HOUSE OF COMMONS

Treasury Committee

Oral evidence: Autumn Statement 2023, HC 286

Tuesday 28 November 2023

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Watch the meeting

Members present: Harriett Baldwin (Chair); Mr John Baron; Drew Hendry; Keir Mather; Anne Marie Morris.

Questions 1-95

Witnesses

I: Richard Hughes, Chair, Office for Budget Responsibility, Tom Josephs, Member, Budget Responsibility Committee, and Professor David Miles CBE, Member, Budget Responsibility Committee.

Examination of witnesses

Witnesses: Richard Hughes, Tom Josephs and Professor David Miles CBE.

Q1 **Chair:** Welcome to this Treasury Committee sitting, in which we scrutinise the autumn statement. This is the first of three evidence sessions. This morning, we have the Office for Budget Responsibility; this afternoon, we have a panel of economists; and tomorrow afternoon, we have the Chancellor to ask questions of. I will start by asking our witnesses to introduce themselves.

Richard Hughes: My name is Richard Hughes. I am chair of the OBR.

Professor Miles: I am David Miles. I take the lead on economic analysis at the OBR.

Tom Josephs: I am Tom Josephs. I take the lead on fiscal analysis at the OBR.

Q2 **Chair:** Thank you. I want to look closely at the claim being made by the Government about debt being on track to fall. In your report on the autumn statement, one of the things that you highlighted is the fact that since the Office for Budget Responsibility was established, you have had six different sets of fiscal rules. Would you describe the current set of fiscal rules as the loosest in that series of six?

Richard Hughes: They are the loosest in the sense that they target a trajectory of debt in five years’ time, but they never actually target the out-turn level of debt. Essentially, there is a rule that constrains the

forecast rather than the out-turn, because there is a rolling horizon for the trajectory of debt. The Chancellor is always targeting getting debt falling in five years' time, but that deadline shifts forward every time we shift our forecast horizon forward, so in that sense the rule never actually requires the Chancellor to get debt falling; it just requires his policy settings at a given point in time to mean that debt will be falling in five years' time.

In this autumn statement, we saw that when our forecast rolls on a year, the Chancellor takes full advantage of the fact that he has an extra year to get there, in the sense that in our latest forecast he has headroom of about £13 billion against his debt falling objective in 2028-29, but if you look at the year before, he has a wafer-thin margin to get debt falling—just over £1 billion—so he has actually reduced his margin against getting debt falling in the previous year, rather than increased it. He seems to be taking full advantage of the fact that when he gets an extra year to get debt falling, he uses up some of that pot.

Q3 **Chair:** I believe that your numbers also show that whereas previously, five years out, you had one set of figures, now in the set of figures for what was five years but is now closer to four years, debt is actually higher than you had previously forecast.

Richard Hughes: That is right. Because it is a target for getting debt falling, rather than for getting a particular level of debt, all that matters is the difference between the level of debt in the final year and the level of debt in the previous year as a share of GDP. Even on that metric of getting debt falling, the margin in what is now year 4 of our forecast, back in March was £6.5 billion but is now just over £1 billion, so he has used up some of that margin in the fourth year. It is only the fact that he has a fifth year that the margin increased.

Q4 **Chair:** Do you think it is fair to characterise the autumn statement as one in which debt is on track to fall?

Richard Hughes: In its own terms, the policies that the Chancellor has set out would mean that debt is on track to fall in five years' time if nothing else changed between now and then. One of the things that we know about the forecast is that a number of risks and pressures are embedded in it, not least the one around the assumption we have to make—because it is stated Government policy—that fuel duties are indexed to inflation. There are also risks around the path of public spending, which is now much tighter in real terms than it was back in our March forecast, because inflation has gone up, but the Government have not adjusted their public spending plans. It is a path where a lot of pressures are pushing up on spending and pushing down on revenues, which would mean that that objective to get debt falling in five years' time is suddenly at risk.

Q5 **Chair:** Thank you for the shout-out to our "Fuel Duty: Fiscal forecast fiction" report in your reporting. My understanding is that the 5p temporary cut to fuel duty is set to expire on 23 March. If the Chancellor decides to extend that temporary cut, how much difference does that

make to the headroom?

Richard Hughes: Overall, were he to decide to do what all his predecessors have done since 2011, which is to freeze fuel duty over the next five years—just as it has been frozen every year since 2011—he would lose around £6 billion off that £13 billion headroom. He would certainly miss the deadline for the previous fiscal rule, which was in 2027-28. Of the £13 billion that he has in 2028-29 now, he would lose about £6 billion of that from freezing fuel duty rather than indexing.

Q6 **Chair:** The reason I chose to lead off on the debt is that obviously we are paying a lot more to service that debt as a country—on the country's mortgage—than we were when you last did your numbers. There were some striking figures on that in your reporting. This year alone, debt interest spending has reached 4.5% of GDP, and I noticed that you highlighted that, as a share of total tax receipts, the UK spent more on servicing its debt than any G7 economy. Do you want to elaborate a bit on that?

Richard Hughes: It is both because we now have a relatively high level of debt, at almost 100% of GDP, and because interest rates have now returned to levels that we have not seen since the financial crisis, around 4% or 5%. That is putting more and more pressure on the public finances. They are consuming around £100 billion a year in day-to-day costs, which would mean it is second only to the national health service as a single spending item in our forecasts.

You can see the pressure that puts on the public finances in terms of the limited options that it gives the Chancellor. Just in the forecast that you saw, between March and November, the increase in the interest rate of around 100 basis points added £15 billion worth of extra cost to managing that high level of debt. One reason why we tend to get the hit from rising interest rates more quickly than other countries in the G7 is a point that we have raised with the Committee before. We have a relatively short average maturity of debt these days due to a combination of the effects of quantitative easing shortening the net maturity of the liabilities of the UK public sector, as well as the fact that we have a relatively large share of inflation-linked debt. When you have both high inflation and high interest rates, that is a sort of double whammy for our interest rate costs on the quarter of public sector debt that is directly linked to inflation.

Q7 **Chair:** Professor Miles, do you think we are in a debt trap, where effectively it is very hard to get out of these rising debt costs that the economy is having to pay for?

Professor Miles: It is a bit more difficult than it was because interest rates have gone up and the likely growth rate of the UK economy has not. The balance between the cost of Government debt and, if you like, the increase in the tax base because the economy is growing, has become a little bit less favourable. I think that is why it has proved to be difficult, even over a five-year horizon, to stop the stock of debt rising, and it just about stops on our central forecast at the end.

Interest rates move around a fair bit, so it is not as if this is an inexorable trend upwards in interest rates. It would be too pessimistic to assume that this is just going to get increasingly difficult. In fact, on our central forecast, the interest rate set by the Bank of England, Bank rate, comes down a little bit a few months—in fact, more than a year—down the horizon: it starts falling from 5% and dips beneath that toward 4%. It seems unlikely that one will get back to the situation we were in just a couple of years ago where Bank rate was almost zero, where the Government could borrow in the inflation-proof market at real interest rates that were minus 2% or 2.5%, or even minus 3%, and lock in at that rate for 20 or 30 years. It seems very unlikely that we are going to go back to that world.

Q8 **Chair:** Tom Josephs, if the Chancellor had made different choices, how much could the debt have been paid down at this autumn statement?

Tom Josephs: There is a number of different ways you could look at that. I think one really interesting feature of our latest forecast is that we have really strong growth in receipts over the forecast period this year and then through the forecast. That is primarily being driven by the stronger, more persistent and more domestically driven inflation that we have seen since our last forecast. That inflation and higher earnings have driven stronger receipts, particularly in combination with the freezing of the personal tax allowances, so we have much stronger receipts over the forecast period.

That stronger inflation has also increased spending, including welfare spending, and debt interest, as we have been discussing, but around 40% of the expenditure is departmental expenditure, where the level of spending is set by the Chancellor, and at this event, the Treasury basically decided to increase that departmental spending by only a relatively small amount.

Q9 **Chair:** My question was really whether the Chancellor could have decided to pay down some of the debt at this fiscal event.

