



National Audit Office

**REPORT BY THE
COMPTROLLER AND
AUDITOR GENERAL**

**HC 142
SESSION 2010–2011**

22 JUNE 2010

HM Treasury

Examination of the forecasts prepared
by the interim Office for Budget
Responsibility for the emergency
Budget 2010

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National Audit Office

HM Treasury

Examination of the forecasts prepared by the interim Office for Budget Responsibility for the emergency Budget 2010

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Amyas Morse
Comptroller and
Auditor General

National Audit Office

22 June 2010

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This report can be found on the National Audit Office website at www.nao.org.uk/obr-budget-2010

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Statement of responsibilities

1 Following the formation of the new coalition Government in May 2010, the Chancellor of the Exchequer announced his intention to change the way the Budget assumptions and forecasts are arrived at. The Chancellor launched the interim Office for Budget Responsibility on 17 May 2010 to make independent assessments of the public finances and the economy to build trust in the official forecasts. Its terms of reference, including its remit for the emergency Budget published on 22 June 2010, are attached at Appendix One.

2 Under sections 156 and 157 of the Finance Act 1998, I have a duty to examine and report on conventions and assumptions underlying the fiscal projections that are submitted to me by the Treasury for examination.

3 Until there is a statutory basis for the new arrangements, my duties under the 1998 Finance Act remain. To reflect the interim arrangements, the Chancellor has requested that I undertake an examination with the following scope:

- To consider whether key economic and fiscal assumptions underpinning the interim Office for Budget Responsibility's forecasts were independently arrived at.

4 This differs from requests by the previous Chancellors to examine the reasonableness and caution of specific assumptions underpinning projections of the public finances. The remit of this work does not include any review of the forecast itself or of specific underpinning assumptions.

5 As a result of the timing of this examination, I have formulated my opinion primarily drawing on evidence of the process surrounding the interim Office for Budget Responsibility's Pre-Budget forecast, supplemented by some evidence concerning the interim Office for Budget Responsibility's Budget forecast.

Criteria for this examination

6 This examination requires a clear understanding of the nature of independent judgements as they relate to economic and fiscal forecast assumptions. My criteria for assessing whether the key economic and fiscal assumptions were independently arrived at are set out in **Figure 1**.

Figure 1

Criteria for this examination

- The Budget Responsibility Committee had full discretion over the scope and nature of its judgments on the forecasts.
- The interim Office for Budget Responsibility had unrestricted access to the necessary data and analysis.
- The interim Office for Budget Responsibility had control over sufficient resources to consider the evidence and form a robust judgment.
- The interim Office for Budget Responsibility effectively scrutinised, questioned and challenged the information and advice it received.
- The Budget Responsibility Committee formed its judgments independently of any views of officials or Ministers.
- The Budget Responsibility Committee had autonomy over the content of its published reports and the means of dissemination.

Source: National Audit Office

7 In practice, these criteria can only be assessed using qualitative evidence and subjective judgements on the persuasiveness of evidence. To the extent that it is almost impossible to prove the absence of factors which might inhibit the ability to arrive at forecasts independently, the key judgement is whether the evidence *reasonably* suggests that the criteria have been met.

Approach to developing these criteria

8 I have derived these criteria from a range of sources, including international comparisons with independent fiscal scrutiny bodies in other countries¹; discussions with independent experts on fiscal policy and institutions; and the Mexico Declaration on Supreme Audit Institution (SAI) Independence (**Figure 2** overleaf). The latter represents the NAO's reference point, as an SAI, for understanding independence. The Declaration recognises eight core principles as essential requirements of proper public sector auditing. Although the interim Office for Budget Responsibility is clearly not an SAI, I consider that many of these principles remain relevant.

9 Importantly, however, not all of these principles can be reasonably applied to the arrangements for the interim Office for Budget Responsibility. In particular, the Mexico principles require that the entity in question has a formally recognised independence supported by statutory provisions. The interim Office for Budget Responsibility has by contrast been created on a non-statutory, interim basis to perform work for the emergency Budget to a very compressed timescale. As a result, my examination does not consider the extent of the interim Office for Budget Responsibility's independence as an entity; but instead examines whether its economic and fiscal assumptions have been independently arrived at.

