HOUSE OF LORDS

Economic Affairs Committee

Corrected oral evidence: How sustainable is our national debt?

Tuesday 23 January 2024

3.05 pm

Watch the meeting

Members present: Lord Bridges of Headley (The Chair); Lord Blackwell; Lord Davies of Brixton; Baroness Kramer; Lord Layard; Lord Londesborough; Baroness Noakes; Lord Rooker; Lord Turnbull.

Evidence Session No. 2 Heard in Public Questions 25 – 65

Witnesses

I: Richard Hughes, Chair of the Office for Budget Responsibility; Tom Josephs, Member of the Budget Responsibility Committee, Office for Budget Responsibility.

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Examination of witnesses

Richard Hughes and Tom Josephs.

Q25 **The Chair:** Good afternoon and welcome to this hearing of the Economic Affairs Committee. I am delighted to welcome to the committee Richard Hughes, the chair of the Office for Budget Responsibility, and Tom Josephs, a member of the Budget Responsibility Committee at the OBR, to discuss debt sustainability. Thank you both very much for coming.

I will ask a starter for 10. The first sentence of your July 2023 report, *Fiscal Risks and Sustainability*, is very stark—"The 2020s are turning out to be a very risky era for the public finances"—and, today, we have the figures on borrowing, and indeed debt interest, which has given rise to a lot of headlines about "headroom" for the Chancellor. A key point that leaps out is: "Central government debt interest payable was £4.0 billion in December 2023, £14.1 billion less than in December 2022", et cetera.

This is what I am trying to establish in my mind to start off with. Your July 2023 report paints a pretty depressing, risky picture. Today's statistics are being interpreted in a more rosy fashion. How worried should be we be about debt sustainability?

Richard Hughes: Thank you for the chance to appear before the committee. I should start by saying that we are not joined today by Professor David Miles, who is the third member of our committee, but he is very keen to submit a written contribution. He is teaching this afternoon, which he does with the other half of his time.

On the sustainability of the UK's debt position, you can answer that question over three different horizons, but, over the very near term, the UK Government have no difficulty raising the finance they need to cover the gap between monthly or annual tax and spending. So in that sense we have no difficulties accessing debt markets in the near term, with the possible exception of what we saw happen in the autumn of 2022. We could get into that if you like, but we have not seen signs of stress in the gilt markets from the volume of government borrowing in the near term.

However, it is fair to say that, even when you look out just over the five-year horizon of our fiscal forecasts, you can see that the level of debt that the Government now have and the rate of interest that they now have to pay on that debt is constraining the range of fiscal choices available to them—2022 was the year when global interest rates started to normalise, yields on gilts started to rise, and interest costs that the Government had to pay out on their now much elevated stock of debt rose from around £50 billion to £100 billion a year.

In response to that, to accommodate that rise and the cost of their debt, the Government significantly cut both current spending and capital spending by government departments. So in that sense you can see that, even over the medium term, having a large stock of debt, which is very

sensitive to changes in interest rates, forced the Government into fiscal choices which, until that happened, they were not comfortable making.

In the long term, the report you referred to shows that, when you look out over a 50-year horizon, the Government's current fiscal policy settings are not sustainable. Demographic and other structural changes in the UK economy are likely to drive up spending, not least on health but also on other areas. If you assume that we keep roughly the same tax system so the tax stays roughly constant as a share of GDP, that drives a large and growing wedge between what the Government are spending on health, education and other areas and on tax to the tune of about 10% of GDP.

That leads to debt spiralling over that period and reaching, when you get to the limit, over 300% of GDP, because the Government are borrowing 10% of GDP just to fund the gap between primary spending and revenue, and they have to borrow ever larger amounts in order to finance their debt interest bill, which also contributes to the rise in debt over that period.

In the very near term, there are no problems with borrowing; in the medium term, having this level of debt is already constraining the Government's fiscal choices; and, in the long term, the Government's wider fiscal policy settings are not sustainable.

Q26 **The Chair:** That was a very helpful scene setter. Let us stick with the near term. In paragraph 5.21 on page 139 of the November 2023 economic and fiscal outlook, if I am reading it right, you are making the point that the room for manoeuvre, as you have just been saying, is very low if you want to fulfil the 0.4 per cent of GDP year-on-year fall in debt in 2028-29. You are saying that that fall could fall to zero if the effective tax rate was 0.4 percentage points lower. Are you saying, therefore, that the room for cutting taxes here is incredibly minimal if you want to stay on track? We can come on to the value of the fiscal rule in a moment, but you are saying that the headroom here is really quite minimal.

Richard Hughes: It is very small relative to the forecast errors inherent in any forecasting process, including ours. The term "headroom" is basically an expression of how much margin for manoeuvre the Government have against the fiscal targets they have set for themselves. They are currently overachieving their objective of getting debt falling as a share of GDP in five years' time by £13 billion.

That number is a fraction of GDP. When you look out five years ahead, our forecasting error for borrowing, and any other forecasting error for borrowing, is anywhere between 2% and 4% of GDP, so it is a quarter to one-eighth of the actual risk that you are facing when you are looking five years' ahead and trying to make fiscal policy.

The Chair: In the forecast to hit that target, it is assumed that certain things, as your report makes clear, will be done that have often not been done. Correct?

Richard Hughes: That is right. Some of the risks come from the outside world in the form of interest rates and energy prices; we have all seen those kinds of shocks, which can affect our economic forecast. But there are other risks that are, in a sense, buried within the policy assumptions that we are required to use when we put our forecast together; there is one on the revenue side on fuel duty, and, on the spending side, what the Government are currently assuming about the path of departmental spend.

Q27 **The Chair:** We will come back to some of the detail later. Can I just pick you up on the medium term? Again, turning to the report from July, I was very struck by this sentence in paragraph 4.49—I will not read out the whole paragraph: "If a government wanted instead to keep debt from rising above 100 per cent of GDP over the long term, this would require a permanent increase in taxes and/or cut in spending of 4.4 per cent of GDP in 2028-29". That is a 4.4% of GDP increase in taxes or cut in spending in that year.

This is a general question. Without getting too hung up on the actual number or the year, are you arguing, therefore, that if, as a nation, we want to keep debt from rising above 100% of GDP, action needs to be taken in the next Parliament to address that in relation to a number of the topics we will come on to talk about—demographics, the green transition, et cetera?

Richard Hughes: Current policy settings are not sustainable. The projections that we did back in July provided a bit of breathing space for the next few years because of demographic factors in particular. The fact that the birth rate has been falling reduces the cost of education in the near term, but that is not good news for demographics in the longer term, because it means fewer workers and taxpayers supporting growing numbers of people who are retired. There is a window of opportunity over the next five to 10 years to take action in these areas to deal with the demographic challenges, and there is obviously a need to take action early to deal with the climate challenges, which we also highlight in the report.

The Chair: Excellent. We will come on to that. First, Lord Turnbull will pick up on some of these points.

Q28 **Lord Turnbull:** I was struck by chart 4.17, which has a debt-to-GDP ratio that is roughly flat or slightly falling. Then, around 2030, it goes whoomph, all the way up to 300%. A lot of attention has gone on that exposure, but even more remarkable is what you call the medium-term horizon, where you have a primary balance improving by 3% of GDP. If your methodology is to forecast in this book and, when you rewrite it, you take the last year of this and add decades on, your starting point is the last year of this medium-term projection. If this starting point is completely implausible, you are starting in the wrong place.

I think less attention should be paid to the fact that it explodes like this, because what is really interesting is the assumption that the primary balance will improve, which gives us more headroom. The crunch will

probably come not in 2035 but a lot earlier. I can see, though, that your problem is that you have to take the Government's assumptions on what they are going to spend and tax. If those are just not believable, you are landed with a starting point for your long-term projection that does not really mean anything.

Richard Hughes: That is correct. You are right that the primary balance in the final year of our forecast, which forms the jumping-off point for those projections, is one of the reasons why, in the near term, debt looks relatively stable before it starts to rise again. That is based on at least two questionable policy assumptions that we are required to programme into our forecast. One is that fuel duty will be indexed to inflation every year. In fact, it has been frozen every year since 2010. That delivers £6 billion of the improvement in the primary balance. If that does not happen, you are already £6 billion down.

The second thing we are required to do is to rely on what the Government tell us are their desired paths for spending on public services, so departmental expenditure limits. At the moment, the Government have them falling as a share of GDP, but they provide almost no detail about how that will be delivered. The Government did a spending review setting out detailed departmental plans for the year until 31 March 2025. Beyond that, we know virtually nothing. It is just two numbers—one for total current spending and one for total capital spending by department.

Some people have referred to that as a work of fiction. That is probably generous, given that someone has bothered to write a work of fiction, whereas the Government have not even bothered to write down their departmental spending plans underpinning their plans for public services.

Lord Turnbull: I cannot see a way out of this other than not accepting the Government's stated fiscal projections for spending and taxes. As long as you are prisoners of that, I do not think you can ever really make sense of these projections.

Tom Josephs: I just want to mention that, in the fiscal risks report, we look at a scenario that essentially goes exactly to your point. We vary the long-term projections by assuming that, at the end of the medium term, DEL spending is 1.5% of GDP higher than in our baseline. That 1.5% of GDP essentially reflects the average increase that Governments have put into public spending ahead of actual spending review allocations over the recent past. That shows that doing that, for the reasons you have set out, essentially brings forward by about 10 years the point at which debt starts to accelerate. By the end of the projection, debt is around 75% of GDP higher.

The other thing to say about the projection of debt in the baseline is that it is based on an assumption of constant positive GDP growth. Actually, we know that we get hit by recessions and shocks at fairly regular intervals. We have a scenario that alters our baseline by assuming that a shock hits the economy every 10 years or so and factoring in their

impacts. That brings forward the point at which debt accelerates and means that you end up with a much higher debt level by the end of the projection.

