

Treasury Committee

Oral evidence: Autumn 2022 Fiscal Events, HC 740

Tuesday 22 November 2022

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Members present: Harriett Baldwin (Chair); Rushanara Ali; Mr John Baron; Anthony Browne; Dame Angela Eagle; Emma Hardy; Danny Kruger; Andrea Leadsom; Siobhain McDonagh; Anne Marie Morris; Alison Thewliss.

Questions 310 - 421

Witnesses

I: Richard Hughes, Chair, Office for Budget Responsibility; Andy King, Member of the Budget Responsibility Committee, Office for Budget Responsibility; Professor David Miles, Member of the Budget Responsibility Committee, Office for Budget Responsibility.

Examination of witnesses

Witnesses: Richard Hughes, Andy King and Professor David Miles.

Q310 **Chair:** Welcome to the Treasury Committee evidence session on the autumn statement. Can I invite our witnesses to introduce themselves?

Professor Miles: I am David Miles, professor at Imperial College.

Richard Hughes: I am Richard Hughes, chair of the OBR.

Andy King: I am Andy King, fiscal expert on the committee at the OBR.

Q311 **Chair:** Thank you all very much. I will just note that this is the first Committee session where we have welcomed our new members and, for public benefit, their register of interests is out there in the public domain. If any of them are relevant to the questions that they are going to be asking you, they will declare those interests at that time.

You have had an unpredictable summer, it is fair to say, Richard, and you had presumably thought that you might be invited to prepare your economic outlook over the summer. From your personal point of view, how was that expressed to you? When were you first told that your services were not going to be required?

Richard Hughes: Yes, it has been an unusual process leading up to this moment. When the leadership election for leader of the Conservative Party and as such the new Prime Minister was initiated, we approached



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the Treasury and had a discussion about our expectation that a new Prime Minister and a new Chancellor would need an updated forecast from us to make whatever fiscal decisions they wanted to make.

We made that approach in late July and, by mutual agreement with the Treasury, set in train the process for preparing an updated forecast. We thought that was particularly important because there had been some big movements in forecast determinants since our last forecast back in March. In particular, gas prices had started rising and then kept rising through the summer. Interest rates also started to rise over the course of the summer and then again some momentum picked up through August.

Q312 **Chair:** So you worked on it throughout the summer.

Richard Hughes: We did, although our initial deadline was to make sure that it was ready for the next Chancellor to be on his desk at the time of his appointment in early September. By the time Kwasi Kwarteng arrived in the Treasury in early September, he had an updated forecast from us.

Q313 **Chair:** So it reached his desk. When were you then told that it was not going to be published?

Richard Hughes: We were informed shortly after that. The precise date is in the foreword to the document, but by my recollection we were informed at the end of that week that he was not going to request a forecast from us to accompany any fiscal statements he was going to make later on in the month.

Q314 **Chair:** What you have published now is quite a bit shorter than what you have typically done. What have you left out?

Richard Hughes: It is shorter than our usual forecast. It is just over 60 pages, whereas our typical EFO is well over 200. There are some people who have liked the new shorter format. It is more concise and more readable. Anthony is nodding his head, but there are others who have missed some things.

The reason it is shorter is that we were, in essence, having to maintain a constant state of readiness to publish a forecast. We had three different deadlines throughout the process, two of which were moved forward, so we had to be prepared to keep iterating on the forecast and publish at relatively short notice. That meant that our time to write it up was more limited.

It is a shorter document. We have made sure we have satisfied all the legal requirements of an EFO set out by Parliament in legislation. It has meant that we have gone into less detail on aspects of the forecast than we usually would. In particular, there is not the long annexe on policy measures that you would usually see in an EFO. We have had to keep that shorter and more summary. There are fewer boxes. This time around we only had four boxes going in depth into analysis. Ordinarily, we would have over 10 in an EFO, going into different issues. We have not had as much of a chance to explain our logic around key analytical questions, nor explore some of the policies in depth.



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I should really emphasise that this is not necessarily the new normal. We really want to get feedback, from you in particular, but also other users of our documents, about whether they welcome a more concise product or whether they miss all the content that they used to have.

Q315 **Chair:** This Committee has been consistent over the summer asking for your forecast to be published alongside what has been referred to as a mini-Budget, but was quite major in terms of some of the measures in it, in September. You mentioned the legal situation. You are required to publish one of your forecasts alongside a Budget and that is why these euphemistic terms of mini-Budget and fiscal event have entered our language, to prevent you from publishing your document alongside it. Do you think we in this Committee and in Parliament should be changing some of the legal language to make sure that major changes to tax and spend in this country are accompanied by one of your forecasts?

Richard Hughes: It is a good principle of fiscal policy-making that major fiscal decisions should be based upon and presented alongside a latest and up-to-date view of the economic outlook.

Q316 **Chair:** Did your lawyers advise that it is the word "budget" that is the key thing?

Richard Hughes: They did. The law says that we have to publish two forecasts a year and one of them has to accompany the Budget, but the law also says that it is for the Chancellor to decide when our forecasts are published. It was for that reason that, despite the fact that we had forecasts ready at the time, because the Chancellor did not ask us to publish them, they remain confidential advice to Ministers.

Q317 **Chair:** We all accept that no forecast is ever going to be a perfect prediction of what happens in the future and what you are looking at really are the risks around the prediction that you put in for the future. It is very noticeable, however, that your forecast is very different from the Bank of England's forecast and I just wondered if you could talk us through what you think are the major differences in assumption that you have taken there.

Richard Hughes: It is different from that set out by the Bank of England, although I should emphasise that the Bank of England actually set out two forecasts in its Monetary Policy Report. It is different from the central one of theirs, which was based on the market assumptions for the future bank rate.

It is more optimistic for the growth outlook than the Bank's forecast. We have a shorter recession and we recover to a higher level for GDP than the Bank. I should emphasise, however, that it is more or less in line with the forecasts of other independent forecasters, so we are quite close to the consensus. It is actually the Bank that is a bit of an outlier in being so pessimistic, in particular about the length of the recession that we both think has already begun.



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Going into the reasons for why our forecasts differ, it is really three things. One is the vintage of data that we took in this forecast versus the one done by the Bank a few days earlier. We took a slightly later vintage of both gas prices and interest rate expectations. Those had been coming down over the course of late October and early November, and the later you went, the more you got the benefit of those gas prices being slightly lower and interest rates being slightly lower.

A second important reason comes down to a difference of judgment, which is around the savings rate and what will happen to the household savings rate in response to this unprecedented, once-in-a-century shock to living standards. We think that the savings rate is going to fall over the course of the next year as people dip into their pandemic savings to support their consumption over the next few quarters. The Bank thinks the savings rate is going to go up as people are holding on to more precautionary savings because they are worried about the outlook for their incomes and their employment. We will see who is right, but, given that this is an unprecedented shock, we thought it was not unreasonable to think that people might do unprecedented things.

Q318 Chair: Is that purely a judgment call? There is no actual evidence base to make either of those two assumptions.

Richard Hughes: It is based on the models that we have and David might want to say a bit more about it. We saw unprecedentedly high savings rates in the recent past when people maintained incomes, but were unable to spend the money. Given that this is an unprecedented shock to their earnings, we thought it was not unreasonable to assume that they might dip into some of those savings to support their consumption when their earnings were lower.

Q319 Chair: It would be interesting to hear from David on that and on the assumptions that have been made about the drivers of inflation. Is it correct that all the forecasters seem to be saying that inflation will come down by the middle of next year? You have inflation of about 7% for the year as a whole. Can you talk us through some of those assumptions as well?

Professor Miles: On the savings rate, such is the hit to disposable income of households that it seemed to us plausible—and economic theory would suggest there is something in this—that faced with such a fall in purchasing power, which recovers a little bit further down the road, people might dip into savings, added to the fact that, in aggregate anyway, the household sector in the UK, largely as a result of the lockdowns in 2020 and 2021, accumulated a really large amount of what you might call excess savings, which could not be explained other than that people were constrained in being able to spend money. That was of an order of £18 billion or so.

It is a big number and we assume that those who can will dip into that. Those who do not have accumulated savings are in a more difficult position, but they may be able to extend mortgages a bit, use credit



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cards and such. We assume that the aggregate impact of that is actually to take the savings rate pretty much to zero.

Q320 **Chair:** Did you have any evidence base for that? Did you do any survey work? What underpinned your work compared to the Bank's work on that?

Professor Miles: There is some survey evidence. People asked, "How are you going to deal with higher energy prices and other prices?" A significant proportion, not a majority but, from recollection, maybe 30% or 40%, say they will dip into savings if they can. We assume that not everybody is able to do that, but a significant proportion are. Just in a longer-term context, there is a huge amount of empirical evidence gathered over many years that temporary reductions in disposable income tend to be matched by a lower savings rate, to some extent anyway. We used both those ideas and took the savings rate down materially more than the Bank of England. That is the most significant factor.

Q321 **Chair:** Then the follow-up question to that is whether that means the risks to your forecast are much more to the downside than the Bank's.

Professor Miles: I am not sure about that, because, if you look at what happened to the savings rate in 2020 and 2021, it got up to something like 25%. That is an extraordinarily high savings rate. We go down to zero, essentially, in this forecast for a short while. Zero is maybe 5% below what you might call normal or average over the last 10 or 20 years, whereas 25% is massively in excess of it.

In some sense, we are only allowing for some relatively small proportion of the excess savings to be run down and it may well be the case that the total savings rate for the household sector is even lower than our forecast. All the risks are not on one side.

Q322 **Chair:** Then, to my questions about inflation, what are the assumptions there?

Professor Miles: The key factor, in a sense, is the partial unwind of the primary factor that has driven inflation up so much, which is the increase in energy prices and gas in particular. We use the market forward rates—which in some sense are a market expectation about where energy prices might go—over the next three years. They would imply, if things turned out in line with those market expectations, that there is a really substantial fall in energy prices, particularly gas prices, starting relatively early next year, but accelerating sharply as you go through 2024 into 2025.

Even if energy prices did not fall but just stayed where they were, because the rate of increase would become very small as you go into the future, if they just stayed flat, that in itself would very likely have brought the inflation rate down a lot. As I say, those forward rates imply that energy prices actually fall very substantially, by something like 30% or 40%, between the middle of next year and towards the end of 2024.



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That is the single most significant factor in driving inflation down really quite sharply in our forecast. It actually takes it slightly negative once you get into 2025 before then moving back up again.

Q323 Chair: Turning to business investment, you are pretty gloomy about business investment overall and you do not really seem to think that any of the measures that the Chancellor announced, like annual investment allowance for example, are going to have a massive impact on business investment.

Richard Hughes: No. Business investment has been pretty disappointing for a while in the UK and, with a shock to household incomes and a shock to consumption, business investment tends to track expectations of future consumption, so at least in the near term, given that we are forecasting a consumption-driven recession, it is unlikely that you are going to see lots of businesses investing into a recession.

You have on top of that an increase in the economy-wide cost of capital from the fact that interest rates have started to rise and that means that it is going to be harder for businesses to raise finance if they want to do investment. The hurdle rate for those investment goes up at the same time as your expectations of future sales are going down.

The Government now are going ahead with the corporation tax rises. Had they not done that, that would have provided some support to investment over the course of our forecast, but, as that measure is now going ahead and the corporation tax rise goes up, that further reduces the post-tax return on investment. All of that for the period we are looking at means that business investment stagnates for a few years before it starts to pick up towards the end of the forecast period as the economy recovers and interest rates start to come down a bit, at least in the short term.

Q324 Chair: Is it too early to say if the super deduction for investment, which was designed to prevent people waiting until corporation taxes went up to invest, has had an impact?

Richard Hughes: It is a bit too early to say, because it does not close until April, so it still has a few months to run. When we last looked at it compared to our original estimates, we had overestimated take-up and how much investment it was going to stimulate. It probably stands to reason, given all the uncertainty around the economic outlook that has now been created by both higher energy prices and higher interest rates, that that increases the headwinds that it would have to get over in order to incentivise further investment. It has not been enough for us to make a material difference to our estimate of the overall final size of the capital stock and levels of investment over the forecast period, which means for us it does not have a big impact on long-term growth.

