2. The new fiscal framework: an assessment

Rowena Crawford, Carl Emmerson and Gemma Tetlow (IFS)

Summary

- The financial crisis and associated recession have reduced revenues and, to a greater extent, increased public spending as a share of national income. Without action, there would have been an unsustainable increase in borrowing and debt. The government's spending cuts and tax rises are forecast to be sufficient to return the UK's public finances to a sustainable position, but the same would have been true under the fiscal consolidation plan set out by Labour in its March 2010 Budget.

- Between 2010 and 2015, the IMF forecasts that most other industrial countries will reduce government borrowing by less than the UK: out of 29 industrial countries, only Greece is forecast to have a sharper decline in cyclically-adjusted borrowing.

- The government has introduced a new independent Office for Budget Responsibility (OBR) to help enhance the credibility of official forecasts. The transparency and presentation of official forecasts have already been improved since the OBR was established; the OBR, the Treasury and other departments should continue to build on this. There is a case for extending the remit of the OBR so that it is able to consider the impact of alternative policy options, at least in some limited circumstances such as the run-up to a general election.

- The government has set itself a new forward-looking fiscal mandate, that policy is consistent with achieving at least a cyclically-adjusted current budget balance by the end of the forecast horizon, and a supplementary target to reduce debt as a share of national income between 2014–15 and 2015–16. The OBR judges that current policy is consistent with the fiscal mandate, and forecasts that the supplementary target is more likely than not to be met. But if the OBR's forecasts are as accurate as past Treasury forecasts, there would still be a three-in-ten chance that further tax rises or spending cuts would be required to avoid a cyclically-adjusted current budget deficit in 2015–16.

- Compliance with the two fiscal targets does not ensure fiscal sustainability. The government's fiscal mandate will require careful monitoring to ensure that it is not being achieved only through policies that are always promised but never implemented. The supplementary target – to reduce debt – applies only to 2015–16; the government should consider what profile of debt it wishes to target beyond that date, taking into account likely pressures on the public finances such as those arising from an ageing population. There are merits in a 'sustainable commitments rule' which would place a ceiling on the flow of future debt interest and other pre-committed payments, rather than on the stock of accumulated public sector debt.

2.1 Introduction

The financial crisis and recession pushed the UK's public finances from an apparently sustainable path to one which, in the absence of an appropriate fiscal response, would have been unsustainable, with high levels of annual borrowing and rising debt. The biggest domestic policy challenge for the government over the next few years will be to ensure that the public finances are returned to a sustainable footing in a way that minimises the fall in living standards arising from higher taxes, lower welfare payments and reduced spending on public services. In the longer term, the government will need to ensure that fiscal policy is consistent with the ongoing sustainability of the public finances. This chapter examines the government's new framework for ensuring sound public finances, including the new fiscal rules and the role of the newly established Office for Budget Responsibility (OBR).

Section 2.2 starts by discussing how tax revenues, spending and borrowing evolved over the course of the recession, and how the government's fiscal consolidation is intended to return the public finances to a sustainable footing. We also examine how the changes in UK government borrowing and debt through the crisis compare with those seen in other similar countries.

The Chancellor, George Osborne, has set himself two new fiscal goals for the medium term. The first (his fiscal mandate) is that policy should be consistent with achieving at least a cyclically-adjusted current budget balance at the end of the forecasting horizon. The second (a supplementary target) is that debt should be falling as a share of national income in 2015–16. Sections 2.3 and 2.4, respectively, discuss these rules and how they might be improved upon.

Similar types of fiscal rules operated by former Chancellors Gordon Brown and Alistair Darling – the golden rule and the sustainable investment rule – had lost a lot of their credibility long before the financial crisis and recession made it almost inconceivable that they would be met and not sensible to try to meet them. Largely to aid public confidence in the new rules and the new government's commitment to fiscal prudence, Mr Osborne has established a new independent fiscal council – the OBR – which is responsible for producing economic and fiscal forecasts and signing off the government's costings of new policy measures. Section 2.5 discusses the remit of the OBR, its early operation and some possible improvements that could be made.

Section 2.6 concludes.

2.2 Borrowing and debt through the crisis

The onset of the financial crisis and associated economic recession radically altered the outlook for the strength of the public finances. Before the crisis, then Chancellor Darling's forecast in March 2008 suggested that the fiscal policy stance at that time was consistent both with the two fiscal rules that he inherited from Mr Brown and with sustainable public finances in the medium term.[1] More recent forecasts – such as those published by

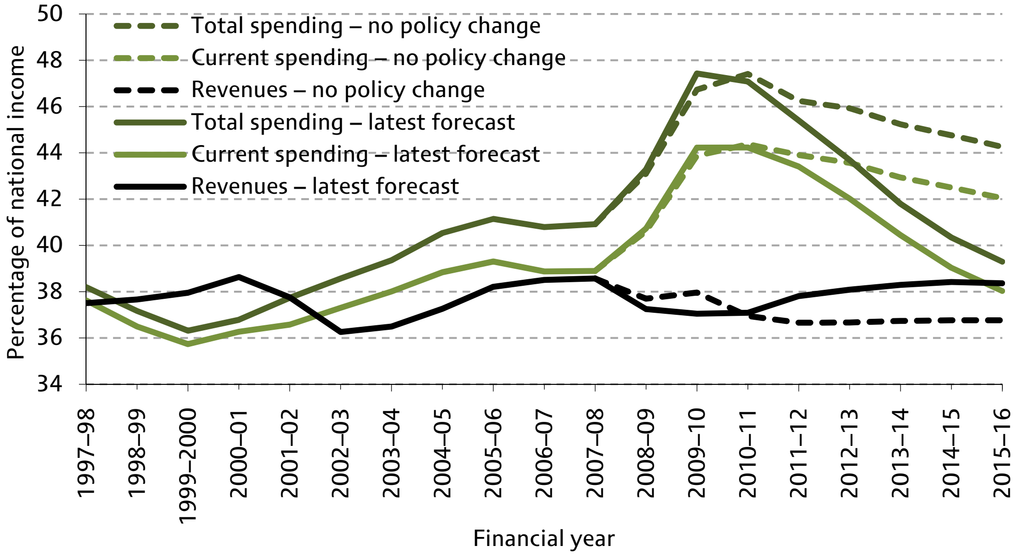
---

[1] The judgement of IFS researchers in the January 2008 Green Budget was that the Treasury's forecasts for public borrowing at that time were actually a little optimistic given its expectations of economic growth. However, the size of the structural hole identified by IFS researchers then was only about one-tenth of the size of the structural hole that is now thought to exist (and the Treasury's expectations of economic growth have also proven optimistic). See R. Chote, C. Emmerson and G. Tetlow, 'Green Budget public finance forecasts', in

the new OBR in November 2010 – suggest that, in the light of adverse economic developments since mid-2008, the previous fiscal plans would no longer be consistent with sustainable public finances. This section examines how public spending and taxes, and hence public borrowing and debt, have evolved in the UK through the recession and how they are projected to evolve over the next five years, both with and without taking into account the impact of the planned fiscal consolidation. We then compare this to the changes in borrowing and debt that have been seen and are forecast in other industrialised countries.

Figure 2.1 shows how tax revenues and spending (both total spending and current spending on its own, i.e. excluding investment spending) evolved as a share of national income from 1997–98 onwards. The dotted lines show how they would have evolved from 2008–09 onwards if the direct impact of fiscal policy measures announced since the March 2008 Budget is ignored.

Figure 2.1. Revenues and spending – with and without policy action



Note: 'No policy change' ignores the direct impact of all fiscal policy measures that have been implemented since Budget 2008.
Sources: Authors' calculations using all Budgets and Pre-Budget Reports since March 2008 (up to the March 2010 Budget are available at http://webarchive.nationalarchives.gov.uk/20100407010852/http://www.hm-treasury.gov.uk/home.htm; June 2010 Budget is available at http://www.hm-treasury.gov.uk/) and the Office for Budget Responsibility's November 2010 *Economic and Fiscal Outlook* (http://budgetresponsibility.independent.gov.uk/econ-fiscal-outlook.html).

The amount of revenue yielded by the UK tax system is generally related to the level of national income, and so tax revenues as a share of national income were relatively unaffected by the financial crisis. The black dotted line shows that, without taking into account the direct impact of policy action since the March 2008 Budget, tax revenues would have fallen from 38.6% of national income in 2007–08 to 36.7% by 2011–12 and then remained at about that level thereafter. This forecast fall reflects factors such as lower-than-expected financial sector profitability – reducing tax receipts from those firms and their employees – and reduced equity and property prices, which reduce revenues from stamp duties, inheritance tax and capital gains tax.

R. Chote, C. Emmerson, D. Miles and J. Shaw (eds), *The IFS Green Budget: January 2008*, IFS Commentary 104 (http://www.ifs.org.uk/budgets/gb2008/08chap5.pdf).

Without taking into account the direct impact of policy action since the March 2008 Budget, total spending would have risen from 40.9% of national income in 2007–08 to 47.4% in 2010–11 before falling back to 44.3% by 2015–16. As discussed in more detail in Chapter 6, the increase largely reflects two things. First, Mr Darling's October 2007 Comprehensive Spending Review set out three-year plans for cash spending by central government on public services, while the economy has since turned out much smaller in cash terms than expected at the time. Second, some elements of spending (particularly welfare spending and debt interest spending) increased as a direct result of the recession.

Public borrowing in 2015–16 would, therefore, in the absence of any policy action since the March 2008 Budget, have stood at 7.5% of national income. With the economy expected to be back operating almost at its trend (or sustainable) level by 2015–16, most of this borrowing would have been structural, rather than simply reflecting some remaining temporary weakness in the economy. Borrowing at this level every year would likely be unsustainable for the UK economy.

To avoid such an unsustainable public finance position emerging, both the Labour government and the new coalition government announced a series of net tax increases and net spending cuts. The latest official forecasts from the OBR for tax revenues and spending, taking into account the impact of policies announced since March 2008, are shown by the solid lines for the years 2008–09 onwards in Figure 2.1. Comparing these lines with the dotted lines shows that the combined impact of policies announced since March 2008 has been to reduce forecast spending by 5.0% of national income and increase forecast tax revenues by 1.6% of national income by 2015–16, and thus reduce forecast borrowing by 6.6% of national income. Borrowing is forecast to be 1.0% of national income by 2015–16, which is below the 2.3% of national income that was borrowed pre-crisis in 2007–08. The tax rises and spending cuts are projected to be sufficient to eliminate the current budget deficit[2] in 2015–16, as shown by the fact that receipts are forecast to exceed current spending in that year. Projections for the cyclically-adjusted current budget under alternative policy scenarios are shown in Section 2.3.

The fiscal consolidation planned by the government is forecast by the OBR to be sufficient to limit the rise in public debt over the next few years (compared with what would have been expected without this policy action) and then result in debt falling as a share of national income from 2013–14 onwards. Forecasts for public debt under alternative policy scenarios are presented in more detail in Section 2.4.