Lord Turnbull: That is chart 4.19.

Tom Josephs: Yes, exactly.

Q29 **Baroness Noakes:** Can I just clarify? You are required to take account of the Government's assumptions on tax and spending for your regular forecasts on fiscal events. Are you required to do the same when you produce your *Fiscal Risks and Sustainability* report?

Richard Hughes: We basically have to make our own assumptions. In the near term, we take what the Government tell us about the path of departmental spending. We have a lot of detail about that for the next two years and then, as I said, basically no detail about it from 2025 to the end of the decade.

Beyond that, because a key part of our long-term fiscal projections is about the path of health spending and education spending, we have to make some assumptions about per-capita spending on those items. We have to assume that per-capita health spending evolves along a certain path and make assumptions about education spending based on spending per pupil.

Within that, we have to make different assumptions about the paths of education and health, but in essence we take the final year of the medium-term forecast as the jumping-off point. At the moment, as Lord Turnbull was saying, it shows a significant improvement in the primary balance driven by holding those spending levels relatively low.

Baroness Noakes: I was just trying to see whether you are required to illustrate these things by scenario analysis, as opposed to embedding them in your core forecasts in the sustainability report.

Richard Hughes: We do scenarios, including on demographics, which have consequences on things like health. We also do scenarios on the health of the population, so if people continue to get healthier over time, it keeps the per-capita spending on health reasonably modest.

Q30 **The Chair:** If a Government continue to spend up to their max headroom—a phrase that has been bandied around in your forecasts—what does that do for fiscal sustainability?

Richard Hughes: In essence, it would stabilise the debt-to-GDP ratio, at the end of our forecast period. It would basically be flat rather than falling ever so slightly. It does not make a huge difference to the debt dynamics going forward, because it is just £13 billion. It sounds like a lot of money, but you are talking about 0.2% or 0.3% of GDP, and debt spiralling by 200%. It does not make a very big difference to the jumping-off point. What happens after that is driven primarily by demographic change and other factors.

The Chair: Excellent. We will come on to that.

Q31 **Lord Blackwell:** Can I ask about the meaningfulness of debt to GDP as a metric in this? Sustainability is obviously a forward-looking concept. Debt to GDP is a current ratio, and we know that it varies a lot across different countries. Arithmetically, sustainability depends on nominal interest rates and growth. Then you have market sustainability, which will also factor in foreign exchange reserves, et cetera. Is there a better way of having a snapshot of sustainability than debt to GDP?

Richard Hughes: One reason why these reports are so long is because we think that there is more to sustainability than the debt-to-GDP ratio. It is not a bad measure of Governments' contractual liabilities, and it has the very great advantage of being comparable internationally, because statisticians collect data on Governments' contractual liabilities. Other things can be subject more to judgment and assumptions.

The UK has the particular advantage of measuring debt at the public sector boundary, so everything owned or controlled by government is within that definition. Other Governments can sometimes play around with the boundaries of government to move things off balance sheet and outside the definition of government. We have the great advantage that, when we talk about public debt here, we really are talking about public debt: it consolidates all public institutions and leaves limited room for manoeuvre for funny business to push things outside that boundary.

It has the great demerit that it does not take account of the cost of that debt. Obviously, if you are paying almost zero interest rates on your debt, it is not much of a fiscal worry. But once interest rates start to go up, you have to worry about it a great deal. For that reason, we also tend to try to draw attention to measures like the debt interest-to-revenue ratio, because it is actually the interest burden that the debt places on public finances that matters for your fiscal choices. The relevant denominator is not so much GDP, but what the Government are collecting from GDP as revenue. That number has gone up considerably; it has more than doubled in the last few years, as interest rates have doubled on a relatively high stock of debt. So you would probably draw more alarm from that debt interest-to-revenue ratio than you might from looking at just the debt-to-GDP ratio.

It is also important to bear in mind, however, that the Government's contractual obligations are not a full account of the Government's obligations. You have non-contractual obligations like contingent liabilities and what the Government owe public servants in pensions. You have things like the triple lock, which in essence is a promise to pay older people a certain amount of money once they retire. You can even think of the health service as being a long-term promise that the Government have made to their citizens. We do these long-term projections to try to capture the long-term implications of those commitments to an ageing population, based on a range of assumptions.

The final limitation with the debt-to-GDP ratio is that it shows just one side of the balance sheet. Governments also have assets, both financial and non-financial. Some of those benefit future generations. If borrowing is being done to benefit those generations, it is worth taking that into account. Also, Governments can engage in financial engineering around their assets as a way to try to flatter the profile of debt, but in ways that are not sustainable because they are based on selling a finite stock of assets to make debt look lower than it will be in the long run.

Lord Blackwell: You mentioned public sector pensions. If I am right, the much bigger figure is the ongoing commitment to the ordinary state pension, which is not factored into the Government's debt.

Richard Hughes: That is right: neither the basic state pension nor public service pensions are captured in that measure of debt. We do not have a funded public service pension scheme, so our civil servants just get paid out of the till as they retire.

Q32 **Lord Blackwell:** I wonder whether we, the Government and the debate should be focusing more on sustainable levels of spending and taxation. It is interesting that your projections show that, because of the ageing population, demographics, health, pensions et cetera, total monetary expenditure going up to over 60% of GDP in 50 years' time. Other than in wartime, we have never managed to get public sector receipts much above 40%. Is the real debate not about sustainability of borrowing but about sustainability of spending? Are the rules on that sufficiently clear?

Richard Hughes: Sustainability issues can be dealt with on either side. The spending promises that we are making to current generations are certainly not sustainable once society ages. In making our long-term projections, because we take tax policy as more or less constant, it tends to imply forecasting at a constant tax-to-GDP ratio—some important exceptions, because there are some bits of the tax system that are themselves not sustainable. I mentioned fuel duty earlier. In a few decades, we will not be collecting any fuel duty, because every car will be electric and they do not pay any fuel duty. Nowadays, you have to ask whether young people are drinking and smoking enough for us to be collecting alcohol and tobacco duties at the current rate.

Lord Blackwell: It is difficult to imagine any tax system raising 64% of GDP in taxation to match that level of spending.

Richard Hughes: There are certainly no advanced economies doing that, although there are advanced economies that are collecting significantly more than we are. Countries not too far from here have tax burdens that approach 50% of GDP. At the moment, we are still below 40%.

Q33 **Lord Blackwell:** The other factor is the growth rate of the economy, which is the divider on these ratios. Your projections show the deficit reducing over the next couple of years before ballooning again. So, despite current levels of debt to GDP, depending on your economic theory there might be an argument for either lower taxation or higher spending

on investment over the short term, if that were to boost the GDP growth rate and reduce those ratios in the long run.

Richard Hughes: Certainly one of the biggest judgments we have to make in doing these projections is what to assume about the future rate of productivity growth. It has been very disappointing over the last 10 years or more, but it was reasonably strong in the period before the financial crisis. So your judgment about what might happen to the path of productivity over the longer term—might it recover back towards those rates or might it stay low?—is really important.

It is one of the reasons why we always do different scenarios around the rate of productivity growth when projecting debt. We did one in the last economic and fiscal outlook which showed that, on some assumptions, if you have low productivity growth, at about 0.5% lower than our forecast, debt rises in every year for ever. If you have just 0.5% of productivity growth higher than what we assume, debt falls back into the sort of mid-80% of GDP within five years, so imagine what difference that makes when it is projected out over 50 years.

However, one thing to bear in mind about the productivity magic bullet, when thinking about sustainability, is the fact that it can be dangerous to talk about productivity growth in isolation, as though the rate of productivity growth might go up but nothing else that matters to the public finances changes. When growth rates go up, interest rates also tend to go up to track them. So, in that sense, the most important equation for this, which is r-g—the difference between the real rate of interest and the growth rate—might not change that much.

Also, an awful lot of what we spend our money on in this country, either directly or indirectly, is somehow connected to the rate of productivity growth. If we are spending 2% of GDP on defence, it will just go up when GDP goes up. The triple lock is linked to earnings. Even in sectors like the health service and education, earnings growth will, to some extent, track productivity growth. So the cost of delivering those public services might also rise if we end up seeing higher productivity and higher pay and earnings in the wider economy.

Lord Blackwell: I think we are coming back to productivity later. I guess what I am trying to say is that the debate is framed around debt levels, but should the real debate not be on sustainable levels of spending?

Richard Hughes: It is the thing that drives the unsustainable debt-to-GDP ratio in our projections by a long way and, in particular, the path of spending on the National Health Service.

Q34 **Lord Layard:** Following up on that, are your forecasts of public spending realistic, not in relation to changes in productivity growth but in relation to the public’s demand for a national health service or a social care service, or to make the courts run properly, or whatever? Is it likely that we could see a continuation of spending at the level that you project?

Richard Hughes: Not if you do not want to see the debt-to-GDP ratio spiral in the way it does. That is based on some fairly reasonable assumptions about what is happening to the age of the population, the health of the population, and the unit cost of healthcare over that 50-year period. We see our population getting older. People used to be getting healthier as they aged, but the data has been more disappointing recently, in the sense that you are getting more years of unhealthy life rather than more years of healthy life. That poses a challenge for the health service. Also, the unit cost of delivering healthcare has been rising faster than the unit cost of everything else in the economy, which means that the cost of delivering healthcare services is not keeping up with the growth in tax receipts.

Q35 **Lord Davies of Brixton:** First, I always think it is a problem, and I want to know the extent to which you think it is a problem, comparing stocks with flows. It is problematic. Where does it figure in your thinking?