Q325 Chair: Are there any other points to make on why your forecasts are so different from the Bank's?



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Richard Hughes: Let me just raise one final thing. I said there were three things. One was the vintage of data and the second was the savings rate. The third is this. Our final steady-state growth rate for the economy in the medium term is higher than the Bank's. We assume, in the long run, that potential output grows by 1.75%. The Bank has a trend growth rate of 1.5%, so our economy after the recession is recovering to a higher rate of growth in the long run than the Bank's does.

Q326 **Chair:** What is the underlying reason for that?

Richard Hughes: It is a number of things. It is partly assumptions about labour force. It is mostly assumptions about the pace of technology growth. You could describe the Bank as a bit more techno-pessimistic compared to us. We think that the rate of growth in technological innovation goes back to somewhere between its pre-financial crisis and its post-financial crisis average, whereas the Bank believes that the financial crisis was more of an augur of just a lower level of innovation going on in the world than we do.

Q327 **Mr Baron:** Can I just press you on your optimistic growth forecasts? Withdrawing from the detail a little bit, if you look back at history and periods of rising interest rates, high Government spending, taxes rising and living standards falling, traditionally that has been a mix for slower economic growth, not optimistic bands? Why is it different this time?

Richard Hughes: The main reason is this. The period you were describing is perhaps the energy shocks of the late 1970s and early 1980s. Those shocks lasted much longer than this shock is going to last, if you believe what the markets are saying about the futures price of energy. They have energy prices coming back down quite dramatically, as David was saying, over the course of next year, which provides some relief to the economy and makes this more of a temporary shock in terms of where we started to the peak.

It is the case that energy prices and gas prices in particular still remain much higher for the medium term than they were pre-pandemic, but the economy is already getting some relief over the course of next year from falling gas prices compared to the energy shocks of the 1970s and 1980s, where the oil price went up and just stayed high for years, which acted as a drag on economies. One can argue that monetary policy was further behind in catching up and reigning in inflation expectations, which also acted as a drag on growth and investment over that period. It is for that reason that we think that this would be a five-quarter recession. That is of a reasonable duration, but it is not like the stagflationary periods that other economies have suffered when they have had big energy shocks.

Q328 **Mr Baron:** You have mentioned that you are techno-optimists compared to the Bank. Would you accept that, despite all the technology prowess of the States, with their big companies there and so forth, and other examples around the world, it has not actually significantly boosted productivity and economic growth, as far as one can tell?



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Richard Hughes: All countries have faced a slowdown in their productivity growth, part of which seems to be driven by this fact that the rate of technological innovation has slowed. It is a puzzle for a reason. We do not precisely know why. Some people surmise that a lot of the innovation in the last decade or so has been about making consumer experiences more enjoyable rather than making our productive lives more productive, and there may even be a tension between those two things. The more diverting your phone is, the less you get done at work. That may be the case. It is something where we have to make a judgment. We have fallen somewhere in between the people who are very pessimistic about the outlook for technological growth and those who think that at some point we are going to go back to the world we were in, in the late 1990s and early 2000s.

Q329 **Danny Kruger:** I was going to ask some questions about your expectations as to the effect of the changes to capital expenditure that the Chancellor announced. We are maintaining the investment that was planned for the next two years, but its rate of growth will slow after that. Can you just talk us through what you think the impact on growth will be from that? There is a follow-up. I am interested in whether you distinguish between different forms of capital expenditure that the public sector might be making, in terms of effect on growth if Departments have the capacity to make choices within the limits they have been given and they are better and worse in the investment decisions they can make.

Richard Hughes: Looking at a long swathe of history, the UK traditionally has underinvested from the point of view of public investment. Net investment was under 2% of GDP back in 2000 and before then, and so we have typically invested less than 2% of GDP as a country in terms of investment coming out of Government.

More recently, and particularly in the March 2020 Budget, the Government set plans to increase public investment a lot, which saw it reach 2.5% of GDP last year. The Government's plans over the next few years, as you say, are more or less protected and it stays roughly around those levels. Obviously GDP is jumping around over the next few years.

From 2025-26 onwards, the Government freeze the capital budget for Departments in cash terms for the remaining three years of the forecast. That means that the share of public investment in the economy drops from around 2.5% down to something more like 2.2% or 2.1% by the end of our forecast period, so it is constant in cash terms but falling as a share of the economy and falling in real terms.

One thing to emphasise about growth effects is that it takes a very long time for investment decisions to have an impact on the long-run growth rate of the economy. If you just think about how long it takes to build Crossrail and HS2, these are 10, 15 or 20-year projects. They have a small economic benefit to aggregate demand while they are being built, but the main benefit they get is from putting a new bit of network infrastructure into the economy. You do not get any of that benefit until the project is finished, so you could have to wait 20 years, and you do



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not get the full benefit until you wait the whole lifetime of the project and probably also economic activity starts to cluster around it.

For all of those reasons, you do not get any sort of immediate bang for your buck from public investment, but what you do get is the benefit of building up over time a larger stock of public capital than you would otherwise have had in the form of that network infrastructure.

We had assumed, based on the Government's plans back in March 2020, that that increase in public sector net investment, which at the time was programmed in for about 0.7% of GDP, was going to raise the public sector capital stock by about a quarter, so a big increase. It is a 25% increase in the overall stock of public capital by the time it ran its course and in the period beyond our forecast horizon that could add 0.1 percentage points to the growth rate of the economy in steady state.

Given that the Government are paring that back somewhat, although not entirely, that will have an effect, but it will be beyond the forecast horizon for this document. When we do our next 50-year projections we will have to think about what it means to have a lower level of investment as a basis for those longer-term projections, but in a given five-year period anything the Government do with public infrastructure does not have a big effect on our assessment of growth, because most of those projects barely get started.

Q330 Danny Kruger: I do appreciate that, but it sends a signal, does it not, that will affect wider sentiment? You mentioned low business investment, which is a chronic problem in our economy. Is there an evidence link between public investment and private? Do you think that the decision to slow the growth of public investment might discourage private business investment, which might have a quicker return than these big public infrastructure projects?

Richard Hughes: It is one of the things that go into our calculation of the gearing ratio between public investment and overall growth. It is not just the benefit of people being able to get from one place to another more quickly. It also bails in private investment, but, as I said, only over a very long period and only if it is sustained.

We always come under pressure and are asked, "Why do you not give the Government more growth benefit for their investment decisions?", and it is partly because those decisions do not get sustained. Governments oftentimes reach for the capital lever as a way of reducing the deficit when they can and it means that, if we base a forecast on an assumption that the Government are going to maintain a high level of capital spending or the whole five years and they do not do it, they do not get the growth that we were assuming in the forecast. We have not revised down growth to take account of a lower public capital stock because basically the effects are so marginal in a five-year period, but when we come back to our next set of long-term projections we will see.

Q331 Danny Kruger: What about the different sorts of capital? Would you



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prioritise trains over broadband?

Richard Hughes: Not really, no, and for the same reason, in that we do not actually know what the Government are going to be spending their money on in five years' time. We have a rough sense. There are some projects that have been committed, but in five years' time it could be on hospitals, on trains or on something else.

Q332 **Danny Kruger:** Moving away from just purely capital expenditure, this is an awful question for you really. What is the optimum size of public expenditure? We read that, despite cuts to departmental budgets, the size of expenditure as a proportion of the economy is growing significantly from 39% to 43%. Partly that is because of smaller GDP and partly it is the cost of borrowing. This is, in a sense, not real money, but it matters in terms of the share of the productive part of the economy. What is your sense of the impact of, as it were, the gross tax take on medium and longer-term growth? What would be the optimum size of the Government, in your view?

Richard Hughes: We try to stay out of philosophical questions in the OBR because we are not philosophers; we are forecasters. For a country like the UK, we have a tax-funded health service, we have an inflation-indexed pension and we have a lot of debt.

A lot of what is driving the growth in the size of the state over this forecast, as it has done over successive forecasts, is those three things getting much more expensive, because interest rates are higher, inflation is higher and we just have a much higher debt stock than we have been used to. We used to have a 30% debt-to-GDP ratio in this country. We now have a 100% debt-to-GDP ratio and, when interest rates triple on that, it just hits Government spending very quickly.

The Government have taken some offsetting action by cutting, as we have discussed, capital spending and by reducing the growth rate of departmental current spending, but there was very little they could do. If they wanted to honour their inflation promise on the welfare system and keep servicing their debts, there was little they could do for those elements of expenditure but try to offset them elsewhere. They had a fiscal objective to get the deficit below 3% and get debt falling, and that implied the tax burden that we got.

Looking at the individual tax measures, we have not assumed any long-run drag on the growth rate, basically because you have offsetting effects. You had some tax measures that are slightly improved incentives to provide additional labour to the market and then other tax changes, like the freezes to thresholds, which basically dull those incentives. We concluded at the end of looking at it that it was not, in net terms, a material effect on labour supply.

Q333 **Dame Angela Eagle:** You have made it clear to the Committee that you had a forecast up and ready to go, which had been updated all the way through summer. When did you discover that Kwasi Kwarteng and Liz Truss were proposing to deliver their mini-Budget without using your



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services? Was it at the very last minute?

Richard Hughes: It is actually set out in the foreword to our document. We were informed on 7 September that the Chancellor was not going to be commissioning a forecast from us to accompany the announcements they were going to make later that month.

Q334 **Dame Angela Eagle:** Did they give you a reason why or did they just dispense with your services via letter?

Richard Hughes: They said that they would commission a forecast from us later in the year, and when they made their announcements on 23 September they said that they were going to commission a forecast from us by the end of the calendar year.

Q335 **Dame Angela Eagle:** Did you have any kind of exchange with them about how dangerous doing that might be, given that clearly the so-called growth strategy was a fiscal event?

Richard Hughes: We had no discussions with the Chancellor or the Prime Minister prior to 23 September. We met with them after that.

Q336 **Dame Angela Eagle:** Yes, they were famously shown walking down Downing Street amid the rubble. Do you think there are any lessons that need to be learned about this episode? Do we need a better definition of "budget" or "fiscal event"? Are there some things that might protect your position that Parliament ought to be thinking about in terms of changing legislation?

Richard Hughes: The Committee in its own reports has commented on the growing tendency in UK fiscal policy-making for major policy announcements to happen without forecasts.

Q337 **Dame Angela Eagle:** It is almost that the Budgets have become unmoored from where they used to be and we have had a trickle of them all the way through the year.

Richard Hughes: It is true. One cannot be too critical of specific instances, because there were cases like in March of 2020. My predecessor had just produced a forecast, then the pandemic hit and shortly after that Rishi Sunak, when he was Chancellor, announced the furlough scheme. It was perfectly legitimate that he needed to move at pace. We then worked very quickly to produce an updated forecast as a basis for the next round of decision-making, but you do not want to wait for us if you have to get something like the furlough scheme in place when people are facing losing their jobs. There have been other instances where essentially discretionary fiscal policy decisions have been made without forecasts. The health and social care levy and the health settlement alongside it was an example.

Q338 **Dame Angela Eagle:** Five fiscal events since March you have detailed in your report.

Richard Hughes: Yes. Good practice as defined by anyone, so not just us but by international organisations that set standards for these things,



would say that you should not make fiscal decisions without them being informed by an up-to-date view of the economic outlook.

Q339 Dame Angela Eagle: I just want to spend a little bit of time talking about the change of fiscal targets and the reduced headroom there. Since 2010 Conservative Chancellors have broken their fiscal rules 11 times. This autumn statement breaks the fiscal rule that was put into place last November by over £11.5 billion, you say in your report. It also breaks the current balance target by £8.7 billion. What are your thoughts about moving to a five-year rolling forecast? It has been called the *mañana* fiscal rule. Do you think it is useful?

