



## Policy provocation paper: Second Round Fiscal Effects

### Context

Carnegie UK's Financing the Future programme has examined how governments can use public finance and fiscal processes to improve collective wellbeing. We brought together experts to discuss key challenges and successes across the UK and collaborated with researchers to understand citizens' views on taxation and international practices for wellbeing budgeting. From this work, we identified important principles and practical approaches that governments across the UK can adopt to strengthen their strategies. However, we recognise that embedding wellbeing in budget processes requires more than one-off changes: it requires multiple, coordinated reforms alongside a culture change in collaborative working to improve governance and decision making in this essential area of public policy.

This paper on second round fiscal effects is one of three connected policy provocations (with the others looking at borrowing powers and wellbeing cost benefit analysis respectively) that set out Carnegie UK's current thinking in an important area of UK fiscal policy. Taken together, these three policy papers aim to prompt debate on improving how wellbeing is embedded in public finances.

This work is intentionally presented as a policy provocation. It does not represent a final or definitive Carnegie UK policy position on this issue. However, we believe there are issues worth articulating and exploring in this policy area. We welcome critique and feedback of the arguments put forward in this provocation.

### Introduction

One of the key policy recommendations arising from our Financing the Future Programme is a call for governments across the UK to better monitor and account for second round fiscal effects in official budgets and projections. These calculations should then be used to weight and inform policy decisions. This process should include the capturing, offsetting and reinvestment of savings in support of preventative policy interventions.

The primary policy rationale for this is that the UK's public finance system needs reform to better support policy making focussed on improving people's lives. Second round fiscal effects - the long-term savings or costs that result when policies increase or reduce demand for public services - are a critical but underutilised tool in fiscal planning processes.

This paper sets out further policy thinking and rationale on Carnegie UK's position on this issue as well as some of the considerations and implications associated with this recommendation against the following headings:

- Executive Summary
- Section 1: Defining second round fiscal effects

- Section 2: International examples of monitoring second round effects
- Section 3: Current UK approach to modelling second round effects
- Section 4: How devolved governments monitor second round effects

This paper is focussed on the policy principles and rationale behind this recommendation through the lens of improving collective wellbeing, rather than the operational specifics of how such a model should be designed and adopted.

## Executive Summary

This position paper sets out the rationale for governments across the UK better monitoring and accounting for second round fiscal effects (SRFEs) in official budgets and projections.

Second round fiscal effects are the longer-term savings or costs to government that result when policies increase or reduce demand for public services.

The current UK approach to fiscal planning and analysis is objectively robust but static<sup>1</sup>, capturing second round fiscal effects only in aggregate forecasts and not at the level of individual policy measures. This means policymakers often have a limited sense of how key policy proposals interact dynamically, including broader fiscal implications.

By seeking to improve how UK governments model and consider SRFEs, fiscal policy choices across the nations can be sharpened and every pound of government expenditure used more effectively. There is particular potential here for fiscal offsetting and shifting investment to preventative policy interventions. While this would represent a complex and challenging shift in economic modelling, there are promising international examples in this space from which UK fiscal institutions could learn.

This paper advocates for the better use and adoption of second round fiscal effect modelling in the UK to improve fiscal policy making and better support policy interventions that contribute to our collective wellbeing.

It is important to note, however, that while this policy would represent a technical change to existing budgeting and modelling, for this policy to be truly effective it must sit as part of wider process and cultural improvements aimed at creating a more coherent and collaborative fiscal landscape across the UK.

## Defining second round fiscal effects

Primary fiscal effects are the initial upfront costs of a policy decision on government budgets.

For the purposes of this policy position paper Carnegie UK defines second round fiscal effects (SRFEs) as:

- The longer-term savings or costs to government that result when policies increase or reduce demand for public services.

An illustrative example of a second round fiscal effects would include how improvements in public health can reduce demand for primary health services. This means the government can meet the same proportion of demand at a lower cost: a second round fiscal saving. Similarly, cuts to social services can increase crime levels, increasing the need for policing and justice services and thereby increasing the cost to government of meeting the same proportion of demand for these services: a second round fiscal cost.