It is clear from Figure 2.1 that the coalition government has decided that a much larger part (73% in 2014–15 rising to 76% in 2015–16) of the fiscal tightening should come from cuts to spending than from tax increases. (This is similar to the Labour government's plans, which implied that 70% of its announced fiscal tightening for 2014–15 would come from spending cuts.)[3] However, because the impact of the financial crisis and recession, had there been no policy response, would have been to increase spending far more dramatically than it would have reduced revenues, the impact of this fiscal tightening package is to return both spending and revenues as a proportion of national income to around the level they were at before the financial crisis. Government revenues

---

[2] The current budget deficit is the amount by which public sector current spending (i.e. total spending less net investment) exceeds total public sector revenues in a particular year.

[3] See R. Crawford, 'Where did the axe fall?', presentation at IFS 2010 Spending Review briefing, 21 October 2010 (http://www.ifs.org.uk/publications/5311).

in 2015–16, at 38.4% of national income, would be at about the same level as they were at in 2006–07; total spending, at 39.3% of national income, would be at about the same level as it was at in 2003–04.[4]

International comparisons

Reducing borrowing

Many other industrial countries have also seen large increases in borrowing over the last few years and are planning substantial fiscal consolidations. (Some of these, such as in the cases of Greece and Ireland, have been prompted by pressure from credit markets which

Table 2.1. Borrowing as a share of national income in the UK compared with 28 other advanced economies

	UK rank	Notes
Headline borrowing		
Level		
2007 (pre-crisis)	Equal 3rd highest	United States and France the same, Portugal and Greece higher
2010	3rd highest	United States and Ireland higher
2015	12th highest	
Change		
Increase, 2007 to 2010	8th largest	
Reduction, 2010 to 2015	3rd largest	Only Iceland and Ireland larger
Reduction, 2007 to 2015	3rd largest	Only France and Greece larger
Cyclically adjusted borrowing		
Level		
2007 (pre-crisis)	5th highest	France, Portugal, Greece and Ireland higher
2010	Equal 2nd highest	United States the same, Ireland higher
2015	16th highest	
Change		
Increase, 2007 to 2010	8th largest	
Reduction, 2010 to 2015	2nd largest	Only Greece larger
Reduction, 2007 to 2015	4th largest	Ireland, Slovenia and Greece larger

Notes: Measures are general government balance as a percentage of GDP and general government cyclically adjusted overall balance as a percentage of potential GDP. The 28 advanced economies on which data comparable to the UK are available are: Australia, Austria, Belgium, Canada, Czech Republic, Denmark, Finland, France, Germany, Greece, Hong Kong, Iceland, Ireland, Israel, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Slovak Republic, Slovenia, South Korea, Spain, Sweden, Switzerland and the United States.
Source: Statistical table 1 (page 117) and statistical table 3 (page 119) of International Monetary Fund, 'Fiscal exit: from strategy to implementation', *Fiscal Monitor*, November 2010 (http://www.imf.org/external/pubs/cat/longres.cfm?sk=24220).

[4] More detailed discussion of the public finance impact of the financial crisis and recession and the Labour and coalition governments' fiscal responses can be found in R. Chote, R. Crawford, C. Emmerson and G. Tetlow, 'Disease and cure in the UK: the fiscal impact of the crisis and the policy response', presented at the European Commission workshop 'The UK Economy, Post-Recession – Same as it Ever Was?', 29 June 2010 (http://ec.europa.eu/economy_finance/events/2010/20100629-uk_seminar/main_en.htm).

forced these countries to apply to the International Monetary Fund for an emergency loan and thus sign up to the austerity measures agreed with the IMF.) Among 29 advanced economies (listed in the note to Table 2.1), the UK had the (equal) 3rd highest level of headline borrowing in 2007 (i.e. pre-crisis). Between 2007 and 2010, the UK experienced the 8th largest increase in headline borrowing, which left the UK still being the 3rd highest borrower in 2010 – as shown in the top panel of Table 2.1. However, between 2010 and 2015, the UK is forecast to have the 3rd largest reduction in headline borrowing (with only Iceland and Ireland forecast to see larger reductions), so that over the whole period 2007 to 2015 the UK will actually see the 3rd largest reduction in borrowing (behind France and Greece).

The story is very similar for cyclically-adjusted borrowing, with the UK seeing the 8th largest increase between 2007 and 2010, but the 2nd largest reduction between 2010 and 2015 (with only Greece being larger), as shown in the bottom panel of Table 2.1. The decline in headline borrowing over this period is largely driven by the government's fiscal consolidation plan reducing structural borrowing, rather than simply a cyclical recovery in the public finances as the economy emerges from the recession.

Limiting the rise in debt

The policy action taken by the government will mean that debt increases by less over the next few years than it would have in the absence of policy action; nonetheless, UK government debt is now (and will be in five years' time) much higher than it was before the crisis. A comparison of the UK's performance on debt with that of 21 other advanced economies is shown in Table 2.2.

In 2007, the UK had the 11th highest level of general government net debt, but between 2007 and 2010 it saw the 5th largest increase, sufficient to push the UK up to having the 9th highest level of debt among this set of countries. Despite the government's plans to reduce borrowing over this parliament, the UK is forecast to see the 12th largest increase in debt between 2010 and 2015, leaving it with the 8th highest level of debt.

Table 2.2. Debt as a share of national income in the UK compared with 21 other advanced economies

	UK rank	Notes
Level		
2007 (pre-crisis)	11th highest	
2010	9th highest	
2015	8th highest	
Change		
Increase, 2007 to 2010	5th largest	Finland, Japan, Ireland and Iceland higher
Increase, 2010 to 2015	12th largest	
Increase, 2007 to 2015	7th largest	

Notes: Measure is general government net debt as a percentage of GDP. The 21 advanced economies on which comparable data are available are: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Iceland, Ireland, Israel, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland and the United States.
Source: Statistical table 8 (page 124) of International Monetary Fund, 'Fiscal exit: from strategy to implementation', *Fiscal Monitor*, November 2010 (http://www.imf.org/external/pubs/cat/longres.cfm?sk=24220).

2.3 The new borrowing target

The new government has set itself a forward-looking 'fiscal mandate': the structural current budget must be forecast to be in balance or in surplus by the end of a rolling, five-year forecast horizon. In other words, after taking into account the estimated impact on the public finances of temporary ups-and-downs of the economic cycle, government receipts should be projected to be equal to, or to exceed, non-investment spending. The end of the forecast horizon is currently 2015−16, but this will change over time – for example, while the forecast horizon of the March 2011 Budget will presumably be 2015−16, the OBR's 2011 Autumn forecast will presumably run to 2016−17. This section critiques this new fiscal mandate and assesses the likelihood that it would be met under the latest OBR forecasts and under two different policy scenarios.

A new golden rule?

The principle behind the new fiscal mandate is the same as that which lay behind Mr Brown's golden rule:[5] that it is appropriate for governments to borrow to finance investment spending, but inappropriate to borrow to finance day-to-day spending. However, as with Mr Brown's golden rule, having tax revenues equal to current spending does not mean that each generation is paying for the public spending from which it benefits (which was the explicit object of Mr Brown's golden rule). For example, there is no guarantee that the stream of interest payments resulting from a decision to borrow to invest will match the stream of benefits that arise from that investment having occurred.[6] Nevertheless, while not optimal, such a rule might be a reasonable approximation to follow most of the time.

By targeting the cyclically-adjusted current balance, the coalition government is, sensibly, allowing borrowing to be higher when the economy is thought to be temporarily weak. This, in principle, will give fiscal policy scope to support monetary policy over the economic cycle, which might be sensible. The same was true under Mr Brown's golden rule: this was assessed not in any one year, but measured over the ups-and-downs of an economic cycle.[7]

The key difference between the new fiscal mandate and the old golden rule is in the way that it is operationalised. The previous golden rule's assessment over an economic cycle required a judgement to be made as to when the current economic cycle began and ended, and also meant that the size of cumulative current budget surplus or deficit that was permissible between now and the end of the economic cycle depended on the cumulative surplus or deficit that had been accumulated so far. These features were unattractive: for example, in June 2005, whether or not the golden rule was on course to be met over the current cycle, which was then thought to end that financial year (2005–06), depended on whether that cycle was believed to have begun in 1999–2000 (in which

[5] This rule aimed for a balance or surplus on the average current budget as a share of national income over the financial years covering an economic cycle.

[6] For a comprehensive discussion, see section 3.2 of R. Chote, C. Emmerson and G. Tetlow, 'The fiscal rules and policy framework', in the January 2008 Green Budget (http://www.ifs.org.uk/budgets/gb2008/08chap3.pdf).

[7] The coalition government's formulation is slightly more restrictive than Labour's golden rule since, while the former allows the automatic stabilisers to operate, the latter left open the possibility of discretionary fiscal stimulus and fiscal cooling over the economic cycle, in addition to the automatic stabilisers, as long as these balanced out. In practice, this distinction is unlikely to matter since the new formulation would only prevent a planned fiscal stimulus from taking place at the end of the forecast horizon.

case it was on course to be missed) or 1997–98 (in which case it was on course to be met). In July 2005, the then Chancellor Gordon Brown decided to revise his previous judgement that the cycle began in 1999–2000 to the view that it actually began in 1997–98 (despite the fact that the evidence used to support such a change seemed no stronger then than it had been previously).[8] Whatever the correct answer to when that economic cycle began, it is difficult to argue that this should have affected the appropriate level of borrowing in 2005–06.

In order to avoid the problems associated with having to date the economic cycle, and the unwelcome feature that surpluses at the start of an economic cycle could allow inappropriately high current budget deficits towards the end of an economic cycle, IFS researchers have argued in Green Budgets since 2005 that the golden rule should be made forward-looking;[9] that is, that the government should set a target for the current budget – or the cyclically-adjusted current budget – for, say, five years hence. This is exactly what the new fiscal mandate does, and is a welcome improvement on the fiscal framework that existed before the financial crisis.

But this is not to say that the new formulation of the golden rule is completely unproblematic. Perhaps the main issue arises with the fact that it relates to a forecast for a fiscal aggregate – the cyclically-adjusted current budget at the end of the forecast horizon – rather than to a fact which is a matter of historical record (such as an out-turn for a fiscal aggregate). This is a problem because the moving horizon means that, although the rule does place a constraint on the government's plans for the future, it does not place any constraints on its behaviour in the short run. For example, the government has set out a fiscal tightening that is forecast by the OBR to restore the structural current budget to balance in 2014–15, a year before the end of the current forecast horizon. By the 2013 Budget, the forecast horizon will presumably be 2017–18, and this will mean that the government would no longer be constrained by its fiscal mandate to implement its planned tightening for 2014–15 or 2015–16 so long as it planned to tighten by enough later so that the structural current budget would be forecast to be in balance or surplus by 2017–18. In a similar vein, future fiscal drag[10] could always be claimed to contribute towards meeting a fiscal target even if in practice a government each year chose to offset this with discretionary tax cuts, never allowing the planned tightening to materialise.

Under the current formulation of the new borrowing rule, a government that continually promised to tighten in future, but never delivered on those promises, would not technically be judged to be breaking the rule. The government has indicated that, once the public finances are closer to balance – presumably towards the end of the current forecasting horizon – the period over which the rule is judged could be shortened. This would reduce the scope for this problem to materialise, but it would not eliminate it. Furthermore, government plans may quickly lose credibility if they were seen continually to promise but never deliver future pain. Careful independent scrutiny of the

[8] As it turned out, the golden rule would have been met over an economic cycle that ran from 1999–2000 to 2005–06, i.e. Mr Brown's redating of the cycle did not, *ex post*, make the difference between meeting and breaching the rule.

