Perspectives on UK economic policy institutions

A LEARNING RESOURCE FOR UNDERGRADUATE STUDENTS IN POLITICAL SCIENCE AND ECONOMICS

MANCHESTER CENTRE FOR ECONOMIC POLICY

Manchester Metropolitan University

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Economic policy and the science of economics

Christine Berry

Debates about economic policy often perpetuate the illusion that it is an essentially technocratic field: one where the 'science' of economics can tell us the optimum way to manage the economic machine, and ordinary people do not have the requisite expertise to intervene. Many people may assume that it is a field ruled by models and mathematical equations rather than by power and politics. And yet the distinction between these two things is in reality far from clear-cut.

'Following the science'?

Like any science, economics is a discipline shaped by the social forces around it and the institutions it flows through. These help to dictate the parameters of the questions it asks and the way it answers them. And the extent to which economic policy is truly governed by 'economic science' – as opposed to half-digested economic orthodoxies filtered through the realpolitik of the day – is a matter for debate. The theoretical frameworks deployed by institutions like the Treasury and the Bank of England are based on assumptions which are deeply contested, and which both reflect and reinforce existing power relations. The claim that these models are based on objective truths, and these institutions staffed by technocrats who 'do not get involved in politics', only enhances the effect. Their very blindness to questions of power and politics means that their deeply political roots and impacts are able to 'hide in plain sight'.

The pandemic should have taught us to be sceptical of the idea that 'experts' can pronounce the single 'correct' solution to policy questions.[1] In the early days of the crisis, the government repeated the mantra that it was 'following the science', and anyone who questioned its strategy was castigated for wading into matters they couldn't possibly understand. However, it rapidly became apparent that the UK was an international outlier in not locking down hard and fast – that its scientists were relying on models whose assumptions were rapidly being disproved, and indeed that there was dissent within the UK scientific community itself about the best strategy to adopt. Opinion was divided about how to manage both the public health risks of covid and the economic risks. But more fundamentally, the tensions between these different risks were matters of moral and political judgement, not evidence. Almost two years into the crisis, nobody pretends any more that the terrible trade-offs involved in covid policy are apolitical decisions that can simply be left to scientists.

One obvious indication that these 'scientific' frameworks are not based on timeless truths is the fact that they evolve and change over time. Indeed, in the case of economic policy, they are doing so before our very eyes – as the pandemic, coming on top of the long fall-out from the global financial crisis, exposes flaws in the orthodoxy and begins to shift the dominant

[1] Berry C (2020) 'To get through this crisis, we must learn how to combine expertise with democracy', openDemocracy, 18 March, available at: https://www.opendemocracy.net/en/oureconomy/get-through-crisis-we-must-learn-how-combine-expertise-democracy/.

assumptions. Peter Hall's concept of 'policy paradigms' – frameworks of accepted norms and assumptions that govern the policymaking process – can help us to understand this.[2] Hall was drawing on Thomas Kuhn's notion of scientific paradigm shifts: the process by which a dominant way of understanding the world is gradually displaced by a new one. Yet, as Hall observed, 'the process whereby one policy paradigm comes to replace another is likely to be more sociological than scientific'. He gives the example of the shift from Keynesian to Thatcherite economics in the 1970s, which arose from a combination of inter-related political, economic and intellectual shifts. Although Hall acknowledges that shifts in the balance of power play an important role in these changes, his main focus is still rather technocratic: he is concerned with how institutions' operating assumptions are perpetuated or challenged through processes of learning. For instance, one could argue that the recent evolution of the Bank of England's role – with the advent of quantitative easing and new responsibilities to manage systemic risks – represents the first murmurs of a paradigm shift in central banking.[3] Regulators' operating assumptions have begun to shift and change in response to the 2008 financial crisis, as the events of the crash exposed flaws in the old assumptions.

Stories of power and the power of stories

Since the crash, there has been a revival of popular interest in another, very different theorist who looked at how dominant assumptions shift. Antonio Gramsci's ideas about 'hegemony' focus on the way in which ideas and narratives about how the world works are deployed to establish and maintain a political consensus that benefits a dominant class or group.[4] Gramsci draws our attention to phenomena that are anything but technocratic: the struggle for power between competing interest groups, the way political discourse can constrain the parameters of the possible, and the conditions under which these limits on the popular imagination are accepted or rejected by the wider public. And yet institutions like the Treasury and the Bank of England are certainly not insulated from these wider dynamics. Indeed, Gramsci's ideas can help to explain how even policy paradigms that are decaying or failing intellectually may nonetheless endure politically and institutionally, if they serve sufficiently powerful interests and remain sufficiently unchallenged and unscrutinised. There is an argument to be made that this is currently the case for (at least some aspects of) UK economic policy – and that it helps to explain why and how it is diverging from some other countries.

In economic policy, as in public health, the UK is increasingly becoming an international outlier. There is a growing consensus among academic macroeconomists that austerity was a mistake which stunted the UK economy rather than helping it recover. Even conservative institutions like the IMF, the OECD and the Financial Times have declared the doctrine irrelevant to the demands of managing the post-covid recovery – at least for countries like the UK, which have their own currency and central bank.[5] And yet, while Joe Biden is pushing through large-scale economic stimulus and pivoting the US towards a more interventionist

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[2] Hall P (1993) 'Policy paradigms, social learning and the state: the case of economic policymaking in Britain', *Comparative Politics* 25(3), 275-296.
[3] Baker A (2015) 'The bankers' paradox: the political economy of macroprudential regulation', SRC Discussion Paper 37, available at: https://www.systemicrisk.ac.uk/sites/default/files/publications/dp-37.pdf.
[4] Gramsci A (2011) *Prison Notebooks: Volume I* (New York: Columbia University Press).
[5] Financial Times (2020) 'The death of austerity should not be mourned', 16 October, available at: https://www.ft.com/content/2f4ef5ab-e07b-4666-8367-e8750817a97e.

approach, the UK seems somewhat stuck in the 2010s – with Chancellor Rishi Sunak promising to reassert hardline fiscal rules, and the Labour Party muting any criticism of this stance for fear of being seen as fiscally profligate.[6]

The contours of political debate laid down in the aftermath of the financial crisis – whereby the Labour government had 'maxed out the nation's credit card' and the Conservatives had to 'fix the mess they were left' – have cast a long shadow. We still see the same metaphors repeated by UK politicians and journalists, who talk about the 'burden' of public borrowing on future generations and the need to 'balance the books'. These contours are matters of rhetoric and narrative – deployed to buttress an ideological aversion to the public sector – not economic evidence. (For one thing, they largely ignore the fact that much of the government's debt is owed to the Bank of England, whose injections of new money into the economy have proceeded in lockstep with the rise in government borrowing – a fact that has drawn senior figures into debates about how far supposedly 'technocratic' monetary policy is truly independent from government-led fiscal policy.) And yet they arguably intertwine with the Treasury's long-held institutional scepticism of public spending to shore up an old policy paradigm, even as it is being disowned by its former champions in other parts of the world.

Policy evaluation: who decides what we value?

Examples of this interplay between policymaking and power abound from outside of these well-worn debates about fiscal policy. The approach to cost benefit analysis (CBA) enshrined in the Treasury's Green Book is a classic example of how seemingly technocratic methods of policy appraisal can disguise an in-built bias towards currently dominant economic interests. Almost by definition, the evaluation of policy via monetisable 'costs' and 'benefits' tends to accord greater weight to those with more market power and more capital. Meanwhile, the social value of things that are hard to quantify or that the market does not value highly – like a healthy environment or healthy people – are underplayed. In recent years, the Treasury has sought to respond to such criticisms by updating the Green Book to take better account of these factors. But this is arguably an attempt to incorporate these critiques within the existing paradigm, rather than a change to the paradigm itself.

Kuhn noted that in science, when anomalies begin to accumulate that cannot be explained within the dominant paradigm, it tends to be 'complexified' to try and accommodate these anomalies – until it ultimately breaks down altogether and is replaced by a new paradigm that better fits the new facts. Similarly, Hall talks about 'first, second and third order' changes to policy paradigms – with only 'third order' change constituting a full-scale paradigm shift. Methodologies such as accounting for 'ecosystem services' or quantifying people's 'willingness to pay' for environmental benefits can be seen in this light – as examples of the neoclassical framework 'complexifying' in response to critiques, when a more fundamental paradigm shift may be needed.[7] These methods acknowledge that the biosphere is a source of value that is not captured by market prices, and thus can be ignored or undervalued by

[6] Berry C (2021) '"A mood in the air… like 1945": democratic socialism and the post-Corbyn Labour Party', *Political Quarterly* 92(2), 255-263.
[7] Craig M, Stephenson H and Meadowcroft J (2019) 'Debating nature's value: epistemic strategy and struggle in the story of "ecosystem services"', *Journal of Environmental Policy and Planning* 21(6), 811-825.

conventional economic analysis. However, instead of questioning the primacy of market prices as a yardstick of value, they attempt to preserve it by attaching imputed market prices to the 'services' provided by the natural world. In other words, they attempt to shoehorn non-market values into the existing market-oriented paradigm, in order to avoid a more fundamental reckoning with the limits of that paradigm.

The political implications of these frameworks became acutely apparent during the Coalition government's era of aggressive cuts to regulation. The apex of this agenda was the 'one-in, one-out' rule – eventually ratcheted up to 'one-in, three-out' – whereby new regulations with a cost to business had to be offset by scrapping other regulations that would save at least an equivalent amount. A Regulatory Policy Committee – whose members included a number of business lobbyists – was set up to review departments' impact assessments, based solely on the 'quality' of their assessment of costs to business. The rhetoric justifying this policy focussed on economic efficiency – the government was simply removing 'red tape' and bureaucracy that stifled businesses from creating value. But since the 'costs' being assessed included anything that might reduce business' profitability – including higher minimum wages, stronger environmental protections and consumer safety standards – in reality, this often amounted to a zero-sum *transfer* of costs and risks from one set of economic actors to another. In other words, 'one-in, one-out' was a policy that directly and explicitly privileged one set of economic interests (business owners) over everyone else. Meanwhile, the benefits of regulation were not just undervalued: they were simply given no weight at all.

This was clearly a deeply political, and deeply consequential, set of decisions. Using 'cost to business' as an arbiter of policy implies that all business profits are legitimate and socially useful – an assumption that simply does not hold in an economy like the UK's, which is characterised by high levels of monopoly, oligopoly and rent extraction.[8] Moreover, because those who are already making the biggest profits have the most to lose from regulatory intervention, monetary analysis like this will tend to reflect and reinforce the existing distribution of wealth and power. And yet the seemingly technocratic nature of the policy appraisal process meant that for a long time this passed beneath the public radar. While at the New Economics Foundation, Stephen Devlin and I repeatedly tried to draw attention to the implications of the deregulation agenda, not just for the economy but for democracy itself – but our efforts to politicise the issue generally met with shrugs and glazed eyes.[9] It was not until the Grenfell fire – an even now widely accepted to have been made more likely by the stripping back of fire safety rules – that 'one in, one out' started to attract controversy.

Reflecting markets: an act of 'neutrality' or tipping the scales?

As the course materials note, similar issues apply to investment decisions as well as regulatory ones. Infrastructure investment in economically stronger regions, like London, has long been deemed better value-for-money than investment in 'weaker' regions, like the North East, because this is where the greatest concentrations of capital are already found and therefore

[8] Berry C (2020) 'Replacing rentier capitalism is one of the defining challenges of our age', openDemocracy, 6 November, available at: https://www.opendemocracy.net/en/oureconomy/replacing-rentier-capitalism-one-defining-challenges-our-age/.

[9] See Berry C (2015) 'Threat to democracy: the impact of "better regulation" in the UK', New Economics Foundation, 12 October, available at: https://neweconomics.org/2015/10/threat-to-democracy.

where the marginal 'benefits' to economic activity are greatest. Thus, rather than redressing regional inequalities generated by the market, economic policymaking actively *reinforces* them, by exacerbating the tendency of already-wealthy regions to suck in more investment and more activity, while denying support to the areas that need it most. In a market economy like the UK's, which is characterised by extremely high concentrations of wealth and power, CBA as practiced in government will tend to reflect and reinforce these existing power imbalances. Notably, the government has pledged to correct these regional biases as part of its 'levelling up' agenda – a proposal previously floated by Labour Shadow Chancellor John McDonnell. But again, the underlying problem with the paradigm remains.

A similar argument can be made about the Bank of England's closely held assumption of 'market neutrality', which has underpinned its approach to asset purchases under quantitative easing (QE). Put simply, the idea behind this is that the Bank's activities should be 'neutral' by reflecting the existing composition of the market, rather than making active decisions about what types of assets to buy and what to avoid. But reinforcing the existing shape of markets is never 'neutral': it actively benefits the existing winners and reinforces the existing shape of economic activity. Indeed, in economic policy, there is no such thing as a 'neutral' intervention. QE itself has been shown to be highly consequential, and highly regressive, in its impacts – driving up asset prices and thus benefitting those who already hold them. As the Bank is beginning to recognise, it may also have impacts on its other objectives – for instance, given that climate change is increasingly recognised as a threat to financial stability, there is a strong argument that central banks should not be purchasing 'dirty' fossil fuel assets and thereby contributing to driving up their value.[10]

This growing recognition of climate impacts is an interesting example of think tanks and civil society organisations, such as NEF and Positive Money, actively pushing for a paradigm shift in the way institutions like the Bank of England think about these issues. At the level of intellectual debate, these actors have been increasingly successful in forcing recognition of the implications of climate change for financial stability. And yet the extent to which this actually changes policy is still constrained both by intellectual frameworks built on market efficiency, and by the political balance of power. As with regulatory reform, actors have found it is challenging to politicise an issue that feels so technocratic and so far removed from most people's everyday experience – even as it has huge impacts on their future quality of life. Meanwhile, the lack of democratic engagement with these decisions leaves the field open to regulatory capture by vested interests in the financial sector itself.