Tom Josephs: I was getting to that point. The choice to keep departmental spending relatively constrained is effectively what led to the lower borrowing in our forecast. If the Chancellor had chosen to increase spending and maintain it at the same real-terms level as in March, that would essentially have cost around £19 billion and would have taken away much of the windfall in borrowing that we had in our forecast.

Q10 **Chair:** We will get into departmental spending in a moment. I just wondered whether he could have chosen to pay down any of the debt at this fiscal event, and by how much.

Tom Josephs: Yes, he could have chosen not to introduce the measures that he chose to introduce, or he could have chosen to increase spending, as I have outlined. The improvement in borrowing before the Chancellor announced his measures was around £27 billion, so obviously he could have chosen to have borrowing falling by that amount.

We have some analysis in the book that shows that the fiscal loosening that the Chancellor decided to announce at this event is the third largest, I think, since the OBR was set up in 2010. The two previous largest ones were the ones that were announced as part of the covid response. So on a historical comparison, the Chancellor announced a fairly large fiscal loosening.

Q11 **Chair:** Do you agree that it is the biggest package of tax cuts to be implemented since the 1980s?

Tom Josephs: That sounds like it refers just to the tax cuts. I am not sure on that particular statistic. The one we have in the book looks at the overall fiscal loosening compared with fiscal loosenings since 2010, and it is the third largest. The March Budget had what I think was the fourth largest, so you have seen two successive events where essentially the Chancellor has chosen to loosen fiscal policy in the face of improvements in borrowing.

Q12 **Chair:** Is it fair asthat the Treasury characterises this as the biggest package of tax cuts to be implemented since the 1980s?

Tom Josephs: I am not sure whether I have the numbers to say whether that is right.

Q13 **Chair:** Richard, do you think that that is a fair statement?

Richard Hughes: It depends on whether you look at one fiscal event in isolation or you look at what is going on with the whole of the tax system. If you take what is going on with the whole of the tax system, over the medium term the tax burden is going up because the effective threshold freezes outweigh the effect of the measures taken.

Q14 **Chair:** If the Treasury chooses to say that, at this fiscal event, this was the biggest package of tax cuts to be implemented since the 1980s, that has to be factually true, hasn’t it?

Richard Hughes: Our historians have not fact-checked that one, and it is not a figure that we have used. It was certainly a large discretionary fiscal loosening, and certainly in the OBR era it is the third largest after the March 2022 economic and fiscal outlook, where we had a big increase in public spending, and then basically the furlough scheme and the big pandemic packages. It is the third largest fiscal loosening in our era. We have not gone back and looked at the Treasury’s own history.

On your earlier question, Chair, we produce a forecast for the debt-to-GDP ratio on a pre-measures and post-measures basis. Another way to answer your question is: if the Chancellor had not taken any policy action in this autumn statement, what chart 4.15 shows is that debt would have been £85 billion lower by the time we get to 2027-28—the end of our forecast period—so he would have reduced debt by £85 billion, which is around 3% of GDP.

Q15 **Chair:** Thanks. That is very helpful. One of the things that is quite startling in your report is the expectations you put on the lifetime loss of

the Bank of England's holdings of gilts. I believe you have estimated that that goes up from £63 billion loss to £126 billion loss since July. That seems to the Committee to be a very large number. We are also doing a separate inquiry into quantitative tightening, and I wonder if you could talk us through how that affects what headroom the Chancellor has to manoeuvre, because it is a very big number.

Tom Josephs: As you say, we have updated our projection of the run-off of the asset purchase facility over the forecast period. I should say there is a lot of uncertainty around that number. The Bank of England sets a plan for the run-off of the APF for the year ahead, so we use that number for the year ahead, but after that the Bank does not set out a detailed plan, so we use our own assumption for the run-off over the rest of the forecast period. That assumption is not greatly different from March. We broadly assume a run-off of around £100 billion in the early years, and then around £80 billion in the later years. The main reason why the estimate of the lifetime loss has increased is because of the increase in Bank rate.

Q16 **Chair:** We understand that. The question was really about what impact that has on the Chancellor's ability to spend. How does it constrain? I understand that some of the profits from the asset purchase facility were transferred to the Treasury. The Treasury has written an indemnity to the Bank of England on these losses, so how does it affect the Chancellor's ability to budget responsibly?

Tom Josephs: The main way it impacts on the numbers is through the cost of the Government's debt interest bill. As Richard said, the fact that a large quantity of gilts is now held in the asset purchase facility means that the UK's public finances are more sensitive to movements in short-term interest rates, because essentially the asset purchase facility remunerates the reserves that the APF—

Q17 **Chair:** We understand that. How much less does the Chancellor have this year to spend as a result of the asset purchase facility and the cost of the debt? How does that affect his spending in the real world?

Tom Josephs: It is a considerable element of the increase in debt interest costs through our forecast. I'm afraid I do not have the exact number at my fingertips. I don't know if Richard has managed to find it.

Professor Miles: The Bank is still holding not far off £800 billion of gilts, which effectively means that that part of Government debt switches to being financed by the interest rate. The interest rate is around 1% higher than we thought in March. Maybe you have lost £8 billion just there, and then you have higher inflation, which has some other impacts. In a year, it is of the order of probably £8 billion and a bit more—maybe £10 billion.

Q18 **Chair:** We understand that. You are saying that the Chancellor has £8 billion to £10 billion less to work with in the real world.

Professor Miles: When the Bank rate is 1% higher than it would have been.

Q19 **Chair:** And what you are saying in your numbers is that that amount,

over the lifetime, has gone up from £63 billion to £126 billion. That is a further £60 billion that it is going to cost future Chancellors because of that decision.

Tom Josephs: I've got the numbers on this. Of that £60 billion difference you mentioned, around £50 billion is basically the result of higher interest rates in this forecast, and about £15 billion is a result of the change in the assumption on the path of the run-off of the asset purchase facility. That just shows you that the real sensitivity here is to the interest rate, rather than to the path of the run-off.

Q20 **Chair:** We understand that. You are saying that, because of those higher interest rates, this is ultimately a cost to the Exchequer.

Tom Josephs: Yes.

Chair: I think we got an answer in the end.

Q21 **Drew Hendry:** Good morning. We already know that, compared with other countries, the UK has lower public spending. Richard, you recently referred to the impact of inflation on public spending. How realistic are the Government's spending plans, given how they have performed against previous spending plans?

Richard Hughes: The most important thing to say is that it is very difficult to assess the credibility of the Government's spending plans, because after March 2025 the Government do not have any spending plans. As we show in the document, when we forecast spending on the 40% of public expenditure, that is under departmental expenditure limits, and so it is allocated out to Departments, such as Health, Education and Transport. We basically have this picture here, which says that we have two years of detailed budgets broken down by Health, Education and Transport. We then have four years of just one number for current spending and one number for capital spending. There is no detailed breakdown of what that means for each Department.

Q22 **Drew Hendry:** You can make a guess about what that means based on the figures we have.

Richard Hughes: You can make a guess, but looking back at history, what do we know about what Governments have done with departmental spending? We know that, in 2010, George Osborne as Chancellor was able to reduce departmental spending in real terms and as a share of GDP, in particular by bearing down on some of the smaller Departments, which don't provide, say, healthcare, education or transport. We also know that, more recently, Governments have tended to have vague spending plans in the run-up to spending reviews. When spending reviews arrive, they then chuck £20 billion to £30 billion into the pot to enable the actual spending negotiations, where they have to allocate out these grey bars to individual Departments.

Q23 **Drew Hendry:** Realistically—I think you referred to this when you talked about the inflation rate and the impact—this means pretty drastic cuts across the public sector. Has the Chancellor required you to include

implausibly low public spending figures in your forecast in order to meet the fiscal rules?

Richard Hughes: In effect, because he has not provided any detail on the choices involved in delivering those numbers, we do not know if they are plausible or not. What we can say is—

Q24 **Drew Hendry:** Surely it is implausible not to have that detail.

