



Treasury Committee

Oral evidence: Autumn Statement, HC 870

Wednesday 10 December 2014

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Watch the meeting

Members present: Mr Andrew Tyrie (Chair); Rushanara Ali, Steve Baker, Mark Garnier, Stewart Hosie, Mike Kane, Mr Andrew Love, John Mann, Jesse Norman, Teresa Pearce, Mr David Ruffley, Alok Sharma, John Thurso

Questions 118 - 249

Examination of Witnesses

Witnesses: **Robert Chote**, Chairman, Office for Budget Responsibility, **Stephen Nickell CBE**, Member, Budget Responsibility Committee, Office for Budget Responsibility, and **Graham Parker**, Member, Budget Responsibility Committee, Office for Budget Responsibility, gave evidence

Q118 Chair: Thank you very much for coming to give evidence to us this morning and thank you for your hard work in the course of the last few months since we last saw you. You have been scribbling away and produced another fat document for us. Before we get into the detail of that, what assurance can you give the Committee that you have been able to get on with your job wholly independently?

Robert Chote: Full assurance. We have had no problems.

Q119 Chair: Whenever you have asked for anything, you have had it immediately from the Treasury, no jiggery-pokery by Treasury officials?

Robert Chote: No.

Q120 Chair: Right. You give us the assurance that, if you were to identify this, you will tell us?

Robert Chote: Absolutely.

Chair: If necessary privately, but also publicly if that is appropriate.

Robert Chote: Yes.

Q121 Chair: Your fiscal and economic forecasts are not quite consistent, are they? This is because of this NHS decision. Can you just explain that to people watching this hearing and then give us your view on it?

Robert Chote: Yes. Basically, we were notified of the additional money that was being allocated to the NHS from the reserve and the consequences for the Government's medium-term spending assumption over the subsequent years, from 2015-2016, after the date at which we had agreed with the Treasury to close down the economic forecast in order to provide a stable basis for the Chancellor to take decisions on. That is never ideal when it happens, and I always want to make sure that we are transparent about those things when that sort of thing happens. It would not, I think, quantitatively have made an enormous amount of difference. If we had run it back through the economic forecast it would have changed the composition of GDP on the expenditure measure somewhat, which would have had some feedback through to the fiscal position, but I think we would have been talking of 0.1% here or there, so it is not something—

Q122 Chair: Have you done that run?

Robert Chote: No, because that would then take another full exercise and you would need to run that back through all the fiscal forecasts.

Q123 Chair: What exactly are you signalling to us, that you are mildly annoyed, that you do not really mind if you get one in a few months' time in the Budget? What are you signalling?

Robert Chote: In an ideal world we would receive—

Chair: We do not live in the ideal world.

Robert Chote: No, we do not. In an ideal world, we would receive the information in time to produce a consistent set of forecasts. On the other hand, if there are political reasons to take late decisions, then it is for the Government to decide whether that is a price worth paying.

Chair: Right, and for us, among others, to ask them about it?

Robert Chote: Yes.

Q124 Chair: There is a third type of—if you do not mind my calling it—housekeeping or administrative issue to raise, which is that I think your own appointment comes up for reconsideration at the end of September.

Robert Chote: That is right, September/October.

Chair: What decisions about the process for this have been put in place?

Robert Chote: My understanding from the Treasury is that their desire is to have the decision taken on that after the election, so that it is something that the next Government could take a view on. That will obviously be rather later in the term than has been the case for my esteemed colleagues, but I think it is the proximity of the election that has led them to think that that would be a sensible thing to do.

Q125 Chair: Do you see a case for some continuity, for some kind of temporary extension to enable this to go a bit beyond the expiry date on behalf of your organisation?

Robert Chote: For reasons of pure self-interest, obviously not knowing until—

Chair: I did use the phrase “on behalf of your organisation”, but if there is a material difference between those two tell us what they are.

Robert Chote: Clearly, as I say, from a purely personal point of view—whether that is good or bad for the organisation is for others to say—I guess it would be not knowing until June or July, depending on when we have a Government and it has got through the more important bits of the to-do list, whether I am still going to have a job in September/October is perhaps leaving it a little later than I would ideally like. If the Chancellor and the other parties would like me to do so, my personal preference is that I would be very happy to carry on to provide some continuity through into some part of the next Parliament. But obviously it is not for me to say what the constitutionally correct thing to do in that circumstance is.

Q126 Chair: Can I move on to talking about the forecasts for tax, particularly income tax? Is the downturn relative to what you would have expected in revenues temporary or permanent? Is it structural or cyclical?

Robert Chote: There is a combination of components there. What is particularly striking, comparing this forecast to the last one, is the fact that the tax to GDP ratio, the average tax rate, the amount of tax we get per pound of economic activity, has fallen quite sharply from last year to this year on our forecast by about 0.5% of GDP. That was not what we had anticipated back at the time of the Budget. There are a couple of reasons for that, the first of which is that even though real GDP growth and, more importantly, nominal GDP growth has been more rapid during the first three quarters of this year than we anticipated back in the Budget, the bits that have outperformed have not been the bits that generate you a lot of tax revenue. It has not been in consumer spending; it has not been in labour income. So there is a compositional element there.

The second thing that has happened is that even though, for example, labour income, the pool of money you are getting income tax receipts from, has been rising less quickly than GDP, we are also getting less revenue per pound of that than we would have anticipated. That partly reflects the fact that the increase in labour income has come more from a rise in employment than it has come from a rise in earnings and the composition of employment has been less revenue rich. More of the employment growth has been in relatively low-paid work at the bottom of the income distribution. In the assumptions we are making, that surprise on the distribution of income and the implications that has had in knocking down the average rate of income tax is something that we are assuming persists through the forecast. So, in a sense, that is a structural deterioration. The fact that we have also taken—

Chair: It is a structural deterioration only in the sense that tax policy has changed and that we now have—sorry to interrupt—less tax coming in from people at the bottom end of the income-earning scale.

Robert Chote: Yes, that is right. The mix of labour income is more slanted to people who pay less income tax than we would have anticipated. Partly you would have expected to be getting less from the bottom because the personal allowance has been increased, but also there is an additional—

Q127 Chair: So you now have to think about whether you want to make an assumption about whether these people will move up the income scale in due course?

Robert Chote: Whether it reskews to the top more revenue-rich element. We do not do a projection of the distribution of income so we have to make some relatively rough and ready judgments on that.

In terms of the fall in the tax to GDP ratio this year, another element, for example, would be the fact that we have had another disappointing year for North Sea receipts and partly—you want to come on to income tax?

Chair: We might come on to that.

Robert Chote: Looking forward, you expect to see the fall in the tax to GDP ratio that we have seen this year reversing itself mostly over the next couple of years. Looking forward, an important source of increase in the tax to GDP ratio is that we assume that productivity growth, real earnings growth, resumes and that means that we start to get fiscal drag again, pulling people up into higher tax brackets. In addition, there is the Budget 2013 policy measure on NICs contracting out, which will push up the average rate of NICs to GDP.

Chair: These are already in your assumptions?

Robert Chote: These are set out in the forecast. The big picture is that you have seen a drop in the tax to GDP ratio for this year, partly for reasons that we do not assume reverse themselves, but the overall decline is reversed over the next three years for reasons such as fiscal drag and other effects.

Q128 Chair: What effect has your forecast for productivity growth had on this? You have lowered your forecast for productivity growth, haven't you?

Robert Chote: Yes. Once again, we have—

Chair: Between your two forecasts?

Robert Chote: Exactly, and that is repeating a pattern that we have seen in recent forecasts of hoping that that was going to turn round and it has not yet.

Q129 Chair: You have now decided it is not, after all, going to turn round?

Robert Chote: We are still assuming it does turn round and there is some tentative evidence of an improvement there, but the profile has been pushed back. The fact that you have a more pessimistic view of productivity growth feeds through to a more pessimistic view of real earnings growth and that then feeds back on to the income tax forecast.

Q130 Chair: Do you expect this downward revision in productivity to be reasonably permanent?

Robert Chote: As I say, we have reflected the disappointment in the recent data. Looking forward, we are assuming that productivity growth begins to pick up back to more normal rates and earnings growth with it.

Q131 Chair: That is the key phrase, towards normal growth, so you are not forecasting above-trend productivity growth at any time in your forecast?

Robert Chote: We have a bit of that to fill the gap up, but basically we have—

Q132 Chair: Sorry, let us just expand on that. “We have a bit of that to fill the gap up.” Just say a bit more about that.

Robert Chote: We would expect some cyclical rebound in productivity growth. However, compare this to the precrisis position and we are assuming that there is a considerable permanent loss. The path to which productivity growth and, indeed, the potential growth of the economy returns is significantly lower than the path you would have anticipated precrisis.

Chair: Right, but that is the key structural element, isn’t it?

Robert Chote: Absolutely.

Q133 Chair: Right, so we have got to the heart of the matter now. This is the key structural element and you are saying that is permanent, that that is structural, that is lost productivity growth that it will not be made up?

Robert Chote: The loss in the level of productivity, the level of potential GDP, is going to be and to remain significantly below what you would have assumed from an extrapolation of the precrisis trend. That basically is what corresponds to the increase in the structural Budget deficit and, therefore, the whole rationale for having a fiscal consolidation to get that in.

Q134 Chair: You expect it may be a bit below. The question is: how much below, and you have taken a pretty firm view about that with not much catch-up, isn’t that correct?

Robert Chote: We have taken a view. We will continue to come back to it and look on it as the evidence emerges. What we have highlighted, though, is that this is the key—

Q135 Chair: All right, let us just ask that question again. You have taken a pretty firm view, haven’t you—

Robert Chote: We have based the forecast on an assumption.

Chair: —arguing that there is not going to be much catch-up?

Robert Chote: The forecast is based on an assumption that there is a significant permanent downward-level shift in the path of potential GDP.

Q136 Chair: But the question is how much. I do not need the numbers. We can talk adjectives, but you have taken a pretty pessimistic view about that. You have said that there will not be that much catch-up.

Robert Chote: If you look at page 47, chart—

Chair: We are getting the answer from your colleague Mr Nickell, who is just saying “Yes”, because then we can move on. We do not need the numbers. We are agreeing that you have taken a relatively pessimistic view that there will not be much catch-up.

