



The Scottish Parliament
Pàrlamaid na h-Alba

FINANCE COMMITTEE

AGENDA

30th Meeting, 2013 (Session 4)

Wednesday 27 November 2013

The Committee will meet at 9.30 am in Committee Room 1.

1. **Decision on taking business in private:** The Committee will decide whether to take items 3 and 4 in private and whether to consider its draft report on the Draft Budget 2014-15 and a list of candidates for the post of adviser in private at future meetings.
2. **Inquiry into proposals for an independent fiscal body:** The Committee will take evidence from—

Dr Jim Cuthbert;

Professor Campbell Leith, Professor of Macroeconomics, University of Glasgow;

Professor Jeremy Peat, Fellow, Royal Society of Edinburgh.
3. **Appointment of an adviser:** The Committee will consider its approach.
4. **Draft Budget Scrutiny 2014-15:** The Committee will consider a draft report on the Scottish Government's Draft Budget 2014-15.

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The papers for this meeting are as follows—

Agenda item 2

Note by the Clerk

FI/S4/13/30/1

Agenda item 3

PRIVATE PAPER

FI/S4/13/30/2 (P)

Agenda item 4

PRIVATE PAPER

FI/S4/13/30/3 (P)

Finance Committee**30th Meeting, 2013 (Session 4), Wednesday, 27 November 2013****Inquiry into proposals for an independent fiscal body****Introduction**

1. The purpose of this paper is to inform the Committee's oral evidence session in relation to its inquiry into proposals for an independent fiscal body.

2. In evidence to the Finance Committee on 1 May 2013 the Cabinet Secretary for Finance, Employment and Sustainable Growth stated that as a consequence of the new financial powers arising from the Scotland Act 2012: "Scotland will require an independent forecasting body that can provide independent assessment to the Government and the Parliament of what might be generated as a consequence of those taxes."¹

3. The Cabinet Secretary has stated that it is his intention to establish the new body prior to the implementation of the newly devolved taxes in April 2015.

4. Given this background, the Committee's call for evidence sought responses on six questions relating to—

- the role and remit of the new body
- whether the new body should be established on a statutory basis
- the powers of the new body
- the accountability of the new body, including how it is appointed
- the objectives of the new body and
- the principles of the new body.

5. The written submissions received, including those from the witnesses who will provide evidence to the Committee at this meeting, can be accessed online at: <http://www.scottish.parliament.uk/parliamentarybusiness/CurrentCommittees/67138.aspx>. The witness submissions have also been circulated to Members in hard copy.

Role, remit and key objectives for the IFI

6. The objective of an independent fiscal body is summarised by Professor Campbell Leith as being "...to allow for short-run flexibility in a way that adherence to fiscal rules may not allow, but to ensure that this does not jeopardise long-run fiscal solvency."

¹ <http://www.scottish.parliament.uk/parliamentarybusiness/28862.aspx?r=8114&mode=pdf>

7. In terms of whether there is a need for an independent fiscal body, the Royal Society of Edinburgh (RSE) highlights the importance of safeguarding the sustainability of public finances, stating that “the more powers that the Scottish Parliament has in relation to revenue generation and expenditure in Scotland, the more important this becomes.”

8. On the same question of the need for such a body, Professor Leith notes that—

“Given that the basic economic case for creating fiscal councils lies in overcoming the deficit bias problem in a way which retains economic flexibility to deal with shocks, the need for a Fiscal Council in a setting where the budget is essentially balanced is less clear.”

9. Professor Leith goes on to state that—

“...even if devolved powers fall short of allowing the Scottish Government significant debt issuance capabilities, there may be scope to formally enhance the Scottish input into the Office for Budget Responsibility’s forecasting activities, particularly over revenue and expenditure items, specific to Scotland.”

10. Looking at the possible remit and role of an independent fiscal body, the RSE identifies four areas of work that an independent fiscal body could be tasked with—

- Reviewing the fiscal outlook for the government and the public
- Reviewing the future revenues likely to be available
- Estimating current structural imbalances
- Estimating the likely consequences of current spending and taxation plans.

11. The RSE also suggests that, beyond a forecasting role linked to the annual budget cycle, consideration should be given to the independent fiscal body having a role to providing analytical commentary on strategically important forward-looking issues and commitments.

12. Assuming three functions of an independent fiscal body are forecasting, risk assessment and costing policy proposals, Dr Jim Cuthbert comments—

- That there should be a good deal of caution about the value that an independent body can add to the forecasting role, given that an independent forecaster will assume the success of the policy unless there is already strong evidence to the contrary
- That an independent body does have potentially a very valuable role to play as regards risk assessment
- Given that serious errors have been made in costing policy proposals in the past, that an independent body could play a valuable role in this function. But, since, costing policy proposals can be a difficult and resource intensive

task, such a body would have to be adequately resourced if it was to be effective in such a role.

13. Beyond the matters of specific elements of the remit and role of an independent fiscal body, submissions also comment on the importance of appreciating the wider context within which fiscal bodies operate.

14. For example, Dr Cuthbert comments on the context in which forecasts are being produced and the assumptions that may be made by fiscal bodies, such as “that some of the key judgements which the OBR made involved assuming the success of important aspects of government policy” and that “this is an almost inevitable feature of forecasts produced in a heavily policy influenced environment”.

15. Dr Cuthbert also considers the potential role of an independent fiscal body from the perspective of managing risk in economic forecasting and identifies the following implications—

- The central forecast produced by such a body will normally assume the success of policy: and is therefore likely to be of little interest in itself.
- Moreover, if this point is not widely appreciated, then the apparent independent validation which the central forecast provides for the success of policy can lead to the risks of policy failure being seriously underestimated.

16. Professor Leith comments on the impact of the policy environment from a slightly different perspective, noting that the idea of the monitoring role of an independent fiscal body “is that such monitoring can remind policy makers of the need to take account of long-run fiscal sustainability wherever policies were being pursued which endangered that”.

Powers of the IFI

17. In terms of powers, the RSE highlights that a Scottish independent fiscal body should have the right to develop its own framework of analysis, data sources and methodology and have full access to data and any related evaluations or analysis made elsewhere.

18. Access to data was discussed by Robert Chote at the Committee’s last meeting. In his evidence to the Committee he noted that—

“...the issue is not just data but analytical capacity. Of course some data are publicly available and you do not need a specific right of access to them, but – to come back to my discussion with the convener about the model for how we interact with the experts in HMRC who produce data on particular taxes – having access to such analytical capacity is crucial.”

19. Mr Chote also highlighted how that works in terms of the various agencies involved. The OBR has agreed a memorandum of understanding with relevant departments and “as part of that memorandum of understanding, we have a committee, with all those bodies represented on it, that looks at the forecasting process.”

20. Members will note that there is a Memorandum of Understanding² between the Scottish Government and HMRC in relation to the Scottish Rate of Income Tax, including provisions on information sharing. The memorandum states—

“HMRC must provide information to the SG that will enable Scottish Ministers and officials to discharge their duties in respect of Parliamentary accountability, scrutiny and rate setting and forecasting in relation to SRIT.”