The US and UK: diverging paradigms

A final example of the interplay between power and policy – and one where the UK once again finds itself being left behind by international shifts – is competition policy. It is a common misconception that the market-liberal or 'neoliberal' approach to the economy prioritises market competition above all else. In fact, recent decades have been characterised by a marked weakening of competition policy, giving rise to growing concentrations of market power. Competition authorities on both sides of the Atlantic have embraced the 'consumer detriment'

[10] Dafermos Y *et al* (2020) *Decarbonising is Easy: Beyond Market Neutrality in the ECB's Corporate QE*, New Economics Foundation, available at: https://neweconomics.org/2020/10/decarbonising-is-easy.

principle, whereby market concentration (for example, produced by a merger or takeover) is only a problem if the regulator can demonstrate a direct adverse impact on consumers. Adverse impacts on workers, democracy or economic stability – all of which arise systematically in an economy dominated by monopolies and oligopolies – cannot be taken into consideration. The US is currently seeing a revival of an older, more muscular approach to competition policy based on a broader 'public interest' test – exemplified by the appointment of Lina Khan to the Federal Trade Commission.

Khan is an outspoken critic of big tech companies such as Amazon and Google, and has explicitly advocated for this bigger-picture approach to competition policy as a means of reining in their power – an agenda that harks back to the 'trust-busting' of Theodore Roosevelt in the early 1900s. By contrast, the UK – which, although it may not be the home of the world's big tech companies, encounters similar issues in sectors ranging from banking to energy to care – shows few signs of such a shift. In a recent letter to the Select Committee for Business, Enterprise and Industrial Strategy, the chair of the Competition and Markets Authority confirmed that they are unable to address widespread concerns about the impact of private equity ownership unless they can prove consumer detriment.[11] This is a clear example of institutional frameworks evolving in different directions, in countries with hitherto very similar political-economic policy paradigms, based on the presence or absence of a government with an interest in challenging corporate power.

These issues matter acutely at this moment in time, when the government appears to be adopting a more interventionist stance towards the economy – but one that continues to centralise power (as with the funding allocated to 'levelling up') and shows little appetite to challenge either tired economic orthodoxies or dominant economic interests. The likelihood is that we will see a more active state, but one that intervenes in ways that reinforce rather than disrupting existing imbalances of wealth and power.[12] This 'new interventionism' will both be shaped by, and in turn will help to (re)shape, the existing constellation of policy institutions, including the Treasury, the Bank of England and economic regulators. Government proposals to reinstate a duty on financial regulators to have regard to the 'competitiveness' of the City are one example of this interplay in action.[13] In this context, democratising the debate about economy policy – and recognising that it *is* a subject for democratic debate, not simply a technocratic territory – is more important than ever.

[11] See https://committees.parliament.uk/publications/6812/documents/72262/default/.
[12] Current debates about whether and how the government should bail out the energy supply sector are a case in point. At time of writing, ministers were suggesting that smaller firms would be allowed to fail while big players would be offered government-backed loans in exchange for taking on their customers.
[13] The Finance Innovation Lab (2021) '"Competitiveness" and the battle for financial regulation', 5 October, available at: https://financeinnovationlab.org/competitiveness-and-the-battle-for-financial-regulation/.

Post-pandemic planning: Can the Treasury and Whitehall adapt?

Sam Warner, David Richards, Diane Coyle and Martin J. Smith

The COVID-19 pandemic presents a colossal and ongoing task for UK public administration. The Treasury will inevitably be at the heart of dealing with future challenges. It is, after all, Parliament's custodian of the public finances. This duty grows in significance during a crisis. It is exercised with cautious resilience, making the Treasury few friends. Whitehall insiders defend the Treasury's robust approach as a reassuring bulwark against potentially frivolous spending decisions advanced by non-specialist 'amateurs' in government departments.[14] Paul Johnson of the Institute for Fiscal Studies argues 'someone does need to question spending proposals, question them hard and keep questioning them'.[15] Maybe there is no one better placed than the Treasury?

In a project funded by the Nuffield Foundation, we are investigating the nature of Treasury control and how it has adapted to an increasingly fragmented and disaggregated governance landscape since 1993.[16] COVID-19 has alerted the public to the power of the Treasury, both as a traditional veto player and a big spender. But outside of Whitehall, the complexities of the spending control framework are poorly understood by academics and the public. As departmental powerplays over scarce resources get underway in the coming months, our timely look at the spending control framework brings to the fore questions about the effectiveness of Treasury decision-making. In the absence of a complete understanding of how money is spent and managed throughout complex policy chains, we are concerned that the 'tyranny of the baseline'—to borrow former Treasury Permanent Secretary Lord Nick Macpherson's phrase[17]—dominates to the neglect of broader, often cross-cutting or long-term concerns. There is always a risk that in balancing competing priorities, the Treasury struggles to maintain a clear line of sight between spending allocations and policy outcomes. There can be profound consequences when this happens.

Treasury orthodoxy and rebuilding from COVID-19

Post-COVID recovery will require considerable rebuilding of the economy and society. The long-term costs of COVID-19—human and financial—are difficult to quantify. The Office for Budget Responsibility (OBR) is clear that the pandemic's legacy will cast a long shadow and existing spending plans do not adequately compensate what we have lost.[18] The Treasury has

[14] Mian E (2014) 'What has the Treasury ever done for us?', Institute for Government, 25 June, available at: https://www.instituteforgovernment.org.uk/blog/guest-blog-what-has-treasury-ever-done-us.
[15] Johnson P (2021) 'The Treasury isn't going to win a popularity contest, and nor should it', The Times, 7 June, available at: https://www.thetimes.co.uk/article/paul-johnson-the-treasury-isnt-trying-to-win-a-popularity-contest-nor-should-it-t0p23fsgx.
[16] See https://sites.manchester.ac.uk/public-expenditure-planning-and-control/ for more information.
[17] Remarks in an Institute for Fiscal Studies podcast, published in June 2021, available at: https://ifs.org.uk/podcast/behind-the-scenes-at-HM-treasury.
[18] OBR (2021) *Economic and Fiscal Outlook: March 2021*, available at: https://obr.uk/efo/economic-and-fiscal-outlook-march-2021/.

been accused of short-sightedness for refusing to fund schools catch-up funding, suggesting the direction of travel is an austere one.[19] When money is announced with great fanfare, more often than not it is repurposed from existing budgets.[20] The long-term consequences for communities will be far-reaching. The political winds are blowing hard but austerity[21] and lockdown[22] fatigue make it difficult to predict where the electorate will end up. More of the same is an unlikely destination.

A 'rewiring, and renewal, of government' has been signalled.[23] Mantras like Build Back Better are rhetorically powerful but must be matched by action.[24] The pandemic has accelerated the UK toward a critical juncture. But institutionalised Treasury caution and well-meaning scepticism may well mean reformers quickly run out of track. You cannot reform government—Whitehall and ministers—without reforming the Treasury.[25] Our research highlights the difficulty of this task as a centralised approach to financial control has struggled to adapt to the UK's disaggregated governance landscape and patchwork of service providers across the public, private and voluntary sectors.[26]

The Treasury is unique. It is a 'five-headed department'—a central department, finance ministry, economics department, foreign policy actor and policy actor—and as a result often struggles given its comparatively small size.[27] Its duties and responsibilities are extensive and as a result, its power in Whitehall is unrivalled. In its dealing with departments, it has a reputation for driving a (very) hard bargain. It is not in the game of winning popularity contests but outside of a crisis it cannot simply ride roughshod over departments. Its relationships are interdependent and mutually constraining.[28] To succeed, it must cultivate and maintain a culture that protects the 'verities' of its 'day job', namely maintaining revenue and containing spending.[29]

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[19] See Staton B and Parker G (2021) 'Sunak feared schools catch-up funding would become permanent', Financial Times, available at: https://www.ft.com/content/7a003fff-a545-4c27-9325-ff42cc7bc3e3.
[20] Whittaker F (2021) '£10m "levelling up" support will come from existing DfE budgets', SchoolsWeek, 19 May, available at: https://schoolsweek.co.uk/10m-levelling-up-support-will-come-from-existing-dfe-budgets/.
[21] See OBR (2019) *Fiscal Risks Report*, available at: https://obr.uk/docs/dlm_uploads/Fiscalrisksreport2019.pdf.
[22] See Barr S (2021) 'Lockdown fatigue: the science behind why you could be feeling more tired', The Independent, 4 February, available at: https://www.independent.co.uk/life-style/health-and-families/lockdown-fatigue-tiredness-covid-uk-b1797529.html.
[23] Cabinet Office (2021) *Declaration on Government Reform*, available at: https://www.gov.uk/government/publications/declaration-on-government-reform/declaration-on-government-reform.
[24] HM Treasury (2021) *Build Back Better: Our Plan for Growth*, available at: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/968403/PfG_Final_Web_Accessible_Version.pdf.
[25] Richards D, Coyle D, Smith MJ, Warner S (2020) 'Cummings and Gove cannot reform Whitehall without reforming the Treasury', LSE British Politics and Policy, 3 August, available at: https://blogs.lse.ac.uk/politicsandpolicy/whitehall-treasury-reform/.
[26] See https://sites.manchester.ac.uk/public-expenditure-planning-and-control/.
[27] Thain, C. (2014) 'What's wrong with the Treasury? A reply to Emre Mian', Institute for Government, 9 July, available at: https://www.instituteforgovernment.org.uk/blog/guest-blog-what%E2%80%99s-wrong-treasury-reply-emran-mian.
[28] Thain C and Wright M (1995) *The Treasury and Whitehall: The Planning and Control of Public Expenditure 1976-1993* (Oxford: Clarendon Press).
[29] Thain (2014) 'What's wrong…'

Adapting to an uncertain future

If the 'essence' of the 'day job' is ever-present, the tools deployed inevitably evolve. Problems arise for government departments—the Treasury included—when tried and tested methods cease to be effective but nevertheless remain the status quo. Institutional norms are often 'sticky'[30] and provide much needed continuity and institutional memory amid Whitehall (and certainly Treasury[31]) churn. This is all to the good until dominant methods crowd out innovative thinking or new ways of working. The dominant ideology of fiscal conservatism can lead to group think with a strong sense that what must come first is prudence.[32]

Crises inevitably reveal fragilities in even the most robust of systems. So far, the UK has not fared well in early assessments of the government's handling of the pandemic.[33] We praised the Treasury's responsiveness in the early stages of the crisis but expressed concern given the numerous 'wicked problems' and inequalities that had been exacerbated.[34] Sticking plaster funding, we argued, would not cut it in the longer-term. Austerity Mark 2 was a foreseeable but bad option.

We have been more critical recently.[35] The scrapping of an industrial strategy struck us as an odd way to Build Back Better. It provided evidence of a further concentration of power at the centre. We are not alone in being concerned about this trend.[36] What's more, a 'new era of austerity'[37] appears to have been smuggled in under the cover of 'active' state and 'levelling up' rhetoric. Calls at a local level for a meaningful multi-year settlement and greater autonomy fell on deaf ears. Local leaders are right to feel aggrieved.[38] We know that cuts to services will follow. The Treasury's short-termism risks undermining the already fragile foundations of shared prosperity. As we argued: 'The Treasury's ethos of centralisation – even though local know-how and accountability are essential – and short-term cost efficiency – even when this is ultimately costly – contributes substantially to that fragility'.[39]

[30] Thelen K (2002) ' The explanatory power of historical institutionalism', in Mayntz R (ed) *Akture-Mechanismen-Modelle: Zur Theoriefähigkeit mackro-sozialer Analysen*, Frankfurt/New York: Campus Verlag.
[31] See https://publications.parliament.uk/pa/cm201719/cmselect/cmpubacc/1596/159606.htm.
[32] Diamond P (2018) 'Groupthink, partisanship, and the end of Whitehall', LSE British Politics and Policy, 5 October, available at: https://blogs.lse.ac.uk/politicsandpolicy/the-end-of-whitehall/.
[33] Gaskell J, Stoker G, Jennings W and Devine D (2020) 'Covid-19 and the blinders of our government: long-run system failings aggravated by political choices', *The Political Quarterly* 91(3), 523-533.
[34] See Warner S, Coyle D, Richards D and Smith MJ (2020) 'More austerity? The Treasury must act against the grain of its own history in responding to COVID-19', LSE British Politics and Policy, 11 May, available at: https://blogs.lse.ac.uk/politicsandpolicy/treasury-covid19/.
[35] See Coyle D, Warner S, Richards D and Smith MJ (2021) 'Budget ditches industrial strategy in favour of centralised levelling up', Bennett Institute for Public Policy, 10 March, available at: https://www.bennettinstitute.cam.ac.uk/blog/budget-ditches-industrial-strategy-centralised-lev/.
[36] See Morphet J (2021) *The Impact of COVID-19 on Devolution: Recentralising the British State Beyond Brexit*, Cambridge: Policy Press.
[37] See https://www.theguardian.com/politics/2021/mar/18/britain-heading-for-new-era-of-austerity-thinktank-warns.
[38] Warner S, Richards D, Coyle D and Smith MJ (2020) 'Why local governments will feel aggrieved by this spending review', The Conversation, 25 November, available at: https://theconversation.com/why-local-governments-will-feel-aggrieved-by-this-spending-review-150695.
[39] Coyle *et al* (2021) 'Budget ditches…'.