Richard Hughes: It would be very nice to have that sort of detail. In other countries you do get that sort of detail; it is an unusual feature of our system that the Government do not tell us anything about their spending plans beyond a spending review period. It leaves us having to do essentially a simulation exercise, which takes the overall envelope for public spending and what the Government have committed to do in particular service areas, such as Education, Health and Defence, and tries to interpolate what that means for the rest of Whitehall in terms of real cuts. We produce a box in the EFO showing that, but those are not the Government's choices; it is really just a simulation exercise for us. It shows that you have what used to be around a 1% real-terms cut in what I know are unprotected Departments—Departments not covered by any particular spending ambition over the medium term. That has now turned into a more than 2% real-terms cut in their budgets. Those are the same Departments that have experienced real-terms cuts for much of the last decade.

Q25 **Drew Hendry:** Let me try a different way of eliciting a clear answer on this. To what extent are the Government's spending plans a fiscal risk?

Richard Hughes: They are a very big fiscal risk, partly because they are so uncertain and partly because they have not been set yet. In particular, if you are planning real-terms reductions in spending in particular areas, the later you leave it, the harder it is to deliver. Whatever risk the Government thought they were carrying back in March, now that we think inflation will be higher, the risk is much bigger: there is now a £20 billion bigger real-terms cut to those budgets than the Government appeared to be comfortable with back in March, because of the higher inflation outlook. The risks in that section of public spending have gone up and have always been relatively high.

Q26 **Drew Hendry:** You would classify that as a high risk, yes?

Tom Josephs: The OBR did some analysis over the summer, which looked at its forecast performance and the reasons for its borrowing errors in the past. That identified that the OBR takes Government spending plans as given, but when it actually comes to spending reviews, what we have seen since the OBR was set up is that Governments have tended to increase those spending plans. I think the average increase that we identified was around £30 billion. On the basis of what has happened in the past, that is a significant fiscal risk.

Q27 **Drew Hendry:** I want to come back to the £20 billion that you mentioned a moment ago, Richard. Is it not likely that departmental spending will actually exceed the Chancellor's plans and that those plans might not be

carried through? And is it not therefore likely that departmental spending will exceed these plans and the Government, when they set out a spending review, will miss those targets?

Richard Hughes: It is certainly one of the biggest risks to our forecast in orders of magnitude, because it's such a large proportion of public spending, because the pressures on it are so great and because the Government have made some quite high-profile commitments to spend specific sums of money out of that. By implication, that implies a very tight squeeze on other Departments. The fact that you leave it quite late to then set those budgets makes it harder for individual Departments to then plan on the basis of delivering them and making the decisions they need to make.

Q28 **Drew Hendry:** "Tight squeeze" could be translated into "devastating", really, in terms of the impact, couldn't it?

Richard Hughes: We do our best not to use emotive language, but to put things into some kind of economic context—

Q29 **Drew Hendry:** I will let you off the hook; I will use the emotive language. That would have a devastating impact, then.

Let's turn to another issue, which is public sector productivity. What improvements would need to be made in public sector productivity for the Government to keep to their spending ceiling, as set out in the economic and fiscal outlook, without any reduction in the provision of public sector services, and to reduce the chance of the fiscal risk that we have been talking about?

Richard Hughes: Significant ones, partly because we don't know what their plans are; and, where they plan to spend money, we don't know what sort of productivity improvements—

Q30 **Drew Hendry:** Could you just try to pin down what "significant" would be, to give me a rough figure for the productivity increase that would be required?

Richard Hughes: Percentage points-worth of improvements in productivity, because that is what the implied real cuts in spending are in some particular areas. It's also worth pointing out that, because the distribution of reductions in spending is so different across Departments, some areas will have to find very significant productivity improvements if they are to maintain services, whereas other areas that are reasonably assured real growth in spending can worry less.

Q31 **Drew Hendry:** You are talking about incredible numbers for the productivity improvements that would need to be found, really.

Richard Hughes: I would say significant; I am not sure whether I would say "incredible".

Q32 **Drew Hendry:** Okay. How realistic is that, given the UK's track record on productivity in the public sector?

Richard Hughes: In some ways, it has to be delivered, in the sense that we have an ageing society—one in which more and more citizens will be consuming, in particular, healthcare and social care. Without productivity improvements in those services, just by dint of the number of people who will be demanding those services versus the number of people available to deliver them, there will have to be productivity improvements if those services are to remain affordable.

What we do in our longer-term fiscal projections is to show what happens if that doesn't materialise and the unit cost of healthcare just continues to rise and rise, as more and more people use healthcare. One of the biggest drivers of our debt going up into 200% or 300% of GDP is the fact that if you don't see unit cost improvements in the cost of providing healthcare, we just don't have an affordable welfare state.

Q33 **Drew Hendry:** I just want to probe a little further on this issue of an unaffordable welfare state and the NHS and the different Departments. What will be the impact on those major Departments of, say, getting halfway towards those productivity requirements?

Richard Hughes: I'm afraid I couldn't put a figure on that. I am sure that somebody who is more of an expert in healthcare or particular areas of service could give you that.

Q34 **Drew Hendry:** But you said we would have to hit those productivity targets to be able to maintain the services as they are, so a failure to meet those targets would be—how would you describe that?

Richard Hughes: Just to find the £20 billion in terms of the reduction in real spending power that you saw in our forecast, that is on the order of a 1% improvement in productivity in some of these services.

Q35 **Drew Hendry:** What would be the impact?

Richard Hughes: You would have to ask a healthcare expert what it would mean for the healthcare system.

Q36 **Drew Hendry:** Would you be worried about the impact?

Richard Hughes: Of course. Much of our economy relies on functioning and effective public services—not just healthcare, but also education, transport and other areas. These things matter. Not improving the productivity of public services is not an option if the UK wants to keep the welfare state that it wants, because more and more people are going to be using it and our resources are constrained.

Q37 **Drew Hendry:** Based on these figures, not hitting the productivity targets would be significantly damaging to public services.

Richard Hughes: Yes, it poses either a fiscal problem, because you have to put more money in, or a human welfare problem, because you are providing lower-quality services.

Q38 **Drew Hendry:** What would your prediction be for hitting these productivity targets?

Richard Hughes: You will have the Chancellor in front of you; you should ask him.

Q39 **Anne Marie Morris:** Can we look at the overall tax burden? The Chancellor made it clear that, in his view, high tax leads to low growth, and that he therefore wanted to reduce the overall tax burden. Mr Hughes, your chart shows that the tax burden as a percentage of GDP is higher in this forecast than in the spring Budget. Yet in the autumn statement, the Chancellor said that he has reduced the tax burden by 0.7% of GDP, so how do we square those different statements? I appreciate that they are different, but it would seem that actually we have not reduced the tax burden. What are your thoughts?

Richard Hughes: The policy announcements in this autumn statement reduce the tax burden from where it would otherwise have ended up. I think that is probably the best way of thinking about it, because the cumulative effect of all of the tax policy decisions that the Government have made since 2019 has been to put the tax burden on an upward trajectory. The most important contributors to that are the freezing of the personal allowances for national insurance and income tax. Also, we are putting up the rate of corporation tax from 19% to 25%. Those two things pushed the tax burden up by about 4.5% of GDP to a post-war high of 38% of GDP. The effect of the tax cuts announced in this autumn statement are to reduce that increase in the overall tax burden by somewhere between 10% and 20%. But overall, the net effect of all the policy decisions that this Government have made is to increase the tax burden. In particular, freezing thresholds in the face of high inflation has led to lots of fiscal drag, which is dragging more and more people into higher tax bands, which means that they are paying a higher effective rate of tax on their nominal incomes.

Q40 **Anne Marie Morris:** To try to put that simply, it is a tax cut if you put it in the context of the projected future tax take with existing policies, but if you look at it in an absolute sense—as in, today, what is the tax take?—actually, tax is still going up. Is that a fair description?