¹ Including the USA, Sweden and Belgium.

10 I therefore adapted the criteria for this examination from the principles in Figure 2, as the basis for my examination of whether the interim Office for Budget Responsibility has formed its assumptions independently.

11 The criteria for this review do not provide a framework for a judgement on whether the interim Office for Budget Responsibility is 'independent' per se. This is not the remit for this examination, as explained above. However, it is the stated intention of the Government to place the Office for Budget Responsibility on a formal statutory footing in due course, and in doing so it may wish to have regard to the principles set out in Figure 2.

Figure 2

Principles of independence, taken from the Mexico Declaration on Supreme Audit Institution Independence

- The existence of an appropriate and effective constitutional/statutory/legal framework.
- The independence of heads and members, including security of tenure and legal immunity in the normal discharge of their duties.
- A sufficiently broad mandate and full discretion, in the discharge of functions.
- Unrestricted access to the necessary information.
- The right and obligation to report on their work.
- The freedom to decide the content and timing of reports and to publish and disseminate them.
- The existence of effective follow up mechanisms on recommendations.
- Financial and managerial/administrative autonomy and the availability of appropriate human, material and monetary resources.

Source: Mexico Declaration on Supreme Audit Institution Independence, International Organization of Supreme Audit Institutions, 2007

Summary of the work performed

Background

12 The interim Office for Budget Responsibility's first forecast, based on existing policy, was published on 14 June 2010.² It is also producing a forecast at the Budget, incorporating the impact of policy measures announced at the Budget and providing a judgment on whether there is a greater than 50 per cent chance that the Government will meet the fiscal mandate.³

13 The interim Office for Budget Responsibility consists of a three-person Budget Responsibility Committee, supported by a Secretariat. The Chancellor appointed Sir Alan Budd to chair the Budget Responsibility Committee on an interim basis. Sir Alan Budd recommended that the Chancellor appoint Geoffrey Dicks and Graham Parker to complete the Committee. The Committee is also advising the Chancellor on the arrangements for the permanent Office for Budget Responsibility.

14 There is an eight person Secretariat of civil servants supporting the Budget Responsibility Committee. These individuals were seconded from the Treasury and are bound by the civil service code which includes political neutrality. The Secretariat is assisted by various experts in HM Treasury, the Department for Work and Pensions and HM Revenue and Customs. The interim Office for Budget Responsibility is currently located in HM Treasury.

Sources of evidence

15 My staff collected evidence from a range of sources, including:

- A written representation from Sir Alan Budd, Chair of the Budget Responsibility Committee.
- Interviews with key individuals:
 - The three members of the Budget Responsibility Committee.
 - Members of the Secretariat of the interim Office for Budget Responsibility.
 - Senior HM Treasury officials.
- The Pre-Budget forecast, 14 June 2010.

² http://budgetresponsibility.independent.gov.uk/d/pre_budget_forecast_140610.pdf

³ The fiscal mandate is the objective(s) for fiscal policy set by the Chancellor.

- Terms of Reference for the interim Office for Budget Responsibility and official statements on the remit and activities of the interim Office for Budget Responsibility.
- A selection of briefing documents and correspondence between the Budget Responsibility Committee, the Secretariat and HM Treasury.
- Informal consultation with external non-government commentators to understand their views on the interim arrangements.
- Desk research into the operation of similar independent fiscal councils in other countries.

16 Evidence was collected between 10 and 18 June 2010. As a result of the timing of this examination, I have formulated my opinion primarily drawing on evidence of the process surrounding the interim Office for Budget Responsibility's Pre-Budget forecast. I have also considered some evidence concerning the interim Office for Budget Responsibility's Budget forecast.