Second round fiscal effects are distinct (although related) to the more well-established practice of monitoring and accounting for second round economic effects. Second round economic effects primarily monitor the wider general equilibrium changes to consumer and business behaviour as they relate to the economy following a policy intervention.

Focussing on fiscal effects over just economic effects is the practice of understanding and accounting for how policy changes impact government receipts and spending requirements over time, both positively and negatively.

It is not uncommon for governments to carry out analysis on the projected growth effects of public investment - sometimes simply referred to as 'second round', 'indirect' or 'dynamic' effects. These differ from second round fiscal effects as they do not focus on whether interventions will decrease demand for government services by improving wellbeing. Rather, they focus on the projected effect of interventions on economic activity. Increased economic activity is typically understood as a way of improving future budgets. However, economic effects are typically difficult to estimate reliably, involve a high level of uncertainty, and carry a risk of double counting - unlike fiscal effects, they are not well suited for factoring into offsetting of preventative policy proposals.

Better modelling and consideration of second round fiscal effects can help to sharpen fiscal policy choices at a time when understanding the impact of every pound of government expenditure matters.

## International examples of monitoring second round effects

### Netherlands

- The Netherlands uses three aligned institutional functions that contribute to modelling of fiscal effects:
- The Dutch Ministry of Finance runs policy and the Medium-Term Budgetary Framework (MTBF). The MTBF explicitly or implicitly shapes the policy horizon used in government analysis (4-year ceilings).
- CPB ([Netherlands Bureau for Economic Policy Analysis](#)) is the independent forecaster and modelling house. The CPB produces baseline projections, impact assessments and multiplier estimates, and operates several models for different horizons/purposes (short, medium, long).
- DNB (Dutch central bank) undertakes complementary analysis on fiscal AND economic policy. Together CPB and DNB publish research on how multipliers evolve over time and across states of the Dutch economy.

### Sweden

- Sweden uses several government-linked macro frameworks and academic models to analyse policy including dynamic, general-equilibrium style effects. These are primarily provided by either the Swedish Ministry of Finance or their [National Institute for Economic Research \(NIER\)](#).
- Sweden's fiscal modelling culture is sophisticated<sup>ii</sup> and feeds into Ministry advice and budgeting. Second round, equilibrium-type reasoning is accepted in technical appraisal, especially for structural/supply policies.

### Canada

- The Canadian [Office of the Parliamentary Budget Officer](#) (PBO) builds fiscal models that include capital-spending modules and has expanded work to estimate how federal investment and demographic/housing changes feed through the economy and the fiscal position. The PBO publishes scenario work that captures some feedbacks between spending, GDP and receipts.
- It is used in fiscal costing, long-run projections and thematic reports (e.g. capital spending, housing).
- The PBO supplies parliamentarians with analyses that sometimes include dynamic/feedback scenarios rather than only static mechanical costings.

### United States

- The [Congressional Budget Office](#) (CBO) performs dynamic analysis that assesses how fiscal policy changes affect the macroeconomy and the federal budget, explicitly modelling macroeconomic feedbacks and longer-run output effects when requested (dynamic scoring / macro feedbacks).
- CBO dynamic analyses are used episodically (e.g. for major tax bills or large spending proposals, dynamic scoring or scenario analyses estimate how GDP responses change revenue or outlay paths).
- Dynamic scoring can be invoked by proponents to argue for self-financing claims and often can become politically contested. Congress often requests both static and dynamic estimates for transparency.

## Australia

- Most substantial fiscal modelling takes place at a federal level via the [Parliamentary Budget Office](#).
- State governments in Australia (notably Victoria) have published scenario-based modelling of fiscal impacts that capture second round revenue implications and demand/supply feedbacks.
- Where fiscal modelling is robust it can be used to shape business cases and fiscal planning, but political/judgemental disputes over how large second round benefits should be assumed still occur.

## Summary

The use of second round fiscal effect in budget modelling and policy making is a growing field of fiscal policy and practice. However, its effective adoption is as much about political culture and buy-in, as it is about having the right technical process in place. Even where robust models exist, policymakers differ on how far to let general-equilibrium assumptions affect official fiscal costings.