Richard Hughes: Based on current policy, the average worker is going to be paying more in tax in five years' time because the thresholds are frozen, so they are going to be drifting into higher tax bands. The particular point of their tax burden, which is national insurance at the starting rate, is going to be 2p lower, but that is swamped by the effect of them drifting into higher tax bands and paying higher tax.

Q41 **Anne Marie Morris:** Okay—so we are talking relatives rather than absolutes. The Chancellor said that it was his view that, if you have high taxes, you have low growth. In your view, is that actually right? Look, for example, at some of the Scandinavian countries. Is that link right? Professor Miles, it looks like Mr Hughes is looking to you.

Professor Miles: What is almost certainly bad for growth is taxes that disincentivise work, saving or investment. Not all taxes necessarily do that. Sometimes you have taxes that may increase the average amount of tax that someone pays on their earnings, but they do not make the

marginal rate of tax—"Should I work full time or part time?"—so very high. That is part of the reason why, when you look across countries, there is not clear evidence that, within certain limits anyway, just a higher overall amount of tax is bad for growth. What is bad for growth is high tax rates at the margin. Being able to control marginal tax rates and trying to bring them down is definitely good for growth. We had a bit of that in the autumn statement through the national insurance contribution measure, which reduces the marginal rate of tax on a very high percentage of the people who are working. I think there are clearly disincentives to work from aspects of the tax system, disincentives to save and disincentives for a company to invest. I would certainly not draw the conclusion that the tax take is irrelevant to growth in the economy. I would not draw that conclusion.

Q42 **Anne Marie Morris:** You are saying that the impact of tax depends on which tax we are talking about. Not all taxes, effectively, will prevent growth. That said, what do you think of the choices that the Chancellor has made of which taxes to cut and which he has left alone?

Professor Miles: The two big measures in the autumn statement, which do release tax, are the corporation tax measure and the national insurance one. The national insurance one is helpful on the supply side. We try to calibrate how helpful it is in bringing some people into work who would not have worked, because you reduce the tax from working with the 2 percentage point cut in national insurance. It also has a bit of an impact on the incentive of the people who are already working to maybe work a little bit more. That does something. In terms of how many more hours are worked in the economy, that measure brings something close to 100,000 full-time equivalent extra workers. Of course, it is not free and it is not cheap, because it costs £10 billion a year, but you get some of that back because more people are working.

The other one was the measure on full expensing of investment. That is also quite expensive; at least, it is expensive immediately, but it becomes cheaper in the long run, in terms of the hit to corporation tax. It effectively lowers the tax rate on investing in certain kinds of assets—plant and machinery—in the UK. That also does something positive on the supply side. We calibrate that. It is not quite as powerful as the national insurance measure, but it adds a bit to the potential productive capacity of the UK economy.

Both those things, as long as they are in place, are permanent, positive effects on the supply side, which offset some of the tax costs.

Q43 **Anne Marie Morris:** Effectively, we see measures that will drive growth. Given the taxes that have been chosen, it does actually work.

Professor Miles: They have helpful supply-side effects, yes.

Q44 **Anne Marie Morris:** What are the things that did not change, which will negatively affect growth?

Professor Miles: What didn't change was the freezing of the tax thresholds. That has some disincentive effects, because if people are pushed up into higher tax bands, either they were not paying tax and they become basic rate taxpayers, or they were basic rate taxpayers who become higher rate taxpayers. The amount of money they get to keep out of the extra hours they might work in a week clearly goes down—and it goes down quite a lot if you go from 20% to 40%. That is a meaningful change. That has, in itself, a negative effect.

There is another effect that, perversely, is potentially positive on supply. Imagine the person who does not go from being a basic rate taxpayer to a higher rate taxpayer because you freeze the threshold but who, as time passes and inflation means that wages tend to move up, is none the less paying tax on a higher proportion of their salary. It does not change the marginal tax rate—that stays at 20%, on basic rate income tax—but more of their salary is paying the basic rate. They will find that that erodes the real value of their earnings. It does not change the incentive to work at the margin, but it changes the absolute amount of take-home pay. For that individual, if anything, because their standard of living has declined as a result, they might actually work a bit more. It has a slightly perverse, positive incentive to work, but there is unambiguously a negative effect for anybody who crosses the boundary and now pays a higher rate of tax at the margin.

Q45 **Anne Marie Morris:** Got it. While you are not a behavioural psychologist, overall, given the choices that were made, are we going to see more people incentivised to work rather than fewer?

Professor Miles: I think the national insurance one is unambiguously a positive—more incentive to work is a definite positive. The threshold freezing is quite complicated to work out, because most people do not cross the boundary: they stay as basic rate taxpayers or higher rate taxpayers, or they stay as non-taxpayers because they do not get to the limit to pay tax. Most people do not change the boundaries, but a lot of those people might find that their standard of living is a little bit lower, and so they have an incentive to work more. There is a smaller group of people who face a really substantial change in the incentive to work at the margin, and they work less.

At the moment, we are doing some analysis to try to work out what the net effect of those is, and it is actually pretty complicated. We will have a clearer view on it by the spring Budget, and we will be able to give you a firmer answer on what the net effect of that is, but the national insurance thing in itself is positive for the supply of labour in the UK.

Anne Marie Morris: That is very helpful, and I look forward to your further work on this topic. For me, there is an unanswered question. I hear what you say—that people will be disincentivised if they find themselves moving to the next rate—but some people do not have the choice of working less. There is the job, and the job has to be done, if you see what I mean. I am not quite sure how you might factor that in, but clearly that is for the spring Budget.

Chair: I think the Office for Budget Responsibility has been doing a lot of work on the behavioural aspects of your forecasting. We note the op-ed that you wrote, Professor Miles, about this behavioural work, which is of great interest to the Committee. It is interesting to hear about some of the challenges and decisions that you have made on that.

Q46 **Keir Mather:** In the "Economic and fiscal outlook", you wrote that "the overall 3.5 per cent peak-to-trough drop in" real household disposal income "per person between 2019-29 to 2024-25 is still the largest reduction in real living standards since ONS records began in the 1950s." In your view, what are the root causes of this prolonged fall in living standards? Are comparable countries seeing similar falls? If not, why not?

Richard Hughes: I will start, and my colleagues might want to supplement. The root cause of the fall in living standards is inflation outpacing growth in earnings. Living standards continue to fall in the early part of our forecast because, while inflation moderates, it proves to be more persistent and therefore outstrips earnings for longer. Also, although households have what they earn, they also have what they are either receiving or paying out in interest payments. That can be a positive or negative, depending on whether you are a saver or whether you have a mortgage or other debts, and it also depends on how quickly interest rates respond to rates on savings versus rates on mortgages.

In our forecast, one of the things that drives a further squeeze on living standards is the fact that interest rates on savings went up relatively quickly. I know that this Committee was not happy with how quickly they went up, but none the less the rates responded more quickly than mortgages do nowadays; more people are on fixed-rate mortgages, and it takes time for them to roll off on to the variable portion, and for that to reflect the latest market interest rate.

Another thing that squeezes living standards in our forecast is the fact that more people are rolling off that fixed-rate portion of their mortgage and rolling on to a much higher variable rate, so in addition to having inflation outstrip their earnings for a further period, they also have higher mortgage payments on the variable rate. It takes until the end of our forecast, which is 2027-28, for real living standards to recover to pre-pandemic level.

Q47 **Keir Mather:** Does that combination of inflation and increased mortgage rates produce a unique picture for living standards in the UK, as opposed to in comparable economies?

Richard Hughes: It is not unique in Europe, because many European countries are net importers of energy and food, and one of the biggest sources of the increase in prices, which has not been reflected in an increase in wages, has been the fact that we are net energy and food importers. When the price of things goes up, we just pay more, and because we are not producing that energy or food, that does not get reflected in higher take-home pay for us as producers. Other European countries that are net importers of energy will also face big squeezes on

living standards. Because we are particularly dependent on gas as our source of energy in the UK, and we import a lot of it, we are particularly exposed to a big rise in gas prices, which is what we have seen over the last 18 months.

