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Dear Andrew

REPORTS ON THE 2015 SPENDING REVIEW AND AUTUMN STATEMENT AND ON REVIEWING THE OFFICE FOR BUDGET RESPONSIBILITY, AND ADDITIONAL INFORMATION FOLLOWING BUDGET 2016 HEARING

In this letter, I will provide responses to your reports of 11 and 22 February, which made a number of recommendations in relation to the OBR. Our responses to your recommendations – and some further information for clarification – are set out below. We have also responded to issues arising at our Budget 2016 appearance before your Committee on 22 March.

REPORT ON THE 2015 SPENDING REVIEW AND AUTUMN STATEMENT

The Committee was surprised by the OBR's interpretation of the Bank's May 2014 guidance. That guidance stated that assets purchased under quantitative easing would not be sold until interest rates reached a level from which they "could be cut materially". Such a rate might reasonably have been thought to be higher than the OBR's assumption of 0.75 per cent. The OBR should in future share its assumptions on the future path of monetary policy with the Bank in advance of publishing its forecast, and discuss formally whether these are a reasonable reflection of the guidance issued by the MPC. (Paragraph 8)

The assumptions we have made about gilt sales from the Asset Purchase Facility (APF) have been revised a number of times, reflecting the Bank's evolving guidance. Importantly, we need to make assumptions about two distinct issues: first, what will happen to the proceeds the APF receives from gilts that are redeemed and; second, the size and timing of any active sales.

Our assumptions have evolved as follows:

- in December 2012 – the first of our forecasts affected by APF flows – we assumed that proceeds from redemptions would stop being reinvested in gilts and active sales of £10 billion a quarter would commence once Bank Rate reached 1 per cent. We said at the time that that seemed "*broadly consistent with the Governor's statement in his Mansion House speech in June 2010 that monetary policy tightening: "When it comes...is most likely to be through a rise in Bank Rate with asset sales being conducted later in an orderly programme over a period of time, leaving Bank Rate as the active instrument*";

- in March 2014, we adjusted our forecast to assume redemptions would stop being reinvested when Bank Rate moved above ¾ per cent. This was consistent with the February 2014 *Inflation Report* statement that "*Updating this guidance [i.e. that the stock of gilts in the APF would be kept at £375 billion until unemployment fell below 7 per cent], the MPC intends to maintain the stock of purchased assets, including reinvesting the cash flows associated with all maturing gilts held in the APF, at least until Bank Rate has been raised from its current level of 0.5%.*" In the absence of specific guidance on active sales, we retained our assumption about the timing and pace of active sales once monetary tightening was underway;

- in December 2014, we changed our assumption on active sales following the May 2014 *Inflation Report* statement that "*the MPC is likely to defer sales of assets at least until Bank Rate has reached a level from which it could be cut materially, were more stimulus to be required.*" This was interpreted as Bank Rate reaching 2 per cent. We retained our assumption that the proceeds of redemptions would stop being reinvested once Bank Rate reached ¾%, since the May 2014 *Inflation Report* also stated that "*Some reduction in the stock of assets could be achieved without active sales, as the gilts in the portfolio mature*". The first element of this guidance appears to be the statement that you cite in your report; and

- finally, in November 2015, based on the latest Bank guidance, we changed our assumption about the level that Bank Rate would need to reach before the proceeds of redemptions stopped being reinvested to 2 per cent. The November 2015 *Inflation Report* stated that "*the MPC expects to maintain the stock of purchased assets at £375 billion until Bank Rate has reached a level from which it can be cut materially. The MPC views sales and reinvestment decisions as equivalent from a monetary policy perspective. The Committee therefore expects to continue to reinvest maturing assets until Bank Rate has reached such a level.*" It also stated that "*Based on historical experiences, the MPC currently judges that such a level of Bank Rate is around 2%. It follows that the MPC's current expectation is that it is unlikely to reduce the stock of purchased assets from its current level of £375 billion until Bank Rate is around 2%.*"

As you can see, changes to our assumptions about how the APF's gilt holdings will eventually be wound down has followed the Bank's public statements and other guidance. The Committee's surprise may reflect the distinction between active sales and 'passive' rundown via redemptions: the Bank's May 2014 guidance (to which you refer) related to the threshold for active sales, rather than to the re-investment of the proceeds from redemption. It is the latter on which new guidance was provided ahead of our November forecast.