[9] This was first proposed by IFS researchers in section 2.6 of R. Chote and C. Emmerson, 'The fiscal policy framework', in R. Chote, C. Emmerson, D. Miles and Z. Oldfield (eds), *The IFS Green Budget 2005*, IFS Commentary 97 (http://www.ifs.org.uk/budgets/gb2005/05chap2.pdf). The argument has been refined and repeated in more recent Green Budgets.

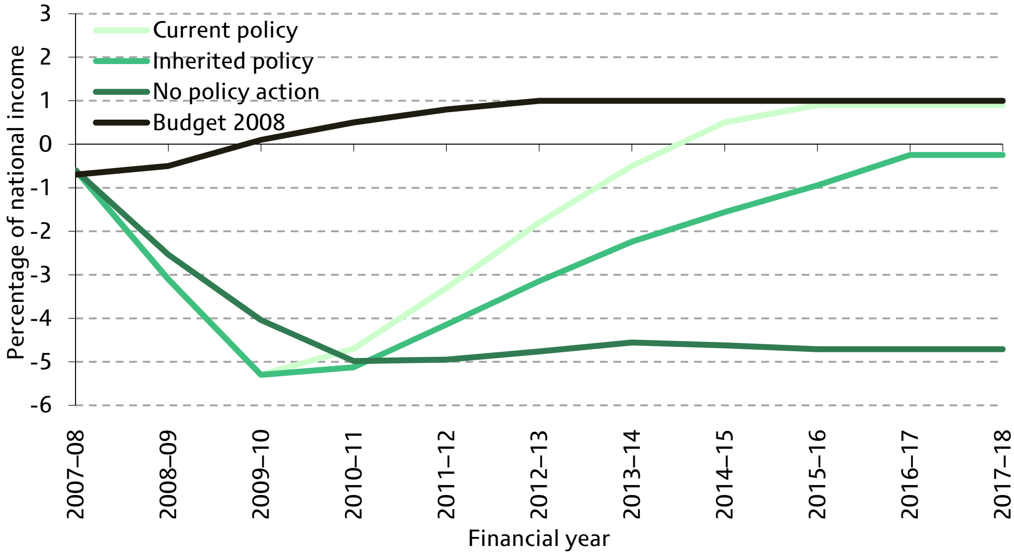
[10] Fiscal drag is the phenomenon whereby, as the economy grows, tax revenues increase as a share of national income. This is because tax thresholds are typically uprated less quickly than growth in the tax base to which they apply.

government's management of the public finances – aided by the increase in transparency and credibility of the official forecasts associated with the introduction of the OBR (discussed in detail in Section 2.5) – will help police a forward-looking rule (with all its attendant benefits) so that any government did not inappropriately manipulate such a target.

Will the UK meet the new golden rule?

Forecasts for the cyclically-adjusted current budget balance, both with and without policy action since Budget 2008, are shown in Figure 2.2. The fiscal mandate requires this to be zero or positive by the end of the forecast horizon (currently 2015–16). At the time of Budget 2008, the cyclically-adjusted current budget was in deficit, but it was forecast to reach surplus in 2009–10 and then level off at a surplus of 1.0% of national income from 2012–13 onwards. So, then Chancellor Alistair Darling's March 2008 Budget forecast was consistent with the new coalition government's fiscal mandate.

Figure 2.2. Cyclically-adjusted current budget balance – with and without policy action since Budget 2008



Notes: Budget 2008 projections assume that the cyclically-adjusted current budget surplus of 1.0% of national income forecast in 2012–13 would have persisted. All other forecasts are based on the OBR's November 2010 *Economic and Fiscal Outlook* projection. 'No policy action' ignores the direct impact of all fiscal policy measures that have been implemented since Budget 2008. 'Inherited policy' takes policy as of the March 2010 Budget.
Sources: As Figure 2.1.

However, as a result of the financial crisis and the associated recession, the structural current budget turned out to be in far greater deficit than was forecast at the time of Budget 2008. Without policy action, the structural current budget would have reached 5% of national income in 2010–11 and would have continued at nearly that level every year in the future. The Labour government reacted to the crisis by introducing a fiscal stimulus package, increasing government spending and reducing government tax revenues in the short term, causing the cyclically-adjusted current budget to reach a deficit of more than 5% a year earlier, in 2009–10.

The new government's planned six-year fiscal consolidation between 2010–11 and 2015–16 will, under current forecasts, be sufficient to bring the cyclically-adjusted current budget into surplus in 2014–15. The structural current budget surplus is forecast to be 0.5% of national income in 2014–15 and 0.9% in 2015–16 – thereby meeting the government's new borrowing target a year earlier than is currently required by the rule.

Clearly, without any policy action, the government's new borrowing rule would not have been met: the structural current budget would still have been in deficit by 4.7% of national income in 2015–16 in the absence of any fiscal consolidation. However, before the general election of 2010, the Labour government had also planned a fiscal tightening, between 2011–12 and 2016–17. The effect of this alternative fiscal consolidation, given current forecasts for the economy and the public finances, is also shown in Figure 2.2. The cyclically-adjusted current budget deficit would have been significantly reduced over this period, but Labour's planned tightening at the time of the March 2010 Budget would not have been sufficient to bring it back into balance by 2015–16.

At the time of the March 2010 Budget, the Labour government had thought its consolidation plan was sufficient to return the cyclically-adjusted current budget to surplus by 2016–17 (i.e. one year later than required by the coalition government's new fiscal mandate). However, more recent forecasts from the new OBR, published since the general election, have suggested that the size of the problem revealed by the financial crisis – that is, the permanent increase in structural borrowing that would have occurred in the absence of any policy action – is slightly greater than was thought in March 2010. As a result, under current forecasts, the Labour government's fiscal consolidation would not have been quite sufficient to return the cyclically-adjusted current budget to surplus in 2016–17.

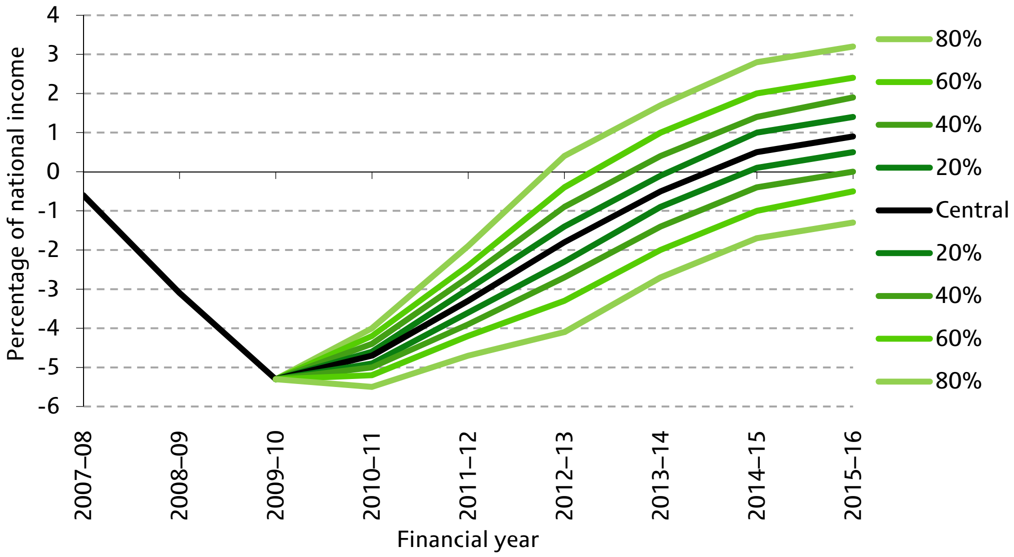
As discussed in more detail in Section 2.5, the government has required the OBR to publish – twice a year – a judgement on whether current policy is consistent with the cyclically-adjusted current budget being in surplus at the end of the forecast horizon. In its November 2010 *Economic and Fiscal Outlook*, the OBR illustrated uncertainty over the cyclically-adjusted current budget using confidence intervals around its central projection. These were calculated on the basis of past forecasting errors made by the Treasury in Pre-Budget Reports (since these, like the latest OBR forecast, were made in the autumn). That is to say, they show the likelihood of future borrowing being in different ranges under the assumption that the OBR's forecasts are as likely to be optimistic as they are pessimistic and that the OBR can be expected to be no better and no worse at forecasting borrowing than the Treasury has been in the past. Therefore, these confidence intervals do not allow for the possibility that forecasts are becoming more accurate over time (for example, due to more advanced human understanding, better data and more powerful processing capability of computers) nor for the possibility that forecasting in the aftermath of a financial crisis and deep recession is harder than forecasting in less turbulent times.[11]

The black line in Figure 2.3 shows the OBR 'central' forecast for the cyclically-adjusted current budget under current policies (the same as the 'current policy' line in Figure 2.2).

[11] The OBR's methodology for computing these forecasts is the same as that recommended by C. Emmerson, C. Frayne and S. Love, 'Updating the UK's Code for Fiscal Stability', IFS Working Paper 04/29, 2004 (http://www.ifs.org.uk/publications/3163). As these authors point out, another problem arising when comparing forecasts with eventual out-turns for borrowing, without taking account of the impact of new policy changes made between the date of a forecast and the eventual out-turn for borrowing, is that it is likely to understate the size of previous forecasting errors. This is because Chancellors are likely to implement a fiscal tightening (loosening) when borrowing looks like it is going to overshoot (undershoot) their previous forecast, thereby bringing the eventual out-turn closer to the original forecast. The OBR should consider adjusting the previous forecasts for the impact of subsequent measures both to describe the size of errors made previously and for computing the confidence intervals on its projections.

Figure 2.3 shows there is a 20% probability that the outcome will lie within the darkest green bands either side of the central forecast, a 40% chance it will lie within the next darkest bands, and so on. There is a 69% chance (based on past forecasting performance) that the cyclically-adjusted structural current budget will be in balance or surplus in 2015–16.[12]

Figure 2.3. Cyclically-adjusted current budget fan chart



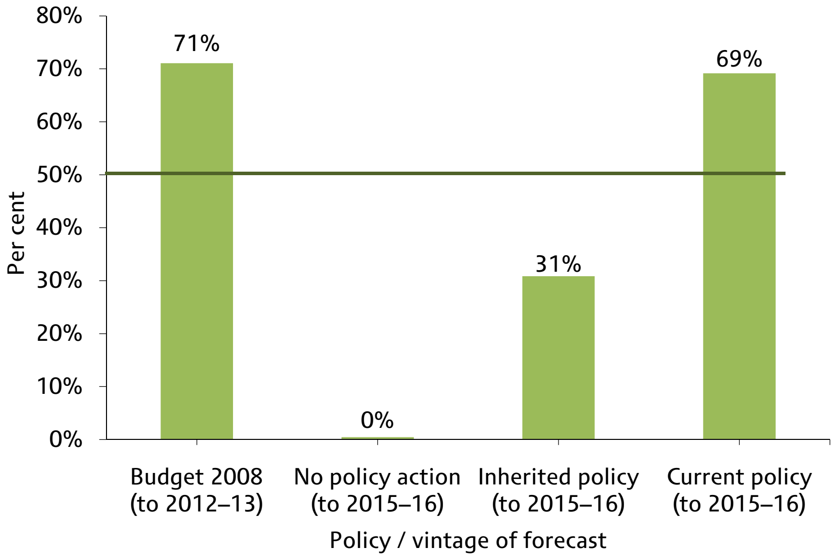
Source: Chart 5.1 (page 135) of Office for Budget Responsibility, *Economic and Fiscal Outlook,* November 2010 (http://budgetresponsibility.independent.gov.uk/econ-fiscal-outlook.html).