Robert Chote: On the view of potential GDP, we are well below the precrisis trend but within the range of other people’s views of how big the permanent hit has been.

Q137 Chair: How much care and thought have you taken in making that assumption, which is a big call and has a huge impact on the medium-term prospects for revenues?

Robert Chote: As you will see from the sections that you have read through and which we have discussed in successive sessions, we set this out in detail at the beginning of the economic forecast in each EFO production that we produce. As the Committee has suggested, we look at a wide range of indicators of the amount of spare capacity and, therefore, the implied level of potential GDP. We put a lot of effort into it, but we would always highlight the enormous uncertainty that lies around whichever judgment you end up taking. It is one of the reasons why—

Chair: Particularly in this area, would you agree?

Robert Chote: Oh, absolutely, yes, because it is—

Chair: Right. I am getting nods of agreement for those who are only listening but not watching.

Robert Chote: It is a fundamentally unobservable variable. That is the difference. It is hard enough to observe some of the observable variables, but this is an unobservable one.

Q138 Chair: I am going to give Mr Nickell an early outing, at least an opportunity to add anything he wants to add. He has only said one word so far in this hearing, which has been extremely useful, clarificatory, and speeds things up a lot. Is there anything else you want to add?

Stephen Nickell: We spent a lot of time talking about this issue and we talked to other people about it as well. The Bank of England, as you know, has devoted many man years of research, person years of research.

Chair: And has a different view somewhat.

Stephen Nickell: I do not think it is that different. The feeling is we believe that you are not going to get the productivity back but gradually the path of productivity will come back to its historic normal level. In some sense, we feel that we are not in a position to argue that the normal level of productivity growth has fallen. That is we have not had enough evidence. We have had six years of weakness, but it would be such a big call to make to argue that the long-run trend level of productivity from now on is going to be different from what it has been outside wartime in the last 100 years.

Q139 Chair: That is exactly what I was trying to get clarification on in my exchange with Mr Chote. You have not made that call?

Stephen Nickell: Correct. As you will notice in the scenarios, we do have a scenario where, over the forecast period, we do not have a recovery in productivity growth and the

outcome is pretty dire. So this is a very important call we are making and it is the best judgment in our opinion.

Q140 Jesse Norman: Mr Nickell, just following up on that for a second, obviously there is a big economics question as to what the causes of the productivity puzzle are. Do you have a view on that now specifically as to why that drop occurred? Is it more about changes in the labour market or is it about deeper changes in the structure of the economy?

Stephen Nickell: There are a few bits and pieces like the increase in part-time working and self-employment and so on, but we see those as relatively minor. If push came to shove, I think we would argue that it is the consequences of the credit crunch that have led to this productivity puzzle. That is to say quite a high proportion of productivity growth is generated because high productivity firms start up and expand and low productivity firms contract and go out of business. There is some evidence to suggest that, because of the credit crunch, there has been a barrier to the expansion of high productivity firms and the starting up of high productivity firms. I am not too convinced about this, but some people argue that the credit crunch as part of the whole business has also led to low productivity activities surviving, so-called zombie firms and so on and so forth.

Jesse Norman: Yes, bank forbearances permitting—

Stephen Nickell: I am more inclined to go for the idea that the credit crunch has restricted the expansion of high productivity activities, partly because of the restriction on working capital, which is fundamentally something that historically has been provided by the banking system.

Q141 Jesse Norman: So high productivity businesses, often manufacturing businesses, need capital, need working capital, need fixed investment. They are not getting it. There has been a decline in the amount of credit available and that has a knock-on effect into productivity?

Stephen Nickell: Correct.

Q142 Jesse Norman: That is helpful. If that is the case, then while we continue to have these kinds of constraints on credit and possibly bank forbearance, easy money and so on, that suggests a longer term path of low productivity growth?

Stephen Nickell: Yes, but the evidence we have from the Bank of England and others is that credit constraints have been easing and are easing. Back about three years ago, we thought by now that it would have eased sufficiently to get back to normal. That has not turned out to be the case, but we think that gradually the credit availability will improve to the extent that it enables us to get out of this situation.

Q143 Jesse Norman: It is not impossible, is it, that if you get a continuance of these situations, relatively extremely low interest rates, easy money conditions, slow feed-through of new credit into businesses, that the productivity assumptions you have made could be generous compared to the possible outcomes over the next three or four years?

Stephen Nickell: That is perfectly true. I hesitate to argue that it is low interest rates, per se, that are behind this. I know that the keeping alive of low productivity activities may have something to do with that, but in my view it is the difficulty for firms that wish to expand to get the working capital and to get the credit backing to do that that is

fundamental. It has to be said that the evidence on this is not that strong. We have a lot of anecdotal evidence, people saying things and so on and so forth, but the hard evidence is quite difficult to gather.

Q144 Jesse Norman: Yes. Mr Chote, you have said that there has been a 0.5% drop in tax collectability and that then rebounds somewhat and, therefore, is not all—in the language we are using—permanent or long term. What percentage remains as you have forecast?

Robert Chote: Well, basically, you reverse pretty much all the reasons for the—the drop between 2013-2014 and 2014-2015 is arithmetically pretty much recouped in a couple of years, and certainly by the end of the forecast, but it rises for different reasons. It is not the same as the reversal of the reasons why it dropped in the first place. There can be something that is permanent contributing to this decline, which is then progressively offset by other factors pushing downwards.

Q145 Jesse Norman: But are you suggesting that the Government's capacity or any Government's capacity to collect tax is increasing in some areas and, therefore, that the possibility is a rosier one than that of even any decline in potential tax revenue gathering or capacity to gather that?

Robert Chote: If you look tax by tax, there are different trends in the long-term buoyancy of those receipt flows. I would not say that there is some newer lower limit above which it is not possible for Governments to raise a given amount of money. We only have to look at the international range to see that there are some countries that tax and spend obviously at much higher levels and some that tax and spend at lower levels. It is striking that the tax to GDP ratio has moved within a relatively narrowish band over that—

Q146 Jesse Norman: Just to finish, it would be a very odd conclusion, though, when you consider how much worry there is about tax arbitrage, loss of tax revenue, leakage, capacity of capital to move, capacity of some labour to move, shifts in the tax system as a result of that, and so on.

Robert Chote: There are lots of tax shifts going on. There is, though, if you are looking forward over this, the return of the sorts of sources of fiscal drag that you usually rely on. Obviously, if you are starting to see real earnings growth and that is pushing people up into higher tax brackets, you get more receipts from that. For example, Stamp Duty, you could argue that the reforms have increased the amount of long-term fiscal drag you will get out of that because you will be having higher average tax rates at the top. On the other hand, there are secular trends going in the other direction. We seem to be on a long-term trend to get fewer receipts from tobacco duty, some sorts of alcohol duty and fuel duty for reasons of technology and consumer tastes. You have things moving in both directions.

Q147 Jesse Norman: Just to be clear, a very final point, which is it is exceedingly volatile. You could prove to be quite far out. Small changes in, for example, productivity growth or real wage growth could potentially change things quite quickly.

Robert Chote: You can certainly see this moving around in unexpected directions. There are also particular factors that can push it up and down from year to year, including policy changes like the NICs change that will have quite a big jump effect in 2016-2017. Yes, these things can move around. Having said that, overall, if you compare the variability of

the tax to GDP ratio to the spending to GDP ratio over the last 10 years, tax is much less so.

Jesse Norman: It is vastly more stable, yes. Thank you.

Q148 Chair: You are acknowledging that this is a huge judgment call with enormous uncertainty outside of it. It has a profound effect on the forecast and on the basis of which the debate will take place in the forthcoming general election. From what I have seen over the years, in fact decades, it is concerning—I should be able to say that—that in the last year of a Parliament there is an instinct of Treasury officials—perhaps I should call it an affliction—which is to salt a little away to discourage too many pledges during election periods. You have not been infected by any of this affliction, have you, Mr Chote?

Robert Chote: No, we take the policy that we are given as it is set out.

Chair: So much time with those Treasury officials, none of that?

Robert Chote: Not at all.

Q149 Steve Baker: Good morning. Mr Nickell, before we move on, can I pick up on this point about lending and businesses and productivity? I was just looking at the sectoral lending figures back to 1997. You can at least see the colours from there, but most of the credit expansion went into mortgages, financial sector businesses and commercial property, and the amount of lending into businesses is broadly constant in context. It is the blue at the bottom. I am just trying to reconcile what I am seeing in the sectoral lending figures with what you have said about the credit crunch interrupting the flow of capital to businesses. We know it has, but is it the truth that most credit expansion went into housing and the financial system?

Stephen Nickell: Without doubt. Of course, a lot of the lending to business went into commercial property. As a proportion of total lending, the amount of lending to non-property, non-financial business is relatively small. Of course, one has to distinguish between SME lending and lending to large companies. Large companies, generally speaking, have access to alternatives to bank lending, the bond market and so on. Of course SMEs and small companies generally rely on or have in the past relied on the banking system.

Q150 Steve Baker: One of the things we are all most concerned about is the productivity of labour in order that real wages should rise. To what extent is this phenomenon of where the credit expansion took place material to that question of labour productivity and wages?

Stephen Nickell: The vast majority of bank lending is on household mortgages. It is just much bigger than everything else. I do not think that fact is of any very significant consequence because, of course, what it means is that if the world gets to be better—that is that the credit crunch reverses itself to some extent—expanding lending to business, and to small and medium-sized businesses in particular, it is just not going to take up very much of the available credit. My suspicion is that one of the reasons that banks will give as to why it is not done is it is just so difficult. Lending to households is so easy in some sense. They fill in a form and they look quite safe. Small businesses are just much trickier.

Q151 Steve Baker: Forgive me, I had better move on. Could I ask what you consider to be the major risks to your economic forecasts? Do you think there is potential for the economy to outperform what you have forecast, Mr Chote?

Robert Chote: It is a simple forecast so there is a roughly 50% chance in our view that it outperforms or underperforms. In terms of the most consequential risk, then this issue about when you are going to see the long-awaited pickup in productivity growth and the pickup in real earnings that will come with that is probably the major uncertainty. Of course, it then links back into this issue of how healthy the underlying potential output of the economy is and, therefore, to where we can rebound as the economy gets back to normal.

