HOUSE OF COMMONS

Treasury Committee

Oral evidence: Budget 2021, HC 1196

Monday 8 March 2021

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Watch the meeting

Members present: Mel Stride (Chair); Rushanara Ali; Mr Steve Baker; Harriett Baldwin; Anthony Browne; Felicity Buchan; Dame Angela Eagle; Mike Hill; Julie Marson; Siobhain McDonagh; Alison Thewliss.

Questions 65 - 140

Witnesses

I: Richard Hughes, Chairman, Office for Budget Responsibility; Andy King, Member, Budget Responsibility Committee, Office for Budget Responsibility; Professor Sir Charlie Bean, Member, Budget Responsibility Committee, Office for Budget Responsibility.

Examination of witnesses

Witnesses: Richard Hughes, Andy King and Professor Sir Charlie Bean.

Q65 **Chair:** Good afternoon and welcome to the Treasury Select Committee inquiry session into the recent Budget. We are very pleased to be joined by three witnesses from the Office for Budget Responsibility this afternoon. I am going to ask them to introduce themselves for the public record.

Richard Hughes: I am Richard Hughes. I am the chairman of the Office for Budget Responsibility.

Professor Sir Charlie Bean: I am Charlie Bean. I am the so-called economics expert on the Budget Responsibility Committee.

Andy King: I am Andy King. I lead on fiscal issues for the committee.

Q66 **Chair:** Welcome to all three of you. You are regulars and I very much appreciate you attending the Committee today. Can I start, Charlie, with a question for you? The latest EFO—Economic and Fiscal Outlook—does not have an upside or downside scenario associated with it. I just wondered whether you could comment on why the decision had been taken not to do that.

Professor Sir Charlie Bean: The key thing is that we still have upside and downside scenarios, but we decided not to recalibrate the upside and downside scenarios that we had last November. That is essentially because the data that has been coming in has been moving the economy pretty much around our central forecast. We still think our upside and downside scenarios are useful for providing context about recent developments in the near-term. The scarring assumptions underlying them further out are still relevant.

We would regard the upside and downside scenarios as still useful indictors of the range of possible outcomes, even though we have not recalibrated them this time minutely to take account of recent data.

Q67 **Chair:** That is very helpful. If the outcome is much better than the forecast that you have come forward with—let us call it the central forecast—what will probably have been the causes of that, in your view? In other words, what are the elements in play that might go in a more favourable direction and cause such an outcome?

Professor Sir Charlie Bean: Clearly, the news on vaccine rollout has been pretty good and somewhat better than we had in our central forecast in November, if anything. However, it is always possible that that could turn out to be even better. There could be upside news on therapeutics and so forth, so it is certainly possible that that may lead to even better outcomes.

As far as the economy side goes, there are upside risks. We particularly locate them in consumer spending. In particular, if more of the accumulated household unplanned or forced savings over the past year or so get spent in the short term than we had pencilled in, that could lead to a stronger upside rebound. That is certainly possible. Equally, the downside risks are still there. They particularly stem from the pandemic, in particular if there are variations and mutations in the virus that turn out to be particularly virulent and resistant to vaccines. That may set things back somewhat, so We still think there are risks on both sides.

As far as the longer term goes, we do not have a clear handle at this stage on the scarring assumptions, which I am sure we will come back to later in the hearing, or how big they are going to be. There is a range of possible outcomes. We still regard 3% medium-term scarring as a sensible central assessment but it could be either side of that, quite clearly.

Q68 **Chair:** Would you put interest rate movements in the mix that you have just gone through?

Professor Sir Charlie Bean: Yes, they would be a source of downside risk. One of the notable events in the past few weeks has been the upward movement in yield curves, particularly in the US, partly on the back of the Biden fiscal proposals and partly on concerns that inflation may pick up over there. People are just generally becoming more conscious that that may be an issue going forward.

In terms of the implication for the UK, I have to stress that, when you look at a rise interest rates, it is crucial what the driver is. The implications for the UK would be very different if the rise in interest rates is associated with a substantial pick-up in growth associated with much better productivity performance, for instance, as opposed to a pick-up associated with a loss of confidence in the policy framework, a concern that deficits might be monetised and lead to inflation, and those sorts of things.

Q69 **Chair:** That is interesting. We have seen, as you have commented on in your report, a 30 basis point increase in interest rates, effectively an additional £6 billion hole in the public finances, which illustrates the sensitivities there. I know these things are immensely complicated and uncertain, but are you feeling confident that the assumptions you have made in the forecast are broadly still tenable or are you increasingly casting a wary eye in the direction of interest rates?

Professor Sir Charlie Bean: We certainly think they were sensible conditioning assumptions. Obviously, people doing the forecast today would have slightly different ones.

Q70 **Chair:** That is what I am asking, in a sense. I know it is a short period since the forecast, but are you feeling a little less easy with the assumptions on interest rates?

Professor Sir Charlie Bean: I would not extrapolate from the recent couple of weeks to say that that is a trend that is going to continue, where we will see markedly higher interest rates in the second half of this year. Where the yield curve is now is a reasonably sensible place for it. As always, market participants change their assessment of the outlook in response to economic news, news about the vaccine and news about policies. It certainly makes sense to recognise that there are risks around that but I am reasonably happy with what we have as a conditioning assumption for the central forecast.

Richard Hughes: One of the reasons why we have had several discussions of the risks around interest rate rises in successive EFOs has been to try to draw attention to the fact that, regardless of what happens to interest rates, the public finances are increasingly sensitive to those changes either upwards or downwards. That is because the effective maturity of our debt is getting shorter and shorter as a result of the interventions of the Bank of England. We have once again gone into some of the arithmetic of that in our EFO and can elaborate on it later in the session if interested.

Chair: Yes, so this is broadly £20 billion for 1%.

Richard Hughes: That is right. As you mentioned, we have already seen 0.3% of a rise since we closed the interest rate part of our forecast. We are almost a third of the way there to that £20 billion from a 1% rise in interest rates.

Q71 **Chair:** Charlie, you mentioned the issue of enforced or unplanned savings and what happens to that over the coming months. How sensitive are the forecasts to that particular issue? It feels instinctively to me that there is probably a huge level of uncertainty around the proportion of that spend that might come through to the economy over the coming period.

Professor Sir Charlie Bean: This has got a lot of attention in public discussion, the press and the City with the commentators there. The main reason we expect to see a rebound in consumer spending and demand in the economy is simply the removal of restrictions on behaviour, re-opening the retail sector and so forth. That accounts for far and away the bulk of the rebound in consumption. As Andy Haldane put it, the economy is like a coiled spring waiting to be released.

The question is whether there will be an additional twist to that imparted by these accumulated savings, which amount to £180 billion. If they were all spent at once, in the space of four quarters, that would add about 6% to the level of consumption this year and next. That is pretty significant.

Q72 **Chair:** What would it do to growth, Charlie?

Professor Sir Charlie Bean: It would add about half of that to growth, three percentage points or something. There would be quite a bit of leakage into imports and so forth, but it would be a significant upside impetus to the recovery if that was all spent. It is highly unlikely that anything like all of it would be spent that quickly. We know that the sort of households that have been accumulating these extra savings are basically high and middle-income households and retirees, who are much more likely to spend the increment to their savings steadily over time. Empirical evidence on this suggests about 5% a year out of an increment to wealth or a transitory increase in income gets spent. That would be repeated over each year of the forecast, so it adds a little under one percentage point to the level of consumer spending over our forecast.

That is why, if you look at the chart of the savings ratio in the document, you will see that the savings ratio we have now is about a percentage point less than what we had in November. That reflects this spending of the accumulated savings gradually over time. There is a bit of front-loading because you would expect some of it to feed into durables. For instance, car registrations were quite low last year and there might well be people who are putting off replacing a car. Now they might go out and buy that new car. Similarly, with the housing market, given that there has been quite a strong market there recently, you would expect to see some spending on white goods and similar sorts of things.

The idea that people will make up for their lost consumption by spending it all over the next few quarters, once the economy has re-opened, is one that I find implausible. It is much more plausible that it will be spread out over several years, effectively.

Q73 **Chair:** That is interesting. The Financial Secretary to the Treasury appeared before us a little while ago and we were discussing the various possible outcomes as we open up. On the matter of whether we needed to raise taxes, he effectively said that, if the recovery is particularly strong with the upside scenario the OBR is looking at, and growth is stronger than expected, we might not need to look at raising taxes. I am not going to ask you to comment on raising taxes or otherwise because those are political policy matters, but could you give us a feel as to, if growth is better than the scenarios of 4%, 7% or 1.6%, how much of an impact that will have on improving public finances? As a benchmark, if growth in the near term is 1% better than we are currently imagining in the central forecast, what does that do to the public finances and the fiscal gap?

Professor Sir Charlie Bean: The important thing here is not so much slightly faster growth over next year or whatever. It is really coming back to that scarring assumption, which, in our central forecast, is a 3% hit to potential output. That means correspondingly lower tax revenues and so forth.

It is perfectly reasonable to argue that, if we do not see that level of scarring, you do not need the same sort of fiscal consolidation in the medium term. Basically, if we get back to the pre-pandemic trajectory that we were on so that there is no scarring, the fiscal consolidation that the Chancellor announced last week, with the freezing of personal allowances and the corporate tax rate increase, will, in principle, no longer be necessary to restore sustainability.