In Figure 2.4, we compare the government's chance of achieving a cyclically-adjusted current budget balance or surplus under current policies with the forecast chance under the other policy scenarios shown in Figure 2.2, assuming the same degree of uncertainty existed around these other central forecasts as the OBR has assumed exists around its forecasts. Under the March 2008 Budget forecasts – that is, the last forecast before the financial crisis and the associated recession struck – there was a 71% chance that there would be a cyclically-adjusted surplus in 2012–13 (which was then the last year of the forecast horizon). Had no post-crisis fiscal tightening been planned, there would have been a negligible chance of a surplus on the cyclically-adjusted current budget by 2015–16. Had the new government instead chosen not to alter the fiscal consolidation plan that had been announced by Labour in the March 2010 Budget, this would have risen to a 31% chance by 2015–16 (and would probably be closer to, but still below, 50% if the forecast horizon had been extended one more year to 2016–17).

The coalition government's policies therefore give it some headroom against the chances of the current budget being in deficit in 2015–16, which would not have been the case had it retained the fiscal tightening planned by the previous Labour government. However, past forecasting errors suggest that there is still a three-in-ten chance that there will still be a cyclically-adjusted current budget deficit by the time we get to 2015–16.

[12] It is the fact that the government is aiming to overachieve its fiscal mandate by 0.9% of national income (that is, the latest OBR forecasts suggest a cyclically-adjusted current budget surplus of 0.9% of national income in 2015–16, rather than a cyclically-adjusted current budget balance) that means that it has an estimated 69% chance of a cyclically-adjusted surplus. As the OBR assumes its forecasts are as likely to prove optimistic as pessimistic, if the government had aimed to meet its fiscal mandate with no headroom then the OBR would have assessed it to have a 50% chance of a cyclically-adjusted balance or surplus in 2015–16.

Figure 2.4. Likelihood of a surplus on the cyclically-adjusted current budget by the end of the forecast horizon



Sources: As Figure 2.1; authors' calculations using table B.1 (page 151) of Office for Budget Responsibility, *Economic and Fiscal Outlook,* November 2010 (http://budgetresponsibility.independent.gov.uk/econ-fiscal-outlook.html).

Specific risks to public borrowing

There are many sources of uncertainty that could cause the public finances to differ from their forecast path. These include the following:

- The financial crisis and associated recession may have had a larger impact on the sustainable level of output in the UK than official forecasts currently assume.
- The public finances might not evolve as the OBR currently forecasts even if the economy were to grow as it expects.

The financial crisis and associated recession may have had a larger impact on the sustainable level of output in the UK than the official forecasts from the OBR currently assume, as discussed in Chapter 1. This would result in the output gap being smaller and, other things remaining equal, a greater proportion of total borrowing, and of the current budget deficit, being estimated to be structural as opposed to cyclical. If a larger proportion of the forecast current budget deficit turned out to be structural, the government would have a smaller margin of error against its fiscal mandate under current policies than the OBR currently estimates. The Treasury's methodology for assessing the impact of an output gap on borrowing implies that a 1% permanent loss in output would structurally weaken the public finances by 0.7% of national income.[13] This estimate, which has since been used by the OBR, implies that an additional 1.3% loss of potential output would eliminate the 0.9% of national income cyclically-adjusted current budget surplus that is forecast by the OBR for 2015–16.[14]

[13] See HM Treasury, *Public Finances and the Cycle*, Treasury Economic Working Paper 5, November 2008 (http://webarchive.nationalarchives.gov.uk/+/http://www.hm-treasury.gov.uk/d/pbr08_publicfinances_444.pdf).

[14] Calculated as 0.9 / 0.7 = 1.3.

Another source of uncertainty is that the public finances might not evolve as the OBR has forecast even if the economy were to. In 1998, the Treasury published estimates of the average absolute errors in forecasting public sector net borrowing that it had made over the period from 1985–86 and also calculated how large the errors would have been had the Treasury correctly forecast the macroeconomy.[15] This found an average error in public sector net borrowing one year hence of 1.2% of national income, of which 1.0% of national income was not explained by errors in forecasting the macroeconomy. Errors in the macroeconomic forecast were relatively more important for longer-run projections, but they still explained only a minority of the total fiscal forecast error. For example, among the forecasts made for four years hence, the average absolute error in forecasting public sector net borrowing was 4.1% of national income, with 2.4% of national income not explained by errors in forecasting the macroeconomy.

One way to consider the uncertainty over how a given level of growth in the economy in the next few years will impact on the public finances is to make different assumptions over how the size of the output gap affects the public finances. To date, the OBR has continued to use the same estimates as produced by the Treasury.[16] The assumed relationship is that to adjust headline borrowing for the economic cycle, you need to add 0.2 times the previous year's output gap and 0.5 times the current year's output gap. On this basis, the headline level of borrowing of 10.0% of national income forecast for 2010–11, in combination with a negative output gap of 4.2% of trend output in 2009–10 falling to 3.2% in 2010–11, leads to an estimate of cyclically-adjusted public sector net borrowing of 7.6% of national income (i.e. 2.4% of national income of borrowing is estimated to be explained by temporary weakness in the economy).[17] As investment spending (net of depreciation and asset sales) is forecast to total 2.9% of national income, this leaves a cyclically-adjusted (or structural) deficit on the current budget of 4.7% of national income.

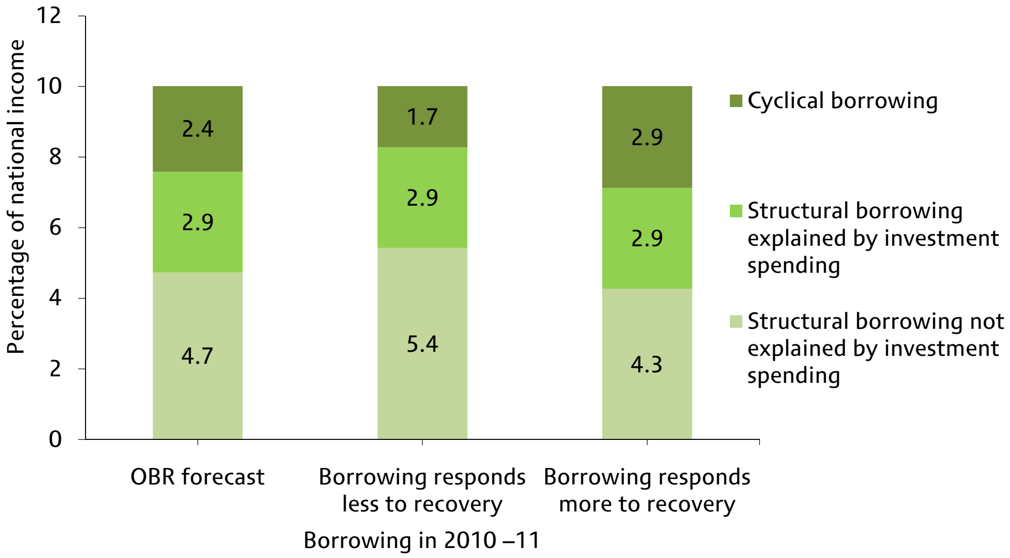
But the 0.5 and 0.2 parameters are estimates, rather than being known with certainty. Thus, even if we were certain about the headline level of borrowing this year, and the level of output gap last year and this year, there is uncertainty about what fraction of total borrowing is structural rather than cyclical. Based on the analysis carried out by the Treasury – that is, assuming we were confident that the Treasury's methodology was completely correct – our calculations suggest that there is a 95% chance that the cyclically-adjusted deficit on the current budget actually lies somewhere between 4.3% of national income and 5.4% of national income. This is shown in Figure 2.5 (with the notes to Figure 2.5 setting out our methodology). Uncertainty over the headline level of borrowing this year, the size of the output gap (as quantified above), and whether the Treasury's methodology is indeed the correct one would increase this range further. But even as it is, the 0.7% of national income difference between the 4.7% of national income OBR forecast for cyclically-adjusted current budget deficit in 2010–11 and the higher estimate of 5.4% – which assumes that the public finances are less affected by the

[15] See table B13 (page 122) of HM Treasury, *Pre-Budget Report*, November 1998 (http://webarchive.nationalarchives.gov.uk/+/http://www.hm-treasury.gov.uk/prebud_pbr98_repindex.htm).

[16] The Treasury's estimates are based on an assessment of how borrowing has varied over the ups-and-downs of previous economic cycles. See HM Treasury, *Public Finances and the Cycle*, Treasury Economic Working Paper 5, November 2008 (http://webarchive.nationalarchives.gov.uk/+/http://www.hm-treasury.gov.uk/d/pbr08_publicfinances_444.pdf).

[17] Calculated as $10.0 + 0.5\times(-3.2) + 0.2\times(-4.2) = 7.6$.

Figure 2.5. Different estimates for structural and cyclical borrowing in 2010–11



Notes: The Treasury's method suggests that cyclically-adjusted borrowing is equal to headline borrowing plus 0.5 times the contemporaneous output gap and 0.2 times the lagged output gap. We assume the Treasury is correct in assuming a 'denominator' effect of economic growth on total public spending of 0.4 times the contemporaneous output gap. For the remaining 'numerator' effects, we take the 95% confidence interval of the weighted sum of the estimated regression coefficients for how cyclical social security, debt interest spending and government receipts vary with the economic cycle (under the assumption that these estimates are independent). This gives a 'less responsive' estimate that cyclically-adjusted borrowing is equal to headline borrowing plus 0.43 times the contemporaneous output gap and 0.09 times the lagged output gap, and a 'more responsive' estimate of 0.55 and 0.27 respectively.
Source: Authors' calculations using results set out in HM Treasury, *Public Finances and the Cycle*, Treasury Economic Working Paper 5, November 2008 (http://webarchive.nationalarchives.gov.uk/+/http://www.hm-treasury.gov.uk/prebud_pbr08_publicfinances.htm) (in particular tables 2.B, 2.C and 2.D) and the forecasts for borrowing, net investment and the output gap from Office for Budget Responsibility, *Economic and Fiscal Outlook,* November 2010 (http://budgetresponsibility.independent.gov.uk/econ-fiscal-outlook.html).

economic cycle – would be sufficient to eliminate most of the 0.9% of national income room for manoeuvre that the Chancellor has built in against his fiscal mandate.