Q48 **Keir Mather:** On the point about household incomes, analysis from the Resolution Foundation shows that the autumn statement's provisions are likely to provide a greater income boost for middle-income and upper-income households than lower-income ones. Could you outline the impact that the discrepancies in distribution arising from these provisions will have on the living standards of those in different income groups?

Richard Hughes: The most sophisticated distribution analysis is done by the Treasury, and by colleagues in the Resolution Foundation. We do that analysis to the extent that we need to understand what the distribution means for the tax and benefit system. Clearly, because there are national insurance reductions, the measures taken in this autumn statement benefit people who are working. They benefit people who are in the labour force and earning, rather than those who are outside the labour force and on benefits.

Also, benefits have been indexed to inflation, so in some cases, at least in the last year or so, benefits have been going up faster than wages. People who are on benefits have seen the real value of those benefits keep pace with inflation better than nominal earnings. In some ways, the real living standards of those at the bottom end of the income distribution have been better protected than those of people further up the income distribution, but not quite at the median or further up. The full effect of tax cuts is felt mostly by those who are working, and who are further up the income scale, because their average taxation rate is lower.

Q49 **Keir Mather:** Since ONS records began in the 1950s, we have seen other periods of high inflation, including in the ’70s and the early 1980s, but we did not see falls in living standards comparable to those we see today. Is there a particular reason why the high inflationary period we are in has produced this concurrent fall in living standards?

Richard Hughes: We have seen imported inflation shocks in the past—the energy crises of the ’70s and early ’80s were examples. What distinguishes this period from those is, first, that back in the 1970s, productivity growth was relatively high compared with now, so real earnings were growing relatively strongly. You also had more of an embedded indexation culture across the economy—more wage agreements had inflation effectively built in. That was one of the reasons why it was more difficult to get inflation under control—price rises were reflected directly in higher wages—but it also meant that, at least from year to year, what was happening to wages reflected recent out-turn for inflation.

A third thing that was happening in the ’70s, and that has largely run its course now, is that more women were joining the workforce. You had more people earning in the economy, and that meant that household take-

home pay was rising, because there were two earners, rather than just a single earner. Each of those things probably supported real incomes better through an equally dramatic imported inflation shock from higher energy prices in the ’70s.

Q50 **Keir Mather:** Drew mentioned the implausible austerity measures that the Resolution Foundation predicted would need to be implemented, and we have talked about cuts to departmental spending. Are you able at this stage to offer a view on the sacrifices that that would require, and their concurrent impact on living standards in the middle to longer term?

Richard Hughes: We can say something about what that would mean for different Government Departments, based on the Government’s plans for public spending. Tom, do you want to say anything about that?

Tom Josephs: We have done some analysis in the book of the implications of the Government’s spending assumption. We took into account that the Government have already made a number of commitments, or set out ambitions in certain areas of spending—in health, overseas development, education, and some other areas. We have calculated what that would mean for the spending room available for all the other Departments. We are talking about quite a significant chunk of spending—around 30%—and that includes spending on things such as prisons and the Home Office. Essentially, that implies reductions of between 2% to 4% a year, in real terms, in those other Departments—fairly significant reductions.

Going back to the previous discussion, there is a question of how that would impact on public service delivery. It would depend on the ability of the Government to drive public sector productivity improvements. It would also obviously depend on decisions the Government made on spending when it comes to setting detailed spending plans in the spending review. It is difficult for us to say exactly what is implied, because we don't have those spending plans, but we can look at the overall implication of the current assumption, and that implies quite significant reductions in the room for spending in those other Departments.

Q51 **Chair:** Is the overall package of measures announced by the Chancellor last week inflationary? Richard?

Richard Hughes: Its overall impact is to add 0.1% to the price level in five years’ time. I wouldn't really describe that as being material for our forecast. That is partly because, on the one hand, the Chancellor is raising lots of tax from frozen thresholds, and then giving some of it back in the form of a rate cut. Over those five years, the tax system is taking money out of people's pockets, rather than having it put back by the sum of Government tax measures.

Also, because a number of the measures announced in this autumn statement support the supply side of the economy, they are not just adding pressure to demand, but also providing some supply to help support it. In our forecast, there are more people working; there are people working longer hours; and there is additional investment. That

helps compensate for what would otherwise be pure demand pressure from a fiscal loosening. I don't think that the policy package in this autumn statement makes a material difference to the outlook for inflation on prices. It does make a small one, however.

Q52 **Chair:** You raised your inflation forecast due to other factors. Is that correct?

Richard Hughes: It is for macroeconomic reasons. We think the labour market is proving tighter, and survey evidence on pay negotiations and pay deals indicates that higher pay settlements are likely to persist into the medium-term.

Q53 **Chair:** What impact has this massively upwardly revised net migration figure of 745,000 had on your ability to model the future?

Professor Miles: We already knew what the GDP number was for last year, and indeed for the first half of this year. The fact that there were many more net migrants coming into the country than was thought before they updated the numbers for last year does not give any more of a boost to GDP or tax revenues, because we already knew what they were. What it does do is probably make one a little more pessimistic on productivity, because although GDP was what it was, and tax revenues were what they were, there were likely more people working, so average productivity, if anything, is a little bit lower than we thought before the number of people coming into the country—and probably the labour force—was last week revealed to be higher.

Looking forward, the assumption we have made on net migration is that it will drop back to around 245,000. Part of the reason for that, and for not changing that assumption from where we were back in March, was that it seemed to be consistent with what I think is a Government aim to bring net migration back down to where it was a few years ago, before covid, when I think it was running at about 250,000. One might question whether that remains a sensible assumption. I think it probably does, because it is pretty clear, from just the last week, that the Government will take further measures to bring net migration down. I do not think that the much higher number for last year and the first half of this year undermines our assumption that the figure will comes back down to around 245,000 by the end of the forecast horizon.

Q54 **Anne Marie Morris:** Professor Miles, can we drill down a bit further into national insurance? You have a pair of scales in front of you. On one side, you put the NI tax forgone, and on the other side, you put the tax raised by not changing the thresholds. Which is heavier?

Professor Miles: Over the next five years, if there is no change in the policy on thresholds until we get to the end of our forecast horizon in 2028-2029, and if there are no further changes to other aspects of tax on labour income or national insurance, the extra money the Government get from the threshold freeze is bigger than the tax giveaway. I do not like the word "giveaway", because it suggests that the Government own everything and give it back to people, but I will call it a giveaway as a

shorthand. That is £10 billion, but over the next five years, the Government may get in the order of £30 billion more because of the threshold freeze.

Not all the £30 billion more comes from labour income, because people pay tax on interest income, investment income and other things, so it is not all a tax on labour income. Still, it is overwhelmingly likely that as things stand, if there is no change, the total amount of tax that people will pay on labour income, as a result of the threshold freeze, will be bigger than, and more than offset, the cut in national insurance.

Q55 **Anne Marie Morris:** Interesting. Can we look at each of the classes—classes 1, 2 and 4—that have received a change? Class 1 is, I think, the one you have been principally referring to in your answers. The change to that will clearly have a very significant impact on employment. Can you expand a little and explain in what way? Can you then look at the impact of the change to class 1 on not just employment, but the wider economy?

Professor Miles: This is primarily about class 1, which is going down from 12% to 10%. That has two effects. First, some people at the margin who thought it perhaps was not worth working might now be persuaded to actively try to get a job, because they will get a bit more after-tax income. That is not a huge effect; it really affects people who are right on the borderline between, "Shall I work?" and "Shall I not work?". We think that is none the less worth about 28,000 more people in the labour force, and they will stay there.

The bigger effect is on the much larger group of people who are already working. There is a bit more of an incentive to work extra hours, because you get to keep more of the pay now. That is a much bigger effect. We think that that is probably the equivalent of 80,000 full-time equivalent people. The first effect, on the people who decide that they will do some work now, rather than not work, is smaller than that; in terms of full-time equivalents, it is probably about 15,000.