To make matters more complicated, the COVID-19 crisis cannot be understood in isolation. It masks Brexit's impact on the UK economy.[40] The 2007/08 financial crisis still looms large as a decade and more of austerity undermined the resilience of public services entering the pandemic.[41] In this context, the Treasury's centralised approach to public spending control becomes problematic when 'affordability' and 'value for money' conflict. The Treasury admits that this happens – it might be controversial, but it is necessary, they say.[42] Criticism of Test and Trace[43] and dodgy procurement practices[44] on value for money grounds can be batted off as a feature of crisis management, but we should not neglect that short termism, cost shunting and waste are endemic features of the spending control framework.[45] As crises coalesce and profound interlocking social, political and economic challenges emerge, innovative ways of working will be required. Horizons will need to be longer. Informed risk taking will have to become commonplace. In rejecting the education catch-up plan, the Treasury was reportedly unconvinced by the evidence base and feared that temporary investment might become permanent. Treasury mindsets must be more malleable than this.

Our research points time and again to similar examples. They are a symptom of the heavily centralised nature of the UK system of government and the fact that departments operate in silos. There is very little input from outside of Whitehall. This problem is intensified because over a period of 40 years or so, governance arrangements have fragmented, complexifying the process of policy implementation and delivery. The constitutional consequences for public accountability and ministerial responsibility are too easily brushed aside.[46] Steering complex policy networks from the centre, is an incredibly difficult task, especially when the Treasury must balance multiple competing demands and perspectives. Information asymmetries cloud decision-making throughout the delivery chain and despite best efforts, allocative efficiency is often stifled.[47]

Rethinking the 'day job'?

Paul Johnson's recent defence of Treasury orthodoxies acknowledged that it is poor at measuring the 'dynamic benefits' of spending decisions. Michael Gove highlighted this fact as a potential obstacle to reform; the Treasury is good at questioning costs, but poor at

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[40] Giles C (2021) 'Covid pandemic masks Brexit impact on UK economy', Financial Times, 1 July, available at: https://www.ft.com/content/fbb70741-34cc-4f54-a66b-a2e4b9445f5b.

[41] Davies N, Atkins G, Guerin B, Sodhi S (2020) *How Fit Were Public Services for Coronavirus?* Institute for Government, available at: https://www.instituteforgovernment.org.uk/sites/default/files/publications/how-fit-public-services-coronavirus.pdf.

[42] See https://publications.parliament.uk/pa/cm201213/cmselect/cmpubacc/661/661.pdf.

[43] National Audit Office (2021) *Test and Trace: Progress Report*, available at: https://www.nao.org.uk/wp-content/uploads/2021/06/Test-and-trace-in-England-progress-update.pdf.

[44] House of Commons Public Accounts Committee (2021) *Codvid-19: Government Procurement and Supply of Personal Protective Equipment*, available at: https://committees.parliament.uk/publications/4607/documents/46709/default/.

[45] Wheatley M, Kidney Bishop T, McGee T (2019) *The Treasury's Responsibility for the Results of Public Spending*, available at: https://www.instituteforgovernment.org.uk/sites/default/files/publications/treasury-responsibility-public-spending-WEB.pdf.

[46] Theakston K (2021) 'The long march through Whitehall', *The Political Quarterly* 92(1), 85-89.

[47] Aldridge A, Hawkins A and Xuereb C (2016) 'Improving public sector efficiency to deliver a smarter state', Civil Service Quarterly, 25 January, available at: https://quarterly.blog.gov.uk/2016/01/25/improving-public-sector-efficiency-to-deliver-a-smarter-state/.

understanding broader social value.[48] Resultantly, the Treasury often undermines otherwise sensible, albeit incremental, reforms. Treasury short-termism and caution often reinforces and replicates the problems it seeks to overcome.

What, then, are we to make of recent reforms? There is a change in tone emanating from the Treasury after years of austerity. After criticism from the Public Accounts Committee among others, departments have been instructed to countenance improved 'outcomes' as a necessary aspect of the spending control framework. Outcome Delivery Plans are the most recent manifestation of this tendency, with central oversight provided by an Evaluation Taskforce located in the Cabinet Office and Treasury.[49] A Public Value Framework is in place to focus minds on maximising the 'value' of spending decisions.[50] It is, though, in keeping with the 'more for less' attitudes of recent years which have undermined public sector productivity.[51] The recently resurrected Sir Michael Barber opined that his system should not cost the taxpayer an extra pound.[52] Familiar themes of joined up working, integrated delivery and a more pluralised approach to policy generally are usual currents. They all feature in the government's Declaration on Government Reform.[53] There is nothing especially radical included. In truth, it all has a 'back to the future' feel to it.

Research by Christopher Hood and Barbara Piotrowska cautions us against optimism about the longevity of this new approach.[54] They find that UK political actors tend to be 'fair weather' output controllers—taking credit when the spending taps are on—but 'all weather' input controllers—reflecting a need to remain tough on bureaucracy to avoid blame for spiralling costs. It is therefore quite interesting that the Treasury is developing a more nuanced approach to spending control despite the continuation of austere times. Rigorous monitoring of inputs, outputs *and* outcomes is important, but as an ex-Treasury official told us, the latter is extremely difficult. It does not sit well with the prevalence of short-term central funds that stifle best practice and have considerable preparation costs and uncertainty associated with them. We have found this at regional and local government level and in the voluntary sector.[55]

The fragility of 'output' or 'outcome' controls reminds us that 'public finance is politics hidden in accounting columns'.[56] It has been ever thus. At its worst, the politics of resource allocation

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[48] Gove M (2020) 'The privilege of public service', speech delivered on 27 June, available at https://www.gov.uk/government/speeches/the-privilege-of-public-service-given-as-the-ditchley-annual-lecture.
[49] See https://committees.parliament.uk/publications/5187/documents/52040/default/.
[50] See https://www.gov.uk/government/publications/public-value-framework-and-supplementary-guidance.
[51] Coyle D, Dreesbeimdieck K, Manley A (2021) 'Productivity in UK heathcare during and after COVID-19 pandemic', The Productivity Institute Working Paper 2, available at: https://www.bennettinstitute.cam.ac.uk/media/uploads/files/Productivity_in_UK_Healthcare.pdf.
[52] See Diamond P (2021) 'What Michael Barber's appointment tells us about Whitehall reform and the "science" of delivery', LSE British Politics and Policy, 21 January, available at: https://blogs.lse.ac.uk/politicsandpolicy/michael-barber-appointment-whitehall-reform/.
[53] Cabinet Office (2021) *Declaration*.
[54] Hood C and Pitrowska BM (2021) 'Who loves input controls? What happened to "outputs not inputs" in UK public financial management, and why?', *Public Administration*, advance online publication, DOI: 10.1111/padm.12741.
[55] Warner S, Richards D, Coyle D and Smith MJ (2021) 'English devolution and the COVID-19 pandemic: governing dilemmas in the shadow of the Treasury', *The Political Quarterly* 92(2); 321-330.
[56] Gray M and Barford A (2018) The depths of the cuts: the uneven geography of local government austerity', *Cambridge Journal of Regions, Economy and Society* 11(3), 541-563.

as we have recently seen can descend into pork barrel politics.[57] The evidence base, therefore, should always be robust. In June's Declaration on Government Reform there are the seeds of a more dynamic approach to spending planning and control. Data pooling, sharing and evaluation feature prominently and are presented as the tool to ensure that needs and not just budgets are met. This is not wholly new—the Cabinet Office and Tony Blair were arguing something similar back in 2000.[58] But the work of the Office for National Statistics, who recently launched the Government Statistical Service Coherence Programme, is encouraging.[59] Provided that meaningful investment is sustained, it is possible that statistics, data and modelling could be used to join up the dots between different department's spending priorities and longer-term outcomes. Other countries like New Zealand have moved in this direction already and point to what a new evidence-informed synthesis between the centre and the street level might look like.[60]

None of this is easy. It requires systemic reform and a re-think of the UK's centralised approach to financial control and Whitehall's detachment from the realities of life for delivery agents on the ground. In December 2018, in an evidence session on value in public spending, the former Permanent Secretary at the Cabinet Office, John Manzoni, informed the Public Accounts Committee: 'we work in Whitehall in a delegated model, which is all fine until it doesn't work. When it does not work, you have absolutely no levers to fix it. We have to build back from that'.[61] This is an honest but surely unacceptable stance to take. The result is incrementalism without meaningful reform. The Treasury needs to adapt the 'day job' to the 21st century and improve its understanding of future costs as a necessary aspect of protecting the public finances. If not in the wake of the COVID-19 pandemic, then when?

[57] Hanretty C (2021) 'The pork barrel politics of the Towns Fund', *The Political Quarterly* 92(1), 7-13.
[58] See Cabinet Office (2000) *Adding It Up: Improving Analysis and Modelling in Central Government*, available at: https://dera.ioe.ac.uk/6321/2/coiaddin.pdf.
[59] See https://blog.ons.gov.uk/2021/06/29/public-data-for-public-good-making-sure-official-statistics-are-better-joined-up/.
[60] See Miller G (2016) 'The social investment approach to public spending in New Zealand', Institute for Government, 17 May, available at: https://www.instituteforgovernment.org.uk/blog/social-investment-approach-public-spending-new-zealand-looking-long-term.
[61] See http://data.parliament.uk/WrittenEvidence/CommitteeEvidence.svc/EvidenceDocument/Public%20Accounts/Driving%20value%20in%20public%20spending/Oral/94118.html.

The Treasury and British decline

Simon Lee

In debates about the relative decline of the UK, Her Majesty's Treasury has long been identified as an institutional impediment to the industrial modernization of the country's manufacturing industries. The Treasury has been accused of possession of a 'contempt for production', a definitive feature which has been held to stand at the centre of British economic policy. Not only has this contempt for production allegedly informed 'fundamentally all the actions of the Treasury and other central policy-making bodies. At the same time, it is what most clearly distinguishes the British government from all others'.[62]

Together with the City of London and the Bank of England, the Treasury has been portrayed as one of the three key institutions which have formed 'the core institutional nexus of British society'.[63] The liberal fiscal and monetary macroeconomic policy 'orthodoxy' pursued by this core institutional nexus, with its focus upon balancing budgets and tight control of public expenditure, has been identified as one of the principal barriers to the implementation of a state-led, technocratic industrial modernization for the UK capable of arresting British decline.[64]

Politicians, historians and political economists alike have all made unfavourable comparisons between the UK's economic policy and performance and that of competitor economies. They have attributed the latter's superior industrial performance to the existence of modernizing agencies, such as the Commissariat Général du Plan in France, and the Ministry of International Trade and Industry in Japan. By the same token, the absence of such institutions in the UK, and the presence of the Treasury instead, has been portrayed as a principal cause of national relative economic decline.[65]

Even when the 1964-1970 Labour government, led by Harold Wilson, instituted a National Plan, Department of Economic Affairs (DEA), and Ministry of Technology to surmount the Treasury's failure to deliver industrial modernization, the Treasury's critics have argued it succeeded in defeating these new institutional rivals. Indeed, former Conservative Defence Secretary Michael Heseltine argued '[t]he DEA's defeat by the Treasury has, for twenty years, prevented governments in Britain from thinking in strategic ways about the future of industry'.[66]

Therefore, the serious charge laid before the Treasury is that it has prevented the development in the United Kingdom of the appropriate societal principles and institutions of a modern

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[62] Pollard S (1984) *The Wasting of the British Economy: British Economic Policy 1945 to the Present* (London: Croom Helm), p.72.
[63] Ingham G (1984) *Capitalism Divided: The City and Industry in British Social Development* (London: Macmillan), p.9.
[64] This argument is cogently set out in Newton S and Porter D (1988) *Modernization Frustrated: The Politics of Decline in Britain since 1900* (London: Unwin Hyman).
[65] This thesis is developed in 'Part Three: Ways Out?' in Smith K (1984) *The British Economic Crisis* (Harmondsworth: Penguin), pp.185-240.
[66] Heseltine M (1987) *Where There's A Will* (London: Hutchinson), p.115.

industrial capitalist economy, namely a 'developmental state' of the sort associated with Japan and other late industrializing Asian economies,[67] or a national system of innovation of the sort advocated by the nineteenth century German national political economist Friedrich List.[68]

The case against the Treasury is a powerful and longstanding thesis in 'declinist' accounts of British economic policy and performance.[69] However, it is a thesis which has come under increasing challenge and criticism from both historians and political economists. The historian William Ashworth, for example, has set out in detail how the Treasury's interventions and regulations during the seventeenth and eighteenth centuries were instrumental in making possible the financing of the commercial and territorial expansion which underpinned the British Empire and Industrial Revolution.[70]