Summary

The Chancellor has set a new fiscal mandate: the structural current budget must be forecast to be in balance or in surplus by the end of a rolling, five-year forecast horizon. The OBR forecasts that the government's policy will more likely than not lead to a cyclically-adjusted current budget surplus in 2015–16 and therefore assesses that current policy complies with the Chancellor's fiscal mandate. In contrast, the policies that the government inherited from its predecessor would have been inconsistent with the new mandate. But there are considerable risks to, and therefore uncertainty around, any fiscal forecast. The OBR estimates that, on the basis of past forecasting performance, there is still roughly a three-in-ten chance of current policies not being sufficient to bring about a cyclically-adjusted current budget surplus in 2015–16.

2.4 The new debt profile target

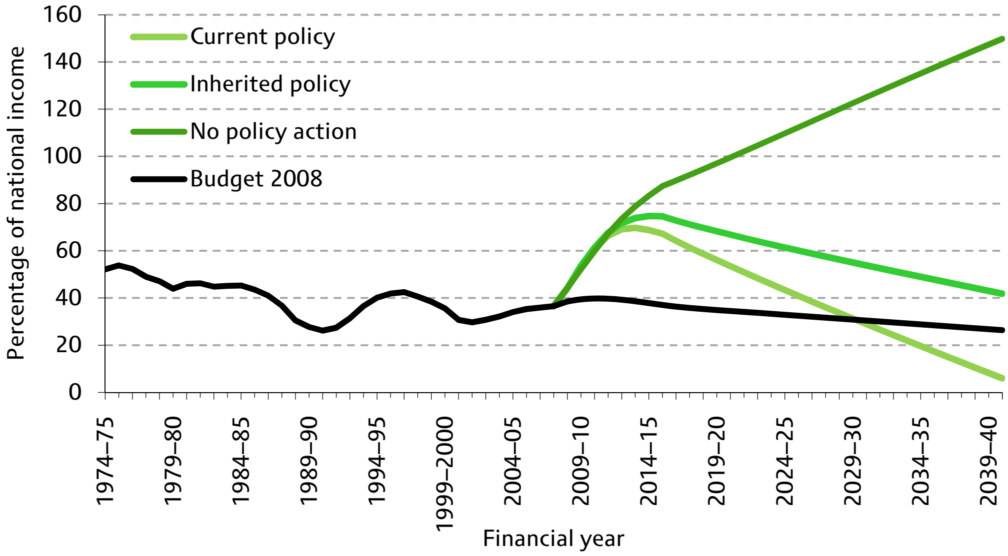
The government's 'fiscal mandate' sits alongside a 'supplementary target': that public sector debt should be falling as a share of national income at the fixed date of 2015–16.

This section assesses whether this target will be met according to the latest OBR forecasts and under alternative scenarios. As this target is only a goal through to 2015–16, this section ends by discussing how one should choose a longer-term target consistent with fiscal sustainability.

Meeting the new debt profile target?

The path of debt implied by the forecasts published at the time of Budget 2008 (before the financial crisis) is shown in Figure 2.6, along with the likely path of debt under three other scenarios: current policy, assuming no policy had been introduced since Budget 2008, and assuming that the new government chose to follow the previous Labour government's policies as set out in the March 2010 Budget. For the years beyond the standard five-year forecast horizon, the figure assumes that the primary balance – that is, borrowing less debt interest spending – is held constant as a share of national income (a standard assumption to make in these types of analyses).[18]

Figure 2.6. Debt forecasts – with and without policy action since Budget 2008



Notes: Forecasts for debt levels assume that non-debt interest spending and revenues remain constant as a share of national income from 2017–18 onwards, while inflation is assumed to run at 2.7% a year and real growth in national income at 2.2% a year. Average nominal interest rates are assumed to rise from 4.1% (the level forecast in the November 2010 *Economic and Fiscal Outlook* for the end of the OBR's forecast horizon, 2015–16) to 4.4% between 2017–18 and 2027–28. From 2027–28 onwards, nominal interest rates are assumed to remain at 4.4%. 'No policy action' ignores the direct impact of all fiscal policy measures that have been implemented since Budget 2008. 'Inherited policy' takes policy as of the March 2010 Budget.
Sources: Historical data are from HM Treasury, *Public Sector Finances Databank*, 11 January 2011 (http://www.hm-treasury.gov.uk/d/public_finances_databank.xls). Forecasts are authors' calculations using all Budgets and Pre-Budget Reports since March 2008 (up to the March 2010 Budget are available at http://webarchive.nationalarchives.gov.uk/20100407010852/http://www.hm-treasury.gov.uk/home.htm; June 2010 Budget is available at http://www.hm-treasury.gov.uk/) and the Office for Budget Responsibility's November 2010 *Economic and Fiscal Outlook* (http://budgetresponsibility.independent.gov.uk/econ-fiscal-outlook.html).

[18] In cases where the economy was not forecast to be operating at trend at the end of the forecast horizon, we actually allow for some improvement in the primary balance beyond the end of the forecast horizon while the economy returns to trend. The primary balance is held constant thereafter.

Mr Darling's March 2008 Budget forecast was for public sector net debt to remain just below the 40% of national income ceiling set by the sustainable investment rule that had been announced by his predecessor, Mr Brown.

In the absence of any policy to deal with the permanent increase in borrowing that was brought about by the financial crisis, debt would have risen sharply as a share of national income, reaching over 87% of national income in 2015–16 and continuing to rise thereafter. Such a scenario would clearly not be consistent with the coalition government's target for falling debt in 2015–16. More fundamentally, such a scenario would, in all likelihood, have led to the UK government being forced into a combination of tax rises and spending cuts, as international investors became unwilling to lend the UK government funds at anything other than prohibitively expensive rates of interest (see Chapter 3 for a discussion of the factors, including high and increasing debt, that are associated with such an event occurring).

The Labour government's plans from Budget 2010 were not quite sufficient to offset completely the increase in the structural current deficit resulting from the crisis implied by the latest OBR forecasts (as was shown in Figure 2.2), but they would have been (just) sufficient to bring about a decline in the national debt each year from 2015–16 onwards. Therefore, if delivered, the fiscal consolidation set out in the March 2010 Budget would be forecast now to leave public sector net debt on a sustainable path and would have meant the government would now be on course to meet the supplementary target for falling debt in 2015–16, although the decline in 2015–16 would have been just 0.1% of national income.

The current government's plan is for a greater and faster fiscal tightening than the Labour government had planned, and therefore debt is currently forecast to be declining from 2014–15, a year earlier than what we estimate would have occurred under the inherited fiscal consolidation package, and a year earlier than the government's supplementary target requires. The decline in 2015–16 is also forecast to be a much more convincing one, of about 1.6% of national income. Despite this faster decline, public sector net debt is not forecast to fall back below the pre-crisis ceiling of 40% of national income until the mid-2020s. This is, however, at least 15 years sooner than we estimate would have been the case under the fiscal consolidation package that the government inherited from its Labour predecessor.

Given that the government is meeting its fiscal mandate for the forecast structural current budget to be in balance or better, it is unsurprising that it is also on course to meet its supplementary target for falling debt in 2015–16. This is because forecasting a structural current budget balance (or surplus) in 2015–16 will be sufficient to imply a forecast of falling debt as a share of national income in that year for any plausible investment plan. For example, if the OBR's *Economic and Fiscal Outlook* forecasts prove correct to 2014–15, and if the structural current budget was in balance in 2015–16 (rather than in surplus by 0.9% of national income as the OBR currently forecasts), then investment spending would still need to exceed the planned 1.3% of national income by 1.8% of national income for public sector net debt not to fall.[19]

[19] The debt falling condition requires:

$$d_t\left(\frac{r-g}{1+g}\right) < ps_{t+1}$$

where d_t is the debt to GDP ratio in period t, r is the nominal interest rate, g is the nominal growth rate of GDP and ps_{t+1} is the primary surplus (as a share of national income) in period t+1. *(footnote continues)*

The greater risks are likely to come from the OBR's fiscal forecasts turning out not to be accurate, although the risk to the supplementary target being threatened given a cyclically-adjusted budget balance is low. If all other forecasts proved to be correct up to 2014–15, then the nominal growth rate of the economy in 2015–16 would have to be around 2.4 percentage points lower (3.1% instead of the currently forecast 5.5%) for the supplementary target not to be met, or, alternatively, the average nominal interest rate on the national debt would need to be about 2.5 percentage points higher.

Options for a longer-term debt target

The supplementary target for the profile of debt applies to one year only. If debt were to fall as a share of national income in 2015–16, but increase in every year up to then and in every year after then, the supplementary target would still be satisfied. Therefore, it is not a sufficient rule – even when combined with the government's fiscal mandate, discussed in the previous section – to ensure fiscal sustainability. After 2015–16 has passed, the supplementary target will no longer be relevant.

Sensibly, the government intends to replace the current supplementary target for the profile of debt in the long term when debt has been brought back down to more 'normal' levels. The current intention is to introduce a new target for debt as a share of national income that is based on an assessment by the OBR of the long-term sustainability of the public finances (the requirement for the OBR to carry out this assessment is discussed in Section 2.5).

This subsection sets out two key issues that need to be considered when setting such a target. First, the government needs to consider the possible impact on public sector net debt of an ageing population. Second, the government needs to consider the case for targeting a broader measure of public sector indebtedness than public sector net debt and, potentially, the case for targeting the cost of servicing that indebtedness rather than the headline level of debt itself.

An ageing population and the public finances

The government's fiscal consolidation is forecast to be sufficient to deal with the short-term pressures arising from the financial crisis and bring debt as a share of national income onto a declining, sustainable path. But the government should – and the OBR will (as discussed in Section 2.5) – also consider longer-term pressures on the public finances. One such pressure is changing demographics: the increasing numbers at older ages, and the fact that they will comprise a larger share of the population, will tend to increase public spending, particularly on health, long-term care and state pensions. If the government does not offset these increases in spending by raising tax revenues or by cutting other areas of public spending, then this will cause higher government borrowing.

An estimate of the impact of these ageing pressures (assuming they are not offset) on debt is shown in Figure 2.7.[20] From the 2020s, the increase in age-related expenditure

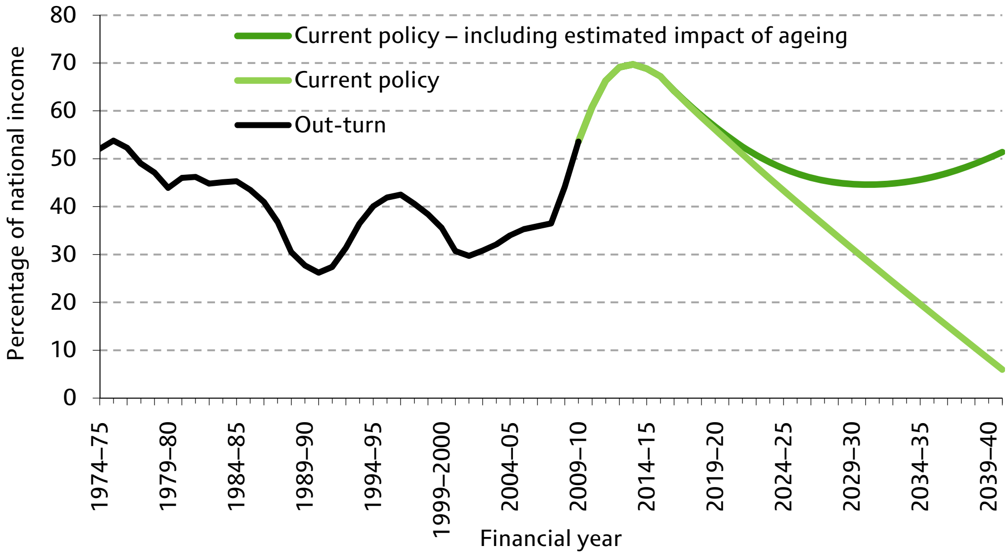
Under the OBR forecasts: nominal growth in 2015–16 is 5.5%, debt in 2014–15 is 68.8% of national income, and the average nominal interest rate on government borrowing is 4.1%. This implies that the minimum allowable primary balance in 2015–16 for debt to be falling is a deficit of 0.9%, compared with the forecast surplus of 1.8%. For debt to be falling therefore requires the primary balance to be 2.7% of national income worse than forecast. 0.9% of national income of this could come from the structural current budget being in balance rather than the forecast 0.9% of national income surplus, but the rest would have to come from greater-than-forecast investment spending.