Equally, if the scarring turns out to be greater than we expect and we end up in that 6% bucket, which I would not rule out, but it is less likely than it might have been, potentially more consolidation would be required. The really central thing here is the evolution of potential output over the medium term. A key driver of that will be productivity performance as well as what happens to the labour force. That is something that we have talked a little about in the report.

Andy King: One thing about this Budget is that the Chancellor has not yet set fiscal rules for the medium term. Usually, the way you would think about these things interacting is that we take a view on potential output and therefore the fiscal outlook absent any policy measures. The Chancellor has fiscal rules and we put those two things together, to estimate the gap between meeting the rules on different outlooks for potential output.

Without any fiscal rules, what we have this time is the Chancellor's revealed preference of achieving a current balance and stabilising underlying public debt. If those were the rules and the Chancellor wanted the same margin against meeting those rules, everything that Charlie has just said would hold. If the rules are different, obviously the gaps are different. The other possibility is that the Chancellor could look to see debt falling more quickly if scarring were less or debt rising slowly if scarring were greater.

Q74 **Julie Marson:** I have some questions on corporation tax and super-deductions, as outlined in the Budget. Richard, what assessment have you made of the impacts of the planned corporation tax increase as they affect growth and employment?

Richard Hughes: Maybe I can start with a few thoughts and then Andy, who has looked at these things in more detail, might want to come in. Looking at the corporate tax package as a whole, taking into account both the super-deduction and the corporation tax rise as they come in towards the end of the forecast, we think that the super-deduction has an effect principally on the timing of investments, rather than the overall level of investment in the long term.

Because it pays companies £130 for every £100 worth of investment, it provides a very strong incentive for companies to bring forward the investments that they had already planned to do at some point over the medium term into the period where they can get the tax advantage and, in effect, get the public subsidy for that investment. We think that it raises investment by about 10% at its peak in the years when it comes into effect, which are the middle years of the forecast. In terms of pounds put in, that is about £20 billion at its peak.

Later on, the super-deduction expires and the corporation tax increase comes in. That then has a disincentive effect. The withdrawal of the temporary super-deduction means that future investment is lower because companies' plans have been brought forward. The increase in the headline rate of corporation tax also increases the marginal cost of capital and therefore acts as a marginal further disincentive to investment.

Andy King: In the short-term, the super-deduction measure is quite a powerful stimulus measure during the recovery period. We had taken the view that a good deal of it will be on imported goods. The effect on GDP is somewhat less powerful than the effect on investment.

In the medium term, the consolidation measures in general, with the CT rise being the largest of them, take effect three, four or five years away, which is at or beyond the Bank of England's monetary policy horizon. We typically, and in this forecast, have assumed that monetary policy can offset the demand effects of these measures to a large extent so the effect of them on growth is modest.

Q75 **Julie Marson:** The super-deduction is estimated to cost the Exchequer about £25 billion. Do you have any assessment of how much of that might be deadweight cost, in the sense that it is a cost on investment that might have happened anyway?

Richard Hughes: It is a bit difficult to answer that question easily because a large part of the intention of the policy is to move investment around rather than to increase it overall. We think that the effect on the overall level of investment is likely to be quite limited, but its effect on moving investment around is quite strong. If the intention is to fuel an investment-led recovery over the next few years, which is our understanding of the policy, the policy is quite effective. If it is a policy that is designed to get the overall level of business investment up, based on that definition, it has a pretty marginal effect on the overall level of investment in the long term, because you are just bringing forward investment from future years into the current one.

Q76 **Julie Marson:** Given a similar amount of tax revenue to be raised, how do those measures compare with increasing income tax or VAT as it would impact growth and jobs?

Andy King: Are you talking about the medium-term increase?

Julie Marson: You said there is a difference in the timescales and the contrasting effects. If we had seen an almost immediate increase in income tax or VAT rates, do you think that that would have produced a completely different effect on growth and jobs? How do those two measures compare?

Andy King: We are asked not to comment on alternative policies. The framework in which we look at the growth effect of policies would say that any form of medium-term consolidation that does not kick in until the third or fourth year of the forecast will have a relatively modest effect on growth because of the assumption that the Bank of England has time to take those things into account when setting monetary policy. The form that the tax or spending measures take will typically have limited differences in the way we would see them in the medium-term forecast.

In the short term, we take a bespoke view of how different measures affect the economy. The super-deduction, in particular, has a powerful effect on the timing of investment. If consolidation measures had been brought in with effect tomorrow, they would have dragged down growth considerably because the Bank of England would have no chance to do any offsetting action.

Q77 **Julie Marson:** Andy, what is the forecast on the impact of high corporation tax on inward investment into the UK from 2023?

Andy King: We do not forecast the FDI inward investment flows. I do not know whether Charlie would want to say anything on the economics of it in general.

Professor Sir Charlie Bean: At the margin, other things equal, it certainly makes it less attractive for a business to operate here. I would stress, though, that there are a lot of things that feed into a firm deciding where it wants to base its operations. It is not just the corporate tax rate, any allowances and things like that; it is also availability of skills, access to markets and a lot of things together. It is relatively unlikely that small differences in corporate tax rates are going to be that central to where a firm decides to build a new plant or something like that. If it is a multinational like Nissan, the corporate tax rate is probably not the most important factor in deciding who builds the next model of car.

Q78 **Julie Marson:** Andy, do you anticipate an increase in cross-border profit-shifting because of the increase in corporation tax?

Andy King: Yes, we did factor in some loss of yield from the measure from profit-shifting activities. HMRC has done a lot of work on how profits have been shifted in the past as the rate has been cut. That provided something of an evidence base, although this is obviously highly uncertain and what matters is the differential between the UK and elsewhere, where elsewhere is not a fixed thing, as we can see with the debate in the US at the moment. The yield of £17 billion at the end reflects a view that some will have been lost to profit-shifting activities.

Also, because the rate change is quite large, the yield and the measure reflect other activities besides cross-border profit-shifting that companies might feel more inclined to take part in just to reduce their taxable profits given the higher rate. Overall, the yield is brought down by around 10% for those kinds of things. It is one of the more uncertain areas because, as soon as you get into how taxpayers' behaviour shifts when they are trying to pay less tax, the uncertainties are greater than just trying to estimate how much will be raised from a given amount of profits.

Q79 **Felicity Buchan:** Good afternoon. It is good to see you all. My questions are on fiscal stimulus and consolidation. Perhaps I can ask Richard quite a generic question. How would you categorise this Budget in those terms?

Richard Hughes: I would categorise it into three buckets, each with its own respective timing. Partly, the Budget extended the rescue funding, which the Government have been providing to households and businesses to make it through the pandemic. It has added about £44 billion to that to take the grand total up to £344 billion spent since the start of the pandemic. That is funding that expires at the end of 2021-22.

There is then a recovery phase of this Budget, the centrepiece of which is the super-deduction for corporate investment, which ends up costing around £12 billion a year and £27 billion in total. That is designed to stoke the fires of the recovery in the way in which we described, bringing investment forward, to give you not just a recovery in consumption but also a recovery in business investment and potentially a more balanced recovery across the two.

Then there is a repair phase, in the final two years of the forecast, where the Government raise about £30 billion through a combination of corporate tax rises and freezes in the personal allowance and higher rate thresholds, plus around £4 billion to £5 billion of further cuts to their plans for public spending beyond the pandemic years. All in all, that raises about £30 billion. In trying to think about what the Chancellor has done in what is a very policy-active Budget, he does those three things at three different points in our five-year forecast.

Q80 **Felicity Buchan:** Do you think that the Chancellor has done enough to stimulate growth? In the US, we see President Biden with a huge stimulus package. Do you think there is enough in this Budget?

Richard Hughes: It is one of those moments where I have to say it is not for me to judge the Chancellor's policy decisions. There are elements of all three of those. There is significant funding against all three of those objectives in the Budget, with a lot of additional resources for rescue, substantial resources for recovery and a substantial down payment on repair. It reflects the fact that it is a Budget that had a lot of policy going on, probably more than we have seen in previous Budgets, where the Chancellor is either spending a lot of money in the near term, trying to rescue the economy, or spending a lot of money at the back end like he did in the pre-pandemic Budget, where he was trying to raise the long-run rate of public investment. In that sense, it was a very busy Budget. Whether the contents of it were sufficient is for others to judge.

Felicity Buchan: I understand.

Professor Sir Charlie Bean: The size of the output gap is difficult to measure under all conditions, but it is particularly uncertain at the current juncture because the response to the pandemic has involved pushing down on both demand and supply in roughly equal measure. As the restrictions are eased, we expect both of them to come back. At least in our central forecast, we do not think there is that large a margin of spare capacity. The output gap is quite small. It would not make sense to have a large demand stimulation.

I should say, in respect of the Biden plan in the US, that there are economists like Larry Summers and Olivier Blanchard who have been exponents of greater use of fiscal policy and who think that the size of the stimulus is far too big relative to the likely size of the output gap there. That is precisely why there has been concern in financial markets about this possibly re-igniting inflation and why interest rates have risen.

If you are thinking about supporting the demand, it is not obvious that there needs to be a substantial policy stimulus at this juncture. It may turn out that our judgment is wrong and that demand does not recover as quickly as supply, in which case it would be sensible for either the Bank or the Chancellor to add additional stimulus. As it is at the moment, we expect the margin of spare capacity to be quite small during the re-opening phase of the economy.