Richard Hughes: One thing to say is that all Chancellors have ended up breaking their fiscal rules, with a few exceptions, since we started having them in the late 1990s when they were first set by Gordon Brown.

Dame Angela Eagle: I remember it well.

Richard Hughes: We seem to be moving to a system where fiscal rules are a guide for fiscal policy-making at the time, rather than something that ex post you can hold them to account for not having met. That was originally the case when Chancellors were on track to meet their targets, and then they broke them, did not do anything about it and set a new set of targets after an election. The timetable for fiscal policy-making and the timetable for political decision-making were not particularly well aligned.

There is nothing wrong with a system where you use your fiscal rules as a guide for policy-making, but it just means that you put a lot of weight on the forecast to tell you whether you are on track, rather than putting weight on the ONS to tell you in outturn data whether you are on track.

Q340 Dame Angela Eagle: It is more about having a fiscal rule attached to a forecast that tells you that you are on track rather than looking at the actual outcome, is it not? Perhaps the longer the fiscal rules take to be judged—five years now, so an increase of two years—the less likely that Chancellor is to be around to take the flak for the judgment, surely.

Richard Hughes: That is right, although I would also stress that we have been through a period of extraordinary volatility in the last few years. We have had a pandemic. We now have an energy crisis. You would probably need to do some quite perverse things with fiscal policy in order to meet your fiscal target in those kinds of contexts, given what is happening to the economy. It is probably a right thing to do to reassess what targets you set yourself in light of the new economic outlook.

The other thing that I should say is that, if we are in a world where shocks are becoming increasingly frequent and serious, and you are concerned about the level of debt and its affordability, you need to aim off a lot more for those shocks when they do happen. It has been a pattern of behaviour of all Chancellors that they leave themselves, as they have again with these targets, a few tens of billions of pounds in headroom against a fiscal target in five years' time, which is a tiny fraction of our forecast error over that time horizon.



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Given what we now know about where shocks come from and about the sensitivity of our public finances to interest rates and inflation, these are very small margins. If you are serious about getting debt down in outturn in five years' time, you probably want a lot more than the £9 billion that the Chancellor set aside.

Q341 **Dame Angela Eagle:** It is 0.3% of GDP, but a 0.4% increase in interest rates would wipe it out.

Richard Hughes: Yes.

Q342 **Dame Angela Eagle:** Debt interest spending has more than doubled in cash terms from £56.4 billion last year, which is 2.5% of GDP, to peak at £120.4 billion this year, which is nearly 5% of GDP. That is the highest since immediately following the Second World War. Who are the main beneficiaries of debt interest that the Government are paying out to? Are these bondholders?

Richard Hughes: They are people who own Government debt. The largest group are people in pension funds and insurance funds. They are the people who have long-term fixed instruments. About a quarter of our debt is now owned abroad, so foreigners, foreign central banks and foreign investors looking for fixed-term investments are also benefiting from this.

Chair: We will be coming to some more questions on this as well a bit further down the running order.

Q343 **Dame Angela Eagle:** There is a note that inflation-linked bonds have quadrupled from 6% to 22% and that the Bank's quantitative easing operations have reduced the maturity of Government debt. In hindsight, could the Government or the Bank of England have made decisions that would have reduced the debt interest cost for the Government?

Richard Hughes: There are two reasons why there is such a dramatic increase in debt interest costs in our forecast. First, we have much more inflation-linked debt than other countries, which means that when inflation goes up that just increases our borrowing costs immediately compared to other countries, which have more of an opportunity to allow inflation to erode the nominal value of that debt away.

Secondly, one side effect of quantitative easing has been to shorten the effective maturity of our debt, because the Bank of England has bought up long-term Government debt and replaced it with its own short-term interest. Because we consolidate both together when we think about the public sector, it means that the net maturity of our debt has shortened dramatically from about seven years down to two. That just means that any rise in inflation or interest rates hits the public finances a lot more quickly, because you are not waiting to refinance very much of your debt.

Q344 **Dame Angela Eagle:** Do you think this has happened almost by accident, because it makes the whole situation much more volatile and the prices much more sensitive to changes?



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Richard Hughes: It is a side effect of monetary policy. I am not saying it is wrong. I am not saying it is not necessarily a price worth paying.

Dame Angela Eagle: I was not asking you whether it was wrong.

Richard Hughes: It is an issue that we have highlighted a lot and have been at pains to discuss for many years. We have talked to this Committee about it and have highlighted the risks that come from shortening the effective maturity of debt as much as we have. In this forecast you have seen the consequences of that.

Q345 **Dame Angela Eagle:** Can I just ask a brief question about fuel duty, which you also highlight in your report? You point out that there is a planned 23% increase in the fuel duty rate due in late March, when the 5% cut, which was temporary, exits and the assumptions about a fuel duty escalator also come in.

The Government yesterday in the debate in the House seemed to be saying that this would not be happening. Why is it in your forecasts? What amount of money would the Government have to find if they decided not to go ahead with that hit to fuel duty?

Richard Hughes: Our forecast is based on Government policy that was announced back in March, which was that there was going to be a 5p cut to fuel duty this year, but then it was going to be made up from April next year, which means that you would add 5p on top of the usual RPI indexation. That was the policy as it was set back in March and as confirmed in the policy assumptions the Treasury gave us to use for this document when we produced it this month.

Were the Government to not go ahead with that policy, it would mean that they lose around £6 billion from the super indexation of fuel duty from April. That said, since 2010 no Chancellor has gone ahead with the planned indexation of fuel duty. When the time comes and they actually have to make the decision, they tend to decide to freeze it, but oftentimes they leave that assumption in there for a period because it makes the forecast look healthier than outturn turns out to be, because, faced with the decision come next March, they may make a different one.

Q346 **Dame Angela Eagle:** If they do that, that means they have to find another £6 billion for the scorecard to even keep the books in the situation they are in now.

Richard Hughes: Yes, that is right.

Q347 **Rushanara Ali:** I have some questions on fiscal consolidation. The Chancellor emphasised in his autumn statement that, with under half the £55 billion consolidation coming from tax and just over half from spending, this is a balanced plan for stability. Looking at the overall picture, what proportion of the Government's fiscal consolidation would you say comes from tax and spending and how does this compare with the fiscal consolidation of 2010?



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Richard Hughes: I might ask Andy to come in. I have been talking a while.

Andy King: There are a few ways of looking at this, because there have been many fiscal events since our last forecast. In terms of the measures that this Chancellor has announced in the autumn statement and the decision not to go ahead with cutting the basic rate of income tax that was announced on the 17th, that adds up to £62 billion in the final year of the forecast, which is precisely half and half tax and spending. The difference with the Treasury's numbers is that they separated out that basic rate income tax measure, so that is where they get the £55 billion rather than the £62 billion, but let us not split hairs.

Looking at things relative to policy as it stood in March, so how it has changed our forecasts, the consolidation is worth about £40 billion in the final year and that is simply because part of this Chancellor's consolidation is to cover the surviving tax cuts from the growth plan, of which the health and social care levy is by far the largest. That consolidation is about a quarter tax and about three-quarters spending.

Perhaps a more pertinent measure, rather than considering it relative to a baseline of a different set of policies, is what is planned to happen over the medium term. If you look at spending and tax relative to where they stood in 2019, spending rises by about 4% of GDP in eight years and so does the tax burden. In that sense, it is an expansion of both state and tax burden over that period.

If you compare it back to what happened in 2010, both what was planned over five years and what was delivered over about eight years, the share was about 80% spending and about 20% tax. Also, in a sense, it led to a shrinking of the state and a very modest rise in the tax burden through raising VAT.

Q348 **Rushanara Ali:** We were promised a few Chancellors ago, but I forget which one, that austerity was over. Austerity is clearly back now, from what you have said, and the IFS said that the British people have just got a lot poorer. The Bank of England Governor, when he came and gave evidence, said that the US has grown by 4.2% since the pandemic, the GDP of the Eurozone countries is 2.1% and yet the UK economy is 0.7% smaller than at the start of the pandemic. These are very worrying numbers for us. He also talked about particular shocks. Paul Johnson talked about own goals.

The autumn statement has stabilised things perhaps, in the light of the mini-Budget fiasco and your organisation being left out of the loop. How do we get out of this doom loop? What should happen in terms of generating growth? Are the steps that have been taken sufficient to get us out of this hellhole that we are in?

Richard Hughes: We need to be careful about providing policy advice to either Government or this Committee, but in terms of what we are currently assuming about the growth outlook and maybe what is holding that back, David, do you want to say a few words?



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Professor Miles: It was not a particularly comfortable position to be in even in March, because energy prices had already gone up quite a bit and the recovery from the pandemic was being held back slightly by a much lower labour supply than we thought. Even in March, things were not tremendously optimistic in terms of the outlook, but the things that have happened since then explain the scale of the shock to the population in the UK. They are increases in interest rates of a scale that simply was not on the cards back in March and a further but very large increase in energy prices.

Q349 **Rushanara Ali:** Just on the increase in interest rates, you are referring to what happened in September having a material impact. We had the monthly increase anyway before September. Could you just separate the two out and explain?

Professor Miles: What happened in September was that there had been an increase in interest rates, which was significantly higher in the UK than in most other industrialised western countries, but what you might call the excess increase in interest rates in the UK has all but disappeared now. By the time we do our autumn statement OBR forecast, the increase in interest rates in the UK looks pretty much in line with the global increase in interest rates, but it is very big.

Just as an illustration of that, if you took 10-year Government bond yields that we had back at the time of March, they were about 1.3% or 1.4%, and financial markets were expecting that that is where they would stay, pretty much. By the time we came to do the forecast a couple of weeks ago, they were 3.6%, so it was not far off a tripling in interest rates and, given the stock of debt that households own and that the Government own, that is a very big hit indeed.

The energy price increase was also very large. Again, if you go back to the time of March, market expectations for where gas prices were going to be on average in 2023 were very much lower than they are right now. Right now they are about 80% higher in global markets. This has affected anybody who imports gas.

Coming back to Paul Johnson's statement that the people of the UK just got poorer, those are the two reasons why it happened. The good news is that it is plausible that both of those effects will be somewhat attenuated as you look into the future. I already mentioned that, if you look at financial market projections as to where energy prices go, actually they fall by quite a lot over the next couple of years. That is very good for households. It is very good for companies in the UK.

Even in the short period since we produced the forecast, interest rates have continued to move down a little bit. The projections for the Bank of England bank rate have always been a little lower two or three years down the road. Our own projections for where mortgage rates go is that it might peak. The average interest rate on the stock of mortgages will go up for a while, but then it will turn the corner and start heading back downwards again, based on market forecasts for where interest rates will



go. I think 2023 is very likely to be a very difficult year, but the years after it will not be quite as bad.

Q350 Rushanara Ali: Going on to public sector net debt, excluding the Bank of England and the underlying measures of debt, it rises to a peak of 97.6% of GDP in 2025-26 before falling. Can you talk us through what the triggers would be that would enable UK public debt to fall as a proportion of GDP?

Andy King: There are two reasons why public debt turns around towards the end of the forecast. One is that, as energy prices and interest rates fall, although remaining higher than previously assumed, that gives support to the economy. If you think of energy prices as the price of an essential, it is almost like a tax rise that we are facing at the moment and it is almost like a tax cut when those energy prices fall back. That recovery in GDP growth means that the GDP is growing more strongly and that helps.

The second reason is the fiscal consolidation measures that were taken in the autumn statement, which are enough to bring borrowing down sufficiently that debt rises more slowly than GDP. Without those measures, debt would have risen forever more. With them, it stabilises and it falls by a very tiny margin at the end of the forecast.

Q351 Rushanara Ali: I just have one more question. I just wanted to see if you concur. Yesterday the chief economist of Pantheon Macroeconomics said that since 2020 we have seen a rise of roughly 400,000 in the number of people who are of working age but economically inactive, and that is about a 1.2% hit on the size of the workforce. When pushed, he thought that it could be a 0.7% hit to the workforce in terms of output. Would you agree with those figures?

