Interesting times

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1. Introduction

Good evening and thank you very much for the invitation to be here.

The last time I had the pleasure of addressing a David Hume Institute seminar was in November 2005, with my Institute for Fiscal Studies hat on. I talked then about the outlook for the public finances and whether the Government of the day was on course to meet the fiscal objectives it had set itself.

The first chart I showed that evening was this one [SLIDE] – the then most recent official forecasts for public sector net borrowing as a share of national income. I queried whether the budget deficit would narrow quite as quickly as these forecasts suggested. No-one imagined that the same picture today would look anything like this [SLIDE]. The financial crisis, the associated recession and the use of fiscal stimulus measures meant that, far from shrinking in the years to 2009-10, the budget deficit soared to a post war high. The deficit did narrow somewhat last year and our March forecast showed it continuing to do so over the next five years as the economy recovers and as the Government's fiscal consolidation progresses.

You might think that the obvious lesson to be learned from this comparison is that fiscal forecasting is a mug's game and best avoided. Well, it is certainly a difficult game, but it is nonetheless a necessary one if tax and spending decisions are to be made in a sensible forward-looking way. And it is a key part of the role of the OBR.

What I plan to do this evening is to explain a little more about our role – why we are here and what we are trying to achieve. And I then want to set out some of the issues that will confront us as we prepare our next analysis of the economic and fiscal outlook, which the Chancellor has asked us to publish on November 29th. Needless to say, a great deal has happened since our last forecast was published in March and a great deal more could happen by then. We live in interesting times.

2. The role and structure of the OBR[1]

[SLIDE] The OBR was created in interim form immediately after the last general election and we became a statutory public body on 4 April 2011. We are one of a growing number of official independent fiscal watchdogs around the world.

The underlying rationale for such bodies is the belief that democratic governments are prone to 'deficit bias' and 'pro-cyclicality' in their management of the public finances – in other words, on average they borrow more than they should, and in particular they spend too much or tax too little during the 'good times' when the economy and the public finances both appear to be performing well. Economists have put forward various explanations for these behaviours and different ones seem

[1] Discussed in more detail in Robert Chote's 2011 Ken Dixon lecture at the University of York: http://budgetresponsibility.independent.gov.uk/wordpress/docs/Ken-Dixon-lecture.pdf

important at different times and in different places. This probably helps explain why the role and structure of fiscal watchdogs varies more from country to country than, say, the role and structure of their central banks does.

The role and structure of the OBR reflects a particular concern that governments in the UK have at times made persistently overoptimistic forecasts for the public finances, notwithstanding outside scrutiny from the IFS and other such institutions. This over-optimism might be a deliberate attempt to disguise the need for unpleasant fiscal action until after an election. Or it might reflect ministers being seduced by their own rhetoric and mistaking a temporary cyclical improvement in the public finances for the enduring benefits of their own far-sighted policies.

Governments have been able to respond to external scepticism by pointing out that they have access to information on public spending and revenues that outsiders lack. The creation of the OBR has removed this line of defence. Unlike many fiscal watchdogs around the world, we do not merely scrutinise government forecasts. Instead, the government has in effect contracted out to us the task of producing them, giving us full access to the information and expertise available in Whitehall to do so. That said, additional scrutiny from outside bodies such as the IFS remains very valuable.

[SLIDE] Our legislation defines the duty of the OBR as being "to examine and report on the sustainability of the public finances". In practice we have four main tasks:

- First, as I mentioned, we are now responsible for producing the official five-year forecasts for the economy and the public finances that the Chancellor of the Exchequer was previously required to produce twice each year by the 1975 Industry Act. One accompanies the Budget Red Book in the spring; the other prepares the ground for it in the previous autumn or winter.

- Second, we use these forecasts to assess whether the Government has a better than 50 per cent chance of achieving the fiscal targets that it has set itself on its existing policies. There are currently two such targets:

    - The 'fiscal mandate' requires the government to set policy so as to achieve balance or surplus in the structural current budget five years ahead (in other words, to ensure that it will not borrow other than to finance investment, after adjusting for the temporary impact of any spare capacity in the economy on revenues and spending).