Q81 **Felicity Buchan:** Thank you. That is very interesting. Richard, can I go back to your three phases and the repair phase? That kicks in after approximately two years. Do you think that is the right timing in terms of when the repair phase should kick in?

Richard Hughes: I just want to pick up on Charlie's point, again with the caveat that it is for the Chancellor to decide what he does and when he does it. It is the case that the output gap Charlie was talking about is small in the near term and closed over the medium term. By the time these measures are coming in, there is not a significant amount of slack in the economy, according to our forecasts. We are growing more or less in line with our trend rate of growth. The employment that we see opening up over the next few years as people come off the furlough scheme has largely resolved itself and people are back at work.

In that sense, what the Government are doing to aggregate demand is not making the output gap larger or dragging down demand when it should be recovering towards its long-run rate of potential. From the point of view of matching the Government's stimulus and consolidation plan with the path of the output gap, the consolidation part of it comes in later on in the forecast when the output gap is closed.

I should also underline Andy's point that we look at the policy package as a whole and we expect people to be rational and forward-looking. To the extent that people foresee tax changes coming, that also has an effect on their behaviour in the near term.

Q82 **Felicity Buchan:** You mentioned that the super-deduction is really just an acceleration of the business investment and you say that it will have a big impact in terms of timing. Is your view that it does not actually add to GDP when looked at over the five-year horizon?

Richard Hughes: It adds to GDP in the sense that it gets us back to the level that we were hoping for sooner. In the long run, it adds slightly to the capital stock because you get more investment sooner, so you get more of the business capital stock in the long run than you would have, had you not had the incentive. Because it then reduces investment thereafter when the deduction is removed, on balance, its contribution to the amount of productive capital in the economy and therefore its output is pretty limited in the long run.

Q83 **Felicity Buchan:** How much of a drag on growth do you think the repair phase will be? Can you quantify that in GDP terms?

Andy King: As I have said previously, it is a very modest effect because of this assumption that, given how far in the future it takes place, the Bank of England will be able to factor that into its own policy decisions. Essentially, our forecast assumes that the interest rate curve has embodied the Chancellor's desire to bring debt back under control.

Q84 **Felicity Buchan:** You have decided not to materially adjust the fiscal multipliers. They basically range from one to zero. The IMF has come out and said that they think, due to the uncertainty, that fiscal multipliers should be higher. They have used a number of two. What is your view on that?

Andy King: We looked at this in some detail for our November forecast and the Congressional Budget Office, our much larger opposite number in the US, has done the same. We have found reasons to both sides. Uncertainty is certainly one factor. The likelihood of crowding out private sector activity is diminished when private sector activity is being held back by public health restrictions anyway. The likelihood of stimulating household spending with the support measures to households is also limited by the public health restrictions, which would act in the opposite direction.

We took the view that there were arguments to both sides. Things were particularly uncertain and, therefore, we stuck, largely, with the numbers that we have used previously. We did make some adjustments, for example the very large sums that are being spent on virus tests and PPE, which, until recently for PPE and still for virus tests, are largely imported and therefore will not have a multiplier effect on UK GDP. Other than those small changes, we felt that the balance of risks was still as before.

Q85 **Felicity Buchan:** Do you think there is a risk, by using lower multipliers, that you disincentivise the Chancellor from investing in the economy?

Andy King: This debate has always confused me slightly. If we use a lower multiplier and the Chancellor wants to achieve a given economic outcome, as far as I can tell, it incentivises him to do more, so as to achieve that outcome. Perhaps I just think about this in completely the wrong way.

Richard Hughes: On the specific point about investment, our highest multiplier is actually for public investment as opposed to other forms of stimulus. To the extent that the Chancellor is entirely guided by the league table of what gets him bang for buck in terms of public spend to GDP, public investment is the thing that gets him the most. That has a multiplier of one. Other things like support for businesses or households get him only a fraction of that.

Q86 **Anthony Browne:** My questions will focus on the fiscal contraction as well. I think I am right in saying that, under the soon to be outdated fiscal rules, the only one it actually meets is stabilising the national debt. The public sector net borrowing stabilises at 96% in 2023-24, ex Bank of England. Richard, to stabilise that national debt, how much is that the result of tax rises and how much is that the result of controls in public spending?

Richard Hughes: This time around, if you look at the ratio of this budget consolidation to what has been done in the past, about 60% is being done through tax and about 40% is being done through spending. If you contrast that with the last time we had a Chancellor who had to deliver a big post-crisis consolidation, which was in 2010, a lot more was being done through public spending and less was being done through tax. There were also subsequent tax reductions, which then reduced even further the proportion being done through tax, which left more of the consolidation being done by spending. So far, this is a more tax-heavy consolidation than we have seen in the recent past in the UK, in previous post-crisis Budgets.

Q87 **Anthony Browne:** It is quite a distinct path from the last time round after the financial crisis. In terms of consolidation, how much is done by taxes? Presumably, you are talking there over the five-year period, but we stabilise the public sector net debt in 2023-24, and it is just that year that the corporation tax rise comes in and the freeze on income tax thresholds has not really started delivering much yield by then. Presumably, most of the stabilisation is actually done before the tax rises come in. We stabilise the debt without the tax rises.

Richard Hughes: Most of the consolidation in the Budget is being done in the final two years in terms of policy. We have a deficit at the moment of around 17% of GDP and much of the work of getting it down to 3% is being done by the economy, not by any policy measures being taken by the Chancellor. It is the policy measures at the end that take him the rest of the way towards what appears to be his aim of balancing the current Budget.

Q88 **Anthony Browne:** My precise question was about stabilising the debt without the tax rises, largely because of nominal GDP growth, presumably.

Richard Hughes: Yes, most of what has brought the debt pressure under control compared to now has been the economy, but the

Chancellor would not have got the rest of the way without some action on either tax or spend.

Andy King: The debt peaks in 2023-24 and the first year it falls is 2024-25. In 2023-24, you have £30 billion of consolidation measures over the two fiscal events since the pandemic, which is about 60:40 spending, very largely the cuts in pre-pandemic plans for day-to-day departmental spending. In 2024-25, you are up to £44 billion of measures and then it is flipped to 60:40 tax, which continues into the following year.

Q89 **Anthony Browne:** Thank you for that clarification. One of the things that has caught the media's attention is the fact that this Budget brings the tax take of the economy to 35%, which is the highest rate since Roy Jenkins was Chancellor back in 1968-69. It fell fairly rapidly after that and there have been various bits of speculation that we are now a permanently higher-tax economy. I know you cannot comment on future policy changes but do you think it is inevitable that we are a higher-tax economy and that we will end up with taxation continuously at this level?

Richard Hughes: Nothing is inevitable. One can say that this is a level of the tax burden that we have rarely seen in the UK in the post-war period. When it has reached that level, it has fallen back, for policy reasons or otherwise.

Q90 **Anthony Browne:** It was for only one year and then it fell very quickly afterwards.

Richard Hughes: Indeed but, that said, we, like any other advanced economy, are an ageing society and we have a larger and larger share of the population being out of work because they are retired, who need to be supported by a shrinking working population. One of the dilemmas that all advanced country Governments face is where they are going to find the revenues from a shrinking working population to support a larger and larger population out of work. That has been driving a rise in tax-to-GDP ratio in almost every advanced economy just because of the demographic arithmetic.

Q91 **Anthony Browne:** You talked earlier, in response to the Chair's questions, about the fiscal rules. Obviously, we need a new set of fiscal rules now. We are not doing it right now because we do not quite know where we are. I am certainly very nervous about the high level of national debt that we have. It is quite unstable in terms of potential future interest rate rises and I would certainly like to see that come down for the sake of my children and grandchildren. We do not have fiscal rules now. When will be the right time to set fiscal rules so that we can start plotting the future course of the national debt? What criteria do you need? Can you do it next year? There will still be huge amounts of uncertainty next year. What boxes do you need to tick before you can start setting the rules?

Richard Hughes: Again, it is very much for the Chancellor when he decides to set fiscal rules and what rules he decides to set. He is legally obliged to state his fiscal objectives to Parliament. The objectives that we have expire in a matter of three weeks. They are being missed by a country mile at the moment so, from the perspective of the charter of budget responsibility, there is an obligation on the Government to do so.

They have indicated in the red book that the review of the fiscal framework, which they launched pre-pandemic, is ongoing and they plan to bring it to a resolution in the near future. Whether that results in a set of fiscal rules in time for us to assess them in the autumn, we will have to wait and see.

In the meantime, we continue to read the runes and look at other things that the Chancellor has said about what his fiscal objectives were. In the last EFO, it had followed the Chancellor's statement at the Conservative Party conference about wanting to balance the books and bring debt under control. We do not just look at what the Government say in legislation, but we look at what they say to the public about what the fiscal objectives are and assess those. We see it as our job to hold the Government to account with what they say they want to do with the public finances, whether they say that in legislation, manifestos, speeches or other fora.

Q92 **Anthony Browne:** In the absence of any other massive economic uncertainty—no more pandemics or financial crises—beyond your forecast horizon, presumably there is no need for more fiscal contraction in order to get the national debt on a downward path. You still have the annual borrowing at less than 3% and it would presumably stay there, and that is less than nominal GDP growth, so the national debt would continue downwards without more fiscal contraction.

