are crucially important to steering the public finances. In addition to separating the decision-making elements of fiscal policymaking, a further approach would be to separate projections of revenue and expenditure from fiscal decision-making. For example: should the projections of revenue and spending be undertaken together or separately? And should those projections be undertaken within or outside the institutions hosting fiscal decision-making? Put another way: how independent are fiscal projections? For many years, the UK has centralised all of the building blocks of fiscal policymaking within HM Treasury. However, such a centralised arrangement represents a choice by the UK, not a necessity, and official projections do not have to be undertaken within HM Treasury. In contrast, Belgium, Austria and the Netherlands are all countries that have used independent national bodies to undertake projections to aid fiscal policymaking.[5] However, such bodies typically do not undertake official projections, but rather provide oversight and scrutiny of the projections used by the government through the production of accompanying fiscal analysis.

[4] An independent fiscal authority may also help to improve the quality of political debate during such a period of fiscal austerity by limiting the credibility of an Opposition party that refused, for political gain, to acknowledge the necessity of public spending cut.
[5] Hallerberg M et al. (2001) "The Use and Effectiveness of Budgetary Rules and Norms in EU Member States" report prepared for the Dutch Ministry of Finance.

Such a choice matters because of the importance of perceptions and credibility in determining the efficacy of fiscal policymaking. Even if governments resist the temptation to plan deficit spending in the run-up to election time, it may be that their projections of revenue and expenditure become excessively sanguine, apparently justifying higher public spending than is in fact sustainable.

At a general level, perceptions matter because many public and private agents rely on fiscal projections in their own forward planning and financial projections. More narrowly, if fiscal projections are perceived to be unreliable, this will damage the credibility of fiscal policy, and may raise the price of government borrowing on the bond markets.

The projections of revenue and spending used by fiscal decision-makers must therefore possess:

- The best technical capacity underpinning them.
- Sufficient resources in terms of time and money.
- The perception of credibility.
- Independence from political influence.

What, in these terms, are the advantages of housing the projection functions in the same institution as the decision-making functions, as is currently the case at HM Treasury?

- *Better decision-making* may result from putting fiscal decision-making within the same institution as fiscal projection-making if that leads to better-informed decision-making.
- Fiscal policymakers, whether elected or appointed, can be held *accountable* and responsible for the quality of projections used, i.e. political incentives aside, such decision-makers have an interest in ensuring the best possible projections are available for decision-making, even if such projections are not in fact made publicly available.

Conversely, there are disadvantages associated with placing the fiscal decision-making and projection functions within the same institution:

- *Organisational bias* in projection-making: promotion, reward and status may be linked to 'toeing-the-line' – most likely implicitly - potentially excluding valuable contrarian opinions from influencing fiscal projections. This effect may be particularly strong if fiscal decision-makers have significant powers over the institution. Indeed, academic research has shown that in several European countries, official growth forecasts used for fiscal policymaking are biased toward being over-optimistic.[6]

- Policymakers risk being subject to *group-think* where all elements of fiscal policymaking are housed in the same institution with no institution charged with an official 'challenge role'. For example, the problem of a shared belief in what is actually unsustainable growth may be self-reinforcing and amplified if all the functions of a fiscal policymaking are combined in the same institution.
- When combined with the credibility associated with longstanding institutions, such as that of HM Treasury, this can also lead to another behavioural economic phenomenon known as *anchoring*, whereby other, non-governmental organisations take the cue for their economic forecasts from HM Treasury. This is particularly likely to occur since no institution wishes to stand out against received wisdom: for any independent forecaster it is far less reputationally damaging to be wrong with everyone else than be wrong on their own.

More generally, the perception of credibility and independence attached to fiscal projections are likely to be higher if they are institutionally separate from decision-making functions within fiscal policymaking. In addition, if official fiscal projections are undertaken by an independent body, projections could be carried out for Opposition political parties on the basis of alternative taxation and spending proposals, reducing the volume of political debate that results from contested fiscal taxation and spending projections, which are ultimately meaningless for many members of the public. Crucially, the separation of decision-making and projection-making raises the possibility of safeguarding part of the system from politicisation, while maintaining the political accountability of the fiscal policy decisions and increasing the transparency of the process.

A key parameter for how fiscal policymaking is undertaken is therefore whether fiscal projections are undertaken separately from fiscal decision-making.

