HOUSE OF LORDS

Economic Affairs Committee

Corrected oral evidence: Economic inactivity: welfare and long-term sickness

Tuesday 5 November 2024

3 pm

Watch the meeting

Members present: Lord Bridges of Headley (The Chair); Lord Blackwell; Lord Burns; Lord Davies of Brixton; Lord Griffiths of Fforestfach; Lord Lamont of Lerwick; Baroness Liddell of Coatdyke; Lord Londesborough; Lord Razzall; Lord Rooker; Lord Turnbull; Baroness Wolf of Dulwich.

Evidence Session No. 2 Heard in Public Questions 29 - 41

Witnesses

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

USE OF THE TRANSCRIPT

1. This is an corrected transcript of evidence taken in public and webcast on www.parliamentlive.tv.

Examination of witnesses

Richard Hughes, Tom Josephs and Professor David Miles.

Q29 **The Chair:** Good afternoon. Welcome to this meeting of the Economic Affairs Committee. I am delighted to welcome Richard Hughes and others from the OBR. Would you introduce yourselves before we go any further?

Richard Hughes: I am chair of the OBR.

Professor David Miles: I am on the Budget Responsibility Committee of the OBR.

Tom Josephs: I am also on the Budget Responsibility Committee.

Q30 **The Chair:** You have had a very busy day, first at the Treasury Committee and now here. Thank you very much for joining us. As a very boring bit of housekeeping, I have to leave on the dot of five, so if I am seen to be slipping out my colleague Lord Lamont will chair the meeting at that point. Just to warn you, we may also have votes, so we may get a bit broken up.

Let me start by asking a big question. We obviously want to go macro and then into the issue of inactivity and welfare, but I will start by talking about the Budget and picking up our last inquiry into the sustainability of UK debt. Do you think that the Budget has increased the risks of the UK's debt becoming unsustainable in the medium term?

Richard Hughes: The Budget was a very big one in policy terms, with a 2% of GDP rise in spending, a 1% rise of GDP in tax and a further 1% rise in borrowing. What it does to the level of headline debt means that it is now broadly flat over the forecast period rather than slightly falling as a share of GDP. On the underlying measure of debt, excluding the Bank of England, which was the old Government's target, it is now rising in every year of the forecast and, based on current policy settings, will continue to rise for some period after that.

The Government are now targeting a different measure of debt sustainability, so-called public sector net financial liabilities, which rise for two years and then begin gently to fall over the remainder of the forecast, because that takes a wider view of the balance sheet, and basically the asset side of the balance sheet is growing slightly faster than the liability side of the balance sheet towards the back end of our forecast. That is what keeps it on a downward trajectory. Depending on whether one takes a more comprehensive view of the balance sheet, taking in all financial assets and liabilities, things look to be just turning the corner and heading toward a more sustainable direction. If you take just a narrow view of public sector net debt, excluding the Bank of England, it is on an ever-rising trajectory. If you look at the cost of the debt burden, for the first time in our forecast it stays above £100 billion in every year of the forecast, which is a measure of the fact that the Government are carrying a higher stock of liabilities into the medium term and paying the cost of doing so.

The Chair: Do you think that means the risks have increased?

Richard Hughes: I would say that the risks are slightly increased because the Government are borrowing more. They have a bigger stock of debt and they have to service that debt. On the asset side, the incentives in their new fiscal framework are to try to make use of what borrowing they can to invest in financial assets that generate a financial return. If that financial return exceeds the cost of its financing, that opens up opportunities to improve debt sustainability. The risk is that the Government are always on the hook for the borrowing and always on the hook for the debt, whether or not they manage to realise the opportunities on the financial asset side of the balance sheet by issuing loans through purchasing equities. One hopes that they generate a better return than the cost of the liabilities. If they do not, that poses challenges.

The Chair: That is very interesting. One of the things that concerns me when I look at it is the growth forecast in the medium term. How worried should we be about that because, as your previous reports have highlighted, growth, in particular productivity increasing or decreasing, has an enormous impact on debt servicing, et cetera. Would you like to say a bit about that, and how much that feeds into your risk analysis?

Richard Hughes: Over the medium term it is broadly unchanged. In the Budget there is a bit of a near-term and temporary boost to demand from the fact that there is a net fiscal stimulus coming out of the Budget that raises spending more than it raises taxes. That boosts GDP growth from about 1.1% this year to 2% next year, but then it falls back to close to what is our more or less unchanged view of the potential output of the UK economy, which is somewhere around 1.5% to 1.66% per year.

On the difference to the long-term growth prospects of the UK that the Government's policy package makes, there is some good news and bad news for growth potential. The Government are raising taxes on payroll. All things being equal, that has an impact on people's willingness to demand and supply labour, and we think that has a cost in employment in the medium term. As to the more positive things for potential output, part of what the Government are borrowing for is public investment, which we think in the long term makes a difference to the potential output of the UK economy. Over the forecast period, it is of roughly equal magnitude. If you look out further, that effect builds up, becomes quite significant and turns net positive by the time we get to the 2030s, but public investment, as we all know, takes time to have an impact. It takes time to get shovels in the ground and get projects completed and for those things to generate the economic opportunities that can boost potential output.

The Chair: That brings me to the risks entailed in moving from PSND to PSNFL. Can you say something about that? Are we in danger of finding ourselves asset rich and cash poor in terms of the Government's strategy?

Richard Hughes: The risks are that it provides the Government with scope to borrow to invest in a fairly narrow set of financial instruments. It is important to emphasise that this does not allow the Government to borrow to invest in all infrastructure; it is only if that investment takes the form of a loan or an equity injection into a private sector company doing the investment. They cannot borrow to invest to build a road; they cannot borrow to invest to build a windmill; they have to borrow to invest in a company that is building a windmill. Because it generates a financial return, it nets off against the financial liabilities on the other side of the balance sheet. The risks therein lie in the fact that that loan might not perform the way the Government might hope. In our own forecasts we assume some element of write-down to the relatively small amount of new liabilities that the Government are generating.

In the past we have all seen government loans of different flavours designed to achieve particular policy objectives, student loans being the most famous example. Those build in, as part of the policy, non-repayment of those loans because they are income-contingent, and they get written off after a certain number of years. By definition, they are not completely performing loans that one has to take account of when doing the forecasts. The risk is that the Government definitely do the borrowing, lend the money and incur the cost of the borrowing. The question is: can they get the return on those investments that they hope to get?

Q31 **Lord Lamont of Lerwick:** Would you comment on the retention of the rolling target for debt? Under the previous Government we had a five-year rolling target; now it is three years, whether you are looking at either the current surplus or PSNFL. It was always said before that it was far too easy for the Government to game it and they were always looking at the fifth year, which was always shrinking; now it is just three years. Is there a great difference?

Richard Hughes: Less can go wrong over three years than can go wrong over five and certainly our forecast errors are cumulative, so the more you get wrong in the near term the bigger it gets the further out you go. Almost arithmetically, there is less risk to those targets by looking three years ahead.

Allied to that reform, the Government have committed to returning to a more regular rhythm of comprehensive spending reviews, with detailed departmental budgets supporting the spending side of the public finances, and for that always to provide, more or less, a two to three-year horizon for departmental spending. I think that the further benefit and assurance you get from a three-year rolling target is that it is more likely to be supported by a detailed set of expenditure plans for the NHS, education, transport and defence, the major government departments, than what we have seen in the past, where Governments have a five-year target for where they want to get borrowing and debt to be, but they have only one year of detailed spending plans about how they are going to get there. So there is less scope to fill in the gap with wishful thinking than there used to be with a five-year target, but three years is still a long way to go and government spending plans can change and government tax plans can change. There is still a risk even around a three-year rolling target.

Lord Lamont of Lerwick: Is it right to say—I think I heard the Chief Secretary say this on television—that, from the point of view of reducing the stock of debt over the longer term, the rule relating to the current Budget is the more important one for credibility, because of the ratio of current expenditure to investment expenditure? Unless investment expenditure exceeded, say, 3%, it would not have such importance for the overall stock of debt.

Richard Hughes: For the moment the current balance rule is the one that is more binding, in that there is about £10 billion-worth of headroom against the target to get the current Budget in balance or surplus, whereas there is £16 billion against the target to get net financial liabilities falling as a share of GDP. Both are relatively constraining on government's fiscal choices, but one thing you could say for the UK is that investing 3%, 4% or 5% of GDP would be a nice problem for the country to have. It is not what we have had over the last few decades, so there is almost an inherent speed limit on how much the Government can ramp up investment in any given year, just because there are basic capacity constraints on the ability to spend the money on new projects. We also tend to discount somewhat government spending plans when they say they will be ramping up capital investment a lot, because we just assume that they will not be able to get the money out the door.