    - The 'supplementary target' requires the ratio of debt to GDP to be falling in 2015-16.

- Third, we scrutinise the government's estimates of the fiscal cost or savings from particular tax and spending measures announced in the Budget. After examining the Treasury's estimates and suggesting changes, we have three choices when we are presented with the final costings – to say: "yes, we agree", "no, we don't" or "we were not given sufficient time or information to reach a judgement", in which case we will revisit the costing later.

- Fourth, we analyse the long-term sustainability of the public finances, looking at the impact of past government activity (as reflected in measures of the public sector balance sheet) and future government activity (by making 50-year projections of spending, revenues and financial transactions). We produced our first annual long-term *Fiscal sustainability report* on 13 July.

To support all this activity, we also publish briefing papers, discussion papers and the like on topics relevant to our remit. We also produce a monthly commentary on the official public finance statistics, to help people interpret the data that emerges between our forecasts. All our reports and analysis are available on our website.

The ability to access data and expertise only available within government is a powerful argument in favour of having an official fiscal watchdog, rather than relying entirely on unofficial ones. But you cannot pretend that the argument is as powerful for macroeconomic forecasting. After all, the OBR does not enjoy any significant informational advantage over the numerous City, academic and international bodies that publish macroeconomic forecasts for the UK on a regular basis. And given the reputation-sapping nature of macroeconomic forecasting, you might think it would be better for us to take an external forecast and use that for our fiscal projections.

One obvious candidate would be the Bank of England's *Inflation Report* forecasts. But, understandably, the Bank's forecasts are designed for its own needs rather than for ours. It publishes forecasts for only two variables – GDP growth and CPI inflation – and over a time horizon of only three years. We need to publish a much more detailed breakdown of spending, income and prices over a five year horizon in order to be able to explain our forecasts for the many revenue streams, spending streams and financial transactions that make up the public finance forecast. Similar gaps would also make it impossible for us to use an average of external forecasts. For these practical reasons, we have to be our own macroeconomic forecasters. But, as I shall point out later, we devote a lot of effort to assessing and explaining the impact on the public finances if the economy was to behave at odds with our central view.

Some commentators have argued that the interaction with ministers and departmental officials necessitated by our remit makes it impossible for us to be truly independent. As I have argued, it is these interactions that allow us to add value to the fiscal analysis already undertaken by the IFS, the National Institute of Economic and Social Research and others. But the fact that people express this concern underlines the need for us always to reassure people of our independence from political pressure. Our governance and accountability arrangements should help do this, but the transparency with which we undertake our work is even more important. Let me say a little about both.

[SLIDE] The OBR's formal independence rests upon our rights and responsibilities as set out in the Budget Responsibility and National Audit Act and in the Charter for

Budget Responsibility, in which the government sets out its approach to fiscal policy. The Act gives us "complete discretion in the performance of [our] duty", as long as we perform it "objectively, transparently and impartially" and as long as we take into account current government policies but not alternative ones. Importantly, the Act gives the OBR "right of access (at any reasonable time) to all Government information which it may reasonably require for the performance of its duty".

The Charter says that our independence includes complete discretion to decide:
- The methodology underpinning our forecasts, assessments and analyses;
- The judgments we make in producing these outputs;
- The content of our publications; and
- Our work programme of research and additional analysis.

The Charter also points out that that the government remains responsible for policy decisions and costings and says that we "should not provide normative commentary on the particular merits of government policies". So if, say, the Government decided to scrap the 50p income tax rate, our job would be to scrutinise its estimate of what this would cost or raise, not to say whether it was ultimately a good idea or not. Neither is it our job to comment on whether we should adopt a 'Plan B' or not.