Findings

Criterion: discretion over scope and judgments

17 The Terms of Reference for the interim Office for Budget Responsibility state that it "will make an independent assessment of the public finances and economy for the June Budget. The interim Office for Budget Responsibility will make all the key judgments that drive it." All interviewees, Sir Alan's written representation and the supporting documentary evidence seen by my staff confirmed that the Budget Responsibility Committee had full discretion over the scope and nature of its judgements on the assumptions and forecasts.

18 The forecasting approach adopted by the interim Office for Budget Responsibility has been to base the forecast on a 'central' view and present the uncertainty around this forecast, representing a shift away from HM Treasury's previous approach of adopting deliberately cautious assumptions. This has been a key driver of changes from past practice. The decision was taken by Sir Alan Budd, now Chair of the Budget Responsibility Committee, as part of the preparations for the interim Office for Budget Responsibility. His view was that that this change was necessary for the Committee to be able to judge whether the Government's policy is consistent with a better than 50 per cent chance of achieving the Chancellor's fiscal mandate.⁴

19 The Committee was briefed and advised by the Secretariat and Treasury officials, to enable it to make judgements on the assumptions and forecast. The Committee obtained advice on technical judgements from Treasury officials, but retained discretion over whether or not to accept this advice.

⁴ An article, "Fiscal Policy Under Labour", published in the National Institute Economic Review, April 2010, sets out Sir Alan Budd's views on uncertainty in fiscal forecasting.

Criterion: unrestricted access to data and analysis

20 The Committee members and Secretariat confirmed that they had the information required in sufficient time, and that all their requests were met. The breadth and depth of analysis reported in the interim Office for Budget Responsibility's pre-Budget forecast is certainly consistent with the interim Office for Budget Responsibility having had full access to government data and analysis. Briefing papers produced by officials for the interim Office for Budget Responsibility seen by my staff provide corroborating evidence.

Criterion: control over sufficient resources

21 The Committee members and Secretariat confirmed that they had sufficient resources to fulfil the interim Office for Budget Responsibility's remit. Although the Secretariat's staff of eight is insufficient to prepare the Budget forecasts, the Secretariat acted as a conduit for a wide range of forecasting resources across HM Treasury, the Department for Work and Pensions and HM Revenue and Customs. The Committee members confirmed that they had been able to ask officials in Government departments to respond to specific questions and re-run their forecasts, and that the turnaround time was no obstacle in reaching their judgements.

Criterion: scrutiny and challenge

22 The Budget Responsibility Committee held over 30 challenge meetings to discuss the economic assumptions and fiscal forecasts prepared by officials from HM Treasury, the Department for Work and Pensions and HM Revenue and Customs. They were assisted in this task by the Secretariat.

23 Although effective scrutiny could of course result in consensus, disagreement provides positive evidence of scrutiny. My staff therefore sought evidence of assumptions on which, as a result of scrutiny and challenge, the Committee adopted a different position to the Treasury. The Committee provided my staff with several specific examples, supported by corroborating documentary evidence, where they had challenged the assumptions and analysis presented to them by officials. The interim Office for Budget Responsibility's Pre-Budget forecast document contains detailed explanation of where and how several of the key assumptions differed from previous Treasury practice.

24 In particular, assumptions about the future path of interest rates provide evidence of the Committee's scrutiny and challenge. During the course of the challenge meetings, Treasury officials questioned whether market rates were suitable for a Pre-Budget forecast, because market rates price in some expectation of the contents of the Budget itself. The Committee preferred to use market rates for the interest rate judgment, since these provide a simple and transparent assumption for the future path of interest rates. The Committee's Pre-Budget forecast adopted the Committee's preference for market rates, while acknowledging the possible inconsistencies and potential upward bias to their growth forecast.⁵

Criterion: independent judgements

25 It is important to understand the extent of interaction between the Chancellor and the Budget Responsibility Committee during the preparation of forecasts, since independence from political judgements is one of the objectives for the Office for Budget Responsibility. My staff identified and reviewed documents relevant to assessing this criterion.

26 Sir Alan Budd met with the Chancellor on one occasion prior to the announcement of the interim Office for Budget Responsibility. In addition, consistent with its Terms of Reference, the whole Budget Responsibility Committee met with the Chancellor on one occasion prior to the launch of the Pre-Budget forecast. The Committee also updated the Chancellor with written summaries of its forecasts as they evolved.