Lord Lamont of Lerwick: I want to touch on a subject that you also touched on, which is the investments that might be made and, therefore, the assets that count towards the PSNFL total. I notice that there is a page in the OBR document that has the wonderful title "Potential fiscal illusions". One of my fears is how those investments are to be valued. On one page you assume that equity investments will increase in line with nominal GDP, which seems to me quite an optimistic assumption, or certainly one that could be questioned. Then you talk about loans, which you have just talked about now. I thought about what happened in the past when British Governments, for example under Harold Wilson, lent large amounts of loans to certain nationalised industries or private sector companies that were in acute difficulty. You say that "other loans are recorded at their nominal value, regardless of the probability of repayment until a decision is made to stop chasing the debt and it is written off. This write-off point may be many years into the future". You said they cannot invest in infrastructure but could lend money to companies investing in infrastructure. Is there not a real danger here about how those things are going to be valued?

Richard Hughes: There is a very real risk on both points and they are two that we are quite alive to. On equities, in the long run, assuming that equities grow in line with nominal GDP is a reasonably central assumption, although equity performance can differ greatly over several years before that comes back to being broadly true. We discovered that, generally, from a forecasting point of view, it is reasonably central to assume they evolve in line with nominal GDP, but there is no doubt that outturn will differ. Governments will need to be prepared for outturns in equity markets to be very different from year to year compared with what our forecast is likely to be. That needs to be something they factor into their headroom against those targets, because you have decades when equities outperform the nominal economy and decades when they underperform.

If you read on, we say that we are going to take a fairly jaundiced look at the Government's loan proposals, and where we think we ought to factor in expected write-downs on those loans we will do so in the preparation of our forecasts. That has long been the approach we have taken with student loans: we do not assume 100% repayment. It is also the approach we are taking to our forecasting and assessment of the loans being undertaken by the national wealth fund and investing in industries where we expect some amount of non-repayment. Those write-offs are part of the forecast rather than something that will surprise ex post in the outturn, but it is something we need to keep an eye on. The National Audit Office will be helping us in that regard to make sure that those forecasts of expected write-offs are central and stay ahead of where we think the performance of those loans is going, because obviously your view of the performance of a loan book can change from month to month and year to year, depending on what you are learning about the industries that are on the receiving end of those loans.

Lord Lamont of Lerwick: Investment can be regarded as a cost on deferred consumption. Some Asian countries have been accused of investing too much, but that has not applied to European countries. What percentages might one look at if you felt that an optimum rate of investment in a European country was to be achieved?

Professor David Miles: It is really a question about the expected rate of return on what you get from the investment relative to the cost of borrowing. We have done some analysis of the rates of return on capital spending that probably generates rates of return that are higher than the current real cost of borrowing. If you take the real index-linked yield as the cost of borrowing, it is plausible that at least a central estimate of what you might get back over the long term in extra GDP from the public sector is that at least infrastructure, physical investment, exceeds that, but that does not allow for a risk premium, and it would be perfectly sensible to think there is quite a high risk premium on big infrastructure projects.

The question then becomes: what kind of risk premium might a Government think is prudent to factor in, over and above the cost of borrowing, to be the acceptable hurdle rate for some public sector investment? Because public sector investment has been low relative to most other countries for a while, it is plausible, but no more than plausible, that there is a decent risk premium at the moment in some public sector investment over what is still a relatively low real cost of debt. The index-linked bond yield is probably about plus 1% or so; it used to be minus something. I do not think I would argue that the relatively limited increase in public sector investment over the forecast horizon that was announced in the Budget last week takes public sector investment to such a level that it is plausible you just cannot get the returns to pay for the debt. I think the big issue is really about what kind of risk premia you want to have built in.

If I may make a brief point about risk, there is a significant element of risk taken on board once you look at public sector net financial liabilities. It is not just on the asset side; it is on the liability side. One of the large assets and liabilities reflects the position of funded pension schemes, largely local authority pension schemes. You have a very large chunk of equities offsetting to a large extent a very large magnitude of liabilities. The valuation of the liabilities can move around very substantially every time you revalue what they are worth, and the equities can move around a lot in the course of any one week. It is also true for some of the assets that are the offsetting of the debt accumulated when you grant student loans. The repayment rate on student loans is pretty hard to forecast. Reasonable estimates of that could change quite significantly from one Budget to the next, so you already have quite a lot of variability in PSNFL even before the Government might be tempted to use it to a greater extent indirectly to finance investment through loans.

The Chair: Lots of people want to come in on this. You are giving such good answers that everyone wants to come in, before we even get to the main subject.

Lord Blackwell: When debt is issued by the Government, whatever the definition, they have to service the interest on it. The way the market is going to look at this, surely, is in the sustainability of debt and the cash flow of the Government and their ability to service that. Is there not a risk that, in taking account of public sector net financial liabilities, if you are netting off relatively illiquid assets, they will do nothing to help service the debt? Maybe some equities can be sold. I wonder whether, as far as the markets are concerned, they will continue looking at the original definition of public sector net debt because that is the one that relates to cash flow, serviceability and sustainability, and that will be particularly true if the two diverge over time.

Richard Hughes: In our own forecasts, on the first page of our EFO, there are three debt numbers. Two are fairly recognisable, old-fashioned definitions of debt, plus we have net financial liabilities, so we are also keeping an eye, as the Government and markets certainly do, on plain public sector net debt as an indicator of fiscal sustainability, and in particular the cost of servicing that.

In expanding the coverage of assets and liabilities that fall within it, even in the old net debt measure the net bit of net debt was very liquid financial assets, basically currency held by the Bank of England and a few other things. That was quite liquid and highly marketable. The Government have now expanded the scope of that to include financial assets that still generate a cash flow. The issue is whether you can cash them out if you have a near-term financing need. They are less liquid in that sense, in that it is not currency that you can sell on the market; it is a loan book and possibly some equity holdings. If you need to liquidate them to meet a repayment, you may struggle to do so or you may have to do it at a discount. Those things were always on the books anyway. They are generating cash flow into the future. It is not going so far as to say that we are going to net off the road network or all the land that the Crown Estate owns or those kinds of things; it is not going quite that far, but it is a less immediately reliable indicator of the liquidity position of the Government than something like public sector net debt might be.

Lord Burns: Many observers commented that the previous five-year rule was easy to game; indeed, we said that in our report. Is it going to be more difficult to game the three-year rule? I assume that the reason for turning it into a three-year rule is to give the impression that it will be much more difficult to game, but we know what happened to the last one. Can you help us on that?

Richard Hughes: Simply, it is two-fifths less easy to game than a five-year rule. The Government have to give greater clarity about their policy for three years than they do over five years, so in that sense there is a better chance of the rule being substantiated by a set of detailed tax and spending policies than was the case when rules were binding not on this Parliament but on the next one, well after the end of a spending review period. In that sense, you can have more assurance about a three-year rolling rule.

One thing to highlight about this set of rules, which was a feature of the last rule and remains a feature of this rule, is that at least on the net financial liabilities rule it is still about things falling rather than the level of things. When you are concerned about the sustainability of the public finances, what you ought to worry about is the level of the thing, not whether it is falling in one year compared with the previous year, because there is still an incentive, which we have certainly seen in the system, to increase liabilities in the near term and turn them off in the medium term with a set of heroic assumptions about what delivers that fall in the final year. That is a lot harder to do over three years than over five.

The Chair: Are there heroic assumptions in this? Last time you were with us you described the previous Government's plans as a work of fiction. Does this have fictional aspects?

Richard Hughes: The detail that remains to be filled in is what happens in the spending review next year. The Government are committed to returning to a regular rhythm of multiyear spending reviews. So far, they have done only a one-year spending review, which goes up to 2025-26. We are still waiting to see what their spending plans are beyond that, including in the years that lead up to when their fiscal target is due. The proof will come next year when the Government do a spending plan that is consistent with meeting those rules.

Those rules apply a pretty tight envelope for public spending once you get beyond this year and next. This year, public spending is growing by 4.8%; next year it will be 3.1%, and then you have 1.3%, 1.3%, 1.3%, and that is fitting in a health service that oftentimes grows at twice that. There are big ambitions around defence, overseas aid and other areas. Fitting that within the fairly tight envelope that is required to deliver those rules remains to be done.

The Chair: To what extent are the assumptions heroic not as regards spending but as regards tax? Taxes will still have to rise in this Parliament.