If you add the two bits together, you are looking at about 100,000 more people who work. They will pay some tax. That will offset part of the cost of the measure; it has a £10 billion or so direct cost, but you get some of that back because more people work, and those people produce GDP, so you get an increase in the supply potential of the economy. Most of that comes from class 1 going from 12% to 10%.

Q56 **Anne Marie Morris:** To what extent have you taken into account the age of the people who might now be incentivised to work? It is clear that older members of society are the group one is encouraging to come back into work, but if you are a pensioner, you do not pay national insurance, so the incentive is less.

Professor Miles: You are absolutely right. There has been no change for those people from the national insurance measure. The numbers I gave for people who decide that they will go into the world of work are younger people. Quite often, they are people who are perhaps not going to go into full-time work. That is why the full time equivalent number of extra people is less than the actual number of heads. We think that these

people will not, on average, be full-time workers.

Q57 **Anne Marie Morris:** Do you know how many pensioners are now working, and is that number growing? I ask because clearly, if there is a trend there, that has some implications for this sort of tax strategy.

Professor Miles: I am not sure this is a very direct answer, but one of the things we have learned is about the participation rate for the whole economy, which fell quite a lot in the aftermath of covid—some people talked about the lost million. We don't think it was ever that high, but it could have been 600,000. A very substantial proportion of those people seem to have come back into the labour force.

In the early days after covid, when people were talking about these 600,000 or more missing people, a story that got quite a lot of attention was that people had taken early retirement. It seems to me, from the latest numbers, that that effect has significantly gone away, which suggests that some people decided, "I'm not going to go straight back into work"—possibly they were still worried about covid—but they have now gone back into the labour force.

Q58 **Anne Marie Morris:** That is very helpful. Can we, then, look at classes 2 and 4? The self-employed were specifically targeted for help by the Chancellor—and frankly, well done to the Chancellor, because they are usually the ignored group. What do you think the impact is of those changes? Getting rid of one class and reducing the other at least streamlines the system, but in the real world, what impact is this going to have on the self-employed?

Professor Miles: I think, in terms of the general nature of the effect, it's similar to the class 1 thing, because it is just a reduction in the marginal rate of tax. Potentially a side benefit as well is a reduction in complexity. But Tom, you have been thinking about this more than me.

Tom Josephs: I think that is right. Essentially the same kind of effects that David has outlined apply to the reduction in class 2 and class 4, which are paid by the self-employed, but the effects are probably smaller, just because the kind of population that is affected is smaller. Also, the gain is just a bit less, because it's a 1% versus a 2% cut. And the removal of the class 2 flat rate is actually quite small in monetary terms. But it is a simplification, because it's certainly the case that class 2 and class 4 were quite a complicated system, so that may also have some benefits.

We assume, in the costing, that there is another kind of behavioural effect, which is that it reduces the incentive for people to incorporate to gain a tax advantage. There is a bit less incentive to do that, which also affects the yield from the measure a bit.

Q59 **Anne Marie Morris:** Is that a good or a bad thing?

Tom Josephs: It is a good thing in the sense that you want to try to avoid a tax system that is creating incentives for people to incorporate just for tax purposes. So if it's reducing the incentive to do that, that is a good thing, I think.

Q60 **Anne Marie Morris:** That is fair. I will ask one final question, if I may, Chair. Clearly, there are people who are self-employed because they prefer, or the nature of what they do is very much, a one-person occupation. There are others who are innovators. For them, might this change be something that drives risk taking and taking an opportunity when, without it, those types of individuals wouldn't have taken that risk?

Tom Josephs: I am not sure that this change, in itself, would really be significant enough to affect those sorts of choices. Again, for the self-employed, the monetary value of this reduction is less than for the employed. We certainly have not modelled that kind of impact.

Q61 **Anne Marie Morris:** Okay, so you have no particular thoughts on its role in kickstarting innovation, if you like, as opposed to regularising and sensibly making life for the self-employed frankly more straightforward.

Tom Josephs: That is correct.

Q62 **Keir Mather:** I want to talk a bit about full expensing. Tim Sarson at KPMG has described the policy of full investment expensing as a timing difference that accelerated tax relief, rather than permanently benefiting affected businesses. Do you agree with that statement? If so, what impact do you believe the front-loading of investment has on business investment over the longer term?

Professor Miles: It is a timing effect, in essence, but that does not mean that it is neutral. Getting the money upfront in terms of paying lower corporation tax because you can offset the whole amount now—as opposed to offsetting a bit now and a bit next year, rolling ahead nine or 10 years down the road—is valuable. In fact, it is more valuable in a world in which interest rates and inflation are higher. That is the source of the benefit to investing. When we do our calculations on "How much is this worth?" and "How much is this going to change investment?", it is exactly that calculation.

It also explains why the cost in the short term is so much greater in terms of lost corporation tax revenue than in the long term, because you give people the tax relief upfront. That is expensive, but you find that you get more corporation tax further down the road, because they are not still offsetting the investment they do today five or 10 years down the road.

The short-term cost looks very high; it looks as costly as the national insurance measure. Actually, the long-term cost is a small fraction of that. In the short term, it is in the order of £10 billion or £11 billion; in the long term, it is probably a bit under £3 billion. You get most of it by that.

Q63 **Keir Mather:** Is there no concern about having a peak in business investment as a result of a measure being put in place that then, to an extent, tails off afterward? Is that a concern in relation to forecasts?

Professor Miles: It shouldn't be, because it is a permanent measure. Therefore, it has a permanent effect on companies wanting to invest a bit more. It is not like a temporary measure, where you know that in two years' time the thing goes away, so you pull your investment forward and

then get a drop-off in investment. That is one of the benefits of it being a permanent measure: you do not distort the timing so much.

Q64 **Keir Mather:** Sure. I was just wondering if there was a pent-up ambition to invest that companies will realise once the measure is implemented that then has a concurrent tail-off over time.

Professor Miles: There could be. There is a slight negative effect, actually, because you have got rid of what would otherwise have been a temporary full expensing. To the extent that there has already been a bit of bringing forward, you lose that, because there is no incentive now to bring stuff forward, since you will get full expensing three, four or five years from now. If anything, in the very short term you might find that investment is slightly weaker because you do not get the bringing forward, but the sustainable and permanent effect is higher investment.

Q65 **Keir Mather:** Full expensing is the third policy announcement since 2021 that allows for 100% capital deductions if you include the super deduction. What is your assessment of why full expensing has been chosen as the right policy measure for the moment, as opposed to the other iterations we have seen over that time?

Professor Miles: The first thing that full expensing does, for those bits of investment that get full expensing and where investment is financed from retained earnings or eschewing equity, is that it makes the tax system neutral. That is a good thing.

As I have just said, unlike these temporary measures where those companies that feel they can bring forward investment do it and those that cannot lose out, in a sense, this is permanent: you do not get what you might almost call those distortions to investment. In fact, for those bits of investment that are financed not by companies retaining earnings or eschewing equity, but by issuing debt, with 100% first year allowance or full expensing they become slightly subsidised by the tax system.

If you felt that part of the problem in the UK was that we had a tax system that distorted away from investment, you have certainly got rid of that when you have 100% first year allowances if it is equity finance—retaining profit or issuing new shares—and something of a subsidy if it is debt finance.

If you thought for whatever reason that the UK was stuck in a low-investment trap, you could argue that it was not such a bad thing to have a system that is at worst neutral, but actually has a bit of a subsidy element as well. That is what full expensing gives you, though of course it does not apply to all investment at the moment. If you rolled it out to everything, you really would have a tax system that was neutral to subsidising on investment, as opposed to disincentivising investment.

Q66 **Keir Mather:** The IFS says that one of the trade-offs of this policy is that it creates a bias towards business investing in qualifying plant machinery, rather than focusing that business investment in other places. Is that factor identified in your forecasts? Do you have any concerns about that

narrowing of business investment on qualifying machinery, rather than it being used for other purposes?