On a specific issue, Lord Blackwell pointed out that you could capitalise future obligations to pay future state pensions. To my mind, that does not make a lot of sense, but if you are going to do that, surely you also have to capitalise the future income that is going to pay. In fact, you are ending up with an identity there. What does that tell you?

Richard Hughes: We do not have a contributory pension system for citizens or public servants. So, to the extent that you capture those obligations, you end up relying on the kind of projection that we do, which captures the spending going out and taxes coming in in future, rather than being able to nicely summarise those by looking at a financial statement for the public sector pension fund. As a former director of pensions, Tom might have some thoughts on this.

Tom Josephs: In our *Fiscal Risks and Sustainability* report, we are trying, exactly, to combine information on stocks and future flows. We take the current debt position, which gives you your stock position, and then look at how future flows are likely to affect it over time both on the tax side and on the expenditure side.

Lord Davies of Brixton: Is what you are trying to assess there the willingness of future generations to pay future taxation?

Tom Josephs: Yes, or the burden it will create.

Lord Davies of Brixton: I always think the word “burden” is—

Tom Josephs: Our assumption in the long-term report on the tax side is broadly of a constant tax-to-GDP ratio, except where there are obvious implications from demographics on effective tax rates, essentially in the future.

Lord Davies of Brixton: That is quite a big exception.

Tom Josephs: It does not make a huge difference to the tax-to-GDP ratio compared to the difference that the demographics make on

spending, given the pressures from demographics feeding through to health and pensions. We do take account of some known pressures on taxation. One of the ones we look at in the report is the impact of the transition to net zero and, essentially, the fact that the Government will lose revenue from fuel duty, which is a substantial source of revenue.

The Chair: Without putting words into your mouth, is what I am hearing that if, in the next Parliament, the Government do not fundamentally rethink what the state does, in particular as regards support for an ageing population and health, there will be an increased likelihood that we get on a path to unsustainable debt? Is that fair?

Richard Hughes: Yes. I would add a number of other long-term challenges to that. The other obvious one is net zero. The Government have made commitments to get from here to net zero by 2050, but we have not seen a fully funded plan for getting there. In our last-but-one risk report, we looked at what the cost of getting to net zero might be.

The Chair: We will come back to that in detail later, because we are very interested in that.

In terms of what the Government do during the next Parliament, are you saying that simply cutting taxes to get growth going again will not necessarily address these structural long-term trends? Do we need a deeper and more fundamental look at what the state does to address these challenges?

Richard Hughes: To give you a sense of the magnitude, the tax cuts that we have seen so far have been relatively modest in terms of the share of GDP that they are taking up and their impact on output. They are marginal changes to marginal tax rates, and they are having a relatively small effect on people's decisions to supply labour. So they are not the kinds of changes that will solve the fundamental long-term fiscal challenge here, which is that, left unaltered, spending on health will go from 8% to 15% as a share of GDP. That is an enormous increase in cost.

The Chair: What timeframe is that?

Richard Hughes: That is between now and 2070, so over the next 50 years. The kind of marginal changes in the level of GDP, driven by the kind of marginal changes that we have seen in tax rates, are not enough to fundamentally change those dynamics and make a difference to the ability to afford a state of that size.

The Chair: Thank you. That is very interesting. We will come back to productivity later.

Q36 **Baroness Kramer:** I have to admit that I am getting so utterly discouraged at this point in time. I apologise for being late: the Bishop of Hereford decided that this was the day for him to be introduced into the House. It is his perfect right, but it was inconvenient for us.

You have been very clear in laying out the structure of the UK's national

debt for us, but could you talk a little about the implications for short-term and longer-term funding of that debt? As you discuss that, perhaps you could draw in your views on the impact of QE and QT. I have some more detailed questions on those.

Tom Josephs: We have talked a lot about the level of debt. In the UK, compared to other advanced economics, the level of our debt is not that of an outlier, although it has been rising more quickly than other countries' over the past couple of decades. However, there are aspects of the composition of our debt that potentially lead to more risks, pressures and vulnerabilities. One is that our debt is now much more sensitive to interest rate and inflation shocks of the kind we have just been through.

Baroness Kramer: Do you mean the cost of QE and the shortening of the maturity of the gilts portfolio?

Tom Josephs: Exactly. The main reason is the shortening of the maturity due to QE. The UK has a relatively long maturity in the gilt stock itself. That is still the case, but a large proportion of those gilts is now held by the Bank of England, which has issued short-term debt in exchange, which essentially has shortened the maturity.

The other reason why we are very susceptible to inflation shocks is because we have a much larger share of index-linked gilts than other countries do, which has built up over time.

Baroness Kramer: Who thought it was a great idea to issue index-linked gilts when interest rates were very low?

Tom Josephs: I think the programme started in the 1980s, so it is very long standing. For most of that period, index linkers have been good value for the Treasury and the taxpayer, because investors have basically paid a premium for the inflation protection that the Government can offer. The Government are usually quite well placed to offer inflation protection, because revenues are linked to inflation as well.

Obviously, we have recently seen a very significant shock to RPI, which index-linked gilts are linked to. In fact, that shock has been greater than the shock that we have seen to the tax base and has therefore become more costly to the taxpayer more recently. You can see—Richard mentioned this earlier—that the debt interest-to-GDP ratio in the UK has shot up by about 1.5% to 2% of GDP, whereas most comparable countries have seen only a very small increase.

I will just go back to the first point that the Chair made and the fact that, this month, we saw a fall in debt interest costs in the latest outturn. I caution against reading very much into those monthly releases, which by their nature are very volatile and noisy. Debt interest costs this month were lower than our forecast just because RPI inflation has come in lower than our forecast. That will have an impact only this month; it does not really tell you anything about the medium term.

The Chair: Do you think we are being a bit Panglossian in the way we

read this?

Tom Josephs: As I say, you should not really read anything into the monthly numbers; they are very noisy and volatile. In particular, debt interest having been a bit lower than we expected this month because of lower RPI is essentially a one-off that does not really tell you anything about the medium-term forecast. I am sorry; that was a slight digression.

Baroness Kramer: No, it was a perfectly valid set of comments. I suppose I am trying to explore a bit more your use of the term "health of the gilt market" or its capacity to continue to absorb debt issuances. We have raised the issue that the Government themselves announced very substantial debt issuances or gilt issuances over the next several years, running between £200 billion and £250 billion. The Bank of England has decided that it is now time to switch over to QT, so it is in the market. It is always hard to know quite what pension funds will do, but a number of them are restructuring in a direction that is taking away their interest in gilts, or at least potentially does. There is a reliance on overseas markets that have a more volatile history. Can you unpack some of that for us? I am just trying to understand how intense our vulnerability is.

Tom Josephs: The points that you have raised are all important. As Richard said, in the short term, there are no signs that the Government are not able to finance themselves. The gilt market functions well, the DMO's auctions are well covered, and our spreads against the US and Germany are close to their historic averages. But there is certainly risk and pressure there.

The financing requirement—the total amount of cash that the Government need to raise in the market each year—is at very elevated levels and is forecast to remain at elevated levels at least over the medium term. As you say, that is due to a combination of relatively high levels of government borrowing and the fact that the Bank of England, for monetary policy reasons, is unwinding QE and is therefore essentially also selling into the market. We expect the quantity of gilts that the private sector needs to absorb to peak next year at close to 8% of GDP, which I think is the highest it has ever been.

The Chair: Could you say that again? I am sorry, I did not quite catch it.

Tom Josephs: The total quantity of gilts that the private sector will have to absorb in the market next year reaches 8% of GDP, which is one of the highest levels it has been. This is known by the market and there are currently no signs of stress, but it clearly creates some risk. Our gross issuance levels are also quite a bit lower than those of some comparable countries. Again, this goes back to the point that our stock of gilts has a long maturity. Other countries, such as the US and Japan, have much shorter maturity gilts and have to roll over more each year, so their financing requirements are quite a bit higher than ours.

Baroness Kramer: Where would their median maturity be? If somebody told me that the median maturity was seven years, I would feel pretty

safe and secure. When someone says two years median maturity, I start to quake, but that may be wrong of me.

Richard Hughes: They are much shorter than ours. Tom might even be able to find the number. For some of these countries, it is in the two-year to three-year mark. In particular, the US has recently been borrowing very short term. Abstracting from QE, we have typically had a maturity in the double digits—14 or 15 years. Once you take QE into account, it shortens quite a bit to two years at its peak. As the Bank of England unwinds QE, it goes back up to something around seven, which gets you closer to the G7 averages.

We still end up benefiting from the fact that the stuff that the Bank of England has not bought up still has a relatively long maturity, so we are not having to roll that sort of stuff over. Countries like the US and Japan, which have borrowed a lot, and borrowed a lot short term, are rolling over debt in the market worth 10% to 20% of GDP every year, which is a lot of the volume for the market to deal with, but their markets are a bit more used to those kinds of volumes than we are.

Q37 **Lord Turnbull:** If you compare two countries both with a 90% debt-to-GDP ratio, you can then look at all sorts of differentiating factors about how resilient and risky that is. One of those differentiators is the proportion of that debt that is held overseas and the proportion that is held domestically. There has to be an assumption, which I think you yourself have made, that the debt held overseas is—I think the phrase was—"more fickle and flighty"—

Richard Hughes: I recognise those words.

Lord Turnbull: —whereas that held domestically is more sound. I question that and whether you can rely on a larger domestic holding. The debt of our local institutions may be less flighty, but there may be less of it. If there are some structural changes going on in their pension funds and insurance funds, that debt may not be as flighty, but it is harder to get hold of. I wonder whether we should not put so much emphasis on the fact of countries having a lot of overseas debt, because it may be flighty but plentiful. Ours may be stable but less plentiful.