Richard Hughes: Spending is where the detail needs to be filled in. The Government have announced a set of tax policies, including a big tax rise in this Budget. About half of that revenue looks reasonably reliable, or as reliable as one can get, in the sense that national insurance is a tax on payrolls and we know who is on the payroll. It is fairly reliably collectable, but the other half of the tax yield comes from a combination of taxes on assets and they rely on assumptions about the behaviour of relatively small numbers of very wealthy individuals and what they do with their money and with themselves, as well as compliance measures of the spend-to-save variety. We have come up with a central estimate of what we think they will yield, but we are always uncertain because they depend on operational decisions being made by tax collectors and HMRC.

Lord Burns: Looking at the draft budget responsibility charter that came out at the end of last week, apart from the things we have touched on today, are there any other major changes in that compared with what we have had on previous occasions?

Richard Hughes: There are a number of developments. One is that it puts into practice the fiscal lock amendments that the Government introduced just after the general election that prevent the Government making large discretionary fiscal policy announcements without a forecast from us. In that sense it should help to provide you and your colleagues in Parliament with greater assurances about the economic and fiscal implications of those changes.

There is also a set of changes around the way we put together the spending side of the forecast, which provide us with greater oversight and assurance about what underpins the Treasury's plans for departmental expenditure. I think that too represents an improvement. From our own institutional perspective, it provides the OBR with certainty of funding on a rolling three-year basis, which we think is very welcome.

Q32 **Lord Londesborough:** The term "investment" is often used in a rather ambiguous way, particularly by politicians, such as when we hear the expressions "investing in childcare", "investing in healthcare" or "investing in the police", when in strict accounting terms they actually mean spending. What guidance has the OBR been given on the definitions of investment?

Professor David Miles: We have very little detail about the extra capital spending of the Government as laid out in the Budget. We have very little idea about where it will actually come, beyond a bit of detail for the next financial year, because we do not have a spending review beyond 2025-26. We are a little bit in the dark.

We have not taken the whole CDEL number for departmental capital spending and said that that is all in roads, rail and infrastructure and we are going to treat it as if it is. We take a fraction of it and then apply a considerable time lag between when you do that kind of physical investment—what you and I would call capital spending—and it showing up in a boost to productive capacity in the economy. I think we have taken what you might call a fairly conservative, although reasonable, assessment of the return you get on it, and it turns out that with those assumptions you get a little bit of a boost to productive capacity, the GDP-making capacity of the UK, four or five years down the road, but most of it comes after that because of the natural time lag. If you do big infrastructure things, you start building something that does not come on stream for four, five or six years. The honest answer is that we have not had a great deal of visibility on exactly where the capital spending will come for most of the five-year horizon we are looking at.

Lord Londesborough: Are we comfortable with the actual definition of investment, as opposed to potential return?

Richard Hughes: We apply national accounts definitions that can be summed up as: if it produces a durable asset that lasts more than a year, that is investment. In the national accounts and the public finances, the definition of meeting the Government's fiscal rules is investment that produces a fixed asset that lasts for more than a year, as well as grants to other institutions that do something similar. If you give a grant to somebody to build a school or social housing, that is a capital grant and ends up as a house at some point. There is a fairly narrow definition of intangible assets that also count as investment within the public accounts, but it is reasonably well defined and policed by the Office for National Statistics. We reflect those definitions in our forecasts and the Government reflect those definitions in their budgetary control system. There have been times in the past—and I am not entirely ruling them out in future—when fast and loose was played with the definition of current versus capital spending. I would not see that as the biggest risk to the fiscal outlook. The bigger risk is that even things that are classed as capital investment do not turn out to deliver the return that one might hope, economically and fiscally.

Lord Davies of Brixton: There is an interesting piece in the "Unhedged" column in the *FT* today about capital expenditure. Intellectual property products as capital expenditure have now overtaken structures and equipment. Is there not some equivalent intellectual property in terms of non-tangibles? You seem to be saying that the ONS can recognise capital only if it is there in a big chunk of something, but the world has moved on from that.

Richard Hughes: I am being slightly unfair to the ONS. It recognises some intangible assets in its definition of capital; where the Government hold patents and licences, those also count as capital investment because they are a durable asset. Just because they are not in bricks and mortar does not mean they do not count as capital investment.

There are two issues from the public sector point of view. For one thing, the Government tend not to have that many of those things and they are not always great at valuing them, because they do not think about them in terms of their commercial proposition. Until you come to the point of trying to sell or privatise something, you tend not to think too much about how you might capitalise the intellectual capital of government knowledge, and only when it comes to the point of thinking about selling them off to the private sector might you put a financial value on them. Where it is possible to value those things, government departments put a value on them and book them on their balance sheets, but typically when you look at a public sector entity versus a private corporation you do not see anything like the level of intangible assets on the government balance sheet because the Government are not thinking about their financial value, they are just thinking about their value in terms of their ability to provide a public service.

Lord Turnbull: To go back to the previous question, it seems to me that there are two reasons why the Government might have chosen to have a different metric for debt. One is that economists say that this new measure is a bit more sophisticated. It brings in more assets and more liabilities, but it does not go as far as requiring you to build new roads and so on. You choose it because it is a kind of *Which?* best buy. The other reason is that it creates more headroom. The concept of headroom is absolutely pernicious. For a lot of people it seems to imply that it is manna from heaven; suddenly, money has turned up. As Lord Blackwell reminded us, this is still debt that has to be paid, so making large use of that concept is not educating the public properly; it is trying to fool them and confuse them. Should we not get away from headroom as one of the major targets of the process?

Richard Hughes: We cannot speculate as to why Governments chose the targets they did. We tend to highlight what features and risks different targets have. It is fair to say that there is no set of fiscal rules that ticks every single box that you might want a financial objective for government to meet. They all have advantages and shortcomings.

One thing we have consistently observed with every Chancellor we have interacted with since the OBR was established is that headroom is in many ways an artefact. Governments set themselves fiscal targets and objectives. Then we produce a forecast of where they are likely to end up against them, and the difference is the headroom. One thing we have observed consistently over time is that that headroom shrinks and shrinks to a number that in terms of our forecasts is minuscule; it is a very small fraction of the errors against our forecasts, so in that sense Chancellors leave themselves very little room for manoeuvre against whatever financial objectives they set themselves, be it headline borrowing, current balance, net debt or net financial liabilities, because they programme tax and spending all the way up to the hilt and then leave themselves very much at the mercy of our next forecast to see whether they are still on track to deliver them, rather than setting aside a lot more margin for manoeuvre that would allow them to absorb those risks and not necessarily have to change fiscal policy.

Lord Turnbull: The natural reaction is to look around for another definition to give you a bit more headroom. Is that not the pattern we see?

Richard Hughes: Each successive fiscal rule tends to be less binding than the last; it certainly has been the pattern in recent years. I think you have to give Chancellors a bit of a break in the sense that they have faced an awful lot of shocks that have blown the public finances off course—first the pandemic and then the energy crisis. You always have to reset and reorient fiscal policy, but nearly all those rules have been basically about trying to get the public finances back on track after a series of shocks.

It is important not to lose sight of the fact that we are still borrowing 4.5% of GDP this year and that is not a sustainable level of borrowing. Every set of fiscal rules we have had since the pandemic has been an attempt to try to set a path back to sustainability from where we are. Basically, Chancellors are giving themselves a bit more time to get to a sustainable position that is somewhere significantly below where we are now, borrowing £120 billion, or 4.5% of GDP, which as a country is clearly not sustainable.

The Chair: The simple truth is that, as you said earlier, the existing debt rule that has been legislated for is not being met under this Budget.

Richard Hughes: No.

The Chair: I think that was what Lord Blackwell was getting at. I have another quick question. When did you identify the error in PSNFL, which is in the footnote on page 152? When did that become clear? I ask it only because it is quite a big error; the differential is quite big, so how and when did that become apparent to you?

Richard Hughes: We knew about it several months ago and let the Treasury know that the error had been made. It was a spreadsheeting error in our forecast. These things happen when you are an official forecaster. I should say that they happen especially for numbers that heretofore none of us has been very focused on. We have 50 very talented people in our organisation and we focus them very heavily on the numbers that policymakers are looking at and that matter for our forecasts. Until recently, net financial liabilities was an interesting additional detail to our forecasts, not a headline target.

We realised the error several months ago and informed the Treasury and gave them a rebased forecast, so all the decisions the Treasury made in the run-up to this Budget were in the light of that. We were aware of it some time ago. I have not picked up in my discussion with market participants that the correction of the error has made much difference to their view of the sustainability of the public finances.

