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The crisis and the raison d'être and prospect for the UK Office for Budget Responsibility versus an Economic Supreme Court

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ABSTRACT & SUMMARY

Each democratic nation with the Montesquieu Trias Politica separation of powers of the Executive, Legislative and Judiciary branches of government is advised to create an Economic Supreme Court as a fourth branch. The new UK Office for Budget Responsibility (OBR) falls short of that and will fail in scientific advice just like the US Council of Economic Advisors, the German Sachverständigenrat, the French Commissariat Général du Plan and the Dutch Centraal Planbureau. The OBR's setup is likely to put the UK on a path of self-fulfilling forecasts of lower sustainable growth and higher unemployment than necessary. This paper is a small update of my 2005 book "Definition & Reality in the General Theory of Political Economy" (DRGTPE) with respect to the economic crisis since 2007. This paper also discusses aspects of the continued stagflation, the euro, investments and the environment.

I. INTRODUCTION

To my knowledge the best explanation of the Credit Crunch is given by Hellwig (2008a) with a lucid review in (2008b). Independently Levitin & Wachter (2010) arrive at essentially the same analysis and provide clarification why other analyses are unsatisfactory. The financial system still isn't repaired though, subsequently we have problems with national budgets and the euro, the EU-27 now have 23 million unemployed (9.6%), the US have 15 million unemployed (9.8%), and Kuttner (2010) reports on the risk of a next banking crisis due to legalities on foreclosures. Colignatus (2005, 2009b) (DRGTPE) gives an umbrella for such crises. This present paper allows a short update of this analysis on the 2007+ events. The cause of this update is the creation of the UK Office for Budget Responsibility (OBR).

Chancellor George Osborne (2010)'s memo that created the OBR involves a major institutional reform in a major country with an impressive contribution to economic theory. Like the USA with the Council of Economic Advisors, Germany with the Sachverständigenrat, France with the Commissariat Général du Plan, and the Netherlands with the Centraal Planbureau the UK now has its own externalized economic advisory and forecasting body (though apparently somewhat limited in its advisory role). At the time of this writing the OBR is in the stage of legislation. ¹

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¹ See <http://www.publications.parliament.uk/pa/ld201011/ldbills/023/en/11023en.htm>

However, none of the advising bodies warned about the Credit Crunch. And when it happened in 2007 they did not adequately warn about the consequences that we face now. The cause is that none of these existing advisors is sufficiently scientific. None is as independent as science requires. My advice since Colignatus (1994) (in Dutch) is that each democratic nation creates an Economic Supreme Court (ESC) as a fourth branch to Montesquieu's Trias Politica of the Executive, Legislative and Judiciary branches of government. The ESC would be based in science and have the role to check the quality of the information in the budget. Parliament would retain the right to allocate funds but lose the option to manipulate information. A draft constitutional amendment can be found in Colignatus (2005) (DRGTPE). When each democratic nation has its own ESC then they can exchange information and indirectly contribute to policy co-ordination. (An additional argument in 2011 is that we would not need an EU supervisory body on the national budgets.)

II. THE DEBATE IN THE UK

Porter (2010) in the Telegraph of May 18 quotes Mr Osborne's explanation why he as Odysseus lets himself be tied to the mast: "Again and again, the temptation to fiddle the figures, to nudge up a growth forecast here or reduce a borrowing number there, to make the numbers add up has proved too great, and that is a significant part of the reason for our current problems. (...) I am the first Chancellor to remove the temptation to fiddle figures by giving up control of the economic and fiscal forecasts. I recognise that this will create a rod for my back down the line. (...) That is the whole point. We need to fix the Budget to fit the figures, not fix the figures to fit the Budget." The Telegraph also reports the response by the shadow chancellor Alistair Darling: "The suggestion that Treasury civil servants have colluded in publishing anything other than accurate figures is just plain wrong. (...) We're required in law to set out forecasts that take account of all decisions taken and we've published these in Budgets and pre-Budget reports."