Unified decision-making and projection functions ⟷ Separation of decision-making and projection functions

[6] Jonung L & Larch M (2006) "Improving Fiscal Policy in the EU: The Case for Independent Forecasts" in *Economic Policy*, Vol. 21, No. 47, p491-534

PART 4: FISCAL POLICYMAKING IN THE UK

Arrangements for fiscal policymaking in the UK in operation under the Labour governments since 1997 can be described as follows:

- Both taxation and spending decision-making were undertaken by elected politicians.
- As fiscal decision-makers, elected politicians exercised a high level of discretion in choosing aggregate levels of taxation and spending, albeit with a medium-term fiscal sustainability framework adjudicated by HM Treasury.
- Spending and taxation decision-making were unified at HM Treasury, i.e. the same elected politicians undertook both.
- The fiscal projection functions were centralised in the same institution as the fiscal decision-making functions, again at HM Treasury.

The approach taken by the Labour government was novel for its deployment of a 'fiscal framework' that involved clearly stated 'fiscal rules', which were nevertheless relatively weak since they were complicated to assess and adjudicated by the same organisation making fiscal policy; HM Treasury. These fiscal rules were:

- *Sustainable Investment Rule*
    - Maintain debt below 40% of national income in every year.
- *'Golden Rule'*
    - Borrow only to invest over the economic cycle, and not to fund current spending.

The rules were supplemented by the Government in 1998 with the publication of *The Code for Fiscal Stability*.[7] The Code, which can only be amended by an act of Parliament, articulated the principles by which fiscal policy was to be implemented.[8] *The Code* sets out commitments to follow the fiscal rules, but no provision was made to constrain policymakers to follow the rules, and it could be argued that the formal oversight mechanism lacked teeth.[9]

[7] HM Government (2008) *The Code for Fiscal Stability*

[8] The principles are:

- *transparency* in the setting of fiscal policy objectives, the implementation of fiscal policy and in the publication of the public accounts;
- *stability* in the fiscal policy-making process and in the way fiscal policy impacts on the economy;
- *responsibility* in the management of the public finances;
- *fairness*, including between generations; and
- *efficiency* in the design and implementation of fiscal policy and in managing both sides of the public sector balance sheet.

[9] *The Code for Fiscal Stability* only provides for two mechanisms of external evaluation:

As described above, the use of principles such as the Government's fiscal framework to guide fiscal policymaking has the advantage of making decisions more transparent than in the absence of any framework by which to measure them. However, there are many ways in which the framework could be improved, by considering some of the following questions: Who defines the rules and with what legitimacy? Who evaluates if rules have been breached? What happens if rules are breached?

In 1997-98 the Government was able to use its democratic mandate to set the two fiscal rules. However, no formal mechanism was ever put in place to respond if the rules were breached. More importantly, in the absence of an official external evaluator, and in the context of fiscal decision-making also being institutionally unified with the fiscal projections used in decision-making, the government was itself the final judge of whether these fiscal rules were met or breached.

Nevertheless, the transparency provided by the fiscal framework did enable external organisations and commentators to hold the Government to account, and much criticism of fiscal policy did occur when other bodies judged that public spending was too high and taxation too low to achieve the fiscal rules. These assessments clearly damaged the credibility of the framework and imposed some political cost on the Government, but they represented the only real political commitment 'device' for the fiscal framework. For most of the electorate, unfamiliar with the arcane details of fiscal policy, such debates arguably lacked any real meaning. Consequently the framework had at best a weak effect in democratising fiscal policy.

Advantages of UK fiscal policymaking and its 'fiscal framework' therefore include:

- Democratic legitimacy:
    - Fiscal decisions are taken by elected politicians with high levels of associated legitimacy and accountability.
- Discretion:
    - With near-total discretion in determining short-term fiscal policy, elected decision-makers are able to respond to changing events and public policy objectives, such as the financial crisis of 2007.

- "The Treasury shall invite the National Audit Office (NAO) to audit any changes to the key assumptions and conventions underlying the Fiscal Projections. The Comptroller and Auditor General shall ensure that any advice is communicated to the Treasury and laid before Parliament."
- "The Treasury shall refer to the House of Commons Treasury Select Committee every report published as a requirement of the Code."

