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THE IMPLICATIONS FOR PUBLIC SPENDING OF FIXED-TERM PARLIAMENTS

INTRODUCTION

1. The United Kingdom takes third place in the *Open Budget Survey 2012* (International Budget Partnership, 2013), behind New Zealand and South Africa in a league table of 100 countries. This Non-Governmental Organisation (International Budget Partnership) is to some extent supplanting the role of official agencies such as the International Monetary Fund which, for understandable reasons, usually step back from publicly rating their members. As a tool to be applied across the world, the required levels of budget transparency are not particularly high, and are relatively easy for a high-income democracy to satisfy. This Memorandum demonstrates that the United Kingdom has no room for complacency. There are certain incorrigible features of the UK public finance system that are relevant to the Committee's remit.

2. The crux of the matter is that the United Kingdom scores well in terms of its formal institutions and practices but the benefits of these are eroded by informal practices that reinforce Executive dominance (Heald, 2003, 2012). These include:
   a) the vast information advantage possessed by the Executive;
   b) the well-established practice of leaking and planting that precedes most Budget, Autumn Statement and Spending Review announcements, which function as distracters;
   c) the gaming of rules, such as treating Private Finance Initiative (PFI) projects as off-balance sheet, arbitraging boundaries between general government and public sector and between public sector and private sector, and redefining the length of the economic cycle in order to satisfy a fiscal rule;
   d) the degeneration of formal Parliamentary financial procedures into mechanical processes that are largely treated as irrelevant; and
   e) the over-stretched remit of the Treasury Committee having the result that it does not function as a 'Spending and Tax Committee', which would be explicitly and continuously focused on spending and tax.

3. The possibility of the Opposition enjoying in their turn the advantages of such Executive dominance has contributed to the lack of pressure for reform. A combination of hung Parliaments and fixed-term Parliaments might alter such calculations of party advantage. Wehner and de Renzio (2013) identified citizens and legislators as agents for higher fiscal transparency in democracies. In their empirical work using the Open Budget Survey, political fragmentation in the legislature is associated with higher levels of fiscal transparency.

4. The Committee's call for evidence is set within the context of the *Fixed-term Parliaments Act 2011*, the requirements of which are summarised by Gay (2011). This Memorandum focuses on the second and third questions asked in the Committee's call for written evidence (Political and Constitutional Reform Committee, 2013):
   - The Spending Review announced in June 2013 covers the 2015/16 financial year only. What discussions can

take place in the final year of the current Parliament to prepare for the next Spending Review?
- What scope is there for future Spending Reviews to more closely mirror the term of a Parliament?

There are some connections to other questions, particularly the interaction between fixed-term Parliaments and coalition government. Moreover, this Memorandum shows how the present conjuncture might lead to improved scrutiny by Parliament of the public finances.

Spending Review System

5. Before 1998, the Treasury had presented Public Expenditure White Papers every year, as the published outcome of Public Expenditure Surveys. A familiar criticism was that there was much year-on-year churning of plans – transport being a cited example – and a lack of strategic direction and of medium-term planning. Spending Reviews have been timed according to the wishes of the Government of the day: 1998 was followed by 2000, 2002 and 2004, setting a frequency of every two years but each covering three years ahead. Then came 2007 (delayed a year because of intra-government considerations) and 2010 (after the Coalition came into office), a frequency of three years yet still covering three years. Then Spending Review 2013 added only one additional year (2015-16) to plans. This resulted from the context of coalition government (the two governing parties wishing to preserve their policy independence) and the practical requirement for 2015-16 plans.

6. A structural change involving fixed-term Parliaments that are expected to run their full five years has potentially important consequences for the planning and control of public spending:
   a) the question of how many years a Spending Review will cover and the extent to which it projects forward into the following Parliament; and
   b) the question of how frequently Spending Reviews are held: the initial practice of every two years (1998, 2000, 2002 and 2004) changed to every three (2007, 2010 and 2013), but there must be one in 2015.[2]

   With the probable length[3] of the Parliament known to all, the dynamics of frequency and duration are likely to change. For example, a Government elected in 2015 might opt in 2015 for a Spending Review covering four years (2016-17, 2017-18, 2018-19 and 2019-20), planning to hold a further Spending Review in 2019 in advance of the 2020 election. Whether there is a majority or coalition government after 2015 seems likely to be an important factor.