We have highlighted a number of other risks in the report in terms of the economy, renewed instability in the euro area, for example, geopolitical issues, weakness of demand more generally, a return to the sorts of volatility that resulted when people were anticipating the unloosening of global monetary policy. There is a long list of things there, but if you wanted to highlight the one that we—and I think most forecasters have wrestled with—have got wrong in recent forecasts, and what will be most consequential for the public finances, it is how the productivity puzzle is going to resolve itself and where that leads you with earnings. I think it is important to distinguish that we are assuming and the benign outcome is that you see productivity growth and earnings growth picking up pretty much in tandem. If you get wage growth picking up without productivity growth picking up, that is not a good outcome because it will confront the Bank of England with choices on inflation.

Q152 Steve Baker: Thank you. With this in mind, can we turn to what the IMF has said, the recent warning of stagnation or persistently weak activity in the global economy? Christine Lagarde recently described this as the new mediocre. Do you think there is merit in this warning that we now face a new mediocre in the global economy?

Robert Chote: If you think about this and the secular stagnation debate that is around there, one thing you can do is distinguish that that critique comes in a demand-side form and a supply-side form. There is one set of people who will be worried on the demand side that we simply cannot get real interest rates low enough, indeed negative enough, to get demand growing strongly enough for unemployment to return to the natural rate for output to get back to potential. Clearly, in the forecast that we have set out, we are assuming implicitly that the current path of monetary policy implied by market expectations will over time see the output gap narrow, will see unemployment return to its natural rate. So we are not assuming a persistent failure to close or to exhaust the spare capacity in the economy.

There is an alternative view of long to medium-term growth pessimism, which is on the supply side, about the fact that we are just going to see a lot weaker productivity growth and a lot weaker potential GDP growth in future. There is the Bob Gordon style argument that we have had three industrial revolutions and that is your lot, and therefore the idea of expecting to return to the historical average rate is not likely to happen. Again, as Steve has just said, that would be a big call to take in the absence of firm evidence on that and our assumption is basically that you see productivity growth and, roughly speaking, potential GDP growth returning to the rates that you have seen on average. But there are different views on that. I

think the European Commission, for example, would have a rather weaker view of potential GDP growth in the future than we do. Others would take the contrary view.

Q153 Steve Baker: I am very conscious of where I want to go. Can I just tie some of this into what we heard yesterday from some of the economists from the City who came in? I had an exchange with them about this notion that savings are being run down and that consumer credit is coming forward, and we agreed that this is demand being brought forward. So if demand is being brought forward today, through the rundown of savings and the taking up of consumer credit, wouldn't we expect a reduction of demand in the future and wouldn't this lead us into a further boom/bust cycle, even within the context of how you think about demand?

Robert Chote: Certainly if you look at the relatively robust pace of growth over recent quarters, that has been reflected particularly in terms of the contribution from the consumer of people running down savings rather than having stronger income growth. We have assumed that it is not plausible, and I think if you look at the last year the real consumption growth has been running further ahead of real wage growth than in almost any other year over the last 15 or 20 or so. Therefore, in our forecast, the main reason we expect the quarterly pace of growth to slow into next year is that you see consumer spending moving more into line with income growth and being less driven by the sort of decline in saving you are talking about.

Q154 Steve Baker: Could I ask you about inflation and deflation? What are your concerns about deflation?

Chair: In a few sentences.

Robert Chote: We are assuming that CPI inflation remains below the Government's target through until I think 2017. Basically you have the bank setting policy as it has explained it is doing. Opposite to the pattern that we saw in previous years, where you had higher oil import costs pushing up external inflationary pressures, now it seems to be going in the other direction: good news on food prices; good news on oil prices. As you know, the bank tends to look through those sorts of things and implicitly focus on a more domestically generated view of inflation.

Q155 Steve Baker: So the bank will look to generate a bit more inflation in order to get back to target, but we are now looking at persistently low interest rates for a very long time. What will be the long-term effect on the economy of such very low interest rates over the long term?

Robert Chote: As you point out, it is the expectation of the rise in interest rates that has pushed out a bit further since the last forecast that we were doing. That is one of the things that is contributing, hopefully, to seeing the spare capacity in the economy used up. It is also having other implications for asset prices, as well, perhaps at the same time. One of the uncertainties—and the bank has wrestled with this of course—is what the new normal, new neutral rate of interest is going to be. They have said, and we have no reason to disagree with it, that it will be lower than what it was before but—

Steve Baker: I am going to have to move on but just if I may—

Chair: We are going to have to move on.

Steve Baker: I want to make one point if I possibly can.

Chair: You can ask one question.

Q156 Steve Baker: That is, I am concerned that we are not focusing on the extent to which monetary policy is discoordinating the market for loanable funds, sending false signals about where we are in the production possibilities frontier, stimulating over consumption and false investment. I think we are going to be caught out by another horrible crash as a result, but I think perhaps this is all for another day.

Chair: I think it might be. Well, it might be for later on today. You just cannot tell.

Q157 Teresa Pearce: Good morning. The Chancellor surprised us before with Help to Buy, and this time he has surprised us with Stamp Duty. How reliant is economic growth in the housing market?

Robert Chote: I will kick off and then Steve. I think the view that we have taken essentially is that the economic growth part is more, as we have said, dependent on when we get back to some real earnings and productivity growth. For example, the increase in household debt is a reflection of the fact that you have the housing market recovering, more household assets as well as more household debt in that sense, so I would not interpret the picture on the household balance sheet side as saying we are dependent particularly on that. I think our underlying judgment is that, if you are looking to see where the long-term health of the recovery is coming from, it is a return to productivity growth and the associated earnings growth that comes with that. Steve, do you want to say anything more on the housing market side?

Stephen Nickell: I would not say the housing market was driving the recovery, but it is true to say that the buoyancy in the housing market means that a higher proportion of activity in the economy is related to housing, to transactions, to estate agents, builders and so on. This is quite a big part of what is happening in the economy today, but I do not think that one could say that this is a fundamental driver. It is simply a recovery of house building and so on that fell dramatically during the recession.

Q158 Teresa Pearce: Are you saying that home ownership and the churn in home ownership and people moving and buying houses is indicative of a buoyant economy, is the cause of a buoyant economy, is that what you are saying?

Stephen Nickell: It means that the economy is more buoyant than it was and that this kind of activity is now returning to historically more normal levels.

Q159 Teresa Pearce: When you are looking at the housing market, which is ownership, and buying and selling of houses, housing in itself is also critical to the economy. I am not one to vote Conservative but Macmillan said in 1951, "Housing is the first of the social services. It is also one of the keys to increased productivity" and the fact that overcrowded houses undermine health, education, work and productivity. We do have a housing crisis, especially in London with people in overcrowded properties. Is anybody doing any work to look at the cost to local government of that and forecasting the way forward, and also the cost of productivity of people living 10 to a three bedroom house? Is anybody looking at that to your knowledge?

Stephen Nickell: Not to my knowledge the direct effect of overcrowding on productivity, but a lot of people are, of course, working on how we can get a faster growth in house building in order to reduce these problems. Of course the difficulty is that we have been building houses at a slower rate than the demand for housing for a long time now, so in some sense there is an enormous gap.

Q160 Teresa Pearce: Yes. There is a lack of supply but also the supply for people who rent is very poor, so do you expect that that affects productivity?

Stephen Nickell: It is plausible but I have no evidence.

Q161 Teresa Pearce: As far as you are aware, there is no one doing any work on that?

Robert Chote: Just on your second point about the impact this has for the social security, I think that is an important thing to look at. If you look at what has been going on in the patterns of Housing Benefit expenditure, the fact that you end up with a shift in tenure with more people renting rather than owning and the Housing Benefit bill has gone up in part because the relative lack of social housing has meant that more people are in the private rented sector paying higher rents and, therefore, being subsidised at a higher level in Housing Benefit. So this is one of the issues we looked at in the welfare trends report earlier on, and those questions of tenure and the balance between social and private renting does indeed have a direct impact on welfare spending via that channel.

Q162 Teresa Pearce: One of my colleagues is going to speak about local government later on, but some local authorities are at breaking point at the moment because of the housing crisis, because of the amount of money they have to spend on the failure. It clearly is a problem for the economy if you do not have that. I understand what Stephen says about supply, and that is a long-term thing that cannot be fixed over night. You cannot just suddenly magic up hundreds of thousands of affordable properties. It just concerns me. We talk about productivity a lot. We talk about businesses but we do not talk about the people who are meant to produce, and if you are living in a house that is damp and you do not get any sleep then you are not going to be the most productive of workers, are you? It just intrigued me.

Robert Chote: You are taking it slightly out of our area. In terms of the mobility and ability for people to get to living in the areas in good quality accommodation, where they can work, this is part of the process of adjustment within the economy that is important. It is not something that we have focused on specifically.

Q163 Teresa Pearce: Could I just ask one question that is not related to housing but I do not think anybody else is going to ask it? When you did your e-book and you talked about universal credit and said you were not convinced that it was going to deliver—you hoped it would but you were not convinced—and you were also concerned about the cost. There have been huge write-offs in the cost. Did you take into account any future write-offs or were you just unsure?

Robert Chote: We are not dealing here with the costs within the DWP's departmental expenditure, either the cost of running—

Teresa Pearce: This is in the part about the welfare cap and how much the welfare spending would be. Clearly if universal credit does not come in on time, on budget—as we have been told repeatedly it will and it hasn’t—there will be an increased cost.

Robert Chote: Ironically, it saves you money in the short term. The delay in it is saving you money in the short term.

Teresa Pearce: But not in as a write-off because you have spent the money and then written it off.

Robert Chote: On the welfare cap expenditure, which is the amount of money that is going to the recipients, as distinct from writing off the costs to “the Government” for doing the process, basically what we—

Q164 Teresa Pearce: So it will not hit this table but it will hit a different table?

Robert Chote: No, and the irony is that, as I say, this shows up because if you delay the rollout of universal credit the gainers do not gain until later and the losers do not have to be paid transitional protection in the meantime. It is a net gain to the Exchequer in the meantime. Whereas, if you look at the judgments that we have taken on things like ESA, and that not moving as quickly, then that goes in the other direction. That is costly rather than saving.