The Chancellor's ties to the mast are still rather loose. O'Grady (2010) in the Independent of May 18 remarks: "Whatever the intellectual underpinning, the OBR is the same in one respect as any other creation of government; it can be abolished. What a Chancellor giveth he can take away." This is somewhat amended by the advice by Budd et al. (2010) and current legislation. Talbot (2010) is unconvinced and suggests a position like the US CBO. Yet a constitutional change will cause that an Economic Supreme Court will be as difficult to abolish as the Judiciary.

The fundamental constitutional challenge is easily overlooked. The economic bodies in the USA, Germany, France and Holland are all quite content with their role and performance, and apparently see no reason for change. For myself, it took me years to disentangle the issue. Yet once it is formulated it should be clear for all to see. The economic advisor has a double role. The support of policy making is done best by applied science. Science however requires independence like in the judiciary. Hence, we are speaking about the core of the constitution.

A crucial question for Mr Darling is what happened with warnings on the Credit Crunch. Apparently those were already filtered out from what reached his desk or possibly even the Treasury itself. Whistleblowers or censored scientists were not protected by scientifically independent positions and economic scientists at the academia were focussed not on policy support but on their papers for the journals. There is currently no place where it all comes together. In November 2008 Queen Elizabeth II visited the London School of Economics and asked: why had nobody noticed that the credit crunch was on its way? Some answers are in the Royal Economic Society Newsletter, by Belsey et al. (2009) and Dow et al (2009). Those answers are unsatisfactory and miss out on the constitutional angle.

III. THE ECONOMICS OF INFORMATION

The case for the ESC follows from common sense, economic theory itself, logic and some mathematical analysis – see DRGTPE. To think differently is wishful thinking, hoping for the magic that it will come together. A hard look shows instead that the economy is too complex to handle it as we do now, even with this OBR, and, also, that economic science is so advanced that it can handle that ESC.

The world is annoyed by the disagreements among economists. However, once there is an ESC with arbitrage at the top of a research body with roots and channels to economic science, then economic scientists would have a forum to try to settle their differences. There will still be disagreements but those will contribute less to chaos and help more in clarification. The scientists who warned about the Credit Crunch and its consequences (like me) would have had a forum and the ESC would have had the scientific obligation to look into the matter, rather than, as happened now, that government bureaucracies neglected the messages. A key point is that not just the top of the ESC must have scientific independence but also the rank and file within the ESC. New ideas and novel approaches tend to be found by youngsters who still have to make a reputation and a government bureaucracy that is targetted at performing in set ways is at odds with this freedom of thought that is crucial for science.

Economic science suffered a severe blow in the public mind because of the Credit Crunch and its consequences. We have to remain clear-headed on the true cause however. The true cause is the current structure of government that is insufficiently open to economic science. Don't blame a science if it has been made cripple in advance.

Economic theory clarifies that information is a key ingredient for the economic process as well, and not just prices and quantities. Economic events can no longer be thought of as coming from some external natural causes. Events are guided by policy advice that derives from economic theory itself. There are complicated issues of self-fulfilling or self-denying prophecies. Some degree of control is required on what theory is used, hopefully by economic scientists and not by the body politic.

There is an earlier discussion by Buchanan & Wagner (1977). They reject current economic planning and in chapter 6 they use the label of the ESC to denounce the current setup. My approach however is to improve the flow of information: and then the label of the ESC properly identifies its optimal function.

The current structure of government and the role of science in government can be understood in the light of history. In the Middle Ages priests had a Chamber in government but they did not evolve into scientists and looked mainly after their own interests and eventually they were ousted. Science evolved and scientists have been called in to help and relations have grown more formalized. But our democracies got stuck in the middle. Also WW II can be analyzed as a consequence of economic mismanagement. This update note uses the Credit Crunch as an example but it actually is only a minor case. The warnings on the Credit Crunch are not the only points that did not make it to the official planning boards. There are also other crucial economic findings that somewhere get lost in the big black hole of the current setup of the Trias Politica. Let me give a clear scientific warning. When our democracies do not adapt their structure with an ESC then our societies remain hugely at risk because of world population growth and the ecological conditions for survival, see Tinbergen & Hueting . The warning signs are clear to see but curiously people do not see the issue as economic and relevant for the budget. Perhaps the

case for the ESC must be won in the public's mind with more mundane issues that people see as economic, such as money.