Richard Hughes: I think one reason why the share of foreign ownership of our debt has been rising is because our volumes have been going up and our domestic debt market is only so big. Actually, some of the most active purchasers of gilts in the recent past have been defined benefit pension funds, most of which are closed to new members, so their demand is not growing. Many of them have also reached full funding, so they are not looking to buy new gilts, and many of them are going into payment, so are looking to liquidate their gilts and realise cash to pay their members.

One reason why more and more of our issuance has ended up in foreign hands is because we have been coming up against the constraints of our domestic debt market. I do think foreign holdings of debt are inherently riskier than domestic holdings, because foreigners do not have to hold

gilts. They have no particular reason to hold them, other than thinking that they are a good investment. If your expenses are in sterling, you have liabilities in sterling and will want to hold assets in sterling, as domestic pension funds and businesses do.

Lord Turnbull: Your obligations to hold sterling may be in secular decline. You say that these defined benefit schemes are declining, so whether they are flighty or not, it is a smaller market to try to fund yourself from.

Richard Hughes: That is right, and a reason not to take it for granted if you are the Government issuing debt into that.

Q38 **Baroness Kramer:** Is there any strategy that gets you out of that? Is there anything that you can do or any scenarios that you play where something happens that changes that profile?

Richard Hughes: You could raise your savings rate. Savers will be looking for safe assets in which to put their money. That is the Japanese solution, which is to have a very high domestic saving rate and sell directly to your citizens.

The Chair: Just to be clear, is the risk attached to the structure of our debt and the volume of debt we are issuing, alongside a large number of other developed countries also issuing large amounts of debt, adding to the sense of risk overall as you look ahead to the end of this decade?

Richard Hughes: Yes, because it makes the cost of our debt more volatile. You have seen that recently. As Tom was saying, because so much of it is index linked, changes to inflation make much more of a difference to our debt interest costs than they do in other countries that have either no debt or a much lower share of debt that is directly linked to inflation. The shortening of maturities makes our stock of debt more vulnerable to the year-on-year changes in interest rates, because more of that hits the stock than would happen if you were rolling it over a much longer time period.

You can see that in the data: our interest costs have gone up a lot faster than that of other G7 countries and have constrained the fiscal choices that we can make right now as a country, compared to the US, France or Italy, because our interest costs have responded so much more quickly. That is one reason why you have seen a much more aggressive fiscal consolidation in this country over the last few years: because you have had to deal with rising interest rates.

Q39 **Lord Davies of Brixton:** This is just a technical point. There is a problem with index-linked securities when inflation is high, because the value goes up. As I understand it, that increase in value, which you potentially do not have to pay until they mature, is still counted as current expenditure.

Tom Josephs: Yes, that is right; it is accounted for in government borrowing on an accrued basis. Essentially, it increases borrowing at the

point at which inflation goes up. This is the point I was making about this month’s release today; it is when the actual cash outlay takes place.

Lord Davies of Brixton: So you do not need taxation to cover that cost; it is capitalised, in effect.

Tom Josephs: But it is accounted for in that way to reflect the fact that it is a real cost on the Government that they are incurring.

Lord Davies of Brixton: I just wanted to be clear.

Baroness Kramer: I am sorry. Could I just try to understand? I am not sure whether it is capitalised in actual fact, whether there is a cash-flow effect in that you are having to pay out the interest, or whether there is no impact on cash flow because it is capitalised and shows in the accounts as current expenditure.

Tom Josephs: The cash-flow impact happens over the lifetime of the gilt, but the impact that the variation in inflation will have on the cash flow over that lifetime is scored in the government borrowing, when it happens.

Richard Hughes: You realise the additional cost as a higher cost to finance in the year in which you face the inflation shock.

Baroness Kramer: But it may feel as though it has less fiscal impact because of that.

Richard Hughes: If we did pure cash accounting, we would not worry about these kinds of things, because we are not spending more cash on interest in the year in which it happens; it just raises the cost of redeeming that instrument when it becomes due for redemption.

Baroness Kramer: The biggest fiscal impact of interest rate changes has been basically through the QE mechanism.

Richard Hughes: It has been through nominal interest rates, both on gilts and on the interest rates paid by the Bank of England on central bank reserve.

The Chair: The losses to the APF are, I think, £126 billion. How is that figure looking now? The report says a “net lifetime loss of £126.0 billion”.

Richard Hughes: Tom specialises in complex accounting questions.

Tom Josephs: That was the estimate we had in the November forecast. We have not updated it since then, but it is very sensitive to interest rate movements. The movements we have had in interest rates since November have been quite significant and will affect that. We will do another calculation in the March Budget.

The APF made a profit for the first 12 years of its life, but because of the rise in interest rates, it has led essentially to net losses on the interest rate differential, which are now costing the Exchequer. Because the Bank

is now engaged in unwinding QE through QT, it is also realising losses on sales and redemptions, which is leading to the losses that we are now seeing. As you say, we make an assumption about the future path of QT, but that path is not actually set out by the Bank of England, which plans just one year ahead. We take what it says and make our own assumption over the medium term. That is the basis of the estimate.

Lord Davies of Brixton: Who is the counterparty to the loss? Obviously if someone is making a loss, somewhere else someone is making a gain.

Tom Josephs: This is a loss to the public sector as a whole.

Lord Davies of Brixton: So it is a net benefit to the private sector.

Tom Josephs: For the first period, it was going the other way—

Lord Davies of Brixton: Yes, and they moaned a lot.

Tom Josephs: —but now it has turned.

Baroness Kramer: It is cash this time, because the Bank of England actually has to transfer money to the Exchequer and money has to be transferred daily to the banks on the reserves.

Tom Josephs: Yes, that is right.

Q40 **Lord Davies of Brixton:** Fiscal rules are pretty controversial now and an item of some abject cynicism. Are they a useful tool in looking at where we are? Does it tell us whether something is sustainable when the fiscal rule is or is not complied with, or if there is a change in the fiscal rule?

Richard Hughes: You should definitely hear from both Tom and me on this question, because we have had lots of experience of UK fiscal rules as well as questions from other countries about what kinds of rules to adopt.

I do think that fiscal rules are a good thing and they have been a good development in fiscal policy-making. You have to ask yourself whether you would invest in a company that did not have a clear financial objective to get back into or stay in profit. The short answer is probably not. Citizens have a right to know what the financial objectives of the Government are. They are raising a lot of tax from us; they should tell us what they plan to do with that tax revenue and how they will make sure that they are good custodians of the public finances. That is the spirit of fiscal rules, where they have been adopted.

It is also the case that there is no perfect fiscal rule. They always introduce distortions. They often lead to gaming behaviour on the part of Governments who want to meet the letter but not the spirit of the rules. We have seen some of that in the UK with successive fiscal rules.

A current rule that we have is to get debt falling as a share of GDP in five years’ time. On the face of it, that is positive from the point of view of trying to bring about debt sustainability when you reach that point. The

challenge is that, because it is a rolling rule, that point is always retreating into the distance; it is a sort of mañana rule. The point at which you have to get debt falling is always five years ahead and never seems to be realised, so it does not necessarily get debt falling in outturn. In recent budgets, we have seen that, as soon as you get an extra year to meet it, the Chancellor fully takes advantage of that extra year.

As we have also discussed, there is a challenge at the moment in the UK in that that our forecast has to be based on a set of policy assumptions which, based on a pattern of government behaviour, do not look central. Governments tend not to index fuel duty, and they tend to add money to departmental spending when it comes to the time to do spending reviews. They have not done spending reviews covering four of the five years of our forecast coming up.

Finally, Governments tend to run things very close to the wire when they have fiscal rules. They leave themselves only a fraction of a margin against a rule that is very highly geared, as we have discussed. We talked about errors in just one month of data worth £5 billion, and the Government have headroom against their fiscal target, in five years' time, of just £13 billion. That is a tiny number compared to the risks that you face.

I do think that these headroom numbers would get less attention if Governments just left themselves more of it, because it would not really matter what happened in one month. When they set themselves fiscal targets, they should aim off by more than just a few billion pounds, because that makes them very beholden to the latest bit of data or the latest forecast, because these numbers are well within the margin for error for both outturn data and actual costs.

Tom Josephs: I agree with Richard. It is really important to have a transparent and clear fiscal objective and fiscal strategy, and to have the political commitment and credibility to deliver that. That is the most important thing. A fiscal rule is then a sort of operational mechanism to help you to communicate and deliver that. I think people can get a bit too preoccupied with the precise design of those fiscal rules, which is a bit second order compared to the overall objective being clear.

As Richard said, there have certainly been periods over the last two or three decades when having clear fiscal rules maintained over a reasonably long period has clearly been important to support Governments to deliver their fiscal strategy.

Lord Davies of Brixton: Just to pursue the point you made, the way fiscal rules have been defined ends up being the difference between two enormous numbers, both of which are inherently unstable. That makes the difference between them a bit of a nonsense, it could be argued.

Richard Hughes: Yes, and it is the difference between two very large numbers at two different points in time—2027-28 and 2028-29—and the

Government are trying to get it falling by a tiny fraction in one year, which depends on a stock of debt that is 100% of GDP and the performance of the entire economy, which is the denominator. So that ratio is very highly geared to what assumptions you make about interest rates, growth and other things that go into our forecasts. As I said, our forecast error for borrowing five years ahead is between 2% and 4% of GDP, and we are talking about a margin that is 0.4% of GDP at the moment.

Q41 **The Chair:** Given all that, you could say that the current rule is meaningless and worthless because it is being observed in the breach rather than the fact it is always five years out and has all these assumptions built in. But, actually, it is worse than that, is it not? Is it not damaging, because it is essentially giving the impression that action is being taken and that we are in a better position than we might be?