Richard Hughes: The underlying debt-to-GDP ratio is falling by the end of the forecast period. Chancellors have traditionally wanted some room for manoeuvre against these fiscal rules to deal with risks, shocks and threats that come along. What we have seen over the last two decades has been a steady ratcheting up of the level of debt because we have never had very long periods of debt reduction in this country. We have brief periods of debt reduction followed by shocks that push the debt levels further up. If you want to rebuild some breathing space, you might want to have debt on a more rapidly declining trajectory than the fairly shallow glide path that we currently have in our forecast.

If you think recessions come along once every 10 years, we have a forecast where, over the next five years, it is only falling, very slightly, over the last two years. If you like this level of debt, I would not leave it there going into the next recession because it is likely to end up much higher.

Q93 **Anthony Browne:** You could almost say that we should mend the roof when the sun is shining. Is that right?

Richard Hughes: Those are not my words but I know others have said so.

Q94 **Anthony Browne:** There has been quite a lot of debate, certainly within the Conservative Party, about the Laffer curve in relation to corporation tax. When George Osborne started cutting it, revenues went up and it was cited as proof that the corporation tax rate was above the peak of the Laffer curve. Here, we are now increasing the rate of corporation tax and the income, supposedly, according to everyone's forecasts, is going up. Do you think there was any merit to the argument that we are beyond the peak of the Laffer curve on corporation tax? Are there any other taxes where you think the rate might be beyond the peak of the Laffer curve, where the Government, according to your modelling, could cut the rates and actually see revenues go up?

Professor Sir Charlie Bean: My judgment for something like corporation tax is that we are not on the wrong side of the Laffer curve. It partly depends on the tax rates that other countries have set as well but, even with the planned increase, it is only taking us back into the pack with most of the other advanced economies. There clearly is a point when the tax rate gets sufficiently high that it will be counterproductive to raise it, but that is quite a different thing from saying that we are actually there. My judgment would be that, with most of the main taxes, you are not on the wrong side of the Laffer curve.

Q95 **Anthony Browne:** Are there any taxes where you think we are on the wrong side of the Laffer curve?

Professor Sir Charlie Bean: There is nowhere that I think it is obviously the wrong side of the Laffer curve. When I was a wee youth, there were very high marginal tax rates.

Anthony Browne: There was a 98% super-tax.

Professor Sir Charlie Bean: That is the sort of thing where there is reason to say you are on the wrong side of the Laffer curve. For the sort of tax rates that we have for the main taxes in this country, I would not think it plausible that we have actually slipped to the wrong side of the Laffer curve.

Q96 **Dame Angela Eagle:** I want to ask some questions about spending plans, particularly your summary box at 3.3 in the fiscal outlook where you observe that the Government have made no provision for virus-related spending after the first two years past the pandemic support and so-called recovery phase, as you set out, Richard. How realistic is that, given the effects of the pandemic on education and the amount of schooling lost, the desire for catch-up, long Covid, large waiting lists in the health service, and the mental health crisis that may come from some of the issues in and around lockdown? How realistic is it to spend less and plan for less public expenditure post-pandemic than was planned pre-pandemic?

Richard Hughes: There are some significant risks to the Government's spending plans beyond 2021. As you say, they assume that the rescue phase of this pandemic is over and that the Government can put all of the Covid genie back in the bottle by March 2022. They have made no explicit additional provision for pressures that they have already recognised in their roadmap, for example the need for an annual revaccination programme, the need for ongoing test and trace capacity to spot new variants and chase them down, the backlog of procedures in the health service that will need to be addressed once the health service is back up to full capacity and not treating Covid patients, or indeed the surplus capacity that the health service might need in order, for example, to segregate Covid patients from non-Covid patients on an ongoing basis.

You also have up to six months of schooling being missed out on by pupils. For the moment, the Government have set aside £1.7 billion for that but it is just for this year, assuming it does not carry forward into future financial years. There are big questions about transport, where the Government have effectively taken the railways back into Government ownership. They have provided very substantial subsidies to Transport for London and the rail network to fill a hole in their fare boxes, which they are assuming will be gone in 2021-22 if they are providing no additional resources for the transport sector thereafter.

We see a pretty long list of legacy costs coming out of this pandemic and very little evidence of explicit provision to meet those costs. Because the Government have effectively gone back to annual spending rounds, we do not have medium-term spending plans for Government Departments outside health, education and defence. We do not know what the consequences of this might be for other Departments if the Government's answer is, "We are going to reprioritise from other things to make sure those pressures are covered". From what we can see, the Government only have a plan that gets them to the end of 2021-22.

Q97 **Dame Angela Eagle:** Then, suddenly, like magic, it all goes back to the way it was before, but with £30 billion of spending consolidation and cuts on the other side of the pandemic. How realistic do you think that is? It is very convenient for the Government's sums to put in these planning assumptions, but is it not also the job of the OBR to think about how realistic something like that is? Just from the Government's own announcement, you have not mentioned social care, for example. There is meant to be a plan for social care and yet no financial provision of any kind. Do you think that there might be a risk that the Government are presenting you with spending plans that are unrealistic in order to flatter their arithmetic?

Richard Hughes: The reason we wrote box 3.3 is that we think there are substantial risks here. As I said, the Government do not set out detailed spending plans beyond 2021-22. They are going to have another spending review in the autumn. We will see whether it is a multiyear spending review that actually sets out a plan for dealing with the pressures over the medium term, or whether they just do another one-year spending round and kick the can down the road for another year. That is a big question for the Government.

It certainly makes our job more difficult in assessing the credibility of the Government's fiscal plans when, essentially, there is only fog beyond March 2022 and going out over the medium term. We have to take the Government's spending plans on faith when we put them into our forecast. Alongside them, we highlight all the risks that I have set out, which we have set out in more detail in box 3.3, where we think those risks are material.

Q98 **Dame Angela Eagle:** Do you think it is part of your remit to draw even more attention to them by commenting on how unrealistic they might be, for example? I know it would not exactly endear you to the Chancellor, but the idea of the OBR is that it should point this stuff out and perhaps have something to say about it rather than put it in a box.

Richard Hughes: It is a pretty long box. It goes into quite a lot of detail. It is something that I really emphasised in my presentation on EFO day. The IFS also picked up on it and drew attention to it. As part of our remit in highlighting risks to the outlook, we are taking it very seriously and trying to draw public attention to it, including in our testimony before you.

Q99 **Dame Angela Eagle:** That is possibly why I am asking you about it. How realistic are the expenditure out-turns for those Departments that do not have three-year spending plans and have already been hit really badly? For example, justice and the courts effectively have a 1% cut at the back end of this Parliament. How realistic are they? Local authorities, which have been hit particularly badly, are also likely to have funding directed to them cut.

Richard Hughes: When you take the Government's overall expenditure envelope, having taken out the £15 billion that they took out over the November spending review and then this Budget, and you plug in what the Government have already committed to on health, education, defence and overseas aid, it implies real-term cuts for the rest of Whitehall going into the next spending round, unless the Government either revisit those commitments or put more money in the envelope.

Whether the Government can deliver on further rounds of real-term cuts to Departments that have already faced significant real-term cuts in their budgets through successive spending rounds comes back to what the Government's priorities are and how they are going to fund them. Once again, because we do not have a multiyear spending plan, we do not know the answers to those questions, as it just gives us the answer one year at a time.

Q100 **Dame Angela Eagle:** Because there are no fiscal rules, or they expire and they were not that forthcoming on them, and certainly there was nothing like the fiscal rules structures that held sway when the OBR was created, do you feel that you are all at sea without an anchor? You do not have things to measure the Government against in the way that your predecessors had, when fiscal rules were so obviously there and part of the architecture.

Richard Hughes: In a formal sense, that is certainly true. It is obviously easier for Governments to move goalposts when those goalposts are not set out in legislation.

Dame Angela Eagle: They are almost floating above the pitch.

Richard Hughes: Indeed, although, in fairness to the Chancellor, the world around him has changed a lot since he was first thinking about fiscal rules. It is understandable that the middle of a crisis is not the time to set firm targets with firm dates. Parliament has, through the legislation it has passed, demanded that the Government set out their fiscal objectives in a piece of legislation and, at the moment, those objectives expire in 20-odd days and they do not have anything on the statute books.

I take the Treasury on faith that it is going to put something on the statute books in the coming months for us to assess more formally. In the meantime, we read what the Chancellor says are his fiscal objectives in other fora and assess those, but they do not have the power of legislation and they do not give us the formal mandate that we would look for to do our jobs properly.

Q101 **Dame Angela Eagle:** If there is no formal mandate that comes out of this process, is there anything you as an institution can do to get back to some kind of rigor?

Richard Hughes: We would continue to assess what the Government say are their fiscal objectives because that is part of our job of assessing whether those objectives are being met. For the moment, it is for the Government to decide when they set those rules and what they choose to do with them.

Q102 **Harriett Baldwin:** I want to go back to a very startling figure that you used in your opening remarks to the Chair. The questions are for you, Sir Charles. You mentioned that the households have built up £180 billion of savings in aggregate, although very differentially distributed in terms of the types of households. I believe you said that you are assuming that, at the end of lockdown, households will spend about 5% of that accumulated saving over the year. Can you talk me through the assumptions and data that you used to make that assumption please?