The current author has argued that, far from being an impediment to the creation of a developmental role for the state, the Treasury has in fact served as a pilot agency for an English, and latterly a British developmental state.[71] Lest we forget, during two World Wars, the Treasury was not an impediment to the effective mass mobilization of the British people and British industry by a highly interventionist warfare state.[72]

In the twenty-first century, this developmental role has been demonstrated by at least three major economic policy interventions. First, the Treasury's coordination of a bailout for UK banks, following the financial crisis of 2007-2008, which amounted, at its peak, to £1162 billion. Second, to boost national economic recovery from the financial crisis, the Treasury's sanctioning of purchases by the Bank of England of gilts and corporate bonds totalling £895 billion. Third, following the contraction of the UK economy by 9.9 per cent of Gross Domestic Product (GDP) during 2020, the largest annual contraction for more than 300 years as a consequence of the impact of the coronavirus epidemic, the Treasury's fiscal policy response of sanctioning government borrowing of £298 billion or 14.2 per cent of GDP in 2020-2021.[73]

As students of UK politics and political economy, we may take issue with the Treasury and Bank of England for having provided so much strategic financial support to the financial

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[67] This argument was developed by the former Labour MP, David Marquand in his 1988 book *The Unprincipled Society: New Demands and Old Politics* (London: Fontana Press), especially pp.113, 175.
[68] Ironically, in Chapter 4 of 'Volume I: The History' Friedrich List's classic 1841 work, *National System of Political Economy* (New York: Cosmo Classics 2005 edition), List actually attributed England's then superiority in manufacturing to centuries of strategic interventions by the state to cultivate England's national 'productive powers'.
[69] Here, we may usefully call upon David Edgerton's 2018 definition of 'declinism' as 'the explanation of relative decline, by what is taken to be national failings' in his book *The Rise and Fall of The British Nation* (London: Allen Lane), p.389.
[70] William J.Ashworth (2017) *The Industrial Revolution: The State, Knowledge and Global Trade* (London: Bloomsbury).
[71] These arguments have been developed, for example, in Lee S (2021) 'The Developmental State in England: The Role of The Treasury in Industrial Policy', in Berry C, Froud J and Barker T (eds) *The Political Economy of Industrial Strategy in the UK* (Newcastle: Agenda Publishing), pp.39-47.
[72] This argument has been brilliantly developed in David Edgerton's (1991) *England and The Aeroplane: An Essay on a Militant and Technological Nation* (London: Macmillan) and his (2006) *Warfare State: Britaim, 1920-1970* (Cambridge: Cambridge University Press).
[73] The Treasury's various policy interventions are summarised each year in its annual report and accounts. See, for example, HM Treasury (2021) *Annual Reports and Accounts 2020-21* (London: HM Treasury), available at https://www.gov.uk/government/publications/hm-treasury-annual-report-and-accounts-2020-to-2021.

services and property market sectors of the UK economy. We may think the Treasury has picked the wrong 'winners', and merely served to redistribute wealth upwards to the top 5 per cent of households who are the principal owners of wealth and property assets.[74] We may also disagree with the way in which the Treasury's interventions have subordinated the interests of the North of England to those of the global financial, commercial and rentier capitalist interests of the City of London's 'Southern Powerhouse'.[75]

However, if we decide to make these arguments, we shall be advancing a very different political analysis and critique of the role of the Treasury than that which has traditionally accused its alleged 'contempt for production' of bringing about national decline. We shall instead be asking very different political questions about power and its exercise in the UK, and in whose interests the Treasury has intervened, rather than criticizing it for having failed to measure up to an 'other country' technocratic blueprint for industrial modernization.

[74] The way in which the Treasury and Bank of England's interventions have led to a flooding upwards, rather than a 'trickle-down' of wealth from the rich to the poor, have been highlighted by the campaigning pressure group Positive Money (see www.positivemoney.org) and in a report from the Bank of England (2012) *The Distributional Effects of Asset Purchases* (London: Bank of England), available at: https://www.bankofengland.co.uk/-/media/boe/files/news/2012/july/the-distributional-effects-of-asset-purchases-paper.

[75] See Lee S (2018) 'Law, Legislation and Rent-Seeking: The Role of the Treasury-led Developmental State in the Competitive Advantage of the Southern Powerhouse' in Berry C and Giovannini A (eds) *Developing England's North: The Political Economy of the Northern Powerhouse* (London: Palgrave Macmillan), pp.59-82.

How does the Treasury make tax policy decisions?

Nick O'Donovan

Tax policy plays an important role in the government's overall economic strategy. Tax policy decisions affect the resources that government, businesses and private households have at their disposal; they can encourage some activities and penalise others; they can be used as a tool for economic stimulus and fiscal retrenchment. Tax policy-making is often presented as a highly technocratic endeavour, reliant upon the expertise of lawyers and economists. However, it is also deeply political. This piece explores how the Treasury manages these political and technocratic imperatives, and assesses whether it does so successfully. It begins by examining the kinds of consideration that inform the Treasury's tax policy-making decisions, before turning to the process of tax policy formation.

What kinds of consideration inform tax policy?

Fiscal considerations are arguably the most important factor involved in tax policy-making. Levels of public spending, coupled with the Government's tolerance for borrowing (arguably, the Treasury's lack of tolerance for borrowing[76]) determine how much money government needs to raise in taxes. Equally, reluctance to raise taxes (or the desire to reduce them) may force Government to rethink its public spending plans.

Since 2010, the Office for Budget Responsibility (OBR) has audited government's tax policy projections, and produced its own fiscal and economic forecasts. It monitors whether government tax and spending decisions are compatible with self-imposed fiscal rules[77], which specify the Government's tolerance for debt and deficit spending. While multiple different tax policies and spending decisions are compatible with the fiscal rules laid down, the Budget team within the Treasury will select tax policy options with one eye on these forecasts, to ensure that the combination of policies that they select are compliant with these rules.

Tax policy is also informed by Government's wider *strategic goals*. These might include ambitions to promote transition to a net-zero economy, or to 'level up'. The Treasury, furthermore, has explicit organisational objectives, which presently include placing the public finances on a sustainable footing, ensuring the stability of the macro-economic environment and financial system, and increasing employment and productivity.[78]

Political considerations also play an important part in shaping tax policy, and tax policy can be a useful political tool. If politics is defined in terms of 'who gets what, when, how'[79], then taxation is clearly deeply political, altering the distribution of resources between different groups. Parties often make high profile pledges relating to tax in election campaigns: for example, in the 2019 election, the Conservatives pledged that 'we will not raise the rate of

[76] Callinicos A (2012) 'Contradictions of austerity', *Cambridge Journal of Economics* 36(1), 65-77.
[77] See https://commonslibrary.parliament.uk/research-briefings/cbp-9329/.
[78] See https://www.gov.uk/government/organisations/hm-treasury/about.
[79] Lasswell, HD (1936) *Who Gets What, When, How* (New York: Whittlesey House).

income tax, VAT or National Insurance'[80], whereas the Labour Party argued for increasing income tax on people earning more than £80,000 per year.[81] While election pledges such as these are not binding – the Conservatives have already broken their tax promises[82] – they nevertheless signal to voters whether governments believe overall tax burdens should rise or fall, and who should pay for or benefit from these changes.

Similarly, outside election campaigns, tax policy announcements play an important political function. Tax cuts are generally seen as popular, a way of signalling to particular voters (for instance, first-time home buyers[83], car drivers[84], and beer drinkers[85]) that government is on their side; they might also be used to signal who government is against (for instance, banks[86], Big Tech[87], and the business community in general[88]). However, the economic impact of a tax change (its "incidence") does not always track its legal form: stamp duty cuts for first-time buyers might increase house prices, and thus benefit existing property owners; taxes on big tech companies might be passed through to their customers in the form of higher prices.[89]

What is the Treasury's role in the tax policy-making process?

Treasury officials, in partnership with their colleagues in HMRC, will at any given time be working upon a range of tax reform options. Generally speaking, these options will be developed at the behest of senior civil servants and ministers, reflecting the political priorities and fiscal needs of government. However, more technical reforms, addressing specific deficiencies in or problems with existing tax rules, might originate from within HM Revenue and Customs (HMRC), as part of its organisational mandate to ensure the ongoing integrity of the tax system. HMRC, as the authority responsible for collecting taxes and enforcing tax rules, generally has better visibility of taxpayer-level data, and direct contact with taxpayers who may flag ambiguities or unintended consequences of existing legislation.

An initial announcement of tax policy measures is usually made in the Autumn Budget, approximately eighteen months before the policy in question is due to take effect.[90] This announcement will include costings of the likely revenue generated by the tax policy change (or revenue foregone, in the case of tax cuts), as calculated by the Treasury but audited by the OBR. The long timeframe provides opportunities for detailed consultation on the measure with stakeholders – including taxpayers, accountants, lawyers, industry groups, and civil society

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[80] See https://www.conservatives.com/our-plan.
[81] See https://labour.org.uk/wp-content/uploads/2019/11/Real-Change-Labour-Manifesto-2019.pdf.
[82] Edgington T and Scott J (2021) 'Are the Conservatives keeping their election promises?', BBC News, 4 October, available at: https://www.bbc.co.uk/news/uk-politics-58401767.
[83] See https://www.gov.uk/government/publications/stamp-duty-land-tax-relief-for-first-time-buyers-guidance-note.
[84] See https://www.which.co.uk/news/2021/03/budget-2021-fuel-duty-frozen-for-11th-consecutive-year/#:~:text=What%20does%20the%20fuel%2Dduty,it%20has%20been%20since%202009.
[85] See https://www.bbc.co.uk/news/business-31940987.
[86] See https://www.gov.uk/government/publications/bank-corporation-tax-surcharge.
[87] See https://www.ft.com/content/4f7aed86-989f-11e7-a652-cde3f882dd7b.
[88] See https://www.bbc.co.uk/news/business-56267284.
[89] See for example Barker A (2020) 'Google to pass the cost of digital services taxes on to advertisers', Financial Times, available at: https://www.ft.com/content/fda648aa-bb52-4ab2-aa18-46b5023cb893.
[90] See for example https://www.gov.uk/government/publications/the-new-budget-timetable-and-the-tax-policy-making-process/the-new-budget-timetable-and-the-tax-policy-making-process.

organisations.[91] This consultation involves consideration of the high-level design of the measure in question, then a more detailed analysis of the precise legislative text that is to make that design a legal reality, drafted by lawyers within the Office of the Parliamentary Counsel (OPC). Following consultation, the draft legislation then passes to Parliament, for scrutiny and approval.

However, more political tax changes – such as those advanced in a governing party's manifesto – might bypass this consultation process. The Treasury's own guidance explicitly states that 'the [g]overnment will generally not consult on straightforward rates, allowances and threshold changes'.[92] Arguably, such tax policy changes are litigated through the democratic process itself. We generally want politicians to keep their promises (or at least, we complain when they don't), so from the perspective of democratic legitimacy, it is preferable to leave these high-level decisions to politicians rather than bureaucrats. However, the expertise of the Treasury, HMRC and the OPC, coupled with the fact that costings are audited by the OBR, can lend these tax policy decisions an air of technocratic authority. Within the UK political system, there is no clear counterweight to this authority. While in the US, for example, all members of Congress have access to technical experts from the Congressional Budget Office and the Joint Committee on Taxation, irrespective of their partisan loyalties, there is no similarly well-resourced equivalent within UK Parliament.

The political function of the Treasury is particularly problematic with regard to the retrospective review and evaluation of tax policy. A technocratic organisation of experts might be expected to constantly monitor and evaluate policies, in-line with the best practice recommendations of the management literature. And, according to the Treasury's Tax Consultation Framework at least, once implemented tax policy changes are regularly monitored, reviewed and evaluated.[93] However, in practice the Treasury and HMRC tend to shy away from such reviews. This is understandable – an unfavourable review of a flagship government tax policy would be politically damaging, were it leaked to the press. Critical internal evaluations of previous policy decisions tend to be restricted to the decisions of previous governments, such as the coalition government's 2012 review of the previous Labour government's 50% additional rate tax bracket (a review that has been roundly criticised on methodological grounds).[94]

In technocratic terms, this is a missed opportunity for organisational learning; in democratic terms, it is a missed opportunity for improving the quality of information available to the public. There may also be an element of institutional politics here too: while the Treasury is often quite

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[91] See https://www.gov.uk/government/publications/tax-consultation-framework.
[92] HMRC and HM Treasury (2011) *Tax Consultation Framework*, available at: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/89261/tax-consultation-framework.pdf.
[93] See https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/89261/tax-consultation-framework.pdf.
[94] HMRC (2012) *The Exchequer Effect of the 50 Per Cent Additional Tax Rate*, available at: https://webarchive.nationalarchives.gov.uk/ukgwa/20140109143644/http:/www.hmrc.gov.uk/budget2012/excheq-income-tax-2042.pdf; for a critique, see Browne J and Phillips D (2017) 'Updating and critiquing HMRC's analysis of the UK's 50% marginal tax rate', IFS Working Paper W17/12, available at: https://ifs.org.uk/publications/9677.

happy to scrutinise the policy decisions of other government departments, it has been criticised by the National Audit Office for failing to apply the same standards to its own decision-making around tax policy.[95] Although the Treasury is adept at translating the political preferences of the present Government into tax reforms, it does not always do so in ways that facilitate democratic oversight of the governing party, nor of the Treasury itself.