Chair: I think we have covered that point. Is that all right, Teresa?

Teresa Pearce: Yes, fine.

Q165 John Mann: Mr Chote, after four and a half years of the OBR, what is your increase in productivity as an organisation?

Robert Chote: Unfortunately, in terms of quantity, that has gone up but I would not necessarily turn to it as a very good index of quality adjusted output. What I would hope, in terms of quality adjusted output, is that we have over time managed to increase the transparency—

Q166 John Mann: I am not interested in hope. What I want to hear is looking at economic statistics, what percentage of the economy can simply not be quantified in terms of productivity?

Robert Chote: What percentage of it can simply not be quantified?

John Mann: Yes, in a way that the OBR cannot be quantified.

Robert Chote: There is unpaid work and the stuff in that area that is not included in the national accounts. Clearly in the public sector the issue about how you measure the output of public services and how you measure productivity there is a very difficult one and is one with which we have wrestled in the successive forecasts that we have done. The way in which it is measured tends to be in a relatively broad brush way that does not adjust very much for the quality of the output. For example, in education, if you continue to educate roughly the same number of children, that is your measure of output. Whether the amount of money you are spending doing that moves up and down that will show up depending on how you measure this as being a change in apparent productivity. But what

you are not taking into account is whether you think the quality of the education is different.

Q167 John Mann: Employers could, instead of looking at increases in productivity to maintain or increase profits, look at hours worked. Put in a pure economical model, if we brought in several million work-ready slaves and offered them to employers for free, then employers could increase or maintain profitability by shifting their workforce. With zero-hours contracts the same principle applies, that employers can increase their profitability, not by looking at investment per head but looking at how to reduce hours per head to get the output that they specifically require. How do you build that into looking at the productivity puzzle?

Robert Chote: Steve may be able to give you a bit more on that. I think a key point to bear in mind is that the productivity puzzle shows up in output per hour, as well as showing up in output per head. So one of the arguments for saying, “Well, maybe the productivity puzzle is not as much of a concern” is because you are reflecting a shift to part-time and short-time working but that does not get rid of the productivity puzzle.

Q168 John Mann: Some people would say it is a concern precisely because of that, because if you can tailor the number of hours precisely using zero-hours contracts then you do not end up overpaying as an employer and, therefore, you have a form of wage deflation built into the economy. That is not a situation we have had in this economy before.

Stephen Nickell: According to that kind of argument that should lead to an improvement in measured productivity, but that is not the way it works. In the data, “hours” is hours worked. So if you are not working you are not working so to speak. Therefore, zero-hours contracts, the way you are thinking about them, I think, is that: here we have someone who is doing 40 hours a week and is paid for 40 hours a week. Now we switch this person to a zero-hours contract, under the zero-hours contract some of those 40 hours might have been spent not doing very much. That will no longer apply, so that the 40 hours will become 25 hours and each of those 25 hours is spent working. That process will lead to an improvement in measured productivity.

John Mann: Therefore potentially a disincentive to invest, which itself has an impact on productivity for the same employer. That is my point.

Stephen Nickell: That is perfectly true but unfortunately what we have seen recently is rather buoyant investment over the last couple of years, and the investment in the previous period—that is before the crash—turns out to have been rather less than buoyant because the ONS keeps changing its mind on what is happening to investment growth, but it now appears to be the case that investment growth before the crash was very modest and investment growth in the more recent past has been quite strong. It is somewhat inconsistent.

Q169 John Mann: Mr Baker raised that issue and why that was happening before. Mr Chote, let me come to a second question for you, if I may. The public sector net debt as a share of GDP is I think down at 81.1%. You said it was going to be 69% in 2010, so that is a huge mistake. Why did you get that so extraordinarily wrong?

Robert Chote: It is a combination of the fact that the borrowing has obviously been higher over the period than you would have anticipated. Nominal GDP, which is the denominator in that calculation, has been lower than anticipated, and in the latest set of forecasts the ONS has changed the new European system of accounts. That has meant there is now more stuff included within the public sector and, therefore, that has pushed up both the cash value of public sector debt and also, but to a lesser degree, the measure of nominal GDP. The fundamental reason is that the borrowing has not come down too.

Q170 John Mann: You sound like a politician with that answer, because let us take the deficit. You said that the deficit would now be a surplus. You said that in this year the surplus would be 0.3%, but in fact we have a deficit. So why did you get that wrong in your calculations?

Stephen Nickell: The reason we got it wrong is because various events took place that were not predicted, like the fact that productivity growth did not recover very rapidly and, therefore, real wage growth did not recover as rapidly as we expected. We did not predict the enormous rise in oil prices that took place in 2011-2012. There are many things that we failed to predict at that time and which turned out to be quite a surprise, so the reason why we got things wrong is that we failed to predict things.

Q171 John Mann: I am asking about your productivity, and when it comes to borrowing you also similarly got it spectacularly wrong. In fact, on all these critical indicators, you were not just a little bit out you were fundamentally out. I mean you almost could not be more out. So I am asking: what is going wrong with you?

Robert Chote: You are responding to the changes in information data that comes out. For what it is worth, our errors in terms of forecasting public sector net borrowing as a share of GDP are smaller on average than those over the previous 20 years, but the point of the exercise is to take on board the latest information and the new judgments you are making each time, and to explain how things have moved from one to the other. As Steve said, the failure of productivity to pick up, the failure of earnings to pick up has been central to that.

Go back to the 2010 forecast—and we went into this in quite a lot of detail in the forecast evaluation report—the puzzle was that in the first two years of this Parliament that the borrowing fell as much as it did when you consider how weak real GDP growth was and then more recently the puzzle has been: why have you seen the Budget deficit not improving as much as you would have expected as GDP growth has accelerated? In both cases, quite a lot of that has to do with the composition of cash spending. In the early years the bits of the overestimation of the growth of the cash economy was not in the bits that lost you revenue. More recently, the pickup in the cash spending in the economy has not been in the areas that raise you a great deal of revenue. So you have in a sense a mirror image of that forecasting error now than you had in the first two years of Parliament.

Q172 John Mann: You are valiantly trying to explain such incredible differences. Obviously economics is in reality the study of human behaviour. Do you think politicians would be wise not to do what the Chancellor did in 2010, which is to eulogise your forecasts as what was going to happen, rather than as a prediction of what might happen if other variables never change? Of course they will change because some of them are out of our control. What would your advice be to a politician in the future in your projections?

Robert Chote: My advice to a politician in the future would be the same as my advice has always been to politicians and to anybody else who consumed economic forecasts in the past, which is: do not bet your farm on whatever the central forecast says but look at the uncertainties that lie around it. Look at the sensitivities. If you set a particular target, for example, to achieve, how wrong does this have to be and in what sort of ways does it have to be wrong for your target to be imperilled? There may be other errors that you can make that do not have a great deal of impact on this.

We spend an enormous amount of effort in this report explaining the uncertainty around these things, and I think one advantage of having us do this rather than perhaps having politicians do this is that there is less of a temptation to engage in conviction forecasting, if you might call it that way. Conviction politics I am sure has a lot to be said for it. Conviction forecasting does not—

Chair: I think we all agree with that. You will have to be very, very quick; a very quick rejoinder and a quick reply.

John Mann: I was tempted to ask which of your current forecasts are the ones most likely to go wrong but I think that would be totally unfair for the reasons you have pointed out.

Chair: Well, why not? Have a go, John. You will get the answer, published fan charts and things like that.

Q173 John Mann: The final question I have is on the multiplier effect. Because obviously if we take Government departments, the multiplier effect of spending varies dramatically in terms of the UK economy. To take two extremes: defence and overseas aid at each extreme. You are doing your projections—

Chair: It will have to be a quick question.

John Mann: —and you have to be building in a presumption on what is going to be cut because of the multiplier effects on the economy within that. So what are the presumptions you are building in, in terms of which budgets are going to be cut and which are not going to be cut, because otherwise we are going to be—

Chair: I think we have the question and we need a brief answer, and if you feel you want to say more would you put it in writing to us afterwards?

Robert Chote: It is a relatively simple answer, which is that the distinction we make is between capital spending and current spending on public services. There tends to be a higher multiplier on capital spending than there is on current. So what we look at is the overall difference there. You are right to say that in some departments there will be more capital, less current, and in some there will be more current, less capital.

Chair: We have had a good canter around that subject and a lot of colleagues want to get in and we have relatively little time, so I would ask colleagues and witnesses to be as brief as possible.

Q174 Mark Garnier: Mr Chote, you have been extraordinarily honest. Every time you come in front of this Committee people have said, “Why did you get it wrong?” and your

answer has been “because economic forecasters get it wrong”. Just out of interest, looking back over the last five years, have you ever come across anybody who has got it right in any way, shape or form, in terms of the forecasts they made five years ago?

Robert Chote: Not in every respect. I am sure some people have managed. There was one economist I think—and this is going back into an earlier period—of the 35 or so polled by the Treasury who correctly realised that GDP would fall in either 2008 or 2009. But he had also been predicting it in the three previous years, so that is the distinction. Somebody can be right eventually.

Mark Garnier: Exactly right.

Chair: This is monkeys typing Shakespeare, is it?

Mark Garnier: It is indeed.

Chair: If we have enough economists, one of them will be right.

Q175 Mark Garnier: All things considered, given the uncertainties that have come out, and given the fact that we know there has been a huge number of different things that have changed over the last five years, given the fact that we are round about a £96 billion Budget deficit is that a fair result, given what has gone wrong, what has changed?

Robert Chote: I do not know about a fair result but I think—

Mark Garnier: It could have done better or actually had done very well all things considered.

Robert Chote: Given that sort of normative appreciation of the quality of policy, as you know, it is beyond our remit but I think what we have tried to do is to explain as best we can why things have evolved as they have; explain as best we can what our central judgment is, looking forward, but then also to say how much does it matter if growth is stronger or weaker, spare capacity higher or lower and so on, and kick the tyres in that way.

Q176 John Mann: Fair enough. Can I turn to wage inflation? Having just said you have very kindly admitted you get it wrong a lot more than economists do, yesterday I was asking questions of some economists and they said that you are getting it wrong on your GDP growth rate and, therefore, your wage growth rate. It was Goldman Sachs in particular that said you are significantly below the Bank of England in terms of your GDP expectations, as a result of which your 2% expected wage growth is probably quite on the low side. Do you want to come back and make a comment about that?