Professor Sir Charlie Bean: It is 5% a year for each of the five years. It is a little more than 5% in the coming year and a little less later on, essentially because we think there will be some concentration on durable spending, so durable purchases that were postponed during the period of restrictions in the pandemic. Now they can be made up. The basis for this is the empirical literature on how consumers spend to an increase in their wealth or a transitory increase in income. There is a lot of empirical work out there for lots of countries that points to a marginal propensity to consume out of this sort of increment to household resources of about 5% a year.

It is more for poorer households. Not surprisingly, households that are credit constrained and really struggling to make ends meet are more likely to spend a higher proportion. Were it the case that this £180 billion had all ended up with lower-income households, we might well have assumed that more would be spent. As I say, all the evidence we have, both from survey information that the Bank reported in its Monetary Policy Report in February and from what we know about the furlough scheme, which has mainly supported lower-income workers, suggests that it is the richer and middle-income households and retirees that have mainly been accumulating these extra savings.

Q103 **Harriett Baldwin:** You think it is behaviourally believable that, having accumulated these savings, the pandemic comes to an end and people will go out and spend in the first year, a bit over 5% of them.

Professor Sir Charlie Bean: Yes, roughly speaking you spend it over 20 years. All the evidence of consumer behaviour is that people like to smooth their spending in the face of fluctuations in income. That is well established. You would not expect households to go out and blow it all in the next quarter or two. That said, we note that there may be a sort of euphoric post-pandemic effect where people are just so pleased to get out on the other side that they treat themselves, whether it is to a special holiday, going out for more expensive meals, some fancy car or whatever it is. There may be a bit of that, but it is reasonable to assume that the bulk of it will be saved.

The Bank's survey information from a regular survey it carries out again reported in its Monetary Policy Report—we also cited it in our flow of funds box—suggests that a relatively small fraction will be leaking into consumer spending. Most of it will be saved, either in bank accounts, where it has predominantly been accumulating, or possibly moved into other financial markets or into the housing market. It is worth saying that one of the reasons that the housing market has surprised us a bit on the upside is perhaps that some of those savings may have been used to put towards a deposit or whatever.

Q104 **Harriett Baldwin:** As you look forward, would you say that the risks around that central projection are fairly even?

Professor Sir Charlie Bean: I would regard the risks around the projection as pretty evenly balanced. As we stress in the report, it is very difficult to put probabilities on different trajectories at the current juncture. We think our central forecast is pretty much in the middle. In terms of the sources of the risks, I would put the source of upside risks as being more to do with economic behaviour, and the source of downside risks as being more associated with unpleasant surprises on the virus, in particular mutations that are vaccine-resistant and prove difficult to deal with, whether it leads to reintroducing restrictions or whatever. I would put more weight on that for the downside risks.

Q105 **Harriett Baldwin:** When you talk about the upside risk because of economic behaviour, can you elaborate a bit more on that?

Professor Sir Charlie Bean: As I say, we have taken what is a reasonably mainstream view about how much of the extra unplanned savings, the £180 billion, will be spent by consumers. It is possible that there may be more, particularly if this post-pandemic euphoria turns out to be more of an issue.

We may also find that the kick from the Chancellor's investment measure, the super-deduction, may be bigger than we expect. As Richard said, we put in an assumption that it adds about 10% to business investment. The empirical evidence we used in making that judgment is mainly drawn from the US, where they have experimented with these sorts of temporary incentives to investment. In particular, we drew on an IMF survey, which draws together results from a number of studies. That actually suggests a slightly bigger elasticity than we put in. There could be an upside risk from that source over the next couple of years as well. Simply because investment is much smaller than consumption, it is the consumption question that I would regard as the primary source of upside risk.

Q106 **Harriett Baldwin:** You say that it is very difficult to make up social consumption. There are only so many meals out that you can eat. Are you sure you are not underestimating the British public and their ability not only to eat out, but to change the money they saved on social consumption and consume it on something else?

Professor Sir Charlie Bean: I am certainly not sure. One thing you learn when you have been in this game as long as I have is never to be sure about anything. In particular, because this pandemic is such an unusual sort of economic shock, it is unlike anything I have ever had to deal with in my working career as an economist, forecaster and so forth, so it is very difficult to know how people will behave. You can go back and look at what happened, say, after the Spanish flu and earlier pandemics. It is dangerous extrapolating from episodes a long time ago where you did not have the same sorts of policy support and things like that.

Q107 **Harriett Baldwin:** That is fair enough. Richard, you have made assumptions about social distancing continuing. What have you been told to guide you on that by public health, in terms of social distancing next winter and next year?

Richard Hughes: We have followed the Government's roadmap in terms of the main restrictions on economic activity, but we have assumed that some residual level of public health restrictions remain from the ending of the roadmap all the way to March 2022. We are not specific about them, but they are of the sort of restrictions on large events. It is uncertain at the moment what international travel is going to be like, even beyond the end of the roadmap. To some extent, restrictions impinge upon economic activity, which is one of the reasons why it takes until the middle of next summer for the economy to return to its pre-pandemic levels of activity.

Either because official restrictions need to remain in place, and possibly need to be tightened if there is some sort of surge in infections over the winter, or because socially there is more voluntary social distancing, so people are just more risk averse about going out and interacting, even after they have been vaccinated, infection levels have come down and headline rates of hospitalisations and deaths have come down to nominal levels—there may be some residual reluctance to go out, to eat out and to go to large events as much as we used to—we assume that that has an effect on economic activity for some period beyond.

Q108 **Harriett Baldwin:** Can you quantify the size of that effect if, for example, people completely went back to normal in terms of social distancing, compared to what you forecast? Can you quantify that difference?

Richard Hughes: It is a single-digit percentage of GDP. We are back within striking distance of pre-pandemic levels of activity by the turn of the year and then we close the remainder of that gap by the summer. It is a matter of 1% or 2%. I think I am right in saying that.

Professor Sir Charlie Bean: That is correct.

Q109 **Siobhain McDonagh:** I would like to ask some questions about the issues of housing, and explore the implication of the OBR's forecast for the property market and the impact of the measures announced in the Budget to support the residential property market. The OBR forecast in November, made just three months ago, predicted that there would be a significant fall in house prices in 2021 and 2022. You are now in predicting that house prices will not fall below their pre-pandemic levels. To what extent is that being driven by the Chancellor's interventions in the Budget on stamp duty and the new mortgage guarantee scheme?

Professor Sir Charlie Bean: The main driver behind that is the extension of the CJRS, which now is co-terminous, roughly speaking, with the public health restrictions, whereas previously it was scheduled to run off earlier, which meant higher unemployment. That would potentially put downward pressure on house prices. We now have a lower rise in unemployment. It peaks at 6.5%. As a result, that puts less downward pressure on prices than we had before. The outturns that have come in, the strength in the recent year, suggest that there is a bit more underlying strength. Here, as I said a moment ago, we think some of that may be this accumulated unplanned savings being used by some households.

On top of that, you have the stamp duty concession, which is primarily a policy that brings forward spending, or a lot of it brings forward spending. That helps to add to strength in the near term, but then falls off after the concession ends. We do not have an explicit component in there for the mortgage guarantee scheme. The big picture now is that prices are pretty stable through 2022-23. That partly reflects the fact that the relatively strong growth in house prices recently has raised house prices relative to household incomes, so that it is starting to stretch affordability. You need a period of relatively low house-price growth, given our household income profile, to bring those two back into some sort of medium-term balance.

Q110 **Siobhain McDonagh:** What impact do you consider the Treasury's mortgage guarantee scheme will have on the residential housing market, even though you have not had a chance to include it in your assessments? My scepticism about it is that, prior to the stamp duty holiday, 95% mortgages were available from lenders without Government intervention. Why is it needed now? Are the Government simply letting the banks off the hook in their obligation to first-time buyers?

Professor Sir Charlie Bean: To the extent that banks are cautious about offering relatively high mortgages, you can say that the underwriting of the risk by the state will increase the supply. You are quite correct that the market has started to loosen up somewhat there. We would not expect this to have a large effect on the market. Our judgment of previous interventions like this is that their effects are generally quite modest.

Andy King: The thing that I have been struck by is that the availability of mortgages at different loan to value ratios is pretty closely correlated with what people think is going to happen to house prices. With the Chancellor's other interventions supporting household income and therefore reducing some of the downside risks around price, you would expect the availability of high-LTV mortgages to come back. The mortgage guarantee scheme will clearly bring them back more forcefully and perhaps more quickly.

When the scheme was around in the mid-2010s, it is difficult to unpick what it did to the broader housing market, because it was launched at the same time as the much larger equity loan component of help to buy, but it had a clear impact on the volume of high-LTV mortgages that were available. You would expect, at a minimum, for it to help first-time buyers relative to other home purchases.

Q111 **Siobhain McDonagh:** The stamp duty concessions and holidays do not do that. Your forecast predicts a modest fall in house prices during 2022-23. Why then, and what analysis have you undertaken of the geographical areas that will be impacted, or property types at risk of significant house-price falls?

Professor Sir Charlie Bean: As I said earlier, you should really think of this as house prices being broadly stable. They trough in the fourth quarter of 2022, but the picture is pretty much stable prices over 2022-23. On the question of the regional dimension, we do not do regional forecasts unless we think it is helpful in understanding what might happen at the aggregate level. If there were circumstances where we thought it was particularly important to separate out what was happening in London and take a separate view there, we would. At this juncture, we did not see a particular value in pursuing the regional dimension. It is only in the macroeconomic forecast. I do not know whether there is anything on the specifics of the stamp duty forecast that Andy may want to mention.