Fiscal watchdogs are much in fashion internationally, but we cannot be complacent about our position. Our counterparts in Canada and Hungary had their budgets squeezed when they started to bark too loudly. Our main protection here is one of transparency – our multi-year budget is set down publicly, so any squeeze would be plain for all to see. The Canadian and Hungarian episodes both demonstrate that making a fiscal watchdog responsible to parliament rather than to the government does not necessarily protect it from political pressure. We are something of a half-way house. We are a non-departmental public body under the aegis of the Treasury, but accountable to parliament via hearings before the Treasury Select Committee. The TSC also has a veto over appointments to, and dismissals from, the Budget Responsibility Committee that formally signs off the conclusions the OBR reaches.

We need to be accountable and responsive to the Chancellor and the Treasury Committee, but we must remain independent of both. Our ultimate responsibility is to the public and we owe them our best judgement, whether the politicians like what we say or not. Getting the balance right between accountability and independence will not always be straightforward. Our non-executives – Lord (Terry) Burns and Kate Barker – can play an important role here. Their task is to help ensure that we fulfil our duty in line with the principles of good behaviour set out in the Act. They can offer a useful second opinion and channel of communication if we in the OBR are concerned about the behaviour of the politicians or if the politicians are concerned about ours.

In a recent study of fiscal councils around the world, Lars Calmfors and Simon Wren-Lewis argued that: "The lack of formal safeguards for the independence of fiscal councils means that they – much more than central banks – have to rely on the informal independence they can acquire through building a reputation for impartial and well underpinned analysis".[2] Our governance and accountability arrangements offer pretty strong formal safeguards for our independence when judged by international standards, but nonetheless the same surely applies to us.

[SLIDE] If we are to build a reputation for impartial and well underpinned analysis, we need to be transparent in both our interactions with government and in the conclusions that we reach.

As I have already mentioned, the Chancellor's decision to outsource the official public finance forecasts to the OBR requires us to have frequent and detailed interactions with those government departments that have expertise in particular revenue and spending streams and those that are involved in the design of specific tax and spending measures. We also have contacts with the Chancellor himself, notably to provide him with draft forecasts that indicate whether we think he is likely to need to take action to remain on course to achieve his fiscal targets.

We endeavour to be as transparent as we can about these interactions. All substantive meetings with the Chancellor, his special advisers and his private office are logged and published on our website. Our *Economic and fiscal outlook* documents set out the dates on which we present our draft and final forecasts to the Chancellor. We publish the deadlines by which we have to be informed of policy measures, in order to guarantee that we can incorporate them in our economic forecasts or ratify their costings. And we list any measures that were revealed to us after these deadlines and explain how we have dealt with them.

Needless to say, government departments have much more resources than we do and some observers wonder whether we can avoid having the wool pulled over our eyes as a result. I don't think that this is too much of a risk if we have the right mix of skills, a combination of inside experience and outside perspective. This is one reason why having some staff and OBR members from the ranks of former Treasury, HMRC and DWP officials is a strength rather than a weakness. They are well equipped to challenge their former departments and often relish the opportunity too.

To demonstrate the quality and impartiality of our work, we also need to be as transparent as possible in the analysis we produce. The more we "show our working", the more people can see why we have reached the conclusions that we have and reassure themselves that they are based on sound professional judgement (even if they disagree with them). To that end we have significantly increased the amount of analytical detail in our *Economic and fiscal outlook* publications. For example, we now publish detailed diagnostics tables explaining why our forecasts for particular revenue and spending streams have changed from one publication to the next. We have revamped the presentation of public spending forecasts, pruning away billions in obscure 'accounting adjustments'. We are publishing more of the variables and assumptions that underlie the forecasts. And we release additional material underpinning the forecasts if people request it after publication. We have

[2] http://www.economics.ox.ac.uk/index.php/papers/details/department_wp_537/

also enhanced transparency by publishing more detail of the forecasting process and more information on our methodologies.

The Treasury has also made an important contribution to the transparency of the Budget process with the publication of its new policy costings documents. These set out the analytical and empirical basis for the costing of each tax and spending measure, including a description of the tax base and an assessment of any assumptions about behavioural effects. These documents reflect the conclusions of the challenge and scrutiny process that we engage in and they include an annex by the OBR in which we highlight particular uncertainties and risks to the estimates, and where we would highlight any disagreements with the costings if we had them.