The associated disadvantages of UK fiscal policymaking include:

- Incentives for elected decision-makers:
  - The temporal horizon of elected politicians, i.e. the next election, is in tension with prudential fiscal decision-making over the economic-cycle.
  - The incentive for the government to accumulate structural deficit for political gain, i.e. to spend more than is prudent to bolster political support.
- Potential organisational bias in revenue projection function:
  - Fiscal projection-making is undertaken within the same institution as fiscal decision-making, potentially creating organisational pressures that undermine the quality of projection-making. Politicians may justify what later transpires to be excessive public spending by predicting highly optimistic levels of economic growth, and therefore tax revenues.
  - Perceptions of organisational bias in fiscal projection-making result in commentators questioning the credibility and independence of fiscal projections.

The UK Experience

The 2009 Budget was a watershed moment, with the UK Chancellor projecting the highest level of public borrowing since the Second World War. In the 2009 Budget[10], the Government linked the fiscal position to conditions in the global economy:

> "Global economic developments will have a profound effect on the fiscal positions of most countries, with debt likely to rise significantly in all advanced economies."

Many of the projections of the 2009 Budget were anticipated in the 2008 Pre-Budget Report, in which the government announced a temporary operating rule for fiscal policy, which entailed the suspension of much of the pre-existing fiscal framework described above. Under the new strategy, the Chancellor announced that:

> "The Government's fiscal policy objectives remain unchanged – to smooth the path of the economy over the short term, and ensure sound public finances over the medium term. To implement these in current economic

[10] HM Treasury (2009) *Budget 2009; Building Britain's Future*, p3-4

> circumstances, the Government will depart temporarily from the fiscal rules until the global shocks have worked their way through the economy in full.
>
> Consistent with *The Code for fiscal stability*, the Government is setting a temporary operating rule: to set policies to improve the cyclically-adjusted current budget each year, once the economy emerges from the downturn, so it reaches balance and debt is falling as a proportion of GDP once the global shocks have worked their way through the economy in full."

This represented the complete failure of the fiscal framework to achieve its aim of medium-term fiscal sustainability.[11] Despite the Government linking the 2009 fiscal position to unpredictable external economic shocks in the global economy, should the arrangements for UK fiscal policymaking share some responsibility for the UK's fiscal crisis in 2009? HM Treasury's analysis of the UK economy in the years before 2008 suggests that the economy was growing at its sustainable long-term rate and that, far from an overheating economy being followed by a crash, the economy was derailed by an external crisis. But, as the Institute for Fiscal Studies (IFS) has suggested, it might instead be the case that HM Treasury had consistently overestimated the growth potential of the economy, leading it to assume that the growth of the early 2000s was sustainable when in fact it was not. As Robert Chote of the IFSA has articulated, it could be

> "that the productive potential of the economy did not go into sudden and unpredictable decline in mid-2007, but rather that the government - among many others - consistently overestimated the potential of the economy in the good years, lulled into a false sense of security by global disinflation."[12]

The obvious question is why this might have happened. One argument is that the political incentives faced by the government, combined with the lack of significant challenge to HM Treasury's forecasts, either from another government body or from a credible external source, allowed consistently optimistic projections to justify excessive spending.

The extent to which these theoretical shortcomings of the fiscal framework can be blamed for the state of the UK's public finances is largely un-testable, and it will remain for economic historians to debate the causes of the 2009 fiscal crisis. Indeed, even if the fiscal projections employed by HM Treasury were independently generated, it is far from clear that those projections would have reached a substantially different conclusion about the sustainability of

[11] Maintaining its approach to fiscal policymaking, built around statements of objective, the Labour Government used the 2009 Queen's Speech to commit itself to halving the fiscal deficit within four years.

[12] Chote R (2009) *A bust without a boom*, Institute for Fiscal Studies, London

UK growth, given the benign inflationary environment of the past decade. In the view of many commentators the 2007 'credit crunch' and subsequent recession were entirely unpredictable, so-called 'black swan' events, and as a result, fiscal policymaking was not to blame.

But while it could not have prevented it, a more robust fiscal framework could have helped to ensure that the UK was better prepared for the crisis. The key question is how better might the building blocks of fiscal policymaking be arranged to ensure the optimal level of democratic accountability while limiting the scope for political considerations to influence policy? The next section outlines the full range of options for a new fiscal framework and assesses the pros and cons of each against these criteria.

PART 5: OPTIONS FOR FISCAL POLICYMAKING THE UK

Could a better fiscal framework have saved the UK from the dire fiscal position outlined in the 2009 Budget? In what other ways could fiscal policymaking be organised to better ensure fiscal sustainability? Many alternative configurations could be conceived. This section summarises some of the arguments and options that follow from them.