Andy King: There is not much, no. There are different tax systems in Wales and Scotland, so we have to think about those separately, but, at the moment, house prices are moving in very similar ways. They all use Charlie's forecast, rather than adjusting them.

In terms of stamp duty receipts, it is clear that activity is more concentrated in more expensive properties at the moment, which we have assumed is a temporary pandemic effect, rather than something that will persist in the future. This is not really to talk about risks of prices at different levels, but the tax forecast assumes that the composition of activity in the housing market will return to more normal pre-pandemic status.

Siobhain McDonagh: I do not know if it is useful, but, anecdotally, I can tell you from a lovely bit of south London that the feeling is that families are taking the opportunity to move out. We are seeing very significant turnover in demand for school places and a big churn in school numbers, which are a portent of some problems for London over the next years.

Q112 **Rushanara Ali:** Good afternoon. My questions are about unemployment and furloughing. As you have mentioned already, your forecast on unemployment has been revised down to 6.5% and yet we are already seeing some big differentials. Youth unemployment is at 14%, compared to 5% across other age ranges. Ethnic minorities and particularly disadvantaged groups are being hit harder. Despite that, do we stand a good chance of avoiding a return to mass unemployment? What are the risks that remain, alongside the risks to those groups?

Professor Sir Charlie Bean: Clearly, there is uncertainty about what is going to happen to unemployment when the CJRS comes to an end. We think it is inevitable that there will be some rise in unemployment because some of the jobs that are presently furloughed are probably non-viable in the longer term. Businesses can keep people on furlough so long as the state is paying the wages, but, when they start having to pick up some of the tab, or all of the tab, they may decide not to re-employ those people.

We do not really know how big that is going to be. We think it is plausible that the rise in unemployment will be less now than we anticipated when we did our November forecast, essentially because of this extension of the CJRS to align with when the restrictions will have been removed. Even for businesses that have not seen demand completely bounce back, they should be able to see the light at the end of the tunnel. They are more likely to hang on to workers temporarily for that last bit, even after the CJRS has ended. That explains why we have lowered our peak unemployment forecast. As I say, we still have it going up to 6.5%. That may turn out to be too pessimistic; it may turn out to be too optimistic.

It is reasonable to expect that unemployment to be concentrated in younger, less skilled workers, many of those who are currently protected by furlough. Then the question will be how quickly they can be re-employed into other sectors of the economy or to other employers. We think that that will happen, but it will take time. That structural shift in the economy necessarily will require a period of elevated unemployment. In addition, we may have some restructuring that is associated with Brexit starting to work through. You will get some employers cutting back and other employers expanding.

Q113 **Rushanara Ali:** I am going to come on to that in a bit. In terms of the forecast, there are still likely to be 300,000 people who will face unemployment. Does that 300,000 represent the number of jobs that are unviable, or is the unviable category of jobs smaller than the 300,000?

Professor Sir Charlie Bean: Potentially, it is rather more than that. We have unemployment going to 6.5%. It is currently a little above 5%. The implication is that that 1.5 percentage points or so unemployment is the unavoidable, necessary structural unemployment.

Q114 **Rushanara Ali:** How much of that could be prevented if there is further targeted furloughing beyond the September period? Is there a case for doing something beyond that period for furloughing?

Professor Sir Charlie Bean: The key thing here is that these are jobs that ultimately are not viable in the long term. Because of changes in the structure of the economy, there is less need for sandwich shop outlets in central London, because people are going to be working remotely on a more permanent basis, and those sorts of things. There will be shifts in the retail sector. The key is not protecting the jobs that are not viable but finding new jobs for those people to go to. If you are talking about a policy intervention, you want something that assists people to find the new jobs, not protecting them in the old jobs that are not viable.

Q115 **Rushanara Ali:** That is really interesting. Richard Hughes, there are policy interventions that address that. We have policies, for instance, on youth unemployment that are not moving quickly enough to get the hundreds of thousands of young people who are unemployed. What other interventions are there? I appreciate you cannot get into specifics. What other actions are needed to try to address the structural changes and viability of jobs?

Richard Hughes: It is one of those moments where we have to say that it is not for us to give the Government policy advice.

Q116 **Rushanara Ali:** I was trying to frame my question in a way that you could, to the structural point.

Richard Hughes: There is a challenge on the structural issue, which we cover off quite a bit in our EFO. One thing that has surprised us on the upside has been how adaptable consumers have proven to be in the way they spend their money. They have managed to spend more than we thought by spending more online and less in person. The share of retail that is now online is about 30%. It was around 20% before the pandemic. We do not know to what extent that is an acceleration of a trend that is now irreversible. Are people going to spend more online and less in shops and the high street?

That is good in the near term, because it supports consumption, but potentially bad for employment over the medium term because retail is traditionally a large employer, in particular of low-skilled people and people just entering the labour market, either out of school or after a period of worklessness. If things like retail are not there, finding ways of connecting people with new sources of employment, and potentially new and different skills of the sort that you do not need to do retail but you may need to work in a more IT-enabled environment, is something that, it stands to reason, could help reduce the long-run structural hit. You have different entry-level jobs for people who are trying to enter the labour market than you used to have. The traditional jobs, pulling pints in a pub or working in a retail shop on the high street, are not there in the volumes they used to be.

Q117 **Rushanara Ali:** My final question is about the implications of the trade agreement on employment and unemployment. The OBR's March economic and fiscal outlook confirms that the UK Government's trade deal with the EU, as a result of the barriers, would lead to a reduction of 4% in economic output and productivity over the next 15 years. Can you talk us through how you arrived at that figure and the implications of it on unemployment in that period?

Richard Hughes: In terms of how we arrived at that figure, it was derived from looking at the average of a range of free trade agreements that countries have managed to conclude with the European Union and between other advanced economies, and looking at the impact that has on the volume of trade. We have had to run that in reverse, because we are going from a situation where we were an EU member state with a very close economic relationship to a more distant economic relationship based on a free trade agreement.

From my perspective, the thing that was the most exceptional about the trade agreement we arrived at, the TCA, was how unexceptional it was. After 40 years of being an EU member state, we basically got a very similar trade deal that countries that have not been EU member states have managed to negotiate with the EU. It is largely focused on goods. It says relatively little about services. In some areas it is a bit better; in some areas it is about the same.

On the whole, it did not lead us to revisit our assumption that, in the long run, it is going to reduce the level of output by about 4%. That is a long-run hit and it assumes labour markets will have adjusted over that 15-yar period, so there is not a long-run hit to the level of unemployment, because you assume that both capital and labour are reallocated to the sectors that remain competitive under the new trading relationship.

Q118 **Rushanara Ali:** There will be no hit in terms of unemployment over that period.

Professor Sir Charlie Bean: There is a transitory effect. We assume that the structural level of unemployment, the natural rate of unemployment in the jargon, rises by a modest amount over the forecast period. We put this in in a previous round. My recollection is that it is something like 0.2 percentage points. The idea is that it takes quite a long time for this restructuring fully to work through. You do not see a large increase in unemployment in the short run. It is more that, over time, some businesses decide, "There is no point in me continuing to operate. It is too expensive to export to the eurozone". By the same token, others decide, "There are now opportunities open to me that were not there before", so they open up new jobs.

Q119 **Rushanara Ali:** Do you see those two things cancelling each other out?

Professor Sir Charlie Bean: In the long run, yes. The period of getting people out of some firms and sectors across into others is typically associated with a period of elevated unemployment. The job destruction usually comes before the job creation.

Q120 **Rushanara Ali:** There will be some discomfort and some problems in the short term, but not in the long term. Would that be a fair way to describe it?

Professor Sir Charlie Bean: As far as the labour market is concerned, yes.

Q121 **Rushanara Ali:** I meant focusing on the labour market, because my colleague, Mike, will have questions later on other elements of this.

Andy King: In my mind, the pain of the labour market effect is felt in wages, rather than jobs. If you have productivity 4% lower, all else equal, you have wages 4% lower. That is where that labour market pain will be felt.

Rushanara Ali: That is sobering, considering we have had a hit on wages in some sectors for a long time.

Q122 **Mr Baker:** I refer to my registered interest in Glint Pay. Before coming on to investment in a bit more detail, I would like to turn back to some of the things you have already covered. You talked about the tax burden and it being a historic high. It put me in mind of your Fiscal Sustainability Report. I think you are not due to give us another Fiscal Sustainability Report until next year. Can you tell me if you have given any thought to what this enormous fiscal event means for the Fiscal Sustainability Report please? Do you have any interim thoughts?

Richard Hughes: This biggest question about the long-run effect of this pandemic will come back to this question of scarring, in terms of how much output we have lost in the long run as a result of the pandemic. For the moment, the verdict is out. In our central forecast, we have assumed a 3% loss of output, and that was back in November. We have been looking at the evidence coming in since then, where it is fair to say there have been some positive surprises on the business investment side, both in the data and reinforced by the measures the Chancellor has taken to kickstart business investment.