7. Although the Spending Review system brought benefits (eg clearer direction and less churning than under the previous annual White Papers), the timing of publication (often in July) had the effect of marginalising Parliament. With the summer recess imminent, the treatment by Parliamentary Committees tends to be perfunctory and the ‘newsworthiness’ has gone by the time Parliament returns in September (previously October). Although this cannot be proved, my own view is that this timing suited Executive processes and knowingly weakened Parliamentary scrutiny. The alternatives that would favour Parliament are May (giving time for Committees to report before the recess) or October (having the disadvantage that Committees’ reports might be too close to the critical period in which the impact of funding decisions is passed down the hierarchy of public sector organisations and then beyond). The fact that there will not be a Spending Review until 2015 affords this Committee the opportunity of taking evidence on the practicalities of various timings.

The Pathology of Spending Numbers

8. In terms of good practice, there is much to commend the UK Spending Review system. However, analogous to Goodhart's Law concerning monetary aggregates (Goodhart, 1984), using particular measures of public spending as control targets changes the nature of those aggregates. This relates to a wider phenomenon: rules or standards are set and decision-makers find ways of circumventing them while formally complying. This illustrates why the banking and financial sectors are so difficult to regulate. In the public sector, 'innovations' are tolerated even though they generate fiscal risks and lead to courses of action that might constitute exceptionally bad value-for-money (VFM). Moreover, they may spread internationally, including into jurisdictions less capable of handling such risks.

9. One factor promoting such gaming of rules is that Governments find themselves 'locked in' by commitments made while in opposition to conform to the plans of the previous Government.[4] The context might be fiscal rules, accounting standards or public expenditure scoring: Governments may justify to themselves the arbitraging of such rules because they feel they were trapped into committing to respect them. Some recent examples illustrate this point:
   a) After 1997, the Labour Government re-launched the PFI as Public-Private Partnerships (PPP), vastly expanding the scale and – through arbitraging FRS 5A (ASB, 1998) by Treasury Technical Note 1 (Revised) (Treasury Taskforce, 1999) – kept the capital costs and borrowing out of the spending and borrowing numbers (Heald and Georgiou, 2011a);[5]
   b) The status of Network Rail was design-engineered to ensure that, whatever the financial reporting treatment, its borrowing would be outside the national accounts numbers;[6]
   c) The 1997-2010 Labour Government kept its election promises not to increase the basic or higher rate of income tax, instead increasing National Insurance Contributions, thereby exploiting the low level of public understanding of the UK tax system;
   d) The 1997-2010 Labour Government redefined the economic cycle in order that it notionally complied with the 1998 fiscal rules;
   e) The Coalition Government has committed to buying electricity output from the EDF-planned Hinkley Point C nuclear power station at a strike price roughly double the current market price; and
   f) The Chancellor of the Exchequer has recently suggested an above-inflation rise in the minimum wage (Parker et al, 2014).[7]

10. The point being made here does not relate to the substantive merits of these policies. The issue is that the form that these policies took was driven by attempts to circumvent rules and standards, politely known as 'arbitrage' but more aggressively as 'cheating' or 'manipulation'. The macro-economic future is likely to be marked by continuing austerity – certainly in comparison with the 2000s. Accordingly, the temptations will grow to arbitrage rules and standards, to exploit low public understanding of expenditure and tax, and to devise policy instruments whose effects are either excluded from published numbers or are inherently difficult to measure. Once the practice of giving long-lived guarantees becomes established, it can be expected to spread, within the United Kingdom and internationally, just as did PPPs. Public expenditure

‘savings’ may be found by converting measurable flows into difficult-to-measure flows, such as direct funding of universities being replaced by funding of students that is only scored as public expenditure to the extent of forecast non-repayment of loans. Entitlements which have a statutory base may be eroded, without consideration of likely additional costs in the form of supplementary assistance.

11. Such developments pose both macro-fiscal risks (published fiscal numbers miss important liabilities) and VFM risks (gaming the rules, under conditions of ‘only show in town’, takes priority over hard-headed assessments on Green Book lines (Treasury, 2003)). Lower down the hierarchy of public organisations delivering public services, the understanding develops that gaming the rules is acceptable because this represents the best outcome that is feasible. Although the Treasury may proclaim that PPPs are undertaken solely for VFM reasons, few at an operational level or involved in political debate believe this. The resulting gap between the formal situation and informal reality is corrosive of public accountability.

12. These dangers are repeated at the international level where external surveillance of country public finances has intensified (Heald, 2013), coming from the International Monetary Fund (in the form of Article 4 consultations) and intensifying within the European Union and the eurozone. Irwin (2012) documented various accounting manipulations and Forte (2001) provided examples of manipulations to Italian data in order to qualify for eurozone membership. It is important to remember that the United Kingdom can set either good or bad examples, with the bad usually attracting the most imitation.