[20] This uses the estimates of the increase in borrowing arising from an ageing population described by the OBR in table 5.6 (page 145) of its *Economic and Fiscal Outlook*, November 2010 *(footnote continues)*

would be sufficient to start a noticeable slowdown in the reduction of debt as a share of national income, and from the start of the 2030s debt is likely to start increasing again.

This suggests that, without further spending cuts or tax rises over and above those already announced, the ageing population will lead to increased spending and hence borrowing and this will be sufficient to prevent public sector net debt from falling back to below pre-crisis levels. Therefore, the government will need to consider the extent to which it is prepared to tolerate a future path for debt that is above that which existed before the financial crisis, and how this compares with its willingness to announce further tax rises and spending cuts in order to limit this situation.

Figure 2.7. Debt forecasts – with and without estimated impact of an ageing population



Notes: As for Figure 2.6. The forecast including the impact of demographic pressures assumes that the primary balance changes from year to year, beyond 2016–17.
Sources: As for Figure 2.6. Impact of long-term demographic pressures on the primary balance taken from table 5.6 of Office for Budget Responsibility, *Economic and Fiscal Outlook*, November 2010 (http://budgetresponsibility.independent.gov.uk/d/econ_fiscal_outlook_291110.pdf).

A 'sustainable commitments rule'?

The key rationale for a debt ceiling is to limit the impact on future taxpayers of tax and spending decisions made today. This could be justified both on the grounds of ensuring financial sustainability and on the grounds of fairness. Specifically, it might be deemed inappropriate to pre-commit too great a share of national income to, for example, service debt that has been accumulated in the past even if that debt is used to finance investment projects from which future generations will benefit.

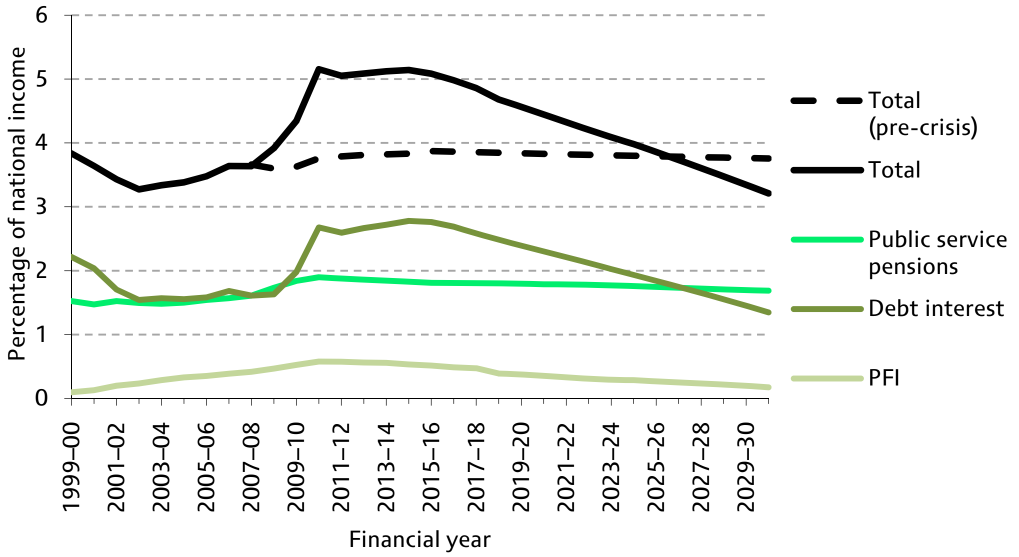
But if it is the burden on taxpayers that is of concern, then we should perhaps focus on the cost of servicing the debt they will have to pay, rather than on the outstanding stock of debt itself. The key difference is that the first depends upon the rate of interest: if the long-term rate of interest at which the government can borrow falls (rises), it would seem reasonable to carry out more (fewer) investment projects from which current and future

(http://budgetresponsibility.independent.gov.uk/d/econ_fiscal_outlook_291110.pdf) and is similar to the analysis the OBR presented in its chart 5.6 (page 146).

taxpayers can benefit. A ceiling on public sector net debt would not allow this, but a ceiling on public sector net debt interest payments would.

For this reason, IFS researchers have argued that the government should consider a target for the amount of future national income that is pre-committed to certain items – dubbed a 'sustainable commitments rule' – rather than (or perhaps alongside) a ceiling on headline debt.[21] A further advantage of such a rule is that it would also lend itself more easily to the inclusion of some of the other commitments that the public sector has made that are not scored in public sector net debt (since the estimates will not be sensitive to the choice of discount rate). For example, both spending on future public service pension payments and payments to Private Finance Initiative (PFI) providers could be included, as both represent pledges made by current governments that future governments will have to – or will be strongly expected to – honour.

Figure 2.8. A possible 'sustainable commitments rule': some projected future public spending obligations



Sources:
Debt interest is public sector net debt interest (i.e. gross interest paid less gross interest received). Data to 2008–09 are calculated as the difference between ONS series ANLO and ANBQ from table 2.3C of *Financial Statistics Freestanding Time Series Data* (http://www.statistics.gov.uk/statbase/tsdtimezone.asp). Figures for 2009–10 to 2015–16 are from OBR public finances supplementary tables 1.11 and 1.12 which accompanied the November 2010 *Economic and Fiscal Outlook* (http://budgetresponsibility.independent.gov.uk/econ-fiscal-outlook.html). Projections beyond 2015–16 are calculated on the same basis as the data in Figure 2.6.
Public service pension spending is taken from figure 4.A (page 64) of Independent Public Service Pensions Commission, *Independent Public Service Pensions Commission: Interim Report*, 2010 (http://www.hm-treasury.gov.uk/indreview_johnhutton_pensions.htm).
PFI commitments from 1999–2000 to 2009–10 are computed from HM Treasury, *PFI Signed Projects List – February 2010* (http://www.hm-treasury.gov.uk/d/pfi_signed_projects_list.xls). Figures from 2010–11 are from table 2.8 (page 26) of Office for Budget Responsibility, *Budget 2010: The Economy & Public Finances – Supplementary Material*, June 2010 (http://budgetresponsibility.independent.gov.uk/d/junebudget_supplementary_material.pdf).
Pre-crisis estimates taken from the 'Budget 2007' line in figure 5.9 of R. Chote, C. Emmerson and G. Tetlow, 'The fiscal rules and policy framework', in R. Chote, C. Emmerson, D. Miles and J. Shaw (eds), *The IFS Green Budget: January 2009*, IFS Commentary 107 (http://www.ifs.org.uk/budgets/gb2009/09chap5.pdf).

[21] See pages 101–106 of R. Chote, C. Emmerson and G. Tetlow, 'The fiscal rules and policy framework', in R. Chote, C. Emmerson, D. Miles and J. Shaw (eds), *The IFS Green Budget: January 2009*, IFS Commentary 107 (http://www.ifs.org.uk/budgets/gb2009/09chap5.pdf).

Our latest estimates for total future public spending commitments on debt interest payments, public service pensions and payments to PFI providers, all based on official sources, are shown in Figure 2.8. Debt interest payments are projected by the OBR to increase from 1.6% of national income in 2007–08 (prior to the financial crisis) to 2.8% of national income in 2014–15. Our calculations suggest that these will then decline over time and return to 1.6% of national income in the late 2020s.

Figures produced by the Independent Public Service Pensions Commission (IPSPC) and the Government Actuary's Department for the IPSPC's recent interim report suggest that spending on public service pensions will increase from 1.5% of national income in 2004–05 to a peak of 1.9% of national income in 2010–11 before declining gradually through to the middle of this century.

Payments to PFI providers for deals already signed have increased steadily from 0.1% of national income in 1999–2000 (as capital spending by the PFI has grown in scale) and are forecast by the Treasury to peak at 0.6% of national income in 2010–11 before declining gradually over time. However, the signing of any new deals would increase future payments beyond the levels shown here; at the time of the June 2010 Budget (when these figures were produced), the Treasury estimated that there were PFI deals with a capital value of £10.8 billion yet to be signed but at 'preferred bidder' stage.[22]

The total of these three streams of payments is estimated to have increased in recent years, with a particularly sharp increase from 3.6% of national income in 2007–08 to 5.2% of national income in 2010–11. They are projected to stabilise around this higher level until the middle of this decade before declining over time. Also shown in Figure 2.8 is the equivalent pre-committed spending total estimated by IFS researchers based on data from before the financial crisis hit, which suggested that it would remain below 4.0% of national income.

The idea of a 'sustainable commitments rule' would need further investigation before being put forward as a firm policy proposal. But it would seem to have the strengths of Mr Brown's sustainable investment rule objective of targeting public sector net debt, along with the additional advantages of allowing higher government borrowing when such finance was cheaper and of taking into account a more comprehensive set of commitments affecting future taxpayers. Which commitments should be encompassed by such a rule would need to be considered very carefully, as would the choice over the appropriate level (or path) of the ceiling on these commitments. Were the government to move towards such a target, official forecasts for public sector net debt as well as other measures of the state of the public finances such as 'net worth' and the 'primary balance' should, nonetheless, continue to be published.

2.5 The Office for Budget Responsibility

In an attempt to enhance the credibility of its fiscal policy commitments, the coalition government has set up an independent Office for Budget Responsibility.[23] This body has taken over responsibility for producing and publishing official economic and fiscal

[22] Table 2.7 (page 26) of Office for Budget Responsibility, *Budget 2010: The Economy & Public Finances – Supplementary Material*, June 2010 (http://budgetresponsibility.independent.gov.uk/d/junebudget_supplementary_material.pdf).

[23] See http://budgetresponsibility.independent.gov.uk/ and http://www.hm-treasury.gov.uk/leg_budgetresponsibility_bill.htm for details.

forecasts from Treasury ministers. The UK is one of a number of countries to have adopted such an independent fiscal council in recent years; Sweden, Canada, Hungary and Slovenia have also all created similar bodies over the last four years. These in turn follow the example of bodies such as the Central Planning Bureau (CPB) in the Netherlands and the Congressional Budget Office (CBO) in the United States.