21. The matter of the relationship between an independent fiscal body and the OBR was commented on by Professor Leith—

“...an independent Scottish Fiscal Council could enhance the policy making process by making independent forecasts of variables of sole interest to Scotland. For other items which impact on both Scotland and the rest of the UK, a formal working relationship between the Scottish Fiscal Council and the OBR which aims to produce a single consensus forecast would facilitate the gains from cooperation, without undermining the credibility of either body.”

Accountability and appointment

22. The RSE suggests that an independent fiscal body should be appointed by, and directly accountable to, the Parliament with appointments to the independent fiscal body made by the Crown.

Conclusion

23. The Committee is invited to consider the above in relation to this evidence session.

Catherine Fergusson
Senior Assistant Clerk to the Committee

² <http://www.scotland.gov.uk/Resource/0041/00417598.pdf>

Limitations on what can be expected from an Independent Financial Scrutiny body.

Note by Dr. J. R. Cuthbert

1. In August 2013, I published a Jimmy Reid Foundation paper, examining the handling of risk by the Office for Budget Responsibility, (OBR), in relation to its economic forecasting role. A copy of this paper is attached. It contains some potentially important lessons about how much might be expected from an independent financial scrutiny body, which are relevant to the Scottish context.
2. The Reid Foundation paper reviewed the way the OBR produces its economic forecasts, and came to the following conclusions:-
 - a) First, that the OBR economic forecasting methodology is heavily judgement based.
 - b) Secondly, that some of the key judgements which the OBR made involved assuming the success of important aspects of government policy: (for example that, by the end of the forecast period, inflation will be stable at the government's target of 3% CPI inflation per annum: or the assumption that quantitative easing will begin to be unwound, and that this will proceed in an orderly fashion, without disturbing interest rates as currently forecast by the futures' market.)
 - c) That the OBR pays insufficient attention to assessing the risks surrounding its forecasts,
3. The paper concluded that, since the OBR central economic forecast depends critically on key assumptions about the success of government policy, this made the central forecast of relatively little interest in itself. The paper recommended that OBR should expend less effort on producing its central forecast, and that it should pay more attention to the assessment of risk: and the paper made a number of specific recommendations to assist in this process.
4. What is probably most relevant for present purposes is the point made at 2(b) above, about the extent to which OBR forecasts depend on key assumptions about the success of government policy. It would be wrong to conclude from this that the OBR is failing to act independently. Instead, as the Reid Foundation paper argued, this is an almost inevitable feature of forecasts produced in a heavily policy influenced environment.
5. This happens for the following reason. Suppose an independent forecaster is trying to forecast the outcome of a particular process, (like the economy), where there is an agent who has a specific policy objective for the outcome of the process, and where that agent has powerful levers that can be used to influence the outcome: (like the Bank of England, with its target for inflation, and its monetary policy control lever.) Then for an independent forecaster, the most rational choice for the central forecast will often be that the desired policy objective is achieved. This is because, if it is obvious to the independent forecaster that the process is currently heading for, say, an

undershoot – then this will be equally obvious to the controlling agent. So the forecaster has to assume that the agent will take corrective action. Of course, this action may be too much, or too little: or other factors may come into play. But the important point is that there is normally no reason for an independent forecaster to assume that the outcome will either consistently overshoot or undershoot.

6. Thus, the normal rational decision made by an independent forecaster is likely to be that the required policy objective is attained. The only circumstance where the central forecast is likely to differ from this is where there is evidence the process is currently heading off course, and where the forecaster has firm evidence that the agent's control lever has been rendered ineffective. This combination of circumstances is likely to be relatively rare.

7. If this conclusion is correct, then there are two profound implications about what can be expected from an independent financial scrutiny body:

- a) The central forecast produced by such a body will normally, (and perfectly rationally), assume the success of policy: and is therefore likely to be of little interest in itself.
- b) Moreover, if this point is not widely appreciated, then the apparent independent validation which the central forecast provides for the success of policy can lead to the risks of policy failure being seriously underestimated. What this means is that having an independent scrutiny body is not unequivocally "a good thing": there are certain dangers involved, as well.

8. Overall, if three different potential functions of an independent financial scrutiny body are identified, namely:-

- a) forecasting.
- b) risk assessment.
- c) costing policy proposals,

then the author's views on each of these are:-

- a) that there should be a good deal of caution about the value that an independent body can add to the forecasting role, given that an independent forecaster will tend to assume the success of policy unless there is already strong evidence to the contrary.
- b) that an independent body does have potentially a very valuable role to play as regards risk assessment.
- c) given that serious errors have been made in costing policy proposals in the past, (e.g., free personal care), that an independent body could play a valuable role in this function. But, since costing policy proposals can be a difficult and resource intensive task, such a body would have to be adequately resourced if it was to be effective in such a role.



Missing the Risk

Misplaced effort by the Office of Budget Responsibility
leads to underassessment of risk

Jim Cuthbert, August 2013

a paper from the The Jimmy Reid Foundation

Section 1: Introduction.

The Office of Budget Responsibility, (OBR), was created by George Osborne in 2010, with its main duty being to examine and report on the sustainability of the public finances. Central to the OBR's remit is the requirement for it to produce independent forecasts of the economy and public finances, setting out the key assumptions made, and giving an analysis of the risks surrounding the economic outlook.

The purpose of the present study is to examine the handling of risk in the OBR's approach to forecasting the economy: and in particular, to assess whether the OBR is adequately assessing the full range of risks surrounding its economic forecast.

One major conclusion of this study is that the OBR's treatment of risk is grossly inadequate, and likely to give an unduly reassuring impression. OBR's main risk assessment is based upon historic forecasting error: i.e., the range of error in past forecasts of quantities like GDP made by various forecasting agencies. But this type of forecasting error is only one of the potential risks. Factors which are largely neglected in the OBR reports include:

- a) the likelihood of future shocks to the economy.
- b) the likely robustness of the economy to withstand a possible future shock.
- c) feedback effects, because OBR bases some of its important assumptions on the view taken by markets on factors like future interest rates, and in turn the markets will themselves be influenced by OBR's forecasts.
- d) the fact that, since we are now in many ways in new economic territory, (for example, as regards the implications of the policy of quantitative easing), the past is not necessarily a useful guide to the future.

But this is not just a question of "could do better". There are fundamental problems about producing forecasts in the kind of environment in which the OBR must operate – an environment where the outcome of the quantity being forecast is itself to a large extent under policy control. This is because, as will be argued later in this paper, a rational central forecast in such an environment will almost always automatically assume the success of policy. In such an environment, therefore, the central forecast itself is of relatively little interest. What is of much more value is an analysis of the risks surrounding the likelihood of the central forecast being achieved.

So the second main conclusion of this report is that the OBR should be radically changing its emphasis. It should be putting much less effort into forecasting, and much more into assessing the potential vulnerabilities to which the economy is subject, and the potential risk factors which could prevent government achieving its economic policy aims.

Such a change in emphasis might be less superficially reassuring than the OBR's current reports: but it would be much more valuable. It would be valuable for the public, because they would feel that they were getting a properly detailed examination of risk. But it would be of particular value to government, because it would almost inevitably focus attention on vulnerabilities in the current economic structure which should be rectified, but are currently in danger of being ignored.