Q33 **Lord Razzall:** Let us move to the other reason why you are here, which is our current inquiry into the overall impact that long-term sickness is having on the economy. We would welcome your views on what you think the cost of failing to remedy that is in terms of fiscal monetary policy and overall growth figures, and whether you think that failure to deal with it will lead to a significant increase in structural unemployment.

Richard Hughes: This has been an ongoing focus of the work of the OBR since the pandemic and since the rise in health-related inactivity became apparent to most people in the aftermath of the pandemic, although we should also say that there were signs of it appearing in 2018-19, going into the pandemic.

We have looked at the issue and tried to get a grip on the risks and challenges it poses to fiscal sustainability over different horizons. Most recently, in our fiscal risks and sustainability report over the summer, we devoted a whole chapter to the question of what would happen if you projected forward the trajectory we seem to be on for the health of the population and its implications for the economy and public finances. They are big and they make a really big difference.

When you think about the fiscal implications of the health of the population, it is a triple whammy in the sense that, if the health of the population deteriorates, you lose tax revenue, you spend more on welfare and you have more pressure on the health service. We tried for the first time to estimate the magnitudes of those different elements by looking at a set of simulations around what would happen if, on the one hand, the population turned out to be 25% healthier, assumed in our central forecast, which, broadly speaking, reverses all the deterioration we have seen in the health of the population in recent decades, and, on the other hand, if the population were 25% worse than in our central forecast, which, broadly speaking, would be a continuation of the deterioration that we have seen recently. We look out over 50 years, because the health of people now is a function of how long they stay in the workforce and what pressure they put on the public finances later. It makes a difference of up to 1 million people in employment one way or the other: 1 million people more if we can stay healthier; 1 million fewer people if we end up less healthy. The difference that makes to the level of borrowing in 50 years is 4% of GDP.

Lord Razzall: Over what period?

Richard Hughes: That is by 2070. Over a 50-year horizon, if the health of the population is 25% better or worse, that is 4% of GDP-worth of borrowing. By far the biggest contribution of that comes from health, which is about 1% of GDP-worth of extra healthcare cost if we are 25% less healthy. It is 1% of GDP less if we are healthier and 1% of GDP more if we are not. There is another half a percentage point of GDP in extra welfare costs, another half a percentage point in lower tax revenues from personal taxes and another half percentage point again from indirect taxes. You get another 2% of GDP for debt interest on the extra borrowing on top of that. So there are really big consequences, which can add up to 4% of GDP-worth of extra borrowing in 2070. If you scale that up over 50 years, you are talking about 40% more debt or 40% less debt in terms of GDP, depending on which of those scenarios you are in. They are very big numbers, of a sort you do not often see when looking at these things.

Lord Razzall: Even if the economy recovers, do you think the damage will have been done to structural unemployment? I hesitate to use that Greek word that nobody understands.

Richard Hughes: Our view has developed on the issue, but David might want to say a bit more about it.

Professor David Miles: I do not think it shows up in the measured rate of unemployment; it is inactivity—people not in the workforce rather than looking for a job. The rise there has been very substantial. Something like 7% of the working-age population is on incapacity benefits. Most of those people now, certainly the ones that have come on recently, are at the severe end of incapacity benefits, with virtually no ability to work or look for work. The numbers are very big. To look at just the unemployment rate, which I know people look at a lot, gives a false picture of the situation in the UK. We have a very low unemployment rate by the standards of history and the standards of other European countries, but the inactivity rate due to ill health is a very big number.

Baroness Liddell of Coatdyke: But is the inactivity rate not associated with ageing, not necessarily long-term sickness?

Professor David Miles: There is an increasing proportion of the total population not in the workforce, for sure, because the proportion of the population over 60, 65 and 70 has been rising. It will continue to rise and it is almost inexorable; in some senses for a good reason, in that life expectancy has expanded so much. It is not in itself a disaster in any sense, but it means that the proportion of the population of working age, to use an old-fashioned concept, which people usually take to be 16 to 64, is very out of date. Not many people at 16 are working and there are lots of people over 64 working, but if you just use that as a definition, the proportion of the population in that group in the UK will be falling substantially because the proportion of those over 64 is rising so much.

Baroness Liddell of Coatdyke: Is it not the case that there are some people who maybe at age 50 or 55 decide to retire and then come back into the workforce but end up unable to get employment? How do you cope with that? How do you factor that into the analysis?

Professor David Miles: You are right that people who might retire at 50 or 55 and five years later try to re-enter the labour force probably have diminished chances of getting the kind of job they might want. It may be that market forces make it easier for people to do that, simply because the ageing of the population gives a shortage of people who are 30, 40 or 50 years of age to fill jobs, and companies say, "We've got some good people here who are 55, 60 or 65. We might not have needed to look for people in that age group five or 10 years ago, but increasingly we do because we just can't find younger people". The market might to a limited extent help you sort that out.

Q34 **The Chair:** I am conscious of time, which is my fault. Before I turn to Lord Rooker, can we come to some of the points that you make in the EFO? I am particularly interested that the forecast is saying that welfare spending on incapacity and disability benefits is forecast to rise from £64 billion in 2023-24 to £107 billion in 2029-30. You say, "This is uncertain because to date it has reflected a complex interaction of drivers across health, the economy and the operation of the benefit system".

I would be grateful if you could go into a little more detail about what you mean there, and in particular, following through from that, para 5.35 where you say, "We have revised up the medium-term incapacity benefits case load forecast. Having previously assumed that incapacity case load would tail back close to pre-pandemic rates, we now assume that roughly half of the post-Covid rise in the growth of the incapacity case load will persist into the medium term". I am interested, in particular, in why you have made that assumption. Maybe you would like to start on the second point or the first, whichever one you would like to take.

Tom Josephs: There is, as you say, a significant increase in the forecast for welfare spending as a whole over the five years. That is almost entirely driven by two components: one is pension spending, which is driven by demographics and the triple lock, and the other is the increase in spending on incapacity and disability benefits. We forecast the case load to rise. It is currently about 30% of the total universal credit case load. We assume it will reach 50%, so it is quite a significant increase.

It is a forecast, so it is uncertain, but we think it is a reasonably central view. It is essentially based on extrapolating what we have seen over the recent past since Covid and assuming that, broadly, those trends continue. We make an assumption that some of the recent increase is likely to have been driven by the cost of living pressures that we have seen since Covid. So we assume that some of that will reduce over the forecast. Our economic forecast is essentially one where those pressures fall away. We do not have quite as strong growth in the case load due to that reason, but it is still quite strong growth.

The Chair: Okay. We should move on because it naturally segues into Lord Rooker's question.

Q35 **Lord Rooker:** Good afternoon. What do you think has been the impact of the changing conditionality on benefits on the incentives of people to work over the years? I am very interested that you have gone back 50 years because I wanted to do that as an example. Looking at the figures, have we not created a welfare state of dependency rather than a work state of opportunity?

I will give you my own example. Fifty years ago, when I was doing my weekend surgeries, in my weekend bag I could have the booklets and the leaflets and I could work out to the penny what people were entitled to on what they told me. It was easy to do. I understand today there is research that filling in the claims is contributing to the health deterioration of people. Something has gone seriously wrong with the benefits system. There cannot be an overall plan over 50 years, obviously. It has grown like Topsy, and each addition seems to be an incentive not to work. Is that a fair assumption; what is your assumption?

Tom Josephs: We produced a report in October that looked at trends in incapacity benefit. I am not sure it quite went back 50 years, but it certainly went back quite a long time. Broadly, the conclusion of that report is that there are multiple drivers for the increase in incapacity benefit case loads over time and changes over time.

There are wider economic drivers: the state of the labour market and the state of the economy more broadly. There is a driver around the underlying health of the population. But there is also, as you say, a driver around the structure and operation of the benefits system. We would say all three of those factors are important, and it is quite difficult to disentangle the impacts of them at any point.

We look specifically at your point on conditionality and the relative conditionality of unemployment benefit versus incapacity benefit over time. There is evidence that the higher relative conditionality on unemployment benefits has contributed to more people moving on to incapacity benefits. That seemed to be one of the drivers in the 1980s when you saw a big increase in incapacity benefit and there was no conditionality, and quite tight conditionality on unemployment benefit. It is also the case now that you have pretty tight conditionality on unemployment benefit and for most people on incapacity benefit much less conditionality. There are two groups now that you are put into on incapacity benefits—a more severe group and a less severe group. If you are put in the more severe group, there is no conditionality attached to that and there is a much higher award compared to unemployment benefit. In the less severe group, there is some conditionality but it is much less strict than is the case for unemployment benefit, and we have seen that more people are now being put into the more severe group, where there is less conditionality.