Richard Hughes: On top of the reasons David gave, another reason why we came out of the pandemic and are going into this next crisis with a lower level of output than other countries is that we have been a bit unusual in seeing rates of labour market inactivity go up after the pandemic. A lot of other advanced economies saw labour participation rising, so inactivity falling, in the wake of the pandemic, but nobody really understands entirely why that has happened in those countries and we have had the opposite effect.

The reasons appear to be complex. There is a mixture of health factors. There seems to be a strong element of early retirement, given the age profile of people who left the labour force during the pandemic and are now not reappearing afterwards. To the extent that a large number of those people are in the older age group, we are fairly pessimistic about their prospects for re-joining the labour market over the course of the forecast that we have here. We have some return, but not very many, so you are still losing hundreds of thousands of people from the labour force from some combination of ill health, early retirement and other factors that appear to have come to pass during the pandemic. It is something that holds back output growth and the level of output in the long run.



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Q352 **Rushanara Ali:** There are 7 million people on waiting lists, so some of these people do want to return to the labour market. The question was about this 0.7% hit.

Richard Hughes: It is something that we want to look into. It would be wrong of us to pretend that we know the dynamics of this. We definitely want to look into it in more detail, because our forecasts heretofore have been based on what had been more optimistic assumptions about returns to the labour market. We want to better understand both what the data says about why they are out of the labour market and what the evidence says about why they are coming back in. We will look at it in more detail, but we did not get chance to in this report.

Q353 **Anthony Browne:** My questions, at least initially, are about departmental spending. Except for schools and hospitals, the nominal departmental spending was kept the same for the next two years as it was previously under the comprehensive spending review, but inflation is a lot higher than it was when that review came out. How tough is that going to be? How much savings are the Departments going to have make?

Richard Hughes: The Government have topped up the budgets of health, social care and schools over the years for which spending plans are set in cash terms going out to 2024-25, but, for the remaining Departments, they are, in essence, being asked to absorb the hit from higher inflation. We should stress that there is a debate about the right inflation index to use to measure the inflationary pressures on Departments. It is probably not as high as the double-digit CPI figure, but it is also probably not as low—

Q354 **Anthony Browne:** Is that because wages will not be going up as high as that?

Richard Hughes: A Department's biggest cost is workforce and wages are only going up by 5% or 6%. Government Departments do not feed people, so they do not have to worry about the food price, although certainly their employees do. They do not feel it directly. They feel it through what they have to pay their employees for wages.

In the near term, Departments are facing a squeeze from higher inflation over the current spending review period. From 2025-26, the Government have taken some cash out of their spending plans. They took about £18 billion out of resource budgets and about £12 billion out of capital budgets. That means that the growth rate of spending beyond 2024-25 falls from—

Q355 **Anthony Browne:** It goes to 1%.

Richard Hughes: Yes. It was growing basically in line with the economy at around 2.5%. It is now down to 1%. That takes about £30 billion in total out of both current and capital spending combined.

Q356 **Anthony Browne:** If I focus on that first bit first, if it is all being hit by inflation, how hard is it going to be for Departments to do that, apart



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from health and education?

Richard Hughes: It will be difficult. As part of the due diligence of the forecast that we do, we talk to finance directors in Departments to ask, "What kind of choices would you have to make?" Their assessment is that it is tough but deliverable, but it means that basically they cannot do all the things that they want to do in the near term and some Departments, as I said, are getting additional support for absorbing those costs, whereas others are not.

Q357 **Anthony Browne:** Beyond that, coming to the 1% increase in spending longer term, which shrinks spending as a share of the economy overall, assuming the economy grows more than 1%, some people have said that is impossible and it is just not going to happen. You have described it as plausible. How difficult is it going to be to meet that spending?

Richard Hughes: The Government do not have detailed spending plans beyond 2024-25, so we do not know what the allocation of spending looks like beyond that. The Government do have commitments that they have made on defence and overseas aid to grow those in line with GDP, so those are growing at 2.5% compared to an envelope growing at 1%. That squeezes the resources available to the rest. The Government have a commitment on real growth in per pupil spending in schools, which we assume is also met.

Then we make a historical extrapolation of the growth rate in health spending of just over 3% within that to look at basically what resources are left over for other Departments that are not covered by some kind of pre-existing protection, and what it would mean is that their budgets fall by about 0.7% per year in real terms. The reason why we say that is plausible is that, yes, it is a real cut in those Departments, but it is actually lower than what they have seen in some previous spending rounds. In the spending reviews of 2010 and 2015, that group of Departments was facing cuts of 3% to 5% in real terms per year in their Budgets. This is significantly less than that, which is why we think it is plausible.

The thing that weighs against it is that the same group of Departments always seem to be asked to bear the brunt of real cuts in their budgets. This would be yet another spending review where they are the Cinderella Departments rather than the ones getting real growth in their budgets, so they have to absorb further real reductions in their expenditure.

The other thing to bear in mind is that, while the Government have taken £13 billion out of spending in this forecast, Chancellors also have a tendency to put around £13 billion back into public spending as the moment of doing a spending review approaches and they actually have to allocate that envelope out around the Cabinet table.

Anthony Browne: The moment of truth.



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Richard Hughes: In the back of our minds we also recognise that this may well pose quite a plausible risk to the outlook by the time you get to the mid-2020s.

Q358 **Anthony Browne:** Various people, not least in the Labour Party, including colleagues on this Committee, have declared that it is a new age of austerity. In numbers, how does this constraint on public spending compare to what happened in 2010 and 2015?

Richard Hughes: Public spending is growing by less, but the rate of growth is still higher than they faced in those periods. As Andy was mentioning, during that period you actually had a fall in public spending as a share of GDP. We measure it as the pressure that it leaves for this unprotected group and it is on the order of minus 0.7% a year compared to minus 3% and minus 5% during those periods, but, again, at some point you get to a limit on how much pain you can continue to impose on the same Departments.

Q359 **Anthony Browne:** That is a fraction of the contraction there was previously then. It is a fifth.

Richard Hughes: It is smaller, yes, but it is still a real cut on a bunch of Departments that have previously faced real cuts in the past.

Q360 **Anthony Browne:** Would you call this an age of austerity?

Richard Hughes: Those are other people's words.

Anthony Browne: I knew you could not answer it.

Richard Hughes: Those sorts of words are not economic words and they are not words that we tend to use in our documents.

Q361 **Anthony Browne:** But it is not the same as what happened in 2010 or 2015. You are predicting inflation being very low, indeed negative, and a period of deflation. What happens if inflation is not that low? What is going to happen to the ability to meet those spending targets then?

Richard Hughes: It makes it more difficult in two ways. First, it increases the financial pressure on the Departments themselves, but it will also increase the financial pressure on Government. We have talked about how they have inflation-linked debt commitments and welfare payments and, if inflation turns out to be higher, there may also be an interest rate reaction, which would put financial pressure on Government. This whole forecast is premised on getting inflation under control over the forecast period and getting it back into single digits very quickly. If that does not happen, that very much adds to the Government's fiscal woes, both in microeconomic terms and in macroeconomic terms.

Q362 **Anthony Browne:** Coming to pensions and benefits, the Government have recommitted themselves to the pension triple lock and that has been welcomed by MPs across the House. How sustainable do you think that is in the long run? Is it not inevitable that at some point it will just increase the share of the economy that is given over to pensions?



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Andy King: Our long-term projections for a very long time have shown how the triple lock ratchets up state pension spending as a share of GDP, which is already rising due to the ageing population. The 2.5% floor out of the triple lock is really the element of it that pushes spending up and it binds in either two or three of the years in this forecast, pushing spending up as a share of GDP. The difficult thing about it is that the lower productivity growth is in the economy, the more often 2.5% will be the highest of the three numbers and the more often spending will rise as a share of GDP. It is a big pressure on the long-term public finances.

Q363 **Anthony Browne:** Is it sustainable long term?

Andy King: It will be sustainable if something else gives. The way we do the long-term projections is that we lay out the implications of policy and some long-term assumptions about health spending, which show the public finances on an entirely unsustainable path over the long term. That is unlikely to happen because something will give, but it illustrates the choices that will have to be made. If the triple lock is to be maintained for decades, it will cause public spending to rise and then there are choices about whether other public spending falls, taxes rise or borrowing rises.

Q364 **Anthony Browne:** Your forecast for welfare spending overall was £19 billion a year more than you had previously forecast in March and that was mainly inflation. Were there other factors there? How foreseeable was it?

Andy King: A little under half of it was inflation being higher than we expected in March and also the triple lock binding, so the triple lock uprating pushing up state pension spending. A little of it is the cost of living payments at the start, which we have grouped under that heading, but then there is a big chunk of it related to what we were talking about earlier, in terms of ill health in the labour market showing up pretty similarly in health-related and disability-related benefits. That adds up to almost £8 billion by the medium term.

Was that foreseeable? We did not foresee it back in March. What we have seen over the months in between are very high inflows into the disability benefits system, which were running at about 40,000 a month pre-pandemic compared to 70,000 a month this year. We had always expected there to be some pick-up after a health crisis, with the difficulty in administering the system through the pandemic, but it has been higher than we thought and seems to be more persistent. There seems to be something similar happening within universal credit in the health-related elements of it.

The upward revision is large. We have had had some in the past where the systems were changing and we got things wrong about how that would affect spending, but it seems to be related, at least in some way, to what is happening in the labour market and possibly to what is happening with the NHS waiting list. It is really something that is on our priority list for trying to understand a bit better how closely these things



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are tied and whether the causes are the same or whether it is coincidence that we are seeing it in different places in the forecast.

Q365 Anthony Browne: Are the main risks to this on the upside in terms of the welfare budget, because it will increase economic activity if inflation does not come down as quickly as you expect it to? Is there not quite a big risk that welfare spending will overshoot?

Andy King: The risks are in both directions. If inflation comes down more quickly, the opposite would be true. In terms of what we have done to the health and disability benefits, we now assume that these caseloads rise as a share of the population throughout the medium term. Hopefully, that might be pessimistic, but that seems to be what the data are showing us at the moment.

Q366 Emma Hardy: Good afternoon. I am not sure how closely you have been following Northern Powerhouse Rail, but you will have seen, perhaps, that it was in the Conservative manifesto in 2019, taken out by Boris Johnson, put back in by Prime Minister Liz Truss and taken out again at the most recent Budget. This was all part of the Chancellor's decision to keep the capital spending flat beyond 2024-25. I just wondered if you are able to tell us now, or in writing, what impact keeping that capital spend flat from 2024-25 would have on nominal or real GDP, interest rates and tax revenues. I am happy for you to put that in writing if you are not able to answer now.

Richard Hughes: I am happy to put it in writing. Just in outline terms, with the full increase in public investment that was planned back in March 2020, that saw an increase of about 0.7% of GDP in public investment. That sounds like a little bit, but it started below 2% so, as a share of total investment, that was a very big increase in the volume of public investment compared to what we are used to doing in the UK. That would have, in the long run, increased the public sector capital stock by about a quarter and the long-run growth rate of the UK by 0.1%. "Long-run" is well beyond the five-year period in this forecast.

Given that some of that has now been pared back, when the time comes to do our long-term forecast again, we will need to reassess how much of that capital stock we now expect to be there and how much growth that will be supporting. It is almost certainly the case that the direction will be negative for growth and productivity in future, because you will have less capital supporting less economic activity in the long run.

Q367 Emma Hardy: Are you able to say anything right now on the impact it would have on interest rates or tax revenues? Do you want to put that in writing?

Richard Hughes: Let us do a proper answer to that rather than me guessing off the top of my head. The effect on interest rates will probably be minor, if not zero. A smaller economy generates less tax revenue, so you would likely lose out.