The structure of this paper is as follows:-

- Section 2 gives a brief outline of OBR's economic forecasting methodology, bringing out the sources of the key assumptions.
- Section 3 summarises, and assesses, the way in which OBR currently handles the question of risk.
- Section 4 looks at the problem of forecasting in a heavily policy influenced environment, and considers the implications.
- Section 5 makes specific suggestions about how OBR should change its approach.

Section 2: The OBR Approach to Forecasting.

The OBR's remit and status is set out in the government's Charter for Budget Responsibility, (Treasury, 2011). The primary duty of the OBR is to examine and report on the sustainability of the public finances, (Charter, para 4.2), and the OBR is, by statute, independent. It does, however, have some particular duties laid on it by the Charter. It has to produce regular forecasts of the economy and public finances. And it has, specifically, to address the question of whether the government is on target to meet its fiscal mandate: that is, it has to assess whether the government is meeting its objective of balancing the current budget, on a rolling five year basis adjusted for the economic cycle. Further, in each report published under its main duty, it has to explain the factors taken into account when preparing the report, including the main assumptions and risks: (Charter, 4.7).

This paper is particularly concerned with the way in which the OBR produces its forecast of the economy, and how it assesses the associated risks – rather than with the OBR's forecast of the public finances. The OBR's approach to economic forecasting is described in detail in its Briefing Paper Number 3, (OBR, 2011). As the OBR notes, its approach to economic forecasting is somewhat different from that adopted by other independent forecasters. Because of the detail required as input to their forecast of the public finances, the OBR forecast contains more economic variables than most other forecasts: and because of the five year period implicit in the government's fiscal mandate target, the OBR forecast covers a longer period than most others.

The OBR has adopted the detailed Treasury macroeconomic model as one of its main tools in producing its economic forecast. The OBR maintains a version of the model independently of the Treasury, and has made it clear that it is prepared to modify the Treasury model if it feels the Treasury version no longer meets its requirements. So, in principle, the OBR's use of the Treasury model is still consistent with its independent role.

It is very important, however, to appreciate that the key determinant of the OBR forecast is not the econometric model itself: but rather the set of judgements and assumptions which the OBR makes, and which feed into the model. This is a point which the OBR themselves make very clearly, (see, for example, Briefing Paper 3, para 2.2 and 2.16ff), where the judgemental nature

of the OBR forecast is stressed. The advantage of the econometric model is that it enables the implications of a given set of judgements and assumptions to be worked out in the detail required for making fiscal forecasts: and also, crucially, because it means that the OBR forecast is constrained to paint an internally consistent picture. (That is, the model should prevent the OBR from making assumptions which are internally inconsistent – at least in terms of the internal logic of the model.) These are important advantages of using the econometric model. But the key determinants of the OBR forecast are the judgements and assumptions which the OBR make. We now consider the set of judgements which the OBR is making.

Probably the two most important judgements which the OBR make are those concerning the so-called output gap, and the trend growth rate of potential output. Some explanation is required of these concepts: for more detail, see for example, OBR's Forecast Evaluation Report, (OBR 2012b), para 2.80. The potential output of the economy is defined as that level of economic activity, (that is, GDP), which is consistent with maintaining stable inflation. The output gap, (which is usually expressed as a percent of GDP), is the difference between the current level of activity in the economy, and the level of potential output. If the output gap is negative, then this means that there is spare capacity in the economy: i.e., economic activity could be increased without generating inflationary pressure. Conversely, if the output gap is positive, the economy is overheating.

As well as these key judgements on the size of the output gap, and on the trend growth rate of potential output, the OBR make a further vital assumption: namely, that the Bank of England, (BoE), manages monetary policy in such a way that the output gap closes over the forecast period. In other words, the OBR assume that the BoE manages interest rates so that, round about the end of the forecast period, inflation is stable at the government target rate of 2% CPI inflation per annum: and that the economy is then operating on the trend line of GDP growth: (see, for example, Briefing Paper 3, para 3.30.)

These two key judgements, (on the output gap, and the trend of potential output), and the assumption about the success of monetary policy, effectively determine the basic outline of the OBR economic forecast, in terms of where GDP and inflation will be around five years ahead. Of course, there is a lot more to the OBR forecast than this: for example, in forecasting what the path of GDP will be between now and the end of the forecast period: and in making assumptions about, or deriving from the model, the whole set of detailed information which OBR require. But the essentials of the OBR forecast are determined by the two key judgements and the monetary policy assumption.

A crucially important point to note is that one of these three elements is the assumption of the success of monetary policy. In other words, success of a key aspect of government policy is taken for granted as a central part of OBR's forecasting methodology. This is a point on which there will be much more to be said in section 4 of this paper. It might at first sight appear irrational for an independent forecaster to be assuming the success of an important aspect of government policy, when the forecasts being produced are intended to be an independent validation of the credibility of that very policy. It will be argued in Section 4, however, that the OBR's monetary policy assumption may not be as irrational as it might first appear, given the very real conceptual problems attached to forecasting in a heavily policy influenced environment. But, as will be argued, these problems have profound implications for the status which should be attached to the OBR's projections, and also for the kind of work OBR should be doing.

Other assumptions made by OBR in the forecasting process are as follows: (this is not a complete list):

- **Oil prices:** that these move in line with the current values of Brent Crude futures prices.

- **World interest rates:** as predicted by current values of relevant interest rate futures.
- **UK gilt edged interest rates:** as predicted by current values of relevant interest rate futures.
- **Equity prices:** grow in line with nominal GDP.
- **House prices:** as projected by the median of independent forecasters.
- **Exchange rates:** determined by model, in line with what is known as the “uncovered interest rate parity condition”: (that is, exchange rates are assumed to move to eliminate the effect of interest rate differentials between the UK and the rest of the world.)
- **Unwinding Quantitative Easing:** OBR assume that Quantitative Easing will begin to be unwound, (that is, that the BoE will begin to sell off the UK Gilt edged securities it has purchased through quantitative easing), as soon as Bank Rate rises above 1%, with sales evenly paced at £10 billion per annum thereafter.

[Sources: mostly from OBR Briefing Paper 3, para 3.3, apart from the assumption on Quantitative Easing, which is from OBR 2013, para 4.23.]

It is worth making two points about this list of assumptions.

- a) For certain important variables, (e.g., UK and world interest rates, and hence also exchange rates), the OBR is relying upon the view which the markets are currently taking about what will happen in the future. This raises the potential for feedback effects between OBR forecasts and market views, feedback effects which could be potentially destabilising. This will be discussed at greater length in section 4.
- b) In at least one very important respect, (the assumption about unwinding quantitative easing), the OBR are again assuming the success of government policy. In other words, it is being assumed that quantitative easing will be unwound, (so the government is not actually monetising a large part of its debt), and that this can be done without disrupting the future path of interest rates as currently predicted by the market.