We have had negative news on the labour force side. You probably recall from our past Fiscal Sustainability Reports that one of the biggest questions is what the working population is going forward. That is partly a question about how many people stay in work longer and about extending retirement ages. It is also a question about migration. In the recent past, we have relied on inward migration to support our labour force overall. Because the ONS is not currently collecting data on immigration and emigration at the border, due to the pandemic, we do not know for certain, but there are some indications that there may have been an outflow of migrants during the pandemic back to their home countries, in particular in the EU. If they or their compatriots do not return to replace the lost workforce, that could have a longer-term impact on the workforce that will be working in future, be able to be taxed and be able to support the population that is out of work.

Q123 **Mr Baker:** That was fantastic detail, but what I had in mind was the overall character of the position we find ourselves in. People watching this who may not know perhaps will not realise that the Fiscal Sustainability Report shows debt gently ballooning away. For the record, you are nodding, and I am grateful. It seems to me that this event has catapulted us forward a decade or more along that trajectory. Again, you are nodding, and I am grateful. I wonder if you might confirm or put some words around those nods. It seems to me that the situation this Government and any successive Governments will face is that they have to make some of the hard choices that perhaps we did not face for 10 years. Is that broadly right?

Richard Hughes: It has ratcheted up the starting level of debt, which is then the jumping-off point for all our fiscal sustainability analysis. We have seen the debt-to-GDP ratio go up, from being in the 70s into the high 90s, as a result of this crisis. Once you then apply the future dynamics around falling workforce and rising number of older people, and you leave the tax to GDP ratio where it is, those debt dynamics have the same trajectory but from a higher starting point. You would then expect for them to have a commensurately higher endpoint and you pay more debt interest along the way, which adds to the cost of that.

Q124 **Mr Baker:** I will just move forwards. You guys talked a bit about the mechanism of bringing forward new investment spending. Could you elaborate in a bit more detail on why you see this as investment spending brought forward and not the beginning of more sustained investment spending? Why do you not think it would be sustained investment spending as investments become productive and profitable?

Professor Sir Charlie Bean: The concession makes it more profitable to invest temporarily, while the super-deduction is there. There will be some projects undertaken that would not be previously undertaken without the super-deduction. In that sense, there is a lasting effect on the capital stock, but as the capital stock depreciates it will go back to where you would have been without the super-deduction. Layered on top of that, you have a very powerful incentive for firms to bring forward investment spending that they expected to undertake in the latter part of 2023, 2024 or 2025 into the period when the super-deduction applies. This is the bringing forward that Richard mentioned.

You have these two effects there. There is a small effect, or a modest effect, of getting businesses to undertake some investments that would not have otherwise occurred. On top of that, there is this intertemporal switching effect. We think that second effect is quantitatively much bigger than the first, but there will be some of the first.

Q125 **Mr Baker:** What sort of much bigger? All that is a very sensible argument of course. I have a couple of questions on it. When you say "quantitatively much bigger", is it an order of magnitude, two orders of magnitude or twice?

Professor Sir Charlie Bean: We think that the sorts of effects that you might expect on investment purely from doing some projects that you would not otherwise do are of the order of £4 billion a year or something like that.

Q126 **Mr Baker:** Let us pause. You set out two effects there and then you said the second one was quantitatively much greater than the first. The second one is £4 billion. What do you expect the first one to be?

Professor Sir Charlie Bean: No, the second one is getting on for £20 billion. The first one is about £4 billion. The intertemporal bit is about four or five times bigger than the doing more projects bit. The second one gets unwound after the super-deduction comes to an end, not all of it within the forecast period. Some of it takes quite a long time. If you think about just the five years of our forecast, there is a cumulative increase in investment as a result.

Q127 **Mr Baker:** I have a confession. I am not a huge investor because I spend my time doing this mad job instead of investing money. If I was an investor, I was running my own firm and I brought forward a investment project, I would be hoping it would be a profitable investment. Then I would be expecting to reinvest some of the money I had made. That is the key point I am trying to make or inquire into. You do not seem to be planning on people having profitable projects and reinvesting those profits.

Professor Sir Charlie Bean: No, these projects are all profitable. We do not assume people do unprofitable projects. People would have been expecting to undertake a sequence of projects, each of which would be profitable. It now makes sense to do those sooner rather than later, to take advantage of the super-deduction. The super-deduction also means that some projects that were at the margin before, unprofitable, will now become profitable. There will be some increase.

Q128 **Mr Baker:** You are not predicting that this seeding of investment will result in a self-sustaining private sector boom.

Professor Sir Charlie Bean: No.

Q129 **Mr Baker:** I am not absolutely convinced that I have got to the heart of why you think that that cannot happen. You have explained very clearly why you think investments will be brought forward. Richard, would you like to explain in other words why you think it is not the beginning of a private sector investment boom? Why do the effects just bring forward the investment?

Richard Hughes: Private investment was already recovering before the measure happened. It is also the case that, because you are bringing forward marginally productive investments, with the benefit of a tax incentive, once that tax incentive goes away that marginal incentive also disappears. To the extent that businesses had investments they wanted to do to build the capacity they wanted to, this helps make them happen. Because the incentive also disappears towards the back end of our forecast, they lose that marginal incentive to bring forward the marginal projects on their list. We are not trying to then invent a set of projects that businesses might want to do that were not in their plans.

Q130 **Mr Baker:** I have many other questions that I was looking forward to asking you, but I am going to boil it down to just one and then hand over. On box 2.6 on page 57, you have put in "Coronavirus and the flow of funds", in which the second bullet point says, "A roughly equivalent quantity of gilts"—to the new bond issuance—"has been purchased on the secondary market by the Bank of England's asset purchase facility (APF) as part of its quantitative easing (QE) programme". It is fair to say that you put it there as a very bald statement of fact. Is there any elaboration that you might want to add to what it means for the public finances to have that situation where the amount of QE, as you put it, is roughly equivalent to the quantity of gilts issued?

Richard Hughes: It has three effects. First, it keeps the gilt market liquid, which is a good thing from the point of view of Governments that want to keep the gilt market around for a long time. Secondly, it reduces the Government's borrowing costs because they are buying up long-term gilts, with a higher interest rate on average of around 2%. They are funding those by the Bank issuing its own debt in the form of central bank reserves, which currently have an interest rate of 0.1%. That saves the Government about £18 billion a year all in, taking into account all the QE done to date, in terms of net interest savings. That is a fiscal benefit to the Government.

It also creates a source of risk for the Government, which is that it reduces the effective maturity of Government debt. Long-dated Government gilts that are being replaced by central bank reserves are an overnight liability of the Bank of England to the commercial banking system. The effect it has on the median maturity of the Government's debt is to reduce it from seven years, if you just look at total outstanding gilts, to about four years once you net off the impact of the fact that the Bank of England owns going on a quarter to a third of that total debt stock and has replaced those long-term gilts with central bank reserves, which have an overnight rate of interest.

Q131 **Alison Thewliss:** I have some questions on the assumptions around scarring. I wonder if I could ask Sir Charlie first about the extent to which you think the Government could have changed your assumptions around 3% scarring through their measures at the Budget.

Professor Sir Charlie Bean: The particular policy that would have an effect would be the super-deduction that we have been talking about, because the path of the capital stock will be higher than it would otherwise have been. It should also be said that revisions to the past data for investment make the hole look a little less deep than we thought. When you crank that through our ready reckoners for the effect on potential output, it would be to reduce the contribution of capital from 0.8% to 0.7% of that scarring assumption.

Basically, of the 3%, we have 2% that is down to productivity and 1% down to the size of the effective labour force. Within that 2% of productivity, about a third of it is because of lower investment. The other two-thirds is what economists refer to as total factor productivity. It is basically all the other stuff: knowledge, efficiency of management, efficiency of the way business is allocated across the economy, all those sorts of things. That is something that economists do not understand well, although there is some survey evidence that the Bank of England has produced and analysed, which suggests that an effect of the order of one percentage point for this total factor productivity component is the right sort of thing. The one percentage point for the labour force is composed of a bit of slightly higher structural unemployment, a bit from outward migration and half a percentage point from, essentially, earlier retirement by some workers, prompted by the pandemic.

The work by O'Connor and Portes, which Richard talked a bit about earlier, has raised at least significant questions about the size of the population and migratory flows. We do not feel we have enough firm knowledge to want to take the O'Connor and Portes numbers into our forecast, but they raise a question at least about how big the labour force will be further down the road. We took the view that it was sensible to stick with our 3% from last time, recognising that there has been some upside news on the investment side, but we have some downside news, potentially, on the labour force side.

Q132 **Alison Thewliss:** I would like to ask you a wee bit more about the impact on migration. First, I wanted to ask why you felt it was that the Bank of England has a more optimistic scarring assumption than you. Why is yours more pessimistic than the Bank's? Is it counting something differently to you? Is that in the figures you talked about?

Professor Sir Charlie Bean: No, the biggest single thing is the labour force part of it, where the only bit they have is a slightly higher increase in equilibrium unemployment for a while after the pandemic. The capital scarring element is going to be pretty similar. It looks like they have a slightly smaller total factor productivity effect than we do. One has to be honest: this is territory where there is a lot of uncertainty. The major difference is that they do not seem to have the labour force effects we do. In our case, it is a third of that 3% scarring. They just have a very small component from higher equilibrium unemployment.

Q133 **Alison Thewliss:** That is interesting to hear what you count and what they do not quite count as part of their calculations. To move on to the issues you mentioned around population, looking at your documents in the blue book, you said that the population could be as much as 2% smaller. What kind of impact do you feel that that will have? Why is that not something that people are talking about a bit more?