Q368 Emma Hardy: In the statement, the Chancellor claimed that "our actions



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today help inflation to fall sharply from the middle of next year". I was just reading earlier that the OECD has actually laid some of the blame for the UK's poor performance on the energy price guarantee. The OECD warns that it will add to overall demand in the economy, increasing inflationary pressures in the medium term. The OECD is saying that the energy price guarantee is going to increase inflation, and the Chancellor is saying in his statement that his "actions today" are helping to decrease inflation. Who is right?

Professor Miles: It decreases inflation in a pretty much guaranteed way that one can quantify quite well, which is in terms of how much higher energy bills would be to households. That will feed through to consumer price inflation, and that would be something like 2.5% higher in the relatively near term. Instead of inflation being around about 11% now and into the early part of next year, that would have been 13.5% or maybe even 14%. That bit is pretty easy to quantify.

I am not quite convinced by the OECD argument that there is an offset to that because inflation is higher. It is true that the support measures to households and companies are expensive fiscally. It adds up to something like £100 billion over the next 18 months or so. That is extra spending power in the hands of households and companies. The way I would describe that is that it makes the recession shallower than it otherwise would have been. That might have some marginal impact because unemployment would have been higher without that; maybe wage settlements would have been a little bit higher. To my mind, those are all second-order things, whereas the first-order thing is that you could pretty much guarantee inflation would have been 13.5% or 14% in the near term without the support package.

Q369 **Emma Hardy:** I am just going to quote what the OECD has said and then ask for your comments on it. It has said, "Better targeting of measures to cushion the impact of high energy prices would lower the budgetary cost, better preserve incentives to save energy and reduce the pressure on demand at a time of high inflation". Is it right?

Professor Miles: It is a slightly strange way to put it. To the final point it makes about pressure on demand, we are almost certainly going to have a recession next year. We are probably at the optimistic end of the spectrum in thinking it is going to be relatively shallow. It still opens up a degree of what you might call slack—space capacity, insufficient demand, frankly, in the economy—and the support measures make that less bad than it otherwise would have been. I find the OECD description a little strange, to be honest.

Q370 **Emma Hardy:** That is interesting. Looking beyond the energy price guarantee and putting that to one side, does the fiscal consolidation in general in the statement help to bring down inflation throughout the forecast?

Professor Miles: The strategy is to give an enormous amount of support to households and companies in the near term, over the next 12 to 18 months or so. That has a logic to it because that is when the hit to



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people's budgets is greatest, when the reduction in demand otherwise would have been even bigger, when real disposable incomes, which already we think will fall something like 7% over the next couple of years, would have fallen even further, more like 10%. You claw the money back towards the back end of the forecast, further down the road.

Again, it is true that, if you did not have that strategy and you did not provide that amount of support in the short run, inflation might be a bit lower, because unemployment would be that much higher and the recession that much deeper. As for whether one thinks that is a good trade-off to make, I am not sure; I am not convinced myself.

Q371 **Emma Hardy:** That is really interesting, thank you. You have inflation falling into negative territory from 2024, which is way below the Bank's 2% target. Does this suggest that the market forecasts for interest rates, on which you base your own forecast, are too high, as the Monetary Policy Committee itself suggested at its November meeting?

Professor Miles: Ben Broadbent, one of the deputy governors at the Bank, before the November monetary policy decision made a speech in which he made it very clear that at that time he felt, with some justification, that the market expectations as to where bank rate was going to go were too high. They subsequently dropped back a bit, and we captured a significant part of that in our own projections. We just used what the market expectations were for bank rate by early November or late October.

As you rightly say, plugging those into our models, we get inflation dropping down to zero and becoming very mildly negative for most of 2025. You might look at that and say, "That just says that the Bank of England is not going to leave interest rates at the level that the market implies if you get down to those low levels of inflation". I am not so sure about that. The Bank of England, quite rightly, has a tendency to look through temporary big overshoots and undershoots of inflation. It is doing it right now. Inflation is 11%. The Bank of England is not setting an interest rate to bring inflation down to 2% by Christmas. If it did, it would need interest rates at 10%, which it knows would be dreadful for the economy, and the chances are, on the Bank's own forecast, that inflation does come back down. In fact, the Bank's forecast is that inflation drops down to pretty close to zero for a short while a little further down the road.

The Monetary Policy Committee's strategy makes a lot of sense. If you think that inflation has moved away from the target for a few quarters, maybe even four or five quarters, but that it is going to come back, do not add to everybody's woes by moving interest rates dramatically to try to bring it back really quickly. That is what they are doing right now, pretty clearly. I suppose our forecast implies that it does something similar on the other side of it if inflation temporarily drops down to zero or even goes negative a little bit. If you look further down the road, at least in our forecast, by the time you get through 2026 and go into 2027, inflation is coming back to the target.



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Would the Bank of England take interest rates to zero or even set them at negative levels simply because the inflation rate in the middle of 2025 is zero or mildly negative? If they look through all that and says, "It is going to come back to 2%; let us not overstimulate the economy right now", one can make a bit more sense of the market expectations for bank rate and our own forecast for inflation.

Chair: We have invited both the OECD and the IMF. Hopefully, we can get them timetabled so that we can ask them their side of the story.

Q372 **Mr Baron:** Can I stay with inflation but bring the subject to bear on our debt interest payments and spending? We know that overall debt interest spending is going to double this year compared to last. We also know that index-linked debt has quadrupled, certainly in the last 20 years, as a percentage of GDP, rising from something like 6% to 22% of GDP. Inflation is much more relevant to how much we spend on our debt interest payments.

You will have to excuse me because I am going to be slightly provocative here. Some of us are sceptical of forecasts when it comes to inflation. For long periods it was clear, courtesy of quantitative easing, that we had artificially low interest rates, inflation in pockets of the economy and high monetary growth, and yet still the policymakers, not just here but globally, were saying that inflation was not a problem. When it was evident that it was going to be a problem, it was going to be transitory. When it was evident it was not going to be transitory, it was going to fall away this year. There is a pattern developing here that does not inspire confidence. You have inflation falling into negative territory from 2024. I put it to you that that is for the birds, is it not?

Professor Miles: We will see. I hope we are right. If it turned out to be right—

Mr Baron: It would be a hell of a shock.

Professor Miles: It would be very helpful to households. The reason it might turn out to be right is that the market expectations of oil and gas prices themselves turn out to be a reasonable guide. That may be wrong. We use it as a central forecast but the uncertainty around that is obviously enormous. If one went back to the middle of 2021 and asked what the market forecast was for where gas prices would be today, I cannot remember exactly but it would probably be about 60p a therm; it is now three pounds whatever. That is six times higher than the market forecast.

Q373 **Mr Baron:** Inflation was rising before the Russian invasion of Ukraine.

Professor Miles: That is absolutely true.

Q374 **Mr Baron:** Monetary growth was going through the roof, and still policymakers, not just in this country, it has to be said, were suggesting that inflation was not going to be a problem. We will see what happens when the energy prices fall out, but it is a much bigger problem than policymakers originally forecast and they are now playing catch-up,



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having been behind the curve.

Professor Miles: I have sympathy with what you say. There was a tendency, during 2021, to stimulate demand through monetary policy, perhaps paying less attention than in retrospect should have been paid to the diminished supply potential of the economies, to bottlenecks and, here in the UK, to a labour force that was actually smaller than we thought. You ran up against demand pushing up against the supply capacity of the economy. That has nothing to do with Ukraine; I agree with that.

The reason why we have had such a spike in inflation, which otherwise may well have gone above the target levels of central banks—

Q375 **Mr Baron:** It has been above them for quite a while.

Professor Miles: Yes, absolutely. It was before the energy price thing. Added to that was something much more powerful, which was this enormous increase, which then took inflation into double-digit figures.

Q376 **Mr Baron:** I am conscious that we still have a little way to go, with other members wishing to speak. Can I just press you a little on this forecast that inflation is going to fall into negative territory from 2024? To what extent do you step back from the minutiae detail and look at medium-term drivers of inflation? I put to you that business supply chains are being shortened as we speak, partly because geopolitical tensions are hardening but also because of the pandemic. That is going to be inflationary. We have climate change and increasingly disruptive weather, causing food shortages and other things. We have ageing demographics, which is going to compound the labour shortages. We have the existence of zombie companies, courtesy of the extremely low interest rate policy that most Governments have employed, which has resulted in a misallocation of capital; there is very reduced creative disruption to make sure that the capital is allocated to more productive means.

When inflation gets embedded, it stays there. It is very difficult to shift if it enters the human psyche. Those medium-term drivers, which I accept are difficult to forecast and put on a dataset or computer—how do you forecast human behaviour?—suggest that inflation is going to remain elevated and volatile for some time to come, do they not?

Professor Miles: You are right in the sense that, if expectations of inflation really get baked into people's psyche and people, if they can, push for 7%, 8% or 9% wage settlements, as far ahead as one can look, it is very unlikely that inflation will drop into negative territory.

Q377 **Mr Baron:** What about those other medium-term drivers, if you do not mind me asking?

Professor Miles: Those other medium-term drivers to do with demographics and supply chains absolutely affect the supply potential of the UK economy. Our forecast reflects some of that, because we think that the supply potential of the UK economy, by the time you get to



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2027, is 3.5% less than we thought in March. We have embedded in our forecast a big hit to the supply potential of the UK economy.

What we also get in the short run are two things. One is a really sharp slowdown in the near term, which creates quite a lot of slack in the economy; unemployment goes up and demand falls short of even a diminished supply capacity of the UK.

Q378 **Mr Baron:** Finally, can I ask why you think policymakers, not just here, as I say—this is a global thing—have got it so wrong about inflation in the past?

Professor Miles: I am slightly repeating myself, but it looks such a catastrophic error, as opposed to a smaller error that was nonetheless significant. It looks catastrophic when you have a central bank with a target of 2% inflation and the inflation rate is 11%, and would have been, potentially, 13.5% were it not for Government support in the form of the energy price guarantee. That looks catastrophic. A significant part of the catastrophe there really is global things that no one could easily have predicted. They are coming from the Russian invasion of Ukraine and what has happened to gas and energy prices. One has to strip that bit out because, in a sense, it is a forgivable error.

Q379 **Mr Baron:** Even though they were ignoring monetary growth figures and evidence of inflation in widespread parts of the economy—

Professor Miles: I agree. That aspect of not having tightened policy, or in fact having loosened policy, on such a scale during 2021 could legitimately be described as a policy error. I describe it that way and it is easy for me to say that in retrospect. You perhaps saw it ahead of many people, listening to what you are saying. That is a policy mistake but it exaggerates it a bit when one looks at just the headline numbers for inflation now and into the next 12 months, because on top of that was the thing that you could be forgiven for not forecasting.

Q380 **Chair:** Just on this number that you have put in of £120.4 billion for interest this year, which is nearly 5% of GDP, a lot of that is to do with the index-linked structure. How much is cash accrual and how much is an actual rolling up in terms of the index-linked principle

Richard Hughes: It is certainly the case that the spike you see in interest costs this year is partly cash interest going up on nominal gilts, but another large effect of that is the fact that all of the impact on the accrued stock of index-linked debt gets scored in one year, as it were, on an accrual basis.

Q381 **Chair:** Indeed, and do we know how much that is? What is the breakdown?

Andy King: The total spending on index-linked gilts is £72 billion, and almost all of that will be the accrual, reflecting the fact that the value of the debt has gone up. A very tiny amount will be the cash.

Q382 **Chair:** It will not be in the financing requirement of the Debt



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Management Office.

Andy King: That is correct.

Q383 **Siobhain McDonagh:** I want to look at issues about personal income tax. Your economic forecast states that, by 2024-25, the tax burden will be at its highest level since the Second World War. What impact will such a high tax burden have on economic growth?

Andy King: The economic evidence, across countries and historically, with the kind of tax burden we are talking about in the UK in this forecast, is that there is not a tight link between how economies grow and how high the tax burden is, essentially because these are relatively moderate tax burdens and the tax rates that are charged are relatively moderate. There are no 80% tax rates left. If you look across Europe, you can find countries with higher tax burdens in the UK that grow more quickly and you can find ones with lower tax burdens that grow more quickly.