Richard Hughes: It is a constraint on decisions that can be made at any point in time, but in the way in which it has been operationalised, it does not get debt falling, because every time you get an extra year you take advantage of it. You saw that in our last forecast: the Chancellor got a windfall of around £20 billion-odd, and he spent all of it because he had an extra year to get debt falling. He did not have to worry about meeting it in 2027-28, as he had in the previous Budget, but in the following year.

The Chair: Should we be looking to keep the rule as it is and allow for these imperfections, or is there an argument for saying that it should be looked at in some shape or form? I am just trying to understand your sense here.

Richard Hughes: As I said, there is no perfect rule. Setting fixed deadlines has its problems. We have seen that in the past: you set a fixed deadline and a pandemic comes along, an energy crisis comes along, and there is no way you will meet the rule in that particular year. If you are going to set a rolling rule, like the one we have, you have to accept that the incentive it creates is for you to never get debt falling in outturn but to always promise it will fall in prospect, which is what has happened in the recent past.

Q42 **Lord Londesborough:** Can we return to the troubling subject of productivity? The OBR’s central forecast is for 1% productivity growth over the next five years. That sounds modest when you compare it to the 2.3% average rate of productivity growth between 1974 and 2008, but it looks like a critical assumption when compared to the average 0.5% between 2008 and 2020.

Rather alarmingly, that drop in productivity is, I believe, unprecedented in more than two centuries, which has led some to argue that this suggests structural issues in our growth potential. I saw in the OBR’s November report, under “Risks and uncertainties”, a neat but chillingly small paragraph warning us that if productivity growth, which you alluded to earlier, falls “back to its post-financial crisis average of ½ per cent”—I do not think it is falling back, because we are below that at the moment—

this factor alone "would increase borrowing by £40.5 billion" in 2028-29. It is highly sensitive, in other words.

So my question is this: is enough attention being paid to the structural slowdown in growth as a source of our deteriorating debt dynamics?

Richard Hughes: A lot of attention gets paid to it. I think it is right. I certainly think that the productivity puzzle is being puzzled over by lots of macro-economists, not just here but around the world. People are doing work to try to understand its drivers. You are right that the single most important judgment we have to make when doing our near and long-term projections is asking what we are assuming about the underlying rate of productivity growth.

We have ended up, after some significant downward revisions in recent years, with a number that lies somewhere between the rosy productivity numbers of the pre-financial crisis era and the very disappointing productivity growth over the last few years. I think that reflects the fact that we are not technological nihilists in the OBR; we think there will still be the kinds of technological changes that increase output per worker over the medium term. However, we have experienced a very disruptive period for UK productivity. The financial crisis did a lot of damage to the productivity of the financial sector. More recently, disruptions to our trading relationships, the pandemic and, most recently, the energy crisis have all been shocks that have sapped our productive potential over the last few years.

We assume that, compared to the very disappointing performance we have seen in the recent past, there will be some recovery but not back to anything like the rates we saw before the financial crisis. We also in our forecasts recognise, capture and reflect where government policy looks to make a difference to the potential output of the economy by boosting the labour supply, boosting investment or boosting other drivers of productivity growth, as we have in recent Budgets.

Q43 **Lord Londesborough:** Which structural areas of productive potential—you have alluded to one or two in your answer—concern you the most?

Richard Hughes: I would say all of them, because none of them are going well. We have chronically low levels of investment in the UK, so we have lower levels of capital per worker, which reduces the productivity of people who are employed. Until recently, an area of relative success for the UK has been expanding the labour supply—in particular, bringing more women into the workforce and having people work for more of their lives, which increases the amount of labour input into the economy.

As I am sure this committee has discussed before, in the wake of the pandemic we face more worrying news about rising levels of inactivity among the adult population, which has put a dent in the growth of the size of the workforce. That was going well until about 2018 and 2019 but has since started going in the wrong direction.

Looking at what is called total factor productivity, or the efficiency with which labour and capital can be combined, there are worrying trends in the course of global economic integration, which has been very important for us. Globalisation has been a considerable force for productivity growth in the UK, especially in areas like financial services and in manufacturing. What was, until recently, a renaissance in the car sector was driven by the fact that we were being incorporated into European supply chains. If that process goes into reverse, we will start to lose those productivity gains that have come from greater integration of trade.

Q44 **Lord Londesborough:** Talking about global scenarios, in international productivity league tables, the headline is that the UK was second out of the G7 back in 1997, but since then we have slipped to second last in the G7. How much do these international comparisons matter when you are looking at the sustainability of debt?

Richard Hughes: The absolute position matters more than the league tables, but they certainly affect investors' perceptions, which is especially important if you rely on foreign investors. Investors' perceptions of your creditworthiness matter, because if you are a rapidly growing economy, that allows you to borrow a lot more in a given year, because people think they are likely to get paid because the economy is booming and tax receipts are booming, so this is all part of a sustainable equation.

If your economy is growing very slowly and you are looking to borrow large sums of money from foreign investors, they are likely to look at your country and think, "They're asking me to lend them a lot of money. I'm not sure how likely they are to pay me back, because their economy is not growing very much and their tax revenues are unlikely to be very buoyant in the long run".

Q45 **Lord Londesborough:** Low growth and low productivity go hand in hand, so you would think at some stage that it will impact the appetite of foreign lenders to continue, particularly when the debt metrics are going north of 100% of GDP. Do you see that as a medium-term threat?

Richard Hughes: I think it is a concern for all advanced economies. I do not think anybody envisaged debt-to-GDP ratios approaching, or going above, 100% in countries like the UK. Countries have not met their debt obligations in the recent past. Greece is the classic example; its debt-to-GDP ratio spiralled in the wake of the eurozone crisis, and it got to the point where it just could not meet its debt promises and it had to restructure.

Q46 **Baroness Kramer:** I have a tiny question. Is this something that gradually gets worse, so you realise that you are going to enter into problems and you have a bit of breathing space to do something, or is it quite cliff-edge? Does it look as though you are doing absolutely fine in the debt market and then, all of a sudden, there is a collapse in confidence and you have gone over the edge?

Richard Hughes: I think it was a Hemingway character who, when asked, "How did you go bankrupt?", said, "First slowly and then quickly".

That is the way it goes for sovereigns as well. There is a period when they are on an unsustainable path, but people are waiting for them to do something about it. Suddenly, when there is a reappraisal of the credit worthiness of the sovereign, the crisis is precipitated because suddenly the interest costs start to rise, that starts to make solving the fiscal equation through any kind of adjustment to tax and spending much more difficult, and they end up going from a path where they probably would have defaulted in 20 years to going on a path where they end up defaulting in about 20 weeks.

Q47 **Lord Blackwell:** Have you calculated what additional growth would be needed to keep spending down at 40% rather than 64% in 50 years' time? I think it is roughly another 1% a year.

Richard Hughes: That does not sound unreasonable. I will not hazard a guess, but it is a growth rate that we have not observed in this country in the recent past.

Lord Blackwell: We could calculate that, but if you could calculate it, it would be useful to know.

Tom Josephs: I want to make one point on this. What is important is not only growth in isolation but, particularly for debt dynamics, the relationship between growth and the interest rate. On that metric, the UK's position relative to other advanced economies has deteriorated over the recent few years, because we have seen a particularly sharp increase in interest rates and not very strong growth rates. Looking at the range among the G7 countries, the UK now has the most challenging r-g, which is the relationship between interest rates and growth. That means that it is much more difficult for Governments to get debt on a stable trajectory. They have to run quite large primary surpluses even to get debt stable.

Q48 **Lord Layard:** Could we turn to demography, in particular immigration? I think it is right that you think that more immigration would be good for the debt-to-income ratio, but maybe you could comment on that.

Secondly, retirement must be a huge factor. I do not know what your assumption was on the state pension age, which has a big impact on the level of retirement and, of course, on the public finances, but how much could most of the problems in the long term that you have pointed to be dealt with by changing the state pension age?

Richard Hughes: I will start with UK demographics and the state pension age. When we do our long-term projections, we take account of the Government's stated policy that the state pension age rises with longevity and that, roughly speaking, you will spend a third of your life in retirement. There is an assumption about the stated increase in the state pension age built into our forecasts. I cannot remember the exact date when it will go up, but some time in the late 2030s there will be another rise in the state pension age. In essence, that buys you some breathing space, but in the long run people will eventually cross it, and unless you keep raising it it will be a one-off benefit to fiscal dynamics rather than a long-run benefit.

The underlying demographics remain pretty stark, in the sense that, in the 1970s, we had about two people in work for every one person in retirement. At the moment, we have about one and a half people in work for every one person in retirement. By the time we get out to 2070, we have only one person in work for every one person in retirement. So the demographic transition, even with that built-in rise in the state pension age, is pretty challenging.

Your question about migration very much depends on the demographic profile of the migrants you are talking about. Basically, between the ages of 20 and 66, most people are making a net contribution to the Exchequer because they are working, and until they get a bit older they tend not to be major consumers of health services and they are not getting a pension. But, before and after those ages, they are net recipients of fiscal support from the public finances, because you are either educating these people or paying them a pension. Later in life, they are consuming a lot of healthcare, as well as social care. So the demographic profile of migrants really matters in terms of their impact on the economy and public finances.

There is an added challenge as a forecaster in the fact that the policy regime has changed a lot in the recent past. We have gone from a situation where the bulk of our migrants were coming from the EU and, because that had been happening over an extended period, we had a reasonably good understanding of their demographic profile: they were more likely to have been of working age, they tended to bring fewer dependants than the domestic population had, and they tended to be more likely to return to their home country, at some point in their lives, or to go to another European country. In that sense, they tended to have a slightly higher employment rate than the UK population. In many cases, they arrived of working age and already educated, so we did not pay for their education.