## Current UK approach to modelling second round effects

The UK Treasury and the Office for Budget Responsibility (OBR) currently adopt a robust but generally more static approach to modelling policy costings. At present, second round fiscal effects are primarily captured in aggregate forecasts, not at the level of individual policy measures.<sup>iii</sup>

Operationally, the current UK approach to costing and modelling fiscal effects falls into two broad areas of activity:

- **HMT costings:** At the point of budget measures being announced, HM Treasury scores policies on a static, first-round basis. This means that only the direct impact on taxes or spending are captured, with no allowance for behavioural or macroeconomic feedbacks (with some exceptions in specific areas like fuel duties or alcohol). The Treasury retains a high degree of discretion in policy scoring.
- **OBR forecasts:** The OBR produces independent five-year macro-fiscal forecasts. While second round economic effects are incorporated at the aggregate level (e.g. policy-induced GDP changes flow through to overall revenue and expenditure projections), these feedbacks are not attributed back to individual policy measures, due to a principle of caution and credibility in economic modelling.

The UK model prioritises caution and avoids potential over-estimation of self-financing measures. However, it comes at the cost of greater transparency on policy interactions and limits the ability to understand dynamic interactions of policy options.

### Overview

The current UK system prioritises caution and simplicity but risks under or over-estimating the true fiscal cost of policies, since second round fiscal effects are often hidden in aggregate forecasts rather than directly attributed to specific policies or interventions.

## How devolved UK governments monitor second round effects

Scotland (Scottish Government & Scottish Fiscal Commission – SFC)

- The SFC produces independent forecasts for devolved taxes (income tax, LBTT, landfill tax) and devolved social security spending.
- Forecasts do include behavioural responses to policy (e.g. income tax differentials and migration/behavioural change).
- Modelling of second round fiscal effects (how those behavioural or economic changes feed back into revenues/expenditures more broadly) is not systematically done. The SFC itself has flagged data and modelling constraints.
- The Scottish Government has occasionally argued for dynamic effects (e.g. from investment), but official forecasts remain static/mechanical.

Wales (Welsh Government & Welsh Fiscal Analysis / OBR)

- The Welsh Government relies heavily on OBR forecasts for UK-wide drivers, and supplements with its own Welsh Tax Forecasts and analysis by the Wales Fiscal Analysis unit in Cardiff University.
- Like Scotland, first-round effects dominate; behavioural adjustments (e.g. land transaction tax changes) are sometimes considered.
- Broader dynamic fiscal feedbacks are not formally modelled.
- The Treasury's block grant adjustment and OBR's macro forecasts dominate.

Northern Ireland (Department of Finance & NIFRS)

- NI has the narrowest devolved tax powers (some local rates, minor taxes).
- Northern Ireland Fiscal Council. The Department of Finance produces costings, but they are mainly static and administrative.
- No serious incorporation of second round fiscal effects.
- Focus is on expenditure control, block grant allocation, and managing volatility.
- Forecasting is dependent on UK-level macro and OBR estimates.

## Summary

All three devolved governments have only limited resource and capabilities to usefully monitor second round fiscal effects. They still largely follow HM Treasury rules and OBR models. Scotland is the most advanced devolved nation in this regard within the UK (via the SFC) but still mostly adheres to OBR-style static methods. No devolved government currently undertakes systematic second round fiscal effect modelling in the way that international examples such as the CPB in the Netherlands does.

## References

<sup>i</sup> OBR Briefing paper on policy costings and forecasts:

[https://obr.uk/docs/dlm\\_uploads/27814-BriefingPaperNo\\_6.pdf](https://obr.uk/docs/dlm_uploads/27814-BriefingPaperNo_6.pdf)

<sup>ii</sup> The Swedish Fiscal Framework – The Most Successful One in the EU? - Andersson, F. N. G., & Jonung, L. (2019)

<https://www.econstor.eu/bitstream/10419/260276/1/wp2019-006.pdf>

<sup>iii</sup> Dynamic Scoring of Policy Measures in OBR forecasts:

<https://articles.obr.uk/dynamic-scoring-of-policy-measures-in-obr-forecasts/index.html>