As we note in the Foreword to each *Economic and fiscal outlook*, we meet with officials from the Bank of England prior to each forecast. Ahead of our November 2015 *EFO*, that allowed us to discuss how we planned to update our assumption about the APF's treatment of proceeds from redemptions.

Prior to our most recent *EFO*, we discussed our interpretation of more recent guidance on Bank Rate decisions before settling on our assumption to use

market expectations of Bank Rate to underpin our forecast when those expectations fall below 0.5 per cent.

The OBR is right to review the models it uses, to seek improvements, and to be frank about mistakes made. Given their potential to alter materially the outlook for the public finances, these changes, improvements and corrections should be done well in advance of fiscal events, and their likely impact made clear at that point. This would help to avoid the mistaken impression that the OBR was fixing its forecasts to suit the Government. (Paragraph 12)

As I said in my letter to you on 5 February, we keep the modelling approaches that we use to forecast particular streams of revenue or spending under constant review as we use them at each fiscal event.

Errors and potential improvements in existing approaches typically come to light only as we go through the forecasting process, which means it will not always be possible to estimate possible effects of changes well in advance of fiscal events. For example, sometimes the profile of the particular revenue or spending stream in question looks puzzling over the forecast period, sometimes the change since the previous forecast seems hard to explain and sometimes the forecast looks hard to square with those for other spending or revenue streams that should be behaving in a broadly similar way. We may also have broader concerns about particular approaches, for example that they lack the transparency we need to present adequate diagnostics to explain changes between forecasts.

Where possible, forthcoming modelling changes have been described in the 'Lessons to learn' chapters of our *Forecast evaluation reports (FER)*. On the spending side, these have included allowing for shortfalls in DEL spending and government lending schemes and changing judgements on local authority reserves in light of the continued build-up in reserves. On the receipts side, the correction to our VAT forecast was identified during the *FER* process and we were able to quantify the effect it was likely to have when incorporated in our next forecast. We also presented analysis of the upside risks to our incapacity and disability benefits forecasts in our 2014 *Welfare trends report*.

The improvements to the fiscal forecast were driven not by a fundamentally better economic outlook, as the Chancellor suggested, but by changes to the OBR's modelling and assumptions. The OBR has altered its models and assumptions in a way that is favourable to the public finances on this occasion. It may subsequently alter them in an unfavourable way. Moreover, the focus on the £27 billion cumulative change over the five year forecast period distracts attention from the fact that the annual improvements were small, and certainly of a scale that could be revised away in the future. What was widely interpreted as a "windfall" may well prove illusory. (Paragraph 16)

In Annex B of our latest *EFO* we have presented analysis of all our previous underlying forecast revisions in order to put these figures in context, both in cumulative cash terms and as shares of GDP (which are more helpful in understanding their size). The conclusions we draw from it are probably not

that surprising: for example, there is a close negative correlation between revisions to our borrowing forecasts and those to our nominal GDP forecasts.

The analysis confirms that November's revisions relatively small: the ninth smallest of the 13 we have made. So perhaps the main conclusion is simply that even in the absence of policy changes, our five-year forecasts will be subject to substantial revision. It is then for the Government to choose whether to offset that 'noise' in our pre-measures forecasts with policy changes or to allow it to feed through to noise in the final post-measures forecast. Our 13 previous forecasts provide examples of each approach.

The decision to reverse planned changes to tax credits has caused the Government to breach its welfare cap in each of the first three years of the forecast period. The Government are meeting the cap in the final two years of the forecast because the OBR agreed to certify the change to the funding of local authority temporary accommodation as an expenditure-cutting policy decision, rather than a fiscally neutral classification change. It is not clear that this measure will materially reduce welfare expenditure. The OBR should explain, in full, why it has certified this as a policy change. The OBR should also explain whether it believes the welfare cap to be vulnerable to 'gaming' by the Treasury, given the lack of clarity about what constitutes a policy measure, as opposed to a classification change. (Paragraph 41)

Of the assessments that Parliament has tasked us to make via the *Charter for Budget Responsibility*, the welfare cap assessment is by some margin the most complex. We need to make judgements in two grey areas: the distinction between policy changes and forecast changes (where operational changes that might or might not be considered part of the business-as-usual delivery of policy come up quite frequently); and identifying classification changes (where the temporary accommodation measure was the first contentious example we had considered). We make these judgements after carrying out a process that is similar to the policy costings process, coordinated by the Treasury on the Government's side and drawing on evidence from DWP and HMRC.