This concludes the description of the relevant parts of the OBR’s approach to forecasting. This paper is primarily concerned with the OBR’s approach to risk, rather than with a general critique of OBR’s central forecast. But before leaving this section, it is worth making one comment about OBR’s approach to forecasting. Namely, that it is surprising that OBR give such a central role to the concept of potential output. What this means is that OBR are basing their forecast primarily on a judgement about a quantity which cannot even be historically observed. This makes it extremely difficult, if not impossible, to do a proper post-mortem on the OBR forecast, if forecast GDP growth does not, in the event, correspond with what actually happens. Of course, it is very convenient for politicians to express their fiscal mandates in terms of concepts which cannot be unambiguously measured: (witness Gordon Brown’s redefinition of the economic cycle as it became clear he might breach his Golden Rule.) The OBR certainly cannot escape consideration of the output gap, given the duty laid upon them to assess whether the government is on course to meet its fiscal mandate. But it is doubtful if they should have taken on board the concept of potential output to such an extent that they actually placed it at the centre of their forecasting approach.

Section 3: The OBR's Approach to Risk.

As already noted, one of the requirements laid upon OBR in reporting on the sustainability of the public finances is to explain the factors taken into account in preparing their report, including the main assumptions and risks. In the OBR's March 2013 Fiscal Outlook Report, three main techniques are employed for assessing risk:

- a) by looking at past forecast errors.
- b) sensitivity analysis: that is, investigating how much OBR's central forecast would change if some of the key judgements underpinning it were altered.
- c) scenario analysis: that is, examining some alternative economic scenarios.

(Further details on these techniques can be found in OBR 2012a)

In line with the first of these approaches, several of the charts showing forecasts of important variables are presented as fan charts, where the central forecast is surrounded by an increasing fan showing the probabilities attaching to different ranges of outturns: the width of the fan reflects experience with past forecast errors.

In line with the scenario analysis approach, material presented in Chapter 5 of the March 2013 Fiscal Outlook looks at the effect on the government's target fiscal aggregates of

- a) various combinations of the assumed size of the current output gap, (5 variant options), with various combinations of the assumed date when the output gap finally closes, (again, 5 variant options).
- b) 5 variant assumptions about the future interest rate at which the government borrows.
- c) 4 different variant options in the assumed coefficients used in cyclically adjusting the fiscal aggregates.

Finally, in line with the scenario analysis approach, two broader illustrative scenarios are analysed in Chapter 5 of the March 2013 Fiscal Outlook: both scenarios are based on different reactions to a 15% depreciation in the Sterling exchange rate relative to the central forecast. As OBR note,

"We stress that these scenarios are not intended to capture all possible ways in which the economy might depart from the central forecast: and we do not attempt to attach particular probabilities to these occurrences." (Fiscal Outlook, para 5.36)

There are a number of very significant weaknesses in the above approach. In particular:

- a) As regards the fan charts based upon past forecast errors, it is important to remember that forecasting error, (i.e., the kind of random error one would normally expect in forecasting any system operating under fairly stable control), is only one of the potential sources of error. Further, it is by no means obvious that the past is a reliable guide to the statistical distribution of forecasting errors in the present or near future. This is particularly the case since economic circumstances over most of the period when past forecast errors would have been assessed are very different from what they are now. With interest rates at unprecedentedly low levels, it is uncertain whether the relationships on which the OBR economic model is founded will continue to hold over the forecast period.

- b) The sensitivity analysis which the OBR report on is very limited. It is limited not only because of the very small range of variant possibilities which the OBR consider: it is also limited in the nature of the analysis conducted. As the OBR note, they have carried out the sensitivity analysis on a ready-reckoner basis: that is, this effectively amounts to saying – what is the effect if one assumption is varied, while everything else is held constant? Real life, however, is likely to be much more complex, with dislocations of the central forecast likely to involve departures of a number of variables from their originally assumed values. So the limited form of sensitivity analysis conducted by the OBR is likely to significantly understate the actual sensitivity of the OBR forecast to variations in assumptions.
- c) The scenario analysis undertaken by OBR is meant to represent a more integrated approach to evaluating the effect of different economic scenarios. But the number of scenarios considered, (only two, both relating to exchange rate movements), is extremely limited.

The analysis of forecasting error, and the sensitivity and scenario analysis conducted by OBR, thus give no real indication as to the potential uncertainty surrounding the central forecast. In particular, the following are effects and contingencies which would need to be considered in any proper assessment of risk and uncertainty.

Potential feedback effects. As noted in the preceding section, the OBR look to the futures market as the source for certain key assumptions: in particular, interest rates, but also crude oil prices. But here we encounter a potentially destabilising paradox. The forecasts produced by OBR must in themselves be an important influence on the market's view of the future: after all, OBR is intended to be an authoritative and independent forecaster, whose views undoubtedly carry considerable weight. So when the market is forming its view on future interest rates, it will in part be influenced by OBR, which in turn takes its assumption from the market.... It is clearly very possible in these circumstances that the market and OBR might become caught up in a cycle of misleading reassurance: and that, equally, feedback effects could lead to considerable instability if such a cycle broke down.

Quantitative Easing risk. As noted in the previous section, OBR assume that Quantitative Easing, (QE), will start to be unwound as soon as Bank Rate reaches 1%, (which, in OBR's March 2013 forecast, is projected to happen in 2016, based upon current interest rate futures.) There must, however, be huge uncertainty attaching to the various ramifications of this assumption. We are, after all, talking about the process of unwinding what Andy Haldane, the BoE's Director of Financial Stability, described as recently as June 2013 as "the biggest bond bubble in history." What will happen in relation to QE unwinding must be inherently uncertain – for one thing, this is completely new territory. For example:

If the market ever came to the view that the government was not going to unwind QE, then this would amount to the view that the government was monetising its debt – such a view would have profound and unprecedented consequences on inflation, and confidence in Sterling.

On the other hand, once QE unwinding actually starts, then this will remove the support to current bond prices supplied by the anticipation of future QE – leading to the possibility of a collapse in bond prices, (i.e., increase in interest rates), which might far exceed what would normally be expected from the relatively modest scale of gilt sales, (£10 billion per annum), which OBR forecasts.

Overall, the risks surrounding QE, (not just in the UK, but worldwide), are so considerable that the BoE's Andy Haldane singled this out, in evidence to the Treasury Select Committee, as the biggest risk to global financial stability.

Effect of external shocks. There is some limited discussion in the OBR documents of the potential effects of future external shocks, (e.g., a messy outcome in the Euro zone), but there is nothing like a full discussion. And OBR have a tendency, when discussing such possibilities, to incorporate the effect in terms of an adjustment to their central forecast, but not in terms of uncertainty. The following quotation illustrates this:-

"As set out above, we expect constrained real income growth, ongoing dislocation in financial markets, the fiscal consolidation and weak global growth to limit the rate of growth over the medium term. As a consequence, we expect the output gap to narrow at a relatively gradual rate..." (OBR 2013, para 3.34).

It is perfectly correct for OBR to adjust their central forecast in the light of their view of factors like dislocation in financial markets, and uncertainties in global growth. But uncertainty in such factors will affect not just the mean of the forecast distribution: it will also affect the variance, (that is, the spread of outcomes), around that mean. This increased uncertainty should be reflected in any realistic assessment of risk: OBR fails to do so.