Robert Chote: Yes, and obviously it depends on the people you have here. If you had had Mr Blanchflower here he would say there is no way things are going to perform as well as we are anticipating. As far as the Bank of England are concerned, we have a comparison on page 92, which shows that we are closer to the average of outside forecasters than we are to the Bank of England. I think the thing to bear in mind with the bank is partly that the difference with the bank reflects the fact that they forecast what the revisions to past data are going to look like, which we do not. So part of the difference two years ahead will

reflect the fact that they expect the data we have for where we are today to have been revised up as well, which is not something we tend to do.

As I recall, one of the other differences from the bank's latest forecast is they have a stronger pace of growth for business investment. As we have discussed, this is trying to pin the tail on a very rapidly moving donkey given the way in which the data are revised here. We have a path for business investment that looks to us broadly in line with the recoveries of the 1980s and the 1990s, but I would lay even more warnings about the uncertainty of: do we actually know where we are today? The discussion with Mr Hosie on many iterations here where we were both trying to explain why investment had not picked up over the last two years and now the ONS tell us it was cantering away very happily as we were having the discussion. So I would lay that caveat there.

Q177 Mark Garnier: Of course, the previous question, we have gone around the houses on a number of different issues to do with wage inflation. We have seen the misallocation of capital, forbearance by banks, productivity problems, zero-hours contracts, which seems to be slightly contradictory, as Mr Nickell mentioned, but one thing we have not talked about is the issue of immigration. As you know, there seems to be two very, very strong arguments of the extreme, one of which is a sort of broad intellectual argument, which is immigration does good things to the economy, it brings in people where you need it, it brings resources where they are needed. At the other end of it, you have this much more hard-line view on it, which is that it kind of suppresses wages; you have a supply of much cheaper people coming in. What is your view on these arguments? I know there is no right answer to this, but can you articulate the arguments about whether wage inflation is being suppressed by just abundant workers being able to come in from Europe, and therefore when you have a massive amount of supply, is it pushing it further down to the cheaper end of the price demand curve?

Stephen Nickell: It is perfectly true and I think you will find it in the evidence that the pay of unskilled workers, particularly in the service sector, has been held back to some extent—not to a massive extent, but to some extent—by unskilled immigration. But I think that there is a huge literature and lots of investigations on the economic pluses and minuses of immigration, and at the end of the day, at least over the next 10 years or so, the general consensus is that for the native population, the existing population, immigration may be a little bit good, it may be a little bit bad economically, but there is not overall that much in it. Obviously there are special situations like in the health service. For example, some 35% of health professionals are migrants and so it is quite plain that if they were not there, the health service would be in absolutely dire straits, so that is a special point. But overall, economically I think the arguments are not fantastically strong in either direction.

If I were thinking about immigration, I think that the argument basically boils down to the number of people. The evidence suggests that since more immigrants means more housing, more roads, more airports, more incinerators, more of this being required, and since the evidence would suggest that people by and large do not like these things, especially if they are near them, I think that is the sort of key issue about immigration people may wish to face up to.

One argument says, “Oh, we are a small island, not much room”. On the other hand, of course there is masses of room. The urbanised part of Britain occupies less than 10% of the serviced area; the urbanised part of Surrey occupies less of Surrey than golf courses, so in some sense there is plenty of space, but as you know, explaining the situation, “There is

plenty of room. These issues are really not very important” does not get you very far. This is not the way people think about these things. People think about these things on the basis of their experience and what they read in the newspapers and most of the things that people object to arise because there are just more people.

Q178 Mark Garnier: This is very, very interesting, but we are slightly drifting away from the wage inflation point of it.

Stephen Nickell: Yes. I thought I dealt with that at the beginning.

Mark Garnier: No, you did, and it is very interesting, but the key point was in the low-skilled areas, then it is having a suppressing effect. Elsewhere it is about skills, and skills are skills, irrespective of where they are coming from.

Robert Chote: It might be worth making the other point that this is not the only source of increased labour supply, the fact that you have older people staying on in the labour market for longer.

Q179 Mark Garnier: Yes. Can you expand on that, because this came up yesterday and there was not much of an opportunity to talk about it, but to what extent is that causing a greater supply?

Robert Chote: I am not sure. I do not know what the evidence is on the relative importance of that. I would just highlight it as another area where you would see that there has been more people working, and I suspect some of those, as with immigrants, more of a skew towards relatively low-paid, relatively low-productivity work.

Q180 Mark Garnier: Ultimately, there is 1.7 million new jobs created in the economy, there are 675,000 businesses, all these kind of fabulous numbers that are coming out, but again it is the supply and demand curve, isn't it? There is a huge amount more jobs, not quite as much new labour, if you like, as the new jobs, but the bottom line is that there are still people around who are prepared to work at that sort of level, which basically means that we are not seeing the wage inflation that we saw precrisis. Is this going to change in the future? Can you see that we are going to see greater wage inflation or are these perennial problems that are going to take quite a long time to work through?

Robert Chote: Again, Steve may want to come back on the immigration point specifically. We were expecting to see wage growth picking up, but as I say, that is primarily linked on to the productivity side and I would once again draw the distinction between the desirable position in which both productivity and wage growth are both picking up than a position in which wage growth picks up and productivity growth does not.

Mark Garnier: That would be very bad.

Robert Chote: To describe wage inflation per se as a good thing, I think you need to caveat that depending on what is happening.

Mark Garnier: Do you want to add anything to that?

Stephen Nickell: Personally, I do not think we are going to have the problems of wage inflation that we had 10, 20, 30 years ago. I do not foresee that.

Q181 Mark Garnier: But the debate is not necessarily wage inflation is a bad thing, it is more the standard of living is a problem or a reduction in living standards is a problem. Do you think we are going to see wage inflation dealing with that standard of living problem?

Stephen Nickell: We expect wage growth to rise, but it is coming back to this productivity issue, this productivity growth. The cost of living crisis is a crisis of no productivity growth.

Q182 Mark Garnier: Everything comes back to productivity?

Stephen Nickell: Yes. You cannot have real wage growth without productivity growth in the long run.

Q183 Mark Garnier: Can I ask just one final question, Chairman? We keep coming back to the revisions of GDP figures, and it was interesting, that chart that you drew us on page 92 with the Bank of England that looks at the revisions. A fundamental question: is the ONS doing a rubbish job?

Robert Chote: I always say that for forecasters to complain about data revisions is like sailors complaining about the sea. This is all that—

Chair: We have the answer there. That will do. I have to move on. I apologise to colleagues and to witnesses, but we have a lot of people we need to get in.

Q184 Stewart Hosie: Mr Chote, you forecast that by 2018/19 there would be a £17.8 billion reduction in central Government debt interest. That is a big fall. How sensitive is that to interest rate changes?

Robert Chote: The net interest is sensitive obviously to the market curve, which we are basically taking market expectations for interest rates and Government borrowing costs into account. The one thing I would add to that is that it is also particularly in looking at changes in the debt interest forecast in the near term. It is also sensitive to what happens to RPI, which notwithstanding the fact that it is not an internationally appropriate measure of inflation, is what we link index-linked gilts to, so if you look at why debt interest is coming in lower this year, for example, I think it is at least as much because of movements in RPI as it due to gilt rates.

Q185 Stewart Hosie: How much of a change would it need either to RPI or to interest rates for the forecast of the economy to be back in the black in 2017-2018 to be out by some years? How much of a change would it mean before that reduction of £17.8 billion was not there?

Robert Chote: We do have a ready reckoner chart, which I do not have with me, which shows you how much of a change and what that leads to in billions, but it is the inflation. If you look at the change in the forecast for debt interest in 2015-2016 relative to March, it is inflation. RPI has moved that by £4 billion, gilt rates have moved it by 1.4, so as I say.

Q186 Stewart Hosie: So between the two, you have a £5 billion change there, which quite conceivably could easily be avoided with a modest change in either?

Robert Chote: Yes. If you look at the way in which our forecast for this has moved in the past, the shift in the curve and the expectations of where market rates are going to start to pick up does have a lot of impact on that.

Q187 Stewart Hosie: I think it would be good if we could see the ready reckoner at some point, just so we will have a kind of quick idea of, “Goodness gracious—”

Robert Chote: It should be on the website, but I think it is—

Stewart Hosie: “—if it is 0.5% increase in RPI, if it is a 0.25% in the base rate, this is the change” because clearly that £17.8 billion reduction is important in the forecast.

Graham Parker: Obviously the interest rate bit mushrooms as you go further out, because it only affects new issues of gilts, so it is not a simple ready reckoner. It will get a lot bigger.

Q188 Stewart Hosie: No, I appreciate that. In the autumn statement, Mr Chote, the Chancellor said that the forecast reduction in interest rate payments, “demonstrates the value of our fiscal credibility around the world”. To what extent were the factors that changed your interest rate payment forecasts related to the Government’s fiscal credibility?

Robert Chote: We were changing it on the basis of what had happened to market rates, whether that was down to a change in view on fiscal credibility or perhaps a view that interest rates were likely to remain lower for longer, whether that was related to your view of long-term and medium-term growth prospects. It will be for the market to tell you why that has moved. A change in the view of credibility would not be the only reason to explain a change in market interest rates.

Q189 Stewart Hosie: Indeed, and thank you for answering that question in the way you did. It is better perhaps to suggest that the lower interest rates as a consequence of looser monetary policy or the forecasting by the central bank or the suggestion by the central bank that rates will stay lower longer, are these not rather more significant than the slightly more intractable fiscal credibility?

Robert Chote: Yes. It is not something that you can decompose from the data.

Stewart Hosie: No, indeed.

Robert Chote: It is a view of what your interpretations are of the movements.

Q190 Stewart Hosie: On a serious point, to change the subject, the IFS have suggested that under current policy, by the time we get to 2019-2020, 88% of deficit reduction will come from cuts as opposed to tax rises. Do you share that view, that it is that kind of quantum?