13. There is a strand of political science literature, associated with Jürgen von Hagen of the University of Bonn, which emphasises the importance for public expenditure control of having strong Finance Ministries (von Hagen and Harden, 1994, 1995). Sometimes this is linked to the advantages for ‘strong government’ of majoritarian voting systems such as first-past-the-post. However, there is a contrary factor, namely the role of democratic legislatures in legitimating top-down decisions on public expenditure and taxation. Without countervailing power in Parliament, the centralised power enjoyed by UK Government can have dysfunctional consequences for the functioning of the public sector and for the taxation system. My own view is that the fragility of Parliamentary scrutiny at the key decision points not only leads to inadequate challenge (policy debate is closed down) but also weakens legitimacy and trust in government. Moreover, the prospect of more effective challenge would afford Treasury officials some protection from over-confident Ministers. Parliament should seek to redefine its role in relation to public finances. At present, the public profile stems largely from the retrospective work of the Public Accounts Committee, in particular from exposures of alleged failure and incompetence.

Proposals for Parliamentary Vigilance

14. The International Monetary Fund (2012) has reinvigorated its work on fiscal transparency, having concluded that inadequate transparency was a factor in the way in which the global financial crisis translated into deep fiscal crisis. The key issue for the Westminster Parliament is how it can become vigilant ‘in real time’, not forced to rely on particular practices being challenged after they have become established. Of course, one of the difficulties is that Executive circumvention of its own and international rules may actually be welcomed by many Members of Parliament who wish, for example, to see the new facilities that such circumventions

permit.[8]

15. It would be possible to spend the last year of the 2010-15 Parliament undertaking a systematic review of future public expenditure and tax options. However, this will not happen because of electoral calculations made by Government and opposition parties alike. Such activity would mean forgoing the informational advantages enjoyed by Government parties and might be beyond the capacity of opposition parties to engage. However, productive use could be made of this period to give serious thought to the role of Parliament in public spending and taxation matters:

a) A valuable innovation would be for the Government to publish an 'End of Parliament Fiscal Report' on the New Zealand model (English, 2011). This has been successful there, in providing a more secure basis for political debate on fiscal matters. The OECD (2002) has included a 'Pre-election report' as a component of its 'Best Practices for Budget Transparency'. The Government might resist this proposal but the Committee exploring the idea would give it a chance to germinate for future adoption. The expectation of having to live in (what in the recent past would have seemed) austere times might give this idea wider appeal;

b) Vigorous monitoring should be undertaken by Parliament of tax expenditures (allowances against tax) and coerced private expenditures (use of law and regulation as a substitute for tax and spending).**[9]** The more that Oppositions get locked into inherited plans, the greater will be the temptations to use unrecorded policy instruments, presenting this as evidence of 'reform' and 'innovation';

c) In the public sector, budgeting data (what is going to happen) attract much more attention than does financial reporting (what has happened). Such a focus is hard-wired into democratic politics and is probably irresistible in general political debate. However, Parliamentary Committees could partially offset the resulting imbalance. The Treasury has now published three sets of Whole of Government Accounts (WGA), for 2009-10, 2010-11 and 2011-12. The WGA itself and the Comptroller and Auditor General's qualifications (Treasury, 2013) create opportunities for reviewing trends in the public sector balance sheet which, taking the long-term perspective, is as important as one-year figures for the fiscal deficit. Warren (2013) examined the usefulness of balance sheet data and Heald and Georgiou (2011b) suggested uses for the UK WGA once there are a run of years. Moreover, a balance-sheet approach will highlight some of the accounting devices (Irwin 2012) used to manipulate budgetary data for particular years;

d) The relationship between financial reporting and national accounts is inadequately explored or understood. This allowed the Labour Government from 2009-10 to treat PFI assets on the basis of IFRIC 12 (International Accounting Standards Board, 2006), thereby bringing most of the value of assets and liabilities on-balance sheet for financial reporting, while planning on a national accounts basis, keeping in place the budgetary incentive to use PFI. This practice continues. A potentially important result of the fiscal crisis is that Eurostat has brought forward a proposal for EU-wide harmonisation of public sector financial reporting (European Commission, 2013), in part in order to improve the harmonisation of national accounts. Parliament, which played a constructive role in the conversion of UK government accounting, first to UK GAAP and later to IFRS, should take interest in these developments;**[10]** and

e) Whatever it were to be called, I propose the setting up in the next Parliament of a 'Spending and Tax

Committee',[11] carving this out of the present remit of the Treasury Committee. Although one might argue that the period since 2008 has been exceptional, a Committee with the wide remit of the Treasury Committee cannot be sufficiently and continuously involved with spending and tax.