[95] NAO (2020) *The Management of Tax Expenditures*, available at: https://www.nao.org.uk/report/the-management-of-tax-expenditures/.

How independent is the OBR, and why does it matter?

Catherine Walsh

The Office for Budget Responsibility's (OBR) mandate is prescribed by the Treasury, orienting its rules-of-engagement in fiscal debate toward Treasury goals. Furthermore, the OBR's macro-economic model is still being co-created with the Treasury, its staffing supplemented by the Treasury, and its operations co-managed by jointly-appointed working groups. We should bear this in mind whenever we read the phrase 'the independent OBR'.

Launched in 2010, the OBR was always intended to be a very public guarantor of the UK government's fiscal behaviour. Its Parliamentary Charter – written by the Treasury – states that 'the OBR is designed to address past weaknesses in the credibility of economic and fiscal forecasting and, consequently, fiscal policy'.[96] The Office's very existence is a strategic attempt to provide economic forecasts that MPs, civil servants, journalists, citizens, and financiers believe is free from political interference by the sitting government. Because the appearance of OBR independence as expressed in public discourse has always been central to its mandate, it is a claim worth scrutinizing further.[97]

The OBR bases much of its claim to independence on transparency of its methods and assumptions in forecasting and assessment, and its willingness to share its conclusions widely. The OBR undertakes economic and fiscal forecasting, evaluates performance against targets, assesses 'long-term stability' of the public finances, and evaluates future 'fiscal risk'. It also scrutinises the costing of tax and welfare measures at each parliamentary budget. As a public body, it provides evidence to parliamentary committees, primarily the Treasury Select Committee, on the occasions of budget and spending reviews. It shares analysis with MPs and civil servants, responds to specific Freedom of Information requests, and releases reports for the press. Its website offers an impressive archive of documents and analyses.[98]

It is the Treasury that prescribes what the OBR will examine and what it will routinely publish. The Budget Responsibility and National Audit Act 2011, the OBR's founding Act of Parliament, opens by declaring the ground-rules for the relationship between the Treasury and the OBR:

> The Treasury must prepare a document, to be known as the Charter for Budget Responsibility, relating to the formulation and implementation of fiscal policy and policy for the management of the National Debt.[99]

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[96] See https://obr.uk/download/charter-budget-responsibility/.
[97] Walsh C (2020) 'Constructing experts without expertise: fiscal reporting in the British press, 2010-2016', *Journalism Studies* 21(15), 2059-2077.
[98] See https://obr.uk.
[99] See https://obr.uk/docs/dlm_uploads/Budget-Responsibility-and-National-Audit-Act-2011.pdf.

The Charter describes the Treasury's own fiscal objectives, the measures against which the Treasury believes it should be judged by the OBR as meetings those objectives, and when the OBR should report publicly on these measures.[100] The OBR is left to decide its own analytical methods with which to judge fiscal performance, and its adjudications are its own. But the criteria for 'fiscal responsibility' are set by the Treasury, and the OBR cannot change them. In addition, the Treasury may add to the Charter at any time whatever it deems appropriate, to then be laid before Parliament for approval (the latest update being October 2021). In its latest incarnation, fiscal responsibility means Treasury-set targets for falling Public Sector Net Debt, for balanced current budgets, and for public sector net investment, as well as welfare spending kept below a Treasury-determined cap. OBR independence amounts to independently answering a strict set of questions that the Treasury has pre-determined to have answered, about itself, in public.

Beyond its dependency as a legal, chartered entity, the OBR's working relationship with the Treasury is also close. Internally, the OBR is funded through the budget of the Treasury as its sponsor department, and so must request its annual funding from the Chancellor of the Exchequer. With a permanent staff of only a few dozen, the OBR is reliant on information and analysis provided by other departments, most notably HM Revenue and Customs, the Department of Work and Pensions, and, again, the Treasury. When the OBR does recruit new staff, they most often come from these same departments, with the Treasury having provided most of its initial staffing in 2010.

This relationship between the OBR and the Treasury is further described in the Memorandum of Understanding (MoU).[101] The 2017 MoU outlines principles for the sharing of information and staff, as well as a collection of special working groups for forecasting (chaired by the OBR), policy, and welfare costings (the latter two are both chaired by the Treasury). In addition, an 'indirect effects process' is coordinated by the Treasury and OBR immediately before fiscal events' like the Budget, in order to 'consider the potential effects of policy decisions on the economic and fiscal forecast, beyond those reflected in the direct costings.' A scan of the (very transparent) Log of Contact between the OBR and government ministers illustrates the level of coordination between the Office and the Treasury.[102]

Another key matter on which the OBR and the Treasury meet is its macro-economic model. Day-to-day, the OBR undertakes broad, technical analysis of the government's finances and fiscal management by estimating tax and welfare costs, and creating economic forecasts. It must also interpret the consequences of government fiscal management against targets, all over defined time-horizons, in order to produce judgments about its numbers. The current version of this macro-economic model is the main tool for the OBR's forecasting process. The model itself was inherited from the Treasury in 2011, but the Treasury has remained very much involved in its subsequent development at the OBR. The model is maintained and developed jointly between the Treasury and the OBR by way of their Model Development Steering Group. Should the OBR and the Treasury disagree on this model, their MoU for the Macroeconomic

[100] See https://www.gov.uk/government/publications/charter-for-budget-responsibility-autumn-2021-update.
[101] See https://obr.uk/docs/dlm_uploads/MoU_model.pdf.
[102] See https://obr.uk/download/log-of-substantive-contact/.

Model states that they would be reconciled by each maintaining their own exclusive versions.[103] Insofar as this has not yet happened, one presumes they remain in accord.

The matter of the OBR's independence is sufficiently contentious and important that its most recent (unnamed) reviewers at the OECD sought to explicitly defend the OBR as politically independent, based on four criteria.[104] The OECD defends the OBR as having day-to-day operational independence, insofar as civil service staff can be hired, fired, and directed to conduct analysis as the directors see fit. It judges the OBR to have established a culture of independence under what they see as impeccable leadership. It argues that the OBR's information sources, assumptions, and methods are available for scrutiny, and that the OBR maintains strict procedures where staff from other government departments have pre-report input. Finally, the OECD argues that there exists a clear understanding of the limits of OBR responsibilities, specifically that these stop short of policy making, rather it is 'providing the independent economic and fiscal analysis that can inform policy making.' Yet in the same report even the OECD implicitly recognises the limited nature of the OBR's independence from the Treasury, suggesting that if the OBR were more independent of the Treasury than it is, then the Treasury would be less inclined to trust it. The OBR's response to the OECD's examiners' report was to issue a press release titled 'OECD review hails OBR's outputs and independence'.[105]

The OBR's dual accountability to both the Treasury and Parliament was described by its first external reviewer as an existential challenge for the OBR.[106] After a decade of operations, the challenge remains because the ideological and material ties that bind the OBR to the Treasury have not weakened. From mandate to staffing, and from models to steering groups, the ties remain strong. Even where the OBR has sovereignty, the Treasury remains the stronger of the two entities.

Much of what the OBR does was done by the Treasury before its invention in 2010. This is why it inherited the Treasury's macro-economic model and was initially staffed by so many Treasury people. The appearance of independence is fundamental to the OBR's *raison d'etre*, which is why it is the adjective that the OBR uses to describe itself in every introduction. 15 per cent of the time a British newspaper article cites the OBR it will automatically describe it as 'independent', so this is a self-characterisation that has penetrated public discourse such that it is rarely questioned.[107] At every Budget, the OBR is cited as an apolitical and impartial fact-checker of fiscal policy. But the OBR is checking a very narrow set of questions, which have been constructed by the Treasury to support its own political direction. And the Treasury helps to answer the questions too. This makes the answers more political and less independent than we are led to believe.

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[103] See https://obr.uk/docs/dlm_uploads/MoU_model.pdf.
[104] OECD (2020) *OECD Independent Fiscal Institutions Review: Office for Budget Responsibility of the United Kingdom*, available at: https://www.oecd.org/gov/budgeting/oecd-ifi-review-of-the-office-for-budget-responsibility-obr-of-the-united-kingdom.pdf.
[105] See https://obr.uk/oecd-review-hails-obrs-outputs-and-independence/.
[106] Page K (2014) *External Review of the Office for Budget Responsibility*, available at: https://obr.uk/docs/dlm_uploads/External_review_2014.pdf.
[107] Walsh C (2020) 'Constructing experts…'.

Dangerous liaisons? Negotiating monetary settlements between the Bank of England and the executive

William Meade

The historic rivalry between the Bank of England and the UK's central executive[108] over the institutionalisation of state money is illustrative of what can be at stake in arguments over apparently 'technical' monetary and fiscal matters. The state is often talked about as a unitary actor, but this can gloss over the internal mechanisms of power required for coordinating policy. In fact, the state is an 'ensemble' of historically derived institutions and organisations with different interests, functions and powers.[109] Achieving the ultimate ends of economic policy – growth, employment, or low inflation, for example – may require actors to forcibly direct the policy-making apparatus as a whole through institution building. And so, whilst these different centres of power might represent particular social interests, there is something to be gained analytically from focusing on *how* they control the wider policy-making apparatus to achieve their ends. That is, something to be gained from identifying the 'disciplinary structures' they build. The historic tensions between the Bank and the UK's central executive reveal precisely this dynamic.

The novelty of the Bank of England, founded in 1694, lay in its banknote-issuing powers and the extra security it provided investors lending to the state.[110] Combined, these institutional innovations underpinned a rapid growth in state debt and private commerce over the next three centuries. The Bank became a new site of institutional power, able to exert influence over monetary and financial conditions.[111] But its power also generated anxiety about its ability to feed inflation and financial speculation. It inevitably, therefore, became an object of, and agent in, political contestation, and a potential rival to the central executive in economic policy.

One catalyst for anxiety about the Bank's discretionary banknote-issuing powers was the early nineteenth-century suspension of gold convertibility.[112] In reaction, a group of liberal Tories fought to put quantitative restrictions on the note-issue. The eventual 1844 Bank Charter Act institutionalised a rule to limit the notes the Bank could issue (in addition to those backed by its gold reserves) to £14million. Their goal was to constrain the Bank and the 'monied powers' they believed acted through it.[113] Yet, although they hoped to rein in inflation and financial instability, in the end they only impeded the Bank's ability to react to financial crises as a 'lender of last resort'. And in narrowing the Bank's remit the unintentional result was to give

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[108] The UK central executive is understood here to include 10 Downing Street, the Cabinet Office, and the Treasury.
[109] Jessop B (1990) *State Theory: Putting Capitalist States in Their Place*. Cambridge: Polity Press.
[110] Knafo S (2013) *The Making of Modern Finance: Liberal Governance and the Gold Standard* London: Routledge; Ingham G (1984) *Capitalism Divided? The City and Industry in British Social Development*. London: Macmillan.
[111] Knafo (2013) *The Making…*
[112] Kynaston D (2019) *Till Time's Last Sand: A History of the Bank of England 1694-2013*. London: Bloomsbury.
[113] Ingham (1984) *Capitalism Divided…*

the Bank the opportunity to achieve a 'technical mastery' and autonomy over monetary policy as it switched its focus to controlling the short-term interest rate.[114]

A similar story can be told about another Tory government struggling to discipline the Bank over a century later. In 1979, Thatcher's government set out to defeat inflation with its new 'monetarist' strategy. They believed that if they could limit the growth of the money supply, then inflation would fall. One challenge was to find a lever through which they could actually bear down on the money supply. Naturally, the Bank would have to be a vital cog in the wheel of any such strategy. Unfortunately, it was not an institution they trusted, since they suspected — correctly — that it was not as committed to monetarist doctrine.[115]

Thatcher and her advisers consequently favoured greater ministerial intervention in Bank affairs, and were deeply opposed to central bank independence. They also advocated for 'monetary base control'[116] partly as a means to directly control the Bank's balance sheet.[117] In many ways this resembled nineteenth-century efforts to control the note-issue. Unsurprisingly the Bank (successfully) resisted, primarily by wielding its considerable technical authority on the subject.[118] In the Bank's view, strict quantitative limits on the money supply would lead to damaging interest-rate volatility.

The Bank, however, was by no means a passive actor and equally sought to control the wider policy-making apparatus as a means of achieving its goals. In the summer of 1975, Harold Wilson's Labour government was faced with a recession, high inflation and a balance of payments crisis. The Bank favoured reductions in government borrowing to lower inflation and shift economic resources into the export sector. The Treasury and Labour leadership, on the other hand, felt that further cuts would be politically too difficult to achieve.[119] In response, the Bank developed a strategy to wield the might of both financial markets and public opinion to force the Chancellor's hand.[120]

Its goal was to get the Chancellor to commit publicly to a target for growth in £M3, a specific statistical indicator for the money supply.[121] Since, by definition, £M3 included the impact of government borrowing, an important way to restrain its growth was to reduce public borrowing.

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[114] Kynaston (2019) *Till Time's Last Sand…*

[115] Clift B (2020) 'The hollowing out of monetarism: the rise of rules-based monetary policy-making in the UK and USA and problems with the paradigm change framework', *Comparative European Politics* 18(3): 281–308; Buller J and Whisker B (2020) 'Inter-organisational distrust and the political economy of central bank independence in the UK', *New Political Economy*, advance online publication, DOI: 10.1080/13563467.2020.1766429.