Failure to assess systemic risk. As the events of 2008 illustrate, systemic risk, (i.e., the risk of the collapse of a large part of the financial system, with corresponding catastrophic impact on the economy), is not just a theoretical possibility. And yet there appears to be no assessment of the factors surrounding systemic risk in the reports produced by OBR. Such an assessment should at least include consideration of the following:

- a) an assessment of the likelihood of a trigger, (like a messy resolution of the Euro zone problems, or the collapse in an asset bubble), which might conceivably start a chain of events potentially leading to systemic collapse.
- b) an assessment of how robust the UK economy and public finances are to withstand a major shock.

Any realistic analysis of the second of these factors would presumably conclude that, with public sector net debt now at 76% of GDP and rising, compared with 36% immediately before the start of the 2008 crisis, the UK public finances are not well placed to withstand a further major shock. In other words, any realistic assessment would conclude there is a significant systemic risk to the UK economy.

Overall, in the light of the above, the conclusion appears inescapable: namely, that the OBR does not come close to fulfilling the requirement in its remit to provide an adequate assessment of the risks and uncertainties surrounding its forecast.

Section 4: The Status of Forecasts in a Policy Influenced Environment.

The OBR's concentration on producing its central forecast, and the limited attention paid to assessing the risks and uncertainties surrounding that forecast, are doubly unfortunate because,

as will be argued in this section, central forecasts mean relatively little in relation to a heavily policy influenced environment like the economy.

Suppose that we are trying to forecast the outcome of a particular process, (like the economy), where there is an agent who has a specific policy objective for the outcome of the process, and where that agent has powerful levers that can be used to influence the outcome: (like the BoE, with its target for inflation, and its monetary policy control lever.) Then for an independent forecaster, the most rational choice for the central forecast will often be that the desired policy objective is achieved. This is because, if it is obvious to the independent forecaster that the process is currently heading for, say, an undershoot – then this will be equally obvious to the controlling agent. So the forecaster has to assume that the agent will take corrective action. Of course, this action may be too much, or too little: or other factors may come into play. But the important point is that there is normally no reason for an independent forecaster to assume that the outcome will either consistently overshoot or undershoot.

In other words, the normal rational decision made by an independent forecaster is likely to be that the required policy objective is attained. The only circumstance where the central forecast is likely to differ from this is where there is evidence the process is currently heading off course, and where the forecaster has firm evidence that the agent's control lever has been rendered ineffective. This combination of circumstances is likely to be relatively rare.

This feature of forecasting in a policy influenced environment is entirely consistent with the fact that, as seen in Section 2, the OBR assumes that the BoE achieves its inflation target by the end of the forecast period: and with the assumption that quantitative easing will be successfully unwound. Making such assumptions is in line with OBR acting rationally: and does not in itself imply that OBR's independence is compromised.

Since, in a policy influenced environment, the normal rational central forecast is that the policy objective will be achieved, this means that the central forecast in itself is of relatively little interest. But the corollary is that what is really important is the assessment of the risks surrounding the central forecast. Consider the following rather dramatic imaginary example. Suppose that the White Star Shipping Company, in order to reassure potential passengers on its new liner Titanic, had set up an independent White Star Forecasting Office, (WSFO), to validate the shipping company's mandate that the new liner would be the fastest and most reliable on the North Atlantic. The rational central forecast produced by the WSFO will be that the Titanic will arrive in New York at around the scheduled time. This forecast in itself is of extremely limited value to the traveller, although the shipping company will make great play of it in its advertising. An additional analysis produced by the WSFO, showing the probabilities of the Titanic being earlier or later than the scheduled arrival time by differing amounts, and based on past experience of the punctuality of similar liners, is of some use to passengers to enable them to plan their ongoing connections: but in practical terms is little more than a convenience. What would really be of interest to the concerned traveller would be if the WSFO produced an authoritative assessment of iceberg conditions in the North Atlantic: and also produced a technical study on the chances of the ship surviving an impact. And such analyses would not merely be reassuring, (or otherwise), to passengers: the existence of an authoritative report highlighting the dangers would itself inform the shipping company about potential dangers it might have underestimated – and greatly reduce the risk of a catastrophic outcome.

Going back to the OBR, what is seen from this example is that the OBR has got its priorities precisely the wrong way round. It puts huge effort into elaborating a central forecast which is of little inherent value, because it depends on key assumptions which assume the success of policy outcomes. But on the other hand the OBR largely neglects the important role which it should be playing, of assessing the major risk factors surrounding the economy.

This situation is convenient for politicians – since the central forecast will almost always be reassuring, and the risks, not analysed, are therefore underplayed. But an independent body like OBR should not be making life easier for politicians, and perhaps unwittingly giving them a false sense of security. The OBR should change its approach: some of the changes it should make are considered in the next section.

Section 5: Suggested Changes.

It has been argued in this paper that the OBR put too much effort into producing its central economic forecast, and too little into assessing the risks around that forecast. In fact, in a 2011 briefing paper on forecasting the economy,(OBR 2011), the OBR itself raised the question of whether it should undertake macroeconomic forecasts at all: as it said then, (para 3.144):

“One might ask why the OBR should produce macroeconomic forecasts at all and why we should not use those of the Bank of England or other non-governmental bodies that produce forecasts for the UK economy.”

OBR, quite reasonably, concluded that it did need to produce a macroeconomic forecast, because no external forecast were available which covered the range of variables and timescale the OBR needed in order to assess the government’s fiscal targets. But the quotation is relevant because it seems to indicate that the OBR itself does not attach the same weight and status to its central forecast which some commentators, and politicians, are inclined to do.

In order to reduce the danger of undue weight being given to the central forecast, it would be advisable if OBR were to alter the terminology it uses to describe its central forecast: describing this more as a projection dependent on certain conditioning assumptions, rather than as a forecast. A suitable form of words might be:-

“This is our central assessment of the path of future economic development, based upon our judgement, but conditional upon certain key assumptions: namely

- c) that monetary policy is successful in achieving the target rate of inflation by [date].
- d) that quantitative easing starts to be unwound during the forecast period, and that this takes place in an orderly fashion, with no distortion in interest rates from the path currently implied by the futures market.
- e) and that there are no profound external economic shocks.”