Our judgement that the temporary accommodation measure met the definition of a policy change rather than a classification change was based on our judgement that the measure would probably result in a change in behaviour, namely local authorities' freedom to manage or prevent homelessness instead of receiving a fee related to use of temporary accommodation, rather than simply rebadging existing spending patterns. We highlighted it in the *EFO* because we recognised that reasonable people might disagree with that judgement. That said, it had no bearing on our assessment of whether the Government had breached the terms of its welfare cap – the Government would have breached it in any event.

Since November, a fresh upward revision to the cost of disability benefits (only partly offset by tighter eligibility criteria announced shortly prior to the Budget) means that our forecast of spending subject to the welfare cap continues to exceed the permitted amount in every year, and by a larger margin than in November. So our Autumn Statement assessment that the welfare cap has been breached still stands.

The devolution of business rates is clearly intended to form part of a package of measures that collectively comprise the Chancellor's "devolution revolution". However, the OBR only assessed the effects of part of this package because they were told by the Treasury that plans to devolve business rates were not "firm policy". Anybody hearing the Chancellor's speech, or reading the Autumn Statement document, would be surprised to hear this. (Paragraph 81)

The Government's intention to localise all business rates represents part of a package that will also provide some additional discretion to local authorities in setting business rates, while also shifting some new spending responsibilities to local authorities. There are elements of this prospective package of measures that could be quantified now, but it would be misleading to include only part it in our central forecast when the Government has stated that when fully specified it will be fiscally neutral as a whole. When the package is fully specified, we will include it in the forecast – and judge whether it is in fact likely to be fiscally neutral. We have provided further background to this judgement in Box 4.3 of our latest *EFO*.

REPORT ON REVIEWING THE OFFICE FOR BUDGET RESPONSIBLITY

Reviewing the Memorandum of Understanding

The report recommends that the Memorandum of Understanding between the Office for Budget Responsibility, HM Treasury, Department for Work and Pensions and HM Revenue & Customs is revised to clarify:

- the scope and limit of requests for factual changes during the exceptional pre-release access period;
- the purpose of allowing Ministers and officials to receive exceptional pre-release versions of OBR documents; and
- which Ministers and officials are granted access to exceptional pre-release versions of OBR documents.

As you point out in paragraph 15 of the report, the recent Treasury review of the OBR recommended that the MoU should be reviewed by September 2016. We already have plans in place to undertake that review over the next few months and will take your recommendations into account when doing so. There is clearly merit in setting out more fully how the fact-checking and exceptional pre-release processes should work.

The exercise of sharing exceptional pre-release drafts with other departments is, in practice, only applicable to the *EFO*. As the MoU states, the purpose of this process is ensure the accuracy and usefulness of documents published at the same time as the *EFO*, such as the Budget (or Autumn Statement) document, and the accompanying speech.

Ahead of sharing the exceptional pre-release drafts of the *EFO*, we request a list of named officials, special advisers and ministers who will see the draft. We have published this list alongside our log of substantive contact for our

latest *EFO* and will continue to do so alongside each forecast, subject to the usual practice of redacting the names of junior officials.

In practice, we have never come under what I would regard as pressure to change any of our text and certainly never any of the forecast numbers. On the occasions that we have received unsolicited drafting suggestions, we have treated them on their merits rather than pre-judging them according to their provenance. No changes have been made that would not also have been made had the same suggestion been made by an internal reviewer.