[116] The 'monetary base' (also known as M0) includes the monetary liabilities of the Bank (i.e. commercial bank deposits at the Bank) and cash circulating in the economy.

[117] Hotson A (2014) 'The 1981 Budget and its impact on the conduct of economic policy: was it a monetarist revolution?", in Needham D and Hotson A (eds) *Expansionary Fiscal Contraction: The Thatcher Government's 1981 Budget in Perspective*. Cambridge: Cambridge University Press, 123–47.

[118] Green J (2020) *The Political Economy of the Special Relationship*. Princeton: Princeton University Press.

[119] Wass D (2008) *Decline to Fall : The Making of British Macro-Economic Policy and the 1976 IMF Crisis*. Oxford: Oxford University Pres

[120] Needham D (2014) *UK Monetary Policy From Devaluation To Thatcher, 1967-1982*. Basingstoke: Palgrave Macmillan.

[121] As a 'monetary aggregate' £M3 includes cash in circulating in the economy and sterling deposits of UK residents in UK banks. However, £M3 could be calculated through its 'credit-counterparts' which included government borrowing.

Raising interest rates was the other way to curtail £M3 growth, but this would restrict needed investment. And if the Chancellor missed his publicly announced target, he would be deemed ‘monetarily irresponsible’ by the public and financial markets alike. A publicly announced £M3 target could therefore put enormous pressure on the Chancellor to meet his target in the only other way possible: reducing government borrowing. This was ‘fiscal policy through the monetary policy backdoor’. As one Bank official put it, a public target would give them a ‘tighter rope round the Chancellor’s neck’.[122]

The Bank realised that it could use publicly announced monetary targets to counteract what it saw as the ‘institutional bias’ against disciplined policy-making across government.[123] Particularly notable was their support for an inflation target in the early 1990s. Along with the publication of an inflation forecast, the Bank could *shape* financial market expectations about future interest rates.[124] Any Chancellor that sought to lower interest rates in a way that contradicted the inflation target would come into conflict with market expectations.

Why does this history matter? At one level, it reveals the endlessly fraught relationship between what might be called, respectively, the fiscal and monetary arms of the state. The Bank and the Treasury developed historically alongside one another, but in fulfilling separate but overlapping functions there has always been friction. This, in turn, shows that the constitution of state money is deeply political. What can appear to the casual observer as natural arrangements for government borrowing, spending and lending are, in fact, institutionalised power struggles. These institutions are embodiments of particular political-economic goals, and not simply background rules. In our current context – high COVID-19 debts, a fragile economy, and impending climate disaster – the desired shape of these institutions should be brought to political consciousness and not buried beneath obfuscation.

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[122] Needham (2014) *UK Monetary Policy…*

[123] Hotson A (2010) ‘British monetary targets , 1976 to 1987 : a view from the fourth floor of the Bank of England’, *LSE Financial Markets Group Paper Series 190*, available at: https://www.academia.edu/5308780/British_monetary_targets_1976_to_1987_a_view_from_the_fourth_floor_of_the_Bank_of_England.

[124] James H (2020) *Making a Modern Central Bank: The Bank of England 1979-2003*. Cambridge: Cambridge University Press; Walter T and Wansleben L (2019) ‘How central bankers learned to love financialization: the Fed, the Bank, and the enlisting of unfettered markets in the conduct of monetary policy’, *Socio-Economic Review*, advance onlinepublication, DOI: 10.1093/ser/mwz011.

New wine, old bottles:
financial regulation after the financial crisis

Adam Barber

The 2008 global financial crisis was unprecedented, leaving almost no domestic economy unaffected. The near-total collapse of the banking and financial sectors in the core economies of the UK, United States and continental Europe has, in the years since the crisis, seen governments and policymakers across the world endeavour to 're-regulate' finance. Though reform has been driven at the global level by international standard-setters such as the Basel Committee on Banking Supervision and the Financial Stability Board, domestic regulators have also been key players in the supposed reimagining of financial regulation.[125] In this piece, I focus upon the UK's reform programme and the role of the Bank of England (BoE) in shaping regulatory responses to the crisis. I argue that while the BoE's expanded macroprudential remit following the crisis has meant that the regulatory context within which banks operate has changed significantly since 2008,[126] supervisory interventions alone may not be sufficient to insulate the real economy from future shockwaves. I conclude that despite an ambitious reform agenda set out by the BoE, financial regulation in the UK after the financial crisis poses new, as well as old, forms of systemic risk.

Ideational drivers of change

In the pre-2008 era, financial regulation at both a national and international level wrongly assumed that market risk could be modelled, predicted and mitigated against with the historical asset values, along with the previous market appetite for certain products, serving as good indicator of future prices and therefore emerging risk.[127] These ideas were underpinned by the work of new classical economists such as Eugene Fama and Robert Lucas who believed that *rational* agents would act in their own utility-maximizing self-interest and that armed with all available information markets would have a strong propensity towards equilibrium.[128] Consequently, financial regulation before 2008 placed a premium upon the monitoring and dissemination of information concerning the risk management and market pricing mechanisms of individual financial institutions.[129]

[125] Taylor, M (2013) 'Regulatory reform in the UK', North Carolina Banking Institute 18(1), available at: https://scholarship.law.unc.edu/ncbi/vol18/iss1/19.
[126] Baker, A (2013) 'The new political economy of the macroprudential ideational shift, *New Political Economy* 18(1): 112-139; Bell, S and Hindmoor, A (2014) 'The ideational shaping of state power and capacity: winning battles but losing the war over bank reform in the US and UK', *Government and Opposition* 49(3): 342-368; Tucker, P, Hall, S and Pattani, A (2013) 'Macroprudential policy at the Bank of England', *Bank of England Quarterly Bulletin* 53(3): 192-200.
[127] Baker (2013) 'The new political economy…'
[128] See Fama, E (1970) 'Efficient capital markets: a review of theory and empirical work', *Journal of Finance* 25(2): 383–417; also Lucas, R (1980) 'Equilibrium in a pure currency economy', *Economic Inquiry* 18(2): 203–20.
[129] Baker A (2015) 'The bankers' paradox: the political economy of macroprudential regulation', *SRC Discussion Paper 37*, available at: http://eprints.lse.ac.uk/61998/1/dp-37.pdf.

However, this rather narrow institutional focus would mean that many of the wider systemic causes of the global financial crisis would go largely unrecognised and which, when the crisis hit in 2007 – and gathered pace throughout 2008 – would have deleterious consequences for the real economy. The subsequent bailout of banks and recapitalisation of financial markets by governments across the world provided ‘empirical disconfirmation’ to those ideas which had dominated approaches to financial regulation in the years before the crisis.[130] Indeed, thinking within regulatory circles post-crisis has taken on a much broader macroeconomic outlook as regulators have sought to create a new policy paradigm that accounts for the destabilizing systemic effects of increased financial complexity within financial markets.[131]

The Bank of England and financial regulation

In the UK, this supposed reimagining of financial regulation has seen the BoE placed firmly at the forefront of regulatory frontiers, with the dissolution of the Financial Services Authority, hitherto the UK’s single regulatory agency. In its place, the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA) were established, which – along with the creation of the Financial Policy Committee (FPC) – has returned power to the central bank.

The FCA is an independent body that regulates banks and other financial institutions providing services to consumers. It does this by monitoring the business conduct of firms and ensuring that products being offered to customers (for example mortgages: consumer loans and insurance) are fair, and in the best interest of consumers. When firms or certain financial products fall short of regulatory standards, the FCA has the power to intervene and may impose fines, suspend institutions from trading, or ban certain products. As such, the FCA helps to protect consumers and enhance the integrity of the financial sector, and markets more broadly, from nefarious activity.

The PRA is regulatory agency housed within the BoE whose primary task is to ensure that the financial system continues to operate in a safe and sound manner. It does this by monitoring and supervising the business models of financial institutions and by creating tailor-made policies that reduce the risk posed by systemically important institutions to the real economy. The PRA is also responsible for monitoring the amount of capital and liquidity held by institutions, and modelling various economic situations to determine how resilient a firm would be in the event of a downturn. From these so-called ‘stress tests’, the PRA will then work with banks and other financial institutions to develop strategies that ensure the resilience of firms and thereby the safety of the entire financial system.

Working alongside the PRA is the BoE’s FPC. Though not strictly a regulatory agency, the FPC does have strong regulatory and control function properties. For example, the FPC is responsible for monitoring and taking action to remove systemic risk within the financial system. It does this by advising regulators, such as the PRA, on what actions need to be taken to reduce risk within the system. The FPC is also responsible for setting the countercyclical capital buffer (CCyB), as well as determining sectoral capital and liquidity and leverage ratios.

[130] *Ibid.*

[131] Persaud, A (2010) ‘The locus of financial regulation: home versus host’, *International Affairs* 86(3): 637-646.

New wine but old bottles?

Upon first reading, the establishment of the FCA, PRA and FPC – and by association a return of regulatory powers to the BoE, along with a host of interventionist policy instruments – would appear to suggest that financial regulation in the UK following the financial crisis has taken on a much more systemic and macroeconomic outlook. However, upon closer inspection, post-crisis approaches to financial regulation present new, as well as old, forms of systemic risk. For example, a focus by regulators on business conduct and the capital and liquidity position of firms has given rise to a rather narrow set of institutional reforms that fail to account for the wider causes of the financial crisis. Likewise, post-crisis regulatory regimes have neglected structural shifts in financial markets that have allowed institutions to 'game' regulatory rules and increase their exposure to less well-regulated markets such as the opaque shadow banking sector.[132]

Weaknesses in institutional approaches to post-crash financial regulation were highlighted by BoE economists Andy Haldane and Vasilieos Madouros, in a 2012 speech at the Federal Reserve Bank of Kansas City in the United States.[133] They suggested that a focus by policy-makers on bank capital and liquidity was an ineffective measure of wider systemic risk and a poor indicator future failure. Various commentators have likewise found that that market volatility in the decade that has followed the GFC has weakened equity values.[134] As a result, market-based valuations of an institutions' liquidity have actually decreased despite an increase in the book value of capital recoded on a firm's balance sheet. This means that, in the event of a selling-down of assets due to a credit squeeze, banks and other financial institutions could be left with huge holes in their balance sheets, ultimately undermining the ability of governments to protect the macroeconomy from risk originating in the financial sector. Moreover, credit default swaps – seen as a market measure of risk and volatility – have increased following the financial crisis, suggesting that markets are now pricing risk at premium despite an overall increase in bank capital.[135]

Following the financial crisis, there has been a neglect by state managers and policymakers to introduce far-reaching structural reform of financial markets. Instead, regulatory attempts to better manage financial markets have rested upon a rather narrow set of institutional processes concerning the capital and liquidity of institutions, as well as business conduct. While the establishment of the FCA, PRA and FPC – and the return of regulatory powers to the BoE more generally – is important, post-crisis financial regulation fails to address the systemically important nature of financial institutions as regulatory stakeholders with the ability to trigger

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[132] Brazier A (2017) '"Debt Strikes Back" or "The Return of the Regulator"?', speech delivered in Liverpool, 24 July, available at: http://www.bankofengland.co.uk/publications/Documents/speeches/2017/speech992.pdf. Brazier was at the time a senior BoE official, and member of the FPC.

[133] Haldane, A and Madouros, V (2012) 'The dog and the Frisbee', speech delivered in Kansas City, United States, 31 August, available at: https://www.bis.org/review/r120905a.pdf.

[134] See Bell, S and Hindmoor, A (2018) 'Are the major global banks now safer? Structural continuities and change in banking and finance since the 2008 crisis', *Review of International Political Economy* 25(1): 1-27; Sarin, N and Summers, L (2016) 'Understanding bank risk through market measures', *Brookings Papers on Economic Activity*, available at: https://www.brookings.edu/wp-content/uploads/2017/02/sarintextfall16bpea.pdf.

[135] Barber, A (2021) *UK Banks and the Lessons of the Great Financial Crisis*. (London. Palgrave).

and amplify stresses within the macroeconomy. As such, and despite an ambitious reform agenda set out by the BoE, financial regulation in the UK after the financial crisis poses new, as well as old, forms of systemic risk that threaten the UK's real economy.

Stress testing at the Bank of England

John Hogan Morris and Paula Bajarano Carbó[136]

When we subject anything to a 'stress test' we are placing that person, object or system under 'a severe amount of pressure' to test 'how resilient it is under extreme conditions'.[137]. When applied to the financial system, bank stress testing involves the running of a future-oriented exercise in which the impact of a hypothetical scenario, of three 'low probability-high impact' events, is measured on the balance sheets, exposures and regulatory capital[138] held across banks in a financial system. So, for example, one could model the impact of a large loss of GDP, a sharp fall in house prices and a significant rise in unemployment. The general idea is to ensure that financial institutions have enough good quality regulatory capital in relation to the types of risk the bank is taking with its investments and exposures.

The Bank of England has carried out stress tests on the regulatory capital held by the major banking groups that fall under its regulatory jurisdiction since the 2008-2009 global financial crisis. The Bank of England Stress testing programme has evolved significantly since the crisis, and should be viewed as both an internal institutional development and a reaction to wider trends in central banking and financial regulation.