27 The introduction to the Pre-Budget forecast contains a public statement by the three Committee members that "All judgements in the forecast have been made or agreed by the BRC and are its responsibility. There has been no ministerial involvement at any stage."⁶ In this regard, nothing has come to my attention that makes me believe the judgements of the Committee were not independently arrived at.

Criterion: autonomy over content of published reports

28 The Committee members confirmed that while they drew on the resources of HM Treasury's press office to disseminate the Pre-Budget forecast, they had full autonomy over its contents. The inclusion of additional assumptions, not previously published by the Treasury, is consistent with interim Office for Budget Responsibility independence and autonomy over publication. For example, an assumption for whole economy earnings growth⁷ had not previously been published by the Treasury out of concern for establishing a 'norm' for wage bargaining. In the interests of transparency, the Committee concluded that it should be published in its Pre-Budget forecast.

⁵ Pre-Budget Forecast, Office for Budget Responsibility, June 2010, Foreword, 3.11.

⁶ *ibid*, Foreword.

⁷ *ibid*, Table 4.2.

Conclusion

29 In my opinion, based on the criteria in Figure 1 on page 5, the key economic and fiscal assumptions underpinning the interim Office for Budget Responsibility's forecasts have been independently arrived at.

Appendix One

Interim Office for Budget Responsibility: Terms of Reference

Role in the forecast

The interim Office for Budget Responsibility will make an independent assessment of the public finances and the economy for the June Budget. The interim Office for Budget Responsibility will be given direct control over the forecast and make all the key judgments that drive it.

The interim Office for Budget Responsibility's first forecast, based on existing policy, will be published in advance of the Budget.

The interim Office for Budget Responsibility will also produce a forecast at the Budget, incorporating the impact of policy measures announced at the Budget.

The public sector balance sheet and sustainability

The interim Office for Budget Responsibility has a role in beginning an independent assessment of the public sector balance sheet and fiscal sustainability, including assessing the impact of ageing, public service pensions and PFI contracts.

The interim Office for Budget Responsibility will provide an initial discussion of public sector liabilities and their implications for the public finances alongside the first forecast.

The fiscal mandate

The Chancellor will retain responsibility for fiscal policy and will set the fiscal mandate.

In the Budget, the interim Office for Budget Responsibility will make a judgment on whether the Government's policy is consistent with a better than 50 per cent chance of achieving the fiscal mandate.

Advice on the permanent Office for Budget Responsibility

The interim Office for Budget Responsibility will provide advice to the Chancellor on the appropriate arrangements for the permanent Office for Budget Responsibility.

This advice should include the interim Office for Budget Responsibility recommendation for the permanent Office for Budget Responsibility's roles and responsibilities, aims and objectives, and appropriate size, status, and funding.

The interim Office for Budget Responsibility will report to the Chancellor around the time of the Budget.

Independence and relationship with the Treasury

The Treasury will be accountable to Parliament for ensuring the interim Office for Budget Responsibility is properly and efficiently run. However, the Treasury will not intervene in the decision-making of the interim Office for Budget Responsibility.

The Treasury will provide the interim Office for Budget Responsibility with full access to the data, analysis and resources necessary to fulfil the roles set out in this Terms of Reference.

The Budget Responsibility Committee should make the key judgments and assumptions underpinning the interim Office for Budget Responsibility's forecasts, analysis and advice.

The interim Office for Budget Responsibility will have discretion over what material is published in fulfilling the remit set out in this Terms of Reference.

The interim Office for Budget Responsibility may choose to consult the Chancellor in preparing documents but is not obliged to do so.

Accountability to Parliament

It is expected that the interim Office for Budget Responsibility will be accountable to Parliament for the delivery of the tasks set out in this Terms of Reference. The Treasury will arrange for the interim Office for Budget Responsibility's documents to be made available to Parliament. Members of the Budget Responsibility Committee will be available to give evidence to the relevant Parliamentary committees.



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