More recently, the composition of migration has changed a lot. Most of our migrants are now not coming from the EU but from other countries. We see in the data that a lot are coming in as students, but a lot are coming to work and they are bringing dependants. For the moment, the assumption we have made about their demographic profile is that they broadly look like the rest of the UK population, so there is no particular economic or fiscal premium attached to migrants compared to UK citizens, because their demographic profile looks more like that of the UK and they are likely to participate in the labour force. We still do not pay for the education of those who are working age, so we save on that bit of it, but we have had to make adjustments for their participation in the workforce and their consumption of public services, because we have also seen rises in dependants.

Q49 **The Chair:** On the number of migrants, page 126 of the July report says that "the increase in our net migration assumption from 129,000 to 245,000 per year has led to a 1.1 and 30 per cent of GDP reduction in the primary deficit and net debt by 2072-73". To be clear, that is saying that

net migration has to run at 245,000 a year for the entire period to avoid that rise.

Richard Hughes: I would say it slightly differently. This is about what we assume is the steady-state level of migration coming into the UK, as part of our long-term projections. The projections that you are talking about are the ones that we did back in July last year. We are learning more and more about levels and composition of migration with every passing month, so we keep all these assumptions under review.

We have consistently raised our assumptions about long-run net migration levels, as we observe what is going on with the data and hear what the Government say about policy. Most recently, our assumption, based on the last set of ONS projections, has been that, in a steady state, around 245,000 net migrants are coming into the country. We will get a new set of ONS projections at the end of this month, which might affect our view of the long-run, steady-state level of migration. Just the change from 129,000 to 245,000 migrants in our last set of projections made a fairly small change to the level of debt at the 50-year horizon. That basically comes down to the fact that the UK does not pay for the education of at least the working-age migrants who come to the UK, so you save on that part of it.

However, in the long run, migrants have children. If they stay, those children have to be educated. They consume health services and claim a pension, so, in the long run, migrants do not look very different from the rest of the population. It is only the fact that, when they arrive, at the very least if they are working-age adults, we have not paid for their education.

The Chair: I suppose my blunt question is: if you brought migration right down to 100,000 in the next five to six years, what would that do to your projections for net debt?

Richard Hughes: It would make a marginal change, but none of these things are going to make a—

The Chair: We will need to suspend for a Division in the House.

The Committee suspended for a Division.

The Chair: Welcome back. Lord Layard has a question.

Q50 **Lord Layard:** I want to go back to the fiscal rule issue. I think it is true that the present debt-to-income ratio is just about the same as the average over the last 200 years, yet a lot of people are saying that we have to pay off the Covid debt, and so on. What is your view as to how strong the case is for trying to reduce it, or is it pretty much okay to stay where we are?

Richard Hughes: We can clearly service the current level of debt at the prevailing interest rate. The challenge with the level of debt we have at the moment is that, in future, we know that the trends will be against us. In the past, we have had debt at a much higher ratio of GDP. At the end of the Napoleonic Wars, and at the end of the Second World War, it was well over 200% of GDP.

However, there were a lot of fiscal tail-winds post-1945: we had a baby boom, there were some big peace dividends from bringing defence spending down from 10% to 2% of GDP, more and more people were coming into the workforce and paying tax. All those things were making it easier to bring the debt-to-GDP ratio down to where it ended up at the end of the last century and the beginning of this one.

The challenge, starting right now with the 100% debt-to-GDP ratio, is that a lot of those tail-winds have turned into headwinds. The peace dividend has run its course, and demography has gone the other way. We do not have a baby boom; we have more of a baby bust, in that the fertility rate is below the replacement rate of the population, and we have an ageing society. The factors pushing up on that ratio look much stronger going forward than the factors that might push it down by supporting growth or tax revenues over that period.

That is the reason to be concerned about the level of debt we have today, relative to previous points in history when we have had the same level of debt or higher.

Lord Layard: I was not suggesting that we let it rise. I was asking what is wrong with keeping it where it is.

Richard Hughes: That is the Government's stated policy. The challenge is that demographics, as well as other challenges we may come on to, will push up spending automatically relative to tax revenues. You have a workforce that is falling as a share of the population and demanders on public spending in healthcare and pensions that are rising as a share of the population. So our existing fiscal policy settings will not keep debt where it is; they will drive receipts down and spending up.

Tom Josephs: Even if you were able to deal with these kinds of spending pressures, there is also the risk, which we have seen materialise over the last 20 years, that the economy gets hit by very big shocks. You want to use fiscal policy to absorb those, but that is extremely expensive in fiscal terms, so debt ratchets up if you are not looking to reduce debt in the times in between the shocks. We have no idea whether those shocks will continue to hit us, but experience in the last 20 years has certainly been that some very large shocks are coming along quite frequently, with huge impacts on the public finances.

Q51 **The Chair:** What assumptions have you made about the ageing population? Obviously, if you have great improvements in healthcare, it might mean that people can work for longer, and it might mean the costs come down. Please explain to us for the record what those assumptions

are.

Richard Hughes: We have the ONS population projections, so we assume that society is ageing. We assume that the unit cost of healthcare continues to outpace the unit costs of other things in the economy. Health cost inflation is rising faster than the rest of the economy, which is basically what it has done over recent decades. Healthcare seems to get more expensive over time and rise as a share of national income. That is partly because we keep coming up with expensive new therapies that we can provide people with.

There is probably also an element of an income effect, which is that, as people become wealthier, they consume a larger share of their income as healthcare, because the other necessities of life become more affordable and consume less of their income. Certainly, as incomes rise across countries, richer countries spend more of their national income on healthcare, so it is a reasonable assumption to make based on extrapolating past trends that, as we get wealthier as a country, we will also keep consuming more of our income as healthcare.

Lord Turnbull: You said earlier that healthcare had risen from 8% or 9% of GDP to 15%. Do you mean health, or health and social care?

Richard Hughes: That is just health. Social care is on top of that. Social care is one or two per cent of GDP, but health is the big-ticket item.

Q52 **The Chair:** I do not want to go down a rabbit hole here, but I am in danger of asking such a question. Coming back to Lord Londesborough's question, I keep hearing about AI and how it will be this magical trend that will increase productivity and deal with lots of problems, including bureaucracy in healthcare, for example, and all the other things that go with it.

It is a difficult question to answer, but how much have you taken account of AI and the tech revolution? This is where I question forecasts 10 years ahead, given the pace of change. We hardly knew last year what was happening this year, so I just question that as a basis for some of these assumptions.

Richard Hughes: I think it offers hope for improving the productivity of the health service, but we do not forecast on the basis of hope. You also have to bear in mind that, if innovation was the magic bullet and the answer to bringing healthcare costs down, we would expect the countries at the frontier of innovation in healthcare to spend less, and they do not; they spend more. Most of these innovations come from the US and tend to get adopted earliest there, and the US spends a much bigger fraction of its income on healthcare than we do.

The Chair: I fear I might have opened up a can of worms.

Q53 **Lord Rooker:** You have indeed. Take a look at the work of Sir Michael Marmot on the inequality in health. We are allegedly providing the same level of service for everybody, but what if we just concentrated on piling in the extra where the inequality is and go hunting for people who do not

have the access that others do? That might be an argument for saying that we do not have a national health service, yet we would be effecting more people well enough to work than if we stayed in a steady state.

Richard Hughes: An important question that we have to look at when we do these projections is not just what happens when people get old but what they are doing before that. Lifestyle choices in different parts of the country certainly lead to very different levels of healthcare requirement later in life. If people can live healthier lives and be encouraged to do so, that can save money down the road.

You ask whether there are parts of the country that are less healthy than others. Yes, there are, but it is not always related to people's access to healthcare and the quality of it, because oftentimes it is too late by that point. The issue is what kinds of lifestyle choices they have made before then and whether they have been able to access good work that is good for their health versus other kinds of work that is bad for their health.

Lord Londesborough: I was joining the Chair in going down a rabbit hole, but a quick observation is that I agree that you should not factor in AI as it is impossible to predict. However, in the last 20 years, digital transformation has done virtually nothing for productivity. That is essentially a health warning about getting overexcited about future innovation. Recent history shows that it has done virtually nothing for GDP.

The Chair: Good observation.

Baroness Noakes: I want to focus on the workforce assumptions that you are making. You have assumed that the labour force participation rate increases during the medium-term forecast period and that helps to get the debt-to-GDP ratio down quite a bit. I want to explore the assumptions you are making in that, particularly with reference to economic inactivity, where we know that there are two overlapping drivers of ill health and early retirement.

What assumptions have you made within that overall assumption of workplace participation, and could you link that with any commentary on the fact that the ONS data, on which we are used to building a picture of what is happening in the workforce, now appears to have become somewhat unreliable? Indeed, the workforce survey has been withdrawn and replaced with only experimental data, at the moment.

Tom Josephs: On participation and inactivity in the forecast, the UK actually saw increases in participation over the 2010s up to Covid. Then, through Covid, we saw a very sharp rise in inactivity. That was common across a lot of countries, but we did not see that unwind in the UK, to any great extent, after Covid. In other countries, the Covid effect seems to have been more temporary. The biggest driver of that increase in inactivity was people with health or sickness-related reasons not working. That is still around. There are still around 450,000 more people who are inactive for long-term sickness reasons, compared to before Covid.

In our last medium-term forecast, we assume that participation falls a bit further in the short term, essentially because we have a slightly weaker economy in the short term. It picks up a bit in the medium term, but it does not get back anywhere near to pre-Covid levels, because we do not assume that that rise in inactivity due to sickness will unwind.

Baroness Noakes: Are you expecting some unwinding of it?