Though the structure and remit of each of these bodies are all slightly different, the broad aims are the same. Essentially, there is a concern that politicians are prone, or are perceived to be prone, to undervalue the longer-term costs of borrowing – perhaps because of pressure from special interest groups or political short-termism – which causes them to allow excessive debt accumulation.[24] Even if politicians sign up to fiscal rules which theoretically constrain the amount of borrowing they are allowed to do (such as Mr Osborne's fiscal mandate and supplementary target discussed above), the complex nature of economic and fiscal forecasting is such that the electorate finds it hard to hold governments to account. If the electorate prefers less borrowing than politicians do, politicians have an incentive to produce optimistic fiscal forecasts to hide their intention to borrow excessively. (It is also possible that, immediately after a change of government, politicians might have an incentive to produce deliberately pessimistic forecasts in order to increase the chance that the new government will be able to announce better-than-expected performance in subsequent budgets.)

Deviations from forecasts could indicate either that the initial forecasts were intentionally misleading or that unforeseen events occurred after the forecasts were produced. This in turn also has a cost for prudent governments: though they may be committed to maintaining sound public finances, they may struggle to convince the electorate and market actors of this, and so may not be fully rewarded for behaving virtuously. This was a key rationale behind Mr Brown's decision to place a lot of personal political capital on his pledge to meet two fiscal rules on becoming Chancellor in 1997: he wanted to convince others that he would not repeat the perceived mistakes of some previous Labour Chancellors.

Fiscal councils are intended to help improve scrutiny of the government's fiscal intentions by providing a transparent and independent assessment of the economic and fiscal position and forecasts. By increasing transparency and credibility, they can complement fiscal rules. The desire for this reform in the UK in part reflects that the fiscal promises of the previous Labour government were undermined by the moving of the goalposts that occurred just as Mr Brown's golden rule looked on course to be missed rather than met (discussed in Section 2.3), and that fiscal forecasts reflected politically-motivated wishful thinking rather than dispassionate professional judgement – notably in the run-up to the 2005 general election.

The remit of the OBR is to:[25]

- examine and report on the sustainability of the public finances;

---

[24] A number of previous papers have discussed the reasons behind excessive government debt accumulation and the arguments for independent fiscal councils. See L. Calmfors, *The Role of Independent Fiscal Policy Institutions*, 2010 (http://www.finanspolitiskaradet.se/download/18.64075cf012c96962a7d800012034/Underlagsrapport+9+2010+Calmfors.pdf) for a useful summary of these.

[25] This list is based on the wording of legislation currently going through parliament. The final remit of the OBR may differ. Source: Budget Responsibility and National Audit Bill [HL] 2010–11 (http://services.parliament.uk/bills/2010-11/budgetresponsibilityandnationalaudithl.html).

- produce fiscal and economic forecasts, and provide an assessment of the extent to which the fiscal mandate has been or is likely to be achieved, on at least two occasions each financial year;
- prepare an assessment, at least once a year, of the accuracy of economic and fiscal forecasts previously prepared by it;
- prepare an analysis, at least once a year, of the sustainability of the public finances;
- examine the impact of decisions made by the government on the sustainability of the public finances, but not comment on the merits of individual policies or examine alternative policy scenarios;
- act objectively, transparently and impartially.

The OBR's funding allocation has been fixed, for the four years covered by the recent Spending Review (2011–12 to 2014–15), at £1.75 million a year. Having such certainty over funding is an important part of establishing an independent fiscal council. It is more likely that such a fiscal council will feel able to act – and will be perceived as being able to act – without let or hindrance from the government if it is certain that comments that are detrimental to the government will not lead to its funding being cut. The recent experience of the Hungarian Fiscal Council – which faces the prospect of its budget for 2011 being cut by nearly 99%, from 835.5 million forints to just 10 million forints – suggests that this risk can be all too real.[26]

The OBR in practice

The OBR produces forecasts for the economy and public finances using resources similar to those previously used by the Treasury. Importantly, the OBR has access to all the same data, expertise and models as the Treasury. The forecasting judgements are made by the three-person Budget Responsibility Committee (BRC), which comprises Robert Chote (Chairman), Stephen Nickell and Graham Parker. Previously, such forecasting judgements were the responsibility of the Chancellor. The OBR is now charged with publishing these forecasts and the Chancellor can either accept them or, in theory, reject them and use his or her own.

Three OBR forecasts have been published since the general election in May 2010. The first two were a pre-Budget report (in June 2010 – preceding the government's emergency Budget) and a Budget forecast (accompanying the June 2010 Budget). Both of these were carried out by an interim OBR, with an interim BRC comprising Sir Alan Budd (Chairman), Geoffrey Dicks and Graham Parker. Since then, the permanent OBR has produced an *Economic and Fiscal Outlook* (in November 2010), which is the latest set of official forecasts. In addition, it provided independent scrutiny and certification of the government's costings of Annually Managed Expenditure (AME) policies in the October 2010 Spending Review.

In the future, it seems likely that the OBR will publish four types of analysis (all of which were previously published at least semi-regularly by the Treasury):

- economic and fiscal forecasts, an assessment of the cost of any new policies, and a judgement on compliance with the fiscal mandate and supplementary target, at the time of the government's Spring Budgets;

[26] 'Hungary to disband Fiscal Council', *Wall Street Journal*, 22 November 2010 (http://blogs.wsj.com/new-europe/2010/11/22/hungary-to-disband-fiscal-council/).

- economic and fiscal forecasts and a judgement on compliance with the fiscal mandate and supplementary target in the autumn; the Chancellor has reserved the right to announce new policy measures at this time, the costings of which would also need to be approved by the OBR;
- an annual end-of-year fiscal report, examining how fiscal out-turns for the last financial year compare with previous forecasts;
- an annual long-term fiscal sustainability report, examining long-term pressures facing the public finances.

Most of the forecasts produced by the OBR are, like all economic forecasts, likely to prove to be inaccurate. Therefore, in order for the OBR to build its reputation, it should take as much advantage as possible of the required end-of-year fiscal report to conduct and communicate detailed analysis of how and why outcomes deviated from the forecasts. Informing the public about the extent to which errors made in forecasts were unavoidable, due to the inherent nature of the task at hand, or were avoidable and therefore will not be repeated again, will be an important part of the OBR's role. This should help to increase confidence that the forecasts were not intentionally misleading and that any lessons that can be learnt are being learnt.

It would be sensible for the OBR to commit to a regular timetable for these. Mr Chote, in evidence to the Treasury Select Committee in December 2010, confirmed that the first OBR long-term fiscal sustainability report will be published in June or July 2011.[27] The end-of-year fiscal report cannot be produced before full out-turn data become available, and it would seem sensible – both to spread workload and to ensure appropriate attention is paid to it – to avoid publishing it at the same time as any of the other statements (meaning that September might be the most obvious month to choose).

Interaction between the OBR and the government

The Treasury does retain a copy of the economic and fiscal forecasting models that now also reside at the OBR. However, if the OBR takes the lead in producing these forecasts, fewer resources may be devoted to maintaining this skill base at the Treasury. Therefore, over time, the OBR could end up being the only government or parliamentary body with sufficient resources to produce detailed economic and fiscal forecasts (or at least being substantially better placed than other official bodies to produce such forecasts). This would have the advantage of avoiding costly duplication of tasks. However, it would have the cost that the government – when deciding whether, and what, additional policy measures might be required – would not have the same forecasting expertise to draw on. It would be necessary, therefore, for the government to know what the OBR's forecasts are before it can decide exactly what policy measures it can or should implement – whether this is giving away extra money if the outlook improves, or announcing further tax increases or spending cuts if the OBR thinks that current policy is not consistent with meeting the Chancellor's fiscal mandate. This exchange of information could happen in a number of different ways and there are advantages and disadvantages to each of them, from the OBR's, the government's and the public's perspectives.

At one extreme, the OBR could decide to have no private interaction with the government at all. It would produce its forecasts independently and then make them publicly

[27] R. Chote, evidence to the Treasury Select Committee, 6 December 2010 (http://www.publications.parliament.uk/pa/cm201011/cmselect/cmtreasy/uc664-i/uc66401.htm).

available, including stating whether current policy was consistent with the Chancellor's fiscal mandate. The government could then decide what action to take in its next Budget. The advantage of this approach is that it would probably help maximise the appearance of independence for the OBR. There should be little suspicion that the OBR has been coerced by ministers into making suboptimal forecasting assumptions. However, there are at least two disadvantages:

- First, the government would potentially be put in the position of the OBR stating publicly that fiscal policy was not consistent with meeting the fiscal mandate before it had had a chance to decide how to deal with this problem. This is almost certainly undesirable from the government's point of view but might also be undesirable for the country more generally if it led to periods of greater uncertainty about the stability of the UK's public finances.
- Second, this approach might lead to worse policymaking. As an example, suppose the government were to decide – in light of the OBR's revised forecasts – that a 1% of national income fiscal tightening was required to reduce borrowing. The government would have to adopt a package of measures that it thought likely to cut borrowing by this amount. However, without the ability to confer with the OBR and without any other official source of forecasting expertise, making such a decision would be difficult. It is quite possible that the OBR would then judge that the package actually raised more (or less) money than the government was hoping for. This would be an undesirable situation for both the government and the public.

The Swedish Fiscal Policy Council is one independent fiscal council that explicitly has no discussions with its government before publishing each annual report. However, this modus operandi is perhaps facilitated by the fact that it is not responsible for producing economic and fiscal forecasts (this is done by other public bodies in Sweden) but considers only broader issues of fiscal sustainability.

An alternative option is to adopt a more consultative approach. This is essentially what the OBR has done so far. Under this model, the OBR discusses its forecasts with the Chancellor; then the government decides what – if any – policies to implement; then the OBR incorporates the impact of these policies into its forecasts, which are published at the same time as the policy announcements. One of the advantages of this approach is that one set of economic and fiscal forecasts can be published alongside the policy announcements at the time of each Budget. A clear advantage from the government's point of view is that it is able to prepare and take action before the OBR makes any public statement. This approach should also aid policymaking by giving ministers access to better information about how the policies they are considering might affect the outlook for the economy and public finances before they finalise policy decisions.