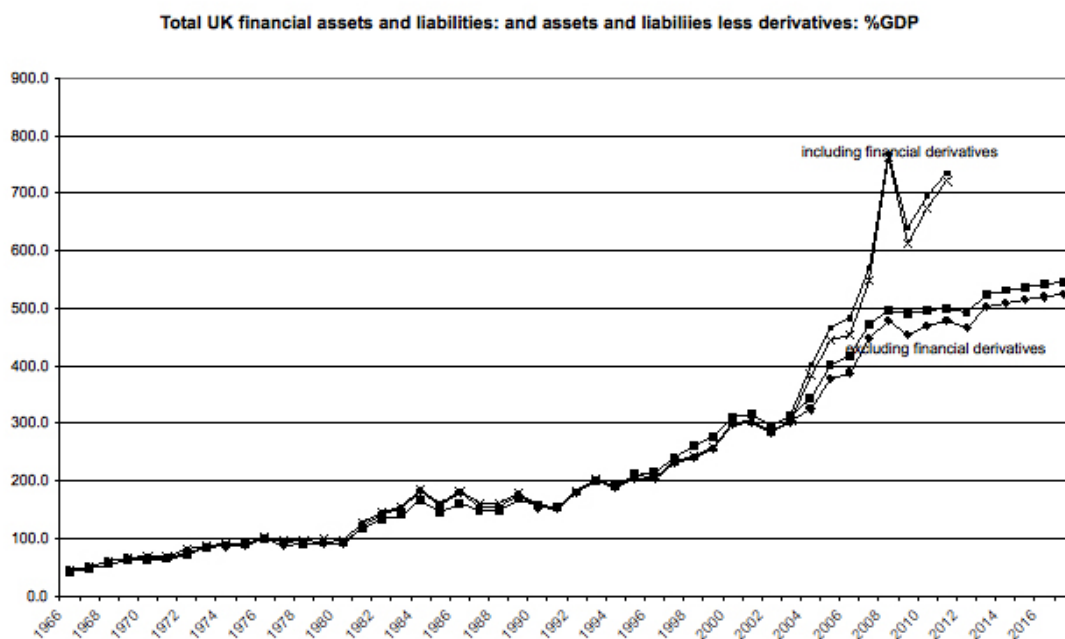
In placing greater emphasis on assessment of risk, it is suggested that there are a number of steps OBR should take. These are as follows.

- First of all, in presenting the results of its macroeconomic projection, the OBR should, as a standard approach, give long time series showing historic values of the key variables, and also the OBR projected values. It would also be useful if this information was presented graphically. This would make it easier for the user to assess whether the OBR projections implied any implausible looking changes in trend: and also whether the relevant variable was moving into an area which implied systemic risk. For example, time series showing the growth of different forms of credit, relative to

GDP, would have acted as flashing warning lights before 2008: (though, of course, OBR itself did not exist then.)

- Secondly, OBR should reconsider what variables it includes in its macroeconomic model: it may be useful, from the point of view of risk assessment, to include some variables which, from the point of view of driving other parts of the model, may not be strictly necessary. The following is one example to illustrate this point. The international assets and liabilities of the UK break down into a number of different categories – primarily relating to direct investment, portfolio investment, other investment, and financial derivatives. The assets in the first three of these categories generate dividend and interest payments which contribute to the current income flow on the current account of the balance of payments. However, the assets and liabilities in the fourth category, namely, financial derivatives, do not generate such income payments: (what counts as an asset or a liability for a financial derivative contract is the amount which the relevant party to the deal would have to pay, or be paid, to be relieved of the contract.) So in the OBR model, what is included as UK assets and liabilities are assets and liabilities excluding financial derivatives: and an assumption is made about the rate of return on these assets and liabilities, which the model uses to generate projected investment income.

While the exclusion of financial derivatives from the OBR model can be justified on model operational grounds, their omission means that something which is potentially very important from a risk point of view is excluded. The following chart illustrates this point.



(source: historic data from ONS Pink and Blue Books: forecast data derived from OBR 2013.)

What the two upper lines in the chart show are total UK assets owned by foreign residents, and total foreign assets owned by UK residents, expressed as a percentage of UK GDP: (in the later years shown the first of these quantities has been slightly greater than the second.)

Also shown in the chart, in the two lower lines, are the above quantities excluding financial derivatives. These are the quantities which are modelled by OBR: and the chart shows, for the lower lines as from 2013, the values implied by the OBR March 2013 forecast.

If we think of the UK economy, in its international relations, as being rather like a very large bank, (a useful analogy made by Nickell, 2006), then this chart is one way of looking at the balance sheet of "Bank UK". Clearly, the view we might take of the potential stability of Bank UK is rather different looking at the upper lines in the chart, as compared with the lower lines, which is what the OBR focuses on. For a fuller appreciation of the potential risks facing Bank UK, the OBR should be considering, and modelling, the upper as well as the lower lines in the chart.

(Note that there are some discontinuities in the ONS series for financial derivatives liabilities on which the above chart is based: but these do not invalidate the point being made.)

The above suggestions would imply useful improvements in OBR's ability, and the ability of users of the OBR projections, to assess potential risks to the system. In a sense, however, these changes would still be relatively cosmetic, compared to the major effort OBR should be making: which is to put serious resources into identifying and analysing the major sources of instability and risk for the UK economy: and into assessing the likely robustness of the economy in the face of potential future shocks.

The OBR clearly commands considerable, and talented, resources. Redeploying these resources into a better assessment of risk would be immensely valuable. In particular, there are disturbing indications that policy makers have not learned the lessons of 2008: and that, despite the increased vulnerability of "Bank UK" in many respects since 2008, the primary current policy response is to get things "back to normal" by inflating further asset bubbles: (for example, through quantitative easing, or through recent government initiatives in the housing market.) As things stand, the OBR, by concentrating on producing a central forecast which to a major extent takes the success of government policy for granted, is actually proving a barrier to fundamental change. If it were to put much more effort into a proper assessment of risk, then the effect would be the opposite, and beneficial, one of acting as a stimulus for change in the UK economy.

Section 6. Conclusion

In this paper, it has been seen how

- a) the OBR pays inadequate attention to the assessment of risks surrounding its central forecast of the economy.
- b) OBR takes as a given in making its central forecast the success of certain key aspects of government policy.

The second point does not necessarily mean that OBR is failing to act independently – since it is a feature of attempting to forecast in a heavily policy influenced environment that a rational independent forecaster will often assume the success of policy in their central forecast. But the corollary is that the central forecast in such an environment in itself means relatively little.

Accordingly, the main recommendation of this paper is that OBR should radically shift the balance of their effort. On the one hand, OBR should put less effort into the production of their central forecast: and it should be clear, in publishing its results, that what it is producing is essentially a projection based on certain conditioning assumptions. On the other hand, it should put much more effort into its assessment of the risks surrounding the UK economy: in particular, in identifying the main potential shocks to the economy, and in assessing the economy's likely robustness to withstand any shock.

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FINANCE COMMITTEE

INQUIRY INTO PROPOSALS FOR AN INDEPENDENT FISCAL BODY

SUBMISSION FROM PROFESSOR CAMPBELL LEITH, UNIVERSITY OF GLASGOW

1. Many countries have adopted some form of independent central bank following the high inflation of the 1970s and economists' analysis of the 'inflationary bias' problem, which suggested that governments' desire to reduce unemployment would lead to high inflation without actually achieving the goal of lower unemployment.¹ A similar development of economic ideas and real world events, are now informing similar moves to create fiscal councils in various countries.

2. Economists have brought together the analysis of public finances with that of Keynesian business cycles to describe how a benevolent policy maker should use fiscal policy to respond to economic shocks which affect the level of government debt.² They highlight that the policy maker needs to trade-off the short-run costs of fiscal austerity against the long-run benefits of lower debt. The striking result from this analysis is that this balance is very fine – it is optimal to use fiscal policy to stabilise debt following shocks, but that returning debt to its pre-shock level should only be undertaken very slowly.