[SLIDE] I have spoken so far about the OBR's core role as a watchdog for the public finances UK-wide. But, from April next year, we will also have responsibility for producing forecasts for Scottish income tax, landfill tax, stamp duty land tax and aggregate levy receipts, in readiness for the proposed introduction of the new Scottish rate of income tax, the devolution of landfill tax and stamp duty to the Scottish Parliament, and the possible later devolution of the aggregates levy. As regards income tax, after a transitional period, there will be a permanent reduction in the block grant to Scotland equivalent to the revenue raised by 10p of the existing basic, higher and additional income tax rates for Scottish taxpayers. This size of this block grant reduction will be based on outturn tax receipts data and OBR forecasts.

Needless to say, making forecasts for these tax revenues at a Scottish level is not straightforward. One approach would be to assume that Scotland accounts for a constant share of UK income tax receipts. This share can be calculated from the Survey of Personal Incomes and was indeed pretty stable as a proportion of GDP (although less so in cash terms) until the mid-2000s. The latest data available is for 2007, so more needs to be done to see how robust this relationship has been subsequently – and whether it moves around much as a result either of Scottish-specific factors or of English-specific ones such as fluctuations in City bonuses.

As a first step in preparing for this new responsibility, we have asked HM Revenue and Customs to set out for us how they propose that we should proceed with the forecasts – as it is they who collect the data upon which the forecasts are based and who carry out the calculations for us. Once they have done so and we are happy with the approach, we will make sure that the methodology is clear and transparent to everyone and that we refine it appropriately as we see how it works in practice.

3. Looking ahead to the November EFO

Now let me turn to a nearer-term challenge for the OBR. We published our last set of economic and fiscal forecasts six months ago and we will publish our next ones in just over two months time on November 29th. As you will appreciate, I am constrained in what I can say about the outlook ahead of that publication, but let me briefly mention some of the developments we have seen since our last forecast and some of the issues that we will need to address as we prepare the next one.

As I have explained, our primary focus is on the medium- and long-term outlook for the government's finances. But many people are naturally more concerned about the short term outlook for the economy – whether the recovery will regain momentum in the coming months or slip into reverse. Back in March our central projection was for a gradual acceleration in underlying economic activity through this year. We expected GDP to be around 1.7 per cent higher in 2011 than in 2010, which was a little more pessimistic than the average of outside forecasts at the time.

[SLIDE] GDP subsequently turned out weaker than we and most other forecasters expected in both the first and second quarters of this year, partly but not entirely as a result of one-off factors such as oil field maintenance work and the disruption of supply chains by the Japanese earthquake. Growth in other advanced economies has also slowed significantly, with the euro-zone and the US (like the UK) seeing GDP rise by only about 0.2 per cent in the second quarter. Confidence in the global outlook has also been undermined by recent policy developments – notably the management of the debt crisis in the euro-zone. Business and consumer surveys now paint a relatively gloomy picture of near-term growth prospects.

As a consequence of all this, the average external UK growth forecast for this year has fallen from 1.8 per cent in March to 1.2 per cent now, with the average forecast for 2012 also falling from 2.1 to 1.8 per cent. My former colleagues at the International Monetary Fund yesterday revised down their forecasts for UK GDP growth to 1.1 per cent this year and 1.6 per cent next year. Indeed the Fund has downgraded its growth forecasts for every major advanced economy next year, as well as pulling down its predictions for world GDP and world trade growth. The global environment looks a lot more challenging than it did at the time of our last forecast.