Tom Josephs: There is a bit of it, but, as I say, the participation rate at the end of our forecast is well below what it was pre Covid. That is important to the forecast. In the 2010s, we saw very weak productivity growth in the UK but, because of the workforce, labour supply increased, which supported growth. Now we are faced with an outlook where you do not get that support from labour supply, which is constraining the outlook for growth in our forecast.

It also has big fiscal implications, because you face the fiscal impact not only of lower participation in the workforce, so lower tax receipts, but of increased welfare costs. The DWP case load for people on inactivity-related benefits has risen and we are forecasting it to continue to rise quite sharply. There are also knock-on impacts on the health service, so there has been a big fiscal cost.

Q54 **Baroness Noakes:** How much of the 1.3% increase in participation is due to winding back some of the increases in economic inactivity?

Tom Josephs: Most of it is due to assumptions about other areas of inactivity away from sickness. The number of people who are inactive because they are caring again fell sharply through Covid and has recovered post Covid, so we assume that that continues, and, in March, the Government announced a policy on extending childcare provision, which supports that.

Richard Hughes: There was also a big influx of students into universities during the pandemic. As they come out of university and go into work, it also supports the participation rate going up.

Tom Josephs: The outlook is uncertain, and we did some analysis in the longer-term report on what might be driving this. We ran some scenarios looking at the impacts of higher or lower assumptions of participation and inactivity. As I say, it has a big fiscal impact, because it hits both tax and spending substantially.

Q55 **Baroness Noakes:** To what extent are you concerned that you are relying on historical patterns that have come from ONS data, which are not in current use now?

Richard Hughes: The ONS has discontinued a number of data series, including those that tell us what is going on in the workforce. It is planning to reintroduce them this year, so we are looking forward to that data. A lot of its data collection was disrupted during the pandemic, and it has struggled to get response rates up from across the population. We are hopeful that, as it improves response rates through a range of

measures and moves to collect data from more online forms and from a wider range of administrative sources, the quality of that data will improve. But you are right: there has been the added challenge in recent months that the data has become less complete and less timely than we have come to expect.

Baroness Noakes: So quite a central element of your forecast could be undermined by data that was not fit for purpose.

Richard Hughes: It is certainly clouded. We try to infer what we can from other sources. We get very rich and high-frequency data from the tax system and things like PAYE, but that tells you only about people who are employed and in the PAYE system. If they are self-employed or somehow employed informally, we know less about them.

Baroness Kramer: This is just a very small question. We know that, in some areas, the impact of Covid unwound after Covid. In other areas, it made a permanent change. Is there anything yet that tells you whether this pattern of much higher levels of early retirement for lifestyle reasons is something to be embedded as more cohorts flow through the age group, or whether this is a one-off that affects just one pool of people? Do we know any of that?

Tom Josephs: The data is showing that it looks like a one-off effect through Covid, because the increase in early retirement has unwound now. The number of people taking early retirement and leaving the labour force for that reason has gone back to where it was pre pandemic.

Q56 **The Chair:** Can I ask about another point that you raise in your report, on page 44, paragraph 2.25? You say, "There is more evidence to support the idea that changes in conditionality and sanctions in non-health-related parts of the means-tested welfare system have contributed to rising health-related inactivity".

On Baroness Noakes's point about the data, how strong is the data that supports that point? If it merits examination, have your scenarios modelled what might happen if changes to the welfare system are made to address this?

Tom Josephs: I do not think our scenarios look at changes to the welfare system. Rather, we looked at changing assumptions more to the underlying drivers behind the number of people who are claiming these benefits for health-related reasons. The data that we get on this comes directly from DWP; it is not ONS data, although it is also useful to use the ONS data to compare.

Q57 **Lord Rooker:** I want to move on the green economy. We are told about new industries and new jobs, a lot of it funded by the private sector. I know you have done reports on this—I fully accept that—but could you set out the main assumptions about the green transition and its effect on debt should your assumptions not materialise?

We have a huge electrification programme—the committee did a report on it—and it is thought that the private sector will do most of this, but

some of the evidence is that it is not. Then there are new energy-efficient buildings, when we still have the oldest housing stock in Europe. Where is the evidence? What will the effect on the debt be if your assumptions do not materialise?

Richard Hughes: This is work in progress for us, because we have done a lot of detailed work on the fiscal costs of meeting the Government's net zero commitment. We want to do more work this summer to look at the other aspects of climate change and what it would cost to adapt to what will happen anyway, even if we get to net zero, either because other countries do not get to it or because we have not done enough to control the rise in global temperatures, as well as what damage might be done to the economy and public finances if we are insufficiently adapted to climate change.

For now, we have focused our efforts on trying to cost what the Government's net-zero commitments are. We started from the very good work done by the Climate Change Committee, which produced a whole-economy cost of getting to net zero by 2050 of £1.3 trillion. Once you take savings into account, that leaves a net cost of about £300 billion for getting to net zero for the whole economy.

In some sectors, that transition is happening without very much government intervention, involvement or spending. There are lots of electric vehicles on the road. That is not because the Government are massively subsidising electric vehiclesl they are just cheaper these days, especially after what happened to petrol prices recently. The transition on the vehicle side is happening relatively cheaply from a fiscal point of view, but we expect net fiscal costs in other areas where the Government need to step in to facilitate the transition from here to net zero.

You alluded to the single most important element of that cost, which is what you do to decarbonise the building stock, especially the housing stock. In the UK, we have lots of gas boilers in buildings. If you want to get to net zero, you need to make those hydrogen boilers, or replace them with heat pumps. That is the single largest element of what we think is the net cost of getting to net zero.

The overall fiscal costs of getting there and helping the building transition, as well as the energy supplier transition, some other bits around transport and a few other bits and pieces, is around 20% of GDP overall: that is, the net impact on the debt stock of getting to net zero, based on what we think the fiscal costs are, is about 20% of GDP.

The single largest element of that cost comes from the revenue side, because fuel duty disappears as a source of revenue. The Government lose 1.5% of GDP every year in tax revenue because cars driving around then are not paying fuel duty; they are getting their electricity from the mains.

The single biggest expenditure item is the cost of transitioning the housing stock away from gas boilers on to electric alternatives. That is

based on an array of assumptions about cost, the speed of transition and e share of those costs that need to be picked up by government. We tried to come up with some reasonably central assumptions of those costs for the UK. When we compared them internationally to bodies that did similar estimates for other countries, the numbers were more or less in a similar ballpark, so that gave us some reassurance. The 20% of GDP cost of getting to net zero, which, if you added it to debt would increase the debt burden by that amount, is just one scenario that you could look at. We have also explored others.

Q58 **Lord Rooker:** You mentioned other boilers. I thought you might mention the possible transition to using hydrogen. The National Infrastructure Commission, much to my annoyance, has ruled out using hydrogen for domestic boilers. It said that hydrogen should be used for the big projects like steel and concrete works. We are also miles behind on what was forecast for heat pumps. I thought 600,000 a year was the plan, and we are nowhere near that. The private sector is not going to pay for that; people need to be persuaded. People will buy boilers at the last minute, because they will not have confidence in the processes. How do we get around that without using public money?

Richard Hughes: We made these estimates in our 2021 fiscal risks report, but we have looked at how the Government have spent money since then. You are right that much of government expenditure in getting to net zero was focused on energy generation, and relatively little has actually been spent on facilitating the transition of the housing stock. I think it is partly because there is this dilemma about whether you go with hydrogen or electric heat pumps, but in practice we are doing neither. The rate of transition away from gas heating in households is much behind the schedule that the Climate Change Committee would set, and the levels of expenditure do not match what we estimated would be needed to make that transition happen.

Q59 **Lord Rooker:** From my point of view, related to the green transition is the cost of energy. We are going to electrify the whole country in a massive way, so the cost of energy is pretty relevant. What assumptions have you made in this regard?

Richard Hughes: We do not know at the moment whether the green transition will turn out to be productivity enhancing for the energy sector or not. Wind is our marginal replacement for gas at the moment. The unit costs of energy between gas and wind have jockeyed for position over the last few years as gas prices and the cost of generating energy through wind have gone up and down.

It is also important to bear in mind that gas is baseload, so it can be relied on as your single largest energy source, because you can scale it up and down. The issue with wind power is that it is there only when the wind is blowing, so if you start relying on it for the majority of your energy, you need very big batteries to deal with when the wind is not blowing. Wind is not as flexible as gas, so the true cost of relying on wind energy is not the marginal cost of a windmill; it is the marginal cost of

the windmill, plus the battery you need when all you have are windmills generating your energy. Battery prices are coming down, but they are still reasonably high.

The unit cost of energy is important for the economy, because, despite the fact that are less energy-intensive, we still rely on energy to power our economy. We saw that in our most recent forecasts when, in the wake of the Russian invasion of Ukraine, there was a big rise in energy prices, which affected our forecast projection for the output of the UK economy. We saw it immediately when growth petered out as energy prices rose, because it constrains households' ability to spend and the ability of businesses to invest. The gearing ratio in our models is that, for every 10% increase in the price of energy, the level of potential output is reduced by 0.13% in one year and 0.18% in eight years' time. So it is a material difference in the level of output that you can generate depending on the cost of energy.

Lord Rooker: Is it therefore quite important that your forecasts give us the marginal cost of energy? A year ago, Sir Dieter Helm sat in that seat when we were doing our inquiry into energy costs, and he made the point that the wind does not always blow and the sun does not always shine, so you need the baseload. Somehow, you have to put that in as a price, because that is the marginal cost of energy.

That seems to be ignored. It is like an add-on. People say, "Yes, we'll get the odd nuclear power station, or keep the odd gas line", but you get a false economy, which the industry quite enjoys. The windmill industry and others will not add the marginal cost of the wind energy into their costs when it is not blowing, but someone must do it, because the country has to pay for it.