We do not look at the tax burden as a way to forecast growth. We look at individual tax measures. In this forecast, we have several measures that raise personal income taxes. Within the forecast, there are things that were announced previously, in particular the threshold freezes throughout personal taxation. I am careful not to say that they are raising a lot of revenue, because essentially we have negative real income growth at the moment, so those threshold freezes reduce the extent to which revenue is lost through real incomes falling. Relative to where the thresholds would have been if raised with inflation, they raise £25 billion to £30 billion, depending on which measures you include by the end of the forecast.

I will ask David to go through the detail, but we assume that has a moderate negative impact on labour supply.

Siobhain McDonagh: You are anticipating my next question.

Andy King: I will probably stop there and let David take over on how we think about what that does to the choices people make in the labour market.

Professor Miles: The tax measures in the Budget do a bunch of different things. Because the value of allowances will be eroded, there are more people who will face higher tax rates and their marginal tax rates are higher. Our assessment is that, on balance, that is a disincentive to work. It is a disincentive because we think that there are two offsetting effects, one of which is slightly more powerful. You get less pay to keep as a result of working the extra hour or the extra day in the week. That is a disincentive.

Q384 **Siobhain McDonagh:** I am sorry to interrupt, David. There are also incentives for promotion. I am thinking about the public sector in particular, so becoming a police sergeant, or becoming a deputy head or a head of year.



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Professor Miles: You are right. The disincentive effect is clear from higher taxes.

There is an offsetting effect that goes slightly in the other direction, which is about higher average rates of tax—for many people the average rate of tax they will pay on their income is going to be that much higher—and the extent that it reduces their disposable income. If they try to compensate for that, they might well work a little bit more. In economics jargon, you have a substitution effect, which is a disincentive to work, and you have an income effect, which is that, because your after-tax income is lower, you might actually work a bit harder.

Our judgment is that the distortionary negative effect of higher taxes is the stronger of those two, so you get a negative effect on the supply potential in the economy from labour supply being lower than it otherwise would be. Things like freezing the tax allowances over time will do that, so that is a negative. We have also had the decision not to implement a health and social care levy, so that is a reduction in tax. That is an offset to that. The net effect of all this is a small but nonetheless non-trivial reduction in the labour supply in the UK.

I agree very much with what Andy was saying, which is that, within limits, the tax take out of GDP can go up or down a few percentage points and it probably does not have an enormous negative or positive effect on the supply potential of the economy. One cannot push that argument too far, because there comes a point—it may be that we are not so close to that point yet in the UK—where the distortionary effects just get greater and greater. They are likely to be what you might call non-linear. While I agree that the distortionary effects of the kind of higher overall tax take out of GDP that we might see in the UK might not do what you might call material damage to the supply potential of the economy, the idea that you could just keep doing things like that without doing damage to the supply potential of the economy is clearly not true.

Q385 Siobhain McDonagh: Not everybody gets treated the same, do they? I thought the autumn statement was notable for its absence of the word “non-dom”. Research from the LSE indicates that clamping down on non-doms would raise around £3.2 billion. Is this a figure that you recognise?

Richard Hughes: We do not work on or comment on policies that the Government have not asked us to work on, so I am afraid that is a question for somebody else. We have obviously scored the measures the Government took quite some time ago to tax non-doms, as they do now. We have not explored alternatives.

Q386 Siobhain McDonagh: You are probably not going to answer my next question either. The Government’s stubbornness is resulting in tax-free income for the millionaires while millions face frozen tax allowances and council tax hikes. Some say £3.2 billion is a drop in the ocean. Do you agree with me that, when it comes to public finances, that is rather a large drop.



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Richard Hughes: That does not sound like a statement I could comment on.

Q387 **Anne Marie Morris:** How you adjust taxation is clearly a very important part to the overall economic growth. Yesterday we had a group of economists in. Their overall comment was that, while a lot had been done to address the tax and spend issues, in terms of meat about growth and levers to deliver that, it was a bit thin, and therefore it becomes increasingly important to make sure that the tax measures are right and proportionate, and will deliver what is expected, so that they do not dampen growth.

When you look at the increase in the personal taxes and the business taxes, which do you think has the biggest impact on growth and therefore we should be most concerned about on the growth agenda?

Richard Hughes: I would echo a point that David made. You did see some significant changes to tax policy in this autumn statement, and in the run-up to it even bigger ones were considered. In the end, they have had broadly offsetting effects because you have not gone ahead with the health and social care levy but then you have frozen the thresholds. We think the net effect of that is smaller than the effect that any one of those measures would have had, but mildly negative for labour supply. You have gone ahead with the corporation tax rise, which has an effect on post-tax incentives to invest.

Overall, if you look at how we have written up the policy measures in the book and the way we have analysed them in the forecast, there has really been not very much long-term growth effect from the net effect of all the policy measures taken in this autumn statement. There are other factors that have led us to change our view of long-run potential outputs in the UK slightly, but none of it really derives from policy measures taken in this Budget. There are some actions, like the ones we have on the public investment side, that in the longer term could have an impact on supply potential, but, to be frank, what is notable about this forecast in policy terms is that very few of them fed through into our long-term assessment.

Q388 **Anne Marie Morris:** That will be true provided that the estimates are right, particularly for something like corporate tax, because that is a big earner. I was a bit surprised, although I am perhaps now understanding what you said, that you think it will lower output by only 0.2%. When I look at the figures there, with the billions of expected tax receipts over the years, in 2023-24 we are looking at £88.8 billion; in 2027-28, we are going to £105.4 billion. Those are big numbers, which seem to me to raise a question mark. How certain are you? What is your level of certainty?

Perhaps before you answer that, let me refer back to something that Professor Miles said earlier, which is his assumption that the energy prices would come down and therefore that was the justification. My concern about that comment is that, while wholesale prices have absolutely come down—they are now lower than they were pre-



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pandemic—the challenge we have is that the output, the spend by the businesses and the individuals, is the retail price, not the wholesale price.

A number of individuals, partly through fear factor, partly having been incentivised to do so because it meant they could then benefit from the Government schemes, entered into sometimes quite long fixed-term contracts at the highest rate, sometimes for as long as five years. Does that not give you pause for thought that your feed-in assumption that energy prices coming down is going to make this all right on the night is perhaps a little optimistic?

Richard Hughes: David will want to comment on the underlying optimism of the forecast as a whole, but, on your first question about how uncertain we are about the corporation tax forecast, the answer is that it is one of the most uncertain aspects of our forecast always, and in particular this time, in that corporation tax is levied on profit, so it depends on the profitability of businesses. There are lots of allowances in the system. It is by its very nature much more volatile than income tax, which, so long as people have a job and are getting paid, they pay. This time around there are some big tax changes and some big changes in rates, which could have larger behavioural effects than you might expect from the smaller changes.

There are also some quite novel things going on, such as the pillar 2 reforms that try to collect a minimum amount of corporation tax from companies resident and operating in particular jurisdictions. It raises huge uncertainty about whether these things can be implemented and then, once they are implemented, how successful they are in a given period. In that sense, our corporation tax forecast is always very uncertain and there are additional reasons to be uncertain this time around.

On the wider question of the uncertainty underlying our whole economic forecast and the business investment part of it, David might want to add more.

Professor Miles: There are lots of sources of uncertainty in the forecast. You have highlighted one of the big ones, which is what happens to wholesale energy prices and whether that is passed through to households and companies. Our central assumption is that the market forward curves for the energy prices tell you something about the most likely path, but the prices can be dramatically different from what the markets are expecting right now. If they are, it will make a very big difference to the forecast. It could be the difference between inflation being zero or slightly negative in 2025 and inflation being 4%, 5% or 6%, which will have a huge impact on households, disposable income and all of that.

On the issue of some people having hedged, used futures contracts and fixed prices, that is absolutely right. Our assumption is that, as you go further into the future, those kind of hedges roll off and ultimately the underlying wholesale price is what drives the cost to people. You are right



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that it affects the dynamics of when they start paying for things. That is true.

Q389 Anne Marie Morris: My concern is that you were talking about this falling in 2024-25. If you are on a five-year fixed-term contract—

Professor Miles: It will not make any difference to you. You are absolutely right. The point at which our forecast gets inflation down to slightly negative territory is a little way down the road. It is towards the middle and back end of 2025, going into 2026.

Q390 Anne Marie Morris: Tariffs on 100 goods are to be removed. Will that shift your growth expectations? How much difference will it make? What goods do you anticipate are going to be impacted by this?

Andy King: That is probably one for me. This has not affected our growth forecast because the measures themselves cost around £150 million, which is very small relative to the economy. I am afraid I am not sure if all the goods are in the public domain, but these are goods that businesses have requested to be zero-tariff. The cost reflects how much they are imported. It is very important for those involved, but macroeconomically it is quite small.

Q391 Anne Marie Morris: I accept that. I can only assume, therefore, that it is more to do with, if you like, an emotional, cultural, feel-good factor, rather than necessarily purely financial, which might change behaviour. Otherwise you are right: it is very much small beer.

R&D is very important, and indeed the Chancellor said it was very important. He said that was something he wanted to ensure we retained, and yet the Chancellor cut R&D tax credits for small businesses. What is the impact of that going to be? The FSB is, as you know, absolutely agast and in full outcry about it.

Andy King: Again, in the forecast we have assumed, in terms of what it means for volume of R&D spending, that the gains from making the large-company scheme more generous offset what you lose from making the small-company scheme less generous. We have left our business investment forecast unchanged, because the composition changes but the total does not.

The R&D tax credits is one area of tax policy where the evidence of its growth impact is quite strong. The other thing that has become increasingly apparent in recent years is that the small-company scheme was being abused as well as being used properly, and so we assume that some of what happens as a result of making the small-company scheme less generous is just that there is less fraud in the system, so less money is lost that way. That is why the combination of the two measures raises money, but, in what we think of as the appropriate use of the two schemes, the rebalancing really is a balanced rebalancing.

Q392 Anne Marie Morris: I will move on to investment zones, but it seems to me, from you are saying, that proportionately the smaller businesses are being penalised to deal with the full problem. I appreciate you are not



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going to comment on policy but that was a very interesting comment, thank you.

The investment zones have been moved, so effectively, instead of being part of levelling up, they are now part of high-potential clusters. That would achieve a very different objective to the objective that was initially set. Clearly, it is a policy issue, not for you, but, in terms of the impact on economic growth, will that achieve it? What do you see as the targets for high-potential clusters? Are we talking about universities or high-tech areas?

Andy King: It is too soon to say. My reading of what is in the autumn statement document is that the Government are in the phase of talking to stakeholders, figuring out what the best approach is.

There have been similar policies over the past decade that we have looked at, such as the enterprise zones, which came with business rates relief, the free ports that are getting underway and those kinds of things. We have not moved our growth forecast for either of those. The thing that we tend to worry about when we look at them from a growth perspective is, essentially, whether they are regional policy that moves activity around the country or whether they are growth policy that increases the size of the pie.

With enterprise zones, the evidence was very largely that they moved activity around. With the free ports policy, the Treasury was quite careful in how it put together the prospectus approach there to try to avoid that. We have basically taken a "wait and see" approach on that. If they are successful, it will show up in growth, but we have not anticipated that. This will be in the same camp when the details come forward.

Q393 **Alison Thewliss:** I have some further questions around energy support packages. I wanted to ask, first of all, how the total cost of the new energy support package compares with the one initially announced in September.

Andy King: Just looking at the energy price guarantee, for simplicity, as announced in September, it would have cost £25 billion this year, which is the cost of the scheme as is going ahead, and about £27 billion next year, whereas, by raising the cap to £3,000, the cost is more like £13 billion. Stopping it after next winter, rather than extending it through the following summer, saves about another £4 billion.

Q394 **Alison Thewliss:** There is quite a significant difference between the two there. In your section on the various economic and fiscal risks within the EFO you note various cliff edges regarding energy-related support. Can you tell me a bit more about the risks of those cliff edges and what that will mean for people in the real economy?