Lord Rooker: Our greatest asset is our people and their capacity and willingness to work. It seems the thrust of the changes has reduced their willingness to work because it becomes easier not to, and we are losing their capacity to the economy. I know this sounds like an outrageous thing to say, but I almost want to turn the clock back 40 years and start again from where we were then to obviate the difficulties we have now. Thank God for that bell, though.

The Chair: We had better adjourn the sitting until we have voted, and then we will return so you can answer that question. Thanks very much.

The Committee suspended for a Division in the House.

The Chair: Welcome back. I will turn to Lord Rooker to ask his question again.

Lord Rooker: I might change my mind and not ask it. But the thrust of it was that we have got in a mess in the last four decades, with no plan, and we have created circumstances where it is easier for people not to work, and yet their capacity and willingness to work is the country's greatest asset. We have reduced their willingness to work by the way the benefits system has been changed, and then we lose the economic capacity of their work. Just before the bell saved me, I was almost tempted to say that we should lop off the last 40 years of changes and go back to where we were, abandoning many of the benefits and starting again where we are today. We might end up with a more efficient system because we could do it with a plan, because there has not been a plan. Is that a fair summary?

Tom Josephs: The conclusion in our report is that it is not just the structure of the benefits system that is an explanation for the changes in incapacity benefit case loads over time; it is a wider set of factors. It is things such as the underlying health of the population, the wider economic condition and state of the labour market, but the structure of the benefit system clearly is also important.

It is also the case that successive Governments have been trying a lot of different programmes and routes to try to get people off incapacity benefits and back into work. We have assessed the likely effectiveness of some of those recently. The evidence on the effectiveness of those programmes is quite limited. There does not seem to be evidence that there is a very obviously successful way to do that. It is very difficult and, as I say, successive Governments have tried a lot of different ways to do that, but it is a difficult problem to solve.

The Chair: You summarised it well. There are the economic drivers, the health drivers and the changes in the benefit structure themselves. Can I tempt you to go a little further in weighting some of those factors? The more I read your very interesting *Welfare Trends Report* the more it strikes me that it is changes in the last few years—we are just about to come on to this—in terms of the response to Covid and since then that have really driven some of these changes. From a previous answer you gave—I am suggesting something here that you may profoundly disagree with—I heard you almost as saying that, whereas some people would say that people becoming sicker is the main driver of what we are seeing in the numbers, changes in the benefits system have driven this and it is not so much health. Am I wrong in that?

Tom Josephs: In the most recent period?

The Chair: Yes.

Tom Josephs: Again, we would say it is a combination of different factors, not just changes in the benefits system. It has certainly been the case that in the most recent period post Covid you had a big shock to the health of the population, and it looks like that was not just a temporary issue but there have been some longer-lasting impacts of that. It is also the case that you have much more incidence of people with mental health issues that are why they are on incapacity benefit than we have seen in the past. That certainly seems to be contributing to the issue.

We have had a big cost of living crisis. The fact that you have a big gap in relative generosity between unemployment benefit and incapacity benefit, combined with a big cost of living crisis, is also a likely reason why more people are moving on to incapacity benefit over time.

The Chair: Very good.

Baroness Wolf of Dulwich: I will hop on this because that is very good timing. Thank you, Chair. I would like to push you a bit more on this as well. I have been reading your extremely interesting *Welfare Trends Report* with some care.

First, I want to flag that, in addition to being, like Lord Rooker, somewhat taken aback by a lot of this, one thing came out to me very clearly that also relates to this recent period. We have had a very strong and ongoing increase in the approval rate. I had thought before I started looking at these numbers that we had had a big increase in on-flows in the number of applicants, but actually that is not really the case. We have had an ever-larger proportion going into the higher award, higher disability, and an ongoing increase in the number of applicants whose applications are approved and a clear fall in the number of those who go into work and therefore drop out, or for some other reason drop out, while their claims are being processed.

Could I push you a little on the approval rate that comes out very clearly from your analysis? What is to me very striking is the increase between, say, May 2018 and May 2023. If you have the report, I am looking at chart 3.10, but it is an ongoing and very interesting theme in your analysis. I suppose this may again relate to the question of what else there is to offer people.

Could you say a little more about whether you think these recent trends are because of real changes in sickness among people who are applying or whether it is actually about changes in the system which mean that when people come through the system there really is not much else to offer them except an approval of benefits and therefore that is what they are getting?

Tom Josephs: You are right. It is a really interesting finding from the report and one that we were very interested in ourselves and we had not realised before. As you say, it shows that the increase in on-flows in the most recent period is partly driven by more people claiming—there have been more initial claims. The bigger driver is the increase in approval rate, as you say, and that fewer people are dropping out of the process before they get to the final stage. Those two factors—fewer dropouts and higher approval rates—are the biggest drivers of the increase in on-flows. We tried to look in quite a lot of detail at what might be driving both the lower dropouts and the higher approval rates. It is quite difficult to identify the drivers. We have a set of possible factors, but we also say in the report that it is an area where we think more research is needed to get really under the skin of it. We have two excellent people who do welfare, but only two people, so there is a limit. We also work very closely with the DWP on it.

Baroness Wolf of Dulwich: Can I follow through on that quickly? First, it is a brilliant report, so please pass that on to the people who wrote it. Is it possible for you to be a little more specific about the sort of research that might give us a clearer answer to what is going on?

Tom Josephs: There are a few things that we highlight in the report. One is more information on the kind of primary health condition of people who are moving on to incapacity benefit, which we do not have at the moment. We have information on a range of health conditions but not the primary one. If we had more information on that, that would help us get to this point of whether this is being driven by changes in the underlying health of the population or whether it is more something about the system.

We talked earlier about conditionality and relative generosity, where it is quite difficult to try to identify how much of a factor that is in decisions that have been made through the on-flow system. Those would be some of the things that we think more research would be useful to look at.

On the point on dropouts, there were some changes to the system that were introduced during Covid that we think may have had an impact on the dropout rate, which we could get into a bit more detail on if you are interested.

On the approval rates, various changes were made to the operational underpinning of the system that could have had an effect, as well as the fact that both claimants and assessors being aware of the difference in generosity and conditionality under the two benefits may be playing a part. More research on all those potential drivers would be helpful in getting to a better understanding of this.

The Chair: Thank you very much. I know that Lord Turnbull has been patiently waiting to ask about this.

Q36 **Lord Turnbull:** Lord Rooker has referred to willingness to work being reduced. I do not think that is the main driver. I think what has been reduced is the willingness of the welfare system to help people. In your report, you say, "Prior to the pandemic, claimants were directed to take their fit note to a jobcentre for verification. During the pandemic, DWP work coaches accepted a fit note without seeing it in person. DWP has since made this their business-as-usual approach". As more and more people come, they have been overwhelmed, there is a strong pressure to reduce costs, and they take the work coaches out and resort to online contact and phone contact. It is entirely the wrong thing to do. There is a door there and the system is pushing people into this system where the sign is "Abandon hope all ye who enter here". Once people get into this system, it is really difficult to get out of it. The way the DWP is operating, it has not redirected its methods to tackling this so that people are not on there for a year, by which time they have given up hope.

The other thing is that there is a tendency to see mental health as a cause, as though it is a kind of miasma or a disease; more people get mentally ill. In my view, what makes people mentally ill is the despair of getting into the system. Once you are in it and the financial pressures grow and anxiety grows, your mental health will deteriorate pretty fast. It is tackling that and giving people contact with people saying, "Don't give up hope. We can bring this back". As it stands, we have resorted to these low-cost methods of intervention, and we need to completely revise the way of working. It is obviously more expensive to administer this thing with more people giving more interviews. It is cheaper in the short run but has, in my view, a massive cost in the long run. The DWP needs to completely rethink the basis of its intervention and accept that it is contributing to this ill health because it is pushing people into this system from which they cannot get out.

Tom Josephs: On the off-flows, which we look at in the report as well, it is certainly the case that off-flow rates from incapacity benefit are low and have not really changed very much over time. It is also the case that there is only a small difference in the off-flow rates between people who are in the more severe group and people who are in the less severe group and therefore are classified as being more able to work.