Robert Chote: I think that is roughly the breakdown. Over the full decade, for example, if we go back five years and forward five years, so the 10 years of what you call the fiscal consolidation—I am here on page 184—of the full change in the budget deficit over this period of 11.2% of GDP, 10.5 percentage points of that is down to a reduction in spending and much less of that is down to a rise in receipts, so 2019-2020 is relatively close. But it depends obviously on the baseline; different people use different baselines.

Q191 Stewart Hosie: That nine to one figure is important, because the deficit consolidation previously published up to and including this year in the Green Book only goes up to 2015-2016, and it shows a four to one ratio cut to tax rises. If it is nine to one or so over the decade, that would imply that what we are about to get next in terms of cuts will be far more substantial as a share of the deficit consolidation that we have seen so far.

Robert Chote: Yes, the mix of the consolidation is changing over time, so basically you have had the gross tax increases; you have had the cut in capital spending as a share of GDP. In terms of the tax increases, an important point to bear in mind here is that although there have been, I think, probably by memory, in excess of 3% of GDP's worth of gross tax increases, but half of that has been given away in other tax cuts and half of it has been absorbed in the sort of underlying weakness of receipts we have been referring to. So an increase in receipts as a share of GDP delivers you very little of this consolidation at all, but you are right on the substantive point: looking forward, if you take the Government's assumption that they have given us for the path of total spending over the next five years—and there is obviously question marks about to what extent that constitutes anybody's policy—and you remove our forecast for things like debt interest and Social Security, you take out the capital spending picture, the bulk of the implied consolidation to come is on a cut in resource departmental expenditure, which is basically day-to-day central Government spending on public services, grants and administration. If you look at that, the implied movement in that over the next five years, you have had about 40% of that cut in this Parliament and an implied 60% of the cut to come in the next few years.

Q192 Stewart Hosie: It is quite helpful to have that figure confirmed, because even in the last two weeks the assumption was 50% to come. It is now clear it is 60% to come, and that seems to be now broadly accepted. Just one final little question.

Chair: Oh good, although all of them have been very good so far.

Stewart Hosie: I knew what you meant. That ratio of four to one was published in the Budget and in the Green Book. It was forecast up to 2017-2018 and then it has been brought back to 2015-2016. Have you come under any pressure not to provide a breakdown of the ratio between cuts and tax increases to be published in any way?

Robert Chote: Not at all. We present those sorts of figures and the implications of the spending proposal in the way we think is appropriate, which is not the same as the—

Chair: Okay, excellent. We have that one as well.

Q193 Mr Love: Can I turn to tax avoidance measures in the autumn statement, and particularly uncertainty of the policy costings? You rated most of the avoidance measures as predominantly medium, high and above. Do you think there is a role to apply a weighted adjustment to revenues above a specific level of uncertainty to be more cautious in the way that these are dealt with?

Robert Chote: In effect, that happens already. With anti-avoidance measures, typically you apply something called an attrition rate to the central forecast, so I think if you take the example of the diverted profits tax, that has an attrition rate assumed eventually of 45%, so you basically assume that by the end of the forecast horizon, people will have found other ways of doing the things that they were doing at the beginning and that therefore eats away at the revenue that we expect these measures to raise. We think if you are going to produce a central forecast, you should have that attrition rating in the central forecast. Then in addition to that, what we have done in this autumn statement is to provide every measure, not just avoidance measures, with an assessment of the uncertainty that lies around the central estimate.

You are right to point out that avoidance measures tend to be at the higher end of that uncertainty spectrum, not least because you typically find it quite hard to understand the likely behaviour of people who have already demonstrated their willingness and ability to change their behaviour quite dramatically in response to the precise incentives set out by the tax system as well. So I do not think it will be appropriate for us to look at the uncertainty rating and then take something off that, because at the end of the day, although it is uncertain, it is still our best central forecast. We think the uncertainty lies on both sides, but with avoidance measures, we do take into account attrition, depending on whether it is a very broadly-set measure or whether it is a very tightly focused one and whether the people the measure is designed to affect are what you might describe as very active managers of their tax affairs or less so.

Q194 Mr Love: Do you think there is more of a role should be played here by the Treasury in highlighting the uncertainties? It is often suggested that they pluck it all out of a hat in terms of the figures they give you. What role should they be playing to help you make sure that your estimates are cautious?

Robert Chote: That is not particularly the Treasury's role. The conversations that we have when each of these measures is brought in is primarily with the experts at HMRC and we probe with them very much on the sorts of issues about, "How robust is your estimate of the tax base?" and what it is you are trying to tax here. We look at how many stages, how many levels of assumptions you have to make to get to an end answer. You look at how uncertain or substantial the behavioural response is likely to be, so it is the experts in HMRC I would be looking to get that information from rather than helpful advice from the Treasury in addition.

Q195 Chair: Have you taken a careful look at it to see whether you think structurally they are doing that job correctly? I think that is Andy's question.

Robert Chote: We are. We look at every measure that comes up. We have also, in line with the recommendation you made, looked back at the performance of some past anti-avoidance measures in terms of the amount of revenue that they have generated and the picture there is that there is a mixture. Some have ended up generating more revenue than anticipated, some less. The big one, the Swiss one, obviously generated a lot less.

Q196 Mr Love: I will come to the Swiss one, but should they be providing a range of cost and revenue estimates to try to help you illustrate the uncertainty that these figures are drawn from?

Robert Chote: I think when the measure is explained to us and we look at the various judgments and assumptions that you make as you go through the scoring, "How big is the pool of money that we are dealing with here? How much of it is likely to be affected by this measure, in what sort of ways? What are the ways that the behaviour is likely to respond and how much attrition do you think there is going to be at the end of the day?" we are often asking questions about the sensitivity, so take this particular judgment, "How much difference would it make if that was 5% one way, 5% the other way?" At the end of the day, the Treasury or the Government has to come up with a central single estimate and we have to come up with a view on whether we think it is reasonable and central. We, in addition, as I say, particularly now have decided to provide people with a more systematic view of the amount of uncertainty that lies behind that.

Q197 Mr Love: Do you think there is any more that you could do to highlight the uncertainty here? Things have gone spectacularly wrong in the past and even if you get 90% of them right and one goes spectacularly wrong, it colours people's attitude towards it. Is there a way we can adjust for that in order to at least say it came within the range that we had suggested?

Robert Chote: I do not know, Graham, whether you want to add anything. The main reason for why we have tried to create this new set of uncertainty ratings is precisely to provide more texture around this sort of debt, rather than just highlighting in the annexe to a Treasury publication, "There are two or three things here that look particularly uncertain". The information that we have provided the Committee with illustrating whether the uncertainty arises primarily from data, behaviour or the modelling hopefully will give people a richer understanding of that. We are not sure that ranges would.

Q198 Mr Love: Perhaps I can ask you to answer this question as well as the comment. How confident are you that these measures that are included in the Autumn Statement will come in on the figures that are being produced?

Graham Parker: We do give each one of these a very thorough investigation, so I am pretty confident that we have a central estimate. It is not going to be right, but I hope we are going to be wrong in one direction as much as we are going to be wrong in the other, so they are central estimates.

But the other question was we do often get figures from HMRC about the effects of different assumptions and so on, so we do see ranges of what you would get. These attrition rates that Robert mentioned, we do kind of make a judgment on which is the right kind of attrition rates to use and we obviously look at the effects of different attrition rates and so on, so we do that as a matter of course. I do not think we would do that in every circumstance, so we have decided to use this kind of uncertainty ranking instead of ranges.

Q199 Mr Love: The last time the Treasury Committee made a recommendation you evaluated, what were the main benefits of that evaluation and what changes have you made as a result of it?

Robert Chote: As I say, in terms of the headline answer, if you look at the range of measures that we examined, the Swiss one stands out as the largest single difference from the forecast for reasons that I think both in terms of the uncertainty around the amount of money that would originally be affected by this and by the behaviour, you can see why the numbers turned out differently. For the remainder, as I say, some have over-performed, some have under-performed. If there is a particular measure for the lessons to take out of this, one that is not unique to this area is that some of these measures take longer to generate. You might be right or still think you are right about the amount of money that is going to come in, but there is a temptation to assume it is going to come in earlier than turns out to be the case because of the operational needs of getting the thing in place and getting taxpayers to respond to it. I would say if there was a single lesson that we have taken out of that exercise other than a reassurance that things can go in both directions, it is probably that.

Q200 Mr Love: What influence has that result had on the work of the HMRC and other departments that are submitting figures to you? Are they now being more cautious, more realistic about a yield over a period of time?

Graham Parker: If they are not, we are asking them to be.

Chair: We have heard that.

Graham Parker: To shift things to the right a bit on several occasions.

Chair: That is an excellent brief reply, thank you very much indeed.

Q201 Alok Sharma: Mr Chote, a very quick clarification on attrition rates. Is what you are saying that your uncertainty rating is a reflection of attrition rates or the attrition rates are already built into the forecast?

Robert Chote: The attrition rate is built into the central forecast, and if a measure has a particular attrition rate, that may be one of the things that you worry about in terms of the uncertainty.

Q202 Alok Sharma: But what this is then saying is if you have the attrition rates built in and then you are piling on another level of uncertainty, so you could say you are doubling up on the attrition rate, you could argue that some of these forecasts are understated in terms of the amount of revenue that may be collected and there may be an upside.

Robert Chote: No, because the uncertainty rating is not affecting the estimate of the amount that it raises.

Alok Sharma: No, I understand.

Robert Chote: The attrition rate is you are then saying once you have done that, how uncertain in both directions above and below. In terms of could they be less or could they be more, they are all central estimates, so there is a 50:50 chance they are higher or lower.

Alok Sharma: Yes, so they could be higher.

Robert Chote: Yes.

Q203 Alok Sharma: Can I turn on to the diverted profits tax—and I do not know, Mr Parker, whether you wanted to take this one—which is there is not much detail out on this at the moment. Can you tell us what information the Treasury shared with you for you to be able to make an assessment on these figures?

Graham Parker: Yes. I think HMRC are going to release a lot more information shortly.

Q204 Chair: Can you just tell us what that is and when?

Graham Parker: I think it might be today.

Robert Chote: Anyway, I think there is a broader explanation from HMRC due.

Graham Parker: On the second half, clearly we are not allowed to see tax confidential information, so all HMRC could really tell us was what they had done. What they had

done in this was they had looked at the actual accounts of the main multinational companies they think are going to be affected by this and they have gone through those accounts.