In this piece, we will provide an outline of the development of the stress testing programme at the Bank of England. The first section provides an overview of how crisis governance has reshaped the status quo of the Bank of England's approach to financial stability. The second section explains how discrete approaches by different central banks reflects wider hierarchies in central banking and regulatory authority. The third section discusses how exploring wider risks to financial stability has led to accusations of central bank 'mission creep'. The fourth section discusses why the why the methodology of tests is extremely significant for the success of the exercise, using the Bank of England's 2021 climate stress test as a case study, and the final section provides some concluding remarks.

From crisis governance to routinized policy tool

The Bank of England Stress testing programme has evolved significantly since the Global Financial Crisis. There is little in the public domain[139] about the 2009/2010 tests which, anecdotally, were an improvised and rudimentary attempt to get a handle on the balance sheet exposure of banking groups within the Bank of England's jurisdiction and aid with recapitalization during the global financial crisis. As such, they were 'top down', meaning

[136] The authors would like to acknowledge the help given by Nathan Coombs, who jointly carried out three of the interviews drawn on here.

[137] Dent, K, Westwood, B and Segoviano, M (2016) 'Stress testing of banks: an introduction' *Bank of England Quarterly Bulletin:2016 Q3*, p.130, available at: https://www.bankofengland.co.uk/-/media/boe/files/quarterly-bulletin/2016/stress-testing-of-banks-an-introduction.pdf.

[138] Regulatory capital refers to the ratio of equity to risk weighted assets held by a financial institution.

[139] For example, there is very little about the crisis stress tests in the memoirs of UK regulators, such as Adair Turner or Mervyn King; where stress testing is mentioned, the focus is on the US or EU exercises. See respectively: Turner, A (2017) *Between Debt and the Devil*. Princeton: Princeton University Press; King, M (2016) *The End of Alchemy: Money, Banking, and the Future of the Global Economy*. London: WW Norton & Company.

that the Bank of England set the macroeconomic scenario and conditions under which the tests were to be run, and then calculated the results without the involvement of the banks themselves.

Following their initial mobilization in crisis governance, stress testing has become a routinized policy tool.[140] This was the result of several interconnected developments that range from the global to local scale. Since the global financial crisis, at the level of the expert communities in financial regulation and central banks – such as the Basel Committee on Banking Supervision – there has been a wider macroprudential shift in financial regulation that focuses on the resilience of the wider system against future shocks, rather than just the stability of individual institutions.[141] Within this wider shift at the level of global governance, the Bank's mandate from the Chancellor of the Exchequer was extended so that its previous focus on monetary policy was broadened to include financial supervision responsibilities.[142] The Financial Policy Committee (FPC) was established in 2013 as part of the new system of regulation brought in to improve financial stability after the financial crisis. The FPC normally has thirteen members[143]. The FPC does have a direct control of number of powerful policy tools[144], but for our purposes here we focus on the way that it, alongside the Prudential Regulation Committee[145] (PRC), contributes to the design and calibration of the Bank's stress testing framework. Banking groups participating in the stress testing programme have access to bail-out facilities should there be a crisis. At the institutional level, this changing mandate has driven cultural changes in the precision and breadth with how risk is measured and mapped.[146]

In the Bank of England's stress testing exercises from 2013 onwards, the Bank decided upon a scenario of macroeconomic shocks, and financial institutions themselves were required to project the impact of the shocks on their balance sheets and regulatory capital: thereby diverging from the original 'top down' model. During these stress tests, the central bank makes a request for unstructured data relating to audits, balance sheets and governance arrangements from approved methodologies and results, reports produced by internal audit or other review functions and 'methods related to the extrapolation of risk factor shocks.' Further, the Bank requires 'an assessment of the key sensitivities of the results and details of how the stress scenarios have been translated into impacts on the income statement and

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[140] Langley, P (2015) *Liquidity Lost: The Governance of the Global Financial Crisis*. Oxford: Oxford University Press.

[141] See: Baker, A (2013) 'The gradual transformation? The incremental dynamics of macroprudential regulation', *Regulation & Governance* 7(4):.417-434; Westermeier, C (2018) 'The Bank of International Settlements as a think tank for financial policy-making', *Policy and Society* 37(2):.170-187.

[142] Research Interview 1: former Bank of England employee, 7 November 2019.

[143] Six of these members are Bank of England staff: the Governor, four Deputy Governors and the Executive Director for Financial Stability Strategy and Risk. There are also five external members who are selected from outside the Bank for their experience and expertise in financial services. The committee also includes the Chief Executive of the Financial Conduct Authority and one non-voting member from HM Treasury.

[144] Some of these new regulatory powers and tools included the ability to set the countercyclical capital buffer (CCyB) rate for the UK, the power to set various capital requirements for financial firms in the UK and the ability to place limits on mortgage lending.

[145] The PRC was known as the 'Prudential Regulation Agency Board' from 2013 to 2017.

[146] Morris, JH (2018) *Securing Finance, Mobilizing Risk: Money Cultures at the Bank of England*. London: Routledge.

balance sheet'.[147] The Bank of England uses this information to assess the rigour of the financial institutions' tests and results, while also running its own stress test on the data.

Since 2014, the results of the tests have been made public. In line with the new mandated responsibilities for systemic resilience, three of the eight banks tested were later asked to strengthen their capital positions further.[148] In the Bank of England's 2015 and 2016 stress tests, 7 major UK banks took part. Together these institutions account for around 80% of the lending to the UK real economy.[149] The 2015 stress test revealed no capital inadequacies for five of the participating banks. One bank did not meet its individual capital guidance after management actions in this scenario, while a second bank did not meet its minimum capital requirement of 6% after management actions in this scenario. This second bank avoided having to submit a revised capital plan due to associated steps taken to strengthen its capital position.[150] The 2016 test results were, overall, encouraging for the Bank of England, because although they revealed that three banks had some capital issues, these banks responded by implementing plans to build further resilience. From 2017 to 2020, no bank has failed the Bank of England's annual stress testing exercise, despite the 2017 and subsequent tests featuring a more severe scenario than the global financial crisis itself.[151] Following the Covid-19 outbreak in 2020, the Bank cancelled its usual stress test and instead ran a desktop 'reverse stress test' exercise, which allowed them to see what sort of shocks and economic problems would decrease regulatory capital buffers by 5%. The Bank was satisfied with resilience they perceived at this time.[152]

Methodological approach and hierarchies of central banks

The development of the Bank of England's approach can also be seen to reflect wider hierarchies of central bank and regulatory authority. The involvement of the regulated institutions in the stress testing exercise does move the programme beyond a mere attempt to explore questions of balance sheet exposure and capitalization whilst managing market concerns around the solvency of institutions.[153] Notably, this approach often improves regulators' understanding of the way firms are modelling risks, and also helps to improve internal communication and data sharing around risk within the participating banking

[147] Bank of England (2017) 'Stress testing the UK banking system: 2017 guidance for Participating Banks and Building Societies', available at: https://www.bankofengland.co.uk/-/media/boe/files/stress-testing/2017/stress-testing-the-uk-banking-system-2017-guidance-for-participating-banks-and-building-societies.pdf.
[148] Bank of England (2014) *Stress Testing the UK Banking System: 2014 Results*, available at: https://www.bankofengland.co.uk/-/media/boe/files/stress-testing/2014/stress-testing-the-uk-banking-system-2014-results.pdf.
[149] Dent *et al.* (2016) 'Stress testing of banks…'. p.138.
[150] Bank of England (2015) 'The Bank of England's approach to stress testing the UK banking system', available at: https://www.bankofengland.co.uk/-/media/boe/files/stress-testing/2015/the-boes-approach-to-stress-testing-the-uk-banking-system.
[151] Bank of England (2017b) 'Stress testing the UK banking system: 2017 results', p.6, available at: https://www.bankofengland.co.uk/-/media/boe/files/stress-testing/2017/stress-testing-the-uk-banking-system-2017-results.pdf%20Accessed%2015th%20November%202021.
[152] Bank of England (2021) 'Stress testing the UK banking system: key elements of the 2021 stress test,' available at: https://www.bankofengland.co.uk/stress-testing/2021/key-elements-of-the-2021-stress-test.
[153] See Violle, A (2017) 'Banking supervision and the politics of verification: the 2014 stress test in the European Banking Union', *Economy and Society* 46(3-4): 432-451.

groups.[154] However, this form of stress testing also reflects how there are wider hierarchies of central bank and regulatory authority.

What do we mean by 'hierarchies of central banking'? Perhaps the most well-known example of this is the way that the US dollar's key role in the global financial system places the US Federal Reserve as the global system's 'hierarchically highest central bank'.[155] Banks all over the world seek to accumulate dollars because much of global trade, international loans, debts, and bank transactions are predominantly carried out using dollars. During times of crisis the Federal Reserve will allow a number of other central banks to use swap lines to borrow unlimited quantities of dollars in exchange for credits in their own currencies. This allows these other central banks to provide 'emergency' dollar supplies to non-American banks during times of financial strain.[156]

A less well-known central banking hierarchy is demonstrated within stress testing. Indeed, the difference in stress testing programmes among central banks reveals a very different way in which not all central banks are created equally. Stress testing involves a combination of computational skill and technology, analytical judgement, data about banking groups, the communication of scenarios and results, and the infrastructure to deliver these processes. It is therefore underpinned by three key processes: data collection, the organisation of data, and the analysis of this data.[157] These processes can be extremely costly the more global, complex and systemically important the banking group being tested is.[158] These geographical obstacles are a key factor in the Bank of England drawing on the financial strength of the regulated institutions by effectively outsourcing the data collection, organization and analysis to the banks being tested.[159] In comparison, the Federal Reserve is able to carry out its own analysis of data because of its greater financial resources.[160]

Exploratory scenarios and 'mission creep'

From 2016 onwards, the Bank of England stress testing approach involves two different and complimentary tests. The Annual Cyclical Scenario (ACS) requires banks to model a series of shocks that are linked to the current financial cycle and reflect the Financial Policy Committee's current assessment of risks in an economy. The ACS informs how the FPC adjusts the previously mentioned countercyclical capital buffer, which is an additional cushion of capital banks are required to have as a shock absorber against potential losses. Consequently, they do have a considerable level of predictability.[161]

[154] Coombs, N and Morris, JH (2017) 'Narrating imagined crises: stress tests, post-crisis regulation, and cultural reform in banking', available at: https://osf.io/preprints/socarxiv/jzt4m/download.
[155] Murau, S, Pape, F and Pforr, T (2021) *The Hierarchy of the Offshore US-Dollar System. On Swap Lines, the FIMA Repo Facility and Special Drawing Rights*, p.2 available at: http://dx.doi.org/10.2139/ssrn.3780794.
[156] Tooze, A (2018) *Crashed: How a Decade of Financial Crises Changed the World*. London: Penguin.
[157] Research Interview 2: private banking group stress testers, 23 August 2016.
[158] Research Interview 3: UK Treasury Official, 14 December 2016.
[159] Research Interview 5. European regulator, 16 October 2016.
[160] Research Interview 4. Bank of England employees, 23 August 2016.
[161] Coombs, N (2020) 'What do stress tests test? Experimentation, demonstration, and the sociotechnical performance of regulatory science', *The British Journal of Sociology*, 71(3): 520-536.

The Biennial Exploratory Scenario (BES) is detached from current thinking about the financial cycle and the setting of the countercyclical capital buffer. It is, instead, an exploratory style test designed to investigate what Paul Langley has called 'fictional futures', namely hypothetical financial stability threats that do not have empirical historical precedent.[162] The first BES exercise was delayed by Brexit and eventually occurred in 2017 with a focus on FinTech. The second BES test in 2019 explored the impact of a severe and broad-based tightening of liquidity. In March 2020, the Bank paused this exercise to ease the burden on staff at participating banks during the Coronavirus pandemic. The Bank decided that the already submitted work during the BES, alongside the experience of real-life shock caused by the pandemic, had provided enough information and so did not restart the exercise.

One significant feature that these exploratory tests exhibit is that they can widen the 'risk imagination' of the Bank, towards more politically controversial issues or developments that are thought to be the responsibility of either democratically elected government or private economic institutions such as credit rating agencies. Crucially, it is through showing that something initially considered to be 'political', or outside of the Bank's mandate, is a threat to financial stability that the Bank can justify its tacit inclusion within the financial stability mandate.[163] For example, the (then) Bank Governor Mark Carney's 2015 speech at insurance broker Lloyds of London outlined how unprecedented catastrophe insurance losses and significant revaluation of fossil fuel linked assets might lead to destabilizing losses.[164]

The third BES aims to provide a better understanding of the financial exposures of banks and insurers to climate-related risks to financial stability. In such a way, the 2021 Climate BES has seen the Bank of England been considered a more activist central bank and has prompted accusations of 'mission creep' from their quite narrow mandates set by governments.[165] For instance, some central bankers, such as of the head of the German Bundesbank Jens Weidmann, have suggested that central bank mandates should prohibit them from becoming proactive advocates of climate action.

The link between methodological assumptions and 'successful' exercises

The 2021 climate exploratory scenario brings to light a final key point, namely the importance of stress testing methodology for the success of the policy. This exploratory test employs three distinct scenarios, each capturing differing degrees of action by financial institutions and insurers over a thirty year period to ensure to ensure a smooth climate transition. Although exploratory, the design seems to be 'hard wired' to show how earlier action will help to avoid disruptive losses should assets, such as carbon-related investments, suddenly devalue hugely.[166]

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[162] Langley (2015) *Liquidity Lost…* p.3; see also Morris (2018) *Securing Finance…*
[163] Morris (2018) *Securing Finance…* p.138-141.
[164] Carney, M (2015) 'Breaking the tragedy of the horizon: climate change and financial stability.' Speech delivered London, 29 September, available at: https://www.bankofengland.co.uk/-/media/boe/files/speech/2015/breaking-the-tragedy-of-the-horizon-climate-change-and-financial-stability.pdf?la=en&hash=7C67E785651862457D99511147C7424FF5EA0C1A.
[165] Langley, P and Morris, JH (2021) 'Central banks: climate governors of last resort?', *Environment and Planning A: Economy and Space*, 52(8): 1471-1479.
[166] *Ibid*.