IV. TAXES AND UNEMPLOYMENT

Let me mention two points that shatter the foundations of the UK coalition government austerity plans. These are two points that the OBR may not have heard about, just as they may not be aware yet of the argument for an Economic Supreme Court. The OBR has no good position to properly function, and the two following examples are intended to show that our democratic states are better advised to go all the way towards a constitutional change. These two points have been developed by me at the Dutch Central Planning Bureau but met with censorship by its Directorate and the full analysis will still come out only when that censorship is lifted.

Consider the proposed raise of VAT to 20%. Standard economic theory advises a shift from income tax to VAT since high statutory marginal tax rates are supposed to deter enterprise and effort. Standard theory uses partial derivatives to model the marginal tax rate. However, we should use total derivatives. The models assume a stagnant Earth while the planet is in motion. When we consider the situation dynamically then we also have to include the indexation of tax parameters. For example, let tax exemption be £ 10,000, the marginal rate 50%, and your income £ 30,000, then your income tax is £ 10,000 or 33.3%. Standard economic analysis focusses on the 50% and policy makers try all kinds of ways to reduce it, such as the shift to VAT. But this is ill considered. Suppose that national income rises over two years with 10% with real growth and inflation, and your income as well, so that your income rises to £ 33,000. If exemption stays put then you indeed pay 50% on the additional £ 3000, so your tax would be £ 1500. However, when exemption is adjusted with 10% as well towards £ 11,000 then you pay 50% on £ 2000, which is £ 1000. Your dynamic marginal is your average rate of 33,3%. This is even more important with rational expectations on this development. This analysis considers averages so that partial derivatives indeed are relevant for micro cases but the macro-econometric evidence supports the total derivatives. Hence, the situation is not as bad as the standard models suggest. The case for switching to VAT is less strong than my fellow economists and advisers to the government say that it is.

The second example concerns the minimum wage. The 2010 gross minimum wage plus employer costs in the UK is £ 12,059. The net income after income tax and premiums is £ 9751 (still including VAT). The difference is given by taxes and premiums at £ 2307 (not including VAT). See Colignatus (2010) for a table for the UK, the USA and Holland. The difference is generally called the "tax wedge". This wedge becomes a different beast at the level of the minimum wage. There it becomes a "tax void". Taxes and premiums below the gross minimum cannot be collected since people are not allowed to work below that minimum. Those taxes and premiums have only a paper existence in the official statutes but no material existence. Since they are not collected they can also be abolished at no cost. Thus there is a free or costless measure to create employment possibilities at the bottom of the labour market.

The two points combine since the VAT causes a larger tax void. Instead of raising VAT to 20% it should be reduced to 1%. VAT might be abolished but it seems useful to keep it around as a tactical policy variable.

This information on the dynamic marginal rate and the tax void is available now for twenty years and is not being used because of lack of respect for science within government bureaucracies, and to some extent also because of lack of respect within the academia for economic scientists within the government (or dismissed from it).

V. A DEEPER CAUSE OF THE CREDIT CRUNCH

The crisis that erupted in 2007 is in need for explanation by economic theory. As said, Hellwig (2008ab) and Levitin & Wachter (2010) are clear on the subprime crisis and the subsequent problems in banking – together called the Credit Crunch. Is that explanation sufficient? My suggestion is that both onset and consequences should also be in explanation. The fiscal and monetary authorities and financial regulators provide us with piecemeal engineering on the fly but there is a lack of overview. The lack of convincing theory and strategy becomes especially worrying when we see the financial crisis affecting the real economy. People and economic activities that suffer are not well-represented in national statistics, see Dorling (2010), which provides analysts with a rosy picture as if the crisis only affects the financial sector and not the real economy. The time honoured solution is to have the poor and powerless work harder and earn less to solve the problems of the rich and powerful. But economic theory can do better.