Andy King: When we are talking about cliff edges, we are just talking about the schemes ending or changing at different points. We are making a relatively simple point. What you saw through the pandemic with the furlough scheme was that there were several end dates. The Chancellor



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looked at them each time relative to what was happening in the pandemic and decided to extend it a number of times.

The rise to £3,000 in April is during the recession in our forecast, and the ending after the following winter, depending on what energy prices are, could have very little effect. If the wholesale energy prices at the moment are proved right, which, as we have discussed, is very uncertain, when the Ofgem price cap comes back into play energy prices will basically smoothly move. If energy prices are much higher, there is a potential for another step up there.

Q395 Alison Thewliss: There is a huge gap in what could happen in various different scenarios, and that will have a significant impact on what figures the Chancellor has to play with.

Andy King: Yes, and they would have big impacts on everything else. If energy prices were higher for longer, you would expect the economy and tax revenue to be weaker. This is a very direct and visible impact, but it would affect everything.

Q396 Alison Thewliss: There is quite significant uncertainty within these forecasts.

Andy King: Yes, absolutely, as you would expect in a big energy shock.

Q397 Alison Thewliss: How much would it reduce the Government's bill if they passed on some of those additional costs and the uncertainty to households by raising the energy price guarantee again?

Andy King: Do you mean beyond its current end date?

Alison Thewliss: Yes.

Andy King: As I say, if the futures market is a good guide to the future, wholesale prices suggest that the Ofgem price cap will be around about £3,000 in early 2024, and declining quite steadily. In our central forecast, there is nothing more to change. If you extended the cap at a higher rate, it would not bind, but there is huge uncertainty around that.

Q398 Alison Thewliss: That is fair. Have you done any modelling on the effect that Government support schemes will have on energy consumption, how people will respond to these types of schemes and what they will do?

Andy King: Yes. The forecasts embody some work that the Government did a few years ago, which put elasticity in the response of energy consumption to higher prices. I think the number is 0.1. For every 10% the price rises, consumption falls 1%. That is a small response, because energy is obviously an essential. In other markets, it would be much higher. The forecasts embody that.

There is not hard data on this yet but, from some of the people monitoring what they can about energy usage, energy usage in October, the first month of EPG, was down a lot. Of course, it was an unseasonably warm month so I am not sure what we can draw from that.



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Q399 Alison Thewliss: There has been quite a significant bit of chat about the impact of increasing the home insulation money that the Government have proposed. A lot of that will not kick in for a while, so it may be outside of your forecast area. Do you have anything on how much insulation would have to be put in to see a significant impact on energy usage?

Andy King: I am afraid I do not have an idea of that.

Q400 Alison Thewliss: That is fair enough. To go further on Anne Marie's point about the impact on business, the businesses in my constituency have shown me some of the eye-watering bills that they are being asked to sign up to right now. It is really quite unaffordable but there is no other contract on offer. For some of those businesses, they are looking at that and saying, "The only way I can save any money is to cut production. I cannot save it on staffing. I cannot save it on the cost of the building. There is no possibility of saving anything on these bills because that is the cheapest I can afford". What impact does that have more widely in the economy if there is not support for some of these businesses come the spring?

Andy King: Within our forecast, the support for businesses is assumed to end in the spring. I know the Government are reviewing it for what will be put in place afterwards. That is one of the factors pushing up inflation for those businesses that can pass it on. It affects economic activity. It is one of the reasons why there is a recession. I do not know if David has more to say on that.

Professor Miles: It is not just the recession. Even though we think the best guess—it is not much more than a guess—is that energy prices drop back, they still drop back to levels that are way higher than they were just a couple of years ago. Because of that, we think that there is a permanent hit, as long as energy prices stay at that level, to the productive capacity of the economy. I said a while back that, by the end of the forecast, we think that the productive potential of the UK economy will be 3.5% lower than it otherwise would be. A big chunk of that is to do with energy prices just being permanently higher than we used to think was normal. It is a long-run effect, not just a short-run effect.

Q401 Alison Thewliss: Thinking of the businesses that I have been speaking to, there are a whole range of them, large and small, with some charities as well. They have these baked-in additional costs. Is there a point at which companies cannot afford that any more and you see a wave of insolvencies? There is already an increasing rate of insolvencies. Some companies have built up a lot of Covid debt. They really do not have anywhere else to go with this additional cost. Will there be a tipping point for the economy there as well, where you are seeing prices that businesses cannot afford and then a subsequent round of further unemployment? You have talked about unemployment going up at some stage as well.

Andy King: That is right. There are tipping points for individual businesses and then that accrues. It looks smooth in our forecast for



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GDP, but that is because that is the total. The total is a combination of those for whom it is the end of that business, those who can pass the costs on and those who can find another way. There is not a tipping point where the economy goes into freefall. It is just that, if prices remain higher and higher, more and more activity is unprofitable. That is the effect that David was talking about: the long-term damage done to the productive potential because a key input to production is more expensive.

Richard Hughes: It is a particular challenge for manufacturing because they just tend to be much more energy intensive than service industries, although some service industries have big premises that they have to heat and light, so they have energy bills that are a big share of their costs.

You referred to the OECD report earlier. It has a fairly idiosyncratic set of countries in terms of its growth outlook in the coming years. Another country that is also suffering particularly over the next year is Germany. That is for a slightly different reason than the UK. Germany has a very big manufacturing sector. They are paying much higher production costs. In the UK we rely a lot on gas for household heating and electricity, and businesses do to some extent if they are in manufacturing, but for the UK high gas prices put pressure on households, consumption and inflation that way. For countries like Germany, with large manufacturing sectors, it puts pressure on production because it is a big input into production.

There are parts of the UK where we have big manufacturing sectors. They are important employers and important parts of the local economy, and that can have knock-on effects on the rest of the UK.

Q402 **Alison Thewliss:** Have you done any modelling or forecasting on the cost of extending the current energy support for businesses and what that could look like?

Andy King: Again, because we are required to forecast on the basis of current policy, no.

Q403 **Alison Thewliss:** I am just curious because it sounded from the Chancellor as if there would be some announcement between now and next April. I just wondered where that is going to fall. It is outside of your forecasting here but before you come back to us with another forecast, so I was just wondering if there was any opportunity to take that into account in a separate report, perhaps.

Andy King: That would depend on—

Alison Thewliss: It depends on what the Chancellor asks you to do.

Andy King: I think the announcement was that the Treasury is reviewing it.

Q404 **Alison Thewliss:** I am a bit concerned because that is falling outwith this and your next one.

Andy King: You would expect it to be captured in the Budget.



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Q405 **Alison Thewliss:** Finally, I wanted to ask very quickly about your assumptions around immigration within the report. Is there anything more you could tell me about the basis on which you are making those assumptions?

Richard Hughes: We revised down our assumption about the long-run steady-state level of migration in the UK around the time of the referendum, in anticipation of the fact that our decision to leave the EU, and also our ability to set our own migration regime, would, in the long run, have an effect on net migration into the UK. It had been running at over 200,000 for the years running up to the referendum. We assumed that the Government's post-Brexit migration regime, which was announced and implemented in 2020, would reduce average levels of migration down to just over 100,000–129,000.

As it has turned out, and as we have observed the new system in operation when it came in in early 2020, net migration levels have stayed above 200,000. The last number we had, for the year to June of this year, was 239,000. In light of that, it looks as though the Government's new migration regime is basically just allowing in more people than we had anticipated. On that basis, we have revised up our assumption for the long-run steady-state level of migration, from 129,000 to 205,000. At the moment it is a bit above that, at around 239,000. It falls slightly down to that higher figure that we had as the basis for net migration in our previous forecasts.

Q406 **Alison Thewliss:** That is interesting. You probably will not want to comment on this but there was some rumour that the Home Secretary had resigned in part because of the forecast around immigration within the economic assumptions.

Richard Hughes: It is not something I have any knowledge of.

Q407 **Danny Kruger:** I want to push you a bit harder, if you do not mind, on this question of energy costs falling. It feels like we are betting the farm on this assumption. The whole basis of the forecast that you made, which is, in a sense, propping up the Government's autumn statement, is on the assumption of very radical falls in energy costs over the next year. When we are asking you why you assume that is to happen, you say, "That is because it is what the market is predicting". That is what markets do: they make predictions; they make bets.

Is that really it, or can you give us your own assessment of why you think energy prices are going to fall so that there will be negative inflation next year? What is the reason for that? Are you assuming the war is going to end? Is that it? Is there a massive increase in supply? What is it?

Richard Hughes: We do rely on the futures curves as the guide for what energy price to use in our forecast. It is a convention used by most other macroeconomic forecasters; the Bank of England does the same.

We are at pains to do sensitivity analysis and risk analysis around those numbers to explore the implications of different scenarios. Back in July, we produced a whole chapter of our fiscal risks report looking at the risks



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around the outlook for energy prices, including scenarios where prices came back more quickly and stayed low, as well as scenarios where prices stayed high.

Without getting inside the mind of people in the markets, you do not quite know what they are thinking about where energy prices will go, but you are right that it does assume that, at some point in the coming two to three years, supply pressures on Europe ease, through a combination of finding alternative sources of gas—LNG, in particular, which has been rising—and potentially an end to the war in Ukraine; that is anyone's guess and not something that we have any expertise in forecasting. For that reason, we do not even try.

There is also an element of demand destruction, which is that people shift away from energy; they lower the energy intensity in general of either their household or their business, or they find alternative sources of energy to gas, as a way of bringing down the overall cost of energy to the country as a whole.

We assume that some combination of those things brings down gas prices. That appears to also be what markets are using. You are absolutely right that a huge amount depends on that coming to pass. We do explore scenarios where gas prices are higher, and we are at pains to try to emphasise, when we make these kinds of judgments and our forecasts are conditioned on them, what the risks around those are.

Q408 Danny Kruger: It is another £70 billion on the energy price guarantee if the energy prices stay as they are. That is utterly unaffordable.

Richard Hughes: Yes, and also a lower potential output for the UK as a country very dependent on gas for its electricity as well as its heat.

Andy King: There is another way of looking at this, which is that the wholesale prices stabilise at a level that is three or four times what was normal before the war and before the pandemic. The world does not have less gas. It is being disrupted by geopolitics. One could look at this and ask why it does not fall all the way back to where it was. Maybe that is because the market does not think the world is going to end, or something else.

When we were looking at energy prices in the summer, some of the pushback we had from the experts we were talking to was that assuming fossil fuel prices remain high forever is just inconsistent with believing the world is going to be able to wean itself off fossil fuels and move to renewables, because the demand for them will fall. Uncertainty is huge, but it goes in both directions.

Q409 Andrea Leadsom: It is a pleasure to see you, and my sincere apologies for leaving for a chunk. It was a pre-existing commitment to a school, so I could not just let them down. Do say if someone has already asked you a question, and I will try to avoid asking something that strays.

Danny has made the point very well about the inherent difficulty with



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forecasting. Inevitably, the one thing you can be sure of with forecasting is that it will always be wrong, because you will never get it spot on. Have you ever got a forecast absolutely spot on?

Richard Hughes: No. Like weather forecasters, we try to put things within error bands. Like weather forecasters, we do not predict the precise temperature or the precise rainfall on a given day.

Q410 **Andrea Leadsom:** We never plan our picnics around the weather forecasts, but we certainly plan our public expenditure around the OBR forecasting. I am not trying to be difficult here but you are extremely predominantly male, and from the City and from the Treasury. Would forecasting benefit from having a more diverse range of people involved in making OBR forecasting analysis, in particular perhaps people who are very often deciding on the household budget, such as women?

Richard Hughes: Forecasting always benefits from taking in an array of perspectives and avoiding groupthink. I am pleased to say that in the OBR we have made a lot of progress in the gender balance of our staff. You are right that the three of us are male but, if you look at the composition of our staff, it is close to parity and has been getting closer over time. On our board we have a mix of genders; on our senior leadership team we do as well.