3. However, it is important to note that this result describes the policy that would be undertaken by a socially responsible policy maker who is able to make credible promises about how they will behave in the future. In the real world, fiscal policy is typically implemented by governments subject to the constraints of the political process. For numerous reasons this may result in a 'deficit bias', analogous to the 'inflation bias' discussed above, which can account for the rising government debt levels in many advanced economies over recent decades. Recognising the costs of such biases, many politicians have sought to tie their own hands by adopting some form of fiscal rule, which often requires debt and deficits to be stabilised over relatively short time-horizons.³ However, possibly since such rules clearly violate the gradual fiscal adjustment implied by economists' descriptions of optimal policy, these rules have often been broken whenever they start to bite. This has happened so often, that it is difficult to see that such rules have any credibility anymore.

¹ Finn Kydland and Edward Prescott obtained the Nobel Prize partly for their work in this area.

² Schmitt-Grohe, S. and M. Uribe (2004), "Optimal Monetary and Fiscal Policy under Sticky Prices", *Journal of Economic Theory*, Vol. 114, pp 198-230, and Benigno, P. and M. Woodford (2003), "Optimal Monetary and Fiscal Policy a Linear Quadratic Approach", *NBER Macroeconomics Annual*, are key references in this literature. Leith, C. and S. Wren-Lewis (2011), "Discretionary Policy in a Monetary Union with Sovereign Debt", *European Economic Review*, Vol. 55, pp 57-74, extend these results to the case of an open economy operating in a monetary union, and using government spending as well as taxation as instruments to stabilise government debt.

³ Leith, C. and S. Wren-Lewis (2013), "Fiscal Sustainability in a New Keynesian Model", *Journal of Money, Credit and Banking*, forthcoming, show that the costs to society of not being able to credibly promise to stabilise debt levels gradually are very large.

4. In response to this economists have recommended that politicians place themselves under the scrutiny of some form of Fiscal Council.⁴ The idea is that such monitoring can remind policy makers of the need to take account of long-run fiscal sustainability, such that the Fiscal Council would highlight, in periodic reports, whenever policies were being pursued which endangered that long-run fiscal sustainability. At the same time, the council could also allow a government to run deficits when the economic conditions implied that it was desirable to do so. In short the aim is to allow for short-run flexibility in a way that adherence to fiscal rules may not allow, but to ensure that this does not jeopardise long-run fiscal solvency.

The Current Proposals:

5. The current proposals are for the creation of a Scottish Fiscal Council in order to forecast revenues from the newly devolved fiscal instruments detailed in the Scotland Act, 2012. Given that the basic economic case for creating fiscal councils lies in overcoming the deficit bias problem in a way which retains economic flexibility to deal with shocks, the need for a Fiscal Council in a setting where the budget is essentially balanced is less clear.⁵

6. Nevertheless, it is certainly possible that the Scottish Government will, at some point in the future, have the ability to freely issue debt, either through increased devolved powers or through full independence. As soon as that possibility is realised, the usual arguments for creating fiscal councils will apply.

7. Moreover, even if devolved powers fall short of allowing the Scottish Government significant debt issuance capabilities, there may be scope to formally enhance the Scottish input into the Office for Budget Responsibility's (OBR) forecasting activities, particularly over revenue and expenditure items, specific to Scotland. Whether that is desirable depends on the relationship between the Scottish Fiscal Council and the OBR, as well as the resource costs of creating a Scottish Fiscal Council from scratch. I now consider each of these issues in turn.

Relationship with the OBR:

8. Under any setting short of full independence, there will necessarily be a relationship between a Scottish Fiscal Council and the UK's OBR. A key question is whether they operate cooperatively (providing a shared forecast on items of joint interest to their respective budgets) or provide separate, potentially divergent, forecasts of common items. One advantage of the former approach is that the two bodies share information and expertise in producing their consensus forecast, and hopefully the quality of the forecast is strengthened as a result. Another is that failing to work together would imply producing competing and often conflicting forecasts which would, in turn, inevitably focus attention on differences of opinion between the two bodies. This is undesirable when the aim of creating a fiscal council is to focus attention on the sustainability of policy, rather than the forecasting process itself. Neither the Scottish Fiscal Council nor the OBR is likely to benefit from a horse-race

⁴ Kirsanova, T., C. Leith and S. Wren-Lewis(2007), "Optimal Debt Policy and an Institutional Proposal to help in its Implementation", Economic Policy, make exactly that case in the context of a Fiscal Council for the UK.

⁵ The Scotland Act, 2012, allows for some debt issuance to fund the gap between actual and forecast tax revenues, but this is limited in scale.

over the respective quality of their forecast – the difficulties inherent in economic forecasting would typically imply that there would be no clear winner in that race, but that the reputation of both would suffer. However, both could gain from a sharing of information and know-how.

9. Accordingly, an independent Scottish Fiscal Council could enhance the policy making process by making independent forecasts of variables of sole interest to Scotland. For other items which impact on both Scotland and the rest of the UK, a formal working relationship between the Scottish Fiscal Council and the OBR which aims to produce a single consensus forecast would facilitate the gains from cooperation, without undermining the credibility of either body.

Capacity Building:

10. The creation of a Scottish Fiscal Council also requires a substantial amount of technical know-how and resources. In creating the OBR, several experienced members of staff from HM Treasury were seconded to the OBR which now has a permanent operating staff of 17 civil servants. The OBR also inherited the Treasury's large-scale macro-econometric model to facilitate its forecasting, and this is now jointly maintained by the OBR and HM Treasury. When considering long-term issues of fiscal sustainability, coherent projections over such a long time horizon require that the forecast be constrained by the relationships implied by a structural economic model, like the Treasury model. The fiscal forecasts must add up, in the sense of being consistent with developments in the macroeconomy. Although the Scottish Government recently began a tendering process to begin the building of such capacity in Scotland, this is not something that can be done overnight and the resource cost of doing so is considerable. Moreover, the limitations of available data for Scotland also place constraints on the level of sophistication that can be achieved by any forecasting body.

FINANCE COMMITTEE

INQUIRY INTO PROPOSALS FOR AN INDEPENDENT FISCAL BODY

SUBMISSION FROM ROYAL SOCIETY OF EDINBURGH

1. The Royal Society of Edinburgh (RSE), Scotland's National Academy, welcomes the invitation to respond to the Scottish Parliament Finance Committee's inquiry into proposals for the establishment of an independent fiscal institution (IFI) in Scotland. This response has been prepared by an RSE working group with appropriate expertise and experience in matters relating to the Scottish economy. The Committee will note that the RSE has recently submitted a response¹ on the National Performance Framework (NPF). Elements of the response on the NPF are relevant to the current inquiry and should therefore be read in conjunction with this response. We would be pleased to discuss further any of the comments made in our responses with members of the Finance Committee.