So what has been happening to the UK's public finances as the economic news has become gloomier? Looking back to the 2010-11 fiscal year, our central forecast in March was that public sector net borrowing would come in at £145.9 billion or 9.9 per cent of GDP in 2010-11 – about £10 billion less than the previous year's post-war peak. [SLIDE] As you can see from this chart, the outturn estimates from the Office for National Statistics are quite volatile even after the fiscal year is over, as new and more complete information becomes available over succeeding months. The latest figures, published this morning, show some significant favourable data revisions, notably for local authority borrowing. Last year's deficit is now estimated to be almost £10 billion smaller than in our March forecast at £136.7 billion or 9.3 per cent of GDP. Central government receipts were about £3.1 billion above our March forecast and central government spending about £1 billion below it. Borrowing by local authorities and public corporations was £5 billion below the March forecast. But these figures will doubtless move around further in coming months.

[SLIDE] Turning to the current fiscal year, as of today we now have provisional outturn data for the first five months of the year – and again there have been some favourable data revisions for recent months. The cumulative deficit so far is currently estimated at £51.5 billion, down £3.8 billion from the same period in 2010-11. (Our March forecast implied a reduction of £15.0 billion for the year as a whole.) Past experience shows that five months data do not necessarily provide a reliable guide to the year as a whole, but what can we tell from what we have seen so far?

- Central government revenues are 4.6 per cent up on last year over the first five months. This is smaller than the 6.9 per cent increase implied for the year as a whole by our March forecast, but this is in part explained by the fact that receipts in the early part of last year were boosted by the one-off bank payroll tax while receipts from the new bank levy have only been scored in the National Accounts for a couple of months.

- A large part of the remaining weakness in revenue growth is explained by developments in the financial and oil sectors. In the case of the financial sector, weak corporation tax payments in July were consistent with the poor results reported by the banks for the first half of 2011. Their profits were hit by weaker investment banking activity, write-downs on Euro area sovereign debt and provisions for the mis-selling of payment protection insurance. Oil revenues were depressed by the temporary closure of some fields for maintenance, which meant that oil production in the first half was significantly weaker than we had assumed in March.

- On the spending side, central government spending is running 3.7 per cent higher than last year, a slightly bigger increase than the 3.6 per cent implied by our March forecast for the year as a whole. The monthly profile of departmental spending does tend to change from year to year, and these monthly figures are also prone to revision. So it is far too soon to say whether this will remain the case for the year as a whole.

- The same caveats apply with even greater force to estimates of borrowing by local authorities and public corporations, where accurate information is only available with a long lag and revisions can be significant – as we saw in today's revised figures for 2010–11. For what it is worth, borrowing by local authorities and public corporations over the first five months of this year is £2.2 billion lower than over the equivalent period last year.

Looking ahead, we expected in March that the increase in revenues – and the fall in the deficit –would be bigger in the second half of the year than the first. For example, we should expect stronger growth in corporation tax receipts from the oil sector as the higher rate of supplementary charge announced in the Budget will only affect the public finances from October. The delayed impact of the 50p income tax rate on incomes above £150,000 should also boost self assessment receipts later in the year. However, weaker financial sector profitability and lower oil and gas production could continue to depress corporation tax instalment payments in October 2011 and January 2012.

Thinking about the relationship between the public finances and the broader economy, given the recent weakness of economic growth it may appear surprising that income tax, VAT and corporation tax receipts are not growing more slowly. It may be that they will respond to weaker growth with a lag, but it is also important to remember that tax revenues are determined more by nominal or total cash spending in the economy than by real, inflation-adjusted activity. Real GDP has grown just 0.4 per cent a quarter on average since the recession ended, but nominal GDP growth has averaged 1.3 per cent a quarter. This partly reflects unexpected price level increases in the final quarter of 2010 and the first of 2011 and it will be interesting to see what happens in later quarters as these influences dissipate.

The bottom line is that while we would generally expect weaker economic activity to put upward pressure on the budget deficit, the outlook for the rest of the fiscal year will also depend on whole economy inflation and a variety of sector-specific factors.