Science requires that we compare various competing economic theories and my suggestion is that my fellow economists study a particular theory that apparently hasn't had sufficient attention yet. The current financial crisis finds a fundamental cause in stagflation. This stagflation originally was open but was later hidden by (financial) deregulation. Hence there is also a corollary for policy making: by tackling stagflation the financial crisis would become manageable. A suggestion on how to tackle stagflation is provided by DRGTPE, along the lines of the above and the relation to the Phillipscurve and its shifts.

The latter explanation finds some corroboration by the analysis by Raghuram Rajan, see the interview by Gunn (2010). Rajan sees easier credit for the poor as a policy answer to poverty. Poverty however is explained by DRGTPE by wrong policies on taxation and unemployment.

VI. A NOTE ON INVESTMENTS AND THE EURO

DRGTPE p156-157 discusses the issue of investments. The current policy in the EU of fiscal cutbacks destroys welfare and creates unemployment when no proper attention is given to investments. Let me quote from p157: "The line of thought that I would suggest is that this optimum requires competing investment banks that develop plans during the economic upswing that can be implemented during the economic downswing. Who worries about pensions and the EU Lissabon Strategy is advised to consider this approach. Since the market is an anonymous beast that may or may not generate such competition, it remains the challenge for governments to mastermind and manage it all." A suggestion after the crisis was to also look at consumer durables as investments with a potentially higher return than the stock market, see Colignatus (2009a).

Above deeper cause for the credit crunch also is a cause for the current problems with the euro. A minimum wage that is too high causes unemployment in the internal / sheltered market. Curiously there is a tendency in some countries to try to resolve this with stimulating the external / exposed market, see Colignatus (1996). Surplus countries like Germany and Holland then cause problems for the deficit countries – and then undermine the euro itself. Instead, such surplus countries should invest in their internal market and reduce wage costs there.

For housing and banking, it may be noted that the funds used for the saving of banks suffering from bad mortgages might also have been used to resolve those bad mortgages, helping both the residents and the bank balance sheets. The reason why it does not quite work like that is because of the leverage by the capital requirement. However, the capital requirement is a beast of its own, see Hellwig (2010). As the major cause are those bad mortgages, the government would rather

target those and use its own leverage. For example, in Holland interest on mortgages is tax deductible. There however is a steep barrier for entrants who must save to generate sufficient equity for a house, which entrants however cannot deduct their interest. There is a general tax deduction incentive for savings (called “spaarloon”) but it has an annual ceiling of EUR 613, and clearly this does not amount to much with regards to buying a house. There is also a curious argument by left wing parties in Holland for abolishing mortgage interest deduction for the rich, which seems to overlook that this basically concerns a shift of the burden amongst the rich themselves with little relevance for the constituencies of those left wing parties. Anyway, rather than having our economies locked in doldrums due to system errors in the past, governments might consider to resolve the problems in the housing market in the same generous manner as with the banks. Of course with a keen eye for fraudulent behaviour where it occurred.

VII. CONCLUSION

The OBR’s setup is likely to put the UK on a path of self-fulfilling forecasts of lower sustainable growth and higher unemployment than necessary (e.g. in November estimated below 7% only after 2013). A Parliamentary enquiry is advisable, also concerning the failures by the foreign economic advisory bodies. This advice extends to the Parliaments of the world. If the Great Depression, World War II, the Credit Crunch and the environment are insufficient incentives, we need only wait for the next major crisis, but then there is always the risk that such a crisis wipes away all scope for rational reconsideration.

Colignatus is the science name of econometrician Thomas Cool (1954). He worked at the Dutch Central Planning Bureau in 1982-1991. His analysis on unemployment met with censorship by the CPB Directorate and he was dismissed with an abuse of power. He advises to a boycott of Holland till this censorship of science is resolved. His website is <http://www.dataweb.nl/~cool>.

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