It is worth stressing that the draft *EFO* text that the Treasury receives in the week before publication is by no means final. I personally devote considerable time over the final weekend to restructuring and redrafting it, while OBR staff undertake a final round of fact-checking to ensure consistency with the fiscal forecast that is finalised on the Friday. So the final version can look very different to that which the Treasury received for fact-checking, for reasons that have nothing to do with any input that they may have provided.

FURTHER EVIDENCE FOLLOWING 22 MARCH HEARING ON BUDGET 2016

We offered to provide further information on a number of areas. Taking each in turn:

- The **fan chart methodology** that underpins our assessment of the probability of the Government meeting its surplus target was set out in *Briefing Paper No.4 – How we present uncertainty* published in June 2012. We used the same methodology to assess the probability of the Coalition meeting its cyclically adjusted current balance target during the last Parliament. While we have not made any material changes to the methodology used, the forecast errors dataset underpinning it is updated each year as a new year of outturn data become available. As I said at the hearing, we are happy to review this methodology and will do so ahead of our next forecast.

- The policy measure '**Business Rates: permanently double the Small Business Rate Relief and extend thresholds**' is shown on the Treasury's scorecard of policy measures as a 'tax' measure, but its effect on our forecast is more complicated. We publish a supplementary fiscal table (Table 2.43) on our website showing all the receipts and spending lines affected by each policy measure on the scorecard. The table below sets out the effect of this business rates reduction. As well as reducing business rates receipts, it boosts corporation tax receipts (because business rates are deductible for tax purposes), reduces our forecast for annually managed expenditure (because 50 per cent of business rates are currently retained locally and we assume that the reduced income would feed through to lower locally financed spending) but that effect is offset by higher DEL spending (because the Government will compensate local authorities for the loss of business rates income). With business rates fully devolved in Scotland, Wales and Northern Ireland, there is additional DEL spending to reflect the Barnett consequentials of the measure.

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Table: Breakdown of scorecard costing for 'Business Rates: permanently double the Small Business Rate Relief and extend thresholds' policy measure

		£ million				
		2016-17	2017-18	2018-19	2019-20	2020-21
Receipts	Business rates	0	-1325	-1360	-1405	-1440
Receipts	Onshore corporation tax	0	0	205	250	255
Current AME	LA self-financed expenditure	0	665	680	700	715
Current DEL	PSCE in RDEL	0	-915	-935	-965	-990
Total shown on Treasury scorecard		**0**	**-1575**	**-1410**	**-1420**	**-1460**

Note: This table uses the Treasury scorecard convention, whereby a positive figure means an improvement in PSNB.

- The Treasury has confirmed that the cost of the policy measure **'Lifetime ISA and raise ISA limit to £20,000'** is almost entirely made up of the lifetime ISA – even more so than we discussed at the hearing. The cost of raising the main ISA limit to £20,000 – for which the only cost is lower income tax on savings income among people saving amounts between the existing and new ISA limits – reaches £15 million in 2020-21, around 1 per cent of the scorecard cost of the combined measure in that year.

- Our assumptions about **the appeals process in PIP reassessments** was set out in paragraph 4.115 of the *EFO*: "*the probability of a DLA claim going through the managed reassessment process being successful for the claimant has been revised up from 74 to 83 per cent, raising the PIP caseload. DWP now has evidence from 7,300 actual reassessment cases that are currently being processed through the 'controlled start' programme. It shows an initial claim success rate of 76 per cent, which we assume will rise to a final success rate of 83 per cent after mandatory reconsiderations and appeals.*" The adjustment from 76 per cent initial success rate to 83 per cent final success rate was informed by evidence from mandatory reconsiderations and appeals taking place during the 'natural' reassessment process that is more advanced than the managed reassessments getting underway through the 'controlled start' programme.

- Flows off **employment and support allowance** (ESA) and onto other DWP benefits are modelled for us by DWP using evidence from historical administrative data, adjusted for our assumptions about the number of work capability assessments being carried out each year. These flows are an important determinant of our welfare spending forecast. We do not make explicit assumptions about the labour market status of individuals that are assumed to flow off ESA and out of the DWP benefit system.

- Our labour market forecast is not constructed in a bottom-up manner that would allow us to comment on what it implies for the Government's promise to halve the **disability employment gap**.

Best regards, Robert

Robert Chote
Chairman