[SLIDE] When we come to look at the longer-term prospects for the public finances in November, there are numerous temporary and persistent influences on revenue and spending streams that we will need to take account of. But, needless to say, prospects for economic growth are crucial in the medium-term and these depend in part upon the amount of spare capacity in the economy (the so-called 'output gap') and the outlook for 'productive potential', the amount of goods and services the economy can produce without pushing up or pulling down inflation.

The more spare capacity there is, and the more rapidly we expect productive potential to grow, the more scope there is for a strong recovery to reduce the budget deficit of its own accord, without the need for policy measures. The pace of recovery then depends on total demand in the economy, with the Bank of England aiming to keep that on a path consistent with its inflation target, taking into account the impact of fiscal policy and other domestic influences, as well as the global environment.

In March we estimated there was an output gap of around 3 per cent in the third quarter of 2010 – in other words that output was around 3 per cent below the economy's productive potential. We forecast that the output gap would widen through the remainder of 2010 and into the first half of this year, reaching 3.9 per cent in the second quarter and through the rest of 2011.

With growth weaker than we forecast over the last couple of quarters, we might now expect to see an even greater degree of spare capacity opening up. However, the various indicators that we use to estimate the output gap suggest that this may not be the case. There are mixed messages from different sectors, for example:

- The CBI's measure of skilled recruitment difficulties in manufacturing picked up in the first quarter of the year, before falling back in the second quarter.

By contrast, the British Chambers of Commerce's measure of recruitment difficulties in services fell back in the first quarter of the year, but has since picked up to a level near that of the third quarter last year.

- The BCC's measure of capital utilisation in manufacturing has fallen back significantly since last year; again, this contrasts with the service sector measure, which has picked up slightly.

- Average weekly earnings growth has picked up in the service sector since the middle of last year, but has fallen back markedly in the manufacturing sector. In both cases earnings growth remains subdued relative to long-term trends.

When it comes to assessing the outlook for productive potential, we assumed in March that it would grow by a little over 2 per cent a year, an assumption based on long-term trends in productivity growth (the output the economy produces per hour worked). During the course of the recovery to date, output per hour has grown more slowly than this and more slowly than it has in recent recoveries. Notwithstanding last week's labour market statistics, employment has increased by more since the recession ended than the pace of the recovery would normally suggest. A key question is to what extent this pattern will persist and what it implies for the growth of productive potential in the medium and longer term.

There is a lot of work to be done sifting the evidence on spare capacity and the outlook for productive potential before we reach a view in November, and by then we will have more business surveys and other economic data to look at. We will also have more information on the path of borrowing in the past.

4. Conclusion

With our next Economic and Fiscal Outlook just a couple of months away, I have had to pose more questions tonight than I have answered. Assessing the outlook for demand in the economy, for productive potential and for the amount of spare capacity is a highly uncertain business, given the current volatile global environment and the mixed picture painted by recent data. The task may be further complicated next month, when the Office for National Statistics publishes its latest Blue Book of National Accounts. This will incorporate a number of methodological and other changes that have the potential to rewrite somewhat the history of the recession, and what went before it. This could require us to look again at some of the past relationships that we use as a guide for our forecasts.

Returning to where I began, our focus is on the medium term outlook for the public finances and on the confidence that the government can have that it is on course to achieve its fiscal objectives. In assessing that, it would be folly to bet the farm on any particular set of macroeconomic forecasts being correct. So we will accompany our central view in November with extensive sensitivity analysis, asking what difference it would make if economic growth was stronger or weaker, the output gap bigger or smaller, or government bond yields higher or lower than in our central view. We will use scenario analysis to test the importance of some of the key judgements we make in the central forecast and the implications of choosing alternatives to them.

Our job is not to pretend to perfect foresight, but to set out our judgements in as clear and transparent a way as we can and to explain what difference it would make to the health of the public finances if the economy was to behave differently. Even if people disagree with the assumptions that we make, or with the conclusions that we reach, I hope that they will recognise that they reflect the best available information, and our professional judgement, rather than politically motivated wishful thinking. If people can have more trust in the evidence base on which policy decisions are based, public debate will be enhanced and the quality of policy-making improved.

Thank you very much.