Conclusion

16. Returning to the Committee's two questions that were set out in paragraph 4 above:

- **The Spending Review announced in June 2013 covers the 2015/16 financial year only. What discussions can take place in the final year of the current Parliament to prepare for the next Spending Review?**

Answers to this question are necessarily speculative because the fixed-term is new and this is the first coalition since 1945. The divergent electoral interests of the Coalition parties suggests that little planning will be done publicly, though the Treasury is likely to be doing its own preparations. An 'End of Parliament Fiscal Report' on the New Zealand model would be a valuable innovation, though political parties expecting to gain an overall majority might lack enthusiasm. Such a document would improve understanding of the fiscal problems likely to confront an incoming government. A practical question is whether the preparation of this document would be the responsibility of the Treasury or the Office for Budget Responsibility (OBR), or divided between them. In New Zealand, where there is no OBR or Fiscal Council, the Treasury prepares the document which is published in the name of the Minister of Finance (English, 2011; Parliamentary Counsel Office, 2005).

- **What scope is there for future Spending Reviews to more closely mirror the term of a Parliament?**

If there were currently a majority Government, my hunch is that the 2013 Spending Review would have covered more years than 2015-16. Again, providing that there were a majority Government, a 2015 Spending Review would then cover the four years to the 2020 election. It is possible that the Treasury wanted the 2010 Spending Review to cover four years, though it is understandable that, in the novel circumstances of a coalition, three years was the maximum thought achievable. Accordingly, the answer to the direct question is that there is scope for the year coverage to be linked to the Parliamentary term. Whether this would happen depends on political calculations: a majority Government would feel obliged to go into an election with costed forward plans (a huge institutional advantage over opposition parties) whereas a minority coalition party and the Opposition would be wary of being locked into numbers after the election.

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[2] The frequency of Spending Reviews and the number of years covered are separate questions. A Spending Review every two years has had three years of plans, with the third year of one becoming the first year of the next. There must be a Spending Review in 2015 because the existing plans stop at 2015-16.

[3] This is 'probable' because Oppositions, which repeatedly challenge governments to call an election, would find it difficult to deny a dissolution to the Prime Minister.

[4] Until November 2008, the then Conservative Opposition had accepted the public expenditure plans of the then Labour Government (Lea, 2008).

[5] Such arbitrage bred a huge 'advice industry', in reality providing cover for off-balance sheet treatment.

[6] Under European System of Accounts 2010, operational from 1 September 2014, Network Rail will be reclassified to the public sector.

[7] Whatever the merits of particular values for the minimum wage, it should be recognised that this is an example of using law and regulation instead of tax and spending.

[8] Lienert (2013) examined how constraints on legislators are essential in order to counter 'deficit bias'. The specification of what legislators cannot do (eg increase total spending or reduce total taxes) and can do raises important issues of institutional design. Nevertheless, their scrutiny role is fundamental to the legitimacy of the budgetary process in a democracy.

[9] There will be circumstances in which tax expenditures and coerced private expenditures are the most effective policy instrument. The concern here is that they will be over-used and used inappropriately, either because they are not monitored or are difficult to measure.

[10] A specific issue is that the United Kingdom has aligned itself to private sector IFRS, with interpretations and adaptations to meet specific public sector circumstances. Paradoxically, though the United Kingdom does not directly follow International Public Sector Accounting Standards (IPSASs), the research study commissioned by Eurostat showed that the United Kingdom has the highest rate of IPSAS compliance among the then EU27 (Ernst & Young, 2012). This reflects the fact that IPSASs are themselves derived from IFRS. An open question is the extent to which the proposed EPSASs will derive from IPSAS or start from a different point. Unless the situation is carefully monitored, the United Kingdom could find itself non-compliant with EPSASs, or have to adopt accounting practices it believes inferior to its present practices, or engage in complicated reconciliations.

[11] Possible other names would be 'Budget Committee' or 'Finance Committee' but I prefer the explicit 'Spending and Tax Committee', a name that would clearly communicate its role. Its remit should include surrogates for public expenditure such as off-budget expenditures, tax expenditures, coerced private expenditures, and unrecorded future liabilities (Heald, 2012, pp. 43-4).