Q411 **Andrea Leadsom:** You do not really, do you? You have one woman on your advisory board. I googled it earlier because I was amazed that the three of you are men. You have one woman who does audit on your advisory board.

Richard Hughes: She provides a lot of advice and input to us. There are only five people on our board in general. I agree that there is more work to be done in the OBR to improve gender diversity at all levels.

Q412 **Andrea Leadsom:** It is not gender diversity, is it? It is difference of experience. Who runs household budgets? Predominantly which gender runs household budgets in the UK? Do you have the answer to that?

Richard Hughes: I am sure women play more of that role than men in the UK, as they do around the world.

Andrea Leadsom: Therefore, it is not just about gender diversity, is it? Noting the inherent difficulty with forecasting, it is about taking views from across different experiences. In the case of the OBR, you are not taking the experiences of the—very often—women who are running the household budget. You are predominantly ex-Treasury civil servants and City financiers, are you not?

Richard Hughes: I am afraid I would take issue with that. We do take views from a broad range of stakeholders. As I said, our staff is relatively balanced in gender terms and is from a range of both professional and ethnic backgrounds. Yes, I worked in the Treasury for much of my career. I also worked abroad in the International Monetary Fund and in other places. We do our best to reflect diversity and our staff in our



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perspectives. We talk to a very wide range of forecasters when we put forecasts together.

Ultimately, what we need is expertise in forecasting. That can be hard to find. It can be especially hard to find for the salaries we pay in the public sector compared to what you can get paid in the City, but we do our best. Our staff are not all drawn from the Treasury by any means. They are drawn from all sorts of different parts of the labour force. Above and beyond all, we want objectivity and expertise. We get that as well as providing a pretty good representation in terms of diversity.

Q413 Andrea Leadsom: I just have one last question on that. To me, an advisory board is a group of people who, by the nature of their diverse experience, are providing advice. They neither need to be paid a massive sum nor do they need to be expert forecasters. They just need to be people who have different life experiences. On that definition, your advisory board is not very diverse in gender or life experience. Would you say that is not correct?

Richard Hughes: We take advice from a lot of different sources. When it comes to our non-executives, there is one man and one woman. One has worked in the Treasury and one has not worked in the Treasury. To that extent, we benefit from advice from somebody who has done our job in a different context at a different time as well as somebody who has looked at and judged the whole system from the outside.

We do get a reasonably good set of advice from those two people. Those are not the only two people we rely on for advice. We look across the economic profession; we look across industry. When we have particular challenges like energy, we ask energy experts. We look to get as wide a range of views as we can because there is no single expert on each subject.

Q414 Andrea Leadsom: I just have a couple of questions on the windfall taxes, the energy profits levy and the electricity generator levy. Your forecast suggests that the energy profits levy is now giving a total headline tax rate of 75% of profits. That is quite a significant sum. That is designed through the autumn statement to be offsetable against investment in the UK. Can you tell us how you have taken into account the potential behaviour change and how you have forecast behaviour change?

Andy King: Yes. The energy profits levy was announced in May and amended in the autumn statement. This is one of the policy measures we are able to take quite a lot of external views on when we are thinking about how companies will respond. In a spreadsheet sense, the investment allowance and the higher tax rate increase the incentive to invest. If you were looking at this purely on those grounds, you would expect investment to rise as a result of the package of measures.

I forget the name, but the organisation that was previously known as Oil and Gas UK, which changed its name recently—



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Andrea Leadsom: What is it called? Is it Offshore Energies UK?

Andy King: No. I am sorry.

Andrea Leadsom: Is it the Oil and Gas Authority?

Andy King: I mean the Government-linked one. I am sorry. I have forgotten the new name. It carried out a survey of what people would do in response. We were particularly interested in that. Our concern was, although on paper it increases the incentive, whether the fact this is the tax rate or the tax system being changed frequently would act as a disincentive.

Based on a combination of looking at how this work in theory and the responses we were seeing in practice, we thought those effects would basically offset. We did not change our forecasts for the volume of investment in the North Sea as a result of this measure. We basically took the view that uncertainty would offset the investment incentive that comes through the allowance.

Q415 **Andrea Leadsom:** Your conclusion, then, is that the offshore energy companies will pay the additional tax, but they will not use the offsetable investment allowance in the UK. They will just pay it as tax rather than using it to invest.

Andy King: In net terms, yes, in aggregate. Some will respond one way; some may be put off by what has happened.

Q416 **Andrea Leadsom:** If you are a company and you are faced with, "You can just give us the money in tax or you can spend the money on growing your business", why would you say, "I will just pay the money in tax?"

Andy King: Some will have investment plans in place already. We have assumed that those investment plans will not change in aggregate. I am not saying that they will not move for individual companies.

Some will decide to invest somewhere else or do less because the tax rate is high. They will think, "What if it changes again?" They will make that type of consideration. Some will be able to offset all because they have large investment plans and some will not. The assumptions we have made are based on the assumption that there will be offsetting effects from those discouraged and those encouraged.

Q417 **Andrea Leadsom:** I would have thought the rational thing to do was to offset right up to the level of the tax that is allowable. That would be the rational thing for a company to do. Anyway, if prices unexpectedly did return to 2021 levels, do you have a forecast on what that would do to tax receipts?

Andy King: We did not look at that sensitivity in the EFO this time. We looked at the potential impact of much higher prices, given what we were talking about earlier in terms of how exposed the public finances are via the EPG.



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We have revised up our forecast for revenues very substantially. The impact on revenues from this tax and, more broadly, the taxes on the North Sea would be of the order of several billion, and possibly in the tens of billions, if prices were to collapse, yes.

Q418 Andrea Leadsom: There is not a similar investment allowance for the electricity generator levy. Does that mean you have costed investment behaviour differently or have you assumed, like with the offshore energy, that it all nets out?

Andy King: This one is more complicated. I feel less confident in what will happen. The thing that we focused on most here was that the generators levy is in some sense more clearly a windfall tax. It is not just a higher rate on all profits; it is a tax rate that is applied to revenue beyond a certain price and it is only for those generators in the renewables sector that are not covered by contracts for difference schemes.

As I understand it, new investment in renewables is almost always covered by contracts for difference now. Those contracts still provide the long-term certainty that the energy experts we speak to deem to be the most important factor in new investment in renewable generation. With this one, the assumption is again that it does not affect investment, basically because new investment does not go into non-contracts for difference renewable capacity. That investment goes into the contracts for difference scheme. That is where that applies.

As I say, I feel less confident about that one. It was a new measure. We could not follow what surveys and businesses were saying as it was happening.

Chair: We have the Chancellor tomorrow so we may want to try that line of questioning again. In terms of today's session, you have highlighted some of the challenges you faced over the summer and in preparing this forecast. Of course we accept that all forecasts are wrought with uncertainty. I just want to check that there is no one who has burning question before we leave. I can see a couple of burning questions.

Q419 Mr Baron: Very briefly, earlier I shared with you certainly my frustration and probably others' frustration about the lack of forecasting accuracy and being behind the curve on the inflation issue and so forth. You talked about going to the market to base a lot of your forecasts, but the market is often proved wrong, as Danny was highlighting. To what extent do you do your own research on, for example, the inflationary effect of shortened business supply lines and demographics? Do you do any of that research yourself?

Richard Hughes: We do. When time permits and with the limited staff complement we have, we do a lot of our own research. In particular, we do our own research when we have these kinds of idiosyncratic shocks. As I said, back in July we did a big report both on the supply chain issue and in general whether global trade intensity is shrinking, whether countries are becoming more self-reliant and what that might do to



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productivity and growth as well as the near-term risks around the energy markets.

We do our own research and our own analysis. We talk to experts who do not fall under the traditional definition of “macroeconomist” but who know something about a trend that is driving economic developments, such as energy price changes and supply chain effects. We look into those where we think they have macroeconomic relevance or where they are novel and we need to understand them.

Q420 Dame Angela Eagle: I just wanted to ask about the increasing tendency of the Government to allow council tax increases to take the strain of paying for social care, particularly. On page 34 of your report, you say you have assumed that the extra flexibility the Government have given local authorities to raise council tax will all come through and they will raise it by 5%. Have you checked to see whether this has happened in the past?

What would the distributional effects be, if all of this money were to come through? The capacity of councils to raise relevant amounts of money in that way is skewed in different areas. My own area, for example, cannot raise nearly the same amounts of money that can be raised in areas where property prices are much higher. When this happens, what do you do to take account of the distributional effects?

Andy King: On the first question, we do look back. For council tax in England, the referendum principles have been 2%, 3% and 3% plus the adult social care precept for some years now. The outturn is typically very slightly below the maximum. That is what we have assumed again here. We do not look a lot at the distribution of how the revenue comes in and the expenditure needs. That is not something we focus on for our job of forecasting the overall public finances.

Q421 Dame Angela Eagle: When that happens, some areas cannot use money that they cannot raise because they are in a different position to other more affluent areas with higher property prices. Therefore, there are skewing effects in the way in which that money can be used to deal with the need there is locally, are there not? Over time they are getting greater and greater, but you do not pick any of that up.

Andy King: This is one of those issues that is clearly very important, but it is not core to our job of forecasting the overall public finances.

Chair: Again, we have the Chancellor tomorrow.

Danny Kruger: I appreciate it has been a long session, so I very much appreciate your patience and time. On page 19 of your outlook, you talk about mortgage rates and the effect on real household disposable income. You make the point that the impact of higher interest rates on mortgage rates will be offset by increases in the savings rate, even though you think the savings rate is going to decline. There is an implication that this is a net neutral effect, but you also acknowledge that the change will be unevenly distributed, which indeed you would expect.



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We are talking about people with mortgages having to pay very high mortgage rates and other people with savings benefiting. There might be some net neutral effect in theory, but in practice we have people with very high mortgage rates to pay. Are you not concerned about the risk of a mortgage crisis, given rising rates?

Professor Miles: You are absolutely right: it is very unequal. Most of the savings are disproportionately owned by people who have higher incomes, who are older and who probably have lower mortgages relative to their resources. Younger people who might have very little savings might have a large mortgage relative to their income. We factor some of the implications of that for consumption by assuming that the negative hit to people who have a big mortgage has a bigger downward effect on their consumption than the positive effect on somebody who has the savings.

Is there the potential for real problems in the housing market and large numbers of people falling behind with their mortgages? I am afraid that potential is there, and there is certainly a risk of that. We use the swap rates to try to work out where the average interest rate is going to go on the stock of mortgages. It goes up for a while. It is slow, though. As you will know, mortgages in the UK predominantly now become fixed-rate mortgages. Higher interest rates do not feed through to most people's mortgages until they re-mortgage. It is a slow and gradual increase in the average interest rate on mortgage stock. For any individual household, it is a big shock at the time their fixed-rate deal runs out.

The Bank of England and the Financial Conduct Authority have had rules, of which I am sure you are aware, for some years saying that mortgage lenders have to assess, when they make a new mortgage loan, whether people could live with a sudden 3% increase in the mortgage rate. Those rules have been there for several years now. They have been in place for at least seven or eight years, by my recollection.

The majority of large mortgages, relative to people's incomes, have been taken out in the last seven or so years. In principle, the mortgage lenders have had to assess whether people could live with a sudden 3% increase in interest rates. That sudden 3% increase in mortgage rates is coming for a very large proportion of people. One hopes that the banks and the building societies had taken pretty seriously what the new rules of the game were and judged whether people could live with a 3% increase. Is there a risk that large numbers of people cannot? Yes, there is a risk.

Chair: Thank you very much. Thank you for your time this afternoon. You have allowed us to probe and scrutinise quite a lot of the assumptions you have made. You have acknowledged yourselves how hard it is to forecast, particularly in these very fast-changing circumstances.

I noted one potential follow-up, which is if you have any more information on the Northern Powerhouse Rail situation. Other than that, that is the end of the session.