Option 1: No 'fiscal framework'

The fiscal framework deployed by Labour in 1997-98 was arguably ineffectual in preventing a medium-term deterioration in the public finances prior to, and certainly after, the credit crunch occurred. It can therefore be argued that the framework was nothing more than cosmetic.

- Summary: The framework's failure and subsequent suspension proves that it was of no, or limited, help in ensuring fiscal sustainability and should be abandoned. The sustainability of the public finances should therefore be left to the government bond (gilt) markets to enforce. Future governments would then be warded off imprudent spending by rising borrowing costs.
- Pros: By giving the government total discretion and flexibility in setting fiscal policy, the government is able to make decisions free of the need to justify fiscal policy against a framework that may no longer be appropriate, or limit room for manoeuvre.
- Cons: Loss of benefits associated with the use of a 'fiscal framework', such as the framing of public expectations and an explicit statement of objectives against which the government can be judged. In addition, bond markets can be limited in their effectiveness as a mechanism for monitoring the medium-term sustainability of public finances, since the price of government bonds will also be affected by external factors, such as appetite for investment risk and the performance of corporate bonds.

Option 2: Independent fiscal advisory body

On a second view, Labour's 'fiscal framework' was broadly successful in that it forced the Government to justify its fiscal stance. However, the framework fell short in that the Treasury's own projections – later found to be wildly inaccurate - were the basis for the policymaking.

- Summary: Fiscal decision-making and projection-making remains centralised in HM Treasury. However, oversight of fiscal decision-making and fiscal projections is enhanced by a new official statutory body charged with producing independent fiscal projections *in addition to* the projections undertaken by the government. This 'fiscal council' or equivalent would replace the current official oversight mechanisms set out in the Code for Fiscal Stability. If the 'fiscal council' produced projections that contradicted those of the government, the government would be obliged to account for differences to Parliament, ensuring that additional institutional and political pressure on the government would result if it were to adopt an irresponsible fiscal policy. A proposal of this nature has been put forward by the Conservative Party, which has advocated the creation of an Office for Budget Responsibility.[13]

- Pros: Stronger oversight provided by a statutory body and the availability of alternative official projections would reduce the scope for organisational bias and group-think to influence the projections and therefore mislead policymakers.
- Cons: Confronted with contradictory fiscal projections from an independent fiscal council, the government of the day would always retain the option to question the credibility and accuracy of the projections produced by an independent fiscal advisory body, just as previous governments have sought to dismiss independent external fiscal projections by respected research institutes. In such a situation, a government may also have a strong incentive to hoard data and restrict the projection-making capacity of an independent fiscal advisory body.

Option 3: Independent projection-making: separation of fiscal projection functions from fiscal decision-making

Similar to Option 2, this third option proceeds from a belief that the failure of the previous framework was based on the (inadvertent) generation of biased projections.

- Summary: Responsibility for all fiscal projections is transferred from HM Treasury to the National Audit Office, or other independent authority. In addition to HM Government, Opposition parties are also granted a right to commission fiscal projections of taxation and spending.
- Pros: The perception of credibility and independence of fiscal projections would be enhanced, and any organisational bias that may result in optimistic forecasts would be eliminated. Political debate would be improved by the availability of alternative fiscal projections to the opposition parties.
- Cons: The quality of fiscal decision-making and debt management may suffer from institutional and administrative separation from fiscal projection functions.

[13] Conservative Party (2008) *Reconstruction: Plan for a Strong Economy*

Option 4: Independent monitoring combined with coercive oversight

A more fundamental indictment of the pre-existing system underpins the fourth option for fiscal policymaking reform, including the view that not only were projections potentially subject to bias, but also the actual tax and spending decisions. This reading argues for some measure of control over fiscal policy being taken away from HM Treasury.

- Summary: Give clear responsibility for monitoring fiscal policy to a House of Commons Select Committee, or an Independent Fiscal Authority, and grant this body some limited coercive powers if the Government fails to meet certain fiscal rules or principles.
- Pros: Politicians retain day-to-day discretionary control over fiscal policy including flexibility to respond to changing events, and fiscal decisions are bestowed with democratic legitimacy. However, by subjecting the Government to coercive scrutiny over fiscal decision-making, the political incentives inherent in current fiscal policymaking would be diluted.
- Cons: Any coercive power over the Government in relation to fiscal policy arguably represents a reduction of democratic accountability and would lack legitimacy, even if this oversight role were fulfilled by a parliamentary body rather than an independent statutory body.