The only clear point at which off-flows have increased is when the DWP has done a major reassessment programme. The most recent one was in the early 2010s, when it reassessed the stock of claimants. It did that as part of the transition from the previous system, Incapacity Benefit, into ESA, and it reassessed people against what is a tighter set of criteria in the new system. That led to quite a significant increase in off-flows. We are not sure about the proportion of those people who went back into work—there is a caveat on that—but it is the only thing where we have seen clear evidence of an increase in off-flows.

The Chair: I seem to remember reading in the *Welfare Trends Report* that the Government obviously have not done a reassessment but consciously decided and announced that they were not going to do so, am I right in saying, in the last year?

Tom Josephs: Yes. They stopped doing the assessments during Covid, and they have said that they will not do reassessments apart from those led by the claimant themselves.

The Chair: They will do no reassessments—

Tom Josephs: Unless a claimant asks for one.

The Chair: This may sound like a very pedantic point, but can you remind us all of the process that a claimant goes through? Box 3.2 on page 38, which is very useful, says, "The claimant typically provides evidence of a restricted ability to work (typically a fit note provided by a member of staff in a claimant's GP surgery)". I may be being very pedantic here—I probably am—but when you say a member of staff in a claimant's GP surgery, I assume that what you really mean is a medical member of staff. You cannot just go in and get the fit note done. It has to be your GP, does it not?

Tom Josephs: I think it has to be a medical professional.

The Chair: So it has to be a medical professional. How much within this process is a medical professional after that point involved in the assessment or otherwise of the claimant? How much has that involvement been diminished during Covid?

Tom Josephs: The medical professional provides the fit note assessment. The fit note is then assessed by the DWP as part of the work capability assessment. That will be done by DWP staff. Sorry, what is the second part of your question?

The Chair: Has it changed? During Covid, there were certain changes.

Tom Josephs: The changes in Covid were around two things. One is that you no longer have to take your fit note along to the DWP to be looked at in person. The second—

The Chair: Let me stop you there. Talk me through what happens. Say I have a fit note and I ring up and I say I have a fit note. Is that it?

Tom Josephs: I have to say that I am not quite sure on the exact detail of how it works now.

The Chair: No one is saying to you, "You've got to show me the fit note". It has to be stamped by your surgery saying, "This is what the problem is". I am just trying to clarify exactly what the process is.

Tom Josephs: I would have to follow up on the exact process now. I do not have the full details of that. I am sure there will be some kind of process for checking that the fit note is in existence, but I am not exactly sure how it works.

The Chair: Just so I am clear, that was changed, so you do not have to provide it in person. Have there been any other changes during the pandemic era that have not been mentioned?

Tom Josephs: On fit notes, the other one that we highlight in the report is that the DWP has started to issue fit note reminders to claimants to remind them that they need to have an up-to-date fit note to be successful in their claim, which it did not do in the past. That could be another factor in why there have been fewer people dropping out of the process, because people are keeping their fit notes up to date.

The Chair: To come back to the data points, just to be clear—and I am returning to the question I asked earlier—when you see those changes that were made during Covid, is it clear that the case loads changed? Can you actually see the process changing and then the response within the claimant changing?

Tom Josephs: No, I do not think we can tie the two things together that clearly, which is why I said earlier that we would need more evidence on that to be able to draw really clear conclusions.

The Chair: I just want to try to get clear in my mind what you are saying.

Lord Burns: I would like to follow up on some of this a bit further. We had some evidence from the DWP that said that not all the increase in long-term sickness has been from the active population. It took 2022 versus 2021 and said that of those who had become inactive due to long-term sickness they had previously been inactive due to other reasons; in other words, what we are getting here is, to a significant extent, a shift in how people are being classified, and indeed the category that seems to have been falling is people who were looking after people in their home. You make a number of fascinating points about this.

Do we not need here a detailed stock-flow analysis of what is happening in terms of long-term sickness? My observation is that the numbers on long-term sickness are much bigger than the increase in inactivity. There has been a shift within this category of inactivity from categories that do not pay the benefits that occur if you are classified as long-term sick, not surprisingly, into long-term sickness.

Do we not need to know much more about both the inflows and the outflows and the reasons for them and where people are coming from? Are they coming from employment? Are they coming from unemployment? Are they coming from other categories of inactivity? My underlying concern is that we are drawing rather more frightening messages about the health of the population from these numbers than we should be, because a lot of this is simply people reacting and responding to all the shocks that came about because of Covid and changes in the mechanisms through which people are being classified or the benefits that they are receiving. There is a much larger bill, but is there really such a deterioration and such levels of sickness? That is the question. Is it not the case that we will not get any further on this without some much more detailed analysis of both the stocks and the flows here?

Tom Josephs: Yes, that kind of analysis would be useful and important. It is certainly the case that the proportion of people who are now inactive due to long-term sickness has risen as a share. But you are right: I do not think we have a very good understanding of where those people were previously. Were they inactive for another reason? Were they in work? That is important.

Lord Burns: Have you been able to take any of this into account in the modelling of this and particularly any impact from changes in the work capability assessment regime?

Tom Josephs: In terms of the work capability assessment, we made an assessment of the changes that were introduced by the previous Government. They made some changes last year to the criteria used in the assessment. We judged that that would lead to more people being placed in the less severe group and fewer people in the more severe group. We assumed that that would have only quite a small impact on employment and overall inactivity because of the point I made earlier, that off-flows from those two groups are not that different. Although more people would be in the less severe group, that would not necessarily translate into a big difference in participation. We assumed that it made a small difference, but it was pretty small.

Lord Burns: Do they come off long-term sickness and go back into other inactivity or once you are on long-term sickness, do you stay there?

Tom Josephs: Most of the evidence is that off-flows are very low and people tend to stay in the system.

Lord Lamont of Lerwick: Could the raising of the pension age have had any effect on all this?

Tom Josephs: Yes. It is a factor that we talk about in the report over the 2010s, and in particular the increase in women's pension age, which probably drove an increase in the case load, because there were more people below the state pension age in that age bracket where inactivity tends to be higher. That drove an increase.

The Chair: Coming back to the points that we have been discussing and circling around, which is the changes that were made during the pandemic, would it be possible to model, if you had a lot of the reassessments reintroduced and you reintroduced fit notes having to be provided in person and so on, to see the impact of that? Is that what you were saying earlier in response to Lord Burns? Am I making myself clear? If you go back and start to implement reassessments, if you start to say, "You have to produce your fit note in person", and you do these other things, can you infer anything from what happened before?

Tom Josephs: On the changes that were made on the fit notes during the pandemic, it would be quite difficult to assess what impact that would have. As I said before, I do not think we can draw any very clear-cut conclusions on the impact that had.

Lord Davies of Brixton: Do you not say somewhere that the trend was already established pre Covid?

Tom Josephs: There was an upward trend that seemed to be starting just before Covid.

Lord Davies of Brixton: That trend started before these Covid changes were made.

Tom Josephs: Yes.

The Chair: That is interesting.

Tom Josephs: On your second point on reassessments, we have clearer evidence from the past that it seemed to have a big effect there. It was, as I said, also due to the fact that the criteria were tighter. People were reassessed against a tighter set of criteria.

The Chair: Thank you. Right, let us move on.

Q37 **Lord Turnbull:** Some people have made something of the fact that there is an interaction with waiting lists and times. It may well be the case that if you have a bad hip, bad knees or whatever, you will not put yourself about seriously looking for work until you get that treated, and if you do get it treated you may well want to get back into work. That is a scenario you can easily imagine, but I think what you are saying is that, numerically, it is not significant. It is more to do with mental health. It is very difficult for people to say, "I'm depressed. I'm in no fit state to work". An assessor or a staff member—I do not think it is easy even for medically trained staff in GP's offices—cannot say, "Oh, no, you're absolutely fine". It is sort of a self-declaration system.

People are under pressure and they look round for where they can improve their well-being, and it is to push and push and find where the better benefits are and where the conditionality is lowest. You will not get away from that, I think, until people are given help to look at other ways of improving their economic standing; otherwise, people are currently, in effect, hunter-gatherers. "I will look round and, if I can get on to this system, I can do a lot better than if I were on sickness benefit or unemployment benefit". Given the terrible toll once people get into the system and the difficulty of getting off it, I do not think that simply carrying on with the business-as-usual approach will ever shift this.

Richard Hughes: It is right that one of our initial hypotheses was that inactivity was rising and NHS waiting lists were rising. To what extent is one the cause of the other? What we found when we dug into the data was that a large number of people are inactive and on benefits. They tend to have been on them for many months, if not a number of years. The average duration on the waiting list is only about 3-5 months. People, generally speaking, are not waiting years to get off the NHS waiting list. Turnover on the waiting list is relatively high. It is just that on-flows are constantly exceeding outflows. That is why you have 7.5 million people waiting. It is not the case that in general you have large numbers of people of working age on the waiting list. Most people on the waiting list are older and no longer part of the labour force, or children. When we last checked, less than half the people on the waiting list were of working age. Quite a number of people on the waiting list are working and of working age, so they are not falling into this group either.