Q205 Alok Sharma: I guess what I am getting at is that how will this work, because the forecast and the certainty of the forecast is also based on deliverability of the legislation or whatever it is that will deliver the diverted tax.

Graham Parker: We asked them quite a few questions about what they had done, so they had just looked at the accounts and then they knew what rules they were going to apply, so they had kind of applied those rules.

Q206 Alok Sharma: But those rules were not shared with you, so you do not know how they will work.

Graham Parker: No, because it depends. The rules are for particular types of schemes these companies are doing and which ones are going to be stopped and so on, but we could see that.

Robert Chote: The general principle of basically areas of activity linking to economic substance to the permanent establishment, those broad principles are there, but if memory serves me right with this measure, at least half of the yield is from the companies that HMRC has gone through the accounts of in detail, so although obviously they cannot share taxpayer confidential information with us, we can reasonably assume that they have a lot of it.

There is also another second limb to it, which is given the characteristics of the firms they have gone into great detail, do others match the risk profile that suggests that they would also fall into it? So there is a mixture of—

Q207 Alok Sharma: Absolutely, and I would not expect them to give you detailed information on individual corporates or indeed individuals. What I am getting at is I am surprised from what I am hearing you have not had an explanation of the mechanism for this tax working.

Robert Chote: We have had enough of it to satisfy us that the uncertainty is more on you could not get the information on the firms that would tell you how much money falls into the particular buckets.

Graham Parker: We have had quite a lot on that, particularly on the timing of it because it does not come into effect until next year but there is very little yield expected in 2015-2016 and then it builds up in 2016/17. So, we know enough about how they think they are going to work it.

Q208 Alok Sharma: Fine. Is this diverted tax compatible with the UK's double taxation treaties?

Graham Parker: They told us they thought it was.

Q209 Alok Sharma: As far as you are aware there are no legal—

Robert Chote: That is not something we are in a position to—

Q210 Alok Sharma: Right. So, as far as you are concerned you were not told there would be any legal problems as a result of this.

Robert Chote: No. On the basis of the—they were confident enough to announce the measure.

Q211 Alok Sharma: This is a unilateral measure. The Government obviously has been leading discussions on tax avoidance at OECD level but this is a unilateral measure. Do you think this will deter FDI coming to the UK?

Graham Parker: These companies, as I understand it, make a lot of money out of their activities in the UK, so we would have to have a pretty major effect to stop them. I do not think this 10% tax on some of their profits is going to be—

Robert Chote: We certainly would not expect them to be leaving the UK as a market to supply goods and services in, whether the FDIs are stopping—

Q212 Alok Sharma: Okay, so basically what you are saying is you do not think there is going to be a material impact in terms of FDI as a result of the Diverted Profits Tax.

Robert Chote: We have not assumed that and certainly we are not assuming that any company that is providing a large amount or supplying a lot of goods and services is going to stop doing that in the UK as a result of this measure.

Q213 Alok Sharma: Can I just turn very quickly to the point on taxing of banks' profits and not allowing losses to be offset? You have given this a very high uncertainty rating. Can you explain that a little bit? What attrition rates were built into the forecasts, then, for this particular measure?

Graham Parker: This is not so much about attrition, although there is some of that in it. It is more about—

Q214 Alok Sharma: You talked about behavioural change.

Graham Parker: The first bit of it is estimating how much profit the banks are going to make, so that obviously governs how much loss of their past losses they will be able to set against that profit.

Q215 Chair: This is the bringing forward of tax really, new money.

Graham Parker: Yes, that is right. But it is a question of when it brings it forward to depends on how much losses they have left in the year and how much profit they are making at any given year. The uncertainty here is really on the modelling and data side and so on, rather than on the behaviour.

Robert Chote: You have to estimate both the gross profits and the gross losses and that is the combination of the two.

Chair: I think we need to return to this subject possibly in writing. It is a very important subject to be raised but we have hundreds of pages of HMRC documentation published today that we need to look at and the context of it.

Q216 Mike Kane: In terms of local government budgetary reserves the authority where I live and represent part of my constituency in Manchester has had to make a £250 million cut from 2010 to 2014. It expects another £59 million in the next financial year followed by £91 million, followed by the year after. In this era of local government finance austerity how come we are seeing reserves going up in these local authorities?

Robert Chote: That is certainly something in the past forecast we have been surprised by. We started out as the squeeze was taking effect, assuming that local authorities would in aggregate be running down their reserves earlier than has been turned out to be the case and as you point out they are continuing to add to them. A couple of points to make on that; one is you are looking here at an aggregate figure and the pressures on local authorities vary by local authority and in particular for the set of responsibilities for which different types of local authorities are responsible.

The second point to make is that the main reason why local authorities continue to stick money in reserves is not to try to smooth out a predictable decline in the resources they will be receiving. It is to reflect the fact that they are uncertain. It is about their uncertainty about their financial position in the future. The combination of the changes in the financial flows they get, of the business rates, Council Tax and so on has meant that you have had local authorities knowing that they are facing a squeeze but being uncertain about the magnitude of that and the effect of that from year to year and in response to that the local authority finance officers, who are a cautious breed by nature, have been ensuring those reserves continue to increase. The assumption we have made is that they will add another £1.5 billion in aggregate this year. That will tail off gradually as the squeeze tightens but we have been caught out by it not tailing off as rapidly as we anticipated before.

Q217 Mike Kane: The Chairman mentioned earlier about monkeys using typewriters. I would say for economists it is like herding cats. You have no idea what local authorities are going to do in the next few financial years in terms of what they do with their budget reserves because it is up to them how much they cut or do not cut.

Robert Chote: We talk to local government experts in the run-up to each forecast round to try to gather intelligence on this point.

Q218 Mike Kane: How well are you doing at that?

Robert Chote: You get some interesting qualitative views around. I think one thing you can be confident of is that the published budgets of local authorities are not necessarily a good idea to the eventual outcome.

Q219 Mike Kane: I have a couple of quick fire questions. Since 2013 public health transferred from the NHS to local government. Does that make budget surpluses harder to predict going forward or not and are those budgets still protected?

Graham Parker: I do not think they are protected within local authorities.

Q220 Mike Kane: They are not protected within local authorities.

Graham Parker: I do not think so.

Mike Kane: That is fine. I am happy with that.

Chair: One more question.

Mike Kane: I had two but I will make it good.

Chair: All right, two more.

Q221 Mike Kane: I wanted to just say in terms of overall Government spending in a local authority area, despite austerity, has it gone down or has it gone up?

Robert Chote: I think we have a chart on local authorities, on page 165. This is shown as a share of GDP but you can see there that has been on a falling pattern that we assume to continue over the course of the forecast, and the falling part, the fall to come is consistent with the expected squeeze on central government grants to local authorities. Obviously we do not know how, you cannot predict in advance how central government will split the squeeze between its own spending and the money it gives to local authorities, so for those purposes we just assumed that they do the same onto both, but they might not.

Q222 Mike Kane: My very final question, having those huge reserves that have been forced on it by austerity is a very bad use of taxpayers' money.

Robert Chote: It is a judgment taken by the finance officers and by the local authorities and I think it reflects the uncertainty.

Q223 Mike Kane: What is your judgment?

Robert Chote: It is not something on which we would have a view as to what the right level of local authority reserves is. I think it will vary very much by the type of local authority and the sort of uncertainties it faces.

Chair: As you have noticed, Mike, Robert has a very broad and straight bat on these questions. There are three more colleagues; Rushanara Ali, John Thurso and then David Ruffley.

Q224 Rushanara Ali: I am going to try to be very brief. My questions are about Stamp Duty. The OBR forecast that reforms the Stamp Duty will raise the level of property transactions by 1% and residential investment by 0.2%. What do you expect to happen to house prices and also do you expect the reduction in Stamp Duties to be passed on to buyers in the form of higher prices for residential properties?

Robert Chote: In terms of the impact on prices we have assumed there is no aggregate effect but basically a distribution effect. For the much larger number of properties for which the average tax rate has fallen, you will see the price rise. For the smaller number of more expensive properties for which the tax rate has risen you would expect to see it fall. The assumption is that in terms of how this is passed on you assume that the change in the tax rate is capitalised into the price, so I think the assumption is that we assume, or rather the costing assumes that for a one percentage point change in the average rate of Stamp Duty for a house or particular property there will be a 1.4% change in the house price, so it is geared by more than one.

Q225 Rushanara Ali: What are the likely geographical implications, do you think, if any?

Robert Chote: I think it corresponds—the change in the tax schedule is clearly one that means you are seeing the average rate rising on properties above £900,000 and something by different amounts depending on where the kinks in the old schedule were, so it is clearly going to have more of a negative effect in those areas that have predominantly more expensive houses. But we would not do a regional examination of this although I think others have published estimates.

Q226 Rushanara Ali: Can I just ask about the estimates on the cost of changes to Stamp Duty? It is estimated to be between £700 million and £800 million per year from 2015-2016 but with a medium to a high degree of uncertainty. Why is there so much uncertainty about this when there is quite a lot of data about property transactions and their value?

Robert Chote: Partly it is the behavioural response and partly it is the fact that in order to get a profile of what you think house prices are going to look like you have data in the past that has to be updated to bring it up to your assumption of where you are today. The other effects, for example, the removal of the slab system means that you would expect some of the current bumps in housing, the distribution of housing transactions to be smoothed out, that is you will not end up with an awful lot of them taking place just under £250,000 and virtually none taking place above, so there is a smoothing out there that is a relatively rough and ready process. Graham, are there any other bits on that?

Graham Parker: Basically the overall level of transactions as well. That is going to affect the costing as well as our forecast. We are given—with the medium highs on both the modelling uncertainty, which reflects that transaction's effect, and on the behavioural effects. The data, as you say, is very good so that has some low, if you look at our matrix and that gets them low, and it is the modelling and the behaviour that brings it up to the medium.

Robert Chote: As you say the uncertainty around a lot is down to the transactions, so whether this forecast looks good or bad in the past would probably have less to do with the quality of the modelling of the policy change but as to whether you happen to get the underlying movements in transactions correct. You can apply the same argument to the difference between our estimates and the Scottish Government's estimate of the LBTT in Scotland. Which one of those ends up looking closer will probably have nothing to do with the quality of the modelling of the change but much more to do with what happens to have been happening to transaction over the same period.