Professor Miles: It depends a bit on whether they are substitutable. If a company could do some investment that fell outside full expensing and that was a very close substitute for plant and machinery then, yes, you could see that it would cross that boundary. It is a bit difficult to quantify that and, in some sense, if you have a piece of investment that is in research and development or something, which may not get full expensing, versus buying a van, they are not really substitutes. It would be surprising if a company said, "We're going to do less research and development and buy a load more vans, because they get the allowance." I suspect that there is not a whole lot in that.

Q67 **Drew Hendry:** Let us talk about tax avoidance for a minute. The autumn statement included what were described as tougher consequences for promoters of tax avoidance schemes. Your forecast for that is £1.3 billion per year. How did you arrive at that figure?

Tom Josephs: A number of anti-avoidance measures were announced by the Government. The main one is an international measure, which is designed essentially to ensure that multinationals pay a minimum level of tax across all the countries in which they operate. That is an OECD-led initiative.

We scored the first part of that at the autumn statement, which was the largest part of it. We estimated that that raised about £2 billion. This is the final stage or the next phase, which will raise further amounts. It is definitely the case that—we explain this in the book—there is a lot of uncertainty around the revenue that will be raised under the measure. By the nature of the fact that it is based on an international agreement, it requires having an understanding of corporate profits across different jurisdictions and being able to operationalise this system across different countries.

Q68 **Drew Hendry:** Are you saying that it is not really possible to forecast the behaviour of potential tax avoiders?

Tom Josephs: It is possible, and we work very closely with HMRC in order to do so, but it is definitely the case that there is a lot of uncertainty around it. In this measure in particular, there is a very high level of uncertainty, which again we flagged up.

Q69 **Drew Hendry:** The bigger problem is tax avoidance for the UK in general.

Tom Josephs: Like every country, the UK has a tax gap between taxes that theoretically could be raised and what is actually raised. I do not think that we have an overall number for that in the book, but it is obviously significant.

Q70 **Drew Hendry:** Given that significant challenge, what are the challenges for you? Going on what you have just said, it looks like it is really difficult to pin that down—nailing down a jelly. What are the challenges for you in forecasting behaviours in the face of new sanctions in particular?

Tom Josephs: This measure is a particularly uncertain one, because of the international dimension. Other measures are focused on the UK tax system alone. Even on those, we always assume that there will be a significant behavioural response, so people will change their behaviour in response to the new measures that the Government are introducing. Therefore, in almost all cases, the yields will tend to fall over time because people react. I guess that is why, essentially, the Government have to keep going with new measures.

Q71 **Drew Hendry:** Let me go back to the original question, which remains hanging and unanswered at the moment: how did you come to the estimate of £1.3 billion per year then?

Tom Josephs: The stages of doing that are set out. We have worked very closely with HMRC, and our analysts on this one have also been working with the OECD to produce these estimates. Essentially, you start with your best estimate of the kind of revenue that these multinational companies generate. You do assessments of where the profits are generated in individual companies—

Drew Hendry: In case we run out of time a wee bit, if you could get to the point where you arrived at the figure of £1.3 billion, that would be really helpful.

Tom Josephs: It is a bit difficult because multiple stages are involved in getting that estimate. Essentially, you are looking at their taxable profits internationally. You are then trying to identify where they may be generating those profits in jurisdictions where they are not taxed below this 15% minimum level, and then trying to estimate, therefore, how much additional tax will be raised through the measure. It is a complicated set of steps that are involved.

Q72 **Drew Hendry:** Let’s come on to those OECD pillar 2 measures that you were talking about in terms of tackling multinational companies shifting profits offshore. The autumn statement says £12.7 billion will be raised over six years. Your costings only show one of the three elements totalling £1.7 billion. Why is that?

Tom Josephs: Part of this was scored previously at previous events, so it is a reform that is taking quite some time to be introduced given the complexity. It has been announced in different stages, so different parts of it have been scored at different—

Q73 **Drew Hendry:** So you can break down that £12.7 billion-figure from the Chancellor.

Tom Josephs: We will be able to, yes.

Drew Hendry: But you haven’t as of yet.

Richard Hughes: Because it has been split across several forecasts and announced in various components, we have not put it all together. We can certainly make an attempt to do so in writing if that would help.

Q74 **Drew Hendry:** Since you have not put it altogether, you gave this costing a high level of uncertainty. Do you stand by that?

Tom Josephs: Yes, for all the reasons I have set out.

Q75 **Drew Hendry:** Why did you give it that high level of uncertainty?

Tom Josephs: Essentially for the reasons that I have been talking about: because it is based on international agreement, so you have the additional complexity that this has to work across a number of different countries. You have uncertainty around the data provided by the multinationals on their profits and taxable profits. You have uncertainty about how this would be operationalised across different countries, and you have uncertainty about the behavioural response of the multinationals. There are a number of different layers, if you like, of uncertainty, which is why we have given it that very high uncertainty rating.

Q76 **Drew Hendry:** Those challenges will be faced by the EU, Canada, Australia and others that are adopting this as well. Let me go on to talk about managing and settling tax debts. HMRC has been allocated £163 million to manage that. Is that sufficient?

Tom Josephs: On that measure, we actually have a pretty good evidence base from similar measures introduced in the past that when HMRC does put more resource into this area, which is tax debt collection, it has been effective in generating additional yield. That is why we—

Q77 **Drew Hendry:** That yield is forecast to be £5 billion, yes? That is what the forecast is.

Tom Josephs: Over the whole forecast period? I have not got that figure right in front of me, but if it is in the book, then yes.

Drew Hendry: I understand that it is your figure.

Tom Josephs: As I say, this is a measure that is targeted at tax debt collection, and tax debt rose quite significantly through covid and after covid, so there is an increased amount of debt that HMRC can collect. As I say, we have pretty good evidence that, when it has put resource into that in the past, it is effective in collecting that debt.

Q78 **Drew Hendry:** Was the work that you did to produce the £5 billion figure based on HMRC evidence, then?

Tom Josephs: We work with HMRC to produce those estimates, and we scrutinise them very carefully. On that one, we scored that amount on the basis of evidence that HMRC was able to provide on previous similar measures.

Q79 **Drew Hendry:** Does the £5 billion raised, which obviously you will check, take into account the behavioural effects of encouraging taxpayers to settle their tax debts?

Tom Josephs: Again, it will. I'm afraid I do not have the full details of the behavioural effects that we will have included in that measure right in

front of me, but there will be some account taken of the fact that there will be a behavioural response.

Q80 **Drew Hendry:** Professor Miles or Richard, do you want to add anything?

Richard Hughes: As a general point, I do not think that tax compliance is an area where we get particularly taken for a ride by HMRC or the Treasury, and the Government have had some quite conspicuous successes in closing tax gaps in key areas. The most conspicuous area is VAT: the VAT gap—the gap between the notional liability for VAT and what is actually collected—used to be around 3% of GDP, but it has fallen to around 1% of GDP over the course of a decade or more. That is success in collecting a whole lot of VAT that was not previously being paid. Part of that is probably due to the increased digitalisation of businesses, and to cash disappearing from society as a means of settling transactions, so it is probably supported by some wider social trends, but it is also due to a determined effort to close tax gaps.

Similarly, the Government have taken a lot of steps to close loopholes in the corporate tax system and broaden the base for corporation tax, and you have seen that show up in higher receipts from another big source of revenue. We look pretty hard, and with a pretty jaundiced eye, at proposals for spend-to-save compliance measures from HMRC, and we make sure that they take account of behavioural effects and other things that might reduce the net yield, but HMRC has a track record of doing reasonably well in tracking down these missing receipts.

Q81 **Mr Baron:** Good morning to you. I wouldn't mind turning to the OBR's assessment of the economic impact of the announced increases in the national living wage. I have a quick question to start: why did this change not feature anywhere in the OBR's "Economic and fiscal outlook" document?

Richard Hughes: We had to anticipate where it might end up in putting together our overall wage forecast. As it was announced after we closed the window for measures, it is not something that we took explicit account of, but it was consistent with our forecast for nominal wages.

Q82 **Mr Baron:** Are you going to come back to it, now that you know the figure?