The treatments that people are looking for from the health service are not necessarily the ones that they list as being the reason why they are not working. They may have health problems, but those need to be treated as health problems, not necessarily as barriers to getting them back into work. The kinds of support they might need to make them capable of working again are not necessarily what the NHS can easily provide to them, because it is mental health support in a lot of cases and the kind of work-focused support that more successful employment programmes provide to the people who are moving off inactive benefits into work.

The conclusion we came to is that the disruptions to the provision of healthcare during the pandemic and following it probably play some part in some instances of people not being able to get back into the labour force, but, if you get the waiting list down, you could very easily still have this problem left at the end of it because that is not actually the barrier to most people getting back into the labour force.

Professor David Miles: Might I make an observation on something said by Lord Turnbull, who raised some very powerful points about people who are on incapacity benefits of the most severe kind where there is a limited expectation that they will re-enter the world of work and they are not being reassessed? The problem in some sense may be even worse than you suggest because it is not just that people are left there and not given some help. There may be some people who feel a bit better and they would consider re-entering the world of work, but they have a concern—maybe exaggerated, maybe not—that, if they go back into the world of work and fall ill again, they then have to re-enter the system and get back to where they were when they had a relatively high level of incapacity benefit relative to unemployment benefit, and they think, perfectly understandably, "That is a risk and I'm not willing to take that risk".

Q38 **Lord Blackwell:** Listening to this, we seem to be debating two possible extreme hypotheses. One is that the rise in sickness is primarily due to poorer health in the community. The alternative extreme hypothesis is that there has not been any underlying change in health; the inflow is not any larger; people are falling out of work, but then they are discovering, for the reasons that have been explained, that they can get higher levels of benefit with less conditionality if they move into long-term sickness. The evidence you have given us in the report is that a large part of that is mental health and other conditions rather than the obvious physical manifestations of ill health, and presumably less easy to check. Therefore, they migrate off unemployment into long-term sickness, and having got there, for reasons that Lord Turnbull has given, they then find it harder to get off it and maybe that contributes to their ill health.

If this is largely a function of the benefits system and the motivation that it provides to people as an underlying hypothesis, which seems to be consistent with your data, what evidence is there that would dispute that and that would say that is not the primary reason?

Richard Hughes: The evidence is certainly there to support that as a key driver of what is happening. We have been looking at this question for more than two years. Whenever we try to find the one thing that explains everything, it does not explain everything. You have to bring all the different causal factors into account: underlying health of the population, incentives created by the benefits system, and so on.

The other thing I would point out is structural changes going on in the economy. Our economy and other economies have bounced back to some great extent from the pandemic, and fortunately so, but it has left some job opportunities behind and some parts of the country behind.

When we looked at where people who were ending up on incapacity benefits came from in the economy, they were oftentimes coming from low-skilled jobs in face-to-face services that had high levels of contact with the general public, and oftentimes they were not manual labour in terms of the physical input but they involved being on your feet all day and they involved interacting with other people all day. The kinds of conditions that they might have come out of the pandemic with in terms mental health issues, anxiety and social anxiety may well also contribute to the fact that, because those are the industries they came from and they are relatively low skilled, it is a challenge for them to move to a different kind of sector. Retail and hospitality are still there, but whether that is the kind of job that they are able to go back to post pandemic with the conditions that they have also remains a question.

There are also economic factors at play, and the kinds of opportunities that the labour market now provides at the salaries that it offers compared with the situation they find themselves in post pandemic also play a role in this. As I said at the start, every time we look at this you have to come back to a confluence of factors that explain how we have ended up in the situation that we have.

The Chair: Can I just quickly jump in on a factual point before I bring in Baroness Wolf? I do not want to detain everyone. It would be very helpful—and I should know this—to see what the assessment criteria are. We keep talking about this, and I need to get straight in my mind, picking up on what Lord Blackwell has said, the assessment criteria for the severe incapacity and the less severe incapacity. Also, you make the point in your excellent report at page 57. What policy changes were made in 2017 onwards to reduce generosity for the less severe incapacity group compared with the more severe incapacity group? Rather than going into lots of detail on that, if you could possibly put that in a letter to us, that would be very helpful, or point us to where we can find all that. I am sure it is in here. Lady Wolf, do you want to come in?

Baroness Wolf of Dulwich: Yes, I just want to confirm this to my satisfaction. There are some things we cannot find out. I keep coming back to the fact that initial claims are not that much higher—they are higher—and yet we all seem to feel that something is going on, whether it is in mental health or whatever it is. Presumably, we do not have any way of finding out because we do not know the detailed breakdown of the claimant groups in, say, 2010 as compared with today. Is that correct? It is very hard for us to know whether it is because of changes in the labour market or growing anxiety.

I completely get your point that a number of different things are going on: that it is partly to do with the changes in the way people are assessed and partly to do with people's nervousness that if they come off they will not go back on again. That must always have been true. At the same time, every time we hear people talking about this, there is also the sense that there is something wider than that. I think you are telling us that we will not ever actually know.

Tom Josephs: On your point on not having a good understanding of the health drivers, that is the case, and one of the things we highlight in the report is that we do not have good data on the primary health condition of incapacity benefit claimants. I assume that was also the case in the past, as you say, so making comparisons is therefore difficult. All these components of the increase in on-flows that you have talked about—initial claims, dropout rates, approval rates—could be because of factors within the system or because people have more severe health issues.

Baroness Wolf of Dulwich: Indeed, but it matters which it is. If we are trying to sort out what to do, it is very hard to do that if we do not know which it is.

Lord Davies of Brixton: In the meeting papers, EAC action item 3 provides a pretty detailed explanation of the assessment system. I am not really sure what people need in addition to what is there.

The Chair: I will have a look at that again. I am interested in the exact criteria that are provided. Sorry, did you have any other questions, Lord Davies?

Lord Davies of Brixton: No.

The Chair: No, that is fine. Fair point. Let us move on to Baroness Liddell.

Q39 **Baroness Liddell of Coatdyke:** Thank you. To what extent could elevated levels of long-term sickness be considered as a regional problem?

Richard Hughes: It does have regional concentrations, and looking at recent data it has been especially pronounced in Northern Ireland, Wales and the north-east of England, and relatively less of a problem in London and the south-east, which partly comes back to the point about where the labour market is more conducive to offering people a variety of different kinds of opportunities compared with other parts of the country.

Baroness Liddell of Coatdyke: The reason I got quite interested in this—and I am going off on a little bit of a tangent here—is that the Resolution Foundation drew attention to the fact that areas where there was a blip, an increase in long-term sickness, also had fewer graduates. I looked at the Fraser of Allander Institute's analysis of the situation in Scotland, and it made exactly the opposite point. There was a higher level, based on proportions, of graduates in long-term sickness, and as a consequence that was skewing the figures somewhat. Have you found that?

Richard Hughes: Scotland seems to be an outlier in terms of what has happened in the Scottish labour market versus other countries and what has happened in this group for reasons we do not fully understand.

Baroness Liddell of Coatdyke: There is that mischance of—

Richard Hughes: It is a bit of a cliché, but Scotland looks more like a microcosm of the United Kingdom, whereas Northern Ireland and Wales are a bit more idiosyncratic in the economic composition.

Baroness Liddell of Coatdyke: We would say we are quite idiosyncratic as well.

Richard Hughes: Yes, in its own way, but economically it looks an awful lot like the rest of the UK, so you expect Scotland to look like the rest of the UK. Because Wales has historically been more manufacturing-heavy, as has Northern Ireland, and has had fewer high-skilled professional jobs than the rest of the UK, it may also be that it has a sectoral mix that is more susceptible to people falling out of the labour market in those sectors and struggling to get back in.

Baroness Liddell of Coatdyke: Thank you.

Professor David Miles: Can I make one brief point about the regions? The regional differences look pretty significant to me. The breakdown is merely what one would expect. In areas in the country where wages are lower, there are on the whole poorer job opportunities and more people are on incapacity benefits, but they are also the regions of the country where health problems seem worse, so in a sense it does not help you identify whether it is just a knock-on effect of job opportunities being poor and people coming on to incapacity benefit for that reason or whether it is primarily because the health is worse and that is why people are on incapacity benefits because those things are correlated.