Q227 John Thurso: I have two questions on the wages side of things. Can I just, Robert, ask you one quick clarification to the answer you gave to Stewart Hosie relating to the years going out to 2019-2020? Presumably what you have up to 2015-2016 is based on the last spending round of the decisions made by the Government. Anything after that is based on assumption and entirely dependent on the different decisions whoever forms the Government makes when they arrive after the election.

Robert Chote: Yes, but we have to have a—you, Parliament have told us to do our forecasts on the basis of current Government policy so we have to ask the Government for a policy as regards public expenditure beyond 2015-2016 as well as beyond it. The way they have chosen to do that is to give us an assumption, a very complicated assumption, for the change in total public expenditure from which we can then back out some public services numbers. That is the basis. It is not our assumption. It is the Government's

assumption but there is clearly a difference of view within the coalition as to what would like to do if they were left to their own devices.

Q228 John Thurso: Between what is policy established and what it might be, depending on who is doing what. Thank you for that. Can I ask you one area, which is if you have done any work on and if you have what it reveals, in respect of public sector pay restraint and its impact on wage growth and GDP? If you have a wage freeze in the public sector what does that do overall to wages and to GDP? You are saving money but does it have an impact in the round in looking at wage growth and what might happen?

Robert Chote: We take what is implied by the Government's policies and spending assumption for what the total amount of money that would be spent on public services would be and then in order to back out a judgement about, for example, what would happen to general Government employment, you have to make some sort of assumption about what is going to happen to wages and therefore what the split between heads and wages.

Q229 John Thurso: But what I am driving at—

Robert Chote: But it changes the composition rather than something that feeds back into the forecast.

Q230 John Thurso: What I am trying to ask is if anybody has done any work on the fact that if you say public sector wages will be restrained by 1% what impact that has. Obviously it is going to depress consumption for people who are in receipt of public sector wages. What impact does it have in the broader economy?

Robert Chote: In its broader sense I do not know who would have done work on that; for example, on what impact the levels of wages that are set in the public sector feeds through to the levels that are set in the private sector. The IFS have done a lot on the relative levels of public and private sector pay and the implications of the current plans for that so you might want to pursue that with them.

Q231 John Thurso: I will. The other question I wanted to ask was relating to tax credits, which have not fallen as fast as expected, particularly given the current labour market conditions. Is there a major reason for that or is it a range of reasons?

Robert Chote: I presume it is the combination of the fact that earnings growth has been relatively low and the assumption that it has been relatively low at the bottom end so there are—employment has grown relatively strongly but quite a lot of that has been people on relatively low earnings who would therefore be entitled to tax credits so that is the main story.

Q232 John Thurso: In your excellent welfare report that I have been ploughing through there is one paragraph in which you note that, "Eligibility coupled with the tougher Jobseekers Allowance sanctions regime introduced in 2012 may have encouraged people to declare themselves self-employed on low income rather than unemployed". Since you have written that in a paragraph I assume that is something you think is reasonably important.

Robert Chote: Yes. Well identified, yes.

Q233 John Thurso: The answer to the question is, therefore, could you explain why you and others have been surprised by this?

Graham Parker: I think a lot of it comes back to what has happened in the labour market in the last two years. There have been a lot of extra jobs created but predominantly at the lower end of the earnings distribution, which is, in effect, a lot of these people have come off the benefit system and now, instead of claiming a benefit they will be claiming child tax credits and so on. That surprised us in the economic forecast, so it is also, the corollary of that is it is for the tax credits as well.

Q234 John Thurso: The point you make in this paragraph is that they become self-employed.

Graham Parker: Yes, there has been a big increase in self-employment.

Q235 John Thurso: What I am asking is do people declare themselves self-employed to get credits because it is an easier way of getting money than remaining on the unemployed benefit, because that is the—

Graham Parker: If you look at the list of measures in the Autumn Statement there are going to be some steps HMRC are taking to make sure it is no longer as easy as it is. I think there are still some checks now and so on, but one of the measures is to impose a much stricter test to see if people claiming tax credits are genuinely self-employed.

Q236 John Thurso: In the welfare report it is quite a big issue because the rise in self-employed, although it is a trend that has been going on for some years it has taken off to a certain degree and it is a great thing if people are becoming self-employed and are working and are productive. In your report there is a clear indication that some people might be less productive self-employed than might previously be supposed because they see it as a route to a better benefit support than the other benefits, which is quite a big thing to say. What you have just said is yes, and the Government have spotted that and they are going to stop it. Is that going to make life difficult for the self-employed?

Graham Parker: It is not going to make life difficult for the genuine self-employed.

Q237 John Thurso: So there are non-genuine self-employed.

Graham Parker: Yes. We think so, yes, and there was some evidence when we looked at the costing that this will catch some people because they have done some investigations.

Q238 John Thurso: We might expect those to be coming out of the employed numbers and going back into the unemployed numbers.

Graham Parker: It is possible.

Q239 John Thurso: I do not have time to progress this but I think that is a very big set of statements you have just made.

Graham Parker: One of the issues with anything to do with self-employment is there is not very much data so we do not know anything about the earnings distribution of the self-employed until quite a long while after the time of those earnings.

Q240 John Thurso: It might be a couple of years before we know what is genuinely happening.

Graham Parker: For instance, we do not know and we will not know until January how many extra people of the self-employed are paying tax because the self-assistance system is always quite a bit in arrears, so that will be the first time we see if there is any big increase in the number of people who are tax-paying self-employed.

Q241 John Thurso: The other implication of that is that tax credits are a drag on productivity because you are subsidising labour at the bottom end of the market rather than making those firms pay your living wage.

Graham Parker: I am not sure how—do we know how you measure—

Stephen Nickell: If you subsidise wages at the bottom end thereby ensuring that people at the bottom end are in work rather than out of work then compositionally the average productivity will be low.

Q242 John Thurso: It is not in productivity. It may be lots of other things. It may be lots of things but not necessarily in productivity and that is the point.

Robert Chote: It is not necessarily a bad thing to have the—

Stephen Nickell: Sorry?

Q243 John Thurso: I think I understood you, did I not? Thank you.

Robert Chote: I hope so.

Chair: Good. We are moving on boldly.

Q244 Mr Ruffley: Mr Chote, departmental underspend reduced the 2015-2016 forecast for underspend by a couple of billion but you have not changed the forecast underspend for 2014-2015. Why was that?

Robert Chote: It is partly because of the announced money for the NHS and the assumption that comes out of the reserve and we look at the amount that would be spent and more is spent in aggregate but not all of that and so on. I think there is a general sense we look each time we are looking at the DEL picture and for this we are focusing on the period up until 2015-2016, that is for which there are DEL plans, not beyond that. I think broadly speaking there looks to be a set of greater pressures in that year that would lead us to assume that the underspend would be less than had previously been the case, of which the most recent announcement adds to it. Is there any more to say on that?

Graham Parker: No.

Q245 Mr Ruffley: You have said in relation to the 2015-2016 you have explained that the assessment is based on the evidence of a declining trend in underspending over the past three years. What conversations do you have with departments in coming to conclusions about underspend or your forecast? Why is this a declining trend in the last three years?

Robert Chote: Go back earlier, and this was also true when I had my previous hat on at the IFS, we were not taking into sufficient account the fact that there is historically a tendency for spending in this area to come in under the Del. The DEL is a limit as it says in the name, and that historically that had been quite large. You then have at 2012-2013 the year in which the Government was particularly keen to ensure that the deficit continued to fall year in year out, and therefore there was a particular effort to try to encourage departments to come in under, so that would have been one of the years from which we are now seeing the movement back. But I think as you would expect over time as the squeeze gets tighter on departments we would expect to see the amount of underspending that is there shrinking over time. That said, we had thought that earlier and been surprised that underspending continued at relatively high levels so it remains a judgement.

Q246 Mr Ruffley: But you expect it to be tighter in the sense that you are expecting lower underspends going forward.

Robert Chote: That is right. Later on in the last year of the current set of departmental plans we still expect it to come in under the limit but by a smaller margin than previously.

Q247 Mr Ruffley: Just one final question on this. When you are calculating the underspends or putting together a forecast, mechanically how does the OBR go about that bit of work? Do you have conversations? What kind of information do you get from the departments?

Robert Chote: As I say we talk primarily to the Treasury's expenditure team who deal with the negotiations with particular departments that they are having. There is published information that you have available to you from supplementary estimates, for example, what is going on there. There may be particular deals that the Government is able to tell us about that it has done on the budget exchange, that is that it has agreed with a particular department that they can spend some money in year X that they would otherwise have been spending in year Y and we obviously are alert to the general noises about the pressures that departments are facing.

In terms of the mechanics we do it at a level looking at capital and resource separately because sometimes there can be a distinction there, and we look at the flows through the year, so you look at what has been the pattern of the size of underspends that departments are forecasting X months into the year and how does that compare with the outturn, that is does there tend to be a slip away between the position in month 7 and the position in month 12 and do we have any reason to believe that it is going to be greater or lesser than it was in past years.

Q248 Mr Ruffley: Final question, I just ask, and I am not a hard-line critic of your forecasts since you were set up at all so do not take this the wrong way. The departmental underspend for 2013-2014 you have reduced from £7 billion to £4.6 billion, which is a bit out. What were the reasons for that?

Robert Chote: I do not know all the specific reasons.

Q249 Mr Ruffley: It is quite a big percentage out.

Graham Parker: I cannot remember the departments concerned but quite a few of the departments did rather better at getting money out of the door than we were expecting. I do not think there is anything specific we can say.

Robert Chote: I cannot remember whether that was predominantly capital or resource.

Graham Parker: I think it was mostly resource.

Robert Chote: It might have been, yes. One of the difficulties was after the year in which there was a particular effort to make it much larger, knowing how quickly you would get that to normal and what normal would look like was not straightforward so we made the best stab at it we could.

Mr Ruffley: Understood. Thank you.

Chair: Thank you very much indeed for coming to give evidence to us, which is still this morning by a whisker and it has gone on slightly longer than planned but there have been some extremely interesting answers, one or two things we might follow up in writing and we are grateful. Thank you.