Richard Hughes: It is right that you cannot just look at the marginal cost of power generation in the wind sector and say that scaling that up is equal to the cost of running the whole economy on wind. We have to deal with this intermittency problem, which you do not have if you are relying on gas or do not have nuclear power as your baseload.

Q60 **Lord Londesborough:** This is just a quick clarification. You said that the overall fiscal cost of net zero is about 20% of GDP, about £500 billion. Is that a cumulative cost or a cumulative extra to the net public debt by 2050?

Richard Hughes: That is right. On an annual basis, it is a bit less than 1% of GDP a year. We assume, for the purposes of illustrating it, that that is on top of whatever the Government are otherwise doing, so the Government borrow that amount in order to get to net zero.

There are other assumptions you can make. If, for example, you allowed green investment to crowd out other investment that the Government were otherwise planning, that could end up saving you money. But we assume that, for the purpose of illustrating its fiscal consequences, it was on top of everything else that the Government were planning to do.

The Chair: How sensitive is that figure to decisions being made in the next Parliament?

Richard Hughes: It is very sensitive, in the sense that one assumes that the longer you leave it, the more costs might escalate, because if you are doing things in a big hurry, that will increase the unit costs of things. If you are trying to replace household gas boilers in a very big hurry, for instance, there is only so much capacity in the British economy, in terms of engineers and equipment, to get that done. If you try to do it all in a big hurry by 2050, that is likely to make the unit cost higher.

The Chair: Has that been modelled?

Richard Hughes: Yes. We have a sort of "hurry up at the end" scenario, which basically doubles the cost of delivering net zero. Costs rise partly because of the cost of the investment needed to make the transition happen. They also arise because, if you leave it late, one of the things our modellers assume is that the Government are levying some kind of carbon tax in order to defray some of the costs of getting to net zero. The longer you leave taking action, the less carbon there is around to tax and fewer years in which to do it. If you want to facilitate that transition by taxing carbon, you have to start doing it now rather than leaving it to when you have already decarbonised, because then there is no revenue to be raised.

Lord Turnbull: Can you clarify this addition to the stock of debt by, let us say, 2028? Presumably the stock of debt by that time must be around £3 trillion. How much extra does net zero add to that stock?

Richard Hughes: At the moment, we have almost a 100% debt-to-GDP ratio, and this is adding another 20% on top of that. So it is material, but it is similar to the kinds of debt we have had to incur to deal with other challenges, such as the financial crisis and the pandemic, which have also cost us around 20% of GDP.

Lord Turnbull: So around £500 billion.

Richard Hughes: Yes.

Q61 **Lord Turnbull:** There is only one question left to ask. We have been talking about the tax burden and its effect on the productiveness of the economy. When one looks around to see where the UK is in terms of tax as a percentage of GDP, there are other people who have taxes that are much higher than ours, with enviable living standards, and people who have tax that is much lower than ours. Is there really any reliable relationship between the aggregate tax level and the productiveness of the economy, or is the real question, if you are going to have tax, that you can have good taxes and bad taxes, but it is the structure of tax that we should be looking at rather than worrying about whether it is 40% of GDP or 45% of GDP?

Tom Josephs: I agree with you. As you say, if you look at the tax-to-GDP ratio across advanced economies, there is a pretty wide range. The

UK is somewhere in the middle of the pack at the moment. There is no real evidence linking your level of tax-to-GDP ratio with economic growth. There are countries on either side of the UK in that ranking that have seen higher growth and stronger economies than the UK. So, as you say, what is more important is the structure of the tax system and the decisions you make on that, and the public spending choices you are making—in other words, what you are using that taxation to fund.

Clearly, if the tax burden just keeps rising, at some point you would expect it to become so distortionary that it impacts on growth. But, as I say, in the range in which advanced economies operate, there is no clear link between the two. When the OBR looks at the tax decisions the Government take and the impact they may have on the economy, we look at individual tax decisions rather than the aggregate level of taxation.

Q62 **Lord Turnbull:** You have spent a lot of time talking about the debt-to-GDP ratio as a metric, and a lot of effort goes into explaining that to the public. Other people write about r-g—the increase in nominal terms of GDP against the nominal interest rate. Is there some merit in bringing r-g, or the relationship between the two, more into the public debate? I think there are very few people who even know what this is all about.

Richard Hughes: We have consistently struggled to get people to engage, but it is the key equation, because, in essence, it dictates how big a primary surplus—so non-interest surplus—Governments have to run in order to keep debt under control. The more the interest rate exceeds the growth rate, the higher a primary surplus Governments need to raise.

One reason why you have seen such a big rise in the tax-to-GDP ratio over the last few years has been the fact that r-g has been going very much the wrong way for the UK; interest rates have been going up, but growth has not. That increases the size of the primary surplus a Chancellor needs to need to run in order to keep debt under control, which is his objective. How is he doing that? He is raising everybody's taxes.

Lord Turnbull: I have not seen a single speech by any Chancellor or shadow Chancellor that talks about this. Lots of them talk about debt-to-GDP ratios.

Richard Hughes: I think so, and it is partly because to some extent, at least in the near term, there are two things that are just happening to them: interest rates have been rising around the world, and ours have reflected that; and growth rates are things that, in the long run, fiscal policy can affect but which, in the near term, are challenging and difficult. I agree that, in the long run, the only equation that matters to debt sustainability is how the interest rate compares to your growth rate.

Q63 **Baroness Kramer:** My question is slightly off-question, but that was such an important point that I need to take it on board. I am just trying to think of how individuals look at the economy. In one of your reports, I

read a comparison between the lifestyle of somebody in a particular role in the UK—I forget which one; it could be any role—and their European and other counterparts. If we were to look back maybe five, seven, eight years, lifestyle was very comparable; if you were a construction worker here or in Germany or the States, your lifestyle was pretty similar, and the same was true for other kinds of professions. Now that has collapsed for the UK.

Is that something that you track? Do you know where it can be sourced? It means something to people, whereas the big, abstract, overarching economic numbers generally do not. I do not know whether you forecast it at all.

Richard Hughes: We certainly track it over time. One of the things we monitor and forecast is what you would call living standards. Certainly compared to history, the UK has faced a very big hit in living standards over the last few years. People's energy costs, food bills and interest rates have gone up, so if they have a mortgage, that is becoming more expensive, and if their earnings have not kept pace with inflation, the income they have to spend on the essentials of life, which they cannot substitute away from easily, is not growing as fast as the cost of them is rising.

So we do track that historically. Someone else has probably done the comparison with abroad, but it matters for us because it matters for how much people are consuming and the decisions they make about things like work and retirement.

Q64 **The Chair:** In your July report, at paragraph 4.38, you say: "Based on our March 2023 forecast, the Government plans to turn a primary deficit of 2.2 per cent of GDP in 2023-24 into a primary surplus of 1.1 per cent of GDP in 2027-28. This 3.3 per cent of GDP turnaround is achieved by increasing taxes by 0.8 per cent of GDP and reducing primary spending by 2.5 per cent of GDP. The delivery of this turnaround in the primary balance is at risk on both the tax and spending sides". You then go on to list why it is at risk—things like an increase in fuel duty that never happens, et cetera.

That analysis still holds fully, I take it. There is nothing really to make you revisit that from July to now.

Richard Hughes: It still holds, with one exception, which we listed as a risk to the revenue outlook and which I would say is now realised, which is that, at the time we did that forecast, the Chancellor said that he wanted to make full expensing permanent, and he did so in the last Autumn Statement. That element of cost, which I think is around £9 billion, has now been realised, so that reduction in revenues has been incurred. He was able to do that partly for the reason we discussed: the deadline for getting debt falling would fall in a year. So he took advantage of that to make full expensing permanent.

With everything else—the £8 billion cost of freezing rather than indexing fuel duty, which is what Chancellors tend to do; the tendency to top up

departmental budgets by £30 billion-odd a year when the time comes to actually set detailed budgets—that risk very much remains.

Q65 **The Chair:** This is the final question. We have talked about the green transition and the impact of demographics. When looking ahead into the next Parliament, if you had to choose an area of policy change that would have the most significant impact on what the state does, where would policy action be most effective to try to make sure that the debt is sustainable and does not hit the trajectory that you are saying it might be on?

Richard Hughes: This is not a cop-out, but generally the areas of weakness for the UK economy and public finances are across the board. It used to be possible to say that we are quite good at getting people into the workforce so that, regardless of how productive they are, at least we have workforce growth. That has slowed and needs to be addressed. We have always been a low-investment country. If you want to boost productivity, you need to boost investment. Our what is called total-factor productivity depends on things like the pace of technological change and our ability to implement that, as well as our trading relationships with the rest of the world. Those things are also at risk and under threat.

Looking at public finances, as we have talked about, there are things that are hollowing out the revenue side of the budget, not least fuel duty, but there are other things. On the spending side, there are huge pressures from ageing on the health side.

One thing we have not discussed here is the geopolitical situation and whether things like spending 2% of GDP on defence will be enough and sustainable going into the future.

So it is difficult to argue that you can afford to ignore any one of those things and still end up in a sustainable position.

The Chair: So you are not willing to say that X should be a priority.

Richard Hughes: I think that worrying about sustainability is a good thing, but it draws attention to a number of things on your dashboard that should be flashing red and leading to action.

The Chair: They are flashing red.

Richard Hughes: And they are flashing red.

The Chair: Thank you very much indeed. It has been a very good session. I am sorry that we have gone on for a bit longer, but that was extremely helpful. Is there is anything that you would like to follow up on in writing?

Richard Hughes: I know that David is keen to submit his own thoughts to you, which he will do in writing. He can probably pick up on points that we may not have covered in enough detail.

The Chair: That would be extremely kind of him. We would be very grateful. We thank you both.