Baroness Liddell of Coatdyke: I must admit I find my head going round in circles all the time with this, because we also have to think quite hard about how we correct this. The means of correction is the hard bit here. Sorry, that was a tangent.

Q40 **Lord Griffiths of Fforestfach:** Given the increase in inactivity post Covid, and the issue of conditionality and assessment in the UK, how does that compare with other European countries?

Tom Josephs: We have not done a comprehensive international comparison. We have looked at some aspects of this. It is the case that in the 2010s the UK performed very well compared with most other comparable economies. We had inactivity falling quite sharply and more strongly than other countries. Most other countries also saw an increase in inactivity during Covid, but in most other countries it then fell back down afterwards. We are a bit of an outlier in the fact that the increase is being maintained post Covid.

Specifically on inactivity due to sickness, we have not looked at that. The IFS has done some work on that, and its conclusion is that the UK seems to be an outlier in having this spike in health-related inactivity post Covid, which it does not see in other countries apart from a couple of them.

Lord Griffiths of Fforestfach: When it comes to the way different countries assess what is wrong and so on, to what extent is there a difference between the way we do it and the way, say, France, Germany and Italy do it? Do you have any knowledge of that?

Tom Josephs: That is not something we have looked at in detail, I am afraid. We have limited resource that we are able to put on this question, so we have not been able to do that. All these systems are very different across countries both in the detail and in the overall approach.

Richard Hughes: Our system attaches more conditionality to benefits in general than some other continental European systems. In Scandinavia, there are benefits systems that attach both more conditionality and more support to people on inactive benefits to support them back into work. One thing that is particularly different about some of these countries is that the conditionality is not just on the individual but on employers. Because they have a social insurance model, the employer is contributing to the cost of health-related benefits, and the conditionality is also on them to find ways of bringing that person back into the workforce. They do not fall off the payroll just because they are on sickness benefits. For that reason, the employer has a stronger incentive to find ways of getting the person back into work. Attached to the government co-financing of their sickness benefit is an obligation on the employer to figure out ways of doing that.

The Chair: Very good, thank you.

Lord Griffiths of Fforestfach: I have one further question, but it is a different question. One of the terrific assets of the OBR is that it looks at the long term and not just the short term. What you do on the short term is terrific. If you take the issue of the welfare state, it started with Lloyd George and then Attlee, and it was a contributory system. At the time of Gordon Brown, it took a turn and became a tax and benefits system, and what we are seeing is more and more of that. I have had endless discussions in the past—he is not alive now—with Frank Field on this issue.

It comes back to Lord Rooker's question: to what extent would you ever look at the last 70 years? The work you do on debt is very important. You take a long-run view. If we are thinking about inflation down the road and the risks we have to take because of external shocks, you have really raised the debate in the UK, which is important. Would you ever consider raising a debate on the mix between a contributory and a tax and benefits system? Do you see that as part of your remit, in a way?

Richard Hughes: Happily, we are prohibited from contemplating alternative government policies. A reshaping of the welfare state would definitely be included. One thing to say about the rest of the world is that in a lot of countries the connection between what you contribute and what you receive from the welfare state is being broken just by dint of demographics. Growing numbers of people are living ever longer and more than their initial contribution would have generated in terms of an entitlement. Even in the US with things such as social security and Medicare, the link between what you paid in and what you get out has been broken because people are living longer than was anticipated. Part of medical success has been the fact that people are around for a lot longer than was anticipated with those programmes, so it is harder to say, "Your entitlement has run out and what you paid in has come to the end, so some of you are going to lose eligibility" for something as important as a pension or healthcare.

The Chair: Very good. That is a great question, but obviously we are unable to go down that particular rabbit hole.

Finally, I want to pick up on Lord Davies's point. I am interested in clarification of this bullet at the bottom of page 57 of your report. I will read it to you just so you know. "A rising approval rate reflects changes to DWP guidance that eased some assessment criteria, alongside improved external advice for claimants and potentially worsening health conditions. The 2017 policy to reduce generosity for the less severe incapacity group is likely to have contributed to the rising share of approvals for more severe incapacity".

I am just interested in the details of that easing and the changes in the generosity. Those are the two points I am interested in. It is not where we are right now. I completely take your point. The brief is very clear on where we are, but that is what I am after.

Lord Davies, you have a question.

Q41 **Lord Davies of Brixton:** Yes. Is there any way out of this? I am not absolutely sure where we are with the Government's policy. I think the original idea was that some welfare reforms would come in with the Budget, but that has been moved a bit down the road. Perhaps you know more about where we are on that. When and how, and how far, do you think you would be able to start adjusting your figures to allow for policies to address these issues?

Richard Hughes: One thing to say before we close is that boosting employment and participation has been a great success story of the British story over the last 20 years. Most countries, even today, would still envy our participation rate and our employment rate. What is worrying is that we seem to be falling backwards now. That is a worry because this has been a bright spark in the UK economy despite some disappointments in some other areas. The worry is why something that we have been doing so well up until recently has suddenly turned the other way. Part of what has allowed that to happen is more women being brought into the workforce, the raising of the state pension age, and those sorts of things that have kept people in work for more of their lives.

The falling back seems to be happening among different groups of people. The biggest group remains older workers. The fastest-growing group is among the young. It is almost certainly the case that any solution has to cater to quite a diverse pool of people who need some kind of intervention and support, both people at the start of their working lives and people who need encouragement to stay in the workforce later in life.

Having been presented with some proposed reforms by the Government, we have scored in our forecast both the fiscal benefits you get from them coming off benefits and the impact on the workforce. So far, those have been basically small-scale pilot projects trying new kinds of intervention, mixing employment-based support with health interventions. We have had a look at the international evidence and think that they might make some difference. The issue is that the success rates are relatively low in the sense that you are talking about one in five interventions sustainably getting somebody back into work for long periods, and when they do come back it is not necessarily full-time, so it is not generating huge differences in employment rates or huge amounts of extra revenue or benefit savings, but it is something.

It will almost certainly be one of those areas where government has to try different things and see what works among different groups of people, come up with a pilot that works and roll it out nationally. You can look around a bit at other countries to see what has worked there, but there does not seem to be one clear template that you can just adopt and implement in the UK context that, when we had a look at it, you could be certain it will have a transformative effect and put us back on this better trajectory.

Professor David Miles: Can I make one brief observation? The rate of return, just in pure economic terms, for getting a young person who might be in their mid-20s or early 30s back into the labour force is potentially extremely high. If there were policies that looked like they were making some progress on that front, it seems to be the kind of thing that the OBR would naturally want to start scoring, and it would become potentially more than self-financing.

Lord Davies of Brixton: Yes, but it is a two-stage process—to put it crudely, stopping their benefits or reducing their benefits and then them getting a job—and they are not necessarily the same thing. Reducing their benefits may lead to poverty and immiseration.

Professor David Miles: I was responding to something Lord Turnbull said, which was that it was an unfortunate situation where some people may move on to the higher level of incapacity benefits and are then, in a sense, left there. Directing resources at helping those people, particularly if they are young people, back into the labour force, is the thing that potentially is self-financing.

Lord Davies of Brixton: Yes, the whole of the 20th century was about moving away from less eligibility and providing support. I hope no one is arguing that we return to that sort of approach.

Professor David Miles: No, I was making a point about helping people re-enter the world of work.

Lord Blackwell: I have just one quick question reflecting on all of this. Given what you said at the beginning about the potential scale of impact of growth in these benefits on the public sector deficit and borrowing and sustainability long term, would it be fair to say that unless government solves this problem everything else it does will not resolve the debt sustainability issues?

Richard Hughes: Certainly, when we looked at this particular issue, which is what has happened to the health of the population and the pressures it puts on the revenue, welfare system and health system, this is one of the areas where you get the biggest long-term return economically and fiscally from preventive interventions that can save you costs down the road. You know when you look at our fiscal forecasts that the single biggest driver of cost is, first, the health service and, secondly, the pension system and welfare, and then, thirdly, if you have people dropping out of the labour force you lose on the revenue side. Three times over you are facing fiscal costs from not getting this right. The opposite is also true if you manage to get it right—if you keep people healthier in the labour force and working for longer. We also know that staying in the labour force and staying active is good for your health. Being out of work and being inactive is not good for your health. It has its own self-reinforcing benefit in that sense.

The Chair: Excellent. Does anyone have anything else to say? I feel we have covered an immense amount of ground. No? Fantastic. We are ending just a couple of minutes early. Thank you very much for coming in on a very busy day. We will end it there. Thank you.