Richard Hughes: We will provide more information about what it would imply for future levels of national minimum wage, were you to try to maintain that level going forward. It is an area where we will probably look to provide some supplementary information, but because that information arrived after we closed our forecasts, we had to basically make an educated guess as to where it might end up.

Q83 **Mr Baron:** Fair enough. As you know, the figure was nearly 10% across the board, which is ahead of inflation. What is your assessment of the impact on inflation, now that you know the figure?

Richard Hughes: We think it would be pretty marginal. You would not expect it to be reflected in a shifting up of the entire wage scale for the

rest of a given firm, because that would clearly be unaffordable for most of them. We are assuming some compression of the wage scale between the lowest paid and the highest paid in order to accommodate this. We do not think that it would make a material difference to the inflation outlook, in and of itself.

Q84 **Mr Baron:** As you know, universal credit tapers away as income rises. Now that you know the figure, have you done any work on how much the Government will save as a result of this measure, given that national living wage tends to be a cost borne by industry?

Richard Hughes: It is not something that we have run through our labour models, unfortunately, because the announcement came so late.

Q85 **Mr Baron:** Because?

Richard Hughes: Because it is not a fiscal policy measure that we explicitly score. We do not take its economic effects into account. You can think of it as being implicit in what we assume for an economy-wide increase in wages and earnings.

Professor Miles: The main reason we increased the overall forecast for average earnings relative to March was that inflation had turned out quite a bit stronger, and tightness in the labour market was also a bit stronger than we thought it would be by now. To the extent that those factors underlay the decision on the living wage and minimum wage, the underlying driver is in the forecast, in effect, because wage settlements are 2% higher this year and will be 2% higher next year than we thought in March.

Q86 **Mr Baron:** So it is informed?

Professor Miles: Indirectly. It has had an impact.

Q87 **Mr Baron:** Can I explore the logic of it, and whether the increase has other objectives? We know that the objective is two thirds of median wages, and we are heading in that direction with this increase. To what extent is this a deliberate policy to make work pay?

I come back to your exchange with Anne Marie about the missing 600,000 immediately after covid. When I say "missing", I mean people who have withdrawn from the workplace, just to be clear to people listening in. I know that that is an estimate, and that we think the figure has gone down, but it is still quite high. It could easily be a couple of hundred thousand. To what extent will the increases in the national living wage encourage at least a good segment of those people to come back into the workplace?

Professor Miles: You are absolutely right about the 600,000 "lost". We have "found" quite a few of them, but there are probably 250,000 or 300,000 still knocking about. The problem has not gone away, for sure.

The tricky question is: who would not like it? Who would be against wages being higher, particularly for people at the lower end of the wage scale, and against that having a positive effect on labour supply? The problem is

the impact on companies. If it is not matched by productivity or changes in work arrangements, it is not in itself a free lunch, because companies will ask, "Do we really want to employ people at the margin, when it will cost considerably more, just because of a Government edict, or a decision of some advisory Committee that wages should be higher?". I do not think you can, in some way, just legislate your way to prosperity. Of course, if it is a spur to productivity-enhancing measures among groups of workers who will be paid significantly more than they otherwise would be, because of minimum wages, it has positive supply-side effects.

Q88 **Mr Baron:** Can I pick you up on that point? We have mentioned poor productivity before in this evidence session. There is a line of economic argument that one reason for it is that we have relied too heavily in the past on relatively—if you will excuse the expression—cheap labour as a substitute for investment. Is there not an argument that, if you increase the minimum wage—don't forget, companies have a reasonably competitive corporate tax rate when compared internationally—the quid pro quo is that it may encourage greater investment in productivity?

Professor Miles: I think there is something in that. To stand back a bit, we have had minimum wages in the UK for decades now. When they were first introduced, there was a feeling that they would be detrimental to employment. You might have thought that they would have some advantages on distributional grounds, but that you would pay a price in terms of less employment. The lesson of the last few decades is that there has been a surprisingly small hit to employment, and I think it is because the mechanism that you describe has been at work: you incentivise productivity-enhancing investments by companies when you make "cheap labour" a little bit less cheap. I think there is something in that.

Q89 **Mr Baron:** Have you done any analysis on that? This is important with regard to the economic argument generally, and it is important when it comes to predicting growth rates and perhaps even inflation. If you and I are right, Professor Miles, what the Government are doing is not just helping people at the low end of the pay scale. I agree that you cannot legislate for prosperity, but you can nudge companies in the right direction through the tax system and the wages system.

Professor Miles: We have not done detailed work on it. I know that one of the experts in this area, Professor Alan Manning at the London School of Economics and Political Science, has done work over a long period of time on the impacts of things like minimum wages. He did some quite pioneering work that suggested that the negative impacts would be offset by these kinds of mechanisms, so there is certainly something in it.

As Richard said, we were not able to allow in our forecast for the announcement made recently, because it came after we had finished our analysis, but it is something we should think carefully about in the future.

Q90 **Mr Baron:** I suggest to you that at a time of near-record employment—it is certainly a strong labour market—when we have reasonably competitive corporation tax rates in this country compared with near and

far neighbours, this might be a good time to look at it, because there is certainly an objective to keep driving the national living wage up. Not only is that the right thing to do to help people at the low end of the pay scale, but it could help nudge companies on productivity. Has any assessment been done of the impact that the increase in the national living wage will have on income tax receipts? If not, do you intend to do that? It might be marginal, but every £10 million helps nowadays.

Richard Hughes: We could certainly have a look. The impact would be very low, because quite a lot of these people are earning either close to or below the personal allowance, so I would be surprised if it was significant.

Q91 **Mr Baron:** Okay. Finally, we know that this will be a cost borne by industry, and perhaps particularly small and medium-sized enterprises. Have you done any assessment of the extent to which that may impact their profitability, and their ability to pay corporation tax and so forth?

Richard Hughes: As I said, we have a general assumption about what happens to earnings across the economy, and across various buckets of income distribution. We do not run a specific decision about the national living wage through that to see what it does to tax receipts. It stands to reason that if wages turn out to be higher, that squeezes profit margins, and you have less in corporation tax; but if wages are higher and are pushing the pay scales a bit, you are also getting more in income tax and national insurance. The average rate of tax on income is higher than the average rate of tax on profits, so that is probably to the net benefit of the Exchequer, so long as employment holds up.

Q92 **Chair:** I have a final question before we let you go. Did the changes that were announced to the levelling-up fund, investment zones and freeports make you change any of your growth or productivity assumptions?

Richard Hughes: They did not, in that the only investment measure that we explicitly took account of in our economy forecast was full expensing, because it was a material, evidence-based and durable sort of measure that we thought was a departure in the tax system in the treatment of investment. We did not take account of the other long list of growth measures, essentially because they looked a lot like business as usual. Governments are always having innovation funds; they are always launching local growth initiatives. We think of that as helping to create an enabling business environment, which we need if we are to continue to grow and prosper. Just carrying on doing those things, as every Government have done in recent memory, we do not think of as being growth-enhancing beyond what we have already seen in the data for the last 20 years.

Q93 **Chair:** Of the 110 things that the Chancellor announced, you think the most significant one, from a business investment point of view, is that full expensing.

Richard Hughes: Yes.

Q94 **Chair:** Even though, presumably, it is very early days for getting any evidence on that.

Richard Hughes: We have evidence from the super deduction and from the temporary full expensing measure, so we have already seen what kind of investment response we get from those measures. That is what informed our estimate of the investment impact of full expensing. You also get support for the labour supply from both the NICs cut and the welfare reform measures announced in the autumn statement.

Those three policies—full expensing, the NICs cut and welfare reforms—were the three of which we took explicit account, and we showed our maths in terms of how they feed through into our forecast. For the rest, we think of them as creating a positive environment for investment, but not in a way that means that we would provide an explicit account of them in our forecast.

Q95 **Chair:** In response to John's questions, you said that you would update things now that you have the national living wage proposal. Is that something you can share with the Committee when it is done?

Richard Hughes: Yes, of course.

Chair: Great. Thank you very much for your time. This has been very informative.