Role and remit considerations

2. In considering the possible scope, role and remit of an IFI in Scotland, it will be necessary to consider the constitutional arrangements within which the body will be operating. The form of IFI required in Scotland is likely to differ under the present constitutional settlement as compared to either independence or the devolution to Scotland of further powers.
3. All existing IFIs have the basic function of forecasting and evaluating the likely-outcomes of current fiscal policies; and commenting on the sustainability of those policies long term. Thereafter the remits vary considerably, including whether they should go beyond the basics and also comment on the extent to which fiscal policy is likely to help achieve the government's more fundamental objectives – such as job creation, growth prospects, income distribution, or structural reform. A small number, including the Canadian Parliamentary Budget Office, have a role in costing and assessing future policy options and scenarios.
4. In the case of the UK's Office for Budget Responsibility (OBR), it is required to provide independent forecasts of the future fiscal revenues and budget position, including the implications for growth and employment that may affect the fiscal position. However, it is forbidden from examining or commenting on the other targets of economic policy or the merits of the other policies that might be used to reach them.

Possible approach in Scotland

5. Even under the limited fiscal autonomy to be expected after the Scotland Act 2012 comes into force, Scotland will have an obligation to safeguard the sustainability of its public finances. As we indicate in paragraph 2, the more powers that the Scottish Parliament has in relation to revenue generation and expenditure in Scotland, the more important this obligation becomes.

¹ http://www.royalsoced.org.uk/cms/files/advice-papers/2013/AP13_08.pdf

Forecasting the future fiscal position

6. The RSE is of the view that it would be valuable to establish in Scotland an IFI capable of providing authoritative and independent assessment of the fiscal position and general prospects for the Scottish economy within the context of UK and international developments. More generally, as our response on the NPF demonstrates, there is a need to strengthen in Scotland the independent assurance of data quality.
7. We would expect an IFI in Scotland to cover the outlook for public finances and financial conditions more generally. An IFI in Scotland could be tasked with: a) reviewing the fiscal outlook for the government and the public; b) reviewing the future revenues likely to be available; c) estimating current structural imbalances; and d) estimating the likely consequences of current spending and taxation plans.
8. The Finance Committee will need to examine whether the forecasting needs of Scotland arising from the level of fiscal autonomy of the Scotland Act 2012 could be met fully and effectively by the UK OBR. We understand that the UK OBR has been tasked with providing forecasts of Scottish income tax, landfill tax and stamp duty land tax. However, we recognise that concerns have been expressed as to whether the forecasts provided by the UK OBR fully capture the distinct circumstances and drivers in Scotland. We would of course expect a Scottish IFI to take due cognisance of the forecasts produced by the UK OBR – at least, but probably not only, while Scotland remains part of the UK.
9. Whatever form the IFI in Scotland may take, it is crucial that the forecasting work undertaken by the IFI is integrated within the processes that shape the Scottish Government's spending plans and the setting of the budget. Notwithstanding, the responsibility for the choice, design and execution of fiscal policy would remain firmly with the Scottish Government. This implies that the IFI's task is essentially technical, even if its work would play an important role in the subsequent political process. However, the scrutiny function of the Scottish Parliament and the ability to hold the Executive to account should, in principle, be enhanced with the establishment in Scotland of an IFI. The Scottish Parliament would be well placed to challenge the Executive in public if it felt that the Executive has not taken full account of the forecasts and fiscal analysis provided by the IFI. This would put an onus on the Executive to defend its plans in public.

Analytical commentary on long term strategic issues and commitments

10. The Finance Committee will be aware that the RSE has frequently raised concerns about the annuality of the budget setting process. This restricts longer-term prioritisation of spend by failing to take account of longer term demands. As such, beyond the forecasting role we set out in the preceding section, consideration should be given to the provision of analytical commentary on strategically important forward-looking issues and commitments. For example, this could include considering and commenting upon the fiscal implications of demographic change. This would enable independent consideration to be given

to financing implications beyond the parliamentary cycle. This could be achieved without interfering with the government's preferences, priorities and targets and could provide analysis of the type and quality undertaken by the Institute for Fiscal Studies. The work of bodies such as the Fraser of Allander Institute and the Centre for Public Policy for Regions (CPPR) would remain important and would provide a counterbalance.

11. This crucial aspect of this function is the capacity to look to the future, beyond current parliamentary cycles. This would complement the approach we outlined in our response on the NPF, where we suggested consideration should be given to extending Audit Scotland's role in relation to the provision of independent validation of *Scotland Performs*. We would, of course, expect an IFI in Scotland to draw on the work of Audit Scotland.

Hosting the forecast and commentator elements

12. Recognising the resource implications associated with the establishment of an IFI in Scotland, we suggest the Finance Committee explores whether the proposed forecasting and strategic commentary functions could be hosted within a consolidated body that includes SPICe. This would not negate the need for additional resource in order to deliver the forecasting and commentator functions, including the provision of staff with expertise in data analysis, statistical modelling and econometrics. However, it could avoid issues related to a proliferation of bodies. This suggested approach would seem to satisfy the requirement for the IFI to be independent from government, which is expanded upon in the next section.
13. It is important to be clear about the distinction between the *technical* forecasting of likely outcomes and the *commentary on major strategic issues and commitments* that have long-term implications. The latter activities will inevitably involve some level of involvement with policy choices. In order to preserve the objective integrity of the technical forecasting work, it should be contained in a cycle of publications which is clearly separate from publications which contain commentary on longer-term strategic issues.

Independence and accountability considerations

14. While many countries have IFIs appointed by, and reporting directly to, Government, in order to support the reputation, impartiality and hence the credibility and impact of the IFI's analysis, a Scottish IFI should be appointed independently by, and directly accountable to, the Scottish Parliament. Appointments to the IFI should be made by the Crown. This approach recognises the importance of ensuring the IFI's freedom from political pressure while balancing this with an appropriate mechanism of accountability to assure its effectiveness and democratic legitimacy.
15. A Scottish IFI should not take instructions from the Government or its agencies. It should have the right to develop its own framework of analysis, data sources and methodology. It should have full access to data and any related analysis or evaluations made elsewhere. Given its independence, a Scottish IFI will need to demonstrate a high degree of transparency in its operations. This calls for the

publication of all material relevant to its work. A parliamentary committee (or committees) could be charged with receiving and considering the reports of the IFI and holding the Executive to account in relation to the policy and budgetary implications of the IFI's work.

Establishment of an independent working group to consider the establishment of a Scottish IFI

16. Within our response we have made it clear that the form of IFI required in Scotland might well differ under the present constitutional settlement as compared to either independence or the devolution to Scotland of further powers. To assist its deliberations, the Finance Committee should consider setting up an independent expert group to examine and report on options for the establishment of an IFI in Scotland in the context of the possible future constitutional arrangements. In undertaking its work, we would expect the expert group to consider the IFI models operating in other countries. The expert group could also consider the extent to which, if any, an IFI in Scotland should have a direct role in setting the policy agenda in Scotland, including the costing and assessment of future policy options.

Additional Information

Advice papers are produced on behalf of RSE Council by an appropriately diverse working group in whose expertise and judgement the Council has confidence. This Advice Paper has been signed off by the Chair of the group and by the General Secretary.

In preparing this Advice Paper we would like to draw attention to the following RSE responses which are relevant to this subject:

- The Royal Society of Edinburgh's response to the Scottish Parliament's Finance Committee on the Scottish Government's National Performance Framework (August 2013)