Existing research that focuses on stress testing regimes across Europe, the US and the UK since the global financial crisis highlights that the wider success of stress testing programmes often relies on how participants, the specialist financial media and wider financial system will respond to the test.[167] As the critical evidential instrument in the Bank's pioneering climate project, the BES methodology must be reliable. However, researchers have already pointed out that some of the more granular methodological assumptions in the 2021 climate test – about whether firms being tested should assume that they would take risk management actions during the scenario – are on the cusp of falling out of line with the stress testing approach taken by the Bank of England in the past, other central banks carrying out climate stress tests,[168] and the catastrophe risk re-insurance industry's own methodologies when dealing with low probability/high impact climate risks.[169] We might well ask whether such interventions will have the desired effect if there are concerns about the plausibility of the tests.

Concluding remarks

The regulatory 'failures' that enabled the global financial crisis catalysed important changes in the way central banks think about financial stability supervision.[170] At the Bank of England, the global shift towards macroprudential financial regulation that included stress testing as a primary tool was not only adopted for the purpose of crisis management, but has since been routinized as an important pillar within the Bank's extended mandate. Alongside accusations of mission creep and academic scrutiny, this changed mandate and the stress testing tool have now also become leading elements of the UK's net-zero campaign, which itself is a product of global shifts in the way we think about climate action. Stress testing is now a central component of the Bank's commitment to – and desire to be a leading figure of – the emerging consensus that central banks have a role to play in the transition to low carbon economies. Thus, stress testing at the Bank of England can be thought of as a pertinent example of the potential for central banks and their mandates to be flexible and reactive, contrary to orthodox inflation-targeting regime boundaries.

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[167] Coombs (2020) 'What do stress tests test…'; Langley (2015) *Liquidity Lost…*

[168] Here we should note that two-thirds of central banks that are undertaking climate stress tests have adopted the same approach to test design that we raise this reservation about; see Network for Greening the Financial System (2021) 'Scenarios in action: A progress report on global supervisory and central bank climate scenario exercises', available at: https://www.ngfs.net/sites/default/files/medias/documents/scenarios-in-action-a-progress-report-on-global-supervisory-and-central-bank-climate-scenario-exercises.pdf.

[169] Chenet, H, Ryan-Collins, J. and van Lerven, F (2021) 'Finance, climate-change and radical uncertainty: towards a precautionary approach to financial policy' *Ecological Economics* 183, article 106957; Banque de France (2020) 'Scenarios and main assumptions of the ACPR pilot climate exercise', available at: https://acpr.banque-france.fr/sites/default/files/medias/documents/20200717_main_assumptions_and_scenarios_of_the_acpr_climate_pilot_exercise.pdf; Jarzabkowski, P, Bednarek, R. and Spee, P (2015) *Making a Market for Acts of God: The Practice of Risk-Trading in the Global Reinsurance Industry*. New York: Oxford University Press.

[170] Best, J (2016) 'When crises are failures: contested metrics in international finance and development', *International Political Sociology* 10: 39.55.

The Bank of England's evolution and the looming threat of climate change

Daniel Bailey

The scientific evidence is clear that climate change is one of the most profound crises facing the UK and the wider world,[171] and numerous industries in the global economy are deeply complicit in generating greenhouse gas emissions and deforestation.[172] Political action on the climate crisis is increasingly urgent, but the ways in which the UK state's diverse range of institutions – each with their own objectives, remits and traditions forged over several generations – should evolve and respond in response to the environmental crisis is subject to fierce contestation. Within the Bank of England – one of the most powerful state institutions of economic governance – a debate rages about its appropriate role of central banks in addressing the crisis.

Since the 1970s, the Bank's focus has been narrowly concentrated on keeping inflation in check through setting national interest rates, regardless of its immediate effects on the economy or unemployment.[173] This scope was a direct result of 'stagflation' and the monetarist interpretation of those events, which re-fashioned an institution which had previously embraced a more holistic approach to economic performance and more overtly political actions.[174] This narrow focus on inflation was formalised by New Labour after their election win in 1997, when Gordon Brown awarded the Bank 'operational independence' and the Bank of England Act 1998 stated explicitly that the Bank of England's monetary policy objectives were to be '(a) to maintain price stability, and (b) subject to that, to support the economic policy of Her Majesty's Government'.[175] This technocratic approach to economic governance was embraced on Threadneedle Street, where the Bank resides, and became seen as essential to retaining the operational independence and depoliticised status of the central bank.

Since the global financial crash of 2008, however, the objectives and practices of the Bank of England have significantly evolved. In addition to the innovation of quantitative easing, the Bank's responsibilities were broadened to incorporate a focus on the stability of the financial system, in addition to its role of ensuring price stability. As a direct result of the failure to prevent the 2008 financial crash, new responsibilities were enshrined in the 2009 Banking Act and the Financial Services Act 2012. This has led to the creation of the Financial Policy Committee tasked with conducting 'macroprudential policy', which entails assessing and

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[171] Intergovernmental Panel on Climate Change (2018) 'Global warming of 1.5 ºC: special report by the IPCC, available at https://www.ipcc.ch/sr15/.
[172] Newell, P (2013) *Globalization and the Environment: Capitalism, Ecology and Power*. London: John Wiley & Sons.
[173] Ingham, G (2004) *The Nature of Money*. London: John Wiley & Sons.
[174] Bezemer, D, Ryan-Collins, J, van Lerven, F and Zhang, L (2018) 'Credit where it's due', UCL Institute for Innovation and Public Purpose Working Paper 2018-11, available at: https://www.ucl.ac.uk/bartlett/public-purpose/publications/2018/nov/credit-where-its-due.
[175] See https://www.bankofengland.co.uk/-/media/boe/files/about/legislation/boe-charter.pdf?la=en&hash=3321FC2EE6ED47FCA9617B4F476B3032629EA6C7.

monitoring systemic financial risks and ensuring the resilience of major commercial banks in the face of systemically de-stabilising volatility.[176]

The risks to financial stability pertaining to climate change could plausibly have seen environmental factors become ingrained in the Bank's governance as a result of macroprudential remit. Although the risks to financial stability posed by investment banks was seen as a more imminent threat at the time, there was a growing recognition that climate change presented both *physical* and *transition* risks.

The *physical* risks of climate-related include the impacts of extreme weather events (e.g. droughts, floods, and storms) as well as longer-term gradual changes in the climate (e.g. sea level rises), which could foreseeably disrupt business operations and cause direct damage to property and infrastructure. The *transition* risks are threats to financial stability brought about by technological innovations, changing consumer preferences or political action intended to aid decarbonisation. According to the World Economic Forum, these risks represent the biggest threat to global economy.[177] These risks are not only substantive threats to the stability of the financial system, but are being amplified by the tendency of the financial markets to invest in unsustainable forms of economic activity.

There were certainly signs that some senior Bank of England officials were re-thinking the Bank's objectives and scope. In February 2015, then-Governor Mark Carney gave a speech announcing the broadening of the Bank's research and policy goals, in which he declared that the old approach of focusing research almost exclusively on efforts to promote low and stable inflation 'had not promoted the good of the country'. As a result of this, he claimed the Bank were looking 'to transform research in the bank to the same extent that the responsibility of the bank was transformed'.[178] Another senior Bank official, Andrew Haldane, criticised the conventional and 'blinkered' economic models which proved so disastrously inaccurate in 2007/08, and argued for a more 'crowdsourced, open-access' approach to economic research and governance. He acknowledged that a narrow focus on inflation alone may be counter-productive in achieving the Bank's primary target, and that a broadened interdisciplinary approach may be suitable response to their failings.[179]

Meanwhile, the Bank of England became one of the founding members of the 'Network for Greening the Financial System'.[180] Under the leadership of Mark Carney, this network of nine central banks and financial regulators aimed to 'integrate the monitoring of climate-related

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[176] See https://www.bankofengland.co.uk/news/2021/march/mpc-remit-statement-and-letter-and-fpc-remit-letter.
[177] United Nations Framework Convention on Climate Change (2016) 'Climate change is biggest threat to global economy', available at: https://unfccc.int/news/climate-change-is-biggest-threat-to-global-economy.
[178] Cited in *Financial Times* (2015) 'Bank of England governor Mark Carney expands research agenda', 25 February, available at: https://www.ft.com/content/ca6768b4-bcea-11e4-a917-00144feab7de.
[179] Cited in New Scientist (2015) 'Bank of England guru: We're crowdsourcing economics', 25 March, available at: https://www.newscientist.com/article/mg22530140-400-bank-of-england-guru-were-crowdsourcing-economics/.
[180] NGFS (2019) 'Network for Greening the Financial System: first comprehensive report – a call for action on climate change as a source of financial risk', available at: https://www.ngfs.net/sites/default/files/medias/documents/ngfs_first_comprehensive_report_-_17042019_0.pdf.

financial risks into day-to-day supervisory work, financial stability monitoring and board risk management', as well as "integrate sustainability into their own portfolio management'.[181]

Yet a more conservative interpretation of macroprudential remit has taken hold within the Bank. The policy implications so far have concentrated on 'stress testing' commercial banks to ensure their resilience in the event of further financial instability.

On climate risks, the bank has collaborated with other central banks to develop clearer ideas of what 'green' or 'unsustainable' investments actually are in order to gently 'nudge' the financial sector toward sustainability. They have also petitioned large financial organisations to disclose their exposure to climate risks so that they can expose them to 'climate stress testing'. These market-friendly forms of governance seek to engender 'perfect information' in ways are conducive to the 'pricing in' of climate risks in financial markets.[182] The Governor of the Bank, Andrew Bailey, has also discussed the possibility of more direct action in January 2020 – the exclusion of fossil fuel assets from the Bank's future asset purchases – although this has not yet been actioned.

The changes to the Bank's governance have thus been, at best, incremental and tentative so far. Certainly, the response has not been commensurate to the necessary speed of decarbonisation. The attempts to 'nudge' financial markets to sustainability have been limited in their effectiveness, and the Bank's response to the Covid-19 pandemic largely reflected the financial market's own neglect of climate risks; undermining the Governor's own call to 'Build Back Better' (Bailey *et al*. 2020).

The possibility remains, however, that macroprudential responsibilities could transform the Bank's governance. The physical and transition risks of climate change de-stabilising the financial sector have rapidly becoming less abstract and distant prospects. Simultaneously, there is increasing confidence in the measurements of the physical and transition risks relating to climate change.

An additional intriguing development of the Bank's institutional scope, which may act as a catalyst for a more radical 'greening' of economic governance, was announced in March 2021. The Treasury bestowed a new mandate upon the Bank to 'support the transition to Net Zero'.[183] This new responsibility is as ambiguous and open to interpretation as the macroprudential remit, and the Bank's Executive Director, Mark Hauser, swiftly dampened expectations of change by asserting that private capital must lead the sustainability transition, and that the role of the central bank must be limited to modest subsidies of green bonds – only penalising financiers of unsustainable economic activity only as a last resort.[184] It would thus be unwise

[181] Bank of England (2019) 'Open letter on climate-related financial risks', available at: https://www.bankofengland.co.uk/news/2019/april/open-letter-on-climate-related-financial-risks.
[182] Tooze, A (2019) 'Why central banks need to step up on global warming', *Foreign Policy*, 20 July, available at: https://foreignpolicy.com/2019/07/20/why-central-banks-need-to-step-up-on-global-warming/.
[183] Bank of England (2021) 'MPC Remit Statement', available at: https://www.bankofengland.co.uk/news/2021/march/mpc-remit-statement-and-letter-and-fpc-remit-letter.
[184] Hauser, M (2021) Bank of England (2021c), 'It's not easy being green', available at: https://www.bankofengland.co.uk/-/media/boe/files/speech/2021/may/its-not-easy-being-green-but-that-shouldnt-stop-us-speech-by-andrew-hauser.pdf?la=en&hash=6859472C053CB4130189220C3141648C0AADF5C2.

to be optimistic about a rapid green transformation of the Bank, and it is certainly unlikely to happen at the speed necessary to address climate change. But the Bank's continued evolution, and the increasing threat of climate change, has only heightened debates about what these institutional changes mean for the Bank's role in economic governance and the formulation of its future policies.

The UK state has been slow to respond, and each state institutions can of course claim that it is beyond the scope of their mandates to act – the Bank of England has been no different. It has thus far eschewed any leadership role on tackling the climate crisis, and has justified this stance through pointing to its limited institutional scope and technocratic status. The Bank of England as an institution, however, is rapidly evolving. The new responsibilities of ensuring financial stability and facilitating a 'Net Zero' transition have spawned differing interpretations of the Bank's role, and conflicting perspectives on the policy implications. Meanwhile, the impacts of climate change will only become more visible and catastrophic. The politics of the Bank will shape the forms and extent of its green transformation.

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