Option 5: Separation of decision-making functions + Rules-based fiscal decision-making

Based on a similar view of the shortcomings of the previous framework, this option advocates an even more radical shift of power away from the Chancellor and HM Treasury.

- Summary: Aggregate taxation and public spending decision functions are separated. Elected politicians choose an aggregate level of taxation. An appointed committee within the National Audit Office, an 'Independent Fiscal Authority' or council subsequently applies a rules-based criteria to determine levels of aggregate public spending to be allowed.
- Pros: By separating fiscal decision-making and transferring some control to an appointed committee, the scope for elected politicians to be incentivised to make fiscally imprudent decisions is limited. An external body setting the limits to public spending may also provide 'political cover' during periods when public spending must be cut.

- Cons: Subjecting the power of elected politicians to coercive oversight, however limited, could be seen as unacceptably anti-democratic. Rules-based decision-making by non-elected appointees may lack the flexibility to respond to external events and changing policy objectives and may therefore lack legitimacy. If fiscal rules prohibit large deficits during periods of economic contraction, the application of fiscal rules may exacerbate recessions by requiring public spending cuts. As with the Eurozone's Stability and Growth Pact, such rules may ultimately be ignored.

Option 6: No change

The final option of returning to the pre-existing 'fiscal framework' once public debt is stabilised, is justified by the view that before the crisis, the framework was doing a good job of creating transparency of fiscal policymaking to hold the Government to account. On this view, the country would not have been better prepared for the financial crisis had a different kind of framework been in place.

- Summary: Maintain existing arrangements for fiscal policymaking and the application of the current fiscal framework, as arguably the most prudent and rules-based approach possible without an unacceptable reduction in democratic mandate of fiscal policymakers.
- Pros: Fiscal decisions are taken by elected politicians with high levels of associated legitimacy and accountability. With near-total discretion in deciding fiscal policy, elected decision-makers are able to respond to changing events and policy objectives.
- Cons: The incentives for elected politicians to use fiscal policy to boost political support is strong, particularly given the scope for organisational bias to result in the adoption of over-optimistic economic growth projections.

PART 6: CONCLUSION – TOWARD INDEPENDENT FISCAL FORECASTING

Whatever account is advanced for explaining the disastrous fiscal situation facing the UK going in the 2010 general election, one thing is clear: there is scope for improving fiscal policy by reforming the institutions within which it is made. The UK confronts a decade of public spending cuts and tax increases that will be painful for politicians and citizens alike. Excessively loose fiscal policy in the years preceding the crash has left the UK in a more difficult fiscal position than it might have been, and threatened the creditworthiness of the government. Against this backdrop, there is a clear imperative to learn the lessons of the failure of the old fiscal framework and act to ensure they are not repeated..

The experiences of the past decade, both in fiscal policy and other areas of government, have demonstrated the power of institutional arrangements to improve public policymaking. By learning the lessons from those experiences, we have the technology to improve fiscal policymaking for the future.

As this paper has explored, the institutional arrangements for fiscal policymaking are not immutably fixed, and always represent a trade-off between competing objectives, most importantly that between political accountability and analytical independence. Already, some commentators[14] are calling for a step back in time, with the policing of fiscal policy left solely to voters and bond markets. But such an approach will fail. For most citizens the intricacies of fiscal policy are far too abstract for the electorate to effectively regulate. The bond markets cease to be effective policemen of fiscal decisions in the context of global financial instability and a flight from risk. Moreover, the costs of rising risk premiums on government debt from excessive borrowing, are borne by the taxpayer over time, allowing politicians to run sub-optimally loose fiscal policy for electoral gain anyway.

In this context, the Conservative Party has set out proposals for an Office of Budget Responsibility. This new statutory body would, under a mandate from the Chancellor of the Exchequer, assess the medium and long-term sustainability of the public finances and produce formal estimates of how much fiscal loosening or tightening would be required for the government to meet its target for public borrowing. Under this scenario, the Treasury would continue to undertake official fiscal projections, but the Office of Budgetary Responsibility would have privileged access to information and data from the Treasury and other relevant institutions, such as the Bank of England, HM Revenue & Customs, etc. However, the Office of

[14] Murray A & Wilkes G (2009) *Fiscal rules ok?*, CentreForum, London

Budget Responsibility's judgement would not be a substitute for the annual judgement on fiscal policy presented by the Budget, and the only sanction facing the Chancellor of the day will be a requirement to explain to Parliament any differences between the judgement of HM Treasury and that of the Office of Budget Responsibility.