However, the disadvantage is that these kinds of private consultations between ministers and the OBR could make the forecasting process less transparent. This in turn could potentially undermine at least the appearance of the OBR's independence. For example, it has been argued that regular meetings between cabinet ministers and officials at the CPB in the Netherlands are sometimes used to coerce the bureau into changing its analysis.[28] Many of the benefits that are derived from an independent fiscal council come from the

[28] Bos and Teulings (2010), cited in L. Calmfors, *The Role of Independent Fiscal Policy Institutions*, 2010 (http://www.finanspolitiskaradet.se/download/18.64075cf012c96962a7d800012034/Underlagsrapport+9+2010+Calmfors.pdf).

increased transparency and credibility, which are argued to outweigh the additional costs of such a body. To lose these advantages would be a heavy price to pay, and the OBR will have to continue to ward against this danger. But the risks of losing the perception of independence are probably outweighed by the potential gains in the quality of policymaking to be derived from the OBR holding meetings with ministers during the forecasting process. Therefore a continuation of the model that has been adopted so far, whereby members of the BRC have held a limited number of meetings with ministers prior to the publication of forecasts, seems appropriate. However, to reduce any suspicions that these meetings might cause the OBR to be coerced into changing its judgements, the OBR should be as transparent as possible about what meetings have been held, and when and how all key assumptions made in its forecasts were decided upon.[29]

Increasing transparency

Macroeconomic forecasts

Instead of tasking the OBR with producing macroeconomic forecasts, the government could instead have made use of the macroeconomic forecasts already being produced by the Bank of England – the existing, official body that is responsible for setting monetary policy but is independent of government. Some of the attractions and drawbacks of such an arrangement were discussed in the 2010 IFS Green Budget.[30]

As this option has not been chosen, there are now two sets of forecasts for the UK economy being produced by bodies that are official but independent of government. Those produced by the OBR will be used when deciding fiscal policy, while those produced by the Bank of England will be used by the Monetary Policy Committee when deciding on monetary policy. Understanding how and why these forecasts are different – or similar – may well be important for assessing how well coordinated are fiscal and monetary policy.[31] Analysis of these similarities and differences by experts both inside and outside these bodies has the potential to increase debate and understanding of which assumptions underlying the forecasts are most important or controversial, and thus could improve the quality of the macroeconomic forecasts produced.

Quite how much understanding of the differences and similarities between these forecasts will be possible will depend in part on how much detail on its forecasts and forecasting models the OBR makes publicly available. Thus far, it has published more detail than the Treasury previously did – for example, on some of the outputs of the macroeconomic modelling that are important inputs into the modelling of the public finances (see first bullet point below). This is a welcome development. The OBR should

[29] Alongside the November 2010 *Economic and Fiscal Outlook*, the OBR published a log of all contacts that had been made between the OBR and ministers. This is quite a high degree of transparency. However, repeating such an exercise may be more difficult in cases where there is more interaction between the OBR and the Treasury, as might be required if the government were considering a substantial package of new policy measures.

[30] See R. Chote, C. Emmerson, L. Sibieta and G. Tetlow, 'Reforming UK fiscal institutions', in R. Chote, C. Emmerson and J. Shaw (eds), *The IFS Green Budget: February 2010*, IFS Commentary (http://www.ifs.org.uk/budgets/gb2010/10chap11.pdf).

[31] For example, in November 2010, both the OBR and the Bank of England published new forecasts for GDP growth. The Bank's forecast was for cumulative real GDP growth to be about 0.5 percentage points higher over the next three years – 2011 to 2013 – than the OBR forecast. The OBR's forecast for growth in the consumer price index (CPI) was also lower than the Bank's up to the end of 2012, but higher thereafter. Sources: Bank of England, *Inflation Report: November 2010*; Office for Budget Responsibility, *Economic and Fiscal Outlook: November 2010*.

continue to go further – for instance, by providing more detail on its underlying economic forecasting models as well.

Fiscal forecasts

There have been a number of welcome increases in transparency that have accompanied the shift of fiscal forecasting from the Treasury to the OBR:

- To date, the OBR's publications have provided much more information on the economic assumptions underlying the fiscal projections than the equivalent documents previously produced by HM Treasury. For example, they now reveal key assumptions about corporate profits growth, earnings growth, and growth in property prices and the volume of transactions.
- The OBR has been responsive to requests for additional detail on its assumptions where this was not already provided in its publications.[32] Furthermore, to aid the perception of impartiality, it has adopted the policy of publishing responses to such requests at a fixed (pre-announced) time and date each month.
- The OBR has also published a document explaining in more detail what the main determinants of their spending and receipts forecasts are and over what key judgements were made.[33]
- The requirement that the OBR provides independent scrutiny of the Treasury's estimates of the 'direct' impact of individual budget policy measures on the public finances[34] has been associated with more detail being publicly provided by the Treasury of how these estimates have been reached.
- Previously, the Treasury published forecasts for the public finances that built in an unquantified degree of 'caution'. That is, the forecasts were claimed not to be the Treasury's best central estimate but rather a slightly pessimistic view. In contrast, the main forecasts of the OBR are central estimates. This then leaves the Chancellor to make the explicit policy decision over the extent of caution with which he or she wishes to aim to meet the fiscal target.
- The OBR explicitly takes uncertainty into account by also publishing 'fan charts' that indicate the likelihood of alternative outcomes, in much the same way as the Bank of England does for its inflation and economic growth forecasts. The *Economic and Fiscal Outlook* also considered the sensitivity of the forecasts to several parameters and forecast the key fiscal aggregates under two alternative economic scenarios.

We have previously recommended all of these improvements (and as far as possible have been practising them in our own Green Budget forecasts). We therefore welcome these developments. So far, the OBR publications have omitted some information that was previously provided in similar Treasury publications. However, it appears that this has

---

[32] A variety of supplementary information has already been made available on the OBR's website: http://budgetresponsibility.independent.gov.uk/publications.html.

[33] Source: Office for Budget Responsibility, *Forecasting the Public Finances*, Briefing Paper 1, January 2011 (http://budgetresponsibility.independent.gov.uk/d/obr_briefing1.pdf).

[34] The Treasury estimates the cost or yield of firm and final policies. These costings take into account direct behavioural effects on the tax base that the policy is applied to and the base of closely related taxes. In the case of benefit reforms, these costings take into account the effect of interactions with other benefits. For further detail of the Treasury's methodology, see HM Treasury, *Budget 2010 Policy Costings*, 2010 (http://www.hm-treasury.gov.uk/d/junebudget_costings.pdf). For a detailed discussion of alternative methods for costing policies, see S. Adam and A. Bozio, 'Dynamic scoring', *OECD Journal on Budgeting*, 2009/2, 99–124.

usually been through oversight rather than intentional omission, and experience to date suggests that, if these gaps are drawn to the OBR's attention, they will be remedied in future publications.

In the realms of both macroeconomic and fiscal forecasting, we would encourage the OBR to make publicly available as much data, and as much detail on its models, as possible.

Consideration of alternative policy scenarios

The OBR's remit expressly forbids it from 'examin[ing] alternative policy scenarios'.[35] In other words, it is not allowed to publish an assessment of what the outlook for the economy and public finances would be under a different set of policies from those legislated by the government (such as those presented in this chapter in Figures 2.1, 2.2 and 2.6). One simple alternative policy scenario for which forecasts should certainly always be published alongside each significant fiscal event (such as Budgets) is that of no new discretionary measures. This would inform debate on the impact of the new measures on both the economy and the public finances.

There are also some other policy scenarios that the OBR's consideration of might aid public debate. The current remit forbids the OBR from commenting on the public finance implications of proposals made by other political parties (or indeed the individual parties that form the current coalition), and also from considering policies that the government has mooted (for example, in speeches, White Papers, legislation, manifestos and the coalition agreement) but not implemented.

This is in contrast to the CPB in the Netherlands, which does provide costings of other political parties' policies, as set out in their manifestos, before each election (and during negotiations over the formation of a new coalition government).[36] The advantage for the OBR of being prevented from considering opposition parties' policies is that it is less likely to be drawn into a political debate on the relative merits of alternative policy options. However, it may not be immune from this, as the current arrangement means that the government will be able to have 'OBR approved' costings for future policies that it has committed to in past Budgets, but the opposition parties will not have this option open to them. The disadvantage for the public of the OBR being prevented from considering opposition parties' policies is that, while existing policies are subject to intense scrutiny, the options with which they are presented at the time of general elections will not be, and so they will find it harder to make informed decisions. Moreover, in the run-up to a general election where it is widely believed that an opposition party is likely to form the next government, the fiscal plans of that opposition party are, arguably, more important than those of the current government for the sustainability of the public finances. Of course, IFS researchers – who are also independent of the government and the opposition parties – and other bodies will continue to provide careful scrutiny of policy proposals including, where possible, costings of new measures. But, in at least some cases, the OBR would have the advantage of having access to better data.

[35] http://budgetresponsibility.independent.gov.uk/d/terms_of_reference_final.pdf.

[36] See http://www.cpb.nl/en/what-does-cpb-do.

Summary

Overall, the OBR is a welcome innovation. The intention, and the practice to date, of promoting greater transparency of official economic and fiscal forecasts will aid scrutiny of the government's compliance with its specific fiscal targets. A better assessment of broader compliance with the longer-term objective of fiscal sustainability should also be aided by the OBR's future work programme. The OBR will need to work hard to maintain its reputation as a politically independent body, particularly as quite considerable discussion and exchange of information may be required between the Treasury and the OBR in advance of the publication of its forecasts. There is a case for extending the remit of the OBR so that it is able to consider the impact on the economy and public finances of alternative policy options, at least in some limited circumstances such as the run-up to a general election.

2.6 Conclusion

The biggest domestic policy challenge for the government over the next few years will be to ensure that the public finances are returned to a sustainable footing in a way that minimises the fall in households' living standards arising from higher taxes, lower welfare payments and cuts to spending on public services. To help signal the government's commitment to strengthening the public finances, the Chancellor has set himself two fiscal goals: that policy should be consistent with achieving a cyclically-adjusted current budget balance at the end of the forecasting horizon (the fiscal mandate) and that debt should be falling as a share of national income in 2015–16 (the supplementary target). The OBR judges that current policies are consistent with the fiscal mandate and forecasts that it is more likely that the supplementary target will be met than missed. The second target is sufficiently unchallenging that it would be unlikely to be missed if the first were met.

Similar rules operated by the previous Labour Chancellors – Mr Brown and Mr Darling – had ceased to have much public credibility long before the onset of the financial crisis made it almost inconceivable that they would be met and unwise for the government to try to meet them. One problem was a perception that the government produced unduly optimistic economic and fiscal forecasts to support its claim that it was on course to meet the rules (particularly in the run-up to the 2005 election) and then moved the goalposts when it looked like the target was going to be missed. In an attempt to circumvent similar credibility issues, the new government has set up the independent OBR to provide forecasts of the economy and the public finances and to assess whether current policies are likely to be consistent with fiscal targets that the government has set itself.

The creation of the OBR has been accompanied by a welcome increase in transparency of both the forecasting process and the forecasts themselves. The provision of central forecasts and descriptions of uncertainty around these should help to improve public understanding of the level of uncertainty in official forecasts and the degree of caution built into the government's stated plans. Perhaps the key challenge for the OBR going forwards will be to work closely with the Treasury and the government in order to ensure that its forecasts take account of as much information as possible, and that government policy is based on as much information as possible, whilst ensuring that it remains, and is perceived to remain, independent.

At some point, the government will need to decide how to adapt its fiscal rules once recovery from the financial crisis is more secure. In particular, the supplementary target for the profile of debt will cease to be relevant from 2015–16. We continue to argue that this government, or a future one, may wish to consider the merits of a 'sustainable commitments rule' which places a ceiling on the flow of future debt interest and other pre-committed future payments, rather than on the stock of accumulated public sector debt. While the fiscal mandate will not become obsolete once the public finances have recovered, it will necessitate careful independent scrutiny of the public finances in order to ensure that governments do not inappropriately manipulate the forward-looking nature of the rule.