Professor Sir Charlie Bean: If that was where it ended up, that would be a significantly smaller potential output, two percentage points. There are two qualifications to make, though. First, that is based on the O'Connor-Portes calculations, which quite purposefully take a reasonable worst-case scenario and come out with a figure that the population might be about 1.3 million smaller, essentially because there has been more outward migration than recognised in the official statistics and less inward migration as well during the pandemic. Other people have also started looking at this. There is a paper by Madeleine Sumption at the Migration Observatory that we reference in the report, for instance, which also tries to dig into changing responses to surveys and stuff like that. She comes up with some smaller numbers, but they are still chunky. We think it still leaves a material downside risk to the labour force.

The real question is not so much what is happening now but also what happens in the future as we come out of the pandemic. If it is indeed the case, as Portes and O'Connor suggest, that there has actually been a lot of net outward migration, workers going home during the pandemic or whatever, will they come back? Some of those workers are going to have settled employment status and may want to come back. Some may not. This is one of the question marks going forward about how big the labour force will turn out to be in five years' time when we are making our scarring assumption.

Q134 **Alison Thewliss:** That is interesting. There was a suggestion, I think in the *FT*, of a graph where there seemed to be a disproportionate impact on London. Are you looking at those kinds of impacts that it might have?

Professor Sir Charlie Bean: Certainly, the Portes-O'Connor work looks at the regional breakdown. They draw attention to the fact that it is likely to be heavily concentrated in London. It seems entirely plausible, given the number of migrant workers working in the hospitality sector in London, the fabled baristas and all that. It is an entirely plausible story that they paint, but there are obviously questions about whether the numerical magnitudes are right.

Q135 **Alison Thewliss:** I do not know if either of your colleagues wants to come in on the issue of scarring or the population aspects.

Richard Hughes: One of the challenges of people coming back is the fact that the immigration regime has changed compared to when they first arrived. All things being equal, for those migrants who do not have settled status, it will be more difficult for them to come back. We tend to have an assumption that the same people coming back to the country are those who are going to be leaving the country. That is not really how migration works. You have inflows and outflows from different countries all the time. One big question is whether the additional barriers to EU migrants coming back, who accounted for a significant share of the increase in the workforce we have seen over recent decades, will pose a challenge for whether you can actually replace these workers if they have indeed left the work.

Q136 **Alison Thewliss:** I think the only mention that was made in the Budget speech about migration was about attracting IT professionals. Is there any way that those will replace those who have left in other sectors?

Richard Hughes: We will have to see. We will take a view on this in the autumn. The ONS has said it is going to produce some updated population figures. One of the things that of course we have to take into account is that the Government are now introducing concessions and exceptions into their new migration regime. To some extent, those might mitigate the impact that it has on reverse flows of migration. We will have to see, by the time we get there, how many of those concessions have been put in place. So far, the ones we have seen have been pretty small and not really enough to move our forecast.

Q137 **Alison Thewliss:** Compared to other crises we have seen in the past, how do you think this is likely to compare?

Richard Hughes: In the near term, this is the largest hit to GDP we have seen in three centuries, since the great frost of 1709. Over the medium term, the amount of scarring we are assuming from this one is considerably less than we saw even compared to the most recent crisis we had in the financial crisis. That is because, perhaps more than in previous crises, we think that, especially if we have effective vaccines, economic life can go back to something quite close to what we had before the crisis hit. Because the crisis originated from outside the economy, once the source of the crisis has been removed, the economy should be able to go back to the way it was.

We assume that some scarring takes place along the way, around 3%. The equivalent figure for the amount of scarring after the end of the financial crisis was much greater. That was partly because of the consequences of an overleveraged financial system for an economy and possibly because everyone was more optimistic about the future path of productivity going into the financial crisis than they should have been.

Q138 **Mike Hill:** Going back to Brexit, my colleague Rushanara touched on your estimated reduction of output by 4% under the EU trade agreement, in relation to unemployment. Looking at it from the perspective of economic outlook and prospects for businesses, there are worries, Sir Charles, given the EU represents 43% of UK trade, that a lot of the businesses currently struggling with red tape et cetera are suffering. That does not seem to be addressed. Listening to Richard before on the 4% estimate, it appears that the estimate you made still stands. Sir Charles, is that correct? What are the upside and downside risks to that estimate?

Professor Sir Charlie Bean: It is certainly true that we have stayed with our 4% assumption, which is what we had pencilled in, in previous EFOs, to reflect a typical free trade agreement. That number is based on studies that various other people have done, including the cross-Whitehall study, but also trade theorists and so forth, using a variety of analytical and empirical approaches. An average of those comes out at around about 4%. We have not done anything new ourselves in this space. We have simply piggybacked on what others have done.

We think that the TCA has pretty much the features that you would expect in a typical free trade agreement, which is why we thought it sensible to stick with the 4%. Of course, within that you have businesses in particular sectors that are very heavily impinged by the extra requirements if they want to export to the EU. It is not just tariffs, which are pretty minimal under the agreement, but rules of origin requirements, the need to certify products and things like that. There certainly are additional costs for businesses. We know that, for some businesses, it is proving particularly difficult, so the people exporting shellfish to the continent are finding problems getting it there quickly enough. I am sure there will be other examples that come up over time. They are the obvious ones that are costs.

Equally, there will be some European producers that no longer find it profitable to sell to us because of the extra trade barriers that are being introduced. That will create opportunities for some British businesses as well. That is where the opportunities on the other side might be. Net, we assume that the consequence is that the level of output the economy can sustain, given the size of the labour force, is 4% smaller.

Q139 **Mike Hill:** One of the downsides is unemployment, in that respect. There are some big ideas knocking about. One of them is in my neck of the woods, which is freeports, for example. These are long-term projects. Businesses are looking for short-term solutions. Surely, if anything, your estimate should be a warning for assistance to be provided much more quickly on that front. That again is a downside, but we could improve on that. In terms of the Economic and Fiscal Outlook, you note that you now expect the temporary near-term disruption to EU-UK trade to reduce GDP by 0.5% or thereabouts in the first quarter of the year. To what extent should we view this as a one-off adjustment to the new trading relationship or a permanent drag on growth?

Professor Sir Charlie Bean: There is risk that it may not turn out to be transitory. In our previous EFO, we had assumed that there would not be significant disruption and, basically, both sides would take a co-operative approach to minimising any temporary disruptions while people learn about the new trading regime and so forth. That has not proven to be correct. There clearly has been some disruption at the borders. Evidence on freight traffic suggests it is largely temporary, but we still have to introduce the various of our restrictions in the middle of the year. That may create some further disturbances. It is possible that the 0.5% hit to the first quarter that we put in may turn out to take a bit longer to work through. There is a downside risk from that, without any doubt.

Richard Hughes: There is another source of uncertainty around the implications of the TCA for the near to medium term. That is that the TCA is largely silent on services and, in particular on financial services, which accounts for a large share of our trade with the EU. There is a memorandum of understanding under negotiation on financial services, which we have not seen and will have to take a view on once we receive the result of it. Because we have a much closer relationship with the EU on services than other countries that have negotiated free trade agreements with the EU have done, it is an area where, necessarily, you have to look at it in bespoke terms. We will look at its implications for what we think about the future of services trade between the UK and the EU once we see what it has to say.

Q140 **Mike Hill:** Financial services leads me to a nice link to my final question for Andy King. In January, Amsterdam overtook London as Europe's largest share trading centre. In February, we heard from the Governor of the Bank of England that, if location policy seeks to drive business into the euro area, "There comes a point where the critical mass of activity and infrastructure that is the UK financial services sector erodes". What risk would an erosion of financial services pose to UK tax revenues?

Andy King: The financial services sector is quite a tax-rich sector, in terms of the tax paid on the salaries of those who work in the sector, the profits of the companies in the sector and a few other smaller tax heads, for example stamp duty on shares. Our forecast assumes that profit growth in the financial sector will be slower than profit growth in the economy as a whole, because of the effect of Brexit on the sector. As Richard has said, we do not have a detailed agreement to look at yet, so this is a holding assumption on the basis that there will be some impact on the sector.

In the example you mentioned, Amsterdam taking a larger share of share trading in shares that are listed in the EU will affect the profitability of the sector, but not the stamp duty on share trading, because that is only on UK shares. The way we have looked at this is to draw on what, in particular, the Bank of England has been able to say about these effects and then to make a top-down, broad-brush assumption for how this will weigh on profit and receipts growth from the sector.

Chair: That brings us to the end of this session. Could I thank all three of you very much indeed for having appeared before us today and answering our questions? Charlie, you rather characteristically and modestly at the beginning described yourself as a so-called economic expert". I am sure that was not a comment on your abilities but more on the inexactitudes of economics and the uncertainties we face at the moment. We certainly feel that you are very much experts as far as we are concerned. We are grateful for the answers you have given us today and, indeed, for all the work you do, which is very helpful, not just to the Treasury but to the economy more generally.

We have had an excellent session today, which lays the ground for the two further sessions we have, if you are listening to these proceedings this week. On Wednesday, we have a panel of economic experts appearing before us. On Thursday at 2 pm, we are very pleased that the Chancellor himself will be appearing before the Committee to answer our questions. That brings us to the end of this session.