Although such a proposal has much to commend it, the flaw within it is easy to identify: at such a time as it is politically expedient, the government of the day will be able to dismiss forecasting disagreements with the Office for Budget Responsibility on the basis of the superior forecasting capability and data within HM Treasury. Further, at different points in the economic cycle, there is a clear danger that HM Treasury can claim the necessary political legitimacy to move the goalposts on the ostensible grounds of the public interest. Indeed, current and previous UK governments have not been short of independent fiscal forecasting oversight, from domestic institutions such as the Institute for Fiscal Studies and National Institute for Economic and Social Research, and international bodies such as the International Monetary Fund and Organisation of Economic Cooperation and Development. Time and again, contradictory fiscal forecasts from such bodies have been dismissed by the UK government when it believes that the very short-term political embarrassment imposed by such disagreements is less than the short and medium term political gain of pursuing the fiscal policy of its choice. Indeed, the political embarrassment of fiscal forecasts judged to be over-optimistic by independent commentators rarely extends beyond the pages of top-end newspapers, and such discussion is arcane and inaccessible to many voters. Even with its statutory mandate, the political risks embodied by an independent Office of Budget Responsibility mean that it represents an institutional arrangement that would likely be weakened to the point of failure, and one that could easily be undermined, for example, by weak leadership of such a body.

However, the current crisis shows that it has never been more important for fiscal projection-making to be perceived as independent and credible. Indeed, given fiscal projections are likely to feature directly in political debate over the next decade of public spending cuts, reliable, credible alternative projections will be invaluable in this process of public spending reform.

For these reasons in particular, the most appropriate reform to the institutions of fiscal policymaking would be the creation of an independent Office for Fiscal Analysis, separated from fiscal decision-makers in government, that would undertake all official fiscal projections. The OFA's independence, which would reflect the independence of the UK Statistics Authority, would ensure that it was entirely free from the risk or perception of organisational bias.[15] Its modelling assumptions and inputs would, as far as possible, be open to public scrutiny and its outputs would be freely available to external bodies such as the opposition parties, thus facilitating higher quality political debate.

The transfer of official forecasting capability out of HM Treasury would allow democratically accountable politicians complete freedom to choose their preferred fiscal stance while ensuring that their choices are not masked (whether intentionally or not) by over-optimistic revenue and expenditure projections. Such an approach would stimulate a more open debate and more reliable projections that would result from this function being undertaken independently.

[15] 'Option 3' in the previous chapter.

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Arrangements for fiscal policymaking ultimately come down to a set of choices around: who should take fiscal decisions and how? Who should carry out the projections of revenue and spending on which those decisions are based? In the UK, fiscal policymaking has traditionally been highly centralised and discretionary, with all fiscal projections and decisions emanating from HM Treasury. The self-imposed fiscal rules of the 1997 Labour government represented an important experiment in the evolution of fiscal policy institutions. The rules sought to articulate formal standards by which fiscal policymaking could be judged thereby increasing political accountability, even if the rules themselves amounted to nothing more than statements of intent. However, the fiscal crisis that confronted the UK in 2009 showed that even if the government's fiscal framework was an improvement on what went before, it clearly wasn't good enough.

The experiences of the past decade, both in fiscal policy and other areas of government, have demonstrated the power of institutional arrangements to improve public policymaking. This has been achieved by separating different functions according to the need for analytical independence, political accountability. Good examples of this include the granting of operational independence to the Bank of England, the establishment of an independent UK Statistics Authority and the setting up of an independent Low Pay Commission to advise on the level of the minimum wage. By learning the lessons from these experiences, the UK has the tools to improve fiscal policymaking for the future.

This paper argues that the most appropriate reform to the institutions of fiscal policymaking would be the creation of an independent Office for Fiscal Analysis (OFA), separated from fiscal decision-makers in government, that would undertake all official fiscal projections. The OFA's independence, which would reflect the independence of the UK Statistics Authority, would ensure that it was entirely free from the risk or perception of organisational bias. Its modelling assumptions and inputs would, as far as possible, be open to public scrutiny and its outputs would be freely available to external bodies, in particular, the opposition parties. These reforms would increase the accountability of government both from the perspective of the markets and the electorate, thus lowering the cost of borrowing and ensuring the pursuit of sustainable fiscal policy in the medium-term.

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